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UNITED REPUBLIC OF TANZANIA

FINANCIAL SYSTEM STABILITY ASSESSMENT

November 2, 2018

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This report is based on the work of the Financial Sector Assessment Program (FSAP) mission that visited the United Republic of Tanzania in April-May 2018. The FSAP findings were discussed with the authorities in October 2018.

- The FSAP team was led by Jay Surti, International Monetary Fund (IMF) and Rinku Chandra, World Bank (WB), and included Mario Catalan (IMF) and Yoko Doi (WB) as deputy mission chiefs, Federico Grinberg, Claney Lattie, Bozena Radzewicz-Bak, Kalin Tintchev (all IMF), Philippe Aguera, Ivor Istuk, Oliver Massetti, Will Paterson (all WB), Michael Andrews, John Quill (IMF experts), Jonathan Katz, and Steven Seelig (WB experts).
- The mission met with Mr. Florens Luoga, Governor of the Bank of Tanzania, senior staff of the financial supervisory authorities and relevant ministries, as well as senior managers of private sector entities.
- FSAPs assess the stability of the financial system as a whole and not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance its resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational or legal risk, or risk related to fraud, are not covered in FSAPs.
- This report was prepared by Jay Surti and Mario Catalan, with contributions from members of the FSAP team.

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Glossary

AML	Anti-Money Laundering
BoT	Central Bank of Tanzania
BoTA	Bank of Tanzania Act
CAR	Capital Adequacy Ratio
CFT	Combating the Financing of Terrorism
DBS	Directorate of Banking Supervision
DFS	Directorate of Financial Stability
DIB	Deposit Insurance Board
DIF	Deposit Insurance Fund
D-SIB	Domestic Systemically Important Bank
EAC	East African Community
ELA	Emergency Liquidity Assistance
FATF	Financial Action Task Force
FIU	Financial Intelligence Unit
FSAP	Financial Sector Assessment Program
FX	Foreign Exchange
GDP	Gross Domestic Product
GMRA	Global Master Repurchase Agreement
HQLA	High Quality Liquid Asset
IBCM	Interbank Money Market
IMF	International Monetary Fund
IT	Information Technology
MNO	Mobile Network Operator
MoU	Memorandum of Understanding
MoFP	Ministry of Finance and Planning
NPL	Non-Performing Loan
NRA	National Risk Assessment
OMO	Open Market Operation
PCA	Prompt Corrective Action
RAM	Risk Assessment Matrix
RBS	Risk Based Supervision
RMG	Risk Management Guidelines
STeM	Stress Test Matrix
TFSF	Tanzania Financial Stability Forum
T Sh	Tanzanian Shilling

EXECUTIVE SUMMARY

Tanzania's bank-dominated financial sector is small, concentrated, and at a relatively nascent stage of development. Financial services provision is dominated by commercial banks, with the ten largest institutions being preeminent in terms of mobilizing savings and intermediating credit. Medium-to-small banks rely systematically more on costlier, short-term, interbank financing and institutional deposits and have markedly higher operating costs.

These structural features underpin financial stability challenges which are significant. Bank asset quality has deteriorated sharply in recent years, and under-provisioning is significant, belying the apparently comfortable capital cushions. Credit growth has fallen precipitously, corporate debt loads have risen, and their cash flows are weak. Dollarization of bank balance-sheets raises the possibility of solvency stress under shocks being exacerbated by funding liquidity pressures, especially at smaller banks.

Elevated vulnerabilities could amplify the impact of external and domestic shocks, including from tighter global financial conditions, lower trading partner growth, prolongation of domestic economic uncertainties, and delays in budget execution and infrastructure investment. Stability analysis suggests that even under a benign baseline economic outlook, solvency positions of government-owned and smaller private banks could come under pressure and the number of undercapitalized institutions may increase. Consequently, economic adversity could expose a sizeable share of banking institutions and assets to significant capital adequacy and liquidity challenges. While the largest banks appear relatively resilient in the face of shocks, reflecting their more diversified income streams, confidence spillovers under stressed times could increase the adverse impact of shocks on these systemic institutions.

These vulnerabilities underscore the importance of a strong financial system oversight and policy framework to preserve financial stability. This is especially important to ensure that shocks do not dent the ability of the financial sector to contribute more robustly to the real economy going forward. In current circumstances, consideration of additional policy action to lower risks and raise the resilience of the banking system and non-financial firms is recommended. Key priorities include measures to reduce nonperforming loans, increase provisioning, increase institutional and systemic buffers to manage domestic and foreign currency liquidity risks, and prompt payment on government-guaranteed loans and resolution of government arrears.

Assessment against international standards spotlighted areas requiring enhancements to banking supervision. Building on the broadly adequate regulatory framework, priorities to enhance supervisory processes include: ensuring adequate staffing of the supervision function; revising the risk-based supervision framework to introduce a single, non-formulaic risk rating system; implementing the consolidated supervision regulation; and adequately and consistently enforcing prompt corrective action regulations, including importantly, through the development and implementation of an enforcement policy that can assist in applying early intervention powers.

The BoT's February 2018 circular for loan classification and restructuring could present financial stability challenges down the road and should be followed up with further guidance on criteria under which problem loans may be restructured and upgraded. Following emerging good practice, the circular requires banks to devise strategic plans for problem loan reduction, establish permanent recovery functions and ensure top management for high risk cases. However, the circular also weakens the BoT's framework and policies to oversee banks' problem loan management by providing banks the ability to upgrade the classification of non-performing loans and to capitalize and recognize as income, the interest on such loans. This could mask vulnerabilities by overstating earnings and capital. It is recommended that the Bank of Tanzania (BoT) follow up on the circular with further guidance on criteria for such credits to qualify for restructuring and upgrade.

Systemic liquidity management is challenged by thin and segmented financial markets, albeit completing the BoT's plans for repo market development and modernizing the monetary framework can attenuate financial stability risks. Institutional liquidity management is costly and uncertain in domestic currency for smaller banks. Reliance on the BoT is significant across the sector for foreign currency liquidity management. Scope exists within the BoT's ongoing plans to reduce interest rate volatility on the Shilling side by clarifying objectives, rationalizing the use of instruments and completing ongoing changes in the secured money markets. Promoting proactive foreign exchange (FX) risk management by banks and corporates, buttressed by macroprudential requirements, could bolster resilience to FX liquidity risks. Completing operational guidance for emergency liquidity assistance remains a high priority.

Financial crises management can be significantly enhanced by operationalizing the existing framework. Development of agency specific contingency plans by members of the Tanzania Financial Stability Forum and of plans for the use of extraordinary powers to maintain financial stability during a systemic crisis by the Ministry of Finance and BoT is paramount. Operational independence and effectiveness of the Deposit Insurance Board (DIB) would be enhanced by appointing its Board and increasing advanced planning for payouts and liquidation. The BoT should require recovery plans from banks and should prepare resolution plans for D-SIBs, once identified.

On the development side, increasing access to formal financial services and provision of long-term finance for a larger proportion of the enterprise sector, particularly micro-, small- and medium-sized firms, are top priorities. Measures that could assist in broadening access and lowering costs include addressing financial infrastructure gaps, bringing nonbank credit providers to smaller firms under the regulatory and supervisory umbrella, beefing up consumer protection and raising financial literacy across the population. Pension funds' investment allocation should be revisited with a view to having these entities contribute centrally to meeting long-term finance needs of the private sector. Simultaneously, measures to increase the supply of liquid securities could be identified.

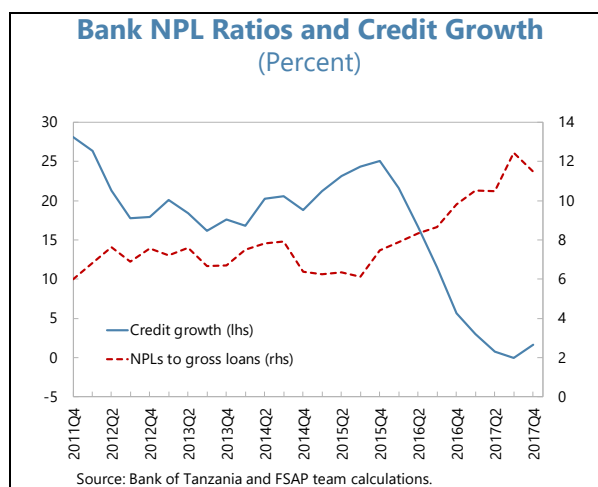
Table 1. Tanzania: Key Recommendations

Recommendation	Timing¹	Agency
Financial Stability Surveillance		
Expand data collection for liquidity, large exposures, currency, and contagion risk and enhance verification of data quality.	I	BoT
Strengthen framework for in-house stress testing and develop framework for constrained, bottom-up stress testing.	ST and MT	BoT
Expand in-house capacity for financial stability analysis, including through training and technical assistance.	ST and MT	BoT
Banking Supervision		
Ensure adequate staffing of the supervision function. (¶41)	I	BoT
Follow-up NPL guidance issued to banks in February 2018 to further clarify conditions under which NPLs may be restructured. (¶39, ¶40)	I	BoT
Revise the RBS framework to introduce a single non-formulaic risk rating system. (¶42)	ST	BoT
Enforce existing Prompt Corrective Action regulations and introduce internal guidance to ensure timely action to deal with identified problem banks. (¶45)	I	BoT
Develop and implement an enforcement policy to ensure effective, consistent and timely corrective action. (¶45)	ST	BoT
Managing Systemic Liquidity (including ELA)		
Develop a coherent and transparent operational strategy emphasizing attainment of BoT's price stability objective. (¶31)	ST	BoT
Enhance surveillance and prudential toolkit for oversight and management of FX liquidity risks and support banks' risk management. (¶34)	ST	BoT
Develop capacity to conduct ELA by compiling comprehensive operational framework. (¶35–37)	MT	BoT
Establish arrangements for obtaining government indemnity for ELA operations under uncertainty regarding solvency of borrowing entity. (¶36)	MT	BoT, MoFP
Deposit Insurance and Financial Crises Prevention and Management		
Appoint a Board to the DIB. (¶47)	ST	MoFP
Operationalize the TFSF MoU for preparing for, and coordinating actions during, a financial crisis. (¶49)	MT	TFSF members
Ensure that the legal framework provides government the ability to provide official financial support under strict conditions. (¶50)	MT	MoFP
AML-CFT		
Adopt the NRA report and establish an action plan. (¶54)	ST	Government
Implement risk-based AML/CFT supervision. (¶53)	MT	AML/CFT supervisory authorities
Note: Where references are provided in parentheses, recommendations in this table should be read in conjunction with the more elaborate discussion in the specified paragraphs.		
¹ = Immediate; ST = Within 1 year; MT = Between 1–3 years.		

MACROECONOMIC CONTEXT

1. Since the early 2000s, economic growth has been strong and medium-term prospects remain generally favorable. Tanzania benefited from market-oriented reforms and prudent macroeconomic policies, supported by consecutive Fund programs. This contributed to real GDP growth estimated at about 6 percent in recent years, poverty reduction, and improvements in social indicators. The government has an ambitious development agenda aimed at closing infrastructure gaps and supporting human development. Under the assumption of an improved business environment based on a prudent and well-managed fiscal policy and a strong package of structural reforms, GDP growth could be strong in the medium term and inflation should remain close to the authorities' target of 5 percent (Figure 1 and Table 4).

2. More recently, several indicators point to slower momentum which, combined with other risks, could complicate the outlook. Constraints in implementing public investments and weak expenditure controls have led to an increase in fiscal arrears. These developments may have contributed to a sharp increase in nonperforming loans (NPLs). In addition, weak cash flows and increased debt servicing difficulties in the corporate sector have suppressed credit demand, with tighter credit standards and economic uncertainty weighing on credit supply (chart). Macrofinancial risks could intensify if economic uncertainties remain prolonged, which together with slow budget implementation, may become a drag on economic activity. On the external front, a tightening of global financial conditions could complicate the financing of the budget and infrastructure projects, and an escalation of trade disputes could also affect exports and economic activity. The financial stability impact of these shocks could be exacerbated by existing balance-sheet weaknesses in the banking and business sectors, especially if asset quality pressures undermine confidence and trigger funding runs in a context of high dollarization. Similarly, large exchange rate movements in response to external and domestic shocks could have an impact on financial stability.



CHALLENGES TO FINANCIAL STABILITY

A. Vulnerabilities Affecting the Tanzanian Financial System

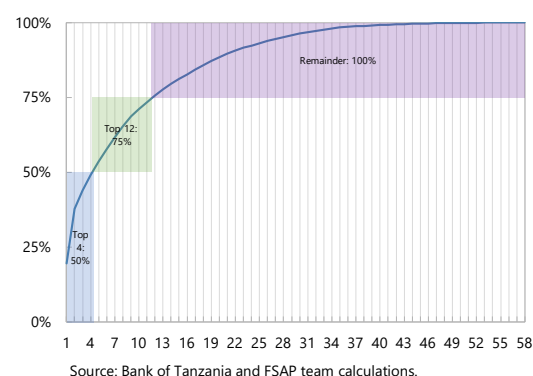
Financial System Structure

3. Banks and pension funds are preeminent in Tanzania's small financial sector (Table 1). Financial sector assets are 36 percent of GDP, with banks (72 percent of system assets) and pension funds (26 percent of system assets) being systemic components.

4. The banking system is concentrated and dominated by privately owned commercial banks (Table 2).¹ 18 domestic and 29 majority foreign-owned banks hold 92 percent of banking assets. The supply of banking services is concentrated (the largest five and ten banks hold 54 percent and 71 percent of assets). Commercial banks hold 96 percent of assets, with the rest comprised of two development banks, seven community banks, and five microfinance banks (0.6 percent).²

5. The nonbank sector comprises 31 insurance companies, six pension funds, and five collective investment schemes (Table 1).³ The pension sector allocates a significant share of its assets to bank deposits (8 percent), and credit to the government (46 percent). The insurance industry, growing rapidly from a small base, allocates a significant share of its portfolio to bank term deposits (30 percent) and government securities (12 percent).

Asset Concentration in the Banking System, December 2017
(Percent of total assets)



Bank Business Models: Sources and Uses of Funds

6. Overall, banking in Tanzania can be characterized as intermediation of domestic deposits for credit provision and investment in government securities (Figure 2). On the asset side, loans (51 percent) and government securities (19 percent) dominate, with deposits at the Bank of Tanzania (BoT) (14 percent) and other banks (9 percent) constituting most of the remainder. Lending is concentrated in the corporate sector (three quarters of the portfolio) and in a few

¹ In terms of size, the 54 commercial banks are classified into four Peer groups. Peer 1 banks are those with assets above T Sh 500 billion. Peer 2 banks comprise banks with assets between T Sh 200 billion and T Sh 500 billion; Peer 3 banks have assets between T Sh 30 billion and T Sh 200 billion; and Peer 4 banks have assets that are below T Sh 30 billion.

² FBME Bank was closed and placed under liquidation by the BoT in early May 2017, after the bank was named as being of primary money laundering concern by U.S. authorities in 2014. In addition, five community banks were closed in January 2018.

³ The six pension funds are being merged into two institutions in 2018.

economic sectors, mainly trade, construction and real estate, and manufacturing. Pension funds hold four percent of bank deposits, establishing an important interlinkage between the two sectors.

7. Portfolios differ significantly depending on bank size and ownership (Figure 3).

- Government-owned banks have greater exposure to agriculture and personal loans and a smaller portfolio share of securities. They also rely more on interbank funding (including through bond issuance) and less on deposits than private banks.
- Peer 1 private banks tend to be more deposit funded than other banks and their credit exposures are more sectorally diversified. By contrast, Peer 2–3 banks have higher credit exposure to sectors that have experienced greater difficulties, including construction, real estate, and transportation, storage and warehousing.

8. Bank balance sheets are highly dollarized and, notwithstanding small net foreign currency (FX) positions, liquidity and credit risks may be significant (Figure 4A). For the entire banking system, 30 percent of assets and liabilities are FX denominated. Peer 2 and Peer 3 banks exhibit higher, and government owned banks, lower, degrees of dollarization. *On the funding side*, two-thirds of FX liabilities are sourced from domestic deposits from households, nonfinancial corporates, and pension funds, with the remaining comprised of financing from foreign financial institutions, domestic banks, and other sources. *On the asset side*, two-thirds consists of loans, with the remaining held as claims on foreign banks and domestic interbank loans.

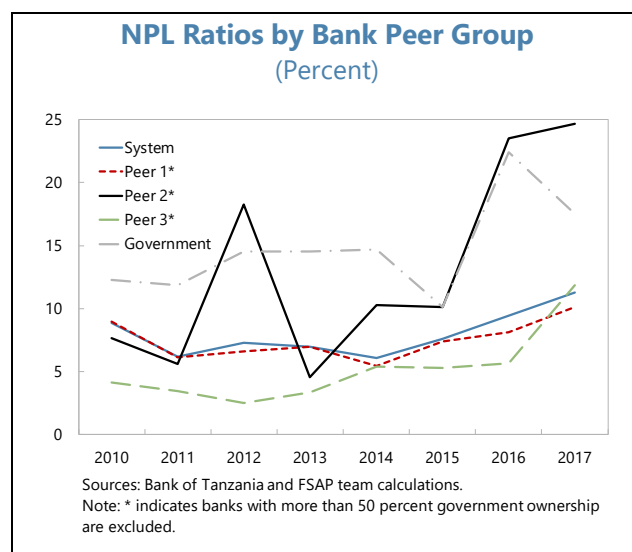
9. As a reflection of their relative strength, large banks (Peer 1) perform more intensive asset-liability maturity transformation than medium- and small-sized banks (Peer 2–3) (Figure 4B). Private banks exhibit no significant differences in the maturity profiles of their liabilities—about 70 percent mature within 90 days for all Peer groups. However, Peer 1 private banks extend credit and invest at longer maturities than Peer 2–3 private banks. Specifically, 30 percent of assets of Peer 1 banks are of maturity greater than two years compared to 15 percent of assets for Peer 2 banks and a negligible fraction for Peer 3 banks.

Banks: Financial Soundness and Vulnerabilities

10. Asset quality problems have increased substantially since 2014, with significant variation across banks (chart). The system-wide NPL ratio increased from 6.8 percent in 2014 to 11.5 percent in 2017. At end-2017, 24 banks had NPL ratios exceeding 10 percent and another 17 had NPL ratios between five and 10 percent. And, while the increase has been widespread, it is particularly pronounced for Peer 2 private banks and government-owned banks. Overall, six Peer 2–3 banks have NPL ratios above 30 percent (Figure 5).

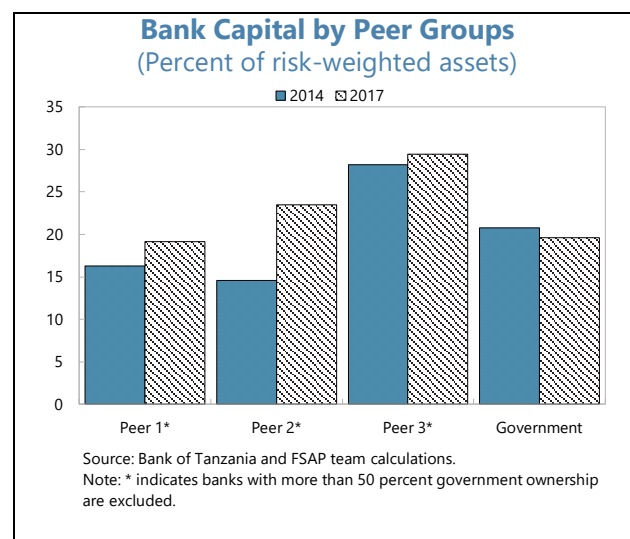
11. The rise in NPL ratios is driven by a combination of economic developments, discretionary government and prudential action, and poor credit risk management. Key drivers include lower than expected government spending, which weighed on private sector profits and wage income and the weaker business environment (most banks); poor credit underwriting (large banks and mid-sized banks); and government action such as rolling over payment arrears to its suppliers, firing of certain public sector employees, ban on use of hotels for conferences and meetings, delays on repayment on government guaranteed agricultural loans and Value Added Tax refunds, and enforcement of recent changes in the tax administration legislation.⁴ For

community banks and microfinance lenders, poor corporate governance, fraud, insider lending, or a higher share of uncollateralized loans were important factors. A forbearance measure introduced by the BoT in December 2015, extended the time-period that banks could keep NPLs on their books from one year to three years, which, combined with a fall in real estate collateral values, may have added a drag on NPL write-offs. Finally, delays and uncertainty associated with judicial processes impinge upon banks' efforts to efficiently sell collateral and write-off bad loans.



12. These multiple drivers have resulted in widespread loan quality deterioration across economic sectors. The weak business environment was a major driver of NPLs on trade, manufacturing, real estate and personal loans; drought adversely impacted agriculture loan quality; demand shocks from trading partners hit agriculture and transport; and government actions impacted performance of loans to hotels and the transport sectors.

13. Many banks appear highly vulnerable to adverse shocks. These banks exhibit a combination of low or negative profitability and high NPLs not covered by provisions, belying the sanguine picture provided by looking only at capital ratios (chart; Figures 5 and 6).

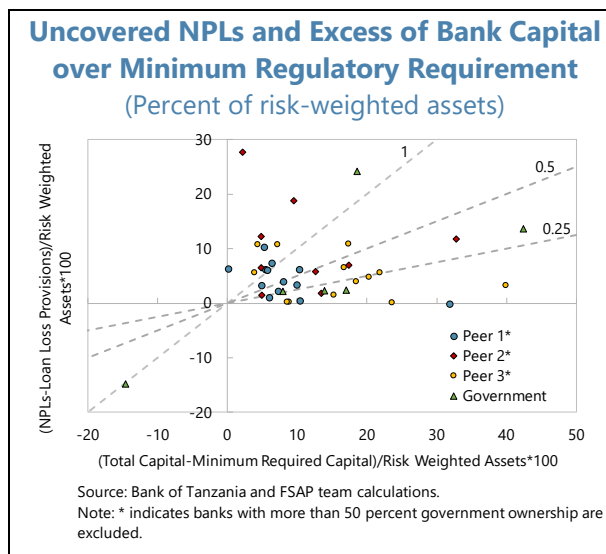


⁴ Termination of employment of certain government employees resulted from discovery of fake certificates and lack of adequate qualification. The BoT estimates that government guaranteed loans constitute 7.7 percent of NPLs and NPLs on personal loans to ex-government employees are 2.67 percent of NPLs as of June 2017. However, the contribution of government actions to NPLs is likely to be higher if one accounts for arrears in payments to firms that, in turn, have been unable to repay their debts to banks. The government is in the process of verifying fiscal arrears.

- Vulnerabilities are particularly high for Peer 2 private banks (loss making since 2011) and government owned banks (low profits since 2015). Loan loss provisioning has been a significant drag on profitability and capital buffers are weak despite fresh infusion of equity in the last two years. Business model viability appears to be a material issue for some of these banks.
- Peer 3 private banks exhibit larger capital buffers and higher provisioning ratios, but profitability has eroded sharply in 2017 and must be monitored going forward.
- The largest banks, with few exceptions, have diversified income and adequate solvency buffers. Their asset quality problems reflect large exposures to weak borrowers—the BoT's analysis reveals that for a majority of the ten largest banks, 50 percent to 80 percent of NPLs emanate from 10 corporate accounts.

14. Deteriorating solvency and high dollarization heightens banks' vulnerabilities to funding liquidity shocks, particularly in FX.

On August 2, 2018 Bank M was placed under BoT statutory management owing to liquidity difficulties (Box 1). More generally, banks could be faced with large withdrawals of FX funding, which would be difficult to meet if FX loans are illiquid. In this regard, ability to manage banking and systemic liquidity risks would ultimately reside in the adequacy of BoT's FX reserves.



15. Business model operational efficiency shows significant variation across bank peer groups (Figure 7). There is great variation in noninterest expense-to-asset ratios. A significant number of Peer 2 and 3 banks, including foreign banks, exhibit extremely high ratios of noninterest expenses-to-assets, exceeding 10 percent. Banks tend to partially offset high noninterest expenses by lending at high interest rates, but despite their capacity to (partially) pass high costs on to ultimate borrowers, banks with high cost structures still tend to have negative profitability.⁵

16. Interconnectedness in the system arises from bilateral balance sheet exposures between pension funds and banks (Figure 8). Peer 1 banks are at the center of the financial system network and are thus systemically important. The two-way bilateral exposures between Peer 1 private banks and Peer 3 private banks are the most significant, but to a lesser extent, Peer 1 private banks also exhibit interconnections with Peer 2 private banks. Government-owned banks are net providers of funding to Peer 1–3 private banks. Among nonbanks, pension fund deposits are predominantly allocated to Peer 1 and Peer 3 private banks. Regarding cross-border bilateral

⁵ This reflects a combination of operational inefficiency and poor (loan) asset quality that is only partially anticipated and offset by high interest rates assessed on borrowers.

exposures, Peer 1 private banks are also at the center stage, as recipients of funding from both parent and non-parent foreign institutions.

17. Banks are vulnerable to potential withdrawal of pension fund and mobile network operators' (MNO) deposits. The mandatory social security schemes offer generous defined-benefit (DB) pensions, which have consistently exceeded contributions in recent years, triggering liquidation of assets including bank deposits.⁶ Deposit insurance cover for pension fund and MNO deposits is poor and these sources of funds can be an important source of flight risk under stressed conditions.

18. Continued unresolved fiscal arrears raise concern given the financial sector's high sovereign exposure. Banks are significantly exposed as are pension funds. Should non-payment on direct government obligations and fiscal arrears continue or increase further, banks' liquidity challenges would rise. Arrears to pension funds may cause them to liquidate bank deposits to meet cashflow needs adding to banks' liquidity pressures. Prompt payment on outstanding government-guaranteed loans and arrears could, therefore, significantly attenuate banks' asset quality problems and bolster financial stability.

B. Banking Sector Stress Tests

Scenarios

19. Banking sector resilience was assessed under a baseline and two adverse scenarios, which draw on the risk assessment for Tanzania (Appendix II, Tables 5 and 6).⁷ The **baseline scenario** assumes stable growth of about 6–7 percent under favorable external conditions and improvements in the domestic business environment, budget execution and tax collection, that together facilitate the scaling up of public investment, decreases in fiscal arrears and bank NPL ratios, and a gradual recovery in credit growth. An **adverse scenario** envisages that recently observed weaknesses in economic indicators and the business environment continue unabated, causing a persistent slowdown in growth. A **tail risk scenario** envisages an extreme but possible combination of external shocks, (severe terms-of-trade shock, global financial tightening, and a slowdown in global growth), and domestic shocks (reduced private and public investment with protracted incidence of government payment arrears). These assumed shocks trigger a sharp slowdown in domestic growth, a currency depreciation, spikes in domestic inflation and interest rates, and a credit squeeze.⁸

⁶ Pension benefit payments have also been put at risk by government arrears.

⁷ The baseline scenario corresponds to the IMF's World Economic Outlook projections as of March 2018.

⁸ Tanzania experienced slowdowns of similar magnitudes following the mid-1970s and early 1990s world recessions.

Banks' Resilience to Stress

20. Six banks are currently undercapitalized (Table 6). 37 out of 45 banks exhibit varying degrees of under-provisioning at end-2017. Correcting for this reduces the total capital ratio of the system by 2.1 percentage points, to 18.1 percent, and the total capital ratios of six banks representing 10 percent of assets in the system fall below the 12 percent regulatory threshold.

Baseline Scenario

21. The system-wide capital ratio rises to 18.9 percent, driven by profitability of Peer 1 private banks, although the solvency positions of Peer 2–3 private banks and government-owned banks decline and five additional banks become undercapitalized. NPL ratios (before write-offs) are projected to remain at current levels over the next three years. Due to widespread NPL and pre-impairment profitability problems, the capital ratios of many banks decline over time. The five additional banks, which become undercapitalized represent 1.8 percent of banking assets.⁹ Overall, under the baseline, 11 banks representing 12.8 percent of assets in the system are undercapitalized at some point during the period 2018–20.

The Banking System Would Exhibit Significant Fragility Under Tail Risk Conditions

22. Solvency stress tests reveal that 22 banks, representing 32 percent of banking assets would become undercapitalized in the tail risk scenario. The combined effects of sharply declining real GDP growth, rising interest rates, and depreciation of the T Sh reduce banks' profitability and capital ratios, mostly through their impact on credit losses and net interest income—direct gains/losses due to T Sh depreciation play only a minor role as net open FX positions are small (Figure 9). NPL ratios rise from 10.4 percent to 22.7 percent, driven by the economic slowdown.¹⁰ Sharply rising NPLs also drive down net interest incomes of most banks which also weighs significantly on bank solvency.

23. Interbank exposures exacerbate system-wide vulnerabilities. Contagion analysis reveals that bank failures could propagate through the system. In the solvency tests described above, nine of the 32 undercapitalized banks exhibit negative capital under the tail risk scenario. Defaults by these banks would trigger knock-on effects on other banks, with five additional banks representing 5½ percent of system assets also ending up with negative capital and an additional bank (1½ percent of system assets) becoming undercapitalized (Figure 10).

⁹ Any potential increase in NPL ratios would exacerbate the undercapitalization problem under the baseline scenario. The capital ratio of one bank which is currently undercapitalized after adjustment for under-provisioning, increases over time in the baseline scenario, and is above the 12 percent threshold by 2020. Counting this bank as undercapitalized increases the total number of undercapitalized banks in the baseline to 11, and their share of assets in the system is 12.8 percent.

¹⁰ The slowdown in real GDP growth accounts for about 90 percent of the increase in the aggregate NPL ratio over the period 2018–20 in the tail risk scenario—the interest rate and T Sh depreciation effects on NPL ratios are estimated to be small.

24. Liquidity tests reveal that banks would face significant shortfalls within a 30-day period in the event of a sustained run, needing to rely on emergency liquidity assistance (ELA) to remain in operation (table). The cash flow test is based on a liquidity ladder analysis, with no differentiation across currencies due to data constraints. It implies that 25–30 percent of non-equity funding in the system is withdrawn within a 90-day period with 15–20 percent of withdrawals occurring in the first 30 days. Banks can counterbalance negative funding gaps by using their cash and excess reserve holdings, and by liquidating securities with the BoT (using standing facilities), but beyond a point, a number of them would have to resort to ELA from BoT to meet liquidity shortfalls.¹¹

25. Withdrawal of funding from pension funds, insurance companies, and/or foreign banks could have significant effects on capital ratios of individual banks. Funding from domestic institutional investors and foreign banks represents a large share of capital for some banks. In absence of any other shock, at least six banks would become undercapitalized if nonbank financial institutions interrupted their provision of funding and triggered asset fire sales by banks.¹²

Liquidity Stress Test Number of Banks that Fail the Test at Different Time Horizons (Shares of assets in the system indicated in bold, in percent)						
	Time period					Total
	0-30 Days	30-60 Days	60-90 Days	90-180 Days	180-360 Days	0-360 Days
PEER 1 (15 banks)	4 13.9	1 1.7	0 0.0	0 0.0	1 1.9	6 17.5
PEER 2 (11 banks)	3 4.3	0 0.0	0 0.0	0 0.0	0 0.0	3 4.3
PEER 3 (17 banks)	4 1.6	0 0.0	0 0.0	0 0.0	0 0.0	4 1.6
PEER 1* (13 banks)	3 11.3	1 1.7	0 0.0	0 0.0	1 1.9	5 14.9
PEER 2* (9 banks)	2 2.8	0 0.0	0 0.0	0 0.0	0 0.0	2 2.8
PEER 3* (15 banks)	4 1.6	0 0.0	0 0.0	0 0.0	0 0.0	4 1.6
Government (6 banks)	2 4.1	0 0.0	0 0.0	0 0.0	0 0.0	2 4.1
Total (43 banks)	11 19.8	1 1.7	0 0.0	0 0.0	1 1.9	13 23.4

Sources: Bank of Tanzania and FSAP team calculations.
 Note: * indicates banks with more than 50 percent government ownership are excluded.

26. Sensitivity analysis confirmed the importance of credit risk, which is amplified by credit concentration (Figure 11). Peer 2 private banks and government-owned banks show higher than average sensitivity to credit quality deterioration. Concentration risk is high, especially among Peer 1 private and government-owned banks—a default of banks' five largest credit exposures would impose significant stress, driving the system-wide total capital ratio to below the 12 percent threshold.

¹¹ A bank needing ELA to continue operating fails the test.

¹² The assumption in the analysis is that banks pay for the withdrawals with asset sales. The application of haircuts (30 percent) to the sales of securities implies a loss of capital for the banks.

POLICIES ADDRESSING FINANCIAL SECTOR RESILIENCE

A. Institutional Framework for Systemic Risk Oversight

27. Tanzania has put in place some of the key elements of a framework for monitoring systemic risks and macroprudential policy responses.¹³ A national coordination body, the Tanzania Financial Stability Forum (TFSF), was established in 2013 through a memorandum of understanding (MOU) executed by the BoT, Social Security Regulatory Authority, Capital Markets Supervisory Authority, Tanzania Insurance Regulatory Authority, DIB, and the Ministry of Finance and Planning (MoFP). The TFSF serves as a high-level forum for surveillance of systemic risk and determination of policy responses to developing risks. It is charged with ensuring prompt and effective identification of, and responses to, developments that pose a threat to the stability of the financial system. Each sectoral authority has committed to put in place its own crisis management plans, with the TFSF serving as a vehicle to coordinate development of national contingency plans. The BoT's Directorate of Banking Supervision (DBS) is represented in the TFSF's discussions, which provides an opportunity to map broader financial sector risks identified in the TFSF into potential banking vulnerabilities. The TFSF is supported by the BoT's Financial Stability Directorate (DFS), established in 2009, which assesses the financial industry's vulnerabilities and the build-up of risks across sectors, issues a bi-annual Financial Stability Report and collaborates with DBS in carrying out scenario-based stress testing.

B. Managing Systemic Liquidity

28. Enhancements to managing systemic liquidity can provide significant support to macro-financial stability. Addressing financial infrastructure and reducing reliance on foreign exchange operations would improve institutional liquidity management on both T Sh and FX sides which could be buttressed through introduction of macroprudential measures and operationalizing ELA.

Improving Policy Transmission and Cost and Access to Liquidity

29. Institutional liquidity management is challenged by volatility in excess reserves and relatively high concentration in the distribution of liquidity across banks. Interbank rates and their volatility have declined recently reflecting excess reserves that are high relative to previous cycles of monetary easing. Despite this, banks continue to hoard liquidity and limited access to excess reserves by smaller banks remains a persistent constraint in the interbank market.¹⁴

¹³ Simultaneously, it also contributes to the Crisis Management Working Group that addresses regional financial stability issues under the auspices of the East African Community (EAC) Committee.

¹⁴ Since 2017, the interbank money market rate stabilized given the BoT increased liquidity injections to stimulate private sector credit. Consequently, banks' clearing balances at the BoT averaged T Sh 734 billion for 2017, relative to

(continued)

30. Foreign exchange operations are the primary means of managing liquidity, while passive monetary operations leave a wide range for excess liquidity to fluctuate. Several monetary instruments are available to the BoT for liquidity management, but FX operations remain at the core of its operating framework. The BoT's FX operations lack clarity in objectives, are conducted on a daily basis, and are sometimes significant, contributing to volatile excess reserves. Over the last two years, net open market operations (OMOs) have not offset FX activity, potentially increasing uncertainty in banks' liquidity planning and resulting in greater volatility in excess reserves and the Interbank Money Market (IBCM) rates (Figure 12).

31. The BoT should prioritize certain institutional and operational reforms to support its intended transition to an interest-rate based operating target. These measures would build credibility of the new framework and strengthen monetary transmission. First, developing a coherent and transparent operational framework and strategy that emphasizes attainment of the BoT's price stability mandate. Second, re-orienting monetary operations to rely on OMOs to manage liquidity and steering the operational target and designing FX operations with distinct objectives. Specifically, the BoT should establish a policy rate bounded by standing facilities, align the operating target with the monetary policy rate, and systemically calibrate OMOs to adequately offset the liquidity position of autonomous liquidity components, including FX operations. Additionally, developing a clear intervention strategy and distinguishing its FX operations by its underlying objectives, are key to fostering two-way volatility of the exchange rate, and make for a more effective interest rate operating framework. Third, establishing a clear accountability framework, to address uncertainties about policy decisions and operations is useful for engaging stakeholders in providing the necessary support for the framework. For instance, enhancing the coordination between the BoT and the MoFP to improve liquidity forecasts is paramount as the BoT seeks to exert greater control over excess reserves.

Building Resilience to Liquidity Shocks by Fostering Money Market Development

32. Systemic liquidity management in Tanzania faces the challenge of thin, segmented and underdeveloped markets (Figure 12). In the first instance, secondary market liquidity for government bonds (the main financial asset) is low, potentially increasing the liquidity premium. Moreover, market institutional arrangements limit the efficient redistribution of liquidity despite the financial system operating with a structural liquidity surplus. This adversely impacts Peer 2 and 3 banks, which rely systematically more on wholesale funding, and who find restricted counterparty relationships and limits at times resulting in high IBCM rates or curtailed IBCM access. Their only alternative is the BoT's Lombard facility, priced at punitive rates.

33. Deepening markets is crucial to increasing the financial sector's resilience to liquidity shocks. The BoT is making steady progress in developing market infrastructure to foster price discovery and increase market access. It plans to implement a trading system for interbank transactions, along with the introduction of the Global Master Repurchase Agreement. Finalizing the

the average of T Sh 400 billion for 2016, with corresponding distribution (as measured by an Herfindahl Index-HHI) of 1700 and 1300, respectively. Note that HHI at or below 1000 shows relatively more unconcentrated distribution.

outstanding operational issues to support the legal basis for perfecting collateral under repo contracts is an essential next step. Moreover, establishing market practices for valuation and repo margining, particularly for longer-term repos, can also stimulate secondary market trading for government Treasury bills and bonds.

Macprudential Tools to Manage FX Liquidity Risk

34. Enhancing the prudential framework to reduce FX liquidity vulnerabilities should be a near-term priority, although international reserves will likely remain the primary FX liquidity backstop. Building institutional FX liquidity buffers should be a top priority, commencing with increased capacity to identify and anticipate FX liquidity mismatches, and including a liquidity coverage ratio, denominated in FX and, conditional on EAC harmonization requirements, reserve requirements in FX. Developing and implementing a comprehensive toolkit however, may only be feasible gradually, so the BoT will likely rely on reserves—either through FX intervention or through ELA in FX. Gross reserves are assessed to be approximately four and a half months of prospective imports (as at March 2018), and their capacity to absorb stress to FX liquidity on their own is unclear. Enhancing assessments of reserve adequacy measures to include short-term banking sector FX mismatches along with the usual import coverage measures, could contribute significantly to calibrating and creating a robust buffer to support financial stability.

ELA

35. Completing the ongoing process of developing an operational framework and tools for ELA is critical. The 2006 Bank of Tanzania Act (BoTA) provides powers and responsibilities to the BoT for ELA and developing the corresponding operational framework and tools for which the BoT has begun preparations is a priority.

36. Key practical gaps hindering completion should be addressed in timely fashion. These include determining an appropriate collateral framework to accept a wider class of assets beyond government securities and pre-arranging indemnification from the government when extending ELA under doubtful or exceptional circumstances, among others.¹⁵ In managing the risks from ELA, it is important that the haircuts for different assets are tested using rigorous valuation techniques, eligible collateral are subject to pre-screening and periodic testing of loan pools to establish values and eligibility for ELA; and ensuring the adequacy of required levels of overcollateralization. In addition, the BoT should adopt a horizon-scanning framework, at least for Domestic Systemically Important Banks (D-SIBs), to anticipate any immediate liquidity needs in either T Sh or FX.

¹⁵ The distinction made is that the BoT may be uncertain about the adequacy of collateral for the duration of the ELA loan, or the repayment/exit strategy of the bank, and hence may require the government to indemnify the central bank against any losses from the activity. The presence of this indemnity, however, is not intended to replace ELA collateral, or diminish incentives for the BoT to assess their sufficiency, and make suitable arrangements to register legal interest.

37. The possibility of ELA in FX is worth establishing as part of the central bank's contingency plan for preserving financial stability. The BoT can consider such needs on a bilateral basis, supported by its ongoing horizon-scanning to identify potential FX mismatches. As this is the last resort for a central bank with constraints on foreign reserves, the enhancements to the prudential frameworks noted earlier are a necessity. Accordingly, while the central bank may be prepared to extend ELA in FX, of greater importance is the application of stringent conditions—including frequently updated repayment plans, monitoring of banks' FX liquidity position, and pre-approval of any payments from the local bank to its parent bank, since the central bank needs to recover FX proceeds from ELA loans within a reasonable time.

C. Banking Supervision and Problem Bank Oversight and Resolution

Banking Regulations

38. Prudential regulations are broadly sound and considerable progress has been made in strengthening rules since the 2010 FSAP. The prudential framework has undergone a major update, including the 2010 risk management guidelines and a suite of new regulations introduced in 2014. Capital adequacy requirements are based on Basel I definitions and risk-weightings, with the addition of capital charges for market and operational risk. The current minimum total capital requirement of 12 percent of risk-weighted assets is augmented by a 2½ percent capital conservation buffer. Meeting Basel III capital standards should not be a challenge for most Tanzanian banks due to capital requirements already exceeding Basel minimums, and the predominance of common equity Tier 1 capital. Basel III liquidity requirements will be more challenging due to a dearth of instruments that meet the Basel definition of high quality liquid assets (HQLA).¹⁶

39. A new circular for loan classification and restructuring introduced by the BoT on February 19, 2018 substantially weakens its framework and policies to oversee banks' problem loan management. Following emerging good practice, the circular requires banks to devise strategic plans for problem loan reduction, establish permanent recovery functions and ensure top management for high risk cases. However, the ability of banks under this circular to upgrade the loan classification of NPLs and to capitalize and recognize as income, the interest on NPLs, is likely to result in overstated earnings and capital. This could mask vulnerabilities and overstate the resilience of some individual banks and the system overall. Such regulatory relief is a step back and it will be important for the BoT to closely monitor banks to ensure awareness of their true position for effective financial stability analysis. Moreover, it is recommended that banks be required to develop capital plans consistent with their NPL reduction strategies in order to be adequately prepared for the withdrawal of regulatory relief at the end of 2020.

40. The BoT should follow-up on this circular to further clarify conditions under which NPLs may be restructured and upgraded. This would complement the guidance already provided in the BoT's February 2018 circular for banks to strengthen NPL management, covering

¹⁶ The BoT has a Basel II/III implementation project with completion targeted for end-2018 in line with EAC harmonization commitments.

establishment of permanent recovery functions, ensuring top management involvement for high risk cases, policies for early warning systems, and improvements in credit risk management. In addition to these, the BoT should issue clarification; for e.g., through a “frequently asked questions issuance that, besides emphasizing its support for banks” efforts to develop a strategy to minimize losses on troubled loans (which frequently means working with the borrower), also highlights requirements necessary for restructuring of problem credits and examples of situations where a restructuring is appropriate and others where it is not. Moreover, it will be important for the BoT to undertake supervisory monitoring of the implementation of banks’ NPL strategies and restructured loans through both, reporting requirements and targeted onsite examinations, and increased supervisory focus on the largest non-performing exposures.

Banking Supervision

41. Effective banking supervision continues to be constrained by lack of adequate resources. The staff of DBS has declined since 2015 while the number of supervised institutions has increased. Supervision staff are also stretched by ongoing projects, EAC commitments, and ad hoc demands including the closure of five small banks in January 2018. DBS lacks sufficient resources for effective ongoing supervision, clearly reflected in its inability to adhere to its policy of an annual frequency of onsite examinations. The examination process and risk profiling of institutions is also hampered by insufficient focus on, and guidance from, offsite analysis.

42. The risk-based supervision (RBS) Framework introduced by the BoT has resulted in a generally effective supervisory review of specific risks and its ongoing revision should be implemented with a view to ironing out identified gaps.

- The RBS framework and manual, introduced in 2010, are significant steps forward from the previous FSAP when the BoT was in the pilot stage of implementing RBS. Based on its experience with the current framework, the BoT intends to revise its framework and procedures to, among other things, put in place a single supervisory risk assessment process.
- The new supervisory rating system should be appropriately judgmental and avoid potential pitfalls identified in the current, formula-driven approach, wherein institutions have been rated as moderate risk with a stable direction despite material weaknesses identified by examiners as being likely to lead to significant future losses. Importantly, the BoT should revise the process for assigning supervisory ratings to individual institutions and should view the management component of the supervisory rating system (CAMELS) as a leading indicator and not a lagging indicator. For example, repeated citations of serious risk management deficiencies should warrant management receiving the most severe rating, notwithstanding current financial results.
- This will assist in determining a more appropriate allocation of supervisory resources through the overall supervisory risk rating of the banks than at present. Operationally, this calls for judgment and, hence, for the final ratings to be the responsibility of more seasoned examiners and DBS management.

- Increased emphasis and additional guidance should be given to offsite analysis given its importance in supporting onsite supervision.

Problem Bank Oversight and Resolution

43. The legal framework for early intervention and bank resolution is broadly adequate.

The early intervention framework is comprehensive, providing broad powers, and the bank resolution framework establishes a special resolution regime with potential for judicial review. Introducing legal changes to allow the Deposit Insurance Fund (DIF) to be used for lesser cost resolutions than depositor payout would be desirable as, at present, the DIF can only be utilized for depositor payouts in the case of bank liquidations.

44. The BoT needs to act more quickly and decisively with identified problem banks.

- It should discontinue forbearance practices, whereby the application of legal powers in the supervision of problem banks has been subject to delays and opt instead for early enforcement action which could contain losses significantly. The five community banks that were failed in January 2018 evidenced a lengthy period of forbearance—successive examinations revealed significant undercapitalization and repeatedly identified risk management deficiencies, yet progressively stronger supervisory action was not undertaken. Some of these entities were allowed to operate with negative capital for a long period of time and while the BoT eventually entered into MOUs with some of these banks, these were not legally enforceable and included further significant forbearance. The delay in taking appropriate early supervisory action ultimately resulted in greater losses at these institutions.
- Current vulnerabilities in the banking system underscore the need for decisive and preemptive corrective action. Of the 54 banks and financial institutions supervised by the BoT, 20 are CAMELS composite 3-rated and 9 are 4-rated.¹⁷ Leaving risks unaddressed in such a situation is risky as even prompt corrective action (PCA) regulations may produce little benefit if asset values decline rapidly causing bank capital to drop precipitously.

45. Developing and implementing an enforcement policy will ensure effective, consistent, and timely corrective action through-the-cycle. DBS does not have documented procedures such as an enforcement manual or intervention policy, or a policy with respect to operationalizing the PCA regulations, to guide decision-making in dealing with stressed banks. Adherence to the capital triggers in the PCA regulations and internal guidance to ensure appropriate responses to non-capital related problems, and to avoid providing extended forbearance when a bank has no realistic chance of recovery would constitute desirable steps. An enforcement policy could also ensure that serious and repeated deficiencies noted in bank examinations are consistently followed up by commensurate enforcement action. A formal policy, administered consistently would assist in

¹⁷ Together, these entities represent 21 percent of the assets in the system. There are no 5-rated institutions, although three entities have negative capital.

inculcating an appropriate enforcement culture and would secure the supervisor's credibility and ability to influence remedial action.

46. The BoT should require banks to prepare recovery plans and it should prepare resolution plans for D-SIBs once these are identified. Recovery plans should assist in identifying options for restoring financial strength and viability should a bank come under severe stress. The BoT should ensure that these financial contingency plans are rigorously reviewed and detail responses to recover from such events as liquidity shortfalls and asset quality deterioration.

D. Deposit Insurance and Financial Crises Management Arrangements

47. Operational independence and effectiveness of the DIB should be enhanced through the appointment of a functioning Board. Although the law states that the Board of the DIB shall meet not less than once in each quarter, a Board has not been appointed by the MoFP since February 2017, when the terms of the previous directors expired. A functioning Board is essential to undertaking and monitoring the implementation of planned actions, particularly in the DIB strategic plan that are important in facilitating movement towards operational independence.

48. Advance preparation needs to be significantly ramped up in order for the DIB to undertake efficient payout of insured deposits and effective liquidation. Since the DIB did not engage in advance preparation for these functions in the case of the five recently failed banks, both processes have been significantly delayed. Delays in liquidation are likely to lead to reduced recoveries and, going forward, it is recommended that the DIB be prepared to make payouts within a seven-day period, in line with international best practice. The DIB does not possess the resources or skill set to carry out bank liquidations on its own and needs to procure the required resources. Since adherence to the government procurement process can take up to a year to obtain the resources needed, a list of resources needed for bank liquidation should be pre-approved through the procurement process and be periodically updated.

49. Financial crisis preparedness and management arrangements can be significantly enhanced by effectively operationalizing the TFSF. While the guiding principles have been agreed for crisis management and the TFSF has regular meetings, an operational coordination mechanism is still pending. This reflects, in part, the fact that some sectoral regulatory authorities have not yet put in place their sector-specific plans. For example, DBS' assessment of the impact of financial sector risks on the banking sector is yet to be comprehensively and consistently applied to derive institutional risk profiles. Specific priority actions to operationalize the TFSF include undertaking of contingency planning by member agencies, development of checklists and guidelines for departments and individuals in the key posts, clear rules for public support to be developed in case of need, and monitoring. It will also be important to subsequently test the framework developed with a crisis simulation exercise at regular frequency to detect any shortcomings. High priority should also be accorded to coordination of activities with home supervisors of foreign banks active in Tanzania, especially regarding communication strategies, cross-border crisis management arrangements and resolution plans.

50. Extraordinary powers may be required to maintain financial stability in a crisis.

Although the authorities have some resolution powers that can be used in systemic crisis situations, there should be a more comprehensive framework that provides for prompt resolution. This can include powers to inject capital, make asset purchases, provide loans or guarantees to weak systemic banks, protect uninsured depositors and creditors, and even nationalization. The authorities may wish to consider passing a financial stability law in advance or to have one drafted for emergency passage when needed. The latter may eliminate the temptation to misuse emergency powers; e.g., providing open bank assistance inappropriately, if an existing law permits it.

E. Tackling NPLs

51. Legal and tax issues are decreasing the efficiency of enforcement and insolvency processes, which impedes NPL resolution. While Tanzania has made significant progress in modernizing many of the laws governing the enforcement of security and the insolvency framework, difficulties in their implementation and use contribute to inadequate NPL resolution. It is recommended that a multi-stakeholder working group be established to identify mechanisms to ensure that the legal and tax framework supports efficient NPL resolution, including channeling a larger percentage of corporate NPL cases through the Commercial Division of the High Court; modifying the role of regional commissioners in the enforcement process; ensuring proper incentives for banks to pursue enforcement and liquidation claims; improving the insolvency law and increasing its use to facilitate restructuring of viable enterprises; and introducing voluntary out-of-court workout guidelines for multi-creditor situations; among others.

FINANCIAL INTEGRITY AND CYBER RISK**A. AML/CFT**

52. Tanzania has addressed most of the deficiencies identified by the 2009 assessment of its anti-money laundering and combating the financing of terrorism (AML/CFT) framework against the previous standard. This has enabled it to exit monitoring by the Financial Action Task Force (FATF) that was triggered subsequent to the 2009 assessment. The shortcomings identified previously included insufficient criminalization of money laundering (ML) and incomplete customer due diligence measures, as well as the lack of: a mechanism to identify and freeze terrorist assets, a functioning financial intelligence unit (FIU), and the designation of competent authorities to monitoring the implementation of AML/CFT measures by reporting entities. Since then, Tanzania has made important progress, notably by amending the AML/CFT legislation and establishing an FIU.¹⁸

53. Measures were also taken under the current standard, but shortcomings remain.

The authorities assessed the ML/TF risks that the country faces with the assistance of the World Bank. The National Risk Assessment (NRA) was conducted from September 2015 to December 2016.

¹⁸ The 2009 assessment was conducted by the Eastern and Southern Africa Anti-Money Laundering Group, (the FATF-style regional body of which Tanzania is a member) against the previous standard (the FATF 2003 40 + 9 Recommendations). Tanzania's assessment against the current AML/CFT standard (the FATF 2012 Recommendations) is scheduled to take place in June 2019.

It was led by the FIU in cooperation with the BoT and included a range of competent authorities, as well as representatives of reporting entities. It assessed the risks in 19 sectors of the Tanzanian economy, including banking, real estate, micro credit institutions and *bureaux de change*. A NRA report was prepared and is pending governmental approval. Measures were also taken to strengthen the supervisory framework for *bureaux de change*. 107 bureaux de change were re-licensed in that context (as of March 2018, compared to 297 operating as of June 2017). Nevertheless, some aspects of the standard are not yet implemented in Tanzania, such as risk-based AML/CFT supervision. Furthermore, the TF offense may be too general to cover the financing of travel for the purposes of receiving terrorist training.¹⁹

54. The authorities should finalize the NRA as a matter of priority and take all necessary mitigating measures. As the ML and TF risks may evolve rapidly, it is important that Tanzania complete the NRA process by adopting the ensuing report, and by establishing and implementing a comprehensive action plan to mitigate the identified risks. This should, in particular, include developing and implementing a framework for a risk-based approach to AML/CFT supervision in line with the risks identified in the NRA. The authorities should also consider amending the CFT legislation to ensure that all situations envisaged in United Nations Security Council Resolution 2178 are explicitly criminalized. Addressing remaining AML/CFT issues may have important broader benefits in terms of preserving access to correspondent banking relationships.

B. Cyber Risks

55. The BoT is spearheading efforts to defend against cyber threats to the banking sector. There has been no cyber risk event affecting individual banks or the sector, albeit threat awareness has increased given that banks are increasingly automating their transactions. The BoT undertook a stock-taking of information technology (IT) needs and commissioned banks' auditors to conduct separate audits of IT systems for financial years 2016 and 2017 for all commercial banks in order to identify common issues and respond with targeted action. The central bank is also developing a regulatory guideline on cyber security—an initial draft, which is at the commentary stage, will be eventually issued after also incorporating industry comments. These efforts are being complemented by initiatives from the financial industry—awareness workshops have been conducted on cyber risks by global banks and major audit firms.

FINANCIAL SECTOR DEVELOPMENT

56. Large parts of the enterprise sector, and in particular Micro, Small and Medium Enterprises (MSMEs), remain underserved by the formal financial sector. Lending is expensive, in part, because of the high perceived risk by lenders. Addressing financial infrastructure gaps could allow for more efficient credit allocation and lower pricing. This includes reforms to the secured transaction system, improvements in the credit bureau, introducing a National ID, and introducing a national Switch. There are also a number of institutions providing credit to MSMEs, including

¹⁹ While Tanzania considers that this is fully criminalized through Section 22 of the Prevention of Terrorism Act (2002), the absence of specific reference to travel may entail a loophole in practice.

non-deposit taking microfinance, digital finance, and invoice discounting providers. The lack of regulation and supervision of these entities undermines data collection and raises issues about the legitimacy of this segment of the financial market, AML/CFT reporting and treatment of their consumers. It is recommended that all credit providers in Tanzania be regulated and supervised. Gaps in financial literacy and consumer protection also need to be addressed by introducing a new financial consumer protection framework.

57. Long-term finance is critical to investment led growth. Pension funds could be a meaningful source of long-term financing. However, they have substantial investments in illiquid and unproductive investments, addressing which will require the resolution of outstanding government loans and a strategy for dealing with the high level of real estate holdings. Measures should be taken to increase the number and size of liquid securities, including equities, debt and structured products, which could be a significant potential source of long-term financing. This includes consideration of privatizing commercial state-owned enterprises, which could be a source of new listings on the Dar Es Salaam Stock Exchange. The monitoring and oversight of Development Finance Institutions involved in facilitating increased access to long-term finance should be improved.

Box 1. Bank M

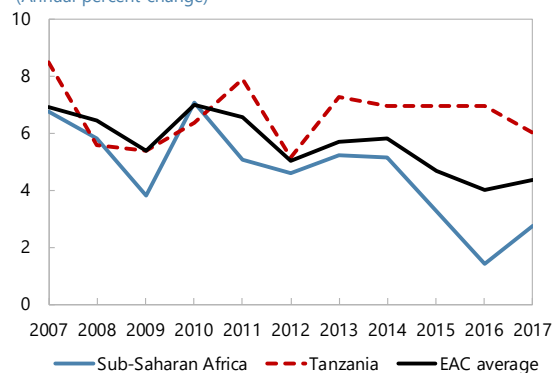
Due to liquidity problems, Bank M was placed under BoT's statutory management and its operations suspended for 90 days on August 2, 2018. While holding a small share of banking system assets (3½ percent), lending (5.2 percent) and deposits (2.8 percent), it is active in the interbank market. No significant contagion impact on other financial institutions nor on confidence in the banking sector has been reported thus far, despite the deposit freeze.

In order to minimize systemic risks, the authorities need to quickly identify and implement a least cost resolution strategy. Priority should be given to providing depositors with swift access to their insured deposits, and to promptly executing a resolution strategy which minimizes systemic risks and resolution costs (including to the deposit insurance scheme). Losses should be borne by shareholders in the first instance, and then uninsured creditors (as consistent with preserving financial stability). The authorities should continue to closely monitor deposit flows at other banks at a high frequency.

Figure 1. Tanzania: Macroeconomic Context

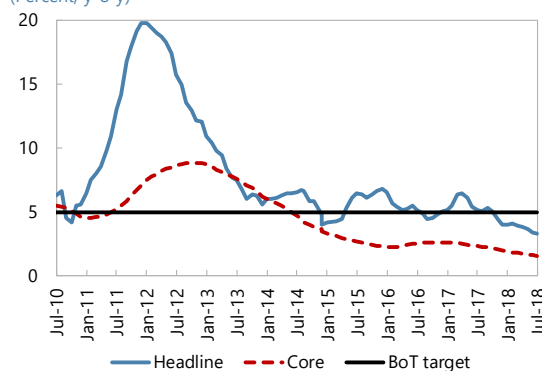
Economic growth has been robust in recent years.

Real GDP Growth, 2006-2017
(Annual percent change)



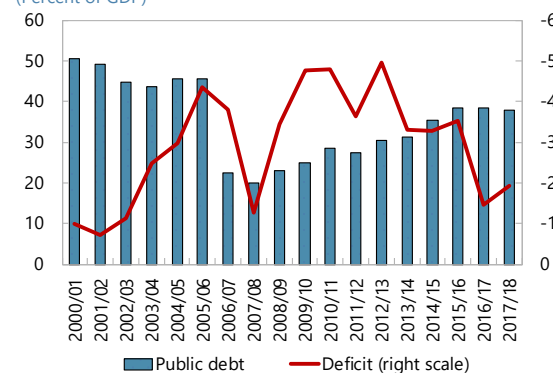
Inflation was contained around the BoT's target.

Inflation
(Percent, y-o-y)



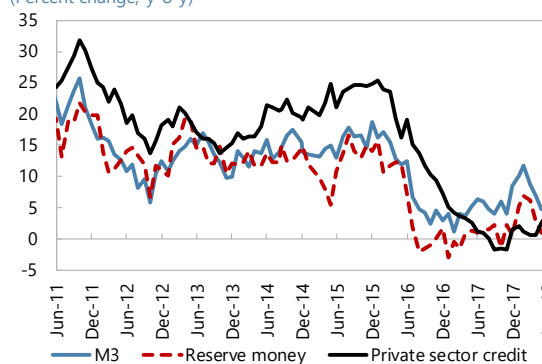
Public debt remains modest and the fiscal deficit is lower.

Public debt
(Percent of GDP)



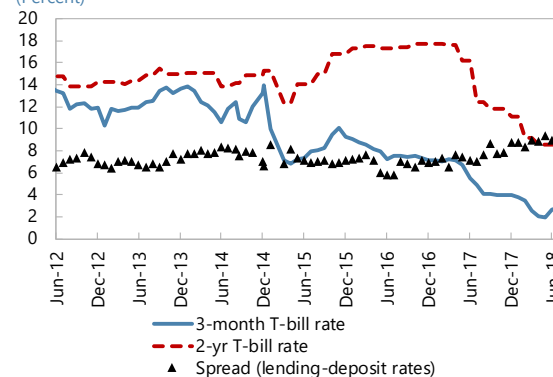
But monetary aggregates and credit growth have slowed sharply.

Money and Private Sector Credit
(Percent change, y-o-y)



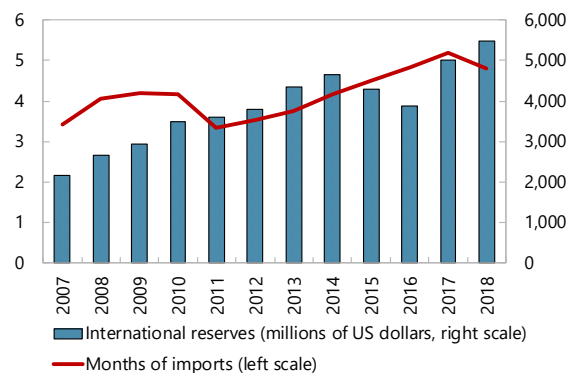
Market rates have gradually decreased...

Interest Rates
(Percent)



...and active FX operations and external borrowing have facilitated an increase in international reserves.

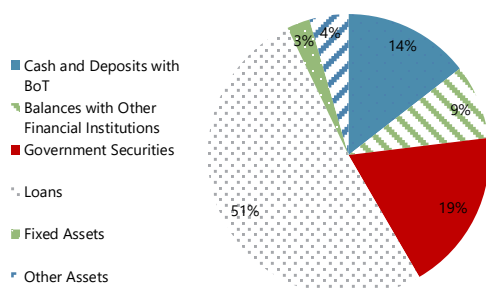
International Reserves and Months of Imports



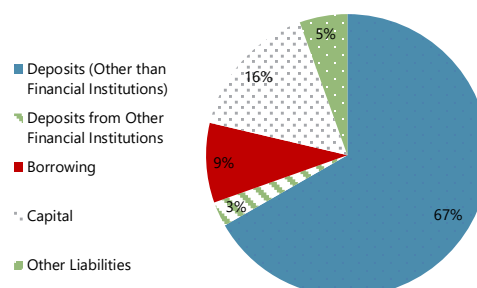
Sources: Bank of Tanzania, IMF World Economic Outlook Database, and FSAP team calculations.

Figure 2. Tanzania: Assets and Liabilities of Financial Institutions
(Percent)

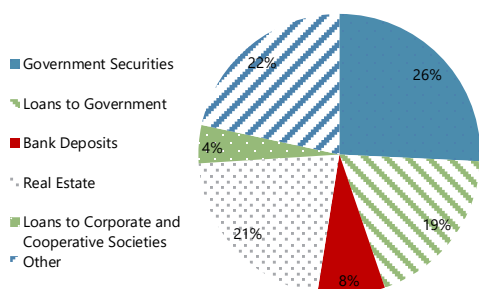
Assets of Banks, December 2017¹



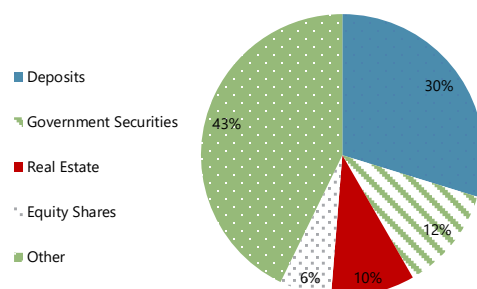
Liabilities of Banks, December 2017



Assets of Pension Funds, September 2017



Assets of Insurers, June 2017

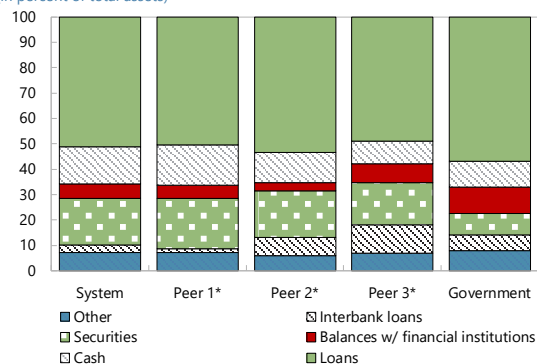


Sources: Bank of Tanzania and FSAP team calculations.

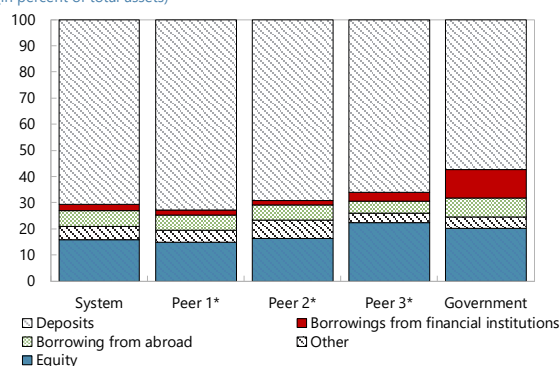
Note: ¹ Balances with other financial institutions include interbank loans receivable.

Figure 3. Tanzania: Composition of Bank Assets and Liabilities**Asset Composition ¹**

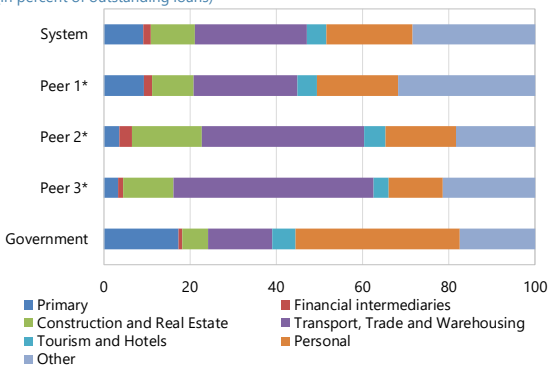
(in percent of total assets)

**Liability Composition ²**

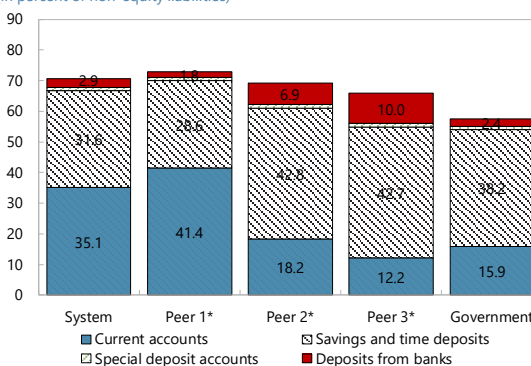
(in percent of total assets)

**Sectoral Bank Lending ³**

(in percent of outstanding loans)

**Deposit Composition**

(in percent of non-equity liabilities)



Sources: Bank of Tanzania and FSAP team calculations.

Note: * indicates banks with more than 50 percent government ownership are excluded.

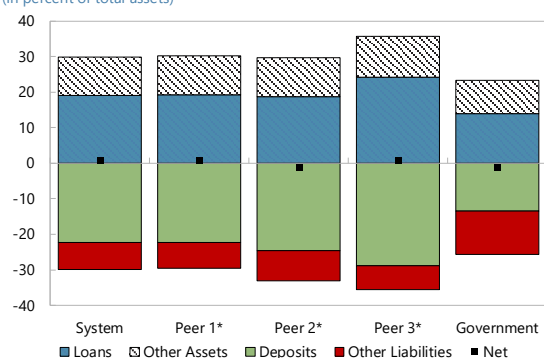
¹ Loans exclude interbank loans; cash includes balances with the BoT; and other includes commercial and other bills purchased, customer liabilities for acceptances, underwriting accounts, equity investment, bank premises furniture and equipment, other property and assets owned, and other assets.

² Borrowing from abroad includes borrowing from banks abroad and other borrowing abroad; and other includes subordinated debt, accrued taxes and other expenses not paid, unearned income and other deferred credit, outstanding acceptances, accounts payable and other liabilities.

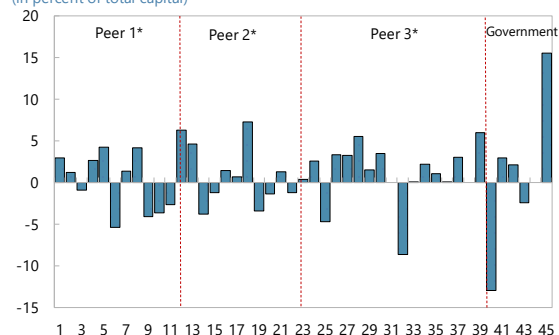
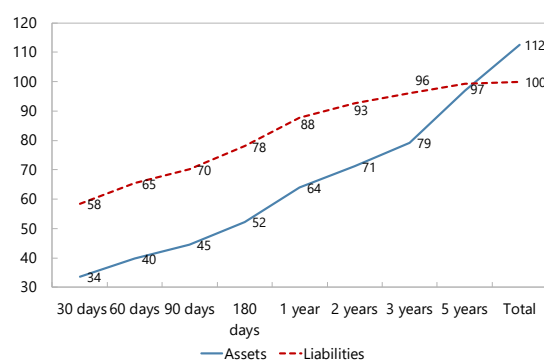
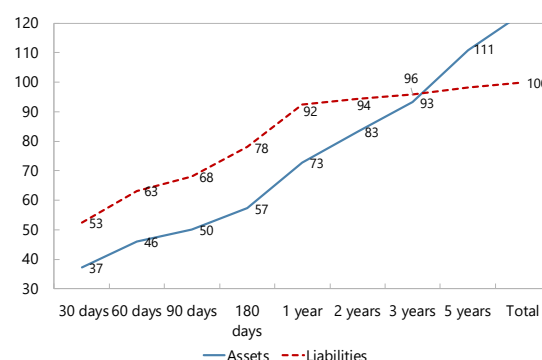
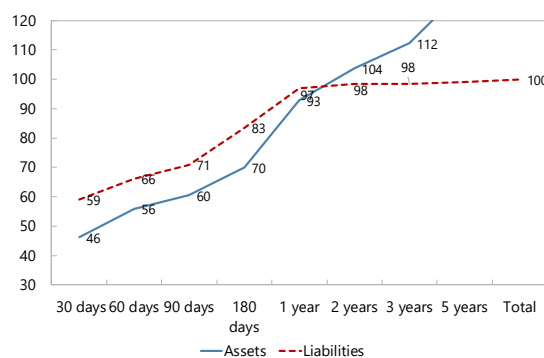
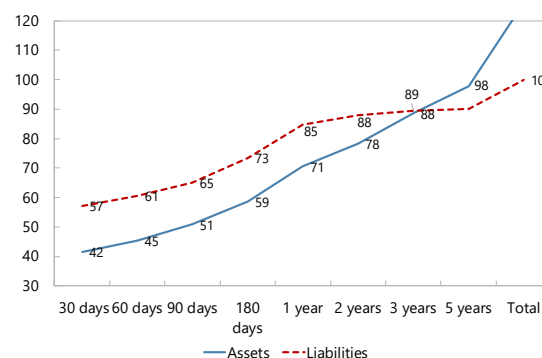
³ Primary includes agriculture, fishing, forest, hunting, and mining and quarrying; and other includes manufacturing, utilities, and health, education, and other services.

Figure 4. Tanzania: Foreign Currency and Liquidity Mismatches in the Banking Sector**A. Dollarized Balance-Sheets with Closed Net Positions****Assets and Liabilities in FX**

(in percent of total assets)

**Net Open FX Position**

(in percent of total capital)

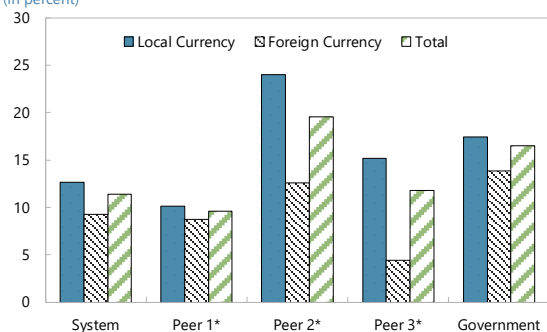
**B. Cumulative Time Profile of Assets and Liabilities****Peer 1 Private*****Peer 2 Private*****Peer 3 Private*****Government Owned**

Sources: Bank of Tanzania and FSAP team calculations.

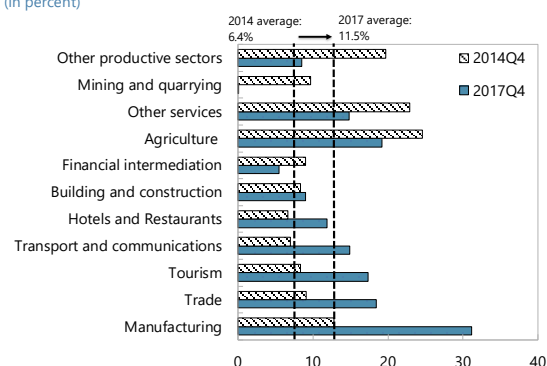
Note: * indicates banks with more than 50 percent government ownership are excluded.

Figure 5. Banks: Non-Performing Loans in the Banking System**NPL Ratios by Currency of Denomination of Loan Portfolios, December 2017**

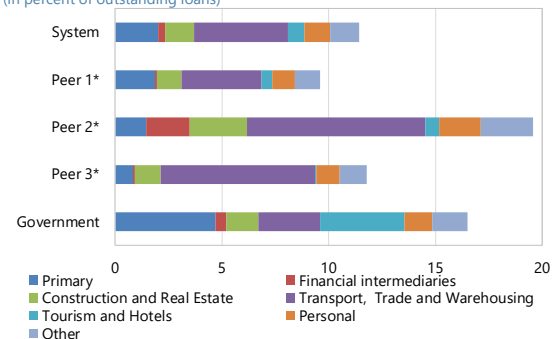
(in percent)

**NPL Ratios by Sector, 2014Q4 and 2017Q4**

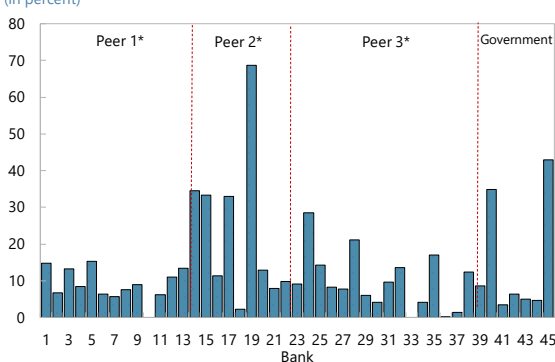
(in percent)

**Sectoral Contributions to NPL Ratios, December 2017**

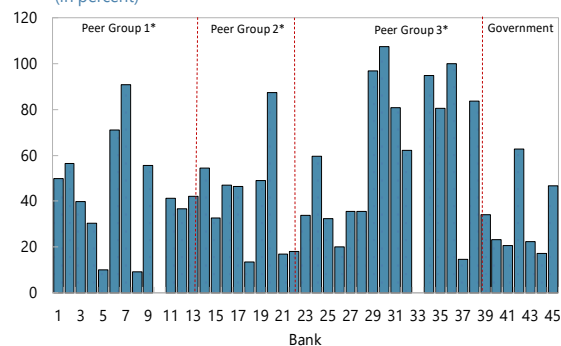
(in percent of outstanding loans)

**NPL ratios by Bank, December 2017**

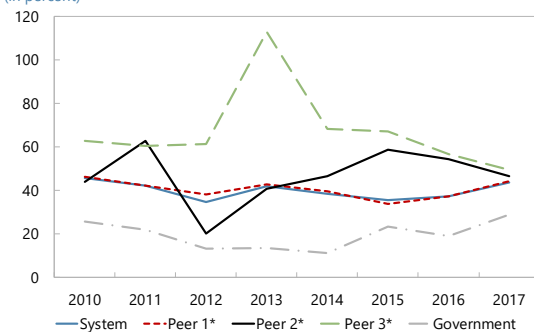
(in percent)

**Provisions to NPL ratios by Bank, December 2017**

(in percent)

**Provisioning Coverage Ratio by Bank Peer Group, 2010–17**

(in percent)

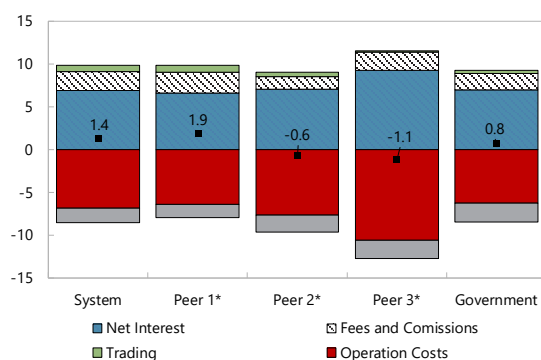


Sources: Bank of Tanzania and FSAP team calculations.

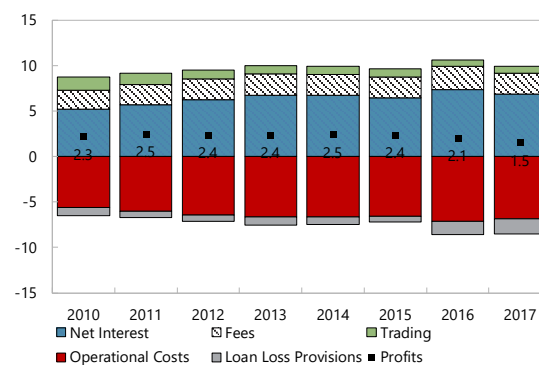
Note: * indicates banks with more than 50 percent government ownership are excluded.

Figure 6. Tanzania: Banks' Income, Expenses, and Profits
(Percent of assets)

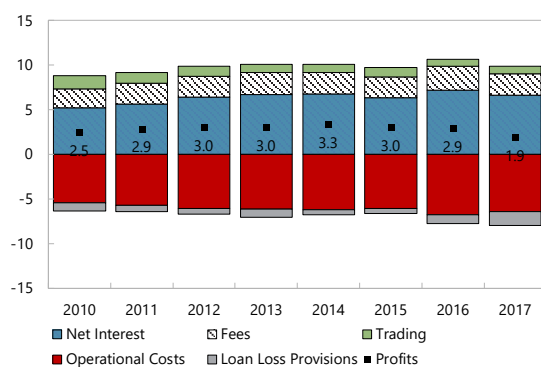
Profits by Peer Group in 2017



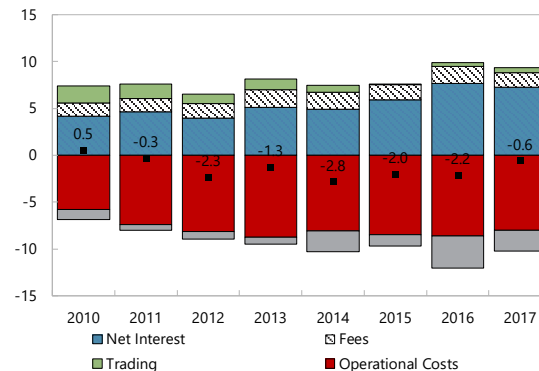
Banking System's Profits, 2010-17



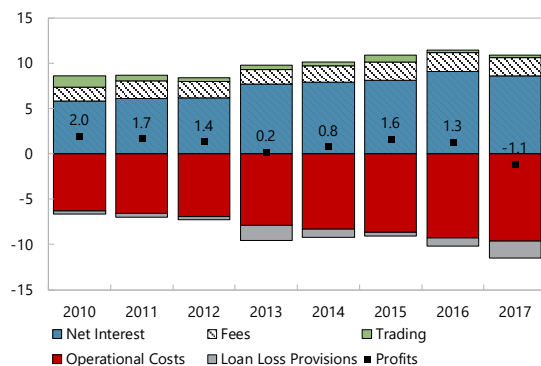
Profits of Peer 1 Banks, 2010-17



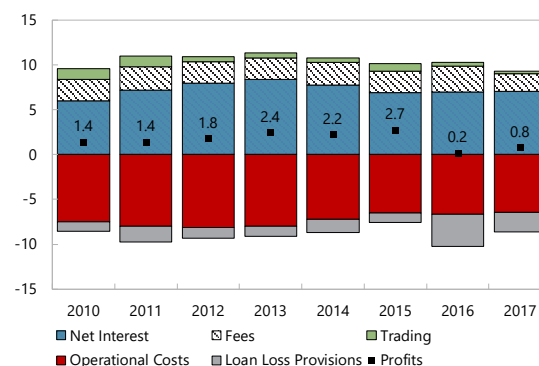
Profits of Peer 2 Banks, 2010-17



Profits of Peer 3 Banks, 2010-17



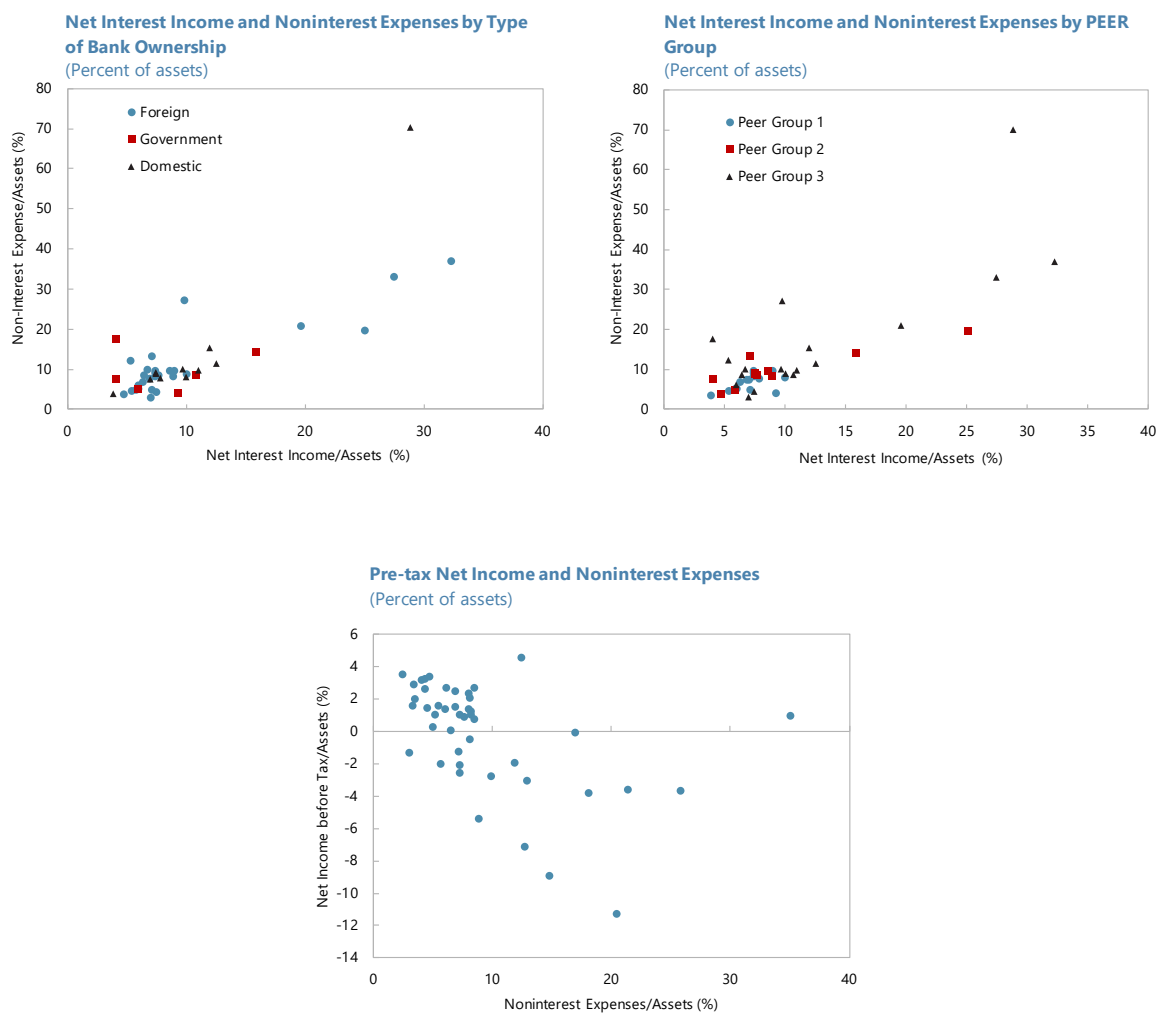
Profits of Government-owned Banks, 2010-17



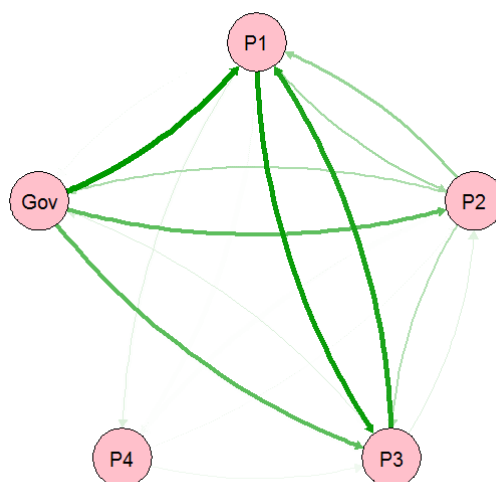
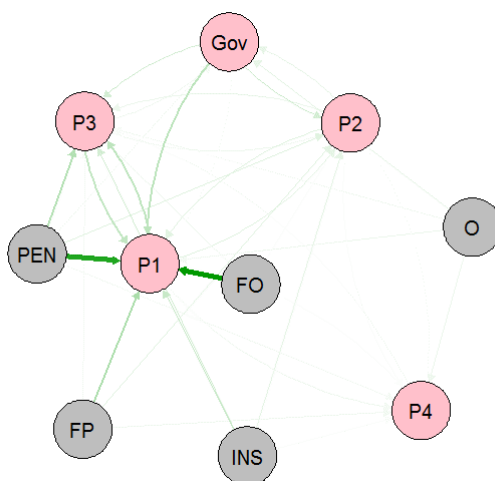
Sources: Bank of Tanzania and FSAP team calculations.

Note: * indicates banks with more than 50 percent government ownership are excluded.

**Figure 7. Tanzania: Banking System Structure:
Variation in Net Interest Income, Noninterest Expenses, and Profitability across Banks**



Sources: Bank of Tanzania and FSAP team calculations.

Figure 8. Tanzania: Interconnectedness in the Financial System**Interconnectedness in the Domestic Banking System****Interconnectedness among Domestic Banks and Nonbanks, and Foreign Institutions**

Sources: Bank of Tanzania and FSAP team calculations.

Note: For domestic institutions, the labels are as follows: "P1" through "P4" indicate the groups of Peer 1 through Peer 4 private banks; "Gov" denotes the group of government owned banks; and "PF" and "INS" denote pension funds and insurers, respectively. Foreign parent banks are labeled "FP" and other foreign banks are labeled "FO". All other institutions (domestic or foreign) are labeled "O". The thickness of the lines indicates relative size of exposures across financial institutions and the arrows point the direction of exposures from lender to borrower. These lines should not be interpreted as indicating a high level of systemic interconnectedness, as the exposures highlighted in the Figure tend to be small relative to the size of balance sheets.

**Figure 9. Tanzania: Solvency Tests Based on Macroeconomic Scenarios:
Contributions to Changes in Total CAR in the Tail Risk Scenario**

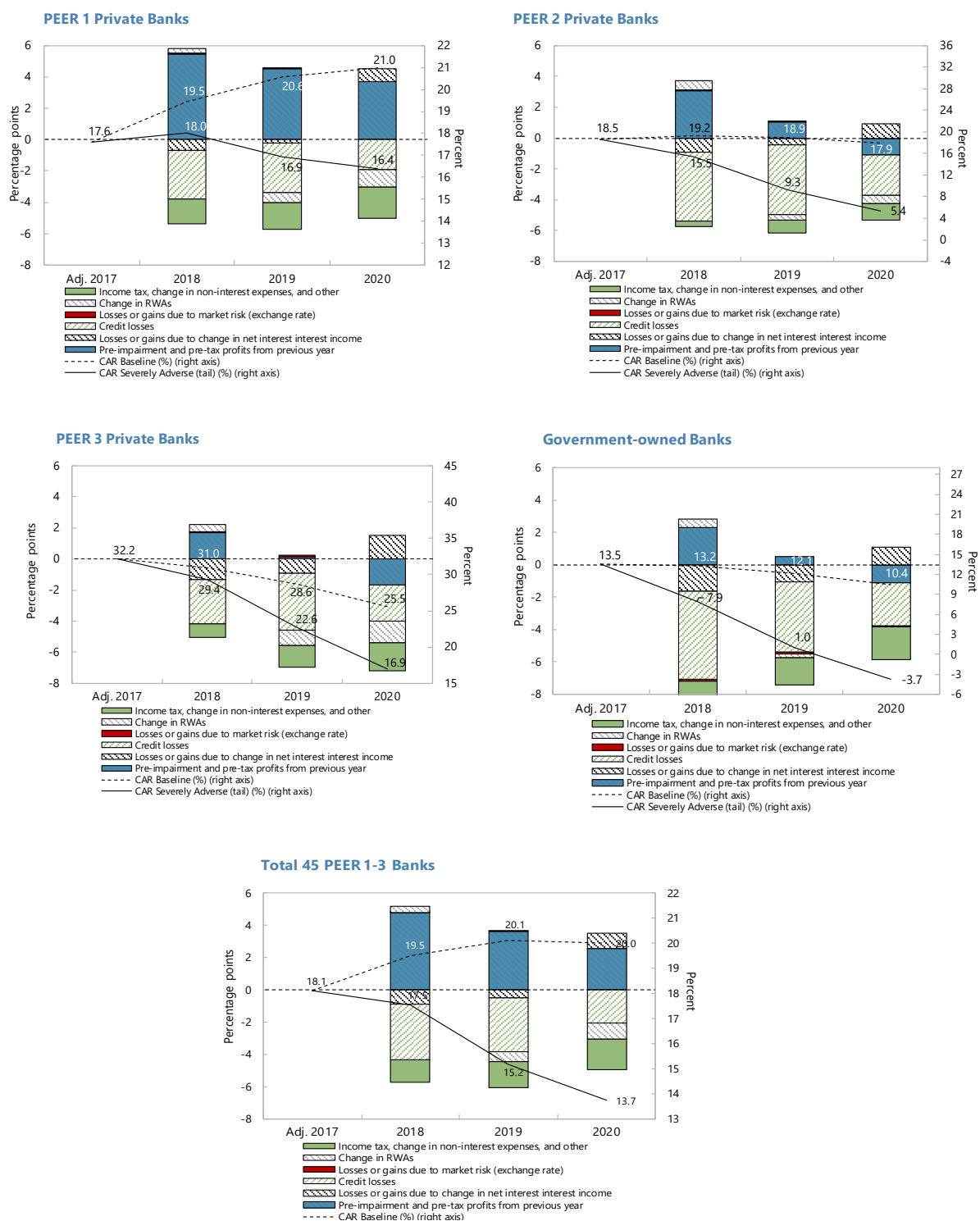
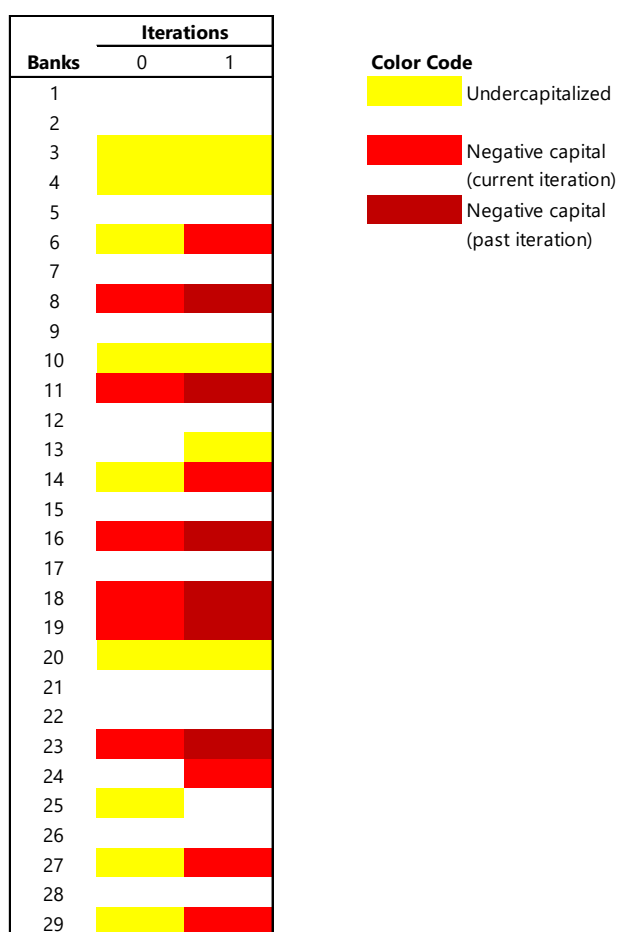


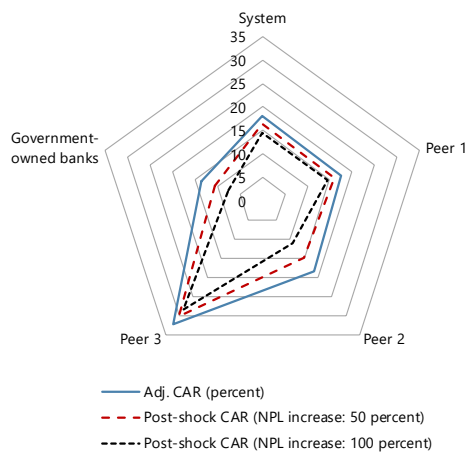
Figure 10. Tanzania: Simulations from Combined Defaults

Sources: Bank of Tanzania and IMF staff calculations.

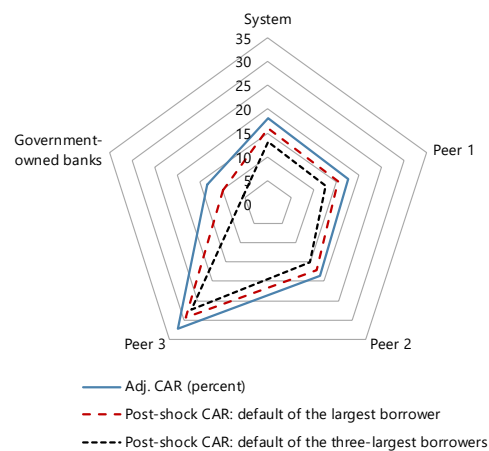
Note: Iteration 0 corresponds to the results of the tail risk scenario of the solvency test. Iteration 1 corresponds to the contagion dynamics through the interbank balance sheet exposures.

**Figure 11. Tanzania: Sensitivity Stress Tests:
Impact of Various Shocks on Total Capital Ratios (CAR)
(Percent)**

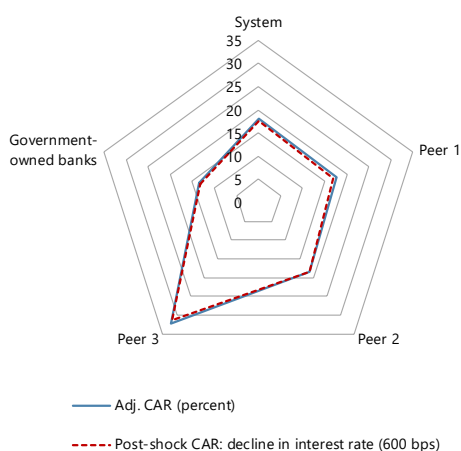
Shocks to the Stock of NPLs



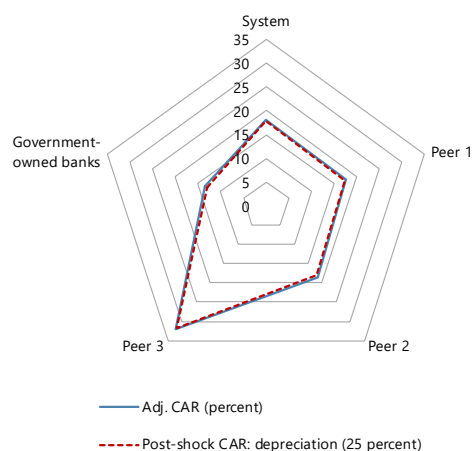
Default of Large Exposures



Interest Rate Shocks



Exchange Rate Shocks

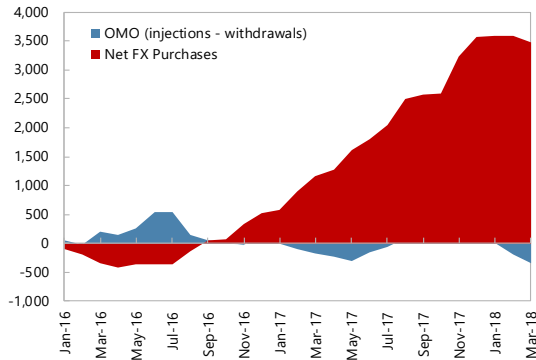


Sources: Bank of Tanzania and FSAP team calculations.

Figure 12. Tanzania: Liquidity Management, Interest Rates and Funding Markets

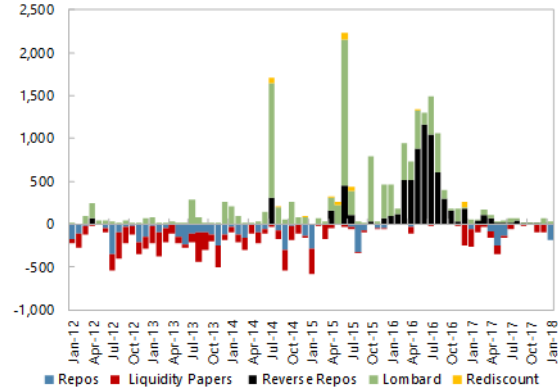
Sizeable FX operations, are not fully offset by OMOs, as...

Liquidity Management and impact on IBCM
(Billions of Tanzania Shillings)



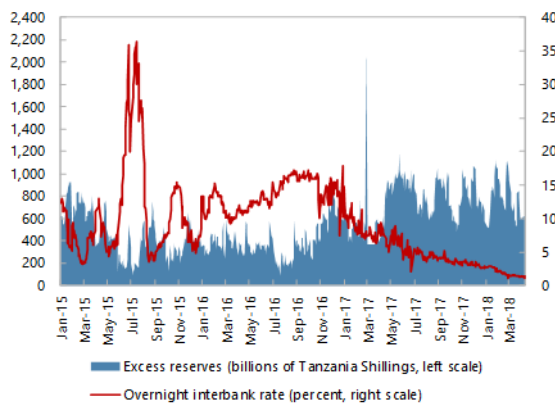
...in recent times, the use of liquidity papers for sterilization has declined.

BoT Monetary Operations
(Billions of Tanzania Shillings)



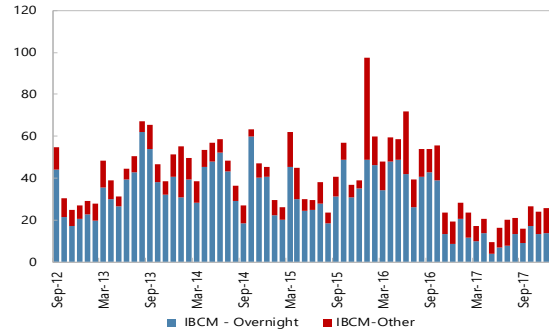
Excess reserves vary significantly and contribute to volatility in IBCM.

Excess Reserves and IBCM



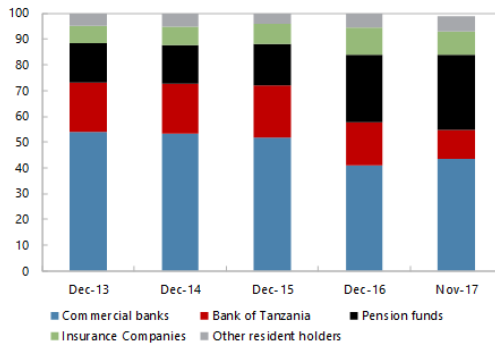
Money market trades are predominantly overnight unsecured transactions, and ...

Interbank Market Volume
(Billions of Tanzania Shillings)



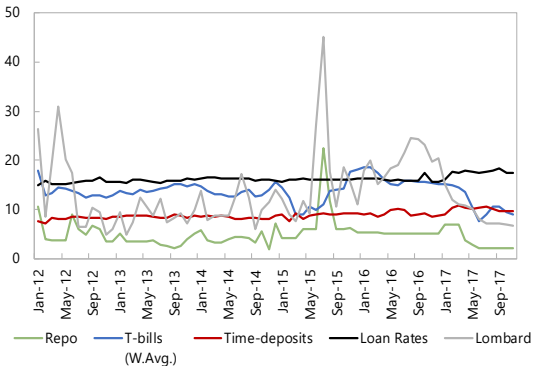
...secondary trading in government securities is limited.

Holders of Government Securities
(Percent of outstanding debt)



Interest rate transmission is weak.

BoT Repo Rate, Lombard Rate and Market Interest Rates
(Percent)



Source: Bank of Tanzania and IMF staff estimates.

Table 2. Tanzania: Structure of the Financial System, December 2017

	Number of institutions	Assets (in billions of TZS)	Percent of total assets	Percent of GDP ³
Banks	54	29,909	71.6	25.7
Commercial banks	40	28,635	68.5	24.7
Community banks	7	156	0.4	0.1
Development finance institutions	2	935	2.2	0.8
Microfinance banks	5	184	0.4	0.2
Insurers¹	31	870	2.1	0.7
Pension funds²	6	10,745	25.7	9.3
Open-ended collective schemes	5	249	0.6	0.2
Total financial system		41,774	100.0	36.0

Source: Bank of Tanzania.

¹ Data as of June 2017.² Data as of September 2017. Pension funds includes six mandatory social security funds.³ GDP here refers to Nominal GDP in 2017, T Sh 116,159 billion.

**Table 3. Tanzania: Structure of the Banking System,
Distribution of Banks and their Assets by Peer Group and Ownership, December 2017**
(Percent of total assets in the system; number of banking institutions indicated in parenthesis)

Peer Group	Ownership			Subtotals by Peer Group	
	Domestic ¹	Foreign ²	Government		
1	45.6 (4)	30.1 (9)	4.6 (2)	80.3	(15)
2	2.0 (2)	7.8 (7)	2.5 (2)	12.3	(11)
3	1.5 (5)	4.6 (12)	0.9 (2)	6.9	(19)
4	0.3 (7)	0.1 (1)	0.1 (1)	0.4	(9)
Subtotals by ownership	49.4 (18)	42.6 (29)	8.1 (7)	100	(54)

Source: Bank of Tanzania.

¹ Excludes banks with more than 50 percent of government ownership.² Banks with more than 50 percent foreign ownership.

Table 4. Tanzania: Financial Soundness Indicators, 2007–June 2018
(Percent, end of period)

	2007	2008	2009	2010	2011	2012	2013	2014	2015				2016				2017				2018	
									Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun	Sep	Dec	Mar	Jun
Access to bank lending																						
Claims on the non-government sector to GDP ¹	14.4	17.9	19.4	13.1	13.6	14.2	14.6	15.5	14.3	15.2	16.2	16.8	17.4	18.0	18.0	17.9	15.7	15.7	15.6	15.7	15.6	16.3
Claims on the private sector to GDP ¹	13.8	17.1	18.6	12.4	12.9	13.2	13.9	14.4	13.3	14.2	15.0	15.7	16.2	16.9	17.0	16.9	14.9	15.0	14.9	15.0	15.0	15.6
Capital adequacy																						
Total capital to risk-weighted assets	16.2	17.0	18.5	18.5	17.8	18.0	18.0	18.0	19.0	17.6	18.6	19.5	20.0	19.2	19.3	19.0	20.8	18.3	20.9	20.5	20.8	20.2
Total capital to total assets	8.1	10.1	10.9	11.4	10.8	10.5	11.0	11.2	12.1	11.2	12.1	12.0	13.0	12.7	13.2	13.5	13.8	13.0	13.6	13.2	13.5	13.2
Asset composition and quality																						
Net loans and advances to total assets	41.2	50.6	46.3	48.6	49.0	49.7	50.8	52.9	53.3	52.8	53.5	54.6	55.1	56.1	56.5	55.6	54.3	53.4	52.7	51.0	50.6	51.8
Sectoral distribution of loans																						
Trade	17.0	18.5	18.8	21.4	21.2	20.9	20.9	21.9	22.5	21.1	21.2	19.4	19.0	19.4	20.3	20.4	23.0	21.4	20.7	20.1	20.3	20.2
Personal						n.a.	n.a.	17.4	16.7	17.3	17.2	18.1	19.0	20.1	18.6	18.6	17.5	18.8	17.3	20.2	26.5	27.1
Manufacturing and mining	20.2	14.7	12.0	12.3	12.3	11.9	11.9	12.3	12.2	13.3	12.6	12.5	12.8	12.7	11.1	11.8	11.2	13.1	13.0	12.4	13.0	12.5
Agricultural production	11.9	10.4	10.2	11.5	11.1	10.7	9.3	8.6	8.3	8.5	8.1	7.6	7.6	7.4	6.7	6.8	6.8	7.1	6.9	6.8	6.3	6.5
Transport and communication	6.9	7.3	9.2	7.3	7.0	6.9	7.0	7.1	7.2	7.6	7.5	7.2	7.6	7.4	7.3	7.1	6.1	5.6	6.0	5.9	5.5	5.8
Real Estate						n.a.	n.a.	4.1	3.9	3.9	4.5	4.4	4.6	4.5	4.7	5.1	5.3	5.0	5.2	5.0	5.2	5.3
Building and construction	5.1	4.9	5.0	9.1	9.2	4.7	4.9	5.3	5.1	4.7	4.7	4.7	4.6	4.6	4.3	4.5	4.5	4.5	5.1	5.1	4.9	4.7
Foreign exchange loans to total loans	31.4	31.8	28.5	34.0	34.8	33.5	35.4	36.3	37.5	38.2	38.7	37.7	37.6	36.7	36.1	36.0	36.5	36.7	35.1	35.8	35.8	36.0
Gross nonperforming loans (NPLs) to gross loans	6.3	6.2	6.6	7.7	8.1	8.1	7.1	6.8	6.7	6.7	6.6	7.9	8.4	8.7	9.1	9.6	11.0	10.6	12.5	11.5	11.5	10.3
NPLs net of provisions to capital	22.0	22.0	17.6	18.0	19.1	22.5	15.6	16.0	14.8	16.2	14.8	18.6	18.8	21.1	21.7	22.1	24.5	22.1	28.5	23.0	25.6	18.6
Large exposures to total capital	183.5	199.4	54.4	125.9	139.3	143.7	91.2	123.2	129.6	125.8	117.4	123.3	129.2	128.5	125.9	109.6	104.1	117.4	125.9	113.6	120.9	124.6
Net open positions in foreign exchange to total capital				-0.2	1.8	-1.7	1.5	-2.5	-2.1	-2.2	-2.3	1.4	-1.1	1.4	-2.4	-1.9	2.2	1.5	2.1	2.0	0.8	3.3
Earnings and profitability																						
Return on assets	4.7	3.8	3.2	2.9	2.7	2.6	2.5	2.5	3.3	3.0	2.8	2.6	3.5	3.0	2.5	2.3	2.5	2.3	2.0	1.4	2.0	1.6
Return on equity	29.0	23.2	18.4	16.0	15.1	13.9	12.8	12.6	17.3	15.8	14.2	12.4	18.2	15.3	12.1	10.7	11.5	10.4	8.7	5.9	8.5	6.7
Interest margin to total income	73.8	...	...	...	...	65.6	67.4	67.8	67.8	65.9	66.4	66.6	65.7	68.1	69.4	69.7	53.5	52.8	52.3	52.0	53.0	53.7
Noninterest expenses to gross income	42.5	48.8	47.6	63.5	65.4	67.8	66.9	67.2	63.9	65.1	67.4	68.4	63.2	64.7	66.9	67.6	50.9	51.5	51.9	52.2	54.0	54.6
Personnel expenses to noninterest expenses	40.5	40.6	42.6	45.9	45.5	42.4	43.4	44.2	46.8	46.0	44.9	43.8	45.5	45.4	44.9	44.7	45.7	45.5	45.4	44.6	46.3	45.7
Liquidity																						
Liquid assets to total assets	48.0	37.6	40.5	35.0	34.3	34.0	32.3	31.0	30.6	30.4	31.0	30.6	29.1	30.4	28.1	28.7	28.9	30.6	31.0	32.6	31.9	30.1
Liquid assets to total short term liabilities	53.0	41.7	46.5	40.2	38.4	38.4	36.2	35.8	38.9	37.7	37.3	37.3	36.6	37.1	34.2	35.1	36.0	38.1	37.9	40.3	39.6	37.6
Total loans to customer deposits	57.6	68.4	61.6	68.8	67.9	68.6	71.8	74.3	76.9	76.0	77.0	78.5	82.4	85.7	87.1	86.3	86.0	83.1	84.9	81.2	81.3	83.9
Foreign exchange liabilities to total liabilities	33.8	32.5	29.7	35.2	35.2	34.4	35.0	35.7	37.6	39.8	41.6	39.6	38.8	37.8	38.9	37.4	37.8	36.0	36.4	35.4	34.2	34.8

Source: Bank of Tanzania.

¹ Calendar year; end of period claims relative to annual GDP.

Table 5. Tanzania: Selected Economic and Financial Indicators, 2015/16–2022/23¹

	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
	Act.	Est.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
(Percent change, unless otherwise indicated)								
Output, prices and exchange rates								
Real GDP	7.0	6.0	5.9	6.2	6.6	6.7	6.8	7.0
CPI (period average)	6.0	5.3	4.3	3.8	4.6	4.9	5.0	5.0
CPI (end of period)	5.5	5.4	3.4	4.3	4.8	5.0	5.0	5.0
Core inflation (end of period)	3.0	1.9	2.0	...	...	...	...	...
Terms of trade (deterioration, -)	2.3	1.9	-6.9	-3.6	0.6	1.6	1.2	0.7
Exchange rate (period average, TSh/USD)	2,156	2,199	2,251	...	...	...	...	...
Real effective exchange rate (end of period; depreciation = -)	0.9	0.5	-1.2	...	...	...	...	...
Money and credit								
Broad money (M3, end of period)	12.5	6.3	5.9	12.0	14.6	15.0	15.3	15.5
Average reserve money	7.2	1.1	4.0	7.0	8.1	8.5	8.7	9.0
Credit to the private sector (end of period)	19.1	1.2	4.0	8.6	11.2	11.7	11.4	14.8
90-days T-bill interest rate (percent; end of period)	15.1	7.6	5.6	...	...	...	...	...
Broad money (M3, percent of GDP, end of period)	23.1	22.0	21.1	...	...	...	...	...
Non-performing loans (percent of total loans, end of period)	8.7	10.6	10.3	...	...	...	...	...
(Percent of GDP, unless otherwise indicated)								
Central government operations								
Revenues and grants	14.8	16.4	15.8	16.1	16.2	16.3	16.4	16.4
<i>Of which: grants</i>	0.5	1.0	0.8	0.8	0.8	0.7	0.7	0.7
Expenditures	18.3	17.4	17.1	19.3	20.0	20.3	20.7	20.4
Current	13.8	10.7	10.7	11.2	11.4	11.5	11.7	11.8
Development	4.5	6.7	6.4	8.1	8.7	8.8	9.0	8.6
Overall balance ²	-3.5	-1.5	-1.9	-3.2	-3.8	-4.0	-4.4	-4.0
Excluding grants ²	-4.0	-2.1	-2.1	-4.0	-4.6	-4.7	-5.0	-4.7
Public debt								
Gross nominal debt ^{3,4}	38.5	38.3	38.0	38.6	39.4	39.9	40.2	40.0
<i>of which: external debt⁴</i>	29.7	29.2	28.9	28.7	28.4	28.2	28.2	27.5
Investment and savings								
Investment	24.7	27.3	25.6	27.6	27.7	28.2	28.6	28.7
Domestic savings	23.7	25.3	23.4	24.4	24.6	24.8	25.1	25.7
External sector								
Exports (goods and services)	19.9	17.7	16.8	17.0	17.3	17.5	17.8	18.2
Imports (goods and services)	25.3	19.7	19.1	20.2	20.4	20.9	21.3	21.2
Current account balance	-6.5	-2.9	-3.3	-4.4	-4.8	-5.0	-5.4	-5.2
Excluding current transfers	-6.6	-3.2	-3.6	-4.6	-5.2	-5.3	-5.7	-5.4
Gross international reserves								
In billions of U.S. dollars	3.9	5.0	5.5	5.7	5.8	6.0	6.6	7.3
In months of next year's imports	4.8	5.2	4.8	4.5	4.6	4.6	4.5	4.4
Memorandum items:								
GDP at current prices								
Billions of Tanzanian shillings	97,304	108,351	119,694	132,701	148,533	166,406	186,607	209,657
Millions of U.S. dollars	45,128	49,265	53,181	57,396	62,370	67,812	73,779	80,430
GDP per capita (U.S. dollars)	937	998	1,052	1,113	1,186	1,264	1,348	1,441
Population (millions)	48.2	49.4	50.5	51.6	52.6	53.6	54.7	55.8

Sources: Tanzanian authorities and FSAP team estimates and projections.

¹ In terms of Tanzanian fiscal year (July-June).² Actual and preliminary data include adjustment to cash basis.³ Net of Treasury bills issued for liquidity management. Excludes domestic unpaid claims.⁴ Excludes external debt under negotiation for relief.

Table 6. Tanzania: Macroeconomic Scenarios for Solvency Stress Tests:
Projections for Selected Variables
 (Percent)

	Year ¹	2017	Paths in Stress Period		
		2018	2019	2020	
Real GDP growth (percent)					
Baseline		6.0	6.2	6.5	6.8
Adverse		6.0	4.5	4.5	6.0
Tail Risk		6.0	0.5	0.0	3.0
Consumer price inflation rate (end of period, percent)					
Baseline ²		5.4	5.0	5.0	5.0
Adverse		5.4	5.2	5.9	5.8
Tail Risk		5.4	7.6	10.7	6.6
Nominal GDP growth (real GDP growth + CPI inflation) (percent)³					
Baseline		11.4	11.2	11.5	11.8
Adverse		11.4	9.7	10.4	11.8
Tail Risk		11.4	8.1	10.7	9.6
Nominal exchange rate change (+ is TZS depreciation vis-à-vis the US dollar, percent)⁴					
Baseline		2.4	1.9	3.0	3.0
Adverse		2.4	3.0	7.0	5.0
Tail Risk		2.4	15.0	25.0	0.0
Commodity prices (level 2017=100)					
Baseline		100	109	106	103.9
Adverse		100	100	100	100
Tail Risk		100	85.0	70.0	70.0
Overnight interbank cash market rate (percent)					
Baseline ⁵		4.9	5.0	5.8	6.0
Adverse		4.9	5.7	6.9	6.9
Tail Risk		4.9	6.9	9.9	7.4
35 days T-bill rate (money market, percent)					
Baseline ⁵		5.4	5.7	6.3	6.8
Adverse		5.4	6.1	7.4	7.4
Tail Risk		5.4	7.4	10.4	7.9
Long term nominal interest rate (10 year bond yield, percent)					
Baseline ⁵		14.8	14.7	14.8	14.8
Adverse		14.8	15.0	15.8	15.8
Tail Risk		14.8	16.0	17.8	15.3
Change in spread between deposit rate and 35 days T-bill rate (percent)					
Baseline	
Adverse		...	0.50	0.50	-0.50
Tail Risk		...	1.25	1.25	-1.25
Nominal growth in bank credit to non-government sector (percent)					
Baseline ⁶		1.2	4.4	8.0	11.3
Adverse		1.2	2.9	6.9	11.3
Tail Risk		1.2	1.3	7.2	9.1
Real growth in bank credit to non-government sector (percent)					
Baseline ⁷		-4.2	-0.6	3.0	6.3
Adverse		-4.2	-2.4	1.0	5.5
Tail Risk		-4.2	-6.3	-3.5	2.5

Source: Bank of Tanzania and FSAP team calculations.

¹ The year 2017 should be interpreted as fiscal year 2016/17; a similar interpretation should be applied to the years 2018 through 2020.

² Under the baseline, it is assumed that the BoT will conduct monetary policy to keep inflation close to its 5 percent target.

³ The rate of change of the GDP deflator is assumed to be in line with CPI inflation.

⁴ The number for 2017 (fiscal year 2016/17) is calculated using end of period official exchange rates (June 2017 vis-à-vis June 2016). The depreciation path in the projection years reflects inflation differential between Tanzania and its main trade partners.

⁵ All interest rates are shown at end of fiscal year (e.g., June 2017). The ex post data come from the BoT, as reported in O6R file.

⁶ Annual percentage change in the credit to non-government sector as of end of the fiscal year (i.e., June). For 2016/17, the data reported by BoT in 2SR file.

⁷ Annual percentage change in credit to non-government sector minus annual percentage change in CPI, as of June.

Table 7. Tanzania: Results of Solvency Stress Tests Based on Macroeconomic Scenarios**Total Capital Ratios by Bank Group**
(Percent)

	2017	Adj. 2017	Baseline 2020	Tail Risk 2020	Adverse 2020
PEER 1 (15 banks)	19.1	17.0	18.8	14.5	18.8
PEER 2 (11 banks)	19.4	16.5	15.4	5.3	14.8
PEER 3 (19 banks)	38.9	36.7	27.1	20.8	27.1
PEER 1* (13 banks)	19.1	17.6	19.7	16.4	19.7
PEER 2* (9 banks)	21.9	18.5	16.8	5.4	16.5
PEER 3* (17 banks)	34.0	32.2	24.7	16.9	24.6
Government (6 banks)	19.9	13.5	9.8	-3.7	6.9
Total (45 banks)	20.2	18.1	18.9	13.7	18.8

Number of Undercapitalized Banks by Bank Group
(shares of assets in the system indicated in bold, percent)

	Adj. 2017		Baseline 2020		Tail Risk 2020		Adverse 2020	
	Banks Undercapitalized	Banks with Negative Capital	Banks Undercapitalized	Banks with Negative Capital	Banks Undercapitalized	Banks with Negative Capital	Banks Undercapitalized	Banks with Negative Capital
PEER 1 (15 banks)	2	0	2	1	6	1	2	1
	6.0	0.0	6.0	2.6	19.9	2.6	6.0	2.6
PEER 2 (11 banks)	3	0	4	2	8	5	4	2
	3.4	0.0	3.9	1.9	8.9	5.4	3.9	1.9
PEER 3 (19 banks)	1	0	4	2	8	3	4	2
	0.5	0.0	1.3	0.8	3.0	1.2	1.3	0.8
PEER 1* (13 banks)	1	0	1	0	5	0	1	0
	3.4	0.0	3.4	0.0	17.4	0.0	3.4	0.0
PEER 2* (9 banks)	2	0	3	1	7	4	3	1
	2.4	0.0	2.9	0.9	7.9	4.4	2.9	0.9
PEER 3* (17 banks)	1	0	3	1	7	2	3	1
	0.5	0.0	1.0	0.5	2.7	0.9	1.0	0.5
Government (6 banks)	2	0	3	3	3	3	3	3
	3.6	0.0	3.9	3.9	3.9	3.9	3.9	3.9
Total (45 banks)	6	0	10	5	22	9	10	5
	10.0	0.0	11.2	5.3	31.8	9.2	11.2	5.3

Sources: Bank of Tanzania and IMF staff calculations.

Note: the capital ratio of one bank which is currently undercapitalized after adjustment for under-provisioning, increases over time in the baseline scenario, and is above the 12 percent threshold by 2020. Counting this bank as undercapitalized increases the total number of undercapitalized banks in the baseline to 11, and their share of assets in the system is 12.8 percent.

* indicates banks with more than 50 percent government ownership are excluded.

Appendix I. Risk Assessment Matrix

Source of Risks	Overall Level of Concern	
	Relative Likelihood	Impact
Domestic Risks		
<ul style="list-style-type: none"> A deteriorating business environment and delays in addressing key infrastructure bottlenecks Sustained overspending and insufficient revenue collection undermine fiscal sustainability in the medium/long term Deteriorating fundamentals undermine confidence in the banking sector, triggering funding liquidity shocks 	Medium	<ul style="list-style-type: none"> A poor business environment would discourage private sector investment, with adverse impact on economic activity. Development of infrastructure is crucial for reducing costs, attracting investment in the real sector, and sustaining growth. Slow execution of infrastructure spending in such an environment would have a negative impact on overall investment and growth. Slower growth would exacerbate the recent rise in NPL ratios, with negative effects on bank profitability, capitalization, and credit growth. Two-way macro-financial feedback loops can amplify banking sector stress.
	Low	<ul style="list-style-type: none"> A temporary increase in infrastructure spending widens fiscal deficits in the short term. Overspending and deficits, however, become entrenched and cannot be reversed in the medium/long term, raising financing pressures/costs and compromising fiscal sustainability. The adverse fiscal dynamics would be exacerbated by insufficient revenue mobilization and tighter external funding constraints. Domestic financing of sustained budget deficits would crowd out credit to the private sector, further deteriorating bank asset quality (NPL ratios).
	Low/ Medium	<ul style="list-style-type: none"> Further deterioration in banks' balance sheets (NPL ratios and corporate borrower defaults) triggers runs on deposits. Banks are unable to meet withdrawals of dollar denominated deposits (if these are sufficiently large) as loans are illiquid, which could then drain the BoT's foreign exchange reserves and put pressure on the exchange rate. In the event, large capital outflows would exacerbate exchange rate pressures, feeding a vicious cycle of loan defaults-bank deposit/capital outflows-schilling depreciation.

Source of Risks	Overall Level of Concern	
	Relative Likelihood	Impact
External Risks		
<ul style="list-style-type: none"> Adverse and protracted global financial conditions reduce the availability of external funding, with adverse impact on public investment 	Medium/ High	<ul style="list-style-type: none"> If tighter global financial conditions turn out to be protracted, they would deteriorate macroeconomic conditions in advanced economies, hampering the availability of external funding for LICs. This would delay public investment and the resolution of infrastructure bottlenecks in Tanzania, constraining growth, putting pressure on bank revenues and asset quality.
<ul style="list-style-type: none"> Significant China slowdown 	Low/ Medium	<ul style="list-style-type: none"> Tighter global financial conditions would also complicate budget financing. Funding costs would increase in the government and private sectors—domestic arrears could rise in such circumstances, hitting state owned enterprises and nonfinancial firms with knock-on adverse impact on bank asset quality. A significant China slowdown would reduce Chinese FDI and loans for infrastructure projects, weakening growth prospects. It would also lower commodity prices, reducing revenue from export of metals as well as external demand from main trading partners—including demand for Tanzania’s port services by neighboring countries. The Tanzanian schilling would depreciate, triggering defaults of dollar-denominated loans—with adverse impact on bank profitability and capitalization.
<ul style="list-style-type: none"> Reduced demand for Tanzanian exports of goods and services from main trading partners due to a global slowdown 	Medium	<ul style="list-style-type: none"> Tanzania’s main trading partners could be simultaneously affected by a global slowdown (including Switzerland, India, China, South Africa, Kenya, and DR of Congo), reducing Tanzania’s exports and economic growth. It would also reduce external demand for Tanzanian tourism services. Reduced foreign currency inflows would depreciate the Tanzanian schilling, triggering defaults of dollar-denominated loans—with adverse impact on bank profitability and capitalization.

Appendix II. Follow-up of 2010 FSAP Recommendations

The table below presents the follow-up actions to key recommendations of the 2010 FSAP reported by the Tanzanian authorities as part of the scoping preparations for this FSAP.

Recommendations	Steps taken to date and actions planned (including timeframes)
Financial structure	
Consider raising minimum bank capital requirements to promote consolidation.	A study of the impact on raising capital was undertaken and as a result capital levels were increased in 2012. Very little consolidation actually happened.
Abolish the loan-to-deposit ceiling (at that time, set at 80 percent).	This was removed from regulatory requirements as part of the 2014 prudential regulations.
Pass regulations for Credit Bureau; create the database for credit information and identification of debtors.	Regulations have been passed. The Databank was established in 2012 and banks are now submitting credit information in the databank for sharing. Two Credit bureaus have been licensed and are now providing services to lenders.
Grant exclusive jurisdiction over enforcement of creditor claims to commercial courts.	Not implemented.
Design and implement a comprehensive reform of civil procedure, to reduce intentional delays by debtors.	The Mortgage Finance (Special Provisions) Act, 2008, specified the rules for injunctions and judicial foreclosures. Further, the Appellate Jurisdiction Act, Civil Procedure Code Act and Magistrates Court Act 1984 were amended to bar an appeal, revision or review against decisions that do not finally and exclusively determine a suit.
Safeguarding financial stability	
Risks and vulnerabilities in the banking system	
Improve timeliness and quality of prudential data; establish consistent dataset for macroprudential analysis.	This is a continuous process—the BoT has developed a web-based Electronic Data Interchange system. This helps in ensuring that banks are now able to submit their regulatory returns and all required reports in a timely manner. The Relationship Officers are constantly conducting an eye-balling analysis in order to ascertain the accuracy and consistency of data submitted to the BoT. Going forward, as the financial system evolves, the process of improving the timeliness of quality of prudential data will move in-step. Establishing a consistent dataset for macroprudential analysis is part of targeted future actions. The BoT reports that it is currently using a proxy dataset in assessing the performance of the property, household and corporate sectors.
Be more proactive in ensuring compliance with prudential limits, including on provisioning and large exposures.	This is a continuous process—the BoT strives to ensure compliance to all prudential limits, including provisioning and large exposures, by continuous offsite surveillance of banks and regular onsite inspections. Once noncompliance is observed, regulatory sanctions are undertaken.
Crisis management framework	
Establish a systemic crisis management plan and framework for ELA; bolster reserves of the Deposit Insurance Fund.	These remains on the to-do list, including establishing an ELA framework that goes beyond daily liquidity management framework and tools. A crisis management plan is available but needs improvement, including undertaking of crisis simulation exercises.

Recommendations	Steps taken to date and actions planned (including timeframes)
Banking sector regulation and supervision	
Address capacity and organizational challenges in banking supervision and reduce hierarchy in the communication protocol between the BoT and the banks.	The BoT has made concerted effort to address capacity issues, albeit this remains a continuous process. The BoT has implemented Electronic Data Interchange (EDI) for submission of statutory returns from banks and has introduced an Onsite Examination System in order to increase efficiency and improve time management in conducting onsite examinations. The BoT meets with senior management of banks on an ad hoc basis even though there is no regulatory requirement to do so. Further, there is a requirement for trilateral meeting with the senior management and external auditors of banks to discuss issues of concern on their banks. While this was the norm until some time ago, this has changed recently so that such meetings are scheduled to discuss out of the ordinary issues.
Increase cooperation with home regulators of major international banks and their internal audit services.	The BoT has entered into MoUs with the Central Banks of the Comoros, Cyprus, the EAC, India, Macao, Nigeria, South Africa, and Zimbabwe.
Seek hands-on technical assistance to implement all aspects of RBS.	Extensive technical assistance has been received in the process of implementing RBS.
Systemic liquidity	
Distinguish clearly between sterilization and intervention objectives in FX interventions; Limit REPOs to fine-tuning operations and SMRs for long-term structural liquidity sterilization.	The BoT participates in the FX market for liquidity management, selling small amounts of USD on descending order; consistent with Average Reserve Money (ARM) objective. At times, the Bank may intervene and sell more to restore order in the FX market. The BoT conducts repos (for sterilization) through variable rate auctions, usually for 7 and 14-days, to manage short-term liquidity in the market. SMR has been used intermittently for long-term structural liquidity management. For the past decade, SMR has remained unchanged at 10 percent except the recent change to 8 percent in December 2014 that was reinstated to 10 percent in May 2015 to address aggregate demand pressure.
Expedite movement of government deposits from commercial banks to the BoT.	Various public institutions have opened their accounts with the BoT. As of March 24, 2016, a total of 158 accounts in T Sh denomination, and 86 accounts in FX denomination were open at the BoT, of which 28 accounts in T Sh denomination and 22 accounts in FX denomination have started to deposit their funds at the BoT.
Promoting Long-Term Finance	
Securities markets	
Design and implement an effective risk management system for securities settlement.	DSE settlement system is now connected to TISS and allows custodians to settle on their bonus account. Efforts underway to separate CSD from the DSE.
Confer adequate supervisory powers on the CMSA; Adopt and apply legislation requiring demutualization of the DSE and splitting the DSE and the CSD into separate corporations.	The Capital Markets and Securities Act 1994 was amended in 2010 to, among others, confer adequate inspection and investigation powers on CMSA, allow international cooperation and widen the scope of market intermediaries. This was one condition for consideration for CMSA's application to become a member of IOSCO. CMSA was admitted to Appendix A in 2011 (jurisdictions whose institutional and legal framework are compliant with IOSCO Principles particularly principles relating to

Recommendations	Steps taken to date and actions planned (including timeframes)
	<p>International Cooperation and Exchange of Information).</p> <p>The DSE demutualization process has commenced. The DSE has now been incorporated as a public company limited by share capital. The DSE is in the process of issuing its shares to the public, and has submitted a prospectus to the CMSA for approval. It is expected that the IPO and eventual listing will be before the end of June 2016. The CMSA has amended the CMS (Establishment of Stock Exchanges) Regulations, 1996 to insert a provision which allows the DSE Limited to be a profit-making company. The DSE has commenced the process of separating the CSD from the Exchange.</p>
Capital flows and capital account liberalization	
<p>Revise capital account liberalization plan to ensure that lifting of controls is properly sequenced and supported by other policies.</p>	<p>The BoT, in collaboration with the MoFP as well as CMSA have taken a gradual approach in opening up of the capital account while putting in place policy supporting frameworks. In May 2014, the capital account was fully opened to EAC residents and the plan is to open up to the rest of the world in the near-future. This was after a thorough review of the Foreign Exchange Regulation of 2014 and Foreign Exchange Circular of 1998, which led to a new draft regulation that permit capital account transactions to the rest of the world with clear safeguards and controls for debt inflows to ensure orderly conditions in the market.</p>
Pensions	
<p>Finalize establishment of Social Security Regulatory Authority and commence operations without delay.</p>	<p>The SSRA was established and became operational in 2010.</p>
<p>Replace fund-specific laws with single common pension law.</p>	<p>The task of identifying and harmonizing key areas of interventions into a single social security law is in-progress.</p>

Appendix III. Report on the Observance of Standard and Codes— Basel Core Principles for Effective Banking Supervision

A. Main Findings

Responsibilities, Powers, Independence, Resources, Accountability and Cooperation (Principles 1–3)

1. **The BoT’s supervisory responsibilities and powers are well established.** Accountability could be improved through public reporting of performance of the supervision function relative to its objectives. The BoT has full power to cooperate with other supervisors and has formal arrangements with the other domestic authorities via the FSF, and MOUs with most, but not all, home countries of foreign banks operating in Tanzania. The FSF, while meeting regularly, is still not operational as a crisis management coordination body, in part because the various sectoral regulatory authorities have not yet put in place sector-specific plans.
2. **Although the BoT is clearly independent in law, the DBS is not adequately resourced to discharge its supervisory responsibilities.** The previous FSAP raised concerns about the insufficient number of supervisory staff. The staff of DBS has declined by 10 since 2015 while the number of supervised institutions has increased. The concerns raised in the previous FSAP have been exacerbated by the increase in the number of ongoing projects, EAC commitments, and ad hoc demands on supervision staff including the closure of five small banks in January 2018. Even when 20 staff deployed in these recently closed banks return to normal supervisory duties, the DBS will have insufficient resources for effective ongoing supervision.

Ownership, Licensing and Structure (Principles 4–6)

3. **Tanzania has a generally high level of compliance with these principles, with appropriate legal requirements and review processes in place.** The vetting processes for proposed directors and senior management, however, could be strengthened by expanding in every case the scope beyond desk review. Although the BoT has conducted such interviews on occasion, in most cases it relies on desk review which involve, among other things, obtaining references and undertaking a background check. The BoT should as a matter of routine interview proposed new owners of significant shareholdings, whether this takes place as part of the licensing of a new bank or transfer of ownership in an existing bank. Similarly, the BoT should interview proposed directors and senior managers as part of the license application process. This would ensure that the BoT always obtains the potentially valuable insights from verifying details in person and confirming the depth of involvement and knowledge of key individuals.

Methods of Ongoing Supervision (Principles 8–10)

4. The RBS Framework introduced by the BoT has resulted in a generally effective supervisory review of specific risks. This is a significant step forward from the previous FSAP when the BoT was in the pilot stage of implementing risk-based supervision. Based on its experience with the current framework, the BoT intends to revise its RBS framework and manual to, among other things, replace the current risk-assessment methodology and CAMELS ratings systems with a single supervisory risk assessment process. It will be important for the BoT to ensure that the revised approach places greater emphasis on offsite analysis and provides additional guidance for staff in completing offsite work. In addition, it will be important that the new supervisory rating system be appropriately judgmental to avoid the potential pitfalls of the current formula-driven approach. There are examples of an institution being rated as moderate risk with a stable direction despite numerous material weaknesses in credit risk management identified by examiners as being likely to lead to significant losses in future. This potentially results in an inappropriate allocation of supervisory resources, as the risk rating is a factor in determining, which banks to prioritize for onsite work.

5. The BoT RBS Framework also includes a CAMELS rating in addition to the risk rating. CAMELS ratings are determined with reference to a guide specifying ranges for key ratios. Although there are also qualitative criteria, in samples reviewed the ratings appeared formula-driven. This may result in CAMELS ratings not reflecting material weaknesses identified by the BoT staff in, for example, the quality of risk management, thus leading to the possibility of a bank with a high and increasing credit risk rating receiving a 2 rating on asset quality (on a 1 to 5 scale, 1 is best). This is compounded by the inherently backward-looking nature of a ratio-based CAMELS assessment, which at best presents a picture of the bank at of its last reporting period.

6. The DBS has already planned to revisit its RBS Framework with a view to, among other things, adopting a single supervisory rating system. This would remove the potential conflict and ambiguity from the two current systems. It will also be important to ensure that the system is suitably judgmental to avoid formula-driven outcomes that obscure significant risks.

7. Planned revision of the RBS Manual should include additional guidance and increased emphasis on offsite analysis. The current manual, introduced in 2010, is the sole internal document guiding DBS staff in the discharge of their offsite and onsite responsibilities, and is heavily focused on onsite. In contrast to the more detailed onsite procedures, there is limited guidance on the completion of offsite analysis.

8. Directorate management should provide additional feedback and on-the-job training on completion of institutional profiles and examination reports. This should focus on increasing the breadth and depth of analysis. Quality currently varies widely, and unless staff are coached and receive training, they will continue with current practices. In most cases offsite analysis currently relies extensively on descriptions of trends in ratios, providing limited insight into what is driving the trends.

9. In order to enhance the quality of offsite analysis, the DBS should implement a program of regular bilateral or trilateral meetings with external auditors. It should also put in place a regular schedule of meetings with heads of key functions within the supervised institutions. DBS staff should use the insights from these additional meetings plus findings from offsite review of banks' internal policies and procedures to enhance the forward-looking perspective of institutional profiles (IPs) and other supervisory analysis.

Corrective and Sanctioning Powers (Principle 11)

10. The BoT has an appropriately wide range of corrective and sanctioning powers, and there is evidence that these have been used. However, the DBS I does not have documented procedures such as an enforcement manual or intervention policy, or a policy with respect to operationalizing the Prompt Corrective Action Regulations to guide decision-making in dealing with banks under stress. The BoT has yet to implement a requirement that larger banks have recovery plans, or to initiate resolution planning in line with the best practices documented in the Financial Stability Board *Key Elements of Effective Resolution Regimes*.

11. More timely action is required when addressing problems in banks. Review of recent cases indicates that serious problems had in most instances been uncovered by DBS staff years in advance of the failure of the bank, yet opportunities to resolve problems before they reached the critical stage appear to have been missed. Failure to act when DBS staff have correctly identified that insolvent banks have no realistic prospect of recovery has led to increased losses for depositors and other creditors.

Consolidated and Cross-Border Supervision (Principles 12, 13)

12. The Consolidated Supervision Regulations and Supplement to the RBS Manual on Consolidated Supervision have provided since 2014 the legal foundation and procedures for consolidated supervision. Although the BoT has convened one supervisory college, the required consideration of group structures and risks has not been incorporated into ongoing offsite or onsite work. Material risks are thus not being identified and monitored. The consolidated supervision procedures need to be implemented for the two Tanzanian banks with international operations, other domestic banks with financial sector affiliates, and more than 20 banks, which are part of foreign groups.

Corporate Governance Prudential Requirements, Regulatory Framework, Accounting and Disclosure (Principles 14–29)

13. The planned new Corporate Governance Regulations provide an opportunity to update the standards established in the Guidelines for Boards of Directors. The existing Guidelines are based on previous Basel guidance, and do not contain all the elements in current Basel standards. However, the current guidelines provide a sufficient foundation.

14. The BoT's prudential standards and supervisory review of specific risks are generally sound. The BoT capital adequacy requirements are based on Basel I definitions and risk-weightings, with the addition of capital charges for market and operational risk. The current minimum requirement is total capital equal to 12 percent of risk-weighted assets, plus a 2.5 percent capital conservation buffer. The BoT has a Basel II/III implementation project with completion targeted for end-2018 in line with EAC harmonization commitments. Meeting Basel III capital standards should not be a challenge for most Tanzanian banks due to capital requirements already exceeding Basel minimums, and the predominance of common equity Tier 1 capital due to the lack of markets for subordinated debt or hybrid instruments. Basel III liquidity requirements will be more challenging, due in part to the dearth in the Tanzanian market of instruments that meet the Basel definition of high quality liquid assets (HQLA).

15. Until February 2018, the BoT's prudential standards for loan classification and provisioning were consistent with international best practices. The recently introduced regulatory relief through end-2020 for loan classification and provisioning is a step back. Despite safeguards and required reporting to the BoT, banks will be permitted to capitalize interest when restructuring overdrafts, will be able to restructure loans up to four times, and will be able to remove the adverse classification of a restructured loan once the debtor has made two (rather the current four) payments. The combination of capitalizing and recognizing as income interest on non-performing loans, and upgrading the classification of non-performing loans, is likely to result in overstated earnings and capital, masking the vulnerabilities and overstating resilience of some individual banks and the system overall. It will be important for the BoT to closely monitor banks to ensure awareness of their true position for effective financial stability analysis notwithstanding the regulatory relief provided.

Summary Compliance with the Basel Core Principles

Core Principle	Comments
<p>Principle 1</p> <p>Responsibilities, objectives and power</p>	<p>The banking supervisory responsibilities and objectives of the BoT are clearly enshrined in legislation. The legal and regulatory framework for banking supervision provides the BoT with the necessary powers to license banks, set prudential regulations and to take timely action against banks in the event of breaches in compliance with laws and to promote safety and soundness issues. The BoT's Banking Supervision Departments (BSD) has planned to update most of prudential regulations by end of 2018 but this timeframe is very ambitious considering the Directorate staffing constraints. Assessors consider that priority should be given to adapt the RBS framework and implement consolidated supervision (see CP 9 and 12).</p>
<p>Principle 2</p> <p>Independence, accountability, resourcing and legal protection</p>	<p>The BoT's DBS has been operating for several years at levels below the authorized number of staff, and far below the level considered as adequate compared to the activities required to effectively discharge its mandate. This same concern was noted in the previous FSAP and appears to have been compounded in the interim by the increasing number of supervised institutions and large number of ongoing projects including EAC commitments, review of laws and regulations, and revision of the RBS framework, as well as ad hoc assignments including deployment of supervision staff in closed banks. As of February 2018, the gap amounted to 19 technical staff positions according to the DBS's own evaluation, compared to the actual number of 42 staff members (excluding ten managers and two advisors). In these circumstances, the BoT is not able to adhere to the internal policy set out by the RBS Manual for an annual bank supervisory cycle. The assessors were unable to determine whether the shortage of resources is wholly attributable to the BoT internal decision-making, or whether a role may have been played by a circular issued by the Public Service Management Permanent Secretary on June 13, 2016 that directed all permanent secretaries, heads of departments, directors, heads of government institutions and chief executive officers of government agencies to reduce staff headcount. Rather than each relationship officer being responsible for one bank as contemplated in the RBS Manual, each relationship officer is now responsible for several banks. In the BoT structure of unified offsite and onsite functions, relationship officers also participate in the onsite examinations of other banks. While helpful in ensuring a broad base of knowledge on the part of the Relationship Officers and serving as a mechanism that should support consistency of approach, it does mean that Relationship Officers are stretched to complete adequate offsite analysis for the institutions for which they are specifically responsible, and to participate as team members or leaders in onsite work at other banks.</p> <p>In order to ensure independence of the BoT, the BOTA should be amended so that there is a statutory requirement that the reasons for removal of the governor or a Board member be publicly disclosed. The circular on "Measures to increase credit to private sector and contain NPLs" issued by the BoT on February 19, 2018 (see also CP 18) may suggest that prudential standards could be pressured by the BoT's legal primary objective "to support the general economic policy of the government."</p>

Core Principle	Comments
	<p>Though BoT confirms it had no operational impact, the recent requirement to obtain the approval of the Office of the President for foreign travel may also potentially impinge on the operational independence of the BoT. The BoT should have complete discretion as an autonomous agency to determine when international travel is required to implement effective consolidated supervision, participate in relevant regional and international meetings and for training. Seeking approval of the Office of the President raises the possibility that DBS staff may not be able to travel as is determined necessary by the DBS to effectively discharge its supervisory mandate.</p>
<p>Principle 3</p> <p>Cooperation and collaboration</p>	<p>The BoT has made progress since the previous assessment: The BoT has Memoranda of Understanding (MoUs) either in place, or in draft, with most relevant domestic and overseas regulators; cooperation in the EAC space has intensified and DBS has organized a first College of Supervisors in 2017 for one of the two banks with international operations (the second one has only one subsidiary abroad). The authorities should consider publishing the MoU between the BoT, the MOF and other domestic regulatory authorities to promote greater accountability and transparency. However, the TFSF is not yet operational as a coordinating body for crisis management and DBS needs to finalize the current draft MoUs with India and Morocco, while MoUs should be completed with Botswana, Djibouti, and Pakistan. The MOUs with the foreign supervisors should be revisited to refer to the resolution of failing banks, as prescribed by the latest recommendations of the Basel Committee (The MoU with the EAC however mentions exchange of information with respect to "handling problem financial institutions"). Formal procedures or processes should be agreed between the BoT and relevant supervisors on how a bank would be resolved in practice.</p>
<p>Principle 5</p> <p>Licensing criteria</p>	<p>Although the fit and proper criteria cover all key elements, a weakness in the practical application of the process is that supervisory staff does not meet with the prospective management team. The fit and proper test process is a desk-based exercise with analysis based on the information provided by the applicant through their application pack. An important feature of an effective fit and proper process is the ability to challenge prospective senior management on the business model assumptions underpinning the financial forecasts of the application and their knowledge of the bank's business plan. Therefore, it is recommended that the BoT exert its power to systematically interview prospective senior management as well as significant shareholders in the fit and proper test process.</p> <p>DBS usually schedules on-site visits in the first two years to ensure accurate business and strategic implementation, albeit, it should also consider more intensive off-site monitoring for all new licensed institutions.</p>
<p>Principle 7</p> <p>Major Acquisitions</p>	<p>With the BoT and the Fair Competition Commission (FCC) having parallel mandates with respect to mergers and acquisitions, it is important to establish the primacy of safety and soundness issues in reviewing financial sector transactions. Internal guidance will be needed for evaluating applications by supervisors. There is currently no specific internal procedure as the criteria specified in the Licensing Regulations 2014 are the ones that would be applied by the BoT in considering issues of fitness and properness, capital adequacy, ability to regulate and supervise.</p>

Core Principle	Comments
<p>Principle 8</p> <p>Supervisory Approach</p>	<p>The global approach for supervision by the BoT is based on a methodology that reflects a continuous and dynamic process. The operational introduction of a risk-based approach in 2010 has strengthened the impact of supervisory activities, which was confirmed to the assessors by banks and external auditors. The BoT should, however, consider the banking groups as a whole: its current approach remains largely focused on a solo analysis of the bank or financial institution. The current framework adds a forward-looking approach for the next twelve months to the risk-based approach, which is a function of several factors, including anticipated changes in the institutional external environment, planned changes in the strategic direction (new markets or products, for example) and management functions and systems. Risks are assessed as either stable, increasing or decreasing. However, there is no discussion in the quarterly Institutional Profiles and examination reports reviewed by the assessors on the potential future impact of the asset quality and liquidity analysis performed on banks' capital. The BoT does not require banks to prepare recovery plans and has not yet defined criteria to identify D-SIBs (see CP 11).</p>

Core Principle	Comments
<p>Principle 9</p> <p>Supervisory Techniques and Tools</p>	<p>The RBS Framework introduced by the BoT in 2007 has resulted in a generally effective supervisory review of specific risks during on-site examinations (see CPs 16 to 25). This is a significant step forward from the previous FSAP when the BoT was in the pilot stage of implementing risk-based supervision. Based on its experience with the current framework, the BoT has identified the need to revise its RBS framework and manual to, among other things, replace the current risk-assessment methodology and CAMELS ratings systems with a single supervisory risk assessment process. Even allowing for significance weightings, the current approach of averaging risk scores is methodologically unsound and in samples reviewed by the assessors produced an overall risk rating which obscured very material concerns identified by examiners in their onsite work. It will be important for the BoT to ensure that the revised approach places greater emphasis on offsite analysis and provides additional guidance for staff in completing offsite work. The current supervisory approach prioritizes on-site, which coupled with the shortage in staff results in too much time devoted to on-site work relative to off-site analysis. Off-site work is based on the quarterly risk-profile update and on-going compliance reviews of prudential returns. In order to enhance the quality of offsite analysis, the DBS should implement a program of regular bilateral or trilateral meetings with external auditors. It should also put in place a regular schedule of meetings with heads of key functions within the supervised institutions. DBS staff should use the insights from these additional meetings plus findings from offsite review of banks' internal policies and procedures to enhance the forward-looking perspective of institutional profiles (IPs) and other supervisory analysis. Going forward, DBS management should provide additional feedback and on-the-job training on completion of IPs and examination reports. This should focus on increasing the breadth and depth of analysis. Quality currently varies widely, and unless staff are coached and receive training, they will continue with current practices. In most cases, offsite analysis currently relies extensively on descriptions of trends in ratios, providing limited insight into what is driving the trends. In addition, it will be important that the new supervisory rating system be appropriately judgmental to avoid the potential pitfalls of the current formula-driven approach. Specific guidelines are also needed to conduct regular business model analysis as well as peer review and sectoral analysis. There are currently no specific, internal off-site examination procedures. This lack of balance between off-site and on-site may also provide senior management with a misleading sense of the overall risk profile of a bank or banking group in the current context where an annual on-site examination schedule for all institutions cannot be implemented.</p>
<p>Principle 10</p> <p>Supervisory Reporting</p>	<p>The BoT may require any information with respect to a bank or financial institution and its subsidiaries to be reported separately for each entity and on a consolidated basis. In practice, the BoT is not yet systematically receiving data on all relevant group entities, although it is a requirement by the current regulation on consolidated supervision (2014), which is still not comprehensively implemented (see CP 12). The BoT reviews governance structures during on-site examinations. However, the work papers of the four sample examination reports reviewed by the assessors indicated little if any focus on the review of valuation practices (see CP 17, Credit Risk; and CP 21, Market Risk).</p>

Core Principle	Comments
Principle 11 Corrective and Sanctioning Powers of Supervisors	The BoT has a full range of corrective and sanctioning powers and there is evidence that these have been used, but there is a need for more timely action. In several instances, serious problems have been identified by DBS staff years before action was taken. The BoT entered into an MoU with one bank even though DBS staff had correctly concluded that there was no realistic chance of recovery. The five community banks closed in January 2018 had been in a problematic situation for many years before action was taken. Adding to the existing Prompt Corrective Action Regulations, 2014, which are partly ineffective in the absence of timely implementation, the DBS should consider complementing the regulations with a set of triggers in addition to capital to ensure action is taken at the earliest stage possible, before more serious problems arise. Opportunities to address problems before they reach the critical stage appear to have been missed, and delays in closing solvent banks have led to increased losses for depositors and other creditors. The DBS lacks internal procedures to guide decision-making in dealing with banks under stress and has yet to implement a requirement for recovery plans for the larger banks, or initiate resolution planning.
Principle 12 Consolidated Supervision	The Consolidated Supervision Regulations 2014 provide the legal foundation while the 2014 Supplement to the RBS Manual provides onsite and offsite consolidated supervision procedures. This regulatory framework needs to be comprehensively implemented and coverage of group issues systematically addressed in IPs and during onsite work. To date, the required consideration of group structures and risks has not been incorporated into either offsite or onsite work. Material risks are thus not being identified and monitored. The consolidated supervision procedures need to be implemented for the two Tanzanian banks with international operations, other domestic banks with financial sector affiliates, and more than 20 banks which are part of foreign groups. DBS should put in place procedures to assess the quality of supervision in home countries of foreign bank subsidiaries in Tanzania. The BoT should also develop a formal policy for assessing whether on-site examinations of a banking group's foreign operations are necessary or whether additional reporting is required. It should also formally assess the quality of supervision conducted by host supervisors in countries where Tanzanian banks have operations. In practice, the BoT had not effectively used its powers in the past to determine the safety and soundness of a bank licensed in Tanzania but whose non-bank holding company was registered in Cayman Islands, and the majority of the bank's operations were outside Tanzania. The supervisors did perform several on-site inspections of the foreign branches of the bank, but did not access the holding company, and did not effectively follow up on serious issues identified in the operations outside Tanzania.
Principle 13 Home-host relationships	While there is evidence of information sharing in practice, aside from EAC Partner States, there is little coordination of activities with relevant foreign authorities. Evidence provided on information sharing dealt with fitness and probity of current or proposed board members, but no other ongoing supervision issues. There are no agreed communication strategies, cross-border crisis management arrangements and resolution plans, reflecting that current MOUs were drafted using older Basel guidance which does not include current best practices on relationships among supervisors. It should be included in the amendments to BFIA that no shell bank would be authorized to operate in Tanzania.

Core Principle	Comments
<p>Principle 14</p> <p>Corporate Governance</p>	<p>The BoT has already begun a project to replace the Guidelines for Boards of Directors with a new Corporate Governance Regulation. Inclusion of a specific requirement for a code of conduct and conflicts of interest policy, as well as a requirement for bank, or if applicable group-wide compensation policies that incorporate current Basel guidance on ensuring alignment of incentives with the long term best interests of the banks, would update the BoT's governance requirements for banks in line with current best practices. While it is important for the BoT to review and update prudential standards on an ongoing basis, the BoT should give higher priority to some other projects, such as revising the RBS Framework, relative to the project to introduce Corporate Governance Regulations.</p>
<p>Principle 15</p> <p>Risk Management Process</p>	<p>The BoT should introduce specific requirements for overall capital and liquidity planning in relation to a bank's risk appetite and risk profile. This could be addressed through the Basel II/III implementation project. Given that use of models has become more prevalent for Tanzanian banks, the revisions to the RBS manual need to include specific guidance on supervisory review and validation, and this work would need to be consistently reflected in onsite reports. It would also be useful to introduce a specific requirement for Chief Risk Officers or equivalent, at least for larger banks, and requirements for recovery plans. These could be addressed in the planned new Corporate Governance Regulations. In addition, the BoT should consider providing more detailed guidance on banks' stress testing programs and making more use of stress testing results for supervisory purposes. This could be addressed through revision to the Risk Management Guidelines (RMG) and RBS Manual.</p>
<p>Principle 16</p> <p>Capital Adequacy</p>	<p>The current capital adequacy requirement applied to all banks in Tanzania is based on Basel I and the Pillar 1 component of Basel II. The BoT has a Basel II/III implementation plan, driven in part by the EAC harmonization agenda, which targets Basel III compliance by end-2018. One challenge for the BoT is that definitions of capital are included in the BFIA, so to adopt Basel III will require amendment to the law. As a practical matter, almost all capital of Tanzanian banks is CET1 as there is no market for subordinated or hybrid instruments. Tanzanian banks are already required to maintain total capital of 12 percent plus a 2.5 percent capital buffer and in most cases report significantly higher capital, so there will be no practical difficulty meeting Basel III capital requirements.</p>
<p>Principle 17</p> <p>Credit Risk</p>	<p>While generally sound and comprehensive, there is no requirement for banks' exposures exceeding a certain amount or percentage of the bank's capital, or credit risk exposures that are especially risky or otherwise not in line with the mainstream of the bank's activities, to be decided by the bank's Board or senior management. The BoT should provide more detailed guidance on stress testing and make greater use of banks' stress-testing results in its risk analysis. DBS staff should receive training to permit them to credibly challenge bank's stress testing assumptions and scenarios.</p>

Core Principle	Comments
<p>Principle 18</p> <p>Problem Assets, Provisions and Reserves</p>	<p>The less stringent classification requirements for development finance loans are inadequate for prudential purposes as interest can continue to be accrued on non-performing loans for six months, three months beyond the Basel standard of 90 days.</p> <p>A much larger concern are the new requirements introduced by a circular issued by the BoT on February 19, 2018. For the three-year period of regulatory relief granted through end-2020, classification and provisioning may not be adequate for prudential purposes. Multiple elements of the regulatory relief are problematic from the perspective of adherence to the requirements of this Principle and Basel Committee <i>Guidance on Credit Risk and Accounting for Expected Losses</i> (December 2015). While the objective of reducing banks' NPLs to 5 percent or less is laudable, the provision of regulatory relief raises concerns that the underlying NPL problem may not be adequately addressed. The requirements for restructuring (Circular item #2) specify that they must be applied only when borrowers with previously good repayment records "lack sufficient working capital to support operations of their businesses." A further requirement is that restructuring must be applied to borrowers who have been "affected by changes in economic variables or business-related events." There is no requirement that banks consider the future viability of the borrower. As a result, credits which may be permanently impaired due to changes in the borrower's condition or the external business environment may be restructured up to four times, effectively deferring recognition of impairment of exposures that on a realistic forward-looking assessment have already given rise to expected credit losses. This is inconsistent with Basel guidance, which requires, among other things:</p> <ul style="list-style-type: none"> • The procedures used by a bank to measure expected credit loss are robust and timely and take into account criteria such as updated valuations of credit risk mitigants (and, in particular, collateral), cash flow estimates based on assessments of borrower-specific factors and current and future macroeconomic conditions, together with other relevant forward-looking information that affects the expected collectability of the bank's lending exposure. • Aggregate allowances on lending exposures are appropriate in accordance with relevant accounting requirements and in relation to the credit risk exposure in the bank's portfolio. • Un-collectability is recognized in the appropriate period through allowances or write-offs. • When assessing capital adequacy, supervisors should consider how a bank's accounting and credit risk assessment policies and practices affect the measurement of the bank's assets, earnings and, therefore, its capital position. • To the extent that credit risk assessment or expected credit loss measurement deficiencies are significant, the supervisor should consider whether such deficiencies should be reflected in supervisory ratings or through a higher capital requirement.

	Comments
	<p>A further specific concern is item #3 in the circular, which provides for capitalization of accrued interest on restructuring. This is permitted with respect to overdrafts where the bank has determined that there is no alternative to capitalizing the interest. Thus, for overdraft facilities where the bank has determined there is no possibility for the debtor to pay interest, the interest may be capitalized, thus avoiding the more appropriate treatment of holding such interest in suspense, which results in the overstatement of income by the amount of the capitalized interest. Further, once the facility has been converted into a term loan and two payments are made, the adverse classification may be removed. Given that the bank has already had to determine that the borrower has no prospects of paying the interest or entering into any other restructuring arrangements, this will result in failure to recognize losses in the appropriate period. The upgrading of facilities after restructuring (Circular item #4), coupled with the possibilities of restructuring a facility four times, means that in practice banks may be able to defer recognition of impairment charges for the duration of the period of regulatory relief. While item #5 requires write-off after four quarters in the loss category, loss loans can be restructured, and with new facilities provided to fund two payments, returned to performing status. If the loan returns to non-performing status, the same restructuring process could be repeated three times. Given reportedly depressed real estate prices, legal processes that can take a year or more to complete, and the risks introduced in provisions of the Tax Administration Act 2015, allowing banks to engage in multiple restructurings, capitalizing accrued interest, and more rapid upgrading of restructured facilities is likely to result in a distorted view of the profitability and soundness of banks. The DBS will need to closely monitor banks' practices to ensure the regulatory relief provided through end-2020 is not abused, and that the BoT is aware of the true position of banks despite the relaxation of regulatory requirements.</p> <p>In its onsite work, the BoT should devote more attention to assessing the value of risk mitigants. This is essential for effective risk management even if banks are not permitted to consider collateral value when determining required provisioning. Further, in light of the provisions of the Tax Administration Act 2015 (Sections 65 to 69) effectively make banks seizing a mortgaged property liable for any and all unpaid taxes of any kind (not just property taxes), raising the possibility that a bank may suffer an additional loss rather than a recovery if it moves to seize and sell any collateral. There is also scope for additional focus on the classification and provisioning of off-balance sheet items, although in most cases off-balance sheet exposure other than for undrawn facilities is small for Tanzanian banks.</p>

Core Principle	Comments
<p>Principle 19</p> <p>Concentration Risk and Large Exposure Limits</p>	<p>Given delays and/or failure to make payment with respect to various Government guarantee programs, it may not be appropriate to provide exemptions from the single borrower limit for facilities with Government guarantees. Even if ultimately paid, the bank incurs an economic loss due to the long delay in recovery. It would also be prudent to apply the single borrower limit expressed relative to capital to foreign exchange placements abroad. While the existing limits ensure some diversification in such placements, it is at least theoretically possible that a large foreign exchange placement abroad could exceed the otherwise allowable risk concentration, potentially leading to failure of a Tanzanian bank should the foreign bank, which in practice is often another group member, fails to repay the placement when it comes due. Thirteen waivers from risk concentration limits had been provided by the BoT between July and November 2017. Four relate to the diversification requirements for placements abroad, whereby banks that have been reduced to a single foreign correspondent account are unable to comply with the diversification requirements specified in the Foreign Exchange Exposure Regulations. Application of the more generally applicable single borrower limit (25 percent of core capital where the exposure is at least 125 percent secured by collateral; 10 percent of core capital where the exposure is below 125 percent secured by collateral; and 5 percent of core capital where the exposure is unsecured) should eliminate the need to provide exemptions. A bank could then have a single correspondent relationship provided that its exposure did not exceed prudent limits. This is the approach taken in most jurisdictions, and the BoT is urged to replace the current diversification requirement in the Foreign Exchange regulations by extending the requirements of the Credit Concentration and Other Exposure Limits Regulations to include all exposures including placement abroad. Other exemptions granted relate to single borrower exemptions for banks that have suffered losses reducing capital. In each case, these banks have been directed by the BoT to increase capital.</p>
<p>Principle 20</p> <p>Transactions with Related Parties</p>	<p>The BoT should consider revising the definition of related parties to fully align with the Basel definition. While the power of the BoT to deem parties to be related means there is no lacunae, it would provide greater certainty if the definition were wholly aligned. The BoT should consider amending the Credit Concentration and Other Exposure Limits Regulations to establish specific requirements covering the write-off of insider exposures. The requirement for loans and advances to staff to be governed by a well-documented policy would be strengthened by the addition of a specific requirement that staff who would be the beneficiaries of such loans and advances must not participate in the approval process. Enforcement of such provisions would be especially important in light of the experience with failed community banks where non-performing insider loans were a significant factor. This could be addressed in the planned new Corporate Governance Regulations.</p>
<p>Principle 21</p> <p>Country and Transfer Risks</p>	<p>The BoT introduced in 2014 prudential standards regarding country and transfer risk. However, a process for supervisory verification of banks' compliance is not yet in place. Given the low levels of country and transfer risk exposures in the system, this can be a lower priority project. Over time, however, the BoT should revise its RBS Manual to provide procedures to review country and transfer risks. There is also a need for guidance on taking country and transfer risks into account for classification and provisioning and stress testing, and to introduce a supervisory return covering country and transfer risks.</p>

Core Principle	Comments
Principle 22 Market Risks	Tanzanian banks' market risk exposure is concentrated in foreign exchange risk and interest rate risk. Although exposure to tradeable instruments is low, the BoT could usefully include a greater focus on verifying mark-to-market practices and timely capture of trading data in its onsite work.
Principle 23 Interest Rate Risks in the Banking Book	The RMGs address interest rate risk in the banking book as a subset of market risk. The coverage in the RMGs is largely descriptive, discussing good practices, but making few actual prescriptions. Neither the Market Risk examination procedures nor any other onsite procedures provide for a detailed review of interest rate risk in the banking book. While it is to the credit of the examiners that this topic received some coverage in two of the sample examinations reviewed by the assessors, it was confirmed through discussion with DBS staff that the more usual practice, reflected in the other examinations reviewed, is to address only those risks specified in the procedures when completing onsite work. The RMGs should be revised to establish clear supervisory requirements with respect to managing interest rate risk in the banking book, particularly as this is the most material market risk for Tanzanian banks. The examination procedures should also be revised to provide for specific review of the policies, procedures, measurement tools and reporting with respect to interest rate risk in the banking book. Additional guidance on stress testing of interest rate risk in the banking book would also be useful.
Principle 24 Liquidity Risks	The BoT will face challenges in introducing Basel III liquidity definitions and requirements due to the dearth of HQLA inherent in a country without broad and deep debt markets. This is an EAC-wide issue and should be addressed in the context of EAC harmonization agreements to ensure consistency across the region. Banking supervision staff should more consistently consider the impact on liquidity of other risks. More detailed review of banks' contingency plans as part of the offsite process would help to enhance the depth of offsite review, and reduce the resources needed during onsite work. The RMGs could usefully contain more prescription on liquidity stress testing although this may in part be addressed through the introduction of Liquidity Coverage Ratio and Net Stable Funding Ratio requirements in the Basel II/III implementation project, as these ratios assess liquidity in stressed conditions. Either through enhanced offsite analysis or additional onsite focus, there needs to be more systematic review of banks' liquidity stress testing.
Principle 25 Operational Risks	The work papers indicate extensive focus on operational risk during onsite examinations. The BoT should consider revising the Operational Risk Examination Procedures to achieve greater prudential focus, as many of the current procedures focus on topics such as physical security and branch inspections, that would be better addressed by the banks' own internal audit functions. This would free examiner resources for greater attention to the risks more likely to threaten the soundness of the bank.
Principle 27 Financial Reporting and External Audit	The BoT could usefully enhance its onsite review of banks' valuation practices. The BoT should institute a program of regular meetings with individual external auditors, for example to review year-end adjustments or in the context of completing onsite examinations.

Core Principle	Comments
Principle 28 Disclosure and Transparency	There is a requirement for more specific guidance on the contents of banks' disclosures. This could be met through Pillar 3 disclosure requirements when the Basel II/III implementation project is complete. Disclosures need to include information on group structures. At present this information is required to be reported to the BoT, but there is no requirement that banks include it in their published disclosures.
Principle 29 Abuse of Financial Services	The 2009 Eastern and Southern Africa Anti-Money Laundering Group mutual evaluation of Tanzania found that the AML/CFT regime was still in its early stage of development and much work needed to be done with regard to the implementation of the AML/CFT system, capacity building and awareness raising within the reporting community and the general public. Since that time, the AML law has been revised and the BoT has introduced its AML/CFT Examination procedures, in addition to extensive work undertaken by the Financial Inspections Unit (FIU) and reporting entities. In June 2014, the Financial Action Task Force (FATF) recognized that Tanzania had made significant progress in improving the AML/CTF regime and was therefore no longer subject to the FATF monitoring process. At the same time, Tanzania joined the Egmont Group of FIUs. It should be noted that subsequent to the 2009 evaluation, a revised version of the FATF recommendations was adopted in 2012, with amendments in 2013, 2015, 2016 and 2017. Tanzania has not been assessed under the 2012 criteria and revised methodology. As part of ongoing cooperation between the FIU and the BoT, the FIU should provide statistical data on the reporting of suspicious transaction reports (STRs). This would help the BoT identify banks that may be failing to report, and provide context for BoT examiners to conclude whether the number of STRs recorded in individual bank STR registers was reasonable given the size and nature of the business of the bank. The AML legal framework requires revision to align with the most recent FATF recommendations. The definition of Politically Exposed Persons needs to be expanded in accordance with the FATF 2012 definition that included domestic persons in addition to foreign persons. Other required revisions include requirements to define business that will not be accepted, and risk-based review of existing customers.

B. Recommended Actions to Improve Compliance with the Basel Core Principles

The authorities should give priority to:

- Ensuring adequate staffing of the supervision function (CP 2).
- Revising the RBS framework to introduce a single non-formulaic risk rating system (CP 1, 9).
- Implementing consolidated supervision by operationalizing the 2014 supplement to the RBS manual (CP 10, 12).
- Enforcing the existing Prompt Corrective Action regulations and introducing internal guidance to ensure timely action to deal with identified problem banks (EC 11).

- Closely monitoring banks' classification and provisioning to ensure that the BoT is able to accurately identify risks and assess resilience for the period of regulatory relief provided on classification and provisioning through end-2020.

Recommended Action Plan to Improve Compliance with the Basel Core Principles

Principle	Recommended Action
Principle 1 Responsibilities, objectives and power	Priority should be given to revising the RBS Framework and implementing consolidated supervision. Updating of the regulations and guidelines can be a lower priority, as prudential standards are generally sound.
Principle 2 Independence, accountability, resourcing and legal protection	DBS staffing needs to be increased so that it is able to fulfill its supervision mandate.
Principle 3 Cooperation and collaboration	Implement the crisis management provisions of the Financial Stability Forum so that it is positioned to be a coordinating body in the event of crisis. Enter into MOUs with all home country supervisors and enhance MOUs with provisions for crisis management. Consider publishing all signed MOUs to enhance accountability and transparency.
Principle 5 Licensing criteria	Consider revising the minimum absolute capital levels at entry Conduct an effective face-to-face fit and proper process to challenge prospective board members and senior management on the business model assumptions underpinning the financial forecasts of the application, and their knowledge of the bank's business plan. Consider scheduling early on-site visits and more intensive off-site monitoring in the first two years after license is granted to monitor implementation of business and strategic plans.
Principle 7 Major acquisitions	Enter into an agreement with the FCC on how financial sector transactions will be reviewed with respect to mergers and acquisitions given the parallel mandates of the BoT and FCC. Develop internal guidance for the evaluation of the proposed mergers.
Principle 8 Supervisory approach	Implement regular analysis of banking groups to complement the current solo analysis of the bank or financial institution. Consistently report in the Institution Profiles a forward-looking view for the next twelve months and report on the potential future impact of the supervisors' assessment of asset quality and liquidity analysis, and other risks, on banks' capital. Require large banks to prepare recovery and BoT to prepare resolution plans for systemically important banks once these are identified.

Principle	Recommended Action
Principle 9 Supervisory techniques and tools	Review as a matter of urgent priority the RBS Manual to replace the two current methodologies with a single approach that does not use averaging or formulas, which can obscure material risks and supervisory concerns. Enhance off-site risk analysis and include more detailed guidance for offsite work in the revised RBS Manual. Organize formal regular prudential meetings with banks. Enhance DBS relationship with external auditors as currently there are no regular technical contacts either during offsite or on-site work.
Principle 10 Supervisory reporting	Systematically collect data on all relevant group entities as required by the Consolidated Supervision Regulations (2014). Include review of valuations practices in the working programs (see also CP 17, Credit Risk; and CP 21, Market Risk).
Principle 11 Corrective and sanctioning power	Strengthen the Prompt Corrective Action framework by establishing more detailed internal guidelines with triggers other than capital ratios to encourage action at the earliest stage possible, before problems are magnified
Principle 12 Consolidated supervision	Implement in on-going supervision (on-site and off-site) the Consolidated Supervision Regulation and the procedures set out by the 2014 Supplement to the RBS Manual. Consistently address group issues in quarterly IPs and during onsite work Develop formal procedures to assess the quality of supervision in home countries of foreign banks subsidiaries in Tanzania, the quality of supervision conducted by host supervisors, and a formal policy for assessing whether on-site examinations of a banking group's foreign operations are necessary or whether additional reporting is required.
Principle 13 Home-host relationships	Increase information sharing and coordination of activities with relevant foreign authorities. Develop agreed communication strategies, cross-border crisis management arrangements and resolution plans. Include in the amendments in preparation to the BFIA that no shell bank would be authorized to operate in Tanzania.
Principle 14 Corporate Governance	Introduce specific requirement for banks to have codes of conduct, and extend provisions on conflicts of interest to exclude staff, not only directors, from a decision-making process from which they might benefit (see also Principle 20).
Principle 15 Risk management	Introduce specific requirements for banks to have capital and liquidity planning processes that take into account the risk appetite and risk profile of the bank. Explicitly require at least large banks to have Chief Risk Officers Provide more detailed guidance on banks' stress testing programs and make more use of banks' stress testing results in ongoing supervision (see Principles 17 and 24). Provide training for examiners so they are credibly able to challenge banks' stress-testing scenarios and assumptions.
Principle 16 Capital adequacy	Completed the planned Basel II/III implementation project.

Principle	Recommended Action
Principle 17 Credit risk	Provide more detailed guidance on banks' stress testing programs and make more use of banks' stress testing results in ongoing supervision (see also Principles 14 and 24).
Principle 18 Problem assets	Closely monitor banks' practices to ensure the regulatory relief provided on classification and provisioning through end-2020 is not abused, and the BoT is aware of true position of banks despite the relaxation of regulatory requirements. Devote additional attention to assessing the value of credit risk mitigants and the classification and provisioning of off-balance sheet items.
Principle 19 Risk concentrations	Remove the exemptions from concentration limits for government-guaranteed exposures in light of experience with delays or non-payment when such guarantees are called. Apply the single borrower limit to foreign currency placements abroad in place of the current restrictions in the Foreign Exchange Exposure Regulations to ensure there are no excessive exposures to foreign banks.
Principle 20 Related parties	Introduce specific requirements for high-level approval for the write-off of insider exposures. Introduce a specific requirement for banks to have codes of conduct, and extend provisions on conflicts of interest to exclude staff, not only directors, from a decision-making process from which they might benefit (see also Principles 14).
Principle 21 Country and transfer risks	Revise the RBS Manual to provide procedures to review country and transfer risk. Provide supervisory guidance on taking country and transfer risk into account for classification and provisioning and stress testing Introduce a supervisory return covering country and transfer risk.
Principle 22 Market Risk	Although tradable instruments and their related market risk exposures are minimal for Tanzanian banks, the BoT should systematically verify banks' mark-to-market practices and systems for timely capture of trading data.
Principle 23 Interest rate risk in the banking book	The BoT should provide more detailed guidance on its expectations for banks' approaches to managing interest rate risk in the banking book. The onsite examination procedures require revision to include specific review of interest rate risk in the banking book.
Principle 24 Liquidity risk	The BoT, in conjunction with the EAC Partner States as required by the commitment to implement Basel III by end-2018, needs to consider how the Basel III liquidity requirements can be met in markets lacking instruments meeting the Basel definition of HQLA. DBS staff should more consistently consider the potential impact on liquidity of other risks such as credit. Provide more detailed guidance on banks' stress testing programs and make more use of banks' stress testing results in ongoing supervision (see also Principles 14 and 17).
Principle 25 Operational risk	Revise the Operational Risk Examination Procedures to achieve greater prudential focus, as many of the current procedures focus on topics such as physical security and branch inspections that would be better addressed by the banks' own internal audit functions, freeing examiner resources for additional focus on risks likely to threaten the soundness of the bank.

Principle	Recommended Action
Principle 27 Internal audit and control	Enhance the onsite review of banks' valuation practices. Introduce a regular program of bilateral and/or trilateral meetings with auditors.
Principle 28 Disclosure and transparency	Provide more specific guidance on the contents of banks' disclosures—this could be met through the Pillar 3 requirements of the Basel II/III implementation project. Require banks to publicly disclose information about their group structure.
Principle 29 Abuse of financial services	The FIU should provide to the BoT on a regular basis statistical information on the submission of STRs by banks and financial institutions. Revise the Anti-Money Laundering legal framework to align with the most recent FATF recommendations.

C. Authorities' Response to the Assessment

- The Bank of Tanzania welcomes the assessors' acknowledgment of the progress made in implementing most of the recommendations from the 2009 FSAP Update, including the August 2010 review of its Risk-Based Supervision Manual (RBS Manual) as well as the 2014 extensive review of regulatory framework. Also in 2014, the BoT adopted a supplement to the RBS Manual to provide procedures for consolidated supervision.
- The Bank also welcomes the assessors' acknowledgment that international standards have continued to evolve, and that this assessment uses the methodology issued by the Basel Committee on Banking Supervision in September 2012, which was revised substantially from the 2006 methodology used for the last assessment of Tanzania. Thus, the ratings assigned during this assessment are not directly comparable to assessments completed in 2009 and 2003 as part of previous FSAPs.
- On a few specific aspects in this report, the Bank' response is as follows:
 - ✓ Regarding staff shortage, the Bank agrees with assessors' comments and concerns regarding inadequacy of staff to effectively discharge its supervisory responsibilities. While the Bank recognize the shortage of staff in DBS, it should be noted that efforts have been taken to rectify this situation by providing additional staff to DBS. The Bank will continue to take action to address the issue of insufficient staff by engaging suitably qualified staff to fill vacant positions.
 - ✓ On supervisory techniques and tools, we wish to submit that significant efforts have been made to improve supervisory techniques and tools since the previous FSAP, including review of Risk-Based Supervision Manual (RBS Manual) in August 2010, acquisition of onsite examination software and automation of onsite examination work papers since 2014. This has resulted in a generally more effective supervision.

- ✓ On the issue of Problem Assets, Provisions, and Reserves, the Bank is committed to properly monitor implementation of the temporary regulatory relief granted to banks and financial institutions in February 2018 to ensure that they do not undermine the adequacy of classification and provisioning for prudential purposes.
- The Bank agrees with the other recommendations made by the assessors and is committed to taking the necessary steps to address the identified gaps.

Appendix IV. Banking Sector Stress Testing Matrix (STeM)

Domain		Assumptions ¹	
		Top-Down by Authorities	Top-down by FSAP Team
BANKING SECTOR: SOLVENCY RISK			
1. Institutional Perimeter	Institutions included ²	<ul style="list-style-type: none">40 banks	<ul style="list-style-type: none">45 banks (Peer 1–3 and government-owned)
	Market share	<ul style="list-style-type: none">98 percent of total banking sector assets (excl. community banks)	<ul style="list-style-type: none">100 percent of total banking sector assets (excl. community banks)
	Data and baseline date	<ul style="list-style-type: none">Supervisory data as of December 2017	<ul style="list-style-type: none">Supervisory data as of December 2017
2. Channels of Risk Propagation	Methodology	<ul style="list-style-type: none">Balance sheet model (Čihák, 2007)	<ul style="list-style-type: none">IMF stress testing framework (see methodology note)
	Satellite models for macro-financial linkages	<ul style="list-style-type: none">N/A	<ul style="list-style-type: none">Dynamic panel data satellite models for bank-level NPL ratios, credit growth, and pre-impairment profit
	Stress test horizon	<ul style="list-style-type: none">1 period	<ul style="list-style-type: none">3 years (quarterly frequency)
3. Tail shocks	Scenario analysis	<ul style="list-style-type: none">Macro scenarios include baseline, adverse and tail risk scenarios.Macro-financial variables include real GDP growth, nominal exchange rate change, overnight interbank cash market rate, growth in nominal and real bank credit to the private sector, short and long bond rates, deposit rates, inflation and commodity prices.Baseline: All variables follow the IMF WEO projections.Adverse: In the adverse scenario, Tanzania's real GDP growth path is about 1 std. lower than the baseline projection. The scenario assumes moderate depreciation and inflation, a cumulative increase in the interbank rate of 200 bps, a cumulative increase in the short rate of 200 bps and a corresponding increase in the long rate of 100 bps. Credit expands moderately at an average rate of 7 percent in nominal terms and 1.5 percent in real terms. Commodity prices remain flat over the period.Tail risk: The tail risk scenario assumes that Tanzania's real GDP growth path is about 3 std. lower than the baseline projection. Commodity prices decline by 30 percent over the first two years and trigger a cumulative currency depreciation of about 40 percent and an increase in inflation, which peaks at about 11 percent in 2019. The maximum interest rate increase is attained in 2019 and represents 500 bps for the interbank rate and the short rate and 300 bps for the long rate. Credit barely expands in nominal terms and contracts in real terms at an average rate of about 2.5 percent.	

¹ The absence of bottom-up stress tests reflects resource constraints at the BoT to coordinate a complex exercise within the time-span of the FSAP exercise.

² Based on current data availability across tests for different types of risks.

Domain		Assumptions	
		Top-Down by Authorities	Top-down by FSAP Team
	Sensitivity analysis	<ul style="list-style-type: none"> • Credit Risk <i>An increase in NPLs:</i> <ol style="list-style-type: none"> by 8 percent (proportional to performing loans) by 8 percent (proportional to existing NPLs) <i>An increase in sectoral NPLs:</i> (proportional to sectoral loans) agriculture: 4 percent manufacturing: 12 percent trade: 7.5 percent personal loans: 5.5 percent <i>Default of largest 1, 3, 5 borrowers</i> 	<ul style="list-style-type: none"> • Credit Risk <i>An increase in NPLs:</i> <ul style="list-style-type: none"> <i>Proportional to existing NPLs:</i> <ol style="list-style-type: none"> by 25 and 50 percent in 1 year by 100 and 150 percent in 2 years <i>Proportional to total loans:</i> by 3, 5 and 7 percent of total loans <i>An increase in NPLs in the following sectors:</i> agriculture (100 percent): trade (100 percent) transportation and communication (100 percent) personal loans (100 percent) <i>Default of largest 1, 3, 5 borrowers</i> <i>Shocks to the loan transition matrix</i> - Downgrades of a fraction of banks' loans in each risk class by a notch <i>Reverse credit risk tests</i> will find the NPL shocks that: <ol style="list-style-type: none"> would bring the banking system's CAR down to (i) 14.5 percent and (ii) 12 percent; would cause banks accounting for 25 percent/50 percent of the banking sector assets to fall below the regulatory capital requirement; would require capital injections of 0.5/1 percent of GDP.

Domain		Assumptions	
		Top-Down by Authorities	Top-down by FSAP Team
		<ul style="list-style-type: none"> • Interest Rate Risk <i>Income Effect</i> - The test assumes an interest rate increase of 200 bps at maturities shorter than 3 years and 400 bps at maturities longer than 3 years • Currency Risk a. currency depreciation/appreciation of 10 percent b. mixed currency depreciation and appreciation • One period multifactor scenario: shocks to NPLs, interest rates, exchange rates, and profits 	<ul style="list-style-type: none"> • Interest Rate Risk <i>Income Effect</i> - Parallel shifts in interest rates in domestic and foreign currency of 300 bps, 600 bps, and 1000 bps • Currency Risk a. currency depreciation of 15 and 25 percent b. currency appreciation of 15 and 25 percent

Domain		Assumptions	
		Top-Down by Authorities	Top-down by FSAP Team
4. Risks and Buffers	Risks/factors assessed	<ul style="list-style-type: none"> Credit losses, profits, losses from maturity mismatches, counterparty and sectoral concentration risk 	<ul style="list-style-type: none"> Credit losses, credit growth, pre-impairment profits, repricing gap, sectoral credit shocks, losses from maturity and currency mismatches, indirect FX risk, counterparty risk, reverse NPL shocks
	Behavioral adjustments	<ul style="list-style-type: none"> N/A 	<ul style="list-style-type: none"> Assumptions for credit growth in various scenarios as well as dividend payout ratio, repricing gap, NOP, noninterest income, expenses, taxes (see scenario section and methodology note). The dividend payout rule is consistent with the aim to build capital conservation buffers
5. Regulatory and Market-Based Standards and Parameters	Calibration of risk parameters	<ul style="list-style-type: none"> Changes in sectoral NPLs calibrated on changes in commodity prices and other risk factors 	<ul style="list-style-type: none"> Projections of bank-by-bank NPL ratios, credit growth and pre-impairment profits based on satellite macro-financial models were used in combination with accounting identities and behavioral assumptions to project banks' solvency positions in each scenario. Banks' NPL ratios were modeled as a function of real GDP growth, the interest rates, and the exchange rate vis-à-vis the U.S. dollar. Under the standard approach, the credit growth projection was based on the macro assumptions and the impact of interest rate shocks on net interest income was assessed in a repricing gap framework for multiple periods
	Regulatory/Accounting and Market-Based Standards	<ul style="list-style-type: none"> Country-specific regulatory minimum CAR 	<ul style="list-style-type: none"> Country-specific regulatory minimum CAR
			<ul style="list-style-type: none"> Newly adopted capital conservation buffer is taken into account

BANKING SECTOR: LIQUIDITY RISK			
1. Institutional Perimeter	Institutions Included ³	<ul style="list-style-type: none"> 40 banks 	<ul style="list-style-type: none"> 43 banks (Peer 1–3 and government-owned banks)
	Market share	<ul style="list-style-type: none"> 98 percent of total banking sector assets (excl. community banks) 	<ul style="list-style-type: none"> 100 percent of total banking sector assets (excl. community banks)
	Data and baseline date	<ul style="list-style-type: none"> Supervisory data as of December 2017 	<ul style="list-style-type: none"> Supervisory data as of December 2017
2. Channels of Risk Propagation	Methodology	Bank run (balance sheet-based) a. Systemic run b. Idiosyncratic run	Bank run and haircuts on liquid assets. <ul style="list-style-type: none"> Cash-flow-based using maturity buckets
3. Risks and Buffers	Risks	<ul style="list-style-type: none"> Funding liquidity shock Market liquidity shock 	<ul style="list-style-type: none"> Funding liquidity shock Market liquidity shock
	Buffers	<ul style="list-style-type: none"> Liquid assets 	<ul style="list-style-type: none"> Counterbalancing capacity Liquid assets
4. Tail shocks	Size of the shock	a. a withdrawal of 10 percent of deposits per day b. lower withdrawals from banks considered strongest: <ul style="list-style-type: none"> by size (total assets) by group (domestic, OECD, non-OECD) pre-shock CAMEL or core FSI rating 	Assumptions for run-off rates on funding sources and roll-off rates on assets in order to estimate the funding gap
5. Regulatory and Market-Based Standards and Parameters	Regulatory standards	<ul style="list-style-type: none"> Hurdle metrics: survival period Local regulatory requirements 	<ul style="list-style-type: none"> Hurdle metrics: funding gap, survival period, regulatory liquid assets ratio Local regulatory requirements
6. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> Number of banks that can meet their obligations 	<ul style="list-style-type: none"> Funding gap by bank and currency, aggregated Survival period in days by bank Number of banks that are liquid/illiquid
³ Based on current data availability across tests for different types of risks.			

BANKING SECTOR: CONTAGION RISK			
1. Institutional Perimeter	Institutions included	<ul style="list-style-type: none"> • 31 banks 	<ul style="list-style-type: none"> • 29 banks
	Market share	<ul style="list-style-type: none"> • 96 percent of total banking sector assets (excl. community banks) 	<ul style="list-style-type: none"> • 97 percent of total banking sector assets (excl. community banks)
	Data and baseline date	<ul style="list-style-type: none"> • Supervisory data as of December 2016 	<ul style="list-style-type: none"> • Supervisory data as of December 2017
2. Channels of Risk Propagation	Methodology	<ul style="list-style-type: none"> • Stress test based on the net interbank exposure matrix (like in Čihák, 2007) • Balance-sheet model 	<ul style="list-style-type: none"> • Espinosa-Sole (2010) interbank network model
3. Tail shocks	Size of the shock	<ul style="list-style-type: none"> • Default of institutions. • The stress test assumes sequential defaults on net interbank credit for each of the ten-largest banks and traces the effects on the other banks. 	<ul style="list-style-type: none"> • Default of institutions • The test assumes LGD of 100 percent and that the funding from a failed bank is not rolled over and borrower banks have to replace it by selling assets with a haircut of 30 percent
4. Reporting Format for Results	Output presentation	<ul style="list-style-type: none"> • CARs for the system and by ownership groups 	<ul style="list-style-type: none"> • Tier 1/CARs for the system and by peer groups • For each range of CARs, number of banks and share in the total system by assets • Recapitalization needs in percent of GDP