INTERNATIONAL MONETARY FUND

IMF Country Report No. 20/199

UNION OF THE COMOROS

SELECTED ISSUES

June 2020

This Selected Issues paper on the Union of the Comoros was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on March 3, 2020.

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International Monetary Fund
Washington, D.C.

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UNION OF THE COMOROS

SELECTED ISSUES

March 3, 2020

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CONTENTS

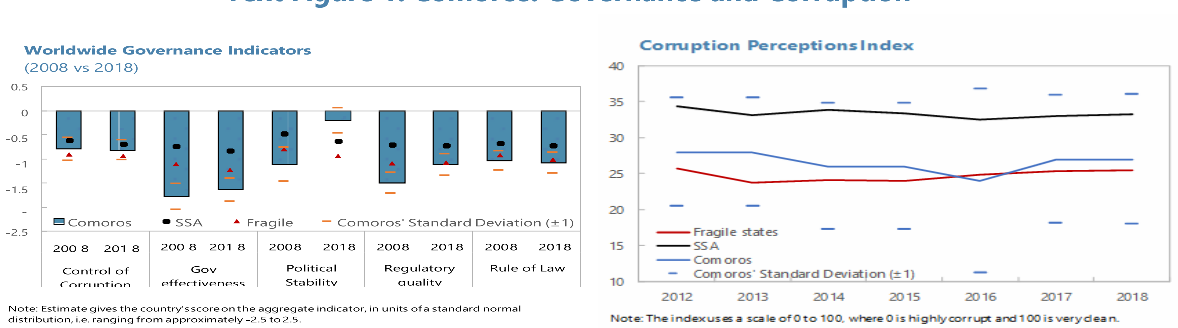
STRENGTHENING GOVERNANCE AND REDUCING VULNERABILITY TO CORRUPTION[1]

Comoros faces governance weaknesses in several macro critical areas including administrating the civil service, managing fiscal operations, ensuring the rule of law, and AML/CFT measures. Addressing these challenges would likely help spur inclusive growth, including by lowering vulnerability to corruption.

1. Weak governance and the resulting vulnerability to corruption can undermine macroeconomic performance. Governance generally refers to "*the various institutions, mechanisms, and established practices through which a country exercises governmental authority, discharges its responsibilities, and manages its public resources*" (IMF 2017, 2018a). Corruption is usefully defined as "the abuse of public office for private gain" and typically results from weak governance (Fisman and Golden, 2017; IMF 1997 and 2017).

2. Notwithstanding its substantial governance strategy, legislative framework, and institutional architecture (Appendix Table 1), Comoros scores below the SSA average on governance and corruption perception indicators (Text Figure 1):

Text Figure 1. Comoros: Governance and Corruption[1]



Sources: Comorian authorities, Worldwide Governance Indicators, Transparency International, and IMF Staff.

[1]Use of these indicators should be considered carefully, as they are derived from perceptions-based data.

- Comoros trails the SSA average (and even other fragile states) in three out of five macro-critical Worldwide Governance Indicators (government effectiveness, regulatory quality, and the rule of law).[2]

[1] Prepared by I. Ahamada, M. Benlamine, L. D'Amico, R. Gupta, and R. Randall.

[2] The Worldwide Governance Indicators, prepared by Kaufmann, Kraay and Mastruzzi (2010), comprise six component indicators (Control of Corruption indicator (CCI), Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, and Rule of Law). The indicators reflect official data and expert judgement, as well as opinion surveys of experts, business executives, and the public, sourced from household and business surveys, commercial business information providers, NGOs, and public sector organizations.

- Comoros also trails behind substantially on the Corruptions Perceptions Index (CPI) produced by Transparency International, an NGO.[3]

3. More specifically, the Fund has found that Comoros suffers from macro-critical governance weaknesses in five areas:[4]

- **The rule of law,** particularly the enforcement of contracts, suffers from a weak judicial system. Cases tend to linger in the courts and judgments are frequently not enforced. This undermines private sector activity.

- **The regulatory framework** suffers from a range of issues including unclear import and export processes and state monopoly on trade in certain products, creating further drag on private sector activity.
- **Fiscal management** suffers from weak public financial management, including weak spending controls and lack of transparency in budget execution.

- **Anti-corruption efforts and AML/CFT measures** are weak as well, which has, among other things, hurt correspondent banking relationships.

- **Management of the civil service** suffers from hiring and promotion decisions based in part on considerations other than merit, leading to weak results in many areas of public administration, including in key areas such as revenue administration.

4. Comoros could likely derive large long-run growth benefits from improving governance. Cross-country research by Hammadi et. al. on Sub-Saharan Africa suggests that "strengthening governance and mitigating corruption in the region could be associated with large growth dividends in the long run. While the process would take considerable time and effort, moving the average SSA country governance level to the global average could increase the region's GDP per capita growth by about 1–2 percentage points."

5. The remainder of the paper discusses the above four governance challenges and makes recommendations for addressing them. Where possible, it also provides cross-country perspective.

[3] The CPI index reflects the perceptions of businesspeople and country experts of the level of corruption in the public sector. In addition to official data, expert judgement, and opinion surveys of experts, business executives, and the public-at-large, the CPI is based on data compiled by international institutions. CPI values cannot be compared across time as changes reflect in part changes in methodology.

[4] The IMF has recently reviewed its approach to governance issues in member countries. With the introduction of the new "*Framework for Enhanced Engagement on Governance*" in April 2018, the Fund is systematically assessing governance vulnerabilities in state functions that are judged to be macroeconomically relevant, namely fiscal governance, financial sector oversight, central bank governance, market regulation, rule of law, and anti-money laundering/counter terrorism financing (AML/CFT). Anti-corruption efforts are assessed also, on the same principles.

A. Governance Issues in Managing the Civil Service

6. Civil service management suffers from hiring and promotion decisions based in part on considerations other than merit. Hiring and promotion decisions appear to be based in part on patronage, contributing to skills mismatch, high turnover, and weak morale and accountability.[1] This in turn leads to weak results in many areas of public administration, including in key areas such as revenue mobilization, public financial management, and education services.

7. Reform efforts should aim at the following:

- Basing civil service hiring and promotion decisions on merit. For this, institute an entry exam (as is already the case at the Central Bank), and strengthen civil servant training.
- Setting ambitious but realistic expectations and hold civil servants accountable for meeting them. This will require, among other things, assessing civil servant's performance assessment, rewarding good performance, and sanctioning weak performance such as absenteeism.
- Improving civil service payroll management: Continue efforts to weed out any remaining "ghost workers", including by fully applying the IT tool that links personnel and payroll data.

B. Governance Issues in Managing Fiscal Operations

Revenue mobilization

8. Weak governance constrains tax revenue and thereby undermines growth in many countries (Text Figure 2). Transmission channels include but are not limited to a weakening of tax compliance, the granting of tax exemptions in acts of favoritism, and outright corruption of tax officials (IMF 2016. Hammadi et. al. 2019, and Table 1). Research suggests that tax revenue is a key determinant of growth: GDP per capita rises sharply once tax revenue rises above 12–13 percent of GDP (Gaspar, Jaramillo, and Wingender, 2016).

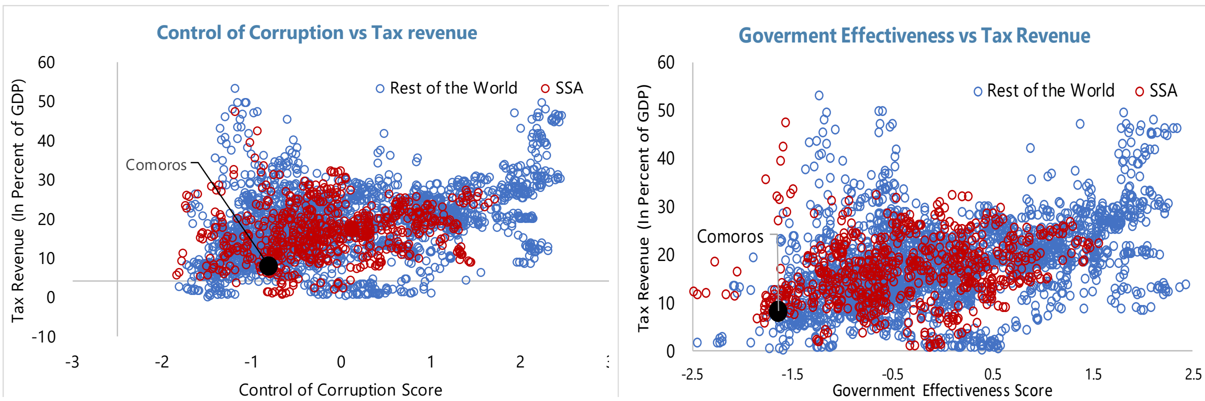
9. In Comoros, revenue mobilization suffers from a pronounced lack of transparency due to excessive complexity in laws and weak application of the law (Table 1). Comoros' fiscal revenue is less than half of the SSA average (8.3 percent vs 17.7 percent of GDP in 2018).

- Revenue generation suffers from complexity in business registration and the tax system (e.g., due to numerous exemptions) that limit transparency and create room for arbitrary decisions, in addition to discouraging business registration and tax compliance.
- The number of active taxpayers in Comoros remains very low, with only 256 active taxpayers being followed in the Medium-Taxpayers' Office (almost all located in the capital, Moroni), while fragile country norms suggest that 1,500–2,000 taxpayers would be more appropriate. Enforcement of tax payment obligations is also weak.

[1] See the World Bank's Systematic Country Diagnostic 2019, paragraph 35.

- Lack of transparency also characterizes fiscal revenue from SOEs. The authorities tend to set SOE fees and charges below cost recovery levels; they supervise SOEs only weakly, with initial steps toward better supervision (concluding performance contracts) taken recently. This results in financial strains on SOEs that obscure (and limit) the ability of SOEs to contribute to fiscal revenue. Transparency further suffers from cross-arrears between SOEs and the government.

Text Figure 2. Comoros: Governance and Revenue



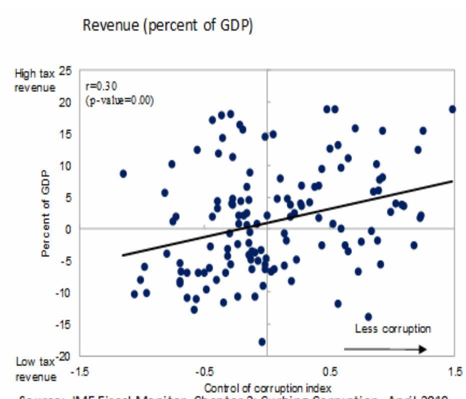
Sources: Comorian authorities, Worldwide Governance Indicators, Transparency International, and IMF Staff.

[1]Use of these indicators should be considered carefully, as they are derived from perceptions-based data.

10. There is also a risk that a lack of transparency may undermine the benefits that Comoros could draw from potential oil and gas wealth. Recent news stories have highlighted the dearth of official information about oil exploration and production sharing commitments.[2]

11. Cross-country evidence suggests that strengthening governance and lowering vulnerability to corruption could boost fiscal revenue in Comoros substantially. IMF research has established a statistically-significant relationship between corruption and revenue, controlling for the level of economic development (IMF, April 2019, Text Figure 3). It found that an improvement in Kaufmann, Kraay and Mastruzzi's Control of Corruption Indicator (adjusted for institutional specificities) by one-third of a standard deviation (equivalent to the average improvement in countries that reduced corruption over 1996–2017) was associated with a 1.2 percentage point increase in the government revenue-to-GDP ratio.

Text Figure 3



Source: IMF Fiscal Monitor, Chapter 2: Curbing Corruption, April 2019.

[2] See « *Hydrocarcures : Les forages exploratoires en 2020* ", La Gazette des Comores, 21 octobre 2019 and https://www.habarizacomores.com/2019/10/la-commission-de-production-de.html#more.

Table 1. Comoros: Impact of Governance Weaknesses on Fiscal Management[1]

Category	Weak Governance/Corruption Transmission Channels	Application to Comoros
Public Resources		
Revenue Administration	• Weakened compliance culture leading to high rates of tax evasion. • Large tax exemptions and investment incentives erode the tax base.	• Tax revenue stood at only 8.3 percent of GDP in 2018 due to excessive exemptions, complexity in the tax system contributing to taxpayer noncompliance, a large informal sector, and weak administration.
Natural Resource Wealth	• Insufficient transparency around petroleum licensing and negotiation of production sharing arrangements	• Recent news coverage of heightened public concerns about a lack of transparency about possible oil exploration and production sharing agreements.
Public Financial Management		
Budget Credibility	• Overly-optimistic revenue and expenditure forecasts. • Lack of a multi-year perspective due to lack of medium-term budget framework.	• Overly-optimistic revenue and investment spending forecasts, contributing to budget overruns and arrears accumulation. • High volume of in-year spending reallocations. • Absence of a medium-term budget framework and lack of budget alignment with the Comoros development strategy. • Inter-Island redistributive/allocational issues.
Wages and Pensions Transparency	• Leakages: Ghost workers and pensioners, resulting in a deadweight loss. • Bloated civil service is inefficient and crowds out socioeconomic spending,	• A large civil service and high public wage bill crowd out other priority spending. The civil service payroll has not yet been fully audited for ghost workers and pensioners.
Public Procurement/ Public expenditure controls	• Leakages: Overpricing of low-quality products and services resulting in wasted resources and lack of value for money. • Insufficient enforcement of expenditure controls, giving rise to off-budget commitments.	• Expenditure controls remain weak (see PEFA assessments), allowing mis-allocation of public resources, extra-budgetary commitments, and a buildup of arrears.
Public Investment Management	• Investment decisions lack transparency and are based on bribes and patronage—including bid-rigging, kickbacks and conflicts of interest.	• While the government's investment plan could provide clearer assessments of the rates of return of envisaged projects, little is known about the transparency of investment spending.
Treasury Financial Management	• Theft from unmonitored accounts outside the TSA. • Embezzlement enabled by weak financial controls.	• Continued use of an "investment account" in parallel with the TSA facilitates off-budget expenditures and limits transparency.
Extra-budgetary Funds and Public Enterprises	• Lack of transparency and compliance with fiscal reporting requirements. • Misappropriation of budget and own funds.	• Fees and charges below cost recovery levels, insufficient accountability in the absence of performance contracts, and cross arrears between the State and SOEs reduces transparency undermine transparency.
Foreign Assistance/External Borrowing/Public Debt		
Debt and Aid/Other Foreign Inflows	• Diversion of funds by bureaucrats.	• Large Comorian citizenship/passport scandal reinforcing AML/CFT concerns and reportedly leading to large-scale misappropriation of funds.

[1] This table builds on Figure 2.3 from IMF Fiscal Monitor, Chapter 2: Curbing Corruption, April 2019, p. 42.

12. Reform efforts should comprise the following:

- **Simplify (including by removing exemptions) and better enforce tax laws and simplify business registration requirements.** Simplification and better application of tax laws offer substantial potential for quick wins.

- **Simplify customs laws (including by further reducing exemptions), and sign and implement the new Customs Code to limit discretion in Customs administration.**

- **Strengthen SOE oversight** (see next section).

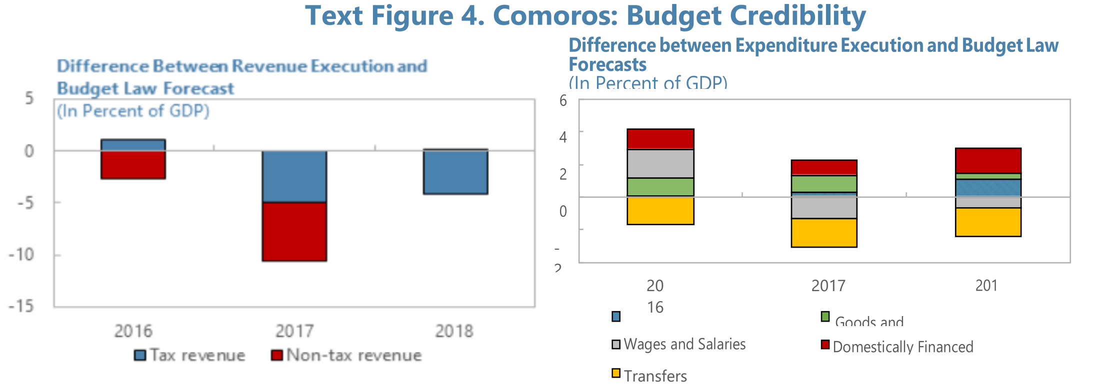
- **Foster transparency in the nascent petroleum industry**. Transparency is a key requirement for avoiding the "resource curse" (Fisman and Golden, 2017). The Fund can provide hands-on support for key elements of the management of natural resources, including the design of petroleum fiscal regimes.

C. Public Financial Management

13. Governance weaknesses hamper public financial management in many countries. Governance problems at the budget execution stage can lower government efficiency through wasteful spending in various channels (Table 1), including by allowing extra-budgetary spending; and circumventing procurement rules and other expenditure controls.

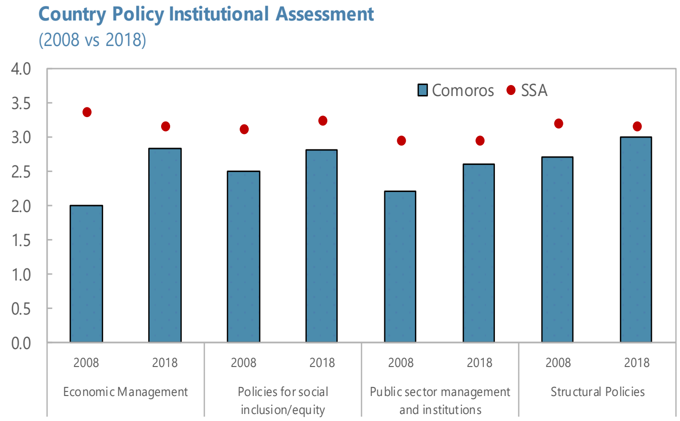
14. In Comoros, public financial management suffers from a pronounced lack of transparency. Overly-ambitious budgeting through 2018 undermined transparency (and credibility) by creating large deviations between budget forecasts on the one hand and realized revenue and spending on the other hand (Text Figure 4). Transparency has also suffered from the fact that (i) some government accounts have remained outside the TSA, and exceptional payment procedures are used frequently; (ii) for the past several years, the authorities have informed neither parliament nor the public about budget execution; (iii) the government has accrued a possibly substantial stock of domestic arrears. Weak oversight of SOEs further lessens transparency of public financial management broadly defined. Low scores in the 2017 Open Budget survey (Text Figure 5) and successive PEFA assessments (for 2016) document the lack of transparency.

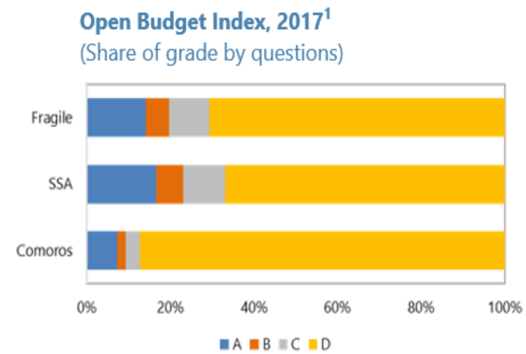
Text Figure 4. Comoros: Budget Credibility



Sources: Comorian authorities and IMF staff estimates.

Text Figure 5. Comoros: Policy Effectiveness





Sources: Comorian authorities, Country Policy and Institutional Assessment—World Bank Group, International Budget Partnership - Open Budget Index, and IMF Staff.

[1]The Open Budget Index (OBI) reflects largely expert assessments, assigning each country a score from 0 to 100 based on the simple average of the numerical value of each of the responses to 109 questions that assess the public availability of budget information. A country's OBI score measures the extent to which it makes key budget documents available to the public in a timely manner and the comprehensiveness of publicly available budget information. The 2017 survey evaluated 115 countries.

15. Addressing governance-related challenges in public financial management will require several actions:

- **Make the return to budget realism permanent:** Base revenue forecasts on robust macroeconomic forecasts and revenue elasticities in line with historical experience while taking account of any structural changes and transitory factors. Similarly, investment spending forecasts should reflect experience, taking account of capacity limitations.

- **Strengthen implementation of the TSA** by transferring government accounts remaining at commercial banks to the TSA and ensuring that emergency spending procedures are used only rarely.

- **Strengthen fiscal reporting:** Ensure that audited or final annual financial statements are published within 6, 9, or 12 months after the end of the financial year pertaining to a "basic", "good" or "advanced" practice level.

- **Audit public-sector arrears and develop an arrears clearance strategy.** In the meantime, strengthening the framework for internal controls—including the control environment, authorization and approval procedures (e.g. mandating the use of payment vouchers for all procurement transactions), risk assessment, and monitoring—and adoption and/or enforcement of sanctions for extra-budgetary spending, would help prevent further accumulation of arrears.

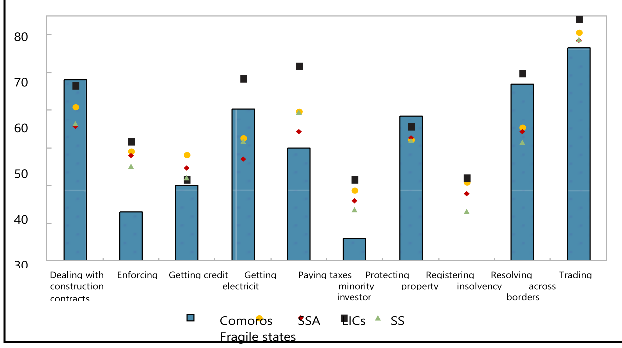
- **Strengthen SOE oversight:** (i) Define performance goals and conclude performance contracts (this has already started); (ii) mandate the preparation of audited annual financial reporting and more frequent less formal reporting to the government; (iii) clear cross-arrears and avoid the incurrence of new ones; and (iv) move towards setting prices at cost recovery after putting into place compensating transfers to the poor. SOE staffing and salary levels should also be reviewed.

D. Governance Issues in Ensuring the Rule of Law

16. The rule of law (i.e. contract enforcement and property rights) remains fragile in Comoros, as cases often linger in courts for years and enforcement of rulings is unreliable. The causes of judicial sector weakness likely include some combination of insufficient funding and political interference.

17. These limitations have an adverse impact on the business environment, for example by curtailing banks' ability to move against delinquent creditors, and likely significantly constrain investment. The 2020 World Bank's Doing Business indicators suggests that Comoros lags the SSA average (and other comparators) in all but two dimensions of its business environment. Comoros' weakest scores relate to the judiciary system—namely enforcing contracts, protecting minority investors, and resolving insolvency (as well as accessing credit, Text Figure 6). Comoros is presently ranked 160th (out of 190 countries).

Text Figure 6
World Bank *Doing Business 2020*



18. Recommended policy actions include the following:

- **Strengthen the effectiveness of the judiciary in protecting property rights and enforcing contracts.** In addition to refrain from exerting of political influence, actions could include seeking a judicial system diagnosis by a credible outside partner; enhancing funding of the judicial system; strengthening staffing in a low-cost manner by complementing the corps of professional judges with laymen judges; and strengthen arbitration options.

- **Create an enabling environment for private investment through regulatory reform**. The authorities have established a 2021 DBI ranking target of 150th (out of 190 countries). The authorities may ask the World Bank to identify opportunities for quick wins.

E. Anti-Corruption and AML/CFT Measures

Anti-Corruption Framework

19. Comoros' implementation of anti-corruption measures is generally weak. For example:

- **The National Commission for Preventing and Fighting Corruption has been recently dismantled, leaving a gap in the architecture.** As a result, regarding the obligation for senior public officials to declare their assets to the Commission, it is unclear whether the interim arrangement to transfer the function of receiving asset to the Accounts Section of the Supreme Court has been effective, given the lack of transparency and capacity gaps within this unit.

- **The transposition of the UN Convention against Corruption, ratified in 2012, has not yet been evaluated through peer-review.** Although some of the corruption offenses have been criminalized, not all of them are fully covered in line with the UNCAC.

20. The authorities may wish to strengthen the fight against corruption by enhancing the rules for asset declarations. For this, they authorities should adjust the range of officials subject to asset disclosure requirements, broaden the coverage of the declarations, verify the accuracy of the declarations and sanction failure or false reporting, and publish the declarations of senior officials. They should also strengthen the administrative arrangements for the agency that will handle the processing, verification and enforcement for the asset declarations regime, including efforts to establish an institution to replace the former National Commission for Preventing and Fighting Corruption.

F. AML/CFT Efforts to Support the Fight Against Corruption

21. The Intergovernmental Action Group against Money Laundering in West Africa (GIABA), to which Comoros belongs, has identified important shortcomings in Comoros' fight against money laundering and the financing of terrorism. The reasons include both weak laws and weak implementation of laws by both the public administration and financial institutions, the majority of which have weak AML/CFT systems. As a result, there have been no investigations or convictions for money laundering or terrorism financing, and correspondent banking relationships have suffered.

22. GIABA asked the authorities to adopt a time-bound action plan to strengthen the legal framework:

- **Amend the Penal Code to adequately criminalize money laundering**. The law fails to adequately criminalize and identify sanctions against kidnapping and the trafficking of human beings, the smuggling of migrants, the smuggling of stolen goods, piracy, insider trading, environmental crimes, the manipulation of markets, and fraud. The law also fails to incriminate accessory offenses.

- **Amend the Penal Code to adequately criminalize the financing of terrorism.** The definition of financing of terrorism does not cover the intended use by an individual terrorist or terrorist organization. Comoros does not formally incriminate the attempt to commit the crime of financing terrorism.

- **Amend the AML/CFT Law to strengthen customer due diligence.** The law needs to strengthen the application of AML/CFT requirements, particularly in the area of customer due diligence and beneficial ownership identification. In addition, the law should specify record- keeping obligations and thresholds for transfers beyond which diligence becomes particularly important.

23. The AML/CFT legal framework has additional weaknesses that the authorities should also address in a timely fashion. The framework should expressly require financial institutions to report (i) transactions that may be related to money laundering and proceeds of corruption, or (ii) suspected financing of terrorism (this is currently not the case as the framework requires reporting only of transactions of funds of unlawful origin). The authorities should also adjust laws such as to (i) prevent the misuse of legal persons (e.g., companies) and arrangements (e.g., trusts) for money laundering and corruption, and (ii) ensure that information on the beneficial owners of these persons and trusts is available to competent authorities.

24. Further, the authorities need to step up implementation of the AML/CFT framework:

- **Enhance the capacity of the Financial Research Service, which oversees implementation of AML/CFT laws.** The service's capacity building needs are extensive.

- **Strengthen the central bank's supervision of financial institutions to ensure they adequately identify and report transactions that may relate to money laundering and proceeds of corruption, with particular attention paid to transactions that involve politically exposed persons.**

25. Finally, the authorities may wish to clarify the status of Comoros' Economic Citizenship Program that gave rise to AML/CFT concerns and contributed negatively to corruption perceptions. Perceptions would likely benefit from the government's clarification of the legal status of the program, the number of citizenships granted, the revenue that should have accrued to the government budget as a result and the revenue that did in fact accrue, and the recovery of misappropriated funds. To the extent that the program continues, the authorities should ensure that foreigners purchasing passports are fit and proper and their source of funds is legitimate.

26. Although the authorities have now formulated and begun implementing an action plan for addressing AML/CFT deficiencies, effectiveness of the national regime remains weak, and stronger efforts are needed. The authorities' objective is for the National Assembly to promulgate a revised Penal Code by end-April 2020, also in light of the next GIABA plenary in May 2020. The authorities should substantially strengthen their efforts in addressing AML/CFT deficiencies by promptly implementing GIABA's outstanding recommendations and ensuring the effectiveness of the national AML/CFT regime.

Table 2. Comoros: Governance Strategy, Legislative Framework, and Architecture

National Anti-Corruption and Prevention Strategy

The National Anti-Corruption and Prevention Strategy was adopted in 2012. It aims to strengthen fiscal controls and enhance public accountability and transparency through improvements in the criminal justice system, the streamlining of legislative procedures, and capacity improvements in the Public Procurement Authority and the Accounts Section of the Supreme Court.

Governance Legislative Framework

Anti-Corruption Law. On July 25, 2008, the National Assembly passed the law 08-013 / AU on the transparency of public, economic, financial and social activities. The law was promulgated on June 21, 2011. The law requires asset declarations for senior public officials, defines criminal activity under the penal code, and specifies the role of the National Commission of Prevention and Fight against Corruption (NCPFC). Moreover, Decree No 12-183 / PR, September 15, 2012 reinforces the Anti-corruption law by strengthening the legal requirements around asset declarations. However, the law has not been operational since 2016, due to the dissolution of the NCPFC, which was itself accused by the current administration of corruption and ineffectiveness.

Public-Private Partnership law. On December 25, 2017, the National Assembly adopted the law 17-019 / AU which specifies the legal framework of the Public-Private Partnerships (PPP). The law was promulgated on January 24, 2018. The law specifies the types of contracts permissible under the PPP framework, and the institutional framework and the rules governing contract awards. Several entities are involved in the implementation of this law.

Anti-Money Laundering/Fighting Terrorism law. On June 28, 2012, the National Assembly adopted the law 12-008 / AU in the fight against money laundering and the financing of terrorism. The law was promulgated on August 2, 2012. This law defines the offenses covered by the law and specifies preventative measures that financial institutions and credit institutions are mandated to implement. Finally, the law spells out the terms of reference of the Financial Intelligence Service (FIS). However, the latest GIABA analysis reports identify several shortcomings in the AML/CFT legal framework. On 2 October 2019, the Ministry of Finance and the Comoros Central Bank in collaboration with COMESA, the World Bank and GIABA launched a study to assess the AML/CFT risks

Institutional Architecture

The National Commission for the Prevention and Fight against Corruption (NCPFC) is an independent administrative authority whose role was to implement the national anti-corruption policy. The composition of this commission and its terms of reference are described in the anti-corruption law. The Comorian authorities dissolved the NCPCC in 2016.

The National Committee to Fight against Money Laundering and Terrorism Financing (Decree No. 12-041 / PR of 18 February 2012) has the following objective: (i) to define the AML/FT national policy, (ii) to propose any legislative, regulatory or administrative reform necessary to achieve its objectives, (iii) to coordinate the various actions to be implemented in accordance with international bodies, (iv) to ensure permanent monitoring of progress made in the field, (v) to monitor the commitments made by the country at the international level, and (vi) to define the necessary vocational training actions.

The Financial Research Service (SRF). This service receives and analyzes suspicious reports relating to money laundering and the financing of terrorism. The SRF works in close collaboration with the Central Bank and may use correspondents in the police, gendarmerie, customs, state judicial and other agencies involved in detecting AML/CFT infractions.

The National Directorate for Controlling Public Contracts and Public Service Delegation (NDCPCPSD). Article 7 of Law 17-019/AU, December 25, 2017, introduces the NDCPCPSD as the entity overseeing public-private partnership contracting operations.

The Public Procurement Regulatory Authority (PPRA). the PPRA presides over disputes under public-private partnership contracts (Article 7, Law 17-019/AU, December 25, 2017).

The Public Private Partnership Support Unit (PPPSU). The PPPSU is the State technical entity presiding over the identification of suitable PPP projects (Article 8, Law 17-019/AU, December 25, 2017).

The Ad hoc Tender Committee. This commission is responsible for preparing tender documents, evaluating tenders, and selecting candidates (introduced in Article 9, Law 17-019 /AU, December 25, 2017).

Source: Compiled by IMF Staff based on information provided by the Comoros authorities

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Table 3. Comoros: Status of Implementation of GIABA Recommendations				
Recommendation	**Current Status**	**Implementation Indicators**		**Responsible Party**
		Baseline Situation	**Targeted Outcome**	
1. Promulgation of the new adopted penal code integrating the offenses referred to in the UN convention on organized or transnational crime and its additional protocols	- The new Penal Code that was adapted unsigned by the former President is being updated to incorporate the recommendations of international organizations regarding: - Criminalization by the penal code of offenses related to trafficking in stolen property, kidnapping of adults and hostage taking, illicit trafficking, drug trafficking, - Criminalization by the code on the environment of offenses related to the environment	- Legal framework in force did not consider all the offenses provided for international conventions	- New revised Penal Code adopted once again by the National Assembly and promulgated by end of April 2020 at the latest	- Ministry of Justice
2. Inexistence of a legal framework incriminating the financing of individual terrorism and of a terrorist organization	- Bill on terrorism is developed and provisions will be integrated into the new code that is being updated.	- Non-existent legal framework	- Provisions of bill integrated in the code under revision	- Ministry of Homeland Security --Ministry of Justice
3. No setting of a threshold for wire transfers	- Bill on payment services and the services providers of the corresponding payment to be elaborated	- Non-existent legal framework	- Law adopted and promulgated end of April 2020 at the latest	- Ministry of Finance, Budget and Banking sector
4. No obligation provided for with regard to financial institutions accompanying information on the originator and the beneficiary of national and international wire transfers	- Bill on payment services and the services providers of the corresponding payment to be elaborated	- Non-existent legal framework	- Law adopted and promulgated end of April 2020 at the latest	- Ministry of Finance, Budget and Banking sector - Ministry of Public service and Public Administration

Table 3. Comoros: Status of Implementation of GIABA Recommendations (continued)

Recommendation	Current Status	Implementation indicators		Responsible Party
		Baseline situation	Targeted Outcome	
5. Non-availability of a local human, technical and sufficient financial resources.	-Available premises and process underway to equip the premises and strengthen the SRF in human resources, skills and financial resources	- Inexistence of a permanent office for the SRF, of an autonomous budget and a permanent staff	- SRF premises equipped and competent permanent staff assigned	- Ministry of Finance, Budget and Banking sector
6. Non-adherence of the Union of Comoros to the Palermo protocol on trafficking in migrants and human trafficking.	-Law authorizing the ratification of the Palermo protocol adopted and preparation of its communication to the President of the Republic end of 2019 at the latest	-Palermo protocol ratified by the Union of Comoros	-Palermo protocol ratified by the Union of Comoros end of April 2020 at the latest	
7. Non-existence of a legal framework and of a mechanism allowing to enforce targeted financial sanctions provided for in Resolutions 1373 and 1267 of the United Nations Security Council (UNSC)	- A bill on terrorism is developed and provisions will be integrated in the new code; - a bill revising the organic relating to the judicial organization of the Union of Comoros is developed so as to establish a judicial, economic and financial pole; -a bill establishing a judicial, economic and financial pole responsible for combatting financial offenses and those related to organized or transnational crime	-Existing legal framework -An economic and financial Brigade, specialized judicial sections and a technical section making up the judicial, economic and financial pole are created	-Provisions of the bill integrated in the code under revision; - Organic law revised with regard to the judicial organization and law on the judicial pole adopted and promulgated end of April 2020 at the latest and judicial pole made operational November 2020 at the latest	-Ministry of Homeland Security -Ministry of Justice

Table 3. Comoros: Status of Implementation of GIABA Recommendations (concluded)				
Recommendation	**Current Status**	**Implementation indicators**		**Responsible Party**
		Baseline situation	**Targeted Outcome**	
8. No obligation imposed to keep registration registers of the declarations of origin and of use of transported foreign currencies, the amount, the identity of the transporter as well as the referral to the SRF in case of discovery of transborder transport of foreign currencies and bearer negotiable securities exceeding the authorized threshold	-Provisions relating to the international convention for the suppression of international terrorism will be integrated in the new code under revision	-Existing legal framework	-Existing legal framework adopted and enforced	- Ministry of Finance, Budget and Banking sector -Ministry of Homeland Security-Ministry of Justice

Source: Comoros Financial Research Service (SRF).

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BANKING SECTOR SOLVENCY STRESS TESTS[1]

Solvency stress tests find that severe but plausible shocks to asset quality would leave a number of medium-to-large institutions undercapitalized. Tests that account for a potentially very low recovery rate of non-performing loans (NPLs), as suggested by anecdotal evidence, find substantial impacts. The findings suggest that the solvency of Comoros' banking system is fragile. At the same time, capital shortfalls remain limited relative to GDP, reflecting the small size of the banking system.

A. Introduction

1. **The Comorian financial system remains underdeveloped.** There are twelve financial institutions: four banks, some of which are subsidiaries of foreign institutions, four micro-finance institutions, and four other financial intermediaries, including one large deposit taking institution (SNPSF, a postal savings institution). For simplicity, all of these deposit-taking institutions will be called "banks" in this study. Banking penetration remains low: only 22 percent of the population reports having an account at a financial institution (including SNPSF) or using a mobile money service in the past 12 months, compared to an average of 43 percent in Sub-Saharan Africa (SSA). Financial system assets are 27 percent of GDP.

2. **System-wide asset quality is weak, impeding credit supply.** At end-March 2019, non-performing loans (NPLs) accounted for 21 percent of total loans, with a median provisioning ratio of 55.7 percent. A small number of clients account for the lion's share of NPLs. The NPL ratio increased to 24 percent of system-wide loans at end-October 2019 and continued to hinder bank lending due to heightened lender risk aversion.

3. **High system-wide bank capital levels mask vulnerabilities in individual banks.** At end-March 2019, the system's capital adequacy ratio (CAR) stood at 24.7 percent of risk-weighted assets (RWA),[2] substantially higher than the regulatory minimum of 10 percent. However, several banks have low capital buffers above the minimum. Taken together, capital needs of the undercapitalized banks account for 0.9 percent of GDP.

4. **Solvency stress tests were conducted to assess the resilience of Comorian banks to adverse shocks, using a range of specifications.** Solvency stress tests assess the ability of banks to meet minimum capital requirements and thus their obligations to creditors, especially depositors, in case adverse shocks affect the quality of bank assets. The assessment is made by (i) determining the likely impact of shocks on bank capital after required provisioning, and (ii) assessing how remaining bank capital compares to minimum capital requirements set by the regulator, in this case the Comoros central bank. Eight financial institutions were tested: the four banks, three micro-finance institutions, and SNPSF.

[1] Prepared by Thierry Bayle (MCM), Mokhtar Benlamine (AFR), and Torsten Wezel (MCM).

[2] For the purpose of determining the minimum capital requirements, financial institutions' assets are weighted according to broad risk categories.

B. Stress Tests

Ordinary Stress Test

5. **The test uses three shocks of increasing severity:** (i) a moderate shock with an increase in NPLs in each bank by 20 percent—corresponding to the average NPL increase seen during 2011–16; (ii) a severe shock with a 35 percent increase in NPLs—the largest annual increase during 2011–16; and (iii) an extreme shock with a 70 percent increase in NPLs—the largest annual system-wide increase in NPLs seen in any fragile state in SSA since the Global Financial Crisis (comprising only those countries that have been reporting NPL data).

6. **In a simple static analysis, the need for additional provisions resulting from shocks to NPLs was deducted from both bank capital and risk-weighted assets**.[3] To translate the impact of the shocks into a reduction in bank capital, a constant provisioning coverage ratio of 55.7 percent was assumed (corresponding to the median coverage ratio of NPLs as of March 2019), assuming that this ratio is adequate to cover expected losses in the event (likely an optimistic assumption that is modified below, paragraphs 8 and 9).

7. **The tests find that the capital ratio of the system falls by 2.1–7.8 percentage points in response to the shocks (Table 1, row "Ordinary stress test").** In the extreme scenario, the system's capital falls to 16.9 percent of risk-weighted assets, and the system's capital shortfall amounts to 1.3 percent of 2018 GDP, an additional 0.4 percent of GDP compared to current capital needs.

- In the moderate scenario, no further bank sees capital drop below the 10 percent minimum requirement.
- In the severe scenario, one bank sees capital fall below 10 percent, resulting in a total of three banks that do not meet minimum capital requirements.
- In the extreme scenario, one more bank sees capital fall below 10 percent. The four banks that are undercapitalized in the extreme scenario account for 39 percent of system-wide deposits.

Recovery Rate Stress Test

8. **An alternative test takes account of difficulties in loan recovery by varying the assumed provisioning ratio. It finds that the capital ratio of the system falls by 5.4 percentage points to 19.3 percent of risk-weighted assets (Table 1, row "Low recovery rate stress test").** NPL recoveries are reportedly very low in Comoros. The test assumes that the recovery rate of NPLs is only 2 percent, as suggested by anecdotal evidence gathered from market participants. Under this scenario, two banks see their capital drop below the 10 percent mark to join the two already undercapitalized banks. The (in total four) banks that result undercapitalized again account for 39 percent of total system deposits, and their

[3] This static view does not consider the cushioning impact of positive bank profits (where existing) nor any tax shields resulting from the losses generated in the stress test. It also does not assume a change in loans resulting from loan growth or write-offs.

capital shortfall corresponds to 1 percent of GDP, an additional 0.1 percent of GDP compared to current capital needs.

9. Tests that combine shocks to NPLs with a low recovery rate of NLPs find substantial impacts. Combining the shocks to NPLs under the ordinary stress tests with a recovery rate of NPLs of only 2 percent (as in paragraphs 8 and 9) finds that the capital ratio of the system would fall by 10.2–25.4 percentage points to as low as -0.8 percent of risk-weighted assets (Table 1, row "Combined ordinary and recovery rate stress test"). In the process, another 1–2 banks would end up undercapitalized. The (in total 4–6) banks that would end up undercapitalized have a capital shortfall of 1.3–2.4 percent of GDP.

Reverse Stress Test

10. A "reverse" stress test finds that it would take a substantial increase in NPLs to lower the system's capital ratio below minimum requirements. Assuming an NPL provisioning rate of 56 percent as in the ordinary stress test, the test finds that it would take more than a doubling in NPLs to lower the system's capital to less than the regulatory minimum (Table 1, row "Reverse stress test"). However, if only a small share of NPLs can be recovered (2 percent, as in paragraph 8), NPLs would need to rise only by 36.5 percent to lower the system wide capital ratio to below the regulatory minimum. In both cases, the capital shortfall would be about 1.8 percent of GDP.

Single Name Concentration Stress Tests

11. A final test simulates the default of one or more of each institution's largest borrowers. It finds that the capital ratio of the system falls by 6.3 percentage points to 18.3 percent of risk-weighted assets (Table 1, row "Single name concentration test"). Banks' portfolios are known to be concentrated on a few borrowers, most of which are common to several institutions. In the absence of granular data, the test assesses the impact of the default of the largest hypothetical exposure permitted by regulation, i.e. a risk-weighted amount of 25 percent of the institution's capital. Under this test, no additional bank sees capital drop below 10 percent. The capital shortfall of SNPSF would increase marginally. (This test uses only the default assumption of a provisioning rate of 56 percent, as no information is available on the provisioning of the specific largest exposures).

Table 1. Comoros: Stress Test Results

Ordinary stress test	Current	*Moderate*	*Severe*	*Extreme*
System CAR (percent)	24.7	22.6	21.0	16.9
Impact on CAR (percentage points)	---	-2.1	-3.7	-7.8
No. banks failing / percent of system deposits	2 / 18	2 / 18	3 / 26	4 / 39
Capital shortfall (percent of GDP)	0.9	1.0	1.0	1.3
System CAR after median coverage	24.0	21.8	20.2	15.9

Low recovery rate stress test	Current	Combined ordinary stress test and recovery rate at 2 percent		
		Moderate	*Severe*	*Extreme*
System CAR (percent)	19.3	14.4	10.4	-0.8
Impact on CAR (percentage points)	-5.4	-10.2	-14.3	-25.4
No. banks failing / percent of system deposits	4 / 39	5 / 55	5 / 55	6 / 61
Capital shortfall (percent of GDP)	1.0	1.3	1.6	2.4

Reverse stress test	*1 more bank fails*	*3 more banks fail*	*System CAR at 9.9%*	
	Unchanged recovery rate			*Recovery rate at 2 percent*
System CAR (percent)	21.4	14.6	9.9	9.9
Impact on CAR (percentage points)	-3.3	-10.0	-14.7	-14.7
Necessary increase in NPL stock (percent)	24.0	80.2	114.0	36.5
Capital shortfall (percent of GDP)	1.0	1.4	1.8	1.7

Single name concentration stress test	Current	*Default of largest exposure*
System CAR (percent)	24.7	18.3
Impact on CAR (percentage points)	---	-6.3
No. banks failing / percent of system deposits	2 / 18	2 / 18
Capital shortfall (percent of GDP)	0.9	0.94