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LIST OF ACRONYMS

BOT	-	Bank of Tanzania
DIB	-	Deposit Insurance Board
DSE	-	Dar-es-Salaam Stock Exchange
EAC	-	East African Community
EU	-	European Union
FDI	-	Foreign Direct Investment
Forex	-	Foreign Exchange
FSAP	-	Financial Sector Assessment Program
GBP	-	Great Britain Pound
GDP	-	Gross Domestic Product
GEPF	-	Government Employees Pension Fund
GFC	-	Global Financial Crisis
IFEM	-	Interbank Foreign Exchange Market
IMF	-	International Monetary Fund
LAPF	-	Local Authority Pension Fund
MOU	-	Memorandum of Understanding
NBC	-	National Bank of Commerce
NIC	-	National Insurance Corporation
NMB	-	National Microfinance Bank
NPL	-	Non-performing loans
NSSF	-	National Social Security Fund
ODA	-	Overseas Development Assistance
PPF	-	Parastatal Pension Fund
PSPF	-	Private Sector Pension Fund
SADC	-	Southern African Development Community
SDC	-	Sovereign debt crisis
SME	-	Small and Medium Enterprises
SSRA	-	Social Security Regulatory Authority
TIRA	-	Tanzania Insurance Regulatory Authority
TISS	-	Tanzania Interbank Settlement System
TRWA	-	Total Risk Weighted Assets
TZS	-	Tanzanian Shilling
US	-	United States
USD	-	United States Dollar
VAT	-	Value Added Tax
WEO	-	World Economic Outlook
ZSSF	-	Zanzibar Social Security Fund

FOREWORD

Financial stability is becoming an increasingly important aspect of macroeconomic management for sustainable economic growth. Traditionally, central banks have had two main functions: (i) manage monetary conditions in the domestic economy to engender prices stability and (ii) promote financial stability through their functions as regulators of the banking system, as banker to banks and as lender of last resort. Basically, under normal conditions, when there is stability in the financial system, central banks tend to focus mainly on a day-to-day conduct of monetary policy for the achievement of low and stable inflation. However, during a period of financial stress, the central banks' emphasis naturally shifts to safeguarding the stability of the financial system as a whole, consistent with their role as regulators and providers of liquidity to the banking system. Experience from financial crises in the past and the current one has shown that financial instability can occur even in an environment where monetary policy has achieved low and stable inflation. This implies that sound monetary policy is not enough to prevent financial instability and guarantee sustainable economic growth.

Since the financial system is made-up of banks and other financial intermediaries, safeguarding the stability and maintaining public confidence in the financial system is the primary responsibility of the Bank of Tanzania in collaboration with the regulators of financial sub-sectors (namely, regulators for pension funds, insurance companies, and the capital market). These regulators are specifically charged with promoting the soundness and efficiency of their respective financial sub-sectors in order to ensure the soundness and resilience of individual institutions. However, at the financial system level, the Bank of Tanzania has a legal mandate to promote and safeguard financial stability as stipulated in various provisions under the Bank of Tanzania Act, 2006 and the Banking and Financial Institutions Act, 2006.

To carry out the financial stability mandate, the Bank of Tanzania established a Financial Sector Stability Department in 2009, whose main responsibility is to undertake overall surveillance and assessment of the financial system, in order to identify any financial imbalances/risks and their implications to financial stability. Furthermore, the Bank is finalizing the process of establishing a Financial Regulators Forum which will bring together the regulators of financial sub-sectors (namely, SSRA, TIRA and CMSA) under the Chairmanship of the Bank of Tanzania. The Financial Stability Department will facilitate the operations of the Forum. The main objective of the Forum is to coordinate actions needed to promote and sustain financial sector stability, and financial crisis preparedness. In the event of financial crisis, the Forum will coordinate implementation of measures needed to manage the crisis effectively and efficiently.

In recognition of the importance of communicating financial stability issues, the Bank of Tanzania will be publishing **Financial Stability Reports** to inform stakeholders about the health of the financial sector and its ability to mitigate risks and absorb shocks, thereby building public confidence on the Tanzanian financial system. These Reports will be published semi-annually. The main Report will be published in September, covering developments for the year ending 30th June and a mid-term review published in March of every year.

This inaugural publication of the Financial Stability Report is not exhaustive in its coverage of financial stability as it dwells mainly on the stability of the banking sector – which nevertheless accounts for 75 percent of the financial sector assets. Overtime, the breadth and depth of the coverage and analysis of financial stability will be extended to include pension, insurance and developments in the capital market. With increased knowledge of the pertinent issues in the financial system and their implications to financial stability, it is hoped that financial institutions, market participants, businesses and households will be able to recognize the relevant risks and vulnerabilities and become better prepared to manage these risks accordingly.

I trust that this publication will stimulate the need for understanding financial stability issues and encourage informed debate. We would also welcome your views and comments on this inaugural edition.

Prof. Benno Ndulu
Governor
30th September 2010

OVERVIEW

The recovery of the global economy continued above expectations during the first half of 2010. However, downside risks to the sustenance of the recovery momentum have also increased remarkably. The risks include uncertainties surrounding sovereign and financial sector in parts of the Euro area that have eroded confidence in the soundness of banks, resulting in an increase in funding costs and liquidity stress. These have led to tighter lending conditions, declining business and consumer confidence, and abrupt changes in relative exchange rates.

Despite the growing threat to sustenance of the recovery of the global economy in recent months, the recovery of the Tanzanian economy continued to strengthen. The GDP grew at 6.0 percent in 2009 exceeding the projected growth rate of 5.0 percent. During the first quarter of 2010, the economy grew at 7.0 percent and at 7.1 percent in the second quarter. The recovery was driven mainly by the strong recovery in global trade, the recovery of the mining, transport and communications as well as financial intermediation. The overall outlook of the Tanzania economic growth in 2010 remains positive and on track to reach the projected 7.0 percent, thereby enhancing prospects for continued financial stability.

Indicators of the financial strength of the banking system show that the system continues to be sound and stable in aggregate terms. Most banks were well capitalized and extremely liquid above the regulatory requirements, while the implementation of the rescue plan by the government helped to buttress the system. Overall, the banking industry continues to record profits, which in turn attracts entry of new domestic and foreign banks. The stress tests conducted by the Bank of Tanzania during the first half of 2010, showed that the Tanzanian banking system was resilient to adverse shocks in interest rates, exchange rate and credit quality, while liquidity levels were sufficient to cushion the system against extreme liquidity risk.

Although the stability of the financial system looks promising for the near future, continued vigilance over developments in the financial system will be maintained as risks always remain. During the period under review, the Bank of Tanzania raised the required minimum core capital for banks from TZS 5.00 billion to TZS 15.00 billion, with a view to enhancing the capability of the banking sector to absorb potential losses. The proposed changes are also expected to improve solvency level of the industry, encourage consolidation and mergers, and further promote competition in the banking sector. Meanwhile, international work on financial regulatory reforms is ongoing through financial stability organizations and committees. A package of new reforms designed to strengthen capital and liquidity standards in financial systems is scheduled to be completed later in the year. Agreements on a number of elements of the package have already been announced. The Bank of Tanzania is making close follow-up on these regulatory developments so as to assess the implications and relevance to financial stability in Tanzania.

With a view to promoting an effective surveillance and prudent oversight of the financial system as a whole, the Bank is in the process of establishing a Forum to bring together all regulators in the financial system under the Chairmanship of the Bank of Tanzania. The primary mandate of the Forum is the coordination of efforts aimed at attaining and sustaining financial stability in Tanzania.

Going forward, the Bank of Tanzania will seek to enhance the stability and efficiency of the financial system mainly through the following priority areas:

- Sustenance of daily surveillance of the financial transactions in the banking sector and through the payment and settlement systems. This intensive approach enables the Bank to identify early warning signals of systemic risks to the financial system, and hence take appropriate measures.

- Sustenance of prudential surveillance and supervision over banks in order to strengthen the resilience of the banking system. In this regard, the Bank will continue to perfect its model of risk-based banking supervision. Specifically, the on-site risk based examination of banks is complemented by an off-site surveillance – a combination that plays a major role in detecting early warning signals of financial distress and facilitates pre-emptive interventions.

- Ensuring compliance by banks to the new increased capital requirements within the agreed grace period. This capital enhancement on its own is not a substitute for banks' own risk-management practices. Consequently, the Bank of Tanzania shall continue to require banks to put in place and sustain robust mechanisms for risk assessments of their operations to facilitate timely detection and reporting of emerging risks.

- Speeding up of the establishment and operationalization of Credit Reference Bureau to facilitate the sharing of information on creditworthiness of customers in the banking system – as one of the measures of managing credit risk.

- Enhancement of crisis response mechanism through development of an effective and coordinated national financial crisis management and resolution framework. This involves among others, strengthening the role of the existing Deposit Insurance Board in safeguarding financial stability and preserving public confidence in the financial sector, and development of contingency plan for provision of systemic emergence liquidity in times of need.

- Finally, the Bank of Tanzania has been assigned a coordinating role in harmonizing the EAC member states' financial stability frameworks in a bid to develop a regional framework for financial stability analysis and reporting. This is in line with the growing exposure to cross-border risks as banks increase their regional operations.

1.0 Macroeconomic and Financial Environment

1.1 Developments in the Global Economy and Renewed Financial Turbulence

The current decade has seen a rapid growth in the volume of financial transactions, increased complexity of financial markets and a more interconnected global economy. This has resulted in greater potential vulnerabilities and risks to the stability of financial systems. Globally, the resilience of financial markets was severely tested during the past two years, following the widespread impact of the global financial crisis. Its powerful shock waves on the world economy have not only brought unprecedented attention to financial stability but have also heightened awareness towards the inherent significance and implications of financial instability on the global economic growth. The crisis which culminated into the worst recession since the Great Depression of the 1930s is gradually moving out of the downturn, albeit at varying speed across countries.

According to recent IMF - WEO, the recovery of the global economy that started largely in the fourth quarter of 2009 into 2010 has been stronger than earlier projected, although uncertainties remain. During the first half of 2010, the global economy continued to record strong growth showing a forecast of 4.5 percent compared to the projection of 4.2 percent during the last update in March 2010. Notwithstanding the stronger forecast, the world average growth rates hide a large difference between and within advanced and emerging and developing economies. The US economy is expected to grow by 3.25 percent in 2010, while GDP growth in the Euro Area is projected at 1.0 percent. Meanwhile, Japan is projected to grow at close to 2.5 percent, and growth in emerging and developing economies is averaged at 6.75 percent (**Table 1.1**).

It is noteworthy that the projected recovery of domestic demand in some advanced economies and the associated revival of the inventory cycles is anticipated to boost exports from emerging and developing economies, including Tanzania. While recovery prospects were bright during the first half of 2010, the downside risks to global recovery have risen sharply on account of uncertainties surrounding sovereign and financial sector risks in parts of the Euro area. The main risks include additional increases in funding costs and weaker bank balance sheets, declining investors and consumers' confidence, and abrupt changes in relative exchange rates. The heightening sovereign risks have also eroded confidence in the soundness of some banks in the Euro area, thus resulting in an increase in funding and liquidity stress in interbank markets. The ultimate impact of the renewed financial turbulence is mainly reflected by the subsequent weakening of global demand, continued high unemployment stance, and the sustained weakening of the property markets in the affected countries. However, implementation of stabilization measures that are being taken by Euro area governments will go a long way in restoring financial stability. Basically, these measures are expected to limit contagion effects to other regions and minimize disruptions in capital flows to emerging and developing economies.

Table 1.1: World GDP Growth Rates

	2007	2008	2009		2010		2011	
			Proj	Actual	Proj Apr-10	Update July-10	Proj Apr-10	Update July-10
World output	**5.2**	**3.0**	**-1.1**	**-0.6**	**4.2**	**4.6**	**4.3**	**4.3**
Advanced Economies	**2.7**	**0.6**	**-3.4**	**-3.2**	**2.3**	**2.6**	2.4	**2.4**
USA	2.1	0.4	-2.7	**-2.4**	**3.1**	**3.3**	2.6	**2.9**
Euro area	2.7	0.7	-4.2	**-4.1**	**1.0**	**1.0**	1.5	**1.3**
Japan	2.3	-0.7	-5.4	**-5.2**	**1.9**	**2.4**	2.0	**1.8**
United Kingdom	2.6	0.7	-4.4	**-2.6**	**1.3**	**1.3**	2.5	**2.1**
Emerging and Developing Economies	**8.3**	**6.0**	**1.7**	**2.4**	**6.3**	**6.8**	**6.5**	**6.4**
Africa	6.3	5.2	1.7	**4.0**			5.3	
Sub-Saharan Africa	7.0	5.6	1.3	**4.1**	**4.7**	**5.0**	5.9	**5.9**
Great lakes region	7.3	5.8	4.3	**4.7**	**6.0**			
Tanzania	7.1	7.4	5.5	**6.0**	**6.9**		6.9	
Developing Asia	**10.6**	**7.6**	**6.2**	**6.6**	**8.7**	**9.2**	**8.7**	**8.5**
China	13.0	9.0	8.5	**8.7**	**10.0**	**10.5**	9.9	**9.6**
India	9.4	7.3	5.4	**5.7**	**8.8**	**9.4**	8.4	**8.4**
Western Hemisphere								
Brazil		5.1		**-0.2**	**5.5**	**7.1**	4.1	**4.2**
Mexico		1.5		**-6.5**	**4.2**	**4.5**	4.5	**4.4**

Source: WEO, IMF

Meanwhile, growth prospects and the projected higher returns to capital in the emerging and developing economies were expected to attract huge capital inflows from advanced economies. However, with the prevailing low appetite for risk associated with the sovereign debt crisis and the dampened global demand, some investors have scaled down their investments and some have even pulled their funds back into safe havens to the disadvantage of emerging and developing countries. Specifically, portfolio flows to emerging markets have shown signs of reversal after recording a significant increase for more than a year between March 2009 and April 2010. However, it is important to note that recent developments in the international corporate sector show prospects for revival of capital flows to emerging and developing countries as the multinational corporations are accessing capital directly from international capital markets. Essentially, most of these transnational corporations are eyeing to expand their existing investments in developing countries and some are venturing into new areas such as agricultural production and agro-processing. This development will have significant impact on economic growth in the recipient countries, including Tanzania. The untapped capacity in agriculture, agro-processing, manufacturing and infrastructure development in Tanzania provides great potential for capital absorption, and more so amidst the declining inflationary pressures that have set-in recently.

Outlook on global financial environment

The impact of sovereign debt crisis and the weaker than anticipated recovery in the US is holding down job opportunities and investors' appetite. Given the nervousness about the possibility of euro sovereign debt to weaken international financial markets, subdued private financing activity is evidently anticipated across international funding markets. Therefore, in the near term, the main risk emanates from increases in funding costs and hence tighter lending conditions that will affect economic activity. Furthermore, the dampened investors' appetite might also affect capital flows to emerging and developing economies contrary to earlier projections. Already, portfolio flows to emerging markets are slowing down since May 2010, after a significant increase recorded between March 2009 and April 2010, although some countries are less affected than others. Consequently, based on the above downside risks, the outlook for global economy is predicted to remain sluggish in spite of the recovery being better than earlier projected. Also, it may be noted that following the onset of the sovereign debt crisis, the room for fiscal stimulus has markedly tightened in most of the developed countries and in the Euro area in particular. Consequently, some countries have no other options but to go for further monetary policy measures (i.e. quantitative easing) to pump-up the economic recovery. In the US, the Fed intends to announce a second round of quantitative easing in a bid to steer consumer spending and promote exports. If the US economy responds positively to the envisaged second round stimulus package, then the global economy may witness an accelerated growth in the foresight.

BOX I: Lessons from the Global Financial Crisis

The onset of the global financial crisis became a wake-up call to many countries to re-examine their macroeconomic management frameworks and policies in order to determine their adequacy in terms of safeguarding not only macroeconomic stability through focusing on price stability, but also financial stability by maintaining a robust, efficient and resilient financial systems. The re-evaluation of policy frameworks centered on the three major processes involved in financial stability analysis, namely surveillance of the financial system; mitigation of potential risks and crisis management and resolution. As a result, relevant lessons were drawn for each process of financial stability assessment.

Lessons for enhancing the surveillance of the financial system

Financial system analysts have revealed that there a build up of systemic risk in the global financial system and extensive 'information gaps' in the surveillance process, as coverage was mainly on the formal regulated financial intermediaries. Consequently, systemic risk was mostly accumulating in the 'shadow banking system' outside the 'regulatory perimeter. Therefore a number of lessons were drawn to enhance the surveillance of the financial system:

- *There was a need for countries to extend the boundary of regulation outwards to cover other groups of financial institutions that are essential to financial stability.*

- *The rapid expansion of credit derivatives and structured finance markets served to camouflage risks, while regulatory arbitrage was a persistent feature of financial engineering in the run-up to the crisis. Consequently, relevant authorities need to monitor closely new products and players in the financial system. Once their operations become relevant to financial stability, they should be incorporated in the macro-prudential surveillance and institute an appropriate regulatory framework.*

- *When the warning signs on the rapid credit growth and asset prices were observed in the respective financial systems, there was no consensus on the appropriate policy response. Therefore, countries need to develop benchmarks and norms for the economic and financial system aggregates in order to assess deviations and put in place appropriate policy responses to address the outlier conditions/potential threats.*

Lessons for enhancing the mitigation of potential risks to financial stability

The intensity of the global financial crisis has revealed weaknesses in the mitigation efforts deployed by many countries which were affected by the crisis.

- *According to post analysis of the capital adequacy of respective banking systems, it was found that there wasn't enough capital in the global banking system to absorb losses while bank remained operating.*

- *The crisis has shown that shortage of liquidity drives an institution to failure much more rapidly than shortage of capital. Consequently, "systemic liquidity" should be a major focus of regulatory efforts, similar to the emphasis that is currently placed on capital adequacy.*

Lessons for enhancing crisis resolution mechanism

Experience has shown that resolving a financial crisis is a messy and costly process. Since many institutions were judged to be 'too systemically important to fail', there was no choice but to cover them under the stimulus/rescue packages which were overly expensive. . In some countries this has led to a serious discussion about reducing the size and complexity of financial institutions. In other countries, emphasis has been placed on the need to make sure that the largest banks are very well capitalised and are strictly supervised.

- *For an orderly and efficient crisis management and resolution, there is need to design measures that will automatically kick-in during a down-turn to restore confidence in the soundness of financial markets and financial institutions. Specifically, a crisis management framework need to be developed that will specify the role of each relevant authority in limiting the damage, stopping widespread contagion and restoring confidence and stability in the financial system. Indeed, various countries (including Tanzania) are now putting in place national frameworks to deal with crisis management and resolution for the financial system as a whole.*

- *From the sovereign debt crisis in the Euro area, it is evident that sustainability of public finances is essential for the confidence of market participants such as consumers and investors. Hence, a sound and prudent fiscal policy is as key to financial stability as is the macro-prudential policy.*

Second, the lessons the euro area should learn from the crisis, especially from its most recent phase which is characterised by a government debt crisis. The sustainability of public finances is essential for the confidence of market participants such as consumers and investors. And a sound macrofinancial environment is key for financial stability, as the last months have demonstrated.

1.2 Domestic Macroeconomic Developments

Structure of the Tanzania External Sector

The level of diversification of the external sector in an economy determines how vulnerable it is to the global economy in terms of trade shocks. The more diversified the export base is, the less vulnerable the economy becomes.

In Tanzania, the structure of the external sector has become more diversified over the past decade, following the economic reforms implemented by the Government since mid 1980s, thereby strengthening the country's resilience to shocks. Specifically, the dominance of foreign exchange earnings shifted from traditional agricultural commodities to non-traditional exports, mainly travel services (tourism), minerals, manufacturing products and transportation services. For instance, between 1998 and 2009, contribution of traditional export earnings dropped from 30.8 percent of total exports to 10.0 percent, while the share of non-traditional exports rose from 69.2 percent to 90.0 percent (**Table 1.2**).

Table 1.2.: Sources of Exports Earnings as a Percentage of Total Exports

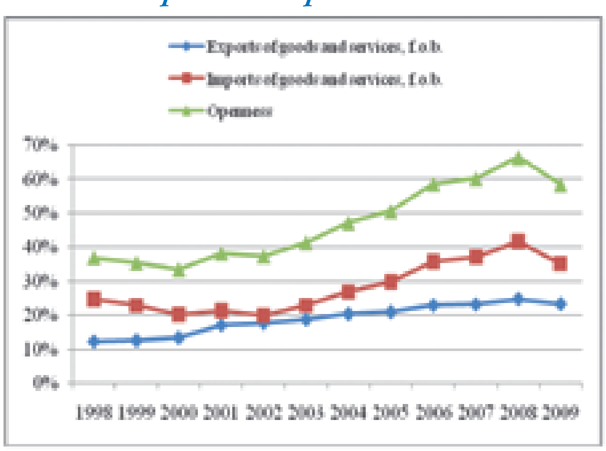
	1998	2007	2008	2009
Traditional exports	**30.8**	**8.2**	**9.9**	**10.0**
Non-traditional Exports	**69.2**	**91.8**	**90.1**	**90.0**
Tourism	49.8	33.5	28.0	27.0
Transportation	5.2	9.3	7.9	7.8
Manufactured Products	4.5	8.7	16.1	11.8
Gold	0.4	22.0	24.1	28.6

Source: Bank of Tanzania

This shift has improved the resilience of the Tanzanian economy to terms of trade shocks since non-traditional exports are more price-competitive than the traditional exports. In additional, processed products including the non-traditional exports can be traded in futures markets more easily than the raw commodities.

The openness of Tanzanian economy with respect to international trade as measured by the ratio of exports plus imports of goods and services to GDP has been rising overtime from 37.0 percent in 1998 to 68.5 percent for the year ending December 2009 (**Chart 1.2**)

Chart 1.1: Export and Import to GDP ratios



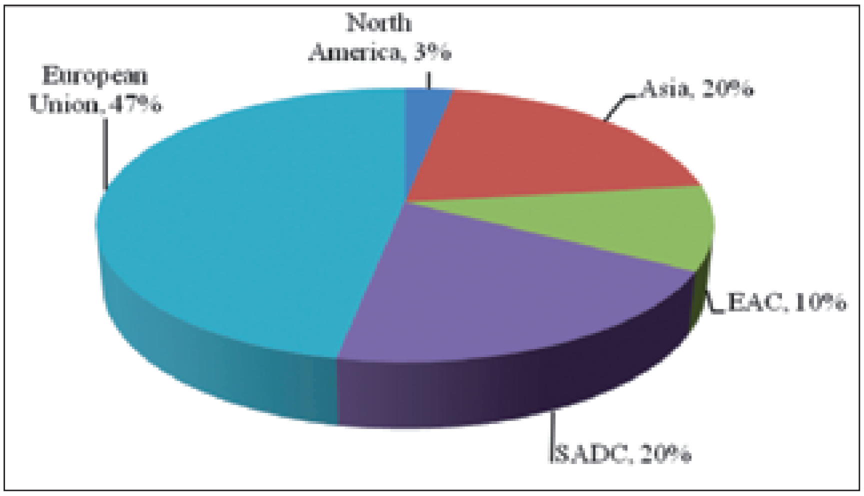
Source: Bank of Tanzania

The level of openness to trade of the Tanzanian economy is bound to deepen more as Tanzania progressively removes the remaining restrictions on capital account transactions. The restrictions are expected to be completely abolished by December 2015. Furthermore, the recently launched common market protocol in the EAC region is envisaged to have profound impact on widening the scope of domestic demand and attracting capital inflows into the region. Tanzania is expected to attract substantial share of that on account of potential investment opportunities in agriculture, energy, manufacturing and infrastructure. Coupled with the anticipated rebound in global trade, the opening-up of the Tanzanian economy to the EAC region and to the global economy at large is expected to contribute substantially in supporting economic growth thus returning to its medium to long-term growth path. However, greater challenges associated with cross-border capital flows and their implications to financial stability remains to be addressed.

Impact of GFC on the Real Economy

The extent to which the domestic economy is affected by external shocks depends on the interactions between the domestic and the global financial system. For Tanzania, the first round effects of the GFC were rather limited largely due to two major reasons, namely: the low level of integration of domestic financial markets with the international financial markets, and the remaining restrictions on capital account, which lowered exposure to the toxic financial assets. At the time of the crisis, foreign assets component in the banking sector was about 11 percent of total assets of the banking system, thus providing minimal exposure to direct effects of the GFC. However, due to integration in the global economy through international trade, the second round effects of the GFC impacted Tanzania through trade following a sharp decline in global demand and a proportionate fall in commodity prices. The performance of key export sectors in Tanzania, especially traditional exports and tourism weakened significantly as economic conditions in the Tanzania's main trading partners - of which US and the Euro Area account for about 50 percent of Tanzania's export market, took a downturn. Basically, the declining international demand led to substantial reduction in export earnings, tourism receipts, and a notable slowdown in FDI inflows, as well as remittances from abroad.

Chart 1.2: Tanzania's exports destination, 2004 - 2008



Source: Bank of Tanzania

As Tanzanian exporters of the major traditional export crops – in particular cotton and coffee during the 2009 season – were preparing to export their stock of crops, world commodity prices dropped sharply following a collapse in demand from major trading partners, thus leading to cancellation of orders. These developments forced some of the exporters to sell the stocks at a loss, hence jeopardizing the ability to service their bank loans. Also farmers with unsold crop could not find buyers as companies suspended crop purchase operations. Since the main vulnerability to banks lies in credit exposure to distressed borrowers, banks became overly cautious at lending to economic activities, particularly those with external linkages.

Given the post-crisis anxiety in the financial system after the freezing of external credit lines and the uncertainty of recovery of the domestic and global economy, the major challenges that the Bank of Tanzania and the Government had to address included the following:

- Prospective build up of non-performing loans in the banking system and its consequences on credit freeze as key exporters suffered losses from the collapse of export prices and demand

- Volatility in the exchange rate heightened by anxiety over foreign exchange shortage as global capital markets and prospects for ODA flows froze

The resulting economic slowdown constrained the government's ability to meet its revenue targets, address food security concerns, while the limited access to financing curtailed options for both public and private sector investment.

Impact of GFC on the Foreign Exchange Market

The contagion of second round effects of GFC operating through the trade, capital flows and confidence channels created pressures and increased volatility in the financial markets – especially the foreign exchange market. The declining foreign exchange inflows subsequently led to low level of foreign exchange supply in the market against the highlighted demand due to anxiety over tightening of international capital and credit lines exerted undue pressure on the exchange rate. If not contained, the pressure on the exchange rate could pose substantial risk to the stability of the financial system due to the revaluation of foreign currency denominated assets and liabilities of financial intermediaries against domestic assets and liabilities.

Between January and December 2009, the foreign exchange market recorded the demand that was way above the normal seasonal demand **(Chart 1.3).** The Bank supplied the market with foreign exchange amounting to USD 1.05 billion, which accounted for about 65 percent of the total market turnover of USD 1.54 billion. This measure was taken to reduce the shortage of foreign exchange, dampen the anxiety and restore confidence in the market. As a result, the depreciation of the shilling against the USD was contained at an average of 12.9 percent during the first 12-months of the crisis – i.e. from about TZS 1,159 per USD in Sep 2008 to TZS 1,309 per USD in September 2009. Specifically, between September 2008 and March 2009, the exchange rate depreciated sharply by 12.9 percent. During the same period, other regional currencies also registered a similar trend. The Kenyan shilling depreciated by an average of 12.5 percent, Ugandan currency by an average of 24.8 percent, while South African rand depreciate by 23.5 percent. As the market pressure on the exchange rate eased coupled with the implementation of the rescue package from April 2009, the shilling stabilized for almost four quarters until the second quarter of 2010 when the sovereign debt crisis kicked in.

It is noteworthy that accumulation of sufficient foreign reserves plays an important role in financial stability since adequate international reserves provide a cushion against the exchange rate risk. On this basis, the Bank of Tanzania seeks to maintain adequate level of reserves at all times. By end of June 2010, the Bank had accumulated foreign reserves amounting to USD 3.5 billion, which was sufficient to cover

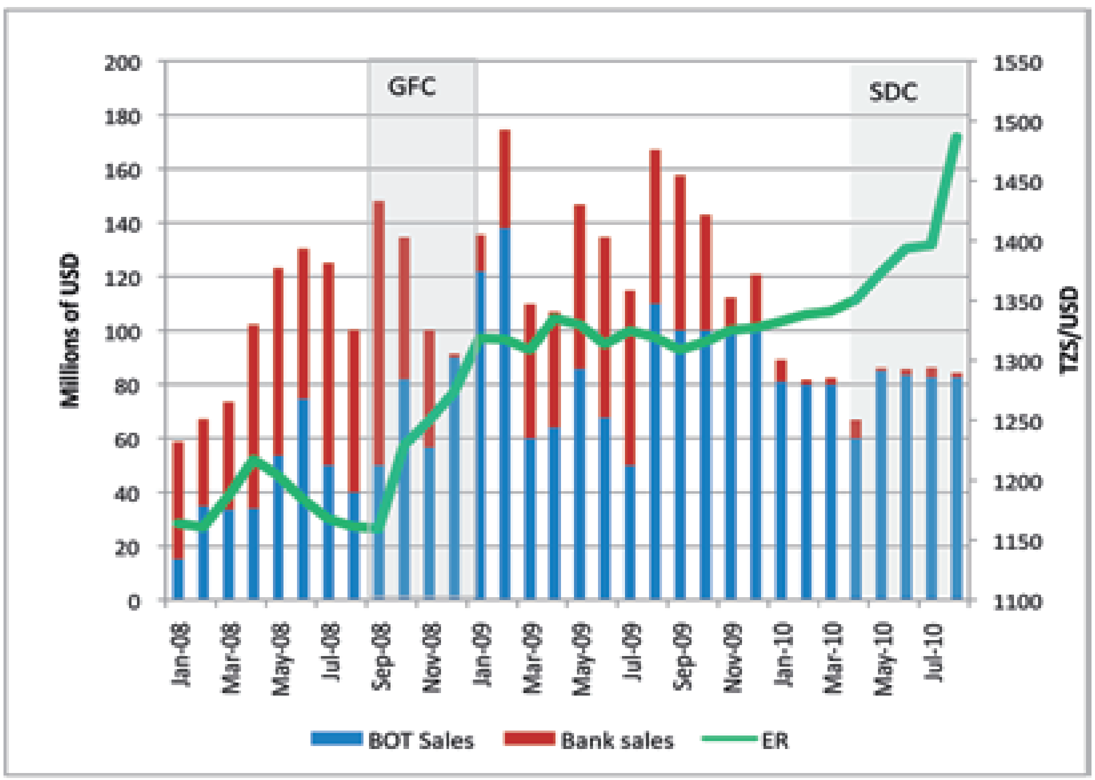
5.5 months of imports of goods and services. This amount of reserves was sufficient to contain even the adverse fluctuations in the exchange rate above those registered during the peak of the foreign exchange demand in the wake of the GFC.

The impact of exchange rate movements on businesses

Movements in the exchange rate affect mainly the export-import oriented businesses in the country, through increased cost of imported raw materials and intermediate goods used in the production cycles. In the past two years, the shilling has come under pressure twice. As depicted in Chart 1.3 below, the first episode came immediately after the onset of the global financial crisis in September 2008 and lasted well into the first quarter of 2009, while the second episode which is associated with the sovereign debt crisis came during the quarter ending June 2010. However, in between the two episodes, a sense of stability prevailed in the foreign exchange market.

The small and medium size enterprises, as well as manufacturing, building and construction sectors which had sailed through the crisis strongly, came under stress on their production costs during the fourth quarter of 2009 and first quarter of 2010, mainly on account of the depreciation of the shilling exchange rate that kicked-in following the sharp movements in currencies associated with the sovereign debt crisis. The Bank continues to monitor closely the movements in the exchange rate for any deviations from market fundamentals in order to address the situation according to its foreign exchange policy.

Chart 1.3: Monthly Average Exchange Rate obtained in the IFEM



Source: Bank of Tanzania

1.3 Tanzania Responses to the Global Financial Crisis

Following the outbreak of the GFC, the Tanzanian economy was not severely affected by the first round effects but the second round effects had adverse impact on the economy through trade, drying up of FDI, and decline in tourist arrivals. To weather the storm emanating from the second-round impact of the GFC, the Government and the Bank of Tanzania took discretionary measures, including targeted interventions to support the affected sectors, and protect vulnerable groups.

Monetary Policy Response to GFC

In response to the credit crunch in the economy and the nervousness in the money market in the wake of the GFC, the Bank of Tanzania on its part adopted a relaxed monetary policy stance essentially to sustain a low interest rate environment in order to enhance credit flow to the private sector. Monetary policy targets were revised upwards to accommodate monetary expansion particularly from fiscal injections. On the other hand, the Lombard and discount rates were lowered to ease accessibility by banks to emergence central bank liquidity. These measures were aimed at making liquidity readily available to banks as the need arose and also to accommodate the Government's countercyclical pressure from the budget for the two years of GFC – 2008/09 and 2009/10. Furthermore, the Bank enhanced its foreign exchange sales as a way of containing the excessive demand of foreign exchange and calming the market - in so doing, restore public confidence in domestic financial markets.

Recognizing that the Bank would have to reverse the current expansionary stance over time so as to anchor inflationary expectations and subdue inflationary pressures while preserving the growth momentum, the exit strategy will be modulated in accordance with the evolving macroeconomic developments.

Fiscal Policy Response to GFC

In view of the need to cushion the economy from the spillovers of the GFC, the Government provided a substantial fiscal stimulus in its 2009/10 Budget. In implementation, a rescue package was announced on the 9th of June 2009, whose key objectives included the following: (i) to protect employment and income levels of the population; (ii) to ensure food security; (iii) to protect key investments, especially in infrastructure; and (iv)to protect social services programs. Specifically, the package contained measures to stimulate domestic demand and targeted financial support to affected activities in the agricultural sector. The major components as accommodated in the Budget were:

- A cut in the VAT rate from 20 percent to 18 percent during the fiscal year 2009/10.
- An exemption from royalty payments for diamond and Tanzanite miners, for two years.
- An expanded agricultural input subsidy program.
- Compensation of losses incurred by agricultural cooperatives and private companies in traditional exports – mainly cotton and coffee.
- Price support in the cotton sector.
- Partial government guarantees for restructuring of commercial loans to affected sectors – manufacturing, tourism and agriculture, and a capital injection for existing credit guarantee schemes for exporters and SMEs.

- A capital injection to the Tanzania Investment Bank to finance agriculture.
- Expanded infrastructure investment, including roads and energy sectors.

The ultimate goal of the rescue package was to enable the economy to weather the storm and set a foundation for returning the economy to its medium-term growth path as quickly as possible. So far, the progress of the economic recovery is good, although the economy is not completely out of danger, particularly, in terms of remaining vulnerabilities in the recovery of the global economy, capital flows, foreign financing and in the domestic growth recovery.

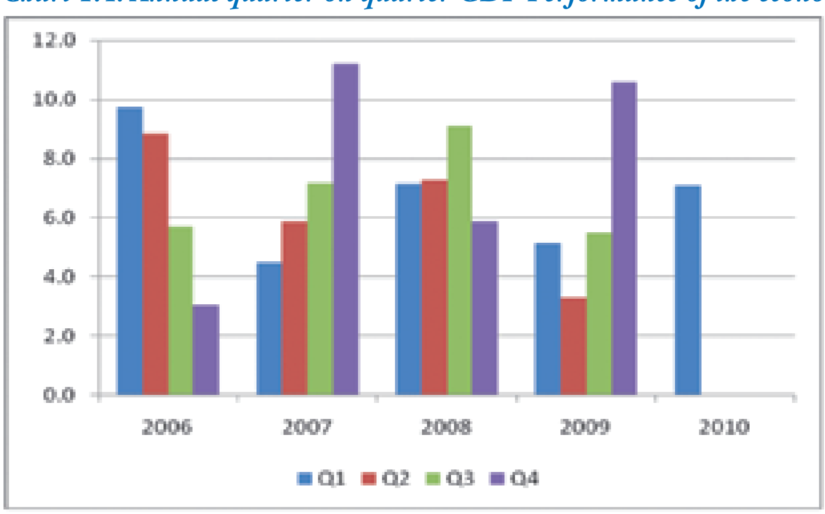
Going forward, the Tanzanian economy is still facing several challenges including: supporting the drivers of aggregate demand to enable the economy to return to its high growth path; restoring credit flow to all productive sectors; unwinding fiscal stimulus over time in an orderly manner and return to a path of prudent fiscal consolidation. Finally, the Bank of Tanzania and the Government need to address the key challenge of ensuring an interest rate environment that supports investment demand.

1.4 Prospects for Economic Recovery and Credit Conditions

Economic Growth

Prospects for better performance of the Tanzania's economy following the global recession in 2009 have begun to emerge. According to latest quarterly GDP statistics, the economy expanded by 7.1 percent during the first quarter of 2010 – representing a significant improvement over a 5.1 percent growth recorded in the corresponding quarter in 2009 (**Chart 1.4**). The strong rebound in GDP performance is mainly attributable to the improved performance in the mining and quarrying, transport and communication, as well as fishing and agriculture (which were severely affected by the crisis). During the first quarter of 2010, mining and quarrying grew by 33.5 percent, compared to a 30.1 percent contraction recorded in the corresponding quarter in 2009, whereas growth rate in fishing and communication improved from 9.0 percent to 13.8 percent and from 7.8 percent to 10.9 percent, respectively. Meanwhile, agriculture grew by only 0.3 percent in the first quarter of 2009, compared to a growth rate of 7.0 percent recorded in the similar quarter in 2008 before the crisis. However, there are signs of recovery as agricultural output has increased by 1.5 percent during the first quarter of 2010.

Chart 1.4: Annual quarter on quarter GDP Performance of the economy (2006 -2010)



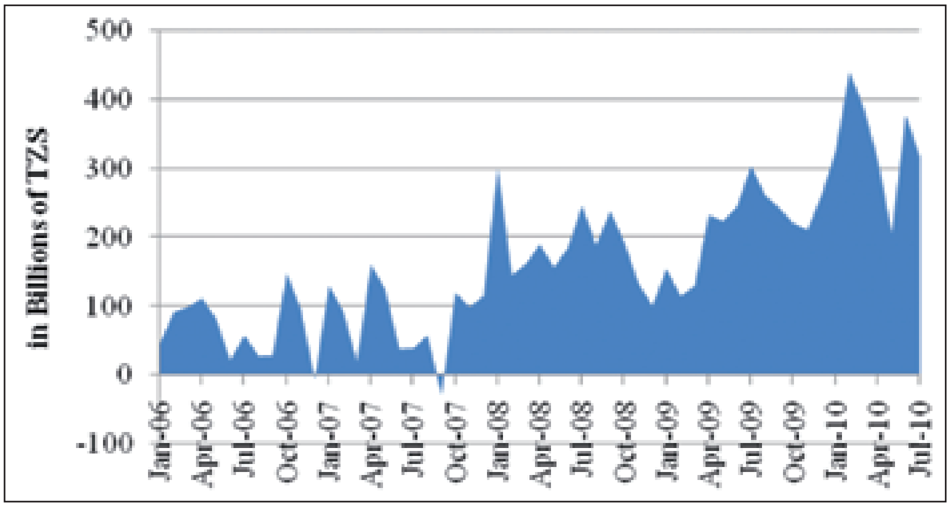
Source: Bank of Tanzania

It may be noted that the manufacturing sector whose performance was relatively strong during the crisis with an average annual growth of about 9 percent during 2008 and 2009, showed signs of a slowdown. During the first quarter of 2010, manufacturing output expanded by a modest 5 percent, compared to 7.9 percent registered in 2009. The sustained strong performance in manufacturing during the crisis was attributed to among other factors, the increased demand of cement in South Africa for world cup related construction, and the GFC limited impact on regional trade. Conversely, the slowdown in manufacturing activities is mainly associated with the decline in demand for cement. Given the good performance in the first quarter of 2010 which is comparable to the first quarter of 2008, the growth of the economy is expected to improve from 6.0 percent recorded in 2009 to around 7 percent in 2010.

Domestic Credit Conditions

Since the on-set of the global financial crisis in 2008, banks have been accumulating excess reserves on account of lack of demand from their main borrowers and a cautious lending attitude on their part. Excess reserves of banks increased from TZS 100.7 billion in December 2008 to a peak of TZS 440.6 billion in February 2010. However, in recent months as banks resumed lending in response to signs of recovery following first quarter assessment of the economy, excess reserves declined from peak at TZS 440 billion recorded in February 2010 to TZS 377.6 billion by end June 2010 (**Chart 1.5**).

Chart 1.5 Excess Reserves of the Banking System

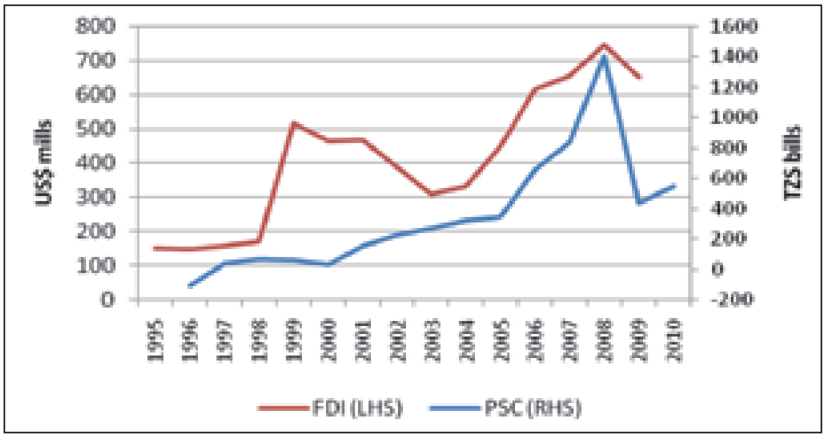


Source: Bank of Tanzania

The recovery of international capital flows was expected to contribute to the revival of credit markets in Tanzania. Available evidence suggests that the flow of FDI contributes to increased economic activity in domestic economy which subsequently stimulates demand for credit (**Chart 1.6**).

Apparently in recent years, the major recipients of FDI were also the major borrowing sectors in the domestic financial system – namely mining, manufacturing, and tourism. Thus, with the credit crunch in the international financial markets, investors in these sectors could not raise off-shore financing, which led to scaling down of operations by some investors, while others went for outright suspension. These developments resulted into a notable decline in domestic lending despite the relaxed monetary policy stance that was adopted to encourage more lending to stimulate economic activities during the crisis. Nevertheless, as risk aversion by banks is slowly dissipating mainly following the implementation of the rescue package and economic recovery prospects, private credit is gradually picking up again.

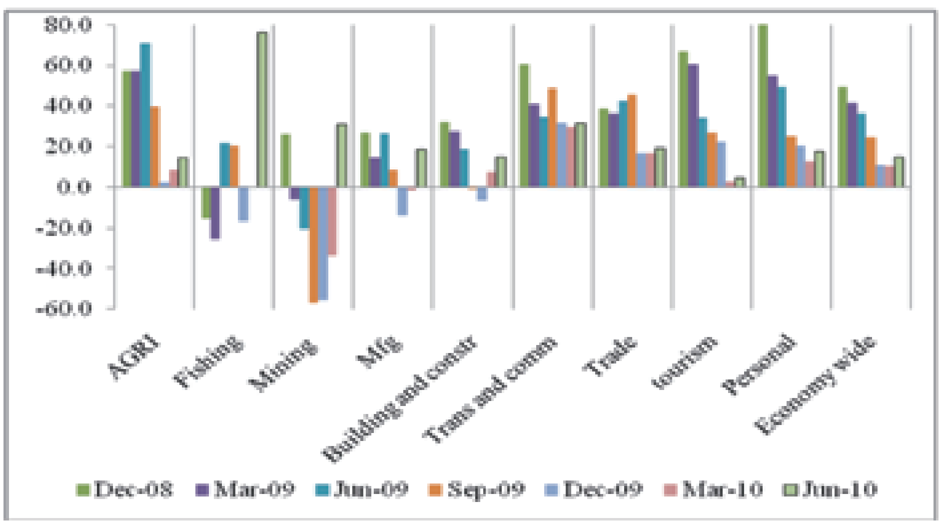
Chart 1.6: FDI Inflows and lending to private sector



Source: Economic Survey and Bank of Tanzania
Note: PSC—Private Sector Credit
FDI—Foreign Direct Investment

Accordingly, the annual growth rate of credit to private sector reached 16.3 percent by June 2010 from 9.6 percent recorded at the end of December 2009. This compares with an average growth rate of about 45.6 percent recorded during the twelve months to December 2008 and an average of 28.3 percent in 2009. Given the prevailing low interest rate environment in the government securities market and the excess liquidity in the banking sector, most banks are expected to increase their lending to private businesses in the foreseeable future. Already, lending across most economic activities recorded positive growth rates on top of the respective growth rates recorded in the quarter ending March 2010 as shown in **Chart 1.7**. There is room for further acceleration in credit to private sector as the recovery gains momentum

Chart 1.7: Quarterly annual growth rate of credit to selected sectors.



Source: Bank of Tanzania

Rebound of Credit Market in Tanzania

The DSE has recently recorded a significant increase in portfolio equity investments at the DSE and also directly in selected assets, particularly in mining and agricultural sectors, signaling partly a rebound of foreign investment activity in the economy. In addition, the participation of foreign investors in the secondary trading activities of recently listed equities has grown tremendously from a mere TZS 58 million recorded during the first half of 2009 to TZS 1.66 billion during the six months to Dec 2009, and further to TZS 4.38 billion in the first half of 2010. These developments are largely associated with the funds spill-over from multinational corporations who are increasingly accessing capital directly from international capital markets and aiming at expanding their businesses in developing countries. Meanwhile, the banking system has also recorded a sharp increase in foreign currency deposits (net of foreign assets) by a whopping 62.2 percent in the year to June 2010.

According to the analysis of sources and uses of funds in the banking system during the year ending June 2010, most banks have simultaneously increased their lending in foreign currency and in foreign placements. While all these developments point to the recovery of the credit markets in Tanzania, it is important to point out that some banks have nevertheless raised their short to medium term lending rates. This move might be on account of the pertaining risk of default mainly by small and medium businesses due to the vulnerabilities on their profits following the general slowdown in economic activity across most businesses during the crisis period and who are yet to show signs of sustainable recovery.

Box II. Selected Financial Stability Aspects and their Importance

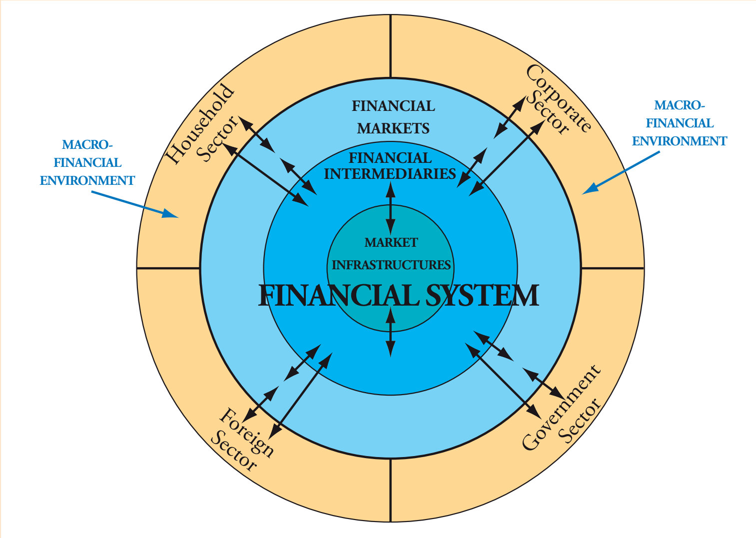
A Financial System *is made up of three components namely; (i) financial intermediaries (including banks, insurers, pension funds, etc), (ii) financial markets (as alternative sources of finance and as links between financial institutions), and (iii) financial system infrastructures including clearance, payment and settlement, as well as legal, regulatory and supervisory infrastructures.*

Financial stability: *Given the components of the financial system and their interconnectedness, financial stability can be defined as a condition in which the financial system– is capable of sustaining critical financial services including credit provision, payment and settlement services and insurance against risks, and be able to withstand shocks on financial intermediation process. On the other hand, financial instability can be started by disruptions from within or from outside the financial system. However, disturbances in individual financial institutions need not necessarily constitute financial instability if they do not impair the overall functioning of the financial system.*

Financial interconnectedness: *Financial institutions are interconnected through the asset and liability management strategies of countries, businesses and households within the domestic financial system and across borders. Countries have also become more and more inter-linked with each other, as the asset and liability management strategies of their sovereigns, financial institutions, and corporations become increasingly global in nature. Inevitably, financial globalization has brought benefits as well as vulnerabilities. The benefits of financial globalization include economies of scale, more efficient intermediation of savings, and pooling of risks. On the other hand, shocks in one part of the financial system can be amplified and transmitted through intermediaries pursuing common global business strategies that collectively become overexposed to risks. Experience has shown that the speed with which illiquidity and losses in some markets can translate into global asset decomposition - which points to the risks of the interconnectedness of institutions in financial systems.*

Systemic Risks: *Are those risks imposed by inter-linkages and inter-dependencies in a system or market, where the failure of a single entity or cluster of entities can cause cascading failures leading to bankruptcies, or bring down an entire system or market.*

SYSTEMIC APPROACH TO IDENTIFICATION OF SOURCES OF RISK:



2.0 Financial Sector Development

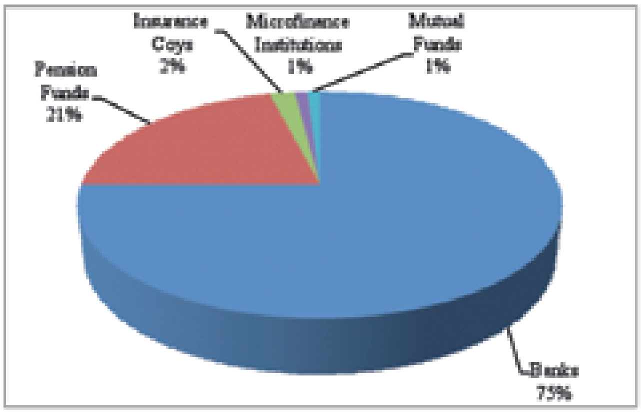
2.1 The Structure of the Financial System

The financial sector in Tanzania has undergone substantial structural change since the liberalization of the sector in 1991. The financial landscape in Tanzania is comprised of mainly banks, pension funds, insurance companies, and other financial intermediaries. However, the sector is dominated by banking institutions which account for about 75 percent of the total assets of the financial system, followed by pension funds whose assets account for about 21 percent and the insurance sector with 2.0 percent of the total assets, while the remaining financial intermediaries hold about 2 percent **(Chart 2.1)**. Financial sector assets have expanded rapidly in the past decade from a total of TZS 1,637 billion at end of December 2001 to TZS 10,040 billion in December 2009. The growth was led by private sector deposits in the banking system.

Despite the rapid growth in financial assets, the financial system depth remains small and access to finance is limited. According to Fin-Scope Survey which was conducted in 2009, the proportion of adult population who use banks and other formal financial institutions was 12.4 percent only - representing about two million adults out of the estimated twenty million. Efforts to improve financial literacy in order to enhance financial inclusion and consumer protection are part of the Second Generation of Financial Sector Reforms. The financial literacy program aims at empowering more individuals to make informed financial choices and increase the reach and coverage of consumer outreach initiatives. It is noteworthy that the ability of consumers to make sound financial decisions, which in turn contributes to financial stability by facilitating the more efficient allocation of resources and risk management in the financial system. Consequently, promoting greater financial inclusion remains a high priority for the Bank of Tanzania as part of its commitment to enhance the stability and efficiency of the financial system.

While the banking sector plays a dominant role in the financial system stability due to its intermediation function, internationally, there is a growing convergence between banking and other sectors as banks broaden their activities to include other financial services. In the EU region, banks are licensed under universal banking laws which allow them to expand their services to include banking, pension, insurance, securities and other financial services. However, the existing banking laws in Tanzania restrict banks from engaging in non-banking financial services. Banks which intend to diversify into other financial services are required to establish separate subsidiaries. The separation of banking services from other financial services provides some cushion against the transmission of shocks across different sectors in the financial system. Nevertheless, there is a significant inter-linkage across the financial sub-sectors in Tanzania.

Chart 2.1: Financial Sector Asset-based Composition – June 2010



Source: BOT, TIRA, CMSA

Banking Financial Intermediaries

As the banking institutions hold about 75 percent of the financial assets, the linkages between the banking sector and the macro economy are perceived to be particularly strong, giving rise to potential concerns about systemic risk and financial stability. As part of its mandate to ensure the stability and soundness of the banking sector, the Bank has subscribed to international prudential and regulatory standards but adapted them to the domestic specificities. With financial stability mandate in mind, the Bank of Tanzania is supervising banks on a consolidated basis, reflecting the way banking institutions themselves manage risks and, in particular, recognizing the possibility of contagion risk within a banking group. Indeed, the regular on-site examination of banks complemented by close off-site surveillance plays a major role in detecting early warning signals that would require prompt corrective action by the responsible bank. This approach has, over the years, contributed significantly to mitigate the level of risks in the banking system. In addition to the authority to supervise banks, the Bank of Tanzania's supervisory mandate is extended to banks' holding companies, subsidiaries and investee corporations in which a bank has a proprietary interest. These regulatory powers coupled with the implementation of the principles of risk based banking supervision to all banking institutions and their subsidiaries; provide a strong foundation for safeguarding the stability and efficiency of the banking sector.

By end of June 2010, the banking sector was made up of 41 banking institutions, out of which 19 were foreign owned. The banking system showed a high concentration of total assets - 57 percent - being held by four big banks, while 43 percent were accounted for by the remaining 37 banks. Generally, foreign owned banks in Tanzania account for about 48 percent of the banking industry's total assets. Despite this significant market share, the effects of the GFC had a limited direct impact to foreign owned banks, notwithstanding the credit crunch suffered by some of their parent companies in Europe and America. The cushion over external exposure is mainly attributed to the structure of the Tanzanian prudential financial sector regulation system, and the existing limitations on foreign currency placements or foreign investments by Tanzanian firms.

Non-banking Financial Intermediaries

Traditionally, insurers and pension funds have not generally been seen as being a significant potential source of systemic risk. The insurance and pension fund sectors are mostly regarded as relatively stable segments of the financial system. They are not seen as interlinked to the same extent as banks are, for example, in interbank markets and payment systems. But the interaction between insurers and pension funds, financial markets, banks and other financial intermediaries has been growing considerably over time. Today, therefore, this traditional view is being challenged. Indeed, insurance companies and pension funds are important players for financial stability depending on their size, their interconnectedness and the importance of their economic functions.

Pension funds and insurance companies are among the large investors in financial markets. For instance, pension funds deposits in the top ten banks in Tanzania represented about 10 percent of total private sector deposits in the banking system as at end June 2010. Most of the time, given the typically long-term investment horizons of pension funds and insurance companies, they provide a source of stability for the financial markets. Furthermore, pension funds and insurance companies have strong and important links with banks and with other financial institutions. Together, pension funds and insurance companies hold between 30percent and 20 percent of the total amount of outstanding government debt securities. Accordingly, due to the sheer size of their investment portfolios, reallocations of funds or the unwinding of positions by these institutions have the potential to move financial markets. In extreme cases, that could put at risk financial stability by triggering large swings in asset prices.

From a financial stability perspective, there is need to have a good understanding of the linkages among the financial system sub-sectors in order to assess the potential transmission of problems from one sector to another. It is in recognition of the contribution of pension and insurance sectors in financial stability, the Bank of Tanzania is expanding its monitoring and assessment of the financial system stability to include the two sectors.

Pension Sector

The key role of the pension sector is to provide income security for retirees. However, a sound pension system can also be a powerful force in developing capital markets and support the provision of long-term finance. By end June 2010, the sector had six pension funds covering formal sector employees.

Although the pension coverage is mandatory to formal employees, only 40 percent are covered. Pension funds' assets account for 21 percent of total assets of the financial system, while the investment portfolios of these pension funds are concentrated mainly in two areas, namely: government securities and in the illiquid commercial real estate. This stance of investment poses substantial threat to financial stability in the event government debt market experiences a significant shock and/or the bust of the growing bubble in the real estate. In this regard, the envisaged opening up of capital account transactions may offer opportunities for diversification of investment avenues for pension funds. As with banks, a similar trend of asset concentration is also observed in pension funds. The three largest pension funds hold about 85 percent of the sector's total assets.

The pension sector is currently undergoing reforms, which among others will reduce asset concentration. Broadly, the reforms are aimed at achieving the following objectives:

- Facilitating the entry of private pension funds to the financial system.
- Establishing an effective supervisory and regulatory framework for private pension funds.
- Formulation of investment guidelines.
- Instituting best practices of corporate governance in pension funds.
- Determine the level of soundness and risk management in pension funds.

So far, substantial progress has been made towards establishing an effective regulatory framework for the sector. The Social Security Act which was passed by the Parliament in June 2008, provided for the establishment of the SSRA, which will share supervisory responsibilities with the Bank of Tanzania, who has been given the mandate of supervising financial matters/transactions of pension funds. The CEO and the Board of SSRA have been appointed, while the Government is finalizing the procedures to make the SSRA operational.

Insurance Sector

The role of the insurance sector is to act as a conduit for households and firms to transfer risks to entities that are more suitable to handle them. Therefore, insurers help to safeguard the stability of household and business balance sheets by insuring their risks. Consequently, the default of an insurer could cause financial distress in these two sectors of the economy, who are also the major counterparties of the financial intermediaries. Distress in the counterparties may in turn trigger instability in the corresponding financial intermediaries.

In conducting their function, insurance firms are directly affected by economic events such as interest rate movements, which can impact asset valuation; and inflation, which can result in policyholders cashing out policies. Moreover, economic distress leading to deteriorating social or economic conditions, or obligations to pay damages as a result of judicial rulings, can result in new liabilities and potentially catastrophic losses. Aside from these direct business risks, the most significant risks to insurance companies are generated on the liability side of the balance sheet. These risks are referred to as technical risks and relate to the actuarial or statistical calculations used in estimating liabilities. In particular, premiums charged could be inadequate to cover the risk and costs. Consequently, much of the supervisory effort is directed towards examining the valuation of technical provisions, as these are estimations of the cost of future liabilities. Further, because insurance products are often complex, generally insurance companies and intermediaries (i.e., insurance brokers) are subject to market conduct, in addition to prudential regulation.

By end June 2010, the insurance industry in Tanzania was comprised of 22 insurance companies with total assets amounted to TZS 331.38 billion (compared to TZS 304.26 billion recorded in June 2009), representing an annual growth of 8.9 percent. The insurance sector shows a high concentration of total assets in few companies. Five companies hold about 70 percent of the total market share in terms of total assets, with the State owned NIC alone accounting for about 39 percent of the sector's total assets.

As with other sub-sectors of the financial system in the country, the insurance sector was not directly impacted by the GFC. However, a slowdown of the economy may have a negative bearing on the demand for risk protection and related products. Generally, in times of financial difficulties, premiums are likely to be affected on account of lower insured amounts as clients seek to reduce costs. On the other hand, claims may increase due to potential incidences of crime and fraud. Thus, during the period of financial stress, there is a possibility that valuation of assets and liabilities held by the insurance sector might be affected. This underlines the need for close monitoring of changes in the value of insurance assets and liabilities by the regulator. The insurance sector is regulated and supervised by the newly formed TIRA. To safeguard the stability of the financial system from potential risks emanating from the insurance sector, TIRA is responsible for promoting the best practices in the insurance industry to mitigate potential risks. In addition, the Bank of Tanzania in collaboration with TIRA is monitoring the financial health of the insurance companies and its implication to financial stability.

Currently, insurance companies' assets are only deployed locally and should be in line with statutory investment provisions. Specifically, insurance companies are allowed to invest in government securities up to 20 percent of their admissible assets; up to 30 percent in bank deposits whereas deposits in one bank do not exceed 5 percent of admissible assets. On the other hand, 50 percent of the prescribed minimum paid-up capital is to be maintained with the Bank of Tanzania as statutory deposits. This amount is to be used in the event of an insurance company fails to meet its liabilities. In this connection, it is important to note that under the second generation of financial sector reforms, one of the areas of reform in the insurance sector is the review of the soundness of the existing insurance intermediaries, the investment policy and the adequacy of their statutory deposits. The findings and the recommendations of the review are expected to have a significant bearing on financial stability

2.2 Cross-sector Linkages in the Financial System

The recent financial crisis has underscored the notion that to safeguard the stability of the financial system, it is not sufficient to focus only on the safety and soundness of individual institutions. Indeed, the macro-prudential approach which involves monitoring and identifying systemic risks generated by individual institutions, as well as by their collective behavior in the financial system was absolutely necessary. It is on this basis that the Bank of Tanzania is closely monitoring the impact of the inter-institutional and cross sector linkages on the stability of the financial system.

The linkages between banking, pension funds and insurance companies are the most important in relation to financial stability in Tanzania. Problems arising in any of these three sectors can have an impact on overall financial stability and vice versa. As a result, supervisors in the three sectors must take into account the advantage in taking prompt supervisory actions to prevent or remedy problems in their respective supervised financial institutions. Furthermore, supervisors should ensure public confidence in their subsectors and in the financial sector as a whole.

Loss of confidence in the banking sector can create financial instability by resulting in a run on banks by depositors, with a subsequent systemic drain on systemic liquidity, which will affect the pension as well as the insurance sector. In recognition of the potential contagion effect of disruptions in banking sector to the rest of the financial sector and also across borders, the Bank of Tanzania closely monitors the inter-linkages of the financial institutions. The objective of this surveillance is to assess the potential systemic risks and propose measures to mitigate their likely impact on financial stability.

Table 2.1: Financial System Interconnectedness (Top Ten Banks)

Amounts in TZS Billions	Mar-10	Jun-10	Changes
1. Placements with Banks Abroad	784.95	732.23	-6.72%
2. Inter-bank Placement/Lending to Domestic Banks	91.56	115.01	25.60%
3. Banking System Deposits from Pension Funds	525.24	526.01	0.15%
4. Banking System Deposits from Insurance Companies	95.01	111.28	17.13%
5. Inter-bank Deposits/Borrowings from Domestic Banks	178.44	158.66	-11.09%
6. Inter-bank Deposits from Foreign Banks	21.01	17.09	-18.65%
7. Inter-bank Contingent Claims to Foreign Banks	243.63	259.63	6.57%

Source: BOT

Linkages among banks

The operations of the banking institutions are closely linked through the payments and settlement systems and interbank placements and borrowings. As of 30th June 2010, total placements with other banks abroad for the Top Ten Banks in Tanzania amounted to TZS 732.23 billion, representing 60.9 percent of placements of the banking sector. The volume of placements started to grow due to the recovery of confidence in the global economy. The total aggregate placements by the whole banking system increased from TZS 659.25 billion in September 2008 to TZS 1,202 billion in June 2010. The main risks arising from offshore placements are associated with occurrence of banking crisis in the foreign banks and foreign exchange fluctuations. In this regard, the Bank of Tanzania prudential banking regulations require banks to diversify their placements abroad in order to mitigate potential risks. Additionally, banks are thus required to report their foreign exchange risk exposure on daily basis (**Table 2.1**).

Linkage between banking and pension sectors

There is a strong and direct linkage between banks and pension funds given that a significant volume of banks deposits come from the pension sector. For instance, at end June 2010, deposits of pension firms in the Top Ten Banks stood at TZS 526 billion – representing about 10 percent of private sector deposits in the banking system. This linkage implies an increasing level of transmission of shocks across the two sectors. As such, any distress in either sector will cause a proportionate shock to the other. Meanwhile, pension deposits in the banking system are bound to increase over time in line with increases in employment rate alongside improvements in salaries. In view of the strong linkage between the banking and pension sectors, collaboration between the respective regulators becomes imperative. The SSRA Act, 2008, provides for sharing of the supervisory role of the pension sector between the SSRA and the Bank of Tanzania. Accordingly, a Memorandum of Understanding (MOU) between the two regulators shall be prepared once the SSRA becomes operational.

Linkage between banking and insurance sectors

Insurance companies are also exposed to the banking sector through their deposits, albeit at a smaller extent compared to pension funds. The total deposits of insurance companies in the banking system account for about 2 percent of banking system's deposits. However, the linkage between the two sectors is expected to deepen in the near future, upon the completion of the envisaged changes in banking regulations which will allow banks to engage in insurance activities. This development will create a gap in the supervision process because the two financial services are currently supervised by two different regulators, namely the Bank of Tanzania for banks and TIRA for insurance. Consequently in due course, a bilateral MOU would be needed to set in motion collaborative supervision of the financial transactions between banking and insurance systems in order to make a comprehensive assessment of the risks arising from the two sectors.

Coordination of Regulators Actions in the Financial System

The GFC has cast new light on the importance of central banks to stay abreast of the rapid changes that take place in the financial system and how relationships between financial institutions, markets and financial products are evolving and the impact on the stability of the financial sector as a whole. Indeed, the growing interconnectedness across financial institutions creates a need for setting up a framework to facilitate the required surveillance of the financial system and the preparedness for financial crisis management. To that effect, the envisaged Financial Regulators Forum, whose membership will include regulators of financial sub-sectors, the Ministry of Finance and Economic Affairs and other co-opted financial stability stakeholders (as per need) will provide a platform for coordinating actions and implementation of measures needed to promote and sustain the stability of the financial system.

2.3 Performance of the Financial System

Generally, the Tanzanian financial system remains in relatively strong condition. This performance reflects several factors including the positive impact of the rescue plan that was implemented to moderate the second-round effects of the GFC on the banking sector and the economy at large; the strong balance sheets of the Tanzanian banks in the period leading into the crisis; and the limited exposure of the Tanzanian financial system to international financial markets. During the whole period of the GFC, the banking system in Tanzania has remained robust and sound with the financial soundness indicators remaining generally above the regulatory requirements.

According to the analysis which was carried out using the financial soundness indicators for June 2010, the banking system as a whole was generally liquid, well capitalized, and resilient to adverse shocks applied during stress testing of the banking system (**Table 2.2**).

Table 2.2: Financial Soundness Indicators of the banking system

Indicators	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10
1. CAPITAL ADEQUACY					
Core Capital/TRWA	19.51	19.27	18.05	20.19	19.06
Total capital/TRWA	20.12	19.70	18.49	20.53	19.36
2. LIQUIDITY					
Liquid Assets/Demand Liabilities	45.15	48.53	46.47	47.06	46.94
Total Loans/Customer Deposits	64.78	60.68	60.84	59.95	59.07
3. ACCESS TO BANK LENDING					
Claims on non-government sector to GDP	18.73	18.64	19.40	17.33	18.74
Claims on the private sector to GDP	17.87	17.81	18.54	16.63	17.85
4. EARNINGS AND PROFITABILITY					
Net Interest Margin	73.51	72.74	73.32	73.22	74.81
Non Interest Expenses/Gross Income	45.33	46.63	47.60	53.52	52.48
Return on Assets-ROA	3.61	3.41	3.22	2.68	2.85
5. ASSET COMPOSITION AND QUALITY					
Foreign Exchange Loans/Total Loans	30.67	29.59	28.88	29.12	32.07
Gross non-performing Loans/gross Loans	7.76	6.42	6.68	7.03	7.21
Large Exposure/Total Capital	146.99	133.48	65.14	93.68	161.53
NPLs net of provisions/Total Capital	24.09	17.80	17.30	15.36	17.30
Net Loans and advances/Total assets	48.76	45.99	46.32	45.22	44.82
6. SENSITIVITY TO MARKET RISK					
Forex Denominated Assets/Total Assets	29.28	27.75	28.40	27.13	30.00
Forex Denominated Liabilities/Total Liabilities	31.04	29.67	29.68	29.12	30.49
Net Open Positions in FX/Total Capital	-5.51	-18.81	-11.53	-11.52	3.36

Source: BOT

Capital Position

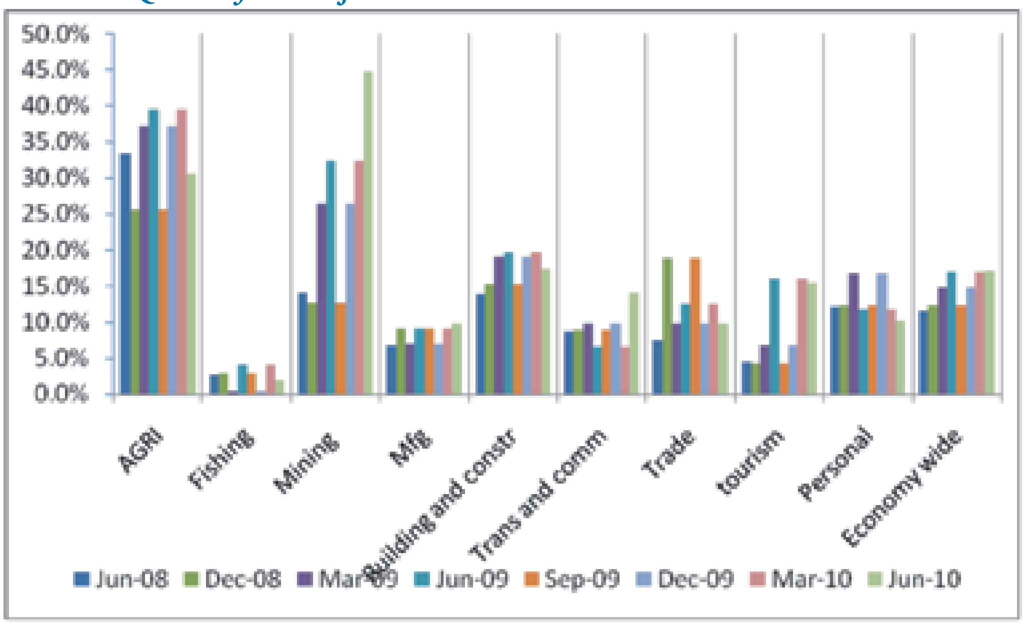
A minimum core capital to total risk-weighted assets ratio of 10 percent of a bank is imposed to all banks as a tool to ensure that banks maintain adequate capital in relation to their risk assets thus protecting depositors' interests and promoting financial stability. By end June 2010, the industry ratio of core capital to total risk-weighted assets was 19.1 percent, being above the minimum regulatory ratio of 10.0 percent. The strong capital position at an industry level provides a sizeable buffer against unexpected losses arising from credit and market risks. Without prejudice to the strong capital adequacy ratio of the industry, the Bank of Tanzania is vigilant in its prudential supervision to ensure that incipient problems in banks irrespective of the size are prudently addressed.

Asset Quality

The level of NPL is an important element when assessing the health of the financial system. In times of economic slowdown, loan repayments become constrained and thus asset quality tends to deteriorate. As per regulatory requirements, this situation would require banks to make additional provisions which in turn have an impact on banks' capital. Normally, the reported NPLs in the banking system exhibit large variation among banks, partly reflecting different exposures to distressed sectors.

During the second half of 2009, the ratio of NPL at an industry level registered a declining trend since June 2009. Within six months period, the NPL ratio declined from 7.8 percent to 6.7 percent by December 2009. This decline was in line with the implementation of the rescue package, which among others, provided for loan rescheduling and loss compensation to affected companies thus dampening the risk of default. On the other hand, during the first half of 2010, the ratio of NPLs slightly edged upwards, mainly because of the limited debt service by businesses whose profitability was impacted by the GFC (**Chart 2.5**). It is however expected that, the NPLs will start declining in the near future on the back of the strong economic prospects for 2011.

Chart 2.5: Quarterly NPLs of the selected economic activities

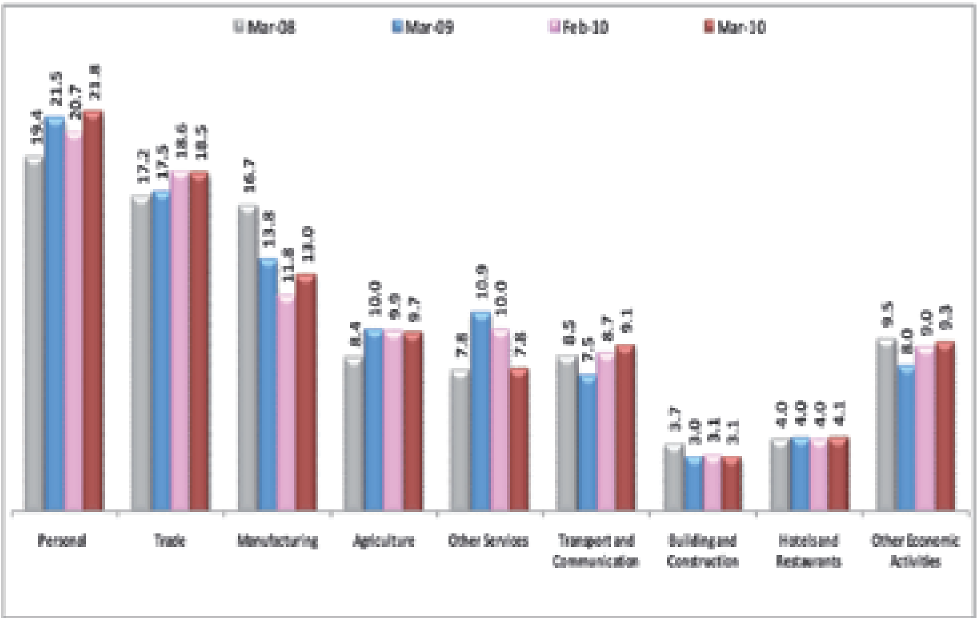


Source: Bank of Tanzania

Credit Concentration

Historical experience shows that concentration of credit risk in asset portfolios has been one of the major causes of bank distress. This is true both for individual institutions as well as the banking system at large. It is therefore important to measure concentration risk in credit portfolios of banks that mainly arises from unexpected changes in macroeconomic and financial market conditions on the performance of borrowers. Against this backdrop, the Bank monitors credit concentration in the banking system to identify early signs of credit risk. In recent years, personal loans have accounted for the largest share of private sector credit with trade and manufacturing coming next. However, the growth rate of personal loans has recently registered a downward trend (**Chart 2.6**). In addition, the NPLs in personal loans have also been on the decline. On the outlook, credit concentration is likely to be directed mainly on trade, manufacturing and agricultural sectors, as personal loans are gradually loosing prominence. Essentially, when there is substantial concentration in the loan portfolio, banks become vulnerable to the failure of large borrowers. However, the exposure of banks to failure of largest borrowers in the above three sectors is limited through government guarantee or cash collateral covering most of the large borrowers, particularly in export oriented agriculture and manufacturing.

Chart 2.6: Percentage Share of Outstanding Credit to Selected Sectors



Source: Bank of Tanzania

Earnings

Profitability in banks is derived mainly from interest income from loans, advances and overdrafts. This source accounts for about 50 percent of banks profits. The other major sources of bank earnings include foreign exchange gain from exchange rate movements – contributing about 13 percent of total income, and interest income from investment in government securities – accounting for about 10 percent. The banking sector continued to be profitable although the level of profitability declined during the post-crisis period. For the year ending June 2010, the sector recorded a decline of about 8 percent in profits after tax. The decline in profitability in the banking industry can be associated with the secondary spillover effects of GFC - namely reduced lending to private sector, reduced earnings from foreign placements, and declining returns on government securities. Similarly, the return on assets which is a measure of efficiency, declined to 2.9 percent compared with 3.6 percent recorded in June 2009.

Bank Liquidity

Liquidity risk is common in banking business and arises due to mismatch between assets which are generally long term in nature and liabilities such as deposits and borrowings which usually are of short term. The maturity profile of the assets and liabilities of banks gives an indication of the magnitude of liquidity risks in a banking institution. Regulatory requirements such as minimum cash or liquid assets ratio are imposed to ensure that banks are all the time capable of meeting the average cash withdraws at short notice. However, in the event of long or short positions, banks may have recourse either to inter-bank money market or the liquidity windows of the Bank of Tanzania.

By end June 2010, the ratio of liquid assets to demand liabilities was 46.9 percent - which was above the regulatory minimum limit of 20.0 percent. The high level of liquidity in the banking sector is attributed to a cautionary lending approach adopted by banks in the wake of uncertainty of the global financial crisis and the slowdown in domestic economic activity. However, the growth rate of excess reserves in the banking system has slowed in response to positive prospects of improved performance of the domestic economy for 2010.

2.4 Financial System Resilience

The ongoing financial sector reforms and increased investments in technology, coupled with enhanced governance and risk management practices, have strengthened the resilience of the financial sector over time. But on the other hand, the increasing level of openness of the economy and the financial system, resulting in greater integration with the external sector makes the task of preserving stability of the financial sector more complex and challenging. This challenge is poised to be amplified by the anticipated capital flows in the country following the envisaged greater capital account liberalization and the EAC Monetary Union. Indeed, the on-going reforms in the financial sector and other related developments in the real economy underscore the need for a heightened and more robust surveillance of the domestic financial system in order to safeguard the resilience of the financial system against the emerging risks and cross-border vulnerabilities.

In September 2009, the FSAP Mission – a joint team of the IMF and World Bank conducted a comprehensive assessment of the resilience of the Tanzanian financial system, while giving special focus on assessing the resilience of the banking sector - which as mentioned earlier represents about 75 percent of the financial system's exposure to financial risks. The final FSAP Report was published in June 2010. The full FSAP report can be accessed online at www.imf.org

Stress Testing on Tanzania Banking System

In monitoring the stability and resilience of the financial system, the Bank of Tanzania conducts on quarterly basis stress tests on the banking system balance sheet against extreme shocks - using a multifactor model. However, overtime, the stress tests will be extended to pension and insurance sectors. The stress testing involves examining the impact of key risks, namely credit, interest and exchange rate, and the liquidity risk on individual banks and on the consolidated balance sheet of the banking industry. The size of the applied shocks is determined by various considerations including the largest historical movement and the projected behavior of the aggregate in the short term.

During the year ending June 2010, the results of the quarterly stress tests showed that the Tanzanian banking system was resilient to adverse changes in interest rates, exchange rate, and non-performing loans, while liquidity levels were sufficient to cushion the system against adverse liquidity risk. The strong resilience to shocks was driven primarily by strong capital positions of banks and other financial soundness indicators performing above prudential requirements throughout the year under review.

Credit Risk

Credit risk is defined as the potential that a bank's borrower will fail to meet its obligations according to agreed terms. Credit risk is inherent in the principal activity of banks and is therefore the single largest factor affecting the soundness of financial institutions and the financial system as a whole. A credit risk has a significant bearing on banks' earnings and solvency. Thus, credit risk management is crucial in a bank's risk management framework. The capital adequacy ratio maintained by banks would give an indication of the degree of risk averseness of the banking sector. Indicators of potential credit risk lie mainly in loan concentration and the ratio of non-performing loans. Credit risk can be significantly mitigated by the use of proper collaterals and adequate loss provisioning.

Concentration of Credit Risk

This type of risk arises from credit concentration in few sectors – a situation which can pose serious stability concerns in the banking sector. It is on this basis, that the Bank of Tanzania is carefully monitoring this potential risk area, while subjecting the large exposures to stress tests. Specifically, banks are required to comply with regulatory requirements to limit the level of concentration of risks in a single borrower. However, the Bank has discretionary powers to exempt a bank on a single borrower exposure limit. Concentration of credit risk can also occur due to substantial exposure to a single asset class. Large exposures are defined as credit facilities exceeding 10.0 percent of core capital net of cash cover and measured by the ratio of the amount of large exposure to total capital. Based on the definition of large exposures in the banking system, it is noteworthy that, the ratio has been declining over time. The decline in credit concentration is attributed to the growth in capital levels and portfolio diversification in banks.

Exchange Rate Risk

Exchange rate risk is generally defined as the possible direct loss (as a result of un-hedged exposure) or indirect loss in the firm's cash flows, assets and liabilities, net profit emanating from an exchange rate movement. Specifically, a direct impact of the exchange rate risk would be felt by a financial institution holding a position in foreign currency, whereas an indirect impact would be on the borrowers or counter-parties of the respective financial institution.

In the Tanzanian banking system, foreign exchange rate risk is mainly dampened by the fact that, borrowers in foreign currency are mainly concentrated in the tradable sectors whose cash flows are also in foreign exchange. This stance implies that their exposure is already hedged against exchange rate fluctuations. By end June 2010, the banking sector seemed to be well cushioned against the exchange rate risk, as reflected by the ratio of foreign exchange assets/total assets at 30.0 percent - being more-or-less equal to that of foreign liabilities to total liabilities, which was recorded at 30.5 percent.

Interest Rate Risk

Stress testing for interest rate risk attempts to determine the impact on financial stability of a change in interest rates through the consequent effect on interest income/expenses as well as the interest sensitive components of the balance sheets of financial institutions. Interest rate risk can occur when a change in rates results in a mismatch of interest rate sensitive assets and liabilities and also when change in rates have an impact on the creditworthiness of borrowers and their ability to repay. Consequently, banks are required under prudential supervision to hold adequate capital for providing a cushion against potential losses that might arise due to changes in interest rate structure in the banking system.

Liquidity Risk

Liquidity is defined as the ability of a bank to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses. Given this definition, liquidity risk is attributed to the inability of a financial institution to meet its liquidity obligations as they come due even on short notice. The stress test done by the Bank examines the ability of banks to withstand the risk that customers would want to withdraw their most liquid deposits (demand deposits plus a maximum allowed amount on savings deposits) within 5 consecutive days. In mitigating liquidity risk in the banking system, the Bank of Tanzania requires all banks to put in place effective contingent liquidity plans including the scenario of accessing the intraday, Lombard and lender of last resort facilities from the Bank of Tanzania.

3.0 Financial System Infrastructure and Regulation

3.1 National Payment and Settlement Systems

The National Payment System (NPS) is a vital component of the broader financial system which supports financial stability in the economy. The payment system has the potential to become a channel through which financial risks can be transmitted across financial institutions and beyond the system and its participants. The values and volumes of transactions processed through the NPS carry intrinsic credit and settlement risks which might expose the whole payment system to potential systemic risks. Furthermore, failure of any payment and settlement system would undermine public confidence which may trigger instability in the financial sector.

As the Bank of Tanzania has a legal mandate to oversee the safety and soundness of the NPS, including the effectiveness and the efficiency of the interbank settlement system, the Bank provides prudential oversight of the system and implements measures to ensure the resilience and keeping-up with modernization of the system in line with adapted international best practices and standards. As a result, the NPS is continuously evolving to accommodate the new developments in the domestic and international payment and settlement industry. In recognition of the impact of payment system's risks to financial stability, the Bank of Tanzania ensures that the limits set on value of specific instruments are adhered to and that payment systems parameters are continuously monitored.

The Tanzania Interbank Settlement System

TISS is a real time gross settlement system operated by the Bank of Tanzania. By virtue of the large values of payments that are settled through the system and its inter-connections of the participating financial institutions, TISS is a systemically important payment system. Consequently, TISS is a critical financial infrastructure in the country which has a huge bearing on financial stability. Based on this importance, several measures have been taken by the Bank to enhance its safety and resilience.

On average, the large-value transactions, settled on real time comprise about 80 percent of the total value settled, while the balance represents the low-value batch settlements. The growing interaction of the financial market and TISS (through participating banks) has demonstrated the robustness and efficiency of the processes and procedures put in place which, in turn, contributes to the stability of the NPS. On the other hand, the low-value high-volume transactions make up the batches and are cleared by the Bank of Tanzania Electronic Clearing House and settled in consolidated batches at specific times of the day.

Retail Payments Systems and Instruments

In the area of retail payments, the Bank's focus is on preserving public confidence in the use of retail payment systems and instruments and establishing adequate consumer safeguards. During 2009, several suspicious transactions and fraud incidences related to Automated Teller Machines (ATM) were noted. In response, the Bank of Tanzania directed all banks operating ATMs to migrate from magnetic stripe cards to chip-based ATM cards. In addition, the Bank directed participating banks to conduct regular reviews of their retail payments systems with a view to improving the systems' security and operational reliability of their services.

To underpin confidence in the use of ATMs, the Bank collaborated with other stakeholders to explore effective ways to proactively combat fraud in this segment of the payment system. A special Task Force was formed drawing members from the Police Force, Tanzania Bankers' Association and the Bank of Tanzania to formulate an effective regulatory framework to ensure and safeguard the integrity and reliability of card payment schemes in the country. Besides the local collaborative measures, concerted efforts to counter such fraud are also being taken by the industry and the relevant international card brand owners. These efforts are directed on two main areas, namely: enhancing the protection of card data and improving the identification and authentication techniques. While the disruptions to retail payment systems may not have systemic implications by virtue of the small value of transactions involved, the impact would be widespread inconvenience in view of the growing volume of transactions that are being processed through ATMs – implying a growing participation of the financial literate population in ATMs. Therefore, if the disruptions are prolonged, they might erode public confidence in the use of such systems and curtail the envisaged promotion and migration to e-payments.

Mobile Payment Services

Tanzania is experiencing strong growth in number of mobile subscribers. According to provisional data as of June 30, 2010, the number of mobile phone subscribers reached 18.5 million, while that of registered users of mobile payments services stood at 9.2 million by end July 2010. The strong increase in the number of subscribers to the mobile payments is mainly attributed to limited access to formal banking services especially in the rural areas. In this regard, the mobile payment provides an avenue for linking bank account holders to the unbanked population. In addition the service provides convenience in making payments for specified utilities and other consumer services. Specifically, mobile phone payment services are mainly used to facilitate top-up of mobile phones credit, airtime transfers between mobiles, funds transfer and corporate bill payment services.

Currently, mobile payment services are provided by two commercial banks and four mobile network operators. The legal and regulatory requirements of the mobile phone payment system require partnering of service providers with commercial banks. The existing arrangement creates gaps in the regulatory framework because the mobile phone payments services are regulated by two regulators, each with a limited scope of coverage. The Bank of Tanzania focuses on the financial transactions, while Tanzania Communication Regulatory Authority (TCRA) regulates the communication infrastructure. In recognition of the importance of developing a rigorous supervisory oversight for this fast developing mobile banking industry, the Bank of Tanzania has signed an MOU with TCRA which provides a mechanism for regulatory and supervisory coordination between the two regulators.

Box III: Generic Risks in Payment Systems and Possible Mitigation Measures

Inability of one of the participants to meet its obligations, or a disruption in the system itself, could result in the inability of other system participants or the inability of financial institutions to meet their obligations as they become due. Such a failure could cause widespread liquidity or credit problems and, as a result, could threaten the stability of the financial system. To mitigate potential risks, information systems and monitoring procedures need to be developed to support the application of rules and procedures related to the monitoring and control of risks in the payment system. The provision of real-time information to participants on the processed payments and settlements as well as their closing positions relative to risk management limits and information on the associated stiff penalties on breaching the limits - would go a long way in safeguarding the stability of the payment system through self-imposed oversight. Specific risks to the financial system may include the following:

Credit Risk: *This is a risk that a party within the payment system will be unable to meet its financial obligations within the system either when due or at any time in the future. The credit risk can be minimized among others, by setting limits on the maximum level of credit risk that can be created by any single participant, and by setting penalties for non-compliance to such limits. It is important that such penalties should reflect losses that could result within the system from participant failure to meet financial obligations as per relevant regulations/guidelines.*

Liquidity Risk: *The risk that a party within the payment system will have insufficient funds to meet financial obligations within the system as and when expected, although it may be able to do so at some time in the future. This risk can be mitigated by ensuring adequate intraday liquidity facilities and incentives to pay promptly. Furthermore, the system should also ensure the availability of central bank liquidity at all times for needy banks and ensure application of stiff penalties if such facilities are not repaid by end of the system's operating hours to avoid moral hazard and abuse of liquidity facilities.*

Legal and Regulatory Risk: *It is important to note that a sound legal framework is fundamental for risk management in the payment system. Rules and procedures of the system should be such that they contain prone areas where the risks are likely to emerge. Thus, a poor legal framework or legal uncertainties may cause or exacerbate credit and liquidity risks in the payment and settlement systems. Therefore, measures to mitigate the potential legal risk may include:*

- *To put in place a complete and reliable legal framework and system's rules and procedures that enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participating in it.*
- *To put in place a clearly defined procedural manual for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and stipulating appropriate incentives to manage and contain risks.*

Operational Risks: *This risk occurs when operational factors such as technical malfunctions or operational mistakes cause or exacerbate credit or liquidity risks. For instance, massive malfunctioning of ATM may cause systemic risk to the financial system. To mitigate operational risks, the design of the payment system should ensure high degree of operational resilience through reliable technology – which should be sufficiently flexible to respond to changing demands. In addition, it is necessary to have in place effective business procedures and manuals to facilitate safe and efficient operations of the system. It is also important to have adequate backup of all hardware, software and network facilities, and the system should be tested and audited frequently.*

3.2 Safeguarding Payment Systems Stability through Risk Reduction Measures

In pursuing its mandate of safeguarding the stability of the payment system, the Bank through the oversight and surveillance of the NPS, identifies potential sources of risks in the system, and make an assessment of potential impact to the system in order to devise measures to contain the systemic risks. Over the years, the NPS, including the TISS has proven to be efficient and effective. The following is a review of the risk reduction measures implemented by the Bank of Tanzania so far in a bid to safeguard the stability of the payment system.

Liquidity provision in TISS

Liquidity is the backbone of every payment system. Without sufficient liquidity to fund the payment instructions, the system would cease to function. The TISS specifications allow for the monitoring of each settlement bank's liquidity and provide an early warning signal should any settlement bank tend to hoard liquidity or display signs of possible liquidity problems. Moreover, the system provides a dynamic collateral facility to enable the automatic granting of loans. Should a bank not have sufficient funds available in its settlement account to settle a payment instruction, a loan will be granted automatically against acceptable collateral reserved in the system. Essentially, the management of liquidity within the payment system provides stability in the NPS and the financial system as a whole. In times of crisis, the ability to monitor the liquidity available to the banks and the payment flows tend to be a valuable tool to reduce the risk of systemic failure.

Limitation of item values

Setting of maximum value limits on specific payment instruments helps contain the excessive exposures for the settlement banks and thus preserve the stability of the payment and settlement system. To this effect, in March 2009, the Bank of Tanzania introduced the maximum value for payment cheques through the NPS. Accordingly, members of the clearing houses in the country were required to present only cheques with value below TZS. 10.0 million. Conversely, items of higher values were cleared through real-time payment stream. This move resulted in more than 80 per cent of total value being settled with immediate finality, enhancing liquidity and reducing credit and settlement risks within the TISS.

Shortening the settlement schedule

It is noteworthy that the shorter it takes to settle financial obligations in the payment system, the more it reduces bottlenecks/ backlogs of transactions requiring processing at the end of each day. The shortening of the settlement cycle proportionately reduces the level of credit and liquidity risks and also instills confidence in the financial system. Hence, the ultimate goal for the Bank of Tanzania is to achieve intraday settlement in the national payment system. While the intraday finality in TISS transactions help to mitigate settlement risks, challenges remain in the settlement of low value – high volume transactions done through cheque system.

Currently, the settlement cycle for cheque system takes between two to five days, thus exposing the transacting parties to considerable financial risks, including criminal actions which are inherent with large value instruments. To address this risk, the Bank is diligently promoting the usage of TISS. The implementation of cheque capping in the clearing houses subsequently increased the use of TISS. Furthermore, the recent decision by the Government to join TISS would also increase the value and volume of intraday transactions with minimum financial risks.

To conclude this section on the impact of risk reduction measures within the national payment systems, a number of credit, liquidity and settlement-risk reduction measures have been introduced by the Bank of Tanzania over the past number of years. This has led to the NPS being one of the strong pillars supporting financial stability in Tanzania. Values and volumes processed in the NPS are growing steadily and so the risks pertaining to the large-value and high volume payment environments are constantly being addressed and resolved. Lastly, the national payment system is continuously evolving to accommodate new developments in the domestic and international payment and settlement industry.

3.3 Developments in the Financial System Regulation

The Bank of Tanzania conducts regular review of the legislative and regulatory measures in use for the banking sector and the national payment system so as to identify areas that need enhancement. The review process has led to – among others - the enhancement of the required minimum core capital for banks from TZS 5.00 billion to TZS 15.00 billion, with a view to strengthening the capability of the banking system to absorb potential losses. The proposed changes are also expected to improve solvency level of the industry, encourage consolidation and mergers, and further promote competition in the banking sector. On the other hand, the adequacy of the existing crisis response mechanism to address a systemic crisis is being examined. Specifically, the state of crisis preparedness within the financial sub-sectors and the role of the Deposit Insurance Board in safeguarding the stability of the financial system are among the areas that are being critically examined by the Bank of Tanzania with a view to putting in place an effective national financial crisis management and resolution framework, which will also include effective depositor compensation arrangements.

The current financial crisis has generated a range of proposals and recommendations for strengthening the resilience of the global financial system, which might be adapted by countries at national level. The envisaged regulatory reforms are centered on: strengthening capital; enhancing transparency and valuation; and strengthening governments' responsiveness to risks in the financial system. The key items on the international financial regulatory agenda include: changes to capital requirement, appropriate oversight and systemic crisis management and resolution frameworks.

According to the new proposal by the Basel Committee of Banking Supervision on capital known as "Basel III", the Committee seek to increase the quality and quantity of capital (especially Tier 1 capital) and to discourage banks' excessive leverage and risk taking. Under this new proposal, among others, banks are required to maintain a minimum core capital ratio of 6.0 percent of risk-weighted assets and an overall total capital ratio of 8.0 percent. In addition to minimum capital requirements under the new proposal, banks will have to hold a capital conservation buffer of 2.5 percent of risk-weighted assets to withstand future periods of stress. With the conservation buffer, the new minimum ratio to risk-weighted assets for core capital is 8.5 percent and 10.5 percent for total capital. At this juncture, it is worth to take note of progress made by Tanzania with regard to strengthening regulatory capital requirements. Currently, the Bank of Tanzania requires banks to maintain core capital ratio of 10.0 percent to risk-weighted assets and 12.0 percent for total capital, both of which are already above the new Basel requirements.

The international reform agenda also calls for enhancement of the oversight of the financial systems in order to ensure that all systematically important institutions and markets are subject to appropriate regulations and supervision. Special attention is given on developing effective ways to enhance the oversight and regulation of non-banking financial institutions such as insurance companies, pension funds – which prior to the crisis; these were less regulated in most countries. Also, ways to strengthen the payment and settlement systems are being developed. The Bank of Tanzania is collaborating with other EAC member states to examine and consider the relevancy of the recommended reforms to financial stability in the region and Tanzania in particular.

3.4 Measures to Safeguard Financial Stability in Tanzania

The GFC has constituted a long awaited wake-up call that countries cannot ignore and one that carries three powerful lessons/requirements that Tanzania like most countries is addressing in order to promote and sustain financial stability at a national level. The first lesson is with regard to the urgent need for all regulatory regimes in the financial sector to strengthen their respective financial regulations and practices. The second imperative is the establishment of a framework to facilitate closer collaboration and coordination among domestic regulators as well as with regional regulators in the regulation of cross-border institutions. The third requirement is the establishment of a national financial crisis management plan.

Specifically, the Bank of Tanzania is focusing on the following priority areas as its pillar for sustaining financial stability in the economy:

- Continuation of sound monetary policy to ensure price stability in the economy. This is an essential pre-condition for sustainable economic growth and maintenance of macroeconomic stability and financial stability in particular.
- Sustenance of daily surveillance of the financial transactions in the banking sector and through the payment and settlement systems. This enables the Bank to identify any early warning signals of systemic risks to the financial system, and hence take appropriate measures.
- Sustenance of prudential surveillance and supervision over banks and the national payment system in order to strengthen the resilience of the banking and payment systems, respectively. With regard to banks, the Bank of Tanzania will continue to perfect its model of risk-based banking supervision. The on-site risk based examination of banks is complemented by an off-site surveillance – a combination that plays a major role in detecting early warning signals of any financial distress and facilitates pre-emptive interventions.
- Speeding up of the establishment and operationalization of Credit Reference Bureau to facilitate the sharing of information on creditworthiness of customers in the banking system – as one of the measures of managing credit risk.
- Ensuring compliance by banks to the new increased capital requirements within the agreed grace period. This capital enhancement on its own is not a substitute for banks' own risk-management practices. Consequently, the Bank of Tanzania shall continue to require banks to put in place and sustain robust mechanisms for risk assessments of their operations to facilitate timely detection and reporting of any emerging risks.
- In addition to the work of the Financial Stability Department, the Bank is committed to make the envisaged financial regulators forum provide an effective platform for coordination of financial crisis preparedness and management in the country.

- Enhancement of crisis response mechanism through development of an effective and coordinated national financial crisis management and resolution framework. This involves among others, strengthening the role of the existing DIB in safeguarding financial stability and preserving public confidence in the financial sector, and development of contingency plans for provision of systemic emergence liquidity in times of need; and for systemic bank resolutions.
- Enhancement of coordination between the Bank of Tanzania and its regional peers in order to promote the state of readiness to handle emerging challenges associated with the envisaged EAC-Monetary Union and further capital account liberalization. Furthermore, the Monetary Affairs Committee of EAC central banks has assigned to the Bank of Tanzania a coordinating role in harmonizing the EAC member states' financial stability frameworks in a bid to develop a regional framework for financial stability analysis and reporting. The assignment has come at an opportune time when member states need to address the growing exposure to cross-border risks as their domestic banks increase their regional operations.

3.5 Financial Stability Outlook

The overall outlook for domestic economic growth in the remaining half of 2010 remains strong, while GDP growth for 2011 is projected at around 7 percent. This strong growth sentiment helps to enhance the prospects for continued financial stability going forward. In the next 12 months, the financial intermediation process in the banking system is expected to gain momentum as credit flow to private sector is being unlocked in line with the anticipated increase in economic activity. Consistently, the non-performing loans of the banking system are expected to decline further as economic activity and corporate profitability improve. All in all, judging from projections of banks' earnings and profitability for 2011, the banking sector looks likely to remain robust in the short to medium term.

On the other hand, the outlook will also depend on the extent of global economic recovery, which would in turn, impact on the demand for exports and tourism. Moreover, should the recovery of the global economy continue to be uncertain and the dollar continues to weaken, there is a high possibility of further increases in global oil prices. Indeed, the increase in oil prices has a substantial upward influence on production costs and ultimately on inflation. All these negative possibilities point to the fact that uncertainties will always remain on financial stability outlook. The Bank of Tanzania is however taking comfort among others, in the downward trend in inflation and the level of foreign reserves in terms of adequate import cover and provision of a sufficient buffer to contain excessive exchange rate movements and any emerging pressures on the balance of payments.

To consolidate and sustain financial stability so far achieved, the Bank will maintain its close monitoring of the impact of domestic and global economic developments, and assess their impact on the Tanzanian financial system in order to identify early warning signals of financial instability and henceforth promote implementation of measures to mitigate the emerging or potential instability in the financial system.