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FINANCIAL SECTOR ASSESSMENT

MALAWI

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AFRICA REGION VICE PRESIDENCY
FINANCIAL AND PRIVATE SECTOR DEVELOPMENT VICE PRESIDENCY

BASED ON THE JOINT IMF-WORLD BANK FINANCIAL SECTOR ASSESSMENT PROGRAM

A joint World Bank-Fund team visited Malawi during two missions (July 10 – July 20 and November 28 – December 7, 2007)[1] in the context of the Financial Sector Assessment Program (FSAP). The purpose of the assessment was to help the Malawian authorities identify financial system strengths and weaknesses with a view to implementing an action plan to increase the system's contribution to economic development.

[1] The team comprised Messrs. Fuchs (Leader, World Bank), Mulder (Deputy, IMF); Agarwal, Beck, Demarco, Feijen, Maimbo (all World Bank), Oppers, Staines (IMF); Pickens (CGAP) Krysl, Stokes, Vollan (independent consultants), Pelealo (Deputy Governor, Bank of Botswana).Ingrid Chikazaza and Tim Gilbo (Consultant and Country manager, respectively) from the local WB office and Maitland MacFarlan and Thomas Baunsgaard (outgoing and incoming IMF resident representatives respectively) and Levi Sato (local IMF office) assisted the mission greatly.

OVERALL ASSESSMENT

1. **Macroeconomic performance has improved significantly over the past three years.** Inflation came down to 10.6 percent in the last quarter of 2006. The fiscal situation has been turned around from a significant deficit to a small surplus in 2006/7.The sharp reduction of liquid reserve requirements has contributed to a decline in interest rate spreads.

2. **Such macroeconomic improvements provide a backdrop for the deepening and broadening of the Malawi financial system, but many challenges remain.** The Malawi financial system suffers from a lack of critical mass, low productivity and high costs resulting in high spreads, limited outreach and product variety. To work on these challenges, the FSAP team recommends efforts that increase competition in the banking sector; strengthen the contractual, information and transactional infrastructure; redefine the role of the state; and continue to strength the legal and regulatory framework. Specifically, the team records and recommends the following:

- With about 1.5 billion USD in total assets, the Malawian financial system is small, even by regional comparison. Low productivity and high operating costs contribute to very high interest spreads. High operating costs underline the importance of innovative approaches to exploit alternative delivery channels, including the use of technology such as branchless banking. Labor market restrictions constrain institutions' ability to lower costs and impede the necessary reorientation towards deposit and lending business. The small size of the economy and the financial system also results in many ownership links, which pose a challenge for corporate governance and supervision.

- FX Trading Guidelines and collusion among the banks have resulted in a very high FX trading spread. This high spread boosted banks' profits significantly while reducing their incentives to expand private sector lending and imposing high costs on importers and exporters. The question whether to reduce banks' FX rents is part of a broader choice between maintaining a shallow, but stable, status-quo and encouraging more competition in the foreign exchange market.

- Facilitating new entry into the financial system could increase contestability and competition. With a judicious merger framework, it might result in some consolidation, which – if limited to small and medium sized banks – could result in lower costs and more competition.

- While the establishment of a Commercial Court is an important step towards reducing inefficiencies in the contractual framework, further steps in reducing delays and costs of property registration, security creation and contract enforcement will be critical. Creating the legal and regulatory framework for credit information sharing can support banks willing to go down-market and increase their lending to small enterprises. If Malswitch were to be sold to the banking sector, a cheaper, interoperable retail payment system could support a more cost-effective expansion of payment services.

- The role of the state usefully could shift from market substitution to market promotion through a supporting regulatory framework. An estimated 90 percent of population are currently unbanked, a large proportion of whom would be considered unbankable under commercial considerations. In their effort to expand the access, the authorities currently provide financial services directly through the Malawi Savings Bank (MSB) and several development finance institutions (DFIs). If instead, their efforts went into strengthening financial, legal and regulatory policies and infrastructure and judicious provision of second-tier lending activities, the private sector could take the lead in the retail delivery of financial services. A supportive regulatory framework, including risk-based Know Your Customer (KYC) rules, would encourage the private sector to adopt new technology in mobile banking to broaden the bankable and banked population. The regulatory framework would include allowing banks to outsource deposit collection, cash handling and account opening.

- The current supervision of the insurance and pension sector is ineffective. Passage of the new Banking Act and Banking Services Bill would enable the authorities to address many of the remaining issues regarding banking supervision, such as establishing clear responsibility of RBM for issuing and withdrawals of licenses. Other steps underway include the better integration of off- and on-site supervision and strengthened use of remedial powers.

I. MAKING FINANCE WORK FOR MALAWI

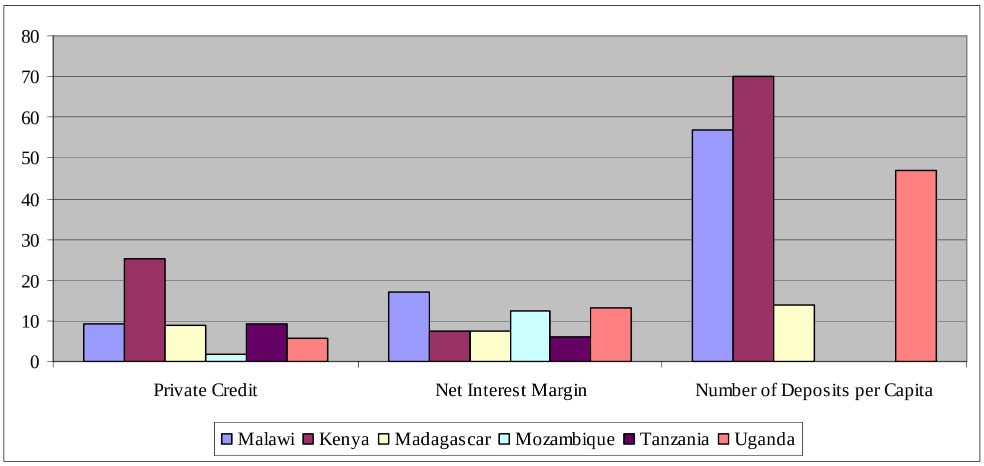
3. **International experience has shown the importance of a stable and efficient financial sector for economic growth and poverty reduction.** Recent cross-country evidence finds that financial sector deepening not only promotes growth; it specifically allows the poorest segment of the population to gain most from further financial sector development. Critically in the context of Malawi, financial sector deepening is associated with a lower incidence of undernourishment – a relationship that may work through higher agricultural productivity.

4. **Beyond financial stability and efficiency, Malawi would benefit from increasing access to a broader range of financial products and services within a more inclusive financial system.** Safe savings instruments and cost-effective micro-insurance products can help the poor smooth consumption over time and assist in insuring them against income shocks. Access to cheaper payment services not only reduces the cost associated with carrying cash and of receiving remittances, but also facilitates participation in the market economy. Finally, access to credit services – although not necessarily the primary financial service many poor need – can help improve investment and employment opportunities, and thereby support integration of a larger proportion of the population into the formal economy, with consequent positive repercussions for income.

5. **Headline indicators of the depth, efficiency and outreach of the financial system show room for improvement and allow tracking progress over time** (Figure 1). While financial sector development is a multi-faceted phenomenon, benchmark indicators allow

tracking progress of financial sector deepening and broadening. Following the Making Finance Work for Africa initiative, this report suggests measuring over time private credit to GDP (depth), interest rate margins (efficiency) and the number of deposit accounts (outreach) as key indicators of financial sector development.

Figure 1: Financial development headline indicators in regional comparison



Source: Financial Structure Database and Beck, Demirguc-Kunt and Martinez Peria (2007)

II. Performance of the Malawian Financial System

A. Structure of the Financial System in Malawi

6. **Malawi's financial system is small even by regional standards and bank-dominated but with a variety of institutions and markets.** The Malawian financial system consists of nine banks, two discount houses, one leasing company, eight insurance companies, four DFIs, a young, but growing microfinance industry and a nascent capital market. Two thirds of 1.5 billion USD in total assets are in the banking system, with the remainder in insurance companies and securities firms. Private pension funds, managed by life insurance companies, constitute a significant component, with 300 million USD in assets. The Malawi Stock Exchange currently has 13 listed companies (all domestic). Market capitalization was 600 million USD at the time of the assessment, equivalent to 27 percent of GDP, while trading in 2006 amounted to only 14.3 million USD or 0.7 percent of GDP, reflecting the small proportion of shares actually traded on the exchange. As in many other countries in the region, no corporate bonds have been issued to date.

7. **Only 10 percent of Malawi's population has access to formal financial services, reflecting the high incidence of poverty, high degree of informality and a high proportion of the population in rural areas.** With a GDP per capita of US$240, Malawi is one of the poorest countries in the world; 52 percent of the population (6.4 million people) lives below the poverty line and 22 percent (2.7 million people) still live in extreme poverty. This suggests that a high percent of the population is regarded as unbankable by commercial

bankers. Banks have an estimated 250,000 customers, with another 250,000 using the services of nonbank financial institutions, including micro-finance institutions. Only 150,000 active formal sector workers are covered by private pension funds; 125,000 active government employees and 30,000 beneficiaries are covered by the public pension scheme.

8. **Malawi's financial system offers a variety of conventional financial services, concentrated on the short-term end of the yield curve, but with an increasing focus on down-market products.** Over 83 percent of loans and 96 percent of deposits have a maturity of less than three months. While there are products with longer-term maturity, such as investment loans with up to 7 years maturity and mortgage loans of up to 10 to 15 years, availability is limited and rates are adjustable. A variety of government-owned institutions offer loan products for small-scale farmers and entrepreneurs, while several commercial institutions have started offering deposit and payment products to low-income and rural customers using smart cards and points of sale. Branches and ATMs are concentrated in urban areas, reflecting the deficient infrastructure in rural areas and the perceived lack of sufficient demand to justify the needed investment.

9. **Significant ownership linkages within the financial system and with non-financial corporations pose challenges for governance and related party transactions.** The largest bank is majority owned by Press Corporation, a holding company with shareholdings in many non-financial corporations. Press Corporation is in turn owned by Press Trust – a large trust run for the benefit of the country. NBS, a mid-sized bank, is 60 percent owned by the largest insurance company, NICO, which also has shareholding in non-financial corporations. Given the low income level and the small size of the economy, such ownership linkages are not surprising. However, they provide a supervisory challenge for regulating related party transactions and lending.

B. The Banking System

Structure and development of the banking system

10. **The favorable macroeconomic environment has resulted in increased private sector lending by banks.** The reduction in the government deficit has created space for the banking system to increase lending to the private sector. This is reflected in an increase in the loan-to-deposit ratio from 45 percent in 2002 to 61 percent in 2006, an increase in the share of private sector lending in total domestic credit from 38 percent in 2002 to 48 percent in 2006 and a corresponding decrease in T-Bill holdings by banks. The sharp reduction of liquid reserve requirements has contributed to a decline in interest rate spreads.

11. **The banking system is predominantly privately-owned, with a significant share of foreign-owned banks.** Except for the mid sized Malawi Savings Bank, which is still 100 percent owned by the government, all banks are privately owned. Five banks are foreign-owned, constituting 29 percent of the banking market, which is somewhat less than the average of 47 percent for Sub-Saharan Africa. Four banks are listed on the stock exchange, although only a small fraction of their equity trades. Two discount houses that facilitate the secondary market in T-bills and constitute 6 percent of total financial system assets

complement the banking system. Three new entrants recently have either requested or received bank licenses, of which one is a discount house and one is a foreign bank that has applied to take-over a small poorly performing local bank.

12. **The banking system is also highly concentrated, as is typical in countries of comparable size and income levels.** The largest five banks account for 89 percent of total assets, higher than the average for Sub-Saharan Africa of 77 percent, but similar to neighboring Mozambique which also has a small system. However, unlike other comparable countries, the three largest banks have roughly equal market shares and account for 76 percent of the market. With 800 million USD in total assets, the Malawian banking system is small in absolute size and even the largest banks in the system are small by regional comparison.

Efficiency and profitability of the banking system

13. **The Malawian banking system shows a very high degree of profitability, driven by rents in the foreign exchange market.** Reaching 6.4 percent in 2006, Malawi’s return on average assets (ROAA) is among the highest in the world. An analysis of the income and cost structures across different business lines shows limited profit margins in the deposit and lending business, but extremely high profit margins in the non-lending, especially foreign exchange business. The contribution of foreign exchange revenue to the overall bottom-line of banks has increased over the past years, with revenue from government securities decreasing and other revenue sources staying constant. However, recent pressures on foreign exchange profits seem to be moving banks into the lending business in search of new revenue sources.

14. **Foreign exchange trading takes place at high spreads.** Members of the dealers’ association have agreed in principle to deal at a fixed margin and this arrangement is supported by the by FX Trading Guidelines (article 4.3) which prescribes that, when buying, banks do not cross (i.e. exceed) the mid-rate. As a result of this arrangement, banks’ foreign exchange activities are very profitable and correspondingly, wide spreads impose a cost on importers and exporters, resulting in higher prices for consumers and potentially lower exports. Because foreign currency turnover is so high compared to the depth of the banking system, the large trading band contributes disproportionately to banks’ profits.

15. **High interest rate spreads reflect high overhead costs, mainly due to lack of scale, high labor costs, inefficiencies, deficient infrastructure, and lack of competition.** Interest rate spreads and overhead costs, respectively 16.3 and 10.7 percent, are very high even by regional standards. International comparisons show that the small size of the Malawian financial system, a history of high and volatile inflation and legal system deficiencies can explain these high spreads and overhead costs. Even after accounting for these factors, however, there is a “Malawi-specific” and unexplained component in overhead costs, which might point to the lack of competitive pressures on banks to reduce these costs. The productivity of employees is also low, while wage compensation is very high.

16. **While changes in the revenue structure might force banks to become more productive, severance pay requirements would make an adjustment costly.** As revenues from T-Bills and foreign exchange markets decrease, pressures to become more productive have risen. However, efforts to restructure banks and their payroll to become more efficient are severely hampered by economy-wide very high severance payment obligations. Efforts to limit wage increases are hampered by a lack of supply of trained staff. Increased specialized banking training, more work permits for foreign bank professionals and a review of the labor legislation regarding severance pay might improve the situation.

17. **Evidence on the degree of competition in the deposit and lending market is inconclusive.** In spite of high concentration, two statistics point to a relatively competitive lending and deposit market. The relatively low profit margin in deposit and lending business as well as statistical analysis (Panzar-Rose) that measures the reaction of output prices to input prices suggests that financial intermediation in Malawi is not less competitive than financial intermediation in many comparable Sub-Saharan African countries. This might reflect the focus of Malawian banks on the high-end of the lending market, traditionally more competitive than lending to small enterprises. On the other hand, high overhead costs, partly related to historically high inflation, suggest the absence of sufficient competitive pressures.

18. **Performance across banks varies, with the government-owned MSB showing significantly poorer performance than its privately-owned peers.** While performance between domestic and foreign banks varies little, MSB shows a significantly lower performance than its competitors, most likely reflecting its government-directed mandate and a long history of non-commercial management. With its network of 5 branches and 35 agencies and with a minimum account opening requirement of only MWK 500, the MSB is able to attract deposits at the lower end of the market, although not as efficiently as it could. The quality of its loan portfolio is poor and highly concentrated, exposing it to significant risk. The Malawian experience is similar to international experience where postal banks can provide valuable deposit and payment services based on their network to an oft-neglected segment of the population, but often do poorly in the lending business.

19. **Consolidation in the banking sector will not necessarily lead to less competition.** A banking system with few, but strong, financial institutions can reap economies of scale while remaining competitive. Ownership structure, contestability and the contractual and information frameworks play an important role. In the case of Malawi, the government would divest its stake in MSB to a strategic commercial owner. At the same time, the government would establish a framework to enable market-based consolidation between banks as well as with bank-like institutions such as discount houses. New entrants would bring more contestability possibly accompanied by further consolidation to move the banking system towards more competition.

Outreach of the financial system

20. **Malawi shows very low levels of outreach and high barriers to accessing bank services.** After accounting for size and income level, Malawi compares with Kenya, Uganda and Madagascar in deposit and loan account penetration as well as the average deposit and

loan size relative to income (a negative indicator of outreach). On the other hand, Malawi's banks charge higher fees than banks in comparator countries for maintaining checking and savings accounts.

21. **For most of the financial institutions in the country, rural households and small and medium scale enterprises do not present a viable business proposition.** Only five percent of Malawi's economically active population uses formal banking services, with another five percent accessing services through microfinance institutions. Estimates suggest that the next 25 percent of the population (in terms of income) is potentially bankable but currently unbanked. However, it is plausible to assume that banks could still target this market with basic payments services for urban-rural remittances, and government salaries and financial subsidy programs using mobile technology. The remaining 65 percent live below the poverty line mostly in rural areas, and can be considered unbankable. While several commercial banks have been trying to go down-market, their attempts have not yet penetrated these underserved populations.

22. **The nonbank microfinance industry remains nascent, with most institutions constrained by limited financial resources, poor physical infrastructure and the lack of financial literacy.** The sector also is constrained in its growth not only by lack of financial resources. Large government-funded microfinance programs dominate the sector with the rest largely supported by development partner programs. The total clientele of the nonbank microfinance segment is about the same as that of the commercial banking system.

23. **While several private financial institutions have started offering branchless banking products, the hitherto modest experience with such innovation highlights the need to attain a critical scale to be sustainable.** Several financial institutions have pioneered branchless delivery mechanisms through the issue of smart or debit cards and POS or mobile branches, with the result that over 100,000 low-income Malawians are using an electronic payment and saving instrument – even if only infrequently. Many of these clients were previously unbanked. Most financial institutions, however, are still on the sidelines. Mobile phone companies have not followed the example of companies in other Sub-Saharan African countries to offer mobile payment and banking services.

C. Pensions and Insurance

24. **Malawi's pension and life insurance sector is relatively deep with assets amounting to more than 10 percent of GDP.** About 150,000 employees in the formal Malawian economy are covered by 450 private pension funds, funded by contributions of both employers and employees, 90 percent of which are managed by two insurance companies. The government runs a pay-as-you-go pension scheme for its employees.

25. **The public and private pensions systems face important challenges including excessive generosity of the public pension system, no formal price indexation and limited supervision.** The public PAYG scheme's generous parameters include substantial early retirement benefits after 20 years of service. The cost of the system is not yet apparent due to the relative youth of the labor force. The FSAP team recommends a parametric reform that starts with a review of benefits. The de facto wage indexation should be replaced with

formal inflation indexation, offset by a lower accrual rate, to reduce the cost but still benefit pensioners by increasing the certainty of their income.

26. **Malawi's insurance sector is small, highly concentrated, inefficient and hampered by limited product and investment diversification**. Gross insurance premiums constituted 1.1 percent of GDP in 2006, in line with the income level of Malawi. Given the small market size (USD 20 million in premium volume), the high degree of concentration is not surprising; two of the eight existing insurance companies account for 80 percent of the market. High management expenses account for the very high underwriting margins of 50 percent of total underwriting volume.

27. **It will be a challenge to expand and mainstream initial attempts at micro-insurance products, but these would help the rural population cope with weather-related risk.** Ninety percent of the population lives in rural areas and is involved in small-holder, rain-fed agriculture making them highly vulnerable to localized rainfall patterns. Initial attempts of rolling out a indexed weather insurance product to rural areas have had mixed success with limited take-up by potential clients, reflecting low incomes, lack of trust and lack of financial literacy. As of now, only a few thousand farmers benefit from such products. Expanding such products to a wider share of population would have to be cost-effective.

D. Development Finance Institutions

28. **An array of government-sponsored DFIs is trying to address market failures with varying degrees of success.** For many, the governance and administrative structure does not provide an incentive-compatible framework to expand outreach in a cost-effective and sustainable manner and contains significant risk of political interference, and therefore result in relatively limited pay-out of loans. These include:

- The Malawi Rural Finance Corporation, (MRFC) with a loan portfolio of about 200,000 clients per year focuses on supporting agricultural production, SMEs, micro-credits and helping individuals with disabilities. While its performance has been significantly above that of comparable institutions in the region, collection on loans has been deteriorating, falling from: 90 percent in 2004 to 74 percent in 2006.
- The Malawi Rural Development Fund (MARDEF), introduced in January 2005, aims at increasing access to finance for low-income groups in rural communities. The fund is essentially a subsidized loan facility with mandated lending targets, administered by MSB for clients screened by MRFC from all regions of the country.
- The Small Enterprise Development Organization of Malawi (SEDOM) has been focusing on a crop marketing loan scheme and a group lending facility, with – at its peak – up to 15,000 customers. SEDOM is loss making with a high overlap in mission with MRFC, and;
- The Development of Malawi Enterprises Trust (DEMAT) focuses on business advisory services but also provides limited loan services to small enterprises. As of September 2007, it had a small loan portfolio of 990 accounts.

29. **While the many government-led programs in the rural areas have been well intentioned, the unintended consequences on the level of interest of the private sector in investing in the financial sector as well as the credit culture of beneficiaries have often been severe**. The programs are failing to reach their intended targets, and when they do, it is at the expense of high subsidy costs. These operations face major incentive and governance problems leading to recurrent problems such as poor loan origination and even poorer loan collection (thereby fostering a non-payment culture), wasteful administrative expenditures, overstaffing, and capture by powerful interest groups. Government lending programs tend to take business from private providers and contaminate the lending environment. Private financial service providers would prefer the government to refrain from interventions such as subsidies and interest rate controls that distort the operation of microfinance markets.

III. STRENGTHENING THE ENABLING ENVIRONMENT FOR PRIVATE PROVISION OF FINANCIAL SERVICES

30. **The next steps in improving the efficiency and outreach of Malawi's financial system will require a further redefinition of the role of government – moving away from directly providing financial services to facilitating private providers in overcoming market failures.** The Malawian authorities have undertaken great efforts to create a privately-owned and managed banking sector, with significant benefits in terms of stability and competition. Technology offers opportunities to offer financial services to more of the bankable population. In order to benefit from technology, a regulatory framework conducive to stable and efficient financial intermediation, an effective contractual and information framework, and a cost-effective payment system will have to be in place. This agenda points towards a significant role of government. However, rather than directly providing financial services, the existing DFIs will need to re-position themselves to help the private sector towards expanding the access frontier.

A. Redefining the Role of Government

31. **In light of the authorities' well-intended interest in serving vulnerable groups of the population, the FSAP team advises that their primary engagement in the financial sector center on policy formulation and wholesale lending activities**. That would have the further benefit of allowing the private sector to grow into the role of providing the retail delivery of financial services. As a first step, the FSAP team recommends a review of current government institutions (MRFC, MSB) and programs (MARDEF, SEDOM, etc). The review should propose any restructuring that would be needed in order to reach economies of scale and to encourage private sector-led efforts to increase access to financial services. The review should also establish an ownership framework policy that would define the government's overall ownership objectives, its role in governance and a plan for implementation. The ownership policy would be made public, and to be effective, would need to become accepted policy not subject to frequent change.

32. **The review should take a long-term strategic view so that unforeseen needs could be addressed efficiently**. One suggestion would be to form a single agency/institution to prepare and draft eligibility criteria, and then tender the actual retail implementation of

specific programs to interested institutions. By leveling the retail financial sector landscape in this manner, the government would increase pricing and product transparency in the microfinance sector; and increase the involvement of the private sector in the delivery of commercially sustainable programs in the country. This approach entails (i) clearly identifying and distinguishing subsidized and non-subsidized programs, and (ii) privatizing government retail programs that have some franchise value. Based on experience in other countries, the team suggests that existing government institutions should only be merged prior to privatization where there are clear benefits related, perhaps, to economies of scale and institutional focus.

33. **The authorities will want to consider whether expected future proposals would fit within the new policy framework.** For example, are the recently proposed Malawi Development Fund (MDF), Financial Inclusion in Malawi Project (FIMA), National Guarantee Scheme and others that will be proposed in future in line with an ownership policy that strives to divest government of retail activities.

B. Regulation and Supervision for a Stable and Competitive Financial System

34. **Banking supervision in Malawi largely complies with a majority of the Basel Core Principles (BCP), but areas of non-compliance remain.** Of the 25 core principles, Malawi fully or largely complies with 17, and is materially or fully non-compliant with 7 (see below); one principle, the KYC (know-your-customer) principle was not yet assessed. Non-compliance is centered on areas of risk assessment and management, transparency, supervisory approach and techniques, and enforcement.

35. **Financial sector supervision benefits from the skill base and independence of RBM, but the institution's supervisory purview faces restrictions and its accountability to the public could be enhanced** (BCP 1.2)**.** RBM's authority and accountability is undermined by the fact that the Minister of Finance is the licensing authority for banks. Revocation of banking licenses requires prior approval of the Minister. Timely issuance of an annual report and publication of its enforcement actions would improve the RBM's transparency and public accountability. Further, the RBM has a wide range of remedial powers, but their use could be enhanced (BCP 23).

36. **Recent on-site visits and the issuance of risk management guidelines have enhanced the supervisory process, but there is scope for further strengthening** (BCP 13, 16, 19)**.** The RBM established a well-structured program of regular on-site examinations that enhances its reputation and credibility as a supervisor. The program should be expanded in 2008 to include on-site examinations of the discount houses. Off-site supervision can feed into the on-site supervision process better by using standard data, risk indicators and stress tests generated off-site. Communication with banks' can be further enhanced through more frequent contacts.

37. **Rudimentary capital markets restrict market discipline for domestically owned banks, putting the burden of a sound system squarely on the supervisory authorities.** Only four banks have shares listed in the Malawi Stock Exchange and, in each case, the free float is small. None of the banks has issued any debt in the market. As a result, banks do not

use the securities market to raise funds or as a source of market discipline. However, two of the three large banks are in hands of foreign owned banks, which are subject to market discipline through their owners and external capital markets.

38. **Regulation and supervision of the insurance and pension sectors is in dire need of strengthening and a regulatory framework should be established for the private pension sector.** The regulatory framework of the insurance sector is outdated (1957). It does not reflect the current structure, operation and needs of the sector. An amendment to the Insurance Bill based on input by, and with the support of, stakeholders has been submitted to Parliament to remedy some deficiencies. Life insurance companies and private pension funds are currently not regulated and supervised by RBM. The Income Tax Commissioner of the Malawi Revenue Authority exerts the only formal supervision over pension plans, but does not have authority to supervise the companies administering the plans. Further, it lacks operational and enforcement capacity.

39. **While Malawi has a well articulated, cabinet approved National Microfinance Policy and Action plan, this has not yet resulted in the necessary legislative and regulatory framework for the industry.** The plan, established in 2002, provides guiding principles for supporting the development of the sector. While a Microfinance Bill and a Payment System Bill have been drafted that would provide the legal and regulatory framework to support the extension of the sector, political stalemate (not relating to these particular bills) has delayed enacting these two bills.

40. **A clear regulatory framework for the use of nonbank retail agents would allow the expansion of branchless banking and thus facilitate expansion of financial service provision into the rural area.** Outsourcing of cash handling and account opening is restricted to nonbanks. This impedes the banking system from expanding outreach into rural areas. Therefore the FSAP team recommended the amendment of the new Banking Act, given that it is currently under review, to explicitly permit outsourcing to agents for cash-handling, including the limited and temporary collection of deposits, and account opening. Similarly, implementing regulations for the new Payment System Bill should allow agents to receive and deliver payments. Risk-based Know-Your-Costumer standards should allow for monitoring of bank customers by third parties or agents, without overburdening and prejudicing small merchants.

41. **Amending the Banking Act and/or the supporting regulations to allow basic financial service provision by nonbanks can further help broaden the financial system.** In a number of other developing countries, including Kenya, non-financial corporations and most prominently mobile network operators, have started providing payment and savings services in an innovative and often more cost-effective way than commercial banks.[2] While none of the incumbent mobile network providers in Malawi has shown any interest in moving into financial service provision, amending the current legal and regulatory

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[2] The closest example is Kenya where Safaricom's M-Pesa has attracted 500,000 customers in only six months.

framework will help accelerate their investment in the sector should market conditions for such investments improve.

42. **Subjecting all deposit-taking institutions to the liquid reserve requirements (LRR) will create a level playing field.** RBM plans to subject MSB to the LRR starting next year, which will help create a level playing field in the deposit market.

43. **A clear policy on mergers and acquisitions (M&A), including documented guidelines and criteria for approval of transactions can help foster a market-based consolidation process.** Defining significant shareholder, investment or controlling interest is critical for the determination of applications for banking mergers and acquisitions. Formulating a clear policy on M&A is critical in the context of possible future consolidation within the banking system.

C. The Payment System

44. **Malawi has made good progress with the modernization of the payment system, but it has not led to the establishment of an interoperable system.** When smartcard payments were introduced, a "proprietary" network system was chosen for transmission of financial messages between the users and the RTGS system in the anticipation that commercial banks would eventually subscribe to the chosen technology. This has not happened. Instead, some of the banks, notably the larger ones, have invested in alternate platforms. Technological and commercial advances have resulted in a broader and cheaper variety of service offerings. Malswitch, a payment service provider owned 99 percent by RBM (and 1 percent by government), operates the RTGS system, an Electronic Check Clearing House (ECCH) on behalf of the banks, and a platform a smartcard payment system.

45. **To maximize efficiency gains, the authorities should consider separating the ownership and management of the wholesale RTGS system from the retail payments clearing function.** The operation of the wholesale RTGS system is typically considered to be a function of the central bank. Therefore, the authorities are encouraged to shift the wholesale RTGS system back to RBM. The retail payments clearing function, on the other hand, could be owned and managed jointly by the banks. As a public good, it would have to live up to certain public policy considerations, such as allowing access to the retail payments clearing infrastructure to all banks operating in Malawi on terms supporting a level playing field.

46. **Were the retail payments system to be owned and managed by the banks, this would result in re-examination of the decision to develop a proprietary communication system for the retail payments clearing.** While this would entail writing off some of the government's previous years' investment in Malswitch, in the long term another solution is likely to be more interoperable and affordable than the current Net 1 platform. However, the government can still play an important catalytic role in encouraging this process, as it is not a foregone conclusion that competing banks will easily or quickly agree on an interoperable system. Following a cost benefit review, the government may also want to consider may consider whether to maintain the option of using smartcards, especially for hard to reach areas without GSM coverage where a magnetic stripe, online solution would not work. In

parallel, the government may well wish to explore how best to establish a more cost-effective means for making social payments.

D. Legal and Information Frameworks

47. **While the legal framework in Malawi fares relatively well to international comparison, scope for improvement remains.** Among comparable countries of the region, Malawi has the highest creditor rights index (8 out of 10), a measure of the degree to which collateral and bankruptcy laws facilitate lending. Enforcement, however, is time consuming and costly; the cost is exacerbated by the high labor costs of the banks. As in many countries of the regions, the court process is slow and inefficient – with 432 days to enforce a contract – mostly due to a culture in which defaulting borrowers seeking injunctions that are upheld by the courts. The enforcement of collateral is a lengthy process and the rarely used insolvency procedures are outdated. Registering property and security creation is expensive and time-consuming. Specifically, creating a charge over or transferring land is beset with procedural hurdles and delay. Legal fees for mortgage / lease / transfer of land transactions, scaled at 1 percent of the transaction value, are excessive. While the recent establishment of the Commercial Court is promising, the contractual framework will benefit from further institutional strengthening. Both land and companies' registries suffer from resource and infrastructural constraints.

48. **A legal and regulatory framework for credit information sharing can foster competitiveness and further broadening the reach of the banking system.** In the absence of an enabling legal framework, Malawi has only one informal credit bureau that is not being used. In the absence of a specific legal framework, creditors are unwilling to deal with this credit bureau. The recently proposed Credit Referencing Bureau Bill provides for the establishment of a credit bureau and the rights and responsibilities of the different parties. However, it only permits the collection of negative information. International experience suggests the major benefit of credit information sharing as regards access and competition comes from sharing positive information as well. Rather than wait while deficiencies in the proposed Bill are rectified and the law is enacted, the FSAP team suggests that the RBM issue directives to facilitate the functioning of credit bureaus.

49. **Malawi's legal framework works well to protect shareholder rights, but the regime governing related party transactions is relatively under-developed.** The Report on the Observance of Standards and Codes (ROSC) on corporate governance finds that basic shareholder rights are in place in Malawi. Shareholders can demand a variety of information directly from the company and have a clear right to participate in annual general meetings of shareholders. Directors are elected and removed through shareholder resolutions. Shares of public limited companies are freely transferable. Changes to the company articles, increasing authorized capital, and sales of major corporate assets all require shareholder approval. Major corporate transactions require shareholder approval. As in the case of banks, there are no rules for takeovers and merger and acquisitions. However, neither the Company Law nor the Code of Corporate Governance provides any requirements related to the review and approval of related party transactions, and there are no requirements for the boards of listed companies to manage conflicts of interests or oversee related party transactions. As the Malawian stock

exchange and the formal economy in general grow, it will be necessary to provide such a framework.

50. **While Malawi has adopted international accounting and auditing standards, lack of regulatory capacity and weaknesses in professional education and training have resulted in limited compliance.** The Report on the Observance of Standard and Codes (ROSC) of accounting and auditing points to limited capacity at the Registrar of Companies to monitor and enforce requirements of public companies to file financial statements. Although the Society of Accountants in Malawi (SOCAM) – a self-regulated membership institution – directed all companies to comply with international accounting and auditing standards, they seem too complex for most local enterprises. Further there is no monitoring and enforcement of compliance with these standards by any of the regulatory entities involved. The ROSC recommends full compliance with international standards only by public interest entities and the development of reporting standards for SMEs appropriate to Malawian conditions. Capacity strengthening of the regulatory entities, SOCAM and training institutions can further improve the compliance with accounting and auditing standards.

51. **The government of Malawi has demonstrated a high level of commitment to establishing a strong AML/CFT framework.** This commitment is reflected by enacting the Money Laundering Proceeds of Serious Crime and Terrorist Financing Act in August 2006; establishing a functional financial intelligence unit (FIU); and beginning an implementation program. Despite these efforts, there is concern with respect to the cash transaction reporting system, as a result of a low reporting threshold, which has generated a large volume of reports and threatens to undermine the FIU's core function of receiving, analyzing and disseminating suspicious transaction reports. Furthermore, banks are the only financial institutions that have made any efforts to comply with the requirements of the Act. In the short term, the priority is to strengthen the capacity of the National AML/CFT Committee to enable its decisions to have a binding effect on all parties/stakeholders as well as the ability to formulate AML/CFT policy and conducting an awareness raising campaign in the nonbanking private sector and the general public.

MAIN RECOMMENDATIONS

Financial sector legislation	Timing
• Major push for passage of outstanding financial sector bills	Immediate/ongoing
Banking system	
• Reduce labor market constraints	Medium term
• Divest MSB to a strategic partner	Medium term
• In order to allow for rational consolidation of the banking system, develop a clear policy on mergers and acquisitions	Immediate
Outreach	
• Conduct comprehensive market survey of demand for financial services	Ongoing
• Move government out of active provision of retail financial services	Ongoing
• Create regulatory framework for outsourcing to agents of cash handling, account opening, and risk-based KYC	Immediate
• Move the wholesale RTGS system to the RBM	immediate
• Write down and sell Malswitch to the banking sector to allow more space for a cheaper, interoperable system	Medium term
Pension sector	
• Create supervisory framework for the private pension sector	Medium term
• Reassess the affordability of the public pension scheme and, review retirement age, accrual rate, and indexation mechanism	Medium term
Bank regulation and supervision	
• In order to enhance accountability of the supervisor and clarity of the market, leave issuing and withdrawal of licenses exclusively to the RBM	Medium term
• Strengthen the way off-site supervision supports on-site supervision including through stress testing	Immediate/ongoing
Contractual and information frameworks	
• Create a framework for the functioning of credit reference bureaus	Immediate
• Facilitate sale of foreclosed property	Medium term
• Delegate the power of Minister of Lands / Chief Commissioner of Lands to approve transfer or mortgage property	Immediate
Monetary operations and instruments	
• Introduce an interest rate corridor by creating a weekly deposit facility and ensuring that the standing facility is always open at a reasonable rate and penalties so that banks are able to manage their excess reserves	Medium term
• Phase out RBM bills and instead use T-bills as a monetary policy instrument or reduce their maturity	Medium term
• Mop up large scale excess reserves to tighten the reign over monetary policy, reduce LRR penalty rates and stick to clear auction rules.	Immediate
Foreign exchange market	
• Implement transparent exchange regime	Medium term
• Enhance competition by lifting restrictions in foreign exchange guidelines that currently create a minimum spread and lifting exchange surrender requirements	Immediate
• Reduce vulnerabilities by imposing stricter limits short-term non-resident positions in the T-bill market	Medium term
• Maintain the foreign exchange bureaus, but create a clearer reporting framework for their compliance with foreign exchange regulations	Medium term
RBM	
• Review the cost of the RBM, including the coin and bank note structure, staffing, and premises	Immediate/ongoing