



Strengthening Financial Sectors

RWANDA FINANCIAL SECTOR DEVELOPMENT PROGRAM

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INTRODUCTION

Rwanda places a high priority on financial sector development and sees it as an integral element in its long-term plan to transform itself into a middle-income country and an economic trade and communications hub.

Therefore, the government responded in a serious decisive results-oriented fashion when provided with a 2005 FSAP report prepared jointly by the World Bank and IMF which diagnosed a number of weaknesses in the financial sector and made recommendations for reforms to address weaknesses. The Financial Sector Development Program (FSDP) presented in this document constitutes that response.

A FIRST Initiative-funded team was recruited and prepared this FSDP under the guidance of the central bank (BNR) and working closely with a national steering committee composed of key stakeholders in each of the areas addressed by the FSDP.

A Cabinet paper was prepared, based on the consultants' work, which presented those elements of the FSDP which represented policy issues together with a detailed matrix of actions needed to implement them. The Cabinet approved the paper and comprehensive policy program in November 2006 and, in principle, endorsed the detailed action matrix which supports it.

The detailed FSDP action matrix (presented in Annex 1) focuses on four major areas, i.e., i) banking, microfinance and access to credit; ii) contractual savings (pensions and insurance); iii) capital markets; and iv) payments systems. Annex 2 presents these same actions by responsible entity. Annex 3 provides a list of priority actions that require technical assistance to implement successfully. Annex 4 presents the full matrix grouped by phases.

That matrix shows a large number of individual actions most of which need to be implemented over the next 24 months. Many of the actions are inter-related and depend to a significant extent on the implementation of other actions. Also, many of them require technical assistance and/or donor financing to implement. Government is seeking additional donor financing to assist in implementing the FSDP.

The Ministry of Finance (MINICOFIN) is establishing a Financial Sector project management unit within its Macroeconomic Department and is seeking to recruit a manager for that purpose as well as an advisor to assist the FSDP National Steering Committee which will continue to oversee implementation of the FSDP.

There is probably no better way to provide an executive summary of the FSDP than to present the Cabinet Paper, itself, as approved by the Cabinet since this does the best job of succinctly explaining the Government's official financial sector development policies,

reasons for those policies, and many of the major actions that have been approved for implementation. The approved cabinet FSDP paper is as follows:

EXECUTIVE SUMMARY: (CABINET PAPER-reformatted)

FINANCIAL SECTOR DEVELOPMENT PROGRAM

AN OVERALL POLICY FRAMEWORK FOR DEVELOPING A FINANCIAL SECTOR THAT EFFECTIVELY SUPPORTS OUR ECONOMIC GROWTH GOAL

Introduction

Rwanda's long-term development plan, as articulated in Vision 2020, seeks to transform Rwanda into a middle-income country and an economic trade and communications hub by the year 2020. An effectively functioning financial sector is a fundamentally important and essential element for achieving this objective. Rwanda seeks to develop a financial sector that is effective, in particular, by:

1. Expanding access to credit and financial services;
2. Enhancing savings mobilization, especially long term savings; and
3. Mobilizing long-term capital for investment.

The World Bank and IMF completed a Financial Sector Assessment study (FSAP) in 2005 that, while recognizing that significant progress had been made, concluded that Rwanda's financial sector was still relatively shallow, undiversified, dominated by an oligopolistic banking sector, and characterized by relatively high lending rates, extremely low insurance penetration, a scarcity of long term debt, home mortgage financing and equity capital, a virtual absence of regulation and supervision of pensions and insurance, and an inadequately functioning payments system. The study went on to recommend that the government establish a road map and identify needs for changes in policy, capacity building and technical assistance to implement these changes.

Government, within the context of, and looking beyond the FSAP, launched the FSDP to come up with a strategy to develop a robust financial sector that, as a key component of the EDPRS, is capable of financing sound economic growth. A National Steering Committee was put in place to drive the process and BNR was charged with the responsibility to provide overall direction. The National Steering Committee, with

guidance from BNR, established 4 supporting subcommittees, consisting of key stakeholders, in the areas of:

- (i) Banking and access to credit;
- (ii) Long term finance and capital markets;
- (iii) Contractual savings regulation (pensions and insurance); and
- (iv) Payments systems.

BNR then assembled a team of external consultants to work in coordination with these committees to develop a policy framework and detailed action program for addressing weaknesses in these four main financial sector arenas. The main policy elements in this program were presented and discussed in a workshop comprising of key stakeholders in order to build consensus on the key reform proposals.

As a next step, this paper seeks Cabinet approval on the broad financial sector policy framework whose objectives are to strengthen the sector and enable it to expand access to financial services and mobilize more long-term savings and investment.

Banking and Access to Credit Policies

Issue: Access to banking services outside of Kigali and the major towns is still very limited as they are only being served by the network of UBPR and a few other micro finance institutions that offer very limited financial services. There are only 29,000 commercial bank borrowers and only 123,000 bank depositors but they account for roughly 75% of Rwanda's deposits and loans. In terms of nation-wide outreach, commercial banks operate only 38 (7%) of the branches. UBPR, on the other hand, has 145 branches, 83,000 borrowers and 499,000 depositors. Three banks still hold a large 66% market share and inadequate competition within the banking system has led to high interest rate spreads (8.6% in 2005), a modest 16% per annum growth in deposits over the past 5 years, and lending primarily to a core group of about 50 relatively large customers concentrated in Kigali and a few sectors.

If UBPR were a fully-fledged bank, it would be the third largest bank financially (about 18% market share of deposits), would operate almost 80% of bank branches, and would serve 80% of the bank depositors and 74% of the borrowers. If it were able to offer most of the services that banks provide to enhance its ability to provide retail and international payments services, it would dramatically increase access to banking services and increase competition for medium and small clients. Moreover, this extremely important institution would be better regulated and supervised if it were treated more like a commercial bank.

Policy Recommendation: In order to provide more competition, broader access to financial services, and sounder regulation of this key institution, it is recommended that UBPR be treated as a de facto commercial bank to enable the umbrella institution to

operate largely as a commercial bank, while fully respecting the cooperative governance principles on which it is based, and enable up to 40 of its larger, sounder cooperative unit members with Globus computer systems to provide bank-like payments services (checking, electronic and international transfers) to its members. These units would also be subject to reserve requirements and all commercial bank regulations except those that directly conflict with cooperative principles and maximum loan size (which initially should be not more than 5% of net worth compared to the 25% of net worth requirement for banks). While UBPR will be able to offer their clients most of the services that commercial banks can offer, their much lower maximum loan size requirement will ensure that they will still lend to a large number of clients and provide a broader range of banking services that their clients would otherwise seek from commercial banks. Banks' inability to provide long term funding is due to the short-term nature of deposits.

Issue: Microfinance institutions (MFIs) also play an important role in increasing access to credit as they have mobilized Rwf 23 million (9% of all financial system deposits) and service 38% of all depositors and 63% of all borrowers. However, a number of MFIs are financially weak, lack adequate management and are, by necessity, not as well supervised as banks.

Policy Recommendation: MFIs are a vitally important part of the financial system and amending and enacting the draft Microfinance Law as well as finalizing the draft microfinance policy is a priority. As a matter of policy, it is recommended that a Micro Finance umbrella organization be established and given strong support by Government and donors as a body to give guidance to the industry. Government support in training of MFIs and their clients as well as capacity building should be enhanced in order to strengthen and professionalize the industry. Increased capital requirements for micro finance institutions especially deposit taking ones should also be implemented. Licensing requirements, regulation and internal controls should be strengthened. Subject to results of a feasibility study, a mandatory stabilization fund should be established for licensed MFIs.

Issue: While most of the banks are in compliance with the existing capital adequacy requirement, this level is still low compared to a typical size of an investment credit requirement.

Policy recommendation: Minimum capital requirement for banks should be increased.

Issue: While commercial banks have most of the money available for lending in Rwanda, only about 10% of their lending is for housing, virtually no mortgage lending is for more than 7 years, there is little long term lending other than for housing and, if BRD is excluded, only 1.5% of bank lending is for agriculture.

BHR has been envisioned as the primary vehicle for financing new homes in the country but it cannot be a major lender because of its small size and its present commercial banking structure, which is inappropriate for this purpose. In the more than 2 ½ years the housing bank has been operating since it was recapitalized, it has supplied only Rwf 800

million for 58 mortgages, if its special subsidized program for civil servants is excluded. During the same time, commercial banks have lent Rwf 22 billion for 985 mortgages. In other words, without meaningful incentives since BHR has been in operation, other commercial banks have made 94% of the new mortgages by number and 96% by value and they have 98% of the deposits.

BHR, as a commercial bank, does not have an appropriate structure for its present strategy of lending primarily for housing. Virtually 100% of its lending is long term and to one subsector (housing), i.e., it is unable to diversify risk. 24% of its deposits are payable on demand (current accounts) and it anticipates to grow this to an even higher percentage of its future inflow of new funds, which is an inappropriate way to fund long-term mortgages.

Policy Recommendation: It is recommended that BHR ceases to collect demand deposits and limit its own mortgage lending to depositors with specialized home financing savings accounts. Commercial banks should also develop mortgage saving accounts to mitigate the inherent problem of a mismatch between long-term mortgage loans and short-term deposits.

BHR should also:

- i) Phase out its direct participation in housing development once its present 12 hectare plot has been developed as it will not have adequate funding to do more development beyond that;
- ii) Sponsor a training program for commercial bank and insurance company residential underwriters;
- iii) Implement a system to monitor and make data available on real estate market values; and
- iv) Catalyze the organization of a real estate valuation association and its support functions. The bank will need substantial technical assistance to enable the staff to perform these functions.

Issue: BRD is a relatively successful development bank. It is a primary source of long term lending for the economy, as 65% of its lending is long term, and it also provides 55% of all bank lending for agriculture. However, it faces a major challenge in finding adequate long-term resources for onlending and because of increasing risk in its lending portfolio as the percentage of lending to agriculture increases.

Policy Recommendation: It is recommended that BRD expand its developmental lending function (term lending and agriculture) through aggressively increasing its funding sources including:

- (i) Attracting new equity shareholders, on condition that they have the same development objectives with government in order to maintain BRD's mission. Government should aim to gradually reducing its shareholding to less than

- 40%, to increase access to funding sources (like IFC, AfDB private arm) that will not lend to government controlled institutions;
- (ii) Designing loan-backed bonds as vehicles for turning successful existing loans into new lendable funds (see capital markets section);
 - (iii) Increasing coordination with commercial banks whereby commercial banks provide co-financing (for the shorter maturities) and loan administration;
 - (iv) Using stronger risk management practices, including prudent sectoral concentration limits; and
 - (v) Continuing to raise substantial debt capital from sources such as AfDB, European Investment Bank, Development Bank of South Africa and East African Development Bank for on-lending.

Long-Term Finance and Capital Markets

Rwanda seeks to build a capital market for raising long term debt and equity, both of which are essential to its long-term development strategy. Long-term investment potential, as well as ability to mobilize long-term savings, will be extremely limited so long as there are virtually no feasible ways of raising long-term capital in the domestic market place. The availability of home mortgage finance, municipal finance and long-term private sector project financing of plant and equipment will continue to be severely constrained so long as there is neither a capital market nor a mechanism for allowing banks to turn long-term loans into liquid funds. However, there is good news in that Rwanda's relatively stable low inflation macro-economic environment considerably enhances the feasibility of developing capital market activity.

A viable capital market depends on three elements:

- i) A sound but facilitating foundation of conditions and regulations within which issuers and investors of long term funds can transact business with reasonable confidence and efficiency;
- ii) Effective demand for long term funds (from users that need these funds) that can be operationalized in the form of implementable instruments; and
- iii) An effective supply of long term funds (from those that have long term funds to invest) that can be made available to meet these demands.

Issue: Rwanda does not have an existing supply of capital market-based long-term debt instruments and, consequently, does not have an interest rate yield curve, which is an essential tool for valuing long-term investment instruments. The short-term debt market appears surprisingly unresponsive to market forces and changes in market conditions, suggesting inadequate competition for these funds. Moreover, the accounting and financial reporting environment based on IAS and IFRS that is a prerequisite for any capital market to develop is still largely undeveloped. Until the new draft Companies Law has been enacted, there is an inadequate regulatory environment to protect market participants. Finally, there is no entity to provide overall guidance and direction to the capital markets for either debt or equities and, hence, no guiding principles or directions.

Policy Recommendation: The following steps should be taken to create a sound and facilitating environment as well as regulations to allow demanders and suppliers of capital to transact business with reasonable confidence and efficiency:

- 1) Develop legal, regulatory and operational guidelines for the operations of the OTC market.
- 2) Establish a Capital Markets Advisory Council to oversee an Over the Counter Debt and Equities market with advisory and regulatory powers.
- 3) Utilize the long-term debt market to create a yield curve.
- 4) Increase competition among buyers of these instruments by allowing foreign buyers and Rwandans from the Diaspora, to participate in the purchase of bonds. The amounts that can be offered to foreign buyers will be determined, with consideration to minimize the risk of foreign capital flows volatility, as well as speculative attacks on the Rwandan franc. The ongoing review of the foreign exchange regulation serves to facilitate this process.
- 5) Ensure that the new Accountants Bill is enacted and implemented so that all financial institutions, large companies, and “public” companies comply with IAS and IFRS accounting standards within time deadlines that create transparency. Amend tax requirements to allow income taxes to be paid on the basis of accounts prepared in compliance with these standards.
- 6) Enact the draft Companies Act which already contains an appropriate regulatory environment for an OTC long term debt and equity market, if amended to allow shelf registering of a prospectus to provide for draw downs of funds as needed rather than having to issue a new prospectus each time.
- 7) Publish Advisory Council guidelines for issuance of commercial paper and bonds, phase in credit rating requirements for new debt and equity issues, and publish guidelines on description and activities for financial intermediaries such as investment banks and broker dealers.

The following steps should be taken to develop the demand for the long-term funds side of this market:

1) BNR on behalf of the Ministry of Finance to reissue that portion of the existing t-bills valued at Rwf 15 billion that represents government deficit financing. At each maturity they would be reissued in a mix of one, two, three, five and seven year treasury bonds at differing rates that create a yield curve with somewhat higher rates for longer maturities and rolling them over as they come due thereafter in accord with government borrowing requirements. This creates avenues for longer-term investments for institutional investors like CSR and life insurance companies as well as individuals.

2) Ministry of Finance to securitize a portion of the existing long term debt owed by Government to CSR (with the amounts to be securitized dictated by cash flow implications for the Government fiscal situation) in the form of longer term bonds at market interest rates, i.e., at rates somewhat higher than t-bill rates and treasury bonds with shorter maturities.

3) Explore the possibility of a partial guarantee to domestic institutional investors from International Financial Institutions (IFC, AfDB, and EIB) to mitigate credit risk over a long-term horizon.

4) Facilitate banks (including BRD and BHR) to issue mortgage-backed bonds secured by good long-term loans (with possibility of recourse) as a way to recycle funds more quickly when the banks need liquidity to sustain disbursement levels. It creates a good exit mechanism and an incentive to extend mortgage loans beyond the current 7 years.

5) Provide the city of Kigali with technical assistance to prepare a bond issue, possibly a general obligation bond or one backed by earmarking tax revenues.

Policy Recommendation: Within a period of two years, building on the established long term debt market and sound framework, the Capital Markets Advisory Council should initially establish two avenues for Rwandan companies to raise equity capital, i.e., i) establishing a framework for quotation and trading of Over-the-Counter stocks in Rwanda; while ii) simultaneously encouraging large Rwandan companies in need of capital to list on the Nairobi Stock Exchange and/or other regional exchanges. Rwanda will retain the ability to broaden its OTC market into a stock exchange at some future time when the supply of debt and equity instruments and the demand for them have attained a critical mass in the form of transaction levels to avoid unnecessary costly investment in infrastructure and regulatory mechanism when the volume of operations are still sub-optimal.

Policy Recommendation: It is recommended that the following steps be taken to increase the availability of long-term funds and savings, which can be potentially channeled into long-term debt and equity investment.

- 1) Establish special longer term home deposit savings accounts in banks (including BHR) to enable accumulation of funds through regular monthly payments over a period of two or more years for down payments on a first home with tax free interest providing the funds are used only for that purpose. Other incentives on such savings accounts include not being subjected to obligatory reserve requirements.
- 2) Facilitate the creation of private pension funds, especially company operated provident and voluntary funds for employees, by putting in place an appropriate legal framework, amending the Tax Act to provide tax incentives to qualified private pension funds operated by companies whether or not providing pensions is their primary business activity.

- 3) Facilitate increased penetration of CSR into the total labor force by creating incentives for the self-employed and informal sector to take advantage of CSR.
- 4) Amend laws to enable pension funds and insurance companies to invest in a wider variety of financial instruments and with more flexibility as to percentages that can be invested in each type of investment, within very prudent guidelines to maintain adequate liquidity, security and a good return on their investment.
- 5) Amend laws to enable pension funds and insurance companies to invest a modest percentage of their investible funds outside Rwanda in investments that meet strict criteria.
- 6) Train and retain a high quality sophisticated professional investment staff for CSR in order to implement significant and appropriate policies of investment diversification into domestic financial instruments with longer maturities.
- 7) Enact a Leasing law to provide a new long-term investment opportunity for financial institutions.

Contractual saving Institutions (NBFIs) Regulation

Rwanda's only NBFIs (CSR and insurance companies) are of critical importance as they are presently the primary source of the country's long term funds and an invaluable developmental resource, in addition to the extremely important functions they perform in providing a social safety net to protect the livelihood of those that retire and of families whose primary income earner dies.

Issue: CSR is Rwanda's largest and arguably it's most important financial institution with assets of about Rwf 185 billion and projected investable inflows of approximately \$250 million equivalent over the next five years. Yet it is essentially unsupervised and unregulated, CSR has not developed prudent investment standards, investment skills and liquidity management policies that are necessary to ensure a sustainable financial position. It also faces difficulties until a Government debt of RWF 63 billion has been paid or at least partially or fully securitized in the form of marketable debt instruments.

Issue: Rwanda's small but important insurance industry is essentially unregulated and unsupervised despite the existence of an Insurance Law and, for 3 years now, a National Insurance Commission (NIC). To be effective NIC would need a legal framework that gives it independence as well as financial autonomy. NIC's ability to enhance its effectiveness is limited by a situation not fully within its control and hard to address, i.e.

- i) Economy of scale problems because of the small size of the insurance industry and financial constraints due to limited ability to fund itself from its regulated companies; and
- ii) Salary constraints that make it difficult to build a strong professional staff capacity. A number of countries with small insurance industries similar to Rwanda have dealt with the economy of scale issue by placing responsibility for insurance industry regulation and supervision within the central bank.

Issue: It is likely that the financial sector policy framework will lead to the creation of additional NBFIs in the future including private pension plans and leasing companies for which there is, at present, no regulatory infrastructure.

Policy Recommendation: It is recommended that the Central Bank Act be amended to enable BNR to develop a consolidated regulation and supervision function for NBFIs, including CSR and other pension funds that may be established, the insurance industry, and, if and when established, leasing and finance companies. 3 options for supervision were considered for the case of Rwanda, (separate institutions for supervision of insurance and CSR; an independent financial services agency for NBFIs; or assigning responsibility for NBFI supervision within BNR). There is considerable synergy involved in supervising both pensions and insurance as many of the issues, especially those involving investment policy and fiduciary responsibility to beneficiaries, are parallel, and considering the economies of scale and technical capacity already available in the BNR, independence and financial autonomy. The option of consolidating all the NBFI under the BNR supervision until such a time that the size of the sector requires a stand alone supervisory authority was considered the best option.

Effort should be made to retain existing NIC technical staff with significant insurance experience within this new unit where appropriate. BNR would require a long term technical advisor to assist in the establishment of the new NBFI supervisory department, coordinate with staff training efforts, and assist in training staff in the function.

The ongoing effort of drafting and enacting a revised insurance code should continue in order to address a number of inadequacies in the current insurance legislation which can not be resolved simply by transfer of supervisory responsibility.

Payments Systems

An efficient payments system constitutes an essential component in the national economy and financial sector infrastructure. The highest priority need is for a

national payments strategy embracing the use of all payments services instruments such as checks, credit and debit cards, ATMs, automatic salary and pension deposits, etc.

Issue: The extensive work to date in respect of national payments should be developed into a formal strategy. At the same time a representative body should be created with the responsibility of maintaining and implementing the strategy. The pressing requirement for automating small to middle value payments, which requires an operational Automated Clearing House, should be addressed.

Policy Recommendation: It is recommended that National Payments Council be established with the primary objective of developing and implementing a national payments strategy. This strategy should address the development of basic payments services targeted at the community at large, based primarily on electronic transfers. The “NPC” should be established with wide representation from the financial, government and commercial communities and be supported by a full time secretariat based in BNR. Its primary objective should be to improve the payments infrastructure through innovation and reform utilizing existing components (like SIMTEL and RITA), and introduce additional technology as it becomes justified.

Policy Recommendation: It is recommended that Government support the national payments system reform by i) introducing legislation requiring all wage and salary payments by medium and large scale enterprises, i.e., entities employing 5 or more staff, to be made electronically into the accounts of financial institutions; and ii) introducing a policy whereby all government payments, national and regional, to the extent feasible be made to, and received from, the accounts of financial institutions. In addition to creating the volume of electronic transactions necessary to sustain the ACH and SIMTEL, it will make money available more quickly to recipients, reduce the use of costly and inefficient cash and check based payments; and iii) make transactions more accountable and less prone to tax evasion.

Policy Recommendation: Once the National Payments Strategy is in place, it is recommended that an Automatic Clearing House (ACH) be quickly implemented and that its potential membership be expanded beyond commercial banks to other entities (e.g., large MFIs, CSR, etc) who meet its agreed access criteria. While the payments system should eventually include a real time gross settlements system (RTGS), its implementation should be delayed until transactions build to levels that make it sustainable and cost effective.

Request to Cabinet:

The Ministry of Finance and Economic planning would like to request Government to adopt these policy recommendations. To this end, the Minister requests cabinet to amend the Central Bank Act to include supervision of the

Insurance and Pension Funds in its mission. A specific action plan, with institutional responsibility and timeline for implementation has been developed in detail in the Financial Sector Development Plan. Once it has been adopted, government will appoint a team to oversee its implementation.

Report organization. Rwanda's FSDP is presented in this report in four chapters, each covering one of the four main areas of focus, i.e., i) Banking, microfinance and access to credit; ii) Long-term finance and capital markets; iii) Contractual savings regulation (pensions and insurance); and iv) Payments systems. The chapters provide rationale and descriptive detail in support of the detailed action plan contained in Annex 1.

Chapter 1: Rwanda FSDP Action Plan for Banking, Microfinance and Access to Credit

Overview

1.01 Rwanda's three primary FSDP objectives are i) expanding access to credit; ii) mobilizing more savings, especially long term savings; and iii) mobilizing more long term investment. The country's banking system and MFIs are absolutely critical to the first two of these objectives. Therefore, the government places high priority on enhancing its ability to achieve these objectives by addressing identified weaknesses and inadequacies in their ability to effectively perform these roles.

1.02 As shown in Table 1, Rwanda's 8 banks (including the development bank and housing bank which, while legally commercial banks are de facto specialized lenders), and 52 licensed nonbank lenders have 419 branches serving a reasonably large one million depositors and 306,000 borrowers. On a combined basis, as of June 2006 they held about 75% of all financial sector assets, mobilized roughly Rwf 259 billion (about US\$ 465 million) in deposits and made loans equal to about 94% of that amount.

Table 1: Rwanda: Banking System Branches and clients (June 2006)

	No of Branches	No of Depositors (000)	No of Borrowers (000)	Value of Deposits (Rwf)	Value Loans (Mil)	Loan Growth 2005
3 big banks	21	100	25	130	118	20%
5 small banks	<u>17</u>	<u>23</u>	<u>4</u>	<u>64</u>	<u>67</u>	<u>19%</u>
all com banks	38	123	29	194	185	20%
UBPR	145	499	83	42	38	54%
Other micro	<u>236</u>	<u>379</u>	<u>194</u>	<u>23</u>	<u>21</u>	n/a
all licensed FIs	419	1001	306	259	244	n/a
Percentage of national market						
3 big banks	5%	10%	8%	50%	49%	
5 small banks	<u>4%</u>	<u>2%</u>	<u>1%</u>	<u>25%</u>	<u>27%</u>	
all com banks	9%	12%	9%	75%	76%	
UBPR	36%	50%	27%	16%	16%	
Other micro /1	<u>56%</u>	<u>38%</u>	<u>64%</u>	<u>8%</u>	<u>8%</u>	
/1 as of Dec 2005						

1.03 A superficial glance suggests that coverage, if UBPR is included, compares reasonably well with the situation for other countries in Sub-Saharan Africa. The May 2005 FSAP report estimated that 24% of Rwandan households are reached by UBPR and an additional 15% are reached by other MFIs, while only 6% are reached by commercial banks. Unfortunately, there are virtually no other financial institutions (with the exception of one pension plan and a small insurance industry), so outreach falls far short of what Rwanda needs to meet its basic objectives for providing access to credit for its citizens and mobilizing increased savings from the system.

1.04 The banking system, especially UBPR, has done a good job of mobilizing deposits and growing loans over the last 6 years as shown in Table 2. Indeed, excluding MFIs for which earlier data are not available, deposits have grown by about 15% and loans by about 13% per annum in real terms. However, growth is primarily due to UBPR which has grown deposits by 21% per annum and loans by an impressive 34.5% per annum in real terms over the time period. Meanwhile, the 3 big banks as a group are lagging, growing only a little faster than inflation.

Table 2: Rwanda Banking System Growth in Loans and Deposits

	<u>Growth in 2006</u>		<u>Growth in 2000-2006</u>	
	Deposits	Loans	Deposits	Loans
3 big banks	30%	16%	13%	8%
5 small banks/1	<u>36%</u>	<u>53%</u>	<u>39%</u>	<u>31%</u>
all com banks	32%	30%	19%	15%
UBPR	47%	48%	26%	40%
Other micro /2				
all FIs (ex MFIs)	34%	33%	20%	18%
Inflation	12.0%	12.0%	5.4%	5.4%

1.05 It should be noted that the 8 banks, while operating only 38 branches (9% of the identified savings mobilizing and lending outlets in the country), and servicing only 11% of the country’s depositors mobilizes 75% of total deposits and 76% of the loans. Bottom line, therefore, the banks are the key to financing long term mortgages and investments, as well as short-term support to agriculture and production, because “the banks are where the money is”.

1.06 Main issues. While most banks have become reasonably sound financially in recent years, their collective performance in helping Rwanda meet its goals falls well short of being satisfactory.

1.07 Among banking system weaknesses that Rwanda, with help from donors, wishes to address on a priority basis are the following:

- 1) Commercial bank branches are limited almost entirely to Kigali and a few secondary cities. There is basically no rural commercial banking system and the rural population outside Kigali and secondary cities has no geographically convenient access to banking services beyond the minimal services offered by UBPR and some MFIs.
- 2) Inadequate competition in the banking system has led to high spreads, inadequate innovation in new products and services, and inadequate incentives for banks to expand services to additional customers or locations. The FSAP report summarized the situation well in stating that the banking system is oligopolistic and offers only very basic savings and credit products, while even relatively unsophisticated products are absent, and lending rates are relatively high.
- 3) Concentration within the banking system, while steadily diminishing, is still undesirably high. The 3 largest banks (BK, BCR and BCDI) on a combined basis still control 65% of bank deposits as of December 2006. This has dropped significantly from their 86% market share six years earlier, as the biggest banks' combined deposits grew at an annual rate of 13%, well below the 39% growth of the smaller banks on a combined basis. BK, the largest bank, experienced a significant drop in market share from 32% to 27% during that time period.
- 4) The banking system has not done a particularly bad job of mobilizing deposits. Total commercial banking system deposits of Rwf 269 billion (about US\$ 489 million) as of December 2006, represents only 11% of GDP which does not compare particularly well with deposit levels in neighboring countries¹ when the lack of other financial institutions is taken into account. Banking system deposits, from a low base, grew by about 20% per annum, or almost 15% in real terms over the 6 years ending in 2006 but this growth, which is less impressive than it may seem when the initial very low base level is taken into account, is likely to be one of the factors responsible for the overall low 3% rate of growth in savings in the country. Anecdotal evidence suggests the existence of substantial savings offshore and even under mattresses because confidence in the banking system is still not high following difficulties experienced by several of them and because of fears associated with Revenue Authority investigation.
- 5) In lending, most banks are competing for a core group of about 50 relatively large corporate customers and credit has, until recently, grown relatively slowly and remains concentrated in Kigali and a small number of sectors. Over the 6 years

¹ Rwandan banking services are shallower than in neighboring EAC countries, with the ratio of bank deposits (including UBPR) to GDP of 19.8% as of December 2005 compared to 21.4% in Tanzania, 32.4% in Tanzania and 40.4% in Kenya. It is likely this gap has narrowed in 2006 given the robust growth in Rwanda's deposits.

ending in December 2006, banking system loans grew only 15%, while UBPR has expanded its lending by 40% per annum. However, in 2006, credit did grow by a robust 30% in nominal terms for the commercial banking system and by 48% for UBPR.

- 6) Among the issues associated with lending are:
 - a) Banks show relatively little interest in making loans to small borrowers.
 - b) Agricultural lending by the commercial banking system added to a tiny Rwf 8.1 billion (only 3% of total loans) as of December 2006 although agriculture represents an estimated 44% of national GNP. BRD alone accounts for about 41% of total lending to agriculture as of that date. However, UBPR lends more for agriculture than does the entire commercial banking system.
 - c) Commercial banks make virtually no home mortgage loans for more than 5 to 7 years and mortgages represent only 10% of the value of outstanding loans.
 - d) Term loans to the productive sectors also seldom exceed 5 to 7 years, and only 16% of commercial bank loans² were term loans as of December 2005. Until recently as a result of the privatization of two banks, there is little innovation in new product areas such as term loans based on salaries that are now being widely adopted in neighboring countries such as Kenya.³
- 7) Banks (based on 2006 data) have unusually high and increasing average interest rate spreads of 8.6% and interest rate margins of 9.7% showing both highly inadequate competition and inefficiency. Due in large part to the high spreads, profit before after tax is a robust 3.4% of assets, up sharply over the previous year, because operating costs dropped significantly in 2006 but are still high 7.6% of assets and 50.8% of gross revenue. High operating costs are due both to inefficient management and to serious economy of scale problems. The average bank has only Rwf 41 billion (about \$75 million) in assets, only about 15,300 depositors and 142 employees. Increasing the number of banks could exacerbate this economy of scale problem. Nonperforming loans still add to a very high 27.3% of total loans, representing a continued serious problem for the banks, but the bad debt situation is now slowly improving and loans made in the last several years are performing far better than the older loans.

² This excludes BRD and BHR for whom most of their loans are term loans. If these banks and UBPR are included, 23.5% of all loans are reported to be term loans of five years or more.

³ BCR is now offering a salary-based product called “credit éclair”.

Strengthen Banks' Role in Providing Better Access to Financial Services

1.08 The proposed action plan matrix is shown in Annex One.

1.09 UBPR. Cabinet has endorsed a policy which will allow the UBPR central unit to become a de facto commercial bank, allowing it to participate fully in the clearing and SWIFT, and subjecting it to the same regulations⁴ that apply to commercial banks with the exception of those regulations related to governance which would conflict with the fundamental cooperative principles on which the UBPR group is based.⁵

1.10 This is one of the most important actions in the entire FSDP program. As shown in the action matrix, this would quickly have the effect of:

- 1) Transforming UBPR into the 3rd largest bank in the country (with a 15% share in bank deposits) and ensuring that this large very important institution is as carefully regulated and supervised as are the commercial banks.
- 2) Reducing the present 3 largest banks' market shares of deposits to 55% and their market share in loans to 45%, thus reducing their ability to dominate the system.
- 3) Providing UBPR with an 80% market share of the number of banking system depositors and 74% share of borrowers, thus extending better access to banking services to the rural areas and to an additional 500,000 depositors. UBPR would operate almost 80% of the bank branch locations, including 100% of the semi-rural locations.⁶
- 4) Enhancing UBPR's ability to compete, thus increasing the overall level of competition. In particular, competition for smaller clients would be increased and the cost of loans and services to many of these clients would be reduced.
- 5) Enhancing banking system ability to mobilize deposits from throughout the country.

1.11 Commercial bank regulation and supervision. While Rwanda's bank regulatory environment is generally satisfactory, changes are needed to facilitate increased competition, require increased soundness in a few areas, and improve financial reporting transparency.

⁴ As an exception, UBPR and its bigger units should be allowed to lend a maximum of 5% of net worth to one credit risk, not the 25% allowed for other banks. This will reduce the risks for UBPR as it develops its initial experience with larger loans than it is used to processing and also ensures that it will continue its past pattern of lending to large numbers of relatively small borrowers.

⁵ Subsequent to the Cabinet decision, UBPR is seriously considering a proposal to transform itself into a company and seek out a reputable international bank to become a strategic partner to assist in their transformation into a commercial bank.

⁶ Of the UBPR "branches" recommended to be connected to the Globus network, 18 are in towns outside of the old provincial centers, 10 are in those centers, and 14 are in Kigali.

1.12 BNR has already implemented two significant changes in regulation under the FSDP program, i.e., i) redefining liquidity requirements to allow banks to count a portion of their demand deposits as long term liabilities for purposes of the requirement, thus substantially increasing the amount of term lending they can do while still in compliance with central bank liquidity requirements ; and ii) increasing minimum capital requirements to reduce the risk that new small potentially weak banks can enter the system and enhance the probability that any new entrants will be drawn from larger, more sophisticated international banks.

1.13 Rwanda needs to deepen competition among financial institutions to better achieve its objective of increasing access to financial services. Four actions relating to regulation that BNR plans to take to deepen competition include:

- 1) Allowing UBPR and its larger coops that have the Globus computer system to lend up to 5% of net worth to a single credit risk.
- 2) Allowing UBPR, its larger coops, and well computerized MFIs that meet high financial soundness criteria to have access to the automatic clearing house (ACH) and SWIFT and expanding access for more well computerized MFIs to the National Credit Bureau.
- 3) Providing UBPR with technical assistance to enable it to make a wise and effective transition to its expanding role.
- 4) Subjecting all financial institutions including UBPR, but excluding MFIs, to the same tax requirements as commercial banks to create an equal playing field.

1.14 Rwanda's banking regulations are reasonably sound and compliant with international norms. The most serious threat to the banks' soundness is the high levels of nonperforming loans, many of them a legacy of extremely unstable conditions more than 10 years ago. Four additional changes in regulations which Rwanda plans to enact to further strengthen banking system soundness include:

- 1) Placing maximum sector concentration lending limits on commercial banks.⁷
- 2) Requiring all banks to submit and implement an action plan for NPL reduction that includes enforcing 'voie paree'⁸ and a streamlined write-off process to eliminate very old uncollectible loans still on the books.

⁷ While, in light of practical considerations associated with the small size of the economy, these may be somewhat higher than limits imposed in some other countries, it is important that reasonably prudent limits be imposed to reduce risk associated with inadequate diversification.

⁸ Voie paree is a Rwandan law that allows banks to foreclose on collateral associated with defaulted loans without going through a prolonged court action.

- 3) Amending the Banking Act to allow Tier 2 capital for commercial and specialized banks.
- 4) Issuing regulations on loan classification and provisioning for retail loans.

1.15 It is essential that Rwanda strengthen the transparency of all financial institution reporting on financial condition and performance and ensure that it is harmonized with East Africa Community (EAC) reporting requirements and practices. This will depend in part on changes in income tax requirements (see accounting section, para 2.89). BNR also plans to:

- 1) Improve and enforce financial reporting requirements in IFRS format for all banks, near banks and other financial institutions it supervises.
- 2) Ensure that commercial bank published accounts meet international best practice requirements and be in harmony with the EAC.

1.16 Commercial bank system development. Far more action is required to further develop the banking system's willingness and ability to provide better access to financial services, improve services, improve financial products being made available, and govern itself. Consequently, under the FSDP, BNR plans to help improve banking system infrastructure, capacity, and outreach to address these concerns.

1.17 BNR plans to improve banking system infrastructure in three major ways, i.e.

- 1) Strengthening the Bankers Association inter alia by providing it with technical assistance and by holding regular monthly meetings between the Governor and the Association.⁹
- 2) Strengthening and speeding up the National Credit Bureau by requiring, where necessary with assistance, to computerize all loan data inputs.
- 3) Making improvements in national payments systems as presented in chapter 4 of this report.

1.18 As part of a high priority program to build capacity and improve skills in the banking system, BNR will require all banks to submit training programs. BNR will also assist the Bankers Association to help the banks build capacity and skills through i) defining a training curriculum for a professional association of bankers; and ii) strengthening links between banks and the School of Finance and Banking.

⁹ These meetings would have 3 primary purposes, e.g., i) allowing the bankers to raise concerns, problems and suggestions on a regular basis; ii) providing the Governor with an opportunity to receive informal and formal feedback on new developments and other subjects for which that would be useful; and iii) sending a signal that BNR considers the Bankers Association to play an important role in representing the bankers, thus making it more important in the bankers' eyes.

1.19 BNR plans to work closely with the Bankers Association and individual commercial banks to improve outreach and access to financial services and products by:

- 1) Developing more term lending products based on salaries similar to those presently being used in Kenya.
- 2) Publicizing recent changes in secrecy laws and financial disclosure practices as they relate to the tax authority to encourage more bank deposits.
- 3) Developing standardized tax-incentivized home owner special deposit programs linked to home mortgages in the housing bank and commercial banks.
- 4) Expanding the BNR-administered agricultural credit guarantee system by expanding its funding sourced from donors and government.
- 5) Providing commercial banks with loan guarantees and/or donor-sourced credit lines to lend more to SMEs.
- 6) Strengthening individual UBPR cooperatives and utilizing them to develop a rural banking system.

Strengthen Housing Bank and the Commercial Banks' role in Mortgage Finance

1.20 The Housing Bank (BHR) is a commercial bank 86% owned by Government and CSR which was recapitalized for the purpose of providing long-term mortgage loans in Rwanda. It is presently well capitalized with about Rwf 1.5 billion in net worth constituting almost 19% of risk weighted assets.

1.21 On an overall basis, as of December 2005, the banking system had made Rwf 137 billion in outstanding loans of which only 11% were for periods of over 5 years. It produced an estimated Rwf 25 billion in mortgage lending over the past 3 years. The Housing Bank (BHR) has a 1.9% market share in outstanding loans and a 3.5% market share in mortgages. As previously mentioned, most mortgage loans other than those made by BHR are for periods of 5 to 7 years.

1.22 Main issues. Although BHR has been envisioned as the primary vehicle for financing new homes in Rwanda, it is too small to supply financing for all but a tiny share of the need for new mortgage financing and its commercial bank structure and strategy are highly unsuitable for the purpose.

1.23 Moreover, BHR's new sources of funds and its responsibilities as a commercial bank make it unsuited to perform the role of a specialized lender. It is unsuitable because it plans to:

- 1) Make virtually 100% of its loans in one subsector, residential mortgage lending, which makes the bank highly undiversified, thus greatly increasing risk.

- 2) Make virtually 100% of its loans long-term even though 43% of its deposits are current accounts (demand deposits) as of December 2006 and demand deposits grew by over 500% in 2006.
- 3) Invest heavily in land and buildings. It has already invested 28% of its assets, equal to 245% of its capital in fixed assets of this type, far in excess of the 100% of capital allowed under BNR guidelines. Moreover, it anticipates needing to invest an additional Rwf 35 billion to develop land it has already bought, some 2300% of its present capital base and almost Rwf 30 billion more than the total liquid funds it now has at its disposal.
- 4) Lend at modest interest rates to borrowers, concentrating on borrowers that can not easily get mortgage loans from commercial banks, i.e., to a high risk group of borrowers.

1.24 As shown in Table 3, the Housing Bank made only 58 mortgage loans ¹⁰to the general public over the 2 ½ years ending June 2006 in an amount of Rwf 0.8 billion (excluding mortgage loans to civil servants from a special fund) over the 2 ½ years since it has been restructured. During the same time period, the other commercial banks have made 985 mortgages in an amount of Rwf 22 billion.

Table 3: Housing Bank and Commercial Bank Role in Mortgage lending

2004-June 2006 (RWF millions)	BHR	Other banks	Other banks share
No of mortgages made 2004-2006	58	985	94%
Value of 2004-2006 private mortgages	800	21,858	96%
mortgages outstanding (May 2006)	2,501	25,401	91%
total deposits	5,754	230,289	98%

1.25 As a consequence, as of June 2006, BHR has made only 6% of the number of new private mortgages and supplied only 3.5% of the new money for private mortgages in Rwanda since 2004 even though its strategy is focused entirely on doing that and the commercial banks have major disincentives (some of them addressed by other parts of the FSDP program) which have previously reduced their willingness to increase the amount and the maturities of their mortgage lending. BHR has only 9% of the mortgages loans outstanding even when the special subsidized loans to civil servants are included.

¹⁰ As of December 2006, total mortgage loans to the general public had increased to 75, but the earlier data are used for the comparative discussion vis. the commercial banks as updated data are not available for them.

1.26 BHR mobilizes only 1% of the deposits so it has little new money available for lending. Moreover, as shown in Table 4 below which compares the BHR balance sheet with that of the banking system in selected areas, its balance sheet is already very unsuitable to being a commercial bank and will become more so as time goes on if it continues to pursue its existing strategy.

Table 4: A Comparison Between the BHR and Banking System Balance Sheet

	BHR Dec 2006	other banks Dec 2006
balance sheet (% of assets)		
uses of funds		
Term loans	25%	16%
total loans	25%	46%
fixed assets (including land and houses)	30%	9%
short term cash	41%	38%
sources of funds		
Deposits	21%	79%
other liabilities	66%	9%
net worth	13%	12%
Composition of Deposits		
demand deposits	43%	50%
term and savings deposits	57%	50%

1.27 BHR already has 30% of its total assets, or about 245% of its capital, invested in land, buildings and fixed assets, compared with the 100% of capital allowed by the central bank. In addition, it has plans to build about 1765 homes on 3 recently purchased plots of land, totaling about 102 hectares, at a cost of about Rwf 35.3 billion {an average Rwf 20 million per house). This investment requirement would exceed its present capital by almost Rwf 34 billion (2300%) and would require about Rwf 30 billion more than its present liquid funds. BHR now realizes that it is unlikely to fund the development of more than one of these projects, but even that would not be appropriate for a commercial bank.

1.28 It should be noted that BHR term loans of Rwf 3598 million already exceed term deposits of Rwf 1346 million by 267% and, even more worrisome, the housing bank expects demand deposits to constitute an increasing share of future funding. Demand deposits, except to a limited extent, represent a highly unsuitable source of funding for investment in land, homes, and long term loans and are little used by prudent commercial banks for that purpose. As of December 2005, for the banking system as a whole, term loans of about Rwf 32 billion, although constituting 23% of loans, add to only 67% of term deposits.

1.29 BHR's loan portfolio, although still quite new, is rapidly deteriorating. Its nonperforming loans have increased to 18% as of December 2006 (up from 5.6% a year earlier) while watch loans increased by Rwf 540 million during 2006, such that 66% of the portfolio was more than one month overdue. While some of these repayment delays are certainly transitory, the rapid increase in NPLs may also reflect the BHR desire to provide loans to borrowers who may not necessarily be able to meet commercial bank creditworthiness standards.

1.30 Strengthen BHR financial condition and its role in supporting increasing home mortgage financing. Cabinet has decided that the housing bank should change its role somewhat, converting itself from a commercial bank, investing its deposits in land, buildings and long term mortgage loans, into a specialized lending institution, more parallel to BRD, with the primary mandate of increasing the amount of home mortgage lending in Rwanda, both through its own direct lending sourced from savings accounts and by catalyzing increased commercial bank lending for home mortgages because the banks are where the money is. In addition, the Cabinet approved a number of other actions designed to increase the amount of long-term home mortgage finance as discussed on pages 52-54 of this report.

1.31 BHR should retain its existing mortgage portfolio, disburse the remainder of its subsidized civil service housing fund (which is rapidly disappearing), and continue to operate special savings deposits for first time owners to whom they would make new mortgage loans. It should also adopt a new strategy that would involve performing a number of functions in support of home mortgage finance in Rwanda. BHR staff would need intensive training to perform these new functions effectively.

1.32 BHR should become a specialized lender which, like BRD, would expand its collection of savings accounts but would no longer collect demand deposits and would collect fixed term deposits only from companies, not individuals, and for time periods of not less than six months.

1.33 BHR should be encouraged to make an arrangement with another commercial bank to maintain current accounts for all BHR mortgage borrowers that receive monthly income and to make automatic deductions from that income to transfer to BHR to meet scheduled mortgage payments. Loan agreements can require these accounts to be set up to facilitate BHR's ability to collect these payments in similar fashion to what they do now.¹¹

1.34 The value of current accounts that BHR would have to transfer to another bank to achieve this would probably represent a relatively percentage of its present current account base as it had 807 current accounts and only 288 mortgages outstanding as of December 31, 2006,. Moreover, the current accounts with the largest balances tend to be those of companies which are not mortgage borrowers (like CSR), which might be induced to keep much of these funds in BHR as longer-term fixed deposits which

¹¹ BRD, which does not collect demand deposits, has somewhat similar arrangements with commercial banks.

represent much more suitable funding for mortgages. The remaining demand deposits, to the extent that they can not be converted to eligible fixed deposits would need to be refunded.

1.35 BHR can raise future long-term funds by issuing bonds collateralized either by its better mortgages or, alternatively, only by its creditworthiness. However, these options may not be feasible for more than a year or two unless BHR substantially improves the overall quality of its loan portfolio or if Government were to choose to guarantee these bonds.¹²

1.36 BHR presently has 2625 savings depositors with deposits of about Rwf 1317 million. It should try to restructure many of these deposits so that they would be particularly suited to assisting depositors to save money for a down payment for a home and establish their ability to save a specified amount every month over a longer period of time by requiring participants to make new deposits at least once a month for a period of about 4 or more years (3 years in exceptional cases) or until such later time that the depositor has accumulated a sufficient amount of money to make a down payment. All these deposits should be for the purpose of saving a down payment for the purchase of a first owned house. Interest rates paid on these deposits should be increased from the present 1-2% to a market rate of interest, say 3% below the 90 day Treasury bill.

1.37 BHR should continue to make new mortgage loans, but only to home savings account depositors in view of the more limited future lending it is likely to be able to conduct, and to limit total amounts of mortgage lending to levels congruent with its long term deposits. As presented elsewhere in the FSDP action plan (para 2.84), the Authorities plan to make interest on these special home savings accounts tax free so long as the money is not withdrawn until used to make the down payment on a house. Once BHR has designed this savings account instrument in detail, the Bankers Association should be encouraged to promote its use by other commercial banks. It is believed that this instrument can significantly increase the amount of long term savings in the country as well as facilitate first home purchases for a number of Rwandans.

1.38 BHR plans to redesign its business strategy to:

- 1) Introduce its standardized home owner savings plan to other banks.
- 2) Phase out its direct participation in housing development once its present 12 hectare plot has been developed as it will not have adequate funding to do more development beyond that.

¹² If Government were to guarantee BHR bonds, it would give BHR a comparative—albeit unfair—advantage over other banks which might lead to its having a lower cost of long-term funds. While this would increase the amount of BHR mortgage lending, it could create a disincentive to the effort to catalyze increased commercial bank mortgage lending which is seen as the major long term source of home mortgages in Rwanda.

- 3) Implement a program by coordinating with the School of Finance and Banking to sponsor enhanced and expanded training for commercial bank and insurance company residential underwriters.
- 4) Implement a system, utilizing staff in the library section of its Human Resources and Logistics Department, to monitor and make available data on real estate transactions and values.
- 5) Expand and strengthen its existing real estate appraisal function in the valuations section of its Studies and Development Department, as a fee-based business with technical assistance support after sending 2 of its existing appraisers for specialized training outside Rwanda.
- 6) Catalyze organization of a small Real Estate Appraiser's Association and support its functions.

1.39 As the new strategy will represent several new businesses for BHR, it is essential that its staff receive comprehensive training over a period of several years as part of implementation. Also, the School of Finance and Banking should expand its offerings related to residential mortgage lending, given the priority placed on this activity by the Government.

1.40 In addition, BHR should investigate the possibility of establishing a mortgage credit guarantee scheme as a major new product to provide commercial banks with partial credit risk guarantees on home mortgage loans they make. While a detailed implementation study needs to be undertaken to ascertain the feasibility of such a program and, if appropriate, refine the details, under one approach BHR could initially set aside a fund of approximately Rwf 1.8 billion (about one third of its liquid funds as December 2006) in a guarantee fund that would be invested in a mix of short term treasury bills and bonds to earn interest income to support the fund. The fund could be prepared to reimburse commercial banks for a portion (possibly 75%) of any final credit-related losses they might incur (after foreclosure and resale) on mortgage loans which BHR has insured for an agreed fee. BHR should not establish such a scheme before FSDP actions required to establish a long-term bond market have been implemented so that commercial banks concerns about liquidity risk are being addressed as well as their concerns about credit risk.

1.41 If a credit mortgage guarantee plan were to be implemented, loan applications, to be insured, would have to meet agreed criteria in terms of amount of down payment, borrower's ability to pay, value of the house as collateral, and maximum loan size. Detailed design would need to include elements to ensure that banks submit most of their smaller home mortgage loans for insurance so that the credit guarantee scheme did not receive and insure only the more marginal loans being made by the participating banks. Such a plan would be designed to incentivize banks to make somewhat riskier loans, i.e., loans with smaller down payments or which are relatively large vis. the borrower's ability

to pay because of the reduction in risk due to the partial insurance in addition to the loans they would normally make,

Strengthen Rwanda Development Bank Role in Long-term Finance

1.42 The Rwanda Development Bank (BRD) plays a significant role in providing long-term and agricultural finance in Rwanda and plays a vital role in helping Rwanda achieve its objectives. As of mid-2006, it had total loans outstanding of Rwf 17.25 billion, a 7.3% share of total bank lending and provided 55% of total bank lending for agriculture. Moreover, unlike the commercial banks that do relatively little long-term or project lending, 65% of BRD's total lending, mostly comprised of project-lending, is long-term.

1.43 Surprisingly, BRD is, at this juncture, one of the most successful development banks in Africa, outside of South Africa, despite Rwanda's past period of instability. As of December 31, 2005, BRD's audited accounts showed net worth of Rwf 4.7 billion (25% of total assets), a profit for the year of Rwf 565 million (a robust 2.9% of total assets), and nonperforming loans (NPLs) which steadily declined over the 2001-2005 period to a level of 15.5% of gross loans. Portfolio quality compares favorably with that of the commercial banks.

1.44 BRD has been lending primarily in local currency with Government taking the foreign exchange risk when underlying loans are denoted in foreign currency. In late 2006, government reimbursed BRD in an amount of about Rwf 2.2 billion for accumulated liabilities associated with this risk, thus eliminating a major balance sheet problem. However, Government will not continue to assume this risk in the future.

1.45 Main issues. BRD faces two major problems which could lead to financial problems in the future that are common among development banks everywhere, i.e., i) an extremely risky asset investment profile; and ii) challenges in raising adequate long-term lending resources. Indeed, because of its aggressive developmental strategy, BRD now faces substantial risks and worrisome trends are developing as follows:

- 1) BRD's gross loans outstanding increased in 2006 by a somewhat alarming 80%, much of it for agriculture. Consequently, while NPLs continued to drop as a percentage of portfolio, they increased by Rwf 330 million during the year. This raises a red flag as it is extremely difficult to maintain quality when lending is expanding so aggressively.
- 2) BRD is not adequately diversifying its portfolio as agricultural lending (which is very high risk) in its planned lending. It represented 28.5% of loans outstanding and 52% of net worth as of December 2006 and is projected to constitute 44% of BRD's disbursements in its 5 year plan.
- 3) BRD has initiated a major new wholesale lending program for MFIs called FOREDEM, another high risk lending area, without setting up

appropriate accounting which would enable it to ascertain its impact on BRD's own financial condition and performance. BRD has legal and financial responsibility for FOREDEM but, until recently, did not consolidate its balance sheet and income statement in its accounts although FOREDEM's Rwf 2.6 billion in assets are undoubtedly of high risk and represent 14% of BRD's total assets. FOREDEM loans are still not classified in accord with BNR requirements for banks.

- 4) BRD, as evidenced by modest noninvestment-related income of a low 0.3% of assets, has not taken advantage of some opportunities to diversify somewhat away from its high risk long-term financing business, e.g., letters of credit associated with equipment it finances.
- 5) BRD is not well structured organizationally and staff-wise to adequately process the high risk investment opportunities that represent its principal arena of investment.

1.46 Despite its sound balance sheet, BRD is facing challenges in raising adequate levels of long-term funds. It depends almost exclusively on external lenders as it does not collect deposits from the public and borrows in local currency primarily for its FOREDEM microfinance support activities. Some international lenders no longer provide significant lending to development banks and others, such as IFC, will not provide loans to government controlled entities. Government and parastatals (the pension fund in particular) presently hold an ownership share of about 56%.

1.47 Action plan for reducing BRD risk. BRD should take the following actions to reduce present very high levels of risk.

- 1) Recruiting a highly qualified chief credit risk officer and ensuring that this officer plays a key role in all credit and other risk-related decisions. We understand that BRD has recently hired such an officer.
- 2) Establishing concentration policies that limit concentration of lending in any one sector, including agriculture, to not more than 30 or 35% of total loans and to continue to expand agriculture lending as a priority, but within that limit. BRD has recently taken a step in this direction by setting up a 40% of total portfolio limit for its agricultural loans.
- 3) Changing accounting procedures for FOREDEM to reflect its financial impact transparently either through consolidation (appropriate given that it is de facto 100% owned and is in the same business) or at a minimum through utilizing the equity method of accounting. Carefully review the risks associated with the FOREDEM initiative being taken by BRD. BRD, as of December 2006, is now consolidating FOREDEM into its accounts, but there are still cost accounting weaknesses and FOREDEM's loan classification procedures, which do not comply with

BNR requirements, still need to be addressed. As FOREDEM is presently loss making and is very high risk, it should be operated as a BNR department, not as a separate corporation.

- 4) Exploring opportunities to increase BRD's noninterest income and allow BRD to issue fee-based lc's for import of items it is financing. This could add significant income as the import content on its 2006 loans was 40%. A 1% fee on the Rwf 4 billion in import content associated with BRD's 2006 approvals would have earned about Rwf 40 million, more than doubling their noninterest income for the year.

1.48 Enhancing BRD's fund-raising capacity. The Cabinet has already made an important policy decision to gradually reduce government's de facto ownership share in BRD to less than 40% by finding new investment from entities that share Government's development objectives. This will enhance BRD's ability to raise funding from sources such as IFC.

1.49 BRD also plans to enhance its ability to raise long-term funds through the following measures:

- 1) Issuing asset-backed bonds (utilizing loans) to entities such as CSR and insurance companies utilizing performing loans in the portfolio as well as BRD's own creditworthiness as collateral. This will enable BRD to turn existing loans into new lendable funds. These bonds would represent debt instruments parallel to those to be issued by commercial banks (see paras 2.63-2.67). It should be noted that the importance of access to local long-term funds, relative to long-term foreign currency denominated funds, will increase substantially now that government has stopped guaranteeing foreign exchange risk for BRD.
- 2) Increasing coordination with commercial banks by developing co-financing mechanisms whereby commercial banks provide a portion of the loans which represent the shorter maturities and take overall responsibility for loan administration and collection in these situations.
- 3) Using stronger risk management practices, including prudent sectoral concentration limits as discussed above.
- 4) Continuing to raise substantial debt capital from sources such as AfDB, European Investment Bank, Development Bank of South Africa and East Africa Development Bank.¹³

¹³ Recently EIB has provided BRD with a Euro 7 million line of credit which can be utilized in either foreign exchange or local currency. This significantly improves BRD's resource position for the intermediate term.

Strengthen MFIs in Providing Better Access to Financial Services

1.50 Overview. MFIs are significant in size and play an extremely important role in expanding access to credit and deposit services in Rwanda. As of December 2005, as shown in Table 5, the 51 licensed microfinance institutions (MFIs)¹⁴ which submitted reports to the central bank had a combined total of 236 branch locations and served about 379,000 depositors and 194,000 borrowers. As a group, MFIs operate 56% of the branch locations in Rwanda and serve 38% of the financial system depositors and 64% of the borrowers. However, as of December 2005, they hold only 8% of the value of both deposits and loans.

1.51 Within the reporting group of MFIs, the 33 which are cooperatives (SACCOs) control 73% of the deposits and 37% of the branches. The remaining 18 are companies. There do not seem to be significant reported differences in average size or performance between the two types of MFIs but the companies are far better capitalized than the coops. Anecdotal evidence suggests that a number of smaller MFIs, particularly those that do not take deposits, did not report. The central bank was forced to close 8 MFIs in 2006 because of very poor financial condition and it is believed that a number of other MFIs which are still operating are also in serious financial condition. As a result, MFIs' financial condition and the adequacy of their supervision have become a high profile issue in Rwanda.

Table 5: Rwanda MFI Summary Data as of Dec 2005
(Rwf mil)
(excluding UBPR)

	Zigama	10 large MFIs	40 small MFIs	Total MFIs	of 18 companies	which 33 Coops
no of branches	12	114	110	236	149	87
no of depositors	38,733	211,992	128,664	379,389	117,087	262,342
no. of borrowers	49,076	113,952	30,801	193,829	105,597	88,192
Assets	16,157	12,744	4,889	33,790	10,112	23,679
Capital	205	1,292	1,500	2,997	1,952	1,044
Deposits	12,002	8,505	2,620	23,127	6,318	16,809
net loans	10,831	7,176	2,578	20,585	6,170	14,416
NPL % /1	13%	11%	18%	13%	11%	13%
net loan/deposit ratio	90%	84%	98%	89%	98%	86%
capital/assets ratio	1.3%	10%	31%	8.9%	19%	4%

¹⁴ This data excludes UBPR which, although presently reporting to BNR as a microfinance institution, is treated in this report as though it were a commercial bank in accord with the recent Cabinet decision.

mkt share (assets)	48%	38%	14%	100%	30%	70%
mkt share (deposits)	52%	37%	11%	100%	27%	73%
mkt share (loans)	53%	35%	13%	100%	30%	70%

1/ NPL data as of June 2006. Not all MFIs reported NPLs
source: BNR

1.52 Overall reported NPLs of 13% would appear satisfactory but it is not known whether classification of loans and provisions for bad debt are adequately reported. Anecdotal evidence suggests that some MFIs have considerably higher NPLs than they report. Indeed, it is probable that on a combined basis, MFI NPLs and provisions are significantly understated as accounting is often weak and supervision of microfinance institutions is only starting and it will take some time before enforcement of regulatory requirements reaches a desirable level.

1.53 Zigama, a cooperative, is much the largest MFI (excluding UBPR), with a total of 12 branches, almost 39,000 depositors and Rwf 12 billion in deposits, a 52% market share in MFI deposits (again excluding UBPR). It is an important financial institution and needs to be thoroughly inspected and carefully watched as it is seriously undercapitalized, reporting net worth amounting to only 1.3% of assets. It reports NPLs amounting to 13% of gross loans.

1.54 On a combined basis, the next 10 largest MFIs, which have a combined Rwf 12.7 billion in assets and Rwf 8.5 billion in deposits, seem to be performing better than other MFIs. The 40 smallest MFIs on a combined basis have only an 11% share in MFI deposits. Average reported NPLs are 18% for the 40 smallest reporting MFIs, which, even if not understated, is troubling. Five small MFIs reported NPLs in excess of 30% of portfolio.

1.55 Obviously, Zigama and the next 10 largest MFIs¹⁵ play an extremely important role while the smaller MFIs play a more marginal role in providing broader access to financial services but seem to represent the bulk of the challenge in terms of improving supervision and dealing with problems of actual and potential financial instability.

1.56 Issues: While MFIs have many internal weaknesses that need to be addressed, inadequate supervision is also a major issue. This is due, in part, to the fact that the majority are cooperatives which, at least until recently, have operated under a significantly different supervisory regime than companies and in part because BNR does not have an adequate number of officers to supervise and inspect all MFIs.

¹⁵ Excluding UBPR, the 10 largest MFIs as of December 2005, based on total assets were Zigama, UCT, RIM, Agaseke, COOPEDU, Ongera Microfinance, Inkingi, Vision Finance, Urwego community, and Urumuli.

1.57 Another major issue is the absence of a satisfactory microfinance association. In mid-2006, there were 3 alternate candidate associations and choosing one to receive full backing from government is a high priority. Other significant issues include the absence of a microfinance law (the draft law is now with Parliament), a need to revise MFI and SACCO instructions to fit the new law and policy, and a mechanism for increasing MFI stability and the safety of their deposits.

1.58 Strengthen MFI regulation and supervision. Rwanda needs to amend the draft Microfinance Law and enact it as soon as feasible. Needed amendments in the draft law circulating in mid-2006 should be made to achieve the following:

- 1) Differentiating licensing and supervision requirements for deposit-taking vis. nondeposit-taking institutions by substantially reducing the requirements for those that do not take deposits.
- 2) Granting full licenses in the future only to MFIs with adequate management that have reached satisfactory levels of financial sustainability, i.e., full financial sustainability exclusive of costs associated with expansion and capital expenditures.¹⁶ Provisional licenses might be considered for MFIs that seem to be steadily moving toward sustainability.
- 3) Not supervising some very small community-based MFIs.
- 4) Considering a reduction in the amount MFIs can lend to directors and staff.
- 5) Establishing standard BNR policies and procedures for dealing with failed MFIs.

1.59 BNR and other Authorities plan to revise MFI and SACCO instructions to reflect the new Microfinance Law and the just enacted Microfinance Policy including:

- 1) Increasing minimum capital requirements significantly for MFIs that take deposits other than for collateral only.
- 2) Increasing maximum exposure limits for group loans (but not for individual loans) above the present limit of 2.5% of equity and deposits.
- 3) Increasing bad debt provision requirements to 100% for any group loan that is more than 180 days overdue as practitioners are of the view that group loans that fall that far behind are never collected.
- 4) Requiring licensed MFIs to place a percentage of their deposits with BNR in the form of (interest-bearing) t-bills, thus creating an interest-bearing reserve requirement to strengthen their liquidity positions without hurting profitability.

¹⁶ Licenses should not be withdrawn from already licensed MFIs which do not meet this criteria, unless their financial condition is sufficiently serious to warrant such a step.

- 5) Reducing minor regulations that are not solvency-related giving due regard to international standards.
- 6) Designing improved simple reporting systems and forms for MFIs.
- 7) Eliminating monthly liquidity reports so that reporting is only required quarterly and enforcing these reporting requirements.

1.60 BNR plans to give high priority to increasing the number of MFI supervisors and deepening their skills through training.

1.61 Strengthen MFI policy and support. In recognition of its importance, Rwanda has recently finalized a national Microfinance Policy and plans to establish and operationalize a National Micro-finance Consultative Committee to provide overall guidance to the industry.

1.62 Rwanda also intends to establish a strong Microfinance Association with the ability to do capacity building in place of an existing association which many MFI stakeholders view as inadequate. In mid-2006, there were two different groups trying to establish such an association as well as the existing association. There is considerable criticism of the existing association from MFI practitioners and several of its officers and/or sponsors were officers of MFIs which were closed this past year. It is essential that Government and the MFIs, themselves, choose one that is considered the best qualified to represent the industry and give that association strong backing to unify the industry. Once such association is in place, the Authorities should assist them in exploring the feasibility and desirability of establishing an apex for MFIs and in preparing and publishing a comprehensive analysis of the MFI industry. Other tasks that the association, with support from the Consultative Committee and BNR, should address include:

- 1) Working with the Authorities to establish training programs and TA for MFI staff in good microfinance practices, management, accounting, MIS, etc.
- 2) Improving linkages and coordination between MFIs, commercial banks and UBPR.
- 3) Working with the MINELOC to catalyze more district and local government coordination with, and support for, MFIs.
- 4) Working with commercial banks (especially UBPR) to develop arrangements for MFIs to help large clients to graduate to the banking system through introductions and providing detailed credit history reports on demand.

1.63 UBPR should aggressively seek to develop linkages with MFIs to service MFI clients whose credit needs outgrow the ability of MFIs to lend. It should also create

strong linkages with SACCOs, even to the point of seeking to assimilate some of the smaller weaker ones, in a manner similar to that used when the 8 MFIs were closed last year, to enhance the stability of the industry.

1.64 A feasibility study, to be coordinated with BNR, for a mandatory stabilization fund for MFIs should be conducted. Such a fund might be operated by BNR or by the Microfinance Association if it becomes strong enough to operate as an apex and administer such a fund. It is likely that such a fund can only be feasible if fully licensed MFIs that meet sound financial condition and performance criteria are allowed to participate. If feasibility is ascertained, priority should be given to establishing a stabilization fund given the importance of MFIs in meeting Rwanda's access to financial services goals and the need to stabilize the industry and restore public confidence.

1.65 The MFI closures in mid-2006 temporarily undermined confidence in the industry in the short-run and created challenges for BNR which did not yet have fully established policies for dealing with a problematic set of issues of this type. Also, there was some delay in initiating a public relations program to explain the extent of exposure to losses for depositors.

1.66 Strengthen SACCO-related financial institution development. The supervision and regulation of deposit-taking SACCOs (also called Coopecs) is always a challenge given fundamental differences between credit cooperatives and other MFIs in terms of their governance and interface with regulatory authorities. Rwanda has already made considerable progress in coordinating the regulation and supervision of SACCOs. The authorities plan to strengthen this coordination further by:

- 1) Signing an MOU between MINICOM and BNR regarding MFI/SACCO regulation and supervision.
- 2) Reviewing the Draft Cooperative Law and resolving conflicts with the new Microfinance Law (SACCO-related clauses) and BNR SACCO instructions.
- 3) Placing a ceiling on UBPR individual cooperative maximum exposure risk¹⁷ to one credit risk equal to the lending ceiling for other MFIs which must be complied with whether or not the cooperative obtains co-financing from the central unit that it onlends at its own credit risk.

1.67 UBPR, once the central unit and larger cooperative units become de facto commercial banks, should, together with BRD, be Rwanda's most important channel for expanding agricultural credit and microfinance lending. High priority should be placed on assisting UBPR to design loan packages to better meet these needs while not incurring excessive risk.

¹⁷ At present, while individual UBPR cooperatives are subject to limits on how much they can lend from their own funds to one credit risk there is no limit on how much credit exposure they can take on one credit risk if they lend funds borrowed from the central unit as well as their own.

Chapter 2: Rwanda FSDP Action Plan for Capital Markets and Long-Term Finance

Overview

2.01 A capital market is a place where long term funds are raised through the issuance of securities. Long term is typically considered to be one year or longer. A capital market encompasses both debt and equity markets. At this time, Rwanda has neither.

2.02 Developing a capital market is crucial for Rwanda as it seeks to achieve ambitious development goals and raise the standard of living for its people. Rwanda's long term development plans are articulated in Vision 2020. A key strategic goal of the Vision 2020 plan is to make Rwanda an economic trade and communications hub in the heart of Africa. This will require significant investment in infrastructure in the form of roads, power, rail, airports and telecommunications. These plans also call for the active participation and expansion of the private sector in Rwanda's economy which will require long term investment in infrastructure and industry, which can only be provided through the mobilization of domestic savings through capital markets.

2.03 Providing affordable housing for Rwanda's burgeoning population is another high priority, in addition to long term funding needs of government and industry. There is currently little long term housing finance in Rwanda. The country's commercial banks are currently ill equipped to provide this long term housing finance as their funding sources remain short term and there are no mechanisms available to allow them to convert long-term mortgages into liquid resources when needed. In any event, housing loans advanced by commercial banks are estimated at less than two thousand over the prior 5 years in a nation of eight million. It is estimated that the demand in Kigali alone for housing is 100,000 new homes per year for the foreseeable future. A source of long term finance must be developed to meet this demand.

2.04 The development of capital markets and long term financing has certain prerequisites. Certainly macro-economic stability is paramount and fortunately the Government of Rwanda (GOR) has made great strides in this regard. Equally important, however, is a strong accounting and legal framework within which a market based financial system can develop. The financial framework within which capital markets will develop and prosper must engender trust and a strong measure of assurance among market participants. It is essential that participants who enter into the arms length transactions that characterize these markets know that these financial commitments will be honored. This system of trust requires that the financial information on which they base their investment decisions are compiled in accordance with accounting principles and practices that are transparent and verifiable. This system of trust also requires that

there be a body of law that sets the ground rules for these transactions and that the law will provide legal redress in the event these rules are not followed. Currently in Rwanda, the accounting and legal norms are not sufficiently developed to encourage or support the development of capital markets. The accounting and legal infrastructure must be developed to provide a sound foundation for a capital market before most of the actions recommended in this chapter can be effectively implemented.

2.05 Main issues. In general, we have attempted to identify weaknesses in the current financial sector that must be strengthened as well as distinct actions that will need to be taken to develop a market for medium and long term finance. A modern accounting and legal framework is a necessary, but not a sufficient condition for the creation of a capital market in Rwanda. Fortunately, the government is aware of many of the shortcomings in this area and among other things has appointed a Business Law Reform Committee to draft legislation that will address weaknesses in this area.

2.06 Until very recently, Rwandan commercial enterprises, unless directed by a regulator to do otherwise, operated under the Accounting Law of 19/78 that sets out accounting practices based on a Chart of Accounts (“Plan Comptable”). This rudimentary system of accounts was not based on double entry bookkeeping. Such a system of accounts was clearly incompatible with modern business practices and the GOR recognized this. A draft Accountants Bill has now been approved by the Business Law Reform Committee and submitted to the Parliament where it is now being considered. Once enacted, it will establish an Institute of Certified Public Accountants, which will train and self regulate a modern accounting profession in Rwanda.

2.07 The existing Companies Law is outdated and does not address in a comprehensive matter the formation of commercial enterprises today and the manner in which they can, among other things, raise capital in the market place. A new draft Companies Law is under review by the Commercial Law Reform Committee. This is a much more substantive law than the existing Companies Law and requires, among other things, the adoption of IAS (International Accounting Standards) by public and private companies. This draft law also addresses in a comprehensive way the procedures for Initial Public Offerings (IPOs), the content of prospectuses supporting IPOs, the rights and obligations of bondholders’ agents, the establishment of special purpose vehicles for collateralizing debentures, and other activities which are critical to developing a long term (LT) debt and equities market. The Action Plan contains refinements to some of this draft legislation, but overall commends the current efforts of the GOR to create a supportive and modern accounting and legal framework for a capital market.

2.08 In addition to creating a framework for capital markets, there are other actions that either build on current activities or are new initiatives. One key action that will build on the current activities of the BNR and will be critical to developing LT finance is extending the current yield curve beyond one year to provide reference points against which other medium and LT debt can be priced. The Central Bank currently conducts a weekly T-Bill auction for 3, 6, 9 and 12 months bills. The bids are all clustered around 10% per annum. Consequently, the current yield curve is flat and of short duration.

2.09 A flat yield curve generally indicates investors anticipate interest rates will neither rise nor fall, and because the very short yield curve provides little reference for LT debt pricing. It may also not be reflective of true short term market forces as a result of inadequate competition among bidders. In any event, a yield curve needs to extend significantly beyond one year to help issuers of LT debt price their paper. It will assist investors in making decisions regarding what represents a fair return on their LT investment in the Rwandan marketplace.

2.10 Yield curves extending 5 to 10 years or more will typically slope up or down depending to some extent on what is often called rational expectations. This theory is based on investors trying to equate current short term (ST) interest rates with what they can earn on longer term bonds. The theory of rational expectations argues that yield curves will slope upwards when investors believe future interest rates will be higher than current rates (which is normal if economic prospects look bright and money will be in greater demand). And in actual fact, if investors feel they can earn more by rolling over ST paper for a higher effective yield than purchasing LT paper, that is what many investors will do - until longer term interest rates become more attractive by rising. Yield curves turn down over time (called an “inverted yield curve”) if investors anticipate future interest rates will decline (which is typical when investors anticipate economic contraction and money is in less demand).

2.11 In any event, a yield curve almost always has to be developed first through the issuance and purchase of risk free sovereign Treasury bills and bonds. The investing community seeks a framework of short, medium and LT pricing based on a creditworthy issuer – typically a sovereign government – first, before other private sector issuers and investors in any volume will commit to issuing and investing in non-sovereign LT debt whether these T-bills and bonds are few in number or comprise a continuous spectrum of yields and maturity dates. In short, a yield curve provides a superstructure upon which debt can be priced and will assist greatly in developing a national capital market.

2.12 One proposed action that will assist in developing this yield curve involves the government’s current Frw 60 billion+ debt to the Caisse Sociale du Rwanda (CSR). Subject to negotiations between the Ministry of Finance and CSR, it is recommended that some portion of this debt, perhaps 20-40%, be met by the issuance of a serial bond at market rates with maturities of one to 10 or more years. The “securitization” or issuance of a substantial portion of this as debt securities will provide a supply of bonds that extends well beyond the government’s current 1 year Treasury bill. Its issuance will help develop a yield curve if the interest rates are market determined.

2.13 CSR is also the single largest repository of liquid assets in Rwanda, and as a pension fund, can be instrumental as an investor in LT instruments issued by other institutions. Insurance companies and, eventually, other private sector pension funds are also targeted in the Action Plan as future investors of LT debt securities.

2.14 While the concept of investors using rational expectations to develop a yield curve provides a good starting point, the theory must be tempered by the amount of securities offered for different maturities as well as the funding available to purchase those securities by pension funds and insurance companies. These institutions, because of their long-term liability structures, are less prone to invest short-term, as they find investing long-term attractive as a means to better match their liability structures and lock in a “guaranteed” longer-term return on a portion of their funds. These companies have contractual LT obligations to meet and if there are LT debt instruments in the market that meet these obligations, they are less likely to engage in ST purchases except for small sums. This is because these ST investments may not, in the end, meet their contractual interest obligations. The non-availability of LT debt securities is not good for pensions and insurance companies and not good for development of a LT debt market. The supply needs to be created to meet this demand.

2.15 The Rwandan Development Bank (BRD) is another institution that is anticipated to be an active participant in the development of capital markets in Rwanda. As a development bank, it has a mandate to assist in Rwanda’s economic development. Eventually, BRD would become an excellent candidate to issue of asset-backed bonds with recourse using performing loans as collateral.

2.16 Rwanda’s primary FSDP objectives as they relate to this situation and issues. The FSDP seeks to increase the current low national savings rate estimated at 3% of GDP. Interventions called for in the commercial banking section of the FSDP target will improve intermediation and deposit mobilization. Interventions in the pension and insurance industries will provide additional mechanisms for LT savings mobilization. Mobilizing these savings and directing them into LT debt and equity investment is the principal objective of the capital markets development initiatives included in this chapter.

2.17 The development of the debt market in Rwanda should take precedence over the equities market in light of the country’s current market situation and development needs. Lack of LT debt finance is preventing achievement of Rwanda’s development plans and is also constraining the development of a vibrant housing sector. The commercial banking system cannot fund this important infrastructure with its current short term funding structure nor can the private sector achieve its potential by relying only on bank overdrafts. The development of the accounting and legal framework, the involvement of government and private sector institutions as issuers and investors of debt instruments, and the implementation of certain market mechanisms will all be required to achieve the FSDP’s objectives of mobilizing domestic resources for LT finance.

2.18 Creating access to an equities market, whether in Rwanda or elsewhere in the region, will provide a means of mobilizing risk capital for Rwandan companies. Currently there is no developed mechanism for the issuance and placement of equities other than private placement.

2.19 Developing an Over the Counter (OTC) market mechanism that will assist companies in raising both debt and equity funds will be a key factor in developing these

markets. An OTC will also be critical in providing a mechanism for trading bonds and equities in a secondary market. Long-term financing will be much harder to accomplish in Rwanda without the ability for investors to exit LT debt and equity investments through a secondary market.

2.20 The Action Plan elements relating to these issues is presented in four sections, i.e., i) the bond and long term debt market; ii) long-term home mortgage finance; iii) other capital market-related elements; and iv) the equities market .

Strengthen Bond and Long-term Debt Markets

2.21 Principal actions that need to be taken to strengthen the bond and long-term debt market are as follows:

2.24 Extend the tenor of BNR (central bank) treasury bills. BNR issuance of T-Bills on behalf of the Ministry of Finance serves the obvious purpose of financing domestic budget deficits. T-Bills issued in excess of actual budget requirements also permit the BNR to manage money supply and interest rates. Extending the tenor of T-Bills beyond one year is an extremely useful first step in establishing a series of LT interest rates which, when plotted and connected, will form a yield curve. This yield curve then provides a basis against which other LT debt instruments can then be priced.

2.25 Without a government Treasury yield curve, there is no market basis for determining the cost of money in the near and distant future. This acts as a strong inhibitor to the issuance of, and investment in, all debt instruments. This T-Bill/Bond determined yield curve also represents a “risk free” cost of money as it is based on sovereign debt that is backed up by the full faith and credit of the government. As such, other debt instruments of similar maturity would typically be priced above this yield curve.

2.26 It is necessary to begin with planning a schedule of T-Bill and Bond issuances that offer investors these longer term debt instruments in order to address the problem of establishing a yield curve. As such, the Action Plan proposes implementing a 2-year rolling plan for T-Bill and Bond auctions. In conducting this planning, planners will not increase the overall amount of currently outstanding T-Bills (presently at Frw 47 billion) but will shift a substantial portion of the 4, 12, 26 and 52 week debt to 2, 3, 5 and, in the third year, 7 year T-Bonds. Over the longer term some 10 and even 15 year T-Bonds might be issued.

2.27 The value of T-Bills that could and should be shifted to longer term maturities should be about 90% of the T-Bills that fund national deficit budget financing. Even though longer term t-bonds should be laddered to ensure that some portion is always coming due within a short time period, about 10% should remain in the form of short-term t-bills to preserve flexibility and ensure enough cash is always available to meet

short-term requirements.¹⁸ National deficit financing currently represents approximately a third of all outstanding T-bills (representing about Rwf 15 billion). The balance represents T-Bills issued for monetary policy purposes and would not be shifted under the scheduling plans.

2.28 In other words, about Rwf 13.5 billion in ST T-bill debt will shift to longer term T-bonds. This should relieve the GOR from constantly rolling over all its T-bill outstandings on a ST basis. Simultaneously, this could put downward pressure on ST interest rates as the Central Bank can reject more ST bids while accepting longer term bids. This initiative of shifting maturities should also serve to lessen criticism leveled by commercial banks that the central bank is “crowding out” commercial banks in their efforts to attract low cost 3, 6, and 9-month deposits from their clients. The current flat yield curve yielding 10%, it is asserted, has the effect of denying cheap funds to banks by creating this 10% floor below which large investors will not deposit funds.

2.29 In the absence of a primary dealer arrangement under which certain financial intermediaries such as banks make a continual market in new Treasury issues, and in the absence of broker/dealers who receive a commission for placing this paper in Rwanda, there is no assured market for LT Treasury Bonds. As such, it may be useful to “prime the pump” with potential investors. Specifically, BNR should plan on bringing these new longer term issues and their scheduled auctions to the attention of CSR, the insurance companies and the larger banks¹⁹ to increase the likelihood that they will participate in the auctions.

2.30 Increase competition for T-bills/bonds. There may be a number of contributing causes for the current flat yield curve, but one very probable cause is lack of competition among bidders. Commercial banks in Rwanda are the largest group of bidders representing some 50% of bids. However, there are only 8 commercial banks in Rwanda and not all of them participate regularly in the auction. It is probable that with such a small group there is communication among the banks prior to submission of weekly bids regarding competitive bids. While this is rational behavior on the part of bidders, and happens in other countries as well, it would be less effective with a larger pool of bidders.

2.31 In order to widen the pool of bidders, the Action Plan calls for initially opening the auction for Treasuries to investors throughout the East African Community and, eventually, to other international investors as well. In order to do that, it would require liberalizing the existing foreign exchange controls. Article 26 of the existing Foreign Exchange Regulations limits the amount of funds that may be externalized to \$50,000. We are recommending that the amount that may be externalized be raised to at least \$250,000.

¹⁸ MINECOFIN should, at some point, prepare a debt management strategy and look at issues such as risk. However, that can be deferred for several years given that the amount of debt being managed is small relative to GDP and as there is no market that can be analyzed in terms of risk relative to cost considerations.

¹⁹ The banks, however, are not expected to be significant buyers of long-term T-Bonds.

2.32 In order to attract bids from throughout the EAC, it would be helpful to have an electronic platform that is used by financial intermediaries in East Africa. Reuters is used extensively by banks and other financial institutions in Kenya, in particular, and would provide a convenient platform for soliciting T-bill and bond bids outside Rwanda. Also, there is no reason to limit the bidding pool to banks and a few other large bidders. All bidders wishing to participate in the auction should be welcomed, but on a noncompetitive bid basis if they are not the large traditional participants.

2.33 Activate money market dealing. As is true in so many activities, one must walk before one can run. It is therefore very important that the financial sector immediately begin to develop experience in trading short term money market instruments as an introduction to dealing in LT instruments. To some extent this can occur simultaneously, but it will be extremely useful for banks in particular to develop interbank trading skills and knowledge gained through money market activities. The treasury management skills and techniques that come from banks dealing in ST money market instruments directly support the skills needed to be participants in a primary and secondary market of longer term debt and equity instruments.

2.34 As any banker can attest, banks are at the mercy of depositor withdrawals and deposits. They need the ability to quickly liquidate assets for cash if the need arises or vice versa. We are recommending that the central bank open up a discount window for T-bills and bonds where this paper can be discounted albeit at a penalty. Discounting shorter term paper would carry a higher penalty discount, as this is to be discouraged as it may destabilize short term monetary policies.

2.35 In fact, the use of the discount window at the central bank should only be considered if the T-bills/bonds cannot be discounted in the open market.²⁰ The increased use of repurchase agreements among banks is recommended to develop interbank trading. This activity will bring with it treasury management skills that will be very useful in developing the trading skills and expertise for dealing in longer term debt instruments.

2.36 Establish an Advisory Council to support an Over-the-Counter bond market. When developing any new sector of the economy, it is helpful to have an entity that can provide guidance and oversight for market participants. In Rwanda, this is particularly relevant, as it has no history of debt markets or resident skills to set this in motion. Such an entity can act as an advocate for the effort by establishing a vision, setting priorities, identifying obstacles, and generally laying the groundwork for developing the sector.

2.37 The Action Plan recommends establishment of a Capital Markets Advisory Council that will provide guidance and oversight for market participants. This Council should be established by Ministerial decree to provide it with a legal identity and a legal framework

²⁰ It is interesting to note that the Central Bank of Kenya, for instance, discourages commercial banks from using the CBK's discount window through not only a hefty discount, i.e., a penalty, but requiring that the commercial bank obtain from the local stock exchange a certificate attesting that the Treasury bond could not be sold on the exchange.

with established policies and procedures within which to operate and provide legal liability protection to its members.

2.38 The Council should have two purposes, i.e., i) acting as an advocate for developing the debt and equity market and providing guidance to the development of that market; and ii) developing draft legislation that will establish a permanent regulator for this market. Initially, the Advisory Council should quickly begin by preparing guidelines for the development of a Rwandan OTC debt market without waiting for regulations for a market that does not yet exist. These guidelines will, after vetting and possible modification over time, be incorporated into a Securities Law.

2.39 The mandate for the Advisory Council would be to provide the appropriate balance of vision and guidance to help develop a primary bond market. The Advisory Council role in developing an OTC market is described in more detail under the Equities Market section of this chapter. The Council can also play a useful role by defining the general parameters of conduct and behavior for market participants. This guidance need not be in the form of voluminous government regulations, but rather guidelines that permit innovation and spontaneity in a fledging market to enable it to grow.

2.40 The Council should be organized in the form of a Board of Directors with a Chairman. Meetings should be convened by the Chairman to take place at least monthly.

2.41 A small permanent secretariat should be created to provide day to day continuity. It should provide administrative support, do research, prepare papers for the Council's consideration, draft proposed guidelines, manage an OTC website, review financial intermediary registrations, and respond to investor and issuer questions. Initially, the Secretariat could be staffed by seconding BNR officials who have been involved in the FSDP capital markets work. However, it is recommended that they be supported by a resident advisor for the first two years of operation.

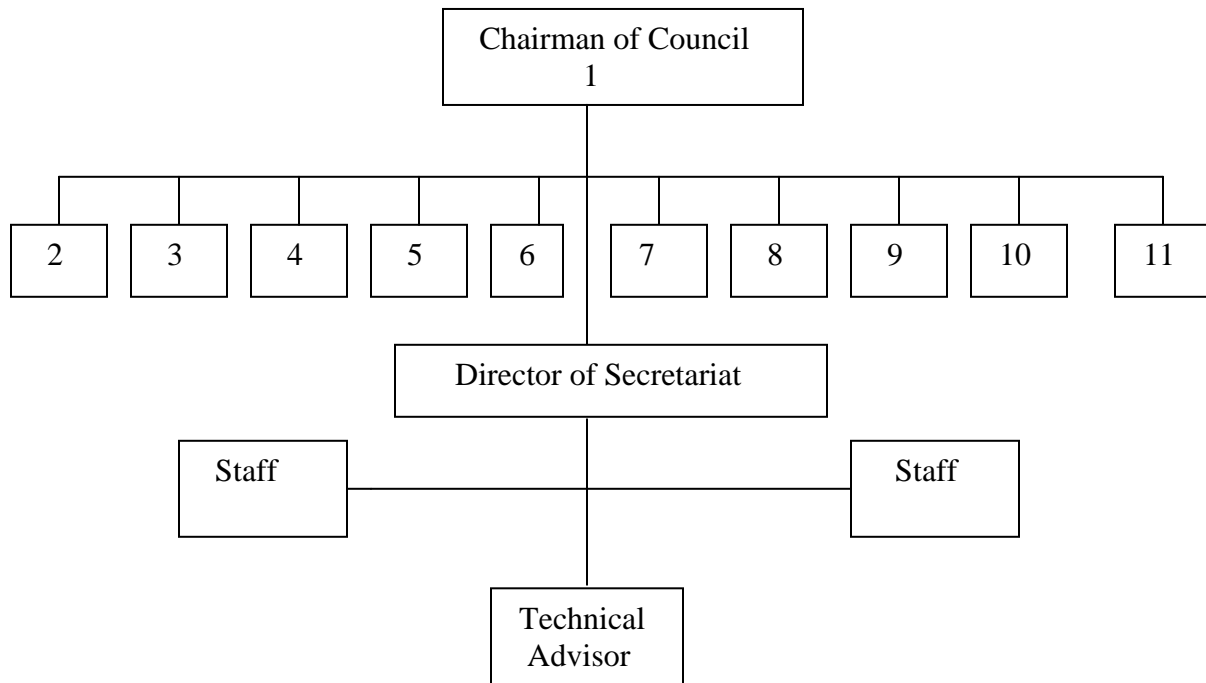
2.42 The most appropriate place to house the council would be the Private Sector Federation because the federation is i) dedicated to promoting the interests of the Rwandan business community and acts as a strong advocate of Rwanda's Vision 2020 goals; and ii) has ample room for a permanent secretariat and board rooms and is very willing to house the Council. However, the Council should be viewed as a public/private partnership as, while it will be overseeing private sector activity, it also represents public sector interests in overseeing an orderly and growing capital market and will, undoubtedly, at least initially need some funding from Government and/or its donors. However, it should not represent a serious financial burden on government.

2.43 It is proposed that this Advisory Council be representative of a cross section of all stakeholders – government and private sector – and act as an advocate for the market providing guidance and assistance in its development. Its membership should reflect professional stature, technical accomplishment and an interest in developing Rwanda's capital market. They should be leaders in the community and represent the key

stakeholders in this new market. It is recommended that membership consist of representatives from the following sectors and institutions:

- 1) Insurance sector
- 2) Commercial banking sector
- 3) Pension funds
- 4) Legal community
- 5) Accounting community
- 6) Corporate business sector
- 7) Small business sector
- 8) BNR
- 9) Other capital markets financial intermediaries (when they exist)
- 10) Ministry of Finance
- 11) Ministry of Commerce

2.44 The suggested organization of the Council is outlined below:



2.45 It should be noted that there will be some regulations that desirably circumscribe the activities of participants in a primary bond market in Rwanda. The draft Companies Law stipulates that only public companies, i.e., companies with more than 25 shareholders, may issue debt (and equity) offerings to the public. Furthermore, these offerings must be accompanied by prospectuses, which require substantial disclosure to

investors and must be filed with the Registrar General. Therefore, any attempt to issue new bonds without complying with these new regulations will run afoul of the draft Rwandese legislation.

2.46 Publish guidelines for issuance of commercial paper and bonds. One of the first contributions an Advisory Council can make to the development of a primary debt market in Rwanda is to set broad parameters for the issuance of debt instruments. The publication of these guidelines will provide the investment community with some criteria for which to judge the relative credit worthiness of new issues. In the absence of a credit rating agency, or the direct approval of a regulatory authority, there is a need for a standard that will provide investors a minimum level of creditworthiness and at the same time advise potential issuers as to their qualification to issue debt instruments.

2.47 The development of these standards should have the effect of stimulating dialogue within the investment community regarding development of a short and long term debt market. These guidelines might address the following criteria for potential issuers:

- profitability
- cash flow
- debt
- capital

2.48 The publication of a set of guidelines for the issuance of short term commercial paper and long terms bonds in Kenya, for example, in the mid-1990's was extremely effective in initiating the development of the fixed income market. Within 18 months of its publication, there were some 12 commercial paper issues and the East African Development Bank (EADB) had begun arranging its first bond issuance.

2.49 While the Kenyan Capital Market Authority had issued these guidelines (which incidentally were not strictly followed in subsequent approvals by the Authority as they were only guidelines) it is interesting to note that the guidelines themselves were a result of much discussion by largely private sector executives asked to participate in a series of ad hoc debt committee meetings sponsored by the Authority.

2.50 A draft set of guidelines has been prepared for the issuance of debt securities that would establish minimum financial standards for private debt issuance and can provide the basis for review and issuance by the Advisory Council. These guidelines cover incorporation, qualifications of issuers, financial performance requirements, guarantors, bank and insurance issuers, supporting documentation, reporting requirements and renewals.

2.51 One of the biggest inhibitors to developing a debt market in any country is the ability of investors (or even a regulatory authority) to accurately determine the creditworthiness of debt issues. This is why the establishment of a credit rating industry is important for debt markets to reach their potential. The international credit rating agencies, however, are expensive and reluctant to establish branches unless there is

sufficient business to support their establishment. They will, however, send missions for short term assignments although these, too, can be expensive. Whether Rwanda pursues development of a “home grown” credit rating industry (which may not be a viable solution because the market is small) or attracts international agencies, or some combination, it is important to realize that credit rating is the best long term solution for building and protecting a vibrant debt market. The Action Plan suggests that credit rating requirements be phased in shortly after 24 months have passed.

2.52 Draft a Capital Markets Authority Law. The Action Plan calls for drafting a Capital Markets Authority (CMA) Law at a later stage, as part of the basic financial infrastructure for a bond primary market, which will establish a regulatory authority to provide oversight and regulation of the new securities industry in Rwanda. It is proposed that the Capital Markets Authority be eventually established as an independent regulatory authority, reporting directly to the Ministry of Finance. Certain oversight authorities, for example those relating to the issuance of debt and equity securities to the public and currently assigned to the Registrar General under the draft Companies Act would be transferred to the CMA under this Act. The CMA Act would establish a Board of Directors that would be representative of stakeholders in the industry. The position and responsibilities of the Chief Executive Officer and other members of the management of the CMA would be delineated in the law.

2.53 Draft a Securities Law. The Action Plan then proposes the drafting and implementation of a Securities Law, also at a later stage, that, among other things, would provide for licensing of various types of financial intermediaries. It is not clear the extent to which the volume of transactions will support the permanent presence of resident capital market-oriented intermediaries. However, common classifications of financial intermediaries in East Africa include Investment Advisor, Broker, Dealer, Fund Manager, Investment Banks and Custodians. Investment Advisors typically advise on and manage segregated investment portfolios for clients. For their corporate clients, they may arrange and issue securities. Brokers are licensed to bring buyers and sellers of securities together for a commission, whereas dealers buy and sell securities from their own inventory of securities. Fund Managers advise on and manage collective investment schemes such as mutual funds, unit trusts, pension plans (including Employee Stock Ownership Schemes). Investment Banks typically will do all the above as well as provide specialized investment banking services such as merger and acquisition planning. Custodians provide custodial services for individual, corporate and other financial intermediaries. There are, of course, other potential financial intermediaries such as Venture Capital Companies, Credit Rating Companies, and Primary Dealers that typically establish themselves as the securities markets become more sophisticated. The Securities Law will also stipulate minimal financial and operational requirements for financial intermediaries operating in Rwanda. In the absence of a stock exchange to regulate, the Securities Law will stipulate certain operating rules for participation in an over-the-counter (OTC) market.

2.54 Enact draft Companies Law. As discussed above, the draft Companies Law is an important part of the basic governing framework for developing capital markets. The

draft legislation is quite comprehensive and the Action Plan endorses its enactment. The law clearly differentiates between incorporated companies as “small private” companies exempted from certain reporting requirements, private companies (with less than 25 shareholders) and public companies. Only public companies will be eligible to make public offerings of debt and/or equity to the public. The procedures for the preparation of a supporting prospectus are included in the law. Three additional amendments to the law are recommended.

2.55 First, the draft law does not include a provision whereby prospectuses may be prepared and lodged with the Registrar General but, instead, continues to support a number of issuances. Many companies, when raising debt finance, do not require all their funding at once. Shelf registering a prospectus permits companies to avoid the costly exercise of preparing new prospectuses for each new issuance as long as current financials are provided investors prior to each tranche. A shelf registered issuance typically remains current for up to 18 months. This provision should be included.

2.56 Second, under the draft act, both private and public companies are required to comply with IAS. The International Financial Reporting Standards (IFRS) build on the IAS and the Act should specifically mention these standards in conjunction with IAS. Neither the draft Companies law nor the draft Accountants Bill mentions a transitioning time period during which IAS/IFAS must be adopted. A time period for transitioning should be stipulated in one of the draft documents. Third, while corporate governance is addressed in the draft Companies Law, the subject requires review vis-à-vis up to date best practices.

2.57 Implement bond issuance program. As previously discussed, implementation should initially focus on government debt. The Government of Rwanda has certain outstanding financial liabilities to the CSR. These obligations on the part of the GOR can be securitized and provide a source of long term bonds which will add to the stock of bonds in the market place and fulfill the government’s obligation to repay this money.

2.58 The outstanding government obligation to CSR is in excess of Frw 60 Billion or about \$100 million. There have been discussions between the GOR and CSR regarding the repayment of this amount. We understand that CSR has agreed to be paid off over a period of years for this debt. The Action Plan proposes that a serial bond be issued for up to 20%-40% of the entire debt. The serial bond issuance would contain a series of bonds, the first of which would have a maturity of 1 year, the second a maturity of 2 years, and so on up to the final year of maturity. It is proposed that the bonds be priced using the government yield curve as a starting point and that the bonds be issued at par value. As the 1 year Treasury bill currently yields 10%, in the absence of any change prior to issuance, this would be the proposed coupon on the first one year bond. Bonds with longer maturities would carry higher coupons. This would create an immediate stock of bonds with maturities of up to perhaps 15 years. These government obligations would require the market to price them if CSR wished to sell them. This would assist in building a LT yield curve and provide the nascent bond market with LT sovereign debt that might be traded.

2.59 In addition to securitizing outstanding GOR debt in the form of bonds, the Action Plan identifies other possible debt issuances by government institutions that would raise fresh LT funding for these institutions as well as building the LT debt market. BRD has numerous investments in loans that could form the basis for one or more asset-backed bond. By placing some of these assets in an SPV (special purpose vehicle—see para 2.65), the development bank could effectively use these assets to collateralize a bond issuance to raise LT funding for other projects. Such a bond issue might be placed with CSR and other potential LT investors such as the life divisions of insurance companies that have LT funds available for investing in such instruments. These sorts of issuances while providing LT funding to government institutions would provide the market place with bonds that could be replicated by other public and private issuers.

2.60 In addition to debt issuances by government institutions at the national level, there are also LT financing needs and market development opportunities at the municipal level. In particular, the Mayor and Deputy Mayor of Gasabo District, Kigali, a municipal district encompassing the northern third of Kigali and 426,000 people expressed strong interest in issuing a municipal bond to finance one or more municipal development projects involving completion of a paved road network and a convention hall in their district. The municipality receives funding from several sources including local tax collection, central government funding, funds generated from a donor-supported development fund as well as various community projects generating funds. Municipal bonds are typically issued as General Obligation or Revenue Bonds. General Obligation bonds are repaid through the municipality's general fund whereas Revenue Bonds are repaid from a particular project, such as a sewer system. As municipal bonds have never been issued in Rwanda, the idea of combining the features of a General Obligation bond with a sinking fund that would periodically set aside predetermined sums of money in order to improve the creditworthiness of the bond was discussed. Whether this bond is pursued or not, the point is that municipal bonds can and should eventually be a source of LT funding for local government authorities and can be an important source of capital mobilization.

2.61 The Action Plan also calls for a private sector debt issuance program. The private sector will require increased credit and capital as economic activity expands. For short term debt finance, commercial paper can be an inexpensive option for some companies to raise debt finance. This market, however, will be limited to a few large well-established companies in Rwanda as it represents unsecured promissory notes for periods up to one year. For longer term debt financing, private sector companies should look to LT bond issuances as an option.

2.62 The commercial banking sector is currently not in a position to supply substantial LT finance as its short term deposit base makes it imprudent to do substantial long term lending which would create an undesirable mismatch in timing between short term deposit liabilities and long term loans. However, commercial banks are prime candidates to issue bonds as they provide a LT source of funding that could appropriately be lent out long-term.

2.63 Banks can issue general obligation bonds for which no specific assets collateralize the bond. Indeed, it is likely that the first bonds issued by the banks in Rwanda will be of this type because they are the simplest to prepare and easiest to understand and process. However, in order to improve the creditworthiness of such bonds, it is possible to collateralize such bonds with assets. Such asset-backed securities (ABS) involve various creative ways of raising finance.

2.64 Mortgage-backed bonds, with the mortgages offered with or without recourse,²¹ are one such security which should be developed as an option to help convince the banks that they do have an exit strategy available if they make mortgage loans with maturities of 10 to 15 years. An ABS is a general obligation bond as it remains a liability of the issuer and the mortgages remain on the books of the issuer. However, it is collateralized by an identified pool of mortgages. Like a normal bond, the mortgage-backed bond pays semi-annual or quarterly interest payments and a bullet payment of the principal at maturity. It differs from a straight general obligation bond only in the event of default. In the event of default, the bond trustee (or bondholders' agent) has the right to attach the collateral and sell it to satisfy bondholders' claims. Such collateralized pools are typically over-collateralized and reviewed at least quarterly to ensure bondholders are protected. Collateral is added when required. The over-collateralization protects bondholders in the event of individual mortgage defaults and/or a general rise in interest rates that would lower the principal value of the collateral.

2.65 Another asset-backed bond (ABS), the "pass through" bond, is probably too sophisticated to be adopted by Rwanda's market over the intermediate term. In this case, the assets are removed from the originator's balance sheet and placed in a trust or special purpose vehicle (SPV). Bond certificates are issued from the SPV to bondholders representing direct ownership in the pool of loans or mortgages. In the case of residential mortgages, monthly principal and interest is paid to the bondholders. These pass through bonds were made popular in the US when the Government National Mortgage Association (GNMA) packaged these mortgages and guaranteed the principal and interest payments. They are, however, subject to early principal repayment by the underlying mortgage holders, particularly when there is a general fall in prevailing interest rates and mortgage holders refinance their mortgages at lower rates.

2.66 A third type of asset-backed bond is a blend of the above two examples. This is called a "pay through" bond. This is a general obligation bond as the assets remain on the balance sheet of the issuer, but the cash flow from these mortgages is dedicated to servicing the bond. There are variations on these three general types of ABS. The draft Companies Law in Rwanda makes provision for the pledging of such assets and the registration of this charge with the Registrar General. However, the concept of

²¹ Mortgages sold or transferred "with recourse" means that the credit risk associated with the individual underlying mortgages continues to be with the lending bank, not the purchaser of the bonds. In such cases, the lending bank has the responsibility to replace mortgages or loans that have become nonperforming with good loans of equal value. Mortgage bonds with recourse will probably be the only form relevant in Rwanda over the intermediate term.

segregating assets into “trusts” or SPVs so that these assets are out of the reach of the originators creditors eventually needs to be developed in Rwanda. A law similar to Kenya’s recently drafted Asset-Backed Securities Regulations needs to be drafted to encourage development of ABS.

2.67 The Action Plan proposes that one or more private banks issue such a mortgage backed bond as a means of replacing bank mortgages with fresh funding to permit the bank to continue providing LT housing finance. At a practical level, for an issue of this type, a financial intermediary will need to be engaged to prepare the Initial Public Offering (IPO) or private offering if it is to be small, and place the bond with investors. It is anticipated that other banks seeking similar LT funding for housing finance will replicate this process and permanently introduce this mechanism into the Rwandan financial sector.

2.68 In working with private sector issuers, it would be appropriate to sponsor one or more seminars regarding the mechanics behind bond issuance. One seminar might target company CFOs, corporate controllers and treasurers to explain the advantages of issuing corporate bonds. Another seminar could target financial intermediaries and particularly banks as the likely arrangers and placement agents for these bonds. Primers and other educational materials illustrating the mechanics involved in each step of issuing a bond could be prepared and distributed to participants. This sort of familiarization program would go a long way toward demystifying bond issuance and hopefully generate interest and enthusiasm in developing this market for LT debt.

2.69 The IFC and USAID, among others in the donor community, have developed guarantee programs to promote private sector development. These programs are intended to help ensure that new bond issues are successfully placed in the market with the objective that such bonds will be replicated in the future without the need for guarantees. These guarantees enhance the creditworthiness of bonds making them more attractive to first time bond investors. In fact, since a USAID guarantee represents a sovereign country guarantee, such debt is often risk rated lower than paper without such a guarantee creating a more attractive investment for banks and other credit institutions. For example, a 50% USAID guarantee in some countries has resulted in such paper being 50% risk rated for capital adequacy purposes.²² Typically, these guarantees are only applicable for bonds issued by private sector entities or quasi-government entities. They are usually not meant to guarantee other government debt issues. In the case of USAID bond guarantees, the guarantee maximum is 50% of the principal value.

2.70 As with most guarantee programs, these guarantees normally carry an origination (or commitment) fee and a utilization fees based upon the amount of the bond outstanding. These fees are negotiable, but a typical origination fee may be 1% of the bond value and the utilization fee may represent another 1% or so per annum of the outstanding guaranteed principal. As such, the cost of guarantees is not insubstantial and

²² The impact of changes in risk weighting are, of course, only relevant for banks and other financial institutions that are subject to capital requirements based on risk-weighted assets. Such institutions are not, at this juncture, expected to be significant buyers of long-term bonds of this type.

does raise the overall cost to the issuer although they can reduce interest paid on the issue to the extent that they reduce risk. Therefore, they have a place in the new issue market and can be very helpful in bringing credibility and a level of confidence to these new issues.

Strengthen Long-term Home Mortgage Finance

2.71 Developing LT housing finance requires that homeowners and financial institutions clearly understand their respective obligations and that the rules prescribing their behavior be fair and reasonable. It implies that homeowners should have the means to expeditiously and inexpensively obtain clear title to purchased property. It also implies that property owners should be able to pledge these titles to financial institutions to obtain mortgage finance. Financial institutions, for their part, should be able to register these pledges and protect their investment through an expeditious foreclosure procedure in the event of borrower default.

2.72 Address current obstacles to titling and financing. In July 2005, Rwanda revised its Land Law that in order to decentralize the delivery of titles and simultaneously eliminate the backlog in the delivery of titles. Unfortunately, implementation of this decentralized system of title issuance had not yet been effected as of August 2006 and in fact no new property titles had then been issued in Kigali since January 2006. We understand, however, that the necessary personnel appointments and Gazetting will be forthcoming soon.

2.73 There are several obstacles associated with administrative procedures that a new property owner must undertake to obtain title which make it unnecessarily burdensome. One significant obstacle to developing the mortgage market is the cost of transferring title on the land registry from one owner to another. The transfer cost is an excessive 6% of the property value which represents far more than the true cost of transferring title. Such a high fee clearly discourages official transfer of title and hinders the development of a vibrant and transparent land market.

2.74 Financial lenders also incur significant costs that hinder mortgage lending. The cost to register a mortgage is currently 2.25% of 130% of the loan value, i.e., 2.925%. This very large and apparently arbitrary fee for a simple registration affects bank behavior as lenders often postpone registration and instead monitor the account. If the account shows any sign of arrears, they will quickly register the mortgage in order to protect themselves in case of a possible default. This is not the basis for a sound mortgage financial market. In total, the transfer fee, the mortgage registration fee, the lenders application fees, the legal fees, appraisal fees, etc. total more than 10% of the purchase price. This is a very real obstacle to land markets and mortgage finance and the 6% registration fee at a minimum ought to be reduced to 1% or less.

2.75 In Rwanda, title is issued on undeveloped land only when construction is completed. This situation creates difficulties in financing new construction since title is

not issued and a mortgage on that title cannot be registered until construction is finished. The procedure is as follows. The municipality establishes a schedule for the land parcels to be fenced and the foundation poured. There is a date to start the construction and a time limit to finish it. Normally, the municipality will perform regular inspections during construction. The permitted time given to individuals is 3 years to complete the construction with 2 possible extensions of one year each. We understand the title process to be as follows:

- 1) Request made for a Cadastral Survey at the District Level and submission of plans and payment of a small tax.
- 2) A leasehold agreement is signed.
- 3) A building permit is issued.
- 4) An occupation permit is delivered.
- 5) After construction is completed; the Registrar will issue a title.

2.76 Lenders interviewed believe that the delivery of a building permit should be sufficient to establish that the applicant has serious intention to build his home and not speculate on the land, which presumably, is the reason behind the current procedure. The proposed modification to issue title prior to finishing construction would have the huge advantage of enabling people to build their home with prearranged financing. This modification, however, may not be accepted easily. There is a strong history in Rwanda of state control over all land. Article 3 of the Land Law stipulates that “Land is part of the public domain ... the state has supreme powers to manage all national land ... and, it is the state that guarantees the right to own and use the land”.

2.77 Officials will need to be convinced that it will help facilitate housing finance and not land speculation in order for this modification to be approved. All lenders interviewed, however, saw this issue as a priority and an obstacle to the financing of new construction in Rwanda.

2.78 The new Land Law (Clauses 35 to 38) requires all family members, including minors, to agree in writing to a lease, sale or mortgage of property. We believe that this clause creates undue delays particularly in light of the fact that signatures have to be executed in front of an appropriate authorized officer (Registrar or State Officer).

2.79 Most people interviewed were of the opinion that to reduce the required signatures to husband and wife, except in the case where there are more than two borrowers, would be preferred. Each spouse should have protection under the law and in practice both husband and wife are normally part of real estate transactions and c-borrowers in most instances.

2.80 Mortgage financing. There is little housing finance in Rwanda today. While the number of residential mortgages has increased slightly over time, Rwanda’s financial sector has advanced fewer than 2000 residential mortgages over the past 5 years, as shown in Table 6:

Table 6: Residential Mortgages Made by Banks 2001-2006 /1

Year	BCR	BK	FINA	BCDI	Bancor	COGE	UPBR	BRD	BHR	Total
2001	12	120	29	34	7	41		2		245
2002	6	65	21	36	18	25	1			172
2003	59	87	23	55	10	19		4		257
2004	7	156	21	71	10	22	15	9	89	400
2005	112	196	13	56	10	29	28	16	105	565
2006	44	125	11	2	12	11	7	2	40	254
Total	240	749	118	254	67	147	51	33	234	1893

1/ BNR records thru July 2006 (BHR figures exclude special funded civil servant mortgage loans)

2.81 Housing demand in Kigali alone has been estimated by the housing bank (BHR) in excess of 100,000 units per annum. In a country of 9 million people, it is evident that the few mortgages being advanced today are seriously inadequate to satisfy the housing demand for Rwanda.

2.82 Direct and indirect interventions that can be made to increase bank lending for housing. To the extent that commercial banks feel they can lend longer term, especially for mortgage loans, they should be encouraged to do so. The BNR should assist this effort by reducing the risk weighting for capital adequacy purposes of mortgage loans from the current 100% to 75%. This would reflect the fact that mortgage loans are inherently more secure than many other types of secured and unsecured loans because a foreclosed home usually retains much of its value. The BNR will be joining a growing number of central banks that have similarly lowered the risk weighting of these loans based on their special status and in accordance with Basel II recommendations.

2.83 Commercial banks and the BHR (see para 1.37) should actively solicit future home-buyers through home ownership long-term savings plans. These plans should provide a structured approach for future homeowners to accumulate the 25-30% down payment currently required by most banks to purchase a home over time.

2.84 While, some insurance companies like Sonarwa have a savings plan, they are not specific to housing. Homeownership Savings Plans take many forms and are used in many countries to encourage home ownership. The following features should be considered for incorporation into such a plan:

- 1) Plan should not be compulsory.
- 2) It should be a registered plan under which the depositor can only withdraw money from the account without incurring significant penalties to buy a new or existing home.

- 3) Contributions and accrued interest on those contributions should only be used for the purpose of buying a first home and both should be tax deductible.
- 4) If the savings are used by the plan holder for purposes other than purchasing a qualifying home, the tax benefits plus interest should have to be reimbursed to the tax authority.

2.85 The maximum annual contribution should be limited in amount and to a certain number of years. (As such, the cost of this initiative to the GOR can easily be estimated using the average anticipated number of years of contribution, marginal income tax rate and an assumed number of probable contributors). There would be very positive benefits if there was widespread adoption of a program of this type by the commercial banks as it would:

- increase the low savings rate in the country
- help build a down payment more rapidly considering the tax benefit
- help moderate income groups to access home ownership
- stimulate the real estate market with a group of new potential buyers,
- help create a longer term investment mentality for a number of citizens
- increase lenders' supply of medium term funds

2.86 Develop the investor base for mortgage-backed products. In addition to working with banks in Rwanda to increase mortgage finance, a market must be developed for replacing the mortgage loans on the books of banks with fresh LT capital. This recycling of mortgage money through mortgage-backed bonds and other LT bond issuances requires laying the groundwork for placement of these instruments with appropriate investors. The life insurance industry and pension plan are prime candidates to invest in mortgage-backed bonds, given the long term nature of their liabilities.

2.87 There are several categories of real estate investment, some of which are more appropriate than others for pension funds and insurance companies. For example, there is:

1) Real estate development: This is high risk/high return investment in most countries. In Rwanda today, CSR, BHR and the major insurance companies are currently active in this area. Because of the current extreme shortage of housing in Kigali, risk is not perceived to be high by local players but the local real estate market can change quickly and this is not the type of investment normally encouraged by insurance or bank regulators.

2) Commercial real estate: This market is prone to extreme swings in most countries because of the risk of over supply during economic recession. There is much construction going on at the present time in Rwanda. Such investments should be viewed as high risk and the extent of this type of real estate investment by any one institution needs to be limited.

3) Completed and fully leased rental projects: These sorts of investments can be properly analyzed and are less risky than the above categories.

4) Residential owner occupied mortgage loans: Whether in the form of direct lending or investment in mortgage-backed instruments, this type of investment properly underwritten, represents the least risky real estate investment and an appropriate investment category for insurance companies and pensions. They offer high yields and generate steady LT cash flow.

2.88 While not appropriate for short term investors, real estate investment will typically yield more than ST investments and carry lower risk in light of their supporting collateral. As such, regulators need to amend existing regulations governing non-bank financial institutions with a view to encouraging these sorts of investments. Insurance and pension regulations in particular should be revised to include mortgage-backed securities as admitted assets.

Strengthen Other Capital Market-Related Elements

2.89 Strengthen accounting and auditing. Strengthening Rwanda's accounting and auditing and ensuring that international standards are adopted are an absolutely essential foundation to building a capital market and needs to be undertaken urgently. As noted above, many Rwandan commercial enterprises are still operating under an antiquated accounting system. The draft Accountants Bill being considered by the Parliament is good legislation and should be adopted. Among other things, it provides for the establishment of an Institute of CPAs (RICA) and the adoption of IAS/IFRS accounting standards as national standards. It provides for the training of accountants in modern accounting practices. In addition to its adoption, the Action Plan is proposing that the accounting standards as laid out in the Accountants Bill be adopted over a 24 month transition period by financial institutions and large corporations.²³ Without an agreed transitioning period, there will be uncertainty among industry participants regarding the implementation timing of new accounting and auditing procedures. As there are currently only an estimated 25 or so fully qualified CPAs resident in Rwanda today, the Action Plan is proposing that technical assistance for training a substantial cadre of qualified accountants be sought. The School of Finance and Banking should strengthen its accounting curriculum. In conjunction with the implementation of a modern double entry accrual accounting system, it is recommended that the tax law be amended to permit corporate tax returns to be submitted in accordance with IAS/IFRS standards.

2.90 Draft secured lending law to assist and provide ST and LT credit to SMEs. The Action Plan calls for enacting a secured lending law soon. We understand that the Commercial Law Reform Cell is currently reviewing a draft bill on this subject so this is an action that the GOR is considering. A secured lending law can play an important role

²³ Smaller companies should be encouraged to abandon the present antiquated chart of accounts but should not be required to adopt international accounting standards if they are not needed to conduct business or meet credit needs.

in increasing credit and capital in the Rwandan economy, particularly to smaller businesses. Some small and medium sized enterprises (SMEs) do not have credit histories and, therefore, have little access to bank credit.²⁴ However, they may have assets that could be pledged. Utilizing these assets opens new funding sources for formal and informal players in the business community and can provide SMEs the financial resources they need to start and operate their businesses. Such a law is also likely to encourage an increase in consumer retail finance.

2.91 A movables registry should also be established where assets of all kinds - vehicles, equipment, securities, and even agricultural assets like cattle - can be registered and pledged to a lending institution which advance credit against these pledged assets would open new sources of funding for commercial entities. Moreover, banks and other credit institutions will find that a single movables registry can be used to register and verify pledged assets of borrowers and thereby protect their investment in these commercial enterprises that were formerly not bankable.

2.92 Adopt a leasing law. The Action Plan also calls for adopting a leasing law that will encourage the establishment and development of leasing, which can play an important role in providing medium and long-term finance. A leasing law is under consideration and we understand that the IFC is currently providing technical assistance in Rwanda on leasing and its uses.

2.93 Leasing, of course, provides enterprises with the option of entering into an agreement to use equipment for a stipulated fee rather than purchasing the equipment outright. In addition to releasing cash for other purposes, it permits the lessee a level of flexibility in terms of exchange and return that is not available to the purchaser. The lessor can develop a level of expertise with respect to certain equipment that would not be attained by a single purchaser and can sometimes exercise a more effective claim in the event of default. The leasing law that is finally adopted should provide appropriate tax benefits that are traditional for this industry for both parties to the leasing transaction as this is necessary to firmly establish this industry as another source of long and short term credit for business and industry.

Strengthen the Equities Market

2.94 An equities market plays an important role in the mobilization and allocation of LT risk capital. It is a market place, whether real or virtual, in which companies can raise equity capital and buyers and sellers can trade their ownership interests in companies. Currently, this market in Rwanda is not developed.

2.95 In developing the equities market in Rwanda, an excellent starting point would be to utilize the same framework and mechanism proposed above to develop Rwanda's LT debt market after launch of the debt market is well underway. The draft Accountants Bill

²⁴ Of course SMEs often face the reverse situation, i.e., they have credit histories, often with MFIs, but do not have adequate collateral to support bank credit.

prescribes the accounting standards to be used by commercial entities. The Companies Law defines and prescribes the permissible activities of private and public companies in raising capital. The role of a Capital Markets Advisory Council to provide advocacy and guidance for the development of the debt market can and should be expanded to assist the development of an equities market. Later, the drafting and implementation of a CMA Act and Securities Law will provide the regulatory framework for the industry.

2.96 The Action Plan proposes that the Advisory Council's role be expanded to include playing a leading role in developing an over-the-counter (OTC) market in equity shares. The term OTC has changed meaning over the years. It used to mean any trading system that did not have a trading floor. Today, however, it refers to stocks that are not listed on a major exchange, such as the Nairobi Stock Exchange or the NASDAQ (National Association of Securities Dealers Automated Quotation system) in the US. In the U.S. today, the OTC market refers to typically small and micro cap stocks that trade on the "pink sheets" which refers to the color of paper on which these stocks are quoted.

2.97 The Advisory Council, in its lead role, should seek broad participation in drafting guidelines that will direct the activities of stakeholders in this stock market. The Council's activities should be inclusive and seek to adopt rational and sensible guidelines that promote the industry. In particular, all financial intermediaries seeking to participate in trading securities with the public should be strongly encouraged to agree to guidelines adopted by the Advisory Council. As the Council is not a permanent regulatory body, its role is to issue basic guidelines, but not mandatory regulations, for development of the capital market. Therefore, its influence will come from the services and usefulness it provides to its stakeholders. Whether all financial intermediaries become members of the Council or simply agree to abide by its guidelines is not important. What is important is that the Advisory Council plays a leading role and that financial intermediaries see their involvement with the Council as to their own advantage.

2.98 One of the most important services the Advisory Council can provide is developing the OTC market as a facility for collecting quotations and making available up-to-date last- trade and volume data. This trade reporting facility would provide the basis for an effective OTC market.

2.99 Establish framework for quotation and trading of OTC stocks in Rwanda. The Action Plan calls for the Advisory Council to obtain from all financial intermediaries bid and offer quotations and actual historical trade prices and volume on OTC securities. It should enter this data into an OTC website made available to brokers and dealers and the investing public. This trade data should also be provided to the press for publication on at least a weekly basis. It is critical that this trade information be made available to the public quickly so that investment decisions can be based on current prices.

2.100 The Advisory Council is in an excellent position to provide this service as it is a neutral party and would be providing a vital service to all future brokers, dealers or market makers. In the US, for example, this very important function of providing brokers with bid and offer quotations and historical trade data on OTC securities is provided

through the Pink Sheets (for equities) and the Yellow Sheets (for bonds). The service is provided by a “for profit” organization called Pink Sheets LLC. This company was started in 1904 and was originally called the National Quotation Bureau. It collected and disseminated trade data on securities that were not listed on a securities exchange. Equity prices were printed on pink paper and bond prices on yellow paper. Over the years, the company updated its reporting facilities to internet quotation services. In 1999, it changed its name to Pink Sheets LLC and introduced an automated real time quotation system on the Internet. The Pink Sheets today provides quotations for some 4700 companies in the US trading over \$50 billion a year. In many respects, this key service was similar to the quotation system provided by the National Association of Securities Dealers though its NASDAQ (National Association of Security Dealers Automated Quotation) system.

2.101 It is felt that that the Advisory Council can and should provide this very basic quotation service to the young OTC market. In doing so, it will be providing a reporting platform that will be mutually beneficial to all future financial intermediaries in Rwanda.

2.102 Establish Guidelines and rules. In any market place, it is important that all market participants abide by the same rules. The Advisory Council, in providing support for a quotation system, is in an excellent position to obtain agreement from financial intermediaries to abide by its guidelines. This should constitute agreement on operating rules whether the Council seeks agreement from its stakeholders or seeks their membership in the Council. In return for abiding by the guidelines laid out by the Council, all financial intermediaries will benefit by “knowing the rules of the game”. These rules can and should be eventually codified into the proposed Securities Law.

2.103 In addition to utilizing the OTC quotation system, the Action Plan also calls for the Advisory Council to issue some additional basic guidelines for financial intermediaries operating in the OTC market. It should publish guidelines which stipulate that financial intermediaries will only trade in shares and debt issues that are “sponsored” by a Rwandan financial intermediary. Furthermore, in order to be “sponsored” by a Rwandan financial intermediary, the financial intermediary must confirm in a written testimonial to be lodged with the Registrar General (and eventually the CMA when that regulator is established) that the company to be quoted is current in its reporting requirements under the Companies Act. This will mean that companies with outstanding share or debt issues that subsequently fall out of compliance with reporting requirements may still be traded.

2.104 Another basic Advisory Council guideline that financial intermediaries should be required to comply with is that any trading on behalf of individuals, as opposed to legal entities, must have the individual sign a statement attesting to the fact that there is substantial risk in investing in an OTC market and that he/she is aware of this risk. In recognition of the lightly regulated nature of OTC markets, this provides a level of assurance to reduce the risk that individuals will be misled by financial intermediaries.

2.105 Financial intermediaries should be free to act as brokers, dealers or even market makers when dealing in shares or debt instruments in the Rwandan OTC market subject to implementation of three basic rules, i.e., i) utilization of a common quotation website; ii) eligible sponsorship of quoted shares/bonds; and iii) acknowledgement of certain risks by individual investors. Note, however, that according to the draft Companies Law under review in Rwanda, only public companies may make Initial Public Offerings of debt or equities. An OTC market can trade shares in a private company if it is “sponsored” but the number of shareholders in such private companies cannot exceed 25. Therefore these shares cannot be offered to the public at large. Exceeding that threshold would make it a public offering and illegal under the draft Companies Law.

2.106 Other guidance for developing the equities market. The Advisory Council should also issue occasional papers that provide overall guidance in developing the market. For example, it should provide guidance to stakeholders on the general parameters for financial intermediaries’ activities. The distinction between investment banking, in a situation where a financial intermediary seeks to raise capital on behalf of an issuer, and a securities broker who seeks to bring buyers and sellers of securities together will require different expertise and organization. Guidelines providing minimal suggested funding requirements for different categories of financial intermediaries would also be helpful in the establishment of new financial intermediaries. The Advisory Council should also encourage the early and continuing participation of foreign financial intermediaries and sophisticated nonresidents in Rwanda as a way of attracting and transferring skills and experience to this new market.

2.107 Over time, it is anticipated that some companies traded on the OTC market will clearly exhibit financial performance attributes that distinguish them from other traded companies which is likely to entitle these companies to graduate to a higher quotation status. The Action Plan suggests that the Advisory Council establish eligibility criteria, such as being profitable in 2 of the prior 3 years, continuing to be IAS/IFRS compliant, and having more than 100 shareholders such that the status of companies that meet these criteria could be indicated by letters appended to their names on the OTC website or given some other designation to show their special status. This higher level of performance, when recognized, would presumably reward these shares with improved trading results on the OTC market, e.g., higher volumes, lower buy-sell spreads, and quicker execution of trades.

2.108 Encourage Rwandan company listing on Nairobi Stock Exchange. An OTC securities market in Rwanda will not initially have the activity and liquidity of mature securities markets. Experience in Uganda, Tanzania and Malawi where stock markets with fairly elaborate infrastructure have not resulted in much capital market activity bears this out. Stock markets must be developed over time and Rwanda’s securities market will be no different.

2.109 While it is recognized that most companies in Rwanda are still small and would not meet the listing requirements of regional stock exchanges, access to equity capital for larger Rwandan companies in at least one other exchange should be encouraged. For

these more established companies, we are recommending that their shares be listed on an established securities exchange such as the Nairobi Stock Exchange (NSE). It is hoped that new financial intermediaries resident in Rwanda will establish relationships with their counterparts in Nairobi, and possibly Kampala and elsewhere. This listing of shares of established Rwandan companies on the NSE will not only promote the transfer of skills, but also provide access to a large and established capital market. The procedures for listing and trading of Rwandan securities on the NSE can be documented and publicized by the Advisory Council to encourage this practice.

2.110 Harmonizing with East African Community (EAC) laws and regulations. At a practical level, Rwanda must adopt standards and norms that first and foremost suit its current needs at the national level. Over time, however, it is anticipated that as markets develop and the economy grows, Rwanda will be able to move broadly towards more internationally recognized standards and norms, especially those prevailing or soon to be prevailing in the EAC, to which it has recently become a member.

2.111 Regional integration with the EAC is also one of the six pillars of Rwanda's 2020 Vision. As such, EAC harmonization must be a priority. While integration into the EAC will cover a host of trade and economic issues, the Action Plan focuses on harmonization within the banking, insurance, pension, and securities sector. It proposes that harmonization committees be formed within the regulatory bodies of these sectors. These committees, in turn, should be charged with drafting Memorandums of Understanding between themselves and their counterparts in Kenya, Uganda and/or Tanzania and/or Burundi. These MOUs should try to agree on timetables for harmonizing key regulatory standards.

2.112 As accounting is a common medium for so many regulatory issues, these MOUs between regulators should initially seek agreement at the accounting level. Overall, an agreement and timetable for convergence toward adoption of IAS/IFAS accounting standards will greatly assist harmonization efforts among all these sectors. This common IAS/IFRS target should provide a basis for comparison and measurement of progress. It will eventually result in allowing comparison of companies' financial performance and aid their compliance with EAC regulatory standards and norms. It should largely eliminate the need for reconciliation or reconstruction of financial reports. Auditing and disclosure standards will be similar and should increase the level of credibility across national boundaries.

2.113 An MOU particular to the securities industry would be very helpful in integrating the capital markets of Rwanda into the wider EAC security markets. Identification of regulatory anomalies would provide a basis for discussion and resolution. The eventual goal of providing a seamless regulatory environment would encourage investors throughout the EAC to invest in Rwandan companies.

2.114 An effort to harmonize the legal codes regulating commerce and industry as well as securities transactions is an ambitious goal, but it must be done. A committee to review inconsistencies between Rwanda and EAC contract law, liability law, etc. would

go a long way toward bringing differences to the table for discussion and resolution. Without an effort at providing a unified legal code, there will continue to be major areas of departure between Rwandan companies and their EAC counterparts. These are likely to generate uncertainty and reluctance, not to speak of disputes, on the part of players and impede progress. A legal review committee, perhaps similar to the current Commercial Law Reform Committee working to implement financial sector reform in Rwanda, could undertake this important task. Over time it will pay benefits in terms of economic integration and prosperity for all.

Chapter 3: Rwanda FSDP Action Plan for the Pension and Insurance Sectors

Overview of the Pensions and Insurance Sectors

3.01 Rwanda has one national pension fund, the Caisse Sociale du Rwanda (CSR), which is the largest financial institution in the country and has been operating virtually autonomously with little regulatory or supervisory oversight. The insurance industry consists of only 4 companies and has, until recently, nominally been supervised by the National Insurance Commission (NIC) which has been relatively ineffective due to an inadequate legal and regulatory framework and to formidable technical capacity and financial constraints. There are, at present, no other pension funds or nonbank financial institutions (NBFIs) in Rwanda and, hence, no structure for regulating or supervising them. The Cabinet has responded to this situation by approving a policy that places regulatory and supervisory responsibility under BNR, the central bank, for CSR and the pension industry, the insurance industry, and other NBFIs which may be established in Rwanda. BNR, in turn, has recently established a NBFI supervision unit and is in the process of staffing it and establishing standard operating policies and procedures, a challenging process in an area in which they have no direct previous experience, and for which they will need substantial technical assistance. The detailed action plan associated with the policies recently approved by Cabinet for these sectors is presented in Annex 1.

3.02 Main issues. By and large, the FSDP Action Plan focuses on the issue of prudent supervision of financial institutions, prudent management of financial institutions, and overarching public policy decisions that can drive the development of the financial sector in Rwanda. The discussion of the contractual savings elements of the Action Plan are organized as follows:

- Rwanda's primary FSDP objectives as they relate to the subject of contractual savings through non-bank financial institutions (NBFIs).
- Threshold public policy issues.
- Pension industry regulation and supervision.
- CSR organization and management.
- CSR investments.
- Insurance industry regulation and supervision.
- Insurance industry development.

3.03 Rwanda's primary objectives for NBFIs. There are two broad themes underpinning Rwanda's action plan for development of the NBFI sector; i.e. promoting savings and building supervisory capacity:

1) Promoting savings: Rwanda is determined to increase the savings rate by offering additional vehicles to promote savings and by taking steps to create more incentive for savings in order to promote formation of capital and to provide investable funds for economic development in the economy. An increased private savings rate, by adding

additional funds to the economic system, can enhance liquidity and, just as importantly, create jobs through creation or revitalizing of NBFIs.

2) Building supervisory capacity: At the present time, there is no comprehensive insurance code, no standard form for financial statements, no accounting standards for insurers, and no investment standards or risk-exposure standards for investments and underwriting. In short, there is neither risk-based nor compliance-based supervision and regulation in the insurance sector. Also, it is apparent that CSR has suffered from a lack of prudential oversight.

3.04 Threshold public policy issues. Four major public policy issues need to be addressed by the Government of Rwanda in order to implement the Action Plan. These issues are discussed below:

3.05 Consolidated supervision of insurance, private pension funds and other NBFIs in BNR: In a country with limited regulatory resources, it makes sense to combine supervisory responsibilities for the financial sector in one venue – thus taking advantage of economies of scale and allowing regulators from the banking sector and the NBFIs sector to cooperate and leverage resources.

3.06 Indeed, if adequate numbers of technically proficient staff were available, the organizational structure for supervision would not be that important. However, in emerging markets with limited availability of regulatory talent, it is more efficient to leverage that talent within a structure that has an already developed institutional culture for supervising financial institutions. The Central Bank of Rwanda (BNR) has that institutional culture.

3.07 There is an urgent need for trained insurance regulatory staff in Rwanda. That staff will need to be recruited, trained and, quite importantly, retained. Recruiting, training and likelihood of retention will be greater if the umbrella organization is BNR rather than NIC, in part because it can pay higher salaries.²⁵ Also, BNR is in a better position to marshal the resources necessary to operate an effective insurance regulatory authority²⁶ because it is an autonomous authority of the Government of Rwanda,

3.08 In line with the training needs for insurance regulators, there may well be opportunities for donor-financed technical assistance to support implementation of rigorous NBFIs standards and procedures if the counterpart agency is BNR, which has a good track record with technical assistance projects.

3.09 The supervision of banks' and insurance companies' financial condition has much in common. Their assets and investments are largely the same in terms of classifications and accounts. Most liabilities are also similar except that insurers have to maintain prudent reserves for claims and banks must maintain adequate reserves against funds deposited and reserves (provisions) for bad debt.

²⁵ NIC had to pay salaries based on the civil service salary scale while BNR does not.

²⁶ For example, BNR could begin assessing all financial institutions for the costs of supervision.

3.10 Insurance and other NBFIs supervision needs a platform – physical space, supportive services, technology support, data bases, and access to personnel management functions which is available at BNR. Moreover, the central bank has demonstrated that it is able to supervise the banking business. It has the respect of the financial markets in Rwanda.

3.11 Second, provide for special regulation of CSR: The case for supervision of CSR by the NBFIs unit of BNR is that CSR's financial condition and liquidity are presently seriously at risk and there needs to be an organ of government dedicated to overseeing the solvency, establishing prudent investment standards, and assessing liquidity of the program. CSR faces a deficit position in 5 or 6 years under the assumption that its current portfolio of investments will be liquid at that time. Given CSR's heavy investment in the real estate sector, this may not be a correct assumption. Moreover, its returns on investments have been mediocre at best, given its heavy investment in real estate.

3.12 CSR also faces a future cash-flow crisis owing to the RWF 63 billion that the Government of Rwanda “borrowed” from CSR without proper evidence of indebtedness or a repayment schedule. This obligation represents more than 70% of CSR's total assets and more than 100% of its reserves. These reserves represent the present value of benefits that must be paid in the future. As noted previously, the actuarial study (limited in value as it was because of the lack of reliable records), concluded that there were serious financial and structural weaknesses in CSR in addition to poor investment performance and the expropriation of the assets of CSR by the government.²⁷ However, Government recognizes the need to resolve this situation and in the process of issuing long-term bonds to CSR to repay most of this money.

3.13 While entrusting supervision of a national social insurance scheme to another agency of government is a somewhat unusual solution, it is founded in necessity in Rwanda given the condition of CSR and the lack of prudent supervisory resources elsewhere in government. Moreover, CSR is the largest financial institution in Rwanda and it is essential that an institution that is skilled at supervising financial institutions exercise appropriate oversight. BNR, as an autonomous arm of government, should be able to work to introduce more transparency and accountability into the CSR program. This does not mean that BNR will become a “super board of directors”. To the contrary, BNR will not have a role in determining policy but it will have a role in ensuring that BNR does have adequate policies and is in compliance with those policies. BNR will be promulgating appropriate regulations dealing with investment standards, investment risks, corporate governance procedures involving investment analyses and approval,

²⁷ None of the money taken was ever “government” money. These are funds that at all times are rightly the property in which all participants in the CSR program have an undivided interest.

reasonable and prudent liquidity and reserving standards, and the ability of CSR to meet its obligations as they become due.²⁸

3.14 Third, review of tax policy to increase incentives for long-term savings: Rwanda has already adopted legislation that provides substantial tax incentives to participants in qualified private pension funds.²⁹ Unfortunately, the enabling legislation (Income Tax Act of 2005) provides, *inter alia*, that a “qualified pension fund” must have provision of pensions as its primary business activity.

3.15 This provision in the law restricts the availability of private pensions in Rwanda since there are currently no “private pension companies” operating in Rwanda. Moreover, this would seemingly prohibit, or at least deter, an employer from establishing a pension fund for the benefit of its employees.

3.16 Moreover, while building a modern economy certainly entails providing incentives for private savings for retirement, programs of this type should not be unsupervised by the Government. Indeed, there is a potential for the assets of private pension funds to equal or exceed those of the insurance sector (this is already the case in other countries in Africa). The FSDP Action Plan provides for building this sector and for a proper statutory and supervisory framework.

3.17 There is a need to allow other financial institutions to offer private pensions since competition will tend to reduce transaction costs and better serve the public. There also should be a method for individuals, groups of individuals (such as labor unions or other trade organizations) and small employers to avail themselves of this benefit and further encourage savings.

3.18 Encouraging the development of another financial sector participant will also drive the development of other financial instruments and provide pools of funds to be invested in the economy.

3.19 Sound public policy dictates that the provision of private pensions be formalized and that standards be enacted to protect participants in private pension funds. The NBF Supervision Department of BNR is certainly the proper authority to regulate private pension funds.

3.20 A more difficult issue is that of making the benefits of savings more available to those who are struggling to pay daily expenses and who have no surpluses. The way to broaden the benefit of savings throughout society is to consider improvements to the

²⁸ It is important to note that BNR will not be regulating or supervising calculation of benefits, eligibility for benefits, dispute resolution, remuneration of CSR staff, and CSR senior management’s discretion in operating the program.

²⁹ Essentially, contribution to a qualified pension fund – up to 10% of income – is deductible from current income taxation.

Caisse Sociale du Rwanda program to make it more of a social insurance scheme with elements of income redistribution and become a sort of social safety net.³⁰

3.21 Additionally, there is very low penetration of CSR into the total labor force. A study should be conducted on how to achieve this. Methods should be adopted to create incentives for the self-employed and the informal sector to take advantage of CSR – if the benefit formula becomes more distributive, this will provide an incentive for more workers to participate. Also, the availability of disability benefits should be widely available to all workers in Rwanda. A significant discount from paying both the employer and employee share of the CSR contribution can also be considered for the self-employed and informal sectors.

3.22 The contribution rate and the amount of covered wages should also be reviewed. Significantly increasing the cap on covered wages can provide the income necessary to improve the program yet keep the CSR solvent. Although there would be a decrease in benefits and an increase of contributions for the more well-to-do workers if the CSR benefit/contribution relationships were changed, those consequences will be mitigated if significant private pension reform and availability is enacted.

3.23 Fourth, permit foreign investments by NBFIs, including CSR: One of the most vexing issues for the NBFIs in Rwanda is that there is a dearth of long-term investments. Moreover, there are limited numbers of entities or projects in which fiduciary funds may be prudently invested. Indeed, CSR and the insurance companies have access to few methods to diversify their investment portfolios or to avoid concentration of risks in any one entity or sector.

3.24 It should be noted that CSR should address fundamental viability issues and the quality of its investment strategy before adopting changes in coverage or strategy which add to its costs without increasing level of incoming cash flows.

3.25 Typically, life insurance companies and pension funds have longer term liabilities. However, sales of their products and calculation of guaranteed benefits are often based upon market conditions at the time of sale. Management must have a method to “lock-in” investment yields that will be sufficient to produce the necessary return on investments over the life of the contract. For example, under a life insurance policy, a rate of investment income is used to calculate the present value of future benefits and expenses. If there is no way for the life insurer to assure the required return over the term of the contract, it faces a risk that interest rates may fall in the future, that inflation could drive up its operational costs that were discounted based on the expected rate of return, or that there may be significant erosion of investment credit risks. In the case of a defined

¹¹ Currently, there is a direct correlation between the amount of CSR benefit due a retiree and the retirees’ earnings. If the benefit formula were amended to replace a greater share of the income of beneficiaries who were relatively less well paid during their working years, then the program could afford to pay higher benefits to the less well-off who did not have surpluses to invest in private savings plans. In this circumstance, the program would become more redistributive and act as a social safety net. However, because the program would still provide a pension benefit to all participants, it likely would still retain the support of the wealthier members of society.

benefit pension program (such as CSR), the interest rate risk is the same as it is for a life insurance company.³¹

3.26 One way to allow NBFIs to hedge the risks associated with having long-term liabilities and insufficient vehicles for long-term investments is to permit investments in assets outside of Rwanda. These investments could be limited as to amount or required to be a part of a bona fide hedging program.³² Such a program also allows NBFIs to diversify their portfolios in order to avoid undue concentrations of economic risk or credit risk. With so few credit-worthy investments in the private sector in Rwanda, there is a tendency for investments of all NBFIs (as a group) to be heavily concentrated in the same subsectors and clients and thus there is an opportunity for a contagion of the entire industry if there is an adverse event involving a particular creditor or entity.

3.27 It is also worth noting that in the insurance sector, reinsurance premiums are always denominated in hard currencies. Likewise, other liabilities that the ceding reinsurer may have will also be denominated in foreign exchange. Since there is currently no method for purchase of swaps on the Rwandan Franc, the only other method of hedging foreign exchange risk is through actual ownership of assets denominated in the particular currency. This is also important for ordinary insurance business that may be denominated in foreign currency. While selling an insurance contract in Rwanda in other than the Rwandan Franc is not permissible, it is possible that some contracts may be stated in Rwandan legal tender but may be indexed to some other currency.

Strengthen Pension Industry Regulation and Supervision

3.28 Pensions overview. Formal pension plans are limited to Rwanda's Pillar One Social Security program operated by *Caisse Sociale du Rwanda*. The industry also sells insured endowment-type products.³³

3.29 Although CSR is the largest financial institution in Rwanda, it has essentially been unsupervised as a financial institution. Presumably, that will fundamentally change following the recent Cabinet decision to place responsibility for its supervision with BNR.

3.30 The CSR program is quite generous by comparison to other countries in the region in that its replacement rate is quite high (benefits for those at age 55 with at least 20 years of contributions are 2% of the average last 3 years of average covered earning for each year of service) and the contribution rate is relatively low (8 % of covered earnings with

³¹ This is a particular problem for a social security-type program since its benefit calculations are often tied to wages. A sudden spike in wages could adversely influence benefit costs if there is inflation. Certainly, inflation would affect expenses of doing business.

³² Some countries have specified the types of foreign investments permitted, such as those rated AAA or the equivalent by reputable credit agencies, or in the paper of multi-lateral donor agencies such as the World Bank or the African Development Bank

³³ These are insurance contracts that pay a specified sum at maturity. The sum is also paid in the event of the death of the insured.

5% paid by the employer and 3% paid by the employee). Survivors' pensions are 50% of the participant's pension plus 25% per child under 25, up to the maximum pension sum. Additionally, the operating costs of CSR are growing faster than contributions and much faster than investment income.

3.31 CSR has an acceptable ratio of active workers to beneficiaries at approximately 4.5: 1³⁴ but active workers who are covered represent only 4% of the employable population. The average contributor penetration in Sub-Saharan Africa is approximately 10% of the labor force.

3.32 An actuarial valuation (dated March, 2005) was performed as at December, 2003 by the Quebec Pension Board (*Regie des Rentes du Quebec*). The valuation was highly qualified because actual data were not used³⁵; instead, some reasonable assumptions respecting contributors, years of service, population growth and longevity, and real interest and wage growth rates were used. Projected CSR negative cash flows begin between 2014 and 2019. In other words, CSR will need to pay out accumulated reserves and not have sufficient resources to build up future reserves. Indeed, the actuarial report indicates that the required contribution rate to pay all benefits and expenses and accumulate necessary reserves at the end of 50 years (December, 2053) would be 17.7 % of covered wages – nearly a three-fold increase over present levels. However, the actuarial report does contain a number of modifications to the current scheme that could mitigate such a serious shock and still maintain a stable (albeit slightly higher) contribution rate and a reasonable pension benefit.

3.33 The Cabinet has approved a number of initiatives to be undertaken by CSR, and those and other issues will be discussed in detail in the Action Plan.

3.34 It should be noted that, while Rwanda has taken an initiative to encourage retirement savings through contributions to qualified pension plans, there are as yet no such plans in Rwanda and the enabling legislation for the tax deduction for contributions (up to 10% of income) requires, inter alia, that a qualified pension fund must be an organization that is primarily in that business. The problems arising from this state of affairs is discussed later in this chapter.

3.35 As noted, currently there is no regularized or regulated pension industry³⁶ in Rwanda other than CSR itself. Various employers have established pension programs on a very small scale for their employees and some individuals have been purchasing insured endowments from insurance companies. The specific actions that need to be taken are:

- 1) Enacting a private pension law to allow development and regulation of the sector.

³⁴ According to a presentation by the CSR Managing Director in April 2006, in 2004 there were 195,860 contributors and 43,559 beneficiaries.

³⁵ Actual data were not used because they were unreliable, according to the study.

³⁶ In this paper, unless the context clearly indicates otherwise, the word "pension" refers to private pensions and not to CSR or other public pensions.

- 2) Providing pension opportunities for the self-employed and others uncovered by private pension plans.

3.36 Pension Law. At the present time, the only hint of authority to establish pension plans in Rwanda is found in the Income Tax which allows a tax deduction of contributions to “approved” pension funds.³⁷ However, there are no provisions in the law for regulation or supervision of such entities. Clearly, this is an unhealthy situation since it could lead to promoters coming into Rwanda to form “pension companies” which could be undesirable while the way the law is presently written freezes out the only financial institutions that are regulated, i.e., banks and insurance companies.

3.37 This situation is not unique to Rwanda. In the past, other countries have been faced with exactly the same situation – a tax law that provides incentives for pension savings, but provides little else in the way of regulation or supervision of these entities. Often the authorities in such jurisdictions have instituted pension reform and enacted pension laws establishing prudential standards regarding licensing, investments, benefit structures, and rights of participants only after there is some sort of scandal. Thus far, there has been no scandal in Rwanda, but the government can ill-afford to wait. After all, if such programs began in order to utilize the sales tool created by the tax benefits, those entities would be fiduciaries of “other people’s money” just as surely as is a bank or an insurance company. Also, just like banks and insurers, pension funds do not provide a product – to the contrary what is sold is a promise. It is incumbent upon the government to exact reasonable assurances that the promises will be kept by imposing licensing standards, investment standards, and provide other protections to participants in these funds.

3.38 Accordingly, Rwanda will draft and enact a law on private pensions that will protect consumers and assure that sound principles of management are implemented by the organizers of these pension programs.

3.39 Drafting a pension law that will be relevant to Rwanda will require some degree of technical assistance. Therefore, the action plan indicates that technical assistance will be sought from the donor community for this important task.

3.40 In going forward with this plan, however, Rwanda has agreed on six elements of a pension law that must be part of the implementation program. These are:

- 1) The law must specify an acceptable legal structure and require that no matter what structures are used, the contributions and investment earnings of participants in a pension plan are to be segregated, as a matter of law, from the assets and liabilities or other obligations or judgments against the pension fund organizers. In other words, the pension fund itself (the contribution investment earning of

³⁷ As previously indicated, under the current law an approved pension fund must have provision of pensions as its core business activity. This requirement means that individuals who have attempted to use this tax benefit are precluded from using banks or insurance companies and private companies can not set up plans for their employees.

- participants) will be considered to be a legal entity separate from the entity that receives a license to form a pension fund.
- 2) Rwanda has decided to vest responsibility for the regulatory structure and supervision of pension funds in a BNR Non-Bank Financial Institutions Supervision Department. Placing responsibility for pension supervision in this department will achieve economies of scale and allow the most efficient and effective use of regulatory resources.
 - 3) Senior government policymakers plan to bring the various stakeholders together to discuss the types of plans that will be offered.³⁸ These stakeholders will include groups such as employers, trade unions, banks, insurance companies, capital market participants, cooperatives, representatives from the informal sector, and self-employed individuals. The law will be focused on determining the contribution methods, funding mechanisms, vesting requirements, portability issues, and benefit systems that will work best for Rwanda.
 - 4) As soon as a pension law is enacted, the income tax law as a companion piece of legislation should be amended to define an “approved pension plan” as one licensed by the NBFBI department of BNR. The Revenue Authority will then need only to examine the license of the pension plan in order to determine propriety of any tax deductions. Also, it must be made clear that any investment income earned by the pension plan is exempt from current taxation to the extent that such earnings are credited to the accounts of participants.³⁹ There must, however, be strict limitations on withdrawal of funds from pension plans prior to retirement and, even then, such early withdrawals should be subject penalties.
 - 5) In adopting the pension law, Parliament should grant broad rule-making discretion to the pension supervisor. This is a normal approach to pension legislation since the various details that need to be regulated are quite complex.
 - 6) NBFBI Supervision should, using technical assistance, promulgate various regulations. The list is quite long, but regulations will be necessary regarding eligibility for various types of plans, contribution requirements, investment standards, required use of a custodian for pension fund assets, portability of benefits, vesting standards, early retirement, reserve requirements for defined benefit plans, how to treat unfunded liabilities of defined benefit plans, incurring prior-service obligations, benefits for new entrants to the programs, and winding

³⁸ There are number of types of potential plans such as defined benefit, defined contribution, profit based, employer plans, trade union plans, commercially available plans, association plans, and group plans. However, defined benefit programs should only be offered by employers willing to guarantee the benefits in the event of adverse results.

³⁹ Rwanda must also determine the tax treatment that will be given to pension benefits. The details of the tax treatments that could be decided are beyond the scope of the action plan and will depend in large part upon consultations with stakeholders and the Government. However, since Rwanda has already decided that contributions are deductible, and if investment income within pension funds is to be untaxed, then it seems that full taxation of benefits at retirement is appropriate.

up of plans either voluntarily or involuntarily. Additionally, accounting rules, financial reporting forms and dates, guidelines for adopting strong programs of corporate governance and internal control mechanisms will all be necessary. Finally, periodic statements of account to participants should be required.

3.41 Pension opportunities for the self-employed and uncovered others. Rwanda needs to anticipate that, once a thriving culture of pensions takes hold, there will be some individuals who will not be able to qualify to join a program. Perhaps their employer has chosen not to form a pension fund or they are self-employed. Perhaps they are the owner of a small business which would like to institute a pension program for its employees, but believes it would be too costly to form and operate; or perhaps a group of small employers or a cooperative would like to offer pensions to their respective employees or members, but finds the process overly difficult or too technical. For cases such as these, the pension law should also provide for the formation of Financial Institution Pension Funds (FIPF).

3.42 Simply stated, FIPFs are pension funds founded by banks and life insurance companies⁴⁰ that offer defined contribution⁴¹ pension programs to individuals or firms not covered by other pension plans. In order to accomplish such an activity, any bank or insurer wishing to establish an FIPF must form it as a legal entity separate from the bank or insurer. This will assure that there is no subsidization of pension funds by the depositors or insured, nor that pension fund assets might be utilized by the bank or insurer. This also assures that, in the event of any claim against a bank or insurer, the assets of the pension fund are immune from attachment. The key concept is that the actual funds are the property of the participants and the FIPF merely manages the funds and facilitates collections and distributions. Of course, the operations of the FIPF would be subject to regulations and supervision as determined by the NBF Supervision Department.

3.43 The attractiveness of an FIPF option is that it creates the opportunity for amassing pension savings virtually universally. This can constitute a major source for increased mobilization of long-term savings in Rwanda. By using already existent financial intermediaries with existing systems of collecting deposits or premiums regularly and also making disbursements, the FIPF's business plan fits nicely into the corporate structure of banks and insurers. If they are able to attract wide participation, unit costs will be low and they will be able to offer their services at competitive rates.⁴² Employers who want to offer pension programs but find the necessary recordkeeping, investment process, and reporting requirements onerous can effectively out-source the program to the FIPF at a cost far lower than the individual firm would pay if it undertook the process itself.

⁴⁰ Such plans are not the same as life insurance products that are purchased as the funding vehicle of a pension fund.

⁴¹ These MUST be defined contribution plans.

⁴² The founder of an FIPF earns income by assessing a small administrative charge to cover the expense of opening and maintaining an account and usually receives a small management fee for investment of the fund's assets.

3.44 There has been no opposition to the concept of FIPF among Rwandans working with the pensions arena, but the concept is new to Rwanda and may not be fully understood. Perhaps it is useful to take a particular example. Assume an individual who works for a firm that does not have a pension fund, wants to avail himself of a tax-deferred savings opportunity to provide for him and his dependents when he is no longer working. Without the vehicle of the FIPF, he would have no way to avail himself of the incentive to save. With an FIPF, however, he can take advantage of the program and thus save for his retired years and at the same time be building up a class of institutional investors that provide capital to Rwanda for its development.

Strengthen CSR Organization and Management

3.45 In July of 2006, the Cabinet of Ministers promulgated a decision respecting restructuring and modernization of the *Caisse Sociale du Rwanda*. This cabinet decision provided, inter alia, for a new organizational structure for CSR and a revised staffing and skills plan for the organization. Also, a modernization plan adopted by the cabinet calls for an internal CSR review of:

- 1) Pension contribution levels, distribution methods and investment policies.
- 2) Review and update of the legal framework.
- 3) Operational update and documentation of CSR.
- 4) Update of CSR's service delivery processes.
- 5) Reevaluation of CSR's structure and staffing based upon the above efforts.
- 6) A capacity building program for CSR staff.
- 7) Public education campaign.
- 8) Computerization program.
- 9) Investment portfolio review and management procedures.

3.46 This modernization plan needs to be reviewed. The Government, in response to the cabinet decision, also plans to conduct a Strengths, Weaknesses, Opportunities and Threats (SWOT) analysis of CSR and to identify additional issues that may need to be addressed.

3.47 While there can be no doubt that the internal review called for in the cabinet decision will have a salutary effect, CSR also needs to conduct a management study to be performed by external consultants. The Government hopes to obtain donor-funded technical assistance for this purpose.

3.48 The SWOT analysis and the CSR management study are very high priority and could be combined. As noted, CSR is the largest financial institution in Rwanda and its success affects thousands of Rwanda workers and their families. Moreover, as previously indicated, CSR faces significant challenges respecting its long-term sustainability.

3.49 Setting aside the issue of CSR investments (which will be discussed below), CSR's management, staffing and service are the most visible outreach of the government to the

labor force. Because it represents an expense to workers without any immediate corresponding benefit, CSR needs to be able to “tell its story” and tell that story with credibility. The actuarial valuation previously cited points out the inordinately high expense ratio of CSR. While there is a need to incur costs in a social insurance program such as CSR, those expenses should be heavily focused on servicing participants, both active and retired.

3.50 Social security institutions are service organizations and are also large financial institutions. Accordingly, the mission of the organization must incorporate both its service functions and its financial intermediary functions within the mission and strategy. The SWOT analysis that the Government will undertake should look at both of these CSR organizational elements. To those ends, the benchmarks to be utilized should include an assessment of the sufficiency of procedures or capacity involving the following:

- 1) Identification ("enumeration") systems.
- 2) Collection of contributions.
- 3) Determination of eligibility for benefits.
- 4) Calculation of benefits.
- 5) Executing payments to beneficiaries.
- 6) Maintaining a data base comprising i) the earnings and contributions records of each participant; ii) the status of current payees (beneficiaries); iii) changes in the basic identification information of current workers; iv) newly issued identification; and v) such other information as is necessary to carry out the purpose of the legislation and the design of Rwanda's social security system.
- 7) Gathering and compiling such information as necessary to assist in enforcement of contribution requirements of employers and employees.
- 8) Maintaining appropriate oversight programs to assure that benefits are paid only to persons entitled to them.
- 9) Maintaining an appropriate policy analysis capability.
- 10) Maintaining an effective dispute resolution mechanism.
- 11) Maintaining a public information and consumer apparatus.

3.51 All these factors are critical, to some degree, to the success of the system. The key factor in success and sustainability, however, is the ability to manage change. This is the capacity within the organization that permits the management to respond quickly and effectively to challenges to performance or sustainability. Thus, to ensure this capacity, the focus should be on the need for information; the capacity of the organization to access that comprehensive information rapidly; and the institutional resources to analyze the importance of data and design responses to change.

3.52 It is also important for CSR to avail itself of any opportunities it finds for procuring technical assistance. Very few social security programs are fault-free and it makes sense to get as much information as possible from other organizations and experts.

3.53 Clearly, too, the organization must find better methods to recruit, train and retain qualified staff. The Government will need to devise mechanisms that will allow CSR to pay competitive salaries, at least for key positions. Some methods that have been effective in other jurisdictions for managing such challenges vis-à-vis the civil service system or other limitations for governmental or quasi-governmental employees are:

- 1) A bonus system based upon rigorous performance reviews.
- 2) Position qualifications and compensation linked to independent indicators measuring comparable qualifications and pay in comparable positions.
- 3) A measure of fiscal autonomy for key CSR personnel.
- 4) An enhanced pension program for key personnel that is vested with the employee based upon certain requirements of performance and years of service.

3.54 Finally, a decision must be made with respect to CSR's suitability as a provider of private pensions as Rwanda introduces such savings and retirement programs. Based upon CSR's current performance, it is clear that it has a sufficient burden in attempting effectively to manage its current responsibilities.

3.55 Normally, it is highly undesirable to have a governmental or quasi-governmental agency such as CSR involved in private pension plans. Such organizations are ultimately responsible to government and not to participants. On the other hand, a private pension program must be operated solely in the interests of its members and not for any other purpose.⁴³

3.56 On a public policy level, it is not wise to encourage more intermediation of funds with governmental rather than private agencies. Building a modern economy requires a vibrant private sector that is making market-based investment decisions. In the pension area, private institutional investors can drive the development of capital markets and add liquidity to the financial system in a way that government-controlled entities can not. At the core, adding yet another government player in the financial institutions business may reduce confidence in the business community that Rwanda is serious about building a market-based economy.

3.57 The Government may see some ancillary benefits from allowing CSR to compete with the private sector (for example, in countries that have attempted to allow parastatal voluntary pension funds in competition with the private sector, the rationale was that people would "trust" the government more than entrepreneurs). In most instances, those countries quickly attempted to privatize these programs and participants found that their performances were less rewarding than private sector funds). Another danger of allowing CSR into this field would be that there would be a perception of a "government guarantee." Although CSR could likely achieve the mechanical segregation of the assets of its private pension business from its public program, it is unlikely that such segregation could occur in fact and possible issues regarding liability for mismanagement would be very complicated to resolve.

⁴³ One need look no further than what happened to over RWF 60 million that was previously expropriated from CSR.

3.58 Erroneous as that perception would be from a legal perspective, if something did go wrong, politicians would have a difficult time resisting a public outcry for government to make the situation good.

3.59 Taking all circumstances into account, benefits that would inure to the public by having CSR operate in the voluntary pension market are not sufficient to countervail the compelling arguments against permitting CSR to expand into this area

3.60 CSR investments. CSR's investment performance, allowing it to meet the income requirements for maintaining sufficient reserves, has not been satisfactory. The fact that its reserves are insufficient (as evidenced by the findings of the actuarial report) is a result of its poor performance. In order to substantially improve performance, CSR needs to:

- 1) Adopt investment policies and procedures that meet reserve requirements and prudent liquidity standards.
- 2) Engage professional investment management.
- 3) Invest in longer-term bonds in order to minimize commercial bank credit risks.
- 4) Issue bonds for CSR debt and securitize the same as marketable securities.

3.61 CSR management has already hired an investment director, and that is a laudable action. It has also made an attempt to formulate an investment plan.

3.62 While the new CSR senior management has made a number of improvements in a short period of time in attempting to turn around the organization, this has not yet carried over into the investment program of CSR. CSR already has significant levels of non-performing real estate investments and those inadequacies have adversely affected its investment returns. CSR has largely ignored the core principles of diversification and anti-concentration of risk in its investment program. It has also not sufficiently provided for its liquidity needs in much of its investment portfolio.⁴⁴ Unfortunately, despite this situation, highly imprudent levels of investment in real estate are the focus of the proposed investment plan.

3.63 It appears that CSR management is attempting to speculate in the real estate market. It may well be that real estate speculation makes sense for a speculator – it does not make sense for a financial institution that should have safety, security and reasonable return as its investment paradigm. This is not to say that CSR should not have interests in the real estate market – however, those interests ought to be as a portfolio investor, and seeking adequate diversity, as opposed to the originator or anchor of the investments.

⁴⁴ Real estate, especially if owned and operated by CSR, is quite illiquid and not easily convertible to cash in order to pay benefits. Additionally, CSR has no specific knowledge about, and does not have a comparative advantage in, being a real estate developer. In fact, in the vast majority of countries, investments such as those already made by CSR in the real estate business (as well some of its inordinately high equity investments) would be prohibited. Statutory prohibitions aside, CSR's investment practices are imprudent and would be eschewed by virtually any knowledgeable investment professional.

Insurance Industry Regulation and Supervision

3.64 Insurance overview. The insurance sector is relatively small which is not surprising given the low rate of insurance penetration (less than 1%) in the country. There is no comprehensive insurance code and NIC, the regulatory authority, is virtually non-functioning due to a lack of adequate and competent staff and a dearth of regulatory authority in the statutory structure of Rwanda. Insurance companies are undercapitalized and there is a lack of technical expertise (for example, there are no actuaries in Rwanda).

3.65 A serious price-war being waged in the insurance sector – particularly with regard to automobile insurance-- is also troubling. Companies are engaged in predatory pricing without regard to ultimate losses or capacity to pay claims. Thus far, NIC – while aware of the problem – has not taken any remedial actions. This is not necessarily its fault, since NIC does not seem to have the authority to supervise the manner in which insurers price and market their products. Additionally, given the lack of technical staff, it would be difficult for NIC to mount a credible effort to prohibit insurance premium rates that are inadequate.

3.66 The expertise of insurance intermediaries (agents and brokers) is also quite low according to the insurance companies and the current insurance supervisor. This lack of capacity exacerbates the predatory pricing problems of the industry and “cash-flow underwriting.”⁴⁵

3.67 Other weaknesses in the sector include a lack of a uniform financial statement format and instructions,⁴⁶ lack of any investment standards – particularly in regard to diversification and anti-concentration of risk standards, allowing the combination of both life and non-life insurance in the same corporate entity, which creates opportunities for disintermediation vis-à-vis the long-term nature of life products and the short-term nature of many non-life products, and lack of clear direction regarding corporate governance and risk-based management and supervision.

3.68 Given the difficulties that Rwanda faces respecting insurance supervision and regulation, there is virtually universal support for a re-engineering of insurance regulation. The lack of an insurance code is a nearly insurmountable obstacle and NIC has never had the resources or the capacity to act as a regulator.

3.69 An insurance supervisory authority exists in order to achieve three valuable public policy objectives:

⁴⁵ “Cash-flow underwriting means that little or no regard is shown to the relative riskiness of a prospective insured. To the contrary, the objective is to write as much business as possible in order to generate cash for immediate needs of the insurer – such as paying claims.

⁴⁶ In many jurisdictions, the instructions for preparing the insurance company’s financial statements are, in effect, the accounting standards that govern the insurance sector. This approach has worked quite well in some countries during the initial period of development. Of course, as the scope of operations and products of insurers become more expansive and diverse, additional accounting standards are often required.

- 1) Monitoring insurance companies' financial condition with a view to detect as swiftly as possible conditions that could lead to the inability of an insurer to meet its contractual obligations.
- 2) Assuring that insurers are properly licensed and conducting their operations in accordance with prevailing laws and regulations.
- 3) Assuring that insurers are meeting their obligations to policyholders in accordance with the terms of the insurance policies and contracts.

3.70 The most important objective of insurance supervision is monitoring financial condition. Insurance contracts are promises to perform in the future -- often thirty or forty years hence in the case of life insurance. Supervision is intended to assure that managers of insurers conduct their operations so that the public will have confidence in the ability of these financial institutions to keep their promises.

3.71 Without a solvent insurance industry, the other regulatory objectives are merely academic. However, it is essential that even a solvent industry conducts operations in accordance with the prevailing law. The insurance supervisor monitors compliance and acts as the first line of enforcement.

3.72 Finally, it has been said that government exists for two reasons -- to protect persons and property and to assure that the proper atmosphere exists for the enforcement of private contracts. The insurance supervisor's role is to assure that in the area of insurance the insurance firms are honoring the promises they make and for which they have collected a consideration.

3.73 Insurance regulation functions include:

- 1) Licensing (including authorizing reinsurers).
- 2) Financial condition internal analysis.
- 3) Financial condition on-site examinations.
- 4) Review of rates and contract forms (includes actuarial analysis).
- 5) Enforcement and interventions.
- 6) Dispute resolution.
- 7) Information management.
- 8) Oversight of agents, brokers, adjusters and actuaries.
- 9) Policy analysis capability.
- 10) Internal training programs to improve the professionalism and capacity of regulators.

3.74 Building BNR supervisory capacity will first entail recruiting a core staff and providing them introductory training. BNR has already taken steps to begin that process -- however, the full follow-through on recruiting and training staff (along with executing an initial work plan) will require some of the technical assistance envisaged as a part of the specific plan of action. Thus, as matter of sequencing, it will be important for BNR to move quickly in planning for its assumption of this additional task -- in view of the recent

cabinet decision to amend the Central Bank Act to place responsibility for NBFIs supervision under the auspices of BNR.

3.75 Rwanda also needs to institute an ambitious plan of action to create an effective insurance supervisory regime with due regard to the functions of supervision. The plan of action:

- 1) Seeks donor support for engaging a long-term resident advisor and various short-term technical assistance specialists to build supervisory capacity.
- 2) Establishes a firm legal and regulatory foundation for insurance regulation in accord with international best practices.
- 3) Establishes a strong insurance supervisory capacity within the NBFIs Supervision division of BNR along with an intense training program for regulatory staff.
- 4) Performs regular self-assessments of its regulatory regime under the International Association of Insurance Supervisors' (IAIS) Core Principles.

3.76 Engaging a resident advisor: Insurance supervision, at this juncture, is essentially a blank slate and the newly constituted staff will need assistance in formulating a practical insurance law and regulations, learning the intricacies of the insurance business, and using modern tools of financial condition surveillance. The great preponderance of evidence relating to technical assistance support for insurance supervisory capacity building shows that full-time, long-term expertise is more valuable and efficient than an equal (or even greater) effort applied on a short-term basis. Resident advisors can be a constant and reliable resource and there is a demonstrable benefit from the "walk in business" that the resident gets – in other words, staff can avail themselves of informal mentoring quite conveniently and the most important spin-off of capacity building (inculcation of confidence in the counterparts) can constantly be nurtured and reinforced.

3.77 Establishing a legal and regulatory foundation: While drafting a comprehensive insurance law requires a significant investment of time and resources, Rwanda has already begun the process. The regulators will review the draft to make sure that essential areas of insurance supervision are adequately addressed and that the law contains sufficient authority for the regulator to adopt detailed technical regulations or guidelines. In cooperation with the resident advisor, the law should be reviewed to ensure that the following elements are present:

- 1) Internationally compliant accounting and reporting standards.
- 2) Prudent actuarial requirements for reserving and rate-making.
- 3) Prudent investment standards.
- 4) "Fit and Proper" standards for management and owners.
- 5) Reasonable minimum capital requirements.
- 6) Necessary distinctions between life and non-life insurance lines of business and a phasing-out of multiple-line insurers.
- 7) Corporate governance standards.
- 8) Unfair trade and claim practices prohibitions.
- 9) Non-judicial, user-friendly dispute resolution procedures.

- 10) Practical licensing and competency standards for agents and brokers.
- 11) Rehabilitation and liquidation procedures.

3.78 Establishing a strong supervisory capacity: High quality and credible regulation of the business of insurance in the public interest is not achievable without a cadre of supervisory personnel who are qualified, trained, empowered, motivated, and adequately compensated. The insurance mechanism permits society to manage risk and thus encourages, inter alia, development and economic growth.

3.79 The regulator will promulgate regulations or procedures dealing with:

- 1) Dynamic capital adequacy and risk-retention standards.
- 2) Reinsurance standards.
- 3) Risk-sensitive off-site performance and solvency monitoring.
- 4) Manuals for internal operations.
- 5) Manuals for risk-based on-site financial condition and market conduct examinations.
- 6) A rigorous program of staff career development and continuing education.
- 7) Harmonizing procedures to the extent possible with those of bank supervision in order to achieve efficiencies.

3.80 BNR has already undertaken the initial planning process in order to implement the supervisory capacity building program, but will need to avail itself of technical assistance resources.

3.81 Performing regular self assessments: Finally, the IAIS has devised a self-assessment protocol for insurance regulatory agencies so that they can measure their status against an objective paradigm. Each six months for the first two years of the action plan, BNR should complete the self-assessment in order to benchmark its progress and demonstrate to the Government and to any donors that capacity is being built.

3.82 Insurance industry development. Although the insurance sector in Rwanda is small, with only 4 licensed companies, this is not necessarily a matter of concern. The real challenge arises in that the amount of insurance business in Rwanda is low and there is insufficient financial and human capital to foster growth of the sector. Also, the demand for insurance services has been stifled by previous stagnant economic growth. As Rwanda's economic growth rate rises and the demand for reliable insurance services grows, the industry must have sufficient resources to meet the demand for new products. This will require insurance companies that are financially healthier, more transparent financial reporting, and an increase in the technical competency of personnel.

3.83 Companies will also be challenged by the need to raise additional capital and to cope with a true system of regulation as well as by the demands of managing growth. Adjusting operations to the demands of modern insurance operations and supervision will be a management challenge.

3.84 BNR plans to conduct a workshop for the insurance industry after the new Insurance Law and regulations are adopted. Far from being a one-day forum, these workshops will include highly technical and comprehensive interactive multi-day programs dealing with risk-management, corporate governance, underwriting, rate-making, reinsurance, financial reporting, and investments.

3.85 Rwanda will also encourage, and provide some support for, the revitalization of the insurance association. However, the association must be seen as an arm of the industry, not government, and must be a proponent for a well-thought-out enrichment program for the industry.

3.86 Rate-making will be challenge because of the lack of actuaries in Rwanda and because no single insurer has sufficient credible data upon which to base rate and underwriting judgments for some lines of insurance.

3.87 The industry should also become a proponent of insurance education for the populace. Too often consumers are unaware of what insurance does – and just as importantly – does not do. This sensitizing of the public to the concept and operation of the insurance mechanism will go a long way toward development of the industry.

3.88 The insurance industry faces a real crisis in automobile insurance – price-cutting is rampant and this very important business line is unprofitable. When rates are inadequate, there is a high probability that claim payments will be delayed or even unfairly denied. The industry indicated that it wanted some sort of mandatory tariffs for automobile insurance. Although there are a number of jurisdictions that establish tariffs (either through governmental action or by an industry-directed pricing agency), the experience of such schemes has been largely inimical to the growth of the insurance industry, adverse to the interests of consumers, or both. If the industry is serious about ending predatory pricing, it should support a strong regulatory agency with strong powers to enforce prohibitions against premium rates that are excessive, inadequate or unfairly discriminatory. Alternatively, the industry could form a rating and statistical organization that could publish actuarially sound reference rates.⁴⁷ Companies would be free to adopt those rates, blend them with their own data, or deviate downward or upward when there is sufficient justification. If the industry is serious about ending the predatory pricing, it should be willing to explore options and ask that Government assist it in restoring and maintaining an orderly market.

3.89 Finally, the industry is subject to an anti-competitive reinsurance market. Much of this is due to Rwandan insurance companies' own shortcomings in the areas of pricing and underwriting. Again, the industry must demonstrate that it is willing and able to address the core issues that effect its bargaining position with reinsurers.

⁴⁷ The trend is to allow these organizations to publish only “pure premiums” – the amount necessary to pay claims costs – and leave the balance of the premium (commissions, expenses, contingencies and profit) to individual company decisions.

Chapter 4: Rwanda FSDP Action Plan for Payments Systems Development

Strengthen National Payment Systems and Strategy

4.01 Overview. In Rwanda today, the need for a national payments strategy is very clear. This is true for most nations that are engaged in major financial sector reform. Indeed, the need for a national strategy is starting to be recognized even in nations such as the United Kingdom and Australia which have advanced payments infrastructures already in place.

4.02 Today, payments are clearly recognized as an essential component in the financial infrastructure of a nation. An efficient national payments system will result in many benefits accruing to its operators and users. These include:

- 1) Modern payment systems are based on the electronic transfer of value. This reduces, and eventually eliminates much of the use of paper-based payment instruments such as checks which always carry a risk of fraud.
- 2) Efficient payment systems with certainty of settlement encourage greater use of accounts in financial institutions and credit and deposit services.
- 3) The use of cash is reduced as funds flow through secure technology-based networks. Funds are more readily available and can be reused much more quickly. This is especially beneficial where capital markets are active.
- 4) Payments made electronically can be processed through the accounts of both the initiator and receiver, giving them a clearer picture of their financial position and reducing the risk of error typically implicit in manual processing.
- 5) Tax collection can be carried out more efficiently with financial data being much more readily available to the revenue authorities than it is in the current environment.

4.03 However, achieving such tangible benefits requires an investment in the form of financial, human and other resources. Such an investment should be made in a structured manner with clear objectives and plans in place to deliver the appropriate rewards. Therefore, a National Payments Strategy (NPS) needs to embrace a wider audience than simply the financial sector. Its implementation will have a significant impact on both the private and public sectors of the community.

4.04 Five key areas of activity must be addressed in order to create a national payments infrastructure that will support the real needs of the community:

- 1) Development of a national payments strategy defining its role and purpose, the rights and obligations of its shareholders, its correct legal and financial basis and appropriate risk management policies.
- 2) Once developed, the strategy must be maintained and enhanced as its development and implementation proceeds. The strategy has to be owned by, and be representative of, the whole community to gain their buy-in and support. The correct body to manage this is a National Payments Council (NPC).
- 3) BNR must reorient some of its payments-related functions and introduce a new payments center for excellence. BNR should reconsider the current settlement structure for payments and review the clearing operations.
- 4) A new automatic clearing house facility (ACH) to provide automated processing of all low-value payments. The 'ACH' should build on existing SIMTEL operations as the provider of common payments processing and network systems.
- 5) SIMTEL needs to reorient its operations by placing greater emphasis on supporting its participating banks' payments activity while at the same time utilizing its commercial freedom to exploit appropriate opportunities in the government and commercial sectors.

4.05 This document defines a 'road-map' to provide Rwanda with a national payments infrastructure capable of supporting the FSDP implementation and providing tangible benefits as outlined above.

4.06 Develop and publish a national payments strategy. The National Payments Strategy document should define the payments systems and services within Rwanda and describe the technology and other components within the supporting infrastructure. It should define strategy and vision, the stakeholder community, legal and financial basis and appropriate risk management policies. It outlines the proposed new initiatives such as the proposed ACH and includes appropriate specifications and other documents relating to existing payments systems. In this way, systems capacity to handle new requests and enhancements can be better evaluated. This will have particular value later when the second and increasingly important requirement for enhancements to existing systems, which manage the larger payments providing quicker settlement and advice of movement to its users, is addressed.

4.07 Developing a structured national payments strategy is the key initial task for the NPC. The strategy is the foundation stone for a plethora of future developments. It must identify the interests of the parties engaged in the payments systems. These groups include the financial institutions, all national and local government bodies, and groups whose activities include the generation and receipt of payments. For example, the large public utilities receive many payments on invoices issued for their services. Such organizations also create payments when managing the salaries of their employees.

4.08 Create national payment systems models. The strategy should be developed in a structured form and should be maintained as a living document reflecting new

developments and NPC decisions. The strategy document should be progressively created as a three dimensional model providing business, operational and technical level models of the Rwandan payments systems infrastructure.

4.09 It is important that the work already carried out and documented in the reports of a number of experts is incorporated into the models where appropriate. The work has provided good background and has outlined the developments that are required. The work-to-date should be processed as follows:

- 1) Relevant subject matter should be analyzed and considered in the light of more recent experience, structured in the proposed models, *or* form the basis for a NPC business case defining and requesting appropriate action.
- 2) The models, once in draft form, should be tested by appropriate NPC workgroups and presented to the Council for formal adoption and publication when consensus is achieved.
- 3) The documents should then be placed under a formal change management system and future reviews by the appropriate NPC groups should be scheduled.

4.10 The primary components of the national payments strategy are typically expressed in a 'Business Level Model' (BLM). The model consists of five components including:

- 1) Strategy and vision: This component defines the role and purpose, for which the strategy is being developed. It also defines the overall business drivers, objectives and principles of the national payments system.
- 2) Stakeholder community: This component develops the roles and responsibilities of the organizations that are engaged in the national payments strategy. The relationships and interactions between each group are defined, as are their rights and obligations.
- 3) Legal basis: This documents the key legislation upon which the strategy is based. It also identifies the key legal and other documents, such as payments scheme rules, that define and underpin the relationships among the stakeholder community.
- 4) Financial basis: This component outlines the funding for the strategy and where it is expected to be raised. It will also develop the basis (but not the detail) on which national payments systems and services should be charged.
- 5) Risk management: The final component addresses the risk management aspects of the national payments strategy and defines the policies to be adopted by systems providers and other stakeholders. In particular, the NPC will wish to see appropriate attention being given to legal, credit, operational and liquidity risks.

4.11 Place models under formal change management and delegate responsibility to the BNR payments support group. Once created, the national payments strategy

forms a blueprint for the ongoing development of the various systems and facilities such as the proposed ACH. It is also used to specify and execute external activities such as legislative change and community awareness programs. Finally, it provides the standards and best practice rules which all elements of the national payments system must conform to.

4.12 It is vitally important that the documents are maintained and placed into a formal change management process with strict rules in respect of changes to the models. Formal reviews should be scheduled to ensure the various specifications and models are current and reflect the current situation.

4.13 The BNR payments support group will provide the primary technical and secretariat support and should be delegated responsibility for development and maintenance of the models and specifications. The group will make substantial use of the NPS models as it facilitates the creation of the various business cases and other submissions to the Council. BNR is the primary stakeholder in the development of the national payments strategy and the payments support group should have access to the significant technical, legal and operational support groups within that institution.

Create A National Payments Council (NPC)

4.14 Rwanda needs to establish a National Payments Council (NPC) and to agree on its terms of reference, governance, operational model and initial work-plan. Rwanda's current payments systems are the paper-based check and payment order systems provided by BNR and the card-based services provided by SIMTEL. The check clearing is being extended to BNR branches and a bill payment system is under consideration at SIMTEL. None of the implemented systems provide a totally satisfactory service and various operational and technical issues detract from their value and potential.

4.15 However, the primary reasons for the problems with payments in Rwanda lay outside the payment system in itself and the solutions involve:

- 1) Encouraging the population's use of accounts with financial institutions. Without this development, any payments initiative within Rwanda will be severely inhibited.
- 2) Increasing access to payments systems for a wider audience of stakeholders such as the micro-finance companies that in turn will make various services more accessible to the community at large.
- 3) Government requiring payments to and from its constituent departments to originate from and be paid to accounts with financial institutions.
- 4) Developing and implementing payments services that are introduced to meet a real need rather than to demonstrate technical capabilities.

4.16 Addressing such issues clearly requires the involvement of a wider group of stakeholders than has been traditionally engaged in payments development. This is because payments have grown from an extension of the banks' back office processes and are now considered an integral element of any modern economy with many elements of

society being affected by their operation. Therefore it is important that a representative group is charged with the ownership and overall development of the national payments strategy in Rwanda. For this reason the creation of the 'NPC' is being recommended.

4.17 The NPC should be established by decree. It should be a body appointed by BNR and work with authorities delegated by that body. It should be chaired by a BNR representative and draw its membership from a wide body of stakeholders. The primary NPC members should include i) commercial banks including UBPR; ii) Government of Rwanda (Ministry of Finance); iii) insurance, micro-finance and other financial sector institutions; iv) utility companies representatives; and v) a retail industry representative.

4.18 In addition the NPC may call on technical advisors such as representatives of SIMTEL or the Rwanda Information Technology Initiative (RITA) as needed.

The NPC's primary responsibilities should include:

- 1) Creating and maintaining the National Payments Strategy in an appropriate documented form.
- 2) Promoting the implementation of the various payments systems and services identified in NPS specifications and other documents.
- 3) Developing the appropriate legal basis for national payments by identifying required changes to the existing legislation and working with the appropriate bodies to facilitate their implementation.

4.19 The NPC should have an interest in areas where payments services are generating the requirement for some exchange of value or payments-related data between financial institutions. To achieve its objectives the NPC will work with:

- 1) The BNR payments support group which should provide a variety of technical and secretariat support services to the Council. A particular responsibility of the payments support group will be assisting in the development of business cases for NPC consideration.
- 2) NPC 'work-groups' which should be convened to address specific aspects of the development and implementation of the strategy. For example, a work-group would be formed to make recommendations on legislative changes.
- 3) NPC project teams which should be formed to manage the implementation of specific initiatives. The proposed implementation of an ACH would require such support.

4.20 Agree on the National Payments Council operations model. The NPC is a body which should meet formally on a regular basis. Its powers should be those delegated by the BNR in respect to payments reform, development and operations. For example, the Council should encourage self-regulation of payments and work with the appropriate BNR departments to facilitate this. It should not usurp any of BNR's obligations or responsibilities in the areas of supervision and oversight.

4.21 The development of the national payments system's operational components should be the primary initial focus of the Council's work. Therefore, enhancements to the current (BNR) clearing facilities and the introduction of the proposed ACH should occupy much of its early deliberations. The process for the introduction of new facilities should be both formal and transparent. While the size and complexity of the documentation will vary, the four principles by which a payments initiative will be defined and approved should be consistently applied and include the following steps:

- 1) The process begins by the creation of a business case by the party or parties who are sponsoring the initiative. The business case should comprise the strategy and vision, definition of stakeholders, legal and financial basis and risk management components – conforming to the standards for the national payments strategy itself.
- 2) The draft business case is developed with the support of the payments support group. The group will be responsible for measuring the proposed initiative's impact on the current National Payments Strategy models, scheduling the presentation of the business case to the NPC and facilitating its completion in the correct form for the Council.
- 3) The business case is presented to the NPC which will approve or reject the initiative. If the proposed development is endorsed, the Council will establish two bodies. First, a steering committee will be formed to oversee the project to ensure delivery to time and budget of the desired objectives. Second, the team charged with the actual development and delivery will be formed, typically comprised of full-time appointees and secondments from the various stakeholders.
- 4) The project (e.g., the ACH), when completed, is handed over to those entities which will manage its operation. Typically, there is a scheme entity which manages the business, settlement and customer facing elements and an infrastructure provider who provides and supports the technology components.⁴⁸

4.22 This process is a typical approach for developing new initiatives and is used in most financial institutions. This model differs from the current approach in Rwanda in that it involves wider community engagement and more formal approval and implementation structures.

4.23 Establish NPC workgroups to address specific issues and problems. In addition to addressing major implementations such as the ACH, the Council will be faced with specific national payment strategy issues which require attention and resolution. Typically, such issues affect a number of elements of the proposed developments; the clearest example is legislative reforms.

4.24 Issues may be introduced by NPC members or other payments reform stakeholders. Also, external bodies including international groups such as the Bank for International Settlements or S.W.I.F.T. could recommend changes that require consideration by the Council. It is recommended that such issues be addressed by a NPC Workgroup. A workgroup formed to address a specific issue, should have a

⁴⁸ In today's SIMTEL model, the 'Operations Committee' roughly simulates the scheme element with SIMTEL itself providing the technology support.

limited life-cycle and produce a recommendation for the Council. There is an immediate requirement for the NPC to establish workgroups in the following areas:

- 1) Legal: A number of areas of current legislation need to be addressed in order to establish the correct legal basis for the development of a national payments strategy in Rwanda. To date, eight of these have been identified and inter alia include BNR powers with respect to payments, finality of settlement and the legality of electronic funds transfer. These require immediate and urgent attention. In addition, taking into consideration likely mid to long-term developments, new legislation needs to be identified and implemented. Of these a law in respect of electronic transactions needs to be implemented, data privacy/protection legislation needs to be addressed and legislation in respect of public key infrastructure (PKI) must be considered. A NPC workgroup should be convened to develop recommendations for action by the FSDP legal reform sub-committee.
- 2) Standards: A fundamental requirement in any payments initiative is the need to exchange information, i.e., data in a common, recognized format. The S.W.I.F.T. organization is the best-known example of a payment system based upon this requirement. There is a need to identify and implement the appropriate international and industry standards. Such standards, which extend beyond technology, and agreement on the acceptance of international best practice as documented in publications such as the Bank for International Settlement's 'Core Principles' will also need consideration. These provide guidelines and principles at the higher operational and strategic levels. It is important that NPC is recognized as the responsible body in Rwanda for such decisions.
- 3) Existing systems: A number of aspects of the current systems require immediate attention. The NPC should establish a workgroup with a mandate to specify the necessary actions to address issues such as the delays inherent in processing payments orders, problems with the end-to-end processing of checks and the interfaces between SIMTEL, the devices its supports, and the banks it services.

4.25 Decide upon payments scheme rules and access criteria required for participating directly in the clearing and settlement processing. A key element in the development of a national strategy is the decision by the various stakeholders on the access to facilities such as the ACH. For example, UBPR and its larger units should be given access even if they do not become a de jure commercial bank. Access is typically either:

- 1) Direct by members of the payments 'scheme' who come together to provide the underlying service, share the risks involved and, crucially, guarantee the settlement. The Scheme members are traditionally commercial banks who can settle directly with BNR.
- 2) Indirect by entities sponsored and guaranteed by the scheme members. The indirect participants negotiate their access rights and privileges with the members based upon their unique business requirement. Indirect participants are usually large institutions generating significant volumes

of payments (utilities, government departments) or second-tier financial institutions.

4.26 The NPC usually determines the access criteria in principle, and reaffirms the rules in detail as the various payments schemes are established. In Rwanda, it is recommended that three schemes be established:

- 1) The first supports those institutions that directly participate in the clearing and settlement of the paper-based instruments such as checks and payments orders. Infrastructure support would be provided by BNR.
- 2) The second addresses the needs of institutions that are provided electronic funds transfer-based services such as the current card services and proposed ACH.⁴⁹
- 3) The third addresses those institutions that will be participating in high value payments and should be based upon the current S.W.I.F.T. national user group. When eventually implemented, the Real Time Gross Settlement System (RTGS) users would be members of this scheme.⁵⁰

4.27 The payments schemes are permanent bodies which should meet regularly and have specific operational responsibilities. They should be required to report to the NPC on specific aspects of operations, for example, the performance of members in respect to settlement. They will also be asked to act as a NPC workgroup addressing issues which are specifically within their area of expertise and knowledge. Each scheme should receive similar operational and technical support from the BNR payments support group to that provided to the Council itself. Access criteria should be included in the rules for the payments scheme and should describe in detail how any initiator of payments can participate.

4.28 Members of the payments scheme responsible for a particular payments service or system should meet a number of requirements in order to have access. Not least of these is the requirement to demonstrate an ability to guarantee their settlement obligations and the ability to meet specific operational and technical standards with respect to submission and processing of payment instructions. The members' performance will be monitored and exceptions acted upon by the appropriate scheme and BNR groups.

4.29 As noted above, the NPC should define the principles upon which any legal entity can have access to the various payments systems. These principles become the basis for the development of rules defining members' responsibility and liability. The rules should be transparent and applied when accepting an application for membership from 'new' would be players in Rwanda, e.g., UBPR. Demonstrating adherence to the entry criteria for a given scheme should guarantee acceptance by the other members and a refusal to accept a member who conforms to the entry criteria should be referred to the NPC.

4.30 Establish an ongoing community awareness program promoting payments systems and services use. An important part of establishing a successful national payments strategy is its promotion to the government and commercial sectors as

⁴⁹ Infrastructure would be provided by SIMTEL.

⁵⁰ Infrastructure support would be provided by BNR.

well as the community at large. No payment system exists in a vacuum and, without the support of these groups, the current cash and paper-based methods will continue to be the systems of choice. The NPC should initiate a dialogue with the Rwanda government – in particular the RITA, the Bankers Association and other appropriate groups - to establish and maintain a program aimed solely at promoting the value of payments services that are being implemented as a result of NPC's work.

4.31 The methods used in like initiatives vary depending on the community being addressed. For example, a program targeting students in their last year of education has been operated with great success in some countries. A similar initiative with local financial sector management and staff addressing business groups has also been successful. At the other end of the spectrum press and TV campaigns have been deployed. The program will need to be far-reaching in Rwanda and, as with so many other components of the national payments strategy, will require the support of not only the banks but also a much wider constituency.

4.32 Initiate lobbying of Rwandan government to demonstrate support for the NPS objectives. The development and implementation of a national payments strategy requires significant investment by many parties. In other nations, the payments infrastructure has evolved over a long period and each element (clearing house, eft-switch etc) has been introduced as the business requirement is identified and quantified. This is not the case in Rwanda and in many other developing economies where the current payments infrastructure is a major inhibitor to the development of the economy.

4.33 As a result central bank intervention into the development of the infrastructure is urgently needed. Such intervention is not uncommon and has appeared in a number of forms in nations with payment systems at various levels of development. For example, in the United Kingdom, the government 'Office for Fair Trading' has pressured the British clearing banks into the development of a new 'FastPay' system providing same day settlement for low value payments.

4.34 As another example, in Europe, the establishment of the 'Single European Payments Area' SEPA has the objective of enabling European citizens to make payments in the Euro area as securely, quickly and efficiently as payments within national borders.

4.35 The common element in these developments is that the commercial banks, either individually or collectively, could not see a clear business case for the initiative. As a result they were reluctant to commit shareholder funds to what they perceived to be a high risk investment.

4.36 These same factors are present in Rwanda and, in the light of recent experience with SIMTEL, any attempt to seek new investment from the commercial banks would undoubtedly be viewed with extreme skepticism. This is simply because the very low usage of bank facilities indicates that the introduction of electronic payments systems and services will require major coordinated effort by many elements of the community. Moreover, a return on investment during the initial period is unlikely. This is not to state that the banks in Rwanda do not wish to see such developments proceed. Investment is inhibited solely by issues outside their immediate control. Some of these are technology related; for example the telecommunications network which is being addressed to some degree. Others, such as the low number of bank accounts, are fundamental. Collectively this results in

low volumes of payments and limited opportunities to generate revenues providing a return on investment.

4.37 Some means of creating the critical mass of payments has to be found and key support could come from the Rwandan government in a number of tangible ways. Two immediate steps that should be taken are:

- 1) Introducing legislation requiring most salary payments to be made electronically into the accounts of financial institutions. Initially, this requirement could focus on employers with a work force of more than five employees with the position reviewed by the NPC in the light of one year's experience. Such legislation should be a priority item for the NPC in that it will generate a significant part of the required 'critical mass' of payments necessary to create a viable business case for the proposed reforms.
- 2) Introducing policies whereby all government payments, national and regional are electronically made to, and received from, the accounts of financial institutions. NPC should lobby the government to insist that its suppliers have accounts with financial institutions and use them to make payments.

4.38 The current low usage of banking services is probably the biggest threat to any payments initiative in Rwanda at this time. Without some intervention to encourage the population and commercial entities to use such facilities, it is inevitable that Rwanda's national payments infrastructure will continue to evolve slowly. Inefficient payments systems will inevitably hinder the development of the financial sector and by default the economy itself.

4.39 Align the NPS with the Rwanda Information Technology Initiative. 'RITA' has been established to support the government objective of creating a knowledge-based economy, in which the Information Technology Center (ICT) will play a central role. In regard to the development and implementation of the national payments strategy, RITA offers support relevant to the FSDP in a number of areas; project management and standards development are two examples. The Council should ensure that the developments within RITA are coordinated with its own work. Equally important, aspects of the project could be exploited to enhance the business and technical aspects of payments reform. For example, RITA plans significant enhancements to the current telecommunications network and linking this implementation to the reform could significantly help financial institutions in the more remote parts of the nation link to the proposed clearing house.

Strengthen the National Bank of Rwanda (BNR) Role

4.40 Develop and implement a new BNR operational structure recognizing each of the Bank's four roles. BNR's payments-related activities will significantly increase as the pace of the national payments reform initiative goes forward. To summarize the definition in the Bank for International Settlements 'General Guidance for payment systems development' (May 2005) the central bank roles that should be recognized in developing its operational structure are that of:

- 1) An *operator* providing systemically important payments systems, issuing cash and operating or participating in the governance of systemically important clearing and settlement as well as operating settlement accounts.
- 2) A *catalyst* coordinating payment system design, operation and policy and advising and facilitating legislative change.
- 3) An *overseer* of the payment system publishing principles, policies, etc; monitoring existing and planned systems and advising on necessary changes in organization and operations.
- 4) A *user* participating in the use of systems owned and operated by external parties including (where appropriate) securities depository systems and automated clearing house facilities.

4.41 These changes are oriented more to formalizing existing operations to avoid potential conflicts of interest than to introducing fundamental change in BNR. However, a significant cultural change will be required within BNR as it engages in a collective effort with NPC to move the payments reform forward.

4.42 BNR will need to recognize that its membership in the payments schemes carries no inherent privileges. As a user of (say) the ACH, it should be subject to the same rules and have identical rights and obligations as all other members of that scheme. These have not been easy changes for other central banks, and it is likely that creating an organization that can function in these roles will pose some difficulties for BNR. However, it is fundamental to the success of the Rwanda payments reform initiative that the Bank succeeds in this endeavor by:

- 1) Recognizing the roles and responsibilities of groups like the NPC which establishes payments as a national asset.
- 2) Disciplining its own operations to the scheme rules to demonstrate support for the principle of self-regulation and testify to its ambition to see the highest possible service levels being observed in the national payments systems and operations.

4.43 These changes require reconsideration of some existing BNR roles and will generate the introduction of new functions because, just as payments have evolved and changed, so the traditional central bank organization structure needs to be realigned with the overall payments reforms being implemented. Not least of the reasons is that there are clearly potential conflicts of interests in these diverse roles and serious thought has to be given as to how best to resolve them. To this end, the BNR should begin restructuring its payments-related activities at the earliest convenient time.

4.44 Establish a BNR payments support group as a center for excellence. A payments support group should be implemented within BNR to provide secretariat and technical support to the NPC and act as the coordinating center for payments activity. For NPC, the payments support group should have the primary responsibilities for:

- 1) Maintaining the national payments strategy that is to be developed and documented in the form of three dimensional business, operational and technical level models. The payments support group should monitor proposed developments and operational changes initiated by the NPC assessing their impact on the strategy and ensuring that changes are reflected in the strategy documentation.
- 2) Scheduling all meetings of the Council and its subsidiary work-groups and project teams. Ensuring that the meetings are efficient and productive by arranging and distributing agendas and other papers in a timely manner. Ensuring that appropriate minutes are taken and circulated and the action points arising from the meetings are followed up.
- 3) Assisting stakeholders in developing the NPC 'business case' for specific initiatives ensuring that the documentation is in a standard format including all appropriate information to support an informed debate, for example, on the proposed ACH implementation.
- 4) Monitoring the operations of the various payments infrastructure systems and services and ensuring appropriate reporting is in place to provide the NPC with data on their performance and operations.
- 5) Developing and managing a NPC website to ensure that the information that should be available to the wider public audience is developed and available. In addition, the website should be used to provide background data and links to external sources of payments information.

4.45 The BNR payments support group should have the responsibility for:

- 1) Ensuring that the appropriate groups within BNR are informed of payments-related developments both locally (in particular Council decisions and activities) and internationally.
- 2) Monitoring the performance of BNR systems supporting any NPC payments services and ensuring that follow-up actions are taken in the event of any failure to meet agreed service levels.
- 3) Facilitating changes to existing BNR operations and systems where such become necessary as a result of a Council-approved payments reform initiative.
- 4) Providing consultancy support to BNR departments engaged as *users* or *operators* of payments systems and services as required and appropriate.

4.46 As the payments support group will have diverse responsibilities supporting both NPC and BNR's payments activities, it is recommended that it be created with a special reporting line directly to the executive within BNR responsible for the FSDP. The potential for conflict of interest does not support having the group reporting to any operational department (supervision, operations, information technology etc) within the BNR's existing structure.

4.47 Carry out an appropriate training program for key BNR staff. A structured training program will be required so BNR staff can develop and support the new

innovations. The training should primarily address the needs of the payments support group. However, training in certain methodologies is also required to ensure that the key task of maintaining the national payments strategy models and specifications can be carried out. The Payments Support Group management and staff should be exposed to current best practice as implemented in other central banks. In addition it is recommended that they learn from the experience of RTGS and ACH infrastructures in other African countries. Three alternative approaches are available:

- 1) Industry conferences such as the S.W.I.F.T. annual conference 'SIBOS', the Informa 'International Payments Week' and the North American Clearing Houses Association (NACHA) 'Global Payments Forum' that provide valuable learning opportunities.
- 2) Visits to central banks which have been through similar experiences are always a valuable learning experience. In Africa, those countries that have advanced their payments reform within the SADC region are recommended. In Europe, the Bank of Slovenia is a role model for payments reform in a small country.
- 3) Courses given by central banks such as the Reserve Bank of South Africa and the Bank of England in various aspects of payments systems. NACHA offers similar courses.

4.48 The benefits of exposure to best practice in payments should not be restricted to the payments support group. Other operational departments such as banking supervision, operations and the international department should also learn from the experience gained by that group. Consideration should be given to either expanding the group engaged in this activity or charging the payments support group with presenting a workshop summarizing their experience and the actions proposed as a result of the exposure.

4.49 In addition, the payments support group needs to gain additional technical skills in order to discharge their obligations to both the NPC and BNR. Of these the primary skills that must be acquired are i) appropriate analysis skills to ensure that the national payments strategy is maintained in the correct manner; ii) formal change management procedures and systems; iii) technical skills sufficient to support the group in developing specifications in a form understandable by the BNR Information Technology Department; iv) communication, presentation and management meeting skills; and v) appropriate software tool user skills that need to be used, for example, MS 'Project' and the documentation control system.

4.50 Many changes being recommended will have a ripple effect throughout the Bank, and other BNR departments should be involved in their implementation. For example, the development of analysis skills should be harmonized with the Information Technology Department's systems development life cycle procedures. Recognition that operating the change management procedures will involve other departments is important and consideration should be given to establishing a bank-wide standard approach to this key activity.

4.51 Review and upgrade existing BNR payments support and systems functions. BNR currently provides check processing and settlement facilities at its head office. This operation is being expanded and implemented at various BNR branches. In

addition the bank is a user of S.W.I.F.T. which claims its own right to support its correspondent banking activity. The S.W.I.F.T. system is also used by some local banks to deliver payment orders in respect of large value, domestic currency transactions. BNR participates in SIMTEL's management but is not a participant in the card services provided by that company.

4.52 BNR should formalize these services and create a scheme for paper-based payments to lead by example. This would require the payments support group to facilitate the following activities:

- 1) Developing a set of formal scheme rules that define the rights and obligations of banks which issue checks, deploy payment orders or participate in the interchange activities defined as clearing and settlement. The key element in the rules is the definition of the responsibilities and liabilities of each party at each check clearing stage from presentment to ultimate settlement. The rules should also specify appropriate fines for failure to meet the scheme's documented requirements.
- 2) Developing an appropriate service level agreement that defines BNR's role as an operator of the clearing. This service level agreement documents each component of the service being provided by BNR to support the clearing service and defines appropriate back-up/alternate path procedures to cover the failure of any one link in the processing cycle. The rules should also document appropriate fines for failure to meet the scheme's documented requirements.
- 3) Developing appropriate user documentation defining how the system actually works for users, operational details such as clearing cycles and courier timetables as well as key telephone numbers. User documentation typically outlines the appropriate form and provides basic instructions on the use of any technology.

4.53 It is strongly recommended that the Bank begin this exercise immediately. The current systems in respect of both checks and payment orders have evolved considerably since their introduction. Formalization of the scheme will allow the payments support group to test its procedures in a neutral environment, i.e., one largely under BNR control. It will provide important lessons in working in a more formal cooperative structure which is essential as payments reform progresses.

4.54 Develop and implement a new settlement structure eliminating systemic risk. The current settlement structure should be developed to support the new payments systems that are under consideration. Key aspects will be:

- 1) Each member of the payments schemes should maintain a settlement account at BNR. The account should be used solely for the purpose of processing the settlement of their obligations in respect to the various payments systems.
- 2) A portion of the reserve assets of those financial institutions which are participating directly in the payments systems – that is settling in their own right – should be placed in a special fund. The purpose of the fund is

to guarantee that in the event of a short, mid or long-term liquidity failure, the bank's settlement obligations will be discharged.

- 3) Procedures should be put in place so a failure in the settlement of low value transactions (card, ACH, ATM) is instantly communicated to the scheme's chairperson and the BNR payments support group. If necessary it should confer with the representative of the financial institution involved and invoke the settlement guarantee, raising the necessary liquidity from its 'special' reserve. When the RTGS is eventually implemented a 'repo' process needs to be developed.

4.55 Modern payments systems effectively substitute the electronic instruction as actual legal tender thereby replacing the bank note. It is vital to the success of such systems that they can be used with total confidence. The only way that a timely settlement can be guaranteed is by earmarking funds to ensure that the obligations can be discharged and users of the payment systems do not risk suffering hardship.

4.56 Implement system eventually to expedite high value funds transfer and monitor daily funds movements and need for a Real Time Gross Settlement facility. A Real Time Gross Settlement System should not be introduced (see page 97) during the early period of the payments reform initiative because current research indicates that the business case for it is weak. However, at some juncture, the presentation of a strong case to the NPC can result in a decision to implement an RTGS.

4.57 However, some changes to existing BNR systems should be introduced to better help financial institutions manage the flows resulting from large value payments. The system should also be modified to provide information indicating when a RTGS should be introduced. The recommended changes in respect of high value payments which should be reflected in the scheme documentation described above are:

- 1) Placing appropriate S.W.I.F.T. technology in BNR banking operations, providing training to operations management and staff and developing the correct documentation.
- 2) Encouraging member financial institutions to use S.W.I.F.T. or another secure electronic transmission method to submit large value payments.
- 3) Expediting advice of the settlement to both originating and receiving institutions. The BNR payments support group should work with the Information Technology Department to identify a secure delivery mechanism.
- 4) Escalating a report on the failure of any institution to settle its obligations to the payments support group for immediate action.
- 5) Executing large value payment orders immediately by the BNR Operations Department whether received by S.W.I.F.T. or in another form at some stage.

4.58 The changes should be coordinated with the implementation of a program that will monitor activity to project the need for a real time gross settlement facility. An

'RTGS' would eventually be implemented primarily to reduce intra-day risk in the payments system. Therefore, the program should i) be pre-loaded with a figure that equates with a 'limit'. The limit equates to the amount of turnover that BNR feels generates the need for a RTGS facility. This figure should be reviewed periodically; and ii) the system should calculate the total volume of payments processed each day and then calculates the rate of growth over an agreed period of business days (say 30). Based on this calculation, it should be possible to project when RTGS implementation should be initiated.

Real Time Gross Settlement (RTGS)

4.59 Neither the volumes nor the total value passing through the current systems provide sufficient justification for the implementation of a Real Time Gross Settlement System at this time.

4.60 The implementation of a RTGS is dictated by the volume of payments through the existing systems which should exceed a threshold beyond which the central bank considers the intra-day risks in the payments systems to be excessive and thus to require implementation of RTGS functionality.

4.61 RTGS is a risk management tool. Therefore, while it may be used as the platform for banks to develop services to its corporate clients, establishing the traditional business case is extremely difficult. For this reason, BNR should establish the software to monitor daily funds movements with the view to ascertaining when volumes levels necessary to make RTGS financially feasible from a cost benefit perspective have been reached.

Implement An Automated Clearinghouse (ACH)

4.62 Once the national payments strategy is developed, the most critical activity will be establishing an automated clearing house. ACHs are defined in many ways in different nations. In some countries, the 'ACH' is simply a system that automates the processing of checks. In others, the definition is diametrically different and the processing of any paper-based payments instrument is totally divorced from the operations of the ACH.

4.63 Rwanda requires a facility where the processing of all low value payments can be carried out in a single location. This to some degree ensures a critical mass of payments generating an appropriate return on investment. It also provides a concentration of key human resource skills. Both should provide a good base for the initial implementation and ongoing development of payment systems and services.

4.64 It is recommended that the ACH introduce electronic funds transfer-based systems to process utility bills, salaries payment and consumer finance in addition to the interchange and common processing aspects of the current card systems. The ACH is important because it will process payments that affect a large cross section of the population as well as the commercial sector, in particular, the clients of large utility companies. A key user of ACH based services is the government - for example tax collections.

4.65 While the value of individual payments are typically low compared with the institutional payment systems that should be processed through a RTGS facility, the number of 'ACH' payments is high. A number of benefits are immediately evident from its implementation as it directly impacts such a wide cross-section of the economy. Strategically, the most important of these is an increased use of bank accounts. A successful ACH is the key factor in moving society from a cash or paper base to electronic funds transfer for its payments processing.

4.66 Create NPC business case and begin procurement. The initial work carried out during FSDP preparation indicates that the implementation of an ACH in Rwanda is viable and necessary and should be developed soon. It should be created around the SIMTEL processing company thus allowing for leveraging the existing hardware, premises and support resource assets.

4.67 A significant amount of work was carried out in researching transaction volumes from sources such as government, insurance and utility companies. In addition, the Bureau of Statistics provided estimates on the population actually in employment and the number of households, both key statistics in estimating the probable transaction flow. Refinement and analysis of this work continues at BNR today.

4.68 All estimates gave a positive view of the business potential for ACH services such as bill payment systems and salary processing. The latter was based upon the acceptance of the recommendation that salaries be paid into an account with a financial institution.

4.69 A proven ACH budget⁵¹ was used as a model with adjustments made for costs already covered by SIMTEL to estimate the operational and capital costs. Finally, variations in respect of population and currency were factored into the model (all other demographics were considered identical in the two countries). The capital costs were not adjusted to make any allowance for existing SIMTEL technology assets which were treated as a sunk cost. Final estimates were based solely on household use of public utilities and the automation of salary payments and resulted in an estimated market potential of one ACH transaction annually per capita. Using the resources already invested in SIMTEL plus a US\$ 1.5 million investment in implementation resulted in a transaction cost of three cents in year one falling to one cent in year five. These results should be validated in the form of full business, operational and technical models that jointly comprise the NPC 'Business Case' which should be created for NPC approval. However, the initial analysis (together with every other estimate) supports a decision to development an ACH facility at this time.

4.70 The task of developing the business case should be delegated to the BNR payments support group which should work with the SIMTEL operations committee. When complete, the business case should be submitted to the NPC for approval. After approval is given, the NPC should put the following project management structure into place:

- 1) A project steering committee reporting to the NPC on a regular basis that comprises the business promoters (and eventual operators) of the ACH initiative. The steering committee should be responsible for ensuring the

⁵¹ This budget has been used in the UK, the Bahamas, and recently, in Lesotho.

project delivers what is defined in the business case and will oversee the project team.

- 2) A project team that will report to the steering committee. The ACH project team should be responsible for the delivery, on time and on budget of the systems, operations and support elements of the clearing house. In effect, the project will deliver an operational business unit.

4.71 Both groups should draw support from the BNR payments support group which, in turn, will provide support in the form of project office administration, budget and progress reports, standards administration and observance.

4.72 The first task of the project is to complete the appropriate documentation and begin the implementation process. This will largely comprise the procurement of the necessary hardware and software technology components and appropriate training for the stakeholders. Estimated establishment cost is \$1.2 million for equipment and supporting TA.

4.73 Establish an appropriate post-implementation operational structure. When ACH implementation is completed, the project steering committee and team should be dismissed and the clearing house operation should be established. This operation typically consists of two complementary entities:

- 1) The payment scheme, which actually functions as the business owner of the payments systems and services for which it is responsible, is an association of members bound by strict agreements. Its members are usually the commercial banks.
- 2) The infrastructure provider who delivers the systems, network and support necessary to deliver the scheme's systems and services. The infrastructure company is a processing company that is typically commercially operated by the investors who are not exclusively payments scheme members.

4.74 The key component is the 'payment scheme' and the ACH clearing and settlement processing is only available to scheme members. The key responsibilities of the payments scheme are to:

- 1) Develop the use of the payments systems and services that it "owns" and manages.
- 2) Manage the settlement between the scheme members and the BNR settlement agent.
- 3) Monitor the performance of the scheme members ensuring that agreed service levels are met and the scheme rules respected.
- 4) Define and oversee the processing and network technology which support its systems and services.

4.75 The key benefits of membership in the ACH payments scheme are:

- 1) The scheme will manage a settlement guarantee scheme in partnership with BNR. This means that the members can have confidence in the settlement of payments.
- 2) Only scheme members will be able to use the payments systems and service directly. This means that infrastructure processing costs (whether or not outsourced) will be charged to members on a 'wholesale' basis.
- 3) The scheme collectively (and working with the NPC) will develop various systems, support and even marketing materials collectively. Therefore, costs can again be shared by participating in a 'cooperate to compete' process.

4.76 Despite its significant role and responsibilities, the scheme is not expected to have a significant operational infrastructure. The recommendation is that it draws support, at least during its initial 2/3 years of operation, from the BNR payments support group or the Bankers Association.

4.77 Agree on the rules and other documents comprising the ACH payments scheme legal basis. At this point, the initial work on the payments scheme – in particular access criteria – will have been carried forward by the NPC and valuable experience will have been gained in formalizing the existing BNR payments schemes. A new payment scheme, comprising the financial institutions that wish to provide a specific payment service or services to their clients, will now need to be established to manage the electronic funds transfer payments services. They need to come together to establish the operational parameters that will govern the whole end-to-end process from the initiation of the payments until final settlement with the ultimate beneficiary.

4.78 Two other key agreements provide the legal basis for the payments scheme and the infrastructure provider:

- 1) A settlement guarantee – the payments scheme with NPC support should negotiate a settlement agent agreement with BNR under which BNR will provide inter-bank settlement facilities utilizing its books. The agreement should include a settlement guarantee system whereby a portion of a financial institution's reserve assets is set aside to guarantee the settlement position.
- 2) A service provision agreement – the payments scheme should contract with a processing company to provide the technical infrastructure necessary to support delivery of common elements of its systems and services. The service provision agreement will specify the detail of the services and support being provided by the infrastructure provider. It will provide the specifications which the scheme members will need in respect of their individual interfaces to the ACH, detail the processing costs, specify 'service levels' for all parties involved and detail any penalties for non-performance.

4.79 The legal and operational documentation will need to be approved by the NPC to ensure its conformity with appropriate standards and 'best practice'. In addition, Banking Supervision at BNR should be keenly interested in the settlement and scheme rules documentation.

4.80 The two agreements outlined above are underpinned by the payment scheme rules. This is an agreement between the members of the scheme that is the basis for their participation in providing the systems and services. The scheme rules are developed to include:

- 1) An end-to-end description of the processes that underpin the payment service delivery which defines each key step within that procedure and the responsibility and liability of each party at that point.
- 2) The access criteria for the scheme based upon fair and transparent criteria for membership. These are developed to ensure that scheme membership is available to any institution that can meet the published criteria. The process includes an appeal to the NPC to mitigate against monopoly situations arising.
- 3) Exit criteria that define at what point a member may leave the payment scheme. These are developed to ensure that a member has not been involved in agreements committing the payment scheme and/or its members to developments in which they will have no part. The criteria also ensure that a member has no payments outstanding for processing, such as incurring settlement obligations that as a non-member they cannot discharge.

4.81 Deliver program to bring all direct and indirect ACH users on-line with appropriate systems, trained staff and support documentation. The ACH implementation will affect a significant cast of stakeholders including:

- 1) BNR which will be impacted in each of its four roles, i.e., as operator, catalyst, overseer and user. The scheme's various interfaces, members and infrastructure will need to be implemented and operational by the time the ACH is functioning. The actual settlement process will operate as a sub-system of the overall process and must be completely tested.
- 2) Payments scheme members who will be direct ACH users must have their own links tested and in place. The members will also have to implement new settlement procedures with the inevitable funds management changes operating.
- 3) Financial institutions that are payments scheme members will be providing ACH payments systems and services to their subsidiaries and clients. For example, UBPR should effectively sponsor its larger cooperative bank affiliates. In some cases, this will require indirect users to have some form of access to the systems. As with other users, their systems and interfaces would then require testing.

4.82 ACH implementation will also require two aspects to be addressed which might be implemented on a collective basis:

- 1) Marketing electronic direct debit and credit systems to be carried out by financial institutions wishing to create unique 'value added' services for their clients. Some aspects can be shared and the work should be coordinated with the NPC sponsored 'Community Awareness Program'.

- 2) Initial training in using the system which should be delivered at two levels. The first will address the overall 'end-to-end' process while the second will be focused more on individual banks' operations. There are significant, if not overwhelming, advantages to the former being carried out collectively in order to establish key common understanding.

Restructure SIMTEL

4.83 The SIMTEL company was established on the basis of extensive work by both external consultants and local experts. Since its inception, it has implemented and carried forward a card-based strategy largely focused around VISA brand products. A network of automated teller (ATM) and electronic funds transfer (eft-Pos) devices have been deployed and are supported. In addition, SIMTEL has quite aggressively pursued opportunities in the bill payment and pre-paid payments areas. At this time none of these have progressed to implementation and a number of operational problems continue to give SIMTEL and participating institutions very serious problems in respect of reputation and credibility.

4.84 The company also has very serious financial problems that require urgent attention. Although the indications are that the daily operations are nearing breakeven levels, recapitalizing SIMTEL's needs to be seriously considered. The financial implications of establishing a new shared processing facility make any consideration of the company being allowed to fail unacceptable. Public and private sector confidence in the overall payments system would be severely damaged and this would inevitably have a negative effect on the proposed new initiatives, perhaps even rendering them nonviable. The forthcoming World Bank funded project effectively appointing interim management will hopefully address these problems and help place the company on a sound financial and operational basis.

4.85 The most recent study of SIMTEL was carried out following the completion of the recent FSDP plan activity in Kigali and a paper (SIMTEL s.a. -INTERIM REPORT) prepared for the company's board. This section discusses the basic strategic issues in light of the recommendations in that paper, recognizing that the appointment of a new consultancy/management team is imminent.

4.86 Develop and implement a new 3 year strategy positioning SIMTEL as a more broadly based network management and processing company. The assumption that SIMTEL is the national payments system is fundamentally incorrect. The company is explicitly a technology-based processing company and as such should be in a position to address a number of opportunities across a wide range of areas within Rwanda.

4.87 Its strategy will naturally be primarily financial-sector focused because of the company's ownership, skill base and the orientation of its technology. However, without a national payments strategy framework within which it can operate, it is inevitable that SIMTEL will drift into initiatives which place it in conflict with its commercial bank owners and be more driven by the technology-based culture within the company than by real business needs.

4.88 It is recommended that SIMTEL adopt a strategy which focuses in specific areas where its existing technology can be leveraged or a clear business case

justifying investment exists. The company should be well positioned to address these as it, almost uniquely in Rwanda, provides superior technology with a proven gateway to the payments network.

4.89 Broaden the activities SIMTEL should build to provide more low value payments systems. There will be a number of initiatives which will be generated as the FSDP plan is implemented. These include:

- 1) Processing for the ACH when completed.
- 2) Working with the current SIMTEL participants to offer card services to a wider community of 'indirect users' in Rwanda.
- 3) Providing processing, network management and support to second-tier financial institutions helping with their institutional strengthening.
- 4) Engaging with international companies to provide software solutions to the financial and other sectors in Rwanda.
- 5) Providing back-up and business continuity support to Rwandan financial institutions.

4.90 As a company, SIMTEL must focus on developing its profile in providing processing systems and support to the financial sector and at all costs avoid being involved in the provision of what may be considered competitive services to those institutions' clients.

4.91 Explore potential opportunities and partnerships in commercial and government sectors and RITA-related activities. In line with the overall strategy which positions SIMTEL as a processing company specializing in payments, SIMTEL should focus on the larger commercial companies and government departments that produce and/or receive payments for core businesses. In the commercial sector the obvious choices are the utility and insurance companies; in government, bodies such as the Rwanda revenue authority should be targeted.

4.92 Most if not all of these institutions have automated to some degree and all share a common problem: i.e., collecting and making payments. SIMTEL should develop a service which converts output from the existing old mainframe systems currently operating in the large utility companies into an approved payment format and casts the client as an indirect ACH user when he forwards payments for settlement.

4.93 The company should also develop a service converting inward payments (collections) into a company-friendly format and forwarding them for internal processing. Again, it is stressed that SIMTEL must work with its commercial bank owners in developing this strategy.

4.94 Further opportunities will be identified as the RITA work develops. RITA has a number of ambitious projects in many areas of Rwandan commercial and government activity which should provide a number of opportunities in the areas of outsourcing (providing secure computer processing power) network management (allowing other entities to use the excess existing network resources and providing management) and consultancy, for example providing access to the payments

system. The company is ideally positioned with the appropriate technical architecture to exploit these opportunities.

4.95 Provide payments processing systems on a 'wholesale' basis exclusively to financial institutions. SIMTEL has as its main owners the biggest customers for its primary services. The major challenge in the successful development of the company will be resolving the inherent conflicts in this scenario.

4.96 SIMTEL should develop primarily as an operational support vehicle to the financial sector providing shared processing and network services. However, as a powerful processing company, it is inevitable that it will identify opportunities in the wider market within Rwanda and will be eager to develop these. On the other hand, the owner banks will not wish to see SIMTEL implementing services which conflict with their individual strategies. The solution is for SIMTEL to develop a strategy which ensures that its payments-related activities are either the common elements of the authorization, clearing and settlement and interchange processing or joint-ventures with one or more of its owners. This solution will:

- 1) Place SIMTEL totally in line with the scheme/infrastructure provider model recommended for the national payments strategy.
- 2) Allow financial institutions to focus on the competitive client-facing aspects of payments services and exploit the savings by cost sharing on the common processes.
- 3) Ensure that potential major areas of contention between the company and its owners are eliminated.

4.97 In parallel, SIMTEL should implement a strategy addressing nonpayment-related business opportunities such as payroll and invoice/bill processing for commercial companies and national ID card support facilities for government.

4.98 In summary, SIMTEL is currently pursuing a strategy which requires a quite fundamental re-think. Its activities must be aligned to exploit initiatives being generated by the FSDP as well as seeking opportunities in the commercial and financial sectors – in particular those coming online with the RITA project. However, it must do so in a manner which places it in a support role for its owners - this is a difficult problem and is experienced by all financial utilities. Therefore, a move to the separated payments scheme/infrastructure provider model is strongly recommended. In this model, the commercial benefits of providing payments services flow to the scheme members while benefits flowing to the SIMTEL owners are in the form of a return on investment.