



Project Information Document/ Integrated Safeguards Data Sheet (PID/ISDS)

Concept Stage | Date Prepared/Updated: 10-May-2018 | Report No: PIDISDSC24659



BASIC INFORMATION

A. Basic Project Data

Country Mozambique	Project ID P166107	Parent Project ID (if any)	Project Name Mozambique: Financial Inclusion and Stability Project (P166107)
Region AFRICA	Estimated Appraisal Date Oct 15, 2018	Estimated Board Date Dec 14, 2018	Practice Area (Lead) Finance, Competitiveness and Innovation
Financing Instrument Investment Project Financing	Borrower(s) Ministry of Economy and Finance	Implementing Agency Ministry of Economy and Finance, Deposit Guarantee Fund, Bank of Mozambique	

Proposed Development Objective(s)

To promote financial inclusion and financial stability in Mozambique.

PROJECT FINANCING DATA (US\$, Millions)

SUMMARY

Total Project Cost	40.00
Total Financing	40.00
of which IBRD/IDA	40.00
Financing Gap	0.00

DETAILS

World Bank Group Financing

International Development Association (IDA)	40.00
IDA Grant	40.00

Environmental Assessment Category

Concept Review Decision



C - Not Required

Track II-The review did authorize the preparation to continue

B. Introduction and Context

Country Context

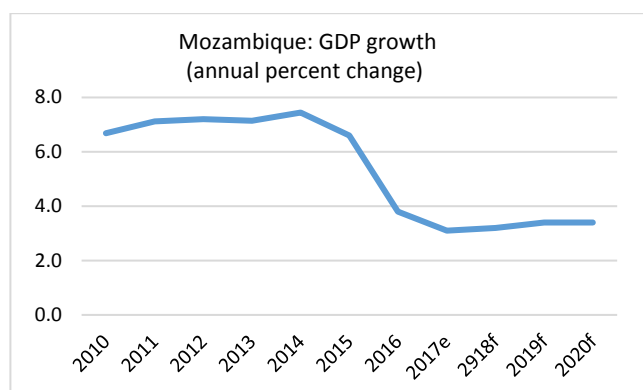
1. Mozambique is a low-income country of 29 million people where two-thirds of the population live and work in rural areas. In addition to land, water, and energy resources, Mozambique is in the process of developing significant natural gas and mineral resources, which has the potential to transform the economy. It is strategically located in the south-east corner of southern Africa, with four of the six countries it borders landlocked and reliant on Mozambique as a conduit to global markets. The center of the country has experienced sporadic episodes of active conflict since the end of the civil war in 1992 but peace talks between the two main political parties have gathered momentum recently. In 2017, Mozambique was included in the World Bank Group's Harmonized List of Fragile Situations. Mozambique has a GDP per capita of US\$ 456, which is among the lowest in the world.
2. Mozambique has down-shifted from a fast rate of growth to a more moderate pace barely above the population growth rate.¹ Real GDP growth averaged 7 percent between 2010-15, but fell to 3 percent in 2017. Lower exports, fiscal consolidation, and tighter monetary policy have contributed to the slowdown in growth, which is expected to continue for the medium term despite the increases in coal and aluminum exports, which are Mozambique's primary exports. Growth has not been inclusive and reliance on the extractive and minerals sector is not expected to keep pace with the net annual inflow of almost 500,000 job seekers. Efforts to allocate more resources for growing small and medium sized enterprises and to diversify the economy can lead to more balanced growth.
3. Mozambique is currently in debt distress and has defaulted on its external obligations.² Public finances have worsened due to a growing wage bill and higher debt service costs and despite reductions in public investment. These spending pressures, along with increasing fiscal risks from financially distressed state-owned enterprises (SOEs) have contributed to the rapid increase in domestic borrowing. Decisive monetary policy measures and the strong commodity export performance helped to stabilize the Metical and bring inflation down to 7 percent at the end of 2017 from a peak of 26 percent in 2016. The appreciation of the Metical helped lower external debt from 103 percent of GDP at end 2016 to 83 percent at end 2017, still an unsustainably high level. With growth likely to stay subdued in the medium-term, the country will need to better allocate scarce domestic resources.

Figure 1: Structural downshift in growth

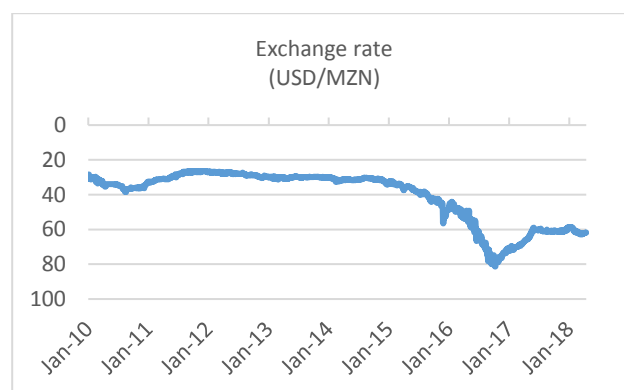
Figure 2: Currency stabilization after rapid depreciation

¹ World Bank. *Mozambique Economic Update*. December 2017.

² The revelation of US\$1.4 billion in previously undisclosed debt in April 2016 undermined confidence and emerged as the economy was navigating an economic downturn brought about by low commodity prices and a regional drought.



Source: World Bank. Notes: e = estimate; f = forecast.



Source: World Bank

Sectoral and Institutional Context

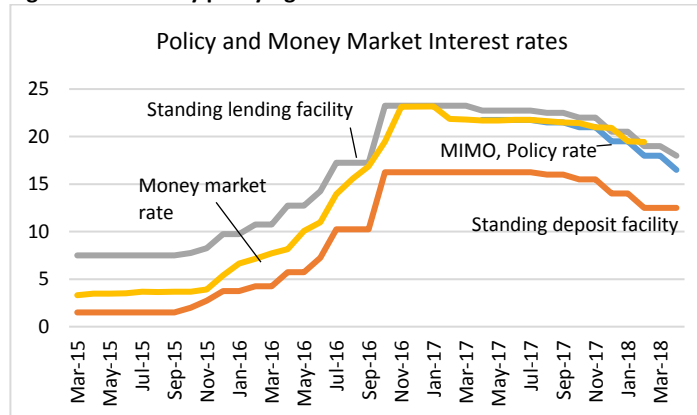
4. The Mozambican financial sector is shallow, bank-dominated and foreign owned. There are 19 commercial banks (up from 12 in 2005) that account for the bulk of financial sector assets. Almost all banks are subsidiaries of foreign banks, primarily from Portugal and South Africa. All banks except one are privately owned. The banking sector is highly concentrated with the three largest banks controlling 72 percent of banking system assets albeit down from 80 percent in 2010. Credit and deposit concentration exceed asset concentration, which suggests that business opportunities in both the lending and deposit sides are captured by the three largest banks.³ Based on the latest publicly available information, there are at least nine small banks with capital of less than MZN1.7 billion (US\$27 million). Some of these banks may not be viable in the medium-term if challenging conditions remain.
5. Macroeconomic dynamics observed since 2015 have been challenging to the banking system, as lower growth and the sharp increase in average lending rates reduced the capacity of many borrowers to repay their debt, in a scenario of significant reduction in credit availability (domestic credit reduced 10% in 2017). Private credit to GDP increased from 11.6 percent in 2007 to 34.5 percent in 2016, but contracted strongly in 2017 to an estimated 25.7 percent, still higher than the low-income country average and median (see table in Annex I). Recent bank failures underscored how quickly risks can materialize and the limitations in the existing frameworks to identify and mitigate risks and resolve failed institutions in an orderly manner (see Box 1). Higher interest rates have increased banks' demand for short term government securities (Treasury bills) although most banks face lower limits on their sovereign exposure due to the country higher risk rating. The cost of funds, i.e., the deposit rate, also increased in 2017 to an average of 17.1 percent (from 10.8 percent in 2016). In 2018 the deposit rate is expected to fall in line with the central bank policy rate.⁴

³ World Bank. *Interest Rates and Spreads in Mozambique*. September 2016.

⁴ It should be noted that the absence of a developed interbank market and a secondary market for trading of short-term debt instruments reduces the effectiveness of monetary policy interventions in stimulating credit to the private sector.

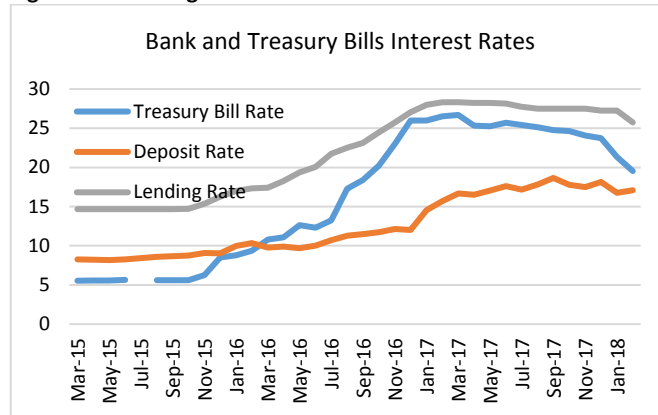


Figure 3: Monetary policy tightened...



Source: Bank of Mozambique.

Figure 4:leading to an increase of interest rates



Source: IMF, International Financial Statistics.

Box 1: Recent Bank Failures in Mozambique

In late 2016, the central bank intervened in Mozambique’s fourth largest bank by assets (Moza Banco) and revoked the license of a small bank (Nosso Banco) with less than 1 percent of system assets. The temporary administration of the larger bank did not trigger a visible reaction from depositors. But the closure of the smaller bank triggered a run to the bank by its clients to withdraw their savings, which generated concerns in large parts of the population. The episode underscores how quickly vulnerabilities can emerge, the importance of better bank supervision, and the limited understanding of deposit insurance in Mozambique.

The bank failures revealed gaps in Mozambique’s regulatory and supervisory framework highlighting the need for effective crisis management tools. Mozambique lacks the legal instruments to resolve failed banks that are standard tools in other countries (e.g. good-bank/bad-bank, bridge banks, etc.). Instead, Moza Banco was provided with unlimited liquidity support (open bank assistance) while under temporary administration and was eventually recapitalized by the central bank employee’s pension fund, which became the majority shareholder with 90 percent of bank equity. The use of the central bank employees’ pension fund resources is unusual and subject to conflicts of interest, showing that the regulatory framework for management of pension funds can be improved.

Because of this experience, Mozambique has begun to improve its legal framework for resolving weak banks, but more work is needed. The absence of an effective bank resolution framework leaves authorities exposed to Too Big to Fail (TBTF) institutions, which increases the expectations that the authorities will bail out distressed financial institutions at significant cost to the taxpayer. This is even more acute for cross-border resolution frameworks, which do not exist in Mozambique. The absence of effective deposit insurance in Mozambique is another critical weakness, particularly as the existing deposit insurance scheme cannot be used to facilitate resolution, which limits the options for the authorities and increases the reliance on public funds to finance the cost of winding up distressed financial institutions.

- 6. The Bank of Mozambique (BOM) attributes the increase in NPLs mostly to tighter supervisory oversight but also to the pass-through effect of the sharp increase in average commercial lending rates. NPLs in the banking sector increased to an estimated 11 percent by end-2017 from 4.3 percent in 2015. NPLs of the three largest banks varied between 4 and 7 percent of total loans, lower than the system-wide average. Some banks have started to swap



some of their non-performing SOE debt for Government bonds with maturities of between 10 to 15 years.⁵ Banks may require additional provisions. As of September 2017, specific provisions were 58.6 percent of NPLs, a reduction from 78.3 percent in December 2016.

7. To shore up the financial system, in 2017 the central bank has increased capital and reserve requirements. Minimum capital requirement increased from US\$ 1.2 million to US\$ 27 million and the minimum solvency ratio from 8 to 12 percent. Some banks may face challenges in complying with the new capital requirements absent support from their parent. As of mid-2017, several banks were below the new minimum capital requirement, although banks have until 2020 to comply. The banking system capital adequacy ratio increased to 20 percent in September 2017 (from 8.8 percent in end of 2016) due to a decline in overall risk-weighted assets, a capital increase in Moza Banco, and liquidation of Nosso Banco. The central bank lowered reserve requirements for domestic currency liabilities in October 2017 from 15.5% to 14.0%. But it increased the requirements for foreign currency liabilities in March 2018 to 22.0 percent from 14.0 percent. Access to the central bank’s overnight window is limited to two days a week, which obliges banks to increase tighten their liquidity management. See Financial Stability Indicators in Annex II.
8. Bank profits do not reflect the deterioration of asset quality. Return on assets and equity (ROA/E) are high at 2.5 percent and 35.7 percent respectively in September 2017, relative to 0.7 and 10.1 percent in 2016. In addition to increased income from government securities, banks appear to have been able to maintain the level of fees and commissions. At 27.9 percent, average commercial bank lending rates in Mozambique are excessively high for most of the private sector and remain above peer countries. The lending–deposit spread is high and in 2017 increased to 10.6 percent from an average of 6.2 percent in 2010–2015, higher than regional and income group medians. This increase reflects the higher risks in the current macroeconomic environment. The spread also reflects structural issues such as high operating costs, lack of credit information, limited availability of collateral, and limited competition. The average cost-to-income ratio for banks stood at 58.2 percent.

Figure 5: Bank solvency indicators have increased...

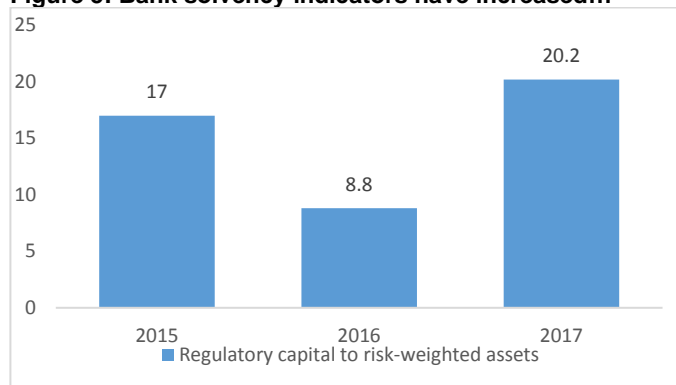
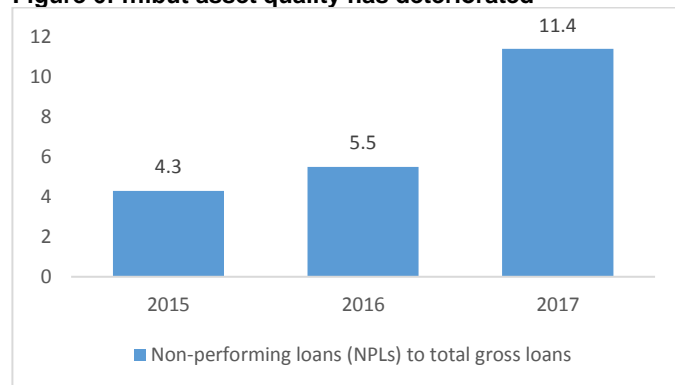


Figure 6:but asset quality has deteriorated



⁵ In 2017, the Government issue two bond series for a total of MZN 7.4 billion (\$US 116.9 million or 0.9% of GDP) directly to commercial banks in exchange of SOE loans that were reaching maturity.



Figure 7: Banks are more profitable...

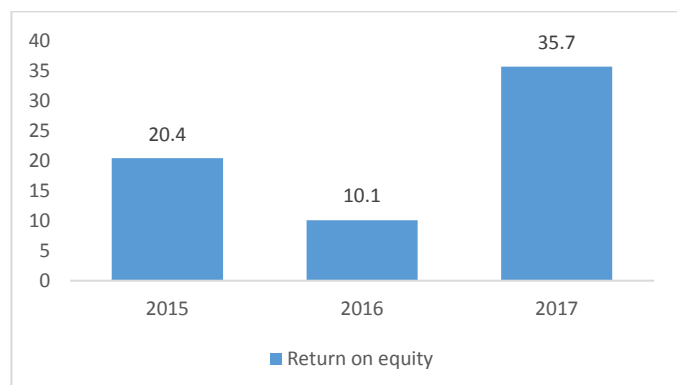
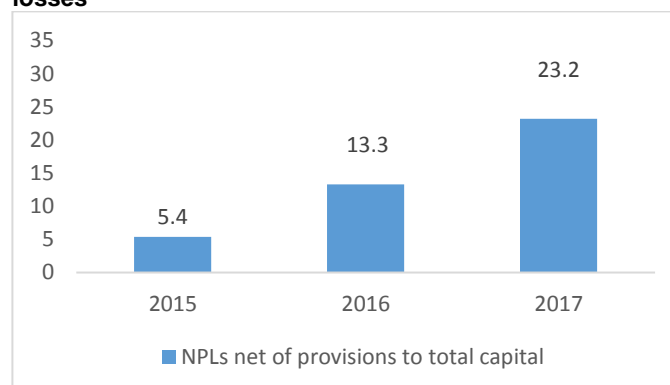


Figure 8: ...but are not provisioning as much for potential losses

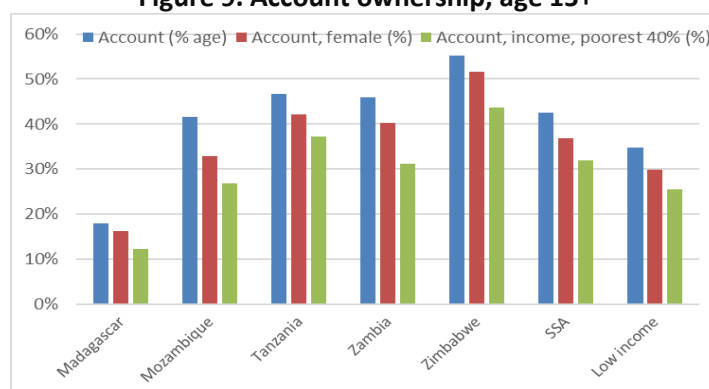


Source: Bank of Mozambique.

Note: 2017 figures as of September 2017.

9. **Access to finance, particularly for SMEs and agriculture producers, is constrained with interest rates on commercial loans close to 30 percent on average.**⁶ The sharp reduction in credit availability, particularly affected construction, manufacturing and commerce. The real cost of borrowing in Mozambique is high compared to peer countries and has increased significantly in 2018 as inflation has come down to single digits. Firms of all sizes cite high interest rates as the main reason for not applying for loans. The number of borrowers from commercial banks is low (69 per 1,000 adults in 2016).
10. **Financial inclusion remains a significant challenge, particularly for women.** Despite recent improvements, the Findex 2017 survey estimates that 58 percent of adult Mozambicans are still financially excluded, i.e., do not have a transaction account.⁷ The growing share of households that have access to formal sector financial services are concentrated in urban centers. Bank outreach in rural areas has improved, albeit from a low base and at high cost. Among the poorest 40% of the adult population, only 27 percent have a transaction account. Account ownership has a significant gender disparity: only 33 percent of women have a deposit account (51 percent for men).

Figure 9. Account ownership, age 15+



Source: Global Findex 2017

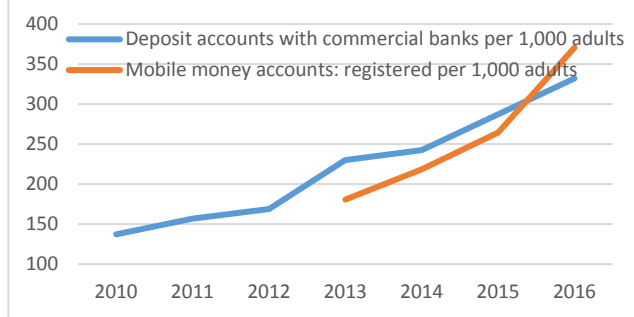
⁶ Although MSMEs contribute to 28 percent of GDP and account for 42 percent of formal employment (2015), most (75 percent) are financially excluded. Lending to the agriculture sector is particularly limited. While agriculture contributes to more than 23 percent of GDP, credit to agriculture represents only about 3 percent of total lending to the economy.

⁷ World Bank. *Global Findex 2017*



11. Digital finance is emerging with a rapid growth of mobile money accounts, which is helping improve access to financial services, although it remains constrained to urban areas. According to the IMF Financial Access Survey, in 2016, there were more individuals with mobile money accounts (370 accounts per 1,000 adults) than with a bank account (332 accounts per 1,000 adults).⁸ However, ownership of accounts does not necessarily translate into usage: according the Findex 2017 survey, only 22 percent of adults use a mobile phone or the Internet to access an account (see Annex III for more details).

Figure 10: Mobile money penetration is expanding...



Source: IMF, Financial Access Survey

Figure 11: ... supported by growth in money agents

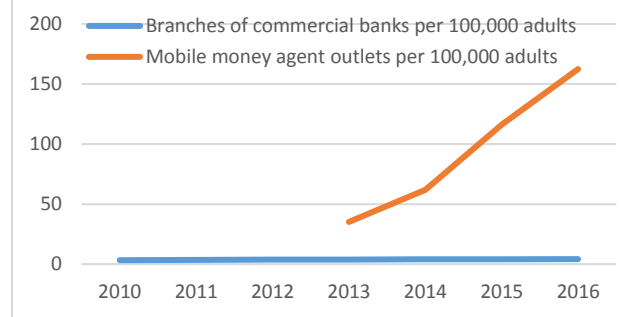
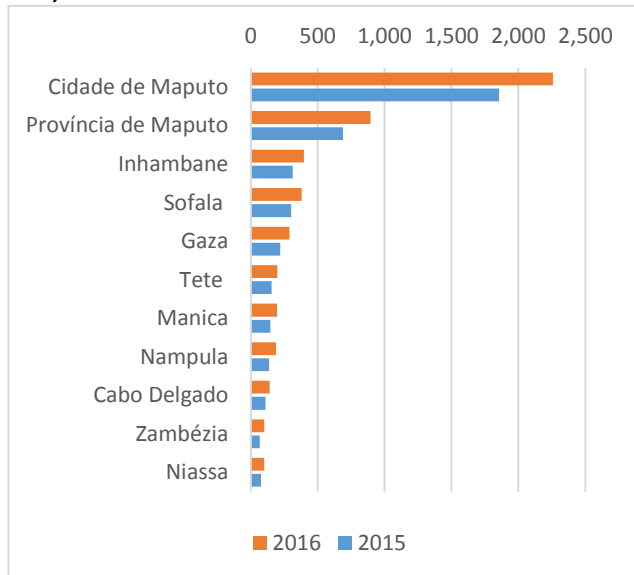
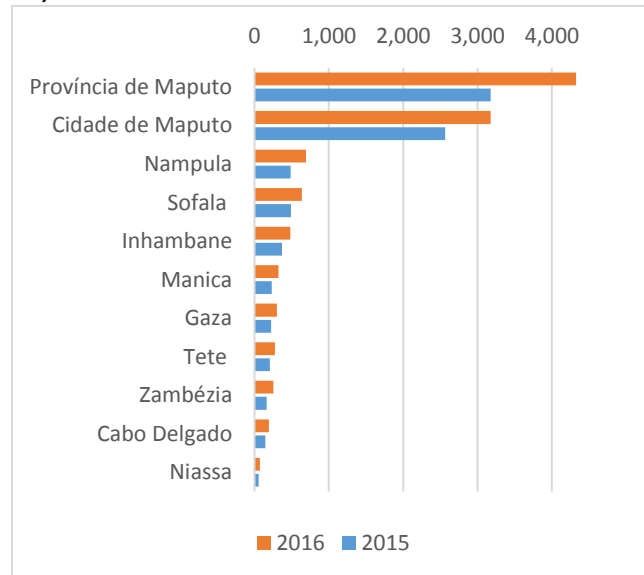


Figure 12: Financial access point by province per 100,000 adults



Source: Bank of Mozambique

Figure 13: Financial access point by province per 10,000km²



12. The payment infrastructure has limited interconnection and full interoperability in retail payments is yet to be achieved. The process for establishing a national switch is ongoing with the acquisition of Interbanco by SIMO, which is 51 percent owned by BOM (see ¶133). The central bank operates a real-time gross settlement system (RTGS), with 16 banks out of 19 connected. The volume of transactions handled by the RTGS has been increasing, reaching 31.6 percent of GDP in 2016. Since 2011 two electronic-money issuers have been operating in

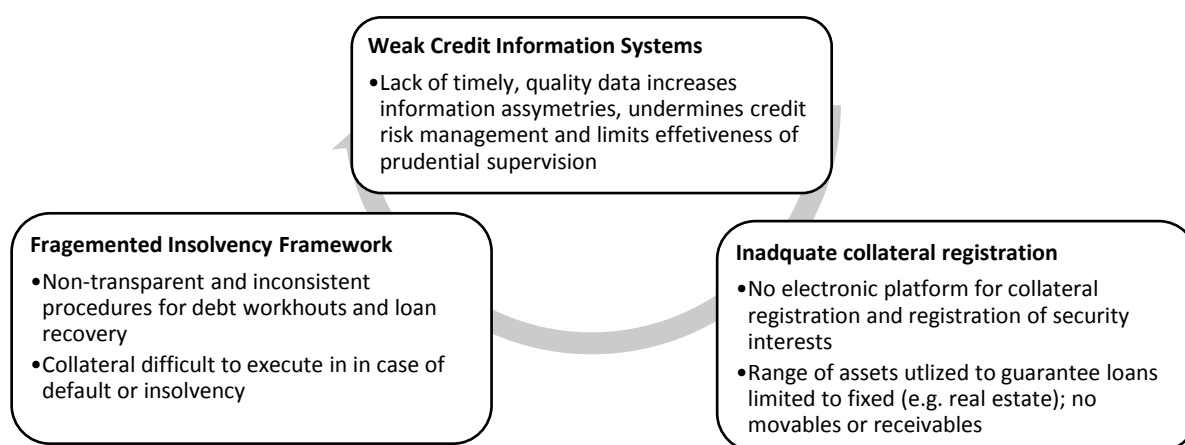
⁸ IMF Financial Access Survey



Mozambique and a third one started in 2017, but their outreach outside Maputo is limited. Still, in 2016 the value of mobile money transactions was 1.1 percent of GDP (an increase from 0.24 percent of GDP in 2014).

13. **Mozambique is the only country in the SADC region without a full-fledged system for large value funds settlement.** BOM assessed its RTGS system and identified shortcomings, particularly the fact that it does not comply with several international principles for financial market infrastructure. BOM has taken a decision to acquire a new RTGS system. Norges Bank is supporting the design of the new system, which will require linkages between central bank and each individual bank and will form the backbone of the country's financial infrastructure.
14. **Mozambique has inadequate credit infrastructure, which undermines efficient financing of private sector activity.** A weak insolvency regime, the absence of large-scale financial reporting, and an inefficient credit reporting system results in suboptimal credit allocation (see Figure below). This partly explains why banks primarily provide asset-based lending and offer little cash flow-based lending or start-up financing, and why they provide limited credit to small and medium sized firms. The Government of Mozambique is advancing reforms to its insolvency framework and has proposed legislation to facilitate the use of movable assets as collateral for loans.

Figure 14: Weak Credit Infrastructure Undermines Access to Finance in Mozambique



15. **The insurance sector is small and highly concentrated.** Insurance penetration is low, with premiums at 1.5 percent of GDP in 2016, little changed from the 1.3 percent registered in 2011. In 2016, there were 19 licensed insurance companies, but the four largest accounted for 87 percent of premiums issued. Several insurance companies are severely undercapitalized and require corrective measures or liquidation. Most coverage is of general, mandatory products (third party motor, workers compensation, etc.). The *Instituto de Supervisão de Seguros de Moçambique* (ISSM) supervises the insurance sector, but lacks independence as almost all regulatory decisions, including application of sanctions and fines, must be referred to the Minister of Finance. It also has limited capacity and staff to carry out its functions. The Bank has been providing technical support to ISSM, including in how to conduct on-site examinations, through the FIRST-funded Long-Term Finance Program, which commenced in 2015.
16. **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 (see Table 1).** The pension fund industry is dominated by the state-run pension fund, *Instituto Nacional de Segurança Social* (INSS) which collects and manages pension contributions from private sector workers. Voluntary occupational pensions are small, but growing. ISSM supervises the pension sector, but this does not include the two biggest pension funds (the private sector workers



fund [INSS] and the central bank employees fund [*Kunhana*]). As a result, investment rules for these pension funds is potentially more flexible than for supervised entities, which have strict asset concentration limits.

17. **The pension scheme for civil servants is a defined benefit scheme funded on a pay-as-you-go basis.** Civil servant pensions are estimated at about 1.7% of GDP, which is high among peers, and is forecast to rise. The Government has plans to transform the scheme into a funded, independent pension fund, and has passed necessary legislation. In 2014, the Government established the *Instituto Nacional de Previdência Social* (INPS) to manage the fund. The INPS is housed in the Ministry of Economy and Finance and is not yet independent as an operational unit. INPS is finalizing a proof-of-life exercise and an actuarial study, which will support efforts to develop a pension management plan prior to establishing the fund. Contributions from employer and employees will be channeled to the new fund, which the Government has requested technical support to design. The Bank's pension team has been provided training to INPS on forecasting techniques and overall pension reforms under the FIRST-funded Long-Term Finance Program.
18. **Capital and debt markets are at a nascent stage and their contribution as alternative sources of financing is limited.** Only 6 companies have equity shares listed on the Mozambique securities exchange (Bolsa de Valores de Moçambique - BVM), in addition to 20 government bonds, and 13 corporate bonds. In December 2017, market capitalization stood at US\$ 1.23 billion (9.0 percent of GDP), of which US\$668 million (4.9 percent of GDP) in government securities. The secondary market lacks liquidity given the predominance of buy-and-hold investors (turnover ratio of 17.8 percent in 2017 and of 6.1 percent in 2016). Twelve commercial banks are the only registered market dealers. The BOM acts as regulator and supervisor of securities exchange and is responsible for management of auctions of treasury bills. Treasury bills are not listed in the securities exchanges and are used by BdM for monetary policy purposes.

Relationship to CPF

19. The proposed project is aligned with the first focus area of the Country Partnership Framework that aims to promote diversified growth and enhance productivity through, inter alia, increased access to finance.⁹ It supports implementation of the Government's 2013 Financial Sector Development Strategy and the 2015 National Financial Inclusion Strategy (NFIS), which seeks to increase access to financial services from the current 25 percent of the adult population to 60 percent by 2022.¹⁰ It builds on a series of financial sector Development Policy Operations (DPO) delivered under the previous CPF, which supported measures to enhance financial stability, increase financial inclusion, and promote long-term finance. It also builds on the experience with the Financial Sector Technical Assistance Project (FSTAP), which ended in 2012 and sought to improve the soundness of Mozambique's banking sector and enhance public debt management.

C. Proposed Development Objective(s)

27. The proposed development objective is to promote financial inclusion and financial stability in Mozambique. This will be accomplished by supporting a series of measures designed to increase access to financial services and strengthen the overall financial safety net, particularly in the areas of bank resolution and deposit insurance.

⁹ World Bank Group. 2017. *Country Partnership Framework for the Republic of Mozambique for the Period FY17-FY21*.

¹⁰ República de Moçambique. 2016. *Estratégia Nacional de Inclusão Financeira 2016–2022*.



Key Results (From PCN)

20. **The project would benefit financially excluded households and businesses in Mozambique and help improve confidence in the financial system.** This in turn promotes domestic savings, which can be mobilized for financing investment by firms and individuals resulting in higher growth, job creation, and poverty reduction. The key project beneficiaries are households and enterprises in Mozambique that are currently not financially included and individuals with insured deposits in the financial system. Deposit insurance is a core feature of an overall financial safety net. Banks operating in Mozambique also benefit from the existence of strong financial safety nets.

D. Concept Description

21. The proposed Project would have two components: (i) broadening financial inclusion and access to finance; and (ii) strengthening financial safety nets. The instrument would be an Investment Project Financing (IPF) with disbursement-linked indicators (DLIs) for the deposit insurance component.

Component 1: Broadening financial inclusion and access to finance

22. Under this component, the proposed Project would finance activities to support the Government of Mozambique in reaching the financial inclusion targets laid out in the NFIS. This includes investments in IT systems to support digitization of Government payments, funding for a financial education campaign and expansion of branchless banking, upgrades in payment systems including interoperability between mobile money operators and banks, and investments in financial infrastructure required to improve access to finance, primarily through digital channels (e.g., movable collateral registry, credit registry, central securities deposit). The project will not provide direct funding for financial intermediation.

Component 2: Strengthening Financial Safety Nets

23. Activities financed under this component could include: operationalization and capitalization of the deposit insurance fund, operationalization of the new resolution framework (including preparation of resolution plans for banks and review of their recovery plans), new regtech and supotech approaches (either through technical assistance or through investments in upgrading the IT prudential reporting platform and improvements in risk management analytical tools), and assessment approach of cyber-risks (for the central bank and commercial banks). The support would also involve training and technical support to the regulator and training to accounting and auditing professionals.
24. The deposit insurance fund in Mozambique, the Fundo de Garantia de Depósitos (FGD), requires additional capital to fulfil its mandate to reimburse depositors from failed banks. The project would support improvements in the deposit insurance scheme, including the ability to fund bank resolution in select cases. Capitalization of the deposit insurance fund would be based on disbursement linked indicators. World Bank financing would be disbursed based on evidence of the financing of the FGD and achievement of DLIs. While most of the project funds under this component will be allocated towards capitalizing the deposit insurance fund, the Project will also support measures related to institutional strengthening of the DGF and MEF as the main beneficiaries of the TA.



SAFEGUARDS

A. Project location and salient physical characteristics relevant to the safeguard analysis (if known)

The project is not expected to have any environmental impact. The project will not involve physical investments that have relevant implications for environmental and social safeguards. Most investments will be in IT software systems and capitalization of the deposit insurance fund. These investments do not require physical displacement of persons or have negative environmental or social implications for indigenous people.

B. Borrower’s Institutional Capacity for Safeguard Policies

Not applicable. The project is category C and is not anticipated to have any environmental and social impacts and risks.

C. Environmental and Social Safeguards Specialists on the Team

Paulo Jorge Temba Sithoe, Environmental Safeguards Specialist
Maria Do Socorro Alves Da Cunha, Social Safeguards Specialist

D. Policies that might apply

Safeguard Policies	Triggered?	Explanation (Optional)
Environmental Assessment OP/BP 4.01	No	Project will not involve physical investments that have relevant implications for environmental safeguards. Most investments will be in IT software systems and capitalization of the deposit insurance fund. These investments do not require physical displacement of persons or have negative social implications for indigenous people nor anticipated to have any environmental impacts.
Performance Standards for Private Sector Activities OP/BP 4.03	No	This policy is not applicable since the project will not involve physical investments or private sector activities
Natural Habitats OP/BP 4.04	No	The policy is not applicable as the project is not involved in physical investments that would affect natural habitats
Forests OP/BP 4.36	No	The policy is not applicable as the project is not involved in physical investments that would affect forests
Pest Management OP 4.09	No	The policy is not applicable as the project will not finance any activities that will use pesticides
Physical Cultural Resources OP/BP 4.11	No	This policy is not applicable since the project will not involve physical investments



Indigenous Peoples OP/BP 4.10	No	These investments do not require physical displacement of persons or have negative social implications for indigenous people nor anticipated to have any environmental impacts.
Involuntary Resettlement OP/BP 4.12	No	These investments do not require physical displacement of persons or have negative social implications for indigenous people nor anticipated to have any environmental impacts.
Safety of Dams OP/BP 4.37	No	Project will not involve physical investments that have relevant implications for environmental safeguards. These investments are not expected to have any environmental impacts.
Projects on International Waterways OP/BP 7.50	No	Project will not involve physical investments that have relevant implications on environment or International Waterways
Projects in Disputed Areas OP/BP 7.60	No	This policy is not applicable

E. Safeguard Preparation Plan

Tentative target date for preparing the Appraisal Stage PID/ISDS

Sep 28, 2018

Time frame for launching and completing the safeguard-related studies that may be needed. The specific studies and their timing should be specified in the Appraisal Stage PID/ISDS

Not applicable.

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APPROVAL

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