SOUTHERN AFRICA GLOBAL COMPETITIVENESS HUB

Financial Services to Support International Trade in Mozambique

Executive Summary

Gaborone, Botswana

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Introduction

The report on "Financial Services to Support International Trade Finance in Mozambique" was prepared under the Trade Policy and Capacity Building Project of the Southern African Global Competitiveness Hub. The report identifies and proposes financial sector interventions in Mozambique that donors or private sector groups could undertake to improve the access of small and medium enterprises (SMEs) to trade-related financial services and thus increase the volume of trade and gains from it. It is recognized that proposed interventions must not jeopardize financial sector stability, the prudential integrity of financial institutions, and the support of sound, sustainable development projects.

The performance of the financial system with regard to the provision of trade finance was reviewed. It was noted that Mozambique's financial sector is limited in terms of the products and services offered, and relatively uncompetitive. Despite relatively rapid economic growth as a whole, credit to private industry has not increased significantly. Nevertheless, there have been considerable improvements in recent years. Banks exist, considerable sound financing is extended, and various private financial entrepreneurs are preparing to launch new products and institutions. Mozambique survived a decade in which two very large state institutions collapsed and others found themselves compelled to proceed cautiously. Now, established banks are liquid and have finance readily available, and most are ready to expand.

There is a range of other institutions, including GAPI, a publicly and donor-financed finance company, providing small project loans to SMEs and apex microfinance funding to smaller microfinance institutions (MFI). Nonbank financing is limited, but the leasing industry is recovering, and several investment and merchant banks handle some financing. Some new institutions are in process of formation. PODE, a World Bank-financed credit line, has funds available. Microfinance is limited but expanding, including going up-market to small enterprises. Microenterprise lenders are partially fund-constrained.

A number constraints to the provision of finance in general, and trade finance in particular, were identified in the legal and regulatory structure as well as in the overall environment. It was noted that the underdevelopment of financial institutions and their low tolerance for risk impedes finance. In addition, insurance – which is particularly important to trade finance - is imperfectly developed, the cost is high, competition weak, and expertise in the existing firms is limited. Other constraints include the limited availability of usable collateral, especially land and property, due to legal and bureaucratic problems; the legal system, where courts are slow and inefficient, particularly in enforcing contracts, payment obligations, and handling bankruptcy; the culture of non-repayment; access to credit information; and high rates of interest on government debt, as a result of which the banks often prefer to invest in government paper. Finally, rapid appreciation of the Mozambican metical and the South Africa rand against the U.S. dollar has disrupted trade and financial markets.

Looking specifically at financial institutions, it was noted that bankable firms and projects are underserved. Interviews revealed that some SMEs, especially in agriculture, had financing problems, in that a number of apparently bankable projects had difficulty getting financed, and that there were relatively few sources of various kinds of credit and insurance. While the Maputo banking market appears to be overbanked for certain types of financial services, other services are difficult to access. Field-to-floor and crop insurance, a favorite of South African banks, is available, if not readily so, and expensive. It was further noted that lending is constrained by perceived high levels of risk, based on unfortunate recent experience; high costs (due diligence and administration), especially for small and unfamiliar borrowers; and lack of expertise to handle many types of lending, including trade finance.

Proposed Solutions

Mozambique's problems with the regulatory and policy environment seem to call for primary focus on policy and legal reform remedial measures: enable the use of land and other potential assets as collateral, improve the functioning of the courts, link sources of credit information. Reforming the legal, regulatory and institutional environment, it is generally agreed, would significantly increase the flow of financing.

Various proposals to start new development banks, publicly financed guarantee and lending programs, and new financial institutions are being vigorously advanced. The team reviewed all of these as well as a number of initiatives team members themselves developed. Among these, the two primary proposals are to promote a facility for preparing project proposals (and support a proposal preparation institute), and (ii) to use framework agreements. Other useful initiatives would be to gather and disseminate credit information more efficiently, to encourage new entrants in banking, insurance, and nonbank financing, and to improve insurance services for trade. These proposals are described below.

1. Promote a Facility for Preparing Project Proposals

While there are potentially good, viable projects are seeking financing, bank managers, especially at branch level, often do not have the skills necessary to assess projects. In addition, projects are often presented in a manner that makes them look unattractive to financiers, who often do not have the time, inclination, or skills to turn these projects into bankable projects. Furthermore, financiers often do not know where to go to find syndicate/funding partners for larger projects, and are unaware of the various mechanisms that can be used to enhance financing proposals such as insurance, guarantees from various NGOs, and government organizations, and of techniques such as collateral stock management, back-to-back letters of credit, red clause letters of credit, etc.

In view of these problems, it is proposed that donors or the private sector sponsor a Project Proposal Preparation Facility (1) to receive projects from entrepreneurs and/or potential financiers that require work to be done on them; (2) to assess the project's viability and likelihood of obtaining financing; and (3) to decide if the project has potential. The facility would make a speedy, preliminary assessment of the project. If the facility decides against the project, it will inform the sponsor and/or financier, with reasons. The sponsor can then decide either to address concerns or abandon the project. If the facility decides that the project has potential, it will then work with the entrepreneur/sponsor to turn the business plan into a bankable proposal. The business plan will include all the elements of a proper bankable document (i.e., budgets, cash flows, marketing plan, human resource requirements, management expertise). The proposal to the financier will include security being offered. In this regard the facility would have already obtained "in principle" approval from potential insurers for, *inter alia*, credit and political risks, guarantors, potential co-financiers, and support from NGOs.

Donors or the private sector might also support one or more packaging institution. Such support would consist of a guarantee that enables the institution to raise facilities from financial institutions to finance small projects or help finance large projects. The institution would be a non-bank financial institution, managed according to conventional good governance systems as practiced in the conventional banking system. It will not, however, be a banking institution. The shareholders and directors of the institution could include its promoters, plus others including USAID who wish to be involved.

2. Use Framework Agreements

Three impediments to trade and trade-related financing for SMEs—risk, cost, and capacity—could be addressed through framework agreements. Such agreements would involve financial institutions working in public-private partnerships to increase the availability of financing for enterprises, especially, but not exclusively, SMEs engaged in trade and related activities.

Framework Agreements have a number of advantages. Creating financial clusters through framework agreements spreads risk among financial institutions, the public sector, and NGO partners, and, by spreading and sharing risk, thereby making support for SME trade-related financing more feasible. Secondly, performing due diligence, structuring, and administration for financing of SMEs is often too costly and time-consuming to justify support for small transactions. Developing framework agreements would involve packaging transactions so that costs are kept to a minimum and shared by the cluster (framework participants). Sharing costs and packaging financial transactions would make financial support for transactions more attractive to financial institutions. Finally, while headquarters of financial institutions may or may not have the expertise to assess risk and to structure trade and related transactions, bankers at the branch level often lack the skills required to undertake such transactions. The same is true for SMEs, which lack the know-how to present financial institutions with bankable transactions. A framework agreement would standardize transactions, providing all

necessary legal and due diligence forms. In other words, both bankers and SMEs would be provided with an "A-Z" manual (including all documentation) to complete a transaction.

Possible participants in framework agreements include banks, non-bank financial institutions, insurance companies, NGOs, multilateral development banks, and donors. Depending on the specific agreement, other private sector entities may participate. Any combination of these entities could create a risk-sharing cluster. For example, suppliers of agriculture equipment and suppliers of fertilizers and seeds could form an agreement. Equipment suppliers could take a portion of risk, along with other participants, by providing buyers with credit terms; and input suppliers could use the agreement to mitigate risk and provide buyer credits to customers.

How risk is shared and in what percentages will depend on the number and nature of participants (commercial bank, insurer, NGO, donor, IFI), but the fundamental principle of risk-sharing would remain the same. For example, those in an agreement could assume risk according to the following percentages: Bank—50%; Insurer—25%; Donor—10%; NGO—5%; International Financial Institution—10%.

The first framework agreement could be model for others. It is considered that the agribusiness sector would be an appropriate sector for the first agreement, as there appear to be good numbers of viable projects and there are also financial institutions and NGOs willing to share those risks. There could also be considerable benefits. For instance, in focusing on agriculture and targeting commercial farms that use outgrowers, the first framework agreement could have a significant impact on development while presenting manageable risks.

3. Other Initiatives

(a) Gather and Disseminate Credit Information Efficiently

In theory, better credit information should increase the flow and decrease the cost of credit. Lenders should be able to avoid borrowers who have not paid in the past and are unlikely to do so in the future. In this regard, Mozambique already has two extremely useful resources: a center of risks at the Central Bank records bank borrower experience and provides it to the banks on request, and a debt register which, according to the IMF, receives 98 percent of the covered debts and records the details of the collateral involved. However, credit information suffers from various shortcomings. For example, it does not include data from key creditors like utilities, nor does it include positive data such as average checking balances. Information is not linked and must be gathered from various sources. And, most important, access is limited (e.g., only Mozambican banks have access to the risk center of the Central Bank). Ideally, any potential creditor should have access, provided they are willing to pay for it.

(b) Encourage New Entrants

Competition and efficiency in the financial sector would be enhanced by new entrants in banking, insurance, and non-bank financing. USAID should keep apprised of new entrants and should assist them in overcoming regulatory constraints to entry.

(c) Improve Insurance Services for Trade

Banks in developed economies use insurance products to structure transactions, thereby mitigating risk and making difficult transactions more viable to finance. This is especially so for agriculture, a sector that holds great potential for Mozambique and SADC. While banks in Mozambique have started to use insurance products to structure transactions, insurance products are not well integrated in bank financing, to the detriment of many transactions. Because it could help increase access to financing among SMEs involved in trade and trade-related activities, as well as exporting firms more generally, insurance should not be overlooked.

For example, the lack of agricultural insurance is considered an impediment to financing. During interviews, banks, insurers, and agricultural businesses identified crop insurance and field-to-floor insurance as two important products for agriculture. Notwithstanding exclusions by specific insurers and/or for specific types of crop, crop insurance covers risk (primarily weather-related) from seed planting to harvest. Field-to-floor insurance covers risk from harvest to the buyer's warehouse. Either

form of insurance mitigates banks' risk and can add a significant element of comfort to financiers when considering credit for agricultural projects.

However, the insurance sector in Mozambique is relatively new, has limited economies of scale, and lacks competition. While some trade-related insurance is available, many banks and agribusinesses find insurance prohibitively expensive and this may be hindering agricultural sector financing. There is also a lack of skills capacity in the sector. To address this, USAID should consider some technical assistance programs for the insurance sector in Mozambique. It should also consider studying regulatory and monitoring practices of the regulatory authority to strengthen the sector and ensure that insurance companies are sound.

Furthermore, the framework agreement recommended above would include banks and insurers, thereby mitigating risk on certain transactions and creating a working partnership through which both financial sectors could collaborate to significantly increase the flow of trade and agribusiness finance in Mozambique.

Development Banks, Agricultural Banks, SME Funds, and Second-tier Banks and Alternatives

Proposals have been put forward for development, agricultural, and second-tier banks, calling for funds to be provided by donors on a concessional basis and to have a long-term and middle-term orientation, as well as a rural bias[1]. Such proposals are not new in Africa: many a government impatient with reluctance in the banking sector to lend to "worthy" enterprises has decided to create a bank to undertake such lending. However, such banks—agricultural, development or otherwise—have generally failed miserably, especially in Africa. The exceptions are typically in microfinance (with which the proposal for a development bank is not concerned) and sometimes in the financing of public infrastructure and large projects in cooperation with large and multinational corporations. Dealing with agriculture and SMEs has proved difficult.

A specific proposal in Mozambique is for a "second tier" development bank that would provide funds to primary lenders. However, a particular difficulty is that the proposed second-tier lender would have few primary lenders to deal with. Though three significant microfinance groups exist, none does much rural finance. At the moment, the most significant primary project lender for SMEs is GAPI; but if it is intended to expand its funds the obvious question is why not do so directly. Of course, much more lending would occur if the second-tier lender took the overwhelming share of the risk—but this then calls into question the role of primary lenders. It is also evident that the banks are not short of funds,

Given the poor record of development and agricultural banks in the region and Mozambique, pursuit of such is, therefore, discouraged. A much more effective way of promoting lending would be through the types of initiatives laid out above, that address the clearly-identified constraints. Microfinance is, however, worthy of donor attention. Although microfinance has developed slowly in Mozambique by international standards, it is nonetheless developing and Mozambique could pioneer microcredit for agricultural production. Again, this may occur independently, but donor support will accelerate it Smallholders are benefiting from linkage schemes and microfinancing and could more effectively be assisted through more of the same, rather than a new development finance institution. Any new USAID-supported interventions should be small and experimental and subject to immediate and effective market tests

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[1] See e.g., "Agenda 2025: The Nation's Visions and Strategies".