



Developing the Supply of Financial Services and Improving the Efficiency of the Banking Sector in Angola

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Preface

This study has been undertaken by The Services Group and Nathan Associates Inc. under the Trade Facilitation and Capacity Building Project (TFCB) under contract No. 690-M-00-04-00309-00 (GS 10F-0277P) with USAID/RSCA and The Services Group. The TFCB Project seeks to increase economic growth through enhancing competitiveness in world markets. The project includes four activity components: Capacity Building and Policy Reform for Trade and Competitiveness, Trade Facilitation, Financial Services for Trade and Competitiveness and Dialogue for Competitiveness. During 2007, there has been a particular focus on Financial Services, reflecting the US Government's African Global Competitiveness Initiative (AGCI), which has as one of its objectives the facilitation of access to finance by enterprises.

The study team consisted of Bruce Bolnick (Team Leader), Caspar Sprokel, Forrest Metz, Alistair Tite, and Thomas Timberg. Drs. Bolnick and Timberg are employees of Nathan Associates, whereas Mssrs. Sprokel, Metz and Tite are consultants for The Services Group (TSG). The study was supervised on behalf of the Trade Hub by Dr. Keith Jefferis.

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Executive Summary

This report has been prepared by the Southern Africa Global Competitiveness Trade Hub to provide the Banco Nacional de Angola (BNA) with a critical analysis of key constraints to improving the efficiency of the banking sector and developing a sound and efficient financial sector in Angola. The report addresses five specific elements of BNA's Policy Matrix for Expanding Credit Access: improving the supply of term finance; expanding access to credit for small and medium scale enterprises (SMEs); reducing the cost of credit; establishing benchmark interest rates to guide the pricing of credit products; and assessing the possibility of introducing deposit insurance in Angola. The report takes into account the special conditions prevailing in Angola, and also draws heavily on lessons from international experience.

Based on this analysis, the report offers more than 80 recommendations for consideration by BNA, the Government of Angola (GOA), and other stakeholders, to improve the supply of financial services and the efficiency of the banking sector. Table 1, at the end of this Summary, presents a compilation of the recommendations, and highlights suggested priorities. In addition, the Appendix to chapter 3 of the main report presents 11 recommendations for strengthening the capacity of the government's lead agency for SME development (INAPEM) to support the provision of business development services for SMEs. This is another essential element of a coherent strategy for expanding access to credit. Many of the recommendations presented here endorse or highlight issues that are already under consideration by the authorities, but many others involve new measures for attention.

FINANCIAL SECTOR FUNDAMENTALS

The principal function of a financial system is to mobilize savings and allocate funds efficiently to businesses, households, and governments. Financial transactions are unique in that the main product is a pledge for future repayment of funds, under specified terms and conditions. As a market in promises, the financial system is driven by *information* about the reliability and solvency of the party pledging repayment. Strong legal and judicial foundations are also needed to ensure contract enforcement and property rights, and establish the rules and regulations governing financial institutions.

Commercial banks dominate the financial landscape in Angola. A sound banking system is a vital public good in that economic agents across the board rely on a stable and dependable banking system to facilitate transactions, protect cash balances, and finance operations. Moreover, imprudent banking practices often provoke crises that impose heavy costs on the economy at large. Banks have a basic obligation to protect the funds obtained from their depositors. They must therefore manage risks carefully and avoid undue exposure to possible losses, while seeking an attractive return for shareholders. In addition to strong corporate governance, a sound banking system also needs effective supervision and judicious regulations as a second line of defense against financial instability.

Yet banks can be sound *and innovative*, particularly in developing new financial services and serving nontraditional clients. To facilitate innovation, the government and the donor community can be catalysts for change. The motivation for intervention stems from market imperfections that cause financial institutions to under-invest in innovations that can benefit economic

development. The imperfections include information gaps on both sides of the market. Thus, most banks lack information on appropriate techniques for serving new markets profitably, while most small and medium-sized businesses do not understand the requirements of the lender and lack the capacity to provide necessary accounting data and business plans. Carefully crafted interventions can therefore help financial institutions test new markets and services and help local businesses become more “bankable” through better management and financial controls.

CHALLENGES FACING ANGOLA TODAY

The analysis in each chapter of the report is framed in the context of conditions in Angola today. It is useful at the outset, however, to highlight some major challenges that influence the development of the financial system. One basic challenge arises from the fact that Angola is still recovering from a long period of conflict that ended in 2002. Wars leave a legacy characterized by weak governance; depressed incomes (along with high expectations); degraded infrastructure and public service systems; high inflation and uncertainty; critical problems with physical security and property rights; exceptionally high unemployment, especially among youth and ex-combatants; and a severe shortage of human and institutional capacity. Despite such obstacles, Angola, by 2007, succeeded in achieving rapid growth driven by an oil boom, combined with an aggressive program of reconstruction. In addition, the political situation has stabilized, security conditions are favorable, and macroeconomic policies have greatly improved. In short, Angola has passed the critical initial tests of post-conflict recovery.

In the financial sector, too, Angola has moved beyond initial post-conflict exigencies and now confronts the deeper issue of establishing a sound and efficient financial system to support broad-based growth and rapid job creation. This takes time, though, because it requires the development of skills in the financial system, as well as public confidence in the banks, a supportive legal and judicial system, and improvements in the business climate. Focusing on the business climate, the government faces a host of challenges that affect the scope for financing local businesses, including poor infrastructure, an unfavorable institutional framework, and persistent macroeconomic imbalances.

One problem is that high spending on reconstruction is working at cross purposes with the goal of reducing inflation. Faced with huge injections of liquidity via Treasury operations, the central bank is in the difficult position of having to hit the monetary brakes by issuing domestic debt or selling foreign exchange. The combination of fiscal stimulus and monetary restraint has created a situation in which inflation remains stubbornly in double digits, interest rates on kwanza loans are out of line with rates on dollar loans, and the strong kwanza may be jeopardizing broad-based growth in manufacturing and agriculture. The best solution is to modify the balance between fiscal and monetary policies; but fiscal tightening is hard to sell in the context of high expectations, ample access to financing, a culture of patronage, and national elections planned for 2008 and 2009.

Another critical challenge to the expansion of credit is the legal and regulatory regime. In its Doing Business assessment for 2008, the World Bank ranks Angola as having one of the least supportive environments in the world for private investment.

Overcoming these challenges requires a firm political commitment. Yet countervailing interests could produce a lack of policy coherence. For example, as noted, the desire to pursue rapid

reconstruction has an adverse effect on macroeconomic stability, which is essential for financial sector development. Also, even though the government recognizes that the private sector is the main engine for growth, there are tendencies to favor populist interventions that may impair prospects for success. A prominent example is the tendency to view the financial system as a conduit for subsidizing favored sectors through cheap credit. These schemes are usually captured by special interests, at the expense of development goals.

Political considerations are always in play. The important thing is that decision makers understand the benefits of fostering a sound and efficient financial system, and the true cost of interventions that impede these developments. Our hope is that the present study provides not only useful recommendations for expanding the supply of financial services and the efficiency of the banking sector in Angola, but also a justification for pursuing the appropriate measures, in the interests of national economic development.

IMPROVING THE SUPPLY OF TERM FINANCE

Until recently, term lending in Angola has been limited to a select group of affluent bank customers. But the financial system in Angola is quickly evolving. Both the deposit base and the volume of credit to the private sector are growing rapidly, and banks are increasingly extending medium and long term loans. The authorities have been promoting this process by enhancing competition through the licensing of new banks and pursuing reforms to develop the financial system, including the creation of a new stock exchange (BVDA), a regulatory authority for capital markets (CMC) and a new Development Bank of Angola (BDA).

Nonetheless, most banks limit their term lending to a select group of customers whom they know and trust and most businesses and households continue to lack access to finance for investment. This is because the banks still face daunting obstacles to expanding the market for term loans. The constraints include a lack of medium to long term sources of funds; a poor institutional environment to enforce loan contracts; a limited supply of *bankable* investment projects; the absence of a central source of credit information for assessing lending risks; and weak institutions for registering property, which undermines the availability of collateral to secure term loans. Moreover, the banks have to view every loan in terms of their need to manage risks carefully.

For smaller enterprises, access to term credit is also constrained by the very high cost of business registration. And while procedural requirements have been greatly simplified at the one-stop shop established recently in Luanda, red tape remains daunting elsewhere in the country. There are also serious problems with the ability of most local entrepreneurs to present a credible business plan or demonstrate effective financial management. Problems with the underlying business environment, including continued double-digit inflation, poor infrastructure, and widespread corruption further impair the scope for term lending for investment. In addition, the strong kwanza virtually rules out the possibility of term lending for investment in export activities other than oil and minerals, and may be undermining the competitiveness of many potential producers in agriculture and manufacturing. One constraint that is less of a problem than expected is the physical outreach of the banking system. Recent investment in new branches has created a network sufficiently well distributed to make term loans available to (viable) businesses in most parts of the country.

Given all of the constraints, it is impressive to see that banks are increasingly engaged in term lending, including housing loans with a maturity of up to 15 years. Banks are evidently comfortable with the financial status of a numerous borrowers, and have found ways to control risk through channels other than judicial action. Nonetheless, there is a need for concerted attention to the institutional problems that still limit term financing for investment.

As a major instrument for overcoming these problems, the government established the Development Bank of Angola (BDA) in June of 2006 to promote domestic investment and support implementation of the national development plan. BDA will manage a Development Fund that receives 5% of the government's fiscal revenue from the oil industry and 2% of revenue from the diamond industry. Previous government-run development finance schemes in Angola have ended in costly failure, but BDA is intent on avoiding this outcome by establishing a culture of careful loan appraisal and diligent risk management. BDA will directly finance projects involving US\$5 million or more, and extend credit lines to partner commercial banks for smaller projects. Additionally, BDA will undertake capital investments, offer long term financing to commercial banks, provide grants for business development services, and offer risk guarantees of up to 90% to commercial banks. Initially BDA is focusing on financing value chains in four priority sectors: maize, beans, cotton, and construction materials.

State-owned development finance institutions (DFIs) in most developing countries have failed due to lax lending standards, political interference in credit decisions, and a patronage approach to staffing. Yet there are prominent cases of success, where DFIs adhere to commercial lending standards and attract high quality personnel, as in Brazil, Peru, and South Africa. In this respect, BDA's plan conforms to best practices. Even so, BDA will be constrained by the limited scope for viable term lending, given Angola's weak business environment. It will also face difficulties in achieving a diversified portfolio to mitigate risks, and scale economies to hold down costs. If BDA finds only a limited number of borrowers who meet its careful appraisal standards, then tensions will grow between its commitment to risk control and the government's interest in moving the money in the run-up to elections in 2008 and 2009. BDA can minimize this risk by using a larger share of Development Fund resources for lending through the commercial banks, or providing long-term financing for the banks themselves.

BDA plans to charge a fixed interest rate of 8% on its loans, including those channeled through partner banks. This may limit commercial bank interest in working with BDA, and also preclude lending to SMEs, which involves higher per unit costs. Moreover, setting a *real* interest rate that is negative in kwanza terms allows investment proposals to pass the test of *financial* viability even when they are not *economically* viable. This invites a serious misallocation of Development Fund resources and diminishes the growth impact of BDA operations. These problem can be avoided through greater flexibility in setting interest rates.

Major corporations in Angola will soon have a new option for term financing via the newly created Angola Stock Exchange (BVDA). While stock and bond markets are a natural source of medium and long term financing, experience elsewhere in Africa suggests that the capital market will not be a major source of *direct* funding for investment, as few firms are likely to test the waters by floating securities. If commercial banks are among the early participants, then the capital market can still have a broad *indirect* impact by channeling long-term savings to term lending by the banks. In any case the government will need to jumpstart the market through public sale of Treasury bonds and shares in parastatal companies. The demand side looks

more promising, given the severe lack of other investment vehicles aside from real estate, and rapid growth of long-term saving in pension and insurance funds.

Disclosure formalities are a major constraint for many potential borrowers. Some African exchanges address this problem through a second tier market with less stringent regulations and reporting requirements. Although securities issued in this market are more risky, the risks can be priced to deliver an attractive yield. The practicality of this scheme in Angola remains to be seen. Another concern is that BVDA is pursuing a high-cost approach that will probably require government subsidies for many years to come. Wherever possible, the new exchange should opt for cost-effective methods of operation.

Two other sources of term finance warrant attention – leasing and venture capital. Leasing is a simple and convenient form of lending using the value of the asset being financed as collateral. The new Financial Institutions Law of 2005 authorizes leasing in Angola, but it is not currently available due to the lack of a regulatory structure. Even when the regulations are issued, the market may be limited due to the lack of a secondary market for liquidating many types of assets. Another potentially important source of investment finance is from risk capital ventures. Over the next 5 to 10 years the supply of risk capital to Africa is likely to display tremendous growth. Currently, though, few Angolan businesses have the technical capacity, management skills, and market potential to attract this form of financing. One way to facilitate venture capital financing would be to provide technical assistance to high-potential enterprises to help them qualify for financing.

Finally, investment financing cannot be separated from the mobilization of long-term saving. The most promising development in this regard is the rapid growth of pension and insurance funds. Currently, the national pension program is operating on a pay-as-you-go basis. This is appropriate for covering disability and ensuring a minimum income for retired workers and surviving family members. But a funded scheme would be far superior in generating long-term savings to meeting the needs of future retirees while stimulating faster development of the capital market. Converting to a funded system is a complex task that requires detailed planning, a strong legal and regulatory framework, highly capable management, and a firewall to prevent the misuse of funds for political purposes. Most important, a funded system requires a blue-chip strategy for allowing diversified investments to protect the growing pool of capital and deliver a rate of return sufficient to secure future pension benefits. But the best time to introduce a funded scheme is when the labor force is young, and current liabilities are low, as they are now in Angola.

Based on this analysis, the report offers 28 recommendations on steps that can be taken to improve the supply of term finance for domestic enterprises in Angola. (see Table 1 below).

IMPROVING ACCESS TO FINANCE BY SMALL AND MEDIUM ENTERPRISES (SMEs)

A central problem for financial sector development in Angola is the need to expand access to finance for small and medium enterprises (SMEs). Traditionally, banks have catered only to major companies. But SMEs, too, have an important role to play in generating broad-based growth, job creation, and a more equitable distribution of income and wealth. Surveys show that lack of access to finance is a primary constraint on SME development. The causes include

problems with the business environment, with the banks, and with the capabilities of SMEs themselves. The latter factor requires addressing the provision of business development services (BDS), in addition to actions focused on the financial sector.

Even though SMEs can be key agents of economic and social progress, it is not easy to design *effective* interventions for their development. Two broad approaches have been widely tested – (i) direct support through training, subsidies, technical assistance, and networking; and (ii) strengthening the market environment for SME development, including macroeconomic stability, improved infrastructure, and eliminating bureaucratic barriers to doing business. In view of disappointing results with direct SME support programs, the international trend in recent years has inclined towards favoring the second approach.

There is no standard definition of an “SME” in Angola, and no recent data on the composition or characteristics of the SME sector. The limited information available suggests that there are tens of thousands of registered SMEs, with many more operating in the informal sector. For lack of a standard definition, banks use idiosyncratic criteria for classifying SMEs; on this basis, eight banks indicated to the study team that 20-30% of their private sector loan portfolio constitutes SME lending. Most of this, however, goes to enterprises that would not be classified as SMEs in other developing countries. In any case, private sector credit amounted to only 6.8% of GDP (2006), suggesting that SME lending amounts to no more than 2% of GDP. A recent survey conducted for BNA and UNDP shows that only 0.4% of micro, small and medium enterprises (MSMEs) have obtained bank credit.

The weak business environment in Angola is a major constraint on SME business prospects, and hence their access to finance. Particular concerns include cumbersome and costly registration procedures; difficulties with property and land use rights; the lack of an efficient and comprehensive credit reference system; and ineffective mechanisms for contract enforcement. Another basic constraint is deficient infrastructure for transportation, power, and communications. Macroeconomic problems include continued inflation and appreciation of the real exchange rate, which can undermine growth prospects for SMEs producing tradable goods.

On the supply side of the finance equation, most banks are wary of the SME market because of the high costs of administering small SME loans, and perceived high risks. Most Angolan banks also lack specialized know-how and staff to assess the viability of loans to SME clients. Yet there are well-tested techniques for overcoming these constraints and lending profitably to SMEs, which have been applied successfully in countries throughout the world such as Bangladesh, Indonesia, Peru, the Philippines, Bolivia, and Uganda. In particular, banks can lend more profitably and safely to SMEs by adopting “microfinance techniques” for this class of clients, to generate a “double bottom line” of commercial and developmental returns. Collaboration with foreign banks or agencies that specialize in SME lending can be a useful source of assistance. In addition, once appropriate regulations are in place, leasing may be a viable alternative to standard bank loans for financing SME purchases of vehicles and equipment. Lending risks can also be reduced by linking credit to insurance coverage, though the cost of insurance may limit its use for SME financing. Physical access to the banks is not a big issue, as geographical coverage has been rapidly expanding, with over 60 new branches established in 2006 alone (more than half in Luanda), and at least 3 branches in every provincial capital.

International experience suggests that the public sector can best support the expansion of financial services to SMEs by providing strong institutional and policy foundations. Promoting a competitive financial market may be the single most important role for public authorities in helping SMEs gain access to credit, because competition fuels innovative lending practices. Another crucial area for action is in establishing a credit registry or bureau, to improve the quality of credit information and provide incentives for small business to adopt sound financial management practices. This is a high priority for Angola.

In contrast, government-directed credit schemes for SMEs tend to retard the development of capacity for SME loan appraisal and risk management, while distorting the distribution of financial resources. An alternative approach is to offer guarantees for bank loans to SMEs, as a partial substitute for collateral. The idea is to help lenders learn to deal with new credit products and non-traditional clients on a competitive and sustainable basis. However, credit guarantees also add to the transactions costs for banks, and they can stimulate bad lending due to moral hazard if the guarantee covers a large fraction of the risk. Also, guarantees are often used as a subsidy in disguise to support activities that are not fundamentally viable. Nonetheless, well-structured partial guarantees can be an effective tool for mitigating perceived risks and overcoming information problems that hinder lending to non-traditional clients.

On the demand side, SMEs in Angola face serious problems in seeking bank loans due to weak management and technical capacity, low education and business experience, limited access to skilled labor, capital, and technology; and lack of knowledge about how to use bank services. Hence, the provision of business development support services (BDS) can be a vital tool for improving SME access to credit. Currently, the supply of BDS is underdeveloped, with few providers and low quality services. The most active providers are the Angola Enterprise Program (AEP) and the Centro de Apoio Empresarial (CAE), with the latter supporting SMEs linked to the oil industry. A new initiative by the Centro de Incubacao de Negocios de Cabinda (N'kondo) is in the early stages of development. In addition, the Development Bank of Angola (BDA) is exploring the possibility of supporting BDS providers to help loan applicants meet its appraisal standards. Demand for BDS is concentrated on assistance with tax and fiscal reporting, and feasibility studies and business plans to access bank financing. Most SMEs, however, lack knowledge about BDS services and their value for improving business results. There is also a high level of distrust about sharing business information with outsiders.

International experience suggests that governments are more successful in promoting SME development when: (i) there is a clearly defined target population of SMEs; (ii) duplicative efforts are reduced by designating a well managed lead agency for SME promotion; (iii) SME promotion agencies are evaluated regularly based on clear performance indicators that cover both activities and impact; and (iv) the cost of BDS services is shared by beneficiaries. SME promotion agencies can play a key role as an informational bridge between BDS providers and SMEs. A central aim must be to encourage market-driven BDS services through qualified private sector providers. In addition, an SME promotion agency can directly support BDS activities with public goods characteristics, such as public information programs and training for trainers.

The U.S. Small Business Administration (SBA) has pioneered many of these practices, including loan guarantees and support for BDS through partnership with the private sector, educational institutions, and other agencies. In addition, autonomous Small Business

Development Centers (SBDCs) are supported through the Small Business Development Center National Information Clearinghouse (SBDCNET), which disseminates SME research, best practices, on-site training and distance learning. The SBA coordinates the various programs, and collects data on their performance and impact.

In Angola, the *Instituto Nacional de Apoio às Pequenas e Médias Empresas* (INAPEM) was established in 1992 as the government's lead agency for promoting Angolan SMEs. Today, INAPEM faces challenges with human resources, work incentives, management and oversight. But its role can be strengthened as an apex agency for promoting BDS, possibly on the SBA model. This will require reorienting INAPEM's mission with regard to entrepreneurship promotion, and will involve action in four areas: strengthening institutional capacity within INAPEM; improving and supporting demand-driven BDS delivery; transforming INAPEM into an apex organization for BDS coordination and advocacy; and instituting a national monitoring and evaluation system. The text of this report includes a SWOT analysis for INAPEM, including strategies to overcome the weakness and threats.

Based on this analysis, the report offers 22 recommendations to improve access to finance for SMEs (see Table 1 below). The report also presents a draft Plan of Action for INAPEM involving 11 proposed activities and 38 sub-activities to meet the challenges noted above (see the Appendix to Chapter 3 in the main report).

REDUCING THE COST OF FINANCE

Bank loans and deposits have grown very rapidly over the past two years in Angola, and yet credit to the private sector still amounted to just 7.2% of GDP in mid-2007; deposit balances totaled just 15.7% of GDP; and banks were being used by only an estimated 6% of the population. Are high interest rates and other banking charges a significant factor deterring greater access to financial services?

Interest rates serve an important function in screening out inefficient uses of funds. If financial markets are competitive, then these rates reflect the opportunity cost of financial resources plus the cost of administering bank operations. The basic question, then, is whether interest rates in Angola exceed what one would expect under competitive conditions, and also whether operating costs are in line with international benchmarks.

Considering the lack of effective institutions for tracking credit histories, registering property, securing collateral, and enforcing loan agreements, the interest rates for top-grade customers in Angola (as of September 2007) was astonishingly low, with dollar-denominated loans starting at 7%, and kwanza-denominated loans at 8% (often indexed to the dollar). By comparison, the prime rate in the United States was 7.75%, and in South Africa 13.5%. The prime rate on kwanza loans was also very low relative to the inflation rate of around 12%.

Interest rates are understandably higher for smaller loans and riskier clients. These factors easily explain reported rates of up to 12% on dollar loans, and plausibly justify reported rates up to 25% on kwanza loans. For micro-lending, however, the interest rate can be as high as 60%, reflecting very high transactions costs relative to the amounts involved, and perhaps a lack of competition in this segment of the market. In any case, these rates are likely to decline as competition intensifies, and as other lending constraints are eased, as discussed above.

Why are the prime lending rates so low? How can banks charge so little? A key factor is that the banks enjoy an attractive interest rate spread despite the low prime rate, by paying very little for deposit funds. BNA data show an interest rate spread of 10.1 percentage points in 2006, mainly because two-thirds of all deposits are in sight accounts, mostly of which bear zero interest. Equally important, the banks have been highly liquid; with bank credit amounting to just 52% of deposits in mid-2007, the banks have little incentive to offer higher deposit rates. In effect, low interest rates on loans come at the expense of savers. The widespread view that Angolans lack a “culture of saving” has, therefore, never been tested because there is not much incentive to save through the banks. BNA’s only direct instruments for influencing the interest spread would be to ease the obligatory reserve requirement, which is quite high at 15% of deposit liabilities, or allow banks to earn interest on obligatory reserves.

A second factor holding down the interest rate on prime loans is that Angolan banks derive a large amount of revenue from fees – 46% in the first half of 2007. This is in line with international comparators, and the fee structure generally falls in the mid-range of international benchmarks. A basic problem, though, is the lack of transparency in the fee structure. This points to the need for stronger requirements for public disclosure in a standard format. Explicit fees, of course, are only part of the transactions cost faced by bank customers. There are also costs associated with documentation requirements, and time for travel to the bank and dealing with the transactions. Experience in other countries suggests that inconvenience costs are often a major deterrent to wider use of bank services. These considerations merit more careful study, and broader dialogue on new technologies for extending services to “unbanked” clients and regions.

The interest rate spread, itself, is the *mark-up per unit* between loans and deposits. But net revenue from intermediation depends also on the volume of lending and the yield on other assets. The “intermediation margin” (*margem financeira*) is the difference between interest earnings and interest expenses, as a percentage of total earning assets. In 2006, despite a high interest spread, the intermediation margin in Angola was not particularly high, at 4.3%. This suggests that the banks’ low transformation ratio (loans/deposits) and low yield on alternative assets have been major determinants of the high spread between lending and deposit rates. Operating efficiency in the banking system appears to be reasonably good, in terms of ratio of costs to assets, the ratio of costs to income, and average assets per employee. Still, many factors are at work in Angola to increase banking costs, so the low ratios are probably an indication of a heavy concentration on high-grade clients. As banks expand their involvement in other segments of the market, these costs are likely to rise. Similarly, bad debt costs, as measured by the ratio of non-performing loans (NPL) to total loans, do not ring alarm bells, but the rapid growth of credit in recent years may be a warning sign of a serious problems to come.

Another determinant of the lending rate is the profit margin. The banking system in Angola has certainly been generating handsome returns on equity for shareholders, even above the norm for Africa, where shareholders tend to require a premium return to compensate for perceived risks. High profits are therefore a significant factor explaining the spreads and fees. But these returns have also attracted new entrants into the industry, which should erode profit margins and lead to better pricing of services in the future for bank clients.

Finally, our investigation shows that the stamp duty on bank loans is not a major cost factor impeding lending. But these duties also generate hardly any revenue for the Treasury, and

create an unnecessary burden for borrowers facing cash constraints. The best practice for taxation in developing countries unequivocally supports elimination of these duties as part of an overall program of tax reform.

In summary, banking costs impede access to financial services for non-prime clients, who face high interest rates on loans, low interest rates on deposits, and high bank fees. It is therefore appropriate for BNA to consider measures that might facilitate a reduction in banking costs. Table 1 outlines 12 recommendations derived from the analysis in this chapter of the report.

DEVELOPING REFERENCE RATES FOR PRICING OF CREDIT PRODUCTS

In its Policy Matrix for Expanding Credit Access, BNA recognizes that there is a need to develop market-based reference rates for government and central bank securities to provide the financial sector with an appropriate benchmark for pricing credit products, particularly those denominated in national currency. Commercial banks generally set their prime lending rate based on the marginal cost of funds in the domestic money market. The gap between the reference rate and the prime lending rate is determined by operating costs, lending risks, and competitive conditions in the market for prime loans. In turn, the interest rate on other loans is set in consideration of the additional risks and costs involved in dealing with less creditworthy clients. For dollar-denominated loans, banks almost universally use the London Inter-bank Offer Rate (LIBOR) as their point of reference; for now, there is no practical alternative to LIBOR for this purpose.

Banks in Angola determine their lending rates in line with these international norms. U.S. dollar loans are generally priced in relation to LIBOR, while kwanza loans are typically priced with reference to the yield on central bank bills (TBCs). The problem with the latter is that the TBC rate is not a market-determined pricing signal, because BNA administers the yield at the weekly “auctions.” A related problem is that the primary market for TBCs is dominated by a handful of large players, as only commercial banks are allowed to bid. Enhancing competition in the primary auction by allowing other bidders into the auction would produce more efficient reference rates for pricing kwanza loans, if BNA would allow the market to speak in determining the TBC yields – which is warranted if BNA wants to use its control of the monetary base as the primary intermediate target for monetary policy.

The price of longer term credit products is normally determined based on the prevailing interest rate for government debt of a corresponding maturity or “tenor”. In countries with well developed capital markets, governments regularly issue debt with various tenors, and secondary market trading is deep enough to provide regular data on the “risk free” yields. The relationship between yield and tenor on these instruments at any point in time is called the yield curve. The Government already issues domestic Treasury Obligations (OTs) to finance designated requirements, with tenors up to 12 years. However, the Treasury sets the interest rates administratively. Even though the Treasury has to assess market conditions in order to sell the securities, it is clear that OT yields, like those on TBCs, do not provide *market-driven* price signals for pricing other securities. Indeed, the interest rate on Kwanza bonds has been far below the rate of inflation, leaving investors with very negative real returns.

Banks in Angola are rapidly expanding their portfolio of term loans, including housing loans; and the new stock exchange (BVDA) will soon be operational. The absence of market-determined interest rates for government debt at various tenors leaves the market without clear points of reference for pricing these products. Establishing a yield curve for government debt would facilitate the development of these markets. To this end BNA (as the government's banker) and the Treasury should establish a detailed plan for introducing market pricing for at least a subset of OT issues, through BNA in the short run, and through BVDA once it is operating.

Lacking market-driven reference rates, kwanza loans and securities can instead be assessed with reference to two market fundamentals: the Interest Rate Parity (IRP) condition; and the need for positive real interest rates (RIR) to clear the market. IRP is an equilibrium relationship between kwanza and dollar interest rates; with dollar interest rates determined by an objective external factor like LIBOR, IRP can be used to establish a benchmark for kwanza rates based on reasonable assumptions about the expected change in the nominal exchange rate. If market participants, on average, expect the kwanza to continue strengthening against the dollar, then the interest rate on a kwanza loan to a particular borrower should be lower than the dollar rate for that same borrower. Similarly, if market participants expect the nominal exchange rate to be stable, then the two rates should be equal. If banks and other leading financial agents can shift funds between the two currencies, then these interest rate relationships should prevail.

The problem is that kwanza inflation is still high. Consequently, the IRP condition is inconsistent with maintaining positive RIR on prime loans. This inconsistency stems from the fact that Angola's rapid growth is fueled by oil earnings, which is causing the kwanza to strengthen while simultaneously fueling domestic inflation. As long as this situation persists, the monetary authorities face a dilemma. BNA can manage the kwanza yield on TBCs to achieve positive real interest rates, or let the market determine the TBC rates and face the possibility that competition will lead to negative real interest rates, which invite major inefficiencies in the allocation of financial resources. The basic disequilibrium can be resolved either by reducing inflation through better coordination of fiscal and monetary policies, or by altering the management of foreign exchange reserves to permit the kwanza to depreciate in line with the inflation differential.

Based on this analysis, the report offers 8 recommendations on steps that can be taken to establish more meaningful reference rates for the pricing of credit products in Angola (see Table 1 below).

DEPOSIT INSURANCE FOR ANGOLA?

With only 6% of households holding bank accounts, the government of Angola is interested in exploring the possibility of introducing deposit insurance to enhance public confidence in the banks and attract more funds into the financial system. It is not self-evident that deposit insurance makes a great difference given other constraints facing depositors, such as negative real interest rates, fees and charges on bank accounts, and a general lack of knowledge about banking services. Nonetheless, there are certainly instances where deposit insurance has had a clear positive effect; in Russia, for example, the introduction of deposit insurance increased deposits by 15%.

In essence, deposit insurance protects depositor's balances in the event of a collapse of the bank in which the money is held. It complements more fundamental safeguards, including bank licensing standards; systems for bank supervision; data disclosure requirements; and lender-of-last-resort operations of the central bank. Deposit insurance takes effect only when these other safety valves fail. Deposit insurance is either explicit, in that there is a clearly defined scheme in place, or it is implicit, in that depositors expect the government to reimburse their losses from failed banks. Explicit schemes allow the government to delimit the conditions and extent of coverage. They are also at least partly self-financing if premiums are charged.

There is a growing consensus that deposit insurance can contribute to financial system growth and stability if it is implemented in a context where bank supervision is tight and debt contracts enforced. Otherwise, the insurance can encourage banks to undertake imprudent lending, which might *increase* the risk of a banking crisis. Developing countries may lack the capacity to credibly manage a deposit insurance scheme, in which case it becomes worthless as assurance for depositors. Still, the number of countries with explicit schemes has increased from about 10 in 1970 to over 80 by 2003. But only 5 African countries have explicit insurance, with 2 others in the process of implementation.

A universal objective of deposit insurance is to enhance trust in the banks by giving depositors assurance that their money is protected, up to a certain limit. Historically, a major motive was to prevent a crisis stemming from "runs on the bank" when a contagious lack of confidence threatened a systemic collapse. Where banks are predominantly owned by large, stable, multinational banking groups with strong controls and effective home supervision, as in Botswana, then this motive is less important.

The establishment of a deposit insurance scheme requires careful planning to determine the appropriate institutional and technical characteristics for Angola. There are many choices to consider. Depository insurance may be voluntary or compulsory for the depository institutions. Globally, 91% of the schemes are of the latter kind, including 100% of those in Africa. This is recommended in the case of Angola, lest the best banks opt out to avoid the premium cost. Since a large number of bank in Angola are foreign owned, there must be a clear understanding of the parent banks' liability in the event of a subsidiary failure.

Most deposit insurance schemes cover a limited amount for each account (or each insured person), and exclude accounts that belong to those with ties to the bank itself. In most countries, the threshold is relatively low, so only a small fraction of deposit balances are covered. Most schemes cover foreign currency deposits. Coverage of inter-bank deposits is less common.

Charging a premium for the insurance helps to defray costs in the event of a bank failure, but also adds a new element of cost to the pricing of bank services. Co-insurance by the depositors, which is much like co-payments for medical insurance, can also be used to reduce the cost to the Treasury. Another technical issue is whether to vary premiums based on the risk profile of insured institution. Approaches that impose additional administrative demands are not well suited, though, for Angola.

Most insurance schemes are funded in advance, but some countries only collect a payment from the insured banks after one has failed. A pre-funded scheme is more credible because the fund is immediately available for use in the event of a crisis. But this raises the question of

where the premium funds should be invested, and by whom. This is especially problematic in countries like Angola with underdeveloped financial markets. It is simplest to let the insurance organization invest the funds in short term instruments, including international investments, with the actual management outsourced to an appropriate external firm. Another important decision variable is the determination of an institutional apparatus to administer the deposit insurance. Different institutions, public or private, may be tasked with different aspects of the technical and administrative aspects.

In addition to technical parameters, the deposit insurance program must be well managed, and work in close collaboration with the banking supervision authority. In fact, the bank supervisor usually assumes responsibility for deciding what to do with failed banks, in consultation with other key agencies. Instituting effective mechanisms to pay claims on time is crucial in maintaining the credibility of the scheme. Similarly, procedures to handle bank assets after insolvency must be instituted in accordance with bankruptcy laws.

On balance, it does make sense to introduce a deposit insurance scheme in Angola, particularly in light of the vulnerabilities created by the entry of small, new banks and the risks associated with rapid growth in bank lending. Whether or not the insurance attracts more funds into the banking system, there is value in clarifying the limits of what will be covered and not covered in the event of a banking failure. In addition, an explicit scheme will at least provide assurance that small depositors will be not be victimized by a possible banking failure, and establish procedures and criteria to administer this guarantee, if it is needed.

More specifically, the report offers 10 recommendations on steps that can be taken to design and implement an appropriate deposit insurance scheme for Angola (see Table 1 below).

CONCLUSIONS AND RECOMMENDATIONS

In summary, there are many serious constraints facing the financial system in Angola today, but there are also many ways to address the constraints through appropriate measures and programs that will facilitate the development of sound and efficient financial markets. There are also some welcome improvements that have taken place already, with helpful policy reforms and developments in the financial sector that are already being driven by increased competition. Table 1, below, summarizes more than 80 recommendations covering the topics discussed in this study. Both the analysis and the recommendations presented herein represent the views of the consulting team, as inputs for consideration by BNA and the Government in their efforts to develop the supply of financial services and improve the efficiency of the banking sector in Angola.

TABLE 1. Recommendations for developing the Supply of Financial Services and Improving the Efficiency of the Banking System in Angola

Issue	Recommendation	Agency	Proposed Priority
Access to term loans	<i>BNA should play a lead role in helping ministries and other agencies understand the links between legal, institutional and regulatory reforms and development of the financial system. For this purpose, BNA should convene a national conference on these issues.</i>	BNA	Top
	<i>Accelerate the development the new credit information system.</i>	BNA	Top
	<i>Establish computerized registries for both non-movable and movable properties.</i>	GOA	High
	<i>Accelerate action on streamlining procedures for business registration throughout the country and reducing the cost of formalizing a business.</i>	GOA	High
	<i>Formally target a major improvement in Angola's ranking in the World Bank "Doing Business" assessment as a policy objective</i>	GOA	High
	<i>Undertake or sponsor studies to help banks understand whether the strong Kwanza is affecting the competitiveness of various sectors and prospects for term lending in those sectors.</i>	BNA or GOA	Secondary
	<i>Maintain a strong macroeconomic policy focus on reducing inflation to single digits. This requires supportive fiscal policy, so as not to place the full burden of stabilization on monetary and exchange rate policies.</i>	Treasury & BNA	Top
Development Bank	<i>BDA should emphasize second-tier financing through commercial banks, and long-term quasi-equity financing of commercial banks, as preferred uses of the Development Fund, to minimize competition with the commercial banks and the risk of political interference in lending decisions.</i>	BDA	High
	<i>Focus BDA financing on term loans of 5 to 15 years, rather than 2 to 9 years as planned, again to minimize direct competition with the commercial banks.</i>	BDA	High
	<i>Allow BDA to use the Development Fund for infrastructure financing, so that BDA can effectively deploy the rapidly growing Fund without compromising lending standards.</i>	BDA & Govt	High
	<i>Allow BDA to participate in regional consortium financing in collaboration with DBSA or other institutions, for the same</i>	BDA & Govt	Secondary

Issue	Recommendation	Agency	Proposed Priority
	<i>reason as above</i>		
	<i>BDA should adopt a flexible interest rate policy that will reflect the actual costs of administering loans to smaller and riskier borrowers. Otherwise, the fixed interest rate may cause partner banks to avoid lending to SMEs.</i>	BDA	High
	<i>BDA should consider setting the interest rate at least two to three points higher than the inflation rate so that the price mechanism itself will help to screen out wasteful projects..</i>	BDA	High
	<i>BDA should appraise both the economic and financial rates of return in the loan screening process to ensure that BDA funding is used for efficient investments. This is especially important if the real interest rate on kwanza loans is negative.</i>	BDA	High
Capital market s	<i>Prepare public offerings of shares in major state-owned enterprises, to help jump-start the stock market.</i>	Treasury	High
	<i>Channel at least a portion of new Treasury Obligation issues through the BVDA, in kwanza terms, and at market prices, in order to stimulate development of the bond market and establish reference rates for the pricing of other securities (see chapter 5).</i>	Treasury	Top
	<i>Consider negotiating an agreement with the Johannesburg Stock Exchange to allow joint listing of Angolan securities.</i>	CMC & BVDA	Secondary
	<i>Set listing and trading fees at a level that will not preclude development of the market, even though this will require heavy subsidies from the Treasury for years to come.</i>	BVDA, CMC & Treasury	High
	<i>Wherever possible seek low-cost options for market development in order to minimize the required subsidy.</i>	BVDA & GOA	Secondary
Other Term Financing Options	<i>Fast-track the drafting and approval of leasing regulation, to unblock an important new avenue for term financing. In preparing the regulations, BNA should confer with banks and other stakeholders.</i>	BNA	High
	<i>Solicit expert opinion to ensure that the tax laws do not create a cost disadvantage for leasing transactions.</i>	BNA	High
	<i>Explore innovative ways to solve the secondary market constraint to asset-based lending.</i>	BNA, ABANC, Private	Secondary

Issue	Recommendation	Agency	Proposed Priority
		sector	
	<i>Establish a demonstration program of technical support to help selected local businesses qualify for venture capital finance, funded by either the government or a donor.</i>	GOA, donors	High
Long-Term Savings: Insurance & Pension	<i>Allow qualified insurance companies and pension schemes to participate in the primary market for TBCs and OTs.</i>	BNA, Treasury	High
	<i>Eliminate the stamp duty on insurance services, to remove an unnecessary and distortionary extra cost factor (see chapter 4 regarding stamp duty on banking services).</i>	Treasury	High
	<i>Seriously consider fundamental reform of the national pension system to replace the pay-as-you-go structure with a system of funded personal accounts, while retaining the safety-net benefits of the present system.</i>	Treasury	High
	<i>Encourage competition in the insurance industry to promote innovation and efficient pricing, while adhering to strict prudential standards to ensure that insurers are financially sound and professionally managed.</i>	INSS, GOA	High
	<i>Above all, continue pursuing a full range of market-supporting reforms and reconstruction measures to improve the overall business environment To the extent that private sector growth is limited by a weak investment climate, so will be the impact of any initiatives to improve access to term finance.</i>	GOA, BNA	High
SME Access to Finance	<i>BNA should maintain its commitment to private-sector-led development of the banking system and fostering competition by licensing qualified bank applicants.</i>	BNA	High
	<i>BNA should accelerate the work on creating a framework for alternative financing products such as leasing and factoring, and encourage the entry of NBFIs into these lines of business.</i>	BNA	High
	<i>BNA should seek a dialogue with international banks that have a strong track record of successful SME lending and discuss the possibility of their entering Angola or providing technical support to interested Angolan banks engaged in SME business</i>	BNA	Secondary
	<i>BNA and the Government should continue to pursue development of capital markets to enhance financial sector competition and create alternative ways for businesses to obtain finance.</i>	GOA, BNA	High
	<i>BNA can encourage SME financing partnerships by actively discussing the issue with the banks.</i>	BNA and Bank Training	Secondary

Issue	Recommendation	Agency	Proposed Priority
		Institute	
	<i>BNA can help to educate the banks on international best practices and prospects for SME lending in Angola, by organizing a conference in conjunction with ABANC on this topic.</i>	BNA and ABANC	Top
	<i>BNA should sponsor a systematic study to document the reasons for rejection of SME credit applications by the banks and suggest changes in procedures, lending criteria, or staff training to overcome unnecessary obstacles to lending.</i>	BNA	High
	<i>Once a sufficient level of interest is reached among the banks, then the Bank Training Institute should seek international assistance to introduce training modules and train trainers on international best practices in SME lending.</i>	BNA and Bank Training Institute	High
	<p><i>BNA should give high priority to accelerating the creation of a credit information system to reduce information asymmetries and facilitate credit in general, and lending to SMEs in particular.</i></p> <ul style="list-style-type: none"> • Participation in the credit information system should be mandatory for all banks and financial institutions. • The credit bureau at BNA may start with only basic information on loan payment history, but it should ultimately adhere to the standard indicated by the six criteria used by the World Bank to assess credit information systems for the Doing Business reports • In the Angolan context a public registry is indeed the most feasible, quickest, and most widely supported option in the short term. It is appropriate, though, that BNA is thinking to shift the system to a private sector operator in the medium term. 	BNA, commercial banks	Top
	<p><i>BNA should accelerate its plan to issue an appropriate regulatory framework for leasing, to unblock an important new avenue for SME finance.</i></p> <ul style="list-style-type: none"> • In preparing leasing regulations, BNA should confer with banks and other stakeholders to avoid undue restrictions. • BNA should encourage the entry of specialized leasing companies that are independent of the commercial banks, to promote the use of leasing to SMEs and enhance financial competition in general. • BNA should confer with the MOF on the tax laws to ensure that leasing is not placed at a disadvantage compared to other forms of finance. 	BNA, ABANC, private sector	High
	<i>Encourage synergies between banking and insurance through dialogue between the supervisory agencies (BNA and ISS),</i>	BNA, ISS,	Secondary

Issue	Recommendation	Agency	Proposed Priority
	the banks, and the insurance companies, and through training modules at IFBA on using insurance to reduce credit risk.	IFBA	
	<i>Encourage competition in the insurance industry in order to promote innovation and competitive pricing – while adhering to strict prudential standards to ensure that insurance companies are financially sound and well managed.</i>	BNA, ISS	High
	<i>Explore the option of joining the Africa Trade Insurance (ATI) network to provide trade credit insurance as a tool for expanding access to credit for Angolan exporters.</i>	GOA, ISS	Secondary
Credit Guarantees	<i>The MOF, BDA and BNA should carefully examine the feasibility of allocating a portion of the Development Fund to a Credit Guarantee Program for SME lending by commercial banks.</i>	MOF, BDA, BNA	High
	<i>Any credit guarantee fund should be carefully designed based on international best practice to develop sustainable capacity for bank lending to SMEs while minimizing the risk of encouraging poor lending practices through moral hazard.</i>	MOF, BDA, BNA	High
	<p><i>To this end, a task team from MOF, BNA, and ABANC should consult with the banks, SMEs, donors, potential corporate partners, and other stakeholders on the best technical design and administrative structure, before introducing any credit guarantee fund. The task team should:</i></p> <ul style="list-style-type: none"> — Identify sources of funding. — Define the eligible SME target group. — Define parameters for partial guarantee. — Define eligibility criteria for participating commercial banks, includes a willingness to introduce best practices for SME lending methodology. — Elaborate standard procedures and reporting requirements that govern the Fund and its relationship with commercial banks, including clear rules for handling bad debts. — Market the guarantee scheme to the banks and the public. 	MOF, BNA, ABANC, private sector, donors, others	High
SME Business Development Services	<i>See the Appendix to Chapter 3 of the main report for a draft Action Plan for INAPEM.</i>	GOA, INAPEM	Top –
Costs of Banking	<i>Be patient in letting market forces do their job! BNA's current policy on approving the entry of sound new banks is intensifying competition and creating incentives for greater efficiency, lower costs, and better pricing of services. The impact on costs, profits, and pricing may be gradual, but it is happening.</i>	BNA, GOA	High

Issue	Recommendation	Agency	Proposed Priority
	<i>Strong and effective prudential supervision by BNA is essential to minimize the risk of subsequent problems that might emerge as a result of the rapid increase in bank credit and the entry of new banks with less sophisticated risk controls.</i>	BNA	High
	<p><i>Improve the transparency of pricing for basic bank services. More can be done by BNA to ensure that this important information is readily available to bank customers. Options include:</i></p> <ul style="list-style-type: none"> • Introducing tighter regulatory requirements for disclosure of banking fees and charges. • Working with ABANC to publish annual or quarterly tables showing basic price comparisons in a simple and standardized format. • Encouraging local consulting companies to include an analysis of banking costs in their banking surveys, and cooperate in providing information. • Introducing stronger regulations on truth-in-lending, requiring commercial banks and other lenders to divulge the <i>effective</i> annual percentage rate (APR) on all loans, in line with established international practices. 	BNA	Top
	<i>Maintain an intense monetary policy focus on reducing inflation in order to reduce macroeconomic risks that affect loan rates, improve the real interest rate on deposits, and reduce the pressure on operating costs arising from rising wages and input prices and appreciation of the real exchange rate..</i>	BNA, Treasury	Top
	<i>Reduce the obligatory reserve requirement -- as and when macroeconomic conditions permit. Once inflation is stabilized in the target range (below 10%) BNA can move towards a less onerous reserve requirement in order to reduce this "tax" on financial intermediation.</i>	BNA	Secondary
	<i>Re-assess data requirements imposed on the banks by BNA to identify possibilities for eliminating duplication and streamlining reporting systems, while still satisfying all legitimate information requirements of the central bank.</i>	BNA, ABANC	Secondary
	<i>Revoke the stamp duty on financial services. This is obviously not a responsibility of the central bank, but BNA can and should initiate a dialogue with the Ministry of Finance for the purpose of convincing the Ministry to eliminate these inefficient duties.</i>	Treasury, BNA	High
	<i>Undertake a special-purpose survey of SMEs and households to obtain data on transactions costs involved in opening and maintaining a deposit account, and obtaining a bank loan. This information can provide a much better picture of the actual costs of accessing banking services, and the impact of costs on the use of banking services..</i>	BNA, ABANC	Secondary

Issue	Recommendation	Agency	Proposed Priority
Reference rates	<i>BNA should continue to maintain positive real interest rates on TBC yields through its management of the primary auction as long as the market is beset by a sharp disequilibrium due to countervailing trends in the exchange rate and inflation. It might be possible, however, to focus interventions short-tenor TBC rates (14 or 28 days), while testing market pricing for other tenors based on pre-announced issues consistent with liquidity management objectives.</i>	BNA and the Government	High
	<i>BNA should establish an agenda for moving away from administering the interest rate in the TBC auctions, in favor of market-based pricing, once the market disequilibrium is resolved through lower inflation or gradual depreciation of the kwanza in line with the inflation differential.</i>	BNA	High
	<i>Enhance competition in the primary market for TBCs by allowing more bidders to participate. This measure will deepen the market, reduce the dominant influence of the large commercial banks, and improve the quality of the market signals.</i>	BNA	High
	<i>To develop the secondary market for TBCs, require licensed traders to post bid-ask spreads, and develop an information campaign to educate the public about saving through TBCs.</i>	BNA	High
	<i>To deal with the occasional problem of LIBOR reference rates moving at cross purposes to monetary policy objectives, BNA might introduce a differential reserve requirements on dollar versus kwanza deposits.</i>	BNA	Secondary
	<i>To develop a yield curve, BNA should seek discussions with the Treasury on a plan for introducing market pricing and kwanza denominations for at least a subset of OT issues, along with a program for stimulating a secondary market in these instruments.</i>	BNA, Treasury	Top
	<i>To set a firm foundation for pricing OTs, the Government should seek a sovereign rating from a major international rating agency, after it settles its remaining negotiations with the Paris Club.</i>	Treasury	High
	<i>The Government and BNA need to improve coordination of fiscal and monetary policies to bring down inflation, and consider altering the management of foreign exchange reserves to allow the kwanza to adjust in line with the inflation differential. This would resolve the disequilibrium in the financial market as described in the text, and prevent a continued real appreciation that may impair the development of productive activities outside the mineral sector.</i>	MOF and BNA	Top

Issue	Recommendation	Agency	Proposed Priority
Deposit Insurance	<p><i>On balance, we recommend proceeding with careful consideration of a deposit insurance scheme for Angola.</i></p> <ul style="list-style-type: none"> • <i>If the Government moves in this direction, the first step is to establish a task team to carefully study the many technicalities identified in the text.</i> • <i>The Angolan Government and BNA should seek technical assistance in assessing the parameters for a possible deposit insurance scheme. The Federal Deposit Insurance Corporation in the United States is one leading agency that has experience in providing international technical assistance experience. (USAID can facilitate this link.) Another option is the International Association of Deposit Insurers at the Bank for International Settlements in Basel.</i> • <i>The assessment process should also include consultation with stakeholders, and study visits to other countries to learn from their experience, particularly countries like Kenya and Nigeria where significant difficulties have been faced.</i> • <i>If deposit mobilization is a major reason for favoring an insurance scheme, then either GOA or BNA should commission a study to survey households and small businesses to determine the extent to which lack of confidence in the banks is inhibiting the use of deposits as a savings vehicle.</i> • <i>We suggest a coverage ceiling per deposit of about \$16,000 for 2008, based on the central tendency in Africa and other developing countries to set the threshold at around 3 times the level of per capita GDP. This is a reasonable, though rather arbitrary, benchmark for Angola.</i> • <i>Simplicity is a virtue in deciding on coverage for foreign exchange accounts, inter-bank accounts, accounts held by linked parties, as exclusions may create considerable administrative costs and delays in the event of a bank failure.</i> • <i>Decisions are also needed on the responsibilities of foreign parent banks for covering deposit accounts in their Angolan subsidiaries, should they fail.</i> • <i>The deposit insurance scheme should be housed within BNA but operated as an independent legal entity, collaborating closely with the bank supervisors. The insurance entity should have a relatively limited role with respect to insolvencies, such as monitoring possible payout needs.</i> • <i>The deposit insurance agent should develop procedures to outsource operational functions in the event of a bank failure, rather than keeping a large permanent staff on hand to deal with activities such as the payment of claims and realization of assets.</i> • <i>The deposit insurance fund should be pre-funded via a</i> 	GOA and BNA	Secondary

Issue	Recommendation	Agency	Proposed Priority
	<p><i>small premium charge on covered deposits, but it will also require seed capital from the Treasury to establish credibility in the eyes of the intended beneficiaries: the depositors.</i></p>		

Acronyms

ABANC	Associação Angolana de Bancos, Angolan Banks Association
AEP	Angola Enterprise Programme
AGCI	African Global Competitiveness Initiative
ATI	African Trade Insurance
BAAC	Bank for Agriculture and Agricultural Cooperatives (Thailand)
BAI	Banco Angolano de Investimentos
BANC	Banco Angolano de Negócios e Comércio
BDA	Development Bank of Angola
BDS	Business Development Services
BFA	Banco de Fomento Angola
BIO	Belgische Investeringsmaatschappij voor Ontwikkelingslanden, Belgian Development Finance Company
BIPIK	Pembinaan dan Pengembangan Industri Kecil, Indonesian Small Industries Development Program
BNA	Banco Nacional de Angola
BNDE	Banco Nacional de Desenvolvimento Econômico (Brazil)
BoB	Bank of Botswana
BPC	Banco de Poupança e Crédito
BRI	Bank Rakyat Indonesia
BTA	Banco Totta de Angola
BVDA	Bolsa de Valores e Derivativos de Angola, Angola stock exchange
CAE	Centro de Apoio Empresarial, Business Support Center
CAMEL	Capital, Assets, Management, Earnings and Liquidity
CDC	Commonwealth Development Corporation
CEBRAE	Centro Brasileiro de Assistência Gerencial à Pequena Empresa (Brazil)
CGAP	Consultative Group to Assist the Poorest
CMC	Capital Markets
COFIDE	Corporación Financiera de Desarrollo, Peru's national development bank
DBSA	Development Bank of Southern Africa
DCA	Development Credit Authority
DELP	Developing Enterprise Loan Product

DFCU	Development Finance Company of Uganda
DFI	Development Finance Institution
EBRD	European Bank for Reconstruction and Development
ECI	South African economic development consulting firm
ENSA	Empresa Nacional de Seguros de Angola, Angolan National Insurance and Reinsurance Company
FDES	Fundo do Desenvolvimento, Economic and Social Development Fund
FDIC	Federal Deposit Insurance Corporation
FIRST	Financial Sector Reform and Strengthening Initiative
FMO	Financierings-Maatschappij voor Ontwikkelingslanden, Netherlands Development Finance Company
GDP	Gross Domestic Product
GME	Global Emerging Market
GOA	Government of Angola
GUE	Guichê Único das Empresas, one-stop shop
IDB	Inter-American Development Bank
IFBA	Bank Training Institute of Angola
IFC	International Finance Corporation
IFMC	Capital Markets Training Institute
ILO	International Labour Organisation
IMF	International Monetary Fund
INAPEM	Instituto Nacional de Apoio às Pequenas e Médias Empresas
INE	Instituto Nacional de Estatística
INEFOP	Instituto Nacional de Educação e Formação Profissional
INSS	(Instituto Nacional de Segurança Social, National Institute of Social Security)
IRP	Interest Rate Parity
ISS	Instituto de Supervisao de Seguros, Insurance Supervision Institute
LAADC	Latin American Agribusiness Development Corporation
LIBOR	London Inter-bank Offer Rate
MAPESS	Ministerio da Administracao Publica, Emprego e Seguranca Social
MOF	Ministry of Finance
(M)SME	(Micro) Small and Medium Enterprises
NBFI	Non-Bank Financial Institution
NGO	Non-Governmental Organisation

NPL	Non-Performing Loans
OECD	Organisation for Economic Cooperation and Development
OT	Treasury Obligation
PAYG	Pay-as-you-go
PBD	Provision of Bad Debit
REMPE	Recenseamento de Empresas e Estabelecimentos, Angolan Business Census
RER	Real Exchange Rate
RIR	Real Interest Rates
ROA	Return of Assets
ROE	Return of Equity
SBA	United States Small Business Administration
SBDC	Small Business Development Center
SBDCNET	Small Business Development Center National Information Clearinghouse
SBI	Shorebank International
SEBRAE	Serviço Brasileiro de Apoio às Micro e Pequenas Empresas (Brazil)
SME	Small and Medium Enterprises
SMEDA	Small and Medium Enterprises Development Authority (Pakistan)
SMME	Small, Medium and Micro Enterprises
SNV	Stichting Nederlandse Vrijwilligers, Netherlands Development Assistance Agency
SSA	Sub Sahara Africa
SWOT	Strengths, Weaknesses, Opportunities and Threats
TA	Technical Assistance
TBC	Titulos de Banco Central, central bank bills
TFCB	Trade Facilitation and Capacity Building Project
USAID	United States Agency for International Development
UNDP	United Nations Development Programme
VAT	Value Added Tax

Chapter 1. Introduction

Bank credit to the private sector in Angola has been growing rapidly over the past few years as a result of an oil-led economic boom, major improvements in macroeconomic stability, and increasingly competitive conditions in the financial system. Yet by virtually any indicator the banking system is still very underdeveloped in terms of scale, outreach, and range of credit services. For example, in a recent survey conducted by the World Bank for its forthcoming Investment Climate Assessment, local businesses identify access to financing as the single most important constraint they face, well ahead of problems such as electricity supply, crime, and corruption.¹

The Banco Nacional de Angola (BNA) and the Government of Angola (GOA) have taken the initiative to address these problems by developing a Policy Matrix for Expanding Credit Access, with support from USAID, and in collaboration with local stakeholders. The matrix identifies key issues relating human resource capacity; information and property ownership; the supply of financial services; other factors relating to supply and demand for credit; and monetary policy. (Appendix A presents the full Policy Matrix.) The present report has been commissioned by BNA and USAID to examine five key elements of the Policy Matrix:

- Improving the Supply of Term Finance
- Improving Access to Finance by Small and Medium Enterprises (SMEs)
- Reducing the Costs of Banking
- Developing reference rates for the pricing of credit products
- Evaluating a possible deposit insurance/guarantee fund for Angola

For each of these issues, the Matrix calls for an evaluation study that will identify practical actions for moving the agenda forward, taking into account prevailing post-conflict conditions in Angola as well as pertinent lessons from international experience.

The methodology for the study started with a review of international best practices for improving access to finance in developing countries, along with documents and statistics on the financial system in Angola.² The study team then conducted interviews and meetings in Luanda with more than 70 officials from BNA, the GOA, the commercial banks, other financial institutions,

¹ Source: *Preliminary Findings for the Angola Investment Climate Assessment*, by Giuseppe Iarossi. This is an unpublished presentation given to the World Bank office in Luanda on July 30, 2007. We thank the World Bank office for providing the study team with a copy.

² A full reference list is presented at the end of the study. Two core documents are the World Bank, *Making Finance Work for Africa*, 2007, and the Angola Banking Survey 2007 (*Banca em Análise*) by Deloitte and the Angola Bankers' Association (ABANC).

business development service agencies, international agencies, and several business leaders.³ The study team also worked closely with the government's lead agency for business development services, INAPEM, which is a focus of the chapter on improving access to finance for small and medium enterprises (SMEs). Members of the study team have also drawn heavily on their personal experience in dealing with financial sector issues and advising governments in other countries of the region and elsewhere.

The report is organized in six chapters. As background, the remainder of this introductory chapter presents a short note on fundamental principles for financial sector development, highlighting the importance of a sound banking system for efficient and broad-based economic growth and job creation. The chapter also discusses special challenges facing Angola today as they relate to financial sector development.

Chapter 2 begins the technical analysis by examining the problem of improving the supply of term finance for domestic enterprises. Chapter 3 looks more specifically at improving access to finance by SMEs in Angola. Chapter 4 then presents a review and diagnosis of the costs of banking in Angola, while Chapter 5 discusses the issue of establishing reference rates for pricing credit products. Finally, Chapter 6 examines the question of whether Angola should introduce a deposit insurance or guarantee scheme.

Drawing on this analysis, the report identifies more than 80 recommendations. Table 1 summarizes these recommendations in matrix format, and also suggests priorities. In addition, the Appendix to Chapter 3 offers 11 recommendations for strengthening INAPEM's capacity to support the provision of business development services for SMEs, as an essential element of the strategy for expanding access to credit. Many of our recommendations endorse or highlight issues that are already under consideration by the authorities, but others involve new measures for attention.

The analysis and the recommendations presented here represent the views of the consulting team, as inputs for consideration by BNA and the Government in their efforts to develop the supply of financial services and improve the efficiency of the banking sector in Angola.

PRINCIPALS OF FINANCIAL SECTOR DEVELOPMENT⁴

Both the analysis and the recommendations in this report are grounded in basic principles of financial sector development, viewed through the lens of experience in other developing countries. Hence, it is important to outline these principles at the outset.

The primary function of the financial system in any economy is to mobilize savings and allocate these financial resources efficiently to businesses, households, and governments. Some

³ Appendix B lists persons interviewed for the study.

⁴ This section draws heavily on Nathan Associates (2007), *Financial Sector Constraints to Private Sector Development in Mozambique*, which was produced for USAID/Maputo under the Trade and Investment Project (TIP), which is available at: <http://www.tipmoz.com/page.php?cat1=117&cat2=262&cat3=557> .

financial institutions, such as commercial banks, serve as intermediaries that channel deposits from the public into loans and investments. Banks also provide payment services that are the lifeblood of economic transactions. Other institutions, such as stock and bond markets, facilitate direct transactions between those who supply financial resources and those who have a demand for funds. In addition, a well-functioning financial system provides clients with instruments for managing risk through portfolio diversification, various forms of insurance, and tools for hedging against economic shocks.

Financial transactions are unique in that the main product is a pledge for future repayment of funds, under specified terms and conditions. As a market in promises, the financial system is driven by *information* about the reliability and solvency of the party pledging repayment. An effective financial system also requires a strong legal and judicial foundation to support the realization of pledges by ensuring contract enforcement and property rights, with clear rules and regulations governing the fiduciary behavior of financial institutions.

In most low-income countries, including Angola, commercial banks dominate the financial landscape. A sound banking system is a vital public good in that economic agents across the board depend on a stable and dependable banking system to facilitate transactions, protect cash balances, and finance operations. Moreover, imprudent banking practices often provoke crises that impose heavy costs on the economy at large.⁵ Banks have an obligation to protect the funds obtained from their depositors. They must therefore manage risks carefully and avoid undue exposure to possible losses, while seeking an attractive return for shareholders.

The first line of defense against instability in the banking system is strong management and effective governance within the banks themselves. But international experience has shown time and again that a second line of defense is also needed, in the form of effective and diligent banking supervision based on time-tested prudential regulations. This supervision includes close attention to ensuring that the banks avoid imbalances in the structure of their liabilities and assets – their sources and uses of funds, respectively – to protect against risks that may arise from various economic or financial shocks. Other tenets of prudential banking include requirements to maintain adequate levels of capital, a limit on loans to individual borrowers, and rules for setting aside provisions against non-performing loans.

While commercial banks have good reason to be cautious about lending risks, *sound banks can still be innovative*. In particular, they can do a much better job of developing new financial services, serving nontraditional clients, mobilizing longer-term liabilities to support term lending, and adopting new techniques to reduce costs and control risks.

⁵ Dozens of banking crises have occurred in Africa and around the world (see Bolnick and McPherson). In Mozambique, for example, the bailout of two major banks in 2001 and 2002 cost the government an estimated 6 percent of GDP. Aftereffects lingered for years in the form of conservative lending by major banks and crowding out from government debt that was issued to recapitalize the failed institutions.

To facilitate such innovation, the central bank, the government, and the donor community can be catalysts for change. The motivation for such intervention is that imperfections in the financial markets lead to systematic underinvestment in financial innovations that can yield major benefits for private sector development, job creation, broad-based economic development and poverty reduction, with broad ripple effects. Any argument of this sort must be treated with caution because “development externalities” are too often invoked in a vague rhetorical sense to justify programs with little, if any, development impact. In this case, however, economic research has repeatedly demonstrated that measures to increase financial depth and breadth have a significant positive impact on economic development.

One basic imperfection in the financial market arises from missing information. Most bankers, for example, lack information on appropriate techniques for developing new markets profitably; on costs and risks of serving nontraditional borrowers; and on the viability, under Angolan conditions, of innovations that have worked well elsewhere. There are also information gaps on the part of potential clients. The managers of many small and medium-sized businesses do not understand lenders’ requirements, and lack the capacity to provide necessary accounting data and business plans. On both sides of the market, well-designed interventions and reforms can help overcome information problems and facilitate access to finance.

In many countries these market imperfections are compounded by a lack of effective competition to drive financial innovation. In Angola the financial system is becoming increasingly competitive. The entry of new banks and the emergence of other financial institutions, including the new stock exchange, will create strong incentives for banks to develop new services and seek new clients. Many of the recommendations in this report relate to measures that can enhance this process.

Paralleling the problems that arise from market imperfections, one must bear in mind that government interventions are also prone to failure. These problems stem from weak capacity to design and implement effective programs, often compounded by a lack of attention to the unintended consequences of government actions. Governments also tend to face a fundamental misalignment between development needs and the incentives facing politicians and bureaucrats, including pressure from rent-seeking special interests. As a result, developing countries often adopt populist interventions that actually inhibit rather than promote the development of sound and efficient financial markets.

The lesson is that public sector interventions must be carefully designed to strengthen and deepen the financial markets, not to supersede or weaken them. In particular, governments should not push financial institutions to extend loans to fundamentally non-viable clients or create artificially “cheap” credit schemes that typically end up favoring special interests, undermining lending standards, and creating incentives for rent-seeking to take advantage of the implicit subsidies associated with low-cost financing. And yet there is undoubtedly an important role for government interventions that serve as a catalyst to help financial institutions test new markets and develop new services, as well as programs that help local businesses

become more “bankable” through better management, better financial controls, and better business plans.

CHALLENGES FACING ANGOLA TODAY

In each substantive chapter below, the analysis is framed in the context of conditions in Angola today. It is useful at the outset, however, to highlight some major challenges that influence the development of the financial system over the next few years.

One basic challenge arises from the fact that Angola is still in the process of recovering from a long period of conflict that only ended in 2002. In the aftermath of war, standard prescriptions for economic development are not always appropriate or effective, because wars typically leave a legacy characterized by:⁶

- An erosion of the rule of law and the effectiveness of governance institutions.
- Sharply reduced incomes and large economic disparities, along with high expectations for a tangible “peace dividend.
- Degradation of infrastructure and public service systems due to years of damage and neglect.
- High inflation and macroeconomic uncertainty.
- Critical problems with physical security and property rights.
- Exceptionally high unemployment, especially among youth and ex-combatants.
- A severe shortage of human and institutional capacity.

International experience shows that the early stage of post-conflict recovery is often marked by a “bounce” in GDP due to the restoration of physical security, the rebuilding of infrastructure, and the implementation of donor programs. The essential challenge, though, is to achieve *sustained* growth that will deliver broad-based improvements in standards of living. In any case, it often takes a decade or more for a post-conflict economy to reach pre-conflict standards of living.

By 2007, the Angolan economy has succeeded in achieving a path of high growth driven by an oil and mineral boom, combined with an aggressive program of post-conflict reconstruction of infrastructure and public services. In addition, the political situation has stabilized, security conditions are favorable, and macroeconomic policies have greatly improved. In short, Angola has already passed the critical initial tests of post-conflict recovery.

Looking specifically at the financial sector, USAID experience points to three immediate priorities in the aftermath of a conflict: establishing a stable currency; restoring secure depository institutions; and rebuilding the payment system. Here, too, Angola has moved beyond the initial exigencies and now confronts the more fundamental issue of establishing a sound and efficient financial system, and more widespread access to credit to support broad-

⁶ This section draws heavily on a recent draft “Guide to Economic Growth in Post-Conflict Countries” from USAID’s Economic Growth Office, Bureau for Economic Growth, Agriculture and Trade, October 4, 2007.

based growth and more rapid job creation. This stage inherently requires more time, because the expansion of credit hinges on the development of skills and infrastructure in the financial system, growing public confidence in the safety of bank deposits, a supportive legal and judicial system, and improvements in the business climate. If lending standards and risk management are weak, if legal and judicial support for credit transactions is unreliable, and if the private sector faces severe constraints, then government-mandates to push credit into the economy are neither effective in promoting economic development nor sustainable in terms of financial sector development.

Focusing on the business climate, the government faces a host of major challenges that clearly affect development of the financial system, including poor infrastructure, an unfavorable institutional regime for private investment, and persistent macroeconomic imbalances. As already noted, the government is aggressively pursuing infrastructure development with financing from mineral income, low-cost loans from China, and domestic bond issues. In both economic and political terms, the need is clear. And as the core infrastructure improves, bankable opportunities for private sector development will expand accordingly.

The problem is that a highly expansionary fiscal policy works at cross purposes to the objective of reducing inflation and establishing credibility for effective macroeconomic management. Given huge injections of liquidity into the economy via Treasury operations (and quasi-fiscal operations of the state oil company⁷) the central bank is in the difficult position of having to hit the monetary brakes by issuing domestic debt (mainly in the form of *Titulos de Banco Central*, or TBCs) or selling foreign exchange. The debt option is not only expensive, but also pushes up kwanza interest rates and provides banks with an easy alternative to expanding credit to the private sector. The option of selling foreign exchange looks better at first glance because it helps to hold down inflation by strengthening the kwanza. But in doing so it also reduces the competitiveness – and bankability – of potential non-mineral exports, as well as domestic production that competes against imports in local markets. Hence, the combination of fiscal stimulus and monetary restraint has created a situation in which inflation remains stubbornly in double digits, interest rates on kwanza loans are far out of line with rates on dollar loans, and the strong kwanza may be jeopardizing broad-based growth in manufacturing and agriculture. These issues are discussed further in subsequent chapters, in the context of specific financial sector problems.

In technical terms, the best way to address this macroeconomic challenge is to improve the balance between fiscal and monetary policies. In political terms, however, tightening fiscal policy is hard to sell, especially in the context of high expectations for post-conflict benefits, more than ample access to financing, and national elections planned for 2008 and 2009.

Another critical challenge relating to the business climate – and the expansion of credit to the private sector – is the legal and regulatory regime. In its Doing Business assessment for 2008, the World Bank ranks Angola as 167th out of 178 countries. Thus, Angola is has one of the

⁷ EIU Country Report: Angola, October 2007.

least supportive environments in the world for private investment. The problems cut across nearly every category in the rankings, including conditions to start or close a business, obtain licenses, employ workers, register property, trade across borders, and enforce contracts.⁸ These problems obviously have little effect on major investments in the petroleum, mineral, and construction. But those are not the sectors of concern for this study.

Overcoming these challenges to the development of the financial sector will require a firm political commitment. While the government clearly embraces these objectives, there are countervailing interests that could lead to a lack of policy coherence. For example, as already noted, the government's (understandable) desire to pursue reconstruction as quickly as possible conflicts with the need for macroeconomic stability, which is an essential ingredient for healthy development of the financial sector. Also, even though the government recognizes that the private sector is the main engine for growth, there are always tendencies to favor populist interventions that impair longer-term prospects for market-driven growth. For present purposes, the most prominent case in point is the political tendency to view the financial system as a conduit for subsidizing favored sectors through cheap credit.⁹ These schemes usually end up getting captured by special interests or used for patronage purposes at the expense of development goals.

Political considerations, of course, are always in play. The important thing is that decision makers understand the benefits that derive from fostering a sound and efficient financial system, and the costs associated with interventions that impede these developments. Our hope is that the present study provides not only a set of useful recommendations for expanding the supply of financial services and the efficiency of the banking sector in Angola, but also a clear justification for pursuing appropriate measures in the interests of national economic development and future prosperity.

⁸ Notably, Angola scores relatively well in the area of Getting Credit, but only because the World Bank's scoring system uses a very limited set of indicators for this category.

⁹ A classic treatment of this issue can be found in Dale Adams, Douglas Graham and J.D. Von Pischke (1984), *Undermining Rural Development with Cheap Credit*, Boulder: Westview Press.

Chapter 2. Improving the Supply of Term Finance

Until very recently, commercial banks in Angola concentrated their credit operations on short-term loans to a narrow range of established businesses. Most local enterprises had no access to term financing through the banks, nor did they have other options to obtain external financing for investment via capital markets or non-bank intermediaries. As a result, most capital investments have been limited to resources from self finance via internal earnings or equity contributions from the owners.. Individuals and households, too, have a need for long term financing, particularly for housing investments, which can provide a strong boost to economic development in a wide range of supply industries (and also bolster political stability). In addition to constraining capital formation, a dependence on self-finance also reduces the efficiency of investment because financial institutions play a valuable role in screening investment ideas and allocating financial resources to productive uses. In short, term financing by the banks can and should be a major driver for efficient private sector development, broad-based growth, and job creation.

In the past two years, the situation has been rapidly evolving. Competition in the banking sector has intensified, and banks are now extending many more loans beyond one year maturity, including long term loans of ten years or more for housing finance. BNA is promoting this process by licensing new banks, and pursuing reforms to stimulate development of the financial system. The Government, too, is engaged in a program of legal and institutional reform that will support the growth of term finance, including the creation of a stock exchange, a new regulatory authority for capital markets, and a new development bank, as well as supporting legal and judicial reforms.

Taking into account the dynamic context in Angola, as well as lessons from international experience, this chapter reviews major constraints to expanding the supply of medium and long term financing to Angolan businesses and households. The discussion will address five major issues:

- Medium and long term lending by commercial banks, including housing finance;
- The role of the Development Bank of Angola (BDA);
- Term financing through capital markets;
- Term financing through leasing and venture capital; and
- The supply of long-term savings through pension and insurance funds.

Each section of this chapter ends with recommendations on actions that can be taken by BNA, the Government, and their development partners to overcome constraints to term financing. Among other things, the recommendations strongly validate the approach that BNA has adopted in its policy matrix for expanding access to credit in general.

Term Lending by Commercial Banks

There is a common perception that Angolan banks do not extend term loans. In fact, medium term lending amounted to 67.3% percent of total bank credit to the private sector at the end of

2006, and 69.6% by July, 2007. BNA sources point out that there are some problems with the way banks report this breakdown, and that many of the medium term loans are near the short end of the range. Still, the picture is quite clear: many banks are lending large sums to the private sector for periods beyond one year.

Our field interviews broadly corroborate the statistics. One major bank indicated that it extends loans with maturities up to 5 years for businesses and up to 20 years for housing. Two other major banks reported providing loans up to 3 years. One small bank routinely approves housing finance out to 15 years, while a second offers 60-month auto loans as its biggest product line. Several other banks mentioned plans to enter the market for housing loans in the near future, perceiving great demand and good business opportunities.

Nonetheless, most banks limit their term lending business to a select group of customers whom they know and trust, and who have a solid source of income. It is not surprising, then, that a recent World Bank survey of 425 enterprises in four major cities found that even formally registered businesses obtain only 5% of their investment funds from banks.¹⁰ In addition, the study team found no evidence that banks extend *long-term* financing for business investment, apart from occasional consortium deals for large corporate clients.

Hence, the banks may be engaged in a large volume of term lending, but most businesses and households continue to lack access to medium and long term financing for investment. The reason is not hard to find, in that Angolan banks face daunting obstacles to expanding the market for term loans.

The constraints

By and large, the constraints to term lending in Angola are familiar in many developing countries, but many of the problems are unusually acute at this stage of the post-conflict recovery. The constraints fall into three basic categories:

- a lack of medium to long term sources of funds;
- a poor institutional environment to support bank lending;
- a limited supply of *bankable* investment projects.

Moreover, the banks have to view every obstacle through the lens of their compelling need to manage risks carefully in order to protect depositors funds, comply with essential prudential regulations, and generate profits for their shareholders.

Lack of long-term funds. Every bank contacted by the study team emphasized that a major constraint to term lending is their lack of access to medium and long term sources of funds. Banks have to balance the term structure of assets and liabilities in order to hedge against

¹⁰ Giuseppe Iarossi, *Preliminary Findings: Angola Investment Climate Assessment*, unpublished Powerpoint presentation to the World Bank office in Luanda, July 30, 2007. The team thanks Chris Porter at the World Bank office for providing this information.

transformation risks, yet two-third of all bank deposits from the public as of July, 2007, were in sight accounts; and most of the time deposits were for periods of less than 180 days.

As discussed in chapter 4, the lack of term deposits is partly a matter of choice for the banks, in the sense that they offer interest rates on such accounts that are far below the rate of inflation. Under these conditions, no one has an incentive to hold savings in the form of a bank deposit account.

In addition, the absence of a capital market (to date) has foreclosed the option obtaining longer term funds by floating bond issues to the public. This problem should be eased in 2008 with the opening of the BVDA, though this is likely to be a gradual process, based on the experience of other emerging stock exchanges. Any significant volume of corporate bond issues probably requires the prior placement of government bonds with a range of maturities, as a pre-requisite for establishing a risk-free yield curve as a benchmark for pricing other securities (see Chapter 5). The capital market can also assist in expanding the supply of term financing by facilitating the issuance of notes or bonds by the banks themselves, which qualify as Tier II capital – thereby contributing to capital adequacy requirements and providing a resource to support bank lending at longer maturities.

The market for private placements to obtain bond financing has also been very limited, though not altogether absent. Indeed, insurance and pension funds expanding rapidly over the past few years (see below), providing a pool of long-term savings that could be tapped for private bond issues. We were told by one informed source that the banks have not been interested in deals of this sort. If this information is accurate, it suggests that the lack of access to long-term funds, as such, is not the binding constraint on term lending by the banks. Other considerations include the cost of long-term funds (relative to the low interest rates being paid on deposit accounts) and the lack of viable lending opportunities due to other constraints facing the banks, as outlined next.

Poor institutional environment. Medium and long term loans to finance capital investment are inherently much riskier than a short-term loan to finance recurrent business transactions. Hence, the scope for term lending is especially sensitive to the quality of the institutional foundation to provide reliable information on clients and enforce contract agreements. In interviews, the banks highlighted the following familiar problems:

Credit information bureau. There is no central source of information on a customer's credit and financial history to allow banks to reduce the risks involved in approving loan applications. With assistance from the FIRST Initiative, BNA is in the process of creating a credit bureau to resolve this problem, but it may still be several years before it is operational.

Judicial system. Judicial processes are so slow and uncertain as to be nearly useless to the banks for settling credit claims. According to the World Bank's Doing Business ratings for 2008, Angola's judicial infrastructure for enforcing a contract is nearly the worst in the world. The Bank finds that it takes over a thousand days to enforce a simple contract from the time a lawsuit is filed in court, and even a smooth settlement will cost an estimated 44% of the amount in dispute. In problematic cases, the cost of a settlement might even exceed the amount to be

recovered. These problems greatly diminish the value of collateral as security for loans, and severely impair bank lending, especially on riskier products like term loans.

Property titles. Land use permits (*Dereitos de uso de Superficio*) and titles to immovable property in many parts of the country are still in disarray as a legacy of the war and the period of socialist management. In 2004 the government passed an important new Land Law to regularize land use records, but there are enormous problems of implementation. To the extent that registries do function, the procedures are extremely cumbersome. According to the Doing Business ratings, it takes 11 months to register property even when there is no dispute about ownership, with costs amounting to 11% of the value. Here, too, the scores for Angola are among the worst in the world. This cost includes a 10% tax on real estate transfers, which creates a strong incentive for under-reporting the value of a property transaction, or evading registration altogether. These problems further limit the use of collateral to secure a loan.

Movable property registries. For many types of movable property other than vehicles, there is no registration system that would allow banks to confirm ownership or track prior liens when appraising credit applications. Here again, the weak institutional environment creates barriers to securing a loan.

Limited supply of bankable investment projects. Most businesses, when asked, identify the lack of access to finance as a leading constraint to investment. But many investment ideas may not be fundamentally viable, and even with sound concepts many entrepreneurs lack the ability to provide banks with sufficient information to justify an affirmative lending decision. The most serious problems include:

Management capacity. Most local enterprises lack the capacity to present their accounts, develop a credible business plan, or demonstrate the management skill needed to make a convincing case for a bank loan to finance capital investments.

Accounting standards. Even when loan applicants do present accounts to the banks, the quality of the accounts is generally poor. Several banks told the study team that they view with skepticism any financial statements provided by clients they do not know, and regard the data as an unreliable basis for assessing creditworthiness. The lack of accounts often reflects a lack of basic education or access to business training, but there are also applicants who prefer not to share business data. In addition, Angola suffers from a severe shortage of qualified accounting professionals, though major universities are providing at least rudimentary training to hundreds of students each year.

Formalizing a business. Businesses cannot apply for investment financing unless they are fully registered. In the past, the process for registration was extremely slow and cumbersome. The government has recently succeeded in streamlining the procedures through a one-stop shop (Guichê Único das Empresas, or GUE) in downtown Luanda. The GUE Director told the study team that registration can now be completed in one day at this site. But elsewhere in the country, nothing has been done to simplify the procedures. According to Doing Business ratings (which do not reflect the recent progress at GUE) it takes an average of 119 days to open even a simple business in Angola – again, one of the worst scores in the world. Doing Business also

shows that the cost of starting a simple business is 344% of per capita income, higher than in all but three other countries of the world. A cost breakdown provided to the study team by GUE shows that an enterprise with initial capitalization of \$1000 has to pay over \$2500 in fees. For most small businesses, this cost virtually prohibits formalization.

Economic fundamentals for viable investment. The single most important determinant of term lending is the viability of the investment plans presented for financing. In this respect, Angola today presents an unusual combination of enormous growth opportunities alongside severe constraints due to the poor post-conflict business environment. There are excellent prospects for investment in activities linked directly or indirectly to the oil economy and the post-war reconstruction of infrastructure. Nonetheless, private investment is constrained by high costs associated with poor infrastructure (especially roads, ports, railroads, and electricity), shortages of skilled labor, weak systems for contract enforcement (discussed above), and widespread corruption.

Inflation. High and variable inflation adds to the risks of financing investment because future market conditions are more uncertain. Also, as long as inflation is in double digits the banks cannot attract longer term deposits without offering a high interest rate that would make term loans much more costly for borrowers, and thereby deter financing for investment.¹¹ Inflation also limits the potential for raising long-term funds by floating bonds on the new stock exchange (discussed below). The higher the inflation rate the greater the uncertainty about future inflation. This increases the risk of long-term bond transactions for both the buyers (who earn a lower than expected real return if inflation goes up) and the sellers (who pay a higher than expected real interest rate if inflation goes down). Even in the highly developed capital market in the United States, long term bond financing by the private sector all but dried up in the late 1970s when inflation reached low double digit levels. The only solution to this dilemma is to stabilize inflation at a more moderate level through strong fiscal and monetary policies, or to issue more complex inflation-indexed bonds.

The strong kwanza. The strong kwanza essentially prohibits term lending for export activities outside the mineral sector, and limits the scope for financing investments in agriculture and manufacturing for the domestic markets where producers face import competition. Many officials told the study team that the government intends to offset competitiveness problems caused by a strong kwanza through programs to increase productivity and improve the infrastructure. For some activities this can work. But more generally it may be wishful thinking for two reasons. First, the extent of real appreciation over the past has been an order of magnitude larger than the productivity growth rate normally achievable in agriculture and manufacturing. Second, infrastructure improvements reduce costs for local producers, but also

¹¹ Even though the *real* interest rate on these loans might not be very high, many borrowers are very hesitant to accept high nominal interest rates due to the risks involved in managing the debt service payments.

make it cheaper for imports to reach consumers.¹² For present purposes, the main point is that the strong kwanza may be having an adverse effect on the competitiveness of certain sectors. Banks can individually undertake appraisal studies to determine whether and where this is a problem. But this information has the character of a public good, in that it can help all of the banks make more efficient decisions on term lending. Hence, we suggest that BNA should sponsor a series of studies on the extent to which the appreciation of the real exchange rate is affecting investment prospects in various industries.

We close this list of constraints with one item that appears to be less of a problem than expected. This is the physical outreach of the banking system. Data provided by BNA show that every provincial capital now has at least three bank branches, and seven cities outside Luanda have ten or more. Recent expansion of the banking system has therefore created a network of offices sufficiently well distributed to make term loans available to viable businesses in most parts of the country.

Implications for the banks

Faced with the obstacles outlined above, banks have good reasons to be cautious about medium and long term lending to finance investments. The surprise is that so much term lending *does* take place. Obviously the banks have devised procedures to work around the constraints, at least for certain clients and some types of loans.

In evaluating lending risks, a primary criterion for the banks is evidence of the applicant's management capability, experience in running a successful business, earning a steady income, and accumulating wealth. This works well for loan applications from top companies and wealthy individuals, as well as other bank clients with a visible history (to the bank) of strong financial management.

Another screening device is to require an equity contribution from the applicant in the form of property, machinery, or cash. This ensures that the loan recipient has a direct personal stake in the success of the investment. In Angola, only a limited number of entrepreneurs and households have had a chance to accumulate much wealth, so this can be a decisive factor in limiting access to term loans, as well as the size of the loans.

For investment credits, bankers require information on the viability of the project to be financed by the loan. Many applications fail this test for lack of preparation. In any case, several bankers told the study team that they put more stock in personal characteristics of the borrowers than in the business plans, financial projections, or accounting statements.

Of course, banks also require collateral. While this is a standard tool for risk control, collateral is usually a subsidiary consideration in lending. The reason is that banks do not want to rely on foreclosure for recovery of their funds, especially under the poor legal and judicial conditions in

¹² In any case, these competitiveness problems are called "Dutch disease" because they were first diagnosed in the Netherlands, which shows that high productivity and excellent infrastructure are not enough to ward off the effects of an appreciating exchange rate.

Angola. Even if loans are secured by a mortgage on real assets, banks cannot expect to realize more than a fraction of the value of the collateral (at best) through legal foreclosure proceedings. And without a property registry they cannot even be sure that the assets offered for collateral are properly owned and unencumbered with other liens. In effect, collateral may serve mainly as a device for screening loan applicants by showing that they have been able to manage their financial resources and accumulate wealth. More substantively, banks can include arbitration clauses in their loan agreements in order to settle claims without recourse to the courts. But even then, the enforcement of an arbitration decision may depend on support from the legal system, which is unreliable. Finally, the attachment of collateral can be a useful bargaining chip for negotiating repayments on overdue loans, because even the threat of legal action to foreclose imposes a significant cost on the debtor.

The limitations on enforcement of collateral apply even to mortgages for housing loans. Given the problems with contract enforcement, it is surprising to see banks move into this line of business, even though the demand for housing loans (and housing improvement loans) is obviously very strong. Indeed, some banks are extending loans with a maturity of 15 years or more, despite their own lack of access to long-term sources of funds. The growth of this market attests that the banks involved are comfortable with the financial status of their borrowers, and their options for controlling risk through channels other than judicial action. Even so, the weak institutional foundations for mortgage lending provide a compelling argument against early efforts to develop securitized bonds based on collateralized debt.

Term loans for the purchase of automobiles appear to be easier to secure. Some bankers told the study team that they use the vehicle registration itself to establish their claim on the asset. In addition, banks can require auto insurance to cover against physical risks to the vehicles being financed, including accident damages and theft.

Implications for BNA and the Government

Sustainable solutions for improving access to term loans from the commercial banks requires efforts to address the root problems identified above. The alternative of papering over the problems with controls or subsidies would be inconsistent with the overall objective of developing a sound and efficient financial system.

BNA has already highlighted most of these constraints in its Policy Matrix for Expanding Credit Access. To establish a hierarchy of priorities, we suggest applying three criteria: the intrinsic importance of the constraint as a barrier to term lending; the political and technical feasibility of measures to mitigate the constraint; and the time needed to deal with the problem. In general, top priority should be accorded to critical constraints for which tangible progress can be achieved in a relatively short time horizon.

Many of the essential structural and institutional issues identified above fall clearly outside the scope of BNA responsibility or span of control. Nonetheless, BNA can help the responsible ministries and government organizations understand how the legal, judicial, and regulatory

problems under their control affect the important national goal of developing the financial sector and expanding the supply of term financing for national enterprises.

Based on this analysis of the constraints to term lending and our understanding of conditions in Angola, we propose the following recommendations for concerted attention by BNA and other government authorities:

Recommendation: *BNA should play a lead role in helping ministries and other agencies understand the links between legal, institutional and regulatory reforms and development of the financial system. For this purpose, BNA should convene a national conference on these issues.*

Recommendation: *Accelerate the development the new credit information system.*

Recommendation: *Establish computerized registries for both non-movable and movable properties.*

Recommendation: *Accelerate action on streamlining procedures for business registration throughout the country and reducing the cost of formalizing a business.*

Recommendation: *Formally target a major improvement in Angola's ranking in the World Bank "Doing Business" assessment as a policy objective.*

Recommendation: *Undertake or sponsor studies to help banks understand whether the strong Kwanza is affecting the competitiveness of various sectors and prospects for term lending in those sectors.*

Recommendation: *Maintain a strong macroeconomic policy focus on reducing inflation to single digits. This requires supportive fiscal policy, so as not to place the full burden of stabilization on monetary and exchange rate policies, and also to minimize the potential adverse effects of Dutch disease on the potential for investment outside the resource sectors.*

Other problems take more time to have a strong impact on expanding the supply of term finance, and therefore may be lower priorities in this context. Nonetheless, every one of the constraints discussed above warrants serious programmatic attention as part of the overall solution package. This includes programs to strengthen the judicial system, fight corruption, rebuild the infrastructure, introduce suitable accounting standards, improve the accounting and management skills of local entrepreneurs (see next chapter), and expand the supplies of skilled labor, including accounting and finance professionals.

The Development Bank of Angola

The Development Bank of Angola (*Banco de Desenvolvimento de Angola*, or BDA) was formally established in June of 2006 as a key instrument for the promotion of domestic investment and implementation of the national development plan. The Development Bank is licensed under the Financial Institutions Act of 2005, and regulated by the central bank, BNA. Its principal activity will be to manage an Development Fund that will receive 5% of the government's fiscal revenue from the oil industry, and 2% of fiscal revenue from the diamond industry. This huge pool of

financial resources is held in a special government account at BNA, but BDA is responsible to manage and allocate the fund.

The record of government-run development finance schemes in Angola, as in most other African countries, has been very poor. In particular, the government's Economic and Social Development Fund (FDES), established in 1999, led to huge write-off from bad debts. The government-owned Farmers' Bank (CAP) was also a financial calamity due to corruption and widespread non-payment by the recipients, who evidently regarded money from the government as a grant.¹³ Schemes of this sort are not only very costly, but also create unfair competition for other financial institutions and damaging precedents that undermine the prospects for developing a sound financial system.

The management of BDA emphatically aims to avoid repeating the past debacles this time around by establishing a culture of careful loan appraisal, based on commercial standards, along with strong systems for managing both client risk and operational risk within the bank itself. They also intend to provide support to the commercial banks, rather than competition for clients. Our interviews suggest that BDA has full support in this regard from senior officials at BNA, the Ministry of Finance, and the Ministry of Planning.

At the time of our field interviews, BDA was in the advanced stages of planning its strategy and operations; actual financing activities had not yet begun. Their business plan includes several mechanisms for putting the Development Fund to work:

BDA will directly finance projects involving amounts of US\$5 million or more; should a project require funding in excess of BDA's prudential limits for single-client exposure, it can also syndicate the loans with other financial institutions.

For projects involving less than US\$5 million, BDA will lend indirectly by extending credit lines to partner commercial banks, under terms and rules specified in an agreement with each partner bank.

BDA can undertake capital investments, including the purchase of shares, bonds, and emerging market funds. BDA management told the study team that they intend to offer long term financing to the commercial banks, in particular, possibly through bond purchases.

BDA will provide grants to business development service (BDS) organizations to help potential borrowers improve their management skills and financial records in order to qualify for investment financing.

BDA can also offer risk guarantees of up to 90% to the commercial banks.

Initially BDA will focus on financing value chains to develop four priority sectors: maize, beans, cotton and construction materials. These sectors have been selected in accordance with the national development plan's emphasis on food security, rural development, and infrastructure rehabilitation. The Bank is also studying the feasibility of expanding operations to include milk,

¹³ The acronyms stand for Fundo de Desenvolvimento Económico e Social, and Caixa de Crédito Agro-Pecuário, respectively.

animal husbandry and manioc. Notably, BDA officials said nothing about directly financing infrastructure projects, which is a core source of earnings for some successful development banks in other countries.

Only Angolan citizens or companies majority owned by Angolan citizens can access loans from BDA. The loans will be denominated in kwanza for periods of between two to nine years, at a fixed interest rate of 8%. This interest rate has been determined from a build-up covering the cost of funds (net of their fee for managing the Development Fund, operating costs, and anticipated provisions for bad debt. They will also charge an administrative fee of 0.75% to 1.0% for origination of the loan; this is in line with standard practice of the commercial banks (see chapter 4 below).

In view of the weak legal/judicial system in Angola, BDA regards the main form of security for the loans to be the viability of the project to be financed. This is fully appropriate, but it does place a tremendous premium on accurate information and a careful loan appraisal process. On the latter, BDA has benefited from technical assistance and loan analysis software provided by experienced development bankers from Brazil. They plan to share the software with partner commercial banks, and train the bankers in project appraisal methods.

As another sign of commercial realism, BDA told the study team that they expect to encounter only a limited number of loan applications that directly pass the strict tests for viability. But they also expect to see many proposals that could be bankable with further refinements and appropriate business training for the entrepreneurs. This is a major reasons for their plan to allocate a portion of the Development Fund for grants to selected BDS providers.

Lessons from other countries¹⁴

As BDA prepares to carry out its mandate, it is useful to review the experience of state-owned development finance institutions (DFIs) in other countries, to understand the conditions leading to success in some places like Brazil, Peru, and South Africa, and the reasons for failure in many other places. From this review we can draw useful insights about key factors that contribute to the likelihood of success or failure for BDA. At the outset, we want to emphasize that the strategy established by BDA is largely consistent with best practices, though there are points of concern that will be discussed below.

Most accounts of international experience with parastatal DFIs in developing countries dwell on the negatives. The reason is simply that many governments and donor agencies spent decades supporting DFIs that proved to be costly failures, with little or no sustainable impact on development.¹⁵ These institutions were created to fill exactly the same gaps in the financial market for investment financing as exist today in Angola. In some cases, as in Malawi and

¹⁴ Portions of this section and some sections that follow are drawn from material in Nathan Associates (2007), *Financial Sector Constraints on Private Sector Development in Mozambique*.

¹⁵ World Bank, *Making Finance Work for Africa*, 2007, p. 87. (The page number is from a final draft version available at: <http://siteresources.worldbank.org/INTAFRsuma/TPS/Resources/MFWfAFinalNov2.pdf>.)

Liberia, DFIs worked well for several years but later succumbed to poor financial management, political interference, or political risk.

The clearest lesson is that pressures to push money out the door to achieve political aims are a recipe for failure. The same can be said of political interventions in the staffing the DFIs. Conversely, the efficiency incentives associated with commercial lending criteria and high quality human resources are vital success factors.

With these premises in mind, many countries in Africa, including Angola, have recently been seeking to restructure or privatize previously failed development banks, or to establish new ones with modern approaches to governance and management. Nonetheless, there are still serious barriers to success due to the familiar problems of identifying viable investment projects, and controlling risks. Even a DFI that fully appreciates the lessons from past failure has to cope with poor information about client finances and market conditions, an unreliable legal and judicial system to secure creditor rights, lax accounting standards, lack of business acumen among local entrepreneurs, and insufficient equity contributions by business owners. In short, most of constraints that limit investment financing by commercial banks apply equally to term lending by a development bank. It is understandable, then, that in cases like Uganda and Kenya, where former parastatal development banks have been converted to private control, the loan portfolios have shifted away from long term financing to a pattern more typical of a commercial bank.¹⁶

Yet government-owned DFIs in some countries are operating very successfully. One example is the Banco Nacional de Desenvolvimento Econômico e Social (BNDES) in Brazil, which has been providing technical support to BDA. For decades, BNDES was a highly politicized organization that lived on budget subsidies to offset huge losses due to a politically driven mismatch between the cost of funds and the return on concessional loans. Today, despite continued government ownership, BNDES has been transformed into a highly professional, well managed, and financially sound organization.¹⁷ BNDES is one of the biggest banks in Brazil, with nearly \$70 billion dollars in outstanding loans in 2006, including a large portfolio of loans to productive sectors to complement its primary business in financing infrastructure. BNDES also has a stellar bad-debt ratio of under 1 percent, and a return on equity in 2005 of 36.4 percent.

BNDES has been the beneficiary of access to captive savings generated by government social programs, complemented by substantial borrowing in the capital markets. As with most financial intermediaries, these liabilities provide a high degree of leveraging that allows the bank to earn a high return on equity with a low return on total assets.¹⁸ Having access to capital markets also

¹⁶ World Bank, *Making Finance Work for Africa*, draft pp. 88-89.

¹⁷ See: www.bndes.gov.br/english/performance.asp .

¹⁸ Due to leveraging it's equity, BNDES earned this high ROE with a Return on Assets of 3.5%.

provides a vehicle for exiting from investment positions that involve equity or quasi-equity financing.¹⁹

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

Much the same can be said for the Development Bank of Southern Africa (DBSA). As a government-owned institution, the DBSA received sizable budget subsidies for the first ten years of operation. In addition, DBSA's invests primarily in infrastructure projects. Only a small portion of its portfolio is allocated to private sector investments based on conservative criteria that would screen out most locally owned businesses in Angola.

Perhaps a more instructive example is Peru's national development bank, COFIDE. For years, COFIDE was a typically inefficient and politicized parastatal development bank in a relatively poor country. Today, the organization has been re-engineered as a highly efficient second-tier DFI. Keys to success have been top caliber staffing and strong political support for the development new instruments to finance private sector investment, with an emphasis on export-oriented agriculture and SMEs – based on commercial lending criteria. The process of transformation also involved some creative solutions to structural constraints, as outlined in Exhibit 2.1 (next page).

¹⁹ Ironically, one criticism of the old DFI model is that it inhibited the development of capital market by offering subsidized investment financing.

Exhibit 2.1. Keys to success for COFIDE in Peru

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

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

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

The bank has also devised creative mechanisms to solve major problems in financing agriculture and SMEs. COFIDE designed simplified loan products based on market research to determine how clients can best be served. To further reduce costs, COFIDE works with clusters of farmers producing the same crop, so that dozens of loans can be negotiated in parallel. Equally important, COFIDE lends through special purpose trusts that own the assets (including land-use rights) until the loan is paid. If a recipient infringes on loan conditions, the trust can transfer the assets to another producer without recourse to the judicial system. COFIDE also maintains a queue of willing borrowers to whom assets can be transferred; this means that there is no need to find a secondary market to realize the value of the collateral.

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

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

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

Source: COFIDE website, and personal communications with Daniel Schydrowsky, former head of COFIDE, and Juan Carlos Mathews, former head of Peru’s Export Promotion Agency, January 2007.

Applying the lessons to BDA

Interestingly, the three “good examples” cited above – BNDES, DBSA, and COFIDE – are all state-owned development banks. Successful examples can also be found in other parts of the world, such as the Bank for Agriculture and Agricultural Cooperatives (BAAC) in Thailand. This shows that state-owned DFIs can be run profitably and effectively under the right circumstances. Even so, the fact that most parastatal DFIs in lower income countries sub-Saharan Africa have failed financially, and as agents of development, poses a clear challenge for the management of BDA in Angola.

BDA is on solid ground in emphasizing an approach that is commercially driven, including “second-floor” lending through partner commercial banks. This structure can go some way in insulating the organization from potential political interference in lending decisions, and creating a built-in demand for careful loan appraisal and commercial returns. It also holds down staffing costs and physical infrastructure costs at BDA, and generates scale economies. In addition, working in partnership with the banks, BDA can help other bankers learn to appraise projects and overcome some of the information problems that otherwise inhibit investment finance.

Angola also has an important advantage over many African countries in that the economy is experiencing rapid growth due to the oil boom, post-war reconstruction spending, and demands from rising consumer income. For target supply chains involving agriculture, however, the oil boom can be a mixed blessing because of its effect on the real exchange rate and competitiveness of domestic production activities. This point underscores the importance of applying careful investment appraisal methods to screen out projects that are not viable, even though they may align with political priorities.

Another clear advantage for BDA is its access to the government’s huge Development Fund, at a favorable cost. Our understanding is that the net cost of these funds to BDA, at least initially, will be 3.75%, based on a gross cost of 7.5% less as a fee of 3.75% for serving as fund manager. The gross figure of 7.5% is comparable to the Treasury’s actual cost of funds on recent domestic bond issues, though these rates are not market-driven (see chapter 5). In effect, the Government wants BDA to intermediate a portion of the country’s earnings from depletion of natural resource wealth and convert it into productive capital investment. This is a sensible policy as long as the intermediation activity succeeds in applying the funds to productive investment, and screening out wasteful and unsustainable projects.

Areas of concern

Alongside the strengths of the BDA business model, we see several areas of concern, which suggest recommendations for possibly improving the development outcomes.

The scope for viable investment financing. The foremost concern is that there may not be a sufficient scope for viable investment in the target value chains to absorb BDA’s rapidly growing Development Fund and cover the cost of running the institution. As noted earlier, underlying weaknesses in the business climate affect the scope for investment financing by a development

bank just as much as they affect the commercial banks. The problems include deficient infrastructure, poor information on client finances, lack of management skills, weak legal support for creditors rights, and the possible loss of competitiveness in some productive sectors due to the strong kwanza. This concern again underscores the need for careful project appraisal.

Commercial standards and political priorities. If many of the prospective borrowers fail to qualify for financing without further management training – as is likely when careful appraisal standards meet the Angolan context – then tensions will grow between BDA’s commitment to risk control and the government’s interest in moving the money – especially in the run-up to elections in 2008 and 2009. In short, there is a danger that political realities will over-ride BDA’s excellent intentions. One way to avoid this risk is for BDA to anticipate the problem and find other productive uses for the Development Fund, such as infrastructure financing (like BNDES and DBSA) or providing long-term funding to the commercial banks for lending that is not restricted to activities designated as priorities by the government.

Scale economies and diversification. The successful parastatal DFIs cited above operate in countries with large and diversified markets. These conditions provide the benefit of scale economies to hold down costs, and portfolio diversification to mitigate risks. BDA cannot easily reap these benefits by investing in Angola alone. This observation suggests that BDA should consider participating in regional consortia in collaboration with DBSA or other institutions.

Support vs competition for commercial banks. All of the parties interviewed by the study team indicated that they expect BDA to be supporting the development of commercial banks, and not competing with them. The problem with this view is that commercial banks are already active in medium-term financing, especially for clients with business prospects strong enough to pass BDA’s appraisal standards. Hence there is a considerable risk of direct competition between the government-funded development bank and the commercial banks. This can be largely avoided if BDA were to focus on longer maturities, say 5 to 15 years, instead of targeting loans of 2 to 9 years as planned. BDA could further reduce the potential for competition against the commercial banks by shifting to a greater emphasis on second-tier lending. This implies reducing BDA’s role in direct lending and expanding the use of Development Fund resources for lending through the commercial banks, as well as providing long-term financing for the banks themselves. This approach will simultaneously ease the maturity mismatch problem faced by the commercial banks as a major constraint on term lending (see above).

Lending terms that preclude SMEs. BDA plans to charge a fixed rate of 8% on its loans, including those that will be channeled through the commercial banks. The indicated rate is based on a calculation of expected costs. This calculation cannot possibly be taking into account the fact that transactions costs are much higher, per unit of loan value, on small loans. The plan further calls for commercial banks to handle loans below US\$5 million. But with the interest rate capped at 8%, they will have no incentive to offer loans to SMEs, even those in the priority value chains. The fixed interest rate is certainly not intended to preclude lending of Development Fund resources to SMEs, but that will almost surely be the effect. To avoid this

difficulty, BDA should adopt a more flexible pricing policy that reflects the actual costs of administering loans to smaller and riskier borrowers.

Negative real interest rates (in kwanza). Offering financing at 8% in an environment with 12% inflation means that real interest rate will be negative in kwanza terms. The main concern is that negative real interest rates allow investment proposals to pass the test of *financial* viability even when they are not *economically* viable. The effect is to invite a misallocation of Development Fund resources, and diminish the economy's growth potential. A simple example can illustrate the point: a project with zero productivity, such as buying and holding idle inventory stocks, will generate enough revenue to repay an 8% loan and yield a positive financial rate of return if prices are rising by 12% per year, even though it is a waste of Fund resources. This problem is best resolved by reducing inflation. But BDA can address the issue directly by charging an interest rate at least two to three points higher than the inflation rate, preferably with adjustable terms. Second, if the interest rate remains at 8%, BDA ensure that its loans are used for *productive* purposes by appraising both the *economic* and financial rates of return on project proposals. To implement this approach, however, BDA would need professional economists on staff or on hire.

Other avenues for development banking

BDA is likely to be the dominant source of long-term financing for domestic enterprises in Angola, especially if it is allowed more latitude in the range of activities that it can finance, either directly or indirectly. It is worth noting, though, that other sources of long-term financing can also play a role. Larger enterprises may be able to source offshore funding directly, while project finance may be available from other established development banks such as DBSA, which is active throughout the region. According to a statement by the chairman of DBSA in 2004, 'We have a serious commitment to invest in Angola and participate in the development of Angola and the southern region. We are going to invest in infrastructure, like water, electricity, railways, highways, bridges, telecommunications and other areas that are government priorities.'²⁰ A regional institution such as DBSA actually has considerable advantages in terms of scale economies, scope for portfolio diversification, and access to top quality technical staff. As noted above, BDA should explore ways to tap into these advantages by seeking partnership deals with DBSA.

Yet other options may emerge in the future. One extremely interesting example is the possibility of private parties establishing a regional DFI dedicated to extending loans to smaller businesses. Exhibit 2.2 presents a fascinating case in point: the Latin American Agribusiness Development Corporation.

²⁰ Source: http://www.angola.org.uk/pdf/newsletter_93.pdf.

Exhibit 2.2. The Latin American Agribusiness Development Corporation

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

LAADC provides medium and long term loans in the range US\$200,000 to US\$3 million for small and medium sized agricultural businesses, mainly for export. Loans are extended to finance investment in agriculture production and processing, often packaged with funds for long-term working capital, debt restructuring, and vertical integration. The current portfolio totals US\$197.8 million in loans involving 344 projects in 16 countries. Banana production and marketing accounts for 10.4% of the portfolio; other major sectors include coffee (5.6%), soyabeans (9.7%) and roses (5.8%). Most loan applications are processed in four to eight weeks. Remarkably, the bank does this with a full-time staff of just 44 people, with a head office in Florida and seven regional offices.

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

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

The creation a regional DFI modeled after LAADC for southern Africa is entirely a matter for the private sector to decide. We mention it here simply to stimulate discussion among potential investors.

Recommendations

The analysis in this section leads to several recommendations for consideration by BDA, BNA, and the Government.

Recommendation: *BDA should emphasize second-tier financing through commercial banks, and long-term quasi-equity financing of commercial banks, as preferred uses of the Development Fund, to minimize competition with the commercial banks and the risk of political interference in lending decisions.*

Recommendation: *Focus BDA financing on term loans of 5 to 15 years, rather than 2 to 9 years as planned, again to minimize direct competition with the commercial banks.*

Recommendation: *Allow BDA to use the Development Fund for infrastructure financing, so BDA can effectively deploy the rapidly growing pool of resources without compromising lending standards.*

Recommendation: *Allow BDA to participate in regional consortium financing in collaboration with DBSA or other institutions, for the same reason as above.*

Recommendation: Adopt a flexible interest rate policy that will reflect the actual costs of administering loans to smaller and riskier borrowers. Otherwise, the fixed interest rate may cause partner banks to avoid lending to SMEs.

Recommendation: Consider setting the interest rate at least two to three points higher than the inflation rate so that the price mechanism itself will help to screen out wasteful projects.

Recommendation: Include an appraisal of both the economic and financial rates of return in the loan screening process to ensure that BDA funds are used for efficient investments. This is especially important if the real interest rate on kwanza loans is negative.

Developing the capital market

The banking industry, of course, is not the only possible source of term financing for domestic enterprises in Angola. This section examines the newly created stock exchange as another potentially important avenue for term financing, at least for major corporations. The following section adds a brief discussion on leasing and venture capital as further alternatives for term financing.

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

Yet commercial banks still dominate the financial system in most developing countries. With few exceptions (such as Kenya and Zimbabwe), capital markets in Africa have not been a significant source of direct financing for the private sector (Exhibit 2.3). The stock and bond exchanges generally serve only a handful of large, prime grade borrowers. Even in Latin America, with few exceptions (such as Chile and Brazil), capital markets are still poorly developed after decades of gradual expansion.²¹ In many countries, commercial banks are among the earliest entities tapping funds through the capital market. Where this occurs, the capital markets have a much broader *indirect* impact by channeling long-term savings to commercial banks to expand the supply of funds for term lending.

²¹ Barbara Stallings and Rogerio Studart (2006), *Finance for Development: Latin America in Comparative Perspective*. Washington. The Brookings Institution and the United Nations Economic Commission for Latin America and the Caribbean. Stallings and Studart attribute the slow progress to the lack of strong institutions to support financial market transactions.

Exhibit 2.3 Stock Markets in Sub-Saharan Africa

"Africa has caught stock-market fever. The continent now has no less than 15 stock exchanges." As Todd Moss reports in his recent book on *Adventure Capitalism; Globalization and the Political Economy of Stock Markets in Africa*, most of these stock markets, with the exception of Johannesburg, have very little volume, require high government subsidies, and have done little to mobilize foreign or domestic investment or channel it more efficiently. The histories vary – some go back to colonial times, most are very recent; most were established on government initiative at least partly for political reasons – but the results are all very similar.

Moss concludes that "Stock markets have the potential to make positive contributions to African development, but only under certain macroeconomic and political conditions." In fact, one of the arguments for creating a capital market is to put pressure on the government for better macroeconomic policies and more transparent governance.

The African proliferation of stock markets goes against the trend of international consolidation. Various efforts are afoot to create common regional markets, though so far they have been impeded by technical and political concerns. The East Africa exchanges which have been relatively active have been increasing their cooperation and extent of cross listing.

In any case, Africa overall receives only a tiny fraction of international portfolio investment. At the end of 2005, investments in global emerging market (GEM) funds totaled some US\$95 billion, of which a mere US\$28 million is held in Africa's 'frontier' markets, i.e. excluding South Africa. Moss suggests that the reason for this neglect is because the markets are too illiquid and the listed companies too small to interest international investors. From international experience, it appears that fund managers typically look only markets with capitalization of at least US\$50 billion and an annual turnover of US\$10 billion. For Africa's 14 'frontier' markets, the combined trading in 2004 was US\$2.4 billion. In 2005, trading in Nigeria amounted to US\$1.9 billion, but nine African markets did less than US\$50 million of trading and six had less than US\$15 million.

To date, companies in Angola have had virtually no recourse to long term financing by issuing bonds or stocks to the public. Even the market for private placements, which one might expect to flourish under these circumstances, has been all but moribund. Presumably, this is due to fundamental factors such as the absence of audited financial statements even for most large companies, a lack of long-term savings from pension and insurance funds (see below), and booming returns in the real estate market.

To begin the process of capital market development, the Government passed a Capital Markets Act in 2006, establishing a national stock exchange, the *Bolsa de Valores e Derivativos de Angola* (BVDA). The Act also established a Capital Markets Commission (CMC) as the regulatory authority for the stock exchange and related financial service providers such as brokers, traders, and mutual fund managers. Senior managers for the BVDA and the CMC have been appointed and plans are well advanced for completing the regulatory framework according

to international standards, and opening the stock exchange in 2008. BVDA management is already in the process of creating an electronic trading system, developing plans for an impressive new physical venue, and soliciting expressions of interest from both borrowers and lenders. They are also providing basic training to staff and interested market participants through a new Capital Markets Training Institute (IFMC), with courses offered by faculty from many partner countries. At the time of our interviews, 156 people were already enrolled in broker-dealer training. BVDA and CMC are also sending staff on study tours to Brazil, Portugal, South Africa, the United States, Spain, and Mozambique. It would be very useful to include tours to more countries in Africa where capital markets have not been successful. In addition, the Bolsa has already initiated an information campaign to educate the public about capital markets.

In short, both the Bolsa and the CMC are systematically putting in place the essential building blocks for opening the market. But the prospects for success hinge on the actual supply and demand for securities in Angola.

The supply side

On the supply side, experience in other African countries suggests that the market is likely to start very slowly with only a few firms testing the waters. If the early listings succeed, then other firms would increasingly view the stock and bond market as a viable source of medium to long term financing.

BVDA management anticipates that about ten qualified companies will initially issue stocks on the Bolsa to raise capital and broaden their shareholder base. Some informed sources felt that this is a realistic expectation, though one expert expressed doubts on grounds that few companies will want to open their books to public scrutiny to satisfy the disclosure requirements for a listing. This argument does not apply, however, to local subsidiaries of international companies that are already subject to strict disclosure requirements through the listing of parent companies in other markets. Similarly, banks may be strong candidates for early listing because they are already subject to independent examination and scrutiny through the banking supervision process. Time will tell.

Without question, the government should help to jump start the market by offering shares in major parastatal corporations to the public. In addition, the government should seed the bond market by offering at least a portion of new Treasury Obligation (OT) issues through the Bolsa in kwanza and at market determined rates (see chapter 5).

Government bond issues are important not only to stimulate trading and develop the market infrastructure, but also to establish reference rates for the pricing of other securities. The pricing decisions are critical. If the cost of raising capital through the Bolsa is very high, then the supply of securities for sale will not materialize. The cost will depend on the quality of the respective securities, the extent of demand; and the transactions costs involved in bringing securities to the market.

To overcome the constraint on market listings imposed by strict disclosure standards, the World Bank has begun to advocate what might be called a “caveat emptor” approach. As explained in a recent Bank publication:

“too much emphasis has been placed ... on building costly regulatory regimes designed to ensure a high level of protection for the retail customer in the secondary market.... Market architecture should be chosen on the basis of local needs and capacities. It may well be, then, that for most African firms, they would be better served by a lighter regulatory approach.”²²

The idea is that listing requirements can be reduced for a “second board” market, and market forces will then establish an appropriate risk premium in pricing the securities.

BDVA is cognizant of this innovative approach to capital market development, and has plans to introduce a less regulated second board for riskier issues. As long as securities on this level are priced to deliver an attractive risk-adjusted yield, they are likely to attract funds. Here again, the pricing may be a critical problem. If the cost of raising funds this way may be too high to interest local companies in using the market to finance investment. And even with lighter disclosure requirements, it remains to be seen whether local businesses are willing to open their books to public view. This market experiment is well worth undertaking, but it remains to be seen whether it can succeed in Angola in the short to medium run.

The demand side

Turning to the demand side, there are two good reasons to expect that initial listings will be successful – assuming that they involve high quality companies. First, with the economy growing so rapidly, many companies and individuals are accumulating wealth rapidly. Yet they face extremely poor returns on deposit accounts, and an acute lack of opportunities for medium and long term investment. Essentially the only outlet for longer term investment has been real estate, and these prices are now extremely high. In any case, serious investors prefer to diversify their portfolios into a range of productive investments rather than concentrating their asset holdings in real estate.

A second major factor is rapid growth of the newly sources of long-term saving, primarily in pension and insurance funds (see below). In addition, as noted above, the BDA has the option of investing the government’s Development Fund in stocks and bonds. The financing of major corporations is not a priority for BDA, but it may be an appropriate use of Fund resources that would otherwise be idle, assuming that the investments pass the test of due diligence and offer an attractive yield.

Foreign investors will probably not be major players at the outset due to exchange controls. BDVA itself is placing no restrictions on foreign investment, but the market is bound by BNA regulations. Even if BNA chooses to relax these controls, it may still decide to restrict

²² World Bank, *MFWFA*, draft, November 2006, pp.94-95

international “hot money” investments, to minimize the risk of exchange rate volatility. Foreign investors, in any case, have not been active participants in most African stock exchanges due to the small size of the listings, inadequate liquidity in the market, uncertainties about the quality of financial disclosures, and doubts about corporate governance. The last two considerations favor venture capital investments, which will be discussed below.

If the foreign exchange controls would permit, BVDA could broaden the demand for local securities by entering into co-operative agreements with the Johannesburg Stock Exchange that will allow dual listings on both exchanges, as well as the exchanges in Botswana and Namibia.

Transactions costs

Another factor that will strongly affect the extent of market participation is the cost of trading. The government and BVDA have decided on a high-cost approach involving high administrative overhead, an expensive physical venue, sophisticated information technology, and an extensive trading program. Since the initial volume of listings is likely to be small, and secondary market activity light, the unit cost of issuing and trading securities would have to be extraordinarily high to cover all of these expenses. Hence, the government surely have to absorb most of the costs through subsidies to BVDA, probably for many years to come. The question is: How large will the subsidy be, and how high the fees imposed on market participants? If the fees for listing and trading are too high, they could be prohibitive constraint on development of the market.

The study team recognizes that the basic decisions affecting the cost structure have already been made and are probably irreversible. Nonetheless, we wish to flag the issue because the government has an important decision to make about the extent of the subsidy. Also, there will be many points in the future when choice will be made that either increase or decrease the costs of operating the exchange and undertaking trades.

To put this in an international perspective, the African countries that have reasonably well developed stock exchanges today typically started out with a low-cost approach involving a small number of private dealers handling over the counter trades. Only as the market volume expanded did they establish more formal and costly trading systems.²³ Conversely, many of the unsuccessful stock exchanges have begun with a high-cost structure that ended up as an impediment to market development (especially in countries where the government cannot afford to sustain heavy subsidies).

Implications for the development of the capital market

This discussion of capital market development in Angola is more descriptive than prescriptive, but several recommendations emerge from the analysis for consideration by the Government, the CMC, and the BVDA:

²³ Even the New York Stock Exchange in the United States worked as an informal network of traders who met under a buttonwood tree for 25 years before being formally registered, and then operated out of a single room for decades. See: http://en.wikipedia.org/wiki/New_York_Stock_Exchange.

Recommendation: Prepare public offerings of shares in major state-owned enterprises, to help jump-start the stock market.

Recommendation: Channel at least a portion of new Treasury Obligation issues through the BVDA, in kwanza terms, and at market prices, in order to stimulate development of the bond market and establish reference rates for the pricing of other securities (see chapter 5).

Recommendation: Consider negotiating an agreement with the Johannesburg Stock Exchange to allow joint listing of Angolan securities.

Recommendation: Set listing and trading fees at a level that will not preclude development of the market, even though this will require heavy subsidies from the Treasury for years to come.

Recommendation: Wherever possible seek low-cost options for market development in order to minimize the required subsidy.

Other channels for term financing

Two other avenues for term finance – leasing and venture capital– warrant attention, even though they are not important factors in Angola at this time.

Leasing finance

Leasing is a form of asset-backed term financing in which the lessor (in effect, the lender) grants to the lessee (the borrower) the use of a moveable or immovable asset in exchange for specified payments that cover the cost of funds tied up in the asset. The lessor continues to own the asset for the duration of the contract. Often the lessee has the option to purchase the asset at the expiration of the lease, at a price determined by terms of the contract. In most economies, banks are not directly involved in leasing because the retention of asset ownership involves management problems that they prefer to avoid. Hence, leasing companies typically compete with the banks, and offer clients an additional option for financing the acquisition of capital goods.

The advantage of a leasing contract is that the lessor faces no legal problems in repossessing an asset if the lessee defaults on payments, because the lessor retains ownership. Therefore, the asset itself serves as the security for the financial contract, and no other collateral is required. Furthermore, lease payments are less onerous than loan payments as a claim on cash flow, because they involve no amortization of principal. As a result, leasing can be a viable option for enterprises of all sizes, as well as individuals who can demonstrate the financial capacity to meet the lease payments.

Leasing is not currently practiced in Angola, though it has been authorized under the Financial Institutions Law of 2005.²⁴ The current barrier is the regulations required to implement this

²⁴ Law nr. 13/05 of September 30, Articles 4(g) and 5 (d).

provision of the law have not yet been finalized. BNA expects that this will be completed soon, with technical support from the FIRST Initiative.

Under the law, leasing companies, as such, cannot take deposits. This limits their ability to mobilize funds and, hence, extend the market for leasing financing. However, registered banks can also conduct a leasing operation, and they are not restricted in mobilizing deposit funds. Given the serious problems involved in attaching and foreclosing collateral in Angola, it would make sense for banks to exploit this opportunity for asset-based financing. The terms of the leasing can easily be designed to cover the cost of managing the physical assets as necessary.

Even with a regulatory framework in place, experience in other developing country suggests that leasing finance will be constrained by the absence of a secondary market for most assets other than vehicles, and perhaps construction equipment. For lack of this market, it is very difficult for a leasing company to realize the value of an asset that is repossessed or returned at the end of a contract. Similarly, the lack of secondary market reference price makes it more difficult for the lessor to establish a fair contract value should the lessee choose to purchase the asset at the end of the contract period.

There are several private-sector approaches for overcoming this constraint. Some equipment suppliers or manufacturers, for example in the construction industry, can use bank financing to extend leasing finance themselves to their customers. In this case, the lessor has the capability to value and sell used assets.

As a variation on this theme, some heavy equipment suppliers are open to discussing 'buy back' agreements with leasing finance entities. Under these agreements the supplier agrees to repurchase the equipment in the event of default on the lease contract and pay the financier a percentage of the value. The repurchase payment depends on the time elapsed since the equipment was supplied. For example they may guarantee a payment of 60% of the original value if default occurs within the first 12 months, 50% for a default within 24 months, and 40% up to 36 months.

As another device for recovering asset value, certain international insurers are prepared to grant 'return of plant cover' to suppliers and financiers of heavy equipment. Under this arrangement the insurance company will, in the case of default, insure the cost of getting the equipment to a location where it can be sold on an active secondary market.

Leasing companies can also create their own implicit secondary market by working with clusters of clients who have similar procurement needs. For example, suppose 30 small commercial farmers in a district are interested in buying pumps, water tanks, spraying equipment, or even irrigation pipes and tractors. The finance company could approve lease contracts with the best 20 clients and hold the others in a queue to receive any assets that may be repossessed, on appropriate lease terms.²⁵

²⁵ Refer to Exhibit 2.1 for a successful example of this technique in Peru.

Yet another consideration is that leasing finance in some countries is constrained by unfavorable tax treatment of this kind of contract. This issue requires an assessment by a specialist with knowledge of both the leasing regulations and relevant aspects of the tax law.

Recommendation. *Fast-track the drafting and approval of leasing regulations.*

Recommendation. *Solicit expert opinion to ensure that the tax laws do not create a cost disadvantage for leasing transactions.*

Recommendation: *Explore innovative ways to solve the secondary market constraint to asset-based lending.*

“Doing deals” to obtain private risk capital

In January, 2007, Citigroup and the Commonwealth Development Corporation (CDC) announced the creation of a \$200 million venture capital fund for Africa.²⁶ Also this year, African telecom pioneer Mohammed Ibrahim established a \$150 million fund for investment in African businesses. These are just two signs of a sea-change taking place in the international market for risk capital.²⁷

By all indications, huge sums of risk capital will be seeking high-potential investments in Africa over next 5 to 10 years. At the same time, most domestic enterprises in Angola have no access to long-term financing for productive capital investments. Will Angolan firms be in a position, to any significant extent, to attract risk capital financing as a source of growth?

The main theme arising from our field interviews for this study is that the problem stems as much from the lack of capacity on the part of the entrepreneurs as in the lack of available funds. Venture capitalist seek projects that are risky, but also promise a high rate of return so that investments that succeed can compensate for those that do not. Hence, they look for businesses with excellent technical capabilities, high potential for growth and profitability, strong leadership, and good management. Very few Angolan businesses can satisfy these criteria, without extensive technical support.

Given these constraints, venture capital funds are unlikely to be a significant source of investment finance in Angola without a program funded by the Government (perhaps through BDA) or by donors to prime the pump by providing the necessary technical assistance to high-potential local businesses. Exhibit 2.5 provides an example from Egypt of how donor support can help to broker deals by bridging the gap between the capabilities of local enterprises and the requirements of risk capital managers. The objective of this assistance was not only to help the immediate clients, but also to help other businesses understand what is needed to access

²⁶ See: www.southafrica.info/africa/citigroup-160107.htm.

²⁷ We use the term “risk capital” to mean private financing deals through which third parties invest in high-potential enterprises that are too risky to obtain financing through organized securities markets or commercial bank loans. “Venture capital” deals generally involve equity positions, but deals can also involve private bond placements, quasi-equity instruments (bonds with a yield that depends on profits), or other variations on the theme – or combinations of all these elements.

risk capital, and to develop organizations that can provide business support services on a commercial basis beyond the life of the project.

Exhibit 2.5 Nurturing Access to Risk Capital in Egypt

A recently completed USAID -funded project supporting the Information and Communications Technology sector in Egypt had a novel feature in that the consulting team consists of investment bankers and accountants rather than IT experts. The reason: the project objective was to help Egyptian ICT firms raise debt and equity financing.

The project team began by applying an *investor-sensitive* tool to identify IT firms with excellent technical skills and strong market potential. The consultants then identified suitable sources of investment funding in the region. Once a deal came into view, the project undertook a preliminary "due diligence" of the prospective investee and recommended measures to improve their marketability to investors. In nearly every case, the target firms needed extensive support to strengthen financial controls and improve business management. The project then assisted the firms in preparing business plans and in negotiating and closing the deal. Notably, the project benefited from a separate Egyptian program to aggressively promote the high level of capacity and cost advantages of local ICT firms.

The project also created a demonstration effect to foster a broader market for equity and debt deals serving small and medium-sized businesses in Egypt. If it only helped a handful of direct clients, the project costs would likely have exceeded the benefits.

The head of the project, Scott Jazyuka, has worked extensively in southern Africa, and believes that the process used in Egypt can work in this part of the world. The important thing is find the right niche in terms of both the local business enterprise and the sources of investment financing.

Source: Interviews and personal communications with Scott Jazyuka, December 2006, January, 2007 and June 2007.

Another key constraint is the cost of arranging a venture capital deal. For example, the World Bank's International Finance Corporation arm (IFC) offers not only financing, but also technical advice on business management, feasibility studies and diagnostic reviews, market research, and environmental, health and safety issues. For small investments, the cost of doing a deal like this can be prohibitive. There are, however, examples in the region of creative methods to minimize the cost of equity and quasi-equity investments in small and medium sized businesses on fully commercial terms, including the cost of concomitant technical assistance.²⁸

Ultimately, risk capital is not a cheap source of financing. Venture funds often seek a real rate of return of 25 to 30 percent, sometimes more, reflecting risks and opportunity costs. Multilateral funds may accept lower returns, but even then the cost of funds is high compared a bank loan.

²⁸ This passage is based on the work of Business Partners in South Africa. Since 1981 this company has undertaken more than 30,000 investments in South Africa, creating an estimated 480,000 jobs on investments totaling ZAR 7.4 billion (for an average of ZAR 480,000). See: <http://www.businesspartners.co.za/>

But there are also important advantages. First, venture capitalists often provide direct management support in addition to funding. Indeed, this is often a condition of the funding. Also, equity or quasi-equity financing does not create a fixed obligation for the entrepreneur, as does a loan. The investor reaps large gains only if the company does so as well.

Recommendation: *Establish a demonstration program of technical support to help selected local businesses qualify for venture capital finance, funded by either the government or a donor.*

Mobilizing long-term savings

One of the most serious constraints to the expansion of term financing in Angola is the very limited supply of long-term domestic savings, other than the Government's Development Fund in the hands of BDA (which is why we place an emphasis above on broadening the options for management of this Fund). Within the private sector, most of the long-term saving is either being used directly as self-finance from business retained earnings, or for investment in the booming real estate market. These forms of saving by-pass the financial institutions and therefore do not contribute to the supply of term finance through the financial system. As discussed above, the opening of the capital market is likely to pull some of these resources into the financial system, though only a small group of elite companies will benefit in the early years.

The most exciting development on the supply side of the equation for term financing is the rapid growth in pension and insurance funds. In many developing countries these two contractual savings industries are a principal source of what the World Bank calls "patient capital." This is partly because the demographic structure is very youthful, which generates rapid growth in the funds under management, and also because these industries have longer-term liabilities to customers that they need to match with long-term assets.

Pension and insurance plans in Angola date back to the period after World War I. However, with national Independence in 1975, these Portuguese companies were nationalized and private sector activity in both industries collapsed. In 1998 the Government established a new Insurance Supervision Institute (the *Instituto de Supervisao de Seguros*, or ISS) under the Ministry of Finance to regulate both pension funds and the insurance market, and in 2001 ended the former monopoly privileges of the state-owned *Empresa Nacional de Seguros de Angola* (ENSA). These reforms mark the beginning of a resurgence in both industries that is now gaining strength.

In the insurance sector, there are now 6 companies, of which 4 also handle pension plans. Total insurance premiums paid in 2005 amounted to US\$362 million (latest data). The ISS expects this figure to top the US\$1 billion mark within three to five years. This rapid growth will be driven in part by the underlying strength of the economy, but also by a new requirement introduced in 2006 for companies to provide employees with workers' compensation coverage. Another surge will occur if the government introduces compulsory third party automobile insurance. This issue is under discussion, and a decision is expected soon.

Normally, one thinks of life insurance as the primary source of long-term savings in this industry. In Angola, the market for life coverage is still tiny, and unlikely to be a source of any significant

asset accumulation in the foreseeable future. Nonetheless, the ISS Director told the study team that insurance companies are required by law to set aside a designated portion of their annual premium income in a prudential reserve against future liability claims. This fund will grow rapidly in step with the overall amount of coverage. Insurance companies are likely to seek medium to long term assets in which to invest at least a sizeable fraction of the reserve funds, since the probability of a sharp decline in the fund balance is extremely low (especially when most risks are reinsured). Presently much of this money is being placed abroad.

AAA Seguros & Pensões is the country's largest private-sector insurer, and also the largest pension manager. AAA currently manages assets for 12 pension plans, of which 9 are closed corporate funds and 3 are open funds. The largest corporate plans are for employees of Sonangol and the Port of Luanda. At the end of 2006 AAA was managing US\$221 million of pension assets. As of September, 2007, AAA was anticipating an increase in the number of pension funds under management to 17 by year end, and an increase in assets under management to as much as \$400 million within three years. Yet AAA estimates that the industry has penetrated less than 2% of the eventual market.

Most existing funds are defined contribution plans. The one exception is a defined benefit plan for a state-owned enterprise. All of the plans are denominated in dollars, which creates a significant exchange rate risk.

Opportunities for investing these pension funds in Angola are very limited, with the bulk of the domestic assets being held in real estate (including AAA headquarters) and government bonds. The absence of more diversified investments creates a serious problem of risk management, especially because the law restricts the share of assets that can be held off-shore. Not surprisingly, AAA is keenly looking forward to the opening of the stock exchange to expand the menu of assets for longer term investment.

Insurance and pension companies like AAA have to purchase government bonds through the commercial banks, because BNA permits only the banks to bid in the primary market. This restriction reduces the yield to AAA by 0.5% to 1.0%, which is an enormous cost considering that the bonds yield less than 8% (see chapter 5). There is no compelling reason for this restrictive policy, which amounts to a tax on one type of financial institution, the insurance companies, for the benefit of another, the banks. The insurance industry is also beset by stamp duties that as much as 5% to the price of a policy, depending on the type of insurance.²⁹ Both of these burdens should be eliminated in the interests of financial sector development.

But there is a much deeper problem with the structure of the pension system in Angola, involving the government-run national social security system program, the INSS (*Instituto Nacional de Segurança Social*). This national program is a traditional pay-as-you-go (PAYG) scheme, with benefit payouts each year being financed by a payroll tax of 11%, of which 8% is

²⁹ See chapter 6 for further discussion of the stamp duty as a cost factor for the commercial banks.

paid by the employer and 3% by the employee.³⁰ As a result of the PAYG structure, the INSS accumulates very little long term saving in the form of a national pension fund.

While it is entirely appropriate for the disability, illness, and safety net benefits of the INSS to operate on a PAYG basis, the international best practice for the pension element is to scrap the PAYG system in favor of a mandatory saving scheme in which contributions accumulate in pension accounts to fund future benefits for each worker. This fundamental reform can make an enormous contribution to domestic savings and development of the capital markets. The idea is not at all novel. Singapore and Malaysia have run mandatory saving schemes for decades through government managed funds; in Chile and several other Latin American countries, similar systems have run for decades through private sector management of the funds.

Converting to a funded pension system is a complex task that requires intricate planning and careful sequencing. The scheme requires a strong legal and regulatory framework, highly capable management, and a firewall to prevent misuse of the accumulated funds for political purposes. Most important of all, the plan requires a prudent a blue-chip strategy for domestic and international investment to protect the value of the rapidly growing pool of capital and deliver a sufficient rate of return to secure future pension benefits. In general, the best time to shift to a funded system is when the carry-over of PAYG liabilities are relatively small; the labor force is very young; and donor support can be found to provide technical assistance and cover transitional costs.

Botswana provides an excellent example of a successful conversion from a PAYG system to a funded plan, with the government covering the transition costs over a three year period out of its accumulated savings derived from mineral earnings. According to Dr. Keith Jefferis, former Deputy Governor of the Bank of Botswana, this measure has helped to transform the capital markets by greatly expanding the supply of long-term savings. He cautions, however, that a rapid scale-up of local investments by funded pension plans can lead to a dangerous bubble in property and share prices, particularly when the supply of local assets is limited. A generous allowance for offshore investment by pension funds and life insurance companies may be needed to reduce such bubble tendencies. In the case of Botswana, these funds are allowed to place up to 70% of their investments offshore.

These observations on the insurance and pension industries suggest the following recommendations:

Recommendation: *Allow qualified insurance companies and pension schemes to participate in the primary market for TBCs and OTs (and Treasury bills, as well, if the government would issue them again).*

Recommendation: *Eliminate the stamp duty on insurance services, to remove an unnecessary and distortionary extra cost factor (see chapter 4 regarding stamp duty on banking services).*

³⁰ Economists generally conclude that the full amount of the payroll tax is actually borne by the workers, through equilibrium adjustments in the wage rate that compensate for the portion paid by the employer.

Recommendation: *Seriously consider fundamental reform of the national pension system to replace the pay-as-you-go structure with a system of funded personal accounts, while retaining the safety-net benefits of the present system.*

Recommendation: *Encourage competition in the insurance industry to promote innovation and efficient pricing, while adhering to strict prudential standards to ensure that insurance companies are financially sound and professionally managed.*

Recommendation: *Above all, continue pursuing a full range of market-supporting reforms and reconstruction measures to improve the overall business environment. To the extent that opportunities for private sector growth are limited by a weak investment climate, so will be the impact of any initiatives to improve access to term finance.*

Chapter 3. Improving Access to Finance by Small and Medium Enterprises

This chapter addresses a central problem for financial sector development in Angola: the need to expand access to finance for tens of thousands of small and medium enterprises (SMEs) throughout the country. Traditionally, commercial banks in Angola have catered to a few hundred major companies and to wealthy individuals at the top of the economic pyramid, and neglected the needs of most SMEs. This dichotomy has persisted even as Angola has achieved strong economic growth led by a booming petroleum sector, with effective macroeconomic stabilization policies, and active post-conflict reconstruction efforts. Despite these gains, SME access to credit through the formal financial sector remains very limited. Yet the SME segment of the economy is critical for achieving broad-based growth, more widespread gains in income, and more rapid employment creation.

Faced with growing competition at the top end of the market, several banks are now moving in the direction of providing more services to the SME market. Yet there is a glaring gap between the financing needs of these local enterprises and the legitimate need of the banks to control the risks and costs involved in dealing with smaller and less sophisticated clients. Serious structural constraints impede lending to SMEs, including the limited capabilities of the entrepreneurs themselves, and fundamental problems with the enabling environment to support the growth of small and medium enterprises. There are also problems on the side of the banks, which need to adapt their lending practices and overcome information problems in order to deal profitably with this new segment of the market.

The present chapter examines the problem of access to finance for SMEs, and the availability of business development services (BDS) to support the growth of viable and bankable SMEs in Angola. The analysis takes into account both the prevailing post-conflict conditions in Angola and major lessons from international experience. Section 1 defines SMEs and explains their importance to economic development. Section 2 discusses characteristics of the SME sector in Angola, and the limited availability of credit and BDS. Section 3 outlines the major constraints that limit access to credit for SMEs, in three categories: problems with the business environment; with the Banks; and with the capabilities of SMEs themselves. Section 4 then reviews international lessons for SME lending, leading to 20 recommendations for consideration. Finally, Section 5 discusses international lessons for the provision of business development services. As per the Scope of Work for this study, this component focuses on how the Government can transform its *Instituto Nacional de Apoio às Pequenas e Médias Empresas* (INAPEM) into an apex agency for promoting business development services. The assessment includes a SWOT analysis, a proposed strategy for overcoming INAPEM's strategic

weaknesses and threats, and draft program for INAPEM involving 11 proposed activities and 38 sub-activities.³¹

The Role of SMEs

Defining SMEs

While precise definitions vary by country and context, the SME segment of the economy is most often identified by level of employment or annual revenue, as well as legal status.³² SMEs generally differ from large corporations by lacking of deep access to resources and professional management. SMEs also differ from micro enterprises, which are typically informal operations, often serving as “survivalist” activities for individuals or families. Although micro enterprises are widespread in Angola, their presence is not necessarily a sign of vibrant entrepreneurship or growth potential.³³

The focus of this chapter is therefore on expanding access to credit for SMEs in the sense of local businesses that are not just subsistence enterprises, but too small to have ready access to commercial bank finance under current conditions. In this context, an exact definition of SMEs is less important than the objective of bringing financial services to a much broader set of local enterprises. For the purpose of delivering business development support, however, a clear definition of SMEs is needed in order to clarify the target group, compile data on its characteristics, and monitor program performance.

Currently, there is no recognized definition of SMEs in Angola. Even INAPEM has not adopted a standard classification. Hence, the task of establishing a definition is included in the action plan for INAPEM, as discussed below. As an input to settling this question, Table 3.1 summarizes the employment-based definitions that have been adopted by several other countries and organizations.

³¹ The consultants assigned to this component, Caspar Sprokel and Forrest Metz, conducted field work in Luanda between August 28 and September 20, 2007. During that time they met with senior officials from BNA, INAPEM, USAID, the Ministry of Finance, eight commercial banks and one development bank, and two other business development service providers. Forrest Metz also worked closely with INAPEM to develop the draft action program presented below.

³² It is difficult to define legal status clearly in Angola because of the complexity of legal and regulatory requirements. SMEs represent a continuum from full compliance, to partial compliance, and complete non-compliance. At a minimum, formal status requires business registration and tax registration.

³³ A recent study found that most micro enterprises in Angola are extra-legal “survivalist” businesses (BNA 2006). However, the literature on micro-enterprise in other developing countries suggests that informality can also be a business choice for entrepreneurs who prefer to avoid the cost of registration and tax compliance, even when they earn incomes comparable to or better than some wage jobs.

Table 3.1. Selected SME Definitions

Country/ Institution ³⁴	Firm Size	
	Small	Medium
Botswana	< 25	25 – 100
European Union	< 50	50 – 249
OECD	< 50	50 -200
Pakistan	< 50	50 – 249
South Africa	< 50	50 -200
USA	20 – 99	100 – 499
World Bank	11 – 50	51 – 300

SMEs and Economic Development

Governments in both high and low income countries offer SME support programs because these enterprises are numerous, face unique constraints, and are seen as important agents of economic growth (Storey 2003). In the industrial countries, more than 95% of all manufacturing enterprises are SMEs, and the share is even higher in many service industries; also, SMEs in most Organization for Economic Cooperation and Development (OECD) countries generate two-thirds of private sector employment, and are the principal source of job creation.

In low-income countries, SME activity is less prominent compared to both large corporations and micro-enterprises. The World Bank estimates that SMEs contribute an average of only 15.6% of GDP in low income countries, compared to 51.5% of GDP in high income countries. In contrast, the informal micro-enterprise sector accounts for an estimated 47.2% of GDP, on average (including subsistence farming). The relative absence of SMEs in low-income economies is referred to as the “missing middle” (De Ferranti and Ody 2007 p.2).

Another World Bank study highlights the potential importance of SMEs in expanding the industrial base and promoting rural development, as well as social impacts that include contributing to poverty reduction, the employment of less skilled labor, the provision of goods and services to poorer households, and women’s empowerment (see Jayawardena 2003). However, other World Bank research provides evidence that SME development projects in low-income countries often fail to deliver the intended impact (Beck et al, 2005).

³⁴ Sources; Botswana: Small Business Promotion Agency; Pakistan: State Bank of Pakistan; South Africa: National Small Business Act ; USA: Small Business Administration.

These mixed results from international research suggest that even though SMEs can be key agents of economic and social development, it is not easy to design effective programs for SME development. SMEs have a particularly important role to play in Angola today to create broad-based development beyond the oil sector, along with jobs for the rapidly growing population, and a more equitable distribution of income and wealth. But the Government of Angola should have realistic expectations about the impact of programmatic interventions to promote SME development, and learn from the experience of other countries about the most promising approaches for state-sponsored initiatives, as discussed below.

International Trends in SME Promotion

There are two general approaches for promoting the development of SMEs in low-income countries. The first is through active government intervention in the form of training, technical assistance, financing, market linkages, organization, information and networking. Direct SME promotion can include the provision of a variety of forms of state subsidies, including concessional lending, subsidized training, tax breaks, grants, and preferential treatment for state awarded contracts. Taiwan and Malaysia used targeted subsidies and promotion of the SME sector with success, and many European Union countries as well as the United States continue to actively and publicly provide direct and indirect subsidies to the SME sector, including programs for special access to financing. In low income countries outside of Asia, however, most efforts at direct assistance have not been effective in promoting a productive and dynamic SME sector.

The second approach to promote SMEs focuses on strengthening the overall business environment, including macroeconomic stability, increasing the quality of and access to general education, improving physical infrastructure, reducing restrictive commercial regulation, strengthening property rights, and increasing the rule of law. The World Bank has taken the lead in supporting this approach, due to the underlying importance of the business enabling environment, as well as the failure of many programs providing subsidies and direct support for SMEs in low-income countries, in particular Africa.

The growing trend in both high and low income countries is for government to move away from direct subsidies and work instead through market based approaches that engage the private sector. The two approaches are not mutually exclusive, however. For example, the OECD is currently promoting programs for Africa that include improvements in the business environment as well as active SME interventions (Kauffman 2005). Best practices in these areas will be discussed in more detail below.

The Importance of Access to Finance for SMEs

International financial data demonstrates that the depth and breadth of the financial system is strongly associated with GDP growth and poverty alleviation. Research also shows that financial

development disproportionately boosts incomes of the poor and reduces income inequality (Beck et al. 2007). The World Bank refers to the impact of financial sector deepening as ‘finance for growth,’ and the impact of financial sector broadening as ‘finance for all.’³⁵

The literature on financial development further shows that SMEs in developing countries face especially serious problems of access to finance (Schiffer and Weder, 2001). Beck et al. (2002) find that financial constraints affect the smallest firms most adversely, and that improvements in the financial system to relax these constraints can be highly beneficial for SMEs. Sections 3 and 4 below identifies specific constraints affecting SME financing and recommend measures to address them in the Angolan context.

Although this study focuses on credit access, it is important to emphasize that SMEs in Angola (and elsewhere) need better access to “financial services” more broadly. This perspective has been clearly recognized in the global microfinance movement, which initially focused on credit but then evolved to encompass the need for convenient and efficient transactions services, mechanisms for saving, money transfers, consumer credit, and insurance. Poor households, like anyone else, need a diverse range of financial instruments to stabilize consumption, improve their businesses, build assets, and shield their families against risk.³⁶ Indeed, saving services for poor households, where well designed, are used far more widely than credit services, often by a factor of five or more, as with the highly successful Unit Desa program at Bank Rakyat Indonesia.³⁷ This makes sense because the poor are generally risk averse, and saving is a risk-reduction strategy for asset accumulation, whereas borrowing can intensify risk.

The same logic applies to SMEs, which can benefit from a full range of financial services to run their business, build assets, manage their cash flow, and mitigate risks. Credit is an important element, but not the only one.

SMEs in Angola

The total number of business enterprises in the Angolan economy, both formal and informal, has been estimated at 660.000 (UNDP 2005 p.3 and Posthumus 2006 p.20). No recent data is available to the public on the number of businesses in the formal sector, and even the government’s new one-stop for business registration, the Guiche Unico de Empresas, could not provide the study team with a national total. This lack of information is itself a sign of serious problems in the business registration process. An immediate implication is that the government should digitize and centralize the business registry records as quickly as possible. This is

³⁵ World Bank, Making Finance work for Africa, November 2006

³⁶ www.cgap.org .

³⁷ See the World Bank’s Independent Evaluation Unit assessment of this program, at: <http://72.14.253.104/search?q=cache:D8SHs1XkG1oJ:lnweb18.worldbank.org/oed/oeddoelib.nsf/DocUNIDViewFoJavaSearch/7DBBAC3B636F7FDC852567F5005D8AD3+BRI+kupedes&hl=en&ct=clnk&cd=1>

extremely important not only to improve the quality of information on the SME sector, but also to facilitate the process of business registration in the first place.

The best data comes from a general business and establishment census (REMPE) conducted in 2002 by the government's Instituto Nacional de Estatística (INE) with technical assistance from the European Union, covering four major cities. The census enumerated 18,600 registered enterprises (INE 2005). This census was conducted during the last stage of the conflict period, before the restoration of macroeconomic stability and strong oil-led growth, so the figure has undoubtedly increased over the past five years. One indication of a more up to date total is a report that the National Institute of Social Security (INSS) is targeting an increase in the number of participating enterprises to 30,000 by December 2007.³⁸ All of these businesses will have to be formally registered. Despite the data weaknesses, this information suffices to show first, that there are tens of thousands of registered MSMEs in Angola, and second, that the vast majority of businesses overall still operate in the informal sector.

As mentioned above, there is no standard definition of an "SME" in Angola. Nor is there any recent information on the composition or characteristics of the SME sector, however defined. Looking back five years, the REMPE results do provide disaggregated information on urban enterprises by firm size (with thresholds at 10 and 20 workers) and business volume (with a threshold of Kwanza 25 million, or approximately US\$430,000 at the time).³⁹ Specifically,

- 2,062 enterprises (11.1%) reported having more than 20 employees.
- 16,548 enterprises (88.9%) reported less than 20 employees.
- 14,434 enterprises (77.6%) reported less than 10 employees.
- 17,354 enterprises (93.3%) reported revenues under US\$430,000.

The dividing line between "micro" and "small" is a matter for debate, to be settled by the government in the course of developing a strategy for SME development (see below). If "micro" is defined as 9 or fewer employees, then the SME target group totaled only about 4,100 enterprises in 2002. If "micro" is defined as 5 or fewer, then the number of SMEs in 2002 was much larger, but to an unknown extent.

SME access to finance in Angola

As of September, 2007, 17 banks were operating in Angola (up from 12 in 2005).⁴⁰ Only a few of the newer and smaller banks are focusing on SMEs as part of their basic business strategy, notably Banco Sol (micro and SME), Novo Banco (micro and small), Banco Keve (medium) and BANC (SME). The credit portfolios of the banks include some SME clients, but not as a result of

³⁸ Jornal de Angola, 4 October 2007, p.32.

³⁹ INE 2005. For the dollar conversion we use the exchange rate of AKZ 58.17 per USD, as per the end of 2002 (www.oanda.com).

⁴⁰ BNA has authorized 19 banks, 17 are operating and 2 are scheduled to begin shortly.

an explicit strategy to develop this market. With increased competition however, several major banks are in the process of moving more actively in this direction.

One complicating factor in determining or monitoring the extent of SME lending is that the banks, like other organizations in Angola, do not use a standardized definition of the target market. Table 3.2 summarizes the responses obtained on this point from several banks during our field interviews. What stands out is the lack of uniformity, with banks variously classifying loans as SME financing based on the average deposit balance, turnover, the number of employees, and loan size. Even where two banks use a common indicator, the thresholds vary widely. Given these idiosyncratic definitions, eight of the commercial banks indicated to the study team that SME lending accounts for roughly 20% to 30% their overall portfolio of credit to the private sector.

Table 3.2 SME Indicators Used by Angolan banks

Indicator	Financial Institution	Amount
Average Deposit Balance	Banco Sol	US\$50k-100k
	BPC	US\$25k-500k
Turnover	BAI	< US\$2m
	Keve	< US\$500k (Small); US\$500k-3m (Medium)
Number of Employees	BANC	25-100 Employees
Loan Size	BFA	< US\$500k
	Novo Banco	Between US\$20k and US\$60k

Overall, private sector credit was just 6.8% of GDP in 2006. This is very low compared to the average of 39.5% for sub-Saharan Africa, and 12.3% for low-income African countries. Applying this overall credit ratio to the banks' self-styled estimates of the "SME" share, we find that SME lending amounts to no more than 2% of GDP (which the IMF estimates to reach US\$61 billion this year). If the SME market were defined more tightly, the figure would probably be even smaller.

Other indicators also shows that access to banking services remains very limited

Population coverage. Several estimates of the population coverage are available based on the number of accounts and plausible assumptions about the proportion of multiple account holders.

Recent estimates by BNA and others suggest that 5% to 6% of the population held a formal bank account in 2006.⁴¹

This coverage ratio is extremely low by any standards. To put it in perspective, one compare the estimates for Angola with the results of surveys carried out by FinMark Trust to measure financial access by households in several African countries. FinScope uses a standardized approach to obtain cross-country comparisons, based on four categories of access:

- Banked: Using service from formal bank.
- Formally served: Using service from formal bank or another formal provider (such as a microfinance institution)
- Financially included: Using service from formal bank, other formal provider, or informal providers.
- Excluded: No dealings with formal or informal providers.

The results of the surveys are shown in Table 3.3.

Table 3.3 Financial Access by Households in Africa

Description	Country			
	Zambia	Tanzania	Botswana	South Africa
Banked	14.6%	9%	43.2%	47%
Formally served	22.4%	11%	49%	55%
Financially included	33.7%	46%	54%	63%
Excluded	66.3%	54%	46%	37%

Source: FinScope (2005 and 2006)

Angola's indicative rate of 5% banking access is far below the percentages seen in medium income countries such as Botswana and South Africa, and even below the rates found in low countries such as Zambia and Tanzania. It is very low compared to IMF reports that 11% of households in 29 SSA countries had access to bank accounts, which in turn is a very low

⁴¹ The figure of 5% is from a BNA Internal Information Bulletin, September 2007; the bulletin estimates a total of 1.3 million bank accounts in 2006, and adjusts for the fact that some people hold multiple accounts. The figure of 6% is an estimate from Deloitte and ABANC, September 2007, p. 23.

standard compared to 29% in other low- and middle-income countries and 90% in industrial countries (IMF, May 2006, p. 39).

SME coverage. Recent survey research conducted on behalf of the BNA and UNDP in Angola found that only 0.4% of MSMEs (Micro, Small and Medium Enterprises) have obtained credit from a formal financial institution, whereas 27% of MSMEs hold cash or savings with a formal financial institution (ECI Africa 2006 p.78). For regional perspective comparison, Table 3.4 shows data on SME banking and credit in Rwanda, Botswana and MSME banking Gauteng province in South Africa⁴²

Table 3.4 Financial Access by SMEs in Africa

	Banked SMEs	Credit
Rwanda	93%	43%
Botswana	85%	9% received bank credit for start-up
Gauteng/South Africa	42% if only business accounts are taken into account, 59% if personal bank accounts are included	Only 2% took out a loan to finance start-up

Sources: Hinton et al. (2006) and Hudson (2007)

The BNA/UNDP estimates for MSMEs in Angola are significantly smaller than the Finscope results for Gauteng, though not by as large a margin as one might expect. For Rwanda and Botswana the access rates are much higher, but these figures are not directly comparable because in both of these cases the samples exclude microenterprises.⁴³

Geographic coverage. Another measure of market penetration is geographical coverage. This can be measured by the number of bank branches in each province, and the number of branches per 100,000 people. Banks in Angola have been expanding their branch networks

⁴² The Rwanda results are from an unpublished qualitative study carried out by C. Sprokel in 4 cities where 89% of the sample enterprises were registered. The Botswana results are from Hinton et al. (2006). Due to small sample sizes, these results should be viewed as indicative rather than statistically sound. Definitions of “SME” varied as per local standards. The data for Gauteng are from a Finscope pilot study, presented by Judi Hudson, June 2007. The study covered 2,001 small businesses. Extrapolating these results, FinMark estimates that small businesses (formal and informal) in Gauteng employ one in six adults.

⁴³ The World Bank in Angola recently conducted an Investment Climate Survey of 425 enterprises in four major cities, of which 420 are MSMEs. This survey will provide a far more detailed picture of credit access constraints. Preliminary results provided by the World Bank show that respondents singled out access to finance as their number one constraint, though more than 80% had not applied for any bank loans due to the complexity of the procedures and lack of acceptable collateral.

rapidly, with a growth of over 60 units in 2006 alone. BNA data for September, 2007, show 362 bank branches. This physical infrastructure is heavily concentrated in Luanda with 197 branches (54% of the total), but there are at least 3 branches in every provincial capital. Hence, banking offices are present throughout the country. Outside the major cities, of course, there is virtually no bank presence.

With a population of approximately 16 million people, Angola has 2.3 branches per 100,000 people, which is more or less in line with the regional average of 2.95, and better than the regional median of 1.61 branches per 100,000 people, based on World Bank data for 14 African countries.⁴⁴

Minimum loan size. SMEs can also be precluded from accessing credit by high minimum loan requirements. Recent data gathered by CAE (2007) provides detailed information on the minimum loan size in Angola.⁴⁵ For most banks, the minimum is around US\$4,000-5,000. Beck et al. (2006) provide a basis for international benchmarking of this figure by tabulating the minimum amount required for a loan as a percentage of GDP per capita. In Angola, a minimum loan size of \$4000 equals 140% of per capita GDP for 2006. This is far lower than the median of 240% for 11 African countries in Beck's sample.⁴⁶ The mean ratio is even higher, at 648%, reflecting enormous variance between figures as high as 3141% in Uganda and 1448% in Ghana, versus a reported zero minimum in Egypt, and very low thresholds in South Africa (16%), Madagascar (17%) and Mozambique (29%).

Overall the CAE data show that minimum balance requirements in Angola offer relatively good accessibility for SMEs, though there is significant scope for improvement. In fact, one new bank that is targeting MSMEs provided the study team with data showing that they can extend kwanza loans in amounts of less than \$1000, albeit at very high interest rates. The affordability or credit will be examined in the chapter banking costs, below.

The Supply of SME Business Development Services

The general consensus among practitioners and policy makers is that the supply of business development services (BDS) in Angola for SMEs is extremely underdeveloped, even in comparison to other low income countries.⁴⁷ A recent evaluation funded by the UNDP describes the market in Angola here as "very green" and characterized by the following attributes:

⁴⁴ Beck, et al., 2005, Table I. This study covers 193 banks in 99 countries including 58 developing countries and 14 low- and middle-income African countries, such as Botswana, Ethiopia, Ghana, Kenya, Nigeria, and South Africa.

⁴⁵ Two banks, Banco Sol and Novo Banco, also offer microloans as part of their product range (ranging between US\$100-10,000 and US\$100-2,000 respectively).

⁴⁶ Of the 14 African countries in the Beck's sample, there is no score for 3 countries on this indicator.

⁴⁷ Posthumus 2006 p. 29. Note that SME BDS here excludes services for the agricultural sector.

- SMEs have few resources to spend or invest in BDS.
- The quality of most BDS for SMEs does not meet international standards, nor satisfy the needs of local businesses.
- Most BDS demand is externally driven to meet legal compliance or bank financing requirements, rather than being motivated by entrepreneurs who see a need to improve their own business capacity.
- There is lack of cooperation amongst the few existing organizations providing SME training and advisory services.

The UNDP study provides a useful classification of the supply of BDS in Angola across all market segments (micro, small, medium and large businesses). In general there are five types of providers, as detailed in Table 3.5

Table 3.5 Classification of BDS providers in Angola

Type of Provider	Characteristics	Target Market
Business Associations.	Formed with a membership based on either geographic location and/or economic activity. The more active associations are involved in trade fairs, and training services through donor (government and NGO) support. Relatively weak in Angola in comparison to other low income countries, rely heavily on external subsidies.	Micro, SME and Large clients
<i>Government Agencies.</i>	Public institutions such as INAPEM and INEFOP which are oriented mostly toward specific government programs or campaigns that involve micro, small or medium sized enterprises.	Micro and SME clients
<i>Individual Consultants and Specialists.</i>	Individuals who develop feasibility studies and business plans for bank credit or conducting independent accounting services – virtually no	SME and Large clients

	training or advisory services outside of these two areas. ⁴⁸	
NGOs	Services oriented towards micro enterprises; quality in services varies tremendously; and they are nearly 100% subsidized and non-sustainable without donor funding and support.	Micro and SME clients
<i>Private Sector Consultancy Businesses.</i>	Major international accounting firms and boutique consulting companies – accounting, auditing, and to a lesser extent feasibility studies and business plans, not training or advisory. These are for profit, fee for service providers which are sustainable and do not depend on direct subsidies.	Large clients – limited SME engagement (mostly with larger medium sized firms).

Source: Posthumus 2006

Only a few initiatives provide BDS specifically to build SME capacity. Most providers focus on compliance with government or banking requests. The most active providers of traditional BDS for the Angolan SME market are the Angola Enterprise Program (AEP) and the Centro de Apoio Empresarial (CAE).

Angola Enterprise Program

The Angola Enterprise Program is a public/private partnership between the UNDP, Chevron and GOA (through INEFOP and MAPESS). The program is oriented to promoting SME development through four areas of activity: business development services; vocational training; microfinance; and the general enabling environment.

In the area of BDS, AEP has had difficulty in developing a sustainable and effective model for the SME sector. These BDS activities were suspended in 2006. An external evaluation study (Posthumus 2006) cited identified serious challenges, including the need for direct promotion of services, lack of management and oversight, and misaligned incentives for performance. AEP has adopted a new BDS model that is expected to be in place by the end of 2007, working through the provider sector and NGO partners.

⁴⁸ UNDP estimates a minimum of 50 to 150 advisors throughout the country however anecdotal evidence suggests that this number is low and that the informal market of business advisors who are willing to assist individuals with information required for loan applications (feasibility studies and business plans) is much higher than 150.

AEP has also developed an “incubator” project to support the survival and growth of small businesses. The project started operations in 2006, and as of September 2007 has provided basic business plan training to over 100 entrepreneurs, with 19 firms in pre-incubation and 4 firms in the incubator. Start up and early stage entrepreneurs are given training and advisory services, office facilities, and networking opportunities. The incubator has adopted a fee-for-service model for business planning courses that are open to the general public, and for rent of office facilities. The project is also moving toward a percentage-of-revenue approach for future companies in the incubator. Given its limited scale, this incubator is costly to operate, and it is unrealistic to expect any significant impact on overall SME development.

Centro de Apoio Empresarial

The Centro de Apoio Empresarial (CAE) was established in September 2005 through the efforts of the enterprise development subcommittee of the Local Content Initiative, consisting of representatives from Sonangol, BP, Chevron, Esso and Total. The aim of CAE is to provide BDS to SMEs involved in providing goods or services to the petroleum industry. Since its inception, over 340 Angolan-owned businesses in Luanda, Lobito and Cabinda have received training and technical assistance, and over 65 are currently certified for supplying the petroleum industry. Around 30 enterprises have won contracts resulting from CAE affiliation. CAE's services assist SMEs with general business training (financial analysis, cost and quality control), as well as modules specific to the petroleum industry such as pre-qualification, bids and contracts, and standards for health, safety and the environment. CAE clients are either involved in or aspiring to access the petroleum supply chain in oil services and general support services such as IT, cleaning, transportation, maintenance, and catering. CAE only works with clients that are majority Angolan owned; formally registered; paying taxes; and have three years of business experience and adequate financial statements.

CAE is looking to expand into promoting SME access to finance. In June 2007, as part of an information campaign, they published a detailed comparative guide to banking services available to SMEs. The objective is to increase awareness of bank services among SMEs, and improve bank responsiveness to SMEs. CAE plans to update this publication periodically. They are also developing a process for referring qualified SMEs to the banks. CAE clients tend to have medium and longer term financing needs above US\$50,000, placing them outside the scope of microfinance services from Novo Banco, or the recent Zimbo project sponsored by Banco Totta and the oil company Total.

During a meeting with INAPEM representatives in September 2007, CAE officials expressed a strong interest in participating in any INAPEM efforts to improve coordination and communication on BDS for SMEs. Given the deep resources of CAE's sponsors (Sonangol and the oil industry) CAE is ideally positioned to be a key player in the development of BDS.

Other Initiatives

The Centro de Incubação de Negócios de Cabinda, or N'kondo, is a business incubation center, established in 2006 by the consortium of Block 0 petroleum partners: Chevron, ENI, Sonangol and Total. The center's objective is to promote SMEs in the Cabinda province, and provides business plan training, start-up advice, and general consulting services as demanded. The services focus mostly on start up activity. Most of the clients are youth who lack business experience and receive services free of charge. The project is still in the early stages of development, and is a long way from realizing the goal of significantly increasing SME involvement in the petroleum supply chain in Cabinda.

The Development Bank of Angola (BDA) started operations in December 2006, with the goal of providing term financing to promote the government's objectives of GDP diversification, job creation, and food security (see Chapter 2 for more details). BDA recently conducted a diagnostic of BDS activities in Angola as part of their program to develop credit policies. Specifically, BDA is exploring the possibility of providing direct subsidies to BDS providers in order to assist businesses (mostly SMEs) that do not initially meet BDA's credit appraisal standards. This initiative is likely to have a significant impact on the BDS market given the size of the government Development Fund that BDA is managing. INAPEM is in discussions with BDA as to potential areas of collaboration.

SME Demand for Business Development Services

As noted above, the demand for BDS among SMEs in Angola is currently motivated by government or bank requirements. The greatest area of demand is for accounting services and the assistance on requirements for tax and fiscal reporting. All of these services are in very short supply. The second area of BDS demand among SMEs is for assistance with feasibility studies and business plans. SMEs seek assistance in this area mostly to obtain financing, mainly from banks, rather than as a resource to develop their businesses.

The demand for other forms of BDS is weak. Recent studies and interviews with local BDS providers highlight several explanations:

- a general lack of awareness that the services are available;
- a lack of knowledge about these services can help SMEs improve their businesses and increase their income;
- a business culture that is still in a transition from rent-seeking, trading, and state subsidies, to an economy based on innovation and entrepreneurship; and
- high levels of distrust in sharing any information outside the company.

Any successful BDS initiatives will have to address these challenges in sustainable and innovative ways.

The constraints to SME lending in Angola

As emphasized above, access to finance is one of the most significant problems facing SMEs in Angola, and around the world, with the smallest firms most adversely affected. This chapter classifies the constraints in three categories: problems with the business environment for private sector development and the provision of financial services; problems within the banking system; and problems within the SMEs themselves.

Problems with the business environment

Weaknesses in the business environment have an especially serious effect on access to credit for SMEs (Beck et al. 2002). As such, the government has an essential role to play in improving the enabling environment and overcoming barriers to doing business.

Many key constraints stem from problems in the legal, judicial and regulatory environment. The scope of the problem is evident in the World Bank's rankings for the overall "ease of doing business" in 178 countries; Angola ranks near the bottom at 167th.⁴⁹ These institutional constraints are well understood by the banks in Angola, and many of the problems are already highlighted in BNA's Policy Matrix for Expanding Access to Credit (see Appendix A). Within this Matrix, the most acute legal and regulatory problems affecting SME financing are the following (with Matrix numbers in parentheses):

- Formal registration. The procedures for business and tax registration are cumbersome and, for small enterprises, prohibitively costly. The recently established *Guiche Unico de Empresas* (one stop shop) has streamlined the process, but only for corporate registrations at one location in Luanda. These difficulties are a formidable barrier to qualifying for a business loan. (Matrix item 2.2)
- Property rights. Serious problems remain in establishing clear title to property and land use, which renders many assets ineffective as collateral. (Matrix item 2.3)
- Credit history. An efficient and comprehensive credit reference system is needed to improve borrower information. (Matrix item 2.4)
- Contract enforcement & dispute resolution: The judicial processes for enforcing loan contracts or foreclosing on collateral are extremely inefficient, unpredictable and expensive, which increases risks and costs for lenders. (Matrix item 2.6)

In compiling this Matrix, BNA has taken the initiative to identify actions and approaches to address some serious problems, but it has also taken care to specify counterpart ministries and organizations that must be involved in delivering solutions. Apart from the credit reference system, which BNA is already addressing, BNA has no authority to deal with the other reforms. What it can do, however, is act as an advocate for accelerating the reforms, under its

⁴⁹ This aggregate measure of the institutional environment for Doing Business takes 10 factors into account: starting a business, dealing with licenses, employing workers, registering. property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and closing a business. See www.doingbusiness.org.

responsibility for the development the banking system. As recommended in Chapter 2, one immediate action for BNA would be to organize national workshops on Institutional Constraints to the Expansion of Credit Access in order to foster a constructive dialogue with the government and other stakeholders on critical links between legal, judicial and regulatory reforms and development of the financial system.

The scope for SME lending is also strongly influenced by conditions in the real economy. Angola, of course, is enjoying extraordinary growth, driven by the boom in oil and mineral exports, and large expenditures for post-war reconstruction. But the rapid expansion of export earnings from natural resources has also caused a sharp appreciation in the real exchange rate due to the strong kwanza and rising domestic costs. In many resource-rich countries, such as Nigeria, this “Dutch disease” phenomenon has weakened competitiveness and dimmed prospects for growth in other industries producing tradable goods – including goods for export and also goods that face import competition in the domestic markets.

Industries involved in the production of non-tradables, such as construction, retail and wholesale trade, business services, and household or personal services, are insulated from adverse affects of the strong kwanza, as are enterprises producing tradables for local markets in regions where competing imports face prohibitively high transportation costs (for now). Given the strength of the Kwanza, however, the impact of the oil boom on many activities in agriculture and manufacturing is an open question – and a significant risk factor for the banks. On large loans, the banks can readily afford to conduct feasibility studies to assess the market prospects. But for SME financing this approach may be too costly. The Government agency responsible for SME development (or possibly BNA, under its responsibility to facilitate development of the banking system), can help the banks overcome these information constraints and facilitate SME financing by producing or sponsoring sector studies to assess the impact of Dutch disease on the market potential for particular products in various regions of the country.

The condition of the physical infrastructure is another fundamental determinant of the potential for SME development and hence the scope for bank lending to SMEs. Out of 125 countries covered in the *2007 Global Competitiveness Report* from the World Economic Forum, Angola ranked a poor 113th place on overall infrastructure quality.⁵⁰ Inadequate infrastructure and public utility services increase costs of production and restrict the market potential for many businesses, but especially SMEs that lack the size and financial strength to compensate for these deficiencies in the business environment. The government, to its credit, is pursuing an intensive program of post-conflict infrastructure investment, but it will still take many years to overcome these deficiencies.

⁵⁰ The overall Global Competitiveness Index, which is produced by the World Economic Forum for 125 countries, is based on nine pillars: Institutions, Infrastructure, Macroeconomy, Health and primary education, Higher education and training, Market efficiency, Technological readiness, Business sophistication, Innovation. Angola ranked 125 out of 125 on overall competitiveness.

As the business environment improves – through better infrastructure, macroeconomic stability, sound property rights, effective contract enforcement, and better information systems – more SMEs will be able to gain access to finance.

Problems within the Banking System

In our field interviews, most of the banks revealed a serious interest in lending to SMEs, but they want to see a good business model, a sensible business plan, and a high probability of repaying the loan plus interest. On these criteria, the banks find it difficult to identify creditworthy SME clients. Nevertheless, increased competition in the market for prime-grade loans is providing a strong incentive for the banks to assess the SME market as a source of growth (Exhibit 3.1: Market Incentives).

Exhibit 3.1 Market incentives for SME lending

- Since the end of 2005 the number of banks operating in Angola has increased from 12 to 17, with 2 more to open for business shortly. This has significantly increased competition for large corporate clients and high net worth individuals.
- With rapid economic growth, deposits are pouring into the banks, which have to find profitable outlets for the additional financial resources. Between 2005 and 2006, total deposits increased by 63.4%. (data from BNA).
- The average interest rate on Treasury bills and Central bank bills (TBCs) decreased dramatically from the 50%-60% range in 2004 to 10% and less at the end of 2006. In 2007, the TBC yield has risen back to near 15% for most maturities, but the available stock has not been kept pace with the growth of bank deposits. These developments are compelling the banks to expand their lending activities

Despite the pull of market forces to enter the SME market, banks are obviously concerned about providing an attractive return for their shareholders, preserving their capital, and protecting depositors' funds. Therefore, most of the banks continue to base lending decisions, even for SMEs, on a traditional approach involving careful risk assessment, and strict collateral requirements (despite the great difficulties that would be faced in foreclosing on collateral).

Banks also face internal constraints that make it difficult to do business with non-traditional SME clients:

- Technical skills. Most commercial bank staff lack the skills and technical know-how needed to deal with the special characteristics of most SMEs in a country like Angola.
- Transaction costs: Banks are reluctant to enter the SME market because of the high cost of appraising, administrative and monitoring, relative to the small size of these loans.

- Risk management: Commercial banks have an inherent aversion to risk, and it is difficult for them to assess the viability of loans to SME clients through traditional lending practices due to lack of information.

Using a global sample of firms, Schiffer and Weder (2001) have substantiated the perception that smaller firm size is associated with greater risk. A group of leading Latin American financial sector experts have explored the factors that contribute to higher risk on SME loans. Their findings are summarized in Exhibit 3.2.

Exhibit 3.2. Higher risk of lending to SMEs

In a study of constraints to credit access in Latin America, a group of leading financial sector experts (called the Latin American Shadow Financial Regulatory Committee) identified five factors that explain the higher risk posed by lending to SMEs:

- Lack of transparency in their financial balance sheets as a result of inadequate accounting practices and lack of clear distinction between company's financial activities and those of the owner.
- Insufficient collateral.
- Meager diversification of income sources compared to large enterprises.
- High sensitivity to changes in the operations of large enterprise customers, which generally exert a monopolistic power over the SMEs that do business with them.
- High uncertainty with respect to the amount of taxes that they must pay during the course of their operations,

Other risk factors not listed by the Shadow Committee include lack of funds for an equity contribution to the project dependence on the health of the proprietor, exposure to crime, and lack of insurance against fire, theft, or natural disasters.

Source: Rojas-Suarez (2007), p.14.

Yet there are techniques for overcoming these constraints and lending profitably to SMEs, which have been applied successfully in countries throughout the world such as Bangladesh, Indonesia, Peru, the Philippines, Bolivia, and Uganda. These methods will be discussed more fully in the next section, which reviews lessons from international experience with SME lending, and implications for Angola.

Problems within the SMEs

SMEs throughout the world are constrained by their limited scope and size of operation, the market power of suppliers and buyers, market access problems, and market information problems. In Angola, SMEs face additional problems including low levels of management and technical capacity, education, and business experience, as well as limited access to skilled

labor, capital, and technology. In addition, most SMEs lack knowledge about how to use banking services.

These micro-level constraints make it very difficult for SMEs to approach the banks with viable projects for financing. In effect, the problem of credit access is due as much to demand-side constraints as to problems on the supply side. The provision of business development support services can therefore be a vital tool for improving the capacity of local SMEs to offer bankable projects, and thereby expanding their access to credit. As shown earlier, however, it is no easy matter to design and implement an *effective* BDS program for helping SMEs on a wide scale in developing countries. We return to this issue below, in our discussion on how INAPEM can strengthen and deepen the supply of business support services for SMEs throughout Angola.

International Lessons for SME Lending Angola

According to a recent World Bank study of international best practices, the public sector can best support the expansion of financial services to SMEs by, first, setting a sound *policy* framework for financial sector development, second, strengthening the *institutional* infrastructure for financial transactions, and third, improving the *information* infrastructure to facilitate credit decisions. Table 3.6 provides a sample of actions that can be taken by governments and central banks in pursuit of these aims, as suggested in the World Bank study.

Table 3.6 Role of the Public Sector in Supporting SME Finance: Best Practices

<i>Set a sound policy framework for the financial sector</i>	<i>Strengthen the institutional infrastructure</i>	<i>Build the information infrastructure</i>
<ul style="list-style-type: none"> ✓ Promote financial sector competition ✓ Provide supportive regulations for banking, leasing, factoring, and equity markets ✓ Rationalize direct interventions ✓ Strengthen legal and judicial frameworks 	<ul style="list-style-type: none"> ✓ Support relevant training and TA for interested financial institutions ✓ Provide or facilitate start-up support for product development, risk mitigation methodologies 	<ul style="list-style-type: none"> ✓ Promote accounting standards ✓ Establish credit bureaus and registries ✓ Invest in information and infrastructure technology

Source: Malhotra et al. 2006

For present purposes, we focus on six major lessons from international experience with operational implications for Angola.

Lesson 1: Financial sector competition promotes access to finance for SMEs and innovation in lending practices. Foreign banks enhance this competition. And private sector banks are best placed to provide sustainable and efficient financing for SMEs.

Recent studies have found that a high degree of concentration in the banking system obstructs access to credit by SMEs. Especially in systems in which severe difficulties exist for the enforcement of contracts, market power arising from a banking concentration leads to greater discrimination against riskier borrowers (Rojas-Suarez, 2007, p.17). Similarly, Beck et al. (2006) point out that banks impose lower barriers in more competitive and open systems, and in countries with better contractual institutions and information frameworks (such as credit information systems). The same study also found that banking fees are lower and it is easier to open bank accounts or apply for a loan in financial systems with a strong presence of foreign-owned banks – even though the foreign banks themselves tend to charge higher fees than the others. Financial sector competition is also enhanced by the entry of non-bank financial intermediaries and active capital markets.

Promoting competitive financial markets may be the single most important task for public authorities in helping small firms gain access to credit. To this end, governments and central banks should establish a level playing field for all financial institutions, and eliminate unnecessary restrictions that impede market competition (De Ferranti and Ody 2007). There is also a vital role for the public sector in organizing basic payments and transaction services, which are an important public good to facilitate private sector development (Claessens 2005, p.27).

In contrast, directed credit programs tend to create serious distortions in the distribution of financial resources and retard the development of credit analysis and risk management skills. When credit is subsidized – a common adjunct to government intervention – a common outcome is that funds end up accruing disproportionately to influential clients rather than the intended target groups with the best growth prospects, including SMEs. There are certainly examples of public sector banks that are well managed and provide highly effective credit programs to MSMEs, such as the Bank Rakyat Indonesia (BRI) in Indonesia, through its Unit Desa program (Exhibit 3.3). But direct government interventions often prove to be counterproductive in countries with weak institutions and politically charged governance structures.

The case of Ag Bank in Mongolia provides an excellent example of the negative impact of government intervention and the benefit of adopting a private-sector approach to SME lending.⁵¹ Ag Bank was founded in 1991 as a state-owned bank for agricultural lending at controlled interest rates. Government interference led Ag Bank into larger loans to state organizations and infrastructure projects. By 1996, its condition had deteriorated to the point where it was placed in receivership. In 1999, the central bank put together a restructuring plan built on independent management, financial soundness, and the goal of profitability, while

⁵¹ Malhotra et al., 2006, p. 37-38.

targeting micro and small businesses and agricultural producers. After reforming its lending and deposit services, Ag Bank was privatized in 2003 to a Japanese company. The turnaround was very successful. Between late 2000 and February 2004, Ag Bank disbursed 878,000 loans and maintained an arrears rate below 2%. With an average loan size of just US\$382 and average deposit balance of just US\$200, Ag Bank became the most profitable bank in Mongolia. It also expanded to have the largest branch network, with 379 offices.

Another widely acclaimed example of successful, sustainable and profitable SME banking is Plantersbank in the Philippines. This is one of the leading SME lenders in the world, with assets of US\$825 million, a loan book of US\$321 million, 69 branches, and profits of US\$5.5 million in 2006. Around 80% of the loan portfolio consists of SMEs, with an average loan size of US\$122,000. Plantersbank has assisted approximately 20,000 SMEs, which in turn created 2 million jobs and impacted 12 million lives. Plantersbank is controlled by private shareholders, with over 40% of equity being held by international investors (including the IFC, FMO and Asian Development Bank, and a leading commercial bank from Korea).⁵²

Exhibit 3.3 SME lending - the case of Bank Rakyat Indonesia (BRI)

BRI offers a case study in how a state-owned bank can run an efficient, sustainable, and highly profitable program of lending to MSMEs. BRI was established in 1968 to channel subsidized credit to farmers at low rates fixed by government. This heavily interventionist approach led to annual operational losses and a ratio of non-performing loans that soared to over 50% in the early 80s. The state and BRI management then chose to change gears and convert to a sustainable, commercially-driven approach. Among other reforms, BRI established an innovative full-service rural banking network starting in 1984 – the Unit Desa program. These rural units were organized as independent and decentralized profit centers. Today BRI's Unit Desa system is the largest and one of the most successful microfinance institutions in the world. Since 1986 the Unit Desa system has consistently generated profits. Indeed, in 1995, on the eve of the Asian financial crisis, Unit Desa profits exceeded BRI profits as a whole, implying that the MSME portfolio was actually cross-subsidizing losses on larger loans. The BRI case illustrates first that subsidized lending and government interference with lending decisions and interest rates is not sustainable, and second, that state-owned banks can indeed be sustainable if the institutions are professionally run, at arm's length from the government, and along commercial lines.

Sources: Malhotra et al. (2006), p. 56.

Application to Angola

The Banco Nacional de Angola and the Government of Angola already committed to the development of a competitive banking system led by the private sector. This is evident in the increase in the number of banks from 12 to 17 in just the past two years. Some of the smaller

⁵² Plantersbank Annual Report 2006 and www.plantersbank.com.ph

banks are focusing their business strategy on the MSME market. Other entrants are competing effectively in the market for prime clients and putting pressure on major banks to develop new lines of business, including SME loans. Competition has also led to a rapid expansion in the overall network of bank branch, rapid growth in both deposits and loans, a sharp decline in the concentration ratio in the industry, and somewhat lower profit margins.

Competition from non-bank financial institutions (NBFIs) is not yet present due to slow progress in issuing regulations to implement provisions of the Financial Institutions Act of 2005 relating to products such as leasing and factoring. The development of capital markets through the new stock exchange will also promote competition for financing top-grade companies, and create further incentives for leading banks to look at non-traditional clients.

Recommendations

- ✓ *BNA should maintain its commitment to private-sector-led development of the banking system and fostering competition by licensing qualified bank applicants.*
- ✓ *BNA should accelerate the work on creating a framework for alternative financing products such as leasing and factoring, and encourage the entry of NBFIs into these lines of business.*
- ✓ *BNA should seek a dialogue with international banks that have a strong track record of successful SME lending and discuss the possibility of their entering Angola or providing technical support to interested Angolan banks engaged in SME business.*
- ✓ *BNA and the Government should continue to pursue development of capital markets to enhance financial sector competition and create alternative ways for businesses to obtain finance.*

Lesson 2. A specialized and innovative credit technology is required to minimize costs and risks on SME loans and enhance their profitability and sustainability. International partnerships can help to establish this lending capacity, to generate a “double bottom line” of commercial and developmental returns.

Normal banking practices rely heavily on analyzing accounts and business plans, legal registration of collateral, and methods for loan management that involve relatively high transaction costs. These techniques do not work well for lending to smaller and less sophisticated SME clients. International experience, especially from the innovative microfinance industry, has established efficient, cost-effective, and risk mitigating techniques for dealing with large numbers of small loans to unsophisticated clients. Innovative commercial banks throughout the world have been adopting these “microfinance techniques” to move down market on a fully commercial basis, at the same time as many microfinance institutions have been formalizing and moving up market to SMEs using the same techniques for low cost lending (De Ferranti and Ody 2007).

Efficient SME lending often involves holistic reforms in lending techniques, and technical assistance from experienced international practitioners. Although there is no single formula to fit all circumstances, the package of adjustments usually includes:

- Creation of separate SME department.
- Hiring and training a cadre of SME loan officers, often with less advanced formal credentials to hold down personnel costs.
- Careful design of SME products to fit the market, with an emphasis on simplicity, clarity, and convenience.
- Adoption of lending techniques that draws heavily on the microfinance approach, including: a focus on character and cash flow rather than collateral and balance sheets; reliance on (informal) references from suppliers, buyers, etc; intensive but low cost monitoring with frequent field visit to client sites; special incentives for loan officers tied to portfolio performance.
- Streamlined procedures for credit approval, documentation, monitoring, and collection, including use of simple credit scoring techniques to accelerate lending decisions.
- Appropriate IT systems to deal with SME business.

An example of a commercial bank down-scaling into the SME market using SME lending technology is TBC Bank in Georgia (Malhotra et al. 2006). With technical assistance from Shorebank International (SBI) in the United States,⁵³ funded by USAID, TBC Bank introduced special SME loans and a Developing Enterprise Loan Product (DELP) to serve businesses that outgrew microfinance but could not yet access bank financing through normal channels. TBC Bank established lending credit risk departments to handle these products, provided specialized training for the staff, and introduced simple credit analysis and monitoring methods. From 1999 to 2002, TBC Bank disbursed 254 SME loans and 411 DELP loans using a US\$6 million credit line from the IFC. In 2002, the average SME loan was for US\$40,000, and the average DELP loan for US\$4,300. The Portfolio at Risk (PAR) was just 1%. The SME loans contributed to TBC's sound overall financial performance between 1999 and 2002, with the loan portfolio growing from US\$9 million to US\$50 million, and the net operating margin rising from 6% to 31%.

While the example of TBC Bank does not involve a large volume of business, it illustrates the advantage of drawing on the expertise of international partners. Useful collaborations may involve foreign commercial banks that specialize in SME lending, aid agencies, multilateral financial institutions with SME expertise (such as IFC), or NGOs. These partnerships help banks that are entering this market segment to move up the learning curve more quickly, reduce transition costs, and generate both commercial and developmental returns. Many international

⁵³ SBI is a wholly owned affiliate of ShoreBank Corporation, Chicago. Since 1990 it has built expertise in micro enterprise, SME and real estate finance projects, working with 45 financial institutions in 9 countries. SME lending and bank capacity development are among its core competencies.

donors, in particular, recognize the 'missing middle' problem and are prepared to offer technical and financial assistance to expand lending and other financial services to SMEs.

Another example of a successful partnership is the Development Finance Company of Uganda (DFCU). Founded in the 1960s as a traditional state-owned development bank, by 1997 DFCU was underperforming on all counts, with a poor portfolio quality (NPLs of 46%) and no clear direction. With financial and technical support from various development organizations, DFCU installed professional management, converted to an SME focus using the types of lending techniques outlined above, and within 5 years became the second largest financial service group in Uganda. Over that period net asset value grew by 26% per year, and the bank became highly profitable. In October 2004, 40% of the bank's shares were sold on the Kampala Stock Exchange. Important to the success of DFCU's focus on SMEs was technical support from DFID, the Shell Foundation, and USAID.

Application to Angola

The transfer of this SME lending methodology, with help from donors and technical assistance providers, can act as a catalyst for introducing new and specialized SME lending techniques, and effectively address the problems of technical skill, cost, and risk, which heavily constrain commercial banks lending to SMEs.

To date, the number of partnerships between commercial banks, aid agencies, and specialized financiers to develop SME lending in Angola is very limited in Angola. One highly visible case is the link between Novo Banco and its international shareholders.⁵⁴ Small business banking is a core element of Novo Banco market strategy (along with micro-enterprise banking). Thus, Novo Banco faces a critical need to make use of cost-effective and risk-minimizing techniques for its own commercial viability. Per March 2007, Novo Banco had approximately 2,200 active borrowers with an average loan of US\$3,260, and over 27,000 savers. In its second full year of operations the bank turned profitable, though it is charging very high interest rates for small loans. International experience suggests that both financial returns and developmental returns will improve after a few start-up years, and interest rates on the small loans are likely to decline as volume expands.

A somewhat different example is that of Banco Totta de Angola (BTA), which has partnered with business development services providers CAE and SNV from the Netherlands⁵⁵ to offer 'Zimbo' loans to SMEs in amounts ranging from US\$5,000 to US\$30,000. The loans are 50% guaranteed by the Total oil company.

⁵⁴ These include ProCredit Holding, IFC, BIO from Belgium and Doen from the Netherlands; the German consulting company IPC is also active as a technical partner.

⁵⁵ *Stichting Nederlandse Vrijwilligers* (Netherlands Development Assistance Agency).

Most Angolan banks have not yet tapped into the funding and specialist knowledge available internationally to develop sound and cost-effective methods for SME financing. Indeed, the specialized SME approach is hardly known in Angola outside of a few small, new banks. What international SME partnerships can contribute most of all is the expertise needed to overcome the internal constraints, within the banking sector, to more rapid expansion of SME lending.

The Bank Training Institute of Angola (IFBA) may in the future be an appropriate venue for providing routine training in SME lending technology, but at this stage it lacks expertise in this area. And in any case, the value of this training depends heavily on prior decisions by the banks to introduce innovative methods for dealing with SME clients. Hence, a more targeted approach to technical assistance is currently warranted, focusing on banks that step forward to embrace this approach. One clear incentive for this to happen is that the first mover, with the benefit of international support, may be able to establish a long-term and profitable advantage in this segment of the market.

Recommendations

- ✓ *BNA can encourage SME financing partnerships by actively discussing the issue with the banks, to inform them of the concepts and hopefully stimulate their interest.*
- ✓ *BNA can help to educate the banks on international best practices and prospects for SME lending in Angola, by organizing a conference in conjunction with ABANC on this topic. The conference can be called 'SME Financing in Angola,' and include presentations by experts in field, as well as roundtable discussions about special problems faced by banks in Angola.*
- ✓ *BNA should sponsor a systematic study to document the reasons for rejection of SME credit applications by the banks and suggest changes in procedures, lending criteria, or staff training to overcome unnecessary obstacles to lending.*
- ✓ *Once a sufficient level of interest is reached among the banks, then the Bank Training Institute should seek international assistance to introduce training modules and train trainers on international best practices in SME lending.*

Lesson 3: Credit registries or credit bureaus greatly facilitate lending and provide banks with a tool to reduce information asymmetries that are especially important in lending to SMEs.

The availability of financial performance information through credit bureaus has been shown empirically to increase the availability of credit. Surveys show that the absence of such information increases the time needed to process loans, the cost of making loans, and the extent of defaults (Berger and Udell 2005). The World Development Report 2005 shows that countries without credit information systems have a private credit/GDP ratio of 16%, in those with publicly owned registries the ratio is around 40%, and in those with private registries it is about 67%.

A credit registry or bureau is most useful in helping financial institutions expand lending to SMEs, because loan requests from smaller businesses are most likely to be constrained by the problem of information asymmetry. In addition, the credit bureau system creates a strong incentive for potential SME borrowers to enhance their financial management skills in order to establish a record of honoring obligations. This record of dependability in meeting payments, once recorded and made available to the banks through a credit registry, serves as an important form of 'reputation collateral' that can help to unlock credit for loan applicants who lack formal collateral. This is especially important under conditions where banks cannot rely on formal collateral anyway due to a weak legal and judicial system, as in Angola. Finally, a reliable credit information system can also assist local businesses in obtaining trade credit from both domestic and international suppliers.

To assess the quality of credit information systems in countries around the world, the World Bank's Doing Business report applies six criteria:⁵⁶

- the use of positive information, such as on-time repayment patterns, as well as negative information on defaults, late payments, and bankruptcies;
- the distribution of data on both companies and individuals;
- the use of payment data from non-bank sources such as retailers, trade creditors, and utilities;
- the capture of more than 2 years of historical data;
- the use of data on loans amounting to less than 1% of GDP per capita, along with coverage in excess of 1% of the adult population;
- legal provisions giving economic agents the right to view their credit records and challenge inaccurate information.

In comparing the effectiveness of public versus private credit bureaus, a study by the IDB (2004) concluded both approaches can deliver good results, though private bureaus have worked somewhat better. This is especially true for Latin America, with ratings of 0.65 for private bureaus versus 0.47 for public systems, on a scale of 0 to 1. The USA only has private credit bureaus (which score 0.9). In other OECD countries and emerging economies the public registries show slightly better scores than private bureaus (0.53 versus 0.48, and 0.52 versus 0.47 respectively).⁵⁷

Application to Angola

The creation of an effective credit information system will be a major step forward in helping banks to deal with credit risk due lack of information about the financial performance of SME loan applicants. As seen above, this risk has been highlighted by every one of the banks as a

⁵⁶ See www.doingbusiness.org

⁵⁷ See Rojas-Suarez, 2007, p.29.

major factor constraining SME access to credit. BNA is therefore on solid ground in highlighting this issue in its Policy Matrix.

BNA initially attempted to introduce a centralized credit information system in 1998, but the system did not function due to lack of a firm legal foundation to enforce compliance by the banks. Recently BNA has brought the credit information project back to life, and aims to have a public registry operational by January 2009, with support from the FIRST Initiative. According to an informed source, the plan is to build the system within BNA initially. For a private credit bureau to be financially sustainable, financial institutions, as beneficiaries of the information, will have to be willing to pay for its services. BNA has indicated it will probably start charging fees once the system is up and running and working properly. The major commercial banks have indicated their willingness to pay for the services of a credit bureau, though the costs will undoubtedly be passed on to clients.⁵⁸

Recommendations

- ✓ *BNA should give high priority to accelerating the creation of a credit information system in order to reduce information asymmetries and facilitate credit in general, and lending to SMEs in particular. As per the Policy Matrix, this entails the development of an appropriate regulatory and legal framework, as well as the implementation of appropriate management and technology systems.*
- ✓ *Participation in the credit information system should be mandatory for all banks and financial institutions. The credit bureau at BNA may start with only basic information on loan payment history, but it should ultimately adhere to the standard indicated by the six criteria used by the World Bank to assess credit information systems for the Doing Business reports.*
- ✓ *In the Angolan context a public registry is indeed the most feasible, quickest, and most widely supported option in the short term. But it is appropriate that BNA is thinking about shifting the system to a private sector operator in the medium term.*

Lesson 4: Leasing is a promising alternative to bank loans for improving SME access to finance for vehicle and equipment purchases.

The previous chapter on Term Financing discusses both the advantages and problems associated with leasing as an alternative to commercial bank loans. In the present context, it is important to note that leasing can be especially important for SMEs that need financing to purchase vehicles or equipment. Its advantage is that the asset financed provides security for the loan, and no judicial action is needed for the lessor to reclaim the asset, because the lessor retains ownership. The financing decision can therefore focus on the simple question of whether the lessee's cash flow is sufficient to service the lease payments. Leasing agreements are frequently designed as hire-purchase agreements, in which the lessee can purchase the asset

⁵⁸ Amounts indicated by banks per credit check ranging from US\$5 to US\$10.

at a appropriately depreciated value at the end of the lease period. Appropriate insurance cover for the leased assets is an obvious necessity to mitigate the lessor's risk. Because of the benefits for economic, financial sector, and SME development, some governments offer tax benefits to promote leasing, in the form of accelerated depreciation on leased assets.

In many countries, leasing has made a major difference in expanding the supply SME financing. For example:

- In Uganda, leasing was a key component in DFCU's approach (discussed above) to expanding its portfolio of financing for SMEs. DFCU's average lease size was US\$22,000, with a NPL ratio below 5%. DFCU successfully lobbied the Ugandan government to ensure that tax legislation was conducive to the development of leasing.⁵⁹
- In Romania, the leasing sector has grown rapidly in response to rising demand for medium-term financing from SMEs. Between 1997 and 2003, the market multiplied tenfold to reach a total volume of more than EUR 1.5 billion. The EBRD has been active in this market, providing EUR274 million to Romanian SMEs in recent years through 10 banks but also 6 leasing companies. Jonathan Woollett, EBRD's Director for Non-Bank Financial Institutions, has highlighted the growth of leasing as an important tool for entrepreneurs to gain access to finance.⁶⁰
- Leasing has also been an important source of SME financing in post-conflict Serbia,⁶¹ with support from the IFC's Southeast Europe Enterprise Development program. Within 16 months of the passage of a leasing law in May 2003, the amount of financing reached EUR 225 million (35% for equipment, 65% for vehicles), and the number of leasing firms grew from 2 to 11. The average lease contract was for EUR20,000, which points to strong SME participation. Major success factors included private sector involvement in drafting the law, and extensive capacity building for financial institutions, SMEs, and business service providers.

Application to Angola

Leasing finance is highly suitable as a source of term financing for SMEs in Angola, though its spread might be hindered by the weakness of secondary markets for many types of assets. Also, while appropriate insurance for leased assets is available, it may be expensive.

Leasing is not available at this time due to delays in issuing regulations that are needed to implement the leasing provisions of the Financial Institutions Act of 2005. BNA has plans to introduce the appropriate regulatory framework, which is eagerly awaited by the banks.

⁵⁹ DFCU information based on a discussion with Peter Hinton, who sat on the DFCU Board during the period of transformation and shift in focus to SMEs.

⁶⁰ EBRD, Press release: EBRD increases support for Romania's leasing market, August 2007

⁶¹ Malhotra 2006 p. 62-65.

Recommendations

- ✓ *BNA should accelerate its plan to issue an appropriate regulatory framework for leasing, to unblock an important new avenue for SME finance. In preparing the regulations, BNA should confer with banks and other stakeholders to avoid undue restrictions.*
- ✓ *BNA should encourage the entry of specialized leasing companies that are independent of the commercial banks, to promote the use of leasing to SMEs and enhance financial competition in general.*
- ✓ *BNA should confer with the MOF on the tax laws to ensure that leasing is not placed at a disadvantage compared to other forms of finance.*

Lesson 5: Insurance is also a useful tool for credit enhancement and risk reduction.

Insurance is another useful tool for reducing lending risks in order to expand SME access to credit and reduce the cost of borrowing. In addition to basic coverage of risks related to fire and theft, and the health of the owner, trade credit insurance can reduce the risks involved in international transactions. For example exporters from Portugal to Angola can use the services of the Portuguese Insurance and Credit Company, COSEC, the leader in the Portuguese credit insurance market, which started guaranteeing exports to the Angolan market in 2006. This coverage last year reached EUR105 million, with 70% of the guarantee sectors representing exports for Construction Products and Materials, Machinery and Equipment, and Electrical Appliances.⁶²

The cost of insurance coverage may seriously limit its use for SME financing. This cost depends not only on the insurer's actuarial assessment of the risk, but also on the degree of competition in the insurance industry, and the growth of the overall insurance sector (to reduce overhead costs through scale economies)

Application to Angola

The insurance industry in Angola is small and competition is limited. The national state insurance entity, the Angolan National Insurance and Reinsurance Company (ENSA), was created in 1978 and enjoyed a monopoly for over two decades. There are now 6 insurance companies, with AAA Seguros being the most important privately owned competitor. Standard insurance cover is therefore readily available, and some banks already package insurance on loans for vehicles and house. However, many bankers are not very familiar with the potential for using insurance to reduce risk.

Trade credit insurance is not readily available within Angola. One way of introducing this coverage for Angolan exporters would be for the Government to join the African Trade Insurance (ATI) network. ATI is a multilateral export credit agency that currently operates in 11 countries in Africa including Kenya, DRC, Madagascar, Malawi, Tanzania and Zambia. ATI not

⁶² www.allAfrica.com

only covers trade credit insurance, but also insurance for political and commercial risk, project loan cover and insurance for foreign direct investment.⁶³ ATI has expressed its interest in entering the Angolan market, though no formal proposal has been submitted yet to GOA. Although this is a promising approach for reducing risk in trade financing, its value to SMEs in Angola is open to question due to the effect of the strong kwanza on export competitiveness for non-mineral products. Before any deal is reached with ATI, BNA or the Government should carry out a study of the potential benefits and costs

Recommendations

- ✓ *Encourage synergies between banking and insurance* through dialogue between the supervisory agencies (BNA and ISS), the banks, and the insurance companies, and through training modules at IFBA on using insurance to reduce credit risk.
- ✓ *Encourage competition in the insurance industry in order to promote innovation and competitive pricing* – while adhering to strict prudential standards to ensure that insurance companies are financially sound and well managed.
- ✓ *GOA should explore the option of joining the ATI network to provide trade credit insurance as a tool for expanding access to credit for Angolan exporters.* Initial steps include entering into discussions with ATI, examining the experience of other African countries in using trade credit insurance, and conducting a study of the potential benefits and costs in the Angolan context.

Lesson 6: Many governments and international agencies support SME financing with guarantees for bank loans. While this is a better approach than direct intervention in lending, guarantee schemes have mixed results. If applied, any such scheme must be carefully structured to avoid moral hazard and serve as a catalyst for overcoming information failures, rather than as a subsidy in disguise.

Credit guarantees are often used as a market-supporting approach to stimulate lending to target groups that otherwise would not qualify for credit. The primary justification is that risk-sharing, as a substitute for collateral, can be a catalyst inducing banks to test new markets and loan products and thereby break through information asymmetries that inhibit the extension of loans to nontraditional customers. The objective, therefore, is to promote sustainable and fundamentally sound financial innovations that foster broad-based growth and poverty reduction. It should be noted, however, that any scheme to stimulate lending by *sharing* the risks should be subordinate in priority to measures aimed at *reducing* risks – such as actions suggested elsewhere in the report to improve information flows, enhance contract enforcement and creditor rights, strengthen SME management capabilities, and improve the business environment.

⁶³ www.africa-eca.com

One of the world's largest credit guarantees programs for SME loans is that of the Small Business Administration (SBA) in the United States.⁶⁴ The SBA originally offered only direct loans to small businesses, but since 1968 has been empowered to guarantee loans advanced by participating commercial banks.⁶⁵ This is now its primary operation. The SBA guarantees losses up to a designated percentage that varies by type of loan. The SBA uses a portfolio approach in which lenders can automatically tap guarantees for loans satisfying certain criteria. This improves efficiency by leaving the credit decisions and the loan administration to the banks, who have the right expertise. It also requires the lenders to retain a share of the risk to mitigate the problem of "moral hazard," which arises if borrowers are lax on loan appraisals and collections due to the presence of the guarantee. In addition, the SBA charges a fee for the guarantee, though it is not high enough to cover the full costs of administration and claims settlement (Levitsky and Prasad 1997)

The SBA program has been criticized for the subsidies required to cover administrative costs, for significant loan losses over the years, for cumbersome procedures; for offering guarantees as high as 85% on some programs (which invites moral hazard); and for fixing the maximum interest that banks can charge as a margin over prime (which may shut out weaker borrowers). Yet the SBA is widely regarded as a success in helping many small businesses gain access to credit. Indeed, one requirement for SBA coverage is that banks must certify that the loans would not be made in the absence of the guarantee. While this formality itself does mean much, 80% of SBA guarantees cover term loans ranging from 5 to 10 years, which would not be readily available to small businesses in the absence of the guarantee (Levitsky and Prasad 1989).

Following the basic SBA concept (though not in every detail), USAID in 1999 established a Development Credit Authority (DCA) to provide loan guarantees in partner countries. Through 2006, DCA had issued guarantees supporting over a billion dollars of loans, including \$225 million in Africa, at a direct cost of just \$40 million – though the contingent liability is ten times larger. DCA provides partial guarantees up to 50%, normally for designated types of loan portfolios. DCA guarantees can also be applied to specific transactions, specific borrowers, bond issues. The overall objective is not just to expand access to credit, but equally to build capacity for lenders to learn to deal with new credit products and non-traditional clients on a competitive and sustainable basis. In Angola, USAID is in the final stages of planning a DCA program for supporting bank lending to the agricultural sector.⁶⁶

The World Bank has also funded many guarantee schemes around the world since the 1980s, mostly in the context of SME financing programs. Although some have been successful, the

⁶⁴ The SBA is an independent agency of the US federal government that has offered direct or indirect help to nearly 20 million businesses since its inception in 1953. Between 1991-2000 the SBA backed more than US\$94.6b loans to almost 435,000 small businesses; between 2001-2006 SBA backed US\$105b of small business loans. See www.sba.org.

⁶⁵ "Small" loans for the SBA can involve sums up to US\$2 million. In 2006, loan covered by the SBA averaged \$126,000, though several popular sub-programs involved average loan sizes of \$45,000 to \$50,000. Data from the SBA website.

⁶⁶ USAID, *Credit Guarantees: Promoting Private Investment in Development, Year in Review 2006*.

Bank now takes a more cautious approach, emphasizing that most efforts have failed to deliver sustainable benefits, and that guarantees often become “a large honey pot attracting rent-seekers” (World Bank 2007, 83)

Indeed, there are significant drawbacks to weigh against the advantages of a credit guarantee program.⁶⁷ Guarantees entail extra transaction costs for the banks. On small loans, the costs can easily exceed the value of the guarantee, so the schemes may not be of much help for a primary target group. The moral hazard problem is also a genuine concern, especially if the guarantee covers a large fraction of the balance at risk. The problem is not just that a guarantee may invite lax lending decisions, but it also dilutes the incentive for banks to incur the cost of recovering overdue payments, especially on small loans.

Yet another problem relates the pricing of the guarantee and the criteria governing the payment of a claim (subrogation). With a low fee and loose subrogation rules, banks have an incentive to use the scheme for loans that would be made anyway, and the guarantee fund is unlikely to cover its costs. However, with a high fee and tight rules, banks might not be interested in using the scheme at all. Most donor-funded schemes, including DCA facilities, involve fees that do not cover the full costs of administration; the implicit subsidy is presumably justified on the premise that guarantee schemes yield significant development externalities by stimulating risk-averse financial sector “pioneers” to enter a market ridden with information constraints.⁶⁸

The main conclusion is that partial guarantees can be an effective tool for mitigating perceived credit risks and information problems that otherwise hinder the development of new financial products and lending to non-traditional clients. But the guarantees have to be very carefully structured to achieve sustainable results and avoid costly problems and economic distortions

Application to Angola

In 1999 the Government established an Economic and Social Development Fund (FDES) as a revolving fund for loans through commercial banks, with FDES bearing between 70% and 100% of the credit risk. The program was plagued with problems, including a repayment rate of under 30% by April, 2003 (UNDP, 2005, p. 11). One cause of this huge write-off was the moral hazard created by government coverage of such a large fraction of the risk. Other problems included direct FDES involvement in the lending decisions, and lack of proper monitoring mechanisms. What is left of FDES has been placed under management of the Development Bank of Angola (BDA), along with additional funding from oil and diamond revenues. As discussed in the Chapter on Term Lending, these funds will mainly be used for lending programs, but a credit guarantee program is also an option.

Despite the adverse experience with FDES, our field interviews suggest that many commercial banks have an interest in participating in a guarantee fund to stimulate SME lending, designed

⁶⁷ For a recent and well balanced assessment, see Balkenhol 2006.

⁶⁸ This term is from Freedman (2004). See also Balkenhol (2006).

in line with internationally proven models. The banks consider partial risk sharing up to 50% as acceptable, as long as they can make their own lending decisions.

The SBA model suggests that a guarantee scheme for SME loans might best be managed by a specialized SME agency such as INAPEM. It is highly unlikely, however, that INAPEM will have the capacity to take on this additional responsibility in the short- to medium-term (see below). If funds for this program come from BDA, then BDA might also serve as program administrator. This approach, too, is not ideal because BDA's mandate is development banking, and SME development requires specialized skills.

Hence, any new credit guarantee scheme using public funds will require a careful assessment of both the administrative and technical arrangements.

Recommendations

- ✓ *The MOF, BNA, and BDA should carefully examine the feasibility of allocating a portion of the Development Fund to a Credit Guarantee Program for SME lending by commercial banks.*
- ✓ *Any such fund should be carefully designed based on international best practice as outlined in Exhibit 3.4, to develop sustainable capacity for bank lending to SMEs, while minimizing the risk of encouraging poor lending practices through moral hazard.⁶⁹*
- ✓ *To this end, a task team from MOF, BNA, and ABANC should consult with the banks, SMEs, donors, potential corporate partners, and other stakeholders on the best technical design and administrative structure, before introducing any credit guarantee fund. In particular, the task team should:*
 - Identify sources of funding.
 - Define the eligible SME target group.
 - Define parameters for partial guarantee.
 - Define eligibility criteria for participating commercial banks, includes a willingness to introduce best practices for SME lending methodology.
 - Elaborate standard procedures and reporting requirements that govern the Fund and its relationship with commercial banks, including clear rules for handling bad debts.
 - Market the guarantee scheme to the banks and the public.

⁶⁹ Any such guarantee program for SME lending should be accompanied by a technical assistance program to help the banks adopt efficient lending techniques for serving this market, as discussed above.

Exhibit 3.4. Best-practice elements for an SME credit guarantee fund

A credit guarantee fund can be an effective catalyst to induce banks to test the SME market and overcome information, risk, and collateral constraints that presently restrict lending to SMEs, but it has to be carefully designed to promote efficient and sustainable approaches to SME financing, and not encourage poor lending practices. The Credit Guarantee should be offered in conjunction with technical assistance to help the banks adopt efficient SME lending techniques, in line with international best practices.

Drawing on international best practices, any such guarantee program should be based on the following principles:

- ✓ Adopt a Portfolio Model in which guarantee covers all loans made by participating lenders within certain criteria.
- ✓ Clearly define the eligible target group of SMEs (e.g. by number of employees, turnover, or assets) and the maximum size of the loans to be covered.
- ✓ Cover a maximum of 50% of the amount at risk to ensure that banks retain a substantial stake in the quality of the loans, to minimize moral hazard
- ✓ For program components designed as a catalyst for new lending business, phase out the guarantee over a period of several years.
- ✓ For longer term investment financing for SMEs, a more permanent risk-sharing program may be needed, as with the SBA model.
- ✓ Let the banks be fully responsible for the interface with SME clients, including loan appraisal, loan administration, loan monitoring, and loan collection.
- ✓ Establish clear and practical rules of subrogation requiring effective collection actions by the banks before turning claims over to the guarantor.
- ✓ Establish effective systems for measuring and reporting performance, including measures of impact/additionality, repayment performance, and economic outcomes.
- ✓ Design the system to minimize the overhead costs of Guarantee Fund management
- ✓ Charge a fee to the banks (and ultimately their clients) to cover at least part – and ideally all – of the administrative costs and claims involved in running the Guarantee Fund.
- ✓ Let the market determine the interest rates in order to avoid market distortions, rent-seeking by otherwise creditworthy borrowers, and restrictions that shut small borrowers out of the system.
- ✓ Establish procedures for remedial action whenever the default rate at any bank exceeds 5%.

Developing Business Development Services for SMEs in Angola

This section addresses international lessons learned about public sector involvement to improve business development services (BDS) for SMEs. The analysis then focuses on how INAPEM can evolve to become an apex agency for expanding the supply and improving the quality of BDS for SMEs in Angola. .

Over the past two decades, the general international trend in BDS services for SMEs has shifted strongly to demand driven approaches, rather than supply led models. Greater attention

is also being given to the quality and sustainability of services, through a market based approach.

Latin America is one region where governments and international donors have advanced experience in SME promotion policies. Research conducted by the Inter-American Development Bank (IDB) has demonstrated, first and foremost, that SMEs benefit from a stable macroeconomic conditions and a healthy regulatory environment. Furthermore, government programs to promote SME development create incentives and opportunities, without introducing unsustainable market distortions.

Beyond these basic points, three major lessons emerge from an overview of trends and experiences in other countries.⁷⁰

Lesson 1: Rationalize Traditional Public Interventions in SME Promotion Activities

Governments are more successful in meeting their SME promotion objectives when they rationalize proposed initiatives and evaluate the potential consequences and impacts of their activities. In practical terms, this means the following:

- *Define the target SME population.* Any program to promote BDS services for SMEs has to define the target population. Regardless of the criteria adopted (employment, revenues, legal status, etc.), a clear definition is necessary in order to identify the target population, determine its needs, and monitor the results.
- *Reduce duplication across government agencies.* SME promotion efforts are frequently duplicated across the government due to overlapping mandates of various agencies. This redundancy can be reduced by establishing an efficient, effective, independent and proactive SME promotion agency. Most countries have seen greater success when there is a lead SME agency with the authority, capability and resources to carry out this mandate.
- *Improve management, control and performance indicators of SME promotion agencies.* Similar to other state institutions, SME promotion agencies can easily lose sight of their mission and become reactive and government-focused rather than proactive and SME-focused. Improving the quality of management and oversight, establishing clear performance indicators, and regular performance monitoring are necessary conditions for efficiency and effectiveness. These indicators should support the development of client-oriented strategies and processes. Exhibit 3.5 lists the types of indicators that can be used in SME promotion initiatives, based on World Bank's operations evaluation department.

⁷⁰ This overview is based on research by the World Bank Institute (Fan 2003) and the IDB (2003).

Exhibit 3.5 Monitoring Indicators for SME Promotion Initiatives

Indicators should be specific to the program and include both baseline data (pre-program) and evaluation data (post-implementation). Examples of appropriate indicators include: SME sales, profits, employment, and labor productivity. Indicators for BDS providers include volume of activity, impact, subsidy dependence, customer satisfaction, and profitability. There is no one set of indicators to fit all SME promotion programs. Yet all indicators should be:

- relevant - to the program being evaluated;
- valid - reflecting the underlying concept;
- reliable - with minimal measurement error; and
- practical - ability to gather data.

When evaluating SME promotion programs there are several considerations:

- plan the evaluation before the program begins operations;
- ensure larger or pilot programs have sufficient evaluation resources;
- gather baseline data on both program participants and a control group, if possible; and
- integrate both qualitative (e.g. structured interviews and focus groups) and quantitative methods (e.g. surveys and econometric analysis).

Source: Hallberg 2004

1. *Condition budgetary allocations to the achievement of impact.*

The performance of SME promotion agencies should not only be measured by their activities, but also the impact of these activities. With a limited amount of resources (skilled staff, facilities, finances, etc.), budgetary allocations that incorporate even a rudimentary cost-benefit analysis have the potential to improve efficiency and outreach greatly, by weeding out program elements that are ineffective.

- *Increase cost recovery for publicly provided or subsidized services.* Support for SME BDS has the potential to reach greater levels of sustainability and impact through cost sharing mechanisms through payments by the SME beneficiaries themselves, to complement contributions from the government and the donor community.

Lesson 2. Accelerate the Development of SME BDS and Allow Open Access to this Market

- *Gather, analyze and distribute relevant information on BDS providers, and the measurable impact of their services.* SME promotion agencies can play a key role in increasing awareness and distributing information related to available BDS providers.

- *Target subsidies for market development to overcome specific market failures, and leverage public resources by mobilizing the private sector to deliver services.* Programs in business development services have proven to be more effective when they promote the development of a private BDS market. Providing competitive grants to qualified BDS providers based on performance is one approach that several states have chosen to strengthen the market for SME business development services. An example is the recent BDS Fund established in Nigeria (Exhibit 3.6).
- *Promote and enforce competition in the BDS sector.* SME owners should be encouraged to obtain BDS support from specialized suppliers that best meet their needs – a demand driven and client-oriented approach.

Exhibit 3.6 Using Competitive Grants for SME BDS - the Case of Nigeria

As part of the current Micro, Small and Medium Enterprise Nigeria pilot project, the Government of Nigeria and the World Bank established a BDS fund to provide matching performance grants to qualified SME BDS providers. Rather than directly supporting SMEs, the project uses competitive grants to expand the capacity of BDS providers to provide quality and affordable services to Nigerian SMEs. The funding is time-bound, transparent, and performance-based. The goal is to deploy cost-effective grants that develop rather than undermine the commercial market for SME BDS.

The project has targeted technical and professional business development services providers in three regions in Nigeria. Eligible grant applicants include business training organizations, management consultants, business support organizations, and NGOs providing business development services; government agencies, and state owned or state controlled enterprises are not eligible for support. Prospective providers compete for grant funding directly relating SME BDS, with amounts that vary based on performance indicators of outcomes and impacts. There is no minimum grant amount, but the maximum for any one client is US\$ 250,000. A total of US\$ 5 million has been allocated to the BDS fund.

The use of competitive grants through the BDS Fund is part of the project's overall SME development strategy. Although it is still in its early stages, and has relied heavily upon the experiences of many other countries, it appears as though the project's use of competitive grants is making important changes in promoting a stronger market for SME BDS.

Source: MSME Nigeria Project 2007

Lesson 3. Invest in Public Goods and Build Institutional Capacity of BDS Providers

- *Limit long-term subsidies for BDS to activities with public goods characteristics, such as public information, and labor and management training.* SME promotion efforts and limited subsidies should serve to promote a healthy and competitive market for providing BDS services through private sector providers. Information is an important public good that can have a significant positive impact on this process. Focusing on the provision of

information has been part of the success of Brazil's SME development efforts over the past three decades, as illustrated in Exhibit 3.7.

Exhibit 3.7 The Power of Public Information – Lessons from Brazil

Brazilian government initiatives to support SMEs began in 1964 with the SME financing and technical assistance program of the Banco Nacional de Desenvolvimento Econômico (BNDE). In 1972 the government established the Centro Brasileiro de Assistência Gerencial à Pequena Empresa (CEBRAE), which served a wider role in promoting SME initiatives, under the direction of the Ministry of Planning. In 1990 the Government passed legislation which changed the name to Serviço Brasileiro de Apoio às Micro e Pequenas Empresas (SEBRAE) and transformed it from a public agency to an autonomous social service organization funded by mandatory contributions from businesses.

SEBRAE has evolved into the country's leading SME BDS provider, and part of its success has been the result of effective dissemination of entrepreneurial information through a variety of media, including:

- Popular radio programs delivered in simple and direct language, reaching lower income and lower educated populations who traditionally lack access to basic entrepreneurial awareness and business related information.
- Quality television programs highlighting management skills broadcasted via educational channels and higher education classes.
- Practical Internet website (<http://www.sebrae.com.br>) that provides targeted information, self training and advisory services that meet the needs, capabilities and realities facing each respective entrepreneur.
- Popular comics that use illustrations to foster greater awareness and understanding of key issues facing micro and small enterprises.

These information channels also serve to refer potential entrepreneurs to service delivery points throughout the country. The centers offer training and technical assistance, provide information, distribute publications and manuals, and also organize SME events, trade shows and competitions.

Source: www.sebrae.com.br

- *Provide training and technical assistance to increase the capacity of private BDS providers.* Development of performance and impact indicators for public sector involvement and private sector service providers – clear roles, responsibilities and performance requirements.
- *Promote innovation in products and delivery mechanisms – especially those targeting smaller enterprises.* SME promotion agencies can play a leading role in facilitating the

entry of new training and advisory techniques and curriculums. Again, the best practices suggest greater effectiveness when these services are provided through the private sector.

These three general lessons are a useful guide for policymakers involved in reforming SME development initiatives. The process of transition from a supply driven to a demand driven model, however, is not an easy one. The case of Indonesia illustrates some of the challenges involved, as summarized in Exhibit 3.8.

Exhibit 3.8. The Transition to Demand Driven BDS – the Case of Indonesia

Until recently, Indonesian SME promotion efforts were part of a supply driven paradigm, which focused on directly providing SMEs with technical assistance, marketing, subsidized financing, and market protection. Similar to the disappointing experiences of the supply driven models in many other countries, the result in Indonesia was a large expenditure of state resources with little impact. Independent assessments from a variety of international organizations, including the ILO and Asian Development Bank, noted that Indonesia's Small Industries Development Program (Pembinaan dan Pengembangan Industri Kecil, BIPIK), founded in 1980 by the Department of Industry, has continually suffered from poor program design, lack of government coordination, deficient implementation, and inadequate monitoring. As a result BIPIK has not been effective in raising the technical capabilities of SMEs. In some cases SME promotion funds were captured by rent seeking political and bureaucratic interests, and often the SME policies undermined BDS markets and subjected efficient SMEs to unfair competition.

The Indonesia experience, similar to other Southeast Asian countries, was based on SME promotion rationales built around social welfare or re-distribution arguments, rather than on concerns over efficiency and development potential. This view sees SMEs as being weak, and needing subsidies and protection. The poor performance of the supply driven model led to the emergence of a new market based or demand driven approach, which sees SMEs as needing greater access to markets, information and services, and focuses on promoting sustainable SME BDS institutions, rather than on direct income subsidies to SMEs.

Despite evidence that the old model has not worked, efforts to reform SME promotion initiatives in Indonesia have not been easy. The Government's policy since 2003 has been to move toward more demand-driven SME promotion policies. This includes strengthening the business enabling environment; and promoting efficient, demand-driven SME business development services through private sector providers which are responsive and accountable to the needs of SMEs. However it is too early to tell how successful it shall be in moving away from the social welfare and patronage-based model.

Sources: Thee 2006 and Timberg 2001

Promoting SME Development Through Partnerships – Lessons from the USA

The U.S. Small Business Administration (SBA) has adopted many of these best practices by moving away from the direct provision of BDS to a partnership model. The SBA promotes access to training and advisory services to existing and prospective SMEs through Small Business Development Centers (SBDCs) that provide one-stop assistance to individuals and SMEs through centrally located offices in every state⁷¹. SME owners in the USA have access to SBDCs for free individual business advisory services, and receive at-cost training for writing business plans, accessing finance, improving marketing and promotion, regulatory compliance, and other areas⁷².

The SBDC program is a partnership between the private sector, educational institutions, and the federal, state and local governments. SBDCs are hosted through leading universities and operate autonomously as SME BDS providers. To qualify for federal government funding, they must raise an equal or greater amount of funding from other sources. In 2005, SBDCs raised nearly \$109 million a year to match \$88 million in federal funding for SME development services. The SBA serves as coordinator to ensure that the objectives of this entrepreneurial development initiative are met. This role includes collecting, measuring and assessing the impact of program objectives (Exhibit 3.9).

⁷¹ There are approximately 1000 service centers and additional outreach offices in the SBDC network, which serve rural, urban and suburban communities throughout the USA.

⁷² In 2006, SBDCs provided individual business consulting services of an hour or more to 201,823 clients; conducted training courses for 465,837 attendees; and provided nearly 3.4 million total hours of consulting and training for small businesses and aspiring entrepreneurs.

Exhibit 3.9. Measuring the Impact of SBDC Performance in the United States

In addition to funding, facilitating, and promoting SBDC activities (see text), the Small Business Administration (SBA) monitors key performance indicators and assesses the impact, costs, and benefits of government subsidized BDS. The key performance indicators include:

Targeting Women, Minority and Veteran Owned SMEs

- In 2006, 45% of SBDC business consulting clients and 43% of training clients were women, 34% of consulting and 21% of training were disadvantaged minorities, and 9.1% of counseling and 5.2% of training were veterans.

Promoting Employment and Growth

- The SBA estimates that in 2005, SBDC clients who received 5 or more hours of consulting services (in-depth clients) created 81,289 new full time jobs, and experienced nearly nine times the job growth of average businesses (15.2% compared to 1.7% for U.S. businesses in general) between 2004 and 2005.
- During 2004 and 2005, SBDC in-depth clients started 19,307 businesses.
- SMEs who receive in-depth SBDC assistance reported sales growth averaging 24.8% between 2004 and 2005 – compared to 6.3% for businesses in general.

Accessing Finance

- SBDCs in-depth clients obtained US\$3.6 billion in financing in 2005. Each US\$1 of SBDC expenditures enabled SMEs to access US\$18.8 of new capital.

Cost Effective Subsidies

- SBDCs generated tax revenue that exceeded the cost of subsidies. SBDC in-depth clients paid an estimated US\$2.8 in new Federal tax revenue for every US\$1 spent by the Government on the program.

Sources: U.S. Small Business Administration statistics; and Chrisman 2005.

SBDCs throughout the USA are supported through the Small Business Development Center National Information Clearinghouse (SBDCNET), which provides the following services:

- dissemination of best practices of SME promotion and technical support information for SBDC advisors;
- practical and timely research for SME entrepreneurs, available at no cost through the Internet;
- on-site training and distance learning for both SBDC advisors and SME clients; and
- the exchange of SME promotion best practices and program ideas throughout the SBDC network.

BDS Market Development – Using Vouchers to Promote Competition

As indicated earlier, international best practices emphasize promoting market mechanisms for the provision of business development services for SMEs. A market based approach has the potential for tapping more resources, stimulating more innovation, and achieving greater sustainability in the provision of BDS to meet the needs of local SMEs. Over the past decade many countries have implemented voucher systems to promote the supply of market-based, demand driven BDS for SMEs.

The use of vouchers enables SMEs to defray a portion of the costs of training from pre-selected and pre-qualified private sector and NGO providers of BDS. These BDS providers then have to compete for the business of SMEs, who are expected to supplement the voucher with funds from their own resources, to ensure that the training and advisory services deliver genuine benefits to the target enterprises..

Research on BDS voucher programs in nine countries has shown that this approach tends to be more successful for micro and very small enterprises. There is less demand from enterprises beyond this range primarily because they require more sophisticated and customized business services, and thus more costly vouchers (Goldmark and Fitzgerald 2001). The research findings also indicate that:

- vouchers should be used selectively and strategically with other BDS market development activities;
- they are more effective when the market has been primed for their introduction; and
- voucher programs need to have a clear exit strategy and should not be seen as a permanent market presence.

Voucher initiatives require high levels of administrative costs and capable program managers to ensure that they are implemented effectively. Successful voucher programs also require basic development support for BDS providers. Countries facing a weak supply of BDS providers and implementing organizations with lackluster program management capabilities should focus instead on developing these two areas before attempting to implement a voucher initiative.

General Education – Developing Future Entrepreneurs

To implement effective SME development policies and initiatives, concerned policymakers face the challenge of promoting a good enabling environment and embracing demand driven BDS approaches. However, for countries in transition from closed to open market economies there is also a strong need for promoting a culture of new business practices through general entrepreneurship awareness and education. This includes working with young people, and incorporating practical entrepreneurship education into secondary school and higher education curricula. Exhibit 3.10 highlights recent efforts by the government of Pakistan in this area.

Exhibit 3.10. Entrepreneurship Education – Making Changes in Pakistan

The Small and Medium Enterprises Development Authority (SMEDA) of Pakistan was concerned that the education system was not promoting entrepreneurship with young people, and that previous government SME programs were limited in reach and design. Hence, SMEDA has embarked on a program to promote entrepreneurship through the schools, to increase awareness amongst youth and provide quality support to aspiring new entrepreneurs. The new SME policy is oriented to the following areas:

- Revising primary and secondary curricula for promoting entrepreneurship amongst the educated youth
- Assuring that entrepreneurship courses are available in higher education, technical and vocational training institutions
- Establishing entrepreneurship competitions amongst university students, including an annual national business plan award providing seed capital.
- Implementing business incubators at selected universities.
- Identifying investment opportunities offered by backward and forward linkages.

SMEDA expects that implementation of these policies will engage a wider segment of the educated population in entrepreneurial activities, and thus increase employment and reduce inequality.

Source: Small and Medium Enterprises Development Authority 2007

Putting the Foundation in Place – SME Promotion Legislation

These lessons and experiences gathered from both low and high income countries provide a useful guide for INAPEM in its efforts to strengthen SME promotion efforts in Angola. However, on a basic level Angola still need to put in place a firm foundation of government policy towards SME promotion. Botswana's experience in the late 1990s is an example of what such a policy entails (Exhibit 3.11)

Exhibit 3.11 Establishing SME Promotion Legislation – the Case of Botswana

In 1998 the government of Botswana enacted a new policy on Small, Medium and Micro Enterprises (SMMEs). The policy was approved by the parliament and resulted from recommendations of an SMME Task Force appointed by the government, but consisting mostly of representatives from the private sector. The policy established a new legal and institutional framework for SMME support (Small Business Act, Small Business Council, and Small Business Promotion Agency); identified new sources of financing for SMMEs (a micro-credit program, and a credit guarantee facility operating through local banks); enacted regulatory changes, including reforming the Companies Act, and licensing laws; and improved business education and training, through the state school system and through subsidized short courses for SME owners and employees.

The guiding principles of Botswana's SMME Policy are to:

- create an SME friendly enabling environment;
- enhance coordination of SME development activities;
- ensure that SME policy is implemented effectively and assessed by measurable objectives, and
- reduce SME dependency on the state.

The specific objectives of the policy are to:

- promote entrepreneurship and a competitive and sustainable SME sector;
- increase economic diversification;
- enhance exports;
- increase sustainable employment opportunities;
- promote SME participation in the supply chain; and
- improve the efficiency and effectiveness of SME BDS.

(Source: adapted from Jefferis 1999)

Implications for Angola and INAPEM

The Government of Angola is aware of the importance of SMEs to its overall economic development policies and the transition to market economy. SMEs have a particularly vital role to play in diversification of the non-oil sectors and employment creation. The authorities also realize that SMEs face a difficult enabling environment, as well as a variety of other external and internal constraints. The government appears to have a commitment to addressing these issues and promoting SMEs, but this interest has yet to materialize into clear, measurable and successfully implemented actions. There is a compelling need to establish an operational definition of the SME target group, improve coordination among government agencies, and transform INAPEM into an active and effective agent for supporting SME clients. These

changes require strong political will at key agencies, principally from INAPEM and its parent, the Ministry of Finance.

This section examines the current state of INAPEM and provides a practical plan of action to strengthen the institution and improve its ability to promote SME development, based on the lessons from international experience discussed above.

The Current Situation

INAPEM was established by the Government in 1992 to promote Angolan SMEs. Originally part of the Ministry of Industry, it moved in 1996 to the Ministry of Finance. INAPEM's mandate previously included promoting access to finance through direct financing activities, as well as promoting business development services. In 2001 the Counsel of Ministers issued decree 81/01 to restructure INAPEM and focus its activities on BDS. Today, INAPEM has approximately 70 employees, with headquarters in Luanda and offices in 8 provinces. INAPEM is the only government agency dedicated to SME promotion. But many other government offices are directly and indirectly involved in activities and initiatives relating to SME promotion, including the Ministry of Industry, Ministry of Public Administration and Employment, Ministry of Finance, National Statistics Institute, Ministry of Education, Ministry of Youth, Ministry of Planning and others.

As a government agency, INAPEM faces problems with human resources, work incentives, management, and oversight. INAPEM has openly discussed with the study team the difficulties in overcoming many of these challenges. From our evaluation based on internal and external interviews, related documents, and visiting a training session, we conclude that INAPEM clearly has room to improve its capacity to promote SME development in Angola. Furthermore, in view of its current weaknesses, it appears unlikely that the organization has the capacity at this time to successfully manage and oversee the implementation of international best practices approaches for SME BDS development, including competitive grants and vouchers.

Table 3.7 provides a more complete analysis of INAPEM's strengths, weaknesses, opportunities and threats (SWOT) analysis.

Table 3.7 SWOT Analysis of INAPEM

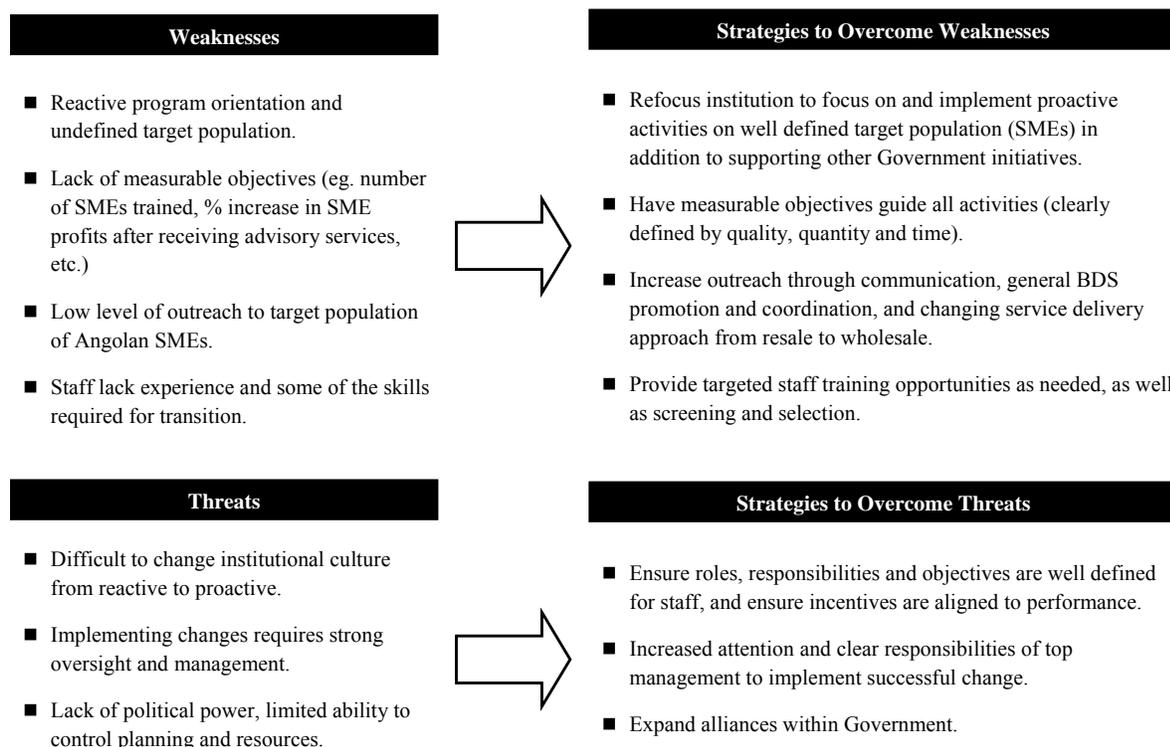
Strengths	Weaknesses
<ul style="list-style-type: none"> • Solid basic training methodology and network of external consultants. • Physical presence in the provinces, and ability to use state resources to access rural areas. • Staff demonstrates a general openness to improvement. 	<ul style="list-style-type: none"> • Reactive program orientation and undefined target population. • Lack of measurable objectives (eg. number of SMEs trained, % increase in SME profits after receiving advisory services, etc.) • Low level of outreach to target population of Angolan SMEs. • Staff lack experience and some of the skills

	required for transition.
Opportunities	Threats
<ul style="list-style-type: none"> • Current transition from state to market based economy provides opportunity to support greater entrepreneurship. • Promotion of SMEs directly supports Government objectives (employment, diversification of GDP, etc.) • Government is in a strong financial situation to fund well managed SME promotion efforts. 	<ul style="list-style-type: none"> • Difficult to change institutional culture from reactive to proactive. • Implementing changes requires strong oversight and management. • Lack of political power, limited ability to control planning and resources.

Recommended Future Directions

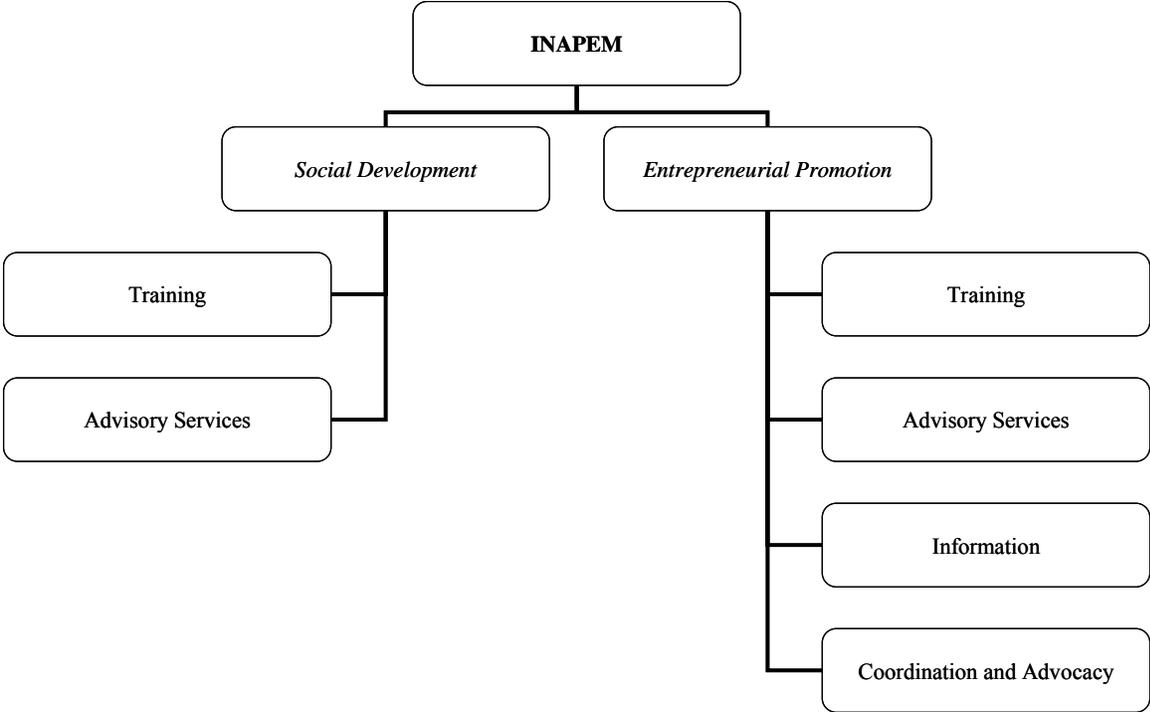
The weaknesses and threats facing INAPEM can be overcome through a variety of strategies based on the lessons learned from other countries, including the flagship experience of the U.S. Small Business Administration (SBA). Figure 3.1 highlights a few suggested approaches to convert INAPEM from a weak and reactive SME promotion agency to one that is both proactive and effective.

Figure 3.1 Strategies to Overcome Weaknesses and Threats



An important step towards adopting these strategies is to reorient INAPEM so that it can pursue the social mandates required by the government and its mandate to support SME development, as well as a new proactive area of entrepreneurship promotion. This new area should involve public information activities, coordination of SME initiatives, and advocacy of SME promotion, in addition to direct training and advisory services. Figure 3.2 provides an overview of this proposed refocus.

Figure 3.2 Proposed Re-focus of INAPEM Activities



Moving towards this new strategy and refocusing activities to be more responsive to the needs of SMEs requires immediate assistance to help INAPEM establish a plan of action that can be used to seek technical assistance from the donor community in four key areas: institutional capacity; delivery of BDS; coordination and advocacy; and information dissemination. Table 3.8 outlines the proposed activities in each areas. The Annex to this chapter presents a more comprehensive view of the draft program, including performance indicators and lines of responsibilities.

Table 3.8 Proposed Areas of Action for INAPEM

Area	Activity
1. Strengthen Institutional Capacity, Management, and Monitoring	1.1. Conduct Staff Training Needs Assessment and Gap Analysis. 1.2. Implement Immediate Management Training (Setting Measurable Goals and Indicators, Accountability and Oversight, Planning, etc.) 1.3. Develop Internal Monitoring and Evaluation Standards and Procedures
2. Improve Delivery of Business Development Services – Training and Advisory	2.1. Implement Staff Training in BDS Based on Results of Training Needs Assessment (Technical and Managerial) 2.2. Update Advisory and Training Materials to Support Greater SME Access to Finance 2.3. Draft Plan to Facilitate SME BDS market (inter alia promote development of private providers)
3. Enhance Coordination and Advocacy	3.1. Donor Coordination – Quarterly Meetings / SME Advisory Committees and Working Groups (UNDP, CAE, CARE, etc.) 3.2. Government Coordination – with MoF, MAPESS (INEFOP), INE, MoE, MoP, MoC, etc. 3.3. Facilitate SME Legislation
4. Implement Information Collection and Dissemination	4.1. Develop SME Baseline Data from REMPE (2002) and establish a Working Definition of SMEs 4.2. Update INAPEM Promotion Materials and Develop Website 4.3. Conduct General Entrepreneurship Awareness Campaign and Media Outreach Targeting Provinces (e.g. Small Business Week)

The need for strengthening institutional capacity within INAPEM itself is the top priority. This requires early action to implement a comprehensive SME training course and staff training

needs assessment. For this purpose we recommend bringing in an experienced SME training specialist from abroad.

The second area of the plan addresses the critical need to improve the delivery of business development services. The overall approach is to support a transition to demand-driven best practices. It is especially important for INAPEM to strengthen its existing technical assistance and training in the area of SME access to finance, for which there is strong demand. INAPEM can respond to this demand by helping SMEs understand banking services, how to develop effective banking relationships, how to negotiating trade financing, and use savings, insurance and other financial instruments to manage risk. To address this concern the plan of action includes specific activities to revise advisory materials and introduce basic and advanced SME modules on access to finance.

Action in the third area, coordination and advocacy, is needed to transform INAPEM into an apex organization. For this to work will require a high-level endorsement for serious action to improved the availability and quality BDS as a major tool for promoting SME development, and the expansion of financial services to SMEs.

Finally, there is also a need for INAPEM to develop and implement a monitoring and evaluation system to provide feedback for program management, enhance transparency and accountability for delivering results, and track the effectiveness of its own programs, and those of BDS programs nationally, in promoting entrepreneurship.

In developing a monitoring and evaluation plan, INAPEM should take into consideration the following questions based on best practices (adapted from Hallberg 2004):

Monitoring the performance of SMEs and BDS providers

- What types of SMEs have participated in the program?
- To what extent has the program reached SMEs in the target population?
- What is the type and extent of SME participation in program activities?
- Are the program resources being used in an efficient manner?
- Does the program have the ability to be financially sustainable over time?

Impact evaluation of SME promotion initiatives

- Did participating SMEs change their behavior as intended?
- Did participating SMEs improve performance beyond the control group?
- Did the program have any unintended negative effects or impacts?
- Did the program have meet targets related to employment, economic growth, access to capital, etc.?
- Was the program an effective use of public resources (cost-benefit analysis)?

As indicated, the proposed Plan of Action is aimed at turning INAPEM into the lead agency for SME promotion in Angola, with primary responsibility to develop and coordinate SME programs nationwide, and provide support to all BDS providers to strengthen the quality of their services. The success of this endeavor depends critically on having a strong political commitment from the parent ministry to reforming and strengthening INAPEM, as well as firm leadership within the

organization and sufficient funding and technical support for the reform program. A continuation of “business as usual” for INAPEM is not a viable or sustainable scenario.

Annex to Chapter 3 - Suggested INAPEM Plan of Action

Area	Activity	Sub-Activities	Key Performance Indicators	Timing	Responsible Party	Need for Donor Assistance
1. Strengthen Institutional Capacity, Management, and Monitoring	1.1. Conduct General Staff Training Initiative	A. Design and approve scope of work.	1 scope of work completed and approved.	1 week	Martins	High
		B. Submit scope of work to public bid.	1 request for proposal.	1 week (drafting) 4 weeks (solicitation)	Martins	
		C. Select training provider.	1 provider selected and contract signed.	2 weeks (selection) 2 weeks (contract signed)	Martins and Conselho de Administração (CA)	
		D. Implement SME promotion training.	XX staff members trained for XX hours.	4 weeks	Consultant	
		E. Conduct examinations.				

Area	Activity	Sub-Activities	Key Performance Indicators	Timing	Responsible Party	Need for Donor Assistance
		F. Design individual training needs assessments and SME training program.	<p>XX staff members are examined.</p> <p>XX staff members receive an individual training needs assessments and gap analysis.</p>	<p>1 week</p> <p>1 week</p>	<p>Consultant</p> <p>Consultant</p>	
	1.2. Implement Immediate Management Training (Setting Measurable Goals and Indicators, Accountability and Oversight, Planning, etc.)	<p>A. Evaluate local management training providers.</p> <p>B. Select provider.</p> <p>C. Implement training.</p>	<p>Curricula, pricing and references collected from a minimum of 3 local training providers.</p> <p>1 provider selected.</p> <p>X INAPEM staff</p>	<p>2 weeks</p> <p>4 weeks</p>	<p>Maria Cecilia</p> <p>Maria Cecilia and CA</p>	Medium

Area	Activity	Sub-Activities	Key Performance Indicators	Timing	Responsible Party	Need for Donor Assistance
			receive advanced refresher management training.	1 week	Training Provider	
	1.3. Develop Internal Monitoring and Evaluation Standards and Procedures	<p>A. Develop monitoring and evaluation plan.</p> <p>B. Implement plan for year and assess on a timely basis.</p>	<p>1 plan developed measuring all activities against verifiable indicators (quantity, quality time).</p> <p>1 plan implemented and assessed formally on a weekly basis.</p>	<p>3 weeks</p> <p>Ongoing</p>	<p>Maria Cecilia and CA</p> <p>Maria Cecilia and CA</p>	Medium

Area	Activity	Sub-Activities	Key Performance Indicators	Timing	Responsible Party	Need for Donor Assistance
2. Improve Delivery of Business Development Services – Training	2.1. Implement Staff Training in BDS Based on Results of Training Needs Assessment (Technical and Managerial)	A. Design 12 month, proactive staff training program, addressing individual and group needs, within resource limits.	1 plan drafted for 12 month period.	2 weeks	Martins	<i>Medium</i>
		B. Implement plan.	1 plan implemented.	12 months	Martins	

Area	Activity	Sub-Activities	Key Performance Indicators	Timing	Responsible Party	Need for Donor Assistance
	2.2. Update Advisory and Training Materials to Support Greater SME Access to Finance	<p>A. Consult with banks to identify information requirements and preferences for SME clients.</p> <p>B. Draft model business plan and feasibility study templates (including financials) as well as financial sector awareness training curricula.</p> <p>C. Distribute templates and draft curricula to banking sector and solicit feedback for improvement.</p> <p>D. Revise final templates and curricula as well as accompanying advisory and training manuals for facilitators.</p>	<p>Informational interviews and document collection conducted with a minimum of 8 commercial banks.</p> <p>1 draft feasibility study template and 1 draft business plan template. 1 draft introductory financial sector awareness curriculum and 1 advanced financial sector awareness curriculum.</p> <p>Templates and curricula distributed to all 19 banks for feedback.</p>	<p>2 weeks</p> <p>2 weeks</p> <p>4 weeks</p>	<p>Mendes and Garcia</p> <p>Mendes and Garcia</p> <p>Mendes and Garcia</p>	<p>Medium</p>

Area	Activity	Sub-Activities	Key Performance Indicators	Timing	Responsible Party	Need for Donor Assistance
	2.3. Draft Plan to Facilitate SME BDS market	A. Draft plan based on best practices. B. Implement plan.	1 plan drafted. 1 plan implemented.	8 weeks Ongoing	Martins Martins	High
3. Enhance Coordination and Advocacy	3.1. Donor Coordination – Quarterly Meetings / SME Advisory Committees and Working Groups (UNDP, CAE, CARE, etc.)	A. Establish objectives of quarterly SME promotion meetings and set schedule for first 12 months. B. Distribute invitations to all involved and interested SME promotion partners. C. Implement and facilitate quarterly donor meetings.	1 list of meeting objectives approved. 4 dates of coordination meetings scheduled. 1 set of invitations drafted and distributed. 4 meetings conducted over the first 12 months (1 meeting every three months).	2 weeks 2 weeks 2 weeks 12 months	Assis Assis Assis Assis	Low

Area	Activity	Sub-Activities	Key Performance Indicators	Timing	Responsible Party	Need for Donor Assistance
	3.2. Government Coordination – with MoF, MAPESS (INEFOP), INE, MoE, MoP, MoC, etc.	<p>A. Establish objectives of quarterly SME promotion meetings and set schedule for first 12 months.</p> <p>B. Distribute invitations to all involved and interested SME promotion partners.</p> <p>C. Implement and facilitate quarterly donor meetings.</p>	<p>1 list of meeting objectives approved.</p> <p>4 dates of coordination meetings scheduled.</p> <p>1 set of invitations drafted and distributed.</p> <p>4 meetings conducted over the first 12 months (1 meeting every three months).</p>	<p>2 weeks</p> <p>2 weeks</p> <p>2 weeks</p> <p>12 months</p>	<p>Assis</p> <p>Assis</p> <p>Assis</p> <p>Assis</p>	Low

Area	Activity	Sub-Activities	Key Performance Indicators	Timing	Responsible Party	Need for Donor Assistance
	3.3. Facilitate SME Legislation	<p>A. Design and approve scope of work for external consultant.</p> <p>B. Select external consultant.</p> <p>C. Draft SME legislation based on international best practices, that reflects the reality of Angola.</p> <p>D. Conduct external consultations, review and solicit feedback from public and private stakeholders.</p> <p>E. Present final draft of legislation and accompanying report to executive and legislative bodies.</p>	<p>1 scope of work completed and approved.</p> <p>1 provider selected and contract signed.</p> <p>1 draft legislation completed.</p> <p>5 public consultations (Benguela, Cabinda, Huambo, Luanda, and Lubango) and distribution to and request for comments from public and private stakeholders.</p> <p>1 final draft presented.</p>	<p>2 weeks</p> <p>4 weeks</p> <p>2 weeks</p> <p>4 weeks</p> <p>4 weeks</p>	<p>Rangel and CA</p> <p>Rangel and CA</p> <p>Consultant</p> <p>Consultant and Rangel</p>	<p>120</p> <p>High</p>

Area	Activity	Sub-Activities	Key Performance Indicators	Timing	Responsible Party	Need for Donor Assistance
4. Implement Information Collection and Dissemination	4.1. Develop Basic SME Baseline Overview from REMPE Data (2002) and a Working Definition of SME	A. Convert REMPE data (<20 employees) into a general baseline.	<p>1 analysis of Angolan SME by size (revenues and employees)</p> <p>1 analysis of Angolan SMEs disaggregated by province</p> <p>1 analysis of Angolan SMEs disaggregated by sector</p>	2 weeks	Garcia	<i>Low</i>
		B. Present data into clear and concise presentation for distribution to staff and partners.	1 summary presentation completed	2 weeks	Garcia	

Area	Activity	Sub-Activities	Key Performance Indicators	Timing	Responsible Party	Need for Donor Assistance
	4.2. Update INAPEM Promotion Materials and Develop Website	<ul style="list-style-type: none"> • Develop “tri-fold” brochure which is oriented toward the needs of SMEs • Provide access in electronic form and create links to partners (government and donor partners). 	<p>1 updated brochure</p> <p>1 basic website developed</p>	<p>4 weeks</p> <p>8 weeks</p>	<p>Martins</p> <p>Martins</p>	<p>Low</p>

Area	Activity	Sub-Activities	Key Performance Indicators	Timing	Responsible Party	Need for Donor Assistance
	4.3. Conduct General Entrepreneurship Awareness Campaign and Media Outreach Targeting Provinces (Small Business Week)	<p>A. Select communication message and target market.</p> <p>B. Distribute message through a variety of medium.</p> <p>C. Develop Small Business Week Campaign</p> <p>D. Implement Small Business Week Campaign</p>	<p>1 marketing strategy</p> <p>XXX minutes of radio time and XXX minute of television time and XX articles printed.</p> <p>1 campaign strategy developed.</p> <p>1 promotion campaign implemented.</p>	<p>2 weeks</p> <p>12 weeks</p> <p>2 weeks</p> <p>1 week</p>	<p>Martins</p> <p>Martins</p> <p>Martins</p> <p>Martins</p>	<p>Medium</p>

Chapter 4. Reducing the costs of banking

This chapter examines the costs to clients of using banking services in Angola, as well as the cost structure of the banks themselves. The basic question is whether these costs are an important factor limiting the scope of financial intermediation, and if so, what might be done to reduce these costs.

The rapid growth in loans and deposits over the past two years suggests, *prima facie*, that the cost of accessing bank services has not been a serious impediment to expansion of the banking system. Yet even now the economy is extremely under-banked. By mid-2007 credit to the private sector amounted to just 7.2% of GDP; bank deposits totaled only 15.7% of GDP; and an estimated 94% of the population still handle their business and personal finances without any access to the banking system.⁷³ By every benchmark, banking services are used by only a narrow segment of the potential market. The cost of bank services may well be one important contributing factor.

The discussion begins with an analysis of the data on the lending rates, deposit rates, and service charges faced by bank customers. The basic finding is that the prime lending rate is surprisingly low, though many non-prime clients face much higher interest rates reflecting extra costs involved in extending credit to smaller and riskier clients. The interest rate spread, however, is high, reflecting the fact that banks pay very low interest rates on deposit. Still, the spread is not out of line with regional norms. Transactions costs in the form of fees and service charges are also high, but within the range normally seen in the region.

The analysis then turns to an assessment of basic factors determining the interest spread and the level of fees, including operating expenses, provisions for bad debts, and profit margins. We also examine the impact of the stamp duty (*imposto de selo*) on the cost of financial services.⁷⁴ The main finding is that profit margins are very high, whereas operating costs have been reasonably low. The cost of bad debt has been in the moderate range, but supervisors at BNA still need to monitor loan portfolios diligently in light of the rapid growth of credit and the entry of new banks. Increased competition in the banking sector has begun to compress profit margins, a trend that should continue. Market pressures should also help to reduce the interest spread as well as the level of fees. Eliminating the stamp duty on banking services would remove a small but significant cost; in any case, this duty is an inefficient and distortionary source of revenue, which ought to be abolished as part of the government's fiscal reform program.

The final section reviews some of the fundamental constraints that add to the cost of banking in Angola, and offers that may help to reduce lending rates, the interest spread, and service charges.

⁷³ Data on deposits and loans are from BNA. The GDP estimate is from the IMF World Economic Outlook database, October 2007. The estimate of population coverage is from Deloitte and BANCA (2007).

⁷⁴ This aspect is specifically required in the scope of work.

Costs Faced by Bank Customers

Lending rates

The next chapter will discuss the reference rates used by banks in Angola to determine the pricing of their loans. At this, we are simply concerned with assessing the level of lending rates. Reports submitted to BNA as of September, 2007, indicate that interest rates at major banks ranged from 7% to 12% on loans denominated in dollars, and from 8% to 25% on kwanza-denominated loans.⁷⁵ For prime-grade customers, the interest rates are astonishingly low considering that the banks are operating in an environment characterized by a lack of effective institutions for tracking credit history, registering property, securing collateral, and enforcing loan agreements. By comparison, the prime lending rate in the United States was 7.75% and in South Africa, 13.5%.⁷⁶ The prime lending rate in kwanza is also very low relative to inflation, which is still around 12%.⁷⁷

Interest rates on loans to less creditworthy clients are, of course, higher. This is to be expected, because such loans involve smaller amounts and riskier clients. Higher interest rates on these loans cannot necessarily be regarded as a sign of inefficiency or excessive costs in the banking system. Notably, one small bank reported charging as much as 60% on micro-credits, and told the study team that these terms reflect their actual cost of administering tiny loans. In fact, lending rates in this range are not uncommon for micro-credits in other countries.⁷⁸ Also, competition in this segment of the loan market is less intense, so banks may be building higher profit margins into their pricing decisions.

The interest rate margin that banks charge above prime is likely to decline as competition intensifies in this segment of the market, and as banks reap additional scale economies from expanding this line of business. In addition, the measures discussed in Chapter 3 with reference to expanding SME access to credit are relevant here. In particular, the margins loans can be reduced by:

- . Strengthening the institutional environment for financial services, by creating a credit information bureau, property registries, an efficient dispute settlement systems, and an effective contract enforcement mechanisms;

⁷⁵ Source: Data reported to Banco Nacional de Angola, and provided by BNA by to the study team.

⁷⁶ Source: <http://www.bankrate.com>, and <http://www.resbank.co.za>.

⁷⁷ Some “kwanza” loans involve disbursements and repayments that are made in kwanza but in amounts that are linked to the US dollar. In an economic sense, these are dollar loans rather than kwanza loans.

⁷⁸ For example, Bolnick (2007, pp. 65-66) reports that leading microfinance institutions in Mozambique charge interest rates of 5 to 7 percent per month, which is equivalent to an annual lending rate of 60 to 84 percent, and that Mexico’s highly regarded *Compartamos* program charges as much as 87.5 percent. In fact, micro-lenders in South Africa and Botswana charge as much as 30% a month, though this for lending to consumers rather than productive business purposes (for which such high charges would be prohibitive).

- Training banks in non-traditional lending techniques to reduce the costs and mitigate the risks of dealing with SME clients;
- Providing technical support to SMEs themselves to improve their financial records, business plans, and management techniques; and
- Improving the underlying investment climate through infrastructure development, the elimination of red tape, better public services, and sound economic policy management, including low inflation and a stable real exchange rate

Why are prime lending rates in Angola so low? How can banks charge so little? Most prime customers, of course, have strong financial records. But they are no stronger than comparable customers in South Africa and the United States. One key factor is that banks in Angola can enjoy an attractive interest rate spread despite the low prime rate by paying very little for deposit funds. A second factor is that Angolan banks derive a large fraction of their total revenue from fees rather than interest income. Hence, they can earn high profits without charging lofty interest rates on loans. These two considerations are discussed in the next two sub-sections.

The interest spread and deposit rates

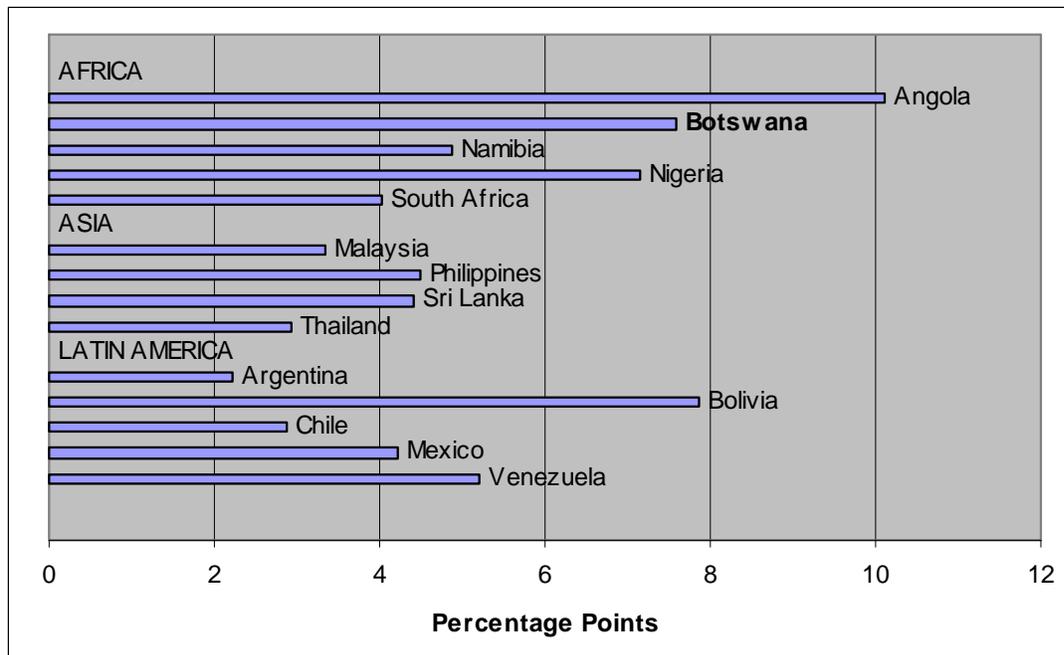
The interest spread is the difference between the interest rate on loans versus deposits. Data provided by BNA show that commercial banks in Angola earned an average interest rate of 11.2% on loans in 2006 and paid an average interest rate of 1.1% on deposits. The spread was therefore 10.1 percentage points. This is very high in absolute terms, and also in comparison to the global average of 7.0 percentage points for lower-middle income countries. For sub-Saharan Africa (SSA), however, the median interest rate spread is 10.7 percentage points. In some respects SSA is the best comparator, because banks in this region face institutional constraints similar to those in Angola. But SSA is also a region that is not noted for efficiency. Hence, the fact that spreads in Angola are marginally better than the median for SSA does not imply strong performance in controlling costs. Indeed, even within Africa, the banking sector in some countries operates with much lower interest spreads; examples include South Africa (4.0 percentage points), Namibia (4.9), Nigeria (7.2) and Botswana (7.6).⁷⁹ Figure 4.1 shows how Angola compares to other selected developing and transitional economies where interest rate spreads are substantially lower.

The banks in Angola earn a relatively large spread not because interest rates on loans are especially high, but because they offer extremely low interest rates on deposits. As of June 2007, more than two-thirds (67.5%) of deposits from the public were held in sight accounts (*depósitos à ordem*), most of which bear zero interest. Equally important, the banks have been highly liquid, with total bank credit amounting to just 52% of deposits in mid-2007 (up from 48%

⁷⁹ Data source: World Bank, World Development Indicators 2007 on-line. Figures are for 2006 or for the most recent year reported in the WDI (in most cases 2005). The SSA median is the author's calculation from the WDI 2007 data set.

at the end of 2006). Banks therefore have little incentive to compete aggressively for funds by offering attractive deposit rates.

Figure 4.1 Angola vs. Selected Countries with Lower Interest Rate Spreads



Under current conditions, bank customers actually suffer a loss on any funds held in kwanza accounts. That is because the prevailing inflation rate erodes the real value of their account balance by 12% per year. Despite this cost, businesses and households still hold deposits to the extent that they require the security and convenience of using the banks for transactions purposes. But they have no incentive at all to use banks as a vehicle for accumulating savings, when better returns can be earned from buying and holding real assets or physical goods (including idle inventory stocks).

The widespread view that Angolans lack a “culture of saving” has, in fact, never been tested because there is no incentive to save through the banks. Experience in many developing countries suggests strongly that banks could mobilize far more deposit funds by offering remunerative and convenient vehicles for saving. But banks are unlikely to offer more attractive deals to depositors under conditions of excess liquidity. This situation will change gradually as the ratio of loans to deposits continues to improve. But a major transformation will require overcoming the fundamental constraints to bank lending, as discussed in the previous chapters.

BNA has one direct instrument for tightening liquidity in the banking system: the obligatory reserve requirement. In fact, BNA did employ this instrument to tighten liquidity in September, 2007, as part of its effort to fight inflation. Under the new regulation, banks must hold 15% of deposit liabilities to the public in the form of cash or zero-interest reserve accounts at BNA. Previously, banks could hold one-third of the 15% reserve requirement in interest-bearing TBCs. The effect of this regulatory change was evident in considerable tightening of the inter-bank market (which is very thin in the first place) and also in the market for TBCs, where bidding fell

short of BNA targets for several weeks. Some banks were even compelled to borrow through BNAs discount window to cover the new requirement – a rare event in Angola, and a clear sign of illiquidity. But these were only transitory adjustments in the management of liquid assets by the banks. The regulatory measure did not alter the underlying liquidity ratio in the banking system, nor the ratio of loans to deposits (the transformation ratio). Hence, this episode did not enhance the incentives for banks to compete for deposit funds. If anything, it has the opposite effect. As explained in Exhibit 4.1, an increase in the requirement for banks to hold non-interest-bearing reserves acts as an effective tax on deposits that tends to tighten credit conditions and increase the interest spread, thus reducing deposit rates relative to lending rates.

Exhibit 4.1 The Reserve Requirement as a Tax on Financial Intermediation

The requirement for banks to hold a fraction of their deposit liabilities as zero-interest cash reserves or reserve deposits with the central bank restricts the amount that the banks can place into loans and other assets that generate income. In financial and economic terms, this is equivalent to taxing the banks on financial intermediation. Although the “tax” could, in theory, have its impact mainly in lowering bank profits, most empirical work shows that the banks generally shift the burden to borrowers or savers, through some combination of higher prices on bank products (loans and other services) or lower interest rates or higher fees on deposits.

The “tax “ effect depends not only on the level of the required reserve ratio, but also on the opportunity cost involved in freezing deposit funds in non-remunerative reserves. The higher the interest rate that can be earned by the banks on alternative uses of the deposit funds, the higher the tax.

To illustrate, suppose the average interest rate on loans and investments by the banks is 10%. If a bank has \$1 million in deposits, it can obtain \$100,000 in revenue if the funds are put fully to work. But if banks have to hold 15% of the deposit balances in zero-interest reserve, as is the case now in Angola, then their deposit base will only generate \$85,000 in revenue. The 15% reserve requirement is therefore fully equivalent having instead a 15% tax on the bank’s revenue from financial intermediation.

One further consideration is that BNA now requires that the banks hold compulsory reserves on US dollar deposits in the form of kwanza accounts, rather than dollar accounts. By tying up additional kwanza funds in compulsory reserves, this measure further restricts the bank’s ability to intermediate kwanza deposits by extending kwanza-denominated loans.

Viewing this relationship in reverse, BNA can take direct action to reduce the interest spread in the banking system by easing the obligatory reserve requirement, which is quite high by international standards.⁸⁰ Nonetheless, this option should only be exercised when macroeconomic conditions permit a relaxation of monetary policy. Presently this is not the case, given the persistence of inflation above the government’s target range. Alternatively, BNA

⁸⁰ The international trend in recent decades has been towards a low reserve requirement (RR), precisely for the reason given in the text. Some countries (Mexico, Canada the United Kingdom) now have a zero RR. The Eurozone standard is 2%. Banks in the United States face a 10% RR but only on transactions accounts, The RR is 2.5% in South Africa, 5% in Botswana, 6% in Kenya, and 9% in Ghana. Source: country websites, Keith Jefferis (for Botswana) and http://www.nationmaster.com/graph/eco_res_req_rat-economy-reserve-requirement-ratio

could diminish the tax effect of the reserve requirement by allowing banks to earn interest on obligatory reserves. This can be done by accepting TBCs as an allowable reserve asset (again), or by paying interest on reserve deposits. Either approach is sound in principle, but in practice they can create serious problems by encumbering the central bank with additional interest expenses. Resolving this problem would require an agreement by the Treasury to either renew the issue of Treasury bills as an alternative to TBCs, or to re-capitalize BNA as necessary to maintain its solvency.

Banking fees

The structure of interest rates on loans and deposits has an obvious effect on the demand for credit and savings services, respectively. But the level of fees and charges for banking services can also impede access to the financial system for many businesses and households.

Data from BNA show that banks in Angola have relied heavily on service charges as a major source of earnings. In 2006, when interest rates were declining rapidly, non-interest income accounted for 62% of total revenue for the banking system.⁸¹ Over the first half of 2007, however, this ratio dropped to 46%, suggesting that the rapid growth in lending is boosting the relative importance of interest income. To put this in perspective, fee income accounts for half or more of total bank revenue in South Africa and Portugal, but less than 40% in Brazil, Botswana, Ghana, and Namibia.⁸² Dependence on fee income is therefore relatively high in Angola compared to other developing countries, but not aberrantly so – especially considering the low prevailing interest rates and serious structural constraints on lending.

Looking at the level of costs for particular services, a recent World Bank study has produced a data set providing (for the first time) standardized indicators on the cost of selected banking services in 58 countries, including 13 in Africa.⁸³ In addition, BNA provided the study team with pricing reports from the commercial banks that can be calibrated against the international data.

Table 4.1 compares the World Bank data with Angolan data on three indicators that may be regarded as proxies for the general structure of banking costs: the minimum balance to open a checking account (percentage of GDP per capita); the annual fee to maintain a checking account (also percentage of GDP per capita); and the cost for an international transfer of US\$250. To add another dimension to the analysis, the study team also tabulated data from

⁸¹ Deloitte-BANCA (2007) gives a lower figure of 50% based on published financial statements from the banks for 2006. Note that non-interest income also includes the net gain or loss from revaluation of foreign assets and liabilities. Given the high degree of dollarization in the banking system, a revaluation of the kwanza generates a large gross loss on dollar assets, and a large gross gain on dollar liabilities. The net effect is much smaller, since prudential regulations prevent banks from maintaining a large open position.

⁸² The figures for Portugal, Brazil and South Africa are from Deloitte and ABANC (2007), page 59. Figures for the other countries are tabulated by the study team from data reported in KPMG (2006).

⁸³ Beck, Thorsten, Asli Demirguc-Kunt and Maria Martinez Peria *Banking service for everyone? Barriers to bank access and use around the world*, World Bank Working Paper #4079, December 2006. This paper actually has data for 14 African countries, but many entries for Zimbabwe are blank; we therefore drop Zimbabwe here.

BNA on the fee charged by five major banks for securing a letter of credit for a \$5000 import shipment. The average cost in September 2007 was \$94, or just under 2% of the value of the L/C. (The cost of stamp duties is addressed separately below.)

The basic conclusion is that fees for banking services in Angola are neither especially high nor low. The costs associated with opening and maintaining a checking account fall in the mid-range of the international benchmarks, being well above the global average, but well below the average for Africa.⁸⁴ The cost of an international transfer is identical to the overall average for countries covered by the World Bank study, but slightly above the average for African countries. For the L/C, we have no systematic international data, but our experience in the region suggests that the prevailing fee is on the high side of the standard range.

Table 4.1. Comparative Costs of Selected Banking Services in Angola

	Annual Fee to Maintain Current Account (% per capita income)	Minimum Balance to Open Current Account (% per capita income)	Cost for International Transfer of \$250
Angola, five major banks, 2007	2.8%	27.7%	6.5%
Average, 58 countries, 2003	2.4%	10.9%	6.5%
Average, 13 African countries, 2003	9.7%	30.6%	5.7%
Selected Countries, 2003			
Brazil	0.8%	0.0%	14.9%
Ghana	5.9%	22.7%	14.7%
Kenya	12.8%	11.7%	8.4%
Nigeria	0.1%	106.4%	n/a
South Africa	2.1%	9.5%	9.5%
Uganda	24.9%	51.1%	0.6%
<i>Notes:</i>			
Data for Angola is an asset-weighted average for the 5 largest banks.			
For Angola, ratio to per capita income are based on non-oil GDP; using total GDP would reduce the indicator values by more than half.			
13 African countries: Cameroon, Egypt, Ethiopia, Ghana, Kenya, Madagascar, Malawi, Mozambique, Nigeria, Sierra Leone, South Africa, Swaziland, Uganda			
<i>Source:</i>			
For international data: Beck, Demirguc-Kunt and Martinez Paria (2006)			
For Angola: Commercial bank reports to BNA (<i>Preçários</i>), September 2007			

While the level of fees does not set off alarm bells, there is still a problem in the lack of transparency about the cost of banking services. According to a survey by FinScope in Botswana, the level of fees and charges was the single most important consideration for customers in determining where to bank. Yet in Angola there is no readily accessible

⁸⁴ In computing ratios to GDP per capita for Angola, we used non-petroleum GDP as the best reflection of income levels for SMEs and households. Using total GDP reduces the figures for Angola by more than half, making the indicators look quite low relative to international benchmarks.

information for comparing the structure of fees at various banks, even for basic banking services. BNA should therefore work with the banking association to enhance the transparency of fees and charges, using a simple and uniform format to help customers compare costs and make informed choices. Indeed, BNA could easily impose tighter rules for the disclosure of bank charges as a regulatory requirement – as is done in several other countries. Greater transparency would also strengthen competition, which should lead to lower costs and more widespread use of the banks. Local consulting companies that produce annual banking surveys could also provide a valuable service by including in reports for next year a detailed analysis of banking fees, with support from BNA.

Another important consideration is that the explicit fees and charges are only part of the transactions cost faced by bank customers, or potential customers, when they make decisions about using bank services. There are also costs associated with complying with documentation requirements, traveling to and from the nearest bank office, and dealing with the respective transactions. Experience in other countries suggests that inconvenience costs are often a major deterrent to wider use of bank services.⁸⁵ To quantify the transactions costs, assess their impact on access to banking in Angola, and identify actionable constraints, BNA and ABANC should consider undertaking a special-purpose survey of actual and potential bank clients, as part of the agenda for expanding the use of banking services.

The transactions costs associated with location will be overcome naturally as banks expand their physical and electronic networks throughout the country. Other costs may remain at levels high enough to price many Angolans out of the financial system, unless at least some forward-looking banks develop low-cost techniques for offering a wider range of financial services to less affluent and sophisticated clientele. Even though early movers are likely to gain a long-term advantage in cultivating this non-traditional segment of the market, information problems limit the incentive for banks to move this direction. And yet information from other countries is increasingly available on methods for implementing low-cost “branchless banking”, which includes agency arrangements (through retail stores, post offices, lottery agents, etc., notably in Brazil) as well as cell-phone and smartcard-based banking. BNA could therefore facilitate and accelerate these innovations by organizing a national conference on “banking for the poor,” in order to foster awareness, information exchange, and open discussion of how these important innovations can best be implemented in Angola.

Determinants of the Interest Spread and Banking Fees

This section examines the principal factors affecting the interest spread and the level of banking fees. In order for the banking system to be sound and viable, the banks have to price their services to cover operating costs and anticipated bad debt costs, and also generate an attractive rate of return for shareholders. The concern here is to establish the extent to which the relatively high interest spreads and service fees observed in Angola reflect either high costs

⁸⁵ See the MicroFinance Gateway on-line library on savings mobilization in developing country, at http://www.microfinancegateway.com/resource_centers/savings/library.

of delivering banking services or high profits in the industry. This analysis provides insight into possible measures that might be undertaken by BNA and other authorities to make banking services more attractive and affordable for a broader range of businesses and households.

The first step is to recognize that the interest rate spread, as such, is not a measure of revenue from financial intermediation. Rather, the spread tells us the *mark-up per unit* between loans and deposits. But the revenue from financial intermediation depends also on the volume of loans relative to deposits, as well as the yield on other earning assets. To assess the revenue from intermediation, one must look at the “intermediation margin” (*margem financeira*), rather than focusing on the spread. This indicator is defined as the difference between interest earnings and interest expenses, often expressed as a percentage of total earning assets.

The intermediation margin

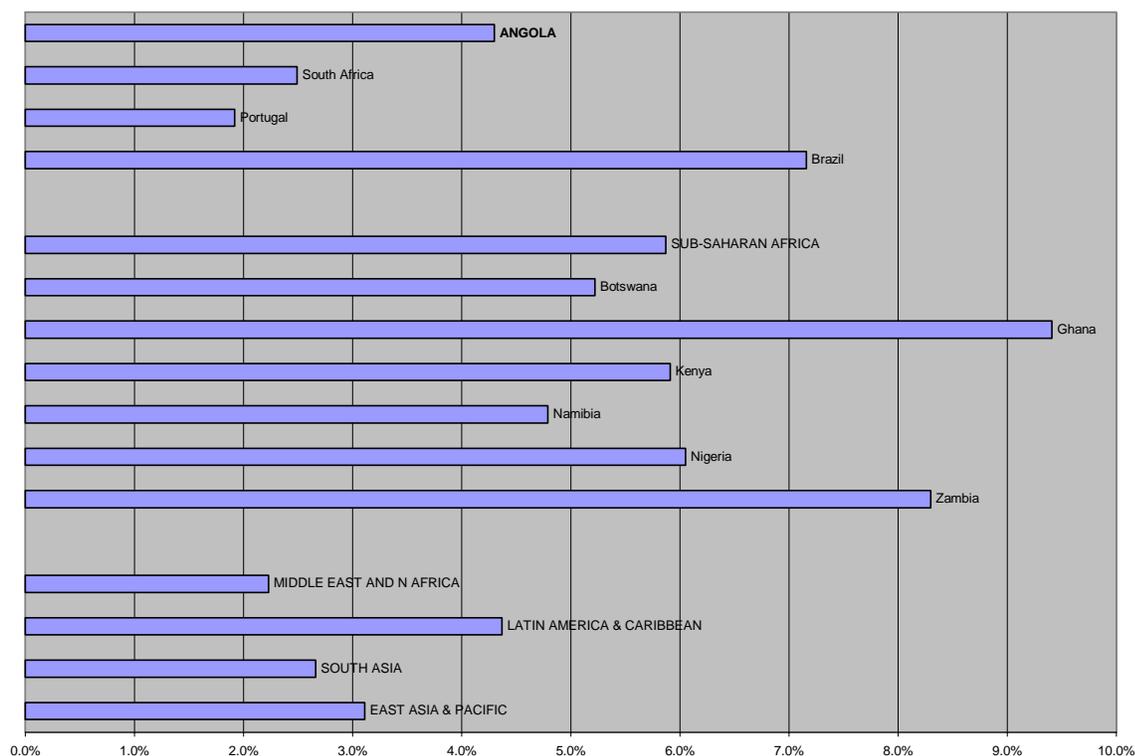
According to BNA data, banks in Angola were operating in 2006 with an intermediation margin that was not particularly high. Despite an interest rate spread of 10.1 percentage points, the intermediation margin amounted to just 4.3% of earning assets.⁸⁶ This disparity reflects the fact that banks were highly liquid, with a large fraction of deposit funds placed in assets bearing a yield well below the average interest rate on loans. In fact, lending totaled just 37% of deposits at the beginning of 2006, rising to 48% at year end. A significant fraction of the liquidity was frozen in non-interest bearing reserves to satisfy BNA’s obligatory reserve requirement (discussed above), but much of it went into money market instruments overseas yielding around 5%, and into local *Títulos do Banco Central* (TBCs) that bore an average yield of well under 10%.

For international perspective, Figure 4.2 shows how the intermediation margin of 4.3% for Angola in 2006 compares to experience in other countries. The margin in Angola was actually well below the average of 5.9% for sub-Saharan Africa, and far less than the figure of 7.2% for Brazil. Yet it was much higher than the margin found in countries with more efficient banking systems, such as South Africa (2.5%) or Portugal (1.92%), as well as the average for several other regions of the world.⁸⁷

⁸⁶ Deloitte and ABANC report a figure of 4.2% based on published commercial bank financial statements.

⁸⁷ International data are for the year 2004, from the World Bank’s Financial Sector Development Indicators 2006.

Figure 4.2 Intermediation Margin in Angola and Selected Countries



The combination of a relatively high interest rate spread and a lean intermediation margin suggests that the low transformation ratio (loans as a percentage of deposits) and low yield on alternative assets have been major determinants of the interest rate structure for loans and deposits. In 2007, the transformation ratio has continue to rise, reaching 54%, but remains very low. At the same time, the yield on TBCs rose to around 15%, though the stock of TBCs has not kept pace with the growth of deposit funds. On both counts, banks may earn a slightly higher intermediation margin this year, but not to a large degree. As a result, the interest rate spread is likely to remain high for the time being, and deposit rates low.

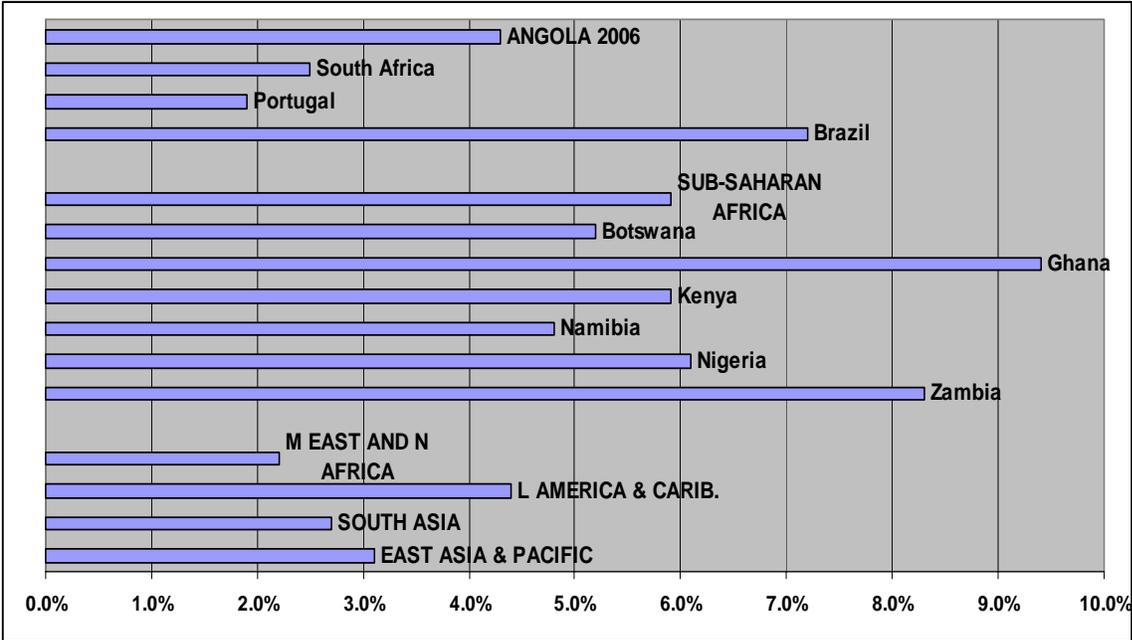
Operating costs

Detailed data from BNA show that operating costs (*despesas administrativas*) for the banking system in Angola amounted to 3.4% of average total assets in 2006.⁸⁸ According to preliminary data for 2007 these costs amounted to just over 2.0% of average assets for the eight months

⁸⁸ Figures reported in Deloitte and BANCA (2007), p. 59, are differ somewhat from those provided by BNA to the study team. The Deloitte report shows a cost-to-asset ratio of 3.7% in 2006. Deloitte may be including some other line items in their definition of operating costs, but the conclusion is similar.

through August, at which pace the ratio for the full year would be 3.1%.⁸⁹ These figures for Angola are among the lowest in sub-Saharan Africa, where the average is 5.7%. Even South Africa has a higher ratio, at 5.8%. As one can see from Figure 4.3, banks in many other countries do have lower cost ratios, such as 2.0% in Portugal, and an average of 2.0% for the Middle East and North Africa. But in general, the cost structure in Angola does not appear to be high compared to international benchmarks for developing countries.

Figure 4.3 Operating Costs as % Average Total Assets in Angola and Selected Countries



This result is surprising, as one would expect to see a high cost structure in Angola. One reason is the narrow scope of the banking system, which limits the extent to which banks benefit from scale economies, especially as they incur fixed costs for modernization. In addition, most banks are expanding rapidly to new locations, new market segments, and new services. These trends bode well for the development of a broad-based and diversified banking system in the future, but also entails significant costs in the short run as banks compete for a limited pool of skilled Angolan personnel, train new staff, invest in new equipment and facilities, and manage the growth.

Several external factors also affect the operating costs for banks in Angola. For example, they have to import nearly all of their supplies and equipment due to the lack of suitable local suppliers. These procurement costs have risen further due to the fact that much of their revenue is in dollar or linked to dollars, while the dollar has weakened against both the kwanza and the Euro (which pertains since banks source many of their supplies in Europe). Procurement costs

⁸⁹ This category includes personnel costs and purchases of goods and services, but excludes taxes, provisions for bad and trading losses or currency losses (which are largely offset by currency gains).

are also unusually high due to extreme congestion and inefficiency at the port of Luanda. Several banks also mentioned poor infrastructure as a significant cost factor, especially the erratic supply of electricity which necessitates the use of expensive generators. Several banks also mentioned the cost of meeting a multitude of reporting requirements imposed by BNA, and suggested that data demands and reporting systems could be streamlined. This cannot be a major cost element, except for the smaller banks, but it bears examination.

With all of these cost pressures in effect, the relatively low ratio of costs to total assets may best be understood as reflecting the heavy orientation of major banks to dealing with large prime customers. As they expand the proportion of their lending in other market segments, where the loan size is smaller and information problems more serious, it is very likely that the cost ratio will rise closer to the average for sub-Saharan Africa. The higher costs involved in lending to non-prime clients are already clearly evident in the interest margins charged by banks for non-prime loans.

An interesting issue is whether personnel costs are unusually high in Angola, compared to other developing countries. Unfortunately, it is difficult to find international data to support a direct assessment. Field interviews suggested that Angolan banks pay a relatively high wage to attract and retain skilled personnel, but this is equally true in many other African countries. One indirect indicator suggests that employment costs are not a major cause of the high costs to asset ratio. Data compiled by Deloitte show that banks in Angola managed US\$1.5 million of assets per employee in 2005 and over US\$1.8 million in 2006. The study team computed corresponding ratios for several other countries, based on bank-level data for 2003 as reported in a 2004 KPMG banking survey for Africa.⁹⁰ The data show a ratio of just under \$1.0 million in assets per employee in Botswana, US\$0.7 million in Namibia, US\$0.4 million in Ghana, and under US\$0.2 million in Malawi. The implication is that staffing in Angola is comparatively lean in relation to the size of the asset portfolio. Nonetheless, personnel costs can be held down in the medium to long run by pursuing measures to accelerate the training of qualified personnel through the universities, the bank training institute, and other training organizations.

One additional indicator is that the ratio of operating costs to income is also quite low. BNA data show that operating costs amounted to 40.2% of bank income in 2005, 38.0% in 2006, and 41.2% for the first semester of 2007. Using data from the KPMG Africa survey cited above, we obtain a ratio of more than 46% for banks in Botswana and Ghana, and above 50% in Malawi and Namibia.⁹¹

The inference from all of these indicators is that banks operating systems in Angola are reasonably efficient.

⁹⁰ KPMG (2004). This survey covers 11 countries, but for most of them the coverage appears to be too limited to provide a useful benchmark. The KPMG report does not include South Africa, and we did not find corresponding data for South Africa on the Internet.

⁹¹ We found on the Internet two fragments of data for South Africa: Standard Bank reported a cost to income ratio of 51.9% in the first semester of 2007; and an old study by KPMG (1999) reported a ratio of 59.5% for the “big 4” in 1998.

Bad debt costs

The most widely used indicator of portfolio quality is the ratio of non-performing loans (NPL) to total loans. Data from BNA show that this ratio for the banking system as a whole was 6.4% at the end of 2005, and declined to 4.8% at the end of 2006. Preliminary data for 2007 show an increase to 5.1% at the end of July. The Banking Supervision Department at BNA emphasized to the study team that these averages mask a wide variation from one bank to the next, with many banks achieving a much better ratio, while a few face more serious problems with portfolio quality.

Banks generally prefer to hold the ratio of NPL to total loans below 3%. In the region, World Bank data show that banks in South Africa, Botswana and Namibia achieve this standard, with ratios of 1.5%, 2.8%, and 2.0%, respectively (data for 2004). In some African countries, however, bank loan portfolios have been far worse than in Angola. For example, the NPL ratio in 2004 was 13.9% in Ghana, and 21.9% in Nigeria. In Mozambique, after two major banks failed in 2001, this ratio rose to 23.4%.⁹²

Notably, well managed microfinance institutions around the world also maintain a NPL ratio of 3% or less using cost-effective risk control techniques, despite dealing with borrowers at the bottom of the scale in financial strength.⁹³ However, commercial banks that employ standard loan management procedures, rather than microfinance techniques, often encounter higher bad debt costs on loans to smaller and riskier clients (which is reflected in the interest rate charged on such loans).

On balance, the NPL ratio for the banking system in Angola is high, but not alarmingly so. One danger sign is that bank credit has been growing very rapidly since 2005. As a result, the denominator of the NPL ratio has been increasing rapidly, whereas shaky loans normally take time to appear. Hence, the decline seen in the NPL ratio between 2005 and 2006 should not be viewed as an indication of an improvement in the overall loan portfolio for the banking system. On the contrary, very rapid credit growth is one of the most robust leading indicators of a possible banking crisis in the future (see Exhibit 4.2). Hence, BNA has to be extremely vigilant in supervising the banks in order to minimize the risk that the rapid growth of credit might spawn a banking crisis through dilution of lending standards, relaxation of risk controls, and dependence on less experienced staff. The risk is especially serious for any banks that do not have well developed systems for risk management. A banking crisis could be extremely destabilizing for the economy, and set back development of the financial system by three to five years. Indeed, the cost of a banking crisis, if encountered, could dwarf all of the other costs examined in this chapter.

⁹² Mozambique data from the IMF, Financial Sector Stability Assessment, 2004, Country Report No. 04/52. Other international data are from World Bank, Financial Sector Development Indicators, 2006.

⁹³ Malcom Harper and S.S. Arora, *Small Customers, Big Market: Commercial Banks in Microfinance*, Bourton on Dinsmore, Warwickshire, UK: ITDG Publications, 2005.

Exhibit 4.2 Rapid Credit Growth and Banking Crises

The Asian crisis of 1997 spawned a series of research efforts to identify empirical early warning signs of an impending banking crisis. One of the most of the most influential studies, by Professors Barry Eichengreen and Carlos Arreta, ran more than 10,000 statistical tests to find “robust” indicators, meaning observable variables that emerge as significant determinants of a crisis using a variety of alternative statistical methodologies. Many variable are statistically significant using a single empirical approach, but very few stand up to a careful test of “robustness.”

Eichengreen and Arreta find just three robust determinants of a banking crisis: rapid growth of domestic credit, large bank liabilities relative to reserves, and recent de-control of deposit rates. On the first point, they find that “bank stability in emerging markets is at risk when macroeconomic and financial policies combine with financial deregulation to create an unsustainable lending boom. Monitoring of borrowers becomes more difficult when the volume of lending rises rapidly; hence, the quality of loans declines.”

Source: Barry Eichengreen and Carlos Arreta, “Banking Crises in Emerging Markets: Presumption and Evidence,” August 2000.

While the NPL ratio provides a very useful indication of portfolio quality, it does not show the actual cost associated with credit risk. For this one must look instead at the charges against income from provisions for bad debt (PBD). BNA data show that PBD charges amounted to 2.1% of average total assets of the banking system in 2005, and 2.6% in 2006. Comparing these figures to the operating costs discussed above, it is apparent that provisions for bad debt comprise a relatively small fraction of the cost structure for banking system. Nonetheless, the relatively high ratio of NPL to total loans and the recent growth in lending suggest that provisions for bad debt may be a larger cost factor in the not-too-distant future. In addition, BNA in September 2007 introduced new regulations to tighten provisioning requirements in Angola. This, too, will probably increase bank charges for non-performing loans in the future, but the gain in prudential supervision is eminently worthwhile.

Profits

Despite earning a rather modest intermediation margin, total bank revenues have been sufficient to yield handsome profits for shareholders in Angola. Data from BNA show that banks earned a return on assets (ROA) of 3.1% in 2005 and 2.7% in 2006. The corresponding return on equity (ROE) was 34.2% in 2005, and 28.7% in 2006.⁹⁴ Even though these returns fell between 2005 and 2006, they remain very high compared to most international benchmarks. For example, the Deloitte-ABANC (2007) report shows that the ROE in Angola has been far

⁹⁴ The 2007 Deloitte-ABANC survey of the banking industry reports that banks in Angola earned a return on assets (ROA) of 3.2% in 2006, and a return on equity (ROE) of 34.9%.

above that earned by banks in Brazil (15.9%), Portugal (11.6%), the United States (13.6%), and South Africa (15.7%).

World Bank data show that banks in Africa typically earn high profits. Based on results for 2000-2004, the Bank reports an average ROE in Africa of 20.1%, versus just 8.5% in the rest of the world. Basic finance theory suggests that the high rate of profit characteristic of banks in Africa can be interpreted as an indication that shareholders require a premium rate of return in this region to compensate for perceived risks and volatility, both economic and political. Yet even by standards for Africa, the banking system in Angola has been delivering a very high return to shareholders, suggesting that a lack of effective competition over that time frame.

The banking system in Angola is certainly not alone in this respect. For example, a 2004 KPMG survey shows that banks in Botswana earned an average ROE of 49% in 2003, and in Ghana, 38%.⁹⁵ Nonetheless, many Angolan banks are clearly incorporating a large margin of profit into their pricing formulas. Profits are therefore a major factor explaining the relatively low cost-to-income ratio in the banking system, as well as the relatively high interest spreads and banking fees.

The good news is that high returns in the banking system have drawn new entrants into the industry and intensified competition for top grade clients. This process has already compressed profits, reduced prime lending rates, and induced banks to explore non-traditional market segments. Before long, the added competition may also lead to better interest rates for depositors and lower service fees for all bank clients. BNA has greatly facilitated this process by licensing new banks in accordance with provisions of the 2005 Financial Institutions Act. Here again, the benefits do not come risk free, because new banks may have untested systems for risk management and less experienced personnel. These considerations reinforce the importance of diligent banking supervision.

The Stamp Duty (*Imposto de Selo*)

The scope of work for this study cites “high costs resulting from the imposition of stamp duties” as one possible cause of high banking costs in Angola, and calls for an assessment of the fiscal and financial impact of removing these duties. The main finding from our investigation is that abolishing the stamp duty would have a fairly small but beneficial effect on the cost of banking transactions. More importantly, stamp duties are a terribly inefficient source of revenue for the Treasury. Best practices for taxation in developing countries provide unequivocal support for abolishing these duties as part of an overall program of tax reform that would compensate for the lost revenue with less distortionary taxes. In the short run, the elimination of certain particular stamp duties on financial transactions would probably entail little cost to the Treasury.

⁹⁵ Asset-weighted average of banks reported in KPMG (2004), with data for 2003, as calculated by the study team.

The stamp duty is actually a complicated set of duties on numerous transactions, as specified by a variety of laws and decrees.⁹⁶ The affected transactions include, among other things, housing leases, corporate capital increases, commercial leases, sales contracts, dividend payments, postal money orders, quitclaims, motor vehicles. The stamp duty is also charged on a various banking operations including:

- New bank loans, at a rate of 0.3% of the amount involved;⁹⁷
- Gross interest receipts by the banks (excluding inter-bank loans), at a rate of 1 percent of the amount involved; and
- Other banking transactions beset by the stamp duty include foreign drafts and public securities sold to the public (both at 0.15% of the amount involved), and loan guarantees (at a rate of 0.3%).

The stamp duty of 0.3% on the initial loan amount is payable by the borrower, whereas the 1% duty on interest receipts is payable by the bank but undoubtedly included in the interest rate on the loan. On a one-year loan, abolishing these two duties would save the client 0.4% of the loan amount (assuming that the bank lowers the lending rate by the full cost saving). This is equivalent to a reduction in the average interest rate from 11.2% to 10.8%.

The cost saving would be proportionately larger for loans with a shorter maturity (putting more weight on the up-front 0.3% charge), and also for borrowers qualifying for a lower interest rate. By the same token, the cost saving is proportionately smaller for a loan with longer maturity or higher interest rate. Taking into account other transactions costs for documentation, time and travel to negotiate the loan agreement, and the bank commission for opening a loan account (which varies from 0.5% to 2.0% of the loan amount),⁹⁸ the abolition of these two stamp duties would probably not have much effect on the accessibility of bank loans to new customers.

Indeed, every bank that we visited responded to our questions about the stamp duty in the same way, saying that it is not a significant cost factor for their borrowers. The Chamber of Commerce gave the same response. But we did hear a few other views. After agreeing that the stamp duty had no impact on his banking decisions, one large-scale entrepreneur pointed out that it still cost him a lot of money on multi-million dollar loans. In addition, two people emphasized that the 0.3% duty involves an up-front payment, which can be a serious hurdle for cash-constrained borrowers.

In addition, the head of the Insurance Supervision Institute (*Instituto de Supervisão de Seguros*, or ISS) said that the stamp duty can be as high as 5% on some types of insurance, which is a

⁹⁶ Source: *Angola -- Síntese do Sistema Tributário*, Ministério das Finanças, Direcção Nacional de Impostos, August 5, 2005 and “Angola: Summary of Tax System – May, 2007,” in IMF, *Angola – Selected Issues*, Staff Memorandum SM/07/286, August 7, 2007.

⁹⁷ This element of the stamp duty is not listed in the MoF or IMF tax summaries, but it was confirmed and reconfirmed by the MoF and a major commercial bank, through our BNA counterparts.

⁹⁸ Source: Bank *Preçários* data sheets submitted to BNA, September, 2007.

significant problem for the growth of this emerging industry. He told the study team that he is negotiating with the government to abolish stamp duty on insurance products.

Turning to the fiscal impact, stamp duties collectively generated 1.27% of the government's budget revenue, and fully 2.69% of tax revenues.⁹⁹ These are not small sums. Unfortunately, the study team did not obtain a detailed breakdown of the stamp duty revenues, but the diversity of the duty schedule and the small size of the banking sector suggest that most of the receipts come from other sources. This proposition is strongly supported by a simple calculation. Suppose that all of the loans outstanding as of the end of 2006 originated that year (which obviously overstates the case). The 0.3% duty on these loan agreements would then yield Kz 796 million in revenue. Adding in the 1% stamp duty on interest income of the banks gives an estimated revenue of Kz 1173 million from these two duties. That represents just 4.2% of the government's total revenue from the stamp duty in 2006, and just a 0.05% of total government revenue last year.¹⁰⁰

Even this tiny sum overstates the benefit to the Treasury from the stamp duty on bank loans because it neglects the administrative cost to collect the money. In fact, one of the strongest arguments against small "nuisance taxes" of this sort is that the cost of collection can amount to a large fraction of the revenue. The stamp duty also violates basic principles of modern tax policy for developing countries. Global best practice is to rely on a few broad-based taxes at low marginal tax rates, to minimize efficiency distortions from the tax system. In addition, the 1% stamp duty on interest income is effectively a tax on gross receipts from lending operations. Taxes on gross receipts were popular many decades ago, but they have been eliminated in most of the world because they are a highly distortionary basis for generating revenue. Neighboring Zambia, for example, revoked the stamp duty completely in 1993 as part of its comprehensive tax reform program.

The conclusion is self evident: Even though the stamp duty on bank loans is not a major impediment to lending, it generates hardly any revenue for the Treasury and creates a totally unnecessary extra burden for borrowers – especially those who face immediate cash constraints. This stamp duty should be abolished, and the sooner the better. Indeed, the Government should ask the Tax Reform Commission to consider eliminating the stamp duty totally as part of an overall program of reforms to improve the efficiency and effectiveness of the tax system.

Conclusions and Recommendations

This chapter has examined the costs of using banking services in Angola, as well as the cost structure faced by the banks themselves. The main findings from the data analysis are as follows:

⁹⁹ Ministério das Finanças, Resumo da Receita por Natureza Económica, Exercício 2006.

¹⁰⁰ For this calculation we use the following data from Deloitte and ABANC (2007): volume of loans outstanding = Kz265,327 million; bank interest income = Kz37686 million. Data from the MoF shows total revenue of Kz27,668 from all stamp duties.

- Competition in the banking system and extensive dollarization of the economy has produced a very low base lending rate for prime borrowers.
- The interest rate on loans to smaller and riskier clients varies over a wide range depending on the size of the loan and the quality of the borrower. Since the base rate is already low, a reduction in these other rates will occur only as competition intensifies in non-traditional segments of the market, and as actions are taken to overcome the fundamental structural and institutional constraints discussed in the previous chapters.
- The interest rate spread in the banking system is high, though within the range often seen in the region.
- The main impact of the high spread is felt not by borrowers, but by depositors who face very unattractive interest rates. Low deposit rates also result from high liquidity in the banking system, because banks have little need to compete aggressively for deposit funds. With deposit interest rates far below the inflation rate, the real interest rate on deposits is sharply negative. This creates an incentive for businesses and households to avoid using bank deposits as a vehicle for accumulating savings.
- Service fees account for a large fraction of total bank income, though the pricing of fees and charges is generally in line with regional standards.
- One major reason for the high interest spread is a low ratio of loans to deposits, combined with low yields on alternative assets. Despite the high spread, banks earn a relatively low interest margin (net interest earnings as a percentage of total bank assets) on intermediation activities.
- By all benchmarks, the banking system is generating handsome returns on equity for shareholders. Hence, non-interest sources of income more than compensate for the relatively low interest margin. Competition should erode these high profit margins, and lead to better pricing of banking services for bank clients.
- Operating efficiency appears to be reasonably good, in terms of ratio of costs to assets, the ratio of costs to income, and average assets per employee. Still, many factors are at work in Angola that tend to increase banking costs, so the low cost ratios are probably an indication of a heavy concentration on high-grade clients. As banks expand their involvement in other segments of the market, these costs are likely to rise.
- Bad debt costs are not particularly high, but the rapid growth of credit is a serious warning sign of possible future problems.
- The most important regulatory constraint affecting the cost of banking is the obligatory reserve requirement – though there are valid reasons at this time to maintain a stringent requirement as a key tool for fighting inflation.
- The stamp duty on financial services imposes a relatively small cost to bank clients. Stamp duties are more onerous for the insurance sector. Eliminating these duties would help to reduce the cost of banking, though not by a large margin, and provide a

significant boost to the growth of the insurance industry. The fiscal cost appears to be miniscule.

This brings us back to the two basic questions posed at the beginning of the chapter: Are the costs of banking an important factor limiting the scope of financial intermediation in Angola? And if so, what can be done to reduce these costs?

The answer to the first question is essentially yes: the cost of banking services is surely an impediment to wider access to the financial system. With the exception prime borrowers, who enjoy very attractive terms and conditions, many other potential borrowers face interest rates that are high enough to impede access to credit. On the opposite side of the ledger, low deposit rates are undoubtedly a severe impediment to use of the banking system as a vehicle for savings. Finally, banking fees undoubtedly discourage the use of banking services by small businesses and poorer households.

What, then, can be done to reduce the costs of banking in Angola? First and foremost, it is important to recognize what should not be done. As discussed in chapter 1, the fundamental objective for BNA is to develop a sound and efficient banking system that also serves the needs of the overall economy. This objective will not be achieved through palliatives that seek to reduce costs through direct controls or unsustainable subsidies that undermine sound lending standards. Instead, the focus should be on market-supporting solutions that will help to reduce costs by strengthening the foundations for efficient financial intermediation, enhancing competition, and eliminating unnecessary costs.

This analysis suggests a series of recommendations, including several that serve mainly to validate the importance of actions that are already in process.

Recommendation: *Be patient in letting market forces do their job!* BNA's current policy on approving the entry of sound new banks is visibly intensifying competition and creating incentives for greater efficiency, lower costs, and better pricing of bank services. The impact on costs, profits, and pricing may be gradual, but it is happening.

Recommendation: *Strong and effective prudential supervision by BNA is essential* to minimize the risk of subsequent problems that might emerge as a result of the rapid increase in bank credit and the entry of new banks with less sophisticated risk controls. These conditions are often a precursor of banking crises that can impose high costs on the economy and retard the development of the financial system. BNA is in the process of strengthening banking supervision.

Recommendation: *Improve the transparency of pricing for basic bank services.* BNA has regulations in place regarding disclosure of information on lending and deposit rates and basic service charges. More can be done by BNA, however, to ensure that this important information is readily available to bank customers, who often regard these costs as a key factor in the selection of banks. Options include,

Introducing tighter regulatory requirements for disclosure of banking fees and charges.

Working with ABANC to publish annual or quarterly tables showing basic price comparisons in a simple and standardized format.

Encouraging local consulting companies to include an analysis of banking costs in their banking surveys, and cooperate in providing information.

Introducing stronger regulations on truth-in-lending, requiring commercial banks and other lenders to divulge the *effective* annual percentage rate (APR) on all loans, in line with established international practices. The APR taking into account fees associated with the credit transaction, as well as the actual interest rate.

Recommendation: *Maintain an intense monetary policy focus on reducing inflation* in order to reduce macroeconomic risks that affect loan rates, improve the real interest rate on deposits, and reduce the pressure on operating costs arising from rising wages and input prices, and appreciation of the real exchange rate.

Recommendation: *Reduce the obligatory reserve requirement as and when macroeconomic conditions permit.* The primary objective of monetary policy is to achieve macroeconomic stability. Once inflation is stabilized in the target range (below 10%) BNA can move towards a less onerous reserve requirement in order to reduce this “tax” on financial intermediation.

Recommendation: *Re-assess the data requirements imposed on the banks by BNA to identify possibilities for eliminating duplication and streamlining reporting systems,* while still satisfying all legitimate information requirements of the central bank.

Recommendation: *Revoke the stamp duty on financial services.* This is obviously not a responsibility of the central bank, but BNA can and should initiate a dialogue with the Ministry of Finance for the purpose of convincing the Ministry to eliminate these inefficient duties.

Recommendation: *Undertake a special-purpose survey of SMEs and households to obtain data on transactions costs involved in opening and maintaining a deposit account, and obtaining a bank loan.* This information can provide a much better picture of the actual costs of accessing banking services, and the impact of costs on the use of banking services. This survey can be undertaken by ABANC, in collaboration with BNA.

In addition, many of the recommendations discussed in previous chapters, in the context of term lending and SME access, have clear relevance to the problem of reducing banking costs. Examples include:

Developing training programs to help banks adopt streamlined business practices for SME lending, which can lower the cost of administering loans without sacrificing portfolio quality.

Promoting the development of non-bank financial intermediaries and capital markets, to provide a wider menu of financing options for the public, and create additional competition for the commercial banks.

Focusing attention on fixing the structural and institutional constraints that not only limit the scope for prudent bank lending, but also increase bank costs. The major constraints include problems with property titles, the lack of registries for movable and immovable property, the

absence of a credit information bureau, poor judicial enforcement of contracts, and weak business skills on the part of many SMEs.

Expanding opportunities for education and training in banking, finance, and accounting, in order to increase the supply of skilled personnel and reduce cost pressures arising from competition for qualified staff.

Chapter 5. Developing reference rates for the pricing of credit products

This chapter addresses the issue of establishing indicative interest rates as a basis for pricing credit products. As indicated in BNA's Policy Matrix for Expanding Credit Access, there is a need to develop market-based reference rates to provide banks with an appropriate benchmark for determining the interest rates on credit products, particularly those denominated in national currency.

Given the extensive dollarization in Angola, the Policy Matrix also points out that the use of LIBOR as a reference rate on USD loans can cause problems when international money market conditions lead to interest rate movements that conflict with national monetary policy objectives. Indeed, the country has encountered this problem in 2007, as dollar interest rates have declined at a time when BNA is seeking to tighten monetary policy in order to fight inflation.

A further consideration is that the banking system is expanding into the market for medium and long term lending, and Angola's new stock exchange – the Bolsa de Valores e Derivativos de Angola (BVDA) – will probably open for operation in 2008 (see Chapter 2 above). These markets can function more efficiently if entities engaged in term financing and the issuance of stocks and bonds can base their pricing decisions on a yield curve providing reference rates for medium and long term government bonds. Many African countries have been seeking to develop a domestic market for government bonds with this purpose expressly in mind.

The first section of this chapter provides a brief explanation of the reference rates normally used for pricing financial products in most financial systems around the world. This is followed by an assessment of reference rates currently used in Angola, and steps that can be taken to establish a yield curve as the basis for pricing longer term loans and securities issues on the soon-to-be-opened stock exchange. The discussion then turns to two important market equilibrium conditions that can be used as benchmark references for assessing the structure of interest rates in Angola: the interest rate parity condition, and the need for positive real interest rates to ensure an efficient allocation of financial resources. These considerations indicate, however, a serious disequilibrium caused by countervailing trends in the exchange rate and inflation due to the oil boom, which complicates any decisions by BNA to move towards full liberalization of the benchmark TBC auctions. Based on this analysis the chapter concludes with recommendations for action to provide better reference rates for the pricing of credit products.

Reference Rates for Pricing Commercial Loans

Commercial banks generally establish a prime lending rate¹⁰¹ for top-grade borrowers using a reference rate based on the marginal cost of funds in the money market. The standard

¹⁰¹ The terminology and definition varies from country to country. For example, South Africa uses the “prime overdraft rate,” or “predominant rate” for this purpose. Note, too, that banks often negotiate interest rates below prime for large loans to truly blue-chip customers.

benchmark is the inter-bank lending rate. In circumstances of tight liquidity, banks may refer instead to the interest rate for acquiring liquidity through the central bank's discount window, as the relevant marginal cost of funds. Alternatively, when banks hold excess liquidity in Treasury bills (or central bank bills), the interest rate on these instruments may be used as the appropriate benchmark for pricing their credit products.

Banks determine the margin between the reference rate and the prime rate on the basis of their assessment of operating costs and risks and competitive conditions in the market for prime loans.¹⁰² In turn, the prime rate serves as the base for pricing interest rates on loans to less creditworthy clients, as well as interest rates on many other types of credit products. Banks determine the *margin over prime* for these loans by assessing the additional risks and costs associated with particular borrowers, including the nature of the collateral, the size of the loan, and the maturity period, among other factors.

On loans to international clients or loans in US dollars to national clients, banks almost universally use the London Inter-bank Offer Rate (LIBOR) as their point of reference. This is because LIBOR is determined in a very efficient global inter-bank money market. LIBOR rates are quoted each day for maturities ranging from overnight to one year, in a number of major currencies including the US dollar and British pound. An alternative inter-bank rate, EURIBOR, is used as the reference for pricing Euro-denominated financial instruments.

To put this summary in quantitative terms, Exhibit 5.1 shows recent values for the reference rates that have been identified here.

¹⁰² In some countries this margin is also affected by the tax treatment of government debt versus interest on loans. In Mozambique, for example, banks pay no tax on T-bills, which greatly increases the margin needed to make lending attractive. See Bolnick (2007), chapter 6.

Exhibit 5.1 Recent international reference rates.

Actual figures for various reference rates mentioned in the text were as follows, as of the end of September, 2007:

- | | |
|---|--------|
| • Federal Funds rate in the United States | 4.75% |
| • Prime lending rate for banks in the United States | 7.75%. |
| • Federal Reserve discount rate | 5.25% |
| • Yield on 91-day U.S. Treasury bills | 4.05%. |
| • 3-month LIBOR rate | 5.35% |
| • 3-month EURIBOR rate | 4.79%. |

In the United States, as an example, the central bank determines the inter-bank lending rate (called the Federal Funds Rate) through open market operations, as a primary tool for monetary management. Banks normally set the prime rate at 300 basis points (or 3 percentage points) over the Federal Funds Rate.

Source: <http://www.bankrate.com>, <http://www.bloomberg.com/markets/rates/index.html>, and <http://www.suomenpankki.fi/en/tilastot/korot/kuviot.htm>.

Reference Rates in Angola

The study team asked senior bankers and financial sector experts in Luanda about how commercial lending rates are determined in Angola. Exhibit 5.2 summarizes the responses. Although there are differences from one bank to another, lending rates are generally set on the basis of reference rates that accord very closely to the international norms outlined above. US dollar loans to prime customers are typically priced at LIBOR plus 3%, while kwanza loans are typically priced with reference to the opportunity cost of liquidity in national currency, represented by the interest rate on central bank bills (*Titulos de Banco Central*, or TBCs). At the time of the field work the TBC reference rate was 15%. One bank also made reference to the cost of overnight funds from BNA's rediscount window, for which the prevailing rate was 19.57% at the time.¹⁰³ None of the bankers expressed any concern about the lack of reference rates for pricing their loans.

The fundamental problem with the benchmarks for pricing credit in Angola is not that the banks lack a compass, but that the TBC compass does not provide market determined pricing signals. Although BNA issues TBCs through a weekly auction, target interest rates are often determined

¹⁰³ The interviews were conducted immediately after BNA introduced new regulations for obligatory reserves. This unanticipated change in the rules forced several banks to borrow through the rediscount window to meet the reserve requirement. Normally, however, commercial banks in Angola have ample liquidity to avoid paying the penalty interest rate for using the rediscount facility.

in advance, with the auction then being administered to achieve the target outcome.¹⁰⁴ If BNA is serious about establishing market-based reference rates for the pricing of credit products, it will have to relax these controls and allow the auction to actually set interest rates.

This is especially important if BNA maintains its focus on controlling the monetary base as the primary intermediate target for monetary policy. If BNA wants to use the TBC auction most effectively to manage base money growth, then it has to let the interest rate vary with the bidding outcomes. Alternatively, if BNA uses the TBC auction to manage interest rates, it must let the amount sold each week vary with the bids. It cannot simultaneously use the auction to target both interest rates and the base money.

If BNA chooses to adopt an interest rate target instead of a reserve money target, then interventions in the money market to manage the TBC rate would be warranted. Recall that the central bank in the United States (the Fed) sets the money market interest rate (the Federal Funds Rate) using open market operations as the preferred tool for day-to-day monetary management, while letting the market determine other interest rates. In Angola today, the inter-bank market is too thin to provide a solid foundation for interest rate management. This situation may change, though, over the next few years if credit continues to grow rapidly enough to diminish excess liquidity in the banking system. Once the inter-bank market becomes an active channel for liquidity management by the banks, BNA intervention in this market to determine the interest rate may become a major tool for monetary policy. In the meantime, BNA might emulate the Fed by intervening in the auction to set the interest rates to short-tenor TBCs (14 days), while phasing in market pricing for other tenors based on pre-announced issues consistent with its objectives for liquidity management. BNA can also influence interest rate outcomes by signaling its expectations via quiet communications with the banks – a practice known as “jaw-boning.”

¹⁰⁴ This information was obtained from discussions with senior officials at BNA. Thus, the rapid increase in the TBC rates in 2007, as cited earlier, was driven by a decision to tighten credit conditions and restore positive real interest rates, in response to above-target inflation.

Exhibit 5.2. Reference rates for commercial loans in Angola

The study team asked senior officers at several banks how they set interest rates on loans. Here is a summary of selected responses (without attribution to specific institutions).

Bank #1: For loans in US dollars the prime rate is LIBOR + 3%. For prime loans in Kwanza the point of reference is the interest rate on central bank bills (*Titulos de Banco Central*, or TBCs), with a normal spread of 3%.

Bank #2: For loans in US dollars the prime rate is LIBOR + 3%. Loans in Kwanza are priced relative to TBCs, giving a range of 15% to 20% per annum.

Bank #3: The interest rate on kwanza loans is set by looking at the market for similar products, by maturity and type of loan, and establishing the break-even point relative to the average cost of deposit funds.

Bank #4: US dollar loans are based on LIBOR plus a spread that has been declining due to market competition.

Bank #5: The reference rate for kwanza loans is the BNA rediscount rate plus a spread that is based on the cost of deposit funds, market competition, and the size of the loan.

We posed the same question to financial sector experts at two leading consulting companies in Luanda, and obtained the following replies:

Financial sector expert #1: The prime rate on US dollar loans is based on LIBOR for 3, 6, 9, or 12 months, as relevant, plus a spread. In principle, the same interest rate should apply as well to loans in kwanza, if one expects that the exchange rate will be stable. But in reality, the basis for pricing most kwanza loans is the TBC tenor with the highest interest rate. This creates a serious disparity in the credit market, since LIBOR is just over 5% and the TBC rate is nearly 15%.

Financial sector expert #2: The standard for US dollar loans is LIBOR + 3%; this low spread is profitable because the average interest rate paid on deposits is not far from zero.

A closely related problem is that the primary market for TBCs is not highly competitive under present conditions, because only licensed banks are permitted to bid. Hence a handful of large players dominate the market. In itself, this is a reason for not letting the market have free play in determining interest rates at this time. (We return to this issue below.) Enhanced competition in the primary auction would produce more efficient reference rates for pricing kwanza loans. This can be achieved by allowing other bidders into the auction, starting with qualified non-bank financial intermediaries and perhaps licensed traders on the stock exchange. There is no compelling case, however, for prohibiting competitive bids from the public at large, subject to a minimum bid criterion and evidence of ability to settle the transaction.

The main argument against enlarging access to the primary auction is that secondary markets may develop more quickly if non-banks are compelled to buy and sell TBCs through the banks or through licensed traders. In practice, however, only sophisticated entities are likely to enter the primary auction, leaving ample scope for developing the secondary market for everyone else. To accelerate this process, BNA can engage in a sustained public information campaign to

encourage savings in the form of TBCs, under its authority to promote development of the financial markets. BNA could also require banks (and other security traders, if any) to establish and publicize bid-ask quotations on TBCs. These comments would apply equally to Treasury bills, if they again come into use.

Another concern with the present system for pricing bank loans is that the use of LIBOR on dollars loans can work at cross purposes with BNA's monetary policy objectives. As noted in the introduction, this occurred in 2007 when LIBOR declined at a time when BNA was tightening monetary policy, to fight inflation. In particular, the 3-month LIBOR dropped from 5.36 percent at the beginning of the year to 5.23 percent at the end of September. Over the same period the 3-month TBC rate in Angola climbed from 6.47 percent to 15 percent. The problem of divergent interest rates can also occur in reverse, with LIBOR rising at a time when local conditions mandate an easing of credit conditions.

Unfortunately, there is currently no practical alternative to LIBOR as the reference rate for dollar loans, especially for international banks that participate in or have access to the global inter-bank money market as either a source or use of liquidity at the margin. If BNA sees a need to resist having dollar interest rates in the local market move in the "wrong" direction relative to its domestic policy objectives, it will have to use other tools to influence the margin between LIBOR and the prime rate on dollar loans.

The most powerful tool available to BNA for this purpose is the obligatory reserve requirement. In fact, BNA did deploy this instrument to tighten credit conditions in 2007 by requiring that required reserves be held in cash deposits only. (The previous regulation allowed banks to hold one-third of the 15 percent reserve requirement in interest-bearing TBCs). To sharpen the impact of using this tool, BNA might consider imposing differential reserve requirements on dollar versus kwanza deposits, and then adjust the dollar requirement more frequently to influence the margin between LIBOR and the prime rate on dollar loans. The problem with this approach is that the reserve requirement is a very blunt tool, and its frequent use creates uncertainties that reduce efficiency in intermediating funds. Also, most prime-grade clients have recourse to lines of credit overseas, and may simply shift their borrowing to external banks if the cost of dollar loans in Angola were to be out of line with interest rates elsewhere. Consequently, an increase in the reserve requirement on dollar deposits may result in a lower interest rate on dollar deposits rather than a higher interest rate on dollar loans.

Reference Rates for Medium and Long Term Finance

For longer term financial products, such as housing loans and various capital market securities, pricing in most countries is determined with reference to the prevailing interest rate on government debt of a corresponding maturity, or "tenor." This debt is generally regarded as "risk-free" in the sense that governments have the capacity to avoid default by exercising their authority to tax or to print national currency if necessary to meet their obligations.

In reality, of course, government obligations are not totally free of risk. In addition to political risks, bond holders face the possibility that government may pursue inflationary fiscal and

monetary policies that erode the real value of repayments. There is also an exchange rate risk for any investors who wish to use debt service receipts for foreign currency transactions. As a result of market interactions, these risks get incorporated into the prices and yields of domestic government debt.¹⁰⁵

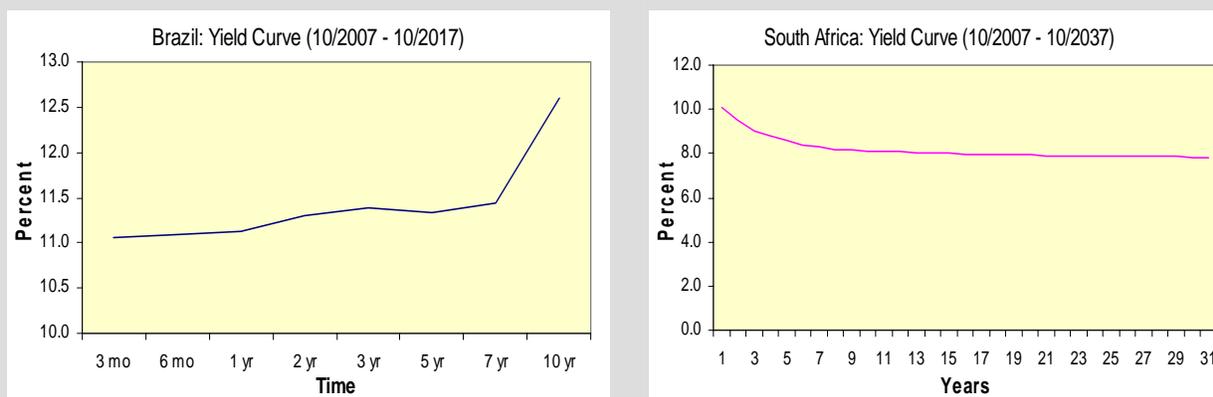
In countries with a relatively well developed capital market, governments regularly issue debt obligations with various tenors, and secondary market trading is deep enough to provide regular market data on the “risk free” yield for various commitment periods. The relationship between yield and tenor on these instruments *at any point in time* is called the yield curve (also known as the term structure of interest rates). Note that one cannot simply look at yields from the primary market for bond of various tenor that have been issued at widely differing dates in order to establish the yield curve. A meaningful yield curve requires either an active secondary market to establish spot prices, or recurrent pricing in the primary market of bonds with a variety of tenors.

Figure 5.1 shows the yield curves for Brazil and for South Africa, as of early October, 2007.¹⁰⁶ The Brazilian curve (which goes out ten years) shows an upward sloping relationship between yield and tenor. This is the norm, reflecting a preference by most market participants for shorter-term instruments with greater liquidity. For South Africa, however, the yield curve (out to 30 years) slopes downward, showing that market forces are driving interest rates lower for longer tenors. This outcome is a less common, but it can arise when market interest rates are above what is perceived as the long-term equilibrium due factors such as a temporary episode of tight money, or a surge in inflation that market participants view as transitory (reflecting confidence in the central bank’s commitment to price stability). The same result can also occur because of strong demand for longer tenors due to a rapid growth in “patient savings” from pension and insurance funds.

¹⁰⁵ An analysis by the African Development Bank estimates that a margin of 600 to 1400 (!) basis points over the US Treasury bill rate may be needed in order for African government obligations to attract international investors. A large part of this margin would probably be attributable to perceived exchange rate risk. See Arunma Oteh, *African Debt Capital Markets Opportunities and Strategies*, African Development Bank, presentation to the World Bank/IMF Seminar on Local Currency Financing: Emerging Trends & Recent Experiences, September 2005.

¹⁰⁶ Source: <http://www.bloomberg.com/markets/rates/brazil.html> and <http://www.bondexchange.co.za>, respectively.

Figure 5.1 Yield Curves, Brazil and South Africa



Developing a Yield Curve

Term lending by the banking sector is expanding, including loans for housing and automobiles. In addition, the new stock exchange (BVDA) will soon open for business. These new markets will develop more quickly and more efficiently if the Government and BNA help to reduce uncertainties about pricing by establishing a set of market determined reference rates on “risk-free” government debt, at various tenors.

As a matter of macroeconomic management, there is good reason for the Government to issue domestic securities even at a time when it is earning enormous revenues from the oil sector and accumulating large foreign exchange reserves. The reason is that rapid conversion of oil income into domestic spending tends to stoke inflation. In contrast, by issuing domestic debt, the government absorbs domestic liquidity, which offsets the monetary impact of capital expenditures and helps to maintain macroeconomic stability. Furthermore, it also makes economic sense for the Government to spread the cost of capital expenditures over the period when benefits will flow, by using debt to amortize the payments. A third motive for issuing domestic debt is precisely to foster the growth of efficient domestic capital markets. This has been an explicit objective in other resource-rich countries like Nigeria and Botswana (Exhibit 5.3).

The Government already issues domestic Treasury Obligations (OTs) on a monthly basis to finance designated requirements, with tenors up to 12 years (Exhibit 5.4)¹⁰⁷ However, the Treasury sets the interest rate administratively on most of these obligations, and instructs BNA to issue the securities on pre-defined terms. Hence, these yields, like the yields on TBCs, do not provide *market-driven* price signals for pricing other securities.

¹⁰⁷ BNA documents describing the OTs state the interest rate on Nova Vida, PIP, and TAAG bonds in terms of LIBOR plus several *basis points*. A basis point is defined as 1/100 of a percentage point. For these bonds, however, BNA seems to be using the term as a synonym for percentage point. As shown in Exhibit 5.4, the effective interest rates actually exceed LIBOR by several percentage points, not basis points.

Exhibit 5.3 Establishing a Yield Curve in Nigeria and Botswana¹⁰⁸

Like Angola, the government of Nigeria has enormous resource-based revenues. Yet it has begun issuing domestic government debt, in large part to establish a yield curve as a benchmark for developing the domestic capital market.

Nigeria initiated this process in mid-2005. At that time there was no domestic bond market, and oil revenue was more than sufficient to cover government expenditures. However, the government chose to hold a large portion of the oil revenue in a “rainy day account” and issue domestic debt to finance some expenditures. The government set a calendar of offerings to be sold by public auction through the central bank, starting with 2 year bonds. The market started with no reference points, so yields were set purely by supply and demand. The yield on 2 year bonds then became the reference for a subsequent issue of 3 year bonds, and then 5 year, 7 year, and 10 year bonds, with intervals of six to twelve months before introducing each new tenor. With the market setting interest rates, the government may have incurred higher costs at the outset, but this encouraged wider interest among investors, which will hold down interest costs in the medium to long run.

This gradual approach has established reference rates out to 10 years. But a proper yield curve requires data on market yields for various tenors *at a point in time*. Nigeria has therefore taken steps to develop a secondary market in which bond prices and yields can be observed daily, through a “primary dealer” system. The government has authorized 15 financial institutions to buy for both their own account and for third parties, with the requirement that they list buy and sell quotes for the secondary market. Although the market is thin and bid-offer spreads are wide, these quotes provide at least reference data on market conditions.

Botswana, where the government also enjoys enormous resource revenues, began a similar process in 2003. The Governor of the Bank of Botswana (BoB) explained that “the reason we are issuing a bond is to develop our own capital market by establishing a long-term yield curve.” Botswana had important advantages including an A-2 rating from Moody’s (better than that of Japan), low inflation, and a history of stability. The initial bonds had tenors of 2, 5 and 12 years, and met with high demand. Other tenors were added in 2004. Botswana also established a system of primary dealers who quote bid and offer rates. More than two years later, a BoB official stated that Botswana still lacked a meaningful yield curve because bid-offer spreads were very wide, and secondary trading was virtually absent. Nonetheless, the bond issues helped to develop the market infrastructure, and many private bonds have been issued using government bond yields as points of reference. Notably, the main reason that the secondary market remains inactive is that institutional investors have adopted a “buy and hold” strategy due to the shortage of such bonds in the market. If more bonds were available to trade, the market would likely be more liquid.

That is not to say that market considerations are absent in the pricing of OTs. For example, the bonds issued to finance equipment for TAAG, the national airline, were issued on terms that the

¹⁰⁸ Sources: For Nigeria: personal communication from Jack Delany, US Treasury bond market advisor to the Government of Nigeria. For Botswana: The Banker, March 01, 2003, via http://goliath.ecnext.com/coms2/gi_0199-2537001/Supplement-Botswana-Out-Of-Africa.html, and a presentation by Bank of Botswana, September, 2005, via <http://www.asea.wananchi.com/Presentations/Steps%20to%20Be%20Taken%20to%20Activate%20African%20Government%20Bond%20Markets.ppt> .

Treasury negotiated with a syndicate of banks. Even without direct negotiation of this sort, the Treasury still has to assess market conditions in order to succeed in selling the securities. Nonetheless, it is clear that OT yields in the primary market are not being determined by anything like an open and transparent bidding process. Indeed, the interest rate on Kwanza bonds has been far below the rate of inflation, leaving investors with a very negative real rate of return.¹⁰⁹

Exhibit 5.4 Government of Angola Treasury Obligations (OTs)

As of September, 2007, the Government of Angola had issued five types of domestic obligations through the Markets and Assets Department (MDA) of BNA:

- Kwanza bonds with an interest rate of 4%, to retire domestic arrears of the Government; issued monthly through banks to creditors with overdue claims on the Treasury, with a tenor of 7 years.
- Kwanza bonds with an interest rate of 6%, to capitalize the Development Bank of Angola (BDA), issued quarterly.
- Kwanza bonds with an interest rate of LIBOR (6-month) + 2 percent, to finance the Nova Vida project; issued monthly, with tenors of 1 to 7 years.
- Dollar bonds with an interest rate of LIBOR (6-month) + 3.2 percent to finance designated capital projects from the Public Investment Program (PIP); issued monthly, with tenors of 8 to 12 years.
- Dollar bonds at LIBOR (6-month) plus negotiated margins for financing the purchase of new airplanes for TAAG; once-off issue in November 2005 to a syndicate of banks, with tenors of 2 to 7.5 years.
- At the beginning of 2005, the stock of OTs outstanding totaled US\$617 million. By the end of September, 2007, this figure had more than doubled to reach US\$1,383 million.

Source: Banco Nacional de Angola

In addition to requiring market pricing for government securities in the primary market, the establishment of a meaningful yield curve normally requires active trading in a secondary market, to provide regular data on market conditions for securities with various tenors. The development of a mature secondary market is likely to be a slow and gradual process. In fact it is difficult to find efficient secondary markets for pricing government debt anywhere in sub-Saharan Africa apart from South Africa. As an alternative, some governments (as in Kenya, Botswana, and Nigeria) regularly issue securities with various tenors in the primary market in order to establish the yield curve. Even so, the pricing for various tenors is often based on thin and sporadic trading, which does not provide a strong basis for setting interest rates on medium to long term loans and securities.

¹⁰⁹ Why, then would anyone buy these bonds? There are three possible answers: political pressure from the Treasury; even worse returns on alternative investments; and prospects for profitability due to paying even lower interest rates on deposits. The third point can just as well be turned on its head by arguing that the poor yield on government bonds compels the banks to continue offering even lower interest rates on deposits.

The fact that a yield curve is difficult to develop quickly is not an argument for inaction. On the contrary, if supply and demand conditions are suitable for establishing a capital market, then an early start to developing the yield curve can facilitate the process of improving market efficiency, even if it take many years for the efforts to bear full fruit.

One obvious objection to letting the market determine the yield on domestic debt of the government is that the Treasury might face high or volatile interest rates, which would create problems for the budget program.¹¹⁰ This risk is best minimized through prudent macroeconomic management. As long as macroeconomic policies succeed in stabilizing inflation, avoiding exchange rate volatility, and ensuring debt sustainability, the interest rate on government debt is unlikely to be a serious problem. In fact, one argument in favor of liberalizing the interest rates on government debt is that this reform strengthens the incentive for macroeconomic discipline, precisely because imprudent policies would be costly in terms of higher interest rates.

A further consideration is that the OTs issued to date by the Treasury have been all been denominated in dollars or indexed to dollars, at yields defined by a margin over LIBOR. To develop meaningful reference rates for the pricing of financial instruments *in kwanza*, the Treasury will have to alter this practice and issue at least some obligations in the national currency, without a rigid link to the dollar. To the extent that the government issues debt to finance expenditures that will be denominated in kwanza, it is entirely appropriate to denominate the securities in national currency as well. Moreover, there is good reason to issue OTs in kwanza even when the purpose is to finance outlays in foreign currency, simply because the budget is denominated in kwanza. In most countries, domestic debt is issued only in national currency, as standard practice, regardless of the use of funds.

To move forward on the development of a yield curve, BNA (as the government's banker) should initiate discussions with the Treasury to establish a detailed program for introducing market pricing for at least a subset of OT issues through BNA in the short run, and through BVDA after it is operating. The program should including measures to stimulate the secondary market. A more detailed proposal can be based on the recent experience in Botswana and Nigeria, as outlined above in Exhibit 5.3.

Market Equilibrium Conditions as Benchmark Criteria

In the absence market-driven reference rates on TBCs or government debt, an alternative approach for benchmarking kwanza interest rates is to consider two basic criteria for equilibrium in the financial market: the Interest Rate Parity (IRP) condition, which emerges from market arbitrage, and the need for positive real interest rates to clear the market. These two criteria lead to very different conclusions about the appropriate pricing of credit and debt in Angola

¹¹⁰ Concern about the possible cost of domestic borrowing is likely to be accentuated by the fact that the Government has obtained billions of dollars on very soft terms from China, for infrastructure projects..

today, with important implications for BNA policy on interest rate determination, as well as management of macroeconomic policy.

Interest Rate Parity

Interest Rate Parity (IRP) is a relationship between kwanza and dollar interest rates, which reflects competitive market behavior of borrowers and lenders who have the option of denominating transactions in either of the two currencies, as is the case today in Angola. As explained in Exhibit 5.5, this outcome in the market is driven by profit opportunities that arise if interest rates in two currencies are out of line with the *expected changes in the exchange rate*.

As discussed earlier, dollar interest rates in Angola are determined with reference to LIBOR, which is an objective external factor. On this basis, the IRP condition can be used as a benchmark for gauging kwanza rates, given plausible assumptions about the expected change in the nominal exchange rate.¹¹¹ A common method for estimating the likely change in the exchange rate is to examine inflation differentials, on the premise that the *real* exchange rate tends to be fairly stable in the absence of major shocks in the foreign exchange market or the real economy. The same premise can be justified in situations where stabilization of the real exchange rate is an objective (explicit or otherwise) of macroeconomic policy.

If the real exchange rate were stable, the kwanza would presently be weakening against the dollar by about 10% per year. This is because kwanza inflation has been hovering around 12.4% in Angola, whereas dollar inflation in the United States has been about 2.4%. Following this line of thought, the IRP condition suggests that the interest rate on kwanza financial instruments should be about 10 percentage points higher than the interest rate on dollar instruments for an equivalent borrower (such as the Treasury, or a prime corporate customer). Effectively, an interest rate of 18% in kwanza entails the same real cost of credit as an 8% interest rate in dollars, because movement in the exchange rate offsets the nominal differential.

¹¹¹ If there were an active forward market or futures market for kwanza-dollar trades, the pricing of currency derivatives would provide an objective gauge of market expectations. Unfortunately, no such markets exists in Angola at this time.

Exhibit 5.5 Interest Rate Parity as a Benchmark

The Interest Rate Parity (IRP) condition emerges from the logic of market behavior when borrowers and lenders have the option of choosing between two currencies, as in Angola. The general relationship is described by the following equation:

$$IR_{akz} = IR_{usd} + \% \Delta ER,$$

where IR_{akz} is the interest rate in kwanza, IR_{usd} is the interest rate in dollars, and $\% \Delta ER$ is the expected percentage change in the exchange rate. The exchange rate here is defined as kwanza per dollar, so that a positive change denotes a devaluation.

IRP tells us that the interest rate on a kwanza financial instrument, such as a bank loan or a bond, should equal the interest rate on a dollar instrument plus a margin to compensate for the expected change in the exchange rate, or exchange rate risk.

If this condition is violated, then market participants can benefit from the disparity through arbitrage behavior that tend to restore the stated equilibrium condition. For example, if IR_{akz} is too high, relative to IRP, then lenders have an incentive to expand the supply of kwanza credit, but borrowers have an incentive to reduce their demand for kwanza credit. In a competitive market this shift in supply and demand will reduce the interest rate on kwanza credit, and return the market to Interest Rate Parity.

Hence,

- If market participants expect the exchange rate to be stable, then the market will equalize interest rates in kwanzas and dollars, for any given client profile and credit risk.
- If market participants expect the kwanza to depreciate by X% over the next year, then the kwanza interest rate has to be X% higher than the dollar interest rate, to equalize the incentives for borrowing and lending in the two currencies.
- If market participants expect the kwanza to strengthen by X% over the next year, then the kwanza interest rate has to be X% lower than the dollar interest rate, to equalize the incentives for borrowing and lending in the two currencies.

The problem with this argument is that the kwanza has been strengthening against the dollar due to the impact of rising petroleum earnings and global weakness of the dollar – despite the fact that the kwanza inflation rate is well above the dollar inflation rate. As a result, the *real* exchange rate has appreciated by 34 percent over the past two years alone.¹¹² The prevailing expectation in Angola seems to be the kwanza will remain strong, and possibly appreciate further due to continuing growth in petroleum revenues. This expectation is reinforced by a

¹¹² Author's calculation from inflation and exchange rate data provided by BDN, and data on dollar inflation from the U.S. Bureau of Labor Statistics, at <http://www.econstats.com>.

recent IMF of the exchange rate in Angola,¹¹³ and by the fact that the authorities welcome the strong kwanza as an aid in fighting inflation.

What does this mean for the benchmarking of kwanza interest rates? If market agents expect the *nominal* exchange rate (rather than the real exchange rate) to be stable, then the interest rate on kwanza financing should be approximately equal to that on dollar financing for otherwise identical deals. For example, if the prime rate is LIBOR + 3% on dollar loans, then the prime rate on kwanza loans should also be around LIBOR + 3%. Anything higher would cause a rational borrower to shun kwanza borrowing, and a rational lender to shun dollar lending, which cannot be a market equilibrium. Similarly, if banks are willing to buy dollar-denominated OTs at LIBOR + 2%, then competitive bidding should yield the same interest rate on kwanza-denominated OTs. Competition would result in a higher kwanza rate only if bidders had serious doubts about the continued strength of the kwanza, which would lead them to demand a premium against the risk of depreciation.

By this benchmark, the current level of TBC yields is far out of line with the market equilibrium. For banks, an interest rate of 15% on risk-free central bank bills in kwanza, with nearly zero transactions costs, is extremely profitable compared to the alternative of earning 8% on dollar-denominated or dollar-linked commercial loans to prime customers, at a time when the kwanza has been gaining against the dollar and is likely to remain strong. A competitive market process ought to result in much lower TBC rates, and hence lower interest rates on kwanza loans. But this outcome would cause problems of its own, as we see next.

Interest Rates and Inflation

As second market benchmark, the nominal interest rate on loans should exceed the rate of inflation in order to have a positive *real* interest rate (RIR) on loans.¹¹⁴ If this condition is not satisfied then the RIR is negative and borrowers effectively repay *less* than the amount borrowed, after taking into account the erosive effect of inflation on domestic currency values. Negative real interest rates destroy the efficiency function of the market in allocating financial resources to productive uses via price screening. To illustrate the point, consider a borrower who takes out a loan with an negative real interest rate to purchase idle inventories of bottled water, and adds no value whatsoever in the process. Due to inflation, the borrower can sell the water at the end of the loan period at an inflation-enhanced price that covers the interest cost of the loan and earns a profit -- even though the activity has zero productivity.¹¹⁵ Besides

¹¹³ Arto Kovanen, "Fundamental Determinants of the Real Exchange Rate in Angola," in *Angola -- Selected Issues*, IMF Staff Memorandum No. SM/07/286, August 2007, pp. 25-43.

¹¹⁴ The real interest rate is calculated as follows: $RIR = (1+IR)/(1+INFL) - 1$, where RIR is the real interest rate, IR is the nominal interest rate, and INFL is the inflation rate. Looking at prior data the INFL term is defined as the actual (annualized) inflation rate over the period of the loan. Looking forward, at any given point in time, the formula requires an estimate of the *expected* inflation rate over the loan period.

¹¹⁵ The argument is even stronger when one takes into account the benefit of deducting nominal interest costs for tax purposes. The non-negativity criterion should actually be stated in terms of the *after-tax* real interest rate, defined as $RIR_{at} = (1+IR-t*IR)/(1+INFL) - 1$, where t is the tax rate. For companies, this is normally 35 percent

encouraging inefficient investment, negative real interest rates also discourage saving through the banking system, thereby reducing the availability of funds to finance investment. More generally, positive real interest rates are essential for mobilizing and efficiently allocating financial resources, which in turn promotes faster growth, more job creation, and higher standards of living.

Financial Market Disequilibrium in Angola

In most countries the IRP condition and the RIR condition provide reasonably consistent benchmarks for assessing domestic interest rates. Angola, however, is facing unusual conditions in that the rapid growth in oil earnings has caused the kwanza to strengthen even though domestic inflation remains well above the international standard. Under these conditions, the two benchmarks produce contradictory results. By the logic of interest rate parity, the strong kwanza should produce a prime rate on kwanza loans no higher than the 8% rate on dollar loans, as a competitive market outcome. Yet with the inflation remaining above 12%, this outcome would entail negative real interest rates. In essence, the combination of a strong kwanza and persistent inflation creates a sharp disequilibrium in the financial market.

As long as this situation persists, the monetary authorities face a dilemma. BNA can continue managing the kwanza yield on TBCs in order to effect positive real interest rates, or it can let the market determine the TBC reference rates and face the possibility that competition will lead to negative real interest rates. The latter outcome would help to reduce the cost of credit for customers borrowing in kwanza – an important policy objective – but at the cost of major inefficiencies in the allocation of financial resources as long as the inflation rate is above the interest rate.

This disequilibrium in the financial market can best be resolved through macroeconomic policies that succeed in reducing inflation. This requires better coordination of fiscal and monetary policies.¹¹⁶ Alternatively, the disequilibrium can be resolved by maintaining expansionary fiscal policy and accepting moderate inflation while altering the management of foreign exchange reserves to permit the kwanza to depreciate in line with the inflation differential. Either of these two approaches would resolve the inconsistency between the interest rate parity benchmark and the need for positive real interest rates on kwanza instruments.

A third solution is the current situation, in which BNA maintains positive real interest on TBCs through its administration of the auction outcome. This practice is common among central banks, and is probably the best alternative at present given the oil-driven disequilibrium in the financial market discussed above. Before long, however, one of the equilibrium outcomes is

under the current tax law in Angola. But borrowers also face fees and transactions costs that increase the effective interest rate. In the text, we ignore these two factors.

¹¹⁶ Even though the budget registered a large surplus of more than 14 percent of GDP in 2006, fiscal policy has been extremely expansionary, with the overall surplus being largely a result of oil revenues. Excluding oil revenue gives a very different picture of how the budget is affecting the domestic economy, with a non-oil primary deficit equaling half of non-oil GDP. See the IMF, *Angola -- Staff Report for the 2007 Article IV Consultation*, August 6, 2007, SM/07/285, p. 4.

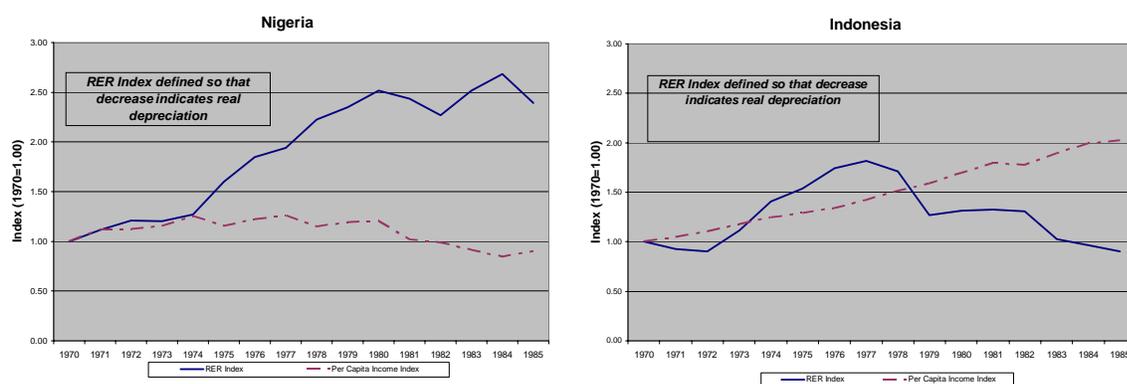
likely to prevail because a continually appreciating kwanza in real terms puts ever greater pressure on the competitiveness and financial viability of many non-oil businesses, especially in agriculture and manufacturing. One clear lesson from the experience of highly successful countries such as, Indonesia and Botswana – in sharp contrast to Nigeria – is that broad-based growth is best achieved by managing foreign exchange reserves to maintain a competitive exchange rate, even in the face of rapid growth in export earnings (Exhibit 5.6).

Exhibit 5.6 Commodity Export Booms and Exchange Rate Policy

Both Indonesia and Nigeria experienced a huge surge in export earnings between 1972 and 1974 as a result of rising world oil prices. In Indonesia, oil exports climbed from 33% of total export revenue in 1970 to 77% in 1975. Over the same period in Nigeria, oil earnings rose from 58% to 93% of total exports. In both cases, the increased supply of foreign exchange caused a sharp appreciation of the real exchange rate (RER): by 45% in Indonesia, and 48% in Nigeria between 1970 and 1975.

Their destinies then diverged. In Indonesia, the government saw that that the RER appreciation was eroding profits for other exporters and producers competing against imports. To reverse this adverse trend, they engineered a dramatic 50% nominal depreciation in 1978 through their management of international reserves (despite the absence of balance of payments pressures and foreign exchange controls). The government repeated this act with another 55% depreciation of the rupiah after the second oil price jump in 1980-82. As a result, the real exchange rate was about the same in 1984 as in 1970. This policies helped to trigger an era of broad-based growth and poverty reduction. Between 1975 and 1995, per capita real GDP rose by 173%.

The path in Nigeria the government allowed the RER to continue appreciating, so that by 1984 the naira was 63% stronger than in 1970. This created intense problems for the non-oil productive sectors, and by 1995, per capita real GDP was 14% lower than in 1975. While Nigeria also had a host of other problems, the two countries shared many characteristics including large populations, rampant corruption, and authoritarian government.



Botswana, like Indonesia, pursued a policy of *depreciating* the pula after their boom in mineral export earnings.¹¹⁷ The result was similar to that in Indonesia: a period of remarkable growth, quite the opposite of the outcome experienced in Nigeria and other countries afflicted by the so-called “resource curse.”

Source: Author’s calculations based on data from World Development Indicators 2007.

¹¹⁷ See Keith Jefferis, *Botswana’s Experience with Monetary and Exchange Rate Policy – Lessons for Angola*, USAID Southern African Global Competitiveness Hub, September 2007.

Conclusions

Commercial banks in Angola have their own established benchmarks for determining interest rates on credit products. The prime rate on dollar loans is normally set with reference to LIBOR, as an international standard. There is more variation in determining interest rates on kwanza loans, but the most common point of reference is the yield on TBCs. These yields, however, are generally administered by BNA rather than being determined by market conditions. In addition, the absence of market-determined interest rates for government debt at various tenors leaves the market without clear points of reference for pricing term loans or bond and stock issues on the new stock exchange. The establishment of a yield curve for government debt would help to facilitate the development of these markets.

Until such reference rates are established, an alternative approach for benchmarking kwanza interest rates is to consider two market equilibrium conditions. The interest rate parity (IRP) condition is a equilibrium relationship between kwanza and dollar interest rates, relative to expected changes in the exchange rate. With a strong kwanza, the IRP condition suggests that market competition should produce kwanza interest rates that are no higher than dollar interest rates for equivalent transactions. But since inflation remains relatively high, the IRP benchmark is inconsistent with a second market benchmark: that *real* lending rates should be positive in order to avoid a serious misallocation of financial resources. This inconsistency arises directly from the prevailing combination of an appreciating currency and an inflation rate that is well above international levels. Both factors can be traced, in turn, to the rapid increase in oil revenues, and the way in which they are managed..

This analysis suggests several recommendations for consideration by BNA and the Government, to develop market-based reference rates for pricing loans and securities in Angola:

Recommendation. *BNA should continue to maintain positive real interest rates on TBC yields through its management of the primary auction as long as the market is beset by a sharp disequilibrium due to countervailing trends in the exchange rate and inflation.* It might be possible, however, to focus interventions on short-tenor TBC rates (14 or 28 days), while testing market pricing for other tenors based on pre-announced issues consistent with liquidity management objectives.

Recommendation. *BNA should establish an agenda for moving away from administering the interest rate in the TBC auctions, in favor of market-based pricing, once the market disequilibrium is resolved through lower inflation or gradual depreciation of the kwanza in line with the inflation differential.*

Recommendation. *Enhance competition in the primary market for TBCs by allowing more bidders to participate.* This measure will deepen the market, reduce the dominant influence of the large commercial banks, and improve the quality of the market signals. BNA can begin this process by opening the TBC auction to qualified non-bank financial intermediaries such as insurance companies and pension funds. Later, BNA can expand the market by allowing competitive bids from the public at large, subject to a minimum bid and evidence of ability to

settle the transaction. Arguments against this, based on a desire to develop the secondary market, are not as compelling as the need to create more competitive conditions in the primary market.

Recommendation. *To develop the secondary market for TBCs, require licensed traders to post bid-ask spreads, and develop an information campaign to educate the public about saving through TBCs.* Here, too, the aim is to strengthen competitive conditions for determining the TBC rate, as a key reference point for bank lending rates.¹¹⁸ Even if BNA opens the primary market to the public (as suggested above), this path will be used by only a limited number of sophisticated agents. The TBC market as a whole will deepen more quickly if other members of the public have access to TBCs through a wider network of traders, and information on the benefits of buying TBCs.

Recommendation. *To deal with occasional problem of LIBOR reference rates moving at cross purposes to monetary policy objectives, BNA may consider introducing a differential reserve requirements on dollar versus kwanza deposits, and adjusting the dollar requirement as needed to influence the margin between LIBOR and the prime rate on dollar loans in Angola.* This instrument could also be used to create incentives for banks to reduce dollarization.

Recommendation. *To develop a yield curve, BNA should seek discussions with the Treasury on a plan for introducing market pricing and kwanza denominations for at least a subset of OT issues, along with a program for stimulating a secondary market in these instruments.*

Recommendation. *To set a firm foundation for pricing OTs, the Government should seek a sovereign rating from a major international rating agency, after it settles its remaining negotiations with the Paris Club.*

Recommendation. *The Government and BNA need to improve coordination of fiscal and monetary policies to bring down inflation, and consider altering the management of foreign exchange reserves to allow the kwanza to adjust in line with the inflation differential.* This would resolve the disequilibrium in the financial market as described above, and prevent a continued real appreciation that may impair the development of productive activities outside the mineral sector.

¹¹⁸ If the Government were to issue Treasury bills again, the recommendation would apply *pari passu* to that instrument.

Chapter 6. Deposit insurance for Angola?

BNA's Policy Matrix for Expanding Access to Credit identifies the absence of deposit insurance fund in Angola as a key issue for investigation, primarily on the grounds that deposit insurance will enhance public confidence in the banks and therefore attract more deposits into the financial system for intermediation. Specifically, the Matrix calls for a study to evaluate the experience with deposit insurance in other countries, and assess the feasibility of introducing a suitably designed program in Angola.

This chapter presents a detailed analysis of the options for establishing a deposit insurance program for Angola. Following a generic explanation of the role of deposit insurance, the paper discusses the various rationales for such a system, and then offers a brief historical review of its spread in recent years to more than 80 countries around the world, though only 5 to date in Africa. The chapter then focuses on the numerous technical issues involved in establishing a deposit insurance scheme, leading to a set of recommendations for consideration by BNA and the Government.

Our main conclusion is that it does make sense, on balance, to introduce a deposit insurance scheme in Angola, particularly in light of the vulnerabilities created by the entry of small, new banks and the risks associated with rapid growth in bank lending. This may or may not serve to attract more deposits into the banking system, but it will have value in providing an explicit guarantee to protect small depositors from being victimized by a possible banking failure. A second major conclusion is that the establishment of a deposit insurance scheme requires careful planning to determine the appropriate institutional and technical characteristics for Angola.

What Is Deposit Insurance?

In essence, bank deposit insurance protects depositors from loss in the event of collapse of the bank in which their money is deposited. Deposit insurance comes in many flavors, and is motivated by a variety of distinct concerns which are discussed below. Deposit insurance is only one way to protect depositors, and not necessarily the best one. Typically, bank depositors are also protected by a careful system for licensing banks; strong professional training for the bankers; internal bank systems for risk control; central bank systems for inspection and supervision; prudential regulations, including capital adequacy requirements and provisions for bad debt; data disclosure requirements for the banking system; and the existence of a lender of last resort function by which the central bank helps troubled commercial banks ride out liquidity problems that stop short of insolvency. Only when this elaborate system of safety valves fails would a deposit insurance program be called on to protect the depositors funds. Moreover, even when the situation does go beyond what the safety valves can handle, the banking authorities often seek mergers or other rescue operations in which a sound banking institution takes over and salvages the unsound ones, in order to minimize depositor losses and systemic risks.

Deposit insurance can be “explicit” or “implicit.” That is, there may be an explicit scheme to insure specified kinds of accounts, or alternatively an implicit expectation that someone, usually the government or the central bank, will reimburse depositors who hold funds in failed banks. This expectation arises in many ways. Sometimes there is an actual statement by the authorities that depositors will not face losses even if no formal insurance arrangement has been established. In other cases, there are *de facto* precedents in which depositors in failed banks were covered, and it is assumed that the precedent will be followed in the future. Yet another case is where the public simply believes that political pressure will compel the government to reimburse depositors. Finally, the assumption of an implicit deposit insurance applies when banks are government owned or controlled, or where private banks are assumed to be “too big to be permitted to fail.”

A recent World Bank paper asserts that “every country establishes a *de facto* insurance system for banks,” if an explicit scheme does not exist. The authors then proceed to list all the countries without a formal system, including Angola, as having an informal one.¹¹⁹ Nonetheless there are certainly cases in which governments have allowed depositors to lose money when banks were closed, as with BCCI in the UK. On the other hand, when the banking system goes into a crisis, as occurred in southeast Asia in 1997, and depositors conduct a “run” on the banks to withdraw their deposits, a typical response is for the government to decide on the spot to guarantee all or most deposits.¹²⁰

Also, in situations without explicit deposit insurance, banking authorities are often reluctant to close failing banks, and then let troubled institutions fall further and further into trouble. As the jargon goes, the authorities indulge in “excess forbearance” instead of “prompt corrective action” Too often, this approach ends up raising the stakes and increasing the eventual losses.

Explicit insurance therefore has several advantages. First, it makes clear the extent of coverage, and (sometimes) permits the government to deny coverage of losses above the defined deposit limit. Second, deposit insurance can provide governments and central banks enough comfort to close failing banks sooner rather than later. Thirdly, if premiums are charged and placed in an insurance fund, then the deposit insurance scheme will be at least partly self financing, and the fund will reduce or possibly eliminate the fiscal cost of bailing out depositors in a failed bank. Lastly, deposit insurance sometimes provides additional impetus to strengthen banking supervision and regulation, by creating an extra layer of scrutiny from the agency responsible for deposit insurance coverage. Nevertheless, it does have a number of potential disadvantages, which are discussed below.

¹¹⁹ D-K 2005, p. 5, 16, 22.

¹²⁰ D-K 2006, p. 11. Among countries which did so are Sweden (1992), Japan (1996), Thailand (1997), Korea (1997), Malaysia (1998), Indonesia (1998), and the United Kingdom (2007), in response to the ongoing Northern Rock crisis. Turkey in 1998 guaranteed all creditors of the banks concerned. Others argue that such blanket guarantees increase the ultimate cost of containing the crisis and prolonging its length and depth, Honahan and Klingebiel 2003.

Preconditions

With these considerations in mind, there is a growing consensus that deposit insurance can contribute to financial system growth and stability, if it is implemented in a context where bank supervision is tight and debt contracts enforced. When proper supervision is not in place, deposit insurance might actually encourage insured banks to undertake imprudent lending, resulting in an increased, not decreased, likelihood of a banking crisis, and higher implied costs for government, the economy, and financial sector development itself. Poor supervision also commonly results in excessive forbearance, which further accentuates the costs involved in closing insolvent banks once it becomes clear that they cannot be rescued. Even in the United States, supervisory forbearance was a very costly problem during the savings and loan and foreign debt crises of the 1980s. This experience let the United States government to mandate “prompt corrective action” – including mandatory intervention by the Federal Deposit Insurance Corporation (FDIC) whenever capital adequacy or the leverage ratio for a particular bank falls below specified levels. Yet commentators have pointed out that even this mandate for prompt corrective action has been largely frustrated by the unwillingness of regulators to require banks to reassess their portfolios at market values (the “mark to market” rule), as widely urged. In Europe, the connection between systems to require prompt corrective action and the success of deposit insurance schemes has been the focus of much more discussion.¹²¹

Another basic point of consensus is that a deposit insurance scheme has to be credibly managed. In some cases the agencies that administer and implement deposit insurance are themselves incapable of paying claimants in time, or ever. Deposit insurance that is not credible is worthless, or worse. As will be shown, many of the existing schemes in developing countries have limited credibility with depositors. We will return to this point below in discussing the choices involved in designing a program.

Beyond these broad generalizations, there is still a lack of consensus on the objectives to be served by deposit insurance, as well as the appropriate design in any given context.

The Rationale for Deposit Insurance

A universal objective of deposit insurance is to enhance public trust in the banks by giving depositors assurance that their money is protected, usually up to a certain limit. But there are several other motives involved. Historically, deposit insurance was instituted in the United States to deal with a crisis in which “runs on the bank” due to a contagious lack of confidence threatened a systemic collapse. That is, deposit insurance was initially designed to increase depositor willingness to keep their funds in banks at a time of economic distress. In effect, offering protection for depositors is seen as a tool to support the stability of the banking system as a whole.

The focus on financial system stability is particularly relevant in countries with a large number of banks, some of which are vulnerable – since all of them may be subject to the “contagion” effect

¹²¹ See Nieto and Wall 2007.

from a bank failure. It is less necessary in highly concentrated market dominated by a few large banks, and with effective banking supervision and an effective lender of last resort function. Also, if banks are predominantly owned by large, stable, international banking groups with strong head office controls, well developed internal risk management procedures, and effective home supervision, then deposit insurance is less likely; on these grounds, Botswana opted not to introduce deposit insurance.¹²² In the case of Angola, the central bank has been licensing new banks and decreasing market concentration, which complicates banking supervision and the lender of last resort functions in a possible crisis. While several of the large banks are effectively controlled by well managed multinational banking groups, there are also a growing presence of banks that lack this layer of control. Under these conditions there are merits to considering deposit insurance.¹²³

An opposing consideration is that deposit insurance is vigorously opposed by many commentators who are fearful of “moral hazard.” That is, they believe bank deposit insurance would deprive bankers of the sanction of depositors withdrawing funds when they think the bank is imprudent in its lending practices or managed poorly. Without that sanction, bankers will make more imprudent loans. Needless to say, those who advocate bank deposit insurance do so in the context of enhanced bank regulation and supervision – often added to a level of supervision and control by the bank deposit insurance institution itself to avoid this moral hazard. *On this basis, the original reason for deposit insurance – crisis avoidance – remains fully valid.*

More recently, four other motives have been manifest, all of which apply to Angola. These are (1) to promote financial development by getting more and more people to place deposit in banks; (2) to enable the accumulation of an insurance fund in good times, which can bear part of the cost of rescuing banks in bad ones; (3) to conform to what is becoming a norm for banking institutions world wide, particularly for banks doing business the European Community; and (4) to limit the government’s liability for covering deposits in failed banks.

Many factors, of course, play a role in deposit mobilization, so it is difficult to isolate the impact of bank deposit insurance. For example, the quality of bank services and the accessibility of bank offices are major determinants of the use of bank deposits. Another important factor is whether employers pay wages through direct deposits. In Angola, the government is planning to adopt this method soon for the civil service, both to cut the cost of cash transfers and help to expand the use of bank deposit services. The interest rates paid on deposits usually play a lesser role.

Nonetheless, there are instances where bank deposit insurance has clearly had a positive effect. When Russia introduced deposit insurance, for example, deposits in the banking system rose 15%.¹²⁴ This not only improved the scope for financial intermediation, but may have led

¹²² Thanks to Keith Jefferis for this observation.

¹²³ See Ngaujuka 2004, p. 96-98.

¹²⁴ The reference here is www.ait.org.ru citing a DIA Website.

also to better monitoring of informal economic activity, including money laundering and tax evasion.

Like many developing countries, the banking system in Angola is not well developed. Recent estimates indicate that only 5% to 6% of households hold bank accounts, so most of the economy, outside a few major corporate entities, still operates exclusively with cash. This creates difficulties for anyone to deal with customers or suppliers in non-local markets. It also creates problems and costs connected with the physical movement of cash and the security of cash stocks, as well as problems for SMEs in establishing a record of good financial management to support a credit application. Some of the fault undoubtedly lies with the banks' lack of aggressiveness in seeking to mobilize deposits, due to excess liquidity. Other factors include the limitations of education and even language holding back customers.

It is also plausible that potential depositors may be concerned about the safety of bank deposits. In fact, the academic literature on savings in Africa emphasizes the importance of having a safe place to put money, and even a willingness to pay for this security.¹²⁵ Hence, deposit insurance for small depositors might encourage them to trust their savings to the banks. Whether or not there is any significant benefit in this respect remains to be seen. One problem is that in Angola today the *real* interest rate on deposits is so negative as to make real assets more attractive than bank accounts as a vehicle for accumulating savings, apart from transactions balances. In addition, households with little education may neither understand or believe information about deposit insurance coverage for their deposits. Even if there is only a small impact on the volume of deposits, however, an explicit deposit insurance scheme still serves the other objectives noted above. Furthermore, any positive effect on the use of deposit services will help to expand financial intermediation, with salutary effects on economic growth and social welfare.¹²⁶

If deposit mobilization is a major motive for favoring a deposit insurance scheme, then these considerations suggest that BNA or the Ministry of Finance should commission a survey of households and small businesses in the main urban centers to determine the extent to which a lack of confidence in the banks is inhibiting greater use of deposits as a vehicle for savings.

¹²⁵ Shipton (2007).

¹²⁶ An alternative approach involves a combination of very strict disclosure of bank financial conditions and "caveat emptor" rules for depositors. In essence, the idea is to provide people with enough information to make their own decisions about the soundness of banks. This approach was pioneered in New Zealand (which also benefited from the presence of strong multinational banking groups), but is not suitable for a developing country like Angola with low financial literacy.

The Spread of Deposit Insurance

In recent years there has been accelerated adoption of deposit insurance schemes. Only in 1970 did the number of countries with a system of this sort exceed 10, but by 2003 it was over 80 – and this is only “explicit” insurance.¹²⁷ The European Union adopted the Deposit Guarantee Directive in 1994 requiring EU members to provide bank deposit insurance with a minimum level of 20,000 Euro. Some countries, like France and Italy, provide much higher coverage.¹²⁸ These European schemes provide limited coverage to protect what are presumed to be more vulnerable bank clients, and incidentally to help spread the popularity of using bank services – thus increasing access to them and furthering financial development.

Deposit Insurance in Africa

Only five African countries presently have “explicit” deposit insurance: Kenya, Nigeria, Tanzania, Uganda, and Zimbabwe. In addition, five Central African Francophone countries¹²⁹ are in the process of introducing it. South Africa announced in 2005 that it intended to introduce a scheme “in 2006,” but the relevant law has not yet been introduced.¹³⁰ According to a financial sector specialist at USAID, the Federal Deposit Insurance Corporation (FDIC) in the United States will be providing the government of South Africa with technical assistance to move this process forward.

Kenya’s Deposit Protection Fund Board was established in 1985 after the failure of four banks. Tanzania’s Deposit Insurance Board was established in 1991, and Uganda’s Deposit Insurance Fund was founded in 1994. Nigeria has a Nigerian Deposit Insurance Corporation established in 1988 by the then Military Government. Zimbabwe’s system was established in 2003.

The number of African deposit insurance schemes is still small, and the circumstances in under which they were established differed from country to country. In Nigeria, though, the scheme was motivated by a period of financial development and expansion, and concerns about the dangers this might pose, similar to the situation now in Angola. On the other hand, weak supervision and administration has meant that the Nigerian system has experienced several waves of bank failure, and the insurance coverage has been less than credible. In Kenya, as well, there have

¹²⁷ D-K 2006, Table I p. 26. We use this standard data source even though other sources cite a slightly higher number of early deposit insurance schemes – such as Czechoslovakia’s and Norway’s in the 1920s. D-K 2006 explain on p. 4 that they exclude Norway’s early scheme because it was a voluntary guarantee fund. Germany has a scheme for cooperative banks which dates back to the 1930s. In Indonesia, a scheme for Credit Unions many years antedates the present government deposit guarantee. The FDIC (1998) cites various insurance programs on the state and federal level that predated the national program in 1934, starting with New York in 1829. According to the International Association of Deposit Insurers (IADI) there are now 95 countries with deposit insurance and another 23 have them in various states of preparation. See also: en.wikipedia.org/wiki/Deposit_insurance.

¹²⁸ D-K 2006, p. 15; Scott

¹²⁹ Cameroon, Central African Republic, Chad, Equatorial Guinea, Gabon and the Republic of the Congo, as part of the regional Communité Economique et Monétaire de l’Afrique Central, or CEMAC.

¹³⁰ Bridge-David 2005.

been serious delays in paying depositors, which undermines confidence in the insurance coverage and reduces its effectiveness.

Choices

Whatever form of explicit bank deposit insurance is provided, a large number of choices must be made about its form and conditions, which will determine its suitability for Angola and its effectiveness.

Coverage of Institutions

The deposit insurance can be voluntary for the depository institutions, voluntary for the insurer (in the sense of exercising selectivity), or compulsory in each case. Though all variants are possible, compulsory coverage is the norm. Globally, 91% of schemes are compulsory, including 100% of those in Africa.¹³¹ Less obviously, the insurer is normally forced to accept any registered institution, though in 27 countries the insurer can revoke or cancel a bank's insurance coverage.¹³² On both of these attributes, compulsory coverage is desirable in Angola. Otherwise some banks or depositors may opt out to avoid the cost of the premium. If strong banks are not in the system, they deprive the fund of premium revenue; and if weak ones opt out, this may leave the most vulnerable depositors without coverage, and prove to be a source of contagion to the rest of the banks.

Foreign Owned Banks

Since several major Angolan banks are foreign owned, and the policy is to encourage their participation in the banking system, it is certainly sensible to include them in any deposit insurance scheme. However, it is essential that foreign parents not escape liability for the prudent management of their Angolan operations. Consequently, at the same time that their deposits are covered, the insurance program has to include a clear specification of the parent bank's liability, in addition to their equity investment at risk, in the event of a subsidiary failure.

Number of Insurance Schemes

In some cases there are several insurance schemes co-exist, but these are exceptional, and usually provided to different categories of banks. In the United States, for example, there are separate schemes for banks and credit unions. Spain, too, has separate funds for commercial banks, savings banks, and cooperative banks. Germany has four schemes, including one for Giro Associations.¹³³ In fact, many countries have separate programs for cooperative credit institutions, which are not included in the database we use to examine the global patterns.

¹³¹ D-K 2005, p. 15,

¹³² D-K 2005, p. 41-42.

¹³³ The IADI in a note dated May 1, 2007 says that there are 8 insurers in Germany, 3 in Spain, 2 in Italy, 4 in Austria, 12 in Canada, and more than they care to count in the United States.

Coverage of Accounts

Most but not all schemes cover a limited amount in each account, or for each insured, and exclude accounts that belong to those with ties to the bank itself. The precise amount of the coverage varies with local circumstances as well as with the motivation for the scheme, and the political pressures exerted by those lobbying for coverage.

Besides the maximum amount covered there are questions about the coverage of foreign exchange accounts, inter-bank accounts, accounts owned by foreigners, and accounts held by related parties.

Foreign Currency Deposits

Most deposit insurance schemes cover foreign currency deposits (yes in 76% of explicit schemes, but just two in Africa).¹³⁴ With 51.4% of the bank deposits in Angola being held in foreign exchange (as of July, 2007), these accounts should be included in any system introduced here.¹³⁵ However, there may be reluctance to provide the additional encouragement to dollarization that this coverage would entail. Especially with the proportion of foreign currency accounts in rapid decline this year, it might be wise to encourage a further shift to national currency by refusing to cover the dollar accounts.

If foreign exchange accounts are covered, the insurer will have to be very careful about matching foreign exchange assets and liabilities of the fund itself, if it exists, to minimize the risks involved in committing to cover foreign exchange accounts.

Inter-bank Deposits

Inter-bank deposits are excluded from coverage in 82% of the countries outside of Africa, but included in most African schemes.¹³⁶ The high coverage in Africa suggest that this responds to some features of the African situation. One of the gains is greater simplicity in administrating the scheme. As will be explained, one of the most difficult administrative tasks facing the insurer at the time of a bank failure is identifying which accounts are covered. The fewer the exclusions, the easier the task. For this reason, Angola should probably include inter-bank deposits, in line with the regional norm. Of course, the more items and persons covered the higher the insurance liability and thus needs for funds. On this basis Laeven argues for narrower coverage.¹³⁷ But since all of the schemes in Africa set very low ceilings on the amount insured in any given deposit, inter-bank deposits would not benefit in any case.

¹³⁴ Demiguc-Kunt 2005, p. 25.

¹³⁵ For reference, as of 1999 foreign exchange accounted for one half or more of all bank deposits in Angola, Argentina, Armenia, Azerbaijan, Bolivia, Bulgaria, Cambodia, Croatia, Georgia, Lebanon, Nicaragua, the Philippines, Romania, Russia, Turkey, Ukraine, Vietnam and Zambia. (Hoholon and Shih, 2002) and this neglects the 100% dollarized economies Ecuador, El Salvador, East Timor, Palau, Micronesia and the Marshall Islands – and Bermuda, the Bahamas and Panama all had currencies pegged to the dollar and some like Lebanon and Hong Kong were informally so pegged.

¹³⁶ Demirguc-Kunt 2005, p. 25.

¹³⁷ Laeven C, 2002.

Accounts Owned by Foreigners

Here there are two issues. First, if there is a banking crisis, foreign owned accounts may well be “bailed in” as part of a final settlement (country-to-country or multilateral) involving foreign creditors. So even if there is no explicit bank deposit insurance on accounts owned by foreigners, the government may have pay the depositors anyway. Further, to the extent that financial services are covered by WTO agreements, discrimination against foreigners would normally be barred.¹³⁸ On these grounds, Angola should include accounts held by foreigners in its insurance scheme.

Related Parties

Most schemes do not cover parties related to the bank, including owners and employees. This exclusion is obviously sensible, but the exercise of delimiting these parties is difficult, and the process of determining which account belongs to whom in the wake of a bank failure is one of the factors that typically delay the settlement with depositors. Deposits are held in various names, some of which may be beneficial holders for related parties, and unraveling the corporate and familial web of interests is slow, laborious, difficult, and uncertain.

Extent of Coverage

Many deposit insurance schemes cover only a small portion of bank deposits, usually those of small depositors only.¹³⁹ In these cases (which are the international norm) the major motivation is obviously not to avoid systemic risk,¹⁴⁰ but to protect small depositors who might have difficulty knowing that their bank has been imprudent, and also to encourage them to participate in the financial system.

Another consideration is that coverage for small deposits may promote the entry of new and possibly smaller banks, by encouraging the public to entrust their deposits to them. This has been explicitly mentioned some contexts where concentration in the banking industry has been seen as problematic, such as South Africa, and may have more general validity where new entrants are being encouraged, as in Angola.¹⁴¹

On the other hand, higher coverage is often associated with a history of reaction to financial crisis, and thus primarily concerned with financial system stability. As of 2003, Bolivia, Indonesia, Malaysia, Thailand, Turkey and Turkmenistan guaranteed all bank deposits. At least four of these six cases represent the legacy of a recent banking crisis. In a recent crisis at a

¹³⁸ This is a complex matter into which we do not have the time to enter here.

¹³⁹ D-K 2005, pp. 20, 31-33

¹⁴⁰ As recently demonstrated in the United Kingdom, in connection with the problems at Northern Rock, even a 10% gap in coverage leaves depositors with an incentive to withdraw their funds as soon as they have reason to doubt the solvency of their bank. In particular, the UK deposit insurance scheme covered 90% of deposits up to GBP30K. This scheme had little effect in stopping the run on Northern Rock.

¹⁴¹ Ngaujuke, Uahatjiri, “Protecting depositors and promoting financial stability in South Africa; is there a case for the introduction of deposit insurance.?” Masters Thesis Rhodes University 2004, at eprints.ru.ac.za.

small British bank, the UK authorities chose to guarantee all deposits in the bank, much to the horror of many observers, even though explicit coverage in the UK is limited to roughly 30,000 pounds.

Other high coverage countries include Norway, with a cap of USD299,401, Mexico at USD2,871,337, Italy at USD130,457, the US at USD100,000, and France at USD 88,410 (data for 2003). All but Mexico are high-income industrial countries, and Mexico itself went through a recent banking crisis.

Most countries, though, only cover deposits under \$50,000 – and in Africa the figures are far lower, with Tanzania insuring \$235, Nigeria \$366, Uganda \$1550, Zimbabwe \$3640, and Kenya \$1313. Many countries cluster around the European Union mandated level of EUR20,000. Countries with lower levels of coverage are clearly less oriented toward financial system stability and are more concerned about consumer protection and encouraging marginal depositors to put their money in banks.

Of course, the absolute amounts have very different significance in different countries. Smaller amounts of coverage are far more significant in countries with poor people (lower income per capita), than in countries with rich people. If we look at coverage levels in terms of GDP per capita (GDP-PC), Norway covers almost 6 times GDP-PC, and Macedonia, Peru, Jordan, Uganda, and Oman cover an even higher percentage. In most countries the coverage is much smaller. For example the ratio in Kenya (2003) was 3.07, in Tanzania 0.88, and in the United States 2.67. For 29 developing and transitional countries in the D-K dataset, the median level of coverage is 3.01 times per capita income. This is very similar to the average for the four African countries reported in the D-K data base. Thus, a figure of 3 times per capita GDP would be a reasonable target for Angola to consider.

A limited number of countries (43) also provide data on the percentage of deposit balances covered (by value). These figures also vary considerably, with a median of 44.6 percent coverage. However, Tanzania only covers 12% of the deposit balances, Kenya 16%, Nigeria 19%, and Uganda 26%.¹⁴² The desired degree of extent of deposit coverage is clearly an important criterion for selecting a level of coverage per deposit. Of course a scheme oriented towards protecting smaller retail depositors, with a fairly low cap, will not cover the majority of deposits by value, given the importance of cooperate deposits in most banking systems.

Another closely related issue is whether the coverage limit applies per account or per depositor. The former is much simpler to apply, as there is no need to look for multiple account holdings. But the latter approach is more in keeping with the intent of the scheme, and the purpose of setting a cap.

¹⁴² D-K 2005, p. 34-35 and p. 56-60. Data are for various years since 2000, depending on the availability of information for each country.

Covering the Cost

The decision of whether or not to charge banks premiums for the deposit insurance involves a tradeoff between adding an additional element of cost to the pricing of bank services versus minimizing the potential cost to the Treasury of paying the guarantee, given its high opportunity cost of funds (due to pressing social and development needs). Any premium charged to the banks will translate to lower returns to bank depositors. However, study after study around the world has shown that small clients are not very sensitive to small changes in the returns they get from on deposits, but far more concerned about security and accessibility. On this ground, the effect of increased cost stemming from premiums for deposit insurance is usually discounted.

Many commentators adhere to the European Union policy that bank deposit insurance schemes should be self supporting and require no government subsidy. Even if full cost coverage is an ultimate goal, the costs could be unsustainable for the banks, or the banks may have enough influence to obtain considerable measure of public subsidy. Only Chile's deposit insurance scheme is solely publicly funded, but 63% of all schemes involve both public and private (i.e. bank premia) funding. The rest are entirely self supporting – mostly in high income countries (i.e. entirely funded by payments from covered banks).¹⁴³ Of course, in the end the government might still end up covering losses that the “self-supporting” scheme cannot afford.

If full cost coverage is a policy goal for Angola, then the level of coverage needs to be kept very low. We recommend, however, that Angola consider adopt a benchmark of covering deposit balances of three times the level of GDP per capita. Using the IMF's latest projection of Angola's income level for 2008, this would amount to approximately \$16,000. Anything in this range would presumably require “seed funding” from the government to provide sufficient resources in the early years, before the scheme accumulates sufficient assets from premium income, to establish a credible level of protection for small depositors.

Coinsurance

Another means to reduce the cost to the Treasury of paying guarantees is coinsurance. This works like co-payments used for some medical insurance schemes. It means that some portion of the deposit loss is born by the depositor, say 10 or 20%. The co-payment also serves as an incentive for the depositor to monitor his bank. Coinsurance is hard to justify, though, when the coverage level is relatively low (which is the norm) both because monitoring is difficult for small depositors and because, as with medical co-payments, it radically increases administrative costs. Even if the coverage levels for deposits are higher, these arguments still apply. Only 21 countries with deposit insurance have coinsurance, mostly middle income countries, and none in Sub Saharan Africa.¹⁴⁴ Consequently, it does not make sense for Angola to consider coinsurance.

¹⁴³ D-K 2005, p. 12.

¹⁴⁴ D-K 2005, p. 25.

Varying the Premiums with Risk

One high profile issue is whether the premium should vary with the risk profile of the insured institutions. The United States was the first country to adopt this approach. There are now 20 countries that do so, with no particular pattern involved.¹⁴⁵ The Bank for International Settlements in Basel has issued a “General Guidance for Developing Differential Premium Systems.”¹⁴⁶ These differentials, if publicized could serve as an indicator to the public of the riskiness of various banks. But precisely for this reason they are typically not published.

While there is considerable logic to recommend a variable premium, to provide incentives for banks to minimize risk, most developing countries do not have adequate statistical bases for determining the risks of actual failure. But the risk rating can also be based on other data about the quality of assets, or for that matter other elements that are usually monitored by supervisors. These are roughly summarized in the acronym CAMEL: Capital, Assets, Management, Earnings, and Liquidity. Obtaining adequate knowledge about risk is a daunting task even in the United States, and more so elsewhere. For this reason, we find few experienced supervisors who endorse risk differentiated premia in relative undeveloped banking markets.

On the other hand, Luc Laeven has developed a model for risk adjustment, which argues for higher premia in developing countries. It is clear that in many countries these premia would be prohibitive; for this reason, Laeven concludes that some countries cannot “afford” deposit insurance.¹⁴⁷

For simplicity, we recommend that Angola not try to develop a risk differentiated premium, even though this will mean the safer banks will be subsidizing the unsafe ones.

Financing the Scheme in Advance or After Crisis

One key alternative is whether the insurance schemes are funded in advance (the rule) or involve payments only after a bank has failed (by other banks, for example). The latter is especially characteristic of high income countries (37% percent).¹⁴⁸ Whether or not there is pre-funding to add credibility to the insurance, the insurer needs access to additional funds in case the accumulated amount is not adequate, which is especially likely to be case if the scheme is new and the fund has not had time to accumulate large reserves. In the case that the fund is insufficient, some arrangement is needed to cover the payments due to depositors. Of course, the fund might be reinsured, but this has never been done to our knowledge.

A pre-funded scheme has clear advantages. First, the fund is immediately available for use. In the midst of a banking crisis, neither the government nor participating banks may find it easy to mobilize funds to pay the depositors. Precisely for this reason the presence of a fund increases the credibility of the insurance scheme.

¹⁴⁵D-K 2005, p. 9

¹⁴⁶February 2005, available at www.iadi.org.

¹⁴⁷ Laeven B.

¹⁴⁸ D-K, 2005, p. 37.

To add to the credibility of bank deposit insurance, some countries do provide a government guarantee of the insurance scheme, and also agree in advance to lend the scheme money as necessary.

One problem with pre-funded schemes is the obvious issue of where to put the money that has been collected: How should it be invested, and by whom? We return to this issue below.

On balance, we recommend a considerable pre-financing of the insurance scheme in Angola through premium charges, because prefunding will enhance its credibility. This is despite the fact that the charge on bank accounts for contributions to the fund will undoubtedly be passed on to bank clients in the form of lower interest on deposits or higher fees.

Institutional Nature of the Insurer

In considering the adoption of an deposit insurance scheme for Angola, the cost and burden of the institutional apparatus to administer the scheme is an important decision variable. Article 73 of the Financial Institutions Law (no 13/05) stipulates that “The Government is responsible for creating, by decree, a fund with the objective of ensuring the guarantee of deposits entrusted to participating institutions, and establishing rules for its operation.” This provision of the Act does not compel the creation of a scheme, but says that it is the government’s job to determine whether one should be established and how it should be structured. It does not follow that the government itself must be the implementing agency.

There are a many institutional variants to choose from. Furthermore, different institutions might be charged to handle different aspects of the insurance scheme, such as setting of terms and conditions, deciding when the insurance is to be paid, paying the actual claims, managing the assets, etc. This approach seems natural, because different institutions have the appropriate abilities to handle the various tasks. Thus the central bank could invest the insurance fund, specialized adjustment and collection agencies could handle the payment of claims and realization of assets etc. Nonetheless, there is a strong argument for a single agency to supervise the entire scheme, set consistent standards, and keep its eye on the main issues: bank solvency, liquidity, and depositor protection. Other considerations are present, but the ineffectiveness of the Nigerian and Kenyan deposit insurance schemes suggests that problems of technical and administrative ability can be very damaging. As pointed out earlier, any advantage from having bank deposit insurance is useless if the insurance is not credible.

In any case, before any institutional structure for deposit insurance in Angola is developed, the authorities should study the Nigerian and Kenyan experiences. To the best of our knowledge there has been no systematic published study of the problems these schemes have faced.

Whether one or several institutions are involved in bank deposit insurance, they can also be privately or publicly owned and controlled. Some countries use private companies or involve a

mutual guarantee scheme, as in France.¹⁴⁹ The use of private schemes, often run and owned by the banks themselves, is favored by some authorities.¹⁵⁰ These have usually emerged in countries that already have well developed banking systems, rather than those who are trying to use deposit insurance to develop their banks.

Most existing insurers around the world are parastatals, especially in developing countries. To the extent one is concerned with a systemic failure of the banking system, only the state may have the resources and credibility to provide the insurance. Secondly, because banking supervision is a central bank or government function, few private firms have access to the data needed to manage an insurance scheme for bank deposits.

Parastatal or not, the activities of the insurer need to be closely coordinated with those of the banking supervisory authority (and other agencies involved in the banking safety net, such as the lender of last resort authority), and these links should be spelled out in some detail.¹⁵¹

In many cases, insurers are mere “payboxes,” in that they handle pay-outs to insured depositors when banks are closed or insolvent, but otherwise have no involvement with the banks, and rely on the bank supervisory authorities to manage the risks. In other cases, the insurers themselves exercise an active supervision over insured banks and may even have authority to impose sanctions and remedial measures if they find it necessary. A number of cases lie in between – with the insurer having some supervisory authority but generally deferring to the primary inspection authority.¹⁵² Of course, in some case the insurer and the supervisory authority (the Netherlands for example) are one and the same – but this is less frequent than one might expect.

Logically, there is a conflict of interest between the insurer, who might like to defer the cost of closing an institution and paying claims, and the supervisor, who often wants to close them quickly. In the United States, after the experience of the savings and loan crisis of the 1980s, there is a legal requirement for “Prompt Corrective Action” by the supervisory authority to avoid this dilemma. But as noted earlier, this requirement is easier to enact than to enforce, if the loans that go bad are not correctly marked to market.

Overall, this analysis suggests that BNA could be a logical place to house a deposit insurance scheme, but many other options are also available. These basic institutional considerations should be a matter of priority in any decision to establish such a scheme in Angola.

¹⁴⁹ D-K 2005, on pp. 39-40 10 schemes are entirely private, 22 joint and the rest “official.” In Africa, Kenya, Uganda and Nigeria are “official,” Tanzania private, and Zimbabwe joint. This despite the fact that the scheme was government funded originally.

¹⁵⁰ D-K 2003 and 2005.

¹⁵¹ IADI

¹⁵² D-K 2005 pp. 41-46. In only 10 cases can the insurer actually intervene in a bank.

Amount of Premium

Since many countries do not pre-fund their insurance, and others subsidize it, and the amount of coverage varies greatly, it should not be surprising that the premia vary as well. Even defining the amount of the premium involves problems. Many developing countries (including all of those in Africa) charge the premium on all deposits, even though only smaller ones are covered – obviously providing a measure of cross-subsidization from uncovered depositors. Industrialized countries typically only charge a premium on insured deposits. The US charges on only domestic deposits (but all of them).

In Africa, Nigeria (which only insures up to \$366, as seen above) charges 0.94% on all deposits, one of the world's highest rates. In comparison, Tanzania charges 0.1% (for \$235 of coverage), Kenya, .15% (for \$1313 of coverage), and Uganda, 0.2% (for \$1515 of coverage).¹⁵³

A few countries impose premia even higher than in Nigeria, but only for some banks and some periods in Greece, Guatemala, Kazakhstan, Macedonia (up to 5% for the riskiest banks), Slovenia (3.2%), Turkey (1-1.2%), and Venezuela (2%). The US charges a risk-based premium ranging from 0% to 0.2%. Some countries with pre-funded operations charge under 0.2%.¹⁵⁴ Several others with risk-based rates are in the same category. There is no relationship between premium levels and deposit coverage levels.

Table 6.1 (at end of draft) provides data on premium levels for an illustrative sample of countries, along with other information on the structure of their deposit insurance schemes.

Other Matters

In addition to technical parameters for a deposit insurance program, there is also a need to ensure that the program is well managed, that claims are executed promptly and effectively, that the assets of insolvent banks are handled efficiently, and that justice is done to those involved in the system. The issues to be resolved or to what extent the insurer will be involved in monitoring banks, in deciding what to do when they get into trouble, in paying insurance claims, in investing the premia if a fund is established, and in disposing of the remaining assets of failed banks.

Monitoring Banks

Most insurance organizations do not monitor banks, but rely on bank supervisors to do so. In several countries, though, the deposit insurance organization also exercises a degree of oversight and shares information with the supervisor. But in cases where the deposit insurer is small and technically weak, there is not much it can contribute in this regard. Unless there were

¹⁵³ DK 2005, pp. 31-33 for coverage, pp 36-38 for premiums. The database has no information on Zimbabwe, with a \$200,000 coverage.

¹⁵⁴ This group includes the Bahamas, Belgium, Bulgaria, Czech Republic, Denmark, Dominican Republic, Germany, Iceland, India, Ireland, Jamaica, Japan, Jordan, Korea, Lebanon, Malta, Norway, Oman, Philippines, Portugal, Russia, Spain Sri Lanka, Taiwan, and Trinidad.

a desire in Angola to provide secondary oversight, it would be sufficient for BNA to remain as the sole supervisory authority, with the additional provision that BNA will have to keep the deposit insurer informed about potential problems, so it can be prepared to act when needed.

Authority to Decide What to Do

As noted earlier, most deposit insurers do not have the authority to “intervene” to save a bank. Of the 11 which do, only the US is a large country. This is because there would be a conflict of interest and because the entirety of the bank safety net is involved in an intervention decision, not just the deposit insurance payment. A paper recently published by the Spanish central bank argues a contrary view: that effective resolution of troubled banks works best when the decision to resolve is based on the minimization of deposit insurance losses and the deciding authority has ample powers of resolution, as is the case with the United States FDIC.¹⁵⁵ This paper contends that the European bank supervisors do not act quickly enough to prevent losses, partially because they have insufficient authority and partially because they are not focused on minimizing insurance losses.

The bank supervisor usually bears the responsibility for deciding what to do with failing banks, in consultation with other key agencies. Normally everything is done to keep alive a salvageable bank, and only as a last resort is it closed or reorganized, at which point deposit insurance comes into play. One form of intervention is that in 26 countries bank insurers are permitted to cancel insurance. These include Kenya and Nigeria, though most of these cases are smaller European countries. Despite the African precedents for this approach, if the insurer has no active supervision role, the right to decide to terminate insurance or close a bank is of limited value. And without the power to intervene or cancel insurance, the insurer becomes, as the phrase goes a “pay box” with little additional responsibility.

Payment of Deposit Insurance Claims

As emphasized above, bank deposit insurance is not worth much its pledge to pay depositors is not credible. And in many countries it is not. The main problem is delays in making payments on claims. For countries which provide data to the World Bank, most schemes report paying depositors within 3 months, which is not of great comfort to anyone who requires the funds for transactions purposes. Only a few countries process payments within days (US and Honduras, with an average of 3 to 4 days). On the other hand, Nigeria took an average of 36 months and Kenya 12 months. These were among the slowest disbursers.¹⁵⁶

In the US, the standard FDIC operating procedure is to close a irretrievably failed bank on a Friday, work all weekend, and be ready to pay off depositors the following Monday. The most recent insurance payout was in 2004, when four banks failed. Three were simply acquired by other banks, and one was closed with payment to covered depositors. Non-covered depositors

¹⁵⁵ Maria J. Nieto and Larry D. Wall.

¹⁵⁶ DK 2005, pp. 43-44.

had to wait alongside other creditors for settlement of the bankruptcy estate of the bank, which can be a very lengthy process. In 2003, there were three bank failures and all were acquired by other banks; in 2002 there were 11, of which 6 were acquired and 5 closed.¹⁵⁷

The fact that two of the countries with the slowest payment process are in Africa is a matter of concern for Angola. Partly this is a question of will on the part of the authorities to facilitate the payment of claims. But it is also partly a matter of technical complexity of the payoff process. Bank records have to be accurate and accessible enough so that the identities of account holders is immediately available; bank employees have to be reliable in paying the right people quickly; and the rules about which accounts are eligible for coverage have to be simple enough so they do not cause undue delays. In particular, the accounts of connected parties have to be clearly identifiable and separable from other accounts. Problems in determining the identity of connected parties and their ownership of accounts have reportedly been a major problem impeding insurance payments in Nigeria. Another problem has been the essential exercise of offsetting deposit balances against credit balances. The Nigerian authorities have particularly complained about the limitations on their authority to pay off claims, as well as the problems caused by the courts and bankruptcy laws.¹⁵⁸ As mentioned above, these potential problems are a good reason for minimizing exclusions in any insurance program that might be established in Angola.

How To Invest the Premia

This issue arises when the deposit insurance scheme is funded by pre-payments. It can be a difficult problem for a country with underdeveloped financial markets. The investment choices can be made under the authority of the insurance institution itself, or by some other government organization. It is simplest to let the insurance organization invest the funds, providing that prudential requirements are strictly specified. Actual management of the fund can be outsourced to an appropriate external firm. In this case, of course, the procurement process for selecting the contractors must itself be transparent and efficient, which is often a difficult task in developing countries. The option we recommend for Angola is to let the BNA handle the investment, as it is already serving as banker to the Government, but under the supervision of the deposit insurance agency if that is another independent body.

The assets of the deposit insurance fund should be placed in short term instruments, since the need could arise at any time to liquidate the funds on short notice, such as TBCs. This requires the availability of an adequate supply of secure, short-term investments, and a market liquid enough for the assets to be sold quickly if necessary. Of course, longer term investments could also be used if necessary, and then serve as the basis for borrowing short term when funds are needed quickly, but that is more complex and usually involves higher costs. To the extent that appropriate short-term investments do not exist in Angola, the sums could be invested abroad,

¹⁵⁷ FDIC website.

¹⁵⁸ Ogunleye.

but that creates potential problems with a currency mismatch between assets and liabilities for the insurer. It also tends to defeat part of the purpose of the whole exercise, which is to develop the domestic financial system – though some external investments are certainly desirable to distribute risk and to provide assets to match the coverage of foreign exchange deposits.

How to Dispose of Bank Assets

When a bank is closed, it obviously has remaining assets in loans, investments, equipment, etc. In the closure process these assets are liquidated and the proceeds applied to meeting the bank's liabilities, including obligations to its depositors. Hence, the management of deposit insurance is intimately related to the question of how to handle the whole process of bank insolvency under the law.

Under the law, most of the issues are common to insolvencies in general, such as the priority among creditors. Obvious claimants include employees, taxes, bond holders, non-insured depositors, and the deposit insurance organization itself. From an incentive point of view, if the insurance organization is handling the recovery of assets, giving it priority seems to make sense. In reverse, at least the senior employees of the failing bank should bear responsibility for a bank failure, so giving them priority seems very unwise. And if an element of government subsidy is involved in any case in the settlement of claims, bank specialists question the advisability of giving priority to tax claims. All of these general cautions are frequently ignored by those setting up bankruptcy provisions for banks. In fact, one of the key problems in resolving distressed banks is the conflict between the normal bankruptcy rules and what would make sense for bank failures. The literature is replete with examples of problem arising from this conflict.¹⁵⁹

Another common bankruptcy issue is the “going enterprise” problem. Many assets might be more valuable if they were to be sustained by a “going enterprise.” Depending on the capacity of those responsible for resolving the assets of failed banks, this argument suggests making an effort in certain cases to keep the bank running, and even provide it with new financing if that is required to avoid a larger loss in asset value. Thus whoever handles the collection of assets for a failed bank needs both expertise and flexibility.

In Angola, there is no separate bankruptcy law for banks, however under Lei No. 13/05 das Institucios Financiera, the BNA does have authority to revoke a banking license, and to intervene in and replace bank managements, though its decision can be appealed to the courts. The actual realization of bank assets is under court direction as part of the bankruptcy process, under a seriously outdated Civil Code. Notably, figures in the World Bank's Doing Business report for 2008 do not look promising, showing an average of just 10.8% asset recovery on bankruptcies overall, with an estimated 6.2 years required for the process. Both of these figures are extremely low by international standards.

¹⁵⁹ See Nieto and Wall or Ogunleye – but more generally the discussion at www.iadi.org.

Reform in the legal framework is therefore highly relevant to the operation of a deposit insurance scheme, to facilitate the winding up of failed banks and recovery of assets.

The realization of bank assets is especially important because it influences the amount that can be recovered on uninsured deposits. For a number of years, no depositor in a failed US bank was left with an out of pocket loss.¹⁶⁰ Other parts of the financial safety net and *ex gratia* payments by the government frequently protected these other depositors as well. One article indicates that in 18 countries, uninsured depositors have also been compensated in cases of bank failure.¹⁶¹

The Frequency of Bank Failure, and its Effect on Deposit Insurance

It is a matter of interest that 25 countries in the World Bank sample reported no bank closures over the latest 5 years of data, but 16 closed more than 10. (The size of closed banks is not reported in the data set.) Nigeria had 30 bank closures, and Kenya 22, which put them among the world leaders. These are the result of bank restructuring programs and the rapid entry of new banks.¹⁶²

Obviously, the number of banks which fail is partly a function of the number of banks that exist. Many countries have very few, whereas others have thousands. It is no accident that countries like Angola, which are in the process of expanding competition in the banking industry, seriously consider deposit insurance.

Deposit insurance has been less invoked in banking systems that are highly concentrated, and where the major banks are deemed “too big to fail.” In that case the bank as a whole is implicitly “insured”, not just the depositors. It is no accident that the first major country to adopt deposit insurance was the United States, which is characterized by an unusually large number of relatively small banks (roughly 8000 at last count).¹⁶³

But the adoption of bank deposit insurance also depends on the vulnerability of the banks, which is again a function of the quality of banking supervision. If few banks ever fail, then the deposit insurance institution will have few opportunities to perform its role. Its personnel may then be idle most of the time, and skills in bank resolution may not be well developed. These problems can be addressed in part by contracting out labor-intensive aspects of the insurance settlement process, such as the payment of claims and recovery of bank assets, to firms with

¹⁶⁰ Ibid.

¹⁶¹ DK 2005, p. 43-44.

¹⁶² DK 2005, pp. 41-42.

¹⁶³ As of 2004, there were 7630 commercial banks and 1345 savings institutions insured by the Federal Deposit Insurance Corporation (FDIC) and 9014 credit unions in the United States. This was down from 12,376 commercial banks and 2815 savings institutions in 1990, and 14,146 in 1934. www2.fdic.gov/hsob/hsobRpt.asp. The number has been gradually declining for decades. All newly chartered deposit taking banks, in any state, have to be covered by FDIC. Branches of foreign banks do not, but almost all United States banks are covered. For reference, 2437 financial institutions reported to the Deutsche Bank in 2002. See <http://217.110.182.54/download/volkswirtschaft/092002bankienstatistik/2002/bankingstatistics/2002.pdf>.

deeper experience of handling bankruptcy. But successful performance of these tasks is partly dependent on the state of the law on bankruptcy both in general and for banks in particular.

Recommendations for Angola

Whether Angola needs bank deposit insurance at this moment is open to question, but on balance the arguments favor of doing so. First, there may be value in providing the public with an explicit level of comfort about the security of deposits. Even so, it is unlikely that the lack of such insurance is a major constraint on expansion of the banking system, given the all of the other constraints banks face, as discussed in other chapters of this report. In any case, the experience in other countries suggests that the absence of explicit deposit insurance engenders a belief that an implicit government guarantee, so an explicit scheme may not make much difference in terms of public perceptions of deposit safety.

There is more value in establishing an explicit guarantee to clarify the limits of what will be covered and what will not be covered in the event of a banking failure. Even in this regard, however, it is not clear that such limitations will be adhered to in the face of political pressures that may emerge if one of the larger banks were to fail. An explicit scheme can also lessen the budgetary costs of whatever coverage is ultimately provided by generating premium income in advance. It should be clear, however, that anything beyond a very low level of insurance coverage will be hard to cover out of premiums.

With the expansion of the banking system, some bank failures are to be anticipated. Hence, deposit insurance may play a useful role in containing possible contagion effects that might stimulate runs on sound banks.

Another benefit of deposit insurance is to provide an explicit guarantee that small depositors will not be victimized by the loss of deposit balances in the event of a bank failure. A deposit insurance scheme also has the advantage of putting in place procedures and criteria to administer this guarantee, if and when needed. One of the main lessons of international experience, however, is that these systems need to be efficiently managed, and the technical complications kept to a minimum for this benefit to be realized.

Recommendation: *On balance, we recommend proceeding with careful consideration of a deposit insurance scheme for Angola.*

Recommendation: *If the Government moves in this direction, the first step is to establish a task team to carefully study the many technicalities identified above.*

Recommendation: *The Angolan Government and BNA should seek technical assistance in assessing the parameters for a possible deposit insurance scheme. The Federal Deposit Insurance Corporation in the United States is one leading agency that has experience in providing international technical assistance experience. (USAID can facilitate this link.) Another option is the International Association of Deposit Insurers at the Bank for International Settlements in Basel.*

Recommendation: *The assessment process should also include consultation with stakeholders, and study visits to other countries to learn from their experience, particularly countries like Kenya and Nigeria where significant difficulties have been faced.*

Recommendation: *If the Government views deposit mobilization is a major reason for favoring a deposit insurance scheme, then either GOA or BNA should commission a study to survey households and small businesses to determine the extent to which lack of confidence in the banks is inhibiting the use of deposits as a savings vehicle.*

Key issues to be resolved include:

Coverage. Decisions are needed on both the level of deposit balances to be insured and the types of deposits to be covered.

Recommendation: *We suggest a coverage ceiling per deposit of about \$16,000 for 2008, based on the central tendency in Africa and other developing countries to set the threshold at around 3 times the level of per capita GDP. This is a reasonable, though rather arbitrary, benchmark for Angola.*

Recommendation: *Simplicity is a virtue in deciding on coverage for foreign exchange accounts, inter-bank accounts, accounts held by linked parties, as exclusions may create considerable administrative costs and delays in the event of a bank failure.*

Recommendation: *Decisions are needed on the responsibilities of foreign parent banks for covering deposit accounts in their Angolan subsidiaries, should they fail.*

Management and control Should there be a separate deposit insurance agency, or should BNA or the Government undertake this function directly? If there is a separate organization, what should be its authority and range of functions? The basic issue is whether the deposit insurer should be a simple “paybox” to compensate depositors when BNA closes a bank, or whether it should be more directly involved in dealing with the insurer should have more involvement in dealing with bank insolvencies. Some of the difficulties of the Nigerian scheme as noted are due to its limited authority – and some remedial action has been taken there.

More specifically, the functions that need to be addressed include: monitoring banks to anticipate failures; preventive intervention; collecting and investing the premia, if a pre-funded scheme is envisaged; deciding when banks have failed and whether they should be shut or reorganized; screening deposit records to determine the necessary payments; paying depositors of insured banks; and realizing the residual assets of failed banks.

Recommendation: *The deposit insurance scheme should be housed within BNA but operated as an independent legal entity, collaborating closely with the bank supervisors. The insurance entity should have a relatively limited role with respect to insolvencies, such as monitoring possible payout needs.*

Recommendation: *The deposit insurance entity should develop procedures to outsource operational functions in the event of a bank failure, rather than keeping a large permanent staff on hand to deal with activities such as the payment of claims and realization of assets. The entity should not play any role in monitoring or supervising the banks, leaving this function in the hands of BNA.*

Funding the deposit guarantee. Many countries do not pre-fund their deposit guarantees, and instead establish procedures for obtaining funds when payouts are needed. Because there is a limit to the ability of the banking industry in Angola to sustain premia, it is almost inconceivable that pre-funding would be sufficient within any reasonable time period to cover the costs involved in dealing with the failure of even a medium sized bank. So some level of subsidy is probably inevitable. However, having even a partial fund is establishes the principle of cost-sharing. It may also facilitate faster pay-outs to at least the poorest depositors in the hour of need, and help to establish credibility and awareness of the insurance coverage. A subsidiary question is whether the premium should apply only to covered balances, or to all deposit balances. The latter approach creates an inefficient element of cross-subsidy. To the extent that a subsidy is required, it is best provided by the Treasury, not by a hidden tax on other depositors.

Recommendation: *The deposit insurance fund should be pre-funded via a small premium charge on covered deposits, but it will also and also require seed capital from the Treasury to establish credibility in the eyes of the intended beneficiaries: the depositors.*

Table 6.1 – Deposit Insurance in Other Countries -- Illustrative Examples

Country	Limit (Dollars 2003)	ForeignEx	Interb	Premium (%)	Base
AFRICA					
Nigeria	366	No	Yes	0.94	All Deposits
Kenya	1313	Yes	Yes	0.15	All Deposits
Tanzania	235	Yes	Yes	0.1	All Deposits
Uganda	1550	No	No	0.2	All Deposits
Zimbabwe	3640				
INDUSTRIAL COUNTRIES					
US	100000	Yes	Yes	0-.27	All Domestic Deposits
UK	19611	Yes	No	Not Prefunded	
Germany	25260	Yes	No	0.03	Insured Dep in CB
France	99410	Yes	No	Not Prefunded	
LUSOPHONE COUNTRIES					
Portugal	31575	Yes	No	.1-.2	Insured Deposits

Brazil	6925	No	No	0.3	Insured Deposits
BIG DEVELOPING COUNTRIES					
India	2193	Yes	No	0.05	All Deposits
Bangladesh	1021	No	No	0.5	All Deposits
Indonesia	Blanket	Yes	Yes	Small charge, details n.a.	
Mexico	2871337	Yes	No	Min .4	All Obligations
OTHER HIGH PREMIUM COUNTRIES					
Greece	25260	Yes	No	.025-1.25	All Deposits
Venezuela	6258	No	No	2	Insured Deposits
Kazakhstan	2774	Yes	No	1	Insured Deposits
Turkey	All	Yes	No	1-1.2	insured savings deposits
OTHER LOW PREMIUM COUNTRIES					
Denmark	40296	Yes	No	0.2	Insured Deposits
Czech Republic	31575	Yes	No	0.1	Insured Deposits
Jamaica	4957	Yes	No	0.1	Insured Deposits
Japan	93371	No	No	.0049-.036	Insured Deposits
Korea	41925	No	No	0.05	Insured Deposits
Norway	299401	Yes	No	**	
Philippines	1800	Yes	Yes	0.2	All Deposits
Russia	3395	NA	NA	under .15	All Deposits
Spain	25260	Yes	No	max .2	Insured Deposits
Taiwan	*	No	No	.05-.06	Insured Deposits

*1000000 Taiwan Dollars

** .005 of assets + .01 of all deposits

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Appendix A: BNA Policy Matrix - Expanding Credit Access

Findings	Objectives	Counterpart Agency	Approach	Action Points
1. Human Resource Capacity				
<p>1.1. Financial Services Education</p> <p>Quality and applicability of the curriculum is in need of improvement. Universities are not offering the appropriate financial sector teaching. There is a need to update and advance capacity building that supports the economic needs of the country. This severely limits capacity for growth in both the financial and productive sectors.</p>	<p>Improve the flow of internationally certified financial staff through strengthening the education system to produce more qualified graduates in finance and business administration.</p> <p>Support the efforts of Angolan universities to update, train and retain qualified teaching professionals in the financial services sector.</p> <p>Ensure that academic curricula in finance and business subjects have a good balance between theory and practice, while adhering to international best practices.</p> <p>Support English language</p>	<p>Ministry of Education</p> <p>Private Educators</p> <p>Private and Public Universities</p>	<p>Sponsor twinning arrangements between Angolan educational institutions and international universities to expand curricula and train the trainers.</p>	<p>Assess the potential linkages to international universities as appropriate.</p>

Findings	Objectives	Counterpart Agency	Approach	Action Points
	training of financial sector professionals to enhance access to additional knowledge and information.			
<p>1.2. Accounting Expertise</p> <p>The major accounting firms are present, and have difficulties in finding qualified staff. Banks and companies have similar difficulties in obtaining accounting staff. Accounting and audit expertise is available in Angola, but is highly concentrated in a small number of professionals.</p> <p>The GOA recognizes this challenge, and provision of the legal basis for a professional association for accountants is part of the MOF's agenda.</p> <p>Contacts with international organizations have been made to look at options to implement a certification program.</p>	Develop a local language accounting and audit certification program that establishes internationally recognized standards. This certification program could form the basis for accounting and audit training by the Angolan university system, with the possible involvement of the Banker Training Institute or a similar institute to be established specifically for accounting.	Accounting Firms International Accounting Associations Accounting Commission BNA MOF Angolan Banking Institute Private and Public Universities	Development of an accounting certification program that adheres to internationally recognized standards with the possibility for regional harmonization.	Explore the feasibility of adapting internationally recognized accountant training and certification programs. Identify alternatives and options of in collaboration with stakeholders.
<p>1.3. Banker Training</p> <p>Banker training is limited and not widely offered by the financial institutions to build</p>	Ensure that the Banker Training Institute is a cost effective source of	BNA Angola Banking	Support linking the Angola Banking Institute with	Assess the linkages to strengthen the Banker Training Institute as

Findings	Objectives	Counterpart Agency	Approach	Action Points
<p>human capacity. There seems to be a perception that training is a cost not an investment.</p> <p>The Banker Training Institute, sponsored by the BNA and developed as part of a WB program, seeks to provide remedial, technical and management training.</p> <p>Private banks supplement this weakness with internal training.</p>	<p>competent training, widely used by private and public banking institutions.</p> <p>Upgrade the curriculum to respond to rapidly changing levels of sophistication as the banking system evolves.</p> <p>Potential opportunity to leverage capacity on other work – e.g. on training lending officers to advise potential clients.</p>	<p>Institute Public and Private Banks</p>	<p>international training programs to ensure current technology and practices.</p>	<p>appropriate.</p>
2. Information and Ownership				
<p>2.1. Know-Your-Client</p> <p>The national ID system is not universally used. Banks resort to getting birth certificates and references from existing clients to verify the identity of new clients. Lack of clarity on identity can deny legitimate access to financial services.</p> <p>Challenges include destruction of previous records, high mobility among the low income segments of the population, instability of</p>	<p>Simplify and streamline the processes to obtain a national ID that can be used to verify identity, improve the effectiveness of credit history reporting, and thereby expand access to financial services.</p>	<p>MOJ MOF Ministry of Territorial Administration Ministry of Urbanization and Environment</p>	<p>Use introduction of credit bureau as catalyst.</p> <p>Possible use of biometrics to inhibit duplication of records.</p>	<p>Need to draw on lessons learned in other countries with similar post-conflict circumstances.</p>

Findings	Objectives	Counterpart Agency	Approach	Action Points
employment, lack of certainty in addresses of record.				
<p>2.2. Bankable Corporate Clients</p> <p>Many small and medium sized enterprises (SMEs) do not have tax identification numbers. This means that stamp duty on debt agreements cannot be collected, and as a result loan documents are unable to be registered and have no legal standing, leaving the lender with no legal recourse in case of default. This severely inhibits lending.</p> <p>The process of company registration is lengthy and needs to be simplified.</p> <p>The one-stop-shop approach has been tried, but since no provision has been built into law for the processes to be centralized in one agency, the impact is reduced.</p> <p>According to the World Bank report Doing Business 2006, the cost of completing registration was estimated at over 600% of the GDP per capita (about \$6,500). This represents a heavy, possibly unaffordable penalty for leaving the informal sector.</p> <p>Administrative disincentives to registering a company and filing tax returns not only</p>	<p>Promote the simple, low cost and quick process of formalizing an SME. The initial effort with a one-stop-shop needs to be completed so that all registration (including obtaining a tax ID) and licensing can be done at a single location or on-line. Ideally, registration would be through the Internet and/or terminals within bank branches, with issuance of all requisite licenses automated so as to eliminate face-to-face contact except for problem resolution.</p> <p>Solutions need to be flexible and robust enough such that they can be replicated and applied at a national level where the</p>	<p>MOJ MOF Ministry of Commerce Provincial and Municipal Administration Private and Public Banks INAPEM Imprenta Nacional</p>	<p>Align the business registration process with international best practices.</p>	<p>Develop a program to rationalize company registration process.</p>

Findings	Objectives	Counterpart Agency	Approach	Action Points
impedes access to finance, but also undermines the tax base.	levels of infrastructure and technological capacity vary.			
<p>2.3. Property Rights</p> <p>Most fixed assets were nationalized after independence. The process has evolved and currently the property registries do not fully reflect the legal title holders and are often cause for irregularities.</p> <p>The absence of regular property and land titles make the use of these assets as collateral ineffective. This limits the ability to access credit and mitigate credit risks.</p>	Promote the development of an easy to access, modern, cost efficient and responsive property registries (cadastre system) that clarify property rights.	MOJ MOF MAT MUA MOP	Comparative review and evaluation of the current property registry processes.	Draw on examples and lessons learned of solutions from post-conflict countries..
<p>2.4. Credit History</p> <p>A credit reference system is lacking. A positive and negative, private and public sector credit bureau enables a borrower to establish a track record of honoring obligations, which can be used to shop among banks for the best credit terms and conditions to obtain lower funding costs.</p> <p>While informal sharing of information between banks certainly takes place, this is unlikely to include recommendations to a competitor to bank good clients.</p>	<p>Implement a modern and technologically capable credit reference system that satisfies the requirements of the financial sector.</p> <p>Develop an appropriate regulatory and legal framework that supports the functioning of a credit reference system.</p>	BNA MOJ MOF Public and Private Banks Other Financial Institutions	<p>Evaluate internal needs and follow with implementation.</p> <p>Concurrently explore harmonization under the FIRST Initiative regional program.</p>	Support BNA's request with FIRST.

Findings	Objectives	Counterpart Agency	Approach	Action Points
<p>BNA has requested support from the FIRST Initiative. This is a high priority for the BNA. The BNA wants a state of the art credit that links with other data systems (i.e., return checks) and offers the flexibility to accommodate short and medium needs.</p>				
<p>2.5. Legalization of Contracts and Guarantees</p> <p>The insufficient number notaries, along with the high costs and limitations associated with their services limit expansion of credit.</p>	<p>Modernize and increase the efficiency of notary services.</p>	<p>MOJ MOF</p>	<p>Update the processes of notary services to the international best practices.</p>	<p>Evaluate the experiences of solutions from other countries.</p>
<p>2.6. Contract Enforcement & Dispute Resolution</p> <p>The banking system avoids recourse to the court system – as cases are resolved slowly, are unpredictable and expensive. This inefficiency increases the risk of credit for the banks, inhibiting them from making loans.</p> <p>A Committee for the revision of the judiciary system was established.</p> <p>Published was the law 16/03 of July 25th, law on Voluntary Arbitrage and Resolution 34/06 of May 15th that reiterates the strong</p>	<p>Modernization of laws and regulations that govern the processes of legal execution of contracts in a predictable, rapid and efficient way in order to meet the needs of the financial system and complies with the international standards of legal protection.</p>	<p>Revision of the Judiciary System Committee Ministry of Justice</p>	<p>Comparative analyses and assessment of the current process of legal execution of contracts.</p>	<p>Assess the options for extra judicial dispute resolution in order to reduce the workload in the courts</p>

Findings	Objectives	Counterpart Agency	Approach	Action Points
commitment to promote and stimulate alternatives resolution of disputes.				
3. Supply of Financial Services				
<p>3.1. Medium- and Long-Term Finance</p> <p>Given the lack of certainty on client identification, lack of credit history, lack of certainty on financial statements, lack of ability to enforce contracts or rely on the liquidation of collateral, the banks are in no hurry to lend to anyone they do not know very well.</p> <p>The banks show low loan to deposit ratios and have excess liquidity.</p> <p>Savings are not mobilized in an efficient manner. There is a need to diversify medium-term credit instruments, such as capital investment loans, leasing, and mortgages.</p> <p>Even though some of the banks are extending their branch networks at a national level, lending activity remains limited, even more so in the provinces.</p> <p>Most of the deposits are in dollars, but the legal and regulatory framework inhibits the</p>	Expand the offering of medium-term financial products while improving the enabling environment.	BNA Public and Private Banks BDA CMC INAPEM	Encourage the development and distribution of medium- and long-term financial products that satisfy economic needs of companies and households.	Draw on lessons learned from other countries with similar constraints in post-conflict environment.

Findings	Objectives	Counterpart Agency	Approach	Action Points
banks' capacity to lend in foreign currency.				
<p>3.2. SME's Limited Capacity to Offer Bankable Projects</p> <p>SMEs in general lack the experience and the resources to develop appropriate project proposal for the banks.</p> <p>Even if the credit products are available the demand is not guaranteed since the SMEs have limited knowledge to effectively get and use the offered services.</p> <p>There are limited business support services to strengthen and deepen the SMEs access to services from the formal financial sector.</p>	<p>Improve and increase the capacity of SMEs to access formal financial sector services.</p> <p>At a level of SMEs improve the project development process with business support services.</p>	<p>BNA INAPEM MOF Public and Private Banks</p>	<p>Generate recommendations to strengthen and deepen the business support services for SMEs to expand access to credit.</p>	<p>Assess current business development support services for SMEs and draw from experiences in the region and in post-conflict countries.</p>
<p>3.3. Access to Microfinance</p> <p>Most of the low income population does not have access to financial services. This market eventually might be better served by Micro Finance Institutions (MFIs). The law of Finance Institutions anticipates the existence of Micro Finance Institutions, although it is not regulated. .</p>	<p>Develop the regulatory and normative framework for MFIs.</p>	<p>BNA</p>	<p>Recommend a regulatory and normative framework that complies with the international standards and is suitable to the conditions in Angola .</p>	<p>Learn from lessons of regulatory and normative framework established in other regional countries</p>
<p>3.4. Real Estate Finance</p> <p>Uncertainty on property rights and the lack of</p>	<p>Long term pension and life insurance savings</p>	<p>BNA ISSA</p>	<p>An evaluation of the real estate finance</p>	<p>GOA to determine level of interest in analysis of the</p>

Findings	Objectives	Counterpart Agency	Approach	Action Points
<p>a source of long term funding limits mortgage finance as bank lending. Since real estate cannot act as reasonably secure collateral, there is no justification for the pension system – typically the major source of long term funding – to provide for market financing through mortgage backed securities.</p> <p>There is a mismatch of assets and liabilities in the long run which limits real estate financing.</p>	<p>prudently invested in residential and industrial real estate finance.</p>	<p>Public and Private Banks Pension Funds</p>	<p>market to support action plans of appropriately sequenced activities.</p>	<p>real estate finance market.</p>
4. Other Factors Relating to Supply and Demand				
<p>4.1. Absence of Deposit Insurance</p> <p>Depositors can feel more confident with financial institutions if a deposit guarantee fund is established.</p>	<p>Establish a deposit guarantee fund that encourages depositors to use the formal banking sector.</p>	<p>BNA MOF Public and Private Banks</p>	<p>Assess the feasibility generate recommendations for a deposit guarantee fund that satisfies the socio-economic reality of Angola.</p>	<p>Evaluate applied models and assess experiences from other countries that have established these insurance funds.</p>
<p>4.2. Indicative Base Rate to Price Credit Products</p> <p>Depositors do not generally earn interest, which generates inefficiencies in the pricing of credit products. Banks do not have an appropriate cost of funds to assess the spread.</p>	<p>Promote the development of a Kwanza base rate.</p> <p>Align the rate of dollar denominated loans and deposits to the economic reality of Angola.</p>	<p>BNA Public and Private Banks</p>	<p>Evaluate monetary policy instruments to support the local base rate.</p> <p>Assess the options to have a dollar base rate for saving and loans</p>	<p>Evaluation and assessment of the lessons learned from other countries with similar conditions.</p> <p>This can be a topic of discussion in the proposed Monetary Policy workshop</p>

Findings	Objectives	Counterpart Agency	Approach	Action Points
<p>The expected CPI provides an internal proxy, but the absence of an indicative base rate (yield curve) for Kwanza obligations inhibits the financial sector capacity to price and offer local currency loans.</p> <p>There are dollar loans and dollar indexed loans that generally use Libor as the referential rate. The risk is that priced dollar loans do not reflect the economic situation in Angola.</p> <p>The low competitiveness in the banking sector generates inefficient agent conditions in the application of adequate rates for deposits and loans.</p>			<p>products that reflects the economic conditions.</p>	

Findings	Objectives	Counterpart Agency	Approach	Action Points
<p>4.3. Stamp Duties</p> <p>Stamp duties are applied to a wide range of financial transactions. While these may be a source of revenue to the GOA, they complicate transaction processing, and increase the transaction cost for clients.</p> <p>Such transaction taxes have generally been removed in other countries as impediments to economic activity and growth.</p> <p>Transaction charges also encourage avoidance through using informal or unregistered channels (e.g. cash) for executing financial transactions, undermining the integrity of national statistics and impeding growth in financial intermediation by the formal financial sector.</p>	<p>Complete an analysis of the costs and benefits of stamp duties, and an estimation of the impact of eliminating them.</p>	<p>MOF Public and Private Banks</p>	<p>Generate recommendations based on the results of the analysis.</p>	<p>Based on the recommendations, GOA could explore whether stamp duties should be eliminated.</p>
<p>4.4. High Costs of Financial Intermediation</p> <p>Transaction costs are high and this limits access. This may be a reflection of limited competitive pressure and unusually high operating expenses due to inadequate economies of scale and costs of doing business in Angola.</p>	<p>Transaction costs that encourage financial intermediation and do not limit access.</p>	<p>BNA Public and Private Banks</p>	<p>Lower the cost of doing business for the banking system by improving the environment in which they operate and encourage competition in the sector.</p>	<p>Explore experiences from other countries to increase the competitiveness of the financial sector.</p>

Findings	Objectives	Counterpart Agency	Approach	Action Points
<p>4.5. Public Awareness</p> <p>The general public has little exposure to banking, and low confidence in the banking system or in their ability to use banks.</p> <p>Banks do not offer adequate channels to inform and educate the public about products and services.</p> <p>4.6 Absence of a Credit Insurance</p> <p>The risk of credit for the Financial Banking Institutions would be reduced if a credit guarantee fund were established.</p>	<p>Improve public education of financial sector through the BNA and the banking system.</p> <p><u>Establish a guarantee fund that contributes to the reduction of credit risk.</u></p>	<p>BNA Public and Private Banks</p> <p>BNA, Ministry of Finance, Public and Private Banks, other entities</p>	<p>Encourage the distribution of appropriate public information material.</p> <p>Assess the viability of generating recommendations for the credit guarantee fund that is suitable to Angola</p>	<p>To evaluate and modify public education materials from other countries that can be used as a model.</p> <p>BNA coordinates with the banks on expanding public education.</p> <p>Assess the models and experiences applied in other countries where these guarantee funds have been established.</p>
5. Monetary Policy Implications				
<p>5.1. Multiplier effect on Money Stock</p> <p>The BNA faces new challenges. The level of financial intermediation – one of the main indicators of economic efficiency – is single digit as a percentage of GDP. Actions that improve the financial intermediation (loans/deposits) have a multiplier effect on the monetary stock. The Instruments of monetary</p>	<p>Support a monetary policy which allows the BNA to protect the value of national currency in the current surplus environment.</p>	<p>BNA</p>	<p>BNA could draw on the experience in other countries that have faced the “Dutch disease”, including Norway, Mexico, Kazakhstan, Dubai, Qatar and others.</p>	<p>BNA to conduct a workshop with foreign central banking experts, potentially including, but not limited, to Norway, Ghana, Uganda and the US to explore the experiences of other</p>

Findings	Objectives	Counterpart Agency	Approach	Action Points
<p>policy must reflect the dynamic growth of the economy, particularly in the sectors of natural resources. For example:</p> <ul style="list-style-type: none"> • The discount ceiling assumes that banks are illiquid and need to access funding – the banks are liquid and do not use the discount ceiling. • The foreign exchange regulations assume limited foreign exchange reserves and establish controls over the access to foreign currency – the country has a sizable flow of dollars and there are possibilities for the regulations to be circumvented. • The open market operations through the auctioning and trading of T-bills assume a stock of T-bills – GOA's budget is now in surplus, and has not rolled maturing bills. • The BNA mops up liquidity by issuing its own bonds, but then it carries the interest expense of the issued paper. • The Treasury issues long term bonds in settlement of accumulated government payables. But there is no market for this type of medium term security. Moreover, for the MOF to call these securities it would need to inject yet more liquidity into the economy. • Deposits are in Kwanza and dollars, but the reserve requirements of 15% of total deposits need to be in Kwanza. The impact is twofold: i) a foreign exchange 				<p>countries.</p>

Findings	Objectives	Counterpart Agency	Approach	Action Points
<p>risk for the banks; and ii) a reduction in the supply of local currency for lending.</p> <ul style="list-style-type: none"> Dollars remain widely used to settle transactions and store value, competing directly with the local currency. 				
<p>5.2. Rationalization of Foreign Exchange Controls</p> <p>The BNA attempts to directly manage foreign exchange inflows and outflows through an elaborate FX licensing and control system.</p> <p>Most countries have found that such direct controls do not work – increasing transaction delays and costs while actually undermining confidence in the currency and inhibiting capital inflows. This is because if there is uncertainty on the export of capital, investors will seek to restrict imports of capital and take advantage of every opportunity for flight capital so as to avoid the risk of being blocked.</p> <p>Given the inherent foreign exchange earnings capacity of the Angolan economy, restrictive foreign exchange regulations probably do more harm than good.</p> <p>In considering a rationalization of the foreign exchange controls, there is concern with the</p>	<p>Rationalization of foreign exchange controls – identify alternatives in the short and medium term that the BNA can use to effectively steer the value of the national currency through indirect means.</p> <p>Staged program of rational foreign exchange controls developed in collaboration with the banking system to ensure a smooth transition.</p>	<p>BNA Public and Private Banks</p>	<p>Review the practical impact of rationalizing foreign exchange controls.</p>	<p>This can be a topic of discussion in the proposed Monetary Policy workshop</p>

Findings	Objectives	Counterpart Agency	Approach	Action Points
potential for short term capital flows that could destabilize the economy, particularly given pending development of a capital market.				

Appendix B: Persons Contacted

National Bank of Angola (BNA)

Amadeu de Jesus Castelhana Mauricio	Governor
Laura Monteiro	Administrator, Banking Supervision
Beatriz de Andrade dos Santos	Director, Banking Supervision
Ana Paula Jose Alves Coelho	Director, Market Operations
Hernani Santana Freire	Director, Legal department
Silvinho C. Bento	Deputy Manager, Banking Supervision
Manuel Antonio Tiago Dias	Deputy Manager, Studies and Statistics
Tuneka Lukau	Deputy Manager, Banking Supervision
Gançalo Ventura Antunes Rita	Division Head, Banking Supervision
Ondjoy A. Cristovao de Barros	Inspector, Banking Supervision
Elavoko do R. Chaves Joao	Inspector, Banking Supervision

Government

Capital Markets Commission

Antonio Baltazar de Sousa	Director
Zacarias Pereira da Conceicao Neto	Director

Institute of Insurance and Supervision

Fernando Jorge Julio de Aguiar	Director General
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Ministry of Finance

Manuel da Costa	Director, Studies and International Economic Relations
Ilda Jamba	Division Chief, Treasury and Finances
Armando Manuel	Director, National of Treasury
Judith da Silva Valente e Sliva	Chief, Economic Studies

Ministry of Planning

Alcino Izata de Conceicao	Chief, Multilateral Development Assistance
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Guiche Unico de Empresas (GUE)

Isabel Formenta	Director
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Financial institutions

Development Bank of Angola (BDA)

Valentina Matias Filipe	Administrator
Amandio Reis Esteves	Administrator
Manuel Nicolau Diogo	Director, Risk Management

Bolsa de Valores e Derivados (BVDA)

Sebastian Manuel	Executive Director
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Bank Training Institute of Angola (IFBA)

Sr. Candido	Director
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Banco Africano de Investimento (BAI)

Luis Filipe Rodrigues Lelis	Executive Director
Carlos Chaves	Director of Planning
Inokcelina dos Santos	Director of Credit

Banco De Fomento de Angola (BFA)

Emidio Pinheiro	CEO
Benjamim Costa de Pinho	Executive Director
Antonio Matias	Executive Director
Sebastiao Massango	Director
Luis Goncalves	Deputy Director
Sandra Silva	Sub-Director

Banco Espirito Santo Angola

Luis Farofia	Director, Control and Budget Management
Edson Lutz	Sub-Director, Finance and Markets

Banco de Poupança e Crédito (BPC)

Paixao Antonio Junior	Chairman
Rosa Jose Silverio Correa Victor	Director, Planning and Control

Banco Internacional de Credito (BIC)

Fernando Leitao	General Director
Vera Tangué Escorcio	Director

Banco Totta de Angola (BTA)

Joao Pinheiro Director of Finance

Banco Keve

Rui Costa Campos Vice-President of the Board

Banco Angolano de Negócios e Comércio (BANC)

Maria do Ceu Figueira Executive Director

Banco Sol

Dra. Varinia Sobral Administrator
Joao Goncalves Financial Director
Gil Benchimol Director of Credit
Carla Van Dunem Sub-Director of Credit
Albertine Jasse Sub-Director, Medium Enterprise and Individuals
Cristiana Lavrador Studies and Projections Cabinet

Novo Banco

Simon Herrmann Chief Operational Officer

Standard Bank

Carlos Duarte Representative officer

AAA Seguros e Pensões

Sao Vicente President and Chairman

SME Development Agencies

National Institute of Assistance to Small and Medium Enterprises (INAPEM)

António Assis Chairman
António Martins Administrator
Maria Cecilia Head, Planning and Studies
Garcia Manuel Manager, Business Training
Alfonso Mendes Director, Technical Assistance
Dalia Director, Technical Assistance

Centro Apoio Empresarial (CAE)

Lars Benson	Director
Fila Francisco	Business Advisor

International Agencies

USAID

Susan K. Brems	Mission Director
Michael Nehrbass	Deputy Chief of Technical Programs
Vic Duarte	Chief, Program Development
Cathy Hamlin	Program Coordinator

US Embassy

Mark Schall	Economic Secretary
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World Bank and IFC

Chris Porter	Advisor
Eduardo Boechat	Senior Investment Officer

UNDP

Joao Eduardo Bettiga	Angola Enterprise Program, Business Incubator Expert
Arcelinda Chingala	UNDP, Angola Enterprise Program, Deputy Director

Private Sector and Other

Jose Alentejo	Câmara de Comércio, Director, Private Sector Support
Pedro Barreto	Deloitte, Managing Partner
Luis Folhadela	KPMG, Senior Manager
Ana Bravo Seabra	KPMG, Senior Consultant
Olivier Bernard	Sonangol Integrated Logistic Services (SONILS), Finance Manager
Etienne Brechet	JEMBAS Assistencia Tecnica, Ltd (JAT), General Manager
Justino de Pinto de Andrade	Catholic University, Director, School of Economics

IN WASHINGTON D.C.

Chris Barltrop

USAID, Senior Financial Sector Advisor

Bill Baldrige

USAID, Senior Financial Sector Advisor

Jose Sulemane

IMF, Advisor to the Executive Director

Alexander Kyei

IMF, Angola Mission Team

Arto Kovanen

IMF, Angola Mission Team

