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Republic of Mozambique: Financial System Stability Assessment Including Report on the Observance of Standards and Codes on the following topics: Banking Supervision, Payment Systems, and Anti-Money Laundering and Combating the Financing of Terrorism

This Financial System Stability Assessment on the **Republic of Mozambique** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **November 19, 2003.** The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **Republic of Mozambique** or the Executive Board of the IMF.

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REPUBLIC OF MOZAMBIQUE

Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and African Departments

Approved by Stefan Ingves and Abdoulaye Bio-Tchané

November 19, 2003

- This Financial System Stability Assessment (FSSA) is based on the work of the joint IMF/World Bank mission that visited Maputo as part of the Financial Sector Assessment Program (FSAP) during February 10-18 and March 27-April 8, 2003. The findings of the FSAP mission were discussed with the authorities in September 2003, as part of the 2003 Article IV Consultation.
- The FSAP team was headed by Alain Ize (MFD) and Michael Fuchs (World Bank) and included Mses. Susana Sosa (MFD), Vera Luz (Central Bank of Portugal), Zeynep Kantur and Korotoumou Ouattara (both World Bank), and Messrs. Thorsten Beck, Peter Kyle, Thordur Jonasson, Ravi Ruparel, Walter Zunic, and Allan Schott (all World Bank), Carlos Perez Verdia (Banco de Mexico), Graham Stokes (Reserve Bank of South Africa), and Ursula Mcrystal (South African Financial Intelligence Center).
- Notwithstanding a remarkable growth over the last decade, the Mozambican financial system is still small, mostly bank-based, and highly concentrated. Bank intermediation has been constrained by difficulties in channeling deposits into loans, reflecting high and volatile real lending rates (particularly in Meticais) and a poor lending environment (including a weak repayment culture and a number of legal and institutional impediments to effective credit selection and recovery). With some caveats, the banking system's exposure to other risks (currency, interest rate, and liquidity) was found to be moderate.
- To limit real interest rate (and inflation) volatility, a more forward looking and proactive monetary management is needed, supported by reforms to enhance the transparency and effectiveness of the monetary framework, strengthen BM's financial independence, consolidate the market for short-term public securities, enhance the transparency of foreign exchange operations, and accelerate the introduction of a Real Time Gross Settlement System. Measures to limit credit risk (and, more generally, strengthen financial system oversight) include legal and institutional reforms aimed at facilitating lending, a gradual shift to International Accounting Standards, and further efforts to shore up bank supervision.
- Looking ahead, a sound financial development and deepening will require phasing out the State's ownership participation in the banking system, enhancing the transparency and accountability of the public pension system and insurance company, taking steps to facilitate the growth of private nonbank intermediaries and institutional investors, and expanding access by the poor to finance. Follow-up technical assistance will be needed in most areas touched upon by the report.
- The main authors of this report are Alain Ize and Susana Sosa.
- *FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.*

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Glossary of Terms

ACH	Automated Clearing House
AML	Anti Money Laundering
BCP	Basel Core Principles
BM	Bank of Mozambique
CAR	Capital Asset Ratio
CFT	Combating the Financing of Terrorism
CPSIPS	Core Principles for Systematically Important Payment Systems
DSB	Department of Bank Supervision
FSAP	Financial Sector Assessment Program
IAS	International Accounting Standards
INSS	*Instituto Nacional de Seguranca Social*
MAS	Mozambique Accounting Standards
MFI	Microfinance Institution
MPF	Ministry of Planning and Finance
NGO	Non Governmental Organization
SADC	Southern Africa Development Community

I. Overall Stability Assessment

1. **Notwithstanding remarkable progress over the last decade, the Mozambican financial system is still young, small, bank-based, concentrated, and highly dollarized.** Over the last 12 years, the Mozambican financial system has made remarkable progress, from mono-banking to a full blown, market-based, financial system. Yet, it is still small and is dominated by banks. Except for a recently founded small bank, all financial intermediaries are majority-owned by foreign institutions, mostly Portuguese and South African. While there is only one remaining bank with a minority State participation, it is the largest in the system, accounting for 45 percent of total deposits. Due in part to the dominance of this bank, the banking system is highly concentrated, with the largest five banks accounting for 96 percent of total deposits. It is also characterized by increasing dollarization.

2. **While Mozambican banks are generally profitable and well capitalized, they are exposed to significant credit risk.** With the exception of some new banks that face start-up costs, Mozambican banks are highly profitable (the average return on equity for the system was nearly 20 percent in 2002). At the same time, except for one bank, all banks have high risk-weighted capital asset ratios (CAR), in excess of 14 percent on average. Credit risk is substantial, however, as reflected in a high ratio of nonperforming loans to total loans (21 percent at end 2002). While these loans appear at first sight to be well provisioned, an adjustment in provisioning rules (including provisioning for the whole amount of non-performing loans, not just the already past-due component) is needed to comply with international accounting standards (IAS). Most banks would remain well capitalized, but the capital position of one large bank would fall substantially below the minimum CAR. While these results are preliminary and should be viewed with caution, they underline the importance of conducting comprehensive audits as soon as possible to ascertain the full impact on the banking system of a shift to IAS. With some caveats, exposure to other risks, including direct foreign exchange risk and liquidity risk, appears to be limited.

3. **The high credit risk to which Mozambican banks are exposed in part results from high and volatile real lending rates but also from a generally poor lending environment.** Real lending rates in Meticais over the period 1999-2002 averaged 17.5 percent (fluctuating between 20 percent and 10 percent). Such high rates mostly reflected very large intermediation spreads (14.5 percent), partly caused by the large provisions on nonperforming loans. Other factors included: (i) high overhead costs, partly reflecting the small size of the Mozambican financial system; and (ii) generally substantial profit margins, reflecting high bank concentration and limited competition. The high credit risk also reflected a poor lending environment, characterized by a high credit concentration on a few highly leveraged borrowers, lack of credit-worthy projects, weak repayment culture, and a number of legal and institutional impediments to effective credit selection and recovery.

4. **The high and volatile real lending rates are partly the reflection of an unstable macro-monetary environment.** Although inflation has declined from the very high levels attained during the mid-1990s, it has remained significant and quite volatile, contributing to real interest rate volatility. While inflation volatility was in part due to significant (weather-related) supply shocks, it also resulted from large, fiscally-induced, demand shocks that were

not offset sufficiently and on a timely basis through monetary policy. The sharp tightening of monetary policy that took place in mid–2001 was effective in stabilizing prices and the exchange rate but contributed to the high recent level of lending rates.

5. **The high and volatile interest rates also threaten the stability and development of the financial sector by promoting financial dollarization and raising the cost of domestic public debt.** In addition to increasing the risk of lending in local currency, the high and volatile Metical lending rates contribute to increase financial dollarization, thereby raising the vulnerability of the financial system. The weak credibility of the Metical also raises the cost of Metical-denominated public securities, increasing the cost of conducting monetary policy and limiting the development of public securities and capital markets.

6. **To overcome obstacles to bank lending and encourage a rapid yet sustainable growth of financial intermediation, important macroeconomic and developmental challenges will thus need to be addressed.** In particular, further efforts will be needed to limit credit risk and intermediation costs. Improving the lending environment and ensuring stable macroeconomic conditions are key in this regard (see below). Phasing out the remaining State's participation in the financial system (and cleaning up at the same time the non-performing debts of para-statal enterprises) will also be a key step to limit moral hazard, strengthen transparency and governance, and enhance competition.

7. **To enhance the stability of the Metical, the current weaknesses of the monetary framework and management need to be addressed.** A low and stable rate of inflation is needed to enhance the credibility of the Metical and promote a sound and sustainable Metical-based financial development. Achieving this goal will require, first of all, a smoother, more forward-looking, pro-active, and more transparent monetary management. Key measures include a better communication and explanation by BM of its monetary goals and actions, and a redesign of its operational procedures.

8. **Reforms are also needed to enhance the independence of the central bank and ensure it has the financial means to conduct its monetary policy under a very low inflation environment.** BM's capacity to target a low, single digit inflation is currently compromised by its weak financial position. If not addressed, this problem could continue to undermine the credibility of the Metical. In a first stage, BM's foreign liabilities (most of which are eligible for debt reduction under the HPIC Initiative) need to be absorbed by the Treasury and procedures for transferring central bank profits reviewed. Bringing BM's problems to the fore would have some fiscal implications that need to be recognized.

9. **To enhance the transparency of BM's foreign exchange operations and its control on net international reserves, gradual reforms of its foreign exchange intervention practices will be needed.** Current intervention practices are not fully consistent with maintaining international reserves within a desired range. For the short-term, BM could continue to set its daily exchange rate based on market developments but be slightly more responsive to deviations of NIR from their target range. For the medium-term, it would be desirable that the exchange rate at which BM sells foreign currency on account of the Government be fully market determined through foreign exchange auctions.

10. **Public debt management also needs strengthening, both to facilitate the conduct of monetary policy and to promote the development of capital markets.** In addition to strengthening central bank independence, replacing central bank bills by treasury bills would deepen the market for government securities. This would facilitate monetary policy transmission, promote the demand for meticais and the development of capital markets, and enhance the scope for smoothing out fluctuations in donors' funds. To help develop the market for treasury bills, the authorities should, inter alia, concentrate their issues, formalize coordinating arrangements between the MoF and BM, pass a debt law, and strengthen the MoF's debt office.

11. **Further payments system modernization is needed.** The introduction of an RTGS system will limit BM's exposure to settlement risk, promote the development of the Metical money market, and facilitate monetary management. However, in view of the need for substantial additional preparatory work, more resources need to be committed to the project.

12. **A number of reforms are needed to improve banks' appetite for making sound new credits in the difficult Mozambican lending environment.** Legal reforms include the adoption of a new Commercial Code, together with a revised Code of Civil Procedure, and the updating of the laws related to secured transactions. As regards institutional reforms, the establishment of a commercial court, dealing with the largest cases, should be considered in due time. Operational reforms include the enhancement of the scope and reliability of the credit registry administered by BM.

13. **Strengthening banking supervision practices will be crucial in improving the soundness of the Mozambican banking system and ensuring a level playing field.** As regards supervisory issues, BM should establish regular communication with head offices of the foreign banks and work more closely with the banking supervisors where these banks are domiciled. In addition, it should continue building up the core knowledge of its supervisory staff. The key regulatory reform is to bring the current loan classification system and loan loss provisioning system in line with international practices (the proposed transition to IAS is discussed below). On matters of intervention and discipline, BM should establish trigger points for legal action, and put more reliance on specific restructuring actions than on monetary fines. The authorities should also undertake a complete review of the legal and regulatory framework for bank resolution.

14. **The authorities should place considerable emphasis on improving market oversight through the adoption of IAS for all banks.** As a first step, diagnostic reviews of the largest banks should be conducted, focusing on credit exposures, pension liabilities and foreign exchange risks. A well-structured convergence plan to define the convergence timetable towards IAS and oversee its implementation is needed. The results of the audits will also provide key benchmarks to assess the need for additional measures to strengthen the balance sheet of the bank which is currently experiencing capital shortfalls.

15. **The insurance and pension sectors are small and suffer from lack of transparency and limited institutional and regulatory capacity.** This could mask sizeable contingent fiscal liabilities, as neither the state insurance company, Emose, nor the state

pension scheme, INSS, regularly disclose reliable financial statements, based on independent actuarial evaluations. In both the insurance sector (regulated by the MoF) and the pension sector (regulated by the INSS) the capacity of the regulator needs to be strengthened. The prudential oversight of both pensions and insurance could be centralized at the MoF, thereby removing regulatory authority on prudential issues from the INSS.

16. **The Mozambican capital market is very small and there is limited scope for development in the short term.** The first objective in the development of capital markets is to build up the market for public securities, thereby providing a market-driven benchmark for the issuance of private securities. Beyond this, a minimalist approach should allow for the local listing and trading of securities with sufficient disclosure but without overburdening the process and favoring as much as possible regional integration and economies of scale. In this context capital controls will need to be reviewed to ensure that they do not unduly restrict regional integration and capital flows across the region.

17. **The microfinance industry has grown rapidly recently but still has a very small outreach, with high concentration in Maputo.** While prospects for further developing microfinance are good, important bottlenecks must be eliminated. These include restrictions on deposit taking (that limit the size and usefulness of the microfinance institutions) and lack of human resources (that increases the cost of intermediating). Allowing microfinance institutions to take deposits without promoting regulatory arbitrage and overburdening the supervisor (or the institutions) will require a careful review of the draft legislation currently under discussion.

18. **Key FSAP recommendations are summarized in Box 1.** Measures to support the soundness of banks (through addressing the potential shortfall in provisioning and improving disclosure and supervision) and stimulate the use of the Metical (through a strengthening of monetary and debt management) should be given the highest priority. Going forward, efforts should focus on improving access to credit and the lending environment and supporting the sound development of institutional investors and longer term financial instruments. The staff will continue discussions with the authorities on the appropriate technical assistance program for Mozambique, based on the FSAP recommendations.

19. **The authorities concurred with most of the FSAP recommendations.** The Mozambican authorities have indicated their general agreement with the basic diagnostic and main recommendations of the FSAP report. However, they have expressed reservations about some recommendations, such as introducing foreign exchange auctions in the short term. In some other cases, such as in switching from central bank bills to treasury bills and reviewing regulations on capital controls, the authorities have expressed the need for further reflection and analysis. A comprehensive technical assistance program supported by the IMF, the World Bank, the African Development Bank and other donors was discussed with the authorities and targeted support already provided in some areas, including in reviewing BM's accounts.

BOX 1. MOZAMBIQUE: SUMMARY OF MAIN FSAP RECOMMENDATIONS

Recommendations	Implementation Timeline [1/]
Monetary and Foreign Exchange Management	
Strengthen BM's analytical capacity.	**Continuous**
Enhance the transparency of monetary policy.	**Continuous**
Introduce weekly primary sales of bills and concentrate their maturities.	**Short-term**
Reform procedures for daily liquidity management and target bank reserves.	**Short-term**
Enhance the responsiveness of the exchange rate to deviations from target NIR.	**Immediate**
Experiment with auction sales of foreign exchange.	**Medium-term**
Strengthening BM's financial independence	
Transfer medium and long term foreign (HPIC) debts to the Treasury.	**Immediate**
Review accounting and profit transfer practices.	**Short-term**
Introduce a special issue of treasury bills to replace the central bank bills.	**Medium-term**
Public Debt Management	
Pass a debt law and formalize coordination arrangements between BM and MoF.	**Short-term**
Develop a consolidated T-bill issue program.	**Short-term**
Exercise call option on Treasury Bonds indexed to Maibor.	**Immediate**
Simplify and harmonize the taxation of financial investments.	**Medium-term**
Payment System	
Strengthen the payment system unit and firm up the RTGS project.	**Continuous**
Introduce a currency modernization program.	**Medium-term**
Supervisory and Market Oversight	
Define a transition program towards full adoption of IAS.	**Immediate**
Establish closer links with foreign shareholders and their supervisors.	**Continuous**
Continue building up the core knowledge of the supervisory staff.	**Continuous**
Strengthen BM's remedial powers.	**Short-term**
Lending Environment (and legal framework)	
Enact the proposed amendments to the BM Law and the Banking Law.	**Short-term**
Review the draft Commercial Code.	**Short-term**
Modernize the Notary Office and the Public Commercial Registry.	**Short-term**
Establish a special division of the Maputo City Court to execute judgments.	**Short-term**
Modernize the Code of Civil Procedure.	**Short-term**
Update the legal framework for secured transactions.	**Medium-term**
Consider establishing a specialized commercial court.	**Medium-term**
Capital Market, Pensions and Insurance	
Build up supervisory capacity.	**Continuous**
Review regulations on capital controls.	**Medium-term**
Improve accounting and disclosure standards for insurance and pensions.	**Short-term**
Improve transparency of state pension scheme.	**Immediate**
Separate the supervisory and administrative functions of INSS.	**Short-term**
Microfinance	
Review draft legislation on microfinance.	**Immediate**
Anti-money Laundering	
Set up an implementation task force.	**Immediate**
Prepare a CFT Law.	**Medium-term**

1/ The time horizon for the implementation of these measures is indicative and may need to be reviewed as measures are implemented.

II. Short-Run Stability Analysis

A. Financial Sector Structure and Trends

20. **The Mozambican financial system is young, small, bank-based, foreign-owned and highly concentrated.** Over the last 12 years, the financial system has come a long way from a mono-banking system to a market-based financial system. Yet, it is still very small, with less than US$2 billion in total assets. As most small and underdeveloped financial systems, Mozambique's financial sector is dominated by banks, which represent about 95 percent of total assets (Appendix II, Table 2). Foreign-owned institutions dominate the banking system; except for a recently founded small bank, all financial intermediaries are majority-owned by foreign institutions, mostly Portuguese, with some banks owned by South African, Malaysian, Mauritian, and Botswana banks. Following the sale at end-2001 of a nationalized bank to a large South African banking concern, there is only one remaining bank with a minority State participation. However, this bank is also the largest in the system, accounting for 45 percent of total deposits. Due in part to the dominance of the largest bank, the banking system is highly concentrated, with the largest five banks accounting for 96 percent of total deposits, which is high by both Sub-Saharan and low-income country standards.

The Mozambican Banking System in International Comparison
(In percent)

	Private Credit/GDP	Deposit/GDP	Concentration
Mozambique	14	23	96
Sub-Saharan Africa	26	27	83
Low-income group	18	21	71

Source: Bank of Mozambique.

Private Credit/GDP is the claims of financial institutions on the private sector relative to GDP. Deposits/GDP is the total deposits in deposit money banks relative to GDP. Concentration is the share of deposits of the largest five banks relative to total banking sector deposits. Sources: IFS and Barth, Caprio and Levine (2003).

21. **The Mozambican banking system is characterized by increasing dollarization and asymmetric growth in intermediation.** Deposits are not unusually low. They constitute 23 percent of GDP, slightly above the median for low-income group median, but below the median for Sub-Saharan Africa. In contrast, credit as share of GDP is well below the median for Sub-Saharan Africa and the low-income group. The banking system's difficulty in channeling deposits into loans is illustrated by the fact that net loans constitute less than a third of total banking assets. Moreover, the aggregate loan-deposit ratio decreased from 68 percent in 1997 to 61 percent in 2002. At the same time, dollarization continues to rise. While in 1997, 44 percent of deposits and 30 percent of loans were in foreign currency, 51 percent of deposits and 70 percent of loans were in foreign currency in 2002. The higher loan-deposit ratio on foreign currency than in local currency (53 percent against 34 percent) reflects greater difficulties of intermediating in Meticais.

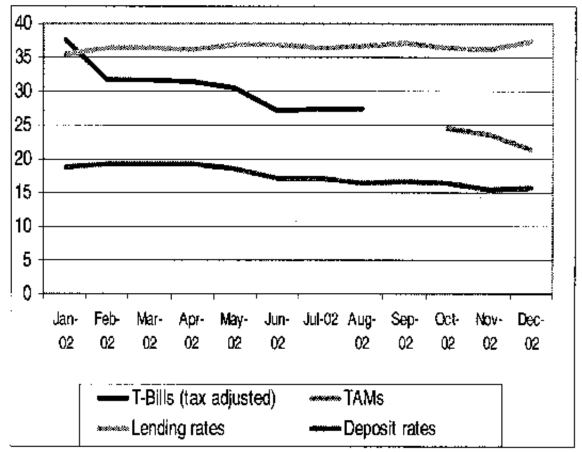
Mozambique: Dollarization and Intermediation Ratio Over Time
(In percent)

	Foreign currency deposits in total deposits	Foreign currency loans in total loans	Loan-deposit ratio
1997	44	30	68
2002	51	70	61

Source: Banco de Mozambique and staff calculations.

22. **High and volatile real interest rate and high interest rate spreads are both a cause and a reflection of a poor lending and saving environment.** High and volatile inflation (and, hence, high and volatile real interest rates), and the small size of the banking system, have driven up interest margins. The spread between Metical deposit and lending rates has been particularly high, reaching 19 percentage points in 2002 (90 days maturity). Over the last four years, the real deposit rate in Metical (90 days) has fluctuated between 5.9 percent and –2.4 percent, suggesting that investing in Meticais is unattractive in view of the volatility of returns. At the same time, the real lending rate in Metical (90 days) has been very high and volatile (fluctuating between 20.4 percent and 9.9 percent), suggesting that it is both costly and risky to borrow in Meticais. The large spread between the lending rate and the interbank rate in part reflects this risk. On the other hand, the substantial gap between the interbank rate and the average deposit rate highlights the lack of alternatives for savers and the limited development of the securities market.

Mozambique: Nominal Lending Deposit and T-Bill Rate, 2002

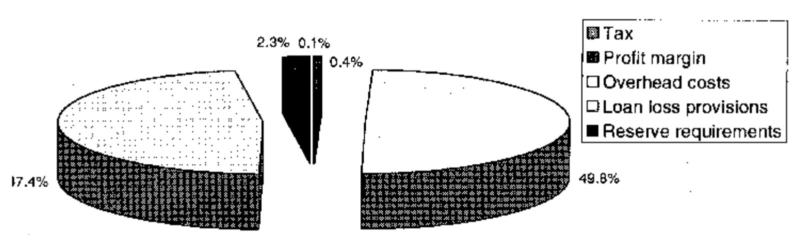


Source: Bank of Mozambique.

23. **Both large nonperforming loans and high operating costs account for the very high bank spreads.** The high spreads between lending and deposit rates reflect: (i) the low loan-deposit ratio (i.e., the limited intermediation conducted by Mozambican banks; and (ii) the high rate of nonperforming loans (22 percent of total loans; Appendix II, Table 3). However, overhead costs relative to total assets are also much higher in Mozambique (8.1 percent) than in the median Sub-Saharan African country (5.6 percent) and low-income country (5.6 percent), reflecting the inefficiency and small size of Mozambican banks.

24. **A large share of nonperforming loans in one bank and high overhead costs account for a large fraction of the ex-ante interest spread.** Half of the interest spreads in Metical is accounted for by loan-loss provisioning, while 47 percent is accounted for by overhead costs. In turn, the high share of loan-loss provisioning can be attributed to the very high share of nonperforming loans in one bank (27 percent of total loans, as against 6 percent on average for the rest of the banking system). The decomposition of interest spreads of Mozambican banks without this bank indicates that loan loss provisions account

Interest spread decomposition MZM

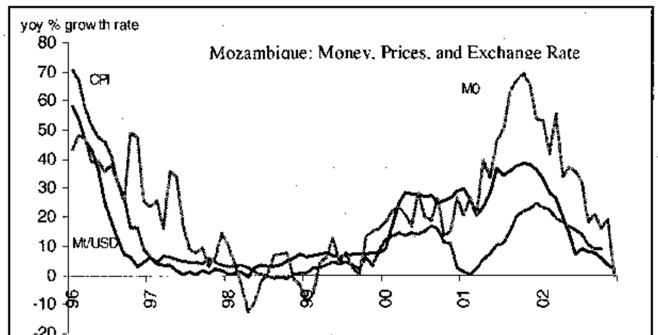


Source: Bank of Mozambique.

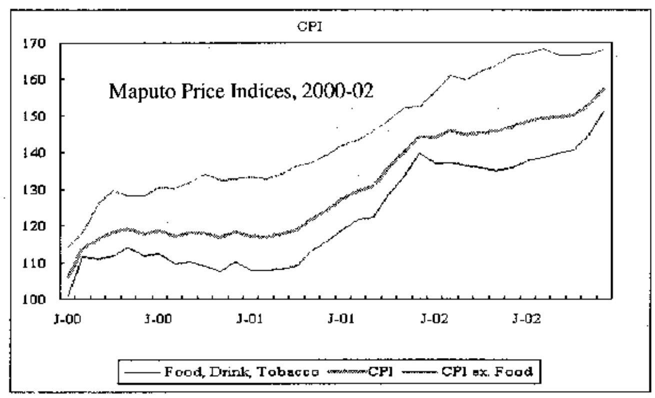
for only 15 percent of the spread, with the profit margin accounting for 31 percent of the spread. This suggests that the poor quality of the loan portfolio of this particular bank has driven up interest rates and spreads in the whole system, providing quasi-rents for other banks.

B. Macroeconomic Vulnerabilities

25. **Significant and volatile inflation constitutes an important potential source of macro vulnerability.** During 1995-2002, average inflation has been significant (16 percent) and inflation volatility substantial, as a result of both supply and demand shocks (see also Appendix, Table 1). Reflecting the large (albeit declining) share of agricultural output in total output and of primary products in exports, the supply shocks mainly originated from climatic disturbances and changes in international commodity prices. The demand shocks have mostly reflected fiscal shocks that were not adequately offset through timely monetary adjustments (see below).

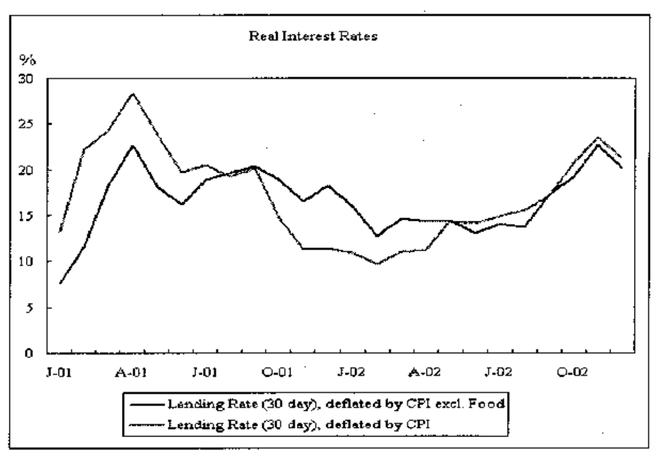


Source: Bank of Mozambique.



Source: Bank of Mozambique.

26. **Price volatility can increase credit risk in many different ways.** The high inflation volatility has resulted in highly volatile real lending rates, thereby increasing borrowing risks. By promoting financial dollarization, it could also undermine the stability of the financial sector ("and induce "fear of floating"). While most banks reportedly channel at present their dollar loans to dollar earning borrowers, both depositors and borrowers are evidently attracted by the more stable (and, in the case of borrowers, much lower) dollar interest rates. Should the demand for dollar deposits continue to grow, it will sooner or later lead to an across-the-board increase in dollar lending. The weak credibility of the Metical also increases the cost of issuing and using Metical-denominated public securities.



Source: Bank of Mozambique.

27. **Mozambique's dependence on foreign aid is also an important, albeit probably not immediate, potential source of macroeconomic vulnerability.** Official grants and loans continue to play a major role in the financing of both the balance of the payments and the fiscal accounts. While there are no signs at present of any abrupt decline in donor funds, it is clear that any major reduction in the future would have serious implications for Mozambique's exchange rate and its capacity to finance its imports and investment program. Even without any such major realignment of foreign funding, lack of synchronization between the flow of foreign funding (in dollars) and that of government spending (in Meticais), as well as delays in foreign disbursements, complicate the MoF's cash flow management and BM's monetary management.

C. Short-Run Financial Sector Stability Analysis

28. **With some exceptions, Mozambican banks are generally well capitalized and profitable.** With the exception of two new banks (which had negative profits in 2002 due to start-up costs), all banks are highly profitable, with an average return on equity for the system of nearly 20 percent and a return on assets of 1.5 percent. At the same time, with one major exception, all banks also have high risk-weighted capital asset ratios (CAR), resulting in an aggregate CAR of over 14 percent. However, the capital position of one large bank falls substantially below the minimum CAR when adjusting its capital for pension and loan provisions that were deferred over a ten-year period (under international norms, these charges need to be immediately accounted for). Moreover, this bank's capital position would worsen further (possibly to the point where it could become a concern for systemic stability) if provisioning rules are applied to the total amount of nonperforming loans and not just the past-due part, as under current Mozambican standards. While other banks would appear to be much less affected and remain well capitalized, a comprehensive audit review is clearly needed to fully assess the impact on the whole banking system of a shift to international accounting standards.

29. **With some caveats, the banking system's exposure to direct foreign exchange risk, interest rate risk, and liquidity risk is limited, overall.** There is limited direct exchange rate risk, since banks' foreign exchange position is subjected to tight regulatory constraints.[1] There also seems to be limited liquidity risk, given that most banks have a high current ratio in Metical (i.e., high ratio of short-term assets to short-term liabilities) and should be able to rely on liquidity support in foreign currency from their major shareholder abroad. In view of banks' large capital positions (setting aside the market leader), and generally moderate exposure to Metical interest earning assets, their direct exposure to

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[1] However, banks' off-balance sheet positions in foreign exchange derivatives (forwards and swaps) need to be checked to ascertain that they are adequately reported as part of their total foreign exchange position. Moreover, banks' exposure to currency risk could take place through the currency mismatch to which their borrowers are exposed. Lack of data prevented assessing such indirect risks.

Metical interest rate shocks is also generally limited. However, one bank, whose assets are substantially concentrated in government bonds, would be significantly affected by a large decline in nominal interest rates.[2]

30. **The vulnerabilities of Mozambican banks lie mostly in their loan portfolio, which is highly concentrated.** In all but one bank, loans to the largest three borrowers constitute more than 50 percent of capital; in two banks, they constitute more than 100 percent of capital. This high loan concentration in part reflects the limited access to bank lending (see below) that restricts banks' universe of large clients to a few, highly leveraged recipients accounting for a large fraction of total bank loans. Thus, banks face limited lending options and widespread lending risk as they either stick with the few corporations that have access to credit (thereby further increasing loan concentration and leverage) or expand their lending to clients that have less access to credit (thereby facing the high risks attached to such lending).

III. Managing Risk

A. Monetary Management

31. **A low and stable rate of inflation is needed for a sound and sustainable financial development.** Low and stable inflation should help reduce and stabilize lending rates, thereby encouraging credit and limiting credit risk for meticai borrowers. At the same time, it should help stabilize expected returns on Metical deposits, thereby helping promote over the medium term financial savings and intermediation in meticais. Conversely, it should limit incentives for dollar intermediation, thereby lessening an important source of financial fragility and potential threat to monetary independence.

32. **BM's monetary policy needs to become smoother, more forward-looking and pro-active.** The authorities should act pre-emptively to limit deviations from policy objectives and avoid extreme swings in interest rates. This will require a strengthening of the Research Department's analytical capacity. In the current stage of market and institutional development in Mozambique, BM should make more use of an intermediate monetary target. Base money could be used for this purpose, once the supply of bank reserves is stabilized.

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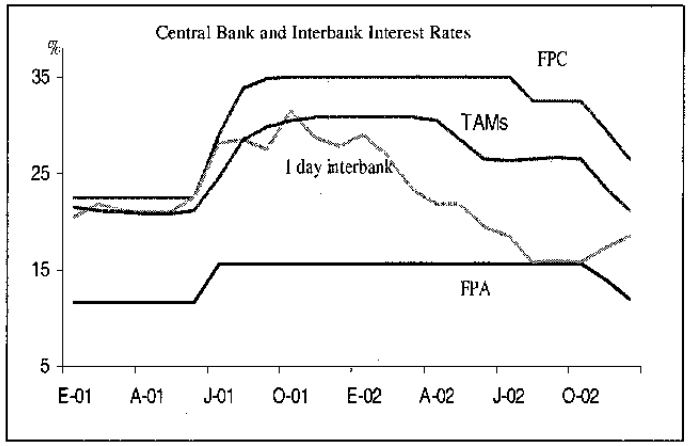
[2] The capital of cight out of ten banks would fall if Metical interest rates fell by ten percentage points (back to 1999 levels) and the capital adequacy of one large bank with large holdings of government securities would decline below the minimum required capital.

33. **The monetary framework also needs to become more transparent.** Market participants do not fully understand the goals or procedures of monetary policy and the reasons underlying changes in the stance of monetary policy (see below). For example, the seemingly uncoordinated evolution of short-term market rates and central bank standing facility rates during 2002 was confusing to market participants as BM's intent of continuing to signal a tight monetary stance through high standing facility rates was de facto contradicted by the rapid decline of short-term market rates. Instead, the sale of bills of all maturities at set prices (effectively on tap) ended up creating an arbitrarily sloped yield curve seemingly at odds with market expectations.

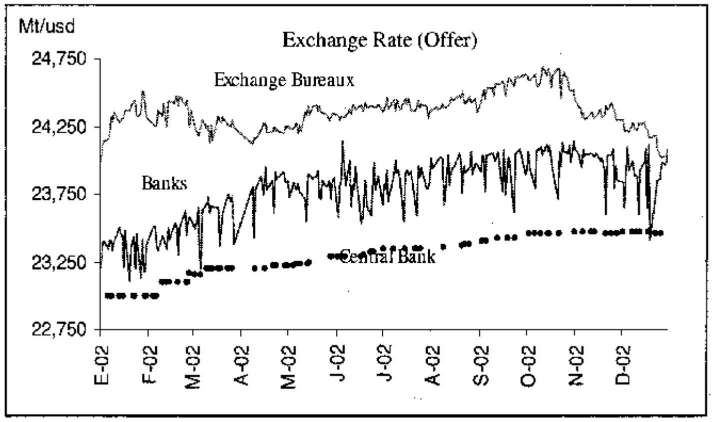


Source: Bank of Mozambique.

34. **To enhance transparency and avoid interfering with market signals, BM should adopt a more open process for formulating and reporting monetary policy and reform its operational framework.** The objectives of monetary policy should be clarified and the modalities of operation and policy changes better explained. To ensure that market signals are properly reflected in the longer-term interest rates, primary sales of T-bills should be separated from daily liquidity management operations and conducted instead through weekly price auctions. To enhance the signaling capacity of its intervention band, BM should narrow the band. To ensure steady liquidity conditions in the interbank market, the volume of such operations should aim at maintaining stable end-of-day bank reserves.

35. **Further payments system modernization will help limit BM's exposure to settlement risk and facilitate monetary management.** The assessment of the Core Principles for Systemically Important Payment Systems (CPSIPS) shows that notable progress has been achieved towards developing a modern payments system, particularly as regards the check clearing and settlement system (See Appendix I). However, further efforts are needed. In particular, the introduction of an RTGS system (currently under initial development) will limit BM's exposure to settlement risk (which at present is very substantial; banks widely expect BM to automatically provide funds in case of failure to settle), promote the development of the Metical money market, and facilitate monetary management. However, in view of the need for substantial additional preparatory work, more resources should be committed to the project. In due time, a currency modernization program (including a currency reform to cut the number of zeros on the bills, the issue of higher denominations bills, and efforts to increase the quality of bills in circulation) would further enhance the attractiveness of the local currency.

36. **Current intervention practices in the foreign exchange market are not fully consistent with achieving an international reserves target and could become unviable in a more open and developed financial environment.** Current practices would probably result in a quasi-fixed exchange rate, should BM not take into account the exchange rate of exchange bureaus.[3] However, adjusting the noncash exchange rate to match changes in the cash rate is a matter for some concern, as the two markets may not necessarily follow the same dynamics. Moreover, the path of the exchange rate is unlikely to be consistent with maintaining international reserves with a desired range. Thus, sharp policy adjustments could be eventually required to correct for large deviations of international reserves from a desirable accumulation path. Over the longer run, current arrangements could also be problematic, once restrictions on capital mobility are lifted and the financial sector develops, opening the possibility of speculative attacks.



Source: Bank of Mozambique.

37. **BM will need to find intervention arrangements that limit interference with market forces while allowing it to continue being heavily engaged on account of government operations.** The goal of allowing the exchange rate to be more fully market determined conflicts with BM's role as the government's banker which, in view of the budgetary currency mismatch, requires that it be present on a near continuous basis in the foreign exchange market. In the short-term, BM could continue to set its exchange rate based on market developments, but make the adjustment rule slightly more responsive to deviations from the NIR target range. Over the medium term, it would be desirable for purposes of transparency and market development to let the market determine (through price auctions) the exchange rate of the foreign exchange sold by BM on account of the Government. To guide more effectively its interventions in the foreign exchange market and set apart its market stabilization role from its fiscal agency role, BM should distinguish between the international reserves which it keeps transitorily on its books in anticipation of government spending and those that it intends to keep permanently.

38. **The reforms of monetary and foreign exchange management need to be supported by a strengthening of the central bank's instrument independence.** BM does not have at present sufficient instrument independence inasmuch as its financial position is

[3] BM sets a daily rate at which it stands ready to sell (de facto) unlimited amounts of foreign exchange. BM gradually adjusts its rate in response to persistent and significant deviations between its own rate and the average selling rate of banks and exchange bureaus.

weak and dependent on (inflationary) seignorage revenue. While it reports a positive capital and declared operating profits in recent years (half of which were distributed to the Government), its net worth and profits become in fact negative once valuation adjustments are properly accounted for. On-going negotiations under the HPIC Initiative are likely to restore BM's solvency. However, it would not be sufficient to ensure its profitability (on a conventional accounting basis). This weak financial position, if not addressed, could prevent BM from sustaining low, single digit inflation in the future.

Mozambique: BM's Summary Balance Sheet
November 2002, in millions of U.S. Dollars

Liabilities	**1,284.8**	**Assets**	**1,470.9**
Non-interest bearing Met. Lib.	381.8	Foreign assets	832.4
TAMs	115.9	Valuation adj.	638.5
Med.-and long-term foreign liab.	787.1		
Net worth with valuation adj.	**186.1**		
Net worth without valuation adj.	**(452.4)**		

Source: Bank of Mozambique.

Mozambique: BM's Estimated 2002 Adjusted Income Account (on a cash basis)
In millions of U.S. Dollars

Expenditures		**43.1**	**Income**		**13.7**
Interest paid		17.7	Interest earned on		
on TAMs and TBs	15.0		foreign assets		13.7
on M/Lterm foreign	2.7		**Profits**		**(29.4)**
liabilities			Inflation tax (9%) 1/		44.2
			Currency	15.1	
Operating expenditure		25.4	Reserve deposits	15.1	
			Government	7.6	
			TAMs	6.4	
			Profits (with inflation tax)		**14.8**

Source: Estimated on the basis of Bank of Mozambique data as of November 2002.

1/ Calculated on the basis of end-2002 inflation.

39. **BM's profitability needs to be bolstered and its profit distribution practices reviewed.** To deal with this problem, the first step would be to transfer most of BM's foreign medium and long-term liabilities to the Treasury and write most of these off under the HPIC initiative. The next step would be for the MoF to undertake a special issue of treasury bills to replace the currently outstanding central bank bills, with the rest remaining on BM's balance sheet. At the same time, BM should review its profit distribution practices to ensure they

follow established international practices.[4] Bringing BM's problems to the fore and letting the MoF assume the cost of interest payments on the outstanding stock of short-term public securities in circulation will have some fiscal implications that need to be recognized.

B. Public Debt Management

40. **Developing a strong government securities market should be viewed as a key immediate priority.** A well-functioning government securities market will facilitate the conduction of monetary policy and the management of the MoF's cash flow, limiting the difficulties resulting from fluctuations in donors funding. The development of a government securities market also constitutes a key step towards deepening financial intermediation and promoting the development of a capital market. In particular, this will provide key benchmarks for a market-determined yield curve. Last, but not least, the development of a Metical government securities market will help promote the use of the local currency and limit incentives for dollarization.

41. **The development of a Treasury bill program with a limited number of maturities should lie at the core of the public debt development strategy.** To limit fragmentation, the number of series of treasury bills must be limited. Legal arrangements will be needed to formalize the delegation by the Government of the treasury bill issuance to BM and facilitate coordination. To reduce the cost of public debt, the government should exercise its call option on Treasury Bonds indexed to the Maibor, taking due account of its impact on the financial soundness of the banks holding these bonds. To facilitate secondary market transactions and promote the growth of a repo market, BM should create (or facilitate the creation of) an electronic registry for government securities. To enhance and stabilize the demand for public securities, efforts will be needed to broaden and diversify the investor base. In particular, the laws for pension funds and insurance companies should be revised to adjust the investment policy of these institutions towards investments that suit their liability structure and risk characteristics. To facilitate the comparison of financial products and limit the scope for tax arbitrage, the taxation of financial instruments (including treasury bills) should be simplified and harmonized. Passing a debt law will enable efficiency and accountability gains. A human resources strategy should be put in place to retain and recruit key staff of the public debt unit at the MoF.

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[4] While BM's Law is generally adequate in this and other respects, some amendments could be introduced when the Law is revised to bring it closer to SADC standards. In particular, BM's capacity to finance the Government should be eliminated once the government short-term securities market becomes sufficiently developed.

C. Supervisory Oversight

42. **BM should further strengthen the quality of its supervisory oversight.** The assessment of the Basle Core Principles for Effective Bank Supervision (BCP) shows that BM has made substantial progress over the last two years in strengthening its bank oversight capacity (see Appendix I). In particular, it has improved its offsite supervision, leading to a more accurate recognition of risks in banks' loan portfolios. Albeit with some gaps, there is a generally adequate legal framework in place. Yet, significant work remains, particularly as regards establishing closer links with foreign supervisors, tightening loan classification regulations, providing further training to onsite and offsite examiners, and strengthening BM's remedial powers.

43. **BM should establish closer links with the foreign shareholders of local banks and their immediate supervisors.** In view of the importance of foreign ownership in the Mozambican banking system, BM needs to be better informed of developments that could affect the soundness of the foreign shareholder banks and banking groups, as well as the condition of financial systems in the parent countries. Thus, during the onsite inspection process BM should ascertain that the operations of the local banks are fully and accurately reported to their respective head office. At the same time, BM should establish formal memoranda of understanding with the foreign supervisors responsible for the controlling shareholders of the major Mozambican banks. These bilateral agreements should foresee the exchange of information on the situation of the banking system in parent countries, on supervisory standards, and on findings about the financial situation of the local subsidiaries. When possible, joint inspection programs involving foreign and Mozambican inspectors would facilitate the exchange of information and transfer of expertise.

44. **The current loan classification system and the loan loss provisioning system should be brought in line with international practices.** A new loan classification should be introduced, that should take in account the repayment capability of the borrower and provision for the full amount of the loan. This new system will require additional provisioning at some banks. Therefore, it should be introduced after an adjustment period (24 to 30 months), following a special portfolio audit review of the major banks (see below).

45. **BM should take further steps to build up the core knowledge of its supervisory staff.** A continued, intensive on-the-job training program will be needed to ensure that BM inspectors feel confident that their knowledge of banking matters is at par with that of the senior managers of the best Mozambican banks. BM should hire as soon as possible an IT consultant with expertise in the assessment of automated information system and an accountant with good knowledge of IAS. The addition of a small group of recent university graduates could significantly improve the quality of BM's onsite and offsite supervision.

46. **BM's remedial powers should be strengthened.** The central bank has proven reluctant to take remedial measures against banks failing to meet prudential requirements and has primarily utilized monetary fines as a deterrent. The proposed amendments to the

Financial Institutions Law allowing the central bank to approve or revoke a license without the approval of the Ministry of Planning and Finance, if enacted, would significantly improve the enforcement powers of bank supervision. In addition, BM should establish trigger points at which it will initiate one or more of the specific legal corrective actions it is permitted to use. Ensuring that the authorities are prepared to intervene and resolve a failing bank if need arises, might call for the preparation of a contingency plan; a process that would imply a review of the legal and institutional mechanisms to intervene a failing bank.

D. Market Oversight

47. **By promoting transparency in financial reporting the adoption of IAS will significantly strengthen market oversight of the banking sector.** However, convergence to IAS will take time and careful preparation. The process should begin with the establishment of a Steering Committee, with representatives from BM, the audit firms and the banks, and the development of a plan with a convergence strategy and a timetable. A key initial task of the committee will be to confirm the key differences between Mozambican Financial Institutions Accounting Standards and IAS.

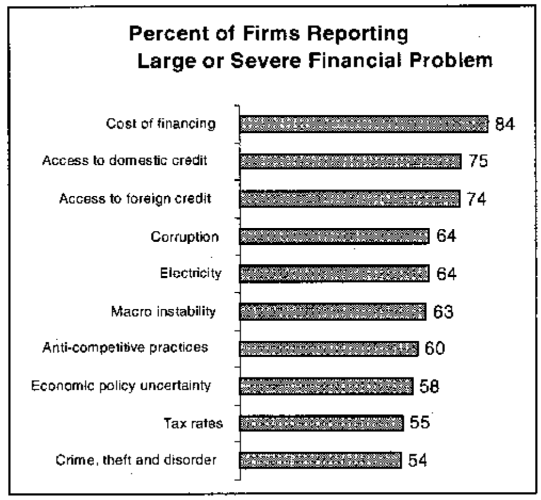
48. **The possible impact of the change to IAS and the need for additional actions to address the weak financial situation of the undercapitalized bank should be assessed through diagnostic reviews.** BM should contract audit firms to undertake reviews of the largest banks. These reviews should focus on three key areas: credit exposures, foreign exchange, and pension liabilities. Once the diagnostic reviews are complete, the steering committee will have a better basis for assessing the time period necessary for the conversion. At the same time, the results of the audits will provide key benchmarks to assess the need for (and define the modalities of) additional measures to strengthen the balance sheet of the bank which is currently experiencing capital shortfalls. In the mean time, BM will need to keep in place an enhanced supervisory regime for this bank.

49. **The accounting standards applicable to enterprises also need to be modernized.** The current accounting standards date back to 1984 and need to be revised towards IAS. While large firms could be required to use IAS, there is merit in retaining simpler Mozambican Accounting Standards (MAS) for the small and medium-sized enterprises. The creation (by the private sector) of an Institute of Accountants would facilitate the development of appropriate standards and provide a much needed framework for training and certification of accountants. The efforts made in this direction by a steering committee of representatives from the audit firms deserve the strongest support from both the government and the donor community.

IV. Enhancing The Scope of Financial Intermediation

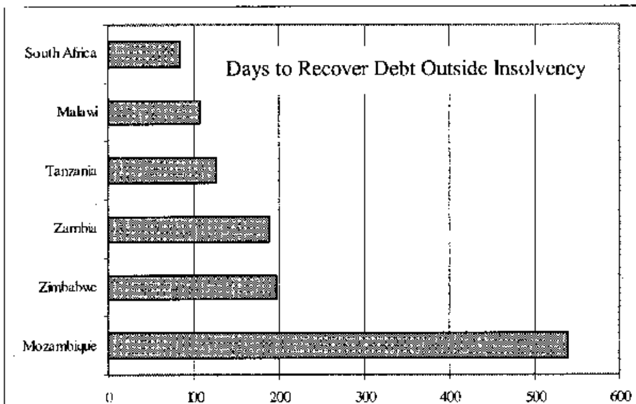
A. Improving The Lending Environment

50. **Difficulty in obtaining credit is the single greatest obstacle facing enterprises.** In 2002, over 80 percent of firms reported the cost of financing to be the most severe obstacle to their business performance. As reflected in the small level of bank credit (as discussed above), few firms rely on formal lending institutions for finance. Internal funding and retained earnings account for 90 percent of working capital financing and around two-thirds of new investment, with only 10 percent of new investment being financed by bank loans. The poor lending environment reflects a weak repayment culture and a number of legal and institutional impediments to effective credit selection and recovery.



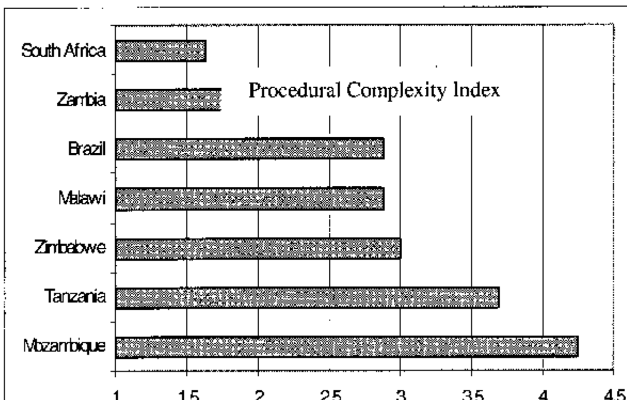
Source: Bank of Mozambique.

51. **Legal obstacles to credit recovery are a major hindrance.** Debt recovery through the courts is highly inefficient and rarely used (it takes on average 540 days to resolve a case in Maputo, much more than in most neighboring countries). Similarly, resolving insolvency in Maputo requires undergoing an inordinate amount of time. Judges are perceived to have inadequate knowledge of commercial law and to avoid commercial cases, which tend to be more complex than civil cases. Outside of Maputo, the judicial system is even less effective.



Source: Bank of Mozambique.

52. **The ongoing revision of the Commercial Code should be supported by modernization of the Code of Civil Procedure.** The draft Commercial Code currently under discussion in Parliament should be withdrawn and reviewed to ensure that it fully complies with best international practices. The current Code of Civil Procedure, which is dated 1967, also needs reviewing. In particular, the complexity and formalism of judicial process should be reduced (comparisons with neighboring



Source: Bank of Mozambique.

jurisdictions show that procedural complexity is much higher in Mozambique). As Mozambique has the least trained judiciary among all these countries, it is not surprising that this complexity results in long delays and perceptions of corruption. Procedural simplification is likely to result in improved access to justice. To support the implementation of court decisions it would be also advisable to establish a special division on judicial execution in the Maputo City Court. Over the longer term the government of Mozambique might also consider establishing a specialized commercial court. As a first step, the demand for such a court should be assessed and the legal reform needed for establishing it examined.

53. **The legal framework for secured transactions also needs updating.** Land cannot be used as collateral, and there are restrictions on pledging movables, on using future property, and on using a changing pool of assets such as buildings in construction. It takes around 2.5 years to enforce a collateral agreement through the official court process. While some banks require irrevocable power of attorney, whereby the creditor can repossess without court involvement, the legality of this procedure is unclear. Lack of clear property title and inefficiency and corruption in the property registry are also consistently reported as major obstacles. Main areas of reform include: (i) developing out-of-court enforcement procedures or summary enforcement proceedings; (ii) modernizing and linking the Mozambican property registries electronically; and (iii) over the longer term, increasing the categories of property eligible as security.

54. **Measures to expand the coverage of the public credit registry would help improve credit selection.** The public credit registry (established in 1997 and reformed in 2000) has been operating successfully. In September 2003 records reached 22,785 borrowers, covering about 98 percent of the amount of credit registered in the balance sheets of the institutions supplying the data. Nevertheless, harsher penalties for noncompliance with data submission requirements, the retention and distribution of longer payment histories, and the expansion of coverage to include nonbank financial institutions and other lenders, would improve the services provided by the registry. Over the longer term, it would also be advisable to introduce the legal framework for information sharing among private parties that would be needed to facilitate the establishment of private credit registries.

55. **Measures to implement the legal framework on anti money laundering (AML) and combat financial terrorism (CFT) would further contribute to a sound and healthy financial environment.** The assessment of the AML/CFT Code indicates that to make the recently enacted AML legislation effective, regulations and implementation guidelines are required. In particular, the current lack of reporting has gone unchallenged as there is not yet an adequate regime in place to enforce compliance. Further efforts are required to spell out the specific requirements with respect to defining suspicious transactions, the manner and method of reporting, and penalties for nonreporting and non-compliance. While the Attorney General's office, the Public Ministry and the Criminal Investigation Police are legally responsible for the enforcement of AML, there appear to be very little co-ordination between these offices, no infrastructure, and generally insufficient resources. A task force needs to be set up to draft implementing regulations, map out the workflow plan, and prepare written

procedures and guidelines for investigating and prosecuting money laundering cases. As regards combating financial terrorism, a law is needed.

B. Increasing Competitiveness in the Banking System

56. **The potentially negative effects of a dominating, partly state-owned, market leader should be addressed.** The current strong dominance of the market leader limits competition as smaller banks benefit from the "umbrella" effect provided by its monopolistic powers. Moreover, such a strong market dominance raises moral hazard through exacerbating the "Too-Big-To-Fail" syndrome, can undermine market discipline and supervisory independence, and raises concerns of lack of level playing field. Measures that could help reduce concentration and level the playing field include: (i) creating a single ATM/debit card network and an automated clearinghouse (ACH) for retail transactions; (ii) eliminating regulatory or supervisory privileges or discrimination depending on the size of the bank; and (iii) giving all banks the chance to compete for the provision of government services rather than concentrating them at specific banks.[5] Phasing out the remaining State's participation in the financial system (and cleaning up at the same time the non-performing debts of public enterprises) will also be a key step to limit moral hazard, strengthen transparency and governance, and enhance competition.

C. Developing the Capital Market

57. **Capital markets in Mozambique are very small and have limited prospects in the short-term.** The legal framework and basic infrastructure for a functioning capital market, including a stock exchange, were created in 1997. There have been three public and private bond issues; only one company stock is listed on the exchange with a total market capitalization of less than 3 percent of the GDP and negligible trading activity. Main preconditions for the further development of the markets seem to be missing. There is no active public securities market to provide market benchmarks. The country is lacking a strong corporate sector with good disclosure and governance standards mainly due to a deficient legal framework and a lack of incentives for companies to comply with high standards. Access to finance through public offerings has also been limited due to low demand by investors.

58. **A step-by-step, minimalist approach is advisable in the short-term.** The first objective should be to develop the public securities markets. There is also a need to build up supervisory capacity through extensive technical training. A minimalist approach should be adopted that promotes efficient procedures for issuing and trading shares (costs of disclosure and bureaucratic delays are still high) while maintaining sufficient disclosure for investor protection and market oversight. Given the small size of the economy, Mozambican capital

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[5] Full implementation of the MoF's budget and cash management system, SISTAFE, will constitute an essential step in this direction.

markets would benefit from integration into the markets of the SADC region. However, regional integration may require a streamlining of capital controls. The current long and costly authorization processes are likely to discourage foreign investor demand in Mozambican securities as well as investments by Mozambican investors in securities listed abroad. As the macroeconomic and prudential environment is strengthened, the authorities might consider phasing out these controls.

D. Pensions and Insurance

59. **The insurance sector in Mozambique is also small and requires further institutional and regulatory development.** While some foreign owned companies recently entered the sector, improving the availability of products and competition, the state owned insurance company Emose still holds a substantial market share. Substantial developments in the regulatory environment have taken place in recent years (including a new Insurance Law and the establishment of a regulatory agency). However, some key regulations in areas such as risk diversification, solvency of insurance companies, consumer protection and taxation are still lacking. In addition, the capacity of the insurance regulator needs to be strengthened through technical training and laws and regulations better enforced. To increase transparency and competition, accounting and disclosure standards should be improved. In the medium term, a strategy should be developed to privatize Emose.

60. **The pension sector is dominated by the state owned unfunded pension scheme administered by INSS, which is also the supervisor of the sector.** There is an urgent need to improve the transparency and accountability of the unfunded state pension scheme administrated by the INSS, which does not disclose its financial statements nor its investment policies. Potential quasi-fiscal contingencies need to be assessed through an actuarial evaluation. INSS should also be required to publicly disclose its financial statements regularly. Some corporate pension schemes exist, which are not regulated or supervised. To limit obvious conflicts of interest, the supervisory and administrative functions of INSS should be separated and the scope of the regulatory framework expanded to include private pension schemes. In the medium term, as its capacity is improved, the Insurance Supervisor could take over the prudential supervision of the pension industry.

E. Developing Finance to Reach the Poor

61. **Microfinance institutions (MFIs) have grown rapidly but still have a very small outreach and low operational efficiency.** While commercial banks, NGOs, savings and credit cooperatives, as well as local associations, all undertake microfinance activities, the microfinance industry as a whole is relatively under-developed in Mozambique compared to other African countries. It now has 55,000 clients but still accounts for about only 1 percent of the credit offered by the banking system and remains an urban phenomenon with high concentration in Maputo and high industrial concentration (four MFIs account for over 80 percent of loans). Average salary and administrative cost are high due to the very limited supply of qualified staff administering relatively small loan portfolios. As a result, returns on

assets and equity remain negative, as in similar African countries with young microfinance industries. Reaching the break-even point is still expected to take some years.

62. **Key bottlenecks need to be eliminated.** The growth of MFIs is currently in part constrained by the fact that they cannot engage in deposit taking nor provide payment services for their customers. The draft legislation on microfinance that is currently being discussed should be reviewed to allow MFIs to offer such services. However, care should be taken to eliminate the possibility of regulatory arbitrage while avoiding overburdening MFIs (and their supervisor).

V. LOOKING AHEAD

63. **Proper prioritization and timing will be important in ensuring the success of financial sector reforms.** Due to the dominant role of banks in the Mozambican financial system highest priority should be given to measures designed to: (i) support the soundness of the banks, including financial transparency and disclosure, and a broad-based strengthening of BM's supervisory capacity; and (ii) stimulate a deeper and more vibrant market for assets denominated in Meticais through a concerted effort to strengthen monetary, foreign exchange and debt management. Going forward it will also be important to initiate reforms related to improving access to credit and the lending environment as well as to support the development of markets for longer-term financial obligations associated, for example, with finance of pensions, insurance and housing. An immediate concern in these areas is to strengthen supervisory capacity so as to prevent regulatory arbitrage between the relatively large, mainstream banking sector and other, considerably smaller non-bank financial intermediaries and microfinance institutions.

64. **Implementation of the main FSAP recommendations will require a comprehensive program of technical assistance stretching well into the future.** To have an impact on financial sector development in Mozambique, coordinated technical assistance support by the Fund and the Bank in all areas listed in Box 1 will be needed. There would appear to be considerable willingness on the part of the donors to support the improvement efforts outlined above.

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES: SUMMARY ASSESSMENTS

This appendix contains summary assessments of adherence to the major international standards and codes applicable to the financial sector. The assessments have helped to identify the extent to which the regulatory and supervisory frameworks are adequate to address the risks in the financial system. They have also provided a source of recommendations for improved financial regulation and supervision in various areas.

Detailed assessments of standards were undertaken based on a collegial peer review process as part of the FSAP by: Walter Zunic (formerly World Bank) and Vera Luz (Bank of Portugal) for the *Basel Core Principles for Effective Banking Supervision*; Graham Stokes (Reserve Bank of South Africa) for the *Core Principles for Systemically Important Payment Systems*; and Paul Allan Schott (World Bank), Vera Luz (Bank of Portugal) and Ursula M'Crystal (National Treasury, Financial Intelligence Center, Republic of South Africa) for the *anti-money laundering (AML) and combating the financing of terrorism (CFT) regime.*

In all three areas assessed, it is concluded that although some progress has been made there is still significant additional work to be done. For further strengthening **supervision of the banking system**, there is a need to establish closer links with foreign supervisors, tighten loan classification and provisioning regulations, establish consolidated supervision, move to international accounting and auditing standards, and strengthen BM's remedial powers. While the Mozambican **payments system** has made substantial progress as regards the clearing and settlement of checks and other retail instruments, it needs further modernization as regards the management of settlement risk and the introduction of effective facilities for electronic interbank payments. Several shortcomings in the current payment system law also need to be addressed. The legal and regulatory framework for **AML activities and the CFT** is inadequate: no implementing regulations to the 2002 AML law have been approved; no law regarding CFT has been passed, and a financial intelligence unit (FIU) has not been established.

The assessments have been discussed in detail with the Mozambican authorities but responsibility for the assessments remains that of the assessors. The authorities' response to the assessments is included at the end of each summary.

A. Basel Core Principles for Effective Banking Supervision

Summary assessment

65. **BM has made significant progress in strengthening banking oversight.** Some basic improvements were made during 2002-2003 in the area of off-site and on-site supervision, including in the recognition of banks' non-performing loan portfolios. However, significant further work is needed, including to: (i) establish closer links with foreign supervisors; (ii) tighten loan classification and provisioning regulations; (iii) establish consolidated supervision; (iv) move to international accounting and auditing standards; (v) provide further training to on-site and off-site examiners; and (vi) strengthen BM's remedial powers.

General preconditions for effective bank supervision

66. **Mozambique has a long way to go towards achieving the goal of meeting the general preconditions for effective banking supervision.** While on paper some of these preconditions may appear to be met or to be in the process of being met, in the day to day practice substantial further change and progress is still required in order to achieve effective judicial systems, robust corporate governance structures and sound accounting and auditing standards and practices. While BM already requires banks to prepare financial statements using IAS 30, the Chart of Accounts should be amended to insure the effective implementation of IAS. In addition, BM's legal provisioning requirements for classified loan should be amended and tightened. Credit decisions are often not made on an arm's length basis, and do not take into account the willingness or ability of the borrower to repay the loan. The justice system is inadequate, which makes it difficult and time consuming for banks to take action against loan defaulters.

Main findings by groups of principles

Objectives, autonomy, powers, and resources (CP 1)

67. **Overall the legislation provides a reasonably satisfactory basic legal framework for supervision of financial institutions.** The Central Bank Law and the Banking Law (BL) clearly define BM's supervisory responsibilities but not its supervisory objectives. While the BL empowers BM to determine if the bank is complying with safety and soundness practices and procedures, and if it is necessary, to apply remedial measures, BM has generally been reluctant or unable to make full use of its enforcement powers, relying primarily on monetary fines.

68. **Personnel management should be reviewed.** BM should have the ability to hire staff with relevant banking experience from the market. It should accelerate efforts to improve quality of staff and when appropriate, transfer staff out of the supervision area and into other parts of the bank.

69. **There is no formal system of cooperation and information sharing between BM and the MoF, or among BM and foreign supervisory agencies.** The latter is particularly important in Mozambique, as all banks are foreign owned. However, the BL permits the exchange of information between BM and other domestic and foreign agencies.

Licensing and structure (CPs 2–5)

70. **The legislation sets out clearly the permissible activities of banks and restricts the ability to use the word "bank" in connection with credit activities.** The BL defines a significant ownership stake as 10 percent of direct or indirect ownership. Associated or group companies are grouped together for the consideration of ownership percentages. The BL requires any prospective significant shareholder to notify BM of its intentions to acquire a significant shareholding. Intended shareholdings above certain thresholds (e.g., 20, 33, 50, and 100 percent) require similar notifications. Regulations define limits to investments and acquisitions for banks and other financial institutions, but do not set specific criteria by which BM could form an opinion on individual proposals.

71. **While BM has the right to set criteria for licensing of banks, the MoF has the final responsibility for granting the licenses.** A new Banking Law, jointly drafted by the BM and the MPF and sent to Parliament, will grant the BM significant operational authority if approved as currently drafted.

Prudential regulations and requirements (CPs 6–15)

72. **Banks are required to meet capital adequacy standards that are broadly consistent with the Basel capital adequacy framework.** However, capital adequacy ratios are, in many cases, calculated on the basis of accounts which are not compliant with IAS, and/or which do not include adequate provisions for loan losses. Although both on-balance-sheet and off-balance-sheet risks are included, the capital adequacy ratio reflects only credit risk, not addressing other risks such as market risk. In due time, the BM should require banks to meet capital ratio requirements on both a solo and consolidated basis.

73. **BM's on-site inspections need strengthening.** While BM carries out regular on-site inspections, a review of a few examination reports indicates that in general the on-site inspectors focus on checking compliance, particularly with loan classification standards and foreign exchange transactions and pay only limited attention to credit policies, practices and procedures.

74. **The current provisioning system does not reflect the true risk of the loan and is cumbersome to be effectively supervised.** In most instances, the provisions are made only for the past due amount of the loan and loan amounts that have not yet matured are generally not classified, even though the loan is past due for months and in some instances for years. In addition, the repayment capability of the borrower is not taken into account when analyzing and classifying a loan. Loans that have been rescheduled should be given the same classification in effect prior to the rescheduling for a period of at least one year or until the borrower has proven his repayment capabilities under the new terms. Although BM has the

power to require a bank to take action if their policies and procedures for granting credit, loan review and ongoing oversight of problem credits are inadequate, these powers are used rarely.

75. **The definitions of large exposures are consistent with the Basel Accord requirements.** Banks are not permitted to extend loans to connected parties on more favorable terms than those of loans to non-related parties. For the supervision of connected lending, the DSB must rely to some extent on the information sent by the financial institutions, since the accuracy of the data is reviewed only at the yearly on-site inspection.

76. **An anti money laundering law was passed in February of 2002.** However the Council of Ministers has not issued pertinent regulations as to the implementation of the law (see the AML/CFT assessment).

Methods of ongoing supervision (CPs16–20)

77. **On-site and off-site supervision is weak since it fails to assess banks' systems for monitoring and managing their operations and fails to address the risks that a bank incurs in the normal course of its business.** Supervision is primarily aimed at the review of credits and compliance matters. In addition, BM lacks the support of an automation examiner who can assess the reliability and accuracy of the information provided by financial institutions.

78. **In general BM examiners are not well versed in the various operations of a banking institution.** Training is inadequate, partly due to the absence of focused training in some specialized areas, and partly because of the staff's lack of foreign language skills and even in some instances, of background expertise in the subject area.

79. **BM does not have a program of regular quarterly meetings with senior and middle management of the banks in order to discuss a bank's performance and general matters related to supervision.** Meetings with management are conducted during on-site inspections and when specific problems arise.

80. **BM does not conduct supervision on a consolidated basis.** However the DSB is aware of the overall structure of the banking organizations and through the on-site examination process has an understanding of the activities of the significant parts of a financial group.

Information requirement (CP 21)

81. **The legislation permits BM to establish the accounting procedures to be used in preparing supervisory reports.** BM requires periodic disclosure of information that is timely, accurate and adequate to furnish a basis for effective market discipline. As of end-2002, BM requires banks to prepare annual audited financial statements based on IAS. However, it also requires the banks to follow the local chart of accounts which is not in compliance with IAS. This has resulted in some banks following IAS in the preparation of

their annual statements, and some banks publishing their annual audited statement following exclusively the accounting principles set by BM.

Formal powers of supervisors (CP 22)

82. **While the BL authorizes BM to take an appropriate range of remedial actions, it has been often slow to act.** The BL allows BM to impose monetary penalties to banks, depending on the severity of the infractions. However, fines that can be applied for each infraction, are low and BM has been very slow to act when important problems, such as the capital falling below the minimum required level, or inadequate provisioning of assets, occur at a bank.

Cross-border banking (CPs 23–25)

83. **There is no Memorandum of Understanding or informal documented cooperation between BM and the foreign bank supervisory agencies.** Reportedly, informal contacts occur between the senior management of BM and foreign bank supervisory authorities.

Main Recommendations of the BCP Assessment

Reference principle	Recommended action
CP 1 Powers, Autonomy and Resources	• Amend the Central Bank Law to include specific objectives for supervision and ensure that BM operates without government interference. • Provide legal protection to BM and its staff. • Establish cooperation arrangements with domestic and foreign supervisory agencies.
CP 2-5 Licensing and Structure	• Amend the Banking Law to specify the criteria for approving an application for a new financial institution. • Lower the threshold for significant ownership and strengthen monitoring of funds used for constituting this ownership. • Establish criteria to evaluate investment proposals and require notification of acquisitions and investments.
CP 6-15 Prudential Regulations and Requirements	• Require banks to calculate and report market risk positions and implement guidelines for risk management. Establish a capital charge or limits on market risk exposure, and monitor and control the exposure of foreign controlled banks with their shareholder. • Issue specific regulations on credit policies and practices and bring loan classification and provisioning in compliance with international standards. • Require the establishment of an internal audit function. • Implement promptly the AML law.
CP 16-20 Methods of On-going Supervision	• Strengthen BM's risk assessment capability. • Supervisors should meet quarterly with senior and middle management of banks to discuss supervisory issues. • Prepare an off-site supervision manual, and collect information on a consolidated basis. • On-site inspections should review the financial reports submitted by the bank, with the assistance of an information technology expert. • Train supervisors to conduct consolidated supervision.

CP 21 Information Requirement	• Amend the chart of accounts to comply with IAS and require that banks submit reports according to IAS guidelines.
CP 22 Formal Powers of Supervisors	• BM should use its legal authority to take remedial actions and establish trigger points for specific corrective actions.
CP 25 Cross-Border Banking	• Establish cooperation agreements with home country supervisors of foreign banks and assess the adequacy of reporting of the Mozambique subsidiary to the parent and its supervisor. Remain informed of the condition of parent countries' financial systems.

Authorities' response

84. **The authorities were in general agreement with the findings and recommendations of the assessors and noted that actions along the recommendations were being taken.** They indicated that some recommendations, such as enhancing the supervisory independence of the central bank and reviewing the accounting standards for commercial banks require further analysis and technical assistance.

B. CPSS Core Principles for Systemically Important Payment Systems

Main findings

85. **The Mozambican retail payments system is functioning reasonably well for the current requirements of the financial system.** The Electronic Clearing and Settlement system (CEL) was not designed with the CPs for SIPS in mind, rather, it has been purposely built to meet the specific requirements and nature of the Mozambique payment system. Thus, compliance with the CPSS Core Principles and Central Bank Responsibilities in Applying the CPs is not particularly high. The system apparently has sufficient capacity to meet current and medium-term requirements, and the IT department is satisfied with the operational and technical procedures. The BM has clearly spelled out its objectives in respect of the development of the payment system for the next five years in a Vision and Strategy document issued in June 2000.

86. **The current payment system law has several shortcomings.** The latter will be addressed by amendments to the Banking Law and the Bankruptcy Act being drafted and by a new Central Bank Act following the SADC model to be adopted. In the CEL system there are no controls to address settlement risk; regulations do not provide to participants a clear understanding of who bears the settlement risks nor of how to manage risks. There are no formal entry or exit criteria for a participant to enter the CEL system, other than obtaining a banking license and being in "good standing". Although normal acceptable standards of security are applied to both the central bank and participant payment systems there are areas of concern. Such areas include the lack of service level agreements between operator and participants, who use different levels of sophistication in their systems; of formal entry and exit criteria to participate; of security system monitoring or testing; of certainty that change-management procedures are applied; and of IT Audit involvement in the process.

Main findings by groups of principles

Legal foundation (CP I)

87. **The current payment system law has several shortcomings.** Efforts are being made to resolve the issues that arise. Amendments to Law 15/1999 (Banking Act) and the Bankruptcy Act will resolve some pending issues. Also, BM is participating in a SADC initiative for the development of a "model" Central Bank Act. BM and the banking industry in Mozambique are also in the process of developing a "Payment System Act" that would provide a complete and reliable framework for a modern, sophisticated payment system in Mozambique, and for the legal support of a RTGS system.

Understanding and management of risks (CPs II-III)

88. **The regulations covering the operation of the CEL system do not provide to participants a clear understanding of who bears the settlement risks nor of how to manage risks.** The Operations Manual, which does not cover risk management procedures, is being updated to cater for the expanded CEL system that is to be implemented during June 2003. The Clearing and Settlement Regulations does not include a section on risk or the management of risk. The Regulations allow the operator a certain amount of discretion in respect of the time-window for delivery, by the participants, of electronic files to the system. The extent of this discretion is clearly limited by the provisions of the regulations; once the deadline is reached, any participant in default is excluded from clearing items on that day.

89. **Current CEL regulations expose the system to risk.** There are no formal entry or exit criteria for a participant to enter the CEL system, other than obtaining a banking license and being in "good standing" (however, certain NPS regulations define minimal technical and operational requirements). The CEL system has no credit limits, either bilateral or multilateral to cap participants' net exposure and there are no "loss-sharing" or "defaulter pays" arrangements. The CEL is a batch driven deferred net system and makes no provision for the management of liquidity risk. While BM's apparent standing behind the settlement of the CEL system appears to have helped reduce systemic risk, it has exposed it to counterparty risk. Partly to limit such exposure, BM is in the initial stages of implementing an RTGS system.

Settlement (CPs IV-VI)

90. **By the very nature of a batch processing system for high-volume transactions, processing takes place through the course of the banking day and continues after the close of business.** Once the RTGS system, in which payments through the system have to be pre-funded, is implemented, high values would be removed from the CEL system, reducing settlement risk. Another possibility would be to institute intra-day settlements for the CEL system to reduce the value of items that are not processed by the end of the day to a minimum.

91. **In the CEL system there are no controls to address settlement risk.** No additional systemic risk financial resources are made available by the participants to ensure timely settlement. Settlement takes place by transferring balances on accounts held by participants at BM; in cases where participants have not had the required funds available for settlement, BM has settled for the delinquent participant (unsecured overdraft, but penalized by the application of a prohibitively high interest rate) and during the course of the day negotiated with the participant for repayment.

Security and operational reliability, and contingency arrangements (CP VII)

92. **Although normal acceptable standards of security are applied to both the central bank and participant systems, there are areas of concern.** Such areas include the lack of: (i) service level agreements between operator and participants, who use different levels of sophistication in their systems; (ii) formal entry and exit criteria to participate; (iii) security system monitoring or testing; (iv) certainty that change-management procedures are applied; and (v) and IT Audit involvement in the process.

93. **Monitoring of the system components has been done informally and no security risk analysis has been performed on the system.** Independent auditors have performed an audit on security aspects. While the Internal Audit Department advised that it tested the security features during the testing phase, this test has not been repeated.

94. **The system apparently has sufficient capacity to meet current and medium-tern requirements.** The equipment installed by the operator has proved reliable and there is a "hot" back-up site implemented approximately 15 km away from the main site in Maputo. Standard features to ensure operational reliability are in place.

Efficiency and practicality of the system (CP VIII)

95. **The CEL system (i.e., including the central system and the participant systems) has been purposely built to meet the specific requirements and nature of the Mozambique payment system.** Participants, with the exception of a small bank that has a manual data-capture system, have implemented systems that suit the requirements of the CEL system.

Criteria for participation (CP IX)

96. **There are no entry or exit criteria for the CEL system.** System participation is open to any organization licensed as a bank in Mozambique and is able to communicate directly with the central system. The participation of some smaller banks, which have not developed their systems to the level of sophistication of the larger banks, impacts on the time of delivery of files to the CEL system.

Governance of the payment system (CP X)

97. **Decisions taken are communicated to the banking industry via the appropriate forum.** High-level decisions are normally communicated promptly, although members of the Association of Mozambican Banks mentioned instances where this had not been done. Additionally, BM maintains a Web page on the Internet and publishes relevant payment system information, including any new regulations or notices. Currently the PSD has insufficient skilled staff to ensure that the CEL system becomes fully compliant with the other nine CP's, as required by this CP.

Central bank responsibilities in applying the CPs

98. **While the CEL system was not designed with the CPISS in mind, BM's development objectives for the payment system for the next five years are clearly spelled out in a Vision and Strategy document issued in June 2000.** This document is published on the BM's Internet web site. In addition, BM has developed a plan for the reform of the payment system over the next few years. BM has close tics with other central banks, specifically with Portugal, and is heavily involved with the other central banks in the SADC region as a participant in the SADC Payment System Project.

Mozambique: Main Recommendations of the CPSS Assessment

Reference principle	Recommended action
CP I Legal foundation	• Continue efforts to modernize the Central Bank Act and develop a Payment System Act, before introducing the RTGS system.
CP II Understanding and management of risks	• Re-examine CEL system from a financial risk perspective. Prepare workshops to draw banks' attention to risks and risk management methods.
CPs IV, V & VI Settlement -	• Transfer high-values from CEL to RTGS, introduce an EFTS system for processing non-encoded Titulos and direct payments in CEL and introduce intra-day settlements into CEL . • Stress need for banks to manage the settlement the risk they bring into the system and phase out BM's implicit backing of CEL settlements.
CP VII Security and operational reliability, and contingency arrangements	• Re-examine CEL against CP requirements and develop a plan of action to ensure compliance, with assistance of external auditors.
CP VIII Efficiency and practicality of the system	• Implement minimum standards for equipment (entry and exit criteria), ensuring a fair and open access. BM should recover the operational cost of CEL.
CP IX Criteria for participation	• Establish criteria for entry to and exit from CEL.
CP X Governance of the payment system	• Initiate a project to ensure compliance with this CP; recruit and train staff.
Central Bank Responsibilities in applying the CPs	• Promote compliance with SPIS core principles. Train staff members.

Authorities' response

99. **The BM analyzed the major findings of the report and agreed with the recommendations made by the assessor, and has enacted efforts in order to enhance the current system as well as to create human resource capacity to fully implement the strategic plan.** Furthermore, the BM has conducted a general revision of the CEL System Regulation to comply with the Core Principles, although it agrees that there is a need to establish a RTGS for large values and time critical payments.

C. Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT)

Main findings

100. **No implementing regulations to the AML law, approved in February 2002, have been promulgated; there is no law regarding CFT, and a financial intelligence unit (FIU) has not been established.** BM, as the primary financial regulator, is responsible for monitoring compliance of the AML legislation with respect to banks and foreign exchange bureaus. A supervisory regime in the insurance sector is being built and BM has embarked on training its inspectorate. Currently, no monitoring or investigation of the proceeds generated from crime is in place. It would appear that the Attorney General's Office is responsible for the prosecution of ML cases, but to date has not prosecuted any. Also, no suspicious transaction reports (STRs) have been issued by any institution. Further efforts are required to spell out the specific requirements with respect to suspicious transactions, the manner and method of reporting, and penalties for non-reporting and non-compliance. There appears to be insufficient skills, resources and funding available to properly address these issues, bearing in mind that this is a country where poverty, fraud and corruption have been identified as prime areas of concern. While the Attorney General's Office, the Public Ministry and the Criminal Investigation Police are the agencies cited in the AML legislation as having responsibility for the enforcement and prosecution of the AML regime, there appears to be very little coordination, if any, between these offices. No infrastructure has been put in place for dealing with ML.

Criminal justice measures and international cooperation

Criminalization of ML and FT (Criteria 1-6)

101. **Mozambique law criminalizes ML, consistent with the Vienna Convention, but while terrorism is a predicate offense for ML, FT is not itself a crime.** It is not necessary for a person to be convicted of a predicate offense in order to be convicted of ML. Predicate offenses that extend beyond drug trafficking are specified in the law. In addition, the offense of ML applies in circumstances when the predicate offense occurs outside of Mozambique. It is unclear whether legal entities are subject to criminal liability, although adequate sanctions for violations of the AML law appear to be available.

102. **The effectiveness of the AML law as a law enforcement mechanism or as a mechanism to deter and detect ML or FT cannot be assessed accurately because there**

have not been prosecutions for ML or FT. However, the AML law is consistent with international standards.

Confiscation of proceeds of crime or property used to finance terrorism (criteria 7-16)

103. **While the AML law provides authority to confiscate property in connection with ML offenses, this authority has not yet been tested.** But the law does not specify authority to: i) identify and trace property subject to confiscation; ii) protect the right of *bona fide* third parties, or iii) void contracts that are prejudicial to the government's ability to confiscate property. Also, there is no apparent authority for freezing or seizing property that is subject to, or may become subject to, confiscation prior to court action authorizing confiscation. The law provides, however, specificity for the domestic use of confiscated property. The confiscation authority and implementation is untested as there has been no investigation or prosecution for ML or FT.

The FIU and processes for receiving, analyzing, and disseminating financial information and other intelligence at the domestic and international levels (criteria 17-24)

104. **Mozambique does not have an FIU or specialized unit within any of the government ministries or agencies to receive, analyze and disseminate financial reports related to ML or any ML predicate offense.** Also, there is no formal mechanism for information sharing with FIUs in other countries. There is no specific mechanism for financial institutions to report STRs to the Public Ministry or provide other information, as either required or provided for under the AML law, or enforcement regimes for such requirements. In addition, there is no capacity to deal with the investigation or analysis of the STRs or other reports, as there appears to be no training or specific skills in this area.

Law enforcement and prosecution authorities, powers and duties (criteria 25-33)

105. **No specific authority has been identified as responsible for investigating ML or FT offences but the ultimate decision to investigate rests with the Attorney General's office.** There is also no specific authority identified for the investigation or analysis of STRs. There is no specific unit that deals with asset forfeiture, confiscation or freezing. The AML appears to authorize special techniques for investigations, such as wire tape and access to computer systems, but only through a court administrative procedure. The country has recently established a working group on corruption and has deployed its resources in this area, but not in ML/FT.

International Cooperation (criteria 34-42)

106. **While mechanisms are available for mutual legal assistance and information sharing, such mechanisms are available on a case-by-case basis, except for Portugal, with whom there is a bilateral agreement.** Mozambique is a member of the Eastern and Southern Africa Anti-Money Laundering Group but has not yet signed the Memorandum of Understanding. There is no specific authority for sharing confiscated assets with other

countries and the Constitution does not allow for extradition according to the Attorney General's Office.

Legal and Institutional Framework for Financial Institutions and its Effective Implementation

General Framework (criteria 43 and 44)

107. **The AML Law provides for several important basic aspects of an AML legal framework, but significant deficiencies remain.** The effectiveness of the general framework cannot be assessed because no implementing regulations have been issued, no reports submitted, and no enforcement of the AML law has taken place. There appears to be sufficient authority in the AML law to preempt privacy or bank secrecy protections that may otherwise exist under the law of Mozambique. No implementing regulations to the insurance sector law have been issued.

Customer identification (criteria 45-48), plus sector specific criteria 68-83 for the banking sector, criteria 101-104 for the insurance sector and criterion 111 for the securities sector

108. **There is no sufficient legal basis to ensure proper customer identification by all financial institutions.** Identification requirements seem to be insufficient and are not supported by any regulation or guidelines in force. The AML law requires financial institutions to include some originator information on fund transfers and related messages in the case of suspicious transactions. However, the law fails to indicate which measures an institution should take to obtain information about the true identity of the customers and does not explicitly prohibit financial institutions from keeping anonymous accounts or accounts in obviously fictitious names and does not address the issue of establishment of numbered accounts.

109. **It is not possible to assess the legal and institutional framework for insurance companies.** Nor is it possible to assess whether there are effective supervisory measures in force. The regulations of the December 2002 Insurance Law, which was approved by Parliament only in December of 2002 and is awaiting promulgation by the President of Mozambique, are being drafted by the insurance supervisor.

110. **BM is conducting very limited compliance testing in the AML area during its routine on-site inspections.** The limited review reflects the lack of specific training in this area and the absence of implementing regulations for the AML law; financial institutions feel that the adoption of strict polices to combat AML will impair competition. None of the banks interviewed had formal identification systems or policies and procedures in place to conduct enhanced due diligence on higher risk customers and/or that took into consideration the risk profile. Until Mozambican regulations are issued, BM should require compliance with Head-Office group-wide AML/CT requirements while coordinating closely with overseas supervisors to avoid regulatory arbitrage and unfair competition.

Ongoing monitoring of accounts and transactions (Criteria 49-51) plus sector specific criteria 84-87 for the banking sector, and criterion 104 for the insurance sector)

111. **The AML law does not require financial institutions to examine in depth the background and purpose of transactions, besides the requirements that suspicious operations should be consigned in writing and conserved by the financial entities.** The definition of suspicious transactions in the AML Law is not precise enough and is not supported by implementing regulations. The AML law does not require financial institutions to give special attention to business relations and transactions in jurisdictions that do not have adequate systems in place to prevent ML or FT or that have been identified as being "non-cooperative" in the fight against AML. BM is drafting guidelines to address these concerns. In general, banks do not have procedures and systems in place to identify unusual activities and lack knowledge to address the risk of complex structured transactions.

Record keeping (Criteria 52-54) plus sector specific criterion 88 for the banking sector, criteria 106 and 107 for the insurance sector, and criterion 112 for the securities sector)

112. **The AML Law requires that clients' identification documents be conserved during 15 years from the day that the respective clients' accounts are closed or when the contractual relation between the co-contractors terminates.** However, no regulation has been issued to implement this requirement. There is a risk that records do not contain adequate information, since most staff is generally unaware of the importance of the information requested when a new account is opened.

Suspicious transactions reporting (Criteria 55–57) plus sector specific criteria 101-104 for the insurance sector)

113. **Discussions about the creation and implementation of the FIU are underway, but the authorities have not yet addressed the question of the FT.** The AML Law provides legal protection against liability for those reporting suspicions under the AML Law. Since the FIU has not been established, suspicious transactions should be reported to the Public Ministry, but this Ministry has never received a STR.

Internal controls, Compliance and Audit (Criteria 58-61), plus sector specific criteria 89-92 for the banking sector, criteria 109 and 110 for the insurance sector, and criterion 113 for the securities sector)

114. **The AML Law requires all financial entities with headquarters on Mozambican territory to adopt a system of internal organization, so as to be, at any time, capable of fulfilling their duties as stipulated in the Law.** In addition, BM issued a Notice in December 2000, regarding internal controls and procedures that must be implemented by financial institutions. However this Notice seems to be insufficient as regards ML.

115. **The development of internal AML/CFT policies and procedures by financial institutions is weak and needs to be strengthened**. No provision in the law requires financial institutions to ensure that employees are duly informed of new developments in ML

and FT areas and well trained on techniques for combating them. No provision in the law requires that financial institutions be required to designate an AML/CFT compliance officer at management level, or to put in place adequate screening procedures to ensure high standards when hiring employees.

Integrity standards (Criteria 62 and 63), plus sector specific criterion114 for the securities sector)

116. **Mozambique has a legal and institutional framework in place to ensure that criminals are prohibited from holding or controlling a significant investment in a financial institution, or from holding any qualified management functions therein.** However, since FT has not yet been considered a crime, there are no measures in place to prevent unlawful use of entities identified as vulnerable to use as conduits for criminal proceeds or FT, such as shell corporations or charitable or not-for-profit organisations. Fit and proper tests seem to be carried out but not regularly reviewed.

Main Recommendations of the AML/CFT Assessment

Criteria	Recommended Action
Criminal Justice Measures and International Cooperation— Criteria I-V	• Ratify the Palermo Convention and make FT a crime. The issue of criminal liability for legal entities should be made clear and part of the law. • Implementing regulations need to be promulgated. Meantime, banks could be required to comply with Head Office group-wide requirements and controls. • Amend AML law to provide for: i) authority to investigate property subject to freezing, seizing and confiscation; ii) protection of the right of *bona fide* third parties who possess property subject to confiscation; and iii) sharing between countries of confiscated property. • Establish an FIU, consistent with international standards. • Sign MOUs with the Eastern and Southern Africa AML Group, and enter into international agreements to share information and provide mutual legal assistance, including authority to freeze and seize assets subject to forfeiture. Amend laws (Constitution if needed), to authorize extradition of individuals involved in ML and/or FT and have authority to enter into asset sharing arrangements with other countries.
Legal and Institutional Framework for Financial Institutions—Criteria I-IX	• The AML Law should require: i) the designation of an AML/CFT compliance officer at management level; ii) adequate screening procedures to ensure high standards when hiring employees; and iii) that foreign branches and subsidiaries observe appropriate AML/CFT standards. • Implement provision of AML law on reporting and disclosure of information, consistent with international standards. • Require detailed, comprehensive, mandatory and enforceable customer identification requirements, applicable to all financial institutions (FIs). • Issue guidelines to strengthen AML and CFT control by FIs, including due diligence for all higher risk clients and identification of beneficial owners of legal entities. Additional training in AML and CFT is needed for supervisors and staff of FIs.

	• Describe what constitutes a suspicious transaction. Require FIs to issue internal guidance notes on monitoring complex, and large transactions and incorporate testing procedures in an inspection manual (compliance with AML should be verified during on-site examinations). • Issue guidance on countries that are considered to be at higher risk from AML/CFT. • Require that FIs maintain records on customer transactions, account files and business correspondence for at least five years. • Require that FIs develop internal policies (and manuals) that clearly describe their obligations in AML/CFT, communicate these policies and procedures to staff, test them, and report results to senior management and external auditors. • Issue guidelines to assist the financial institutions in detecting patterns of suspicious financial activities and a sanction system for non reporting. • Review fit and proper assessment of stakeholders, directors and senior managers in a continuing basis.

Authorities' response

117. **The authorities generally agreed with the assessment and noted their on-going efforts to implement the AML Law.** They have requested technical assistance to draft the implementation guidelines and started training supervisors on the relevant issues.

MACRO FINANCIAL INDICATORS

Table 1. Mozambique: Selected Macroeconomic Indicators, 1996-2002

(As of May 2003)

Total population (end-2000)	16.0	16.1	16.5	16.8	17.2	17.7	18.1
GDP per capita (2000)	181	215	241	243	210	195	199
	1996	1997	1998	1999	2000	2001	2002
Real Sector							
GDP (percentage change)	7.1	11.1	12.6	7.5	1.5	13.0	7.7
GDP (in billions of U.S. dollars)	2.90	3.45	3.96	4.09	3.63	3.44	3.6
Consumer price index (e.o.p.)	95.0	101.0	100.0	106.2	118.3	144.2	157.3
Gross National Private savings (in percent of GDP)	-2.1	1.9	5.0	7.7	11.5	11.2	19.3
(Annual change in percent of beginning-period broad money, unless otherwise specified)							
Monetary and credit data							
Monetary base	25.0	14.7	-3.6	15.8	26.4	53.7	15.7
Money (M1)	29.3	18.6	28.3	26.6	41.3	37.8	21.8
Broad money (M2)	31.8	26.3	40.1	35.1	42.4	29.7	20.1
Net domestic assets	-17.5	11.8	9.3	23.9	11.6	9.1	-0.9
Yield on government bills (90 days, in percent)	...	...	...	11.8	21.8	31.7	18.5
Reference bank lending rate 1/	...	29.9	22.9	22.6	22.6	35.3	37.1
Public finances (in percent of GDP)							
Central government overall balance							
Before grants	...	-11.9	-10.5	-13.2	-18.0	-20.1	-19.7
After grants	...	-2.6	-2.4	-1.5	-6.0	-6.6	-7.9
External sector (in millions of US$, unless otherwise indicated)							
Meticais per US$ (end of period)	11,295	11,604	12,366	13,300	17,140	23,320	23,854
Trade balance	-556.5	-530.0	-572.7	-915.1	-798.3	-360.3	-663.2
Current account, after grants	421.9	-297.9	-435.8	-718.0	-478.0	-497.0	-421.0
Foreign direct investment (net)	72.5	64.4	212.7	381.7	139.1	255.4	156.0
Gross official reserves (end period)	383	532	625	669	746	727	823.0
Reserve cover (months of imports) 2/	4.8	6.8	7.8	5.5	6.3	6.4	5.1
Reserve cover (short-term external debt) 2/	...	...	...	...	...	...	...
Total external debt	...	...	...	...	5,059	...	...
Central bank short-term foreign liabilities 3/	-2,705	-2,913	-3,312	-3,023	-4,506	-6,404	-5,684
External interest payments to exports (in percent) 2/	31	29	31	33	28	22	...

Sources: Mozambican authorities and staff estimates.

1/ Bank lending rate with a maturity of one year.

2/ Exports of goods and services (excluding factor income).

3/ Remaining maturities of 1 year or less.

Table 2. Mozambique: Financial System Structure, 1997-2002 1/

	Dec-97			Dec-98			Dec-99			Dec-00			Dec-01			Dec-02		
	Number	Assets [bil meticais]	Percent of total system	Number	Assets [bil meticais]	Percent of total system	Number	Assets [bil meticais]	Percent of total system	Number	Assets [bil meticais]	Percent of total system	Number	Assets [bil meticais]	Percent of total system	Number	Assets [bil meticais]	Percent of total system
Banks																		
Private																		
Domestic													1	81	0.22	1	117	0.32
Foreign	6	11,469	98.41	7	12,793	97.26	8	15,475	97.45	13	22,128	96.89	12	34,523	95.75	12	34,849	94.59
State-owned 2/																		
Nonbank																		
Leasing companies 3/	1	149	1.28	1	192	1.46	1	182	1.14	3	387	1.69	3	900	2.50	3	1,190	3.23
Securities firms																		
Mortgage institutions																		
Credit unions and cooperatives	1	25	0.22	1	40	0.30	1	53	0.34	3	116	0.51	3	237	0.66	3	312	0.85
Microfinance institutions	0	0	0.00	1	111	0.84	2	152	0.96	2	157	0.69	2	251	0.70	2	289	0.78
Other	6	11	0.09	8	18	0.14	10	18	0.11	29	49	0.21	30	64	0.18	25	84	0.23
Total financial system	**14**	**11,655**	**100.00**	**18**	**13,154**	**100.00**	**22**	**15,880**	**100.00**	**50**	**22,837**	**100.00**	**51**	**36,056**	**100.00**	**46**	**36,841**	**100.00**

Source: Bank of Mozambique

1/ Data on institutional investors (insurance companies, pension funds, etc.) was not available.
2/ Including development banks. Nonbank development finance corporations should be included separately under "Other nonbank".
3/ Estimates by IFC based on new leasing volume, assuming that 3 percent of fixed investment is financed with leasing and a ratio of 2:1 of assets to new leasing volume.

Table 3. Mozambique: Financial Soundness Indicators for the Banking Sector, 1997-2002

(In percent, unless otherwise indicated)

	Dec-97	Dec-98	Dec-99	Dec-00	Dec-01	Dec-02
Capital Adequacy						
Regulatory capital to risk-weighted assets*	19.42	11.83	17.02	-2.13	5.49	14.01
Regulatory Tier I capital to risk-weighted assets*	14.44	10.51	16.80	-2.07	6.03	11.97
Capital (net worth) to assets	...	...	...	-2.70	8.22	7.83
Asset composition and quality						
Sectoral distribution of loans to total loans*						
Agriculture	19.00	20.00	22.00	19.00	18.00	15.00
Industry	29.00	31.00	27.00	27.00	25.00	22.00
Construction	5.00	5.00	4.00	5.00	4.00	4.00
Commerce	25.00	25.00	24.00	23.00	20.00	17.00
Transportation and Communication	4.00	5.00	6.00	5.00	7.00	5.00
Other	17.00	13.00	18.00	22.00	27.00	36.00
FX loans to total loans	29.55	30.93	35.57	40.24	64.69	69.87
NPLs to gross loans* 1/	19.17	16.86	14.63	17.76	23.43	20.80
NPLs net of provisions to capital* 1/	...	...	...	35.00	11.00	-17.00
Earnings and Profitability						
ROA*	0.59	0.50	0.42	0.04	0.14	1.59
ROE*	6.27	3.87	...	...	3.51	22.10
Interest margin to gross income*	...	...	...	...	10.22	3.40
Noninterest expenses to gross income*	...	...	...	...	16.92	27.67
Personnel expenses to noninterest expenses	...	...	...	...	51.71	47.81
Trading and fee income to gross income**	...	...	...	...	33.09	39.68
Spread between reference loan and deposit rates (90 days local currency)			...	...	14.00	19.00
Funding and Liquidity						
Liquid assets to total assets***	...	...	...	41.51	34.64	46.23
Customer deposits to total (non-interbank) loans	...	...	...	188.00	217.00	240.00
FX liabilities to total liabilities	44.00	41.95	45.28	54.53	63.30	61.26

Source: * Included in the "core set" of FSIs. ** Numbers subject to review. *** Includes deposits at parent banks

1/ NPLs are defined according to Mozambican accounting standards (they only include part of the past-due loans).