December 2020
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FINANCIAL STABILITY REPORT

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Foreword

In light of the powers conferred by Law no. 1/92[1] of January 3, the mission of the Bank of Mozambique (BM) is to ensure the preservation of financial stability.

In the pursuit of this mission, BM implements macroprudential policy, whose actions and results are summarised in the Financial Stability Report (FSR/REF), an annual publication that highlights the main analyses of the financial system compared with the previous year.

With this publication, BM intends to maintain a line of communication with the public in general, and with the financial system in particular, as well as to stimulate debate on relevant issues inherent to financial stability.

BM defines financial stability as the preservation, over time and in any economic scenario, of safe, robust, efficient and resilient financial intermediation and payment systems, both to financial shocks and imbalances, which ensure that confidence in the financial system is maintained.

Promoting efficient financial intermediation in our economy is important because it mobilises savings, strengthens the operation of the payment system, reinforces the resilience of the financial system and contributes to the mitigation of systemic risk.

With a view to assessing the resilience of the financial system and enabling timely measures to be taken, BM assesses systemic risk on the basis of a quantitative matrix consisting of nineteen indicators grouped into six categories, which presents the dynamics of risk in the domestic financial system.

We aim to ensure that the financial system in general, with a focus on the banking sector, continues to register adequate levels of solvency and liquidity that enable it to contribute to crisis resolution and management, minimising global systemic risk, and to prioritise inclusive and comprehensive action, within the traditional scope of financial intervention.

[1] Law no. 1/92, of January 3, Approves the Organic Law of BM.

From this perspective, this edition of the REF/FSR brings forth the main vulnerabilities and risks, in the international and domestic macro-financial context, the performance of the Mozambican financial system, as well as macro-prudential measures and regulatory initiatives implemented by the BM and other entities with legal capacity in 2020, which contribute towards maintaining and strengthening the stability of the financial system.

The Governor

Rogério Lucas Zandamela

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Acronyms

BM	Bank of Mozambique
Bp	Base points
CE/GDP	Ratio of Credit to the Economy over Gross Domestic Product
COVID-19	Disease caused by the new coronavirus, SARS-Cov-2
D-SIBs	Domestic Systemically Important Banks
DD	Demand Deposits
DTI	Debt to Income Ratio
DUAT	Right of Land Use and Exploitation
FC	Foreign Currency
ICSF	Credit Institutions and Financial Companies
IMF	International Monetary Fund
ISSM	Insurance Supervision Institute
GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
HHI	Herfindahl-Hirschman Index
LTV	Loan to Value
MEF	Ministry of Economy and Finance
MVM	Securities Market
MZN	Metical
NFS	National Financial System
NPL	Non-Performing Loan
REF	Financial Stability Report
ROA	Return On Assets
ROE	Return On Equity
SADC	Southern African Development Community
S&P	Standard and Poor’s
TD	Term Deposits
USD	United States Dollar

Executive Summary

In 2020, the global economic and financial environment was marked by the COVID-19 pandemic, which conditioned economic activity and led to a decline in global output. Consequently, there was an increase in unemployment and sharp drop in the volume of exports, posing enormous challenges to financial stability.

At the domestic level, the consequences of the pandemic were severe in several sectors, and were reflected in a negative growth of the Gross Domestic Product of 1.3%, which limited the State's capacity to collect revenue, in addition to increasing vulnerabilities and risks in the financial system.

Despite this challenging context of the national economic environment in 2020, the Mozambican financial system (banking, insurance and securities sectors) remained resilient, sound and stable.

In effect, the banking sector that dominates the provision of financial products and services, despite maintaining high concentration rates in three systemically important institutions, continued to have capital and liquidity levels above regulatory requirements and, therefore, profitability and solvency and liquidity risks remained low. However, credit risk remains a concern, due to the high rate of credit defaults, contributing to the deterioration in asset quality.

The Mozambican insurance sector boasts positive developments in both life and non-life business, in a context in which the structure of investments representing technical provisions is dominated by financial investments, with evident deceleration of investments in buildings. In 2020, the overall production of insurance companies recorded an annual growth of 4.9% (after 21%, in the same period of the previous year), a performance that reflects the economic environment described above.

Market capitalisation, the main indicator of the Securities Market (MVM), increased fundamentally due to the dynamics of Treasury bonds, which represented 77.3% of this index. This scenario increases the sovereign risk to which holders of these securities are subjected, especially those in the banking and insurance sectors, and also influences the systemic risk and financial stability in general.

Nevertheless, despite its tendency to worsen, systemic risk prevailed at the moderate level, influenced, apart from the worsening of sovereign risk, by the increase in the categories of market risk and profitability and solvency risk, in a context in which the macroeconomic and credit risk categories remained unchanged.

To contain the risks and mitigate the vulnerabilities of the National Financial System (NFS), resulting from the new paradigm, prudential, monetary, foreign exchange and payment system measures were announced and implemented, which released capital and expanded and directed liquidity, with the purpose of maintaining the functionality of the financial markets and ensuring financial stability.

Regarding financial stability-oriented measures, the BM finished implementing additional capital requirements for all banks in 2020, which strengthened their ability to absorb credit losses and cope with financial market disruptions.

Under macroprudential measures, in 2020, the BM maintained the conservation buffers for domestic systemically important and quasi-systemically important banks, set in 2019 at a minimum of 2% and 1.0%, respectively, in addition to lending requirements related to loan-to-value (LTV) and debt-to-income (DTI) ratios for credit institutions and financial companies, both capped at 100%.

I. INTERNATIONAL MACRO-FINANCIAL ENVIRONMENT

In 2020, the global economic and financial environment was marked by the COVID-19 pandemic, which led to the shutdown of main economic activities (industry, transport, hospitality, tourism, commerce and educational institutions), leading to a reduction in global output, an increase in unemployment and a sharp drop in the volume of exports.

To mitigate the effects of this shock, government authorities provided the economy with unprecedented levels of financial stimulus to mitigate further damage. This included significant monetary and fiscal policy support, which helped maintain the flow of credit to households and businesses, facilitated the recovery of the productive sector and helped contain risks to financial stability.

This stance has contributed to the resilience of the global financial system, as noted in the April 2021 Global Financial Stability Report (GFSR). However, the resulting increase in global sovereign debt fuels fears about the stability of the global financial system.

The announcement and launch of the vaccines in late 2020 underpinned hopes of a global economic recovery in 2021, which favoured the rise in prices of risky assets, with the potential to affect investor confidence and put macro-financial stability at risk.

The uneven distribution of vaccines and a delayed economic recovery have the potential to constrain capital flows to emerging markets, especially if economically stronger countries normalise their monetary policies.

Indeed, considering that emerging markets face increased challenges given their large external financing needs, a persistent rise in interest rates in advanced economies will lead to a repricing of risk and tighter financial conditions.

This scenario could condition the post-pandemic restart of the business sector, which faces a situation of over-indebtedness, which will affect credit quality, with implications for profitability and risk management by banks.

The above-mentioned delay in the recovery of economic activity may lead to the rescue of accommodative policies, with repercussions on the increase in vulnerabilities and risks for the global financial system.

In South Africa, Mozambique's main partner in the Southern African region, the COVID-19 pandemic brought challenges to the financial system, which nevertheless remained stable and functioning effectively, despite the significant risks it faces.

South Africa's systemically important banks are expected to remain adequately capitalised, even in the face of a stress scenario (increased non-performing loans and a more severe macroeconomic slowdown than projected).

II. RISKS AND VULNERABILITIES OF THE MOZAMBICAN FINANCIAL SYSTEM

Systemic risk remained stable in 2020, at the moderate level, despite the deterioration of the financial stability index and the vulnerabilities of the National Financial System (NFS), influenced by the worsening of the sovereign risk, profitability and solvency risk and market risk indices.

Military instability in the northern and central zones of the country conditioned the NFS, in a context of the COVID-19 pandemic and recurrent extreme weather events, with the potential to influence the quality of the credit portfolio.

2.1. Systemic risk assessment

The systemic risk assessment is based on a matrix, which is a quantitative tool, presenting the dynamics of risk in the Mozambican banking sector.

The matrix is composed of nineteen indicators, grouped into the following six categories:

(i) macroeconomic risk;
(ii) sovereign risk;
(iii) profitability and solvency risk;
(iv) credit risk;

(v) funding and liquidity risk; and

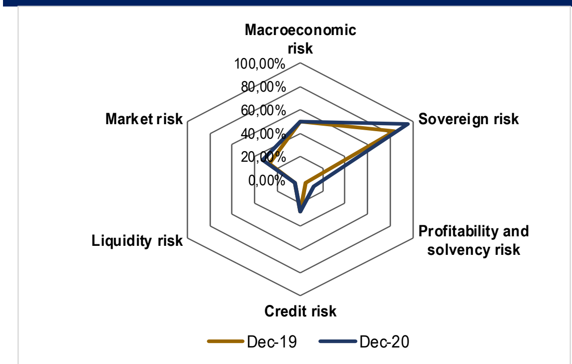
(vi) market risk.

Systemic risk is measured through a financial stability index, which can be classified as low, moderate, high or severe.

In December 2020, systemic risk remained at the moderate level, notwithstanding the worsening of the financial stability index by 4.06pp, in relation to that of 2019, now standing at 37.19% (box 1).

This worsening of the financial stability index was influenced by the behaviour of sovereign, profitability and solvency and market risks (Chart 1), where the level of risk increases from the centre to the outside of the web.

Chart 1. Developments in Systemic Risk (%)



Source: BM

The assessment by risk category makes the following observations:

2.1.1. Macroeconomic risk

In 2020, macroeconomic risk remained at the moderate level due to the favourable developments in inflation, notwithstanding the contraction of economic activity.

Inflation remained at 3.5% in December 2020, the same magnitude observed in the same period of 2019, while the economy recorded a deceleration of 1.3% in the period under review.

2.1.2. Sovereign risk

Sovereign risk prevailed at the severe level in 2020, due to the increase in the government credit-to-total credit and public debt-to-GDP ratios.

In effect, the ratio of government credit to total credit rose from 54.02% in December 2019 to 57.58% in December 2020, and the public debt to GDP ratio rose from 78.81% to 96.70% in the same period, influenced by both the increase in the balance of public debt and the weak performance of the economy in 2020.

The increase in the ratio of credit to government/total credit shows that banking institutions continue to favour investments in government[2] securities to the detriment of credit to the economy.

2.1.3. Profitability and solvency risk

In 2020, the profitability and solvency indicators remained at satisfactory levels, namely low and moderate risks, which contributed largely to the preservation of the banking sector's stability and the maintenance of systemic risk at a moderate level, despite the adversities seen in the period.

The low risk in this category indicates that the sector's level of capitalisation is sufficient for it to face possible stress situations without serious disruptions. It should be noted that, in December 2020, the solvency ratio of the banking sector stood at 27.18%[3] , a figure 15.18 pp higher than the minimum legal limit set by law for banks.

With regard to profitability, the sector performed positively, contributing to maintaining a low risk level, although there was a downward trend in the respective indicators (ROA and ROE) in 2020. In fact, in 2020, the banking sector had a positive net result equivalent to 2.20% of total assets (ROA) and 18.75% of equity (ROE), after a positive result equivalent to 2.96% and 24.93%, respectively, in the previous year.

In 2020, the risk levels of the indicators banking efficiency ratio (cost-to-income) and coverage of non-performing loans (NPL) by provisions rose from low to moderate, reflecting the negative effects of the COVID-19 pandemic and military instability in the central and northern regions of the country.

The COVID-19 pandemic and military instability led to increased operating costs for banks, which prompted the authorities to take several measures that included allowing commercial banks to undertake renegotiations of the terms of loans of affected customers, with dispensation from additional provisioning[4] , and reducing the reserve requirement ratio.

2.1.4. Credit risk

In 2020, credit risk remained at the moderate level.

With regard to the NPL ratio, despite the adversities during said period, it remained at around 10.0%, corresponding to the high-

[2] To finance the public deficit caused in part by the increase in spending on the military component and social support for both the displaced population, victims of military instability, and to minimise the effects of the COVID-19 crisis.

[3] After 28.89% in December 2019.

[4] Circular No. 02/EFI/2020 of March 23.

risk level and continuing well above the maximum level recommended by best international practices (5.00%).
Credit developed positively in this period and boasted an acceleration of 8.90 pp, moving from a growth of 5.14% in December 2019 to 14.04% in December 2020. However, this indicator remained at the low risk level.

The gap of Credit to the Economy per Gross Domestic Product (CE/GDP), another indicator of credit risk, continued at negative levels, reflecting the deceleration of the business cycle, but attenuated by the recovery of the financial cycle.

2.1.5. Funding and liquidity risk

In 2020, the funding and liquidity risk remained at a low level, favoured by both the developments of the loan-to-deposit ratio and the short-term liquidity coverage ratio, which presented values corresponding to low risk, reflecting the high liquidity existing in the market and the weak growth of credit to the economy.

2.1.6. Market risk

In 2020, market risk worsened slightly compared to December 2019, although it remained at the moderate level, fundamentally due to the increased volatility of the Metical's exchange rate against the US dollar.

The indicators for the ratio of foreign currency (FC) to total deposits, FC loans to total loans and the financial system's **prime rate** were stable throughout the year, which allowed for the market risk to be maintained at a moderate level.

Box 1. Methodology for calculating the Financial Stability Index

The systemic risk assessment is based on a financial stability index that is determined through a systemic risk matrix, composed of 19 risk indicators, grouped into 6 risk categories, which correspond to the main sources of systemic risk in the Mozambican banking sector, namely:

- macroeconomic risk;
- sovereign risk;
- profitability and solvency risk;
- credit risk;
- funding and liquidity risk; and
- market risk.

For each of the indicators, four risk intervals have been defined, namely: low risk, moderate risk, high risk and severe risk, the respective thresholds having been set on the basis of regulatory prudential limits, supervisory judgements, best practices and international experiences.

To determine the financial stability index, weightings were established to represent the risk situation of each indicator, whereby low risk was weighted at a maximum threshold of 27.5%, moderate risk at 50.0%, high risk at 72.5% and severe risk at 95.0%.

The first step in determining the general financial stability index is to calculate the index for each risk category, which is obtained from the average of the weighted risk values of the respective indicators. In turn, the financial stability index is determined through the average of the indices of the risk categories.

For the financial stability index, both the risk categories and the overall systemic risk, four risk ranges have been defined:

From 5.0% - 27.5% - low risk;
From 27.5% to 50.0% - moderate risk;
From 50.0% to 72.5% - high risk;
From 72.5% - 95.0% - severe risk.

It should be noted that the lower the value of the financial stability index, the greater the financial stability; in other words, financial stability is inversely proportional to the value of the respective indicator, or the systemic risk is greater the higher the value of the financial stability index.

2.2. System vulnerabilities

Despite the challenging context of the national environment in 2020, the national financial system continued to carry out its operations of financial intermediation and provision of payment services.

The year 2020 was marked by some vulnerabilities that affected the performance of the domestic financial system, especially the COVID-19[5] pandemic, which led to various restrictions to mitigate its spread, military instability in the central and northern regions of the country and extreme climatic events, whose impact led to a reduction in economic activity.

2.2.1. COVID-19 Pandemic

The effects of the COVID-19 pandemic led to the adoption of measures and public policies to contain its spread resulting in significant operational and financial disruptions for many businesses and households.

The employee rotation implemented to lower risk of infection, disruptions in the supply chain and sudden reduction in demand have created constraints for companies in virtually every sector of the economy and contributed to a decline in their performance.

On the supply side, the most direct transmission channel was associated with the inability of carrying out certain activities, especially in the hotel and restaurant business.

On the demand side, there was a reduction in income and in the confidence of households and companies. Households changed their consumption habits to adapt to the income reduction.

For companies, the cancellation of orders, the extension of payment deadlines and the need to make current expenditures that can no longer be postponed (salaries, instalments of loans, payment of services, and others) have given rise to growing liquidity needs.

The spectrum of difficulties for families and companies honouring their commitments to the bank, in the face of financial difficulties, was present in our economy, due to the decline in economic activity.

[5] With an impact on the reduction in external demand for Mozambique's main export commodities.

The restructuring of bank customers' loans as part of the COVID-19 pandemic served to curb/impede the increase in the levels of non-performing loans. Effectively, NPL remained around 10% (decreasing from 10.2% in December 2019 to 9.8% in December 2020), while the NPL coverage ratio decreased to 74.1% after 88.7% in December 2019.

2.2.2. Military instability in central and northern regions of the country

Military instability, with greater incidence in the northern region of the country, worsened in 2020 and caused the destruction of infrastructure, including bank branches, which hindered the provision of and access to financial services and limited financial inclusion.

The destruction of infrastructure, generating population displacement and increasing costs in the defence, security and humanitarian assistance sectors, obliges the State to abandon certain development projects to meet the costs associated with the conflict.

The State's increased spending on the military[6] component and on social support for affected families has resulted in an increase in the public deficit, which has been financed through the issue of public debt securities (Treasury Bonds and Bills) taken on by the financial sector, which has had the effect of worsening the sovereign risk.

Military instability has increased uncertainty over the implementation of the investment programme in the Rovuma Basin, with financial implications for domestic economic players involved in exploring local content opportunities and eligible to engage in the project.

Limited movement of people and goods, restriction of public services’ operation, deterioration of the business environment, destruction of public and private infrastructure, including bank branches, in the areas affected by the instability have limited and made access to financial services more expensive, thus slowing down financial inclusion in the country.

2.2.3. Adverse climatic factors

In 2020, the country was once again devastated by extreme climatic factors, which compromised the environment and well-being of the population, generating

[6] In effect, according to information from the MEF, expenditure on the defence and security sector in 2020 increased, compared to the previous year, with its weight increasing from 4.0% to 5.9% on State expenditure.

economic costs with repercussions on the stability of the financial system.

In fact, strong winds and lightning caused floods all over the country, in addition to cyclone Chalane in December 2020, which affected the provinces of Sofala, Zambézia and Manica.

These extreme events that have repeatedly struck the country have destroyed infrastructure (roads, factories, crop fields, and others) and reduced production levels, making it difficult for affected families and companies to honour their commitments to the banking sector.

The impact of extreme events on infrastructure also increases credit risk by reducing the value of the asset given as credit security.

2.2.4. Public sector debt

In 2020, public sector debt increased, influenced by the increase in public expenditure that was not offset by tax revenue, which fell in line with the performance of economic activity, contributing to an increase in sovereign risk.

The greater pressure on the public expenditure side resulted from public sector spending to contain the COVID-19 pandemic, weather effects and military expenses.

The sharp drop in economic activity influenced the level of tax revenue collection, which fell by 14.6%, an expected fact, considering the downward forecast of the revenue limit laid down by the 2020 State Budget (Law 3/2020), as well as the amendment (Law 11/2020).

This decline in revenue, in a context of unpostponable expenditure, precipitated the increase in public debt by 26%, compared to the same period of the previous year (Table 1). The increase in public debt led to the deterioration of the public debt/GDP ratio in 2020, which rose from 78.8% in 2019 to 96.7%[7], in the period under review.

Table 1: Public Debt Stock - Million MT

	2018	2019	2020
External Debt	596.699	599.482	752.745
Internal Debt	139.377	154.595	195.961
Total Debt	**736.076**	**754.077**	**948.708**
Current Capital Revenue		276.788	236.322
GDP	895.567	956.786	982.402
Debt/GDP	82,2%	78,8%	96,7%
Debt variation (%)		2,4%	26,0%

Source: MEF (*) projected value

[7] This is far from the limits considered acceptable for both the IMF (65%) and SADC (60%).

High levels of public debt bring added concerns about the potential increase in sovereign risk bound to fears of possible State hardships in attending to its commitments to the financial system.

2.2.5. Country's confidence in the international market

In 2020, the country's confidence[8] in the international market remained at substantial risk[9] levels (Table 2), with Mozambique continuing to restrict access to international financial markets, which may increase domestic financial market risk on the exchange rate and interest rate fronts.

Table 2. Country rating in the international market [10]

Agency	Dec 18	Dec 19	Dec 20	Perspective
Moody's	Caa3	Caa2	Caa2	stable
Standard & Poor's	SD	CCC+	CCC+	stable
Fitch Ratings	RD	CCC	CCC	stable

Source: Moody's; S&P; Fitch

Mozambique's rating by the main financial rating agencies (Standard & Poor's, Fitch Ratings and Moody's), which was unanimous, was based on forecasts of negative economic growth, rising public debt and depreciation of the Metical throughout the year.

Table 3. Country rating in the international market – SADC comparison

	Moody's	Standard & Poor's	Fitch Ratings
Mozambique	Caa2 (stable)	CCC+	CCC
South Africa	Ba2 (Negative)	BB- (stable)	BB
Angola	Caa1	CCC+	CCC
Eswatini			
Zambia		SD	RD
Tanzania			
Botswana	A2	BBB+	
Mauritius	Baa1		
Malawi			B-

Source: Moody's; S&P; Fitch

This rating places the country far behind the other countries of the region (Table 3), which have a qualitatively better rating, and this may be a differentiating factor in attracting investment to the respective economies.

[8] Investors use the country's confidence in the international market to make investment decisions in a given economy.

[9] Rating achieved in October 2019, after the removal from the financial default category.

[10] **Caa3:** substantial risk; **Caa2:** substantial risk; **SD:** default; **CCC+**: substantial risk; **RD:** default; **CCC**: substantial risk

Box 2. Initiatives to prevent and combat money laundering and terrorist financing

In November 2019, began the process of the National Assessment of Money Laundering and Terrorist Financing Risks (ANR), with a view to mapping the main national threats in this field, alongside an assessment of the main vulnerabilities and sectoral controls, which shall allow for identifying response measures to remedy weaknesses found.

The process was jointly organised by the Ministry of Economy and Finance, through the Mozambique Financial Intelligence Office and the World Bank, with funding from the UK Department for International Development (DFID).

In parallel, under the leadership of the Ministry of Economy and Finance and coordination of the Mozambique Financial Information Office (GIFiM), preparations began in April 2019 for the 2nd Round of Mutual Evaluation of Mozambique on Anti-Money Laundering and Countering the Financing of Terrorism (AML/CFT) by the Eastern and Southern Africa Money Laundering Group (ESAAMLG).

This is a process triggered within the scope of compliance with the 40 Recommendations of the Financial Action Task Force (FATF), which assesses, on a rotational basis, the following aspects:

(a) The effectiveness of the national regulatory and institutional framework to combat ML/FT; and

b) Clarify Technical Compliance aspects of the System, which assesses the implementation of specific requirements of the FATF 40 Recommendations and other international instruments, as well as Laws, Regulations and Guidelines issued by supervisory authorities.

From the point of view of Bank of Mozambique supervisory action on the matter, due to the Covid-19 pandemic, only one on-site inspection was carried out in 2020, leaving the rest of the intervention in the context of the traditional off-site monitoring of supervised institutions to assess the degree of compliance with the supervisory recommendations previously issued.

In light of the off-site inspections referred to above, 3 credit institutions were charged with contraventions and, as a result, fines, amounting to 67 million meticais, were imposed.

In order to refine its approach to the new challenges posed by the dynamics of the financial sector, the BM has developed activities leading, among others, to:

a) Review of banking legislation to improve measures to prevent and combat ML/FT, namely:

   - Strict requirements for entering the financial market (authorisation process for incorporation) requiring, in addition to the identification of the founding partners or shareholders and the specification of the capital subscribed by each, the identification of the actual beneficiaries of the participation;

   - Faster information exchange with other national and international authorities;

   - The BM may revoke the authorisation to engage in financial business, should an institution seriously or repeatedly violate the legal or regulatory provisions for preventing and combating ML/FT.

b) Implementation of risk-based supervision over banking and non-banking financial institutions, such as bureaux de change, operators of remittance services, including e-money operators;

c) Effective implementation of UN Security Council Resolutions on terrorism and its financing;

d) Improved coordination with other supervisory authorities and justice administration entities;

e) Continuous adaptation of human and technological resources for effective supervision.

It is also very important that supervised institutions are made aware of the need to continually adapt their internal control systems, in terms of prevention of ML/FT, which in the coming years will be based on the risk indices and mitigation measures taken from the NRA report, to be disseminated by the BM, as well as the recommendations resulting from the Mozambique Mutual Evaluation report.

III. PERFORMANCE OF THE FINANCIAL SYSTEM

3.1. Banking sector

Notwithstanding the effects of the COVID-19 pandemic and military instability, the banking sector, which dominates the provision of financial services, remains sound, stable, profitable and liquid, even if NPL levels remain high.

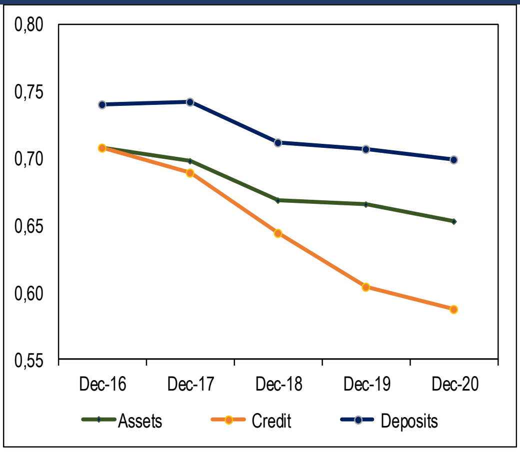
Capital and liquidity levels are above regulatory requirements, therefore, profitability and solvency and liquidity risks remain low.

However, credit risk remains a concern, due to the high rate of credit defaults, which has been contributing to the deterioration in asset quality.

3.1.1. Concentration levels in the banking sector

The Mozambican banking sector continues to maintain high concentration rates, despite the downward trend of the Herfindhal - Hirschman index (HHI) observed in recent years.

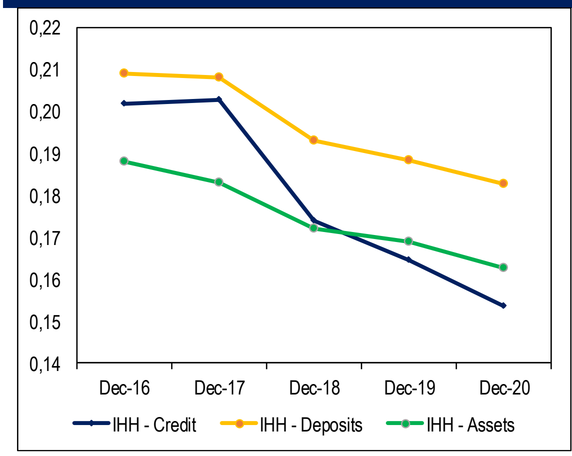
Chart 2. Developments in concentration levels of the three largest banks - December 2020



Source: BM

Last December, together, the three largest systemically important banks in the banking sector, concentrated 65.3% of total assets, 69.9% of deposits and 58.7%, of credit in the banking sector (Chart 2), with the HHI concentration index set at 0.158 (0.164 in Dec/19) for assets, 0.178 (0.183 in Dec/19) for deposits and 0.149 (0.159 in Dec/19) for credit (Chart 3).

Chart 3. Developments in concentration levels in the banking sector - Herfindahl-Hirshmann Index (HHI) - December 2020



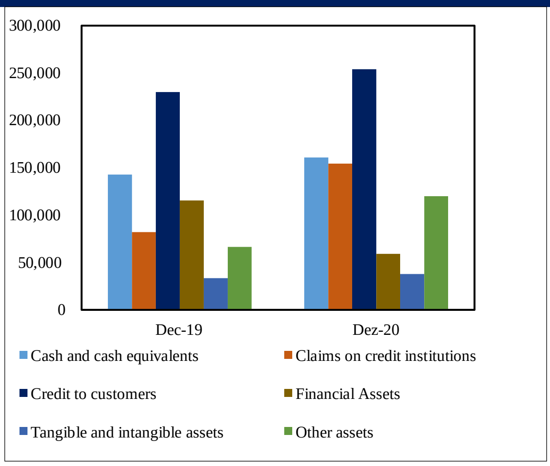
Source: BM

3.1.2. Balance Sheet Structure

3.1.2.1. Main asset items

In December 2020, the assets of the banking sector amounted to 786,290 million meticais, representing a growth of 17.3% over the same period of the previous year, and an increase, in relation to GDP, from 69.4%, in December 2019, to 80.0%, in December 2020. This change was mainly driven by the increase in claims on credit institutions (88.3%) and other assets (80.7%) (Chart 4).

Chart 4. Main asset items - December 2020



Source: BM

The increase in assets was financed by a 23.1% increase in deposits over the period concerned.

Despite growing 10.5%, net impaired credit still represents a substantial portion of the banking sector's balance sheet. In late 2020, it recorded a slight reduction in its weight in terms of total assets, settling at 32.3% (34.3% in December 2019).

In the period under review, credit institutions continued to invest, as in previous years, mostly in net and lower risk assets, which represent, in aggregate terms, 47.6% of total assets (50.8% in December 2019).

This stance is maintained in a context of change in the composition of the structure of the most liquid assets, characterised by a decline in the weight of Financial Assets and Cash and Cash Equivalents and an increase in claims on credit institutions.

In fact, the percentage of Financial Assets, Cash and Cash Equivalents and Claims on Credit Institutions in total assets was 7.5% (17.2% in December 2019), 20.5% (21.3%) and 19.6% (12.2%), respectively.

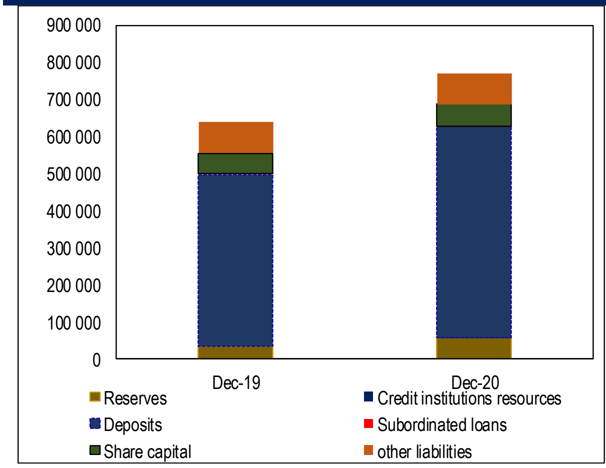
3.1.2.2. Main items of liabilities and equity

With regard to liabilities, deposits, which are the main source of funding for credit institutions, rose to 567,871 million meticais in December 2020, which corresponds to growth of 23.1% when compared with the same period the previous year.

406,271 million meticais of total deposits stood for national currency (71.5%) and 161,600 million meticais (28.5%) for foreign currency.

In the period under review, the banking sector's equity totalled 134,069 million meticais, representing an increase of 8.5% compared to December 2019 (Chart 5). This change was essentially due to the expansion of reserves by 22,179 million meticais (62.3%).

Chart 5. Main items of liabilities and equity



Source: BM

3.1.3. Financial strength indicators

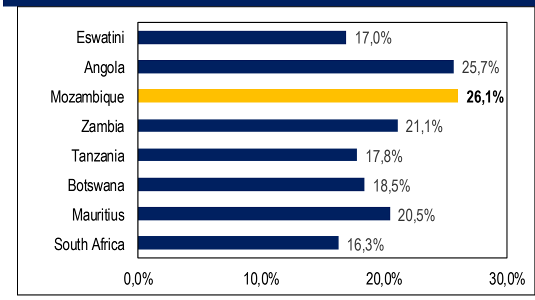
3.1.3.1. Capital adequacy

Credit institutions met the minimum capital requirements at the end of December 2020, which contributed to maintaining profitability and solvency risk at the low level, although these indicators reduced compared to the previous year.

The solvency ratio stood at 26.1% (29.0% in December 2019), a figure that is 14.1 pp above the regulatory minimum (12%). This drop (2.9 pp) occurred in 2020, resulting from the increase in risk-weighted assets (21.5%), which was higher than the increase in eligible equity (9.3%).

This level of the solvency ratio of the domestic banking sector is above the SADC average (Chart 6).

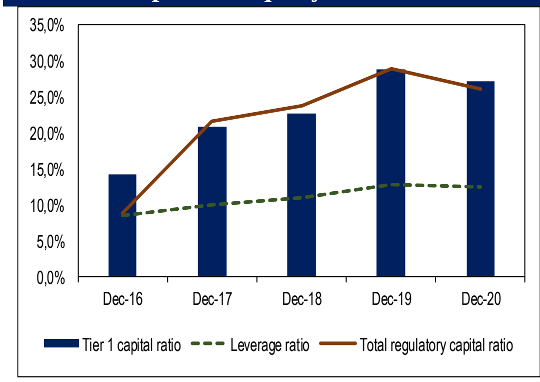
Chart 6. Solvency – SADC comparison



Source: BM

The Tier I ratio on risk-weighted assets stood at 27.2% (28.9% in December 2019). This change signifies a slight deterioration in the coverage of higher quality capital over risk-weighted assets (Chart 7).

Chart 7. Capital Adequacy



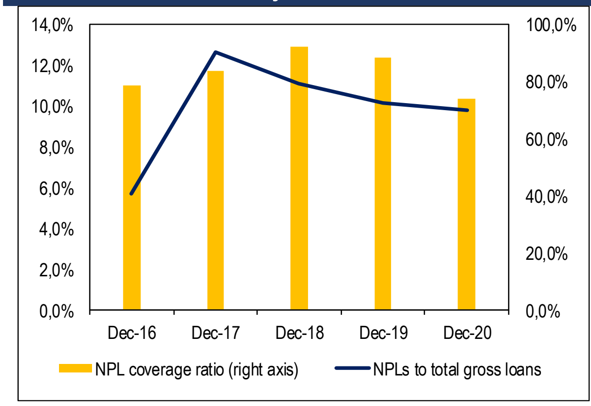
Source: BM

The leverage ratio, another indicator of capital adequacy, which indicates the extent to which assets are financed by equity, remained stable in the period at 12.5% (after 12.8% in December 2019).

3.1.3.2. Asset quality

In December 2020, the ratio of non-performing loans (NPL) to total credit, the main indicator of asset quality, remained around 10.0% (Chart 8), a figure above the international benchmark of 5%, contributing to the maintenance of credit risk at a moderate level.

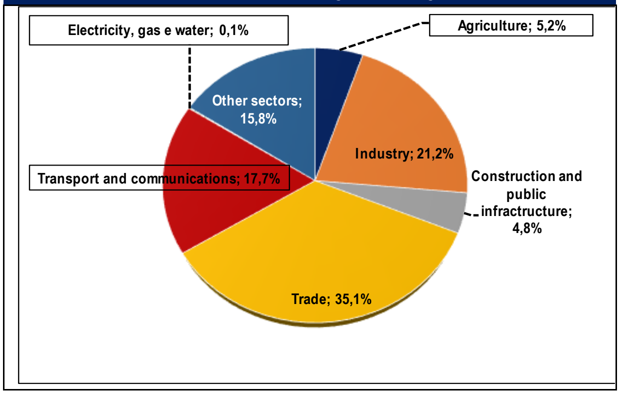
Chart 8. Credit Quality



Source: BM

In terms of the distribution of NPL by activity sectors in December 2020, Commerce recorded the highest concentration with 35.1%, followed by Industry (21.2%) and Transport and Communications (17.7%) (Chart 9).

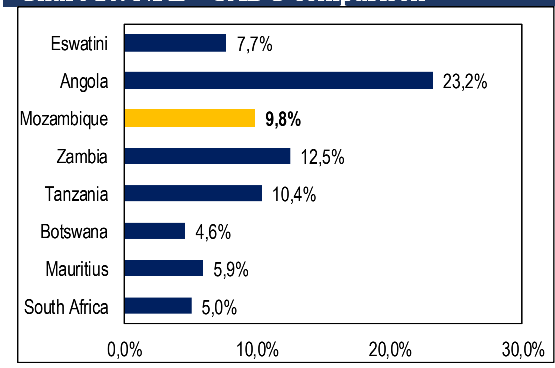
Chart 9. NPL distribution by activity sectors



Source: BM

In the SADC countries shown in Chart 10, Mozambique's level of non-compliance is close to that of Tanzania, being surpassed by Zambia and Angola.

Chart 10. NPL – SADC comparison



Source: BM

The coverage of non-performing loans by specific provisions decreased from 88.7% in December 2019 to 74.1% in December 2020 (Chart 8).

3.1.3.3. Profitability

The main profitability indicators of the banking sector remained at satisfactory levels, despite being low on the previous year, which contributed to maintaining the low risk level of the profitability and solvency category.

Return on assets (ROA) stood at 2.2% (3.0% in December 2019) and return on equity (ROE) at 18.7% (24.9% in December 2019).

Net interest income as a percentage of operating income stood at 65.9% in December of 2020 after 67.6%, in the previous year, which shows the fall of financial intermediation in the generation of results.

The cost-to-income ratio stood at 62.1% (59.2% in December 2019), indicating a reduction in banking efficiency (Table 4).

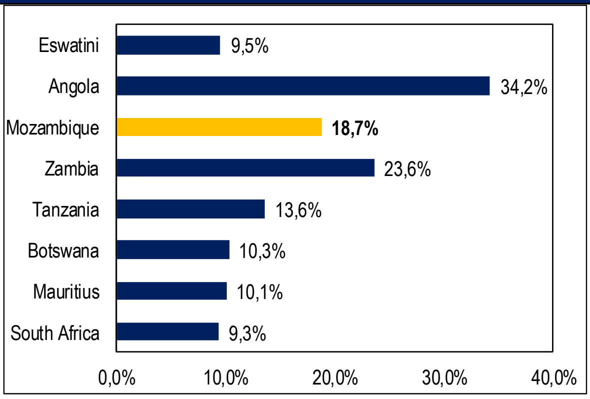
Table 4. Key Profitability Indicators

Description	Dec-17	Dec-18	Dec-19	Dec-20
ROA	2.6%	3.1%	3.0%	2.2%
ROE	32.0%	29.8%	24.9%	18.7%
Financial Margin	71.2%	71.6%	67.6%	65.9%
Cost-to-income	56.4%	58.0%	59.2%	62.1%

Source: BM

The level of profitability of the national banking sector, measured by ROE, was higher than that of some Southern African countries, with the exception of Angola and Zambia (Chart 11).

Chart 11. ROE – Southern Africa comparison



Source: BM

3.1.3.4. Liquidity and fund management

In general, the main liquidity indicators, in particular the transformation ratio, evolved favourably in December 2020, compared to the same period of the previous year (Table 5), consolidating the low level of the funding and liquidity risk category.

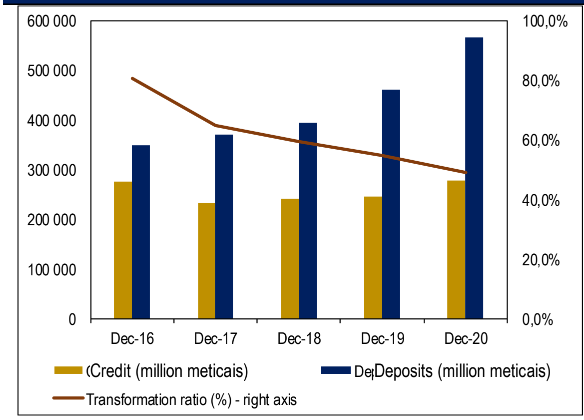
Table 5. Main Liquidity Indicators

Description	Dec-17	Dec-18	Dec-19	Dec-20
Net Assets/Total Deposits Ratio	53.6%	57.9%	57.1%	58.9%
Net Assets/Total Assets Ratio	37.0%	39.3%	39.3%	42.5%
Short-term liquidity coverage ratio	51.3%	56.2%	56.1%	58.5%
Loan-to-deposit ratio	64.7%	59.3%	54.7%	48.9%

Source: BM

The reduction in the transformation ratio (Chart 12) was due to deposits increasing at a faster rate than credit, which contributed to the fall in profitability, as credit is the main item in the assets portfolio.

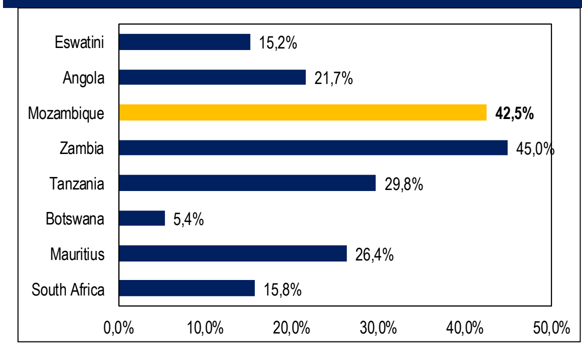
Chart 12. Credit, deposits and transformation ratio



Source: BM

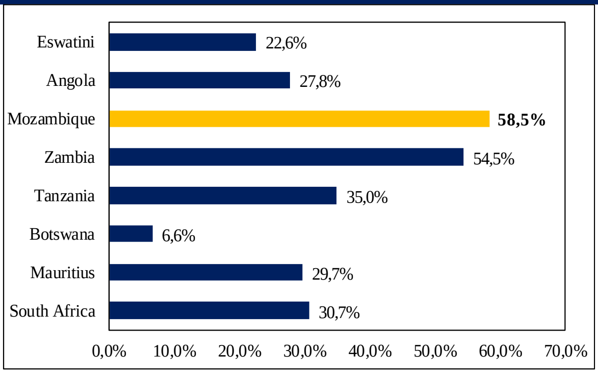
The level observed in liquidity indicators in Mozambique was higher than most of the economies of some Southern African countries (Charts 13 and 14).

Chart 13. Net assets/Total assets' ratio - SADC comparison



Source: BM

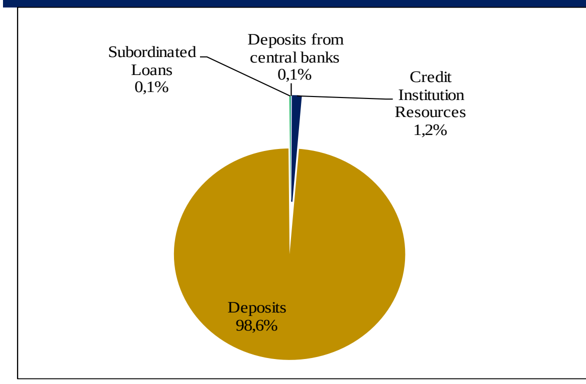
Chart 14. Short-term liquidity coverage ratio - SADC comparison



Source: BM

Deposits continue to represent the banking sector's main source of funding, accounting for 98.6% of total sources of funding in December 2020 after 97.2% in the same period last year (Chart 15).

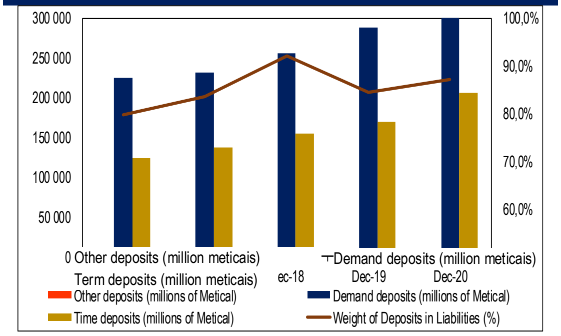
Chart 15. Sources of funding of the banking sector



Source: BM

With regard to the structure, 62.6% corresponds to demand deposits, with the remainder equivalent to the term component (36.2%) and other deposits (1.2%). Both demand and term deposits recorded increases equivalent to 23.7% and 21.3%, respectively, when compared to the same period of 2019, thus contributing to the continued strengthening of the banking sector's funding flows (Chart 16).

Chart 16. Evolution and composition of deposits



Source: BM

Box 3. Role of stress testing in improving the financial stability assessment

Macroprudential stress testing emerged in the nineties as a “risk management tool” for banks and other financial sector institutions. However, at this time, little importance was given to this important instrument for monitoring financial stability.

Only with the outbreak of the international financial crisis at the end of 2007 did the need for stress tests become more relevant.

The tests have a futuristic perspective, seeking to quantify losses that could occur in the portfolio or financial institution in a scenario of exposure to very adverse conditions in the near future.

The BM has already been developing stress tests directed at each of the banks in the system, through Prudential Supervision. However, stress tests that allow for assessing the resilience of the banking system as a whole (macro stress test) need to be carried out.

Macro-prudential stress testing is a useful and indispensable tool for the technical assessment of the soundness and robustness of the financial system. This tool assesses two main aspects of financial institutions' performance, namely solvency and liquidity.

A solvency stress test measures the capacity of financial institutions of continuing to perform their basic financial intermediation functions: taking deposits and granting loans, in a macroeconomic upset scenario.

The liquidity stress test examines whether financial institutions raise sufficient funds (cash inflows) to support cash outflows in a stress scenario.

BM is developing mechanisms for conducting macroprudential stress tests to improve its ability to measure the resilience of the banking sector to adverse shocks such as the current COVID-19 pandemic, extreme weather events (cyclones, floods, drought, etc.), military conflicts, high public debt, among others.

Box 4. Lending to the real estate sector

In 2020, the banks continued to have reduced exposure to the real estate sector, either through home loans or by foreclosure, when looking only at the statistics on credit to the sector.

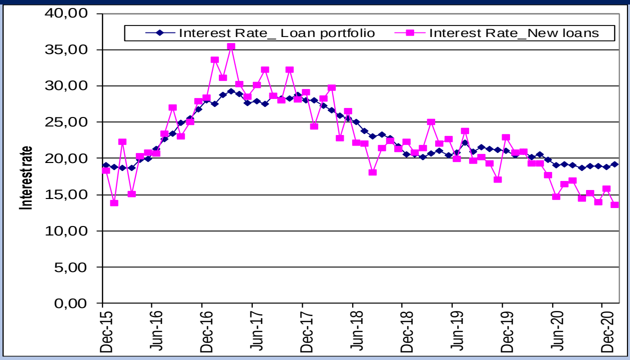
In effect, the credit for housing faces some limitations, with emphasis on:

- Excessive bureaucracy and the requirement of a lot of documentation, by the banks, in the processing of the file, namely:
  - ✓ Promissory contracts, title deeds, real estate certificates, insurance, among others, for the acquisition of real estate already built;
  - ✓ Right of Land Use and Exploitation (DUAT), building permits from municipalities, fees and others, for the purpose of self-construction.
- Unavailability of good credit in the market, as players in the banking sector are unwilling to offer credit to applicants, be they households or businesses.

Additionally, home loans are constrained by:

- Low household disposable income (GDP per capita of about USD 522.00), which was aggravated by the recessive scenario[11] and the history of high interest rates (Chart 17);

Chart 17. Interest rates on loans in FC



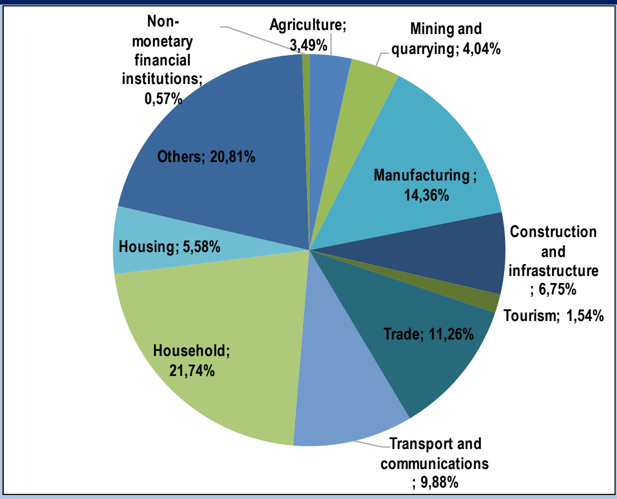
Source: BM

- High property prices on the market, given the income of most of the Mozambican population.
- The economic cycle that the country is going through, characterised by weak aggregate demand and fears about the capacity of families and companies to honour their commitments.

However, looking at the distribution of credit by sector and purpose, it can be seen that the portion allocated to housing, especially when added to that of individuals and other purposes, has some expression, which shows that despite the constraints, the banks remain active in the real estate business.

[11] In the current context, among the banking sector's clientele, households are the segment that has been most affected by the less positive performance of the economy, reflected in the increase in overdue credit, particularly consumer credit.

Chart 18. Credit to the economy by sector



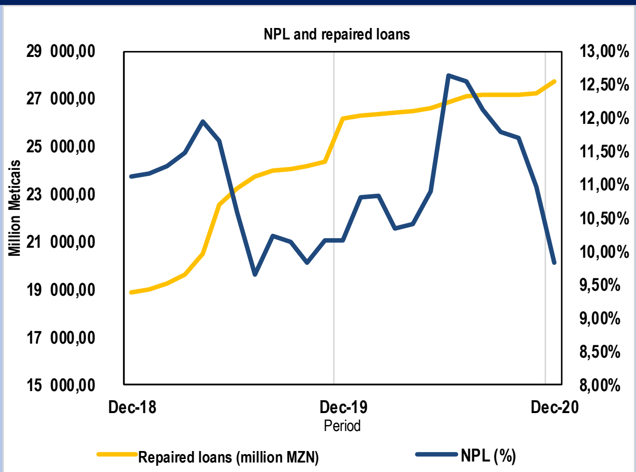
Source: BM

As per Chart 18, credit to individuals has a significant weight on the total, representing around 20.0%, which, associated with mortgage loans, increases the weight to figures close to 25.0% of the total credit granted by the banking sector.

Meanwhile, it has been difficult to discern the various applications to which personal loans are directed. It is, therefore, essential to be careful about the banking sector's exposure to this type of credit, particularly in a context where the quality of the sector's assets is not as desirable. This fact may partly justify the retraction of banks in the financing of this segment.

In fact, using quarterly data from December 2002 to December 2020 on mortgage and personal loans, and assuming that an important part of personal loans[12] is for housing and other durable goods, we conclude that the housing market may represent a key element to consider when we want to measure the costs of a potential default in the credit portfolio for the banking sector, particularly regarding the developments in NPL and credit risk, the most relevant banking risk.

Chart 19. Developments in NPL(%) and repaired loans (million meticais)



Source: BM

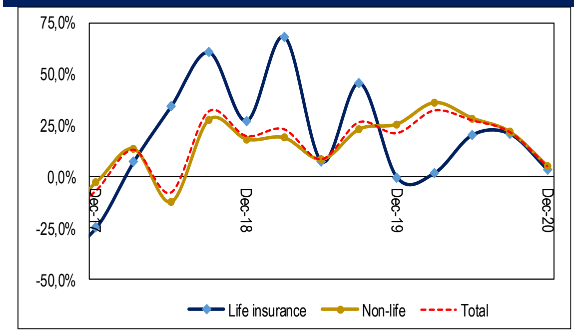
[12] Supposedly for consumption

3.2. Insurance sector

The overall production of insurance companies recorded a growth in 2020 of around 4.9%, when in 2019 it had expanded by 21%. This weak performance was influenced by the economic outlook[13] that the country is undergoing, which affected all sectors of the economy, including insurance.

A determining factor for these developments was the timid performance of the life branch, whose production increased by only 3.5%, which still represents an improvement compared to the 0.3% drop that occurred in 2019 (Chart 20).

Chart 20. Overall production of insurers (year-on-year change)

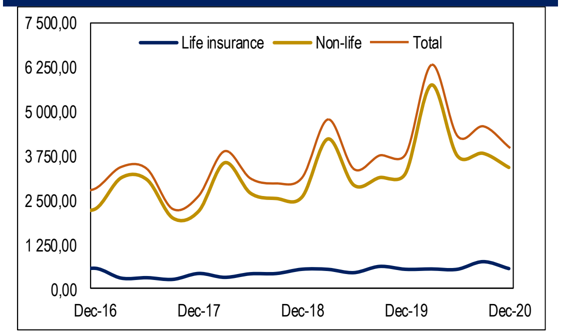


Source: ISSM

This half-year evolutionary trend in the insurance sector was driven by the cancellation of insurance policies by some companies, a fact motivated in part by the restructuring and reduction of the workforce in companies and corporate bankruptcies in some cases as a result of the spread of COVID-19.

In absolute terms, in the period under review, overall production grew by around 186.4 million meticais, driven by the production of the non-life branches, whose contribution to total production stood at 167.2 million meticais (Chart 21).

Chart 21. Overall production of insurers (million meticais)

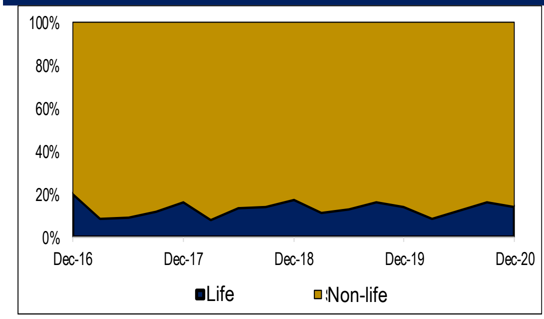


Source: ISSM

The performance of the non-life business lines was decisive to these developments, representing the largest share of the market, standing at 85.9% (Chart 22).

[13] Increased risks and uncertainties for the Mozambican economy: COVID-19, military conflicts and natural disasters.

Chart 22. Weight of branches in the overall production of insurers (million meticais)

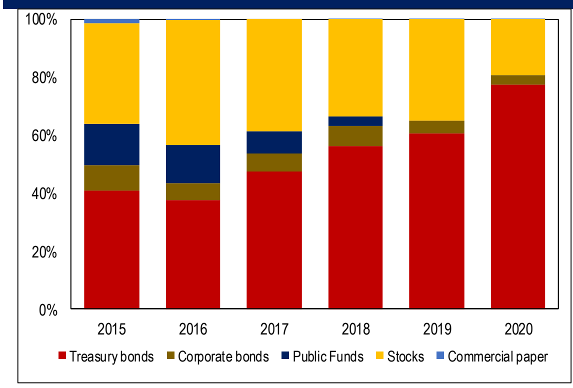


Source: ISSM

3.3. Securities Market

In 2020, treasury bonds accounted for about 77.0% of market capitalisation (60.6% in 2019). This shows the great weight of the State in the securities sector [14](Chart 23), which increases the sovereign risk to the holders of these securities, especially those in the banking and insurance sectors, while also influencing systemic risk and financial stability in general.

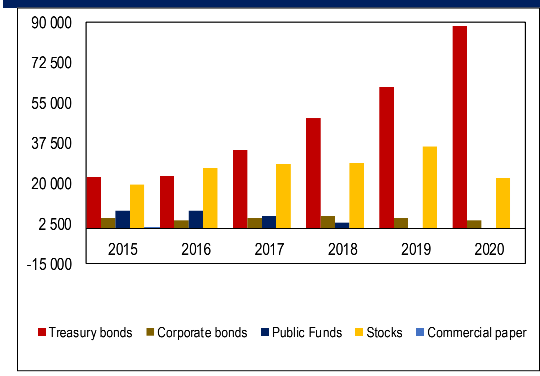
Chart 23. Weight of the Various Securities Market' Segments in Market Capitalisation



Source: BVM

The dynamics of treasury bonds influenced the performance of market capitalisation, the main indicator of the Mozambican securities market, which increased by 11.8%, rising from 102,138.7 million meticais in 2019 to 114,215.7 million meticais in 2020 (Chart 24).

Chart 24. Market capitalisation (million meticais)

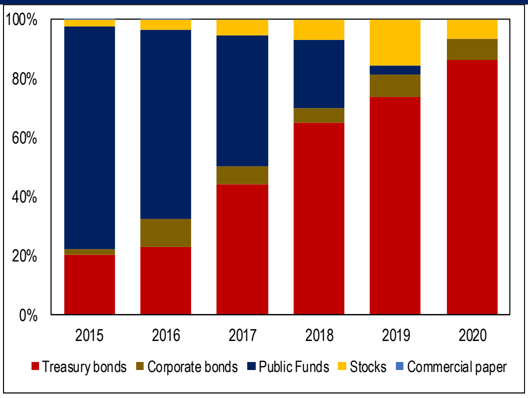


Source: BVM

With regard to the volume of trading by category of listed securities, treasury bonds once again recorded the greatest weight in 2020, with approximately 86.0% of the total, with corporate bonds and shares completing the remainder, with 7.0% and 6.8%, respectively (Chart 25).

[14] This weight of government bonds has been increasing consistently over the last five years, with the exception of 2016.

Chart 25. Weight of trading volume by type of security



Source: BVM

This dynamic does not favour the broadening of financing sources for companies, which could eventually contribute to reducing their financing costs, through more attractive rates, putting downward pressure on banking sector rates, which would impact on the reduction of market risk, with a consequent improvement in the financial stability index.

On the other hand, the low volume of transactions in the equity and corporate bond segments in 2020 suggests that the capital market is still not an alternative for private corporate financing.

This fact can also be confirmed by the number of instruments listed by each segment of the Securities Market (MVM), where corporate bonds and shares have a relatively small participation, when compared to government bonds [15](Table 6).

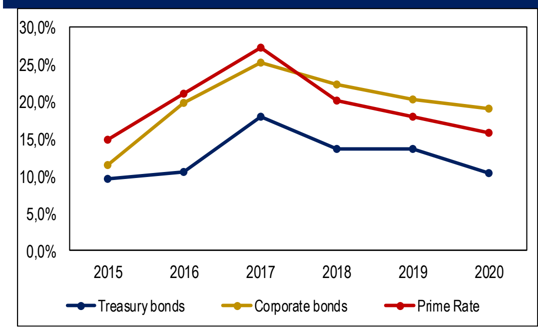
Table 6. Issuances quoted on the BVM

	2015	2016	2017	2018	2019	2020
Treasury bonds	21	21	17	26	31	35
Corporate bonds	17	13	13	16	15	13
Public Funds	1	1	1	1	0	0
Stocks	4	4	6	7	10	11
Commercial paper	3	1	0	1	1	3
Total	**46**	**40**	**37**	**51**	**57**	**62**

Source: BVM

Additionally, the fact that an important part of brokers is, at the same time, players in the banking sector, seems to condition the growth dynamics of private corporate financing through the securities market, causing corporate bond rates to be aligned with retail banking sector rates (Chart 26).

Chart 26. Interest Rates on Bonds quoted on the Mozambique Stock Exchange (BVM) and Prime Rate



Source: BVM

[15] In 2020, they represented approximately 56.0% of the total number of listed issues on the MVM.

IV. MACRO-PRUDENTIAL POLICY MEASURES

This chapter brings forth the main macro-prudential policy measures implemented by the Central Bank in 2020 as part of its functions as the monetary, regulatory and supervisory authority of the financial system, as well as other initiatives that contribute towards maintaining financial stability.

The BM, as the national macro-prudential authority, defines and implements macro-prudential policy. The BM regularly analyses the financial system to identify current and future vulnerabilities and risks under more likely and adverse scenarios, i.e., it identifies, monitors and assesses systemic risks.

The aim of macro-prudential policy is to make the financial system resilient to risk absorption, ensuring adequate levels of financial intermediation and contributing to sustainable economic growth.

Following the outbreak of the COVID-19 pandemic, it did not prove necessary to impose new measures in order to mitigate its harmful effects on the economy and the stability of the national financial system.

BM decided to uphold the macro-prudential policy measures already established in 2018 to mitigate systemic risk, namely:

- Conservation buffer for D-SIBs set at a minimum of 2.0%;
- Conservation buffer for domestic quasi-systemically important banks (Quasi D-SIB) set at 1.0%;
- 100.0% limit on the LTV indicator in the granting of loans to customers of Credit Institutions and Financial Companies (ICSF);
- 100% cap on DTI indicator in loans to customers by ICSF;
- Establishment of the countercyclical capital buffer of own funds as a tool to prevent and mitigate excessive credit growth and excessive leverage.

It should be noted that the countercyclical capital buffer is an additional capital requirement for smoothing the effects of variations in the economy's credit cycle.

The non-activation of this buffer is due to the low or negative nominal growth of credit to the economy and the fact that the credit/GDP ratio continues to grow below the potential long-term trend.