EC 371: MONEY BANKING AND FINANCIAL DEVELOPMENT *(2011/12 Class)*

Chapter III: The Evolution of the Tanzanian Monetary and Financial System

A guide *–Not Edited*

1.1 Monetary system prior to 1919 in East Africa

--Tanganyika (thus EA) was in commodity money up to 1880s
--No common medium of exchange (several monies –conus shells, rings, cowrie shells, beads, etc.)

--The period from 1890–1919
–circulation of foreign money/currency e.g. Germany Rupee
–they initially started in the coastal areas, later penetrated the interior
–those currencies circulated with other monies that existed before (no central authority or central bank)

--1914–1916 (characterized by currency volatility -WW I period)
–Volatility was so large in EA due to the war
–considered need for a regulatory body

1.2 East African Currency Board (EACB) from 1919

--1919 –East African Currency Board (EACB) was established
–headquarter in London, Nairobi was the centre
–Rupee was abolished
–Kenya and Uganda the first members
–Tanganyika joined in 1920
–Zanzibar in 1936
–Other British colonies (neighbors) joined later

Roles of the EACB

–To supply/issue its own currency (EA shilling) in EA,
–Fixed the exchange rate, between the Boards' currency and pound (GBP)
–To control currency in East African States. It could increase currency in circulation by exchanging with GBP
e.g. Increase money supply by buying foreign exchange and vice versa, very crucial for controlling inflation
–Borrowing by the governments was allowed since 1955 at prescribed limits.
The Board authorized to extend credit to governments of constituent countries up to 200 mill in 1955, the limit was raised to 400mill EA Shs in 1957, 1959 the Board was authorized to acquire local T-bills
–Note: 1960 head quarter shifted to Nairobi

–Crop financing facility was introduced in 1961, where commercial banks borrowed to meet seasonal demand for credit
–commercial banks were allowed to open accounts with the Board (Bankers to banks) i.e. lender of the last resort
–1962 the Board started a clearing system for commercial banks
–1966, the Board was dissolved paved the way to the respective central Banks and country's currencies

1.3 Development of Commercial Banking & Non-Bank Financial systems

1.3.1 Commercial Banking –pre 1960s

Note: Evolution of commercial banks in EA & Tanganyika in particular does not go together with the evolution of money in the region

i) Germany Banks

a) Deustch Ostafrikanische Bank –established in 1905
–received deposits
–issues currencies (notes and coins)
–performed both commercial and central bank duties

b) Handels Bank of Ostafrika –established in 1911
–introduced in Tanga
–played commercial roles only (received deposit & extend credit)

ii) British Banks

a) National Bank of India –later changed to National & Grindlays Bank (1896)
–offices in Mombasa, Nairobi and Kampala

b) Standard Bank –formed in 1911
–originated in South Africa later in EA

c) Barclays Bank
–mainly commercial activities i.e. extend credit and receive deposits

Note: 'Native Restriction Ordinance of 1923' –operated up to 1940, forbidding banks to give loans to natives

Shortcomings of Foreign Banks in East Africa

i) Located in tows (Tanga & DSM)
ii) Financed external trade only, mainly collection exports and distribution of imports – no productive activities were financed

iii) No credit extended to indigenous people of EA, lack collateral (lack liquid assets or land was commonly owned) credit skewed to colonial masters (Indians, Britons, Germans etc.)
iv) Surplus/interest earnings were repatriated –invested in London
v) Lack of long term credit facilities for long term projects
vi) Did not promote local entrepreneurs –more Asians personnel were recruited

--1940s: With the rise of Nationalism
–banks attempted to create long term credit facilities
–institutions with indigenous origin (local capital) emerged

Examples
–Land and agricultural Bank of Kenya (1931), financed settlers in Kenya
– Land and agricultural Bank of Tanganyika (1945)
–Uganda Commercial Bank (1950)
Roles/Functions
–they provided long term loans for agriculture & manufacturing
–short term credit for crop finance

Weaknesses
–Indigenous banks had little capital, thus limited their activities compared to foreign banks

1.3.2 Development of Non-Bank Financial Institutions
Other financial institutions also existed in the region. These include those which financed motor vehicle and small scale manufacturing such as:
i) Credit Finance Corporation Ltd.
ii) The United Dominion Corporation (EA) Ltd
iii) The national Industrial Credit (EA) Ltd

Others provided housing finance:
i) The first permanent Building Society
ii) The Savings and Loan Society
iii) The East African Building Society
iv) The Housing Finance Company of Kenya
v) The Permanent Housing Finance Company of Tanganyika

A question: *What is the difference between a bank and a non-bank financial institution?*

2.0 MONETARY AND FINANCIAL SYSTEM OF TANGANYIKA/ TANZANIA FROM 1961

Calendar of major monetary and financial events in Tanganyika/Tanzania

i) 1919 – East African Currency Board (EACB)
ii) 1961 –Independence
iii) 1962 –The Cooperative Bank of Tanganyika
iv) 1966 –BoT formed (from BoT Act Dec. 1965)
v) The Peoples Bank of Zanzibar formed in 1966
vi) 1967 –Arusha declaration
vii) 1967 –NBC formed
viii) 1971 –CRDB formed (full commercial bank in 1984)
ix) 1971/72 –credit and finance plan launched
x) 1978 –the development role added as one of the BoT roles
xi) Informal/parallel markets for forex, credit, goods etc. as a way of circumventing controlled (formal) markets)
xii) Late 1970s and early 1980s the country was in economic crisis
i.e. Tanzanian economy experienced a number of shocks that led to severe macroenomic imbalances which also undermined the performance of the financial sector
–early 1980 had own initiated reforms (SAPs & NESP)
–1986 Jul: The government launched a comprehensive Economic Recovery Programme (ERP) to: improve macroeconomic management; tackle the underlying structural weaknesses and; encourage more active private sector participation in the economy. The programme involved policies designed to: a) increase output; b) reduce inflation and c) improve balance of payments.
xiii) 1988 The Presidential Commission of Inquiries into the Monetary and Banking System in Tanzania (also called Nyirabu Commission) formed. Whose implementation formed the first major financial sector reforms called First Generation Financial Sector Reforms (FGFSR).
xiv) Recommendations of the Financial Sector Assessment Programme of 2003, paved the way to the Second Generation Financial Sector Reform (FGFSR) in 2006/07

Different Monetary Regimes in Tanganyika/Tanzania

Based on the calendar of major financial and monetary events, the evolution of monetary and financial system of independent Tanzania can be described as having gone through the four regimes. The framework adopted from Kimei (2000), namely:

i) Currency Board regime 1961-1971
ii) The credit rationed regime (controlled regime) 1971-1986
iii) Credit ceiling regime 1987-1993
iv) The market oriented/clearing regime (1993 to date)

2.1 CURRENCY BOARD REGIME 1961-1971

<u>Recall</u>:

–Commercial banking was introduced in Tanzania in 1905, when the Deutsche Ostrafrikanische Bank opened its office in Dar es Salaam and issued its own coins and notes.

–The country's currency became the German rupee. This currency was legal tender up to the end of World War I in 1919.

–Tanzania became a mandate territory under the British immediately after the end of World War I and its monetary system was aligned to that of Kenya and Uganda, through the establishment of the East African Currency Board (EACB) in December 1919. At the same time, German banks were taken over by British banks throughout the country.

2.1.1 EACB as the Monetary Authority in Tanganyika/Tanzania

Despite the introduction of the fiduciary issue and the crop finance facility, the issue of currency by the EACB continued to be mostly driven by changes in foreign reserves because the sizes of the two facilities were quite limited and conditions of the use by each member country quite stringent. As a result, anti-inflationary discipline was maintained, thereby safeguarding the convertibility of the EAS at a fixed exchange rate.

The impending break up of the EACB in 1965 also exacerbated the foreign exchange pressures to the extent that by June 1965, exchange and import controls were imposed on transactions with all sterling area countries except Kenya and Uganda. Transactions with Kenya and Uganda briefly came under control in February 1967 to curb capital flight following the adoption of the Strategy. This was lifted in June 1967, and the treaty for East African Cooperation was signed. Transactions with Kenya and Uganda were again brought under exchange restrictions in March 1971.

The East African states agreed to establish separate central banks and currencies after efforts to form an East African Federation failed to materialize. The Bank of Tanzania Act was passed in the National Assembly in December 1965, and the central bank began its operation on 14 June 1966. The act empowered the Bank of Tanzania (BOT) to perform all the traditional central banking functions: issue of currency, domestic monetary management and external monetary management.

The BoT had to reorient its policies in view of the proclamation of the Arusha Declaration in 1967, and the act was subsequently amended in 1971 to enable the BOT to perform development functions.

During the period 1966–1971 the operations of the Bank of Tanzania tended to follow the tradition of the EACB. The Tanzanian shilling (Tsh) continued to be largely convertible as it was backed by a reasonable amount of foreign exchange reserves, despite an increase in the proportion of domestic credit as a source of money supply.

2.1.2 Banks and Non Bank Financial Institution in Tanzania/Tanganyika

By 1960, Tanganyika had EACB as the overseer of financial system and a total of 8 commercial banks, 1 cooperative bank, 2 non-bank financial institutions, cooperative societies, and 1 postal office savings bank. Of the 8 commercial banks, 3 were big banks (Barclays Bank D.C.O, The Standard Bank of South Africa (latter changed to Standard Bank) and Grindlays Bank –British Origin (Nkoba 2007). The three banks formed a market cartel in the country and the interest rates charged were aligned to those in London money market.

Soon after independence three indigenous banks were formed:

i) The Cooperative Bank of Tanganyika was launched in 1962 and was replaced by the National Cooperative Bank (NCB) in 1964;
ii) National Bank of Commerce formed in 1965; and
iii) The Peoples Bank of Zanzibar formed in 1966

2.2 THE RATIONED ECONOMY

Why ration?

The regime started with introduction of annual finance and credit plan in 1971/72, which lasted until 1986/87. In line with the Arusha Declaration strategy, the Government of Tanzania tailored monetary policy towards directing the loanable funds available with the financial system to the development of the public sector (the central government and the parastatals i.e. financial and non-financial institutions).

2.2.1 Development of Central Banking

The EACB which existed up to December 1965, acted as the central bank for EA although it did not perform some of the central banking duties. With EACB all reserves were maintained in London because the commercial banks had their headquarters in London.

The Bank of Tanzania (BoT) was established by the Bank of Tanzania Act of 1965. The bill was passed in December 1965 and BoT started operation in 1966. However, in addition to traditional roles of the central bank, the BoT was also vested with developmental roles following the transition towards socialist state after the Arusha Declaration in 1967.

i) Traditional Roles of the BoT

a. Issue currency (fiduciary issue)
b. The banker to the government

c. Banker to banks –commercial banks and designated financial institutions (NIC, NPF etc.)
d. Lender of the last resort

ii) Domestic monetary management

Under this function the central bank directly interact with government, banks and designated and specialized Financial Institutions

a) Interaction with the government

i) Financing government budget deficit
ii) it manages the public debt government (domestic and external debt)

–Deficit is the difference between government revenue and expenditure. Fiscal deficit can be financed in three ways first, domestic or foreign interest bearing debts, foreign loans and grants and borrowing from the central bank or printing money 'deficit monetization'. Interest and principle are paid to the lender. The process create the national debt, which is commonly managed by the central bank

–The BoT also advices the government on financial matters

b) Interaction with designated and specialized financial institutions

–In this arrangement BoT gives short term loans (crop finance facility). These loans enable the banks and DFIs to lend for agriculture and industrial production

–By giving direct loans and advances repayable on demand or at certain fixed dates in future (served as Lombard and intraday facilities of today)

–discounting bills of exchange, promissory notes and other credit instruments

–**The specialized institutions** were also influenced through interest rate policy on loans set by the Bank. BoT also controlled the volume allocation, terms and conditions of credit (the main weapons of **monetary policy**)

iii) External monetary management

–it centered on stabilize the domestic currency (TZS)

a. The Bank manages foreign exchange reserves (gold, forex, SRDs in the IMF)
b. Policy formulations (the then import controls)
c. Export promotion (retention scheme)
d. It manages all transactions with the IMF
e. Determination of exchange rate (when the shilling was pegged to a basket of foreign currencies)

iv) Developmental Role

–The objective was to make sure that central bank is active participant in economic development. Thus the BoT was active in the following roles

a) extend long term and medium term loans to banks
b) contribute to the banks share capital
c) Extend guarantee facilities to DFIs

d) Supervised and scrutinized the operations of all specialized financial institutions
e) Organized financial plan (annual plan) including finance and credit plan (credit conditions in the country) and foreign exchange plan.

Following the Annual finance and credit plan, –introduced in 1971/72, the monetary policy was tailored towards directing the available funds in the financial system to development of the public sector (the central government and parastatals). The policy package constituted:

- controls over interest rates,
- variety of lending directives,
- rediscounting facilities or
- special lending schemes designed to increase the volume of bank credit extended to priority sectors of the economy often at a preferential interest rates.

As a result of poor capitalization, parastatals tended to relay heavily on the banking system for working capital.

–Targets were set on supply of credit to different sub-sectors, including central government and paratatals (cooperative unions, crop marketing boards etc.). The private sector was allocated the residual of the planned credit.

Under the financial planning framework, monetary policy objectives were construed to be achievable by way of setting ceilings on credit expansion alone, without invoking other monetary policy instruments that could influence the behaviour of banks and hence support the ceilings. This is reflected in the manner in which interest rate policy was conducted. Interest rate policy aimed to ensure cheap finance to public enterprises, which gradually became the major borrowers of the banking system, absorbed over 85% of total credit formation by mid 1970s.

The granting of credit to public sector entities was in turn made on administrative rather than commercial considerations. The result of this policy thrust was <u>financial repression</u>.

Over time, the fixed interest rates were eroded by high inflation to negative real levels. As a consequence, financial savings mobilization and the efficiency of their allocation deteriorated drastically. The relative cost of capital no longer reflected the scarcity of that input, and investment tended to be relatively capital intensive, particularly in the public sector, which had privilege access to credit.

2.2.2 Development of Commercial Banking and Non-bank Financial Intermediaries from Early 1970s to 1986

Following Arusha Declaration all major means of production were nationalized including financial institutions. The reorganization of financial institutions was based on specialization, such as commercial banking, insurance, industry, agriculture etc. For example National Bank of

Commerce (NBC) was the only commercial bank until 1984 when CRDB was transformed to commercial bank; NIC, the only insurance company in mainland Tanzania; Tanzania development Finance Limited (TDFL), as private and Tanzania investment Bank (TIB), as the public institution to finance industrial sector. Thus, the system created either monopolies or oligopolies along the line of operations.

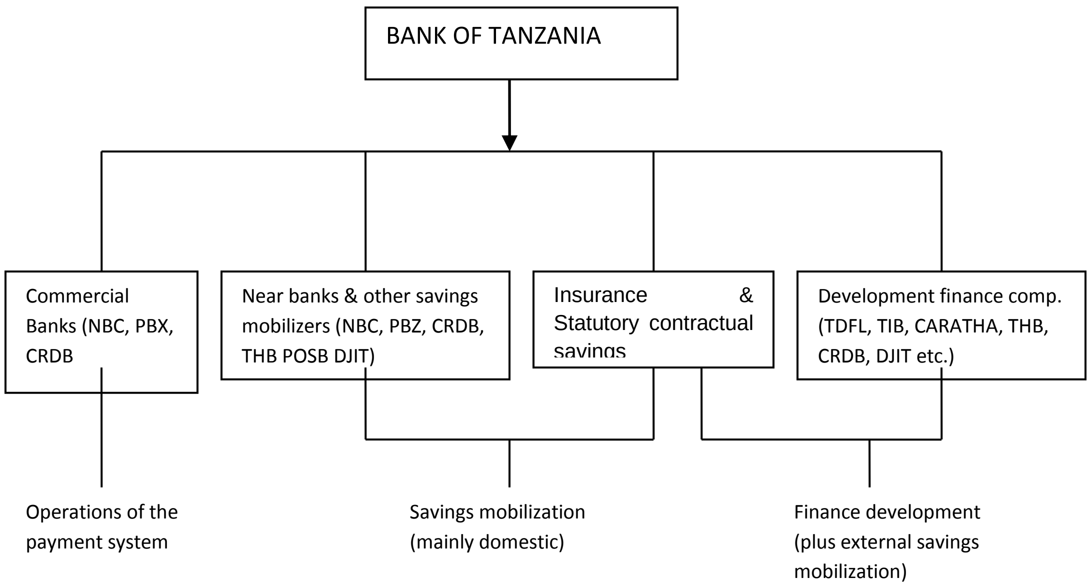
The system consisted of the central bank at the top (apex) followed by other institutions with different specialization, along the sectors **(figure 1 below)**. The set-up however, had two faces, first it had characteristic of socialist financing system i.e. monopoly and central bank participation in development, and capitalist in the sense that also existed private institutions and the central bank not acting as a commercial bank.

By early 1980s the Tanzanian financial system consisted of about 14 financial institutions including the BoT, namely:

- *3 commercial banks*
  - NBC (formed 1967 following nationalization of 9 foreign and local banks)
  - CRDB 1971 (transformed into full commercial bank in 1984)
  - PBZ 1966 (for Zanzibar)
- *Savings institutions*
  - Postal Office Savings Bank (POSB)
  - Diamond Jubilee Investment Trust (DJT)
- *Medium and long term finance (development finance institutions)*
  - TIB
  - Tanganyika Development Finance Ltd. (TDFL)
  - THB
- Investment intermediaries/institutions (hire purchase company)
  - Karadha Co., a subsidiary of NBC
- *Statutory contractual savings*
  - NPF (later NSSF)
  - PPF
- Insurance companies
  - NIC (mainland TZ)
  - ZIC (Zanzibar)

As noted above, except TDFL and DJIT all other financial institutions were owned and controlled by the government. Each institution was established under a specific statute that defined its objectives, area of confinement, management and the model of accountability. However, this modality lacked reference to any common supervisory Authority. Due to poor capitalization, the parastatals tended to rely heavily on the banking system for working capital.

Figure 1: Financial Superstructure of Tanzania in early 1970s



<u>Note</u>

NBC –National Bank of Commerce
PBZ –People's Bank of Zanzibar
CRDB –Cooperative Rural Development Bank
THB –Tanzania Housing Bank
POSB –Postal Office Savings Bank
DJIT –Diamond Jubilee Investment Trust
NIC –National Insurance Corporation
NPF –National provident Fund
TIB –Tanzania Investment Bank
TDFL –Tanganyika Development Finance Co. Ltd
KARADHA –is a subsidiary of NBC

2.3 CREDIT CEILING REGIME 1986 – 1993

2.3.1 The Performance of Financial Sector in Tanzania Prior to Reforms

Roles of Financial Sector in any economy

The financial sector consists of commercial banks, non-bank deposit taking financial institutions and other financial institutions. The following are the roles of financial sector in any economy:

- Financial Intermediation
  - Deposits mobilization
  - Channeling resources to profitable users through extension of affordable credits
- Opportunities for savings
- Facilitate payments
  - Clearing and settlement of financial claims
- Risk management
  - Risk sharing through investments diversification, insurance and hedging
- Exerting corporate control
  - Lenders monitor performance of their borrowers to alleviate risk of mismanagement of resources

However, the overall performance of financial system in Tanzania during the late 1970s and 1980s (prior to reform period), has been inadequate. ***The following were the shortcomings:***

i) The growth of commercial bank deposits had consistently been negative – Commercial bank deposit declined from TZS 7,447.6 million in 1979 (at 1976 prices) to TZS 3,611.1 million by 1986.

ii) Public sector dominated credit flow, only 10% of credit channeled to the private sector. Up to 1986 the public sector received over 90% of total lending from commercial banks.
–The government was the principal recipient followed by the parastatals including cooperatives and marketing boards. As a result banks were overburdened by non-performing loans, which accounted for about 70% of total commercial bank lending. As a result poor repayment record severely restrained the ability to lend.

iii) Medium and long term lending declined since 1979. The accessibility was also a problem especially to the rural poor.

iv) The payment system was restrained by the poor performance of the financial institutions –skewed to urban centers leaving the rural areas underserved.

v) Other inefficiencies –poor customer care, long queues in the banking halls, limited financial products etc.

In addition to poor savings mobilization and lending record of the financial sector, several other features were observed before the reform period:

i) Administrative setting of interest rates by the central bank
ii) Intervention by the party and the government on the day to day operations of the financial institutions
iii) The equity capital of financial institutions was by far short of the capital required to cover loses arise from non-performing loans
iv) Miss-reporting of actual profits or losses of financial institutions

By early 1980s the economy of Tanzania was experiencing a severe economic crisis characterized by:
--Large and unsustainable fiscal deficits (it averaged 12% of GDP during 1980–1985),
--excessive monetary expansion (averaging 31% during 1980–1986);
--High inflation (averaging 30.5% in 1980–1986) and,
--a sharp deterioration in savings, investment and output performance.

In early 1980s Tanzania launched own reform programmes, which could not be implemented due to lack of funds. Nevertheless, the prescription (policy package) contained in the three-year SAP launched in June 1982 was helpful in containing the expansionary tendencies that followed the War with Uganda and the coffee boom. However, this sign of improvement in monetary management reversed from 1985/86 as a result of difficulties encountered in controlling credit expansion to non-central government public sector institutions, the parastatals, crop marketing boards and cooperative unions.

In 1986 the country reached an agreement with the World Bank and IMF to undertake the reform measures under their guidance and support. The reform programmes, include ERP I of 1985/86 – 1988/89, which centered on issues related to price stability and growth, and ERP II 1989/90 – 1991/92 which specifically targeted, among others, financial sector reforms.

In 1988 the Presidential Commission of Enquiry into the Monetary and Banking System in Tanzania (commonly referred to as the Nyirabu Commission) was appointed to review structural, organizational, procedural and the operational arrangements, and policy issues related to the financial sector. The Commission identified three broad issues affecting the financial system as:-

i) Structural problem: composition
–state owned banks and financial institutions (centrally controlled) created monopolies, and
–interference by the ruling party and government;
The two problems rendered the institution insensitive to opportunities and constraints in the market.

ii) Operating in unfavorable business and policy environment:
–Huge budget deficit, BoP deficits, high inflation,
–weak private sector and;
–lending to state owned enterprises

iii) Managerial deficiencies
–it affected both financial and non-financial state owned enterprises.
Result: huge loses and growing non-performing loans and thus inadequate resources mobilization.

The Commission submitted its report in 1990 with the following recommendations:

i) Measures to strengthen the policy and regulatory environment e.g. macroeconomic stability, sound fiscal policy, monetary and structural policies and appropriate legal and regulatory environment (supervision);

ii) Measures to create and foster competition in the financial sector e.g. licensing private and foreign banks, adopting market based monetary policy instruments and liberalizing the interest rates;

iii) Measures to restructure the existing state owned banks and financial institutions diagnosed as insolvent –clearing up the balance sheets (removing the non performing assets and recapitalize them);

iv) Measures to restructure the parastatals (non-financial institutions) which were the major source of insolvency of financial institutions

<u>*Note*</u> *The literature on financial sector reforms hovers on the famous hypothesis of Mckinnon and Show (1973). The hypothesis states that; the financial repression arises mainly when a country imposes ceiling on nominal deposits and lending rates at a relatively lower level of inflation. The resulting low or negative interest rate rates discourage savings mobilization and the channeling of mobilized savings through financial system. While low or negative interest rates facilitate government borrowing, they discourage savings and financial intermediation, leading to credit rationing by banks which impact negatively on investment and economic growth. Therefore, Mckinnon and Show called for financial liberalization as a necessary condition for economic development in countries where the financial sector is repressed.*

2.4 MARKET CLEARING REGIME 1993 to date

2.4.1 First Generation Financial Sector Reforms (FGFSR)

The FGFSR began with the implementing recommendations of the Nyirabu Commission geared towards strengthening the financial system and make it responsive to increasing demand for financial services in the economy. More specifically the main recommendations included:-

i) Reform of commercial banks so as to strengthen competition in commercial banking;
ii) Reform of development finance institutions to encourage establishment of local savings and credit institutions that can provide credit to agriculture;
iii) Reform of other financial institutions such as the National Insurance Corporation (NIC), Zanzibar Insurance Corporation (ZIC), Post Office Savings Bank (POSB) and Karadha, with a view to improving service to customers and ensuring financial viability, integrity, and sustainability
iv) Strengthening Bank of Tanzania's role in formulating and implementing Monetary Policy.
v) Reviewing other existing legislation establishing, related to, or affecting banks and financial institutions.
vi) Putting in place new supporting facilities such as: Credit Guarantee Schemes; an inter-bank clearing system; a credit reference bureau; formation of a Tanzania Banker's Association to promote the highest standards of professionalism and service among bankers in Tanzania
vii) Putting in place suitable legislation and infrastructure to cater for credit needs of special groups such as small enterprises and small farmers.

In implementing the first generation reforms, the government started financial sector reform with enactment of the Banking and Financial Institutions Act (BFIA) of 1991.

Through the BFIA the BoT issued:-

–prudential regulations for management of risk assets of banks and financial institutions,
- in July 1991 issued licensing guidelines,
- in October 1991 issued capital adequacy and other regulations.

The new banking legislation raised the entry barriers in terms of minimum capital and was accompanied by institutional reforms to strengthening entry of new players in the sector and supervisory capacity of the central bank. Also measures to restructure the financially distressed state owned banks were implemented.

Other legislations include:

- The Loans and Advances Realisation Trust Act (LART) 1991

- The Forex Act of 1992
- Parastatal Sector Reform Commission established in 1993
- The CMSA 1994
- The Bank of Tanzania Act in (1995) amended in 2003
    - Single objective of price stability
    - Indirect monetary policy instruments
- The Insurance Act 1996
- The land Act (1999) to facilitate use of land as collateral
- The National Microfinance Policy of 2000

The Impact of FGFSR

Some impacts of FGFSR include the following:

i) Lending to public sector reversed in favor of private sector

ii) Increased number of private banks and other financial institutions in the sector

ii) Increased competition stimulate some improvement in financial services

iii) Some of the new entrants introduced long opening hours, cut queues in the banking halls, provide more personalized services

iv) A number of innovations occurred e.g. credit/debit cards, ATM, interest bearing current accounts, savings account with cheque books

v) Cheque clearing has been speeded up

Ask for review questions!!!!

2.4.2 The Second Generation Financial Sector Reforms (SGFSR)

Despite the successes attained in the First Generation reforms, there were still many shortcomings in the operations of the financial sector. More importantly was the fact that the contribution of the financial sector towards growth of the Tanzanian economy is small compared to other countries. It was therefore necessary to develop a reform program for the financial sector to uplift contribution of the sector towards achieving the economic growth goals stipulated in the National Strategy for Growth and Reduction of Poverty (MKUKUTA) and a similar program for Zanzibar (MKUZA).

In order to identify the strengths, vulnerabilities and general soundness of the country's financial system, the Financial Sector Assessment Programme (FSAP) for Tanzania was conducted in 2003 by the IMF/World Bank. The FSAP report recommended a number of legal, judicial and institutional reforms that would remove the remaining obstacles to lending, deepen financial intermediation and help develop the financial system. These include:-

i. Reform of the government-owned financial institutions, including finalization of the privatization process.
ii. Legal and Judicial Reforms to remove the main obstacles to lending.
iii. Enhancing access to financial services including the promotion of microfinance and creation of credit registry.
iv. Liberalization and development of long-term investment by insurance companies and Pension Funds.
v. Avoiding policy prescriptions or practices to open special windows for SMEs at financial institutions, or the need for government-promoted development banks.
vi. Further improvement of banks' regulation and supervision and crisis preparedness.

As a follow-up to the FSAP report recommendations, the Minister for Finance appointed an Inter-Institutional Committee (IIC) under the Chairmanship of the Governor of the Bank of Tanzania. The Committee was required to review the recommendations of the joint IMF/World Bank FSAP report, and propose actions required for implementation. The IIC completed its work and submitted its report to the Minister for Finance in June, 2005.

The main activities under the Action Plan for implementation of the SGFSR have been developed with a view to addressing the remaining bottlenecks and challenges that exist in the financial system. They revolve around 10 broad areas, each with its clearly spelt out objective(s), as follows:

i. **Legal and Judicial Reforms:** (streamlining court procedures and reducing the backlog of cases, improving court physical facilities, increasing the number of judges and magistrates as well as increasing their knowledge in financial issues).

ii. **Monetary Policy Reforms:** (improving implementation of monetary policy analysis, further developing BoT's financial stability analysis function, and development of an appropriate sterilization plan and market intervention policy.)

iii. **Strengthening the Banking Sector:** (strengthening the capacity of banking supervision, strengthening the capacity of selected banks, review of banking regulations, improvement of risk management programs for small banks, establishing framework for operation of credit reference bureaus, review of the deposit insurance framework, developing reporting systems for anti-money laundering, and strengthening the financial reporting framework).

iv. **Developing Financial Markets:** -promoting vibrant primary and secondary markets (strengthening the regulatory and supervisory functions of CMSA, developing secondary market for money and government securities markets, developing the framework for corporate and municipal bond markets, promoting good governance, and improving public awareness of financial markets).

v. **Reforming the Pension Sector:** These reforms focus on promoting an efficient and competitive pension sector supported by appropriate legal and regulatory structures. The activities include: strengthening the regulatory framework, establishing and operationalising a pension regulator, improving the investment capacity of pension funds to manage investments and undertake actuarial analysis, increasing outreach to informal sector, and strengthen capacity for formulating and implementing pension policies.

vi. **Strengthening the Insurance Industry:** These reforms focus on promoting an efficient, sound and competitive insurance industry with wider outreach and market based investment policies. Activities include: strengthening the capacity of the Insurance Supervisory Department (ISD) in risk based supervision and actuarial analysis, acquiring insurance supervision software, developing the bank assurance framework, reviewing investment policies, and reviewing the life assurance framework.

vii. **Strengthening Micro and Rural Finance:** These reforms will focus on promoting a viable and sustainable microfinance industry with wider outreach, and operating under an enabling legal and regulatory framework. The activities include: strengthening the regulatory framework for MFIs and SACCOs, enhancing the capacity of the supervisors, supporting transformation of MFIs and SACCOs umbrella organisations, and creating networks and apex institutions for SACCOs. The objective is to improve the scale and quality of micro-finance and SME finance services particularly to the low-income market segment.

viii. **Employment:** These reforms focus on putting in place appropriate labour laws and labour relations policies that are in line with international best practices that support financial sector development. Activities include: review and updating of legislations, and building the capacity of implementing institutions.

ix. **Land Administration:** The reforms will introduce and promote an efficient legal and judicial infrastructure for collaterization of land and settlement of land disputes. Activities will support the roll-out of Governments Strategic Plan for Implementation of land laws including strengthening national and district land registries, formalizing property rights in unplanned areas, and strengthening infrastructure for dispute resolution.

x. **Facilitating the provision of Long-Term Development Financing (LTDF):** These reforms will support improvement in the availability and access to long term financing for enterprises, infrastructure and housing. The activities include: establishing a policy framework for provision of long term financing, setting up a development finance guarantee scheme and long term finance facility, developing an infrastructure financing framework, establishing a development finance institution, strengthening the SME guarantee scheme, establishing a framework for leasing, developing a framework for mortgage financing, and strengthening capacity for formulating and implementing long term finance policies.

3.0 AN OVERVIEW OF THE CURRENT FINANCIAL SECTOR DEVELOPMENTS IN TANZANIA

3.1 Introduction

Following the discussion above, the following is the current status of the financial system in Tanzania:

- From 4 banks and deposit taking financial institutions (1990) to 33 (2007)
- From 1 insurance comp. (1990) to 18 (2007)
- From 3 pension funds (1990) to 6 (2007)
- Banks private sector credit grew from 4.4% (2001) to 13.8 % of GDP (2007)
- Modern payment system using advanced technology *[TISS, ATMs, debit cards, Cell-phones- e.g. M-pesa]*

Table 1: The Current Structure of Financial System in Tanzania by Institutions

	Commercial Banks	Non-Bank Deposit Taking Financial Institutions	Isurance	Pension Funds	Investment Funds	Savings/credit Unions	Microfinance Institutions	Forex Bureaus
1995	10	9	6	4		450		93
2000	17	9	10	5	1			105
2001	18	7	10	5	2	650		
2002	21	7	10	6	2			
2003	21	9	12	6	2	1,264		
2004	25	9	13	6	2			
2005	27	7	14	6	3	1,875	57	111
2006	27	7	17	6	3	2,028		113
2007	28	5	18	6	4	3,469		142

Owing to reform efforts, diversification of financial sector is increasing. This is evidenced through the following facts:

- Commercial banks assets proportion fell from above 90% of the total (2003) to less than 75% in 2007
- Pension funds assets share increased from 5.8% in 2003 to 18.3% in 2007
- Assets proportion of insurance companies rose from 1.2% in 2003 to 2.6% in 2007
- Investment funds assets share increased from 0.1% in 2005 to 1.9% in 2007

Table 2: Holding of financial assets by Institutions

	Commercial Banks	Pension Funds	Non-Bank Deposit Taking Financial Institutions	Insurance	Investment Funds
2000	86.37	10.71	2.92		
2002	88.1	7.95	1.97	1.98	
2003	91.5	5.84	1.46	1.21	
2004	73.69	18.8	4.35	3.17	
2005	73.02	20.55	3.53	2.86	0.05
2006	74.65	19.65	2.86	2.6	0.24
2007	74.54	18.3	2.66	2.63	1.86

Financial markets are also on board!

i) *Govt. securities market:*
- Threshold for minimum bid in the primary market reduced from TZS 50 miln. to TZS 5 miln. since March 2006.
- Government bonds listed in the DSM Stock Exchange
- T-Bill rates have been declining in the recent past

ii) *DSM Stock Exchange growing*
- Number of listed companies have increased from 2 in 1998 to 10 in 2007
- Market capitalization from 2.8% of GDP 1998 to 4.2% in 2006

iii) *Forex Market is active*
- Operating under managed floating exchange rate policy
- A unified market with aligned IFEM and bureau rates
- Volume of transactions is rising steadily
- Exchange rate has remained fairly stable over the past 1 year

iv) *Payments system efficiency has increased*
- Tanzania Inter-bank Settlement System has made clearing of high value and time critical payments real time for its members since April 2004
- Electronic Clearing House System (starting January 2002), has reduced clearing days from 5 and 30 within the location of the house and inter-regional transactions to 2 and 7, respectively

3.2 Remaining Challenges

Notwithstanding good financial sector developments Tanzania still have a lot of challenges, these include:

- Access to credit for rural, and SMEs remains low due to high interest cost and collateral requirements
- Financial markets are shallow (volume of transactions)
- Limited sophistication and a narrow range of instruments
- High concentration in the banking system which limits adequate competition and leads to inefficiencies
- Largest 8 banks hold 83% of total banks' assets, and 85% of total banks' deposits

3.3 In addressing the challenges a number of steps have been taken especially through the SGFSR and are at deferent levels of implementation. These include:

i. **The Bank of Tanzania Act, 2006 and the Banking and Financial Institutions Act 2006:** These bills were passed into law by the Parliament in April 2006, and provide more power and independence to the Bank of Tanzania to enable it to effectively implement monetary policy and regulate the banking sector.

ii. **Tanzania Investment Bank (TIB):** The Government has decided that TIB will be transformed into a Development Finance Institution. Arrangements are underway to ensure that it is restructured in accordance with this new mandate based on international best practices, and is well capitalised. A consultancy study towards this end has been finalised awaiting appropriate action by the Government.

iii. **Credit Guarantee Schemes:** Three schemes have been established and are still being strengthened. These are: Export Credit Guarantee Scheme (ECGS); SME- Credit Guarantee Scheme; and Development Finance Guarantee Facility.

iv. **Finance Leasing:** The Financial Leasing Bill was passed in Parliament in April 2008 and the law became effective on 1st July 2008. The Act is expected to assist SMEs and start-up companies without collateral to access investment capital. The Guidelines under the law are being finalised.

v. **Mortgage Finance:** The strategy for development of a mortgage finance market in Tanzania has been developed, and includes an action plan for the formation of a liquidity facility, capacity building for legal reform, and development of legal and regulatory framework. The strategy proposes among other things, the amendment and enactment of laws that will give impetus to the development of mortgage finance in Tanzania, as well as other administrative actions, as follows:-

   a. **A Bill to Amend Certain Written Laws** with a view to providing further provisions for mortgage finance, namely:-
      - The Land Act: To include provisions placing responsibility on the mortgagor to verify the existence of spouse for the purpose of obtaining consent for mortgage loan.
      - The Land Registration Act**:** To include provisions that create legal recognition of unit titles.
      - The Civil Procedure Act: To include provisions that will cure the problem of frivolous injunctions by availing only two defenses against defaulting borrowers namely; “I did not borrow the money” and “I have paid the Loan”.
      - The Magistrates Court Act**:** To encapsulate provisions to cure frivolous appeals.

   b. **A Bill to enact the Unit Titles Act** provide for among others the:-

- management of the division of buildings into units, clusters, blocks and sections owned individually and for common ownership and use of designated areas;
- issuance of certificate of titles for the individual ownership of the units, clusters or sections of the building.

c. **Enactment of other Laws** that will regulate the intermediary sectors (Estate Agents, Valuers, and Property Managers) and review tax legislation so as to create incentives for the growth of unit titles industry in the country.

d. **Administrative actions** include:
   - The establishment of a housing department (Housing Officers) in local authorities and the Ministry of Land with a view to improving management of housing issues and the management of unit property matters.
   - The Establishment of a national database related to housing matters.
   - To conduct public education on mortgage finance and unit property issues.

These recommendations have been submitted to Government for further action. The two bills are expected to be presented to the National Assembly /Parliament in the November 2008 session for first reading.

Pension Sector Reforms: The report by M/s Codogan Financial, that proposes comprehensive reforms of the pension system in Tanzania, is still under review by the Government. The Social Security Regulatory Authority Bill was passed in Parliament in April 2008 to enable the establishment of an independent regulator for the social security sector and empowers BOT to issue investment guidelines and regulate the financial aspect of Social Security. The law is expected to take effect on 1st November, 2008.

vi. **Credit Reference system:** The reports on the legal and regulatory framework for the establishment of a credit reference system have been completed and submitted to BOT. It is proposed that credit reference system be made up of, the public credit reference databank, which will be managed by the BOT, and private credit reference bureaus which will be licensed by BOT. The report included regulations and licensing guidelines for credit reference bureaus, and regulations for the credit reference databank. BOT is in the process of implementing these recommendations.

vii. **Rural and Microfinance:** A study on the setting up and operationalisation of a microfinance supervisory function at the BoT has been completed by the consultant and three deliverables have handed-over to BoT, namely:-

a. Proposals for setting up the supervisory function in the Microfinance Department in the Directorate of Banking Supervision.
b. Technical notes and computer programmes for off-site and on-site supervision of Microfinance institutions, and
c. Conducted training for Microfinance Department staff on supervision of microfinance operations.

Moreover, a Study Developing a Strategy for Rural Financial Services has been completed. The draft report was discussed by stakeholders in June 2008. The consultant has submitted the final report which is now being reviewed by BOT.

❖ **Steps have been taken to improve Govt. securities market as well**

- Secondary Market for Govt. Securities
  –T-bonds listed

- New Instruments
  –A challenge for every financial institution to innovate products in its area of specialization

- To increase competition and stimulate secondary trading, auctions frequency reduced to fortnight for T-bills and once a month for T-bonds since January 2008
- For liquidity management efficiency, settlement date reset to 1 day after auction, from 2 days after auction
- Eenhancement of the BoT Central Depository System (CDS) in progress

The end