The Implication of the of the 2006/7 Budget to the Financial Sector

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Introduction

The Tanzanian Financial sector has experienced rapid growth in recent years mainly as a result of structural reforms. The foundations of the policy and regulatory framework were laid in the early 1990s with enactments that included the Banks and Financial Institutions Act (1991) the Bank of Tanzania (BOT) Act (1995) and the Capital Market and Securities Act (1994). The sector has been fairly stable. For example, timely intervention by the BOT has managed to minimize the effects of bank closure/collapse and stave off contagion effects. These reforms are also coupled with strong supervisory framework. The Second Generation Financial Sector Reform took off in the 2005/06 fiscal year and included the enactment of the new Banking and Financial Institutions Act and the new Bank of Tanzania Act in April 2006. Among other things the new Acts aim at strengthening the supervision of banks and financial institutions and expanding availability of credit at competitive terms.

Despite the success, there have been arguments in the popular press, seminars and workshops that the financial sector – and the banking system in particular – has been ineffective in channeling credit to borrowers. The points of contention have been the inability of banks to channel funds to certain sectors and groups such as agriculture and small and medium enterprises (SMEs) – which are perceived as risky - high lending rates and low deposit rates, and concentration in holding of government securities. Other issues are concentration of banking services in big cities and lack of products such as mortgage finance, lease finance, micro finance and other term finance.

Recent developments in the sector are encouraging (See Table 1 in Appendix 1) and one would expect the budget to build of these developments by, among other things, addressing some of the shortfalls pointed above.

The 2006/7 Budget and the Financial Sector

A budget affects the financial sector in two broad ways. Firstly in terms of how the budget is actually financed which may have bearing on the supply and demand of loanable funds in the economy and hence the price of the funds (interest rate). Secondly is through policy pronouncements that may have short or long-term effects to the sector. The 2006/07 Budget Frame (as summarized in Table 2 in Appendix 1) does not seem to have funding requirements that will significantly affect the financial sector in terms of the supply and demand of loanable funds. However, the target of inflation rate not exceeding 4 percent from the current 6.9 percent may result into selling government to mop up liquidity.

Policy and regulatory-wise, the 2006/07 budget takes cognizance of a strong financial sector as a prerequisite for a stable economy by continuing the implementation of the Second Generation Financial Sector Reform. The reforms include:

- Strengthening the policy environment for the financial sector to grow and to be able to extend its services to more people;
- Strengthening the financial markets so as to bring more competition and efficiency;
- Reforming the regulatory framework of pension funds;
- Strengthening the insurance industry;
- Creating an environment for facilitating the availability of micro credit services;
- Reforming the land registration system for enabling land to be used as a collateral against credit or mortgage; and
- Putting in place arrangements for development of medium and long term finance

The 2006/07 budget addresses problems associated with financial the intermediation in a number of ways. Firstly, the government has agreed with the CEOs of all banks in the country to jointly appoint a special committee which shall review and evaluate problems associated with the banking system. The joint committee is to be formed within one month and submit its recommendations to the Government in October 2006.

Secondly, the budget lays down measures to empower micro borrowers and SMEs by facilitating their access to credit. The strategies to be employed include:

- Using SACCOS to provide loan capital for people to start economic projects. This will involve establishing SACCOS of different community–based groups which will be facilitated to access credit from commercial banks and financial institutions;
- Enabling people in the low income groups to use assets such as land and houses as collateral in loans from financial institutions. This will include reforming the land registration system; and
- The government to continue to guarantee bank credit through the Small and Medium Enterprises Credit Guarantee Scheme (SME-CGS) and the Export Credit Guarantee Scheme (ECGS). An evaluation of the schemes will be undertaken to address complaints raised about the operations and management of the schemes.

Thirdly, the budget focuses on large and long-term borrowers through restructuring the Tanzania Investment Bank (TIB) and the establishment of a Development Finance Guarantee Fund (DFGF). The process of reforming TIB began in the 2005/2006 fiscal year with the idea being to transform the bank into a development bank that will mobilize finance and provide long-term financing for all production sectors. Reforming the bank will involve recapitalization of the bank through conversion of government funds amounting to shillings 17.5bn that were being managed by the bank into share capital. Combining with the retained earnings of 7.4bn the bank's capitalization will be shillings 24.9bn which still fall short of the minimum capitalization requirement of a development bank which is shillings 50 billion. The details for the establishment of the DFGF are unclear but it is expected that the fund will start issuing guarantees during the current fiscal year

Fourthly, to encourage investment in capital markets, two amendments were made to the Income Tax Act. The first is aimed at reducing corporate income tax rate from 30% to 25% for newly listed companies in the Dar es Salaam Stock Exchange (DSE) with at least 35% of equity ownership issued to the public. This reduction, which will be effected for a period of 3 years from the date of listing, is aimed at encouraging companies to go public and broaden corporate ownership in Tanzania. The second is the reduction of the withholding tax rate on interest income by Collective Income Schemes (CIS) from 30% to 10% as it applies to individuals, in order to encourage collective investment in the country.

The Implications of the 2006/07 Budget Pronouncements to the Financial Sector

Most of budget issues having bearing on the financial sector are policy related and their implications highly depend on how the policies are implemented.

The joint committee of Banks is an excellent step in finding ways of ensuring that funds at the disposal of banks and other financial institutions flow to productive activities. However, it is unlikely that banks themselves will come up with a comprehensive solution. The position held by the banks on key issues – such that high interest rates are due to high default risk and loan management costs – is unlikely to change overnight. Likewise lack of collateral is partly attributable to the regulations that in some ways are viewed as inhibiting innovations in collateralization. A more comprehensive approach – also involving the Government (represented by the BoT) and borrowers – may be preferred in handling intermediation problems associated with the banking system.

Small and Medium Enterprises (SMEs) are the probably the best channel through which policy makers can attack poverty. Evidences from micro finance institutions and banks providing micro finance services show that only 10 percent of the credit in the economy goes to SMEs despite SMEs having low default rate – in the region of 1 percent. Launched in September 2005 and managed by the Bank of Tanzania, the SME-CGS aims at addressing this problem. The scheme was initially allocated 2bn shillings with promise of more funds to be provided as needed. So far only 18 SMEs have accessed credit through the scheme and the scheme is under criticism in a number of fronts. On the one hand SMEs (potential borrowers) have cited lack of information arguing that the participating financial institutions (PFIs) have all information but it does not reach the targeted people. Policies that are relevant to enable the institutions to lend the way the borrowers would like are also not in place. On the other the PFIs want the government to guarantee 100% and argue that the policies are drawn such that they are specific for each PFI rather than all PFIs. Of course a 100% guarantee would make lenders irresponsible and may fail to enforce repayment.

Restructuring the Tanzania Investment Bank (TIB) and the establishment of a Development Finance Guarantee Fund (DFGF) are also positive moves. The former may be more effective if it starts with a narrow focus – say lease and mortgage financing – coupled with having majority of shareholding in the private hands. The latter is the ideal approach as the trend is for Governments to withdraw from direct lending and facilitate channeling credit mainly through guaranteeing borrowers.

Amendment to the Income Tax Act that lowers the withholding tax rate on interest income by Collective Income Schemes (CIS) from 30% to 10% is probably targeting the Unit Trust of Tanzania's Umoja Fund. The lock-in period for the fund ends on July 31st 2006 and one scenario is for the unit holders to cash-in and realize the gain from Government subsidy. In the short run cashing-in will have effects on liquidity and/o deposits in the banking system: with more than 113 billion shillings in assets, a cash-in of say 40 percent releases substantial funds that will be looking for investment opportunities. The lower withholding tax rate applies to individually and its effect on the amount that is retained in the fund can not be determined unambiguously. The objective is to make CISs better investment opportunities – comparatively – and the lower withholding rate means that some investors will be willing to buy into the Fund and probably stave off massive selling of units. The move is, therefore, likely to stabilize the Fund based on the assumption that individual investors in CIS have fairly reasonable level of sophistication.

Will lower corporate income tax rate for 3 years encourage firms to list equity securities in the Dar es Salaam Stock Exchange (DSE) and/or encourage public equity ownership? Theoretically the answer is affirmative but the speed at which firms are listing at the DSE is unlikely to change significantly. Firstly, though the listing conditions are fairly modest (See Appendix 3) they are not in favor of small firms. Adding other costs such as legal fees and roadshows means that the benefit of lower tax may not be sufficient to make the difference between listed firms and unlisted firms wide enough. Secondly, some factors responsible for the slow listing may be hard to overcome by using tax incentive. One such factor is the ownership structure whereby even some of the substantially large private firms are family owned or are owned by closely knitted groups.

Recent trends in the budgets have shown a tendency to rely mostly on internal sources of funds. Vision 2025, for example, underline the need for the domestic debt to play a bigger role in the future, and calls for replacing foreign financing of budget deficit with domestic financing over the medium to long run in line with the self-reliance targets[1]. This is likely to lead to the Government gradually expanding maturities by issuing longer maturing instruments which enables the government to benefit from falling term premium without significant increases in yields. Developing secondary market and securitization are also critical since the crowding out effect is lessened by the presence of nonbank investors or the presence of developed secondary market where the participants in the primary markets offload the securities to individual investors in the secondary market. Opening the Treasury securities market to small investors by introducing retail products – such as the proposed Government retail personal savings products – and developing retail channels for other securities is also important.

Other recent developments also open up opportunities for Tanzania to finance its budget – particularly the development component – through borrowing externally from 'non-traditional' sources. Recent study by a team, comprising staff from the International Monetary Fund's African Fiscal, Monetary and Financial Department, concluded that Tanzania may not have a need for IMF resources going forward. This is likely to put Tanzania on a policy

[1] The initial targets in the National Debt Strategy were to reduce the foreign debt component to 65 percent of the total debt in 3-5 years and to 50 percent in 10-15 years.

support instrument (PSI) over the medium term with the implications being that the IMF's role will be more or less that of an international credit rating agency rather than a provider of financial support. The study also proposes what was mentioned earlier – that the BOT’s independence be enhanced to help deepen domestic debt markets and expand private sector credit. In this line one also needs to note that the new BOT Act gives the bank power to issue, purchase and sell its own debt securities for monetary policy purpose.

Conclusion

The implications of the budget to the financial sector largely depend on how the issues related to the sector will be implemented and the reactions of the target/affected economic agents. While some of the ideas look and sound noble, it has not been uncommon for the government to fall below expectations when it comes to implementing its policies. In some of the issues, especially those with long term implications, we may need to adapt a wait-and-see approach!

APPENDICES

APPENDIX 1: Summary Tables

Table 1: Summary of Recent Macro Developments Related to the Financial Sector

		2004	2005	% Change
	Growth of the finance and insurance sub-sector of the Finance and Business Sector (percent)	4.4	5.7	
	Capital formation at current prices (Billion of shillings)	2,599	3,149.4	21.2
	Capital formation (Billion of shillings)	624.37	735.18	17.7
	Contribution of Private Sector to capital (percent)	65.1	62.4	
	Commercial banks' credit to various sectors (Billion of shillings)	965.986	1,219.3	
	Loans to private sector (Billion of shillings)	1,060	1,425	34.4
	National Debt (USD Million)	9,726.9	9,961.3	2.4
	• National Debt: External (USD Million)	8,022.9	7,934.4	
	• National Debt: Domestic (USD Million)	1,704.0	2,026.9	

Table 2: The 2006/07 Budget Frame (Figures in Million of shillings)

	REVENUE			EXPENDITURE	
	Domestic Revenue	2,460,995		Recurrent Expenditure	3,116,121
	External concessional loans and grants (including debt relief)	2,226,116		Development Expenditure	1,734,467
	Drawdown on Reserves	163,477			
		4,850,588			**4,850,588**

APPENDIX 2: Summary of How the Small and Medium Enterprises Credit Guarantee Scheme (SME-CGS) Works.

- The scheme guarantees loans to SMEs ranging from 5million to 200 million
- To be eligible an SME has to be dully registered with majority ownership by Tanzanians who are prepared to offer any enforceable collateral incuding personal guarantee and third party guarantee.
- The SME submit its loan application with the Participating financial institutions (PFIs).
- The PFI will conduct normal lending procedures
- The PFI submits loan to eligible SME to the scheme for approval
- The scheme shares the credit risk (of the principal amount only) with the PFI on 50:50 basis

APPENDIX 3: Summary of Listing Requirements and Fees at the Dar es Salaam Stock Exchange

Listing Requirements

NO.	CRITERIA	FIRST LIST (TIER)	SECOND LIST (TIER)	OTC LIST
1.	Company status	Duly incorporated as a public company (securities freely transferable)	Duly incorporated as a public company (securities freely transferable)	Duly incorporated as a public company (securities freely transferable)
2.	Prior existence[2]	At least, three consecutive years of audited accounts	At least, three consecutive years of audited accounts	
3.	Paid up Capital	TShs. 50 million minimum "Rights issues" within three months)	TShs. 25 million minimum "Rights issues" within three months)	
4.	Public Holdings (as a % of Issued Securities)[3]	25% minimum (excluding employees).	10% minimum (excluding employees).	
5.	Amount of:-[4] a. Preference or equity shares b. Corporate Debt	TShs. 40 million - minimum TShs. 30 million - minimum	TShs. 20 million - minimum TShs. 15 million - minimum	
6.	Minimum No. of Holders	1000	300	
7.	Documentation	Prospectus for public offering	Prospectus for public offering	Prospectus approved with CMSA and filed with Registrar of Companies
8.	Working Capital	Sufficient	Sufficient	
9.	History of Profitability	Good profit and dividend record (3 years)	Good profit and dividend record (2 years)	

Listing Fees

Fee Description	Fee Amount/Rate
Initial Listing fees (when a company comes to the market for the first time)	0.2% of the value of the securities to be listed subject to a minimum of TShs.2,000,000/= and a maximum of TShs.20,000,000/=
Additional Listing Fees (payable by a company already listed and is seeking listing of additional securities)	0.1% of the market value of the additional securities subject to a minimum of TShs.1,000,000/= and a maximum of TShs.10,000,000/=
Annual Listing Fees (payable annually by all listed companies)	0.05% of the market capitalisation of listed securities at a particular date subject to a minimum of TShs.2,000,000/= and a maximum of TShs.10,000,000/=
Offer for sale fees (payable by a holder of large block of securities in a listed company offering to sell the block to the public investors)	0.15% of the market value of the securities being sold subject to a minimum ofTShs.2,000,000/= and a maximum of TShs.10,000,000/=.

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[2] In exceptional cases, the Council may accept a shorter period if that is desirable in the interests of the company or investors and the Council is satisfied that investors will have the necessary information available to arrive at an informed judgment

[3] Exceptionally, a lower percentage may be accepted by the Council where the amount of securities of the same class and the extent of their distribution would enable the market to operate with a lower percentage.

[4] This does not apply to additional listings of securities of the same class.

Commission rates and Taxes
Equities

Considerations	**Brokerage Commission**	**Transaction Fee**	**Fidelity Fund Fee**	**Total Cost to Investor**
On the first TShs.10,000,000	1.70	0.28	0.02	2.00
On the next TShs.40,000,000	1.50	0.28	0.02	1.80
On any sum above TShs.50,000,000	0.80	0.28	0.02	1.10

Bonds

Transaction Size	**Applicable Commission**
Up to Tshs. 40 million	1/16%
On any additional amount exceeding Tshs. 40 million	1/32%
Minimum commission	Tshs. 5,000/=

Central Depository (CDS) Fee: TShs.100/= per transaction.