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Financial Sector Constraints on Private Sector Development in Mozambique



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Preface

This study has been undertaken by Nathan Associates Inc. under the Trade and Investment Project (TIP) in Mozambique, under contract No. GS-1-F-0619N, Task Order 656-M-00-05-00037-00, with USAID/Maputo. The purpose of TIP is to provide support to the Ministry of Industry and Commerce and the Confederation of Mozambican Business Associations (CTA), among others, to increase international market access for Mozambican products and enhance Mozambique's competitiveness by reducing the cost of doing business. The project includes a variety of initiatives to create a more supportive enabling environment for local businesses.

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Executive Summary

This paper examines key financing constraints to development of the domestic private sector in Mozambique, focusing primarily on the high cost and low availability of credit. The paper also includes a detailed review of the legal and judicial foundations for financial sector development, and controversial banking regulations relating to foreign exchange lending and international payments. The analysis leads to more than 60 recommendations for overcoming financial constraints in order to improve the climate for investment, trade, job creation, and growth.

FINANCIAL SECTOR FUNDAMENTALS

The principal function of a financial system is to mobilize savings and allocate funds efficiently to businesses, households, and governments. The market for finance is unique in that the transactions involve an exchange between a payment today and a pledge to repay later. As a market in promises, the financial system relies heavily on information about the reliability and solvency of the party promising repayment. In addition, strong legal and judicial foundations are needed to ensure contract enforcement and property rights, and establish the rules and regulations governing financial institutions.

Commercial banks dominate the financial landscape in Mozambique. As intermediaries, banks have a fundamental obligation to protect the funds obtained from depositors. They must therefore manage risks carefully and avoid undue exposure to possible losses, while seeking an attractive return for shareholders. A sound banking system is vital to the economy as a whole, because economic agents across the board depend on banks to facilitate transactions, protect cash balances, and finance operations. In addition to prudent management and strong corporate governance, a sound banking system also needs effective supervision and judicious regulations as a second line of defense against instability.

Yet banks can be both *sound and innovative*. In particular, they can do a much better job of developing new financial services and serving nontraditional clients. To facilitate innovation, the government and the donor community can be instrumental as catalysts for change. The motivation for intervention stems from market imperfections that cause financial institutions to underinvest in innovations that can benefit economic development. The market imperfections involve information gaps on both sides of the market. Most banks lack information on appropriate techniques for serving new markets profitably, while small and medium-sized businesses often do not understand the requirements of the lender and lack the capacity to provide necessary accounting data and business plans. Carefully crafted interventions can help financial institutions test new markets and services and help local businesses become more “bankable” through better management and financial controls.

FINANCIAL SYSTEM TRENDS IN MOZAMBIQUE

The scope of financial intermediation in Mozambique compares well to low-income countries globally, but remains very weak in absolute terms. For example, both the ratio of broad money to GDP—a basic indicator of monetization—and credit to the economy as a percentage of GDP are above the median for low-income countries but very low in absolute terms. In 2005, three large banks accounted for 80 percent of total bank assets and 83 percent of total deposits. This degree of concentration helps to explain the high profit margins, the large spread between deposit and lending rates, and the high banking fees in the system. Nonetheless, new banks are entering the market. By early 2007, 13 banks were in operation, with one awaiting a license. Some of them are also offering innovative services to new groups of clients, including micro, small, and medium-sized businesses. The rest of the financial sector, however, is not very dynamic. This includes the insurance sector, leasing companies, the stock and bond exchange, and private pension funds.

Macroeconomic stability is a cornerstone for financial development. From 2004 through early 2006, macroeconomic conditions were characterized by exchange rate volatility, rising inflation (to a peak of 17.1 percent in April 2006), and heavy domestic borrowing by the government (with net credit to the government reaching 40 percent of total bank credit in the first quarter of 2005). These conditions pushed up interest rates and crowded out credit to the economy. Since early 2006, however, the government and the central bank appear to be succeeding in restoring macroeconomic stability, which should contribute to lower interest rates and improved access to credit for the private sector.

In addition, the government is pursuing programs to develop the financial sector, with donor support. Two notable programs are the Financial Sector Technical Assistance Program (FSTAP), led by the World Bank in cooperation with the Ministry of Finance, and the Rural Finance Support Program (RFSP), led by the International Fund for Agricultural Development (IFAD) under the Ministry of Planning and Development. FSTAP, a \$28.5 million program, aims to improve the soundness of the financial system, debt management, and financial intermediation. RFSP, a \$34 million program, operates through the government's Economic Development Support Fund (FARE) and targets reducing poverty, improving rural livelihoods, and enhancing the viability of rural enterprises through sustainable access to financial services in rural areas. Other agencies, including the IMF and USAID, also have programs with components for financial sector improvement. In addition, the government has been pursuing a major program of legal and judicial reforms.

Despite these encouraging signs of progress, the financial system is still very underdeveloped. And simply waiting for the market to produce solutions is not an acceptable solution. Thus, the challenge for this study is to identify steps that can be taken by the government, the central bank, the donors, and Confederation of Mozambican Business Associations (CTA) members—both as agents of change and advocates for reform—to overcome key financial sector problems facing the business community more quickly and effectively.

EXPANDING ACCESS TO CREDIT

There is a glaring gap between the perceived needs of the private sector and the requirements of the banks in Mozambique. Many leaders of the business community view the lack of access to

credit as a sign that the banks are imposing unduly conservative standards on loans to small and medium enterprises. Among other things, collateral requirements prevent budding entrepreneurs from qualifying for loans, or even applying for loans. The major banks, however, view the problem in terms of their need to avoid undue risks. They need evidence of the applicant's management capability and experience in running a successful business, as well as the viability of the activity to be financed by the loan. Financiers also require an equity contribution by the applicant and collateral as security against repayment problems.

One avenue to bridge this gap is to improve the creditworthiness of local businesses. This can be done most simply by helping small and medium-sized enterprises (SMEs) understand the traditional path to bank credit, which entails building a relationship with the bank and accumulating savings. Another approach is to provide local entrepreneurs with training in basic business management practices. Looking to the future, more resources must also be devoted to educational programs in accounting, finance, marketing, and business administration. Greater use of insurance as a credit enhancement can help local businesses gain access to loans; to this end, the government should consider joining the African Trade Insurance (ATI) network. The current process of reforming bankruptcy laws can also be part of the solution, by helping local businesses restructure their balance sheets. Outside the bankruptcy process, procedures should be established to help businesses work out legacy debts through mutually agreeable settlements with their creditors.

For many SMEs, the best path to obtaining credit is indirect, through suppliers or buyers in the supply chain. These agents have the best information to judge creditworthiness; in addition, they can readily extend credit and collect repayments through regular business dealings. A study on trade credit systems in Mozambique would be useful to shed light on the status and challenges of this type of financing. In addition, a system of small claims courts would help to stimulate broader use of these financial arrangements.

The most important requirement for expanding creditworthiness is further reform to improve the climate for private sector development. One direct measure that the government can pursue to improve business conditions would be to eliminate arrears on its payments to suppliers and contractors, and also to eliminate undue delays in paying VAT refunds. More broadly, the CTA must continue to be a strong advocate of market-supporting reforms needed to improve the business environment.

Improving the creditworthiness of local businesses is half of the story. The other half involves enabling banks to overcome obstacles in dealing with nontraditional clients. A major contribution to this end can be achieved by restructuring the credit information system and by helping businesses learn how to establish a good credit rating. Most banks could also benefit from donor assistance to help them identify lending opportunities in unfamiliar segments of the market and develop cost-effective financial technologies to serve the needs of SMEs, on the basis of the experience of the microfinance industry. Donors can also stimulate innovation by underwriting new types of lending programs with carefully designed credit guarantees. Any such guarantee scheme should not exceed a 50 percent share of risk, and the arrangement should be designed with a phase-out plan to ensure that it serves as a catalyst for change rather than a subsidy.

Caution, however, is warranted to avoid exploitation of such schemes by rent-seeking interest groups.

Although microfinance is not a major theme for this study, it must be recognized that microfinance institutions are expanding rapidly, albeit from a small base. The major institutions are growing on a commercial basis as registered banks or credit cooperatives. Hence, it is advisable to allow the industry to grow organically, rather than introducing subsidized schemes that might yield short-term gains (at high cost) but undermine the sustainable development of the financial sector.

The application of mobile telephone technology to banking services is one of the most exciting trends in the world of banking. This development will transform access to financial services in countries like Mozambique, where poverty and geography limit the infrastructure of the banking system. The technology already exists, it can operate in areas without bank offices or land-line phones, and it is cheap enough to attract a broad customer base and run profitably for even tiny transactions.

IMPROVING ACCESS TO TERM FINANCE FOR INVESTMENT

Most of the private capital formation in Mozambique has been financed by large-scale foreign investors with access to international capital markets; meanwhile, local businesses lack effective means to finance their investments. To bridge this gap, a proposal to establish a national development finance institution (DFI) has gained considerable support. The proposed DFI would be a professionally managed, profit-driven, second-tier lender, established as a public-private partnership with majority control by nongovernment shareholders. The DFI would receive no interest rate subsidies, though it would benefit from having access to funding on soft terms from international agencies as well as credit guarantees to ameliorate the risks of lending to the target market. Many local stakeholders strongly support the proposal, whereas most donor agencies and international experts have expressed strong reservations based on past failures.

Indeed, experience with DFIs in most developing countries has not been heartening. But DFIs usually fail as a result of a parastatal structure that invites political interference and poor management. More recently, countries such as Brazil, South Africa, and Peru have transformed their development banks into successful commercial operations. Nonetheless, these countries are not good comparators, because they are far ahead of Mozambique in having access to highly skilled personnel, large and diversified domestic markets, access to long-term funding through well-developed capital markets, and excellent infrastructure to support the productive sector. These factors are major determinants of the likelihood of success for any new DFI in Mozambique.

Prior efforts to tackle the problem of investment financing in Mozambique have yielded few results. Yet a new venture by GAPI and Rabobank is an encouraging vote of financial confidence in the feasibility of a well-structured DFI. This example also provides a good answer to the question of whether Mozambique should establish a development bank: If serious investors are convinced to put their money into specific plans, then yes. Otherwise, no.

Creating a national development bank is not the only way to expand access to investment finance for local enterprises. One alternative is to pursue a regional solution. A regional DFI that focuses on SME development would be better able to deal with the constraints facing a national institution. A particularly interesting model is the Latin American Agribusiness Development Corporation (LAADC), which is privately owned, and geared to serve small and medium-sized agribusinesses in the target region. Another option is to expand the application of asset-based lending through lease contracts based on the value of the asset being financed. Mozambican law does not permit leasing companies to take deposits, but any company with sufficient capital can apply for a banking license along with authorization for leasing.

A more innovative approach to investment financing is creating a lightly regulated “caveat emptor” capital market with less stringent regulations and reporting requirements for issuing securities. The idea behind this approach is that these securities will be more risky, but the risks can be priced to deliver an attractive yield. The practicality of this scheme remains to be tested.

Yet another source of investment finance is through risk capital ventures. This type of financing has been notably unsuccessful in Mozambique. But over the next 5 to 10 years the overall supply of risk capital to Africa is likely to display tremendous growth. This trend greatly raises the potential value of technical assistance to identify high-potential local enterprises and help them qualify for risk financing through improvements in management, financial control, and technical capability. In addition, creative methods can be introduced to reduce transaction costs in conjunction with financing and advice on business management.

Finally, investment financing cannot be separated from the mobilization of long-term sources of saving. The most promising vehicle for this purpose is a thorough reform of the pension system. Currently, Mozambique has a mandatory pension program for private employees and a separate system for civil servants, both operating on a pay-as-you-go basis, with only a handful of supplementary schemes. The pay-as-you-go system is appropriate for covering disability and a minimum income guarantee for retired workers and surviving family members, but a funded mandatory savings scheme would be far superior in generating long-term savings, while meeting the needs of retirees. Converting to a funded system, however, is a complex task that requires detailed planning, careful sequencing, a strong legal and regulatory framework, highly capable management, and a firewall to prevent misuse of the funds for political purposes. Most important, a funded system requires a blue-chip strategy for allowing diversified investments to protect the growing pool of capital and deliver a rate of return sufficient to secure future pension benefits.

REDUCING THE COST OF FINANCE

The problem of access to credit is intertwined with the cost of borrowing. If financial markets are competitive, then interest rates reflect the opportunity cost of financial resources and serve an important function in screening out inefficient uses of funds. The question is whether interest rates in Mozambique are reasonably competitive. For dollar-denominated loans, interest rates ring no alarm bells. International benchmarks such as the LIBOR and the U.S. Treasury bill are about 5 percent. A margin of 5 to 7 percentage points over these benchmark rates is understandable as a provision for the risks and costs associated with lending in Mozambique.

The interest rates on metical loans, however, appear to be higher than economic fundamentals would warrant. The rates are not readily explained by inflation, because after adjusting for this factor, real interest rates in Mozambique have been well above the median for low-income countries in sub-Saharan Africa. In addition, the interest rate differential on metical versus dollar loans is greater than could be expected on the basis of currency risk. These observations suggest that the metical interest rate results from noncompetitive behavior in the lending market. This thesis is corroborated by the enormous rate spread between metical loan and deposit rates, which was 13.8 percent in 2006 (for 180-day loans and deposits).

Nonetheless, the interest rate on metical lending is not particularly high compared to the tax-free rate on local Treasury bills, which is a key benchmark. But why is the interest rate so high on T-bills? This rate jumped from under 10 percent in 2005 to over 15 percent in the second quarter of 2006, when the Bank of Mozambique let the auction process determine the rate. Commercial banks, however, are the only bidders allowed in the primary market, which severely limits competition. Letting more bidders enter the primary auction could be a very effective way to reduce this key interest rate.

There is a perception in the business community that metical interest rates have been driven up by crowding out from government borrowing. This was certainly the case in 2004, when net claims on government soared from under 10 percent of total credit to over 40 percent. Since early 2005, however, the government has pursued a more prudent fiscal policy, relieving this pressure. Another factor is the reserve requirement, which stood at 11.51 percent at the time of our field work. With one-ninth of deposit funds frozen in reserves at zero interest, banks respond by setting a larger spread between the interest rates charged on loans and paid on deposits. The Bank of Mozambique could reduce this upward wedge on lending rates by paying interest on required reserves or allowing T-bills to count as reserves.

In addition to the high cost of borrowing, another major grievance is that banks impose excessively high fees on a variety of services, including letters of credit, bank guarantees, fund transfers, and account statements. In 2005 and 2006, fee income accounted for 43 percent of gross income, so banks are clearly exploiting this revenue source. A basic problem is the lack of transparency in the fee structure. This points to the need for a detailed study of banking fees in Mozambique, along with the introduction of stronger requirements for public disclosure in a standard format. By the same token, the government should strengthen the legal requirements for truth in lending, backed by a strong public information campaign and an effective enforcement mechanism.

LEGAL FRAMEWORK FOR FINANCIAL SECTOR DEVELOPMENT

A sound legal framework is critical for the healthy development of financial markets. When legal foundations are weak, banks tend to avoid unfamiliar risks and require higher interest rates to mitigate the added costs and risks of lending. The government of Mozambique is pursuing legal and judicial reforms as part of its financial sector development program, but much still needs to be done.

The Constitution of the Republic of Mozambique (CRM) defines the basic principles of the justice system and establishes the Supreme Court as the apex of the judiciary, along with the

Administrative Court to handle administrative, tax, and custom cases, and the Judicial Court to handle civil, criminal, and general jurisdiction cases. Judicial function is exercised by district and provincial courts, operating under the Supreme Court. Community Courts have also been established in administrative centers, villages, and peri-urban areas. Recently, an important step was taken in creating commercial sections in the Provincial Judicial Courts, to enhance expertise in commercial cases and facilitate settlement.

Property rights are a central issue. Where these rights are secure and readily transferable, land and buildings serve as the most important form of collateral for lending. According to the Constitution, land is owned exclusively by the state and is nontransferable. Land is obtained for economic purposes through use rights. Use-rights transfers can be authorized only if an improvement or structure has been built on the land, but the authorization is highly subjective because of a lack of stipulated regulations. Urban buildings, however, can be freely transferred without prior authorization, along with the use right for underlying land. The land law itself does not require changes, but rules for authorization of property transfers should be clarified and simplified, and use rights should be more freely usable as collateral.

The use of other forms of property as security for loans is impaired by the lack of an effective property registry system. Certain categories of goods in which banks might take a security interest, such as industrial equipment, cannot be registered. Even for assets that can be registered, the process is not computerized and is therefore unnecessarily long and error prone. Reported problems of corruption also pose a threat to public trust in the system. Reform of the registry system should not only computerize and simplify the procedures, but also cover a wider range of assets. Measures to detect and prosecute corruption should be established. A public–private partnership for management of the system can help improve the efficiency of the organization.

Another major legal issue is the efficacy of bankruptcy and insolvency laws in determining the rights of creditors and debtors and settling claims for entities that cannot meet their obligations. Although the law now stipulates conditions under which an entity would be considered bankrupt or insolvent, in practice, the bankruptcy system is highly inefficient. Between 1999 and 2005, only 13 bankruptcy and insolvency cases were filed and only 16 cases reached final adjudication. The government is taking steps to rectify the problems by creating commercial sections in the judicial court and reforming the bankruptcy code to simplify and modernize procedures.

The legal and judicial system must also ensure that creditors can execute claims against debtors who default on loans, short of pursuing bankruptcy. The most common instrument used to enforce such claims, *titulos executivos*, require no court action at the declaratory stage of the collection process, but judicial involvement is still needed for the execution of claims; this step often interjects lengthy delays and great uncertainty into the process. Thus, reforms should focus on the execution stage. Introduction of a “management-assisted judicial execution” could greatly speed up the execution process by assigning the purely administrative tasks to a private service provider. The Community Court System can be an effective forum for resolving small disputes, particularly in rural and peri-urban regions.

Under Mozambican law, arbitration procedures are available as an alternative to litigation, depending on the inclusion of an arbitration clause in contracts or agreements. But arbitration is

of little value in settling nonperforming loans in which there is no dispute about the debt. Nonetheless, arbitration can be a useful tool in dealing with other disputes between financial institutions and their customers.

Following recent reforms, the overall legal framework for the financial system itself is in good shape. The laws clearly stipulate the functions of the central bank, regulations for establishing and operating financial institutions, rules pertaining to domestic and international financial transactions, reserve requirements, and regulations governing microfinance and the insurance industry. Appropriate laws also cover bank secrecy, anticompetitive behavior, and prudential principles for credit and financial institutions. Poor administration of certain aspects of the law, however, poses serious problems for financing the private sector. For instance, the very high fees on ordinary banking transactions and the absence of interest on demand deposits suggest violations of the prohibition of anticompetitive behavior (Article 46 of Law 15/99). In other areas, the laws are too rigidly implemented. For example, establishing a new credit institution requires separate and sequential steps for licensing and regulation, which add unnecessary delays to the process. Also, many aspects of the legal structure require further regulations to close loopholes or address uncertainties.

In summary, the government has made commendable progress in improving the legal framework to support financial sector development. Further reforms are needed, however, in areas such as property rights, property registration, bankruptcy law, contract enforcement, and adjudication of small claims.

OVERCOMING PROBLEMS WITH FOREIGN EXCHANGE RESTRICTIONS

Two recent regulations (*avisos*) relating to foreign exchange loans and payments have been highly controversial. The first, Aviso 5/2005, requires banks to set aside a provision against bad debts for loans denominated in foreign currency that are issued to nonexporters. This *aviso* is intended to discourage banks from lending in foreign currency to borrowers who do not have an income stream in that currency, to avoid a potential systematic risk that could arise from abrupt changes in the exchange rate (as occurred in the Asian financial crisis in 1997). In addition, a widespread currency mismatch among borrowers makes it more difficult for the central bank to allow major exchange rate adjustments even when warranted by market conditions, which further accentuates the risk. Finally, a rapid increase in foreign currency lending had been compromising Bank of Mozambique's ability to manage money supply growth through standard tools such as Treasury bill sales and repurchase agreements.

The controversy over Aviso 5 arises largely because many businesses now have to borrow in meticals at an interest rate of about 25 percent rather than in dollars at an interest rate of about 10 percent; this change especially affects interest rate-sensitive sectors such as housing construction. Data on bank credit before and after the *aviso* corroborate that borrowers were indeed pushed into the higher-cost metical loans. Nonetheless, the argument overlooks the fact that a large fraction of the interest rate differential reflects currency risk. For borrowers with metical income, an interest rate of 10 percent on a dollar loan is less of a bargain if the currency might devalue. In any case, avoidance of the currency mismatch is the whole point of the *aviso*.

Several technical problems, however, do merit attention and correction. First, the *aviso* does not provide a clear definition of the term “exporter”; as is, the regulation seems to exclude many borrowers who earn all or part of their income in dollars. In such cases, restricting dollar loans actually accentuates the currency risk. The regulation could be further improved by permitting dollar loans to borrowers who are hedged against currency risk through an approved form of forward contract. This provision might not have much effect in the short term but would stimulate the development of the market in forward contracts.

Finally, the 50 percent loan-loss provision appears to be excessive. There is no evidence to suggest that 50 percent of loans to nonexporters would be at risk because of potential currency volatility. Moreover, the objective of improving control of the money supply would be better achieved through the conventional method of imposing a higher reserve requirement on dollar deposits.

The second controversy relates to *Avisos* 2/2006 and 6/2005 relating to foreign exchange payments and receipts for trade transactions. *Aviso* 2 was put on hold in the wake of strong opposition from stakeholders, and a draft revision is being considered; meanwhile, *Aviso* 6 remains in effect. The most contentious points relate to the timing and procedures on payments for imports. Among other things, the regulation restricts prepayments and requires bank guarantees for such transactions; it also requires imports to be shipped in the name of the bank, which must scrutinize and approve the documentation before goods can be cleared by customs. Export restrictions include requiring transport documents to be issued to the order of the exporter’s bank and endorsed to the importer’s bank.

The main purpose of the regulation was to tighten enforcement of exchange controls by ending illicit capital flight in the form of foreign payments for phantom imports or the retention of export proceeds outside the country. Although motivated by reasonable intentions, the effect of the regulations is to compromise the competitiveness of Mozambican businesses by imposing costly processing fees, restrictions on contractual payment arrangements, and delays in clearing goods through customs. And yet the measures are unlikely to have much effect in stemming capital flight. Indeed, the restrictions enhance the incentive for economic agents to hold assets externally. History suggests that capital flight tends to ebb when exchange controls are relaxed, not when they are tightened. A better policy would be to liberalize and streamline the payments regime while tightening enforcement of the laws against money laundering and financial crimes.

Whereas *Aviso* 5/2005 is a suitable policy instrument that warrants technical adjustments, *Avisos* 2/2006 and 6/2005 impose costs that greatly outweigh their benefits.

CONCLUSIONS AND RECOMMENDATIONS

On the basis of this analysis, the study offers more than 60 recommendations for consideration by CTA members, the government, the Bank of Mozambique, and international partners involved in financial sector or private sector development programs. It is suggested that the CTA’s Financial Sector Working Group review the recommendations and select a limited set of priorities, on the basis of economic rationale and political feasibility. The working group can then identify champions in the business community to lead the advocacy for these issues, in dialogue with the government, the central bank, and the Banker’s Association, to find solutions to the problems. In

addition, CTA member organizations should pursue a systematic campaign to improve public awareness about key financial sector reforms and work with donors to mobilize technical assistance and financial support.

The CTA and its member organizations might consider pursuing the following recommendations as quick-win priorities, either directly or through advocacy and dialogue:

- Introduce greater competition in the primary market for Treasury bills
- Introduce new regulations to enhance transparency in the banking system, including standards for informing customers of the effective cost of borrowing and the fees for banking services
- Liberalize the regime for export and import payments, but with stricter enforcement of the basic foreign exchange laws
- Broaden the set of borrowers who can qualify for loans in foreign exchange without triggering the loan-loss provision requirement, in a way consistent with the objective of minimizing currency risk for the banking system
- Other short-run priorities might include taking concrete steps to
- Develop a public information program to help unsophisticated local entrepreneurs understand basic business management techniques and the realities of dealing with banks;
- Organize a national conference on mobile-phone banking to expand access to financial services to previously unbanked population groups;
- Seek an arrangement with one of the commercially successful Latin American development banks to appraise the proposal for a national development bank in Mozambique, taking into account the realistic scope for lending and the structural constraints;
- Undertake a systematic study of fees for standard banking services in Mozambique; and
- Break the judicial logjam in processing the execution of claims for payment by introducing the management-assisted judicial execution proposal.
- At the same time, CTA's Financial Sector Working Group and member organizations should pursue a sustained dialogue with policymakers on issues that will take more time to resolve, such as
- Negotiate donor support for technical assistance to help local businesses improve financial controls and package loan proposals for approval by the banks;
- Introduce an inflation rule as a tenet of monetary policy;
- Create a second-tier bond market to open new avenues for financing for larger domestic businesses, creating competition for the banks in dealing with traditional clients;
- Mobilize long-term savings through fundamental reforms to convert the pension system from pay-as-you-go principles to a defined contribution system; and
- Modernize the information systems and expand the scope of coverage for property registries.

In summary, many of the financial system constraints that impede private sector development in Mozambique can be relaxed through appropriate measures and programs to support the development of sound and efficient financial markets. CTA and its member organizations can play a vital role in moving the agenda forward through direct programs and by acting as strong advocates for reform on behalf of the local business community.

1. Introduction

For 2007, the World Bank's *Doing Business* report ranked Mozambique 140th of 175 countries analyzed. This poor result shows that the private sector in Mozambique faces enormous problems with the institutional enabling environment. In the area of "getting credit," Mozambique does much better, ranking 83rd. This gives the impression that the financial system is not a major problem. The *Doing Business* score, however, is based on only two aspects of the financial system: legal rights (covering collateral and bankruptcy laws) and credit information systems. Mozambique has a middle-of-the-pack score on each of these criteria. And yet financial sector constraints are widely perceived to be one of the most serious impediments to private sector development in Mozambique. For example, a 2003 *Investment Climate Assessment* by the World Bank and others found that "a severe lack of affordable finance for enterprises...remains the single most important constraint to the development of the Mozambican private sector" (World Bank 2003, 63). This finding was derived from a survey of local manufacturing companies. The Ministry of Planning and Development obtained a similar result in a 2006 survey of 158 manufacturing companies. This study found that manufacturers consider the cost of finance to be the greatest obstacle to growth, with credit access ranking third (of 25 issues) (Mozambique Ministry of Planning and Development 2006, 15).

In view of the importance of the financial system to private sector development in Mozambique, the Confederation of Mozambican Business Associations (CTA) requested support from USAID for an independent and objective analysis of key concerns of the business community relating to financial sector constraints, with practical recommendations for addressing these problems to improve the climate for investment, trade, and business growth.

This report presents the results of the study. Its main focus is on the low availability and high cost of credit to the private sector. CTA members also expressed grave concerns about the impact of recent banking regulations dealing with foreign exchange lending and international payments. These issues are also addressed. In addition, the report includes a detailed assessment of the legal and judicial system, which constitute the institutional foundation for healthy development of the financial sector. Several other topics, such as microfinance and pension reform, are examined more briefly in the context of addressing CTA's primary concerns.

The methodology for this study was to start with a review of documents and statistics on the financial system in Mozambique, including reports from the IMF and the World Bank.¹ The study

¹ A full reference list is presented at the end of the study. Core documents include IMF, *Financial Sector Stability Assessment*, March 2004; World Bank, *Financial Sector Technical Assistance Project Appraisal*,

team also conducted more than 60 interviews in Maputo, Nampula and Washington with senior business leaders, bankers, central bank and government officials, donor officials, and donor project experts.² The study also draws on lessons from international experience, based on recent literature on financial sector development, as well as the personal experience of members of the study team.

The report is organized in nine chapters, including this introduction as Chapter 1. As a starting point to the analysis, Chapter 2 presents a short note on financial sector fundamentals, highlighting the importance of a sound banking system for economic development. Chapter 3 completes the background discussion with a brief review of recent trends in the financial system in Mozambique.

Chapter 4 focuses on the basic problem of access to finance, including steps that can be taken to improve the creditworthiness of local businesses and provide the banks with better tools for doing business with small and medium-sized enterprises. Chapter 5 looks specifically at access to longer-term financing for investment; this chapter includes a discussion of the ongoing debate on establishing a new national development bank, as well as alternative approaches for enhancing the availability of long-term financing. The high cost of finance is discussed in Chapter 6, while Chapter 7 examines the legal and judicial foundations for financial sector development. Chapter 8 assesses the contentious regulations relating to foreign currency loans and transactions.

Throughout the report, analysis is accompanied by action-oriented recommendations for reform. Chapter 9 summarizes the main conclusions and principle recommendations, including suggestions on quick wins, other high priorities for the short term, and priorities for the longer term. Some recommendations relate to programs and services that might be undertaken directly by CTA members or other private sector stakeholders. Most, however, are for the business community to address as stakeholders and advocates for reform. To move the agenda forward, we propose that CTA's Financial Sector Working Group review the recommendations in this report, select a limited number of immediate priorities, and identify champions in the business community to assume responsibility for pursuing these issues through either action or advocacy.

Although the report focuses on the financial constraints faced by local businesses, its underlying theme is the importance of fostering a sound and efficient financial system rather than pursuing short-term palliatives that could impair or undermine financial sector development. Thus, the analysis and recommendations emphasize addressing the root causes of financial sector constraints, such as information asymmetry, management weaknesses in the business community, the lack of suitable lending techniques for banks to deal with nontraditional borrowers, weakness in the legal and judicial foundations for financial transactions, and underlying problems with the business environment, which limit the scope for productive investment by the business community.

November 2005; African Development Fund, *FSTAP Appraisal Report*, June 2005; IFAD, *Rural Finance Support Programs Report and Recommendation*, December 2003; and World Bank, *Making Finance Work for Africa*, 2006.

² Appendix A lists persons interviewed for the study.

2. Financial Sector Fundamentals

The primary function of the financial system is to mobilize savings and allocate the funds efficiently to businesses, households, and governments. This process operates through a variety of institutions serving both savers and borrowers. Some financial institutions, such as commercial banks, serve as intermediaries that channel deposits from the public into loans and investments. In the process, banks also provide payment services that are the lifeblood of economic transactions. Other institutions, such as stock and bond markets, facilitate direct transactions between those who supply financial resources and those who have a demand for funds. In addition, a well-functioning financial system also provides clients with instruments for managing risk, including convenient avenues for portfolio diversification, various insurance contracts, and tools for hedging against shocks such as exchange rate fluctuations.

The market for finance is unique in that it involves an exchange between a payment today and a pledge of repayment later, under specified terms and conditions. This is true of transactions involving deposits, loans, trade in bonds or stocks, pension fund contributions, or insurance premium payments. As a market in promises, the financial system is driven by *information* about the reliability and solvency of the party pledging repayment. As one lender put it to the study team: “I have the money and I want to lend it out, but I can’t without better information.” An effective financial system also requires a strong legal and judicial foundation to support the market in pledges by ensuring contract enforcement and property rights and by establishing clear rules and regulations governing financial institutions.

In low-income countries like Mozambique, commercial banks typically dominate the financial landscape. As financial intermediaries, banks have a fundamental obligation to protect the funds obtained from depositors. Banks therefore have a vital interest in managing risks carefully and avoiding undue exposure to possible losses, while seeking an attractive return for shareholders.

Sound banking practices are of vital interest to the economy as a whole. Economic agents across the board depend on a stable banking system to facilitate transactions, protect cash balances, and finance operations. Furthermore, imprudent banking practices often lead to crises that impose heavy costs on the economy at large.³ Thus, a sound banking system can be viewed as a public good.

³ Dozens of banking crises have occurred in Africa and around the world. (See Bolnick and McPherson.) In Mozambique the bailout of two major banks in 2001 and 2002 cost the government an estimated

The first line of defense against instability in the banking system is prudent management and strong corporate governance by the banks themselves. But international experience has shown that a second line of defense is essential: effective banking supervision and time-tested prudential regulations. Among other things, prudential banking involves close attention to the maturity structure of bank liabilities (sources of funds) and assets (uses of funds). Because banks depend on deposits that are subject to withdrawal on short notice, they are constrained to focusing their lending mainly on relatively short maturities. Banks must also protect against risks that might arise from exchange rate fluctuations. This is done by avoiding a significant mismatch between the currency structure of assets and liabilities and ensuring that borrowers are hedged against exchange rate risks. Other tenets of prudential banking include requirements to maintain adequate levels of capital on the balance sheet, a limit on loans to individual borrowers, and rules for setting aside provisions against nonperforming loans.

For all of these reasons, commercial banks tend to be cautious about lending risks and to emphasize short-term lending over longer-term investment financing.

Yet sound banks can *still be innovative*. In particular, they can do a much better job of developing new financial services and serving nontraditional clients. A classic example (discussed in chapter 4) is Bank Rakyat Indonesia (BRI), the largest commercial bank in Indonesia. Starting in the 1980s, BRI developed specialized loan and deposit products and turned micro and small enterprise lending into a major profit center, while providing financial services to millions of clients.

To facilitate innovation, the government and the donor community can be catalysts for change. The motivation for intervention is that inherent imperfections in the financial markets lead to systematic underinvestment in financial innovations that have major benefits for economic development.

In the broadest terms, measures to overcome financial constraints on private sector development can yield important externalities through ripple effects that generate production, jobs, and incomes well beyond the benefits accruing to those involved in the financial transaction. This argument must be treated with some caution, however, because “development externalities” are often vague, and rhetoric claims to this effect are widely used to justify programs that actually have little, if any, development impact. At the same time, the development of viable financial services for new clients can undoubtedly generate multiplier effects for the economy.

A second imperfection in the financial market arises from missing information. Most bank managers, for example, lack information on appropriate techniques for serving new markets profitably; on the costs and risks of servicing nontraditional borrowers; and on the viability, under Mozambican conditions, of innovations that have worked elsewhere. There are also information gaps on the part of bank clients. The managers of many small and medium-sized businesses do not understand lenders’ requirements and lack the capacity to provide necessary accounting data

6 percent of GDP. Aftereffects lingered for years in the form of conservative lending by major banks and crowding out from government debt that was issued to recapitalize the failed institutions.

and business plans. On both sides of the market, well-designed interventions and reforms can help overcome information problems and facilitate access to finance.

These market imperfections are compounded by a lack of effective competition in the financial system. In advanced economies, competition drives financial innovation. But in Mozambique (and many other developing countries), the financial market remains highly concentrated, with a few major banks dominating the system. Over time, the entry of new banks and the emergence of other financial institutions will intensify competition and create strong incentives for financial institutions to develop new services and seek new clients. Some of the recommendations discussed in this report relate to measures that might enhance this process.

Parallel to these market imperfections, government interventions are also systematically prone to failure. These problems stem from weak government capacity to design and implement effective programs and assess unintended consequences (especially in low-income countries); and a fundamental misalignment between development needs and political and bureaucratic incentives, including pressure from rent-seeking special interests. For these reasons, developing countries have often pursued interventions that end up inhibiting, rather than promoting, the development of sound and stable financial markets.

The lesson is that public sector interventions must be designed carefully to strengthen sound financial markets, not supersede or weaken them. In particular, governments should not push financial institutions to extend loans to fundamentally nonviable clients. Nor should governments create “cheap” credit schemes that favor special interests, undermine commercial lending, and create rent-seeking incentives (through an interest rate differential).

In contrast, there is a role for temporary interventions that serve as a catalyst to help financial institutions test new markets and develop new services, as well as programs that help local businesses become more “bankable” through better management, better financial controls, and better business plans. The programs to assist local businesses can also be pursued through business organizations such as CTA or the Mozambique Bankers’ Association and also through private enterprises’ furnishing support services to other businesses.

3. Financial System Trends in Mozambique

This chapter briefly reviews recent developments in the financial system, to provide perspective for the analysis of financing constraints to private sector development. As in many other low-income countries, a few large banks dominate the financial system in Mozambique. The development of a deeper and broader financial system is limited by the low productivity of many enterprises and fundamental structural weaknesses in the economy, including weak legal and judicial institutions. In addition, the financial system has been buffeted by macroeconomic instability. All these factors contribute to the low overall level of financial intermediation and lending to the private sector.

Despite these limitations, favorable trends have developed. In the past two years, financial intermediation has grown rapidly. The banking system is now rebounding from a period of consolidation following the restructuring of two failed banks in 2001 and 2002. In addition, new financial institutions have been entering the market, gradually enhancing competition and expanding the range of financial services. The government is also pursuing supportive policies through improvement in macroeconomic policy management and the implementation of important new programs to develop the financial sector.

GROWTH OF FINANCIAL INTERMEDIATION

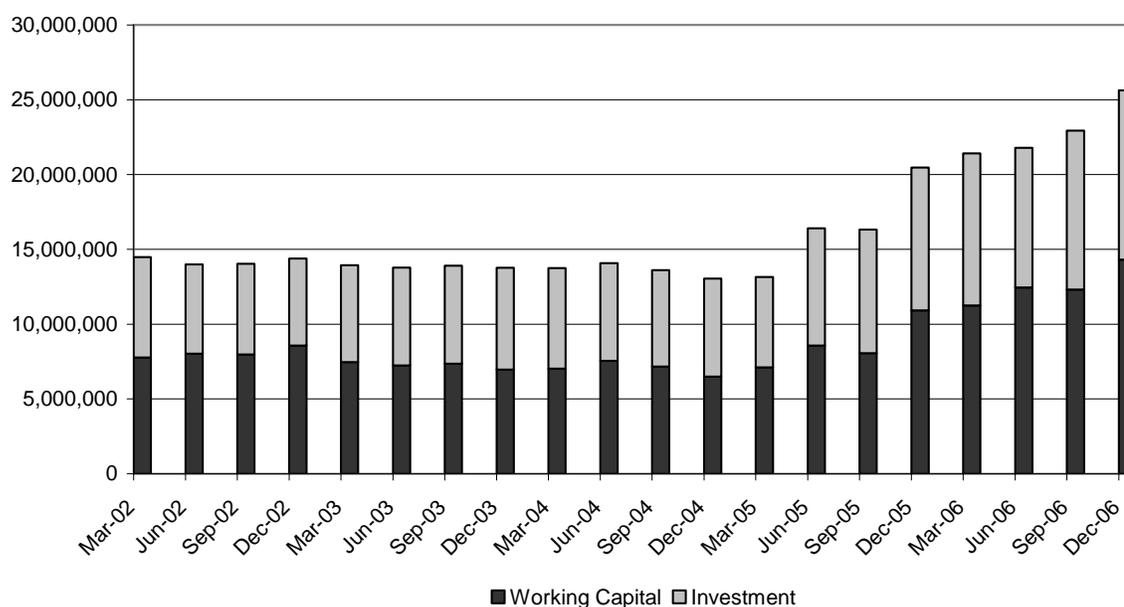
A simple indicator of financial intermediation in low-income countries is the degree of monetization, measured by the ratio of broad money to GDP. In Mozambique, broad money includes currency in circulation plus bank deposits, in both local and foreign currency. Broad money has risen from 24.4 percent of GDP in 2002 to 28.5 percent in 2006.⁴ The increase indicates that Mozambique is making steady progress in expanding the deposit base in the banking system. Indeed, the level of monetization in Mozambique is now slightly higher than the median for low-income countries throughout the world (25.9 percent), and well above the median for low-income African countries (21.7 percent).⁵ To be sure, these are weak benchmarks. In countries with well developed financial systems, the ratio of broad money to GDP is often well above 100 percent. For example, in South Africa, the ratio was 132 percent in 2006 (Statistics South Africa 2007).

⁴ Unless indicated otherwise, data presented in this chapter are taken from or calculated from Bank of Mozambique sources and IMF tabulations of Bank of Mozambique data.

⁵ The benchmarks are computed using data from the World Bank's World Development Indicators 2006.

Another key indicator of financial intermediation is credit to the economy. After two major bank failures in 2001, commercial banks were very cautious about new lending. Figure 3-1 shows that credit to the private sector was stagnant even in nominal terms until the third quarter of 2005. Factoring in inflation, credit to the economy was actually declining in real terms. The good news is that the financial integrity of the banking system recovered during this period of consolidation. At that time, total capital for the banking system fell far short of minimum prudential requirements (IMF 2006, 30); regulatory capital was actually negative in 2000 because of huge loan losses. In 2001, the overdue portion alone of nonperforming loans amounted to 23.4 percent of gross bank lending,⁶ and the bank sector booked a return on equity of just 3.5 percent. By mid-2006 (latest available figures), regulatory capital for the banking system amounted to a healthy 13.1 percent of risk-weighted bank assets; the overdue component of nonperforming loans was down to 3.7 percent; and the banks booked a very high 32.8 percent return on equity. Indeed, the negative trend in bank lending from 2002 to 2005 (shown in Figure 3.1) reflects lingering aftereffects of the banking crisis, as banks adopted very conservative lending practices to reduce the legacy of nonperforming loans.

Figure 3-1
Commercial Bank Credit to the Economy, 2002–2006 (nominal MT)



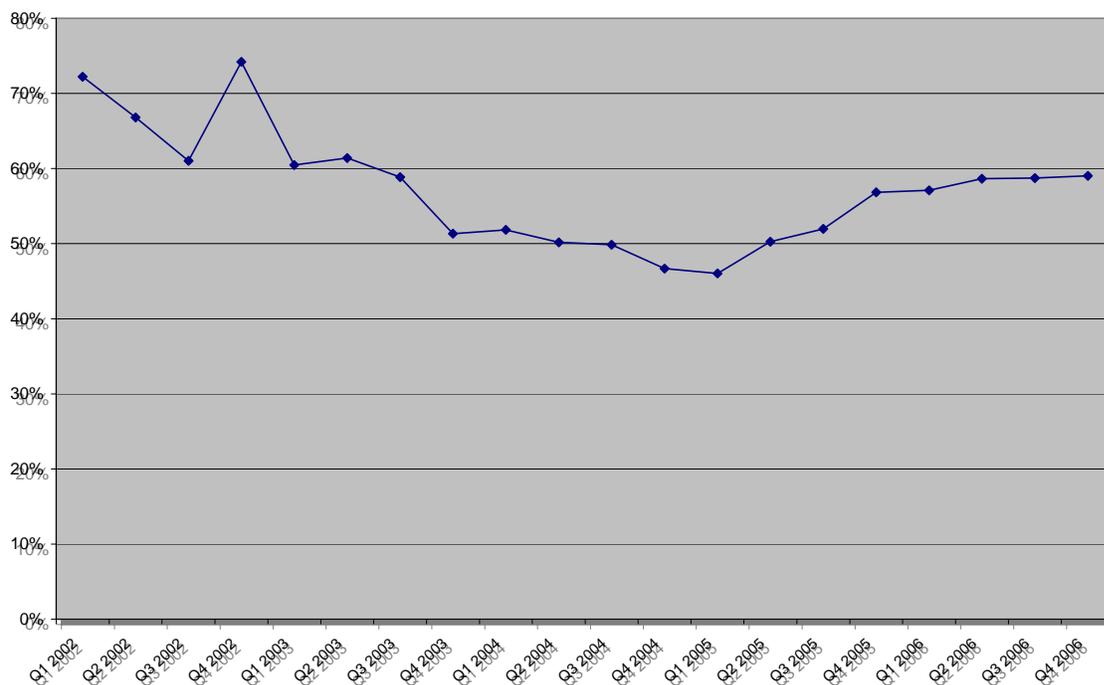
Since 2005, bank credit to the economy has almost doubled in nominal terms, rising to 15.5 percent of GDP by December 2006. This exceeds the median for low-income countries worldwide, which is 12.1 percent of GDP. For comparison, the corresponding figures for Zambia and Tanzania are 7.6 percent and 10.4 percent, respectively. Figure 3-1 also shows that 44.1 percent of total credit to the economy at the end of 2006 was categorized as lending for investment, up from 40.4 percent at the end of 2002.

⁶ In 2007, the Bank of Mozambique is expected to modify the regulations on nonperforming loans so as to conform to international standards of including the loan value at risk rather than just the overdue component.

These indicators show that financial intermediation in Mozambique compares surprisingly well to the norm for low-income countries. In absolute terms, however, the banking system is still very underdeveloped. Furthermore, as shown in Figure 3-2, credit to the economy is relatively low as a percentage of deposits in the bank system. Thus, it is not a lack of available deposit funds that constrains the supply of credit to the private sector.⁷

Figure 3-2

Credit to the Economy Relative to Deposits from the Economy, 2002-2006



ENTRY OF NEW FINANCIAL INSTITUTIONS

According to the latest annual survey of the banking sector in Mozambique by KPMG, three large banks accounted for 80 percent of total bank assets, 79 percent of total credits, and 83 percent of total deposits in 2005 (KPMG and Mozambique Bankers' Association 2006). By any standard, this is a highly concentrated industry. The limited degree of effective competition can also be seen in high prevailing profit margins, the large spread between the deposit and lending rates, and widespread concerns about high interest rates on loans and high banking fees (see Chapter 6).

Even so, new banks have been entering the market in response to unexploited opportunities, facilitated by legal reforms that have clarified the rules and regulations governing financial institutions (see Chapter 7). By early 2007, 13 banks were in operation, with one more awaiting a

⁷ Other important banking system trends will be discussed in this report, including interest rates (chapter 6), local and foreign currency lending (chapter 8), and the structure of lending by sector (also chapter 8).

license.⁸ Eventually this expansion of the banking system should reduce the degree of concentration and intensify competition for deposits and loans.

More important in the short term, some of the new banks are offering innovative services to new groups of clients, including micro, small and medium-sized businesses and, to a lesser extent, rural enterprises. Indeed, the microfinance sector has been restructuring on a stronger institutional footing. Three microfinance institutions are now fully licensed commercial banks (NovoBanco, SUCREMO, and Banco de Oportunidade de Moçambique). Another major microfinance institution, Tchuma, is a registered credit cooperative. All these institutions are growing rapidly. Dozens of other institutions are also active in this market,⁹ though they are relatively small in outreach and impact. The prospects for growth, however, are very good because of a supportive legal environment and a large donor-funded program to promote innovative approaches to rural finance (see New Programs, below).

The rest of the financial system is not very dynamic. The insurance sector is becoming more competitive but remains small (apart from compulsory forms of coverage). There are three active leasing companies, but they are all owned by banks. The stock and bond exchange remains very small, with little secondary trading and no mutual funds emerging to mobilize savings more broadly. Very few private pension funds have been established. And there is no market for commercial paper or factoring operations. In short, there are positive structural trends, but the overall broadening and deepening of the financial system will be a slow, long-term process.

MACROECONOMIC STABILITY

From 2004 through early 2006, macroeconomic conditions in Mozambique were characterized by exchange rate volatility, rising inflation, and heavy domestic borrowing by the government. These conditions adversely affected the financial system by pushing up interest rates and crowding out credit to the economy. Since early 2006, however, the government and the central bank appear to be succeeding in restoring macroeconomic stability.

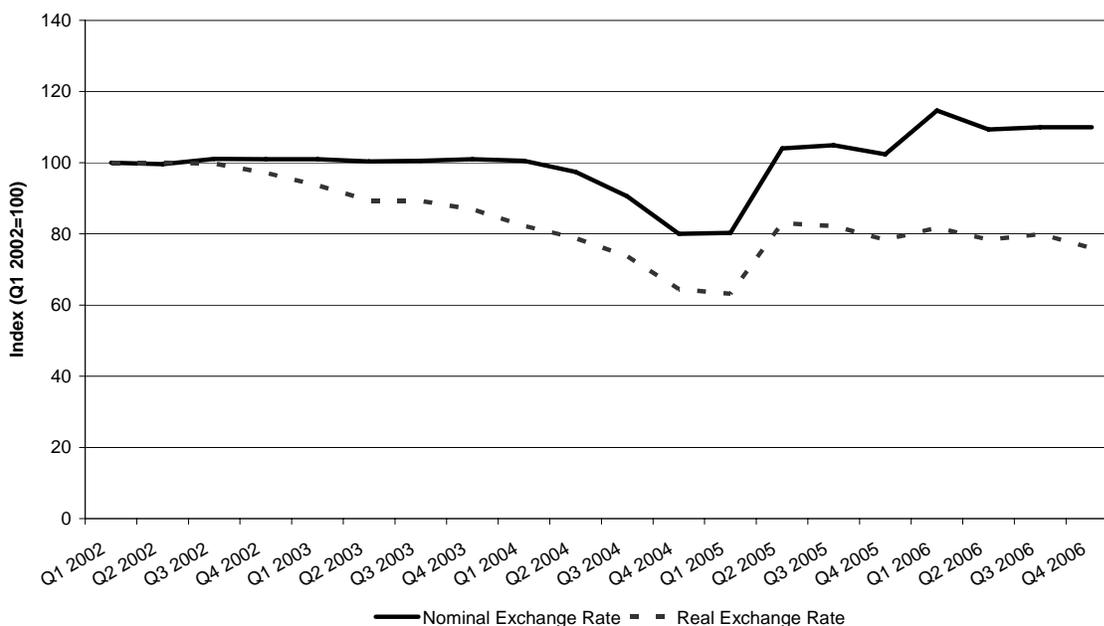
Figure 3-3 shows trends in the real and nominal exchange rate against the dollar from 2002 through 2006, starting with the exchange rate.¹⁰ In 2002 and 2003, the central bank maintained a very stable nominal exchange rate against the dollar, which meant that the real exchange rate gradually appreciated. From that point, however, the exchange became unstable, first appreciating by 20 percent (from 23.86 to 18.80 per dollar) during 2004, then depreciating by 43 percent depreciation by early 2006 (to 27.07 per dollar). Since the middle of 2005, the nominal exchange rate has been much less volatile, while the real exchange rate—which affects the competitiveness of local businesses—has been much more stable than in earlier years.

⁸ This is the figure cited by senior officials at the Bank of Mozambique in February 2007.

⁹ Fion de Vletter identified 32 active microfinance “operators” as of mid-2005, including the banks noted above (de Vletter 2006).

¹⁰ The trend is shown here using a quarterly index defined to equal 100 at the beginning of 2002 (as a basis for comparison).

Figure 3-3
Real and Nominal Exchange Rate Trends, 2002–2006



Another recent symptom of macroeconomic instability was rising inflation. Measured on the basis of 12-month changes in the consumer price index, the inflation rate rose from less than 5 percent in mid-2005 to a peak of 17.1 percent in April 2006. This volatility in the inflation rate is partly a lagged response to volatility in the exchange rate, in that a strong appreciation helps to hold down price increases, whereas a large depreciation directly increases the price of imports, as well as domestic products that compete against imports. Rising oil prices were also an important factor. Since early 2006, however, inflation has been subsiding; by year-end, the 12-month increase in the consumer price index was back to single digits, at 9.3 percent. For 2007, the IMF forecasts a further deceleration of inflation, to less than 6 percent. This should lead to lower interest rates on local-currency loans by cutting the inflation premium and lowering the risk of exchange rate instability.

Domestic borrowing by the government has similarly exhibited a recent pattern of sharp deterioration followed by clear signs of improvement. Heavy government borrowing in the domestic financial market tends to crowd out bank lending to the private sector, while also putting upward pressure on interest rates. Between the third quarter of 2004 and the first quarter of 2005, net credit to the government soared from just 9 percent of total bank credit to more than 40 percent. This led to a correspondingly sharp decline in bank credit to the economy. Since early 2005, however, the government budget has been under far better control, and the massive crowding out of credit to the private sector has been reversed. Net bank claims on government have fallen by 40 percent in absolute terms and have receded to 17 percent of total bank credit. In 2006, the government budget was financed with no net domestic borrowing; the same is planned for 2007.

By sustaining the recent improvements in macroeconomic policy management, the government and the central bank can make an important contribution to reducing interest rates and improving the private sector's access to credit.

NEW PROGRAMS TO DEVELOP THE FINANCIAL SECTOR

Another very favorable trend is the recent start of two large programs to develop the financial system in Mozambique: the Financial Sector Technical Assistance Program (FSTAP), led by the World Bank under the auspices of the Ministry of Finance;¹¹ and the Rural Finance Support Program (RFSP), led by the International Fund for Agricultural Development (IFAD) under the auspices of the Ministry of Planning and Development.¹² Both programs have been slow in getting underway, which has created an impression in the business community that nothing is going to happen. But both of them appear now to have passed through the startup phase and have begun to implement important substantive activities.

FSTAP is a \$28.5 million program designed to improve the soundness of the financial system, improve debt management, and increase financial intermediation. In addition to managing the overall technical assistance program, the World Bank is responsible for four program components: enhancing the capacity of the central bank for banking supervision and provision of financial infrastructure; improving financial accountability and transparency; strengthening public debt management; and improving efficiency and depth in the money market and the government bond market. Five other components are being managed by others: strengthening micro and rural finance, by German Technical Cooperation and the German Fund for Reconstruction (GTZ/KfW); strengthening the regulatory and supervisory regime for the insurance industry by the African Development Fund (ADF); modernizing the social security system (ADF); improving the legal and judicial environment for lending, with a focus on bankruptcy law and property registries (ADF); and strengthening capacity for investigating financial crimes (ADF) (World Bank 2005).

The RFSP is a \$34 million program that operates through the government's Economic Development Support Fund (FARE). The objective of the program is to reduce poverty, improve rural livelihoods, and enhance the viability of rural enterprises by supporting the development of sustainable access to financial services in rural areas. The major program components include support for institutional, policy, and legal reforms to strengthen the environment for sustainable rural finance, financial and technical support for innovation and outreach by rural finance institutions, and support for community-based rural financial institutions (IFAD 2003).

Besides these two major programs for financial sector development, the government has been pursuing reforms to the legal and judicial system (see Chapter 7). In addition, the IMF has been providing technical support to the Bank of Mozambique in banking supervision, international accounting standards, foreign exchange management, and monetary policy. Several other donors

¹¹ The program is cofunded by the African Development Fund, German Technical Cooperation and the German Fund for Reconstruction, the Swedish International Development Agency, and Britain's Department for International Development.

¹² The RFSP is cofunded by the African Development Bank.

have programs involving financial sector elements, notably including USAID's provision of partial credit guarantees for loans to agriculture, through its Rural Finance Program, and technical support for rural enterprise development through its Global Development Alliance with the Cooperative League of the USA (CLUSA).

THE ROAD AHEAD

This short review of recent trends in the financial sector in Mozambique shows that the sector is a dynamic work in progress. The system is expanding and developing in response to market incentives, facilitated by improvements in macroeconomic policy management and ongoing institutional and regulatory reforms. In addition, the government and its international development partners are already pursuing initiatives to broaden and deepen the financial system.

Despite these encouraging signs of progress, the market innovations are at an early stage of realization. Meanwhile, the financial system is still very underdeveloped, and the problems of access to credit, the cost of credit, and foreign exchange restrictions are widely regarded as immediate and serious constraints on the development of the domestic private sector. In view of the inherent market imperfections discussed in Chapter 2, simply waiting for the market to evolve is not the best solution. At the same time, all parties must be on guard against expedient interventions that would weaken the development of a sound financial system.

Thus, the challenge for this study is to identify prudent, market-supporting steps that can be taken by the government, the central bank, the donors, and members of the business community as agents of change and advocates for reform, to overcome financial sector problems more quickly and effectively.

4. Expanding Access to Credit

This chapter examines the central problem of access to credit for the domestic private sector in Mozambique. The discussion starts by outlining the glaring gap between the perceived needs (*necessidades*) of the nonbank business community and the requirements (*exigências*) of the banks.¹³ But simply pressuring banks to relax their lending standards is not an appropriate solution to the problem of credit access. Banks have a legitimate need to avoid risks that might jeopardize their depositors' funds, their capital base, and their profits. Likewise, banking supervisors have valid reasons to impose prudential regulations that protect the stability of the banking system, as a public good that benefits the entire economy. Sustainable solutions to the access problem must instead address the root causes, by relaxing information constraints, reducing lending risks, lowering transaction costs, strengthening the institutional foundations for credit transactions, and improving the economic fundamentals for productive private investment.

We therefore present a variety of approaches for narrowing the gap in access to credit from both sides: first, by improving the creditworthiness of local enterprises, and second, by helping banks learn to deal prudently and profitably with a broader range of borrowers. The analysis is concerned mainly with improving access to finance for small and medium-sized local enterprises that have the potential for growth and development. But the chapter includes a short discussion of the role of microfinance as well, and the exciting new field of mobile phone banking, which will transform the accessibility of financial services for the poor.

Three related topics are reserved for later chapters. Access to term credit for investment will be discussed in Chapter 5, including the contentious issue of establishing a national development bank. Chapter 6 examines the critical problem of high interest rates, which severely limit access to credit for the productive sector. Chapter 7 reviews the legal and judicial foundations for financial market development, including problems with property rights, property registration, and the execution of credit claims.

VIEW FROM THE PRIVATE SECTOR

Complaints about the lack of access to credit are a common thread running through virtually every discussion about constraints on private sector development in Mozambique. Business leaders recognize that the problem stems partly from high interest rates, as well as weaknesses in

¹³ Throughout this report we use the terms “private sector,” “business community,” and “business leaders,” to refer to nonbank businesses. The reason for the imprecision is simply to avoid wordy phrasing.

the real economy.¹⁴ But the debate centers on claims that the banks are imposing unduly conservative lending standards for a country that is still recovering from centuries of colonial repression, decades of destructive wars, a failed attempt to impose central planning, and pervasive poverty. For example, small entrepreneurs who are attempting to climb out of poverty possess few assets of value to offer as security for loans. Yet the banks generally demand collateral valued well in excess of the loan. In addition, the legacy of a weak education system leaves budding entrepreneurs with weak management skills. Even those with sound ideas are not well equipped to present solid business proposals complete with financial statements, cash flow estimates, and marketing plans.

Lacking significant collateral or a well-developed business plan, many entrepreneurs know that it would be difficult to gain approval for a loan. This perception alone prevents most businesses from even seeking a loan. This can be seen in a recent survey of more than 150 manufacturing enterprises in Mozambique: most respondents identified access to domestic credit as a serious constraint to doing business, but 93 percent of the firms without a bank loan had not applied for one (Ministry of Planning and Development 2006, 31–32).

On this basis, many local business advocates conclude that banks should lower their lending standards to finance the growth of the local business community.

VIEW FROM THE BANKS

Most major banks told our study team that they are willing to be flexible in meeting the needs of any client with a good business, a sensible plan for using borrowed funds, and a high probability of repaying the loan plus interest. At the same time, they emphasize that they are not charitable organizations; they are in business to earn a return on equity for their shareholders, while preserving the bank's capital and protecting depositors' funds. This necessitates careful management of lending risks.

In evaluating lending risk, a primary criterion is evidence of the applicant's management capability and experience in running a successful business. Next, bankers seek information on the viability of the activity or project to be financed by the loan. Many applications fail this test for lack of preparation. One bank gave the example of an applicant who applied for a loan to manufacture plastic bottles without providing any assessment of whether locally produced bottles could compete with imports from South Africa, where manufacturers have the advantage of scale economies.

A third criterion is reliable financial information. It is not uncommon for bankers to see proposals that sound good but lack even simple cash flow data to demonstrate the financial condition of the enterprise. The lack of accounts often reflects a lack of basic education, but many applicants are unwilling to share business data as well, out of concern that the information might be passed along to tax authorities.

¹⁴ To paraphrase one business leader, "The main problem is poverty. Just poverty. There is credit, but the people are too poor to qualify for loans."

Financiers require a fourth criterion as well, an equity contribution by the applicant, in the form of property, machinery, or cash. This is to ensure that the loan recipient has a direct personal stake in making the business succeed. In Mozambique, few entrepreneurs have had the chance to accumulate much wealth, so this can be a decisive factor in limiting the size of a loan.

Of course, banks require collateral as well, for risk management. Yet collateral is usually a subsidiary consideration. One banker even told the study team that the usual perception about collateral being a key constraint was simply wrong, and that the real constraints were the quality of the business proposal and the bank's knowledge of the client's dependability as a borrower.

The reason banks do not view collateral as a central consideration is that they strongly prefer to avoid foreclosure for recovering their funds. Nonetheless, when loans do go bad, they want recourse to security that is sufficient to cover the unpaid balance *plus* overdue interest. Given the length of time that may be needed for contract enforcement, the total amount due can be much bigger than the original value of the loan. Banks also have good cause to seek collateral in excess of the loan amount because of uncertainty about the resale value of the assigned assets.

An equally important consideration is that collateral serves a screening function by providing indirect information about the loan application. To paraphrase one senior banker: "Think about the characteristics of an applicant who has little or no collateral. What does that say about the quality of his business? What does it say about his ability to manage finances and repay the loan?"

IMPROVING CREDITWORTHINESS

One way to close the gap between the needs of the business community and the requirements of the banks is to address the borrower side of the market, through measures that improve the creditworthiness of Mozambican enterprises. In this section we discuss six approaches: helping local businesses understand the traditional path to bank credit; providing business support services; making better use of insurance as a credit enhancement; helping businesses resolve legacy debts to clean up their balance sheets; sourcing funds indirectly through suppliers or buyers; and pursuing general improvements in the business environment.

One recurrent theme is that organizations such as the CTA and the Bankers' Association can play an important role in facilitating or mobilizing action to help local enterprises deal with information problems that limit their access to credit.

Traditional Path to Bank Credit

New businesses and small enterprises nearly everywhere in the world have difficulty in qualifying for loans through normal banking channels (as distinct from microfinance institutions, discussed below). World Bank studies in 40 developing and transitional countries show that most small businesses have no recourse to external financing. Even in industrial countries, bank loans historically played only a minor role in funding small and medium-sized firms (Cull et al. 2006).¹⁵

¹⁵ This paper also summarizes results from the 40 World Bank studies mentioned above.

When a small enterprise does obtain bank credit, it generally pursues a gradual process of overcoming information constraints and building a relationship with its bank. The first step is simply to maintain an active deposit account and demonstrate an ability to manage cash flow and generate a regular stream of income. This provides a basis for qualifying for an overdraft facility or a working capital loan using a minimum deposit balance as collateral. By repaying these startup lines of credit on time, the business gradually qualifies for larger loans. To accelerate the process, businesses can use interest-bearing deposit accounts to accumulate savings and build equity. Over time, the bank gains familiarity with the client and his or her business prospects. In the course of developing this relationship, banks often provide advice on financial management to help the business improve its market position and accumulate assets that can be used as collateral. After all, it is in the bank's own interest to cultivate the relationship and market other bank services to clients in good standing.

When local businesses allow customers to purchase on credit, as a competitive tool for expanding sales, they may be able to use the receivables as additional collateral for loans. The practice of discounting trade credit is one of the world's oldest forms of financing working capital, and a common entry point to credit for small businesses. The mechanism is less useful, however, in countries where the legal system does not support claims on movable property (see Chapter 7).

Wider use of commercial receivables could also provide space for the emergence of independent factoring operations,¹⁶ which could compete with commercial banks as a source of short-term financing. In this regard, the study team received several comments about the lack of trust in the business community in granting commercial credit. Expanding the use of trade credits is one way for businesses to help themselves gain access to bank loans.

Both the CTA and the Bankers' Association can help SMSEs throughout the country gain access to credit by providing information and advice on how to build a banking relationship. This can be done through business development programs and media campaigns, with support from the government or from donors. Not every SMSE will be a good candidate for a bank loan, however. Some business owners and farmers offer good potential for managing credit, while others do not.

***Recommendation:** Help SMSEs overcome information asymmetries by learning how to build relationships with banks, through information programs developed and implemented by the CTA and the Bankers' Association.*

***Recommendation:** Promote wider use of commercial receivables as collateral for loans and as a basis for developing independent factoring operations to compete with banks.*

Business Support Services to Enhance Access to Credit

In the Mozambican environment, many businesses do not pass the credit test because of a variety of internal problems: weak management, loose financial controls, inefficient production

¹⁶ In a factoring deal, a business holding accounts receivable sells ("assigns") the right to collect to a factor, at a discount (often 70 percent) of the face value. This allows the business to offer trade credit as a marketing tool and still receive most of the payment up front. The factor then collects the full amount due, retains the amount advanced plus interest, and passes along the remainder of the payment to the business.

techniques, and poor market conditions. Entrepreneurs may perceive a lack of access to finance as a major constraint, but often, a genuine solution to the problem requires finding ways to improve the businesses themselves.

In a developed economy, the necessary tools can be obtained by hiring better managers and skilled staff and by accessing training and support services in the market. In Mozambique, however, skilled personnel are scarce, and the market for support services is extremely thin. In any case, a small business with a weak cash flow and no access to credit cannot easily afford professional support services. Furthermore, the market for business solutions has its own information failures in that unsophisticated entrepreneurs rarely know the value of an improved accounting system or better inventory management, let alone the possibilities for improving product quality, penetrating new markets, or adopting more efficient technologies. In short, SMSEs in Mozambique have little if any access to market-based services to solve their business problems and improve creditworthiness.

These conditions clearly justify donor-supported interventions to provide local enterprises with information, training, and technical support to overcome constraints on growth. The interventions can be targeted directly at helping businesses access credit, or there can be a credit access component of a broader private sector development program. Either way, the programs should enhance business management and accounting skills, with assistance tailored to the size and sophistication of the client group. Many micro and small enterprises require training on very basic topics such as record keeping, the difference between turnover and profit, how to calculate a mark up, simple budgeting and planning, inventory management, marketing, and maintaining a bank account. For clients with viable borrowing needs, technical support should include assistance in preparing business plans and packaging loan requests.

To use a familiar metaphor, the objective of any such program is not to give local entrepreneurs fish, but to teach them to fish. The program should therefore be a catalyst for overcoming information constraints and creating a sustainable basis for business growth. To be cost-effective, any program should also yield wider demonstration effects, so that other enterprises will also learn to fish by observing the success of direct beneficiaries. Otherwise, the cost of technical support can easily exceed the program benefits.

One avenue for providing business support services is through microfinance institutions with many clients. In fact, several microfinance institutions have appealed for help in this area. Empirical evidence indicates that providing small borrowers with simple lessons in business management can improve their income and repayment rates (Karlan and Valdivia 2007).

Another method is to develop a series of radio programs in which each topic is presented in simple terms to a large audience, preferably including time for listeners to call in with queries. The South African Broadcasting Corporation developed a television series of this sort, which perhaps could be purchased and translated into Portuguese and other local languages.

CTA members can be key partners in helping to shape the design of donor interventions to provide business support services and also as possible implementing agents. Even without donor involvement, however, business organizations such as the CTA or the Bankers' Association should consider organizing mentorship programs to assist local entrepreneurs in improving

financial management and preparing credit applications. To do so, the central organizations could work with grassroots members to develop a network of retired businesspeople, bankers, and finance specialists, and then solicit applications from small businesses interested in obtaining credit. The applicant could be matched with a mentor, who assesses the viability of the business and the loan proposal and informs the entrepreneur about problems that need fixing for the entrepreneur to qualify for a loan. If the project has good potential, the mentor may help the entrepreneur turn the idea into a bankable proposal, complete with a budget, cash flow, marketing plan, and security for a commercial loan, or simpler documentation for microfinance. Some mentoring might be *pro bono*, but the program will be sustainable only if the host organization imposes fees to cover administrative costs and pay an honorarium to mentors, perhaps adding a “success fee” for larger clients who succeed in getting a loan.

Looking to the future, one of the most important interventions for improving the creditworthiness of local businesses is to accelerate the development of education programs in accounting, finance, management, marketing, and entrepreneurship. The World Bank’s FSTAP is making a start in this direction through a component that will introduce international accounting standards for large and medium enterprises and strengthen the curriculum for educating accountants (World Bank 2005). In addition, USAID/Maputo should consider taking advantage of the funding available through the Africa Global Competitiveness Initiative (AGCI) for programs to expand “access to bookkeeping and accounting expertise and services,” including the development of local language accounting tools and certification programs (AGCI 2006, 4).

Recommendation: *Develop a donor-supported program to provide local entrepreneurs with training in basic business management practices, with the aim of enabling them to improve their business prospects and ability to present sound loan applications to banks.*

Recommendation: *Establish a private sector–led program for mentoring local businesses, through organizations such as the Bankers’ Association or regional business associations, by matching retired professionals with interested entrepreneurs, and also through the development of information programs through the press and over the radio.*

Recommendation: *Provide more resources for professional educational programs in accounting, finance, marketing, and business administration, to produce high-caliber business professionals for the future.*

Insurance as a credit enhancement

Insurance can be a useful tool for expanding access to credit and reducing the cost of borrowing, by mitigating elements of risk in a loan agreement. Some banks already package insurance with their loans, but there is scope for wider use of insurance as a credit enhancement, and for the introduction of new insurance products covering other types of risk. The competitive dynamics of the insurance industry will determine the pace of developments to reduce the cost of coverage and provide innovative new services. At the same time, training is needed for bankers, to help them understand the potential for using insurance to reduce risk. Furthermore, business clients would be more willing to use insurance as a hedge against risk if policy terms were more transparent and provided clearly written explanations of the risks covered, the conditions under which payments are made or withheld, and the procedures for entering and settling a claim.

The insurance industry in Mozambique is very small but growing steadily. There are now five companies, three of which cover close to 90 percent of the market. State-owned EMOSE, a former monopolist, accounts for approximately half the market. Mandatory products such as workers' compensation and third-party liability motor insurance account for nearly half of total premiums. Other popular forms of noncompulsory insurance include supplementary auto insurance, life insurance, and fire coverage.

Trade credit insurance is a major area for development. In South Africa, companies wishing to export to Mozambique can insure trade credit through companies such as Coface/CUAL and the Credit Guarantee Insurance Corporation, but coverage of this kind is not readily available in Mozambique. One option for introducing this coverage is to join the African Trade Insurance network. African Trade Insurance is a multilateral export credit agency that operates in more than a dozen African countries, including Burundi, Kenya, Malawi, Rwanda, Tanzania, Uganda, and Zambia. African Trade Insurance provides not only trade credit insurance, but also insurance for political and commercial risk, project loan cover, and insurance for foreign direct investment.

Services include

- Protection for exporters against nonpayment or insolvency of the buyer before or after shipment in accordance with underlying contractual terms and conditions;
- Access to financing through the assignment of insured receivables under an export contract, as security for working capital finance, or discounting of trade receivables after shipment;
- Better buyer knowledge through due diligence analysis before the issuance of a policy; and
- Debt collection and recovery services for unpaid trade receivables under the terms of the credit insurance policy.

African Trade Insurance has expressed a keen interest in entering the Mozambique market. Membership in the network requires an initial minimum government capital contribution of \$7.5 million. Loans have been available for this purpose through the International Development Association (IDA); cofinancing has been available through the European Investment Bank.

Several microfinance institutions are tying insurance to their regular lending programs.¹⁷ For example, Banco de Oportunidade de Mozambique has teamed with Hollard Insurance to cover each loan at a cost of 0.2 percent of loan value, paid at the time of issuance. Tchuma and SOCREMO are also structuring loans with credit life insurance. Some microfinance institutions are investigating the possibility of offering funeral coverage and disability coverage. These developments are hampered, though, by the lack of reliable health records or access to good health services.

At least one bank reported to the study team that it is exploring the possibility of packaging insurance with loans for export crops such as cotton and tobacco, drawing on experience in

¹⁷ Excellent information on microfinance-related insurance products can be found at: http://microfinancegateway.org/resource_centers/insurance/products .

neighboring countries. Pricing will be an obstacle, but introducing this insurance on loans to larger agribusiness ventures may help stimulate demand across the agricultural sector.

The capacity for development of the local insurance industry is limited by the lack of qualified insurance professionals, including actuarial expertise; the lack of options for investing accumulated reserves and diversifying the investment portfolio; and lack of information on customers. The regulatory system is also very weak. Some steps are being taken to strengthen the insurance sector under the FSTAP; this component, which is being implemented by the African Development Fund, provides assistance to the Inspector General of Insurance (IGS) to develop insurance regulations, establish an effective supervisory framework, and build capacity for prudential regulation of the industry.

The following recommendations, based on this analysis, could help accelerate the development of the insurance industry and increase the availability and affordability of insurance products to serve the business community:

Recommendation: *Encourage competition in the insurance industry.* Competition will be a key factor in promoting innovation and improving the pricing of insurance products. Caution must be exercised, however, to ensure that new companies are sound and reputable.

Recommendation: *Improve dialogue between banks and insurance companies.* In general, loan officers in Mozambique have little understanding of the role insurance can play in mitigating risk and potentially reducing lending cost. The new Insurance Association and the Bankers' Association should work together to develop joint programs to develop synergy between the two industries.

Recommendation: *Enhance the transparency of insurance policies* through laws or regulations requiring policies to describe in simple, nontechnical language the risks being covered and the procedures for entering and settling a claim.

Recommendation: *Expand professional capacity in the insurance industry.* The development of a strong insurance industry depends on the availability of trained insurance professionals. The Insurers' Association should establish training and certification standards for all insurance agents. The association could also offer basic skills training, funded by member fees.

Recommendation: *Review the African Trade Insurance proposal.* Trade credit insurance can be an important tool for expanding access to credit for Mozambican exporters. The government should explore the option of joining the African Trade Insurance network by reviewing materials provided by African Trade Insurance and contacting counterparts in countries like Malawi and Zambia to learn about their experience with the services.

Cleaning up Bad Debts

A common refrain in discussions about credit for the private sector in Mozambique is that some businesses cannot obtain credit because of a legacy of debt. Just as the government obtained

debt relief through the HIPC¹⁸ process, one hears the argument that local businesses should have access to debt relief so that they, too, can restructure their balance sheets and qualify for new loans. The HIPC analogy resonates where local businesses are encumbered by an overhang of debt that cannot be repaid, such as debt incurred on decade-old privatization deals that failed for various reasons (including government policy changes, as with the cashew industry). In this case, a full or partial write-off simply recognizes reality and allows the debtor to move forward with a stronger balance sheet.

The HIPC analogy breaks down, however, because the international process addressed situations for which there did not exist any form of bankruptcy procedure: the settlement of unpayable levels of sovereign debt to official creditors. To circumvent the lack of an international bankruptcy court, official creditors developed a series of work-out arrangements, starting with short-term debt relief and culminating in the HIPC mechanism. The latter approach eliminated a large fraction of the external debt to official creditors for the poorest countries, albeit with extensive conditions.

For a local business burdened by a debt overhang, domestic bankruptcy laws ought to provide recourse for seeking relief and restructuring the balance sheet. In reality, the bankruptcy laws in Mozambique are rarely used, to the point that even most judges are not familiar with the process. Reforms are now underway to modernize the legal framework (see Chapter 7), but it will take years to establish an effective bankruptcy system.

This leaves a debt-laden business the option of negotiating a mutually satisfactory work-out arrangement with its creditors. The settlement could involve a schedule for partial repayment in exchange for a write-off of the balance, or the conversion of some debt to equity.¹⁹ Creditors often have an incentive to negotiate, because it is in their interest to recover a portion of the debt and help the debtor re-establish a viable financial position as a basis for future growth. When the government is the creditor, some flexibility in negotiating a work-out is warranted.

***Recommendation:** Ensure, through active dialogue, that the current process of reforming the bankruptcy law meets the needs of both creditors and debtors.*

***Recommendation:** Establish recommendations on model procedures for working out legacy debts, and provide training to both banks and debt-laden businesses on methods for reaching mutually agreeable settlements.*

Financing from Suppliers or Buyers

For some MSMEs in Mozambique, financing from larger suppliers or buyers can be an efficient alternative to borrowing directly from a commercial bank. Associated businesses have a huge information advantage over banks because they have observed the dependability of small enterprise clients through repeated transactions over an extended period of time. They also have a relatively low-cost mechanism for extending and recovering trade credit, through the normal course of doing business. Furthermore, a valued business relationship is a strong incentive for repayment. Thus,

¹⁸ HIPC is the acronym for the international debt-relief initiative for highly indebted poor countries.

¹⁹ Another option is to close the debt-laden business and reallocate any remaining resources to a new venture with a fresh balance sheet. In Mozambique, however, closing a business is complicated by labor laws that impose an extremely high cost for redundancies.

where regular business ties exist, trade credit should involve less risk and much lower transaction costs than a bank loan. In effect, SMSEs should be able to access credit indirectly through larger associates in the value chain who deal with banks on more favorable terms.

Trade financing is already a common practice in several agrobusiness sectors, notably cotton, tobacco, and sugar. In these markets, relatively large processors supply inputs on credit to hundreds of small outgrowers and collect the repayment plus interest when the crop is harvested and sold, usually through exclusive purchase arrangements. The exclusive purchase arrangement has been controversial because it restricts competition, however. Agrobusiness operators contend that exclusivity is needed to prevent outgrowers from selling to third parties (“side sales”) when the market price is above the contract price, and that the predetermined price is an important device to shield vulnerable outgrowers from the risk of unfavorable changes in market conditions. This is not the place to discuss the pros and cons of exclusivity. The point here is that trade finance can be a valuable channel for supplying working capital to small enterprises that would otherwise lack access to credit.

Aside from the agribusiness sector, the use of trade credit in Mozambique appears to be largely restricted to deals within certain ethnic networks. For general business purposes, the practice is not widespread, even when business relationships are long-standing. Given the advantages of trade financing for MSMEs, its scarcity in Mozambique might be surprising. In fact, a recent World Bank study of small firms in 48 developing countries showed that trade financing is generally uncommon in low-income countries. The study found that credit from suppliers is available to more than 10 percent of small businesses only in middle-income countries like Brazil, Guatemala, Mexico, and the Philippines (Beck et al. 2004).²⁰ This evidence suggests that deeper institutional problems of contract enforcement outweigh the economic benefits of extending credit through a trade relationship.

Even though trade credit may not be available for most enterprises in Mozambique, it could still play an important role for some types of small enterprises, including those involved in cash crop value chains, and enterprises with regular business linkages to international corporations. In many countries, supermarkets have become major vehicles for financing smallholder production of food crops, in combination with providing inputs, technical support, and marketing channels. Hence, the promotion of trade credit should be part of any information campaign to help local businesses solve their financing problems. To this end, CTA members or a donor should undertake a systematic study of trade credit networks in Mozambique to see what is working, identify the constraints, and assess the scope for expanding the use of this efficient mechanism for financing small businesses.

The government and donors can also improve the institutional foundations for trade credit through the ongoing legal and judicial reform process. In particular, the creation of regional small claims courts could reduce the risk involved in extending trade credit to small businesses by providing fast, convenient, and reliable adjudication of small debts. This point will be discussed further in Chapter 7.

²⁰ Beck et al. examines financing patterns for small firms in 48 countries.

Recommendation. *Include information on trade credit as an integral part of any program of technical assistance or public information to help local businesses improve access to credit.* Although it is unlikely that trade credit will be widely used, it can be an important resource for small enterprises that enjoy regular business relationships with larger firms.

Recommendation. *Initiate a study of trade credit systems operating in Mozambique, to assess the conditions that favor success and the constraints to broader access.*

Recommendation. *Include in the legal and judicial reform program new foundations for the establishment of local small claims courts, to support the development of the market in trade credits.*

Strengthening the Business Environment

The most important determinant of creditworthiness is the availability of viable business opportunities. Thus, the quality of the business environment is a critical determinant of access to credit for local enterprises. As business conditions improve—in areas such as infrastructure, elimination of red tape, integrity in public administration, macroeconomic stability, trade facilitation, property rights, contract enforcement, and labor force quality—more businesses will gain access to finance, as the economy creates better opportunities for growth. Indeed, the lack of access to finance today may in large part be a symptom, rather than cause, of poor prospects for private sector development. It is beyond the scope of this paper to enter into a detailed discussion of the overall business environment. Suffice it to say that the government has an essential and continuing role to play in broadening the scope for private sector development by improving the enabling environment and overcoming barriers to doing business.

The most direct and immediate way for the government to alleviate financial constraints for local businesses is to eliminate its own arrears in paying suppliers and contractors, as well as delays in paying VAT refunds.²¹ These practices amount to involuntary loans from cash-strapped enterprises to the Treasury, at zero interest. The sums are often large enough to have a substantial negative effect on the cash flow of the enterprises. If an enterprise manages to cover the cash flow gap by drawing on a line of bank credit, it ends up paying a high rate of interest on funds that are being used by the government, and not for its own business purposes. This egregious problem is entirely avoidable. Indeed, ending arrears should be a basic element of the ongoing program to improve public expenditure management.

A related issue is that local businesses should be able to use government contracts as security for loans. According to central bank officials, accounts receivable from the government are acceptable as collateral (under Aviso 5 of 1999). Yet several businessmen told the study team that banks do not accept this documentation as security. This stance by the banks compounds the financial squeeze caused by government arrears.

²¹ On VAT refund delays, see Bolnick 2007.

Recommendation. *CTA and its member organizations must continue to be strong advocates of market-supporting reforms that are needed to improve the business environment as a requisite for widening access to credit for the private sector.*

Recommendation. *Eliminate government arrears on payments to suppliers and contractors. CTA members should be in the forefront of pressuring the government to deal with this problem.*

Recommendation. *Develop systems for monitoring and publishing data on arrears as in the government's standard budget reports. Without transparent information on arrears, budget accounts may provide a misleading impression of government outlays, the budget balance, and public debt.*

Recommendation. *Streamline the system for paying VAT refunds to eliminate undue delays. CTA members should intensify efforts to work with the Revenue Authority and the Ministry of Finance to implement recommendations made in other reports to end delays on VAT refund payments and improve the transparency of the refund mechanism.*

Recommendation. *Ensure that banks apply the regulation permitting the use of accounts payable from the government as security for loans. The CTA's Financial Sector Working Group should confer with the banking supervision department at the Bank of Mozambique to ensure that banks understand and apply the pertinent regulations.*

ENABLING BANKS TO EXPAND LENDING

The previous section examined ways to expand access to credit by enhancing the creditworthiness of local enterprises. Equally important are measures that enable banks to overcome obstacles in dealing with nontraditional clients. The obstacles include a lack of information on loan applicants and small business operations in general; high administrative costs, which limit the viability of small loans; and inherent aversion to risk, which reduces the incentive to invest in testing innovative approaches to penetrate new markets.

This section focuses on four methods for dealing with these obstacles: restructuring the credit information system; providing technical support to identify new lending opportunities; assisting in the development of products and procedures for dealing with SMEs; and offering partial credit guarantees as a catalyst for innovation.

Another way to expand banking services into new markets is through the pressure of competition. As financial markets develop, profit margins on traditional lending business decline, and high-grade borrowers gain more choice on where and how to obtain financing. These trends will create strong incentives for banks to seek new clientele. Financial sector competition is discussed further in chapter 6, in the context of examining the problem of high interest rates.

Restructuring the Credit Information System

Asymmetric information is a major obstacle to lending. Without detailed information on the qualifications of particular loan applicants, banks often perceive that loans are too risky, even if the business prospects are fundamentally sound. One of the most effective ways to reduce the

severity of this constraint is to reform the credit information system. In the view of the IMF, a well-functioning credit information system provides lenders with “rapid access to accurate and reliable standardized information on credit history and financial condition of potential borrowers” (IMF 2005, 256).

The World Bank’s widely cited Doing Business reports highlight the importance of credit information systems. Under the category “Getting Credit,” rankings for each country are based on four indicators, of which three involve the depth and coverage of credit information systems. (The fourth is an index of legal rights.) The Bank gauges the depth of credit information using six criteria, which include the use of positive information (for example, on-time repayment patterns) as well as negative data (defaults and late payments), and the use of data from retailers, trade creditors, or utilities to supplement data from financial institutions.²²

In Mozambique, there is now one credit information system, run by the Bank of Mozambique. The system, called the Central Credit Registry, contains information on borrowers with current loans from registered financial institutions supervised by the Bank of Mozambique, along with data on debts that have been written off and other outstanding accounts.²³ The credit information system is accessible only in the network of reporting institutions and is subject to bank secrecy rules.²⁴ This electronic database provides banks with important information for screening out loan applicants with a record of poor repayment. But it falls far short of best practices in providing data on the creditworthiness of other clients.

Without exception, all of the financial sector officials, central bankers, and private sector representatives interviewed for the present study endorsed the idea of establishing a privately run credit information service that would provide broader coverage of the economic population, more comprehensive data on credit history and financial condition, and wider access to the information to support a variety of financial transactions. Additional data items could include current and past account balances, checks returned for insufficient funds, regularity of payments on utility bills and credit cards, and notices on tax arrears.

This information would help financial institutions expand the scope for lending, reduce the time and cost required to screen loan applications, and ultimately lower the cost of borrowing. The system would also create strong incentives for potential borrowers to manage their finances carefully to establish a record of honoring obligations. In addition, a reliable credit information system could assist local businesses in obtaining trade credit from both domestic and international suppliers.

A great deal of work is needed on the institutional design to ensure that a bureau of this sort could operate on a sound financial basis—which entails a willingness of clients to pay for the service.

²² See <http://www.doingbusiness.org/MethodologySurveys/GettingCredit.aspx> .

²³ Regulations governing the Central Credit Registry are defined in Bank of Mozambique’s Aviso 007/GGBM/2003 (Millennium Challenge Corporation 2005, 23).

²⁴ Debtors and prospective debtors have the right to know the information related to them as well as to request clarifications, corrections and updates. Such persons are also entitled to appeal to the Bank of Mozambique.

Also needed is a solid legislative foundation and effective supervision and regulation. Equally important, the system requires strict attention to information security, along with measures to protect consumers against the posting of false or misleading information and tight safeguards against political interference.

The International Finance Corporation (IFC) and the Millennium Challenge Corporation (MCC) have considered supporting the creation of a private credit bureau along these lines. In addition, the U.S. government funds are available for expanding credit bureaus in southern Africa through the AGCI (MCC 2005).²⁵ Whether or not these particular sources of funding materialize, private sector stakeholders should advocate for this reform. If funding becomes available, the CTA's Financial Sector Working Group (*pelouro*) should participate in the dialogue on the institutional design to ensure that the system meets the needs of borrowers as well as lenders. CTA members can also be important agents for informing the private sector about the new system and advising local businesses on how to develop a solid credit rating.

Recommendation: *The CTA's Financial Sector Working Group should collaborate with donors on the establishment of a private credit bureau to ensure that the private sector is represented in discussions of the design of a new information system for financial transactions.*

Recommendation: *CTA, or member organizations such as the Bankers' Association, should inform the private sector about the establishment of a new credit bureau and provide information about financial practices needed to build a good credit rating.*

Identifying New Lending Opportunities

Another mechanism for dealing with information constraints is technical support to banks to help them ascend the learning curve of identifying profitable opportunities for lending to enterprises that lack the capability to submit standard accounts and business plans. Technical assistance to banks complements the provision of business support services to SMEs.

An early prototype for this approach was the Small Enterprise Development Program (SEDP) in Indonesia.²⁶ Introduced in 1978 with World Bank support, the aim of the program was to develop indigenous businesses and create jobs by educating bankers in how to deal with MSMEs. The technical assistance focused on producing case studies in 12 provinces, showing banks how loans could be structured for common MSME activities such as furniture making, vegetable farming, fishing, brick making, fruit beverage producing, minibus operation, mattress selling, and beauty salons. Study teams operated out of regional offices of the central bank, and study findings were distributed to commercial banks on the authority of central bank regional managers.

The SEDP also provided training for bankers on MSME lending, as well as technical and financial support to help banks gain experience in implementing streamlined lending procedures

²⁵ See http://www.agoa.gov/agoa_forum/USAID%20Press%20Release%20-%2005-11-06.pdf for a general description of the AGCI.

²⁶ This example is based on the author's experience as SEDP economic adviser to Bank Indonesia from 1980 to 1982.

for the small loan market. By 1980, the World Bank cited SEDP as the largest program in the world for micro and small enterprises loans. The SEDP scheme had a serious flaw, however—loans were subsidized and guaranteed. As a result, the loan portfolio proved to be unsustainable. But the learning and training components had lasting effects in helping banks penetrate the MSME market. Most notably, the country's largest bank, Bank Rakyat Indonesia (BRI), embraced this market and went on to develop an extremely successful and profitable microfinance program, which is discussed in the next section. These innovations were championed by the president of BRI, who had headed the SEDP at the central bank.

Providing technical assistance to banks in understanding the prospects for lending to local MSMEs is undoubtedly important, yet the information itself may not lead banks to pursue this market. One reason is the cost of investing in the development of streamlined lending procedures and retraining loan officers, which makes it difficult for small loans to be profitable. Entering this new line of business entails a substantial upfront investment and a likely initial period of losses. Hence, mainstream banks may calculate that the costs and risks outweigh the benefits of the innovation.

But breaking through this barrier can yield large economic and social benefits for the national economy. In view of these development externalities, donors should consider providing technical support to banks in appropriate lending techniques, along with temporary financial support to defray the costs and risks of innovation. The next two subsections focus on these issues.

***Recommendation:** Donors should consider a program of pilot case studies to educate bankers about viable opportunities for lending to local MSMEs.*

Introducing Appropriate Lending Techniques

Another promising method for expanding access to bank credit in Mozambique is the introduction of appropriate techniques for lending to SMEs. Standard banking practices depend heavily on processing information about each credit application and involve relatively high transactions costs. These methods are ill suited for dealing with unsophisticated customers and small loans. For example, one banker told the study team that it can take four to five weeks to analyze a credit application in Mozambique, compared to less than one day in Portugal, for lack of data on market conditions for many products. His conclusion was that such loans are very difficult to handle. As Figure 4-1 shows, major banks in Mozambique are far less efficient in processing SME loans than banks in other African countries. An alternative conclusion, however, is that this banker needs to learn about other methods for handling loan applications from entrepreneurs who do not have the capacity to provide a business plan with a careful market analysis. Indeed, another bank told the study team that it routinely approves small loans in one day, based on microfinance principles, and does so profitably (though at very high interest rates).

Fortunately, there is no need to create new lending technologies out of whole cloth. Through decades of experimentation and competition, the microfinance industry has demonstrated the viability of many methods for mitigating risks, reducing costs, and providing financial services to

small enterprises in low-income countries with weak institutional infrastructure.²⁷ The discovery of cost-effective technologies has been called the “real genius” of the microfinance industry (Roodman and Qureshi 2006).

Figure 4-1
Time to Process SME Loans

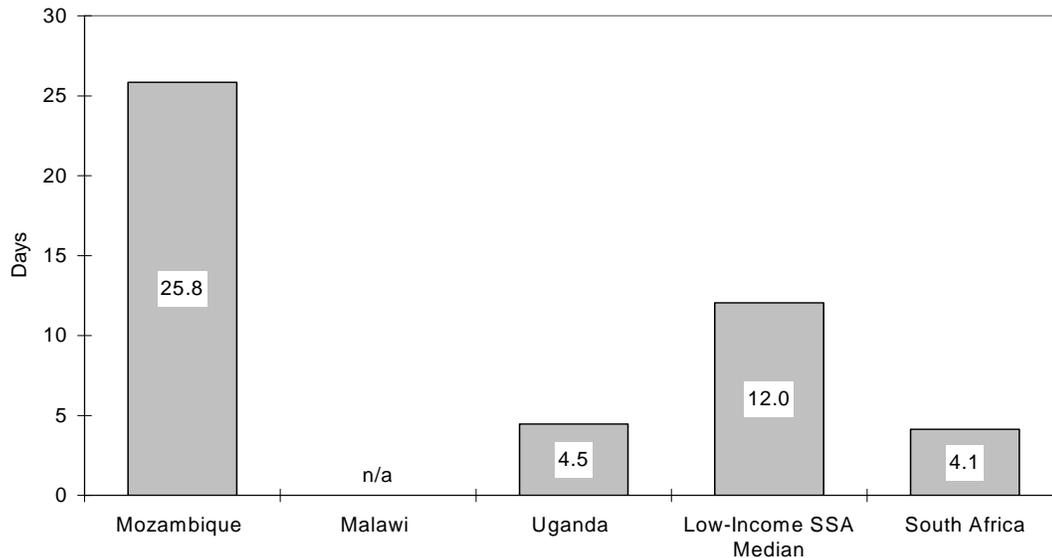


Exhibit 4-1 presents the pioneering example of Bank Rakyat Indonesia (BRI), which introduced innovative financial services more than 20 years ago and transformed microfinance into a major profit center for the largest bank in Indonesia. Commercial banks throughout the world have been adopting techniques of this sort to move down market on a commercial basis, just as microfinance institutions have been formalizing and moving up market using proven techniques for low cost lending (de Ferranti and Ody 2007).

This is not the place to discuss microlending techniques in detail, but some examples may be instructive. Many financial institutions serve the lower end of the business pyramid at low cost by offering a standard menu of simple products and a technology interface that can be handled easily by inexpensive staff. These techniques also boost demand, because simplified processes encourage small clients to step through the door. Another method for minimizing risk is to limit the initial loan to a very small amount based on qualitative information, and then boost the limit gradually according to repayment performance. Lending costs are greatly reduced for repeat business. Banks can also improve efficiency by dealing with clusters of similar small borrowers, to spread initial costs and overheads. As the BRI example shows, there is also enormous potential demand for well designed savings services, which can add to the profitability of serving this segment of the market. Finally, the BRI case demonstrated the importance of establishing management systems and incentives for bank staff to deal with small loans and small savings accounts.

²⁷ Principle sources of information on microfinance techniques are the Microfinance Gateway, the Consultative Group to Assist the Poor (CGAP), and the Microfinance Information Exchange (MIX).

Exhibit 4-1

BRI's Rural Unit Program in Indonesia

Banks in many developing countries have established profitable programs for lending to MSMEs. The Rural Unit program at Bank Rakyat Indonesia (BRI) has a special place in the microfinance hall of fame as the earliest such program to achieve full commercial viability on a large scale. For more than two decades, this program has been a major profit center for the largest bank in Indonesia.

From 1970 through 1983, BRI handled special government credit programs for micro and small enterprises and small farmers. These programs were heavily subsidized and ultimately unsustainable. Starting in 1984, the bank phased out subsidized lending and adopted an entirely new approach to serving the same clientele through its rural units (unit desas). The new lending program, called KUPEDDES, was carefully structured to meet the needs of target borrowers and yield a profit for the bank. This was done by designing very simple procedures to minimize transaction costs and setting interest rates to cover these costs (including the cost of funds). A major innovation was to introduce bonus incentives for bank officers in the field, to promote these loans (Patten and Rosengard 1991).

The KUPEDDES program includes loans for working capital and investment capital, for up to 36 months. Entirely new businesses are ineligible.

Loans are extended to individual borrowers, not groups, with no restriction by economic sector. Loans are standardized and packaged in terms that unsophisticated clients can easily understand. Some standardized loans include a grace period to suit client cash flow patterns. Borrowers can increase their credit limit as they repay loans on time. The interest rate is 3.5 percent per month, with 0.5 percent per month refunded upon timely repayment of the full obligation. The program requires collateral, such as land, buildings, motorcycles, or personal property. Due to the cost of foreclosure, however, assets are rarely seized. The collateral serves mainly as a screening device and a psychological incentive for repayment.

By 1985, BRI added a special saving scheme to expand the funding base for KUPEDDES loans. The scheme was carefully designed to appeal to very small savers and also to provide incentives for bank officers to mobilize funds. At the end of 2005, BRI's special programs for micro and small customers covered 3.3 million active borrowers and more than 32 million savers (Microfinance Information Exchange 2007). The average loan balance has risen over the years to \$700; the average saving balance is \$116. The program has been highly profitable every year since 1986, even through the travails of the Asian financial crisis.

As noted above, most commercial bankers do not know much about these techniques for lending, and those who do may not perceive this unfamiliar line of business as a profitable market opportunity. Thus, donor support may be needed to help banks cover the risks and costs of introducing these new lending practices.

Recommendation: Donors can help banks overcome lending barriers by providing technical assistance, and even temporary cost-sharing arrangements, as a catalyst for testing financial techniques that are appropriate for serving the savings and credit needs of SMEs in Mozambique.

Underwriting Innovation with Partial Credit Guarantees

Many business leaders in Mozambique advocate the use of government- or donor-funded guarantees to stimulate bank lending to clients who would not otherwise qualify for credit. More often than not, government-financed guarantee schemes turn out to be little more than subsidies

in disguise, driven by political considerations and rent-seeking special interests. Nonetheless, major donors such as the World Bank and USAID have supported guarantee schemes in many countries. The justification is that risk-sharing can be an effective catalyst to induce banks to test new markets and loan products and overcome information constraints that restrict lending to nontraditional customers. The objective is not to subsidize borrowers, but rather to promote financial innovations that foster broad-based growth and poverty reduction.

USAID provides credit guarantees of up to 50 percent through the Development Credit Authority (DCA).²⁸ There are four types of DCA arrangements: guarantees for participating lenders on loans to approved borrowers; guarantees on bond issues; guarantees on designated loan portfolios (distinct from individual loans); and portable guarantee commitments provided to individual businesses for negotiating loans with banks of their choice. In Mozambique, USAID has used the DCA for loans from BCI-Fomento to new cashew-processing factories in the north.

The World Bank has also funded many guarantee schemes around the world since the 1980s, mostly in the context of SME financing programs. Although some have been successful, the Bank now takes a more cautious approach, emphasizing that most efforts have failed to deliver sustainable benefits and that guarantees often become “a large honey pot attracting rent-seekers” (World Bank 2007, 83)

Indeed, there are significant drawbacks to weigh against the advantages.²⁹ If banks have a negative view of a loan applicant’s prospects, they will not lend even when half the risk is borne by a guarantee fund. And if they have a positive view, then the guarantee may be unnecessary and ineffective. Only in marginal cases will a partial guarantee make a difference and stimulate new lending. The scope for success is further diminished by the fact that guarantees entail extra transaction costs for banks. On small loans, the costs can exceed the value of the guarantee.³⁰ In addition, guarantees create moral hazards, as the arrangement may alter borrower behavior and make default more likely. (This outcome is especially common with government-backed guarantees). A guarantee can also create moral hazard on the part of the handling banks by diluting their incentive for recovering small overdue loan payments.

Another problem relates to pricing the guarantee. With a low fee, banks have an incentive to use the scheme for loans that would be made anyway, and the guarantee fund will not be in a position to cover its costs. With a high fee, banks might not be interested in using the scheme at all. Most donor-funded schemes, including DCA facilities, involve fees that do not cover the full costs; the implicit subsidy is presumably justified on the premise that guarantee schemes yield significant

²⁸ See http://www.usaid.gov/our_work/economic_growth_and_trade/development_credit/index.html .

²⁹ For a recent and well balanced assessment, see Balkenhol 2006.

³⁰ A senior official for BancoNovo told the study team that his bank prefers not to participate in credit guarantee programs.

development externalities by stimulating risk-averse “pioneers” to enter a market ridden with information constraints (Freedman 2004).³¹

These concerns suggest that the other measures discussed above should be the first recourse for helping banks learn to deal profitably with nontraditional clients.

Recommendation. *Credit guarantees can be a useful tool for helping banks learn to deal with new types of clients, but they must be designed as a catalyst for innovation, rather than becoming a subsidy for lending or an inducement to ignore genuine credit risks.*

Recommendation. *Any credit guarantee program aimed at MSMEs should have a minimum of bureaucracy and a maximum risk-share of 50 percent, sliding to zero in five years.*

Recommendation. *The CTA’s Financial Sector Working Group should work with USAID and other agencies to study the scope for credit guarantees, taking into account both the advantages and disadvantages of a guarantee scheme.*

ROLE OF MICROFINANCE

Microfinance has been defined as “the supply of loans, savings, and other basic financial services to the poor...to run their businesses, build assets, stabilize consumption, and shield themselves against risks.”³² This definition indicates that the main purpose of microfinance is to help poor households escape the poverty trap and cope with shocks through access to loans, deposit accounts, transaction services, and (more recently) insurance. A focus on the poor generates important social welfare benefits. Yet very few of these clients have the capacity to blossom into dynamic businesses (Ferranti and Ody 2007). Many microfinance institutions also diversify up market and provide a critical entry point into the financial system for small businesses with more potential for growth. In addition, as discussed above, the microfinance industry has been an outstanding engine for innovation in cost-effective financial technologies, some of which can be adapted for use by commercial banks. All of these functions—helping the poor, providing an entry point to finance for small businesses, and demonstrating new financial technologies—are important for the development of financial markets in Mozambique.

An excellent study by Fion de Vletter (2006) reviews the history of microfinance in Mozambique, the status of the industry in 2005, its potential for growth, and challenges for the future.³³ Until recently, the industry was dominated by scattered NGO operations with limited coverage, an unsustainable dependence on subsidies, and a narrow focus on credit services. In 2004, the government clarified the legal and regulatory framework (see chapter 7). Since then, the industry

³¹ Freedman states, “USAID charges an upfront commitment fee and an annual utilization fee for its DCS guarantees. These fees are set below a cost-recovery level” (p. 14). The gap is covered by annual appropriations from Congress.

³² <http://www.cgap.org/portal/site/CGAP/menuitem.9a218408ac5bc61fae6c6210591010a0/> .

³³ De Vletter’s study is available at www.undp.org/mz/en/content/download/296/1405/file/microfinance%20in%20mozambique%20report%202006.pdf

has developed stronger institutional foundations. Overall, de Vletter identified 32 microfinance institutions, including small local entities. The major ones are formal financial institutions that operate on a commercial basis under central bank regulations, with audited accounts. NovoBanco, SOCREMO, and a new entrant, Banco de Oportunidade de Mocambique, are registered commercial banks, which allows them to offer savings and transactions services as well as credit. Another major institution, Tchuma, is a registered credit cooperative.

The industry has entered a phase of rapid growth. SUCREMO, for example, nearly doubled its loan portfolio in 2006, while lending by NovoBanco grew by nearly 60 percent.³⁴ At the end of 2006, NovoBanco alone served more than 64,000 savers and had more than 21,000 active loans totaling \$12.9 million. The major institutions are also branching out spatially, as core urban markets become increasingly competitive. For example, Banco de Oportunidade de Mozambique is initiating rural mobile banking services, and NovoBanco is entering the market for agricultural loans this year. These trends are especially heartening because they reflect organic growth on a commercial basis, rather than an expansion driven by unsustainable subsidies.³⁵ The microfinance industry, however, is still very small for a country with a population of nearly 20 million. Outreach is particularly weak in rural areas, where most people reside.

One reason for limited penetration of the rural economy is simply that the industry is still at an early stage of development. But there are also real constraints to delivering financial services in rural areas characterized by severe poverty, dispersed populations, and high costs for transportation and communications. In light of these problems, the natural course for *commercial* microfinance institutions is to operate initially in urban areas, then expand into secondary towns and rural areas that are reasonably accessible by road. This process is now well underway.

For localities that cannot support commercial operations, limited financial services can be provided through various sorts of village saving and credit schemes. Another option, of course, is to underwrite financial services with subsidies, in the interest of poverty alleviation. There are always pressures to apply subsidies as the solution to this problem. But subsidized schemes are inherently unsustainable, and therefore do not contribute to financial sector development. Worse, they tend to subvert the expansion of other approaches to rural finance that are sustainable. Thus, the social objectives are best pursued in other ways, such as community development grants.

These observations are particularly important for the \$34 million RFSP, which will operate for the next eight years under the government's Economic Development Support Fund (*Fundo de Apoio à Reabilitação Económica*, or FARE), with support from IFAD and the African Development Bank. The objective of the RFSP is to "improve the livelihoods of rural households and the viability of rural enterprises" through "sustainable provision of rural financial services" (IFAD 2003, vi).³⁶ Ironically, FARE's previous operations epitomized the failure of state-led,

³⁴ The first set of figures comes from interviews with senior officials. The details for NovoBanco are from the bank's 2006 report, available at: <http://www.mixmarket.org>. This website has detailed financial and outreach data on major microfinance institutions worldwide, including nine in Mozambique.

³⁵ In contrast, a recent study in Malawi finds "no microfinance operations in Malawi that are fully financially viable" (Burritt 2006, 7).

³⁶ Even though the IFAD document is dated 2003, the program did not start until 2006.

subsidized credit in Mozambique. Now FARE managers are committed to fostering sustainable business solutions to rural finance problems. FARE will do this under RFSP through technical assistance, grants, and cofinancing on soft terms, to help client institutions cover the startup costs of developing new rural markets.

The obvious danger is that RFSP may itself become a source of subsidies that undermine the sustainability of rural finance solutions. To avoid this trap, FARE will have to be very careful in selecting subprojects that foster innovation and outreach without distorting market development, and avoid political interference in the funding decisions. This will not be easy, when program managers face pressure to disburse \$17.4 million in grants and soft credits. The managers, however, express confidence that their objectives, rules, and procedures are clear, and decisions will be made on technical grounds, without political overtones.

To strengthen adherence to the intended approach, it would be helpful for FARE to work closely with the Micro Finance Working Group, which donors have established to coordinate assistance in this sector. Even if the working group has no authority over decisions, it can play a useful role as an independent advisory body to review and endorse FRSP funding decisions.

***Recommendation.** Let the microfinance industry continue to grow organically, on a commercial basis, rather than promoting unsustainable subsidized schemes to provide financial services to the rural poor.*

***Recommendation.** In rural areas where commercial financial services are not available, poverty reduction objectives should be pursued through programs other than subsidized credit.*

***Recommendation.** Establish close coordination between FARE and the Micro Finance Working Group as an independent advisory body to review RFSP funding decisions, to ensure that RFSP achieves its objective of fostering innovation and outreach without undermining the development of sustainable rural financial services.*

MOBILE PHONE BANKING: ACCESS THROUGH TECHNOLOGY

The application of mobile telephone technology to banking services (called “m-banking”) is one of the most exciting trends in the world of banking. This development will transform access to financial services in countries like Mozambique, where poverty and geography limit the physical infrastructure of the banking system. The technology already exists, it can operate in remote areas where there is no bank office or land-line phone service, and it is cheap enough to attract a broad customer base and run profitably for even tiny transactions.³⁷

M-banking is expanding rapidly in developing countries. The Philippines is a market leader, with two mobile phone companies serving nearly 4 million customers. The services include access to account balances, payment transactions, fund transfers, and even international remittances, all at

³⁷ CGAP, a multilateral organization that includes most major donors, has excellent information on m-banking technology at <http://cgap.org/portal/site/Technology/>. CGAP recently received a \$24 million grant from the Gates Foundation for programs linking technology and microfinance.

an extremely low cost (Porteous 2006, 23). DfID is also supporting a microfinance scheme through which TEBA Bank in South Africa is opening minibranches in 20,500 retail outlets (DfID 2007). The retailers can both accept payments and pay out money through cell phone connections. Also in South Africa, the WIZZIT system, which operates as a unit of the South African Bank of Athens, targets previously unbanked population groups; the system signed up more than 50,000 customers in the first two years of operation, with brick and mortar offices of its own. The average cost per transaction is USD 0.04 (CGAP et al. 2006, 10). In Kenya and Tanzania, DfID and Vodaphone are piloting schemes to bring m-banking to remote villages, including access to loans through a participating microfinance institution.³⁸ M-banking is also getting heavy promotion by major banks in Nigeria. In Mozambique, several banks do provide basic m-banking services, including access to account balances and payment of certain bills, but only to customers who already have a bank account and a mobile phone contract.

Although m-banking is suitable for any level of clientele, it is especially relevant for micro and small clients, and sparsely settled rural areas with cellular service. In Mozambique, mobile phone networks reach all major cities, most towns, and many villages throughout the country. Yet nothing has been done to promote this technology as a means for providing banking services to the vast majority of the population outside major urban centers.

In a recent paper on rural finance, the Bank of Mozambique recognized the enormous potential of m-banking (along with mobile banking and point-of-service agencies) for expanding financial intermediation to rural areas (Bank of Mozambique 2007). This leap in technology now needs a catalyst in the form of donor support and strong advocacy by stakeholder groups to broaden access to financial services. In conjunction with efforts to implement the technology, a public education program is also needed to help the business community and the population at large to learn about the technology.

In addition, the regulatory framework may require further development to protect consumers, ensure system security, establish clear rules for the operation of remote agencies (Lyman et al. 2006). Banks are already permitted, however, under Article 4 of Law 15/99, to carry out “other operations” analogous to those permitted by the law. Unlike many other domains in Mozambican law where innovation depends on prior regulation, this provision allows financial institutions to innovate at their own pace. The legal field is therefore open for mobile telephone banking to develop even before enabling regulation is available. All that may be required in the near term for the practice to take off is a nod of encouragement from the Bank of Mozambique. A more developed regulatory regime may follow later. Banks are already sufficiently regulated and supervised to enjoy the benefit of the doubt that the legislature has allowed them. M-banking can generally be structured to eliminate the risk of large-scale money laundering, since the system is most suitable for small payments.

Initially, services are likely to concentrate on deposits and withdrawals from accounts, electronic payments, including transfers between individuals, and remittances to or from family members in other regions or countries. These are valuable services in their own right for rural and poor

³⁸ See DfID’s website and Porteous 2006, 25.

households. Before long, though, innovative financial institutions are likely to add credit services to the mix, in pursuit of profits at the base of the economic pyramid. Another impetus to the spread of m-banking is that the technology also creates large new marketing opportunities for cellular phone operators.

Recommendation: *With donor support, the Bank of Mozambique should convene a national conference on mobile phone banking, to discuss steps that can be taken to take advantage of this transformative new technology for delivering financial services in Mozambique.*

5. Improving Access to Term Finance for Investment

The previous chapter examined access to finance in general terms. This chapter focuses on longer-term lending for private investment. Investment lending is widely viewed as one of the most important problems in finance for development. Long-term investment credits are also riskier and technically more difficult than normal commercial loans because the payoff for capital investment is inherently less predictable than the short-term cash flow from high-turnover operations.

In Mozambique, private capital formation over the past decade has been dominated by large-scale foreign investors with ready access to international capital markets. Meanwhile, the vast majority of locally owned businesses lack means to finance the investments that are essential for restructuring, expansion, and new ventures. This gap in the financial system has motivated strong interest in the establishment of a new development finance institution (DFI). The first section of this chapter assesses a leading proposal for a DFI in light of experience with development banking in several other countries—lessons of both success and failure. We emphasize the identification of factors that would determine the likelihood of success for any new DFI in Mozambique. Taking these considerations into account, any decision on the viability of a DFI lies in the hands of the investors who would be putting their money at stake.

The creation of a national DFI is not, however, the only way to expand investment finance for the productive sector in Mozambique. The chapter examines four other options: participation in a regional development bank, which could reap scale economies and benefits of diversification; expansion of asset-based lending; creation of a “second-tier” bond market; and providing technical support to local businesses with strong prospects, to help them tap into rapidly expanding pools of risk capital for Africa. The chapter also touches on the underlying problem of mobilizing long-term savings, which are essential for any serious expansion in long-term lending. On this side of the picture, the central issue is pension reform. The final section of the chapter pulls together the major conclusions and recommendations from the analysis.

SHOULD MOZAMBIQUE ESTABLISH A DEVELOPMENT BANK?

The proposal to establish a new DFI in Mozambique has been hotly debated. Many (but not all) business leaders favor this approach. A DFI has also been endorsed in the national vision

statement, Agenda 2025.³⁹ Many donor agencies and international experts, however, have expressed deep doubts about the advisability of creating this new institution; their view is based on the widespread failure of efforts to establish DFIs in the past. But many local stakeholders are not swayed by the argument. They see that past failures were based on a parastatal model that is very different from the approach now proposed. Furthermore, some countries do have DFIs that function well from both financial and developmental standpoints. Perhaps the most important point, however, is that many business leaders consider the risks involved in establishing a DFI to be worth taking because they view the lack of investment finance as a serious obstacle to private sector development, job creation, sustainable growth, and poverty reduction.

We do not attempt to answer the question definitively, but instead to present a balanced analysis that addresses some pertinent questions: How have DFIs succeeded in places like Brazil and South Africa? Why have they failed in many other countries? What can we learn from this experience about the conditions needed to make a DFI work in Mozambique? What factors contribute to the likelihood of success or failure?

Experience in Other Countries

Accounts of international experience with DFIs in developing countries typically dwell on the negatives. The reason is simple: many governments and donor agencies, including the World Bank, spent decades supporting DFIs that turned out to be costly failures that delivered little or no sustainable impact on development (World Bank 2007, 87). These institutions were created to fill exactly the financial market gap that exists today in Mozambique. In some cases, as in Malawi and Liberia, DFIs worked very well for several years, before succumbing to poor financial management, political interference, or political risk. More commonly, state-owned DFIs had a consistent record of poor lending decisions that had high fiscal and economic costs and undermined the development of sound financial institutions. By accumulating large portfolios of nonperforming loans, poorly run DFIs also create dangerous systemic risks to the financial system.

The basic problem is that most failed programs involved parastatal organizations. The obvious lesson—which stakeholders in Mozambique appear to accept—is that government control and politically motivated decisions on lending and staffing are a recipe for failure. The quality of human resources, the structure of corporate governance, and the incentives associated with a commercial orientation are vital success factors. In addition, having outside capital at stake creates a strong (though not foolproof) motivation for sound management and prudent lending practices.

With these premises in mind, many countries in eastern and southern Africa have been seeking to restructure or privatize previously unsuccessful development banks, or establish new ones with a modern approach to governance and management. In some countries, such as Uganda and Kenya, former parastatal development banks have been converted to private control, but the loan

³⁹ The proposal is presented in Section 6.4.3.9.1 of the Agenda 2025 document, which opens with the statement “The establishment of a development bank may play a crucial role in economic development in Mozambique.”

portfolio has shifted to a pattern more typical of commercial banks (World Bank 2007, 88–89). Closer to home, SADC’s Development Finance Resource Center (DFRC) has been working with a network of regional DFIs to restructure along commercial lines, with support from the Southern Africa Development Bank. Our interview with technical specialists at DFRC did not elicit much optimism about the outcome of these efforts. Moreover, a recent effort by the multidonor Financial Sector Reform and Strengthening Initiative (FIRST) to support the DFRC network ended prematurely when the consultants determined that most DFIs in the network lacked a sound business strategy, and several appeared unsustainable (FIRST 2005).

With everyone now well aware of the failures of the parastatal model, what accounts for the lack of recent DFI successes in low-income African countries? The answer seems to lie in a familiar set of constraints: weak economic fundamentals, lax accounting standards, and weak legal and judicial foundations for securing creditor rights.

On the other side of the ledger, DFIs are now operating successfully in some countries, often with the backing of international agencies. One widely cited example is the Banco Nacional de Desenvolvimento Econômico e Social (BNDES) in Brazil. For decades, BNDES was a highly politicized organization that depended on huge budget subsidies to offset losses stemming from a politically driven mismatch between the cost of funds and the return on loans. Today, despite continued government control, BNDES is a highly professional, financially solid, well-managed organization.⁴⁰ BNDES is one of the biggest banks in Brazil, with nearly \$70 billion in outstanding loans in 2006, including a large portfolio of loans to productive sectors. BNDES also has a stellar bad-debt ratio of under 1 percent and had a return on equity of 36.4 percent in 2005.

BNDES has benefited from captive savings generated by government social programs and substantial borrowing in the domestic and international capital markets. As with most financial intermediaries, these liabilities leverage the capital base so that the bank can earn a high return on equity with a low return on total assets.⁴¹ Without this advantage, lending rates would have to be far higher. Access to capital markets also provides a vehicle for exiting investment positions involving equity or quasi-equity financing.⁴²

BNDES also has the advantage of a deep pool of highly educated and skilled personnel, a huge and diversified domestic economy, well-developed domestic capital markets, and excellent infrastructure to support the productive sector. In each of these respects, BNDES is not a suitable benchmark for Mozambique.

Much the same can be said for the Development Bank of Southern Africa (DBSA), which is also mentioned frequently as an example for Mozambique to emulate. As a government-owned institution, the DBSA received sizable budget subsidies for the first 10 years of operation. In addition, DBSA invests primarily in infrastructure projects. Only a small portion of its portfolio is

⁴⁰ See: www.bndes.gov.br/english/performance.asp.

⁴¹ BNDES earned this high rate of exchange with an ROE of 3.5 percent by leveraging its equity.

⁴² Ironically, one criticism of the old DFI model is that it inhibited the development of a capital market by offering subsidized investment financing.

allocated to private sector investments, mostly based on conservative criteria that would screen out all but a few locally owned businesses in Mozambique.

India is similar to Mozambique in that it is a low-income country with serious infrastructure deficiencies, including a highly inefficient judicial system. But in many other respects, the foundations for development banking in India are far stronger than in Mozambique; these include a vast supply of skilled human resources, large market, diversified economy, and access to capital markets.

Indeed, it is difficult to find a comparator country that is structurally similar to Mozambique and has a successful development bank. It is important, nonetheless, to draw lessons from the successes. An especially instructive example is Peru's national development bank, COFIDE. In the past, COFIDE was a typically inefficient and politicized parastatal development bank in a relatively poor country. Today, the organization is a highly efficient second-tier DFI. (This means that COFIDE channels loans through other financial institutions.) One key to success has been high-caliber staffing. Another fundamental asset has been top-level political support for the development of commercially viable instruments to finance private investment, with an emphasis on export-oriented agriculture and SMEs—without the political baggage that undermined so many other state-owned DFIs. The process of transformation also involved some creative solutions to structural constraints, as outlined in Exhibit 5-1.

What is Proposed for Mozambique?

A widely discussed proposal for Mozambique (Ratilal 2006, points 37, 43, and 44). would create a professionally managed national DFI as a public–private partnership, with majority control by parties other than the government. The proposed DFI would be a second-tier lender (like COFIDE) that would operate for profit, without interest rate subsidies from the government. Some have suggested, however, that the DFI should enjoy a subsidy through access to funding on soft terms from international agencies, as well as credit guarantees to ameliorate lending risks. (These attributes are stated explicitly in the Vision 2025 statement.) The new development bank would undertake medium- to long-term lending for productive investment projects, focusing on needs unmet by current financial markets, particularly in rural areas.

Several people interviewed for this study considered the issue already to have been resolved, through the decision of GAPI and Rabobank (Netherlands) to open a new universal bank that will focus on lending to agriculture and SMEs. Many others, however, continue to press for a larger national institution.

Factors Influencing the Likelihood of Success in Mozambique

The international evidence discussed above suggests the factors that will influence the likelihood of success for a national DFI in Mozambique. Interestingly, all three successes cited—BNDES, DBSA, and COFIDE—are state-owned banks. Evidently, state-owned DFIs can run profitably and effectively under some circumstances. Even so, the fact that virtually all parastatal DFIs in low-income countries of sub-Saharan Africa failed financially—and as agents of development—creates a strong presumption against the parastatal model for Mozambique.

Exhibit 5-1

Keys to Success for COFIDE in Peru

The Corporación Financiera de Desarrollo (COFIDE) is Peru's national development bank. For decades, COFIDE operated as an old-fashioned, inefficient parastatal, financing politically driven projects and businesses. In 1992, it was restructured as a wholesale (segundo piso) bank operating on commercial principles. The new institution is professionally managed and highly successful.

COFIDE provides term loans through "first floor" retail banks, with a focus on financing exports, SMEs, and agriculture. The bank raises medium- to long-term funds from international financial institutions, domestic capital markets, international lenders, and government agencies. The cost of funds is market based, but at favorable interest rates because of the bank's strong balance sheet and government backing. COFIDE passes this advantage on to its customers, but with an ample margin to cover administrative costs and risks (as the World Bank does with IBRD loans).

From 2001 to 2006, COFIDE was headed by a well-known development economist, Daniel Schydrowsky. According to Dr. Schydrowsky, the foremost secret of COFIDE's success is that COFIDE recruited top-caliber staff and provided intensive training in economics, finance, banking, and management.

The bank also devised creative mechanisms to solve major problems in financing agriculture and SMEs. COFIDE designed simplified loan products on the basis of market research to determine how to serve clients best. To further reduce costs, COFIDE works with clusters of farmers producing the same crop, so that dozens of loans can be negotiated in tandem. Equally important, COFIDE lends through special-purpose trusts that own the assets (including land-use rights) until the loan is paid. If a recipient infringes on loan conditions, the trust can transfer the assets to another producer without recourse to the judicial system.

COFIDE also maintains a queue of willing borrowers to whom assets can be transferred; thus, there is no need to find a secondary market to realize the value of the collateral.

COFIDE reduces risk by packaging credit insurance into the loan agreement. The insurance is covered by a 2 percent premium through a government insurance fund that operates without budget subsidies and reinsures on a commercial basis in the international market. The low insurance rate is possible because of scale economies and other enhancements built into the loan package.

Building on these innovations, COFIDE negotiated with leading retail banks to greatly reduce their margins on term credit to small farmers. The deal required a major change in attitude: instead of seeking high margins on a small client base, the banks were convinced that more profit could be earned by lowering interest rates to stimulate rapid market growth. Of course, this was possible only because of the viability of the activities being financed, and the competitiveness of Peruvian products (especially agricultural products) in the international market.

Another critical ingredient, according to Dr. Schydrowsky, has been constructive government pressure to persuade conservative bankers to accept the innovations needed to overcome market failure in the provision of term finance, such as structural information constraints and costly lending methods. Government ownership of COFIDE, however, also entails the risk of less constructive interference in the future. The main guard against this is the professionalism of the organization and its record of success in financing the growth of local enterprises.

The proposed DFI for Mozambique is therefore on solid ground in emphasizing a commercial approach with no government subsidies. Equally important is the suggestion that nongovernment shareholders have a controlling stake. This structure would help to insulate the organization from political interference in hiring and lending decisions, while creating a built-in demand for strong management, careful loan appraisal, and a reasonable return on investment.⁴³

The proposal to structure the DFI as a second-tier institution has pros and cons. Channeling loans through retail banks can hold down staffing levels, generate scale economies, and avoid the cost of establishing physical infrastructure throughout the country. In addition, by working in partnership with retail banks, a second-tier DFI can introduce innovations that help commercial banks learn to deal profitably with new types of business. This arrangement may serve as a catalyst to help banks overcome information problems that otherwise inhibit investment finance. Against these advantages, the need to work with bureaucratic and conservative commercial banks in Mozambique could stymie the success of a second-tier DFI. Most commercial banks also have high operating costs, which would complicate efforts to deliver low-cost credit.

Weaknesses in the environment for development banking in Mozambique must also be taken into consideration. From the perspective of experience in other countries, including the cases of success, the major concerns include a familiar litany of problems:

- Effective demand for term loans. The foremost concern is that the market for viable development finance may be too thin to support the cost of creating a large new institution. The next section of this chapter reports on the experience of several risk capital operations that identified only a few solid investment opportunities. The underlying issue is whether the availability of term finance is indeed the binding constraint for most local entrepreneurs. While this is certainly a popular perception, many businesses that seem to need investment financing may not have truly viable projects. Thus, the lack of finance may be a reflection of underlying structural weaknesses in the economy, deficiencies in the business environment, and a fundamental lack of competitiveness.
- The supply of top-caliber personnel. The appraisal of long-term investment proposals requires much more skill than commercial lending. Successful development banks normally require a cadre of highly capable MBAs, economists, agronomists, and industrial engineers.
- Scale economies and portfolio diversification. The successful DFIs cited above operate in countries with markets that are much larger and more diversified than in Mozambique. In a small, low-income country, viable investment opportunities may be limited, and the average loan size relatively small. Also, portfolio diversification is a fundamental tool for risk management. For a DFI that is part of an international group, shareholders can diversify across national boundaries. The same effect can be achieved by promoting a regional, rather than national DFI (see below).

⁴³ Of course, private control is not a foolproof remedy for unsound practices. Mozambique has suffered through examples where two privatized but badly run banks collapsed, at a high cost to the economy. The integrity and capability of controlling shareholders is just as important as privatization.

- Information on creditworthiness. Information on creditworthiness is especially important for long-term finance. As discussed in chapter 4, the current system in Mozambique helps lenders screen out bad risks but does not provide information to screen in good risks. Establishing a new credit bureau with more complete financial information would help to improve the information base for term lending.
- Legal and judicial constraints. Long-term investment lending is inherently more risky than rapid-turnover commercial lending. Hence, the quality of the legal and judicial system is more important for a DFI than for a regular commercial bank. This includes systems for registering property, assigning collateral, and foreclosing on collateral, as well as general support for the enforcement of contracts. Chapter 7 discusses the legal and judicial problems facing lenders in Mozambique.
- Access to long-term funds. The successful DFIs examined above leverage their shareholders' equity by borrowing in domestic and international markets. This leverage is essential for commercial operations. Indeed, the intermediation of funds is a basic function of any financial institution. In Mozambique the domestic capital market is extremely thin, and access to external capital markets would be possible only for a DFI controlled by high-grade international shareholders and run on market principles.

An alternative way to mobilize funds is the GAPI-Rabobank approach of registering as a commercial bank and accepting deposits from the public. Indeed, the Agenda 2025 proposal emphasizes the importance of deposit mobilization. But a widespread network for accumulating deposits requires a very different institutional structure than the proposed second-tier approach. Also, if the bank depends heavily on short-term deposits for funds, then much of the lending should be short term as well, to avoid a mismatch of assets and liabilities.

Many DFIs obtain long-term financing from donor agencies or multilateral sources. This financing is usually on market-based terms but at favorable interest rates, because the international agencies normally pass along their advantage in borrowing on the international markets. For a country like Mozambique, this form of backing would be critical to compensate for the lack of access to other sources of capital. In addition, having access to long-term financing at favorable rates would allow the DFI to extend term loans at correspondingly lower interest rates. This arrangement expands the potential set of borrowers and benefits those who qualify for loans.

Pricing DFI loans on the basis of low-interest financing from international partners has unintended consequences, however. Low-interest lending through a DFI is likely to retard the development of local capital markets. Concessional financing is also a lure for rent-seeking and favoritism in credit decisions. In addition, low lending rates inevitably attract borrowers who would be eligible for financing from other sources; to this extent, the DFI ends up simply subsidizing investments that would have been undertaken anyway, rather than financing additional investment.

For Mozambique, it is a matter of judgment whether the medium-term benefits of expanding the supply of investment finance outweighs the potential side effects. Critics of development banking generally place a heavy weight on the byproduct costs. Both the benefits and costs should be taken into account in any decision.

In light of these issues, it is perhaps no surprise that prior efforts to tackle the problem of investment financing in Mozambique have yielded few results. Yet the GAPI-Rabobank venture is an encouraging vote of financial confidence in the feasibility of a well-structured DFI. The fact that a major international bank is committing funds to participate in a rural development bank in Mozambique (with support from KfW and the Norway fund) indicates that the problems and risks discussed here are manageable. Time will tell.

The GAPI-Rabobank example also provides a good answer to the underlying question of whether Mozambique should establish a development bank: If serious investors are convinced to put their money into specific plans, then yes. Otherwise, no.

ALTERNATIVES TO A NATIONAL DEVELOPMENT BANK

The establishment of a national development bank is only one of several approaches that can be pursued to address the problem of access to investment financing. This section examines four other options: a regional development bank; asset-based lending; a “second-tier” bond market; and technical support to help strong local businesses tap risk capital.

Regional Development Finance Institution

Especially for a small country like Mozambique, a regional approach to development banking has considerable advantages over a national approach. An institution with broader geographic scope can reap scale economies, reduce risks through diversification, recruit from a broader pool of top-quality staff, and tap into international capital markets more easily. With proper governance and management, it could also be insulated from government interference more securely.

Of course, this is a role already played in the SADC region by DBSA. As discussed above, DBSA is a wholly owned by the Government of South Africa, and extends loan primarily for infrastructure investments. But it also finances a substantial portfolio of private investments throughout the region. DBSA investments in Mozambique include Mozal, the Sasol natural gas pipeline, Electricidade de Mocambique, Maputo Port Development Corporation, as well as Marromeu Sugar and Maragra Açucar. Mozambique has been the recipient of more financing from DBSA than any other SADC country besides South Africa. Even so, most of the funds have been allotted to large-scale foreign-owned investments or infrastructure companies. Thus, DBSA is not satisfying the needs of locally owned SMEs (Mbele 2005). The main problem with pursuing a regionally based development bank is that small businesses in the poorest countries are likely to be excluded from the action. (To the extent that this is due to genuinely weak fundamentals, however, a national development bank should not make the loans either.)

An alternative model would involve the establishment of a privately-owned and managed regional development bank dedicated to extending loans to smaller businesses. Exhibit 5-2 presents an interesting example of the Latin American Agribusiness Development Corporation.

The Latin American Agribusiness Development Corporation (LAADC) model merits serious consideration for Mozambique and other countries in the region, with appropriate adaptations for conditions in Southern Africa. For example, a regional bank of this sort could hedge risks by diversifying its portfolio across sectors, even if agribusiness were the primary focus. Also, it would be best to locate the institution in a country that does not impose exchange controls, such

as Botswana. This option would also facilitate cooperation between the DFI and the SADC/DFRC network of development banks.⁴⁴

Exhibit 5-2

Latin American Agribusiness Development Corporation

The Latin American Agribusiness Development Corporation (LAADC) is a privately owned regional bank that was set up to finance agribusiness investments in Latin America and the Caribbean. The equity capital comes from major international banks and agribusiness companies such as Bank of America, Cargill, J P Morgan Chase; Monsanto, Dole, Rabobank Curacao, and Unilever.

LAADC provides medium and long term loans in the range US\$200,000 to US\$3 million for small and medium sized agricultural businesses, mainly for export. Loans are extended to finance investment in agriculture production and processing, often packaged with funds for long-term working capital, debt restructuring, and vertical integration. The current portfolio totals US\$197.8 million in loans involving 344 projects in 16 countries. Banana production

and marketing accounts for 10.4% of the portfolio; other major sectors include coffee (5.6%), soybeans (9.7%) and roses (5.8%). Most loan applications are processed in four to eight weeks. Remarkably, the bank does this with a full-time staff of just 44 people, with a head office in Florida and seven regional offices.

LAADC was founded in 1970 with a small amount seed capital (\$2.4 million) and a large vision of stimulating commercial agriculture throughout the region. Initially, the only available debt financing for the LAADC came from long terms loans from USAID. Private lenders, at the time, were unwilling to take the risk of providing long-term funding for this novel venture in a troubled region. Today, the bank has long-term financing from both multilateral organizations (Norfund, IFC, DEG/KfW, FMO, IIC) and commercial banks.

SOURCE: <http://www.laadsa.com/>

The LAADC required donor financing at the outset to leverage its equity capital, before the institution could gain access to private capital markets. As discussed in the previous section, international agencies have been an important source of long-term capital for development banks. Below-market financing, however, can be a mixed blessing: they stimulate lending on the one hand, but reduce efficiency and financial sector development on the other.

Asset-based Lending

The common perception that banks in Mozambique do not extend term loans for investment is not entirely valid. At the end of 2006, investment loans to the productive sector amounted to 19.5 percent of total bank credit to the economy.⁴⁵ In addition, several commercial banks own affiliated leasing companies through which they finance capital assets through leasing contracts,

⁴⁴ Rabobank and the DEG affiliate of KfW are among the LAADC investors. Because these organizations are also active in Mozambique, they can provide further information about the LAADC model.

⁴⁵ Author's calculation using Bank of Mozambique data on the composition of Deposit Money Bank credit. Loans to the "productive sector" are defined here as bank claims on the economy excluding loans to the trade sector, individuals, housing, and "other." It is no surprise that relatively short-term loans dominate commercial bank loan portfolios, because short-term deposits are the main liabilities.

as distinct from loans. The advantage of leasing is that the financing is based on the value of the asset itself, and need not involve the assignment of other collateral.

Specifically, in a leasing contact, the lessor grants to the lessee, in exchange for valuable consideration, the use of moveable or immovable assets that continue to be owned by the lessor. The lessee normally has the option to purchase the assets at the expiry of the lease, at a price determined by terms of the contract. Lease financing can only be carried out by licensed leasing companies or duly authorized banks.⁴⁶ Most banks do not engage directly in leasing, because the retention of asset ownership requires asset management expertise that they often lack.

In many economies, leasing companies provide competition for the banks. In Mozambique, however, the only three finance leasing companies currently operating are bank affiliates: African Banking Corporation Leasing (Moçambique), BCI Leasing, and BIM Leasing. One independent leasing company, United Leasing Company, has not written any new contracts in several years because of capital constraints; it is now restructuring, with plans to become more active.

The law in Mozambique does not allow leasing companies to take deposits. This limits their ability to mobilize funds and, hence, offer lease financing. However, any adequately capitalized company with an interest in the leasing business can apply for a banking license along with authorization for leasing. This arrangement would allow the company to engage in leasing and also accept deposits, under appropriate prudential regulations to protect the depositors.

Leasing operations in Mozambique strongly favor the financing of vehicles over other types of equipment. The main reason is the absence of a ready secondary market for other assets. This makes it very difficult to realize the value of assets that are repossessed, or returned at the end of a contract. By the same token, it is also difficult to determine an appropriate valuation for used assets, in order to establish a fair price for purchase of the asset by the lessee at the end of the contract period.

The secondary market constraint for assets other than vehicles can be overcome in several ways. Some companies, for example in the construction industry, have arranged leasing deals directly from equipment manufacturers in South Africa, who have the capability to assess and sell used assets. This example suggests that lease financing in Mozambique could become much more widespread if leasing companies could use South African markets to realize value on other types of repossessed or returned assets. A possible way to facilitate this development would be to establish special procedures to expedite cross-border trade and payments for certified leasing companies engaged in the sale of used equipment.

Finally, leasing companies could create their own implicit secondary market by working with clusters of clients with similar procurement needs. For example, suppose that 30 small farmers in a particular district are interested in buying pumps, water tanks, spraying equipment, or even irrigation pipes and tractors. The finance company could approve lease contracts with the best 20

⁴⁶ Decree 56/2004 provides rules governing leasing transactions, as well as the rights and obligations of the respective parties.

clients, and hold the others in a queue to receive any assets that may be repossessed, on appropriate lease terms.⁴⁷

A “Caveat Emptor” Capital Market

Organized capital markets – stock and bond exchanges – are a natural source of financing for medium and long term investments. These institutions provide an efficient venue (physical or electronic) where borrowers with long term needs can mobilize financing from lenders who have long term savings objectives, or at least an appetite for holding long term securities as part of a diversified portfolio. Well functioning capital markets also stimulate capital operations by providing a vehicle for exiting from investment positions and derivative transactions for hedging risks. In addition, by offering high-grade borrowers an alternative source of financing, capital markets create competition for the banks, resulting in lower bank lending rates and more innovative banking practices.

Yet commercial banks still dominate financial markets in most less developed countries. With few exceptions (such as India), capital markets are not a significant source of financing for the private sector. The stock and bond exchanges that do exist generally serve only a handful of large, prime grade borrowers.

In Mozambique, the legislative framework for capital markets was established in 1998,⁴⁸ and the Mozambique Stock Exchange (Bolsa de Valores de Moçambique, or BVM) opened for business in October, 1999. In practice, Mozambique Stock Exchange BVM has not been a significant source of finance for Mozambican enterprises. At present, it has only 6 equity listings and 11 bond listings (mainly Treasury issues), and trading is very light. One reason is that the laws and regulations are tightly prescriptive, imposing a high quality threshold for issuing securities, and a substantial reporting burden on listed firms. These rules are meant to protect unsophisticated savers. But the high regulatory and procedural costs also prevent anyone other than a large modern company from issuing securities.

To overcome the stagnation characterizing nascent capital markets in so many LDCs, the World Bank has begun to advocate what might be called a “caveat emptor” market. As explained in a recent Bank publication:

“too much emphasis has been placed ... on building costly regulatory regimes designed to ensure a high level of protection for the retail customer in the secondary market.... Market architecture should be chosen on the basis of local needs and capacities. It may well be, then, that for most African firms, they would be better served by a lighter regulatory approach” (World Bank 2006, 94–95).

Thus, one way to make the Mozambique Stock Exchange a more dynamic source of finance for local enterprises is to introduce a second, less-regulated tier for riskier listings. This approach is a close cousin to the “junk bond” market developed in the United States in the 1980s. The idea is

⁴⁷ See Exhibit 5-1 for an example of successful use of this technique in Peru.

⁴⁸ Decree 48/98 of 22 September established the Regulation of the Securities Market (*Regulamento do Mercado de Valores Mobiliários*). Decree n° 49/98 of 22 September established the Mozambican Stock Exchange. Through a variety of circulars, the Bank of Mozambique has defined regulations governing the Mozambique Stock Exchange.

that listing requirements would be reduced, perhaps substantially, and market forces would establish an appropriate risk premium in pricing the securities. Reportedly, reforms are under discussion that would empower Mozambique Stock Exchange to open and regulate such a market. Given the importance of a vibrant capital market, it makes very good sense for Mozambique to attempt a reform along these lines.

Would this idea work in Mozambique? There is little doubt that a second tier securities market could attract funds if the listed securities are priced to deliver an attractive yield. The problem is that the cost of funds could be too high to induce local companies to use this market for financing investment. Also, transactions costs would still be a significant barrier, despite the lighter regulations. (Light regulation does not mean no regulation.) Finally, it remains to be seen whether local businesses are willing to open their accounts to scrutiny by outside investors. A likely scenario is that a second tier market would start very slowly, with only a few firms testing the waters. If the early listings succeed, however, then other firms would increasingly view the stock and bond market as a viable source of medium to long term financing.

“Doing Deals” for Private Risk Capital

In January, 2007, Citigroup and the Commonwealth Development Corporation (CDC) announced the creation of a \$200 million Citigroup Venture Capital International for Africa.⁴⁹ This is just one sign of a major change taking place in the international market for risk capital.⁵⁰ By all indications, huge sums of risk capital will be seeking high-potential investments in Africa over next 5 to 10 years. At the same time, most domestic enterprises in Mozambique continue to lack access to long-term financing for productive capital investments. Will Mozambican firms be in a position, to any significant extent, to attract risk capital financing as a source of growth?

Experience to date with risk capital funds or similar operations in Mozambique is not encouraging. The CDC, for example, created a venture capital fund (MINCO) in 1997 to finance small and medium enterprises (by British standards) in Mozambique. A recent report from the Economist Intelligence Unit cites as Minco’s most notable investment the United Leasing Company,⁵¹ which is no longer actively engaged in leasing transactions. One major bank, BCI, also set up a venture capital operation several years ago, which ended up doing only very little business before shutting down.

The African Enterprise Fund of the International Finance Corporation (IFC), which was set up to deal with small investments across the continent, has also struggled to find viable investments. The IFC has been marginally more successful with its Small and Medium Enterprise Initiative (MSI) in Mozambique. This initiative provides risk capital for local businesses in amounts

⁴⁹ See: www.southafrica.info/africa/citigroup-160107.htm.

⁵⁰ We use the term “risk capital” to mean private financing deals through which third parties invest in high-potential enterprises that are too risky to obtain financing through organized securities markets or commercial bank loans. “Venture capital” deals generally involve equity positions, but deals can also involve private bond placements, quasi-equity instruments (bonds with a yield that depends on profits), or other variations on the theme – or combinations of all these elements.

⁵¹ This information is from an EIU article, Mozambique: Financial Services, posted on April 2, 2007 at: <http://www.tmcnet.com/usubmit/2007/04/02/2458980.htm>.

ranging from \$100,000 to \$1 million. The MSI focuses on agriculture, manufacturing, services, and tourism. To date, the MSI has financed only a handful of investments, but other applicants are under consideration.⁵² It is interesting to note that the IFC's usual strategy for exiting from this kind of investment is through a phased buy-out by the owners.

The main theme arising from interviews conducted for this study is that the problem is not so much the lack of available funds, but rather the paucity of capable borrowers who qualify for financing. Despite the fact that venture capital funds and risk capital managers have a higher risk threshold than the banks, they still require an attractive risk-adjusted rate of return. Hence, they look for excellent technical capabilities, high potential for growth and profitability, strong leadership, and good management. To paraphrase the words of one financial manager, "I have the money and I want to give it to them, but I can't without better information" to show that the financing can be employed successfully.

Transactions cost are again a consideration. For example, the MSI offers not only financing, but also technical advice on business management, feasibility studies and diagnostic reviews, market research, and environmental, health and safety advice. For investments at the smaller end of the target range, the cost of doing deals is prohibitive.

These considerations suggest that any significant expansion of risk capital financing in Mozambique will require donors to prime the pump through technical support to local businesses with high potential. In addition, the introduction of more efficient techniques for doing deals could reduce transactions costs and widen the net for such financing.

Exhibit 5-3 provides an example from Egypt of how donor support can help to broker deals for investment financing by bridging the gap between the capabilities of local enterprises and the requirements of risk capital managers. The objective of this type of assistance is not just to help the immediate clients, but more broadly to create demonstration effects and establish sustainable support services that will help other local businesses understand what is needed to access risk capital, and learn how to do it.

As for the cost element, one example is the work done by Business Partners, a risk capital firm in South Africa. This private company has used creative methods to minimize the cost of equity and quasi-equity investments in small and medium sized businesses on fully commercial terms, including the cost of concomitant technical assistance. Since 1981, Business Partners has undertaken more than 30,000 investments in South Africa, creating an estimated 480,000 jobs. The company's investments total ZAR 7.4 billion (for an average of ZAR 480,000).⁵³ Recently, with IFC support, Business Partners has begun to expand operations to other parts of Africa, by opening affiliates in Madagascar and Kenya.

⁵² Information on BCI's venture fund and the IFC's initiative are from interviews with senior officials, and from an IFC brochure on the MSI initiative.

⁵³ See: <http://www.businesspartners.co.za/>

Exhibit 5-3 *Nurturing Access to Risk Capital in Egypt*

A USAID-funded project to support the Information and Communications Technology sector in Egypt has a novel feature: the consulting team consists mainly of investment bankers and accountants, rather than IT experts. The reason is that objective is to help ICT firms obtain debt and equity financing.

To do this, the project team starts out by applying an investor-oriented tool to identify IT firms that have excellent technical skills, strong market potential, and a need for access to financing for investment. The consultants then match the firm to potential investors in the region. Where a deal appears to be feasible, the project undertakes a preliminary "due diligence" of the IT firm and recommends measures to improve their marketability to investors. In nearly every case, the IT firm needs extensive support to strengthen financial controls and improve business management. The project then assists the firm in preparing a business plan and in negotiating the deal. Notably, the project benefits from a parallel Government program that is aggressively marketing the skills and cost advantages of Egyptian ICT firms.

Ultimately, the project should create a demonstration effect to foster a broader market for equity and debt deals serving small and medium-sized businesses in Egypt. In fact, one component of the project is to train local institutions to offer executive instruction to other firms in areas like entrepreneurship, finance, management, and marketing. In the end, if the project were to help only a handful of direct clients, the costs would likely exceed the benefits.

The head of the project, Scott Jazynka, previously worked in Mozambique. Among other things, he helped BCI set up its venture capital arm, which subsequently closed due to lack of effective demand. Nonetheless, Jazynka believes that the process used in Egypt can work anywhere in the World. The important thing is find the right niche in selecting strong local businesses and identifying appropriate sources of investment financing.

SOURCE: Interview and personal communications with Scott Jazynka, December 2006 and January, 2007.

A final consideration is that risk capital is not cheap. Venture funds seek high yields so that the successful investments will compensate for others that do not work out well. It is not uncommon for private venture funds to seek a real rate of return of 25 to 30 percent, sometimes more, reflecting the risks and the opportunity cost of the funds. Multilateral funds may accept lower returns, but the real cost of funds is still high compared that on a bank loan. However, there are also advantages, in that equity or quasi-equity financing does not create a fixed obligation for the entrepreneur. Thus, the investor reaps a gain only when the client company reaps a gain, as well.

MOBILIZING LONG-TERM SAVINGS THROUGH PENSION REFORM

Pension reform is too large and complex issue to be covered in any detail in the present study. But it is too important to be neglected in thinking about the problem of long term financing in Mozambique. Beyond providing a safety net for the labor force and allowing elderly workers to maintain a decent standard of living after retirement, a well designed pension system should also be a central vehicle for mobilizing long-term savings and channeling a rapidly growing pool of long-term funds into the domestic financial markets.

Unfortunately, the pension system in Mozambique utterly fails to serve this purpose. The current system consists of a mandatory social security system covering private sector employees, under the National Institute of Social Security (*Instituto Nacional da Segurança Social*, or INSS); a separate system for civil servants, which operates through the government budget; and supplementary private pension plans. For the mandatory INSS system, employers contribute 4% and employees 3% of their monthly payroll and wage packet, respectively, to pay for illness, disability, and retirement benefits for eligible workers.⁵⁴

Because the pension system is vital for financial sector development, pension reform is a major focus of the ongoing Financial Sector Technical Assistance Project (FSTAP). Under FSTAP, the African Development Fund (AFD) is providing technical support to strengthen the INSS system and improve the legal and regulatory framework for supplementary private pension plans.

The AFD appraisal report paints a grim picture of the INSS system as it now operates (African Development Fund 2005, 6–9). Only about 20% of formal private sector employees are actively contributing into the system; that amounts to roughly 3.5 % of the economically active population in Mozambique. In addition, the INSS is extremely inefficient in dealing with noncompliant employers, processing claims and payments, and even in keeping records.

From the point of view of financial sector development, the central problem is that the INSS runs on a pay-as-you-go (PAYG) basis. This means that contributions received in any year go into paying benefits due that year. Also, the financial condition of the system is opaque. No public information seems to be available on the balance between cash-in and cash-out, nor on how the INSS is investing any net accumulation of funds.

The supplemental private pension system is also extremely weak. Only a few large businesses (such as Mozal and some banks) provide coverage for their employees. At the moment, there is no specific legislation governing private pension funds. However, the Ministry of Finance has contracted consultants to assist in preparing modern legislation for this purpose; a draft is expected later this year.

Under FSTAP, the AFD is helping INSS expand coverage and compliance; improve system administration; restructure the organization; undertake an actuarial analysis; develop an investment policy; and build capacity. What is missing is deeper thinking about the structure of the system. While it is fully appropriate for the disability, illness, and safety net benefits to run on a PAYG basis, the pension element should be overhauled by scrapping PAYG in favor of a mandatory saving scheme, in which contributions accumulate in individual accounts to fund future benefits for each worker. This fundamental reform can make a critical contribution to domestic savings and development of the capital markets.

The idea is certainly not novel. Singapore and Malaysia have run mandatory saving schemes for decades, under government management of the funds; in Chile and several other Latin American countries, similar systems have run for decades with private sector management of the funds.

⁵⁴ These contribution rates are retained in the new Law on Social Protection: Law n° 4/2007 of February 7.

To be sure, converting to a funded pension system is a complex task that requires detailed planning and careful sequencing over a period of years. The scheme will require a strong legal and regulatory framework, highly capable management, and a firewall to prevent misuse of the funds for political purposes. Most important of all, the plan requires a prudent a blue-chip strategy for a diversified portfolio of domestic and international investments, to protect the rapidly growing pool of capital and deliver a rate of return sufficient to secure future pension benefits.

In general, the best time to shift to a funded system is when the carry-over of PAYG liabilities is small; the labor force is young; and donor support can be found to provide technical assistance and cover transitional costs. For Mozambique, this means that the best time to start the planning is now.

CONCLUSIONS AND RECOMMENDATIONS

The lack of term financing for productive investment is clearly a problem for private sector development in Mozambique. The evidence from other countries on the role of development finance institutions is decidedly mixed: while most development banks have been costly failures, especially in Africa, there are also notable examples of success. In Mozambique, however, any development finance institution (DFI) will face structural constraints that are more severe than in the countries usually cited as examples of success. Any decision on establishing a DFI must therefore be based on a careful appraisal of the potential market and local operating constraints. Beyond the idea of establishing a national development bank, this chapter has also emphasized that there are also other promising approaches that should be examined to expand the supply of development finance. The following recommendations follow from the analysis:

Recommendation: *The decision on establishing any new development finance institutions in Mozambique should be driven by commercial considerations.* The test of viability is whether commercial investors will back a specific plan with a majority equity stake and management control. The example of GAPI and Rabobank is a case in point, which suggests that the entry of smaller, more focused development banks may be more appropriate at this time than a large national DFI.

Recommendation: *International agencies should consider providing long-term financing on quasi commercial terms (as in other countries) to support any DFI that passes the viability test suggested above.* Such support is likely to be critical for the success of any DFI initiative, to leverage equity capital.

Recommendation: *If the Government wishes to pursue the idea of creating a national DFI, the first step should be to engage independent experts to study the feasibility of specific options for Mozambique.* The study should involve experts with experience in commercially sound development banking, through partners such as DBSA in South Africa, BNDES in Brazil, COFIDE in Peru, or KfW from Germany.

Recommendation: *The Government should consider participating in the creation of a regional DFI to serve the needs of for small and medium enterprises.* A regional approach could overcome some key barriers to success for a national institution, including scale

economies and diversification. The initiative could be pursued through SADC's Development Finance Resource Center (DFRC), or through negotiations with private investors, along the lines of the LAADC in Latin America, as discussed above.

Recommendation: *The government and the central bank should stimulate wider use of asset-based lending by expediting cross border trade and payments for the export of second-hand equipment to secondary markets in South Africa.*

Recommendation: *Private sector associations should work with banks and leasing companies to develop innovative ways to solve the secondary market constraint to asset-based lending, as suggested in the text.*

Recommendation: *The Bank of Mozambique and the Mozambique Stock Exchange should examine the possibility of introducing a second-tier bond market, to encourage the issuance of corporate bonds with lighter regulations and market pricing of the additional risk. While this novel approach might not succeed, it is a testable option for expanding access to term financing for the private sector, while also creating competition for the banks.*

Recommendation: *The government should seek donor support to prime the pump for expanding access to risk capital through technical assistance to high-potential local businesses, along the lines of USAID's information and communications technology program in Egypt, or the operations of Business Partners in South Africa.*

Recommendation: *The Government should seriously examine new approaches to mobilize long-term domestic savings through fundamental reform of the national pension system, based on funded personal accounts to replace the present pay as you go system (except for a minimum safety net benefit).*

Above all, the government must continue pursuing reforms to improve the overall business environment. CTA members, in turn, must be strong and persistent advocates for the full range of reforms. If business opportunities for the private sector are severely limited by a weak investment climate, so will be the impact of any initiatives to enhance access to term finance.

6. Reducing the Cost of Finance

The last two chapters examined how access to finance can be improved by addressing problems related to information systems, management skills, and transactions costs, as well as the weak economic fundamentals facing the business community. Another major constraint on access to credit is the high interest rates on bank loans. High interest rates directly limit the scope for financing business activities and heighten the risk of lending (see Exhibit 6-1). Higher risk, in turn, feeds back into higher interest rates. In short, access and cost are intertwined.

An important function of interest rates is to screen out less efficient uses of funds and allocate credit to activities with the best prospective rates of return. If financial markets are reasonably competitive and not distorted by heavy government borrowing, then interest rates should reflect the opportunity cost of financial resources. Under these conditions, the screening function of interest rates benefits economic development, and problems of access to credit are best addressed by dealing with other constraints discussed earlier. Furthermore, among eligible borrowers, an interest rate premium is fully warranted for riskier loans.

So, are the observed interest rates in Mozambique in line with market conditions? This chapter suggests that the interest rate for dollar-denominated loans bear a reasonable relation to the opportunity cost of funds, but for metical loans, the interest rate seems to be higher than economic fundamentals would suggest. This analysis leads to recommendations on measures to reduce the interest rates on metical loans. The chapter also includes a briefer discussion on two related issues: the very high interest rate on microcredits, and high fees for banking services.

WHY ARE BANK LENDING RATES SO HIGH?

Figure 6-1 shows recent trends in the interest rate on bank loans denominated in domestic and foreign currency (using the average rate on 180-day maturities as a benchmark).⁵⁵ After the banking crises in 2000–2001, metical interest rates soared to 38 percent. As the crisis eased, the rate fell below 21 percent in 2005, and then rose to nearly 25 percent in 2006. Over the same period, the interest rate on dollar-denominated loans hovered between 6 and 10 percent, following

⁵⁵ Unless stated otherwise, data in this section come from the Bank of Mozambique and IMF compilations of Bank of Mozambique data. Interest rates vary according to maturity, type of loan, and risk profile of the borrower. Because the whole structure tends to move in tandem over time, it is simplest to focus on a benchmark rate. Often the prime rate is used. But because few borrowers in Mozambique qualify for this rate, we prefer to use a benchmark reflecting the actual cost of borrowing.

a pattern that closely mirrors international trends.⁵⁶ The gap between metical and dollar interest rates has been relatively stable at just under 15 percent for the past two years.

Exhibit 6-1

High Interest Rates as Source of Lending Risk

The risks involved in lending to small and medium-sized businesses are the major reason for a spread between the prime lending rate (which applies to prime-grade customers) and the rate charged to other borrowers. But this is a two-way street, as high interest rates, themselves, are a source of risk for the lender. This risk arises through four channels:

The higher the interest rate, the larger the fixed cost of debt service as an encumbrance on the borrower's cash flow. As a result, high interest rates accentuate the risk that the borrower might be unable to meet his or her debt obligation because of shocks that reduce income or increase cost.

High interest rates create a risk of "adverse selection." This term means that more prudent borrowers tend to drop out of the borrowing pool as interest rates rise. If banks had perfect information about the characteristics of each loan applicants, they would simply set interest rates to reflect the respective risks. Faced with asymmetric information, however, the banks cannot always distinguish good risks from bad and may

attribute higher risk to a whole pool of borrowers as interest rates rise. The related problem of "moral hazard" involves a change in the behavior of particular borrowers. When a borrower faces business problems that could lead to a loan default, there is a tendency to take riskier decisions in the hopes of a favorable outcome. This situation is more likely to arise when interest rates are high. Hence, high lending rates can cause riskier behavior.

Finally, high nominal interest rates often arise in conjunction with high inflation. But high inflation goes hand in hand with uncertainty about the course of price changes. If inflation slows unexpectedly, then the real cost of borrowing is higher than expected. In addition, nominal income for any given borrower may rise more slowly than the general rate of inflation. These risks are elevated when inflation is high. In short, borrowing at an interest rate of 25 percent with 15 percent inflation is much riskier than borrowing at an interest rate of 10 percent with zero inflation – even though the real interest rate is the same in both cases.

Interest Rate on Loans in Dollars

On dollar-denominated loans, an interest rate of about 10 percent rings no alarm bells, because the benchmark LIBOR is over 5 percent and the risk-free rate on U.S. Treasury bills is about 5 percent. These rates represent the opportunity cost of dollar funds. A margin of about 5 percentage points over these international rates is understandable as a provision for the risks associated with lending in Mozambique, plus the cost of administering loan transactions.

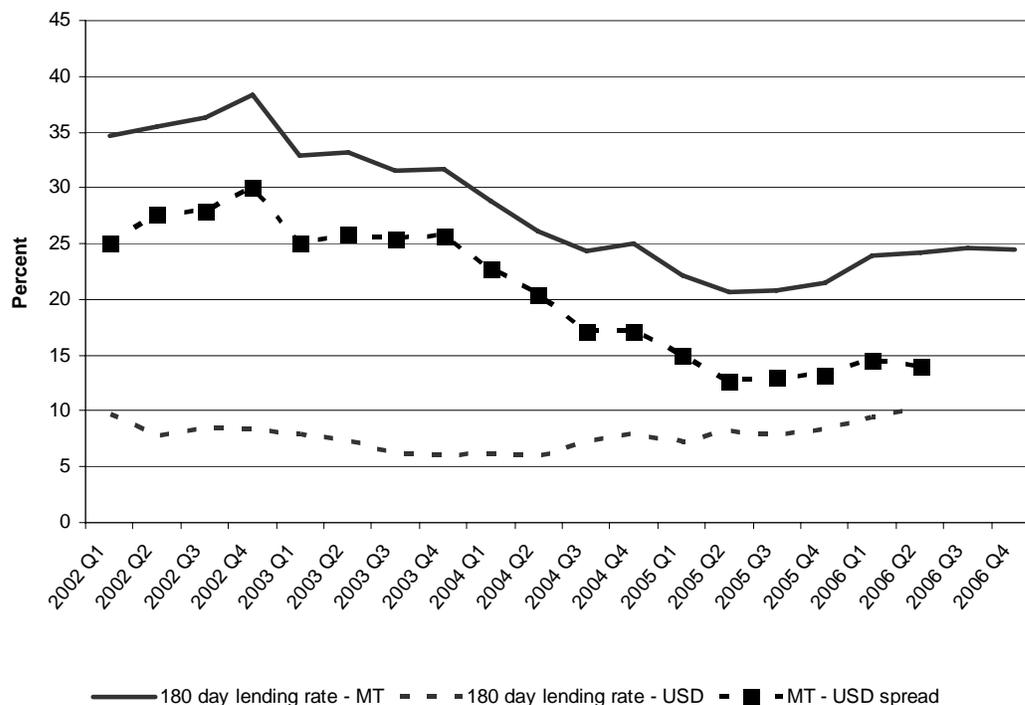
Interest Rate on Loans in Meticals

A basic determinant of metical loans is the rate of inflation. Taking into account the effect of inflation in eroding the purchasing power of the metical, an interest rate of 25 percent with 15 percent inflation involves the same real cost of borrowing as an interest rate of 10 percent with

⁵⁶ The London Interbank Offer Rate (LIBOR) fell from 5.5 percent in 2001 to 1.2 percent in 2004 and then rose to 5.6 percent by the middle of 2006 (moneycafe.com).

zero inflation (though the risk attributes differ, as explained in Exhibit 6-1.) In both cases the real interest rate is 10 percent, which is comparable to the rate charged on dollar loans.

Figure 6-1
Interest Rates on Loans in Meticals and Dollars



Thus, one of the most important instruments for reducing the nominal interest rate on metical loans is prudent macroeconomic management to maintain low and stable inflation. Indeed, the central bank should consider the adoption of a simple inflation rule as a tenet of monetary policy. By announcing a target range for moderate to low inflation and then pursuing policies to hold inflation within this range, the Bank of Mozambique can squeeze out the interest rate premium that lenders impose to cover inflationary expectations and inflation risk.

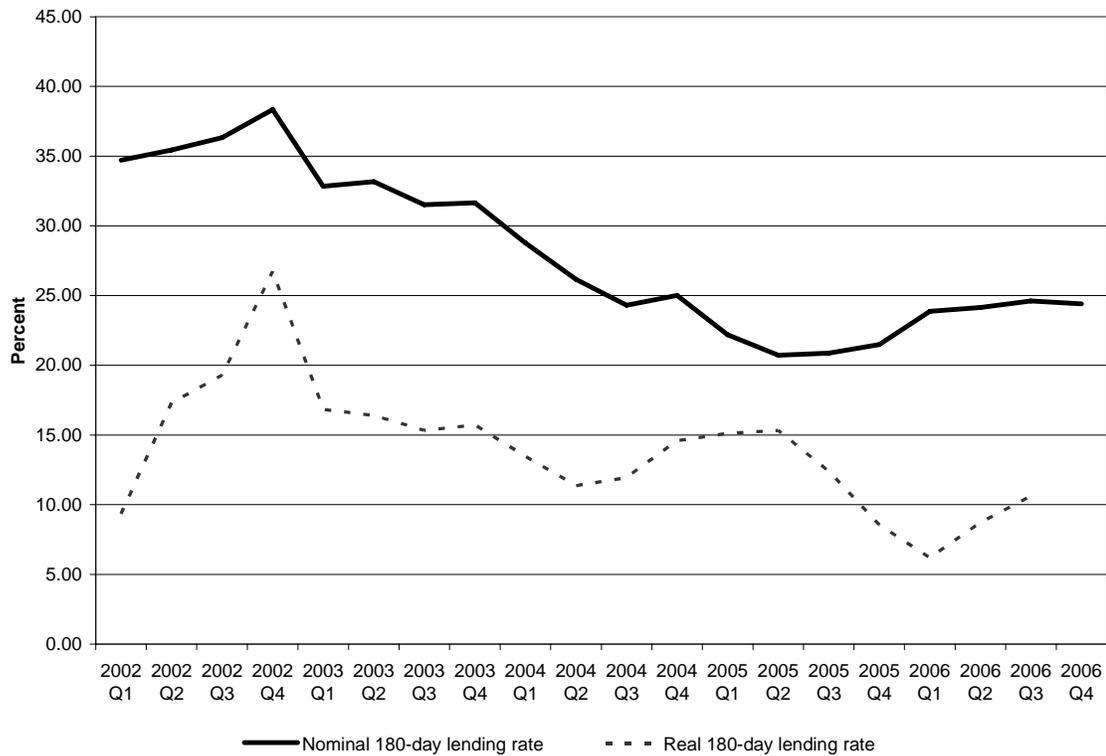
Figure 6-2 shows that the real interest rate in Mozambique soared to over 25 percent in 2002 as nominal rates soared; it then dropped in 2003 to a plateau of about 15 percent as nominal rates declined steadily. In the second half of 2005, the real interest rate fell to 6.2 percent as inflation jumped, and then climbed back to 13.7 percent at the end of 2006 when inflation subsided.⁵⁷ Overall, the real interest rate averaged 12.2 percent in 2005 and 2006, which is well above the median for low-income countries in sub-Saharan Africa, 8.8 percent.⁵⁸ This regional benchmark

⁵⁷ Because most lending is done in Maputo, we calculate inflation using the Maputo Consumer Price Index. The results are virtually the same using the national CPI. At each point in time, we use inflation for the latest 12-month period, to smooth out seasonal variations. This is equivalent to assuming that borrowers use the 12-month inflation rate to form expectations about inflation over the period of their loan.

⁵⁸ Calculated from World Development Indicators 2006 (World Bank 2006).

suggests that the nominal interest rates on metical loans are higher than the inflation rate alone would indicate.

Figure 6-2
Nominal and Real Interest Rates on Loans in Meticals



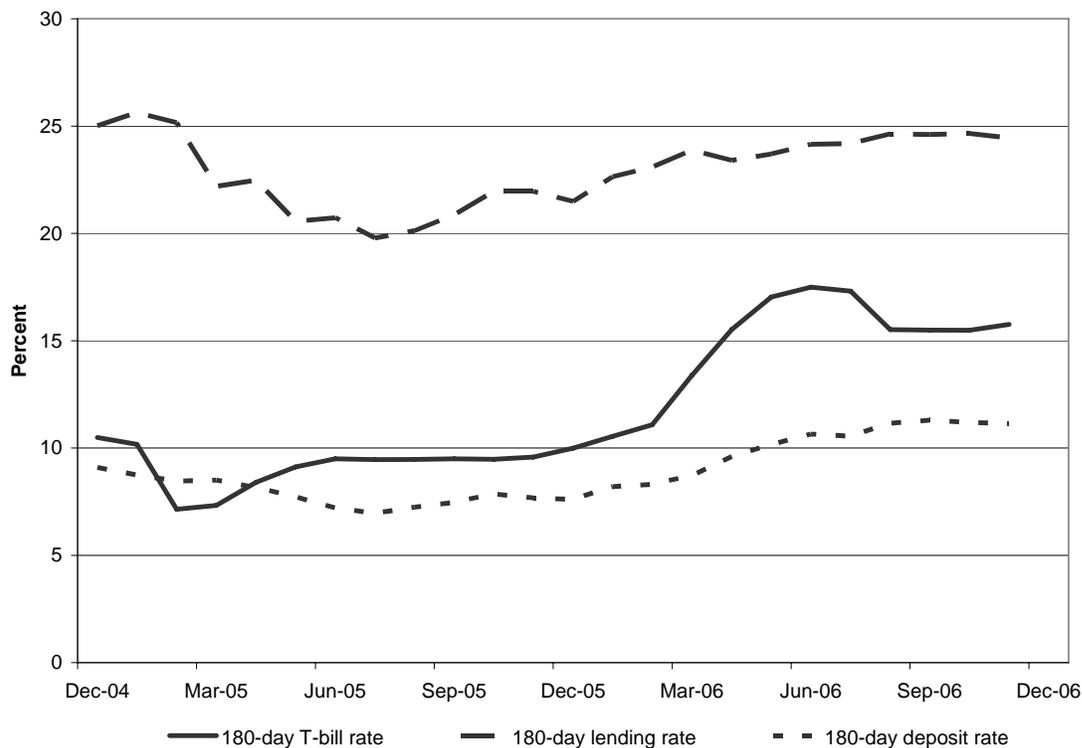
Inflation also affects expectations about exchange rate movements, which are a critical factor determining the differential between metical and dollar interest rates. Substitutability between these two loan products is sufficient for market arbitrage to drive the interest rate differential to a level that reflects currency risk. (This is called the “interest rate parity” condition.) For example, if market participants believe that the exchange rate is totally stable, then the cost of borrowing in dollars and meticals should be roughly equal (controlling for client risk). If “the market” expects a 15 percent devaluation over the next year, then a difference of 15 percentage points between metical and dollar rates would equalize the effective cost of borrowing in these two currencies.

As seen in Figure 6-1, the metical–dollar interest rate differential has been just under 15 percentage points since 2005. In that period, inflation averaged 10 percent, and by all indications, the spike in inflation in early 2006 was temporary. If inflation were to be sustained at 10 percent, then a devaluation of 10 percent per year might be expected on the premise that the central bank endeavors to target a stable real exchange rate. Indeed, the central bank could even target a slower rate of devaluation against the dollar, because the dollar has been weakening

against other major currencies. The bottom line is that the interest rate on metical loans appears to be higher than the logic of interest rate parity would indicate.⁵⁹

Of course, the high metical interest rate might reflect a market expectation that inflation will soar or that the metical will depreciate sharply. In the absence of more sophisticated financial derivatives, there is no clear way to determine these expectations accurately.⁶⁰ Nonetheless, the metical-dollar interest rate differential does appear to reflect noncompetitive behavior in the lending market. This inference is supported by other signs of noncompetitive pricing, such as the enormous spread between loan and deposit rates, as shown in Figure 6-3. In 2006, the metical rate on 180-day loans exceeded the metical rate on 180-day deposits by 13.8 percent, on average. This is more than twice the spread of 6 percent on dollar loans and deposits.⁶¹ The actual spread is even larger, because banks pay zero interest on most metical deposits.

Figure 6-3
Nominal Interest Rates on Metical Loans, Deposits, and T-Bills



⁵⁹ Arguably, the interest rate differential might also reflect greater risk in the pool of metical borrowers. The risk factor, however, cannot explain why a given borrower would face such a large differential on metical loans compared to dollar loans—except to the extent of risk caused by the high interest rate itself! The higher metical rate also cannot be explained by difficulties in collecting bad debts, since that factor applies equally to dollar loans.

⁶⁰ In more sophisticated financial markets, market expectations for inflation can be gauged by the pricing of inflation-adjusted treasury bills or inflation derivatives, and expectations of currency risk can be gauged by the pricing of forward contracts or futures contracts. Chapter 8 argues that forward contracts could also help to resolve problems caused by recent changes in banking regulations relating to dollar lending.

With three banks dominating the banking system and the virtual absence of competition from nonbank financial markets, it is not surprising to see signs of oligopoly behavior. The obvious remedy in the medium term is to encourage competition by facilitating the entry of well-managed banks, expanding alternative sources of finance through the bond and stock markets, and establishing new institutions such as a market for commercial paper and factoring operations.

From another perspective, however, the situation looks different. The interest rate on metical loans is actually consistent with the prevailing rate on Treasury bills, which is a benchmark for the opportunity cost of metical funds. In the last half of 2006, the T-bill rate was just over 15 percent, compared to nearly 25 percent on 180-day loans. That looks like a large difference. But interest earned on T-bills is tax free. Hence, the interest rate on loans would have to be about 20 percent just to match the effective yield on T-bills. In this light, the prime lending rate of 19.9 percent at the end of 2006 is not high at all. And the difference between the prime rate and the 24.4 percent observed on 180-day loans probably reflects the risk of lending to nonprime clients.

Thus, the analysis suggests that although metical lending rates are very high, they are in line with the T-bill rate. In that case, the real puzzle is the interest rate on T-bills: Why are they so high?

Interest Rate on Treasury Bills

Figure 6-3 also shows that the T-bill rate jumped from under 10 percent in 2005 to more than 15 percent in the second quarter of 2006. The reason is that in March 2006 the Bank of Mozambique ended its practice of controlling the T-bill rate and began to allow the auction to determine the rate.⁶² This policy enables Bank of Mozambique to use the T-bill market more effectively as a tool for open market operations and to control reserve money and hence inflation. In addition, the auction ought to produce T-bill rates that reflect market conditions and provide a clearer basis for the pricing of other financial products.

What, then, is driving the rate on this risk-free asset to 20 percent (adjusted for tax), when inflation is around 10 percent? The answer again seems to lie in a lack of competition: Only commercial banks are authorized to bid for T-bills in the primary market. This restriction is meant to encourage development of the secondary market, but instead means that a few banks dominate the auction.

This observation suggests a quick and simple solution: The central bank should authorize more bidders to participate in the primary market for T-bills. At a bare minimum, registered nonbank financial institutions should be allowed to bid, including insurance companies and corporate pension funds. Indeed, there is no good reason to exclude individuals who are sophisticated enough to deal with the auction procedures.⁶³

⁶¹ Calculations by the author from IMF and Bank of Mozambique data.

⁶² The figure also shows that Bank of Mozambique efforts to fix a low T-bill rate in 2005 did not succeed in reducing bank lending rates. This was possibly due to instability in the exchange rate, but it could be another sign that banks do not price loans competitively.

⁶³ This step was taken in Zambia within a year of introducing the first T-bill auction in 1993, precisely to enhance competition in the auction market. This raised some logistical issues, but they were not serious problems. (The author of this report was adviser to the Ministry of Finance in Zambia at that time.)

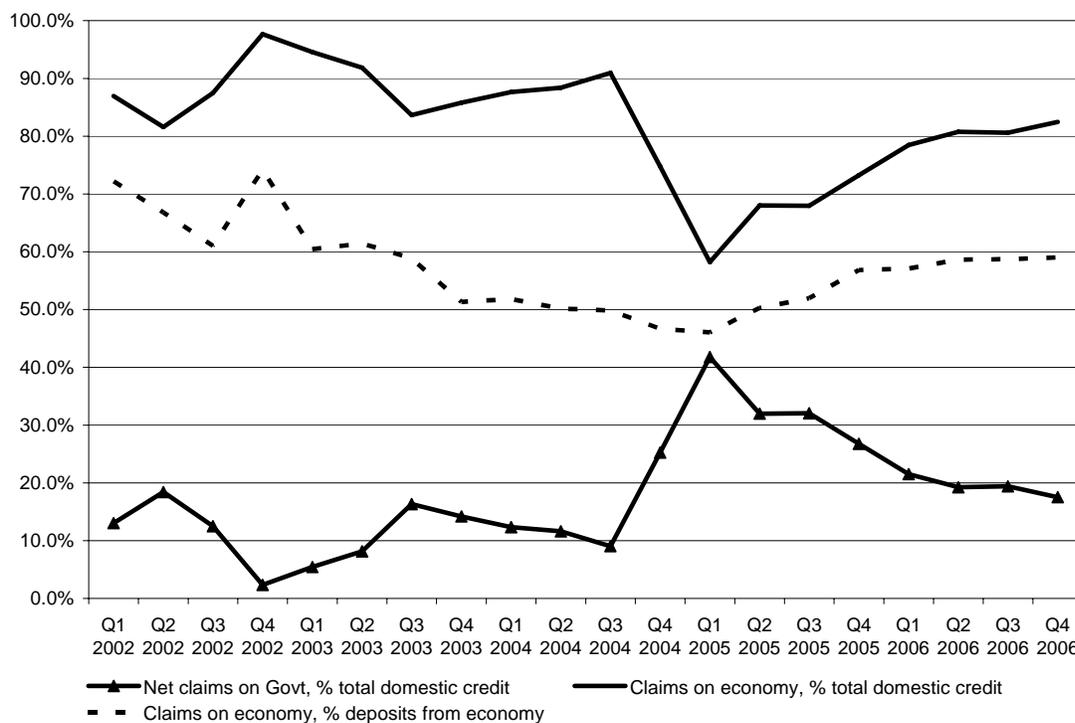
OTHER FACTORS AFFECTING BANK-LOAN INTEREST RATES

We have discussed four causes of high interest rates on metical loans: a high and unstable inflation rate; instability of the exchange rate; the inherent risks and costs of lending in Mozambique; and the lack of competition in the market for treasury bills and bank loans. This section discusses two other factors: government borrowing and the obligatory reserve requirement.

Government Borrowing

The study team heard many comments about how domestic borrowing by the government crowds out lending to the private sector and drives up interest rates. Figure 6-4 shows commercial bank claims on the economy and net claims on government, as percentages of total domestic credit.⁶⁴ These two numbers sum to 100 percent, so the lines are mirror images. For most of the time since 2002, net claims on government fluctuated between 2 and 18 percent of total domestic credit. Starting in the last quarter of 2004, when national elections were held, irresponsible fiscal policies caused government borrowing to soar, pushing net claims on government from under 10 percent to more than 40 percent of total domestic credit. As a result, financing for the private sector fell from 91 percent of total domestic credit to just 58 percent, over a span of just two quarters at the end of 2004. At that time, bank credit to the economy accounted for less than half of the deposits from the economy (dashed line in Figure 6-4). The government’s large appetite for domestic borrowing in 2004 and early 2005 undoubtedly contributed to high interest rates on loans to the private sector.

Figure 6-4
Crowding Out Due to Government Borrowing



Since early 2005, however, fiscal management has improved tremendously, allowing bank claims on the economy to rebound to over 80 percent of total domestic credit and nearly 60 percent of deposits. The government appears now to be committed to a fiscal position involving little or no net domestic borrowing. Under these conditions a steady decline in the treasury bill rate could be expected—if the market were competitive.

Reserve Requirement

The cash reserve requirement is a traditional tool of monetary policy that is used (infrequently) by central banks to limit the extent to which commercial banks extend credit, relative to their deposit base. At the time of this study, Bank of Mozambique required commercial banks to hold 11.51 percent of their deposit liabilities in non-interest-bearing liquid assets. Thus, roughly one-ninth of the deposit funds are frozen as required reserves. Accordingly, banks need to impose a higher spread between the interest rates on loans and deposits to meet any given earnings target. The impact on lending rates, as such, depends on how this adjustment is split between loans and deposits. At most, the reserve requirement would justify an increase in lending rates by one-ninth, which is the difference between 21.5 and 24 percent.

The Bank of Mozambique plans to lower the reserve requirement this year. That will help reduce the interest rate on loans. A few countries, such as Mexico and Canada, have cut the reserve requirement to zero, which eliminates the upward wedge on bank lending rates. Another device to eliminate the wedge, which is more widely used, is for the central bank to pay interest on required cash reserves. A variation on this theme is to redefine the regulation as a liquid asset requirement and allow banks to hold reserves in the form of Treasury bills. This would reduce the cost to the banks of satisfying the requirement.

The study team heard that the Bank of Mozambique has considered paying interest on reserve accounts but decided against it for the time being because of the cost involved. Of course, by not paying interest on these accounts, Bank of Mozambique merely causes the banks to shift the cost onto the shoulders of borrowers and savers, as explained above. Because the reserve requirement exists for the purpose of monetary policy, a good case can be made for the monetary authority to shoulder the cost itself. Even simpler would be the option of redefining the reserve requirement in terms of liquid assets, including Treasury bills. By intensifying competition for T-bills, this measure should also reduce the T-bill rate and thus lead to further reductions in bank lending rates. Of course, any change in the reserve requirement must be carefully considered in the overall context of monetary management.

Recommendation: *The government can reduce interest rates through more consistent macroeconomic management to lower inflation, reduce volatility in the currency markets, and minimize crowding out. CTA members, in turn, should be strong and persistent advocates of prudent macroeconomic policy.*

⁶⁴ An example will show why net credit to government is the correct indicator to use: If the banking system holds MT 1 million of credit to the government but also MT 1 million of government deposits, net credit is zero and so is the overall effect of the government position on bank lending to the private sector.

Recommendation: *The Bank of Mozambique should consider the formal adoption of an inflation rule as a tenet of monetary policy. By announcing a target range for moderate to low inflation and then pursuing policies to hold inflation within this range, the Bank of Mozambique can squeeze out the interest rate premium that lenders impose to cover inflationary expectations and inflation risk.*

Recommendation: *The Bank of Mozambique should authorize more bidders to participate in the primary market for T-bills, to enhance competition in determining T-bill rates.*

Recommendation: *The Bank of Mozambique should consider paying interest on required cash reserves to reduce the upward wedge on bank lending rates caused by the reserve requirement. Alternatively, Bank of Mozambique should consider redefining the requirement to allow Treasury bills to count as reserves.*

Recommendation: *The Bank of Mozambique should encourage more competition in the banking system and more competition from nonbank sources of finance such as the bond market.*

INTEREST RATES FOR MICROCREDIT

Interest rates on microcredits are far higher than rates on normal bank loans, mainly because of structural features of this segment of the market. In Mozambique, prominent microfinance institutions charge interest rates of 5 to 7 percent per month, which is equivalent to an annual rate of between 60 and 84 percent. Even at these extremely high interest rates, microlending facilities are attractive to borrowers who face critical cash needs and might otherwise have to borrow from an informal lender at rates of 20 percent per month or more.⁶⁵ Some types of microenterprise, notably small traders, also use short-term loans at these high rates to finance high-turnover transactions. For most business purposes, however, these high interest rates prohibit the use of microcredit as a source of financing.

The basic problem is the high cost of administering tiny loans, relative to the balances involved. On a credit of \$100, a monthly interest rate of 5 percent generates just \$5 per month of gross income to the lender. This has to cover expenses for personnel, training, facilities, equipment, travel, and the communications involved in appraising, approving, disbursing, monitoring, and collecting the loan, as well as the cost of funds and the cost of bad debts. Arithmetic necessitates a relatively high interest rate for commercially sustainable lending operations, even for efficient microfinance institutions that use appropriate technologies to minimize costs and risks.

Yet many microfinance institutions in other countries are financially viable with interest rates closer to 3 percent per month.⁶⁶ By this standard, microcredit in Mozambique is unusually

⁶⁵ The study team heard evidence of informal lending rates in the range of 18 to 23 percent per month in the Nampula region. In Malawi, traditional *katapila* money lenders routinely charge 50 percent per month compound interest and readily collect on debts through the traditional court system. (Bolnick 1992).

⁶⁶ Acción International, a world leader in microfinance development, reports that most microfinance organizations charge annualized rates of at least 30 percent. Grameen Bank charges especially low rates of

expensive. The difference seems to be due mainly to the early stage of development of the industry in Mozambique.⁶⁷ Local microfinance institutions are still dealing with high startup costs, along with a lack of scale economies and limited competition. Over the next five years, market forces are likely to drive the lending rates down to more typical levels, as the industry grows and matures, at least in the cities and larger towns where there is a sufficient base of potential clients.

Thus, the best way to reduce interest rates on microcredit is to continue facilitating the entry and growth of financial institutions that operate on commercial principles. Indeed, a degree of convergence between microfinance institutions and standard commercial banks would help accelerate the process. On the one hand, the entry of larger banks into this segment of the market would intensify competition; on the other hand, diversification up-market by microlenders would help spread overheads and reduce the costs for handling small credits. Microfinance institutions that are licensed as banks also have the advantage of offering deposit accounts, which allows them to mobilize funds from the community, lower their cost of funds, and spread overheads—while simultaneously providing customers with valuable services for accumulating assets and managing cash flow variations. In rural areas, however, microfinance institutions will continue to face very high costs because of low population and business densities, as well as high logistical costs; in those areas, community-based microfinance organizations are likely to be more efficient than more formally structured institutions.

Quick fixes such as subsidized lending schemes or legal restrictions on lending rates may be politically tempting, but they are counterproductive for developing the microfinance sector. Subsidized lending tends to be unsustainable and limited in outreach, yet undermines the viability of lending on commercial terms by more sustainable institutions. Similarly, ceilings on interest rates make it difficult or impossible for microfinance institutions to generate an adequate return on equity and therefore short-circuit the development of the industry.

This argument is not a plea for *laissez-faire*. On the contrary, a major theme of this report is that well-designed interventions are needed to facilitate and support financial market development. Thus, programs such as RFSP and FSTAP (see Chapter 3) can accelerate innovations that will lead to lower interest rates on microcredits. The argument against interest rate ceilings also needs qualification. Although imposing artificially low lending rates would inhibit market development, there is still a need to protect unsophisticated microborrowers from loan sharks who charge abusively high interest rates in the name of microfinance. In South Africa, for example, widespread abuse of microborrowers led to the creation of the Microfinance Regulatory Council. For Mozambique, the primary tool for dealing with this problem should be the passage of legal requirements for truth-in-lending requirements, backed by a strong public information campaign and an effective enforcement mechanism.

10 to 20 percent. On the high side, Mexico's Compartamos program charges up to 87.5 percent (Acción International website).

⁶⁷ For example, NovoBanco incurred net losses during its first four years of operation, achieving a positive return on equity for the first time only in 2006. (Data from the Microfinance Information Exchange, www.mixmarket.org).

Recommendation: *Further development and expansion of the emerging microfinance industry in Mozambique is the best remedy for reducing interest rates on microcredits. Donor programs to facilitate and support the development of this market segment can help accelerate the process.*

Recommendation: *Quick fixes such as subsidized lending schemes and binding interest rate ceilings are to be avoided, because they undermine the development of sustainable and efficient solutions to the problem of high interest rates.*

Recommendation: *Laws and regulations are needed to protect unsophisticated borrowers against abusive practices by loan sharks operating as microfinance institutions.*

BANK FEES

Apart from the high cost of borrowing, bank customers in Mozambique regularly complain about high to exorbitant fees on a wide range of banking services. In the course of interviews, the study team heard many reports of high fees for letters of credit, bank guarantees, international transfers, routine account statements, and even a \$35 charge for a simple letter attesting to a client's good standing. These reports are consistent with data showing that fee income accounted for a remarkably high 43 percent of gross income in 2005 and 2006, a period when the return on equity for the banks averaged 30 percent (IMF 2007, Table 7, 30).

The study team attempted to corroborate the claim that bank fees are unusually high in Mozambique by seeking information from the banks stating their fees for standard services. One major bank provided a brochure and one claimed to have a brochure that was not readily available. We also asked assistants to visit the banks to solicit information on fees, but it proved to be very hard to collect, especially in any form that would permit comparisons.

Further evidence of opacity in the fee structure comes from a recent World Bank study on the cost of bank services in 58 countries, including 12 in Africa (World Bank 2006). For Mozambique, two banks responded, representing a combined 49 percent share of the deposit market in 2004. The study shows that Mozambique is a leader in efficiency on one indicator, because banks require only a single document to open a checking or savings account (the national identity card). For most of the cost indicators, however, respondent banks in Mozambique provided no data that could be used for the comparative analysis (see Table 6-1).

These findings (or lack of findings) suggest a need for stronger regulations on the disclosure of standard banking fees in Mozambique. This information is important not only to protect consumers against hidden and abusive fees, but also to strengthen competition in setting fees, by empowering customers with information.

In addition, a detailed study of the fee structure in Mozambique should be undertaken by the Banker's Association, in collaboration with CTA's Financial Sector Working Group, to clarify the baseline facts and suggest recommendations on the appropriate format for standardizing such information. As a starting point, Table 6-1 summarizes the World Bank's survey results for African countries, as a benchmark for the selection of indicators and the range of values.

Table 6-1
Comparison of Banking Fees in Africa (2004)

Country	Fee for Consumer Loan (% of Min. Loan Amount)	Fee for SME Loan (% of Min. Loan amount)	Fee for Business Loan (% of Min. Loan Amount)	Annual Fee for Checking Account (% of GDP per capita)	Annual Fee for Savings Account (% of GDP per capita)	Fee for Using ATM Card (% of \$100)	Cost to Transfer \$250 Internationally (%)
Mozambique	n.a.	n.a.	n.a.	n.a.	0.3	n.a.	n.a.
Cameroon	9.7	4.3	4.3	7.9	1.2	n.a.	9.2
Ethiopia	n.a.	0.6	0.6	n.a.	n.a.	n.a.	1.9
Ghana	2.9	1.3	1.3	5.9	0.6	0.2	14.7
Kenya	1.8	1.6	1.6	12.8	2.1	0.2	8.4
Madagascar	1.4	2.5	2.5	5.2	n.a.	n.a.	4.3
Malawi	1.0	1.3	1.3	22.0	3.6	0.1	6.4
Nigeria	n.a.	n.a.	n.a.	0.1	n.a.	0.5	n.a.
Sierra Leone	2.1	1.8	1.8	26.6	n.a.	n.a.	6.9
South Africa	4.4	1.6	1.6	2.1	0.9	0.3	9.5
Swaziland	n.a.	n.a.	n.a.	7.2	1.1	n.a.	14.4
Uganda	2.7	1.5	1.5	24.9	3.4	0.2	0.6
Zimbabwe	3.1	2.5	2.5	n.a.	n.a.	n.a.	n.a.
Average	3.2	1.9	1.9	11.5	1.6	0.2	7.6

SOURCE: World Bank 2006

Finally, anyone who obtains bank credit probably will have to pay a variety of fees for the processing of the loan agreement. The fees can significantly increase the cost of borrowing but the information is conveyed (if at all) in a form that is far from transparent. The Bank of Mozambique should therefore issue stronger truth-in-lending regulations to require commercial banks and other credit institutions to clearly divulge the effective annual percentage rate (APR) on loans, including the annualized interest rate and the cost of associated fees, in line with established international practices.

Recommendation: *The Bank of Mozambique should issue stronger regulations on disclosure of banking fees, following a standardized format. At the same time, CTA should engage with banks, through the Bankers' Association, to be more transparent by publishing material detailing the normal fees for each major form of service and posting the information on their websites.*

Recommendation: *The Bankers' Association and other CTA constituents should undertake a systematic study on banking fees in Mozambique, relative to benchmark charges in neighboring countries.*

Recommendation: *The Bank of Mozambique should issue stronger truth-in-lending regulations requiring commercial banks and other credit institutions to divulge effective APRs on loans, in line with established international practices.*

7. Legal Framework for Financial Sector Development

Financial system development depends critically on the legal framework to determine property rights, ensure contract enforcement, define the rights of creditors and debtors, and establish rules governing financial institutions and transactions. The efficiency of the judiciary also has a major effect on the availability and cost of credit.⁶⁸ When the legal and judicial foundations for finance are weak, banks tend to avoid unfamiliar risks and require higher interest rate spreads to cover the added cost and uncertainty involved in recovering problem loans. Consequently, legal and judicial reforms are essential for overcoming some root causes of limited access to credit and high borrowing costs for local enterprises.

The government of Mozambique has been pursuing legal and judicial reforms through its financial sector development program. But a great deal remains to be done. Some of the basic laws affecting the financial system are very much out of date compared to best practices. Also, the court system is weakened by inadequately trained judges and court officers, poor oversight of judicial performance, and widespread (though difficult to measure) corruption. Some of these deficiencies are reflected in the World Bank's Doing Business report for 2007. For example, Mozambique ranks as one of the 10 most difficult places in the world for enforcing a simple commercial contract. The country also gets a low score on legal rights for lenders and borrowers, based on laws relating to collateral and bankruptcy.

This chapter begins with an overview of the judicial system in Mozambique and then focuses on six topics of direct relevance to the financial system: property rights; property registration; bankruptcy and insolvency; the execution of claims; leasing; alternative dispute resolution; and laws governing the financial system itself. Each section includes a discussion of major issues, along with proposed solutions.⁶⁹ The chapter closes by summarizing the main conclusions.

OVERVIEW OF THE JUSTICE SYSTEM

The Constitution of the Republic of Mozambique defines the basic principles of the justice system and the rights of citizens in that system. The constitution also establishes the Supreme

⁶⁸ For empirical evidence on the link between judicial efficiency and interest rates, see Laeven and Majnoni 2003.

⁶⁹ Other chapters touch on legal and regulatory issues: Chapter 4, legal framework for microfinance; Chapter 5, laws on leasing and pensions; and Chapter 8, foreign exchange regulations.

Court at the apex of the judiciary, along with the Administrative Court to handle administrative, tax, and customs cases, and the Judicial Court to handle civil, criminal, and general jurisdiction cases.

The function, organization, and jurisdiction of the judicial courts are set forth in Law 10/92 of 6 May.⁷⁰ This organic law specifies that judicial function is exercised by district and provincial courts operating under the Supreme Court. The judicial court system is managed by the President of the Supreme Court and the Higher Council for the Judicial Magistrature (*Conselho Superior da Magistratura Judicial*, or CSMJ). The CSMJ also determines the structure and governance of the Judicial Inspectorate, which oversees the performance of judges and other court employees. This instrument is currently under review and likely to be replaced shortly.

The government recently took an important step to improve the judicial process for commercial law by creating special commercial sections in the Provincial Judicial Courts, through Decree 53/2005 of 22 December. The aim of this reform is to focus judicial attention and develop judicial expertise on commercial cases. In 2006, the President of the Supreme Court issued orders creating commercial sections in the Provincial Courts of the City of Maputo, Sofala Province, and Nampula Province. Intensive training in commercial law is needed for the judges and court officers assigned to these new commercial sections. Initial training is being provided through the African Development Fund component of the FSTAP.

In addition to the constitutionally mandated judiciary, Law 4/92 of 6 May established a system of community courts to operate in administrative centers, villages, and peri-urban neighborhoods. These courts were given jurisdiction over minor civil matters and family relations arising from customary law and may not impose prison sentences.⁷¹ The government also has near-term plans to replace the law governing the community courts.

LAND AND PROPERTY RIGHTS

When property rights are well defined, secure, and readily transferable, land and buildings serve as the most important form of loan security for small businesses. Conversely, weak or insecure land and property rights, and limitations on the transfer of title, are serious impediments to the development of credit markets.

Mozambique's Constitution establishes the state's exclusive ownership of land and prohibits the sale or transfer of land, as well as the mortgage or judicial seizure of land. The Constitution also establishes that the state shall determine the conditions for the use and enjoyment of land.

⁷⁰ This is the standard nomenclature for citing laws in Mozambique. Law 10/92 of 6 May refers to the sixth law passed in 1992.

⁷¹ A Labor Court system was also created in 1992, under Law 18/92 of 14 October. These courts have special jurisdiction in matters of labor, occupational illness, workplace accidents, Social Security, and fines levied by the labor inspectorate (under the Ministry of Labor.). In practice, no Labor Courts have been set up. Instead labor matters are handled by labor sections of the judicial courts or, where no special section exists, under the general jurisdiction of those courts.

Under the 1997 Land Law (Law 19/97 of 01 October), land is obtained for economic purposes through the acquisition of usage rights (*direitos de uso e aproveitamento*, or DUATs). The transfer of usage rights requires prior authorization by the government and can occur only if improvements, construction, or infrastructure are built on the land. Urban buildings (*prédios urbanos*) are deemed to have “economic autonomy” in relation to the land. These structures may be freely transferred without prior authorization, and the corresponding usage right thereby transfers automatically. Lots in certain urban or municipal areas may also be transferred without prior authorization. Decrees in 1998, 2003, and 2006 deal with the procedures for regulation of rural and urban land.⁷²

Within this framework, the main problem for the private sector is that land cannot be used as collateral. Improvements and structures can be so used, but the transaction costs are high. This is because the Land Law (Article 16) and Land Regulations (Article 15) stipulate that the transfer of improvements or structures requires prior approval of the authority that originally allocated the underlying land. The parameters for granting this authorization are highly subjective and the timing unpredictable because procedures are not stipulated in the regulations. Thus, a favored applicant may obtain authorization in one week to transfer a plot on the strength of erecting a modest perimeter wall, while a less-favored applicant may be denied authorization after erecting a major structure. Worse, the application could languish indefinitely. (If an application is denied, appeal may be possible.)

Ideally, usage rights should be freely usable as collateral. Politically, this is a nonstarter for the time being. Strictly speaking, real assets on rural land could still be a practical form of security for bank loans if clear regulations were available for authorizing the transfers. No change in the land law, as such, would be needed.

A draft regulation prepared under CTA’s auspices, was presented for discussion with the government in September 2006. The draft aims at regulating the time permitted for, and the criteria applied to, the procedures for transferring improvements and structures. It provides, for example, that in the absence of explicit rejection within 30 or 45 days (depending on the case), the application is deemed to be implicitly approved (*deferimento tácito*). The draft regulation further provides that improvements or structures with a proven value of 50 times the annual land fee on the subject plot are sufficient to support authorization of the transfer. These two provisions would remove delays and discretion from most property transfers. The draft also contains rules clarifying conditions in which usage rights alone may serve as security for bank credit. In this proposal, if the bank seeks to realize property collateral and the improvements are insufficient to support a usage-rights transfer, the bank may seek to have the use right revoked and obtain a preference right in respect of a new usage right for the underlying land.

In urban areas, the application of some of the principles in the Urban Land Regulation, including the free transfer of unimproved land in qualifying urban areas, will help improve the profile of land as collateral.

⁷² Decree 19/07 of 8 December deals with Land Regulations for rural areas and municipalities without cadastral surveys; this is amended by Decree 1/2003 of 18 February. Decree 60/2006 of 26 December deals with Urban Land Regulations.

REGISTRY FOR OTHER REAL PROPERTY

In addition to land and buildings, many other assets are suitable as security for loans. However, the use of other real property requires a convenient and effective system—clear rights and procedures—for registering and transferring title.

Mozambique's Real Property Code (*Código de Registo Predial*, or CRP) is established in Decree-Law 47 611 of 27 February 1968. The purpose of property registration is to publicly validate rights to real property. The CRP lists the facts, claims, and decisions subject to registration. Registration is optional, upon request by the interested person. In most cases, contracts to transfer unregistered real property are enforceable between the parties but cannot be invoked against third parties. The one instance in which the registration of real property is required to validate a transaction (even between the parties) is in the constitution of a mortgage. Real property registration is also governed by the principle of presumption of ownership by the person in whose name it is registered, with priority for the first registration over all subsequent registrations of the same property.

The CRP provisions are applicable solely to the registration of real properties. Certain vehicles, such as automobiles, airplanes, and ships, are subject to analogous forms of registration. But no other chattels are subject to the registration regime. Important categories of assets that lenders might take as security, such as industrial equipment, cannot be registered. This discourages the financing of such equipment by financial institutions.

For property subject to registration, the manual procedures stipulated by law add to the cost and create delays. The laborious entry of data into large ledgers and the parlous circumstances in which ledgers are kept slow down the registration process, reduce the accuracy of the information, and put the records at unnecessary risk.

Another serious problem is that there have been instances in which corrupt notary and registry staff have colluded with private parties to deprive rightful owners of their real property. These corrupt practices, if allowed to flourish, pose great risk to the integrity of the property registry and public confidence in the system.

The CRP clearly needs to be updated or replaced. It is our understanding that the government intends to do so and has already revised the Commercial Code and the code governing the registry of legal entities. The reform of the CPR should simplify procedures for registration and allow the introduction of new technologies, including creation of an electronic database of registry entries, that can be accessed by financial institutions and the public.⁷³ The revised CRP should also expand the scope of the registry system to cover many more classes of assets. In addition, the government should consider establishing a public–private partnership to manage the property registries, with a formula to determine the revenue accruing to the state. Finally, and especially if property registries remain under state management, corrupt practices must be vigorously investigated and prosecuted.

⁷³ The African Development Fund component of the FSTAP project includes work on creating and linking electronic property and mortgage registries.

The establishment of a well-managed property registry covering a wide range of assets, in which registrations are quick, simple, inexpensive, and reliable, would unquestionably help to expand access to credit for many Mozambican enterprises.

BANKRUPTCY AND INSOLVENCY

Well-designed bankruptcy and insolvency laws are needed to determine the rights of creditors and debtors and establish procedures for the orderly settling of claims for entities that cannot meet their obligations. In economic terms, bankruptcy law should provide a court-mandated vehicle allowing businesses with a legacy of excess debt but viable future prospects to restructure their debts and emerge from bankruptcy with a fresh opportunity to grow. For overly indebted companies with poor prospects, the law should provide an efficient liquidation procedure to settle the debts and free up any remaining assets for more productive uses.

In Mozambique, bankruptcy and insolvency are not subject to a specific law for that purpose. Rather, they are governed by rules of the Code of Civil Procedure (*Código de Processo Civil*, or CPC), under the colonial-era Decree-Law 44129 of 28 December 1961.⁷⁴ Under the CPC, bankruptcy occurs when a business person (*comerciante*) cannot meet his or her obligations.⁷⁵ Depending on circumstances, bankruptcies can be classified as casual, culpable, or fraudulent. The last two are criminal violations. Grounds for declaration of bankruptcy include

- Cessation of payments by the business person, duly proven
- Absence of an agreement with creditors or rejection of an agreement with creditors by the court;
- Absence or flight of the businessperson without naming a legal representative to manage the business;
- Waste or loss of goods or other abusive behavior by the businessperson that demonstrates a manifest intent to fail to meet his or her obligations; and
- Clear insufficiency of assets of a limited liability company to satisfy its liabilities.

A declaration of bankruptcy may be requested within two years from the occurrence of any of these events, even if the businessperson has stopped exercising the trade or has died, or when an event referred to above takes place in the first six months after the ceasing of trade by the debtor. The declaration of bankruptcy precludes the bankrupt entity from administering or disposing of assets as recorded in a judicial inventory.⁷⁶

⁷⁴ As amended by Decree-Law 1/2005 of 27 December) In particular, bankruptcy and insolvency are covered by Articles 1135- 1312 and Articles 1313-1325.

⁷⁵ The term insolvency in Mozambique refers to debtors other than business persons, whose liabilities exceed his or her assets. Most provisions related to the bankruptcy apply, with appropriate modifications, to the insolvency of non- business persons.

⁷⁶ Decree 38 088 of 12 December 1950 establishes the Code of Execution for Tax Debt (*Código das Execuções Fiscais*, or CEF). The CEF regulates the coercive collection of debts owed to the State arising from rates, taxes and other sources. The CEF provides that executions for tax debt are not suspended by declaration of bankruptcy or the conclusion of an agreement with creditors.

The following persons have standing to request a declaration of bankruptcy:

- Any creditor, whatever the nature of his claim, as well as the public prosecutor's office in the event of the flight or absence of the merchant without naming a legal representative, by application; and
- A bankrupt businessperson who has not invoked a meeting of creditors within 10 days after effectively ceasing to make payments, by presentation.

Among the modest changes made to the CPC in 2001 was the extension of Mozambican jurisdiction in cases of cross-border bankruptcy and insolvency of persons domiciled in Mozambique.

The bankruptcy system in Mozambique has not been working well. Many companies are technically bankrupt, yet relatively few bankruptcy declarations have been issued by the courts. According to the Department of Information and Statistics of the Supreme Court, from 1999 through 2005, only 13 bankruptcy and insolvency cases were filed. During that period, 16 cases reached final adjudication. At the end of 2005, 91 cases remained pending.

The relative infrequency of bankruptcy declarations may be explained by the complexity of the proceedings and the delays and legal fees that complexity engenders. When these costs are weighed against the limited prospect of recovering residual assets—especially given the legal priority of the state and the employees as creditors—it is likely that many unsecured creditors opt not to throw good money after bad. One simple measure that would make the bankruptcy system more dependable for lenders would be to accord secured creditors higher priority than the state in claiming assigned collateral assets, in effect recognizing that the assignment of collateral constitutes a transfer of ownership in the event of default on the debt.⁷⁷

The complexity of Mozambique's bankruptcy procedures was recognized as far back as the colonial era. To deal with the problem, in 1973 the government created the Bankruptcy and Insolvency Chamber (*Câmara de Falência e Insolvência*) with a view to training judges and court-appointed administrators to manage the affairs of bankrupt firms and insolvent individuals (Decree n° 449/73 of 8 September). The provisions remain in effect today. Yet judges are unfamiliar with bankruptcy proceedings. With so many cases demanding attention and no practical enforcement of the “first in, first out” principle of case management, judges tend to sideline complex, unfamiliar, and time-consuming bankruptcy proceedings.

The low incidence of bankruptcy filings may also be a symptom of the business culture, which entails a high tolerance for bad debt, or a standard pricing premium by the banks to spread the cost of bad debts across the client base, or both. Still, basic legal reforms can facilitate changes in this culture.

The most important step taken to date has been the creation of new commercial sections in the Provincial Judicial Courts, under Decree 53/2005, as noted above. In the future, bankruptcy cases

⁷⁷ *The Economist* (2007) describes bankruptcy reform in Brazil in 2005 that moved secured creditors ahead of both the government and workers in the queue for claims on assigned assets, stating that this change had a major effect on the willingness of banks to extend loans to the private sector.

will be assigned to these commercial sections and handled by judges with better training in commercial law. The training process is just getting started, so the results remain to be seen. In addition to training judges, there is also a pressing need to train bankruptcy administrators. The training of administrators should be widely available, to ensure competition for the work. Also, procedures are needed to prevent bankruptcy administrators from receiving appointments on the basis of favoritism. The greater the number of service providers, and the fairer the process for assigning work, the better served the business community will be.

In addition to creating commercial sections in the court, the government recently began reforming the bankruptcy code itself, with support from the African Development Fund, under the FSTAP. The consultants involved in this process have been tasked to draft provisions that will simplify bankruptcy procedures, professionalize bankruptcy administration, and streamline the role of the judges, with the aim of allowing firms to survive as going concerns in order to minimize adverse effects on employment, tax receipts, and poverty.

One concern about the direction of this reform is that an overemphasis on preserving firms will defeat another important purpose of bankruptcy law, which is to ensure that residual assets of a failed entity are released quickly for higher-value uses. In Mozambique, many moribund firms are entities that were privatized in the 1990s, put into the hands of the emerging national entrepreneurial class. Thus, there is political pressure to protect current owners and managers. But there should be a countervailing provision in the law to clarify the circumstances in which economic recovery is held to be unlikely, in which case liquidation rather than temporary bankruptcy protection would be pursued.

EXECUTION OF CLAIMS FOR PAYMENT

Beyond the settling of bankruptcies, the legal and judicial system must also facilitate the enforcement of other creditor claims against debtors who default on loans. The ease of executing claims is a serious concern for borrowers as well as lenders, because it has an important influence on the availability and cost of credit.

This section examines the provisions of the Code of Civil Procedure (CPC) relating to the execution of claims. This phrase refers to the judicial process by which a violation of rights, such as documented claims on debtors in default, are coercively redressed. The enforcement of such claims requires a legal instrument of execution (*título executivo*) that determines purpose and limits. Various legal instruments can serve as a basis for execution, including judicial judgments and arbitral awards, authenticated documents constituting an obligation, and documents signed by individuals recognizing an obligation.

The legal instruments used most often by financial institutions to secure loans are, in fact, *títulos executivos*. They are subject directly to execution for payment without court action at the declaratory stage of the legal process. Even so, the execution process requires judicial involvement. Specifically, an ordinary execution for payment of a claim involves the following procedures:

- Application by the executor to the court for execution of the seizure

- Service of process on the party against whom execution is sought, to pay or to indicate goods for judicial seizure to satisfy payment, within 10 days.⁷⁸
- The party against whom execution is sought may, at this point, interpose various defenses.
- Judicial seizure (by the court or its agent) of rights, chattels or real property.⁷⁹ In the case of secured debts, seizure is, in the first instance, of the assets assigned as security, but may extend to other property if the value of the security is insufficient to satisfy the purpose of the execution.
- Creditors are summoned to prove their claims against the debtor, which are evaluated by the court.
- Payment to the creditor may then be made in cash, by handing over of the security, by earmarking of income (as determined by the court), or by the proceeds of sale of the property seized.

This description shows how the execution of a claim for payment can easily get bogged down in court, despite the fact that financial institutions regularly secure their loans with legal instruments that are subject directly to execution (*títulos ejecutivos*). Thus, reform efforts to facilitate lending should focus on the execution stage of the process. As explained earlier, one major reform is already underway: the establishment of new commercial sections of the judicial courts. Judges assigned to the commercial sections are receiving specialized training that is scheduled to end in June 2007.

Nevertheless, additional measures should be considered to enhance the efficiency of the commercial sections for both bankruptcy and execution matters. One such measure would be the introduction of “management-assisted judicial execution.” Under this measure, the court would engage private service providers for secretarial support in execution matters. All decisions requiring the exercise of judicial discretion would remain with the judge. But other steps, such as organizing the case file, contacting the parties, and organizing a police presence to assist in seizures, would be performed by the private service provider. In essence, privatizing the administrative support functions could significantly accelerate the pace of executions and require no changes to any major legislation.

Finally, the Community Court system is an important forum for resolving disputes, particularly in rural and peri-urban areas. The Ministry of Justice is preparing a new draft law to reform and revitalize this system. This initiative presents an opportunity to establish a geographically dispersed system of courts that could settle small claims to stimulate more lending and trade financing to small enterprises, including loans to small farmers through out-grower schemes for

⁷⁸ A summary—as distinct from ordinary—execution differs in that the executor may immediately indicate goods to be seized, along with the application for execution. In this case, the debtor is simultaneously served with process and informed of the goods to be seized. He or she has five days to present defenses. If the executor does not specify goods to be seized, then the debtor has five days to indicate those goods and offer a defense. Thereafter, the procedure continues as described.

⁷⁹ Certain types of goods are not subject to seizure, or in some circumstances, are partially exempt from seizure.

commercial crops. Access to a respected local forum that quickly enforces small debt contracts can make lenders much more willing to enter into such arrangements.

To this end, the ministry should ensure that the revised law establishes jurisdiction for the community courts over debt claims up to an appropriate ceiling for covering such loans. The new legislation should also establish reasonable fees to support the courts as a sustainable institution.

ALTERNATIVE DISPUTE RESOLUTION

Under the Law on Arbitration, Conciliation, and Mediation (Law 11/99 of 8 July), arbitration procedures are available as an alternative to litigation before or during judicial proceedings. In commercial disputes, recourse to arbitration normally depends on the existence of a contractual arbitration clause or an arbitration agreement. Arbitration is to be conducted with respect for the principles of freedom of contract, flexibility, privacy, integrity, speed, equality, the right to be heard, and the right to reply. Otherwise, the procedures to be followed may be freely chosen by the parties or, in the absence of such choice, by the arbitrators. The parties may also freely choose the substantive rules of law applicable to the case, within the bounds of good practice (*bons costumes*) under Mozambican law. An arbitral award has the same effect as a judicial decision and, when definitive, constitutes an instrument subject directly to execution.⁸⁰

Given the state of the court system in Mozambique, increased use of arbitration could clearly be of great benefit for resolving many disputes, including those of a commercial nature. But in the case of bank loans to the private sector, the benefit of arbitration is limited. Arbitration is a declaratory proceeding that generates an arbitral award. These awards, like judicial rulings, are instruments subject directly to execution. As noted above, most financial instruments, properly drawn, have no need for a declaratory proceeding, because they are already subject directly to execution. In other words, the problem for lenders is to enforce their claim, not to determine the claim. Under these circumstances, the drama begins where arbitration would end, and the arbitration process adds no value in resolving the dispute.

That said, arbitration and mediation can offer considerable benefits in resolving other types of problems in the financial system. Bank of Mozambique officials are aware that disputes frequently arise between financial institutions and their customers and often involve complaints by borrowers or depositors. But there is no systematic mechanism to resolve these kinds of problems. A dispute resolution service sponsored or sanctioned by the Bank of Mozambique would be a useful innovation to deal with these problems. This could take the form of an arbitration arrangement, or the establishment of an ombudsman's office to investigate and settle financial sector complaints.

⁸⁰ In addition, Law 9/2001 (of July 7) provides that an arbitral tribunal may resolve disputes arising from administrative contracts as well as the contractual or extra-contractual liability of the Public Administration or officeholders or agents thereof, for harms arising from their actions or in respect of predominantly economic matters, as long as there is an arbitral agreement in effect. An arbitral award, once definitive, has the same executive force as a decision of the first section of the Administrative Court.

LEGAL FRAMEWORK FOR FINANCIAL INSTITUTIONS

This section outlines major elements of the legal framework for banks and nonbank financial institutions and discusses several related issues.⁸¹ The legal framework defines, among other things:

- Purposes and functions of the Bank of Mozambique, as the central bank.
- Rules and procedures for establishing and operating various types of financial institutions
- Rules on foreign exchange transactions
- Supervisory and prudential regulations to safeguard the stability of the financial system, including minimum capital rules and prudential lending limits
- Reserve requirements for banks and other deposit-taking institutions
- Rules relating to accounting standards and financial transparency
- Laws for the prevention and suppression of money laundering and other financial crimes.
- Regulations governing the Bank of Mozambique's Central Credit Registry.
- Regulations governing securities markets, the Stock Exchange, and the operation of mutual funds
- Regulations for microfinance
- Regulations governing the insurance industry

The fundamental legal basis for the licensing and operation of credit and finance companies is established under the Credit Institutions and Financial Companies Law 15/99 of 01 November, as amended by Law 9/2004 of 21 July. The law defines credit institutions as including

- Banks,
- Leasing companies,
- Credit cooperatives,
- Factoring companies,
- Investment companies,
- Microbanks,
- Electronic funds institutions, and
- Other institutions specifically recognized as such by law.

It also defines other financial institutions, distinct from credit institutions:

- Financial brokerage companies,
- Brokerage companies,
- Investment fund management companies,
- Asset management companies,
- Venture capital companies,
- Group purchase administration companies,
- Exchange houses,

⁸¹ Appendix B provides a more complete and annotated list of major laws, decrees, and central bank notices relating to the financial system.

- Credit card issuance or management companies,
- Discounters, and
- Others specifically recognized as such by law.

In addition to providing a broad foundation for development of the financial sector, Law 15/99 establishes rules on bank secrecy and the basic supervisory and prudential principles applying to credit and financial institutions. Unlike Mozambican legislation in many other fields, the law also includes prohibitions against anticompetitive behavior.

In most respects, the legal framework for the financial system is in good shape. The prudential and supervisory rules for the banking system are in line with international standards. Similarly, the minimum capital requirement for opening a bank, currently MT 70 million (US\$2.6 million), is reasonable for Mozambique.

One set of problems involves foreign exchange controls; this will be discussed in chapter 8. Several other legal issues are also addressed elsewhere in the report, including requirements for raising capital on the stock exchange and problems with the pension law (both in chapter 5).

From the point of view of financing problems faced by the private sector, perhaps the most serious is poor administration of certain aspects of the law. Indeed, an emphasis on new legislation often diverts attention from seeking practical improvements to the administration of existing laws. One important example is that supporting regulations have not been issued for implementing Article 46 of Law 15/99, which prohibits anticompetitive conduct among financial institutions. Some features of the market, such as high fees, including ad valorem fees in some cases, on ordinary transactions, and the common practice of not offering interest on demand deposits, suggest a lack of effective competition. Yet there is no evidence of concerted attention to solve this problem by Bank of Mozambique. Indeed, it is not strictly necessary for the Bank of Mozambique to issue regulations on anticompetitive conduct to put teeth in Article 46; it could make progress by simply letting banks know that their pricing practices will be examined more deliberately.

The Bank of Mozambique has also not taken action to end the frequent practice by which banks deny customers rightful access to their deposit funds (usually for foreign currency deposits). Nor has the Bank of Mozambique done much to discipline reported cases of fraud by bank employees against customers, which apparently are not uncommon. Foreign exchange regulations are also reputed to be widely violated by some types of nonbanks because there is no effective enforcement. Another example involves the anti-money-laundering law (Law 7/2002), which has been on the books for five years. Officials in the Public Prosecutors Office (*Ministério Público*) have been trained in investigation of money-laundering (and, reportedly, conducted some investigations), but we are not aware of a single conviction obtained under this law.

In contrast to this lax enforcement, some provisions are unduly rigid and strictly enforced. For example, under Law 15/99 (as amended), a firm that wishes to enter the market as a credit institution must first go through a licensing process, and only thereafter pursue a separate process for “special registration” before it can begin operations. Yet much of the information required for registration duplicates what is supplied and analyzed in the licensing process. In practice, the serial processes result in a substantial time penalty for new entrants to the banking system,

because the Bank of Mozambique's Department of Supervision and Control is slow to analyze applications. If anything, the Department of Supervision and Control should encourage applicants to submit the documentation for both licensing and special registration at the start of the process and review the information in parallel. When the license is issued, special registration could follow immediately. No change in the law is required; the only thing needed is a commitment to good customer service.

This combination of long delays in licensing followed by a failure to exercise practical enforcement is a pattern that repeats itself in many regulatory contexts in Mozambique. These problems discourage entrants and allow anticompetitive and irresponsible practices to go unchecked. We are aware of at least one large international bank that considered opening in Mozambique but chose not to do so in part because of a perception of lax enforcement of banking laws that are needed to create a level playing field. Encouraging new, well-capitalized entrants to the market would stimulate competition.

CONCLUSION

The government's legal reform program has made great strides in improving the institutional foundation for financial sector development. Recent landmarks include the amended law on Credit Institutions and Finance Companies (Law 9/2004), the creation of commercial sections for Provincial Tribunals (Decree 53/2005), the establishment of clear regulations for microfinance institutions (Decree 57/2004), the clarification of leasing rules (Decree 56/2004), and an upgrading of the Central Credit Registry (Notice 007/GGBM/2003). In addition, the government has also finally passed a new Commercial Code and Code on Registry of Legal Entities, to replace archaic colonial codes.

Further reforms underway include new or revised laws on pensions, bankruptcy, foreign exchange controls, and community courts. A new labor law is also in process, which could have important bearing on the efficacy of the bankruptcy law (because high termination costs are a major impediment to orderly restructuring of debt or company liquidation). CTA members can play an important role through advocacy and dialogue on the design of new laws and regulations. As a key stakeholder, CTA can potentially influence both the technical analysis and the political balance and help shape the outcomes to improve financial services for local enterprises.

Recommendation: Priorities for CTA attention in reforming the legal and judicial framework should include:

1. *Introducing the proposed system for management-assisted judicial execution* to break the bottleneck in executing credit claims. This is both very important and easy to do.
2. *Modifying the legal foundation for the Community Court system so that it will have the authority to serve as small claims court*, with appropriate fees to support the institution.
3. *Encouraging the Bank of Mozambique to focus on strengthening enforcement of banking laws* rather than creating more red tape to overcome problems (as in the case of Aviso 2/2006, as discussed in Chapter 8).

4. *Incorporating in the new Bankruptcy Law a provision to move secured creditors ahead of the state in exercising claims against assigned collateral assets.*

Recommendation: CTA should also be an active agent in promoting

1. *Legal reforms that facilitate the transfer of property use rights outside the major urban areas to unlock important capital assets as security for loans.*
2. *The introduction of an arbitration mechanism or creation of an ombudsman's office to handle complaints about the banking system, through the Bank of Mozambique.*

8. Overcoming Problems with Foreign Exchange Restrictions

This chapter examines two controversial regulations (*avisos*) that have been issued recently by the central bank relating to foreign exchange transactions. The first, *Aviso 5/2005* requires banks to set aside a provision against bad debts for loans issued to non-exports denominated in foreign currency. The second, *Aviso 2/2006* tightened procedures introduced by *Aviso 6/2005* on foreign exchange payments and receipts for trade transactions.

Our analysis leads to the conclusion that *Aviso 5* serves a valid and important policy purpose, though amendments are warranted to clarify its coverage and add flexibility, as is consistent with the policy objectives. For *Aviso 2* and its predecessor, however, the costs outweigh the benefits. These measures impede trade and reduce the competitiveness of local businesses while offering little prospect of reducing capital flight and financial crime. Finally, our analysis suggests that a relaxation of exchange controls would contribute to economic growth by facilitating trade and encouraging a return of flight capital.

AVISO 5/2005

The Bank of Mozambique issued *Aviso 5/2005* in May 2005 to redress a systemic risk arising from bank loans denominated in foreign exchange (usually dollars) to clients who do not have an income stream in foreign exchange. Some public statements by central bank officials suggest that a second objective was to reverse the trend toward the dollarization of the economy by making it more difficult to borrow in dollars. In essence, *Aviso 5* requires banks to book a specific provision amounting to 50 percent of foreign currency loans to borrowers who are not exporters. If and when a loan of this sort falls into arrears, the bank must increase the provision to 100 percent.⁸² A “specific provision” is a charge against earnings and a corresponding increase in the bank’s loan loss reserve. The charge against earnings may also lower the bank’s capital base, which the central bank monitors closely to ensure compliance with prudential regulations on

⁸² Article I refers to “borrowers that are not exporters;” Article II creates an exception for foreign currency loans “secured by irrevocable export documentary credits, contracts or other documents in favor of the borrower.” *Aviso 7/2005* amended *Aviso 5* by clarifying the provisioning requirement on loans to exporters and others covered by Article II. This part of the *Aviso* is not germane to the present discussion.

capital adequacy.⁸³ If and when the loan is repaid on time, the specific provision is reversed; this involves a reduction in the loan loss reserve by the amount of the original provision and a corresponding addition to earnings.

Aviso 5 does not prohibit lending in foreign currency to nonexporters, but it clearly and intentionally creates a strong incentive for banks to avoid this practice. When a bank does lend in foreign currency to a nonexporter, it must impose a substantially higher interest rate to offset the effect of the provision requirement.⁸⁴

Justification for Aviso 5

The central bank's concern about systemic risk is warranted. The main purpose of the regulation is to avert the risk of insolvency and instability in the banking system that can arise with a large change in the exchange rate. Prudential regulations throughout the world have long stipulated that banks have to balance their foreign currency assets and liabilities, within limits. (In Mozambique the limit is a difference of 10 percent.) Since the Asian crisis in 1997, the international financial community has become acutely aware that similar risks arise when bank customers face a mismatch by earning income in one currency and borrowing in another.

For example, a company that borrows in dollars while earning income in meticals can face bankruptcy overnight if there is a large and sudden devaluation. The devaluation causes an immediate increase in the burden of repaying the loan and worsens the balance sheet by increasing the local-currency value of debt. If many bank customers are in this position, the financial system as a whole is at risk. According to information from the Bank of Mozambique, nearly one-fourth of foreign currency loans to the private sector went to nonexporters before Aviso 5 was issued.⁸⁵

This risk has a more subtle but potentially serious side effect. If a large devaluation triggers a banking crisis, then the central bank faces implicit pressure to resist a major exchange rate adjustment even when it is warranted by market conditions. Yet delaying the adjustment often means that the market disequilibrium worsens, which increases the likelihood of a larger and more abrupt devaluation later, and hence a larger risk to the banking system. Given the very high economic cost of banking crises, central banks in many countries have introduced regulations to minimize these risks. The fact that no such crisis is in sight is not a valid argument against this kind of regulation. Indeed, one clear lesson from the Asian crisis is that overt signs of an

⁸³ The provision reduces either retained earnings, which enter "Tier 1 Capital" by international standards, or distributed earnings (dividends), or a combination of both.

⁸⁴ The extent of the interest rate effect depends on the specific conditions. For example, if the bank seeks to avoid any reduction in reported earnings, it has to add a full 50 percentage points to the interest rate to cover the provision requirement. In contrast, if the bank were to focus on loan fundamentals rather than the accounting facade, it only has to raise the interest rate to the extent that the provision reduces earnings on other loans due to a capital adequacy constraint; if capital is not a constraint, the amount involved could even be zero. Also, the aviso has little effect on short-term loans that are issued and repaid within a single accounting period, because the loan-loss-reserve provision would be reversed before the books are closed.

⁸⁵ This information was provided by Shakill Hassan, Directorate of Studies and Policy Analysis, Ministry of Planning and Economic Development, with reference to an unpublished Bank of Mozambique report.

impending crisis may come too late. It is best to nip the problem in the bud by avoiding currency mismatches in the first place.

As noted, Aviso 5 also served as a tool to reverse the trend toward dollarization of the economy. Although this is mainly a political objective, a legitimate monetary policy issue is also at stake. The main tools used by the Bank of Mozambique to mop up liquidity and manage the growth of the money supply—namely, treasury bill sales and repurchase agreements—involve metical transactions. They have no direct effect on the dollar component of broad money, which includes currency in circulation and deposits in the banks. As Figure 8-1 shows, foreign currency loans (mainly in dollars) rose rapidly as a share of total deposits in the three years leading up to Aviso 5, reaching 60 percent of the total by the first quarter of 2005. The graph also shows that the share of deposits in foreign currency was not increasing at that time. Taken together, these observations show that the ratio of dollar loans to dollar deposits was rising rapidly. One effect of these trends was to weaken the central bank's ability to manage monetary policy using traditional instruments.

Figure 8-1
Share of Loans and Deposits in Foreign Exchange

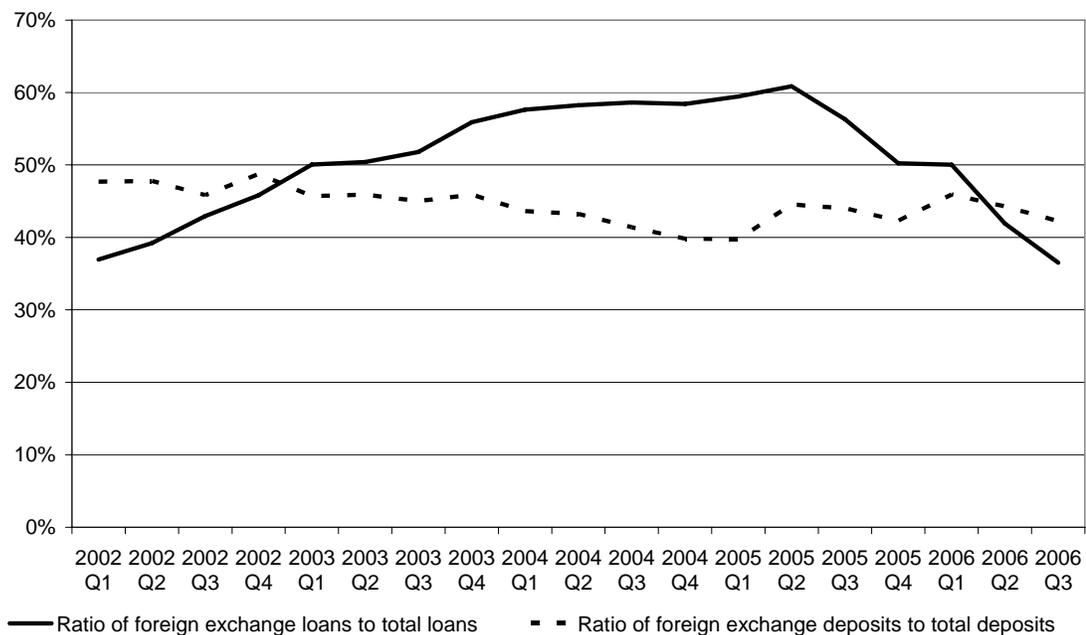
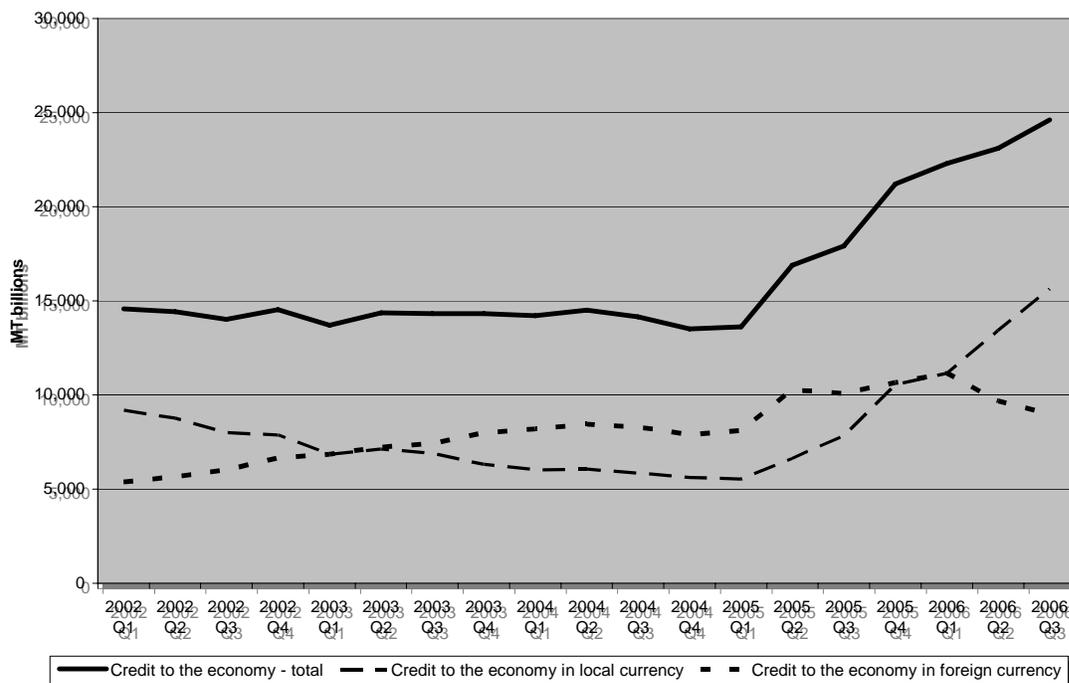


Figure 8-1 also shows that Aviso 5 was effective in reversing the trend toward the dollarization of lending. By the end of 2006, lending in foreign currency had fallen from 60 percent of total credit to just 36 percent. Figure 8-2 shows that metical lending had actually been declining in nominal terms before Aviso 5 and then grew rapidly after the Aviso took effect. The Aviso caused foreign currency lending to stabilize initially and then decline even in nominal terms.

Why had banks been consenting to lend in dollars to unhedged borrowers at a low interest rate? A common explanation is that bank customers routinely misunderstood or disregarded the exchange rate risk and insisted on dollar loans to get the lower interest rate. Indeed, research by economists and psychologists strongly substantiates a widespread misperception of risk. Banks therefore

faced a choice of lending in dollars or losing customers. Most of them chose to keep the customers and hope for the best. Thus, a final justification for Aviso 5 is to avert this competitive incentive to take risk by constraining all banks to avoid such loans.⁸⁶

Figure 8-2
Local and Foreign Currency Loans



Problems with Aviso 5⁸⁷

One major problem cited by business leaders is that Aviso 5 prevents many borrowers from obtaining dollar loans at an interest rate of about 10 percent and pushes them into metical loans at an interest rate closer to 25 percent. Consequently, the aviso adversely affects interest rate-sensitive sectors such as housing construction. Table 8-1 and Figure 8-3 show that the evidence for this hypothesis is mixed. The annual growth of credit for housing did indeed slow to 7 percent in 2005 and 2006, from 13 percent the previous two years.⁸⁸ But lending for construction soared by 193 percent for the latter period, after declining over the previous two years. Similarly, loans to manufacturing rose by 32 percent in 2005 and 2006, after a sharp decline the previous two

⁸⁶ An alternative hypothesis is that the banks actively sought the Aviso to obtain leverage in switching customers to high-profit metical loans. Banks have an incentive to do this if they exercise market power and maintain an interest rate differential between metical and dollar loans that significantly exceeds what is warranted by currency risk. This appears to be the case, as discussed in Chapter 6.

⁸⁷ This section benefits from the analysis presented in Hassan and Arndt 2006 and discussions with Shakill Hassan.

⁸⁸ The numbers are not so easy to interpret due to the fact that Bank of Mozambique data reports do not show the proportion of loans, by sector, in foreign versus local currency. This is an important technicality when the exchange rate is volatile, as it was during the period before Aviso 5.

years. Yet the trading sector has been the main beneficiary from the recent surge in bank lending. This pattern corroborates the charge that Aviso 5 has pushed borrowers into high-cost metical loans because short-term commercial credits are more viable than loans for productive purposes at high interest rates.

Table 8-1

Composition of Total Bank Credit to the Economy, March 2004 to March 2006

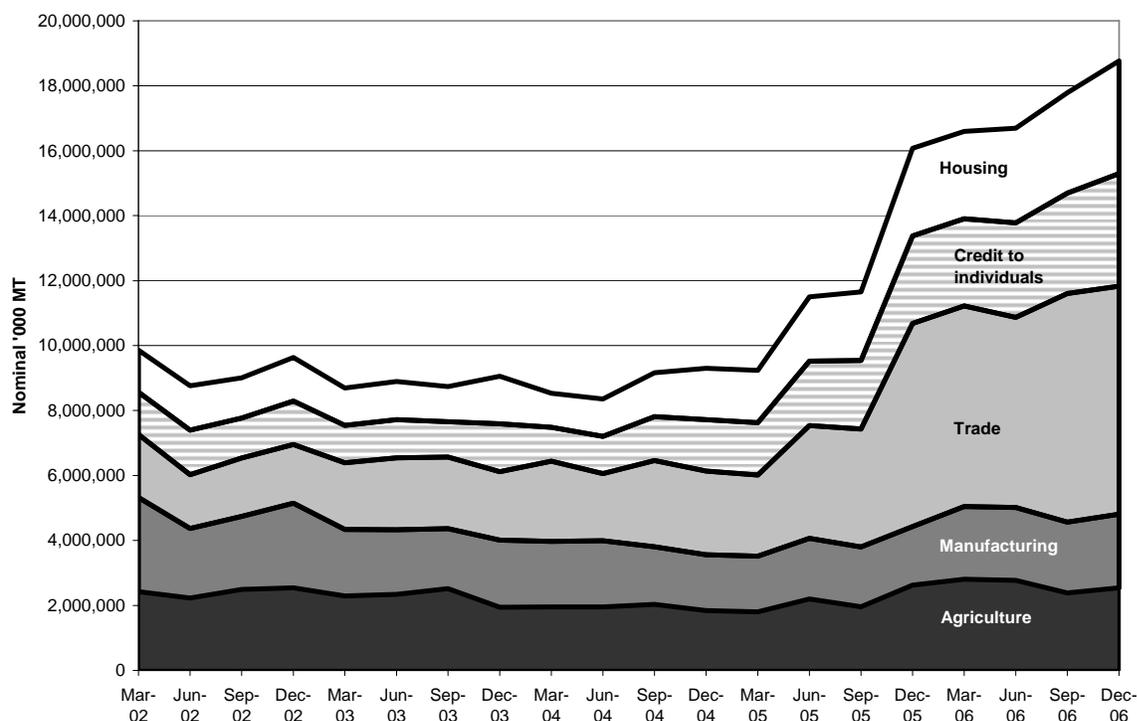
Sector	Total Credit					% Increase	
	Dec. 2002	Dec. 2003	Dec. 2004	Dec. 2005	Dec. 2006	Dec. 2002–Dec. 2004	Dec. 2004–Dec. 2006
Agriculture	2,149,029	1,607,133	1,363,057	1,611,077	1,470,696	-36.6	7.9
Fishing	254,187	264,057	366,709	849,898	901,949	44.3	146.0
Mining and quarrying	91,232	265,956	269,997	625,909	1,213,972	195.9	349.6
Manufacturing	2,609,301	2,066,708	1,723,951	1,799,492	2,268,462	-33.9	31.6
Electricity, gas, and water	399,211	28,378	51,696	158,985	361,386	-87.1	599.1
Construction and public works	583,154	739,498	492,631	922,535	1,443,910	-15.5	193.1
Tourism	554,894	491,055	392,161	844,509	929,416	-29.3	137.0
Trade	1,805,260	2,114,366	2,575,072	6,255,482	7,019,970	42.6	172.6
Transport, storage, and communication	765,092	778,303	818,046	1,186,591	1,576,201	6.9	92.7
Nonmonetary financial institutions	81,359	212,660	214,333	565,272	295,393	163.4	37.8
Credit to individuals	1,340,547	1,468,411	1,581,512	2,698,403	3,469,584	18.0	119.4
Housing	857,591	550,395	973,288	869,500	1,043,031	13.5	7.2
Other credits	2,898,343	3,176,484	2,219,571	2,101,529	3,629,392	-23.4	63.5
Total	14,389,200	13,763,404	13,042,024	20,489,182	25,623,362	-9.4	96.5

Even so, this argument against Aviso 5 ignores the main reason for the regulation—to minimize currency risk. Also, if the differential between metical and dollar interest rates reasonably reflects the devaluation risk, then a 25 percent loan in meticals is no more costly than a 10 percent loan in dollars. The apparently “low interest rate” on dollar loans is actually a poor deal for borrowers with a metical income stream if there is a serious expectation that the metical could devalue by at least 15 percent per year. (A move from 25 to 30 meticals per dollar is a 20 percent devaluation.) As noted above, misperception of risk is commonplace. Nonetheless, Chapter 6 suggested that the interest rate gap in Mozambique is greater than exchange rate risk alone would suggest. Thus, a preference for borrowing in dollars makes good sense, depending on one’s tolerance for risk.

A greater concern relates to the definition of a hedged currency position. Aviso 5 allows exporters to borrow in dollars, but the term “exporter” is not defined. It obviously encompasses manufacturers who export all of their output. But what about a manufacturer who seeks a loan for exports representing half of total output? Or 25 percent? What about a tourism operator or an international trucking company with income largely in foreign exchange? Or a resident working for a foreign agency and receiving wages in dollars? In such cases, borrowing in dollars mitigates

the currency mismatch, and borrowing in meticals perversely accentuates the currency risk, while penalizing the customers.⁸⁹

Figure 8-3
Composition of Credit to the Economy (Selected Sectors)



The regulation should also permit borrowing in dollars when the customer is hedged against currency risk through an approved form of forward contract. Presently, several banks offer forward contract facilities, through which good customers can buy or sell foreign exchange for delivery up to 12 months ahead. As these facilities are rarely used, the point may seem moot. But it is actually very important. Allowing forward contracts to serve as a hedge for dollar loans would stimulate the demand for such contracts and accelerate the development of this extremely valuable market for risk management. After all, a forward contract is essentially insurance against foreign exchange risk. The process of market deepening is likely to be slow, but as it transpires, the pricing of forward contracts will provide increasingly useful information on market perceptions of currency risk. And this information will reinforce arbitrage to minimize unwarranted disparities in the interest differential between dollar and metical loans.

The availability of a market price for currency risk will also strengthen incentives for prudent macroeconomic management, including flexible management of the exchange rate to minimize the risk of a serious disequilibrium in the foreign exchange market.

⁸⁹ Aviso 5 has a “clarification” clause indicating that banks should refer questions of this sort to the Department of Banking Supervision at the Bank of Mozambique. This is an unsatisfactory substitute for clear rules.

A third problem with the Aviso is that the 50 percent loan-loss provision appears to be an excessively disruptive tool for achieving the policy objectives. The purpose of a loan-loss provision should be to build up reserves against potential losses from nonperforming loans. Under present conditions, it is very unlikely that 50 percent of the loans to “nonexporters” would be at risk because of currency volatility. Certainly the Bank of Mozambique has not presented any argument to this effect. Indeed, even the high degree of exchange rate volatility during the year before Aviso 5 (when the dollar fell from 23.4 to 18.4 meticals and then rose again to 24.1 meticals) was accompanied by a *decline* in nonperforming loans as a percentage of total bank loans. This suggests that the central bank could guard against systemic risk from a currency crisis with a provision requirement far less than 50 percent. One senior bank manager suggested to the study team that a 5 percent provision would be more logical. The main conclusion is that the central bank needs to undertake a careful study of the risks and experience with currency volatility in other countries and calibrate the loan-loss provision accordingly.

The 50 percent provision is also inappropriate as a tool for achieving the apparently secondary objective of strengthening central bank control over money growth. A more conventional way to influence the growth of lending relative to deposits is through the reserve requirement. In this case, the problem of monetary control involves the rapid growth of liquidity from dollar loans. A logical response would be to introduce a higher reserve requirement on dollar deposits.

This analysis leads to the following recommendations for consideration by the Bank of Mozambique, in collaboration with the banks, and in dialogue with the business community.

***Recommendation:** The Bank of Mozambique should clarify the definition of “exporter” and modify the exemption to include other borrowers with an income stream in foreign currency.*

***Recommendation:** The Bank of Mozambique should eliminate the loan loss provision requirement for borrowers who are hedged with their income stream or an acceptable forward contract. This measure is not only consistent with the policy objective but will also stimulate the forward market.*

***Recommendation:** The Bank of Mozambique should undertake a careful study of the potential systemic risk arising from lending to unhedged customers and reduce the provision requirement accordingly.*

***Recommendation:** The Bank of Mozambique should consider adopting a differential reserve requirement on dollar versus metical deposits and then use this instrument to control dollar lending for purposes of monetary management.*

AVISO 2/2006

Aviso 2/2006 was issued in May 2006 to modify banking procedures for foreign exchange transactions relating to exports and imports. The procedures were previously governed by Aviso 6/2005, issued a year earlier. Aviso 2 caused an uproar from the private sector as well as complaints from banks. As a result, the Bank of Mozambique placed the Aviso on hold, which meant that Aviso 6 remained in force. In March 2007, the Bank of Mozambique issued a draft

revision of the regulation for comment by stakeholders. In line with the terms of reference for this study, the present analysis focuses on Aviso 2, as issued, but we also include comments on a draft revision that Bank of Mozambique circulated in March 2007.

Aviso 2/2006 includes a long list of regulatory details. Many of them reflect normal banking practices, but some elements are unusually restrictive. The most contentious points involve import transactions, including the following stipulations:

- Apart from the exception cited below, payment for imported goods can be made only through letters of collection (cobrança documentária) or letters of credit (crédito documentário). For imported services, payment can be made only through letters of collection or bank transfers (Article 3.1).
- Apart from the exception cited below, no foreign payment shall be made until the importer has presented documents proving that the goods have cleared customs (Article 3.2).
- Total or partial advance payments can be made only in exceptional cases when there is a solid relationship of trust between the banker and the importer and the importer agrees to submit to the bank the required customs entry documents within 90 days (Article 3.3).
- Payment for services can be made only against confirmation by the beneficiary that the services have been rendered (Article 3.4).
- In every case in which advance payments are made, the full amount must be backed by a bank guarantee (Article 3.5).
- All transport documents shall be issued to the order of the originator's bank (Article 6).
- The bank shall "check the documents in great detail," and only after examination and settlement shall the documents be endorsed by the bank and released to the importer (Article 11).

For exporters, payment can be received in the form of checks and bank transfers, as well as letters of credit and letters of collection. One restriction has evoked controversy: Transport documents shall be issued to the order of the exporter's bank and endorsed to the importer's bank (Article 14).

Many of these stipulations are also found in Aviso 6/2005. In particular, Aviso 6 allowed total or partial prepayment for imports of goods and services only as an exceptional circumstance, on the condition that the importer has a "solid relationship of trust" with the bank and agrees to submit the required import documentation to the bank within 90 days. However, Aviso 6 imposed only a bank guarantee requirement for prepayments of more than US\$50,000.

Aviso 2/2005 strengthened the language of Aviso 6/2005 at many points, especially in relation to prepayments. It also added an opening injunction that banks must ensure that international transactions conform to the law, and in case of doubt, abstain from approving the payments. This adds teeth to the regulation by placing the burden of proof on the banks and preventing them from citing uncertainty about the nature of the transaction as an excuse for making dubious international payments.

Because most Aviso 2/2006 restrictions are also in Aviso 6/2005, they remain in force even though 2/2006 has not been put into effect.

To address some of the concerns raised by the commercial banks and private sector representatives, the Bank of Mozambique has circulated a draft revision of Aviso 2/2006 for comment. The proposed changes include

- Allowing all three forms of payment cited in Article 3.1 (see above) to be used for imports of both goods and services.
- Stating explicitly that banks bear the responsibility to ensure that import documents are collected within the 90-day period following an advance payment, while still referring to advance payment as an exceptional case and for merchandise imports only.
- Clarifying the use of the single customs document (documento único) for initiating import payments, and the timeframe for completing payments following submission of the single customs document to the bank.
- Dropping an article requiring banks to verify preshipment inspection details as part of the import documentation procedure.

Justification for Avisos 6/2005 and 2/2006

Mozambique retains foreign exchange controls on capital transactions to prevent capital flight and avoid the risk of macroeconomic instability due to short-term (“hot money”) capital flows, which would be very difficult to sterilize in an environment with shallow financial markets. In this context, the main purpose of Avisos 6/2005 and 2/2006 were to tighten the implementation of exchange controls by ending illicit capital flight in the form of foreign exchange payments for phantom imports and the retention of export proceeds outside the country. The regulations also help the central bank combat money laundering and other financial crimes by requiring that banks obtain full documentation to substantiate a match between the international payments and actual trade activities.

Aviso 2/2005 strengthened Aviso 6/2005 in relation to prepayments, including a tougher requirement for bank guarantees on prepayments. A senior official at the Bank of Mozambique explained that the revision was needed to deal with widespread abuse of the initial regulation. He explained that more than 80 percent of import transactions were taking advantage of the clause allowing prepayments in “exceptional” circumstances. This was intended as a special case, to be used with discretion. Accentuating the problem, many customers, including some big companies, arranged for prepayments but failed to submit the required import documents. In more than a few cases, prepayments were based on what proved to be false invoices. And in some cases, copies of the same false invoice were submitted to several banks, leading to multiple illicit payments.

In short, the system for processing trade payments was being misused as a channel for illicit international transactions. The avisos were introduced to stem these abuses.

Problems with Avisos 6/2005 and 2/2006

Although the regulations were motivated by good intentions, the costs appear to greatly outweigh the benefits. The main problem is that the bureaucratic requirements work at cross-purposes to

the greater national interest in facilitating trade to grow the economy. Across the world, developing countries are striving to minimize constraints to trade and enhance the competitiveness of local businesses. These avisos instead add layers of red tape to trade transactions and increase the cost of international deals for Mozambican companies. The avisos also push local companies into paying stiff fees for letters of credit or bank guarantees, even when straight payments would be most efficient (see Chapter 6 on bank fees); they limit the flexibility of payment arrangements in contracts with overseas suppliers or buyers; they add additional administrative steps for trade transactions; and they create extra delays and costs for clearing goods through customs.⁹⁰

The regulations burden the banks, as well, with requirements for the inspection, control, flow, and storage of documents. For exports, trade documents have to be made out to the order of the bank; the exporter has to hand the negotiable papers to the bank, who forwards them to the importer's bank for processing and release to the importer. For importers, incoming shipments must be assigned to the bank, and only after the bank inspects and signs the documents can the importer access the goods. Banks will have to engage extra staff to deal with the additional work load. In some cases, bills of entry involve complex technical contents that can be difficult for bankers to confirm in detail. Careful scrutiny of the documents could result in days of delay in clearing the goods, which add up to extra administrative costs, working capital costs, and often demurrage charges for the customer. In addition, the banks undoubtedly impose additional fees for processing the documents. Basically, the stipulated process is cumbersome, time consuming, and expensive.

The limitation on contract flexibility is equally troubling. The two avisos state that prepayments should be authorized in exceptional circumstances only. But there is nothing extraordinary about a major international corporation requiring full or partial prepayment on a shipment or service delivery to a relatively small customer in a poor country with weak institutions for contract enforcement such as Mozambique. Likewise, where exporters have an ongoing relationship with an overseas buyer, there is nothing extraordinary about the buyer offering prepayment as a form of low-cost working capital finance, to enhance competitiveness for the overall supply chain. International contracts take diverse forms, and efforts to restrict legitimate terms of payment or increase the transaction cost effectively throw sand in the gears of commerce.

If the avisos were necessary to achieve compelling benefits, then the costs might be worthwhile. But this is not the case. To paraphrase a former central banker from a neighboring country, imposing these controls to stem capital flight is like trying to sweep back an avalanche with a broom. Worldwide experience has shown that controls rarely stop capital flight. For example, at the time of the Latin American debt crisis in the early 1980s, observers estimated that the amount of flight capital from Latin America equaled or exceeded the total debt of the affected countries, despite strict capital controls.

At best, these controls encourage people to find other ways of circumventing the currency regulations to accumulate assets out of the country. And at worst, they create a perverse incentive for economic agents to hold more assets externally. This is a reality, not a theory. Many countries,

⁹⁰ This section benefits from the analysis in Cruz and Hassan 2007.

including neighboring South Africa, have discovered that capital flight starts to ebb and reverse when exchange controls are relaxed, not when they are tightened. Thus, the Bank of Mozambique should be moving in exactly the opposite direction, toward making foreign exchange transactions simpler and faster, rather than trying to sweep back the avalanche.

Restrictions on trade transactions are especially likely to be ineffectual in controlling illicit financial activities if the existing laws are not being enforced. Even the strict anti-money-laundering law that has been in place since 2002 has resulted in no apparent prosecutions or convictions. Furthermore, banks are not necessarily the main culprits in facilitating illicit foreign exchange transactions. On more than one occasion, the study team heard that the violations are often facilitated by bureaus de change (which also provide important competition for commercial banks and help to hold down fees and margins on foreign exchange transactions). Indeed, major banks cannot afford to risk costly sanctions for currency violations because they are subject to strict controls from parent corporations abroad in addition to supervision by the Bank of Mozambique.

In short, these avisos have the effect of impeding trade, imposing additional financial costs on the private sector, and encumbering banks, while doing little to solve the problems.

Assuming that capital controls stay in place, for the reasons stated above, a preferred alternative to the avisos under review would be to relax procedures for making international payments on trade transactions while tightening enforcement of the rules. To be specific, importers and exporters should be free to negotiate any payment arrangement that best suits their business requirements as long as the terms comply with the foreign exchange law. But they must also be held responsible for documenting that the international payments are justified by legitimate trade transactions.

The 90-day requirement for submitting documentation is appropriate, though perhaps too tight. But it must be enforced. Banks that do not receive and review a minimum of required documentation within the stipulated time frame should be subject to stiff sanctions, including onerous fines, and for repeat violations, revocation of their license to deal in foreign exchange. This is done in South Africa. The threat itself helps to ensure that banks adhere to the law. Importers and exporters should also be required to maintain documentation subject to random audit by investigators for the central bank or the Office of the Attorney General (*Procuradoria Geral da República*). This system will undoubtedly allow a degree of abuse to slip between the enforcement cracks, but the benefits of tight restrictions are not worth the costs.

At the same time, the Bank of Mozambique should work closely with customs, the commercial banks, and other business leaders to modernize information flow among traders, ports, and banks. The goal should be to introduce a system to accelerate the clearance of shipments through the ports, while simultaneously enabling electronic remittance of duties and taxes, strengthening the integrity of international payments, and reducing the overall cost of international transactions. With modern information technology, this win-win-win-win solution is entirely feasible for major ports and companies with computerized information management systems.

The draft revision of Aviso 2 that the Bank of Mozambique has circulated for comments would relax some of the restrictions and reduce some of the paperwork requirements imposed by the previous regulations. Otherwise, it would do little to solve the problems discussed here.

The rules relating to capital transactions should also be reviewed to eliminate unnecessary red tape. For example, the Bank of Mozambique could issue approval once per year for a *schedule* of payments to service international loans or pay royalty fees, rather than requiring businesses to seek separate approval for each remittance. The current practice adds to the cost of doing business without materially improving compliance. The Bank of Mozambique could also introduce information systems that allow commercial banks to file payment requests electronically; this would reduce paperwork delays and errors, with particular benefits for bank clients outside Maputo.

A final point relates to the process pursued in issuing regulations. Evidently, the Bank of Mozambique held no consultations with stakeholders before releasing Avisos 6/2005 and 2/2006. In the wake of protests, Bank of Mozambique has now engaged the banks and the business community in discussions about revising the regulations. This participatory approach should be the standard procedure. Through such consultations, technocrats at the central bank help stakeholders understand proposed regulations and benefit from hearing from constituents about practical business considerations.

In summary, the analysis in this section leads to the following recommendations for consideration by the Bank of Mozambique and other stakeholders:

Recommendation: *The Bank of Mozambique should modify the regulations to allow businesses wide latitude in structuring contracts for international trade transactions, while requiring that the transactions comply with the law. This can be done by allowing full or partial prepayment as a normal business practice, subject to submission of official documents to confirm the delivery of goods or services within 90 days.*

Recommendation: *In conjunction with liberalized rules for trade transactions, the Bank of Mozambique should intensify enforcement of the law via periodic random audits of bank and nonbank financial institutions that handle foreign exchange and apply heavy fines for noncompliance.*

Recommendation: *Banks and nonbank financial institutions that are repeat offenders should face revocation of their license to deal in foreign exchange.*

Recommendation: *The Bank of Mozambique should work with customs, banks, and business leaders to modernize information flows and accelerate the clearance of shipments through the ports while strengthening the integrity of the international payment system and reducing the cost of international transactions.*

Recommendation: *The Bank of Mozambique should also consider simplifying the rules and procedures relating to capital transactions, in light of international evidence showing that restrictive regimes in fact encourage capital flight.*

Recommendation: *The Bank of Mozambique should institutionalize consultations with stakeholders to discuss in advance the design of laws and regulations wherever possible.*

9. Conclusions and Recommendations

This purpose of this study has been to analyze key financial sector constraints to private sector development in Mozambique, as identified by local business leaders through the Confederation of Mozambican Business Associations (CTA), and to offer practical recommendations for overcoming these problems. The study has focused on the central problems of limited access to credit and the high cost of credit. In addition, the study examined weaknesses in the legal and judicial foundations for financial sector development, and recent problems arising from banking regulations relating to foreign exchange loans and international trade transactions. The analysis has drawn on information obtained from more than 60 field interviews conducted in February, 2007, as well as insights obtained from prior studies of the financial system in Mozambique, and lessons from international and regional experience.

Our analytical conclusions can be summarized as follows:

- A sound banking system is a public good that benefits the whole economy. Yet banks can be sound and innovative. In particular, they can do a much better job of developing appropriate financial services to deal with nontraditional clients. Public sector interventions should be carefully designed to strengthen the financial markets, and not weaken them through short-term palliative measures. (Chapter 2.)
- Trends in the financial system in Mozambique are actually very positive, including rapid growth of lending to the private sector, extensive legal reforms, the entry of new financial institutions serving diverse clients, and a clear government commitment to a comprehensive financial sector reform program, funded by several major donors. (Chapter 3.)
- The central problem of access to credit reflects a large gap between the legitimate needs of banks to avoid undue risk, and the perceived financial needs of many local businesses. Sustainable solutions must address the root causes by overcoming information problems, reducing lending risks, lowering transactions costs, strengthening the institutional foundations for credit, and improving the economic fundamentals for efficient and competitive private sector growth. (Chapter 4.)
- Access to long term capital for investment is a special problem. A widely discussed proposal to solve the problem by establishing a national development bank has positive features, but there are also constraints that must be taken into account. The proposal should move ahead if serious commercial investors are convinced to put their money into it, but not if it depends on government subsidies. At the same time, alternative

approaches should be considered for providing term finance. These include a regional development finance institution; expansion of asset-based lending; the creation of a second-tier bond market; and technical assistance to help high potential enterprises bridge the management gap to access venture capital. In addition, an overhaul of the pension system should be considered to expand the supply of long term capital. (Chapter 5.)

- Bank lending rates on dollar loans appear to be in line with international benchmarks, taking into account the costs and risks of lending in Mozambique. Interest rates on metical loans, however, appear to be higher than one would expect on the basis of economic considerations. Yet the metical lending rate bears a reasonable relationship to the interest rate on Treasury bills. Hence, the crux of the problem appears to be inadequate competition in the primary market for T-bills. In addition, banking fees are widely regarded to be excessive, though systematic data are hard to find. (Chapter 6.)
- The Government of Mozambique has been pursuing legal and judicial reforms as an integral part of the financial sector development program. Further reforms are needed in areas such as property rights, property registration, bankruptcy law, contract enforcement, adjudication of small claims, and arbitration of disputes with the banks. However, a focus on legal reform tends to divert attention from the corresponding need to improve enforcement of the existing laws. (Chapter 7.)
- Two recent banking regulations relating to foreign exchange loans and transactions have provoked great controversy. Our analysis suggests that Aviso 5/2005, on loans denominated in foreign exchange, serves a valid and important policy purpose, but with too rigid a design. In contrast, Aviso 2/2006 and its predecessor, 6/2005, which govern international payments for imports and exports, impose costs on the business transactions that greatly outweigh the likely benefits in terms of controlling financial crimes. (Chapter 8)

Based on this analysis, the study offers more than 60 recommendations for consideration by CTA, the Government, the Bank of Mozambique, and international partners involved in financial sector or private sector development programs. Some of these recommendations point to reforms that are already underway, including activities being pursued through the Financial Sector Technical Assistance Project (FSTAP), the Rural Finance Support Program (RFSP). Other suggestions point to measures or programs that are not yet on the agenda. The analysis also underscores the importance of broader reforms to the business environment, which are essential in order to expand the scope for bankable business growth and productive investment.

The study identifies several actions that CTA members, in particular, can pursue, mainly relating to information programs and business support services. Most of the recommendations, however, are best viewed as issues for the business community to address through advocacy. To move the agenda forward and achieve results, we recommend that CTA's Financial Sector Working Group carefully review all of the recommendations in this report, and then:

- Select a limited number of immediate priorities, focusing on issues that are not only important for overcoming financial constraints, but also have strong analytical justification and a politically feasible solution.

- Identify champions within the business community to assume primary responsibility for driving the advocacy for each priority issue.
- Seek a collaborative dialogue with the government, the central bank, and the Bankers' Association on finding the best way to solve the problems.
- Play an active role in informing the public about the need for key reforms, in order to broaden the political constituency for action.
- Seek a dialogue with donors to help mobilize support on issues that require technical assistance or outside funding, and contribute to discussions on the design of any resulting project.

As quick-win priorities for immediate attention, the CTA and its member organizations might consider pursuing some of the following recommendations, either directly or through dialogue with the government, the Bank of Mozambique, and interested donors:

- Introduce greater competition in the primary market for Treasury bills. (Chapter 6)
- Introduce new regulations that enhance transparency in the banking system, including a standardized presentation of the effective cost of borrowing, and a standardized format for informing customers of the fees for normal banking services. (Chapter 6)
- Replace Aviso 2/2006 with a liberalized regime for export and import payments, along with stricter enforcement of the underlying foreign exchange laws. (Chapter 8)
- Amend Aviso 5/2005 to broaden the set of borrowers who can qualify for loans in foreign exchange without triggering the loan-loss provision requirement, consistent with the objective of minimizing currency risk for the banking system. (Chapter 8)

Other short-run priorities might include taking concrete steps to:

- Develop a public information program to help unsophisticated local entrepreneurs understand basic business management techniques and the realities of dealing with banks, through press releases and radio programs. (Chapter 4)
- Organize a national conference on mobile-phone banking to accelerate the introduction of this transformative technology for expanding access to financial services to previously unbanked population groups. (Chapter 4)
- Seek an arrangement with one of the commercially successful Latin American development banks, such as BNDES in Brazil or COFIDE in Peru, to study the proposal to establish a national development bank in Mozambique, taking into account the realistic scope for lending and the structural constraints. (Chapter 5)
- Undertake a systematic study of fees charged for standard banking services in Mozambique, in comparison with comparable fees in neighboring countries. (Chapter 6)
- Break the judicial log-jam in processing the execution of claim for payment, by introducing the Management Assisted Judicial Execution proposal. (Chapter 7)

At the same time, CTA's Financial Sector Working Group and member organizations should also pursue a sustained dialogue with policy makers on more difficult issues that will take more time to resolve. For example, the medium- to long-term priorities might include advocacy to:

- Negotiate donor support for technical assistance to help local businesses improve financial controls and package loan proposals for approval by the banks. (Chapter 4)
- Introduce a formal inflation rule as a principal tenet for monetary policy. (Chapter 6)
- Create a second-tier bond market to open new avenues for financing for larger domestic businesses, and create competition for the banks in dealing with traditional clients. (Chapter 5)
- Mobilize long-term savings through fundamental reforms to the pension system, involving a conversion from pay-as-you-go principles to a defined contribution system. (Chapter 5)
- Modernize the information systems and expand the scope of coverage for property registries. (Chapter 7)

In summary, there are serious problems with the financial system, which constrain private sector development in Mozambique. Many of the constraints can be relaxed through appropriate measures and programs to support the development of sound and efficient financial markets, as outlined in this study. Furthermore, CTA and its member organizations can play a vital role in moving the agenda forward through programs to help small and medium enterprises improve their creditworthiness, and by acting as strong advocates for essential reforms, on behalf of the local business community.

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Appendix A: Resource Persons Contacted

IN WASHINGTON D.C.

Sherri Archondo	World Bank	Senior Financial Sector Specialist
Chris Barltrop	USAID	Senior Financial Sector Advisor, EGAT
Charles Chuka	World Bank	Senior Advisor to Exec. Dir. Africa Region 2, (Former Gen. Mgr, Reserve Bank of Malawi)
Jean Clement	IMF	Mozambique PRGF Mission Team Leader
Scott Jazynka	Nathan	COP, Egypt ICP Project
Victor Lledo	IMF	Financial Sector Specialist
Samuel Maimba	World Bank	Senior Financial Sector Specialist
Juan Carlos Mathews	Nathan Associates	COP, Peru MYPE Project
J. Peires	IMF	Mozambique Mission
Daniel Schydrowsky	BIDE	Former President, National Development Bank of Peru (COFIDE)
Jose Sulemane	IMF	Advisor to Exec Director for Mozambique

IN MOZAMBIQUE

Business Representatives, Maputo

Jose Alves	Agro Alra	Chairman
Jose M. de Carvalho	Consultores de Comercio Intl. Lda	Managing Partner
Tony Currie	Maragra Sugar Estate	General Manager
Paulo Fumane	CTA	Executive Director
Jane Grob	CTA	Pelouro on Finance, and Partner, SCP
Jim LaFleur	CTA	Advisor
Estevao M. Langa	AAM	Economist and Executive Secretary
Paulo Negrao	Citrum	Financial Administrator
Agostinho Vuma	VUMA Construction	Director General
Romeu Rodrigues	CETA	CEO

Business Representatives, Nampula

Eduardo Abacar	ABC Services & Filhos
Abdula Tarmamade Abdula	ASTRA
Ali Cherif Deroua	AIA & Alexim Lda
Tertuliano Juma	AEMPRESA
Antonio Pereira Momade	ACIANA
Jose Marques Monamela	CTA-Nampula
Gokaldes Murargi (Jess)	Casa Damodar
Elisa Ngulele	Vyper Solutions

Banco de Mocambique

Antonio Abreu	Bank of Mozambique	General Manger
Samuel Banze	Bank of Mozambique	Director, Banking Supervision

Financial Sector - Maputo

Robert Cantin	UCB	Managing Director
Teotonio Jaime Comiche	BIM	Conselho de Administracao
Antonio Correia	Standard Bank	Director of Credit
Antonio Jose Domingos	General Inspectorate	Inspector General for Insurance (IGS)
Joao Figueiredo	BIM	Vice Chairman & CEO
J.A. Ferreira Gomes	BIM	General Manager
Yann Groeger	Banco Novo	Director General
Robert Hobart	General Inspectorate	Technical Advisor for Insurance (IGS)
Keith Jeffris	Consultant	Former banker
Carlos Madeira	AfricBankingCorp	Head of Treasury
Simba Manunure	Hollard Insurance	Technical and Commercial Director
Adriano Meleiane	Consultant	Former Governor, Bank of Mozambique
Piet Nel	Global Alliance	Director Insurance
Chuma Nwokocha	Standard Bank	Director of Finance
Majid Osman	BCI	President/Chairman
Werner Pauw	Banco Austral	Director
Prakesh Ratilal	Consultant	Former Governor, Bank of Mozambique
Trudi Schwarz	Banco Opport Moz	CEO
Antonio Souto	GAPI	CEO
Victor Viseu	United Leasing Company	CEO

Financial Sector, Nampula

Daniel Oliveira	BCI Fomento	Operation Coordinator, Northern Region
Unknown	Novo Banco	General Manager, Nampula Agency

GOVERNMENT

Antonio Cruz	MPD/DNEAP	National Director
Augusto Sumburana	MOF/GEST	National Director,

DONORS AND DONOR PROGRAMS

Tim Born	USAID	
Tine Knott	USAID	
Nelson Guilaze	USAID	
Carvalho Neves	USAID	Rural Finance Advisor
Kwesi Agbley	Nathan	COP, Mozambique Tourism Project
Rui Benfica	World Bank	Rural and Micro finance specialist
Gregory Binkert	World Bank	Economist
Emmy Bosten	IMF	TA Coordinator
Simon Vanden Broeke	DfID	Economic Advisor
Jose Chichava	FSTAP	Coordinator
Karimould Chih	FSTAP	Program Manager – Microfinance
Graca Maria Chiuta Cumbi	FARE/RFSP	Technical/rural finance assistant
Felix Fischer	IMF	Resident Representative
Helder Fumo	FARE/RFSP	Credit Analyst
Cipriano Gomes	FARE/RFSP	Innovation and outreach facilitator
Tracy Lloyd	IFC	Investment Officer - Program Manager
Aurora Malene	FARE/RFSP	Technical/rural finance officer
Antonio Nucifora	World Bank	Deputy Country Director
John Walter	Technoserve	Director
Channing Arndt	MPD/DNEAP	Senior Advisor

IN GABARONE

Stephan Kufeni	SADC/DFRC
Joseph Nyamuda	SADC/DFRC

Appendix B: Legal Framework

The laws, decrees, and notices governing the financial system were compiled for this report as a service for readers by SAL & Calderia, Advogados e Consultores, Lda. The information reflects the state of the law as of March 18, 2007.

Law nº 1/92 of 03 January

Law 1/92 defines the nature purposes and functions of the Bank of Mozambique. Bank of Mozambique is the country's central bank, responsible for monetary policy, credit policy, payments in international transactions and banking, among other matters. In particular, Bank of Mozambique is responsible for the supervision of financial institutions.

Law nº 3/96 of 04 January

Law 3/96 approved the Exchange Law, which supplies the rules governing acts, transactions and operations of the resort carried out between residents and nonresidents and that may or do result in payments to or from abroad. The Exchange Law also defines exchange operations and explains who may carry them out; provides rules for local and foreign currency denominated bank accounts; international flows of funds; and exchange violations, among other matters.

A new foreign exchange law, intended to replace Law 3/96, has reportedly been proposed by the Council of Ministers to the Parliament. Despite repeated attempts, we were unable to obtain a copy of the bill.

Law nº 15/99 of 01 November (as modified by Law nº 9/2004 of 21 July)

Law 15/99 approves the Credit Institutions and Financial Companies Law, defining and sending basic rules of operation for a wide variety of financial institutions. It also provides sanctions for the violation of those rules.

The following are defined in the law as credit institutions:

- Banks;
- Leasing companies;
- Credit cooperatives;
- Factoring companies;
- Investment companies;
- Micro banks;
- Electronic funds institutions; and

- Other institutions specifically recognized as such by law.

The following are defined as financial institutions

- Financial brokerage companies;
- Brokerage companies;
- Investment fund management companies;
- Asset management companies;
- Venture capital companies;
- Group purchase administration companies;
- Exchange houses;
- Credit card issuance or management companies;
- Discounters;
- Others specifically recognized as such by law.

Law 15/19 also regulates such matters as the licensing of credit institutions and financial companies by the Bank of Mozambique; bank secrecy and the exceptions thereto; and the basic supervisory and prudential principles to which financial institutions are subject. In addition, unlike Mozambican legislation in many other fields, Law 15/99 includes prohibitions against anticompetitive behavior.

Law nº 7/2002 of 05 February

Law 7/2002 establishes a legal framework for the prevention and suppression of abuse of the financial system for the laundering of money and other assets arising from criminal activity. Law 7/2002 describes the different types of criminal behavior and supply sanctions therefore. It also imposes duties on financial institutions in respect to their clients so as to prevent money laundering and supplies means for the investigation thereof. Law 7/2002 was further regulated by Decree nº 37/2004 of 05 February.

Decree nº 56/2004 of 10 December (as modified by Decree nº 31/2006 of 30 August)

Decree nº 56/2004 approves the Regulations of the Credit Institutions and Financial Companies Law. It establishes the rules and procedures applicable in general and to the specific types of credit institutions and financial companies. Excepted from this decree are credit cooperatives and microbanks which are governed more specifically by Decree nº 57/2004 of 10 December.

Aviso nº 5/GGBM/96 of 19 July

Aviso 5/GGBM/96 approves the Regulations of the Exchange Law. It establishes rules regarding exchange operations, registration with the Bank of Mozambique, foreign currency considered legal tender in the country, import and export of goods, authorization of foreign loans, the repatriation of capital invested and profits earned, and bank guarantees, among other matters. Under the terms of Aviso 5/GGBM/96, exchange operations in an amount greater than US\$5,000 require prior authorization and registration at the Bank of Mozambique.

Aviso nº 05/GGBM/99 of 24 March

Aviso nº 05/GGBM/99 establishes the ratios and prudential limits to be followed by credit institutions. It governs such matters as solvency ratios, diversification of risk in various classes of operations, including foreign exchange operations.

Aviso nº 06/GGBM/99 of 16 June

Aviso nº 06/GGBM/99 approves the rules related to the publication of the financial statements of credit institutions.

Aviso nº 11/GGBM/99 of 13 December

Aviso nº 11/GGBM/99 establishes certain internal controls to be followed by credit institutions and financial companies, particularly with a view towards preventing and detecting fraud.

Aviso nº 13/GGBM/99 of 13 December

Aviso nº 13/GGBM/99 approves the rules regarding the plan of accounts to be used by credit institutions and financial companies.

Aviso nº 00009/GGBM/2001 of 31 December

Aviso nº 00009/GGBM/2001 approves rules related to bank supervision on a consolidated basis.

Aviso nº 007/GGBM/2003 of 23 June

Aviso 007/GGBM/2003 approves the Regulation of the Central Credit Registry, a species of credit bureau for financial institutions. All financial institutions providing credit must report to the Central Credit Registry. All information supplied to them by the Central Credit Registry is subject to bank secrecy. Reports are only available to actual creditors of the person with respect to whom the report assault or to financial institutions considering a request for credit by such person. Any such information may not be transmitted to a third party.

Debtors and prospective debtors have the right to know the information related to them as well as to request clarifications, corrections and updates. If not satisfied, such persons are entitled to appeal to the Bank of Mozambique.

Aviso nº 2/GGBM/2004 of 20 April (as modified by Aviso nº 3/GGBM/2004 of 25 August)

Aviso 2/GGBM/2004 governs the obligatory reserve requirements of deposit-taking credit institutions.

Aviso nº 5/GGBM/2005 of 20 May (as modified by Aviso nº 7/GGBM/2005 of 13 June)

Aviso 5/GGBM/2005 approves special provisions for credit operations in foreign currency by financial institutions in Mozambique. It provides, among other matters, for the obligatory creation of a reserve equal to 50% of the value of the loan for loans in foreign currency granted to

borrowers who are not exporters. It also provides for increases in such reserve for late-performing and nonperforming loans.

Aviso nº 4/GGBM/2005 of 25 May

Aviso 4/GGBM/2005 establishes the minimum capital for credit institutions, financial companies and micro-finance operators. It provides for reductions in such minimum capital requirements depending on the geographical location of the institution, for the purpose of encouraging such institutions to set up branches in underbanked areas.

Aviso nº 6/GGBM/2005 of 28 June (as modified by Aviso nº 2/GGBM/2006 of 29 May)

Aviso 6/GGBM/2005 approves the Regulation on the Import and Export of Goods and Services. It establishes the minimum procedures and documentation to be supplied in transactions that entail international payments through the national banking system. It imposes on banks extensive obligations regarding the collection and preservation of documentation in respect of such transactions.

Decree nº 54/99 of 8 September (as modified by Decree nº 36/2005 of 29 August)

Decree 54/99 regulates the Constitution and operation of mutual funds, i.e., a pool of assets belonging to more than one person (called “participants”) arising from the joint investment of capital by such persons. The decree determines how it opens are established, what kinds of funds may exist and the limitations on their operations.

A mutual fund must be managed by a mutual fund management company (*sociedade gestora dos fundos de investimentos*), a species of regulated financial company. Mutual funds may be open or closed; closed funds must be managed by a commercial or investment bank. Mutual fund management companies are further regulated by the Law 15/99 (as amended) and its regulation (i.e., Decree 56/2004).

Decree nº 48/98 of 22 September

Decree 48/98 approves the Regulation of the Securities Market (*Regulamento do Mercado de Valores Mobiliários*, or “MVM”). The regulation establishes the basic principles that govern the organization and operation of securities markets and the participants therein. In addition to the primary market, a secondary market in securities is conducted through the Mozambican Stock Exchange (*Bolsa de Valores de Moçambique* or “BVM”).

The Mozambique Stock Exchange was, in turn, created by Decree nº 49/98 of 22 September, which also approves its internal regulation. Through a variety of circulars (subordinate normative instruments issued by the Bank of Mozambique), the Bank of Mozambique has provided procedures, rates and other rules governing the Mozambique Stock Exchange.

Decree n° 57/2004 of 10 December

Decree 57/2004 approves the Regulation for Microfinance. Microfinance is understood as the provision of financial services in transactions of modest or medium-size, carried out by licensed microfinance operators other than banks active in the sector. The Regulation for Microfinance divides microfinance operators into four categories in accordance with the nature of their activities. Those whose activities are more extensive (namely, microbanks and credit cooperatives) are both licensed and registered by the Bank of Mozambique; others (savings and loan organizations, microcredit operators and deposit-taking intermediaries) are subject only to registration with the Bank of Mozambique. The former are subject to Bank of Mozambique supervision applying the prudential rules; the latter are only monitored, and lightly, by the Bank of Mozambique.

Law n° 24/91 of 31 December

Law 24/91 eliminated the State monopoly on insurance and reinsurance in Mozambique, opening the market for private providers. Its subordinate regulations, including Decree n° 42/99 of 20 July, created the General Inspectorate of Insurance (*Inspecção-Geral de Seguros*, or “IGS”). The IGS is also responsible for supervision of pension funds.

Law n° 4/2007 of 07 February

Under Law n° 4/2007 of 07 February, (along with subordinate regulations remaining in effect under the terms of the law repealed by Law n° 4/2007), employers contribute 4% and employees 3% of their monthly payroll and wage packet, respectively, to provide illness, disability, and retirement benefits for eligible workers, through the National Institute of Social Security (*Instituto Nacional da Segurança Social*, or “INSS”). Private pension schemes are permitted but only as complements, rather than alternatives, to INSS.