Executive Summary

This study argues the need for a policy environment supporting both urban informal sector dynamism and rapid transition from subsistence to monetization in agriculture. Such policies must include measures facilitating access to financial services for households, which are the backbone of the informal and subsistence economies.

The economy of Timor-Leste is divided between a farm sector in which as many of 80% of workers remain, with most of these still dependent on subsistence production, and a non-farm sector in which micro- and small enterprises are an overwhelming majority. Most urban enterprises operate in an informal environment, while in both the farm and non-farm sectors the household is the basic unit of economic activity.

With only about 40,000 workers in the private sector and some 15,000 potential labor market entrants each year, there are severe limits on the capacity of the non-farm sector to offer wage employment to new job-seekers. In these circumstances, it is pertinent to ask: what is the meaning of ‘private sector development’ in Timor-Leste? With such a large rural subsistence element remaining, it is appropriate to commence private sector development there. Diversification and monetization of farm output is crucial to raising rural incomes. Access to financial services is needed for the embryonic rural private sector, to support produce trading and the supply of manufactured goods to a rural economy making the transition from subsistence.

Beyond agriculture, ‘informal’ enterprises form a major component of the non-farm sector. The distinction between formal and informal enterprises is problematic in Timor-Leste. While business registrations give some guide to the extent of formal enterprise activity, even many registered entities exhibit ‘informal’ characteristics, in terms of scale, use of family labor, home-based operation, technologies employed and other criteria. Thus while all ‘formal’ enterprises are registered, not all registered entities in Timor-Leste can be regarded as formal. Numbers of workers employed provide some guide to the formal/informal divide. Among formal (i.e., registered) enterprises, while more than 70% have fewer than 10 employees, almost 20% have from 10 to 20 workers. Among informal (i.e., unregistered) enterprises, slightly more than 50% have only a single worker. The distinction is thus between the small and the very small; even in the ‘formal’ sector, more than 90% of entities have fewer than 20 workers. Hence even most formal enterprises conform to the definition of micro-enterprise.

In 2004, about half of informal (unregistered) enterprises fell below an annual turnover of $1000. But even in the formal (or registered) sector more than 15% of entities had turnover below this level. Urban enterprises, both formal and informal, were predominantly engaged in trading. Low levels of startup capital also categorize both groups. About a quarter of formal, but fully 90% of informal, enterprises had startup capital of less than a hundred dollars ($100). Few entrepreneurs of either category access non-personal or non-family resources for startup capital, suggesting extremely limited resort to institutional sources of finance and a potentially substantial market for microfinance services.

In the urban economy, much informal economic activity is stagnant and derivative in character. A more dynamic informal sector with better access to financial services would bring benefits, including increased alternatives to waged employment, a more equitable distribution of income and increased supplies of goods and services in the consumption baskets of urban dwellers. Greater supply and diversity of informal sector production will support policies of wage restraint designed to reduce Timor-Leste's relative wage-cost disadvantage.

The formal financial system is still limited in outreach. It consists essentially of the banking system: three commercial banks, each an overseas branch of a foreign institution, and one local institution operating with a limited banking license. Each of these serves distinct but limited market niches within the broader population. Regulatory and supervisory functions for the banks are performed by the Banking and Payments Authority (the BPA).

There are no non-bank financial institutions subject to BPA supervision and there is no insurance company serving Timor-Leste, nor any leasing finance entities. Beyond the formal, regulated, institutions, there are microfinance institutions (MFIs), savings and loan cooperatives, and pawnshops. While MFIs are of limited significance in dollar terms, they have succeeded in reaching between a fifth and a quarter of poor households. There are also informal mechanisms to provide financial services.

The financial system of Indonesian East Timor was destroyed in 1999. Since the re-introduction of banking, the level of domestic credit has grown as a proportion of non-oil GDP, suggesting some recovery of financial depth, while rising bank deposits as a proportion of non-oil GDP point to improving levels of financial intermediation. Financed in the aggregate entirely by domestic deposits, bank credit rose very rapidly throughout 2004 to reach almost 22% of non-oil GDP early in 2005. This was only half the proportion for all 'low-income' countries, of which Timor-Leste is one. The system was intermediating 87% of deposits to domestic lending. Together with evidence of excess demand for bank credit, this suggests the need for expanded savings mobilization to bring Timor-Leste up to a more appropriate level of financial depth.

BPA is a central bank in embryo and is required to promote a market-based banking and financial system. It has explicit responsibility to nurture microfinance and to build savings capacity, including in rural areas. Financial sector development in Timor-Leste is constrained by lack of human resources in the sector, by low levels of 'financial literacy' in the population and by a lack of ancillary services in the business community. Crucial deficiencies exist in the legal and regulatory environment for financial services. Most urgent is the establishment of a basic legal framework to establish, recognize and enable enforcement of property rights.

There is substantial unsatisfied demand for financial services and the great majority of the population remains untouched by formal financial services. Historical experience from the years of Indonesian rule suggests that aggregate savings in Timor-Leste could increase substantially beyond the 2005 level. With a population of some 200,000 households and fewer than 60,000 deposit accounts in 2005, it would be appropriate to plan the extension of services to the great majority of these households, commencing with the 9 district capitals and 65 sub-district towns still largely unserved. A total of 200,000 deposit accounts in all classes of institution by 2010 would be realistic, if the financial infrastructure were made available. Innovative approaches would be necessary. Cellphone-based systems could allow financial institutions to operate away from their branches. For more remote areas, technology exists to allow field staff to provide offline services using handheld electronic devices. In addition, the planned expansion of postal service points would permit cautious trialing of deposit and remittance services using those new facilities.

To meet demand for credit, the approach should be incremental, achieving judicious expansion by appropriate and sustainable institutions. Currently-active commercial banks will respond to excess demand for bank credit, while approval for the entry of one or two suitable new banks would increase competition. New entrants will have made their own feasibility studies. This is preferable to target-setting by authorities, who may instead aim to facilitate progressive and market-driven expansion of credit services in response to observed indicators of excess demand at the margin. Appropriate lenders will include MFIs and Credit Unions (CUs) in addition to banks, as well as new non-bank commercial lenders. There is no good case for either a state development bank or a government postal bank to remedy gaps in service provision.

The three currently-operating commercial banks each serve distinct market niches. The entry of the third bank seems to have stimulated beneficial competition, evidenced by reduced fees and margins. Recent lending growth has been rapid and a substantial backlog of demand exists, testing the limits of domestic loanable funds. The BPA is ready to consider new applications for entry. Further diversification of banking operations within a competitive framework appears the most promising option for achieving outreach to unserved population groups, while lowering costs and improving service levels overall. Bank BRI, an Indonesian institution specializing in rural- and micro-banking and with particular strength in deposit-mobilization, conducted a study of the feasibility of re-entering the Timorese market in 2003. BRI did not proceed, but if it were to do so it would contribute greatly to diversity and competition within the system.

Timor Leste also possesses a microfinance banking institution, the IMfTL. Granting a license for an institution similar to small, locally-based and successful microfinance banks in Indonesia and the Philippines was a positive innovation, offering a distinct and poverty-focused model of operation. Despite its relatively poor performance, some regulatory handicaps, and unresolved issues of ownership and governance, the presence of such a banking model within the Timorese financial system is an asset that should not be surrendered lightly. Amidst deliberations about its future, the option of its being acquired by a private, for-profit, entity for ‘back-door’ entry to the banking system is not appealing. The best option for retaining IMfTL’s distinctive focus could involve attracting equity and expertise from an institution such as the IFC and/or a private international, not-for-profit investor active in micro-banking.

Microfinance institutions (MFIs) have particular relevance to Timor-Leste's need for financial services, given the micro-scale of most economic units. This is recognized in official policy; the 2002 National Development Plan directed BPA to support donors and NGOs to develop micro savings and credit schemes, especially in rural areas. The BPA does not plan to create a regulatory environment specifically for MFIs. Instead it takes a non-interventionist and broadly supportive stance that tolerates limited deposit-taking by MFIs on the basis that they can be regarded as 'membership' institutions.

Service providers have formed a national association, AMFITIL, to establish a framework for setting performance and reporting standards, based on international best practice principles. It has eleven member institutions of which four, including IMfTL, are specialist providers. Members report performance data to on a regular basis. At end-2004, reporting institutions had outreach to some 26,600 savers and 19,200 borrowers and MFIs (excluding IMfTL) were dealing with more than 20% of poor households. Sustainability is a major problem for Timorese MFIs and they regard capacity-building as a particular need. AMFITIL provides a suitable platform for coordinating assistance to the sub-sector. The best MFIs have demonstrated comparative advantage in lending to the poor but are constrained in accepting deposits, while IMfTL has had difficulty in lending to the poor but has a legal mandate for deposit-taking. This suggests a working relationship between MFIs and the IMfTL could provide mutual benefits.

In terms of the adequacy of financial services, all enterprises are penalized by real interest rates that are relatively high for dollar-denominated loans. Even larger firms with access to external sources of credit suffer from a domestic credit environment in which the absence of supplier- and consumer-credit facilities limits marketing and distribution. Smaller enterprises suffer particularly from the lack of supplier credit. All firms suffer to a greater or lesser extent from a lack of specialized financial services, such as insurance, equipment leasing and venture capital, which lag in the current legal environment, and are disadvantaged by the absence or limited availability of a range of complementary business services. Urban informal enterprises and rural households suffer many of the disabilities mentioned above and also the absence of domestic remittance services. Limited understanding of business and money ('financial illiteracy') is pervasive at this level. In rural households, but also for the urban poor, lack of access to safe, convenient and liquid deposit facilities is a particular deficiency.

Recommendations

A. General recommendations

1. Among other benefits, the maintenance of low inflation in a stable macroeconomic environment will support the development of an adequate and sustainable supply of financial services.
2. Concerning the role of financial services in stimulating private sector development, the Review recommends that priority be given to measures facilitating access to financial services for households, which are the backbone of the subsistence and informal economies. This will accelerate

the transition from subsistence in agriculture and the growth of income-generating activities beyond agriculture. The primary household service need is for deposit services, while credit, remittances and payments services are also required.

3. The Review endorses the emphasis of policies outlined in the GoTL Sectoral Investment Program for Private Sector Development. These call for a policy shift, from direct interventions to assure the availability of financial services, to increasing reliance on intermediation through the financial system and support for the creation of enabling environments.
4. Given the paucity of sources of credit in Timor-Leste, the Review views as appropriate a relatively permissive and non-interventionist approach to the emergence of private non-bank lenders. It would also be important for authorities to be sensitive to the continuing importance of a variety of non-formal and cross-border credit sources, and to appreciate their contribution to financing economic activity in Timor-Leste.
5. GoTL may want to focus on continue to remedy deficiencies in the legislative, regulatory and judicial frameworks affecting financial services, and in the array of relevant professional and business services, with particular emphasis on measures to permit financial service contracts to be secured and enforced. The Review turns to this subject in Section E, below.
6. Concerning the demand for financial services, the Review accepts that unsatisfied demand for credit and unfulfilled capacity for saving are both substantial in Timor-Leste. With regard to credit, the Review makes specific recommendations below concerning the need for a larger number and greater diversity of lending institutions. Also, consistent with its view that the household should be the primary focus of policy, it urges GoTL to set a national target to reach 200,000 deposit accounts, in a variety of institutions, within a five year period. This could commence with extension of services to the 6 district towns and 65 sub-district towns that are largely unserved at present. In addition, extension of services using cell phones and offline electronic devices needs to be trialed and developed. As the national network of postal service points is expanded, cautious trials could be conducted of using these for deposit and remittance services.
7. With regard to expanding the availability of credit, the Review recommends against setting quantitative targets, arguing instead for pragmatic and incremental expansion. Authorities may want to adopt an active stance, facilitating and monitoring the progressive expansion of services by a diversity of sustainable institutions in response to observed indicators of excess demand at the margin. However the Review recommends against the creation of a state banking institution for Timor-Leste. The prior expansion of deposit-taking facilities, to un-reached population strata and into un-served geographic areas, will provide indicators of credit capacity for the information of lenders and the authorities. However the SIP suggestion that postal centers could be employed for lending would add a more complex dimension to their functions, likely to result in failure. In urban areas and the

formal sector, reliance on market forces in an enabling environment will support the necessary growth of credit.

8. A major deficiency is a pervasive lack of 'financial literacy'. This flows from limited familiarity of Timorese people with the monetary economy. It can also be viewed as an aspect of weak entrepreneurship, traceable to their hitherto limited role in the modern economy. Widespread financial illiteracy prejudices smooth functioning of financial systems and reduces the welfare of retail users of financial services. However, systematic saving by households engenders financial literacy. Financial institutions are among the agencies which can contribute to helping people understand the workings of a monetized economy, beginning with the discipline of saving. While the temptation to overload school curricula should be resisted, there is scope for schools to contribute to the financial literacy of young people. For budding entrepreneurs, Business Development Centers established under the Small Enterprise Project are a valuable resource, meriting further support from the international community and the GoTL.

B. For the banking sector

1. A number of considerations support the case for one or more new entrants to the banking sector. These include evidence of excess demand for bank loans, reduced interest margins and improvements in services following the entry of the third bank and the potential for greater system stability with a larger number of lenders. Entry by an additional bank, even if it were specialized in a particular niche, could have a beneficial influence on services across the board in so small a market, as well as contributing to the overall resilience of the sector. Diversification within a framework of competition is likely to be the most promising option for achieving outreach to un-served population groups
2. GoT-L may want to re-examine the possibility of Bank Rakyat Indonesia's resuming commercial microbanking activities, with a view to encouraging the bank to re-work and re-consider its 2003 feasibility study for returning to Timor-Leste.
3. Specialized state banks set up to support rural and agricultural development, including in small island states in the Pacific, have a generally bad record. The case for such a bank in Timor-Leste is unconvincing. Nor would it be wise to see the proposal in the Sector Investment Program for a network of postal service centers to perform banking functions as a prelude to the creation of a state postal bank.
4. IMfTL has value as a distinctive banking model which brings diversity to the banking sector. Small regulated banks catering to a poor and low-income clientele and employing microfinance best practice have done well elsewhere in the region. Timor-Leste has made a regulatory breakthrough by licensing IMFTL as such a bank, even if regulatory constraints currently impede its outreach. The Review recommends that modes of ownership and governance be found that are consistent with its original mandate for serving the poor, as

well as being acceptable to the BPA for a class C banking license (to permit regulatory requirements on deposit-taking and liquidity to be relaxed).

5. Concerning options for the future of IMfTL, the least-preferable would be private-for-profit ownership intent on gaining ‘back-door’ entry to the commercial banking sector. The best chance of fulfilling the Institute’s original mandate could be to obtain capital and expertise from the IFC and/or a private international not-for-profit equity investor active in micro-banking.
6. While IMfTL should not abandon payroll lending, its micro-lending mandate should be pursued more energetically by a combination of direct retail lending and wholesale lending to the MFI sub-sector. For the former it would need to adopt best practice microfinance principles, and for the latter it could combine lending relationships with arrangements to accept some deposits from MFIs on behalf of their members.
7. A proposal for other commercial banks to engage in such ‘linkage’ relationships with Timorese MFIs is made in the Sector Investment Program, together with a suggestion to provide credit guarantees. Unfortunately, the commercial rationale for seeking to induce bank/MFI linkages in this manner is not yet convincing in Timor-Leste, as credit guarantees raise the possibility of moral hazard. Commercial banks would probably have to be compelled to engage in such linkages on anything more than a ‘token’ basis and such compulsion or suasion would set a bad precedent.
8. While credit guarantees are not advisable, another suggestion, that a bilateral donor might find means to ‘enhance’ the bankability of selected enterprises, should be examined. The proposal involves providing assistance to small- and medium-scale businesses, concurrent with but not tied to their dealings with banks, designed to increase the chances of borrowers’ commercial success. Such dealings involve a delicate balance between facilitation and moral hazard. If the right balance could be found this would be a useful initiative.
9. The same bilateral donor is considering whether it might support capacity within the Business Development Centers established under Small Enterprises Project (SEP) II to assist clients in dealing with banks, and specifically to help them prepare loan applications. To the extent such training produces entrepreneurs who have internalized the basic principles of business planning (as distinct from those clutching a pre-cooked loan application) this would be a positive contribution to lowering barriers to access.
10. Monitoring and analysis of developments in the banking sector would be assisted by improvements in the quality and relevance of sectoral lending data reported by the BPA.

C. For the microfinance sector (MFIs and CUs)

1. Given the difficulties Timorese MFIs experience in achieving sustainability and their financial vulnerability, priority should be given to institutionalizing their presence in the country. This requires attention to sustainability and less emphasis on expansion except where scale is crucial to sustainability. Such a priority is consistent with a more general strategy of judicious expansion of

credit at the margin for all financial service institutions, as recommended by this Review.

2. The policy stance of the BPA in regard to MFIs, that specific regulation of the sub sector is inappropriate at this stage, appears to be sound. It elevates the significance of self-regulation procedures developed by AMFITIL, the industry association, and leaves MFIs more free to innovate and experiment.
3. BPA chooses for now to regard MFI deposit-taking as contributions by 'members', and not in breach of the Banking Act. This position is reasonable so long as net balances (the excess of loans over deposits) are substantially in favor of the MFI in each case. Nonetheless, BPA's stance further underlines the need for effective self-regulation by AMFITIL and its members to protect the savings of poor people.
4. Consideration should be given to strengthening AMFITIL's capacity as an effective representative, standard-setter and (increasingly) *de facto* supervisor of MFIs. The setting and adoption of common performance standards, reported via the AMFITIL network and monitored by it, would be a most positive development for MFIs. While operational sustainability, based on fees levied from members, should be set as an objective to be reached within a determinate timeframe, AMFITIL would need interim assistance to set up and staff a free-standing secretariat. Partnership with external agencies including IFC/PEDF could serve to strengthen AMFITIL's pivotal role within the microfinance sub-sector.
5. MFIs have manifold needs for assistance. Capacity-building, in the broad sense that includes training for management and staff, technical assistance for many operational procedures and exposure to best practice operations in neighboring countries should all be considered. Transport and office equipment, and generators for electricity in many areas, are also necessary. Capacity-building assistance for clients is also needed. This can be seen as an approach to improving the financial literacy of a key group of micro-entrepreneurs. Business Development Centers established under SEP II now have capacity to contribute to this process. The fact that many potential clients are women needs to influence the approach BDCs take to such training. MFIs could benefit from linkages with a rejuvenated IMfTL whose mandate for poverty-lending had been confirmed and whose ownership and governance issues were resolved. Linkages could provide for wholesale lending to, and deposit-collection from, MFIs on behalf of their clients.
6. While at least one credit linkage between a commercial bank and an MFI has been established, the arguments for this occurring on a more general basis are not compelling on commercial grounds.
7. Decree legislation has been passed to regularize the status of the credit union movement, a positive step. CUs are legally entitled to mobilize member savings and serve a market segment between those of MFIs and banks. CUs ought to feature in any concerted campaign to lift national savings capacity, but the danger of loss of deposits by weak CUs gives pause to plans for their expansion. Perhaps the best short-term strategy is for World Council of Credit

Unions (WOCCU) or one of its affiliates to maintain low-level assistance relationships with the CU movement.

D. The need for new financial products and complementary services

Discussion of the adequacy of financial services, in section 10, below, and elsewhere, leads to a checklist of financial products and complementary business services whose availability would support more rapid private sector development. Given the banking sector is relatively better developed, the more immediate financial product deficiencies are found in the non-bank sector.

1. Among bank products, the absence of domestic money transfer, or remittance services, is notable. For the transfer of funds to unbanked areas, the proposed postal transaction centers offer the most likely channel, although electronic service possibilities discussed below in section 5 and elsewhere should also be considered. With many Timorese living overseas and with the commencement of recruitment of Timorese for offshore employment contracts, it should also be possible for the postal network to achieve working relationships with the foreign exchange banks or with Western Union to enable transmission to workers' home villages. This may be an early priority for the network upon its establishment.
2. A number of important non-bank credit products were not available in Timor-Leste at the time of the Mission, although in the case of equipment leasing the legislative and regulatory preconditions were in final draft preparation and have since been passed. Finance companies offering personal loans or facilitating supplier and consumer finance were not active, although there was no legal barrier to their establishment (as seen in the case of the pawn broking operation described in section 10). Given that BPA has a permissive attitude, the principal concern of public policy should be to require transparency in loan contracts, rather than to promote such lending actively. For the largest enterprises, venture capital facilities would be a useful addition to the small range of financing options currently available. However, improvements in the broader legislative environment for company formation, collateral and enforcement of financial contracts would be necessary to promote start-ups in this field.
3. Insurance has been a major gap in the range of financial products available, although regulations are now in place. Applications for insurance licensing however, are still to come. As with banks, the issues of the number of players and the credentials of applicants are policy matters for decision by the BPA.
4. With regard to deficiencies in complementary business services, at least one bank visited by the Mission regarded the absence of notary services as a constraint on its capacity to lend prudently, though this may reflect differences in national banking cultures and practices. It probably also reflects a divergence of national cultures in the legal profession and system in Timor-Leste. Deficiencies in accounting and auditing services are undeniably a barrier to the interpretation of financial statements as normally required for loan proposals. The absence of a national credit register for the banking sector,

has been another constraint on willingness to lend. The BPA has taken some preparatory steps towards preparing for the establishment of a credit registry with the support of technical assistance. This is a vital step towards improving information sharing, risk management and willingness to lend. A collateral register is a facility sometimes mentioned as desirable to assist lenders to avoid fraud, but this argument seems less cogent than the case for solving the broader issues of loan enforcement. In short, the solutions to most of these problems is likely to be incremental; action to attract accounting firms to set up shop may be possible but time will be required to sort out problems pervading the legal and judicial systems.

E. The legislative and regulatory environment

1. Deficiencies in the legislative and regulatory environment affecting financial service provision are quite well understood. However, the difficulties of putting an appropriate framework in place are due to limited capacity in a Government struggling to secure reform on all fronts and to the need to fashion coherent arrangements in a system with elements drawn from several legal systems. The establishment of a basic legal framework, particularly with regards to property and land, would provide an adequate interim basis for growth in economic and financial activity, pending an incremental process by which specific legislative gaps are filled and more intractable deficiencies are addressed. Legal impediments to the provision of commercial insurance and equipment leasing are among the specific gaps to which early attention needs to be directed.

Into this latter category fall systemic weaknesses in commercial dispute resolution and enforcement. These cannot be remedied quickly, given human resource deficiencies in the judicial and bureaucratic systems. More specifically, implementation of the law for insurance is an urgent priority as is the establishment of the insurance industry itself in Timor-Leste. Bankruptcy legislation and regulations are likewise of urgent concern to lenders. Legislation for equipment leasing also needs urgent attention as it offers some relief for the collateral issue.