Financial Sector Constraints on Private Sector Development in Mozambique

Executive Summary

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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 the 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 private 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 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.