Lesotho:
Financial Sector Development Strategy

October 21, 2013

Preface

This Financial Sector Development Strategy was prepared for the Government of Lesotho by a consulting team comprising A. Michael Andrews, Keith Jefferis, Paul Murgatroyd, and Douglas Webb. The team wishes to thank their many counterparts who provided much of the input for the development of the Financial Sector Development Strategy. The strategy builds on more than 25 recent and ongoing financial sector projects, so for many policy areas the role of the consulting team was largely to pull together and coordinate, not to produce new diagnostics or recommendations. Stakeholder review and feedback indicates there is broad consensus around the policy actions contained in this strategy.

We are especially grateful to the Central Bank of Lesotho for logistical support, and officials throughout government, in particular the Ministry of Finance, the Ministry of Development Planning, and the Ministry Trade, Industry, Cooperatives and Marketing. We are in debt to the many private sector representatives, donors and staff of the International Financial Institutions who were so generous with their time, including MacMillan Anyanwu of the World Bank and Stephen Swaray and Michael Tharkur of the IMF. We wish to thank FIRST Initiative for financing the work necessary to produce this strategy, and our task manager, Francesco Strobbe of the World Bank who provided overall guidance and support.

Field work was conducted in April and August 2013 and this report reflects the situation in Lesotho as of those dates.

Contents

Acronyms

ACH	-	Automated Clearing House
AFRITAC South	-	Africa Regional Technical Assistance Center-South
ATM	-	Automated Teller Machine
BEDCO	-	Basotho Enterprises Development Corporation
CBL	-	Central Bank of Lesotho
CMA	-	Common Monetary Area
CMS	-	Case Management System
CoP	-	Certificate of Proficiency
CRA	-	Credit Reporting Act
CRB	-	Credit Reference Bureau
DB	-	Defined Benefit
DC	-	Defined Contribution
DOC	-	Department of Cooperatives
EFT	-	Electronic Funds Transfer
EMV	-	Eurocard, MasterCard, Visa
EPA	-	Economic Partnership Agreement
FIA	-	Financial Institutions Act
FSC	-	Financial Stability Council
FSDS	-	Financial Sector Development Strategy
FSU	-	Financial Stability Unit
GDP	-	Gross Domestic Product
GoL	-	Government of Lesotho
ID	-	Identification
IMF	-	International Monetary Fund
IT	-	Information Technology
KYC	-	Know Your Customer
LAA	-	Land Administration Authority
LHLDP	-	Lesotho Housing and Land Development Corporation
LMCH	-	Lesotho Manual Clearing House
LNDC	-	Lesotho National Development Corporation
LPB	-	Lesotho Post Bank
LSW	-	Lesotho Wire
M	-	Maloti
MCC	-	Millennium Challenge Corporation
MDP	-	Ministry of Development Planning
MFI	-	Microfinance Institution
MM	-	Mobile Money
MNO	-	Mobile Network Operator
MOAFS	-	Ministry of Agriculture and Food Security
MoCST	-	Ministry of Communication, Science and Technology
MoF	-	Ministry of Finance
MoLG	-	Ministry of Local Government and Chieftainship

MOU	-	Memorandum of Understanding
MSMEs	-	Micro, Small and Medium Enterprises
MTICM	-	Ministry of Trade, Industry, Cooperatives and Marketing
MVA	-	Motor Vehicle Accident
NBFI	-	Non-Bank Financial Institution
NPS	-	National Payment System
NSDP	-	National Strategic Development Plan
NSSA	-	National Social Security Act
OPC	-	Office of the Parliamentary Counsel
OTC	-	Over-the-counter
PAL	-	Payments Association of Lesotho
PAYG	-	Pay As You Go
PCA	-	Prompt Corrective Action
PODCPF	-	Public Officers Defined Contribution Pension Fund
POS	-	Point of Sale
PPP	-	Public Private Partnerships
PS	-	Principal Secretary
PSB	-	Payment System Bill
P2P	-	Person to Person
ROSCAs	-	Revolving Savings and Credit Associations
RSCGs	-	Rural Savings and Credit Groups
RTGS	-	Real Time Gross Settlement
RUFIP	-	Rural Financial Intermediation Program
SACCOs	-	Savings and Credit Cooperatives
SADC	-	Southern African Development Community
SARB	-	South Africa Reserve Bank
SLA	-	Service Level Agreement
SME	-	Small and Medium Sized Enterprises
SMME	-	Small, Micro and Medium Sized Enterprises
SUFIL	-	Support for Financial Inclusion in Lesotho
TA	-	Technical Assistance
VSLA	-	Village Savings and Loan Association
WSBI	-	World Savings Bank Institute

EXECUTIVE SUMMARY

This Financial Sector Development Strategy (FSDS) follows from the National Strategic Development Plan (NSDP) objectives for the financial sector in order to maximise its contribution to economic and social development in Lesotho. While few of the NSDP goals are financial sector-specific, without a sound and vibrant sector providing access to financial services, few national aspirations can be achieved.

The FSDS builds on a strong foundation, with more than 80% of Basotho adults using formal or informal financial services, one of the highest rates of financial inclusion in Africa. There is still more to be done, particularly in expanding access to savings and transactions products in rural areas and credit to small, micro and medium-sized businesses (SMMEs).

Developing the Financial Sector
Experience has highlighted the need to reconcile sometimes conflicting policy objectives, have a structure to coordinate and monitor implementation, focus on high impact projects, and to minimise the need for new organisations and institutions. The policy actions required cut across multiple ministries and agencies, thus requiring an Implementation Committee able to coordinate and make decisions at the highest level.

An over-riding concern in the preparation of the FSDS is the need to minimise the costs of institutions and infrastructure since these costs are ultimately borne by Basotho, whether as consumers or taxpayers. This led to five key principles for the FSDS:

- Using existing institutions to the greatest extent possible
- Considering new organisations only if warranted after a rigorous cost-benefit analysis
- Considering scale and other economies available through regional initiatives
- Making the most of opportunities offered by new technology
- Using existing international and regional professional qualification and training programs, delivered where feasible in partnership with existing local educational institutions.

Phase I of the FSDS focuses on the required structures and processes to be put in place during 2014. These include Cabinet approval and monitoring, a senior level Implementation Committee, and a limited-life FSDS Secretariat which will coordinate across different functional areas within government and provide technical support to the champions responsible for each set of policy actions. Establishment of a Steering Committee for financial sector law reform is another key component for Phase I to help ensure that the needed laws and regulations for FSDS implementation proceed expeditiously.

Financial Inclusion
Increasing financial inclusion and access to credit are two of the top priorities in the NSDP. The FSDS builds on work already underway in the Ministry of Finance (MoF) to increase the effective demand for financial services and broaden and deepen the supply of financial services. The MoF will expand the initial data base available from the 2011 FinScope survey

by using a similar approach to prepare a small enterprise survey. This will provide a better understanding of the demand for financial services and the data will be used to establish national targets and measure performance in increasing financial inclusion.

Initiatives to increase effective demand build on prior and ongoing projects to increase financial literacy, support small, micro and medium businesses (SMME), and structural reforms to strengthen the credit discipline, lending and recovery environment.

The MoF will continue to be the focal point for financial literacy initiatives, including a financial literacy baseline study, development of a strategy, and implementation. The Ministry of Trade, Industry, Cooperatives and Marketing (MTICM) will be the focal point for SMME inclusion. This will include consolidating the two existing partial credit guarantee schemes into a single program administered by Lesotho National Development Program. The Basotho Enterprises Development Corporation will focus on entrepreneur training and business advisory services.

Building on progress with land title reform, the establishment of an electronic land register and simplifying the enforcement of a mortgage of land will further reduce the risks and costs of lending against leasehold titles and thereby benefit potential borrowers. The outdated Hire Purchase Act will be replaced by modern law that will allow all forms of movable and personal property to be used as collateral, helping SMMEs access credit. Review of the system of enforcement of court judgements will build on previous legal reforms, including the establishment of the Commercial Division of the High Court. A new insolvency law will provide more flexible forms of business rehabilitation.

The four commercial banks serve the majority of Basotho accessing formal financial services. One of the major challenges is increasing competition. Given the costs of serving a small and widely distributed population with traditional “bricks and mortar” locations, the most immediate and likely sources of competition are from outside the banking system. Mobile money, which is being rolled out by the telecom operators, will quickly evolve into a de facto savings account. This offers great potential to extend formal financial services to many Basotho who are currently unbanked.

Regulatory constraints on expansion of financial services will be minimized to the extent consistent with consumer protection and financial stability. This will include removal of fees for banks to open new branches and automated teller machines, use of tiered know-your-customer requirements to facilitate provision of basic accounts, streamlining of the requirements for use of agency networks by financial institutions, and amendment to the Insurance Act to better accommodate micro-insurance.

The mandate and objectives of Postbank will be reaffirmed and its governance strengthened by appointment of a new board of directors. A strategic review will consider continued stand-alone operations or seeking a strategic partner, with the primary objective of achieving sustainability without ongoing subsidies.

Deposit-taking microfinance institutions have the potential to offer Basotho alternatives to the banks, and thus increase competition. The new regulatory regime is supportive, and applications from existing credit-only institutions wishing to accept deposits, or potential new entrants, will be processed expeditiously by the Central Bank of Lesotho (CBL). Less formal rural savings and credit groups and village savings and loan associations will continue to be supported with training, and their contribution to financial outreach will be documented in the next FinScope Survey. Small savings and credit cooperatives will be exempted from CBL oversight and remain under the purview of the Department of Cooperatives pursuant to a planned new Financial Cooperatives Act. Capacity for oversight will be enhanced and ongoing support and training will be provided for both the Department and savings and credit cooperatives.

The recent sharp increase in mortgage financing provided by financial institutions reflects the success of land administration reform. Building on this, stamp duty and transfer fees will be reviewed to reduce costs which can deter provision of housing finance on a commercial basis.

A survey of the agricultural sector, similar to the planned small enterprise survey, will provide the basis for further policy actions to support the growth of commercial agriculture. A feasibility study for crop insurance will be undertaken. Effective demand from the agricultural sector will be enhanced through the use of agricultural extension offices to deliver financial literacy and other training.

The inevitable convergence of mobile money and deposit-taking will be facilitated through an enabling regulatory environment. To ensure consumer protection, mobile network operators are required to hold all network balances in trust with a bank. To encourage competition with the banks, payment of interest on mobile money balances will be permitted.

Establishing a credit reference bureau will help credit providers make sound lending decisions which will increase availability, and over time reduce the cost of credit to individuals and small businesses. The final elements of the legal framework have been put in place, and entry of at least one credit bureau is expected shortly.

Mobilising Financial Resources and Promoting a Savings Culture

Enhancing consumer projection will build confidence and draw savings into the formal financial sector. The CBL will work with financial institutions to develop a code of sound practices for financial consumer protection. While voluntary adoption is expected, the Financial Institutions Act will be amended to provide the CBL with the power to impose a code if necessary. It is also desirable to provide a redress mechanism for consumers, and to this end the MTICM will review the options for establishment of a financial ombudsman.

The current capital market constraint is the shortage of investment opportunities—local investors such as pension funds and life insurance companies would hold more domestic debt and equities if available. The Government debt issuance program, conforming to well-established principles for bond market development, will lay the foundation for growth of domestic capital markets. Domestic financing tranches will be encouraged for infrastructure projects. Capital market regulations will be issued to facilitate growth of an over-the-counter

(OTC) market for equities, and interest will be solicited from regional stock-broking firms to operate a local OTC market. In the longer term, consideration will be given to a shared infrastructure stock exchange operated in conjunction with a regional exchange.

Putting in place a modern legal framework is the highest priority for the insurance sector. To this end, the Insurance Bill will shortly be passed into law. In the medium term, a package of amendments will be introduced to reflect recent developments in best practices, the need to better accommodate micro-insurance and annuities as a class of long-term insurance, and to enhance consumer protection through enhanced requirements for brokers. The operations of the Motor Vehicle Accident scheme will be reviewed, and consideration given to compulsory third-party motor vehicle insurance.

Pensions are a high priority because of the social objectives of ensuring Basotho are provided for in their retirement and the role of pension funds in mobilizing long term savings and developing the capital markets. The key actions required are adopting an overall national pension policy, establishing the regulatory framework for private pensions, and introduction of a public pension consistent with the national policy. Following development of the national pension policy, work already underway on preparing laws governing private pensions and a statutory social insurance and pension scheme will be completed.

Improving Efficiency—The Payments System

The Payment System Bill will be enacted to more clearly provide a foundation for CBL oversight of the payment system. A policy decision will be taken following further stakeholder consultation whether to address the rapidly evolving field of retail payments through the Payment System Act, the Financial Institutions Act, or new legislation. Operation of the Automated Clearing House will pass from the CBL to the Payments Association of Lesotho. The CBL will consider options for processing card transactions, which are currently handled by SASWITCH operated by the South African banking system.

Given the large scale and importance to the economy of inward remittances from Basotho resident abroad, a comprehensive survey of the cross-border remittance market will be undertaken. In the near term, mobile network operators will be encouraged to provide cross-border remittances services, and the CBL will liaise with the South African authorities to resolve any regulatory barriers and develop appropriate data collection mechanisms and safeguards.

Financial Stability and Soundness

A sound and stable financial system is a prerequisite for the social and economic transformation envisioned by the NSDP. Building from a strong foundation, the CBL will focus its oversight on domestic institutions and liaison with the South African authorities to ensure effective consolidated supervision of the South African-owned institutions operating in Lesotho. Insurance and pension supervisory capacity will be built through training and recruitment. Ongoing work to build capacity in financial stability analysis and bank supervision will continue to be supported by technical assistance from the International Monetary Fund.

The elements of the financial safety net required to effectively respond to distress in the financial sector will be put in place. The CBL will develop a new liquidity facility for banks to meet the extraordinary need that might arise in a crisis. The current legal frameworks will be revised to provide powers to intervene in and resolve problem institutions in line with new international best practices. Following from the commitment in the NSDP to introduce deposit insurance, a scheme appropriate to the small size of the Lesotho financial sector will be developed.

The steering group for financial sector law reforms will help ensure that the many laws and regulations required to implement the FSDS are quickly enacted. It will set legislative priorities, monitor progress and avoid inconsistencies with existing and planned laws, and coordinate with the FSDS Secretariat.

Implementation

Following FSDS approval by Cabinet, the FSDS Implementation Committee, comprised of Principal Secretaries (PS) and the CBL Governor, will report regularly to Cabinet on progress. The Implementation Committee will be chaired by the PS MoF. Reflecting the important link between the FSDS and the NSDP, the vice-chair will be the PS Ministry of Development Planning.

The Implementation Committee will be supported by a strong Secretariat, housed at the CBL and including staff seconded from the Ministries and agencies responsible for key FSDS policy actions. Individual champions will be chosen for each set of policy actions. The Secretariat will monitor and report progress to the Implementation Committee based on ongoing liaison with the various champions. It will function as a gate-keeper to ensure all donor support for financial sector development is aligned with the FSDS.

I. Developing the Financial Sector

1. This Financial Sector Development Strategy (FSDS) is one of the key components required to achieve the aspirational goal established by the National Strategic Development Plan (NSDP)—an accelerated and sustainable economic and social transformation of Lesotho. The FSDS is the first of a series of strategies planned for each key sector of the economy to elaborate on the objectives established in the NSDP, focusing on specific policy actions and the needed steps for effective implementation. The FSDS builds on many prior and ongoing initiatives to develop and strengthen the financial sector to maximise its contribution to the economic and social development of Lesotho.

2. Financial sector development is crucial to fulfilling the objectives of National Vision 2020 and the goals outlined in the NSDP. While relatively few of the national objectives and goals relate specifically to the financial sector, the vision of an accelerated and sustainable economic and social transformation cannot be achieved without a sound and vibrant financial sector providing access to financial services in all areas of the country, facilitating economic activity and mobilising savings for productive investment in the growth of Lesotho.

3. Many of the specific FSDS initiatives span several of the six strategic objectives for the financial sector established in the NSDP:

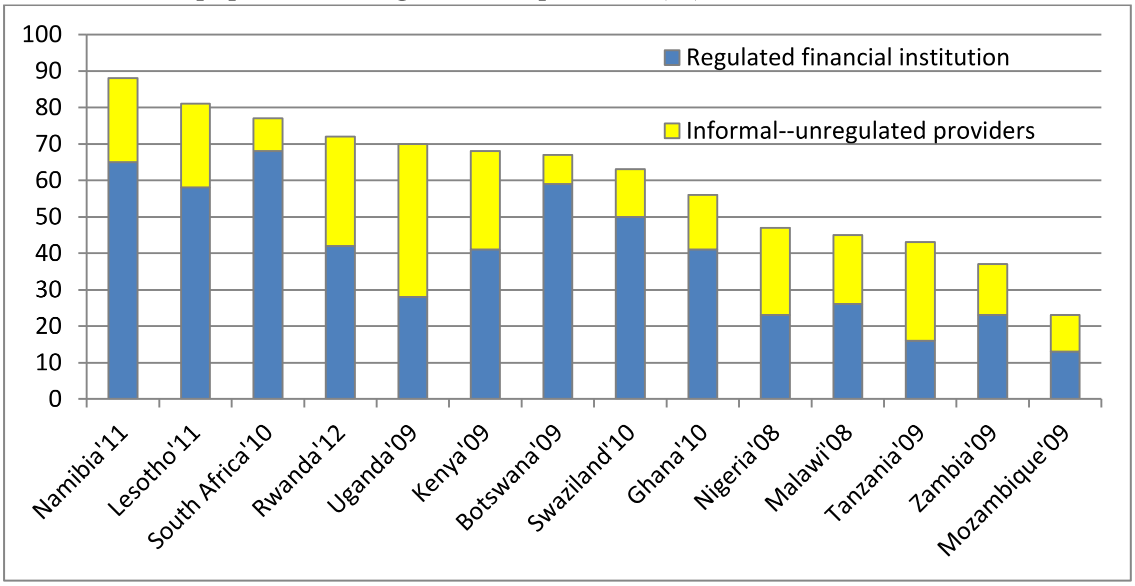
- Improving access to finance
- Increasing alternatives for mobilising financial resources
- Promoting a savings culture
- Improving financial sector efficiency
- Bridging the skills gaps in the financial sector and increasing financial literacy
- Improving financial stability and soundness.

4. The FSDS builds on a strong foundation. While there is still more to be done to expand outreach and increase savings and investment, Lesotho compares favourably to other countries in Africa in access to finance (Chart 1). Many of the elements of a modern and effective financial sector are already in place (Table 1).

5. The formal financial sector is bank-dominated. The four banks—three subsidiaries of South African banks and the government-owned Lesotho Post Bank (LPB)—serve about 435,000 Basotho, approximately 38% of the adult population, through 44 branches. The number of physical locations—branches and automated teller machines (ATMs)—have been expanding rapidly but with significant regional disparities. In Maseru there are about 10 branches and ATM locations for every 100,000 people, whereas in Mokhotlong, for example, there are only two branches and ATM locations for every 100,000 people.[1]

[1] Finmark Trust, *FinScope Consumer Survey Lesotho 2011*.

Chart 1. Adult population using financial products (%).



Source: Finmark Trust, most recent FinScope surveys, available at http://www.finscope.co.za/new/pages/default.aspx?RandomID=53957435-1ad2-41e3-91fa-5bc49d3ae836&linkPath=MenuContainer&lID=1

Table 1. Lesotho formal financial sector, end-2012.

	Number	Assets (maloti 000s)	Assets ($ millions)	Assets (% of GDP)
Banks	4	8,706,909	1,025	42.3
Insurance companies[a]	7	2,995,400	360	14.5
Life	5	2,740,000	329	13.3
General	3	255,400	31	1.2
Asset managers[b]	2	2,850,000	336	13.8
Pension plans[b,c]	150	3,500,000	412	17.0
SACCOs	120	n.a	n.a.	n.a.

a. Data at end-September 2012. There are four life insurance companies, two general insurance companies, and one composite company writing both long term and short term insurance.
b. There is an element of double counting as a significant portion of the assets under management are pension fund assets.
c. Estimates range from 100 to 200 private occupational pension plans with total assets of about M1 billion, plus the 2.5 billion assets of the Public Officers Defined Contribution Pension Fund and the smaller Corporate Bodies pension scheme.

n.a. = not available.

Notes: Exchange rate end-Dec 2012 8.49, end-Sept 2012 8.31. Estimated GDP 20,559 million maloti.

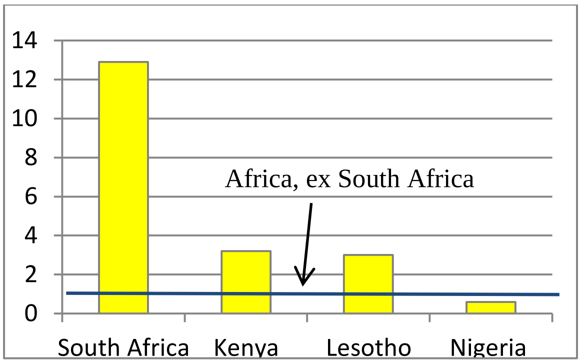
Source: CBL and industry participants' estimates.

6. While the insurance sector is small, insurance penetration in Lesotho, estimated at premiums equal to about 3% of Gross Domestic Product (GDP), is well above the African (excluding South Africa) average of 1.1% (Chart 2). One of the reasons for the relatively high level of insurance penetration is the popularity of

funeral policies. These relatively inexpensive policies are the main reason why 62% of Basotho adults have an insurance product, versus 50% who have a savings product.

7. The absence of a government social security system has spurred the development of private pension plans and medical insurance for the formally employed. Despite the lack of a legal framework for pensions and the dated insurance law, there are an estimated 100-200 occupational pension plans, most of which are administered by life insurance companies.

Chart 2. Insurance premiums (% of GDP)



Sources: CBL, A.M. Best.

8. Other formal and informal financial institutions serving the population of about 2.1 million include Lesotho National Development Corporation (LNDC), which operates a partial credit guarantee scheme but does not lend, approximately 120 Savings and Credit Cooperatives (SACCOs), 2 non-deposit-taking micro-finance institutions (MFIs), about 65 Rural Savings and Credit Groups (RSCGs), and 330 Village Savings and Loan Association groups (VSLAs, supported by Care and by Catholic Relief Services).

9. Lesotho's unique situation has important implications for financial sector development, and in particular the expected financial sector contribution to the objectives of the NSDP. The relatively small number of financial institutions that can reasonably be expected to thrive in a small economy may restrict the level of domestic competition. Fortunately, technological change and other innovations are bringing into the Basotho market non-traditional competitors as such mobile-money products provided by telecom operators, and new delivery channels such as networks of agents to supplement or substitute for more traditional bricks and mortar branches. A key FSDS objective is the establishment of an appropriately flexible regulatory regime to encourage non-traditional competitors, while at the same time ensuring sufficient consumer protection and financial stability.

10. The FSDS will build on previous policy initiatives to establish the necessary preconditions for expanding access to finance. While there is still more to be done, many of the needed initiatives have already been identified, and the benefits from recent reform initiatives are now becoming evident. For example, ongoing land administration reform has greatly increased the availability of leasehold titles and streamlined the process of registering mortgage security, leading to rapid growth in mortgage lending (Chart 3).

11. Lesotho ranks in the middle of regional countries in the mobilisation of savings through the banking sector, but has lagged behind in extending credit to the private sector (Table 2). Recent efforts to improve the lending environment have

begun to bear fruit, with sharp increases in the last two years in bank lending to businesses and individuals.

Table 2. Indicators of banking sector development (% of GDP).

	Credit to the Private Sector	Bank Deposits
Botswana	24.0	38.6
Lesotho	13.6	35.6
Mozambique	23.2	32.5
Namibia	48.0	62.5
Swaziland	24.3	27.9
South Africa	67.7	59.1
Zambia	10.9	18.6

Source: World Bank Financial Development and Structure Dataset (updated April 2013), available at http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTRESEARCH/0,,contentMDK:20696167~pagePK:64214825~piPK:64214943~theSitePK:469382,00.html

12. Civil law reform, including establishment of a commercial court and streamlined small claims procedures have improved the lending climate for both SME and household lending. The result of these reforms, moral suasion to encourage banks to invest domestically more of the savings mobilised in Lesotho, and continued low interest rates which have encouraged banks to seek higher returns by growing their loan portfolios have all contributed to a sharp increase in the banking system loan to deposit ratio and a corresponding decrease in the portion of bank assets invested abroad, primarily South Africa (Chart 4).

Chart 3. Bank lending (maloti, millions).

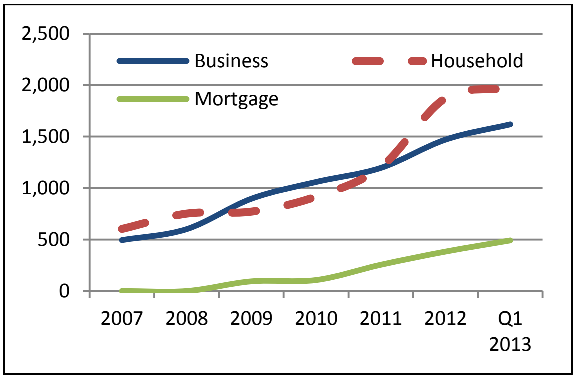
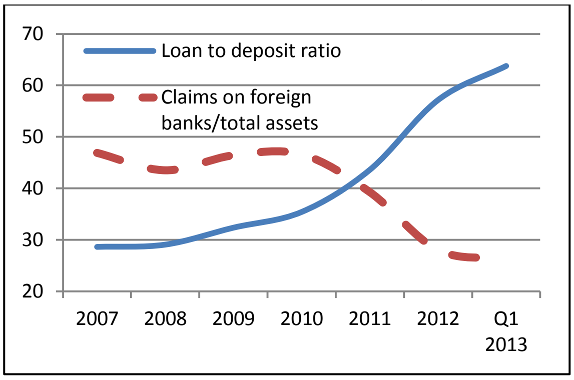


Chart 4. Bank balance sheet ratios (%).



Source: CBL.

13. The proximity of the South African market and major role played by South African institutions provides benefits and challenges. While estimates vary, industry participants unanimously agree that the size of Lesotho's financial services market is larger than indicated by the size of the domestic financial services industry due to the ready availability of financial services in South Africa. This puts pricing pressure on domestic institutions, which may struggle to achieve economies of scale within Lesotho. It also presents potentially conflicting policy objectives—efforts to encourage growth of domestic institutions such as prohibitions on cross-border purchases may result in higher costs to Basotho consumers, as well as possibly conflicting with commitments under trade agreements. Similarly, requirements for

domestic investment by financial institutions may contribute to local economic and financial market development, but may also increase concentration risk and lower returns due to the limited availability of investments in Lesotho, particularly capital markets instruments like government bonds and equities.

14. Key considerations that have shaped the FSDS are the need to balance sometimes conflicting policy objectives, the need for coordination and efficiency taking into account the specific needs of a small economy, and the opportunities to build on regional initiatives. Against the backdrop of a number of already well-established financial institutions, increasing levels of financial inclusion and recent expansion of credit, the FSDS focuses on completing initiatives already underway, clearing bottlenecks and implementing a number of high impact initiatives. Guiding principles for implementation of the FSDS are outlined below, and addressed in more detail in the implementation chapter.

A. Minimising Costs to Consumers, Industry and the Exchequer

15. Serving the needs of a small and widely distributed population presents challenges. Whether services are delivered by government or the private sector, the costs of institutions and infrastructure are important considerations. One reason why a number of prior financial sector initiatives have not been implemented is that the costs for establishing and operating new institutions, agencies or networks exceed the expected benefits, or are simply unaffordable in a small economy. Costs to industry are ultimately passed on to consumers, and costs to government are similarly born by taxpayers. Thus, the FSDS focuses on several key principles to minimise the need to create and support new institutions:

- Using existing institutions to the greatest extent possible
- Considering new organisations only if warranted after a rigorous cost-benefit analysis
- Considering scale and other economies available through regional initiatives
- Making the most of opportunities offered by new technology
- Using existing international and regional professional qualification and training programs, delivered where feasible in partnership with existing local educational institutions.

B. Implementation—Phase I

16. This FSDS provides the overarching framework for policy actions required to ensure that the financial sector makes its expected contribution to NSDP objectives. The need for an overall plan and coordination is imperative, as the large number of individual projects inevitably cuts across a range of functional responsibilities and are related to a number of policy objectives.

17. The crucial first phase of the FSDS, to be completed during 2014, focuses on putting the implementation structure in place. This will include measures to address the backlog of needed laws and regulations. The implementation plan also recognises that many of the required initiatives are already underway. Thus, while there are many

policy actions targeted for completion over the next year, these relate to initiatives that are already underway which will be brought under the aegis of the FSDS to ensure the necessary coordination across different functional responsibilities. In addition, new initiatives identified in the FSDS beyond the Phase I focus on implementation measures will begin to be completed from late 2014 onward.

18. Effective implementation and monitoring will be achieved through Cabinet approval of the FSDS, regular reporting to Cabinet on progress by a high-level Implementation Committee,[2] and the establishment of a strong donor-funded Secretariat which will be established within the Central Bank of Lesotho (CBL) to support FSDS implementation.

19. A lesson from experience is the need for a gatekeeper and quality control function for the support provided by donors. While well intentioned, in some cases financial and technical support has not been fully consistent with government priorities or adequately coordinated with other projects. The terms of reference and deliverables of all financial sector-related technical assistance (TA) will be reviewed by the FSDS Secretariat. This will help to ensure that all ongoing and future projects align with the FSDS, and that the outputs meet requirements and expectations.

20. The FSDS action plan extends through the 2016/17 fiscal year, in line with the planning horizon of the NSDP. The importance of the sequencing and prioritisation of the required actions (see Appendix 2 for the action plan matrix) will also help to address one of the lessons from previous reform efforts—the limits of absorptive capacity. Capacity constraints are particularly acute in the CBL, which has responsibility for many key financial sector initiatives. The pressing need to develop policies and prepare legislation and regulations makes it difficult for the CBL to concurrently build effective supervisory capacity, particularly in the sectors targeted for further development including pensions, insurance, and the capital markets.

21. Capacity limits and the bottlenecks in ongoing projects will be addressed through immediate focus putting in place the required implementation structure, combined with marshalling technical assistance to support these implementation measures. Other actions will be sequenced through 2016/17, and the FSDS will be used as a tool to coordinate technical assistance, with donors asked to commit support directly to FSDS policy actions rather than developing projects independently.

22. **The structure and process for overall FSDS implementation is crucial.** Drawing the lessons from previous efforts to coordinate activities across multiple government and private sector stakeholders, the key elements for implementation and monitoring are:

- Cabinet approval of the FSDS—targeted by end-2013

[2] The Financial Sector Steering Committee established in 2008 includes a range of private and public sector stakeholders. It provides a useful forum for consultation and will continue to meet as needed. The Implementation Committee will comprise only the senior government officials responsible for FSDS implementation, and unlike the Financial Sector Steering Committee will be a decision-making body accountable to Cabinet.

- Establishment of a high level (Principal Secretaries and Heads of Agencies) FSDS Implementation Committee—January 2014
- Establishment of a Steering Committee for financial sector legal reform—March 2014
- Establishment of a dedicated and well-resourced Secretariat to support the Implementation Committee and law reform steering group, including secondees from participating Ministries and Agencies and necessary expert support—June 2014
- Designation of individual high level champions for each set of policy actions—June 2014
- Regular progress reports by the Implementation Committee to Cabinet, beginning March 2014.

23. **Clearing the long-standing legislative and regulatory backlog will put in place the legal foundation for numerous FSDS policy actions.** There are more than 10 laws or sets of regulations in varying stages of development or awaiting enactment by Parliament that are important for financial sector development. A steering group for law reforms will be established linking the Cabinet Office, Attorney General, Office of the Parliamentary Counsel (OPC) and the Ministry of Law. With support from the FSDS Secretariat, the steering group will set legislative priorities, consider proposals for judicial reforms, and monitor progress. Technical assistance will be sought for the OPC and the CBL to provide additional law drafting capacity, recognizing that the legal reforms envisaged by the FSDS represent significant incremental demand on the normal law-drafting program. The OPC will consider establishing a dedicated unit for financial sector law drafting activities. Organisation of the FSDS

24. The following four chapters of the FSDS provide a concise narrative of the current situation or condition of the relevant aspects of the financial sector, together with identification of the desired change or required outcome to achieve policy objectives. They have been organised around the strategic objectives for the financial sector identified in the NSDP. Additional detail and supporting analysis are contained in a series of technical notes prepared as background to the FSDS, and in more than 25 recent or ongoing projects addressing various aspects of financial sector development that were reviewed as part of the preparation of the FSDS.

25. Most sections of the FSDS conclude with a table summarising the set of policy actions for that topic. These policy action topics form the basis for the outcome-based matrix in the final chapter of the FSDS. Further detail on each action item, including the expected time frame, prioritisation, entities responsible and requirements for technical assistance are provided in the matrix in Appendix II. The final chapter addresses implementation, including mechanisms for monitoring and coordinating all of the work related to the FSDS.

II. FINANCIAL INCLUSION

26. The NSDP identifies increasing financial inclusion and access to credit as a high priority and one of the main financial sector challenges. Addressing these challenges requires a focus on both the supply of credit, and the factors which affect the demand for credit. The FSDS will build on the successful policies to promote financial inclusion, deepen the savings culture and enhance financial literacy introduced in the Inclusive Finance Strategy of Lesotho and related projects under the Support for Financial Inclusion in Lesotho (SUFIL) program. This entails a broad two pronged strategy to: i) increase the effective demand for financial inclusion; and ii) broaden and deepen the supply-side institutions' contributions.

A. Overall Strategy for Increasing Financial Inclusion

27. Several complementary initiatives are required to better understand the demand for financial services and monitor progress in increasing financial inclusion. The Ministry of Finance (MoF), as the focal point for financial inclusion, will coordinate work in this area.

28. The 2011 FinScope study is a very useful tool for understanding the market place demand for financial services and it provides a benchmark for establishing national targets and measuring performance against targets as time goes on. The Department of Private Sector and Financial Institutions in the MoF will expand this initial data base by using a similar approach to prepare a small enterprise survey to deepen understanding of this important market for services.

29. A second FinScope study will be commissioned in 2015 to provide a measure of progress in meeting financial inclusion objectives. This study will deepen analysis of other formal financial institutions' activity by breaking it down into the types of formal and semi-formal financial institutions to separately measure the impact of SACCOs, MFIs, RSCGs and VSLAs.

30. Constraints on effective demand for financial services represents an even greater challenge than strengthening supply-side contributions for achieving increased financial access, whether provided by the banks or other institutions. The recent fundamental change in the level and type of commercial bank lending, shortly after land titling reform enabled lenders to better use land as collateral, provides evidence that if effective demand[3] conditions allow for profitable expansion of the envelope of services and lending, the supply-side institutions will respond.

31. Therefore, the FSDS gives highest priority to increasing effective demand for financial services as the first strategic prong. It does so primarily by i) coordinating and focusing government and donor-supported financial inclusion initiatives within the MoF at the policy and reform identification level while relying almost entirely on the most relevant line Ministries for implementation; ii) better defining and understanding the demand market for financial services; iii) increasing financial

[3] Effective demand is defined as "bankable" demand, i.e., demand from borrowers capable of submitting credible loan applications and deemed to be creditworthy by lenders.

literacy; iv) strengthening the Ministry of Trade, Industry, Cooperatives and Marketing (MTICM) program for increasing SME effective demand for financial services; and v) strengthening the credit disciplinary, lending and recovery environment.

32. The second strategic prong focuses on strengthening supply-side institutions and their incentives for contributing more to financial inclusion. It does so primarily by i) increasing commercial bank participation; ii) strengthening the Lesotho Post Bank (LBP) to increase its contribution; iii) strengthening MFIs, informal institutions and SACCOs; iv) facilitating the expansion of effective mobile phone banking; and v) devoting special attention to housing and agriculture given unique financing aspects associated with these subsectors.

Policy actions-Overall Strategy for Financial Inclusion
• **MoF to continue as focal point for financial inclusion** • **Use the 2011 FinScope study to better understand the demand for financial services and provide a benchmark for establishing national targets and measuring performance** • **Conduct a small enterprise survey using a similar approach to that of the FinScope study** • **Conduct a new FinScope study in 2015 which breaks down the other types of formal institutions and expands that category to include RSCGs and VSLAs**

B. Increasing Effective Demand

33. Initiatives to increase effective demand will build on a number of existing programs. These include SUFIL projects on financial literacy and financial inclusion, existing government programs to support small, micro and medium businesses, and structural reforms to strengthen the credit discipline, lending and recovery environment.

Financial Literacy

34. Broadening and deepening financial literacy is a priority because converting unbanked enterprises and households into bankable customers involves more than moving financial institutions down-market. It also requires inculcating financial literacy within this potential client base to enable future clients to utilise financial services in an effective and responsible way. It is desirable that potential clients understand what deposit, transfer and loan services are available, how much they cost, and how to apply for and use them effectively and responsibly.

35. The MoF Division of Private Sector and Financial Institutions will be the focal point for designing the overall financial literacy strategy and coordinating its implementation. The target group is large and diverse, involving SMEs, existing clients of formal and informal institutions, farmers, and students and, eventually, the general population.

36. As part of the overall strategy, a financial literacy baseline study will be commissioned to identify the target groups and design a cost effective strategy and implementation plan for reaching them. It is envisaged that the approach will initially target existing users of financial services as they are the ones most likely to be bankable and can quickly use what they learn. This would involve participants in MFIs, RSCGs, VSLAs, and SACCOs with the objective of helping them to obtain services from banks and other providers.

37. A second element of the overall strategy will be to retain another consultancy to develop tools and a training manual to implement the training, drawing to the extent feasible on materials already developed for use in other countries. This same project will also include training a group of trainers. It is envisaged that the trainers will be drawn primarily from Lesotho faculty and university students associated with the financial arena as well as SACCO supervisors and agriculture extension officers.

Policy Actions-Financial Literacy
• **Establish MoF as the focal point in government for financial literacy and coordinate all donor sponsored initiatives there** • **Conduct a financial literacy baseline, strategy design and implementation study** • **Develop the tools and a manual to implement training** • **Train a small group of trainers to roll out training** • **Focus primary initial effort on participants in MFIs, VSLAs, RSCGs and SACCOs who have opportunity to use what they learn** • **Identify existing relevant training and education facilities and focus on one such facility to provide higher level training**

Support for SME Financial Inclusion

38. Increasing financial inclusion for SMEs is a high priority as they play a key role in providing employment as well as growing the economy. The MTICM will be the sole focal point for implementing this strategy within government as it has the primary mandate for achieving it and oversees Lesotho National Development Corporation (LNDC) and the Basotho Enterprises Development Corporation (BEDCO), the Government's best tools for supporting increased SME access to credit. The strategy will depend entirely on the private sector to provide the credit.

39. LNDC is a well-established parastatal with a mandate to initiate, promote and facilitate the development of manufacturing industries, mining and commerce in a manner calculated to raise the level of income and employment in Lesotho. It has an already established M10 million partial credit guarantee program that is well designed to support pursuing its mandate. It will be assigned sole responsibility for implementing the Government's partial credit guarantee scheme on a managed funds basis as a "one-stop facility" for lenders by merging the M50 MoF million credit guarantee facility with its own.

40. LNDC’s mandate will not change as its role with respect to guarantees for SMEs and commercial agriculture will consist solely of managing financial aspects of the guarantee program. It will continue to pursue its other functions which, inter alia, include promotion and technical support services for new larger industrial and commercial projects, including public-private partnership (PPP) projects in cooperation with MoF which will be the focal point for these projects. LNDC may be less associated with government programs than BEDCO in the minds of borrowers as it is financially independent of government, is an important bank customer, will not have direct contact with SME guarantees, and has significant profit-oriented financial management experience.

41. LNDC will manage the combined partial credit scheme as a managed fund, for the most part using its present terms, conditions and modus operandi, but will remove its M200,000 minimum floor and project appraisal functions to expand program’s scope to cover SMEs and commercial agricultural entities as well as medium and large scale industrial projects. It will continue to provide monitoring and consulting support for guaranteed medium-sized entrepreneurs for whom guarantees in excess of M200,000 will be issued, while depending on BEDCO to provide the monitoring and consulting support for the smaller borrowers. An MOU will be signed between LNDC and BEDCO as a coordinating mechanism for their respective programs by outlining the roles and responsibilities of each.

42. BEDCO has now conducted training programs for 32 years in pursuit of its mission to build sustainable enterprises contributing to national economic growth. MTICM, in recognition of the key role BEDCO should play, recently doubled government funding for its programs. While BEDCO also has other programs and products, its core services for SMMEs are provided through an Entrepreneur Development Program Department and its 60 higher level staff. The department has three offerings, namely, Entrepreneurial Training, Business Advisory Service (both highly relevant for improving their clients’ ability to access credit), and Business Research.

43. BEDCO’s entrepreneur training provides assistance in how to start and improve a business, as well as on financial planning, marketing, bookkeeping, record keeping, etc. As part of this training, BEDCO will increase the emphasis on assisting borrowers with the preparation of business plans, loan applications, and how to make presentations to bank loan officers. BEDCO will market a broader package to augment the attractiveness of these applications to banks, where appropriate, by offering an LNDC partial credit risk guarantee, as needed, and its Business Advisory consulting support for borrowers at no cost to the bank or the borrower, if a loan to these trained entrepreneurs should become nonperforming,

44. BEDCO’s trainers and business advisory consultants also need to be better trained and the curricula need improvement. Consultants will be retained to address these needs with the objective of converting BEDCO into a centre of excellence for training for new and existing entrepreneurs. The number of BEDCO trainers will be

increased and/or training will be conducted in locations outside Maseru as required to adequately train all clients needing this support.

Policy Actions-Support for SME Financial Inclusion
• **Make MTICM the focus of Government strategy and support for strengthening BEDCO entrepreneur training and catalysing more SME lending** • **Make LNDC the sole manager of the Government partial credit guarantee program for SMMEs and merge the M50 million MoF facility into its facility** • **Remove LNDC M200,000 credit guarantee program limit floor and promote using credit guarantees to support both BEDCO trained-entrepreneurs and its own programs for medium and large scale projects, including PPP projects** • **Make BEDCO's entrepreneur training and business advisory service its primary and the government's sole focus for support in this area** • **Increase number of BEDCO trained entrepreneurs with focus on how to run a business, prepare a business plan and loan application** • **Assist SME entrepreneurs as needed with loan presentations augmented by offers of partial credit guarantees** • **Offer BEDCO monitoring and, as needed, consulting support for guaranteed borrowers with smaller loans** • **Sign MOU between LNDC and BEDCO on modus operandi for using LNDC credit guarantees to assist BEDCO clients at banks**

C. Strengthening the Credit Disciplinary, Lending and Recovery Environment

45. Many of the needed structural reforms to improve the credit environment are already underway. These include: land titling and administration reform, credit reporting and the national identity card scheme, a simplified small claims procedure for the Magistrates Court, and establishment of a Commercial Division of the High Court. A number of these initiatives need to be completed, and in several cases there is scope for further enhancement, for example through the automation of court case management and automated document filing systems. Also, there are several important further reforms required, including introduction of a secured transactions law and establishment of a national registry for security over moveable property, improvements to the system for enforcement of court judgments, and enactment of a new insolvency law.

46. Less formal lenders such as RSCGs and cooperatives tend not to resort to the legal system for debt recovery.[4] Local courts which are located within communities and use Basotho customary law have the potential to help in the pursuit of willful defaulters. The Department of Cooperatives (DOC) also provides a mediation service for disputes involving cooperatives, including failure to repay. These less formal

[4] "Development of Effective Loan Recovery Strategies of Financial Groups in Lesotho," Rural Financial Intermediation Program (2010).

alternatives, as well as reliance on intervention by chiefs, will be encouraged to help strengthen the credit repayment culture.

Mortgages of Land

47. Reform of land titling, particularly issuance of leasehold titles, has already contributed to a sharp increase in bank lending. Nevertheless, there are aspects of the system that could be further improved, with two reforms in particular—an electronic land register and simplifying the enforcement of a mortgage of land—expected to reduce the risks and costs of lending against leasehold titles and thereby benefit potential borrowers.

48. The establishment of an electronic land register is a high priority. The paper-based land registry will be replaced by an electronic registry that will permit lawyers and others to search remotely, and potentially to file transaction documents online. As the volume of registered leases is growing, with a corresponding rise in the frequency of land transactions, the manual system is at risk of falling behind and also presents a greater risk of fraud.

49. The enforcement of a mortgage of land will be considerably simplified by eliminating the need for a debt recovery claim to be filed in the High Court and to be subject to a hearing before a judge. This unnecessary step adds delay and uncertainty to the debt recovery process. With an average time to get a hearing date of 6-12 months, and an elapsed time from the filing of a claim in the High Court to the issue of a judgment of 345 days[5], a creditor faces a lengthy delay[6] before even beginning the process of enforcement of its claim.

50. In the majority of cases where a debtor has defaulted on a mortgage contract, the reason is simply the inability of the debtor to pay. In these cases, it should be sufficient for the creditor to issue a notice of default and wait for a short period, say 14 to 21 days, to allow the debtor an opportunity to remedy the default. If the non-payment is not remedied, the creditor should be able to immediately call the entire balance of the loan, and promptly obtain an order of the Commercial Court without the need for a formal hearing that authorizes the enforcement of the mortgage through a forced sale of the property.

51. In that minority of cases where the debtor may have a credible defense to the repayment claim, the debtor would have the right to apply to the court to halt the enforcement of the mortgage until the debtor has been heard. To minimise the risk of frivolous delays, the court should only halt the sale if the debtor has first satisfied the court that there is likely to be a successful defense.

[5] *Doing Business in Lesotho,* the World Bank (2013). Reforms of the Commercial Division of the High Court have resulted in the average time to resolve a commercial case falling to 345 days in 2011, compared to 695 days before the project began.
[6] The Commercial Division of the High Court has adopted simplified and accelerated case management rules that are leading to quicker case disposal.

52. In most circumstances, this simplified process would allow the creditor to rapidly proceed to enforce the mortgage following a default, rather than the current situation where it can take more than a year to obtain a court judgment. The creditor would also largely avoid the substantial filing and legal costs normally incurred in the court process.

53. An additional problem faced by a lender wishing to enforce its mortgage is that the debtor may still be in occupation of the property. The lender must in these circumstances apply to the Magistrates Court for an eviction order, and then wait for court officers to enforce the eviction. Experience has been that there can be lengthy delays in obtaining and enforcing an eviction order.

Policy Actions-Mortgages of Land
• **Implement an electronic land register** • **Introduce a simplified system for obtaining an order of the Commercial Court permitting the sale of a mortgaged property following default** • **Orders authorising sale of mortgaged property will also authorise eviction by court officers of occupants of the property**

Security Over Moveable Property

54. The outdated Hire Purchase Act will be replaced by a modern secured transactions or personal property law that will allow all forms of movable and personal property to be used as collateral for loans and other financial obligations. This will allow SMEs to offer a bundle of assets comprising stock, receivables, and equipment. Revolving assets such as stock and receivables generally comprise the bulk of the assets of these micro businesses, and a law that allows them to be effectively collateralised or factored can unlock credit flows and improve access to credit.

55. An electronic national public registry will be established in which the financier can register the details of its security interest. Following stakeholder consultation, an action plan will be developed and implemented for the establishment of the registry. The action plan will address the need for regulations for the proper functioning of the registry, and training of stakeholders on the legal framework and use of the online system. The registry may be government-operated in the same way as the company registry, or privately operated, perhaps by a credit bureau. Until the registry is established and operational, the financier should have priority over any third party claims in the order in which the instrument is filed with the Deeds Registry or the financier takes control of the property following default

56. A modern secured transactions law will provide a foundation for the lease finance business in Lesotho.[7] Lease finance is an attractive means for SMEs to acquire assets. In order to encourage growth of leasing the CBL will issue guidelines

[7] The Financial Lease Regulations 2013 will also support financial leasing.

for the licensing of leasing businesses as Type III financial institutions[8] under the Financial Institutions (Credit Only and Deposit Taking Microfinance Institutions) Regulations. Self-enforcement will be permitted to avoid lengthy delays through the court system. On default by the lessee, the lessor (the financer) will be able to repossess and resell the asset with a minimum of formalities, following a simplified enforcement procedure similar to that to be provided for mortgages of land.

Policy Actions-Security Over Moveable Property
• **Replace the Hire Purchase Act with a modern secured transactions or personal property law** • **Establish a national on-line public registry for security interests in moveable property** • **CBL to issue guidelines for registering leasing businesses as Type III financial institutions** • **Permit self-enforcement of security interests**

Court Enforcement of Creditor Rights

57. Further steps will be taken to enhance the benefits from the establishment of the Commercial Division of the High Court, streamlined rules for case management and the planned introduction of an automated case management system. The NSDP has identified the time taken to enforce court judgments as a critical issue in improving the investment climate.[9] The time limit proposed in the NSDP is a partial solution that will be supplemented by a fundamental review led by the Ministry of Justice of the enforcement of court judgments, including (i) allowing a secured creditor to obtain a court enforcement order without the need for a prior hearing; and (ii) the role of High Court sheriffs and Magistrates Court messengers in the enforcement process.

58. The review will consider a system for enforcement of judgments of the High Court and the Magistrates Court by judicial employees instead of independent contractors. This would place those responsible for enforcing judgments on the same employment basis as other court officials while reducing the costs of enforcement through the abolition of commission payments. Consideration will also be given to allowing the lawyer representing a claimant to have the option of serving writs and of locating assets to satisfy the judgment. While in the normal course lawyers would prefer that court staff handle these matters, the existence of an option for a party to take these steps if they have not been carried out within a specified period would increase transparency and accountability.

59. Increased accountability will also be provided by the High Court Case Management System (CMS), which is expected to begin operating in mid-2013. The CMS will include standard times for each step of the enforcement process and will red-flag matters that are not completed. The CMS will generate regular reports that

[8] The Third Schedule to the FIA includes "finance houses" that provide finance and operating leases.
[9] NSDP, page 79.

will allow senior managers to identify recurring problems with achievement of standards.

Policy Actions-Court Enforcement of Creditor Rights
• **Conduct a review of the system of enforcement of court judgments, including simplified procedures allowing a creditor to obtain an enforcement order without a prior hearing, and changing the role of sheriffs and messengers, with the goal of reducing costs, improving the speed and reliability of outcomes, and improving accountability and transparency** • **Replace commissions for successful enforcement with fixed fees payable to the court together with actual expenses** • **Provide the option for the lawyer of the party seeking enforcement to carry out private service if service of writ is not completed within a fixed period** • **Provide option for the claimant to locate assets to satisfy the judgment if not located by the sheriff or messenger within a fixed period**

Insolvency

60. A new insolvency law will be enacted that conforms to modern approaches to the administration of insolvent estates and does not distinguish, except to the extent necessary, between corporate and other entities or individuals. This law will provide for more flexible forms of business rehabilitation such as voluntary administration that do not necessarily require the involvement of a court.

61. A voluntary administration procedure allows the company itself or any creditor holding security over all or most of the company's assets[10] to appoint an administrator, such as a private lawyer or accountant. The appointment of an administrator freezes the company's financial position while the administrator and the creditors decide on the future of the company. In the meantime, the administrator has full control of the company. If the administrator and the creditors decide the company cannot be saved, the creditors have the option either of entering into a scheme of arrangement as to how debts will be written off or settled, or to apply to the court to put the company into liquidation. It is important that the majority by value of creditors have the power to bind the minority in voting on a scheme of arrangement.

Policy Actions-Insolvency
• **Enact a new insolvency law reflecting modern approaches to administering insolvent estates**

D. Strengthening Institutions and Increasing Outreach

62. The FSDS actions to strengthen the supply-side and increase outreach by formal institutions place the highest priority on the commercial banking system as it is by far the largest provider and potential provider of financial services. Efforts to increase outreach build on the recent sharp increase in lending by the commercial banks—strong growth in 2012 followed by a further 9.5 % increase in total loans

[10] An unsecured creditor may also apply to the court to appoint an administrator.

outstanding for the quarter ended March 31, 2013. Other potentially relevant institutions such as MFIs, VSLAs, RSCGs, and SACCOs are presently few in number and make a relatively small—albeit important—contribution to financial inclusion.

63. The strategy also depends heavily on new innovations, particularly in mobile phone banking, to broaden and deepen financial inclusion for many who are presently inadequately served by the financial sector. This reflects the view that the most immediate and likely largest sources of competition for the commercial banks will come from outside the banking system. Mobile phone banking begins as a payment mechanism, but quickly evolves into a de facto savings and transactions account. Other potential sources of competition are new entrants to the financial sector such as deposit-taking MFIs.

64. Given the small size of the domestic market there is limited scope for entry by a new bank. Moreover, the recent growth in lending by the incumbent banks suggests there is intense competition in the markets served by the three large commercial banks. One potential contribution to increased outreach is to strengthen the competitive position of LPB, which might be best accomplished by seeking a strategic partner with a different banking model than the three large incumbents.

Increasing Commercial Bank Participation

65. As of June 2013, Lesotho had 44 bank branches (approximately one branch per 48,000 people) and 130 ATMs which together represented one bank access facility per 12,000 people. The number of ATMs is steadily increasing as are Point of Sale (POS) terminals, which have increased 70 percent over two years, exceeding 700 as of June, 2013. Many of the branches and ATMs are in Maseru and coverage elsewhere is thin.[11] Physical facilities are not likely to increase much outside the cities because of low population densities, small financial markets in rural areas and mountainous terrain. Thus, non-traditional delivery channels such as mobile phone banking and agency banking are key tools for increasing financial inclusion in these areas.

66. Reflecting the high priority on financial inclusion in the NSDP, the CBL will revise its data collection from the commercial banks to include information on both value and number of accounts for total deposits, type of deposit, category of loan (corporate, personal, and SME/asset based), and by authorised value size categories. Once such data are available, it can be used to track progress in expanding the client base. Banks will be asked to prepare a strategy for meeting monitorable targets relating to some of these targets.

67. Regulatory constraints on banks' expansion of their low income client base will, to the extent appropriate, be minimised. For example, constraints on where banks may place ATMs and the cost of licenses to place them will be removed. Consistent with the approach for mobile money, tiered know-your-customer (KYC) requirements

[11] The FinScope study noted that some people had to travel as far as 120 kilometers to the nearest banking facility.

will be introduced for deposit accounts so that those with a value cap to be determined can be opened with streamlined requirements. VSLAs and RSCGs registered under the Friendly Societies Act will be allowed to open deposit accounts. Agency banking guidelines will be introduced to facilitate the expansion of agency and POS banking. On the other hand, banks will be required to transparently publish as well as physically post all detail with respect to fees and interest rates charged to assist consumers in understanding the transactions they are entering into.

68. Banks will be encouraged to introduce entry-level deposit accounts with minimal or no fees and no minimum balance requirements. These could borrow some characteristics from the "Mzanzi" accounts introduced for new depositors in South Africa. Such accounts, established by the big four South African banks and the post office, have been a major contributor to increasing the number of banked adults. In encouraging banks to introduce such accounts in Lesotho, the South African experience will be reviewed to learn from both positive and negative aspects.

69. Bankers cite the inadequate credit information, debt recovery environment and unqualified SME and individual loan applicants as the primary constraints to significantly increased lending to smaller clients. The strategy directly addresses reducing these constraints through measures to improve the credit environment, financial literacy initiatives and training and support for entrepreneurs. Enactment of a secured transactions law and a national registry to permit all forms of movable and personal property to be used as collateral will provide banks with another useful tool for expanding less risky asset-based lending

70. There are also capacity constraints as the pool of potential staff trained to the certificate level in banking is inadequate and banks do not have enough loan officers who are adequately experienced and trained to handle SME lending satisfactorily. The Bankers Association will invite proposals for establishing pre-employment banking certificate level training from relevant educational training institutions such as the Institute of Development Management and the Centre for Accounting Studies in partnership with an external entity experienced in delivering certification courses for bankers.

Policy Actions-Increasing Commercial Bank Participation
• **Modify monthly commercial bank reporting system to include priority financial inclusion data which banks can readily provide** • **Agree with banks on strategies and informal targets for expanding access to finance and track progress on a quarterly basis against targets** • **Remove constraints to sound banks' efforts to expand markets, e.g., location and number of ATMs, introduce tiered KYC requirement consist with the regulations for mobile money, and open VSLA group accounts** • **Allow commercial banks to adopt appropriately regulated agency banking** • **Introduce stronger transparency requirements with respect to publishing and posting fees and interest rates through required disclosure regulations** • **Encourage commercial banks to introduce entry-level deposit accounts with**

- **minimal fees and other requirements**
- **Arrange for a local training institution in partnership with an experienced external institution to offer pre-employment certificate of banking courses**

Strengthening Lesotho Post Bank

71. A viable future for LPB is dependent on addressing several important preconditions to enable it to operate efficiently and compete with private sector providers of financial services. This may ultimately require seeking a strategic partner or sale of a majority shareholding. Short and medium term efforts will focus on satisfactorily addressing the preconditions before revisiting its strategy and attempting to develop a viable business plan congruent with its mandate.

72. These preconditions are to: i) reconfirm the mandate of LPB, and ii) strengthen its governance. There has not been full agreement among two Ministries, LPB staff and its Board of Directors and donors as to its mandate and, hence, the strategy for pursuing that mandate. This will be addressed through Government reaffirmation of the LPB mandate and objectives. Governance will be enhanced by establishing a single point of contact with Government as shareholder, and appointment of a board of directors with the same independence and skills expected of a private sector bank. The Board will have full authority—independent of government and donor interventions—and be held accountable for pursuit of the LPB mandate.

73. While LPB plays a small role in the banking system in terms of market share and ability to compete, it does play an important role in serving small savers. It had 72,000 depositors, or about 20% of the total number of banks accounts[12] as of December 2012, but only 4% of the value of total bank deposits. LPB also expands geographical coverage for the banking system, as several of its 13 branches are located a considerable distance from any other bank branches—albeit sometimes in markets too small to support viable branch operations. The LPB contribution to expanding access to credit, however, has been both less significant and more problematic. At end-June 2103, it had a 0.3% market share in lending and a loan to deposit ratio of 5.3% (compared to 64% for the banking system).

74. LPB's capital and liquidity positions are strong. However, it has received M62.9 billion in subsidies over the last 6 years, approximately equal to the losses incurred before grant income during that time period. While results are slowly improving, it still falls far short of achieving sustainability. LPB, in addition to subsides paid in by government, has received substantial technical and other support from the International Fund for Agricultural Development (IFAD), the World Savings Bank Institute (WSBI), SUFIL and the Millennium Challenge Corporation (MCC).

[12] Data available for 3 of the 4 commercial banks suggests there about 300,000 depositors system-wide and, therefore, an LPB market share of more than 20% of depositors by number.

75. LPB is not at present a full participant in the National Payment System (NPS). It recently became a member of Lesotho Wire (LSW), however its smartcards are not compliant with Eurocard-Mastercard-Visa (EMV) standards and it does not participate in the SASWITCH system for the acquisition of ATM and POS transactions. Only about 1,000 LPB smart cards have been issued, and ongoing customer take-up is very slow, in part because the cards are not inter-operable with other POS terminals and ATMs available in Lesotho. In many respects it would be advantageous for LPB to participate more fully in the NPS. However, this would require considerable investment in information technology (IT) systems, including its core banking system, and card processing technology. Regrettably, LPB is unable to finance the necessary investment at present, and in fact, upgrading its participation in the NPS is only a small part of the business challenges that LPB faces.

76. LBP has struggled in its effort to become profitable while meeting conflicting objectives imposed on it by the owner and donors. LPB faces a significant challenge in building sufficient market share to cover its cost base. There will be increasing competition from new mobile money products that will come to dominate the lower end of the market, as well as competition from the other banks which are more advanced in rolling out their own electronic products (e.g. FNB's e-wallet) and targeted lending products (e.g. Standard Bank's quick loan for SMMEs). Moreover, LPB's ability to achieve sustainability as a government-owned institution while pursuing a strategy that depends primarily on serving the unbanked as well as its ability to conduct profitable lending focused on the unbanked is not clear.

Policy Actions-Strengthening LPB
• **Reaffirm within Government the LPB mandate and objectives that among other things lead to a financially viable and sustainable commercial bank** • **Place entire shareholder responsibility in MoF as the clearly defined sole LBP direct contact in Government** • **Appoint a board of independent directors (no ministers or civil servants) comprised of individuals with the same qualifications expected of a private sector bank** • **Give the board full independence (from government and donors) to pursue the mandate, oversee the management of the bank, and be accountable for performance** • **Delay major changes in activities (i.e. senior staff recruitment, diagnostic studies, strategic re-orientation or implementation studies etc.) until the above higher level issues are resolved** • **Conduct a strategic review of Postbank considering the options of continued stand-alone operation, seeking a strategic partner, or winding-up if neither of the foregoing options would lead to sustainable operations** • **Adopt strategy and business plan consistent with results of the strategic review** • **Focus any new TA on how best to implement business plan to achieve sustainability**

Microfinance Institutions

77. Priority will be given to preparing an appropriate legal and regulatory MFI framework that balances effective oversight with the creation of a supportive environment to attract new entrants. The CBL will focus its oversight primarily on deposit-taking institutions as the primary purpose of central bank supervision is to protect depositors. In addition to the actions included in the later section addressing CBL supervision, measures will include requiring that all licensed MFIs comply with a mandatory requirement to provide loan information to the credit reference bureau.

78. The CBL will prepare and promulgate an information packet outlining the legal, regulatory and supervision environment in which deposit-taking MFIs in Lesotho would operate. This will be part of an effort to attract a highly qualified international institution that would focus on individuals and smaller businesses to enter the Lesotho market.

79. MFIs have the potential to compete with banks in providing deposit-taking as well as credit products. While MFIs do not yet play a significant role in Lesotho, finalisation of the MFI framework will provide the necessary foundation for the expansion of existing competitors and possible entry by new players. Three institutions have been licensed by CBL as credit-only MFIs, but only one is presently operating. There are also a number of less formal Non-Bank Financial Institutions (NBFIs) unlikely to be licensed or supervised by CBL that play a role in expanding financial inclusion. These include VSLAs, RSCGs, TEBA, money-lenders and revolving savings and credit associations (ROSCAS).

Policy Actions-Microfinance Institutions
• **Require that all licensed MFIs submit loan information to the credit information system** • **Process quickly the license applications from existing MFIs that meet deposit-taking requirements** • **Promulgate information on the deposit-taking MFIs regime as part of the efforts to attract a highly qualified international institution whose modus operandi focuses on small clients**

RSCGs and VSLAs

80. RSCGs and VSLAs have the potential to make an important niche contribution to the overall financial inclusion strategy as they are bringing financial literacy and participation to people whom the more formal financial system has difficulty in reaching. One of the strengths of these entities is that for the most part they are not government programs. Further, their size and nature means that they should not attract burdensome regulation.

81. Despite the relatively small number of individuals served (about 4,600), RSCGs and VSLAs are sufficiently important to the financial inclusion strategy that

the Ministry of Agriculture and Food Security (MOAFS) extension services will take on the responsibility to monitor these programs on a long-term basis and be available, when asked, to provide technical advice. At least one extension officer from each district will receive specialised training to assist in performing this function, as well as delivering the financial literacy campaign on an ongoing basis. Both the RSCG and VSLA programs deserve ongoing donor support so long as the monitored data base gives evidence of continued success.

Policy Actions-RSCGs and VSLAs
• **Assign district-based agricultural extension officers responsibility for monitoring and giving advice to RSCGs and rural VSLAs as well as for furthering financial literacy** • **Provide specialised training to individual officers to enable them to perform these functions effectively** • **Avoid regulation of VSLA/RSCG programs and any identification of these programs with government** • **Raise additional donor support on an ongoing basis as long as monitored data base and FinScope study results give evidence of continued success**

SACCOs

82. Like RSCGs and VSLAs, SACCOs have the potential to make a niche contribution to the overall financial inclusion strategy. Key actions focus on the need to establish an appropriate regulatory and supervisory regime. This requires the provision of appropriate powers and establishment of standards for financial cooperatives that are currently absent in the Cooperative Societies Act, and the initiation of oversight of large financial cooperatives by the CBL pursuant to the FIA.

83. While available data on the SACCO sector are fragmented and dated, it is clear that aside from one large cooperative, most are small and provide limited services to a small number of members. Only 4 of 51 SACCOs operating in 2011 had managers, with about that many being significant in size (100 or more members).

84. There are no formal regulations for SACCOs and supervision has been minimal in recent years. While the DOC has 14 SACCO supervisors (with 1 deployed in each of the 10 districts) who have some training (roughly to the level covered by the current College of Cooperatives curriculum) and experience, direct supervision has been minimal as the Department has received virtually no budget to support that function over the two years ending March 2013. DOC believes that SACCOs with less than 50 members cannot function effectively, cannot easily afford to pay for audits, and cannot, especially if they are in rural areas, be easily supervised.

85. The FIA places responsibility for the oversight of financial cooperatives with the CBL. Recognizing that small cooperatives present minimal risk to the financial system, the FIA provides that the CBL may, by regulation, exempt such cooperatives from CBL oversight. The CBL will exempt cooperatives with total deposits of less

than M5 million from the provisions of the FIA, provided they are subject to effective oversight by the Commissioner of Cooperatives. A new Financial Cooperatives Act will provide the needed legal framework for oversight by the Commissioner. The respective responsibilities of the CBL and Commissioner will be documented in an MOU.

86. The new Financial Cooperatives Act will provide the Commissioner of Cooperatives with full remedial powers which for small cooperatives. These powers will include the ability to quickly impose resolutions on SACCOs in distress, impose penalties for noncompliance with reporting and auditing requirements, and dismiss officers who have acted improperly or have personal financial obligations to the SACCO more than 30 days past due. New requirements will establish a minimum of least 50 members before a SACCO can be licensed, and deposit taking from or lending to non-members will be prohibited.

87. The DOC supervision structure will be strengthened by building the capacity to conduct prudential reviews of the SACCOs not exempted from CBL oversight at least biannually, with the majority to be reviewed at least once a year. A course of several weeks' duration will be delivered all SACCO supervisors on accounting, financial management, credit management, recoveries, governance, providing financial literacy advice to members, and prudential inspection. Requirements with respect to reporting and annual audits will be enforced. A feasibility study will be undertaken to assess the capacity of the Co-operative College of Lesotho, or the Institute for Development Management to provide the required training. Technical assistance will be sought as required to support delivery by a local institution.

88. Technical assistance will be provided to enhance SACCOs' ability to supply loan information to the credit information system and their participation will be made mandatory. DOC will set up a register of all SACCOs overseen by the DOC in which the number of members, date of the last prudential inspection and the date covered by the last financial audit are recorded and monitored.

89. The Commissioner of Cooperatives will issue a directive providing a period of one year for SACCOs to meet a minimum requirement of 50 members and complete the required annual audit. [13] Those that do not comply within the specified time period will, under powers to be provided under the new Financial Cooperatives Act, be deregistered by the Commissioner, which has the effect of removing the legal right to continue in business. Members of deregistered SACCOs will be encouraged to join another nearby SACCO, or if they wish to continue on a less formal basis, form a self-regulated association such as a VSLA or RSCG that can be registered under the Friendly Societies Act.

90. Unviable SACCOs will be encouraged to amalgamate or voluntarily wind-up, and the provision of training and other support will focus on those with reasonable

[13] SACCOs with small memberships (the present minimum allowed size is 10 members) have difficulties in achieving sustainability and complying with requirements such as audited accounts.

prospects for success. Confidence in the system and protecting members' deposits are paramount, hence the quality of SACCOs is more important than the quantity.

91. SACCOs with deposits of more than M5 million will be subject to prudential oversight by the CBL in accordance with the provisions of the FIA. The FIA will be amended to clarify aspects of the supervisory regime and the deposit-taking powers of these cooperatives. The DOC, as outlined in the future Financial Cooperatives Act, will retain authority over registration, membership and cooperative governance issues for all SACCOs. A diagnostic audit will be conducted of the largest cooperative and appropriate action taken as necessary, before CBL takes responsibility for its supervision. An MOU will be signed outlining the respective roles and responsibilities of DOC and CBL for the large cooperatives to be supervised by CBL.

Policy Actions-SACCOs
• **Draft and enact a new Financial Cooperatives Act which provides DOC with full supervisory and remedial powers** • **Retain DOC authority as outlined in the future Financial Cooperatives Act, over registration, membership and cooperative governance for all SACCOs regardless of size** • **Issue regulations for SACCOs under the Cooperative Societies Act and, when in effect, the new Financial Cooperatives Act** • **CBL by regulation will exempt financial cooperatives with deposits of less than 5 million maloti from the provisions of the FIA** • **Amend the FIA to clarify aspects of the supervisory regime for large SACCOs and their deposit-taking powers** • **Sign MOU between CBL and DOC that clearly defines respective role, authority, responsibility and rights to information to avoid overlap or conflict** • **Conduct a diagnostic audit for the largest cooperative before CBL takes supervision responsibility, with TA provided if necessary to address any supervisory issues identified** • **Provide DOC supervisors with training and resources necessary to develop effective financial supervision of SACCOs it supervises** • **Complete feasibility study for the Lesotho Cooperative College to deliver the training and support required by financial cooperatives and DOC staff** • **Provide technical assistance to support delivery of training by a local institution** • **Assist SACCOs in complying with a mandatory requirement to provide loan information to the Credit Bureau, when established** • **Pursue a strategy of consolidation by deregistering SACCOs that cannot grow to 50 members or more as well as those that cannot submit an audited financial statement within one year and encourage deregistered groups to form VSLAs or RSCGs** • **Conduct prudential reviews for all smaller SACCOs annually or biannually depending on size and performance** • **Enforce annual audit requirement as stipulated in law**

Housing Finance

92. Commercial banks are the primary source of housing finance, with mortgage loans increasing by over M294 million (about 150%) during the last two years to a level of M492 million as of end-March 2013, primarily because the land titling exercise makes mortgage lending more attractive. The banks anticipate fairly rapid further expansion of mortgages during the next several years, in response to the ongoing systemic land regularisation and improvement of the rural leasehold process. This will enable a large number of medium and higher income households to offer land as collateral to obtain a mortgage. The FSDS will rely on banks to finance housing for these higher income groups.[14] As mobilisation of long-term funds is required to support any substantial increase in this lending, the stamp tax on long-term deposits and debt instruments will be removed.

93. Regulatory requirements which impose unnecessary impediments or high transaction costs on small mortgages and/or incremental house financing will be reviewed with the objective of reducing them. For example, the requirement for debt recovery claims relating to mortgages to be the subject of a hearing and a formal judgement of the High Court before enforcement action can be taken will be removed, while allowing borrowers with valid reasons for disputing the claim to seek relief from the court. Stamp duty and transfer fees which can add up to 7 percent of land sales value are a significant deterrent to land title formalisation and encourage informal transactions in which possession changes but title is not transferred, which largely eliminates property value as collateral for financing construction of a home. MoF and the Land Administration Authority (LAA) will review the rates of these duties and fees, with the goal of reducing the total costs incurred on the disposal of a leasehold interest to a level that does not materially deter these transactions.

Policy Actions-Housing Finance
• **Rely on commercial banks as the primary source of housing finance for medium and high income households** • **Remove stamp duty on long term deposits and debt to enhance mobilisation of long term funds for lending** • **Review the level of stamp duty and transfer fees payable on land transfers with a view to significantly reducing them**

Agricultural Finance

94. Commercial banks in Lesotho, like banks elsewhere in Africa, lend relatively little to agriculture. A survey of the commercial agricultural sub-sector will be undertaken to better understand its nature and its access to finance. This will facilitate development of additional policy actions to support the growth of commercial agriculture.

[14] The broader policy issue of affordable housing and a national housing policy is outside the scope of the FSDS, which relies on the financial sector to finance housing on a commercially viable basis.

95. Constraints on increasing lending to the agricultural sector lie primarily on the demand side. While recent improvements in land titling and registration enhance effective agricultural demand for credit, improving ability to use crops as collateral for credit would also make a major contribution. Therefore, a crop insurance feasibility study will be undertaken with the objective of making crop-collateralized lending more attractive for banks.

96. The strategy for increasing effective demand, in addition to establishing a same day electronic land registration system to create bankable collateral for loans and the introduction of a law and registry to facilitate use of moveable property as collateral, will focus on improving financial literacy in the rural areas. This will include reaching out to SACCO, RSCG and VSLA members, as well as commercial farmers. The campaign will be coordinated and delivered by means of the existing agricultural extension offices in each of the districts.

97. An extension officer, trained to specialise in finance, will be placed in each district and given the responsibility for delivering a financial literacy program, as well as giving financial advice to RSCGs and farmers. The Chief Extension Officer and the 10 district officers specializing in finance will receive training on how to conduct financial literacy workshops.

Policy Actions-Agricultural Finance
• **Conduct a survey of the commercial agricultural sector with a focus on access to finance** • **Undertake a crop insurance feasibility study** • **Coordinate all district and rural-based financial literacy training through the agricultural extension district offices** • **Place a financial literacy resource officer in each of the 10 district agricultural extension offices** • **Train Chief Extension officer and the 10 district officers in finance to prepare them to hold financial literacy workshops in the district offices and advise RSCGs and farmers on financial issues**

E. Innovation for Financial Inclusion

98. Expansion of mobile money (MM) and agency banking are probably the most important sub-strategies for increasing the supply-side contribution to expanded financial inclusion. This is because of the cost advantages of serving a widely disbursed rural population through existing infrastructure—mobile telecom systems and retail businesses—relative to financial institutions' "bricks and mortar" locations. Therefore an enabling regulatory environment will be established, combining the necessary elements of consumer protection and maintenance of financial stability with a light regulatory touch that does not stifle innovation. Specific measures will include use of a tiered approach to KYC requirements, trust fund requirements, prohibition of

the use of funds held in mobile money systems for lending, and prohibition of tied agents.

Mobile Money

99. MM services have recently been established by Mobile Network Operators (MNOs) in Lesotho. Although originating as payments/transactions products, experience from other countries suggests that product offerings will evolve rapidly. The first round of evolution is likely to be an extension of the money transfer model to a broader range of payments services, including:

- Using mobile phone e-money balances for payments at stores (merchant payments)
- Bill payments, such as utilities like DSTV
- Bulk payments, such as wage payments by employers
- Micro-insurance, including payment of insurance premiums and claims
- Micro-finance loan disbursements and payments
- Government welfare payments such as old age pensions

100. All of these are basically payment transactions and do not require any significant adjustment to the business model or the approach of the regulator. They can essentially be handled in terms of service level agreements (SLAs) between the provider of the messaging and payment platform (the MNO) and the entity on whose behalf the payments are made.

Regulation

101. In common with many other countries, Lesotho does not have a regulatory framework for financial services that is specifically designed to accommodate mobile money services. In the near term this is being addressed through Mobile Money Guidelines that have been issued for MNOs, and forthcoming Guidelines to be issued for banks and third-party operators. MNOs have been given permission to operate MM services on the basis of a Letter of No Objection from the CBL, and the Guidelines that make reference to Section 6(h) of the CBL Act. However, this section simply states that one of the CBL's functions is "to promote the efficient operation of the payments system" and there is doubt as to MM application to the authorisation of MM services. The Guidelines are interim provisions only, and once the Payment Systems Bill (PSB) is enacted, the three sets of Guidelines will be revised as necessary and reissued as Directives or Regulations. Ultimately, it would be preferable to combine the three Guidelines into a single set of Regulations covering Mobile Money independently of the type of institution offering the service.

102. One of the challenges is to meet anti-money laundering KYC requirements without unduly restricting the growth of mobile money accounts. This has been addressed in the MM Guidelines for MNOs to allow different "tiers" of customers that would be subject to "Least", "Partial" and "Full" KYC. The tier with "Least" KYC requires only simple registration (with no verification), and has daily and monthly transactions limits of M2,500 and M10,000 respectively. The other tiers

require partial or full verification of the information provided. With the introduction of national identification (ID) cards KYC procedures will become much easier as eventually all or most adults will have an ID card that will prove identity.

103. The Mobile Money Guidelines accommodate "individual" and "merchant" categories of customers. The merchant category is required because of the need for higher daily and monthly transaction limits, given that merchants may wish to send or receive payments that could be considerably higher than the current maximum limits (which are daily – M7,500 and monthly - M20,000 for the "Full KYC" category).

104. The draft Mobile Payments Guidelines (Bank-Centric) will be further revised in light of the FIA and stakeholder consultation to ensure that they are consistent with the draft MM Guidelines for MNOs in relation to the use of agents and tiered KYC requirements.

105. The MM activities of MNOs potentially fall under two regulators – the CBL and the Lesotho Communications Authority (LCA), which regulates telecommunications services. The division of regulatory responsibilities will be clarified through an MOU between the CBL and LCA confirming that MM is not a telecommunications service per se but a financial service that makes use of a (separately licensed) telecommunications platform, and hence falls under the purview of the CBL. The MOU is under discussion and will be finalised shortly.

106. Consideration will be given to requiring MNOs to provide financial services through a separate subsidiary. This would help to provide regulatory clarity as the telecoms provider (the MNO) would be licensed by the LCA, and the financial services subsidiary (of the MNO) would be licensed by the CBL. This would also have advantages with regard to the maintenance of trust account balances.

Trust Accounts

107. All customer balances on the MM system (e-value) must be backed in full by a deposit in a trust account in the name of the MNO (or subsidiary of the MNO) at a licensed bank. This achieves two objectives. First, customers have the security that all money deposited onto the system is backed by "bank money," and hence funds on an MM platform should be as secure as funds deposited in a bank. Second, it prevents the MNO from deploying MM balances to other, potentially more risky purposes. It also aims to ring-fence the funds backing the MM balances from the MNO's other financial balances and business operations.

108. Protection of customer balances will in due course be enhanced by requiring that an MNO provides MM services through a legally separate entity, which could be a subsidiary of the MNO. In the event of financial problems encountered by an MNO, the trust account would be an asset of the MM subsidiary, and not (directly) of the MNO.

109. Although the value of trust account balances is at present very low, it is likely to increase rapidly. This could lead to concentration risk, particularly if multiple MM

providers held their trust accounts at the same bank. Hence, the CBL will be empowered to require trust account balances to be split across more than one bank when deemed prudent to diversify risk.

Payment of Interest

110. As noted above, and as discussed in more detail below, convergence between payments and banking services is anticipated and will be encouraged as a means of improving access to finance. It is also desirable to have a level playing field between banks and non-banks in the provision of MM services. Therefore, non-bank MM providers will be permitted to pay interest on MM balances, should they choose to do so.

Policy actions-Mobile Money
• **Complete drafting and issue MM Guidelines for banks, and ensure that as far as possible they provide a level regulatory playing field for different types of operators (banks and MNOs) offering similar products** • **Draft MM Guidelines for third-party operators (i.e. companies that are neither banks or MNOs)** • **Ensure that the three sets of MM Guidelines are consistent with the PSB, and issue them as Directives or Regulations under the Payment System Act once it is passed, eventually combining into a single set of regulations** • **Finalise a Memorandum of Understanding between the LCA and CBL regarding the division of regulatory responsibilities in respect of financial services provided by MNOs.** • **Require MM service providers to split trust accounts across banks once they reach a certain size** • **Require MM services to be provided by a legally separate entity, and the trust account to be held in the name of that entity rather than of the MNO** • **Permit the payment of interest on MM balances, should services providers choose to do so.**

Government Welfare Payments

111. The use of a mobile money platform for government payments to individuals (G2P) is potentially a strong driver of growth. The Lesotho Government makes regular (mostly monthly) payments to over 100,000 individuals, for pensions, child grants and other welfare payments. The cost of making these payments is very high in some areas, for logistical reasons. Moving these payments to a mobile platform could entail major cost savings for government, and as well provide a boost to mobile payments more generally. It would, however, be necessary to ensure that certain preconditions are in place, notably ensuring an effective and efficiency agency (especially cash-out) network.

Policy actions-Government Welfare Payments
• **Complete cost-benefit analysis of moving welfare and related payments to a mobile money platform**

Agency Networks

112. The oversight regime for agency networks balances the requirements for a "light touch" –so as not to stifle innovation—with essential requirements for consumer protection and financial stability. The current treatment of mobile money agent networks and bank agent networks is inconsistent, as it is much more difficult for banks to appoint agents than it is for other MM providers to do so. The regulatory framework for the appointment of agents will be revised, recognizing the need to encourage innovative delivery channels and the ongoing convergence of mobile money and traditional banking, as well as ensuring a level regulatory playing field between different types of service providers.

113. MNOs in Lesotho are establishing networks of agents, mostly retail stores, along with "super-agents" that will enable agents to balance e-money and cash. The CBL has appropriately left the management of agent networks to the MNOs, rather than imposing strict regulation. The MNOs have clear business interests in ensuring that the agent network functions efficiently, that agents are knowledgeable and can educate customers, and that agents are honest. Hence there is an incentive for the MNOs to manage, invest in, train and discipline agents as necessary, which minimises the need for close regulation. Nevertheless, the CBL will need to monitor the functioning of the agent network and of the MNOs management of it.

114. The CBL MM Guidelines prohibit "exclusivity" arrangements with agents, i.e. if one MNO signs up an agent it cannot prevent the same agent from working for a different service provider. This helps to promote competition by prohibiting localised monopolies, particularly in small communities where they may be only a small number (or perhaps even only one) potential agent. However, there may be drawbacks to prohibiting exclusivity, since there is less incentive for any one service provider to invest in training an agent serving multiple principals (because this may benefit their competitor). The CBL will review the non-exclusivity provision and consider permitting both exclusive and non-exclusive agent relationships.

115. While the MM Guidelines for MNOs are not prescriptive with regard to the use of agents, the legal requirements for the use of agents by banks are much stricter. The FIA imposes strict requirements on the accreditation of agents, including being registered companies (not individuals) and having a five year financial history. To enhance competition, banks should be able to use agents for mobile money transactions on substantively the same basis as MNOs, including being able to implement tiered KYC requirements. To achieve this, the FIA will be amended as required.

Policy actions—Agency networks
• **Monitor quality of MM agent network and customer service** • **Review prohibition of agent exclusivity arrangements with a view to permitting both exclusive and non-exclusive arrangements** • **Amend the FIA agent banking requirements to facilitate the provision of mobile money agency services by banks on a comparable basis to those of MNOs.**

Convergence Between Payments and Banking

116. It is desirable to encourage the inevitable trend towards using mobile money as a de facto savings account in order to extend financial services to the unbanked. Once money is loaded on to a phone, there is no requirement for it to be transferred to someone else – it can be simply left on the system, and then withdrawn at the convenience of the account holder. For unbanked individuals, this may be an attractive option, when compared to the alternative of holding savings in the form of cash, or bank accounts which may incur fees.

117. Payment of interest on MM balances can encourage savings. The regulatory framework will be clarified by introducing a new licensing category under the FIA to provide for MM including deposits. This will facilitate the entry of non-banks into the provision of MM deposit services to the public, in recognition that they can provide financial products and services that may be unattractive to conventional banks. This will encourage innovation, improve efficiency, and help extend the "frontier of access" of financial services to the unbanked and financially excluded. The licensing category will be flexible enough to accommodate MNOs as well as third party operators, such as technology or payments companies. Effectively, the new licensing category would be used in this case for a "narrow bank" that takes deposits but does not lend, and represents a blend of some banking and payments functions. While the term "mobile money" is often used for such products, a broader title of "e-money" may be more appropriate, as it is not restricted to money held on mobile phones.

118. Deposit-taking MM/e-money licensees will be required to have appropriate bank deposit back-up trust arrangements. The new licensing category will comprise both payments system and banking elements. Although the main function of bank regulation and supervision is to protect customer deposits, the main risks arise from the assets (lending) side of the bank's balance sheet. Such risk can be reduced by prohibiting intermediation of funds (deposits), through a requirement that the entire electronic value held on the system (in customer accounts) is fully backed by a deposit, or trust account, in a licensed and prudentially regulated bank (or banks). This approach minimises the main risks that arise from intermediation – counterparty and liquidity risk. Hence regulatory and supervisory concerns can be focused on operational and technology risks.

119. These new licenses for entities in the e-money deposit business will have several requirements including:

- Requiring the financial service provider to be a legally separate entity, and permitting that entity to be owned by a non-bank
- Requiring normal corporate governance and "fit and proper" tests for the directors and senior managers
- Permitting both money transfer/remittance services and opening e-money deposit accounts for customers (e.g., on a phone or a smartcard)
- Permitting both individual and corporate (registered company) customers

- Requiring that all electronic balances are backed one-for-one by a trust account deposit at a licensed commercial bank (or banks)
- Requiring the entity to have an acceptable SLA with a partner bank
- Permitting the outsourcing of functions (e.g. the messaging platform, provided by a parent MNO), subject to an acceptable SLA
- Permitting the appointment of agents to handle account opening, conduct customer KYC checks, and provide cash-in and cash-out services
- Providing for regulatory oversight of operational and technological processes and risk management procedures relating mainly to system security and integrity, record-keeping, accreditation of agents, management of the agent network and liquidity, customer service and anti-money laundering requirements
- Permitting the payment of interest on e-money/mobile money balances, using the proceeds of interest paid on trust account balances, as this permits a broader and more attractive range of products to be offered.

120. E-money deposit-takers will not be permitted to provide loans (credit) directly on their own account. However, they will be permitted to provide loans through an agency agreement with a licensed credit provider (a bank, a credit-only institution or a microfinance institution). Thus, the e-money licensee would be purely a channel for dispensing credit and collecting repayments on behalf of the lender of record.

121. The accounts offered by these e-money deposit-takers will have value caps – the intention is that accounts should be used by the unbanked, or by the banked for low-value transactions. Thus, it is not appropriate for these accounts to be used to accumulate large balances. While the exact amount of the value cap will be subject to further discussion with stakeholders, an amount in the range of M20,000 to M50,000 would be appropriate. For balances above this value, customers should move into the traditional banking system.

122. Over the medium term a new licensing category will be introduced through amendment to the FIA. In the near term, an applicant for such an e-money deposit-taking business could be accommodated using a combination of the Type II Savings Bank and Type IV Money Transfer categories. While it is likely that the proposed new licensing category would be mainly of interest to MNOs in the provision of mobile banking products, it will have a broader relevance. For instance, other providers may be interested in providing card-based e-money accounts, where the balances are held on smartcards and accessed through ATMs or POS machines.

123. Banks will be permitted to open similar low-value accounts on the same basis as MNOs and other entities making use of the new licensing category. This provides a level playing field and encourages banks to extend their outreach using innovative products.

Policy Actions—Mobile Money/e-Money Accounts
• **Introduce a new licensing category under the FIA to permit low-value MM/e-**

money accounts to be opened by non-banks (including MNOs)

- **Require MM/e-money accounts to be backed in full by trust account deposits in licensed commercial banks**
- **Prohibit credit creation by non-bank MM/e-money licensees**
- **Decide value cap on non-bank MM/e-money accounts**
- **Consider using existing FIA licensing categories to permit such e-money accounts as an interim measure before amendment of the FIA if there is demand from MM service providers,**

Micro-Insurance

124. The current regulatory framework will be revised to better accommodate micro-insurance. The high uptake of funeral insurance illustrates that an affordable product well designed to meet identified risks can have significant success. Micro-insurance refers to insurance products that are designed to be suitable for the needs of low-income households, and may relate to a range of characteristics including premium and coverage levels, product design, and modes of distribution and delivery. Premiums will typically be small, so as to be affordable for low-income households, and the level (value) of coverage will be commensurately low. Distribution and payment channels need to be suited to the target market in terms of physical outreach and accessibility as well as keeping costs low.

125. Funeral insurance—a specific type of micro-insurance—has been highly successful in Lesotho. This reflects the importance that Basotho place on having access to sufficient finance in the event of the death of a family member – one of the most important risks faced by Basotho adults. Of the 62% of adults that use insurance, about 60% obtain this from formal sources (insurance companies and funeral parlours), and about 40% do so from informal sources (mostly membership-based burial societies). Use of insurance is higher in rural areas than in urban areas. This suggests a number of important lessons. First, people will pay for financial services that they perceive as having value in their lives. Second, insurance products can be designed and packaged in a way that is suitable for low-income households. Third, the informal sector plays an important role in filling the gap in formal sector provision. Fourth, it is possible to find ways of delivering this particular financial service cost-effectively in rural areas.

126. The current regulatory structure is not well-suited to the provision of micro-insurance. The regulatory framework including the new Insurance Act will be reviewed with a view to providing the flexibility to accommodate micro-insurance products and appropriate distribution channels. For example, the requirements for insurance intermediaries are inflexible and not well suited to accommodating the selling of insurance products by agents (e.g. stores and MFIs) for whom it is not their main line of business.

127. Funeral insurance is widespread and obtained from three sources: life insurance companies, funeral parlours and burial societies. Only one of these

segments – life insurance - is currently regulated. There are particular concerns about the unregulated activity of funeral parlours offering burial insurance as a side-line to their main business. There are risks to consumers emanating from the lack of insurance skills in this segment, which could result in inappropriate risk management, inadequate premiums (pricing), and potentially the inability to meet claims.

128. The planned medium term amendment to the Insurance Act will accommodate funeral insurance as a category of micro-insurance. The requirements for such a licence – for companies that only offer funeral insurance – will aim at protecting consumers, be appropriate to the risk level of the business, and not be unduly onerous. Requirements will include minimum capital and "fit and proper" requirements for directors, establishment of a separate fund for the funeral insurance scheme, regular reporting to the CBL, regular review of premium levels, and requirements for fair treatment of consumers.

129. Developing micro-insurance beyond the provision of funeral insurance may be possible, but is likely to be challenging and requires both innovation on the part of service providers as well as supportive reforms. Product and service innovation is needed in respect of:

- Developing new types of products that are suited to the risk needs and budgets of low-income households
- Developing bundled insurance products, such as combining other forms of insurance with funeral cover
- Finding means of keeping expenses low (so that risk premiums are not overwhelmed by overhead costs)
- Using partnerships and low-cost channels for collection of premiums, such as mobile money transfers and agent networks;
- Considering the feasibility of providing livestock insurance, for which there appears to be considerable demand, and the requirements for support systems (such as livestock identification).

130. There have been proposals for specific new types of micro-insurance relating to agriculture, including crop (weather) insurance and livestock insurance, for which there appears to be considerable demand. However, these will need to be investigated further in order to determine the viability of such products in Lesotho, and the need for complementary infrastructure. For instance, crop insurance will require a means of monitoring localized weather conditions (whether through ground based or satellite systems), and livestock insurance would require a comprehensive cattle identification system.

Policy Actions-Micro-insurance
• **Revise regulatory framework through amendments to the Insurance Act to ensure that it does not place barriers in the way of micro-insurance product and service providers, in particular by (i) providing for the supervision of funeral**

undertakers in the provision of insurance products; (ii) permitting banks to distribute a wider range of insurance products; (iii) permitting partnerships with entities outside of the insurance sector that will promote effective low-cost service delivery; (iv) ensuring that the use of mobile phones as a delivery channel and payment mechanism is not excluded

- **Introduce provision for a category of funeral insurance, with regulatory requirements aimed at protecting consumers and appropriate for the level of risk in the activity**
- **Develop insurance products and services along with delivery channels that are relevant to the needs and budgets of low-income households**
- **Undertake an assessment of the viability of crop and livestock insurance, including identification and cost-benefit analysis of any complementary developments that may be required**
- **Implement an effective consumer education programme combining training on financial literacy and insurance related matters including standard terms and conditions and insurance procedures**

F. Credit Information

131. Enactment of the Credit Reporting Act 2011 (CRA) and gazetting of the implementing regulations has provided the legal foundation for the establishment of a Credit Reference Bureau (CRB) in Lesotho. One company has been licensed by the CBL and is expected to begin operations shortly. Access to the reliable database of credit information available through a CRB will help credit providers to make sound decisions on extending credit, which will increase the availability, and over time, reduce the cost of credit to individuals and small businesses.

132. An important underpinning for the CRB project is the introduction of national ID cards. As the national ID project is implemented, the credit information held by the CRB will be more accurate, compared to a situation whereby there are uncertainties resulting from unclear naming and spelling and multiple identifiers.

133. In implementing the CRA, credit providers will be divided into different categories with regard to the phasing of implementation. Banks are likely to be the most prepared with regard to the systems necessary for reporting to a CRB and thus will be the first participants in the reporting system, followed by non-bank lenders (such as credit only and microfinance institutions) and co-operatives. Participation in the credit reporting system, after a transition period, will be obligatory for all of these institutions. Other credit providers such as retailers and utilities, will be brought into the credit reporting system at a later stage.

134. One credit bureau has already been licensed. The size of the market in Lesotho will limit the number of potential operators, and it may be unrealistic to expect more than one operator to seek registration. Nevertheless, multiple South African credit bureaus able to lever off their existing systems may find the market attractive. The Act makes provision for credit information to be processed outside of the country if necessary, so a CRB operating in South Africa would be able to use existing systems

and could probably operate with a minimal physical presence in Lesotho (but it would need a legal presence in the country and secure registration with the CBL).

135. There will be agreed reporting formats and systems for electronic submission of data from data (credit) providers to the CRB(s), and from the CRB(s) to the CBL. The initial variables and format for data capture at the level of the credit provider, how the CRB database(s) will operate, and what type of data will be submitted by the CRBs to the CBL will be determined. Consideration will also be given to the format and procedures for credit enquiries from credit providers to the CRB(s). These tasks require both designing reporting and database formats, and establishing software and communications systems to implement (some of which may be available off-the-shelf from South Africa, rather than being designed from scratch). Once a potential CRB service provider has been identified and a firm commitment made to establish a CRB in Lesotho, the CBL will engage in discussions regarding reporting formats.

Policy Actions-Credit Reference Bureau
• **Bring different categories of credit providers into the reporting system on a phased basis, starting with banks** • **Introduce standardised reporting and database formats, and communications systems for CRB implementation**

III. MOBILISING FINANCIAL RESOURCES AND PROMOTING A SAVINGS CULTURE

136. The principal initiatives targeted at the NSDP objectives of mobilising financial resources and promoting a savings culture are enhanced consumer protection and providing additional market-based and longer term savings and investment vehicles.

137. Capital market development has a symbiotic relationship with the growth of institutional investors—pension funds and insurance companies—which have a need for long term assets to match their long term liabilities. One of the challenges in Lesotho is that there is currently an inadequate supply of long term investment opportunities—insurance and pension funds would hold more Government debt if available, and also have a keen interest in high quality local corporate debt or equities.

138. While the supply of high-quality local debt and equities will grow over time, it is important not to compromise the interests of pension fund members and annuity owners, who are best served by diversified portfolios. Thus, the policy approach emphasises the prudent person requirement for pension and insurance portfolio management. Local asset requirements will be carefully considered in the context of assets available in the domestic market and not compromising the interests of savers.

A. Consumer Protection

139. An important element in promoting a savings culture is creating an expectation among consumers that they will be fairly treated by financial institutions. Customers who feel they have been treated unfairly may shun the formal financial sector. The MTICM is developing a policy for consumer protection, which may ultimately lead to creation of a consumer protection law.

140. The CBL will work with banks and other licensed financial institutions to develop a code of sound practices for financial consumer protection as an initial step towards enhanced consumer protection in the financial sector. While it is expected that industry will voluntarily adopt such a code based on principles proposed by the CBL, the FIA will be amended to permit the CBL to mandate a code of conduct if industry does not adopt a code satisfactory to the CBL within a reasonable time. The code of conduct will be available to the public at the premises of financial institutions and through their web-sites.

141. Another dimension of consumer protection is providing a redress mechanism to address the imbalance of power between financial institutions and their customers. If a consumer is dissatisfied with treatment by a credit provider, a complaint may be made to the consumer complaints section of the MTICM. The Ministry will attempt to resolve the complaint by discussion with the credit provider, but has no statutory powers to compel a solution. In the case of financial cooperatives, a consumer may complain to the DOC, though again the Department is limited to mediating between the complainant and the cooperative.

142. Currently the CBL also receives and acts on some financial consumer complaints, but its powers are limited to the prevention of unfair practices. CBL has no power to require that a consumer be compensated for any loss suffered as a result of those practices. CBL involvement in resolving consumer complaints is less than ideal. Consumer issues, while of high public policy importance, seldom present a threat to financial stability. Thus, to avoid the possibility that the CBL may either devote insufficient resources to consumer issues or be distracted from its core financial stability mandate by consumer complaints, the options for establishing a financial ombudsman will be explored.

143. Given a small population and an expected small number of complaints, it would be preferable to attach or incorporate the financial ombudsman function within another suitable institution. The role of the financial ombudsman could potentially be placed within the MTICM and operationally linked to and supported by the consumer complaints section.

144. A financial ombudsman would publicise the financial sector code of sound practices for consumer protection and receive complaints if the consumer had been unable to get satisfaction from the institution. The ombudsman would review and investigate as required and recommend resolutions to institutions. When deemed appropriate, the ombudsman would publicise its conclusions where it considers the

issue to have wider application than the specific complaint, or "naming and shaming" is required to encourage financial institution compliance. The operating costs of the financial ombudsman will be recovered through an assessment on the financial services industry.

Policy Actions-Consumer Protection
• **CBL to work with financial institutions on a code of sound practices for consumer protection** • **Amend the FIA to provide CBL authority to impose a code of conduct** • **MTICM to undertake a study of the options for establishing a financial ombudsman**

B. Capital Market Development

145. Broadly speaking the capital markets comprises debt and equity instruments. Debt markets develop first, and may be followed by equity markets. The government bond market provides an important foundation for the establishment and growth of the corporate bond market, providing a yield curve which is central to the pricing and trading of other debt securities, and a regular flow of issues to support development of underwriters and market-makers.

146. Government will introduce a debt issuance program conforming to well-established principles for bond market development. This will include an annual issuance schedule coupled with announcement in advance of each auction of specific amounts, tenors and rates. The focus will be on benchmark issues focusing initially on the shorter end of the yield curve—three and five years. To enhance liquidity, there will be a program to re-open older, less liquid issues for buy-back or exchange for current benchmark issues.

147. Adherence to a regular bond issuance schedule, even if government has no immediate need for the funding, is important to meet the demand for longer term assets by institutional investors and establish volumes of bonds outstanding that could facilitate secondary trading to help markets develop.

148. Government can further develop the bond markets by encouraging a domestic financing tranche for major infrastructure projects, and considering the use of bond financing to meet government policy objectives such as building affordable housing. PPPs are a potential source of domestic bond issuance. As noted below in the discussion of insurance and pensions, the binding constraint on long term investment in Lesotho is the shortage of investable assets rather than a shortage of funds.

149. Lesotho currently has no formal market for the issuance and trading of equities, although this has not precluded restricted public offerings of securities, for example by Moruo Developments Limited to raise part of the financing for the Pioneer Shopping Mall in Maseru. Over the medium term the elements required for an over-the-counter (OTC) platform for equity issuance and trading will be put in place

to facilitate similar financing and investment vehicles. Should a significant number of companies make use of the OTC platform, consideration will be given at a later date to pursuing an arrangement with an established exchange in the region such as a dedicated board for the listing of Lesotho stocks. An independent, fully-fledged stock exchange is unlikely to be a viable entity in Lesotho under current circumstances, or for the foreseeable future.

150. There is no regulatory foundation for capital markets at present. The main legislation of relevance to companies offering shares or debt to the public is the Companies Act, 2011. These provisions will be reviewed to determine if further legal provisions are required to facilitate offers of securities to the public and trading on the OTC platform. Capital market regulations have been drafted, but these need to be revised to support the establishment of an OTC market. Regulations relating to the issuance of securities and trading on the OTC market will be designed so as not to discourage further issues of securities or make the costs of doing so excessive. Details of OTC trading will need to be disclosed to the CBL for monitoring purposes..

151. LNDC in conjunction with the CBL will explore the possibility of inviting a regional stock-broking firm to establish an OTC market in Lesotho. This approach was originally used with success in Botswana, where the informal Botswana Share Market operated successfully for 13 years until superseded by the Botswana Stock Exchange. One useful lesson is that the Botswana Share Market was commercially viable, while the Stock Exchange requires continuing government subsidies, suggesting that an OTC market is likely more appropriate for a small economy.

Policy Actions-Capital Market Development
• **Introduce a government debt program including a preannounced schedule and regular benchmark issues with three and five year tenors** • **Consider requiring a domestic financing tranche for infrastructure and other major government projects** • **Review the relevant provisions of the Companies Act to determine if any further regulations are required in respect of offers of securities to the public** • **Issue Capital Market Regulations that are designed to support the development of a vibrant OTC market** • **Solicit interest from regional stockbroking firms to establish a share dealing operation in Lesotho and an OTC market** • **Discuss the potential of a shared infrastructure stock exchange model with different possible formats with SADC exchanges**

C. Insurance

152. Although the insurance sector is better developed than in many African countries, there is considerable scope to expand the risk coverage and long-term savings provided by insurance products. Putting a modern legal framework in place is the highest priority for the insurance sector.

Legal and Prudential Framework

153. The current legal framework for insurance is outdated and in need of modernisation. This will be addressed in two stages. First, the Insurance Bill under preparation since 2005 is being passed into law. While there are a number of identified shortcomings in the draft Bill, stakeholders clearly indicated a preference for speedy enactment rather than further delay for extensive revision.

154. The second stage will involve the preparation of a comprehensive package of amendments to bring the new Insurance Act in line with the recent extensive changes in international standards for insurance regulation and supervision. In particular, these will address governance, risk management and solvency margins, intermediaries, and consumer protection. The amendments to the Insurance Act will also specifically provide for micro-insurance, and move much of the detailed requirements into regulations, which are more readily revised than the law itself to keep up with evolving best practices. The amendments will also support adoption by the CBL of a risk-based approach to supervision of insurance companies.

155. The revised prudential standards will be based on the Solvency Assessment and Management regime currently under development in South Africa. Building on the extensive work already undertaken by the South African Financial Services Board to implement the new international standards has several benefits. First, it minimises the policy development costs—an important consideration given the limited resources of the CBL. Second, harmonising prudential standards for insurance contributes to regional harmonisation, and third, it facilitates coordination and consolidated supervision of the large South African-owned insurance companies operating in Lesotho.

156. The sale of pension annuities is likely to become an increasingly important part of the life insurance business as the Public Officers Defined Contribution Pension Fund (PODCPF) and other pension funds mature. Pension fund members retiring from defined contribution (DC) schemes need to purchase an annuity to provide for their pension, and life insurance companies have the appropriate skills (in terms of actuarial risk management and asset-liability matching) to do this. The Insurance Bill does not specify annuities as a class of business and an amendment will be required to rectify this and to provide for the formulation of regulations for the supervision of this specific class of business. These will reflect the distinct risks that it entails in terms of asset-liability matching, provisioning and solvency margins.

157. Three measures will be implemented to enhance consumer protection. First, brokers will be required to hold premiums collected in a separate trust account to mitigate the risks that brokers may fail to pass on premiums payments to the insurer. Payments from the trust account will be permitted only for remittance of premiums to insurance companies and transfer of earned commission income to the brokers' general account. This insures segregation of customer premium payments held in trust from the brokers' general funds. The effective supervision of brokers will to a large

extent rely on the review of brokers' trust accounts to ensure that the segregation requirements are met.

158. A second measure aims to improve the quality of insurance brokers. At present, brokers need to register with the CBL but do not have to meet any professional qualification requirements. It is appropriate to require individual brokers – even if working for a company – to have a professional qualification. The most common such qualification in the region is the Certificate of Proficiency (CoP) in Insurance, offered by the Insurance Institute of South Africa. The industry should engage with the National University of Lesotho and/or private educational institutions to arrange for CoP courses to be offered at least during a transition period, and perhaps on a permanent basis should demand be sufficient.

159. The CBL will impose disclosure standards through the regulations to be issued under the Insurance Bill for funeral cover, having regard to the fact that many of the issuers are funeral homes with little knowledge of sound financial consumer practices, and who will often be dealing with vulnerable customers with limited financial literacy. A requirement for licensing of all providers of funeral insurance will be introduced subsequent to the enactment of the Insurance Act to provide for a tailored licensing requirement for micro-insurance.

Policy Actions-Insurance
Finalise and pass the Insurance Bill as soon as possible   **Begin work immediately on amendments to address shortcomings in the Insurance Bill including corporate governance, solvency margins and risk management, improving the regulation of intermediaries, enhanced consumer protection, risk-based supervision, inclusion of annuities as a class of long-term insurance and issuance of appropriate regulations**   **Base the new prudential standards on the Solvency Assessment and Management regime currently under development in South Africa**   **Require premium income to be kept by brokers in a separate trust account from own-account funds and only withdrawn for the payment of premiums to insurance companies and broker commission income.**   **Ensure supervisory review focuses on brokers' adherence to the trust fund requirements**   **Require individual insurance brokers to hold the CoP qualification.**   **Engage with education institutions to offer courses leading to the CoP qualification.**   **Introduce by regulation disclosure standards for funeral insurance**   **Introduce a licensing requirement for all providers of funeral insurance**

Cross-Border Competition

160. The restrictions on cross-border trade in insurance contained in the Insurance Bill will be revisited prior to enactment, as they may not be in the best interests of Basotho consumers and may be in contravention of existing trade agreements,

particularly the Southern African Development Community (SADC) Trade in Services Protocol and the SADC-European Union Economic Partnership Agreement (see Appendix 1).

161. There is no clear case to treat insurance differently to other goods and services when it comes to cross-border trade. In almost all other cases of tradable commodities, consumers have a choice whether to buy locally or to import, and the discipline imposed by foreign competition is an important spur to domestic efficiency. Lesotho residents can open bank accounts in South Africa, and should be able to buy other financial services, such as insurance across the border. There is evidence that the terms offered by South African life insurance companies are more favourable than those in Lesotho, so to restrict access to such polices could make consumers worse off, as well as being unenforceable in many cases.

Policy actions-Cross-border Competition
• **Review Insurance Bill restriction of access of residents to insurance policies issued outside of Lesotho, with a view to ensuring compliance with trade obligations and making insurance available to Lesotho residents in the most efficient manner**

General Insurance

162. Unlike the long-term insurance business, there is no savings component to general insurance, which is a transaction-based business involving premiums paid to insure risks for finite periods. The small size and limited capacity of the local insurance industry to take on risk means that a high proportion of risks are reinsured. This is particularly the case for large commercial risks, which are almost entirely reinsured with foreign reinsurers. Reinsurance is much more important for short-term risks than for long-term (life) risks.

163. The adequacy and appropriateness of the current statutory motor vehicle accident (MVA) scheme will be reviewed. This scheme, financed by a fuel levy, provides personal injury compensation in the case of motor vehicle accidents involving uninsured drivers, but no compensation for damage to property. The MVA scheme is currently insured through Lesotho National General Insurance Company, but with no cap on liability it is difficult to reinsure and challenging to operate on a viable basis. Compulsory third–party cover would help to reduce the economic losses from uninsured damage.

164. Following review and stakeholder consultation, a determination will be made whether Lesotho should adopt the prevalent international practice of requiring mandatory third party motor vehicle insurance. This could provide a considerable base of business for the general insurance sector – in other countries, third party motor vehicle insurance typically accounts for about 30% of business for general insurers.

Policy actions-General Insurance
• **Review operation of the Motor Vehicle Accident (MVA) scheme** • **Consider the introduction of compulsory third-party motor vehicle insurance**

D. Pensions

165. Developing the pension sector in Lesotho is a high priority. An appropriate framework for individuals to provide for their own retirement needs helps to meet important social objectives as well as contributing to capital market development and the mobilisation of long term savings for productive investment.

166. The key actions required are: i) establishing an overall national policy covering the role of public (statutory) pensions and private pensions; ii) establishing the regulatory framework for private pensions, including tax policy; and iii) introducing a public pension consistent with the overarching national pension policy. A number of initiatives are already underway, and a key element of the FSDS is coordination to ensure consistency with the overarching national policy.

167. The pension sector in Lesotho currently consists of:

- A universal state old age pension, payable to all adults over the age of 70 years
- The PODCPF for civil servants, which is by far the largest of the established funds with about M2.5 billion total assets
- The Corporate Bodies pension scheme, a defined benefit (DB) fund covering employees of parastatals
- An estimated 100 to 200 private occupational pension funds, largely operating on a DC basis.

168. Currently the pension fund sector is almost entirely unregulated. The PODCPF is subject to its own founding Act, but there is no statutory basis for the general regulation of pension funds other than limited requirements under the tax regime. The lack of regulation and supervision potentially exposes pension fund members to the risk that pension funds may not be able to honour their long term commitments due to a wide range of risks, including fraud, excessive risk exposure and inappropriate management of pension fund assets held in trust.

Overarching Policy

169. There are two elements to the overall national policy on pensions: the establishment of a statutory public pension scheme, and the framework for private pensions. Thus far, work on these two elements has proceeded independently, which has created some challenges as decisions with respect to one element affect the other element as well. Thus, an overarching policy will be prepared, specifying the intended roles of the public and private pension schemes, and spelling out the policy and oversight responsibilities of the authorities involved—the Ministry of Labour and Employment, the MoF and the CBL.

170. The main issues to be addressed in the national pension policy are:

- Clearly establishing the roles of statutory and private occupational pensions
- Ensuring that the design of the statutory pension appropriately considers affordability and fiscal implications
- Extending coverage to achieve generalised pension provision for formal and informal sector employees
- Formalising the regulation and supervision of the industry, and data collection
- Enhancing the role of pension funds in generating long-term savings and financing the long-term investment needs of the economy, along with necessary capital market development
- Ensuring that accumulated benefits are properly preserved to provide pensions on retirement, and that the payment of pensions and pension annuities is adequately provided for.

171. The draft National Social Security Bill specifies that the Minister responsible for social security shall be responsible for the development of a national policy framework for social security in Lesotho (section 94). Given the intersection of social security programs with fiscal issues and financial sector development, this work will be coordinated with the MoF and CBL. With respect to pension provision, this framework will clearly lay out the expected roles of different pension schemes. From the perspective of financial sector development, this will provide a high level view on the anticipated role of private pension schemes, and clearly indicate where regulatory responsibility lies for the various schemes. This will enable the CBL to finalise its policy on private pension schemes, and to develop a regulatory framework.

Regulatory Framework for Private Pensions

172. There is currently no framework for private pensions. Stakeholder discussion of the draft Policy Paper for Occupational and Private Pension Funds, and the draft Pension Law and Supporting Regulations made it clear than the proposed approach was unsuited to Lesotho. The policy approach is being revised to take into account the structure of the existing pension industry in Lesotho, which is similar to that found throughout Southern Africa. The policy on private and occupational pensions also has to reflect key decisions taken with respect to the proposed new statutory public pension scheme.

Preservation of Benefits

173. One of the issues that regulation will address is preservation of benefits. This entails a legal requirement that at least a portion of pension entitlements is converted to a pension payment stream, and is not simply converted to cash or other financial assets. The risk in the latter case is that these assets will be depleted, and that the objective of pension accumulation – old age financial security – will not be achieved. This is a particular problem because of "longevity risk" – the risk that people will outlive their financial assets, whether due to long life or simple miscalculation.

174. The policy framework for private pension funds will include relevant aspects of the tax regime. The overall objectives are to encourage savings and to promote the

preservation of benefits. In keeping with practice elsewhere, there will be restrictions on the use of pension and provident funds that have been accumulated from tax-exempt pension contributions. These restrictions ensure that the majority (typically two-thirds) of the accumulated funds are preserved in a form that will provide a pension income on retirement, such as an annuity or programmed withdrawals which would provide income from retirement to a specified age, typically 90. It will be possible to take the remainder (up to one-third) as a lump sum. It is conventional to restrict the proportion of income that can be used for tax-exempt pension contributions (typically 15% or 20% of income for each of employees and employers contributions). It is also conventional that pension income received is taxable – thus making the tax concession effectively a tax deferral rather than a tax exemption.

175. A further preservation problem arises when fund members change employment. Current regulations permit benefits accumulated in an occupational pension fund to be encashed when a member changes jobs, which reduces the amount accumulated for retirement and undermines the purpose of tax exemptions for pension contributions. The regulations will be revised to prevent such encashment and ensure that on changing jobs, benefit entitlements can either be transferred to a new occupational scheme or are frozen (deferred) until the member reaches retirement age.

Investment and Asset Management

176. The majority of pension funds in Lesotho (including the PODCPF) are DC funds, which involves accumulating entitlements in individual pension accounts, backed by a pool of assets earning investment returns that are added to these individual accounts. The strategy used to invest the assets of a DC fund is therefore of crucial importance; over a long period of time, the investment returns can be more important in determining the final pension entitlement than the contributions.[15]

177. Asset management strategy for pension funds should follow a number of basic principles to secure an acceptable combination of return and risk. In a small economy it is likely that an investment strategy that best serves the interests of the pension fund members will have a relatively small proportion of funds invested domestically – simply because of the limited range of investment opportunities available and the need for diversification. This is a particular problem in Lesotho, where the economy is small and financial and capital markets are limited. Hence, only around 10% of the assets of the PODCPF are invested domestically, with the remainder in South Africa and the rest of the world.

178. The regulatory policy approach will therefore carefully balance the interests of pension fund members – and their legitimate interests in maximising their pensions – and the interests of the economy. This is particularly important with respect to imposing local asset requirements on pension funds. Pension fund trustees should employ investment strategies that will best serve the interests of the pension fund members (indeed this is the typical legal obligation of pension fund trustees). From a

[15] For instance, contributions of M100 per year would accumulate to M4,000 over 40 years with zero investment return, but to M12,000 with an investment return of 5% a year.

public policy objective, however, other objectives come into play. Pension funds are one of the primary sources of long-term savings in most economies, and therefore represent an important source of funds to finance the long-term investment that is necessary for an economy to grow. An investment strategy that protects pension fund members, and results in a high level of offshore investment, may be sub-optimal from a broader economic perspective.

Annuities

179. Regulation of the purchase and selling of annuities will be clarified through amendment to the Insurance Act to provide for annuities as a distinct class of business and to provide for appropriate regulations. Pension annuities are an integral part of any DC pension system, because of the requirement that retiring pension fund members purchase an annuity to provide their pensions. In Lesotho, annuities are currently available from only one life insurance company, and (for members) from the PODCPF.

180. Sale of annuities will be restricted to life insurance companies, or pension funds subject to appropriate reinsurance provisions. Because the risk of annuities and the needed skills to manage the risks are similar to the life insurance business, annuities are in most countries primarily sold by life insurance companies. In some countries pension funds are allowed to also sell annuities, but this needs to be hedged by reinsurance of some kind, as pension funds do not have the skills or the balance sheets (particularly reserves) to adequately manage long-term annuity risk.

181. One of the constraints facing annuity providers in Lesotho is the lack of domestic government bonds, especially long maturity bonds. This will be addressed in part by the intended regular sale of government bond benchmark issues to facilitate capital market development. However, as the supply of government bonds is likely to be insufficient, annuity providers will have to match large portions of their liabilities with investments in South African government bonds.

Economic and Capital Market Development

182. The regulatory approach will balance the interests of pension fund members with the broader objectives of economic and financial market development. Common perceptions of local asset requirements often reflect a misunderstanding of the problem. The main reason that a large proportion of long-term funds are held outside of the country is not that the owners or managers of those funds are unpatriotic or malicious, but a shortage of suitable investment opportunities, i.e. the problem is with the demand for long term funds, not the supply.

183. Imposing local asset requirements will be handled carefully in view of the need for diversification of assets in order to maximise risk-adjusted returns for pension fund members. Following further stakeholder consultation, an initial local asset requirement, perhaps in the range of 10-15% of the total portfolio, will be established. This could be increased over time as the local capital market develops and more suitable assets become available. The experience of Namibia and Swaziland, where higher local asset requirements (30-35%) have been imposed, is

that funds will in any case flow out of the country to South Africa, given the lack of capital controls within the Common Monetary Area (CMA). The most likely route for this to happen is through investment in money market assets that are registered locally (such as a collective investment scheme or bank deposit) so as to meet the technical requirement, but which themselves invest predominantly in external assets.

184. Similarly, the imposition of requirements for services to be procured locally also needs to be handled carefully. Given the small size of the market and the specialised nature of services required, it is unlikely that competitive forces will be very effective and that pension fund members will be vulnerable to paying inflated prices for the services received, thus reducing pension benefits. Thus, actual or potential competition from South Africa plays a crucial role in keeping prices in check in Lesotho. The legal framework will provide that the trustees are responsible to decide which asset managers to employ, on the basis of commercial criteria and their obligation to fulfil the best interests of the members. The proposal in the draft pension policy to require all services to be procured from locally registered and licensed service providers – which furthermore cannot be entirely foreign owned – will be revisited to achieve a reasonable balance between member interests and the need for local economic development.

185. The various regional and international agreements on trade in services that Lesotho is party to also have implications for proposed measures to restrict foreign investment in and cross-border purchases of financial services (see Appendix 1). Any proposals to impose new restrictions on trade in financial services would almost certainly be prohibited under these agreements. Hence the proposals in the draft pension policy to impose restrictions on the ability of pension funds to utilise foreign service providers, or to impose ownership restrictions on local service providers, would be inconsistent with these trade in services agreements, and thus will be reconsidered.

Other Regulatory Issues

186. The pension policy will clarify the categories of institutions that need to be licensed by the CBL, including pension fund administrators, asset managers and other service providers such as advisors. Minimum qualifications for trustees will be established, and the policy—to be reflected in legislation—will make clear the obligations of trustees to act in the best interests of fund members. There will also be guidance on investment policies through adoption of the prudent person rule.

Proposed Statutory Social Insurance and Pension Scheme

187. A new public pension scheme will be introduced as part of wider social security provision. Draft legislation has been prepared to give effect to this decision, although discussions and consultations are still taking place. The implications of the proposed new public pension scheme are important, not least for the PODCPF and existing private pension funds. This needs to be reflected in the overarching pension policy and the framework for private pension plans.

188. The key elements of the draft legislation are:

- A new public pension scheme that will cover all workers
- All businesses must participate and membership will be compulsory for all employees (details of membership for the self-employed are still to be settled, but will be voluntary)
- The scheme will operate as a DB pension scheme with pension entitlement earned after a qualifying period
- In addition, there will also be a range of social security benefits for members such as maternity pay and workers' compensation
- Contributions will be paid by both employees and employers
- Contributions will be fixed as a percentage of income up to a ceiling to be determined
- The scheme will operate mainly on a pay as you go (PAYG) basis with benefits paid from contributions; however, contributions exceed benefits payable in the early years, so a surplus investment fund will result
- There will be an additional voluntary DC scheme based on individual accounts for those earning more than the ceiling
- Various new institutions would be created, including a National Social Security Organisation, a National Social Security Fund, and the Social Security Regulatory Authority.

189. A number of these elements will be revised and clarified following further stakeholder review. These include the affordability for employers, the fiscal implications for government, interaction with the existing old age pension, and ensuring adequate coverage for workers in the informal sector. Appropriate contribution levels are especially important. If set too high, they may discourage participating in the formal sector, but if set too low, the benefits will be unaffordable.

190. The impact of the new mandatory scheme on existing pension funds and the potential future growth of private pensions is another key issued to be addressed. There is provision in the draft legislation for members of existing "public schemes", including the PODCPF, to become members of the new scheme, and for the assets of those schemes to be incorporated into the new scheme. However, there is also provision for an exemption for the PODCPF and its members. Following further stakeholder consultation, including with PODCPF members, an early decision will be taken as to whether this exemption will be granted.

191. The establishment of the new fund has major implications for all existing pension funds. First, members of existing pension funds will be obliged to become members of the new schemes. They will have the option of continuing with their membership in existing pension schemes, but this will be on a supplementary basis. Those earning more than M100,000 per annum will face a choice of continuing with their existing pension fund membership or contributing to the supplementary component of the new fund.

192. The second implication for existing pension schemes is that their membership may be reduced, and their prospects for future growth will be more uncertain. Third, contribution inflows will fall, not just because membership may be reduced, but because a significant proportion of contributions will be diverted to the new scheme, and private schemes will only receive supplementary contributions.

193. Thus, the overarching policy framework needs to consider the extent to which Lesotho wishes to encourage the development of private pension funds. If this is determined to be a desirable policy objective, consideration will be given to exempting members of other occupational pension funds from membership of the statutory scheme. This will in turn require the timely introduction of a statutory framework for the registration and regulation of private schemes.

194. The new statutory scheme will have an impact on savings and capital markets, although the extent of this impact depends on whether or not the PODCPF and other existing funds are integrated into the new scheme. The new scheme is intended to be only partially funded and operated mainly on a PAYG basis; however, it will accumulate significant financial assets in the early years, mainly for demographic reasons and the fact that there will be a 15 year qualifying period for eligibility for pensions.

195. Since the new statutory DB scheme will not be fully funded, it is unlikely that the Lesotho pension fund sector will grow to a comparable size, in terms of assets, as the Botswana and Namibia pension sectors (although it would be large in terms of membership); in those countries, most pension schemes are fully funded. Furthermore, because future statutory pensions will be paid from contributions and accumulated assets and not from pension annuities, this will tend to restrict the growth of future demand for annuities. Nevertheless, there will be a need for asset management functions for the new fund, and there will be increased demand for local assets, even if most of the assets are invested outside of the country.

196. The current draft legislation envisages the creation of a number of new institutions, including a National Social Security Organisation, a National Social Security Fund, and the Social Security Regulatory Authority. While each of these has identified roles, the final legislation will be revised to reduce the required institutions, taking into account the impact on the government budget, employers' costs (and hence firms' competitiveness), and the extent to which the contributions of members are applied to expenses rather than the accumulation of benefits. Rather than create a Social Security Regulatory Authority, the CBL will be charged with oversight of the mandatory public scheme as there is considerable commonality with the oversight of private pension plans and insurance.

197. Responsibility for investment policy will be clarified under the draft legislation through introduction of a "prudent person" requirement with regard to the discharge of investment management functions. Also, as noted above the legislation will be revised so that the currently proposed separate Authority will not be created,

with the CBL instead assuming oversight responsibilities. Thus, the power to oversee the discharge of the prudent person investment mandate will fall to the CBL.

Policy Actions-Pensions
Prepare an overall national policy on pension provision, specifying the roles of public (statutory) and private pension schemes and the responsible authorities—the Ministry of Labour and Employment, Ministry of Finance, and CBL   **Start collecting data on pension funds on the basis of information held by the PODCPF, the Corporate Bodies Pension Fund, life insurance companies and major corporates, in order to provide a more accurate estimate of the size of the industry**   **Review and revise the tax regime relating to contributions to pension and provident funds and the preservation (withdrawal) of benefits, encouraging savings and promoting the preservation of benefits by restricting the encashment of pension funds on change of employment and on retirement**   **Finalise the Policy towards the development of the private pension (individual and occupational funds) sector, to provide the basis for establishing a legal framework**   **Take into account the coverage of the proposed new statutory occupational pension fund**   **Clarify the scope of intended regulation of pension funds and other service providers, including pension fund trustees**   **Balance the needs of pension fund members (savers) for an optimal balance of risk and return and broader development needs that require long-term savings to be available for investment in the economy**   **Local asset requirements recognising prudent limits on domestic investment**   **Prepare a statutory framework (law and regulations) for the regulation of pension funds and related entities such as asset managers**   **Permit and encourage pension funds to prudently diversify risks across asset classes and location of investments**   **Permit retiring pension fund members to buy annuities sold in South Africa, in order to ensure choice and competitive pricing**   **Ensure pension and insurance legislation and regulations comply with regional and international commitments under trade in services protocols**   **Review and revise draft National Social Security Act (NSSA) in light of overarching pension policy**   **Include a "prudent person" requirement in the NSSA with regard to investment management functions**   **Review the proposed creation of three new institutions: the National Social Security Organisation, the National Social Security Fund, and the Social Security Regulatory Authority for cost and efficiency reasons**   **The CBL rather than a new authority will oversee the Fund**   **Determine whether PODCPF members will be exempted from the new statutory scheme**   **Consider providing for members of other occupational or private pension funds to opt out of the new statutory fund**

IV. IMPROVING EFFICIENCY—THE PAYMENTS SYSTEM

198. Lesotho's payments system is undergoing rapid modernisation and transformation. A range of policy actions are underway or planned to provide enhanced regulation and oversight capacity, as well as developing specific components of the system that cover the full range of payments, clearing and settlement channels. This work takes place in the context of the SADC payment system project and the need to position the domestic payment systems to benefit from integration within the rest of the Southern Africa region.

A. Payments System Regulation and Oversight

199. At present Lesotho does not have legislation that specifically provides a legal basis for regulation and oversight of the payments system. This will be addressed by the PSB, which more clearly provides the foundation for the CBL to oversee the payment system. Other legislation will be amended to address the rapidly evolving payments landscape, in particular the emergence and rapid growth of a wide range of retail payments options.

200. The PSB will establish a Payment System Management Body, comprising the CBL and banking and financial institutions, for the purpose of organizing, managing and setting standards for the payments system. The Bill also requires entities that propose to offer clearing, settlement or interbank payment services to obtain a license from the CBL. The Bill has been drafted to be consistent with SADC Model Payments System legislation and with National Payments System (NPS) legislation in other SADC countries, thus providing the basis for further integration of Lesotho into the SADC payments system.

201. Once the PSB is enacted it will be necessary to have regulations that give it effect. Drafting of regulations will begin immediately, rather than waiting for the law to be passed, in order not to delay implementation. This will enable the Act to come into force shortly after being passed by Parliament.

202. Two other important legal reviews will be completed to address payment system issues. The first of these relates to the Bills of Exchange Act, which dates back to 1912 with an amendment in 1964. The Act will be amended to reflect the full range of payments instruments in modern usage. The second is the proposed Insolvency Act. As part of the planned introduction of a modern insolvency statute, drafting will accommodate the "zero hour rule"[16] with respect to the RTGS need for final and irrevocable payments, and will be in compliance with NPS rules regarding the insolvency of an NPS participant.

Policy Actions-Payment System Regulation and Oversight

[16] The zero-hour rule involves backdating the timing of an insolvency to the first (zero) hour of the day on which the insolvency takes place. This is inconsistent with an essential payment system characteristic, which is that when a transaction has been concluded it cannot be unwound (i.e. settlement is irrevocable). Revision of the Insolvency Act will provide for different categories of debtor such that insolvency of a payment system participant would not be backdated to the zero hour.

- **Finalise the PSB and present to Parliament for approval**
- **Finalise drafting of supporting regulations necessary to implement the Payment System Act**
- **Review Bills of Exchange Act to update and make consistent with other legislation and modern payments channels**
- **Accommodate the "zero hour rule" for payment system participants in the new Insolvency Act**

B. High Value Payments and Settlement

203. The real time gross settlement (RTGS) system, LSW, generally operates effectively. Until recently all Government payments were routed through the LSW from manual instructions, which resulted in a major administrative burden for the CBL from manual processing of low value payments in a system intended only for high value items. Government payments have now been separated into two streams, one for high value payments (to the LSW) and one for low value payments (to the EFT). The next stage will be for Government to submit payment instructions in electronic rather than manual form.

Policy Actions-High Value Payments
• **Ensure that Government payment instructions are submitted in electronic form**

C. Clearing Systems

Cheques

204. Cheques are currently cleared manually through the Lesotho Manual Clearing House (LMCH). A program is in place to introduce an automated cheque clearing system, including the establishment of cheque standards that would improve cheque security and allow machine-readability. An electronic cheque clearing system is being procured. The new automated clearing house (ACH) system will allow the submission of electronic cheque payment instructions to the clearing house, and the storage of cheque images. This should result in greater security and faster cheque processing and clearing.

205. The Payments Association of Lesotho (PAL) represents the CBL and the banks, and is currently hosted and resourced by the CBL. The PAL will take over the operation of the ACH (for both cheques and EFTs) once it is up and running, and the ACH will be moved out of the CBL. The CBL's role will concentrate on payments system oversight rather than operator of a retail clearing system. PAL should be resourced and financed by all members, not just the CBL. The PAL/ACH will apply for licensing once the Payments System Act is in force.

Electronic Funds Transfers

206. A clearing system for electronic funds transfers (EFTs) has been in place since late 2011, whereby EFTs are processed by Bankserv in South Africa. The Bankserv

contract runs until 2015. While the system functions efficiently, there are concerns about its cost. The ACH system being procured for cheques can be supplemented with a module for EFT processing. Before the Bankserv contract expires, the CBL will evaluate the available options for EFT processing post-2015, including continuing with Bankserv, adding a module to the ACH, or other regional solutions.

Policy Actions-Clearing Systems
• **Finalise the procurement of the ACH** • **Reach agreement between the CBL and the banks on cheque standards and the introduction of new machine readable cheques** • **Prepare for the transfer of the ACH (cheques and EFTs) from the CBL to the PAL** • **Prepare an application to the CBL for licensing of the ACH once the Payment Systems Act comes into force** • **Require all PAL members to contribute resources** • **Determine and evaluate options for EFT clearing post-2015**

D. Retail Electronic Payments

207. Retail electronic payments are not currently regulated in Lesotho. However, there is a need for oversight and the imposition of standards as necessary. The PSB will provide the basis for oversight, but it primarily deals with interbank payment systems, clearing and settlement systems, and does not give much attention to retail electronic payments such as mobile money transfers or card-based transactions. Nevertheless, there is scope to regulate retail electronic payments under Sections 12 or 29 of the PSB, which would allow the CBL to issue Directives or Regulations relating to the provision of payment services to third parties; however, dealing with retail electronic payment systems is not the primary purpose of the PSB.

208. There are several ways in which a regulatory and oversight capacity for retail electronic payments could be further developed. One option would be to introduce an amendment bill at a later stage to explicitly address retail payments issues pursuant to the Payment System Act, while a second option would be to introduce a dedicated piece of legislation for retail electronic payments. Both would take some time.

209. A third option would be to regulate retail payments under the FIA, and has a number of potential advantages. First, the FIA is a flexible piece of legislation, which accommodates a range of financial service providers under different tiers, including money transfer operators. It would be relatively straightforward to amend the FIA – which will be amended for other reasons – to include retail payment system service providers more generally. A second advantage relates to the convergence between payments and deposit-type services (e.g. the merging of mobile money transfers and mobile banking, and the growth of “e-money”). From a policy perspective this convergence should be encouraged, as it will help to reduce costs and broaden access to financial services. Given that more regulatory concerns tend to arise from the quasi-deposit taking aspects of such products and services, regulation under the FIA

would be more likely to encourage convergence than regulation under payments legislation. However, it will be important to ensure that payments system oversight objectives are properly dealt with if retail payments are regulated under different legislation.

Policy Actions-Retail payments
• **CBL to take a policy decision as to whether the FIA, the Payment System Act or new legislation should be used to regulate retail electronic payment systems, and draft any necessary legislation or amendments and regulations**

Mobile Money

210. There is as yet no statutory basis for the regulation of mobile money, and the industry is being managed on the basis of Guidelines issued by the CBL. As discussed in more detail in the context of innovative products for financial inclusion, these Guidelines will be revised into Directives once the Payment Systems Act is in force. This, however, is a temporary solution because, as noted above, the Payment Systems Act is not well suited to the regulation of retail payment systems. In the medium term, a new regulatory framework will be developed for mobile money (or mobile financial services more generally) that achieves the following objectives:

- Encourages convergence between mobile payments and mobile banking, enabling the provision of deposit-taking services as well as payments services
- Promotes competition for the banks from non-bank service providers
- Facilitates access to financial services for the unbanked
- Includes appropriate regulation that is calibrated to the risks involved, and focuses the design of regulation on products rather than institutions
- As far as possible, creates a level playing field across different types of institutions when they offer similar products.

211. This will be best accomplished through the development of a new licensing category under the FIA.

Card Transactions Switch

212. The CBL will consider the available switching options for processing Lesotho card transactions, and following stakeholder consultation adopt an appropriate action plan. At present card transactions originating from ATM and POS machines in Lesotho are all handled by the SASWITCH network, operated through the South African banking system. SASWITCH clears transactions that originate from cards and terminals operated by member banks.

213. Some concerns have been expressed about the settlement of SASWITCH balances in South Africa, via the accounts of merchants and Lesotho commercial banks in that country. However, it is not clear that this introduces any risks that are not already present in the banking system in Lesotho. Nevertheless, the CBL could, if deemed desirable after review and stakeholder consultation, introduce a requirement that settlement takes place through book entry at the CBL.

214. The available options include continuing with SASWITCH, moving to another commercial provider in the region such as VISANET, sharing with a switch provider in another country in the region, promoting a regional (CMA or SADC) switching solution, or establishing a domestic Lesotho switch. The CBL will assess the options against the criteria of facilitating new entry, securing interoperability, and consistency with longer-term plans for regional payments integration in the region. Before any decision is made, all possible options (including a domestic switch) will be subject to a cost-benefit analysis.

Policy Actions-Card Transactions Switch
• **Review the experience of other countries, especially within the region but also further afield, that have introduced domestic switches** • **Identify the options available for providing switching solutions in Lesotho (including status quo, domestic switch, platform sharing and a regional solution)** • **Assess the merits of available solutions in terms of openness to new financial institutions, interoperability of cards, ATMs and POS machines, and consistency with longer-term plans for regional integration of payments systems** • **Complete cost-benefit analysis of available options before making any decision on establishing a domestic switch**

Regional Integration

215. The SADC Payments System Project has a long-term vision of modernisation, connectivity and integration of payments systems throughout the SADC region. The Lesotho PSB has been reviewed and amended with the objective of complying with SADC Payments System requirements. National payments systems within the region will be modernised on the basis of common standards that will also facilitate future linkages. An important component of the cross-border system has recently been launched with the linking of RTGS systems in the CMA, which will facilitate electronic cross-border payments. As a result, the use of cheques for cross-border payments will be terminated.

216. Given the intention to integrate regional payment systems and the availability of systems with excess capacity in other SADC countries, as payment systems continue to evolve Lesotho will explore regional options before launching domestic initiatives. A comparative cost-benefit analysis of domestic and regional options will be undertaken to ensure productive use of scarce resources and integration into the regional payments system, which will ultimately be to Lesotho's benefit.

Cross-border Remittances

217. Lesotho is heavily dependent upon cross-border remittances, mostly from South Africa, due to the significant number of Basotho working abroad. There is substantial scope for improving the efficiency of cross-border remittances. Estimates vary, but perhaps 90% of cross border remittances totalling between M2 and M4 billion flows through informal (unregulated) channels. The high reliance on informal channels has several disadvantages: it is risky, unpredictable and slow; it is not well

documented; and the funds do not flow into the formal financial system. Making formal (regulated) remittances channels more efficient, accessible and affordable would have advantages for migrants, recipients and the authorities.

218. Sending the equivalent of a $200 remittance from South Africa to Lesotho costs on average $35, representing 17.5% of the total amount.[17] This cost is extremely high compared to other countries with similar migration patterns and remittance volume flows, and is above the global average of 9.1% and also above the cost for the sub-Saharan African region of 12.2%.

219. Given the large scale of inward remittance flows and their importance to the economy, the potential benefits of more efficient and lower cost remittance channels could be considerable. A comprehensive survey of the remittances market will be undertaken to help establish the magnitude of flows, the channels currently used, and the challenges that need to be addressed, as well as to identify possible interventions to improve efficiency and ensure compliance with international standards.

220. The main potential in the short-term will come from enabling cross-border mobile phone remittances, whereby a transaction can be initiated from a mobile phone in South Africa and received on a mobile phone in Lesotho. The main barriers to such remittances are regulatory rather than technical. These will be addressed to facilitate access to such a channel as soon as possible, while ensuring that the normal safeguards relating to cross-border remittances are in place. Moving remittances from cash-based informal channels to electronic formal channels will assist in monitoring cross-border transactions and the collection of necessary data. It is also likely to be considerably cheaper for users than other available channels.

Policy Actions-Cross Border Remittances
• **Complete a comprehensive survey of the cross-border remittances market to identify characteristics, challenges and potential interventions to improve efficiency** • **Encourage MNOs to provide cross-border remittance services from South Africa to Lesotho** • **Liaise with the South African authorities to resolve any regulatory barriers to cross-border mobile phone transactions and develop appropriate data collection mechanisms and anti-money laundering safeguards**

V. FINANCIAL STABILITY AND SOUNDNESS

221. A sound and stable financial system is a prerequisite for the social and economic transformation envisioned by the NSDP. The CBL has already begun the process of introducing a macro-prudential approach—a top down view of risks inside and outside the financial sector—to complement its long-standing micro-prudential

[17] World Bank, Remittance Price Worldwide

focus on the health of individual institutions. This will continue with a new unit within the CBL established to focus on broad financial stability issues, increased coordination and cooperation with other authorities within the region, and further enhancement of the regulatory framework and the CBL's supervision capacity.

A. Approach to Financial Stability

222. The nature of the financial sector—a small number of institutions dominated by subsidiaries of South African institutions that are important in the domestic market but not material to the parent banking and insurance groups—requires a focus on two main issues in efforts to maintain financial stability. First, the CBL will pursue the measures at its disposal to mitigate South Africa risk—the threat that problems elsewhere in one of the South African financial groups active in Lesotho, or more widespread distress in the South African financial sector, triggers a crisis in Lesotho. This is facilitated by the requirement for foreign institutions to operate as subsidiaries rather than branches, as in a crisis the subsidiaries can be more effectively ring-fenced from problems elsewhere in the group.

223. Second, and perhaps counter-intuitively, the CBL will focus the bulk of its supervisory resources on domestically-owned institutions—LPB, insurance companies and large cooperatives—even though these are the smaller institutions and less likely to present a systemic threat. These institutions are the sources of risks that the CBL might reasonably expect to mitigate through conventional risk-based supervisory approach, and in fact, those where there is a potential threat to the government budget through the need to recapitalise LPB or from political pressure to save local institutions.

224. As a practical matter the CBL is not able to influence the supervision of the South African parents of Lesotho financial institutions, nor influence the macro-economic policies of South Africa. While it will develop an approach for macro-prudential monitoring, the CBL will have very limited ability to use the macro-prudential tool-kit. Thus, the main elements of mitigating South Africa risk are:

- Focus the efforts of the planned Financial Stability Unit (FSU) of the CBL on monitoring the build-up of risks within the CMA region, relying extensively on liaison with the South African Reserve Bank (SARB) and other regional authorities
- Information sharing arrangements with the SARB to provide early warning of emerging problems in financial groups active in Lesotho
- Resolvability assessments and resolution plans developed in conjunction with the SARB and other host jurisdictions that focus on the ability of subsidiaries to continue to operate even if there is severe distress elsewhere in the group, and to achieve an orderly wind-down of subsidiaries or transfer of business to another institution in the event of problems elsewhere in the group
- Explore in conjunction with the other CMA regulators the possibility of reaching agreement on a resolution plan that would protect depositors in Lesotho (and other small jurisdictions) from the risk of loss arising from excess funds placed with the parent. As a condition of not requiring

subsidiaries to maintain sufficient local assets to cover all depositors' claims, Lesotho (and other CMA host authorities) would require an agreement with the South African authorities that in the event of a need to intervene in the parent group, sufficient South African assets would be released to meet the group's obligations to the subsidiaries. The very small size of the CMA subsidiaries relative to the groups suggests that negotiation of such an agreement may be achievable.

225. The current cooperation arrangement between the CBL and SARB will be supplemented by a new MOU documenting information sharing and coordination arrangements. This will include the resolvability assessments, review of resolution plans and contingency planning measures noted above.

226. The FSU to be established within the CBL will be a minimally resourced unit serving to coordinate work done elsewhere in the CBL and the SARB, and to conduct the analysis necessary to prepare a macro-prudential overview to complement the institution-specific assessments produced by the supervision directorate.

227. A Financial Stability Council (FSC) will be established with a mandate to oversee the development of the contingency planning framework, serve as the standing committee on crisis management, and provide a forum to address financial sector policy issues, monitor progress with prior initiatives and provide guidance on needed regulatory and other financial sector reforms. In times of elevated financial stress, the FSC would meet on an as-needed basis, with technical support mobilised from the Supervision, Financial Markets and Operations Departments of the CBL, in addition to the FSU.

228. In the Lesotho context, the membership of the FSC—heads of agencies with responsibility for financial stability—would include the Governor of the CBL, the Principal Secretary MoF, and such other senior officials as may have a mandate to contribute to financial stability. Composition of the FSC, its mandate and operating guidelines will be finalised with the benefit of further technical assistance provided by the IMF.

Policy Actions-Financial Stability
• **Establish the Financial Stability Unit within the CBL** • **Finalise composition, mandate and operating guidelines of the Financial Stability Council**

B. CBL Strategic Plan

229. The CBL Strategic Plan 2010-2014 will be superseded by a new plan fully reflecting the policy actions of the FSDS. In preparing the new strategic plan, the CBL will ensure that the issues it has responsibility for such as payment system oversight, supervision, contingency planning, and other topics, are appropriately reflected in the strategic plan, with adequate resource allocations for effective

completion. The needed review of FSDS priorities against the CBL structure and resources provides a platform for the CBL to take a higher level approach to the strategic plan, focusing on its mandate and key elements of the FSDS, than the more operational level approach reflected in the current strategic plan.

Policy Actions-CBL Strategic Plan
• **Prepare new CBL strategic plan fully reflecting policy actions of FSDS** • **Focus on matching resources to CBL mandate and FSDS priorities**

C. CBL Supervision

230. The CBL is the principal supervisory authority for the financial sector, which provides the opportunity to achieve effective oversight without the cost of establishing multiple agencies. As noted elsewhere in the FSDS, oversight of the planned public pension scheme and the planned OTC market will be undertaken by the CBL rather than establishing new authorities. The cost of expanding CBL capacity into new financial-sector related areas is much less than establishing new institutions.

231. Currently the Supervision Directorate has divisions for the supervision of Banks, NBFIs, and Insurance. The oversight of all deposit-taking institutions—banks and, should they be licensed, deposit-taking microfinance institutions, and cooperatives not exempted by the CBL from the provisions of the FIA—will be consolidated in a single division. There is commonality in the required supervisory processes and skills needed to oversee all types of deposit-taking institution, so non-bank deposit taking institutions will not be included in the portfolio of the current NBFI division.

232. The CBL faces a challenge due to heavy demands on supervision staff for the development of policy, legislation and regulations. This will in part be addressed by providing specific technical support to the CBL for policy development and legal drafting. A resident advisor will be sought with the necessary expertise in financial sector issues combined with a strong common law background, knowledge of the SADC region and familiarity with the related statutes in Lesotho. These qualifications are prerequisites, as experience shows that policies, laws or regulation prepared by consultants without these qualifications can be counterproductive.

233. The CBL will undertake a comprehensive review and revision of prudential reporting requirements. Some changes will be required as a result of new regulations, and others have been recommended by the IMF to enhance the CBL's collection and analysis of information on risk exposures. Further changes are required to systematically collect data on financial inclusion, as discussed earlier in the FSDS. To minimise the burden on the industry, a single revision to the reporting requirements will be completed once all of the implementing regulations for the FIA are in place. A CBL team will work with industry stakeholders to develop formats, definitions and other reporting requirements for all institutions subject to the FIA.

Bank Supervision

234. The CBL approach to bank supervision is well established, using a risk-based approach that broadly conforms to international norms. The CBL is receiving ongoing technical support from the IMF and AFRITAC-South, and will continue to implement the range of recommended improvements.

235. A Prompt Corrective Action (PCA) regime will be introduced as part of the package of regulations implementing the FIA. The advantage of PCA is that the requirement for minimum supervisory action as capital triggers are breached helps to ensure timely measures to protect depositors, if necessary by taking control of a failing institution before the point of actual insolvency.

236. The CBL intends to implement Basel II to replace the current Basel I-based capital adequacy requirement. This will be done in a manner tailored to the needs of the local market. The CBL will harmonise the capital adequacy regime on the South African standard with the expectation that the Standardised Approach under Basel II would be applied to LPB and any other domestic deposit-taking institutions that may be licensed in future. Foreign owned banks would be permitted to use the advanced approaches subject to agreement with the home supervisor—the SARB—with respect to effective consolidated supervision. The CBL will adopt the Basel III capital definitions and liquidity standards, modelling the requirements on those of the SARB. This approach has several advantages for Lesotho:

- Basing the requirements on the SARB standard minimises the resources required to develop and implement regulatory policy, and contributes to regional harmonisation
- Permitting the South African subsidiaries to use the advanced approaches under Basel II, subject to agreement on effective oversight by the SARB, reduces costs for the subsidiaries by not imposing a different local capital adequacy standard, with reliance on the SARB removing the need for the CBL to develop specialist skills in model validation and back-testing
- The Basel II Standardised approach is most appropriate for domestic deposit-taking institutions, combining quantitative standards similar to Basel I with the other key elements of Basel II—Pillar 2, supervisory review, and Pillar 3, disclosure
- Adopting the Basel III capital definitions is beneficial for harmonisation across the region, but in the absence of a market for subordinated debt or hybrid capital instruments will have limited practical impact on local institutions.

237. Adopting the Basel III standards for the liquidity coverage ratio and net stable funding ratio offers the opportunity to contribute to harmonisation across the region, and at the same time revisit the current liquidity standard, which may be unnecessarily restrictive. Development and introduction of the new liquidity standard will be done in consultation with the SARB for consistency in application and phase-in periods.

Insurance and Pension Supervision

238. The CBL will be responsible for pension supervision once the required legal foundation is enacted. The commonalities between pensions and insurance suggest that a combined Insurance and Pension Division would be the most appropriate organisational structure. In addition to insurance companies and pension funds, the CBL will be responsible for oversight of brokers, agents, advisors and related service providers.

239. The most pressing issues are the completion of the legal framework for pensions, and the modernisation of the framework for insurance. The CBL has limited capacity to effectively supervise the insurance industry, and prospectively, the pension sector. This will be addressed through a combination of training and technical assistance to build capacity, and through recruitment of staff with insurance and pension expertise.

Non-Bank Supervision

240. The CBL will finalise its approach to NBFI oversight reflecting appropriately graduated regulatory and supervisory requirements. This will result in the dissemination of the CBL's policy guidance, and issuance of the non-bank regulations pursuant to the FIA. Non-bank deposit taking institutions will be subject to a bank-like regime, reflecting the special nature of deposit-taking, and supervised by the same CBL division responsible for banks. The regime will be adjusted as required to reflect the cooperative ownership of SACCOs, and to tailor requirements to the smaller size of non-bank deposit-takers. Requirements for other non-bank institutions will focus on registration, reporting and consumer protection, recognizing that prudential requirements are only required to protect depositors or the stability of the financial system.

241. Moneylenders are at present not subject to the FIA. Once the Financial Institutions (Credit Only and Deposit Taking Microfinance) Regulations 2013 have come into force, the Moneylenders Act will be repealed. Thereafter, moneylenders will be licensed as credit only microfinance institutions, and potentially as deposit taking microfinance institutions. The CBL will set a threshold, probably based on asset size, below which moneylenders will be exempted from the FIA provided that they are members of a self-regulatory apex association that will effectively monitor lending practices.

242. Credit only microfinance institutions would normally be subject to market conduct regulation only, although section 9(2) of the FIA requires that such an institution shall have a minimum core capital to be set by the CBL. The CBL will use this power to encourage credit-only institutions to establish the apex noted above, by establishing a two-tier minimum capital requirement. All those with capital less than the specified higher tier would be required to be members of the self-regulating apex. Due to the minimum capital requirement, moneylenders wishing to become microfinance institutions will need to become a company.

Policy Actions-Supervision
• **Consolidate supervision of all deposit-taking institutions in one division** • **Implement bank supervision recommendations from IMF technical assistance** • **Establish by regulation a Prompt Corrective Action regime** • **Introduce Basel II capital adequacy regime tailored to the local market** • **Adopt Basel III capital definitions and requirements** • **Adopt Basel III liquidity standards** • **Build insurance and pension supervisory capacity through training and recruitment** • **Finalise and disseminate the CBL policy guidance on non-bank supervision** • **Exempt moneylenders from the provisions of the FIA provided they are members of a self-regulating apex organisation and repeal the Moneylenders Act**

D. Financial Safety Net

E. Financial Safety Net

243. Effective response to distress in an individual institution or in the financial sector more broadly requires a financial safety net, typically comprising effective supervision, central bank liquidity support, a special resolution framework for financial institutions, and depositor protection. The safety-net elements not currently in place in Lesotho will be addressed, bearing in mind the need to minimise the resources and institutions required to meet the needs of a small economy and financial sector.

CBL Liquidity Support

244. The CBL will develop a new liquidity facility for banks designed to meet an extraordinary need that might arise in a crisis. While the banking sector historically has been very liquid, should a crisis arise it would be desirable to have an additional tool to permit a solvent bank to borrow from the CBL even if it had exhausted its holdings of security acceptable for the standing intraday and overnight facilities. The CBL will develop the terms and conditions for this facility and pre-position itself and the banks for a crisis by preparing the documentation in advance, and having "shelf" agreements with each bank ready for execution should they be required.

Resolution Frameworks

245. The current legal framework for resolution of troubled financial institutions will be revised. The provisions for intervention and resolution in the FIA and Insurance Bill both fall well short of the international standard established by the Financial Stability Board, and the Cooperative Societies Act provides virtually no basis for serious supervisory action. There are alternative approaches such as establishing separate legislation or including the resolution regime in a deposit insurance statute, but it is more appropriate for Lesotho to minimise the need for new legislation and institutions by introducing the required powers through the respective

financial institutions legislation. Thus, as part of the broader review of the FIA, an appropriate new part will be added to provide the necessary suite of powers to intervene in, and if necessary impose a resolution on a failing institution.

246. The new part of the FIA will be modelled on the 2009 revision of the United Kingdom Banking Law, with appropriate modifications to align with the existing legal framework. Similarly, after enactment the Insurance Bill will be revised to provide parallel powers for the resolution of insurance companies, as part of the medium term project to bring the law into alignment with the modern regime prescribed in the International Association of Insurance Supervisors Insurance Core Principles. The planned new financial cooperatives statute will include resolution powers for small financial cooperatives.

Deposit Insurance

247. In line with the commitment in the NSDP to introduce deposit insurance, a scheme appropriate for Lesotho's financial sector will be developed. The deposit insurance agency will have a narrow mandate limited to collecting premiums, managing the fund and making payments should they be required due to failure of an institution. Coverage will include all deposit-taking institutions licensed and supervised by the CBL. Providing coverage for deposit-taking microfinance institutions, should any be licensed, will help them to compete against the incumbent banks that may be viewed as too big to fail and thus inherently safer than other deposit-taking institutions. The deposit insurance function will be domiciled in the CBL, recognizing the cost efficiencies relative to building a fully-fledged deposit insurance agency.

Policy Actions-Financial Safety Net
• **Develop a new CBL extraordinary liquidity facility for crisis management** • **Pre-position "shelf" agreements with all banks to facilitate use of the new liquidity facility** • **Introduce a special resolution regime in the FIA** • **Introduce a special resolution regime in the Insurance Act** • **Provide remedial powers including a special resolution regime for small financial cooperatives in a new Financial Cooperatives Act** • **Introduce a narrow-mandate minimally resourced deposit insurance scheme to be domiciled in the CBL**

F. Strengthening the Legal Framework for Financial Institutions and Markets

248. A steering group for financial sector law reforms will be established, linking the Cabinet Office, the Attorney General, OPC, and the Ministry of Law. Representatives nominated by the Chief Justice and the Ministry of Justice will join the steering group where related judicial reforms are under consideration. The steering group will have the responsibility to set legislative priorities, to consider proposals for judicial reforms, and to monitor progress. The steering group will also require that the

sponsors of new legislation confirm that bills are not inconsistent with cross-border trade in services commitments. The steering group will be supported by the FSDS Secretariat, which will coordinate provision of technical assistance including legal drafting support. In this way, there will be a two-way flow of information on the overall financial sector strategy program and the supporting legal reforms.

249. Addressing the remaining gaps in the legal framework for the regulation and supervision of the financial sector is a high priority. Generally this will follow a two stage process. In most cases the priority will be on enacting legislation currently in an advanced stage of development, followed in the medium term by revision of this legislation to address a range of identified issues. This reflects the views of stakeholders who have clearly indicated a preference for prompt enactment of an improved legal framework over further, possibly lengthy, delay to incorporate further amendments.

250. The CBL already has a team working on phase two with respect to the FIA. In addition to correcting a number of drafting errors identified since the enactment of the FIA, the team will solicit input from stakeholders on further amendments to the FIA that might be desirable in light of the experience to date with the legislation, and will coordinate preparation of the additional amendments required for implementation of the FSDS. These include:

- Establishing a new licensing category to accommodate e–money providers
- Providing similar treatment for agency networks as is currently afforded MNO agency networks
- Revising Section 23 to accommodate Basel III capital definitions
- Clarifying the meaning of large financial cooperatives
- Amending the minimum core capital requirement for large financial cooperatives to recognise impaired capital
- Clarifying that cooperatives may not accept deposits from non-members
- Removing restrictions on the forms of security for credit that may be taken by financial cooperatives
- Providing that the CBL may impose a code of conduct for consumer protection
- Providing for a special resolution regime.

251. In addition, depending on the results of stakeholder consultation, amendment to the FIA may be required to accommodate retail payments as the SADC model payments law, to which the draft PSB conforms, does not specifically address retail payments.

252. The CBL will require similar teams for the planned medium term revisions to the Insurance Act, and Payment Systems Act, as well as for completion of the Pensions Bill.

Policy Actions-Strengthening the Legal Framework

- **Establish steering group for financial sector law reform**
    - **Obtain legal drafting support for OPC, CBL and Ministries responsible for financial sector laws and regulations**
- **Enact bills currently in an advanced state**
    - **Payment Systems Bill**
    - **Public Debt Management Bill**
    - **Insurance Bill**
- **Enact regulations for Acts in force**
    - **Financial Institutions Act**
    - **Data Protection Act**
    - **Credit Reporting Act**
    - **Identity Cards Act**
- **Review, revise and enact outstanding financial sector legislation**
    - **Pension Bill**
    - **Social Security Bill**
- **Draft new legislation and repeal or amend related legislation**
    - **Financial Cooperatives Bill**
    - **Secured Transactions Bill and repeal the Hire Purchase Act**
    - **Insolvency Bill and repeal the Insolvency Proclamation and consequent revisions to related legislation**
- **Medium term revision to legislation in force or to be enacted**
    - **Financial Institutions Act**
    - **Insurance Bill**
    - **Payment Systems Bill**
- **Repeal the Moneylenders Act**

VI. IMPLEMENTING THE FINANCIAL SECTOR DEVELOPMENT STRATEGY

253. Commitment at the highest level is required to address the challenges of implementation. Phase I of the FSDS, to be completed in 2014, focuses on putting the required implementation and monitoring structure in place.

254. Following approval by Cabinet of the FSDS, Cabinet will receive quarterly progress reports from the FSDS Implementation Committee. The FSDS Implementation Committee will be chaired by the Principal Secretary (PS) MoF. Recognizing the important link between the FSDS and the NSDP, which is the responsibility of the Ministry of Development Planning (MDP), the vice-chair of the Implementation Committee will be the PS MDP. Other members of the Implementation Committee will be the Governor of the CBL, PS MTICM, and PS Ministry of Law.

255. Designation of senior level champions for each of the 34 policy action topics will create individual responsibility and accountability. The output-based matrix contained in this chapter identifies all of the institutions involved in completing each set of policy actions, with the institution responsible for providing the champion highlighted in bold type. The responsible institution is required to designate an individual as champion, who will be in charge of planning and implementing an appropriate work program to achieve the objectives of the policy actions. The

necessary resources will be provided by the involved institutions, with provision of technical assistance and other external resources as may be arranged through the FSDS Secretariat. The champion will report quarterly to the FSDS Secretariat, which will roll up these reports to produce a quarterly overview of progress against the expected outputs, as well as for ongoing dialogue with those responsible for implementation.

256. The detailed action matrix contained in Appendix II is a tool to be used by the individual champions to identify and sequence the various actions required, serving as the foundation for the work programs required to achieve the expected output. It will also be used by the FSDS Secretariat to monitor progress based on quarterly reporting by the relevant champion. As work on the policy actions progresses, it will be necessary to revise some action plans in light of experience and on-going developments. When these result in material changes—actions deleted, added, changes in timing or sequence, or significant amendments—for any of the sets of action plans, the resulting revised work program will be provided to the FSDS Implementation Committee to obtain approval for the change.

257. The composition of the FSDS Secretariat is intended to facilitate coordination and cooperation among the Ministries and agencies. Conceptually the FSDS is a limited-life project management team, whose mandate will expire at the conclusion of the FSDS planned for 2017. It will comprise a small core group of officials, who will be supplemented by resources expected to be provided through donor support for one or more long term advisors, and short term technical experts to address specific policy topics. The provision of donor supported technical assistance will be especially crucial to the CBL, which is responsible for the majority of the policy actions under the FSDS.

258. The Technical Secretariat will be housed at the CBL. Reflecting its project management responsibilities and the importance of FSDS implementation, the Technical Secretariat will report on a day-to-day basis directly to the Governor of the CBL while being accountable to the Implementation Committee for the discharge of its ongoing monitoring, support, gatekeeping and quality control functions.

259. The FSDS Secretariat will fulfil several important functions. It will monitor and report progress to the Implementing Committee based on ongoing liaison with the various champions. It will also take a lead role in preparing draft policies on cross-cutting issues such as pensions, and coordinating the participation of multiple stakeholders in forums such as the steering group for legal reforms.

260. The Implementation Committee closely supported by the FSDS Secretariat will coordinate the seeking of donor funding and technical assistance for all financial sector related projects. Experience suggests there will be significant donor support, however priority actions will be financed through the budget rather than being abandoned for lack of donor support. Donor funding will be sought to support the FSDS Secretariat, including retention of short-term and long-term advisors to provide specific expertise.

261. The FSDS Secretariat will function as a gate-keeper to ensure all donor support for financial sector development is aligned with the FSDS. This will involve reviewing all project proposals and terms of reference for consultants to ensure focus on specific policy actions and expected outcomes. In light of experience, the FSDS Secretariat will also review all technical assistance deliverables before sign-off, providing an important quality control function that has not always been in place. With the Secretariat's expected technical capacity and detailed knowledge of the FSDS, this will help to avoid some of the problems with previous technical assistance projects:

- Failure to consider inter-related policy objectives
- Lack of coordination among related projects
- Recommendations unsuitable for Lesotho
    - New institutions without considering cost implications in a small economy
    - Failure to consider the regional context and options
    - Laws and regulations inappropriate in the context of Lesotho and its laws, or failure to consider interaction with other existing or planned laws

A. Required Resources—Phase I

262. The FSDS Secretariat is crucial to effective implementation and monitoring. It will comprise a head and three professional staff, with accommodation and support services provided by the CBL. Reflecting the limited life nature of the Secretariat—three years from inception in 2014 through the 2017 planning horizon of the NSDP—consideration will be given to staffing the Secretariat through contractual appointments or by personnel detached or seconded from the Ministries and agencies responsible for FSDS implementation. As the 2017 sunset of the NSDP approaches, FSDS progress will be assessed with a view to determining how best to follow-on, and whether a continuation of the Secretariat is desirable.

263. The head of the FSDS Secretariat ideally will be an individual with considerable knowledge of financial sector development issues and the broader NSDP planning process, combined with senior level management experience commensurate with the project management mandate. Familiarity with government processes, particularly development of policy papers and legislation is essential.

264. One of the key tasks of the Secretariat is supporting the work of the Steering Group for financial sector law reform. Thus, one of the Secretariat staff should have significant experience with development of legislation and regulation in Lesotho. The other staff would ideally have technical expertise in one or more of the key policy areas of the FSDS.

265. The small core professional staff of the FSDS Secretariat will be supplemented as required by experts engaged for specific topics. Donor support will be solicited to supplement available budget funds to ensure that the Secretariat is able

to provide the individual project champions with the technical assistance required for completion of each project action.

B. Implementation—Phase I

Policy Action Topic	Outputs	Completion Date	External Resources	Responsible Agencies*
Implementing the FSDS	1. Cabinet Approval	1. Dec. 2013	No	**CBL,** MoF
	2. FSDS Implementation Committee established	2. Jan. 2014	No	**Cabinet**, CBL, MDP, MoF, MOAFS, MoLG, MTICM
	3. Steering Committee for financial sector legal reform established	3. March 2014	No	Cabinet Office, Attorney General, **MOL**, OPC, CBL
	4. Champions designated for each Policy Action Topic	4. June 2014	No	As designated
	5. FSDS Secretariat established	5. June 2104	Yes—TA support to FSDS Secretariat	Implementation Committee
	6. Quarterly progress reports to Cabinet	6. March 2014 and ongoing	Yes-TA support to FSDS Secretariat	Cabinet, Implementation Committee, **Secretariat**

*Agency in bold responsible for providing the topic champion.

C. Financial Inclusion

Policy Action Topic	**Outputs**	**Completion Date**	**External Resources**	**Responsible Agencies***
Financial Inclusion	1. Completed small enterprise study 2. Finscope 2015	1. 2016 2. 2016 (report)	Yes—TA Yes—TA	MoF, **MTICM**
Financial Literacy	1. MoF coordinating all donor-sponsored financial literacy initiatives 2. Financial literacy baseline complete 3. Financial literacy strategy complete 4. Financial literacy implementation study complete	1. Dec. 2013 and ongoing 2. June 2014 3. Dec. 2014 4. March 2014	No Yes—TA Yes—TA Yes—TA	**MoF,** SUFIL, RUFIP
Support for SME Financial Inclusion	1. LNDC sole manager of Government partial guarantee 2. Increased number of BEDCO trained entrepreneurs 3. MOU between LNDC and BEDCO	1. Dec 2014 2. June 2015 and ongoing 3. Dec. 2014	No Yes—TA No	**MTICM**, LNDC BEDCO LNDC, BEDCO
Mortgages of Land	1. Electronic land register operational 2. Simplified mortgage enforcement and eviction procedures in place 3. Review of stamp duty and transfer fees on land transactions completed	1. June 2014 2. Dec. 2014 3. Dec 2014	No No No	**LAA** **Commercial Court** **MoF,** LAA
Security Over Moveable Property	1. Policy on secured transactions completed 2. Bill submitted for cabinet consideration 3. Moveable property register operational 4. Guidelines issued for licensing of leasing business	1. Dec. 2014 2. June 2015 3. June 2016 4. June 2014	Yes—TA Yes—TA Yes—TA No	**MTICM,** CBL **MTICM** **MTICM** **CBL**
Court Enforcement of Creditor Rights	1. Study of reforms to the sheriff and messenger services completed 2. Option for party service of proceedings introduced and expanded role in execution of judgements in place	1. June 2014 2. Sept. 2014	Yes—TA No	**Ministry of Justice,** High Court **Ministry of Justice,** High Court
Insolvency	1. Policy on new insolvency regime completed 2. Bill submitted for cabinet approval	1. June 2015 2. Dec 2015	Yes—TA Yes—TA	**MTICM,** CBL **MTICM,** CBL

Policy Action Topic	**Outputs**	**Completion Date**	**External Resources**	**Responsible Agencies***
Increasing Commercial Bank Participation	1. Bank reporting revised to include financial inclusion data (part of broader revision to reporting) 2. Quarterly report on progress against banks' informal targets for financial inclusion	1. March 2015 2. June 2015	No No	**CBL**, Bankers Association **CBL**
Strengthening LPB	1. MoF established as sole representative of the shareholder 2. Board of independent directors appointed 3. Strategy and business plan adopted	1. June 2014 2. Sept. 2014 3. Dec. 2014	No No Yes	**MoF**, MoCST **MoF** **LPB,** MoF
RSCG and VSLAs	1. District-based agricultural extension officers responsible for monitoring and advising RSCGs and VSLAs 2. Training provided for district extension officers	1. March 2014 2. Sept. 2015	No Yes—TA	**MOAFS** **MOAFS,** SUFIL
SACCOs	1. Draft Financial Cooperatives Bill submitted to Cabinet 2. Regulation issued to exempt SACCOs with less than M5 million in deposits from the FIA 3. MOU between DOC and CBL defining roles, responsibilities and coordination mechanisms 4. Diagnostic audit of largest cooperative completed	1. March 2015 2. March 2014 3. March 2014 4. March 2014	Yes—TA No No Yes—TA	**DOC** **CBL** **CBL, DOC** **DOC**
Housing Finance	1. Stamp tax on long term deposits removed	1. March 2015	No	**MoF**
Agricultural Finance	1. Commercial agricultural survey completed 2. All district and rural-based financial literacy training coordinated through agricultural district extension offices 3. Financial literacy officer in place in all 10 district agricultural extension offices 4. Training provided to Chief Extension Officers and financial literacy officers 5. Crop insurance feasibility study complete	1. March 2015 2. March 2015 3. March 2015 4. Sept. 2015 5. March 2016	Yes-TA Yes-TA No Yes—TA Yes—TA	**MOAFS** **MOAFS,** SUFIL **MOAFS** **MOAFS,** SUFIL **MOAFS**

Policy Action Topic	Outputs	Completion Date	External Resources	Responsible Agencies*
Mobile Money	1. Revised Mobile Money Guidelines issued for non-banks 2. Mobile Money Guidelines issued for banks and non-bank MNOs, providing a level playing field 3. Three sets of Guidelines revised as necessary and issued as Directives under the Payment System Act 4. MOU in place regarding financial services provided by MNOs 5. Study completed of cost-benefits of moving welfare and related payments to a mobile money platform	1. Dec. 2013 2. June 2014 3. Sept. 2014 4. Mar. 2014 5. March 2015	No No No No Yes—TA	**CBL** **CBL** **CBL** **CBL,** LCA **MoF**
Agency Networks	1. FIA requirements for agency banking amended to parallel the agency requirements for MNOs (part of broader FIA amendment project)	1. March 2015	Yes—TA—drafting support	**CBL**
e-Money Accounts	1. New licensing category established in FIA to accommodate e-money providers (part of broader FIA amendment project)	1. March 2015	Yes—TA—drafting support	**CBL**
Micro-insurance	1. Specific licensing category established for funeral insurance (part of broader Insurance Act amendment project)	1. Sept. 2015	Yes—TA—drafting support	**CBL**
Credit Reference Bureau	1. Credit Reporting Regulations issued. 2. Standardised reporting and database formats, and communications for CRB implementation agreed	1. Dec. 2013 2. March 2014	No Yes—TA	**CBL,** MoF, OPC **CBL,** CRB users, CRB

*Agency in bold responsible for providing the topic champion.

D. Mobilising Resources and Promoting a Savings Culture

Policy Action Topic	Outputs	Completion Date	External Resources	Responsible Agencies*
Consumer Protection	1. Code of sound practices for consumer protection adopted by financial institutions 2. Study completed of options to establish a financial ombudsman	1. Dec 2014 2. March 2016	No Yes-TA	**CBL**, Bankers Association, DOC, financial institutions **MTICM**
Capital Market Development	1. Government debt issuance resumed on pre-announced schedule of regular benchmark issues	1. Dec 2014	No	**MoF**
Insurance	1. Insurance Bill enacted. 2. Medium term Insurance Act amendment project completed—amendments enacted. 3. Review of MVA scheme complete.	1. March 2014 2. Sept 2015 3. March 2015	No Yes—TA—policy and drafting Yes-TA	**CBL** **CBL** **Ministry of Transport**
Pensions	1. National Pension Policy complete 2. Policy for development of private pensions complete 3. Draft pension bill submitted to Cabinet 4. Revise draft Insurance Bill to establish annuities as a separate class of business 5. Draft NSSA revised in light of National Pension Policy	1. March 2015 2. Sept 2015 3. Dec. 2016 4. Dec. 2014 5. Dec. 2016	Yes—TA Yes-TA Yes-TA Yes-TA-drafting assistance Yes-TA	**CBL,** MoF, Ministry of Social Security **CBL**, MoF **CBL**, MoF **CBL** **Ministry of Social Security,** MoF, CBL

*Agency in bold responsible for providing the topic champion.

E. Improving Efficiency—The Payments System

Policy Action Topic	Outputs	Completion Date	External Resources	Responsible Agencies*
Payments Regulation and Oversight	1. Payment System Bill introduced in Parliament 2. Implementing regulations enacted 3. Bills of Exchange Act reviewed and revised for consistency with modern payments methods	1. Dec. 2013 2. March 2104 3. June 2015	No Yes-TA Yes-TA	**CBL** **CBL** **CBL,** MOL
High Value Payments	1. All participants abiding by payment system rules.	1. Dec 2013	No	**CBL**, MoF
Clearing Systems	1. ACH procured and operational 2. Operation of the ACH transferred to PAL	1. Dec 2014 2. Dec 2015	No No	**CBL**, PAL **CBL**, PAL
Retail Electronic Payments	1. Study complete and policy decision taken on regulating retail payments under the FIA, Payment Systems Act, or new legislation	1. Dec. 2014	Yes-TA	**CBL**
Card Transactions Switch	1. Cost-benefit analysis of various options completed.	1. Dec. 2014	Yes-TA	**CBL**
Cross-Border Remittances	1. Survey of cross-border remittance market completed	1. March 2015	Yes-TA	**CBL**

*Agency in bold responsible for providing the topic champion.

F. Financial Stability and Soundness

Policy Action Topic	Outputs	Completion Date	External Resources	Responsible Agencies*
Financial Stability	1. Financial Stability Unit established 2. Composition, mandate and operating guidelines of the Financial Stability Council finalises	1. Dec 2013 2. March 2014	Yes-IMF TA Yes-IMF TA	**CBL** **CBL,** MoF
CBL Strategic Plan	1. New strategic plan through 2016/17 completed	1. March 2014	Yes-TA	**CBL**
CBL Supervision	1. Supervision of all deposit-taking institutions consolidated in one division 2. PCA regime introduced by regulation 3. Basel II and III capital adequacy regime introduced 4. Policy Guidance and NBFI Regulations in place	1. March 2014 2. March 2014 3. March 2015 4. Dec 2013	No Yes-TA Yes-TA Yes-TA	**CBL** **CBL** **CBL** **CBL**
Financial Safety Nets	1. New extraordinary liquidity facility in place 2. Special resolution regime introduced in FIA (part of broader FIA amendment project) 3. Special resolution regime introduced in the Insurance Act (part of medium term amendment project) 4. Remedial powers including special resolution regime provided in new Financial Cooperatives Act	1. March 2015 2. March 2015 3. Sept. 2015 4. March 2015	Yes-TA Yes-TA Yes-TA Yes-TA	**CBL** **CBL** **CBL** CBL**, DOC**

*Agency in bold responsible for providing the topic champion.

APPENDIX I—IMPLICATIONS OF NEGOTIATIONS ON TRADE IN SERVICES

Lesotho is already a member of various regional and international trade agreements covering trade in goods – including the Southern African Customs Union (SACU), the SADC Free Trade Area (SADC FTA) and the World Trade Organisation (WTO). As a result there are few restrictions on the import and export of goods, and there is largely equal treatment between domestic and foreign firms involved in the production of goods.

Trade agreements are now being extended to included trade in services, as well as goods. Those that are relevant to Lesotho include the SADC Trade in Services Protocol, and the Economic Partnership Agreement (EPA) between (some) SADC countries and the European Union. An interim EPA has been initialled by Lesotho, pending the finalisation of the full EPA.

The EPA covers trade in goods and services, and has a number of implications for Lesotho and other signatories. Under the EPA, each SADC country has to put forward six service sectors to negotiate the basis for trade liberalisation in that sector between the country and the EU. Lesotho, like several other SADC countries, has nominated financial services as one of the six service sectors to be liberalised. Although the final arrangements for trade liberalisation in the sector are still to be negotiated, there are already significant implications, including:

- any existing restrictions on market access (for foreign service providers) need to be scheduled (notified);
- the Standstill Clause in the Interim EPA (Article 67) signed in 2008 means that after that time, no further restrictive measures (in terms of market access or national treatment) can be introduced in banking, or in financial services more generally;
- any legislation under review or being drawn up should factor in the likely demands for liberalisation under the full EPA when it is eventually signed.

The specific activities or proposals that need to be reconsidered in the light of these commitments include:

- The proposal (in the draft Insurance Bill) to restrict the placing of insurance business outside of Lesotho, (unless it has been shown that no Lesotho insurer can offer the cover required); this would include pension annuities;
- The proposal (in the draft Pension Policy) to prohibit provision of pension services by asset managers, administrators, intermediaries or any entity (person) that is not incorporated in Lesotho and licensed by the regulator;
- The proposal (in the draft Pension Policy) to require administrators and asset managers to have a local shareholding of at least 30 % initially
- There may also be problems with any Local Asset Requirements for pension funds and insurance companies, not least because restrictions on investing in rand-denominated assets cannot be justified on the basis of prudential regulatory requirements (given that there is no exchange rate risk).

Financial services is also one of the six priority sectors scheduled for negotiation under the SADC Trade in Services Protocol. Negotiations began in August 2012 and are scheduled to be completed within three years. The objective is to “progressively negotiate removal of barriers to the free movement of services”. It is likely that this will also lead to the removal of restrictions on cross-border trade in financial services within SADC in a similar manner to the SADC-EU EPA provisions.

The General Agreement on Trade in Services (GATS) defines four “modes of supply” for cross-border trade in services. The definition of these modes, how they relate to financial services, and the likely conflicts emanating from proposed Lesotho financial services legislation, is shown in the tables below.

GATS Modes of Supply – Trade in Services

Mode	Criteria	Supplier Presence	Example
Mode 1: Cross-border supply	Service delivered within the territory of the Member, from the territory of another Member	Service supplier not present within the territory of the member	Local pension fund hires services of foreign asset manager Resident buys insurance outside the country against a risk inside the country
Mode 2: Consumption abroad	Service delivered outside the territory of the Member, in the territory of another Member, to a service consumer of the Member		Resident has an account at a foreign bank
Mode 3: Commercial presence	Service delivered within the territory of the Member, through the commercial presence of the supplier	Service supplier present within the territory of the Member	Foreign financial service provider (e.g. insurer, bank, asset manager) establishes an operation within the country
Mode 4: Presence of a natural person	Service delivered within the territory of the Member, with supplier present as a natural person		(Individual) agent of foreign insurance company sells policies to residents
Note: Adapted from the document MTN.GNS/W/124, available on the World Trade Organisation Website. Source: http://en.wikipedia.org/wiki/General_Agreement_on_Trade_in_Services, accessed 16th May, 2013			

Examples of Existing or Proposed Restrictions on Trade in Financial Services

Restriction	**Mode of Supply**	**Market Access or National Treatment**
Pensions		
Resident pension fund cannot employ a foreign service provider (e.g. asset manager or administrator)	Mode 1	MA
Foreign asset manager cannot operate in Lesotho without being licenced by CBL	Mode 3	MA
Foreign asset manager must establish a local subsidiary and have at least 30% local ownership	Mode 3	NT
On retirement, a Pension fund member has to buy an annuity from a local insurer and cannot buy from a foreign insurer	Mode 1	MA
Insurance		
Resident using a broker to place insurance has to use a domestic broker	Mode 1	MA
Broker cannot place insurance with a foreign (non-resident) insurer without permission of CBL	Mode 1	MA
Foreign insurer cannot sell insurance in Lesotho without being licenced by CBL and establishing an office in Lesotho.	Mode 3	MA
Foreign agent of a foreign insurer, or a foreign broker, cannot sell insurance in Lesotho without being licenced by CBL and establishing an office in Lesotho.	Mode 4	MA

APPENDIX II—POLICY ACTION MATRIX