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Could reduction of violations in forex market be a key to mitigate risks of the depreciation and devaluation of Malawi Kwacha?

By

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Abstract

The acute depreciation and devaluation of the Malawi Kwacha in the past ten years seems to stem out in part due to massive illegal externalisation of forex by unscrupulous business people aided by banks despite the existence of various Acts of Parliament and Reserve Bank of Malawi's Directives, Press Releases and Forex Trading Guidelines. There appears to be little willingness to severely punish the perpetrators as penalties meted out on wayward banks are not publicly disclosed and this is unsustainable as the rewards for mischievous behaviour seems to outweigh any penalties thereof. It is the local ordinary citizen who suffers from high prices of inorganic fertiliser and hence possibility of food insecurity, rising fuel prices and shortage of drugs in the hospitals. Now is time to act.

Type of Paper: Literature Review

Key words: Devaluation; Malawi; Violations; Forex

1.0 Introduction

This study was premised on the visible violations perpetrated by Malawian forex authorised dealers and their possible impact on depreciation and devaluation of the Malawi Kwacha against the major trading currencies with ripple effects on the local economy such as cost-push inflation, slow economic growth (recession) and waning investors' confidence.

Chikoti (2019) vividly describes the violations in Malawi forex market as follows:

[Reserve Bank of Malawi says it will not tolerate illegal foreign currency trading, forex externalisation transfer pricing manipulation and money laundering in the country.

… went on to say that several individuals who obtained foreign currency from banks and foreign exchange bureaus masquerading as travellers are also answering charges of obtaining foreign currency for one reason and using it for another.

… "Investigations and transfer pricing audits regularly carried out by the Malawi Revenue Authority have revealed that an amount equivalent to U$ 394.60 Million translating to approximately MK239.27 billion is suspected to have been illegally externalised through transfer pricing by several multinational companies operating in Malawi," he explained.].

The true scale of annual potential forex losses to

Malawian economy could be quite high as only transfer pricing violations have bee quantified. Perhaps issues of forex scarcity could not have surfaced if all participants in the forex market were acting in good faith. Chikoti (2019) describes the connotations of illegal externalisation of forex in Malawi to its economy:

[… According to …, Malawi just like any other African economy needs to build enough foreign exchange reserves to meet its strategic imports which include medicines, Fertiliser and petroleum products.].

It is therefore surprising how violations in forex market are tolerated when the consequences are dire to each and every citizen of Malawi. This study therefore undertook the following research objective:

a) Evaluate the role of authorised dealer in Malawian forex market.
b) Assess the adequacy of the statutory and contractual obligations on the activities of the authorised dealers.
c) Determine any remedial action to redress the violations in the forex market.

1.1 Role of authorised dealers in forex market

The role of commercial banks in the foreign exchange currency business is well documented in Malawi as they sell and buy forex, receive or send forex on behalf of clients through telegraphic transfers (TT) – as outlined in

Schedule 11 of Directive on Disclosure of Information By Banking Institutions (2010). Banks also give out forex loans or off-balance sheet financing in form of letters of credits, foreign guarantees, foreign exchange currency swaps, and foreign exchange currency forward agreements as outlined in the Banking (Foreign Currency Exposure Limits) Directive (2012).

Non-interest income derived from foreign exchange currency business is one of the major drivers for profit as averred by Kampanje (2012a)

[Bank industry profits have been extremely high in Malawi largely due to non-interest income from foreign exchange business - Lea and Hanmer (2009). Joint IMF-World Financial Sector Assessment Program (2008) noted collusion amongst banks on foreign exchange business thereby operating in an oligopoly economic system resulting in increase in cost of both importers and exporters cascading into higher prices for consumers and potentially lower exports.].

The oligopolistic tendencies stated above further complicates the macro economic environment of Malawi and it is therefore not surprising that there are several statutory provisions supported by a plethora of directives to sanitise the industry and these are discussed below.

2.0 Legislations and Directives

2.1 Legislation for foreign currency in Malawi

2.1.1 Banking Act 2010

The Banking Act 2010 scantly covers matters of foreign currency as this subject matter was discussed under section 23(ii) regarding the powers of the Registrar of Financial Services in the issuance of appropriate directives to restrict or prohibit the bank's uncovered positions in foreign currency including in excess of specified limit. Meanwhile, section 38(e) empowers the Registrar to issue and amend directives regarding foreign assets and liabilities. Definition of foreign currency is not provided for in the Banking Act 2010.

2.1.2 Financial Services Act 2010

The Financial Services Act 2010 does not define foreign currency and does not include Foreign Exchange Act as part of the financial service law. Section 2(m) of Financial Services Act however stipulates that a financial institution is any person who by way of business in Malawi, buys or sells from; sells or lends foreign currency to; or exchange foreign currency with a person other than the Reserve Bank. This section mirrors section 10(1) of the Exchange Control Regulations.

2.1.3 Exchange Control Act

Section 2 of the Exchange Control Act 1989 provides the following definitions:

- Foreign currency means any currency that is not or payable or expressed otherwise than in, Malawi currency.
- Foreign exchange means foreign currency and foreign securities. Foreign securities include:
    - any securities the principal of or interest from which is repayable or payable in any country other than Malawi or in a foreign currency;
    - any securities in respect of which the funds necessary for the repayment of the principal or the payment of the interest are provided from any country other than Malawi;
    - any securities that are registered outside Malawi;
    - any security, debt or right which may be prescribed under section 3 for the purposes of this definition.

Securities includes stocks, shares, bonds, debentures, debenture stock, unsecured notes transferable or negotiable deposits, treasury bills, units or submits of a unit trust and policies of life or endowment assurance and also includes deposit receipts in respect of the deposit of any such securities and documents of title to any such securities.

Malawi currency means any currency that is, or is payable or expressed in currency that is, legal tender in Malawi.

First schedule of Exchange Act designated the licenced commercial banks as authorised dealer.

2.1.3.1 Exchange Control Regulations

The Exchange Control Regulations were issued as part of the Exchange Control Act 1989 and cover several topical issues. Additional regulations have been issued out for specific matters over time with the following notable ones:

- Exchange Control (Forex and Bureaux and Foreign Exchange Fixing Sessions) Regulations, 1994, deemed to have come into operation on 4th February, 1994. It introduced forex bureaux and tourist operators as part of authorised participants and the regulations they need to follow in the trade.

  The Exchange Rate Regime was no longer fixed from February 1994 and was subjected to weekly review by Foreign Exchange Fixing Committee to freely establish the rate based on supply and demand for foreign currencies by authorised participants.

- The authorised participants being Reserve Bank of Malawi (RBM), authorised dealer banks, forex bureaux, licensed brokers in foreign exchange transactions, companies incorporated under the Companies Act and other enterprises which in the opinion of the RBM met the requirements of the fixing session. Consequently, RBM issued out Exchange Control (Forex and Bureaux and Foreign Exchange Fixing Sessions) Regulations, 1994.

- RBM however issued new Exchange Control [Foreign Exchange Bureaux] Regulations, 2007 after noting serious fraudulent transactions amongst several industrial players - High Court of Malawi, Miscellaneous Civil Case Number 163 of 2007 – Golden Forex Bureau Ltd and Others vs The State (Minister of Finance) and Reserve Bank of Malawi
- The 2007 regulations required all the forex bureaus to be attached to authorised dealer banks as part of the licencing requirements but this was legally challenged and the High Court ruled in favour of the forex bureaus.

The Exchange Control Manual was launched in 2009 to assure Malawian exporters and importer of RBM's commitment to a fully liberalised foreign exchange regime and this in part would be achieved through delegated authority to authorised dealer banks to handle advance payment applications of up to US$20,000.00 – Ligoya (2009). The tangible benefits of the Exchange Control Manual might not have been justifiable in the short term as Malawi experienced the most acute forex shortage leading to scarcity of fuel evidenced by dry pumps at the feeling station for days in the last quarter of 2009 and this problem was on and off until middle of second quarter of 2012 – Kampanje (2012b). Fertiliser subsidy programme not only meant for maize as country's staple food crop but also tobacco in an effort to support the smallholder farmers with a hope of increasing the country's exports is partly to blame for the acute forex shortage in 2009 – Kampanje (2018).

Authorised Dealer Bank have been accused of aiding illegal externalisation of forex in Malawi through payment of fake invoices and bills but these attract huge penalties if positively identified as highlighted in the Guidelines for Forex Trading Activities of Reserve Bank of Malawi (2018) and Reserve Bank of Malawi (2019) in section 2.4 below. The penalties for such malpractices are however not publicised raising serious doubts as to whether the malpractice is tolerated or not.

2.2 Directives

2.2.1 Foreign Currency Exposure Limit Directive

Section 5(1) of Banking (Foreign Currency Exposure Limits) Directive 2012 stipulates:

[The aggregate of a bank's foreign exchange risk exposure (short and long currency positions) both on-bank and off-balance sheet, as measured using spot buying rates, shall not exceed thirty five per cent (35%) of the bank's core capital.].

Section 11(1) of the said directive stipulates that:

[Where a bank fails to observe the limit a specified in paragraph 5, it shall pay a penalty at the prevailing bank rate plus ten percentage points. This rate is multiplied by excess exposure, (calculated as the difference between thirty five per cent (35%) exposure limit and the average exposure for the week and core capital. Since it I or only a week, this is smoothened by a ratio of 7:365 days (or 1:52 weeks).].

This directive appears to be at the backdrop of Malawian bank's enthusiasm to earn non-interest income which in some instances has been much higher than the traditional lending aspect of banking business. The details of the possible offenders and the penalty meted out however not been made public so far.

2.2.2 Valuation of Assets Directive

Financial Stability Report (2015:5) annotated:

[i. Valuation of Assets Directive: Under this directive, ADBs are required to use the reconciled actual trade-weighted rates for end of day valuations. This is meant to encourage banks to take due diligence when setting up exchange rates with their customers and avoid speculative purchases of foreign exchange at significantly higher prices than would otherwise fundamentally be determined. Under this Directive, ADBs that engage in speculative purchases would be registering valuation losses from the day of purchase onwards until the market trade-weighted exchange rate also depreciates to equal or exceed the prices at which the respective banks' purchased the foreign exchange portfolio under valuation. In the process, if a bank quotes a higher exchange rate, the same bank will be required to record a higher exchange rate risk position than the average player in the market, a situation which would need proper justification to stakeholders.].

This directive came in after Reserve Bank of Malawi had observed wayward behaviour from authorised dealer banks where desperate customers were given higher exchange rates above the market quotes.

Banks do simply circumvent this directive through informal arrangements with customers using the forward agreements in which exchange rates applied on specific import bills are way above the market rates and the difference is treated as commission. It is a give or take scenario when forex is scarce and importers simply pass on the excess cost to the next customer. It has been known that in such arrangements, the agreed rate is sometimes higher than the Black-market spot rate but importers have to transfer funds through telegraphic transfer in view of restrictions in the exporter's country.

2.2.3 Valuation of Assets Directive

Financial Stability Report (2015:5) annotated:

[ii. Directive on Intra-day Traded Rates: This requires commercial banks to consider changing intra-day traded rates only when the value of the transaction is at least US$250,000.00. This is intended to allow the market to filter out noise as much as possible and allow fundamentals to determine the level and direction of the exchange rate. It must be noted that this Directive does not in any way give monetary authorities direct control over the exchange rates. Banks will continue to freely determine exchange rates in line with the current exchange rate regime by determining the magnitude and direction of the exchange rate for all significant trades. Banks are still allowed to freely and competitively determine the prices in line with the current exchange rate regime.].

The minimum threshold of US$250,000.00 is way above the average transactions undertaken by Malawian importers. Those are bills which require intense scrutiny. Some authorised dealers encourage importers to submit series of invoices or bills instead of lump sum so as avoid serious scrutiny from the regulators. The Intra-day Directive is thus defeated.

2.2.4 The Liquidity Reserve Requirement Directive

Financial Stability Report (2015:5) annotated:

[**c) The Liquidity Reserve Requirement (LRR) Directive:** This Directive requires all commercial banks to observe their LRR on foreign currency in its Kwacha equivalent. The Directive was designed in such a way that banks had an added incentive to offload to the market part of the foreign exchange reserves they were holding or would otherwise hoard in exchange for the Kwacha reserves. Therefore, any increase in foreign currency deposit liabilities would translate directly into an increase in local currency reserve requirements for the next

LRR observance period, which in turn implied a liquidity squeeze on the banks. It was envisioned that banks would notice the need and benefit on their part to release some of the foreign exchange they would manage to offload from their books and allow the Kwacha to appreciate in the process or at least halt the then daily observed depreciations. By reducing the noise and allowing market participants to consider the underlying fundamentals in the process, encouraging banks to take due diligence when transacting with their customers especially when buying, and stimulating the supply of foreign exchange to the market, which in turn mopped up local currency, the depreciation of the Kwacha exchange rate was ably reversed and expectations also turned around at a time not seasonally expected. Consequently, a momentum was created and it further elicited those that could offload their positions to the market to do so before the foreign currencies had lost much value.].

There is clear evidence that Malawian banks have not acted in good faith as far as forex is concerned. The remedies instituted by Reserve Bank of Malawi however appear to be inadequate and ineffective where concerned banks use off-shore transactions by using related parties or correspondent banks so that such transactions would be difficult to monitor in Malawi.

It is told that Malawian forex bureaus were able to establish letters of credits to some African countries and other parts of the world simply by word of mouth between early and mid-2000s. Auditing correspondent banks account statements could provide a true picture of the activities of the authorised dealers. The bank directives should also incorporate procedures for reviewing the Nostro (forex deposits with other banks) and Vostro Accounts (forex deposits from other banks) held by authorised dealers.

2.2.5 Capital Adequacy Directive

Section 5(1) stipulates that a bank shall maintain a minimum core capital of Malawi Kwacha equivalent of five million United States Dollars (USD5,000,000.00) or such a higher amount as the Registrar may determine.

It could be argued that banks might be discouraged from opting for speculative higher exchange rates as noted in section 2.2.2 above as this affects their capital adequacy ratios. The reality of the matter is however that only small bank can feel the effects of the adverse movement of the exchange rate which was main driver for acquisition of the smaller banks in Malawi as noted by Kampanje (2021). This means that bigger banks can misbehave in the foreign currency exchange rate determinations with no impact on the capital adequacy directive.

2.3 Press Releases

2.3.1 Travel Allowances

Reserve Bank of Malawi (2010a) issued out guidelines for

Foreign Travel Allowances and Endorsement of Passports in which it compelled authorised dealers to comply with the following:

[Authorized foreign exchange dealers are, thus, required to observe the following procedure when issuing travel allowances:

a) thoroughly examine a traveller's passport and satisfy themselves that the traveller, indeed, qualifies for a travel allowance to ensure that:
b) a traveller who obtains foreign exchange from more than one authorized dealer in foreign exchange is not accorded excess facilities;
c) a previously endorsed page has not been removed from the passport; and
d) the applicant is not using a replacement passport/travel document.].

The above press release provide evidence of abuse of the forex purchases by unscrupulous people piling up foreign currency most of which was channelled into the black market to realise substantial profits.

2.3.2 Approval of import orders above US$50,000

Reserve Bank of Malawi (2010b) was greatly concerned with the significant trade imbalances and instructed that all imports orders and payments in excess of US$50,000.00 must have its prior approval. Furthermore, all matters relating to capital accounts such as fees, charges and others needed RBM's prior approval. This was the departure from the truly liberalised forex market it had adopted in February 1994 as per Exchange Control (Forex and Bureaux and Foreign Exchange Fixing Sessions) Regulations, 1994 stated in section 2.1.3.1 above.

There was a substantial backlog of import bills piled up in local commercial banks but their authenticity was questionable in some instances.

2.4 Foreign Currency Trading Guidelines

2.4.1 The rationale for Forex Trading Guidelines

Reserve Bank of Malawi issues out updated versions of the Foreign Currency Trading Guidelines specifically targeting authorised dealer banks in additional to specific directives discussed in section 2.2 and press releases in 2.3 above on matters of reporting requirements, ethical considerations, trading limits, penalties for violations and other matters. The trading guideline therefore encapsulates the relevant legislative provisions, directives and press releases.

The Forex Trading Guidelines are periodically updated to take into account of the changing environment and economic conditions. Sangala (2016) noted that the new forex guidelines were issued out in March 2016 and RBM refuted allegations that it was trying to control the exchange rates but simply allow the market to operate efficiently and penalise inefficient dealers.

The said guidelines were revised on 15th March 2018 and effective from 19th March 2018 – Reserve Bank of Malawi (2018). Subsequent revision of the said guidelines was also done on 6th September 2019 and effective from 16th September 2019 – Reserve Bank of Malawi (2019).

2.4.2 Spreads between buying and selling rates

The Reserve Bank of Malawi prescribes the spread between buying and selling rates of telegraphic transfers (TT) as well as cash. For instance, spread for TT was 3 percent and cash was 6 percent – Reserve Bank of Malawi (2018) and was slashed to 2 percent and 3 percent respectively – Reserve Bank of Malawi (2019).

Local banks have been known to devise means to maximise revenue from forex trading in view of the huge appetite by the importers and this is recovered through other charges or commissions.

2.4.3 How effective are forex trading guidelines?

The guidelines have been around for over twenty five years albeit with little success yet to be displayed in view of massive illegal externalisation of forex in Malawi with dire consequences on Malawian economy.

Mtonga (2018) annotated:

[The … and …, through the transaction analysis, uncovered last month that a syndicate of … nationals siphoned off more than $7.4 million (about K5.4 billion) in 2017 through dubious import payments. The racket to illegally externalize forex has been going on for decades; it is not new. According to the Global Financial Integrity, Malawi is among the 25 worst countries in the world where money laundering is flourishing with over K200 billion being illegally moved out of the country annually.

… One cannot believe that the .. Director General … only "advised the banks and other deposit-taking institutions to avoid being used as conduits for money laundering. … also warned "employees working in financial institutions that those who aid a customer in such illegal transaction could be prosecuted for money laundering which carries a maximum of life imprisonment." Really? For such a serious offence banks can only receive advice while their employees can only receive a warning?].

Mtika (2018) provided further details on the dubious transactions above:

[Weak controls over Malawi's banking system and delays in prosecuting cases when money-laundering has been discovered are allowing foreign companies, including some … ones, to take millions of dollars out of the country illegally and with impunity, according to court documents and interviews with experts and officials.

In the capture of banking system and financial institutions, it has been discovered that between January and November 2017, the Finance Intelligence Authority (FIA) uncovered 63 unsupported forex transactions worth US$7.4 million (approximately K5.4 billion), remitted without imports being returned into Malawi, according to information from the Reserve Bank of Malawi (RBM) and the FIA itself.

Broadly, the offences involve the making and use of false documents and deceptions by persons applying for permission to remit large sums of foreign currency abroad.

In one instance, between January and July 2017 at ... Branch in the city of … using account numbers – …, …, and … obtained US$2,192,292.50 but no imports were made.

Both Reserve Bank of Malawi and the Finance Intelligence Authority have evidence that huge sums of illicit funds are possibly being laundered using the Malawian banking system under the disguise of import payments being made by what appears to be legitimate businesses.

“All cases to do with illegal externalization are done by … nationals. My suspicions are that they sponsor terrorism,” … said.].

The stiff penalties which are supposed to be meted out on the banks and their employees on wayward forex trading appear to be reserved and not implemented by the Regulator as courts have wondered on banks' insensitive attitude towards the massive illegal forex externalisation as noted by Chimjeka (2022):

[High Court Judge … Friday found a couple, … and …, guilty on counts of money laundering and forex externalisation amounting to US$6 million (about K5.1 billion).

But … has chided what he called the sloppiness and attitude of the banks that were involved in the process saying their conduct contributed to the commission of these crimes.

The two have been found guilty for using foreign currency for a purpose different from the one specified –which was contravening Exchange Control Regulations.

… The charge says the accused, between May 7, 2016 and February 8, 2019 at … Bank and … Bank in Lilongwe used foreign currency amounting to US$ 6,011,500 as business allowances for their purported employees, for a purpose different from what was specified.

… In February 2019, RBM reported that illegal externalisation of foreign exchange and transfer pricing cases had drained as much as K500 billion as at the close of 2018.].

The banks simply failed to adhere to the Reserve Bank of Malawi Press Release stipulated under 2.3.1 above and this could be sign of troubled industry.

The estimated illegal externalization of forex in 2018 of about MWK500 billion was close to USD685 million which was adequate to fully cover Malawi's fuel, inorganic fertiliser and pharmaceuticals import bills for the whole year. There is a need to be extra vigilant as a country.

2.4.4 Details of penalties meted out on banks

There is lack of information regarding the penalties imposed by the Reserve Bank of Malawi on non-compliant banks. Names of perpetrators as well as monetary and other fines imposed thereof are not available in the public domain. This is a missed opportunity as naming and shaming of wayward banks could be one of the most effective deterrents.

Reserve Bank of Malawi (2005:31), Reserve Bank of Malawi (2009:33) and Reserve Bank of Malawi (2012:35) simply stated that occasionally monetary penalties were administered on several banks for non-compliance with foreign currency exposure limits. Disclosure of the violators would have acted as moral coercion as it would dent corporate governance rankings. The Registrar of Financial Institutions Annual Report (2018:52); (2019:59); and (2020:62) simply clumped supervisory fees, levies and penalties. That compressed information was not helpful to any relevant stakeholders.

The Reserve Bank of Malawi Annual Reports showing its income and expenditures for years 2016 to 2020 do not show penalties on the forex trading violations as a separate line although they could be part of the sundry income. Illegal externalization of about USD685 million in 2018 alone should have attracted substantial penalties to be separately reported if anything is to go by. This is a peculiar scenario considering the fact that penalties were enhanced in 2019 such that "Conniving with customers with an intention to manipulate the market and prices" attracts a fine of USD100,000.00 and so is penalty for "Manipulation of exchange rate". The Use of fake or sterile documents to externalise funds results in the revocation of authorised dealer bank status (licence) and concerned employees referred to Fiscal Police for prosecution. None of these penalties have been disclosed by Reserve Bank of Malawi.

3 Conclusions and recommendations

There are comprehensive statutory provisions, directives from Reserve Bank of Malawi, Press Releases by Reserve Bank of Malawi as well as Forex Trading Guidelines which if followed to the book would protect the forex in Malawi thereby avert massive depreciation and devaluation of the local currency against the major trading currencies. Sadly this has not been the case, resulting in cost-push inflation as fuel is imported and once there is increase in pump price due to devaluation or depreciation the Malawi Kwacha, price of all goods and services increase automatically. All this due to few unpatriotic traders and others who take advantage of the weak Malawian banking system to externalise precious forex such that the transport system is threatened by lack of petroleum products, food insecurity due to inadequate inorganic fertiliser and lack of essential drugs in the public hospitals and health facilities. The biggest losers are the ordinary citizens who have no cushioning strategies or hedging mechanisms to the cost of living.

The Reserve Bank of Malawi and Financial Intelligence Unit have chance to investigate and claim back all the forex illegally externalised abroad. Billions of USD which have been siphoned in Malawi prevented the fulfilment of the Vision 2020 and so it will be in the Vision 2063. The banking industry must be thoroughly investigated and demonstrate that any wrong doing will not go unpunished.

The desire to realise supra-normal is main driver for wayward behaviour in forex trading amongst Malawian banks and therefore no bank should be spared from rigorous scrutiny because the consequences for violation of the forex trading have affected the dignity of Malawian citizens.

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