TANZANIA BANKERS ASSOCIATION

FINANCING SOLUTIONS TO CONTRACTING INDUSTRY CHALLENGES

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1.0 Background:

The primary function of banks the world over is to play an intermediation role i.e., to collect funds (through borrowing) from surplus households and invest the funds (through lending among others) to deficit units. In this way, banks are considered the harbinger or buttress of economic development of any country.

Tanzania embarked on fundamental transformation of its economy almost two decades ago. Not surprising, top on the agenda in the economic reforms was the need to overhaul the financial system. In view of pivotal role it plays in the country's economy, the banking sector was the first to undergo reforms. Implementation of the reforms followed recommendations of the Presidential Commission on the need to modernize the banking sector dubbed the "Nyirabu Commission". The Commission recommended inter alia enactment of modern legislation to regulate banking business in a liberalized market. Consequently, the Banking and Financial Institutions Act, 1991 was enacted. In 1995 the bank of Tanzania Act was enacted to replace a previous legislation that was enacted in 1965. After almost 15 years of experimenting, the two legislations were repealed and replaced in 2006.

The two laws referred to above are supplemented by a number of regulations the most important ones in this context are the Concentration of Credit and Other Exposure Limits as well as the Management of Risk Assets. On this score, all banks are duty bound to comply with the dictates of the two laws and regulations as well as directives given by the Bank of Tanzania – the regulator. Failure to comply attracts penalty such as fine, disqualification of directors and officers involved and in extreme situation, withdrawal of the banking license.

Following the liberalization of the banking sector in 1991, the country has witnessed a number of both local and foreign banks being established in the country. To-date, there are 33 banks operating in the country. This figure does not compare favourably with neighbouring countries such as Kenya (78) and Uganda (46). On the upside, Tanzania has the lowest incidences of bank failure in the region (only three) since 1991 which implies that the banking sector in Tanzania has matured and is resilient to shocks.

2.0 Access to Finance:

One of the challenges facing the Tanzania banking sector is the perennial complaint about the inaccessibility of financial products to the productive sector. Recent statistics released by a credible institution indicate that only 6% of Tanzanians (both retail and corporate) have bank accounts. On the other hand credit is available to only 3% of the population! As a result of this financing gap, businesses including contractors have resorted to other but expensive financing sources.

3.0 Relationship between Banks and Contractors:

Contractors play crucial role in the economic development of a country. In order for a contractor to successfully perform this role, he needs to create, nurture and maintain close relationship with his banker. It is very unfortunate that this is not always the case with developing economies like Tanzania.

It is the objective of this presentation to identify (from the bankers' perspective) some of the challenges facing contractors in accessing finance. It is our view that after identifying the challenges we will then attempt to reflect on appropriate financial solutions.

As mentioned earlier, were all in agreement as to the importance of contractors in the economic development of a country. For instance, the construction boom we are currently witnessing is clear indication of the emergence of a middle class in our society. This class has both the appetite for and propensity to invest for the future. In GDP terms this group has significant contribution. Moreover, the mini-revolution that is happening in the industrial sector is another clear indication of the evolution of the contractors' business.

4.0 Current Products offered by Banks:

At the moment, banks in Tanzania offer very limited range of financial products to contractors. The following are some of the vanilla type of products:

- Bid bond
- Performance Guarantee
- Advance payment guarantee
- Over draft facility
- Term loan

Bid bond usually is applied by a contractor during the process of submitting bid documents. One of the common experiences in the banking industry is that such request is brought "under a certificate of emergency" i.e., at the latest hour. This problem is prevalent in all classes of contractors and bankers are yet to discover the reason!

Performance bond is a bank guarantee given to a third party (employer of the contractor) that the contractor (customer of the bank) will complete a specified contract and will fulfil its terms.

Advance payment bond refers to a guarantee given by a bank to a third party securing advance payment made by the said third party.

Over draft facility refers to credit facility granted to a contractor (customer of the bank) through a cheque account in which the account is allowed to go into debit to a specified limit (over draft limit). Interest is charged daily on the debit amount. This

facility is suitable for short-term or working capital requirement. It is cheaper than term-loan because in the latter, interest accrues on the entire loan amount.
Term Loan is credit granted to a customer on condition that it is repaid in instalments or all at once on a given date at an agreed rate of interest. Tem loans are used to finance capital investment or item of a long-term nature.

As it can be noted from the definition of the typical financial products available to contractors, relationship is **key.** Bank-customer contract is founded on a relationship which in turn creates "track record". In sum, a banker needs both comfort and audit trail of its customer's performance and such comfort is reflected in the customer's account turnover. The turn over is evidenced by bank statements. It is for this reason banker's are hesitant to advance credit or any form of accommodation to a customer without or with very little account history with that bank.

In the same token, bank-customer relationship referred to above will be harmed if a customer decides to maintain relationship with more than one bank. "Split banking" is preferred by customers who desire to "hide" their financial requirements. As a result, the primary bank ends up not having a complete picture of the financial performance of its customer. Disclosure of financial requirement is advantageous to the customer in that it enables the bank to leverage its costs by taking into account additional services it will give to a customer such as LC fees, guarantee charges etc. On the other hand, by preferring only one bank, the bank acting as financial adviser to the customer is in a better position to determine both the type and quantum of financial requirement of its customer. For instance, a customer who seeks to acquire plant and machinery may be advised to do a finance lease or term loan and not an over draft. Like wise, a customer may be either under or over funded or worse still wrongly funded (e.g., by a loan instead of equity).

One area that is still wanting in Tanzania is property finance through mortgage facility. The Land Act was amended in 2004 as a result of outcry from the banking industry that the law was an impediment to instead of creating an enabling environment in facilitating property development especially home ownership.

Notably, contractors in their capacity as property developers did very little to voice their concern. Perhaps the silence is attributed to the fact that contractors were not seen as crucial stakeholders in property development in Tanzania.

In a developed economy, property developers maintain very close business tie with banks. Banks play dual roles i.e., front office marketing/sales point and financier. Property developer (who in some cases is the contractor) holds ownership of the property. This synergy is yet to be developed in Tanzania due to a number of reasons including poor land delivery mechanism, inadequate legal system and lack of suitable funding base (long-term finance).

5.0 Contractors' Precarious Position:

Most contractors who approach banks for financing suffer from two strategic weaknesses. The first one is their inability to properly evaluate both the financial and management capacity of the employer. On the other hand, banks are renowned for the "thorough" or stringent procedure they use in evaluating a loan applicant. The same is not the case with contractors when applying for a job. As a result, once the contractor had secured a given project say with a local authority, he approaches a bank for financing. Inevitably, the bank will request for "financials" of the employer say, of the past three years. The second strategic weakness flows from the first. The contractor finds himself running from one financier to another ostensibly to attract financing within limited time oblivious of the banking requirements for important information. As a result of this rush, the contractor ends up missing the financing or accessing it very late thereby making him vulnerable to penalties.

Associated with the rushing for time is the problem of contractors submitting inadequate and sometime misleading information to his bankers. For, we should remember that despite the urgency in sourcing finance, banks as risk managers must make an informed credit decision. They cannot make that decision if information sought is not forthcoming or misleading information is given. Lack of proper information has resulted into delays by banks in arriving at a proper credit decision.

As a result, banks are blamed for delaying granting credit without examining the reasons causing the delay.

6.0 Lack of Capacity:

A quick survey of significant projects executed by contractors in Tanzania shows that major projects are awarded to foreign contractors. We are aware of the out cry by local contractors that they are not accorded with adequate attention by empowering them through "constructive preference". It must be said that big contractors have easy access to finance due to a number of factors such as management competence, adequate capital goods which act as security and favourable bank track record. For instance, a commercial bank (whose funding is mainly short term) is likely to favourably consider a financing request by a contractor Class 1 of a reputable international brand instead of a request by a contractor of similar class but who lack the three ingredients mentioned above.

The inherent weak position of local contractors is aggravated by competition (including undercutting) among themselves. Internal competition works to the benefit of giant contractors and who are foreign owned entities. It is our view that small and medium size contractors should always consider either merging or forming consortium that is capable of competing with the giant. The CRB should consider this aspect as one of critical importance if intends to lift the small contractor from the precarious position referred to above.

Lack of capacity should also be viewed in terms of the equity of the company. Construction companies the world over are funded both by shareholders funds and loan capital. As such, the company whose funding is predominantly bank finance is likely to become financially stressed because loan finance is costly compared to equity. The challenge under these circumstances is how a company can attract equity instead of bank finance? This is a one million dollar question with no easy answers. However suffice to say that there are known methods of raising equity through both private and public means.

7.0 Management Quality:

Management is the life line of any business. Experience in the banking industry shows that businesses managed by professionals of the industry involved are prone to troubles including inability to grow. For instance, not all engineers are good in human resources or financial management. Yet small and medium size contractors are managed either as family business or as one man show. When a company managed in this form approaches a bank for financing, the first question to be asked is the organisation structure of the company together with succession plan. The rationale behind this request by banks is for the purpose of determining the extent to which the company has underwritten the risk of management incompetence and those associated with one man's show such as sickness, death or intense family squabbles. It is important therefore that construction companies adhere to sound management principles and practices.

8.0 Security:

As was mentioned at the beginning, banking business is governed by the Banking and Financial Institutions Act, 2006, Bank of Tanzania Act, 2006 and regulations made thereunder. One of the regulatory requirements is that banks must demand security to cover for their advances or commitments (e.g., guarantees). The prudential threshold is that security must have value that cover 125% of the exposure. The 25% is intended to cater for interest that will accrue and legal costs. The regulations further provide for clean lending (up to 5% of the core capital) and partially secured lending (up to 10% of the core capital). There is also an aggregate ceiling to unsecured and partially secured facilities. Security is required as part of risk management. In other words, banks do not lend against security but on the soundness of the business to repay the loan i.e., cash flow lending. Security/collateral merely is a fall back position. Again, realization of security being a costly legal process is not favoured by bankers.

A number of contractors seeking financial accommodation from banks find themselves disqualified due to lack of or inadequate collateral. As a result, collateral requirement has now become one of the complaints levelled against banks. The typical security offered by contractors is landed property and plant and machinery. Landed property is charged through the creation of a mortgage whilst plant and machinery is charged by a debenture or chattel mortgage.

Demand for security to the small and medium size contractors is more pronounced than say to a first class international contractor. Whether a company should be granted unsecured or partially secured loan (even the type of collateral to be accepted) will depend of the financial and reputation standing of the company. For instance, a first class international contractor would view reputation damage as a very serious matter. Here it is relevant to mention that there are a number of cases where banks found themselves holding forged/duplicate registration cards of trucks and earth moving machinery owned by local contractors. Typically, it is common to find that the equipment involved has been offered as security to more than one bank. The underlying point here is that reputation damage is not held in high esteem by certain local contractors.

Integrity is the hallmark of trust bankers have on their borrowing clients. Unfortunately, once clouds of shadow start gathering, distasteful behaviour of some contractors has, more or less, pushed the cost of credit to the roof leaving behind a feeling that bankers are administering "collective punishment". For it must be remembered that access to finance is dependent on two drivers namely; cost of funds and risk premium. The risk attached to the collateral play a very important factor in restricting credit facility to contractors. The risk is further aggravated by costly and inefficient court system.

9.0 Finance Leasing:

Absent of finance leasing arrangement /product is one of the severe limitations for the acquisition of capital assets by contractors. The recently passed finance leasing bill to be accompanied by appropriate tax breaks will no doubt alleviate the problem of contractors being poorly equipped. In the absence of finance lease, contractors have resorted to expensive term finance and which had the effect of overloading company's balance sheets whilst creating a strain in their cash flows. This however is a subject that is being dealt with by another speaker to this conference.

10.0 What are the appropriate financing solutions?

The answer is not straight forward. Financial solutions vary from one person to another depending on financial requirement of each person. In general however, contractors require a combination of financial products. For instance, overdraft is imperative when working capital is required. On the other hand, finance leasing, equity or term loan or a combination of the two appears to be the most suitable financial product where acquisition of capital goods is required.

The most important factor to be borne in mind is the need by the contractor to fulfill all the conditions that would enable him to access the financing. Conversely, the contractor should be able to determine the type of finance that his business requires at a particular time and this demands him to establish a candid relationship with his banker in order to enable the later to arrive at an informed credit decision. Contractors should consider banks as their right hand men and not impediment to the success of their business.

Finally, contractors should recognize that they are now operating in a very different environment - a competitive environment - where no one owes anybody a living. To survive in a competitive market, contractors must properly equip themselves financially, organization-wise and in capacity terms so that they can deliver to the satisfaction of the client. A contractor who is always in default in his projects is likely to default in the obligations to his banker so is the contractor who is always applying for extension of time or one who is changing his banker the way we change our clothes.

Thank you!