April 2018

2017 Zambia Banking Industry Survey: Cautiously Optimistic

pwc

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Foreword

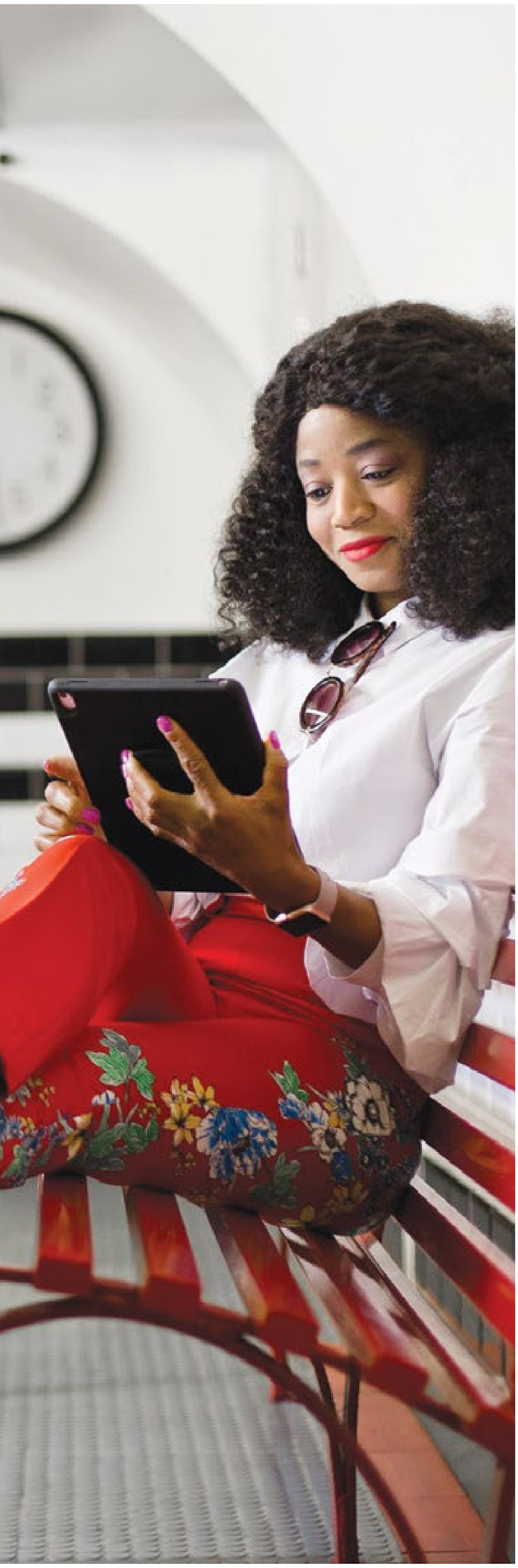
It is my pleasure to welcome you to the second edition of our Zambia Banking Industry Survey, ***Cautiously Optimistic****. With a 100% participation rate from the 17 banks in Zambia, we believe our survey provides comprehensive insight into matters affecting the sector.*

The good news is that 2017 was a better year than 2016 for both the Zambian economy and the banking sector. Positive trends in economic indicators coupled with actions by the Bank of Zambia to ease the tight monetary policy environment provided an opportunity for financial institutions to achieve positive growth and strong financial performance.

By providing the survey results together with our views on pertinent issues, we aim to provide banking industry stakeholders with an up-to-date and balanced assessment of the sector. We would like to thank all of the respondents, without whom we would not have been able to produce this report.

Andrew Chibuye
Partner
Financial Services Leader, PwC Zambia

Executive summary



Economic recovery from the 2015 to 2016 doldrums has been at a subdued pace, with growth rates over the last two years notably lower than in previous years, when Zambia's GDP averaged 6.7%. As a result, the effect and extent of this recovery on the sector has been varied.

The annual inflation trajectory for 2017 trended downwards from 7.5% in January to 6.1% at the end of the year, well within the Bank of Zambia's (BoZ) target band of 6% to 8%. Considering that one of the central bank's objectives is to maintain price stability, the continued decline in inflation is one of the reasons the monetary policy rate (MPR) was reduced four times during the year by a total of 525 basis points– from 15.5% at the start of 2017 to 10.25% at year-end. In addition to the policy rate adjustment, the central bank reduced the statutory reserve ratio (SRR) from 18% to 8% during the same period. The easing of liquidity conditions was also aimed at stimulating private sector growth through lending. As a consequence, average lending rates edged lower in 2017, although current levels are still considered high.

The performance of the kwacha against the US dollar exhibited two distinct trends during the year. In the first half of 2017, the kwacha strengthened against the US dollar from a monthly high of K9.48/USD in January to a peak of K8.87/USD in July 2017. However, this trend reversed in the second half of the year, with the kwacha depreciating to K10.38/USD in December 2017. It eventually closed the year at about K9.99/USD.

It is therefore within this context that the survey results should be interpreted. We were particularly intrigued to find out how the changes in the macroeconomic environment would inform respondents' views on what they considered to be the most pressing issues during 2017.

What did respondents say?

Similar to 2016, respondents converged around a common population of issues that impacted their respective businesses in 2017, although there remained relatively low congruence on the issues of most significance. That being said, while the top five issues show a relatively low score when assessed on a 10-point scale, the scores in the 2017 survey are, on the whole, comparatively higher than in 2016.

Three of the top five issues are carried forward from 2016. These include credit risk (the second issue of most significance for banks in both 2016 and 2017), managing costs (which moved from the top issue for banks in 2016 to the fifth issue of most significance in 2017), and cyber security (the fourth most important issue for banks in 2016 and 2017).

However, liquidity risk and interest rate risk, which were the third and fifth most significant challenges for banks respectively in 2016, have been replaced by two new challenges in 2017: implementation of IFRS 9, which was the third issue of most significance, and improving revenue growth, which was the top issue.

Figure 1: Industry-wide survey results of the top 5 issues

	2016		2017
1	Managing costs (5.4)	**1**	Improving revenue growth (5.7)
2	Credit risk (4.4)	**2**	Credit risk (5.5)
3	Liquidity risk (3.9)	**3**	Implementation of IFRS 9 (5.1)
4	Cyber security (3.3)	**4**	Cyber security (3.5)
5	Interest rate risk (3.2)	**5**	Managing costs (3.3)

Improving revenue growth

Banks identified improving revenue growth as the most significant issue in 2017. This is in contrast to managing costs, which was the top issue facing banks in 2016, but ranked fifth in the current year.

Although improving revenue growth and managing costs are different issues, they could both be broadly interpreted to mean that enhancing financial performance - albeit manifested in different forms – remains the most important issue for banks. Enhancing financial performance can be achieved either through revenue growth, cost optimisation, or both. This shift in focus from costs to revenue is a consequence of the change in the interest rate environment.

Credit risk

Credit risk is arguably the largest traditional risk known in banking. An ever-present risk, credit risk retained its ranking as the second most highly-rated issue in 2017. This is attributed to the level of non-performing loans (NPLs) that increased to 11.6% during the year, above the prudential limit of 10%. Respondents attributed this deterioration in NPLs to the high level of Government arrears, the challenging economic environment and high interest rates. As a consequence of what respondents perceived as a high credit risk environment, lending to the private sector increased by 9% compared to a 91% increase in Government security investments.

Implementation of IFRS 9

Considering the significant changes presented by the adoption of IFRS 9: Financial Instruments, which came into effect on 1 January 2018, it is perhaps of little surprise that banks have ranked this issue third. The expected loss model introduced by IFRS 9, a seismic shift from the incurred loss model that was applicable in the previous standard, IAS 39, is at the centre of the numerous challenges that banks have to overcome. Some of the specific challenges highlighted by respondents include: availability and incorporation of forward-looking information; availability and quality of historical data; model building; business impact assessment; determination of significant increase in credit risk; and availability of necessary skills.

Cyber security

Respondents' views on the significance of cyber security remained unchanged and the issue was again ranked fourth. However, 2017 was characterised by WannaCry, ransomware and other phishing-related cybercrimes globally. Local regulation around cybercrime still remains a challenge. Industry cybercrime currently focuses on card fraud and card-not-present online transaction challenges.

Managing costs

As mentioned earlier, managing costs that was ranked as the issue of most significance in the prior year is ranked fifth in the current year survey. With declining interest rates, banks have, for the most part, been able to re-align their funding structures by replacing expensive deposits acquired during the liquidity crunch of 2015-2016 with more reasonably priced deposits. In addition, while industry-wide operating expenses increased by 5.3% during the year, this was well within the annual inflation rate of 6.6%. A combination of these factors has contributed to the less significance that respondents have attached to managing costs this year.

Figure 2: Top five issues among Zambia's six largest banks

	2016		2017
1	Cyber security (6.6)	1	Credit risk (7.8)
2	Managing costs (6.4)	2	Cyber security (5.2)
3	Local GDP growth (3.9)	3	Improving revenue growth (4.5)
4	Credit risk (3.3)	4	Managing costs (4.0)
5	Liquidity risk (3.2)	5	Implementation of IFRS 9 (3.3)

The top five issues identified by the six largest banks is consistent with the industry-wide survey results, albeit varying in order of significance. It is worth noting the high level of convergence around credit risk as the issue of most significance in 2017. This is largely informed by the increased level of NPLs in the industry. This cohort also attached more significance to cyber security, which is a reflection of the greater risk they face as a result of the comparatively higher volume and value of transactions they process through digital platforms.

Figure 3: Top five issues for the rest of the banks

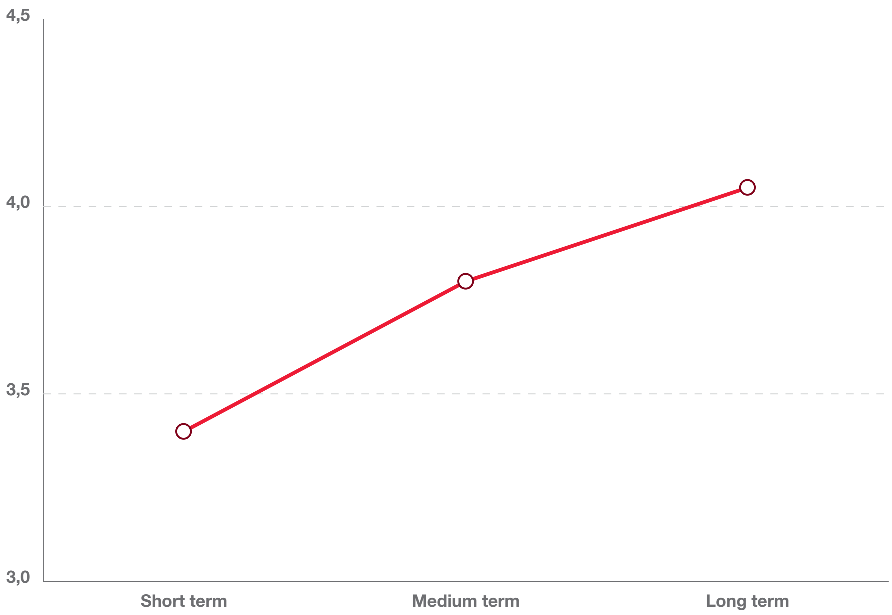
	2016		2017
1	Credit risk (4.9)	1	Improving revenue growth (6.4)
2	Managing costs (4.8)	2	Implementation of IFRS 9 (5.8)
3	Improving revenue growth (4.3)	3	Credit risk (4.3)
4	Liquidity risk (4.1)	4	Capital management (3.6)
5	Interest rate risk (3.1)	5	Tax compliance (3.3)

The ranking of the top three issues for the rest of the industry is identical to the ranking at an industry-wide level. However, this group of banks is also concerned about capital management and tax compliance. Capital management remains a thorn-in-the-side for many of the banks within this group particularly because the dispensations granted by the BoZ to allow for implementation of capital plans expired at the end of 2017. This state of affairs creates a great sense of uncertainty about what may happen next.

Looking ahead

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 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.

Figure 4: Level of optimism



In the short to medium-term, respondents attributed their reduced optimism to concerns about fiscal discipline, expectations of GDP growth, stability of monetary policy and uncertainty surrounding the International Monetary Fund programme.

In the long-term, respondents were optimistic about the growth prospects of the Zambian economy. However, this optimism is tapered by concerns about sustainability of debt levels and changes in the political landscape.

Survey results

We obtained 100% participation from all 17 commercial banks operating in Zambia and for that reason are confident that the findings presented below are a compelling reflection of the issues that the industry considers to be of most significance.

In this section, we provide a detailed analysis of the top five (5) issues of most significance and summary of other issues within the top ten (10). Considering the divergence in size of the banks, we also segmented the respondents into two broad cohorts; the six largest banks by asset size and the rest of the industry.

Top five issues across the industry

Figure 5: Industry-wide survey results of the top five issues

2016		2017	
1	Managing costs (5.4)	1	Improving revenue growth (5.7)
2	Credit risk (4.4)	2	Credit risk (5.5)
3	Liquidity risk (3.9)	3	Implementation of IFRS 9 (5.1)
4	Cyber security (3.3)	4	Cyber security (3.5)
5	Interest rate risk (3.2)	5	Managing costs (3.3)

The Survey Team

Left to right: Lyndon Lane-Poole, Andrew Chibuye, Muchemwa Silavwe, Martin Bamukunde, Andrew Sikwanda, Sonia Morgan, Musuku Mutoni, Lubona Mpikwa, Gabriel Mumba and Michael Mumba

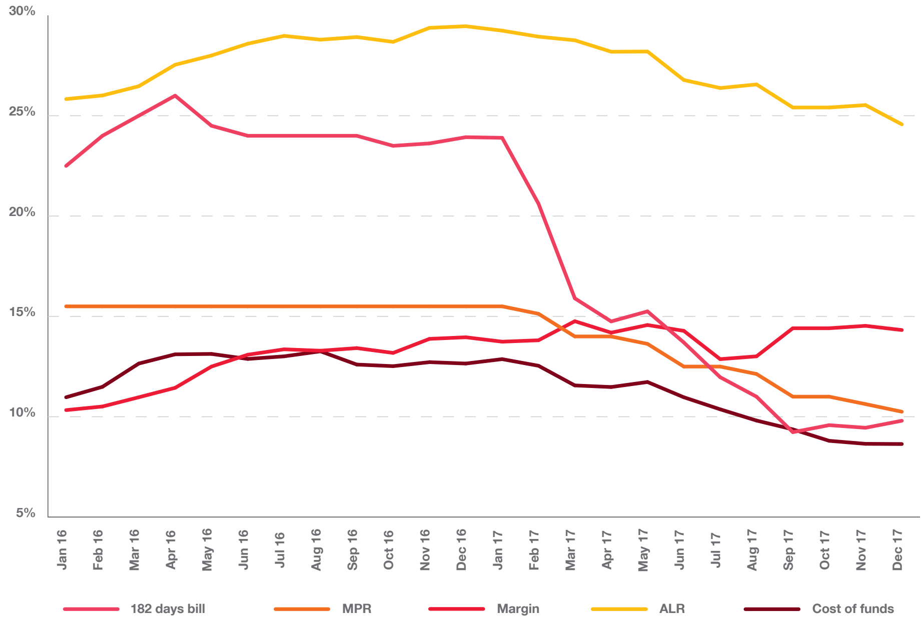
1. Improving revenue growth

Improving revenue growth was the most pressing issue affecting banks in 2017.

Banks are engaged in a never-ending pursuit of maximising revenue without exceeding what may be deemed as commensurate cost levels. This effort is further complicated by the dynamic interest rate environment in which banks operate, particularly in developing countries like Zambia.

It is therefore understandable, if not expected, that in a high interest rate environment, banks would seek to focus more on cost optimisation as opportunities to grow revenue would be more readily present in the form of high interest rates. Conversely, revenue growth would become more of a focus in an environment where interest rates exhibit a downward trend, largely due to the diminished opportunities that a relatively low interest rate environment presents.

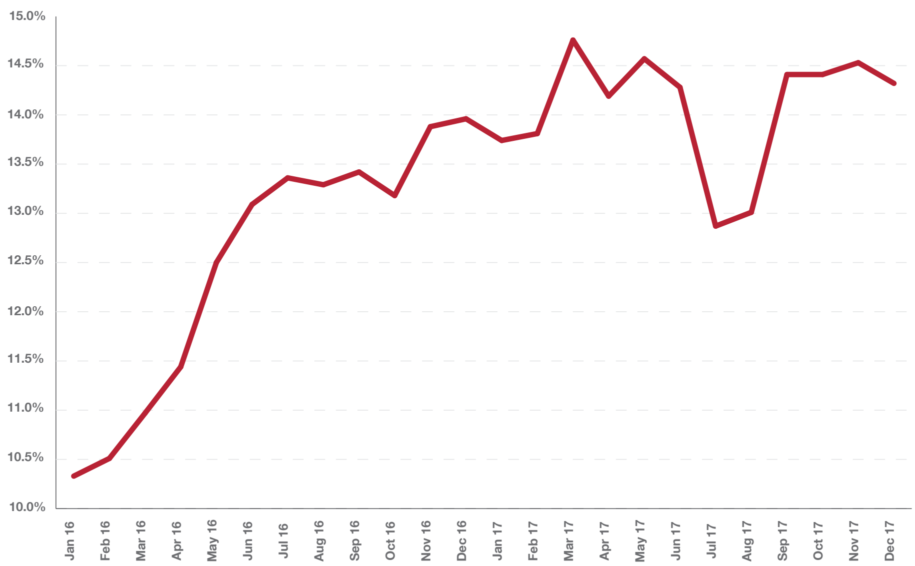
Figure 5: Interest rate trajectory (%)



The process applied by banks in determining lending rates is fairly complex and is intended to incorporate the impact of changes in the MPR, the cost of funding and the yields on Government securities. The lending rate also includes a credit spread (margin) which is compensation for the credit risk profile of the borrower or counterparty, and a profit margin on the costs incurred in originating or arranging credit.

Our analysis indicates that average lending rates generally trended downwards during 2017 as a result of monetary policy easing. Specifically, average lending rates fell by 4.7%, from 28.9% in February 2017 to 24.5% in December. In contrast, the lending margin during the same period increased from 13.7% to 14.3% - an increase of 0.6%.

Figure 7: Lending margin - (%)



Widening of lending margins in an interest rate-easing environment signals the perception of deteriorating credit risk relative to 2016. Ordinarily, lending margins are expected to exhibit a trend similar to the general interest environment as lower interest rates ease the burden on borrowers which, all things being equal, reduces the risk of default. However, despite the decline in interest rates, NPLs in 2017 increased by 1.9% from 9.7% to 11.6%, which validates the perceived increase in credit risk. This increase is more likely a lag effect of the high interest rate regime of 2016 and the continued high level of Government arrears. Significant defaults are still linked to Government as counterparties are owed for services provided to the state.

Banks generally reference the yield on Government securities (risk-free rate) when pricing loans and other forms of debt extension such as bonds. One interesting observation is that the same yields are determined by commercial banks that bid in Treasury bill and bond auctions as they seek to maximise returns on investments. This in essence creates a vicious cycle where banks determine the risk-free rate and then reference the same rate in determining the pricing levels for private sector credit. Therefore, in situations where banks desire a higher return on Government securities, they will apply upward pressure on the risk-free rate, which will have a knock-on effect on rates charged to the private sector and invariably increase the risk of default.

2. *Credit risk*

Credit risk remained the second most significant issue for banks in 2017.

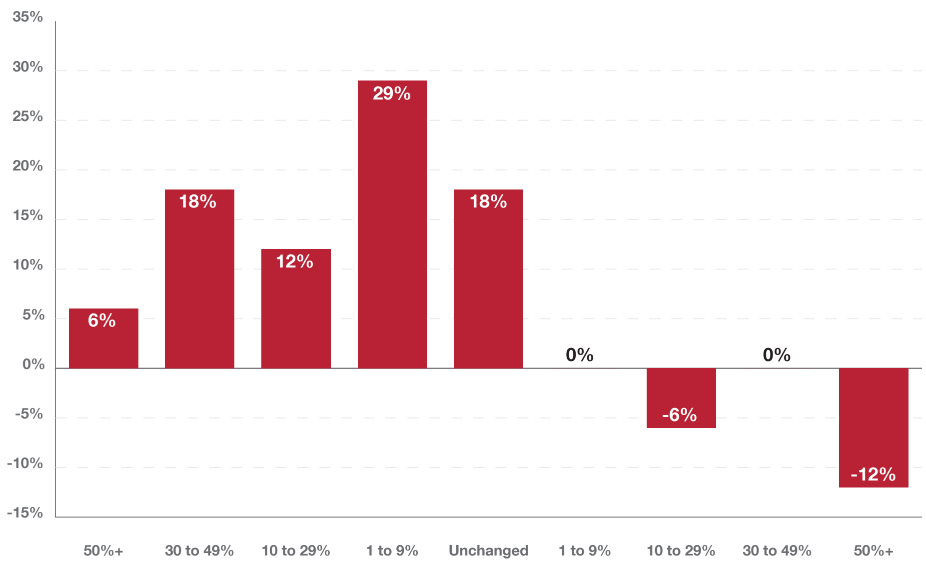
The economy showed signs of recovery or at least stabilization - in 2017, with Zambia recording GDP growth of 4.2%, according to preliminary data from the Central Statistics Office (CSO). However, 53% of respondents indicated that the increased loan impairments witnessed in 2017 were largely on account of continued economic challenges. This suggests that the economy has not yet fully recovered from the economic turbulence of recent years.

Non-performing loans

Our survey results show that 65% of banks recorded an increase in impairments in 2017, while 18% indicated the number of impairments remained unchanged and 17% recorded a drop in impairments. These findings are interesting when set against last year's backdrop of improved economic stability, falling inflation and interest rates. Such a setting would normally point to an improvement in borrower credit profiles and a reversal in credit losses but perhaps further cement the notion that the economic recovery is not fully complete.

However, the banking sector witnessed an increase in NPLs in 2017. Prudential loan impairment charges increased to K558 million (2016: K433 million) and the NPL ratio rose to 11.6% (2016: 9.7%).

Figure 8: Trends in impairment



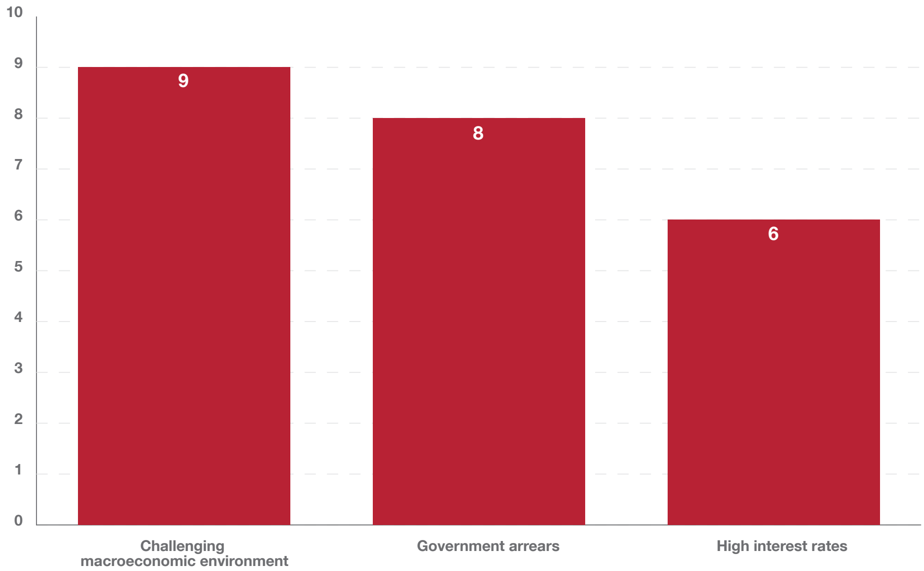
The three main causes of NPLs in 2017 identified by the banks surveyed were:

- The challenging economic environment (53% of respondents)
- The delay in payment of Government contractors (47% of respondents)
- High interest rates (35%)

These causes remain unchanged from 2016, but the order has shifted slightly, with Government arrears becoming a larger contributor to NPLs than high interest rates. It is evident that banks remain concerned about Government's inability to pay contractors, and the banks' response has been to reduce lending to contractors and suppliers with Government contracts.

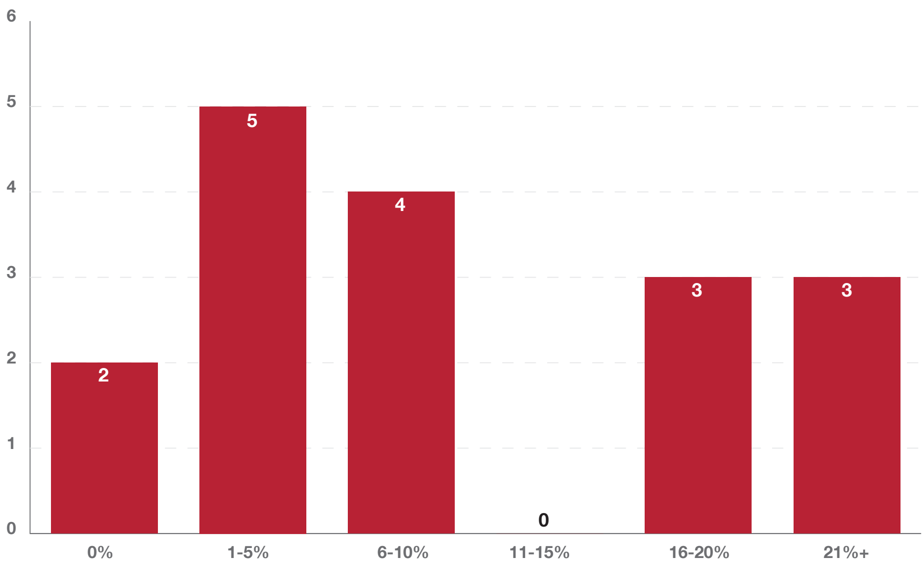
Over the course of 2017, the Central Bank loosened its monetary policy stance significantly and the MPR was reduced from 15.5% to 10.25%. However, despite this industry average lending rates have remained relatively high.

Figure 9: Top 3 contributors to NPLs



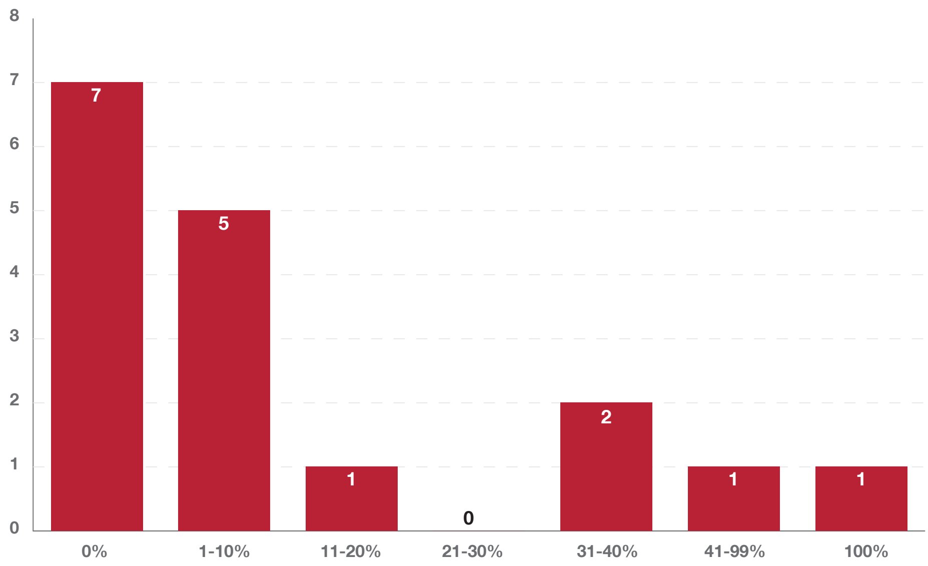
The average NPL ratio for the industry stood at 11.6% (2016: 9.7%). The survey findings indicate that banks outside the top six had an NPL ratio of between 1% and 9% save for two banks which had ratios above 20%.

Figure 10: NPL ratio as at 31 December 2017



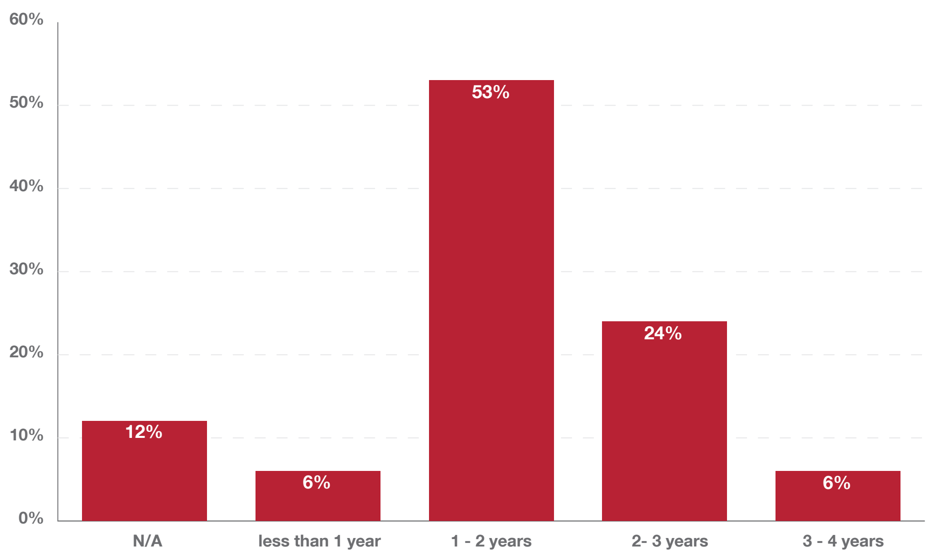
Our survey findings show that, according to 47% of respondents, Government arrears contributed significantly to their NPLs. Consequently, the sector's appetite for projects and entities that have Government associated cashflows has reduced as the timing of these cashflows is becoming more uncertain. The majority of the affected businesses are local SMEs with little alternative funding options. Although several pronouncements have been made by Government about settling these arrears, the desired impact on the banking industry is yet to be seen.

Figure 11: Impact of Government arrears on NPLs



Another issue surrounding credit risk is the length of time it takes to foreclose on collateral which continues to negatively impact the ability of the industry to recover credit advanced. Some 83% of respondents indicated that it takes them in excess of one year to foreclose on collateral, with the slow judicial system, availability of willing buyers and high legal costs incurred to recover collateral identified as the top three reasons for the delays. The key solution to these challenges is a more efficient judicial system that will support a faster realisation of value from collateral held.

Figure 12: Average time to realise collateral

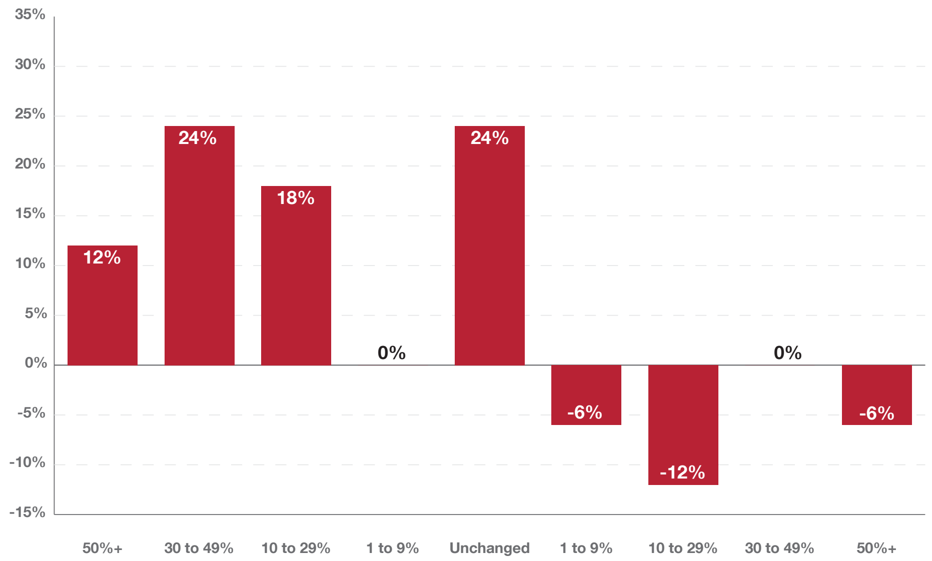


Credit trends

Despite the benchmark policy rate trending lower, expectations were that the credit risk appetite of lenders would increase as the borrower credit profiles improved. This was, however, not the case. Some 65% of respondents noted an increase in the loan loss provision number relative to 2016.

Interest rates still remain relatively high despite the reference rate declining 575bps on account of a widened credit risk spread.

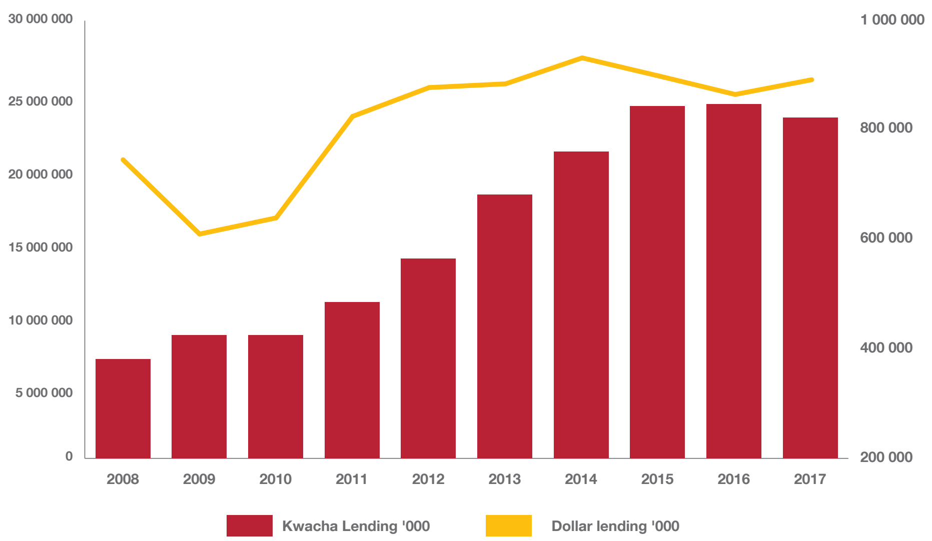
Figure 13: Lending activity trend



47% of respondents indicated that lending activity was either similar or lower than 2016 whilst 53% have reported an increase in lending. Generally, the six largest banks continued to report subdued lending activity.

Overall, the the monthly average credit outstanding for loans denominated in kwacha reduced by K 1.9 billion (7.64%) from 25.3 billion in 2016 to K 23.3 billion in 2017 whilst dollar denominated average credit outstanding increased marginally by USD 26.8 million from USD 866 million to USD 892 million, an increase of 3.1%.

Figure 14: Average credit outstanding

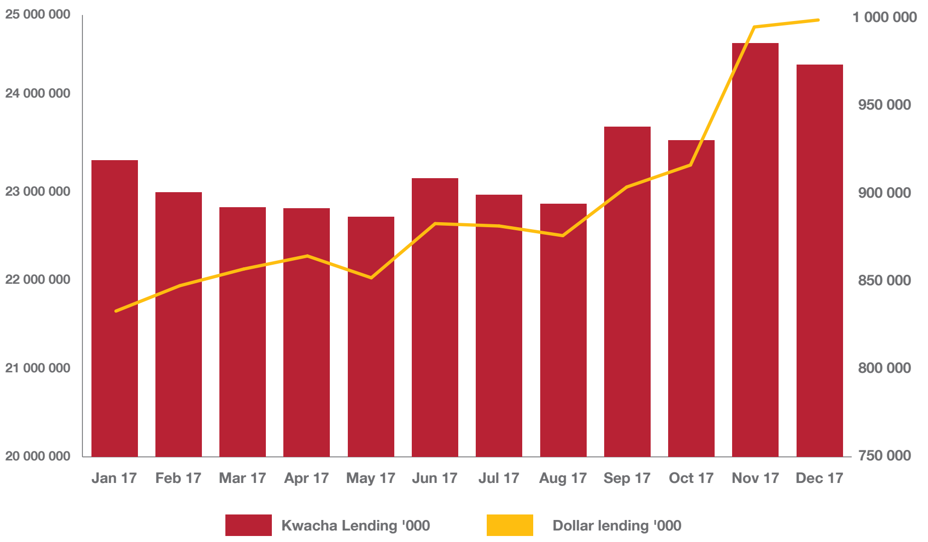


Source: Bank of Zambia Fortnightly statistics

In the first half of the year, there was little or no appetite for lending. The notable increase was in the months of September and November, when lending rose by 4% and 5% respectively from the previous months. This coincided with the revisions of MPR and SRR by the BoZ in those months.

When analysed on a month by month basis, we noted a general upward trend in credit extension. It remains to be seen whether this will be sustained given continued concerns regarding NPLs.

Figure 15: Credit outstanding



Source: Bank of Zambia Fortnightly statistics

3. Implementation of International Financial Reporting Standard - Financial Instruments (IFRS 9)

The banks surveyed said complying with the new IFRS 9 standard was the third most significant issue they faced in 2017.

However, a sharp disparity within the sector was as the foreign banks generally rated it lower than their local counterparts. In our view, this reflects the fact these banks leveraged off centralised approaches adopted by their parent companies towards implementation of the standard. Local banks , on the other hand , voiced concerns over their readiness to implement the standard with key challenges highlighted around investment in necessary technology, skills and possible need for additional capital.

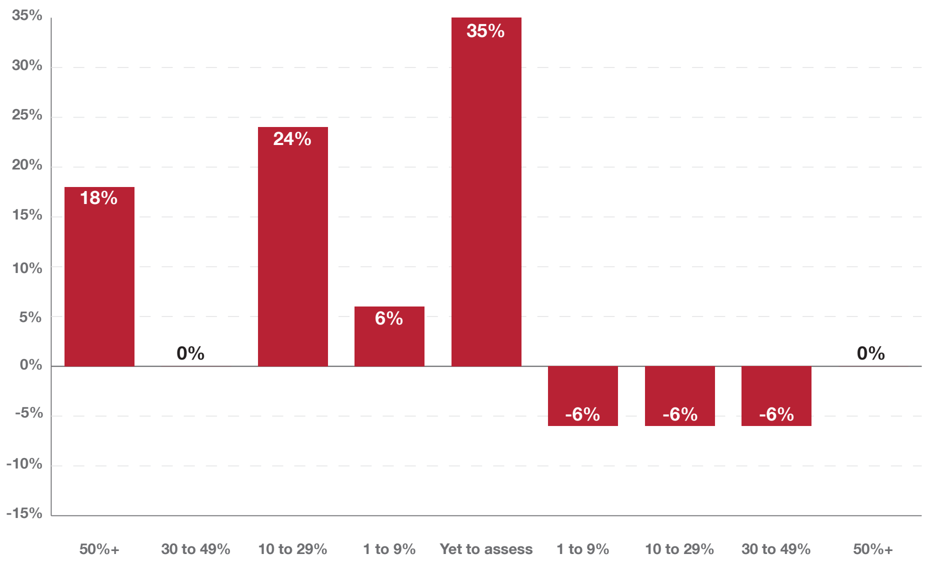
The new IFRS 9 impairment model was developed due to criticism of the IAS 39 incurred loss model after the financial crisis, where IAS 39 was regarded as resulting in banks recognising losses too little and too late. Banks themselves often said that the IAS 39 model prevented them from recognising losses they were anticipating but had not yet incurred. The IASB therefore sought to dvelop a new model based on Expected Credit Losses which is more forward looking.

While the idea of an expected, as opposed to incurred, model might be straightforward, the final standard is highly complex both in terms of requirements and the practical implementation challenges.

Of the total respondents, 48% said they expected an increase of some sort in their impairment, while 18% indicated that the implementation of IFRS 9 will result in them recording a reduction in their impairment balances. These varying responses are reflective of factors such as loss experience, expectations about the future, as well as the opportunities presented by the standard.

Meanwhile, 35% of respondents said they were yet to assess the impact of the new standard. Given the significant impact the standard is expected to have, and the time and resources needed for successful implementation, it is concerning to note the lack of urgency on this matter.

Figure 16: Expected impact of IFRS 9 on impairment



Asked to rank the major challenges in the implementation of the standard, obtaining forward-looking information ranked highly, with over 80% of the respondents viewing this as the foremost issue. The use of forward-looking information to determine the impairment loss is an important part of the new approach and sets it apart from the IAS 39 incurred loss model. This forward-looking information is that which is determined as reasonably able to predict future credit losses and includes information on the country's GDP, inflation, unemployment rate, Government borrowings and commodity prices, among others.

Reliability of this information is key in the assessment of future credit losses as this will help in determining how much and when expected losses should be reported. The foremost challenge faced in this regard relates to the disparities in sources of data. Should banks make use of public information such as that provided by the BoZ, the CSO and other relevant ministries, or should they rely on third party sources, such Moody's, S&P and Bloomberg? How does the data held by various sources compare?

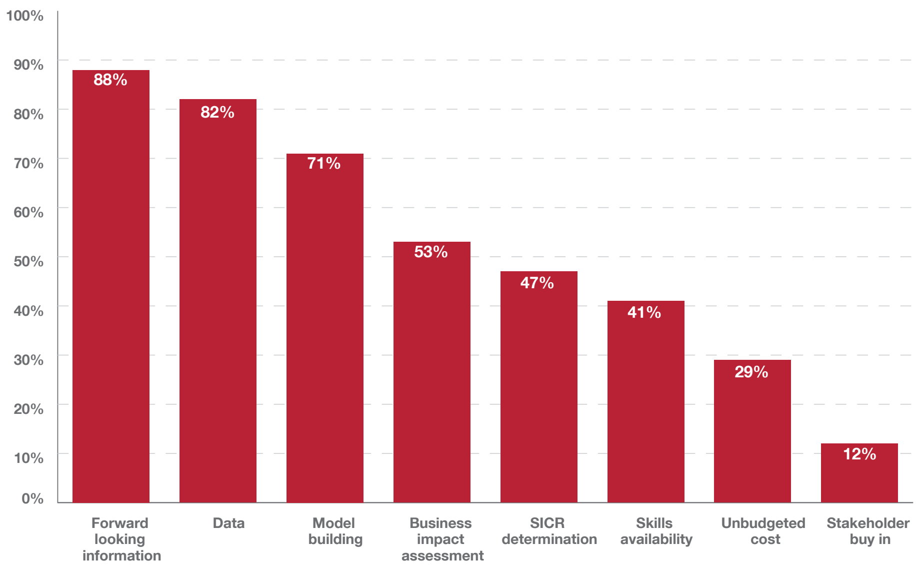
The second most significant challenge identified by respondents was obtaining relevant data. In this respect, data is seen as separate from the challenge of forward-looking information in that this is something within the control of the business as it is generated from internal management information systems. Implementation of IFRS 9 may require analysis of historical loss experience to determine among other things, the probability of default. A number of banks have found that their management information systems have not been designed in a way to allow for easy and efficient collation and analysis of the required information. In many instances, key information such as collateral details and values are maintained on physical files. This echoes the need for additional investment in smarter and more robust technology. Another common challenge noted was that relevant information was maintained in silos which further complicates the analysis process.

The third most significant challenge identified by respondents relates to the model-building process. Effective implementation of the standard for entities with significant exposure to credit risk, such as banks, is through the use of models to estimate impairment losses. Unlike the IAS 39, the models to be used under IFRS 9 are complicated owing to the various enhancements introduced.

This process is especially complicated for banks with significantly varied loan portfolios. Model building is a complex matter that often requires the services of external consultants such as actuaries and other professional advisors.

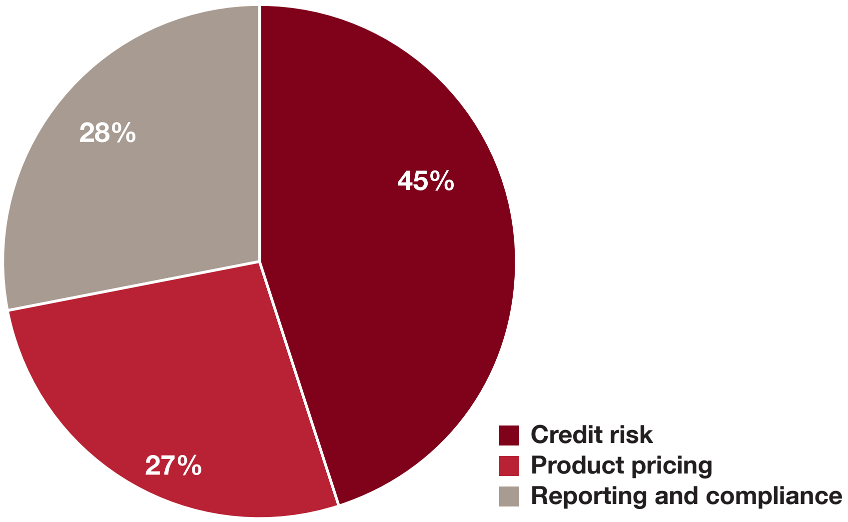
Other matters noted as challenges included business impact assessment, determining significant increase in credit risk and availability of skills, in that order. Interestingly, respondents did not view stakeholder buy-in and unbudgeted costs as major challenges. With 35% of the respondents yet to assess the impact, we expect that unbudgeted costs will ultimately be an issue, especially for local banks.

Figure 17: Challenges implementing IFRS 9



We also asked survey respondents what the broader impact of IFRS 9 would be on their bank's strategy. Most respondents recognise that the standard will have an impact across all their bank's operations. 45% of respondents indicated that the most significant impact would be to their credit risk management strategies, resulting in more carefully thought-out loan portfolios and tighter controls around lending. Another impact highlighted was on pricing as the expected losses may increase risk premiums. Respondents also indicated they expected a significant impact on reporting and compliance with increased investment in resources necessary for reporting and compliance.

Figure 18: IFRS 9 Impact on bank's strategy



The survey also showed that respondents expected benefits to accrue to them from the implementation of the standard. The majority of the respondents indicated that the new standard will encourage greater credit risk management and interaction between frontline, credit, finance and risk functions to produce the necessary data and aid decision making. Other notable benefits include the ability to apply a more insightful lending strategy, more prudence and the earlier recognition of losses.

4. Cyber security

Similar to 2016, respondents ranked cyber security as the fourth most significant issue affecting the industry, a reflection of the continued importance technology plays in delivering services to customers in the sector.

Over 90% of respondents confirmed that they offered their clients either Internet or mobile banking, or both. A further 38% indicated that between 40% and 60% of customer transactions are now conducted via electronic channels. It is this continued integration of the core banking system with the Internet and third party enablers that provides the greatest cyber risk as it has removed the traditional security perimeter that enterprises previously relied upon so heavily.

Banks must understand that there is no such thing as perfect security, but an agile and commercially pragmatic approach to the threat of cyber security is required. A critical first step in managing the cyber threat is the development of a cyber security framework that details how the institution will manage identified cyber security risks. A well-crafted framework allows an organisation to assess and improve its ability to prevent, detect and respond to cyber-attacks. The sector's customers will be pleased to note that 88% of respondents confirmed having a detailed cyber security framework in place, of which 60% rated their frameworks as mature. Without regulatory guidance, a number of banks have therefore adopted cyber-risk frameworks and other information security from their parent banks and global standards such as ISO 27000 and COBIT 5.

The consequences of a cyber-attack can be dire if an institution does not have a well laid out response plan and therefore discussions around cyber security and a bank's security framework should be of strategic importance. We expect executive/governance committees and boards to drive these discussions and assessments and give the issue the prominence it requires.

5. Managing costs

Managing costs has slipped from the most significant issue in 2016 to fifth in 2017. As previously highlighted, our view is that the broader issue is enhancing financial performance, but with the change in the interest rate environment and improving economic fortunes, cost management is of lesser concern.

A significant component of a bank's overall cost structure is its cost of funds. In 2016, the central bank adopted a tight monetary policy that resulted in a liquidity crunch and increased cost of deposits. As BoZ has loosened its monetary policy stance, the six largest banks have taken advantage of this additional liquidity to bring their overall cost of funding down. The other banks, however, have not been able to apply the additional liquidity in a similar fashion resulting in the average interest expense margin for the year sitting at 10%, as opposed to 4% for the top six banks.

Total industry operating expenses increased by 5.3% to K5.2billion (2016: K5billion). This is below the annual inflation rate of 6.1% for 2017, reflecting stringent cost control across the sector. A closer analysis of the overheads show that salaries and employee benefits account for 46% of total overheads, with an increase of 5.3% over 2016 which is also below the annual inflation rate. It remains to be seen whether this employee cost rationalisation was achieved with a focus on long-term employee productivity and overall operational efficiency.

It is interesting to note that the cost incurred as a result of fraud and forgeries has risen significantly to K40 million from K17million in 2016. This is a cause for concern and it is our view that banks should continue to invest in the resourcing and competence of their internal risk departments. The risk of fraud continues to increase and is a reflection of the change in the operational business models that now rely significantly on automated systems and third party collaborators.

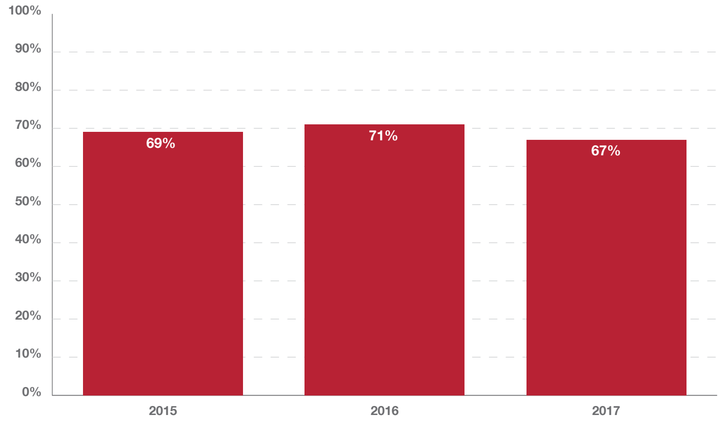
Professional fees paid to consultants bore the brunt of the cost cutting with a reduction of 37% to K177 million (2016: K282 million). This is consistent with our survey, which noted that the top three measures employed by the sector in reducing costs were:

- Tighter contracting with third party vendors
- Operational efficiency measures
- The automation of processes.

This focus on sustainable cost rationalisation will allow banks to right size and position themselves to grow profitably.

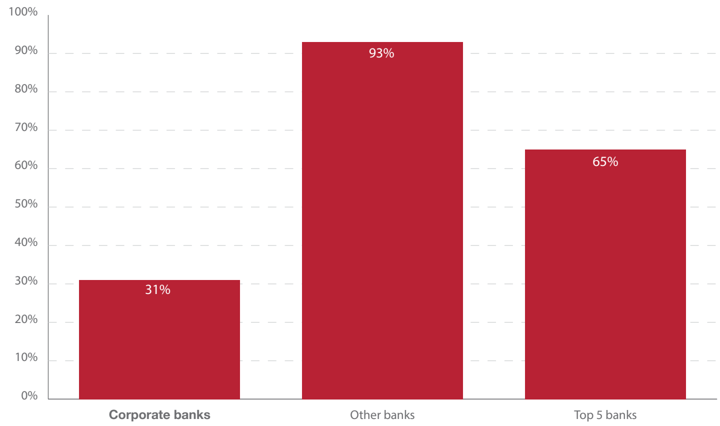
The sector's ability to rationalise costs while maintaining growth in operating income (2017: 13% increase) has had a positive impact on the cost-to-income ratio, which has dropped to 67%, below the 2016 and 2015 levels of 71% and 69% respectively.

Figure 19: Cost to income



Our analysis of the cost-to-income ratio across the industry, based on prudential returns, varied significantly depending on business model, size and maturity of the bank. It is evident that the top five banks (by asset size) have greater control over their cost-to-income ratio on account of their size and maturity of asset base. The Corporate banks have a cost-to-income ratio of 31% as they do not have the significant cost burden of a retail branch network. Our analysis reveals that for banks with a branch network, the ability to generate a strong net-interest margin is critical to covering thi significant cost burden. Consequently, those banks that have been unable to do so have higher cost-to-income ratios. We understand that some banks remain saddled with expensive deposits which continue to dictate a higher cost of funding. As these deposits fall off respective balance sheets we expect this situation to improve.

Figure 20: Cost-to-income ratio



We extended our comparison of Zambian banks' average cost-to-income with peer East African markets and noted the relative competitiveness of the cost-to-income parameter of Zambia's banking sector.

Figure 21: Comparison of banking cost-to-income ratio

	Zambia	Tanzania	Uganda	Kenya	Rwanda
Year end	**Dec-17**	**Dec-16**	**Dec-17**	**Dec-16**	**Dec-17**
CIR	**67%**	**62%**	**74%**	**71%**	**48%**

Sources : Country Central Bank website

Segmentation of survey findings

In an effort to extract more insights from the survey, we segmented the respondents into two broad cohorts; the six largest banks by asset size, and the rest of the industry. The six largest banks continue to dominate the industry and as at 31 December 2017, controlled 73% of the market share (2016: 72%). For this reason, we believe that the banks within this cohort are likely to perceive and respond to issues differently from the rest of the industry.

Top issues among Zambia's six largest banks

Figure 22: Top five issues among Zambia's six largest banks

2016		2017	
1	Cyber security (6.6)	1	Credit risk (7.8)
2	Managing costs (6.4)	2	Cyber security (5.2)
3	Local GDP growth (3.9)	3	Improving revenue growth (4.5)
4	Credit risk (3.3)	4	Managing costs (4.0)
5	Liquidity risk (3.2)	5	Implementation of IFRS 9 (3.3)

The population of the top five issues identified by the top six banks is consistent with the industry-wide survey results, albeit varying in order of significance. Worth noting is the high level of convergence around credit risk as the issue of most significance in 2017. This is largely informed by the increased level of NPLs in the industry in 2017 which at 11.6% was in breach of the 10% prudential target.

Cyber security also remains high on the agenda for the six largest banks in comparison to the rest of the industry. This is attributed to the comparatively greater use of digital platforms by these banks. Consequently, the likelihood of suffering a cyber-attack, in addition to the magnitude of potential losses, is higher.

Implementation of IFRS 9, while still one of the top five issues, was ranked fifth by the six largest banks, compared to second by the rest of the industry. This ranking is a reflection of progress that these banks have made in implementing IFRS 9. This is perhaps of little surprise considering that five of the six largest banks are foreign. Consequently, these banks have the resources and competencies more readily accessible through support from their respective parent companies.

As a result of the positive changes within the macro-economic environment, liquidity risk and local GDP growth were not ranked amongst the top five issues in our current year survey. That being said, these two issues were ranked sixth and seventh in the current year which implies, level of significance notwithstanding, liquidity and local growth remain on the agenda.

Top issues among the rest of the banks

Figure 23: Top five issues among the rest of the banks

2016		2017	
1	Credit risk (4.9)	**1**	Improving revenue growth (6.4)
2	Managing costs (4.8)	**2**	Implementation of IFRS 9 (5.8)
3	Improving revenue growth (4.3)	**3**	Credit risk (4.3)
4	Liquidity risk (4.1)	**4**	Capital management (3.6)
5	Interest rate risk (3.1)	**5**	Tax compliance (3.3)

The ranking of the top three issues for this group of banks is identical to the ranking at an industry-wide level. However, this group of banks is also concerned about capital management and tax compliance.

The Rubik's Cube

The analysis of the quarterly prudential returns submitted by banks indicates that the industry as a whole had excess capital of K 3 billion as at 31 December 2017. While this portrays a picture of financial soundness for the industry, it disguises the fact that four banks were yet to comply with their respective capital requirements. The capital deficiency of these four banks is estimated at K 309 million.

The four banks mentioned above exclude any foreign-owned banks whose capital computations were based on the lower threshold of K 104 million. These banks applied the lower threshold on the understanding with BoZ that they would implement capital plans that involved changing their respective ownership structures to meet the definition of a locally owned bank.

This state of affairs is despite BoZ having extended on average five year dispensations to banks that were non-compliant when the change in minimum capital requirements came into effect in 2012. The objective of these dispensations was to allow those banks implement their respective capital plans to ensure full compliance within the agreed timelines.

This begs the question: what happens next?

The options available to BoZ appear to be rather limited. Granting an extension of the existing dispensations could put into question BoZ's resolve to ensuring compliance with the existing minimum capital requirements, while repealing or relaxing the requirements would potentially send the wrong signals and dampen confidence within the sector. This is tied to the wider policy inconsistency Regulators in Zambia have been cited for. The worst possible outcome, revocation of banking licenses, could cause irreparable damage to the industry in the short, medium and long-term, which makes amalgamation or mergers an immediate option for some commercial banks.

As the regulator, BoZ is faced with the unenviable task of solving this Rubik's Cube-esque problem where any well-intended action will, in many cases, be followed by an unintended negative consequence – the severity of which may vary.

BoZ will therefore have to craft a solution whose outcome does not appear to weaken its position as the regulator, while at the same time remaining cognisant of how its action or inaction could impact the banking industry as a whole.

Tax compliance

In his budget speech, the former Finance Minister Honorable Felix Mutati indicated that the philosophy that informed the relatively minimal tax changes in the budget was that of stability within the tax regime. In order to achieve its revenue collection targets, the Zambia Revenue Authority (ZRA) focused its efforts on enforcing existing provisions of the Income Tax Act. With a view to ensuring more tax compliance, ZRA adopted, and has continued to adopt, a more aggressive stance. It is the pressure that ZRA has continued to exert that has resulted in the increased level of significance that tax compliance received in the current year survey.

Other survey findings

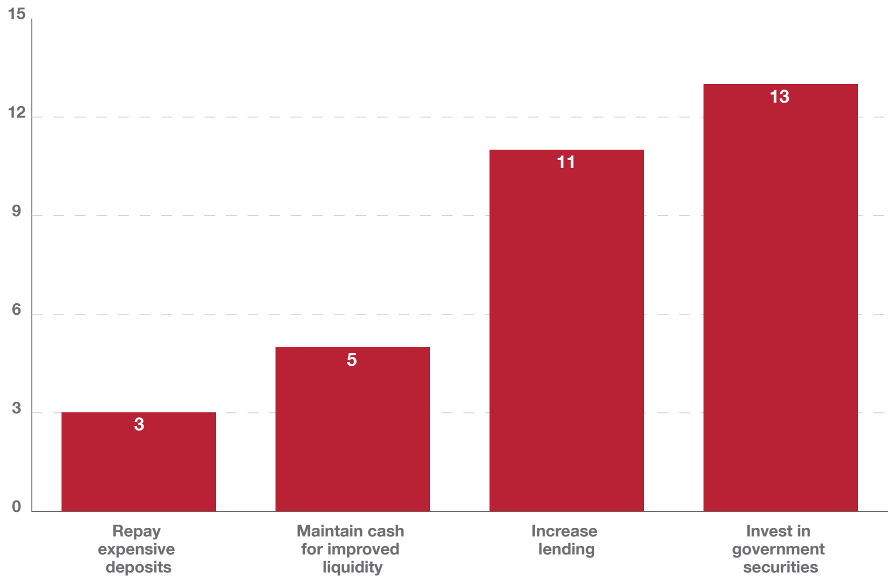
Show me the money...

Ranked third in our 2016 survey was managing liquidity risk. This ranking was largely a reflection of the tight monetary stance that had been adopted by BoZ in response to the sharp depreciation of the Kwacha and skyrocketing inflation.

As mentioned earlier, BoZ continued to ease its monetary policy stance during the year with the MPR and SRR closing the year at 10.25% and 8% respectively. Expectably, this stimulated the unlocking of liquidity within the market which we believe informed the decision of respondents to attach less prominence to liquidity risk in the current year.

While the easing of the monetary policy would have come as a source of delight for the industry, it does beg the question, where has all the money gone? When asked about how they deployed this additional liquidity, majority of respondents indicated that they had either invested this much needed additional liquidity in government securities, increased lending or both.

Figure 24: Use of additional funds



Our analysis of the trend in the stock of government securities corroborates this response. Specifically, since February 2017 when BoZ signaled an easing of the monetary policy, the monetary value of government securities has increased by 36%, from K 34.8 billion to K 47.2 billion.

In relation of total assets held by banks, the contribution of investments in government securities has increased to 26% from 14% in the prior year. Also worth noting is that, over the last year, the proportion of government securities held by banks as a percentage of the total stock of government securities has increased to 39% (K 18.5 billion) from 29% (K 9.4 billion). The increase is attributed to the term structure of interest rates which has made it very lucrative to lock excess liquidity in government securities.

As banks bid to strike a balance between maximizing returns on interest bearing assets and managing credit risk, increased investment in government securities will invariably result in crowding out of the private sector. This is particularly more pronounced in an environment where credit risk may be perceived as relatively high – as is the case in Zambia. Consequently, while the stock of government securities held by banks increased by a staggering 98% (K 9.13 billion), from K 9.4 billion to K 18.5 billion, credit outstanding has increased by 9% (K 2.8 billion), from K 31.6 billion to K 34.4 billion.

The weight of regulation…

Respondents highlighted regulatory compliance as an area of significant concern. The compliance spectrum is broad and includes dealing with the Central Bank, Securities and Exchange Commission and Know Your Customer (KYC) matters. The time and human resource spent on attending to various compliance related matters has significantly risen in the recent past. This takes senior management time away from attending to the core business of dealing with customer needs but also adds cost to the bank.

Increasingly banks have found themselves complying with regulations from different regulators that ultimately have the same objective. Streamlining these requirements will undoubtedly reduce the compliance load. Another concern is the introduction of regulations without due input from the sector. The 3 year parallel run on Basel 2, delayed Corporate Governance guidelines and soon to be introduced SEC Act come to mind. A clear view on the final position of some of these regulations would undoubtedly assist banks clearly determine their compliance obligations and resource appropriately.

Challenges and opportunities

Challenges

1. Fiscal discipline

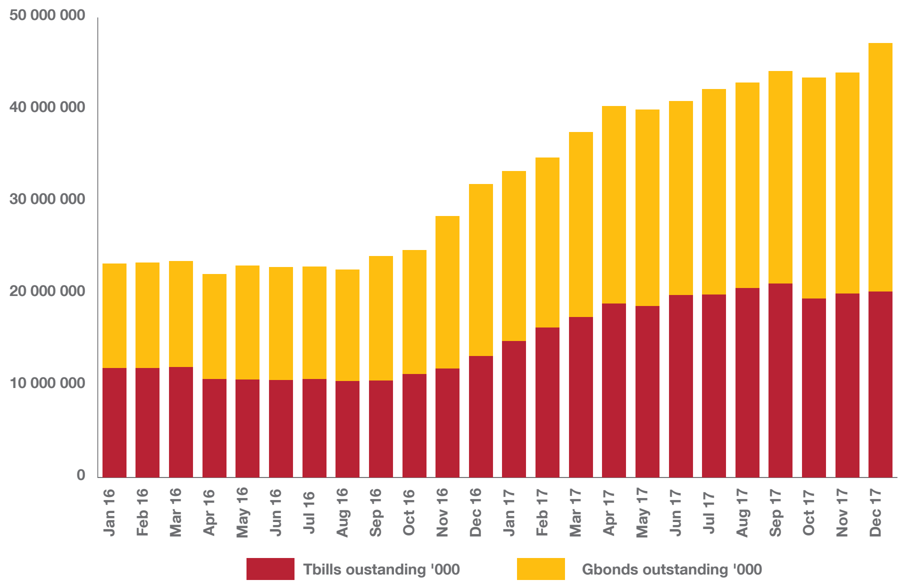
Survey respondents ranked the ability of the Zambian Government to achieve and maintain fiscal discipline as a significant factor influencing their perception of the current and future prospects for the economy. Substantive actions have been taken by the BoZ in 2017 to ease the monetary policy environment and these should be complemented with demonstrable fiscal discipline in order to ensure a favorable environment for the banking sector and economy as a whole.

Government arrears to the private sector have continued to be a significant contributor to NPLs in the banking sector, especially players that have failed to service credit facilities because the Government has not settled their dues with them. Settlement of amounts owed has not been at the pace most stakeholders had hoped for and this gives rise to fundamental questions regarding the sustainability and going concern of the entities that Government owes.

In 2016 we forecast that the full effect in terms of NPLs had not been realised on account of factors such as proactive debt restructuring. The rise in the industry NPL ratio bears this out.

Another factor impacting this area is the level of Government borrowing and its sustainability. In 2017 there was a significant rise in the level of domestic borrowing driven by Government's appetite for local currency debt, an actualisation of the budget pronouncement as the Ministry of Finance shifts towards domestic market funding of its fiscal programmes.

Figure 24: Total government securities issue



In addition, the country has obligations to Eurobond note holders due in the coming years.

We therefore ask:

- As long as Government continues to borrow in such an aggressive manner, what incentive will financial institutions have to lend to the private sector given the lower level of perceived risk attached to Government paper?
- When will we see a tapering off in Government's appetite to borrow? Is there a magic number?
- Are arrangements being put in place to ensure debts are serviced adequately?

However, we are encouraged by the development of the 2017-2019 Medium Term Debt Strategy. Its effective implementation will help manage internal and external liabilities whilst providing confidence that debts will be settled as and when they fall due.

2. Market structure and concentration

The market continues to show asymmetrical tendencies when a comparison is performed between the larger and smaller players. According to the prudential returns, the industry-wide total profitability of K1.3 billion, an increase of 33% over the 2016 reported profit after tax of K990 million, represents a record performance. However, the six largest banks contributed K 1 billion of this profit, representing 77% of the industry-wide profitability.

With respect to capital, in totality, the sector reported a capital adequacy ratio of 27% which indicates that the industry is in a strong position. However, a closer look shows that there are players at opposite ends of the spectrum and this poses some risk to the overall stability of the financial sector.

Specifically, there are four banks that are yet to meet their respective minimum capital requirements, with the total gross deficit standing at K 309 million. The level of expected market consolidation has not materialized, possibly due to competitive reasons. However, the dispensations previously granted by the Central Bank are coming to an end and it remains to be seen how events will unfold.

3. Talent acquisition and management

Adequacy of appropriate banking skills is a significant challenge facing the sector. A premium is attached to key resources which continues to make talent acquisition and retention in the sector an expensive venture. The cost of resources has a direct bearing on the productivity realised and with the continued focus on technology-driven initiatives, such as automation and digitisation, the focus on this matter is likely to become ever more significant.

However, the solutions are unlikely to be achievable in the short term. New skills that are aligned to technology-influenced Organisational structures, products and services will be required. This may entail the reskilling of existing staff, or identification and recruitment of a different cadre of employee.

One way of developing talent is via secondments both into and out of Zambia. This is an option that is likely to be more easily available to banks that are part of multi-national organisations. Based on survey respondents, the banking sector had approximately 7,500 staff employed at the end of 2017. Of these, the number of inbound and outbound expatriates numbered 74 and 40 respectively. This represents 0.98% and 0.54% of the total industry head count.

4. What's the issue with non-performing loans?

NPLs in themselves are an expected cost of doing business in this sector. The current trend needs to abate if robust credit growth and performance is to be seen. While the reasons for the current high NPLs in the sector may largely reflect the stress on the economy, there also remains an underlying issue of the overall credit culture within Zambia. The central bank has made efforts to improve this by promoting financial literacy and a savings culture. Our view is that the consequences of non-repayment of credit is an issue that informs the credit culture that should be urgently addressed. Interventions may include:

Judicial reform to allow for faster disposal of collateral; and

Extending the impact of negative credit reference reports issued on individuals and corporates to the wider economy.

There are many other measures that are required to reform the credit culture in Zambia but every journey has to start somewhere and we believe the matters highlighted are good first steps.

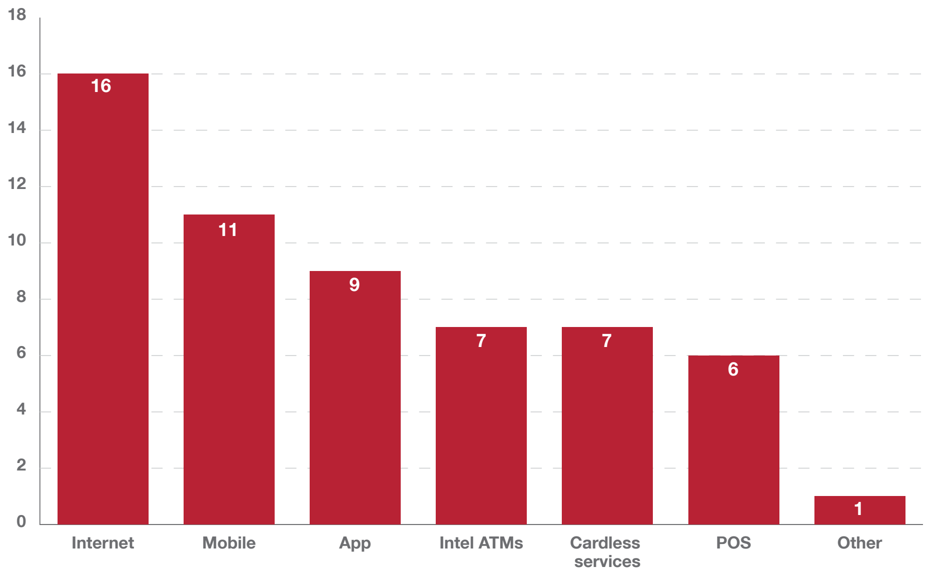
Opportunities

1. Technology; the game changer

Technology enabled products and services are now firmly at the frontier of product and service development and enhancing the customer experience. Technology also provides for the opportunity to lower costs and enhance staff productivity.

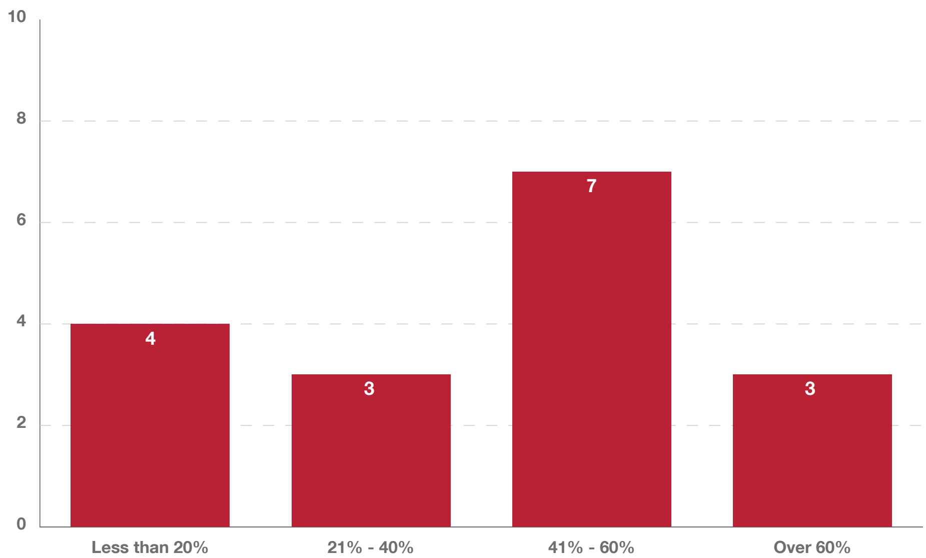
Most banks indicated the existence of several technology-based channels through which customers are able to transact. Sixteen of seventeen banks provide Internet banking with mobile banking (USSD enabled) available from eleven banks. In 2017, several players took advantage of the increased availability of smart phones by launching of mobile phone applications.

Figure 25: Technology enabled channels



Banks also reported that the following proportion of applicable transactions (deposits, withdrawals and transfers) were made using e-channels.

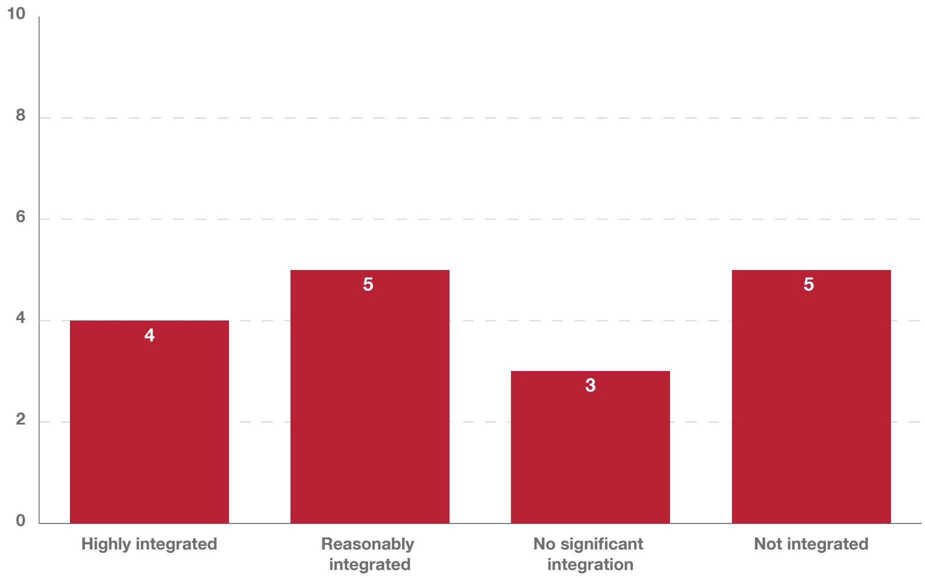
Figure 26: Use of electronic channels



Banks acknowledge that they are not always the best-in-class with regards to development and the roll out of IT-based solutions. Therefore, partnering with others, for example mobile phone operators, to offer complimentary services does provide a great opportunity for growth and financial inclusion. However, as at the end of 2017, the extent of collaboration with the mobile phone operators varied markedly.

It's definitely a case of watch this space in as far as the further evolution of technology, device accessibility, customer needs and demands are concerned.

Figure 27: Intergration with mobile telephone operators



Definitions[1]

2. Financial inclusion

Reaching the unbanked and tapping into the potential thereof is a priority of most banks in Zambia. The Government, regulators and many other stakeholders continue to pay keen interest in the progress being made in this area.

Great successes have been recorded with regards financial inclusion. However, there is still a lot to be done.

There is evidence of the sustained commitment of major stakeholders to achieving fairly robust financial inclusion targets. Banks are an important element of the process and are provided with a substantial opportunity to grow their customer bases as long as they develop suitable products. In 2017, the National Financial Inclusion Strategy was launched covering the period 2017 to 2022. In it, ambitious yet achievable targets are outlined together with actions required to achieve them.

To fully take advantage of opportunities available as the country pursues its financial inclusion targets, the banks will need to collaborate with other service providers. According to ZICTA, the volume and value of transactions being processed through mobile payments platforms have increased from 2016 by 11% and 30% respectively. Overall value of transactions processed in 2017 amounted to K4.6billion.

Some challenges noted in achieving targets by survey respondents included:

- Infrastructure and accessibility of some parts of the country
- Lack of trust in the banking system
- Preference for use of cash for transactions undertaken
- New ZRA Tax Payer Identification Number (TPIN) requirements for bank accounts
- Low level of financial literacy
- Inadequate regulatory framework supporting new products and services

[1]Highly integrated (allows for transfers between customer bank account and mobile money wallet for any of the mobile phone operators and vice versa)

Reasonably well integrated (allows for transfer from customer account to mobile money wallet for any of the mobile phone only)

No significant integration (may be maintaining cash float for mobile phone operators)

Not integrated (does not interface with the mobile phones operators)

Conclusion

In the recent past, economic factors gave rise to the need for banks to adapt in order to survive. That said, the challenges faced created the opportunity for the Banks to review their operations and structures in order to improve productivity and enhance profitability. In 2017, Bank of Zambia played its part and took important measures aimed at improving liquidity in the market, championing financial inclusion and creating an environment that was meant to stimulate growth of more affordable credit.

Expectations on banks are high. Despite the difficulties the sector has faced in recent years, stakeholders need banks to contribute ever more to Zambia's economic growth agenda. Achieving a balance between the many societal expectations placed on banks and the realities faced by the sector is critical to achieving a win-win situation for all.

Progress has been made but much remains to be done to achieve universal financial inclusion. The Banking fraternity needs to partner with the government and other relevant stakeholders and find a way to forge a partnership to deliver this promise. Opportunities continue to exist around technology enabled products and services that facilitate access to a broad range of quality and affordable financial products and services.

The recent past has certainly been challenging. However, we believe there is reason to be optimistic about the immediate and future prospects of the banking industry and economy as a whole, albeit with some caution.

Appendix

Financial performance and analysis

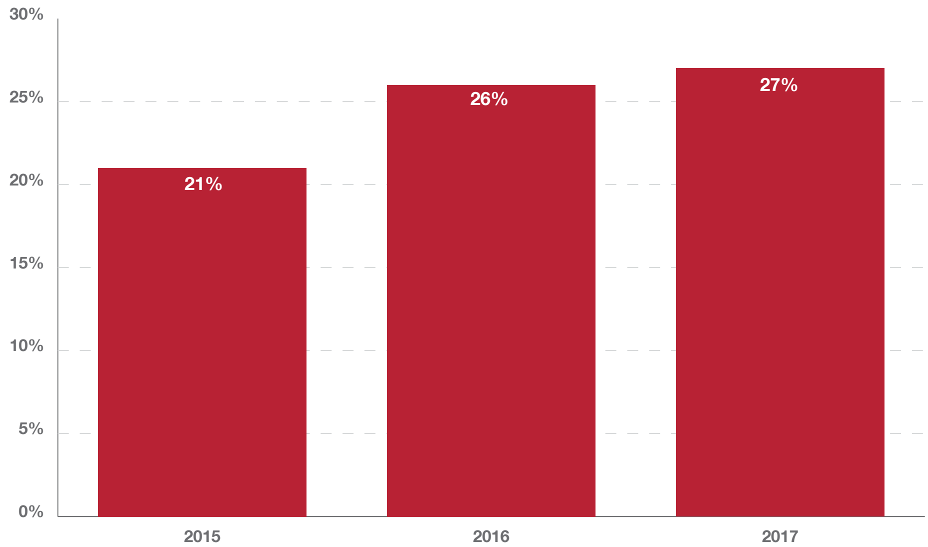
1. Capital adequacy ratio

In the current year, the capital adequacy ratio (CAR) recorded a marginal increase from 26% in 2016 to 27% in 2017. The increase was mainly attributed to an increase in the aggregate industry profit. This increase in profits was driven by the increase in interest income from an increased investment in government securities. However, the increase is marginal because the risk weighted assets (RWA) remained unchanged. This was because the increase was on account of investment in government securities which have a risk weighting of nil.

The average CAR of 27% for the industry is above the 10% minimum required by the regulator. On this basis it may be concluded that the industry as a whole is well capitalised .However, as earlier mentioned there are four banks yet to meet their minimum capital requirements as at 31 December 2017.

Chart I below shows the increase in the industry CAR for the period 2015 to 2017.

Chart I: Capital adequacy ratio

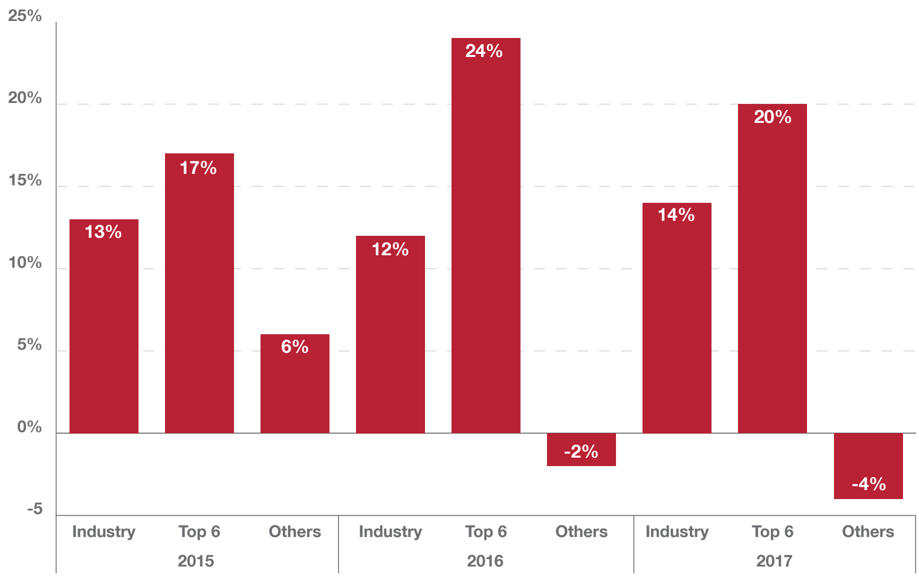


Source: Bank of Zambia

2. Return on equity

The return on shareholders' funds increased 2% in the period under review from 12% recorded in 2016 to 14% in 2017. The increase was mostly attributed to better industry profitability. The six largest banks recorded a ROE of 20% which is higher than the industry average above. However, this was lower than the ROE of 24% recorded in 2016. The rest of the industry also recorded a reduction from -2% to -4%. This was a mix of weak results as well as an increase in capital positions as a number of these banks injected additional capital during the year.

Chart II: Return on equity

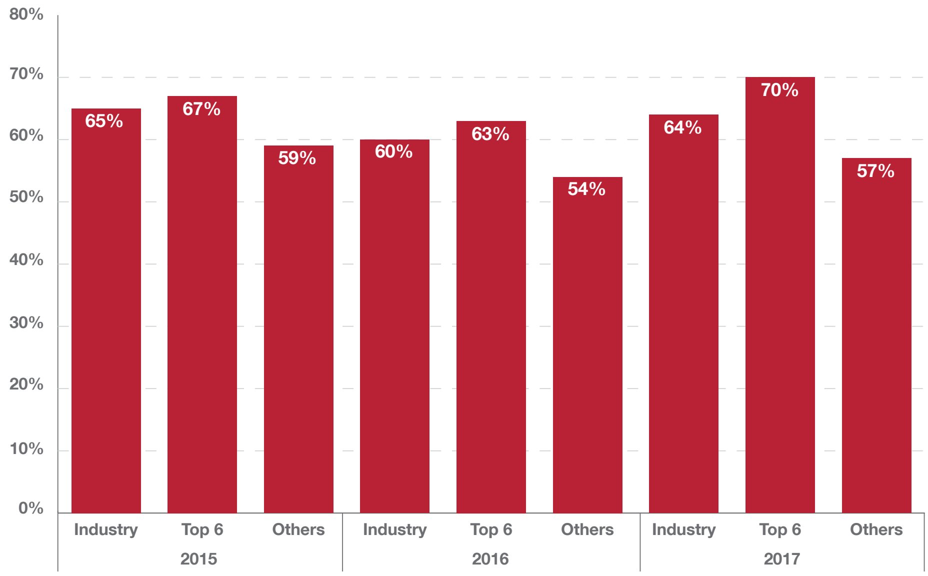


Source: Bank of Zambia

3. Net interest margin

The industry net interest margin increased by 4% in 2017 from 60% in 2016 to 64% in 2017. The six largest banks recorded an increase of 7% compared to 3% for the rest of the industry. The general increase in net interest margin is attributed to the increased investment in government securities as well as the cost of funding reduction following the lowering of monetary policy rates.

Chart III: Net interest margin



Source: Bank of Zambia

Glossary

1. Capital adequacy ratio (CAR)

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

2. Return on equity (RoE)

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

3. Net interest margin (NIM)

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

4. Net profit margin (NPM)

$$NPM = \frac{\text{Profit after tax}}{\text{Net interest and non-interest income}}$$

5. Cost to income ratio (CIR)

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

6. Loans to deposits ratio (LDR)

$$LDR = \frac{\text{Total loans}}{\text{Total deposits}}$$

7. Non-performing loans ratio (NPLR)

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

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