1. This Financial Sector Assessment summarizes the findings of the joint World Bank–IMF FSAP. The main FSAP mission took place May 4-23, 2003.¹

I. OVERALL ASSESSMENT OF DEVELOPMENT PRIORITIES AND FINANCIAL STABILITY

2. Even though the current depth and efficiency of Tanzania’s financial system fall well short of what is needed to help support economic growth, there are clear indications that the foundations of a sustainable advance are being laid. Over and above the impressive macroeconomic stabilization, which was an essential underpinning of any financial sector recovery, extensive policy reforms have been put in place over the past few years, notably the organizational and financial restructuring of the two largest banks, the opening of entry to financial services providers—including the sale to private sector interests of much of the state’s shareholding in banks—and the substantial liberalization of domestic financial intermediation.

3. But these sweeping reforms did not at first yield improved access to financial services by economic agents. The loss of convenient access to banking services, through the inevitable closure (in the early phase) of some loss-making bank branches and through an initial increase in minimum balance requirements by some banks under new ownership,

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compounded the effects of wider social changes to reduce access to banking services in less favored areas. The history of non-repayment in the 1990s makes it understandable that banks were initially slow to replace by new credit the stock of non-performing loans that had been written-off. Instead, they responded to the gradual recovery of local currency bank deposits by accumulating extensive additional holdings of government paper. Furthermore, despite lower inflation, a growing proportion of bank deposits is being denominated in U.S. dollars and more than two-thirds of these are placed in the international money markets.

4. **There has been accelerating pick-up in credit in the last two years.** Competition for the recognizably creditworthy borrowers has intensified at all levels in the urban areas. This is being reflected by some reduction in the very high gross interest spreads for the largest borrowers. Similar trends are observable in micro-finance lending. This gradual restoration of credit has been marked also by the introduction of such lending technologies as group and progressive lending, the employee loan secured by salary deduction arranged at group level, and pre-export crop finance against warehouse receipts. There is no reason to believe that this process is anywhere near mature. For some segments, such as lending to small urban commercial business, the market is said to be saturating—though this would not be the case if enhanced lending techniques were employed; for other segments, such as the salary deduction loans to employees, there is certainly plenty of scope for expansion.

5. **Large swathes of the economy are, however, working with little formal credit.** This is true of much of agriculture and the rural economy. Poor physical infrastructures (especially roads and telephones) make payments and deposit services highly costly for the high fraction of the population that resides in remote rural areas. And—crop finance aside—neither banks nor microfinance institutions (MFIs) have made any significant headway in finding secure and cost-effective ways of lending to these areas.

6. **New business models and lending technologies thus need to be bought into play.** For some years to come, a key task for government will be to help ensure the legal and information infrastructures on which the banks and other financial institutions can build. For instance, the comparative absence of longer-term credit is often remarked and blamed on the Land Act 1999. Undoubtedly, this altered the balance of protection away from the lender to the borrower and introduced many uncertainties. There has been a continuous pressure from the banks for extensive changes in this law to allow them to secure lending on landed property with greater assurance. It is unlikely that much expansion of longer-term finance can be expected without some amendments to the land law, though it will not be a panacea. It is not only in Tanzania that financiers are reluctant to commit funds to uncertain ventures even if secured by a mortgage on real estate. Examination of this legislation suggests that much of the difficulties for the lenders—and *a fortiori*—for the availability of credit, can be resolved fairly easily without compromising the main social goals involved, such as the desired and justifiable protection of borrowers against oppressive conditions or predatory lending. Other legal and regulatory reforms that could help remove barriers to such lending technologies as leasing are discussed below; these should be put in place now as they will soon be needed even if not yet called for by the financial intermediaries.
7. **Despite this cautious recovery of credit and confidence, the overall stock of credit outstanding in Tanzania remains exceptionally low (around 6 percent of GDP).** The average loan to deposit ratio of the banking system is only 34 percent. Given these figures, and the dominance of banks in the financial system, it is not surprising that more pro-active direct policies such as the establishment of specialized institutions at the behest of government to expand credit to underserved sectors (for example in rural areas) or at longer terms have been mooted. Even if the experience of other countries with such innovations had not been at best mixed, the fragility of the recovery of financial sector confidence in Tanzania would argue for extreme caution in such direct innovations. Just as the private sector is beginning to emerge from its shell, aggressive below-cost provision of financial services from a government-sponsored agency would be sure to halt or postpone what would likely be more sustainable market innovations.

8. **The spread between bank lending and deposit rates has declined recently, but remains high.** Weighted average lending rates (for domestic currency lending) were 14–15 percent in early 2003, while deposits paid approximately 3 percent, implying a hefty spread of 11–12 percent. While this has contributed to rather high profitability of the banks, a large part of the spread can be explained by high risk premium charged by the banks for credit risk, weak market infrastructure, and difficulties in enforcement of creditor rights.

9. **The privatization process of state-owned banking institutions is not yet complete.** In particular, National Microfinance Bank (NMB), Tanzania Investment Bank (TIB) and Tanzania Postal Bank (TPB) remain in public ownership. The first is by far the most important, with its extensive branch network and its deposits totaling about 18 percent of the banking system. Having operated under a MOU for several years, the NMB has only recently begun to expand its loan portfolio, based largely on a model of small-scale loans to individuals, whether for business purposes, or as salary deductions. Its 12,000 borrowers account for only 1.5 percent of total bank credit, but there is considerable potential for this bank, with its current business strategy, to grow into as important a source of credit for Tanzanian business as it is currently a source of payment and other facilities to its 750,000 depositors. Governance of a bank of this size—it has liquid assets in excess of T Sh 150 billion (US$150 million)—is of the utmost importance, and argues for ownership to lie securely with controlling shareholders for whom the prospect of a long-term flow of banking profits is more attainable and attractive than the short-term lure of access to loanable funds. The highest qualified bidder is likely to be an external investor who sees the value of the bank’s current franchise in its many branches across the country and who brings the patience and resources to continue to build on the current business model. A prompt offering of a clear majority stake in this bank is highly recommended as the best way forward.

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2 The lending rates and the spread declined from about 20 percent and 16 percent, respectively, in early 2001 to the current levels in early 2002 and stayed generally flat since.
10. TPB has an agency contract with the Postal Service (a significant shareholder in the Bank) which gives it an extensive indirect network for deposit taking and money transfer business. Its own branch network and prospects for successful lending activities are limited. Pending privatization, the safest course of action for the authorities in relation to this bank is that it becomes almost a “narrow bank” with strict limits on credit expansion. The management of the TIB, which has only one branch, would like to see a return to medium- and long-term investment banking, and to expand fee income, such as it has been earning on liquidations and loan collections. However, this appears an unlikely prospect under present conditions and existing capacity. In particular, its depositors are not willing to place medium-term deposits in view of credit risk. The bank’s remaining resources are not a very promising basis for expansion, and the government may do best by seeking a merger or a purchase and assumption transaction.

11. Two competing visions of Tanzania’s future financial sector differ as to whether micro and small-scale financial services will be provided more by formal sector banks reaching down, or by the development of community—or NGO-based MFIs. This question will continue to be debated for many years, and no conclusive answer can yet be proposed; nor does it seem wise for policy to lock in exclusively to either vision to the exclusion of the other. Certainly, there is the very promising development that some banks, notably NMB and Akiba Bank, have displayed their capacity and willingness to enter the retail microfinance business vigorously. Already, in terms of numbers of small depositors, as in provision of access to money transfer services, the banks easily outweigh the savings and credit cooperatives. In terms of numbers of loans, the opposite applies, but the position is changing.

12. The move toward a more systematic and thorough regulatory regime for those few MFIs taking more than T Sh 1 billion in deposits is very welcome. However, these developments risk leaving a certain policy void in respect of smaller institutions. To the extent that only these institutions can reach remote rural areas in the current state of Tanzania’s transport infrastructure, they should not be suppressed by excessive regulation, especially for those in rural areas. Instead, the authorities should consider ways of encouraging the development and strengthening of umbrella organizations (such as by contracting international expertise for promotion and training in the provision of second-tier services), and of greater reliance by these MFIs on local banks rather than external donors for loanable funds (with a view to their being monitored by the bank).

13. A distinctive and comforting feature of the financial environment in Tanzania is the high degree of liquidity. Availability of loanable funds is unlikely to be a constraining factor in the medium term. This is true for both long-term as well as short-term funds, given the growing investible resources of the pension funds and, to a lesser extent, the insurance

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3 The former can offer a wider range of services and benefit from economies of scale, but may suffer from higher unit costs and less effective use of social capital (information and peer pressure) in lending.
companies. Pension funds in particular need good investment returns if they are to have any chance of meeting the obligations which will eventually fall due. The availability of long-term resources for future investment in securitized medium- and long-term bank loans and corporate bonds, as well as the equities in which they now invest, is a source of strength for the system, but one which will only come to full fruition when the banks have identified suitably bankable medium-term loan opportunities.

14. **The performance and potential of the insurance sector, which was opened to new entry as recently as 1998, is overshadowed by the very poor condition of the former monopoly National Insurance Corporation (NIC). This insolvent entity has rapidly lost market share due to its poor reputation for paying on claims. Rehabilitating the NIC will be a difficult task, and it may be too optimistic to hope that a reputable foreign buyer would be interested in buying it. Without such external assistance soon, the company should be closed to new business and steps taken to facilitate an orderly entry of the other players in the different geographical regions of the country. Proposals for a national reinsurance company endowed with a compulsory cession of a portion of the industry’s business (including that part which would not need to be reinsured inside or outside of Tanzania) should be shelved. This is not the time for such a venture, which fills no evident market gap, acts as an earmarked tax on existing firms and is sure to introduce an additional element of cost to the policyholder likely to outweigh the limited saving in foreign exchange (essentially of any profits currently accruing to foreign providers of avoidable international reinsurance).**

15. **Steady progress in the number of equity listings on the Dar es Salaam stock exchange (DSE) cannot mask the fact that the operation of the exchange and of its regulation still represent a drain on scarce public funds and are likely to do so for some time.** With about 70 percent of the market in the hands of the two foreign parents of the major listed companies, and a sizable portion of the rest held either by state agencies or the public pension funds, the free float of shares is very tiny, and typical daily trading comes to only a few thousand dollars. Despite the prospect of some foreign portfolio investment following the welcome partial liberalization of equity purchases from abroad and of cross-listings, the exchange is likely to play a very limited role for several years to come. There are moves to develop an integrated securities market in East Africa. In practical terms, any such moves to regionalization should be driven primarily by the goal of reducing (through shared or outsourced services) operational and regulatory overheads; it remains unclear whether an integrated East African securities market would represent a move in this direction, or whether it would be superior in this respect to a tie-in with one of the other major exchanges in the region.

16. **Payments and securities settlement infrastructure also needs to be upgraded.** The steps taken toward the introduction of an electronic funds transfer clearing system and, in due course, a real time gross settlement system for large payments between banks are welcome. Some gaps need to be addressed in the proposed arrangements and their governance. These include, among others, a noteworthy settlement risk in foreign exchange transactions and settlement and credit risks relating to repo transactions. An important potential side effect of these developments will be the opportunity to replace the use of
checks for the bulk of retail payments (including government payments such as pensions) by methods that will be much faster and safer for the recipients.

17. **Monetary policy instruments are well developed in Tanzania and the Bank of Tanzania (BOT) has sufficient instruments at its disposal to cope with the surge in aid inflows now in prospect.** This will be a challenging time for monetary policy, with the need to ensure that excess liquidity does not reignite inflation, while at the same time avoiding the opposite error of over-tightening policy if the demand for money shifts. An adaptive stance based on continuing analytical work in estimating the demand for money and responding to changing information will be needed. Monetary policy based on out of date estimates of the relevant relationships could be damaging. It will help if the monetary authorities make greater efforts to be clear and transparent about their monetary policy objectives.

18. **The shallowness of wholesale money, bond and exchange markets continue to present challenges.** The implementation of monetary policy can be complicated by the fact that, despite overall excess liquidity in the system, some banks are structurally short of shillings and cannot always borrow at a reasonable rate on the interbank market. This can pose a threat to monetary policy if the BOT feels obliged to accommodate such pressures at the cost of what are hoped will be temporary deviations from the planned monetary path. Some recommended technical improvements may help to deepen the interbank money market and ease these pressures. The BOT has also been very active on a day-to-day basis in the foreign exchange market—it would do well to stand back a little and allow this market to develop some depth on its own. The primary government bond market has also proved to be shallow—probably the authorities have pressed forward too strongly in trying to sell so much medium- and long-term paper at modest yields.

19. **The soundness of the banking system was evaluated using a stress-testing approach (which could be further developed and systematically applied by the BOT).** The results point to a system capable of surviving an array of even sizable shocks. At the same time they highlight the need for attention to interest rate risk (maturity mismatches) and the potential for excessive concentration in the banking counterparties for foreign placements.

20. **The framework of banking supervision is overall adequate when assessed against the Basel Core Principles.** Some of the bank regulations may however be too constraining, though a tightening is called for in a couple of areas. As is often the case, the most important dimension in which improvements could be made to onsite supervision is in shifting away from checking compliance to an evaluation of risks and risk management capacity. Better offsite monitoring of credit concentrations, asset quality and connected lending is required. Supervision would also be strengthened by enhancing BOT’s independence from the government with respect to revocation of licenses and corrective action.

21. **Although no crisis is in prospect, contingency planning should be developed now.** Among the issues that need to be thought through carefully are how, when, and under what
circumstances lender of last facilities should be brought into play. In this context, the potentially damaging liquidity support by the Deposit Insurance Fund (DIF) should be avoided—its role should be explicitly confined to that of a pay-box.

22. **An full assessment of AML/CFT is under way**; the ROSC will be included with the overall FSAP documentation.

**II. MAIN ELEMENTS OF THE DEVELOPMENT AND FINANCIAL STABILITY PRIORITIES**

23. **Looking forward, there is every reason to hope and expect that Tanzania’s financial system will continue to consolidate recent gains.** The solid expansion of credit, including by the international banks, both in aggregate terms and to a wider range of small-scale borrowers (albeit from a very small base) can be expected to continue given growing confidence by the lenders that the credit environment will continue to improve. Increasingly vigorous competition and availability of deposit resources point to the likelihood that some banks will reach down further into serving small-scale clients. The stability offered by the thrust of the overall financial sector policy environment can underpin such gains. Continued strengthening of the environment and the financial infrastructure should guide Tanzania’s financial sector policy in the coming years. In essence, this requires completing the task of divestiture of state-controlled entities in banking and insurance; strengthening the legal and judicial framework supporting lending; several steps to clarify and deepen the regulatory, information and technology infrastructure underpinning finance for households and microenterprises, including payments and depository services; steps to encourage long-term pension and insurance funds to financing longer-term private investments; strengthening of monetary and prudential technologies.

24. **The development of the Tanzanian financial system and its institutional and financial strengthening requires a long-term and a planned approach.** The following list of the most important proposed actions is in an approximate order of urgency in each area. The success of these efforts would require the preservation of macro economic stability.

**Reform of government-owned financial institutions**

- Move promptly to sell a substantial majority stake in NMB to a suitably qualified buyer.

- Initiate privatization of TIB, as is, or piecemeal; do not pursue with the view that the bank could be transformed into an effective development bank.

- Pending privatization, limit growth on TPB’s loan portfolio; transform it into a narrow bank with limited credit expansion, perhaps to relatively stronger NGO MFIs and graduating MFIs.

- Early restoration of public confidence in the insurance market through a buyer for NIC; failing which close the NIC to new business through an orderly wind up.
Shelve official plans for a national reinsurance company.

**Legal and judicial reform**

- Accord high priority to achieving a compromise on the land act issues relating to granting of credit (shorten the statutory delays—but retain protections against predatory lending for small mortgages; tax capital gains on sale of land).
- Institute reforms in the Companies Law to strengthen the protection of minority shareholders (against directors and other insiders).
- Provide additional resources to the Commercial Court for speedy settlement of cases; also undertake a broader strengthening of the judicial and court system, as well as the modernization of the company and land registries.
- At an appropriate time, remove scope for ambiguity in the company accounts in line with international standards in the accounting and auditing, and corporate governance.

**Enhancing access to financial services**

- Clarify regulatory intentions regarding smaller MFIs; adopt a light handed and delegated approach to the small providers of basic financial services.
- Encourage the development and strengthening of umbrella organizations and greater reliance by these MFIs on local banks rather than external donors.
- Consider an agency for cooperative financial institutions focusing on capacity building and financial infrastructure; seek donor funding for this type of initiative.
- The BOT should take the lead on the credit registry/bureau project and push ahead speedily with a simple—but if necessary compulsory—systems of credit reporting by all licensed lenders.
- Clarify or amend regulations concerning the treatment of leasing companies.
- Eschew policy prescriptions to open special SME windows at financial institutions or for government-promoted development banks as such initiatives in current conditions may badly disrupt the development of self-sustaining SACCOs or NGO-based MFIs.
- Develop payment system infrastructure to facilitate retail payments for the use of non-cash instruments, money transfers in rural areas, government payments.
**Long-term investment**

- Liberalize investment requirements for insurance companies.
- Facilitate the emergence of securitized loans or guaranteed bonds by pension funds in preference to non-transparent lending to government-sponsored entities.
- Exercise caution in any plans to fold remaining unsold state-owned enterprises into a unit trust to be sold to the general public.

**Managing systemic liquidity, market intervention, and infrastructure**

- Develop a sterilization plan to respond to the evolving liquidity situation and inflows.
- Undertake analytical work on money demand.
- Reduce the frequency of money and foreign exchange market interventions; facilitate the development of interbank money and foreign exchange markets.
- Increase transparency of monetary policy and debt market operations.
- Ensure an orderly and secure development of payments and securities settlement systems by clarifying BOT’s oversight role, and remove identified risk gaps in existing and proposed systems.
- The BOT should also define its strategy for the retail payments infrastructure. This should include achievement of inter-operability of card-based networks. The impact of privatization of DECH on cost and availability of retail payments needs to be carefully considered, including the impact outside Dar es Salaam.

**Bank regulation and supervision**

- Immediate review of some regulations as mentioned, aimed at relaxing unduly constraining barriers (collateral requirement for large loans; aggregate large loan limits; fixed asset ceiling for banks), and to tighten some loopholes (exposure to individual offshore banks).
- Move towards a risk based supervision system and continue strengthening capacity and techniques for on-site and offsite supervision.
Crisis preparedness

- Develop a financial system crisis prevention and management plan; strengthen the financial safety net through clarifying BOT’s LOLR role, and ensuring that the role of the DIF is confined to that of a pay box.

Taxation

- Review at an appropriate time issues relating to deductibility of specific loan-loss provisions; equalization and remuneration of reserve requirements; taxation at the pension payment stage; and recalibrate the tax treatment of capital gains on new share issues.