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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR
A PROPOSED DEVELOPMENT POLICY CREDIT
IN THE AMOUNT OF SDR 18 MILLION
(US$25 MILLION EQUIVALENT)

TO THE

REPUBLIC OF MOZAMBIQUE

FOR A
SECOND PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY OPERATION (FSDPO II)

September 1, 2015

Finance and Markets Global Practice
Southern Africa Country Department 2
Africa Region

REPUBLIC OF MOZAMBIQUE – GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of August 31, 2015)

Currency Unit:	Metical
US$1.00	40.84 MZN
US$1.00	SDR 0.712352

ABBREVIATION AND ACRONYMS

ABC BANK	African Banking Corporation
AfDB	African Development Bank
AGDPO	Agriculture Development Policy Operation
AML	Anti-Money Laundering
AMSME	Africa Micro Small and Medium Enterprises
ATM	Automated Teller Machine
ATS	Automated Transfer System
BCI	*Banco Comercial de Investimentos*
BdM	*Banco de Moçambique*
BOM	*Banco Oportunidade de Moçambique*
BT	*Bilhetes do Tesouro*
BVM	*Bolsa de Valores de Moçambique*
CA	Current Account
CDD	Customer Due Diligence
CEL	*Sistema de Compensação Electrónica*
CFT	Combating the Financing of Terrorism
CoM	Council of Ministers
CPFL	Consumer Protection and Financial Literacy
CPI	Consumer Price Index
CPS	Country Partnership Strategy
CSD	Central Securities Depository
CSE	Crisis Simulation Exercise
CUT	*Conta Unica do Tesouro*
DFID	Department for International Development
DGF	Deposit Guarantee Fund
DNEAP	*Direcção Nacional de Estudos e Análise de Políticas*
DNS	Deferred Net Settlement
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
DVP	Delivery Versus Payment
ECA	Europe and Central Asia
ELA	Emergency Liquidity Assistance
EMAN II	*Estratégia para a Melhoria do Ambiente de Negócios*
EMATUM	Mozambican Tuna Company
ESAAMLG	Eastern and Southern Africa “Anti Money” Laundering Group
e-SISTAFE	*Sistema de Administração Financeira do Estado*
FDI	Foreign Direct Investment
FIG	Financial Investment Group

FIRST	Financial Sector Reform and Strengthening Initiative
FISF	Financial Inclusion Support Framework
F&M	Finance & Markets
FS	Financial Sector
FSAP	Financial Sector Assessment Program
FSDPO	Financial Sector Development Policy Operation
FSDT	Financial Sector Deepening Trust
FSTAP	Financial Sector Technical Assistance Project
FY	Fiscal Year
GBM	Governor of Bank of Mozambique
GCCC	*Gabinete Central de Luta contra a Corrupção*
GCR	Global Competitiveness Report
GDP	Gross Domestic Product
GIFiM	Financial Information Center of Mozambique
GIIF	Global Index Insurance Facility
GIZ	*Gesellschaft für Internationale Zusammenarbeit*
GoM	Government of Mozambique
GRS	Grievance Redress Service
GTZ	*Gesellschaft für Technische Zusammenarbeit*
ICA	Investment Climate Assessment
ICAAP	Internal Capital Adequacy Assessment Process
IDA	International Development Association
IFC	International Finance Corporation
IFMIS	Integrated Financial Management Information System
IFRS	International Financial Reporting Standards
IGEPE	*Instituto de Gestão das Participações do Estado*
IMF	International Monetary Fund
INE	National Statistics Institute
ISSM	*Instituto de Supervisão de Seguros de Moçambique*
KfW	*Kreditanstalt für Wiederaufbau*
KYC	Know-Your-Customer
LNG	Liquefied Natural Gas
LOLR	Lender of Last Resort
MDM	Mozambique Democratic Movement
M&E	Monitoring and Evaluation
MFSDS	Mozambique Financial Sector Development Strategy
MICOA	*Ministério para a Coordenação da Acção Ambiental*
MINAG	Ministry of Agriculture
MINASA	Ministry of Agriculture and Food Security
MITADER	*Ministério para a Terra, Ambiente e Desenvolvimento Rural*
ML	Money Laundering
MoF	Ministry of Finance
MoEF	Ministry of Economy and Finance
MOU	Memorandum of Understanding
MPD	Ministry of Planning and Development
MSME	Micro, Small and Medium Enterprises
MTDS	Medium-Term Debt Management Strategy
MZN	Mozambican Metical
NCB	Non-Concessional Borrowing

NFIS	National Financial Inclusion Strategy
NGO	Non-Governmental Organization
NPL	Non-Performing Loan
OEOT	Obligations and Incentives of Primary Dealers
OP/BP	Operational Policy/Bank Procedures
OT	*Obrigações de Tesouro* (t-Bills)
PA	Prior Actions
PAF	Performance Assessment Framework
PARP	*Plano de Acção para Redução da Pobreza*
PCN	Project Concept Note
PDO	Project Development Objective
PEDSA	*Plano Estratégico do Desenvolvimento do Sector Agrário*
PEFA	Public Expenditure and Financial Accountability
PES	*Plano Económico e Social*
PFM	Public Financial Management
PFMIs	Principles for Financial Market Infrastructures
PNISA	*Programa National de Investimento do Sector Agrário*
PRSC	Poverty Reduction Support Credit
PQG	*Plano Quinquenal do Governo*
PSD	Payment Systems Department
PSI	Policy Support Instrument
PV	Present Value
RENAMO	*Resistência Nacional Moçambicana*
ROA	Return of Assets
ROE	Return on Equity
RTGS	Real Time Gross Settlement System
SC	Steering Committee
SDR	Special Drawing Rights
SISTAFE	Government Financial Management Information System
SME	Small and Medium Enterprise
SOEs	State Owned Enterprises
SOM	Market Operations System
SORT	Systematic Operations Risk-Ratings Tool
SPV	Special Purpose Vehicle
SSA	Sub-Saharan Africa
TA	Technical Assistance
TF	Terrorism Financing
UN	United Nations
UNCDF	United Nations Capital Development Fund
USAID	United States Agency for International Development
USD	United States Dollar
VAT	Value Added Tax
WB	World Bank

Regional Vice President:	Makhtar Diop
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Task Team Leader:	Yira Mascaró/Mazen Bouri

REPUBLIC OF MOZAMBIQUE

SECOND PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY OPERATION (FSDPO II)

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The Second Programmatic Finance Development Policy Operation is being prepared by an IDA/IFC team consisting of: Yira Mascaró, Lead Financial Sector Development Specialist, GFMDR; Mazen Bouri, Senior Financial Sector Specialist, GFMDR; Valeria Salomão Garcia, Senior Financial Sector Specialist, GFMDR; Carlos Leonardo Vicente, Senior Financial Sector Specialist, GFMDR; Paola Granata, Consultant, GFMDR; Marilyne Goncalves, Senior Financial Sector Specialist, GFMDR; Bujana Perolli, Financial Sector Specialist, GFMDR; Cigdem Aslan, Lead Financial Officer, FABDM; Anderson Caputo Silva, Lead Securities Market Specialist, GFMDR; Alice Zanza, Senior Financial Sector Specialist, GFMDR; Fiona Elizabeth Stewart, Senior Financial Sector Specialist, GFMDR; Peter Friedrich Wilhelm Wrede, Senior Insurance Specialist, GFMDR; Jan Philipp Nolte, Senior Financial Sector Specialist, GDMDR; Katie Kibuuka, Financial Sector Specialist, GFMDR; Jorge Joao Faria, Financial Sector Analyst, GFMDR; Magalie Pradel, Program Assistant, GFMDR; Enrique Blanco Armas, Senior Economist, GMFDR; Elvis Teodoro Bernado Langa, Financial Management Specialist, GGODR; Cheikh Sagna, Senior Social Development Specialist, AFTCS; Luis Schwarz, Senior Finance Officer, WFALA, Luz Meza-Bartrina, Senior Counsel, LEGAM; Carlos Da Maia, Consultant, GPVDR; Pedro Olinto, Senior Economist, GPVDR; Denise Leite Dias, Senior Financial Sector Specialist, GFMDR; Jose Antonio Gragnani, Senior Securities Market Specialist, GFMDR; Furqan Ahmad Saleem, Senior Financial Specialist, GGODR; Peter Moll, Senior Economist (OPSPQ); Maiada Mahmoud Abdel Fattah Kassem, Finance Officer, WFALA, and Dionisio Augusto Nombora, Public Sector Specialist, GGODR.

SUMMARY OF PROPOSED CREDIT AND PROGRAM

REPUBLIC OF MOZAMBIQUE

SECOND PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY OPERATION (FSDPO II)

Borrower	Republic of Mozambique (GoM).
Implementing Agency	Ministry of Economy and Finance (MoEF); *Banco de Moçambique* (BdM).
Financing Data	IDA Credit-Regular terms, with final maturity of 38 years, inclusive of 6 years of grace period. Amount SDR 18 million (US$25 million equivalent).
Operation Type	Programmatic DPO. The series has three single-tranche operations and this is the second.
Pillars of the Operation And Program Development Objective(s)	The three pillars of the operation are: (I) Financial Stability; (II) Financial Inclusion; (III) Long-Term Financial Markets. The development objective of this operation is to reinforce financial stability, increase access to finance by households and firms, and enhance the development of long-term financial markets.
Result Indicators	Pillar I: (i) percentage of banks classifying their Non-Performing Loans (NPLs) according to the new regulation; (ii) percentage of banks implementing the new risk management guidelines; (iii) percentage of deposits balances and accounts covered by the Deposit Guarantee Fund (DGF); (iv) criminalization of terrorism financing. Pillar II: (i) number of e-money accounts; (ii) percentage of the population with access to formal banking services, including "formal-other"; (iii) call for proposals from service providers to apply for a private credit bureau license or operate the bureau on behalf of BdM; (iv) percentage of banks disclosing to consumers the effective cost of banking services; (v) number of days to clear a cheque; (vi) percentage of transactions settled through the Real Time Gross Settlement System (RTGS). Pillar III: (i) number of short- and medium-term bonds issued and reopened in the domestic market through competitive auctions; (ii) level of dematerialization and immobilization of all medium- and long-term debt securities registered in Central Securities Depository (CSD); (iii) Percentage of members of private pension funds with access to on-line, individual account information; (iv) Percentage of insurance companies presenting Key Facts Statements for consumers of insurance products The complete list and details of the baseline and targets can be found in Annex 1: Policy and Results Matrix.
Overall Risk Rating	The overall risk rating is moderate. The main risks to this operation are related to implementation capacity, macroeconomic management, and political commitment to reform given the new Government appointed in January 2015.
Climate and disaster risks (required for IDA countries)	There are no short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating).
Operation ID	P151861

IDA PROGRAM DOCUMENT FOR A MOZAMBIQUE – PROPOSED SECOND PROGRAMMATIC FINANCIAL SECTOR DEVELOPMENT POLICY OPERATION (FSDPO II)

I. INTRODUCTION AND COUNTRY CONTEXT (INCLUDING POVERTY DEVELOPMENTS)

1. **The Second Programmatic Financial Sector Development Policy Operation (FSDPO II) is the second in a series of three DPOs that seek to promote financial sector (FS) development.** All the operations in the series are single tranche. The amount for FSDPO II is US$25 million equivalent. Its main objective is to reinforce financial stability, increase access to finance by households and firms, and enhance the development of long-term financial markets.

2. **Mozambique's economy has grown rapidly since the end of the Civil War in 1992.** Annual GDP growth averaged 7.4 percent over the past two decades. Robust growth was made possible by sound macroeconomic management, a number of large-scale foreign-investment projects ("megaprojects") and significant donor support. Mining, electricity and services led the expansion, and in recent years growth has increasingly been driven by massive foreign direct investment (FDI) inflows focused on the extractive industries. Major discoveries of coal and natural gas may transform Mozambique into a significant player in global fuels markets. But, to reap the benefits of a growing resource sector, the Government will need to develop the capacity to manage the country's extractive industries and ensure that they contribute to sustainable, broad-based growth, poverty reduction, and shared prosperity.

3. **Mozambique's rapid economic expansion over the past twenty years has had only a moderate impact on poverty reduction**. In 2013 Mozambique's per capita income was US$593, less than one-third of the Sub-Saharan Africa (SSA) average. Economic growth in the 1990s was accompanied by a significant drop in poverty rates, but since the early 2000s the link between growth and poverty reduction has weakened. Between 1997 and 2003 the poverty headcount rate fell from 68 to 56 percent (12 percentage points) yet between 2003 and 2009 poverty fell by only four percentage points. The weakened relationship between growth and poverty reduction is due to the changing pattern of growth, which in the past decade was driven by capital-intensive, import-dependent sectors and megaprojects. This pattern of growth is also reflected in Mozambique's labor markets, which continue to be dominated by low skilled labor in the agricultural sector while the rest of the economy is unable to offer better-remunerated jobs for the 300,000 new workers entering the labor force every year.

4. **Moreover, the returns to growth have been heavily concentrated in the country's southern regions and urban centers, while poverty remains pervasive in the north and rural areas nationwide.** Most of the drop in the depth of poverty in the country seems to have happened in the Maputo province. For the rest of the country, individuals living in extreme poverty in 2009 appear to be as poor as those living in extreme poverty 12 years before. Between 2003 and 2009, while poverty rates dropped in most of Mozambique's provinces, they have increased in Zambezia, Sofala, Manica and Gaza, while in Nampula province (where 22 percent of the poor live) poverty remained practically unchanged during this period. As a result, the number of poor people in these five provinces increased by 1.6 million (2.4 percent per annum). In 2009, these five provinces accounted for approximately 70 percent of the poor in the country, up from 59 percent in 2003.

Zambezia and Nampula alone accounted for almost half of the poor (48 percent), up from 42 percent in 2003. Differences in returns to household attributes or endowments seem to explain most of the differences in the evolution of poverty rates between Nampula and Zambezia and the rest of the country. This is likely due to a combination of a relatively poor education quality, a lack of opportunities of income generation activities for educated people in these regions, and a limited access to financial services. This suggests that policies aimed at accelerating poverty reduction in Mozambique will need to aim at (i) better integrating these two provinces with the rest of the country's economy, and (ii) improving the quality of endowments/attributes of households in these provinces, especially the quality of education and access to financial services.

5. **Key development challenges in Mozambique include the need to enhance inclusive growth and diversify the economy by boosting private sector productivity.** Accelerating poverty reduction and promoting shared prosperity will require more inclusive growth in Mozambique. On the other hand, the economy remains fairly concentrated in terms of its export basket (focused on natural resources). This limited diversification signals the low productivity of other sectors in the economy. Mozambique's growth over the last two decades has presented a largely unrealized opportunity for the domestic private sector. Moreover, the current development of the country's non-renewable natural resources offers an opportunity, but constraints to maximizing those linkages are related to the competitiveness and productivity of local firms. Indeed, Mozambique's ranking in the 2014-2015 Global Competitiveness Report (GCR) is 133 out of 144, which reflects a restrictive business environment.

6. **For Mozambique to achieve broad-based growth and for the private sector to generate jobs, it is imperative to deal with the ongoing challenges of access to finance for firms and households**. Access to finance remains a defining challenge for the private sector in Mozambique, particularly for smaller enterprises. The 2014-2015 GCR found that access to financing was the top constraint for doing business in the country. Similarly, a 2012 survey of manufacturing firms showed that access to finance was the top constraint for business growth, with over 50 percent of firms identifying access to credit as a constraint and only 14 percent of firms having a bank loan.[1] Additionally, a 2012 Finscope Survey Report found that 75 percent of micro, small and medium enterprises (MSMEs) were financially excluded. Financial inclusion for individuals is also limited. The 2013 World Bank's demand side Financial Inclusion and Capability Household Survey (WB FinCap Survey) found that only 27 percent of Mozambican adults currently use a financial product or service from a bank and that access rates in rural areas are much lower than in urban areas (19 percent of adults being banked in rural areas versus 46 percent in urban areas). [2]

7. **By promoting FS development (including greater stability and access), the proposed operation will contribute to poverty reduction, more inclusive economic growth and enhanced private sector competitiveness.** Evidence strongly indicates that if effectively regulated and supervised, FS development spurs economic growth, reduces income inequality, and helps to lift households out of poverty (World Bank 2008).[3] This leads to strong positive impact

[1] The survey was conducted by the Ministry of Planning and Development and the University of Copenhagen.

[2] Mozambique was not included in the 2014 Global Findex Survey. The 2011 Global Findex Results for Mozambique did not correlate with the evidence from other surveys in country and is somewhat dated. We used alternative surveys available.

[3] World Bank (2008); "Finance for All? Policies and Pitfalls in Expanding Access".

on economic growth over long-term periods (Demirguc-Kunt and Levine 2008).[4] Moreover, FS development is also pro-poor, reduces income inequality by disproportionately boosting the income of the poor and is associated with a decline of extreme poverty (Beck, Demirguc-Kunt and Levine 2004 and 2007).[5]

8. **The Government recognizes the importance of FS development to reduce poverty and improve the business environment.** Towards that end, a number of FS reforms have been initiated and the *Mozambique Financial Sector Development Strategy 2013-2022* (MFSDS) was adopted to provide a vision and a comprehensive and detailed roadmap for reforms in the FS.

9. **This DPO directly contributes to the realization of the MFSDS and the goals of the WB Country Partnership Strategy (CPS) for FY12-15 by focusing on three pillars: (i) Financial Stability; (ii) Financial Inclusion; and (iii) Long-Term Financial Markets.** Actions to promote financial stability seek to enhance bank regulation and supervision, strengthen the banking safety net and crisis management frameworks and, improve the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework. Actions to promote financial inclusion focus on: improving access to finance in underserved areas/sectors (including rural areas) through e-money and agent banking, improving the credit reporting system (to promote access to credit for smaller enterprises and lower income individuals in particular), and enhancing the transparency of financial information and consumer protection and strengthening payment systems. The measures to promote financial inclusion, in particular through agent banking and mobile financial services also have significant potential to bridge the regional imbalances in access to finance mentioned earlier. Actions to promote long term financial markets include further developing the Government bond primary, and basic steps towards secondary markets (through strengthening the bond auction mechanisms and market outreach) and developing the insurance sector (by strengthening micro insurance regulations). This Programmatic DPO was initially envisioned to be a two part series. However, a third in the series has been added in recognition of the breadth and complexity of reforms being supported and the time required for all reforms to be fully implemented. Specifically, in the Financial Inclusion Pillar, where the development of new modes of delivery of financial services (such as through agent banking and mobile financial services) is only now starting. Additionally, in the Long-Term Financial Markets Pillar, the insurance and pension sectors are still at an early stage of development while the capital markets remain dominated by Government bonds with reforms for the development of these markets still very much ongoing. Finally, in the Financial Stability Pillar where much reforms have already occurred, there is still an unfinished agenda to further bolster financial sector supervision as revealed in the recently held Crisis Simulation Exercise. The three main risks to this operation are related to: (i) implementation capacity; (ii) macroeconomic management, with a high current account (CA) deficit, rising public external debt to finance infrastructure investment and a more expansionary fiscal policy; and (iii) sustainability of commitment to reform after the general elections of 2014. Related mitigating measures for these risks have been put in place.

[4] Demirgüç-Kunt, Aslı, and Ross Levine (2008); "Finance, Financial Sector Policies, and Long Run Growth"; World Bank.

[5] Beck, Thorsten, Asli Demirgüç-Kunt and Ross Levine (2004); "Finance, Inequality and Poverty: Cross Country Evidence"; Policy Research Working Paper 3338; World Bank. Beck, Thorsten, Asli Demirguc-Kunt and Ross Levine (2007); "Finance, Inequality and the Poor"; Journal of Economic Growth.

II. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

10. **Growth in 2014 reached 7.4 percent, in line with projections.** Agriculture accounts for about 26 percent of GDP and employs 78 percent of the labor force. Trade and retail services make up 10 percent of GDP, while the weight of the industrial sector continues to decline from 17 percent of GDP a decade ago to 12 percent in 2014. Growth has been broad-based across economic sectors. The main contributors to GDP growth in 2014 were financial services, agriculture and extractive industries. Extractive industries has been the most dynamic sector in the economy for the past few years but its contribution to growth remains limited given its relatively small share in the economy. Growth in extractive industries has decelerated compared to previous years, given low commodity prices and infrastructure constraints. Mozambique adopted in 2014 a new base year (2009) for the compilation of national accounts, taking into account new available data sources and new sectors of economic activity. The revised GDP figures are slightly higher than previous GDP figures (4 percent higher in 2012). Growth in the first quarter of 2015 has slightly decelerated to 5.9 percent, and is supported by trade and related services, extractives and manufacturing.

Figure 1: Sectoral contribution to GDP growth

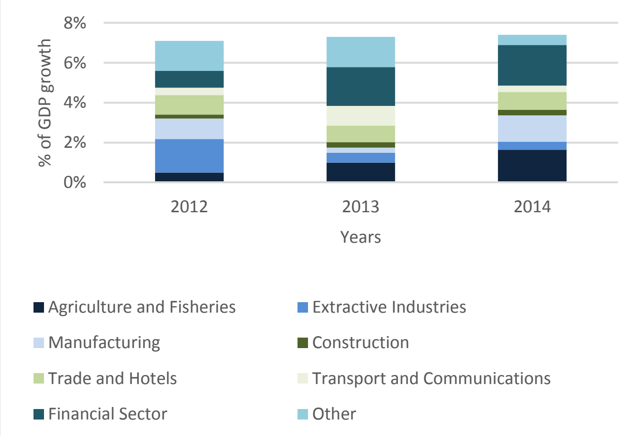
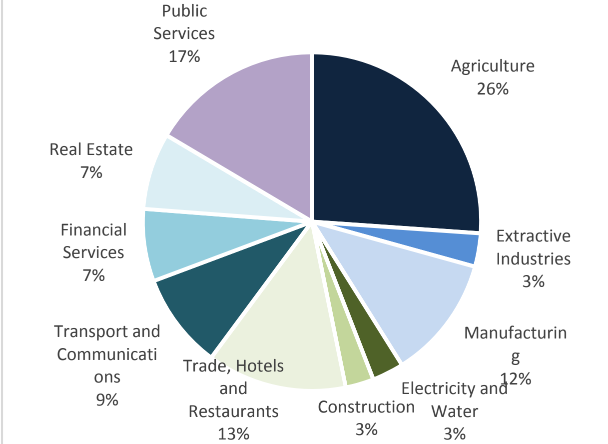


Figure 2: Sectoral breakdown of GDP in 2014



Source: INE and World Bank staff calculations.

Table 1: Key macroeconomic indicators, 2011-2017

	2011 Act.	2012 Act.	2013 Act.	2014 Est.	2015 Proj.	2016 Proj.	2017 Proj.
GDP (nominal – billion meticais)	385	424	470	526	591	676	770
Consumption (% of GDP)	92.9	92.9	92.8	94.1	93.2	92.2	90.9
Investment (% of GDP)	18.4	17.3	17.6	14.9	15.7	16.8	18.1
Net exports (% of GDP)	-11.3	-10.2	-10.4	-9.0	-9.0	-9.0	-8.9
Real GDP growth rate (%)	7.1	7.2	7.1	7.4	7.0	8.2	7.9
CPI inflation (%, annual average)	10.4	2.1	4.2	2.3	4.0	5.6	5.6
CPI inflation (end of period)	5.5	2.2	3.0	1.1	5.5	5.6	5.6
Base money (% change)	8.5	19.7	15.7	20.5	16.5	15.2	15.2
Credit to the economy (% change)	6.4	19.9	28.7	28.3	17.5	15.5	15.9
Policy lending rate (end of period)	15.00	9.50	8.25	7.50	--	--	
Gross domestic savings, exc. grants (% of GDP)	2.1	7.0	9.0	7.7	7.2	7.2	7.0
Gross domestic investment (% of GDP)	31.7	54.1	56.0	48.4	48.6	51.6	48.8
Government	14.1	12.9	15.2	18.6	16.2	14.9	15.3
Other sectors	17.6	41.1	40.8	29.8	32.4	36.7	33.5
Total government revenues (% of GDP)	19.7	22.4	26.9	27.8	25.5	25.7	25.9
Total government expenditure (% of GDP)	31.9	31.4	34.9	43.3	36.9	34.6	34.6
Overall balance (after grants) (% of GDP)	-5.0	-4.0	-2.8	-10.4	-6.5	-5.5	-5.8
Terms of trade (% change)	2.8	-5.7	-9.0	-3.3	-0.1	0.7	-0.1
Current account balance, incl. grants (% of GDP)	-23.1	-42.3	-40.0	-34.7	-38.2	-42.1	-39.9
Real exchange rate change (% change)	18.7	10.6	6.3	--	--	--	

Source: GoM, BdM, IMF and World Bank estimates and projections.

11. **The Government started efforts to tighten fiscal policy in 2015.** Fiscal policy has been expansionary over the past few years, expanding from 32 percent of GDP in 2011 to an estimated 43 percent of GDP in 2014. This has been partly facilitated by rapid growth in tax revenues, which have grown from 17 percent of GDP in 2011 to over 24 percent in 2014, reflecting efforts to improve tax administration and capital gains taxes from the extractive industries. Excluding capital gains taxes, tax revenues have increased by 1 percentage point per year over the past few years. This increase in revenue compensated for a decline in aid flows, which in 2014 financed 12 percent of expenditures (down from 30 percent in 2009). The new government is committed to a prudent fiscal stance as suggested by the recently approved budget for 2015. In the 2015 budget, expenditure is forecast to decline by 6.4 percentage points of GDP and the deficit will narrow by almost 4 percentage points of GDP. Both current expenditures (particularly goods and services) as well as capital expenditures will decline. The wage bill will decline slightly, from 11.4 percent of GDP to 10.9 percent of GDP. Personnel costs are expected to slowly decline below 10 percent of GDP by 2018. This more prudent fiscal stance demonstrates the new government's reform orientation, which will be crucial as Mozambique continues to prepare for managing a much larger resource envelope when resource revenues start to flow.

Table 2: Fiscal framework, 2011-2017

	2011 Act.	2012 Act.	2013 Act.	2014 Prel.	2015 Proj.	2016 Proj.	2017 Proj.
		(% of GDP)					
Total revenues	19.7	22.4	26.9	27.8	25.5	25.7	25.9
Tax revenue	17.2	19.1	22.9	23.8	21.7	21.9	22.1
Income and profits	6.5	8.7	11.9	11.7	9.1	9.9	10.0
Taxes on goods and services	8.6	7.9	8.1	9.2	9.4	9.2	9.3
International trade	1.7	1.8	2.1	2.2	2.1	2.1	2.1
Other	0.4	0.8	0.7	0.8	1.1	0.7	0.7
Nontax revenue	2.5	3.3	4.0	4.0	3.8	3.8	3.8
Grants received	7.4	5.2	5.3	5.1	4.9	3.4	2.9
Total expenditures and net lending	31.9	31.4	34.9	43.3	36.9	34.6	34.6
Current expenditures	17.8	18.5	19.7	24.3	20.7	19.7	19.3
Compensation to employees	9.3	9.8	10.5	11.4	10.9	10.5	10.2
Goods and services	3.1	3.6	4.3	7.8	4.4	3.7	3.4
Interest payments	0.9	1.0	0.8	1.1	1.4	1.5	1.7
Transfers	4.5	4.1	4.0	4.0	4.0	4.0	4.0
Capital expenditures	13.1	11.9	13.1	15.5	14.3	12.9	12.3
Externally financed	7.9	6.0	6.0	7.1	6.9	6.3	6.0
Domestically financed	5.3	5.8	7.1	8.4	7.4	6.6	6.3
Net lending	1.0	1.1	2.1	3.1	1.9	2.0	3.0
Externally financed	0.8	1.1	2.2	3.0	1.9	1.9	3.0
Domestically financed	0.1	-0.1	-0.1	0.1	0.1	0.1	0.1
Domestic primary balance (before grants)	-2.8	-1.0	0.9	-4.1	-1.2	0.8	1.9
Overall balance (before grants)	-12.4	-9.1	-8.1	-15.4	-11.4	-8.9	-8.7
Overall balance (after grants)	-5.0	-4.0	-2.8	-10.4	-6.5	-5.5	-5.8
External financing (net)	3.5	3.3	5.8	8.9	5.7	5.4	6.4
Domestic financing (net)	1.5	0.7	-3.0	1.4	0.8	0.0	-0.5
Memorandum items:							
Total public debt*	37.5	41.1	46.9	55.4	61.2	61.7	60.8
External	31.2	35.5	38.1	46.7	50.9	52.7	53.3
Domestic	6.3	5.6	8.8	8.7	10.3	9.1	7.4

Source: GoM, IMF, and World Bank estimates and projections.

12. **Inflation rates have been relatively low and stable during the past two years.** Inflation was lower than projected in 2014, at 1.1 percent (year on year) in December. The yearly average in 2014 was down to 2.3 percent, well below BdM's target of 5-6 percent. Low inflation reflects the strength of the Metical against the South African Rand and a decline in commodity prices in international markets. Inflation continued to be relatively low in the second quarter of 2015, estimated at -0.82 percent (year-on-year) in May 2015 despite a weaker Metical against the US$. Inflation was somewhat higher in some parts of the country, especially the North, which were affected by the floods earlier this year. Low inflation and a weaker external environment enabled BdM to ease monetary policy, with policy rates now at a record low of 7.5 percent. These efforts had limited impact on market rates, suggesting a weak monetary transmission mechanism.

13. **Lower exports and FDI inflows have put pressure on the Metical in the past 6 months.** Low commodity prices and somewhat weaker FDI inflows have put pressure on the Metical, which has gradually depreciated against the US$ from around 30 MZN/US$ in mid-2014 to 38 MZN/US$ by end of June 2015. Over the same period of time, international reserves have declined from US$3.2 billion in August 2014 to US$2.6 billion by end June 2015. It will be important that authorities maintain a flexible exchange rate regime to allow adjustment to take place and avoid further loss of reserves.

14. **The financial sector remains robust**. Credit continued its strong growth, increasing by 28.3 percent in 2014 following a 28.7 percent increase in 2013 and with credit to the economy reaching 37.0 percent of GDP in 2014 (compared to 28.0 percent of GDP in 2012), led by very rapid credit to households. The ratio of deposits to credit hovered around 127 percent in December 2014. Profitability levels have recovered with Returns on Assets (ROA) and Return on Equity (ROE) at 2.1 percent and 22.2 percent in 2014 respectively. Liquidity is in line with requirements as demonstrated by a ratio of liquid assets to total assets of 30.0 percent in December 2014. NPL ratios have risen slightly from 2.3 percent in December 2013 to 3.3 percent in December 2014 which could be the result of a combination of stricter NPL regulations and as such is viewed by the BdM as a one-off adjustment. Credit to the economy is expected to grow at an average of about 16 percent in 2015-2017, which shows a healthy growth and also reduces the risks of overheating.

15. **Mozambique's export basket remains very limited, reflecting the narrow scope of the economy: in 2013, three items (aluminum, coal, and electricity) accounted for 45 percent of exports.** Total exports grew at an average annual rate of 13 percent from 2004 to 2013, driven by foreign-financed megaprojects in aluminum, coal and natural gas industries. Coal mining began in mid-2011 and is expected to become a major export, although infrastructure constraints and declining coal prices may affect development prospects. Ultimately, natural gas is projected to dominate the export mix towards the end of the decade, with gas exports anticipated to exceed the total value of current exports.

16. **The current account deficit has narrowed slightly to 34.7 percent of GDP in 2014.** Savings remain relatively low and insufficient to finance the large investments being made by the public and private sectors. As a result, the current account deficit increased over the past few years to over 40 percent of GDP. The current account deficit narrowed in 2014 to US$5.8 billion (or 35 percent of GDP), the result of a lower trade deficit. The current account deficit does not indicate a fundamental imbalance in the economy, as it reflects the impact of rapid import growth associated with large FDI inflows. While consumption or intermediate goods imports increased by 20 percent over the past two years, capital goods imports increased by 85 percent over the same period. FDI reached between US$5-6 billion in 2012 and 2013 and is projected at US$4.2 billion in 2014, or around one-third of GDP, and financed over 70 percent of the current account deficit. This trend compares favorably with most of the last decade, when FDI financed 35 percent of the deficit. Reserves have declined from US$3.2 billion in August 2014 to US$2.6 billion at the end of June 2015 or slightly below 4 months of non-mega project imports which seems adequate.

17. **Public debt (in nominal terms) has grown rapidly, from 37.0 percent of GDP in 2011 to an estimated 55 percent in 2014.** This increase reflects the growth of domestic and external debt. An increasing share of this debt has been contracted on non-concessional terms. As a result, the joint WB-IMF Debt Sustainability Analysis (DSA) for Mozambique (April 2014) increased the country's debt distress risk rating from low to moderate. All public and external debt indicators remain below their threshold levels, but under a number of stress scenarios they breach their thresholds. It should be noted that the impact of these potential shocks in the DSA is also intensified because of the way the DSA simulates these shocks. Standard stress tests revert to historical values which are, in the case of Mozambique, significantly different from current and expected values. This is due to the structural change in the Mozambican economy resulting from the large-scale exploitation in the natural resources sectors. New debt is being used to finance a large increase in infrastructure investment to close the country's infrastructure deficit. If infrastructure investments generate high returns, they could result in higher growth in the medium

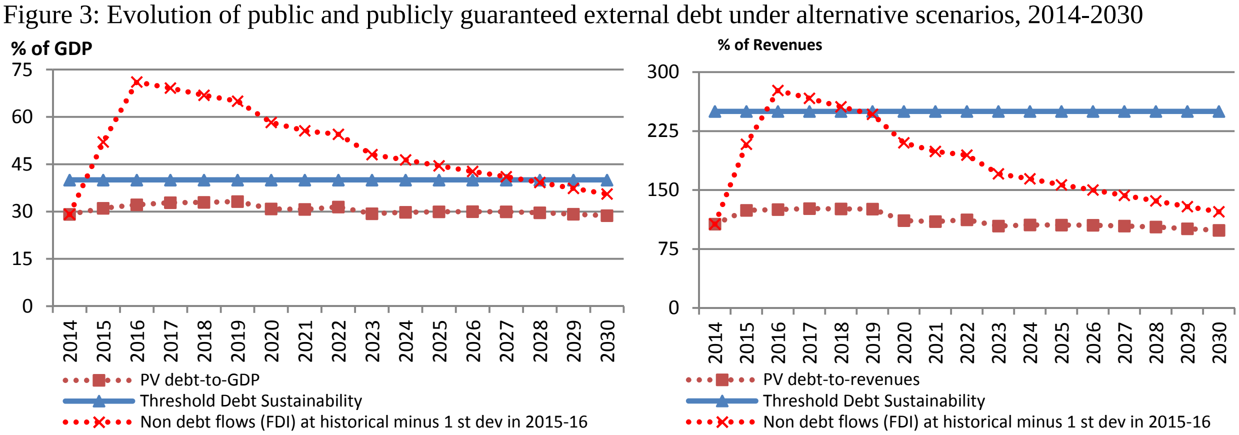
term. In the near term, Mozambique will need to moderate borrowing and ensure that it has the capacity to manage a larger debt burden and a more complex investment portfolio. There is limited information on fiscal risks but recent developments (see below) raise concerns regarding their management.

Table 3: Balance of payments, 2011-2017

	2011 Act.	2012 Act.	2013 Est.	2014 Est.	2015 Proj.	2016 Proj.	2017 Proj.
		(US$ millions)					
Trade balance (goods)	-2,249	-4,048	-4,357	-4,035	-4,531	-5,551	-4,524
Exports, f.o.b.	3,118	3,856	4,123	3,916	4,031	4,501	5,392
Of which: megaproject exports	2,015	2,173	2,196	2,429	2,544	2,724	3,346
Imports, f.o.b.	-5,368	-7,903	-8,480	-7,952	-8,562	-10,052	-9,916
Of which: megaproject imports	-1,852	-2,143	-1,934	-1,487	-2,516	-3,554	-2,834
Trade balance (services)	-1,482	-3,073	-3,259	-2,932	-2,546	-2,762	-3,930
Income balance	-190	7	-59	-202	-246	-459	-792
Of which: megaprojects dividends	-157	0	-1	0	0	-70	-179
Current account balance (b. grants)	-3,844	-6,822	-6,713	-6,268	-7,032	-8,445	-8,882
Current transfers	863	829	1,421	1,372	842	755	763
Of which: external grants	785	538	460	471	551	429	399
Current account balance (a. grants)	-3,059	-6,284	-6,253	-5,797	-6,481	-8,016	-8,483
Financial account balance	2,933	6,292	6,204	5,293	6,022	7,955	8,406
Net foreign borrowing (gen. gov.)	531	546	1,058	1,412	942	1,055	1,359
Net foreign borrowing (priv. sec.)	-39	516	-92	354	1,023	2,192	2,196
Net FDI	2,599	5,215	6,175	4,902	4,048	4,706	4,858
Other investments	-159	14	-937	-1,375	10	3	-6
Overall balance	323	377	396	-106	40	418	415
Memorandum items:							
Current account balance (% of GDP)	-23.1	-42.3	-40.0	-34.7	-38.2	-42.1	-39.9
Gross international reserves (US$ m)	2,428	2,798	3,191	3,071	3,079	3,463	3,845
In months of projected imports	2.4	2.7	3.3	3.1	2.7	2.8	2.6
In months of projected imports (exc. mega projects)	3.0	4.2	4.9	5.0	4.7	4.8	4.9

Sources: BdM, IMF and World Bank estimates and projections

Figure 3: Evolution of public and publicly guaranteed external debt under alternative scenarios, 2014-2030



Source: IMF and IDA. 2014. "Mozambique Debt Sustainability Analysis," Washington DC.

18. **The issuance of a large bond with a government guarantee by the Mozambican Tuna Company (EMATUM) in 2013 raised concerns about lack of transparency in the use of public funds, fiscal risks, and public investment management.** In September 2013, the government-owned fishing company EMATUM issued publicly guaranteed bonds with a total value of US$850 million. The bonds were issued to finance investments in a tuna fishing fleet and coast guard and maritime security services. The 2014 budget incorporated the costs of the coast guard and maritime security services, which are not commercial in nature (US$350 million). The transaction may have contributed to delays in the implementation of other major infrastructure projects so that Mozambique would remain within the non-concessional borrowing (NCB) limit agreed in the IMF's policy support instrument (PSI).

19. **EMATUM may have significant fiscal implications, but the weaknesses in the operation are also being used to strengthen transparency and accountability.** Following discussions with development partners, the government committed to subject EMATUM to strict financial controls and audits and to implement an action plan focused on improving public investment and fiscal risks management. External audits of EMATUM for 2013 and 2014 have been made publicly available (on the company's website) with an unqualified opinion. The Government has argued that a larger share of the proceedings of the bond were used for defense equipment (US$500 million) and that it is therefore likely to take on a larger share of the debt. The disclosure of the company's audits and the larger share of the Government on the debt have led to heated debates in the country's parliament. EMATUM would need to start redeeming the bond in 2015 using its own generated revenues, but it is now clear that the company will not have the resources to do so, and the government guarantee may be called upon. EMATUM developments have also led Standard and Poor to a downgrading of Mozambique's credit rating from B to B-.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

20. **Mozambique's medium-term macroeconomic outlook is positive.** Annual growth is projected at 7 percent in 2015. The initial growth projection (of 7.5 percent) was revised downward by 0.5 percentage points as a result of the floods that affected the center and north of the country in early 2015. Growth is expected to recover in 2016 and 2017 to around 8 percent as agriculture recovers from the 2015 floods and growth continues strong in the resource sector, construction, transportation and communications. In the short run, resource-related FDI, and infrastructure investments, both public and private, are expected to be major contributors to growth. While commodity prices are low, they are unlikely to decline further and are instead expected to gradually rise. Liquefied Natural Gas (LNG) investments in Mozambique are expected to continue given the current market conditions. Unexpected declines in commodity prices may have an adverse impact on Mozambique's economic prospects as it could affect the country's external balance and the timeline for investments in LNG plants in the north of the country.

21. **The authorities need to continue with the fiscal consolidation efforts.** The 2015 budget approved by the parliament already starts a process of fiscal consolidation. Authorities plan to continue reducing public spending to a level below 35 percent of GDP by 2016 and the deficit (after grants) from over 10 percent in 2014 to 5.5 percent in 2016. The authorities expect that such a reduction in spending will be achieved given: the return of expenditure to a normal path after the implementation of one-off outlays on elections and maritime security in 2014; a plan to reduce the wage bill gradually from its elevated level of over 11 percent of GDP in 2014; and slower growth

in expenditure on goods and services and investments. The authorities expect the domestic primary balance (before grants) to decline from a deficit of 4 percent of GDP in 2014 to 3 percent of GDP surplus by 2019.

22. **The central bank (*Banco de Moçambique* – BdM) will continue to maintain a policy stance consistent with single-digit inflation.** Inflation is projected to stay between 5-6 percent through 2017. After significantly easing monetary policies in 2013, BdM will focus on keeping inflation low through 2015. It will be important to monitor the impact of a weaker Metical on prices of imported goods and the pass through to inflation. BdM's ongoing capacity-building efforts will strengthen Mozambique's monetary policy framework and enhance the effectiveness of its inflation-targeting regime. In early 2012, BdM started publishing a quarterly monetary policy report aimed at anchoring price expectations through more timely and transparent communication of recent economic developments and monetary policy decisions.

23. **The current account deficit, although increasing, will remain sustainable given its financing by FDI and borrowing by Special Purpose Vehicles (SPVs) set up by large foreign corporations involved in the gas developments.** The current account deficit is projected to increase to 42.1 percent of GDP in 2016. While both new and traditional exports are projected to grow rapidly, so are imports required by large-scale investments in the minerals and gas sectors, generating large current account deficits through the end of the decade. Projected investments during the construction phase in the gas sector are several times the size of the entire Mozambican economy and as such, large current account deficits are to be expected. These deficits will be financed by FDI inflows, projected at between US$4-5 billion per year during 2015-17, as well as foreign borrowing by investors in the mining and natural gas sectors. The anticipated rise in resource exports should improve the current account balance towards the end of the decade. Reserves are projected to increase, from US$3 billion at the end of 2014 to a projected US$3.8 billion by 2017, worth around 5 months of projected imports (excluding megaproject imports) during the same period.

24. **The total public debt stock will stabilize at current levels in the near term**. The fiscal tightening discussed above as well as slower growth in public investments will reduce the fiscal deficit. It would be important to improve debt management and investment planning capacity by prioritizing the different investments projects and at the same time reducing the pace of borrowing. The Government is aware of the risks posed by inadequate controls on borrowing, and has expressed its intention to both slow the growth of new public external debt and reduce the share of non-concessional loans. The new Medium Term Debt Strategy, currently being prepared, will also establish borrowing limits for the Government in the short and medium term. Debt remains sustainable, but it will be important to closely monitor debt dynamics and support the Government's efforts to improve its debt management capacity. These efforts will be complemented by reforms to improve fiscal transparency and enhance public investment efficiency.

25. **Despite its positive overall economic outlook, the Mozambican economy faces significant downside risks, such as a sharp drop in commodity prices.** The increasing importance of FDI and natural resource exports leaves Mozambique's economy vulnerable to declining export demand, volatile commodity prices, and tighter global financial conditions. Weaker international commodity markets could affect large-scale investments planned for the coal and gas sectors, which seems to be the case already in coal mining. In light of these risks, both the

public and private sectors in Mozambique should avoid excessive leveraging backed by future rents from natural resources. In terms of political environment, over the past two years, the government security forces and the armed wing of the opposition party, *Resistencia National Moçambicana*/RENAMO, have repeatedly clashed. Although tensions now appear to have subsided after the October 2014 elections, events in the last few years are a reminder of the potential for such tensions to have devastating economic and social consequences.

26. **Overall, Mozambique's macroeconomic framework provides an adequate basis for FSDPO II**. This assessment is based on the country's strong macroeconomic performance over the past decade and the expectation that robust growth will continue in a stable and supportive policy context. The government remains committed to prudent monetary and fiscal policies as evidenced by the fiscal consolidation effort reflected in the 2015 budget. This fiscal consolidation will need to continue in the near term. Further macroeconomic management reforms are currently being supported through TA and by the current Poverty Reduction Support Credit (PRSC) series. For example, prior actions under PRSC-10 include: (i) a revised methodology for the elaboration of the medium-term fiscal framework, making appraisal of public investments mandatory for all projects in excess of US$5 million equivalent; (ii) adoption of the 2014-2017 Integrated Investment Program; and (iii) implementation of the first annual domestic borrowing plan, based on the medium-term debt management strategy. Additionally, FSDPO II would support the strengthening of the government's securities primary markets through the implementation by MoEF of the bond issuance calendar envisaged in the 2015 annual borrowing plan.

2.3 IMF RELATIONS

27. **The IMF concluded its 4th Policy Support Instrument (PSI) review in July 2015.** Mozambique started a new PSI with the IMF in 2013. The 4th PSI review (See annex 3) acknowledged Mozambique's strong growth record. Program performance was assessed as mixed because of macroeconomic policy slippages, particularly on the management of international reserves, while progress in implementing structural reforms was adequate. Key structural reforms suggested by the review include improving Value Added Tax (VAT) and overall tax management, continuing public financial management reforms, strengthening public investment management capacity and improving the business environment. The Bank and the IMF cooperate closely in supporting the GoM to promote financial development, including through the provision of complementary TA. FSDPO II is aligned with MFSDS, the approval of which was a structural benchmark in the previous PSI.

III. OVERVIEW OF THE FINANCIAL SECTOR

Financial Sector Institutions

28. **Banks dominate the Mozambican financial sector, accounting for almost all the financial sector assets and more than 95 percent of total credit in the financial system**. The banking sector was liberalized in 2003, and foreign participation in commercial banks is widespread (mostly from South Africa and Portugal –constituting the largest banks in the system—though more recently including entrants from Nigeria and other pan African Banks). After a steady increase resulting from the authorities' concerted effort to introduce competition and innovation in the sector via reduction of minimum capital, the number of banks in the system has been stable since 2010 at 18 active banks. Despite that, the system remain concentrated, with the three largest (foreign-owned) banks having 85 percent of the total assets of the banking system in 2013. There

are also 10 microbanks (microfinance banks), eight credit cooperatives, 285 microcredit operators and 12 savings and loan organizations; nonetheless, the microfinance sector growth has been stagnant, with total number of clients remaining below 200,000 and a declining total portfolio. Similar to the banking sector, the microfinance sector is also highly concentrated, with five microbanks holding over 80 percent of the loan portfolio and 60 percent of the borrowers. Two E-money issuers have started to operate in Mozambique since 2011 but their outreach has been limited and growth has been slow, mainly due to the difficulty in expanding the agent network beyond Maputo due to continued lack of awareness of e-money products and limited experience of mobile money agents. Despite the increase in the number of insurance companies from 5 (in 2009) to 17 in 2014 (and 58 insurance brokers), the insurance market is small with insurance premiums to GDP at 1.5 percent as of 2013, and is concentrated and focused on corporate clients. The private pension fund industry is also small (with eight funds and six pension fund managers) but developing with a total asset size of US$850 million as of 2014. Pension coverage in Mozambique is limited to formal sector workers, and extends to around 7 percent of the population, which is towards the lower end of regional comparisons. Although the securities market has been improving over the last five years, it is still very incipient and focused on (mostly Government) bonds.

Financial Sector Stability

29. **The financial system remains stable but there are emerging risks that need to be monitored and mitigated.** Banks continue to be funded locally and this has limited the risk of contagion from overseas crises, particularly for foreign owned banks that are more likely to be exposed. Overall, the financial sector regulatory and supervisory environment continues to improve. The central bank (*Banco de Moçambique – BdM*) has been passing a number of regulations to strengthen oversight, risk management by banks, and protect against systemic shocks. Nonetheless, there are a number of economy-wide risks to the financial system and some emerging sector-specific risks. Broad risks can arise from exogenous shocks such as declining commodity prices (such as coal and aluminum on which the economy is already dependent and gas on which much future growth and income is projected). Additionally, the rapid increase in credit provisions, particularly to households, has raised concern about over-indebtedness especially given the overall low levels of financial capability, current limits to information infrastructure, emerging standards for financial consumer protection, and emerging credit risk management practices by banks with regard to medium- to low-income households.

Cost of Financial Services

30. **The high cost of credit is a key factor limiting the use of bank credit to finance investment**. Nominal lending rates have largely remained above 20 percent for the last 14 years while real rates have surged since early 2011 as inflation fell to single digits. These high interest rates – in addition to origination fees and commissions as well as other costs – mean a high price for borrowers' access to bank credit. The 2014-2015 GCR found that access to financing was the top constraint for doing business in the country. High lending rates reflect high interest rate spreads – the difference between lending rates and deposit rates. For instance, in September 2014, the average spread between a one year lending rate and a one year deposit rate was 11.27 percent, down from its peak of 13.37 percent reached in January 2014. Average spreads have largely remained above 10 percent for more than ten years. The effective interest rate spread is also high at 10 percent despite declining since 2011. Mozambique's margin is close to those of Kenya and Zambia but is double than that of South Africa.

31. **At the request of the BdM, the World Bank is preparing an Interest Rate Decomposition Analysis Policy Note, which aims to identify the key components and drivers of interest rate levels and spreads in Mozambique.** The analysis is ongoing with the note expected to be ready later in 2015; however, preliminary results indicate that the drivers of this phenomena include: high operational costs; lack of information on borrowers – credit reporting in Mozambique is currently only done by a credit registry operated by BdM, which has many limitations; limited availability of collateral; demand for credit outpacing the economy's capacity to generate savings and deposits; and increased competition for wholesale deposits (from pension funds, insurance companies, and large corporates) driving up the cost of funding for banks and consequently interest rate spreads and average lending rates.

Financial Inclusion Landscape

32. **Despite the significant expansion of total bank deposit and credit over the past several years, access to financial services by both households and MSMEs remains a pressing challenge.** Perhaps the most notable improvement in recent years has been the tripling in the total number of deposit accounts from 2005 to 2011 (though it is recognized that there might be significant double counting as many enterprises and individuals hold multiple accounts). According to Finscope 2014, 20 percent of total adults (+15 years of age) have a bank account, representing an increase of eight percent compared to 2009. The 2013 WB FinCap Survey found that 27 percent of adults currently use a financial product from a bank. However, there is still urgency to expand financial services to currently underserved or unserved areas. The total number of financial services access points has been somewhat stagnant outside Maputo, and Mozambique compares poorly with regional peers. Access points in Mozambique remain significantly below other countries in the region, such as Kenya, and South Africa. In 2014, there were about 4.30 bank branches and 8.4 ATMs per 100,000 adults in Mozambique. This compared to 10.34 branches and 61.88 ATMs per 100,000 adults in South Africa, and 5.57 branches and 9.99 ATMs per 100,000 adults in Kenya in 2013.

33. **A further concern is that many existing deposit accounts may be dormant/inactive, which may be a result of the lack of both products and channels that meet the needs and habits of new financial consumers, as well as a consequence of low levels of financial capability**. While an estimated two thirds of the population lives in rural areas, the FinCap Survey found that financial access rates of the rural adult population were very low, with only 19 percent reporting currently using a financial product from a bank, compared to 46 percent of urban adults. Similarly, Finscope 2014 revealed that while 40 percent of urban adults are banked, only 10 percent are in the rural areas. Access to finance is also a major constraint for the private sector, particularly for MSMEs. The 2012 FinScope MSME Survey found that 75 percent of MSME owners are financially excluded. Lending to the agriculture sector is particularly limited. While agriculture contributes to around 23 percent of GDP, according to the National Statistics Institute (INE), credit to agriculture represents only 2.2 percent of bank credit.

34. **The creation of an enabling environment where banks and nonbank players, i.e. nonbank e-money issuers and payment services operators, can symbiotically co-exist is critical for the success of the financial inclusion agenda**. It is also crucial to achieve an enabling environment for interoperability that does not stifle innovation and investments in new market segments. Finally, it is important to address demand side constraints such as improving financial capability and strengthening regulation and supervision for financial consumer protection by both

the BdM and the *Instituto de Supervisão de Seguros de Moçambique* (ISSM). Finally, there is a need to further develop the capital markets, as well as the insurance and pension sectors, to not only improve product offerings for retail consumers but also provide access to long term finance to meet infrastructure and housing finance requirements and to diversify sources of financing for a range of enterprises, including SMEs.

IV. THE GOVERNMENT'S PROGRAM

35. **Following a broad and inclusive preparation process, the Council of Ministers (CoM) approved in April 2013 the MFSDS for 2013-2022**. The Government initiated the preparation of this Strategy following the conclusions of the 2009 FSAP Update. Through a Financial Sector Reform and Strengthening Initiative (FIRST) funded Project, the Bank supported the Strategy development process. The adoption of the Strategy sends a strong signal to the market and donors of the Government's commitment to keep engaging in serious reforms in the FS. Additionally, a WB Financial Inclusion Support Framework (FISF) Mozambique Country Support Program is supporting the preparation of a National Financial Inclusion Strategy (NFIS) in line with MFSDS, which will provide a detailed road map on reforms to promote financial inclusion and a monitoring and evaluation (M&E) framework.

36. **The goal of the MFSDS is to promote the development of a sound, diverse, competitive, and inclusive FS which provides citizens and businesses with convenient access to a range of appropriate and high quality financial services at affordable prices.** The policies and actions of the MFSDS are organized into three groups of strategic objectives: maintaining FS stability, improving financial access and increasing the supply of private capital to support development.

37. **The proposed operation series is closely aligned to the MFSDS and will support its implementation.** MFSDS strategic objectives overlap with the three Pillars of the FSDPO series. MFSDS includes a detailed Results Framework that specifies policy objectives, specific objectives and strategic actions. The FSDPO series supports the objectives and actions that will have the greatest impact on the PDO (and the Strategy's vision). A number of reforms under the MFSDS across the three pillars (as described in the following section) are ongoing and reform momentum has accelerated recently following a brief hiatus as the new Government was installed. At the moment, the Steering Committee is being reconfigured to take into account the recent Government formation which merged several Ministries (among the key changes were the integration of the former Ministry of Planning and Development (MPD) and the Ministry of Finance (MoF) into a new Ministry of Economy and Finance (MoEF) which assumes the Chair of the Committee.

38. **MFSDS is an integral part of the Government's overall vision for inclusive growth and poverty reduction**. The Mozambique's third poverty reduction strategy paper (PARP) which is coming to an end in 2015, has as one of its three pillars employment generation with a focus on SME development. The Parliament approved in April 2015 the new *Plano Quinquenal do Governo* (PQG) 2015-19. The PQG 2015-19 has employment promotion, improving productivity and competitiveness as an overarching theme to achieve more inclusive growth. These policy documents provided the framework for the MFSDS and other complementary sector specific initiatives. Specifically, MFSDS complements the following sector specific policies of the GoM: (i) the *Strategic Plan for Agricultural Development 2010-19 (PEDSA)*, which emphasizes the importance of agricultural and agribusiness finance; (ii) the *Business Environment Improvement*

Strategy 2013-2017, which aims to simplify the operating environment for businesses; and (iii) the *Rural Finance Strategy,* which focuses on measures to promote rural savings and credit. Finally, the FSDPO II will support the new PQG 2015-19 which has among its five priorities the promotion of employment and competitiveness and calls for a robust, modern, inclusive, and broad financial sector as part of the second PQG pillar for a balanced and sustainable macroeconomic environment.

V. PROPOSED OPERATION

5.1 LINK TO THE GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

39. **The Pillars of the FSDPO series overlap with the strategic objectives of the MFSDS.** Thus, the FSDPO series will support reforms to: (i) maintain FS stability (FSDPO Pillar I: Financial Stability), improve financial inclusion (FSDPO Pillar II: Financial Inclusion); (ii) and increase the supply of private capital to support development (FSDPO Pillar III: Long-Term Financial Markets). Moreover, the FSDPO series is aligned with MFSDS specific objectives and actions, as shown in the table below.

Table 4. Examples of MFSDS objectives and actions related with FSDPO series reforms

MFSDS Policy Objective	MFSDS Specific Objectives and Strategic Actions
MFSDS Strategic Objective I: Financial Sector Stability	
Monetary stability	**Government debt market development:** improve information on public debt, increase the stock of outstanding OTs to stimulate market development without increasing domestic debt.
Banking system stability	**Loan classification and provisioning:** bring loan classification and provisioning rules in line with international best practice and make them more risk based. **Anti-money laundering (AML):** complete the process of developing an effective AML function. **Implementation of Basel II:** finalize the adoption and implementation process of Basel II.
FS safety nets	**Crisis management:** develop a crisis management plan; conduct crisis simulation; establish a deposit insurance system.
Development and strengthening of pensions and insurance sectors	**Regulatory framework:** develop the regulatory framework for the pensions and insurance sector. **Supervision capacity:** strengthen pension and insurance supervision capacity.
MFSDS Strategic Objective II: Financial Access	
Develop FS infrastructure	**Payment & securities settlement systems**: develop the legal framework for e-banking and mobile financial services; promote e-payments. **Credit information systems**: increase scope and coverage of the system; increase ease of access to credit information; liberalize the sector to allow for private credit registries.
Increase access to finance	**Consumer protection program:** strengthen consumer protection in the financial system through increased transparency, fair treatment, and effective recourse. **FS outreach:** increase financial services providers outside major urban areas. **Increase access to formal financial service:** provide a bridge between rural commercial clients and the commercial finance system; facilitate commercial bank loan access.
MFSDS Strategic Objective III: Supply of Private Capital	
Develop capital markets	**Medium-Term Debt Management Strategy**: guarantee regular and scheduled issues of domestic debt instruments within a well disseminated process; harmonize the exchange and monetary markets policies with capital market policies. **Broadening the investor base:** by strengthening regulations and setting out investment criteria for private and public pension and insurance funds.

40. **The FSDPO series has incorporated lessons from FSDPOs in Africa, Europe and Central Asia, and Latin America as well as country-specific lessons,** such as: ensuring cooperation at all levels of government; including TA and strong analytical underpinnings;

considering the political economy and timing of reforms; and collaborating closely with donors to ensure a coordinated approach. Implementation capacity is limited in Mozambique and most FSDPO reforms fall under two institutions. Thus, the number of reforms supported by the FSDPO series has been kept at a manageable level (considering timing and sequencing issues) and complementary TA has been mobilized to support the implementation of reforms. The GoM has demonstrated commitment to the implementation of FS reforms over the last decade (as evidenced by the implementation of FSAP recommendations) and FSDPO is closely aligned with MFSDS. Moreover, the DPO series is helping to prioritize key MFSDS reforms and boosting the reform momentum to complete the last step in the approval process of some reforms that had been in the making 2-3 years.

5.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

41. **Annex 1 details prior actions for DPO I and II, indicative triggers for DPO III, and related results.** Reforms in the policy matrix have been classified in the three pillars: financial stability, financial inclusion and long-term financial markets. Annex 2 compares indicative triggers for FSDPO II (as identified in the FSDPO I Program Document) and prior actions for FSDPO II. The Prior actions for DPO II (all completed) and related reform areas are summarized in Table 5, while the description of the operation below covers all reform areas covered by the DPO series, achieved or planned.

Table 5. Summary of Prior Actions supported under FSDPO II

REFORM AREAS	PRIOR ACTIONS (PA)
Pillar I: Financial Stability	
Strengthening the banking safety net and crisis management framework	**PA1**: The BdM strengthens the crisis management framework by conducting a crisis simulation exercise (CSE) to identify weaknesses/gaps. **PA2**: The MoEF capitalizes the DGF with initial Government contribution based on Decree No. 49/2010.
Improving the AML/CFT framework	**PA3**: The CoM approves AML/CFT Law Regulations.
Pillar II: Financial Inclusion	
Improving access to financial products in underserved sectors/areas	**PA4**: The BdM issues regulations regarding protection of e-money custody accounts (Aviso sobre Protecção de Fundos Resultantes da Emissão de Moeda Electrónica). **PA5**: The BdM regulates the access and exercise of activities for banking agents.
Increasing the efficiency of borrowers' collateral to promote access to credit	**PA6**: The CoM re-submits the draft Law to Parliament for the creation of credit bureaus in line with international principles.
Enhancing the transparency of financial information and protecting consumers	**PA7**: The BdM establish minimum requirements for protecting bank card account holders.
Pillar III: Development of Long-Term Financial Markets	
Strengthening government securities primary markets	**PA8**: The MoEF implements the bond issuance calendar envisaged in the 2014 annual borrowing plan by conducting at least four competitive auctions. **PA9**: MoEF announces its intention to conduct at least one reopening of OTs in 2015.
Enhancing long-term funding sources (insurance and pensions)	**PA10**: ISSM sets maximum coverage limits for micro-insurance products.

42. **The TA package accompanying the FSDPO series is providing support for reforms in each of its three pillars and the team is coordinating further TA by the World Bank Group and other donors.** Pillar I is also receiving TA from a FIRST funded project on crisis simulation and the IMF (on AML/CFT regulations and banking sector supervision). Reforms related with financial inclusion (Pillar II) have been receiving TA from the Bank's FISF program.[6] Policy reforms advanced by the DPO are being complemented by the Financial Sector Deepening Trust (FSD Mozambique), financed by DFID to encourage private sector innovations for enhancing financial inclusion.[7] GIZ and KFW have also been providing technical assistance and market development interventions that complement the DPO. Under Pillar III, reforms related to the development of debt and capital markets and cash flow management are receiving TA from the FSDPO team and a FIRST-funded project ("Mozambique: Debt Markets Development"). Finally, a proposed FIRST project is expected to provide TA related to Pillar III, with the goal of expanding long-term financing sources with a focus on pensions and insurance sectors.

43. **The design of this operation is supported by extensive FS analytical work conducted by the Bank, the GoM, and other donors (Table 6)**. The FSDPO series has benefited from the FS analysis in the 2009 FSAP Update, which provided detailed recommendations and helped to identify FSDPO reforms. Strategies prepared by the Government were key inputs for the FSDPO, the most relevant being MFSDS. The MTDS and an ongoing FIRST project on Debt Market Development provided inputs for the reforms in FSDPO-Pillar III. The Rural Financial Strategy highlighted the need to increase financial inclusion in rural areas and led to the inclusion of reforms in the policy matrix to enhance access to financial products/services in underserved areas. Reforms supported in Pillar II on financial inclusion have benefited from: (i) the WB's 2012 Diagnostic Report for Consumer Protection and Financial Literacy covering banking and microfinance, and the 2014 assessment on consumer protection covering the insurance, securities, and the pensions sector, which provided recommendations for addressing weaknesses in the financial consumer protection framework; (ii) BdM's 2013 study on "Challenges of Financial Inclusion in Mozambique: An Analysis of the Supply", which identified reforms to increase access in underserved areas; (iii) the "Mapping of Retail Payment Services Landscape" (FinMark Trust 2012) highlighting the need to strengthen the regulatory framework of e-money; and (iv) several surveys, including the WB Financial Inclusion and Capability Survey Report (2014), the Finscope Mozambique Survey Report (FinMark Trust 2009), and Finscope for SMEs (FinMark Trust 2013), which have provided data on financial inclusion and related recommendations supporting FSDPO reforms. Under the FISF project, the Bank team is currently preparing a Consumer Protection and Financial Literary Diagnostic Review Report for the non-bank sectors (insurance, pensions, and capital markets) that has already informed measures under Pillar III.[8]

44. **The operation has additionally been substantially informed by significant consultations held with the Government, financial institutions, private sector, and donor partners.** As indicated earlier, the DPO is based on the Government's Financial Sector Development Strategy whose development was underpinned through a broad consultative process. Specifically, a strategy stakeholder consultation workshop was held on February 2011 which was

[6] FISF is providing TA, knowledge, and capacity building for policy and regulatory reforms to promote financial inclusion during 2014-2017 (including on the development of the national financial inclusion strategy, retail payments, MSME finance, and financial consumer protection and literacy).
[7] FSD Mozambique is supporting a range of activities, including supporting financial institutions in developing appropriate and diverse financial services for low-income individuals and MSMEs, providing matching grants for accelerating private sector innovations and undertaking market research and surveys as needed.
[8] The CPFL Report on insurance, pensions, capital markets is expected to be finalized by June 2015.

attended by representatives from the Ministry of Finance, Bank of Mozambique, regulators, research institutes, banks, microfinance institutions and donors. A Steering Committee (SC) chaired by the Minister of Finance (now Minister of Economy and Finance), and consisting of members of key Government agencies, was formed after this workshop to oversee the Strategy development and implementation process. Additionally, through the FIRST project, the Bank supported the launching of the Strategy at a public event that was held in June 2013 presided over by the Minister of Finance who officially opened the Launch Seminar and including over 100 participants from the Government, the donor community, and the private and financial sectors. The event was well covered in the media. Following the event, English and Portuguese copies of the Strategy and Executive Summary were published and distributed to stakeholders. DPO relevant consultations include for example: (i) with investors, insurance, companies, and pension funds for the Long Term Financial Markets Pillar, (ii) with banks for the reforms related to the deposit guarantee and credit bureau in the Financial Inclusion Pillar and reforms aimed at strengthening banking supervision in the Financial Stability Pillar. Most recently, in July 2015 the Mozambique Financial Inclusion Strategy/Action Plan Consultation Workshop, supported by the FISF project, was held in Maputo. The workshop was organized by the BdM and was attended by a range of participants representing various Government agencies, banks, microfinance institutions, insurance companies, private sector, and donors as well as local media. Topics of discussion included interoperability of payment systems, linking with informal sector, value chain finance and increasing access to agricultural credit, bank business models, promoting use of technology for delivery of services as a way to overcome infrastructure constraints to access – all areas being supported through DPO reforms. Finally, the partnership between the World Bank and the MoEF and BdM for financial sector development has been long lasting and has been cemented through the DPO and related technical assistance projects.

Table 6: DPO Series Reform Areas and Analytical Underpinnings

REFORM AREAS	ANALYTICAL UNDERPINNINGS
PILLAR I: FINANCIAL STABILITY	
Banking regulation & supervision; Strengthening the banking safety net & crisis management frameworks	FSAP Update; MFSDS; IMF Reviews Under the PSI for Mozambique; FIRST project on Contingency Planning analytical work.
Improving the AML/CFT framework	FSAP Update; MFSDS.
PILLAR II: FINANCIAL INCLUSION	
Improving access to financial products in underserved sectors/areas	FSAP Update; MFSDS; Diagnostic Report for Consumer Protection and Financial Literacy for banking and microfinance (2012), and for insurance, pensions, securities (2015- forthcoming); Mapping of Retail Payment Services Landscape; Challenges of Financial Inclusion in Mozambique; 2014 Finscope Mozambique Survey Report; Finscope for SMEs; An Overview of the Constraints to the Development of Housing Finance Sector; Financial Inclusion and Capability Survey Report ("Enhancing Financial Capability and Inclusion in Mozambique: A Demand-Side Assessment"); National Financial Inclusion Strategy (2014 – draft); Mozambique Financial Inclusion Support Framework (FISF- ongoing) .
Increasing the efficiency of borrowers' collateral to promote access to credit	FSAP Update; MFSDS.
Enhancing transparency of financial information and protecting consumers	MFSDS; Diagnostic Report for Consumer Protection and Financial Literacy; Challenges of Financial Inclusion in Mozambique: An Analysis of the Supply; Financial Inclusion and Capability Survey Report; Mozambique Financial Inclusion Support Framework (FISF- ongoing) .
Strengthening and broadening access to payment systems	FSAP Update; MFSDS; Diagnostic Report for Consumer Protection and Financial Literacy; Mapping of Retail Payment Services Landscape.); Mozambique Financial Inclusion Support Framework (FISF- ongoing).

REFORM AREAS	ANALYTICAL UNDERPINNINGS
PILLAR III: LONG-TERM FINANCIAL MARKETS	
Strengthening government securities primary markets	FSAP Update; MFSDS; Medium Term Debt Management Strategy; Government Debt Management Performance Report; FIRST Debt Market Development TA Project (ongoing).
Enhancing long-term funding sources (insurance and pensions)	MFSDS; Access to Insurance in Mozambique (Cenfri 2012); CPFL Report on insurance, pensions, securities (2015- forthcoming).

Pillar I: Financial Stability

Enhancing banking regulation and supervision (FSDPO I, III)

45. **FSDPO I supported (as a prior actions): (i) a new regulation on loan classification that revised the definition and recording of NPLs bringing it more in line with international best practices; and (ii) the issuance by the BdM of risk management guidelines for banks fostering better risk management practices in line with international practices.** The NPL regulation came into force in January 2014 and implementation is ongoing. While it is difficult to isolate the impact of the NPL regulation from other business factors, the NPL ratio (based on the new regulation, which is more stringent) has increased (from 2.3 percent in December 2013 to 5.3 percent in December 2014). Under the new regulations, NPLs include loans (full exposure) that are 90 days or more overdue and, importantly, the full exposure is required to be classified and provisioned. While most banks have submitted to BdM their risk management programs, full implementation of the guidelines will take longer as banks adjust their internal systems and capacities accordingly.

46. **FSDPO III will support enhancing banking stability and access by having as a trigger the issuance of a regulation increasing minimum capital for banks.** BdM has been working for several years on revising the minimum capital required for a financial institution to operate in Mozambique which is currently lower in Mozambique in comparison to other Sub-Saharan Africa countries. While the most direct effect of increasing minimum capital concerns stability, there are also expected benefits in terms of financial access given that well-capitalized banks are in a better position to provide sustainable access. The World Bank team will discuss with the regulator options being considered for smaller institutions, paying attention to access and stability considerations. During DPO I, the mission was provided with a 2011 draft for a new regulation and the BdM informed the mission that further changes were to be made and the new draft submitted to the Board for review and comments. At this time, the authorities informed that the Board reviewed the draft and required some changes, as well as further background on the matter. For this reason, the Aviso (Notice) is proposed as a FSDPO III trigger (even when it had been identified as a FSDPO II trigger –please see Annex 2).

FSDPO III Trigger 1: "The BdM issues an Aviso to increase minimum capital levels for banks."

47. **BdM has enhanced its risk-based capital requirements by introducing Basel II elements into its regulatory framework**.[9] BdM has been working for a few years now on Basel

[9] FSDPO I identified the following related FSDPO II trigger: "The BdM continues to strengthen bank regulation and supervision by: (i) increasing minimum capital levels for banks; (ii) incorporating capital requirements for operational and foreign exchange risk (following Basel 2 simplified standardized approach)". While (i) is now a trigger for FSDPO III (as mentioned above), (ii) has already been implemented (through regulation published in December 2013 as

II implementation, based on the simplified standardized approach. After sharing with the industry draft regulations and having one year of parallel running (Basel I and Basel II), the BdM puts in force a revised framework for prudential capital requirements, incorporating a new definition for computable capital, as well as charges for operational risk and market risk, in addition to revising the approach to credit risk. Notices 11,12,13,14 and 15/GBM/2013 of December 31, 2013 came to force in January 2014. Regulation has been reported to be overly complex, requiring further discussions and clarifications, with banks still reporting difficulties in interpreting the regulations/providing reports. Total capital aggregate levels declined from 16.9 percent (December 2013) to 15.1 percent (December 2014). The World Bank team did not have access to banks' individual data but it was reported that some banks recorded a fall of 2-4 percentage points in their capital adequacy ratios. BdM has also been working to implement a requirement for banks to develop an internal process to assess the adequacy of capital levels (ICAAP). Notice 20/GBM/2013, of December 31, 2013, laid down the minimum requirement for the ICAAP process. Although the regulation came to force in January 1st, 2014, in practice banks were expected to submit their first ICAAP report to BdM in 2015.

48. **FSDPO III would support the adoption of regulations on concentration limits for placements abroad to address country and transfer risks.** The adequate management of concentration risk is one of the key elements in keeping safety and soundness of banks. Indeed, BdM stress testing identifies concentration risk as the main vulnerability in the Mozambican financial sector. In 2014 BdM put in place guidelines regarding concentration risk, requiring banks to have policies and procedures in place in order to adequately monitor and manage concentration risk. In the aftermath of the financial crisis, countries with a heavy presence of foreign banks started to monitor more closely placements abroad of foreign-owned banks (particularly at their parents) as a relevant source of concentration. BdM has been working for a while on developing regulations on concentration limits on placements abroad in order to address country and transfer risks. Currently technical work is ongoing.

FSDPO III Trigger 2: "The BdM adopts regulations on concentration limits for placements abroad to address country and transfer risks."

Strengthening the banking safety net and crisis management frameworks (FSDPO I, II, III)

49. **Over the last few years the BdM has made efforts to develop a crisis management framework, supported by the TA provided by the WB and the IMF**. Achievements include the approval of regulation for Emergency Liquidity Assistance (ELA), issuance of a decree establishing a deposit insurance scheme through the Deposit Guarantee Fund (DGF), as well as the issuance of guidance to the BdM on how to deal with systemic events and problem banks. Albeit the initial decision to establish a crisis management committee within the BdM, more recently it has decided to postpone such initiative given capacity constraints and current priorities.

50. **FSDPO I supported (as a prior action) the development and approval by BdM of regulations pertaining to ELA for banks enabling it to act as a lender of last resort.** Such regulation is a first important step towards establishing an effective and fully operational Lender of Last Resort (LOLR) facility for banks operating in Mozambique. BdM has started developing internal procedures to guide the provision of liquidity assistance. An upcoming crisis simulation exercise is expected to test Mozambique's crisis preparedness, including the ELA arrangements.

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described below). Given that this goes beyond the timeframe of FSDPO II, this reform has not been included in the proposed DPO as a prior action.

51. **FSDPO II supports a crisis simulation exercise (CSE).** Crisis management arrangements have been tested through a CSE, supported by a WB FIRST-funded TA which took place in April 2015. The CSE encompassed two weeks of intensive preparation by the World Bank and BdM with a strong component of BdM's staff capacity building, which included the design and development of the simulation scenarios. It is worth highlighting that the CSE was attended by the Governor and members of the Board of the BdM, as well as a senior representative from the MoEF. Following up on the CSE, a workshop will be conducted in the last quarter of 2015 to discuss findings and design an action plan for addressing identified gaps, with World Bank support. A CSE has been identified under MFSDS, as a critical activity needed to enhance the financial stability. The objectives of the CSE are to test and identify scope for improvement on how the authorities would respond to the emergence of serious problems in one or more financial institutions; intra/inter-agency coordination; the adequacy of existing laws, regulations, policies and procedures for dealing with such situations, including resolution powers; the practicability and effectiveness of tools recently introduced in Mozambique. FSDPO III would support (as a trigger) the implementation of actions to address weaknesses/gaps identified in the CSE.

FSDPO II – Prior Action 1: "The BdM strengthens the crisis management framework by conducting a crisis simulation exercise (CSE) to identify weaknesses/gaps"
FSDPO III – Trigger 3: "Implementation of actions to address weaknesses/gaps identified in the CSE".

52. **FSDPO II keeps supporting the establishment of a Deposit Guarantee Fund (DGF).** Currently there is no deposit guarantee scheme in operation in Mozambique, which is crucial for the development of a financial safety net. In the absence of such an explicit scheme, depositors and banks assume that the Government will reimburse deposits in the event of bank failure, meaning that there is an implicit system-wide guarantee for all deposits. This represents a large unfunded contingent liability on the state. In recent years, Mozambique has undertaken a number of steps to introduce a DGF. These steps include a 2010 Council of Ministers Decree to establish the DGF (as a "pay-box"). The decree envisages that the BdM will act as the Fund manager, stipulates the minimum Government contribution, and the membership of the Management Committee that would oversee the Fund. Additionally, FSDPO I supported (as a prior action) the nomination of the members of the DGF Management Committee, which will oversee the Fund. This was an essential step for the operationalization of the DGF, which was pending since 2010.

53. **The capitalization of the DGF will take place following guidance incorporated in the Council of Ministers Decree**. DPO I supported the nomination of the members of the DGF Management Committee ("Committee"), which will oversee the Fund and the DGF unit has been operating since 2013 at the BdM premises. The 2010 Council of Ministers Decree set out an initial DGF fund contribution with 60 million meticais (MZN) from Government and 15 million MZN from commercial banks. However, since that time, the deposit base has been expanding rapidly with the number of deposit accounts / 1000 adults nearly doubling from 2009 to 2013 from 131.64 to 240.60. As a result, the required initial seed funding for the operationalization of the fund will be greater than initially envisaged in the 2010 Decree. KFW has been providing technical assistance to the authorities for the DGF and has allocated Euro 3.5 million to support the fund's initial capitalization, which will be disbursed once all the necessary conditions are in place. The BdM has also allocated 30 million MZN to support the initial fund capital which is additional to the Government contribution of 60 Million MZN supported by FSDPO II. The DGF Committee has conducted an initial analysis which identified a gap after taking into account the contributions from the Government (60 Million MZN), BdM (30 Million MZN), KFW (Euro 3.5 million), and

commercial banks (15 Million MZN). While the full capitalization of the DGF (up to a certain target ratio needed to enable the deposit insurer to fulfill its mandate) is an ongoing process which will be achieved through annual contributions of its future member financial institutions, a certain seed capital is required for the fund to become operational (i.e. commence insurance of deposits up to 20.000 MZN corresponding currently to approximately 90 percent of deposit accounts). FSDPO III would support (as a trigger) the adequate capitalization of the DGF for it to become operational.

FSDPO II Prior Action 2: "The MoEF capitalizes the DGF with initial Government contribution based on Decree No. 49/2010".
FSDPO III Trigger 4: "The DGF is adequately capitalized".

Improving the AML/CFT framework (FSDPO I, II, III)

54. **FSDPO I supported (as a prior action) the approval of a new AML/CFT Law by the Parliament.** The law was published in the *Boletim da Republica* in 2013 and represents a major improvement in the AML/CFT legal framework. As a result, Mozambique is in a much better place to fight money laundering and terrorism financing. Indeed, the new law criminalizes the collection and provision of funds for terrorist activities and groups, as well as expands the application of preventive measures Customer Due Diligence (CDD), record keeping, and reporting obligation) to a broader range of financial and non-financial actors, including in the insurance, securities, real estate, precious stones and metals sectors. The law allows Mozambique to bring its AML/CFT regime into closer compliance with international standards and supports the work of Mozambique's Financial Information Center, which had been hampered by the lack of an appropriate legal framework.

55. **FSDPO II supports (as a prior action) an implementing regulation for the new AML/CFT law.** The regulation was published in the *Boletim da Republica* on October 29, 2014. This Regulation is an important step for Mozambique as it details the CDD measures of the AML/CFT law and addresses some of the changes that were introduced to the international standards in 2013, including the obligation for reporting entities to identify beneficial owners and set up internal systems to assess their exposure to Money Laundering (ML) and Terrorism Financing (TF) risks, the establishment of a risk-based approach in the implementation of AML/CFT measures, and the introduction of transparency measures in the NGO sector to prevent its use in terrorism financing. Further, the authorities have prepared a new Central Bank directive to guide banks and capital market entities in implementing the AML/CFT Law.

56. **Going forward, the authorities are preparing a Counter Terrorism Law**. This Law would establish a legal framework for the implementation of the United Nations Security Council Resolutions related to the freezing of terrorist assets (Resolution 1267 and 1373). While the existing AML/CFT law does not allow freezing without delay of assets held by UN designated terrorists and terrorist organizations, the revised Counter Terrorism Law would fully implement UN Resolutions 1267 and 1373 and address this issue. FSDPO III would support the submission by CoM of this Counter Terrorism Law to Parliament (as a trigger). The IMF is also assisting the authorities to establish a regulatory and supervisory framework for selected designated non-financial businesses and professions, which include among others, dealers in precious metals and stones and real estate agents.

FSDPO II Prior Action 3: "The CoM approves AML/CFT Law Regulations".
FSDPO III Trigger 5: "The CoM submits the draft Counter Terrorism Law to Parliament".

Pillar II: Financial Inclusion

Improving access to financial products in underserved sectors/areas (FSDPO II, III)

57. **The authorities have been working towards developing an adequate regulatory framework that would encourage the growth of innovative financial instruments and services, including e-money issuing, mobile banking and agency banking, in a safe and efficient manner.** E-money issuers have been operating in Mozambique since 2011, and an enabling regulatory environment is important to further encourage the development of e-money issuance by banks and nonbank players. While the legal and regulatory framework does not pose obstacles for e-money issuing by both banks and nonbanks, there is a need to set clear rules for safeguarding customer funds held against the e-money issued. BdM has passed an Aviso requiring that an amount equivalent to the e-money issued be deposited in trust accounts held by the nonbank e-money issuer at an authorized deposit taking credit institution. By setting rules to ensure the availability of the funds for immediate redemption, withdrawal or other use by customers, and to protect such customers against other creditors of the e-money issuer (in the event of insolvency and other similar developments), this measure has the potential to increase trust in e-money as a safe means of payment. The Aviso also requires the use by e-money issuers of interest earned in the trust accounts for increasing efficiency and reducing costs of trust accounts, thus strengthening Mozambique's path toward a more inclusive financial system.

FSDPO II Prior Action 4: "The BdM issues regulations regarding protection of e-money custody accounts (Aviso sobre Protecção de Fundos Resultantes da Emissão de Moeda Electrónica)".

58. **In addition, BdM has passed a regulation that will enable banks and microbanks to engage agents for the delivery of basic financial services.** The regulation enables banks and microbanks to hire retail establishments and others such as nonbank e-money issuers and financial cooperatives to act as agents for the delivery of basic financial services (deposits/withdrawals, transfers, loan disbursement/repayment, bill payments, balance enquiries, account statements, account opening/closing applications, loan application, others). The recent geo-spatial mapping of access points conducted by the WBG under the Financial Inclusion Support Framework (FISF) technical assistance activities will help banks and microbanks better identify areas where agents can be placed. The Aviso has a significant potential impact in enhancing financial access in rural areas, and increasing convenience of access points (and reducing costs for providers) in urban areas. The authorities also aim to develop a comprehensive regulatory and oversight framework for retail payment systems, which takes into account various elements of services delivered through electronic channels, including mobile financial services, internet banking, and remittances. Apart from ensuring safety, efficiency, fairness and open access, inter alia, such regulatory and oversight framework is intended to set minimum standards for governance, risk management (including business continuity), security (including through the use of authentication factors) and consumer protection (including responsibilities in case of frauds or misuse of customer information). The latter will receive support under the FISF program.

FSDPO II Prior Action 5: "The BdM regulates the access and exercise of activities for banking agents".

Increasing the efficiency of borrowers' collateral to promote access to credit (FSDPO I, II, III)

59. **FSDPO I supported (as a prior action) the approval of the draft Insolvency Law by the Council of Ministers, which was passed by Parliament in March 2013, introducing several important aspects that can foster greater access to credit.** This law made resolving insolvency easier by introducing a court-supervised reorganization procedure and a mechanism for prepackaged reorganizations, by clarifying rules on the appointment and qualifications of insolvency administrators, and by strengthening creditors' rights. Largely as a result of this reform, Mozambique moved up 46 points in the 2015 Doing Business Report Resolving Insolvency Indicator from 153 to 107. To support the smooth and effective implementation of the law moving forward, the USAID Speed Project, partnering with the leading business association and law firm in the country launched an ambitious training program for commercial judges throughout the country, training a total of 45 judges and mediators while also disseminating information about the law for both public and private sector audiences. Moving forward, there are plans for the establishment of an Association of Insolvency Lawyers in the country.

60. **FSDPO II would support the re-submission of the draft Credit Bureau Law to Parliament.** The authorities have made progress in encouraging an enabling environment for the establishment of credit bureaus. So far, credit reporting in Mozambique has been limited to the credit registry operated by BdM, which has limitations. A draft Credit Bureau Law was prepared and submitted to Parliament in February 2014. However, the law was not adopted by Parliament prior to elections. Therefore, given that a new Parliament and Government are in place, the CoM re-submitted the draft law to the new Parliament in June 2014, which was approved in July 2014. Following the passing of the law, BdM is planning to adopt a regulation for the operation of credit bureaus, including inter-alia, detailed requirements for collecting credit information and using, storing, protecting and transferring it, rules for refusal, suspension, and termination of the license, principles and responsibilities for internal and external operations of the credit bureau, the rights of data subjects, dispute resolution mechanisms, and other aspects. FSDPO III would support, as a trigger, the passage by CoM of regulation guiding the operations of credit bureaus, and the development of the monitoring and enforcement mechanisms that will allow for a safe, reliable and efficient credit reporting system. In addition to the regulatory framework, BdM will establish an oversight framework for credit reporting, with the monitoring and enforcement mechanisms that will allow for a safe, reliable and efficient credit reporting system.

FSDPO II Prior Action 6: "The CoM re-submits the draft Law to Parliament for the creation of credit bureaus in line with international principles".
FSDPO III Trigger 6: "The CoM passes a regulation guiding the operations of credit bureaus, and develops the monitoring and enforcement mechanisms that will allow for a safe, reliable and efficient credit reporting system".

61. **Reforms to modernize the legal and regulatory framework for secured transactions and to establish a movable collateral registry would support movable assets based lending in Mozambique.** The existing legal framework for secured transactions is fragmented through provisions scattered in a number of laws and regulations. In addition, Mozambique does not have

a centralized registry for security interests in movable assets. This gap, in addition to the deficient legal framework and enforcement procedures, makes movable asset-based lending a risky business. Therefore, priority reforms include: (i) the development of a modern legal framework allowing all types of assets to be used as collateral, and covering the areas of creating and registering a security interest, priorities, enforcement, and debt resolution; and (ii) the establishment of an online movable collateral registry. FSDPO III would support, as a trigger, CoM's submission of the draft Law on Secured Transactions to Parliament.

FSDPO III Trigger 7: "The CoM submits the draft Law on Secured Transactions to Parliament".

Enhancing the transparency of financial information and protecting consumers (FSDPO II, III)

62. **FSDPO II has supported regulations to increase transparency on terms and conditions and charges on bank cards, and on commissions and charges applicable to financial products offered to consumers.** The authorities have been working on strengthening the legal and regulatory framework for financial consumer protection and further efforts are necessary. In this context, BdM has issued a regulation on bank cards, which among other things, sets minimum requirements on the content of service contracts, disclosure of terms and conditions, charges, consumers rights, and minimum services expected, with respect to credit, debit and prepaid bank cards. It is also revising Aviso 5/2009 to increase effectiveness of disclosure of fees and charges for basic financial services, and to improve provisions regarding sales practices. The Aviso also determines prohibited fees, such as those related to monthly current account statements, withdrawals at bank branches, and daily balance enquiries. The reforms are expected to broaden the range of products covered by the protective provisions and also to enhance some provisions on disclosure of information, such as revision of the standard fee nomenclatures. The expected impact would be increased trust in the financial sector, and increased level of usage of bank cards as a result of positive consumer experience.

FSDPO II Prior Action 7: "The BdM establishes minimum requirements for protecting bank card account holders".
FSDPO III Trigger 8: "The BdM amends Aviso 5/2009 to broaden the definition of products and services covered and promote greater transparency and disclosure in the industry, and to establish a standard methodology for financial institutions to disclose total cost of financial products to consumers".

63. **FSDPO III would support additional consumer protection reforms as triggers.** BdM has established a dedicated unit for market conduct supervision, which is being supported with capacity building by the World Bank, under the FISF program, including with respect to the development of supervision and monitoring methodology to ensure compliance with the increasingly improved consumer protection regulation. Additional reforms to be supported under FSDPO III include the issuance by BdM of standard formats for financial institutions to disclose total cost of financial products to consumers and other basic terms and conditions of the most commonly used retail financial products, such as credit cards, consumer loans and current

accounts; support to BdM to strengthen the legal framework for financial consumer protection.[10]. Such reforms will enhance the mandate of BdM in regulating and supervising the protection of financial consumers and the transparency of information in the market.

FSDPO III Trigger 9: "The BdM will strengthen the legal framework for financial consumer protection".

Strengthening and broadening access to payment systems (FSDPO I, III)

64. **A standalone Payment Systems Department (PSD) was established with two Divisions (Development and Services) and an Oversight Unit**. This was a welcome reform, and the oversight unit's capacity is being strengthened with the hiring of additional staff. Considerable efforts have also been made in developing an oversight framework for payment systems with the assistance of the IMF, resulting in the approval of the oversight manual by BdM in 2013. It will be important that the oversight unit's capacity continues to be strengthened through the additional planned staffing and implementation of approved manual.

65. **FSDPO III will support (as a trigger) the elimination of remaining risks in the current Real Time Gross Settlement System (RTGS), and the introduction of failure-to-settle arrangements in the electronic clearing system (CEL).** This measure had been identified as a trigger for FSDPO II but more time will be needed to implement it. The BdM continues to engage in efforts aimed at completing the implementation of the in-house developed RTGS system, with significant challenges and remaining risks. Participation in the system is currently voluntary for banks, eroding the benefits of RTGS processing and posing risks. The link between the BVM's Central Securities Depository (CSD) and the RTGS system is yet to be achieved. In light of the risks still posed by incomplete implementation of the RTGS system, the CEL continues to be the main system for handling payments and settlement obligations arising from the interbank transactions, which also faces settlement risks.[11] In order to reduce settlement risk, BdM's Board has approved revisions to the CEL system regulations, but they are yet to be implemented in the system. FSDPO III would support as triggers BdM's introduction of failure- to- settle arrangements in the CEL system, and the elimination of remaining risks in current RTGS system; as well as the adoption by BdM of an oversight framework for retail payments, including remittances building on the support of the WB FISF Program. The RTGS system which was implemented as a module of the BdM's core banking system appears to be based on legacy technology which is not rules based. Modern technology enables the combination of the RTGS system component and the CSD, the so called automated transfer system (ATS). A number of emerging economies have implemented the newer version of the RTGS system which offers more features, efficiency and dynamic management of collateral within the system to reduce settlement risk. The authorities could consider this option in order to avert possible reputational and operational risk emanating from the time it has taken to fully implement the RTGS system.

[10] The development of a standard methodology for financial institutions to disclose the total cost of a financial product was identified as a trigger for FSDPO II but, given a list of priority reforms in the area of financial consumer protection, it will be supported by FSDPO III.

[11] In value terms, over 70 percent of total settlements is handled through the CEL system, notwithstanding its deferred net settlement (DNS) nature and inherent risk.

FSDPO III Trigger 10: "The BdM introduces failure-to-settle arrangements in the CEL system and addresses risks remaining in current RTGS system."
FSDPO III Trigger 11: "BdM adopts an oversight framework for retail payments, including remittances, and prepares a retail payment system strategy in close cooperation with other authorities and market players".

Pillar III: Development of Long-Term Financial Markets

Strengthening government securities primary markets (FSDPO I, II, III)

66. **The Government wishes to develop the domestic bond market, which in the medium/long term would provide an important anchor for deepening capital markets.** Recent measures to strengthen debt management practices include establishing a debt management committee, publishing for the first time a medium-term debt management strategy, preparing annual borrowing plans for Government bonds (2013 and 2014) and issuance by MoF (now MoEF) of a decree and related legislation that establishes primary dealership system for Treasury Bonds (OTs) in primary and secondary markets.

67. **FSDPO I supported (as a prior action) the implementation of at least two competitive bond (OT) auctions by the MoF following the 2013 annual borrowing plan and in line with the primary dealership legislation (Decreto 5 of March 2013 and Diploma 90 of April 2013) and the public announcement of the auction results on the BVM website.** Five auctions were conducted in total in 2013: one in April, June, September; and two in December. The April auction allowed the market to set the price for the first time and was oversubscribed 3.8 times. This issuance and the others that followed in 2013 paved the way for the initial development of the primary market and even more active issuance in 2014. Both the government and investors have started to develop a common understanding on the functioning of the primary market, which also helped identify areas that require further improvement. New reforms to support primary markets are being designed with help of WB TA funded by FIRST as discussed below.

68. **FSDPO II supports the implementation of the bond issuance calendar envisaged in the 2014 annual borrowing plan by conducting at least four competitive auctions.** In the long-term, a well-developed, communicated and implemented borrowing plan is expected to improve the functioning of the primary market and promote better price discovery for other issuers. Competitive auctions in 2014 exceeded the number included in the prior action (four), reaching 8. Nevertheless, no issuances have occurred in 2015 given that the 2015 Borrowing Plan was only approved in June 2015. The approval of the Borrowing Plan, in turn, was dependent on the approval of the 2015 Budget Law which only occurred in May. The passage of this year's Budget Law has been delayed given the recent elections for the Government and the Parliament.

FSDPO II Prior Action 8: "The MoEF implements the bond issuance calendar envisaged in the 2014 annual borrowing plan by conducting at least four competitive auctions".

69. **The process of reopening OTs will be supported by FSDPO II and III.** Ongoing WB TA funded by FIRST will support authorities in this exercise including on the assessment of any potential IT bottlenecks. The implementation of reopenings requires prior and careful assessment to identify volumes, maturities of securities to be reopened as well as the frequency of such

operations. The introduction of reopenings has been integrated in the preparation and publication of the 2015 annual borrowing plan. The World Bank, as part of the ongoing FIRST Debt Market Development TA Project has already provided technical assistance in the preparation of the planning re-opening of OTs.

FSDPO II Prior Action 9: "MoEF announces its intention to conduct at least one reopening of OTs in 2015".
FSDPO III Trigger 12: "Substantial progress in the process of reopening the OTs by including on BVM website the target amounts of every series of OTs and conducting at least 1 reopening of OTs".

70. **FSDPO III would support the review of Decree 5/2013 and Diploma 90/2013 incorporating improvements in auction rules and in Obligations and Incentives of Primary Dealers (OEOTs).** The issuance of Decree 5/2013 and Diploma 9/13 represented a major step for the initial development of the government securities markets (OTs). The two regulations include general provisions for the OT market and technical aspects related to placement, issuance and trading of these government bonds, including a set of OEOTs. Several areas for improvements in these regulations that could better support the development of the OT market are being mapped with the support of FIRST Debt Market Development TA Program. Examples include aligning auction mechanism rules to the best international practices and revising the set of incentives and obligations of OEOTs to encourage greater participation in primary and secondary markets. New regulations incorporating recommendations from the ongoing TA program are expected to be enacted by December 2015.

FSDPO III Trigger 13: "Review of Decree 5/2013 and Diploma 90/2013 incorporating improvements in auction rules and in the incentives and obligations of OEOTs".

71. **FSDPO I supported (as a prior action) the passage by MoF of a Diploma on the operational norms of the CSD for the BVM.** The Diploma recognized the powers of BdM as the regulatory authority to oversee the CSD, identifies participants and the role of other players in the CSD. The operational procedures being developed by the BVM will further elaborate the standards laid down in the Diploma in order to enable delivery vs. payment (DVP). These reforms will further strengthen the framework for the settlements of capital market transactions.

FSDPO III Trigger 14: "The BVM approves the procedures for the CSD to enable delivery versus payments (DVP)."

72. **FSDPO I supported (as a prior action) the issuance by BdM of a comprehensive set of norms to update money market regulation.** This package paves the way for stronger interbank activity, which could leverage reforms for longer-term financing. An active money market is a critical pillar in the overall development of Government bond markets and longer-term financing. Improved liquidity management and price discovery in money markets allow market participants to fund longer-term portfolio allocations.

Enhancing long-term funding sources (insurance and pensions) (FSDPO II, III)

73. **Growing the presently under-developed insurance sector is a priority for the Government.** Insurance penetration in Mozambique is still shallow (only 1.5 percent of premium to GDP). Life insurance products such as deferred and immediate annuities complement public and corporate pensions as a key pillar of many countries' retirement provision architecture; however life insurance in Mozambique is much smaller than the small non-life insurance sector. The *Instituto de Supervisão de Seguros de Moçambique* (ISSM) has been created in 2011 as the successor of the previous supervisory department of the MoF to oversee the insurance, reinsurance, and pensions sectors. ISSM recognizes that it will benefit from considerable capacity building in order to establish the procedures necessary to supervise the insurance industry according to international best practice, and to keep regulation and supervision up to the evolution of insurance.

74. **A revised insurance law was enacted in 2010 and corresponding regulations approved in 2011.** This law includes regulations for micro-insurance. The intention is to allow access to formal insurance to considerably larger populations of first time customers. This will require the ISSM to monitor a considerably larger number of innovative insurance concepts provided by a new array of intermediaries to people who are particularly vulnerable to mis-selling or misunderstanding. It will increase ISSM's responsibility to detect and impede inappropriate products submitted to it under the current file-and-use system. The advent of micro-insurance will also grow the market for voluntary retail insurance sold to increasing numbers of households, thus contributing to the growing importance of the ISSM's consumer protection role. The ISSM has passed in June 2015 the Aviso setting the maximum coverage limits for micro-insurance, which is the final piece for the micro-insurance regulatory regime.

FSDPO II Prior Action 10: "ISSM sets maximum coverage limits for micro-insurance products".

75. **Pension regulations are expected to receive TA from the proposed FIRST funded TA and were identified in the WB consumer protection review carried out in Mozambique.** Recent relevant reforms to promote pensions sector development in Mozambique include the establishment of a pension regulator (ISSM in 2012), approval of pensions regulation (Council of Ministers Decree No. 25/2009 Regulations on the Establishment and Management of Pension Funds as a Form of Complementary Social Security) and licensing of private pension funds during 2010-2014. Nevertheless, oversight/supervision of this sector has several weaknesses. The proposed pension regulations to be supported by FSDPO III will help fill gaps in the current regulatory framework and start imposing proper operational standards on the industry, giving the regulator a framework in which to judge acceptable market behavior. The regulations will help the supervisor by clarifying the most important issues to oversee and standards to be observed by funds and their providers. Giving the regulator a strong framework to assess the funds and to strengthen their position vs. the industry (so that they have objective measures for assessment and then to impose changes in behavior) will be an important part of building supervisory capacity and therefore ensuring the industry develops on a sound basis.

FSDPO III Trigger 15: "ISSM issues pension regulations".

76. **FSDPO III would support the approval of an updated manual for on and off site supervision in the pensions and insurance sector**. ISSM intends to move towards a risk based

approach to supervision, especially for non-life insurance. This will be accompanied by strengthening the supervisor's ability to regularly collect and analyze timely relevant data from insurance companies and pension funds. This will provide important additional information to incorporate risk based supervision procedures. Although an inspection manual for insurance exists, it needs to be updated to reflect the new realities and expanded objectives. The manual also needs to be adapted to cover specificities for the pension sector (such as how to assess the governance of the pension fund Supervisory Boards). The updated manual for insurance and pensions will also promote stronger consumer protection and marketplace transparency. In the case of insurance, through requiring key fact statements for insurance products; in the case of pensions, through providing private pensions account holds with online access to their individual account information.

FSDPO III Trigger 16: "ISSM approves an updated manual for on and off site supervision in the pensions and insurance sector."

5.3 LINK TO CPS, OTHER BANK OPERATIONS AND THE WBG STRATEGY

77. **FSDPO contributes to the three pillars of Mozambique's CPS (FY 12-15):** (i) Competitiveness and Employment; (ii) Vulnerability and Resilience; and (iii) Governance and Public Sector Capacity. FSDPO is included under *Pillar I* of the CPS to promote access to financial services while consolidating achievements in FS stability and soundness. FSDPO series supports the overarching goal of the CPS of broad-based inclusive growth by enhancing financial inclusion and stable financial markets. More developed financial markets also boost productivity by improving capital allocation and promoting entrepreneurship. FSDPO II contributes to *CPS Pillar II* by promoting financial stability and better access to financial products (e.g. payments, savings, insurance and credit) that enhance the resilience of individuals and enterprises to shocks. Recent financial crisis have made evident their potential to inflict large economic and social costs, proportionally larger for poorer segments. In particular, the DGF supported by FSDPO provides assurance to small savers on the recovery of their deposits in case of bank failure. *CPS Pillar III* is supported through FSDPO II reforms related to public debt management and AML/CFT.

78. **The PDO of the FSDPO series contributes directly to the WB's twin goals of ending extreme poverty and promoting shared prosperity by promoting FS development.** FS development is pro-poor and is associated with significant declines of extreme poverty. Pillar I will contribute to a stable financial system (thereby benefiting the poor to a greater extent) and support a DGF that will protect the savings of smaller depositors. Pillar II will contribute to the WBG's twin goals by enhancing financial inclusion and focusing on reforms that will benefit lower income individuals, smaller enterprises and rural areas in particular (such as credit bureaus and branchless banking). Pillar III will contribute to the diversification of funding sources for business (thereby stimulating private investment, economic growth, and poverty reduction) and the development of pensions and insurance sectors, which will reduce vulnerability and enhance resilience to shocks by individuals and enterprises.

79. **FSDPO series builds on previous FS projects and complements ongoing projects to reach CPS goals.** FSDPO builds on the achievements of the Financial Sector Technical Assistance Project (FSTAP) and of the FIRST TA, which promoted FS stability and supported reforms that will be deepened by FSDPO II. This DPO will also benefit from the 2009 Competitiveness and Private Sector Development Project and the 2013 Integrated Growth Poles Project, which contribute to CPS Pillar I by seeking to improve the business environment, strengthen SMEs'

capacity, and improve the performance of enterprises. Finally, a three DPO series complements the proposed FSDPO to achieve CPS goals. The PRSC series consists of three operations (the 9th approved in 2013 and 10th approved in 2014) which seek to improve the business climate and the transparency in the management of extractive industries, strengthen social protection, and enhance PFM (the latter including the medium term debt management strategy and implementation of borrowing plan, which are complementary to reforms supported by FSDPO Pillar 3). The ongoing Agriculture DPO series (AGDPO) is a series of three operations to improve agricultural technology, enhance access to productive assets and financial services (thereby complementing Pillar II of the FSDPO series), and improve monitoring of sector performance. AGDPO supports CPS Pillar I in a policy area that is not covered by FSDPO. The Climate Change DPO series consist of three DPOs (the first was approved in 2013 and the second in 2014) that build effective institutional and policy frameworks for climate resilient development. This contributes to CPS Pillar 2 by working in a policy area that is not included in the FSDPO series. Reforms supported by the FSDPO under Pillar II (particularly credit bureaus and branchless banking) reinforce existing IFC FIG's Africa Micro Small and Medium Enterprises (AMSME) advisory program projects in Mozambique, which seek to promote SME banking (through a project with Bank ABC Mozambique) and increase access to finance for women entrepreneurs (through a project with BCI Fomento Mozambique). Lastly, Pillar III of the FSDPO series would complement IFC's F&M's Global Index Insurance Facility (GIIF) advisory project (which is in pre-implementation phase) and is targeted to operate in Mozambique, among other countries.

5.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

80. **FSDPO series is aligned with MFSDS, which followed a broad and inclusive preparation process; collaboration with other donors active in the FS is strong.** The FSTAP left a legacy of a strong cooperation between the Bank, AfDB, KfW, and GIZ. A Memorandum of Understanding (MoU) was signed in 2009 between the Government and the 19 donors providing general budget support (including the Bank). DFID has launched in 2014 a Financial Sector Deepening Trust (FSDT), which seeks to replicate the success of Kenya's FSDT in promoting access to finance and will provide TA for policy reforms under this operation. The Bank has also been liaising closely with the UNCDF on their forthcoming program for promoting greater financial inclusion. Consultations with other donors take place regularly through the Financial Sector Working Group, which brings together leading donors in the FS for periodic updates, exchange of information, and coordination of policy dialogue. The Bank is an active member of the Private Sector Working Group, which promotes a more enabling business environment for private sector development, including greater access to finance for MSMEs.

VI. OTHER DESIGN AND APPRAISAL ISSUES

6.1 POVERTY AND SOCIAL IMPACTS

81. **Mozambique remains one of the poorest countries in the world despite high GDP growth and it is increasingly recognized that growth has become less pro-poor over time (Jones and Tarp 2012; DNEAP 2010; Arndt et al 2012).[12]** While Mozambique is one of the

[12] Jones, Sam and Finn Tarp (2012); "Jobs and Welfare in Mozambique: Country Case Study for the 2013 World Development Report"; United Nations University, World Institute for Development Economics Research. DNEAP (2010); "Pobreza e bem-estar em Moçambique: Terceira avaliação nacional"; Technical report; Ministry of Planning

fastest growing economies in SSA, poverty reduction in the country has been considerably less responsive to growth than in the rest of the region. As a result, consumption poverty rates have remained persistently high. This is especially true in the rural areas, suggesting a widening urban-rural gap and upward pressure on income inequality. While Mozambique has continued to experience a general decrease in poverty, this has been heavily concentrated in urban areas, where only 30 percent of the population resides (Alfani et al 2012). Poverty is concentrated most heavily in the country's Central and Northern regions. Mozambique's low growth elasticity of poverty reduction is a major challenge that needs to be addressed to accelerate poverty reduction (World Bank 2015)[13]. In turn, increased disparities across provinces seem to be the main determinant of Mozambique's poor performance in translating growth into poverty reduction.

82. **Rapid macroeconomic growth has not been accompanied by a transformation of the labor market (Jones and Tarp 2012).** The economy has failed to generate sufficient high quality jobs that effectively translate macroeconomic growth into welfare gains. Mozambique's population tends to be young and rural and is growing rapidly. The majority of Mozambicans earn a living from smallholder agriculture, and the very low productivity of these activities is a key reason why poverty remains high. Productivity gaps between sectors are large and widening and this is largely due to the slow productivity growth in agriculture. Spatial differences in the distribution of labor are large with the central and northern regions having the bulk of the agricultural workforce and overall population.

83. **The proposed operation is expected to have positive social and poverty impacts by promoting FS development.** Evidence strongly indicates that, when effectively regulated and supervised, financial development spurs economic growth, reduces income inequality and helps to lift households out of poverty (World Bank 2008). Well-developed financial systems have a strong positive impact on economic growth over long-term periods (Levine 2005; Demirguc-Kunt and Levine 2008). FS development is also pro-poor and is associated with significant declines of extreme poverty (Beck, Demirguc-Kunt and Levine 2004 and 2007). While not conclusive, empirical evidence suggests that there is a strong beneficial effect of financial development on the poor and that poor households and smaller firms benefit more from financial development. For households, financial development facilitates consumption smoothing and human capital investment. For firms, increased access to finance is associated with higher returns and better performance. Similarly, theory indicates that financial development facilitates entrepreneurship by people with promising ideas but little collateral and income and provides access to risk management among others (Demirguc-Kunt and Levine 2009).[14] FS development reduces income inequality by disproportionately boosting the income of the poor and evidence suggests that the indirect effects of finance on inequality are substantial (Demirguc-Kunt and Levine 2004 and 2009).

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and Development, Government of Mozambique. Arndt, C., Hussain, M.A., Jones, E.S., Nhate, V., Tarp, F. and Thurlow, J. (2012); "Explaining the evolution of poverty: the case of Mozambique"; *American Journal of Agricultural Economics*.

[13] "Concept Note: Mozambique Poverty Assessment: Translating Growth into Faster Poverty Reduction and Shared Prosperity"

[14] Demirguc-Kunt, Asli and Ross Levine (2009); "Finance and Inequality: Theory and Evidence"; Policy Research Working Paper 4967.

84. **FSDPO II Pillar I will contribute to a stable financial system, thereby benefiting the poor to a greater extent.** Financial crises harm the poor disproportionately, affecting poverty and income distribution through a variety of channels (Baldacci, de Mello and Inchauste 2002).[15] Financial crises typically lead to a slowdown in economic activity and, consequently, rise in unemployment and/or falls in real wages. If there is also fiscal retrenchment, this often leads to cuts in public outlays on social programs and transfers to households among others. Thus, financial crisis are associated with deterioration in poverty indicators. Specifically, the DGF supported by the FSDPO series is expected to minimize the fiscal costs associated with the resolution of financial institutions and protect the savings of smaller depositors. Pillar I also includes stronger AML/CFT safeguards for the financial system which are essential for the system's integrity and stability. However, one inadvertent impact of stricter AML/CFT requirements is limiting access to low income clients as banks impose additional documentation and Know-Your-Customer (KYC) requirements. This adverse impact can be mitigated by banks applying more of a risk-based approach to KYC requirements so that low income clients are not negatively impacted.

85. **Under Pillar II, better financial inclusion will benefit the poor.** Modern development theory sees the lack of access to finance as a critical mechanism for generating persistent income inequality and slower growth (Demirguc-Kunt and Levine 2008). Small enterprises and poor households face much greater obstacles in their ability to access finance all around the world but more so in developing countries such as Mozambique. Reforms under FSDPO II Pillar II will benefit lower income individuals, smaller enterprises and rural areas in particular. First, credit bureaus should contribute to increased access and affordability of financial services (Demirguc-Kunt and Levine 2008). Better credit information is particularly beneficial for individuals and enterprises with little or no collateral. This is the case of low income individuals and micro and small enterprises. Low income individuals, in particular in the rural areas, cannot by law use their main asset, i.e., land, as collateral. Further, these individuals often own small household firms where they sell their agricultural produce. But without a proper credit information system, they are unable to access the financial system in order to start, operate, and expand their businesses. As a result, household enterprises often operate on a low productivity basis, with implications for the poor. Second, in most cases, the difficult access to the banking system by the poor occurs because banks work where they have economies of scale. In other words, the spread of formal banking services rises with income. And as discussed above, incomes are lower in the rural areas, in particular in the Central and Northern provinces of Mozambique. Reforms to expand agency banking and e-money will have a positive impact on vulnerable groups by expanding financial services in these areas and by reducing transactions costs (e.g. traveling costs) through electronic systems. This allows accounts to be maintained at relatively low costs to savers and borrowers located in these underserved areas. Third, reforms on consumer protection and financial information will be particularly helpful for less sophisticated consumers. Lack of knowledge about the type of charges implemented by the banks often push away uneducated and low income individuals from the financial system. They would rather opt for less secure and more expensive ways of saving their incomes and of accessing funds. Anecdotal evidence mentions burying money and/or placing it under the mattress as some of the ways the poor save. As for accessing funds, they often resort to expensive informal micro money lenders. Thus, with improved transparency on terms and conditions of charges on financial products and services, low income individuals will have a greater incentive to approach the financial system.

[15] Baldacci, Emanuele, Luiz de Mello and Gabriela Ichauste (2002); "Financial Crisis, Poverty and Income Distribution"; IMF Working Paper.

86. **FSDPO II will promote women's access to finance.** For example, promoting innovations and improvements in financial products and delivery models (such as e-money and agency banking) would benefit women in particular since they have more time and mobility constraints than men. Addressing constraints on the demand side begins with reinforcing the ability of women to act as informed and capable financial consumers. Therefore, reforms to strengthen financial consumer protection would also benefit women, who are more vulnerable than men and usually have lower financial knowledge and skills. Finally, reforms to increase the efficiency of collateral (such as credit bureaus and collateral registries) which allows women to establish a credit history and use a broader set of assets would improve their access and usage of financial services.

87. **FSDPO II Pillar III will contribute to the diversification of funding sources.** This diversification is expected to stimulate private investment, economic growth, and poverty reduction. Actions to strengthen government debt markets are critical for reducing costs and increasing efficiency in the banking sector. For instance, regular supply of government bonds will improve predictability and transparency in the FS; auctions of government securities and their announcement will improve efficient pricing of financial instruments. Additionally, FSDPO III will promote the strengthening of the insurance and pensions sectors. While insurance reduce individuals and enterprises vulnerability to shocks, pensions provide protection against the risk of poverty in old age and can provide an important source of domestic long-term capital for investment.

6.2 ENVIRONMENTAL AND SOCIAL ASPECTS

88. **This operation is not expected to have any negative environmental impacts given the policy areas and reforms covered.** FSDPO II prior actions seek to enhance financial stability (Pillar I), promote financial inclusion (Pillar II), and develop long-term financial markets (Pillar III). Reforms to promote financial inclusion can increase access to credit, particularly for smaller firms. This could generate the creation/growth of localized and easy to implement businesses (small scale income generating activities, such as flower growing, horticulture, agriculture, etc.). Although some minimal downstream impacts may occur as result of the small income activities, these efforts will be easily dealt with and monitored by the Government, particularly the Ministry of Agriculture and Food Security (MINASA) and the Ministry for Land, Environment and Rural Development (*Ministério para a Terra, Ambiente e Desenvolvimento Rural* - MITADER) which is the leading agency responsible for the implementation of the Environment Law and coordinates all aspects related to environmental management. These entities are currently implementing Bank funded projects which have existing well trained Environmental & Social Safeguard Specialists. Furthermore, MITADER and MINASA have acquired considerable experience with World Bank projects and are quite familiar with implementation and supervision procedures including with the set of environmental and social national regulations. Both entities are staffed with sufficient technical capacity to monitor such micro-projects likely to be funded by financing services.

89. **The legal framework for environmental protection is relatively well developed in Mozambique, and efforts are being made to strengthen implementation and enforcement capacity.** The Law on the Environment (Law No. 20/97) is the basis for environmental regulations and applies to all public and private activities with potentially significant environmental consequences. The Environmental Legislation in Mozambique establishes the general basic principles of environmental policy. The environmental law promotes among other things, the rational use and management of environmental components so as to promote improvements in the quality of life of the citizens and to value the traditions and knowledge of local communities.

Whereas the Environmental Law establishes general principles for the proper management of natural resources, other legal instruments that complement the contents of this law have been approved, in particular the Decree 45/2004. This decree is especially relevant for environmental conservation and preservation, given that it seeks to define various limitations and prohibitions in accordance with the area in question, determines the need for approval of complementary standards governing some specific activities (e.g. the catching of ornamental fish and coral reefs to be protected, among other things). In addition, it determines competences related to issuing various licenses and permits as well as the need for the opinion of other entities with competences in this area. The supervision of the application of these regulations is attributed to MICOA now restructured to the new Ministry of Land, Environment and Rural Development.

6.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

90. **Mozambique's PFM system is considered adequate to support the FSDPO series.** While there have been successful PFM reforms in the country, there are still challenges, particularly in terms of application of internal controls at decentralized levels, the flow of funds to and information gathering from remote districts, the lack of PFM staff, delayed budget releases and the high levels of off-budget spending. On-going PFM reforms are fully geared up to respond to these challenges. Hence, the FSDPO II will be disbursed following standard IDA procedures.

91. **PFM improvements have been a cornerstone of reforms towards good governance and sound macroeconomic management.** Public Expenditure and Financial Accountability (PEFA) indicators show a trajectory of improvement since 2006. These improvements have been in all dimensions, including multi-year planning, annual budgeting, procurement, accounting, internal controls, auditing, and public access to key fiscal information. The *Sistema de Administração Financeira do Estado* (SISTAFE) legislation (2002), along with new PFM policies and procedures, provided a solid foundation for the PFM structure, and a government-wide IFMIS (e-SISTAFE) has been implemented progressively as the information technology platform for implementation of the legislation. Approved budgets and key financial reports are made public on the website of MoEF. While weaknesses in internal controls and the limited use of external audits remain a concern, the government continues to strengthen these systems with support from development partners. Mozambique's State Budget is published by the government and accessible to the general public in printed form and through the website of MoF's Budget Directorate, both the proposed budget as well as the version approved by the national assembly. Quarterly budget execution reports are also published, up to 45 days after the end of the quarter. According to the most recent Open Budget Survey, the Open Budget Index for Mozambique has risen significantly, from 28 in 2010 to 47 in 2012. Accordingly, the FM risk rating for the Operation is moderate.

92. **Substantial progress has been achieved in institutional and regulatory procurement reforms, but gaps remain between these and the procurement performance of sector delivery systems affecting transparency and accountability.** The Government has established the legal framework and institutional architecture of a public procurement system that generally meets international standards of efficiency and accountability. However, it would be important to introduce an independent complaint system to increase the integrity and functionality of the public procurement system.

93. **Going forward, the updated PFM Vision 2011-2025 is the guiding tool for PFM improvements in Mozambique.** Implementation of this Vision is supported by development partners and an amount in excess of US$157 million is planned for five years. The Bank is

supporting PFM reforms through various projects, including the PRSC 9, the National Decentralized Planning and Finance Program and the Cities and Climate Change Project.

94. **Anti-fraud and corruption measures in Mozambique are established through various laws and regulations (including an outdated penal code; more recent anti-corruption laws; and a Defense of the Economy Law from 1982).** The Anti-Corruption Law, adopted in 2004 (Law No. 6/2004 and Decree No. 22/2005)[16] and limited to corruption involving bribes, is being revised and strengthened. The Anti-Corruption Package, adopted by the Council of Ministers in July 2011, and submitted to Parliament for approval in December 2011, is yet to be approved in its entirety. Nonetheless, some important anti-corruption legislative pieces have been approved, including (i) Whistle-blower and Witness Protection Law, which came into effect on December 13, 2012; (ii) Public Probity Law, which includes conflict of interest and asset declaration requirements; (iii) Organic Law of Prosecution Service, which allows the Anti-Corruption Agency (*Gabinete Central de Luta contra a Corrupção* - GCCC) to investigate and prosecute corruption crimes, including embezzlement, illicit enrichment, and conflict of interest. The amendment of Anti-Corruption Agency competencies is already in effect, but whistle-blower and witness protection legislation will take time and resources to be fully implemented. At that time, the legislation would provide Mozambique a strong anti-corruption framework consistent with best practices.

95. **The proposed financing will be disbursed following standard IDA disbursement procedures**. The financing will be disbursed as a single tranche after effectiveness and fulfilment of the tranche release conditions and upon submission of acceptable withdrawal applications from the MoEF. IDA will deposit the funds in a dedicated foreign exchange account of BdM in Frankfurt which is included in the country's foreign exchange reserves. Within two working days, the BoM will credit the Metical equivalent of the funds to the Transit Account of the MoEF. The Metical equivalent funds will be transferred from the dedicated account to the *Conta Unica de Tesouro* (CUT) and will be used as State budget revenue and recorded in the State accounts as such. Within 30 days of the BoM being credited, the Government of Mozambique will provide confirmation to IDA that the amount of the Credit has been credited to the MoEFs CUT and that the funds are available to finance eligible expenditures. The funds will not be used for Excluded Expenditures in accordance with the Financing Agreement. If the Bank determines at any time that an amount of the Credit was used to make a payment for an excluded expenditure, the Borrower shall promptly make a refund of such amount upon notice from the Bank. In line with noted improvements in PFM, particularly in oversight and follow-up mechanisms, an audit report will not be mandatory under the series. However, IDA will reserve the right to request an audit should it feel there is a need for such. Should an audit be requested, a legally registered, private and independent audit company meeting international standards on auditing and qualifications of the auditors assigned will perform the annual audit in accordance with Terms of Reference to be agreed upon with the GoM. The Government shall equally ensure that the annual entity financial statements of the BoM are audited in accordance with international standards on auditing as promulgated by the International Federation of Accountants, and are publicly available. Audit costs will be met by the GoM.

[16] Law No 1/79 dated January 11 and Law No 9/87 dated September 19 covered anti-corruption issues before the revised legislation in 2004-05.

96. **The IMF concluded a Safeguards Assessment of the Mozambique Central Bank in mid-2011, which confirmed that its control, accounting, reporting, and auditing systems are adequate and aligned with international standards**. The assessment made recommendations to further strengthen the governance structure of the BdM, notably by opening the Central Board and the Audit Board to independent experts from outside the BdM and MEF. It also recommended that the Audit Board should ensure more systematic follow-up of audit recommendations and that the audit charter be subject of an external quality assurance review in accordance with international standards. The authorities are in the process of implementing the action plan that was drawn-up as a result of the safeguards assessment. In the context of the IMF PSI, the Government agreed to follow up on the recommendations of the Assessment and implement a series of related measures.

6.4 MONITORING AND EVALUATION

97. **MoEF will be responsible for the overall oversight and implementation of the DPO.** Within MoEF, the lead department will be the National Treasury. The BdM is a key partner in implementation as many of the actions under the inclusion and stability pillars fall under its purview. BVM will be the main technical agency for the actions related to capital markets while the ISSM will be the main technical agency for actions relating to insurance and pensions. MoEF and BdM, as the lead implementing agencies, have extensive experience and are fully versant with Bank policies and procedures through investment lending and policy based operations.

98. **A results framework has been developed for the Operation (Annex 1).** The results framework is consistent with the goals set out in the MFSDS and the broader Five Year Government Plan. The monitoring of FSDPO II will benefit from the Government's monitoring and evaluation mechanisms for the implementation of the MFSDS. The achievement of targets will be assessed based on market players and household surveys and will draw on the regular supervision function of the BdM, national level data, and specialized surveys on access to be conducted. The World Bank will play a supporting and monitoring role, reviewing progress and making needed adjustments. The FSDPO II team will monitor overall progress achieved towards the expected outcomes of the DPO series. The review will be based largely on the monitoring indicators and the goals of the program.

99. **Grievance Redress**. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

VII. RISKS AND RISK MITIGATION

100. **The overall risk rating for FSDPO II is moderate.** The three main risks to this operation are related to implementation capacity, macroeconomic management, and political commitment to reform given the change in administration.

101. **FSDPO II has an implementation capacity risk given the range and relevance of reforms covered and the concentration of these reforms in two implementing agencies. Implementation capacity risk is moderate.** The concentration of efforts helps to streamline and focus the dialogue and the two lead agencies possess relatively well trained staff and advanced systems. However, there are several measures to be implemented by the MoEF and BdM and some require numerous technical decisions. To ameliorate the implementation capacity risk the team is: (i) maintaining an ongoing dialogue with the authorities on the reform package; (ii) providing targeted TA on supported reforms and coordinating further TA to be provided by Bank/IFC experts and other donors; and (iii) considering the political economy of reform while following a pragmatic approach, understanding that some complex financial sector reforms take more time to materialize.

102. **The second risk is the maintenance of a stable macroeconomic environment due to: an expansionary fiscal policy, rising public debt, rapid increases of CA deficits and downside risks. Macroeconomic risks are moderate.** Fiscal policy has become expansionary, with increased spending (related with personnel costs for priority sectors and the elections as well as infrastructure projects and EMATUM) and a higher budget deficit. There is also rising public debt (to finance infrastructure investments), with a rising share of non-concessional loans in new external debt. The authorities have committed to tighten fiscal policy though (and this is reflected in the approved 2015 budget). As savings remain relatively low and large investments are being made by the public and private sectors, the CA deficit is worsening. The deficit does not indicate a fundamental imbalance in the economy though it reflects the impact of rapid import growth associated with large FDI inflows. The Mozambican economy also faces significant downside risks such as declines of commodity prices and the country's security situation, which could affect the development of coal and gas sectors. Government capacity needs to be strengthened: (i) in the medium term given the expected increase in government revenues from natural resources; and (ii) in the short term to manage government debt and public investment related with infrastructure investments. Prior actions included in this DPO (Pillar III), the PRSC series and the IMF PSI will mitigate risks related with this lack of government capacity. The GoM has a stable working relationship with the IMF anchored by a PSI, which has contributed to ensuring sound macroeconomic management.

103. **There are political risks associated with the change in administration. Political risks are substantial.** Following the October 2014 elections, Mozambique has a new president since January 2015 who comes from the ruling party Frelimo. Frelimo also secured a strong majority in the parliament (144 seats out of 250 in total), though in sharp decline compared to the previous election in 2009 when it garnered 75 percent of the vote. Renamo, the largest opposition and former rebel group, more than doubled its seats (89 seats), and MDM, a third political party with parliament representation, obtained 17 seats, also doubling its presence. A new Government was named in January 2015 streamlining several Ministries with a key change being the merger of the former Ministry of Planning and Development MPD and the Ministry of Finance into a new Ministry of Economy and Finance. Political risks for the FSDPO series are mitigated by the highly participatory process through which the new MFSDS was developed, which strengthened the

ownership of the strategy by stakeholders in government, the private sector and financial institutions. The continuation of FS reforms in prior election cycles and stability of the technical staff in the relevant implementing agencies are also mitigating factors of political risk. Further, the DPO series focused on prior actions that were advanced and support the Government on the implementation of reforms covered by the DPO series through related TA. The likelihood of major policy reversals with this new Government is therefore limited; indeed the new Government has largely continued the reform program adopting several reforms both in the financial sector and in other key areas since it was installed.

Risk categories	Rating (H, S, M or L)
1. Political and governance	**S**
2. Macroeconomic	**M**
3. Sector strategies and policies	**M**
4, Technical design of project or program	**M**
5. Institutional capacity for implementation and sustainability	**M**
6. Fiduciary	**M**
7. Environmental and social	**L**
8. Stakeholders	**L**
9. Other	
Overall	**M**

H: High; S: Substantial; M: Moderate; L: Low

ANNEX 1: POLICY AND RESULTS MATRIX

PRIOR ACTIONS UNDER DPO I (Approved Board Date July 2014)	PRIOR ACTIONS UNDER DPO II (Board Date September 29, 2015)	PROPOSED TRIGGERS FOR DPO III	RESULTS
PILLAR I: FINANCIAL STABILITY			
Enhancing banking regulation and supervision			
The BdM has issued a loan classification regulation that revises the definition and recording of non-performing loans (NPLs) to bring them more in line with international best practices. The BdM has issued risk management guidelines for banks fostering better risk management practices in line with international best practices.		The BdM issues an Aviso to increase minimum capital levels for banks. The BdM revises its regulation on concentration limits incorporating limits on placements abroad.	Percentage of banks classifying their NPLs according to the new regulation Baseline: Regulation not yet issued (March 2013). Source: BdM Target (2017): At least 85 percent of banks, representing not less than 90 percent of the total bank assets. Percentage of banks implementing the new risk management guidelines Baseline: Risk management guidelines have not been issued (March 2013). Source: BdM Target (2017): At least 85 percent of banks, representing not less than 90 percent of total bank assets.
Strengthening the banking safety net and crisis management frameworks			
BdM has developed and approved regulations pertaining to emergency liquidity assistance (ELA) for banks enabling it to act as lender of last resort.	The BdM strengthens the crisis management framework by conducting a crisis simulation exercise (CSE) to identify weaknesses/gaps.	Implementation of actions to address weaknesses/gaps identified in the CSE.	
The MoF and BdM have concluded the nomination of all members of the Management Committee of the Deposit Guarantee Fund (DGF).	The MoEF capitalizes the DGF with initial Government contribution based on Decree No. 49/2010.	The DGF is adequately capitalized.	Percentage of deposits balances and accounts covered by the DGF Baseline: 0 percent (March 2013). Source: DGF Target (2017): The DGF is operational and is insuring depositors up to a coverage limit, which would insure at least 90 percent of the total deposit accounts.

PRIOR ACTIONS UNDER DPO I (Approved Board Date July 2014)	PRIOR ACTIONS UNDER DPO II (Board Date September 2015)	PROPOSED TRIGGERS FOR DPO III (to be	RESULTS
Improving the AML/CFT framework			
The AML/CFT Law has been enacted by Parliament.	The CoM approves AML/CFT Law Regulations.	The CoM submits the revised Counter-Terrorism Law to Parliament	Criminalization of terrorism financing. Baseline: Existing AML/CFT law does not criminalize terrorism financing (March 2013). Source: ESAAMLG Target (2017): Revised AML/CFT law criminalizes terrorism financing demonstrated by Mozambique's progress reports validated by ESAAMLG. Source: ESAAMLG
PILLAR II: FINANCIAL INCLUSION			
Improving access to financial products in underserved sectors/areas			
	The BdM issues regulations regarding protection of e-money custody accounts (Aviso sobre Protecção de Fundos Resultantes da Emissão de Moeda Electrónica). The BdM regulates the access and exercise of activities for banking agents.		Number of e-money accounts. Baseline: 0 (2009). Source: BdM. Target (2017): 500,000. Source: Finscope. Percentage of the population with access to formal banking services, including “formal-other”. Baseline: 12.7 percent in 2009. Source: FinScope. Target (2017): 25 percent. Source: FinScope and planned WB Financial Capability Survey.

Increasing the efficiency of borrowers' collateral to promote access to credit			
The Council of Ministers has approved a draft Insolvency Law.	Council of Ministers re-submits the draft Law to Parliament for the creation of credit bureaus in line with international principles.	BdM passes a regulation guiding the operations of credit bureaus, and develops the monitoring and enforcement mechanisms that will allow for a safe, reliable and efficient credit reporting system. The Council of Ministers submits the draft Law on Secured Transactions to Parliament.	Call for proposals from service providers to apply for a private credit bureau license or operate the bureau on behalf of BdM. Baseline: Law not yet passed (March 2013). Source: BdM/MoEF. Target (2017): Call for proposals issued. Source: BdM.
PRIOR ACTIONS UNDER DPO I (Approved Board Date July 2014)	**PRIOR ACTIONS UNDER DPO II (Board Date September 2015)**	**PROPOSED TRIGGERS FOR DPO III (to be completed)**	**RESULTS**
Enhancing the transparency of financial information and protecting consumers			
	The BdM establish minimum requirements for protecting bank card account holders.	The BdM amends Aviso 5 /2009 to broaden the definition of products and services covered, to promote greater transparency and disclosure in the industry, and to establish a standard methodology for financial institutions to disclose the total cost of financial products to consumers. The BdM will strengthen the legal framework for financial consumer protection.	Percentage of banks disclosing to consumers the effective cost of banking services. Baseline: 0 percent (March 2013). Source: BdM. Target (2017): 80 percent. Source: BdM.

Strengthening and broadening access to payment systems			
The BdM has strengthened its national payment system by carrying out an organizational separation between the oversight and the operations functions.		The BdM introduces failure-to- settle arrangements in the CEL system and addresses risks remaining in current RTGS system. BdM adopts an oversight framework for retail payments, including remittances, and prepares a retail payment system strategy in close cooperation with other authorities and market players.	Number of days to clear a cheque. Baseline: two days in Maputo City and six days outside Maputo City. (March 2013). Source: BdM. Target (2017): two days in Maputo City and two days outside Maputo City. Source: BdM. Percentage of transactions settled through RTGS. Baseline: Less than 5 percent in December 2012. Source: BdM Target (2017): 70 percent. Source: BdM.

PILLAR III: LONG-TERM FINANCIAL MARKETS			
PRIOR ACTIONS UNDER DPO I (Approved Board Date July 2014)	**PRIOR ACTIONS UNDER DPO II (Board Date September 2015)**	**PROPOSED TRIGGERS FOR DPO III (to be completed)**	**RESULTS**
Strengthening government securities primary markets			
The MoF has conducted at least two competitive bond (OT) auctions following the 2013 annual borrowing plan published in January 2013 and in line with Decree No. 5 dated March 22, 2013 and Ministerial Diploma No. 90/2013 dated April 16, 2013 and has publicly announced the auction results on BVM's website. The MoF has approved the operational norms of the CSD for the BVM. BdM has issued a comprehensive set of norms updating money market regulations, including on: (a) interbank markets; (b) repos/reverse repos in the interbank money market; (c) money market operations amongst banks and between BdM and banks; and (d) primary and secondary markets of treasury bills, as evidenced respectively by Notices 5 through 8 all dated June 6, 2013.	The MoEF implements the bond issuance calendar envisaged in the 2014 annual borrowing plan by conducting at least four competitive auctions. MoEF announces its intention to conduct at least one re-opening of OTs in 2015.	Substantial progress in the process of reopening the OTs by including on BVM website the target amounts of every series of OTs and conducting at least 1 reopening of OTs. Review of Decree 5/2013 and Diploma 90/2013 incorporating improvements in auction rules and in the incentives and obligations of OTs. The BVM approves the procedures for the CSD to enable delivery versus payments (DVP).	Number of short and medium term bonds issued and reopened in the domestic market through competitive auctions. Baseline (January 2013): At most 1-2 non-competitive OT issuance per year; no re-openings. Target (2017): At least 5 competitive auctions, including at least 1reopening. Level of dematerialization and immobilization of all medium and long term debt securities registered in CSD. Baseline (January 2013): Only listed securities fully dematerialized. Target (2017): Full dematerialization and immobilization of all securities registered in CSD.

Enhancing long-term funding sources (insurance and pensions)			
	ISSM sets maximum coverage limits for micro-insurance products.	ISSM issues pension regulations. ISSM approves an updated manual for on and off site supervision in the pensions and insurance sector.	Percentage of members of private pension funds with access to on-line, individual account information. Baseline (2014): 0. Target (2017): 50% of members Percentage of insurance companies presenting Key Facts Statements for consumers of insurance products. Baseline (2014): 0. Target (2017): 50% of insurance companies.

ANNEX 2: COMPARISON OF FSDPO II TRIGGERS AND PRIOR ACTIONS

FSDPO II Triggers identified in FSDPO I	FSDPO II Prior Actions	Comments
	Pillar I: Financial Stability	
The BdM continues to strengthen bank regulation and supervision by: (i) increasing minimum capital levels for banks; (ii) incorporating capital requirements for operational and foreign exchange risk (following Basel 2 simplified standardized approach).		A draft regulation for increasing minimum capital requirements has been prepared by the BdM but is still under discussion by the BdM Board which would like to ensure that the regulation does not inhibit competition, inadvertently limits access to finance, and is benchmarked with other countries' while taking into account Mozambique's current financial system. With regards to incorporating capital requirements for operational and foreign exchange risk (following Basel 2 simplified standardized approach), this action was published in December 2013 and is under implementation; however, its time period precedes that which can be considered by FSDPO II
The BdM strengthens the crisis management framework (e.g. conducting a simulation exercise to identify remaining weaknesses and developing a surveillance framework).	The BdM strengthens the crisis management framework by conducting a crisis simulation exercise (CSE) to identify weaknesses/gaps.	Slight revision of wording; action is an essential step along the path for further strengthening the crisis management framework.
The MoF capitalizes the DGF with initial Government contribution based on the existing decree	The MoEF capitalizes the DGF with initial Government contributions based on Decree No. 49/2010.	No change.
	The CoM approves AML/CFT Law Regulations.	New prior action that complements FSDPO I prior action (AML/CFT Law).
Pillar II: Financial Inclusion		
The BdM issues the e-money custody accounts regulation (*Aviso sobre Protecção de Fundos Resultantes da Emissão de Moeda Electrónica*).	The BdM issues regulations regarding protection of e-money custody accounts (Aviso sobre Protecção de Fundos Resultantes da Emissão de Moeda Electrónica).	No change.
The BdM develops regulations for branchless banking (e.g. e-banking, mobile financial services) covering the provision of financial services through different channels or institutions as well as risk management aspects.	The BdM regulates the access and exercise of activities for banking agents.	Regulation for banking agent is one of the regulations that permit the provision of financial services through different channels. Regulations for e-banking/mobile financial services are a FSDPO III trigger.
Council of Ministers submits the draft Law to Parliament for the creation of Credit Bureaus in line with international principles.	Council of Ministers re-submits the draft Law to Parliament for the creation of Credit Bureaus in line with international principles.	Slight change in wording to indicate that the CoM had to re-submit the draft Law given the new Parliament that was sworn in after the elections.

The BdM passes the Aviso on bank cards (*Regulamento de Cartões Bancários*) to establish minimum requirements on the content of service contracts, disclosure of terms and conditions, charges, consumer rights, and minimum services expected.	The BdM passes the Aviso on bank cards The BdM establish minimum requirements for protecting bank card account holders.	No change.
The BdM passes a regulation that establishes a standard methodology for financial institutions to disclose the total cost of financial products to consumers ('effective interest rate').		FSDPO II trigger has become a FSDPO III trigger. While this remains a priority for the BdM on consumer protection, TA on this reform has recently started under FISF which will inform the design.
BdM strengthens its oversight function of payment systems by: (i) staffing the oversight unit and (ii) the implementation of an oversight manual.		This has been dropped as it reflects an ongoing process (additional staff and implementation of approved manual).
The BdM introduces failure- to- settle arrangements in the CEL system and addresses risks remaining in current RTGS system.		FSDPO II trigger has become a FSDPO III trigger. While there is some progress related to draft CEL regulations addressing failure to settle risks, additional crucial related areas are expected to benefit from TA efforts recently started under FISF.
Pillar III: Long Term Financial Markets		
The MoF implements the bond issuance calendar envisaged in the 2014 annual borrowing plan by: (i) conducting at least four competitive auctions (one per quarter), and (ii) starting in 2015, begin the process of reopening the OTs to reach levels consistent with gradually creating benchmark securities.	The MoEF implements the bond issuance calendar envisaged in the 2014 annual borrowing plan by conducting at least four competitive auctions. MoEF announces its intention to conduct at least one re-opening of OTs in 2015.	"One per quarter" was deleted from part (i) given the delay in the passage of the 2015 Borrowing Plan related with the recent elections.
The BVM approves the procedures for the CSD to enable delivery versus payments (DVP).		In addition to the operational procedures, some implementation will be needed to fully achieve DVP. Therefore, this is now a FSDPO III trigger.
	ISSM sets maximum coverage limits for micro-insurance products.	New prior action in the context of DPO III covering insurance and pensions.

ANNEX 3: IMF RELATIONS

IMF Executive Board Completes Fourth Policy Support Instrument for Mozambique

Press Release No. 15/315
July 2, 2015

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of Mozambique's economic performance under the program supported by the Policy Support Instrument (PSI).[1] In completing the review, the Board also approved the modification of three assessment criteria and one indicative target for June 2015 in line with the updated economic outlook for Mozambique.

The PSI for Mozambique was approved by the Executive Board on June 24, 2013 (see Press Release No. 13/231)

Following the Executive Board's discussion, Mr. Min Zhu, Deputy Managing Director and Acting Chair, issued the following statement:

"Mozambique's continued strong growth performance and low inflation are commendable. Investments in large coal and natural gas projects underpin a positive medium-term outlook, but low commodity prices have increased near-term risks.

"Recent program performance under the Fund's Policy Support Instrument has been mixed. While structural reforms have been proceeding, there were macroeconomic policy slippages and reserve losses in late 2014. With a strong fiscal adjustment envisaged in the current budget and a recent tightening of liquidity conditions, needed steps to maintain macroeconomic stability are now in place. The decline in international reserves has largely been reversed, and greater exchange rate flexibility will help the economy to better respond to external shocks in the period ahead.

"The strong fiscal adjustment in the budget appropriately calls for revenue mobilization and expenditure restraint, while safeguarding social programs. Recent fiscal reforms have strengthened the policy framework but more needs to be done to improve public financial management, including by stronger controls over state-owned enterprises and enhanced management of fiscal risk.

"Ongoing progress on a broad range of structural reforms, including the passage of the new mining and hydrocarbon legislation, is encouraging. Nonetheless, further measures are needed to make poverty more responsive to growth and strengthen the business climate."

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[1] The PSI is an instrument of the IMF designed for countries that do not need balance of payments financial support. The PSI helps countries design effective economic programs that, once approved by the IMF's Executive Board, signal to donors, multilateral development banks, and markets the Fund's endorsement of a member's policies (see http://www.imf.org/external/np/exr/facts/psi.htm). Details on Mozambique's PSI program are available at http://www.imf.org/mozambique.

IMF COMMUNICATIONS DEPARTMENT

Public Affairs	Media Relations
E-mail:publicaffairs@imf.org	E-mail:media@imf.org
Fax: 202-623-6220	Phone: 202-623-7100

ANNEX 4: LETTER OF DEVELOPMENT POLICY

REPUBLIC OF MOZAMBIQUE
MINISTRY OF ECONOMY AND FINANCE
OFFICE OF THE MINISTER

Letter nº 081 /MEF/GM/ /2015 **Maputo, August 19, 2015**

Subject: Letter of Development Policy for the Second Programmatic Financial Sector Development Policy Operation (FSDPO II)

Dear Mr. Lundell,

1. I am writing on behalf of the Government of the Republic of Mozambique to request the FSDPO II in the amount of US$ 25 million from the International Development Association (IDA), to support the implementation of the Mozambique Financial Sector Development Strategy (MFSDS) 2013-2022, which was adopted by the Council of Ministers in April 2013. The aforementioned Credit will help meet the financing requirements that Mozambique faces to implement the MFSDS during the annual budget for the year 2015.

2. We would like to commend your commitment to the Government's financial sector development program, which seeks to encourage a "strong, healthy, inclusive, competitive, transparent and resilient financial system that promotes economic development".

To:
Mr. Mark Lundell
Country Director
For Mozambique, Madagascar, Mauritius, Comoros and Seychelles
World Bank
Maputo

3. The objective of the FSDPO is to reinforce financial stability, increase access to finance by households and firms, and enhance the development of long-term financial markets. This will contribute directly to the strategic objectives of the MFSDS of maintaining financial sector stability, improving financial inclusion, and increasing the supply of private capital to support development. Moreover, the FSDPO II will also support the new Plano Quinquenal do Governo (PQG) 2015-19 which has among its five priories the promotion of employment and competitiveness and calls for a robust, modern, inclusive, and broad financial sector as part of the second PQG pillar for a balanced and sustainable macroeconomic environment.

4. FSDPO II has been designed within the context of the Memorandum of Understanding (MoU) between the Government of the Republic of Mozambique and the international aid partners, including the World Bank Group, signed in March 2009. The MoU outlines the participant's approach to the provision of budget support, among other related measures.

Macroeconomic context

5. *Mozambique's economy remains robust*, despite both internal and external shocks.

- In 2014 economic activity grew by 7.4 percent, in line with projections. The main contributors to GDP growth in 2014 were financial services, agriculture and extractive industries. Growth in the extractive industries, the most dynamic sector in the economy for the past few years, has decelerated given low commodity prices and infrastructure constraints. We expect the economy to grow by 7 percent this year, a slight downward revision by 0.5 percent due to the negative effects of the floods that took place in early 2015 as well as a significant decline in government spending. We expect growth to recover in 2016 and 2017 to around 8 percent as agriculture recovers from the 2015 floods and growth continues strong in the resource sector, construction, transportation and communications. In the short run, resource-related FDI, and infrastructure investments, both public and private, are expected to be major contributors to growth.

- The year-end *inflation* rate remained very low at 1.1 percent, well below the target of the Central Bank. Inflation is expected to accelerate but still remain within the Central Bank target of 5-6 percent this year, supported by a relatively weak South African Rand, a decline in commodity prices and strong agricultural production. Inflation continued relatively low in the first quarter of 2015, estimated at -0.8 percent (year-on-year) in May 2015, despite the floods in the center and north of the country and a weaker metical against the US$. Low inflation and a weaker external environment enabled BdM to ease monetary policy, with policy rates now at a record low of 7.5 percent. These efforts had limited impact on market rates, suggesting a weak monetary transmission mechanism. Mozambican authorities remain committed to maintaining a low inflation environment.

- The 2015 budget, approved by the parliament, reflects an effort to tighten fiscal policy. Expenditure is forecast to decline by 6.4 percentage points of GDP and the deficit will narrow by almost 4.0 percentage points of GDP. Both current expenditures (particularly goods and services) as well as capital expenditures will decline. We plan to continue with this fiscal consolidation path, based on a gradual reduction of the wage bill, slower growth in expenditure on goods and services and investments. We expect public spending to be further reduced to a level below 35 percent of GDP by 2016 and the deficit to fall further by another percentage point of GDP to 5.5 percent.

- The current account deficit has narrowed slightly to 34.7 percent of GDP in 2014. Savings remain relatively low and insufficient to finance the large investments being made by the public and private sectors. As a result, the current account deficit has increased over the past few years. The current account deficit does not indicate a fundamental imbalance in the economy, as it reflects the impact of rapid import growth associated to large FDI inflows, which have been between US$5-6 billion since 2012 (around one-third of GDP). Lower exports and FDI inflows in the second half of 2014 put significant pressure on the Metical, which depreciated from 30 MZM/US$ in mid-2014 to 38 MZM/US$ by end of June 2015. Reserves have declined from US$3.2 billion in August 2014 to US$2.6 billion in June 2015. Reserves cover remains adequate in terms of months of non-megaproject imports (approximately 4), but we intend to increase reserves to build the necessary buffers against shocks.

- The current account, although projected to increase to 42.1 percent in 2016, will remain sustainable given its financing by FDI. Projected investments during the construction phase in the gas sector are several times the size of the entire Mozambican economy and as such, large current account deficits are to be expected. These deficits will be financed by FDI inflows, projected at between US$4-5 billion per year during 2015-17, as well as foreign borrowing by investors in the mining and natural gas sectors. The anticipated rise in resource exports should improve the current account balance toward the end of the decade. Reserves are projected to increase, from US$3 billion at the end of 2014 to a projected US$3.8 billion by 2017, worth around 5 months of projected imports (excluding megaproject imports) during the same period.

- The financial sector remains robust. Credit continued its strong growth, increasing by 28.3 percent in 2014 following a 28.7 percent increase in 2013 and with credit to the economy reaching 37.0 percent of GDP in 2014 (compared to 28.0 percent of GDP in 2012), led by very rapid credit to households. The ratio of deposits to credit hovers around 127 percent in December 2014. Profitability levels have recovered with Returns on Assets (ROA) and Return on Equity (ROE) at 2.1 percent and 22.2 percent in 2014 respectively. Liquidity is in line with requirements as demonstrated by a ratio of liquid assets to total assets of 30.0 percent in December 2014. NPL ratios have risen slightly from 2.3 percent in December 2013 to 3.3 percent in December 2014 which could be the result of a combination of stricter NPL regulations and is such is viewed by the BdM a one-off adjustment.

- Public debt (in nominal terms) has grown rapidly, from 37.0 percent of GDP in 2011 to an estimated 55.4 percent in 2014. This increase reflects the growth of domestic and external debt. As a result, the joint WB-IMF DSA for Mozambique (April 2014) increased the country's debt distress risk rating from low to moderate, although all public and external debt indicators remain below their threshold levels. New debt is being used to finance a large increase in infrastructure investment to close the country's infrastructure deficit. If infrastructure investments generate high returns, they could result in higher growth in the medium term. In the near term, we intend to moderate borrowing and ensure we have the capacity to manage a larger debt burden and a more complex investment portfolio. Total public debt is expected to stabilize around 60 percent over the next few years, supported by fiscal tightening and slower growth in public investments.

- We will continue with our current combination of *fiscal and monetary policies* with a view to maintaining macroeconomic stability in the medium-term and supporting the priorities laid out in the recently approved *Plano Quinquenal do Governo*. We will also strengthen our macroeconomic planning tools and economic policy coordination within the government and with the Bank of Mozambique (BdM). Monetary policy will remain oriented toward achieving the objectives of keeping inflation low and stable, safeguarding the financial system, and encouraging lending to the economy. We will continue reforms to improve operations of the banking system and broaden further access to financial services for depositors as well as borrowers. Fiscal policy will continue to meet the objectives in terms of natural resource taxation, priority spending on infrastructure investment, health and education, and income redistribution.

Implementation of the Poverty Reduction Strategy

6. The Government's Poverty Reduction Strategy (PARP) is coming to an end in 2015. The PARP's overarching focus is on achieving accelerated economic growth and employment creation, and its key objective is to reduce the national poverty rate from its current 54.7 percent to no more than 42 percent by 2014. The PARP's three strategic pillars are: (i) boosting productivity in the primary sector, particularly agriculture and fisheries; (ii) promoting strong employment growth by attracting increased investment and building the human capital of the labor force; and (iii) supporting improvements in social indicators. The two cross-cutting support pillars are good

governance and macroeconomic stability. The PARP is aligned with the Government's 5-year development plan (Plano Quinquenal do Governo-PQG) and operationalized through annual implementation plans (Plano Económico e Social – PES) and budgets (Orçamento do Estado – OE), both approved by the national assembly. Progress in PARP implementation is assessed through yearly reviews conducted jointly by the Government and G19 on the basis of the PARP performance assessment framework (PAF).

7. *Enhancing production and productivity in agriculture.* Agriculture employs 78 percent of the economically active population and contributes 23 percent to GDP. Thus productivity increases and the expansion of areas under cultivation are key to improvements in the livelihood of the population. To this end, we have adopted an agricultural sector development strategy (PEDSA) for 2011-20 and just launched an agricultural investment plan (PNISA) 2013-17 that will help to gradually shift production from subsistence to commercial farming. We have also introduced new regulations for the production of seeds and fertilizers. As a result, we have seen significant progress in our objective of increasing agricultural productivity. During 2013 15 percent of farmers were assisted by extension services to adopt new technologies. The area with rehabilitated irrigation infrastructure reached 5,800 ha and 73 percent of all roads are considered to be in good condition.

8. *Creating employment.* The ability of the private sector to create productive employment will be crucial in our efforts to ensure that growth is inclusive. We have adopted a new strategy for the Improvement of the Business Environment 2013-17 (EMAN II) and are working with a series of development partners, including the World Bank Group, to implement the interventions included in this strategy. We have recently approved a long term development strategy for the country (Estrategia Nacional de Desenvolvimento) which seeks to guide development in Mozambique over the next 20 years to improve the wellbeing of the population through structural transformation and expansion and diversification of the productive base. As a result of these efforts we have continued to strengthen vocational training and improved opportunities for SMEs in public tenders. In all, 270,267 formal sector jobs were created: 92,140 in the public sector and 178,127 in the private sector.

9. *Enhancing social and human development.* Efforts to boost primary school enrolment continued. The net school enrollment rate at age 6 in first grade increased to 77 percent. Significant strides in this regard have been the creation of an increasingly gender-equitable system, particularly in secondary schools, and progress in monitoring and evaluating student performance in primary schools. In the health sector, the 2012-16 Health Strategy and the Monitoring and Evaluation plans were adopted recently, which aim to push forward improvements in the still relatively weak public health system. PFM systems in the sector have also strengthened with bi-monthly monitoring of the sector accounts. Development outcomes show some progress across a range of sectors, including an increase of assisted deliveries from 65 to 69 percent, an increase in the number of households benefitting from social assistance from 344,000 to 365,000 as well as an increase in the number of water sources in rural areas from 19,000 to over 23,000.

Financial sector reforms and the MFSDS

Evolution of the financial sector

10. *Over the past two decades, Mozambique has successfully implemented major financial sector reforms that substantially improved the sector's performance.* In the decade to 2003, the Mozambican financial system moved from being entirely state-owned to a market based system dominated by banks that represented about 95 percent of total financial system assets. Prior to 2003 the overall quality of financial intermediation was severely limited by substantial amounts of nonperforming loans (NPLs) in the banking system, high and volatile real lending rates driven by high NPL levels, large operating costs, a lack of competition in the system, as well as a generally poor lending environment. High and volatile metical interest rates also threatened the stability and development of the financial sector by promoting dollarization and raising the cost of domestic public debt.

11. *To address the problems of the banking sector, important reforms were undertaken by the Government between 2005 and 2007.* The Government, in collaboration with donors and civil society, developed and implemented a comprehensive financial sector reform strategy supported by the Financial Sector Technical Assistance Project (FSTAP). Notable financial sector reforms

included: revisions and/or adoption of new laws and regulations for the regulatory framework of the financial sector; (ii) the establishment of new institutional mechanisms for banking supervision and the resolution of commercial litigation; (iii) the introduction of International Financial Reporting Standards (IFRS); (iv) the establishment of the Financial Information Center of Mozambique (GIFiM) ; (v) introduction of the electronic funds transfer subsystem; (vi) enhanced transparency; and (vii) use of market instruments in the implementation of monetary and exchange rate policy.

12. *As a result of these efforts,* (i) total assets in the financial system increased; (ii) State intervention in the banking sector decreased; and (iii) NPLs for the system as a whole declined dramatically (from 21 percent of total loans at end-2002 to 2.1 at end-2008).

Recent and planned reforms in the financial sector

13. *The BdM will continue reforms aimed at enhancing financial sector surveillance.* It remains focused on:

- Strengthening banking supervision with a view to mitigating and preventing systemic risk. BdM has issued several regulations addressing shortcomings in the definition of non-performing loans classification and provisioning criteria, providing risk management guidance/minimum criteria for banks, as well as updating its risk-based prudential capital requirements. BdM has been reviewing the minimum capital required for a financial institution to operate in Mozambique.

  BdM has put in place guidelines regarding concentration risk, requiring banks to have policies and procedures in place in order to adequately monitor and manage concentration risk. The BdM is also working on revising its regulation on concentration limits in order to address placements abroad.

- Strengthening crisis management framework and financial safety nets. BdM has put significant effort on the development of a crisis management framework, partly supported by Technical Assistance (TAs) provided by the WB as well as the IMF. As a result, BdM has issued in 2013 a range of discretionary measures to be taken in case of problem banks, as well as high level guidance on how to deal with systemic banks. Further, the BdM issued a regulation on Emergency Liquidity Assistance (ELA) in 2013. Such regulation is a first important step towards establishing an effective and fully operational Lender of Last Resort (LOLR) facility for banks operating in Mozambique. As part of its efforts in enhancing its crisis preparedness, BdM issued Notice 03/GBM/2013, comprising a high level guidance on how to deal with systemic events and a range discretionary measures to be taken in case of problem banks. The BdM has started carrying out stress testing on a regular basis. Crisis management arrangements were tested through a Crisis Simulation Exercise (CSE), supported by World Bank Technical Assistance, which took place successfully in April 2015. A workshop is planned to discuss findings and design an action plan for addressing identified gaps.

- Making the Deposit Guarantee Fund (DGF) operational. The members of the DGF's Executive Board were appointed in May and June 2013 and the DGF unit is now operational hosted at the BdM. Initial contributions toward the DGF capital were made from the BdM and participating banks. An important milestone for the operationalization of the DGF is the contribution from Government which took place in June 2015 as set out in the DGF decree.

14. *We will step up our efforts to improve financial inclusion as part of Mozambique's Financial Sector Development Strategy (FSDS) for 2013-2022.* Towards that end, the BdM has been leading the preparation of a Financial Inclusion Strategy with a detailed Action Plan for the three year period 2016-2018. The pillars of the Inclusion Strategy are: (i) improving access and usage of financial services; (ii) strengthening financial sector infrastructure; (iii) consumer protection and financial literacy. Key reform priorities include:

- Establishing private credit bureaus. A law allowing the creation of private credit bureaus was approved by the Council of Ministers and has been submitted for Parliament's consideration in June 2015. BdM will adopt a regulation for the operation of credit bureaus, including inter-alia, detailed requirements for collecting credit information and using, storing, protecting and transferring it, rules for refusal, suspension, and termination of the license, principles and responsibilities for internal and external operations of the credit bureau, the rights of data subjects, dispute resolution mechanisms, and other aspects.

- Promoting mobile banking. Regulations for protection of emoney deposit accounts were passed by the BdM in June 2015. The regulation covers broad principles and specific rules to be followed by issuers in the operation of e money schemes and in assisting the BdM as the regulator and overseer of such schemes, to carry out its mandate of safeguarding such funds Two mobile operators have been licensed and are in operation.

- Promoting banking outreach. Regulations for the establishment of banking agents were passed by the BdM in April 2015. This regulation enable banks to engage agents for the delivery of basic financial services, with a significant potential impact in enhancing financial inclusion in rural areas through agency banking.

- BdM has been working on strengthening the legal and regulatory framework for financial consumer protection, which is an important enabler of improved financial inclusion, as well as helping ensure that financial inclusion has positive economic and household level impacts. BdM has issued a regulation on bank cards, which among other things, sets minimum requirements on the content of service contracts, disclosure of terms and conditions, charges, consumers rights, and minimum services expected. It is also revising Aviso 5/2009 to improve the regulatory framework for the transparency and disclosure of fees and charges for basic financial services. BdM has established a dedicated unit for market conduct supervision, which is working on strengthening its regulatory and supervisory framework

- Collateral framework. We will work on a Collateral Bill with an eye to establishing a moveable collateral registry.

15. *The AML/CFT framework continues to be improved.* A new law on AML/CFT was promulgated on June 28, 2013 and published in the Boletim da República on August 12, 2013. This law, represents a major improvement in the AML/CFT legal framework and allows the Republic of Mozambique to

bring its AML/CFT regime into closer compliance with international standards and supports the work of Mozambique's Financial Intelligence Unit, which had been hampered by the lack of an appropriate legal framework. In addition, an implementing Regulation to the new AML/CFT law has been approved and published in the Boletim da República on October 29, 2014. This Regulation is an important step for Mozambique as it addresses some of the changes that were introduced to the international standards in 2013, including the obligation for reporting entities to identify beneficial owners and set up internal systems to assess their exposure TF risks, the establishment of a risk-based approach in the implementation of AML/CFT measures, and the introduction of transparency measures in the NGO sector to prevent its use in terrorism financing. Further, the authorities have prepared a new Central Bank directive to guide banks and capital market entities in implementing the AML/CFT Law which is expected to be issued soon. Going forward, the authorities are preparing a Counter Terrorism Law with a view to establish a legal framework for the implementation of the United Nations Security Council Resolutions related to the freezing of terrorist assets (Resolution 1267 and 1373).

16. *The BdM will further enhance financial stability and promote market development through reforms in the national payment system.* Enhancing oversight practices. The BdM approved a payment systems oversight policy strategy in March 2012 and will finalize and implement an oversight function in 2014The BdM has taken the important decision to review and update the Payments System Vision and Strategy document in line with technological developments and the increased attention being drawn towards the retail payments area in developing countries in particular.

17. *We are committed to promoting capital market development.* As part of this effort, the Government has taken steps to develop the domestic bond market, which in the medium/long term would provide an important anchor for deepening capital markets. Recent measures to strengthen debt management practices include establishing a debt management committee, publishing for the first time a medium-term debt management strategy, preparing annual borrowing plans for Government bonds (2013 , 2014, and 2015) and issuance by Ministry of Finance(now Ministry of Economy and Finance - MoEF) of a decree and related legislation that establishes primary dealership system for

Treasury Bonds (OTs) in primary and secondary markets. In 2014, the MoEF held eight auctions for Government bonds. Moving forward, we will continue to implement measures to improve auction procedures and enhance the effectiveness of the OT market. The most important measures are related to: the auction mechanism; the introduction of non-competitive bids; and the ability to re-open securities.

18. *We will continue our effort to promote the insurance and pensions sectors.* The Insurance Supervision Institute of Mozambique (ISSM) has been created in 2011 to oversee the insurance, reinsurance, and pensions sectors. A revised insurance law was enacted in 2010 and corresponding regulations approved in 2011. This law includes regulations for micro-insurance. The ISSM has recently passed the Aviso setting the maximum coverage limits for micro-insurance, which is the final piece for the micro-insurance regulatory regime. The advent of micro-insurance will also grow the market for voluntary retail insurance sold to increasing numbers of households, thus contributing to the growing importance of the ISSM's consumer protection role. Recent reforms to promote pensions sector development in Mozambique include approval of pensions regulation and licensing of private pension funds during 2010-2014. Nevertheless, oversight/supervision of this sector will be further strengthened. Future pension regulations will help fill gaps in the current regulatory framework and start imposing proper operational standards on the industry, giving the regulator a framework in which to judge acceptable market behavior. The ISSM also wants to move towards risk based supervision of the insurance sector especially of non-life lines of business.

The MFSDS and FSDPOII

19. In recent years the Government, development partners, and academics have completed analytical work designed to identify further reforms which could strengthen, broaden, and deepen the financial sector. *The objective of the MFSDS*[4] *is to consolidate stakeholders' recommendations*

[4] The MFSDS draws on: (i) FIRST Initiative-sponsored field work in 2011 to consult with stakeholders, update, refine, and elaborate earlier drafts of the strategy; (ii) the Financial Sector Assessment Program (FSAP) completed by the World Bank and International Monetary Fund (IMF) in 2009; (iii) National Campaign for Rural Savings (2005); (iv) Programa de Apoio às Finanças Rurais (2005); (v) Rural Bancarization Strategy (2007); (vi) Rural Development Strategy (2007); (vii) World Bank Country Economic Memorandum (2009); (viii) Investment Climate Assessment

across the financial sector into a single document, which: provides the Government's policy framework and strategy for the development of the financial sector over the next decade; elaborates specific activities which will support the achievement of the MFSDS' goal; and, puts in place the institutional mechanisms required to coordinate and control its implementation.

20. *The MFSDS has been developed in order to tackle the major challenges to the development of the financial sector.* These challenges can be subdivided into two groups, namely:

- Economy-wide structural impediments to financial intermediation that limit the number of creditworthy clients. Poor physical infrastructure, obstacles to the use of technology, weaknesses in the legal and regulatory framework, weak financial reporting by non-bank financial institutions and problems in using credit information infrastructure and framework for credit enforcement are but a few of these impediments.

- Limited competition in the banking sector and high transaction costs that reduce incentives to intermediate deposits into loans while also contributing to higher borrowing costs.

21. *The goal of the MFSDS is to promote the development of a sound, diverse, competitive, and inclusive financial sector which provides citizens and businesses – particularly SMEs – with convenient access to a range of appropriate, high quality, financial services at affordable prices.* The policies and actions that will implement the MFSDS are organized into three groups of strategic objectives: (i) maintain financial sector stability; (ii) improve financial access and support the growth of financial inclusion; and, (iii) increase the supply of private capital to support development.

22. *In order to reach the objectives of the MFSDS, the implementation of its policies and strategic actions will be guided by four principles:* (i) maintenance of macroeconomic and financial stability; (ii) fostering competition in the financial system; (iii) encouragement of innovation; and (iv) improving access to finance and inclusive growth.

(2009); (ix) FinScope™ (2009); (x) the Rural Finance Strategy (2011), (xi) the Government's Medium Term Debt Management Strategy (2012), and (xii) the Banco de Moçambique's Strategic Plan.

23. *FSDPO II is aligned with the strategic objectives of the MFSDS (i.e. increased financial sector stability, financial access and private capital), its focus areas (such as bank regulation and supervision, financial sector safety nets and infrastructure, and domestic bond markets), and its goals.* The latter include: the strengthening of loan classification and provisioning requirements, risk management, AML monitoring and enforcement; the adoption of prompt corrective actions; the establishment of a deposit insurance system; the expansion of credit information; and improving the framework for creditor rights, e-banking and mobile financial services.

24. Reforms to be supported by the FSDPO II are:
    - The BdM strengthens the crisis management framework by conducting a crisis simulation exercise (CSE) to identify weaknesses/gaps.
    - The MoEF capitalizes the DGF with initial Government contribution based on the existing decree.
    - The Council of Minister approves AML/CFT Law Regulations.
    - The BdM issues the Aviso regarding e-money custody accounts regulation (Aviso sobre Protecção de Fundos Resultantes da Emissão de Moeda Electrónica).
    - The BdM issues the Aviso for banking agents.
    - Council of Ministers re-submits the draft Law to Parliament for the creation of Credit Bureaus in line with international principles.
    - The BdM passes the Aviso on bank cards (Regulamento de Cartões Bancários) to establish minimum requirements on the content of service contracts, disclosure of terms and conditions, charges, consumer rights, and minimum services expected.
    - The MoEF implements the bond issuance calendar envisaged in the 2014 annual borrowing plan by conducting at least four competitive auctions.
    - Starting in 2015, MoEF begins the process of reopening the OTs to reach levels consistent with gradually creating benchmark securities.
    - ISSM issues Aviso setting maximum coverage limits for micro-insurance products.

Conclusion

25. To conclude, we would like to highlight the Government's commitment towards maintaining macroeconomic stability and promoting financial sector development through the implementation of the MFSDS. In this context, the Government hopes IDA will approve the requested FSDPO II to support recent and planed reforms in the financial sector which seek to promote the development of a sound, diverse, competitive, and inclusive financial sector.

Sicerely

Adriano Maleiane
Minister of Economy and Finance
And Governor for Mozambique

C.c:
H.E. Ernesto Gove
Governor of Bank of Mozambique