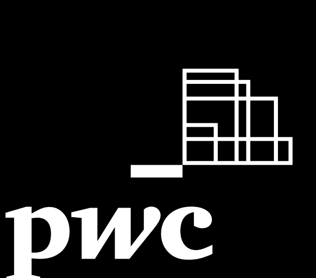
2021 Zambia Bank and Non Bank Industry Survey Report



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Contents

Foreword	3
Introduction	4
Survey results	4
Cybersecurity	10
State of the economy	11
Performance of the financial industry: Is it sustainable?	22
Digital transformation	24
High credit risk and NPLs	26
Impact of COVID-19 on operations	34
Tax environment for banks and non bank financial institutions (NBFIs)	35
Environment, social and governance for banks and non bank financial institutions	40
Financial inclusion	47
Financial performance and analysis	49
Glossary	53
Contributors	54

Foreward

Welcome to the sixth edition of the Zambia Bank and Non-Bank Financial Industry Survey.

This is the second financial industry survey that we have conducted during the COVID-19 pandemic. Although the pandemic continues to influence the sector, its impact has waned as the virus has loosened its grip on the world and companies have adapted to new ways of working.

Zambia's outlook has improved notably since the previous survey following the United Party for National Development's win in last year's general election. Renewed optimism in the country's economic prospects, coupled with a relatively high interest rate environment, has driven strong performance in the financial services sector in the last 18 months.

However, the sector continues to face challenges as financial services evolve towards more technology-based offerings. Financial institutions are therefore having to adapt constantly to this to stay ahead of the competition.

All of this and more is reflected in our 2021 survey. We hope you find our findings useful.

We would like to thank the Bank of Zambia governor, Dr Denny Kalyalya, and his team for being gracious in giving their time to share their thoughts and also for challenging us to continue elevating the value of this report. We also thank the survey respondents and guest contributors, without whose input this report would not be possible.

Finally, thank you to the PwC team, our community of solvers, for their tireless effort in putting this report together. In particular, we would like to thank Bupe Kazimoto, who was instrumental in coordinating this report, and who is moving on from PwC to pursue other career opportunities. Bupe, thank you for your valuable insights and for leading the team so masterfully. On behalf of PwC, we wish you all the best in your future endeavours.

Happy reading!

Martin Bamukunde

Partner, Financial Services Leader

Andrew Chibuye

Country Senior Partner

1. Introduction

On 9 September 2022, government lifted most of the remaining COVID-19 restrictions, officially drawing the curtain on the pandemic, or at least the more severe elements of it. This marked the beginning of the end of the most turbulent two and a half years in Zambia's recent past.

Despite the national health emergency and economic crisis brought about by the pandemic, in 2021 Zambia's banks recorded their highest profitability in history, while non-banks also saw significant growth in profits. The financial services sector, buttressed by the Bank of Zambia's (BoZ) COVID-19 interventions, maximised the opportunities the pandemic presented despite disruptions to operations and the increased risk profile. While results vary, it is clear that institutions that held strong liquidity and capital positions prior to the pandemic extracted more value from the unprecedented circumstances.

Opportunities for banks for the most part related to lending to government to finance the Farmer Input Support Programme (FISP) and investment in government securities, either through public auctions or private placements. However, whether the banks' strong performance is sustainable remains to be seen, particularly in view of government's focus on fiscal consolidation and a decline in interest rates.

As the sector emerges from the pandemic and returns to a more recognisable, yet unfamiliar, sense of normalcy, the consequences of the pandemic will continue to shape the banking sector in Zambia. These consequences include accelerated digitisation and associated cybersecurity risks, hybrid working models, greater focus on environmental, social and governance (ESG), increased competition from non-traditional players, and the broader evolution of financial services. All this, along with the ongoing effects of a fragile domestic economy, is reflected in our survey results.

The International Monetary Fund's (IMF) intervention to help resolve Zambia's economic problems has been the subject of much debate. However, an IMF programme seemed inevitable for some time, rendering such debate academic. What is important now is that government stays the course and maximises the opportunities presented by an IMF programme, while, at the same time, minimising the attendant costs in the pursuit of sustained economic recovery.

Economic growth and the performance of financial institutions go hand in hand. Therefore, the implementation of an IMF programme has the potential to have a huge impact on Zambia's banking and broader financial services sector.

2. Survey results

We now present the main findings from the 2021 survey.

To gather data for the survey, we sent questionnaires to financial institutions operating in Zambia and asked them about the issues currently affecting their business. Questionnaires were sent to all 17 banks and 32 non-bank financial institutions (NBFIs) in Zambia.

Two separate questionnaires were sent out to financial institutions. The first questionnaire went to the chief executive officers (CEO)/managing directors (MD) of each commercial bank and asked them to rank the most significant issues facing the sector and what their bank's strategic imperatives were going forward. The second questionnaire was sent to the chief financial officers (CFO) of banks and NBFIs, and asked a broader range of questions about the challenges facing the sector. The questionnaire sent to the CFOs of the NBFIs also asked them to rank the issues affecting the sector and their strategic imperatives. The response rate was 81% from the CEOs/MDs of banks, 94% from the CFOs of banks and 50% from the CFOs of the NBFIs.

In analysing the responses, PwC Zambia used a weighted average to identify the most significant issues at both a combined and disaggregated level.

One notable difference in this year's survey results is a greater divergence around the issues affecting financial institutions in 2021. This is reflected in lower overall scores for the top five issues.

The top five issues facing banks in 2021 as reported by the CEOs/MDs of banks were (from most to least significant):

1. **Cybersecurity**
2. **The state of the local economy**
3. **Digital transformation**
4. **Impact of an IMF programme on the banking sector**
5. **US dollar liquidity**

The top five issues facing NBFIs were:

1. **Digital transformation**
2. **Liquidity risk**
3. **State of the local economy**
4. **High credit risk and non-performing loans (NPLs)**
5. **Interest rate risk**

Digital transformation and the state of the local economy were the only common issues between banks and NBFIs in the top five.

2.1 Top five issues: Banks

Cybersecurity was identified as the most significant issue facing banks for the first time in our survey's history, with an average score of 5.8. This compares to a score of 4.1 in 2020, when it was ranked fourth. Respondents cited that given the nature of modern banking operations, cybersecurity continued to be a growing area of focus for banks

The state of the local economy, the most pressing issue identified by banks in 2019 and 2020, dropped to second place in 2021, with an average score of 5.5. Based on our discussions with respondents, it is clear that there is a growing, albeit cautious, sense of optimism with regards to the economy.

The impact of a deal with the International Monetary Fund (IMF) on the banking sector was identified as the fourth most pressing issue for banks in this year's survey, with an average score of 3.6. While this score might not seem high, our discussions with respondents, both banks and NBFIs, show that most of their business concerns were linked either directly or indirectly to the potential benefits of an approved IMF deal.

Digital transformation returned to the top five this year with a score of 4.2, ranking it the third most pressing issue affecting banks in 2021. This is a significant rise in the rankings since the last survey, when it scored 1.9. The impact of a proposed IMF programme and the availability of US dollars in the banking sector were the fourth and fifth most significant issues facing banks in 2021.

Finally, it would appear that banks have now adjusted their operations to the impact of COVID-19, with the matter dropping out of the top five this year, although it remains a pressing issue for banks outside of the biggest six (by asset size as at 31 December 2021).

The table below presents the top five issues affecting banks in 2021 and shows how these issues have changed over the last three years.

Figure 1: Top five issues for banks, 2019–2021

	2019		2020		2021
State of the local economy	9	State of the local economy	8.6	Cyber security	5.8
Impact of COVID-19	8.9	Impact of COVID-19	8.2	State of the local economy	5.5
High credit risk and NPLs	6.5	High credit risk and NPLs	4.4	Digital Transformation	4.2
Capital management	6.5	Cyber security	4.1	Impact of the proposed IMF program on the banking sector	3.6
Improving revenue growth	5.6	Fee and service charge erosion	3.2	USD Liquidity	3.4

Source: PwC analysis

2.2 Top five issues: Six largest banks (by asset size as at 31 December 2021)

With the exception of high credit risk and non-performing loans (NPLs), the top five issues of the six largest banks are similar to those of the banking sector as a whole.

However, an increased focus on digital transformation and cybersecurity is more apparent among the six largest banks than it is in the broader banking sector. In 2021, these two issues both scored seven, indicating a significant amount of convergence relative to other issues in this year's survey. This implies that banks, especially the largest banks, are paying particular focus on exploiting opportunities in technology while remaining alert to the dangers posed by cyber threats.

Figure 2: *Top five issues – six largest banks*

	2019		2020		2021
State of the local economy	9.3	State of the local economy	9	Digital transformation	7
High credit risk and NPLs	6.2	Impact of COVID-19	7.8	Cyber security	7
Escalating cost of doing business	4.6	High credit risk and NPLs	5.3	State of the local economy	5.5
Fee and service charge erosion	4.5	Cyber security	5.3	USD Liquidity	4.3
Increased competition from non-traditional players	4.4	Fee and service charge erosion	3.5	High credit risk & NPLs	4.2

Source: PwC analysis

2.3 Top five issue: Other banks

Among the other banks in the industry, the state of the local economy was the most pressing issue in 2021, while cybersecurity was second.

The impact of COVID-19 also continues to be an issue of concern and was ranked third among other banks. However, it is important to note the significant reduction in the importance of the issue from an average score of 8.4 in 2020 to 4.8 in the current survey. Broadly speaking, it seems banks have adapted to the changes brought about by the pandemic.

The other most pressing issues for other banks were the impact of a proposed IMF programme (fourth most pressing issue) and US dollar liquidity (fifth most pressing issue). This was in line with the banking industry as a whole.

Figure 3: *Top five issues – Other banks*

	2019		2020		2021
Impact of COVID-19	9.4	Impact of COVID-19	8.4	State of the local economy	6.9
State of the local economy	8.8	State of the local economy	8.3	Cyber security	6.4
Escalating cost of doing business	6.7	High credit risk and NPLs	3.8	Impact of COVID-19	4.8
Capital Management	6.6	Liquidity risk	3.6	Impact of proposed IMF	4.5
Improving revenue growth	5.4	Cyber security	3.3	USD Liquidity	3.5

Source: PwC analysis

The table below shows the common areas between the two subsets of the banking industry (the six largest banks and the rest of the banks), as well as the areas where they diverge. It is interesting to note that the impact of COVID-19, which was important to the other banks, did not feature at all in the responses of the six largest banks (where no respondent identified it as an issue at all). It is also worth noting the relatively low score of high credit risk and NPLs among other banks (2.6), which is interesting given that the issue has received a high score in previous years.

Figure 4: *Six largest banks vs other banks*

Top 6 Banks		Industry	Top 6 banks	Other banks	Other banks	
Digital transformation	7	Cyber security	7	6.4	Impact of COVID-19	4.8
High credit risk and NPLs	4.2	State of the local economy	5.5	6.9	Impact of proposed IMF	4.5
		USD Liquidity	4.3	3,.5		

Source: PwC analysis

2.4 Top five issues: NBFIs

Digital transformation was ranked the most significant issue for NBFIs in 2021, while liquidity risk was the second most significant issue.

With respect to liquidity risk, NBFIs reported general liquidity in the market as an issue, while commercial banks said it was specifically a lack of US dollar liquidity that was a concern. However, when we asked respondents why liquidity was an issue, we found the underlying reasons and solutions were similar among banks and NBFIs. In particular, respondents hoped that an IMF programme would act as a catalyst to resolving the various liquidity challenges.

High credit risk and NPLs, the state of the local economy and interest rate risk were the third, fourth and fifth most significant issues affecting NBFIs in 2021.

Figure 5: *Top five issues for NBFIs*

	2019		2020		2021
Impact of COVID-19	8.7	State of the local economy	8.1	Digital Transformation	5.7
State of the local economy	8.2	Impact of COVID-19	7.5	Liquidity risk	5.6
High credit risk and NPLs	6.8	High credit risk and NPLs	5.9	High Credit Risk and NPL	5.1
Liquidity risk	6.6	Improving revenue growth	5.3	State of the local economy	4.7
Escalating cost of doing business	5.8	Depreciation of the Kwacha	4.5	Interest rate risk	4.6

Source: PwC analysis

When comparing the results between banks and NBFIs, we noted that the latter were more concerned about industry-specific risks – liquidity, high credit risk and interest rate risk - than the commercial banks were.

Figure 6: *Survey results across banks and NBFIs*

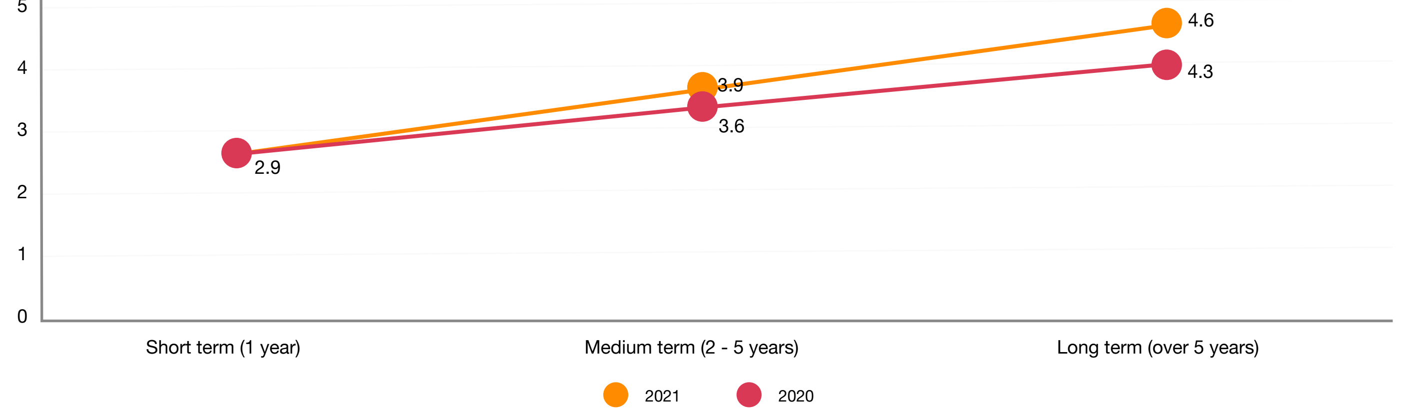
Banks		Common Issues	Bank	None Bank	None Banks	2021
Cybersecurity	5.8	State of the local economy	5.5	4.7	Liquidity risk	5.6
Impact of proposed IMF program	3.6	Digital transformation	4.2	5.7	High Credit Risk and NPLs	5.1
USD liquidity	3.4				Interest rate risk	4.6

Source: PwC analysis

2.5 Outlook for the industry

Feedback from respondents indicates they are cautiously optimistic about the outlook for the banking and non-banking sector, and the financial services industry as a whole. As in last year's survey, respondents were asked to indicate their level of optimism on a five-point Likert scale, with one being least optimistic and five very being optimistic.

Figure 7: *Level of optimism regarding prospects for the Zambian financial sector: Banks*

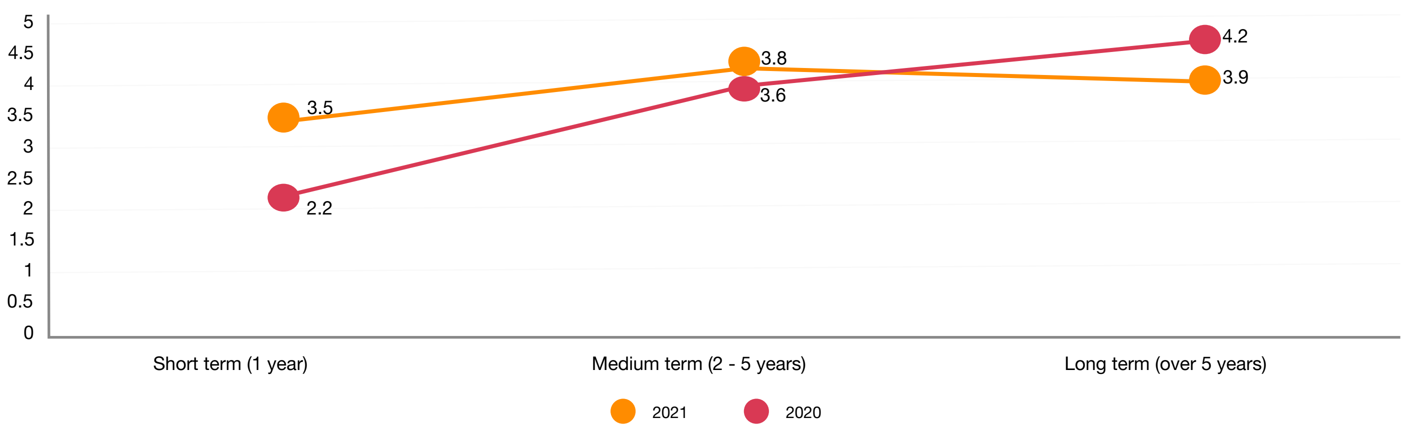


Source: PwC analysis

Banks remain cautious about prospects for the next year. However, there is a clear improvement in sentiments over the medium to long-term.

Among NBFIs, we noted a significant improvement in their short to medium-term outlook for the industry, although interestingly there was a small decline in optimism for the sector's long-term prospects.

Figure 8: *Level of optimism regarding prospects for the Zambian financial sector: NBFIs*



Source: PwC analysis

The increased short-term optimism among NBFIs shows that they are looking towards a bright future in light of recent economic developments, which include the recently approved IMF programme, positive steps towards Zambia restructuring external debt, and general improvement in economic indicators, such as inflation and the exchange rate. However, this short-term optimism is tempered by concerns about the stability of important industry fundamentals, such as liquidity, interest rates and the effects of regulation, and the impact these might have on financial performance.

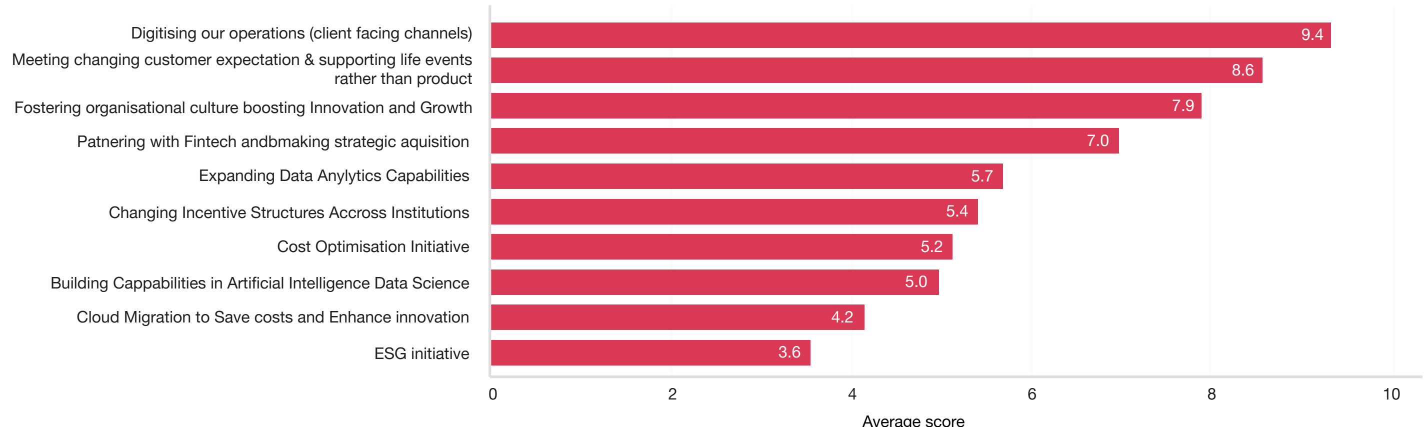
2.6 Strategic priorities

Given the importance placed on digital transformation and cybersecurity, it is unsurprising that most participants view digitising their operations as a priority.

Respondents were asked to rank a list of ten areas of strategic importance for their business going forward from most to least significant. A score of 10 was assigned to the most significant area of strategic importance.

Among banks, digitising operations had the highest average score of 9.4. This was followed by meeting changing customer expectations (8.6) and fostering organisational culture (7.9). It is clear that digital transformation is top of the banking sector's agenda as the economy recovers from the challenges of recent years.

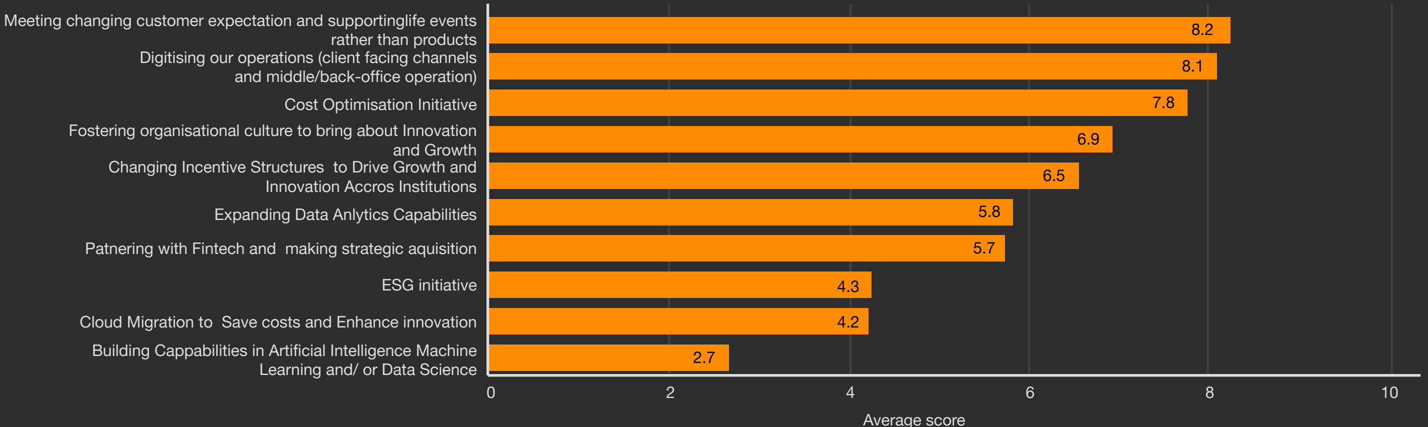
Figure 9: *Strategic imperatives (average scores): Banks*



Source: PwC analysis

Meanwhile, for NBFIs, meeting customer expectations was the most important strategic imperative (8.2) rather than product innovation. However, digitising operations was not far behind, with a score of 8.1 - implying that the strategic priorities of both banks and NBFIs are broadly aligned.

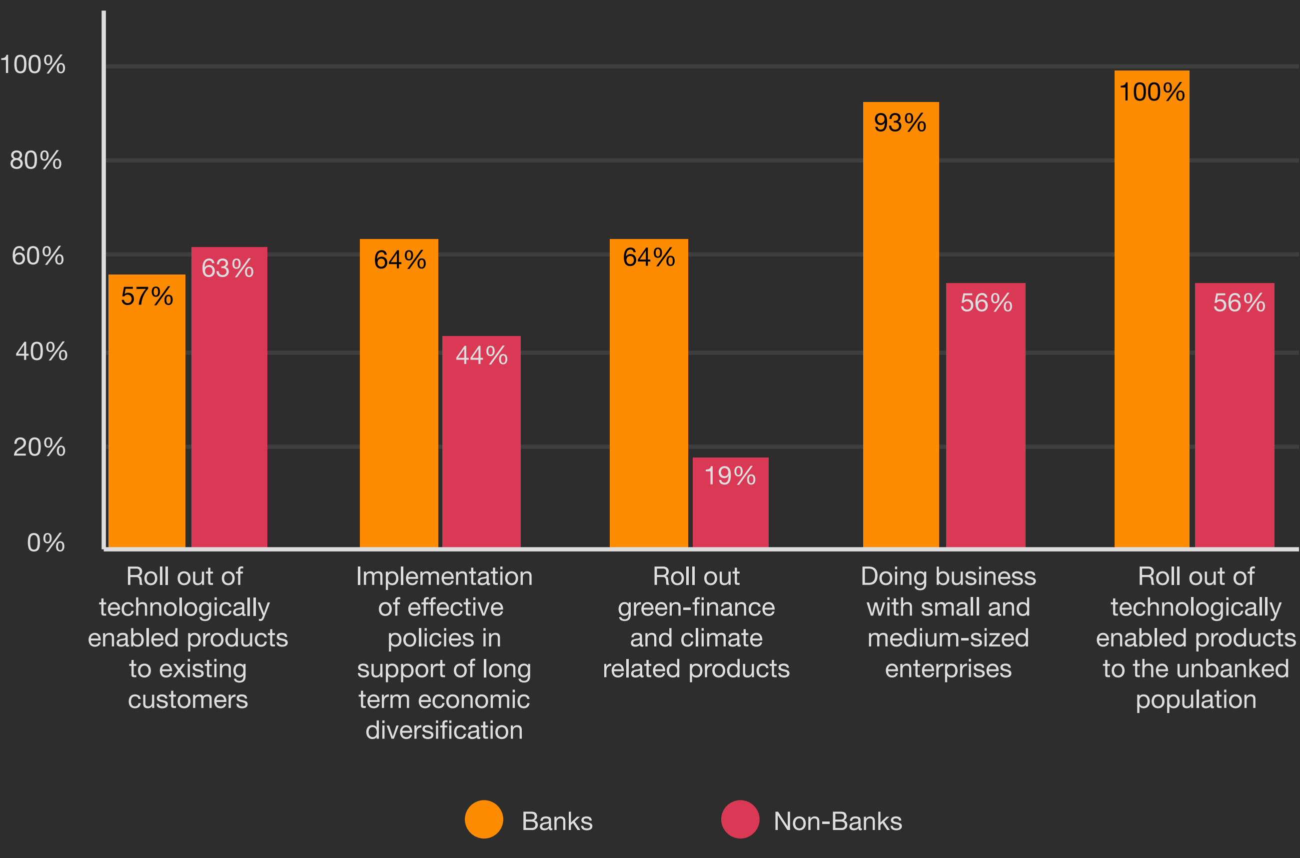
Figure 10: *Strategic imperatives (average scores): NBFIs*



Source: PwC analysis

It is in this context that we asked all respondents the question: Where do you see the greatest opportunity for sustained growth and profitability in the sector?

Figure 11: *Opportunity for sustained growth and profitability*



Source: PwC analysis

****Note:** *Individual respondents to this question were able to give more than one suggested course of action. The percentages above therefore show how many respondents reported on a similar issue. Due to this, percentages across the options do not add up to 100%.*

As the chart above shows, respondents see the roll out of technology-enabled products as offering the greatest opportunity for growth in the medium to long-term.

3. Cybersecurity

Cybersecurity was identified as the most pressing issue faced by banks in 2021 with a score of 5.8, up from fourth place in 2020, when it scored 4.1. Among NBFIs, cybersecurity scored 3.7 (2020: 1.2), falling just a few points short of the top five most significant issues affecting NBFIs.

Our survey results show the growing importance of information security among banks and NBFIs. Financial institutions are being forced to adopt better cybersecurity measures due to geopolitical change, technological advancements across different markets, and information security considerations as companies increasingly opt for flexible working models in the post-COVID-19 world.

The financial sector has been working to innovate and digitalise its services, and this has led to an unprecedented increase in cyber-related attacks. These attacks range from ransomware attacks to mobile money fraud, and make institutions and customers nervous about using technology for financial transactions.

According to *PwC's Cyber Threats 2021: A Year in Retrospect* report, ransomware was the most significant cyber threat faced by organisations across different geographies and sectors in 2021. Leak sites exposed data of approximately 1,300 ransomware victims in 2020, while in 2021 this number rose to 2,435 victims. The majority of ransomware attacks were financially motivated, while others were believed to be politically motivated.

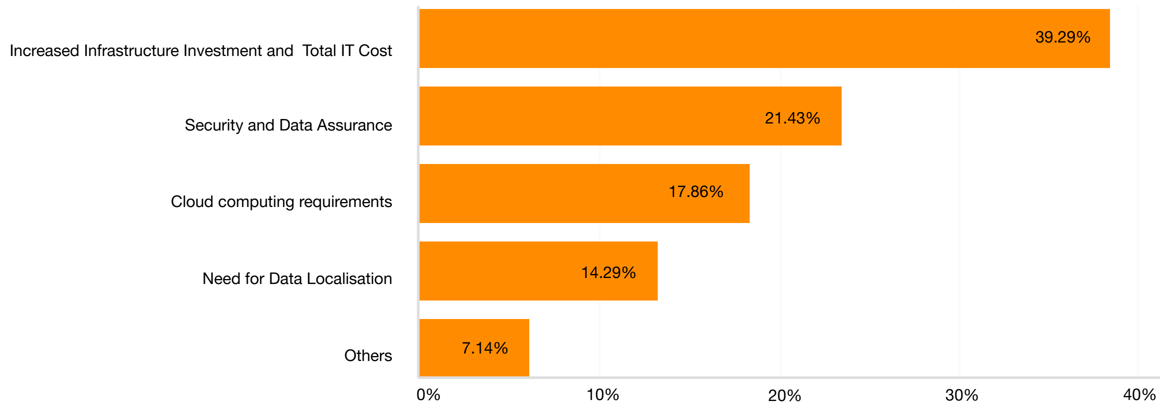
In Zambia, *The Data Protection Act* and *The Cybersecurity and Cyber Crimes Act* were enacted by parliament in 2021. This brings the number of nations in Africa with specific data protection legislation to 33.

The right to information, the right to object erasure, the right to processing restraints and the right to portability are all protected under *The Data Protection Act*.

Meanwhile, the introduction of The Cybersecurity and Cyber Crimes Act was met with mixed reactions. On a positive note, the Act shows how, from a legal perspective, government has made significant strides towards enhancing information security. However, some entities are hesitant to fully implement the requirements set out in the Act. When asked in our survey in what ways the Act would impact business, the most common concerns identified by NBFIs and banks were as follows:

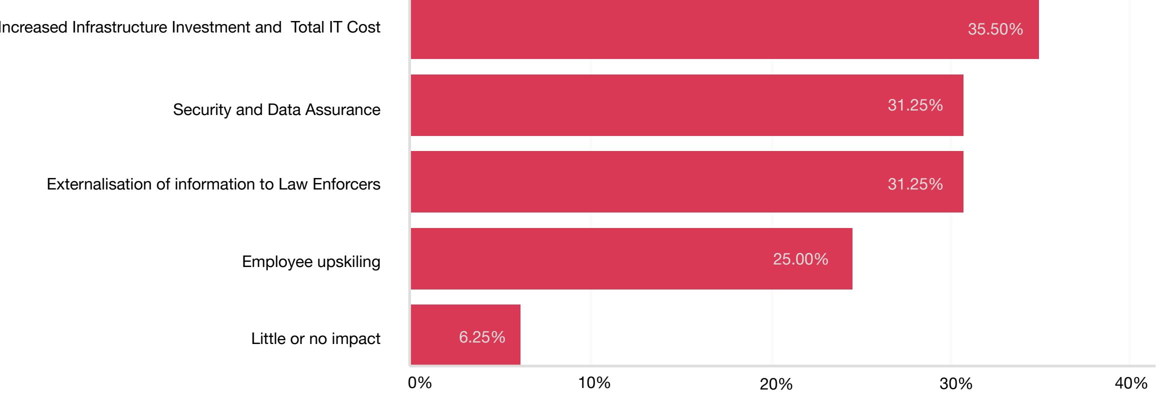
- Huge capital and operational costs required to enhance the various critical information infrastructure and systems needed to meet the security obligations, including ongoing monitoring of traffic by the authorities.
- Security and data assurance: The Act includes the establishment of a Central Monitoring and Coordination Centre to implement interception laws, among other policies. This will give enforcement officers the right to intercept information capable of causing financial loss to banks, financial institutions, account holders and beneficiaries of funds being remitted or received by such account holders or beneficiaries. Consequently, data protection issues will arise from the implementation of these provisions of the Act.
- Obstructing cloud computing and the need for data localisation. The requirements around data localisation would restrict and limit the full potential of cloud computing as data localisation requirements would impact data sovereignty requirements around both personal and commercial data.

Figure 12: *In what ways will the Cyber Security and Cyber Crimes Act of 2021 impact your business*



Source: PwC analysis

Figure 13: *In what ways will the Cyber Security and Cyber Crimes Act of 2021 impact your business*



***Note:** Individual respondents to this question were able to give more than one suggested course of action. The percentages above therefore show how many respondents reported on a similar issue. Due to this, percentages across the options do not add up to 100%.*

Source: PwC analysis

PwC's Cyber Threats 2021: A Year in Retrospect report revealed that the following sectors are most likely to be impacted by threat actors[1]:

- **Telecommunications**. In 2021, telecommunications companies were a particular target for espionage-motivated actors collecting sensitive information. As financial services increasingly rely on the phone and data services provided by telecommunications companies, this is an important threat to note.
- **Technology.** With the rapid uptake of innovative technologies, threat actors continue to target intellectual property rights. A key target area is supply chain and island hopping attacks, especially where companies provide IT and cybersecurity services to customers.
- **Financial services.** This was among the top three most affected sectors, with a focus on financial service listings due to interest from buyers and the likelihood of financial gains.
- **Retail.** Threat actors target retail companies because they know these companies need to maintain operational uptime and so are likely to pay ransoms quickly. As financial institutions have been working closely with the retail industry to provide easier ways for customers to process payments, it is important to note how this threat could impact these services.

4. State of the local economy

The state of the local economy continued to be a significant issue for financial institutions in 2021, although it was no longer the most critical issue. Among banks, the score fell from 8.6 in 2020, when the state of the local economy was the most significant issue, to 5.5 in 2021, making it the second most important issue affecting the sector after cybersecurity. Among NBFIs, the state of the economy dropped from being the most pressing issue in 2020, with a score of 8.1, to the fourth most pressing issue last year, with a score of 4.7.

When we delve deeper into respondents' responses, however, we notice that most issues of concern among companies in 2021 are linked to the state of the economy. For example, among banks, the impact of a proposed IMF programme and US dollar liquidity both feature in the top five issues and are related to the health of the broader economy. Meanwhile, the issues of concern for NBFIs, such as interest rate risk and liquidity risk, are also dependent on dynamics in the local economy.

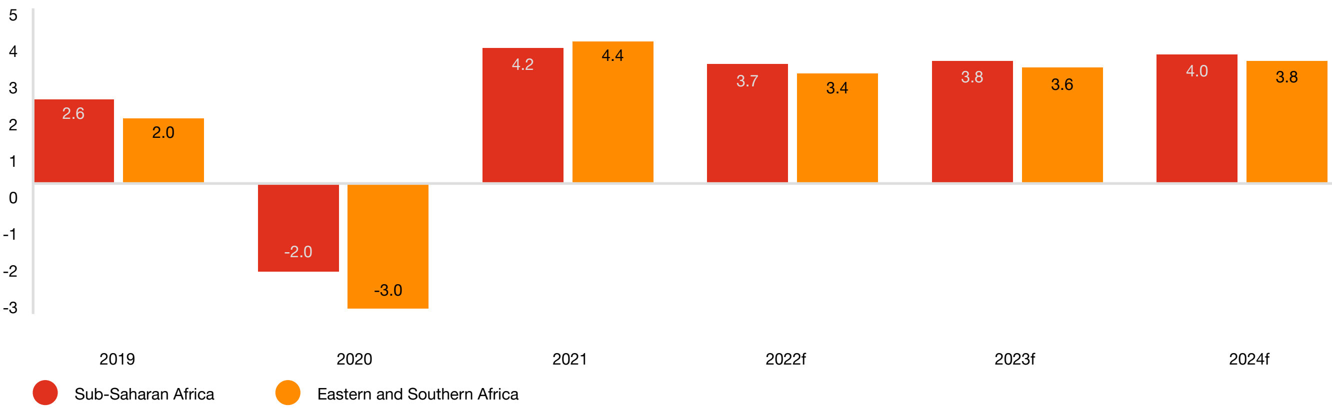
In light of this, it is helpful to assess the prospects for both the regional and domestic economies.

1 PwC, 2022. Cyber Threats 2021: A year in Retrospect. https://www.pwc.com/gx/en/issues/cybersecurity/cyber-threat-intelligence/cyber-year-in-retrospect/yir-cyber-threats-report-download.pdf

4.1 Economic context: Sub-Saharan Africa outlook

- The impact of the COVID-19 pandemic caused economic output in sub-Saharan Africa (SSA) to contract by 2% in 2020. In 2021, the SSA economy expanded by 4.2%, more than recovering the losses in real GDP suffered during the preceding year. The regional economy was supported by a rebound in international commodity prices and a gradual easing of social restrictions both locally and abroad.[2]
- SSA's economic growth has slowed in 2022 to date due to the global fallout of Russia's invasion of Ukraine. While most African countries have limited direct financial and trade dealings with the affected economies, the decline in global economic growth alongside elevated commodity prices have created many headwinds for the SSA region. (We see this later in this report when discussing Ghana's efforts to secure an IMF programme.) The cost of staple foods and farming inputs is also negatively impacting the region. The SSA economy is expected to grow by 3.7% in 2022 with the east and southern Africa sub-region forecast to see its real GDP increase by 3.4%.[3]

Figure 14: *Regional economic growth is slowing due to 2022's headwinds*



Source: The World Bank

4.2 Zambia's economic outlook

i. Economic growth trends

Key highlights in this area include:

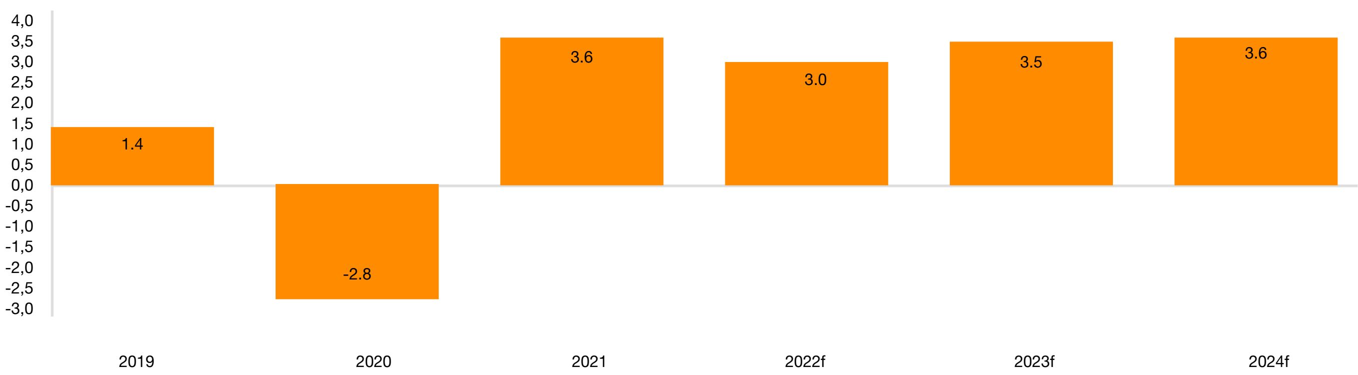
- Recovering from a real GDP decline of 2.8% in 2020, the Zambian economy grew by 3.6% in 2021 on the back of higher copper prices, improved business and investor confidence following the August 2021 elections, and continued recovery in the agricultural sector as rainfall patterns normalised.
- All sub-sectors recorded growth during the year except for mining, with the sector continuing to be challenged by supply chain disruptions and excessive rainfall.[4] The financial and insurance sector recorded an average growth rate of 6.7% during 2021 - outpacing growth in the overall economy.[5]
- The Zambian economy grew by 2.4% year-on-year in the first quarter of 2022. The Zambia Statistics Agency recorded year-on-year growth in the public administration, education, information and communication, electricity generation, accommodation and real estate sectors.[6]

2 World Bank, 2022. Global Economic Prospects, January. https://openknowledge.worldbank.org/handle/10986/3651
3 World Bank, 2022. Global Economic Prospects, June, https://openknowledge.worldbank.org/handle/10986/37224
4 World Bank, 2022. Overview. https://www.worldbank.org/en/country/zambia/overview
5 Bank of Zambia, 2022. Monthly Bulletin, June. https://www.zamstats.gov.zm/publications/
6 Bank of Zambia, 2022. Monthly Bulletin, June. https://www.zamstats.gov.zm/publications/

The BoZ Quarterly Survey of Business Opinions and Expectations 2022 Q1 shows that Zambian businesses are positive about growth in the year ahead. This outlook is based on expectations of favourable policies under the new government, as well as the approved IMF extended credit facility (ECF). However, business leaders were also concerned at the time about the adverse effects of Russia's invasion of Ukraine on the global market.[7] This is reflected in the marginally negative readings for May and June in Stanbic Bank's Zambia Purchasing Managers' Index (PMI).

PwC expects the Zambian economy to grow 3% in 2022. However, the BoZ highlighted in May some of the key challenges to the growth outlook this year. These include: 1) the impact of the global fallout from Russia's invasion of Ukraine on supply chains; 2) a slow recovery in trade with key partner countries; and 3) uncertainty surrounding the resurgence of new and more contagious COVID-19 variants.[8] The World Bank has also warned that African exporters of industrial metals, crude oil and ores could feel pressure from decelerating growth in China, the world's second-largest economy. These exporters include countries such as Angola, the Democratic Republic of Congo, the Republic of Congo, South Africa and Zambia.[9]

Figure 15: *Global economic recovery rates*



Source: PwC analysis

ii. Inflation and monetary policy

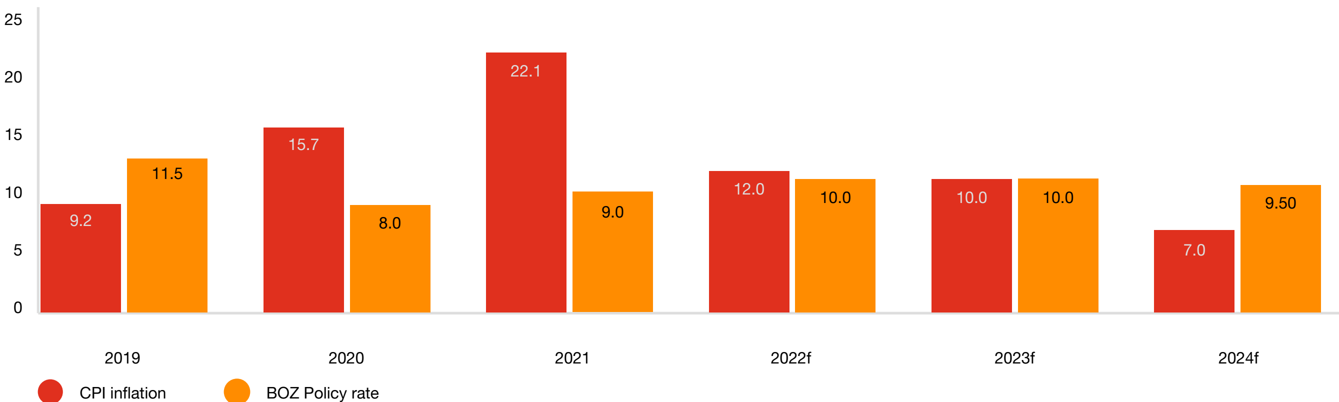
Headline inflation in 2021 averaged 22.1% due to continued currency weakness. This is substantially above the BoZ's target range of 6% to 8%. Inflation peaked at 24.6% year-on-year in July 2021 before starting a downward trend. Inflation was measured at 9.7% year-on-year in June 2022, which was the lowest reading in nearly three years, before rising to 9.9% year-on-year in July. Inflation averaged 12% in the first seven months of 2022.[10]

The BoZ Monetary Policy Committee (MPC) commented in August that it expects the deceleration in inflation to continue during the second half of 2022, reaching the 6%-8% target range by the first half of 2024. The central bank cited enhanced fiscal consolidation and support from the IMF as key assumptions, with these boosting market confidence and anchoring inflation expectations.[11] PwC expects inflation to average 12% in 2022.

The MPC lifted interest rates by 50 basis points in both February and November 2021 to anchor inflation expectations. The policy rate has been unchanged at 9% in 2022 so far due to a deceleration in inflation, as well as the central bank's expectations that inflation would decline towards the target range by the end of 2023.

7 Bank of Zambia, 2022. Quarterly Survey of Business Opinions and Expectations, Q2. https://www.boz.zm/quarterly-survey-of-business-opinions-and-expectations.html
8 Bank of Zambia, 2022. Monetary Policy Committee Statement, May. https://www.boz.zm/MPC_Statement_Q2_2022.pdf
9 World Bank, 2022. Global Economic Prospects, June, https://openknowledge.worldbank.org/handle/10986/37224
10 Trading Economics, 2022. Zambia Inflation Rate. https://tradingeconomics.com/zambia/inflation-cpi
11 Bank of Zambia, 2022. Monetary Policy Committee Statement, May. https://www.boz.zm/MPC_Statement_Q2_2022.pdf

Figure 16: *CPI Inflation versus BoZ Policy rate trend*



Source: PwC Analysis

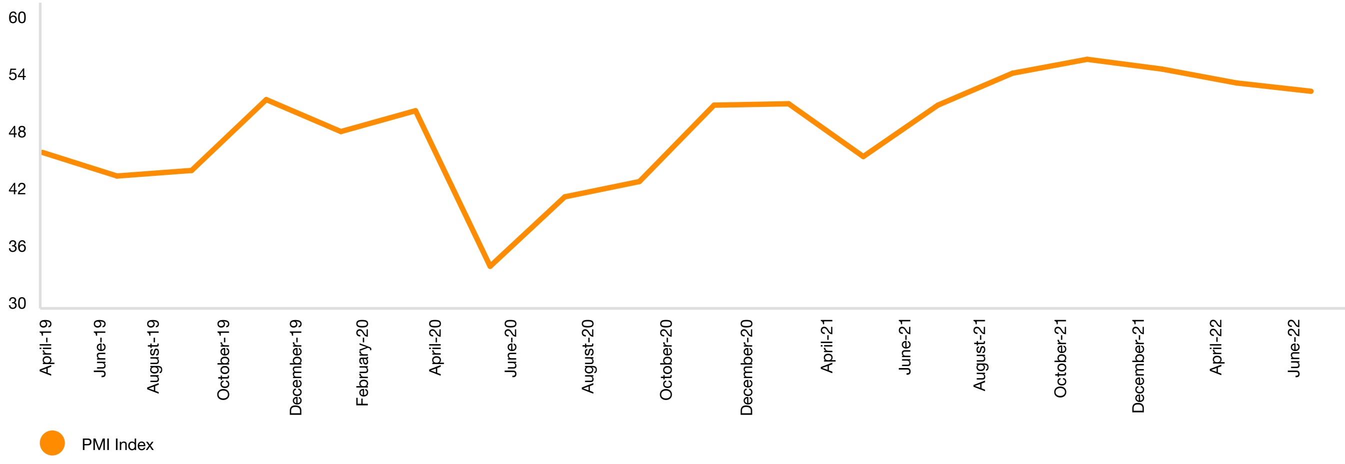
iii. Private sector activity

The Stanbic Bank Zambia PMI shows that private sector activity declined sharply in Zambia between May and June 2020 as shown in figure 17 below. A reading above 50 on the PMI – an indicator based on survey responses by purchasing managers at around 400 private sector Zambian companies – reflects growth in business activity.

The PMI increased in five out of the 12 months in 2021 and averaged 49.8 during the year – signalling a minor decline (on average) in private sector activity during the year. Local businesses were operating within a challenging domestic economic environment. This included a second and third wave of COVID-19, elevated consumer price inflation, rising interest rates, the depreciation in the kwacha's exchange rate against major currencies, and uncertainties around the country's fiscal and public debt situation.

The monthly purchasing managers reports showed limited growth in activity during the first half of 2022, with private sector activity contracting marginally in May (49.8) and June (49.9). This was followed by a positive reading in July (50.5) and a neutral measurement in August (50). The latest Stanbic Bank Zambia PMI report (August 2022) cited challenges like low customer numbers and money shortages as well as longer supplier delivery times. However, there was also some good news, including softer inflationary pressures on purchase prices and staff costs, and favourable exchange rate movements. Zambian companies continued to increase their employment and purchasing activity during August on the back of recent demand improvements.[12]

Figure 17: *Private sector activity trend*



Source: Stanbic Bank Zambia PMI

12 Stanbic Bank, 2022. Stanbic Bank Zambia PMI, August. https://www.pmi.spglobal.com/Public/Home/PressRelease/a25e559e920748979350d7b113ba09d1

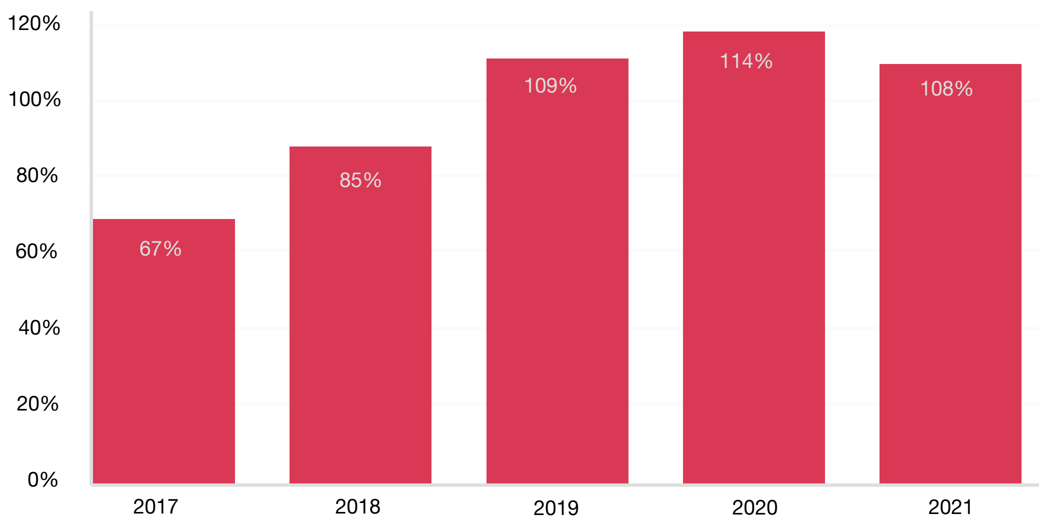
iv. Fiscal policy and public debt

Zambia's fiscal deficit expanded from an equivalent 8.3% of GDP in 2019 to 11% of GDP in 2020 in order to finance increased investment and current expenditure needs. Debt financing to fund this shortfall resulted in the country's public and publicly-guaranteed debt rising from 109% of GDP in 2019 to 114% in 2020.[13]

The Ministry of Finance and National Planning communicated to government bondholders that the country's macroeconomic situation necessitated immediate external debt relief. This was due to the drain of debt service payments on the fiscus causing arrears in payments to domestic service providers. The sharp depreciation of the kwacha also significantly inflated the foreign currency debt payments. The financial pressures caused by the COVID-19 outbreak resulted in Zambia becoming the first African nation to default on its debt during the pandemic era after failing to pay a US$42.5m Eurobond repayment in November 2020. Zambia skipped another coupon payment in January 2021 on its 2027 Eurobond.

The BoZ noted an improved fiscal outcome during the first quarter of 2022 on the back of higher mining-related revenues as well as a lower cash deficit in the second quarter due to reduced expenditure and stronger revenue performance. The central bank expects a narrowing in the fiscal deficit this year and in 2023 due to enhanced revenue mobilisation measures, rationalisation of expenditure, and expected debt restructuring under the G20 Common Framework. The BoZ said in May that it expects the fiscal deficit to narrow from an equivalent of 9% of GDP in 2021 to 6.3% of GDP in 2023.[14]

Figure 18: *Debt to GDP ratio trend*

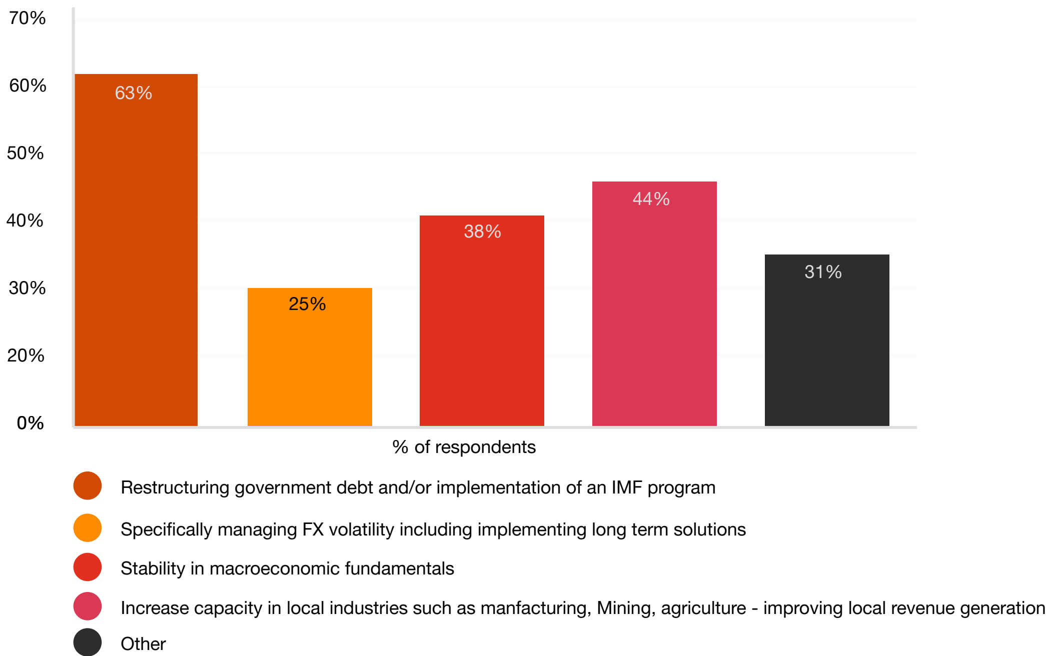


Source: Fitch ratings

13 African Development Bank, 2021. Zambia Economic Outlook.
14 Bank of Zambia, 2022. Monetary Policy Committee Statement, May. https://www.boz.zm/MPC_Statement_Q2_2022.pdf

Most of our banking respondents felt that resolving the current debt situation was the most effective course of action that Zambia could take to improve the economy. This is demonstrated in the graph below:

Figure 19: *Actions required to stabilise the economy according to Bank respondents*

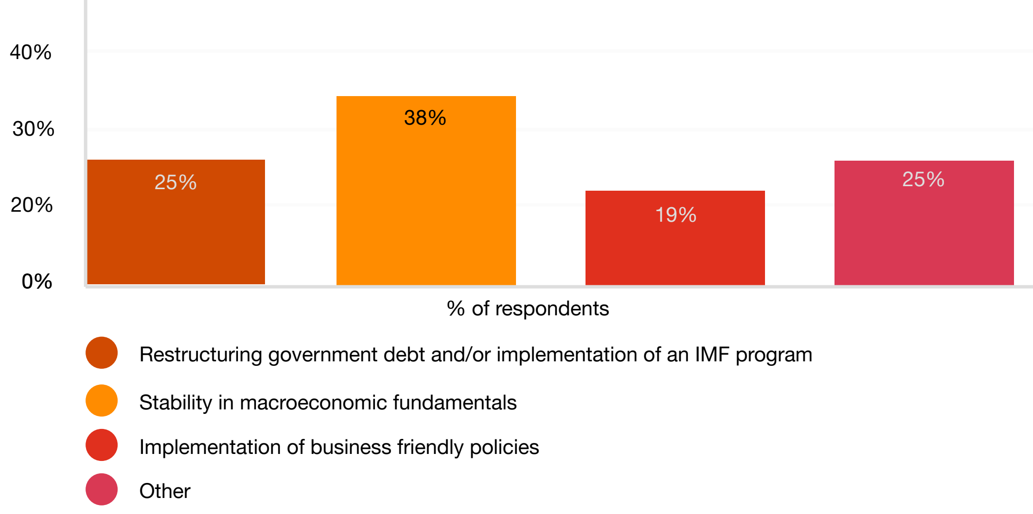


Source: PwC analysis

***Note:** *Individual respondents to this question were able to give more than one suggested course of action. The percentages above therefore show how many respondents reported on a similar issue. Due to this, percentages across the options do not add up to 100%.*

NBFIs had slightly different responses to the banks, with most focusing on the stabilisation of macroeconomic fundamentals such as FX volatility, interest rates and inflation. This is perhaps unsurprising considering the top five issues for NBFIs included liquidity and interest rate risk.

Figure 20: *Actions required to stabilise and/or improve the economy: NBFIs*



Source: PwC analysis

***Note:** *Individual respondents to this question were able to give more than one suggested course of action. The percentages above therefore show how many respondents reported on a similar issue. Due to this, percentages across the options do not add up to 100%.*

4.3 IMF proposed bailout package and its impact on the banking sector

Against this backdrop, we will now look at the IMF deal and its potential effect on the banking sector. The impact of a proposed IMF programme was ranked the fourth most significant issue among commercial banks in 2021.

On 31 August 2022, the IMF approved a 38-month US$1.3billion ECF programme to help Zambia restore macroeconomic stability and foster sustainable economic growth.[15] The country plans to make an upfront fiscal adjustment by redirecting expenditure away from inefficient public investment and poorly targeted subsidies towards greater investment in health and education and the delivery of more social benefits.[16]

According to the IMF Country Report on Zambia, the expected impact of the IMF programme on the banking sector is closely linked to its macroeconomic effects as a whole. Some of these include[16]:

- Creating the breathing room required to increase targeted social spending in health and education while implementing fiscal reforms.
- Helping to facilitate the Zambian government's restructuring of external debt under the G20 Common Framework.
- Improving country risk perceptions among credit agencies and international investors. A deal is likely to lead to increased foreign capital inflows.
- An immediate disbursement of approximately US$185m.

As outlined by the IMF, fiscal adjustments will need to be made and sustained as part of the programme. Some of the measures contained in the IMF report on the ECF in Zambia include[16]:

- Elimination of implicit subsidies on fuel. In other words, reversing the reduced excise duties on petrol and diesel, and the policy decision to zero rate them for VAT purposes.
- Modification of subsidies in the agricultural sector.
- Reduction in other public investment expenditures.

The news of the approved IMF programme has been welcomed by all sectors as the kick-start needed to get Zambia's economy back on track. In fact, as we investigate further, the benefits of the programme are expected to at least partially and/or temporarily address some of the most pressing issues reported by respondents, such as liquidity risk, interest rate risk and so on.

In her address on the ECF programme, IMF CEO Kristalina Georgieva indicated her support for the government's plan to restore macroeconomic stability, but, interestingly, outlined IMF support for locally designed strategies in the implementation of the programme. According to the IMF, "one of the programme's key objectives will be to increase the level and quality of social spending to reduce poverty and inequality as well as improve access to basic social services." The IMF's website goes on to highlight specific measures including:

- Extending the Social Cash Transfer to 994,000 recipients and increasing the monthly benefit from K90 to K110.
- Supporting programmes to mitigate food security risks.
- Programmes to promote education, including keeping girls in school and providing free education and meals.
- Supporting the government's recent recruitment of 41,000 additional health and education workers.
- Is the IMF programme the answer to Zambia's problems?

Is the IMF programme the answer to Zambia's problems?

The IMF has drawn criticism in the past for its programmes in developing countries. Critics argue that the reforms attached to IMF programmes, such as fiscal austerity, high interest rates, privatisation, the removal of subsidies and open capital markets, have often resulted in hardship for local populations and have been counterproductive for target economies. It is for these reasons that in his 2002 book, *Globalisation and Its Discontents*, Nobel Prize–winning economist Joseph Stiglitz accused the IMF of being responsible for the failed development policies implemented in some of the world's poorest countries[17].

15 Frequently asked questions in Zambia: https://www.imf.org/en/Countries/ZMB/zambia-qandas
16 Zambia: IMF Country Report No. 22/292: REQUEST FOR AN ARRANGEMENT UNDER THE EXTENDED CREDIT FACILITY—PRESS RELEASE;
17 Jonathan Masters, Andrew Chatzky, and Anshu Siripurapu, 2021. The IMF: The World's Controversial Financial Firefighter. https://www.cfr.org/backgrounder/imf-worlds-controversial-financial-firefighter

Zambia is not alone in seeking assistance from the IMF. Other African countries have also requested financial assistance and the IMF is currently involved in 20 of the 54 African economies. Programme examples include:

- **Egypt and Angola:** currency challenges have necessitated IMF assistance. The programmes were meant to hasten economic recovery and restore policy credibility, and were largely responsible for the relative success of Egypt (2016–2019) and Angola (2018–2021).
- **Kenya:** the country has various arrangements for IMF funding, the last of which, about US$2.34billion, was approved in April 2021.
- **Mozambique:** the country received approval for the ECF in May of 2022 as it works towards attracting new investors in light of a rise in the production of liquefied natural gas.
- **Tanzania:** in June 2022, IMF staff members and Tanzanian authorities established a staff level agreement for a medium-term ECF.
- **Ghana:** in mid-July 2022, IMF staff visited the country to assess the economic situation and discuss the outline of a potential domestic programme it might support.

In the case of Ghana, its latest request for IMF assistance comes off the back of the completion of a previous programme that ended in 2019. If successful, this would be the 17th time since independence that Ghana has requested assistance from the IMF. (For Zambia, the recently approved deal will be the 13th time it has requested assistance from the IMF[18].)

The purpose of the previous programme was to assist Ghana in restoring debt and macroeconomic sustainability. It was hoped at the time that Ghana's dependance on the IMF would reduce significantly in the future. Since then, however, Ghana has had to navigate the COVID-19 pandemic and the economic shocks caused by Russia's invasion of Ukraine. Economic slumps in the US and China have also impacted the Ghanaian economy negatively.

Some interesting data about the Ghanaian economy that is strikingly similar to that of Zambia's includes:

- Its debt stock has more than doubled since 2015 to sit at 76.6% of GDP at the end of 2021. Interestingly, the finance ministry's plan for amortising that debt lies with the latest request for an IMF programme, which will allow it to regain access to international capital markets and roll over existing debt after recent credit downgrades[19].
- In May 2022 inflation in Ghana hit an 18-year high of 27.6% year-on-year[20].
- The Cedi currency declined 23.5% against the dollar since 2022 began.
- Ghanaian exports are largely driven by dependance on primary commodities such as gold, cocoa and crude oil. This leaves it especially vulnerable to shocks in global commodity prices.

Many of the challenges above are similar to those faced by the Zambian economy. According to the IMF, Ghana achieved significant macroeconomic gains over the course of the IMF-supported programme which concluded in 2019, with rising growth, single digit inflation, fiscal consolidation and a clean up of the banking sector. However, as the IMF noted at the time, "sustained fiscal discipline was needed to reduce financing needs and manage debt burdens".

Although no two economies are alike, there are lessons Zambia can learn from Ghana's case. In both countries there seem to be deeper structural issues in the economy that could take decades to address, particularly their reliance on a few primary commodities for exports.

There is also a clear change in tone in the IMFs approach, with an emphasis on local strategies for the implementation of the ECF programme. This is a shift from the times when the IMF would dictate the policy decisions that were attached to their assistance.

Despite the expected benefits of the IMF programme, Zambia is not yet out of the woods. Government still needs to finalise restructuring agreements with its external debt holders to alleviate the debt burden that has long stifled economic growth. Overall however, these steps towards agreeing to an IMF programme are in the right direction.

18 IMF,. Zambia: History of lending commitments as of August 31, 2015.
19 Theophilus Acheampong, 2022. Ghana's return to the IMF within three years underscores its deeper economic problems. https://theconversation.com/ghanas-return-to-the-imf-within-three-years-underscores-its-deeper-economic-problems-187041
20 Theophilus Acheampong, 2022. Ghana's return to the IMF within three years underscores its deeper economic problems. https://theconversation.com/ghanas-return-to-the-imf-within-three-years-underscores-its-deeper-economic-problems-187041

4.4 Liquidity and interest rate risks

US dollar liquidity was the fifth most important issue facing banks in 2021, with a score of 3.4. Among NBFIs, liquidity risk in general was the second most pressing issue. Meanwhile, interest rate risk was the fifth most pressing issue among NBFIs, with a score of 4.6.

Although liquidity risk and interest rate risk were reported as two separate issues in our survey, both are related to the health of the local economy and the financial sector.

i. Liquidity risk

Liquidity risk was a pressing issue among NBFIs in 2021, with a score of 5.6. It was much less of an issue for banks, who collectively scored it 1.5.

According to *the Bank of Zambia 2021 Annual Report*, liquidity was rated satisfactory, with their measure of liquidity - the ratio of liquid assets to deposits and short-term liabilities - increasing to 60.5% from 55.3% among financial institutions at the end of 2020. Given the improvement reported by the BoZ, why was liquidity still an issue for respondents, particularly NBFIs?

In its 2021 annual report, the BoZ acknowledged that the improvement in liquidity conditions was largely a result of funding from the Targeted Medium Term Refinancing Facility (TMTRF). The TMTRF was launched in response to the COVID-19 pandemic and allowed non-bank financial institutions, which includes NBFIs, to refinance loans at lower interest rates.

Over half, or 54%, of NBFIs that responded to our survey said they either strongly agreed or agreed that the TMTRF had been effective at responding to the challenges of the pandemic. Some respondents (20%) strongly disagreed, while 27% neither agree nor disagree.

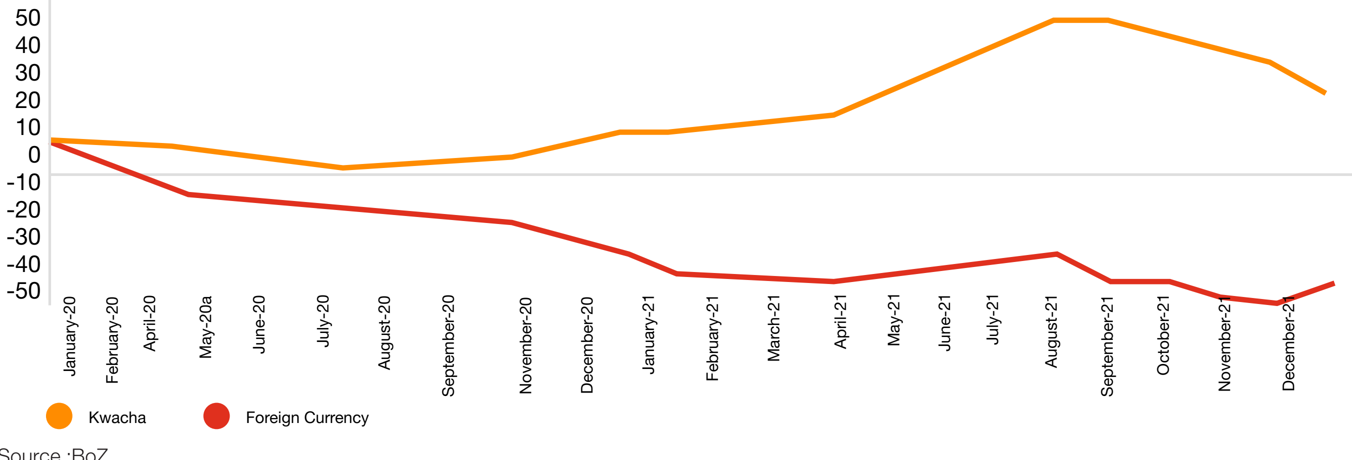
BoZ data indicates that in the latter part of 2021, domestic credit throughout the financial sector (banks and NBFIs) improved significantly primarily as a result of the liquidity provided by the TMTRF facility.

Figure 21: *TMTRF effectiveness among NBFIs*

30%
20%
0%
20%
27%
27%
27%
1
Strongly Disagree
Agree
Strongly Agree
Neither Agree or disagree

Source: PwC analysis

Figure 22: *Growth in Credit by currency*



Source :BoZ

NBFIs that responded to the survey said they had struggled recently with loan repayments from small and medium enterprises (SMEs), a significant source of their liquidity, because their cash flow was tied to government contracts.

A number of respondents said the pause in the progression of government contracts by the new government to allow for audits was a cause for concern, not just for NPLs but also for liquidity. They said the issue not only impacted their ability for further onward lending, but for a few respondents, it affected their ability to meet day-to-day obligations.

Respondents also indicated that challenges in sourcing funds were linked to Zambia's international risk profile. Zambia's high sovereign debt and its subsequent default on Eurobond repayments has reduced investor confidence. This means that NBFIs have had less access to international lenders to finance further lending.

ii. US dollar liquidity

Banks reported US dollar liquidity as the fifth most pressing issue facing the banking sector in 2021. We noted that a number of bank respondents rated this issue highly while some others did not even include the matter in their top 10 at all. Respondents who rated it highly issue indicated two main issues:

- The change in legislation that required mines to pay mineral royalties directly to the Bank of Zambia.
- Not all commercial banks have the same access to US dollars from customer deposits and transactions. This, combined with the issue above, made a number of commercial banks reliant on the central bank for supply of hard currency.

In recent years, the issues above were also exacerbated by the growing debt situation and governments need to service foreign currency borrowings. Given that a significant portion of this debt was denominated in US dollars, demand from government for foreign currency increased significantly, leaving a shortage in supply to adequately meet the requirements of government and financial institutions.[21] This surge in demand for US dollars fuelled the depreciation of the kwacha, particularly in 2020, when the currency's value fell by 46% to close the year at K21.1/US$1. The kwacha subsequently appreciated in the latter half of 2021, ending the year at K16.67/US$1, according to the BoZ's 2021 annual report.

Improved macroeconomic prospects and the allocation of special drawing rights by the IMF in August 2021 were key drivers of the appreciation of the kwacha that year. The IMF's involvement in particular contributed significantly to the improved availability of foreign currency in the market.

However, the fact that US dollar liquidity is a top five issue indicates that although there has been increased improvement in exchange rate stability, some commercial banks are still having practical challenges accessing hard currency. It is hoped the injection of US$185m that is expected to accompany the recently approved IMF deal will make a noticeable difference to liquidity conditions in Zambia.

The IMF's concessional funding will also improve investor confidence. This in turn should lead to increased foreign direct investment and foreign currency inflows, making more US dollars available in the domestic market.

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21 Ministry of Finance and National Planning, 2018. ***2018 Annual Debt Statistical Bulletin***

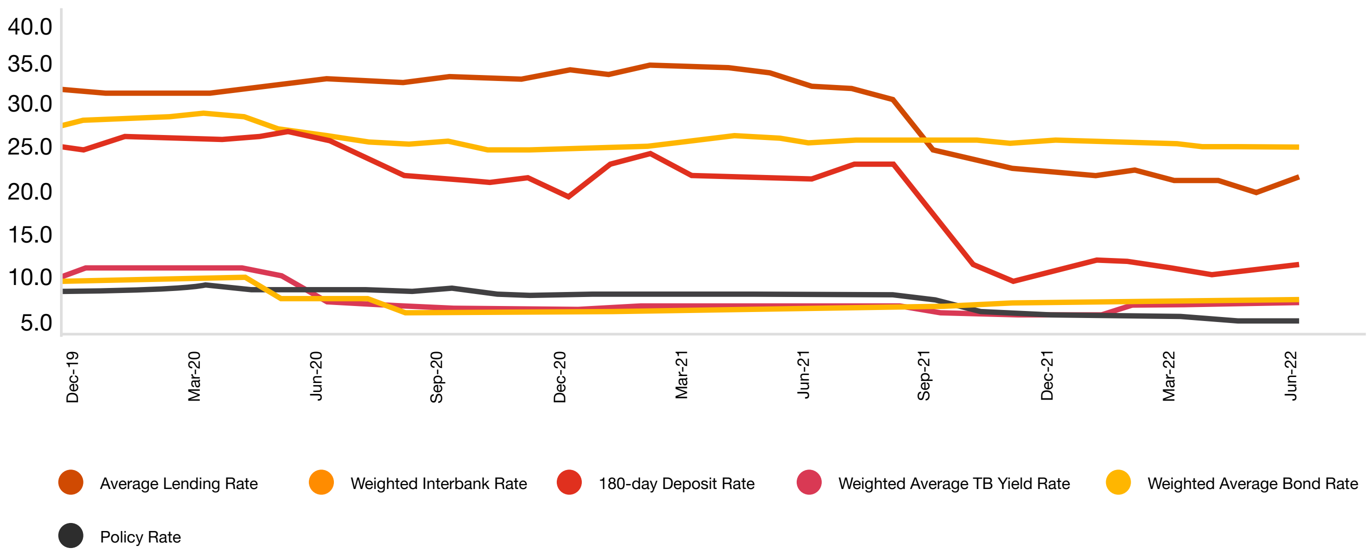
https://www.mofnp.gov.zm/?wpdmpro=2018-annual-debt-statistical-bulletin

Ministry of Finance and National Planning, 2021. 2021 End-December Debt Statistical Bulletin https://www.mofnp.gov.zm/?wpdmpro=2021-end-december-debt-statistical-bulletin

iii. Interest rates

NBFIs reported that interest rate risk was the fifth most pressing issue, with a score of 4.6. The recent situation regarding interest rates in Zambia was something of an anomaly. During the August 2022 Monetary Policy Committee statement presented by the BoZ, nominal interest rates from December 2019 to June 2022 were presented in the following graph:

Figure 23: *Zambia's USD Debt in Billions*



Source: Bank of Zambia

The graph shows that the weighted average bond rate and TB yield rate closed at 21.9% and 14.5% respectively at the end of December 2021. There was a significant reduction in these rates around August and September 2021 when the rates were 33.4% and 20.2% respectively. This compared with the commercial bank nominal average lending rate, which closed the year at 25.9%.

What is interesting to note is that:

- Up to August/September 2021, the commercial bank average lending rate was lower than the weighted average bond rate and only slightly higher than the average TB yield rate.
- The commercial bank average lending rate has remained fairly constant, moving from 25.1% in December 2020 to 25.9% in December 2021.

Due to the high returns being offered by the government, a number of financial institutions invested in the public sector, no doubt contributing to record profitability, particularly in the banking sector.

It is important to note that, for NBFIs in particular, it is generally expected that lending rates will be higher as their clientele is generally higher risk, which attracts a higher risk premium. Nonetheless, the graph above remains relevant in showing the significantly high yields on government securities relative to private lenders.

The drop in interest rates will put further pressure on NBFIs to reduce the interest rates on customer loans. This will compress their margins and ultimately affect their financial performance unless they can make up for any reduction through increased volumes.

Based on our discussions with respondents, returning to adequate levels of liquidity in the market is vital if financial institutions are able to participate in the lending market. Once again, respondents pointed to the unfolding events regarding an IMF programme as having the potential to unlock market liquidity.

5. Performance of the financial industry: Is it sustainable?

By Betty Wilkinson

The world is accelerating very fast and our work in financial markets is growing at a more rapid pace. Data availability and consideration is helping us identify anomalies so we can try to see what is happening and why. Global awareness of key issues like climate change, economic and social inequalities, and the nature of global, national and local public and private governance are under the microscope. In this article, the anomaly of higher bank profitability in a tough economic time is considered.

Things have changed dramatically in the financial sector since last year's PwC report. Zambia has a new government, an IMF deal in finalisation, lower inflation, shifts in budgeting to stronger public accountability and use, 3.6% growth in 2021, and a sense of economic recovery and optimism as things move forward. The BoZ legislation has been upgraded and other Acts have been passed, including for insurance.

Making sense of high banking profitability and what to expect next?

It is important to look at the anomaly of high profitability levels for banks over the last year or so in Zambia when the country was in the middle of a very severe economic situation. Finscope 2020 (published in August 2021) also showed a drop in bank participation by citizens to 20.4% in 2020 down from 24.7% in 2015[22]. So less people are using banks and more are using mobile money (58.4% in 2020 from 14.0% in 2015.)

In a time when globally economies are under pressure and there are serious challenges in keeping businesses afloat, with inflation high and challenges brought about by the aftermath of COVID-19, we would expect to see a bit of slowdown in profitability and performance as banks adjust to economic and client circumstances.

However, in 2021, counter to what we might expect, banking sector performance improved in many ways. The BoZ 2021 Annual Report shows that ten of the 17 banks in Zambia were subsidiaries of foreign banks, with these banks dominating the sector in terms of total assets, loans, deposits and profitability. In 2021, the number of banks with ratings below satisfactory dropped from nine to three. During the year, the banking sector also enjoyed favourable capital adequacy, asset quality, earnings performance and higher scores on performance indicators compared to 2019 and 2020. The satisfactory banks (14 of 17) held over 95% of total assets and deposits, up at least 9% from the prior two years. In addition, there was a significant write-down of NPLs in 2021, which we would have expected to have a negative impact on profits. Market liquidity helped, due to the government spending and TMTRF injections.

The BoZ's annual report shows that banking sector profitability improved very significantly in 2021. The sector showed profit before tax (PBT) of K8.1billion, 227.6% higher than the previous year, and net profit of K5.1billion, over 300% more than each of the prior two calendar years. Higher profits were due to net interest income, non-interest income and lower provisioning as a result of an upgrade of local currency debt by Fitch in April 2021.

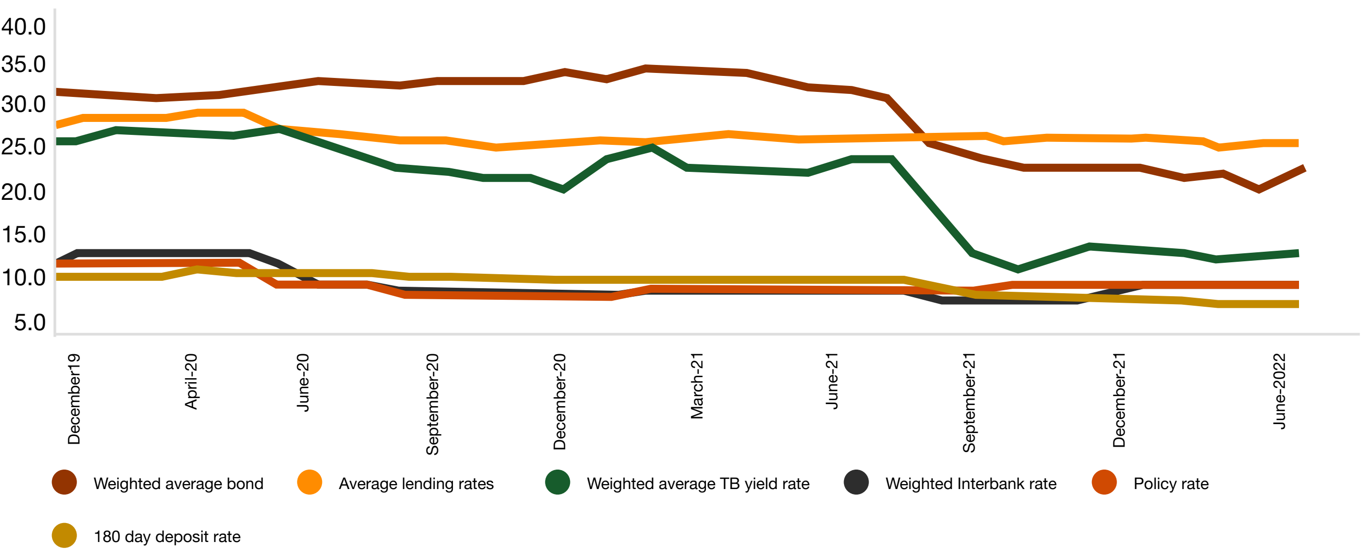
Does this make sense in an environment during 2021 where politics were uncertain, the government defaulted on debt, currency exchange rates against the US dollar fluctuated significantly and growth was centred on good rain and higher copper prices, both of which are exogenous and subject to risks?

From research, the key determinants of bank profitability include: bank-specific credit growth; longer-term interest rates and the net interest margins; and rising sovereign risk premia[23]. Also, diversification of services into digitised offerings (ATMs, cards, mobile money) increases profits[24]. We know that banks in Zambia are rapidly closing branches and replacing them with mobile money and ATMs. The strongest example of this was when Standard Chartered Bank closed almost all of its branches and replaced them with ATMs and a range of agent arrangements. Risk premia is dropping with the change in government and economic management, and this would be expected to increase profitability, but not so fast and so much in the last quarter of 2021. Banks were smart in taking up government debt instruments where interest rates were high, and lending using low-cost funds from TMTRF. But what about interest rates and the composition of bank assets?

22 fsdZambia, 2021. FinScope Zambia 2020 Survey Report, pg 24. https://www.fsdzambia.org/publication/finscope-2020-final-release/
23 E. Kohnscheen et al, Determinants of Bank Profitability in Emerging Markets, BIS Working Paper No. 686, January 2018
24 Tu DQ et al, Central Bank Review, Vol 20 Issue 2, June 2020

An extremely interesting figure was presented in the Monetary Policy Committee public statement from the governor of the BoZ on 17 August 2022. The chart is reproduced below:

Figure 24: *Interbank rate and BoZ policy rate (%)*



Source: Bank of Zambia

The figure above shows three interesting results. First, just after the elections in August 2021, the interest rates for treasury bills and bond rates started declining significantly, showing a change in the market assessment of risk in Zambia. Second, the policy rates and 180-day deposit rates are close to flat, showing that the market managers reflect expectations of dropping inflation and careful management of interest rates. Third, and this is the one that may be an anomaly, the average lending rate is not dropping in the same way, and thus we are not seeing a lower cost of borrowing for businesses and the economy.

Let us look at net interest margins (NIM), which are defined as a measure of the difference between the interest income generated and earned by banks and the amount of interest paid out to their deposits, relative to the amount of their interest-earning assets. We are looking at the difference between what banks charge as their average interest on loans and what they pay in the average interest on deposits. What we want to see is lower NIMs. Looking at other countries in Africa, data from GlobalEconomy.com for 2019, the last year when Zambia was reported, shows that Zambia had the ninth-highest rate of 40 Africa reporting nations, with 7.96% higher loan interest charged than deposits interest paid. In 2021, the BoZ reported the NIM in Zambia at 9.9%, up from 9.3% in 2020. Based on the 2020 data from GlobalEconomy.com, this would indicate Zambia had the second highest margin of those countries reporting. The average based on the 23 African countries reporting in 2020 was 5.28%. What is unclear in Zambia is whether the interest rates paid on deposits are net of fees charged, or these are shown separately as non-interest income. The bottom line remains, however, that the NIM in Zambia is too high and probably unjustified based on the conditions in the country.

The implication of these results is that Zambian banks are earning significantly from setting a margin on interest rates which is substantially higher than other countries. It is also growing fast. The BoZ annual report shows Zambia's NIM rates increased from 8.4% in 2012 to 9.3% in 2020 and 9.9% in 2021. Loan interest rates are composed of the cost of money to lend (deposit interest rates), inflation, administrative and risk costs of lending, loan losses and profits. However, if the costs of funds are not going up rapidly, inflation is falling fast, banks are reporting better efficiency ratios (undoubtedly due at least in part on digitisation), risks are going down as debt resolution and the IMF deal is being finalised, and loan losses are low and have been written off, why are the NIM and lending rates not declining?

6. Digital transformation

Significant strides are being made at the national level to enhance digitisation across different sectors through the government's SMART Zambia initiative.

Despite this, Zambia remains at an early stage in the adoption of digital technologies. The UN Capital Development Fund's *Zambia Inclusive Digital Economy Status Report 2022* gave the country's digital economy a score of 45. Countries with scores of 70 or greater are considered to have high-level digital economic development, which suggests that Zambia is still in the start-up phase of its digital economy.[25]

Financial institutions are having to adapt rapidly to technology-led changes. This is reflected in the responses to our 2021 survey in which digital transformation was rated the third most pressing issue for commercial banks, with an average score of 4.2, while for NBFIs it was the most pressing issue, with an average score of 5.7.

Among the banks that responded to the survey, results show that:

- The majority of banks that responded to the survey said that between 41% and 80% of customer transactions (deposits, payments, withdrawals) by value had been undertaken using electronic or digital channels.
- Among NBFIs the level was much lower, with most NBFIs indicating that less than 40% of transactions by value were undertaken through electronic or digital channels.

6.1 Technology is driving innovation

The 2021 survey results indicated that the drive for digital transformation has brought about important changes for banks and NBFIs. These include:

- Investment in digital channels. Digitisation has become a game changer in business operations. The increased uptake of digital products and services by customers and service providers has resulted in significant financial investments in digital channels by banks and NBFIs.
- Innovative products and customer centricity. With COVID-19 being a key digital accelerator, there have been relentless efforts by banks and NBFIs to incorporate data analytics to drive businesses by understanding customer behaviour in the build up of constant, efficient products and services.
- Diversification of digitised offerings, such as ATMs, cards and mobile money, among others, are determining bank profitability in emerging markets.[26]
- COVID-19 has also impacted bank operations and the use of digital platforms has made remote working possible with the use of more digital documents and digital signatures.
- Focus on the employee. The drive to digital transformation has resulted in a significant focus on employee capability. Banks and NBFIs expressed the aim to provide adequate access to digital learnings as they seek to ensure their human resource is upskilled, reskilled and cross-skilled to drive the ever-changing technological advances.

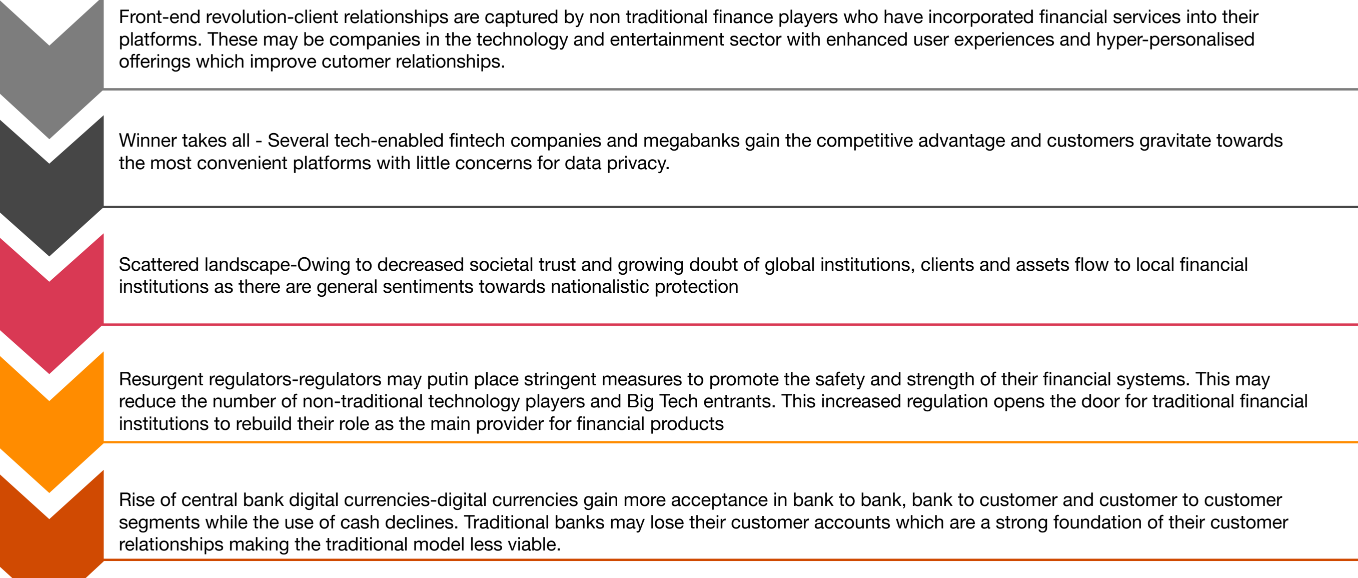
25 Zambia Inclusive Digital Economy Status report 2022, pg 12 https://openknowledge.worldbank.org/handle/10986/33806
26 E. Kohnscheen et al, Determinants of Bank Profitability in Emerging Markets, BIS Working Paper No. 686, January 2018

6.2 How will Zambia's financial sector look in the future?

Both banks and NBFIs have identified digital transformation as a key driver of future business growth. How these institutions choose to integrate technology into their business will determine what Zambia's financial sector looks like going forwards.

As part of the PwC Retail Banking 2025 and Beyond survey, we developed five hypothetical scenarios of what the future of the financial sector could look like over the next decade.[27] These are outlined in Figure 25.

Figure 25: *What the future of the financial sector could look like*

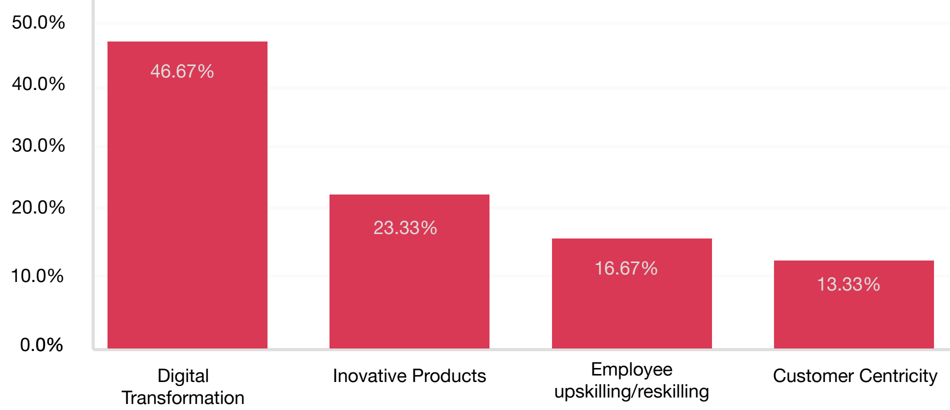


Source: PwC analysis

6.3 What does the bank of the future look like?

We asked banks what three steps they are taking in preparing to be the bank of the future. Most banks expressed the importance of investing in digital transformation and product innovation. The other two key steps they are taking include employee upskilling and reskilling, and focusing on customer centricity.

Figure 26: *Priorities for the future*



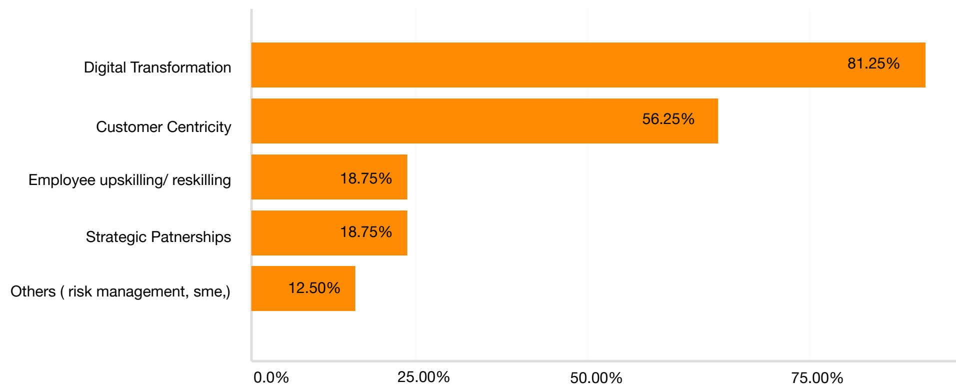
Source: PwC analysis

27 PwC Retail Banking 2025 and Beyond, pg 5 https://www.pwc.com/gx/en/industries/financial-services/publications/financial-services-in-2025/retail-banking-2025.html

6.4 What does the future of NBFIs look like?

We asked NBFIs what three strategic steps they were taking in preparing to be the NBFI of the future.The responses show that NBFIs see digital transformation and customer centricity as the two main drivers for the future of their sector. Operational excellence and strategic partnerships were also highlighted as areas of focus going forward.

Figure 27: *NBFIs future priorities*



Source: PwC analysis

***Note:** *Individual respondents to this question were able to give more than one suggested course of action. The percentages above therefore show how many respondents reported on a similar issue. Due to this, percentages across the options do not add up to 100%.*

7. High Credit risk and NPLs

For the first time since we launched this survey, high credit risk and NPLs do not feature in the top five issues for commercial banks. However, high credit risk and NPLs were still a significant issue for NBFIs in 2021, who ranked it as the third most pressing issue facing their business last year.

Figure 28: *Trend of NPLs-Banks and Non Banks*

Year	Banks' ranking	Banks' score	NBFIs' ranking	NBFIs' score
2021	6	2.9	3	5.1
2020	3	4.4	3	6
2019	3	6.5	3	6.8
2018	5	4.7	1	6
2017	2	5.5	Not applicable	Not applicable

Source: PwC analysis

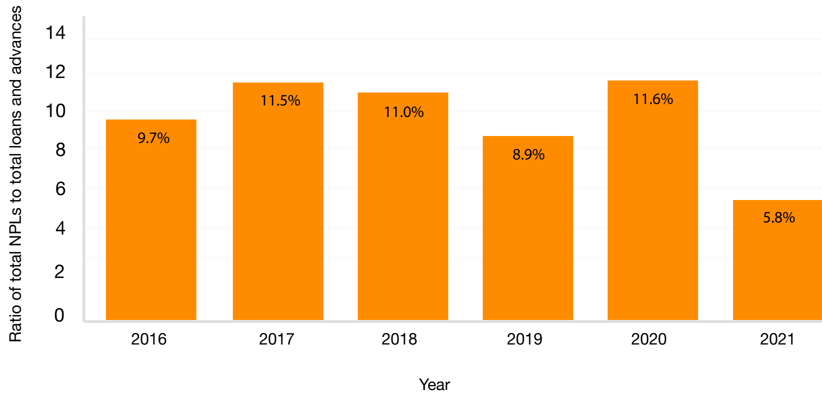
High credit risk and NPLs only just dropped out of the top five issues for commercial banks, however. The issue was ranked sixth by banks in 2021. The lower score of 2.9 in 2021 compared to 4.4 in 2020 perhaps reflects how participants are shifting their focus to strategic issues such as digital transformation. It could also be a consequence of the improved economic outlook.

Among the six biggest banks, however, high credit risk and NPLs remain more of a concern. The issue was ranked the fifth most pressing concern for those banks in 2021, with a score of 4.2, although this is still a drop in both ranking and score compared to 2020 and 2019.

7.1 NPLs and advances: banks

The commercial bank NPL ratio has fluctuated over the course of the past five years, averaging 9.8. The 2021 ratio marks a significant improvement from the previous year, dropping by 50% from 11.6% in 2020 to 5.8% in 2021.

Figure 29: *Ratio of NPL to total loans and advances-Banks*



Source: Bank of Zambia

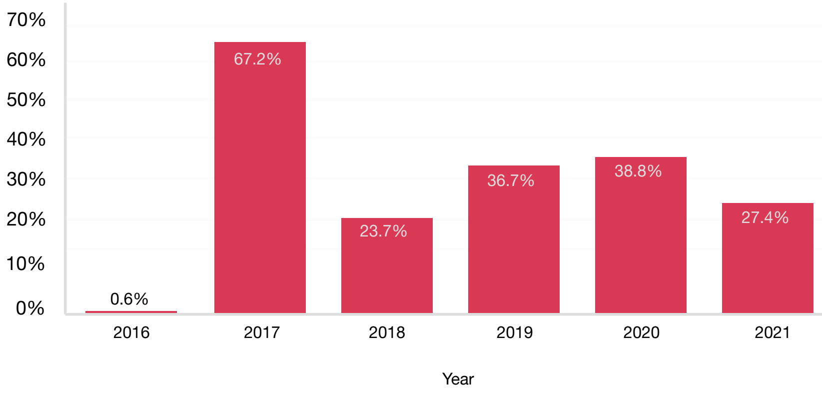
According to the BoZ's 2021 annual report,[28] the reduction in the NPL ratio for banks last year was due to a decrease in the number of NPLs, which fell 48.4% to K2.6billion between 2020 and 2021. This was mainly driven by significant write-offs of legacy bad loans, which were deemed irrecoverable.

This might indicate that there was no underlying improvement in loans that were previously non-performing despite the introduction of the TMTRF. However, considering the largely positive sentiment respondents had towards the intervention by the central bank, it would seem the TMTRF prevented the credit situation from worsening. Specific views around the TMTRF are discussed further down in this section.

7.2 NPLs and advances: NBFIs

As with commercial banks, there was a notable improvement in the NPL ratio for NBFIs in 2021, with the NPL ratio decreasing from 39% in 2020 to 27% last year. Over the last six years, the ratio has averaged 32.5%, with the highest percentage of 67% recorded in 2017.

Figure 30: *Ratio of total NPLs to total loans and advances*



Source: Bank of Zambia

According to the BoZ's 2021 annual report[29], the improvement in the NPL ratio among NBFIs was due to a significant reduction in government arrears for civil servant loans, an issue which had previously plagued the sector. This improved the sector's underlying credit situation.

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28 BoZ, 2021. Bank of Zambia Annual Report 2021. https://www.boz.zm/2021_Bank_of_Zambia_ANNUAL_REPORT.pdf
29 BoZ, 2021: Bank of Zambia Annual Report 2021 https://www.boz.zm/2021_Bank_of_Zambia_ANNUAL_REPORT.pdf

However, while not the same issue as civil servant loans, interview feedback from NBFIs indicated that there was concern with respect to ongoing audits currently being performed on government contracts. In particular, there was a fear that the audits would affect the fulfilment of any such contracts. They fear that this would have a knock-on effect on the ability of customers linked to such contracts to meet payment obligations on time which would negatively affect their NPL ratios.

However, the NPL ratio among NBFIs of 27.4% (as at the end of December 2021) remains above the BoZ prudential limit of 10%.

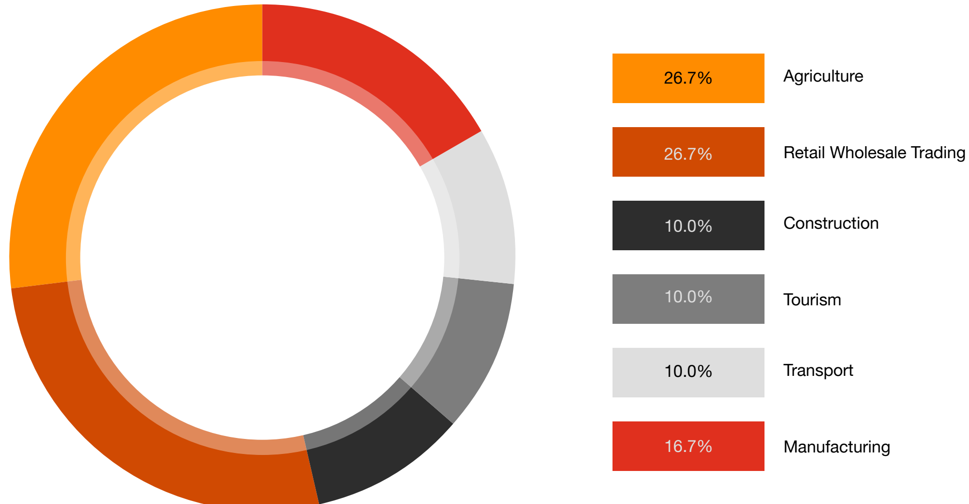
7.3 Sector analysis

i. NPLs and commercial banks

The retail wholesale industry and the agriculture industry are the two biggest drivers of NPLs in Zambia, according to survey respondents, with each contributing 26.7% towards total non-performing loans in 2021. Together they accounted for 53.3% of NPLs recorded by banks. The manufacturing industry contributed 16.7% of NPLs, while the construction, tourism and transport sectors each contributed 10% of NPLs.

The agriculture sector has the biggest impact on NPLs, with the six largest banks in particular all affected by NPLs to the sector.

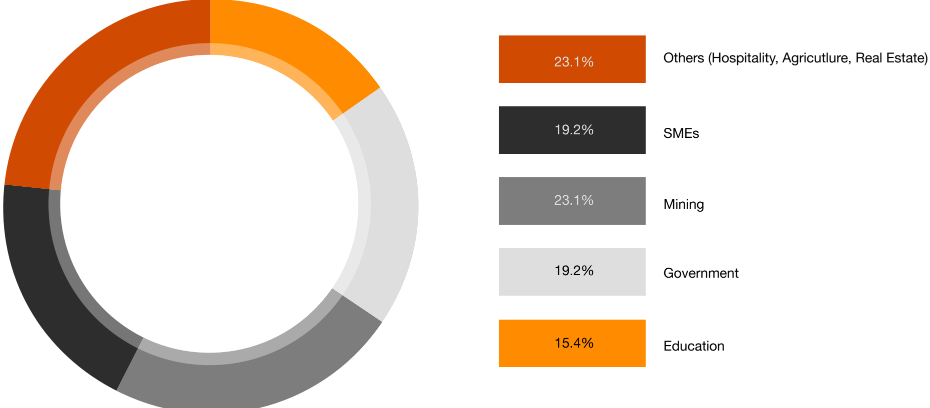
Figure 31: *NPL assessment by sector: banks*



ii. NPLs and NBFIs

Mining accounted for the highest percentage of NPLs among the NBFIs that responded to our survey, accounting for 23.1% of NPLs in 2021. Government and the SME sector each accounted for 19.2% of NPLs, while the education sector accounted for 15.4%.

Figure 32: *NPL assessment by sector: NBFIs*



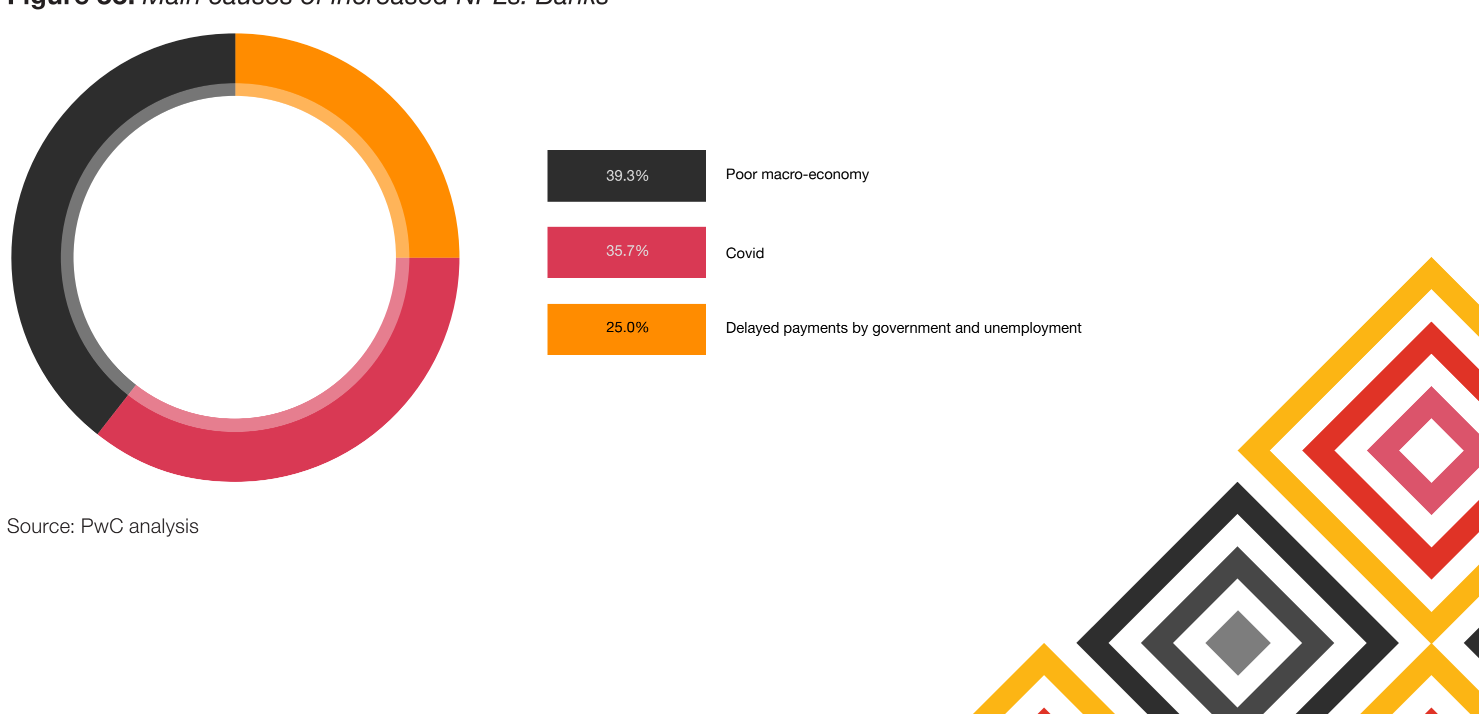
Source: PwC analysis

7.4 Key drivers

Prior to the 2021 general elections, Zambia experienced serious macroeconomic challenges. These have been covered in more detail under section 4 above but some significant issues included high inflation, widening fiscal deficits, unsustainable debt levels, low international reserves, tight liquidity conditions, increased fuel prices and a depreciating exchange rate. The impact of these economic conditions gave rise to high unemployment and delayed government spending.

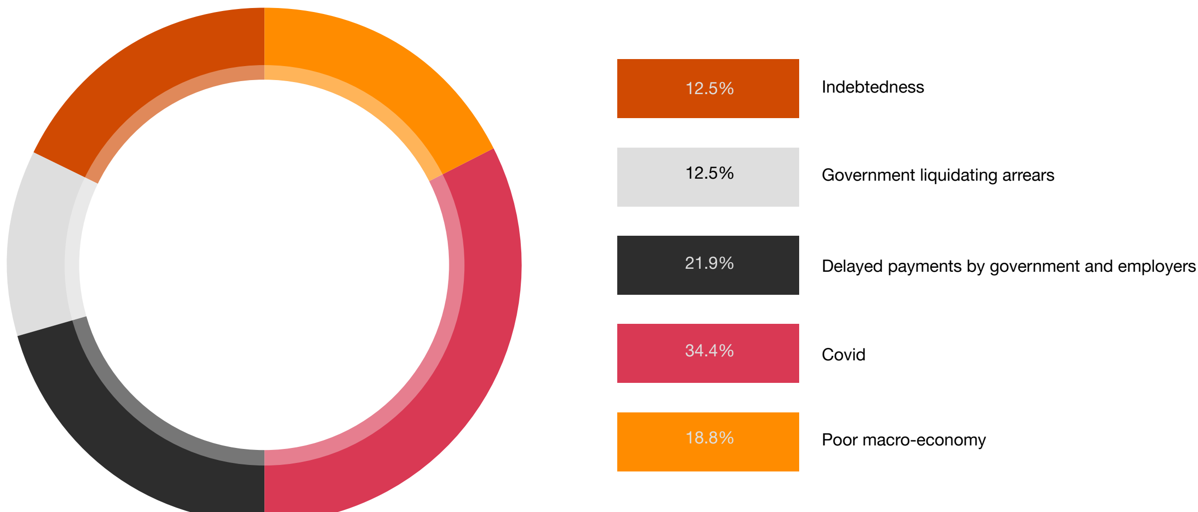
These macroeconomic challenges had an adverse impact on industries like retail and agriculture, which recorded the highest percentages of NPLs in 2021. The high NPL rate from these sectors was due to the increased cost of inputs arising from the economic challenges and decreased output, which was driven by reduced consumer spending. Such challenges were further exacerbated by the impact of COVID-19, which contributed towards a further decrease in consumer spending when lockdown measures were implemented.

Figure 33: *Main causes of increased NPLs: Banks*



Source: PwC analysis

Figure 34: *Main causes of increased NPLs: NBFIs*



Source: PwC analysis

7.5 Performance of the TMTRF

COVID-19 was a significant contributor to the increased levels of NPLs noted by survey respondents in 2021. The BoZ implemented specific measures to help banks and their customers navigate some of the challenges of the pandemic, the most notable of which was the K10billion TMTRF. The facility was designed to provide liquidity to eligible financial institutions for onward lending to viable and priority sectors of the economy. The facility was offered to banks at a relatively low cost and was tailored towards lending to targeted sectors of the economy.

As the graphs below show, the majority of the banks and NBFIs that responded to our survey confirmed that they had used the facility. Among the banks that responded to the survey, 62.5% said they had drawn down on the fund, while 53.3% of NBFIs said they had accessed financial support through the TMTRF.

Figure 35: *Percentage of respondents that utilised the TMTRF: Banks*

31.3% No
6.3% No response to question
62.5% Yes

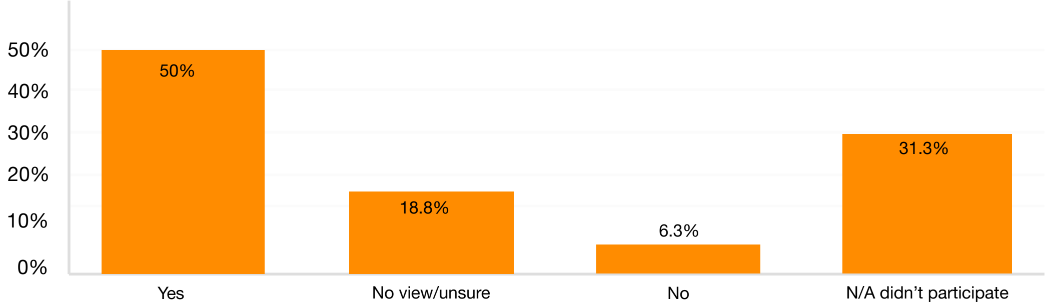
Source: PwC analysis

Figure 36: *Percentage of respondents that utilised the TMTRF – NBFIs*

Source: PwC analysis

We specifically asked commercial banks whether the facility had helped prevent loan forbearance among customers and by extension had helped them manage NPLs. Their answers were mixed, with half of the banks that responded indicating that the facility had helped achieve this objective.

Figure 37: *Did TMTRF help prevent loan forbearance among customers? - Banks*



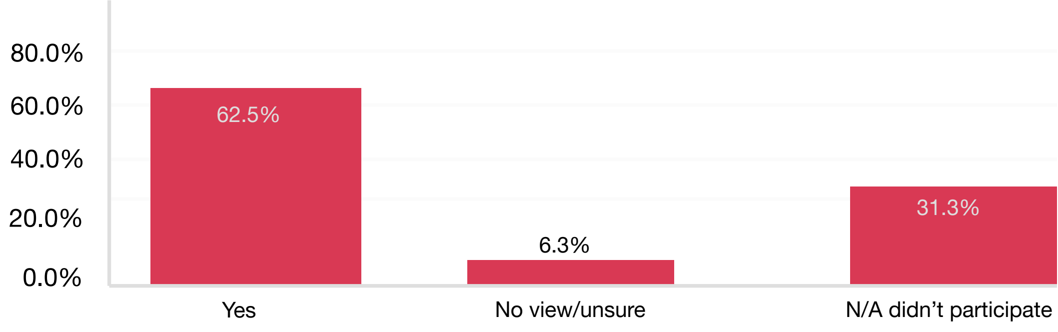
Source: PwC Analysis

***Note:** *Individual respondents to this question were able to give more than one suggested course of action. The percentages above therefore show how many respondents reported on a similar issue. Due to this, percentages across the options do not add up to 100%.*

It is important to bear in mind that over 30% of bank respondents did not draw down on the facility. If we focus only on those banks that did participate, the positive response rate increased from 50% to 66%. Some of the reasons cited by those respondents who did not participate in the facility included:

- No demand among customer base.
- Unable to receive approval from the central bank.
- No customers met eligibility requirements.
- No need for the facility.

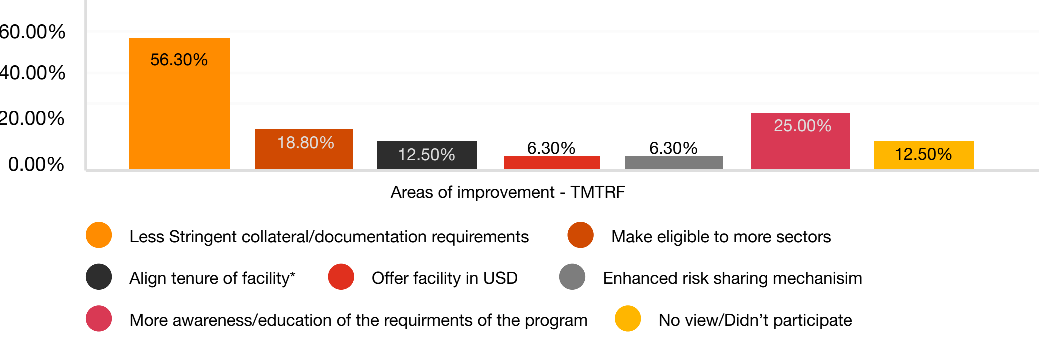
Figure 38: *Did TMTRF assist with bank liquidity?*



Source: PwC Analysis

We also asked the banks what challenges they faced with the facility or what areas could be improved upon. The views are outlined in the table below:

Figure 39: *Areas of improvement: TMTRF*



Source: PwC Analysis

Note 1: *Some respondents felt the tenure over which the banks had to repay the facility to Bank of Zambia needed to be matched with maximum tenures over which the banks customers would need to repay the facility*

Note 2: *i) Respondents were able to give more than one answer to the above question and ii) even those respondents who didn't participate in the facility may have had a view on the matter. Therefore the total of percentages above do not add up to 100%.*

The most significant issue faced by commercial banks with respect to the facility related to collateral and documentation requirements. In particular, a number of respondents highlighted how many customers in the targeted sectors were SMEs or individuals who were unlikely to have the collateral or documentation in place to meet the requirements of the facility. Considering that the facility was mainly targeted towards assisting such customers, more flexibility in this area would be useful in similar facilities in the future.

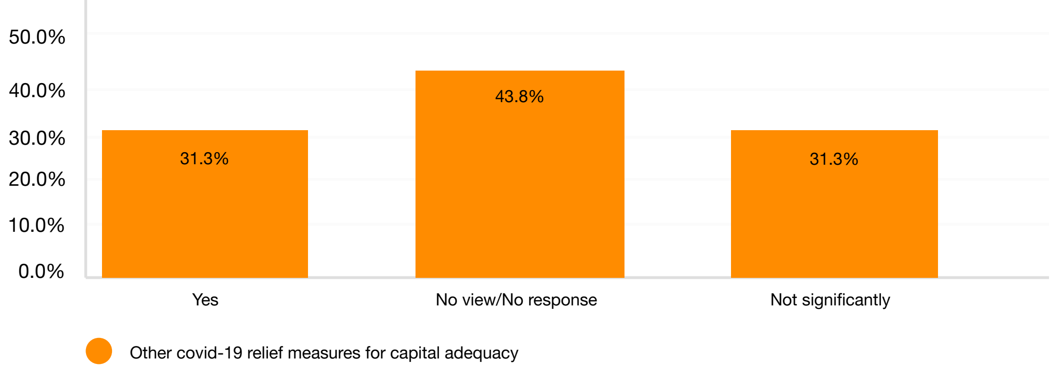
7.6 Other COVID-19 relief measures

While the TMTRF was perhaps the most notable intervention undertaken by the central bank in responding to the pandemic, it was not the only one. The BoZ introduced various measures to provide some relief to banks in their capital adequacy assessments including:

- Extending the period over which IFRS 9 day one adjustments could be accounted for capital adequacy purposes.
- Extending the period over any COVID-19-specific impairment overlays could be accounted for capital adequacy purposes.
- Relaxing of restrictions over which collateral could be applied when calculating provision losses for NPLs for capital adequacy purposes.

We asked commercial banks whether these measures provided any significant benefit:

Figure 40: *Other COVID-19 relief measures - banks*



Source: PwC Analysis:

***Note:** *Individual respondents to this question were able to give more than one suggested course of action. The percentages above therefore show how many respondents reported on a similar issue. Due to this, percentages across the options do not add up to 100%.*

As the table above indicates, the response to these additional measures was entirely positive among commercial banks. The majority of respondents (75.1%) either did not think the measures significantly helped or did not have a view. Most respondents said the measures did not make a significant difference because they were already adequately capitalised before the pandemic.

8. Impact of COVID-19 on operations

The impact of COVID-19 on the operations of banks and NBFIs reduced significantly in 2021. The table below demonstrates how focus on the issue has shifted between 2020 and 2021:

Figure 41: *Impact of COVID-19 on the operations of banks and NBFIs*

	Banking industry		Largest 6 banks		Banks other than largest banks		NBFIs	
Year	Score	Rating	Score	Rating	Score	Rating	Score	Rating
2021	2.4	8	Not rated	N/A	4.8	3	3.3	8
2020	8.2	2	7.8	2	8.4	1	7.5	2

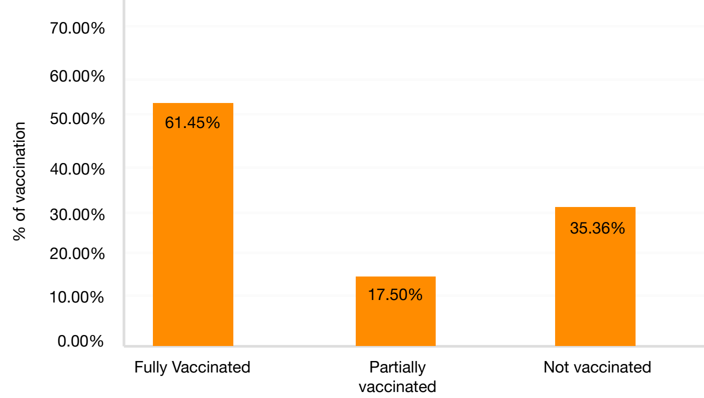
Source: PwC analysis

In 2020, COVID-19 was one of the most pressing issues affecting financial institutions, with banks and NBFIs ranking it the second most significant issue that year. However, COVID-19 has become less of an issue for banks and NBFIs as restrictions have slowly been lifted, not only in Zambia but also globally. Only other banks, those banks outside the country's six largest banks, included COVID-19 among their top five issues in 2021, ranking it the third most pressing issue.

It is interesting to note that none of the CEOs of the six largest banks mentioned it as an issue. However, even among the other banks, the issue has become less pressing, representing the significant strides that have been made in working in a COVID-19 conscious environment.

As with all sectors in the economy, the roll out of COVID-19 vaccinations has been critical in allowing normalcy to return to the workplace. The survey results show that 88% of respondents (both banks and NBFIs) said they knew the COVID-19 vaccination rates among staff members. As a result, we were able to ascertain the average rates of vaccination. These are shown in the table below:

Figure 42: *Average level of vaccination - banks*



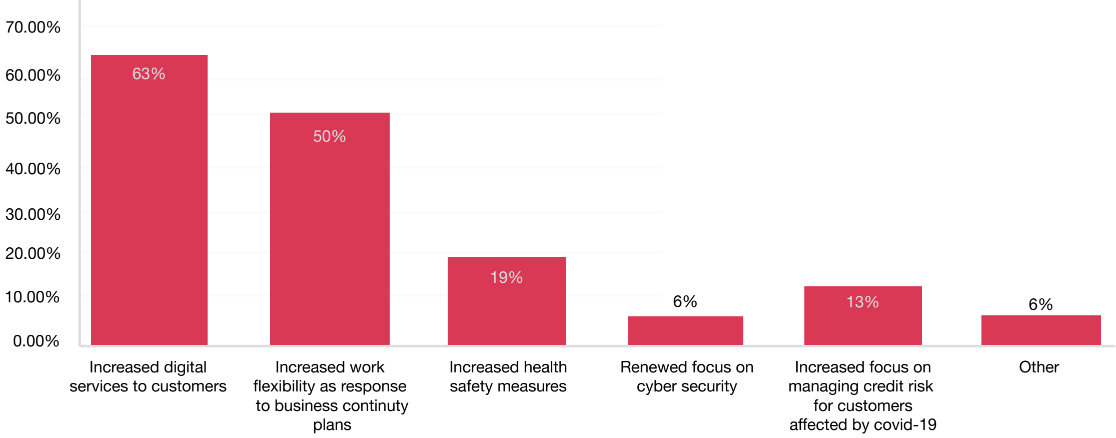
Source: PwC analysis

***Note:** *The table above reflects average levels of vaccination among fully vaccinated, partially vaccinated and non vaccinated staff separately. Therefore 61.45% reflects the average level of vaccination across only vaccinated individuals across the respondents. A consequence of this is that the summation of the percentages aboves will not add to 100%.*

Almost two thirds of staff members across the banks have been vaccinated which, from our discussions, has been one of the main reasons COVID-19 is now less of an issue for institutions than in the previous two years.

The banking sector, as in other industries, has also adapted to the post COVID-19 environment by changing the ways in which employees work. The use of technology has allowed businesses to operate effectively despite the pandemic. This is reflected in respondents' views regarding how COVID-19 has changed their business:

Figure 43: *How has Covid - 19 changed your business operations going forward? - Banks*



Source: PwC analysis

***Note:** *Individual respondents to this question were able to give more than one suggested course of action. The percentages above therefore show how many respondents reported on a similar issue. Due to this, percentages across the options do not add up to 100%.*

The majority of banks, 63%, said the pandemic meant they had increased their digital services offerings to customers. A further 50% of banks said increased work flexibility had allowed banks to continue operating relatively normally during the COVID-19 era.

The larger banks have been able to adapt more quickly to the demands of working with COVID-19, most likely due to them having more resources. However, our survey results indicate that other banks in the industry are not far behind.

9. Tax environment for banks and NBFIs

9.1 Survey responses

The most common issues raised by respondents were:

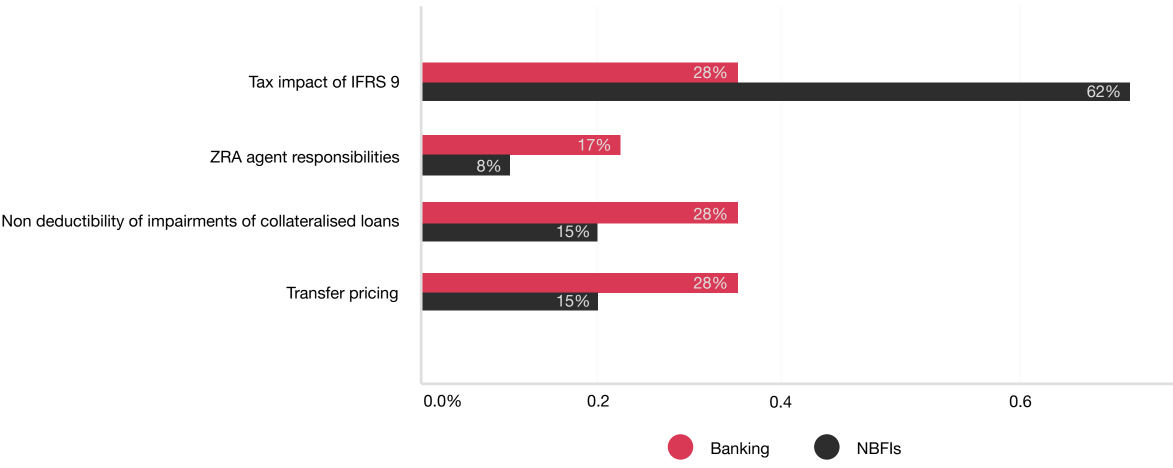
i) Non-deductibility for corporate income tax of impairments on loans backed by collateral.

ii) Changes to the recognition and measurement of impairment provisions brought about by IFRS 9, which has been the standard on accounting for impairment since 2018.

These issues have resulted in increased levels of impairment compared to those under IAS 39, the previous standard for accounting for impairment.

The survey responses show that 28% of banks and 62% of NBFIs expressed concern over the tax impact of IFRS 9, with 28% of banks and 15% of NBFIs expressing concern over the non-deductibility of impairments of collateralised loans (see chart below). These two issues are quite closely interrelated and when looked at together represent the most pressing issues from our respondents. This also represents an increase in concern over this matter among respondents compared to our 2020 survey, and underscores the fact that the tax impact of IFRS 9 remains a critical area for both banks and NBFIs.

Figure 44: *Most impactful tax law changes*



Source: PwC analysis

The main considerations around the issues were:

i) Non-deductibility for corporate income tax of impairments on loans backed by collateral

Only impairments arising from loans that are not backed by collateral under the BoZ approach of recognising and measuring impairments are allowable for tax purposes under the provisions of the Income Tax Act.

In calculating taxable profit, banks and NBFIs are required to add back impairment provisions recognised using IFRS 9 and instead claim a deduction for impairment provisions based on the BoZ's prudential regulations for loans. However, this claim is restricted to impairments on the proportions of loans that are not backed by collateral. As a result, in cases where the IFRS 9 impairment provision is greater than the BoZ provisions, this results in additional income tax liability.

ii) Changes to the recognition and measurement of impairment provisions brought about by IFRS 9

For financial reporting purposes, the expected credit loss model approach under IFRS 9 results in increased impairments compared to the incurred loss model approach, which was previously used for financial reporting purposes (IAS 39). Our survey results indicate that the impact of IFRS 9 is more of an issue for NBFIs than banks, with 62% of NBFIs saying it was the most impactful tax law change compared to 28% of banks.

A combination of the above two factors introduces complexities in the recognition and measurement of current tax for financial reporting purposes and the determination of the corporate income tax payable to the tax authorities. Adequately accounting for these issues is critical for ensuring tax compliance and is therefore an area banks and NBFIs need to pay particular attention to.

9.2 Likely direction of Zambia's tax policy and possible implications for banks and NBFIs

Fiscal policy is a major driving force in any economy and Zambia is no exception.

In Zambia, fiscal (including tax) policy is outlined in several key government documents which are managed under the Ministry of Finance. The documents each have a specific timeframe and include Vision 2030, the eighth National Development Plan (NDP), which runs from 2022 to 2026, the Medium Term Expenditure Framework (MTEF), which lasts from 2023 to 2025, and the National Budget. Collectively, these policy documents detail the country's strategic direction, development priorities and implementation strategies.

The economic agenda of the political party in power inevitably influences the content and direction of these documents. The United Party for National Development (UPND) government's economic policies are outlined in its party manifesto 2021-2026.

Finally, ZRA implements the fiscal policy and its implementation strategy is defined in its Corporate Strategic Plan (CSP). The latest CSP runs from 2022 to 2024.

Given the above, how will the current fiscal/tax policy and its implementation affect banks and NBFIs in the short to medium term? And will this policy be enough to ensure Zambia attains Vision 2030, which envisages all Zambians living in a prosperous, middle-income country by 2030?

i. Government strategy

The UPND's tax policy/ tax reform objectives outlined in its party manifesto are as follows:

- To develop revenue mobilisation systems both at sub-national and national government level.
- To generate less taxation from income on individuals and corporations, and more from consumption and property taxes.
- An overall broadening of the tax base to lower the burden on individuals.
- To reform the personal income tax regime by removing several regressive elements that favour high-income taxpayers at the expense of low-income households.
- To streamline tax incentives to be effective, targeted, seal tax leakages and maximise in-country capital retention.
- To address the proliferation of regulatory and licensing fees that increase compliance costs and corruption.
- To modernise and strengthen the capacity of key revenue administration institutions, including promoting increased exploitation of IT.

In our view, the above objectives have now, by and large, filtered into government's tax policy, as outlined in the eighth NDP and the MTEF. Through these policy documents, government via the Ministry of Finance has outlined measures and strategic plans to achieve maximum domestic revenue mobilisation in order to restore fiscal sustainability.

The following are some of the other main measures government wishes to employ to achieve fiscal sustainability:

- Rationalise company tax rates to ensure harmonisation at 25% to encourage compliance and innovation.
- Streamline taxation of small and medium enterprises to foster growth.
- Review tax treatment of fringe benefits provided by employers to employees to curtail tax avoidance.
- Reinstate VAT and excise duty on petroleum products.
- Rationalise the VAT treatment of mains water supply and sewerage services to augment reinvestment and provide safe drinking water.
- Expand the scope of excisable products and review the current rates to further mitigate some consumption externalities.
- Introduce digital stamps on bottled water, juices, energy drinks, soda, alcohol and tobacco.
- Reduce the VAT registration threshold and streamline voluntary registration for VAT requirements.
- Streamline the tax exemption structure and facilitation processes to improve transparency and compliance monitoring, and ensure incentives are better targeted and not wasteful.
- Implement cooperative compliance systems to improve the efficiency of tax administration and protect the rights of taxpayers.

- Accelerate the integration of tax administration IT systems within ZRA and with third parties.
- Rescope implementation of the Tax Invoice Management System through the Electronic Fiscal Devices.
- Streamline the mineral royalty tax regime.
- Review non-tax fees not adjusted in the last five years.
- Expand the automation of the collection of fees through the Government Service Bus.

Government hopes that by implementing the above reforms it will broaden the tax base, seal revenue leakages and create a business-friendly policy environment that promotes investment, industrialisation and innovation.

i. Impact of Zambia's tax policy on banks and NBFIs

Some of the above measures were announced in the 2022 National Budget and came into effect in January this year. Those that affect the financial services sector include:

Corporate tax rates

To help banks retain capital for future investments and attract foreign direct investment, government reduced the corporate tax rate for banks from 35% in 2021 to 30% in 2022.

Extension of exemption

To encourage a culture of saving as well as to promote financial inclusion, government extended the tax exemption relating to payments of interest arising on bank accounts held by individuals to all interest earning accounts held by individuals with institutions registered under the Banking and Financial Services Act 2017. Previously, the exemption only applied to savings and deposit accounts.

Withholding tax

Interest payable to local banks and financial institutions licensed under the Banking and Financial Services Act 2017 is now exempt from withholding tax (WHT). In addition, interest paid by a bank or an institution registered under the Banking and Financial Services Act 2017 in respect of interest earning accounts held by individuals is exempted from WHT.

iii. Possible future changes

In light of government's aim to broaden the revenue base by getting more tax revenue through consumption taxes like VAT, it is possible that some banking services that are currently exempt or zero-rated may become standard rated (that is, taxable at 16% VAT).

Furthermore, as it is government's objective to rationalise company tax rates to ensure harmonisation at 25% to encourage compliance and innovation, we may see the company tax rate for banks drop to this level.

9.3 Tax policy implementation and enforcement strategies and the bank and non bank financial institutions

ZRA's corporate plan is based around four strategic pillars. Each pillar has an intended outcome and strategic objectives for how to achieve this outcome. The CSP includes:

Figure 45: *ZRA Corporate strategic plan (CSP), objectives and results*

Strategic pillars	Strategic objectives	Key result areas
Tax compliance	1. Optimise revenue collection 2. Enhance compliance	Enhanced revenue collection
Customer focus and collaboration	1. Improve public perception 2. Improve customer experience	Satisfied and knowledgeable taxpayers
Process efficiency	1. Develop and stabilise ICT systems 2. Improve business processes 3. Improve data integrity	Simplified, efficient, and reliable business systems
Right people	1. Increase human capital and staff motivation 2. Improve infrastructure and facilities	Committed, competent and high performing workforce

Source: Zambia Revenue Authority Corporate Strategic Plan 2022 - 2024

The above pillars are designed to help ZRA attain the objectives of the NDP and Vision 2030.

Some of the visible actions taken by ZRA in relation to its CSP that may have implications on the banking sector are:

1. Data matching exercises (desktop audits) of information submitted to ZRA across tax types in which ZRA undertakes reconciliations and issues audit findings requesting taxpayers validate returns submitted. This calls for added compliance and documentation retention by taxpayers.
2. Introduction of new electronic platforms. The COVID-19 pandemic adversely affected supply chains and economic activity, as well as the general well being of millions of people. In addition the pandemic changed the way in which financial institutions work, which required a major digital drive. In this regard, ZRA launched various e-platforms, for example, TaxOnphone, TaxOnApp and payment via WhatsApp, to address remote working. In addition, 2020 saw the implementation of the taxonline 2.0 platform for the submission, tax registration and publication of ZRA circulars.
3. Upskilling of ZRA officers through training and collaboration with tax authorities of other jurisdictions.
4. Tax-centric workshops aimed at educating taxpayers on compliance requirements and available support resources to foster taxpayer relations and collaboration. This also provides a platform for taxpayers to air their views. Aiming to reach taxpayers, ZRA has also taken to social media platforms to engage taxpayers and communicate compliance requirements, announce new legislation and issue tax reporting deadline reminders.

In response to the above, banks and NBFIs need to understand their obligations, undertake internal tax compliance reviews (given that in some cases the penalties for non-compliance can be punitive) and retain sufficient documentation. In addition, given the implementation of the new tax online platform, it would be prudent to undertake a validation exercise to verify the completeness of records data migration from the old system to the new one.

Given that the finance sector is essential for economic stability, it is important that stakeholders engage government on the implementation, execution and effects of the action plans above for an overall sustainable outcome for both government and the industry.[30]

30 PwC, 2021. The Road to Recovery. https://www.pwc.com/zm/en/assets/pdf/zambia-budget-bulletin-2022.pdf

10. Environment, social and governance for banks and NBFIs

Organisations are increasingly under pressure to move beyond charitable corporate social responsibility activities and integrate ESG policies into their business strategy.

According to the report ESG and Banking by Strategy&,[31] PwC's global consulting business, financial institutions need to reassess their strategies in the context of ESG and its impact on revenues and risks, if they are to transform their business and reaffirm their purpose in society.

The report says that over the past two years the impact banks have on the environment and society has come under increased scrutiny as has the impact the environment and society have on banks. For example, the COVID-19 pandemic posed financial and operational challenges for financial institutions, but it also gave them a unique opportunity to support their staff, customers and communities at the most critical point of need.

Amplified by rapidly rising societal standards for organisations as well as social media, concepts such as ESG factors-based enterprise value assessments have risen up the agenda for many companies.

However, despite a growing body of thought leadership on ESG, it remains an area many executives are still grappling with.

10.1 What is ESG?

In its simplest form, ESG provides an umbrella framework within which to assess a company's impact and dependency on society and the environment, as well as the quality of its corporate governance. It is important to note that ESG not only focuses on climate change and environmental performance, but also social aspects and the organisation's governance of both. All three pillars of ESG are equally important.

Figure 46: *The three pillars of ESG*

	Enviromental Impact of a company on the environment or the environment on the company	• Includes controls of: **carbon emissions**, impact on **deforestation and nature loss**, over-consumptoion and **non-renewable resources**, and production of **waste products** • Also incorporates positive contributions such as **financing of environmental** improvements (e.g green finance initiatives)
	Social Contributions of a company to fairness in society	• Considers **contributions to equality, trust and welfare in society** (including **improving labour rights** and **diversity and inclusion**) within a firm's workforce, and across its supply chain and distribution • Also includes product safety, respect for privacy and data security for instance in propositions
	Governance Processes for decision making, reporting and ethical behaviours	• Focuses on the quality and scope of **reporting**, the nature and type of **accountability**, level of **independent oversight**, and **ethical behavious** in a firm – on both ESG and non-ESG matters • Considers elements such as **board structure**, director and audit **independence** and **executive compensation**

Source: Strategy& analysis

31 Strategy&, 2019. ESG and Banking. https://pwc.to/2RWNICD

10.2 Why is ESG important for banks in Zambia?

There is a view that ESG is important only for companies operating in developed markets and that it is not relevant in the developing world. This is not true. Internal and external pressures are driving the need for financial institutions everywhere to consider ESG.

Banks are no longer answerable to just shareholders, but a new set of stakeholders: customers, employees, suppliers, communities, the press and regulators. These broader and more vocal groups are increasingly interested in how ESG drives corporate performance.

Zambia's new government has identified environmental sustainability as one of the four pillars on which its economic transformation will be based. The importance of this particular pillar has been under-scored by the formation of the Ministry of Green Economy and Environment, which has been tasked with formulating policies and legislation around the green economy and climate change. It also promotes investment in economic activities that are low carbon, resource efficient and socially inclusive. The new ministry's work will affect the entire economy, including financial services, creating both risks and opportunities for financial institutions.

As in other jurisdictions, banks are likely to have to focus more on two broad categories: (1) financing green initiatives (sustainable finance, green bonds etc); and (2) greening the financial system. As an example, the framework for green bonds is being worked on and Green Bond Guidelines have already been gazetted. The new ministry has stated that incentives for green bonds, such as zero-rating of withholding tax on interest as well as tax deductibility for the issuance costs of green bonds, is already being looked into. A green bond is a fixed-income instrument that finances environment-friendly projects. Green bonds appeal to an expanding pool of investors who are interested in making a positive social and environmental impact, while earning commercially appealing returns.

Other initiatives include the creation of a regulatory framework for carbon markets in Zambia.

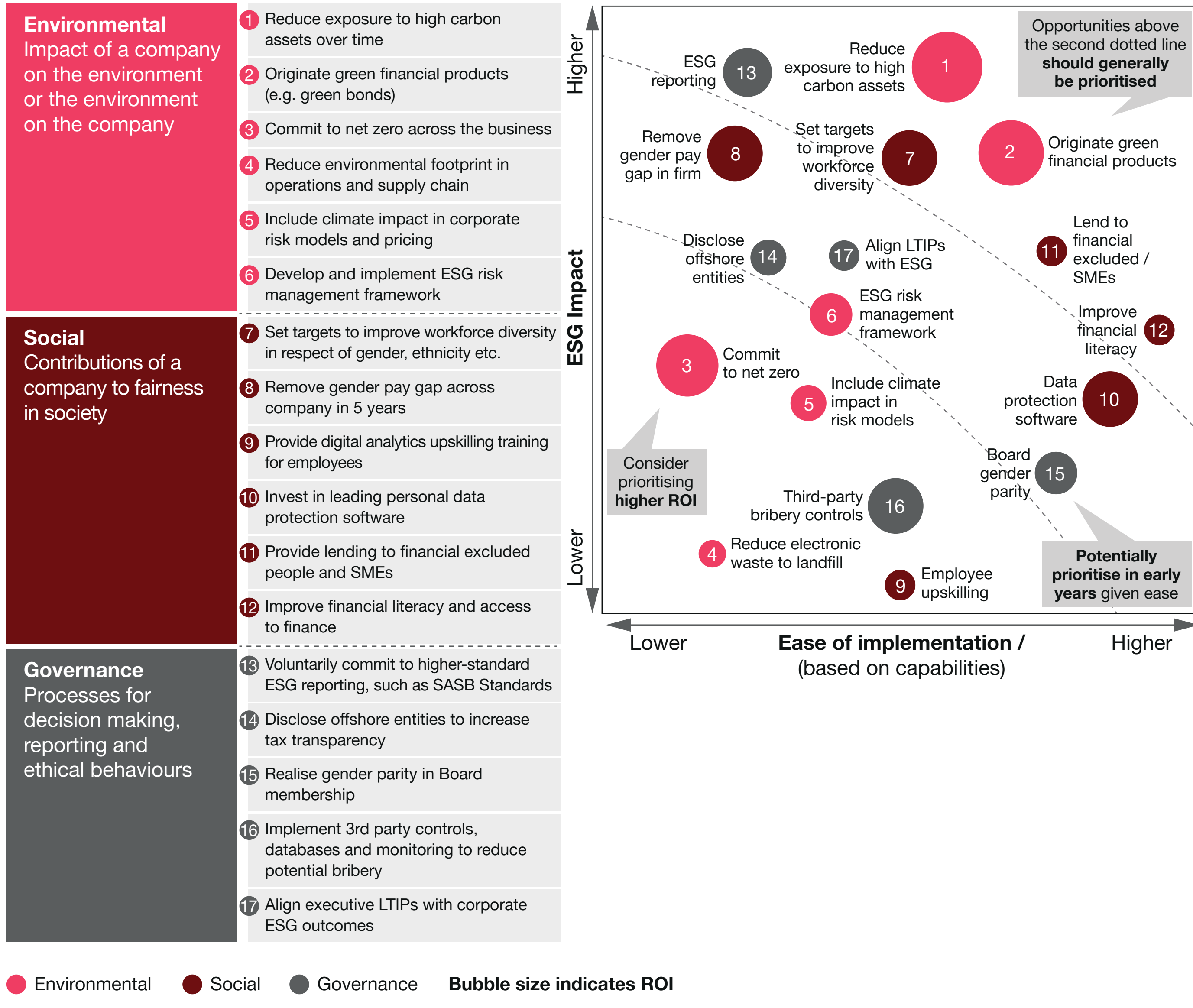
10.3 What next?

According to the report by Strategy&, financial institutions must set an ESG agenda based on their own organisation's purpose and values if they are to ensure ESG accountability. They must then assess strategic ESG opportunities by identifying elements of their business and operating model that they can change or redesign.

The figure below, which is taken from the Strategy& report, provides an example of such an assessment. Rather than selecting initiatives at random, ESG actions should be assessed on how impactful they are, how important they are to the stakeholders and how easy they are to implement. While leaders will naturally want to estimate the return on investment, there remains much to do to narrow the gap between historical performance measurement (e.g. return on investment) and the new, longer-term concepts coming with ESG[32].

32 Strategy&, 2019. ESG and Banking. https://pwc.to/2RWNICD

Figure 47: *Strategic ESG opportunities assessment framework*



Source: Strategy& analysis

On reporting, under the 'G' or Governance pillar, more needs to be done to bridge the gap between historical ways of measuring performance and new, longer-term concepts coming with ESG.

A practical way to do this is through the implementation of sustainability or ESG reporting. One of the umbrella ESG reporting frameworks used for this is what some refer to as integrated reporting. This uses the principles of the International Integrated Reporting Framework to integrate the financial and ESG information that is most material to business strategy and value creation. This can help communicate broader performance to stakeholders and show the connection between ESG and company financials.

A combination of this framework with issues-specific ESG standards like SASB or GRI would lead to enhanced, good quality sustainability reporting.

Sustainability reporting is evolving rapidly so caution should be taken and time invested selecting and implementing the relevant sustainability reporting system for the organisation.

Further tax transparency under the governance or 'G' pillar is critical. Total tax contribution (TTC) disclosures is one way that organisations achieve tax transparency. In 2005, PwC developed the TTC Framework, which shows the tax contributions an organisation makes to the Treasury through all tax bases, not just profit taxes.

Companies are under increasing public scrutiny to explain their tax strategies and taxes paid. A total tax contribution study can demonstrate how an organisation contributes to the integrated economy (both domestically and globally), while a public tax strategy or tax principles can help establish a narrative around business motivations. The TCC framework gives information on the taxes that companies pay in a way that is easy for various stakeholders to analyse and comprehend.

The TTC framework is built around two essential criteria:

- The definition of tax.
- The distinction between taxes that are the company's cost (taxes borne) and taxes that the company collects on behalf of government (taxes collected).

Tax contribution is further segmented into taxes borne and taxes collected. Taxes borne are a direct cost to a business, such as corporation tax and irrecoverable VAT. Taxes collected are collected by a business from taxpayers on behalf of the government such as PAYE and WHT.

The role of the banking sector as a credit intermediary cannot be overstated. A TCC framework offers an opportunity for the tax contribution of the banking sector to be quantified and analysed so that policy makers can assess whether the operating environment is supportive of the sector. At the same time, it offers an opportunity for the banking sector to report on value creation by illustrating the interconnection between financial and non-financial information.

Overall, we expect the market to focus more on the social impact of banking, particularly as the BoZ consults in key areas such as affordability of unsecured credit and vulnerability of customers. ESG could also be a point of differentiation or a source of cost, particularly where it is not aligned with a bank's corporate strategy. While some may be able to meet stakeholder needs and achieve attractive returns, others may experience increased risks over time.

The banking industry has a role both in launching new ESG products, such as compliant savings products, and financing third parties that spur innovation, like environmental technology start-ups. As such, executives should make an active choice in what their ambition is and how they are going to deliver on it. To ensure success, banks should set ESG targets, and track and report these to stakeholders. The best performers will be those who most closely align choices to ESG ambitions, as this enables them to meet stakeholder needs while creating value.

10.4 Survey findings on ESG

Respondents from both banks and NBFIs were asked to rate the importance of aspects of ESG relative to their organisation's risks and development, as well as how they expected their institution's operating model to evolve over time. The following are the survey questions and results.

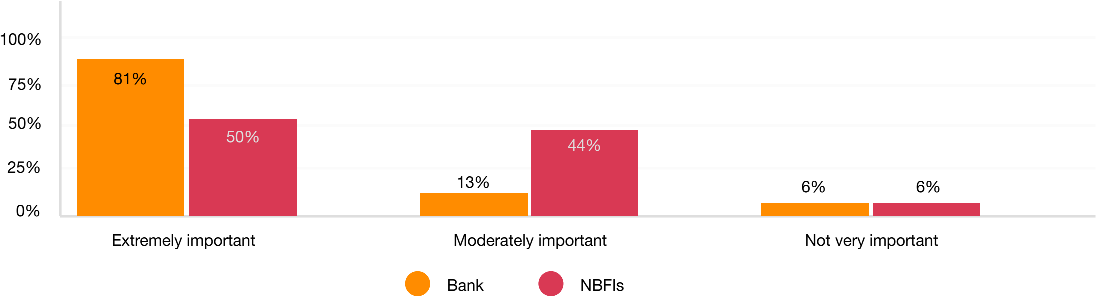
i. ESG risks and opportunities being a critical factor in strategic decision-making

In coming up with their strategic goals, organisations often look at the key risks and opportunities posed by emerging trends, and ESG is no exception. Institutions are more likely to succeed in the long-run when risks are recognised and reduced, and opportunities are fully capitalised on.

To make ESG part and parcel of an organisation's culture, it needs to be embedded in that entity's strategy. There are various ways in which entities can integrate ESG into their strategy and this includes - but is not limited to - identifying material ESG issues and designing initiatives to address the gaps in the business strategy, ensuring organisational alignment all the way up to the board and leveraging existing reporting requirements.

The survey responses show that both banks and NBFIs feel it is important to consider the risks and opportunities posed by ESG when making strategic decisions, with 81% of banks and 50% of NBFI respondents saying that it was extremely important.

Figure 48: *ESG risks and opportunities being a critical factor in strategic decision–making.*

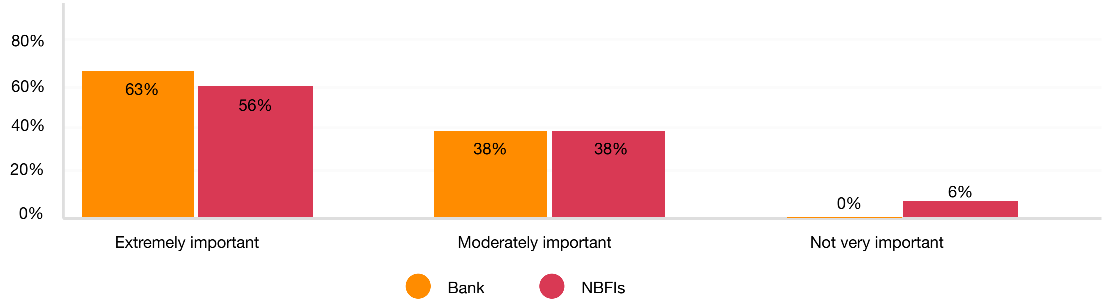


Source: PwC analysis

ii. Prioritising ESG issues in the interests of customers, society and our reputation, even if doing so reduces short-term profitability

Our survey shows that both banks and NBFIs would rather prioritise ESG issues as long as these issues address the interests of customers, society and their reputation - even if doing so means forgoing profits in the short-term. Specifically, 63% of banks and 56% of NBFIs thought this was extremely important, while 38% of both banks and non banks indicated it was moderately important. Six-percent of NBFIs thought this was not very important.

Figure 49: *Prioritising ESG issues in the interests of customers, society and our reputation, even if doing so reduces short-term profitability.*



Source: PwC analysis

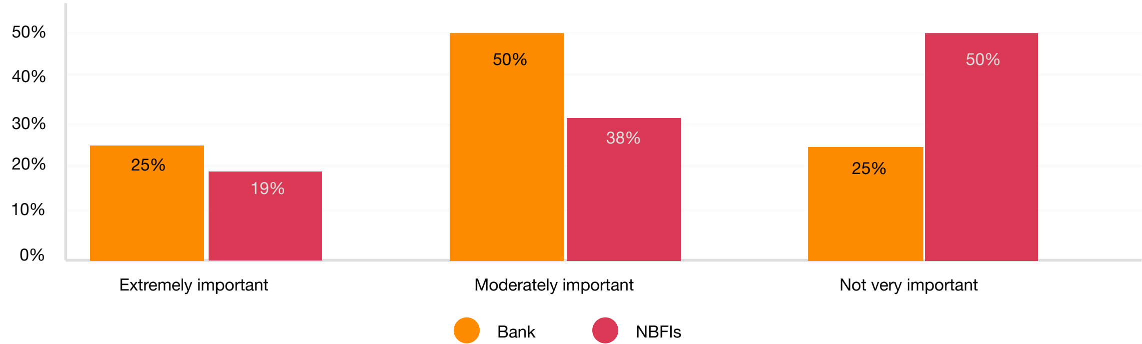
The above results are important in coming up with a view on how entities in the financial services industry see these aspects of ESG. Based on these results one would say that, despite the pressure of profits, 63% of banks and 56% of non banks felt prioritising ESG issues was extremely important.

iii. ESG performance measures and targets to be included in executive pay

Currently, there are few or no regulatory requirements relating to ESG and this may lead to corporates not taking ESG as seriously as they should. However, one way to mitigate the lack of regulation around ESG is to ensure that those charged with ESG plans and commitments are part of the key performance indicators (KPIs) for those organisations.

The results from our survey indicate that most banks (75%) thought this was either extremely (25%) or moderately (50%) important. In contrast, the results among non banks are more evenly mixed. Some 50% of non banks said they believed including ESG performance measures and targets in executive pay was either extremely important (19%) or moderately important (31%), while 50% said that it was not very important.

Figure 50: *ESG performance measures and targets to be included in executive pay*



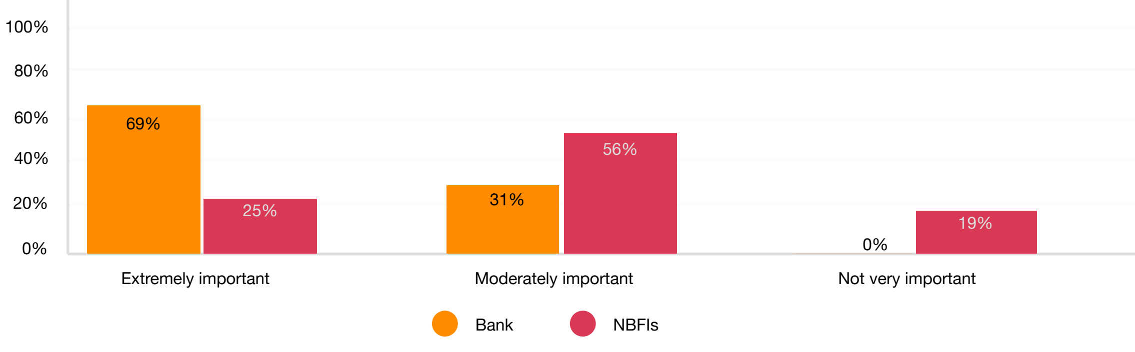
Source: PwC analysis

iv. Investors adversely perceive companies that are not taking sufficient action on ESG issues

Given their lengthy investing timelines, long-term investors that value sustainable economic imperatives find ESG investment appealing. Understanding a company's risks and opportunities from a sustainable perspective is beneficial. Investors who care about the financial, competitive, strategic and public perception aspects of their investment will benefit from a compelling ESG proposition.

Our survey results show that 69% of banks felt this point was extremely important, while 56% felt it was moderately important. However, only 25% of NBFI respondents felt it was important, with the majority of NBFIs (56%) feeling it was moderately important and 19% of NBFIs seeing it as not very important.

Figure 51: *Investors adversely perceive companies that aren't taking sufficient action on ESG issues.*



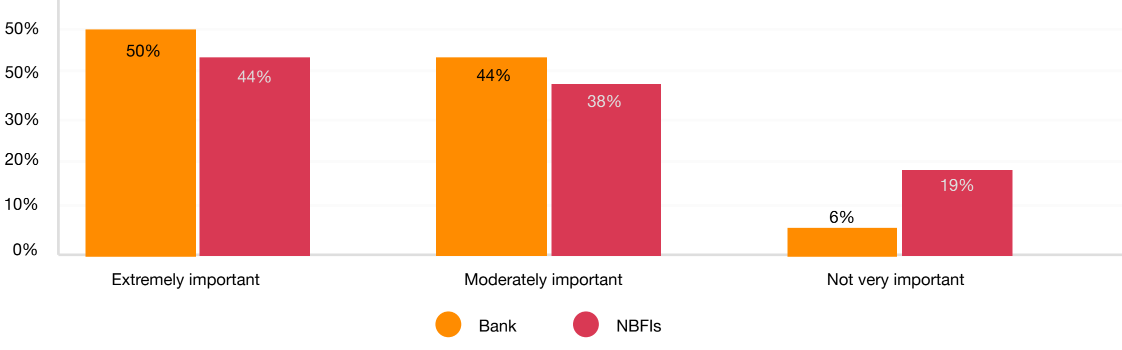
Source: PwC analysis

v. Enhancing disclosure, reporting and transparency around ESG topics

In an article published on the World Bank's All About Finance blog on whether ESG disclosure can improve investment efficiency, the authors note that: "Enhanced ESG disclosure plays a role in reducing information asymmetries, especially adverse selection costs that reside in the corporate debt market, leading to investment efficiency gains." The article authors go on to say that "non-financial reporting plays a key role in improving investment efficiency, which can in turn have significant consequences on the real economy and added benefit to providing more transparency on firms' corporate and social responsibility". [33]

This chimes with our survey results, where 50% of banks and 44% of NBFIs said enhancing disclosure, reporting and transparency around ESG topics was extremely important.

Figure 53: *Enhancing disclosure, reporting and transparency around ESG topics.*



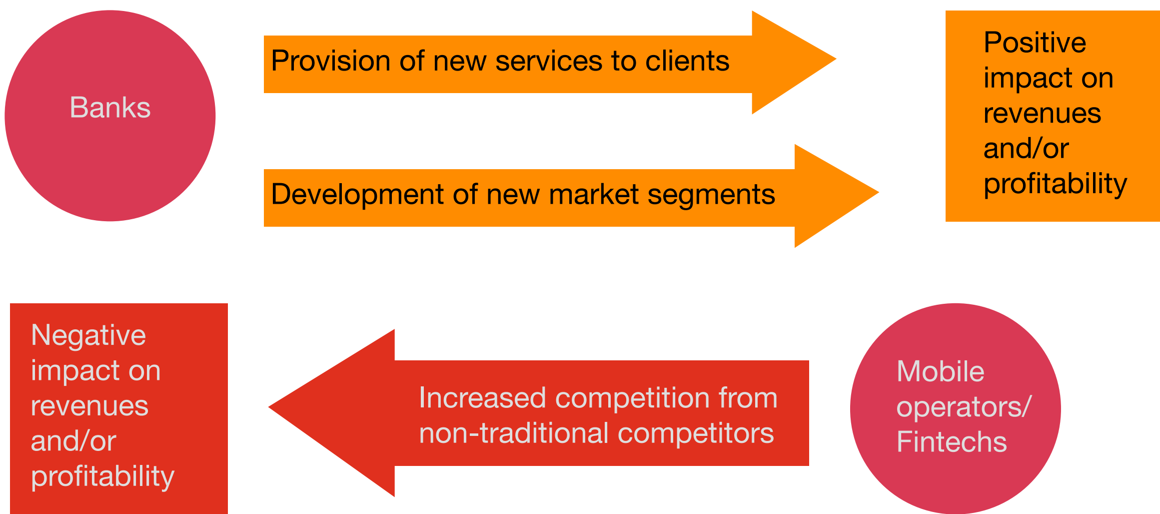
Source: PwC analysis

33 Elsa Allman and Joonsung (Francis) Won, 2021. Can ESG Disclosure Improve Investment Efficiency? https://blogs.worldbank.org/allaboutfinance/can-esg-disclosure-improve-investment-efficiency

11. Financial inclusion

Innovation and advancement in technology has had a significant impact on the financial services sector. This is illustrated in the below diagram:

Figure 54: Impact of Innovation and advancement in technology on the sector



Source: PwC analysis

11.1 The financial inclusion agenda and key developments

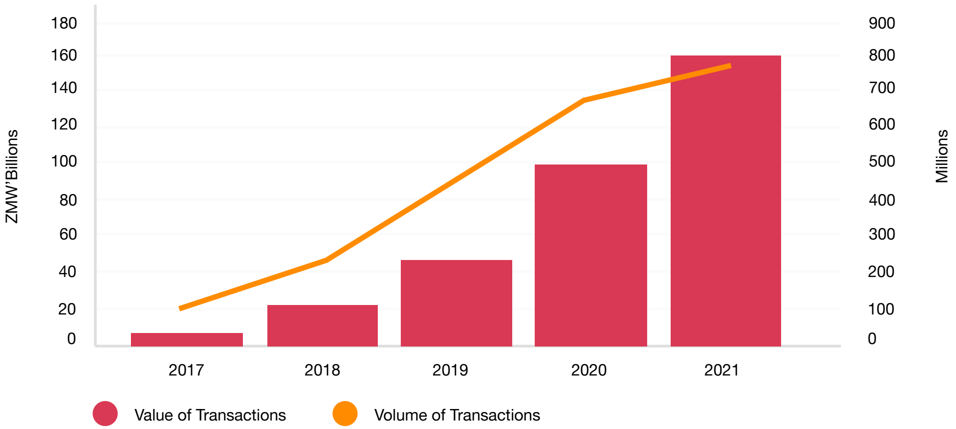
Financial inclusion is a priority for the Ministry of Finance. Government's goals for financial inclusion are set out in the National Financial Inclusion Strategy (NFIS) 2017 to 2022[34]. These goals include:

1. An overall increase in financial inclusion (formal and informal).
2. Improved physical access to high-quality financial delivery channels, including branches, agents, and automated teller machines (ATMs).
3. Innovative and diverse financial products and services that meet customers' needs.
4. Improved outreach and adoption of digital financial services.
5. Greater availability of affordable financing for SMEs, smallholder farmers and agricultural entities.
6. Enhanced consumer protection and increased financial capabilities of consumers.

Significant progress has been made towards attaining goals one to four, mainly due to the increased use of mobile money platforms. Evidence of this can be seen in the growth of mobile money transactions over the past five years, both in terms of value and volume.

34 Ministry of Finance, 2017. NATIONAL FINANCIAL INCLUSION STRATEGY 2017–2022. https://www.boz.zm/National-Financial-Inclusion-Strategy-2017-2022.pdf

Figure 55: Mobile money trends 2017 - 2020



Source: Bank of Zambia, PwC Analysis

Increased use of a 'payments-as-a-platform' model has been a key contributor to the growth in mobile money payments because it has enabled more value to circulate in the mobile money system. This model connects mobile users with third party vendors, who range from utility companies, schools and universities to small shop owners.

The GSMA State of the Industry Report on Mobile Money 2021[35] highlighted some key trends. These included:

a. More than US$1trillion in mobile money transactions took place globally in 2021, of which sub-Saharan Africa accounted for US$697.7billion.

b. US$403.4billion of transactions were processed in Eastern Africa (including Zambia).

c. Merchant payments globally nearly doubled, reaching an average of US$5billion in transactions per month and accounting for 21% of the value circulating in the mobile money system.

d. Bill payments processed via mobile money globally increased by 37% to exceed US$5billion per month

e. Bulk disbursements globally topped US$65.8billion, largely driven by an increase in salary payments made via mobile money and government-to-person payments, such as social cash transfers.

According to *The Global Findex Database 2021*, only 15% of adults in sub-Saharan Africa reported having saved using their mobile money account even though account ownership is most widespread in this region.[36] In contrast, 76% of adults in high income economies reported having saved via mobile money.

Digital payments were a major driver of the increased footprint of mobile money services in developing economies, with the share of adults making or receiving digital payments increasing from 44% in 2017 to 57% in 2021.

Statistics showing the uptake of mobile money globally, in sub Saharan Africa and in the eastern African region (including Zambia) serve as proof of the increasing use of technology-based platforms.

However, executives should not view the potential user bases and the variety of services offered through the payments-as-a-platform model as simply mechanisms to increase revenues through fees and charges. The variety of uses of tech platforms have greater value in the data that can be collected from the day-to-day transactions of users.

35 GSMA, 2021. State of the Industry Report on Mobile Money 2021. https://www.gsma.com/mobilefordevelopment/wp-content/uploads/2021/03/GSMA_State-of-the-Industry-Report-on-Mobile-Money-2021_Full-report.pdf

36 Global Findex Database Report 2021. https://www.worldbank.org/en/publication/globalfindex/Report

11.2 Zambia and the use of data

There are several activities that have taken place around the use of data. The UN Capital Development Fund has embarked on a few local projects targeted at the use of data with organisations such as Kazang, MTN, Zanaco and data automation with the BoZ.

A notable development has been the introduction of financing by MTN mobile money. The mobile money provider has partnered with firms to enable it to provide short-term finance products that are leveraging the use of data analysis and analytics. One such partnership is between MTN Zambia and Jumo to offer a product called Kasaka Loans.

11.3 Future technological developments

Global attention is shifting to digital currencies. The Atlantic Council estimates that as of May 2022, ten nations have fully implemented digital currencies, with Nigeria, the continent's largest economy, debuting its Central Bank Digital Currencies or government coins in October 2021.[37]

New services will be supported by digital currencies, which will also reduce the cost of payments for transfers and allow SMEs to make real-time payments. Risks to financial stability, cybersecurity and operational privacy continue to be of great concern. According to Bloomberg, the BoZ is looking into Govcoins as it believes they could increase financial inclusion, and improve traceability, safety and the effectiveness of payment systems.[38]

11.4 What next?

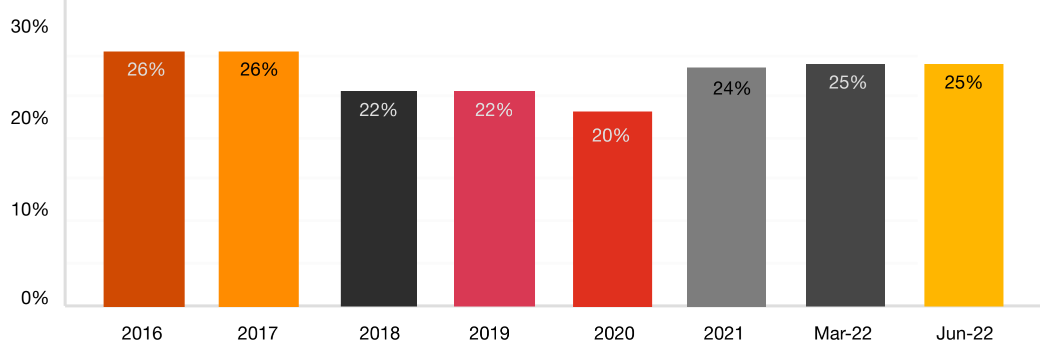
The modern global economy is becoming ever more dynamic and this is forcing companies to think outside the box and adapt. For organisations that serve as intermediaries, such as banks, the challenge is not only maintaining or improving a competitive position, but also surviving during these tough economic conditions. How financial institutions choose to adapt could be the difference between corporate survival and extinction.

12. Financial performance and analysis

12.1 Capital adequacy ratio

Banking sector

Figure 56: Capital Adequcy Ratio - Banks



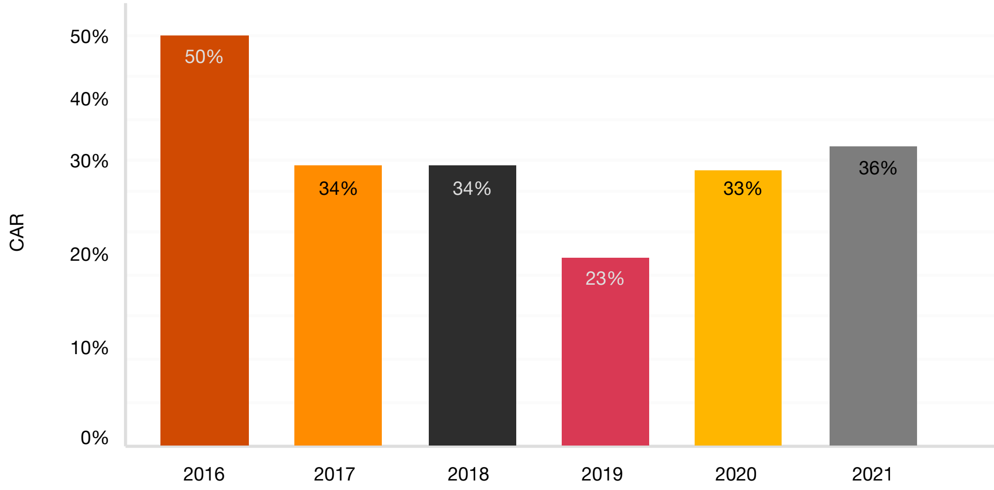
Source: PwC analysis

37 https://www.imf.org/en/Blogs/Articles/2022/06/23/blog-africa-cbdc
38 https://www.bloomberg.com/news/articles/2022-02-09/zambia-explores-digital-currency-but-warns-against-crypto

The capital adequacy ratio (CAR) increased slightly from 20% in 2020 to 24% in 2021. At the end of the first half of 2022, the CAR grew by another 1% to reach 25%. The increase was mainly attributed to an increase in aggregate industry profit. The industry's average CAR of 25% nevertheless exceeds the BoZ's minimum requirement of 10%, showing that the sector as a whole is still well capitalised.

NBFIs

Figure 57: Capital Adequacy Ratio - NBFIs

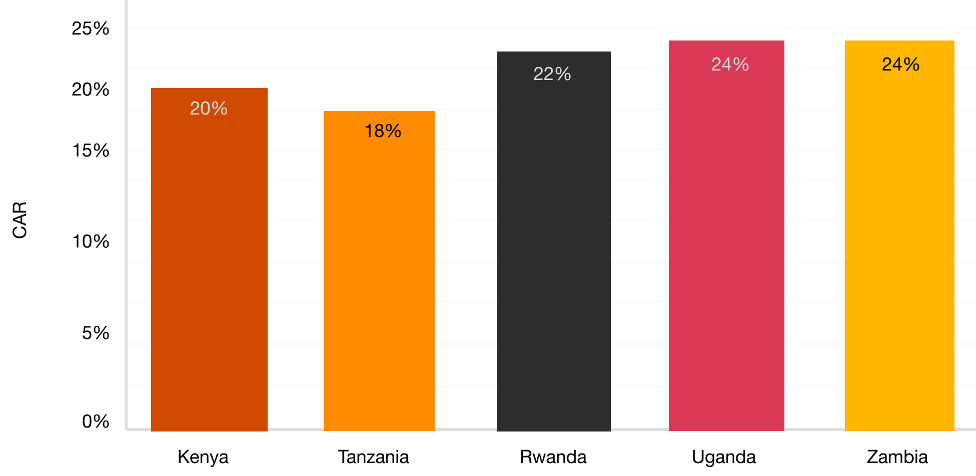


Source: PwC analysis

The CAR increased in the current year by 3% to 36% from 33% in 2022. The increase in the CAR was driven by the aggregate industry profit. This was mainly attributed to an increase in revenue from government securities during the year. At 36%, the CAR is well above the minimum required position of 10% by the central bank.

Regional analysis

Figure 58: Capital adequacy ratio for selected African Countries



Source: PwC analysis

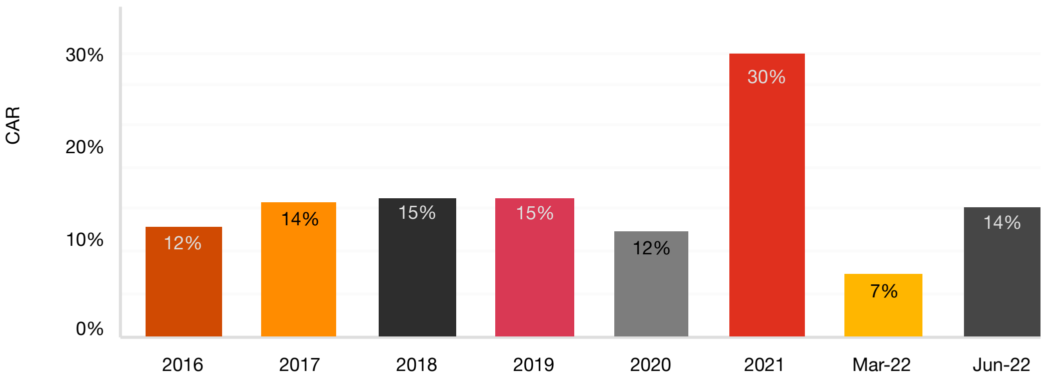
The CAR of the Zambian banking sector is higher than all the other selected countries, other than Uganda, which was also at 24% as at 31 December 2021. Zambia's CAR was higher than the banking sector in Kenya (20%), Tanzania (17%) and Rwanda (22%).

*Due to limitations of data, the CAR for the region has been computed as of 30 June 2021.

12.2 Return on equity

Banking Sector

Figure 59: Return on Equity - Banks

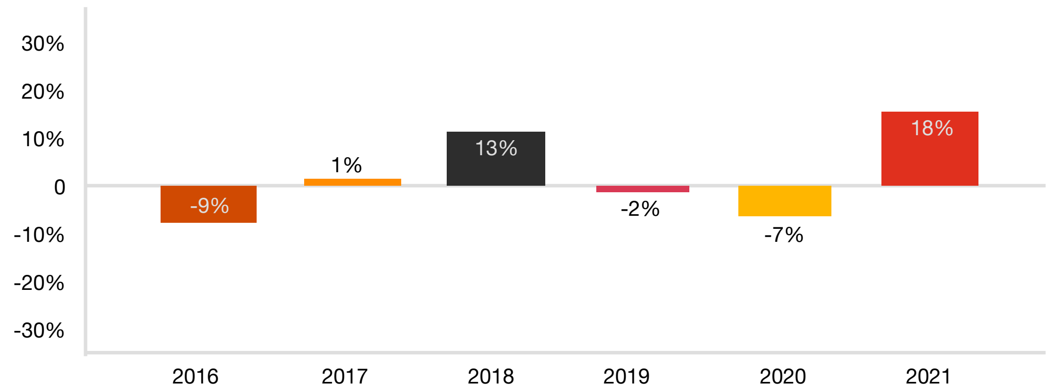


Source: PwC analysis

The return on equity (ROE), which was 12% in 2020 and 30% in 2021, grew by 18%. This was largely driven by the increased profitability of the sector in 2021. However, the ROE decreased to 7% at the conclusion of the first quarter in March 2022 and rebounded to 14% by June 2022. The industry's profitability increased as a result of decreased impairments caused by stronger economic sentiment.

NBFIs

Figure 60: Return on Equity - NBFIs

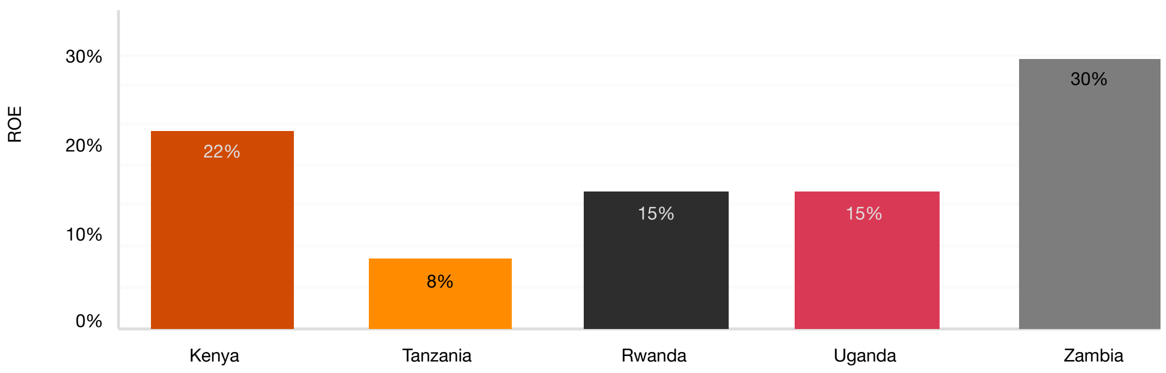


Source: PwC analysis

The ROE increased in the current year to 18% from -7% in 2020. The negative ROE of 7% in 2020 was mainly driven by high operational costs and a reduction in profit for the year (losses of K233.9million), resulting in a combined loss in the industry. However, profit improved (K665,058,000) in 2021, recording positive growth.

Regional comparison

Figure 61: ROE for selected African Countries



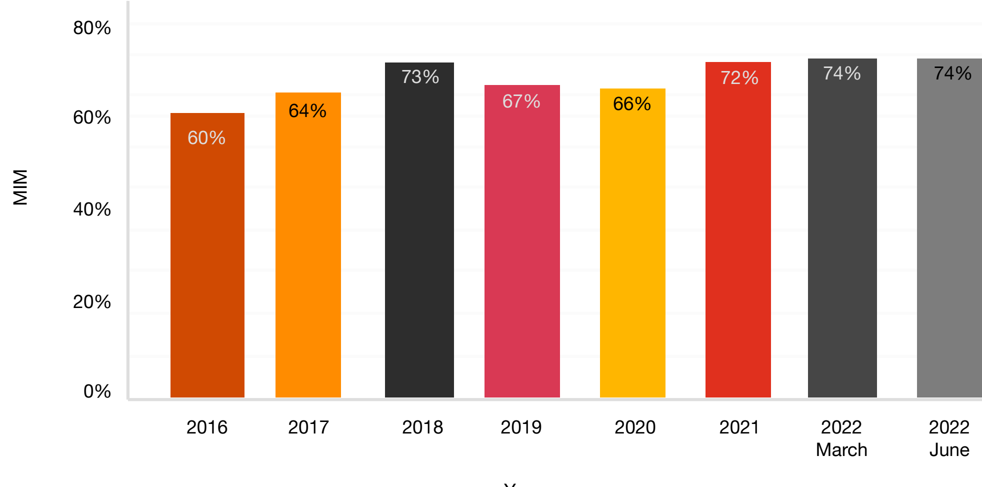
Source: PwC analysis

The Zambian banking industry ranks highest at 30% (from 12% in 2020) compared with the selected countries. This was attributed to increased lending to the government under FISP. Tanzania, at 13%, ranked the lowest of the countries chosen for comparison, up from 8% in 2020, while Rwanda and Kenya scored 15% and 22%, respectively, up from 12% and 15% in 2020.

12.3 Net interest margin

Banking sector

Figure 62: Net Interest Margin - Banks

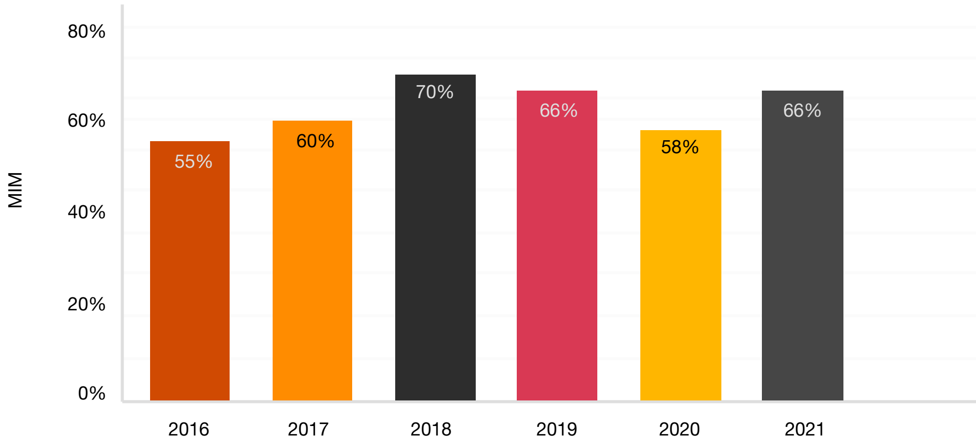


Source: PwC analysis

The industry's net interest margin (NIM) grew from 66% in 2020 to 72% in 2021. The reason for this growth was an increase in interest income of 35% to K17 million in 2021 from K12.5 million in 2020. The NIM increased further in 2022 ticking up further to 22% as at June and March 2022. The six biggest banks saw a NIM gain of 8% in 2021, compared to a 6% increase for the remainder of the industry.

NBFIs

Figure 63: Net Interest Margin - Non Banks



Source: PwC analysis

The net interest margin increased by 8% in 2021 to 66% from 58% in 2020. The increase was driven by a 7% increase in interest income and a 3% reduction in NPLs.

Glossary

1. Capital adequacy ratio (CAR)

$$CAR = \frac{(\text{Tier 1 capital - goodwill}) + \text{Tier 2 capital}}{\text{Risk weighted assets}}$$

2. Return on Equity (RoE)

$$RoE = \frac{\text{Profit for the year}}{\text{Shareholders equity}}$$

3. Net interest margin (NIM)

$$NIM = \frac{\text{Net interest income}}{\text{Interest income}}$$

4. Non-performing loans ratio (NPLR)

$$NPLR = \frac{\text{NPLs}}{\text{Gross loans}}$$

Contributors

Andrew Chibuye
Country Senior Partner

George Chitwa
Tax Leader

Martin Bamukunde
Partner, Assurance

Lyndon Lane-Poole
Associate Director, Assurance

Andrew Sikwanda
Associate Director, Assurance

Bupe Kazimoto
Senior Manager, Assurance

Bupe Mutale
Manager, Assurance

Nema Mseteka
Manager, Assurance

Charity Kabwe
Manager, Tax

Chimba Chisengalumbwe
Manager, Tax

Esanju Maseka
Manager, Assurance

Evelyn Tembo
Manager, CMD

Contributors

Vasty Nkhoma
Senior Associate, Assurance

Emily Wayua
Senior Associate, Tax

Chembe Mulutula
Senior Associate, Assurance

Kasongo Lufuma
Senior Associate, CMD

Malama Mwilwa
Associate, Advisory

Pendo Manjele
Senior Associate, RAS

Mamba Hachongo
Senior Associate, Assurance

Natasha Mwelwa
Associate, Assurance

Chansa Musonda
Associate, Assurance

Betty Wilkinson
Economist/Advisor

Wen Zekko
Senior Associate, Assurance

Louden Hampinda
Manager, Assurance

Contributors

Temwani Nyondo
Senior Associate, Assurance

www.pwc.com/zm

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