STRATEGIC STUDY DRAFT TECHNICAL NOTE

FINANCING DEVELOPMENT AND TRANSFORMATION

The Centro de Políticas Estratégicas produced this strategic study technical note. This a draft version of the Technical Note for comments and to be used for Forum Events. Please share comments at luci.fonseca@palgov.gov.cv.

II Fórum Nacional de Transformação
CABO VERDE 2030

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Executive Summary

Cabo Verde made major economic progress after the 1st Forum on Economic Transformation in 2003. As a result, Cabo Verde graduated from a Least Developed Country to a Middle Income Country (MIC). By 2030, Cabo Verde aims to reach the Upper-MIC group in the context of continued implementation of its Agenda for Economic Transformation. The country vision aims to build an Inclusive Nation that is fair, prosperous, with opportunities for all. In order to achieve this, Cabo Verde will have to be better at competing, based on high productivity, quality standards, efficiency and better international integration.

The issue of financing for development is central to this economic transformation. Investment opportunities are strong but they occur at a time when the borrowing capacities of the Government, and the national private sector capacities are more limited and economic growth is weakening. In this context, a pragmatic and comprehensive approach is needed to explore all options for financing investment projects. The new agenda will aim to design sustainable solutions to meet the challenges and financing requirements of Cabo Verde's development and growth ambitions through 2030. The action plan envisaged is summarized as follows:

- **Improve budget revenues and involve more the private sector in public investments:** Tackling growing debt and maintaining investment capacity will require the following mesures:

(i) increase tax revenue by expanding the tax base through new targeted taxes and optimized rates, and improved tax collection through capacity building, this without unduly penalizing businesses;
(ii) increase private investor financing through public private partnerships (PPP), in order to decrease the burden and share of investment financing on the public treasury while improving management of public infrastructures and services;
(iii) to that effect establish appropriate framework such as a Financing and PPP Unit to improve the project management process and supervision of major public and PPP investment projects;
(iv) Attract more, and diversify FDI inflows, by deepening and accelerating the ongoing process of improving the business framework and investment promotion policies, in accordance with internationally recognized best practices.

- **Optimize ODA Assistance and diversify Development Partners:** The MIC status is expected to open up new but more expensive funding opportunities. Optimization requires further strengthening the capacity for preparation and better selection of projects and optimal allocation of projects between donors. To that effect increased cooperation with new emerging market countries (e.g., BRICS) would enlarge opportunities for accessing new funding, and possbily more competitive sources.
- **Strengthen Banking and non banking financial institutions:** Several levers will be used to strengthen the banking and non-bank institutions and foster more adapted financing solutions to smaller companies.

(i) Promoting the emergence of strong banks: New and updated Banking and Financial Institutions Laws and Regulations would enable better supervision by the Central Bank and more transparency of onshore and offshore banking. These initiatives include progressive incorporation of *Basel III rules* in accordance with best practices observed in other MICs. These measures would be enhanced by introducing new risk management tools such as a Credit Information Bureau and undertaking annually a financial stability assessment.

(ii) Targeted support to promote SME financing: Small and medium enterprises (SME) face stringent terms and conditions of borrowing. To remove such constraints and facilitate their access to borrowing, as well as equity, newly established financial institutions, such as Novo Banco, venture capital and guarantee funds, should be supported financially and technically to play efficiently their role. Leasing Finance and Factoring transactions should be promoted; these activities require a secure legal and fiscal framework for lenders, particularly in terms of property rights, the exercise of guarantees, insolvency and liquidation processes, and transparent and no double taxation.

(iii) Support to Micro finance institutions: Providing more access to financing for smaller, rural based and urban micro enterprises requires promoting microfinance institutions. Technical and financial assistance should be provided to existing institutions. The regulatory framework should be reviewed for the development and expansion of microfinance activities and the establishment of internationally recognized microfinance institutions and microfinance rating agencies should be promoted.

(iv) Development of refinancing options through securitization: Securitization transactions can be easily developed thanks to the existence of large volumes of mortgages and of a Stock Market. An adequate legal and fiscal framework should complement these. In the longer term, securitization will help banks and financial institutions improve their lending capacity and asset/liability and other risk management activities.

(v) Promoting Non-banking Financial Institutions: Development of contractual savings from insurance institutions and pension funds can strengthen bank resources and cover the needs for long-term investments and liquidity of the Stock Market. The Government should promote the growth of insurance, social security and pension insurance schemes, particularly for accelerated development of retirement savings and inclusion of the entire population through a better coverage of those in the informal sector.

- **Stimulate the stock market:** The financial market must reach a critical mass to play an important role in financing the economy and supporting the development of a "finance" cluster. The Government should implement a program to stimulate all the factors supporting the development of the market:

(i) Stimulating financial and long-term savings: A public information campaign should better familiarize investors and corporations on investment and funding opportunities available through the Stock Market. New regulatory and tax frameworks will be designed to facilitate Stock Market listings of companies in major sectors (banks, telecommunications, tourism, construction, real estate), listing of SMEs and foreign companies and the development of mutual funds. Securitization will add needed impetus to the diversification and expansion of the supply of securities.

(ii) Develop financial transactions and support activities: The Government should promote the development of an intermediation and asset management industry offering a rich range of investment products. Financial training will be encouraged. Infrastructure and information and communication technologies should be upgraded to provide fully automated treatment systems and competitive transactions.

(iii) Enhance cooperation with international markets: Promoting a stock market and developing activities within the "finance" cluster require stronger integration to international markets. Cabo Verde will develop cooperation with other financial markets, including other ECOWAS, to facilitate and enhance the trading of foreign securities and transactions between these markets.

- **Channel Remittances towards financing of the economy:** Remittances could have a greater impact on the development of Cabo Verde's economy if they are focused more on investment than consumption. This will require making available better remunerated and more secure financial products and investment opportunities. This would include facilitating greater access to housing ownership, encouraging investments in mutual funds, and more tax incentives for financial savings.

Implementation of reforms may encounter difficulties if certain constraints on the business environment and the availability and cost factors are not lifted. In this respect, the State should undertake an active policy to (i) improve the legal and judicial framework to international standards, well-suited to the development of high value banking and financial services, (ii) provide at competitive costs infrastructures and services essential to the development of the banking and financial activities (including electricity, ICT, air transport), (iii) develop support activities and (iv) build the necessary human capital.

For a rapid and effective implementation of the reforms, the Government should focus on the projects with high short-term impact including (i) the establishment of a dedicated unit for project financing and public-private partnerships, (ii) the establishment of a Credit Information Bureau, (iii) the strengthening of the microfinance institutions, (iv) the improvement of the supply of leasing and factoring services and (v) the launch of a securitization project.

It is expected that these various measures (i) would improve Government revenues and ability to sustainably finance public projects, and foster the development of (ii) a strong banking sector, able to support large enterprises and SMEs in financing their investment projects and operations and with greater resilience to systemic shocks, (iii) a dynamic and innovative financial industry which contributes significantly to long-term financing of companies and the Government, and the needs of institutional and individual investors, including the diaspora, and (iv) a finance cluster contributing more significantly to GDP. Successful implementation could generate new financing capacities through the banks, the FDIs and the stock market that could represent more than 120% of Cape Verdean GDP.

Context

Cabo Verde made major economic progress after the 1st Forum on Economic Transformation in 2003. A wide range of reforms were undertaken to improve government efficiency and the business environment while major investments were realized in infrastructure to turn the country into an attractive place to do business. As a result, Cabo Verde has good standing and great visibility with international investors, particularly in the tourism sector. Tourism, construction and real estate boomed and laid the ground for a stronger economic base with revenues that topped remittances and levels of foreign direct investment (FDI) higher than Official Development Assistance (ODA). In 2008, Cabo Verde graduated from a Least Developed Country to a Middle Income Country (MIC).

By 2030, Cabo Verde aims to reach the Upper-MIC group in the context of continued implementation of its Agenda for Economic Transformation. The Agenda is articulated around seven clusters and five success factors (Business environment, Infrastructure services, Education, Entrepreneurship and Private Sector Development, and Financing development). The country vision aims to build an **Inclusive Nation that is fair, prosperous, with opportunities for all**. In order to achieve this, Cabo Verde will have to be better at competing, based on high productivity, quality standards, efficiency and better international integration.

The issue of financing for development is central to this economic transformation. Investment opportunities for cluster development and implementation of the necessary infrastructure are strong; however, they occur at a time when the borrowing capacities of the Government and the national private sector capacities are more limited and economic growth is weakening. In this context, a pragmatic and comprehensive approach is needed to explore all options for financing investment projects, from the smallest to the largest, from the simplest to the most complex. The objective is to ensure increased access to innovative local and international sources to finance and implement the transformation agenda.

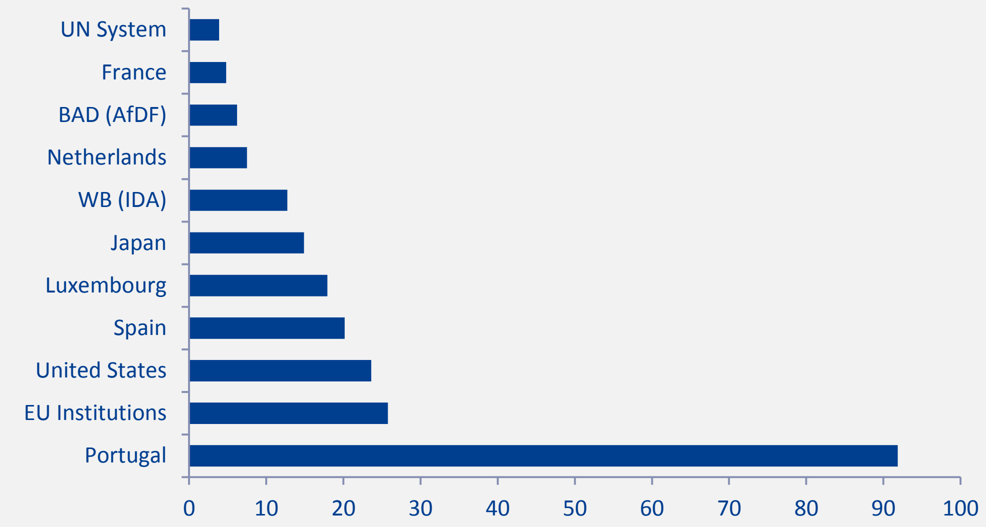
Significant achievements in many fields

The assessment of Cabo Verde's financing capacities takes into account several specific comparative advantages that the country has built over the past decades. These advantages include high credibility achieved with donors, above average absorption capacity of ODA, an advanced financial system, an attractive business environment for international investors and significant contribution from its diaspora.

High credibility with donors and good absorption capacity

Cabo Verde has succeeded in drawing a significant volume of ODA to finance its development. Its good performance in terms of transparency, governance (the Mo Ibrahim Index ranks the archipelago 3rd in 2013 after Mauritius and Botswana) and political stability, have helped to position the country as one of the highest recipients of ODA. Net aid flow received represented 14% of GNI in 2011 and 13,3% in 2012. Main donors are Portugal, the EU institutions, United States of America, Spain, Luxembourg and Japan.

Figure 1: Cabo Verde annual average ODA inflows from 2007 to 2011

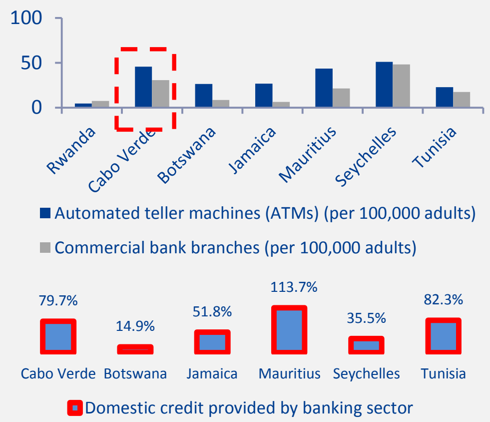


Source: World Bank

An advanced financial sector with a high contribution to financing the economy

The financial system is well-advanced in several aspects; The banking sector is diversified with seventeen (17) local and offshore banks, a stock market, eight (8) micro-finance institutions, and several insurance and non-bank financial institutions. Cabo Verde emerges as a model with the high contribution of its banks in financing the economy. In fact, financial institutions provide a level of domestic credit equivalent to about 80% of GDP, twice the average achieved in middle income countries. The population also has a higher level of access to financial services, compared to other MICs. The market capitalization of listed companies on the local Stock Market, reached about 17% of GDP in 2012. The stock market is increasingly being relied upon by the Government to cover the balance of its financing needs.

Figure 2: Access to financial services

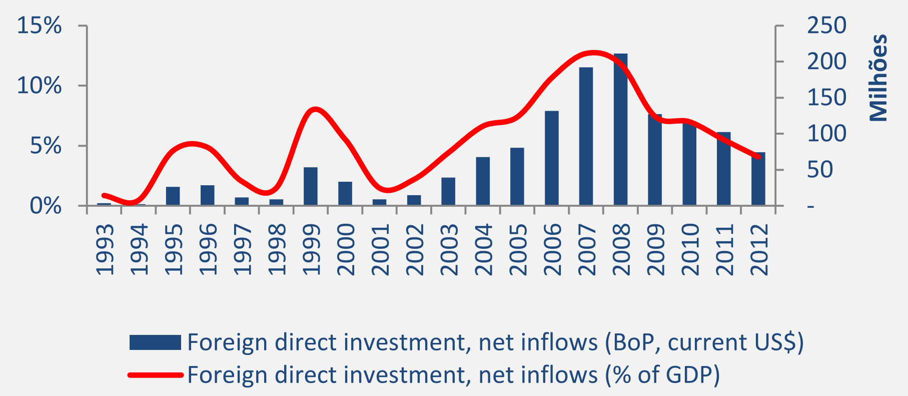


Source: World Bank

Dynamic growth of Foreign Direct Investment

Foreign Direct Investment (FDI) has become a major source of financing for Cabo Verde's economy. From 1993 to 2012, the FDI net inflows grew at a compound annual rate of 16%, and even 46% between 2002 and 2008, reaching 13% of GDP in 2008, before the European financial crisis and the following economic slowdown reversed the trend. Cabo Verde has set up a business environment favorable to FDI, particularly those targeting export-oriented activities: equitable treatment of foreigners, transparent and competitive markets, tax incentives, and free transfers of profit dividends and capital gains, as well as possible repatriation of capital investment. However, Cabo Verde lags behind similar countries (SIDS) in terms of FDI attraction (as a percentage of GDP)

Figure 3: Evolution of Foreign Direct Investments in Cabo Verde

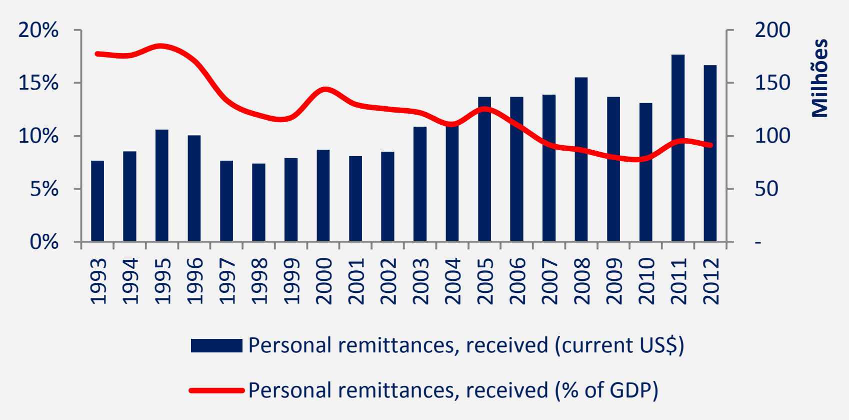


Source: World Bank

High contribution of the diaspora

"*Cabo Verde has the particularity of having more Cabo Verdeans or descendants of Cabo Verdeans living outside the country than in it*". This important diaspora has been contributing to their homeland economy through transfers of funds, investments, and as a source of qualified human resources. The volume of remittances has been growing over the years (reaching approximately 170M USD in 2012 and 9% of GDP); migrants' deposits contribute also to the liquidity of the banking sector and are now reaching 39% of total deposits. This contribution of the diaspora is considered as a major lever for the development of the country and the Government intends to reinforce the relationship with migrant communities as a continuing undertaking in implementing the transformation agenda.

Figure 4: Evolution of Remittances in Cabo Verde



Source: World Bank

Some constraints to overcome

In spite of these encouraging achievements for the financing of the Cabo Verdean economy, there are still some constraints to be considered when designing sustainable solutions to meet the increasing financing requirements of development. The main constraints include the high public indebtedness level, the increasing cost of borrowing, the vulnerabilities of the economy and of the financial system, and the weaknesses of the private sector.

High public indebtedness and budget deficit

The volume of total outstanding debt has inflated during the last decade, reaching today a level that raises concerns about its sustainability. In 2013, the total public debt stock was estimated at 95.6% of GDP (IMF). Of this stock an 81% amount are concessional loans, of which 50.5% are multilateral; the World Bank Group and the African Development Bank are the main creditors. Budget deficit in 2012 reached -13.5% of GDP and was estimated at -12.8% for 2013 by IMF. This deficit was due principally to public funding of important investment programs, insufficient tax revenues and on lending to State Owned Enterprises (SOE). As a result, Cabo Verde's Issuer Default Rating for long-term foreign and local currency borrowings was downgraded from B+ to B by Standard and Poor's in December 2013 and by Fitch in March 2014.

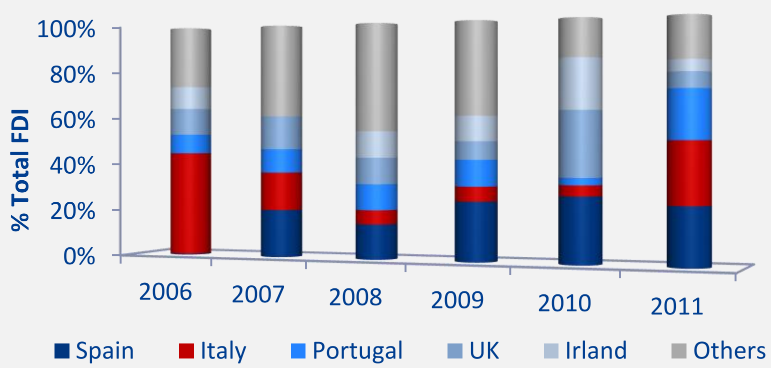
Increasing financing costs

As a result of its transition to the status of an MIC, Cabo Verde's access to concessional funds will be progressively limited even though more funding sources will be available. Borrowing terms and conditions will get closer to those of commercial markets. Rating downgrades will also have a negative impact on the borrowing costs when Cabo Verde will have to issue debt on international markets.

Vulnerability of the economy and financial system

The economy of Cabo Verde suffers from a high concentration of key sectors and from vulnerabilities to external factors. Tourism represents more than 20% of GDP and remains the principal sector that draws foreign direct investments (in 2011, 70% of FDI was in tourism and real estate). The fisheries sector, although representing just 1% of Cabo Verde GDP, generates 70% of its export receipts. The economy also remains sensitive to external environments, mainly the Euro Zone where Cabo Verde draws the essential of its external financing needs and realizes 85% of its trade volume.

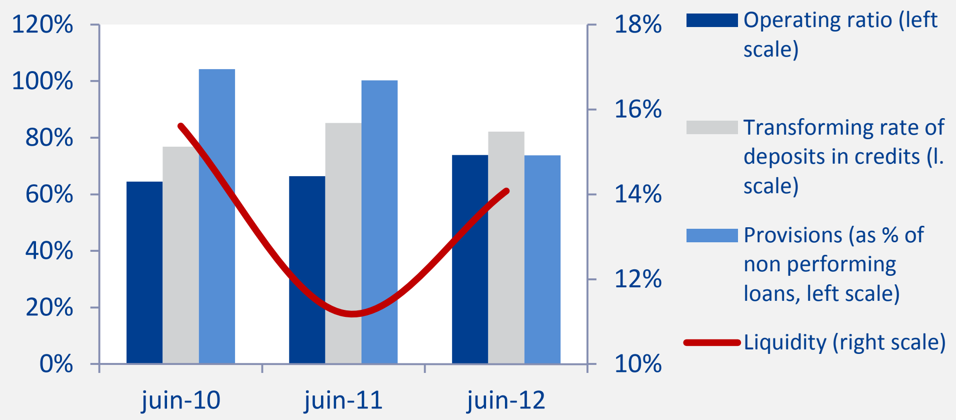
Figure 5: FDI Breakdown by origin of investors



Source: 2013 Investment Climate Statement-Cabo Verde, Bureau of Economic and Business Affairs, U.S. Department of State

The banking sector is also highly concentrated as the two largest onshore banks account for 70% of total bank loans. The significant weight of bank loans in real estate and tourism (42% of total loans to the private sector) represents a major risk factor. Increasing volumes of non-performing loans aggravate the situation. In addition, there is a low diversification of risk as the five largest borrowers represent more than 120% of bank equities. Additionally, bank deposits originate mainly from non-residents. Along with these constraints and risks, the development of the capital market is still limited as its equity market registers only 4 listed companies, with a very low turnover (2% of market capitalization traded).

Figure 6: Banking sector overview



Source: Banco de Cabo Verde

Weakness of the private sector

Micro and Small Enterprises (SMEs) are the largest part the private sector, where a majority of enterprises operate in the informal sector. SMEs represent 93% of the total number of enterprises in Cabo Verde and employ 41% of the workforce. In spite of the improvements in the business environment, there are still many constraints to address to strengthen the private sector and help achieve the ambition of higher growth and diversification in the new transition period. One of the main constraints relates to the borrowing capacities of the private sector. It is still difficult for most SMEs to access credit. About 37% of companies identify access to finance as a major constraint and only 24% of investment requests are financed by the banks. In general, collateral and loan risk guaranties are estimated to be the equivalent of 176% of loan amounts requested. Other important constraints concern the rigidity of the labor market, the weak regulation of the insolvency and liquidation processes and the high cost of public utility services.

Main challenges to face

In reference to the aforementioned achievements, however dampened by the constraints, the ambition for economic diversification, cluster development, and infrastructure construction requires that certain challenges be met. These challenges will also determine guidelines for economic policy in financing development.

Undertaking important investment programs with an already high debt

The current debt burden of Cabo Verde is one of the most difficult constraints facing the financing of economic transformation. The projects undertaken and funded over the last decade have been substantial, but financial requirements for identified new investments, particularly in transport infrastructure, are much higher. Funding for these projects will require more efficiency in the selection and management of investment projects, improved government financing capacities and greater private sector involvement and contribution.

- **Improvement in project selection**

The processes of selecting, managing and evaluating investment projects should be reviewed and upgraded. The Government will face, not a scarcity of available funding but rather a constraint of debt sustainability. It will be important to channel Government resources to projects with higher economic impacts, ensure timely management of projects and within budgets, to guarantee a significant return on investment. This shall require a lean project management system and sufficient budget resources for project preparation, contract negotiation, implementation control and maintenance. Under these conditions, the dynamics of public debt to GDP ratio will be sustainable, and in the long-term, will maintain Cabo Verde's capacity to fund its projects.

- **Increase of tax revenues**

The Government is the largest contributor to the financing of public projects through its own tax revenues. Greater efficiency in project management also requires that the Government allocate larger budget resources to project management. In order to increase the level of public project financing from internal funding, while maintaining a sustainable level of indebtedness, it is crucial to significantly increase the level of fiscal revenue. Policy objectives should include a broadening of the tax base, an improvement of tax collections, and an increase in selected tax rates, in accordance with an optimal and targeted approach avoiding an eventual negative impact in the business environment. These initiatives should be complemented by new incentives, rationalized support and more government controls over SOEs performances, with a view to decreasing their reliance on public subsidies.

- **Delegation of more activities to the private sector**

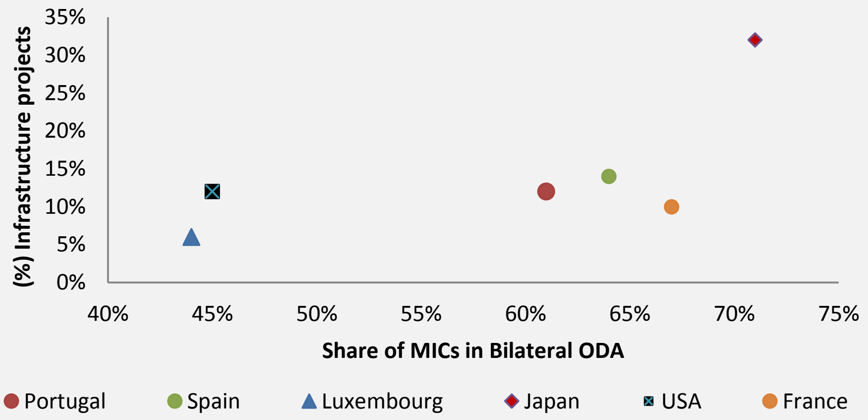
Increased private sector role and participation in investment projects will be a critical enabling factor in the success of the second phase of transformation of Cabo Verde. Over the past decade the Government alone has played a vital role in building the foundations of the economy. However this was undertaken at a heavy price including an unsustainable debt burden and limits on its capacity for action in the years to come. The new wave of investments should be undertaken as much as possible in association with the local and foreign private sector. The practice of delegation of public services to the private sector, particularly in the operation of infrastructure and public utilities, should be emphasized and facilitated. In order to further increase public investment levels, the government should adopt appropriate laws and regulations to facilitate and promote public private partnerships (PPP). FDI should also be heavily promoted by reforming and bringing the business environment up to international best practice standards.

Improving public finance capacities to compensate for decreasing access to concessionary funds

Cabo Verde relied mostly on ODA which helped mobilize substantial funding at exceptionally favorable and concessionary terms and conditions (low interest rates, and up to 10 year grace and long amortization periods). Its graduation to the category of MIC will open new doors for funding but will imply a reduced access to concessional resources. The rise in the cost of borrowing will increase the stress experienced from an unsustainable level of public indebtedness. Cabo Verde will have to adapt its financial cooperation strategy to overcome the decline in concessional financing. At the same time, the country will have to explore innovative new funding methods as well as ways and means to increase user contributions to the cost of investment and operating charges.

➢ **Optimization of ODA**

Figure 7: ODA Breakdown by recipients and sectors



Sources: OCDE, PG

Cabo Verde will partially lose access to funding from IDA/WB Group, and ADF/AfDB Group, which had contributed the most to the development of its infrastructure. Other sources, such as the market windows of the IBRD and AfDB, will provide new funding opportunities for larger investments requiring higher volumes of capital and borrowing. However they will come with stricter eligibility and economic and financial feasibility requirements as well as higher interest costs. In addition, the country's traditional financing partners are expected to devote a significant part of their assistance to MICs. Thus the risk of contraction of funding amounts would be limited.

Faced with new ODA terms and conditions, the government should adjust its strategy for financing public projects. One of the first steps is to optimize the allocation of projects among existing development assistance funding partners. To optimize ODA, the portfolio of projects would be allocated between donors, taking into account more systematically the possibilities offered by each partner and the interest of the country. For example, Japan could be expected to focus on transport infrastructures as economic infrastructures projects represent about 40% of its bilateral cooperation.

➢ **Diversification of partners**

The second area of improvement of financing public investment is the diversification of partner countries. Strengthening its partnership with the major emerging economies like the BRICS, which have significant financing capacity, should be of interest. Brazil is active in the agro-industry area and is willing to expand cooperation relationships with Portuguese speaking countries in Africa; India in technical assistance, particularly in industrial technology; China is active in Africa, mostly in infrastructure.

➢ **Development of structured financing based on user's contribution**

Public investment with high economic impact, and the possibility to easily collect fees from users, can further extract contributions from these users for their funding. The principle is already applied to the financing of road maintenance by a tax on petroleum products. In some countries, an axle tax levied on heavy trucks, contributes to financing the maintenance and construction of roads. Cabo Verde may extend this principle in particular for the development of transport infrastructures.

Improving private sector financing with a small and highly leveraged financial sector

Compared to other MICs, the current contribution of banks to finance the economy is already very high, even if it does not meet all business needs, including long-term financing and funding of SMEs. The banking sector will remain a major pillar in financing the transformation of the economy, particularly in the context of a growing involvement of the private sector in project development. Its ability to meet the investment needs and short term working capital requirements of businesses will be crucial to the success of the new phase of transformation. It will be reinforced by stronger regulation of the sector, the development of new quality and risk control services, targeted support measures by the Government to private sector financing, and a better use of the leveraging capacities of the Stock Market for long term borrowing and investment capital financing.

- **Strengthening the financial system**

Strengthening the stability of the banking sector is a key objective in order to provide sustainable funding and foster the development of a high-value "finance" cluster. Vulnerabilities will then be mitigated and systemic risk better managed. This raises questions regarding the prudential regulation and supervision of financial risks. In general, it is recommended to move rapidly towards the Basel III principles or higher norms as in Seychelles. This country imposes a higher capital adequacy ratio and now ranks at the top of small MICs for the level of capitalization required for banks; Cabo Verdean banks are on average less well capitalized in this group of countries.

Moreover, the stability of the financial sector should be evaluated regularly for proper management and mitigation of systemic risks. For higher transparency of financial system transactions and improvement of the quality of bank assets and loan portfolios, a credit information bureau would be a well-suited tool. The implementation, benefits and costs generated by an information bureau are illustrated by the Moroccan experience summarized below.

Box 1: Credit Information Bureau in Morocco

- Founded by the initiative of the Central Bank of Morocco in 2007.
- Mainly **owned by a private company** (Experian at 67%) and in minority by other banks (15%) and assurance companies (18%)
- **Monitored by the Central Bank** of Morocco.
- **Process is clearly set**: data are sent by all financial and non-financial institutions once a month to the Central Bank which forwards the respective data to the Credit Bureau.
- **Data** concern specific client information like current and historical repayment potential in financial but also non-financial institutions, indebtedness and financial operations indicators.

Requirements for establishing the Credit Bureau in Morocco:
- raising awareness of this topic in the community;
- creating an IT system which would enable a transparent and efficient share of data;
- staffing and empowerment of the employees.

Benefits of the set of a Credit Bureau in Morocco:
- enabled the financial market to be transparent and competitive;
- simplified and reduced loan approval process as the data are directly provided from Credit Bureau;
- number of non-performing loans (NPLs) has substantially decreased, while loan volumes are growing.

Cabo Verde is also considering the establishment of large international banks to develop the financial cluster. Given the small size of the banking sector, it is likely that this strategy will only raise interest from investment banks and possibly in the long term, once the feasibility conditions are met, principally the availability of numerous qualified human resources, in various specialties, and good integration with international markets, particularly the African markets.

- **Establishing targeted support for SME financing**

Strengthening of the banks does not solve all the problems of enterprises' access to finance. It will be necessary to provide targeted State support to SMEs which face severe financing constraints. The Government tools to support the private sector financing generally include partial guarantee funds, credit lines or public credit institutions, and venture capital funds. However, despite the ADEI's growth and competitiveness fund (FCC) and the Novo Banco loan guarantee program, meaningful outcomes are still to be realized. Significant volumes of financing are needed to make these types of financial products operational. Initially seed money should be expected from public finance sources, friendly governments, and the diaspora; in the medium-long term, further funding could be provided internationally, through investment promotions towards intermediaries who have access to international markets and appetite for financial risk in Cabo Verde.

Certain professional skills are required by these institutions to be able to offer sophisticated financial products. These skills include risk analysis and in-depth financial research and analysis. Candidates with actuarial or investment banking experience, and strong executive management credentials in the finance area should be hired in order to strengthen the capacities of these institutions.

The government can also encourage the development of specialized institutions and products that are more suited to SME financing. Strengthening micro-finance institutions will offer more consistent solutions to the needs of small businesses and cooperatives, particularly in the agriculture and fisheries sectors. However, it takes time to develop cost effective business models in microfinance. It would be therefore useful to attract recognized institutions that will disseminate best practices in this field. Promotion of leasing and factoring can meet the equipment and working capital needs of SMEs that cannot offer significant guarantees. The development of innovative financing solutions such as crowd-funding could also be facilitated with adequate regulation and investment in requisite ICT infrastructure.

- **Supporting financial market development**

The existing stock market is an attractive financing medium. It also represents a major pillar in the development of a "finance" cluster. It is at an early stage of development covering a limited number of large companies, but plays an increasing role in funding the public treasury and in the management of assets of non-bank financial institutions. A more efficient contribution of the Stock Market to the economic transformation project implies a significant growth in market capitalization and liquidity, the improvement and diversification of the supply of investment products, and the stimulation of financial savings.

An agenda for development financing

The preceding diagnosis of current funding alternatives for Cabo Verde's economy has highlighted the strengths, but also constraints, for each financing option and the challenges to address to successfully finance development projects. To this end, the following actions are defined to translate the strategic orientations and help Cabo Verde find the needed funding resources.

Increase the Tax Revenues

Cabo Verde has already made substantial progress in implementing its structural fiscal reform program. VAT has been harmonized with the definition of a standard rate; three new codes were adopted (General Fiscal Code, Fiscal Procedures Code, Fiscal Execution Code) and the adoption of the Income Tax Code is in progress; the establishment of a taxpayer unit shall support the collection of taxes.

The first steps to increase State revenues include improving the efficiency of tax collections. Referring to the Mauritius experience, the main drivers include accelerating the simplification of administrative formalities, notably through electronic declarations and treatment, the strengthening of the technical and human capacity through the recruitment and training of new inspectors, the increase in the pace of controls, and the launching of a broad public campaign to promote responsible attitude and citizenship among the population.

A second set of measures aims at broadening the base of tax contributors and optimizing tax rates. The thresholds and procedures for levying taxes and applying the appropriate rates could be modulated to increase the number of contributors and the volumes of revenues. For example, the increase in VAT, excise duties and stamp duties has had a significant positive impact on tax revenues in 2012 in the Seychelles; considering that the VAT rate in Cabo Verde is lower than in other ECOWAS countries (around 18% in general), there is a margin for increase. However, this adaptation should be carefully designed to take into account the competitive edge of the economy.

Thirdly, Cabo Verde may finance certain projects by increased contributions from end users through fees. Part of the cost of road maintenance is funded by a levy included in the price of fuel. This levy could be raised to a level that better meets the needs of adequate investment in road maintenance. In some countries, a stronger contribution is required for heavier trucks that cause greater damage in road infrastructure (e.g., the axle tax). This principle can be applied to several types of activities if tax collection systems are simplified and made more efficient, and the service is cost effective for the user (roads, airport infrastructure, and telecommunications).

Fourth, the reform of remaining SOEs could be accelerated to reduce the contribution of the Government to their financial viability. Performance-based management contracts should be generalized for SOEs and regulation on prices should aim at reducing their deficits and government subsidies. The Government should consider all opportunities for partnership with the private sector, from management contracts to privatization, to improve operational performance and development of SOEs.

The expected impacts of tax reforms include a significant improvement in Government revenues and ability to finance public projects. This should lead to better control of the budget balances and translate positively on its sovereign risk rating as well as on its future borrowing and debt service capacities.

Optimize Official Development Assistance

Cabo Verde was able to finance a major program of public investments given the excellence of its relationships with its technical and financial partners, and an efficient planning system. This system allows a better selection of priority projects and coordination between the Ministry of Finance, the Ministry of Foreign Affairs and the sector Ministries for a more appropriate allocation of projects between various donors in accordance with their aide intervention strategies.

The status of MIC opens up new funding opportunities but with rates closer to market terms and conditions. On the positive side such funding can be for longer terms. Moreover there are bilateral donors who finance MICs in more significant proportions, even if the terms and conditions are not concessional. Japan, France and Spain are among countries that dedicate more than 50% of their bilateral aid to MICs.

Cabo Verde is expected to easily adapt to such new terms and conditions, and to seek maintaining an effective contribution from technical and financial partners to its funding. The country will strengthen the capacity of departments in charge of the preparation and selection of projects, and ensure more systematic and optimal allocation of projects between donors. Economic cooperation with Major Emerging Countries (e.g., BRICS, Turkey) will be further developed to take advantage of new funding opportunities that are often more competitive.

The expected results in this area include better channeling of funds to projects with the highest economic impact, maintenance - in the medium term - of a high contribution of bilateral financing with better terms and conditions, in particular longer amortization periods, and the assurance of improved debt sustainability. In the long term, Cabo Verde would no longer rely on ODA; viable macroeconomic policies, and better project selection and management should guarantee greater access to financial markets at commercial rates for funding. It is also expected that the enhanced skills in resource mobilization policies and procedures will provide significant additional impetus to the country's investment promotion efforts.

Develop Public-Private Partnership

The funding strategy of the economic transformation must give prominence to public-private partnerships in which Cabo Verde has yet limited experience. The development of such projects requires a variety of technical skills for further support to the departments concerned, including: the promotion of projects with national and international private sector partners; conducting technical, economic and financial feasibility studies; drafting and evaluating legal documentation and studies for PPPs; preparing and evaluating tender and other procurement contracts; undertaking contract negotiations; and project monitoring.

A dedicated team should be established to implement PPP projects. Based on internationally recognized best practice models of PPP Units, and taking into account the country's political and administrative organizations, the creation of such a PPP team within the Ministry of Finance is recommended. The capacity building required for project preparation and monitoring with technical and financial partners (see section on ODA) and for the development of PPPs justify the creation of a single unit in charge of "supporting the project financing and development of PPPs".

This specialized unit will be set up within the Ministry of Finance to assist sector and branch departments in the preparation, evaluation and funding of their projects. It will also be responsible for developing government policies and strategies on PPPs and assisting in the creation of the necessary legal and regulatory framework.

This important initiative is expected to have a major impact in the financing of all income generating projects (energy, water, sanitation, maritime transport, air transport). It is also expected to contribute in developing technical know-how and national expertise that will help to attract and facilitate private investments, and to promote competitive infrastructures while controlling and mitigating sovereign risks associated with such investments.

Box 2: PPP unit in Mauritius

In 2002, Mauritius set up a PPP Secretariat which is under the supervision of the Ministry of Economic Development, Financial Services & Corporate Affairs. This unit drafted PPP legislation (PPP Act 2004) and produced PPP guidance manual.
There are 4 key players in the Mauritian PPP scheme:

- **The Contracting Authority** whose role is to identify, appraise, develop and monitor a project to be implemented, to undertake a feasibility study for PPP project and to prepare a request for proposal on the approval of the feasibility study;
- **The PPP Committee** makes an assessment of a project submitted and gives its recommendations. It also formulates policy in relation to PPP projects and develops PPP awareness in the country;
- **The PPP Unit** deals with matters relating to PPP referred to it by the PPP Committee;
- **The Central Procurement Board** ensures transparency and equity in the bidding procedures by examining the bids received and approving the award of the project.

Attract more diverse Foreign Direct Investment

The development of FDI is a major and crucial component for financing the transformation, particularly in the context of high public indebtedness, and to induce a necessary rise of the private enterprise activities. Foreign investors are always looking for countries which have a favorable legal and regulatory framework that encourages them to invest by making available an investment process that is as smooth and as short as possible.

A detailed strategy is proposed in the separate Technical Note on Business environment. It aims at improving the business environment and FDI by positioning Cabo Verde as one of the highest-ranking African and Insular countries in the Doing Business, setting up efficient and optimal administrative processes and developing a world-class country investment promotion system.

The expected outcomes and impacts are substantial for an economy that has so far, been strongly driven by foreign private investment over the last decade. FDI, which peaked at more than 13% of GDP in 2008, will remain a major source of financing for private sector development across the clusters and for the development of major PPPs in infrastructure during the new transformation phase. Compared to other Small Island Developing States (SIDS), Cape Verde ranks in the bottom third in terms of net stock of FDI. An increase in the stock of FDI between 50% and 80% of GDP can be an achievable goal.

Strengthen the capacities of the Banking System

The banking sector, which already plays a central role in financing the economy, will have to grow to play an added and more significant role in its transformation. Several levers will be used for this purpose, including the adaptation of the regulation to foster the emergence of stronger banks, the development of new institutions, and products and support instruments to more appropriately finance the private sector. This bank role would be complemented, and strengthened, by expanded activities of the Stock Market, to lead to a higher volume of long-term financing of investment projects.

- **Promotion of the emergence of a strong banking system**

The first steps involve the adoption of the Basic Banking Law and the Law on Financial Institutions to enable better regulation of onshore and offshore banks by the Central Bank. In the medium term, prudential regulation should be strengthened to incorporate the Basel III rules and even go to higher standards as in the Seychelles; this will strengthen the stability of the banking sector, bringing it up to international standards, and will facilitate the development of a financial cluster.

Box 3: Basel III in Mauritius

The **Bank of Mauritius (BoM)** supports the underlying objective of the Basel III reform package, which is to strengthen the resilience of the banking sector and intends to implement measures that are relevant to the Mauritian jurisdiction. The Bank wants to ensure that the transitional arrangements to implement the new standards allow the banking sector to meet the higher capital standards through adequate earnings retention and capital raising, while still supporting lending to the economy.

- **2008**: Set up of a **dedicated Basel II Unit** at the Bank of Mauritius to take forward the implementation of the Basel II framework;
- **2009**: **Standardized approach** of the Basel II framework had been implemented. Most banks were operating above the minimum regulatory capital adequacy ratio of 10% and were well-positioned to make the transition to the new Basel III rules.
- **October 2012**: BoM issued a ***Consultation Paper on the Implementation of Basel III in Mauritius***. The Paper set out the Basel III rules and the Bank's broad proposals for implementing the core Basel III capital measures, including the implementation timelines.
- **May 2013**: Issue of a draft ***Guideline on the Scope of Application of Basel III and Eligible Capital***. Thereafter, rules have been set and circulated in the banking industry, as well as tentative timelines, in order to implement some of the elements of the stronger Basel III capital framework.

IMF Executive Board conclusions on the Mauritian economy's 2013 overview:
- Strong regulatory context: Regulatory Tier I capital to risk-weighted assets are well above Basel II and the proposed Basel III requirements;
- Banking system remained well-capitalized and resilient;
- Non-performing loans increased slightly;
- Banks remained profitable with a 20% return on equity despite low leverage ratios;
- Liquidity ratios have worsened in recent years and were on the low side of international comparisons.

Bank of Mauritius is consulting with banks on implementation of Basel III regulations and continues to publish its bi-annual CAMEL rating for all domestic banks: (C)apital adequacy,
(A)ssets, (M)anagement Capability, (E)arnings, (L)iquidity. The plan is to implement Basel III for all domestic banks by year 2015.

The second short-term measure is the creation of a Credit Information Bureau. Experiences in many countries show that such instruments improve risk management and significantly increase banks' confidence in lending.

Strengthening the banking sector will also require more regular monitoring of systemic risks outlined in the first part. The organization of the Financial Stability Committee will be adapted to allow at least an annual risk assessment of the banking system.

➢ **Targeted support to promote SMEs and priority projects financing**

The majority of businesses in Cabo Verde are either micro or small enterprises. They are facing rather constraining terms and conditions of borrowing from the banks. Such constraints need to be urgently addressed to facilitate wider access to funds by this important segment of the business sector. Related priority projects in the agenda for economic transformation should also be supported.

The Government has already developed new financial institutions such as Novo Banco and guarantee funds to facilitate the access of private companies to equity financing in particular. The issue here is to focus on a review of the regulatory and operational frameworks as well as the level of financial support to render these instruments more effective.

➢ **Development of financial products and services adapted to SMEs and micro enterprises**

Improving the financing of private enterprises also requires promoting financial institutions and products more in accordance with their size and specific economic constraints. To this end, the government should promote and support the development of microfinance institutions with technical and financial assistance. This requires also a review of the regulatory framework to provide the flexibility necessary for the efficient development of microfinance activities. Establishment of recognized microfinance institutions and rating agencies will also be promoted.

The Government should also support development of leasing and factoring services that offer more suited funding solutions for small businesses. These activities require a secure legal and fiscal framework for lenders, particularly in terms of property rights, the exercise of guarantees, and taxation. It is recommended that the review of the regulatory and fiscal framework be done in close consultation between the government, the financial sector and the non-financial private sector.

- **Development of refinancing options**

The Government could support the banking sector by establishing conditions for the development of securitization. A large volume of mortgages and a Stock Market are prerequisites for the development of securitization. An adequate legal and fiscal framework should complement these along with the promotion of support services including the installation of rating agencies, financial engineering capacities, central depository, and auditing and legal advice services. In the long term, securitization will be an advantage for banks by improving the management of their balance sheets (e.g., asset/liability management) and their prudential constraints.

Box 4: Regional Fund for Mortgage Refinancing of WAEMU

- **Mission**: refinance, for the exclusive benefit of its shareholders, the loans granted by them to their customers.
- **How?** By the issuance of warrants, bonds, debt securities or securities of any kind on regional financial market of WAEMU and also on the international financial markets within the regulations.
- The resources collected by the Fund are given back to its borrowers shareholders as refunding loans (at the same rate conditions, duration and depreciation as bonds obtained in the financial market), minus operating costs (making prospectus, advertising, road shows, placement fee, etc…).
- Loans raised from the Fund must be secured by a first mortgage taken over a land title to the exclusion of any other title.

The portfolio of housing loans offered to refinancing to the Fund must have at any time:
- an average life equal to the remaining term of the requested refinancing loan;
- an equal or greater average rate than the refinancing loan on which is backed;
- an amount at least equal to 120% of the refinancing loan .

In return for its refinancing, the Fund charges a fee of 1% of the amount of each loan granted.

- **Promotion of Non-Banking Financial Institutions**

Development of insurance institutions and social security organisms is in perfect synergy with the development of the financial sector. The effective realization of their missions requires a developed financial market for the fruitful and secure management of their assets and their operations. They also enable significant financial savings to strengthen banks resources and cover the needs for long-term investments and the liquidity of the Stock Market.

The Government should promote the growth of insurance, social security and pension insurance schemes, particularly for accelerated development of retirement savings and inclusion of the entire population through better coverage of even those in the informal sector.

Box 5: Pension Scheme in Botswana

Botswana's pensions industry has grown rapidly **from 11%** of financial system assets in 1996 **to 31%** in 2008, due to an increasing number of firms that established pension funds for their employees and following Government's establishment of the Botswana Public Officers Pension Fund (BPOPF) in 2001.

BPOPF is currently the largest pension fund in Sub Saharan Africa and it recently announced that it will in future allocate 14% of its funds to alternative assets including property, private equity, infrastructure and hedge funds. It is managed by private sector asset managers.

Pension funds are governed by the Pension and Provident Funds Act and until March 2008 were regulated by the Registrar of Pension Funds at the Ministry of Finance and Development Planning.

Government's actions to support development of pension funds:

- Replacement of the defined benefit scheme by a defined contribution fund for government employees in 2001;
- Establishment and funding of the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) to regulate Pension Funds, Asset Management, Consumer/Micro lending, insurance and Collective Investment Undertakings in 2008;
- Set of significant minimum regulatory requirements including financial reporting, governance and death benefit distribution ones.

In 2010, Bostwana received a grant from AfDB to equip the NBFIRA with a Risk Based Regulatory Model (RBRM) in line with international best practices and implement the IT system to support it. This would enable NBFIRA to provide effective regulation and services, and thus position it to negotiate adequate fees with the regulated industry.

It is expected that these various measures will foster: (i) the development of a strong banking sector, able to support SMEs and large enterprises in financing their investment projects and operations; (ii) an active and innovative sector, offering competitive solutions for each type of client; and (iii) an industry contributing more significantly to GDP, and with greater resilience to systemic shocks. Margin of increase of the Bank credit/GDP ratio is limited but compared to Emerging countries and other SIDS, 30% could be a reasonable target.

Stimulate the Stock Market

The financial market must reach a critical mass to play an important role in financing the economy and supporting the development of a "finance" cluster. The Government should implement a program to stimulate all the factors supporting the development of the market: capital supply, demand, support services, infrastructure and cooperation with other markets.

- **Stimulate financial and long-term savings**

Stimulation of financial savings involves working on several fronts. The Government could develop a campaign to better familiarize investors, companies and institutions on opportunities in the Stock market. A special effort will be made to develop investment opportunities and investment products available to investors while facilitating their access to financial markets (e.g., mutual funds). Taxation will be eased in the early stages of their development to make these products more attractive.

- **Develop the listing of new companies and mutual investments**

Strengthening the Stock market also involves the development of the supply of securities, investment instruments in adequate volumes to meet the needs of domestic investors and attract the interest of international investors (securities, money markets, bond markets, equity, balanced mutual funds...). The listing of new companies will be promoted by targeting and encouraging major sectors to be listed (banks, telecommunications, tourism, construction, real estate) and by facilitating terms and conditions of trading and opening compartments for SMEs and foreign securities. Securitization will also strengthen the supply of securities.

- **Develop the financial industry and support activities**

The Government should promote the development of an intermediation and asset management industry offering a rich range of investment products. Financial training will be encouraged to promote the emergence of professionals mastering the financial market techniques and transactions. Infrastructure and information and communication technologies will be upgraded to provide fully automated treatment systems and competitive transactions.

- **Enhance cooperation with international markets**

Promoting a stock market and developing activities within the "finance" cluster require stronger integration to international markets. Cabo Verde will develop cooperation with other financial markets, including other African markets, to facilitate the trading of foreign securities on its markets and transactions between these markets.

An efficient Stock market will result in a dynamic and innovative financial industry which contributes significantly to GDP through long-term financing of companies and the Government, and by meeting the needs of institutional and individual investors. From experiences in Africa and other emerging countries, a successful development strategy of the financial markets could increase over 50% of GDP their contribution to the financing of the Cape Verdean economy.

Channel Remittances towards financing the economy

At the beginning of this study, remittances were mentioned as one of the key development triggers. Indeed, remittances are crucial in the expansion of both the financial sector and the economy. Their impact can be further strengthened by channeling them more towards investments rather than consumption. This will require making available more interesting financial products and investment opportunities to the diaspora, such as facilitating housing ownership, investing in mutual funds, along with more tax incentives for financial savings.

Migrants' deposits already account for around 39% of bank deposits and contribute significantly to their liquidity. It is expected that the involvement of migrants in long-term investment products will stabilize their savings and contribute to the increase of long-term financing of the economy.

Develop the enabling factors

Implementation of reforms may encounter difficulties if certain constraints associated with the business environment and the availability and cost factors are not lifted. In this respect, the State should undertake an active policy of strengthening the position and capacities of Cabo Verde in the following areas:

- The legal framework; in addition to the adoption of specific measures on the financial sector (notably the Bank Basic Law and the Law on Financial Services), Cabo Verde should target a legal and judicial framework very favorable to business in general, conducive to the development of high value banking and financial services in particular; one expected outcome should be a radical improvement of the position of the country in the "Doing Business" ranking on "investor protection", "resolving insolvency", " enforcing contracts " and " Registering property".

- Infrastructure; the State shall promote the availability at competitive costs of infrastructure and services essential to the development of banking and financial activities (including electricity, ICT, air transport).

- Support activities to the financial sector; the State shall promote the development of essential support activities for the financial sector (accountants, auditors, legal advisors, notaries, process servers, technical advisers, IT services, back office support, business services...).

- Human resources; building human capital should be considered in a broader perspective of developing the financial cluster; qualified personnel should be provided to all banking, financial and support activities; the quality and diversity of human resources in this sector will be a key competitiveness factor of the Cape Verdean financial place internationally.

Short term implementation

The reforms are detailed in the table below. For their rapid and effective implementation, we recommend to focus in the short-term on the following initiatives and projects:

- The establishment of a dedicated unit for project financing and public-private partnerships ; the unit will assist in investment project programming, the optimal financing with technical and financial partners, the identification and structuring of PPP projects, and the promotion of major projects; the recruitment of experienced professionals, an operating budget for the unit and funds for various studies shall be needed.

- The establishment of a Credit Information Bureau; consultation between the Central bank and the financial sector will be important to agree on how to collect information and monitor credit ratings, adapt the legal and regulatory framework and set up a partnership with a specialized credit information company.

- The strengthening of the microfinance institutions; this includes technical and financial support to existing institutions, promotion for the establishment of recognized microfinance institutions and microfinance rating agencies.

- The improvement of the supply of leasing and factoring services; consultation between the Ministry of Finance, the Central Bank, the financial sector and business organizations will help to define the legal and fiscal framework for a better development of these modes of financing and

- The launch of a housing mortgage refinancing project; the short-term objective might be to replicate the experience of mortgage loans refinancing performed by the West African Regional Mortgage Refinancing Institution (CRRH-UMOA); this initiative requires a study of the legal, fiscal, economic and financial frameworks for a successful mortgage in Cabo Verde.

Table 1: Policy recommendations

Objectives		Suggested reforms	Main actors
Increase tax revenues		Improve the efficiency of tax collections	Ministry of Finance and Planning
		Broaden the base of tax contributors	
		Optimize tax rates	
		Increase contributions from end users through fees	
		Accelerate the reform of remaining State Owned Enterprises (SOEs)	
Optimize Official Development Assistance		Strengthen the capacity of departments in charge of the preparation and selection of projects	Ministry of Finance and Planning Ministry of External Relations
		Improve the process of project selection and allocation between donors	
		Develop cooperation with Major Emerging Countries	
Develop Public-Private Partnership		Establish a dedicated team to support Financing and PPP projects	Ministry of Finance and Planning
Strengthen the capacities of the banking system	Promote the emergence of a strong banking system	Adopt the Basic Banking Law and the Law on Financial Institutions	Ministry of Finance and Planning Banco de Cabo Verde Financial Stability Committee
		Incorporate progressively the Basel III rules	
		Establish a Credit Information Bureau	
		Undertake annually a financial stability assessment	
	Targeted support to promote SMEs and priority projects financing	Provide financial support to render guarantee and venture capital funds more effective	Ministry of Finance and Planning ADEI
		Provide technical assistance to the SME financing institutions	
	Development of financial products and services adapted to SMEs	Review the regulatory framework for the development and expansion of microfinance activities	Ministry of Finance and Planning
		Promote the establishment of an international recognized microfinance institution	
		Promote the setting of microfinance rating agencies	

Objectives		Suggested reforms	Main actors
	and micro enterprises	Review the legal and tax frameworks to support the development of leasing and factoring services	Banco de Cabo Verde ADEI Private Sector Business Associations
	Development of refinancing options	Establish conditions for the development of securitization transactions	Ministry of Finance and Planning Banco de Cabo Verde BVC
	Promotion of Non-Banking Financial Institutions	Promote the growth of insurance, social security and pension insurance schemes	Ministry of Finance and Planning Banco de Cabo Verde
Stimulate the Stock Market	Stimulate financial and long-term savings	Develop a public information campaign to promote stock market investment and funding opportunities	Ministry of Finance and Planning Banco de Cabo Verde BVC
		Promote the development of mutual funds	
		Provide tax incentives in the early stages	
	Develop the listing of new companies and new securities	Promote the listing of new companies by targeting and encouraging major sectors	Ministry of Finance and Planning Banco de Cabo Verde BVC
		Open compartments for SMEs and foreign listed securities	
	Develop the financial industry and support activities	Promote the development of an intermediation and asset management industry	Ministry of Finance and Planning Ministry of Higher Education Banco de Cabo Verde BVC
		Develop professional financial training and education	
		Upgrade infrastructure and information and communication technologies dedicated to the banking and financial sector	
	Enhance cooperation with international markets	Develop cooperation with other financial markets, including other African markets	Ministry of Finance and Planning BVC
Attract more diverse Foreign Direct Investment		See detailed strategy in the policy note on business environment	
Channel more remittances towards financing the economy		Enable more and diversified financial products and investment opportunities to the diaspora	Ministry of Finance and Planning BVC CI
		Set tax incentives in favor of diaspora investments	

Appendices

Appendix 1: Regional Economic Convergence Criteria

ECOWAS (Economic Community of West African States)

- *Primary Criteria (considered as crucial for achievement of convergence):*

1. Budget deficit / GDP ratio (excluding grants) lower than or equal to 4%
2. Inflation rate lower or equal to 5%
3. Central bank financing of budget deficit lower than or equal to 10% of previous year's tax revenue
4. Gross External Reserves higher than or equal to 6 months of import coverage

- *Secondary Criteria (policy instruments that reinforce achievement of the primary criteria):*

1. Prohibition of new arrears and liquidation of all outstanding arrears
2. Tax receipts / GDP ratio higher than or equal to 20%
3. Salary mass / Total tax receipts ratio lower than or equal to 35%
4. Public Investments financed from internal resources / Tax receipts ratio higher than or equal to 20%
5. Positive real interest rates
6. Real exchange rate stability

WAEMU (West Africa Economic and Monetary Union)

- *First order criteria :*

1. Average annual inflation rate of no more than 3%
2. A basic fiscal balance-to-GDP ratio that is zero or positive
3. Overall debt-to-GDP ratio of less than 70%
4. No change, or a decrease in domestic and external payment arrears

- *Second order indicators :*

1. External current account deficit (excluding grants) less than 3% of GDP
2. Wage bill should be less than 35% of tax receipts
3. Ratio of domestically financed investment to tax receipts over 20%
4. Tax receipts-to-GDP ratio over 17%

EU (European Union) Maastricht criteria:

1. National budget deficit at or below 3 % of GDP
2. National public debt not exceeding 60% of GDP

Appendix 2: Banking regulation in Seychelles

Financial services represent about 28% of GDP of Seychelles. The supervision of the sector is made by the Financial Services Supervision Division of the Central Bank. The banking regulation system of Seychelles is characterized by:

- ✓ A requirement of a transfer of at least 20% of net profits each year to the legal reserve fund until it is equal to the paid-up capital;
- ✓ A Liquidity Risk Management Regulation requires banks to maintain a minimum of 20% of total liabilities as liquid assets;
- ✓ A reinforcement of the supervisory framework.

The Financial Institutions Act of 2004 (FIA) stipulates that banks must maintain a minimum regulatory capital to risk weighted asset ratio of 12%, which is also in line with Basel standards on minimum capital requirements. However, if it falls below 12% but remains above 8%, then Central Bank may grant the institution a period of up to one year to correct the deficiency. In 2011, Capital Adequacy Ratios of banks in Seychelles reached 24%.

An amendment of the FIA was made in 2011 to increase competition and transparency of the sector by:

- ✓ introducing a single licensing regime under which the licensee can conduct both domestic and offshore banking business;
- ✓ strengthening prudential standards: a leverage ratio has been introduced as a measure of a bank's solvency (a bank would be considered insolvent if its capital falls to 1.5 % or less of its tangible assets on a non-weighted basis);
- ✓ the creation of a Credit Information System (CIS).

Source: Central Bank of Seychelles

Appendix 3: How Mauritius has built a strong financial center

Created in 1989, the Stock Exchange of Mauritius (SEM) was a limited liability company until 2008 when it became a state-owned company. With 89 listed companies, its market capitalization is about 8 billion USD. SEM is a member of the World Federation of Exchanges.

SEM opened to foreign investors through the lifting of exchange controls in 1994. They also benefit from many incentives like:

- Free repatriation of the product of the sale of detained shares;
- No withholding tax on dividends;
- No tax on capital gain or gain on disposal.

Among the different reforms undertaken to make SEM a strong financial center in Africa:

- Set up of a central depositary and clearing system in 1997 for faster compensation, settlement and risk reduction through a mechanism of guarantee funds;
- Launch of an automated trading system in 2001;
- Negotiation of Treasury bonds on the market was introduced in 2003 to have a dynamic secondary market;
- Creation of a market window for SME in 2006;
- More flexible listing rules to be more attractive to Global funds;
- Possibility to trade and settle in Euro and Pound Sterling currencies since 2010 and in US dollars in 2011;
- Introduction of the listing and trading of Exchange Traded Funds in 2013.

Appendix 4: Microfinance

Microfinance is a source of financial services for entrepreneurs and small businesses that are excluded from classic financial system. The growth in domestic microfinance is triggered when an economy is composed of a large portion of micro entrepreneurs. One of the principal challenges of microfinance is providing small loans at an affordable cost. The global average interest and fee rate is estimated at 37%, with rates reaching as high as 70% in some markets. The reason for the high interest rates is not primarily cost of capital, but high operating costs.

The microfinance institutions (MFI) can take many forms:

- Nonprofit organizations;
- Formal financial institutions: commercial banks, state banks, agricultural development banks, savings banks, rural banks and non-bank financial institutions;
- Informal financial service providers: moneylenders, pawnbrokers, savings collectors, money-guards, ROSCAs (Rotating Savings & Credit Associations), ASCAs (Accumulating Savings & Credit Associations) and input supply shops;
- Member-owned organizations: self-help groups, credit unions, and a variety of hybrid organizations like financial service associations and CVECAs (self-reliant village savings and credit bank);

Concerning the development of microfinance, it is necessary to set a suitable legal and regulatory framework.

In West Africa, microfinance sees a more significant development as well, in terms of number of institutions, market penetration, performance and institutional development. Applying a homogeneous regulatory framework in West Africa has been accompanied by the creation of an information system which, even if it has to be improved, allows relatively precise quantitative diagnosis of microfinance in the WAEMU region.

Regulatory and policy environment in Rwanda for Microfinance is now very strong, outpacing the capacity building in the sector. The government is supportive of the sector and has prioritized extending access to financial services for the rural community:

- Set of a program aiming to ensure that every sector has a Saving And Credit Cooperative (SACCO) to hold deposits and provide micro loans.
- Government provides subsidies to mitigate overhead costs for 3 years.
- The supervision of SACCOs made by the Central Bank.
- A credit reference bureau was also established in 2010 and MFIs are required to report to the bureau.

Appendix 5: Crowd-funding

Crowd-funding can be defined as a collective effort of many individuals who network and pool their resources to support efforts initiated by other people or organizations, usually over the Internet. Individual projects and businesses are financed with small contributions from a large number of individuals, allowing innovators, entrepreneurs and business owners to utilize their social networks to raise capital.

Crowd-funding websites helped companies and individuals worldwide raise $89 million from members of the public in 2010, $1.47 billion in 2011 and $2.66 billion in 2012. In 2012 there were more than 1 million individual campaigns globally. In 2013 the industry was projected to grow to $5.1 billion.

Crowd-funding can offer unique support for budding and existing entrepreneurs on multiple levels. No other investment form, be it debt or equity, can provide the benefits of pre-sales, market research, word-of-mouth promotion, and crowd wisdom without additional cost. Where entrepreneurs and SMEs have difficulty accessing funding from traditional financial institutions, crowd-funding allows funders to utilize personal networks to fund their businesses and create jobs. Benefits of crowd-funding for the economy are visible in significantly less concentrated markets, better market rates (true return and price), funding diversification, financial stability and development of alternative financing channels.

Depending on the main goal and 'return' to the investor, one can define several crowd-funding business models:

- ***Donations (FundAnything, Rally.org, Experiment.com)***

NGO's have used this model to attract donations for specific projects for over ten years. Unlike traditional fundraising, donations are collected and ear-marked for a specific project. Because funders know that their money will be used on a very specific project, they are more willing to donate higher amounts per person.

- ***Rewards (Indiegogo)***

This business model is used by project owners who want to collect donations for a specific project and can give (often small) non-financial rewards in return. The rewards are of a symbolic value and provided by the project owners.

- ***Pre-Sales (Kickstarter – funders are buying products of new, creative artists)***

It is possible to put a new product or service online and ask funders if they are interested to order and pay in advance. This replaces traditional market research and validates demand while providing working capital, if successful.

- ***Lending***

With lending-based crowd-funding, a company will borrow money from a group of people instead of a bank. The role of the platform can be diverse. Some of the platforms will act as a middle-man and will also make the repayments to the lenders, where other platforms act only as match-makers and the borrower and lenders will be connected when the deal is closed.

- ***Social Lending (Kiva)***

Some platforms provide the possibility of lending to social projects with no interest being offered, for example where businesses in developing countries can receive micro-financing without any interest being paid to the lending party.

- ***Peer-to-Peer Lending (LendInvest, Zidisha)***

This model is used by borrowers who are looking for a loan with a lower interest rate than the one they can get from a bank. It can also be used by borrowers who can offer fewer securities. Existing data shows that default rates for P2P lending on average are very low - below 1%. This subset of crowd-funding is continuously growing and profitable. New lending is estimated at well above €20 million per month for Europe (2011 data).

- ***Equity Crowd-funding (Seedrs, Companisto, Symbid)***

Equity crowd-funding takes into consideration companies which want to attract an investment from a group of people. It generally includes equity-like arrangements, offering the same payoff as equity (shares), and where the "funder" is actually merely a creditor who has a contractual right to receive that payoff. At the moment Equity Crowd-funding is the least developed form of Crowd-funding. In part this is due to the legal liability that the collection of equity raises, which in many countries would not be legal, unless a specific regulation is set in place. Regulation of Equity Crowd-funding has recently received attention from policymakers in a number of countries beginning from 2012-2013.

Pillars for development of Crowd-funding include:

- Regulation - being developed both in USA via JOBS Act (Jumpstart Our Business Startups Act) as well as in Europe, both not entirely defined yet
- Education - especially to entrepreneurs and then to potential funders
- Further research on Crowd-financing - from universities, research centers

Regulation

- Update the laws to allow small and medium businesses the opportunity to raise capital through their own personal networks to ensure their autonomy and job-creating capabilities.
- Build awareness for SMEs on how to utilize crowd-funding and create guidance through best practices for crowd-funding platforms, entrepreneurs, and funders.
- Coordinate and relax the rules in company laws under which entry-level company regimes can offer and assign shares to new investors, thereby abolishing formal procedures.
- Establish transparent reporting guidelines and documents, such as generic time-sheets and subscription agreements. Moreover, entrepreneurs should be asked to provide automated reporting to their funders on a timely basis.
- Address customer protection and generate reasonable and fair guidelines relating to the financial interest, exposure and diversification of funders and investees across multiple crowd-funding business models. This needs to provide guidance around fraud, risk explanations and potentially the testing of funders' knowledge.
- Customer identification is a key issue with both projects and funders; this includes know-your-customer, customer due diligence procedures and anti-money laundering aspects.

Education

- Raise awareness of potential investors, donors, lenders, about the opportunities offered.
- Invest in training and awareness-raising for entrepreneurs and funders.
- Promote its success and abilities in growing local, regional and pan-European economies and job creation by financing entrepreneurial and innovative projects.
- Educate the public as to the benefits of crowd-funding, so that more funders and promoters can take advantage of this opportunity.

Research

- Fund academic and market studies addressing the impact of crowd-funding on the economy.
- Initiate and fund studies on national, regional, and local communities: ways SMEs can utilize crowd-funding; the success or otherwise of different policies and techniques that can increase the use of crowd-funding.
- Promote transparency and cooperation among entrepreneurs, crowd-funding platform operators and funders, to keep the data open and attainable.