TECHNICAL REPORT

Export Finance Limitations as a Barrier to Export

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The assignment for this report was to explore the alternatives for new interventions by USAID in Mozambique's financial sector to support an attempt to make exports a key part of USAID's poverty reduction strategy for the country.[1] USAID has some presence in the Mozambican microfinance sector using A.I.D. Washington funds. Other donors, notably the World Bank, International Monetary Fund (IMF), and German GTZ (Gesellschaft fuer Technische Zusammenarbeit), are prominent in dealing with the main line financial sector, which serves small and medium enterprises (SME) in the formal sector—the prime candidates for promoting alternative exports.[2]

The report is based on my reading of documents and discussions with a remarkably perceptive and able group of people in Mozambique who did an excellent job of enabling a novice like me to understand, in a relatively short time, the peculiarities of the export and financial sectors in Mozambique.

CURRENT STATE OF EXPORT FINANCE

Lending in Mozambique

In June 2002, commercial banks' outstanding credit to the economy was worth $14.0 trillion—$8 trillion in meticals and $6 trillion in foreign exchange.[3] Table 1 shows the breakdown by sector and ostensible purpose.

Lending has risen in nominal terms since December 2001 and has increased dramatically in the "other" category. In transport, for which credit has declined, a good proportion of credit goes for road transport (buses and trucks). Credit to trade is mostly, but not overwhelmingly, for working capital. About a trillion meticals goes to food processing (including tobacco) and 0.35 trillion meticals for textiles and garments. The figures should be outstanding, but they are followed by a strange set of tables that appear to show a total of 8 trillion meticals outstanding.[4] This clearly is not the case

[1] Nathan Associates Inc. USAID/Mozambique Country Strategic Plan: Assessment of Potential Labor Intensive Exports, September 16, 2002; and Nathan Associates Inc. Mainstreaming Trade: A Poverty Reduction Strategy for Mozambique, October 2002. Funded by the USAID Trade Capacity Building Project. The policy matrices in the two documents hypothesize that financial limitations may be obstructing export.

[2] SMEs are defined in variable fashion, as are microenterprises. A definition relying on employment figures is convenient because the statistics are readily available. USAID defines microenterprises as any enterprise with fewer than 10 employees. Others use different criteria. Indonesia, for example, defines medium enterprises as having a total capital value of $200,000 (excluding buildings and land). Various Mozambique programs have loan size caps of between $200,000 and $400,000 for SMEs.

[3] Banco de Mozambique. *Bolletin Estatistico*, June 2002, Table III.A.4, p.13.

[4] Ibid. Table IIIA.5, pp. 14–17.

because the end of June figures from Banco Internacional de Moçambique (BIM) alone showed 5.1 trillion meticals in loans, plus 3.4 trillion payable on demand.[5]

Table 1. Distribution of Credit by Sector and Type June 2002 (trillions of meticals) [6]

Sector	Working Capital	Investment
Agriculture	0.800	1.000
Cattle	0.007	0.025
Forestry	0.067	0.015
Fishing	0.156	0.115
Mining and Quarrying	0.006	0.043
Manufacturing	1.103	1.038
Electricity, Gas, and Water	0.284	0.060
Construction	0.365	0.216
Tourism	0.367	0.156
Trade	1.275	0.386
Transport	0.393	0.382
Nonmonetary Financial Institution	0.030	0.045
Other	3.151	2.467

Source: Banco de Moçambique. *Bolletin Estastico,* June 2002. Table III.A.4., p 13.

Banco de Moçambique, the central bank, does not collect or release data on export or SME finance. But the consensus is that export credit is generally available to established exporters with orders in hand.[7] The banks primarily finance larger enterprises, often foreign or state owned. One of the banks' complaints is that individual prudential loan lending limits (25 percent of their capital) constrain their activities. Nonetheless many of them do small-scale enterprise lending, and developing their retail lending departments is a strategic priority for some. The largest bank, BIM, has a subsidiary, Novobanco specializing in microcredit. Several banks have investment or venture wings or subsidiaries and most have done some project financing, much of which might qualify for the small and medium category. However, the greatest SME lending activity seems to come from some specialized funding institutions.

The Sociedade de Gestão e Financiamento para a Promoção da Pequena e Media Empresas (GAPI) is 70 percent owned by the government of Mozambique and 30 percent by the German foundation Friedrich-Ebert-Stiftung. It manages funds for, *inter alia*, foreign aid credit agencies such as Kreditanstalt Für Wiederaufbau (KfW), the Caisse Française de Développement (CFD), and the Danish International Development Agency (DANIDA), mostly for funding fixed-asset acquisition.

[5] Banco Internacional de Moçambique (BIM). Evolução da Actividade Primero Semestre 2002 (n.d., n.p.).

[6] Ibid.

[7] World Bank Group Small and Medium Enterprise Department. Draft SME Country Mapping, Snapshot of SME Activities in Mozambique, SMEs' Access to Capital (II-B), September 11, 2002; and several interviews with bankers, names not given.

Forty percent of its shares are to be sold by the government, and a management buyout as well as other alternatives is under consideration. It currently has more than $13 million in assets and an average loan size of $35,000 in 310 projects. Its capitalization is $3 million, almost all based on loan reflow. Its rates vary, but the norm is 32 percent, a little less than that of the banks.

Most of GAPI's clients are outside Maputo and it is opening branches throughout the country as part of a decentralization strategy. Loan losses were reported at 6 percent, but arrears of longer than one day were 16 percent. It uses Bank Austral's branch network where it does not have branches and sometimes serves as a second-tier lender.[8] It is a general and relatively sound vehicle for handling donor lines of credit. To be more precise, it is a highly profitable institution but only because it receives low-cost donor funds. In only one of its lines of credit does it bear foreign exchange risk. Some of its funds come from grants, but many are soft loans at a discount from the rate at which the government of Mozambique borrows.[9] Thus, although GAPI is a profitable organization and sustainable in its own terms, it depends entirely on concessional donor funds.

The World Bank project PODE (Projecto para o Desenvolvimento Empresarial) has extensive loan provisions—for established enterprises, as much as $300,000, and for new borrowers, on somewhat concessional terms of as much as $40,000. However, almost no loans have been made, probably because the PODE lending terms are not attractive to banks because they can loan their own overliquid funds at the same rates without the problems of dealing with the program. There are also demand-side problems in terms of documentation, and probably collateral. All lending in Mozambique, including through PODE, has been constrained by high interest rates.[10]

Fundo de Fomento a Pequena Industria (FFPI) is a government fund that makes working-capital loans to SMEs. Its activities are, like GAPI's, concentrated in Maputo, though it does have some activity elsewhere. Its maximum loan size is $50,000, collateral 110 percent, for 12 months, at above-market rates with fees. Fifteen percent is deducted up front, plus a fee of from 0.5 to 1 percent according to industrial branch. At the end of 1999 it had a portfolio of $900,000 in average amounts of $13,000. Loan losses were 28 percent.[11] Presumably its definitions of loss are the same as GAPI's.

The Fundo de Apoio a Reabilitação Economica (FARE) offers loans accompanied by training courses to small businesses, including those in agriculture and fishing. In the first semester of 2000 it funded four projects for 278 million meticals. The loans are for 1–3 years and highly subsidized—at 50 percent of the Central Bank discount rate. Its direct lending is reputed to be limited, as is its ability to serve as a second-tier lender. It also offers guarantees of loans to rural general stores of up to 300 million meticals each, at a fee of 0.5 percent per quarter.[12] This is roughly what one would expect from such a highly subsidized lender.

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[8] World Bank SME Department. SME Country Mapping II-B, and interview with Antonio Souto and Anabele Mucavele at Sociedade de Gestão e Financiamento para a Promoção da Pequena e Media Empresas (GAPI) in Maputo.

[9] GAPI, interview.

[10] Ibid.

[11] World Bank SME Department. SME Country Mapping II-B.

[12] Ibid.

Reportedly the African Development Fund is planning to offer $4.5 million in credit through GAPI and FFPI. This will be for SMEs with assets of up to $1.3 million for loan amounts of up to $200,000. There is also an NGO called Associação Moçambicana Para o Desenvolvimento Rural (AMODER) that lends to rural trading enterprises and as of 1998 had 238 loans outstanding with a total value of $1.7 million.[13]

Forty to 45 microfinance institutions (MFI) do exist (definitions vary but maximum loans of under $1,000 and average loans of $200 seem the mode). Fourteen of these are registered with Banco de Moçambique, and a proposed Canadian International Development Agency (CIDA) project exists to help with their supervision and regulation. The CIDA project is promoting a new law that would permit nonbank and cooperative MFIs to mobilize savings and provide some measure of deposit insurance. This project is projected at $4.8 million, including work with three to four MFIs and the provision of funds to them. The World Bank reports that of the 40–45 programs that exist, only 14 are active, serving about 25,000 clients mostly in the south and primarily in Maputo. They are donor funded and largely unsustainable at their present levels without external subsidization. They typically charge rates of 60–72 percent a year. MFIs that are not commercial banks or cooperatives are not supposed to mobilize deposits unless they have capital of more than $1 million, although the CIDA project proposes to change this.[14] MFIs in Maputo consider that they fund little export but much import.

The IFC is supporting technical assistance to the Tchuma Savings and Loan Cooperative (which is perhaps tied to the Banco Commercial e Investimentos [BCI] but I could not confirm this) and has an equity investment in Novobanco, to which it is also providing technical assistance. USAID through Washington-based matching grants is reported to be supporting both of these initiatives and ACCION International as well. The National Cooperative Business Association has a project on commercialization of agriculture with microcredit characteristics through GAPI. GAPI itself funds several of these microfinance programs.

Novobanco offers loans from $300 to $15,000 (with an average of $350) for fixed investment, working capital, and housing improvement. It has 3,000 clients, almost all in Maputo, but is expanding, opening branches in Beira and Nampula. The maximum maturity of its credits is 24 months, and its rates are 36–42 percent a month.[15] These lower interest rates are probably sustainable only because it offers larger loans than other MFIs.

Sociedade de Credito de Moçambique (SOCREMO), with German-funded technical assistance, has roughly 4,500 borrowers with $1.1 million outstanding, average loans of roughly $300, and 1.1 percent of its portfolio at risk from bad debt. It covers its operational costs. It lends a maximum of $5,000 and has two branches in Maputo and one in Beira. It is proposing to expand in the south and center of the country.

UNDP has been funding Microstart of Mozambique to provide institutional development support to MFIs.[16]

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[13] Ibid.

[14] Ibid and interviews with Banco de Moçambique and SOCREMO.

[15] Ibid.

[16] Ibid.

Many donors provide technical assistance to MFIs, so one hopes that the industry soon will flourish. Much of the microfinancing is being extended in the context of agricultural commercialization projects, especially in the north.

A Swedish International Development Agency (SIDA) project in Niassa takes a promising approach. The project has sponsored equipment sales through microfinancing and installment loans, but of particular interest is a series of 10 short-term (one-year renewable) joint ventures with private agroproduct commodity traders. These are real joint ventures to which SIDA commits management and for which it jointly controls the bank accounts. SIDA contributes half the capital and receives half the profits after paying for its own management services. Last year, the profit from SIDA's half of the investment in these joint ventures was $60,000. It aims in the next two years to receive $150,000 of profits, which will cover its entire annual costs in the project. The joint ventures purchase products from 6,000 small farmers, and much of their activity is for exporting. SIDA has just done a small study showing that Niassa exports more than 6 tons a day of agricultural produce.

An interesting parallel is the GAPI–National Cooperative Business Association project, which provides $150,000 at commercial terms through 24 "forums," each composed of a number of farmers' associations of 30 or so farmers. Altogether several thousand farmers are involved, also in the north.

There are two venture capital firms, one of which funds enterprises for 10 to 40 percent of their capital with its own investment ranging from $50,000 to $1 million. What they are actually doing is unclear from the draft report of the World Bank Country Mapping for Mozambique.[17]

One survey of small businesses reported that 34 percent received supplier credit, but the regional survey referenced in the World Bank Country Assistance Strategy reported that 50 percent of firms received credit and 64 percent extended trade credit. There are some leasing companies. One of them reports that vehicles accounted for 66.3 percent of its leased assets, and equipment 25.6 percent in 1998.[18]

The European Union extends a credit line to support imports from Europe, including fixed-asset acquisition.[19] The U.S. Export-Import Bank has provided some financing in Mozambique, although it says it does so on a "case-by-case basis," and for that reason the banks report that the process is quite complex. I have not been able to find out whether the U.S. Overseas Private Investment Corporation has done anything here.

Financial Instruments

As far as exporters are concerned, the following financial instruments are usually at issue:

- Post-shipment financing
- Preshipment financing—working capital to make the goods for a confirmed order

[17] World Bank SME Department. SME Country Mapping.

[18] Ibid.

[19] Ibid.

- Enterprise financing—financing at various levels to create the capacity that will secure export orders
- Export risk insurance.

To the extent that post-shipment and preshipment financing is not available or is costly (because of high country risk premiums—perhaps inaccurately high), some relatively low-cost steps can be of use. The third category, enterprise financing, is a high-risk one and normally requires high equity participation by the debtor firms for its success. However, in highly informal and transition economies such as Mozambique's, firms often have little equity—certainly little recorded on their books. Donors and governments persist in promoting enterprise financing, but successful projects are rare and depend on a particularly supportive environment. The fourth kind of instrument, export risk insurance, is complex and linked to trade information in general and thus requires a level of sophistication most developing countries lack.

Subsidy and Guarantee

Two topics recur frequently in export financing—subsidies and guarantees. Although almost all other forms of financing now generally are deemed to work better on an unsubsidized basis, export financing is frequently subsidized on the grounds that subsidizing export financing subsidizes exports. In fact, almost all the academic material indicates that it is impossible to demonstrate much of value in export financing subsidy or much impact on increasing exports.[20] Nonetheless, many commentators assert the value of such credit subsidies, most industrial and many developing countries provide them, and the killer argument seems to be that the successful cases of export-led growth frequently have had them.[21]

I suggest that the direction of causation may be mis-specified. The existence of these programs shows the general commitment of a government to promoting exports rather than serves to promote them directly. With this sort of commitment, bureaucratic obstacles fall, and support is demonstrated—the president goes abroad to promote a country's goods, and politics is subordinated to trade promotion. (I am reminded of meeting a British diplomat in a bicycle shop in suburban Washington, D.C., almost 40 years ago, where he had walked in to promote British bicycles.)

These credit subsidies are under heavy attack under new WTO rules and will be banned for least-developed countries as of 2004 and for others earlier, although the exact process is still to be seen. There is considerable literature on them in Organisation for Economic Co-operation and Development (OECD) countries, but remarkably little in developing countries.[22] Appendix C lists some of these export credit programs.

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[20] Arvind Panagariya. Evaluating the Case for Export Subsidies. World Bank Working Paper No. 2276, January 2000; Mihir A. Desai and James R. Hines Jr., The Incidence of Export Subsidies as Revealed by Market Reactions, Harvard Working Paper, March 2002, retrieved on November 25, 2002, from http://www.people.hbs.edu/mdesai/incidence.pdf. Note contrary unsupported assertion in ed. Gerald Helleiner. *Non-Traditional Export Promotion in Africa: Experience and Issues.* 2002. London: Palgrave.

[21] Helleiner, *Non-Traditional Export Promotion in Africa.*

[22] International Financial Consulting, Review of Export Credit and Finance Services: International Developments in Export Credit and Finance Services, London, September 2000.

In general, it is agreed that if a subsidy is to be provided, it is better to provide it as start-up assistance to institutions or to underwrite some transaction costs.[23] At one point USAID proposed sharing the cost of export subsidy feasibility studies for several of its projects, although I gather that this was not successful.

Guarantees are justified because they can leverage considerably greater volumes of credit than they cost, but only if lenders are really ill-informed and ready to do lending with partial coverage. In fact, what one typically encounters is demands for 100 percent or even 150 percent guarantees of loans extended. USAID itself frequently provides such guarantees (now under the Development Credit Program) for, say, 50 percent of principal on an insurance premium basis, but the number of banks interested in such things frequently is limited. I should emphasize that USAID guarantees are not subsidized, and banks would be eligible to participate only if their new lending claims are lower than their premiums. Theoretically, guarantees are a way to introduce banks to new categories of business, but other, more direct forms of subsidy are typically easier to promote. Appendix D is the Development Credit Program description from the USAID Web site. There are alternative ways for USAID to share some of the export lending risk, such as taking a small equity share in a lending institution.

A couple of lenders indicated some interest in USAID-type loan guarantees, assuming that they could do a lot of lending while limiting their exposure, but I am not sure that their interest will be sustained when the matter is explained further to them. Most of these institutions lend in amounts larger than those usually covered in such USAID programs.

Interest Rate

The rate of interest in Mozambique, even the real rate of interest, is high. The computation and determination of that rate, however, are not clear. Businessmen talked about a real rate in the low 30 percent range. Average interest rates from the banks are listed in Table 2.[24]

Lending rates for loans in meticals as of June 2002 ranged from 32 to 48 percent depending on maturity, and the rates for deposits ranged from 15 to 20 percent depending on maturity. Loans in foreign exchange, presumably mostly U.S. dollars, ranged between 8 and 15 percent, mostly the latter for longer maturities, and foreign exchange deposits were paid at from 1 to 3 percent. Of course, the difference reflects not only assessments of relative inflation, but the fact that dollar-funded borrowers and transactions differ systematically from metical ones. What this dollar–metical interest differential means in real terms depends on banks' expectations, and many banks clearly still

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[23] For microfinance and agrocredit, the *locus classicus* is *Rural Finance for Food Security of the Poor: Implications for Research and Policy* (Food Policy Review 4), by Manfred Zoeller for the International Food Policy Research Institute, June 1997.

[24] Banco de Moçambique. *Bolletin Estatistico*, Table IV.A.1, p. 19 and faxed data from Dr. Waldemar F. de Souza, October 14, 2002.

have highly inflationary expectations.[25] The World Bank Country Economic Memorandum concedes that conservative expectations about inflation are a problem in the financial sector.[26]

Much of the world routinely operates at rates like those in Mozambique and even higher, and much microcredit is at even far higher rates. Multinationals and the Western middle class do not pay such rates. In Mozambique, much lending, including project lending, occurs at these high current rates. One informant has been able to arrange financing for roughly 10 new projects in the agribusiness sector. In one case, by offering 120 percent collateral, he has reduced rates, but in a couple of others he had to arrange an 80 percent guarantee. It would be interesting to compare the rates of export competitors such as Mauritius and Madagascar. The suggestion made by some informants to encourage lending to exporters at dollar rates, even from PODE funds, has something to be said for it.

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[25] This statement is based on the explanations of several bankers about why they did not seek increased deposits and were worried about the cost of funds.

[26] World Bank. Mozambique Country Economic Memorandum: Growth Prospects and Reform Agenda*,* Report No. 20601-MZ. February 7, 2001, p.46.

Table 2a. Bank Interest Rates for Meticals in Mozambique

Lending																		
	2001												2002					
MATURITY	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
7 days	29.46	29.46	35.96	34.42	29.49	28.77	27.26	31.02	33.44	37.57	39.05	44.74	47.95	45.30	48.50	48.92	48.64	48.36
15 days	25.75	25.75	25.75	23.88	24.76	25.00	28.84	28.94	33.64	38.36	38.42	41.73	43.10	44.67	44.98	45.28	46.00	47.65
30 days	25.47	25.44	25.60	29.04	26.47	26.42	29.40	31.78	32.66	31.91	33.85	36.14	36.33	36.91	36.71	35.87	36.68	35.46
45 days	25.71	25.71	25.71	25.86	26.23	26.40	28.76	31.86	32.67	33.29	37.27	38.42	39.72	38.89	41.01	40.66	38.66	40.31
60 days	26.86	26.82	26.82	26.93	25.93	26.28	30.24	32.36	31.04	34.06	36.48	36.80	38.16	37.71	37.37	38.08	38.70	37.75
90 days	25.33	25.33	25.33	25.55	25.53	25.54	29.25	31.50	31.66	32.09	34.47	34.54	35.44	36.38	36.40	36.11	36.81	36.91
180 days	25.33	25.33	25.33	25.39	25.29	25.42	26.65	28.76	28.90	29.80	32.54	33.20	34.22	34.49	34.71	35.11	35.90	35.67
1 year	25.13	25.13	25.13	25.29	25.21	25.13	28.52	31.16	31.31	32.50	34.27	35.27	35.89	36.16	36.03	36.06	36.71	36.83
2 years	23.98	23.98	23.98	24.66	24.73	25.11	27.55	28.34	28.90	30.01	32.49	32.76	34.20	34.63	34.06	34.25	33.56	33.54
> 2 years	23.87	23.87	23.87	24.63	24.76	24.80	27.36	25.60	25.97	28.27	30.47	31.03	31.87	32.08	32.01	32.56	32.56	32.42
Prime rate	20.50	20.50	20.50	21.10	21.10	21.40	22.80	24.40	24.40	24.60	25.20	28.33	25.50	25.50	25.50	25.50	25.50	25.50
Special line of credit	20.00	20.00	20.00	20.00	20.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00	8.00

Deposit																		
	2001												2002					
MATURITY	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
30 days	10.01	10.14	10.23	10.43	11.27	11.91	12.53	12.20	12.28	14.40	16.30	16.79	16.77	17.04	16.24	17.98	16.31	15.35
45 days	8.50	8.50	8.50	10.48	10.18	11.77	14.10	14.19	15.38	15.21	16.73	17.91	20.04	19.57	20.02	19.75	18.84	18.34
60 days	10.66	11.11	11.21	12.17	12.15	13.55	12.36	13.82	14.88	16.25	17.57	19.33	20.40	20.66	20.64	21.44	19.85	18.77
90 days	12.69	12.90	13.02	12.99	13.09	14.04	14.57	14.92	15.41	16.23	17.96	18.95	18.88	19.20	19.35	19.40	18.81	18.34
180 days	13.12	13.45	13.52	13.48	13.49	14.27	14.96	15.88	16.27	16.68	18.04	18.56	18.99	19.33	19.39	19.93	19.60	18.92
1 year	12.90	13.14	13.21	13.11	13.30	13.96	14.98	15.26	15.53	17.15	18.40	19.41	20.00	20.62	20.55	21.36	20.72	20.65
> 1 year	11.94	11.94	11.94	11.94	11.95	13.07	13.49	14.62	14.82	16.11	17.59	18.93	18.95	19.94	19.59	20.43	20.74	19.65

Table 2b. Bank Interest Rates for Foreign Exchange in Mozambique

Maturity	Dec	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug
Lending									
7 days	13.99	12.66	12.46	14.16	14.01	14.55	14.19	14.78	14.68
15 days	13.09	11.43	14.58	11.37	14.58	13.07	14.58	12.00	14.58
30 days	12.79	9.75	9.95	9.97	10.29	8.89	8.94	9.17	9.06
45 days	9.70	7.62	7.93	8.42	9.19	9.59	9.16	9.72	8.46
60 days	10.13	8.47	8.10	9.11	10.11	8.86	9.07	9.61	9.16
90 days	9.76	9.23	9.26	8.81	8.90	9.03	8.29	7.89	7.97
180 days	9.61	9.22	9.39	9.68	9.55	9.73	8.24	7.95	7.93
1 year	10.34	9.94	10.09	10.27	10.31	9.80	9.10	8.59	8.34
2 years	10.30	9.72	9.64	10.05	10.15	9.64	9.61	8.85	8.74
>2 years	10.31	9.38	9.33	9.40	9.40	9.26	9.25	8.29	8.28
Prime rate	7.00	6.94	6.95	6.95	6.95	5.95	5.95	5.95	5.95
Deposit									
30 days	1.62	1.62	1.81	1.86	1.74	1.65	1.62	1.54	1.56
49 days	1.99	1.70	1.58	1.57	1.56	1.34	1.36	1.58	1.48
60 days	2.18	1.70	1.79	1.74	1.70	1.81	1.74	1.37	1.34
90 days	1.88	2.02	1.65	1.68	1.43	1.51	1.37	1.44	1.44
180 days	2.19	1.85	1.84	1.90	1.77	1.86	1.85	1.75	1.62
1 year	2.44	1.97	2.12	2.47	2.02	2.06	2.15	1.80	1.83
>1 year	2.83	3.04	4.05	4.32	3.11	2.66	3.28	3.32	3.32

The question is whether the rates are justifiably high or are high because of artificial and illegitimate reasons. The World Bank, in its Country Assistance Strategy, has promised an investigation of this matter.[27] The factors that are suspected of contributing to high interest rates are the effects of government borrowing to recapitalize two failed banks, which purportedly led to a crowding out of private credit demand and excessively high bank margins. The influence of the government's borrowing on rates is doubtful, although here we get into some highly contested macroeconomics. And because the banks are still liquid, it is hard to imagine how the government borrowing can be crowding anything out. Nonetheless, such borrowing has an effect through "the interest rate channel." Margins at the moment are high, because with a 20 percent deposit rate, and three-fourths of deposits in generally low-cost current accounts, banks' cost of funds should be low. Reportedly there is an unpublished Banker's Association study on this matter. In the case of high margins, to paraphrase the World Bank Country Economic Memorandum, the suspects are inefficiency, lack of competition, and overly conservative expectations.[28] By implication, the high rates may be exacerbated by the lack of infrastructure (such as a credit information bureau, accounting firms) or regulatory sanction of appropriate (in terms of collateral) lending instruments.

Heavy government borrowing and perhaps more general macroeconomic concerns will have to be dealt with at the level of general macroeconomic and budgetary policy. High bank margins may respond to regulatory reform initiatives and the promotion of new institutions. These new institutions might include new banks or specialized nonbank financial institutions (NBFI). Some reluctance by NBFI promoters to register NBFI suggests that the regulatory environment may not be quite right. However, the number and type of financial institutions have increased considerably during the past decade, as can be seen in Table 3.[29] There was further wide-scale discussion of forming new institutions, and several of the banks, especially BCI and BIM, have based their strategy on networking with NBFIs. Appendix E discusses the banks' margins.

[27] World Bank. Mozambique Country Assistance Strategy, Report No. 20521 MOZ, June 14, 2000, p. 17. The full text reads, "In the financial sector, the Bank will complete a diagnostic study and continue to provide advice to improve banking supervision and financial intermediation, particularly by analyzing the causes of high interest rates, by advising on financial sector efficiency and implementation of contract law, and by strengthening bank supervision in accord with the Basle Core Principles. The Bank Group will continue to work with the IMF to assist the Government in monitoring the stability of the financial sector, particularly in the wake of the recent floods. To promote competition in the banking sector, IFC will seek to expand its involvement with additional equity investments, term resources, and institution building. IFC will work to spur increased competition and intermediation through the establishment of new non-bank financial institutions, particularly in leasing, insurance, housing finance, and microfinance, which will help increase access to financial services for the poor. IFC will also provide advisory and technical assistance on regulatory and institutional issues."

[28] World Bank. Country Economic Memorandum, p. 46

[29] Faxed by Mr. Waldemar de Souza, October 14, 2002.

Table 3. Evolution of the Financial System of Mozambique

Institutions	1991	2002
Central bank	0	1
Commercial banks	3	11
Investment banks	0	1
Credit unions	0	6
Real estate finance institutions	0	3
Venture capital firms	0	1
Group purchase firms	0	1
Other intermediate credit institutions	0	2
Microfinance institutions	0	14
Representation offices	0	2
Foreign exchange house	4	32
Insurance companies	1	5
Insurance brokers	0	8
Interbank markets	0	2
Capital markets	0	1

Informality

Informality—operation in ways not sanctioned or noticed by the law and sometimes contrary to its provisions—pervades the Mozambican economy. This fact qualifies all analysis and undermines a portion of it. Informality exists in the classic developing-country form of large numbers of small, traditional firms, especially in rural areas. But it also exists in the transition economy–type of large unrecorded activities by registered firms. The result is that many perfectly bankable firms are not so bankable on the basis of their formal accounts. In some countries, what is lacking in the formal books is routinely dealt with by keeping multiple sets of books. This is both difficult and apparently unfeasible in Mozambique. Thus, successful efforts to formalize informal activities should have benefits for the financial system. A specific proposal is made later in this report. But USAID also has some experience with financial institutions that deal with informal entities without insisting on formalizing them, particularly in the microenterprise sector.

Banking System Capacity

More generally there are formal obstacles that inhibit the financial system's functioning and, *inter alia*, its service to exporters. These include narrow definitions of collateral that are exacerbated by the uncertain status of land tenure, and terms and conditions ill adapted to certain industries. To overcome these obstacles, an effort to familiarize banks with appropriate commercial forms (back-to-back letters of credit for garments for example), coupled with lobbying focusing on those who design bank systems and procedures, and support for pilot efforts, might be appropriate.

The banking system also has limited experience with loan workout techniques, which could be addressed as well, either by providing training or by inducing distressed asset firms to move into the country.

Rural Finance

There is great need for deposit and remittance facilities in rural areas.[30] This, rather than credit, is probably the main commercial opportunity in rural areas. In fact, the innovations undertaken in cultivation and the general extension of cultivation indicate that deposit facilities often provide all the credit farmers need or can use. For innovation in and extension of cultivation, some credit facilities may be needed, but these often can be handled through intermediaries—fertilizer and agroproducts dealers—as well as by mutual and rotating credit arrangements (*chitakas*).

There is a lack of institutional presence to provide these facilities. The Bank Austral government monopoly on transmitting remittances from mine workers is shamefully unexploited. (A follow-up visit with Amalgamated Banks of South Africa [ABSA], which is the new owner of Bank Austral, might indicate its plans in this respect.) The credit union movement hardly exists, though I find it hard to believe that the Roman Catholic Church did not promote this kind of thing in the past as it has elsewhere. MFIs, both registered and unregistered, are obvious potential resources. Although dealers, buyers, and sellers of produce, seed, fertilizer, and the like do provide credit, they are too few, and often are alleged to exploit monopolistic positions.

The strategy is to encourage the growth of all financial institutions in rural areas, probably emphasizing and building on savings and remittance services. Although USAID's general focus on the provision of farm storage facilities is undoubtedly unexceptionable, existing warehouses could also be involved with bank credit.[31] Switzerland's development cooperation has some experience here. The legal framework for opening branches and new financial institutions outside metropolitan areas is strong after a law liberalizing banking (Law No. 15) was passed, but encouragement, training, and even pilot subsidization might be called for. The World Council of Credit Unions and ACDI/VOCA have a track record with cooperatives; other NGOs have experience with MFIs. Even the commercial banks might build on their branch networks; perhaps one or two should visit Indonesia, if they have not done so already, to see Bank Rakyat Indonesia's initiatives.

Studies

The World Bank conducted a survey under its Regional Program on Enterprise Development that found that "[t]he most important problem identified by businesses is the weak financial market,

[30] Joseph Hanlon. The Land Debate in Mozambique: Will Foreign Investors, the Urban Elite, Advanced Peasants or Family Farmers Drive Rural Development. Research Paper commissioned by Oxfam GB Regional Management Center for Southern Africa, July 12, 2002, 5–6.

[31] World Bank. Country Economic Memorandum, 39–40.

which hampers their ability to operate and invest."[32] The World Bank conducted a financial sector study that has been completed since 2000 but it has not released it.

A systematic study of Mozambican financial markets and institutions is still probably called for. It would be worthwhile to ascertain the profile of finances among potential export firms, the availability of overseas and informal financing, and something about the detailed systems and procedures of banks and other financial institutions as they influence credit allocation.

The central bank's Economics and Statistics Department plans a periodic survey of the finances of Mozambican firms, including SMEs.[33] Some of these studies will require close cooperation with the regulatory authorities and the banking industry. This is particularly essential in a civil law country, like Mozambique, with strong protections for confidentiality, and one that has just undergone a financial sector crisis marked by the recapitalization of two large banks .

TWO VIEWS

Paradigm One

Mozambique has a weak SME sector; a lack of capital is a major—perhaps the main—obstacle to its growth. Different-size firms in different industries cannot obtain financing or at least cannot obtain financing under adequate conditions in certain forms for certain purposes. The well-wishers in the international community establish financial institutions or encourage existing institutions (but mostly establish them) to provide the sort of financing that SMEs require. This relaxes constraints on the availability of funds but frequently has unsatisfactory results—new institutions fail or they never function at all.

SMEs do not flourish either because factors other than a lack of capital handicapped them or the financial institution soon becomes insolvent because of unforeseen operational or credit risk. In Mozambique, many financial institutions have not been around long enough for anyone to know if they will work. I hypothesize that most of the risks are on the financial institutions' side.

USAID must determine whether there are financial market niches in which a subsidized start-up financial institution eventually could be sustainable and promote SME investment. Many foreign donors think this is possible in Mozambique.

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[32] Ibid., p. 45. The World Bank SME Department addresses this in more detail in its draft SME Country Mapping for Mozambique, p. 1 summary: "…Credit offerings are limited to 'blue chip' borrowers. … Small businesses are highly undercapitalized and in need of financing," and credit is high-cost and requires 300 percent collateral; In the SME Country Mapping Snapshot–SMEs' Access to Capital (II.B), the World Bank reports that SMEs think they need financing but banks do not think they are creditworthy. However, "There is more credit available in foreign currency for export oriented industries." Furthermore, "[s]hort term credit is more readily available with the vast bulk of lending [for] less than two years. While most commercial banks are not interested in lending to SMEs, there are a few programs and institutions that focus on SME lending," and "[t]here are a number of microfinance institutions." The SME Mapping Gap Analysis–SMEs' Access to Capital (III.B) gives more details.

[33] Interview with Waldemar F. de Souza, October 14, 2002.

Paradigm Two

Firms manage their portfolios to maximize their net returns (profits). They use those portfolios to perform some operations in a production chain for a particular industry. Because of a lack of certain financial instruments or the high cost of those instruments, firms are constrained in performing some of the operations in a production chain. Such financial instruments (insurance, loans, financial advice) would enable firms to expand their operations.

For example, firms may not export because from their lack of export risk insurance they perceive that the risk-adjusted returns for exporting are too low. Firms may not engage in a particular agroprocessing, for example, because they lack credit for the necessary equipment.

Lack of information, problems with low initial demand, or regulatory obstacles may prevent financial entrepreneurs from offering needed instruments. Or, offering a needed instrument might be unattractive for a profit-oriented financial firm.

Subsidies of financial instruments sometimes might be justified by social externalities. Or a small initial public investment may be justified to dispel ignorance (excessive risk aversion), overcome free-rider problems (by compelling banks to provide data to a credit bureau—although industrial countries do not do this), deal with political risk, or conduct seminars and discussions for financial institutions about potential new instruments. Ultimately the measure of success for such public investment will be that a self-sustaining financial instrument will be created and adopted by mainline institutions. For example, in some countries, authorities have cooperated with private investors to create leasing and forfeiting companies, commercial credit companies serving markets not served by banks, export risk insurance facilities, credit reference bureaus, training on export, and SME financing. Governments and international donors also have supported seminars to expose decision makers to a variety of financing alternatives. In microfinance these donor and government interventions frequently dominate the market.

These government initiatives are all rational responses to market failure. A facility can be created at low cost and sometimes can enable export and SME production.

Because financial markets involve risk and regulation, a government role is often critical in promoting innovation, and offering new instruments in particular. However, government investments are frequently both off-budget and costly. Obviously, the desired innovation should be cheap, effective, and fully costed in budget terms.

FINDINGS

Export financing in the narrow sense is available to most of those with confirmed export orders—especially post-shipment financing, but generally also working-capital financing for completing an order. Banks expressed a slight interest in export financing enhancement through credit risk insurance and credit information and ratings. An initiative is underway on the latter account, though I was not able to determine if it is serious.

Many existing enterprises need financing for balancing modernization, rehabilitation, and expansion (BMRE). This is apparently what the PODE project was intended to provide. Unfortunately, banks have no particular incentive to participate in PODE, and borrowers are deterred by the high rate of interest dictated by, among other things, macroeconomic priorities. Even much of the activity of formal-sector enterprises is still informal, which handicaps formal-sector financing.

There also appears to be a lack of knowledge about loan workout and the capacity to implement loan workout arrangements. Working out loans would enable the restructuring and salvaging of the distressed assets that now characterize part of the banking system.

Commercial banks are hesitant to extend credit, for understandable reasons, but they could be provided technical assistance such as training as well as an information infrastructure (e.g., a credit information bureau) to encourage them to do so. Whether guarantees will produce enough additional lending to justify their additional expense is a question that will have to be explored.

Financial services to informal enterprises and microenterprises and in rural areas are limited, but providing financial services might help increase exports.[34] Particularly in border areas where substantial exporting takes place, financing might be linked with formalization. In fact, access to formal-sector financing is typically a major incentive for formalization, as discussed later in this report.

A STRATEGY FOR USAID MOZAMBIQUE

The involvement of USAID Mozambique in the financial sector for the purpose of promoting exports should be based on the following principles:

- Reconstruction of the financial sector is a complex process and is primarily the focus of other donors; USAID therefore needs to coordinate its involvement with other donors.
- The problems to be addressed are general for all enterprises, and only incidentally and to varying extents for export-oriented industries.
- Both the informal and even formal aspects of the financial sector are imperfectly understood by everyone, so interventions need to be careful, preferably low cost, and self-correcting.

Short-term Initiatives

On the basis of the foregoing principles, the following initiatives are immediately justified, provided that other donors are not engaged in them:

- USAID could sponsor a short seminar on financing modalities for garment exporters such as back-to-back letters of credit. Mauritian, South Asian, and Southeast Asian bankers who can explain to local bankers what kinds of tools are used should make presentations. Close cooperation should be sought with the South African banks, which own a number of Mozambican banks. This seminar would be aimed at banks and bank regulators, and perhaps some finance companies. If the seminar proved successful it might lead to suggestions for further work helping with the details of the financial instruments concerned and become a model for similar sessions aimed at financing other export sectors such as tourism or furniture.
- USAID could sponsor studies on the financial sector jointly with the Banco de Moçambique. An initial study might review the operational systems and procedures of the commercial banks as they affect small businesses or export financing. Such a study

[34] World Bank. Country Assistance Strategy, p. 16.

would help identify the obstacles to bank lending and permit appropriate reforms in banking regulations and targeted technical assistance. (Appendix F provides an example of such a study conducted with the Bank of Indonesia.)

- A more general financial sector study may be called for, particularly if the World Bank–sponsored study is not released or proves inadequate. USAID collaboration might consist of providing technical assistance or even the personnel to conduct the studies. But close cooperation with the Banco de Moçambique and probably the World Bank and even IMF may be required.
- Some exploratory work might be done on schemes for leveraging additional bank financing either through a credit guarantee or by providing some investment into a finance company with other partners. USAID is clearly in no position to assess the creditworthiness of particular parties. There is obviously some interest on the part of the banks, though it is not clear if those expressing interest are willing to extend additional private funding beyond what USAID might provide.
- Some exploratory work also could be done on the potential for supporting new institutional initiatives to increase the ease with which banks lend. Providing training of the sort sometimes provided with USAID credit guarantees would be an easy initiative to implement. USAID support for a credit information bureau or for export risk insurance still may not meet with much demand from the banking community.
- USAID has tried providing conditional matching funds for the preparation of project proposals elsewhere with mixed success, but it might be possible to provide something while avoiding the reasons for the failure of previous efforts. However, this type of assistance is what PODE, Technoserve, and others now provide for free.
- Finally, USAID could provide assistance in increasing the capacity for loan workout, either through encouraging distressed asset firm entrance or training.

Longer-term Initiatives

BMRE Facility

Some private investors are interested in setting up an institution that could purchase distressed assets from financial institutions and put them through a workout process. Obviously, such an institution would like to have funds for new lending after it has developed a feasible restructuring package. These investors believe that one of the factors that contribute to distress is informality—that is, the enterprises concerned have adequate assets but they are not on the books, and the punishment for immediate formalization is severe in terms of taxation and other penalties. The promoters are searching for relatively cheap loan funds, a one- or two-year tax and regulatory holiday so they can formalize their enterprises, and other things.

Exactly how USAID should respond to this interest is not clear; looking at successful experiences with distressed asset workout, BMRE funds, and formalization programs elsewhere might be useful to determine if any could be adapted to Mozambique's situation. The first step might be to commission a quick desk study on these three subjects. If interest remains, a public discussion of the comparative experience might help. Distressed asset funds active in East Asia and that are established institutions in many developed countries might be interested in working in Mozambique.

Pilot Financial Activity to Leverage Private Funds

Supporting a pilot activity to leverage private funding would increase lending and competition to reduce interest rates. Several models come to mind. One is the kind of finance company promoted by the Agha Khan Fund for Economic Development, in which the fund typically contributed 10 to 20 percent of the capital as well as management, and the rest usually is raised from various banks, domestic and foreign, and institutions such as the IFC. Another model that comes to mind is the *financiera* (finance company) I reviewed in Honduras years ago that was owned by commercial banks with a 20 percent USAID contribution. They took borrowers on reference from the banks, typically those who could offer only 100 to 150 percent collateral rather than the 300 percent norm, and financed them for one round before they moved back to their parents' books.

Increasing financial sector competition is ostensibly government policy as well: "Government policies are aimed at encouraging lowering financial intermediation costs by enhancing the development of nonbank financial institutions."[35]

Some sort of guarantee fund is also possible, but again, there would have to be some indication that this in fact would leverage additional funds. USAID under the Development Credit Program frequently has extended guarantees for SME lending by banks. Typical terms for a guarantee have been 50 percent of face value, and a 2 percent annual fee. This would involve both Mission commitment and central funds.

If these initiatives are successful, they could provide the basis for broader interventions by USAID and other donors. If they fail, the amount of the resources at stake is not large.

Finally, USAID already plays an important role in microfinance in Mozambique. There is reason to believe that some of the existing microfinance initiatives support exports, particularly in the north of Mozambique. As USAID expands its work in microfinance, it will have a positive effect on the level of exports. It might be worth studying SIDA's experience to determine if promoting commercialization and export justifies the cost.

These steps are not justified for the export sector alone, but rather as contributions to general financial sector development. Most require close cooperation with and probably sponsorship by the financial sector authorities in the Banco de Moçambique and Ministry of Finance.

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[35] Ibid.

Appendix A. Interviews and Contacts

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Appendix C. Official Export Credit Agencies of OECD Member Countries

Official Export Credit Agencies of OECD Member Countries[36]	
Australia	Export Finance and Insurance Corporation
Austria	Oesterreichische Kontrollbank AG
Belgium	Office National du Ducroire/Nationale Delcrederedienst
Canada	Export Development Corporation
Czech Republic	Export Guarantees Development Corporation
	Czech Export bank
Denmark	Eksport Kredit Fonden
Finland	Finnvera Oyj
	FIDE Ltd.
France	Compagnie française d'Assurance pour le commerce extérieur
	Direction des Relations Economiques Extérieures (Ministère de l'Economie)
Germany	Hermes Kreditversicherungs-AG
Greece	Export Credit Insurance Organization
Hungary	Magyar Exporthitel Biztositó Rt.
Italy	Sezione Speciale per l'Assicurazione del Credito all'Esportazione
Japan	Export-Import Insurance Department
	Japan Bank for International Cooperation
Korea	Korea Export Insurance Corporation
	The Export-Import Bank of Korea
Mexico	Banco Nacional de Comercio Exterior, SNC
Netherlands	Nederlandsche Credietverzekering Maatschappij NV
Norway	The Norwegian Guarantee Institute for Export Credits
Poland	Korporacja Ubezpieczén Kredytów
Portugal	Companhia de Seguro de Créditos, SA
Spain	Compañía Española de Seguros de Crédito a la Exportación, S.A.
	Compañía Española de Seguros y Reaseguros de Crédito y caucíon, S.A.
	Secretaría de Estado de Comercio (Ministerio de Economía)
Sweden	Exportkreditnämnden
Switzerland	Export Risk Guarantee
United Kingdom	Export Credits Guarantee Department
United States	Export-Import Bank of the United States

[36] Retrieved November 25, 2002, from the OECD Web site http://www1.oecd.org/ech/act/xcred/ecas.htm.

Other Agencies	
France	Coface Scrl
Germany	Gerling Credit Insurance Group
Hong Kong	Hong Kong Export Credit Insurance Corporation
India	Export-import Bank of India
Indonesia	Asuransi Ekspor Indonesia
	PT. Bank Ekspor Indonesia (Persero)
Israel	Israel Foreign Risks Insurance Corporation Ltd
	Israel Discount Bank
Italy	Società Italiana Assicurazione Credit SpA
Malaysia	Malaysia Export Credit Insurance Berhad
New Zealand	EXGO
Oman	Export Credit Guarantee Agency, Oman Development Bank
Singapore	ECICS Credit Insurance Ltd
Slovenia	Slovene Export Corporation, Inc.
South Africa	Credit Guarantee Insurance Corporation of Africa
Sri Lanka	Export Credit Insurance Corporation
United Kingdom	EULER Trade Indemnity plc
United States	Overseas Private Investment Corporation

Appendix D. Description of the Development Credit Program

Development Credit Program (DCP)[37]

Democracy and Governance

[Economic Growth and Agricultural Development]

[Environment]

[Human Capacity Development]

[Population, Health and Nutrition]

[Women in Development]

[Program Development and Strategic Planning]

Development Credit Program

[Glossary]

[Abbreviations and Acronyms]

Last updated: Wednesday, 29-May-2002 18:52:59 EDT

Private investment and effective credit markets are critical for economic growth in developing countries. Abundant private domestic capital exists in most of these countries but is not properly mobilized and put to work. USAID believes that a combination of technical assistance and true risk-sharing DCP guarantees is an effective tool to address the historical, cultural, and other factors that cause this fundamental problem. Moreover, the US has a unique comparative advantage in this sector with US financial intermediation serving as a model of efficiency and US financial experts viewed as world class leaders. DCP assistance is intended to induce lending to creditworthy but underserved credit markets such as the small and medium scale businesses and farmers who frequently benefit from DCP guarantees. With DCP training and technical assistance, local financial institutions, companies, and USAID missions work together to develop innovative demonstration activities to mitigate market distortions, mobilize local private capital, and expand credit services. In the three years since the inception of DCP, USAID mission demand has grown rapidly. Increasingly, private sector activities formerly assisted through grant funding are now being assisted with disciplined, less costly DCP credit enhancement. When the private banks and investors successfully experiment with providing credit to underserved sectors, the expectation is that they will continue to direct credit to these sectors when DCP assistance is no longer available.

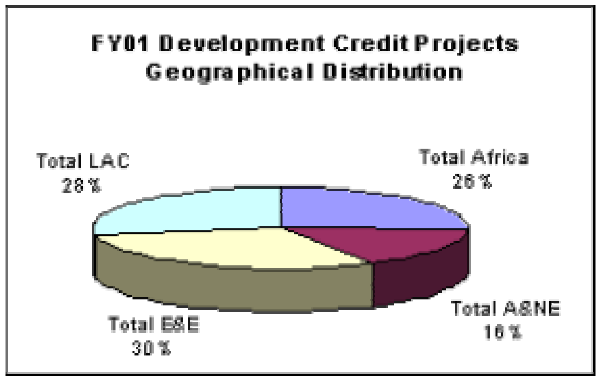
USAID is requesting consolidation of all credit assistance under a single allocation of DCP transfer authority. Activities previously funded under a separate Micro and Small Enterprise Development (MSED) authority will be funded under DCP according to priorities established by the Congress. The consolidation of all credit activity under DCP will result in accounting and administrative efficiencies and avoid separate accounting duties and expense. Transfer authority subject to a set ceiling is requested in lieu of a direct DCP line item appropriation. Transfer authority will assure that mission development objectives drive the use of DCP and not the imperatives to fully

[37] Retrieved November 25, 2002 from http://www.usaid.gov/pubs/cbj2002/cent_prog/global/dcp/

expend appropriated accounts. The added flexibility of the transfer authority also gives Congress and the Agency a versatile financing tool that can be used as needed to quickly respond in times of emergency or shifting priorities.

DCP Guiding Principles:

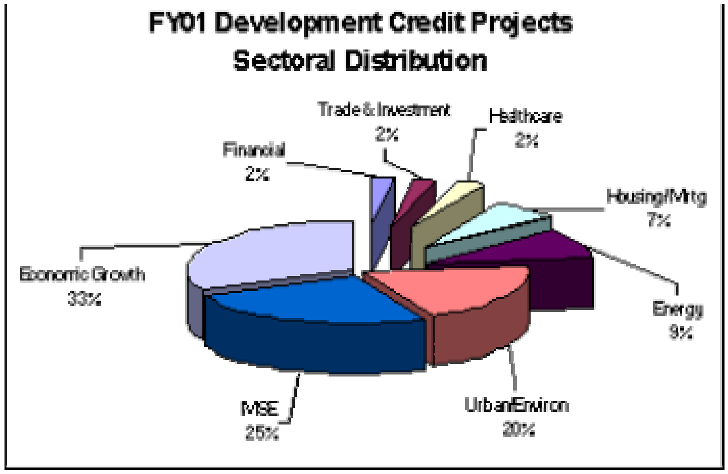
- Projects contribute to the achievement of USAID objectives;
- Risk is shared with private sector partners;
- Host-country participants commit to financial discipline leading to a more appropriate and efficient use of U.S. funds;
- Prudent risk management methods are used to assess project risk;
- Projects will address market failure; and
- DCP will emphasize credit support to private sector institutions over sovereign loans and guarantees.



DCP is not an additional source of funding, but merely an alternative use of existing appropriations, whereby funding from other USAID-managed accounts can be transferred to the DCP account. DCP augments grant assistance by mobilizing private capital in developing countries for sustainable development projects.

Since the inception of DCP in 1998, a total of fourteen projects in ten countries have been approved. These projects permit a credit portfolio of $141 million in local currencies at a credit subsidy cost to the Agency of $5.4 million. The contingent liability of the existing DCP portfolio amounts to $65.8 million.

In FY 2001, 22 USAID Missions and bureaus submitted 49 proposals requesting the use of DCP. Together, these activities could mobilize over $400 million in local currency financing, at an estimated credit subsidy cost of $30 million. Additionally, more than a dozen new projects are in early stages of development for FY 2002. These projects could mobilize up to $100 million more in local currency project finance at an estimated subsidy cost of $7 million. These activities include large infrastructure projects in Egypt and loan guarantees for earthquake reconstruction efforts in India and El Salvador.



The FY 2001 projects address almost every targeted development sector. The Agency is confident that credit can be used effectively to support private-sector involvement in the financial, healthcare, infrastructure, trade & investment, housing, mortgage, micro-finance and energy sectors in developing economies. DCP has also proven especially effective for supporting the growth of small and medium enterprises, obviating the need for the appropriated authority provided under the MSED Program. New demand for DCP credit enhancement in FY 2002 is likely to exceed current demand.

For FY 2002, USAID is requesting $8 million in directly appropriated funding for credit administrative expenses and $25 million in transfer authority for DCP credit subsidy.

Development Credit

	FY 2000 Actual	FY 2001 Appropriation	FY 2002 Estimate
Credit Subsidy			
Transfer authority for DCP	[3,000,000]	[5,000,000]	[25,000,000]
Appropriation for DCP	-	1,500,000	-
Appropriation for MSED Program	1,500,000	1,500,000	-
Appropriation for UE Program	1,500,000	-	-
Administrative Expenses			
Appropriation for DCP	-	4,000,000	8,000,000
Appropriation for MSED Program	500,000	500,000	-
OE Funding for MSED Program	1,100,000	335,000	-
Appropriation for UE Program	4,990,000	-	-
OE Funding for Direct Loan Program	2,600,000	-	-

To conform with the Federal Credit Reform Act of 1992, the $8 million appropriation request for credit administrative expenses reflects the total cost of the development, implementation and financial management of all Agency credit programs, including certain costs previously funded by the Agency OE appropriation. It covers a total of 23 full-time direct-hire staff associated with management and oversight of new DCP activities and the continued administration of existing credit portfolios with outstanding principal in excess of $13 billion. In addition to providing direct support to field missions contemplating or using the transfer authority, it also includes funding for legal support and financial accounting services.

The $25 million of DCP transfer authority will be used to guarantee loans and loan portfolios in every region of the globe and in every economic sector targeted by USAID. In FY 2002, the Global Bureau will assist Missions in supporting such activities as bond financing; small- and medium- enterprise (SME) development, competitive financial services; and creative municipal financing and clean energy. Activities funded through DCP add value to the Agency's overall efforts by:

- **Demonstrating** to financial institutions in developing countries that mobilizing local private capital to fund activities in their own countries is a profitable, worthy venture;
- **Creating competitive markets** by providing local financial institutions with an incentive to provide financial services to historically disadvantaged social groups and all viable economic sectors;
- **Improving policies and increase transparency within financial institutions and the legal framework guiding those organizations;**
- **Establishing efficient credit markets by helping institutions develop business plans, revise credit policies and train staff properly; and**
- **Increasing Employment** through increased lending to SMEs and spillover effects into related sectors.

Appendix E.
Where Does the Bank Interest Margin Go?

Computing Mozambique's commercial banks' net interest margin is complex because banks engage in a number of income-generating activities other than intermediation. The two commercial banks for which I have annual reports, Bank Standard Totta de Mozambique and Banco Internacional de Moçambique, generated considerable income on three other items—foreign exchange gains (they all keep a lot of money in foreign bank accounts and the metical has been devaluing), fee-based income (they are heavily involved in servicing foreign trade), and in recovery of bad but provisioned loans. There are a lot of the latter in the system at the moment so recovering them is always an option.

For example, Bank Standard Totta (BST) had a gross interest margin for 2001 of US$11.5 million, and after making provisions for bad debts of $2.7 million, a net margin of $8.8 million. But its total income of $23.1 million included $9.3 million of foreign exchange gains and $5 million of fee-based income and "other operations." It had additional income of $3.4 million from "extraordinary items," almost all bad-debt recovery and write-back of provisions.

Banco Internacional de Moçambique (BIM) had a gross interest margin of $27.3 million for 2001, which after provisions for bad debt of $6.2 million, gives a net interest margin of $21.1 million. But it also had $5 billion of commission income, and $156 million from "treasury operations," mostly "translation of foreign exchange reserves," which was countervailed by a loss item of $154 million to give a net gain of $2 million.

Thus "costs" are considerably higher than "net interest margin," and understandably so. For BST, these costs were $12.3 million, composed of $5.8 million for personnel costs, $4.5 million for cost of supplies and services, and $2 million for depreciation. I suspect some of this is newly purchased computer software. Of course, the provisions of $2.7 million should be added to this, giving a total of $15 million.

For BIM, if we ignore the foreign exchange item, costs were $31 million, including $13.3 million for staff costs, $11 million for other administrative costs, and $3.6 million for depreciation. The relatively low level of staff costs as compared to the much smaller BST, suggests it does not pay its people so well. It also has $1.9 million in other provisions and $1.1 million in other operating costs. The "other provisions" are liabilities on retirement obligations of staff and other potential expenditures. This strange item appears to amount to provisions for future operating expenditures.

For reference, BST had total assets of $212.9 million, of which $56.9 million was in loans and advances. On deposit with other banks was $111.2 million, overwhelmingly abroad. BIM had total assets of $648.5 million, of which $230.3 million was in loans, and $72.6 million in securities. (This comes from a consolidated statement of the "group," which includes an investment bank.) Whereas BST is over provisioned, as indicated by its recovery against provisioned loans and the fact that it reports 112 percent coverage, BIM shows $90.7 million as a provision liability.

Again for the more familiar loan–deposit ratio, BST has $170.4 million in public deposits versus its $56.9 million of credit, or a loan–deposit ratio of 33 percent. BIM has $502.4 million of deposits versus $230.3 million of loans, for 46 percent. These are not unbelievably low, especially given the recent bad-debt experience in Mozambique and the perceived exchange risk.

The rate of return on equity, depending on how you count it, was 41.7 percent for BST, and the rate of return on assets was 4.8 percent—both astronomic in comparative international terms. For BIM, the rates were approximately 13 percent and 0.5 percent. These ratios are probably calculated in slightly different ways but I did not verify how the calculations might have differed.

Appendix F. Commercial Bank Systems and Procedures for Retail Loans in Indonesia

Among its responsibilities, Bank Indonesia regulates and supervises the banking system, especially the commercial banks. This regulation is intended to serve the needs of the real economy, especially the small and medium enterprise (SME) sector. Indonesia's approximately 165 commercial banks had about 40 trillion rupiahs of officially defined SME lending outstanding at the end of 2000, including considerable consumer and housing lending. New regulations have redefined the SME lending category, but figures using the new definition have not yet been released. In general, Bank Indonesia is committed to expanding small and medium credit to businesses in Indonesia.

From the banks' point of view, SME lending usually is treated as part of a bank's retail lending.[38] In most banks this retail lending is defined primarily in terms of limits on the size of credit. The Indonesian Bank Restructuring Agency defines retail credit as credit accounts with outstanding balances of less than 5 billion rupiahs. This limit roughly coincides with those used by some very large commercial banks. Most banks have a lower limit, perhaps 1 or 2 billion rupiahs. Retail credit is now the focus of many banks' business strategy. Two banks are committed to having 50 percent of their lending in the retail category by 2004, and one is targeting 80 percent. Many other banks already focus on the retail sector.

Each bank, within the general constraints of Bank Indonesia regulations, has its own procedures and incentives for handling retail loan accounts. A four-threshold model gives a possible explanation of the volume of retail lending in terms of these procedures and incentives.

THEORETICAL BACKGROUND

What Does It Mean to Make a Loan?

Lending typically requires a sequence of steps involving a number of parties, including the following:

1. Exploration of alternatives by the borrower
2. Marketing outreach by the lender
3. Preliminary exploration and negotiation between borrower and lender
4. Formal application, evaluation, and approval by the lender
5. Disbursement by the lender and receipt by the borrower.

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[38] Teguh Pudjo Muljono, *Bank Budgeting: Profile Planning and Control*, Jogya: BPFE, 1996, 210; Juti Irmayanto et al., *Bank and Lembaga Keuangan Lainya*, Jakarta: Penerbit Universitas Trisakti, 2000, p. 33.

Who Makes a Loan?

A number of parties typically are involved, actively and passively, in these steps. Especially in SME lending, three actors are critical—the approving officer, the relationship and/or credit officer, and the applicant. For SME or retail loans there is typically one sanctioning officer (or sometimes a credit committee), although that officer depends on a loan officer or credit or relationship officer to prepare the loan file. There is also a person or business that decides to apply, although the applicant may rely on advisers to prepare loan materials and may require the cooperation of others in assembling them. Thus if a business license is required to obtain a loan, the applicant needs the cooperation of the licensing authority (Ministry of Industry and Trade) to obtain the license. If title papers for collateral real estate are required, the applicant may need the cooperation of a clerk in the land title record office.

For a given transaction, it should be possible to diagram all the cooperating agents needed and pinpoint the costs and limitations of using them. Something similar has been done in the studies that The Asia Foundation and USAID have commissioned on the costs of obtaining a business license. I do not know of anyone having commissioned similar studies for loans.

In some banks retail is a single undifferentiated category, scheme, or product of its own, with a prescribed system and procedures. The details vary, but usually a set group of documents must be submitted, various requirements for collateral must be met, and the application must go through a sequence of steps before a loan is sanctioned and disbursed.[39] Usually final authority is much lower in the bank hierarchy for retail than for commercial or corporate market segments. In several banks the approving authority is the branch manager, although sometimes a credit committee is involved.

Although some banks have an undifferentiated retail product with a separate system and procedure called a retail loan, others have various subcategories, schemes, or products with differences in the details of systems and procedures. These may differ because of the size of the loan, the nature of the borrower (new borrower, retiree, teacher, civil servant), the ostensible purpose of the loan (consumption, housing, small enterprise), or the form of lending (cash credit or overdraft, a term loan with a balloon payment, or a complex mix of lending forms).

For small loans, the process is usually simpler on the approval side—not the least because most of the preparation burden can be transferred to the applicant. Thus the decision to approve a small loan usually can be described simply in terms of the influences on the approving officer or committee.

How Do They Make Loans?

In some cases, the standard terms and conditions for SME and retail loans are advertised publicly. Bank Indonesia requires that all commercial banks have an approved credit manual specifying their lending procedures in detail.[40] Although theoretically there is considerable room for variation, most of the manuals follow a standard pattern. There is usually some discretion in the interpretation, as for the evaluation of collateral. Nonstandard conditions often are imposed by each sanctioning officer,

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[39] Thomas Suryatno et al, *Dasar-Dasar Perkreditan*, Edisi Keeimpat, Jakarta: Gramedia, 1997, pp. 69–86; Teguh, op. Cit., 210–242 and 144–46, This describes the various elements of system and procedures.

[40] Pedoman Pemberian Kredit referred to in Pedoman Pendirian Bank Umum and SE 32/33.

and additional fees and charges sometimes are exacted for the sanctioning officer personally. The sanctioning of loans is typically subject to a lending-budget limit on the total amounts of such loans disbursed. However, this is rarely an operational constraint because sanctioning officers rarely come close to their authorized limits.

I do not know of any systematic study of the deviation of actual terms and conditions from the norm. The Ministry of Cooperatives and Small Enterprise has attempted a cataloguing of the published standard terms and conditions under which commercial banks lend to SMEs, but it informed me that securing cooperation has proven difficult.

What Determines the Amount?

The amount of small loans made is a thus a function of how many loans the authorized officers approve. The rates and conditions are usually standard. The prime determinants of how many loans are made are probably the following:

- The demand for such loans at the set terms and conditions
- The incentives the sanctioning officers have to make or not make such loans.

The incentives and disincentives can be direct, such as targets for small loans, penalties for small loans in arrears, etc.—items that typically are used in the routine personnel evaluation and promotion system of the bank concerned. But they can be indirect, such as effects on the bank branch's overall business (returns, deposit mobilization) or on the branch manager's relationship with supervisors and the local community.

The study of the bank lending process is one where the factors that affect the lending process are quantified. These factors are both conscious and expressed, and subconscious and unexpressed. In other words, it is necessary to interview approving officers about what they think influences them as well as study the approving officers' actual decisions and how they fit with their self-analysis. Nevertheless, it should be possible to formulate some hypotheses and test them. The following hypotheses are to be addressed:

- If few loan applications are refused or withdrawn, it seems probable that demand, under current terms and conditions, is the major determinant of lending. Application withdrawals are critical and hard to monitor, because once it is clear that a loan will not be approved, the application for it frequently is withdrawn. The research problem is that withdrawal is often an informal and undefined process, distinct from approval and denial. The only way to solve this problem is to correlate reports from loan officers with those from small entrepreneurs.
- If there are few career rewards for SME lending, or severe sanctions for lending that fails, it can be hypothesized that this is a major contributing factor to low levels of lending. This hypothesis could be tested by correlating incentive systems and levels of lending.
- If the lending authority of sanctioning officers is also constrained, those constraints should also play some part in governing levels of lending. Again, some correlation between the degree of constraint and lending is to be expected.

- Finally, it can be expected that informal social pressure within the banks and local community also will influence lending levels. This can perhaps be tested primarily through attitude surveys of loan officers.

These factors come into play after the effect of more formal constraints such as the level of interest, the quality of collateral demanded, and the requirements for licenses and documentation.

SUMMARY OF A RESEARCH AGENDA

Research on the factors that govern bank lending to SMEs should address the following questions:

- Who can sanction small loans (SME/retail), up to what amounts, and under what terms and conditions?
- What volume of such loans is applied for and either sanctioned, denied, or withdrawn? (The latter is a particularly difficult point.)
- What career or direct incentives are provided to bank sanctioning officers to make or not make such loans?
- What other pressures affect bank sanctioning officers in making such loans?
- What are the prescribed terms and conditions for SME and retail loans, and to what extent are they adhered to?
- Which of these terms and conditions in fact result in small loans not being given?

Most of this information can be obtained by asking a bank's head office for its rules, regulations, and instructions about such small loans. Other information might be obtained by surveying selected sanctioning officers themselves. Finally, some issues can be elucidated only by conducting case studies of loans as they are made.

Purpose and Design of Study

The purpose of this study is to research the factors that encourage or discourage SME and retail lending by commercial banks in Indonesia by documenting the actual systems and procedures of seven representative banks and determining how they affect the volume of lending.

Sample and Categories, Justification

Resources were not available for a survey of all or even most banks. Eight banks were to be chosen to be broadly representative of the main categories of banks involved in retail credit. However, under the category of foreign or joint sector bank, none was found to be engaged in retail business lending, although several have large credit card and consumer lending businesses. Finally the sample included only seven banks.

Two government banks were chosen because they account for a large part of retail lending. Two provincial development banks and two private commercial banks that survived the monetary crisis also were included in the sample.

Questionnaire

A questionnaire/interview pro forma was prepared and designed to define retail lending in the banks surveyed and specify the elements of the systems and procedures that are used for such lending in each bank. Questions were designed to elucidate what factors and incentives influenced the volume of retail lending—such as the career and salary incentives for such lending and bank lending budget and business plans. It will come as no surprise that when bank lending budgets and business plans provided for retail lending, and/or when there were considerable incentives for retail lending, it usually grew. The opposite was also true—when bank policies and incentives discouraged retail lending, it did not grow.

Administration

The questionnaire and study were discussed with the senior managers and responsible officers in the banks' head offices. Several banks provided their documented procedures for handling such loans (manuals, pro formas). Then, when possible, discussions were held with branch or district officers. Some banks made these officers available at their head offices, but most branch and district officers (five of the seven) were visited in their offices in the field.

Most banks also provided written responses to the questionnaires, in some cases two responses, one from the center and the other from the field offices. (Five of the seven provided written input.)

Most of the branches surveyed were in the Jabotabek or Surabaya metropolitan areas, and one was in Jogya. The Jogya branch was suggested because the branches of the bank concerned in Jabotabek and Surabaya were undergoing reorganization. During the course of the survey, a second branch of one of the larger government banks was visited because it was particularly engaged in retail lending.

A caveat of some importance: The larger banks are quite large, as is Indonesia. Despite the presence of centrally mandated procedures and policies, considerable leeway in pursuing a particular focus sometimes is extended to branches. Sometimes these special focuses are designated as pilot or experimental efforts, but in other cases they are simply exceptions. This pattern was noted in two large government banks (only one from the sample) and is a rational response to the need to develop their retail business, as their business plans mandated. Smaller banks are likely to be more tightly controlled and uniform in their activities, but even their branches emphasize different activities and frequently have differing levels of autonomy in making loans.

General Categories of Retail Lending

Program versus Commercial Lending

Most banks undertake some program lending—lending using funds provided at least in part by the government or others under mandated terms and conditions. Frequently, this lending is highly targeted and is subsidized to some extent. This lending typically is conducted and supervised by a different group of people than retail lending, and has a completely different set of systems and procedures, usually mandated by the donors, connected with it. Most program lending that came to light during our survey was connected with the former Bank Indonesia programs typically funded with so-called liquidity funds, and now turned over to other state-owned enterprises such as PT Madani. Other program lending was funded by the provincial governments, especially the provincial development banks.

One important program of cooperation is underway between some of the surveyed banks and the Indonesian Chamber of Commerce and Industry (KADIN), but it does not involve program funding or important changes in systems or procedures, and little lending has occurred under it so far. In another case, a foundation was very involved in providing technical assistance to bank clients who were borrowing through normal retail channels. Table F-1 shows the approximate levels of program and retail lending of the banks surveyed.

Table F-1. Lending by Banks in Survey Sample (rupiah)

Bank	Assets (trillion)	Lending (billion)	Retail (billion)
Bank A	247.00	n/a	n/a
Bank B	65.00	n/a	10.00
Bank C	9.10	4.77	46%
Bank D	2.80	1.26	81%
Bank E	3.20	209	Almost all
Bank F	0.92	n/a	Almost all
Bank G	5.30	n/a	45%

N/A—not available

Our study focused on retail, nonprogram lending because program lending was being studied extensively by others.

Consumer, Housing, Labor Export, and Salary Advances

Some of the surveyed banks had different, special lending products for consumer and housing lending guaranteed against the salary of the borrower (typically a civil servant). This was a major category of lending for several banks, particularly the provincial development banks and one of the large government banks, that seems to have been largely unaffected by the monetary crisis. Similarly, some of the banks, especially the other large government bank, extended considerable consumer credit (and in one or two cases credit to suppliers) to the customers and suppliers of their larger clients. Two of the banks had special programs for funding labor export, coordinated with labor export agencies.

Definition by Authority Levels

For our purposes, and for most of our informants, retail lending was defined by the levels of authority needed for approving loans. In most cases, a specific maximum size of loan is sanctioned at a lower level in the bank. In a couple of smaller banks, even the smallest loans were subject to review at the central level by a credit committee. These banks had an internal definition for retail lending. In a couple of cases there was more than one retail category. In only one case was the regulatory SME definition involved in defining retail lending.

Table F-2 shows the authority levels for different sorts of lending.

Table F-2. Authority Required for Approval of Loans

Bank	Approval Authority
Bank A	Up to 2 billion rupiah, hub/spoke manager and Credit Risk Management Unit
	Up to 5 billion rupiah, regional manager and Credit Risk Management Unit
Bank B	Up to 1 billion rupiah, branch manager
	1 billion–2.5 billion rupiah, regional manager
	2.5 billion–5 billion rupiah, Head Office
Bank C	Class C to 300 million rupiah
	Class B to 700 million rupiah
	Class A to 1 billion rupiah Branch Manager Committee
Bank D	350 million–600 million rupiah, branch manager depending on the level of the manager
Bank E	Up to 500 million rupiah, branch manager ,
Bank F	Up to 50 million rupiah, Branch Credit Committee
	More than 50 million rupiah, Central Credit Committee
Bank G	50 million–500 million rupiah, Branch Credit Committee
	More than 500 million rupiah, Central Credit Committee

The definitions differ considerably. This is natural considering the varying business strategies and situations the banks find themselves in. All but one of our banks concentrate primarily on small-scale business, and the definitions reflect that fact.

Special Products

To our surprise, we found no special business loan products in the different banks surveyed unless the labor export was considered as such.

Saliency of Retail Lending

In Overall Bank Lending

Retail lending played an important role in the overall lending of the banks we surveyed. To what extent this is characteristic of the general banking system is currently not possible to determine. Bank Indonesia ceased publishing the relevant statistics almost two years ago. Anecdotal evidence suggests that the figures from our surveyed banks are roughly the norm for the categories they represent.

Bank Strategy

Although we were not sent copies of business plans, we were assured that all of the banks surveyed gave a prominent place to retail lending in their future strategies. It is reported that the big public banks plan to increase their current retail-lending portfolio from 15 percent to 50 percent of their entire portfolio by 2004, and one of them plans to have more than 80 percent of its portfolio in that sector. This would represent a major transition, even if we do not factor in their need to expand their activities overall. The smaller banks even now have an overwhelmingly retail portfolio and all have ambitious expansion plans.

In Evaluation of Employee Performance

Implementing strategic plans is not always automatic. Implementation should begin with specific targets in the credit budgets usually allocated among regions and branches. Although these credit budget targets should be treated flexibly and periodically revised, they do guide lending. The strategy should be expressed in the standards by which the managers and employees of the bank are judged. There are still important differences at the operational level in this respect. At one extreme, the employees at two banks indicated that there was no incentive for them to do retail lending; in fact, the focus was on collections and consolidation, deposit gathering, and fee-based income. At the other extreme, the employees in two banks could and did receive incentives amounting to 2–3 months of salary for surpassing their lending targets. In one case, the incentive was on a branch level; in the other, in a small profit center of one to three professional employees. It is no surprise that both of these banks reported healthy increases in retail lending. At least two other banks reported the planned introduction of such direct incentives. For the remaining banks, expansion of retail lending was rewarded, presumably during the annual personnel review process.

There were significant differences in the extent of marketing for retail lending. Only one bank emphasized this element, but two others may in fact do some vigorous marketing. The other banks had a more passive approach to lending business. This passivity is perhaps justifiable—several banks reported a flow of businessmen who visit the bank to inquire about borrowing. With such strong demand, bank employees might be very busy simply attending to those who come in.

Of course, what should be marketed is not just loan services but the entire range of bank services, including fee-based ones. These have especially high potential with many small business clients who need services but often find it difficult to keep them in house.

Unfortunately, none of the banks had software that enabled them to calculate the potential profitability of each transaction or client, although some were considering introducing such software. Two are reported to have had purchased packages that would do the required calculations, but have not implemented them. One bank does have small profit centers for which such calculations would be particularly useful.

Procedures

Marketing of Retail Lending

There does not seem to be much marketing of retail lending. Only one bank reported an active marketing program, although, as noted, all the others reported many inquiries every week (see Table F-3). Thus the pressure simply may not be there to search out good borrowers.

Table F-3. Number of Inquiries, Applicants, and Approvals

Bank	Inquiries	Applicants	Approvals
Bank A	No Loans	31	All renewal
Bank B	5 a day	20–25% of inquiries	n/a
Bank C	n/a	40 per month	20
Bank D	n/a	25 a year	5
Bank E	n/a	n/a	n/a
Bank F	n/a	20-25%	most
Bank G	n/a	n/a	n/a

N/a—not available

Handling of New and Existing Clients

Our questionnaire focused on the processing of loan applications, which naturally focused the response on new borrowing applicants, although they may have been clients of the bank for some time. According to the annual report of one small, private bank, almost all its increased lending came from increased lending to existing clients (and the increases have been considerable). Both the small commercial banks in their response noted their emphasis on business track record. One said that it rarely considered businesses that had not been operating for two years; the other emphasized the inquiries it makes about applicants. One of these banks also emphasized the frequency with which it uses the Bank Indonesia Debtor Information System in refusing credits—that is, it refuses loans on the basis of the finding of difficulties with previous loans.

Further investigations need to probe the use of past performance data, beyond that contained in annual accounts for loan evaluation. The management of one bank claims to make extensive use, at least, of its own lending records. All banks verify information with other banks when required. Again further investigations in this field need to probe specifically what the experience is of such inquiries.

The provincial development banks and one of the large government banks at its branch level reported more entirely new loan clients. The other large government bank had one new client at the branch surveyed.

Material to Apply for Loan

Documentation

Extensive documentation is uniformly required as is specified in Table F-4.

Table F-4. Documentation Requirements for Loans

	Bank A	Bank B	Bank C*	Bank D	Bank E	Bank F	Bank G
Application form	X	X		X	X	X	X
Tax identification number	X	X		X	X	X	X
Personal identification number	X	X		X	X	X	X
Deed	X	X				X	X
Vehicle registration	X	X				X	X
Pay stub	X	X				X	X
Permission from spouse	X	X				X	X
Marriage certificate	X	X				X	X
Bank information	X	X				X	X
Business license	X	X				X	
Corporate registration	X	X		X		X	X
Corporate accounts	X	X				X	X
Financial reports	X	X			X	X	
Insurance policy	X	X				X	X
Trade license		X			X	X	X
Corporate registration		X			X	X	X
Business registration receipt					X		
Receipt for bank accounts					X		
Other license					X		
Project proposal					X		

*Data not available

It appeared that the documentation per se was not a problem for most banks, although two mentioned the difficulty of obtaining tax identification numbers from applicants, and other surveys indicate that business licenses may be a problem, although perhaps not for non-microenterprise retail customers. In one case, an effort to market loans to large numbers of retail clients had run into difficulties, not so much because of bureaucratic documentation as because of the format of their financial accounts. Another bank, also a large public sector one with many new small borrowers, mentioned the same problem.

Collateral

Several banks mentioned that problems with securing appropriate collateral constrained some otherwise viable borrowers.

As various guarantee approaches are now suggested to increase the volume of retail lending, it may be necessary to suggest the effects of such guarantees on required collateral levels. There is also some room for discussing the limits on eligible collateral—formal limits through Bank Indonesia and informal limits through provisioning and auditing standards—as an obstacle to retail lending. One bank (not in the sample) reported that it had to restrict the use of warehouse bills as eligible collateral because of the strictures of due diligence auditors.

One subject of interest is that the definitions of collateral given in the field were the reverse of the definition in the regulations: Secondary collateral in the regulations was defined as securities, land, and valuables; primary collateral was stocks and bills receivable. In the field, the definitions for these were reversed.

Commercial Evaluation

The hardest information to secure was the most critical—the assessment of the commercial viability of borrowers and their enterprise. Perhaps there are no specified accounting ratios, or cash flow analysis in some cases, or perhaps the standards are not formalized.

Only one respondent cited the creditworthiness of applicants who actually made loan applications as a negative factor, presumably because such applicants drop out early in the process when they learn the terms and conditions for loans.

Field Verification

All the banks did field verification of the data submitted in loan applications, certainly to the extent of visiting the business premises and inspecting the collateral, but it is not clear how much labor input is used for this. And no one reported that the results were salient in the approval process.

Sanctioning Authority

All of the preparatory work was done by lower-level bank employees, but sanctioning was typically at a somewhat higher level.

General Economic Environment

One would expect the generally weak state of the Indonesian economy to have a depressing effect on demand for retail business credit, but all the banks that are open for new lending report a great number of new inquiries. And although one bank loan officer reported that many of the applications that came to her were not commercially sound, most of the other respondents indicated that the binding constraints on their lending were rather the lack of collateral, difficulties in doing the necessary analysis, or their own limited time and energy. Of course, if bank employees are fully occupied, any significant expansion of credit under a given system and procedure ultimately is constrained by the number of loan-processing personnel. In fact, the expansion of activity ultimately requires adding staff and perhaps branches. It is hard to assume that many Indonesian banks are constrained by the number of staff in their lending activities, although this constraint should soon make itself felt at the speed that some of banks are expanding their lending. This study, however, was not oriented to the issue of demand.

A study conducted by one of the large government banks revealed that 71 percent of the potential clients who were surveyed and not served would have qualified for loans on both formal and commercial grounds. The major reason that they were not served was that they were not interested in the bank's loans under the current terms and conditions.

Commercial Laws and Regulations of Bank Indonesia

To the extent that the documentation requirements and particularly the requirements for collateral were directly or indirectly mandated they, of course, constituted limits on increased lending.

Bank Policy

The more immediate constraints to lending are a bank's own lending policies. Certainly for the two banks that indicated that they had little interest in increasing lending this is the case. The other five said explicitly that lending budgets were not constraints, and at least three of those five banks have many branches that characteristically exceed their budget by a great deal. The other two banks were the provincial development banks, which indicated that the budgets were continually revised to increase lending. Both talked about increased lending, although the increase is not clear in the reported data in the published accounts of one of the banks.

Career Incentives

Incentives to employees naturally had strong effects on lending. The enthusiasm and rapid increase in retail lending in the small and government banks that had such incentives were clear. One small bank did not have such an incentive, but has been increasing lending (albeit somewhat less rapidly) and indicated that increased lending was strongly rewarded in personnel evaluations. This was also indicated in the case of another bank.

Competition

Another issue that was not probed in our survey was competition in lending, which apparently is still subdued at the retail business level, although clearly not for consumer lending or for winning new customers in general, for which credit provision must be an element.

Lessons Learned from This Study

Because program lending funds have been relatively ineffective in promoting enterprise in Indonesia, expanding commercially motivated retail lending would seem the way to expand small- and medium-scale lending. In fact, commercial medium-scale lending and retail business lending seem to overlap.

Fortunately, the commercial strategies of many banks commit them to expanding such lending, demand seems buoyant, and such lending appears to be increasing.

The most obvious obstacle to increased retail lending is that despite committing themselves to expanding retail lending, several large banks have not translated this into appropriate systems and incentives for employees.

Banks that want to increase retail business lending do not seem to have problems in doing so, although the procedures are cumbersome and require documentation that seems extraneous by international standards. It requires a policy commitment by the bank, with appropriate incentives for staff.

Despite the existence of a nascent scoring system in one of the large government banks, banks have not developed standard methods for analyzing and approving small business loans, but prefer to rely on the business judgment of their lending officers, reviewed by a credit committee. Except for the other large government bank, the banks surveyed also made little use of their own data in deciding credit policy, although the size of the small commercial banks perhaps meant that these items could be handled intuitively. The small commercial banks indicated they made use of the Bank Indonesia Debtor Information System. How this fits in with the initiatives of the private bankers association PERBANAS and the state banking association HIMBARA to promote techniques such as credit scoring and the use of credit bureaus is not clear. But the first step might be to standardize the techniques for evaluating loan applicants' accounts in terms of accounting ratios and verifying the standards against lending experience.

The exacting collateral requirements that constrain lending may partially reflect regulatory constraints, although most bank decision makers seemed to feel that they were necessary. It is not clear that any system of guarantees will relax these constraints unless regulatory reforms are undertaken.