2018 Zambia Banking and Non-Banking Industry Survey

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Contents

Foreword

Welcome to PwC Zambia's 2018 Banking and Non-Banking Industry Survey. We are excited to present findings from a wider pool of respondents this year which, as the title suggests, includes not only commercial banks but non-bank financial institutions (NBFIs) as well.

We have widened the survey coverage to acknowledge the complementary nature of services offered by commercial banks and NBFIs. Together, these institutions provide a significant proportion of the financial products and services accessed by individuals and businesses operating in Zambia. Customers who are unable to transact with commercial banks can often access financial services through NBFIs instead. In addition, the intensity of competition between commercial banks and NBFIs is increasing as both types of institution target the same customer segments with similar products and services.

Our survey sought an organisation-wide view in response to the questions asked. With a response rate of 100% from the 18 commercial banks in Zambia, and a rate of 51% from the 47 NBFIs surveyed, we are confident that this report is representative of the views of the sector.

For the first time, we have also included comparative information from a similar survey undertaken by PwC in East Africa as well as industry financial performance indicators to provide a gauge of how banking institutions in Zambia fare relative to institutions in other countries.

We would like to thank all of the respondents for taking the time to complete the survey. In addition, I would also like express my sincere gratitude to the PwC team that worked tirelessly to prepare this publication. A special thanks to our guest contributor Betty Wilkinson of Financial Sector Deepening Zambia for her time and invaluable insight.

We trust you will find this report useful. As always, we welcome your feedback on the survey and, in particular, any enhancements we can make in the future.

Andrew Chibuye
Partner
Financial Services Leader, PwC Zambia

Executive summary

Financial institutions are affected directly by changes in the macro-economic environment, arguably more than any other sector. This is true not only in Zambia but across Africa.

In addition, financial institutions find themselves increasingly exposed to the ever-changing challenges posed by non-traditional players, who are using innovation and technology to create customer-orientated solutions.

These dynamics are taking place as the focus from regulators and other stakeholders continues to escalate exponentially.

In light of this, the slowdown in Zambia's economy in recent years has inevitably created challenges for the financial institutions questioned for our survey. Although the economy remained relatively stable in 2018, subdued economic growth and the Kwacha weakening against major currencies were particular areas of concern.

Based on information from the Ministry of Finance, growth of real gross domestic product (GDP) is estimated to be 3.7% in 2018, marginally higher than the 3.4% reported in 2017. Subdued economic growth has the effect of limiting opportunities available for financial institutions to execute their role as financial intermediaries, which in turn constrains their ability to achieve growth targets.

Inflation crept up to 7.9% in 2018 from 6.1% in 2017. Despite the small increase, the relative price stability led the Bank of Zambia to reduce the monetary policy rate (MPR) from 10.25% to 9.75% in February 2018. Average annual commercial bank lending rates reduced from 27% for 2017 to 24% for 2018. Meanwhile, worryingly, gross international reserves continued to fall, reducing from $2.4 billion in 2016 to $2.1 billion in 2017, and an estimated $1.6 billion by the end of 2018 – the equivalent of 1.9 months of imports.

The trend in the performance of the Kwacha against the US Dollar in 2018 shows a pattern indicative of its relative fragility. Specifically, after mild volatility during the first eight months of the year, the Kwacha lost about 18% of its value over the remaining four months of 2018. According to the Bank of Zambia, this rate of depreciation was mainly attributable to higher net demand for foreign exchange, the strengthening of the US Dollar as a result of an increase in the Federal Reserve rate, and negative market sentiments arising from Zambia's credit rating downgrade.

Given this economic backdrop and the constantly-changing nature of financial services, we were keen to see whether banks and NBFIs would identify similar issues facing their businesses in 2018 or tell different stories about the challenges they faced.

Survey results

Building on the success of our 2016 and 2017 surveys, we extended the scope of the current survey to incorporate commercial banks and NBFIs (described collectively as "financial institutions" for the purpose of this report). For this survey, the population of NBFIs included microfinance institutions, building societies, savings and credit institutions, leasing and finance institutions, and development finance institutions. In total, we sent questionnaires to all 18 banks and 47 NBFIs, and attained a response rate of 100% and 51% respectively.

Our survey questionnaire covered eight broad areas including: the state of the industry; technology; the future of banking; financial inclusion; cyber security; financial crime; taxation; and talent management.

With respect to the most pressing issues during the year, respondents were requested to rank issues in order of significance, with 10 being the most and one being the least significant. In analysing the responses, we used a simple average to identify the issues of most significance at both a combined and disaggregated level.

We obtained and analysed consolidated industry performance statistics as compiled from the quarterly prudential returns that financial institutions submit to the Bank of Zambia and publish periodically. The results of our analysis were used to provide further context for the survey responses received. Publicly available statistics for the economy, commercial bank and NBFI sectors in Zambia and countries where were used for comparative purposes were also obtained.

We also supplemented the survey findings and industry financial analysis with interviews of respondents from commercial banks and NBFIs in order to ensure that we obtained a full understanding of the answers provided.

Top Five Issues – Banks and Non-Banks

There were three common issues identified by the financial institutions surveyed: credit risk; growth of the local economy; and implementation of International Financial Reporting Standard 9: Financial Instruments (IFRS 9).

Credit risk was the most pressing issue affecting NBFIs, while banks ranked it fifth. Meanwhile, banks said growth of the local economy was the most significant issue they faced in 2018; NBFIs ranked it second. Implementation of IFRS 9, which came into effect on 1 January 2018, was ranked third and fourth by banks and NBFIs respectively.

Issues over which banks and non-banks diverged include improving revenue growth, and abolishment of unwarranted fees and charges, both of which were a concern for banks, but did not feature in the top five issues affecting non-banks. Meanwhile, managing liquidity risk and client retention were among the top issues for non-banks but not for banks.

Table 1: *Survey results across banks and NBFIs*

Banks	Common issues	Non-Banks
Improving revenue growth 5.3	Credit risk 5.3	Managing liquidity risk 4.6
Abolishment of unwarranted fees and charges 4.8	Growth of the local economy 5.1	Client retention 4.1
	Implementation of IFRS 9	

Top Five Issues – Banks

Growth of the local economy was the issue of most concern for banks in 2018, reflecting apprehension over the impact of sluggish economic growth on the banking sector.

Three of the five most pressing issues for banks in 2018 were matters brought forward from 2017. These were: improving revenue growth (ranked second in 2018 and first in 2017); implementation of IFRS 9 (maintaining its ranking of third); and credit risk (ranked fifth in 2018 and the second in 2017). Intriguingly, cyber security (ranked fourth in both 2017 and 2016) was ranked twelfth in 2018. The other issue to drop-out of the top five issues for banks was managing costs (ranked fifth in 2017 and first in 2016).

Overall, credit risk is the only issue that has continued to feature among the top five most pressing concerns since our inaugural survey in 2016.

The ever-changing perception of risk by respondents is a reflection of either their efficiency in resolving issues of most significance or the dynamic nature of the external factors that shape the environment in which they operate – or both. Our view leans more in favour of the latter rather than the former. This is because the issues presented as most pressing tend to be consistent with emerging risks that either did not exist in prior years or whose potential impact became more pronounced in the period during which the survey was conducted.

Assuming this trend continues, it is difficult to predict with accuracy what will be the most pressing issues for banks in the medium and long-term.

Table 2: *Top five most pressing issues for banks 2016 – 2018*

	2016	2017	2018
1	Managing costs 5.4	Improving revenue growth 5.7	Growth of the local economy 5.6
2	Credit risk 4.4	Credit risk 5.5	Improving revenue growth 5.3
3	Liquidity risk 3.9	Implementation of IFRS 9 5.1	Implementation of IFRS 9 5.2
4	Cyber security 3.3	Cyber security 3.5	Abolishment of unwarranted fees and charges 4.8
5	Interest rate risk 3.2	Managing costs 3.3	Credit risk 4.7

Top Five Issues - Zambia's Six Largest Banks

Four of the top five issues identified by the country's six largest banks are consistent with the broader banking sector survey results, albeit in varying order of significance. These include growth of the local economy (the top issue for the six largest banks and the broader banking sector in 2018), credit risk (the third most signficant issue for the large banks last year compared to fifth for the wider industry), improving revenue growth (fourth versus second for the sector), and abolishment of unwarranted fees and charges (the fifth most important issue for the big banks and fourth for the banking sector).

The notable difference is that this group identified managing costs among the top five most pressing issues, replacing the implementation of IFRS 9, which was reported as the third most signficant issue in the industry-wide bank survey results.

As with the broader bank survey results, credit risk is the only issue that has continued to feature among the top five most pressing issues for Zambia's six largest banks since our inaugural survey in 2016. Credit risk was cited as the third most signficant issue for Zambia's six largest banks in 2018.

Table 3: *Top Five Issues - Zambia's Six Largest Banks*

	2016	2017	2018
1	Cyber security 6.6	Credit risk 7.6	Growth of the local economy 6.3
2	Managing costs 6.4	Cyber security 5.2	Managing costs 5.8
3	Growth of the local economy 3.9	Improving revenue growth 4.5	Credit risk 5.2
4	Credit risk 4.1	Managing costs 4.0	Improving revenue growth 4.6
5	Liquidity risk 3.1	Implementation of IFRS 9 3.3	Abolishment of unwarranted fees and charges 4.5

Top Five Issues – Other Banks

Although in a different order, the top issues identified by those banks outside the country's six largest banks are consistent with the broader banking survey results. The notable difference is that these respondents identified implementation of IFRS 9 as the most pressing issue for 2018. In contrast, the six largest banks did not report this issue at all within their top five.

In line with the industry-wide results, credit risk has continued to feature among the top five most pressing issues since our 2016 survey, although the level of significance assigned to it has continued to wane. It was ranked first in 2016, third in 2017 and fifth in 2018. In addition to credit risk, the rest of the banks have continued to highlight improving revenue growth within the top five most pressing issues. It was ranked third in 2016, first in 2017 and the second in 2018.

Table 4: *Top Five Issues - Other Banks*

	2016	2017	2018
1	Credit risk 4.9	Improving revenue growth 5.7	Implementation of IFRS 9 6.1
2	Managing costs 4.8	Implementation of IFRS 9 5.8	Improving revenue growth 5.5
3	Improving revenue growth 4.3	Credit risk 4.3	Growth of the local economy 5.3
4	Liquidity risk 4.1	Capital management 3.6	Abolishment of unwarranted fees and charges 5.0
5	Interest rate risk 3.1	Tax compliance 3.3	Credit risk 4.5

Top Five Issues – Non-Bank Financial Institutions

Credit risk was identified as the most signficant issue for NBFIs in 2018. This relatively high level of congruence around credit risk among NBFIs is interesting given the varied nature, size and level of sophistication of the NBFIs surveyed. This level of significance is a reflection of the perceived or actual level of credit risk that is inherent within their customer base.

In addition to the three issues in common with banks – credit risk, growth of the local economy and implementation of IFRS 9 – NBFIs identified managing liquidity risk and client retention as the two other issues of most significance.

Given the significant reliance on borrowed funds and generally low level of cheap deposits available to meet funding requirements, it did not come as a surprise that liquidity risk was as a significant issue for NBFIs.

The other matter unique to this sector was client retention. This is largely on account of the intense competition among players driven by the relatively low switching costs, the large number of service providers and the demand for relatively simple products such as salary backed loans.

Table 5: *Top five most pressing issues – NBFIs*

2016	
Credit risk	**6.0**
Growth of the local economy	**4.5**
Managing liquidity risk	**4.6**
Implementation of IFRS 9	**4.1**
Client retention	**4.0**

A view from the region

Between August and November 2018, PwC undertook the East Africa Banking Survey amongst Chief Executive Officers, Chief Financial Officers and other senior representatives of commercial banks in Kenya, Rwanda, Uganda and Tanzania.

The survey focused on five key areas:

1. General industry trends
2. Banks of the future: technology & innovation
3. Risk management perspectives
4. Impact of adoption of IFRS 9
5. Financial crime & Anti-Money Laundering/ Counter Financing of Terrorism (AML/CFT)

Key survey findings:

Industry-wide, the following developments ranked as the three most significant issues for the respondents across the region:

East Africa	
IFRS 9 implementation	**(45%)**
Interest rate cap	**(18%)**
Competition from non-bank institutions	**(16%)**

As regards risks facing the industry, credit risk, compliance risk ranked as the top two with a relatively even distribution of other risks.

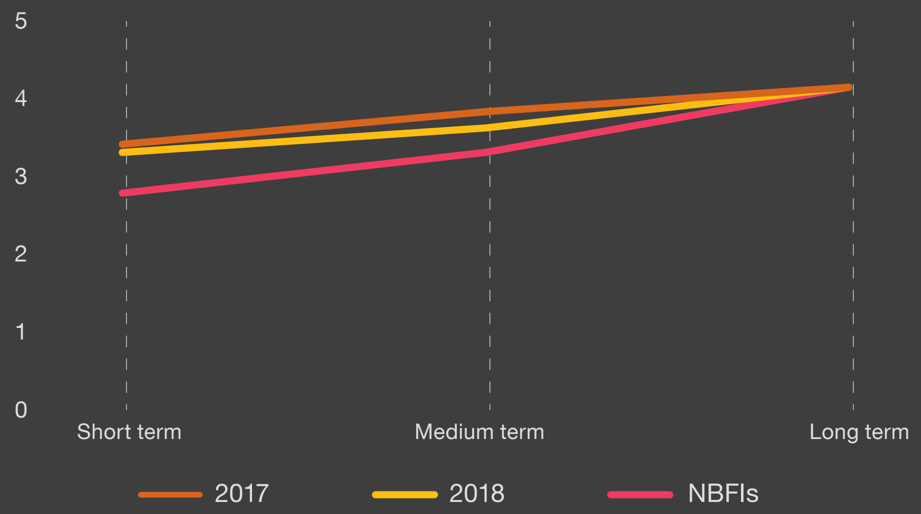
Additional detail is provided later in this report.

Looking ahead

As in previous years, our survey also sought to assess the level of optimism within the industry. Respondents were requested to indicate their level of optimism on a five-point Likert scale, with one as least optimistic and five being very optimistic.

On the whole, respondents were mildly optimistic about the future of the banking industry in Zambia. The level of optimism exhibited by respondents was indicated as increasing over time, with respondents more optimistic about the long-term than the short to medium-term horizon. However, it is worth noting that NBFIs exhibited a considerably lower level of optimism over short to medium-term industry prospects compared to their counterparts in the banking industry.

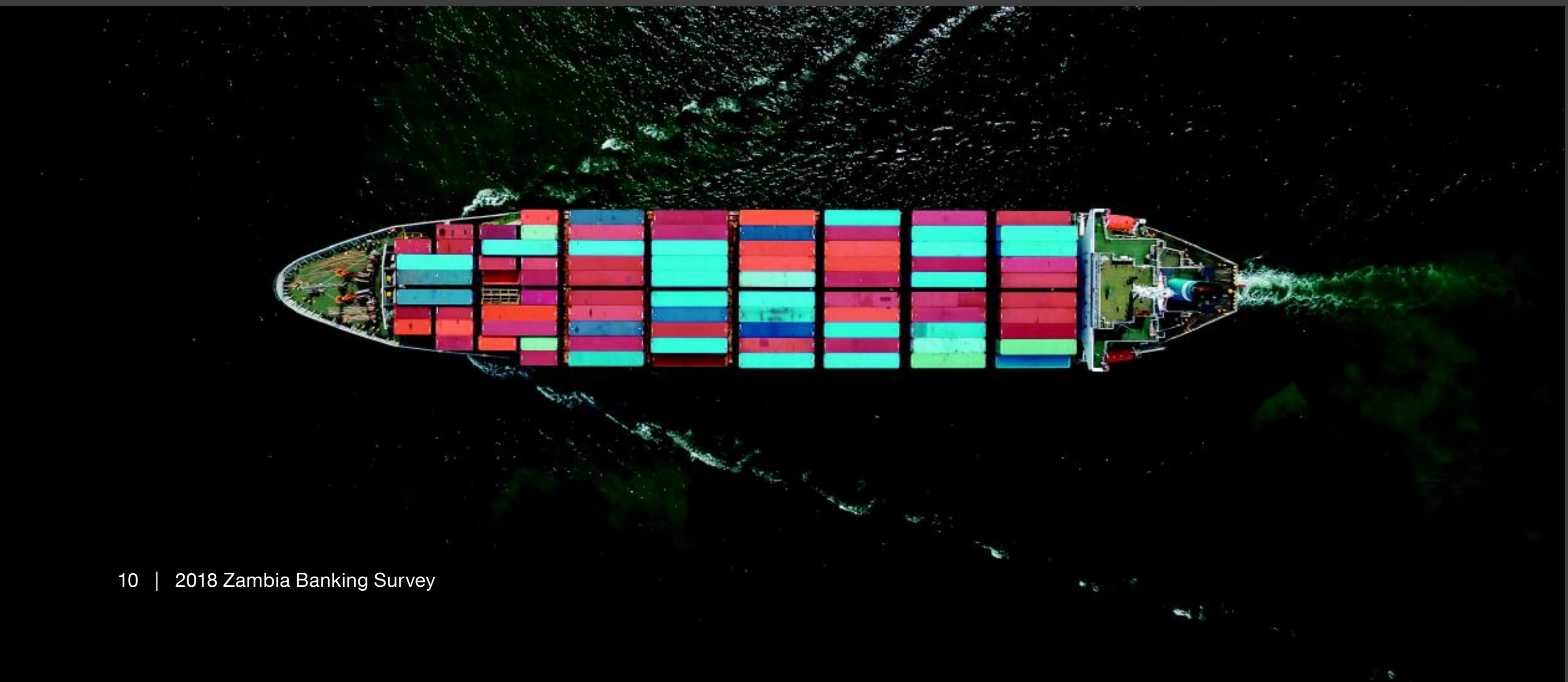
***Figure 1:** Level of optimism*



Respondents' level of optimism in the banking industry remains largely unchanged from 2017 – and for the same reasons. In the short to medium-term, respondents' mild optimism was muted by concerns over fiscal discipline, expectations for GDP growth, monetary policy stability, and uncertainty surrounding the International Monetary Fund programme.

Interestingly, NBFIs did not highlight any unique reasons for their comparatively lower level of optimism. They simply reported the same set of concerns, but from a less optimistic viewpoint.

In the long-term, financial institutions said they were optimistic about growth prospects for the Zambian economy. However, this optimism is tempered by concerns over the sustainability of debt levels and changes in the political landscape.

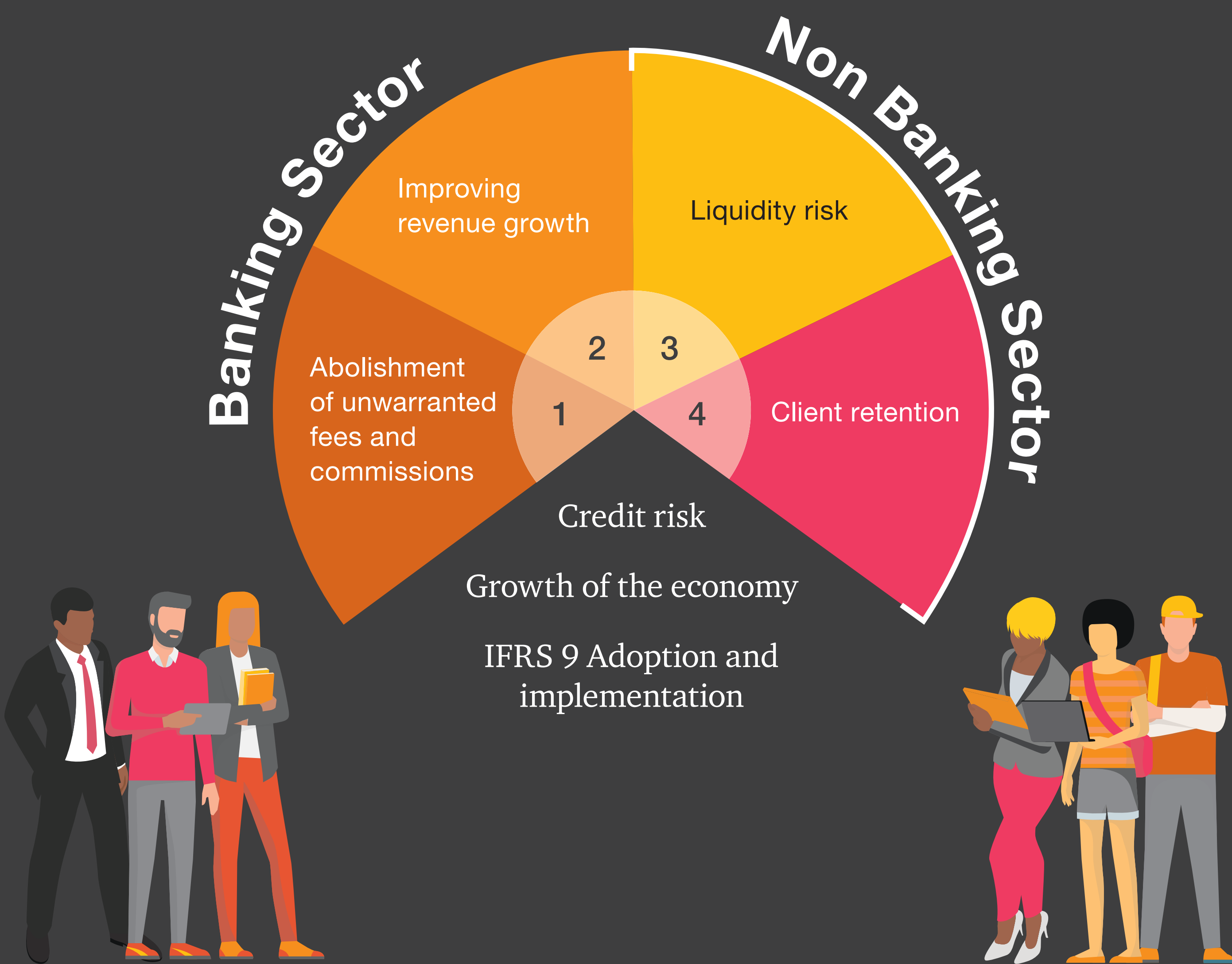


Analysis of the top issues in 2018

As discussed previously, there were three common matters among the top five issues affecting both banks and non-banks in 2018 (see Figure 2 below). These included the growth of the economy, credit risk and the implementation of IFRS 9. There were also issues that banks ranked among their top five, but NBFIs did not, and vice-versa. For banks, improving revenue growth and the abolishment of unwarranted fees and commissions were both important, whereas for NBFIs, liquidity risk and client retention posed challenges.

In this section, we discuss each issue in more detail and provide further analysis in order to provide a better understanding of why these issues, whether common or unique, posed challenges for financial institutions in 2018.

Figure 2: *The common issues affecting banks and NBFIs*

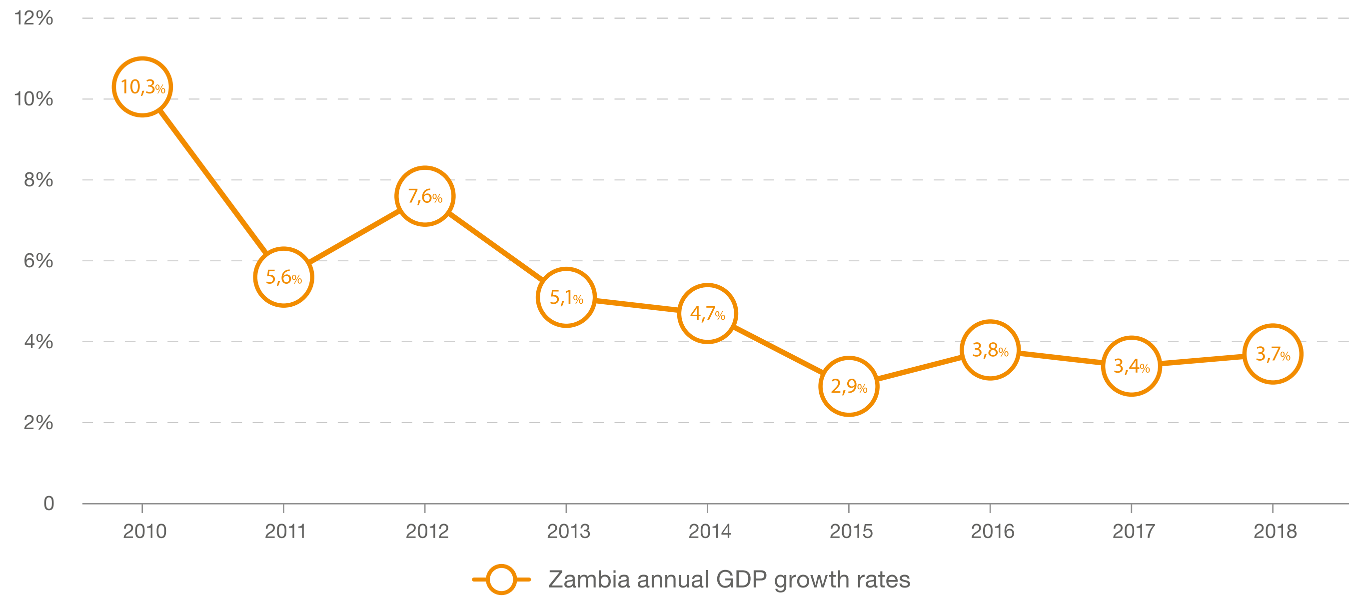


Issues affecting banks and non-banks

Growth of the local economy

Annual growth of real gross domestic product (“GDP”) is estimated to be 3.7% in 2018, according to figures from the Ministry of Finance, marginally higher than the 3.4% reported in 2017. According to the World Bank, the subdued economic growth in 2018 was a consequence of poor agricultural harvest, lower copper prices and fiscal debt challenges that continue to crowd out private sector growth.

Figure 3: *Zambia annual GDP growth rates*



Source: The World Bank

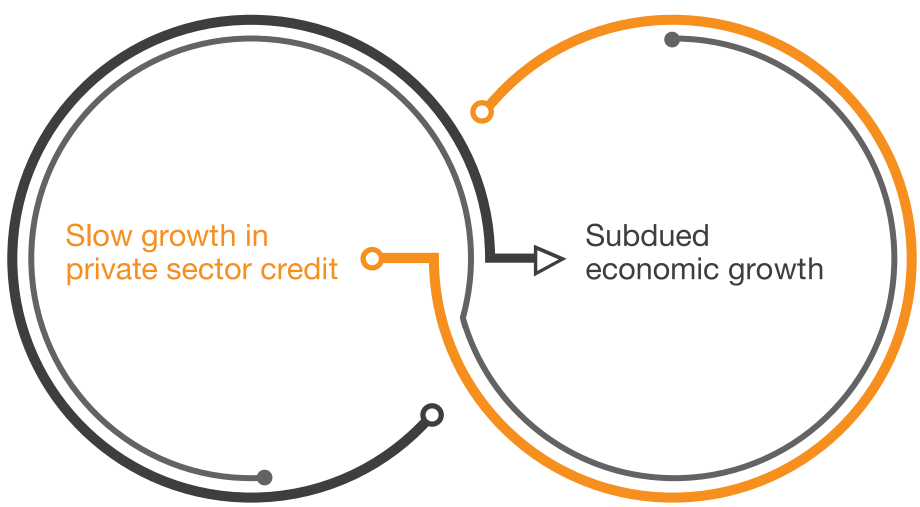
Although the economy continues to show signs of recovery, Bank of Zambia noted that delayed implementation of fiscal adjustment measures in addition to escalating debt and debt service payments continue to pose downside risks to economic growth. Critically, to support sustainable macro-economic stability and attain higher growth, prompt and effective implementation of effective fiscal adjustment measures remain crucial.

Given the causal relationship between economic growth and performance of financial institutions, both banks and non-banking institutions cited growth in the local economy among the top five issues they faced in 2018. Banks said growth in the local economy was the biggest issue affecting their business last year, while NBFIs said it was the second. most important issue.

As regards the actual nature of the relationship between economic growth and performance of financial institutions, the results of the survey suggests a relationship where performance of financial institutions is dependent on the rate of economic growth. This implies that one of the driving forces for increased demand for financial services is increased economic growth, which translates into more opportunities for financial institutions to execute their role as financial intermediaries and generate profit.

However, because of that intermediary role, financial institutions are a key player in stimulating the same economic growth on which prospects of their financial performance depend. Specifically, financial institutions play a crucial role in mobilizing savings, facilitating trade and directing a country's scarce resources to their most productive use. Consistent with this, Bank of Zambia has noted that, despite the continued recovery of the private sector credit, the pace of growth has been too slow to stimulate significant economic activity. This could create a vicious cycle where slow growth in private sector credit frustrates economic recovery, and the resultant sluggish economic growth causes financial institutions to exercise caution in their lending decisions, constraining economic growth even further.

Figure 4: *The Vicious Cycle*



Credit risk

Credit risk continues to rank as one of the top five pressing issues for both commercial banks and NBFIs in this year's survey. Analysis of the survey results indicates that it was rated the top issue for NBFIs in 2018, while the banking sector ranked it as the fifth most pressing issue. Among the country's six largest banks, credit risk was the third most pressing issue last year.

The Banking industry wide Non Performing Loans ratio has decreased from 12% in 2017 to 11% at the end of 2018 but remains above the prudential target of 10%. This, when taken in light of the continued subdued economic activity and relatively high average nominal commercial bank lending rate of 23.8% at December 2018 may explain why credit risk remains a pressing issue.

Non performing loans

Our survey results show that 41% of banks recorded an increase in Non performing loans (NPLs) in 2018 while 35% indicated the number of NPLs remained unchanged and 24% recorded a drop in NPLs. for NBFIs, 77% of respondents recorded an increase in NPLs, 9% observed little change whilst and 14% recorded a reduction.

Figure 5: *Trend of NPL for commercial banks*

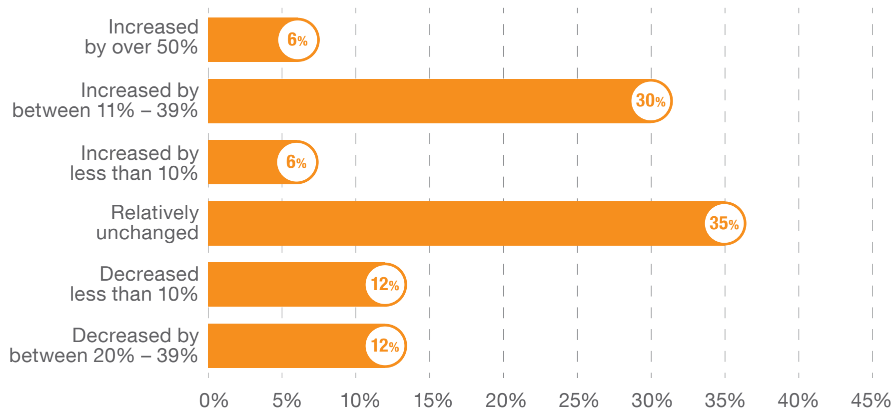
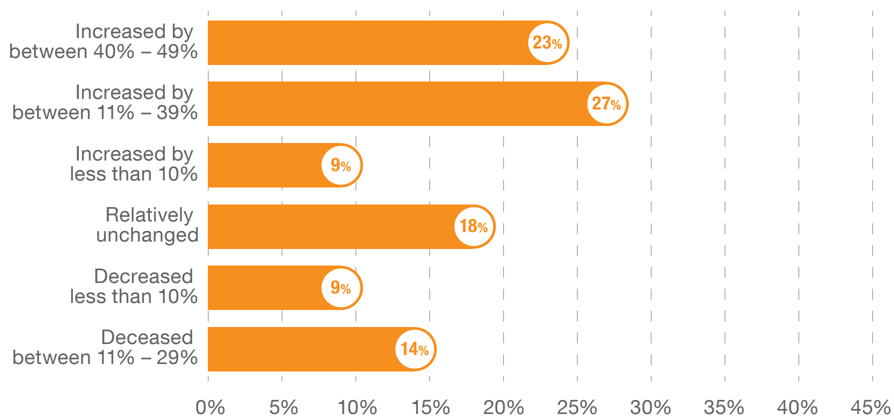


Figure 6: *Trend of NPL-NBFIs*



When asked to identify the top factors impacting the increased NPL balances, both sectors identified Government related arrears and slow economic growth as the top two issues driving the NPL trend in 2018. The banks that indicated an improvement or relatively unchanged NPLs attributed this to improved management actions to enhance collections and recoveries.

Table 6: *Top 3 factors impacting the NPLs*

No	NBFIs	Banking sector
1	Adverse economic factors	Nonpayment of government related arrears
2	Over borrowing	Reduced economic activity
3	Delays in government remittances	Increased cost of doing business

Lending trends

Despite credit risk being raised as a top concern, both banks and NBFIs indicated that they had actually increased lending activities in 2018 compared to 2017. Among banks, only 6% of the respondents indicated they had reduced their lending last year, with the majority of banks increasing lending significantly. Total gross loans increased by K4.7 billion (19.5%) over 2017. This response is supported by the fact that in general, the Central Bank reported an increase in the average credit outstanding as at the end of 2018 among commercial Banks (See Figure 22: Average credit outstanding).

Results among NBFIs were mixed, with some institutions indicating an increase in lending and others stating lending reductions of between 11% and 39%. Total gross loans increased by K1.3 billion (21%) over 2017.

Figure 7: *Trend in lending activity in 2018 relative to 2017-NBFIs*

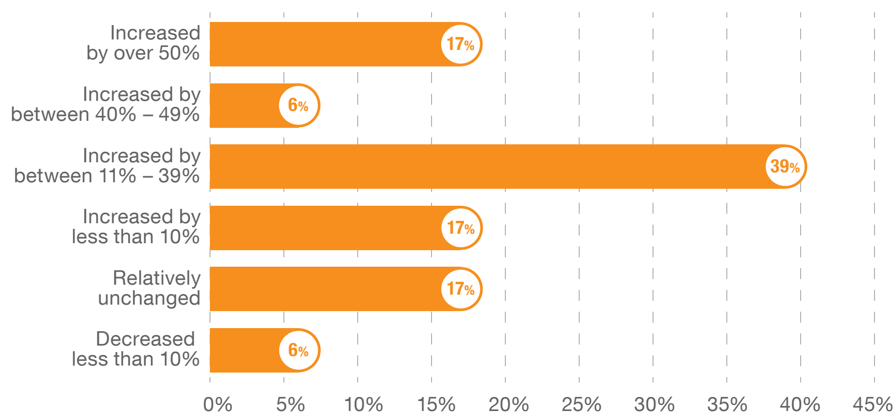
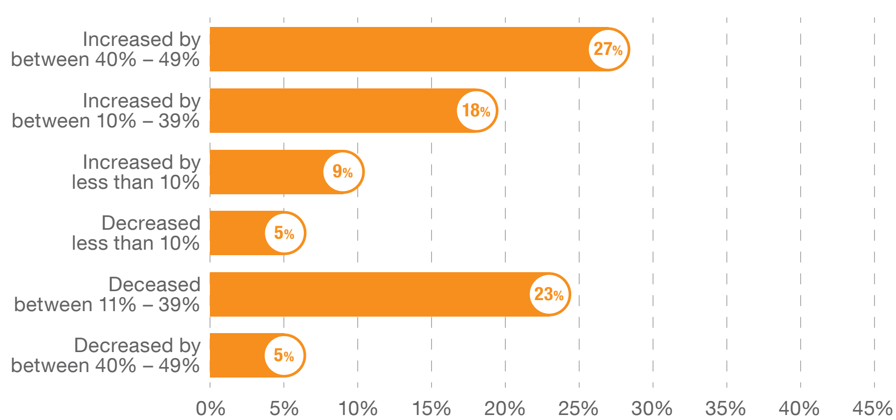


Figure 8: *Trend in lending activity in 2018 relative to 2017-NBFIs*



For those that recorded an increase in lending activity, this increase was spread across various sectors from agriculture, mining, construction, wholesale and retail to personal loans. The full analysis of the sector increases in lending for both banks and NBFIs can be seen in Figure 9 and 10 below.

Figure 9: *Sectors benefiting from increased lending-NBFIs*

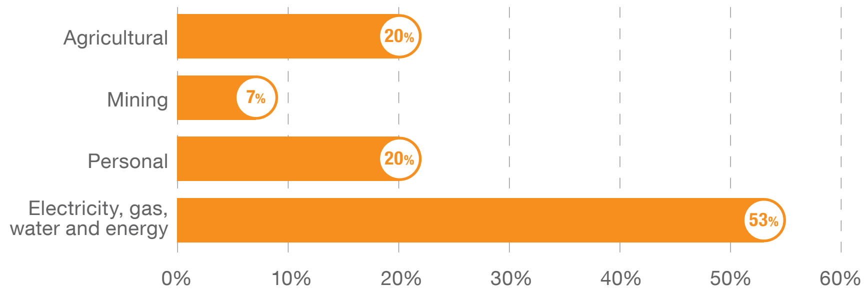
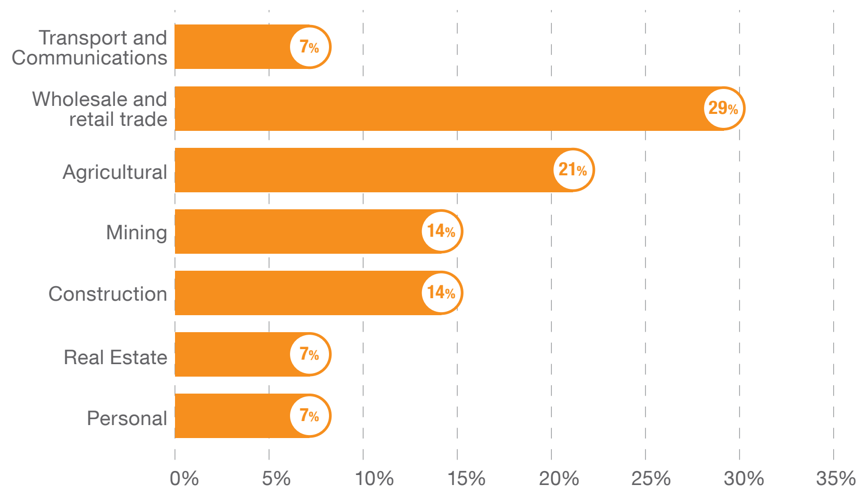
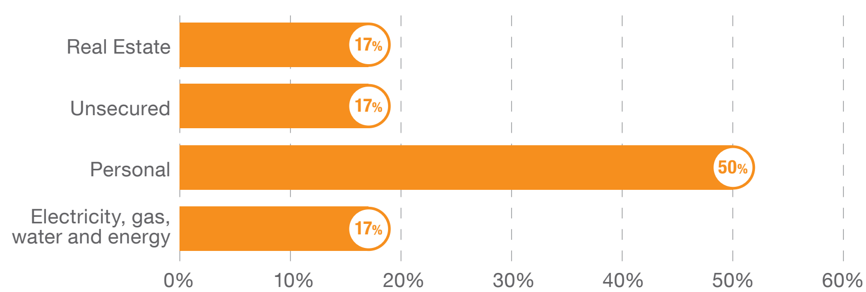


Figure 10: *Sectors benefiting from increased lending-Banks*



Furthermore, when asked to identify sectors where the industry as a whole reduced lending activity in the year, the banks identified the construction sector as the only industry impacted, while for NBFIs the responses were mixed, with personal lending being most affected (see Figure 11 below).

Figure 11: *Sectors with reduced lending activity*



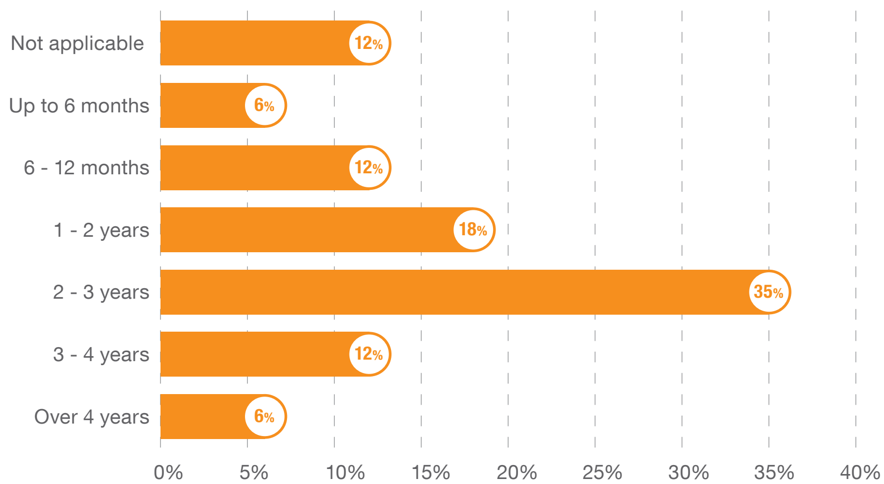
Other credit risk issues

Other issues affecting credit risk in the country include:

Foreclosure challenges

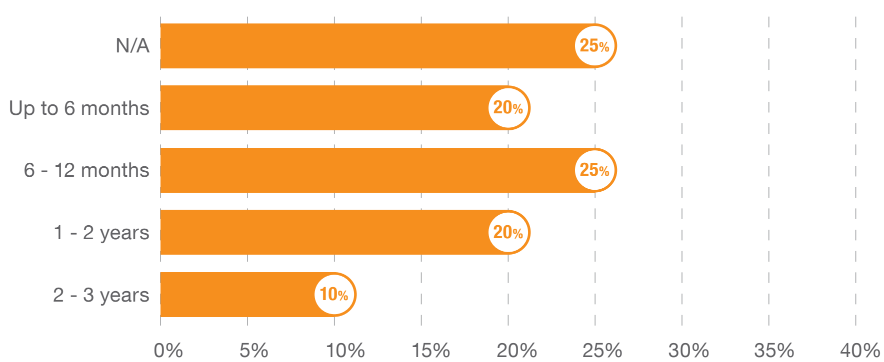
Our survey results showed that compared to 2017, for commercial banks, the number of respondents where foreclosure on collateral took over 1 year reduced from 83% to 71%. This is a positive trend likely to have been influenced by more aggressive approaches by banks to make recoveries on non performing loans.

Figure 12: *Average foreclosure period for banks*



The time required to foreclose on collateral was also identified as an issue among the NBFIs. When asked to state the length of time it takes to realise cash flow from collateral held on those loans that defaulted, over 55% of respondents stated that on average, it took them a period of between 6 months and 3 years, while 25% of the respondents reported no challenges with foreclosure process. The relatively lower rate when compared to commercial banks, as well as the fact that 25% of the respondents did not see foreclosure as an issue, may be due to the fact that most NBFIs obtain lower value collateral which is easier to realise.

Figure 13: *Average foreclosure period for NBFIs*



Salary backed loan concentration for NBFIs

The following was put to NBFIs: "Lending by some NBFIs is concentrated on salary-backed loans to employees of Government and Government agencies. What are the three main causes for this concentration?"

Respondents indicated that the biggest motivation was the perceived low credit risk that Government workers posed as a result of stable employment and low employee turnover. Other reasons included were that workers were easy to locate in terms of default as well as low collection costs (payments are almost guaranteed).

The above factors were also listed as the main reasons why NBFIs are less likely to diversify from salary-backed loans. However, recent challenges experienced regarding timely collections of amounts due may result in a re-evaluation of this strategy.

The three major challenges identified as the cause of delays in foreclosure include the lack of willing buyers, a slow judicial system, and high legal costs required to complete the court processes.

IFRS 9-Implementation

Implementation of IFRS 9 was identified by commercial banks as the third most pressing issue in 2018, while non-bank institutions ranked it fourth. This variation in ratings is expected given the different credit exposures arising between the two groups of financial institutions.

Billed as one of the most complex and demanding accounting standards of its time, the implementation of IFRS 9 was not expected to be smooth based on responses to our 2017 survey. Successful implementation of the standard requires input from different operational functions and a range of skills including those of actuaries and economists. The difficulty of implementation has been compounded by the fact that most players in the Zambian market did not start implementing their compliance projects early.

That said, the first year of IFRS 9 implementation has come and gone and, with the exception of a few entities in the market, most institutions have either completed the adoption and implementation, or are about to conclude their implementation projects. Our survey results show that 100% of the banking sector and 85% of NBFIs had adopted and implemented IFRS 9 by the end of 2018.

In light of this, we asked the question:

"What have been the most challenging aspects of IFRS 9 implementation for your institution?"

Both sets of respondents said that model building and gathering forward-looking information was the biggest challenge in the implementation of the standard. Technically, these two are interrelated as forward-looking information is needed for a model to be compliant. Based on our experience helping some of the local entities in the market, we have noted that these two issues tend to be a challenge as they require the implementing organisation to make use of skills, such as actuaries, that are not readily available in Zambia.

Apart from the two issues, banks and NBFIs identified obtaining relevant data as another issue that presented a challenge. Further details about the challenges brought about by the implementation of IFRS 9 for banks and NBFIs are presented as below:

Figure 14: *Challenges in implementation of IFRS 9-Banks*

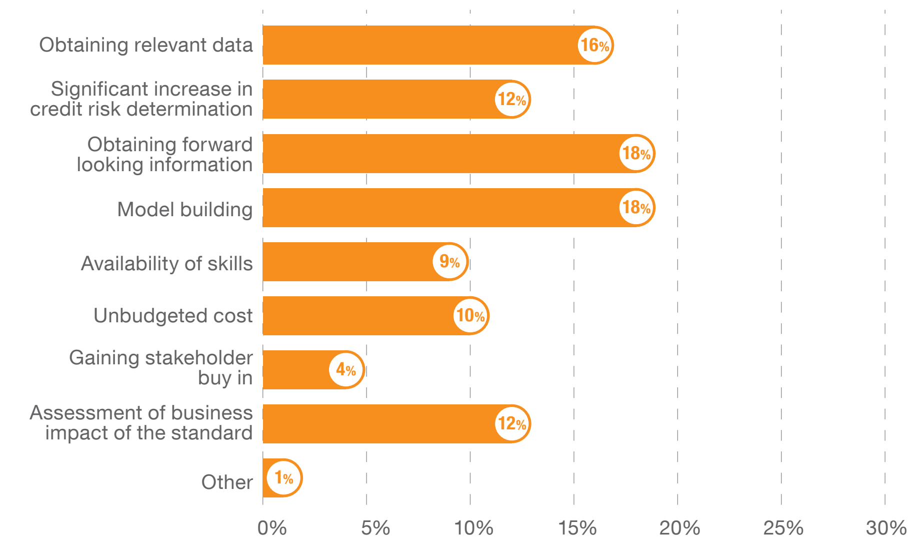
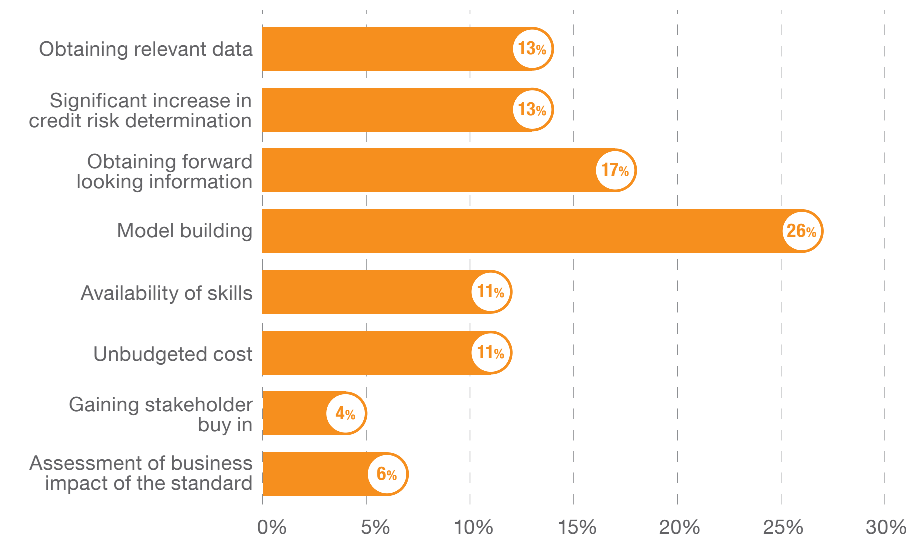


Figure 15: *Challenges in implementation of IFRS 9-NBFIs*



On the upside, we noted that respondents have identified benefits from the adoption and implementation of the standard. These range from improved credit risk management to benefits enhanced disclosures of credit risks and exposures in financial statements. The top five benefits were;

Table 7: *Benefits from implementation of IFRS 9*

No	Banking sector
1	Improvement in the quality of the loan book
2	Assessment of viability of the entire portfolio as forward looking
3	Improved pricing based on risk
4	Improved business processes and decision making
5	Enhanced collaboration between business lines, risk ,credit and finance

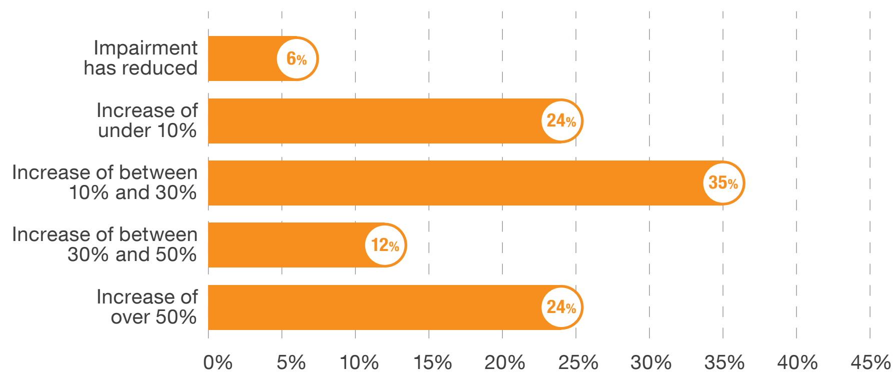
Interestingly, while the implementation of IFRS 9 was a key issue for banks and NBFIs as a whole, it was not a significant issue among the country's six largest banks.

Although not evident from the survey results, we believe this is because all but one of the six largest banks in our survey have group relationships on which they relied for the successful implementation of the standard. For these banks, IFRS 9 projects started as far back as 2014/15, giving them more than sufficient time to implement the standard.

IFRS 9's Impact on Loan Loss Provisions

Among banks, over two thirds of those surveyed said they had experienced an increase in loan loss provisions of 10% or more, with almost a quarter of banks saying loan loss provisions had increased more than 50%. At the other end of the scale, less than a quarter of banks reported an increase in loan loss provisions of less than 10%, while 5% of participants indicated a reduction in impairment.

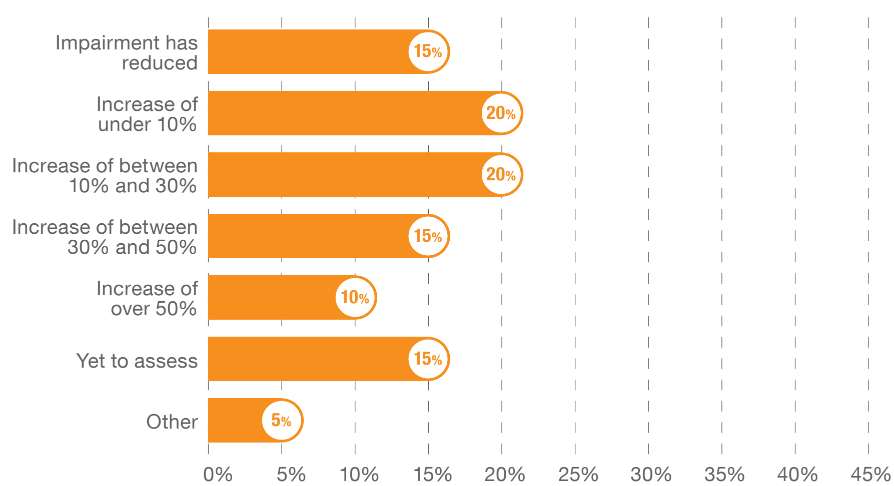
Figure 16: *Impact of IFRS 9 on loan loss-Banking sector*



As with banks, the impact of IFRS 9 on NBFIs was mixed. 45% of NBFIs said they had recorded an increase in loan loss provisions of 10% or more, with the majority of those seeing an increase in provisions of between 10% and 50%. Twenty percent said they had seen an increase of provisions of less than 10%, and 15% said impairments had been reduced.

Unlike in the banking sector, results from the NBFIs show that 15% of respondents were yet to assess the impact, which, given the timing, is a worrying statistic.

Figure 17: *Impact of IFRS 9 on loan loss–NBFIs*



IFRS 9 – The Next Stage

Based on our experience working with local and international financial institutions in their IFRS 9 implementation projects, we have noted that implementation of IFRS 9 enables entities to have a better view of the consequences of their lending practices. This is reflected in both the historical trend analysis as well as the forecast trends which IFRS 9 implementation requires. Entities are now able to decide whether the historical trends – with the help of forward looking information – should be carried forward or not.

Financial institutions should now build on the implementation project undertaken and move away from seeing IFRS 9 as a project to business as usual. We expect the application of IFRS 9 to be an issue for the industry for the next two to three years as financial institutions continue to refine the impairment models as their understanding of the standard improves and more quality data becomes available.

Areas that need to be addressed in 2019 and thereafter include:

- Back testing of 2018 assumptions – Will the assumptions used in the first year be confirmed as reasonable when compared to the actual results for the year are compared? This “look back” procedure is not only a requirement but is considered best practice.
- Automation of models – Some of the challenges noted in the implementation of IFRS 9, such as data source and input of other operational departments, will require financial institutions to upgrade their systems. The use of manual standalone models, in most cases excel based, while good because of ease of use and easy audit trail is not optimal given the susceptibility to excel to errors.
- Further segregation of institutions’ customers and risk management to make sure the correct provisions are calculated for each customer segment.
- Training of in-house staff and retention of skills – With the Bank of Zambia now requiring financial institutions to report both the statutory loan loss provisions and the IFRS 9 provisions, financial institutions cannot afford to rely on the outside consultants who were engaged by them during the implementation phase. Instead, institutions need to ensure that their own staff have the necessary skills.

Another aspect the financial institutions will need to deal with in 2019 and beyond is the impact of delayed Government remittances of loan repayments from Government loan schemes.

From the IFRS 9 perspective, Government delays in making remittances are considered an indication of a significant increase in credit risk and lead to an increased probability of default, and, ultimately, an increased expected credit loss. This is because in normal instances Government backed loans are categorised as stage one or performing loans. Delays in receipt of cash may mean that the loans will migrate to stage two, those loans with a significant increase in credit risk, for which the probability of default is significantly higher as it is measured to the life of the loan.

The standard does allow for rebuttal of the 30 day “back stop”, i.e override of the presumption that any loan that is more than 30 days overdue has experienced a significant increase in credit risk. However, persistent breach of this requirement would result in a less convincing argument that the risk has in fact not increased. So whereas it can be argued that the arrears are “technical” and will cure as the amount is due from Government, if there is no absolute cure of the arrears and the situation continues in perpetuity the argument is diminished. The expectation is that rebuttal would probably be more convincing for “one-off” situations as opposed to situations where breaches become repetitive.

The situation is exacerbated by the fact that in most cases, no collateral is held against salary-backed loans. The limited opportunity for recovery of any portion of the loans given the lack of collateral means that the resultant losses recorded are significant.

It is hoped the delays experienced in remittances will be resolved before the industry is impacted significantly.

Top issues for commercial banks - but not NBFIs

Improving Revenue Growth

Although two different issues, improving revenue growth and managing costs are in most cases seen as complementing each other. Where revenue growth cannot be attained, most entities will switch to managing their costs, while revenue growth without managing costs may be a futile exercise in achieving financial targets.

For banks, the case for managing the usually high cost of funding means that revenue growth may not be obtained from the funded income. Banks therefore see the non-funded income as a target where revenue growth can be attained due to the fact that, in most cases, the non-funded revenue streams are accompanied by relatively lower costs. In addition, these costs are within the control of the entity as opposed to with funded income.

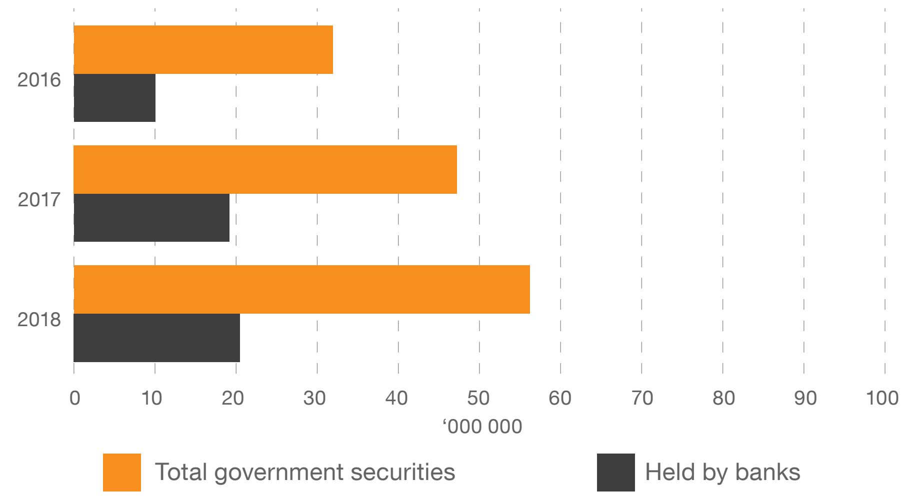
The survey showed that in 2018 banks recorded revenue growth in net interest and other income when compared to 2017. This increase in net interest and other income is supported by a significant reduction in the interest expense, which recorded a 24% reduction. This was largely on account of the repricing of expensive deposits that were contracted during the liquidity crunch not too long ago. Overall the banking sector generated a total of K8.3 billion (2017: K7.3 billion) net interest and other income, which represented an increase of 14% (2017: 11.7%) for the industry.

An analysis of the sector's revenue sources shows that year-on-year the banks' net interest income increased from K4.1 billion to K4.7 billion, or an increase of 17.4% (2017:15.6%), while the net non-funded income increased from K3.2 billion to K3.6 billion or 9.8% (2017: 7.2%). The increase in the net interest and other income was mostly supported by growth from interest on government securities and the increase in other income.

Interest from government securities

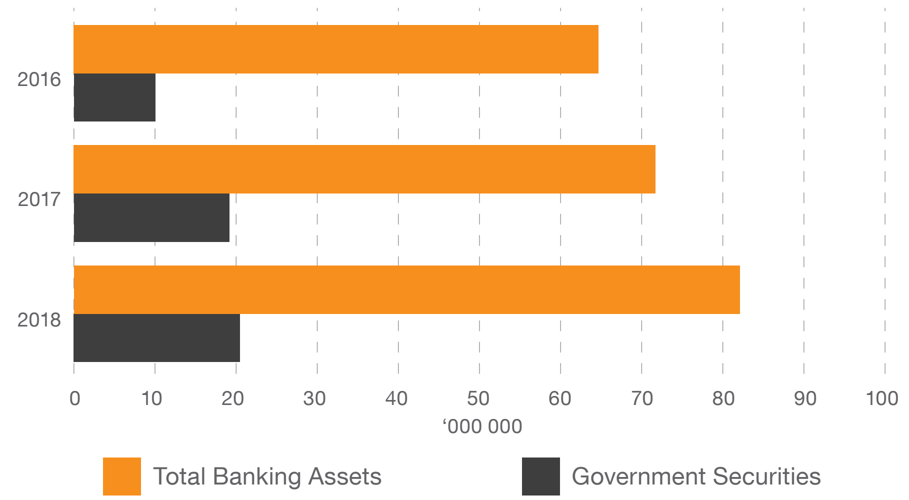
Though the revenue growth in the banking sector was propelled by interest from Government securities, it is worth noting that, on average, the total exposure to securities taken on by banks was relatively flat year-on-year as shown below.

Figure 18: *Investments in Government securities*



Source: Bank of Zambia

Figure 19: *Government securities as a percentage of total industry assets*



Source: Bank of Zambia

If the investments were the same between 2017 and 2018, how did the banks then record a growth in the interest revenue from Government securities? Our analysis shows that the answer lies in the fact that since 2018 yields on Government securities have taken an upswing. The year opened with rates of 15.38% and 18.56%, and closed at 21.30% and 20.12% for treasury bills and Government bonds respectively.

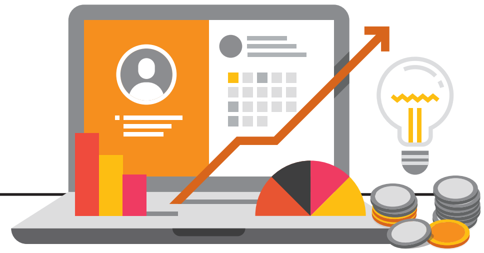
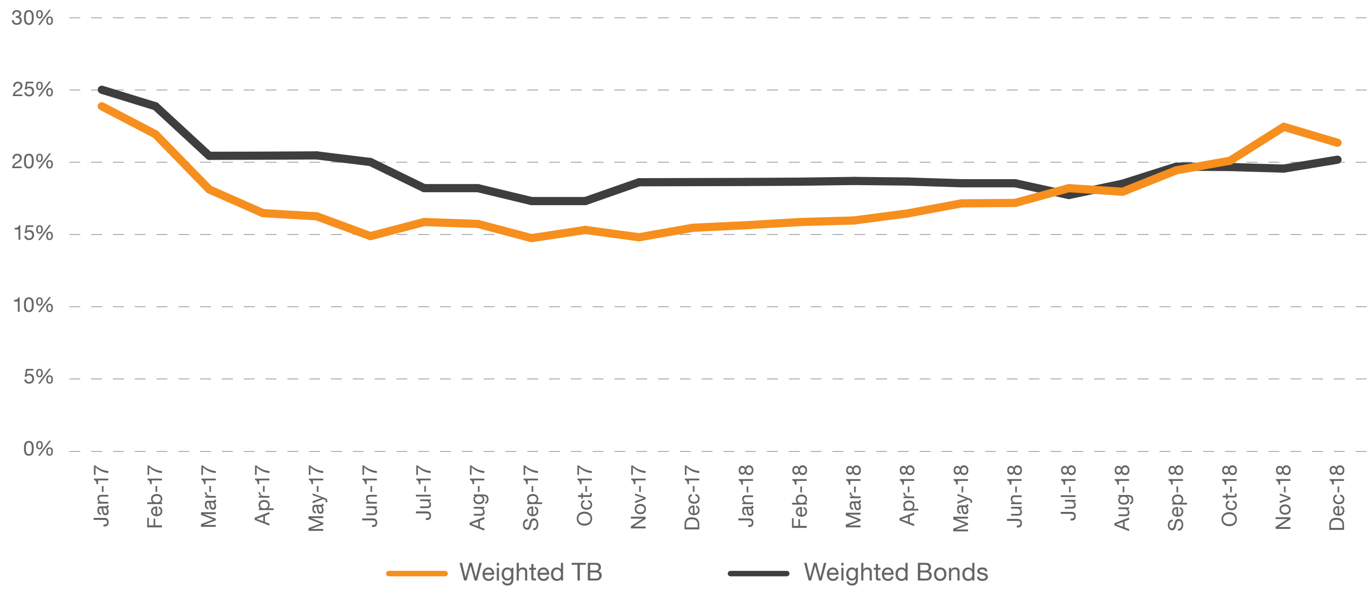


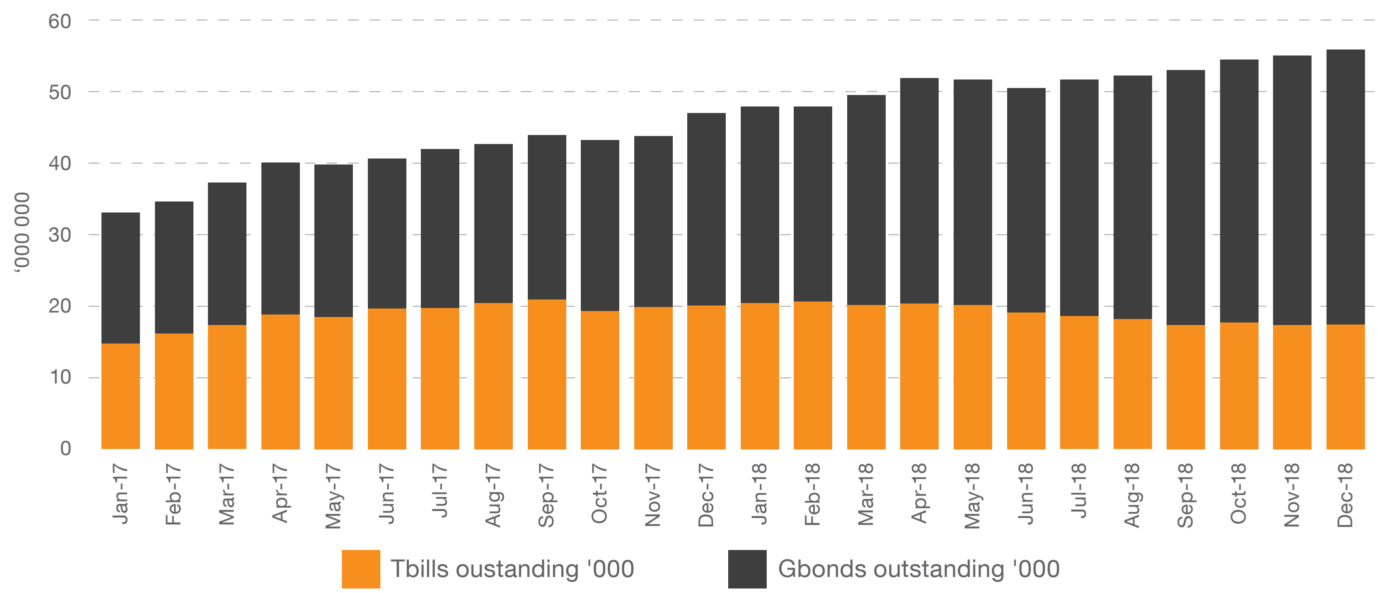
Figure 20: *Monthly trend in stock of Government securities*



Source: Bank of Zambia

Further analysis of the split between treasury bills and bonds as investments in government securities show that overall there is a shift to increase investments in bonds rather than treasury bills.

Figure 21: *Monthly trend in stock of government securities*

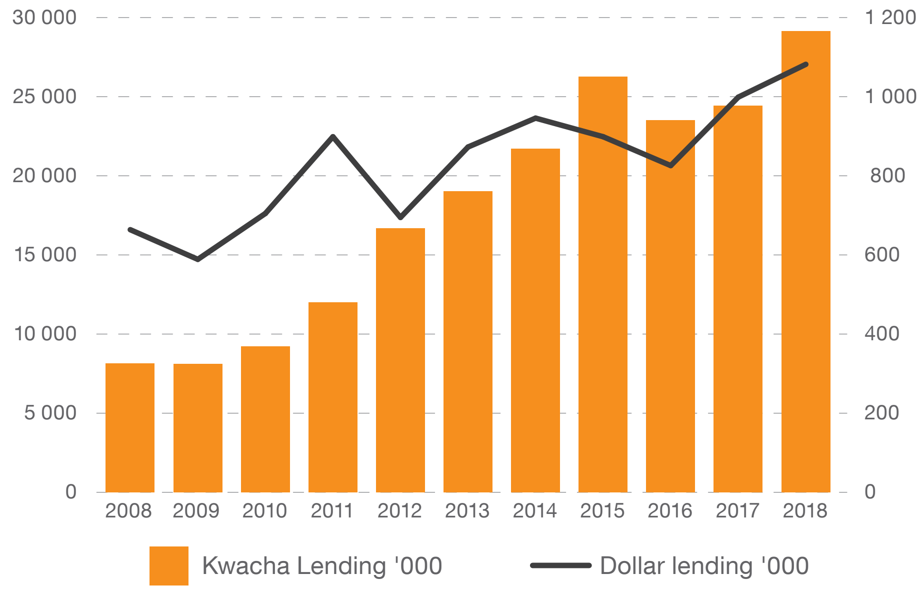


Source: Bank of Zambia

Interest from loans and advances

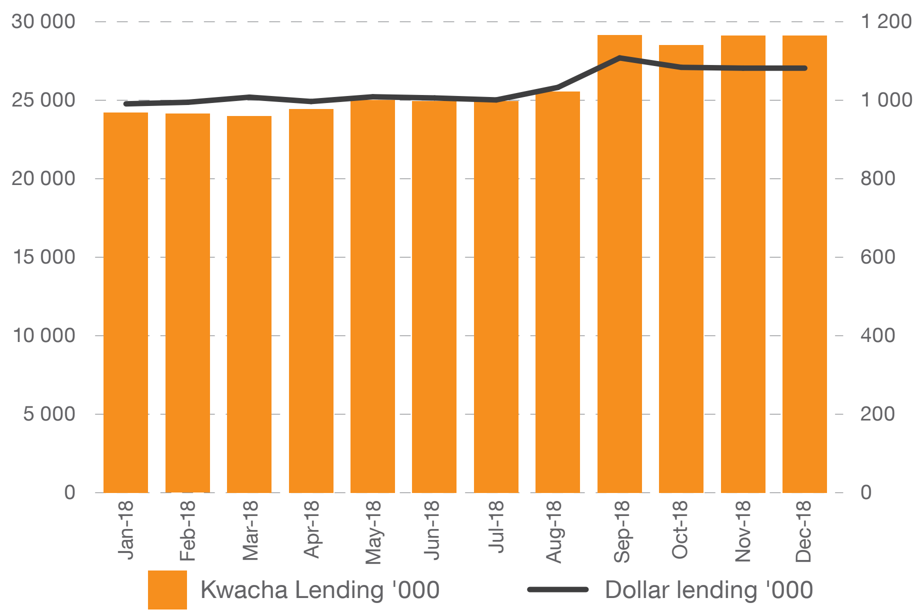
The sector recorded a marginal reduction in the gross interest income from their traditional product offering, loans and advances to customers. The total interest recorded in the current was K3.97 billion compared to K3.93 billion. This was despite the fact that overall, the average credit outstanding in 2018 when compared to 2017 showed an increase of 8% as shown below.

Figure 22: *Average credit outstanding*



Source: Bank of Zambia

Figure 23: *Average month end outstanding*



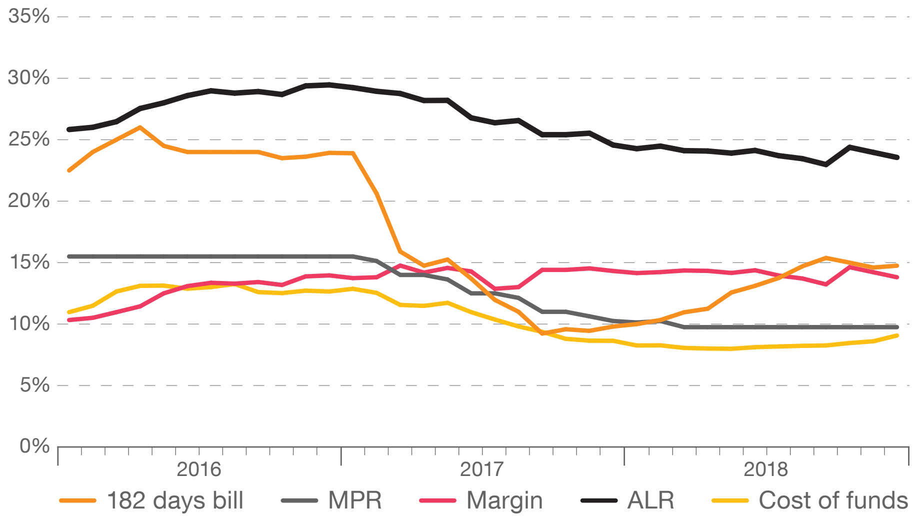
Source: Bank of Zambia

The rate of growth observed for interest income from loans and advances was mostly affected by the trend in interest rates. We analysed the interest rates as published by the Bank of Zambia and noted the following:

- A reduction in the Bank of Zambia MPR, which started the year at 10.25% and ended at 9.75% after having been adjusted in February 2018;
- A marginal reduction in lending margins from 14.31% in January 2018 to 13.88% in December 2018;
- An overall reduction in the average annual lending rates from 27% for 2017 to 23.92% for 2018.

There was also a general reduction in the cost of funding during the year. On average, the cost of funds in 2018 reduced from 10.57% to 8.29%.

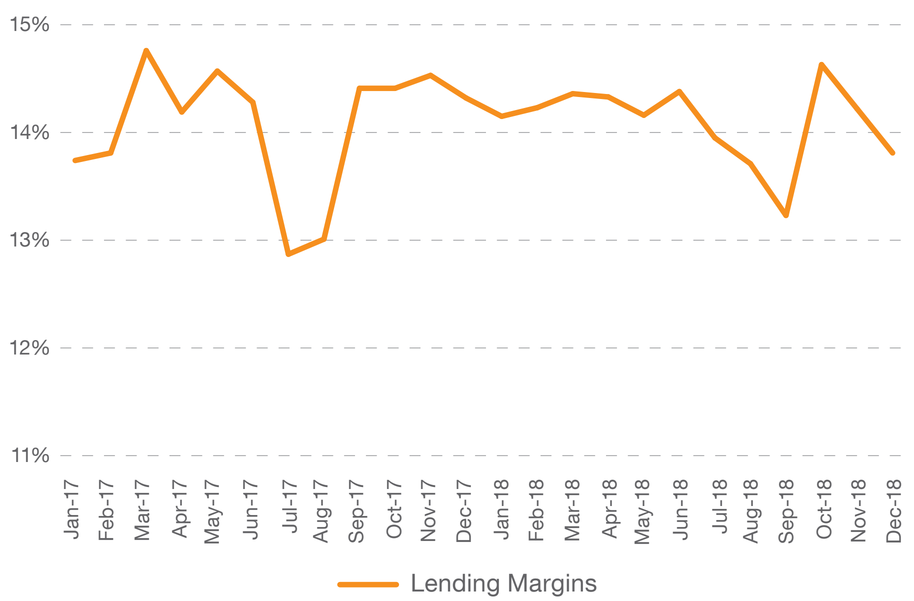
Figure 24: *Average interest rates*



Source: Bank of Zambia

A close scrutiny of the lending rates showed that while the margins were stable during the year on average, there was an unexplained slip recorded in September 2018.

Figure 25: *Lending margins trends*



Source: Bank of Zambia

Non-Funded Income

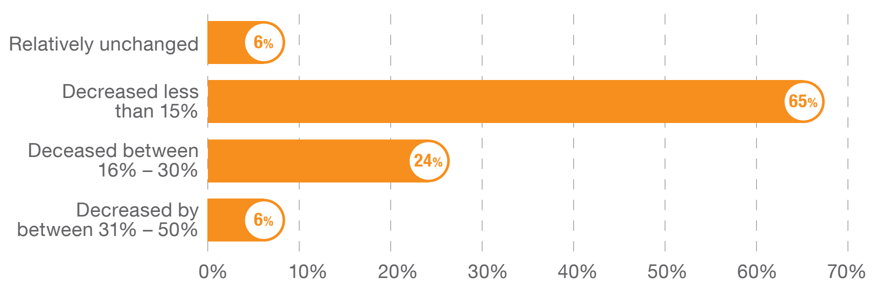
The major source of non-funded revenue for the banks in 2018 related to foreign currency transactions, with an increase of total non-interest revenue of 9.8% from K3.2 billion to K3.6 billion. Of this, foreign currency transactions made up 28% of the current year's balance.

Abolishment of unwarranted charges and fees

In 2018, the Bank of Zambia moved to curtail the number of fees and commissions charged by banks to their customers. The regulator published a comprehensive list of fees that banks would not be able to charge effective from September 2018 in their directive, The Bank of Zambia Prohibition Against Unwarranted Charges and Fees. Noncompliance with the directive is regarded as an offence and financial institutions that do not adhere to the rules are liable upon conviction to a fine or imprisonment not exceeding two years or both. In line with the Banking and Financial Services Act, this conviction may be extended to directors and other senior staff members being imprisoned or fined while the entity may be fined.

It is perhaps too early to assess the full impact of the abolishment of these fees and commission on the sector given that the rules came into force in the third quarter of 2018. However, when asked the question "In percentage terms, what has been the impact on monthly revenue as a result of the abolishment of unwarranted fees and charges?" 65% of respondents estimated a reduction in their monthly revenues of up to 15%, while 24% of the respondents recorded a reduction of between 16%-30%.

Figure 26: *Impact of monthly revenue as a result of the abolishment of unwarranted charges and fees*



Source: Bank of Zambia

Given this impact, we sought to establish how the banking sector had reacted to the directive.

Two themes were observed: cost control and reduction; and new product development. In terms of cost management, respondents highlighted measures such as the delay of planned investments, staff retrenchments, development of alternative cost efficient channels, and other cost control initiatives. For product development, banks indicated development of new offerings as an area being explored, whilst optimising revenues from remaining products and services was another.

All in all, the sector's revenue from fees and other charges recorded an increase from K1.97 billion to K2.19 billion or 10.9% when compared to 2017 despite the introduction of the directive. It's full effect will be seen in 2019.

In 2019 and beyond, banks will need to think outside the box as the regulation of fees and charges may continue. Our understanding is that the scope of the current abolishment represents Phase I of a broader project designed to reduce the cost of banking in Zambia. Phase II of the project is expected to focus on the pricing structure of the remaining fees and commissions. Once both phases of the project have been implemented, this will certainly change the landscape of non-funded income in Zambia. Consequently, banks will have to hasten their development and deployment of strategies designed to mitigate the impact of lost revenue.

The challenge for the Bank of Zambia is to carefully execute what is undoubtedly a delicate balancing act of reducing the cost of banking without the unintended consequence of discentivising banks from investing in the sector.

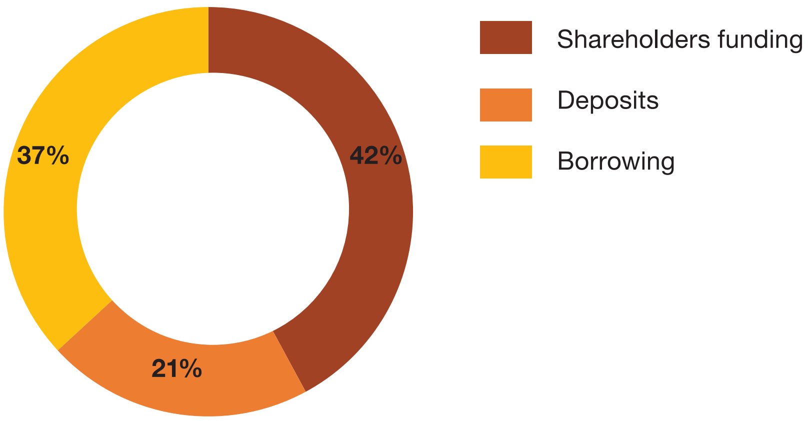
Top Issues for NBFIs but not banks

1. Liquidity

The availability of resources to fund balance sheet growth as well as enhance institutional capacity remains a core issue for NBFIs. Unsurprisingly, NBFI respondents ranked Liquidity as the third most pressing issue they faced.

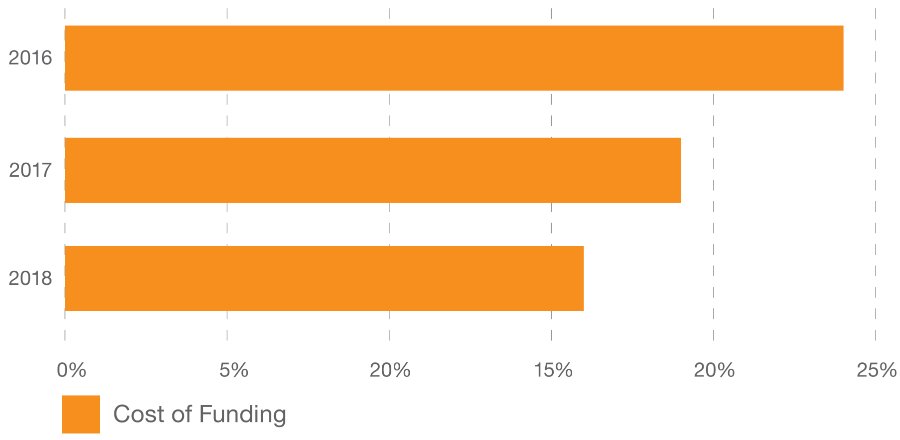
Respondents reported their main sources of funding as depicted in Table 1: Source of funding. The main source of funding is shareholder equity and loans, usually in the form of direct investments made by the owners of the NBFIs. This accounts for 42% of NBFIs' funding. Other key sources include borrowing from related or third parties (37%) and deposits which account for 21%. Unlike Banks that have access to affordable deposits, the majority of NBFIs are non-deposit taking making it more challenging to access liquidity that is readily available and affordable. As a result, majority of this funding still comes at a high cost.

Figure 27: *Sources of Funding*



According to Bank of Zambia statistics, while the average cost of funding has reduced from 24% in 2016 to 16% in 2018, this remains relatively high. The high cost of capital adversely affects NBFIs, posing a challenge on how to competitively price products,be cost effective and positively manage liquidity. See Figure 28: Cost of Funding below.

Figure 28: *Cost of funding*



Source: Bank of Zambia

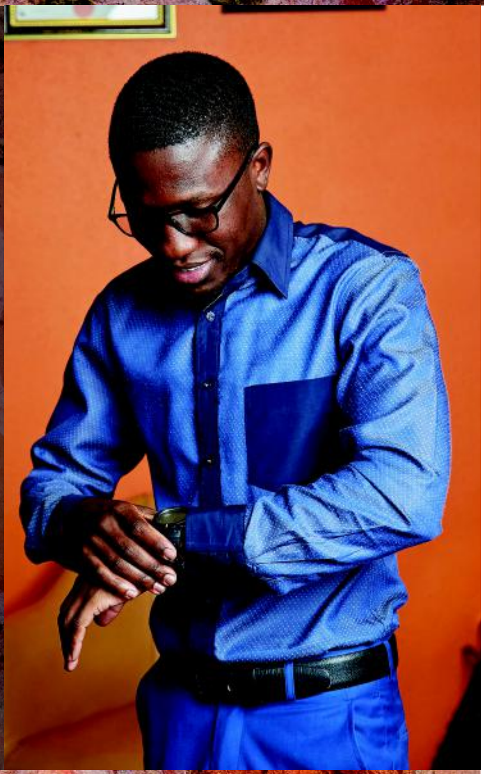
If cheaper more flexible sources of finance can be obtained, NBFIs will be able to better manage their liquidity needs, both for business growth and day-to-day operational obligations.

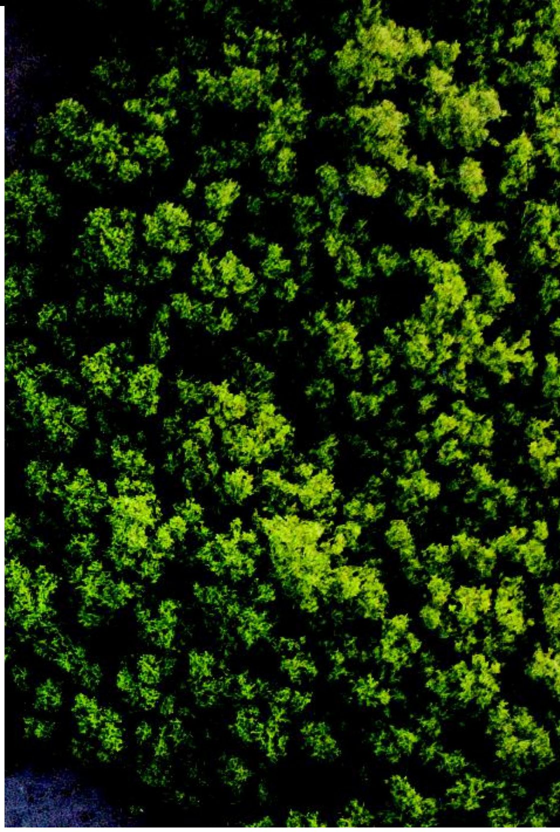
2. Client retention

Survey respondents reported that client retention is an ongoing challenge for the Non Banking sector. This is driven by low switching costs, lack of customer loyalty, the need for quick cash and the state of the local economy.

A typical customer in this sector, generally demands less complex products and is primarily intersted in a swift turnaround of funds. This need for quick cash means that NBFIs must run an adaptable business model that can respond easily to changing customer needs and a rapidly growing competitor landscape. NBFIs with more liquidity are able to gain a competitive advantage by offering more flexible repayment plans.

According to Survey respondents salary-backed loans to civil servants, are the largest market for NBFIs. Because of the ease of making deductions through the Payroll Management and Establishment Control system (PMEC), NBFIs have generally exhibited low motivation to diversify from lending to this customer base. This has led to increased competition and intensified cannibalisation among lenders.





A view from the region

The three most significant issues highlighted in our East Africa Banking Survey were as follows;

Table 8: *East Africa Banking Survey*

East Africa Banking Survey	
IFRS 9 implementation	**(45%)**
Interest rate cap	**(18%)**
Competition from non-bank institutions	**(16%)**

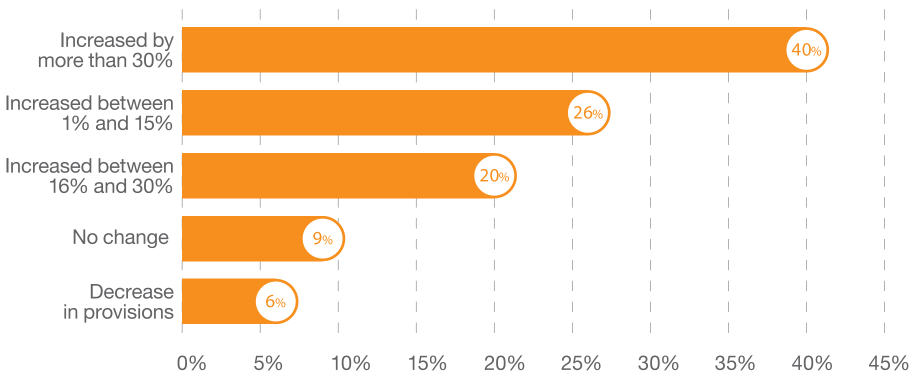
In addition to the above issues, credit and compliance were risks identified as affecting banks in the region.

IFRS implementation

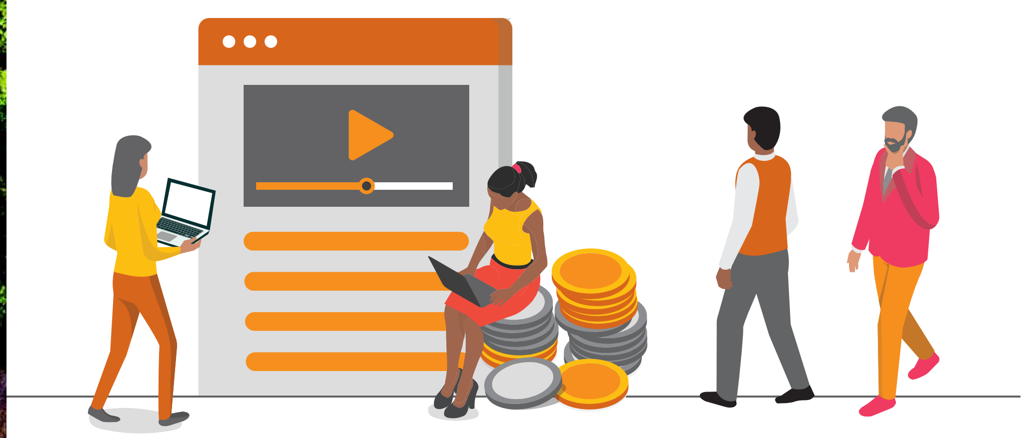
IFRS 9 implementation was ranked as the issue of greatest significance that affected commercial banks in 2018.

In terms of overall impact, the trends observed with regards changes to impairment following implementation of the standard was relatively consistent with the findings for Zambia.

Figure 29: *Impact of IFRS 9 on loan loss provisions for East Africa Banks*



Source: PwC East Africa banking survey



Challenges were encountered developing models for the purpose of computing Expected Credit Losses.

These included:

- Forecasting future information (73%)
- Estimating exposure at default parameters for off-balance sheet instruments (62%)
- PD model estimation - availability of historical default rates and determination of forecast horizons (46%)
- LGD model estimation - Availability of reliable collateral values (38%)
- Exposure at default for revolving facilities (30%)

A variety of approaches were adopted to comply with IFRS 9. It is expected that the models developed will be enhanced in 2019 and onwards as commercial banks develop a better understanding of the standard and as data gaps and shortcomings observed in the adoption phase are remediated.

3. Interest rate capping

This issue, although unique to Kenya, was the second highest rated issue. This is, most likely, a reflection of the broad impact that the issue had on commercial banks in the country. Zambia did have a similar regime between 2013 and 2015.

A total of 63% of respondents in Kenya indicated that the introduction of the interest rate cap reduced their Net Interest Income by between 1%–15%, whereas 37% reduced it by 16%–30%. When asked about the tactical or strategic steps that they are taking to respond to challenges posed by the interest rate cap, the majority of respondents indicated that they are reducing operational costs (33%) and growing focussed on growing their non-funded income (25%).

4. Competition from non-bank institutions

There is a general acceptance that non-bank institutions are now offering products and services that compete directly with solutions traditionally provided by commercial banks. The nimble approach of the merging competitors and the quick uptake of new offerings by customers make this a matter that can not be taken lightly.

According to PwC's Global Retail Banking 2020 survey 55% of bank executives view non-traditional players as a threat to traditional banks. Interestingly however, this issue of competition from non-banks was ranked 23rd by the banking industry as a whole and by the top six banks and 22nd by the banks outside the top six in Zambia. This is despite the apparent exponential growth of some of the players that are providing similar or substitute products and services to what commercial banks provide and the survey response provided where 70% of commercial banks indicated that there is a risk of part of their business being lost to non traditional competitors like fintechs within the next five years.

5. Credit risk

Across the region, the top contributors to credit deterioration were as follows:

***Table 9:** The top contributors to credit deterioration*

Contributor	% of respondents
Economic Slowdown	56%
Poor credit underwriting	28%
Delay by government to pay large contractors	25%
Over-exposure in certain sectors	22%
Diversion of funds by borrowers	22%
Fraud	14%

Although the average GDP growth in 2017 for East Africa was 5.9% according to the African Development Bank, there was a slowdown in Kenya due to the extended electioneering period in 2017 and a slight slowdown in Tanzania, whereas there was an uptick in Uganda and Rwanda.

The levels of non-performing loans (NPL) was influenced by high levels of government debt, a challenging economic environment and high interest rates. Generally, banks in the East Africa region are implementing several measures at the same time to alleviate credit deterioration.

Other topical matters

Tax compliance and management - a major risk

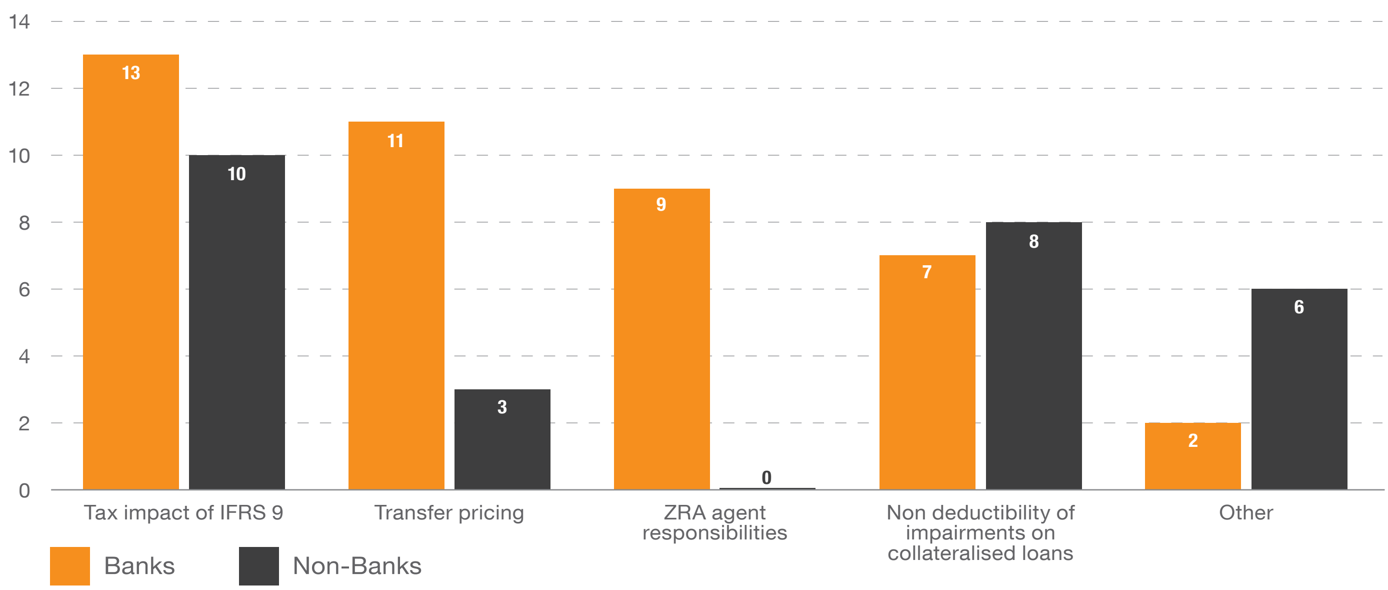
At a headline rate of 35% of a financial institution's bottom line, corporate income tax - and tax in general - is one of the most significant expense lines for commercial banks and NBFIs.

As a result, taxes present a significant risk to banks and NBFIs. This is exacerbated by the significant penalties and interest levied by the Zambia Revenue Authority (ZRA) for non-compliance. Therefore, banks and NBFIs require proper and careful management to ensure the risk is mitigated sufficiently.

With this in mind, we included a number of questions on critical tax matters that affect the sector and solicited responses on how these affected survey participants.

What were the issues?

Figure 30: *Taxation*



Source: PwC East Africa banking survey

Non-Deductibility of Loan Impairment Provisions for Corporate Income Tax Purposes

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

This matter was noted as an issue by seven commercial banks and eight NBFIs.

Changes to Impairment Provisions Required Following the Advent of IFRS 9 Financial Instruments

Following on from the matter above, the changes to the basis for impairment provisions on account of the adoption of IFRS 9 have resulted in increased impairments being recognised, and therefore additional tax liabilities. This is the most pressing tax issue for banks and NBFIs. Respondents have expressed their concerns about the additional tax liabilities brought by the significant changes in the impairment provisions after the adoption of IFRS 9, which came into effect on 1 January 2018.

This matter was noted as an issue by 13 commercial banks and 10 NBFIs.

Enhanced Transfer Pricing Regulations that Carry a Maximum Penalty of K24 Million

Transfer pricing has become a significant tax issue for both businesses and the tax authorities and this has been reflected in our survey where banking respondents ranked it the second most impactful tax matter.

The fundamental principles underpinning the enhanced transfer pricing regulations is that related party transactions must be at arm's length and that appropriate documentation articulating how this is achieved be in place. Compliance with these regulations is a now a key area of focus for businesses in Zambia, in no small part due to the significant penalties that non compliance may attract such K24 Million and possible imprisonment of directors.

Prior to 2018, there was no explicit statutory requirement to prepare and maintain transfer pricing documentation. In 2018, the ZRA issued revised transfer pricing regulations containing Zambia's new transfer pricing documentation rules for Zambian groups whose revenue exceeds K20 million and for multinational enterprises. The regulations cover record-keeping requirements for Zambian resident taxpayers that entered into related party transactions in the year under review. The regulations are effective for tax years beginning from 1 January 2018 and documentation should be in place at the time of submitting the corporate income tax return i.e. by 21 June.

It is worth noting that Zambia has had transfer pricing legislation since 1999. Thus notwithstanding the lack of detailed documentation rules prior to 2018, the ZRA expect tax payers to have in place transfer pricing documentation that demonstrates that transfer prices are consistent with the arm's length principle for years that precede the 2018 amendments and fall within the statute of limitation (which was six years as at 1 January 2018).

In addition to the above, effective from 1 January 2019 there has been an increase in the statute of limitations for transfer pricing purposes from six years to 10 years plus an increase in the penalty for non-compliance with transfer pricing regulations from 10,000 penalty units to up to 80,000,000 penalty units (i.e. from K3,000 to K24 million).

Given these legislation updates, transfer pricing has become a focal point for companies. With the majority of banks having related party transactions, banks will need to ensure that they have transfer pricing policies in place which are duly supported with appropriate documentation.

A number of commercial banks are part of multinational groups that are often organised in a manner that enables them to benefit from the economies of scale that accrue to large entities. The level of integration and volume of transactions between the local entity and group companies varies widely from minimal banking-related transactions to highly integrated structures that include shared service centres that execute ongoing tasks as part of business as usual. In contrast, most of the NBFIs have significantly less related party transactions. As a result, this was noted as a significant tax matter by 11 of the 18 commercial banks but only three of the 23 NBFIs that responded to the survey.

Administrative Responsibilities Relating to the Appointment of Banks as Agents of ZRA

Under the various tax acts banks can be appointed as agents of ZRA for collection of tax at source, mainly for recipients of funds from banks for services rendered or from bank customers. This results in an additional administrative responsibility for the banks and has been highlighted as a matter of concern by 9 of the 18 respondents. This matter appears not to affect NBFIs as none of the respondents highlighted it as a concern. However, it is possible that those which are deposit taking could be appointed as agents by the ZRA to execute various functions.

Other Matters

The restriction of carry forward tax losses to five years is another challenge noted by survey respondents. A number of financial institutions, especially NBFIs, said that having incurred significant start-up costs followed by a lengthy period before breaking even, the time horizon does not always allow for recovery of tax losses incurred. This ultimately results in a higher set-up cost for an already capital intensive business.

Strategies for Managing Tax Risk

In response to our follow-up question about how the various tax risks are being managed, respondents indicated that a range of actions are being undertaken. These included engaging external consultants, and lobbying through industry associations and the Bank of Zambia.

It is clear from the responses that management of tax risk is important for financial institutions. Ultimately, having a proactive strategy for managing tax risk, supported by a structured tax function and the implementation of controls to manage the risks, is critical. Given the drive by Government to increase taxpayer compliance, effective tax management is an issue requiring urgent attention.

Sales Tax and its Likely Impact on the Cost of Doing Business

Although sales tax was not part of the survey, it is likely to have an impact on the industry. Therefore, it bears mention that following the announcement in the 2019 National Budget speech, read by the Minister of Finance Margaret Mwanakatwe on 28 September 2018, the Sales Tax Bill has now been shared. It is intended to repeal and replace the Value Added Tax Act that was enacted in 1995.

The objective of the Bill is, amongst others, to: introduce sales tax on the supply of goods in Zambia on/by manufacturers, producers, distributors, wholesalers and retailers, and importers of goods into Zambia; impose a sales tax on the supply of services in Zambia by service providers and importers of services; and exempt certain supplies, imports and exports of goods and services from sales tax.

The Bill proposes a two-tier rate system: a 9% sales tax to be imposed on all qualifying domestic supplies of goods and services, and 16% on imports of goods and services.

A key distinction between VAT and sales tax is that VAT has a credit system which ultimately translates into the final VAT being borne fully by the consumer of the goods or services. On the other hand, sales tax based on the Sales Tax Bill appears to have a cascading effect.

Put simply the cascading effect results in tax being levied on tax. If sales tax is levied on a good or service at each stage of the production process up to the point of being sold to the final consumer (with each successive transfer being taxed inclusive of any previous sales taxes) then the end tax amount will be greater than the stated/headline tax rate.

Based on information that came to bear during public consultations with trade associations leading up to the issuance of the Bill, indications were that items that are currently not subject to VAT (either because they fall under the exemption or the zero-rated schedule) will be exempt from sales tax. Thus the expectation is for all financial institutions currently falling under the above two schedules to be exempt from sales tax.

In any case, banks already absorb the VAT costs as they are not permitted to claim VAT on their purchases. Therefore, all other factors remaining constant, the costs absorbed on local purchases is likely to reduce - assuming a minimal cascading effect.

Technology

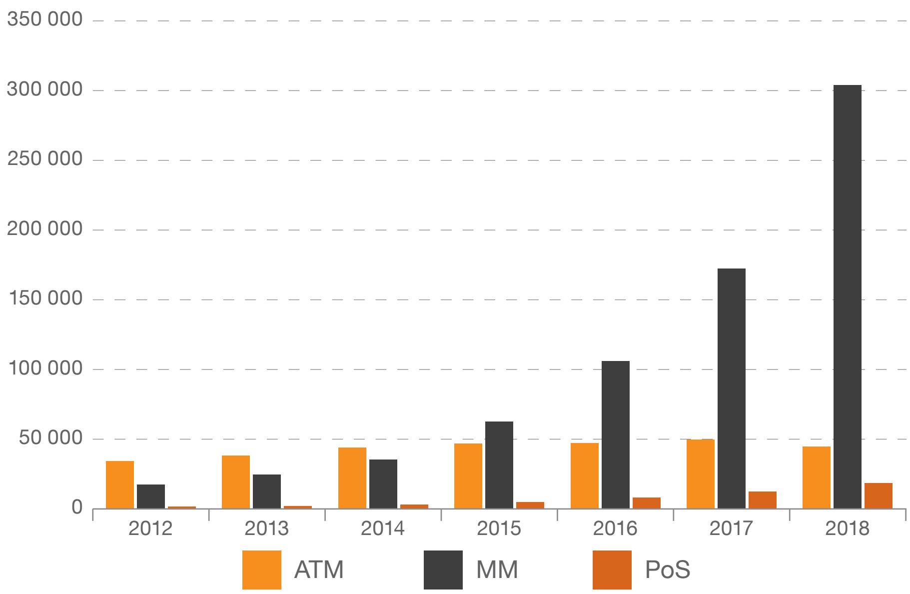
The world continues to gravitate towards technology based products and services. The wide availability of affordable devices coupled with the desire by customers to have real time access to convenient financial services have driven the rapid uptake to innovative service offerings. At the same time, financial institutions have been incentivized to invest in technology enabled solutions in order to improve efficiency, enhance customer experience and roll out cutting edge services, all at a lower cost than that required for traditional channels.

Fewer and fewer “brick and mortar” branches are being constructed as commercial banks and NBFIs “Go Digital”. Factors such continued cost pressure, competition – especially from non-traditional players and revenue growth challenges have meant that most players have technology and digitization as a critical success factor in order to achieve strategic goals.

That said, according to PwC’s *2018 Global Digital Banking Consumer Survey*, 65% of consumers believe that it is still important to have a local bank branch, and 25% would not open an account with a bank that did not have at least one local branch. Consumers still value the ability to ask for help and be guided through the process – in person. At the same time, traditional banks’ business is at risk from FinTech disruption. FinTechs are targeting services like payments, funds transfer and personal finance.

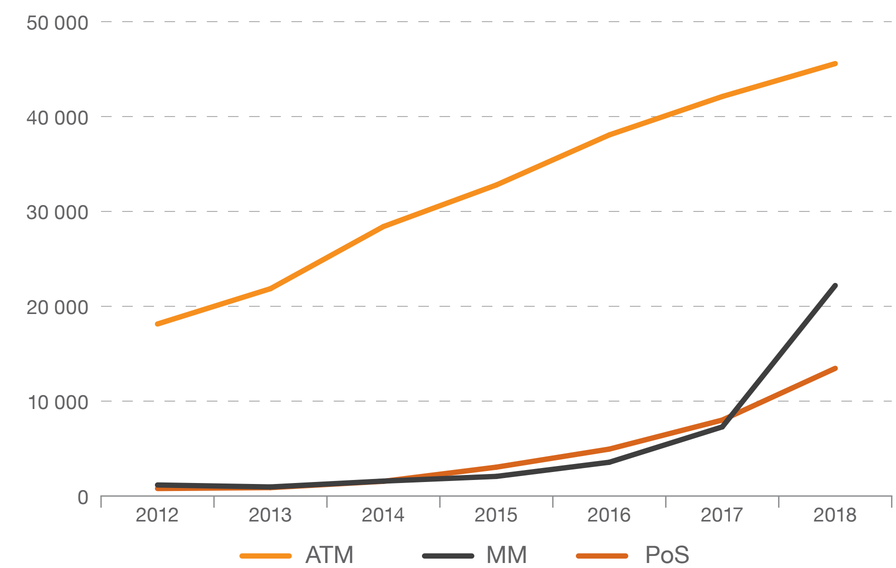
There has been a significant growth in the digital banking channels based on the payments recorded by the Bank of Zambia as at 31 December 2018. Mobile money continue to be the leader with transaction volumes exceeding 300 million in 2018.

Figure 31: *Digital payment platforms*



Source: Bank of Zambia

Figure 32: *Digital channel platforms*

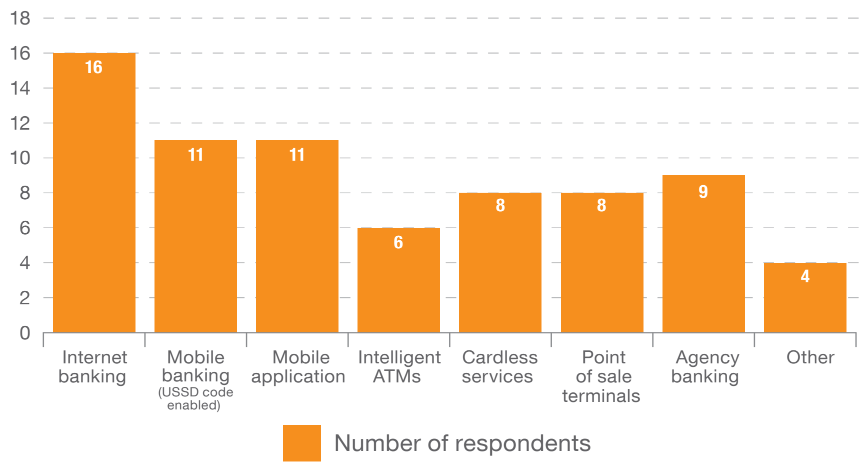


Source: Bank of Zambia

In value terms, ATM transaction still continue to be the leader based on the three conventional channels being used by majority of ordinary Zambians with total value exceeding K40 billion as at 31 December 2018.

Internet and mobile banking continue to rank top among the channels that banks offer to their clients. About 16 of the banks responded that they offer internet banking. This was followed by mobile banking (USSD enabled) and mobile applications, which are provided by 11 banks.

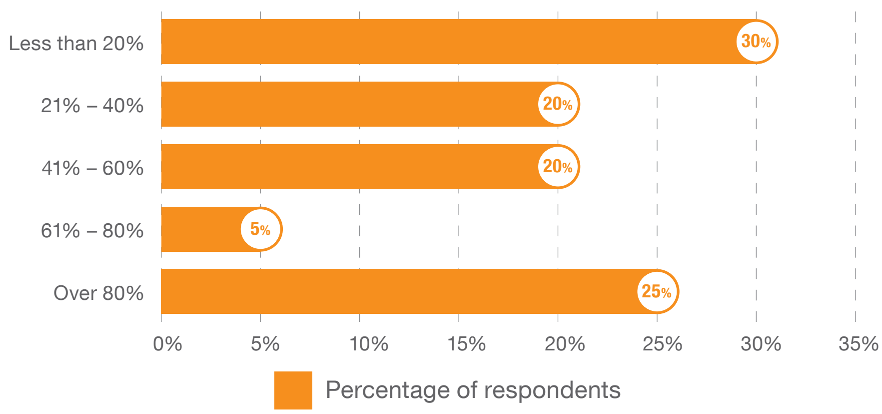
Figure 33: *Use of alternative channels - banks*



25% of respondents indicated that over 80% of customer transactions (deposits and transfers/ payments) are executed through technology enabled channels (2017: 18%) with 30% having less than 20% of the above customer transactions processed through digital channels (2017: 23%). There is a trend of higher use of alternate channels year on year.

Our East African Banking survey similarly explored this matter and the nature of digital channels offered by commercial banks in East Africa were very similar. This perhaps re-enforces the view that digitisation of service delivery is necessary for all banks.

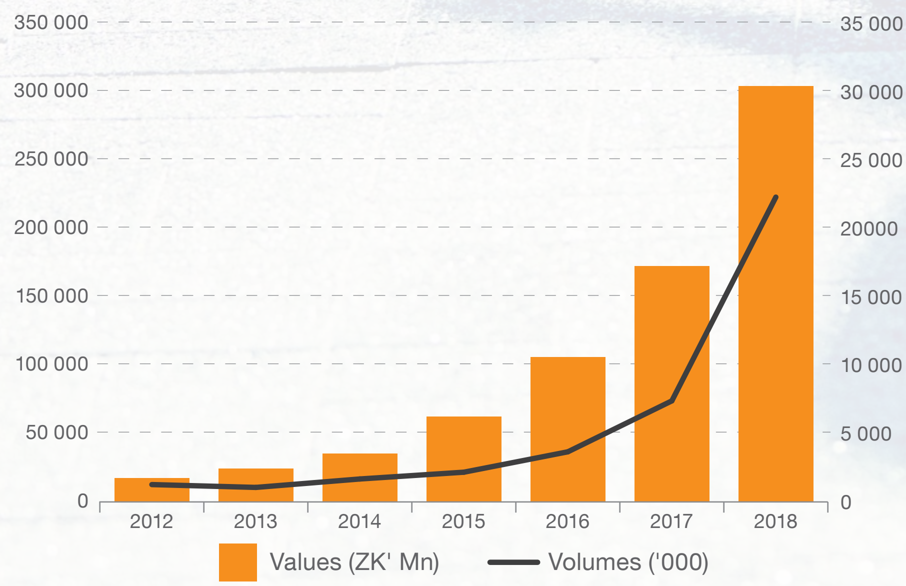
Figure 34: *Use of alternative channels - non banks financial institutions*



The rise and rise of Mobile Money

Financial inclusion continues to be a topical agenda item for the industry. Mobile Money is a key channel through which this agenda is being driven and its growth has continued on an exponential trajectory. The total value of mobile money transactions processed in 2018 amounted to K22 billion (8% of GDP) up from K1.1 billion in 2012, representing a Compounded Annual Growth Rate of 63%. Kenya, widely considered as the gold standard with regards mobile money use in the world, had transactions equivalent to 44% of its GDP processed through mobile money channels in 2018 according to the Central Bank of Kenya. This illustrates the potential that this product has in achieving financial inclusion and facilitating economic activity. As the acceptance of mobile money continues to improve, especially as a means to settle transactions with merchants, we expect to see the current growth trajectory to continue.

***Figure 35:** Mobile money payments*



Source: Bank of Zambia

Financial Inclusion and Banking: What you might be missing

Betty Wilkinson, CEO Financial Sector Deepening Zambia
April 2019

Why is financial inclusion important to banks and NBFIs? Three reasons. First, it is part of the National Financial Sector Development Policy and National Financial Inclusion Strategy, as well as the Bank of Zambia Strategic Plan and other key Government policies that affect financial institutions' business. Second, there is clear research evidence that when financial inclusion increases, economies grow in more sustainable, resilient, and balanced ways, in turn expanding demand for financial services. Third, the unserved and underserved are a significant untapped client market who will be loyal and profitable to your bank if services are reliably and easily provided to them, particularly if you digitise.

In Zambia, financial inclusion is expanding in two main ways. For rural people, especially for women, the growth of savings groups is the entry point for lending, savings, and microinsurance. For youths and urban dwellers, the growth of digital finance and expansion of mobile money services is occurring, from cash-in/cash-out to savings held in mobile wallets, small-scale digital borrowing, and blended services including transfers and financial education. Since we know that both of these areas can have strong potential engagement with banks and NBFIs, financial institutions have the option to develop linkage products for the rapidly expanding savings groups to help clients graduate into their services. Financial institutions are already starting to figure out how mobile money can extend their physical reach into areas where brick and mortar investments do not make sense. Deepening this with fintechs is a good way for financial institutions to grow; financial institutions should stop being so afraid to talk to fintechs about their problems as there are some really smart, creative people ready to solve them with you. There are incubators for think tanks in Capetown and Nairobi, along with our own home-grown one in Lusaka, Bongo Hive.

What are the statistics financial institutions should really care about with regard to financial inclusion? Banks and NBFIs need to find more clients that are profitable, loyal, and will promote them. Here is what financial institutions are likely to be missing:

- Zambia has a young population. The median age across its 17 million people is 16.8 years, according to figures from the Central Statistics Office. This means that financial institutions' potential client base is young, likely to be in school or early in the workforce, uses informal financial services (since they are easier to understand and access), and is oriented towards the use of cell phones. If financial institutions create opportunities for children and youths to learn about money and save early in these institutions, they are likely to be better money managers, more responsible borrowers, and more loyal customers. Where are the free savings accounts for children?

- Women received 16% by number and 12.5% of total loan disbursements by value in 2017 from banks, according to data from the Credit Market Monitoring reports per Bank of Zambia. Worldwide studies clearly show that women are significantly more likely to save, borrow if given the opportunity, to repay on time, and to be a "sticky" or loyal customer. This is a real chance for financial institutions to acquire and keep a much more valuable client base. The gender gap between men and women in Zambia, in terms of formal financial services, is 9.9%. That means that men are better served than women in terms of formal financial sector products overall, as well as for loans. Changing this can present business opportunities for banks and NBFIs.

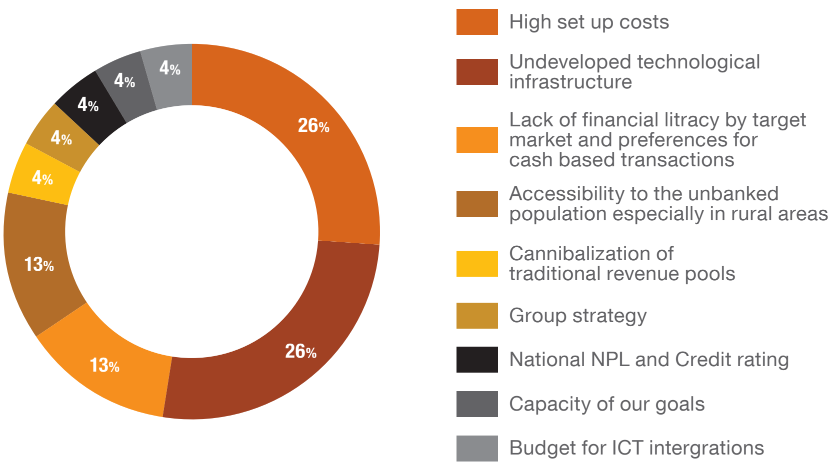
- Currently, 600,000 savings groups members save about K14.5 million each year and inter-lend K255.6 million, earning 25.05% on savings. Savings groups develop clients for banks and other financial institutions, since our research clearly shows how people enter financial services this way, then grow to sizes where they want bank services. Savings groups provide: (a) reliable credit information from savings group members as a credit score; (b) significant funds for deposits, along with member savings histories; (c) potential clients who are showing their ability to run small enterprises profitably (61% of loans and savings share-outs are used to start or grow a business); and (d) the option to provide banking bundled services to experienced groups. Financial institutions might benefit from getting to know and engaging with this market.

Financial inclusion

Achieving the financial inclusion targets set remains a priority for all stakeholders in Zambia. Increasing access to financial services is seen as critical to, overall, improving the quality of life of citizens. It also provides a significant growth opportunity for financial institutions.

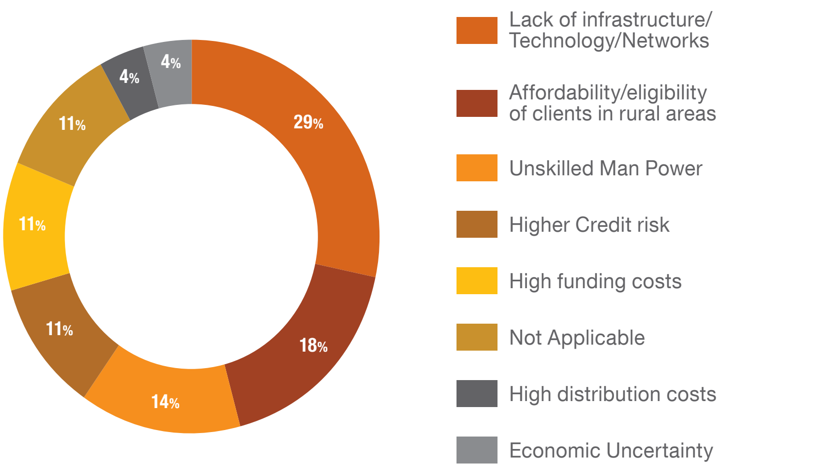
The high setup cost required to harness the opportunity that exists in the unbanked sub-sector is a hindrance to the achievement of financial inclusion targets. This, together with the limited infrastructure in some parts of the country rank as the biggest challenges that financial institutions have encountered. Other hindrances are low financial literacy of the target market and lack of easy access to rural Zambia.

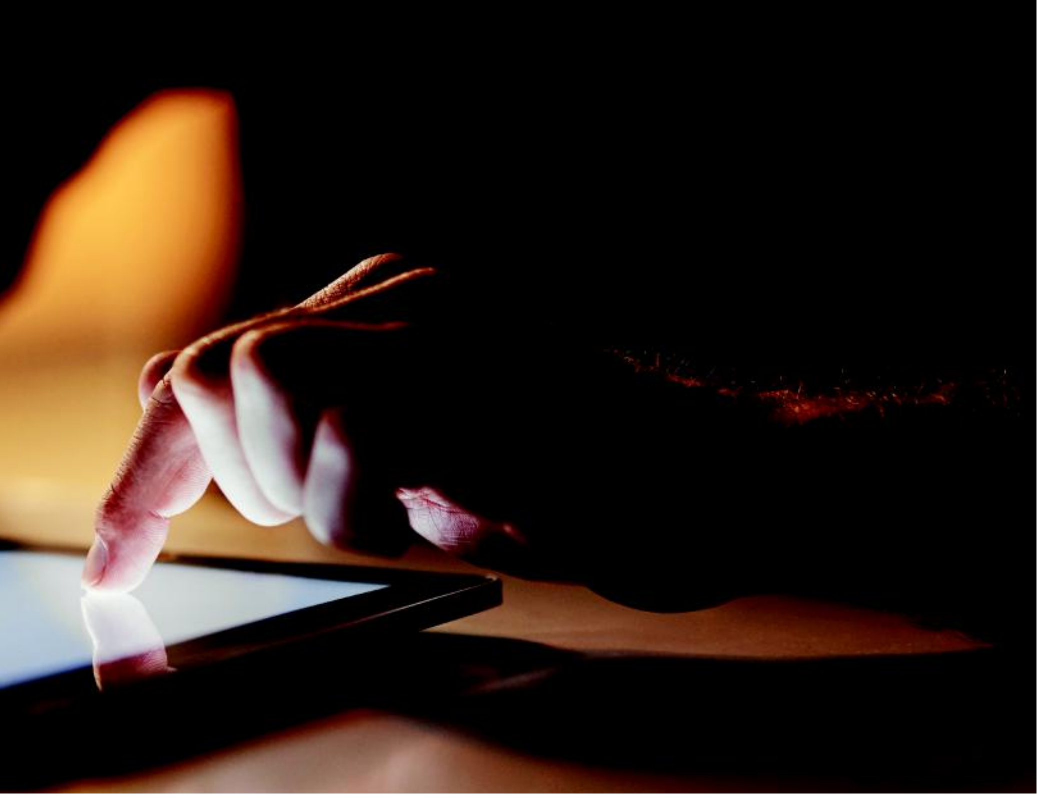
Figure 36: *Challenges hindering banks to achieve financial inclusion*



NBFIs, interestingly, seem less enthusiastic about the opportunity that financial inclusion provides. 47% of the respondents indicated that the country's financial inclusion drive has not significantly affected their strategy. Given extensive investment being made by the government to improve accessibility to rural areas coupled with the wider mobile phone network coverage that is expected, we wonder if this stance will change. We will wait and see.

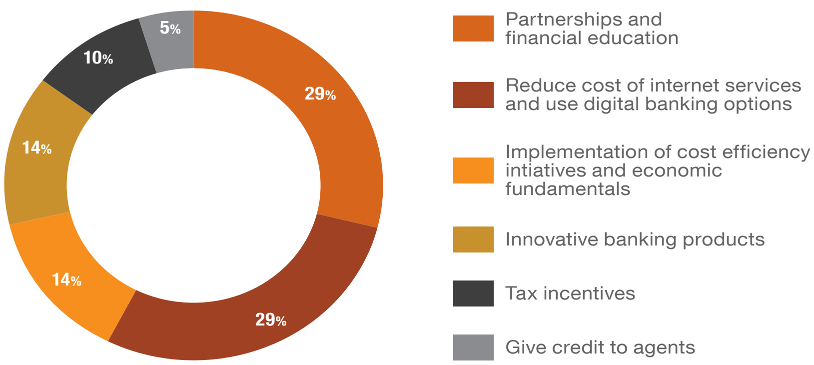
Figure 37: *Challenges hindering non-banks to achieve financial inclusion*





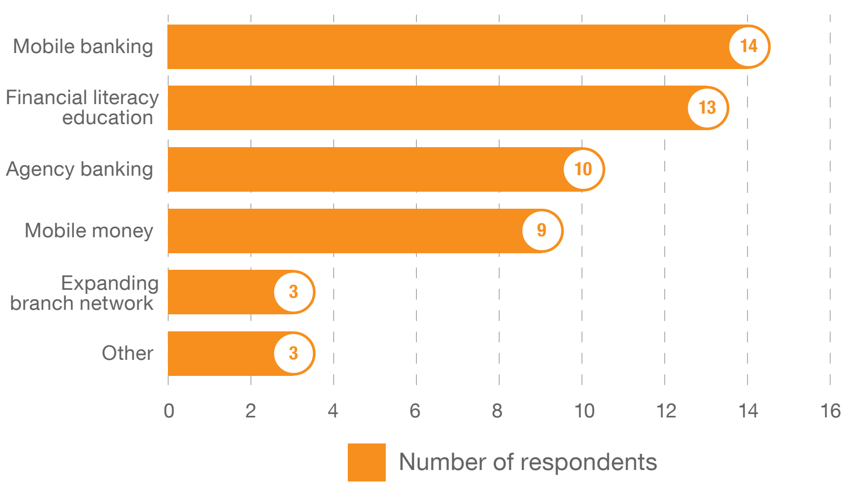
The solutions to the challenges faced were as follows;

Figure 38: *Proposed solutions to achieve financial inclusion*



Banks still perceive mobile banking as one of the top enablers to achieving financial inclusion targets with fourteen respondents highlighting it as critical to success. Thirteen stated that financial literacy training is also fundamental.

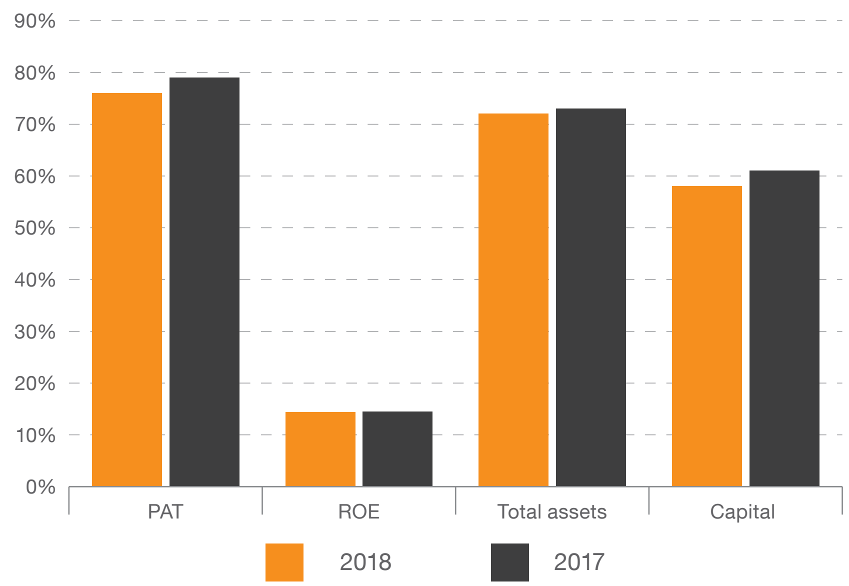
Figure 39: *Responses for the proposed interventions to achieve financial inclusion for Banks*

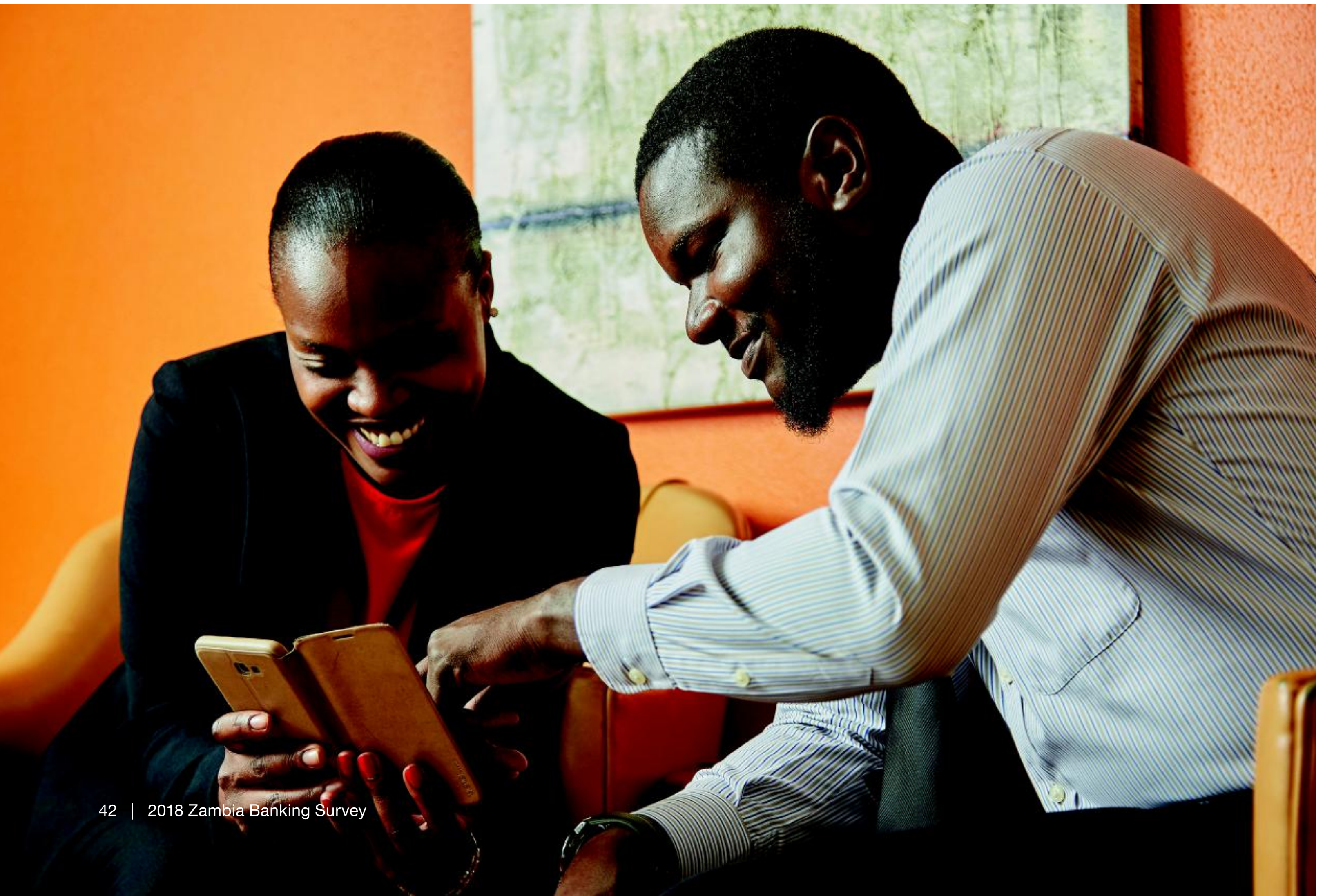


Concentration in the market/ profitability - Commercial banks

An analysis of the 31 December 2018 prudential returns indicates that the disparity between the larger and smaller players continues. Figure 40 below shows the continued dominance of the larger market players across key indicators such as Profit after tax, Return on equity, Total assets and Shareholders equity. While the overall structure of the market has not changed much, the disparity at the far ends of the spectrum are continuing to widen and the availability of capital remains a key differentiator. As banking continues to evolve and the need for investment in new products and delivery channels becomes ever more apparent, the smaller players are likely to be more affected. Whether this results in some level of market consolidation within the banking sector and/ or with non banking financial institutions remains to be seen.

Figure 40: *Top 6 share of market*





Cyber crime

In 2018, respondents to our survey ranked the threat from cyber crime 12th for commercial banks and 18th for non bank institutions. This is a significant change in their perception of the risk as it was ranked as 2nd in 2016 and 4th in 2017. Why the significant decrease in the perception of this risk? Our understanding is that the answer lies partly in the fact that respondents indicated that their primary response to cyber threat has been education of employees and customers followed by technological enhancements to firewalls and anti-virus softwares. While the types of threats presented by cyber remain unauthorised access/hacking attempts and malware, what we understand has changed is the market's appreciation of the risk.

We have seen some of the larger banks build dedicated Information security teams that continuously monitor intrusion attempts and other system vulnerabilities. Other banks have rolled out extensive customer awareness and sensitisation campaigns on the most common kinds of cybercrime being faced in the industry. The market is encouraged not to fall into a false sense of security that the risk has been mitigated and adopt a more relaxed approach to the threat. As we look to the future, with more than 76% of respondents expecting more than 50% of their customer transactions to be done via digital channels in 5 years' time, it is important to avoid becoming complacent with the information that we know.

Innovations create new vulnerabilities and as such the cyber threats faced by the sector continue to grow. It is important not to lose sight of the risks and we encourage the sector to

- Continuously monitoring of cyber risk posture and any changes that may affect the organisation's risk exposure.
- Extending the scope of security monitoring beyond your perimeter. Traditionally, Information security operations focus on the internal assets.
- Rigorously vetting of partner solutions such as mobile money and payment gateways that integrate with your ecosystem to manage the risk of compromise. Ongoing maintenance and monitoring of these interfaces should be planned and executed accordingly.

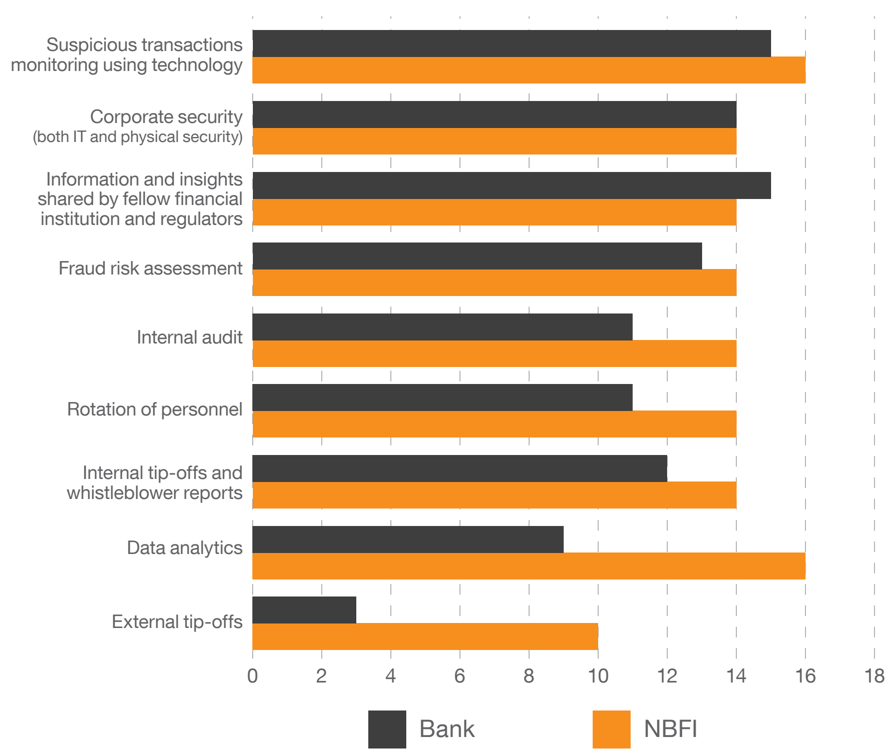
Financial crime

While not ranked as one of the top risks, fraud and financial crime remain a topical issue for both the bank and non banking sectors. We asked respondents two key questions; " What are the top schemes fraudsters have attempted to perpetrate?" and "What measures have you found most effective in deterring financial crime?"

Banking respondents indicated Employee fraud and Phishing attacks on customer accounts as the top two schemes perpetrated whereas non banks reported Document falsification during the credit process and Employee fraud. Our East African Banking Survey also revealed similar trends with the top 2 most commonly reported financial crimes being document falsification and card fraud. Phishing attacks on customer accounts came a distant third.

The measures found as most effective indicate a strong correlation between the two sectors and therefore perhaps, wider sharing of information may further help further mitigate the risk.

Figure 41: *Cyber crime*

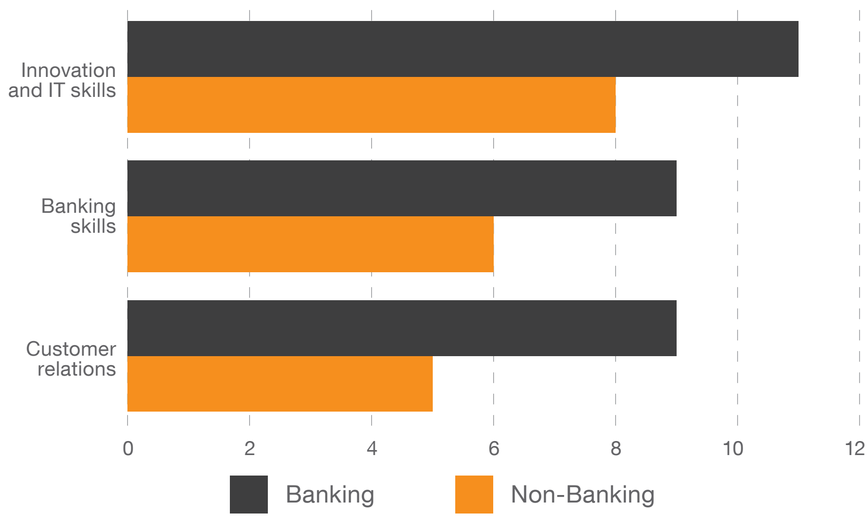


Talent management

Skills

As the financial services sector continues to invest heavily in technology to deliver services and enhance customer experience what remains clear is that technology alone cannot meet customer expectations. Consumers still value human interaction and accountability. Interestingly, both banking and non banking respondents ranked Customer relationship and Information technology and Innovation as key skills their teams will require to meet their long term ambitions. The availability of core banking skills such as credit, treasury and risk management was also highlighted by the banking sector as one of the top three skills necessary for the future. The non bank respondents narrowed this to credit management skills specifically likely due to the singular focus of this market.

Figure 42: *Skills*

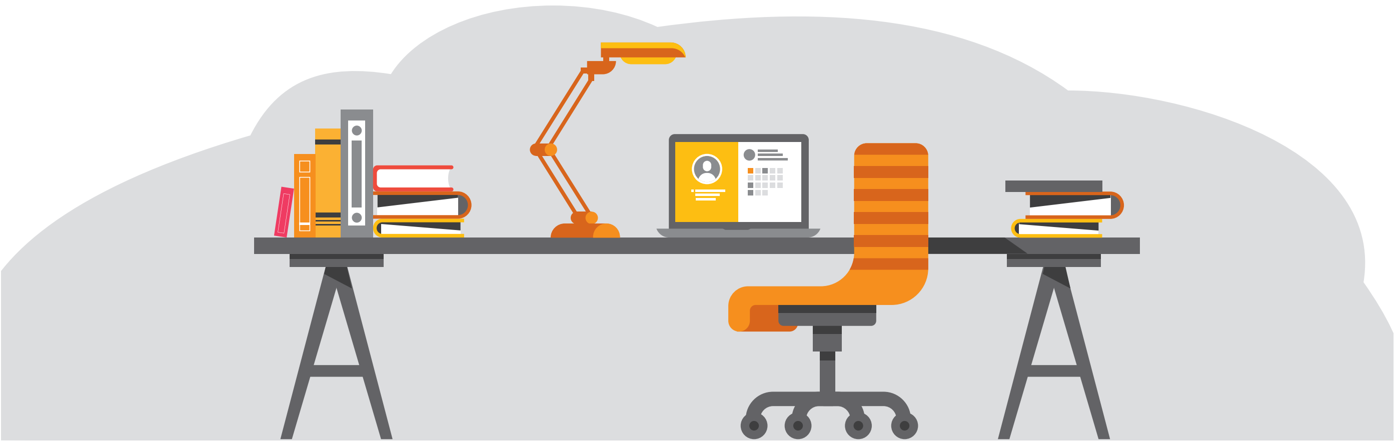


Gender equity

Improving gender equality in the financial services sector is one of the Bank of Zambia's strategic objectives for the period 2016 to 2019.Improving gender equality in the financial services sector is one of the Bank of Zambia's strategic objectives for the period 2016 to 2019.

Based on survey responses, female representation within senior management sits at 32.5% for banks and 40% for non banks. The situation across the various bank was varied with 2 respondents indicating no female representation in senior management and 3 indicating representation of 50% or better. In comparison, 7 out of 18 non banks indicated female representation at senior management of 50% or more.

Deliberate policies to build and nurture a talent pool of female leadership and finding ways to provide a better work life balance were the top 2 solutions identified by respondents to the banking survey. Implementing these solutions is undoubtedly complex and may raise additional questions on equity and efficiency that entities need to carefully navigate. However, the benefits of having a gender balanced workforce cannot be argued.



Conclusion

The Financial sector remains a dynamic one with several external and internal forces shaping its future prospects. Undoubtedly, the state of the economy is front of mind for players in the sector given the broad impact that challenges can have on organisations. This, coupled with the competitive forces that continue to intensify mean that it is imperative that financial institutions introspect and adapt not only to cope with the challenges faced, but also to exploit the opportunities that exist.

Ensuring that growth strategies developed by institutions are responsive to the various opportunities and challenges posed, we believe, will be the key differentiator between those that will thrive, those that will just survive and those that will fail altogether.

We hope that you have found this report informative and will put it to use as you develop your strategy.

Financial performance and analysis

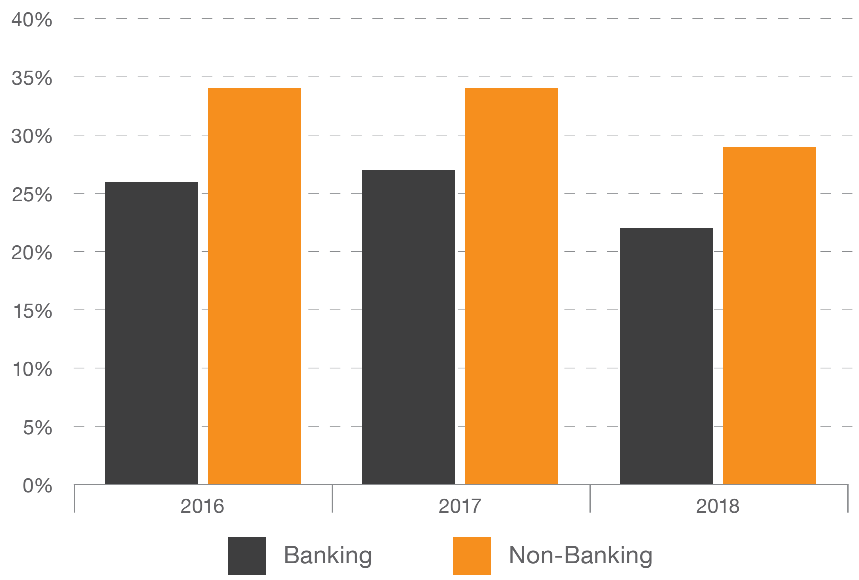
1. Capital Adequacy Ratio (CAR)

For the Banking sector as a whole, the CAR recorded a decrease from 27% in 2017 to 22% in 2018. In the Non Banking sector, the CAR decreased from 34% to 29.3%. For both sectors, the decrease was mainly attributable to the significant increase in market assets such as loans and advances. This directly lead to a significant increase in the risk weighted assets relative to regulatory capital.

The average CAR of 22% for the Banking sector and 29.3% for the Non Banks is above the 10% minimum required by the regulator and hence it can be concluded that the industry as a whole is well capitalized.

Figure below shows the trend in the industry CAR for the period 2016 to 2018.

Figure 43: *Capital adequacy ratio.*

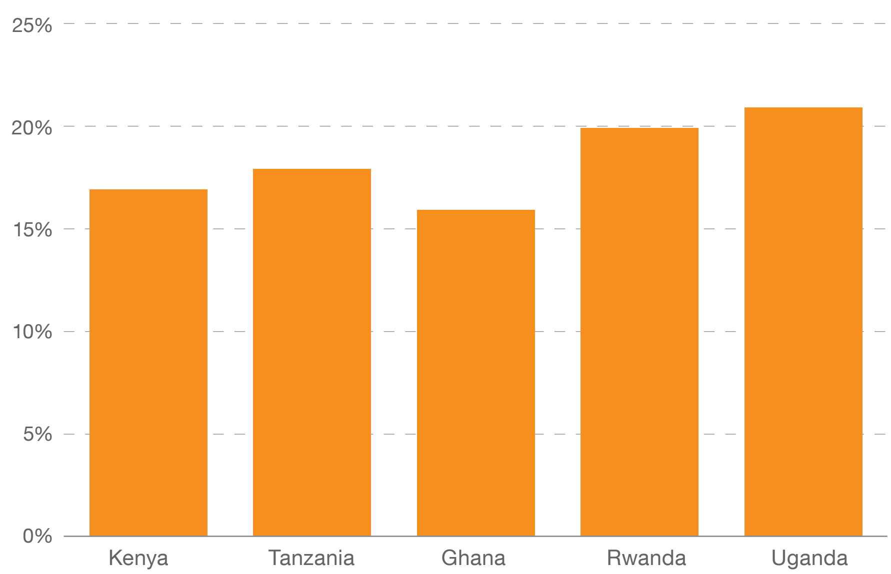


Source: Bank of Zambia

Regional Analysis – Selected Countries

The CAR of the Zambian Banking and Non Banking sector is higher than other countries in the region. At 27% and 22% as at December 2017 and 2018 respectively, the CAR was higher than the banking sector Kenya (17%), Tanzania (18%), Ghana (16%), Rwanda (20%) and Uganda (21%) as at 31 December 2017. Nations such as Kenya and Ghana have now implemented Basel II and consequently would not be required to carry as much capital as would be the case in Zambia.

Figure 44: *Capital adequacy*



Source: Central Bank of Kenya, Bank of Tanzania, Bank of Ghana, Bank of Uganda and Central Bank of Rwanda

**Note: Due to limitations in publicly available information, the statistics for the regional comparisons have been obtained as at 2017*

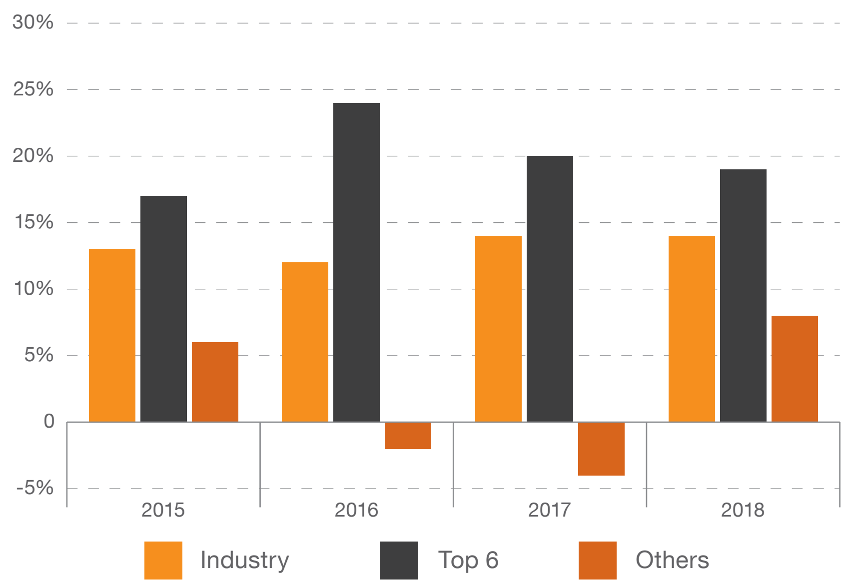
2. Return on equity (ROE)

Banking Sector

The ROE of the Banking sector recorded an increase from 14% in 2017 to 15% 2018. This movement is generally in line with marginal growth in profitability of the industry as a whole between the two periods of K5.6 million. There was a reduction recorded on the ROE of the top 6 banks by 100bps. This was countered by the increase in the ROE of the industry from (-)4% in 2017 to (+)8% in 2018. The improved ROE for the rest of the industry is mainly down to improved profitability in the industry in 2018.

The Non Banking sector has seen a steady improvement in the return on equity for the period between 2017 and 2018. Gross income, has steadily improved within the industry with an increase of K600 million in interest income between 2017 and 2018. This corresponds to the significant increase in lending between 2017 and 2018 with net loans and advances increasing by K1.2 billion between the two periods. This has resulted in an increase in the ROE for Non Banks from 0.9% in 2017 to 13% in 2018.

Figure 45: *Return on equity*

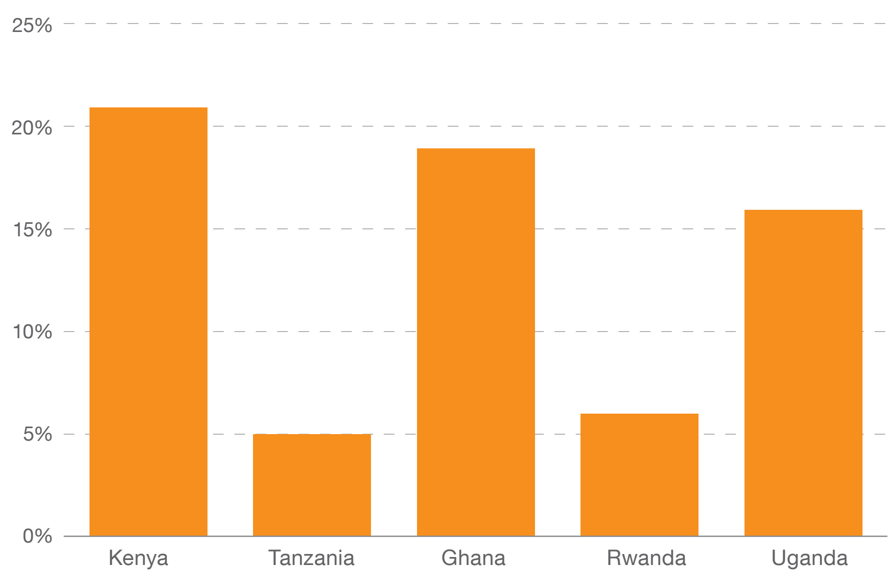


Source: Bank of Zambia

Regional Analysis – Selected Countries

At 14%, the Zambian Banking industry lies in the median range when compared against other similar nations. Of the nations selected for comparison, Kenya ranks the highest with 21% as at 31 December 2017 followed by Ghana at 19% and Uganda at 16%. It is higher than both Rwanda and Tanzania however. It should be noted that Banks in the East African region, and particularly Kenya, have had their interest margins compressed due to an ongoing interest rate capping regime. While there has been a drive in these countries to increase non funded income, this has undoubtedly affected the ROE of the Banking sector.

Figure 46: *Return on equity*



Source: Central Bank of Kenya, Bank of Tanzania, Bank of Ghana, Bank of Uganda and Central Bank of Rwanda

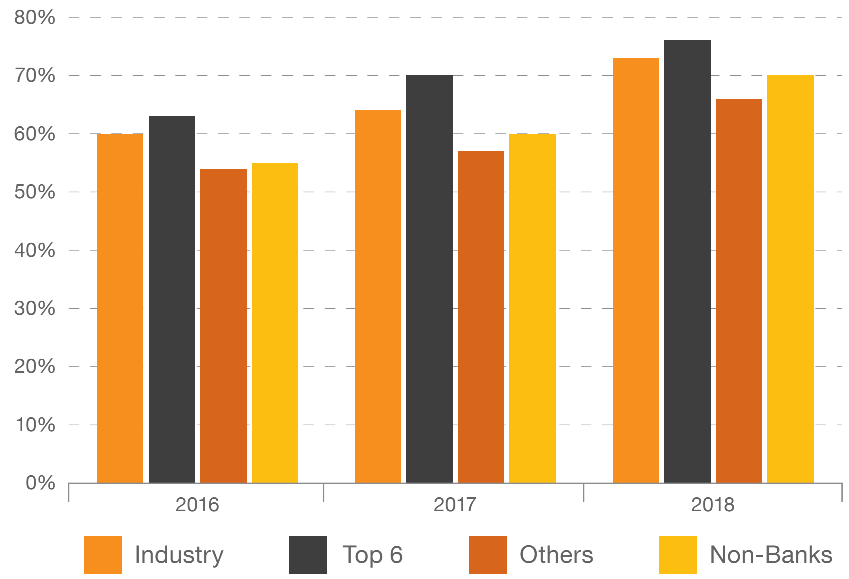
3. Net interest margin

For the Banking Sector, net interest margin increased by 9% in 2018 from 64% in 2017 to 73% in 2018. The six largest banks recorded an increase of 6% to 76%compared to 9% (from 57% to 66%) for the rest of the industry. The increase in the net interest margin is mainly attributable to increased investments in government securities. Further, the yields on these securities increased from 15.38% and 18.56%, and closed at 21.30% and 20.12% for treasury bills and Government bonds respectively driving up the interest income.

In the Non Banking sector, the net interest margin has steadily increased from 55% in 2016 to 60% and 70% in 2017 and 2018 respectively. The increase was driven by the large increase in interest income over the period (59%) relative to the growth in interest expense (23%). This was driven by a significant increase in both the number and value of loans and advances during the period.

The table below charts demonstrates the increase in the net interest margin from 2016 to 2018.

Figure 47: *Net interest margin*

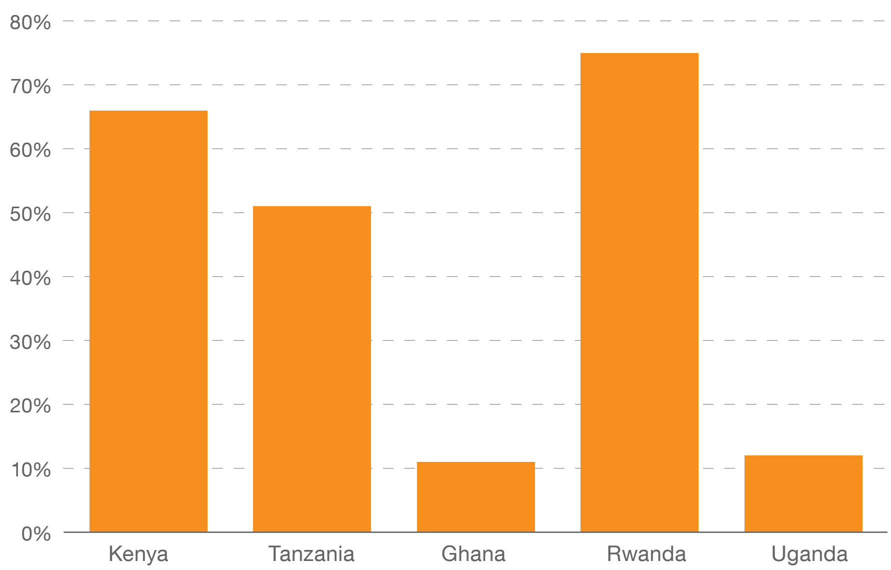


Source: Bank of Zambia

Regional Analysis – Selected Countries

At 70% in 2017 and 2018, the net interest margin for the Zambian Banking Industry ranks quite high in comparison to other selected nations bettered only by Rwanda at 75%. This is mainly due to the high interest rate environment on commercial loans prevailing in Zambia relative to other countries while the interest rates on deposits and financing for Banks is relatively low. This comparison is affected further affected by the interest rate capping regime prevailing in the East African Region further compressing the net interest margin downwards.

Figure 48: *Net interest margin*



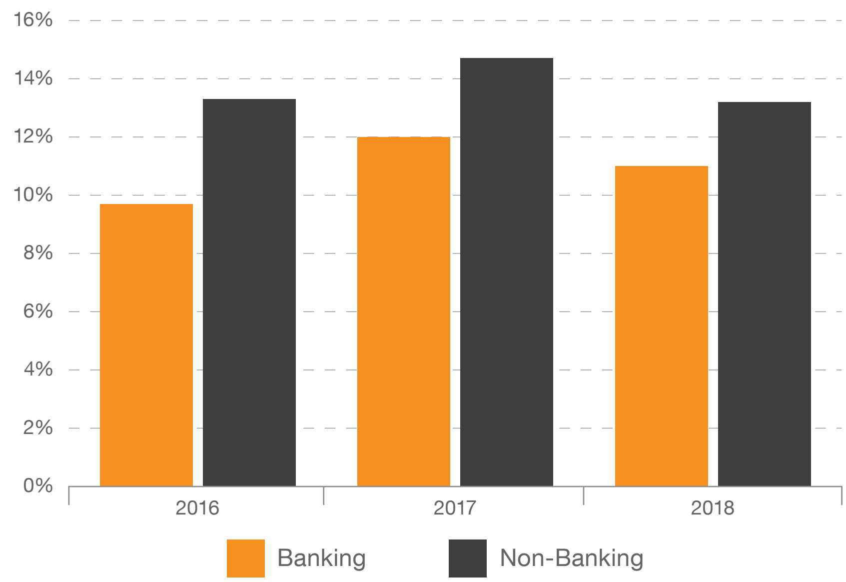
Source: Central Bank of Kenya, Bank of Tanzania, Bank of Ghana, Bank of Uganda and Central Bank of Rwanda

4. Non Performing Loans (NPL)

The percentage of non performing loans to gross loans in the Banking Sector decreased from 12% to 11% from 2017 to 2018 respectively. This was mainly driven by an increase in the overall lending in the industry which reduced the proportion of NPLs to the gross loan value.

For the Non Banking sector, the NPL ratio decreased from 14.7% to 13,2% in 2017 and 2018 respectively. Similarly to the Banking sector, this was largely driven by the increased lending in the sector while the absolute value of the NPLs remained relatively similar between the two periods.

Figure 49: *Non Performing Loans*

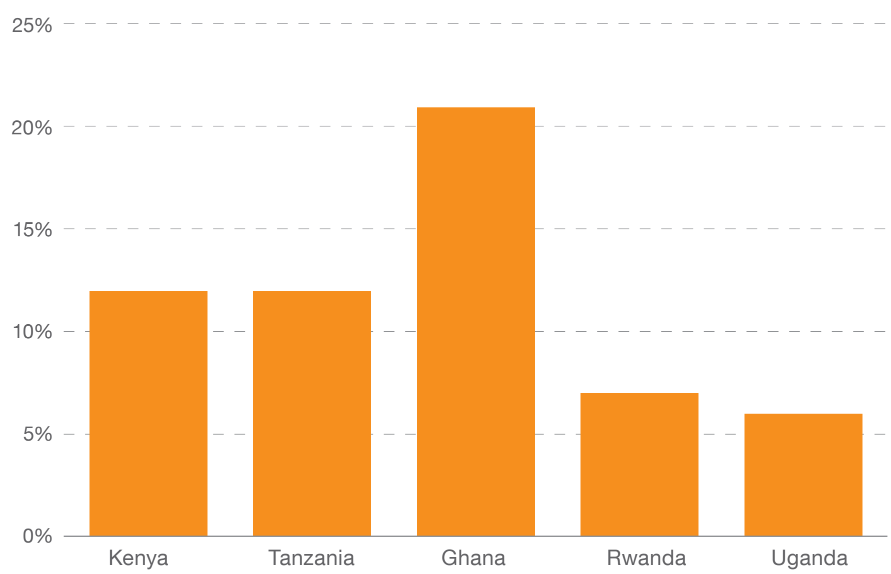


Source: Bank of Zambia

Regional Analysis – Selected Countries

At 11% and 12% in 2018 and 2017 respectively, the Zambian Banking industry lies in the median range when compared to other countries in the region. This is relatively similar to Tanzania (12%) and Kenya (12%) as at 2017 but significantly lower than Ghana at 21.3%. In Ghana this was largely driven by the migration of legacy loans into NPL status. Zambia's NPL ratio still ranks higher than Uganda (6%) and Rwanda (7%) which have relatively lower numbers of NPLs.

Figure 50: *Non Performing Loans*



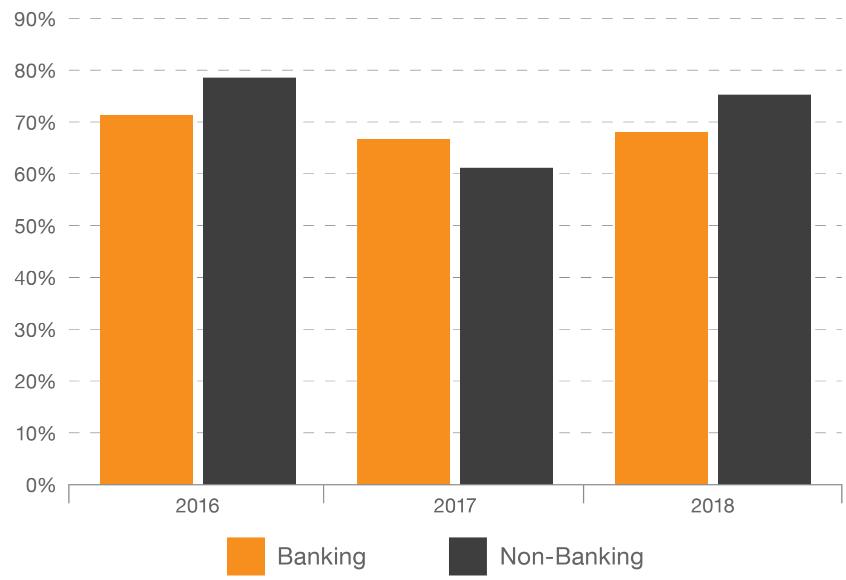
Source: Central Bank of Kenya, Bank of Tanzania, Bank of Ghana, Bank of Uganda and Central Bank of Rwanda

5. Cost to Income Ratio (COI)

2018 recorded an increase in the COI of the Banking sector between 2017 and 2018 from 66.7% to 68%. This was mainly driven by a K1 billion increase in operating expenditure by the Banking industry during 2018.

Similarly the Non Banking sector recorded an increase of 14.1% from 61.2% in 2017 to 75.3%. This was largely driven by an increase in operating expenditure on employee benefits and other expenses.

Figure 51: *Cost to income*

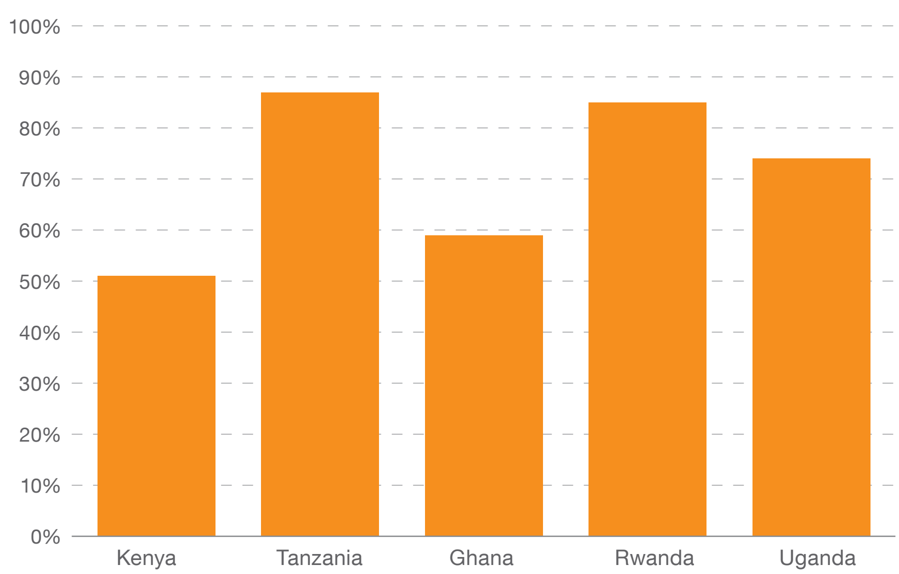


Source: Bank of Zambia

Regional Analysis – Selected Countries

At 66.7% as of 2017, the Zambian Banking industry lies in the median range when compared to other nations in the region as at December 2017. As 2017, Tanzania (87%), Rwanda (85%) and Uganda (74%) had a higher cost to income ratio while Kenya (51%), and Ghana (59%) had lower ratios. As at 2017, this would indicate that the Zambian industry lies in the median range of costs relative to income.

Figure 52: *Cost to income*



Source: Central Bank of Kenya, Bank of Tanzania, Bank of Ghana, Bank of Uganda and Central Bank of Rwanda

Glossary

1. Capital adequacy ratio (CAR)

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

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. Cost to income ratio (CIR)

$$CIR = \frac{\text{Operating expenses (excluding provision loss)}}{\text{Net interest income + non-interest income}}$$

5. Non-performing loans ratio (NPLR)

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

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