

**Two Generations of Tanzania Financial Sector Reforms from 1991:  
From Washington Consensus to Institutional Economics.**

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*Dekan*

*Erstberichterstatter*

*Zweitberichterstatter*

*Tag der mündlichen Prüfung*

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## **Dedication**

To my mother, Mary, for her love, support, character formation and inspiration!

In loving memory of my father - Lazarus, and my sisters - Beatrice and Deodatha!

To His Excellency Archbishop Paul Ruzoka, my teacher, mentor and spiritual leader.

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## List of Abbreviations

ABSA	Amalgamated Banks of South Africa
AML	Anti-Money Laundering
ATI	Association of Tanzania Insurers
ATM	Automated Teller Machine
BDI	Burundi
BEN	Benin
BEST	Business Environment Strengthening for Tanzania
BFA	Burkina Faso
BFIA	Banks and Financial Institutions Act
BGD	Bangladesh
BOT	Bank of Tanzania
CAF	Central African Republic
COM	The Comoros
CRDB	Cooperative and Rural Development Bank
CSMA	Capitals and Securities Market Trust
DANIDA	Danish International Development Agency
DFID	Department for International Development (UK)
EACB	The East African Currency Board
EAS	The East African Shilling
ETH	Ethiopia
FGFSR	The First Generation of Financial Sector Reforms
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GEPF	Government Employees Pension Fund
GMB	Gambia
HTI	Haiti
IFEM	Inter-bank Foreign Exchange Market
IMF	International Monetary Fund
ISD	Insurance Supervisory Department
IT	Information Technology
KEN	Kenya
KGZ	Kyrgyzstan
KYC	Know your customer
LART	Loans and Assets Realisation Trust
LBR	Liberia
LIC	Low Income Countries
MDG	Madagascar
MLI	Mali
MMR	Myanmar
MOZ	Mozambique
MWI	Malawi
NBC	National Bank of Commerce
NIB	National Insurance Board
NIC	National Insurance Company
NIE	New Institutional Economics
NMB	National Microfinance Bank
NPL	Non-Performing Loans
NPL	Nepal

NSSF	National Social Securities Fund
OECD	Organisation for Economic Co-operation and Development
PBZ	People's Bank of Zanzibar
PPF	Parastatals Pension Fund
PSCP	Private Sector Competitiveness Project
PSPF	Private Sector Pension Fund
ROA	Returns on Assets
ROE	Returns on Equity
RWA	Rwanda
SGFSR	The Second Generation of Financial Sector Reforms
SIDA	Swedish International Development Agency
SOE	State Owned Enterprises
SPILL	Strategic Plan for Implementation of Land Law
SSA	Sub-Saharan Africa
SSRA	Social Securities Regulatory Authority
TBA	Tanzania Bankers' Association
TCD	Chad
THB	Tanzania Housing Bank
TIAA	Tanzania Insurance Agents Association
TIB	Tanzania Investments Bank
TIBA	Tanzania Insurance Brokers Association
TIRA	Tanzania Insurance Regulatory Authority
TJK	Tajikistan
TZA	Tanzania
UGA	Uganda
URT	United Republic of Tanzania
USA	United States of America
WW1	The First World War
WW2	The Second World War
ZAR	Democratic Republic of Congo (Zaire)
ZMB	Zambia
ZSSF	Zanzibar Social Securities Fund
ZWE	Zimbabwe

## **Abstract**

This study investigates about the process of financial sector reforms in Tanzania from 1991, in what have come to be known as the first and second generations of financial sector reforms. Tanzania was a socialist country from 1967 up to 1985. With the change in the presidency in 1985 for the first time since the independence, socialism was abandoned.

From early 1980s up to 1985 Tanzania was in a very serious economic crisis and in urgent need of assistance. It is at that time when the new president accepted the conditionalities of the IMF/World Bank and started to embark on Structural Adjustment Programs (SAPs) with a view to stabilize the economy and open it up for the free market system. As part of the SAPs, in 1991 the Banking and Financial Institutions Act was enacted, which is the turning point in the history of the financial sector in Tanzania. Private Banks, both domestic and foreign were allowed to enter the Tanzanian market and do their business. This marked the beginning of the first generation of financial sector reforms.

This study was motivated by the question why two generations in two decades? It seeks to answer the following questions: 1) Why was it that Tanzania had two generations of financial sector reforms in only two decades? 2) What is the difference in focus in the two sets of reforms? 3) What are the theoretical underpinnings of the reforms in the two generations and 4) What could still be done for a better financial sector?

Data were generated mainly from the project documents that designed and implanted those reforms (appraisal documents and implementation reports). These documents were supplemented by semi structured interviews for the policy makers, and the quantitative data from the databases of the IMF/World Bank and the BOT.

From data analysis it is clear that the approach of the first generation of financial sector reforms was not going to yield the desired results, because there were no adequate foundation

of supporting institutions for the functioning of the private sector, such as the quality of property rights, the quality of registries, absence of credit information and referencing, and weak contract enforcement mechanism. So the private institutions were limited in the width of offering their services, albeit still making good profit. They could not improve significantly the outreach of financial services, especially in credit extension in general and long term credit in particular.

The SGFSR were designed after the IMF sponsored Financial Sector Assessment Program, and were to be built on the foundations of the FGFSR. Their preoccupation was to create the necessary institutions that were lacking and to improve the quality of the existing institutions that support financial sector development, such as land regulations and management systems, contract enforcement mechanism, credit bureaus and the framework for long term finance.

At the time of writing the report already positive signs of development of the financial sector are evident. Great opportunity has come in the area of mobile phone financial services, and regulators need to encourage innovations in that regard while ensuring the safety of the system.

# Chapter 1

## Introduction

### 1.0 Background to the Problem

In September 2008 the housing bubble burst. The bursting started with the collapse of Lehmann Brothers, and triggered the worst financial crisis since the Great Depression. A summary of the sequence of events that triggered the crisis is shown in Table 1. The bursting of the bubble set into motion the process that brought about massive losses first to Lehmann Brothers and then to the other big financial institutions that were connected with it in their business in what is known as the Domino effect, spreading the effects to the real sector as well. The contagion manifested more evidently in the housing sector, where most of the subprime mortgages defaulted, because of the drastic fall in the prices of homes, forcing foreclosures and leaving the banks in possession of properties that could sell only at massive losses.

**Table 1: Steps to 2008-2009 Financial Crisis**

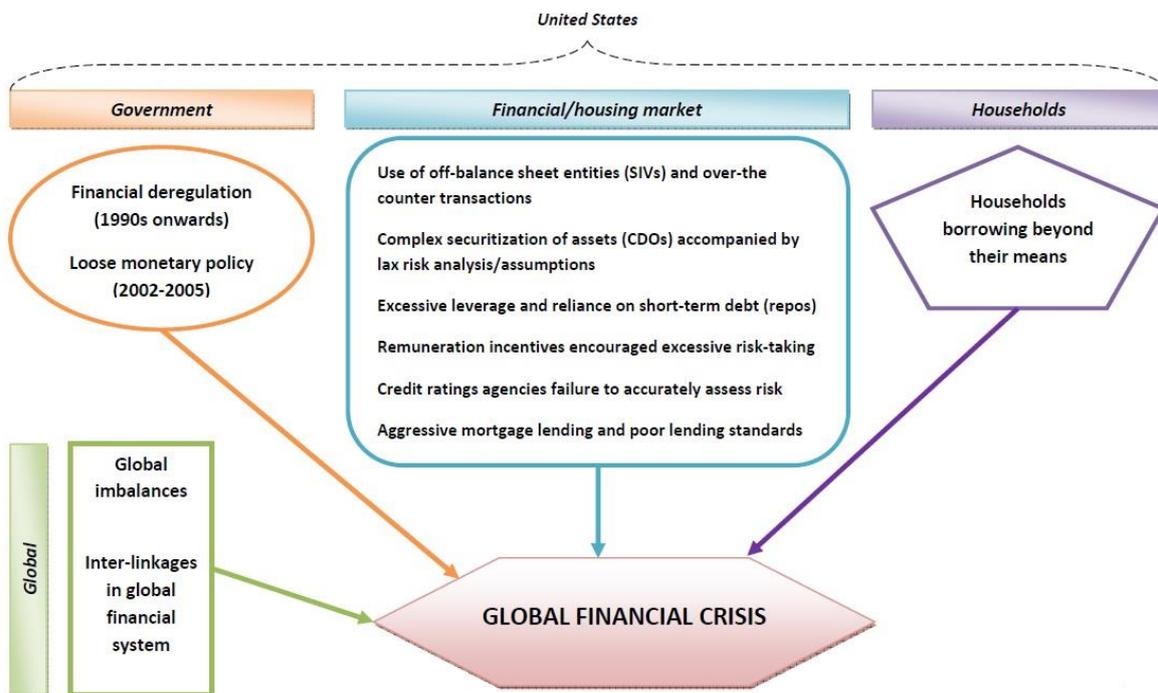
	Step	Risks
1.	Household borrows from the originator (broker or lending institution)	<ul style="list-style-type: none"><li>• Assymmetric information – broker did not fully know the creditworthiness of the borrower</li><li>• Lax lending standards further deteriorated in 2004 and 2005 (‘teaser’ interest rates no equity loans, no documents)</li><li>• In some states in the US the mortgage contract is ‘without recourse to the borrower’ – i.e. households can walk away from the mortgage</li></ul>
2	Originator sells the mortgage to another financial institution	<ul style="list-style-type: none"><li>• Perverse incentives – since the risk was sold on, originators had the incentive to sell as many mortgages as possible (‘originate-to-distribute’ model)</li></ul>
3	Financial institutions issue mortgage-backed securities (MBS)	<ul style="list-style-type: none"><li>• MBS issuers (particularly the government sponsored enterprises, Fannie Mae and Freddie Mac) transferred thousands of loans to structured investment vehicles (SIVs), an off-balance sheet special purpose vehicle (SPV) which allowed these institutions to avoid capital requirements (allowing greater leverage). These SIVs had to be brought back onto the balance sheet once securities were downgraded after the crisis started.</li><li>• Securities were separated into senior, mezzanine (junior) and non-investment grade (equity) tranches, but effective tranching relies on assumption that proper risk analysis on the underlying assets was done (which was not the case).</li><li>• Mortgages were selected from geographically diverse areas but the risk of correlated default was much higher than predicted.</li><li>• Securitization increased rapidly since 2001, which was based on the growth of sub-prime and Alt-A loans.</li></ul>
4	Private financial sector issues collateralized debt obligations	<ul style="list-style-type: none"><li>• CDOs issuers purchased different tranches of MBS and pooled them together with other asset-backed securities (backed by such assets as credit card, auto, business and student loans)</li></ul>

		<ul style="list-style-type: none"> <li>• CDOs 're-securitized' securities allowing further re-distribution of risk (and hence, adding further complexity), converting some of them into new senior AAA-rated securities.</li> <li>• Investment banks were not supervised like commercial banks and thus were not required to adhere to capital requirements. These banks could borrow short-term and hold risky longer-term assets with low levels of capital.</li> </ul>
5	Growth in credit default swaps (CDS)	<ul style="list-style-type: none"> <li>• CDO issuers purchased CDS, which enabled them to receive AAA ratings. These purchases were not regulated as over-the-counter transactions.</li> </ul>

Source: Verick & Islam (2010 p. 19)

The process of contagion was not limited to USA where it originated, but spread to other parts of the world where there was a strong interconnectedness in the extension of credit, as well as the investment of funds in the stocks of the international companies as shown in figure 1.

**Figure 1: Key Factors behind the 2008-2009 Financial Crisis**

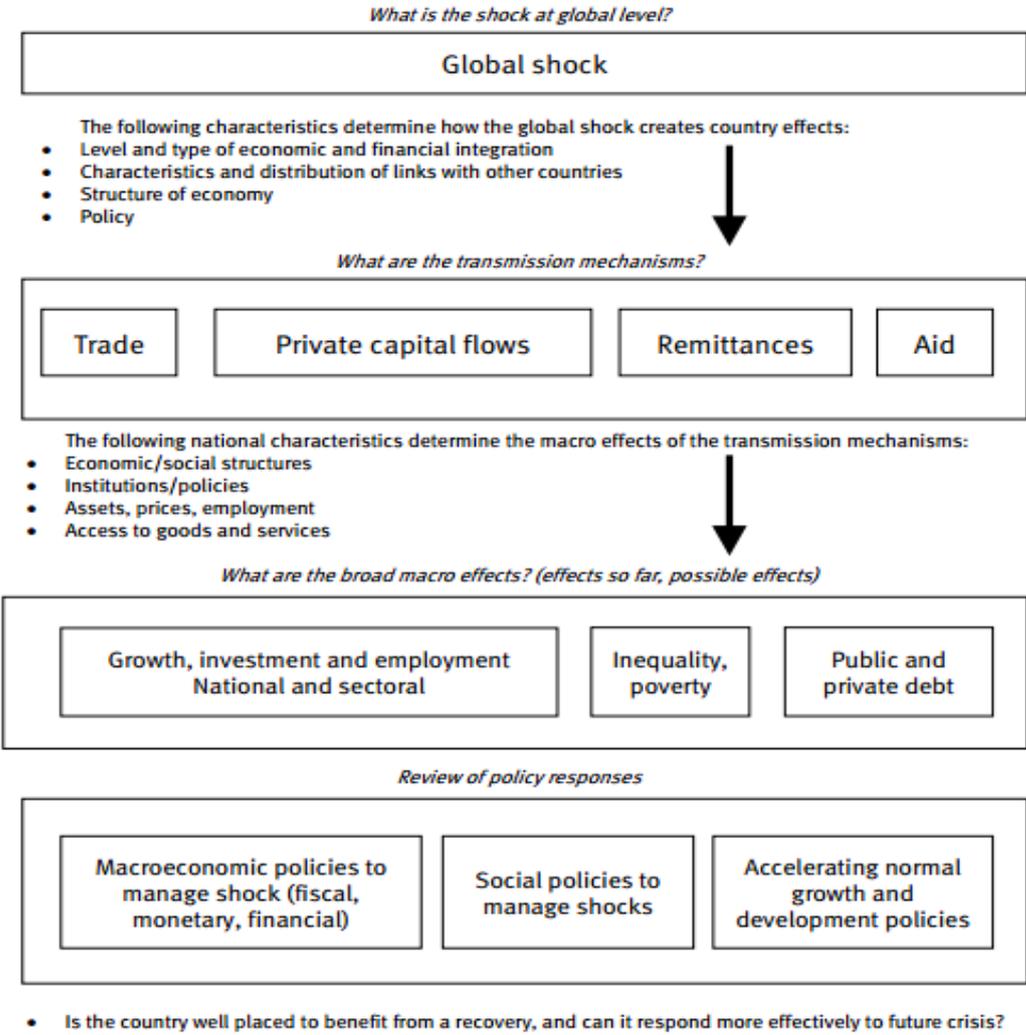


Source: Verick & Islam (2010) The Great Recession of 2008-2009. Causes Consequences and Policy Responses.

Hence the first round of the financial crisis spread to Western European countries and affected not only the financial sector but spread also to the real sector too, which suffered from credit crunch, where the financial institutions were not able to finance the working capital of

other companies, forcing the cut down of quantities produced, with the necessary laying off of workers. Economies of these Western countries entered into a recession (Verick & Islam, 2010).

**Figure 2: Financial Crisis Transmission Mechanism to Developing Countries**



Source: te Velde, et al. (2010)

The recession produced a second round of effects, whose transmission mechanism is shown in Figure 2. This round affected even the developing countries, Tanzania included. The effects had to do with the decrease in the demand of raw materials from the industrialized countries, and the decline of remittances, official development aid, foreign direct investment and volume of transactions in the stock exchanges (Lunogelo, Hangi, & Mbilinyi, 2010).

In response to all these effects of the financial crisis, economic policy makers came up with some emergency policy measures to rescue the situation as again shown in Figure 2. The

immediate reaction of USA and other countries affected by the first round of the financial crisis was the issuing of rescue packages (stimulus packages) to try to rescue their economies. This then was followed by a series of policy measures to try to contain the high risk that had found its place in the different new products in the financial system, to avoid a repeat of a crisis of similar proportions. So in most of the countries affected by the crisis, a series of financial sector reforms were taking place, to try to incorporate the lessons learnt from the devastating experiences of the financial crisis. In countries that were affected by the second round of the financial crisis, special packages were deployed to contain those effects. They also adopted some agenda for reforms to avoid the repeat of the crisis.

It was at that point that the researcher became interested to learn more about the reforms taking place in his country in response to the crisis. When the researcher started to familiarize himself with the financial sector reforms in Tanzania, he came to understand that there was already a process of reforming the financial sector even before the 2008 financial crisis in the process that is known as the Second Generation of Financial Sector Reforms. Of course some agenda were added to the already ongoing reforms, to accommodate the lessons from the financial crisis, but the bulk of the agenda of the reform was from the Second Generation Financial sector reforms, that started before the global financial crisis.

It that point the researcher became interested to study the Second Generation of Financial Sector Reforms. He wanted to understand also about the First Generation of Financial Sector Reforms as a background, and what are the unique characteristics of each of the two generations.

### **1.1 Statement of the Problem**

The researcher was very much interested to investigate and understand more about the fact that there has been two generations of financial sector reforms in just two decades. One would think of a generation to spread to more than one decade, and in matters of policy reforms,

one would expect the target to be long term too. What was it that caused the reformers of the financial sector in Tanzania to have two generations of reforms in such a short period of time?

Financial reforms of 1990s in Tanzania were most dramatic and changed completely the way the financial institutions were operating in Tanzania. New laws were passed to allow private institutions, both domestic and private, to provide financial services in the country. The existing Government owned financial institutions had to be restructured and then privatized to promote efficiency and competition in the provision of the services. Government intervention in setting interest rates, exchange rates, and allocating credit was withdrawn. The framework for monetary policy was changed also, with the possibility of using indirect instruments of monetary policy. In addition to that the Bank of Tanzania (hereinafter BOT) had more autonomy in discharging its duty of overseeing the financial system in the country. Of course, to be able to function efficiently in the new policy environment, the BOT had to build the capacity to efficiently supervise the financial system using the Directorate of the Banking supervision. One would be tempted to think that before the decision to undertake such drastic reforms, a thorough feasibility study was carried out, and it was established that the type of reforms were right in content and timing. Moreover, one would expect that the reforms of such magnitude were obviously not supposed to bear all the fruits in the short run. Of course, one could expect a short period of adjustment to the new setup, which might not rule out completely a temporary decline in the quantity and/or quality of services as the new system was taking root and public confidence in the system was growing.

However, after just over a decade of these new policies, a period which cannot be considered to be long term, a new round of equally intensive reforms followed, with a new name: the Second Generation of financial sector reforms (hereinafter SGFSR) to contrast them with the 1990s reforms known now as the First Generation of Financial Sector reforms (hereinafter FGFSR). It is here that the researcher perceived an interesting problem, which he needed to study and understand. Why were the SGFSR necessary at the time they were taken

and what was lacking in the FGFSR and what was it that made the two sets of reforms different. So this study seeks to explore the process of the most recent generation of financial sector reforms in Tanzania.

Policy reforms are ubiquitous in all countries, because the world is dynamic and new challenges keep coming up even as the solutions to already identified challenges are found and applied. In Tanzania too there have been numerous reforms to economic policies from the colonial era throughout due to needs of the different times and to address the challenges at hand. However, major strands of earlier reforms can be associated with important historical events in Tanzania, such as the national independence and the Arusha Declaration. However, some reforms were driven by agendas set by international financial organizations (e.g. Washington Consensus by IMF and World Bank), such as the structural adjustment programs of the mid-1980s to 1990s with the emphasis on liberalization, deregulation and privatization. The economic reforms in question cover all aspects of the production, distribution, consumption and the services that aid and accompany them. Sometimes the reforms addressed specific economic sectors and their specific challenges. This study is interested in understanding the rationale, and the process of the financial sector policy reforms, especially the most recent ones.

Financial sector reforms that were designed by the IMF and World Bank in 1980s, found their way in Tanzania from early 1990s<sup>1</sup>. They were intending to solve the structural problems that were deemed to be the cause of the economic problems that were plaguing the nation at that time. This did not only happen in Tanzania, but it was common to most of the developing countries in Africa, Latin America and the Caribbean, Asia and even in the Eastern European countries. In Tanzania the Banking and Financial Institutions Act (BFIA1991) was the first in a series of financial sector reforms and opened up the financial sector for the private sector, as well as laid the foundation for the operation of the free market in the financial sector.

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<sup>1</sup> See Wobst (2001, p. xii) for the Structural Adjustment Programs

The researcher found it interesting that only a decade later, evaluations of the implementation of the financial sector reforms ushered in by the BFIA 1991 pointed out to some major weaknesses in the operations of the new structure of the financial sector, necessitating another round of reforms. Now since there is a quick succession of two rounds of reforms, the FGFSR (1990s) and the current SGFSR. This gave the researcher some interest in studying the SGFSR to explore the type of challenges addressed by the reforms and whether some of the challenges in the FGFSR were also being addressed in a different, more effective way.

## **1.2. Objective of the Study**

The main objective of the study is to study the rationale, the process, the key players as well as the content of the two generations of financial sector reforms in Tanzania with a view of finding out the rationale of both, the theories governing the approaches, and the challenges that they were addressing. The study aimed at exploring the major focus of the reforms and make their evaluation.

## **1.3 Research Questions**

The research questions that the study seeks to explore are:

1. Why is it that we have two generations of financial sector reforms in two decades?
2. What is the major focus of the FGFSR and the SGFSR?
3. What are the theoretical underpinnings of the reforms in both generations of reforms?
4. What could have been done differently for a better financial sector?

## **1.4. Methodology**

This is a case study, which seeks to explore the process of reforms in the financial sector in Tanzania from around the year 1991 up to the end of 2013. The study used qualitative methods to collect data to answer the research problems. Here, first and foremost, the documents that were used to prepare and evaluate the reforms were reviewed and the content

of reforms explained therein were also analysed. To follow up the understanding of such documents, interviews were conducted with key participants of the process from the Directorate of Strategic Planning and Institutional Review, Directorate of Financial Stability, Directorate of Banking Supervision as well as the Directorate of Economic Research of the BOT. Interviews were also conducted with Officials of CRDB Bank, NBC (1997) Ltd., Mkombozi Bank and NMB Bank in Tanzania. One interview was also conducted with the Deputy Director of the Tanzania National Planning Commission under the President Office.

In assessing the effects of these reforms on the financial sector, a benchmarking methodology was used to compare the financial development indicators for some regional peers as well as the averages of the Low Income Countries and Sub-Saharan African countries and hence position Tanzania against the peers. Using the Access Possibilities frontier a critical evaluation of the policies adopted was done.

In the analysis it was important to use the theoretical framework of institutional economics, as the major focus of the SGFSR was to strengthen institutions that were already existing and to create new ones where necessary. The focus was to have institutions that create incentives for financial sector development, and remove obstacles for financial development and thus support the new structure and functioning of the reformed financial sector. It is actually this conceptual framework that distinguishes the approach of the FGFSR and the SGFSR.

### **1.5 Data Collection and Analysis**

Two field trips for collecting data were done for the research. The first one was from 21<sup>st</sup> February 2012 to 25<sup>th</sup> May 2012, and the second from 25<sup>th</sup> July 2013 to 10<sup>th</sup> September 2013. The one was a pilot study, and helped to identify the key topical areas of investigation. This was important, because it enlightened the researcher to get the realistic orientation of the study, and necessitated a change of focus, from the initial investigation on the reform of Banking regulation and supervision as a response to the financial crisis, to the current topic looking at

wider reform issues during the first and second generations of financial sector reforms. In the first field trip the researcher managed to conduct a focus group discussion with senior management of Mkombozi Bank Ltd and interviews with Directors of Risk Management of CRDB Bank and NBC (1997) Ltd, and with Corporate Control Manager of NMB Bank. However, it was very difficult to get access to officials of the BOT. After a long procedure of seeking permission, the researcher ultimately managed to get to interview two staff members of the Directorate of Bank Supervision, who agreed on the condition that they were not to be recorded. They also gave the researcher some documents containing recent regulations, as well as the Annual Report of their Directorate. The researcher also submitted a qualitative interview schedule for a staff member of the Department of Financial Stability, who chose not to be orally interviewed, and provided a written response instead.

The data from the first field work gave the orientation to the research but are not very much used in this final report because they provided a turning point, whereby the major focus of the study changed from investigating about reforms in regulation and supervision of the banking sector as a response to the financial crisis to focusing on the broad policy reforms in the financial sector from 1991, in the two generations of financial sector reform

In the second field trip the major source of data for this study was from the BOT, because all the financial sector reforms were coordinated by the BOT. The Directorate of Strategic Planning and Performance Review, as well as the Directorate of Economic Research were very useful for that matter. Interview with the Head of Project Management Unit in the Directorate of Strategic Planning and Performance review was the most important of all interviews conducted. In addition to the interview, the official sent to the researcher some documents of projects relevant to this study by email and they have actually proved to be the most important source of data for this study. Apart from that, the researcher managed to conduct an interview with the Director of Economic Research. Finally he conducted an interview with the Deputy Executive Secretary of The Planning Commission under the President Office.

The data from interviews were stored in voice recorders, and were then transcribed and analysed by sorting out to get the major themes and their logical arrangements, and finally they were used to provide answers to research questions of this research.

Quantitative data to provide the trend of the various financial development indicators were obtained from the databases of the databases on the World Bank website- <http://databank.worldbank.org/data/home.aspx>, and from the BOT website – [www.bot-tz.org](http://www.bot-tz.org) .

## **1.6 Organisation of the Research Report**

This study is arranged in seven chapters. This chapter introduces the study by giving background to the research problem, and then introduces the problem together with the research questions and methodological issues. Chapter two presents the theoretical foundations of the relevant issues that actually drove the reforms in the financial sector in Tanzania.

Chapter three presents a brief history of the financial sector in Tanzania from the time of the German colonial rule up to the 1980s when the structural adjustment programs were being implemented. Chapter four gives a narrative presentation of important events of the first generation of financial sector reforms, highlighting the emphasis on stabilization, liberalization and privatization. In the case of Tanzania, it was also the change from socialist approach of managing the national economy to the free market one (Wobst, 2001, pp. 1-2). An assessment is then made to evaluate the effects of the FGFSR to the financial sector in Tanzania up to 2003, when the agenda for the SGFSR was being formulated. Chapter five then presents the major selected issues addressed by the second generation of financial sector reforms, emphasizing the theoretical underpinning of New Institutional Economics as the foundation of the reforms, focusing on the strengthening of existing institutions and creating new ones where none were existent. The aim of those institutions was to promote development enhancing behaviour and remove barriers to financial sector development. Chapter six presents the discussions on the findings, linking the rationale of the reforms to the theoretical framework of institutional

economics. Chapter seven concludes the study by summarizing the major points of the study and highlighting the conclusion of the study, while giving areas for further research on financial sector reforms using institutional economics approach and closing the report.

## Chapter 2

### Conceptual and Theoretical Frameworks, Key Concepts

#### 2.1 Introduction

In this section presents the key theories and concepts that guided the study. In addition to presenting these theories, a brief description of the relevance of the theories to the current study is also presented.

The main theories are the New Institutional Economics and the Access Possibilities Frontier. Key concepts and terminologies that form the core of the analysis of this work are also presented.

#### 2.2 New Institutional Economics

This is a school of economics, that complements the neo classical school by correcting some basic assumptions of the latter about information and transaction costs, and by recognising their importance. Stiglitz explains shortly that the new institutional economics is an attempt to incorporate a theory of institutions in Economics (Stiglitz J. , 1992, p. 3). Stiglitz relaxes the implicit assumption of instrumental rationality<sup>2</sup> made by the neo classical economists to acknowledge that most often information is incomplete and that individuals have culturally derived mental models which they use to process information. So different individuals arrive to different equilibria. In such a case there must be a cost of transacting, which necessitates the formation of institutions, because information is “costly and assymmetrically held by parties of exchange” (Stiglitz J. , 1992). So institutions are formed to reduce uncertainty in human exchanges. Stiglitz puts it this way, “The neoclassical result of efficient markets only obtains when it is costless to transact. When it is costly to transact, institutions matter” (Stiglitz J. ,

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<sup>2</sup> Instrumental rationality is a concept that assumes unlimited computational powers of decisions maker and his ability to make an objective description of the world as it really is. The consequence of this assumption is that we can predict choices that will be made by the rational decision maker, without the knowledge of the decision maker mode of calculation

1992). So institutional economics modifies the instrumental rationality assumption of the neoclassical economics while it maintains scarcity as the beginning of economic analysis. It then adds institutions as one of the critical constraints, and analyses the role of transaction costs as the connection between institutions and costs of production. Institutional economics views the political process as a critical factor in the performance of economies, and as a factor that explains the differences in the performance of economies, and explains the inefficient markets.

### **2.2.1 What are Institutions?**

North (1994) defines institutions simply as “the rules of the game”. He viewed them as rules that provide a framework of incentives that shape economic, political and social organisations. North (1994) saw institutions to be constituted by:

1. Formal rules (laws and constitutions)
2. Informal constraints (conventions, codes of conduct, norms of behavior)
3. Enforcement of the two above mentioned items.

Schmid (2004) conceived institutions as “the norms more than just the rules of the game, providing constraints”. They are also enablement to do what individual cannot do alone. In that way they affect beliefs and preferences and provides cues to uncalculated behaviour.

Ostrom (1990) defined institutions as rules, norms and strategies used by the humans in repetitive situations. Key words for him are rules and norms. By rules she meant the shared prescriptions (must, may, may not) that are mutually understood and enforced in particular situations in a predictable way by agents responsible for monitoring conduct and imposing sanctions.

Scott (2001) identified three basic pillars of institutions and found it important to have a good interpretation of the 3 basic pillars that are vital ingredients of institutions: the regulative systems, the normative systems and the cultural-cognitive systems. He held that the regulatory pillar was legally sanctioned. It included laws, rules, regulations and sanctions. For Scott

(2001) the normative pillar was morally governed and included certification and accreditation, and finally the cultural-cognitive pillar was culturally supported. It included common beliefs and shared logic of action.

### **2.2.1.1 Institutions and Organisations**

The two terms are sometimes used interchangeably in a rather confusing manner. It is important here, to give a clear distinction of institutions and organisations in the way the institutional economists used the terms. Whereas institutions are understood to be “the complexes of behaviours that persist over time by serving some collectively valued purpose, organisations, on the other hand are understood to be the structures of recognized and accepted rules, formal and informal”. (Uphoff, 1986, pp. 8-10)

### **2.2.1.2 Link between Institutions and Organisations**

Institutional evolution is shaped by the connection between institutions and organizations. Institutions are the rules of the game while organisations and entrepreneurs are the players of the game. Organisations are made up of groups of individuals, bound together by common purpose so that they achieve a certain objective. Examples of organisations include political bodies (political parties, senates, city councils and regulatory bodies); economic bodies such as trade unions, firms, family farms, cooperatives etc., and educational bodies such as universities and schools (Kirsten, Karaan, & Dorward, 2009).

Organisations come into existence to reflect the opportunities provided by the institutional matrix. If institutional matrix rewards productive activities then organisations will arise to engage in productive activities.

### **2.2.2 Levels of Institutional Organisation**

Williamson presented the 4 levels of institutional organisation. At the very top (level 1) there is embeddedness. This is the social environment, or the informal institutions. This level includes traditions, religion, culture etc. The second Williamson’s level is the institutional

environment. In this level we find the formal rules of the game, which include laws, property rights, constitutions etc. The third level is the level of governance, which is actually the play of the game. In this level we find the alignment of the governance structures with the transactions. And finally on the fourth level we have the performance. This represent all what the neoclassical economists presented, including optimization, prices, quantities and incentives. (Williamson O. E., 1999)

North presents the dichotomy to be between micro and macro level. Whereas macrolevel institutions deal with institutional environment in which organisational forms and transactions are embedded, or rules of the game which affect the behaviour/performance of economic actors. Davis & North (1970) define the macro level institutions to be the set of fundamental political, social and legal ground rules that establish the basis for production and exchange and distribution. Micro level institutions, on the other hand, deal with the institutions of governance. Whereas some scholars consider these to be subclass of institutional environment (North, 1990); others focus on individual transactions, considering modes of managing transactions represented by Williamson (1993) who included market and quasi market and hierachical modes of contracting in the micro level analysis. He conceived of micro level institutional analysis to be that which analyse questions regarding organisational forms (integration vs outsourcing), and institutional arrangements: arrangements between economic units that govern the way members can cooperate or compete.

Ostrom also had a view of multiple source structures located in diverse analytical levels as well as diverse geographical domains. At one level there are multiple and nested action arenas, and across level we also find nesting of arenas, collective actions and constitutional choices which set the rules of the game (Ostrom, 2005)

### **2.2.2.1 Embeddedness**

Grannovetter (1985) viewed the economy to be structurally embedded in social networks that affect its functioning. Another scholar concurred with the position but elaborated that human economy is embedded and enmeshed in institutions, economic and non economic. (Polanyi, 1975) The inclusion of non economic institutions by Polanyi (1975) is crucial in the understanding of embeddedness. Economic action takes place in the networks of social relations that make up the social structure. Dimaggio added that economic action is embedded not only in the social structure but also in culture (Dimaggio , 1994).

### **2.2.2.2 Formal and Informal Institutions**

In Williamson's presentation of the four levels, we find the use of terminology that dichotomize institutions into formal and informal, and I would like to define them here:

#### **2.2.2.2.1 Formal Institutions**

Formal institutions are the formal rules which are formally written down and enforced by the state (Kirsten, Karaan, & Dorward, 2009). Of these formal institutions, law is given most attention, as it is clear that legal environment, especially the quality of contracts and property law, affect the economy. Laws shape the way business, natural resources and social activity are organised, determine the incentive structure, through their influence on protection of property rights and contract enforcement mechanisms, since rights are meaningful only if they could be enforced (Kirsten, Karaan, & Dorward, 2009). Constitution is also important, as it includes the fundamental set of rules that govern the way societies and states are organised. Clague holds that institutional arrangements are devised by the collective and individual actions of members. (Clague, 1997). From the constitutional order flow statutes, common law and various regulations.

#### **2.2.2.2 Informal Institutions**

.. formal rules make up small part of the sum of constraints that shape choices... the governing structure is overwhelmingly defined by codes of conduct, norms of behavior and conventions (North, 1990, p. 36)

Informal institutions are unwritten rules and informally sanctioned rules. The unwritten rules are important in structuring social conduct. Cultural endowments include normative behavior, codes of society and mental models for interpreting experiences (Kirsten, Karaan, & Dorward, 2009). These change very slowly.

Some terminologies associated with informal institutions are defined below.

Conventions are habits, customs, routines and standard practices (Kirsten, Karaan, & Dorward, 2009). Biggart & Beamish (2003, p.444) defined conventions as understandings, often tacit, but also conscious, that organize and coordinate action in predictable fashion. They are usually agreed upon, flexible and are guides for economic interpretation and interaction. Favereau & Lazega (2002) defined conventions as values, rules and representations that influence economic behaviour.

Customs are pragmatic solutions to economic problems reified as normal. They may serve elite interests. Individuals adhere to certain customs even if costly because of their emotional commitment and self identity.

Norms are shared prescriptions known and accepted by most participants. They involve intrinsic costs and benefits (Ostrom, 2005) Ostrom adds that social norms, such as customary laws can sometimes be superior to administrative or judicial dispute resolutions among people with close ties.

#### **2.2.3 Scope and Function of Institutions**

The function of institutions is to help agents to improve their welfare. Several institution may serve the same function.

According to North (1993) institutions exist to perform the following functions: first to form incentive structures of a society and second to determine economic performance by influencing the costs of production through influencing the input and transaction costs. Hall & Soskice (2001) view institutions to have the function of shaping the behaviour of firms in three ways: first institutions are socializing agencies in that they instil a particular set of norms and attitudes in those who operate within them. Second, they confer power on certain actors who in turn affect the course of the institution. And third institutions of political economy form a matrix of sanctions and incentives to which relevant actors are supposed to respond.

Hodgson (1998) sums up the view of New Institutional Economics on functions of institutions by highlighting that institutions are governance tools which help individuals cooperate to overcome market failure and manage conflicts resulting from different interests or clash of ideology. But he emphasises that this notion must coexist with equally valid notion that institutions are formed and changed by individuals.

This work will draw from the function highlighted by North (1993) that institutions form incentive structures of society that are determinants of economic performance, due to their influence on transaction and information costs.

### **2.2.3.1 Imperfect Information**

Neo classical economics was built on the assumption of a perfect market. One of the assumptions of the perfect market is that economic actors (individuals, households, firms, governments) have complete information about all aspects of business profit and consumption utility, including market opportunities, available technology, costs of production under alternative production arrangements, prices, natural resources, quality of goods produced and the intention of fellow actors. This assumption was necessary for the general equilibrium theory based on demand and supply. However, in the real world there is no perfect and freely available information. This fact leads to risk and uncertainties in transactions, as most often either the

buyer or the seller will have more information than the other party, the reality known as information asymmetry. Searching for and obtaining information regarding the products and buyers, or the customers and their intention, is very important to reduce those risks of transaction failure. But searching for information is not costless, some costs known as transaction costs are involved, which often are significant (Akerlof, 1970; Stigler, 1961; Stiglitz J. E., 1985a; Stiglitz J. E., 1985b; Arnott, Greenwald, & Stiglitz, 1993)

Recognition that imperfect information leads to recognition and hence incorporation in Economic analysis and policy, of substantial transaction costs in most forms of economic activity, and has profound implications in Economics (Stiglitz & Grossman, 1980). Transaction costs impede exchange, and so impede competitive markets' ability to reach efficient equilibria even for private goods (market failure is normally attributed to public goods), leading to market failure. Modification of institutions to allow more efficient resource allocation and exchange becomes an important subject of economic policy (Stiglitz & Grossman, 1980)

Different approaches have come about on how to analyse institutional issues in transactions and contracts. These include moral hazard and agency theory, transaction cost economics and incomplete contracts theory.

#### **2.2.3.1.1 Moral Hazard and Agency**

Agency theory, developed by Jensen & Meckling (1976), Fama (1980), Fama & Jensen (1983) studies the effects of institutions in reducing transaction risks and costs arising from imperfect information in carrying out transactions.

#### **2.2.3.1.2 Transaction Costs vs Transaction Risks**

Transaction costs are costs originating from the various actions taken to reduce transaction risks. That is why some scholars consider transaction costs and transaction risks together (Dorward, 2001; Poulton, Kydd, & Dorward, 2005). This is because economic agents are supposed to invest in transaction costs to reduce the risks of transaction failure. Despite

transaction costs, it is difficult to eliminate transaction risks completely. So transaction costs provide an optimal trade off where marginal transaction costs are equal to marginal utility of risk reduction.

The transaction costs involved include the costs of establishing and enforcing the exclusive property rights and the definition and enforcement of the attributes of the goods or service exchanged. Transaction risks represent the losses incurred because of failure to enforce exclusive property rights, which arise with public goods and externalities. Transaction risks also occur when there is a failure to enforce the required attributes or complete the transaction, problems which arise due to difficulties in obtaining information about the goods, services or the actors involved in the exchange (commitment problem). Another type of transaction risks arise from difficulties to enforce the agreements (Poulton, Kydd, & Dorward, 2005)

#### **2.2.3.1.3 Principal Agent Problem**

Principal-Agent problem is related to the problem of one party (agent) acting on behalf of another (principal). It arises when an agent, who is supposed to act in the best interests of the principal deviates from those interests and pursues his/her own interests. Ideally those interests were supposed to be spelled out in the employment contract. The aim of the contract is to provide the incentive to the agent to act in the best interests of the principals (Kirsten, Karaan, & Dorward, 2009).

##### **2.2.3.1.3.1 Agency Theory**

Agency theory addresses the question of how the principal can structure contracts, incentives and sanctions in a way that will best influence the behavior of the agents towards achieving the principal's goals (Kirsten, Karaan, & Dorward, 2009). This involves some costs known as agency costs.

### **2.2.3.1.3.2 Agency Costs**

Agency costs are the sum of monitoring expenditures of the principal, the bonding expenditures of the agent and the residual loss (Jensen & Meckling, 1976). So there is a link between agency costs and transaction costs.

### **2.2.3.2 Transaction Cost Economics**

Arrow (1969) defined transaction costs as the costs of running the economic system. Williamson (1985) distinguished between the *ex ante* and *ex post* transaction costs. *Ex ante* transaction costs are those of drafting, negotiating and monitoring an agreement, whereas *ex post* transaction costs include costs of maladaptation, haggling, setup and running associated with governance and the bonding costs of securing commitment. Williamson also added that transaction costs are unique costs to each agent or firm and are related to the process of exchange itself. Coase (1960) argued that provided there are costs of reaching, modifying and implementing agreements (transaction costs), the relative merits of different organizational forms depend on a comparison of the costs of transacting under each. Eggertson (1990) enumerated six types of transaction costs

1. Costs associated with searching information about the product to be contracted upon.
2. Costs associated with bargaining that is needed to find true position of buyers and sellers when prices are endogenous.
3. Costs associated with the making of the contracts.
4. Costs associated with monitoring of contractual partners.
5. Costs associated with enforcement of a contract and the collection of damages when partners fail to observe their contractual obligations.
6. Costs associated with the protection of property rights against third party encroachment

Schmid (2004) adds another set of two to the list: that the future is uncertain and the reality that deviates from the unbounded rationality assumption: i.e. the human brain is not capable of handling complex decision making in a predictable manner

Transaction Cost Economics maintain that the implication of positive transaction costs is that contracts are typically incomplete (Grossman & Hart, 1986; Hart & Moore, 1999). So transaction costs are incurred by parties to protect themselves against the hold up problem<sup>3</sup>, and institutions are there to economize on such costs, to reduce the information and transaction costs.

So the focus of transaction cost economics is on the costs of doing business, specifically the making, monitoring and enforcing of contracts. The ease or difficult of contracting and the type of contract made are determined by the nature of transaction costs which, in turn are influenced by the extent to which the information is imperfect, and risks involved in the event of transaction failure. (Kirsten, Karaan, & Dorward, 2009)

Williamson (1991) identifies three determinants of transaction costs and of transaction cost-reducing governance structures: the specificity of assets involved, the uncertainties surrounding the transaction and the frequency of that transaction. He argues that the higher the degree of asset specificity the higher transaction costs, also the higher the degree of uncertainty the higher the transaction costs and the lower frequency of transaction the higher the transaction costs. Williamson argues that increases in these three variables are associated with shifts from spot markets to hierarchical form of governance, which involve vertical integration of a variety of alternative governance structures or institutional arrangement.

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<sup>3</sup> Hold up problem is a hazard that occurs when parties that have invested in relation specific assets expose themselves to the risks that may arise if circumstances change their trading partners may try to expropriate the rents accruing to the asset.

So the working hypothesis of Transaction Cost Economics is that an economic organisation is an effort to align transactions, which have different attributes, with governance structures, with different costs and competencies in a cost economising way. (Williamson, 1991). Dorward (2001) is more precise in putting it that an economic organisation is an effort to maximize profits, allowing for trade-offs among risks of contracting, transaction costs required to reduce the risks and normal production (transformation) costs, risks and revenues.

### **2.2.3.3 Property Rights**

Property rights are a fundamental institution governing who can do what with resources (Kirsten, Karaan, & Dorward, 2009). Bromley (1991) defined property rights as “the capacity to call upon the collective to stand behind one’s claim to a benefit stream”. Furubotn & Pejovic (1972) view property rights as the claims, the entitlements and related obligations among the people regarding the use and disposition of a scarce resource.

From the above definitions, the key element is that property rights have more to do with social relations. A property right is not a link between a person and a thing, they are

“the relations between people with regard to a thing, or the benefit stream generated from the thing. All property rights are associated with the duties of others to observe them, and also with the duties of the rights-holder to do certain things to maintain the right to the resource” (Kirsten, Karaan, & Dorward, 2009).

Institutional economists put a strong emphasis in the importance of defining property rights well and precisely. Well-defined property rights and institutions for implementing them make it possible to arrange for the transfer of rights and also the trade off among the arrangements meaningful. If property rights are well established and there is no transaction costs an externality can be internalised between two private parties through bargaining and negotiations (Coase, 1960). Coase showed that in the absense of transaction costs, the outcome would be efficient and equitable regardless of who owns the property rights. He showed also that in the presence of transaction costs, different systems of property rights may yield different outcomes in terms of efficiency and equity.

Esminger (1992) argues that the system of property rights that eventually evolve is a function of their economic consequences and ideology regarding equitable distribution of the benefits of the rights, and the bargaining power of the various interest groups. Demsetz (1967) and Alchian & Demsetz (1973) argue that the formalization of property rights in land is necessary and very important for economic development. They further argue that well defined property rights guide incentives to reap personal gains from the opportunities arising from the property (long term investments) and also create opportunities to access finance and enhance efficiency in land market. So well defined property rights are very important. Platteau (1995) argue that in the case of Africa, well defined property rights might compromise with some community advantages of the collective ownership of land. Platteau adds in another work that

“high transaction costs, poor, partial and arbitrary enforcement of rights, and lack of infrastructure can seriously constrain the efficiency of individual property rights especially if those rights do not enjoy the support of custom and general sense of fairness” (Platteau, 1996 cited by Kirsten, Karaan, & Dorward (2009, p. 49)).

It is important to note, however, that property right scholars accept the importance of flexible and adaptable institutions especially to population trend and resource availability/scarcity provided those changes are not be in the direction of privatization (Kirsten, Karaan, & Dorward, 2009). A special balance must be made between the individual property rights and the common interests of the society consideration such things as transaction and enforcement costs, and factors related to the environment, technology and distribution.

#### **2.2.3.3.1 Incomplete Contract Theory**

This theory focuses on “the way different organizational structures assign property rights to resolve the issues that arise when contracts are incomplete” (Kirsten, Karaan, & Dorward, 2009, p. 49). In this theory organization arrangements are discussed on the basis of ownership and control of key assets.

The basic idea of Incomplete Contract theory is that due to bounded rationality and the high cost of drafting a “complete contract” it is very difficult in day to day transactions to have

contracts that specify *ex-ante* all details and contingencies relevant to the transactions. Due to those limitations, most of the contracts that are entered to are incomplete. Specifically an incomplete contract has gaps, missing provisions, and ambiguities and has to be completed (by renegotiation or by the courts) with strictly positive probability in some states of the world (Hart O. , 1993)

Oliver Hart provided the seminal idea for incomplete contract theory, but developing the ideas of Williamson. However Hart took a perspective different from Coasian view that the genesis of firms is incomplete contracts, and proposed that the incompleteness of contract is “brought about by bounded rationality, and incomplete information which, in turn, necessitates the allocation of power and control” (Grossman & Hart, 1986).

### **2.3 Financial Access Frontier**

Financial possibility frontier is a diagnostic tool that was developed by World Bank Economists (Beck , Maimbo, Faye, & Triki, 2011; Beck & Feyen, 2013; Beck & de la Torre, 2007) who were concerned with policies that promote financial deepening in developing countries. The World Bank Economists believe that financial deepening taken at the right pace leads to long term growth. However, financial deepening taken too rapidly would lead to a financial crisis.

The basic question posed by the economists is how far can and should countries go in facilitating financial deepening? Might there be levels of financial deepening that is too high for an economy? (Beck T. , 2012).

#### **2.3.1 The Conceptual Framework**

The financial possibilities frontier is constructed by analysing the drivers of supply and demand for financial services. The main drivers are fixed costs and default risks (Beck & de la Torre, 2007). In addition to those, there are cultural factors and financial literacy (Beck , Maimbo, Faye, & Triki, 2011). So from these constraints, potential and actual demand and

supply curves for financial services were constructed, and formed the basis and framework of analysing the outreach of financial services.

### **2.3.1.1 Fixed Costs**

There are fixed costs involved in the provision of financial services at individual, institutional as well as economic system level. Considering these fixed costs, it is necessary for businesses in the financial sector to capture economies of scale so that they operate profitably. Normally such economies are achieved by either providing high value services or high volume services or a combination of the two.

### **2.3.1.2 Risk**

Risk here is more relevant for credit services because in those services default is an important consideration. Risk is the possibility of making loss because the actual transaction value received by the financial service provider turn out to deviate from the expected transaction value.

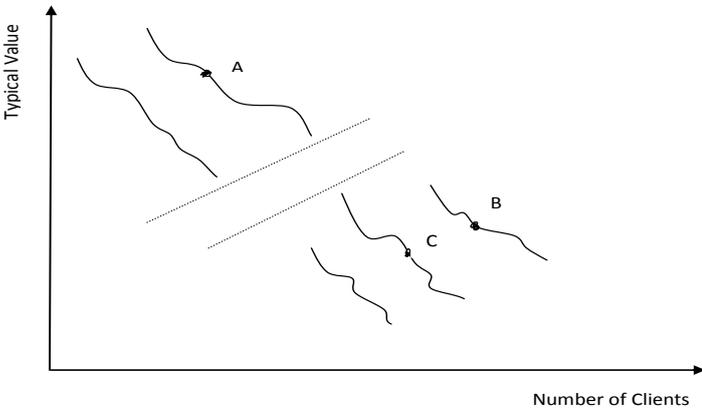
Risk can be borrower specific or systemic. Systemic risk is the type of risk that affect all the market players at the same time. This may be due to macroeconomic uncertainty such as inflation, terms of trade, real interest rates and real exchange rates. Contractual and informational environment is also important in the determination of systemic risk. The importance of that environment is due to the serious effects of poorly defined creditor rights and difficult to enforce creditor rights, deficiencies in accounting practices, the absence of well-functioning credit bureau and geographical limitations (Beck T. , 2012).

It is very important to consider risk because the providers of financial services reduces the supply of their services once they perceive the default risk to be too high. The presence of risk brings about agency problems, which arise from the fact that agents do not work for the best interests of the principals. In this case, the debtors intentionally do not disclose all the important information relevant to the project for which they borrow, thus they may use the loan

funds for projects with higher risks than the creditor is aware of. This is the situation known as information asymmetry. In this situation the debtor stands to gain in the good state of the world while limits his/her loss in the bad state of the world, a situation known as moral hazard. When interest rates charged on the loans is too high, it tends to attract riskier borrowers who are likely to default, because honest borrowers will shun from such contracts. This will result in higher probability of default (Beck & de la Torre, 2007).

**2.3.2 Isoprofit Curves**

**Figure 3: Isoprofit Curve**



Source: Beck & de la Torre (2007), *The Basic Analytics of Access to Financial Services* p. 85

Beck & de la Torre (2007) used the isoprofit curve to develop the framework of analysing the supply originating broadening of the financial services.

The curve above is an iso-profit curve. The iso-profit curve is drawn for a given level of state variables. It shows “the combination of transaction number of payments and savings services that yield the same profit for a given financial institution” (Beck & de la Torre, 2007)

The horizontal axis measures the number of transactions. For the ease of analysis, Beck & de la Torre (2007) assume that the number of transactions increases with the number of

clients. The vertical axis measures the ‘typical’ value<sup>4</sup> of the payment or savings transaction handled by the institution. (They hold the number of transactions per client constant).

The iso-cost curves are downward sloping since an increase in the number of clients is needed for the financial institution to make the same profit as we move towards lower typical transaction value. The curves are parallel, with curves more distant from the origin representing higher profits. Movement along an iso-profit curve towards a larger number of clients represents, by definition, a supply induced broadening of access.

Beck & de la Torre (2007) note that the iso-profit curves are not continuous as we move towards a larger number of clients. This is because it is not easy for financial institutions to trade off smoothly a higher transaction value for a higher number of clients while still making the same profit. That is why there are discontinuities in the iso-profit curves since the different production functions may be needed to provide low value high volume transactions than the one needed to provide high value transactions. The discontinuities explain the difficulty for the same financial institutions to provide both low value and high value services. But, more importantly, they explain why the financial institutions in the developing countries cluster at the North West corner (few clients – high value services) with only a few institutions in the South East corner (many clients – low value services). The banks in developing countries are not motivated to incur costs to change their production function in order to move to the South East to a point like B (Beck & de la Torre, 2007).

Beck & de la Torre (2007) argued that lack of competition is the main reason for the banks not to move to the South East corner point B. They could make money comfortably by targeting larger firms and wealthier households. In this way they would have little motivation to manage the idiosyncratic costs effectively to reach the new clients in the South East. Since

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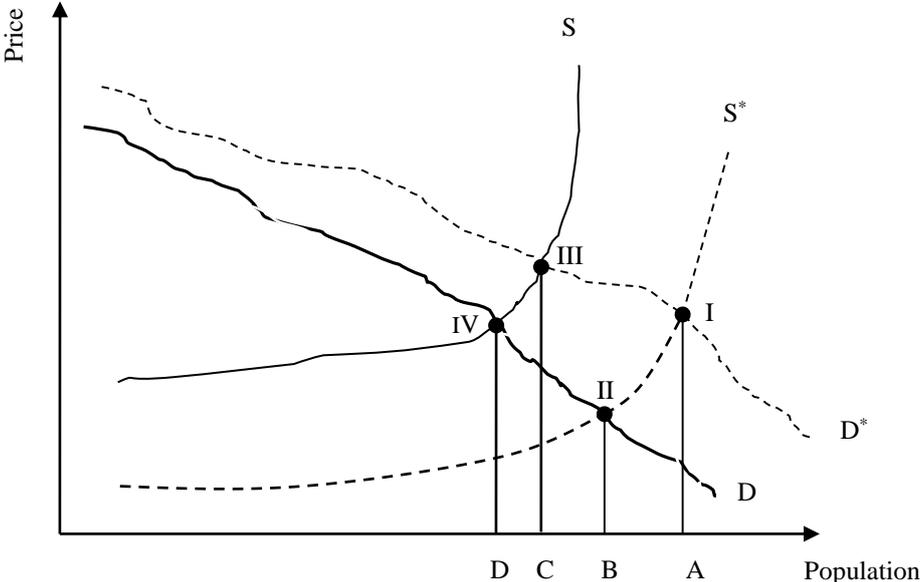
<sup>4</sup> Typical value is the average value of the transactions of a client. It is assumed that the number of transactions per client is constant.

many potential new entrants are small banks, and since the customers in the South East are more costly to serve, this group is underserved by both the larger banks and the small banks.

**2.3.3 Introducing the Frontier**

Beck & de la Torre (2007) found that price and income level are the major economic determinants of demand for payment and savings services. However, the socio-cultural factors have significant impact too. At the same time, fixed costs and risks were the major determinants of supply for deposits, payment and savings services.

**Figure 4: The Access Possibilities Frontier**



Source: Beck & de la Torre (2007), The Basic Analytics of Access to Financial Services.

**2.3.3.1 Potential demand Curve**

Consider  $D^*$  a potential demand curve in figure 4. This curve is driven purely by economic factors i.e. income and price.

$D^* = f\{income, price\}$ , whereas demand increases as income increases and decreases as price increases.

Demand reflects the marginal willingness to pay for the financial services. Beck & de la Torre (2007) expect customers with demand for large-value/high volume transactions to have a higher marginal willingness to pay than customers with few and small transactions. So a higher price reduces the share of the population that will demand payment and savings services, thus a downward sloping demand curve.

### **2.3.3.2 Actual Demand Curve**

Beck & de la Torre (2007) analysed D (the actual demand curve) in the following way. This is the demand curve that takes into account the non-economic demand factors that include financial illiteracy and Cultural factors.

$D = f\{income, price, financial\ illiteracy, cultural\ barriers\}$ , whereas Demand is related to income and price as above and increases as financial illiteracy increases and, likewise, it decreases with the increase in the cultural barriers.

Normally the actual demand is below the potential demand. This is because, for a given level of price and income, self-exclusion arising from illiteracy and cultural factors such as religious or ethnic issues, reduce the actual demand. We assume that there would not be an over-demand for financial services due to illiteracy and cultural factors, and so the actual demand will not exceed the potential demand (Beck & de la Torre, 2007; Beck , Maimbo, Faye, & Triki, 2011).

The distance between the actual and the potential demands denotes self-exclusion and that distance need not be constant across the population spectrum. But assuming self-exclusion to be inversely related with income, the gap between the potential and actual demand increases as we go along the horizontal axis (Beck & de la Torre, 2007; Beck , Maimbo, Faye, & Triki, 2011).

### **2.3.3.3 Supply Curve**

Beck & de la Torre (2007) assumed supply to be purely driven by the fee charged for the services. As the fee increases, it becomes more profitable for service suppliers to reach a larger share of the population by targeting households and firms with increasingly lower and lower value transactions. So the supply curve is upward sloping. As we move along the horizontal axis, the curve becomes steeper. This is explained by the switching costs and the flat iso-profit curves (Beck & de la Torre, 2007; Beck , Maimbo, Faye, & Triki, 2011).

In Figure 4: The Access Possibilities Frontier,  $S^*$  denotes the potential supply<sup>5</sup>, that is assumed to be the supply resulting from the aggregation of the supply from the highest feasible iso-profit curves for a given price.

### **2.3.3.4 The Access Possibilities Frontier**

Point I is the Access Possibilities frontier. It is the intersection of the potential demand and potential supply curves. Point I denotes the maximum outreach point for payment and savings services that can be reached in a country's financial system given the state variables. Point I is the constrained maximum, associated with a bankable population  $A$  on the horizontal axis. So  $1-A$  is the non-bankable population<sup>6</sup>.

#### **2.3.3.4.1 Moving forwards the Access Possibilities frontier**

The access possibilities frontier can be moved by shifts (or changes in curvature) in the potential supply and potential demand curve as a result of changes in the state variables (Beck & de la Torre, 2007; Beck , Maimbo, Faye, & Triki, 2011). Factors that can help to shift the Access Possibilities Frontier forward are: the increase in per capital income, the more even distribution of the national income, Improvement in a country's infrastructure and the

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<sup>5</sup> Potential supply is the share of the population that can be serviced by efficient financial service providers, given the state variables. Efficiency in supply implies that providers maximize profits for a given price, so they are located in the highest feasible iso-profit curve

<sup>6</sup> Non bankable population is the share of population that cannot be provided with market based payments and savings services given the state variables.

improvement in a country's institutional environment (Beck & de la Torre, 2007). The other points in the Access possibilities frontier represent the different types of Access Problems. In the following sections Beck & de la Torre (2007) are going to introduce those access problems.

#### **2.3.3.4.2 Demand Driven Access problems**

Point II represents a point demand side access problems. The potential supply  $S^*$  curve intersects with the actual demand curve  $D$ . This is the access problem resulting from a lower than potential demand, due to self-exclusion of agents in the demand curve. The banked population is lower than the bankable population. So along the horizontal axis A-B is a measure of a demand driven access problem (Beck & de la Torre, 2007).

#### **2.3.3.4.3 Supply Driven Access Problem**

This is represented by points III and IV in figure 4. Both are points representing inefficient supply (due to high costs). The result of this sub optimal supply is creation of the equilibria where the banked population is lower than the bankable population given the state problem. Point IV is worse than III as self-exclusion results in a demand lower than the potential demand. So A-C and B-D are measures of access problems driven purely by supply inefficiency (Beck & de la Torre, 2007).

#### **2.3.3.4.4 State variables Driven Access Problem**

This is the case where point I in fig. 4 is lower relative to countries with comparable levels of economic development. This happens in the case when there is political instability or weaker informational and contractual environments (Beck & de la Torre, 2007).

When contractual and informational environment is conducive for lending, then the rate of increase of loans granted to applicants by lenders increase at a faster rate as interest rate increase. So weak contractual and informational environment cause the supply of credit services to be lower than the potential, because of incentive problems (Beck & de la Torre, 2007; Beck & Feyen, 2013; Beck , Maimbo, Faye, & Triki, 2011).

### **2.3.4 Policies to Promote access to Financial Services**

The first important step by Beck & de la Torre (2007) for policy formulation is to determine whether the access problem is because the financial system is inside the possibilities frontier. If this is not the case, then to determine the reasons why the frontier is, say, too low compared to similar countries.

#### **2.3.4.1 Market Developing Policies**

These are the types of policies that address the deficiencies in state variables. They are policies that are appropriate when the prudent access possibilities frontier is below the potential. This cluster of policies aims at raising the sustainable frontier by changing the state variables. These state variables include the legal and constitutional reforms, public sector reforms, and macroeconomic upgrades. The extent of applying those policies depends on the extent of macroeconomic volatility, the state of contractual and informational environment, and the scope of idiosyncratic risk diversification (Beck & de la Torre, 2007; Beck T. , 2012; Beck & Feyen, 2013)

So in market developing policies structural reforms are needed to improve institutions and other state variables. Some of the structural reforms are outside the reach of financial sector policy makers. Labour is an important input in the financial service provision. Any distortions in the labour market affect the position of the potential financial possibilities frontier. Similarly, communications services are crucial to the development of financial services provision (World Bank, 2004a). Undeveloped telephone infrastructures as well as limited competitiveness in the provision of phone services do actually drive up the costs for financial services. In addition to that, a deficient transportation infrastructure can increase the cost of outreach in the more remote areas, even when we have innovative mobile banking (Beck & de la Torre, 2007; Beck T. , 2012; Beck , Maimbo, Faye, & Triki, 2011).

Another important factor is “the level of costs of doing business” due to various reasons, including widespread corruption, insecurity, deficient electricity provision, which together drive up the fixed cost element of financial service provision with negative repercussions for outreach. Last but not least, the size matters, in that small economies should find ways to reap benefits of economies of scale” (Beck & de la Torre, 2007). Sometimes the small economies have to see how they can reap the benefits of cooperation with neighbours.

#### **2.3.4.2 Market Enabling Policies**

Here, regulatory policies and actions that promote innovation and competition are important. When there is a healthy level of competition, financial service providers will try to innovate in order to keep themselves in the business. The type of innovations here will include the tailoring of the services for the low income clients, the use of mobile branches, cell phone banking for remote areas at low costs etc. All of these have an ultimate result of improving cost management. Financial institutions will only be motivated to go for such measures when there is competition (Beck , Maimbo, Faye, & Triki, 2011; Beck T. , 2012).

##### **2.3.4.2.1 Demand Side Policies**

When the financial system is operating below the possibilities frontier, and where the main problem is self-exclusion due to cultural barriers and financial illiteracy, appropriate policies will have to be the provision of financial literacy campaigns to raise the awareness of the necessity and advantages of the using credit to develop the small enterprises would be appropriate (Beck & de la Torre, 2007; Beck T. , 2012).

Cultural barriers such as objections to some credit services on religious grounds could be overcome by offering special products that are tailored to the group, such as Islamic Banking.

##### **2.3.4.2.2 Supply Side Policies**

These are the short and medium term policies that create incentives for private lenders and investors to step in and offer their services without shifting too much risks and costs to the

government. Market enabling services aim to foster competition to enable the market to increase financial services, at the same time lower the cost of provision of the services due to efficiency gained as a result of operating in a competitive market (Beck T. , 2012)

Removal of impediments to entry in the market is one of prominent market enabling policies that featured high in the Washington Consensus. Also modernization of payment systems and creation of credit registries are important in this regard. Together with that, forcing institutions to share their information, as well as preventing special clubs being formed help in enabling the market to grow and to attract investors (Beck & Feyen, 2013)

#### **2.3.4.3 Market Harnessing Policies**

These are policies that aim to prevent the financial system from moving beyond the frontier, i.e. to target long-term equilibrium. Among these include the risk oversight and management, supervisory framework, macro-prudential management, upgrading of regulatory framework to mitigate risks that stem from increased competition, cross border regulatory framework to prevent such spread of risk as that which caused the financial crisis of 2008-2009, as well as consumer protection frameworks and financial literacy programs aiming at making consumers make prudent decisions (Beck & de la Torre, 2007).

### **2.4 Application of Theoretical Framework in this Study**

In this chapter I have introduced the framework of New Institutional Economics as well as the financial possibilities frontier. It is important to note that the financial possibility frontier derive its theoretical underpinnings also from New Institutional Economics, as it identifies risks and transaction costs to be the most important considerations in analysing demand and supply of financial services.

New Institutional Economics is used here as an interpretative tool to understand the logic of SGFSR, especially when it comes to issues that not to be directly connected with the financial sector such as the improvement of the efficiency of the courts, and property rights. Throughout

NIE will be used to show the link between the policy measure and the reduction of risks and transaction costs, hence providing incentives for providers of services to provide more of their services, and to avoid opportunistic behaviour from both supply and demand side.

The exposition of Financial Possibilities frontier concluded by deducing the different types of policies that are available to policy makers depending on the state of the financial sector. Among the most important considerations is the determination of whether the economy's financial possibility frontier is below what is expected at its level of development, compared to countries of the same level of development or not.

## **2.5 Conclusion**

This section introduced the theoretical framework of Institutional Economics, which is the main interpretive framework of the current reforms that are being done in Tanzania in the SGFSR. Major theories that are developing in Institutional Economics were presented such as Informational Economics, problems of Moral Hazards and the relationships between agents and principals, Transaction cost Economics, and Incomplete contract theory, to mention but a few. But then a specific tool to analyse financial sector, which is also built on the foundation of Institutional Economics – The Financial Possibility Frontier was introduced in sufficient detail. This tool will be used to assess the relevance of the policies (market developing policies or market enhancing policies and market harnessing policies) that have been taken, based on the state of development of the financial sector at the point of the reforms.

## **Chapter 3**

### **The History of the Reforms in the Financial Sector in Tanzania**

#### **3.0 Introduction**

This chapter lays the foundation of understanding the reforms that are taking place now, by looking at the way the financial sector was developing in Tanzania from the colonial period up to the time of the structural adjustment programs in the late 1980s. Throughout the chapter, important developments are highlighted together with the causes and effects in the broad economic context.

The sections of this chapter are organized according to the phases of German Colonial rule, the British Colonial rule, Pre Arusha Declaration independent Tanzania, and then the socialist phase after the Arusha Declaration. The approach is to trace the major players in the financial sector and their role in the economy at all these different periods.

#### **3.1 The Financial Sector in Colonial Tanganyika**

Tanzania passed under two phases of colonial occupation. From 1884 Tanzania was a German colony, and remained so for 30 years. In effect Germany lost Tanganyika as a colony in 1914, when the WW1 broke out (Kimei, 1987, p. 42).

##### **3.1.1 Financial Sector under the German Rule**

The economic interest of the German colonial master for Tanganyika was to make it serve as a source of primary products for use in German industries. So the early efforts made by the administration were focusing on establishment of plantations and setting up of the infrastructure to transport the products for export. Thus tea, sisal, cotton and coffee plantations were established and began production (Kahama, Wells, & Maliyamkono, 1986, pp. 17-18; Kimei, 1987, p. 43; Abdi, 1977, p. 42). At the same time, the Germans constructed two railway lines – the Central Railway Line and the Northern Railway Line – by 1905, just over twenty years of establishing their rule. The railway lines were used to transport labourers to the plantations as

well as to transport the crops from the plantations to the ports for exporting them (Kimei, 1987, p. 43). The financial institutions that came up were to serve the plantation economy. So plantation areas as well as those with major transportation activities hosted the branches of the financial institutions. During the German colonial rule only two financial institutions were introduced and operated in Tanganyika.

### **3.1.1.2 Banking in Tanganyika under German Colonial Rule**

The financial sector was set up to serve the structure of the colonial economy and so fulfill the objective of the colonial occupation (Abdi, 1977, p. 42; Kimei, 1987, p. 43). There were only two banks that established their operations in Tanganyika. The Deutsche Ostafrikanische Bank was established in 1905, and had the functions of issuing the currency as well as being the banker to the government. It also served in the main production centers and in the entry and exit points by facilitating payment and providing the credit that was needed by the plantation owners as well as the exporters (Kimei, 1987, p. 71). In 1911 Handelsbank für Ostafrika was established, and opened its first branch in Tanga, the main sisal producing area (Kimei, 1987, p. 71). The objectives of establishing it and the manner of its functioning suggests that it was more of a cooperative bank. So up to 1914 when the war broke out there were only two banks in Tanganyika, one operated as a central bank and commercial bank and another as a cooperative bank.

### **3.1.2 Financial Institutions during the British Rule**

It is important to note that at this juncture that, the period from the end of the WW1 until 1945 Tanganyika had an undefined political status (Kimei, 1987, p. 43). It was during that time the indigenous population gradually started to produce cash crops in their own small scale farms. In 1945 Tanganyika became a Trusteeship under the United Nations, and from there on that the British government started to address developmental issues more seriously in Tanganyika. One big difference with the German rule is that the British government allowed the indigenous population to engage in the production of cash crops such as cotton, coffee and

tobacco, and so the share of the subsistence sector started to decline. At the same time there was the commercialization of the food crops, as the quantity of food crops being marketed was increasing. So the intense activities of the financial institutions developed gradually as the status of the colony was clear.

### **3.1.2.1 Central Banking during the British Rule**

When Germany lost the war, the League of Nations gave its mandate to Britain (which was already ruling Kenya and Uganda back from 1884) to administer Tanganyika. However, the political status was not clearly defined until after the end of World War II in 1949 (Kimei, 1987, p. 42). As it was the normal custom of the British colonial administration, East Africa was a common currency area and all the monetary issues were organized by one board, the East African Currency Board (hereinafter EACB), that was founded in 1919 (Kimei, 1987, pp. 57-58). The functions of the EACB included the control over the supply of currency of the colonies under its authority. It was necessary that the monetary affairs were so managed as to ensure the complete convertibility of the East African Currency to the Pound Sterling. But before that, the EACB did the task of issuing the new East African Shilling that was to replace the four currencies existing hitherto.<sup>7</sup> The fall in the value of silver during the period of the currency conversion resulted into heavy losses to the EACB, which limited the growth of the Board in the early years. The Great Depression that followed also weakened the position of the EACB further only to recover from 1932. It was only after 1949/50 that the EACB distributed its first dividends amounting to 3 million East African Shillings (hereinafter EAS) to member countries (from net income earned on the reserves). (Kimei, 1987, p. 59)

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<sup>7</sup> In Tanganyika there were the Indian Rupee, the German silver rupee issued by the Deutsch Ostafrikanische Bank, the German token coins issued during the war (1914-1916) and the local rupee coins issued by the British Currency Commissioner during 1916-1919.

### **3.1.2.1.1 Monetization of the African Population during the British Rule**

Kimei (1987, p.60) noted that during the period 1919-1955 the EACB acted passively as an automatic money changer, to guarantee the automatic convertibility of the EAS to the sterling and vice versa, but that it did not play any active role neither in influencing the quantity of currency nor the local credit conditions. The increase in the use of money, however, was experienced because of the decision of the British government to encourage the indigeneous population to produce cash crops, thus removing those farmer from the subsistence sector, and consequently monetizing them (Kimei, 1987, pp. 60-61).

### **3.1.2.1.2 Fiduciary Issue**

From 1955 there were some changes in the policy of the EACB that allowed the board to lend the money to the governments under its authority through the fiducial issue.<sup>8</sup> Tanganyika was allowed to issue East African Shillings 56 million in 1956, 114 million in 1959 and 112 million in 1961. These ranged from 15 to 26% of the overall government budgeted revenue.

### **3.1.2.2 Commercial Banking during the British Colonial rule**

In 1919 when the EACB was established and included under its authority Tanganyika, there were only two financial institutions inherited from the German era, the Deutsch Ostafrikabank and Handelsbank für Ostafrika (Kimei, 1987, p. 71).

#### **3.1.2.2.1 Domination of Commercial Banking by ‘The Big Three’**

With the exit of the Germans from Tanganyika three banks of British origin took over: The National and Grindlays Bank, The Standard Bank and the Barclays Bank.<sup>9</sup> These were known as the Big Three, and dominated the banking scene in Tanganyika up to 1950, when more smaller banks entered Tanganyika. The big three had made an agreement in 1929 in which

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<sup>8</sup> Through the fiducial issue provision, the EACB was allowed to issue currency against the securities of the governments and other specified intergovernmental organizations. In effect that meant that there was a possibility that currency in circulation could increase without matching with the rise in foreign exchange reserves.

<sup>9</sup> For more about the big three see Kimei (1987, pp 71-72)

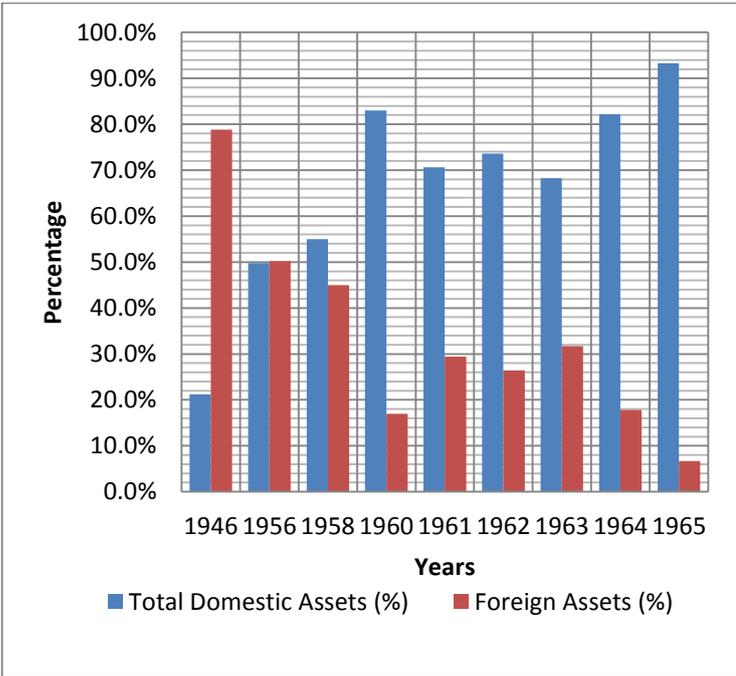
they pledged to cooperate in their business which included fixing the minimum charges among themselves. They also agreed to harmonize their interest rates and exchange rates, as well as to discriminate the outsiders. They also made their own arrangement for clearing of the payments (Kimei, 1987).

**3.1.2.2.2 External Oriented Operations and Capital Flight**

Still the structure of the economy under the British rule was the same as that of the Germans: characterized by dependence. Their main preoccupation was to facilitate export – import trade, and in this way they did not serve the local entrepreneurs. They had very little impact on the indigenous people (Abdi, 1977, p. 48).

In terms of managing the commercial banks assets and liabilities, we also see a preference for investment in foreign liquid assets: cash at the central office and correspondent banks and investment in foreign assets. In 1950 68% of their assets were in foreign obligations, and 44% of the loans extended were for financing export trade and distributing the imports (Abdi, 1977, p. 48).

**Figure 5: Domestic and Foreign Assets Growth**



Source: Abdi (1977, p.48)

### **3.1.2.2.3 Cooperative Movement**

It is worth mentioning that the period under the British rule is the one marked by an increase in monetization, due to permitting the indigenous people to produce cash crops in their own farms. The British administration responded to this development by introducing the cooperative movement in 1932, which was growing very rapidly and which became one of the beneficiaries of credit from the commercial banking (Kimei, 1987, p. 82). But in general the commercial banking had little impact in transformation of the economy. It was still a dependent economy with external oriented production pattern, and the banks were still owned by the foreign companies and operated according to the interests of the foreign countries. So we can say that, commercial banking and the financial sector in general had a very small contribution to the indigenous economic development (Abdi, 1977, p. 46).

### **3.1.2.3 The Introduction of Regulation of Commercial Banking**

Up to 1960 there was no any legislation guiding the operations of the banks, so they were guided by the policies and regulations of the respective multinational that owned and controlled them (Kimei, 1987, p. 73). Kimei (1987) also continues to observe that it was only in 1960 that the Bank Ordinance (1960) was enacted. The ordinance, among other things, stipulated that only a company or a cooperative society licensed by the Registrar of Companies may perform such business. It also defined the minimum paid up capital (EAS 2 million), and required that at least 25% of their annual income be invested in East African governments bonds and stocks, and introduced a mandatory inspection by the Registrar of the Companies (Kimei, 1987, p. 73). Kimei (1987) notes that there was a very important omission, in that no regulation was put forward on liquidity of banks.

### **3.1.3 Conclusion**

Financial sector in the colonial period was run by the multinational banks, and had to serve the major economic aim of the colonial economy: the production and export of primary products. In this way branches were opened in the areas of the plantations, and in the ports where exports and imports were carried out. The Central banking functions were mainly limited to the issuing of the currency and managing its stability (as was the case during the German colonial rule) and in addition to that managing the convertibility to the pound sterling.

We are not able to trace any policies that aimed at developing the market or enabling the market. It was in 1960 with the Banking Ordinance that we see some regulations like the minimum paid up capital and the requirement for inspection.

### **3.2 Financial Sector after Independence**

The newly independent country inherited from the British rulers an economy that had a sizeable subsistence economic activities and population, with 30% of GDP being accounted for by those activities. It was only 4% of the population that was employed on wage-labour (Abdi, 1977; Kimei, 1987). Agriculture contributed more than 50% of the GDP, and the rate of growth of nonagricultural production was slow (Abdi, 1977). There was no much diversification of the main export products, with cotton, sisal and coffee being the major ones, and the foreign sector was still very important. Thus the same structure of dependency was there .

The newly independent nation resolved as national priority to strive to maximize growth by the private enterprises while adhering strictly to external and internal balance. The main approach was to increase agricultural output by improving traditional methods, at the same time transforming agriculture to one that was capital intensive, at the same time to invest in socio-economic infrastructure and achieve structural change through increase in import substitution industries (Kimei, 1987).

### **3.2.1 Phase I: 1961-1967 Continuation of the Inherited Structure**

There was no much change in the financial sector in the first years after independence. The only change was that some new indigenous banks were formed: The Tanzania Bank of Commerce (1965), the National Cooperative Bank (1964) and the People's Bank of Zanzibar (1966). Nevertheless, the big three (National and Grindlays, Standard and Barclays) were still dominating with 48 branches out of the total 70 in Tanzania, and were organised in a cartel at the time of nationalization (Abdi, 1977). The rest were under the other smaller foreign banks and the newly established indigenous banks. The EACB was still performing the Central Banking role, while new arrangements for post independence Central Banks for the three East African countries were underway. In 1966 the BOT took over from the EACB all the central banking responsibilities guided by the BOT Act 1965 (URT, 1965; Kimei, 1987; Kahama, Wells, & Maliyamkono, 1986, p. 77).

### **3.2.2 Phase II: 1968 – 1991 Market Replacement Policies**

After the Arusha Declaration in 1967, commercial banking underwent major reforms. All foreign banks were nationalised and the National Bank of Commerce was taken over. The branches of all the nationalised banks were taken over by the National Bank of Commerce in the mainland and by the People's Bank of Zanzibar in Zanzibar and Pemba (Kimei, 1987, pp. 123-126).

The vision of the new leadership was to have a banking system that would give priority to the service to the community and not solely focus on the maximization of profit (Kahama, Wells, & Maliyamkono, 1986, pp. 130-140). The government owned banks were thought (by the newly independent government) to be more efficient in mobilization and redistribution of savings for the requirement of economic development, and to ensure that even the rural areas were served adequately. (Abdi, 1977; Kahama, Wells, & Maliyamkono, 1986, pp. 138-140). So the National Bank of Commerce opened branches in all district headquarters in order to reach as many people as possible. It was an attempt to promote outreach (Kimei, 1987).

So 1967 -1991 was a period in which the commercial banks were owned and operated by the state. The state also controlled the prices (interest rates and exchange rates) in the financial sector. It is important to point out that the commercial banking became monopolistic and lacked competition. It also proved to be inadequate and ineffective for resource mobilization (Kimei, 1987).

### **3.3 Conclusion**

This chapter traced the development of the financial sector from the time of the German rule up to the Socialist era in Tanzania. It is shown that the financial sector was very limited in the colonial rule, as it was catering the needs of the traders who were engaged in the international trade, and the producers of the primary products. The majority of the population was not yet monetized and so were not impacted by the presence of the banks. The spread of the financial services was also concentrated in the major production areas and was very limited in terms of depth and breadth and even outreach, and the major players were foreign banks.

It is shown in this chapter also that after independence, there were efforts to introduce local banks, and all of those banks were state owned. After Arusha Declaration in 1967, all the foreign banks present in the country were nationalized and their assets were taken over by the National Bank of Commerce in Tanzania mainland and the People's Bank of Zanzibar in the Zanzibar and Pemba. It is also shown that there were efforts to promote the outreach, and the NBC opened branches in all the districts in Tanzania. But at the same time all credit was centrally allocated. The challenges that arose from this system will be discussed in chapter 4 as they form the background to the reforms that were undertaken to liberalize the financial sector as well as to privatize the state owned enterprises in the sector.

## Chapter 4

### The First Generation of Financial Sector Reforms

#### 4.1 Problems of the State Dominated Tanzanian Financial Sector

Cheng & Podpiera (2008) gave a very good summary of the situation of Tanzania in the 1980s:

In Tanzania, the poor performance of the state-owned financial sector in the late 1980s forced the government to search for new policy directions. Non performing loans (NPL) accounted for over 65% of the loan portfolio, fiscal and financial operations were intermingled, and the regulatory system was inappropriate (Cheng & Podpiera, 2008).

Nyagetera & Tarimo (1997, pp. 72-73) summarized the following characteristics of the financial sector by the time of 1990s reforms.

1. Domination of the public sector in terms of ownership and control of almost all financial institutions
2. Heavy intervention by the government in the day-to-day management of banks and in decisions regarding pricing and resource allocations
3. Absence of competition among financial institutions.

Due to those characteristics that persisted during all this period combined with a deteriorating macro-economic environment, there were some structural problems that Nyagetera & Tarimo (1997, p.73) summarized:

“First that the payment system was inadequate and inefficient. Their second argument is that the existing financial institutions were monopolistic and uncompetitive. Third, they point out to the fact that interest rates and exchange rates were being set by the government, and credit and foreign exchange were being allocated by the government. This led to an ineffective resource mobilization, with ineffective instruments and strategies. Fourth, and as a result of the preceding factors, large portfolios of nonperforming loans were accumulated. Fifth, that most financial institutions suffered from capital inadequacy, and finally there were weak policies to address the problems”.

The World Bank (1999) explains the same problems in another way:

There was no legal framework for harmonizing the activities of all financial institutions and no supervisory body for enforcing adherence to prudential standards. The government maintained interest rate controls and used state-owned banks as a means of directing credit to parastatals and cooperatives. The financial institutions disregard for

asset quality, combined with an unfavourable economic environment led to a large accumulation of nonperforming loans.<sup>10</sup>

Due to these problems, in August 1988 the Government set up a Presidential Banking Commission, under the former governor of the BOT, Charles Nyirabu – hence the name *The Nyirabu Commission* - to analyse the problems and offer suggestions as to what to do to rescue the situation. The commission submitted its report to the Government in July 1990 (Nyagetera & Tarimo, 1997, p. 73; World Bank, 1995b, p. 2; African Development Fund, 2000, p. 1). The recommendations focused on stimulating competition by establishing freedom of entry of both domestic and local private banks, strengthening the existing financial institutions by removing non-performing loans and strengthening corporate governance (World Bank, 1995b, p. 2). As a result of the recommendations: through the assistance of Financial Sector Adjustment Project, funded by the World Bank, The African Development Bank and the governments of the United Kingdom and Switzerland (African Development Fund, 2000, p. 1), new Legal and institutional framework was prepared and installed, major restructuring of the financial institutions was done, private (both domestic and foreign) investors were allowed to and did establish their financial institutions in Tanzania, a good portion of non-performing loans were recovered and the management of the monetary policy was revamped. In short, the new focus was on the need to stimulate competition by allowing foreign banks and joint ventures (Nyagetera & Tarimo, 1997, pp. 73-84; African Development Fund, 2000, pp. 3,8-10; World Bank, 1995b, pp. 2-3).

#### **4.2 First Generation Financial Sector Reforms**

Following the report of the Nyirabu Commission recommendations, there was a major shift in the institutional framework from the emphasis on public sector towards the private sector which operates by market oriented principles (Nyagetera & Tarimo, 1997, pp. 71-74; African Development Fund, 2000, p. 3; World Bank, 1995b, p. 3). This is clearly seen by the decision to allow free entry and exit of financial institutions (Nyagetera & Tarimo, 1997, p. 76;

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<sup>10</sup> World Bank. (1999). *Tanzania: Recent Economic Development*. Washington DC: World Bank. p. 29.

Lipumba, 1992; African Development Fund, 2000, p. 11; World Bank, 1995b, p. 10), as well as to restructure the hitherto existing public sector institutions (Nyagetera & Tarimo, 1997, p. 75; African Development Fund, 2000, p. 8; World Bank, 1995b, pp. 8-9). A number of supportive legislations were enacted for that purpose, the main ones being: The Banking and Financial Institutions Act 1991 (hereinafter BFIA 1991), the Loan and Realisation Trust Act 1991 (hereinafter LART 1991), the Foreign Exchange Act 1992, Capital and Securities Markets Act 1994, BOT Act 1995 and Insurance Act 1996 (Nyagetera & Tarimo, 1997, p. 73; African Development Fund, 2000, p. 8; World Bank, 1995b, pp. 7-10)

#### **4.2.1 Removal of Rigid Controls**

Interest rates and exchange rates were controlled by the government since the Arusha Declaration. This was reformed and from June 1992 the BOT gave up the responsibility for setting interest rates. However, the BOT retained the authority to set the maximum lending rate (Nyagetera & Tarimo, 1997, p. 74; World Bank, 1995b, p. 7). In addition to that, there was another restriction that the 12 month deposit rate should be above inflation. However, from July 1993 the maximum lending rate was removed (African Development Fund, 2000, p. 7; World Bank, 1995a), and from July 1995 there was no longer the restriction on the deposit rate, thus the interest rates were fully liberalized (Nyagetera & Tarimo, 1997, p. 74).

Exchange rates restrictions were also lifted gradually. In April 1993 the Bureaus de Change started operations and were authorized to buy and sell foreign currency at freely determined rates. The official rates, however, for official transactions were still set by the BOT (Nyagetera & Tarimo, 1997, p. 74). The government established the weekly foreign exchange auctions, which from July 1993 involved only the Bureaus de Change, but from August the same year included in addition all commercial banks. These auctions were to unify the exchange rates. From June 1994 daily Inter Bank Foreign Exchange Market (hereinafter IFEM) was established to replace the auctions, and from July 1996 the participation to the IFEM was

restricted for commercial banks and non-bank financial institutions (Nyagetera & Tarimo, 1997, p. 74).

Another lifted restriction was the Branch Network Management. Banks were free, after BFIA 1991 Act to expand or reduce the branch network. As a result of this loss making branches by the NBC were closed (Nyagetera & Tarimo, 1997, p. 75).

#### **4.2.2 Creation of Competitive Environment**

BFIA 1991 provided for the freedom of entry of the private sector – both domestic and foreign – into the banking business, and eliminated the restrictions on competition. As a result new financial institutions established their business in Tanzania (Nyagetera & Tarimo, 1997, p. 75; African Development Fund, 2000, p. 8).

Since prior to the reforms all the banks were state owned, and had an accumulation of non-performing assets, it was necessary to restructure the state owned banks. This was done by first conducting an audit in 1992 that classified the bank assets, so as to identify the magnitude of the Non - Performing Assets. The bad assets were passed on to the LART, and the NBC, CRDB and THB were prepared for recapitalization (Nyagetera & Tarimo, 1997, pp. 75-76; African Development Fund, 2000, pp. 8-9).

#### **4.2.3 Strengthening of the Supervisory Capacity of the BOT**

The new legislations: BFIA 1991, Foreign Exchange Act 1992 and the BOT Act 1995 provided regulations and guidelines for licensing of new financial institutions, the minimum capital requirement for the financial institutions, and set exposure limits and requirements for off-site reporting. Moreover, they established the guidelines for prudential management of the financial institutions (URT, 1991; URT, 1995; African Development Fund, 2000, p. 8; World Bank, 1995b, pp. 7-8). All these empowered the BOT for a more effective regulation and supervision of the banks (Nyagetera & Tarimo, 1997, pp. 76-77).

In order to meet the new challenges of supervision stipulated by the BFIA 1991 and the BOT Act 1995, the BOT upgraded its Supervision Unit into the Directorate of Banking Supervision in 1992, through technical assistance provided through the Financial Sector Adjustment Credit (FSAC) and Financial Institutions Development Project (FIDP) (African Development Fund, 2000, p. 8). The capacity of the Directorate was also built through training and external technical assistance as well as computerization (African Development Fund, 2000, p. 8). New guidelines were also introduced to facilitate the implementation of the BFIA. This was only a beginning of the long process of establishing effective supervision, which is a never ending process. The Directorate of banking Supervision has become an important part of the functioning of the financial sector in Tanzania.

#### **4.2.4 New Approach to Monetary Policy**

Prior to these reforms the monetary policy formulation and implementation were guided by the BOT Act 1965, with the amendments of 1971 and 1978. According to that framework monetary policy had multiple goals: to regulate money supply, to fix monetary variables and to provide for development finance (Nyagetera & Tarimo, 1997, p. 74). In this way it was not focused. In more than two decades, the monetary policy so handled failed to achieve the desired objectives set. In fact, Annual Finance and Credit Plan (hereinafter AFCP) was taken to be everything in the conduct of the monetary policy, and therefore even the monetary targets were not explicit, and were assumed to be implied in the AFCP (Nyagetera, 1992).

In fact, the BOT had no autonomy in setting the monetary targets, since the money supply was endogenous. The most important issue for the government was that its activities were adequately funded. In this way the growth of money supply was being dictated by the fiscal deficits. (Nyagetera & Tarimo, 1997, p. 77)

#### **4.2.5 Restructuring and Privatization of State Owned Banks and Financial Institutions**

Lack of competition was an issue of major concern to the financial sector in Tanzania at the beginning of the reforms. This was because of the monopoly position of the NBC in the mainland Tanzania and the PBZ in Zanzibar (World Bank, 1995a, p. 9). All efforts to allow new entry would not bear any positive results if the monopoly banks continued to exist the way they were. One of the recommendations of the Presidential Banking commission was to split NBC into two units, thereby promoting competition (World Bank, 1995b, p. 5). But the first step was to restructure the NBC, and all other state owned banks and to remove their NPLs through the Loan and Assets Realisation Trust (LART).

##### **4.2.5.1 The Role of the Loan and Assets Realisation Trust (LART)**

This was a government body, created through an act of parliament in June 1991 with the aim of recovery of the non-performing loans of the state owned financial institutions. In June 1992 the administration of the LART was set up by the appointment of the Administrator, the Board and Tribunal members (World Bank, 1995a, p. 8). At the same time Memorandum of Understanding was signed, specifying the responsibilities of the financial institutions and the Government in the process of transferring non-performing loans (Nyagetera & Tarimo, 1997, p. 75; World Bank, 1995a, p. 8). Meanwhile, the BOT completed the task of conducting portfolio reviews and loan classifications of all the state owned banks in 1993, and all the non-performing assets of NBC, CRDB and TIB were transferred from the balance sheets of the banks to LART for recapitalization. By 1994 recapitalization of over TShs. 200 billion worth of bonds to NBC, CRDB and TIB was done (Minister of Finance - Tanzania, 1995, p. 40; World Bank, 1995a, p. 8). However, total recoveries by LART were only TSh. 1.6 billion by December 1994 (World Bank, 1995a, p. 8).

The work of LART was meant to prepare the financial institutions for privatization once the quality of assets was good (Minister of Finance - Tanzania, 1995, p. 40). In the following

sections the actual process of privatization of the state owned banks: NBC, CRDB and TIB will be presented.

#### **4.2.5.2 Restructuring of NBC and Privatization of NBC (1997) Ltd. and NMB**

The privatization of NBC was to follow after recapitalization (Minister of Finance - Tanzania, 1995, p. 40; World Bank, 1995a, p. 9). However, the issue of privatization of the largest bank was politically very sensitive (Cull & Spreng, 2008, p. 7). No wonder that the Tanzanian parliament took a very long time to give its authorization of the privatization of the National Bank of Commerce, which at that time was the only commercial bank in Tanzania (World Bank, 2000a, p. 7). But finally consensus was reached. It was agreed, as the Presidential Commission for Banking advised, to split the NBC into two banks and a holding company. Privatization was justified as necessary since the new banking laws suited most the privately owned financial institutions, and the macroeconomic environment was opened to the market forces (Minister of Finance - Tanzania, 1995, p. 39). But, in addition to that, it was clear that the reforms would not have resulted in the desired competition in banking if nothing was done on the monopoly position of NBC (Minister of Finance - Tanzania, 1995, pp. 39-40). So on October 1<sup>st</sup> 1997, the split of NBC was complete and NBC (1997) Ltd, NMB Ltd., and NBC Holding Company became three distinct entities and were operational (World Bank, 2000a, p. 7; Cull & Spreng, 2008, p. 6).

NBC (1997) Ltd and NMB Ltd. were to be distinguished by the core businesses. NBC (1997) Ltd. was to be a fully-fledged commercial bank and focus its attention on corporate and large customers (World Bank, 2000a, p. 8; Cull & Spreng, 2008, p. 7). On the other hand, NMB was to provide both commercial and microfinance services to both urban and rural areas. The business plan of NMB was to be tailored to the needs (both savings and credits) of small urban and rural businesses and agricultural customers (World Bank, 2000a, p. 8; Cull & Spreng, 2008, p. 7).

What followed after the split was to privatize both banks. But it was clear from the very beginning that the NBC (1997) Ltd. was more attractive to the potential investor due to its core business, and the fact that it was the biggest Bank with over 30% of market share of total bank deposits in Tanzania (Cull & Spreng, 2008, p. 7). It was not easy though, as the experience of restructuring up to that time had resulted into less services by the banking sector. There was that political sensitivity of the government convincing the population that it was doing the right thing (World Bank, 2000a, p. ii; Cull & Spreng, 2008, p. 7).

In August 1998 both banks were offered for sale. As expected NBC (1997) Ltd. attracted bids much quicker and by January 1999, ABSA had won the bid and purchased 70% of the shares of NBC (1997) Ltd. From April 1<sup>st</sup> 2000 ABSA took over the management of the bank (Bank of Tanzania, 2000). The cost of restructuring NBC (1997) Ltd was around US \$ 9 million compared to the estimated \$3.6 million (World Bank, 2000a, pp. ii-iii; Bank of Tanzania, 2000).

#### **4.2.5.3 Privatization of NMB**

When NBC was split into NMB and NBC (1997) Ltd., NMB was to be designed to adopt a core business of catering for small scale financial services serving small urban enterprises and rural agricultural undertakings (World Bank, 2000b). This type of business seemed not to be attractive to investors. So when both banks were offered for sale in August 1998, bids for NMB were slow in coming, whereas things moved very fast for NBC (Bank of Tanzania, 1999). This was partly because all the loans (assets side of the balance sheet) had been moved to the balance sheet of NBC (1997) Ltd., and so NMB remained short of assets, with liabilities exceeding assets by over TZS 84 billion, and had only a provisional license (World Bank, 2007, p. 29). In addition to that, the staff expertise in microfinance business was short of what was needed at that stage of transition (Bank of Tanzania, 1999).

As an interim step, NMB entered into a US\$ 4.9 million legally binding contract with a management contractor: The Development Alternatives Inc., a US consulting firm, expert in

microfinance business to manage it for three years from July 1999 (World Bank, 2007, p. 19; Cull & Spreng, 2008, p. 8). The contract, however, was extended several times until September 2005 when privatization was completed (World Bank, 2006a, p. 30). The contractor was to be responsible for the management of day to day business of the bank, while transforming it into an efficient, stable, profitable, low-cost savings bank and ultimately into a microfinance bank. The government provided the management with a time-bound plan. One of the items in the agreement was not to extend credit for all the time under the management in order to strengthen the balances sheet position of the bank. Lending started in August 2000 (World Bank, 2007, p. 11). Up to August 2000 NMB was investing in the government securities, and drew the rest of its income from fees from remittances, payment services and account charges (World Bank, 1999b, p. 30).

There were delays, however, in implementing the plan for NMB privatization. Many reasons contributed to the delay, one of them is that NMB became profitable under the management contractor, and so voices expressing opposition to privatization increased, and the whole issue was becoming politically sensitive (World Bank, 2007, p. 7; Cull & Spreng, 2008, p. 10). At some point President Benjamin Mkapa had to replace the whole Board of Directors because they also expressed opposition to privatization, he had to insist before their replacement that privatization would go on regardless the opinion of the board (Cull & Spreng, 2008, p. 10). However, this affected the original plan of privatization, as some amendments were done to the plan. Even though the original plan was to sell 70% of NMB shares to a strategic investor, the actual sale was only 49% to Rabobank of the Netherlands on September 30<sup>th</sup> 2005<sup>11</sup>, at the sale price of USD 29 million. Eventually the government remained with 51% of shares, 21% of the shares were sold to Tanzanians (Cull & Spreng, 2008, p. 11).

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<sup>11</sup> See World Bank, 2007, p. 5

It is worth noting, however, that although the Government retained the majority shares, it was not interfering in any way in the running of the bank. Also the performance of the bank in terms of profitability and asset quality was good too. Another important thing to note is that, privatization need not go with contraction in the access of financial services, as NMB succeeded to enter into microfinance business with great success (World Bank, 2007, p. 11&30)

#### **4.2.5.4 Restructuring of CRDB**

The process of recapitalization involved the transfer of TZS 5 billion of the non-performing loans to LART. A further TZS 40 billion was written off, being offset by the treasury bills. Apart from that the Tanzania government injected TZS 2.3 billion in CRDB as equity (African Development Fund, 2000). Following recapitalization through LART, the next step was to privatize CRDB. Privatization was an issue that was very sensitive politically at that time, and perhaps that sensitivity led to a small bank (CRDB) to be the first to be privatized. Discussions between DANIDA, who financed the process, and the Government of Tanzania reached a consensus in 1992 and by October that year a restructuring plan was finalized (World Bank, 1995b). When the management of the bank was changed in 1993, commitment to privatization became stronger. The plan called for the privatization of CRDB by the selling of shares to cooperatives and private individuals. 30% of shares were held by a DANIDA funded trust pending their sale to the public. A new organizational structure was put in place and more than 600 members of the staff were retrenched. Still the performance was not good, as losses continued to grow and the viability of the bank was in doubt. The biggest step towards privatization was in 1995 with the sale of 41% of shares to the public, 29% to a Trust capitalized by DANIDA, and 30% to cooperatives and corporations. However, it was after the passing of the tests on the capital adequacy of the bank, the level of recovery, provisioning and write-off of impaired assets that a freeze on lending imposed by BOT was removed and CRDB was fully licenced. In July 1996, CRDB was renamed into CRDB Bank Ltd, and became the first

Tanzanian bank to be privatized (African Development Fund, 2000; Minister of Finance - Tanzania, 1995).

#### **4.2.6 Government Redefining its Role**

From the Arusha declaration up to the mid-1980s, the government, in addition to the ordinary functions of providing social and economic infrastructure as well as maintaining law and order, had assumed an additional role of being an active participant in industrial production, commerce and trade. With the first generation of financial sector reforms, the government committed itself to gradually abandon its active role in industry, trade and commerce. This was done by the passing of new legislation allowing the private sector to enter into the businesses hitherto restricted to the government as well as by the systematic and gradual privatization of the state owned enterprises.

With the National Investment Promotion Policy of 1996 and the National Investment Act of 1997, the Tanzanian government resolved to strengthen its capacity to perform the role of policy formulation and reform, management of the economic infrastructure, provision of supportive legal and regulatory framework, maintaining law and order, and ensuring that the contract enforcing mechanisms were functioning. This was necessary to provide enabling environment to the private sector to function smoothly, since the existing institutions were all set up to support the economy dominated by the public sector. But this involved a lot, and had later to be more fully addressed in the Second Generation of Financial Sector Reforms, to be discussed in the next chapter.

#### **4.3 Remaining Challenges**

Much was achieved by the first generation financial sector reforms as discussed above. However, critical challenges still remained, which were constraining the development of the financial sector and its role in promoting economic development in the country. The discussions in the parliament of Tanzania on the two bills to repeal the BFIA 1991 and the BOT Act 1995

were used to extract the major challenges that were pointed out by the legislators as key shortcomings of the financial sector in Tanzania.

#### **4.3.1 Dualism in the Economy**

It was evident from the discussions in the parliament that the country development was still characterized by some dualisms, the most important for our discussion here being rural versus urban, formal versus informal, and the rich versus the poor. The financial sector that emerged after the first generation financial sector reform failed to address equally the needs of the different parties in the dualism. The majority of Tanzanians still live in the rural areas, and the economic activity of the majority of those rural Tanzanians is agriculture. However, the first generation financial sector reforms produced a financial system in which the rural areas were almost completely neglected. Most of the bank branches that were operating in the rural areas prior to 1991 were closed as part of the restructuring of the NBC. New banks are concentrating their activities in major urban areas, especially Dar es Salaam, Mwanza, Arusha and Moshi. The loan portfolio of the banks also show a low representation of agriculture. The members of the parliament showed this concern when they were discussing the BFIA 2006. Honourable Simbachawene said: “Our agricultural sector will not grow, will never be a priority in the real sense if we do not take deliberate steps to assist small holding peasants”.<sup>12</sup>

Another Member of Parliament Hon. Said Arfi, emphasised on the need to address developmental challenges of the rural areas said:

Banking services are nowadays available only in urban areas. The rural population have nowhere to deposit their surplus. The scarcity of banking services has increased, and to make matters worse they are still limited to big urban centres, and in some cases only up to district headquarters.<sup>13</sup>

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<sup>12</sup> See URT (2006) Tanzania Parliament Hansard, 3 (6), p.49

<sup>13</sup> See URT (2006) Tanzania Parliament Hansard, 3 (6) p. 95

Hon. Elisa Molel expressed the same concern: “Banks have been running their business only in urban areas, they are yet to extend their services to rural areas, hence the low income population do not benefit from their presence”<sup>14</sup>

Still the needs of the poor and the marginalized in the country was another concern by Hon. Simbachawene: “Our people are ready, they are ready and committed to alleviate their poverty, but have no access to credit”<sup>15</sup>

All of those lawmakers were emphasizing the fact that the financial sector as it developed after the BFIA 1991, has left a large section of the population unserved. The first generation financial sector reforms succeeded in increasing the number of financial institutions in business, but did not succeed to make that service reach the majority of the people in the rural areas engaged in agriculture. The reforms to empower the free market have not produced a solution to the problem of financial inclusion.

#### **4.3.2. Inadequate Long Term Finance**

It is expected that a well-developed and efficiently functioning financial sector would be able to provide long term finance too. This is important because the projects funded by these types of loans are the ones that contribute to a healthy long term growth performance. Long term finance may be used to buy machinery and equipment. It may also fund construction of houses for residential or business purposes and setting up new factories and production plants. Unfortunately, the performance of the financial sector in Tanzania after the first generation of financial sector reforms did not witness sufficient growth in this type of financial service. The lawmakers showed their concern in this regard in their discussion to pass the Banking and Financial Institutions Act 2006. Hon. Katagira said:

The banks operating in Tanzania are satisfied to extend short term credit and still get profit. Medium and long term finance have more risks, because the longer the time to

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<sup>14</sup> See URT (2006) Tanzania Parliament Hansard, 3 (6) p.46

<sup>15</sup> See URT (2006) Tanzania Parliament Hansard 3 (6) p.48

repay, the more uncertainties and possibility of loss. The government must then provide incentives to the banks to lend more.<sup>16</sup>

Another Member of Parliament Hon. C. Keenja was more specific on issue of housing finance: “We do not have any institution that finance housing. We had THB, which was liquidated and yet nothing has replaced it, to afford us with housing finance. We need to have a Housing Financing institution”.<sup>17</sup> And Hon. Chegeni added that “It is important that housing financing be developed in Tanzania, so that people may afford to construct houses”<sup>18</sup>.

### **4.3.3 Credit to Private Sector Growth below the Expected**

When the first generation of financial sector reforms was being prepared, it was expected that financial intermediation would increase at a good rate. However, a good amount of the funds mobilized was not efficiently channeled to productive investment projects in the private sector as shown in Figure 11. Banks remained with far more liquidity than the level stipulated by prudential regulations. In the parliamentary discussion of the Bill of Banking and Financial Institutions, Hon. Simbachawene put it shortly that “our banks have excess liquidity but do not have borrowers”<sup>19</sup>

In the same parliamentary discussions the Minister of Finance explained that one of the reasons for limited growth of credit to private sector was the crowding out of credit by government securities. The government securities were offering higher returns to the bank at their level of risks to the extent that banks preferred to invest their deposit money in these low risk securities. The high yield of the government securities also contributed to the raising of the lending rates, which in turn resulted into excess liquidity<sup>20</sup>.

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<sup>16</sup> See URT (2006) Tanzania Parliament Hansard 3(6) p.64

<sup>17</sup> See URT (2006) Tanzania Parliament Hansard 3(6) p.68

<sup>18</sup> See URT (2006) Tanzania Parliament Hansard 3(3) p. 52

<sup>19</sup> See URT (2006) Tanzania Parliament Hansard 3(6) p. 48

<sup>20</sup> See URT (2006) Tanzania Parliament Hansard 3(3) p. 40

#### **4.3.3.1 Provision of Collateral for commercial lending**

In this aspect, there are two problems that are closely relevant. Most borrowers do not have the requisite assets to pledge as collateral. Even those who really own houses or land, do not have titles to legally certify their ownership. So for most of the people in the rural areas, land and landed property holdings cannot be used as valid collateral. This makes it difficult for them to access loan facilities since banks need to be assured of recovery in the event of default. In the developed countries, even without having the legally recognized title deeds, creditworthiness can be used instead to access finance as suggested by Hon. Ezekiel Maige:

“It is important that there be incentives on the side of government to accept the common assets owned by the people, such as land, farms or permanent crops such as coffee, which in fact provide certainty that it would still be there in three to four years of the maturity of the loan, and so could be pledged as security. Currently there is no incentive on the part of the banks to do so. This is a missed opportunity to alleviate poverty for the needy.”<sup>21</sup>

But this also was not adequately addressed in the first generation financial sector reforms.

#### **4.4 Assessment of the Performance of the Financial Sector 1991-2003**

In this section I am going to go through some of the indicators of financial development indicators from the time the reforms were initiated up to 2003, when the Financial Sector Assessment Program was done. I will go through some measures of financial depth: namely Broad money as a percentage of GDP and credit to the private sector as a percentage of GDP. Next, measures for efficiency of the financial sector will be examined. Here I will take the interest rate spread as well as the interest rate margins. I will also include some measures of costs, to see the percentage of total costs that went to non-interest expenses, to see how effective are the banks in allocating the funds at their disposal to productive activities. I will also look at measures of access to finance, to see how the development of the financial sector has helped the sector to reach to a greater percentage of the population.

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<sup>21</sup> See URT (2006) Tanzania Parliament Hansard 3(6) p. 103

#### **4.4.1 Financial Depth**

Financial deepening is the increase in the level of financial services in a country. It is reflected in the availability of wide range of products for investors for their savings and risk management, and for borrowers for their credit needs and risk management.

I will take three measures of financial depth: Broad money as a percentage of the GDP, credit to private sector as a percentage of the GDP and Deposits as a percentage of the GDP (World Bank, 2004). I use the data provided by the World Bank's database: World Development Indicators, available online. In each of the indicators, my aim was to take the data from 1992 to 2003. This is because the reforms began with the enacting of the BFIA 1991, and so the trend of these indicators will shed light as to the impact of these reforms in the development of the financial sector.

##### **4.4.1.1 Broad Money as a Percentage of GDP**

Farlex Financial Dictionary<sup>22</sup> defines Broad Money to include highly liquid instruments like all physical currency and deposits in checking accounts, but also less liquid deposits like those in savings accounts, certificates of deposit, institutional money market accounts, repurchase agreements and other assets that do not circulate very often. It may also include debt securities with maturities of less than two years, repurchase agreements and other assets.

Broad money is a proxy measure of financial depth. It measures the level of development of payment services as well as that of savings and credit intermediation (Lynch, 1996, p. 7). The figure below shows the trend of the development in Broad Money as a percentage of GDP in Tanzania and in East African countries (for comparison) as well as averages for Sub-Saharan Africa (SSA) as well as Low income Countries (LIC) from 1992 to 2003. This period of time was chosen because of the fact that the FGFSR began in the year 1991 with the enacting of the

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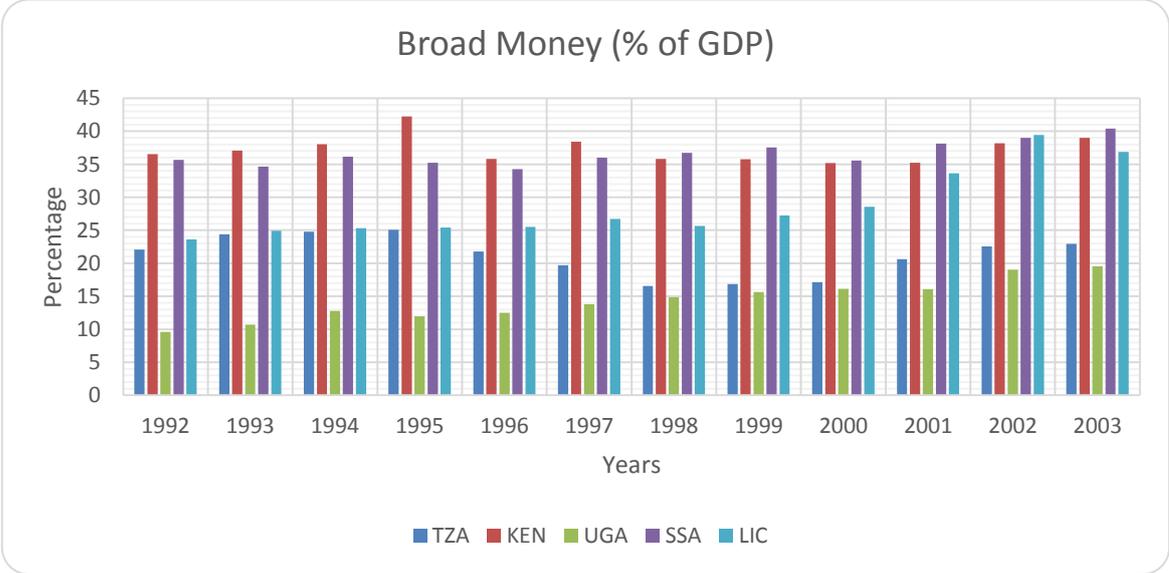
<sup>22</sup> Farlex Financial Dictionary (2012) accessed on 16 April 2014 from <http://financial-dictionary.thefreedictionary.com/Broad+Money>

BFIA 1991, and ended with the Financial Sector Assessment Program 2003, whose findings and recommendations created the agenda for the SGFSR.

In the figure below (Figure 6) the level of Broad Money as a percentage of GDP for Tanzania is consistently higher than that of Uganda but always lower than that of Kenya and the LIC and SSA averages. However, the trend for Tanzania shows a slight initial increase in the first years up to 1995, and then a decline in the following years up to 1998<sup>23</sup>, and then an increase at a slow rate up to 2003. Comparing the level of Broad Money at the start of the financial sector reforms and at the time of closing the first generation of the reforms, we see that there was a very small increase from 22.07% of GDP to 22.95% of GDP.

Hence I can say from the figures of the Broad Money time series, that the reforms did not have a significant impact on the financial deepening in the first 12 years.

**Figure 6: Broad Money as a Percentage of GDP**



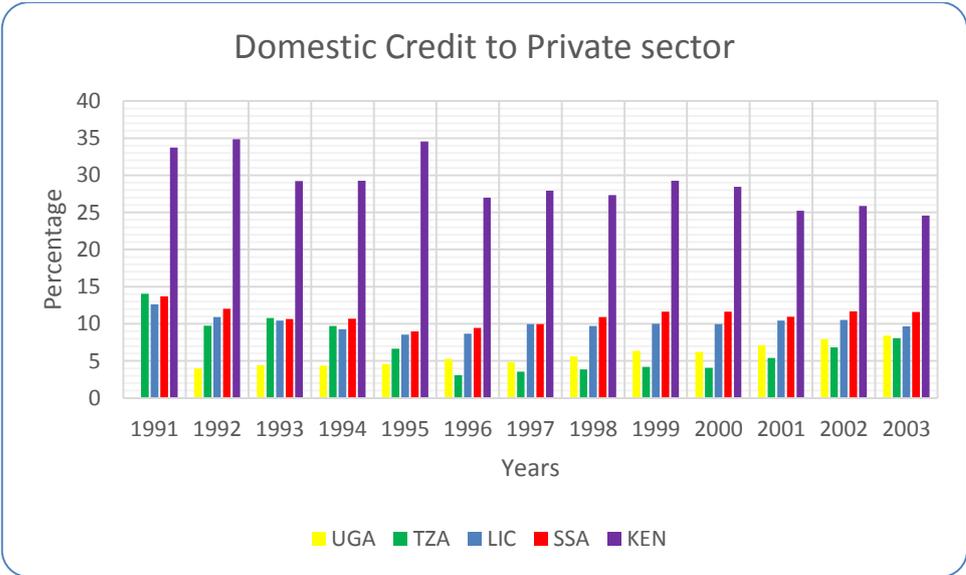
Source: World Bank (2014): World Development Indicators

<sup>23</sup> It should be noted that in the year 1996 NBC (the then biggest commercial bank in Tanzania with more than 90% of total assets of the banking sector) started its restructuring. The restructuring involved the closure of some branches and the laying off of more than 2000 members of staff. In 1997 NBC was split into two banks NBC (1997) Ltd. And NMB. Most likely the decline was due to the shock to the banking sector caused by that exercise.

**4.4.1.2 Private Credit to GDP**

Financial development must be connected to increased financial intermediation (Caporale, Rault, Sova, & Sova, 2009). Financial intermediation in turn is the process whereby the savings are mobilized from those who have savings and investment needs, to fund the investment projects of borrowers and entrepreneurs who have creative and productive projects that need financing. Unless the savings mobilized are channeled to viable productive undertakings, the whole process of financial intermediation would be useless. So some scholars view the indicator of domestic credit to the private sector to be the best indicator of the development of financial sector (Djankov, McLiesh, & Schleifer, 2005). In the figure below, the trend of domestic credit to the private sector from 1992 to 2003 are shown for Tanzania, Kenya and Uganda as well as for SSA and LIC.

**Figure 7: Domestic Credit to Private Sector**



Source: World Bank (2014) World Development Indicators

Figure 7 shows that one year of the beginning of the financial sector reforms in 1991, in terms of Domestic credit to the private sector as a percentage of GDP, Tanzania (14.03%) was behind Kenya (32.67%) but slightly above the averages of the LIC (12.63%) and SSA (13.68%). The data for Uganda are not available for that year. One year after the inauguration of the

financial sector reforms, (1992) Tanzania recorded a decline to 9.74% of the GDP credit to the private sector, which was higher than Uganda (4.0%) but lower than Kenya (34.84%) and the averages for the region of SSA (54.20%) and for the income group LIC (14.08%).

The trend for Tanzania in the first decade of reforms shows an initial decrease to reach the minimum of 3.09% in the year 1996, before the level of domestic credit to the private sector started again to increase at a slow rate to reach 8.08% in the year 2003. So for the period of the first generations of the financial sector reforms, domestic credit to the private sector declined from an initial level of 13.9% in 1992 to 8.08% in the year 2003.

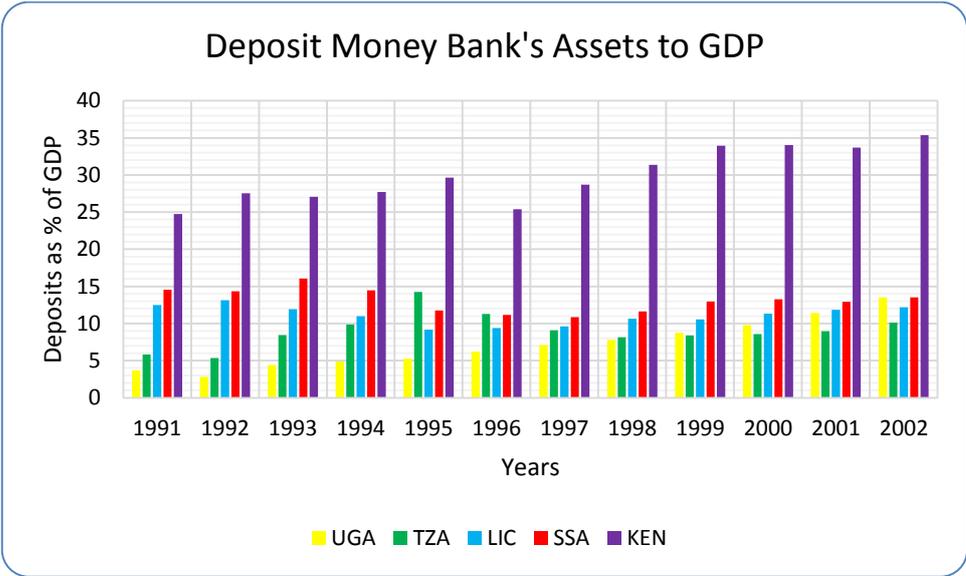
Again, using domestic credit to the private sector as a percentage of GDP as a measure of financial deepening, we see that the first 12 years of the financial sector reforms did not have a positive impact on financial deepening. It is noted also that Uganda, which had a lower level of this indicator in 1992 (the first available data in this period) was experiencing constant increase in the level of domestic credit to private sector as a percentage of GDP.

#### **4.4.1.3 Bank Deposits as a Percentage of GDP**

The main function of financial institutions is financial intermediation. Financial intermediation is the process of pooling together the resources of the savers and making them available for entrepreneurs for investing them in viable investment projects. So the extent to which the financial institutions in an economy can mobilize savings is an indicator of how efficient the financial institutions are in that particular economy. It is also a measure of depth of the financial sector in that economy.

We are going to examine the data we have in hand for the bank deposits as a percentage of GDP in the first decade of the reforms. We are going to include the data for Kenya and Uganda for comparison, and the data for LIC and SSA for benchmarking.

**Figure 8: Deposit Money Bank's Assets to GDP**



Source: World Bank (2014): World Development Indicators

Tanzania had an initial level of domestic deposits as a percentage of GDP of 5.83%, which was higher than the level of Uganda with 3.66%, but very much lower than the level of Kenya of 24.73% and the regional average of the SSA of 14.57% and the average of LIC countries of 12.49%. In the year 2002 the level of domestic deposits as a percentage of GDP for Tanzania of 10.14% was catching up with the regional averages for SSA (13.5%) and LIC (12.17%), although the level of Kenya was still very much higher at 35.35%.

Regarding the general trend for the period, we find that there was an initial increase to the maximum of 14.24% in 1995. This is the period when barrier of entry was lifted for private financial institutions both foreign and domestic, and new entrants began to enter the market. The period of initial increase was followed by a declining trend for the years 1996-1998 reaching a minimum of domestic deposits that were 8.13% of the GDP in 1998. Again this is the period in which the largest bank in the country, the National Bank of Commerce (NBC) was being restructured. The restructuring involved the closure of loss making branches, which reduced the access to the financial services in the rural areas. The period from 1999 -2000 experienced a very slow but constant increase in the domestic deposits as a percentage of GDP.

This corresponds with the period of completion of the privatization of CRDB Bank and NBC (1997) Ltd, and the increasing number of entrants into the market. However, most of the increase was in the major urban centers, especially Dar es Salaam, Arusha, Mwanza and Moshi.

We can note that during this period there was a slow deepening of the domestic deposits. It was catching up with the regional averages, but was still very low for the ideal financial sector to produce a significant contribution to economic development. So the initial reforms have not yet transformed the financial sector to the intended level of growth and contribution to the economy.

#### **4.4.2 Banking Competition and Efficiency of the Financial Sector**

Financial sector efficiency refers to the extent to which the financial sector fulfills its function resulting into the maximum possible financial intermediation with minimum possible costs. Efficiency can be measured by how the products are priced in the financial sector. When there is a wide gap between the selling price of the products sold and the purchase price of the products bought by the financial sector, the respective sector will be inefficient, in the sense that potential safer credit takers will be priced out because of too high lending rates. Also some depositors may also may decide not to deposit in the respective financial institutions because of too low deposit rates (Honohan & Beck, 2007). The causes of this inefficiency may be many and varied, but the major one is the lack of competition, which makes a few institutions too dominant in the banking sector to be able to dictate the price movements in the market. This may provide an explanation for too high lending rates and too low deposit rates. Another reason, which can be felt more when combined with the lack of competition may be the operating costs that are too high (Beck , Maimbo, Faye, & Triki, 2011, p. 50), necessitating the financial institution to price such products as credit high enough to be in the position to break even. Loan loss provision and reserve requirement by the Central Bank is another factor, necessitating the banks to charge a higher risk premiums for credit extended. Beck , Maimbo, Faye, & Triki, (2011) argue that the spreads are caused by differences in bank characteristics such as size,

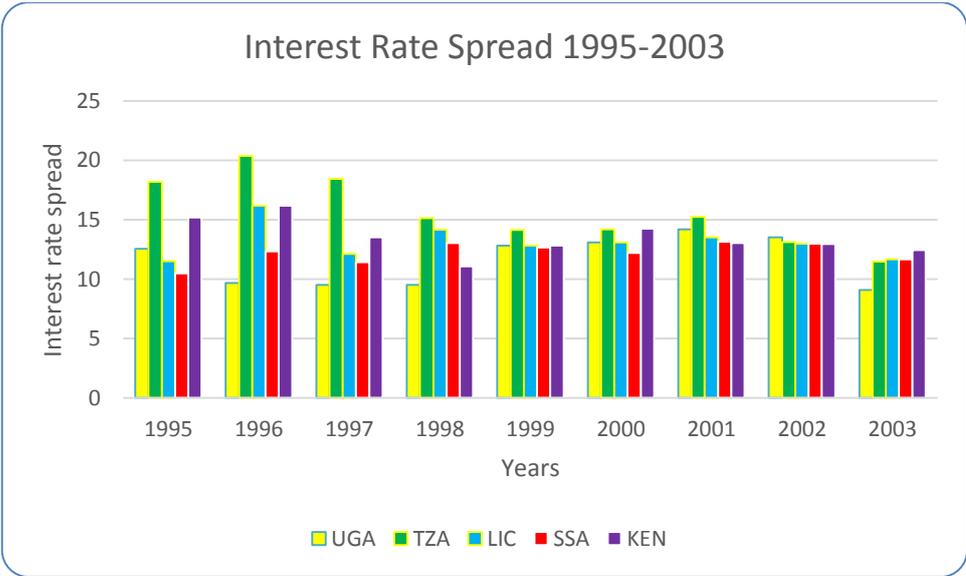
liquidity, ownership and variation in market structure; and country characteristics such as the institutional framework and the level of economic development. On the issue of institutional framework, Beck , Maimbo, Faye, & Triki (2011) point out that it has mainly to do with the contractual framework, whereby the less developed the contractual framework, the higher the interest rate spreads. They also add that higher capital requirement increases overhead costs and margins.

Interest rate spread for the period of reforms will be examined. The data available are from 1995 onwards, but they will be sufficient to make an assessment of the efficiency of the financial sector.

**4.4.2.1 Interest Rate Spread**

Interest rate spread in a financial system refers to the difference between the average lending rate and the average deposit rate in that financial system (World Bank, 2004). In Figure 9 below the interest spread for Tanzania is presented, and the comparison with Kenya and Uganda is made, while also the benchmarking against the LIC and SSA data is made, to show how the level of Tanzania compares with countries of similar level of development.

**Figure 9: Interest Rate Spread 1995-2003**



Source: World Bank (2014) World Development Indicators

In the graph of interest rate spread, we notice that in our first year of observation and in the following six years, the spread for Tanzania was higher than those of Kenya and Uganda, as well as those of SSA and LIC. We note also that the maximum spread was in the year 1996, which is the time when the biggest bank in the country, the NBC was undergoing its restructuring. The restructuring of NBC caused the immediate effect of reduction of financial services because of closure of the loss making branches in the areas of comparatively less economic activities.

We notice also that from 1996 up to the year 1999 there was a slow but regular decline of the level of the spread from 20.3% to 14.14%, followed by an increase in the following two years 2000 and 2001. Interest rate spread then declined to 11.5% in 2003.

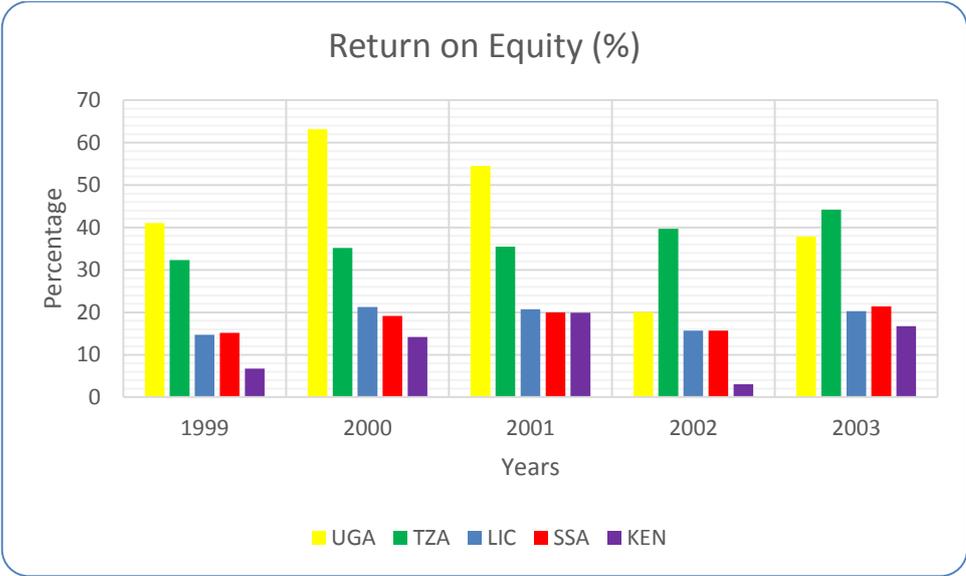
In the early years of reforms it was clear that the gap of the spread between Tanzania and the East African neighbors, Kenya and Uganda was wider than in the year 2003, when Tanzania had a lower spread than Kenya, and was almost at the same level with the regional averages, while slightly higher than Uganda.

The data for spread shows that during the period of reforms there was a constant improvement in the level of spread. This may be due to the entry of private financial institutions and the restructuring of the biggest bank – the NBC – which led to the split of the bank into NBC 1997 Ltd and NMB Bank, which definitely increased competition. Even then Tanzania, Kenya and Uganda need to do more in this respect, as the spread above 10% is still high.

I will examine the profitability of the banks, which have been mentioned above to be connected in a way with lack of competition and inefficiency in the financial sector, which in turn contribute to the high spread.

**4.4.2.2.1 Return on Equity**

**Figure 10 Return on Equity**



Source: World Bank (2014) World Development Indicators

This study noted that the BOT uses the fact that banks in Tanzania have got high profit margin to be a point that demonstrate the healthy position of the operations of banks. I will take that with reservations, because the high profit margins are not obtained in an environment where the interest rate spreads are so high. So, high profit margin may be a symptom of inefficiency that ensue due to lack of competition.

Figure 10 above shows the return on Equity for Tanzania. Return on Equity is a measures of profitability against the shareholders’ funds invested in the business.

$$Return\ on\ Equity = \frac{Profit\ after\ Tax}{Owners\ Equity\ plus\ Retained\ earnings}$$

In figure 9 the actual data for ROE in Tanzania are given, and for comparison purposes, the corresponding figures for Kenya and Uganda, as well as the averages for LIC and SSA for benchmarking purposes. The data available for all these countries are from the year 1999. For the first three years, Uganda recorded the higher profit margin (41% in 1999, 63.14% in 2000 and 54% in 2001) than the regional neighbours(for Tanzania and Uganda respectively 32.3%

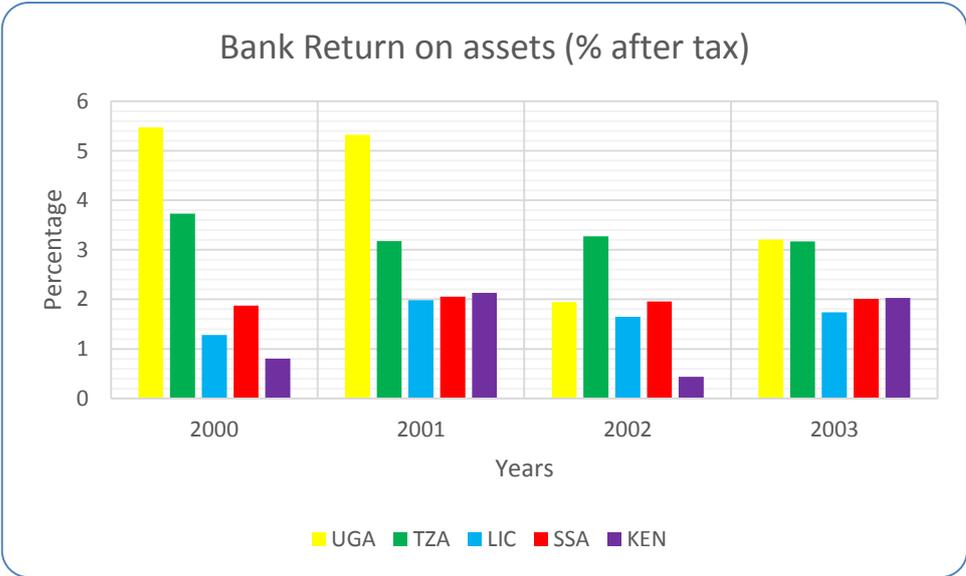
and 6.72% in 1999, 35.18% and 14.2% in 2000, and 35.47% and 19.87% in 2001) and the averages for the SSA and LIC (for LIC and SSA respectively 14.7% and 15.17% in 1999, 21.22% and 19.15% in 2000 and 20.7% and 19.95 in 2002). We note that Tanzania was always the second in those three years after Uganda. For years 2002 and 2003 Tanzania recorded the higher profit margins than the neighbours in East Africa with ROE 39.68% in 2002 and 44.18% in 2003. Uganda had ROE of 20.06% in 2002 and 37.87% in 2003, whereas Kenya had 3.05% in 2002 and 16.72% in 2003. The averages of ROE for SSA and LIC were also lower than the corresponding Tanzanian figures.

**4.4.2.2 Return on Assets**

Returns on Assets is another measure of profitability. It measures how best the financial institution puts the assets at its disposal to a good use.  $Return\ on\ Assets = \frac{Profit\ after\ Tax}{Total\ Assets}$

In figure 11, the figures for Returns on Assets for Tanzania as well as Kenya and Uganda are presented, and the averages for SSA and LIC are provided as well.

**Figure 11: Return on Assets after Tax**



World Bank (2014), World Development Indicators

The pattern is similar to that of ROE, both in Trend and in the way the countries compare. We note, however, that in 2003 Uganda had a marginally higher ROA of 3.21% compared to

Tanzania’s 3.17% for the same year, whereas the ROE for the same year was higher for Tanzania than Uganda.

We note also, that Tanzania had consistently higher ROA than the averages for SSA and LIC, but was closing the gap with time.

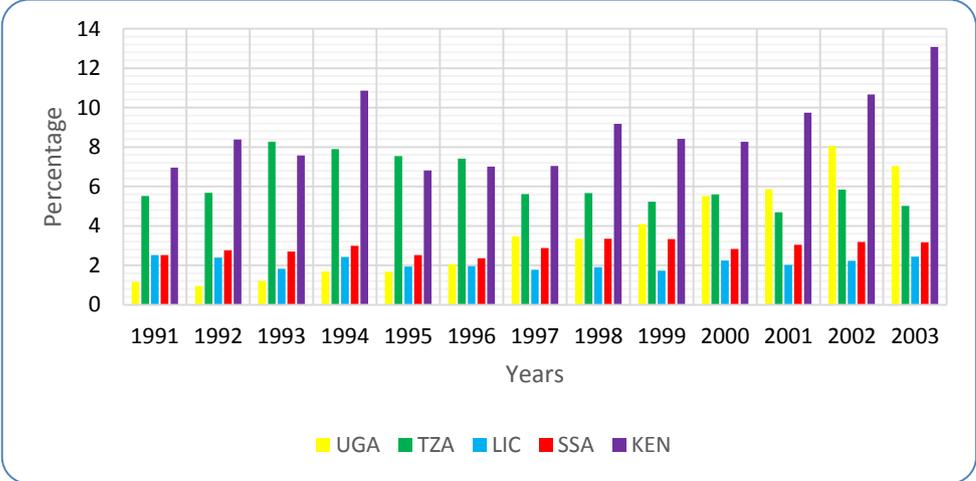
The figures for ROE in Tanzania show that there was an environment that created the possibilities of the financial institutions to earn higher profit margins than the average margins for SSA and LIC.

**4.4.2.2 Government Crowding Out Private Sector Credit**

In an economy where the free market functions efficiently credit is allocated to the projects that have the best returns. Where most of the resources mobilized by the financial sector go to the government and state owned enterprises, the allocating mechanism is considered to be inefficient.

The graph below shows the trend of credit to government and state owned enterprises from the start of the first generation financial sector reforms until they year 2003 where the FSAP took place.

**Figure 12: Credit to Government and SOE as a Percentage of GDP**



Source: World Bank (2014) World Development Indicators

Observing Figure 12, we see that Tanzania began the reforms with large portions of the resources mobilized directed to the government. We note that Kenya and Tanzania have been the countries with highest percentage of credit to the government compared to Uganda and the averages for SSA and LIC. However, Tanzania managed to lower this share of credit, and from the 1997 it was extending lower percentage of GDP to the government than Kenya, and from 2000 even lower than Uganda. This shows that reforms were working well in this respect for Tanzania. The challenge remains that the yield of the government securities are rather high, causing the banks to prefer a lower risk higher return investment of the resources mobilized.

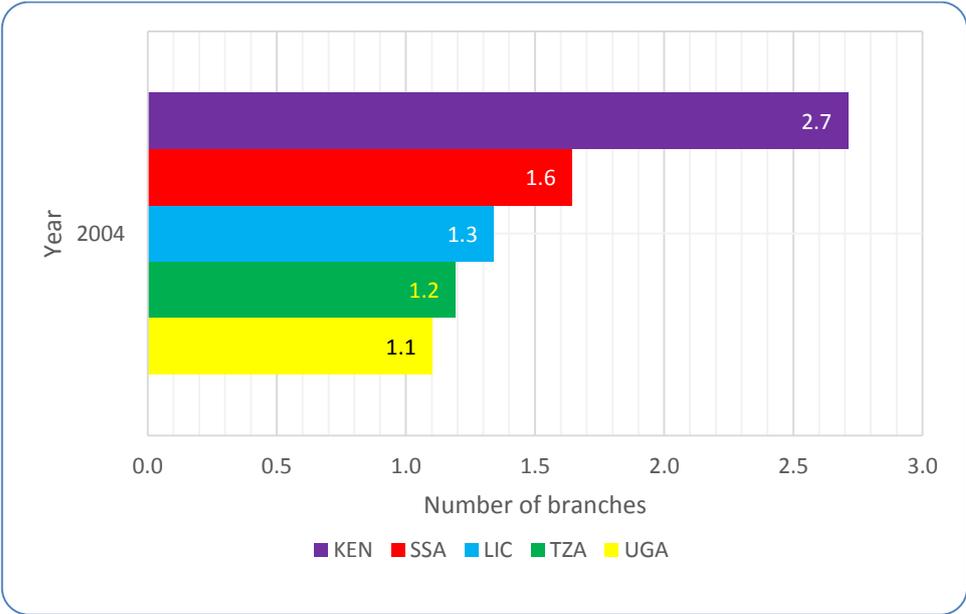
#### **4.4.3 Access to Finance**

It is difficult to obtain accurate and reliable indicator of access to finance in a country. (Beck , Maimbo, Faye, & Triki, 2011) (Abdi, 1977). However, there are proxies that are available and give a good indication of the extent of access to finance in a given country. Such proxies include the number of branches per capita, ATM and/or point-of-sale per capita, and number of bank accounts per capital. In 2004, the World Bank launched an effort to collect proxy indicators on outreach by measuring the number of branches and automated teller machines (ATMs), and deposit and loan accounts. (Beck, Demirguc-Kunt, & Peria, 2007)

##### **4.4.3.1 Commercial Bank Branches per 100,000 Adults**

We are using the data provided by the World Bank on outreach. The data available is from 2004 as Beck, Demirguc-Kunt & Peria (2007) noted. So we use only the data for 2004, which show where Tanzania stood after the first round of reforms.

**Figure 13: Commercial Bank Branches per 100,000 adults**



Source: World Development Indicators

From the data in figure 13, Uganda and Tanzania with 1.1 and 1.2 branches per 100,000 adults respectively were marginally below the SSA and LIC averages for Commercial Bank Branches per 100,000 adults. Kenya with 2.7 branches per 100,000 adults was very much above the averages of 1.3 branches for LIC and 1.6 branches for SSA per 100,000 adults in the year 2004.

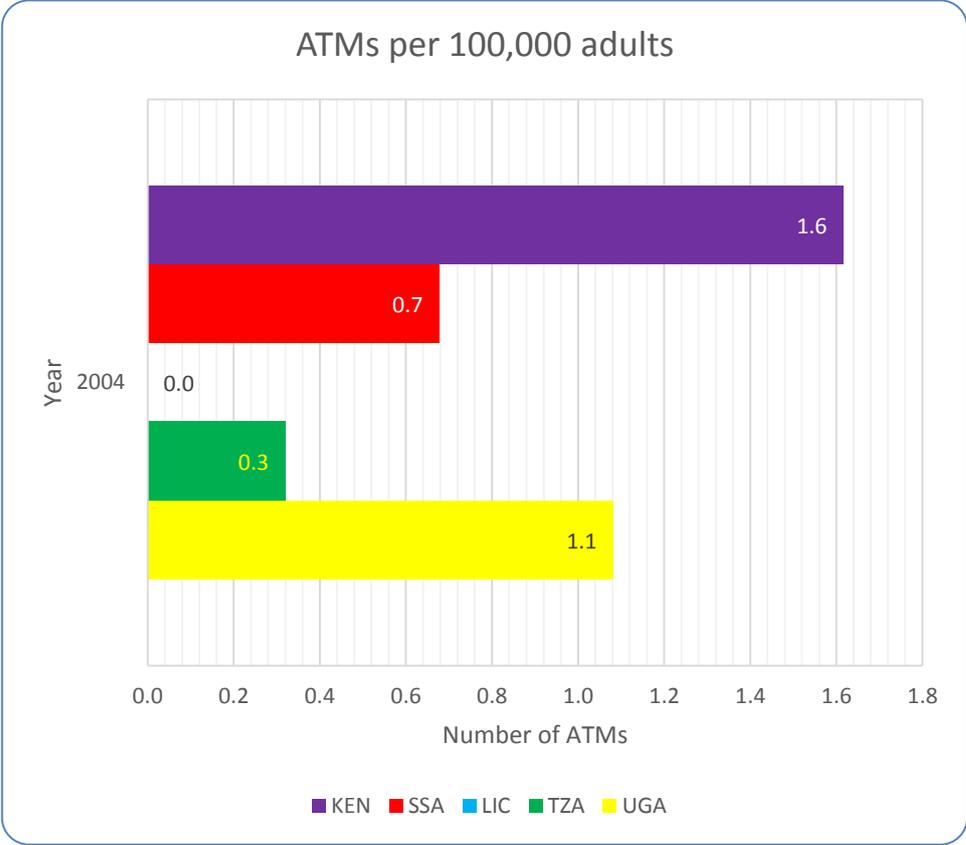
This shows that the access of the banking services in Tanzania was still very much underdeveloped compared to the countries. That is most of the reforms resulted into a growing number of financial institutions concentrated in bigger urban areas. So still much has to be done to develop the Tanzania Financial sector in that respect. Policies that will enable the banks and other financial institutions to open sufficient number of branches in both rural and urban areas are still very much needed.

**4.4.3.2 ATM per 100,000 Adults**

Another proxy measure used by the World Bank is the number of ATMs per 100,000 adults. For this measure also the data are available for Tanzania, Kenya and Uganda as well as

the averages for SSA and LIC from 2004. We take the data for 2004 to indicate the level of access for the respective countries after the 12 years of the FGFSR.

**Figure 14: ATMs per 100,000 adults**

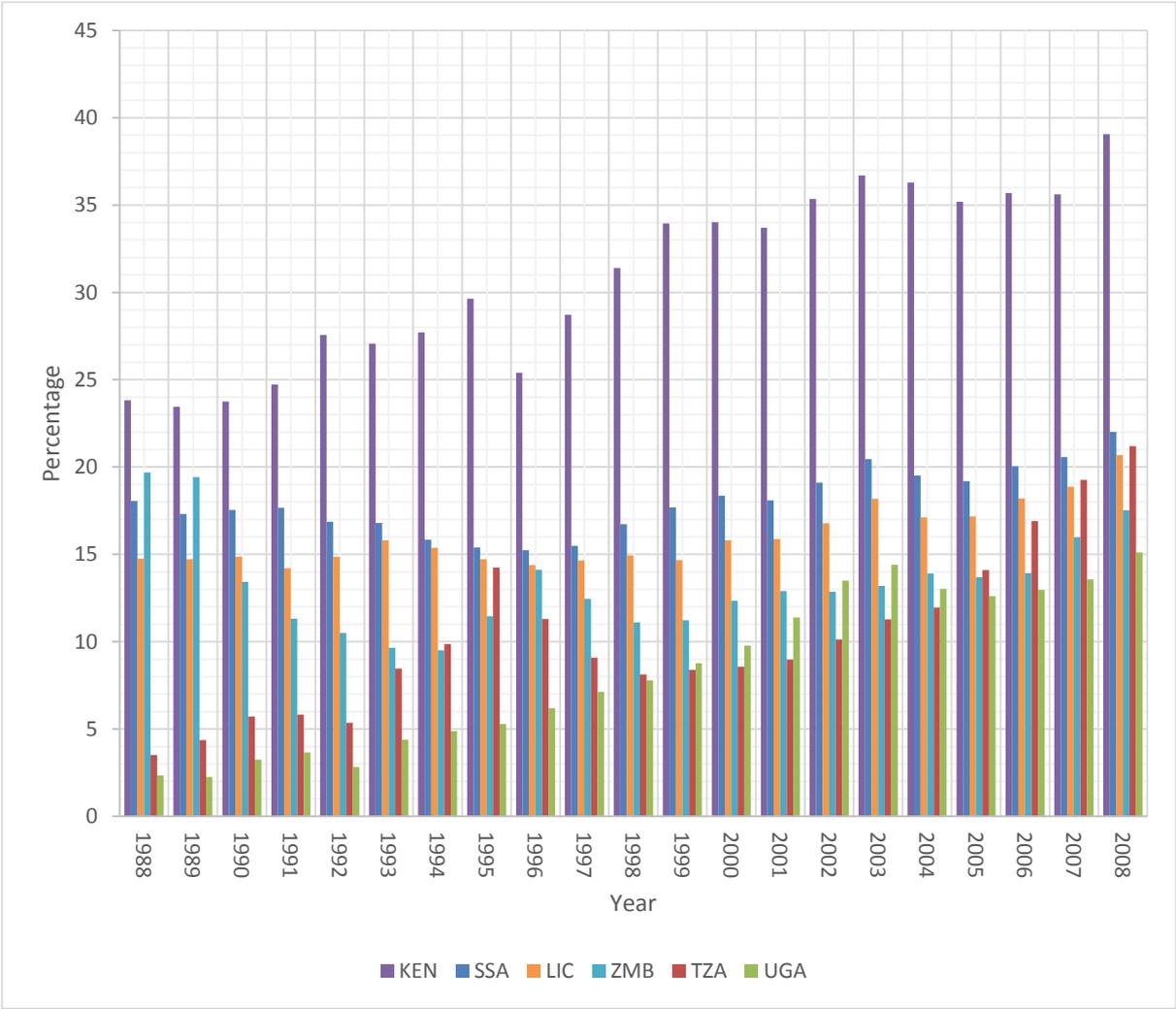


Source: World Bank (2014) World Development Indicators

The data in figure 14 shows that Tanzania had the lowest number of ATMs per 100,000 among the three East African countries. With 0.3 ATMs per 100,000 adults, compared to Uganda’s 1.1 and Kenya’s 1.6, Tanzania was very much behind even the SSA average of 0.7 ATMs per 100,000 adults.

Again this reinforces the observation in the previous section that a decade of FGFSR did not succeed very much to significantly develop the financial sector in terms of the access of finance in Tanzania.

**Figure 15: Bank Deposits as a Percentage of GDP**



Source: World Development Indicators

Figure 15 above shows the position of Tanzania, vis a vis the countries of the same environment and the averages of Low Income Countries (hereinafter LIC) and the Sub-Saharan Africa (hereinafter SSA). The data for all other countries are available from 1981, but the data for Tanzania are available from 1988.

It can be noted that Kenya is above all selected countries in terms of the Bank Deposits as a percentage of GDP, and throughout the time observed Kenya was above the averages of SSA and LIC.

Regarding Tanzania, we note that it has always had the ratio of Bank Deposits to GDP lower than the average for SSA and LIC.

It is interesting to note the trends also. Tanzania Deposits have been rising 3.5% in 1988 to 5.35% 1992, the deposits then increased at a faster rate to reach 14.23% of the GDP in 1995, 8.1 % in 1998. There was a constant upward trend then throughout to reach 21% in 2008. One may note, however a general upward trend from 1992 – the year when the reforms started to take effect, suggesting that there has been a positive impact of the reforms on deposits in Tanzania.

#### **4.5 Washington Consensus**

Washington Consensus is a collective phrase to depict those development strategies based on market fundamentalism. The policies were emphasizing privatization, liberalization and macroeconomic (usually meaning price) stability, while at the same time striving to downscale and minimize the role of government (Stiglitz J. , The Post Washington Consensus, 2005). The architects of these policies believed that since these policies succeeded in the Western Europe and USA, then they were an instant solution to all economic problems. So most of what was done in the FGFSR was motivated by this set of reform packages called Washington consensus.

The policies did not consider that there are market failures due to imperfect information and agency problems. They did not consider the need for safety nets and the necessity to promote equity, both of which cannot be done by the free market (Stiglitz J. , The Post Washington Consensus, 2005, p. 24)

#### **4.6 Conclusion**

This chapter has presented the major policy measures of the first generation financial sector reforms. I have shown in this chapter that among other things, the policy makers removed the rigid controls of the government, and created the competitive environment by allowing the private sector to enter the financial sector provision in Tanzania. The BOT had to strengthen their supervisory capacity, which is necessary in for the stability and safety of financial system. The FGFSR also established the foundation of the functioning of indirect monetary policy. But the bulk of the work of the FGFSR was in the restructuring and privatisation of the state owned

banks. The LART played a crucial role of transferring the non-performing loans from the banks' balance sheets and collecting as much of them as possible. The biggest bank NBC was split into two, and later privatized. Another state owned bank CRDB was also privatized. It is pointed out there that the government changed its role, from being an active provider of the services in the financial services, to the one of being the facilitator of the financial system, by building the institutions that provide incentives for the development of the financial sector. It is shown in this chapter that despite all these reforms, the immediate impact was the decline in service provision, and to strengthen the differences between the formal and informal sectors, the rural and the urban, and also market failure in the area of long term finance. This set up the agenda for the SGFSR, the topic that will be picked up in the next chapter.

## **Chapter 5**

### **Second Generation Financial Sector Reforms**

#### **5.1 Introduction**

The FGFSR allowed entry of private financial services providers, both domestic and foreign. Also attempts were made to restructure and privatize the state owned financial institutions. Some institutions were not yet privatized, such as the Peoples' Bank of Zanzibar and the postal banks. This chapter presents the major policy measures that were taken during the SGFSR. It addresses the attempts to improve the business environment, the measures to establish the mechanisms for efficient flow of information by having efficient registries in the land administration, in business registration and in the credit information and credit referencing. In the chapter also deals with the reforms in the legal and judicial system. Reforms done in the pension sector as well as the insurance sector will be presented and their influence of long term finance.

#### **5.2 The Background to the Second Generation Financial Sector Reforms**

In 2003, after a decade of reforms, the World Bank together with the International Monetary Fund in collaboration with the BOT, conducted a comprehensive assessment of the financial sector in Tanzania in the view of assessing the effectiveness of the reforms undertaken, and to identify the areas of weakness that needed to be addressed. In July 2003, the Financial Sector Assessment Program (hereinafter FSAP) mission presented their report to the BOT (Bank of Tanzania, 2004). In the reports, there were recommendations that the FSAP made, and which the BOT adopted as agenda for the SGFSR

Bank of Tanzania (2007a, p.10) gives the major recommendations of the FSAP mission:

- Reform of the government owned financial institutions, including finalization of privatization process of financial institutions still under government ownership.
- Legal and judicial reforms to remove the main obstacles to lending

- Enhancing access to financial services, including the promotion of microfinance and creation of credit registry.
- Liberalization and development of long-term investment by insurance companies and pension funds.
- Avoiding policy prescriptions or practices to open special windows for SMEs at financial institutions, or the need for government –promoted development banks
- Improvement of banks regulation and supervision and crisis preparedness.

In March 2004, the Ministry of Finance created an Inter-institutional committee for the SGFSR, to oversee the FSAP reform agenda (IMF, 2004, p. 48; Bank of Tanzania, 2005; World Bank, 2006b, p. 10). The Inter-institutional committee worked to prepare the action plan, which was ready by June 2005 and was submitted to the Minister of Finance for approval (Bank of Tanzania, 2006; World Bank, 2006a, p. 10). In August 2005 a seminar for Permanent Secretaries of the Revolutionary Government of Zanzibar was conducted, to sensitize them on activities of the SGFSR, and the financial responsibility for the Government of Zanzibar (Bank of Tanzania, 2006). Various consultants were engaged to advice on specific issues of the reform programs, and their advices were incorporated in the Financial Sector Reform implementation Plan, which was ready by March 2007, and was adopted by the Government for implementation (Ministry of Finance Tanzania, 2007).

In the following section, major reforms that were done in the spirit of the SGFSR will be presented.

### **5.3 Business Environment Concerns before the SGFSR**

From the experience of the first generation of financial sector reforms it was clear that the transition from the centrally planned economy to market economy was not so smooth. The institutional arrangements that are supposed to work well in the market economy were introduced in the environment which was not yet ready for them. It was necessary then to start to create institutions that would create a conducive business environment for the market economy to function efficiently, and hence to enable the reforms that had been undertaken from 1991 in the financial sector to bear fruit. That is why “during this period (1990s), the

government convened a task force to identify areas of legal reform required to bring the legal system in closer conformity to the requirement of a functioning market economy” (Finnegan, 2004)

### **5.3.1 Efforts to Improve Business Environment before SGFSR**

It is important to acknowledge that there were already efforts to improve the business environment even before the SGFSR, though the efforts were not viewed as major items of the reform agenda itself. In the first generation financial sector reforms the major concern was to create the structure of free market economy. In the first place, reforms were done to remove price controls so as to let the market set the prices of the different financial products available in the market. Measures were taken to allow freedom of entry and exit of the financial institutions in the financial business, both domestic and foreign through the enactment of the BFIA 1991 and the BOT Act 1995. Other measures were directed to remove the direct intervention of the government in the financial institutions functioning apart from providing the legal and regulatory framework. The greatest preoccupation, however, was to strive to privatize the as many of the state owned enterprises as possible, and different donors were interested to support the strengthening of the private sector in Tanzania (African Development Fund, 2000).

At the time of preparation of the agenda for SGFSR, the private sector in Tanzania, was dominated by micro, small and medium enterprises (MSMEs), with a study giving a figure of 2.7 million MSME, 60% of them in urban areas, and with high rate of exit - estimated 60% exiting the business within the first 5 years (World Bank, 2005b).

However, there existed some major regulatory barriers for doing business. The law had no provision of separation of personal vs business assets, and this made most of the businesses to die once the proprietor died (World Bank, 2005b, p. 4).

It was also difficult to register a company, for company registration could be done in Dar es Salaam only. Also permits to start pharmacies, tour agencies, restaurants and cell phone

service provision were issued in Dar es Salaam only and costed between USD 4,000 and USD 5,500 (World Bank, 2005b, p. 5).

The officials responsible to handle such procedures were also excessively slow in applying the law, and so most decisions were arbitrary and even when one was not satisfied the options were limited, one could take up to 570 days to have one's objection granted.

The costs of starting and closing a business were on the average USD 2,700 and 2,750 respectively, which was four times the average yearly wage of a Tanzanian. The access to stock market was also restrictive, demanding a track of profitability for three years, and some USD 50,000 in capital (World Bank, 2005b, p. 4).

Important indicators of business climate in Tanzania at that time are given in the table below together with selected countries for comparison:

**Table 2: Selected Business Climate Indicators for Tanzania**

		TZA	SSA	KEN	UGA	CHN	IND	OECD
Starting a business	Duration (days)	35	63	64	36	48	71	19
	Cost (% of GDP per capita)	161	215	46	117	14	62	6.8
	Min Capital (% of GDP per capita)	6	297.2	0	0	947	0	41
Hiring and Firing workers	Difficulty in hiring Index	67	47	33	0	11	56	30
	Rigidity of Hours Index	80	63	20	20	40	40	50
	Difficulty in firing Index	60	47	30	0	40	90	27
	Rigidity in Employment Index	69	53	28	13	30	62	36
	Firing Costs (weeks of wage)	38	53	47	12	90	79	35
Enforcing Contracts	Number of Procedures	21	35	25	15	25	40	19
	Duration (days)	242	434	360	209	241	425	225
	Cost (% of GDP per Capita)	35	42	41	22	26	43	11
Getting Credit	Collateral creation cost (% of per capita GDP)	21	..	3	12	0	11	..
	Coverage	0	8	0	9	4	0	75
	Credit information	0	1	4	0	3	0	5
	Private Bureau coverage	0	35	1	0	0	1.7	590
	Legal rights	5	4	8	5	2	5	6
Closing business	Actual time	3	3	5	2	2	10	1.5
	Actual cost % of estate	22	19	22	30	22	9	7

World Bank (2005a) Doing Business in 2006

So it was important that something was to be done to improve the business climate in Tanzania, by removing those regulations, policies and institutional constraints. So business

environment strengthening was an important ingredient of the institutional reforms of the SGFSR (World Bank, 2005b, p. 4)

### **5.3.2 BEST agenda**

In July 2002, the preparation of the Business Environment Strengthening for Tanzania (BEST) program was completed and was formally adopted under the President's Office for Planning and Privatization (World Bank, 2003). It was initially funded by DANIDA, DFID, SIDA and the Government of Netherlands: the total cost of \$25.4 million over 5 years period from December 2003 (DANIDA, 2008). This BEST program aimed at addressing Legal and Judiciary Issues (Land law, Labour law, Business licensing legislation, commercial court, and tax issues) (DANIDA, 2008). The ultimate aim of BEST was to reduce the burden on businesses by eradicating as many procedural and administrative barriers as possible (Tanzania Bankers Association, 2007b, p. 12). So when the SGFSR was adopted by the Government, the World Bank was willing to join in as a co-donor for the agenda of business environment strengthening. World Bank signed a MOU in July 2006 (DANIDA, 2008).

#### **5.3.2.1 Business Licensing**

In the pre-reform era there were some rigid regulations regarding business licensing that acted as barriers to the starting of new small and medium enterprises. The aim of licensing fee was revenue generation, apart from its normal regulatory function (Ministry of Finance Tanzania, 2004. Para 10). Through the BEST initiative, license fee rule for small businesses was changed from July 2004. From that time on, the license fee was applicable only upon establishment rather than on an annual basis. This was intended to reduce the costs of business. The reforms were a shift to transparent and efficient licensing for registration, not for revenue generation (Ministry of Finance Tanzania, 2004. Para 10). This spirit of improving the quality of institutions, was already manifesting and was to be the major preoccupation of the SGFSR. Of course, the SGFSR was to continue with further licensing and other business environment reforms

### **5.3.2.1 BEST Agenda under the SGFSR**

Under the SGFSR, there was a new program Tanzania: Private Sector Competitiveness Project (PSCP), whose agenda coincided with the agenda of the BEST program including, the Review of Civil Justice System in Tanzania and the Review of Land Dispute Settlement.

#### **5.3.2.1.1 Review of Civil Justice System in Tanzania**

This was a long term project that was undertaken by BEST project from 2005 -2012, and the final report has been published only recently. (URT, 2013), and the major focus is to make the civil cases be decided on the issues at stake, and not to let other issues that do not have direct bearing with the issue at hand be the reason for delay of the cases. Also the review has stressed on the importance of alternative dispute resolution mechanism for commercial cases, as where it is possible it reduces time and expenses of reaching a resolution.

### **5.4 Financial Access**

FSAP identified one of the challenges that the Tanzanian Financial sector was still facing to be that of limited outreach (World Bank, 2000a). A decade of financial reforms could not achieve to increase the financial access to a greater percentage of the poor people, both rural and urban. But with the rural population, the problem was even worse, since the expansion of new financial institutions as well as that of the branches of the already existing institutions was concentrated in urban areas. The problem that limit this financial access was the inability of the poor people to fulfil the lending conditions of commercial banks. So there were some barriers to the expansion of lending. The first obstacle is that most of the poor people do not have the collateral acceptable by the commercial banks to qualify for loans. Even though they might own land, they could not use their land holding as collateral because in most cases the rural land is not registered, and so they did not have title deeds (DANIDA, 2008).

To address these challenges, the SGFSR embarked on the initiative to create credit registries and credit reference systems, to reform land laws so as to improve property rights and

improve land administration systems that acted as impediments to financial access. There are other issues, which address more than one challenge, and will be treated in the subsequent sections.

#### **5.4.1 Establishment of Credit Registry and Credit Reference System**

The FSAP strongly recommended the creation of credit registry and a credit reference system. This is the arrangement that would enable the people who do not have material collateral to have the possibility of creating a reputational collateral, which would facilitate their access to finance (World Bank, 2005b).

##### **5.4.1.1 Credit Registries**

Credit registries are the depositories of data about history of individuals and businesses and their reputation of borrowing and repaying. They are also powerful tools of assessing, supervising and monitoring credit risk in the economy (World Bank, 2013a). World Bank explains further that Credit bureaus also offer fraud detection, debt collection, marketing services and credit scoring, while credit registries offer ratings to financial institutions and other services to financial supervisors.

For our purpose of financial sector reforms, creation of credit registry and credit reference bureau was targeting to increase the access to finance. World Bank (2013) in their Doing Business Report for the year 2013, highlighted this importance. They argue that,

Credit registry helps to reduce information asymmetry thus helping both the lender and the borrower. The lenders will be in a position to get, through the credit registry, information that would otherwise be elusive to them, thus empower them to make more informed decisions. On the other hand, the borrowers will be in the position to develop good reputational collateral for repayment. This supplements the traditional collateral that they might not have. In this way credit registry and credit referencing system empower both the lenders and the borrowers and hence facilitates access to credit to those formerly excluded because of lack of traditional collateral (World Bank, 2013a, p. 90).

##### **5.4.1.2 SGFSR and Credit Registry**

Immediately after adopting the agenda for SGFSR in March 2007, the authority overseeing the implementation of the program, the BOT, hired Sterling Merchant Finance Co.

Ltd. to provide a framework for Credit Reference System (Bank of Tanzania, 2007c). The consultant moved quickly to have the framework ready, and was ready by October 2007, then a workshop of stakeholders was held. In the conference the consultant company presented its report on regulations as well as licensing guidelines for credit reference databank and credit reference bureau and handed it on to BOT for further action (Bank of Tanzania, 2008). BOT then submitted the regulations and guidelines to the government for publishing them in the government gazette (Bank of Tanzania, 2009). On 14<sup>th</sup> May 2010, the Credit Reference Databank Regulations (GN 177) and Credit Reference Bureaux GN 178 licencing guidelines were gazetted (Ministry of Finance Tanzania, 2009; World Bank, 2013b, p. 32; URT, 2013, p. 98).

The next step was to start the process of establishing the credit reference databank. A consultant was hired to oversee the installation and commissioning of the credit reference databank in December 2011 (IMF, 2012b). At the same time a public notice inviting credit reference databank and bureaus operators to apply for licenses was issued, and received an immediate response from international operators (Ministry of Finance Tanzania, 2011). By September 2012, the work of installation of databank was completed and Creditinfo International GmbH of Germany was licensed for Credit Reference Databank operations. In December 2012 Dun and Bradstreet Co. from USA became the first Credit Reference Bureau operator to be licensed in Tanzania (IMF, 2012a; World Bank, 2013b).

So now a credit reference databank and a credit bureau are operational, and a good foundation has been laid for promoting financial access among the people who lack traditional collateral. Information is already being shared among lenders in order to reduce information asymmetries between borrowers and lenders, and increase access to credit. At the same time it is expected that the creation of credit reference system will reduce default rates and lower the cost of credit as well as improve borrowers' responsibility and behaviour.

#### **5.4.2 Reforms Related to Land Laws**

In the SGFSR many reforms were done in connection with land laws. These reforms were trying to address and solve the main challenges that manifested during the FSAP. The Financial System Stability Assessment Report for Tanzania noted that there were some reforms done, which contain important advances, but are “flawed in important respects with implications for the availability of mortgage based finance”. (IMF, 2003b, p. 28 para 65) The report goes on to elaborate on the missing legal foundation arguing that:

.. because of bankers’ caution as well as the collateralization requirements of the BOT, mortgages remain important in Tanzania banking, even where the main assurance of creditworthiness is the expected cash flow of the business. (IMF, 2003b, p. 28 para 65)

The IMF (2003b) report (FSAP) also mentioned that the Land Act 1999 had added impediments to the development of mortgage lending, but the problems (statutory delays and prohibition on sale of improved land) were technical and could be resolved. It is worth noting that the IMF (2003) report did not mention financial sector development impediments associated with Land Courts as stipulated in the Land Cases Adjudication Infrastructure and the Land Registry and Tilting processes. By 2003 there was a multiplicity of land courts at various levels that were not properly networked, and so there was a need to look at the land courts landscape and update it in terms of resources and personnel, as well as the court infrastructure. There were also the multiplicity of laws governing land aspects that were not properly harmonised, resulting into a system that was very ineffective. (Bank of Tanzania, 2007b, p. 78)

So, the main challenges were: absence of adequate capacity for adjudication of land disputes, presence of conflicting legislations related to land issues, and absence of land registries at and district levels (Bank of Tanzania, 2007a, pp. 147-150). The existing land adjudicating system was based on Civil procedure code Cap. 33 and Land Dispute (Court) Act No. 2/2002. The use of civil procedure prolonged preliminary procedure in filing pleadings thus hindering a speedy disposal of disputes. Even when the Mortgage Financial (special provision) Act No. 17/2008 was passed, land disputes adjudication jurisdiction was placed at the Land

Court instead of commercial court (URT, 2013, p. 105). The procedures in the Commercial Court was more appropriate. But even the effectiveness of Commercial Court contract enforcement was being undermined by the court brokers who were supposed to oversee the execution of commercial court rulings. The court brokers, however were not disciplined and were not complying with the rulings of the commercial court. Hence it was found necessary to establish the new procedures of appointment of court brokers as well as supervising them.

SGFSR adopted the agenda to reforms the shortcomings to the land law that acted as impediments to the development of the financial sector.

#### **5.4.2.1 Enhancement of Property Rights**

Property rights are “the liberties or permits to enjoy the benefits of wealth while assuming the costs which the benefits entails” (Alchian & Demsetz, 1973). Kironde (2006) further explains that property rights prevent a person or group of persons or institutions from forcibly expropriating what belongs to the other and thus enable the cooperative solution to arise voluntarily. The owner of the rights is guaranteed the right to use, the right to benefit from the property, the right to change its form and substance and the right to transfer the rights, and so gives the owner the incentive to use them in the most productive and competitive manner (Kironde, 2006).

Jaffe & Louziotis (1996) and Feder & Noronha (1987) put property rights into three categories: the right to use, the right of exclusion and the right of transfer. They further explain the categories that with the right to use, the property owner has the final say as to whether the property should be used and if so how, with the right of exclusion: those who have no claim to the property are prohibited from benefiting from it. With the right to transfer, the owner is enabled to trade the rights for another bundle of rights contained in another asset. Another scholar , Eaton, gave a rather more extensive definition of property rights

Property rights are economic interests supported by the law. In real estate, these property rights are referred to as bundles of rights because the ownership of a parcel of real estate may embrace a great many rights, such as the right to occupancy and use, the right to sell or rent it out in whole or in part, the right to bequeath, the right to transfer by contract for specified period of time and the rights to the benefits to be derived by occupancy and use of real estate. (Eaton, 1995, p. 45)

Taylor (2004) summarized the property rights in the table below

**Table 3: Categories of Property Rights and Definitions**

Property Right	Meaning
<b>Occupy/Use/Enjoy</b>	The right to occupy without the threat of eviction
<b>Restrict</b>	The right to restrict others from accessing the property (right of exclusion)
<b>Dispose/Buy/Inherit</b>	The right to sell, or give away, or mortgage, or buy or inherit
<b>Develop/Improve</b>	The right to be able to put the property to some form of development such as building, or installation of infrastructure
<b>Cultivate/Produce</b>	The right to use land/property to grow food , keep animals, or operate home based economic enterprises
<b>Sublet</b>	The right to be able to pass on the land or property to somebody else for rent and for a duration of time
<b>Fix rent</b>	Freedom from rent control legislation
<b>Pecuniary</b>	The right to benefit from any increase in property values
<b>Enforce</b>	The right to legal redress in the event of breach of laid-down rights
<b>Access services</b>	The right to enjoy services such as access roads, drains, open spaces, sewers and social services
<b>Access formal credit</b>	The right to use the property in financial transactions, including it as collateral

Source: Taylor (2004)

#### 5.4.2.1.1 Why are Secure Property Rights Important?

Secure and well defined, transferrable property rights are important for various reasons. First, is that secure property right is a *condition sine qua non* for land related investments, which may in themselves be sources of employment to many people, and certainly contribute to the growth of the economy. Second, secure property rights open possibilities for access to formal credit, when the rights are acceptable as collateral required for acceptance of credit contract. The third advantage of secure credit rights is the increase in government revenue, as properties with secured rights are charged property taxes that are a revenue to the government. But government revenue increase indirectly from the growth of the businesses that are stimulated by the secured rights, which increase the tax base.

#### **5.4.2.1.2 Property Rights in Tanzania**

The FGFSR did not pay much attention to the issue of property rights. Up to 2007, property rights were not adequately settled and the system of property registry was not very efficient as noted by Rabenhorst & Butler (2007, p. 9). So high in the agenda of SGFSR was the issues of improving regulations regarding property rights, as well as providing those rights to the holders of land by registering the unregistered properties (Rabenhorst & Butler, 2007). The system that was existing at that time was of issuing and maintaining paper documents (title certificates) in the registries. The system was labour intensive, and sometimes lacked personnel, while archival facilities were poor and inefficient (Rabenhorst & Butler, 2007, p. 9). There was also inadequate orientation toward customer service, and most of the activities had to be approved by the Ministry of Land in Dar es Salaam, i.e. there was a high degree of centralization. This caused delays in processing the documents, and in the case of mortgage formation, delays in retrieving the stored documents.

Before the reforms land tenure in Tanzania was in the form of a right of occupancy and leasehold. There was no freehold system. The primary legislation governing land ownership was the Land Act, No. 4 of 1999 as well as the Village Act No. 5 of 1999. Under the Land Act, there were several categories of land but the most relevant was the general land. The right of occupancy or leasehold of the general land was under the authority of the Commissioner for Lands. Village land, on the other hand, was under the administration of the village authorities and when offered for occupancy or lease, certificate of title could be granted by these authorities to the holder.

Just after the FSAP, IMF Country Report No. 03/238 highlighted the importance of strengthening property rights in Tanzania. Specifically, IMF reports:

The comparative absence of long term credit is often blamed on the Land Act of 1999, which may have shifted the balance of protection away from the lender to the borrower. There has been continuous pressure from the banks for extensive changes in this law to allow them to secure lending on landed property with greater assurance. It is unlikely

that much expansion of longer term finance can be expected without some amendments to the law, though such amendments will not be a panacea. (IMF, 2003a)

World Bank (2003) had specifically mentioned the possibility of collateralization, foreclosure and consent of spouse to be the critical impediments to lending. In the meantime, even during the FSAP there were efforts to make reviews in the Legal and Judicial sector to enable them to facilitate the growing and efficient functioning of the private sector in Tanzania. Work was already being done through the BEST program that was funded by DANIDA, DFID, SIDA and the Government of the Netherlands. So by the time the FSAP came with the recommendations on the 10<sup>th</sup> of July 2003, even before the Inter Institutional Financial Sector Reform Council was established (established in March 2003), the Principal Secretary of the Ministry of Finance was already talking of the implementation of reform agenda:

To remove the remaining impediments in the development of the financial sector, amendments to the Land Act, which continues to hamper the use of land as collateral will be presented to the Parliament in October 2003. Before that the proposed draft amendments will be reviewed jointly by the Ministry of Lands, the Attorney General Chamber, the BOT and the Tanzania Bankers' Association, to ensure that they are consistent with the Government objective of increasing access to bank credit by much wider range of population. (Ministry of Finance, 2013, para. 31)

In this way, I am of the position that the spirit of the SGFSR (focus on upgrading the institutional qualities) was already existing even before the formal launch of the programs that came under the official name of the SGFSR. On the 20<sup>th</sup> of October 2003 the Land (Amendment) Bill, 2003 was submitted to the Parliament for the first reading, approved in February 2004, published in the Government Gazette No. 42 Vol. 84, and was assented to by the President on 30<sup>th</sup> March 2004 (IMF, 2004).

Regarding the property rights, the amendments sought to simplify the procedures for registration and titling of the landed property. These amendments were “a result of sustained pressure from the banks to the legislators to allow them of secured lending on landed property with greater assurance” (IMF, 2003a). In the Land (Amendment) Act 2004, the right of ownership of land is recognised both statutory and customary as explained by Urbansolutions

(2012). The Act states clearly that interest in land has value, and anybody occupying land (even under customary law) is liable of compensation both for the loss of interest in the land and for other losses and provides for the possibility of transferring land from one category to another. (URT, 2004)

Urbansolutions (2012) summarizes the content of the Land (Amendment) Act 2004 that it is the principal legislation on land matters. The Act covers the underlying legislation surrounding mortgages in Tanzania under Chapter X of the Act. That land in Tanzania is public land and remain vested in the President as the trustee for and on behalf of all citizens of Tanzania. The Act also divides Public Land into three categories: The general land<sup>24</sup>, the village land<sup>25</sup> and the reserve land<sup>26</sup>. There is a provision in the Act that clearly defined the mechanism of transferring land from one category to another. Emphasis is put on the fact that interest in land has value, and that value is to be taken into consideration in any transaction affecting that interest (Urbansolutions, 2012).

Land Act 1999 moved to legally secure customary rights. Under this Act, customary rights are given equal status to granted rights of occupancy. The Village Land Act provides for the possibility to acquire written and registered documentation of customary land rights (Willy , 2003).

#### **5.4.2.1.3 Formalization of Land Ownership**

The problem of dead capital was one of the barriers to access finance. Dead capital is unregistered land and the assets that are attached to it. It is called dead capital because of the

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<sup>24</sup> All land that is not reserved land or village land is general land, but includes also unoccupied or unused village land. See Urbansolutions (2012, p.14)

<sup>25</sup> All land belonging to registered villages, land demarcated and agreed to as village land by relevant village councils and land that villages have been occupying and using as village land for 12 or more years under customary law is known as village land. See Urbansolutions (2012, p. 14)

<sup>26</sup> All land protected by law, or designated land such as national parks, land for public utilities (highways and those under the Town and Country Planning Ordinance), wildlife reserves and land classified as hazardous, which designates land whose development would pose a hazard to the environment (e.g river banks or mangrove swamps) is known as Protected Land. See Urbansolutions (2012, p. 14)

loss of opportunities to the holder such as using it as collateral and even selling it at market price (De Soto, 2000).

Given the magnitude of the problem, it was not realistic that measures to formalize property rights in Tanzania would cover the whole country in a short period of time.

#### **5.4.2.2 Land Registry Modernization**

First Generation of Financial Sector Reforms did not cover issues of Land Registry. In the preparation of the documents for the SGFSR, a review of the prevailing condition of the registry at the time was done, to reveal some major weaknesses. It was reported that

There was a lack of efficient and transparent land registration system leading to corruption and/or fraudulent land transactions. This is manifested by rampant forged or fake title deeds offered to banking and financial institutions as security for loans. (Bank of Tanzania, 2007b, p. 80)

Also the national land registration databank was non-electronic and not well-coordinated. On the contrary, the procedures of registration were slow and antiquated leading to delays in registration of titles (URT, 2013, p. 32). Also processing recommendation for financing to mortgage issuers was taking too long because of the slow procedure of searching through and retrieving the manually kept documents in the registry (Bank of Tanzania, 2007b; URT, 2013, pp. 32-33)

The Committee that prepared the agenda for the SGFSR felt that there was a need to modernise and link (network) land registries in the country to avoid multiple registration and multi-titling of the same property (Bank of Tanzania, 2007b)

So the agenda of SGFSR in the issues connected with land registry was made in an attempt to address the weaknesses in the land legislation that continued to constrain the financial sector development. In the program document we find that the objective of addressing the land issues in the SGFSR is to “introduce and promote an efficient and harmonious legal and judicial infrastructure for collateralization of land and settlement of land disputes” (Bank of Tanzania,

2007a, p. 147). The four activities that are mentioned are: to strengthen a mechanism for adjudication of land disputes<sup>27</sup>, to modernise the land registries<sup>28</sup> and land title registry and search services to reduce the time lag in registering land titles<sup>29</sup>, and resolve the Land Act issues relating to granting of credit<sup>30</sup>. The main activity connected to the Land Act issues was to amend the land regulation, to remove impediments to land-related collateralization.

In the letter of intent to the Managing Director of IMF dated 10<sup>th</sup> July 2003, the Minister of Finance showed that plans were underway to computerise and improve the land registry (Ministry of Finance Tanzania, 2003, para. 31 ). The Government Roadmap on the Improvement of the Investment Climate in Tanzania shows the establishment of Land Registration and Land Information System at the headquarters, six Zonal Offices and in all districts to be the major short term and long term agenda (URT, 2013, p. 42). The work of designing the system had already been completed by the consultants - Cowi A/S and Orgut Consulting AB. The work of procurement of contractors for supplying equipment and installing them in place, as well as the training of operators was underway (URT, 2013, pp. 42-43)

Another important step was the preparation of the Strategic Plan for the Implementation of the Land Act, in which strategic principles and priority areas and activities, together with the time frame for their implementation for 10 years (2005-2014) were clearly delineated. The priority was on the update and, where necessary, amendments of existing laws and policies to enhance access to land by investors (titling and registration laws). (Urbansolutions, 2012).

### **5.4.2.3 Land Titling**

The development of mortgage finance, needed amendments of some legislations related to land administration. The issues of registration and titling were important for the development

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<sup>27</sup> Bank of Tanzania, 2007a, p. 147

<sup>28</sup> Bank of Tanzania, 2007a, p. 148

<sup>29</sup> Bank of Tanzania, 2007a, p. 150

<sup>30</sup> Bank of Tanzania, 2007a, p. 149

of mortgage market, and were already considered in the Land (Amendment) Act 2004, and the Strategic Plan for Implementation of Land Law (SPILL) had this as the important emphasis (Urbansolutions, 2012).

There was also a move to create incentives to Housing Development Companies to build affordable housing to the majority of the people, while utilising the land more efficiently and facilitating access to the home owners of the services. The incentives were to be created by removing barriers that were holding back estate developers from constructing apartments for selling to several owners at the same time (Rabenhorst & Butler, 2007). It was then necessary to consider the creation of a law that would facilitate registration of apartments and give more securities to lenders. So the SGFSR started the process of setting the regulations enabling the estate developers to construct high buildings with a big number of flats (or units) and sell each unit to different buyers, with each unit owner eligible to get a title deed after completing the sale agreement. (Urbansolutions, 2012; World Bank, 2010, p. 3). Mortgage Finance (Special Provisions) Act 2008 provided for the management of the division of buildings into units, clusters, blocks and sections owned individually or co owned. It is a way forward in creating incentives towards property development, as well as mortgage finance market.

Interests of third parties in the mortgaged properties was another serious barrier to the development of mortgage market. Chapter X of the 2004 Land Act amended the earlier regulation that had the provision of foreclosure by the power of sale, and added an exception to it where residential properties could only be foreclosed through judicial enforcement process. The 2004 amendment intended to protect individual borrowers and their families from banks eager to take their matrimonial homes at default. The presence of this provision was a disincentive to lenders as it made the enforcement of contracts more difficult, involving long and expensive litigation process. This, in effect, works against the borrower in the long run, as the number of lenders to enter the market would be reduced, competition will also decline, and interest rates will have to be higher. So in 2008 Mortgage Finance (Special Provisions) Act, the

non-judicial mortgage enforcement procedure was restored. Another important contribution of the Mortgage Finance (Special Provisions) Act no 17 of 2008 was the clear stipulation of the only reasons that provides for a possibility of a court to deny a foreclosure claim: i) if the loan has been paid and ii) if the loan was never taken. The new law does not entertain the Spousal Consent for matrimonial home loophole used before by many to prevent foreclosing (World Bank, 2010, p. 3).

Heavy penalties were introduced for those intending to abuse the spousal consent for matrimonial home to block foreclosure. According to Mortgage Finance (Special Provisions) Act no 17 of 2008, not to disclose a spouse when mortgaging a home is now a criminal offence and one could be sentenced to pay half of the loan amount as fine, or go to jail for up to 12 months in case of being found guilty of such offence (World Bank, 2010, p. 3).

### **5.4.3 Legal and Judicial Reforms**

In the previous section some reforms were mentioned that have connection with land laws and their enforcement. In this section we concentrate on the functioning of the judiciary, especially in the issues of commercial dispute resolution and the enforcement of contracts. Here also we admit from the outset that there were plenty of reforms already done prior to 2003 when the agenda of the SGFSR was being set. The FSAP highlighted the need to strengthen the commercial court by providing it with the required resources and building its capacity.

This study is going to begin by linking the ongoing reforms with the agenda of the SGFSR and proceed to see what was actually done in the SGFSR.

#### **5.4.3.1 Commercial Court**

Soon after the liberalization of the economy of Tanzania in 1986, the business community both domestic and international were lobbying for the creation of a specialized commercial court. After the BFIA 1991, when the new foreign banks entered the Tanzanian market, international investors, who had acquired shares of the newly privatized banks and other

business firms, added their support to the commercial court. They needed a swifter judicial mechanism for recovering their debts. (Finnegan, 2004)

Finnegan (2005) argues that the existing courts were not very efficient in resolving the commercial disputes. In the first place, some members of the judiciary lacked a sound understanding of applicable commercial laws and legal principles. Sometimes these members of the judiciary were required to handle cases involving commercial disputes, resulting into less efficient and less effective commercial dispute resolution. A specialized commercial court would address that weakness. He also noted that there were widespread cases of poor management of cases and corruption, which could have come about as a result of low levels of remuneration within the judiciary and the lack of adequate physical infrastructure because of inadequately funded operating budgets. Another problem that Finnegan (2005) noted was the loopholes given by the Civil Procedure code, which entertained casual adjournments and temporary injunctions, which in turn increased the delays and compounded the backlog problem. Finnegan (2005) gives a concrete example that a sample of commercial cases filed in 1997 revealed that 56% of them were still pending and had yet to be resolved as of December 2000, and of the 44% of cases that had been resolved took an average of more than 15 months.

So due to those challenges, during the early 1990s the government convened a task force to identify areas of legal sector that required reforms in order to bring the legal system in closer conformity to the functioning of the market economy. One of the recommendations adopted by the task force was the creation of a specialized court to hear commercial and financial cases. This recommendation was accepted at the highest level of the government and was formally approved in 1997 (Finnegan, 2004).

From 1998, The Danish Overseas Development Agency (DANIDA), took a specific interest in the commercial court project. DANIDA provided financial assistance for the establishment of the court, including the training of the court staff, refurbishment of the

permanent Commercial Court building and the provision of equipment and supplies (Finnegan, 2004)

The Commercial court of Tanzania started operations as one of three divisions of the High Court of Tanzania in September 1999 (URT, 2010). The aim of establishing it was to put in place a specialized court which would cater for the business community by resolving the commercial disputes efficiently and effectively. This was necessary in the prevailing situation of liberalization and privatizations (URT, 2010; Finnegan, 2004)

There was a need among the business community as well as the investors both domestic and foreign, for a court that would effectively, efficiently and speedily resolve commercial disputes that were to emerge in the wake of the expanded business and commercial activities. The commercial court came as a result of privatizations that came by (URT, 2010).

#### **5.4.3.1.1 The Focus of Commercial Court Tanzania**

From its inception, the Commercial Court of Tanzania targeted to handle cases of commercial significance. These included cases involving the formation and governance of business firms, the contractual relationship of firms, the restructuring or payment of commercial debts, the liabilities arising out of a firm's business activities etc. (Finnegan, 2004). However, commercial court subject matter is not exclusive, instead, the court shares the jurisdiction over commercial matter concurrently with the general division of the high court. In the first three years of operations, the court had a pecuniary jurisdiction over cases involving amounts of controversy of at least TZS 10 million, which was later raised to TZS 100 million in 2002. The commercial court charges a higher filing fee. In this way it is viewed to be prohibitively expensive to small businesses (Finnegan, 2004).

Finnegan (2004) noted that the majority of cases filed with the commercial court involved debt recovery claims or other type of contract dispute, and the businesses that lead in filing the cases in the commercial court were the banks.

#### **5.4.3.1.2 Assessment of the Performance of Commercial Court prior to SGFSR**

Commercial courts managed to handle the cases more efficiently and speedily. In the first four years cases took an average of 4 to 5 months to be resolved, compared to 4 to 5 years for commercial cases at the High Court general division. (Finnegan, 2004)

“Expectation from the business community is very high”. Lord Justice Bwana (2006) noted this when he said “bankers expect courts to act justly, effectively and speedily in disposing of cases. They expect this to be done by adhering to the highest judicial ethics and observing a sense of responsibilities to the society” (Bwana, 2006). It is against this background that the challenges that still remaining will be pointed out.

#### **5.4.3.1.3 Challenges of Commercial Courts to be addressed by SGFSR.**

Lord Justice Steven Bwana noted that:

It had become frustrating in the sense that debt recovery was a time consuming process. Debtors used courts to obtain orders which delayed liability or the execution process. Injunctions were misused and overstretched even beyond their legally recognised limits. Once an injunction was obtained by the debtor against the financial institution, nothing else was forthcoming. In so doing, banks and other financial institutions ability to lend money to other borrowers became frustrated. In brief, while the rest of the country was forging ahead economically, the courts of law were used to frustrate those efforts. That was wrong. The law institutions, especially the courts, should become principal tools for the promotion of business growth. In order to be so, it is my view, that law and the courts in particular must move faster and be more responsive to social or business change. The courts, which interpret the law, should not only frustrate those positive changes in society but they should also not remain static while everything else moves on. Courts must develop and adopt themselves to the signs of time in society. (Bwana, 2006, p. 3)

Bwana (2006) in the quote above is referring to the issues of injunctions, adjournments, execution or failure of court orders by court brokers, being indifferent as to the effect of their actions to the economic development of the country. These were still there even after the establishment of the commercial court and were still acting as barriers to the expansion of the financial sector.

But although the court is to take most of the blame for that, there are situations whereby the work of the court is made difficult by some laxity on the side of the banks in handling their contracts. Bwana (2006 p.4) talks of this laxity “there should be professionalism in handling

lending contracts right from the stage of drafting them”. He continues to elaborate that “the banks should use proper contract documents. They should also ensure that security documentation is regularized, and verify the value of property pledged and the status of the spouses in the case of matrimonial homes”. Finnegan (2005) sums up these problems of due diligence by banks by pointing out that: first that some flaws are created (by the lender) during the granting of the loans and in the prosecution process, second borrowers/spouses capitalize on the flaws so created and third the provisions of the law – which seems to lean on borrowers favour but unfairly against the lenders – allow such capitalization. Finnegan (2005) also emphasized that sometimes the lack of due diligence is of high degree to the extent that securities are incompatible (of very low value) with the facilities extended.

Though the commercial court so established helped in improving the commercial dispute resolution mechanism in Tanzania, there were still much to be done to improve contract enforcement. That is why the first objective of the SGFSR is to “improve access to financial services as a result of better lending environment and efficient legal and judicial infrastructure” (Bank of Tanzania, 2007a, p. 21). Also the very first key priority area of the SGFSR is defined to be Legal and Judicial Reform. Among the activities involved were to improve the facilities for land and housing tribunals and to strengthen the existing commercial courts and enhance their efficiency and establish commercial court in Zanzibar. (Bank of Tanzania, 2007a, pp. 23-26).

### **5.5 Reforms in the Contractual Saving Institutions**

In Tanzania, the major contractual savings institutions are the pension funds followed by the insurance companies. They are important component of the financial sector because they are the biggest customers of the commercial banking in terms of deposits, and also the leading holders of the government securities. Moreover, in a country which is experiencing acute shortage of long term financing, they could provide part of the solution, because the maturities

of their contracts are typically long term, and so it could be easier to match those deposits with long term finance, that is so crucial for the economic growth (World Bank, 2006b, pp. 31-32).

The SGFSR, realised the importance of these contractual saving institutions, and included them in objectives 7: “To promote an efficient and competitive pension sector responsive to market demands and supported by appropriate legal regulatory structures”, and objective 8: “to promote an efficient, sound and competitive insurance industry with different products and wider outreach and market based investment policies” (Bank of Tanzania, 2007a). So two out of 10 objectives were dedicated to the contractual savings financial institutions. Stability of these contractual savings institutions is very important, as they are the major provider of liquidity to the commercial banking institutions, as well as the leading holders of the government securities. This work is interested in the nature of reforms in the pension funds and insurance companies, due to their importance in the stability of the financial system. The nature of their investment policies is also important, so this section is interested on the changes in these policies due to their effect on the availability of long term finance.

### **5.5.1 Regulatory Reforms of Pension Funds**

The initial study done by the SGFSR on the pension funds observed the fact that the pension funds were “excessively liquid and heavily weighted to government securities” (Bank of Tanzania, 2007a, p. 111). So it was deemed necessary to develop an appropriate legal and regulatory framework for the pension funds and to provide for the possibility of establishment of the private sector pension funds. The major focus of the reform was to harmonise the rules, legislation and procedures governing all the pension funds, and to allow for the portability of benefits across the pension funds. In addition to that, the reforms provided a unified legal and regulatory framework. The SGFSR also put in place the framework for supervising the pension funds which paved way for the establishment of the Social Securities Regulatory Authority (SSRA) and the commencement of its activities.

In 2006, M/S Cadogan Financials (US based financial consultant firm) was hired to draft various policy options for reforming the pension sector. In October 2006 M/S Cadogan Financials presented their findings to the government for review and policy formulation (Bank of Tanzania, 2007c).

The reform agenda was guided by the fact that Social security is a right stated in article 22 of the UN Declaration of Human rights of 10<sup>th</sup> December 1948, and article 11(1) of the Constitution of the United Republic of Tanzania, which states:

The state authority shall make appropriate provisions for the realisation of a person's right to work, self-education and social welfare at times of old age, sickness and disability and in other cases of incapacity ... (URT, 1977, Article 11[1])

However, apart for such a right being provided for in the constitution the reality on ground is different. In 2006, social security covered only 5.4% of the labour force (then estimated at 16 million), with the informal sector labour mostly excluded, as well as most of the disadvantaged groups (Bank of Tanzania, 2007b, p. 40).

Even for those included, the benefits provided to them “were not adequate to meet the beneficiaries' basic needs” (Bank of Tanzania, 2007b, p. 41), and so there was an urgent necessity of reviewing the number and magnitude of benefits as well as to introduce indexation of current levels of earnings (Bank of Tanzania, 2007b, p. 41).

It was also observed that the benefits of the existing pension funds were not portable when members move from one fund to another, or to other countries in the East African Community. This is due to lack of uniformity of legislations, operational rules and procedures. Sometimes this implied that members had to lose their rights when they had to move (Bank of Tanzania, 2007b, p. 41).

It was also observed that different pension funds were under different ministries, governed by different rules and procedures that brought about conflict in administration. The PSPF, GEPF PPF and ZSSF were under the Ministry of Finance; while NSSF was under the

Ministry of Labour and Social Welfare and LAPF under the Ministry of Local Government and Regional Administration. On top of that, there was no common regulator in place, and no common coordinator of the activities of the funds (Bank of Tanzania, 2007b, pp. 41,43).

Another important area of reform was investment policy. Here the issue uniformity of asset allocation to different sectors across the different funds, which up to the time of reforms differed from one fund to another was considered an important reform agenda. It was considered important to reform the regulations such that all be governed by a set of uniform investment policies regarding asset allocation. It was observed also that there was a need to widen the investment horizon so as to boost the investment returns and reduce risks (Bank of Tanzania, 2007b).

Since pension funds manage contracts which are long term in nature, and at the same time there was an acute shortage of long term financing in the financial system, adjustment of investment policies to enable the pension funds to contribute to the improvement of the position of long term finance, which is important for growth and poverty alleviation (Bank of Tanzania, 2007b).

It was also important to introduce flexibility in pension management. Up to the time of SFGSR, pensions were being adjusted on ad hoc basis, and so there was a need to introduce indexation, which systematically adjust the pensions to the cost of living and inflation (Bank of Tanzania, 2007b).

Another important issue for reforms was the inclusion of regular actuarial valuations in the management of the pension funds. At the time of SGFSR, actuarial valuations were done at the interval of three to five years, and were conducted by external experts. It was deemed important to conduct those valuation more frequently, and to build the capacity of internal experts to conduct them, even at the level of the supervisory authority (Bank of Tanzania, 2007b).

There was also a need to construct a new supervisory and regulatory framework, to achieve uniformity in the practices of the different pension funds, and this was important as the plan to introduce of private pension funds could only be realised once there is a regulatory framework in place. The new regulation were expected to embrace the above mentioned challenges such as inadequacy of benefits, coordination, and transferability of the benefits and internal governance of the funds as well.

Another important issue is that of governance. The review found out that there were not sufficient specifications of the composition of the board, especially on how to select the members. The choice of members was arbitrary, and though effort was made to ensure inclusion of major stakeholder groups, sometimes it was not realised. But more important is the representation in the Board meetings of the associations of pension fund professionals (Bank of Tanzania, 2007b).

The process of reviewing resulted into a draft of the National Social Security Bill, which was submitted to the parliament in February 2008 for first reading. The major issue in the bill was the establishment of the Social Security Regulatory Authority (hereinafter SSRA) (Bank of Tanzania, 2008). The bill was passed by the parliament and became the Social Securities Act 2008, in June 2008. As already mentioned above, the Act provided for the establishment of the SSRA, which was to be vested with the responsibilities of regulating and supervising the pension sector in the mainland Tanzania (Ministry of Finance Tanzania, 2011, para. 40). In November 2008, the Social Securities Act became effective, and the SSRA was officially established as a regulator of the pension funds in Tanzania mainland and the issuer of investment guidelines, while the BOT was given the power to supervise the financial matters of the fund (Bank of Tanzania, 2009). However, it was only in September 2010 that the SSRA started to operate, with the appointment of the first CEO (Ministry of Finance Tanzania, 2011).

The SSRA started implementing its task by registering the existing social security funds as per section 8 of the Social Securities Act 2008, and introduced immediately a regulatory oversight over the registered funds (Ministry of Finance Tanzania, 2011).

The SSRA also did an actuarial valuation of the existing funds, with the aim of informing the further necessary policy decisions, including investment guidelines (Ministry of Finance Tanzania, 2011). In the actuarial audits conducted, some public pension funds were found to have actuarial deficits<sup>31</sup>, and were deemed unsustainable due to a combination of low returns in investment and the generous benefit packages (World Bank, 2013b).

In March 2012 the SSRA issued investment guidelines for the pension funds, which addressed the issues of returns on investments as well as the extent to which the benefits were reasonable. The aim is to boost returns in investment, while assuring the possibility of meeting the reasonable benefit payments (IMF, 2012a, p. 44 para. 50). But at the same time, the pension funds saw an opportunity to contribute in the promotion of long term finance, since most of the contracts are long term, so it is easy to match them with long term assets. During the reform period it is useful to note that, intensive training was given to the staff of SSRA to build the capacity for the fulfilment of the duties of supervising and regulating the pension funds, as well as to be able to conduct actuarial analysis (World Bank, 2006a).

So the SGFSR introduced the SSRA with the duty to supervise and regulate the pension funds, at the same time the SGFSR paved ways to the issuing of new investment guidelines to ensure reasonable returns leading to reasonable benefits for the members. The SGFSR also identified the pension funds as one of the important sources of long term finance, and incorporated in the investment guidelines the issues of long term investment.

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<sup>31</sup> The results of the actuarial evaluation of the five mainland pension funds (PSPF, LAPF, NSSF, GEPF and PPF) were released by the government in April 2013 and revealed that PSPF was not actuarially sound. This was consistent with the independent actuarial report funded by the FSP.

**5.5.2 Regulatory Reforms of Insurance Sector**

As mentioned above, the eighth objective of the SGFSR was to “promote an efficient, sound and competitive insurance industry with different products and wider outreach and market based investment policies” (Bank of Tanzania, 2007a, p. 21).

It is worth noting that the insurance sector was liberalized in 1996 by the issuing of the Insurance Act Cap. 394 of 1996, which, among other things, established a supervisory authority of the Insurance sector The Insurance Supervisory Department under the Ministry of Finance and Economic Affairs.

In the FSAP 2003, the committee responsible for reforms in the insurance sector observed that there was an need to address challenges in the following major area: to revise the supervisory functions of the insurance sector, to adopt an active and coordinated approach to corporate governance, to revise the investment policy and to boost the public confidence (IMF, 2003b).

With regard to supervisory functions, FSAP observed that the existing system was enforcing compliance through legislative and administrative measures such as the on-site inspection (Bank of Tanzania, 2007b). This system was deemed to be rigid, costly and time consuming, especially in the practices of on-site-inspections

It was also observed that the investment policies of the different pension funds were too restrictive as shown by Bank of Tanzania (2007b):

**Table 4: Investment Policy of Social Security Funds**

S/N	Investment Type	Proportion of Total Assets
1	Government Securities	20%
2	Bank Deposits	30%
3	Statutory deposits at BOT	50%

Source: Bank of Tanzania (2007b)

It has to be noted that such policy was set in 1998 as a prudent measure in the initial stages of the liberalized marketplace, hence it was more protective. But after some years of the presence of the private sector, it was felt that there was a need of reviewing it, due to the fact that most of the insurance companies have achieved stronger stability, and have built strong positions in reserves and shareholders' funds, and so the position of liquidity was very good for meeting the payment claims. A new and more urgent challenge, however, was to boost the investment returns, because the premia included only a thin risk premium and claims were increasing whereas the investment policy was still very cautious and too risk averse (Bank of Tanzania, 2007a).

In the agenda that was finally adopted, reform in the insurance sector was also included. Areas in which the SGFSR sought to reform the insurance sector include the revising of important legislations governing the sector, and ultimately to make amendment to the Insurance Act (Bank of Tanzania, 2007a, p. 50). There was a felt need to move towards risk based supervision, and hence it was necessary to build the capacity for that, including installation of the necessary IT infrastructure, and the knowhow of handling the supervision software (Bank of Tanzania, 2007a, p. 51).

Other important aspects include the preparation for legal and regulatory framework for the participation of banks in the insurance business. In addition to that there was a need to strengthen public confidence in the insurance industry by revisiting professional indemnity limits for intermediaries and create an effective and quick redressing mechanisms for the insuring public, and speedy settlement of insurance disputes (Bank of Tanzania, 2007a, p. 52).

The SGFSR, in developing the framework for long term financing, found out that the insurance companies could provide part of the solution to this problem, as the nature of most insurance products were of long term maturity. Since long term financing, which is crucial for long term growth, is still very limited in Tanzania, and since most of the assets provided by the

banking sector are of short term duration, and since the capital markets for shares and bonds are not well developed, possibilities from insurance companies as well as pension funds could alleviate this problem. So a revised investment policy for the insurance companies as well as for pension funds could provide the much needed boost to long term finance (Bank of Tanzania, 2007a).

So, eleven years after the enactment of the act in 2007, the process of enacting a new Act started and came to completion in April 2009 when a new Insurance Act No. 10 of 2009 was enacted. Among the changes brought by the Insurance Act No. 10 of 2009, was the establishment of the Tanzania Insurance Regulatory Authority<sup>32</sup>. The regulatory authority was given more powers than the former Insurance Supervisory Department, which was more advisory than functional (TIRA, 2010). Also the Act provided that the functioning of TIRA was to be independent of the Ministry of Economic Affairs and the top leaders of the authority are now appointed by the President, and not the minister as before the Act (TIRA, 2010). Another important change is the inclusion in the Board of the representation from insurance professional bodies such as the ATI, TIBA and TIAA. Prior to the Act members of the Board were chosen according to the discretion of the Minister. The new Act has established a special quasi-court tribunal, under the leadership of a senior lawyer (of the level of a High Court Judge), to deal with disputes between policy holders and insurers on issues related to their contracts (TIRA, 2010). In connection with that, an Appeals Tribunal was established by the Act.

## **5.6 Addressing the Problem of Long Term Finance**

The FSAP report noted that there was an “absence of a framework that facilitate long-term development financing targeting infrastructure and basic service provision which would propel growth and economic development” (Bank of Tanzania, 2007b, p. 83) . So far, such investments had been funded by the Government Budgetary allocations as well as donor

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<sup>32</sup> Section 5 of The Insurance Act No. 10 of 2009 provides for the establishment of the regulatory authority.

support. Donors, however, have their preferences, and so only those projects preferred by donors get funded. Moreover, due to funding sources, there is inadequate participation of local stakeholders, those who are actually most affected by the projects. In addition to that, there is no market-based transparency in the provision of long term development finance.

In the pre FGFSR period, CRDB was specializing in development finance for rural areas, TIB was also dedicated to promote long term investment by funding those investments, and THB was giving housing finance, which is long term finance too. TDFL was also no longer effective in long term financing (Bank of Tanzania, 2007b, p. 83).

So after the implementation of FGFSR, the FSAP assessed that there was “a vacuum in the long-term development financing” (Bank of Tanzania, 2007b, p. 83). The report continued that the institutions that were created for that purpose were “lacking a sustainable framework” (Bank of Tanzania, 2007b, p. 83)

The FSAP assessed also that the financing needs were increasing with “the increasing of Small and Medium Scale Enterprises (SMEs), and the expansion of the industrial sector” (Bank of Tanzania, 2007b, p. 84). The need of a better infrastructure for the expansion of the economic activities such as better roads, good communication network, reliable power supply, clean and water supply was growing too, whereas the financing available was mostly short term.

The private sector financial institutions were mainly commercial banks, which in the case of Tanzania were faced with problems of maturity mismatch in their attempts to contribute to the provision of long term finance. The biggest non-bank financial institutions are in the business of insurance and pension sectors. Both insurance companies and pension sectors contribute very little in the provision of long term finance although the maturity of their liabilities are mainly of long-term nature and could very well be matched with long-term assets such as loans and other long term financing.

So FSAP felt a need for preparing a framework that would facilitate the increase in the provision of long term finance by financial institutions in the private sector. Three issues were important, and all are issues pointed out by the new institutional economists to be necessary. It was necessary to establish and improve property rights, to strengthen contract enforcement mechanisms and remove loopholes of information asymmetries, and finally to make the macroeconomic conditions supportive of long term finance (IMF, 2003b).

### **5.6.1 Property Rights and Long term Finance**

In the issues of property right for long term finance, the SGFSR had to address the issue of land delivery systems, to modernise the land registry together with its searching and retrieving of records, and to improve the legal framework supporting mortgage financing, and condominium laws.

#### **5.6.1.1 Land Delivery System**

This is a system that connects the servicing of residential land by the government, to provide roads, water supply and electricity while demarcating the plots to be allocated for building purposes, then giving the property developers opportunity to construct residential houses for selling them to the public, and finally connecting the property developers to the financial institutions that will enable the individuals and households to take possession of the residential home, while paying for it using mortgage financing (Tanzania Bankers Association, 2010, p. 9).

This system was lacking, but it is very important. Recent reforms discussed in section 5.4.2 of this work have provided for the possibility of such arrangements.

#### **5.6.1.2 Legal Framework Supporting Mortgage financing**

SGFSR resulted into the Mortgage Financing Act of 2008. In the act, the property rights of an individual purchasing a house and creating a mortgage were clearly defined *vis a vis* third parties (spouses included). In the new regulation, it is a criminal offence not to disclose the

presence of spouse for a home for which a mortgage is created, and in case of violation, a fine of half the value of the mortgage could be charged or an imprisonment of up to one year could be sentenced upon the offender (URT, 2008, p. 5, para. 8).

Also SGFSR made some amendments to the civil procedure code to remove the loopholes used by lawyers for making delaying tactics when contracts are to be enforced.

### **5.6.1.3 Condominium Laws**

These are rules governing the relationship of parties who hold land horizontally (Tanzania Bankers Association, 2010, p. 9). They are very useful in the development of housing and mortgage markets in urban areas, because they provide incentive for developers to build flats and apartments needed by the medium and lower end population, also useful in the case of scarcity of land (Rabenhorst & Butler, 2007, p. 11). Condominium laws were introduced in Tanzania in 2008, by the Unit Titles Act No.18 of 2008. Paragraphs 8 to 11 provide legislation on the registration of the units and paragraphs 19 to 27 establish the rights of the owners of those properties (URT, 2008a). The law also provided for the formation of association of owners to manage and maintain the common property of the building.

### **5.6.2 Role of Insurance Companies and Social Security Schemes**

In the agenda of the SGFSR, these contractual savings institutions were given high attention. In section 5.5 of this work analysis was made in what actually happened in these sectors as to the reforms. One of the important aspects of the reforms in this section was to provide for the possibility of long term investments. In 2012, the BOT published the Social Security Schemes investment Guidelines, which were made in accordance with the Social Security Act of 2008 and included the maximum of 40% of total assets to be invested in long term debt (commercial paper, promissory notes and corporate bonds), up to a maximum of 30% to be invested in licensed collective investment scheme (Bank of Tanzania, 2012). Thus another source of long term investment has come forth.

### **5.6.3 Lease Finance in Tanzania**

Leasing is a medium term financing technique for the procurement of machinery, equipment, vehicles and properties. It is a complementary form of financing, and is a good alternative to the traditional long term bank loans. It is good because it increases a company's ability to source financing, and is suitable for small and medium enterprises that lack collateral to access traditional forms of finance.

Efforts to develop lease finance in Tanzania were pioneered by Tanzania Lease Project, which is the initiative by the government of Tanzania, in collaboration with the IFC and the government of Tanzania to empower Tanzanians to participate in the economy by having more possibilities of financing (World Bank, 2005). In 2005 the initiative conducted a study of the leasing market in Tanzania, with a view of profiling the leasing industry in Tanzania, and identify critical issues for the growth and development of the industry. In the April-July 2005 study, three major obstacles to the growth of lease finance were identified to be, one is the absence of leasing legal framework and the connected issues of enforcement of lease contracts and repossession of leased assets, two was the inadequate tax incentives for leasing and three the lack of public awareness of the opportunities for lease finance (World Bank, 2005, pp. 1-2). In August 2005 a discussion was held between the World Bank, commercial banks, equipment and vehicles suppliers, the TRA, CMSA and other stakeholders to discuss issues of feasibility of lease finance in Tanzania.

The ultimate aim was to introduce and develop lease finance in Tanzania. In actual fact, the Tanzania Lease Project was a technical assistance team on leasing to the government of Tanzania under the framework of the SGFSR, and was working on preparation of leasing product development for the financial services sector. In November 2007 the bill was presented to the National Assembly and was passed on April 11 2008, and the law came into force on 8<sup>th</sup> of June 2008. It was revised by The Banking and Financial Institutions Act (Financial Lease) 2011 by Government Notice No.151.

The point to take from that is that leasing has now a legal framework on which it is operating, and several companies are in the business, starting with the SERO Lease Finance Ltd., Tanzania Investment Bank, Scania Finance South Africa (PTY) Ltd to mention but a few. Public education is still important to develop this even further (World Bank, 2007a).

#### **5.6.4 Development Financial Institution**

One of the agendas of the SGFSR was to transform Tanzania Investment Bank into a National Development Bank/Development Financial Institution (NDB/DBI). This was to carry on with the normal long term lending while offering technical assistance and support such as Business Support Services, equity financing, as well as acting as conduit to Official Development Assistance. This transformation is aimed at promoting long term finance in the economy which is vital for long term growth. The capital of NDB/DBI was provided by the government, and was TShs. 50 billion in 2008 (Tanzania Bankers Association, 2007, pp. 10-12).

This bank is necessary because the private financial institutions failed to be attracted to priority economic sectors such as manufacturing and agriculture, which have the capacity to promote exports while using local resources both human and natural, while striving to embrace modern technology (Tanzania Bankers Association, 2007, p. 12).

### **5.7 Improvement in the Financial System Infrastructure**

#### **5.7.1 Payment System**

Payment systems play a critical role in promoting greater access by the population to banking and financial services and reduce the use of cash as a means of effecting payments in the economy. So FSAP felt a need to develop a payment system infrastructure to facilitate retail payment.

However, there were efforts already underway for modernisation of payment systems that were launched in 1996. In April 2004 Tanzania Inter-bank Settlement System was launched,

which offers online real time account management and inter-bank high value and time sensitive fund transfers (Bank of Tanzania, 2010).

Biggest development in the payment systems, however, came about from the avenue that was not expected, due to innovations in the use of mobile phone money transfer and payment systems. This needed a regulatory framework to make sure that the transactions are safe enough, and up to now has contributed very much in the inclusion of many people, formerly excluded from financial services.

### **5.7.2 Credit registry**

Section 4.4.1.1 has already treated what was done regarding the creation of credit registry. But it was important to have it under this section because it is also one of the most important financial infrastructure that help to create incentives for both lenders and borrowers to develop credit provision.

From the side of lenders, they are now able to overcome the problem of information asymmetry, and hence they are in the position to screen in the best possible way their loan applicants and identify risky borrowers, and avoid them, while granting loans to safe borrowers. On the side of borrowers, credit registry create the incentive for compliance with the loan contract, to avoid having bad reputation, because whatever they do with their current loans affect their future prospects of getting credit in the future.

### **5.7.3 Accounting Standards**

FSAP noted that Tanzania had adopted the International Financial Reporting Standards (IFRS) since July 2004. Some of the standards were directly applicable to banks and financial institutions, yet some were in conflict with requirements of some of the BOT regulations. One such requirement was IAS No. 39 that takes into account the value of collateral when calculating the amount of provision for loan losses, which was conflicting with a Prudential Regulation of BOT: the Management of Risky Assets Regulation of 2001 which does not take

into account the value of collateral in the determination of provision for loan losses. Also in some cases IFRS require the use of Fair Value Accounting whereas the prudential regulations required to use historical cost accounting (IMF, 2010, p. 50).

So there was a need to synchronise the reporting requirement. The BOT, the TBA and the NBAA were to work out the differences and come out with harmonized regulations, and that was done accordingly.

However, NBAA needs to update its capacity to coordinate the auditing of the financial institutions, because it is the duty of the NBAA to provide a list of auditors acceptable for auditing financial institutions, and also to monitor those auditors to ensure that they audit in accordance with the International Auditing Standards (IMF, 2010, p. 50)

## **5.8 Conclusion**

This chapter has covered the policy measures introduced by the SGFSR. They are mainly concerned with the institutions that create incentives for the development of the financial sector. This included the creation of credit registry, which gives incentives to the borrower to use the borrowed funds wisely as it may affect their future borrowing capacity. On the side of the lenders, credit registry is a mechanism of obtaining important information that enable them to choose low risk borrowers to extend credit to, and so even those who lack physical collateral could be able to get credit. The SGFSR also dealt with the issues of improvement of the business environment and enhancement of property rights.

## Chapter 6

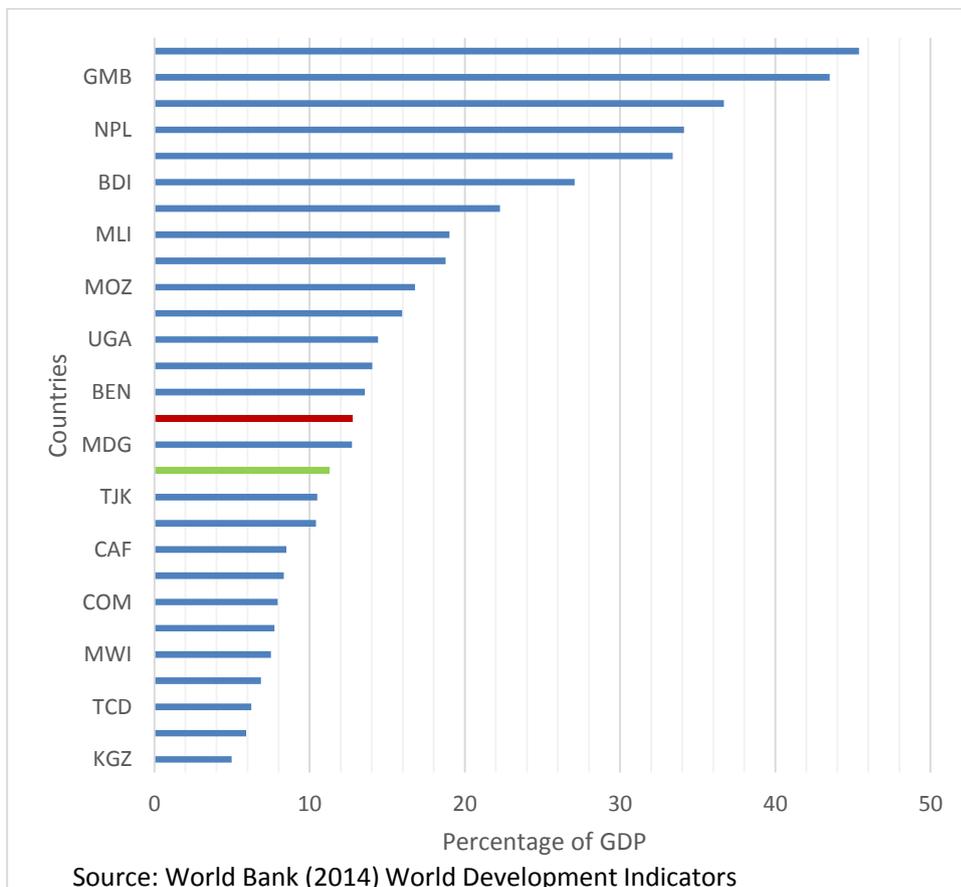
### Discussion on Findings

#### 6.1 Introduction

In the previous chapter findings were presented about the different reforms that were done during the SGFSR that have relevance in the financial sector, especially banking sector. The findings were presented after a background of the first generation of financial sector reforms and their effect in the development of the financial sector. It was clear that the first generation of financial sector reforms brought about an increase in the number of institutions offering financial services, and that there was an overall improvement in terms of the It is not sufficient to establish free market mechanism if the quality of institutions supporting the market system are dysfunctional or of poor quality.

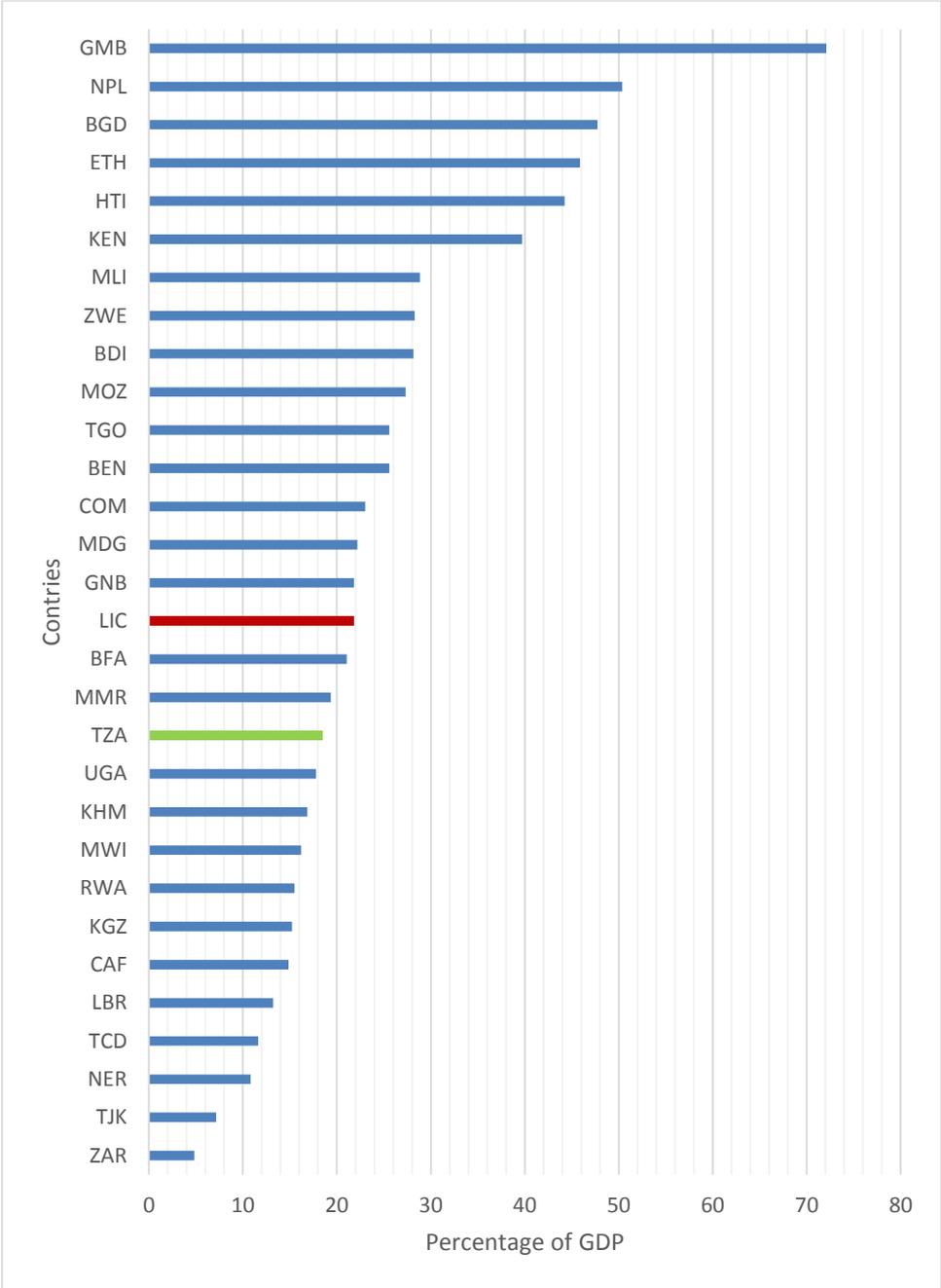
#### 6.2 Benchmarking Tanzania against Low Income Countries

**Figure 16: Deposit Money as a Percentage of GDP**



In terms of deposit money as a percentage of GDP, Tanzania was just below the average of LICs as is shown in Figure 16. With just over 10% of GDP being mobilized, the financial sector was quite behind the peers after the FGFSR. It can be said that the financial sector of Tanzania had the Financial Possibility frontier below its potential, hence calling for market developing policies and market enhancing policies.

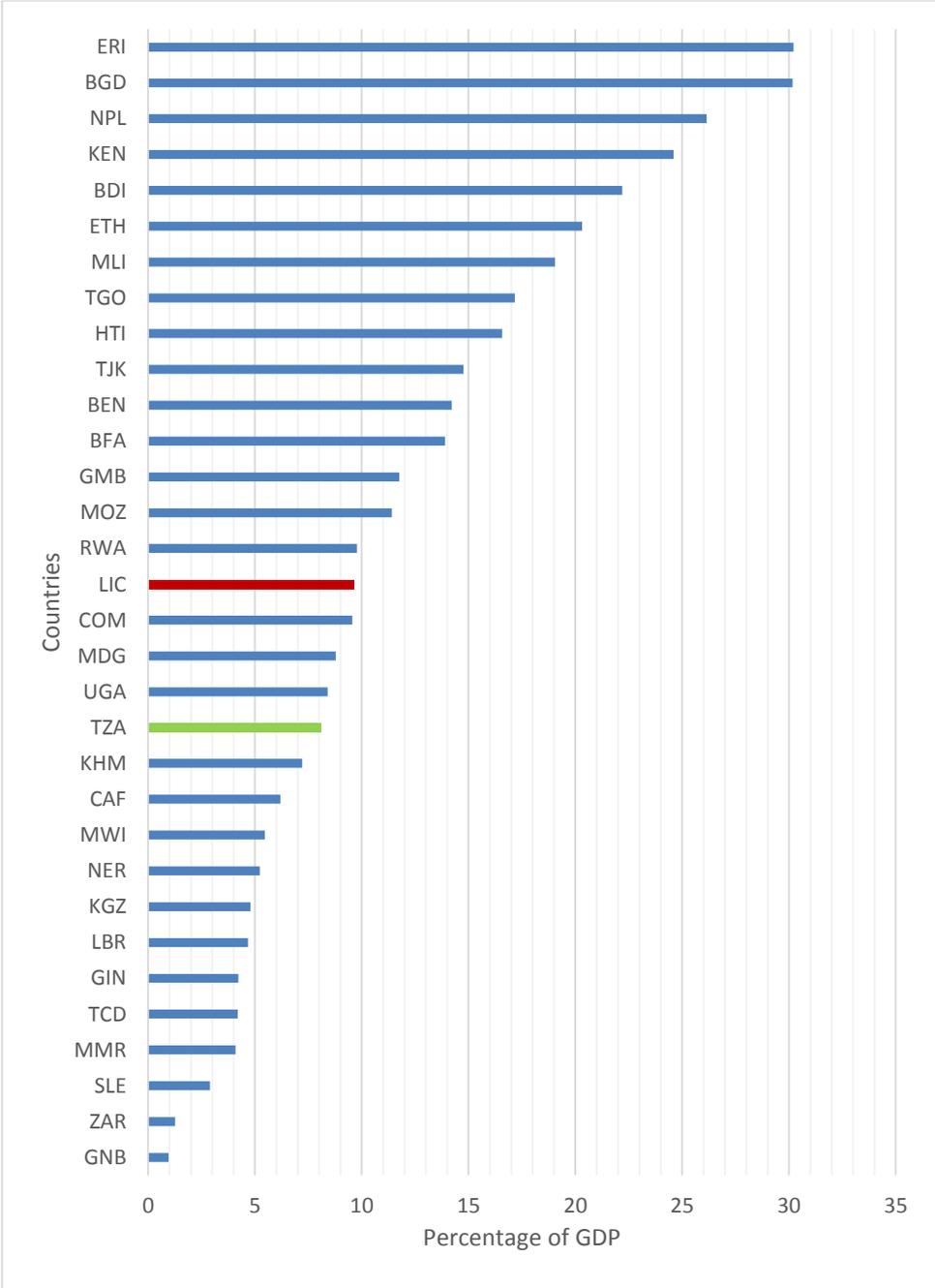
**Figure 17 Benchmarking Tanzania’s Liquid Liabilities as a percentage of GDP**



**Source: World Bank (2014) World Development Indicators**

Here again, liquid liabilities as a percentage of GDP Tanzania was again just below the LIC average, indicating that Tanzania was performing below its potential. The financial possibility frontier was below that of the peers, and so much needed to be done to improve the state variables, including stabilizing the inflation, and making sure communication and infrastructure was efficient.

**Figure 18: Domestic Credit to Private Sector**



Source: World Bank (2014) World Development Indicators

Figures 16-18 provide the positioning of Tanzania financial development by the time SGFSR were about to be prepared. It was the interest of this study to see whether Tanzania was at the same level with the countries of similar level of development or not. The choice of the indicators is due to the availability of data for the majority of the countries at that time, moreover, they are all measures of depth of the financial sectors, which gives fairly a good picture of the degree of development of the sector.

In all the three indicators, Tanzania is below the average of the LIC. We may conclude that Tanzania's level of financial development was below the countries of equal level of development. This has got some implications for policy options.

Beck & de la Torre (2007) are of the position that if a country's level of financial development is below those of countries of similar level of development, then the set of policy options that is best for that country is supposed to be market developing policies as well as market enhancing policies.

This study showed in chapter 4 what was done in the SGFSR. In this chapter attempt will be made to categorize those reforms and assess whether they were the type of policies actually needed at that level of development.

### **6.2.1 Market Developing Policies done**

In chapter 2 of this study, a financial possibilities frontier framework by Beck & de la Torre (2007) was introduced. This is a method of determining which variables are relevant for policy reforms in a financial sector at a given moment. In the framework, the authors propose that if at the time of reforms, a country's financial sector is at the level of development below other countries of the same level of development, then that country needs to embark first in the market developing policies. Market developing policies were explained to mean those policies

that aim to push out (shift) the financial possibilities frontier, by addressing constitutional changes, legal reforms and an upgrade of macroeconomic performance.

The SGFSR addressed mainly the legal challenges matters related to property rights (sections 5.4.1 and 5.6.1), company law, and bankruptcy law and contract enforcement (Section 5.4.3): which involved both the reform in the civil procedure and the strengthening of the commercial court, as well as facilitating capacity building for the courts to handle the regular volume of cases for timely resolution.

### **6.3 Agenda Comparison: FGFSR and SGFSR**

The FGFSR was an outcome of policy prescriptions for the Structural Adjustment Program that were prepared by the World Bank/IMF and had the backing of the US Government. The package of policies came to be known as the Washington Consensus.

The emphasis of those policies for the financial sector was on stabilization of the macroeconomic fundamentals, liberalization of the financial sectors, and privatization of the state owned financial institutions. It was believed by the architects of the policies that any country, regardless of its history and social economic and political conditions, will experience immediate effect of growth and development once it adopts such policies. So Tanzania received the same packages through several projects from IMF/World Bank and African Development Bank, and was expected to experience a significant development in the financial sector.

The first thing done in Tanzania was to establish a new legal framework for the proposed change in the way the financial sector should operate. This was done by the passing of the BFIA 1991 and later followed by other acts. Among other things the new act allowed the establishment of private financial institutions both domestic and foreign. It was necessary for the government to restructure the state owned financial institutions, beginning with the removal of non-performing loans from the banks' balance sheets and transferring them to the Loans and Assets Realisation Trust (LART), then the split of NBC into NBC (1997) Ltd., to be specializing

in serving large business customers and, NMB which was to specialize to serve small urban and rural customers. Then both NBC (1997) Ltd and NMB were privatized alongside CRDB, another state owned commercial bank existing in Tanzania at that time. Attempts were done to privatize PBZ but did not produce the desired results

The FGFSR also found it necessary to set up a financial infrastructure that would support the private sector dominated financial system. This included the supervisory framework and the payment systems. The supervisory framework required necessitated the upgrading of the Supervision Department at the BOT into a Directorate of Banking Supervision, as well as building the capacity of the new directorate to function and discharge the assigned duties efficiently. This capacity building included technological upgrade in terms of computer systems as well as the experts of operating them, and a lot of training for all the staff members on how to handle risk based supervision. Of course new technical staff, equipped with skills of risk based supervision was hired too.

#### **6.4 SGFSR and Correction of Market Failure**

The preoccupation of the SGFSR was first to complete the unfinished agenda of the FGFSR and then to proceed to upgrade the institutions and create new ones where there was none. The main aim of the institutions so created and strengthened by the SGFSR was to correct the market failure which manifested itself by the fact that the FGFSR failed to promote access to finance to the population in remote rural areas and to the small businesses and low income individuals in the urban centers and the failure to improve the availability of long term finance.

##### **6.4.1 Nature of Market Failure: An Institutional Economics Explanation**

Still the majority of Tanzanians live in rural areas, and most of their activities are accompanied by title deeds to certify the ownership. So they could not be used as collateral. Moreover, Tanzania has not yet issued national identification cards to her citizens and so there was a difficulty even of establishing identities of the people in the informal sector. So, most

people could not qualify to open an account in a formal financial institution. These factors curtailed demand, and excluded people from the possibility of having access to finance.

Apart from the demand side constraints, there were also supply side problems. These were mainly connected with the weak contract enforcement mechanism. In the case of credit, there was so much risk involved in lending because in the event of default it was difficult to recover the funds so extended. The court system, that through the civil justice system was supposed to enforce the contract, was still undeveloped. The commercial court was already established during the FGFSR, but had pecuniary jurisdiction and so excluded those claims that fall outside the pecuniary jurisdiction. Even for those claims that went to the commercial court, lawyers found some legal loopholes that enabled them to keep postponing the cases and appeal, to the extent that the delays in the cases continued. Moreover, even in the case where a bank or financial institution managed to get a favorable judgment, court brokers who were supposed to execute the judgment were sometimes disappointing with some corrupt practices whereby some of the properties were sold at a price below actual cost. All these increased the transaction costs (costs of monitoring and enforcing the contract) tremendously.

In addition, there was also a market failure caused by lacking important information about the reputation of the potential credit recipients. This resulted in the reluctance on the side of the banks to lend to new and unknown customers. Even when they had to lend, there was a problem of moral hazard (hidden actions by the borrowers with the proceeds of the loan) and adverse selection (high interest rates so charged omitted good borrowers and so increased risk of default).

Thus it was clear that there was a market failure and in such case, it was necessary for the government to intervene to correct the market failure, without which the overall economic objective of growth and poverty reduction was impossible to achieve.

It is from this that we can understand the steps taken by the government to correct such failures in the market. The government had to intervene to ensure that access to finance was enhanced, but also medium and long term finance was available and kept growing.

#### **6.4.1.1 Addressing Information Asymmetry**

Information was assumed to be readily available and costless by the neo classical economists' analysis in their basic assumption of perfect competition. But information is not actually free and financial institutions as well as their clients have to incur some costs to avail themselves with information necessary to make prudent business decisions before entering into a contract.

In the financial sector in Tanzania, there was no credit information bureau. Without the vital information from credit bureaus, when companies are applying for loans, they normally disclose only limited information about themselves the projects which they are applying the loan for. Most of these applications are turned down, unless the company is big enough, with sufficient collateral, and with reputation built through transparency in accounting system, by publishing regularly their audited reports. So new companies, especially small and medium, with no collateral were mostly excluded, because they were perceived to be risky borrowers. Even when some of them were accepted, they were charged high interest rates.

So the government in consultation with IMF/World Bank and other bilateral partners decided to invest in the creation of credit information databank as well as credit reference bureaus through the SGFSR, which are already operational.

##### **6.4.1.1.1 Expected impact of Credit Bureaus**

The formation of credit bureaus in Tanzania is expected to provide reliable, less costly and readily available credit information. This will be a source of objective information which will help the lenders make unbiased decisions, whereby one of clear criteria for assessing the risk of default will be the credit information.

#### **6.4.1.1.1 Informed Decisions by Lenders**

Efficient credit information bureau is a source of reliable and objective information, the access to which helps the lenders to make informed and unbiased decisions in their lending, in terms of riskiness of borrowers.

#### **6.4.1.1.2 Increase Access to Credit to Hitherto Excluded Groups**

The establishment of credit bureaus gives the lenders greater incentive to lend to the hitherto excluded groups of small businesses and individuals lacking acceptable physical collateral, because credit information gives them reputational collateral. In this way credit information bureaus are expected to promote credit to the poor, and increase the possibility of small businesses to succeed. The ultimate consequence will be to stimulate innovation, increase business activity, reduce poverty and promote growth.

#### **6.4.1.1.3 Increase Borrowers Discipline**

The awareness of the presence of credit information bureau increases discipline among the borrowers. Borrowers know that their reputation is at stake in their management of borrowed money, in that way they become more careful. They know that failure to repay their loan to only one lender may destroy their future access to loans from other financial institutions. In this way, credit bureau is an institution that creates incentive in the part of the borrowers to repay the loans they borrow in time.

#### **6.4.1.1.4 Fosters competition**

When efficient credit information sharing mechanism exists, it allows new entrants to make use of existing information, which would have been a privilege of only the biggest companies without such a sharing mechanism. Here active government involvement is needed (Beck , Maimbo, Faye, & Triki, 2011, p. 8)

### **6.4.1.2 Addressing Transaction Costs**

Another cause of market failure is transaction costs, which were not part of the Neo Classical Economic analysis, but which distort the mechanism through which the market reaches the equilibrium. In the case of financial institutions in Tanzania, source of transaction cost emanates mainly from the business environment, quality of property rights as well as contract enforcement mechanism.

#### **6.4.1.2.1 Business Environment**

A poor business environment characterized by poor contract enforcement mechanism, weak judiciary, difficult process of registering and closing a business, including bankruptcy procedures. All these factors provide disincentives for entrepreneurs to enter business in the respective economy. Those who decide to enter business, have to cope with higher risks due to uncertainty of the fulfilment of contracts, and the potential losses that could result therein. That is why business environment was one of the major focuses of the SGFSR.

##### **6.4.1.2.1.1 Contract Enforcement**

Banks and financial institutions willingness to extend credit to small enterprises and individuals as well as to new relationships depend very much on the confidence they have in the contract enforcement mechanism in the country. There is so much risk involved in lending even with the presence of credit bureau and acceptable collateral. If lenders believe that, through the contract enforcement mechanism in place, they will be in the position to recover their funds quickly and at very low costs even when the borrowers did not have the inclination to repay, then they have more incentive to extend more credit even to new and unfamiliar customers.

Empirical studies testify to that. Bae & Goyal (2009) concluded in their study that efficient contract enforcement mechanism results into greater access to credit by firms. Safavian & Sharma (2007) found out that in countries where the contract enforcement mechanism is slow there is a tendency of having lower credit to private sector as a percentage of GDP than

where contract enforcement mechanism is efficient. Ahlquist & Prakash (2010) observed that countries with efficient contract enforcement mechanisms tend to attract more FDI than those with inefficient ones. Dabbla-Norris & Inchauste (2008) concluded in their study that the informal sector tends to decrease in places where there is efficient contract enforcement mechanism.

#### **6.4.1.2.1.2 Strengthening the Commercial Court**

Tanzania addressed this issue by strengthening the performance of the Commercial court by opening the branches of Mwanza and Arusha, by equipping the court with modern technology of handling court documents, by capacity building through training to judges and supporting staff, and by changing some laws to make the commercial court more efficient, and by the amendment of the civil procedure law, to remove the loopholes that were used by the advocates to delay the procedures and so delay the contract enforcement.

#### **6.4.1.2.1.3 Bankruptcy Laws**

Bankruptcy has to do with the enforcement of debt contracts. Creating efficient bankruptcy procedures creates incentives that encourage good behaviour by discouraging high risk lending, and also discourage borrowers from engaging in non-prudent loans and reckless financial decisions.

When bankruptcy procedures are efficient firms and individuals get rid of the stigma of bankruptcy and have the motivation to innovate and start new businesses. This is because they are sure that efficient firms are protected by bankruptcy procedures, whereas distressed firms are liquidated quickly and efficiently, hence they maximize the value of debt recovered at the lowest cost. On the contrary, when the insolvency procedures are less efficient, debt is recovered at lower rate, and much costs are involved than necessary.

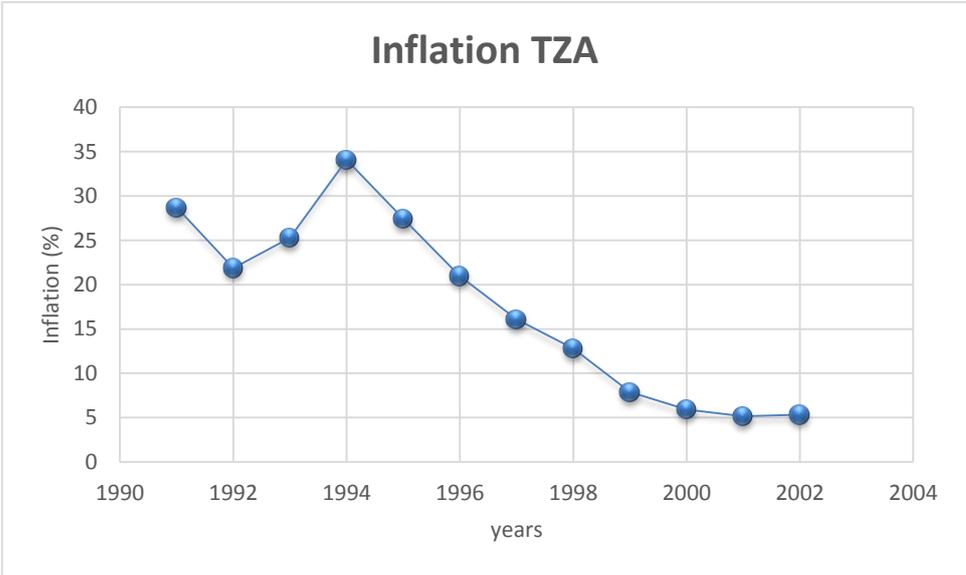
From the side of the providers of secured credit, when they operate in an efficient bankruptcy framework they are assured of the mechanism of their debt recovery, hence are motivated to continue lending.

### 6.4.1.3 Addressing the Shortage of Long Term Lending

The FGFSR did not succeed to promote long term lending. We cannot over-emphasize that long term lending is crucial for any economy because it is an important driver of growth, which in turn contributes to poverty alleviation.

Long term finance did not respond to the reforms done by the FGFSR because of several reasons. Among them is the macroeconomic condition that did not give confidence to providers of finance to lend long term is inflation.

**Figure 19: Historical Inflation in Tanzania**



Source: World Bank (2014) World Development Indicators

Apart from inflation, inefficient contract enforcement mechanism discussed above is a serious impediment to long term finance too, as it creates a disincentive to lending in general and to lending long term in particular.

The issue of property rights is also important. This is both for the supply side as well as demand side. From the supply side, because lending requires collateral. But there are cases where the collateral pledged for specific loans were also pledged for another loan, or were not as described in the documents presented with application documents. This is because of the weaknesses in collateral registry. The existing property registry was manual and fragmented, and so there was a possibility of having one property pledged even for two projects, or having a property registered at a value very much above the actual value. For the demand side because some potential long term loan applicants

An important sub section of long term finance is housing finance. This was almost neglected after the liquidation of THB, and there was almost a complete absence of this important component of long term finance. The poor performance of housing finance in Tanzania is partly explained by the legal framework in the issues related to property rights.

SGFSR addressed this issue, by modernizing the existing property registry, transforming it from paper based manual handling to electronic handling, aided by computer systems and information technology.

## **6.5 Recommendations**

I am convinced that strengthening the institutions is the right thing. So the SGFSR has done a good job in this aspect so far, and is continuing to do so even further.

It is my opinion that the government should go further, and apply moral suasion, to make the banks to go more for the unbanked. There are mechanisms that have already been tried and were proved to be working that can be promoted in Tanzania too. Among these, two most prominent are agent banking, and mobile branch banking. Agent banking is the type of banking in which the commercial banks use other businesses such as post office to offer their services in places where the construction of brick and mortar branches has not yet materialized. In this way the banks can expand outreach using agents.

The photo below shows a truck that is used as a mobile branch for offering banking services, and in that way they can be deployed to more than one place in a single day, and in that way give the possibilities for as many people who are otherwise excluded from the financial services to get their access.

**Figure 20: Mobile Banking Services in Rural Areas**



Source: Field Data (photo taken by the researcher)

## 6.6. Conclusion

This chapter has made a discussion on the main findings of the study. It has highlighted that the focus of the FGFSR was to make a transition from financial sector in a socialist country to one in a liberalized economy. The FGFSR was driven by the Washington consensus, a package of reforms that were stressing on stabilization, liberalization and privatization. However the SGFSR came in to provide the financial sector with the necessary institutions that were needed to provide the right incentives for behaviour that promote the financial sector and

to provide sanctions against those practices that are holding back the financial sector. It was a switch from the Washington Consensus to New Institutional Economics.

## Chapter 7

### Summary and Conclusion

#### 7.1 Study Overview

This study sought to investigate the nature and content of SGFSR in Tanzania, in terms of the uniqueness of the reforms and the rationale in the light of New Institutional Economics. It was necessary for the study to begin by going through the background of the financial sector in Tanzania from the colonial times, to the post-independence time. In the post-independence time, it was useful to divide the financial environment of Tanzania into the Pre Arusha Declaration, the Arusha Declaration era, the FGFSR era and the SGFSR era.

It has been shown that FGFSR was a necessary consequence of the deep economic crisis in the 1980s in Tanzania, which was caused, among other factors, by the structural imbalances that affected even the financial sector. The lack of indirect monetary policy instruments, the rigid control of prices of the financial products (interest rates, foreign exchange rates, etc.), the direct intervention of the government in the allocation of credit, and the fact that the major customers of the financial institutions were state owned enterprises, resulted into a financial system that was made up of banks with poor asset qualities (heavy presence of non-performing loans) and which crowded out private sector credit. So, even the other economic reforms that were going on under the structural adjustment programs could not be complete without reforming the financial sector. So the FGFSR began in 1991 with the U-turn legislation: the BFIA 1991, followed by other acts reforming the BOT, the Foreign Exchange policy, the inauguration of capital markets by the enacting of the CMSA 1995 and many more. The focus of the FGFSR was first to aim to achieve stability in terms of the prices of different products in the financial sector, as well as striving for fiscal and external balances and the control of inflation, to liberalize the financial sector and to restructure and eventually privatize the state owned financial institutions, starting with the commercial banks and other specialized banks.

However, despite embarking on these reforms with high intensity from 1991, by 2003 when the FSAP was done, the financial sector was still wanting in important aspects, greatest among them being the failure to stimulate long term lending, and the failure to expand the outreach of the financial sector especially to rural areas and to lower income segments of individuals, households and enterprises. There were still a good number of barriers that held back the development of such aspects of the financial sector, but most of them could be grouped under the poor quality of institutions. The state of property rights at that time in Tanzania were not supporting the collateralization and hence the development of credit to private sector; contract enforcement mechanisms was such that it was discouraging banks to extend credit to new and small customers, and the absence of credit reference bureaus, the non-existence of registries for properties and businesses as well as the absence of identification of citizens and street addresses continued to act as a barrier to the development of credit to the private sector, especially long term investments. And finally the business climate, especially the high inflation, the business registration regulations and corruption acted as barriers to the establishment of new businesses, and increase the cost of doing business for the financial institutions, hence make the products to be too expensive for marginal customers.

So, following the recommendations of the FSAP, agendas for the SGFSR were prepared and different committees to oversee specialized agendas were put in place. This study shows that the major focus of the SGFSR was on building good quality institutions where they were completely absent, and to improve the quality of existing institutions. Those institutions were meant to provide the right incentives for profitable behaviour in the financial sectors as well as put the sanctions for undesirable behaviour.

Specifically the SGFSR focused on four major issues: the improvement of property rights, the improvement of contract enforcement mechanism, the institutions for generating and sharing critical information (credit bureaus, national identification database, property registries, and business registries) and the general improvement of the business climate, including the

attempt to remove the rigidities in the starting and winding up a business, conducive macro-economic conditions, and addressing the problems of corruption.

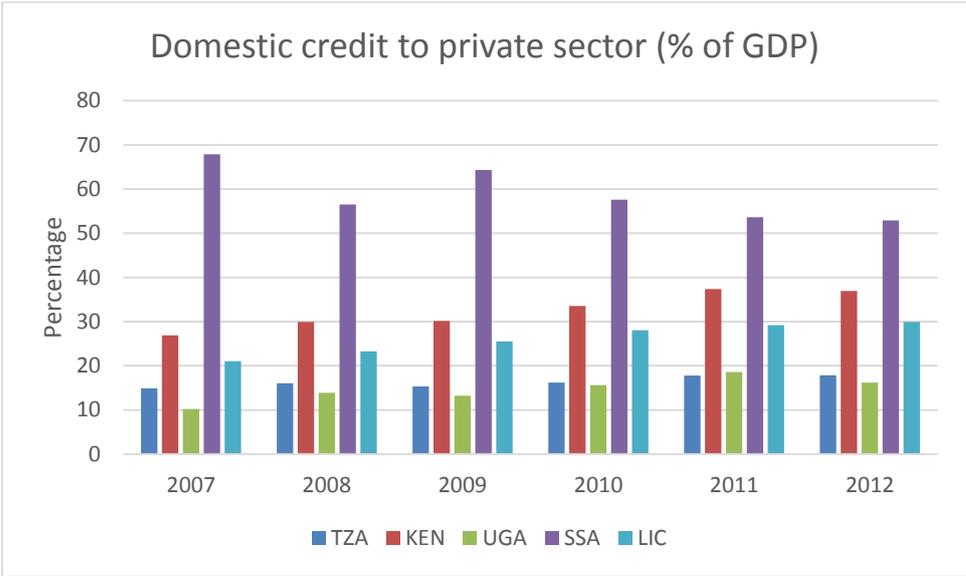
## **7.2 Assessment of the Financial Sector after Starting the SGFSR**

This study accepts that the steps taken in the reform of the financial sector are in the right direction. Most of the reforms were market developing and market enhancing, and these are the real needs of the financial sector in Tanzania. This is because Tanzania's financial sector development was below that of the countries with similar level of development (mostly low income countries). There was a need to stimulate competition, which was done in the FGFSR by allowing new entrants to enter the financial sector in Tanzania, while splitting the largest bank NBC into NBC (1997) Ltd. and NMB banks. This reduced the market share of the two newly formed banks, although not significantly. The SGFSR dealt with institution building. The institutions that were formed and improved removed some obstacles to financial sector development. For example, the establishment of credit bureau empowers the marginal borrowers, who had no physical collateral, by providing them with the possibility to build a reputational collateral, which gives him/her the possibility of getting credit to invest in productive ventures. The simplification of the procedures to register property as well as the provision for the occupiers of land under customary law of the possibility to get the customary right of occupancy is a step forward to the removal of the people from informal sector to the formal sector, and making them bankable.

### **7.2.1 Financial Depth**

Using domestic credit to private sector as a measure of financial depth, we see that Tanzania is still behind the regional neighbours and averages for SSA and LIC, although it is narrowing the gap. But the trend for Tanzania is that credit to private sector is growing albeit slowly from 14.9% in 2007 to 17.9% in 2012

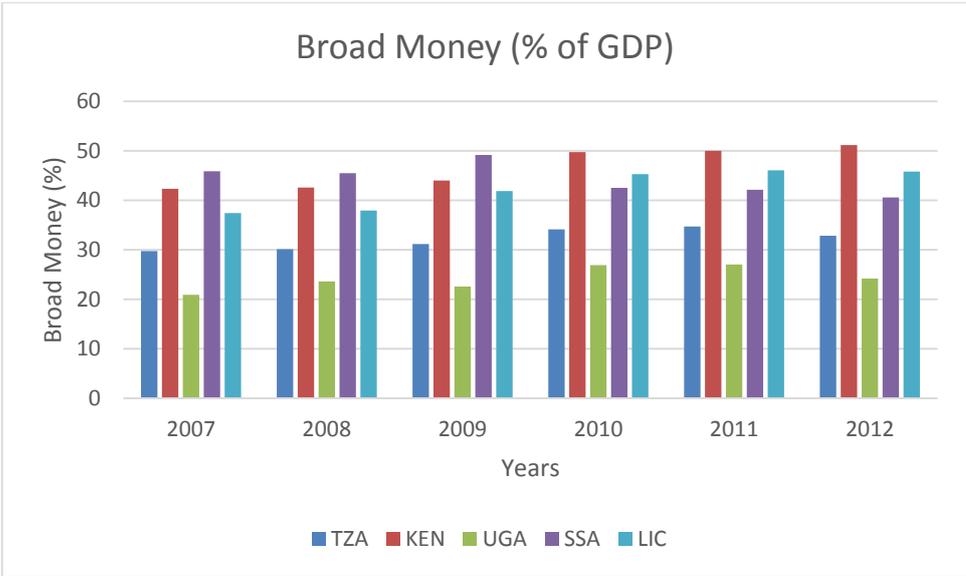
**Figure 21: Domestic Credit to Private Sector as a Percentage of GDP**



Source: World Bank (2014) World Development Indicators

In terms of broad money as a percentage of GDP, Tanzania has more depth than Uganda but lower than Kenya throughout. During this period Tanzania has higher depth than the regional averages of Sub Saharan Africa and Low income countries. The trend is also positive from 29.7% in 2007 to 32.8% in 2012, despite a one year decline from 2011 level of 34.7% to 32.8% in 2012 as shown in figure below.

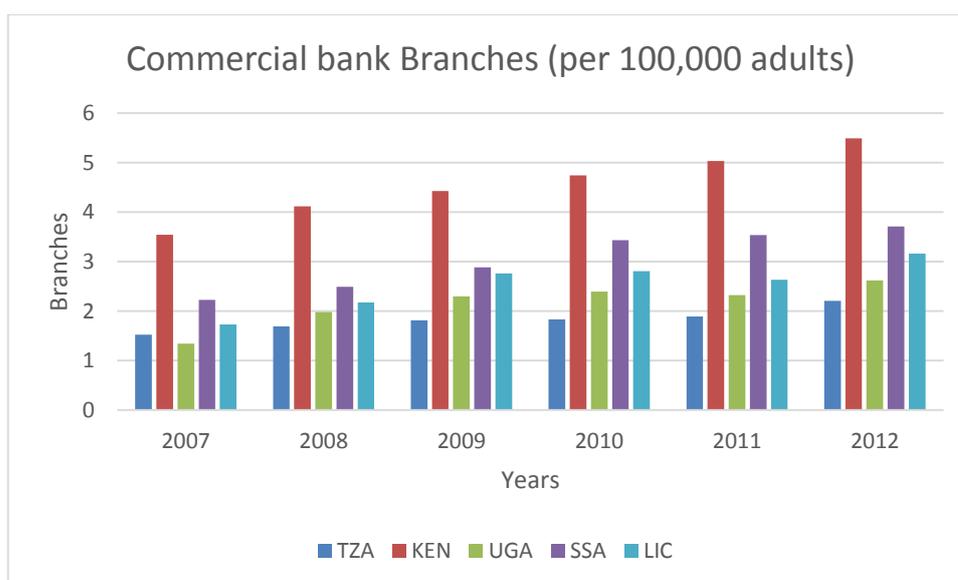
**Figure 22: Broad Money as a Percentage of GDP**



Source: World Bank (2014) World Development Indicators

## 7.2.2 Financial Access

**Figure 23: Commercial Bank Branches per 100,000 adults**

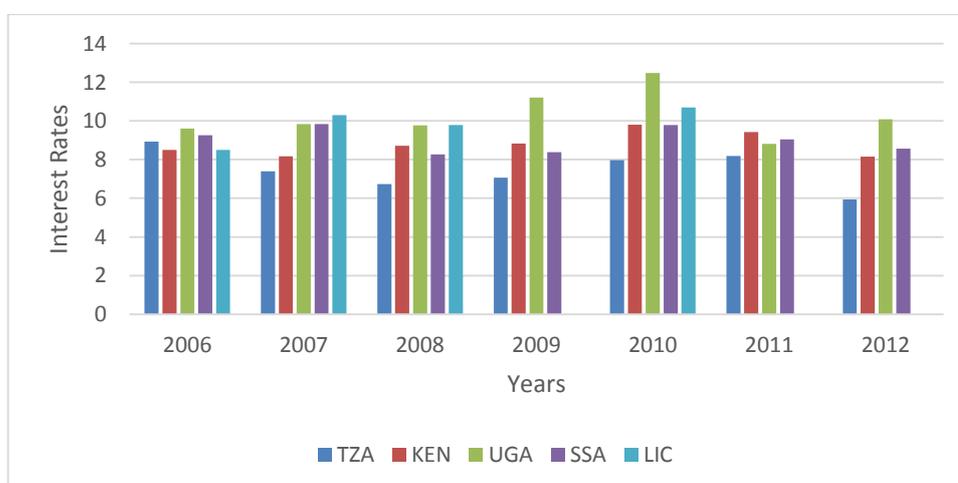


Source: World Bank (2014) World Development Indicators

In terms of financial access, Tanzania is moving in the right direction. The number of branches is rising, although the country still lags behind Kenya and Uganda in this aspect and is below the average for SSA and LIC. More incentives are needed to promote further growth in access to financial services. However it has to be noted that the current trend in Tanzania is the fast increase in mobile phone financial services.

## 7.2.3 Banking Efficiency

**Figure 24: Interest Rate Spread**



Source: World Bank (2014) World Development Indicators

Again we use Interest Rate spread as the measure of efficiency. This measure shows how efficient the banking system is in the country. The criteria for assessment is the lower the spread the better the efficiency of that respective country.

Here is the indicator in which Tanzania performs better than the neighbours. From 2007 the spread in Tanzania is lower than in the neighboring countries of Kenya and Uganda, and the averages for Sub-Saharan Africa and the Low Income Countries.

Again this is an indication that the results of these reforms are producing their effects, but the effects are going to manifest in the long run, and so discipline and patience should be maintained.

### **7.3 New Opportunities**

Financial services in Tanzania and other developing countries have received a big boost by the growing possibilities of using the mobile phone to provide financial services. Regulators have to encourage innovations in this regard, strengthen risk based supervision to ensure that the system remains safe will increasing financial access, payment and savings services and even credit.

New opportunities can always be found if innovation is encouraged and if the institutions that support the financial sector are strengthened.

It is also my position that the Government must also consider to rethink its role in the financial sector in the case of market failure, which is evident in the issues of access to finance and long term finance. Despite the wisdom from Washington Consensus of government to keep out of the business of the financial sector, still there will always be a gap that will not be filled if there continues to be market failure.

#### **7.4 Contribution**

This is the first study to explore the financial sector reforms of the first and second generations in Tanzania in a single study. This study also is the first in using the framework of New Institutional Economics as a conceptual framework to understand the underpinning of the reform process. It is my hope that other scholars of Financial Institutions in Tanzania will follow suit and explore other aspects of the financial institutions in Tanzania using this framework.

#### **7.6 Future Studies**

This study limited itself to the banking sector, except for issues whose challenges could be solved by other financial institutions, as the case of pension funds and insurance companies and their role in filling the gap of long term finance. There is a possibility of making other studies that are more focused on the other types of financial institutions and markets. The issues addressed in the SGFSR such as information asymmetry and finance, or property rights and finance, or contract enforcement and finance are also ripe for investigation.

There is also a possibility of making a comparative study, say between Kenya and Tanzania, or Uganda and Tanzania, where more than one economy are studied together

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## Appendices

### Appendix 1: List of Interviewees

1.	All Senior Staff of Mkombozi Bank	Mkombozi Bank	24.03.2012
2.	Mr. Deogratias Usangira	NMB Bank	12.04.2012
3.	James Isaack Mabula	CRDB Bank	17.04.2012
4.	Mr. Ndaskoi	NBC Bank	18.04.2012
5.	Dr. Mung'ong'o & Dr. Zegezege	Bank of Tanzania	10.05.2012
6.	Dr. Longinus Rutasitara	Planning Commission	01.09.2013
7.	Mr. Albert Mkenda	Bank of Tanzania	02.09.2013

## Appendix 2: The First Fieldwork



University of  
Bayreuth

Chair of VWL V, esp. Institutional Economics

Prof. Dr. Martin Leschke

(0921) 55-60 40 • Fax (0921) 55-60 42  
martin.leschke@uni-bayreuth.de  
Room RW - 1 138 • 95440 Bayreuth

University of Bayreuth • Chair of VWL V • 95440 Bayreuth

To whom it may concern

30.01.2012

Dear Sir / Madam,

### Recommendation for Research Field Work of Venance Ndalichako

Venance Ndalichako is a PhD student at my Chair of Economics 5, University of Bayreuth, Germany. He works under my supervision and his thesis is titled 'Regulation of Systemic Risk in the Banking Institutions in Tanzania: Lessons from the Recent Global Financial Crisis'.

Venance Ndalichako is currently preparing his thesis. For this purpose, he needs further information from individuals, organizations and institutions in order to enhance his understanding and to strengthen his study.

Any help offered to him in these matters will be highly appreciated. Please do not hesitate to contact me if you have any suggestions or recommendations.

Thank you in advance,

Yours sincerely,

A handwritten signature in cursive script, appearing to read 'Martin Leschke', written in dark ink over a light background.

Prof. Dr. Martin Leschke

## Appendix 3: The Second Fieldwork



**Universität  
Bayreuth**

Lehrstuhl für VWL V, insb. Institutionenökonomik

Prof. Dr. Martin Leschke

☎(0921) 55-60 42 • Fax (0921) 55-60 40

[martin.leschke@uni-bayreuth.de](mailto:martin.leschke@uni-bayreuth.de)

RW I / Zimmer 01.138 • 95440 Bayreuth

Universität Bayreuth • Lehrstuhl VWL V • 95440 Bayreuth

To whom it may concern

Bayreuth, den 23.07.2013

Dear Sir / Madam,

**Recommendation for Research Field Work of Venance Ndalichako from 25<sup>th</sup> of July until 10<sup>th</sup> September**

Venance Ndalichako is a PhD student at my Chair of Economics 5, University of Bayreuth, Germany. He works under my supervision and his thesis is titled "Regulation of Systemic Risk in the Banking Institutions in Tanzania: Lessons from the Recent Global Financial Crisis"

Venance Ndalichako is currently preparing his thesis. For this purpose, he needs further information from individuals, organizations and institutions in order to enhance his understanding and to strengthen his study.

Any help offered to him in these matters will be highly appreciated. Please do not hesitate to contact me if you have any suggestions or recommendations.

Thank you in advance,

Yours sincerely,

Prof. Dr. Martin Leschke

## Appendix 4: Questionnaire for BOT

### Questionnaire for Dr. Deogratias Massawe.

1. Why was it necessary to embark on the SGFSR?
2. How was the process of reform carried out?
3. What were the challenges that called for the SGFSR?
4. What were the major influences in the SGFSR
  - a. IMF/WB
  - b. Donor countries
  - c. BoT Supervision and regulation
  - d. Basel Standards
  - e. Parliament?
5. What are the major reforms carried out?
6. What are the new regulations that came out as a result of SGFSR?
7. Were any former regulations relaxed, which ones?
8. Will the banking sector become deeper due to the implementations of the SGFSR?
9. Will the banking sector become broader? Explain.
10. Will the banking sector stability and safety be enhanced? Explain
11. Will the financial sector in general be a better stimulant for economic development?

## Appendix 5: Appointment for Interview: Ndaskoi - NBC

<b>Subject:</b>	MEETING WITH Rev Mkanwa
<b>From:</b>	Severin ndaskoi (Severin.ndaskoi@nbctz.com)
<b>To:</b>	frndalichako@yahoo.com;
<b>Date:</b>	Tuesday, April 17, 2012 11:23 AM

When: 18 April 2012 15:00-16:00 (UTC+03:00) Nairobi.  
Where: Severin's office

\*\*\*\*\*

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The Disclaimer forms part of the content of this email.

## Appendix 6: Response to Questionnaires

<b>Subject:</b>	RESPONSES TO QUESTIONNAIRE
<b>From:</b>	VICTOR TARIMU (vctarimu@hq.bot-tz.org)
<b>To:</b>	fndalichako@yahoo.com;
<b>Date:</b>	Tuesday, May 1, 2012 9:36 AM

Dear Fr. Ndalichako

Attached please find responses to the Questionnaire on Systemic Risk in Banking System. In addition, please find attached Financial Stability Report prepared by Bank of Tanzania, which will shed some more light on the questions.

Feel free to contact me in case you require further clarification on the responses.

Regards  
Victor C. Tarimu

## Appendix 7: Appointment for Interview BOT

St. Augustine University of Tanzania  
P.O. Box 307  
MWANZA  
02.09.2013

The Director  
Directorate of Strategic Planning & Performance Review  
Bank of Tanzania  
P.O. Box 2939  
DAR ES SALAAM.

Dear Sir

### **Re: REQUEST FOR DATA FROM YOUR DIRECTORATE**

Reference is made to the subject above.

My name is Venance Ndalichako from St. Augustine University of Tanzania. Currently I am doing my Doctoral studies at The University of Bayreuth, Germany – under the Chair of Institutional Economics. The Title of my study is: The Second Generation Financial Sector Reforms: An Assessment for Relevance.

At the moment I have come to Tanzania to conduct my field work.

I would request for your permission to conduct some interviews in your directorate so as to enhance my understanding of the study and so strengthen my dissertation.

I would highly appreciate any help that you will offer to me.

Thank you in advance,

Yours Faithfully

Fr. Venance Ndalichako

**PhD Candidate.**

## Appendix 8 Aftermath of BoT Interview, Further documents received



Venance NDALICHAKO <vndalichako@gmail.com>

---

### Data Requested from BOT

3 messages

---

**Albert Mkenda** <avmkenda@bot.go.tz>  
To: "vndalichako@gmail.com" <vndalichako@gmail.com>

Tue, Sep 3, 2013 at 3:04 PM

Dear Fr. Ndalichako,

As agreed, attached are some of the documents that may assist you.

Regards

*Albert Mkenda*  
*Head, Project Management Unit*  
*Technical Assistance Programmes Coordination Department*  
*Directorate of Strategic Planning and Performance Review*  
*Bank of Tanzania*  
*10 Mirambo Street*  
*5<sup>th</sup> Floor, South Tower*  
*Tel. +255 (0) 22 223 5583*  
*Mob. +255 (0) 766 083 393*

---

 **FSAP\_July 2003.pdf**  
1851K

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**Albert Mkenda** <avmkenda@bot.go.tz>  
To: "vndalichako@gmail.com" <vndalichako@gmail.com>

Tue, Sep 3, 2013 at 3:06 PM

Also this one.

*Albert Mkenda*  
*Head, Project Management Unit*  
*Technical Assistance Programmes Coordination Department*  
*Directorate of Strategic Planning and Performance Review*  
*Bank of Tanzania*

---

**From:** Albert Mkenda  
**Sent:** Tuesday, September 03, 2013 4:05 PM  
**To:** 'vndalichako@gmail.com'  
**Subject:** Data Requested from BOT

[Quoted text hidden]

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 **PAD FSSP.pdf**  
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**Albert Mkenda** <avmkenda@bot.go.tz>  
To: "vndalichako@gmail.com" <vndalichako@gmail.com>

Tue, Sep 3, 2013 at 3:08 PM

Also this one. Esp. for long term mortgage sector.

*Albert Mkenda*  
*Head, Project Management Unit*  
*Technical Assistance Programmes Coordination Department*  
*Directorate of Strategic Planning and Performance Review*  
*Bank of Tanzania*  
*10 Mirambo Street*  
*5<sup>th</sup> Floor, South Tower*  
*Tel. +255 (0) 22 223 5583*  
*Mob. +255 (0) 766 083 393*

---

**From:** Albert Mkenda  
**Sent:** Tuesday, September 03, 2013 4:07 PM  
**To:** 'vndalichako@gmail.com'  
**Subject:** RE: Data Requested from BOT

[Quoted text hidden]

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 **PAD HFP.pdf**  
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