POLITICAL INTERVENTIONS AND BANK FAILURE IN PRE-LIBERALIZED TANZANIA

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Abstract: Over the years there has been an increase in the number of bank failures in both centralized and decentralized economies. Internal reasons given for bank failures include reckless lending, corruption, non use of prudent classification and risk assessment methods, fraud and management deficiencies. External factors such as deregulation; lack of information among bank customers; homogeneity of the banking business, connections among banks do cause bank failure. For centrally planned economies, government and political interference in the banking operations and policies also contribute to bank failure. Tanzania, which until recently had a centrally planned economy, and the government having majority (51%) share holding in parastatals and banks also experienced bank failure in the form of non-performing assets (NPAs). By 1991, due to increased lending to financially distressed parastatals and cooperative unions, the NBC suffered large non-performing loans (NPAs) equal to 70% of the total bank NPAs. Considering the high rate of NPA's suffered by NBC, this paper tries to show that government and political interventions and the non-use of prudent credit scoring methods had contributed to the NBC failure.

INTRODUCTION

Over the years there has been an increase in the number of bank failures in both centralized and decentralized economies (*The Economist*, 1992; European Bank for Reconstruction, 1993; Saunders, 1994[1]; Williams, 1995; and Ogema & Smith 1998a). In Africa, failures have been experienced in more than forty countries including Ghana, Kenya, Bukina Farso, Burundi, Cameroon, Congo, South Africa, Uganda, Tanzania etc. (Kimei, 1998).

Bank failures affect the customer in terms of relationships and its benefits (Slovin *et al*, 1993; Ogema and Smith, 1999). Bank failures or distress also lead to contraction of activity and decline in output in the economy. The effects and impacts sometimes go beyond the firm which has banking relations (Rajan, 1992, Grossman, 1993; Gilson & Vetsuypens, 1993; Aharony and Swary, 1996; Freixan and Parigi, 1998; Ogema and Smith, 1999). The impact of bank failure is larger if the failing bank is considered as "a Too Big to Fail Bank" (TBTB),

because it could trigger the collapse of the entire banking system or the economy as a whole. Considering the importance of the TBTB, it has been common for governments to intervene and bail out such failing banks (Chijoriga, 1997; Ogema and Smith 1999). For example, in 1991, the Tanzanian government was forced to save the National Bank of Commerce (NBC), which was "a too big to fail bank" by advancing it a sum of T.shs. 18,886,550,000/= (about US$ 37 million) in the form of government bonds to cover for its non-performing loans. Most of the banks in African countries facing problems have either been bailed out, closed or restructured (Kimei, 1998).

Empirical evidence suggests that bank failures are due to external (macro) and internal (micro) factors (William, 1995; Chijoriga, 1997; Kimei, 1998). Included in the internal factors are: reckless lending, corruption, fraud and dishonest, embezzlement, management deficiencies, poor credit documentation, non-use of prudent credit classification and risk

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1 Saunders 1994, gives a detailed account of US commercial bank failure from 1981 to 1991 as a percentage to total USA assets, whereas Kimei (1998) offers a summary account of banking failure in fourty African countries.

assessment methods, lack of adequate capital, low level of technology, lack of full information disclosures, concentration of ownership and lending to insiders and poor supervision capacity. The causes of bank failures of the Meridian Bio Bank, Trust Bank and Greenland Bank in Tanzania are considered to have been contributed more by internal factors.

External factors such as poor monetary and fiscal policies, bank deregulation/regulation policies and procedures, lack of information among bank customers, homogeneity of the banking business, and connections among banks do cause bank failures. In centrally planned economies, government and political interference in the banking policies and operations also contribute to bank failure. For some developing countries, globalization is also contributing to the banking failures. The small and inexperienced banks fail to cope with the stiff competition of the big multinational banks in terms of products and services offered. The failure of the NBC, and other government owned banks (the Tanzania Investment Bank (TIB), Tanzania Housing Bank (THB) and Cooperative and Rural Development Bank (CRDB) were due to both internal and external factors. By 1991, NBC had large sums of NPA which were due to financially distressed parastatals and cooperative unions. The NBC non-performing assets or loans equalled to 70% of the total bank NPAs. The remaining balance belonged to TIB, THB and CRDB banks.

The high NPAs suffered by the government banks and other institutions had led to the restructuring of almost all banks including the National Bank of Commerce (NBC) which had the largest (80%) commercial bank total portfolio. By 1997 NBC was split into two banks; the NBC (1997) and the National Micro Finance Bank (NMB). The two banks deal with trade banking and micro financing respectively. Beginning April 2000 NBC (1997) LTD had been fully privatized. THB has been liquidated,

while the TIB and CRDB have been reformed and privatized respectively.

Based on an empirical survey conducted in 1995 - 1996, this paper tries to show the effect of government and political interventions and the non-use of prudent credit scoring methods on bank lending decisions, leading to failure. Using the case of the NBC as a failing bank, the research hypothesized that political and government interventions had led to wrong lending decisions and hence affecting the sustainability of the bank. It is also hypothesized that, where there is political and government interventions in the lending policies and procedures, the use of prudent classification methods will assist in knowing the credit worthiness of the firm; but it may not stop the bank from making wrong decisions. The failure period referred in this paper is from the Arusha Declaration (1967) to the period prior the reforms of 1991.

The paper is divided into five sections. Section one presents the background information which is followed by the literature review section explaining the effects and possible causes of bank failure. Section three offers a brief description of the financial and socio-political system in Tanzania. The empirical survey, its methodology and results, both descriptive and statistical are presented in section four. Section five ends with the conclusion.

In any one party state, there is party supremacy and therefore little or no distinction between government business and party political business. Tanzania was a one party state during the period under discussion. In this paper the words government and political interventions tare used synonymously.

LITERATURE REVIEW ON THE EFFECTS AND POSSIBLE CAUSES OF BANK FAILURE

There is abudant literature and empirical evidence which demonstrate the importance

of financial institutions and banks (Leland and Pyle, 1977; Fama, 1985; Gertler, 1988, and Saunders, 1994). A bank usually offers a multitude of services including the checking account, savings deposits, lending facilities, and insurance. During its operations, the bank creates a close relationship with its customers and its affiliates (Ogema and Smith, 1998 a & b). When a bank fails not only the customers suffers, but it sometimes the entire economy may be affected. Failure of bank leads to a chain of losers such as: uninsured depositors losing all or part of their deposits; insured depositors suffering temporary liquidity problems; firms losing debt financing and other bank benefits, chief executives (CEOs) of the bank and bank employees losing their jobs or getting unwanted transfers; and banks which have banking relations getting negative spillover effects known as "informational contagion" (Rajan, 1992, Gilson & Vetsuypens, 1993; Freixan and Parigi, 1998; Ogema and Smith, 1998a & b). Empirical evidence shows that the impact of a bank failure is more severe to a firm which has close banking relationships. It also indicates that firms which had close relationships had their stock prices declining (Slovin *et al*, 1993; Ogema and Smith, 1999). The impact of failure is worse when there is a complete bank liquidation/bankruptcy declaration. The contagious effect by way of negative spillover effect is also evident in firms or banks which do not have a direct relationship with the bank (Aharony and Swary 1983 & 1996, Freixan and Parigi, 1998, Ogema and Smith, 1999).

Possible Causes of Bank Failure

According to the literature, reckless lending, corruption, fraud and dishonest, embezzlement, management deficiencies, poor credit documentation, non use of prudent credit classification and risk assessment methods, lack of adequate capital, low level of technology, lack

of full information disclosures, concentration of ownership and lending to insiders and poor supervision capacity are considered as bank specific (micro) related causes of failure (Williams, 1995; Chijoriga, 1997). Other than bank specific and internal related factors, there are general (macro) factors such as poor and sluggish monetary and fiscal policies, bank deregulation/regulation policies and procedures, which may trigger the collapse throughout the entire banking system or the economy a whole. As already explained, the issue is more serious if the failing bank is a TBTB, where the failure of a very large bank could lead to a ripple effect throughout the financial system, disrupting the monetary and fiscal policy implementation and affecting many other banks and the international banking payment and settlement system (Freixan and Parigi, 1998).

Homogeneity of the banking business, lack of information among depositors, concentration in few customers/groups, and connection among banks may also trigger a collapse of the banking industry. One common feature about the banking business is that, it is a homogenous type of business where products offered are almost similar except for the interest rates and quality of services. Thus, a failure in one bank can trigger failure in the other due to the relationship which exists between them.

Lack of information among depositors may lead bank customers to think that their bank also has problems like the one in trouble. This may force them to withdraw their funds (bank run), creating liquidity problems to the failing bank (Saunders, 1994, Chijoriga, 1997). For example, when NBC was having NPA problems, some of NBC's big customers closed their accounts with it, and moved to the newly established banks. Additionally, as the failing bank struggles to stay afloat it may call for its outstanding loans and refuse to make new ones. This may create what is known as a "credit crunch" and hence contribute to depressing of the economy.

Concentration on a few borrowers or group of borrowers may also create a possibility for a bank collapse. For example, one of the reasons why the British Barings Bank was forced out of business was because of one major customer (*The Economist*, 1996). When this major customer suffered liquidity problems, the bank was equally affected. Likewise, NBC had offered a large part of its loan portfolio to public (parastatals) firms and cooperatives which had turned out to be NPAs. Thus, when the public firms (its major clients) failed to pay its debts, the NBC found itself in liquidity problems.

Connections between banks create problems for the bank, especially if the failing bank is a big player in a particular market. e.g. a sizable lender to other banks; an important link in payment and settlement systems etc (Freixan and Parigi, 1998). When a bank is not connected with other banks, or it is not a TBTB, the government may not bail it out, and may be left to fail. Good examples are British Barings Bank in England, Bank of Credit and Commerce in the US, and Meridian Biao in Tanzania which were not bailed out by respective the governments. Like NBC bank in Tanzania, many of the banks in the Scandinavian countries in the 80's and 90's were state owned banks and had an important role in the economy. When these banks experienced crises their governments bailed them out.

Banks usually play a key role in the transmission of monetary policies from the central bank to the rest of the economy. But, sluggish and/or un-directional monetary policies and increased interest rates can create problems to the banks. Germany and the Netherlands are seen as countries which have been having stable monetary policies, and as a result, they have had few serious bank failures. In the case of Tanzania, the unclear and un-directional monetary policies had contributed to the bank failure (BOT, 1995).

Failure to cope with technological changes can also cause bank failure. Using old outdated technology creates inefficient and ineffective banking payment and settlement system. Until recently, NBC was not using any computers for customer services. This had led to a lot of complaints from its customers due to inefficiencies and delays. In some cases, poor data storage and record keeping systems, the bank was exposed to fraud, money embezzlement and thefts.

Poor risk management is also mentioned to be one of the reason for bank failure. When a bank does not properly analyze the customer's credit worthiness, there is a danger of offering a loan to a possible loan defaulter. Use of credit scoring methods such as the Multivariate Discriminant Analysis (MDA) does assist in classifying a customer and assessing in advance the probable risk of default. The non-use of prudential methods such as the MDA in screening and reviewing a loan application can result in making wrong decisions as to who should be offered or rejected a loan. The advantages of using the MDA are many, including knowing in advance the likelihood of default and enables the bank to make correct lending decisions (Altman, 1968, 1980 & 1983; Chijoriga, 1997). Wrong lending decisions lead to either the bank making an error (referred as type I error) of offering a loan to a possible defaulter, hence losing the principal amount and interest, or making the other error (the type II error) of not offering a loan to a credit worthy loan applicant, and therefore losing the interest income and the customer. Both errors can cause bank liquidity problems.

The literature also mentions political and government interventions as being causes of bank failure (Chijoriga, 1997; Kimei, 1998). This is more the case in centrally planned economies where majority state and where most of the lending policies and other regulations are controlled and regulated by the government. The Central Bank (CB) plays the role of being the regulating bank and the government bank. Before the current economic and political

reforms, the majority of the former socialist countries had centrally planned economies. The government usually chose the sector to which lending priorities should be given. This often had nothing to do with the financial viability or profitability of the sector or project.

As observed by Collier (1991), lending in socialist banking system is determined by government priorities rather than the market. He also observed that in socialist countries, lending to the public sector was determined by need rather than by viability. This implied that, loans to the public sector were made to cover the operating difficulties instead of being directed to assets formation and continued investment. Using the example of Tanzania, Collier shows that all loans outstanding at the end of 1987 were to cover the operating difficulties of the crop marketing parastatals[2]. His conclusion was that, the banking system was the agent for the sale of government debts and not doing the financial intermediation function. The consolidation of bank intermediation function with government accounts created a close relationship between the public sector deficit (distress/failure) and the increase in the monetary supply. The final effect of this dual relationship was that, when the government had budget deficits, it's banking institutions had also financial difficulties. It also had an effect on the rate of inflation.

Due to the above mentioned problem, the Tanzanian banks faced the same problems of stock and flow problems as their socialist counterparts in the Eastern Blocks.[3] The stock problem is where the true value of bank assets fall far short of liabilities, thus making banks technically insolvent. The flow problem is where new loans extended by the system

may continue to turn into bad debts banking (stock of non performing loans). To solve both problems, the government needed to deregulate the banking system to a system where both current and future credit operations by banks satisfy criteria of allocative efficiency, prudent credit evaluation methods and proper risk management.

Regarding deregulations, empirical evidence has shown that, in the early 80s, as deregulation was introduced, banks started lending to all comers (without much scrutiny). The problems of deregulation was that some of the customers who were offered loans were not credit worthy customers. The banks found themselves lending to risky borrowers hoping for fat profits. But, because interest rates were left to increase, it created a bubble, and borrowers began to default. As capital markets which were considered as alternative ways to raise funds emerged, borrowers moved from the banks to these new alternative sources which to them were cheaper in terms of interest rates. In Tanzania and many developing countries, micro financing institutions (MFI) have become alternative credit lending institutions especially for the rural poor and micro and small business enterprises (MSEs). Major reason for the shift is the expected low interest rates.

Evidence also reveal that, reckless lending, corruption, and fraud within banks also cause bank failures. In an interview with Mr. Hope who was the director of the Federal Deposit Insurance Corporation (FDIC) he pointed out that, from a survey of US bank failures between 1979-1989, they found that 89% of the failures were due to management deficiencies, and of these, 81% had no loan policies or loan policies were ignored. Other causes were deficient system controls, over aggressive lenders, economic conditions and dishonesty (Williams, 1995; Chijoriga 1997).[4] The reasons advanced by Mr. Hope did also apply to the Tanzanian case.

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2 See more in Kilindo and Nyangetera (1995). "Financial Sector Reforms in Tanzania: An Assessment." In Msambichaka L.A. *et al* (1995). *Beyond Structural Adjustment Programmes in Tanzania.* Economic Research Bureau, University of Dar es Salaam, Tanzania.
3 European Bank for Reconstruction and Development (1993), Banking Reform in Central and Eastern Europe page. 8-10.

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4 For more details of the possible causes of bank failures see Williams, 1995 and Chijoriga, 1997.

It is clear from the literature that if government and politics interference in the lending decisions there is possibility of a bank failure. This is proved by the NBC case which had suffered high NPAs due to the linkage between the government policies and directives and NBC operations. The literature lacks empirical evidence which shows the relationship between bank failure, political and government influence and non-use of prudent credit scoring methods. It is therefore, the intention of this paper to bridge that gap. Taking the case of NBC as an example it can be hypothesized that, if there is government and political influence and the bank does not use prudent scoring methods than there are higher chances of making wrong lending decisions. Therefore, the use of MDA can only be functional in centrally planned economies if the banking operations are left to follow the market allocative system and are independent.

TANZANIA: THE FINANCIAL AND SOCIO-POLITICAL SYSTEM

Tanzania is among the less developed (LDCs) third world countries which were until recently characterized by a centrally planned and an agrarian economy, which is the main source of government revenue and the principal employment sector for the majority of the people. In Tanzania, prior to the economic and political reforms of 1991, government planning was centrally based where politics featured much in the running and control of the economy (Rwegasira, 1991 & 1992).

Before 1919, the currency used in Tanzania mainland was the German Rupee; and the subsidiary coins were the Heller. Commercial banking was introduced in 1905, where the Deutsch Ostaafricanische Bank was the first commercial bank. The Bank of Tanzania (BOT) which is the central bank was established in 1966 through the Act of 1965. Prior to the BOT establishment all monetary issues were directed by the East African Currency board (EACB).

The BOT took over the role of EACB and replaced the Annual Finance and Credit Plan (AFCP) and the Foreign Exchange Plan (FEP) (Kimei, 1987, BOT, 1995).

In 1967, the Arusha declaration was promulgated, followed by the nationalization of all major economic activities including financial institutions and banks. After the Arusha Declaration, and before the 1991 bank and financial institutions structural reforms and privatization exercise, all the commanding heights of the economy were controlled and owned by the government. In most cases, the government had a 51% majority share ownership, and the government ownership representation was done through the Treasury Registrar. It was after the Arusha declaration, that many parastatal organizations were also established. The banks and financial institutions were also categorized as government parastatals.

The Arusha Declaration led the BOT to reorient its functions. The monetary instruments guided by market operations were suspended and replaced by the direct instruments (Ndulu, 1998, Noni, 1998). In order to solve some of the rural development problems and monetary supply, the government through the BOT, established four special funds, the Rural Finance Fund; the Industrial Finance Fund; the Export Credit Guarantee Fund; and the Capital and Interest Subsidy Fund. Unfortunately, these funds did not achieve the intended results of controlling money supply and supporting rural development. Instead, they did lead to increased monetization of government deficit, increased financing to agricultural boards and state parastals which were frequent loan defaulters. The ultimate effect was the rapid growth in money supply which escalated the rate of inflation.

Parallel to the establishment of the BOT, the government established financial institutions and banks. By end of 1990, there were 7 banks, and 9 financial institutions. Except for the Tanganyika Development Finance Limited (TDFL) and the Diamond Trust Bank (DTB), all other banks and financial institutions were

owned by the government Commercial banking was monopolized by the National Bank of Commercial (NBC) for Tanzania mainland and the Peoples Bank of Zanzibar (PBZ) for the Zanzibar Islands of Pemba and Unguja. Other banks such as the Tanzania Investment Bank (TIB), Tanzania Housing Bank (THB), Cooperative and Rural Development Bank (CRDB), and the Tanganyika Development Finance Ltd. (TDFL) were specific parastatals and the cooperative unions.

During the 1967-1991 period the banks and financial institutions performed economic and political roles in the economy. NBC acted both as a commercial bank and a development bank offering loans to un-viable projects, to mismanaged parastatals and the cooperative unions.

Politics, Ideology and Bank Failure

Until 1991, Tanzania was a one party state under the Chama cha Mapinduzi (CCM). During the period the party was supreme over all economic and political activities was a close connections between the government and the ruling party CCM. CCM under its *Ujamaa* socialist ideology, consolidated the political and economic independence through self reliance. Under the *Ujamaa* philosophy the role of the market in determining production and distribution was minimal. The CCM party determined the political and economic policy direction of the country. The government was merely the implementing agent of party decisions and translated the political party policies into ministerial and government departmental policies including plans and economic guidelines for business firms (Rwegasira, 1991)[5]. During the period, government emphasis was on rural development and directed much of its resources to the agricultural sector.

Through its direct credit controls, the government has set priorities as to which sector of the economy should be given lending priorities[6]. Because of the dual government ownership of the banks and the parastatals, bank lending policies, procedures and regulations favored government owned firms (parastatals and agricultural marketing boards). For example, at the end of 1988, out of 78% NBC loan portfolio, the majority went to parastatals and cooperative unions, with only 3% going to private firms (Kilindo and Nyangetera, 1995)[7]. It is unfortunate to note that while much of the government resources were directed to agriculture, by the late 70s and early 80s the agricultural sector did show a declining trend, leading to loss in resources.

Macro bank lending regulations and requirements such as interest rates were in most cases determined by the government through the BOT[8] (a government representative) with no relation to return on capital. In 1987, when the inflation rate was running at 30%, loan interest rates were fixed also at 30%, implying zero real interest rates. This meant that, there was no advantage to lend, but rather an increase in the incentive to borrow (Chijoriga, 1994). Additionally, this had an effect in decreasing deposits, leading to an increase in the ratio of lending to deposit. BOT reports show increased M2/GDP ratio, implying increased loanable funds.

As earlier mentioned, before the Banking and Financial Institutions Act (BFIA) of 1991

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5 Rwegasira (1991: 46-47) gives a more detailed account of socio-economic and political environment in Tanzania.

6 For example, in the BOT Act, 1965 and the subsequent amendments of 1972 and 1978, it is specifically mentioned in sections 44 and 45 that, lending priorities were given to industrial and agricultural production.

7 According to Kimei (1998), it is estimated that in the first half of the 1980's over 90% of credit extended by all financial institutions in Tanzania was directed by government. Kimei C.S. Sound Banking Management and Macroeconomic Stability in Africa, Mimeo, 1998,.

8 The central bank adopted the function of development finance through applying artificially low interest rates and overvalued exchange rates, mandatory credit ceilings and credit as well as foreign exchange allocations to specific sectors.

and other economic reforms, the government had majority share holding (51%) in the majority of parastatals and banks. One problem which the government had created for itself was the unplanned establishment of the parastatals which proved to be a heavy burden to the government. By 1990, there were more than 400 parastatals organizations as compared to 47 in 1967 (TAPO, 1989). The majority of the parastatals were receiving subvention from the government. Unfortunately, the financial performance of the parastatals was poor and some of them were frequent loss makers and had to depend on government subvention for existence, which proved to be a heavy burden to the government.

When the parastatals were experiencing financial difficulties and unable to pay the bank loans, the government solved the problem by directing the NBC to offer loans to the troubled parastatals and cooperative unions. The NBC was therefore the government clearing house for its problems. The consequence was increased government budget deficit. The government's involvement in the economic activities increased government borrowing from the central and commercial banks, leading also to increased inflation. Due to loss making, poor management, increased debt and non-performing assets (loans) from lending institutions, and lack of adequate capital and poor financial management (TAPO, 1989), the government was forced to make several structural reforms including privatization of some of the parastatals including the financial institutions.

Other than government involvement at policy and macro levels, the government had some influence in the day to day running activities and polices of the parastatal organizations and banks. The President was the appointing authority of the Chief Executives (CEOs) of the parastatals, and governing boards including banks and financial institutions. For one to be nominated to the top position

of a public firm, he/she had to be a member of the ruling party (CCM). Party allegiance sometimes superseded managerial competence when appointing the CEOs of these organizations. For example, political commissars were appointed to monitor some of the parastatals (Rwegasira, 1991; 1992), but the commissars had little technical skills, experience and knowledge of the activities of the firms they were entrusted to monitor. Transfer of incompetent CEOs within parastatals was a common phenomenon.

At micro level, bank lending policies and procedures were in most cases determined by government directives. According to Rwegasira (1992), there were sometimes conflicts between government directives and bank operations. There are reported cases whereby political and government officials did direct who should be given a loan. This was usually done through written notes and memos from the political leaders to the CEOs of the banks, and finally to the bank lending officer. These notes and memos overrided the bank boards or individual bank officer's decisions. Many bank officials agreed that many of the loans which were given to the ruling party economic wing company (SUKITA) and the cooperatives were in many cases issued after political pressures.

At times, government officials made statements without any regard to the effects on the bank's performance.[9] For example, a senior official was quoted saying that, no public corporation or government department should deny its services to another corporation or department just because one is indebted to the other. The statement implied that no public corporation (including the commercial bank which was government owned) should refuse to give credit to another parastatal simply because of unsettled previous debts. Therefore, parastatal liquidity and debt problems

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[9] Rwegasira K. *Problem of Financial Analysis in Institutional Lending Operations: Some Lessons from Tanzania.* Averbury Ashgate Publishing Limited, 1992, 36.

were supposed to be considered as a mutual indebtedness of public (parastatals) business organizations, and hence the bank has to assist such businesses. The result of this action was increased parastatal debts, which they could not repay.

It is evident from the above that the government and political interventions had created problems in the running and control of firm's operations by not allowing the invisible hand (free market) to operate in the efficient resource allocation. In the end, the banking system had large amounts of bad debts and NPAs. According to the Presidential Banking Report (1990), the NBC's provisions for bad and doubtful debts was estimated to be 45% of its commercial bank loan portfolio. This implies that, out of the total loan offered, 45% could not be collectable and declared as NPA.

The country is now in the midst of economic reforms which include the restructuring and reform of the banking and financial institutions. Some of the post 1991 banking and financial institutions policy reforms are directed at:

i)   Major reform of the public sector,
ii) Eliminating government propensity for intervention in the financial system, particularly as regards the setting of financial prices and allocation of credit and foreign exchange.
iii) Eliminating restrictions on competition and free entry into the financial sector.

The current banking reforms in Tanzania will succeed only if the problematic enterprises are also thoroughly restructured (privatized) so as to be financially viable. It is hypothesized that bad banks are an outgrowth of bad firms and not visa-versa. The non-availability of a capital market had forced all individual firms (private and public) to have only one source of financing - the lending banks. Therefore, the creation of the capital market will not only facilitate extra source of financing and alleviate the banks burden as the only source of finance, but will also create a competitive environment for adequate disclosure and transparency of the financial status of firms. Assuming the majority of investors prefer sweet to sour, no prospective investor would like to buy a "lemon" instead of an "orange".

Since 1990, there are several changes which have taken place. These include:

i)   The establishment of the BFIA, 1991 and privatization of banking industry. This has allowed private banks to operate in Tanzania. In 1999, there were ten (10) private banks, namely, Stanbic Bank, Greenland Bank, Habib Bank; Trust Bank, Akiba Bank and Eurafrica Bank. Unfortunately, Trust bank and Greenland bank had already shown signs of financial crisis.[10]
ii) The restructuring of the NBC operations and it's branches. The bank has been split into two: NBC (1997) Ltd. and NMB.
iii) The privatization of government parastatals through joint venture, direct sale, receivership, and/or total liquidation or other forms of re-organization. As a result of this exercise, some of the parastatals which had Non-performing Loans (NPA) have ceased to exist.
iv) The creation of the Loans and Advances Realization Trust (LART) to which all the non performing loans of the banks have been transferred to and which has been given the task of collecting all the NPAs.
v)   The development of a Stock Exchange Market as an alternative source of financing.
vi) Development of the Micro Financing Institutions for financing micro and small businesses.

Empirical Survey

In this section we present the research methodology and results of a study conducted in 1995 -1996. The study was part of the

[10] By April 2000, Trust Bank had been bought by a new bank called Dephis Bank. Greenland bank was under the Central Bank supervision and in the process of being liquidated.

doctoral study (Chijoriga, 1997). As earlier mentioned, the objective of the said research was to investigate how political interventions and the non-use of prudential credit scoring methods affected bank lending decisions leading to bank failures. Specifically the research did review the overall financial institutions and bank lending policies; regulations and procedures; the NBC lending policies and procedures, and the application of the MDA to lending decisions. The basic research questions were to test:

i) Whether bank officers' lending decisions were hindered by government and political directives or any other top authority;

ii) Whether the use of MDA could improve their lending decisions.

Although there were government interventions in foreign banking, the study limited itself to domestic lending. The study reviewed data from 1985-1990 for the estimation sample and 1991-1994 for the validation sample. 1990 was considered as the failure date. Both primary and secondary data collection procedures were used. For primary data, the open ended questionnaire supplemented with personal interviews and observational methods were used. A sample of 100 bank officers dealing in credit lending from 27 branches covering 7 regions were interviewed. Out of the 100 questionnaires distributed 63% were returned. Main source of secondary data was the NBC top 1000 customers composing of 58% of the total loan portfolio; financial statements of the 56 NPA and PA customers of NBC, LART reports, TAC, BOT reports and other Financial Regulations and Guidelines etc.

Empirical Results

Government Lending Policy, Procedures and Regulations 1967-1991

As earlier mentioned, banks are usually conduits through which monetary policy actions affect the rest of the financial sector and the economy

in general. They play a key role in the transmission of monetary policy from the central bank to the rest of the economy (Ndulu, 1998; Noni, 1998). In Tanzania, between 1967 and 1991, the BOT (government agent) regulated all banking and financial institutions. Through its direct credit controls, the BOT set priorities as to which sector of the economy should be given lending priorities. For example, in the 1965 Act and the subsequent amendments of 1972 and 1978, it is specifically mentioned in sections 44 and 45 that, lending priorities were to be given to the industrial and agricultural production. This has been again enforced by the new Banking and Financial Institutions (BFI) Act of 1991, Policy and Procedural Guidelines on Licensing of Bank and Financial Institutions Part II. According to the BFIA 1991 and guidelines, the lending priority areas in the rural sector include, rural based industries, mining and tourism. Nevertheless, the statement contradicts with part III of the 1991 guidelines where it encourages banks to operate prudently along commercial principles[11].

There is little evidence showing the direct influence of the IMF and the World Bank (WB) in the government lending policies and procedures. However, the IMF and WB did indirectly through the 80's to 90's Economic and Recovery Programmes (ERP) and Structural Adjustment Programmes (SAPs) influence the monetary and fiscal policies and its implementation. The government through the treasury and BOT fiscal policies and its implemented the ERP and SAPs as prescribed by the IMF and WB hence influencing on the overall economic growth of the country. The ERP and SAP changes have lead to the open market economy. A major recommendation within the SAPs and ERP was the

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[11] In the BFIA, 1991 part III, section 13, it is specifically mentioned that; "Every application must fully recognize that the nations economy is primarily rural and agricultural in nature and banks or financial institutions will be expected to support such activities."

elimination of the role of the government in the provision of social services including health and education and the none government involvement in the running of parastatals. Most of the BOT monetary policy changes taking place are also a result of the IMF and WB direction. The introduction of the BFIA 1991, the split of the of the NBC, and the introduction of multi-parties was as a result of the IMF and WB pressures. The social impact of the ERPs and SAPs is beyond the discussion of this paper.

The implementation of the direct control policy in Tanzania was not very successful[12], and the priority sectors created problems to the NBC. Bank lending to various sectors indicated increased lending to the marketing of agricultural produce sector. The survey results show that the lending policies favoured more parastatal and agricultural marketing boards which had government majority share holdings. As shown in Table 1, while the marketing of agricultural produce was getting almost 50% (1988) of the total lending, other sectors like tourism, building and construction, public administration, export of agricultural produce were getting not more than 5% each. This was not because it was a priority sector, but rather, as explained earlier, the loans were to be used to solve the marketing boards deficits arising mainly from operational losses.

Evidence also indicates that all loans outstanding at the end of 1987, were to cover the operating difficulties of the Crop Marketing Parastatal.[13] Moreover, as already mentioned, at the end of 1988, out of 78% of NBC loan portfolio the majority went to parastatals and cooperative unions, with only 3% going to private firms (Kilindo and Nyangetera, 1995). It is interesting to note that, even when the banks had experienced big problems in lending to the agricultural sector, in subsequent years

the sector continued to receive a lions share of the loans. The reason for continued lending was due to government directives or pressure and the priorities of the various economic policy programs[14] and this was within the government lending policy.[15]

Table 1: *Percentage of Domestic Lending to Various Sectors of the Economy*

Year	Agricultural produce marketing	Mining and Manufacture	Agric. production	Transport
1988	50.8	19.6	8.2	2.1
1989	48.2	21.0	7.9	2.1
1990	34.2	24.7	9.2	2.6
1991	38.5	22.1	10.1	2.3
1992	27.3	21.0	8.2	2.2
1993	26.0	21.0	8.5	4.0

Source: BOT Economic and Operations Report, June, 1994, page 65.

As noted, most of the loans issued for rural oriented projects e.g. cooperative unions, ended up as non-performing loans (worth Tshs. 4,360,056 loans). According to Kimei (1994), total NPA for major financial institutions were estimated at 200 billion Tshs. equivalent to about 60% of total assets and about 50% of the total government expenditure for 1993/94.

In the 1965 BOT Act, nothing was mentioned with regard to control and monitoring of risk assets. The control and monitoring procedures were set arbitrarily. In order to avoid/reduce possible bank failures, the new 1991 BFIA requires each financial institution to have in writing, a credit policy which specifies the criteria and procedures in evaluation, processing, approval, documentation and release of credits. The document extends further by requiring banks to have periodic review of assets portfolio, annual review

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12 BOT: Its Functions and Monetary Policy Instruments October 1995, page 18.
13 Collier, P. (1991). "Monetary Creation and Financial Liberation in a Socialist Banking System: Tanzania 1983-88." *World Development*, Oxford, Pregamon Press, Vol. 19, No. 5: 533-538.

14 It is specifically mentioned in the 1991 NBC Annual Report and Accounts that, "the Bank has continued to channel the scarce resources at its disposal to the priority sectors of the economy in line with the spirit of the National Economic Recovery Program."
15 The NBC Annual Report and Accounts for the year ended 30th June 1991 page 20 indicated having offered 49% of its total lending to the Marketing of Agricultural Produce.

of extension or renewal, diversification of credit risk, as well as the amount and period of credit offered. The new Act goes to the extent of giving so many details on how to classify loans and other risk assets. The procedure nevertheless seemed to be more binding to the NBC, which was then a wholly government owned bank. Again, this is evidence that the government through the BOT still controls the banking lending and operational procedures.

Sections 46 and 48 (1) of the 1965 BOT Act gave BOT the authority to prescribe maximum or minimum deposits and loans rates of interest which commercial banks and other specified financial institutions could use with no relation to return on capital.[16] This had an effect of increasing inflation and money supply as pointed out earlier. For example in 1987, when the inflation rate was running 30%, loan interest rates were fixed also at 30%; implying zero real interest rates. This had also an effect in decreased deposits. Because lending increased due to increased inflation, the lending to deposit ratio also increased. Figure A-1 explains this phenomena. As shown, when there was high inflation rates i.e. 1986 and 1987, there was also an increase in the lending to deposits ratio. The BOT facts and figures also demonstrate an increase in the M2/GDP ratio, implying increased loanable funds. Under normal circumstances, it should be followed by increased investments and economic growth through increased production. This did not happen in Tanzania, instead, it increased non-performing loans, and inflation. With the BFIA of 1991, banks are supposed to operate in a market oriented environment where the BOT only sets minimum interest rate levels.

From the above, it is clear that the BOT regulates not only the banking and lending policies, but also the procedures to be followed by banks and financial institutions and this gave very little autonomy for the operating bank, especially when such a bank was a government owned such as the NBC.

16 BOT Act of 1965, section 46 and 48 (1).

NBC Performance and Lending Decisions

The National Bank of Commerce was established after the Arusha Declaration, by the NBC Act no 1 of February 1967. According to the 1967 Act section 4(i), some of the objectives of the bank included:

i) To provide banking services in accordance with the conditions appropriate in normal and proper conduct of banking business.

ii) To conduct its business without discrimination except on such grounds as appropriate in the normal and proper conduct of banking business.

iii) To carry out the business of banking in all of its branches, agencies, and departments or subsidiaries.

iv) To service as a catalyst for economic development in the country.

Before the 1991 BFIA, NBC had a monopoly to commercial bank lending. It had commanded a market share (in terms of deposits held) of approximately 80%, making it the major mobilizer of savings and the lending provider of commercial banking services. As earlier mentioned, other banks such as THB, CRDB, TIB & TDFL were specific purpose banks, and had very limited commercial banking activities. Over the years, NBC had gone through tremendous structural changes both in terms of its organizational structure and operations. By the end of 1991, NBC had grown to 203 branches and 337 Agencies spread in 20 Tanzanian mainland regions. The structural changes which had led to the split of the bank were a result of the advice from the World Bank and recommendations of the Price Water House consultancy report (1995). By the end of February 1996, due to structural changes the NBC was operating with only 142 branches and it had retrenched 43% of its working force.

Looking at the lending and deposit ratio of NBC, it was found that from 1980/81 to 1990/91, the ratio was above 50% in all the years except for 1980/81, 1982/83 and 1983/84. In

some cases, it was even more than 100% e.g. 1987/88, 1988/90 and 1990/91 (see figure A-2 and A-3 for NBC selected liquidity and its lending to deposit rations). The situation was worse for the lending to savings deposit ratio. This tended to provide proof that, there were less savings as compared to other types of deposits, e.g. demand and time deposits. A good explanation for this, is the government repressive policy. Because real interest rates were low, there was no benefits from savings, and this tended to discouraged customers from putting their money in the bank. However, because interest rates were lower than inflation rates, it encouraged borrowing. The negative real interest rates had also an impact on customer negative returns on investments (ROI), hence affecting the repayment of the bank loans. NBC investment to savings (IS), investment to lending (IL) and investment to total deposit (ID) ratios had declined throughout the years.

Except for 1989/90 when there was a special effort to collect the debts, loan overdraft increased, while bank debt recoveries declined. The increased overdrafts had the effect of decreasing the NBC working capital, and creating a liquidity problem as indicated by declining liquidity ratios. Most of NBC loans were short term loans which were supposed to be repaid within a short period of time. However, if a customer had channeled the money to long term projects, then a mismatch of financing and investment (assets formation) was created, hence affecting repayment of the loan.

Due to the increased large non-performing loans which NBC and the other banks had suffered, in 1991 the Loans and Advances, Realization Trust (LART) was formed. According to section 5 of LART was charged with the duties of holding for and on behalf of the government any non-performing assets of a bank and other financial institutions, and to recover all amounts outstanding in respect of all transferred no-performing assets. The total value of loans transferred to LART amounted

to the tune of Tshs. 18,886,550,000.00 (about US $ 37,773,100). This involved 56 NBC customers out of which 22 were parastatals, 6 cooperative unions and 28 private firms. In exchange of the NPAs, NBC received government bonds. Although the number of failed (NPAs) parastatals were few, their total NPA value was higher than the private firms.

During the personal interviews, many of the bank officers mentioned that sometimes during the customer loan review process they were instructed form the top (NBC CEOs, board members, and political leaders) as to which customers they should give a loan. This was done through instructional notes and memos requiring them to offer loans to unevaluated customers, many of which ended having no proper records. They also mentioned that when the ruling party CCM was in budget pressures, it was common to borrow through its economic wing "Shirika la Uchumi na Kilimo Tanzania" (SUKITA), even if the bank officers has evaluated SUKITA as a probable loan defaulter.

In the questionnaire, one the questions which the bank officers were requested to answer was which factors hindered their decision making process. The factors which they were to rank included, political directives, government directives, top management interventions, head office interventions, board of directors directives, and central bank directives. From the responses, government interventions ranked first, followed by political interventions and top management directives. board of directors interventions ranked sixth. The statistics do prove that those clients who has good connections with the government and political officials had larger amounts of NPAs as compared to those without connections.

Statistical Results

As earlier mentioned, 100 questionnaires were distributed to 100 NBC bank officers from 27 different branches of the 7 sampled NBC operating regions. During the interviews and in the questionnaire one of the questions which

the bank officers were requested to answer was which method of credit scoring (i.e. loan evaluation and classification) were they using as a basis for their lending decisions. Of the total respondents, 38.6% indicated using financial/ratio analysis, whereas 61.4% indicated using other methods including judgmental method. Based on the results it shows that the bank officers had relied largely on the judgmental method for loan evaluation. The implication of this is that, although there were government interventions, the method of evaluation used by the bank could also have contributed to the taking of wrong decisions. In view of the deficiency of the judgmental method, the MDA method was developed and tested on the NBC data.

In developing the MDA, the 56 NBC customers (PAs and NPAs) were divided into 2 equal samples of validation and estimation samples. Due to non-availability of data no private firms were included in the estimation sample. Before an MDA model was developed, some general statistical tests to evaluate multi-collinearity, goodness of fit and the normality test were carried.[17] Using both the stepwise and direct method for variable selection, the final MDA model had 12 variables grouped into liquidity, performance, leverage, profitability and firm size ratios.

The statistical MDA credit scoring method proved that by using the judgmental methods the bank officers had made wrong decisions by offering loans to possible loans defaulter. The correctness of the final MDA model had 92.86% correct classification with 20% and 0% of type 1 and type II errors respectively. This implied that, if the bank officers had used the MDA model in classifying their lending customers, they would have been 92.86% correct in classifying their customers and making a total error of 7.14%. From the results one can conclude that by using the MDA the bank officers would have been able to know with more accuracy which clients were credit worth or not. When the model was tested for lagged periods, the results revealed that the bank failures

(NPAs) could have been known one to two years before failure. Again, if the bank (NBC) had used the MDA model, the bank could have known earlier (in advance) the possible defaulters among it customers and taken some corrective measures.

Basing on the validation sample data and using the Z-scores form direct (Z_1) and stepwise (Z_2) methods in comparing parastatals and private firms probable default, indicated that more public firms which were basically favored by the government has lower Z-scores (Z_1 (25%)), Z_2 (16.6%)) as compared to private ones (Z_1(0), Z_2 (6.3%)), indicting that loans given to the public firms were riskier as compared to private ones (see Table 2). Table 2 tries to show the difference in Z-scores between private and public firms.

Overall the results did show that, political interventions influenced the offering of loan to probable loan defaulter. The more loans were given to the public owned firms which were not credit worth, and the less the bank used objective method, the higher were the chances of the bank making wrong decisions and hence suffering higher NPAs.

CONCLUSION

Based on the empirical research described above, this paper has shown that, government and political interventions on the bank lending policies, procedures and regulations did influence the failure of the bank. Through government credit control policies, government and political interventions had favored certain sectors of the economy which sometimes did not have credit worthy projects. Indeed, the study results had proved that the use of objective methods of credit screening such as the MDA could improve the bankers' correct lending decisions. It was also shown that, failure of the firms could have been known 1-2 years before actual failure. Furthermore, the study has demonstrated that public firms which were linked to government and political structures were more favoured in terms of getting loans,

Table 2: *The Validation Sample Actual Classification and MDA Prediction*

F	C	T	S	Z₁	A	P	Z₂	A	F
1	NPA	PU	LRG	0.12	1	2	102.	1	2
2	PA	PR	LRG	0.80	2	2	12.8	2	2
3	PA	PR	LRG	0.07	2	2	7.38	2	2
4	PA	PR	LRG	0.84	2	2	3.19	2	2
5	NPA	PR	ME	4.96	1	2	-4.04	1	1
6	PA	PR	LRG	0.75	2	2	5.27	2	2
7	NPA	PR	ME	1.16	1	2	5.47	1	2
8	PA	PR	LRG	0.65	2	2	6.10	2	2
9	PA	PR	LRG	0.81	2	2	5.82	2	2
10	PA	PR	LRG	1.11	2	2	3.67	2	2
11	PA	PR	LRG	0.72	2	2	52.7	2	2
12	PA	PU	SM	0.34	2	2	1.11	2	2
13	PA	PR	LRG	0.24	2	2	5.92	2	2
14	PA	PR	LRG·	0.36	2	2	6.36	2	2
15	PA	PU	SM	-0.01	2	2	1.18	2	2
16	PA	PU	ME	17.2	2	2	63.2	2	2
17	PA	PU	LRG	1.90	2	2	12.6	2	2
18	PA	PU	SM	2.14	2	2	6.17	2	2
19	PA	PU	SM	0.16	2	2	-2.41	2	1
20	PA	PU	SM	-1.29	2	1	-4.70	2	1
21	PA	PU	SM	0.17	2	2	2.86	2	2
22	PA	PU	LRG	-0.39	2	2	6.20	2	2
23	PA	PU	LRG	0.64	2	2	63.6	2	2
24	PA	PU	ME	0.42	2	2	4.97	2	2
25	PA	PR	LRG	1.31	2	2	21.4	2	2
26	PA	PR	LRG	0.01	2	2	39.8	2	2
27	PA	PR	LRG	2.13	2	2	1.33	2	2
28	NPA	PR	LRG	2.37	1	2	2.46	1	2

Key:

F = Firm Number; C = Firm classification; T = Firm Type; S = Firm Size; A = Actual Firm Classification; P = Firm Prediction; PA = 2 = Performing Assets; PU = Public Firms (Parastatals) (State Owned); PR = Private Firms; LRG = Large Firms; ME = Medium Firms; SM = Small Firms; Z1 = These are derived by using the MDA with the step-wise method; Z2 = These are scores derived from using the MDA with the direct method.

much as it is clear that public firms were more likely to default on loan repayment as compared to private firms.

Overall, the study has shown that the use of objective methods can assist in making correct bank lending decisions. However, in centrally planned economies were government and political interventions do dictate bank lending policies, procedures and regulation, the bank may not realize the advantages of using objective credit scoring methods for lending decision making.

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