



# Increasing Private Sector Participation in the Stock Exchange in Mozambique

Supporting the Policy Environment for Economic  
Development (SPEED+)

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# EXECUTIVE SUMMARY

The Mozambique Stock Exchange (BVM) is very small with only five listed companies and very little trading. Market capitalization/GDP and turnover/GDP ratios are among the lowest in the world, and little capital has been raised through new issues in the past few years. The newly installed management team at BVM is determined to make the market larger and more active in order to make it an effective source of finance in the next phase of the country's development.

There is a considerable overlap between the objectives of the BVM and the SPEED+ Program's objectives: both aim to improve the business environment by making the corporate sector more transparent and both aim to enhance protection of minority investors. The BVM seeks to accomplish these aims since it can only build a thriving equity market if the entire business sector is more transparent, laws are enforced and investors have confidence that their interests are protected.

Both the SPEED+ Program and the BVM aim to secure better protection of the rights of minority investors through revision of present laws. Other areas where the objectives of the BVM and SPEED+ coincide are a) upgrading accounting standards, b) development of credit bureaus and c) reform of bankruptcy law.

In addition to advocating specific reforms in the business environment, the BVM, like all stock exchanges, has a pivotal role to play in upgrading standards of corporate governance, which means the system by which corporations 1) choose their objectives, 2) formulate and execute plans to attain those objectives, 3) ensure that the activities of the company are consistent with the interests of all shareholders and 4) make sure that the company respects the law and observes good business practices. Recent reports by international bodies, such as the African Peer Review Mechanism and the Africa Corporate Governance Network have highlighted several serious shortcomings in corporate governance in Mozambique.

The stock exchange promotes good corporate governance by enforcing its rules for listed companies including those about disclosure and requirements for mechanisms to empower investors. Beyond this, the BVM has the capacity to be a prominent institutional advocate of a stronger business environment in its interactions with the media and the authorities. The stock exchange only directly influences listed companies. Nevertheless, by pressing for reforms in the legal framework and setting rules for listed companies, which are usually the most visible in any country, it tends to raise norms for all companies, whether listed or not.

In addition to its role in promoting a sounder business environment, the BVM is a mechanism for raising capital. However, in current circumstances it is not fulfilling this mission, since all potential participants in the capital market--issuers, intermediaries and investors-- are characterized by low levels of activity and awareness. A successful reform must spur all of these market participants to higher levels of activity. This report contains a series of recommendations to accomplish this aim. Some of the recommendations for reform can be initiated by the BVM alone, but many will require legislative and institutional reforms throughout the capital market. For example, the report makes recommendations about the ownership, governance and regulation of the BVM, which will require changes in the law.

Capital markets business is now dominated by the banks, which generally do not perceive investment banking or trading as areas with strong potential. Some recommendations are made about how the laws and regulations might be adjusted to oblige banks to establish specialized subsidiaries and to stimulate the emergence of more non-bank intermediaries such as brokers, dealers and investment banks.

Neither companies nor investors are well informed about the basics of equity investment. Many companies do not see any advantages of public listing, since the capital market has not proven to be an effective vehicle for raising funds the burden of listing, such as dilution of insider control, mandatory disclosure and the risk of shareholder litigation are also dissuasive. A series of measures to increase investor interest in the equity market of Mozambique is suggested with the enactment of a law on mutual funds and easing of exchange restrictions on foreign investors cited as specific steps that should be taken very soon.

The report also observes that the number of listed companies may soon rise due to a planned wave of new issues by IGEPE the institution that is responsible for companies with state ownership and by listing of “megaprojects” in the natural resource sector. While welcoming the rise in listed companies, the report emphasizes the need to strengthen the corporate governance rather quickly, since experience shows that large-scale privatization without adequate safeguards for investors can have disastrous economic and social consequences.

Finally, some suggestions are put forth about how the investor community can gain better access to financial information.

# INTRODUCTION

During June/July 2017, a team comprised of national and international experts undertook an appraisal of the present situation of the capital market of Mozambique with the objective of providing advice concerning possible reforms to the newly installed management team of the Mozambique Stock Exchange, Bolsa de Valores de Moçambique (BVM)<sup>1</sup>. The team reviewed pertinent written information (See bibliography) and conducted a series of meetings with the management of the BVM as well as public sector officials, private executives and other stakeholders. This note summarizes findings about the current state of the market of and makes recommendations for reforms.

Part One will analyze the role that the equity investment plays in the overall economy and suggest how the BVM, working with other stakeholders, can improve the business environment, especially with respect to a) disclosure and accounting standards and b) the legal framework for the protection of the rights of minority investors. Based upon a stronger system of disclosure and protection of investors, the BVM can help construct a robust framework for corporate governance in which companies are accountable to shareholders and more focused on raising the level of efficiency throughout the economy.

Part Two will overview how the equity market performs financial intermediation, enabling savers to obtain competitive returns while the user of capital obtains financial resources for investment, and as such, suggest reforms in the structure and regulation of the capital market (sometimes called the securities sector) in Mozambique in order to align the BVM with international practices while making it more efficient and systemically stable.

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<sup>1</sup> Background from <https://www.thebusinessyear.com/mozambique-2016/liquid-flows/review>

# PART ONE: THE STOCK EXCHANGE AND THE BUSINESS ENVIRONMENT

## A. STRONG BUSINESS ENVIRONMENT: A NECESSARY CONDITION FOR A FUNCTIONING STOCK EXCHANGE

The capital market can play a pivotal role in building a robust business environment in emerging markets, such as Mozambique, where many of the key attributes of an advanced economy are still in formative stages. (<sup>2</sup>) Over the past decade, several reports from international bodies have strongly recommended that emerging markets develop capital markets in order to lessen systemic vulnerability and improve access to finance for businesses of all sizes. In particular, excessive reliance on banks lowers economic efficiency and increasing systemic risk.

In countries where the legal, regulatory and information infrastructure is weak, banks and informal funding will account for nearly all financial intermediation. In countries with very low levels of development, most finance (and indeed most economic activity) will take place through informal channels. Under informal finance two or more individuals agree to undertake a business endeavor part of which is to provide financing. The persons involved may enter the agreement because the formal economic system cannot be trusted to structure and execute the transaction and the financial system cannot be trusted to match savers and users of capital under the most efficient conditions. When the legal system cannot be trusted to enforce contracts, firms will seek business partners based on their ability to provide extra-legal protection. When formal financial markets cannot evaluate and price prospective deals accurately, entrepreneurs will resort to ad hoc financing arrangements outside of legally designated channels. Businesses often misreport earnings to lower their tax burden. Since many companies do not maintain trustworthy accounts, it will be difficult to obtain information and make investments in formal markets, forcing activity outside the formal system.

In most countries, the most active institutions in the formal sector are the banks. In general, banks need reasonably reliable legal protection and reasonable access to information. Thus, banks are strong advocates of strengthening creditor protection (including bankruptcy law) and in improving information through credit bureaus. On balance, however, banks are comparatively adept in dealing in opaque markets with slight legal protection. Banks also rely on collateral and guarantees as well as informal sources of information and personal connections. Banks will understand that in many cases the legal system cannot be relied upon and will therefore minimize situations that might require formal legal redress. Moreover, because they usually obtain a specified return under a loan contract, banks often avoid business risky but promising companies and will concentrate on low-risk activities where they have close ties to borrowers. When alternative financing sources are lacking,

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<sup>2</sup> In cases, where the expression “the stock exchange” is used it refers to any stock exchange. When references are specifically to Stock Exchange of Mozambique, that term or BVM is used

banks enjoy a monopoly of formal finance and frequently can impose prohibitively high lending charges. Now in Mozambique, the public has channeled large amounts of money into the banking system where deposit rates are high. Thus, banks exercise a disproportionate position in formal financial intermediation.

Despite the dominant position of banks, problems in obtaining bank credit persist in Mozambique. Thus, in the World Bank Doing Business reports for Mozambique in 2016, the country was identified as having a wide range of structural problems that resulted in the country receiving scores on the ability to obtain credit well below those of most sub Saharan African countries<sup>3</sup>. This would strongly imply that 1) the banking system needs serious reform and b) non-banking sources of finance should be developed.

Due to the inability of obtaining finance through formal channels at reasonable rates, many promising companies may not be able to realize their potential and the economy will not operate at high levels of efficiency. As specified in the SPEED+ Program, the critical objective of improving the business environment is to strengthen the formal structures of the economy to encourage market participants to move out of the shadow economy and become more productive.

The capital market, especially the stock exchange, is the sector of the economy which more than any other depends upon a transparent business environment and a reliable legal framework to function. In a capital market, transactions are executed publicly at “arm’s length” in impersonal markets and all parties must have confidence that when contracts are not respected the legal system can provide redress. Because it depends upon publicly disclosed information and needs a sound legal framework to operate efficiently, the stock exchange in any country tends to be one of the strongest proponents of strengthening the formal business environment. In the case of Mozambique, this can be seen by comparing the objectives of the BVM with activities of the SPEED+ Program.

## 1. Protection of Minority Investors

To take the clearest example, it is a central objective of the stock exchange to be able to provide protection for minority investors. The implicit contract in making a public listing is that companies “going public” are soliciting capital from shareholders that do not exercise control over the corporation. Those shareholders in return should reasonably expect to receive reliable information and equitable treatment. By making a public offering and remaining listed, the company is accepting this obligation toward its shareholders.

By its nature, investment involves more risk than banking. In banking a depositor places funds on in a bank and the bank extends credit on its own balance sheet (i.e. at the bank’s own risk.) Investors by contrast provide funds directly to companies and assume all the risk inherent in their investment. They must therefore be informed of the risks that they are assuming.

The importance of improving protection of the rights of minority investors has been repeatedly emphasized in World Bank Doing Business reports for Mozambique, most recently in 2016. <sup>4</sup>The specific issues regarding the rights of minority investors cited in the World Bank report are virtually identical to a list that would be proposed by the BVM. Countries receive scores on several

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<sup>3</sup> <http://www.doingbusiness.org/data/exploreeconomies/mozambique/#getting-credit>

<sup>4</sup> <http://www.doingbusiness.org/data/exploreeconomies/mozambique/#protecting-minority-investors>

indicators relevant to the protection of minority shareholders including a) methods of resolving conflicts of interest, b) director liability, c) ease of shareholder suits, d) extent of shareholder voting rights and e) corporate transparency. Countries are tracked over time and compared to similar countries. Of 190 countries that were assessed on the protection of minority investors Mozambique ranked 132 in 2016.

The issue of the rights of minority investors will also be addressed in the upcoming SPEED + work on revision of the Commercial Code.

## 2. Accounting Standards

Another area where the objectives of the stock exchange largely overlap with those of the SPEED+ Program is in the domain of disclosure and accounting standards. Banks also tend to advocate strong disclosure and high accounting standards, but banks can deal better with substandard accounting and poor disclosure, since banks maintain long standing informal relationships with borrowers, where information is exchanged confidentially. Investors in the capital market are prohibited from exchanging information informally and listed firms may not practice “selective disclosure.” All relevant data must be publicly disclosed.

One of the requirements for firms that want to list on the stock exchange is that they must disclose certain information about the firm. Specified norms for disclosure must be observed and that disclosure must be in accord with the most reliable accounting principles in the country. Because stock market investors need reliable information, the BVM is likely to be a strong advocate of improving accounting standards. The need to provide data in intelligible forms has long been recognized as a high priority for Mozambique by the SPEED + program<sup>5</sup>.

In 2008, the World Bank conducted a general assessment of the accounting regime including the capabilities of the domestic accounting profession to gather and analyze information as well as the application of international accounting standards<sup>6</sup>. The report concluded that Mozambique was in the earliest stages of creating an accounting infrastructure to meet the needs of an emerging market economy.

The report also noted that there were a minimal number of adequately trained accountants in the country. The Report recommended the formulation of a country action plan aimed at building institutional capacity to promote and maintain high quality accounting and auditing practices in Mozambique. Among the specific items that should be included in the action plan were:

- Creation of a national professional accountancy body with the assistance of the International Federation of Accountants (IFAC);
- Introduction of legal requirements for mandating and disseminating International Financial Reporting Standards (IFRS) for larger entities and simplified financial reporting standards for small and medium enterprises;

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<sup>5</sup> <http://www.speed-program.com/archive/by-type-archive/reports-archive/international-accounting-standards>

<sup>6</sup> World Bank (2008,) Report on the Observance of Standards and Codes (ROSC) Mozambique: Accounting and Auditing.



- Establishment of a sustainable arrangement for monitoring and enforcing application of IFRS and International Standards on Auditing (ISA);
- Provision assistance to the small and medium practices to strengthen capacity to operate as modern audit firms; broader training programs on practical application of IFRS: and
- Introduction of an improved accountancy curriculum in higher educational institutions.

### 3. Credit bureaus

While the stock exchange is mainly interested in financial information for larger borrowers, it has a general stake in upgrading standards of accounting and reporting throughout the economy. Credit bureaus are most relevant to banks which are likely to remain the principal supplier of funds to SMEs.

In a dynamic economy, new firms are constantly formed and many of them will have the capacity to become larger. Thus, as companies approach the stage in which they may seek public listing they will be expected to observe progressively higher norms of transparency and to apply high quality accounting standards as companies progress through the growth cycle they are of growing interest to the BVM. Additionally, if the BVMs market for listing SMEs (Second Market) becomes more active it will have a direct interest in developing credit bureaus to supply investors with information on listed SMEs. The Speed+ Program is working on this issue as well<sup>7</sup>.

### 4. Bankruptcy

Another set of issues where the Speed+ Program and the BVM have almost identical interests is in strengthening the legal framework to protect those who provide financing. Both the Doing Business reports of the World Bank and the report of the African Corporate Governance Network ACGN (see next section) specify numerous laws that need to be amended. An active equity market assumes that investors and the companies in which they invest will operate in the formal legal system. In the course of business companies will become involved in legal disputes among themselves and investors may make legal claims against other entities in the investment process. More than any other participants in the economic system, the equity market requires a robust legal framework.

One critical area of concern is bankruptcy law. Bankruptcy law, like credit bureaus is of interest to both banks and investors. In addition to enabling claimants to recoup some compensation from bankrupt entities, as representatives of the shareholders (who are usually the last in line in bankruptcy), the capital markets have direct interest in the treatment of various kinds of creditors such as banks, suppliers, senior debt holders and subordinated debt holders.

The World Bank assessment examined whether the bankruptcy law has created a transparent and predictable framework to protect credit right. The specific questions addressed include:

- Is a unified legal framework for a secured transaction is present;

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<sup>7</sup> <http://www.speed-program.com/our-work/by-topic/doing-business/cta-review-of-credit-bureau-regulations>

- Can businesses obtain security right in a single category of assets, without specific description of collateral and whether such rights extend to future or after-acquired assets?
- Does a modern collateral registry exist for both incorporated and non-incorporated entities in which registrations; amendments; cancellations and searches can be performed online by any interested third party?
- Are secured creditors paid first (i.e. before tax claims and employee claims) when a debtor defaults outside an insolvency procedure?
- Are secured creditors paid first (i.e. before tax claims and employee claims) when a business is liquidated?
- Can creditors access borrowers' credit information online (for example, through a web interface, a system-to-system connection or both)?

A new insolvency law has recently been passed. The next step will be to monitor implementation<sup>8</sup>.

## 5. Public Consultation

One final set of issues where the interests of the Speed+ Program coincide with those of the BVM is in the area of consultation in the legislative process<sup>9</sup>. Consultation regarding pending regulatory action is an integral feature of all stock exchanges. It is the established procedure of all stock exchanges and capital market regulators to publish drafts of proposed measures for public comments and to specify a deadline for replies. The BVM would clearly like to have the opportunity comment on laws that may impact the exchange itself, its members or listed companies.

The Constitution (Article 73) states that one of the pillars of democracy in Mozambique is the participation of the people regarding national issues. In recent years, many observers and stakeholders began to perceive a need to develop well-structured procedures for broader consultation with interested parties into the legislative process.

In 2012, a legislative proposal on public participation in the lawmaking process was developed. The proposal entailed an analysis of the legal and constitutional system of Mozambique and a comparative analysis of similar legislation in selected countries. As a result of this process of research and consultation, a draft law has been prepared that will be soon be discussed by the parliament. In May 2017, SPEED+ helped organize a conference to explain the content and purposes of this law to the public

Reform in the business environment requires a constituency dedicated to consistently pressing for improvement in the business environment. The stock exchange as well as other major participants in the capital market such as institutional investors, intermediaries, the financial media and regulators can normally be expected to play a leading role in demanding higher standards of disclosure.

Efforts to upgrade business standards will affect companies that never list on the BVM. For example, if the stock exchange imposes requirements that to be listed companies must present their accounts in accordance with high standards of accounting, the accounting profession will have strong incentives to upgrade accounting standards throughout the economy. Similarly, if the stock exchange

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<sup>8</sup><http://www.speed-program.com/our-work/by-topic/doing-business/speed-reports-2011-004-insolvency-law> -

<sup>9</sup> <http://www.speed-program.com/public-participation-on-legislative-process>

insists on improving laws regarding investor and creditor protection, all companies, whether listed or not, will benefit from upgraded legal standards.

## B. THE STOCK EXCHANGE AND CORPORATE GOVERNANCE

### I. The Challenge of Corporate Governance

The corporate form of organization of economic activity has proven to be a powerful force for growth and efficiency. At the same time, investment in equity is different from other forms of investment. While a bond investor for example expects a stipulated return with no ownership or control rights over the borrower, the equity investor acquires partial ownership in an entity that evolves over time and hence investors must remain engaged in monitoring the company. The construction of mechanisms enabling investors to exercise their ownership and control rights (i.e. a system of “corporate governance”) is an important challenge for any modern economy<sup>10</sup>.

Investment in publicly listed companies entails potential agency problems that must be adjudicated through the system of corporate governance. Agency problems refer to the principal/agent problem. Someone (a principal) engages another person to act on their behalf (i.e. be their agent.) The challenge of agency relationships is to assure that the agent actually does act in the interest of the principal.

Agency problems in business may not be evident in early stages of development when most economic activity is undertaken by individual entrepreneurs or small groups of individuals who know each other personally and monitoring is simple. Agency problems become more evident when individual owners invite new investors to join as co-owners or when the owners hire professional managers to run the company.

In order to make decisions in well-ordered way, companies must devise systems of “corporate governance”, which according to one simple definition means “procedures and processes according to which an organization is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organization such as the board, managers, shareholders and other stakeholders and lays down the rules and procedures for decision-making.” One ongoing challenge of the governance system is to align the interests of the owners or shareholder with those of the managers. In many economies, most companies are controlled by groups of insiders and in these cases the challenge is to assure equitable treatment of minority investors.

The corporation assigns roles to individuals and devise ways to monitor the behavior of those responsible for executing the strategy (the management) and to align the interests of managers and the owners (shareholders) of the company. It will inform the investors of progress in achieving goals.

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<sup>10</sup> There also exists a market in private equity which solves resolves issues of control and agency differently than the public equity market. Private equity operates alongside the public market and has relevance for Mozambique. When a closely held company is considering expansion and/or transformation there are reasons to consider public listing as well as private equity. However, the relative merits of public versus private equity are not discussed in this note, which focuses upon public equity markets.

Finally, it will devise means for investors to obtain financial returns and to be able to buy and sell ownership rights on an ongoing basis.

Experience has shown that stock exchanges are key actors in raising standards of corporate governance throughout the economy. By setting listing rules, which typically involve guarantees of the rights of investors as well as requirements of transparency and disclosure, they are in effect screening currently listed companies for compliance with accepted corporate standards and implicitly setting standards for those companies that may wish to list at a later time. Although the stock exchange usually only lists a limited number of large companies, it has the potential to influence the business environment throughout the economy. Those companies that list tend to be the largest, most prestigious and most visible companies. These companies play an important role in defining norms of accepted behavior for smaller companies. Thus far, contacts with individuals and spokesmen for industry groupings in the business sector of Mozambique have revealed that many companies are not able to meet minimal standards of disclosure and transparency to consider listing now but would like to explore the possibilities of “going public” in the future.

## 2. Privatization and Corporate Governance

Corporate Governance is a daunting challenge for companies that are privatized, especially when privatization results in widely dispersed groups of unsophisticated small investors acquiring sizable shares of equity. In an environment of weak investor protection, insiders can use their dominant positions to extract value from the company to the detriment of minority shareholders. For example, the most valuable assets of the company might be sold at sub-market prices to favored insiders. Special purpose vehicles (SPVs) may be used to conceal debt or to hide assets that are stripped from the company. If disclosure standards are not high and boards of directors are not sufficiently informed or independent, the system of checks and balances cannot prevent abuses.

Abuses of these kinds were common during the mass privatizations in Russia and other transition economies during the 1990s. In a context of opacity and ambiguity about the rights and responsibilities of various parties and weak legal protection, well placed insiders were able to produce considerable wealth for themselves while leaving small investors with virtually worthless claims on companies that had been looted. Since Mozambique is now contemplating large-scale privatization, the country will need to build a governance system that is capable of defending small shareholders against the predatory behavior of insiders. Various analyses have found the protections of minority investors in Mozambique to be in need of improvement.

## 3. Standards and Practices in Corporate Governance

The corporate governance framework typically comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices that reflect each country's specific circumstances. As countries have sought to strengthen their own systems, they often utilize international standards as points of reference. On a global basis, the single most widely used standard is the G20/OECD Principles of Corporate Governance of 2015<sup>11</sup>. The Principles (originally

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<sup>11</sup> <http://www.oecd-ilibrary.org/docserver/download/2615021e.pdf?expires=1498834098&id=id&accname=guest&checksum=C030C85F75CA98B876EEF1DBF510AEBC>

developed in 1999 and revised in 2006) were initially aimed at OECD countries but were subsequently modified to reflect the concerns of emerging markets as well.

The G20/OECD Principles, which are primarily designed for large private listed companies, are also relevant to smaller and unlisted companies. The Principles have also been adapted to apply to companies that have total or partial state ownership.

The G20/OECD Principles cover six broad categories of issues:

1. The Basis for An Effective Corporate Governance Framework
2. The Rights and Equitable Treatment of Shareholders and Key Ownership Functions
3. Institutional Investors, Stock Markets, and Other Intermediaries
4. The Role of Stakeholders in Corporate Governance
5. Disclosure and Transparency
6. The Responsibilities of the Board

The G20/OECD Principles stipulate that stock markets can play a decisive role in enhancing corporate governance by enforcing requirements that promote effective corporate governance among their listed issuers. Also, stock markets provide facilities by which investors can discipline the company by buying and selling the company's securities. The stock market's rules and regulations that establish listing criteria for issuers are important elements of the corporate governance framework. The regulatory authorities for stock markets should have the authority, integrity and resources to fulfil their duties in a professional manner. The Principles also stipulate the rights and equitable treatment of shareholders and the rights of minority (non-controlling) shareholders to equitable treatment along with controlling shareholders. The Principles also make provisions for the possible for the recognition of stakeholders as legitimate claimants on the company. The Principles also specify standards for transparency and disclosure indicating the kinds of information to be disclosed. The Principles include guidance about the role of the board of directors in overseeing management.

#### 4. Assessments of the Corporate Governance System in Mozambique

The G20/OECD Principles are global standards. There are also organizations that have been active in defining good practices on a pan-African level and monitoring the corporate governance practices of many African countries while pressing for continued reforms.

The African Peer Review Mechanism (APRM), a Specialized Agency of the African Union (AU), was established in 2003 by the African Union in the framework of the implementation of the New Partnership for Africa's Development (NEPAD). APRM is a tool for sharing experiences, identifying best practices, assessing policies and practices to foster political stability, high economic growth, sustainable development and economic integration.

The APRM conducts extensive reviews of policies in four main areas, including corporate governance. The most recent corporate governance review of Mozambique took place in 2010. The final report noted the absence of many essential features of a sound corporate governance framework, including the lack of a national code of corporate governance. The report identified many areas where reforms were needed included the need to introduce international accounting standards, and the need to revise the commercial code, while observance of codes and standards was assessed as being in serious need of improvement.

Another key grouping that is active in promoting better practices is the African Corporate Governance Network which has members from 12 countries (including Mozambique) with substantial input from the World Bank and IFC. The ACGN, which began activities in 2013, aims to promote principles of transparency and accountability in African countries and has a sizable number of training programs. The ACGN seeks to disseminate best practices on issues such as managing conflicts of interest. It has been instrumental in providing assistance in the development codes of conduct for directors.

In its 2015 report for Mozambique, the ACGN identified lack of legal knowledge and the absence of a strong judicial system as major challenges for the business environment. The report also stated, “Despite the reforms that have been introduced, including the Commercial Code, there is still considerable lack of public knowledge of laws and regulations related to the business environment and corporate governance” The report notes that those economies in Africa that are doing the best are those with political stability, effective public institutions, efficient public sectors, and strong private sectors which have good corporate governance. Good corporate governance requires checks and balances, accountability and transparency. Corruption is greatest where institutions are weak, and corruption itself undermines the fabric of societies. The SPPEED+ program also noted the work of the ACGN with respect to the protection of minority investors<sup>12</sup>.

The ACGN report observes that Mozambique ranks 21st out of 54 countries on the 2015 Ibrahim Index of African Governance, 139th (mostly unfree) in the 2016 Index of Economic Freedom, 112th out of 168 countries on the 2015 Corruption Perceptions Index, 133rd out of 140 countries on the 2015/2016 Global Competitiveness Index and 133rd out of 189 on the World Bank’s most recent Ease of Doing Business rankings. The report also says that the introduction of better standards of corporate governance is directly related to the development of the economy. To improve Mozambique’s performance in these various rankings there needs to be a reduction of corruption and an increase in business transparency and accountability.

In its chapter on Mozambique, the ACGN report finds that while there have been improvements in the legal framework which would stimulate improved corporate governance (the revision of the Commercial Code, and introduction of International Financial Reporting Standards for example) there is a need to focus on building an understanding of both corporate ethics throughout the country as well as to improve implementation of legislation and of business’ understanding of legislation.

One of the key issues identified was political will. The report suggests that Mozambique should focus on implementing a series of recommendations made by the African Peer Review Mechanism which include a national corporate governance regulator, building capacity to implement legislation and ensuring that companies understand more about corporate governance and the benefits of improving their transparency.

The ACGN report concluded that it is essential for the link between corporate governance, business development and economic growth to be better understood in Mozambique. Companies with better corporate governance can access finance. “Countries where good corporate governance is practiced attract more investment. Businesses which are better managed, more transparent and

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<sup>12</sup> <http://www.speed-program.com/blogs/by-author/carrie-davies/better-corporate-governance-for-a-better-economy>

more accountable tend to develop faster and become greater contributors to the economy and to the country's development because they can access finance for their growth. More investment by better businesses, less corruption, more tax income for the state, fairer employment practices, more jobs – these are things that can flow from improved corporate governance. To achieve this, Mozambican companies, need better access to information, fair application of laws and strong incentives to be transparent and well governed. Business can take a lead in this area, but support from government and civil society will also help to make these changes.”

As has been argued thus far, the issues of concern to proponents of improved corporate governance largely overlaps with those generally seeking to improve the overall business environment. Thus, the World Bank's Doing Business index scored countries on indicators such as access to credit, credit bureau coverage, strength of legal rights, depth of credit information, protecting minority investors, conflict of interest regulation and extent of shareholder governance. These issues are very similar to those of interest to entities such as the SPEED+ Program which are trying to improve the business environment.

# PART TWO: REFORM OF THE MOZAMBIQUE STOCK EXCHANGE (BVM)

## 1. Background: Present Situation of the BVM

The Mozambique capital market is very small by any measure. <sup>13</sup>Table I compares the country's equity market capitalization (i.e. the value of all shares listed on the exchange) with those of other African countries as well as some relevant international benchmarks. The Table shows that sub-Saharan African capital market markets (except for South Africa) are all very small by international comparison. Thus, data compiled by the World Bank show that the market capitalization of equities on the exchanges of most African countries as a share of GDP was well below the average of 60% for middle and low-income countries.

**Table I: Indicators of Equity Market Development in Sub-Saharan Africa, 2016**

Country	Market Capitalization/GDP (%)	Number of Listed Companies	Turnover Ratio-a
Ghana	8	31	3.5
Kenya	24	65	5
Mauritius	62	62	4
Malawi	13	14	1
Nigeria	10	169	5
Tanzania	4	18	30
Uganda	31	8	0.4
South Africa	234	303	38
Zimbabwe	41	60	8.1
Zambia	14	16	20
<b>Mozambique</b>	<b>4</b>	<b>4</b>	<b>0.3</b>
Low & middle income countries	60		24
Upper middle income countries	62	N.A.	201
High income countries	117	N.A.	120

a- Volume of trading ÷ market capitalization; Source: World Bank, World Development Indicators. Report of stock exchange

<sup>13</sup> Capital market operations generally consist of a) primary market operations or placing new securities with investors on the market, 2) trading in secondary markets by brokers and dealers and 3) asset management or investment of portfolios on behalf of others. (This is an extremely simplified list of operations, describing a very basic market, but is basically adequate for the discussion of the present situation of Mozambique.)



Within the sub-Saharan African group, Mozambique had one the lowest capitalization/GDP ratios of any country with an established stock exchange. Similarly, markets in Africa are illiquid, meaning that little trading takes place. Mozambique also has an extremely low turnover ratio, (the value of trading as a share of market capitalization.)<sup>14</sup>

The same picture emerges when measuring the capacity of various markets to raise capital. Table 2 compares the amount of equity raised through Initial Public Offerings (IPOs) by countries in Africa in 2012-16. Once again, Mozambique lagged other countries, raising only \$11 million during this period while other African countries, most of which also had rudimentary capital markets, raised significantly more. Therefore, if Mozambique could simply bring itself up to levels of other countries of the region its capability to provide resources for development would increase significantly.

**Table 2: Initial Public Offerings (IPOs) on African Exchange 2012-16**

**IPOs on AFRICAN EXCHANGES, 2012-16**  
(\$ MILLIONS)

Exchange country	2012		2013		2014		2015		2016		Total	
	Number of IPOs	Capital raised (\$m)	Number of IPOs	Capital raised (\$m)	Number of IPOs	Capital raised (\$m)	Number of IPOs	Capital raised (\$m)	Number of IPOs	Capital raised (\$m)	Number of IPOs	Capital raised (\$m)
<b>South Africa</b>	5	258	4	261	9	742	12	668	7	823	37	2 742
Johannesburg	3	247	4	261	8	734	9	640	4	706	28	2 588
Johannesburg AltX	2	11	0	0	1	8	3	18	3	117	9	154
<b>North Africa</b>												
Egypt	0	0	0	0	1	109	4	762	4	214	9	1 075
Morocco	1	3	1	122	1	127	2	91	1	196	6	538
Tunisia	2	8	12	191	6	126	2	43	1	21	23	388
Algeria	0	0	0	0	0	0	0	0	1	68	1	68
<b>Sub-Saharan Africa excluding South Africa</b>												
Nigeria	0	0	1	190	1	538	1	23	0	0	3	751
Mauritius	0	0	0	0	1	29	0	0	1	96	2	124
Kenya	2	75	0	0	1	7	1	36	0	0	4	117
Ghana	0	0	0	0	1	1	2	1	2	102	5	104
Botswana	1	47	0	0	0	0	1	9	1	42	3	98
BRVM	0	0	0	0	1	7	1	14	1	83	3	84
BVMAC	0	0	1	66	0	0	0	0	0	0	1	66
Uganda	1	66	0	0	0	0	0	0	0	0	1	66
Rwanda	0	0	0	0	0	0	1	39	0	0	1	39
Tanzania	0	0	1	2	2	6	1	16	1	6	5	28
Mozambique	0	0	1	11	0	0	0	0	0	0	1	11
Zambia	0	0	0	0	1	9	0	0	0	0	1	9
Zimbabwe	0	0	0	0	0	0	0	0	1	<1	1	<1

\* Data includes IPOs listed on African exchanges and therefore excludes outbound IPOs. Companies listed on two exchanges or more are accounted for on each exchange.

Source: 2016 Africa Capital Markets Watch

<sup>14</sup> See also the *Economist* (2016).

At the center of the capital market in Mozambique is the Mozambique Stock Exchange (BVM)<sup>15</sup>. After enabling legislation was enacted in 1998, the BVM was incorporated in 1999 and began operating with some technical assistance from the World Bank and the Lisbon Stock Exchange in October of that year. BVM is a state-owned institution under the Ministry of Finance<sup>16</sup>.

In theory, the BVM is regulated by the Capital Markets Authority, an entity created by the central bank. The Securities Market Code (Decree Law no. 4/2009) lays out some basic principles and provisions governing the organization and functioning of securities markets. However, the central bank (Bank of Mozambique) is mainly occupied with monetary policy and banking regulation and has not been very active in capital market oversight. Discussions with central bank supervisory personnel indicated that their expertise in capital market supervision is not deep and they do not devote much effort to the task.

Trading of securities listed on the Mozambique Stock Exchange can take place in either the Official Listed Market (MCO) for large companies, or on the *Second Market* for SMEs. Any company seeking listing on the MCO must have capital of at least 16 million MZN with 15% of equity as free float and 2 years of audited accounts.<sup>17</sup> For the *Secondary Market* minimum capital is 4 million MZN with 5% of equity as free float and 9 months of audited accounts. Listed companies are required to produce a prospectus at the time of the IPO and to produce annual reports and make periodic disclosures of material developments. The requirements for the Second Market are more lenient, but no companies are listed

A system for the registration, custody, clearing and settlement is an essential component of any capital market<sup>18</sup>. Mozambique's Central Securities Depository (CSD) was established in 2006. As of end-2015, the CSD had 10,760 registered investors, 16 financing intermediaries, 44 registered issuers, and 68 registered securities. During 2015 the CSD processed 122 corporate actions and recorded 70 bond trades and 427 equity trades.

By every measure, the equity market is small and inactive. Only six companies are listed on the MCO including one SME. At the end of 2016, There were four publicly listed companies 1) Cervejas de Moçambique (CDM), which produces and distributes alcoholic beverages, 2) Companhia Moçambicana de Hidrocarbonetos, SA (CMH), a subsidiary of Empresa Nacional de Hidrocarbonetos EP that works in the hydrocarbon sector and is the current operator of Mozambique's Pande and Temane gas fields, 3) Engenharia e Construção, SA (CETA), a large industrial conglomerate, and 4) Empresa Moçambicana de Seguros, E.E. (EMOSE), a provider of insurance products and services.

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<sup>15</sup> Bolsa de Valores de Moçambique. Background from <https://www.thebusinessyear.com/mozambique-2016/liquid-flows/review>

<sup>16</sup> See BVM (2016a.)

<sup>17</sup> Free float refers to the share of equity that is actually available for trading. For example shares may be held by the state by another company, by block of insiders.

<sup>18</sup> A securities depository is an entity that holds and administrates securities and enables securities transactions to be processed by book entry. Securities can be held in a physical (but immobilized) or dematerialized form (i.e. so that they exist only as electronic records). In addition to the safekeeping and administration of securities, a CSD may incorporate clearing and settlement functions. <https://stats.oecd.org/glossary/detail.asp?ID=6776>

At the end of 2016, the four listed companies had a market capitalization of 26.7 billion MZN, but trading volume was extremely thin and the turnover ratio was only 0.3%. Most African countries that have exchange have significantly higher trading volume and according to World Bank estimates middle and low-income countries in all regions of the world had an average rate of 24%.

In April 2017, Matama, a meat processing company made an IPO of 1.8 million shares of common stock at a par value of 250 MZN, representing 100% of the equity of the company. Unfortunately, the company was not able to place its targeted amount, owing to the recognized weaknesses of the equity market. Investment bankers were unable to find investors and it is unclear how concerted an effort to distribute the offering was made. In any case, investors were not well informed of the offering and showed little interest. And on August 18, 2017, the first SME was listed on the exchange: Zero Investimentos SA, which provides investment-related services.

In addition to equities, the BVM lists and trades treasury bonds which have maturities of 3-4 years. There were 21 issues amounting to 23.1 billion MZN. A system of primary dealers for government bonds is in place.

Treasury bonds are sold at auction under a pre-announced calendar in which the BVM discloses how much will be offered and participants place bids during the auction. Like other countries Mozambique has a system of primary dealers, whose function is to provide liquidity to the market. In most markets, the government bond market is the most liquid of any markets with very high volumes of trading. At the end of the bidding period (usually a few hours) the BVM allocates shares of the issue based on bids at the auction.

In the past few years, primary dealers had been keeping most of new issues rather than sell them on to other institutions. Initially bonds were fixed rate but with interest-rate instability rates are adjusted periodically based upon Treasury bill rates. A few recent auctions have been canceled due to weak demand. In most jurisdictions, primary dealers are expected to make markets in bonds, but in Mozambique the primary dealers hold on to most government bonds. Thus, the market in Mozambique, although more active than the equity market, is not very liquid. The turnover ratio is less than 3%, way below rates in other markets.

Treasury bills are short term with fixed maturities issued by the central bank but are not traded on the BVM. The yield on Treasury bills is currently about 27%.

There were 13 corporate bond issues with 3.7 billion MZN and a turnover ratio of 7% in December 2016. Many banks have issued subordinated bonds that can be used in calculating their capital which in turn determines their capacity to lend.

There previously was a market in short-term commercial paper on the BVM, mostly issued by corporates (mainly banks) but activity has been contracting for a few years. There were six issues outstanding at the end of 2014, but only three a year later. At the end of 2016, there was one issue of short-term commercial paper issue of 157 million MZN; that issue has since been redeemed and there now are no outstanding issues.

### Summing Up

The review of the BVM in the past few weeks has revealed that the low level of capitalization and trading activity on the exchange are consequence of low levels of development and awareness among all potential capital market participants —issuers, intermediaries and investors. Furthermore, the entire market is hampered by inadequate flows of information.

Capital market intermediaries not well developed in Mozambique and it is very difficult to identify any institutions that are dedicated to pursuing capital market business as a profitable line of endeavor. Capital markets business is in the hands of the banks, which generally do not perceive investment banking or trading as areas with high potential. Moreover, banks are essentially more inclined to stick to their basic lending business, which is highly attractive, than brokerage and investment banking which currently are not.

Discussion with corporate and financial industry associations indicate that the neither issuers nor investors are well informed about the basics of equity investment. Many companies do not see any obvious advantages of public listing, especially since the capital market has not proven to be an effective vehicle for raising funds. Meanwhile, many companies are deterred the burden of listing, such as dilution of insider control, mandatory disclosure and the risk of shareholder litigation and need to be convinced that the benefits of listing outweigh the costs.

A successful reform must attack all these problems. In some cases, the recommendations for reform can be initiated by the BVM alone, but many will require legislative and institutional reforms throughout the capital market. The following sections will suggest possible reforms in various parts of the legal, institutional; and regulatory system. The final section will suggest the outlines of a comprehensive reform and propose some preliminary ideas of the sequencing of reforms.

## 2. Reform Ownership, Governance and Regulation

The BVM is currently owned by the government. In most other countries, exchanges are either mutual (i.e., owned by the exchange's members -- usually intermediaries) or are listed entities. It is unlikely that the BVM generates revenue on its own and so it is probably funded by the government which tends to make it still less profit-oriented. Since it is hard to identify new potential owners of the BVM as a mutual institution and since it is also hard to specify what the BVM would do as an independent company, it is probably best to leave it provisionally in its current ownership with the objective of eventually moving to another ownership structure.

The current practice of assigning regulatory responsibility to the central bank should be reconsidered. In the first place, the main concern of the central bank of any country is with monetary policy, systemic stability and possibly banking supervision. A capital market regulator typically addresses other concerns such as setting rules for the fair and transparent operation of the markets (including exchanges) and of setting disclosure requirements as well as protection of investors from practices such as market manipulation and insider trading. Therefore, serious consideration should be given to the establishment of a separate supervisory body for capital markets. The governing board of that entity might be comprised of representatives of intermediaries, investors and listed companies as well as the central bank and other public entities. The head of the supervisory agency should be selected outside the internal personnel channels of the central bank and the ministries.

Due to the central bank's interest in systemic stability and the present lack of depth in other official bodies, it may be advisable to maintain some link between the central bank and the capital market supervisor for an indefinite period.

One of the earliest tasks of the new securities regulator would be to launch a review of current practices for conformity with the IOSCO Objectives and Principles of Securities Regulation. This could be helpful in defining the optimal organization structure and objectives of the new institution and establishing a procedure to align practices in Mozambique with global standards. For a discussion

of the role of the International Organization of Securities Commissions (IOSCO), the IOSCO Objectives and Principles and how IOSCO operates in emerging markets see Box I. The securities regulator of Mozambique may also want to consider joining IOSCO and participating in the work of its Emerging Markets Committee.

### **Box I: The Role of IOSCO in Capital Markets in Emerging Markets**

The International Organization of Securities Commissions (IOSCO) is the international body that brings together the world's securities regulators and is recognized as the global standard setter for the securities sector. IOSCO develops, implements and promotes adherence to internationally recognized standards for securities regulation. It works intensively with the G20 and the Financial Stability Board (FSB) on the global regulatory reform agenda. IOSCO's members regulate more than 95% of the world's securities markets in more than 115 jurisdictions; securities regulators in emerging markets account for 75% of its ordinary membership.

The IOSCO Objectives and Principles of Securities Regulation have been endorsed by both the G20 and the FSB as the relevant standards in this area. They are the overarching core principles that guide IOSCO in the development and implementation of internationally recognized and consistent standards of regulation, oversight and enforcement. They form the basis for the evaluation of the securities sector for the Financial Sector Assessment Programs (FSAPs) of the International Monetary Fund (IMF) and the World Bank.

IOSCO is the only international standard setter that has a Committee solely responsible for emerging market issues. This inclusiveness increases IOSCO's effectiveness and positions it to play a bigger part in shaping the global regulatory framework: The Growth and Emerging Markets Committee is the largest Committee within IOSCO. The Committee seeks to promote the development and greater efficiency of emerging securities and futures markets by establishing principles and minimum standards, providing training programs and technical assistance for members and facilitating the exchange of information and transfer of technology and expertise. The GEM comprises 87 members and 20 non-voting associate members. Emerging economies are expected to represent a growing portion of IOSCO membership as new members continue to join.

[www.iosco.org](http://www.iosco.org)

BVM also might want to consider establishing linkages with regional or global trading platforms. Mozambique now participates on the Committee of SADC Stock Exchanges (CoSSE) which aims to facilitate cross listing and trading among SADC members. Current plans envisage the expansion of these activities in coming years.<sup>19</sup> The BVM may also want to link up with global platforms<sup>20</sup>. All these linkages can accelerate the introduction of technological advances into the market, broaden the investor base and lead to increased research coverage of the market of Mozambique.

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<sup>19</sup> BVM (2017a.)

<sup>20</sup> For example, see Blas (2014.)

### 3. Increasing the Number of Listed Companies

As noted previously, only five companies are now listed. According to press reports, the BVM expects three additional listing in 2107<sup>21</sup>. The BVM plans to list 12 new companies in 2017-19<sup>22</sup>. Nevertheless, the corporate sector remains unconvinced that significant benefits will result in public listing while the burdens of public listing are evident. The BVM and other major players in the financial system will have to persevere in their education efforts to persuade the corporate sector that the advantages of going public outweigh the costs.

The experience of many countries indicates that for an exchange to succeed, it is crucial to have a steady flow of new issues in their formative years. The following section analyzes the likely main sources of new listed companies.

Companies under the Control of the Institute for the Management of State Holdings (IGEPE.)

During the transition to a market-oriented economy in the 1990s, the government privatized about 1,400 state-owned enterprises (SOEs) with the assistance of the World Bank. IGEPE was created in 2001 with the mandate to restructure unprofitable SOEs and maintain and manage profitable SOEs. In 2001, IGEPE had a portfolio of 279 companies. However, IGEPE found that several factors, including unpaid liabilities and delay tactics by other shareholders, constrained and created delays in IGEPE's plan to dispose of unprofitable companies

IGEPE currently manages a portfolio of 99 State Enterprises which are partly or completely state owned. Enterprises under IGEPE are organized in corporate form and are committed to following generally accepted rules of corporate governance and to publishing periodic accounts that are audited by an external auditor. IGEPE is represented on the board of companies in proportion to its ownership. A new law on public enterprises is under discussion which will be finalized by the end of 2018.

IGEPE divides companies in its portfolio into two categories a) those that are inherently public such as utilities and b) those that are candidates for partial or full privatization.

Those that are candidates for privatization are assessed according to four criteria

- a) Economic sustainability
- b) Linkages to key sectors of the economy
- c) Financial profile
- d) History of dividend payments

It is planned to sell all viable companies through a combination of sales to strategic investors and IPOs with listing on BVM. A MOU with BVM is expected to be signed under which the terms of privatization through the exchange are made explicit.

#### *Megaprojects*

Mozambique has several very large projects in the field of natural resource development (e.g. oil and gas and minerals) that are expected to yield large revenues in coming years. One of the

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<sup>21</sup> O País, July 6, 2017

<sup>22</sup> BVM (2017a.)



requirements of the law authorizing those projects is that a certain part of the equity of these concerns (5-20%) should be listed on the BVM. Although this law has not been enforced it has potential to expand considerably the number of listed companies and the capitalization of the exchange.

#### *Banks and Insurance Companies*

There are an estimated 18 banks operating in the country as well as a few insurers. None of these is currently listed. It might be advisable to require those entities to list on the BVM. In addition to increasing the number and variety of companies for investment, this would have the added attraction of increasing transparency these companies, which are already overseen by financial supervisors, by exposing them to market scrutiny.

#### *Other Companies*

There are many private companies in Mozambique that have flourished since the systemic reform two decades ago. Most of these companies are still under the control of their founders, or their families and close associates. Experience suggests that as companies mature their original owners want to consider ways to grow their companies and /or to plan for succession. There are costs to listing, not only the listing fees themselves but also the costs of preparing documents, engaging auditors and meeting disclosure requirements. Public listing also exposes the company to additional risks of shareholder litigation. There are also benefits such as the prestige of public listing, a lower cost of capital (especially compared to private equity) and the relatively simple “exit” for owners to “cash out” by selling shares

Each individual owner must determine the best course for the development and survival of their companies. Public listing is probably not the best solution for all companies but it should be a viable option. Discussions with the business community in Mozambique show that many business owners and managers do not understand the benefits of listing. One of the medium-term objectives of the BVM should be to educate the corporate sector about the advantages derived from listing

#### *Public Listing and Corporate Governance*

In the preceding section, it was mentioned the government intends to list many companies owned by IGEPE on the BVM with part of their shares transferred to the workers in the listed companies. Additionally, the law now calls for employees of companies working on Mega Projects to receive ownership of shares. While this project may be useful in creating a class of small investors, it needs to be carefully controlled and scrutinized. The free distribution of shares to a dispersed group of unsophisticated investors has often produced socially and ethically unacceptable outcomes in other countries. Some of the worst abuses were the looting of privatized companies in transition economies. It is essential to have adequate safeguards in place to prevent such occurrences.

At this point it is worth repeating a warning from Part One of this report. Once a company is listed publicly, it must introduce a system of corporate governance that deals transparently and fairly with minority investors. Abuses of minority investors can be egregious under mass privatization in an environment of weak corporate governance and investor protection. In many cases, controlling investors accept outside investors while devising means to continue running the company exclusively in the interests of insiders. Adequate corporate governance systems are required to prevent such abuses.

### *Small and Medium-Sized Enterprises (SMEs)*

There is currently a Second Market of the BVM that is reserved for SMEs with more lenient requirements than the MCO. However, no companies have ever been listed. In all markets SMEs face more difficult problems in listing than larger companies. The disclosure requirements as well as the regulations mandating formal corporate governance structure can be costly and difficult to implement in SMEs. The cost of preparing necessary statements and meeting other listing requirements are similar to those of large companies, but in view of their small scale the compliance burden is proportionately higher for SMEs.

It should also be mentioned that many economically advanced countries have tried unsuccessfully to create SME exchanges. It has proven difficult to find investment banks that are willing to launch primary issues or brokers who are interested in trading, due to their uneconomic scale. Similarly, it is difficult to obtain reliable information on companies, when the investment houses that would normally be doing such research find it unprofitable. Additionally, investors often do not want to consider companies where the amount of tradeable equity is small and liquidity is low

As a first step in creating an effective system for the SME exchange it might be advisable to study the example of platforms such as the Alternative Investment Market (AIM) in the United Kingdom or Alternext, which is affiliated with Euronext. Several emerging markets have also had a measure of success. In order to design an effective structure for the SME exchange the experience of other countries should be carefully studied.

## **4. Expanding the Investor Base**

One of the obvious reasons that the BVM is inactive is that most categories of investors that are active in other markets are largely absent. This discussion will divide investors into three categories, individual (or retail) investors, institutional investors and foreign investors. The present situation and the prospects for reform of each category of investor will be analyzed.

Although Mozambique is a low-income country with little tradition of investment, one can point to some hopeful signs. Recent research indicates that among the main determinants of whether new stock exchanges succeed are a) an increase in the savings rate and 2) the rise of assets held in the banking system.<sup>23</sup> While the national savings rate is rather low by international comparison, savings in the formal sector are rising much faster than national income. According to World Bank, the savings/ GDP ratio, which had risen from very low levels in the 1990s has recently been low and unstable partly reflecting unstable government finances. (See Figure 1.)

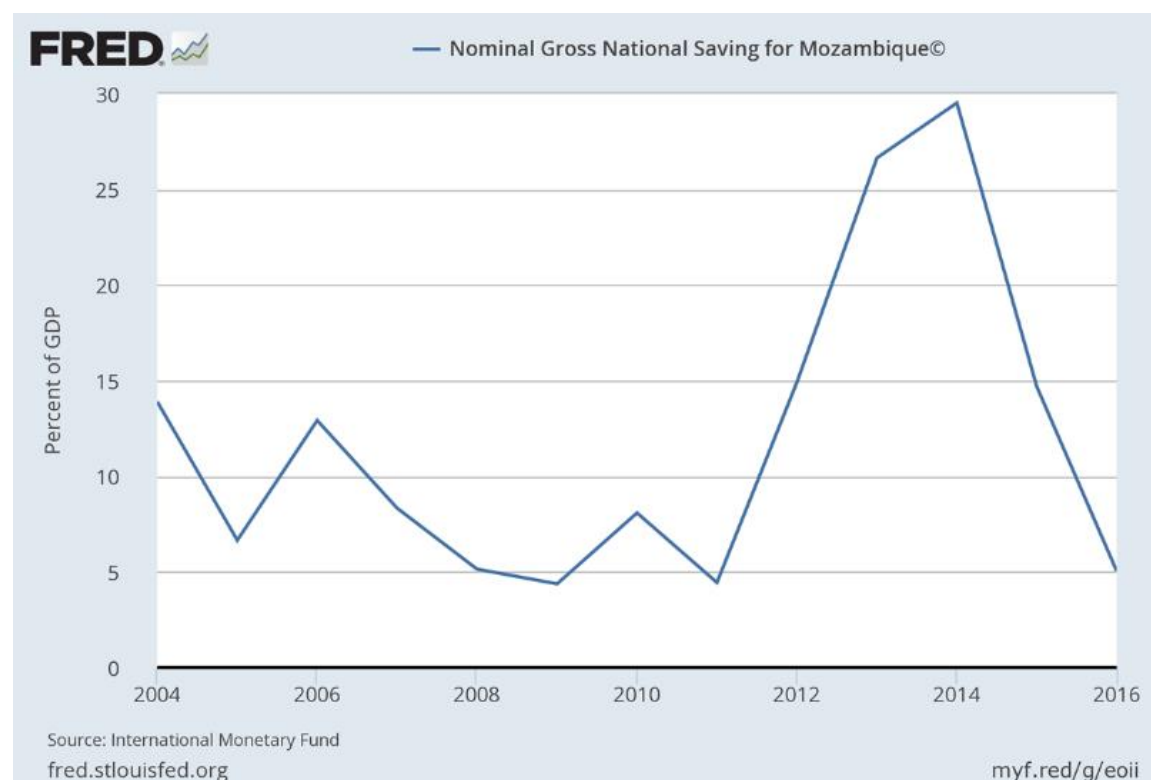
Meanwhile, the ratio of bank deposits to GDP has risen from about 15% in 1995 to about 40% at present. (See Figure 2.) In other words, as incomes rise the middle classes are building up assets in the formal financial system. It is completely understandable why the public is holding large bank deposits with interest rates at present high levels. When an individual can obtain a return in excess of 20% (and a real return around 15%) on safe assets such as bank deposits, it is hard to persuade that individual to purchase riskier assets, such as equity. Moreover, as far as can be determined few capital markets intermediaries are making strong marketing efforts at this time. It will be a challenge to persuade the citizenry, through public education and through the development of a wider range of alternative instruments, to diversify away from bank deposits.

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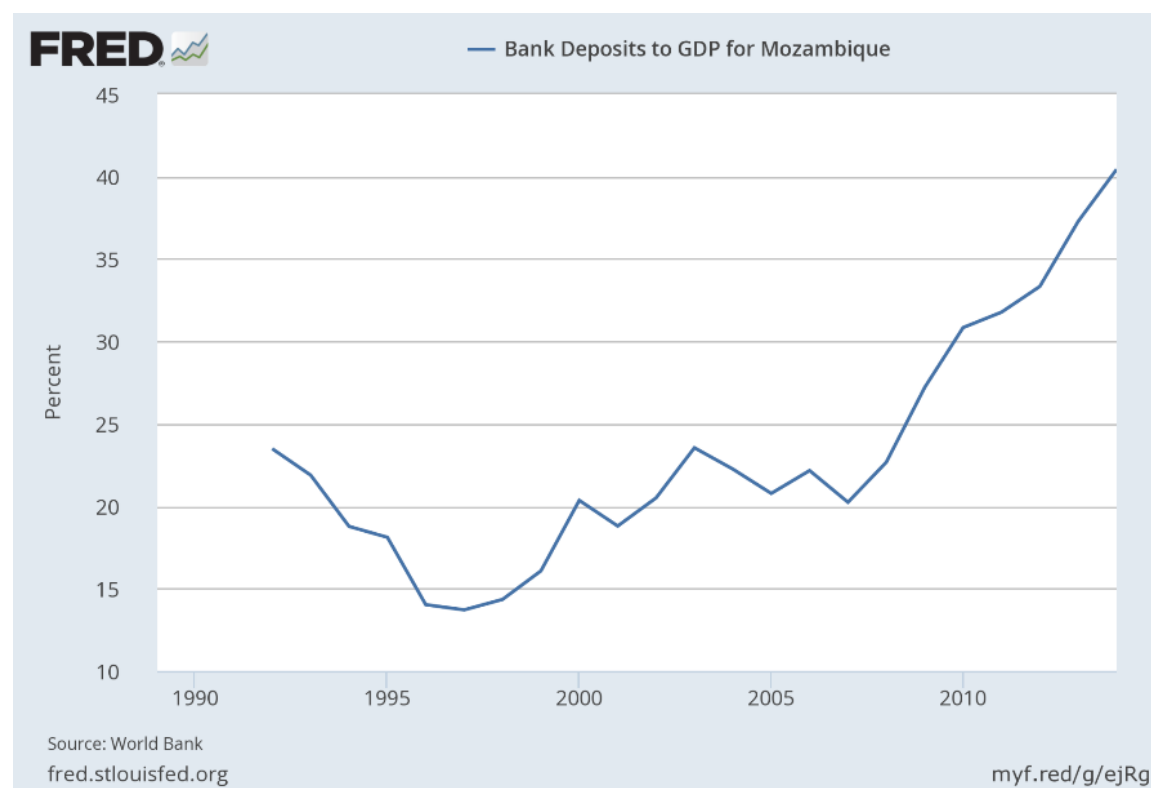
<sup>23</sup> See Beck et al. (2016.)



**Figure 1: Gross National Savings/GDP in Mozambique, 2004-16**



**Figure 2: Bank Deposits as a share of GDP in Mozambique, 1992-2016**



### *Individual (Retail) Investors*

The first challenge in reinvigorating the equity market is to persuade a critical mass of individuals to directly invest in the BVM. In any society, sizable parts of the population are willing to invest in individual stocks. Their motivations may be to earn steady dividends or to trade frequently or they may simply enjoy investing. In any case, it is in the interest of the BVM to have many retail investors as part of the shareholder community.

The experience of most countries is that as per capita income rises, the public tends to shift pattern of asset holding toward institutional savings products, such as mutual funds, pension funds and insurance. The latter two categories will be discussed in the next section. In most countries, individuals invest through mutual funds (fundos de investimento) rather than through direct stock ownership. The principle of a mutual fund is that a professional asset manager creates a portfolio of assets of specific characteristics (e.g. stocks, bonds, money market instruments etc.) and invites individuals to purchase shares in the fund. The investor obtains access to professional asset management, a diversified portfolio and a proportional share of the returns on the portfolio while the asset manager receives fees for organizing and marketing the fund. The costs on investments in mutual funds tend to be lower than on direct investment in a portfolio of assets.

The mutual fund is now an established feature of all advanced financial systems and is spreading to many emerging markets. Mutual funds are organized and managed by a variety of financial (and occasionally nonfinancial institutions.) Commercial banks, investment banks, brokers and insurance companies typically offer mutual funds. For a mutual fund industry to emerge it is necessary to enact a law authorizing the establishment of such funds and setting rules for their organization and regulation, governance and distribution. The BVM has proposed that such a law be enacted.

### *Institutional Investors (Pension Funds, Insurance Companies, etc.)*

Most advanced countries have experienced an institutionalization of wealth meaning that as national income per capita raises individuals hold larger shares of their wealth in the form of institutional assets. The rise of institutional asset holdings and the resulting emergence of a class of investment professional who deploy funds to deliver high returns using sophisticated investment techniques is one of the main forces driving the development of financial markets in recent decades. In addition to their roles as asset holders, these institutions often collaborate with the stock exchange in militating for an improved environment for minority investors. This is logical since, as professional portfolio investors, they have an enormous stake in maintaining a fair and transparent environment. Their relatively small presence in Mozambique means that there are fewer institutions capable of acting as a force pressing for an improved business environment. The growth of institutional investors would enlarge the constituency for reform.

Institutional investors (pension funds and insurance companies) usually prefer to hold long term assets to match their long-term liabilities. While not entirely absent in Mozambique, these institutions are of much smaller dimensions than their counterparts in higher income countries. There are only a few pension funds and most of those hold short-term instruments and real estate with a very small amount of equity. Discussions with pension funds suggest that they hope to be able to increase equity exposure in the future, but for the moment the lack of information and low liquidity on the stock market limit the scope for investment.

The insurance sector is also very small and concentrated the non-life (property and casualty) sector. Non-life insurers tend to hold shorter term assets than life insurers who need to invest to cover

their long-term liabilities. Consequently, they are reasonably pleased with the current climate where they can invest in short-term assets at very high yields. Discussions with insurance industry executives suggested that if the life insurance sector were to develop, it would share the same concerns about the low transparency and liquidity in the equity market that were expressed by pension funds and thus would not make an increased commitment until tangible structural progress occurs.

### *Foreign Investors*

All advanced financial markets are characterized by high levels of foreign participation. In emerging stock markets, foreigners tend to be more active traders than domestic entities and hence play an important role in adding liquidity to the market.

In current conditions portfolio manager and investors in major markets are experiencing historically low returns on traditional assets such as government bond. Many professional investors are looking for countries that offer promising opportunities for gains. These markets are often called “frontier markets” in financial parlance. The markets that are most attractive are those with a) a favorable macroeconomic environment and b) recent reforms of a structure in the financial markets that make it possible to achieve above average financial returns.

Due partly to its recent fiscal problems and conflicts with creditors on international bonds, most rating agencies rate Mozambique as sub-investment grade, which dissuades foreign investors from considering the country. If Mozambique can achieve visible gains in stabilizing its macroeconomic situation while enlarging the opportunities for investment through the BVM, it could attract significant portfolio inflows.

One final category of foreign investors might eventually be of interest as equity investors consists of sovereign wealth funds (SWFs). Many countries with foreign exchange earnings that exceed their current needs have established SWFs to place those assets for the long term.<sup>24</sup> A partial list of SWFs would include Norway, Singapore and several Middle East oil producers. While SWFs make decisions based mainly on consideration of long-term financial return, they also give weight to non-financial considerations. Thus, SWFs constitute a potential source of foreign equity investment that warrants serious consideration.

One irritant that dampens international enthusiasm for placing assets in the BVM is the regime of exchange restrictions under which extensive delays occur in authorization of both inward and outward transfers. There are justifications for considering exchange restrictions, particularly if the country were to experience destabilizing flows into the financial markets. That is not now the case and it would be wise to think about moving to a more flexible policy on foreign exchange.

## **5. Developing Active Intermediaries**

In its present state, the capital market lacks intermediaries that are committed to operating on the capital market. In this report, the term “capital market intermediaries” means financial institutions whose main activity is to facilitate direct transactions among market participants. Some of the most common capital market intermediaries are a) investment bankers who structure offerings on the

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<sup>24</sup> See Mellersh (2015.)

primary (or new issues) market; b) brokers and dealers who execute trades on the secondary market and c) asset managers (or portfolio managers) who invest portfolios of securities on behalf of others. In contrast, banks lend using their own balance sheets. Unlike banks, which typically rely on interest for income, capital market intermediaries are remunerated through of fees and commissions.

There are ten authorized brokers on the BVM, but nine of these are banks. <sup>25</sup>Banks are not necessarily opposed to an active stock exchange, but as things now stand they are rather indifferent. The banks, like everyone else, can see that limited business is currently transacted on the exchange and that it is not within their power to change this. Moreover, banks, which do rather well in the present situation of high interest rates, have strong motivations keep their clients as borrowers than steer them into the capital markets.

Since the onset of the global financial crisis, a consensus has emerged in many international forums that emerging markets should develop alternative channels of finance and diminish reliance on bank funding. Excessive reliance on banks is perceived as increasing the level of systemic vulnerability. In addition to diminishing systemic risk, it is in the interest of Mozambique to encourage the emergence of a class of capital market intermediaries to operate outside the banking system.

One of the first steps to encourage the development of autonomous capital market intermediaries would be to require that all banks wishing to engage in capital markets business must do so through a separate subsidiary. This is the legal requirement in most countries. In addition to reducing the risk of financial contagion, this approach would encourage bank's capital market entities to develop the infrastructure necessary for the profitable operation of a capital markets. Banks would be motivated to acquire skills in investment banking and trading while building capability to market investment products to potential investors. Furthermore, capital market intermediaries would have to develop research and communication capability in order to reach investors. A capital markets subsidiary could market products such as mutual funds. All of this of course assumes that business on the BVM will increase sufficiently to support a profitable endeavor.

The authorities should also encourage the emergence of independent broker/dealers, intermediaries without links to banks who would engage solely in capital market business. The BVM has set a target of bringing at least five new brokerage/ investment banking firms to enter the market by 2019. <sup>26</sup>This arrangement is permitted under present laws and there apparently at least one independent brokerage house (the Portuguese-affiliated Banco de Investimento Global or BIG) established in the country and others reportedly have asked for authorization. This trend should be encouraged.

To bring expertise in intermediation as well as other aspects of investment, it would be advantageous to encourage foreign brokerage houses to establish in Mozambique.

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<sup>25</sup> BVM (2017a.)

<sup>26</sup> BVM (2017a.)

## 6. Deepening the Information Infrastructure

Effective financial intermediation depends upon continuing flows of information. Bankers, investors, brokers and other market participants require access to information that may impact the investments they are considering. One key element in informing investors is the material that is provided by companies that list on the exchange as part of their disclosure requirements. The BVM has a direct role in facilitating this flow of information as well as an indirect role in pressing for more transparent accounting practices.

In addition to mandatory disclosure, a thriving investment culture requires continuous and voluminous flows of supplementary information. The following paragraphs indicate some of the sources of information that are usually considered necessary for the sound functioning of capital markets. The BMV can take a proactive role in promoting some of these institutional sources of data but other market participants will have to contribute as well.

Rating agencies are private companies whose function is to provide information about companies and other entities that wish to borrow on the bond market. The best-known rating agencies are Moody's, Standard and Poor's and Fitch's. There is at present no such institution established in Mozambique. In many emerging markets, joint ventures have been formed with local partners. The rating agencies usually rate larger companies and this have relevance for the larger firms listed on BMV. Credit bureaus perform similar functions for smaller companies, which would be helpful in deepening the information infrastructure. As noted in Part One, SPEED+ is trying to foster the creation of credit bureau in Mozambique.

If active capital market intermediaries emerge, they will produce research for investors, including recommendation to buy, sell or hold specific stocks. This source of research, which is usually supplied free by brokers to their customer, can be supplemented by other vendors of counseling services who provide advice for fees.

Several specialized services that specialize in providing information electronically are important parts of the information infrastructure. These services include Bloomberg's and Thomson Reuters which operate globally. These suppliers can forge alliances with local entities to deliver financial information quickly in a way to support rapid investment decisions. Alliances between a major global information vendors and local interests are common in emerging markets.

The BMV, possibly in partnership with some other institutions may want to sponsor the establishment of a capital markets research institute. Such an institute can produce longer-term research about the structure of the market and take the lead in identifying future trends and policy issues. The institute can also hold conferences and sponsor practical work of interest to persons interested in improving the functioning of the market.

The list of information suppliers can be supplemented by the traditional financial press and the newer on-line suppliers of financial information. The degree of participation of the BVM will vary for each kind of information supplier. In some cases, it can take an active role in building new institutions. In others, the initiative will come from private market in which case the BVM can act as an advocate and offer its encouragement

# PART THREE: CONCLUSION AND RECOMMENDATIONS

As the preceding discussion has made clear, the capital market of Mozambique is still in the early stages of development and many of the basic features of a functioning market (e.g., issuers, investors, intermediaries and information flows) are only present in a rudimentary form. In addition to operating as a means of raising capital, the BVM simultaneously has to emerge as a key player of the corporate governance infrastructure by nurturing an environment in which companies act transparently, efficiently and in the interests of all investors.

While a comprehensive reform must eventually, address all challenges, resources are scarce and all reforms cannot be implemented at the same pace. This section proposes a set of reforms for the BVM and the capital market, based on the discussion in this report, and suggests an order in which the reforms might be implemented. Rather than proposing a strict timetable, recommendations are divided into those which can be introduced rather quickly and those which should be addressed in the medium and long term.

## 1. Short- to Medium-Term Reforms

**Corporate governance.** The BVM should take the lead in announcing a plan upgrading corporate governance practices in Mozambique. The reform should be based upon implementing the G20/OECD Principles of Corporate Governance as well as other standards that may be developed through regional forums, such as the ACGN. Efforts to improve corporate governance could cover related aspects of the business environment, such as bankruptcy law and credit bureaus. The BVM should work in partnership with associations of corporate directors and institutional investors. One early output of this work could be a Code of Corporate Governance for Mozambique.

**Capital Market Supervision.** Regulation of the capital market should be transferred the central bank from to an independent body dedicated to investor protection and the maintenance of fair and transparent markets. The governing board of that entity might be comprised of persons representing intermediaries, investors and the corporate sectors as well as the central bank and other public entities. Due to the central bank's interest in systemic stability and the present lack of depth in other official bodies, it may be advisable to maintain some institutional link between the central bank and the capital market supervisor.

**New Listings.** The BVM should work with IGEPE and the Megaprojects as well as banks and insurance companies to develop a calendar for bringing new listings to the market in an orderly manner. Since much of the equity that results from these listings will be distributed to the public, the BVM should insist that listing will be conditional upon observance of adequate standards of corporate governance, especially equitable treatment of minority investors. The BVM should continue its campaign to persuade other companies of the benefits of public listing.

**Exchange restrictions** should be reassessed with the objective of broadening access for foreign investors who wish to purchase securities on the BVM.

### *Legislation and Regulation*

As discussed above, certain legislation has either already been proposed or if not yet proposed would make a useful contribution to the next phase of reform of the capital market. Among the key legislative and regulatory changes that can be implemented rather quickly the following should be mentioned:

- A law creating a supervisory agency for capital markets, including the BVM;
- A law requiring banks to undertake capital market business through a dedicated subsidiary, which would be supervised by the capital markets supervisor;
- A law authorizing the creation of mutual funds (fundos de investimento) specifying their legal form and governance structures to be supervised by the capital markets supervisor;
- A law authorizing the creation of rating agencies. To the degree that rating agencies are supervised, it would be the responsibility of the capital markets supervisor; and
- Reassessment of exchange restrictions.

## **2. Medium to Long-Term Reforms**

The ownership and governance structure of the BVM should be reconsidered and aligned with international practice.

The capital markets supervisor should undertake a review of current practice in Mozambique to assess their conformity with IOSCO Objectives and Principles of Securities Regulation. An action plan to implement the IOSCO Principles should be formulated. The supervisory agency should consider joining IOSCO and participating in the work of its Emerging Markets Committee.

A study should be taken to consider the feasibility of a specialized exchange or platform for SMEs in Mozambique, drawing on the experience of other countries.

The BVM should study the possibility of introducing new products, such as futures, options and exchange-traded funds (ETFs.)

Various forms of linkages with foreign securities exchanges and platforms should be considered. these linkages can accelerate the introduction of technological advances into the market, broaden the investor base and lead to increased research coverage of the market of Mozambique. BVM also should consider expanding its present linkages with SADC Stock Exchanges (CoSSE) which aims to facilitate cross listing and trading among SADC members. The BVM may also want to link up with global trading platforms.

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