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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 18/96-2

12:05 p.m., November 19, 2018

2. United Republic of Tanzania—Financial System Stability Assessment

Documents: SM/18/260 and Correction 1; and Correction 2; and Supplement 1

Staff: Catalan, MCM

Length: 37 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
D. Mahlinza (AE)	
	H. Razafindramanana (AF)
	J. Corvalan (AG), Temporary
	G. Kim (AP), Temporary
	M. Coronel (BR), Temporary
	P. Sun (CC)
	J. Rojas (CE), Temporary
L. Levonian (CO)	
	S. Benk (EC)
	A. Castets (FF)
	K. Merk (GR)
	M. Roy (IN), Temporary
	L. Cerami (IT), Temporary
	Y. Naruse (JA), Temporary
	M. Saadaoui (MD), Temporary
	P. Al-Riffai (MI), Temporary
	M. Josic (NE), Temporary
	N. Vaikla (NO), Temporary
	Z. Smirnova (RU), Temporary
	F. Rawah (SA), Temporary
J. Agung (ST)	
P. Inderbinen (SZ)	
	M. Chen (UK), Temporary
	D. Crane (US), Temporary

G. Tsibouris, Acting Secretary
S. Kalra, Summing Up Officer
E. Mannefred, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
African Department: Irina Bunda, B. Radzewicz-Bak. Monetary and Capital Markets Department: M. Catalan, M. Cihak, Federico Grinberg, C. Lattie, K. Tintchev, X. Yao. Statistics Department: J. Hur. World Bank Group: Y. Doi. Alternate Executive Director: I. Mannathoko (AE), K. Obiora (AE), M. Psalidopoulos (IT). Senior Advisors to Executive Directors: O. Odonye (AE), T. Sitima-wina (AE), G. Vasishtha (CO), F. Bellocq (FF).

Advisors to Executive Directors: A. Abdullahi (AE), O. Bayar (EC), X. Cai (CC), J. Essuvi (AE), I. Fragin (GR), J. Garang (AE), M. Ismail (AE), M. Kikiolo (AP), A. Nainda (AE), E. Ondo Bile (AF).

2. UNITED REPUBLIC OF TANZANIA—FINANCIAL SYSTEM STABILITY ASSESSMENT

Mr. Mahlinza and Mr. Odonye submitted the following statement:

Our Tanzanian authorities appreciate the constructive engagement with staff during the recent Financial Sector Assessment Program (FSAP) mission. They broadly concur with the key policy recommendations and recognize that a strong institutional framework for systemic oversight is critical to addressing vulnerabilities and preserving financial stability. While substantial progress has been made with financial sector reforms, more still needs to be done to enhance the capacity to effectively monitor systemic risks and address remaining macroprudential policy challenges. At the same time, the rapidly changing financial landscape heralded by innovations in Financial Technology, within the traditional financial paradigm, requires additional vigilance. In addressing and dealing with these challenges, the authorities intend to draw on the Fund's Technical Assistance for both the FSAP reform agenda and for any associated needs that may arise as new technologies gain traction.

The authorities have made considerable improvements to the financial regulatory system since the 2009 FSSA Update. Most of the recommendations were implemented, including the conclusion of the Risk-Based Supervision (RBS) Manual, the adoption of the supplement to the RBS Manual on procedures for consolidated supervision by Bank of Tanzania (BoT), and many other extensive improvements to the regulatory framework. Furthermore, the BoT took steps to close capacity gaps by recruiting additional staff into the Directorate of Banking Supervision and remains committed to engaging suitably qualified staff to fill vacant positions. Since 2014, the BoT has made additional reform measures such as improvements to supervisory techniques and tools, the acquisition of onsite examination software, and the automation of onsite examination work papers. Our authorities have pointed out that the methodology used in the 2018 assessment has been revised substantially from the 2006 methodology applied in previous FSAPs. Therefore, they argue that staff's comparison of ratings in this assessment, with those of past FSAPs requires clarification. In addition, the current FSAP assessment applied a different model for stress testing as opposed to the BoT's CIHAK model and produced different results, a point that staff agreed to reflect in the report.

Over the years, Tanzania has achieved macro-financial stability, anchored by a strong financial supervisory and policy framework. As noted by staff, prudential regulations remain sound and considerable progress has been made to strengthen the Bank of Tanzania (BoT's) prudential framework, since the 2009 FSAP. This progress includes changes to the 2010 risk management guidelines and the introduction of new regulations in 2014. While the capital adequacy requirements are still based on Basel I, they are supplemented by capital charges for market and operational risks. The current capital adequacy ratio of 12 percent of risk-weighted assets, buffered by a 2½ percent capital conservation, is above the regulatory minimum. With higher capital requirements than the Basel minimum and a predominance of common equity Tier 1 capital, most Tanzanian banks can meet Basel III capital requirements. The BoT is also working hard to develop liquidity instruments with high quality liquid assets (HQLA), in an effort to transition to a price-based monetary framework.

On non-performing loans, the BoT would like to emphasize that the circular for loan classification and restructuring is a temporary relief to banks and financial institutions, and undertakes to remain vigilant in monitoring implementation and addressing associated consequences including abuse. The Bank remains totally committed to financial stability and will conduct effective scrutiny of banks' books to ensure that loan classification and provisioning conforms to prudential rules. Going forward, supervisors and examiners will also be more agile in monitoring the quality of assets with an emphasis on provisioning and reserves.

The authorities remain committed to monitoring systemic liquidity constraints, interconnected risks and vulnerabilities associated with structural liquidity. In this context, they have prioritized focus on repo market development and modernization of the monetary framework. Critical to this is the plan to reduce interest rate volatility on domestic currency by clarifying objectives, rationalizing the use of instruments and completing ongoing changes in secured money markets. They recognize that promoting a vibrant foreign exchange (FX) market, anchored by sound macroprudential measures, would bolster resilience to relevant risks. Despite the observed dollarization of banks' balance sheets, the banking sector's Net Open Position (NOP) remains within the regulatory limits. In addition, the BoT has devoted additional resources to completing its operational guidance for emergency liquidity assistance.

Regarding deposit insurance and financial crisis prevention and management, the authorities concur with the need to strengthen the existing resolution framework. The dominance of interconnected institutions and related credit exposures underscore the importance for group-wide risk-based supervision of financial corporates. In this regard, improvements to agency-specific plans are being accelerated and the authorities are strengthening the oversight regime and bolstering the crisis and resolution framework from several fronts. The Tanzania Financial Stability Forum agrees with the need to use extraordinary powers to maintain financial stability during a systemic crisis through the Ministry of Finance and BoT. At the same time, the operational independence and effectiveness of the Deposit Insurance Board (DIB) will be enhanced with the constitution of its Board to accelerate the planning for payouts and liquidation when needed. The BoT will require recovery plans from banks and prepare resolution plans for systemically important banks in the domestic market (D-SIBs), as soon as they are identified.

Our authorities view increasing access to formal financial services and boosting long-term finance for a larger proportion of the micro, small and medium enterprises with urgency and renewed importance. In this respect, they agree with measures that broaden access and lower the cost of financial services. This includes addressing financial infrastructure gaps, bringing nonbank credit providers to smaller firms under the purview of the regulatory authorities, strengthening consumer protection and improving financial literacy. Our authorities will also examine pension funds' investment allocations with a view to broadening long-term financing to the private sector, and explore modalities for increasing the supply of liquid securities.

Finally, we reiterate our authorities' commitment to implementing reforms needed to strengthen the resilience of the financial system. They are mindful of the fact that effective implementation and sequencing of the FSSA recommendations will need significant resources, including ample Technical Assistance from the Fund. The government is committed, along with all relevant regulatory institutions, to focus on tackling the challenges identified in the report with a view to advancing financial sector development and preserving financial system stability.

Mr. Merk and Mr. Fragin submitted the following statement:

We thank staff for the comprehensive report and Mr. Mahlinza and Mr. Odonye for their informative buff statement. We concur with the thrust of the FSSA, which provides a valuable contribution in identifying vulnerabilities in Tanzania's financial system as well as priority areas for policy action.

We note the significant upward trend in nonperforming loans (NPLs) since 2015, leaving many banks vulnerable to shocks, as highlighted by staff. Measures aiming to reduce NPLs as well as to increase provisioning appear warranted. In this context, we also see merit in staff's recommendation to clarify conditions under which NPLs may be restructured, following up on the BoT's February 2018 circular.

We further take note of the interconnectedness between pension funds and banks, as well as of the financial sector's high sovereign exposure. As staff emphasizes, this poses significant risks – especially in the context of unresolved fiscal arrears, which could lead to liquidity pressures in the financial system.

We also share staff's recommendation to enhance the BoT's institutional and operational frameworks. As proposed by staff, this should include strengthening liquidity management in line with the BoT's price stability objective. In this context, we would welcome if staff could elaborate on its recommendation to distinguish FX operations by the underlying objectives and on its assessment of FX operations in Tanzania, more broadly.

Mr. Gokarn and Mrs. Roy submitted the following statement:

We thank the staff for an informative paper and Mr. Mahlinza and Mr. Odonye for their insightful buff statement. We generally agree with the staff assessment. While Tanzania has recorded healthy growth rates since early 2000s with moderate inflation, aided by market-oriented reforms, prudent macroeconomic policies and consecutive Fund programs, there appears to be some gaps in the financial sector which need to be bridged for sustained medium- to long-term growth.

The authorities are to be commended for reform efforts, including tackling corruption and tax evasion to improve revenue collection, and the drive for industrialization and human development. In the financial sector, it will also be necessary for the authorities to make vigorous efforts towards reducing NPLs and preventing the emergence of further NPLs, introducing necessary macroprudential measures, increasing financial inclusion to strengthen the banking and real sectors, developing the financial markets and encouraging and reducing the risks in the microfinance sector to encourage safe credit off-take through microfinance channels. The FSSA mentions that the weak business environment was a major driver of NPLs on trade, manufacturing, real estate and personal loans. Was the weakening of business environment driven by specific domestic or global factors in the form of shocks to some critical sectors?

The FSSA mentions that medium-to-small banks rely systematically more on costlier, short-term, interbank financing and institutional deposits and have markedly higher operating costs. They also have high noninterest expenses which they try to offset by lending at high interest rates, but still tend to have negative profitability. In this situation, it may be useful for the Tanzanian banks to develop a retail depositor base which will help them to acquire stable, low-cost current and savings account deposits instead of relying on high cost institutional deposits. For this, there has to be a concerted drive by the banks and authorities to encourage the population to open and access bank accounts for their financial transaction needs. Low cost deposits will also reduce the lending rates and bring down the default rate and increase credit offtake which has been falling. What is the extent of financial inclusion in Tanzania in terms of the percentage of population having access to the banking sector?

The FSSA highlights the fact that along with falling credit offtake, corporate debt loads have risen with weak cash flows and dollarization of bank balance-sheets. This raises the possibility of solvency stress under shocks being exacerbated by funding liquidity pressures, especially at smaller banks. Since the foreign currency exposure appears to be high, the financial system could be adversely affected as the current global financial scenario anticipates tightening of liquidity conditions if some potential adverse conditions materialize. In this situation, what is the extent of natural hedges available to the Tanzanian corporate sector and what is the prospect of building financial hedges against such vulnerabilities?

The FSSA evaluates that the capital cushion is low, if the extent of NPLs and lower-than-required provisioning is taken into account. Lending is also concentrated in a few economic sectors, mainly trade, construction and real estate, and manufacturing. Some of these sectors like construction and real estate are prone to over-heating which could result in further accretion of NPLs if growth slows further or other adverse conditions envisaged in the tail risk stress test materialize. Have the Tanzanian authorities instituted macroprudential measures such as LTV ratios, sector-specific risk weights, etc. for guarding against further growth of NPLs?

Microfinance channels can ideally finance SMEs and agriculture in far-flung rural areas where bigger commercial banks may not have a presence. The FSSA mentions that for community banks and microfinance lenders, poor corporate governance, fraud, insider lending, or a higher share of uncollateralized loans were important factors in the uptick in NPLs. It appears that reducing the risks in the microfinance sector is necessary through appropriate regulation and oversight to encourage safe credit off-take. Staff comments are welcome in this regard.

The authorities are trying to develop the repo market and a strengthening of the Emergency Liquidity Assistance has also been suggested. All of these developmental measures require the availability of good quality and liquid collateral in sufficient quantity which can be traded economically and safely through securities markets. What is the extent of availability and tradability of government and corporate securities in Tanzania? What are the improvements needed for developing the local currency bond market in Tanzania?

Interconnectedness in the system arises from bilateral balance sheet exposures between pension funds and banks. The pension sector in Tanzania, which operates mandatory social security schemes, allocates a significant share of its assets to bank deposits (8 percent), and credit to the government (46 percent). Pension funds hold four percent of bank deposits, establishing an important inter-linkage between the two sectors. Banks are vulnerable to potential withdrawal of pension fund and mobile network operators' (MNO) deposits. The risk of withdrawal arises from two sources. First, the mandatory social security schemes offer generous defined-benefit (DB) pensions, which have consistently exceeded contributions in recent years, triggering liquidation of pension fund assets including bank deposits. 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. Second, government arrears to pension funds can cause them to liquidate bank deposits to meet cash flow needs adding to banks' liquidity pressures. To resolve these problems, government arrears to pension funds – and banks – need to be cleared urgently and the viability of the social sector schemes improved. The buff statement mentions that the authorities intend to draw on the Fund's Technical Assistance for both the FSAP reform agenda and for any associated needs that may arise as new technologies gain traction. Has the need to improve the viability of the social sector schemes through restructuring, increasing contribution rates, wherever possible, and improving allocation of pension funds to long-term assets with remunerative yields, been considered, along with the necessary Technical Assistance?

Mr. Tan and Ms. Latu submitted the following statement:

We thank staff for the comprehensive report and Mr. Mahlinza and Mr. Odonye for their informative buff statement.

The favorable medium-term outlook is at risk from circumstances that threaten the stability of the Tanzanian financial system. Heightened signs of credit deterioration highlight escalating bank solvency concerns, particularly in the context of high dollarization of banks' balance sheets and under-developed domestic financial markets. Given the interrelationship between the financial and real sectors, the whole Tanzanian economy is vulnerable to amplified financial and macroeconomic impact arising from currency shocks. To consolidate recent progress made toward raising banking prudential standards, continued efforts are needed to enhance the Bank of Tanzania (BoT)'s capacity to exercise effective supervision, financial system oversight and crisis management. We agree with the broad thrust of staff's recommendations and would like to provide the following comments for emphasis.

Effective adoption of risk-based supervision is essential to fostering sound bank practices. In line with staff's recommendations, priority should be given to enhancing the supervisory capacity of the BoT's Directorate of Banking Supervision (DBS) to perform forward-looking risk assessment and take prompt supervisory intervention against unsafe banking practices and activities. We appreciate that this is an iterative process and we encourage the authorities to continue leveraging on the Fund's technical assistance to make further progress on the remaining 2010 FSAP recommendations. That said, we are concerned with the regulatory relief, albeit temporary in nature, granted to banks for loan classification and restructuring in February 2018. We note the BoT's reassurance on close monitoring against any notable weakening of credit review standards and processes.

We welcome the authorities' update on the constitution of the Deposit Insurance Board (DIB). Against the backdrop of significant financial stability challenges, this is an important step towards establishing DIB's credibility and facilitating its role for effective crisis preparedness. In the event of crisis, the ability of DIB to act nimbly and decisively will nurture market confidence and contribute to speedy recovery. Much more can be done on various fronts to support swift execution of crisis responses by the authorities under different scenarios. At the heart of this are staff's recommendations on the development of contingency plans, the conduct of deposit payout within 7 days which is in line with the international best practice, and the provision of appropriate resources and expertise to liquidate problem banks when needed.

Default risk from government obligations and fiscal arrears give rise to potential contagion effects. The financial sector has relatively high exposure to the Government in terms of holdings of government securities and the

Government’s payment obligations to pension funds. In addition, the Government supports the corporate sector through its fiscal spending. Considering the stress test results that flagged significant fragility under the tail risk scenario, which included a protracted incidence of government payment arrears, this is a source of concern and appropriate measures should be taken to mitigate the associated spillovers risks. Can staff elaborate on the likely options that may be appropriate in this regard?

Prudent regulation and robust supervision is not an end in itself but a means to harness finance as an enabler of economic growth and financial inclusion. We commend the authorities for the progress made in improving financial access to the under-served sectors of the economy, such as the micro, small and medium enterprises, and in promoting more inclusive economic growth. Moving forward, we encourage further efforts to this end including addressing the financial infrastructure gaps identified by staff.

With the above remarks, we wish the authorities of Tanzania continued success in their policy endeavors.

Mr. Benk and Mr. Bayar submitted the following statement:

We thank staff for the insightful Financial System Stability Assessment (FSSA) report, and Messrs. Mahlinza and Odonye for their helpful buff statement. Against a regional and global backdrop characterized by a heightened state of risks, the 2018 FSSA provides a timely update on how to continue strengthening financial sector stability in Tanzania. We agree with the thrust of staff’s assessment and positively note the authorities’ resolve to address the identified weaknesses and improve compliance with the Basel Core Principles. We would like to add the following comments for emphasis.

Sustaining and strengthening Tanzania’s economic performance hinge on a healthy and well-functioning financial system. Owing to the authorities’ market-oriented reforms and prudent policies, Tanzania has managed to sustain a robust growth performance since the early 2000s. Despite the strength of the economic activity, Tanzania’s bank-denominated financial system suffers from some structural weaknesses, particularly pertaining to asset quality and liquidity management. System-wide non-performing loans have risen considerably with significant variations across banks, thereby leading to pockets of substantial stress within the banking system. In this regard, we underscore the crucial role of the delays in the delivery of the government’s domestic financial obligations and encourage the authorities to take prompt steps to resolve this protracted issue. As regards recent forbearance measures, we note the authorities' intention, as stated in the buff, to frame them as a temporary relief to banks and other financial institutions. Nevertheless, we agree with the staff assessment that these steps could substantially weaken the Bank of Tanzania's (BoT) oversight framework and mask vulnerabilities in the system. On the systemic liquidity management, we acknowledge the structural nature of the challenges posed by thin, segmented, and underdeveloped markets, and welcome the BoT's steady progress in promoting the market infrastructure, with a particular focus on the development of the repo market and modernization of the monetary framework. More needs to be done in this field, including through designing an operational framework and tools for an Emergency Liquidity Assessment (ELA), and the more effective use of macroprudential instruments to buttress FX liquidity buffers.

In view of the identified gaps and vulnerabilities, ensuring a robust institutional capacity for on-site and off-site supervision is key. We welcome the authorities' commitment to providing the supervisor with adequate staffing, as well as improving the supervisory techniques and tools, including for on-site examinations. We appreciate the progress in the implementation of the risk-based supervision and encourage the authorities to address identified gaps, particularly through complementing the current formula-based supervisory rating system with a judgmental perspective, as appropriate.

The early enforcement of mitigatory actions is essential in minimizing and containing the potential losses stemming from problematic banks. We note with concern the FSSA's findings on the closure of five community banks in January 2018, where a lengthy period of forbearance and the failure to undertake strong supervisory action have led to large losses in these institutions. Taken together with the findings of the stress tests, we see an urgent need for the authorities to ensure decisive and preemptive corrective action for other problematic cases. Could staff elaborate more on the reasons for inaction/delayed action in this case, including possible governance issues beyond the BoT? We also wonder about the extent to which the results of the authorities' CIHAK model differ from the findings of the staff models.

We commend the significant progress the authorities have achieved in strengthening the AML/CFT framework, which has enabled Tanzania to exit monitoring by the Financial Action Task Force. We welcome the self-assessment on the remaining shortcomings, and the authorities' willingness to address them in cooperation with the relevant international organizations, as well as a range of competent authorities. Staff's comments about the current state of risks with respect to correspondent banking relationships are welcome.

Mr. Sun and Ms. Cai submitted the following statement:

We thank staff for the well-written report and Mr. Mahlinza and Mr. Odonye for their helpful buff statement. We welcome the considerable progress the authorities have made in financial regulation and market infrastructure following the 2010 FSAP recommendations, which has strengthened the resilience of the financial sector. We broadly agree with the thrust of the staff's appraisal and would limit our comments to the following.

Continuously enhancing the institutional framework in line with international standards and strengthening the operational coordination mechanism should remain priorities for the authorities. The establishment of the Tanzania Financial Stability Forum (TFSF) is a step in the right direction to enhance coordination, especially at the national level. We encourage regulators to develop their sector-specific plans in due course to facilitate a timely operationalization of the coordination mechanism.

Given the fact that liquidity is mainly provided by banks in Tanzania, enhancing the management of systemic liquidity is critical. We take positive note of the availability of monetary instruments for liquidity management. Nevertheless, challenges remain in FX operations, including a lack of clarity in objectives. We agree that deepening markets is crucial for building resilience to liquidity shocks and we encourage the authorities to continue improving market infrastructure to foster price discovery and increase market access. We see merit in staff's recommendation for establishing the Emergency Liquidity Assistance (ELA) in FX as part of the central bank's contingency plan to better preserve financial stability. Given the constraints on foreign reserves faced by the central bank, what could be possible stable sources of FX? Staff's comments are welcome.

Additional efforts are warranted to strengthen banking supervision and to implement the bank resolution framework. We take note of the new circular regarding loan classification and restructuring which, in staff's view, may weaken the framework and policies for banks' problem loan management. Could staff elaborate more on the reasons for the new circular? It is good to see that the legal framework for early intervention and bank resolution is broadly adequate, and we encourage the authorities to act more quickly and decisively with problem banks going forward.

More could be done to enhance financial services for enterprises, especially micro, small, and medium sized enterprises. At the same time, financial infrastructure gaps should be addressed. Regulation and supervision on microfinance, digital finance, and invoice discounting providers should be further strengthened. We agree that pension funds could be a meaningful source of long-term financing, and we encourage the authorities to take more measures to address the unproductive and illiquid investment problems of these funds.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Ostros and Mr. Vaikla submitted the following statement:

We thank staff for a comprehensive report and Mr. Mahlinza and Mr. Odonye for their informative buff statement. We welcome progress made to the financial regulatory system since the 2010 FSAP recommendations, particularly in strengthening the prudential framework and monitoring of systemic risks. We share staff´s view that Tanzania´s financial stability challenges are significant, therefore we encourage the authorities to continue improving the financial system policy framework, including enhancing banking supervision, improving the systemic liquidity management, and strengthening financial crises management. As we broadly agree with the thrust of the staff's appraisal and the recommendations of the FSSA report, we will limit our comments to the following points.

We positively note that Tanzania´s economy has benefitted from prudent macroeconomic policies and poverty reduction in recent years. However, we are concerned over signals of weakened control of public expenditure and urge authorities to continue with prudent and well managed fiscal policies. The recent increase in fiscal arrears have contributed to the significant rise in NPLs. Also, tighter credit standards and weaknesses in corporate sector hold back both credit demand and supply, which have resulted in a substantial deceleration of credit growth. These developments have weakened the economic outlook and call for action to preserve financial stability.

External risks could pose a threat to domestic financial stability and amplify existing vulnerabilities. We note staff´s assessment that potential tightening of global financial conditions could decrease the availability of external funding, which could delay public investments, affect economic activity, deteriorate banks already weak loan quality, and create liquidity risks. We share staff´s view that significant macrofinancial challenges could raise should economic uncertainty remain or global financial conditions tighten suddenly.

Stress tests showed that the banking sector´s resilience needs to be improved. According to staff´s analysis, the banking system would exhibit significant fragility under tail risk conditions, which would leave several banks, representing a third of banking assets, undercapitalized. Moreover, liquidity tests show that banks would face significant shortfalls and would need to rely on ELA. Also, strong interconnectedness between banks and pension funds could pose significant risks to banks' funding and capitalization, should the withdrawal of domestic institutional investors trigger asset fire sales by banks. In this regard, we underline that focus should be placed on strengthening the financial system oversight and policy framework. Reducing nonperforming loans, increasing provisions, strengthening buffers, payment on government-guaranteed loans, and resolution of government arrears should be key priorities going forward, as recommended by staff. Given the banks' high dollarization and reliance on foreign exchange operations and on domestic institutional investors, building resilience to liquidity shocks is recommended.

Tanzania has made important progress towards strengthening its AML/CFT framework. It is encouraging that the authorities have taken important steps, such as amending AML/CFT legislation regarding the criminalization of money laundering, customer due diligence measures, and the functioning of financial intelligence unit. Going forward, we believe that efforts are required to implement risk-based AML/CFT supervision and amend CFT legislation, which are also important steps to preserve the access to correspondent banking relationships.

The financial system has an important role to play in facilitating the reallocation of credit towards productive investments. Credit remains expensive particularly for smaller enterprises, which have difficulties to get required financing. We recommend undertaking substantial reforms to address financial infrastructure gaps, including introducing national ID, improvements to credit bureau and brining all credit institutions under a regulatory and supervisory umbrella, as recommended in the FSSA report. Privatizing SOEs and public listing of their shares could be attractive investment for pension funds, which would also enable to shift their investments away from current illiquid assets and decrease their interconnectedness to banks.

Mr. Mouminah, Mr. Alkhareif and Mr. Rawah submitted the following statement:

We thank staff for the well-written report and Mr. Mahlinza and Mr. Odonye for their helpful buff statement. We broadly concur with the FSSA and would limit our remarks to the following points.

We take positive note of the progress made by the authorities in improving the financial regulatory system since the 2009 FSSA update and would like to underscore the importance of further strengthening the financial system oversight and policy framework to help preserve financial stability. This is important in view of the elevated vulnerabilities, including deteriorated asset quality, significant under-provisioning, and liquidity pressures. In this connection, the focus should be on enhancing banking system resilience through increasing buffers and provisioning, reducing NPLs including by clearing government arrears. We also take note that the authorities will closely monitor the issues related to the temporary relief provided to banks under the Central Bank of Tanzania (BoT) February 2018 circular for loan classification and restructuring.

It is encouraging to note that Tanzania has made important progress in strengthening the AML/CFT framework and that most of the deficiencies identified in the 2009 assessment were addressed. In this context, we encourage the authorities to address the remaining shortcomings, including by adopting the NRA report and establishing and implementing a comprehensive action plan to mitigate the identified risks. We also share staff’s view on the importance of further developing the risk-based AML/CFT supervision. While we agree with staff that maintaining access to CBRs could broadly benefit from addressing the remaining shortcomings in the AML/CFT framework, staff’s assessment on the status of Tanzania’s CBRs would be welcome.

Finally, we appreciate the authorities’ emphasis on addressing issues related to the limited access to formal financial services and boosting long-term finance for a larger proportion of the enterprise sector, especially MSMEs, as noted in the buff statement. Here, while the buff has broadly highlighted key priorities, we missed in the report a detailed discussion on the authorities’ planned measures to increase access to formal financial services and the provision of long-term finance. Staff elaborations would be welcome. Similarly, we would appreciate staff’s views on the plans for enhancing mobile banking and taking other fintech-related initiatives to help improve financial inclusion.

With these remarks, we wish the authorities further success.

Mr. Doornbosch and Mr. Josic submitted the following statement:

We thank staff for the comprehensive report and Messrs. Mahlinza and Odonye for their insightful buff statement. The authorities have been successful in implementing market-oriented reforms and prudent macroeconomic policies since the early 2000s, which have largely contributed to strong economic growth and a more stable financial sector. However, rising domestic economic uncertainties in combination with an increasing likelihood of external shocks have exposed challenges to financial and macroeconomic stability. Against this background, we welcome the authorities' commitment to implement staff's recommendations and take the necessary steps to address the identified gaps. Since we share the trust of the staff appraisal, the following comments are for emphasis.

The adverse scenario, even the tail risk scenario in the banking resilience stress test could become a baseline scenario. High frequency indicators already point to a decline in credit growth, an increase in fiscal arrears as well as a deterioration of the banking assets, all of which could occur with an economic slowdown. In such a situation, it is likely that one of the adverse scenarios of the banking resilience stress test could materialize. Considering that economic adversity could expose a sizeable share of banking institutions and assets to significant capital adequacy and liquidity challenges, as highlighted by staff, we encourage the authorities to steadfastly implement staff's recommendations.

Increase in non-performing loans (NPLs) requires the implementation of reforms on several fronts. Taking into account that the ratio of NPLs has increased markedly, we share staff's view that an adequate increase in provisioning is needed. At the same time, we encourage the authorities to follow up on the recent NPL guidance, to further clarify conditions under which NPLs may be restructured, and thus resolve any potential misuse. In addition, prompt payment of government arrears remains the utmost priority. Lastly, improving governance of public sector banks, which shows significantly higher levels of NPLs compared to the rest of the banking system, as well as further reform of the judicial processes enabling efficient collateral selling, should be considered in the medium-term.

The institutional framework for systemic risk oversight should be further enhanced. We share staff's view that ensuring adequate staffing of the supervision function in the Bank of Tanzania (BoT) as well as the Deposit

Insurance Board (DIB) is an immediate priority. While we note that the authorities have made significant progress with implementing risk-based supervision (RBS), as emphasized in Messrs. Mahlinza and Odonye's buff statement, given the interconnectedness of the financial sector, and consequently the increased risk of contagion, we encourage the authorities to continue with the introduction of single supervisory risk assessment process. Lastly, considering several cases of active or possible resolution cases, appointing a functional Board of the DIB should be high on the authorities' priorities.

While we welcome the progress with the financial crises management framework, reforms should be completed. The BoT should actively use their full set of legal powers as well as timely enforce actions in case of problematic banks to prevent or at least minimize the losses. In addition, the Tanzania Financial Stability Forum (TFSF) as a highest coordinating body for crisis management, should put more efforts in defining sector-specific contingency plans as well as finalizing the framework for prompt resolution in case of individual or systemic banking crises.

In the medium-term, we support the introduction of risk-based AML/CFT supervision. We commend the authorities for addressing most of the deficiencies in the AML/CFT framework identified in the 2009 FATF assessment, which is now largely in line with international standards. However, considering the evolving ML and TF risks, as well as the need to maintain access to corresponding banking relationships, upgrading the risk-based AML/CFT supervision is needed down the line.

Mr. Villar and Mr. Rojas Ramirez submitted the following statement:

Tanzania has created an institutional organic framework, the Tanzania Financial Stability Forum (TFSF), aimed at preserving financial stability and financial soundness. On the functional side, the government of Tanzania and the BoT have made progress in the conduct of comprehensive macroprudential strategies. Still, challenges ahead remain high.

At a moment of economic deceleration and increased vulnerabilities, the recommendations made by staff in its Financial Stability Assessment appear to be quite timely: implementing policy instruments to manage systemic liquidity and to improve banking supervision and bank resolution capacities. Enhancing operational independence and independence of the Deposit Insurance Board (IDB) seem to be important priorities.

We note that FX operations are the main instrument used to manage liquidity and may represent vulnerabilities. We welcome staff's recommendations on undertaking reforms to implement interest-based operating targets on liquidity management, targeting price stability, developing Open Market Operations OMO, favoring liquidity forecasts, and defining a FX policy consistent with liquidity management policy objectives. Deepening secondary liquidity markets is crucial for strengthening the banking system and increasing the financial sector resilience to liquidity shocks. We encourage authorities to complete the operational framework for Emergency Liquidity Assistance ELA and to enhance macroprudential tools to manage FX liquidity risk.

Banking supervision needs to improve its resources, staffing, guidance for defining processes, and risk profiling. Special attention must be given to tackling NPL resolution. We concur with staff that even if the legal bank resolution is adequate, BoT needs to be able to fix problem banks quickly and decisively.

Finally, we encourage authorities to follow staff's recommendations on improving (AML/CFT) and cyber security standards and promote financial system development to increase access to formal financial services, particularly for micro, small, and medium-sized firms.

Ms. Levonian and Ms. Vasishtha submitted the following statement:

We strongly support FSAPs as a means to help countries identify important sources of systemic risk in the financial sector and develop and implement policies to enhance the financial sector's resilience to shocks. We thank staff for the United Republic of Tanzania's comprehensive Financial System Stability Assessment (FSSA), and Messrs. Mahlinza and Odonye for an informative buff statement. We agree with the broad thrust of the FSSA report. We also welcome the significant progress made by the authorities in enhancing the financial regulatory system since the 2009 FSSA Update.

Tanzania's financial sector is small, bank-dominated, and at a relatively early stage of development. It is facing significant financial stability challenges including a sharp deterioration in asset quality in recent years, a rapid decline in credit growth, and high corporate debt. In addition, bank balance sheets are highly dollarized, and liquidity and credit risks are a cause for concern.

Many banks appear highly vulnerable to adverse shocks. Based on staff stress tests, the banking system would come under significant fragility under tail risk scenarios. 22 banks, representing about 32 percent of the banking system's assets, would become undercapitalized in this scenario. Inter-bank exposures could propagate bank failures through the system exposing system-wide vulnerabilities.

Preserving financial stability in this challenging environment requires strong financial system oversight and policy frameworks. We broadly concur with the key priorities identified in the staff report: measures to reduce nonperforming loans, increase provisioning, increase buffers to manage domestic and foreign currency liquidity risks, and prompt payment on government-guaranteed loans and resolution of government arrears.

The Tanzanian authorities, including the Bank of Tanzania (BoT), have made significant progress in implementing most of the recommendations from the 2009 FSAP Update. While the current assessment finds prudential regulation of the banking sector to be generally sound, effective banking supervision is constrained by lack of adequate resources. The Directorate of Banking Supervision (DBS) is facing staffing shortages and lacks sufficient resources for effective supervision, impacting its ability to conduct onsite examinations annually. We note positively that the BoT is taking measures to rectify this situation by providing additional staff to DBS. More generally, we commend the BoT's resolve to take the necessary steps to address the shortcomings identified in the current assessment.

Tanzania has addressed most of the shortcomings identified by the 2009 assessment of its AML/CFT framework against the previous standard, which has enabled it to exit monitoring by the Financial Action Task Force (FATF). The important progress made in amending the AML/CFT legislation and establishing a financial intelligence unit is noteworthy. While the authorities have undertaken measures under the current standards as well, deficiencies remain which need to be addressed on a priority basis. Addressing these gaps will also help in preserving access to correspondent banking relationships.

To sum up, we are reassured by the authorities' resolve to implement reforms to address the underlying vulnerabilities in the financial system and make the system more resilient to shocks. We wish the authorities continued success in their reform efforts.

Ms. Riach and Mr. Castets submitted the following joint statement:

We thank staff for a detailed report and Mr. Mahlinza and Mr. Odonye for their informative buff statement. While we regret the delay in the Article IV calendar, we welcome this opportunity to spend some time focusing on Tanzania's FSAP, often FSAPs receive less attention than they deserve when presented together with the Article IV reports. The report provided a helpful, yet sobering overview of the Tanzania financial sector, there are clearly significant challenges ahead and current vulnerabilities, we support staff's recommendations, and are encouraged by the authorities' commitment to implementing reforms needed to strengthen the Tanzanian financial system.

Banking Sector Stress Test

The banking sector stress test results were worrisome. The banking sector already appears vulnerable today with 6 out of 45 banks undercapitalized and 37 of them exhibiting signs of under provisioning. It is concerning that applying a relatively favorable baseline scenario would worsen the situation further with 11 banks projected to be undercapitalized. However, the stress test results suggest the same outcome would occur under both the baseline scenario and adverse scenario. Can staff explain why the results are the same, and for the domestic business environment what is the likelihood that the baseline scenario will prevail over the next three years compared to the adverse?

Financial Inclusion

We note the lack of assessment on financial inclusion within the Tanzania financial system. We feel this is important from both the development perspective, but also for financial stability, given higher inclusion should provide a wider, stickier deposit base. We would be interested in any insights from staff.

Public Sector Finance Management

We support the authorities' efforts to reduce corruption and enhance public sector finance management but would stress the need to ensure minimal disruption to the financial sector that some of the steps can present. In particular it is important to clear payment and VAT refund arrears as quickly as possible to ensure adequate cash flow and help reduce non-performing loans in the system.

FSAP and LICs

We believe FSAPs are important Fund products, and strongly support the FSAPs process. Although we recognize that FSAPs are resource intensive, and therefore prioritization needs to occur, however FSAPs for LICs are still very rare. As a way forward, several international partners have co-funded the Fund’s Financial Sector Stability Fund which aims to provide FSAP type product tailored for LICs; we hope to see more of these coming to the Board soon. Can staff elaborate or how the FSAP and FSSR methodologies and schedules will work together?

Previous Fund and the IEO report on engagement in Fragile States both assert that the Fund must “move decisively from mainly providing technical advice (“what to do”) to assistance with implementation (“how to do it”)”. Fund FSAPs will often result in many recommendations, for many LICs with low level of administrative capacity, staff’s role should not stop at providing recommendation. Instead staff should go further, working closely with other departments and the country to understand the capacity constraints and political landscape, to help create a plan to maximize gains from FSAPs. We believe Country Strategy Notes could play a valuable role in helping implement staff advice.

Mr. Di Tata and Mr. Corvalan Mendoza submitted the following statement:

We thank staff for the comprehensive Financial System Stability Assessment (FSSA) for the United Republic of Tanzania and Mr. Mahlinza and Mr. Odonye for their helpful buff statement. The appropriate timing of this report and the selection of themes, eight years after the 2010 FSAP recommendations, provide a good basis to promote a healthier financial sector. The report analyzes in depth the regulations governing the system and calls for stronger policy action to foster a sound financial system while flagging emerging vulnerabilities. We note a somewhat somber tone when it comes to the implementation of recommendations from previous years.

Some new elements are compounding financial risks. Bank asset quality has deteriorated in recent years, and under provisioning is significant. In particular, the Bank of Tanzania’s (BoT) 2018 circular for loan classification caught our attention. The criteria to upgrade the classification of non-performing loans (NPLs) and to capitalize and recognize as income the interest on such loans is of concern. We support staff’s advice to follow international best practices on the characterization of NPLs to avoid masking loans in stress, which simply are overstating earnings and the level of capital on banks' balance sheets. We would appreciate further clarification from staff on the authorities' plans to address this situation.

In view of tighter global conditions and prevailing uncertainties, close monitoring of the financial system is warranted, particularly given the degree of dollarization of banks' balance sheets. We found Figure 4 of the report informative on characterizing the net open FX positions of banks. Unhedged foreign exchange positions constitute an area of concern. Could staff shed some light on bank lending to unhedged borrowers and how unhedged positions could be minimized? We also encourage the authorities to take steps to strengthen liquidity management, foster money market development, and introduce macroprudential tools to help mitigate financial stability risks along the lines proposed in the report.

The report indicates that even under a benign baseline scenario, solvency positions of government-owned banks and smaller private banks could come under pressure and the number of undercapitalized institutions may rise. Presently, six banks are undercapitalized and 37 out of 45 banks show different degrees of under-provisioning. We wonder if these differences are mainly related to different exposures to government assets, which may have triggered financial instability through the accumulation of fiscal arrears. Could staff comment on the steps that are being taken to resolve fiscal arrears, which adversely affect both banks and pension funds?

The report rightly points out to the need to avoid, at all costs, the pressures to roll back the agenda that was put in motion to strengthen financial regulation and supervision. We take positive note of the Tanzania Financial Stability Forum (TFSF) created five years ago but we notice that much remains to be done to implement past recommendations. Making the TFSF operational will promote financial crisis preparation, which is urgently needed. We also agree with staff on the importance of developing contingency plans by the TFSF and plans for the use of extraordinary powers to maintain financial stability during a systemic crisis by the Ministry of Finance and the BoT. There is also a need to enhance the operational independence of the Deposit Insurance Board by appointing its Board and developing adequate plans for payouts and liquidation. In addition, it is worrisome that the staff of the Directorate of Banking Supervision (DBS) has declined since 2015 and that insufficient resources for effective supervision seem to be the norm. More resources (staff, technology), are needed to better understand the situation of banks, pension funds, capital markets and insurance. Could staff comment on the authorities' plans in this area?

We welcome that Tanzania has addressed most of the deficiencies identified by the 2009 assessment of its AML/CFT framework, which has enabled the country to exit monitoring by the FATF. We encourage the authorities to complete the NRA process by developing and implementing an action plan to mitigate the identified risks.

With these comments, we wish the Tanzanian authorities well in their future endeavors.

Mr. Kim and Mr. Kikiolo submitted the following statement:

We thank staff for the comprehensive report and Mr. Mahlinza and Mr. Odonye for the buff statement. We are pleased to note that considerable progress has been made since the 2010 FSAP and the Tanzanian authorities have implemented most of its recommendations. However, the Tanzanian financial sector, characterized by the dominance of a few large banks, is still vulnerable to adverse shocks. Loan quality deterioration and the rise in non-performing loans (NPL) ratio are continuing concerns in the banking sector. In this regard, we view this 2018 FSSA as very timely and we encourage the authorities to work through the recommendations. We agree with the thrust of the report and make these few points for emphasis.

We are pleased to acknowledge that the authorities have strengthened the financial supervisory and policy framework, which includes amendments to the 2010 risk management guidelines and the introduction of new regulations in 2014. We are also encouraged by the reform measures that lead to the use of improved supervisory techniques and tools. While we understand the Bank of Tanzania’s intention to provide banks with temporary relief, we support staff’s recommendation to further clarify conditions in the NPL guidance issued in February 2018. We encourage the authorities to remain vigilant and to manage banks’ NPL ratio in a prudent manner.

We support staff’s recommendations for the authorities to enhance crisis management frameworks. While we welcome the development of an institutional framework for systemic risk oversight, we expect the authorities to strengthen coordination between the different agencies making up the Tanzania Financial Stability Forum (TFSF). Respective agencies within the TFSF should prioritize finalizing their respective sectoral plans so that the crisis coordination mechanism could be operationalized.

The stress test outcomes are quite concerning, with 22 out of 45 banks failing the solvency test while 13 banks failed the liquidity test. It underscores the importance of having an effective Emergency Liquidity Assessment (ELA) framework that could be speedily operationalized when required. We encourage the authorities to take steps to achieve a workable ELA. We also emphasize that the authorities should take decisive steps to resolve problem banks as soon as they are necessary, because any delayed actions would only exacerbate already elevated vulnerabilities. We echo the call by the authorities, as highlighted by Mr. Mahlinza and Mr. Odonye in their buff statement, for the Fund to provide technical assistance in support of the FSAP reform agenda.

While we positively note the authorities' commitment to monitor systemic liquidity and other associated risks, we agree with staff that the authorities should move away from using foreign exchange (FX) operations as primary means of managing liquidity and orient towards an interest-based operational target. We are pleased that the authorities broadly agree with staff's recommendation. Considering that recommendations on FX interventions have already been made in the 2010 FSAP, we would like to ask staff what the main obstacles authorities have faced are in expediting the implementations and how the Fund will support the authorities to make much needed changes.

Despite the authorities' successful implementation of previous AML/CFT recommendations, we note that there are some remaining issues as indicated by the National Risk Assessment the authorities undertook with support from the World Bank in 2015-2016. We support the call by staff for the authorities to adopt the NRA report in the short term and work systematically on the recommendations to implement the risk-based AML-CFT supervision over the medium term. We welcome the efforts by BoT to defend against cyber threats to the banking sector. We also encourage the authorities to press on with reforms that would facilitate efficient allocation of credit to the underserved borrowers, especially micro, small and medium enterprises.

Mr. Psalidopoulos and Ms. Cerami submitted the following statement:

We thank staff for the detailed report and Mr. Mahlinza and Mr. Odonye for their helpful buff statement. Tanzania has made good progress towards greater financial resilience; however, as clearly underscored in staff's report, the country is vulnerable to significant external and domestic risks that require close monitoring and proactive actions to further develop, deepen and strengthen the financial system. In this vein, we are encouraged by the broad agreement among staff and the authorities on the key policy recommendations and by the authorities' intention to draw on the Fund's TA to address the remaining and emerging vulnerabilities, including those arising from new technologies.

The health of the Tanzanian financial system has improved, also helped by the reforms undertaken following the recommendations of the 2010 FSAP, particularly in the area of prudential regulation, where the country has benefited from extensive technical assistance (annex II). As a result, banks are overall adequately capitalized based on Basel I requirements and well positioned to comply with Basel III capital standards. However, like staff, we are concerned by the recent deterioration of asset quality and the upward trend in NPL ratios observed across bank of all types and size. In this respect, the temporary regulatory relief accorded by the Bank of Tanzania's circular on loan classification, which allows the banks to upgrade the classification of NPLs and to capitalize the interest on such loans, is of concern and we urge the authorities to closely monitor the implementation of the new guidelines and ensure that loans are properly classified.

Systemic liquidity management remains a challenge also on the back of the still incomplete reform of the central bank operational framework. We support staff recommendations to develop a transparent framework based on open market operations, including repos, and on an interest-based operating target, with the aim to strengthen monetary policy transmission, reduce interest rate volatility, and foster the development of the interbank market. Equally important in a system that heavily relies on the foreign exchange market for liquidity management will be the development of a transparent framework for foreign exchange interventions with clear objectives distinct from those of monetary operations. We take positive note that the authorities are prioritizing the development of the repo market and the modernization of the monetary framework. As swift progress in this area appears feasible, in our view, especially if supported by Fund's technical assistance, we wonder whether the authorities have discussed with staff about a possible request.

Finally, while we share the need for greater financial inclusion by addressing financial infrastructure gaps, ensuring a level playing field between banks and other intermediaries, and enabling financial innovation, we join staff in encouraging the authorities to bring all credit providers into the regulatory and supervisory perimeter, including the rules on investor and consumer protection as well as AML/CFT requirements and controls.

Mr. Raghani and Mr. Ndong Ondo Bilee submitted the following statement:

We thank staff for the comprehensive Financial System Stability Assessment (FSSA) report and Mr. Mahlinza and Mr. Odonye for their insightful buff statement. Tanzania has made significant economic progress over the years, underpinned by prudent macroeconomic policies. Nevertheless, vulnerabilities in the financial sector stemming from asset quality, under-provisioning, financial dollarization, and uncertainties from the external environment as flagged by the recent stress testing pose significant challenges to the stability of the financial system and could undermine the progress achieved. The FSSA has suitably focus on systemic liquidity management, banking supervision, crisis management, and strengthening of AML/CFT framework and NPLs resolutions. As broadly agreeing with staff appraisal and recommendations, we would like to provide the following comments for emphasis.

Addressing systemic liquidity management issues is instrumental to ensure macro-financial stability. The liquidity vulnerabilities in the banking system identified by the report with respect to high dollarization, costly FX operations, limited accessibility, among others should be expeditiously addressed. To this end, we concur with staff advice that targeted measures should aim at developing a framework for achieving the Bank of Tanzania (BoT) price stability targets, enhancing the sector's resilience to liquidity shocks by putting in place a well-functioning money market structure, and strengthening the prudential toolkit to mitigate FX liquidity risks. The operational framework and tools for Emergency Liquidity Assistance (ELA) should also be swiftly finalized to institutionalize liquidity access. That said, we would welcome staff comments on the differences highlighted in the buff's statement between the new methodology for stress testing of 2018 FSAP, compared to that of 2006 and the BoT's CIHAK, and the potential impact on the current assessment.

We welcome Tanzania's robust prudential regulations and the progress made since the 2010 FSAP. Nonetheless, we are concerned that the new rule for loan classification and restructuring significantly cripples the BoT's current framework for Non-Performing loans (NPLs) oversight. This issue should be addressed in a timely manner and due consideration given to staff recommendations for its proper clarification. In the same vein, any legal and tax impediments to the adequate NPL resolution should be identified and tackled accordingly. Having said that, we are reassured by the temporary nature of this circular and by the commitment of the BoT to stay alert and to sort out any negative effects that may arise from its application as rightly emphasized in Messrs. Mahlinza and Odonye's informative buff statement.

Further efforts are needed to enhance banks supervision and resolution including updating the current risk-based supervision framework introduced in 2010, as well as providing adequate powers and tools to strengthen bank resolution framework. The board of the Deposit Insurance Board (DIB) should as well promptly be appointed to support its adequate functioning, as highlighted in the report. We also concur with staff that the operationalization of the existing framework is necessary to strengthen deposit insurance and financial crisis management. To this end, focus should be geared towards developing contingency plans, clarifying extraordinary powers, improving coordination, as well as testing the framework through simulation exercises.

Enhanced access to proper financial services will be paramount to support private sector growth. It is comforting to note that the authorities view this issue with urgency and renewed importance and would like to encourage them to implement the necessary measures that will close financial infrastructure gaps, promote loans from nonbank credit providers to small firms and boost consumer protection. Also, we see merit in revising the pension funds' investment allocation to contribute to the private sector investment.

We welcome the implementation of the recommendations of the 2009 assessment of Tanzania AML/CFT's framework i, including the amendment of the AML/CFT legislation and establishment of an Financial Intelligence Unit (FIU), although, additional efforts are still warranted. Notably, the still pending Authorities' approval of the 2015 and 2016 assessment undertaken by the National Risk Assessment (NRA) agency with the assistance from the WB continues to undermine effective functioning of the AML/CFT framework. We welcomed measures taken under such assessment, which streamlined the supervision framework by reducing the bureau de change to 107 in 2018, from 297 last year, but we wonder what is causing the implementation delay of NRA. Staff's comments are welcomed.

Ms. Pollard and Ms. Crane submitted the following statement:

We thank staff for the informative report and Messrs. Mahlinza and Odonye for the helpful buff statement. This financial sector assessment is well-timed, considering the rising financial risks that were apparent at the time of the PSI review earlier this year. While there has been overall progress on financial sector strengthening, we are concerned by apparent slippages in some areas – for example the declining number of supervision staff and a loosening of loan classification standards –and urge the authorities to persist in their efforts. We are encouraged by the authorities' interest, referenced in the buff statement, to seek IMF capacity development support to follow up on FSSA recommendations.

NPLs. Rising nonperforming loans (NPLs) combined with under-provisioning are a serious concern meriting decisive action from the authorities. We take note that government arrears to suppliers/private sector have contributed to the problem. We echo staff's caution that the February 2018 circular risks weakening provisioning for current high levels of NPLs. Authorities should seek to increase provisioning to effectively account for weakness in credit quality. Moving forward, strengthening bank loan underwriting capacity could help improve the credit quality of the loan portfolio, and ultimately could also reduce loan costs for approved borrowers.

Liquidity Conditions. In light of weaknesses identified in the liquidity stress tests, we encourage the authorities to prioritize development of an emergency liquidity assistance backstop from the Bank of Tanzania, with appropriate safeguards. Nonetheless, the central bank's capacity for support in a severe stress scenario will remain limited. Thus, further work to improve liquidity conditions and mitigate risks for banks should proceed in parallel.

Financial Sector Development. Stronger attention to improving access to finance for business and households is critical, considering Tanzania's private credit growth lags even regional peers such as Kenya, Uganda, and Rwanda that are also experiencing a private credit slowdown. We welcome the authorities' plans to focus on financial sector development priorities identified in the FSSA, as highlighted in the buff statement. These include addressing financial infrastructure gaps, better regulation of nonbank credit providers to smaller firms, strengthening consumer protection and improving financial literacy.

AML/CFT. While Tanzania has made progress against its 2009 assessment, we encourage the authorities to redouble their attention to implementation ahead of the upcoming mutual evaluation which will have a heightened focus on implementation. We welcome the work on the National Risk Assessment and underscore the importance of finalizing it and sharing the results with the private sector. Finally, while we welcome the IMF's attention to potential AML/CFT deficiencies, we would note that the upcoming evaluation by the regional FATF body will provide a more comprehensive and definitive assessment that should guide future efforts by the authorities.

The Acting Chair (Mr. Zhang) remarked that he was glad that the authorities appreciated the constructive engagement with the staff throughout the entire Financial Sector Assessment Program (FSAP) process. He commended the authorities on their commitment to implement reforms to strengthen the resilience of the financial system.

Mr. Inderbinen made the following statement:

We thank the staff for the comprehensive report and Mr. Mahlinza and Mr. Odonye for their informative buff statement. We did not issue a gray statement, so I would like to offer the following remarks on Tanzania's Financial System Stability Assessment (FSSA).

Like other chairs, we acknowledge the efforts to address the recommendations of the 2010 FSAP and the improvements that have been made since. At the same time, the report makes clear that further progress is needed to strengthen the resilience of Tanzania's financial system to shocks, and also to enable the financial system to support economic growth. On the latter point, we note that large parts of the private sector, including micro, small, and medium-sized enterprises remain underserved by the formal financial sector.

A general theme that the staff report conveys is that while the main legal and statutory elements of financial sector oversight are in place, operational policies and resources to ensure the effective implementation of supervision are largely missing. We share the concerns expressed by Mr. Doornbosch, Mr. Villar, Ms. Levonian and others on the understaffing of the Directorate of Banking Supervision (DBS). It is particularly concerning that staffing at the DBS has been further reduced over the last two years. This has led to continued forbearance and has not enabled the prevention of the collapse of the five community banks earlier this year.

There is also the need for more follow-through in resolution. The resolution regime also needs to be backed by an adequately funded deposit insurance scheme to enable payouts in accordance with international best practice. However, the fund currently lacks the necessary funding, and the report falls short of recommending how this important shortcoming can be addressed. Maybe the staff could comment on that. Among the key recommendations of the FSAP, we also missed a recommendation that funding for the deposit insurance scheme be secured.

Furthermore, we note the low profitability and high shares of NPLs that are not covered by provisions, which have exposed banks to liquidity and solvency risks, as highlighted by the stress tests that the staff have run. This points to the need to increase provisioning for NPLs and to take steps toward a restructuring. This process, in turn, necessitates greater clarity from the Bank of Tanzania with regard to loan classification of NPLs and the conditions under which NPLs could be restructured. Moreover, the legal framework should be adjusted to allow for an efficient NPL resolution.

Finally, we encourage the authorities to build on past progress to further strengthen the Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) regime. We join staff in urging the authorities to finalize the National Risk Assessment and to review the definition of "terrorist financing" in the current legislation.

With this, we wish the authorities all the best going forward.

Ms. Levonian made the following statement:

We thank staff for a thorough FSSA report and Mr. Mahlinza and Mr. Odonye for their comprehensive buff statement.

Like many fellow Directors, we support the key recommendations of the FSSA report. We have issued a gray statement, so I will just touch on a few items.

The authorities have implemented most of the recommendations from the 2009 FSSA, and important enhancements have been made to the financial sector system. However, more needs to be done given the lingering financial stability challenges, which are being compounded by the rapidly evolving financial landscape, including innovations in financial technologies. We agree with staff that reform efforts should give priority to measures to reduce NPLs and increase provisioning, to strengthen buffers to manage domestic and foreign currency liquidity risks, and to ensure prompt payments on government-guaranteed loans and resolution of government arrears. Elaborating on the banking sector, as noted in the staff report and the buff statement, prudential regulations are generally sound; but a lack of adequate resources is constraining effective banking supervision. We are reassured to see that the Bank of Tanzania is already taking steps to address the situation. The authorities should continue to focus on addressing the remaining gaps in the AML/CFT framework and to further strengthen supervision. This will also help in preserving correspondent banking relationships (CBRs).

We welcome the authorities' resolve to take the measures needed to strengthen the overall financial system, and we wish the authorities well.

The staff representative from the Monetary and Capital Markets Department (Mr. Catalan), in response to questions and comments from Executive Directors, made the following statement: [1]

On behalf of the whole FSAP team, I would like to express our gratitude to the authorities for the excellent collaboration throughout this process.

I would like to do two things. First, I will summarize some of the key messages from our work. There is an overlap between this summary and the main themes that have been raised in the gray statements. Second, we will address a few specific questions jointly with my colleague, Mr. Gelbard.

The first key finding from our analysis and assessment is that financial vulnerabilities and stability challenges are significant. We find some degree of undercapitalization and underprovisioning of banks currently, and also some structural profitability problems in the system, which implies that, even under a baseline scenario, these undercapitalization problems could become more severe as time goes by.

One of the concerns is that these solvency problems could morph into liquidity problems if significant shocks were to hit the economy. There is a vulnerability related to dollarization in the system that also requires some degree of mitigation to secure financial stability.

The second key message is that, given these risks and vulnerabilities, action is necessary. We encourage the authorities to take strong, decisive action. This has several dimensions.

First, increasing buffers is important; in particular, capital buffers and liquidity buffers in foreign currency. This should be interpreted more broadly as a need to correct some of the underprovisioning problems that are manageable at this point. Also, a conservative, narrow application of the 2018

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

February circular that allows for some restructuring of loans under easier-than-normal conditions. It is a temporary relief that has been in place since February 2018.

With respect to the prudential framework, there has been significant progress since the last FSAP, as it has been noted in many gray statements and in our report. The authorities have a plan to continue strengthening the set of prudential regulations until there is convergence to a Basel III-type of framework. We recommend they take these steps as quickly as possible. This involves defining systemically important institutions, introducing a liquidity coverage ratio (LCR)—and in this case, it would be recommended that the LCR is also introduced in foreign currency, given the degree of dollarization in the system—and also finalizing all the institutional arrangements within the Tanzania Financial Stability Forum.

With respect to the effectiveness of bank supervision, it has been noted already that there is a need for more resources. We are also glad to see in the buff statement that some actions are being taken, and the authorities acknowledge the need to move forward with these.

In terms of early intervention and the resolution of banks, the problem has not been the legal setup, but rather, taking action on time—the implementation of prompt action to prevent problems for building up and making the losses associated with bank failures larger at the end. It very important to create a culture of early enforcement within the supervisory function at the Bank of Tanzania.

Now let me address some specific questions that we did not cover in our written responses to the gray statements. In particular, there were some questions related to financial inclusion and the role of mobile banking; some development issues related to access to finance by small- and medium-sized enterprises (SMEs); and also, the availability of long-term finance for all types of enterprises, both large and small.

Our assessment has been conducted jointly with the World Bank. This is an area that has been covered mainly by the World Bank, but I will try to summarize the findings and the main recommendations.

On inclusion, Tanzania has been very successful over the past decade. The percentage of the population that is covered by some form of financial service has increased from 16 percent to 60 percent over the past 12 years. This significant expansion is almost completely explained by the mobile money accounts, the expansion of the system of transfers, person-to-person transfers that are facilitated by the mobile network.

What remains in terms of development is to provide a large fraction of the population with access to saving and credit services. This is still the domain of the banking sector, and it covers less than 20 percent of the population. There is still some work to do in expanding these types of services.

With respect to the mobile money accounts, it is also important to lock in the gains that have been achieved. One particular aspect that we mentioned in our report is the need to make sure that these individual accounts with mobile operators are protected by the deposit insurance system. At present, the mobile operators have a deposit with the banks, and it is necessary to have some sort of a see-through principle in place so that the deposit insurer can actually pin down what is the amount that corresponds to each individual person who has an account with a mobile operator. The authorities are working on addressing this issue, which is also part of the agenda within the East African Community (EAC) more broadly.

With respect to the second aspect of development, which is access to finance by small enterprises, the situation is that only the large corporates have access to credit and, to a much lesser extent, the small enterprises. There is a significant challenge. There are two types of bottlenecks or constraints. Some have to do with the informational problems. Many SMEs are informal. They are not registered. They do not keep books. This puts them at an informational disadvantage, relative to the formal, larger corporates.

Then there is also insufficient data being collected by the whole system, both by the regulators and also by the credit registry system. There are some money lenders that are very small that are outside the regulatory perimeter. When a formal lender tries to give a loan to a particular SME, it is difficult to determine whether this SME is also borrowing from some informal lender that is outside this regulatory perimeter. Some of our recommendations, like expanding the regulatory perimeter, will help to address some of these constraints.

Finally, with respect to the availability of long-term financing, this affects not just the small enterprises but also the large ones. There are two elements that one could mention. One is pension funds, which are the natural providers of longer-term finance. But in the case of Tanzania, they are being affected by the effect of government expenditure arrears. About 50 percent of their portfolio is either government securities or loans to the government, and they have been affected by their arrears. Another quarter of the portfolio is real estate holdings. A big part of these real estate holdings does not generate any income. That leaves only one-quarter of all the assets of pension funds available for deposits in the banking systems: equity, investments, and lending to or purchasing bonds from the corporate sector. It is a very small allocation to provide long-term finance to the private sector.

Some of the reforms go in the direction of the divesting part of these real estate holdings. Dealing with the government arrears problems would also help pension funds both to generate the cash flows but also to channel investments to corporates.

More generally, one could also argue that improving the business environment, which is one of the elements that is discussed in the report, could attract more FDI, which is a form of long-term financing, and also a resumption of privatization of state-owned enterprises could encourage listings of companies in the stock market and, therefore, a deepening of capital markets.

Finally, I would like to address the question about the deposit insurance system. At present, the funding of the system, it is about 2 percent of all the insured deposits, which is not low by international standards. The challenge lies more in deploying the money quickly when a bank fails. The standard international recommendation is that this should be done within seven days after a bank is closed. In the case of Tanzania, the experience has been that it takes much longer for depositors to recover the money.

The staff representative from the African Department (Mr. Gelbard), in response to questions and comments from Executive Directors, made the following statement:

I will address a few questions on the nature of fiscal arrears, government arrears to pension funds, banks, and suppliers. There was also a question about the steps being taken to resolve them.

Regarding arrears to various pension funds, they were estimated at about 2.8 percent of GDP in FY2017-18. About two-thirds of these arrears are related to the undercapitalization of the funds when they were established.

Recently, the authorities have merged these funds into two—one for public and one for private employees—and adjusted the benefits downward to try to ensure their sustainability. The government also has some arrears to pension funds related to the infrastructure projects it has recommended them to undertake. These arrears are gradually being cleared.

Regarding government arrears to commercial banks, they affect only a few banks and have contributed to about 8 percent of NPLs. They consist of unpaid claims and the credit guarantee schemes to support agricultural exports.

All in all, however, the largest problem has been the rapid accumulation of arrears to the suppliers of goods and services and construction companies. These are estimated to be about 3 percent of GDP. The arrears have contributed to delays in companies servicing bank loans and, hence, the rise in NPLs last year.

Earlier this year, the government has prepared a strategy to prevent the accumulation of payment arrears and repay them. Key measures include generating all payments through the integrated Financial Management Information System to ensure that they are matching funds to meet expenditures and to strengthen cash planning and commitment controls procedures. This strategy also envisages setting aside a certain amount of resources each year to ultimately clear the stock of arrears.

The staff will follow up on the above issues regarding the arrears strategy, implementation, and other key FSAP recommendations in the context of the forthcoming Article IV consultation discussion scheduled for early 2019.

Mr. Mahlinza made the following concluding statement:

On behalf of my Tanzanian authorities, I thank Directors for their support for the completion of the 2018 FSSA. The policy advice and recommendations aimed at supporting the authorities’ efforts to enhance macro-financial stability in Tanzania are appreciated and will be swiftly conveyed to the authorities.

In the written gray statements and verbal interventions this afternoon, Directors took note of the recent progress in improving Tanzania’s financial landscape and market infrastructure since the 2010 FSAP, including: enhanced prudential regulations, the introduction of a risk-based supervisory framework, and the improved monetary framework. Nevertheless, Directors noted that financial stability challenges remain elevated, with deteriorating asset quality, declining credit growth, and liquidity pressures. In this regard, the authorities are determined to address emerging vulnerabilities by taking urgent action to lower risks and to increase the resilience of the financial system.

In an effort to establish a strong institutional policy framework for the financial system, the authorities stand ready to strengthen the oversight of the problem banks. They concur that adequate staffing and resources are vital for an effective supervisory system and have started taking steps to address this. The Bank of Tanzania and other regulatory agencies have agreed to strengthen cooperation, acting individually and in concert to revamp needed resources.

To ensure a sound and solid financial system, the authorities are committed to enhancing liquidity management within the banking sector. The Bank of Tanzania is leading efforts to promote proactive foreign exchange management by banks and corporates, consistent with internationally approved macroprudential requirements. Lately, the lead regulator has devoted extensive resources to completing the operational guidelines for emergency liquidity assistance.

Concerning financial crisis prevention and management, the collaborating agencies have been sensitized on their responsibilities and are committed to promptly undertake these when the need arises. While these agencies are established as independent entities, they have been requested to accelerate improvements to agency-specific crisis prevention and management plans. Efforts are also being made to enhance the coordination role of the Tanzania Financial Stability Forum. At the same time, the authorities have committed to enhancing the effectiveness of the Deposit Insurance Board; by constitution, its board. Furthermore, the Bank of Tanzania has taken steps to contain NPLs and is currently reflecting on the need to increase provisioning for loan losses.

The government has stepped up efforts to clear arrears to the private sector, with a view to keeping the economy afloat. We have also just heard from the mission chief that there is an arrears clearance strategy that has been put in place.

On the financial system developments, the authorities have resolved to continue deepening financial markets, increase access to formal financial services, and address financial infrastructure gaps. The authorities have taken measures to address shortcomings in the AML/CFT framework and are working on completing the remaining gaps.

Finally, I wish to thank the FSAP team, led by Mr. Surti, for their hard work and active engagement with the Tanzanian authorities during the assessment and for responding to the comments by Directors. My Tanzanian authorities value the Fund's advice and technical assistance and look forward to further collaboration in implementing the recommendations of the FSAP. In this respect, my authorities are preparing a comprehensive action plan, outlining the technical assistance needs arising from the FSAP, to be shared with both the World Bank and the Fund.

The following summing up was issued:

Executive Directors concurred with the findings and recommendations of the 2018 Financial System Stability Assessment (FSSA). They welcomed the important progress made by Tanzania since the 2010 Financial Sector Assessment Program, particularly in strengthening financial prudential regulations, putting in place some key elements of a framework for monitoring systemic risks and macroprudential policy responses, and initiating a transition of the monetary framework toward an interest-rate based operating target. To build on this progress and ensure that the Tanzanian financial system is stable, efficient and inclusive, Directors called for policy action to lower risks and raise the resilience of the banking system. In this context, they encouraged the authorities to implement the recommendations of the FSSA.

Directors noted that despite favorable macroeconomic conditions, financial stability challenges are significant with deteriorating asset quality, falling credit growth and liquidity pressures. Directors noted that continued macroeconomic stability, an improved business environment, better execution of fiscal policy and resolution of government payment arrears would help address financial sector vulnerabilities and risks.

Directors stressed the need to improve asset quality, address non-performing loans and increase capital buffers in the banking system. In this context, they cautioned against potential excessive use by banks of the regulatory relief provided by the Bank of Tanzania's circular for loan classification and restructuring. They encouraged the authorities to issue further guidance aimed at preventing banks from overstating capital ratios and earnings.

Directors emphasized the need to enhance surveillance and monitoring of liquidity risks in foreign exchange, and introduce regulations aimed at limiting them. These regulations, buttressed by macroprudential requirements, would complement measures to promote proactive foreign exchange risk management by banks and corporates. Completing operational guidance for emergency liquidity assistance, including in foreign exchange, also remains a priority.

Directors encouraged further efforts to align the prudential framework with international standards and best practices. They welcomed the authorities' plans for Basel II/III implementation in line with EAC harmonization commitments and encouraged the authorities to advance the framework for identification of domestic systemically important banks. Directors also noted the need to strengthen enforcement of prompt corrective action regulations within an adequate legal framework. Remaining shortcomings in the AML/CFT framework also need to be addressed and risk-based AML/CFT supervision needs to be further developed. Directors underscored the importance of ensuring that adequate staff and resources are available for bank supervision.

Directors underlined the need to deepen financial markets, increase access to formal financial services and address financial infrastructure gaps. Policy actions in these areas would help to enhance financial inclusion and contribute to improved growth prospects.

APPROVAL: April 8, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Financial Supervision and Bank Oversight

1. It is worrisome that the staff of the Directorate of Banking Supervision (DBS) has declined since 2015 and that insufficient resources for effective supervision seem to be the norm. More resources (staff, technology), are needed to better understand the situation of banks, pension funds, capital markets and insurance. Could staff comment on the authorities' plans in this area?

- Regarding staff shortage, the Bank of Tanzania (BoT) agreed with the FSAP team's comments and concerns regarding inadequacy of staff to effectively discharge its supervisory responsibilities. While the Bank recognizes the shortage of staff in the Directorate of Banking Supervision DBS, efforts have been taken to rectify this situation.

2. We note with concern the FSSA's findings on the closure of five community banks in January 2018, where a lengthy period of forbearance and the failure to undertake strong supervisory action have led to large losses in these institutions. Taken together with the findings of the stress tests, we see an urgent need for the authorities to ensure decisive and preemptive corrective action for other problematic cases. Could staff elaborate more on the reasons for inaction/delayed action in this case, including possible governance issues beyond the BoT?

- In the staff's opinion, there are a number of contributing factors for the delay in taking timely and appropriate supervisory actions. A critical factor is that the Bank of Tanzania has not engendered a supervisory culture of enforcement and accountability. To assist in the development of such, recommendations were made for the development of a formal enforcement policy. It is also quite apparent, given the development of critical deficiencies and asset quality issues soon after a number of these entities were authorized, that they did not have appropriate technical and management skill sets. Greater scrutiny of skill sets of proposed management is needed in the Bank of Tanzania's licensing process. Whether there was outside pressure on the Bank of Tanzania to delay action could not be ascertained.

Liquidity and Foreign Exchange Issues

3. We see merit in staff's recommendation for establishing the Emergency Liquidity Assistance (ELA) in FX as part of the central bank's contingency plan to better

preserve financial stability. Given the constraints on foreign reserves faced by the central bank, what could be possible stable sources of FX? Staff's comments are welcome.

- Identifying stable sources of foreign currency may be challenging given the expected tightening in external financial conditions. In this regard, the staff recommends that over the near-term, the Bank of Tanzania prioritizes the build-up of institutional resilience to liquidity shocks, particularly in FX, through enhancements to the micro-prudential and macro-prudential frameworks.

4. The authorities are trying to develop the repo market and a strengthening of the Emergency Liquidity Assistance has also been suggested. All of these developmental measures require the availability of good quality and liquid collateral in sufficient quantity which can be traded economically and safely through securities markets. What is the extent of availability and tradability of government and corporate securities in Tanzania? What are the improvements needed for developing the local currency bond market in Tanzania?

- Illiquidity in the government securities market emanates from two sources. First, the paucity of investors, which reflects the current rules for capital market access that provide limited access to EAC member countries only. Second, high fragmentation of issuances, which results in some bonds having few holders and markets with insufficient trading.

- Development of local bond markets would be facilitated by diversifying investor access; establishing margining and valuation practices that conform to best practices; developing the legal and regulatory infrastructure to enable ownership transfer, particularly for secured lending; and creating benchmark issues that are potentially held across a wider range of investors.

5. While we positively note the authorities' commitment to monitor systemic liquidity and other associated risks, we agree with staff that the authorities should move away from using foreign exchange (FX) operations as primary means of managing liquidity and orient towards an interest-based operational target. We are pleased that the authorities broadly agree with staff's recommendation. Considering that recommendations on FX interventions have already been made in the 2010 FSAP, we would like to ask staff what the main obstacles authorities have faced are in expediting the implementations and how the Fund will support the authorities to make much needed changes.

- The limited actions to adjust FX intervention frameworks is a characteristic feature of LICs in relation to general 'fear to float', and the existence of multiple objectives for central bank operations. MCM stands ready to assist the authorities' program to modernize its operational framework through capacity-building, once the authorities request assistance following standard (formal) procedures assistance in this area.

6. ***We support staff recommendations to develop a transparent framework based on open market operations, including repos, and on an interest-based operating target, with the aim to strengthen monetary policy transmission, reduce interest rate volatility, and foster the development of the interbank market. Equally important in a system that heavily relies on the foreign exchange market for liquidity management will be the development of a transparent framework for foreign exchange interventions with clear objectives distinct from those of monetary operations. We take positive note that the authorities are prioritizing the development of the repo market and the modernization of the monetary framework. As swift progress in this area appears feasible, in our view, especially if supported by Fund's technical assistance, we wonder whether the authorities have discussed with staff about a possible request.***

- During the FSAP process, the authorities expressed appreciation for technical assistance provided by the IMF and MCM in the past. MCM conducted a diagnostic assessment for the development of the secured lending (repo) market in January 2018, which the authorities have incorporated in the reforms of the repo market. Informally, the authorities expressed interest in receiving further assistance, after the completion of the FSAP. The IMF and MCM stand ready to provide further assistance in the future and encourage the authorities to request assistance following standard (formal) procedures.

7. ***We also share staff's recommendation to enhance the BoT's institutional and operational frameworks. As proposed by staff, this should include strengthening liquidity management in line with the BoT's price stability objective. In this context, could staff elaborate on its recommendation to distinguish FX operations by the underlying objectives and on its assessment of FX operations in Tanzania, more broadly?***

- BoT currently transacts in the FX market for two reasons: (i) for adjusting Shilling liquidity and (ii) to smooth exchange rate volatility. At the decision-making and operational levels these objectives are not distinguishable ─ FX sales contribute to significant liquidity absorption, which is subsequently reversed by significant net purchases; and operations are conducted through bilateral arrangements which makes price determination, allocation and impact on FX market liquidity opaque.

- The staff recommends that BoT designs its operations around different objectives, and develop a clear intervention policy, which will ultimately support the credibility of the transition to the interest-rate based operating framework. First, the BoT should reduce the daily, active reliance on FX and use open market operations to adjust Shilling liquidity. Second, BoT's dealings in the FX market should be made transparent by conducting transactions at market prices, documenting and publishing allocation guidelines, and disseminating information on intervention operations.

8. In view of tighter global conditions and prevailing uncertainties, close monitoring of the financial system is warranted, particularly given the degree of dollarization of banks' balance sheets. We found Figure 4 of the report informative on characterizing the net open FX positions of banks. Unhedged foreign exchange positions constitute an area of concern. Could staff shed some light on bank lending to unhedged borrowers and how unhedged positions could be minimized?

- Banks are required to provide loans denominated in foreign currency only to corporates that generate income in foreign currency (typically, exporters). Thus, the existence of a natural hedge against foreign exchange fluctuations is required by the regulation to mitigate risk of default by corporates.

9. Since the foreign currency exposure appears to be high, the financial system could be adversely affected as the current global financial scenario anticipates tightening of liquidity conditions if some potential adverse conditions materialize. In this situation, what is the extent of natural hedges available to the Tanzanian corporate sector and what is the prospect of building financial hedges against such vulnerabilities?

- Banks are required to provide loans denominated in foreign currency only to corporates that generate income in foreign currency (typically, exporters). Thus, the existence of a natural hedge against foreign exchange fluctuations is required by the regulation to mitigate risk of default by corporates.

- There are no developed derivatives or futures markets that corporates could use to build financial hedges against such vulnerabilities.

Nonperforming Loans

10. The FSSA mentions that the weak business environment was a major driver of NPLs on trade, manufacturing, real estate and personal loans. Was the weakening of business environment driven by specific domestic or global factors in the form of shocks to some critical sectors?

- It was driven by domestic factors. Despite good intentions, anti-corruption efforts have contributed to delays in VAT refunds and procurement for public investments, which, together with overambitious development projects have led to the accumulation of expenditure arrears and negatively impacted the corporate and pension fund cash flows. In addition, the 2019 WB's Doing Business survey pointed to a deterioration in several areas, including trade, registering property, and dealing with insolvency.

***11. Have the Tanzanian authorities instituted macroprudential measures such as LTV ratios, sector-specific risk weights, etc. for guarding against further growth of NPLs*?**

- The authorities have not instituted LTV ratios or sector-specific risk weights that can be adjusted for counter-cyclical/macroprudential purposes. To guard against further growth of NPLs, staff notes that improving information collection on NPLs, improving the data in the credit reference database, and addressing gaps in institutions' loan origination for better risk-assessment and pricing, particularly for large corporate loans, are key priorities for effective credit risk management. The further improvements in regulatory framework are expected to include enhancements to risk-based supervision, the planned new Corporate Governance Regulation, Consolidated Supervision Regulations, and transition to Basle III, should provide a foundation for bank of Tanzania to develop a comprehensive macroprudential framework in line with best practices.

12. The FSSA mentions that for community banks and microfinance lenders, poor corporate governance, fraud, insider lending, or a higher share of uncollateralized loans were important factors in the uptick in NPLs. It appears that reducing the risks in the microfinance sector is necessary through appropriate regulation and oversight to encourage safe credit off-take. Staff comments are welcome in this regard.

- Staff recommends that all credit providers ─ including institutions in the non-bank and microfinance financial sectors – be proportionally regulated and supervised. Priority recommendations are to improve data collection of institutions' activities, and address gaps in financial literacy and consumer protection. The staff was advised of the recently issued the National Microfinance Policy which outlines a framework for expanding regulatory and supervisory coverage to include all players in the microfinance space.

13. We take note of the new circular regarding loan classification and restructuring which, in staff's view, may weaken the framework and policies for banks' problem loan management. Could staff elaborate more on the reasons for the new circular?

- The circular was motivated by the sharp increase in non-performing loan ratios. It provides banks with temporary relief. Specifically, the measures are meant to apply through end-2020 and carry three main components of forbearance: (i) doubling to four, the number of times a bad loan may be restructured; (ii) providing for the conversion of overdraft facilities into term loans and the capitalization of accrued interest; and (iii) halving the length of repayment performance (to two quarters) before allowing upgrade of restructured bad loans. By allowing banks to upgrade the loan classification of NPLs, the measures can help reduce bank provisioning requirements and credit losses. By allowing recognition as income of the interest on NPLs, the measures can mitigate the adverse impact of rising NPLs on banks' net interest incomes. For these reasons, the measures are likely to result in overstated earnings and capital.

14. We support staff's advice to follow international best practices on the characterization of NPLs to avoid masking loans in stress, which simply are overstating earnings and the level of capital on banks' balance sheets. We would appreciate further clarification from staff on the authorities' plans to address this situation.

- The authorities expressed commitment to monitoring the implementation of the circular and avoid potential abuse by banks. In particular, it is important to prevent restructuring and upgrading of problem credits which are not reflective of the ability of the borrower to repay the loan on reasonable terms, as this may allow the unrecognized buildup of vulnerability that could then result in significant damage to the bank. It is critically important that the BoT make clear to banks and financial institutions that loan restructurings not be used to shield recognition and appropriate provisioning of credits with well-defined weaknesses. In regard to the means to achieve the stated objective, it is not clear yet whether the Bank of Tanzania has started developing the specific guidance (on criteria for restructuring/upgrading credits) recommended by the FSSA.

Financial Sector Exposure to the Government

15. Considering the stress test results that flagged significant fragility under the tail risk scenario, which included a protracted incidence of government payment arrears, this is a source of concern and appropriate measures should be taken to mitigate the associated spillovers risks. Can staff elaborate on the likely options that may be appropriate in this regard?

- This question will be addressed by AFR at the meeting.

16. The report indicates that even under a benign baseline scenario, solvency positions

of government-owned banks and smaller private banks could come under pressure and the number of undercapitalized institutions may rise. Presently, six banks are undercapitalized and 37 out of 45 banks show different degrees of under-provisioning. We wonder if these differences are mainly related to different exposures to government assets, which may have triggered financial instability through the accumulation of fiscal arrears. Could staff comment on the steps that are being taken to resolve fiscal arrears, which adversely affect both banks and pension funds?

- This question will be addressed by AFR at the meeting.

Financial sector development/financial inclusion

17. We appreciate the authorities' emphasis on addressing issues related to the limited access to formal financial services and boosting long-term finance for a larger proportion of the enterprise sector, especially MSMEs, as noted in the buff statement. Here, while the buff has broadly highlighted key priorities, we missed in the report a detailed discussion on the authorities' planned measures to increase access to formal financial services and the provision of long-term finance. Staff elaborations would be welcome.

- Staff will respond at the meeting.

18. We would appreciate staff's views on the plans for enhancing mobile banking and taking other fintech-related initiatives to help improve financial inclusion.

- Staff will respond at the meeting.

19. The buff statement mentions that the authorities intend to draw on the Fund's Technical Assistance for both the FSAP reform agenda and for any associated needs that may arise as new technologies gain traction. Has the need to improve the viability of the social sector schemes through restructuring, increasing contribution rates, wherever possible, and improving allocation of pension funds to long-term assets with remunerative yields, been considered, along with the necessary Technical Assistance?

- A thorough assessment of the sustainability and structure of the pension system is beyond the scope of the IMF financial sector assessment under the FSAP. However, the pension system is being reformed. On April 2018, the Parliament issued a new pension law that would consolidate 5 pension funds into two. This consolidation has not yet been implemented. According to the law, every Fund will remain governed by its own Act which regulates member registration, contribution collections, investments and payment of benefits.

20. What is the extent of financial inclusion in Tanzania in terms of the percentage of population having access to the banking sector?

- The share of the adult population in Tanzania that is financially included jumped from 16 percent in 2009 to 65 percent in 2017. This increase has been primarily driven by the expansion of mobile money services, which are currently used by 60 percent of the population. Mobile money is largely used for Person to Person (P2P) transfers; the platform has not yet been used to upgrade consumers from pure transactional services to full financial services—including saving and credit services. These services remain the domain of the banking sector; population with access to commercial bank services stands at 17 percent.

21. We note the lack of assessment on financial inclusion within the Tanzania financial system. We feel this is important from both the development perspective, but also for financial stability, given higher inclusion should provide a wider, stickier deposit base. We would be interested in any insights from staff.

- While adult population participation in commercial banking is low (17 percent), financial inclusion has made significant progress in Tanzania through Mobile money (60 percent of adult population). Mobile money companies contribute to the deposit base as they are required to deposit their funds in commercial banks.

AML/CFT

22. We welcome the implementation of the recommendations of the 2009 assessment of Tanzania AML/CFT's framework i, including the amendment of the AML/CFT legislation and establishment of an Financial Intelligence Unit (FIU), although, additional efforts are still warranted. Notably, the still pending Authorities' approval of the 2015 and 2016 assessment undertaken by the National Risk Assessment (NRA) agency with the assistance from the WB continues to undermine effective functioning of the AML/CFT framework. We welcomed measures taken under such assessment, which streamlined the supervision framework by reducing the bureau de change to 107 in 2018, from 297 last year, but we wonder what is causing the implementation delay of NRA. Staff's comments are welcomed.

- Tanzania conducted its ML/TF risk assessment from September 2015 to December 2016 using the World Bank methodology. The FIU coordinated the NRA, collaborating with the Bank of Tanzania. The exercise involved the formation of the National ML/TF risk assessment working group (NRAWG) compromising 127 participants from 80 key government and private sector institutions. As the NRA Report is yet to be approved by the Government, the main findings cannot be shared with competent authorities yet. The authorities did not relay the cause for the delay in this respect. We will continue to monitor the situation and correspond with authorities to seek an update in this regard during the next AIV surveillance mission.

23. We commend the significant progress the authorities have achieved in strengthening the AML/CFT framework, which has enabled Tanzania to exit monitoring by the Financial Action Task Force. We welcome the self-assessment on the remaining shortcomings, and the authorities' willingness to address them in cooperation with the relevant international organizations, as well as a range of competent authorities. Staff's comments about the current state of risks with respect to correspondent banking relationships are welcome.

- The risk that withdrawal of corresponding banking relationships (CBRs) could accentuate financial fragilities in Tanzania is not deemed to be high (by staff). So far, only a few banks have been affected. However, these banks were able to maintain services and operations by establishing alternative arrangements, notably through reliance on other Tanzanian banks with uninterrupted CBRs. The adaptation has been smooth—without noticeable costs.

24. While we agree with staff that maintaining access to CBRs could broadly benefit from addressing the remaining shortcomings in the AML/CFT framework, staff's assessment on the status of Tanzania's CBRs would be welcome.

- Please see response to previous question.

Stress Tests

25. The banking sector already appears vulnerable today with 6 out of 45 banks undercapitalized and 37 of them exhibiting signs of under provisioning. It is concerning that applying a relatively favorable baseline scenario would worsen the situation further with 11 banks projected to be undercapitalized. However, the stress test results suggest the same outcome would occur under both the baseline scenario and adverse scenario. Can staff explain why the results are the same, and for the domestic business environment what is the likelihood that the baseline scenario will prevail over the next three years compared to the adverse?

- In contrast to the "tail risk" scenario, the shocks applied in the "adverse" scenario are small and result in a moderate deviation of GDP growth from baseline projections. Bank capital ratios are lower than in the baseline (results under the two scenarios are not the same) but the differences are not sizable. In sharp contrast, in the tail risk scenario, growth slows significantly and the overall impact on the banking system is larger and more broad-based. In this regard, it is important to note that stress testing methodologies account for non-linearities in the transmission of macroeconomic shocks to NPL ratios and credit losses. NPL ratios increase at increasing rates as the magnitude of (macroeconomic) shocks applied become larger. This is reflected in results (stressed capital ratios).

26. We wonder about the extent to which the results of the authorities' CIHAK model differ from the findings of the staff models.

- There are significant differences in methodologies between the stress tests conducted by the Bank of Tanzania and the 2018 FSAP. In line with MCM guidelines developed after the global financial crisis, the FSAP implemented solvency stress tests based on multi-year and multi-factor scenarios, using granular supervisory data. It also implemented cash flow-based liquidity tests and contagion tests based on network analysis. This is in contrast to the Bank of Tanzania approach, which is based on a static sensitivity analysis (a 2007 methodology developed by IMF staff). A positive outcome of the FSAP is that IMF staff has worked in collaboration with staff from the Bank of Tanzania to implement for the first time a new generation of tests based on upgraded methodologies.

- More specifically, in the FSAP analysis, macroeconomic shocks impact bank solvency over a 3-year horizon. Shock transmission is assessed via satellite models and dynamic projections of banks' balance sheets and income. The analysis incorporates also second-round interbank contagion effects. The liquidity tests employ cash flow analysis based on a maturity ladder approach.

27. We would welcome staff comments on the differences highlighted in the buff's statement between the new methodology for stress testing of 2018 FSAP, compared to that of 2006 and the BoT's CIHAK, and the potential impact on the current assessment.

- Please see previous comment.

FSAPs and LICs

28. We believe FSAPs are important Fund products, and strongly support the FSAPs process. Although we recognize that FSAPs are resource intensive, and therefore prioritization needs to occur, however FSAPs for LICs are still very rare. As a way forward, several international partners have co-funded the Fund's Financial Sector Stability Fund which aims to provide FSAP type product tailored for LICs; we hope to see more of these coming to the Board soon. Can staff elaborate or how

the FSAP and FSSR methodologies and schedules will work together?

- The Financial Sector Stability Review (FSSR) is a donor-funded, demand-led technical assistance instrument that combines a diagnostic review conducted primarily by experts with follow-up capacity building to deliver sound financial sector reform. The FSSR covers a wide range of financial sector areas that are relevant to identifying and addressing both existing and emerging financial stability related risks and vulnerabilities as pertinent to the jurisdiction, covering banks, non-banks and financial markets. Missions are also encouraged to cover the links between financial inclusion, integrity and stability as for example through reviewing the causes and implications of the reduction in CBRs. STA also contributes to the FSSR by reviewing the production and dissemination of financial sector data such as FSIs. The World Bank has also been invited to work in parallel to the FSSR by focusing on financial sector development related aspects to take advantage of the engagement with the authorities.

- Both the FSSR and the FSAP are useful instruments for financial sector work in the Fund's member countries. The FSSR is targeted towards low and lower-middle-income countries, while the FSAP is an instrument for the entire membership. Both instruments address financial stability: the FSSR conducts a diagnostic review to identify gaps in a member country's capacity to analyze financial stability, while the FSAP contains an in-depth assessment of financial stability, including rigorous stress tests. Formal assessments of the observance of international standards are a voluntary part of the FSAP and are often conducted, while they are not conducted in the FSSR, though they are used to guide the advice being provided. The FSSR results in a comprehensive TA roadmap, while the FSAP does not (though TA may follow). The TA road map is then discussed with the area department and the World Bank and TA delivery agreed and prioritized. There is a preference for a programmatic approach to any follow-up TA to attain maximum impact. The FSSR report, being a technical assistance product, is not discussed by the Executive Board; however, publication of the report is encouraged.