2019 Bank and Non Bank Industry Survey

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Foreword

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It goes without saying that the challenges that we as a country are currently facing are the most significant of our time.

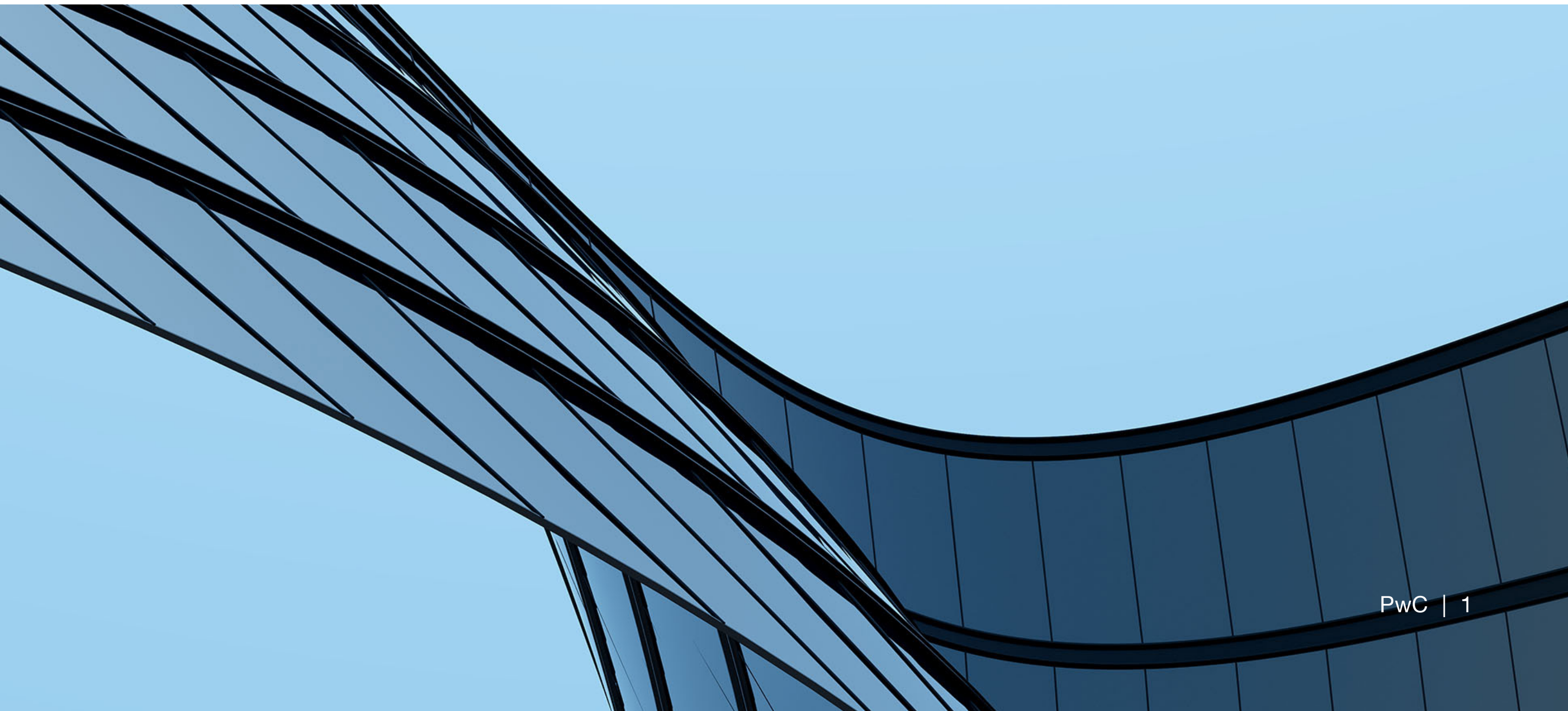
Even before the effects of the Covid-19 pandemic became apparent, Zambia was grappling with the impact of sluggish economic growth brought on by a combination of factors. These include the fiscal strain occasioned by the country's debt repayment commitments, the effects of the energy deficit, exchange rate volatility and rising inflation.

Zambia's economic challenges have affected banking and non-banking financial institutions (NBFIs) to varying degrees. It is a commonly held view that the full impact of Zambia's pre-Covid-19 economic challenges and the further complications brought on by the Covid-19 pandemic are only now becoming apparent. We have endeavoured to include an assessment of how various aspects of Bank and NBFI operations and performance have been affected.

We requested a single response from each of our respondents representing the view of the organisation. In total, we sent questionnaires to all 18 banks and 47 NBFIs and attained a response rate of 89% and 30% respectively. This compares to a 100% and 51% achieved when we prepared our 2018 report.

We would like to thank all of the respondents for their input. A sincere thanks also to our guest contributor, Betty Wilkinson from the Financial Sector Deepening Zambia (FSDZ), and the PwC team that brought this report together.

We look forward to receiving your feedback.



Executive summary

We are now well and truly on our way towards fully defining what operating under the 'new normal' will entail.

Banks and NBFIs have been at the forefront of providing critically needed essential services in order to keep economic activity going. That said, as businesses on the 'front-line', they have, like others, been impacted from an operational as well as a broader economic perspective.

The full impact of the challenges brought on by the prevailing circumstances is now becoming more apparent and it is likely that the effects will be felt for a while to come.

You will note that this report has been published later than we have traditionally done since 2016. During the onset of the Covid-19 pandemic, we received feedback from participants to defer our survey to allow them deal with the immediate challenges the pandemic posed. We took advantage of the deferred report launch to adjust the survey to cover, to the greatest extent possible, the emerging effects of the Covid-19 pandemic on banks and NBFIs. The economic environment remains very dynamic, and more and more will become apparent with the passing of time. Whereas our previous surveys have been mainly for particular calendar years, this report extends beyond 2019 to take into account developments in 2020.

Survey results

This is the fourth edition of our Bank and Non Bank Industry Survey and for the first time 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 89% and 30% respectively.

Our survey questionnaire covered ten broad areas: the state of the industry; impact of Covid-19; technology and the future of banking; financial inclusion; cybersecurity; 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 ten being the most and one being the least significant. In analysing the responses, we used a weighted 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 to the survey responses received. Publicly available statistics for the economy, commercial bank and NBFI sectors in Zambia and other countries for comparative purposes were also obtained.

Top five issues – banks and NBFIs

There were three common issues identified by the financial institutions surveyed: state of the local economy; the impact of Covid-19; and credit risk.

The state of the local economy was the most pressing issue affecting banks, while NBFIs ranked it second. For their part, NBFIs ranked the impact of Covid-19 first and banks ranked it second. Credit risk was the third-ranked common issue amongst the banks and NBFIs.

Issues over which banks and NBFIs diverged included capital management and improving revenue growth, both of which were a concern for banks but did not feature in the top five issues affecting NBFIs. While managing liquidity risk and the escalating cost of doing business were among the top issues for NBFIs, this was not so for banks.

Figure 1. Survey results across banks and NBFIs

Banks		Common issues		NBFIs	
Capital management	6.5	State of the local economy	8.7	Liquidity risk	6.6
Improving revenue growth	5.6	Impact of Covid-19	8.7	Escalating cost of doing business	5.8
		Credit risk	6.6		

Top five issues – banks

The state of the local economy was the issue of most concern for banks in 2019, as was the case in 2018, which continues to reflect the apprehension over the impact of the weakened economy on the banking sector.

In addition to the state of the local economy, which ranked first in 2019 and 2018, an additional two of the five most pressing issues for banks in 2019 were matters brought forward from 2018. These were: Improving revenue growth (ranked fifth in 2019 and second in 2018); and credit risk (ranked third in 2019 and fifth in 2018). Intriguingly, implementation of IFRS 9 (ranked third in both 2018 and 2017) was ranked eighth in 2019. The other issues to emerge in the top five issues for banks are the impact of Covid-19 and capital management.

Overall, credit risk (since 2016) and improving revenue growth (since 2017) are the two issues that have consistently continued to feature among the top five most pressing concerns in our bank survey.

Figure 2. Top five issues for banks 2017–2019

2017		2018		2019	
Improving revenue growth	5.7	State of the local economy	5.6	State of the local economy	9.0
Credit risk	5.5	Improving revenue growth	5.3	Impact of Covid-19	8.9
Implementation of IFRS 9	5.1	Implementation of IFRS 9	5.2	Credit risk	6.5
Cybersecurity	3.5	Abolishment of unwarranted fees and charges	4.8	Capital management	6.5
Managing costs	3.3	Credit risk	4.7	Improving revenue growth	5.6

Top five issues – six largest banks

Two of the top five issues identified by the country's six largest banks[1] are consistent with the broader banking sector survey results. These are the state of the local economy (the top-ranked issue for the six largest banks and second-ranked by the broader banking sector in 2019) and credit risk (the second most significant issue for the six large banks compared to third for the wider industry).

Figure 3. Top six banks vs industry vs other banks

Top 6 banks		Industry		Other banks	
Escalating cost of doing business	4.6	State of the local economy	9.0	Impact of Covid-19	9.4
Abolishment of unwarranted fees and charges	4.5	Credit risk	6.5	Capital management	6.7
Increased competition from non-traditional players	4.4			Improving revenue growth	5.4

Overall, the state of the local economy and credit risk are issues that have continued to feature among the top five most pressing issues for Zambia's six largest banks since 2016, while the abolishment of unwarranted fees and charges has featured since 2018.

Figure 4. Top five issues – six largest banks

2017		2018		2019	
Credit risk	7.6	State of the local economy	6.3	State of the local economy	9.3
Cybersecurity	5.2	Managing costs	5.8	Credit risk	6.2
Improving revenue growth	4.5	Credit risk	5.2	Escalating cost of doing business	4.6
Managing costs	4.0	Improving revenue growth	4.8	Abolishment of unwarranted fees and charges	4.5
Implementation of IFRS 9	3.3	Abolishment of unwarranted fees and charges	4.5	Increased competition from non-traditional players	4.4

1. Largest banks determined by asset value.

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 (refer to Figure 3). The notable difference is that these respondents identified the impact of Covid-19, capital management and improving revenue growth as the most pressing issues for 2019.

Overall, improving revenue growth and credit risk are issues that have continued to feature among the top five most pressing issues for other banks since 2016, while the state of the local economy has featured since 2018.

Figure 5. Top five issues – other banks

2017		2018		2019	
Improving revenue growth	6.4	Implementation of IFRS 9	6.1	Impact of Covid-19	9.4
Implementation of IFRS 9	5.8	Improving revenue growth	5.5	State of the local economy	8.8
Credit risk	4.3	State of the local economy	5.3	Credit risk	6.7
Capital management	3.6	Abolishment of unwarranted fees and charges	5.0	Capital management	6.6
Tax compliance	3.3	Credit risk	4.5	Improving revenue growth	5.4

Top five issues – Non-Bank Financial Institutions

As our survey was performed during the period when rapid adaptation to the prevailing Covid-19 induced challenges was ongoing in Zambia, we noted that the NBFIs identified the impact of Covid-19 on their operating environment as the most significant issue.

Three of the five most pressing issues for NBFIs in 2019 were matters brought forward from 2018. These were: state of the local economy (ranked second in 2019 and 2018 respectively); credit risk (ranked third in 2019 and first in 2018); and liquidity risk (maintaining its ranking of third in 2019 and 2018). Surprisingly, implementation of IFRS 9 (ranked fourth in 2018 was ranked twenty second in 2019). The other issue to drop out of the top five issues for NBFIs was client retention (ranked fifth in 2018).

Overall, credit risk, state of the local economy and liquidity risk are the only issues that have continued to feature among the top five most pressing issues since 2018.

The other matter unique to this sector was the escalating cost of doing business. This is largely on account of increased operational costs such as continued load shedding by ZESCO and inflationary price increases.

Figure 6. Top five issues – NBFIs

2018		2019	
Credit risk	6.0	Impact of Covid-19	8.7
State of the local economy	4.5	State of the local economy	8.2
Liquidity risk	4.6	Credit risk	6.8
Implementation of IFRS 9	4.1	Liquidity risk	6.6
Client retention	4.0	Escalating cost of doing business	5.8

Analysis of the top issues

Issues affecting banks and NBFIs'

Impact of Covid-19 and growth of the local economy

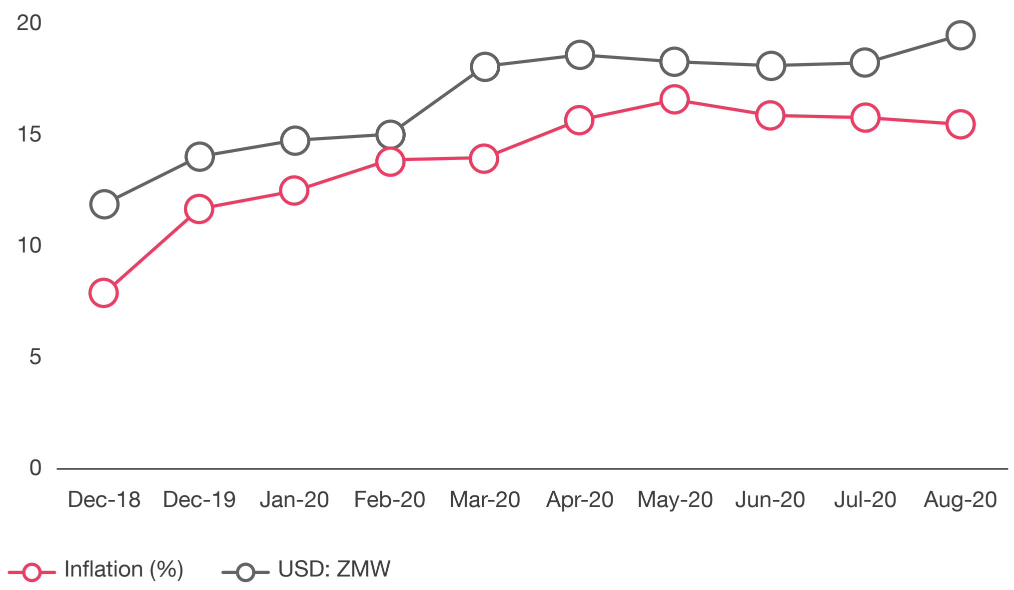
Navigating the impacts of the Covid-19 pandemic has not been an easy feat for any nation in 2020, with the pandemic resulting in reduction in mobility and overall demand of goods and services. The July 2020 world economic outlook has projected a contraction of -4.9% (global) and -3% (emerging and developing economies).

The Zambian economy has by no means been immune, with the African Development Bank revising its 2020 growth projections down from 2.4% prior to the Covid-19 pandemic to -4% (best case) and -6.5% (worst case). The travel restrictions and slowdown in global trade has hit the tourism and mining sectors particularly hard and have also impacted foreign exchange inflows into the country.

The Zambian Kwacha has seen a depreciation of 29% against the United States Dollar (USD) since the advent of Covid-19 in March 2020 to August 2020. Inflation has also increased from 13.9% to 15.5% during the same period.

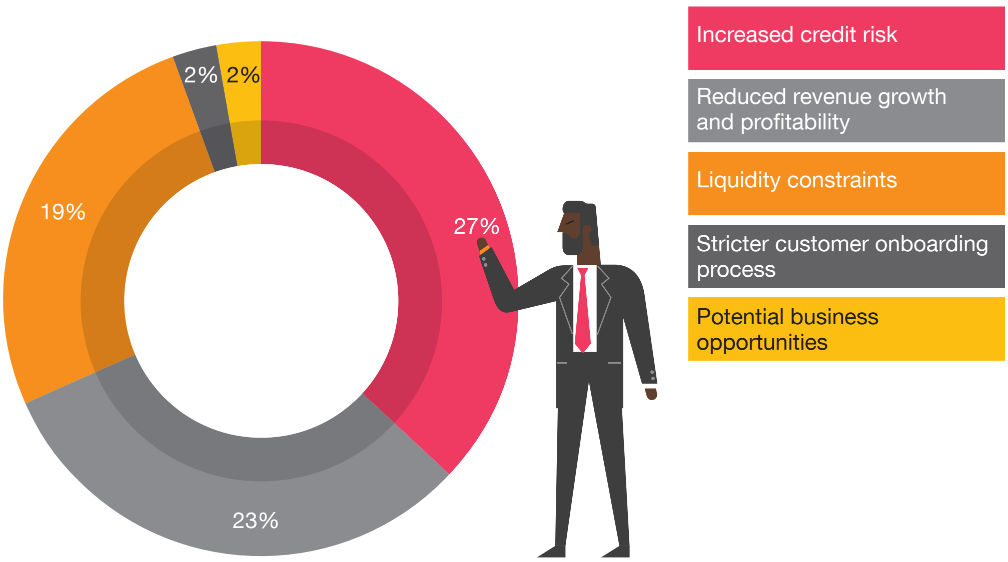
The local banking sector has been impacted by these negative trends, with Fitch solutions forecasting that credit growth will slow down from 17.7% in 2019 to 7.6% in 2020. This can be evidenced from responses that we received to our survey, with the largest number of responses highlighting that the current economic conditions have resulted in an increase in operational costs and credit risk, and a reduction in revenue growth and profitability.

Figure 7. Exchange rate and inflation



Source: Bank of Zambia

Figure 8. Effects of the strain on the Zambian economy



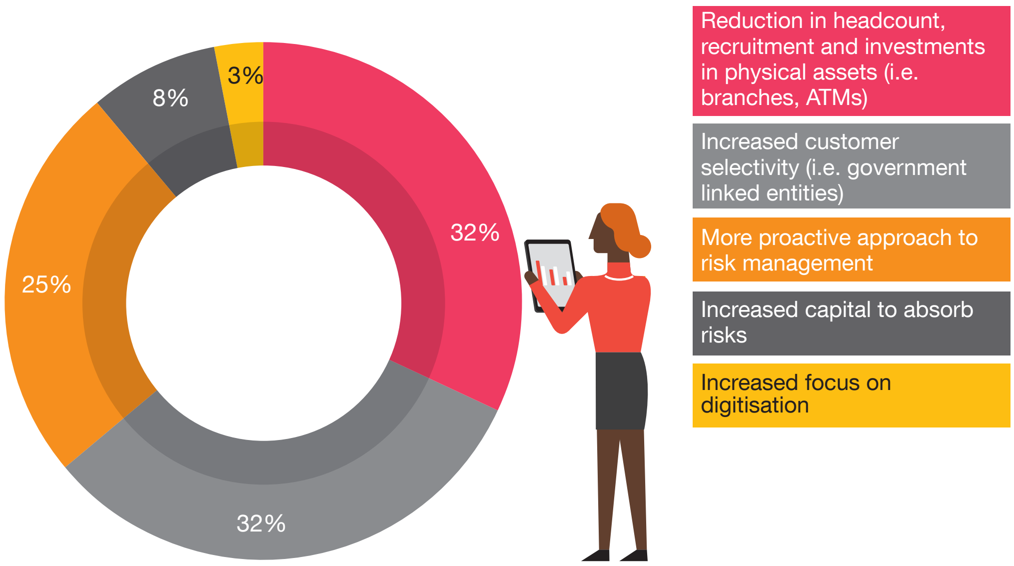
Source: PwC analysis

In a quest to overcome current economic headwinds, most respondents have opted for traditional survival strategies such as cost-cutting measures by reducing headcounts and further investments.

In addition, a significant number of respondents stated they have taken stricter measures before undertaking transactions with both existing and new clients to manage rising credit risk.

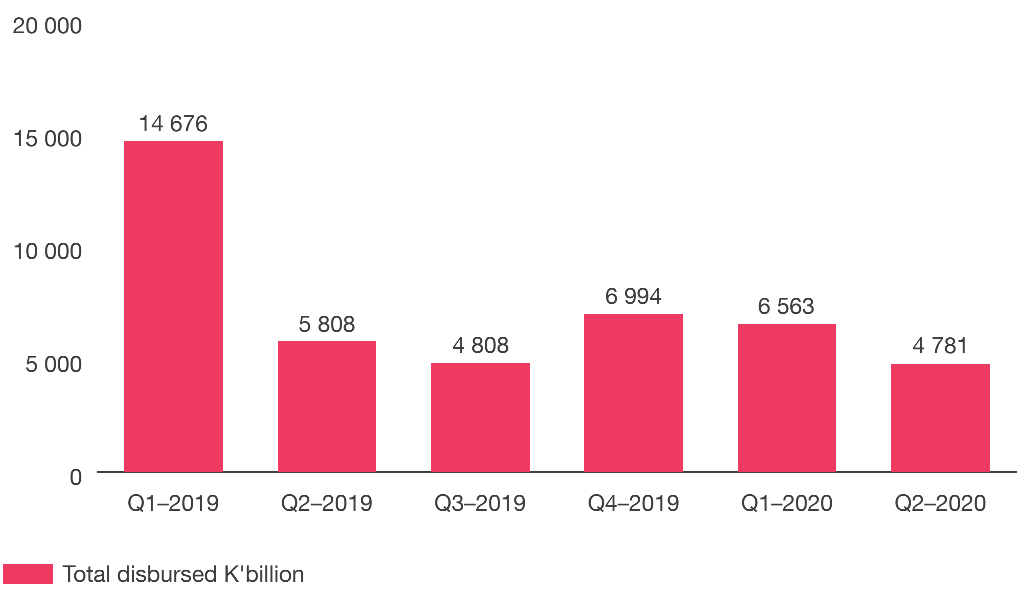
As expected, this has had a significant impact on loans disbursed both in terms of value and volume, as is evident in the 30 June 2020 Bank of Zambia's Credit Market Monitoring Report see figures 10 and 11.

Figure 9. Strategic response to the current economic challenges faced



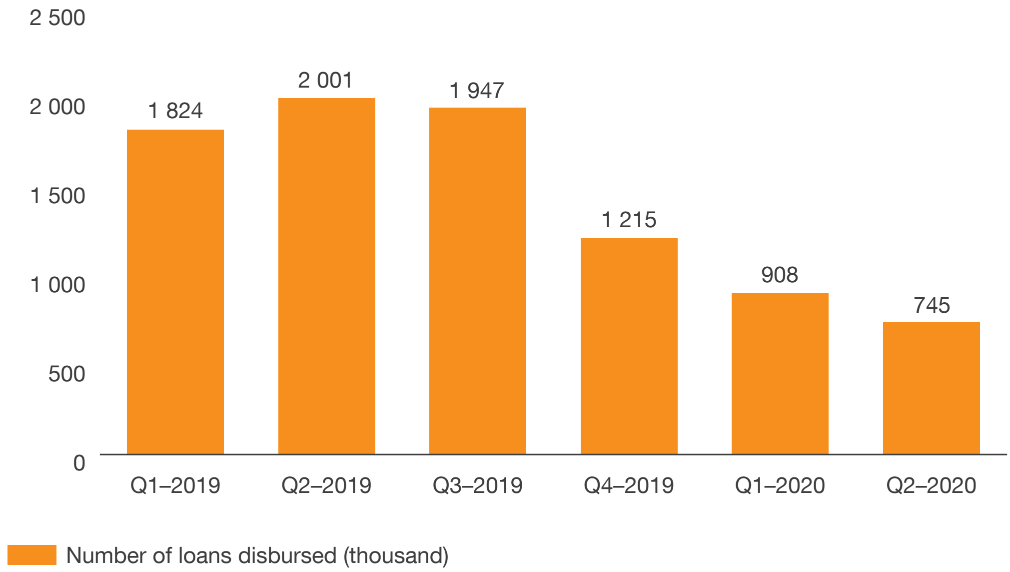
Source: PwC analysis

Figure 10. Value of loans disbursed K'billion



Source: Bank of Zambia

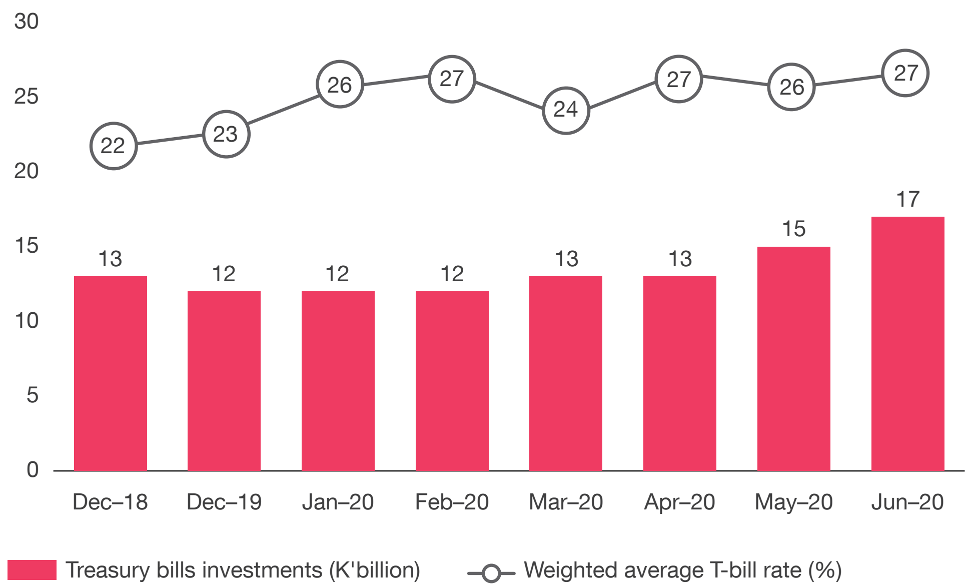
Figure 11. Volume of loans disbursed (thousand)



Source: Bank of Zambia

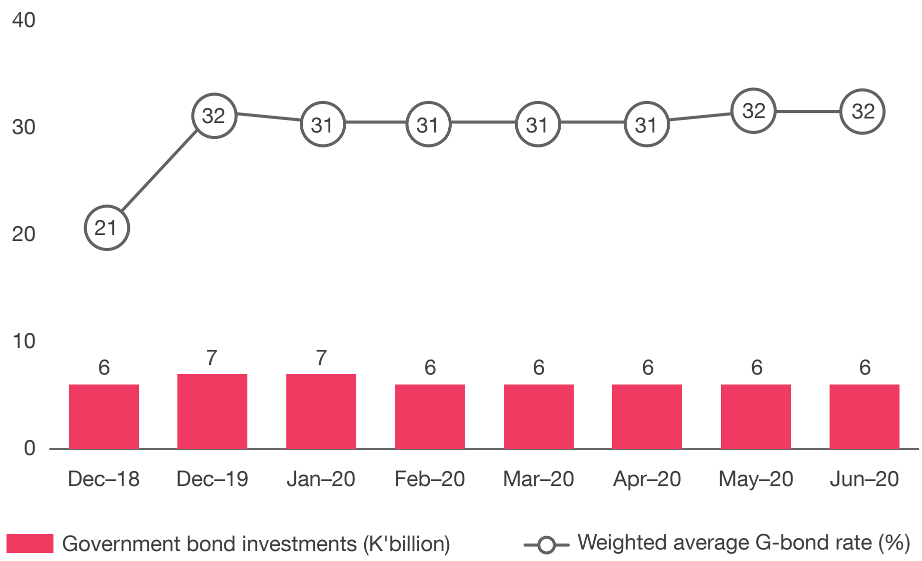
The current high yields of government bonds and treasury bills will further crowd out private sector lending, as the risk profile of private sector lending has worsened due to the deteriorating state of the local economy.

Figure 12. Treasury bill investments weighted average yields



Source: PwC analysis

Figure 13. Government bond investments and weighted average yields

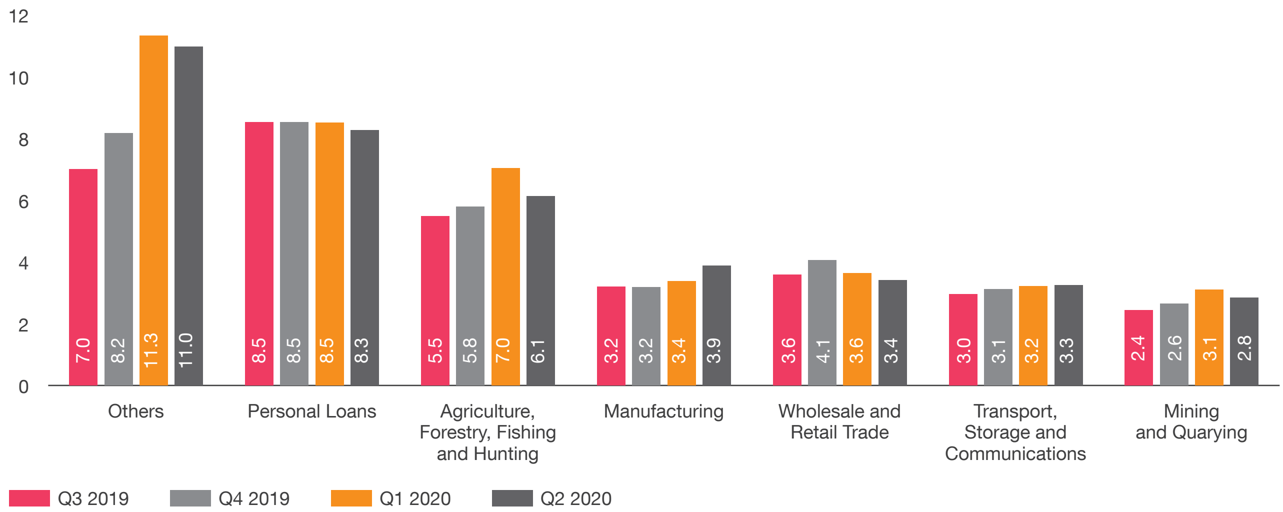


Source: PwC analysis

The effects of Covid-19, the energy crisis and global warming have severely impacted most sectors of the Zambian economy for a variety of reasons.

Area of lending	Challenges
Personal Loans	1. Loss of jobs via redundancies and hiring freezes due to poor financial performance of employers. 2. Reduced disposable income (inflationary pressures). 3. Reduced demand for assets that are USD quoted (depreciation of the ZMW vs USD)
Agriculture	1. Poor yields due to unfavourable weather conditions (global warming-related) 2. Challenges in getting essentials inputs due to disruptions in global supply chains (Covid-19 related) 3. Increased costs of inputs (depreciation of the ZMW vs USD). 4. Higher costs of business and production (inflationary pressures and higher energy tariffs)
Manufacturing	1. Disruption of work due to increased health and safety measures (Covid-19 related) 2. Lower production levels due to energy shortages (energy-related) 3. Higher costs of business and production (inflationary pressures and higher energy tariffs).
Wholesale and retail trade	1. Challenges obtaining goods for trading due to disruptions in global supply chains (Covid-19 related) 2. Increased costs of goods for trading and general operating costs (inflationary pressures, depreciation of the ZMW vs USD).
Transport storage and communication	1. Disruption of work due to increased health and safety measures (Covid-19 related). 2. Higher costs of operations (inflationary pressures, higher energy tariffs, depreciation of the ZMW vs USD).
Mining	1. Lower demand due to disruption of global supply chains (Covid-19 related). 2. Disruption of work due to increased Health and Safety measures (Covid-19 related) 3. Lower production levels due to energy shortages (energy-related) 4. Higher costs of business and production (inflationary pressures and higher energy tariffs).

Figure 14. Distribution of loans per sector

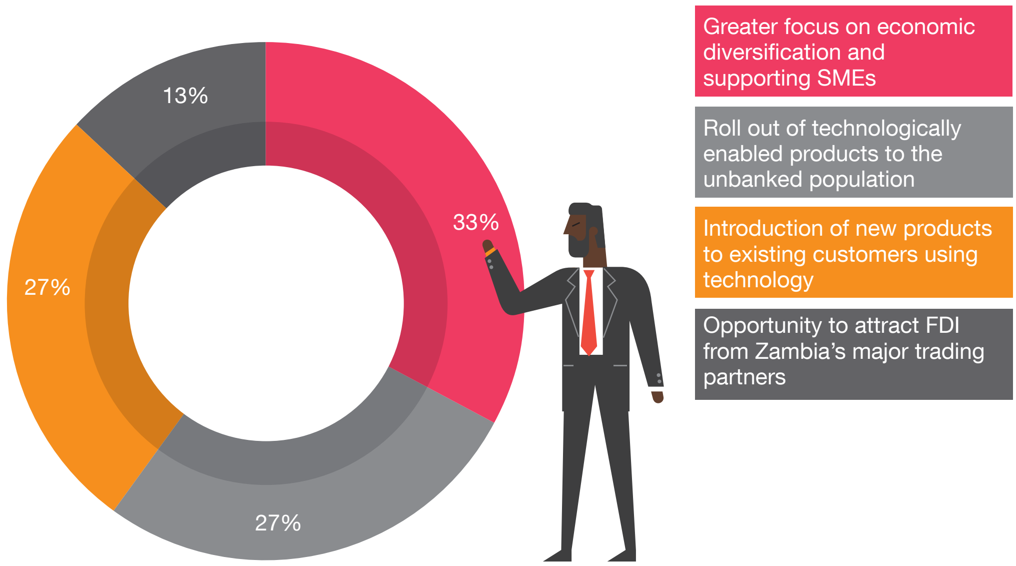


Source: Bank of Zambia

Challenges can however at times present opportunities, and at least one third of respondents believe that focusing on economic diversification and supporting the growth of SMEs provide the greatest opportunity to navigate these challenging times and sustain growth.

Supply chains have been one of the biggest victims of Covid-19 due to the containment measures implemented to tackle the spread of the pandemic. This provides a great opportunity to support local SMEs involved in areas such as manufacturing, logistics and warehousing and energy solutions such as off-grid power solutions.

Figure 15. Greatest opportunity for the sustained growth and profitability of the sector



Source: PwC analysis

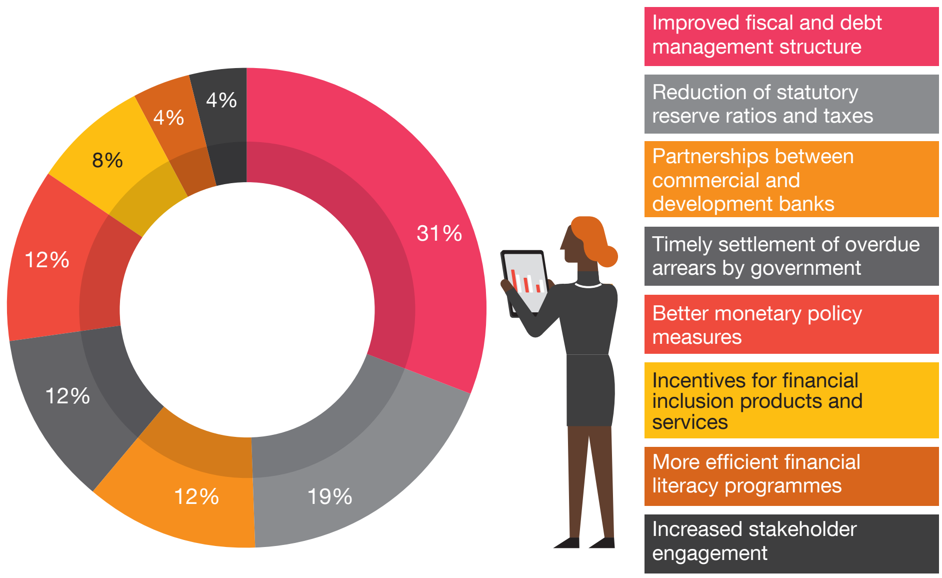
The use of technology to change the way businesses operate to achieve better efficiency, enter new or underserved markets and offer new products has been an ongoing conversation for many years. A big bottleneck in pushing this agenda has been the question of whether the benefits would justify the investments required. Respondents believe that technological solutions presented the best opportunities by either utilising them to tap into new markets and unbanked customers (27%) or to offer new products to their existing clients (27%).

Investing in effective business intelligence systems can help banks drive profitability by using past and real-time data to develop solutions that can create value for their clientele. Organisations should focus on procuring the suitable hardware infrastructure and software, recruiting and training staff with the required skills and knowledge, and incorporating this into the overall strategy of the organisation.

The way forward

There is still a need to take measures to address headwinds that can be mitigated locally.

Figure 16. Suggested solutions to the challenges



Source: PwC analysis

Some of the solutions proposed included improved fiscal discipline and debt management. These would include measures such as restructuring of international debt to create more fiscal space, coupled with fiscal measures such as postponing future capital projects.

A further issue that was raised was the need to adjust statutory reserve ratios and taxes during times of recession. Reserve ratios were increased from 5% to 9% in December 2018, with the compliance arrangements for the reserve required changing from weekly to daily.

One win that could be achieved from the current events would be the prioritisation and acceleration of the economic diversification and digital transformation.

Respondents generally feel that there is a need for the policy makers to engage them in decisions and measures being implemented in the industry.

The financial services sector is a key player in the stabilisation and growth of any economy and its importance is more pronounced in tough times to stimulate activity in the private sector. There is a need for all stakeholders to engage each other in order to plot a road map and policies that would encourage the growth of the sector.

Sub-Saharan Africa outlook

By Christie Viljoen

Recent data from Africa's largest economies show a sharp slowdown in activity during March and April 2020, followed by a slow recovery in the months thereafter.

The second quarter of the year witnessed the most severe decline in economic activity in decades. Based on developments in 2020 so far, the World Bank sees the Sub-Saharan African (SSA) economy contracting by 3.3% this year. This will be the region's first recession in a quarter of a century.[1]

From a geographic perspective, the economic pain will be widespread, with all countries on the continent forecast to see deteriorated economic prospects compared to 2019. The decline in real gross domestic product (GDP) is expected to be larger in Southern and East Africa. This is due to larger output contractions in major economies like South Africa and Angola as well as the disruption of lockdowns globally to the African tourism industry. Most countries in these two regions also implemented stringent domestic containment measures.[2]

SSA GDP is forecast by the World Bank to grow by 2.1% in 2021. Baseline projections assume that new COVID-19 cases will continue to slow across the region, new outbreaks will not lead to national lockdowns, government policy responses will boost business and consumer confidence, the global economy will continue to rebound, and commodity prices will remain stable. In the downside scenario, the region's GDP is projected to expand by only 1.2% in 2021. This would be caused by heightened uncertainty related to the evolution of the pandemic constrains on domestic consumption and investment, while lower commodity prices weigh on exports.[3]

1 World Bank, 2020. Africa Pulse, October (Advance Copy). https://openknowledge.worldbank.org/bitstream/handle/10986/34587/9781464816482.pdf?sequence=17&isAllowed=y

2 World Bank, 2020. Africa Pulse, October (Advance Copy). https://openknowledge.worldbank.org/bitstream/handle/10986/34587/9781464816482.pdf?sequence=17&isAllowed=y

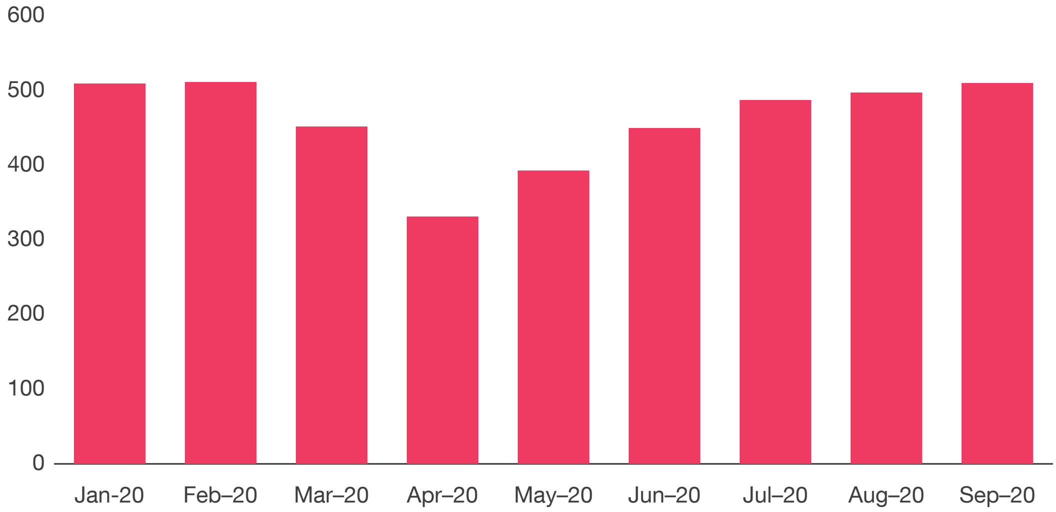
3 World Bank, 2020. Africa Pulse, October (Advance Copy). https://openknowledge.worldbank.org/bitstream/handle/10986/34587/9781464816482.pdf?sequence=17&isAllowed=y

Zambian economy and outlook

Zambia did not implement widespread lockdown measures and the stringency of its social containment measures was low compared to some other African economies. Furthermore, the government slowly started lifting these restrictions from as early as April 24. Nonetheless, the adverse impact from local and international disruptions to Zambian society still had a negative economic toll on the country.

The Stanbic Bank Zambia Purchasing Managers' Index (PMI) indicates a deterioration in private sector activity during March and April, followed by a slow recovery thereafter. The PMI is a monthly survey of around 400 private sector companies in Zambia across the agriculture, mining, manufacturing, construction, wholesale, retail and services industries. A reading below 50 indicates that business activity declined compared to the preceding month.

Figure 17. Zambia's PMI has been slowly recovering since May 2020



Source: IHS Markit

Local businesses reported a decline in sales volumes in March and April due to subdued consumer demand caused by pandemic-induced economic disruptions. While the country did not implement widespread lockdown measures, the adverse impact of a slower global economy and disruption to supply chains adversely affected local businesses and consumers.[4]

There was some recovery in the PMI during May and June. Nonetheless, the Bank of Zambia Quarterly Survey of Business Opinions and Expectations (QSBOEs) noted subdued consumer demand (amidst tight liquidity conditions), high energy prices and electricity load shedding as some of the challenges faced by business during the second quarter.[5]

By August and September, the PMI was back to levels seen prior to the pandemic. A number of sub-indices in the September edition of the PMI were at their highest level since the outbreak of COVID-19. Nonetheless, the PMI remained below the key 50 level, indicating that private sector activity continued to decline – albeit at a much slower pace.[6]

Looking ahead, the September PMI indicated that the degree of confidence about the 12-month outlook for business activity was at a seven-month high as sentiment continued to recover. Nonetheless, with the PMI still below the key 50 level, business activity was unlikely to recovery much during the remainder of 2020. New orders continued to fall while currency weakness inflated input and production costs.[7]

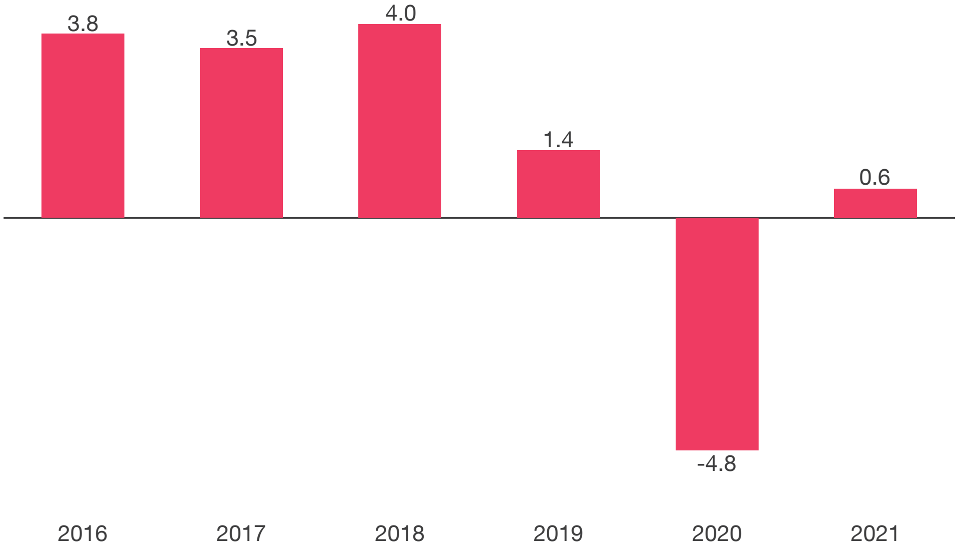
The Bank of Zambia (BoZ) said during August that it

4 Bank of Zambia (BoZ), 2020. Quarterly Survey of Business
5 Bank of Zambia (BoZ), 2020. Quarterly Survey of Business Opinions and Expectations, June. https://www.boz.zm/QSBOEQ22020RREPORT19082020.pdf

6 IHS Markit, 2020. Stanbic Bank Zambia PMI September. https://www.markiteconomics.com/Public/Home/PressRelease/ec599ef0156e4a6590ae1cab8df031d0
7 IHS Markit, 2020. Stanbic Bank Zambia PMI September. https://www.markiteconomics.com/Public/Home/PressRelease/ec599ef0156e4a6590ae1cab8df031d0

expects the country's economy to contract by 4.2% in 2020. This is similar to the International Monetary Fund (IMF) forecast of a 4.8% recession. The central bank blames the economic decline on a substantial decline on consumer and investment spending due to disruptions to business activity in the country. The BoZ sees tourism, retail and construction as the most affected sectors. In light of this outlook, the central bank reduced interest rates by 1.25 percentage points during August.[8]

Figure 18. From slow growth in 2019 to a deep recession in 2020



Source: IMF

Another key constraint for the Government of Zambia is the fiscal challenges caused by COVID-19. In response to the pandemic, the state suspended import duties on mineral concentrate and export duties on precious metals to support the mining sector. The government also waived tax penalties and fees on outstanding tax liabilities resulting from the pandemic. The Government of Zambia issued an K8 billion bond to help finance COVID-19 related expenses, including health spending, arrears clearance, and grain purchases.

In recent months, the Ministry of Finance communicated to bondholders that the country's macroeconomic situation necessitated immediate external debt relief. This is due to the drain of debt service payments on the fiscus causing arrears in payments to domestic service providers. The ministry expects the fiscal balance to reach a deficit equal to 5.5% of GDP during the current fiscal year. At the time of writing, the government's engagement with bondholders was still ongoing.

[8] Bank of Zambia (BoZ), 2020. Monetary Policy Committee Statement, August. https://www.boz.zm/monetary_policy_committee_statement_august_2020.pdf

Impact of COVID-19 on banking in other African countries

- **Botswana** – This slowdown in economic growth has hit the banking sector in particular. Banks are seeing a decline in asset growth, lending activity and profits. The decline in asset and loan growth is expected to be compounded by shrinking profits across the financial sector. Nonetheless, there are currently few systemic credit risks to be concerned about.
- **Ghana** – Operating conditions in Ghana's banking and financial services industry has been made more challenging by the Covid-19 pandemic. Higher loan loss provisions and subdued lending growth – associated with under-strain household and business finances – are weighing on the profitability of and growth in the banking sector.
- **Kenya** – Banks are facing considerable downside risks to their profitability due to the impact of the COVID-19 pandemic on domestic and regional (East Africa Community) economic activity. Credit growth, for example is being constrained by the ongoing disruption in business activity both locally and in the region.
- **Malawi** – COVID-19 has adversely affected banks' operations and profitability levels. Key customers have experienced a significant drop in their business as economic activity slowed. Asset quality has weakened this year, with the banking sector's non-performing loans (NPLs) ratios rising above the central bank's benchmark levels.
- **Mozambique** – The banking sector is experiencing more subdued lending activity due to the adverse impact of the pandemic and lockdowns on business activity. Banks are bracing for an uptick in loan delinquencies despite central bank measures implemented to ease pressure on clients affected by the pandemic.
- **Namibia** – Banking sector growth is stalling due to the economic recession and rising unemployment. Demand for loans and other credit is being undermined by job losses. A decline in employment and earnings is causing an increase in NPLs over the short term.
- **South Africa** – While government and central bank support measures have boosted liquidity in the banking sector, demand for new credit has been limited after banks provided debt repayment holidays to businesses and households. Banks are now dealing with the post-debt holiday impact of significant job losses on households' ability to service their repayment obligations.
- **Tanzania** – Weaker economic growth is limiting growth in client loans. The drop on tourism revenues (which supports around 10% of employment in the country) is impacting income and expenditure and, as a result, demand for a range of banking services.

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Credit risk

Considering that one of the primary roles of commercial banks is to provide access to financing, it is not surprising that credit risk remains a fixture in the top five most pressing issues. Analysis of the results shows that respondents from both commercial banks and NBFIs ranked credit risk as the third most pressing issue in this survey, compared to fifth and first, respectively, in the 2018 survey.

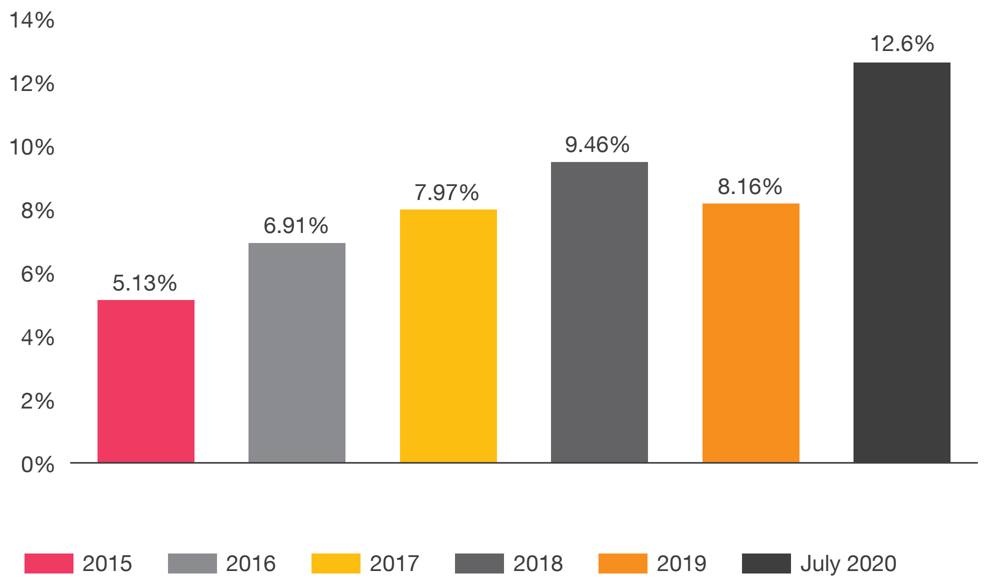
Figure 19. Ranking of credit risk over the years

Year	Banks ranking	NBFIs ranking
2019	3	3
2018	5	1
2017	2	Not applicable
2016	2	Not applicable

Non-performing loans

The banking industry-wide non-performing loans (NPLs) ratio reduced slightly from 9.5% in 2018 to 8.2% at the end of 2019. In absolute terms, the value of NPLs increased by K0.151m to K2.893m (2018: K2.742m). The ratio of non-performing loans to total loans rose to 12.6% in July 2020 from 8.2% in December 2019, exceeding the prudential threshold of 10.0%. The NPL ratio increased largely on account of the effects of the Covid-19 pandemic.

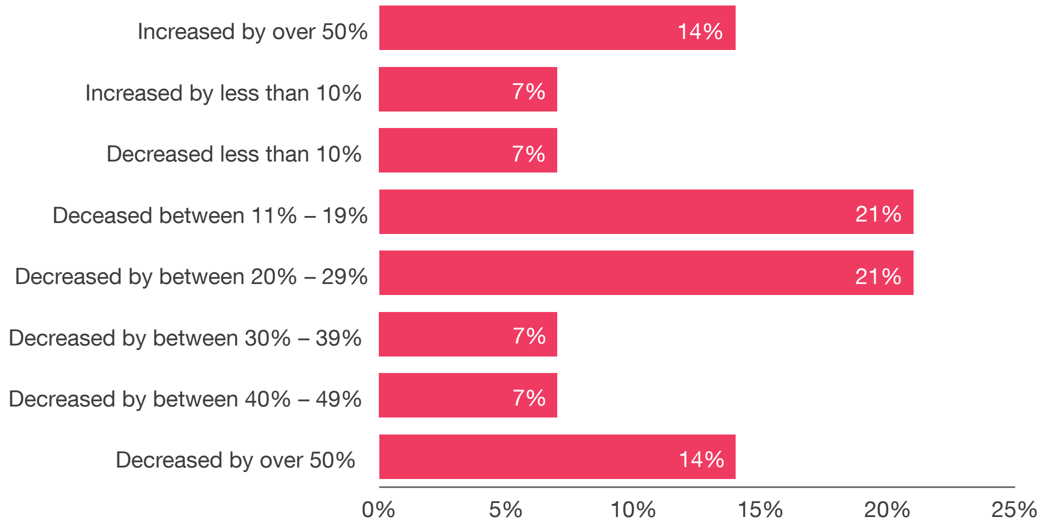
Figure 20. Non-performing loan ratio



Source: Bank of Zambia

Our survey results show that 79% of banks recorded a decrease in NPLs compared to 21% that reported an increase in 2019. The NPL reduction can be explained by a number of factors, some of these being reduction post IFRS 9 adoption and a more cautious lending practice to reduce the risk of default. However, subsequent to 2019, due to the prevailing Covid-19 induced challenges the banking industry has seen an increase in the NPL ratio as shown in the July 2020 data in Figure 18 above. With this increased level of credit risk, the industry has experienced a slowdown in private sector credit as banks exercise restraint in advancing credit in a weakened economic environment.

Figure 21. Trend of NPL for commercial banks



Source: PwC analysis

For the non-banking sector, the NPL ratio increased from 17.6% to 22.4% in 2018 and 2019 respectively, the ratio remained above the prudential maximum benchmark of 10.0%, and further increased to 24.9% as at July 2020. The considerably high level of NPLs continues to be attributed to challenges in collection of repayments on salary-backed loans and delayed repayments from the informal sector customers which have been heavily affected by Covid-19.

Similar to the prior year, when asked to identify the underlying factors causing the relatively high level of NPLs, both banks and NBFIs identified the economic downturn and government-related arrears as the common issues driving the continued high level of NPLs. The banks and NBFIs that indicated an improvement or relatively unchanged NPLs attributed this to improved management actions to enhance collections and recoveries.

Figure 22. Top three factors impacting the NPLs

No	NBFIs	Banking sector
1	Economic downturn	Economic downturn
2	Job losses	High interest rates
3	Government arrears	Government arrears

We asked which sectors contributed most to the trend in NPLs in 2019, and both banks and NBFIs identified wholesale and retail trade and agriculture.

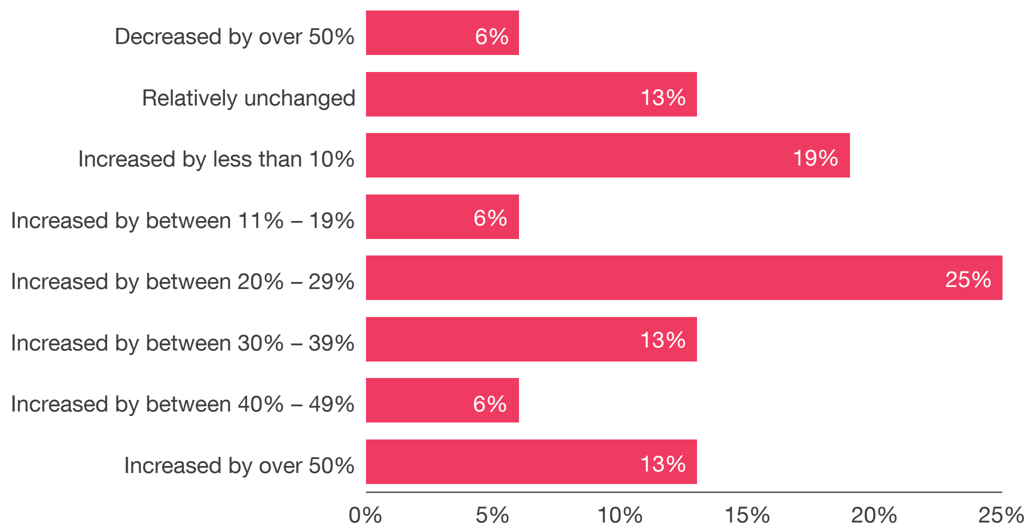
Figure 23. Top 3 sectors contributing to the NPLs

No	NBFIs	Banking sector
1	Wholesale and retail trade	Agriculture
2	Public sector	Wholesale and retail trade
3	Agricultural, mining and personal	Manufacturing, mining, construction, tourism and hospitality

Lending trends

Despite the increased concern around credit risk, both banks and NBFIs indicated that they had increased lending activities in 2019 compared to 2018. Among banks, only 6% of the respondents indicated they reduced lending in 2019, with the majority of banks increasing lending significantly. Total gross loans increased by K6.5bn (22%) to K35.5bn (2018: K29bn). 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 2019 among commercial banks mainly due to high demand for working capital by corporates to bridge financing occasioned by the build-up in domestic arrears.

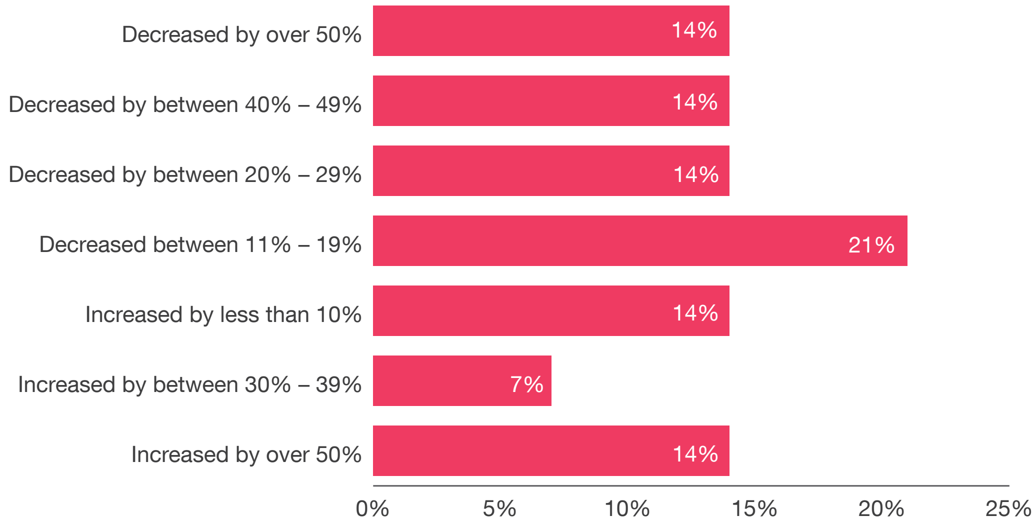
Figure 24. Trend in lending activity in 2019 relative to 2018 – banking



Source: PwC analysis

Results among NBFIs were mixed, with some institutions indicating an increase while others stating reductions of between 11% to 50%. Total gross loans increased by K0.96bn (12.8%) to K8.54bn (2018: K7.57bn).

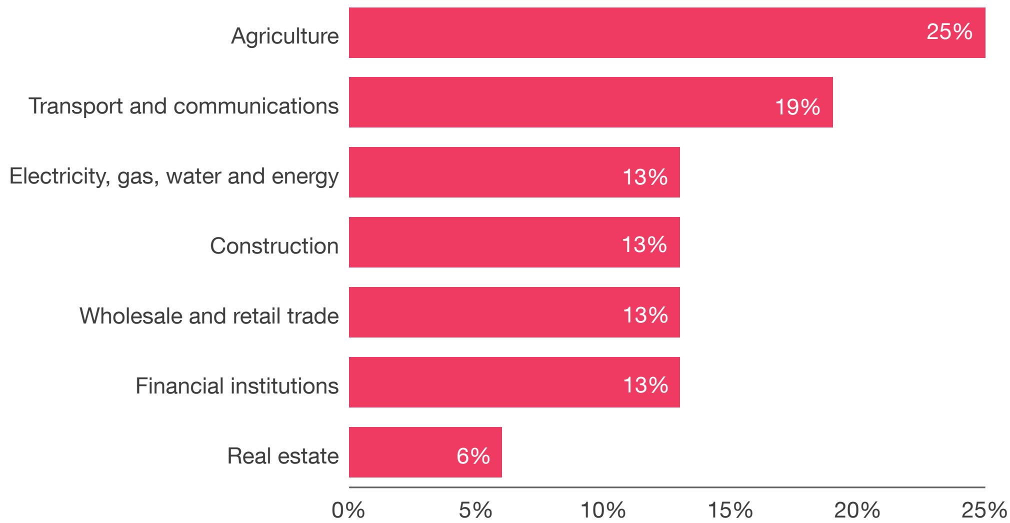
Figure 25. Trend in lending activity in 2019 relative to 2018 – NBFIs



Source: PwC analysis

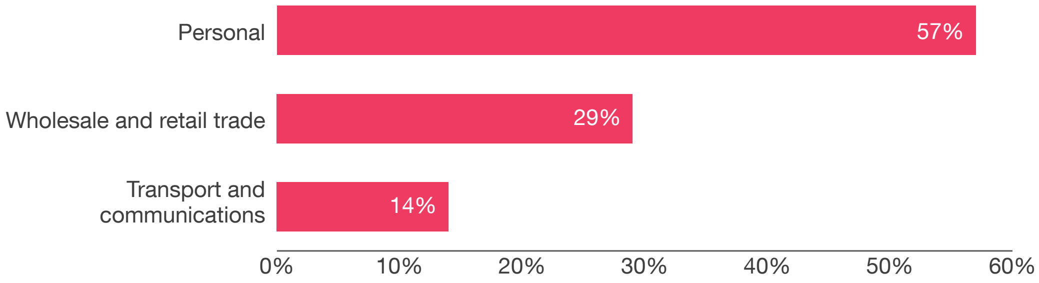
For those that recorded an increase in lending activity, this increase was spread across various sectors from agriculture, transport and communication, personal, construction, wholesale and retail trade. The full analysis of the sector increases in lending for both banks and NBFIs can be seen in Figures 26 and 27 below.

Figure 26. Sectors benefiting from increased lending – banks



Source: PwC analysis

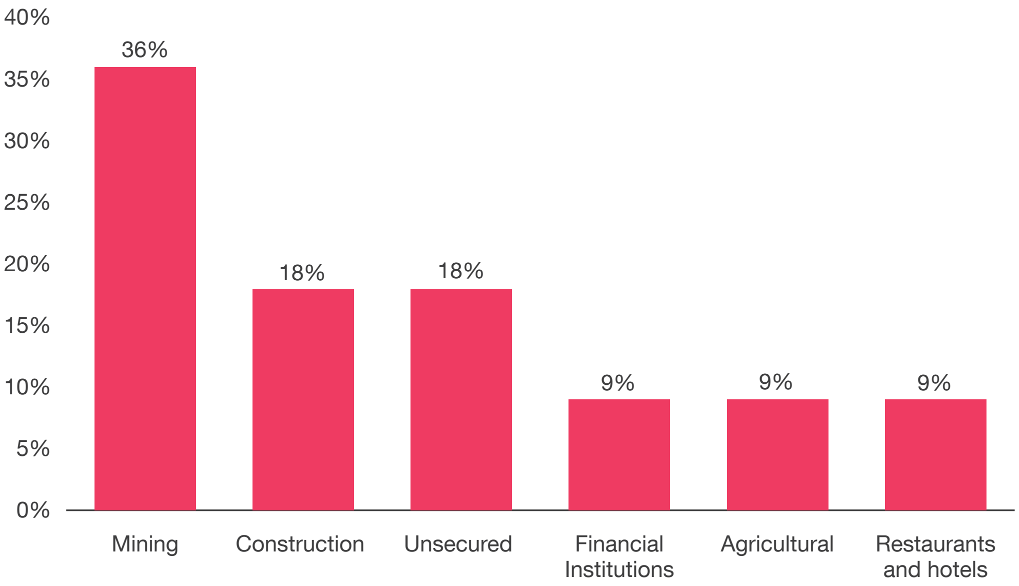
Figure 27. Sectors benefiting from increased lending – NBFIs



Source: PwC analysis

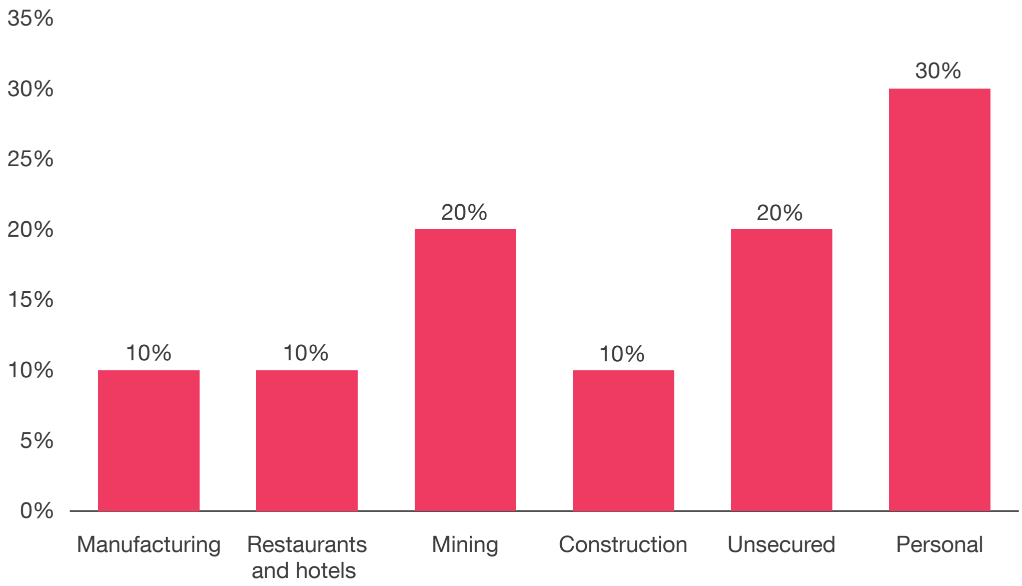
Furthermore, when asked to identify sectors where the industry as a whole reduced lending activity in the year, the banking sector identified the mining sector as the largest industry impacted, while for NBFIs the responses were mixed, with personal lending being most affected (see Figures 28 and 29 below).

Figure 28. Sectors with reduced lending activity – banks



Source: PwC analysis

Figure 29. Sectors with reduced lending activity – NBFIs



Source: PwC analysis

Lending rates generally impact a borrower's willingness to assume debt and also influence the potential increase or reduction in the NPLs. When asked to identify the top factors impacting determination of lending rates, both sectors identified cost of funds and increased credit risk as the top two factors in 2019.

No	NBFIs	Banking sector
1	Cost of funds	Cost of funds
2	Increased credit risk	Increased credit risk
3	Economic downturn	Monetary policy rate

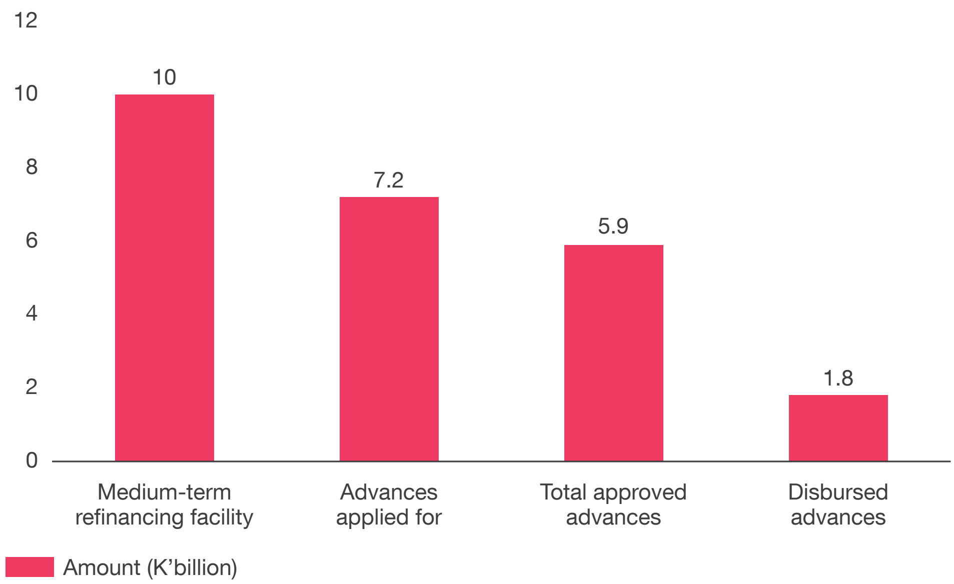
Impact of Covid-19 and credit risk

In response to the deteriorating economic environment and negative effects of the pandemic, Bank of Zambia introduced measures aimed at safeguarding the stability of the financial system. Some of the more notable measures included:

- A Targeted Medium-Term Refinancing Facility (TMRF) with an initial amount of K10bn to provide liquidity;
- Scaled-up open market operations;
- Revised rules in the operation of the interbank foreign exchange market;
- Revised loan classification and provisioning rules; and
- Extension of the transitional arrangement in amortising day 1 impact of IFRS 9 adoption on impairment.

Bank of Zambia had received applications worth K7.2bn on the TMRF and approved K5.9bn of those loans as at 22 September 2020. However, the uptake was quite low at 18.0%, amounting to K1.8bn. A total of K1.5bn was disbursed to banks, while the remaining K0.3bn was disbursed to non-banking financial institutions.

Figure 30. Medium term refinancing facility as at September 2020



Source: Bank of Zambia

Further analysis of the impact of Covid-19 has been performed in the sections that cover financial performance, IFRS 9 and growth of the local economy.

Top issues for commercial banks

Capital management

Capital is an important element for financial institutions and may present an existential threat if not managed properly. The importance of capital management is pronounced, now more than ever, given the unprecedented pervasive impact of the Covid-19 pandemic. In recognition of these challenges, respondents ranked capital management as one of the top five most pressing issues with an overall average score of 6.5.

Given the varying sizes of banks, capital requirements applicable and the extent of the impact the current economic environment on financial performance, the resulting degree of attention paid to capital management varies. Banks whose capital position is more sensitive to changes in financial performance are likely to be hit the hardest, therefore, more attention on capital management is expected of them.

Indeed, further analysis of survey responses reveals that, similar to our 2017 survey, banks outside the top six (by asset size) identified capital management as one of the top-five most pressing issues. However, unlike the 2017 survey where this group of banks identified capital management as a top-five issue with an average score of 3.6, the current year average score is much higher at 6.7. While it is clear that there isn't much consensus between the six largest banks and the rest of the banking industry on the significance of this issue, it is clear that the *smaller* banks continue to feel the strain on capital more disproportionately – and this pressure is increasing.

However, as shown in the table shown below, the banking sector, as a whole, is sufficiently capitalised. The CAR is above the minimum prescribed threshold and has only decreased by one percent since December of 2019. Further, the CAR has remained unchanged in the quarter ended 30 June 2020 – the first quarter since the on-set of the Covid-19 pandemic in Zambia. Whether this position of strength can be sustained into the second half of the year and further into the future remains to be seen.

Figure 31. Capital position of banks

Description	Dec 2019 (K'000)	Mar 2020 (K'000)	June 2020 (K'000)
Total risk-weighted assets	**51,270,901**	**56,678,777**	**56,605,318**
Total primary (tier 1) capital	10,327,835	10,552,673	10,652,682
Eligible secondary (tier 2) capital	1,069,945	1,348,000	1,298,768
Total tier 1 and 2 capital	**11,397,780**	**1,900,673**	**11,951,450**
Capital adequacy ratio (CAR)	**22%**	**21%**	**21%**
Minimum total capital requirement	7,250,241	7,632,852	7,594,587

Source: Bank of Zamiba

Considering the current tough economic environment and the uncertainty surrounding the path and pace of recovery, the importance of prudent capital management cannot be overemphasized. Sufficient capital enables banks to absorb current and future losses, accommodate transactions of a certain size and risk profile, provides a source of readily available funding and builds/preserves confidence in the sector.

Response from the regulator

In response of the impact that the pandemic, Bank of Zambia announced relief measures to support the financial sector and provide prudential relief to FSPs. These included:

- An extension of the period over which Day 1 Impact of the IFRS 9 is amortised for capital adequacy purposes to 31 December 2022. This also covers any increases in loss allowances on account of the Covid-19 pandemic.
- Partial use of capital instruments that do not qualify as Common Equity Tier 1 and Tier 2 Capital. This only applies to NBFIs.
- Restructuring of existing facilities for counterparties adversely affected by the pandemic. Such restructuring does not result in adverse classification which would otherwise have resulted in increased loss allowances.
- Collateral transition arrangements resulting in the temporary suspension of the restriction on the use of collateral in the computation of loan loss allowances
- Liquidity support through the Targeted Medium-Term Refinancing Facility

Given that these measures were announced in April 2020, it is too early to assess the full extent of their effectiveness in preserving the capital position of the industry and their sustainability into the future. That notwithstanding, overall, the above interventions have provided much-needed relief.

Improving revenue growth

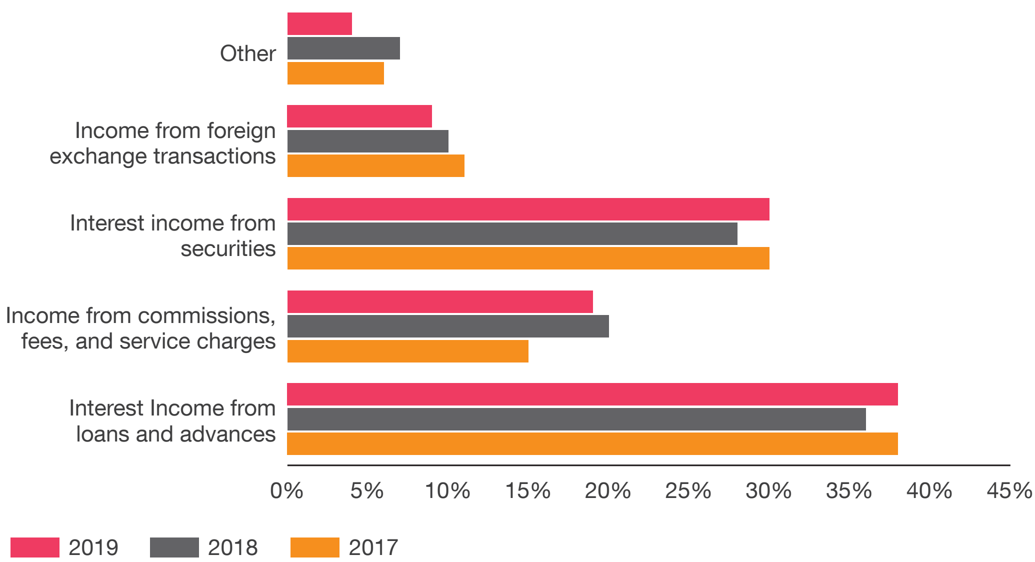
For the third consecutive year, commercial banks identified improving revenue growth as one of their top five most pressing issues with an average score of 5.45 out of 10 (2018: 5.3 and 2017: 5.6). On the other hand, similar to our 2018 survey, improving revenue growth was not an issue for the NBFIs. Unlike commercial banks, NBFIs currently have limited sources of income relying almost entirely on interest income on loans and advances. This is in a stark contrast to commercial banks which have over the last few years adopted a strategy of transitioning towards more non-funded income in the form of fees, commissions, FX trading and other service fees.

The 2019 survey showed that the commercial banks registered 13% growth in total net interest and other income to K10.2 billion (2018: K9.04 billion) which represented a reduction in the growth rate in comparison to 2018 (15%). A further analysis of the 2019 growth rate indicated that while the total revenue growth rate was down, net interest income growth rate was stable at 19% (2018:19%) with net non-interest income registering a significantly lower growth rate of 3% (2018: 10%).

The current year reduction in the growth rate for net non-interest income could be attributed to the fact that commercial banks suffered a first full year of the impact of Bank of Zambia's move to

abolish 'unwarranted fees' which came into effect in September 2018. The lower than average increase in growth rate in this revenue stream raises questions as to whether banks are prepared to innovative and replace lost revenue. This is supported by the fact an analysis of the revenue streams for commercial banks shows that the composition of revenue has remained relatively unchanged with a slight reduction in 'other revenue' while interest income continues to contribute the bulk of the total revenue, albeit with changes in percentage make up.

Figure 32. Percentage makeup of revenue type



Source: Bank of Zambia

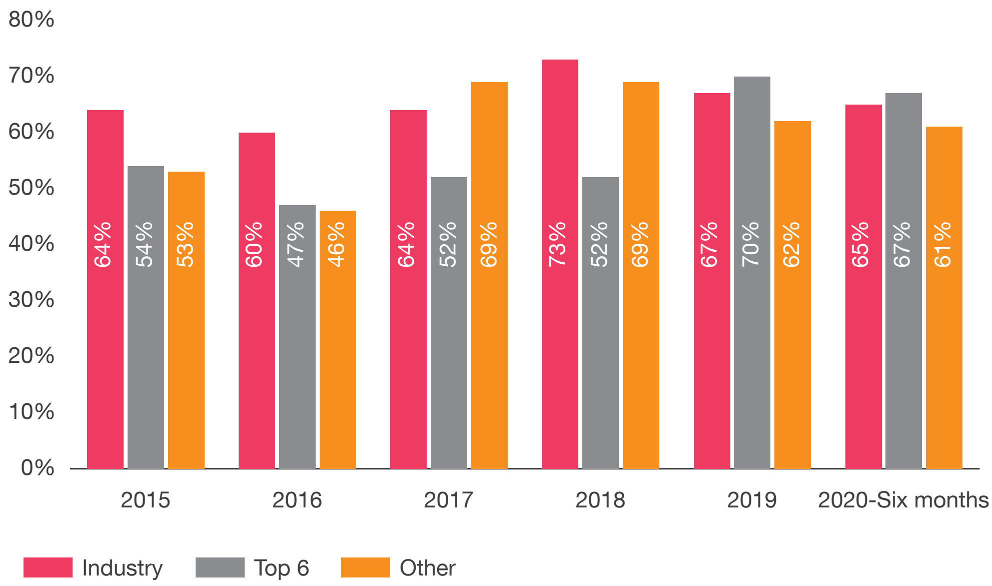
Interest from loans and advances and securities

As depicted in Figure 31 above, the major source of banks' revenue remained '*interest income from loans and advances*' (38%), followed by '*interest from government*' (30%). On a net basis, in combination, these recorded a year-on-year growth rate of 19% (2018: 19%) in net terms.

Details	2017	2018	2019	2019 % movement	2018 % movement
Gross interest income	7,187,810	7,520,993	9,714,837	29%	5%
Gross interest expense	(2,567,484)	(2,034,221)	(3,173,644)	56%	-21%
Net interest income	4,620,325	5,486,772	6,541,193	19%	19%

The 19% growth in net interest income was on the back of 20% growth in gross interest (2018: 5%). However, this was offset by a 56% increase in gross interest expense (2018: 21% decrease). To weather such an increase in interest expense and record a 19% growth in net terms, it is evident that banks had to pass-on most of this cost to their customers. This is supported by the analysis of the industry-wide Net Interest Margin (NIM) which showed a reduction of only 6% from 73% in 2018 to 67% in 2019.

Figure 33. Trend in interest income and expenses

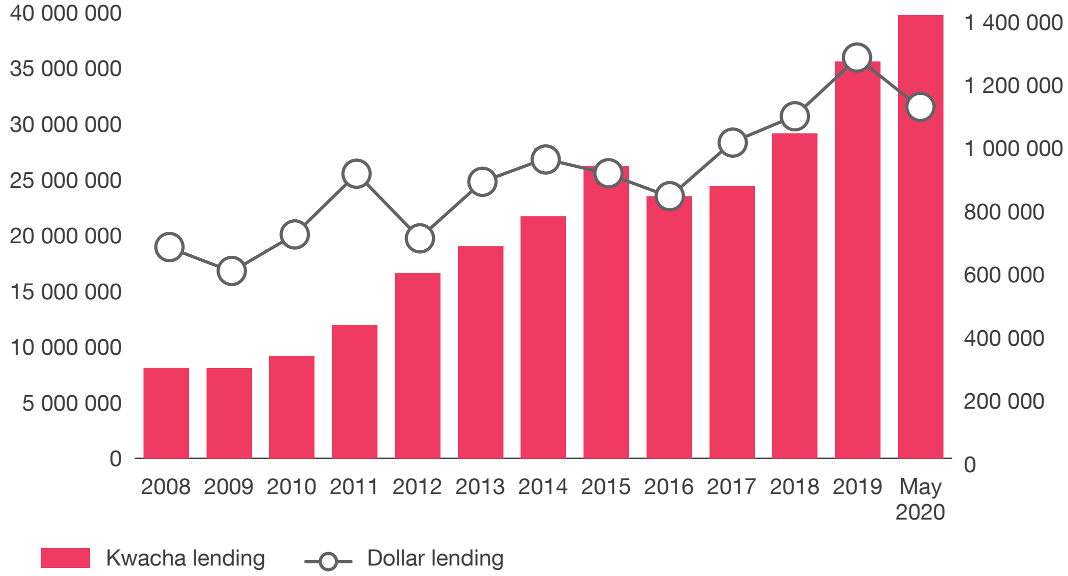


Source: Bank of Zambia

Further analysis shows that while the industry wide NIM was negatively impacted by the increase in interest expense, the top six banks were insulated. Collectively, the NIM for the top six banks increased from an average of 52% in 2018 to 70% in 2019.

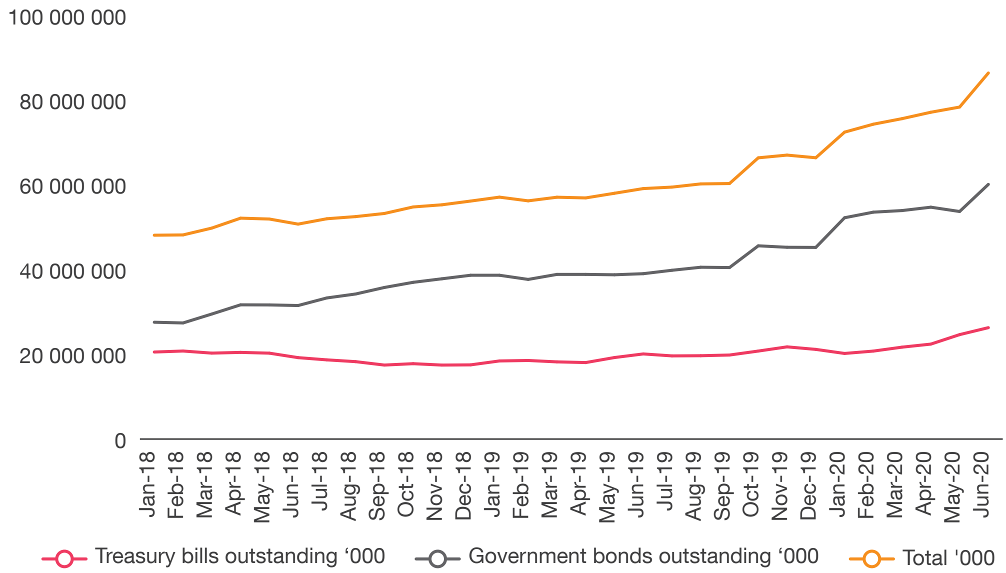
A review of the composition of the facilities issued by commercial banks also showed that there was an increase in the dollar facilities issued year on year. As alluded to earlier, the issue of dollar-denominated facilities seems to provide additional return on margins to banks with the depreciation of the kwacha and hence could have been the source of the growth in the year.

Figure 34. Dollar/Kwacha lending facilities



Source: Bank of Zambia

Figure 35. Government securities in issue

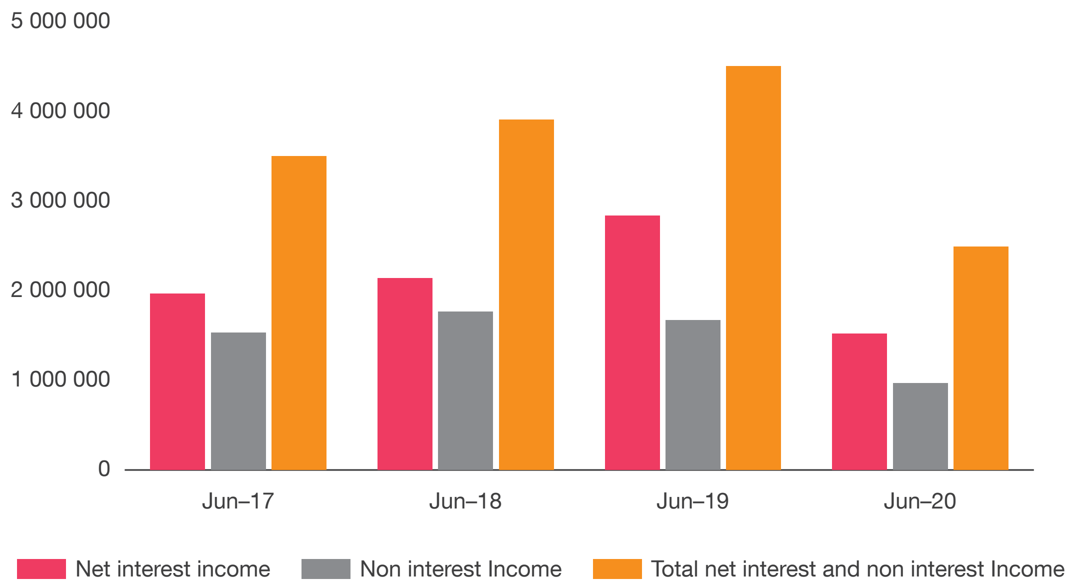


Source: Bank of Zambia

Impact of Covid-19 on revenue growth

While it is too early to analyse the impact of the Covid-19 pandemic on revenue for the banking industry, we analysed the industry's Q2 2020 results based on publicly available information for the three-year period to June 2020, and the results are as detailed below:

Figure 36. Impact of Covid-19 on income growth



Source: PwC analysis

It is clear from the above analysis that revenue for the six months period ended June 2020 has contracted significantly in comparison to previous half years – June 2019 and June 2018. It remains to be seen whether this trend will continue into the second half of the year and spill over into 2021.

Top issues for NBFIs

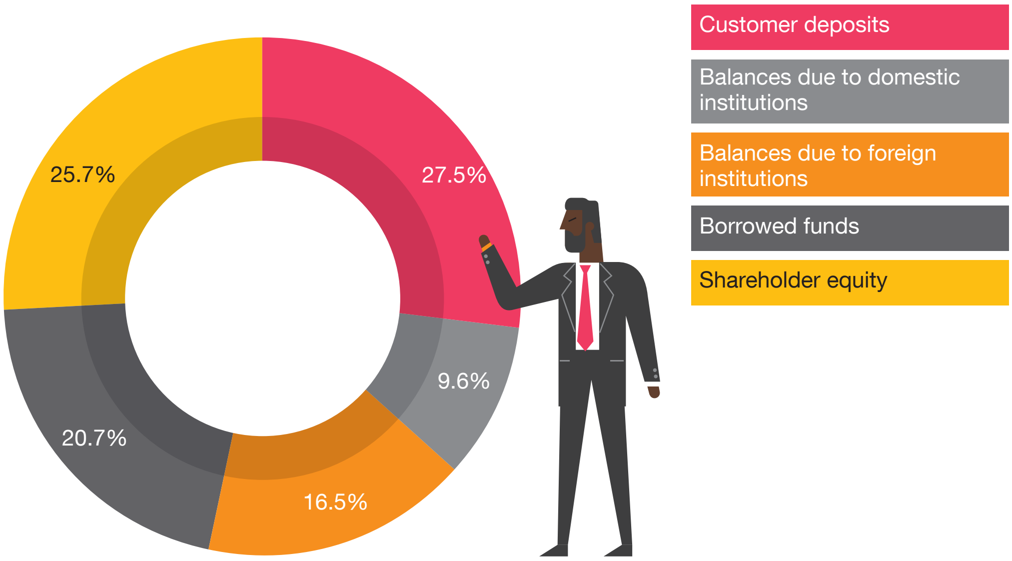
Managing liquidity risk

Source of funding

The availability of resources to fund the operations of non-banking financial institutions (NBFIs) is key. These funds are required to meet obligations (finance costs, operating expenses) and grow the balance sheet of the business (issuance of loans, other investments to spearhead growth) and also to be able to repay the borrowings.

In managing liquidity risk, NBFIs consider the source and cost of the funding that they have. According to Bank of Zambia Statistics for 2019, 38.18% (2018: 42%) of the funding of the NBFIs is from shareholders. Based on this analysis, on average, shareholder investment has contracted by 3.82%. Balances due to foreign institutions and deposits make up 43.9% (2018:37.55%) of the remainder.

Figure 37. NBFI source of funding

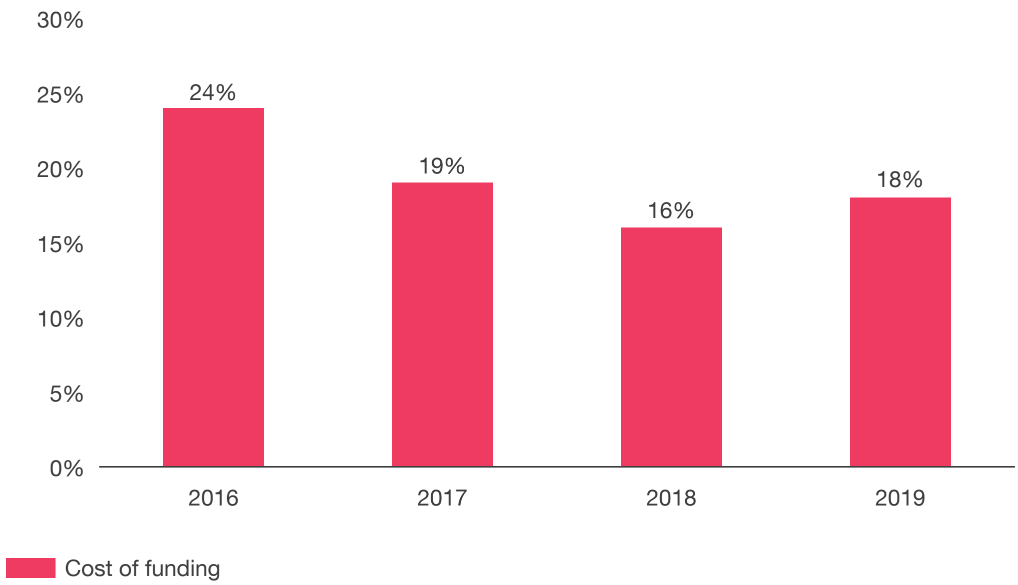


Source: Bank of Zambia

Cost of funding

The cost of funding for NBFIs has increased by 2% to 18% in 2019 from 16% in 2018. This is as a result of the diversification in the source of funding, where more expensive funds are now being used.

Figure 38. Cost of funding



Source: Bank of Zambia

Shareholder loans attract interest, and for 2019 contributed 26.0% of the total interest expense for the NBFIs. Deposits contributed 27% of funding, and 27.5% of the total interest expense. Deposits are a relatively cheaper source of funding, however, most NBFIs are non-deposit taking and the contraction in the economy means that deposits may fall. Most deposits in NBFIs are demand deposits and can be withdrawn any time by customers. This makes them a relatively unstable source of funding for NBFIs. Local banks and foreign banks contributed a total of 16.1% to the total funding of the NBFIs while contributing 44% to the total interest expense, indicating that these are relatively expensive sources of funds but are also easily accessible.

The source and cost of this funding affects how the sector prices its products. The NBFIs with cheaper and more diverse sources of funding, that are able to access it at cheaper rates, are able to remain more competitive in the market. The more competitive NBFIs will easily manage their liquidity needs both for business growth and day-to-day operational needs.

Escalating cost of doing business

According to the Bank of Zambia Statistics for 2019, the cost-to-income ratio for NBFIs has increased to 89% in 2019 from 75.3% in the prior year. There is continued pressure on the top line due to increased operational costs and impairments. NBFIs are responding to this by implementing cost-containment measures. According to survey respondents, these include long-term plans for leaner operations, reduced headcount, slowed recruitments and a push for innovations in new ways to serve customers.

As noted in the impact of Covid-19 and the growth of the local economy section of our report, inflation has increased from 10% in December 2018 to 15.7% at the end of April 2020. Customers with facilities from NBFIs are facing an increasing number of demands on their income, and this makes it increasingly difficult for NBFIs to collect on outstanding facilities. This has increased the probability of default for various customers, which results in higher impairment charges.

There is a need to manage the cost base for the business while maintaining profitability or merely breaking even in current times. The cost of funding continues to negatively affect the operations of business. As noted in the managing liquidity section of our report, the main funding for NBFIs is deposits and balances due to foreign financial institutions, and these are linked to high interest rates and the associated high interest expense.

Other topical issues

Impact of IFRS 9: Financial instruments

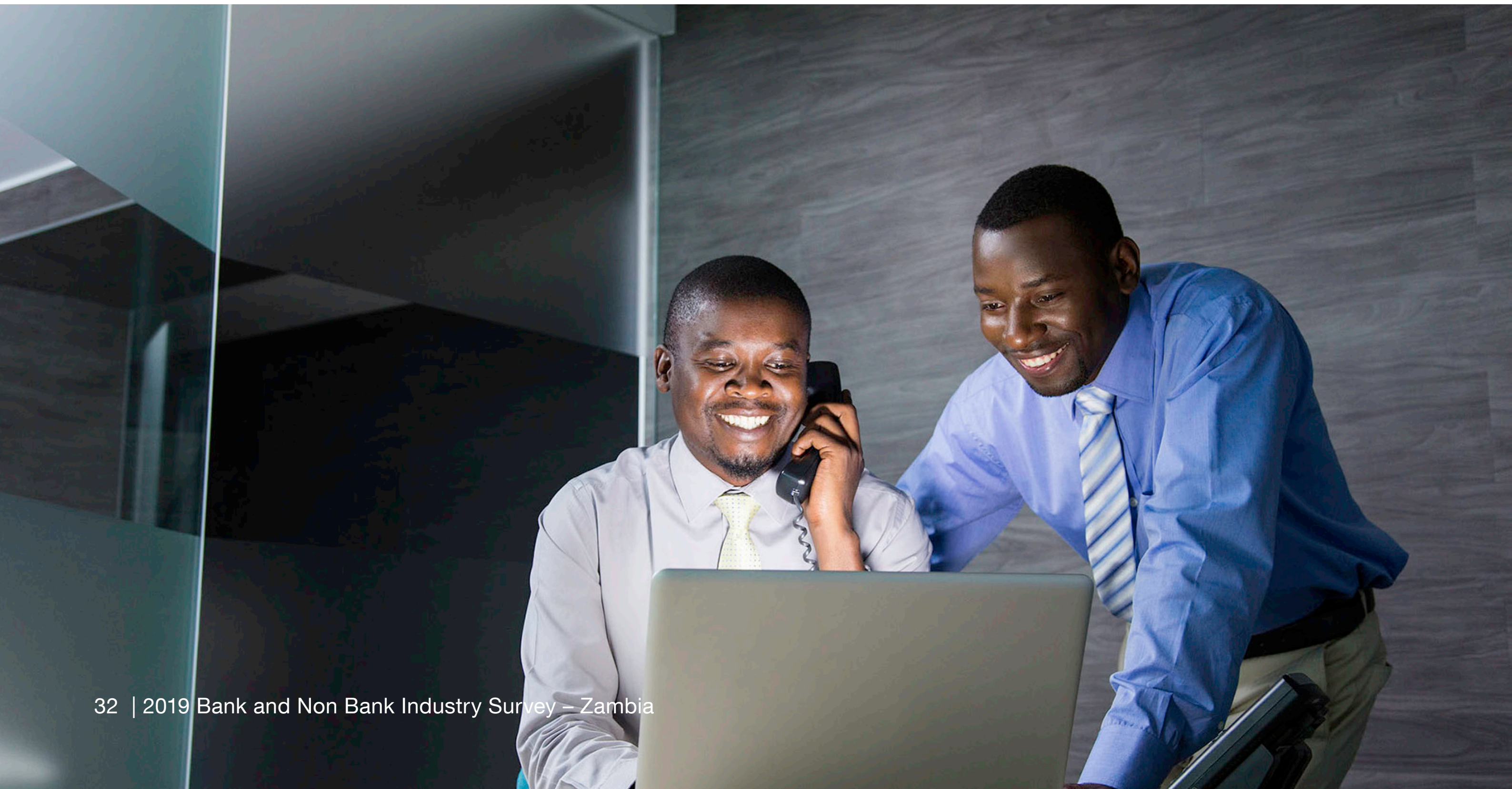
In its second year of application, most banks and NBFIs are expected to have navigated through most of the challenges experienced during 2018 – the first year of adoption. Compared to prior year, where banks and NBFIs ranked the impact of IFRS 9 as the second and fourth most pressing issue respectively, in the current year survey, both banks and NBFIs ranked the impact of IFRS 9 as the ninth most pressing issue.

Do these results surprise us? Not really. 2019 was generally expected to be the year of stability, refining existing impairment models and bedding-down underlying business processes compared to the pre-implementation challenges experienced during the pre-adoption years (2016 & 2017) and the first-year of adoption, 2018.

In the current year survey, we also sought to assess the progress made by respondents in dealing with the top three challenges noted during our 2018 survey.

These challenges included: automation of the impairment models, accounting for government linked facilities and training of staff (capacity building). Our analysis of the responses shows that, overall, while respondents have made progress, this remains a work in progress:

- **Automation of the models**: The survey indicated that 73% of respondents are still using Microsoft Excel-based models and have not transitioned to more sophisticated alternatives since adoption of the standard in 2018. This is largely on account of the cost implications of automatically interfacing impairment models into the existing IT environment outweighing the perceived benefits. Therefore, it is likely that banks and NBFIs will embrace more automation once better equilibrium between cost and benefit is attained. Ultimately, this decision should be designed to ensure that the enhancement of existing impairment models is commensurate with the size and complexity of the business. In the meantime, banks and NBFIs will have to continue navigating through the challenges posed by Microsoft Excel-based models including the risk of manual errors and the absence of audit trails.



- **Training of in house experts**: This continues to be an issue with 66% of respondents. Due to the relative complexity of the standard, as well as the dynamic nature of the operating environment, it is reasonable to expect that this issue will persist at least into the short to medium term. While automation may compensate for some of the technical deficiencies experienced during implementation of the standard, it is imperative for respondents to invest in regular entity-specific training programmes.

- **Dealing with delayed government remittances**: The results from the current year survey show that, 79% of banks and NBFIs with government exposures (either through loans advanced to government or sovereign investment securities) recognised impairment with staging of either 1 or 2. The results also showed that FSPs with foreign ownership were more likely to treat government exposure as stage 2 when compared to those with local ownership.

In addition to above findings, in the current year survey, respondents from both banks and NBFIs highlighted additional challenges including the sourcing of forward looking information and using qualitative factors in determining significant increase in credit risk (SICR).

Going forward, it is reasonable to expect that the challenges noted with respect to forward looking information and SICR will increase largely on account of the complexities introduced by the Covid-19 pandemic. The pandemic has triggered a severe economic crisis with the uncertainty surrounding the depth and duration of containment measures resulting in a more unpredictable future. Public health regulations such as social distancing and closure of some industries will only make the issues that need to be addressed in application of IFRS 9 more complicated. In summary, we expect most banks and NBFIs to spend some time on IFRS 9 on the following:

- **Impact of payment holidays on staging and SICR**: Most banks already have programmes aimed at mitigating the impact of the Covid 19 on their customers such as offering payment holidays or reduction in monthly repayments. While this may avert the issues of eventual impairment, the standards require FSPs to account for other implications such as modifications which may result in gains or losses depending on how the payment holidays are structured.

- **Accounting treatment of negotiated repayment plans with borrowers**: Similar to payment holidays offered to a group of customers or industry-wide holidays, it's expected that other customers indirectly affected by the pandemic will apply for renegotiated terms on their facilities. This, as the case for payment holidays, may lead to losses or gains .

- **Management's ability to identify the sectors badly hit by the pandemic**: With the rapid spread of the pandemic and given the uncertainty on public health containment measures, the source of information to be used to update the models may be scarce. This is compounded by the fact that even in prior years, the source of information has been identified as one of the hindrances to effective application of the standard.

- **Accounting treatment for loans received from the Bank of Zambia as a stimulus to cushion the impact of Covid-19:** Depending on the terms and conditions, the accounting treatment is likely to impact the financial performance and position of FSPs.

- **Requirements to completely remodel the ECL in cases where the current models are unable to appropriately apply the macro-economic indicators**: Most models currently in the market may not have been designed to operate in a stress scenario. For instance, the use of a negative outlook for 2020 and its implications for the future may result in unusual outcomes.

- Further disaggregation of loan portfolios and risk management to ensure that provisions are more reflective of the facts and circumstances surrounding each customer segment.

- Requirements for post adjustments and /or overlays to models.

Tax compliance and management

Tax risk management still remains important

Zambia achieved middle-income country status in 2011, following which tax became a key source of revenue for the GRZ to finance the National Budget. Thus, domestic revenue mobilisation remains a key component of fiscal policy, with the Government setting a socio -economic objective of increasing domestic revenue mobilisation to at least 18% of GDP by 2020.

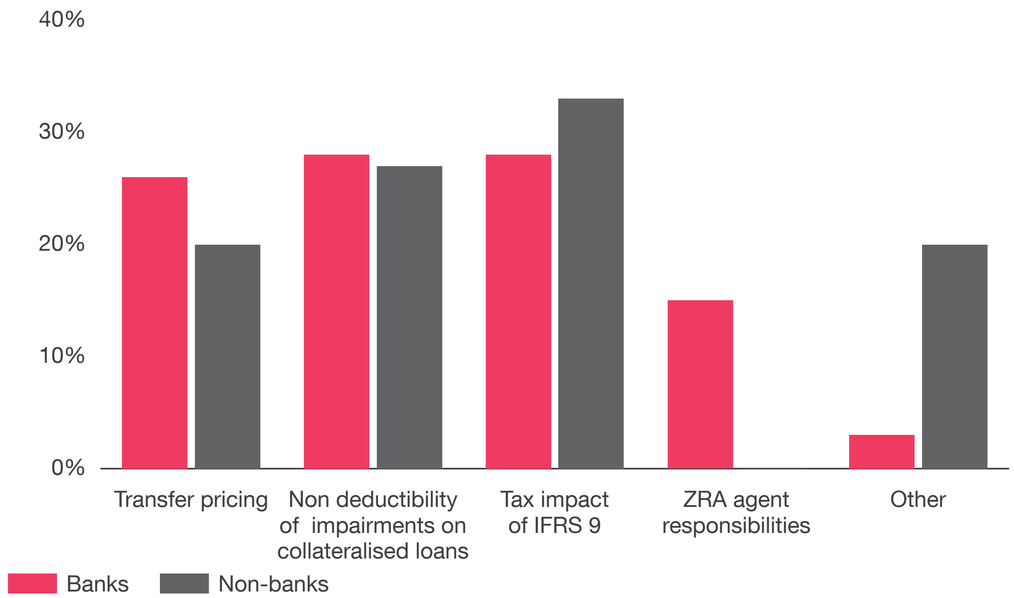
Over the years, the Government has continued to implement measures aimed at strengthening domestic revenue mobilisation, including modernising tax administration and continuing the drive to increase tax compliance.

With the above measures and focus on domestic revenue mobilisation by the Government and Zambia Revenue Authority (ZRA), it has become critical for banks and NBFIs to have in place tax risk management structures that facilitate seamless tax compliance and contain tax costs.

In our survey, we asked 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 38. Tax matters



Source: PwC analysis

From the above, it is clear that the adverse tax impact of impairments appears to be the greatest sources of concern for banks from a tax perspective with a combined 56% of the responses being attributable to concerns around the tax implications of impairments – with 28% of the responses being in respect of the non-deductibility of impairments on collatoralised loans, and another 28% being attributable to the increased current tax liability resulting from the change of impairment provisions under IFRS 9.

This is also the case with NBFIs, with a combined 60% of the responses being attributable to concerns around the tax implications of impairments – with 27% of the responses being in respect of the non-deductibility of impairments on collatoralised loans, and another 33% being attributable to the increased current tax liability resulting from the change of impairment provisions under IFRS 9.

Non-deductibility of impairments on collateralised loans

For purposes of context, in computing taxable profit, banks and NBFIs are required to effectively add back impairment provisions recognised using IFRS 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.

As indicated above, given that 28% of the responses from banks and 27% from NBFIs were attributed to this matter, this is a clear concern.

Changes to the impairment provisions of IFRS 9 which have resulted in additional tax liabilities

IFRS 9 requires banks and other issuers of financial instruments to assess at each reporting date whether the credit risk of a financial instrument has increased significantly since its initial recognition. IFRS 9 requires banks to recognise impairment sooner. Credit provisioning under IFRS 9 is on an expected loss basis, which replaces the incurred loss model under IAS 39.

Another 28% of the response from banks and 33% from NBFIs are attributable to this matter. It is therefore a source of concern.

Transfer pricing

Another key area of tax that affects banks and NBFI is transfer pricing.

Contextualising transfer pricing risk

The advent of globalisation, increased complexity as well as the interdependency and integration of businesses have resulted in transfer pricing becoming one of the most key issues to both business as well as tax authorities in the jurisdictions that those businesses operate in.

Several 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 Zambia, transfer pricing regulations require that all related-party transactions be at arm's length and that appropriate documentation articulating how this is achieved be in place.

Compliance with transfer pricing regulations is now a key area of focus for Zambia subsidiaries of MNEs and local Zambian companies that are members of a Zambian group with annual revenue above K20 Million. Non-compliance with the transfer pricing regulations may attract a penalty up to K24m and possible imprisonment of directors.

On an annual basis, the ZRA expects taxpayers to have in place transfer pricing documentation that demonstrates that transfer prices are consistent with the arm's length and documentation should be in place at the time of submitting the corporate income tax return – i.e. by 21 June. On request by the Zambia Revenue Authority (ZRA), the documentation should be submitted within 30 days of the request. Further, taxpayers are required to keep all records and other information relating to transactions entered into with related parties for ten years.

In view of the above, transfer pricing has become a focal point for companies. With most 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.

Survey results

Zambia has not been spared this reality, with this being clearly reflected in this year's survey results: transfer pricing has been ranked by banks as the third most impactful tax matter by banks, with 26% of the respondents saying transfer pricing was the one tax matter that impacted them the most.

Similarly, 20% of NBFIs highlighted this as a key risk, ranking it third highest.

Administrative responsibility relating to appointment of banks as agents of the Zambia Revenue Authority

Under the various principal tax acts, banks or NBFI can be appointed as agents by ZRA for collection of tax at source from recipients of funds from banks for services rendered to banks or from the bank customers.

Survey results

This results in an additional administrative responsibility for the banks and has been highlighted as a matter of concern for 16% of the respondents.

This matter appears not to affect NBFIs, as none of the respondents highlighted it as a concern.

Other tax matters of interest

The Government anti-tax avoidance agenda

Because of the importance of domestic revenue mobilisation to the Zambia fiscus, the GRZ has sought to modernise tax administration as a priority. As part of this process the GRZ has joined the global initiatives to fight tax avoidance. This includes membership and active participation in the programmes and initiatives of the Africa Tax Authorities Forum (ATAF) and the Organisation for Economic Cooperation and Development (OECD) Base Erosion and Profit Shifting (BEPS) Inclusive Framework.

It is key that tax functions within banks keep track of the above so that they fully incorporate these in their tax risk management strategies to ensure alignment and to avoid unplanned tax cost.

Recent changes in Zambian tax legislation that may be attributable to the above initiatives include the termination of the Zambia–Mauritius Double Tax Agreement (DTA) that is effective from 1 January 2021. This may result in possible double taxation for payments that banks and NBFIs may make to Mauritian resident recipients.

Another change is the recent tightening of transfer pricing legislation, including the proposed requirement for maintenance of Country-By-Country Reporting documentation that was announced in the National Budget Speech read by the Finance Minister, Hon. Dr Bwalya Ng'andu, on 25 September 2020. This will complete the three-tier transfer pricing documentation requirement that is prescribed under the BEPS Inclusive Framework.

Banking post-LIBOR: are you prepared?

Another development that is of relevance to the transfer pricing documentation requirement for loans and other debt transactions is the phasing out of the London Interbank Offered Rate (LIBOR) by the end of 2021.

As you are aware, LIBOR serves as the benchmark for an estimated US$370trn in financial transactions worldwide. The discontinuance of LIBOR at the end of 2021 will require alternate base rates to be used by market participants. Emerging alternative rates differ by region, currency, tenor, and basis.

This pending change has transfer pricing implications for multinational enterprises (MNEs) across all industries, including financial services, that have intercompany arrangements tied to LIBOR. MNEs should evaluate the impact on existing arrangements and policies and prepare a transition plan that addresses the anticipated impact from LIBOR discontinuance.[9]

9 https://www.pwc.com/gx/en/tax/newsletters/pricing-knowledge-network/assets/pwc-tp-discontinuance-of-libor.pdf

Technology

Technology is increasingly taking centre stage in product and service provision. From enhancing operational efficiency, to lowering costs, improving customer experiences and heightening the appeal of products and services, the traditional way of doing business continues to be transformed. 81% of banking respondents and 38% of non-banking respondents anticipate that the greatest opportunity for the sustained growth and profitability of the financial sector lies in the introduction of new products to existing customers using technology and the rollout of technologically enabled products to the unbanked population.

One such product that is enabling this is the mobile money-related products. There has been a significant growth in mobile money transactions over the past three years, with a Compound Annualised Growth Rate (CAGR) of 89% in value and the number of transactions by 47%.

In addition, mobile money transactions surpassed traditional forms of transactions such as ATMs and point of sale services (POS). The number and value of transactions is projected to increase after the introduction of the national financial switch.

Mobile money trends 2017 – 2019				
Mobile money transactions	**2017**	**2018**	**2019**	**CAGR %**
Value (K'Million)	7,287.75	22,191.57	49,445.75	89
Volume of transactions (Million)	172.43	303.96	552.64	47

Payments statistics 2017 – 2019				
Form of payment	**Mobile money**	**ATM**	**POS**	**Direct Debits**
Volume (Million)	552.64	41.77	26.94	1.13
Volume of transactions (Million)	49,445.74	48,054.88	20,094.82	1,026.61

GSMAs State of the Industry report on Mobile Money 2019 gives insights into the biggest trends in mobile money. Some of the interesting trends mentioned were:

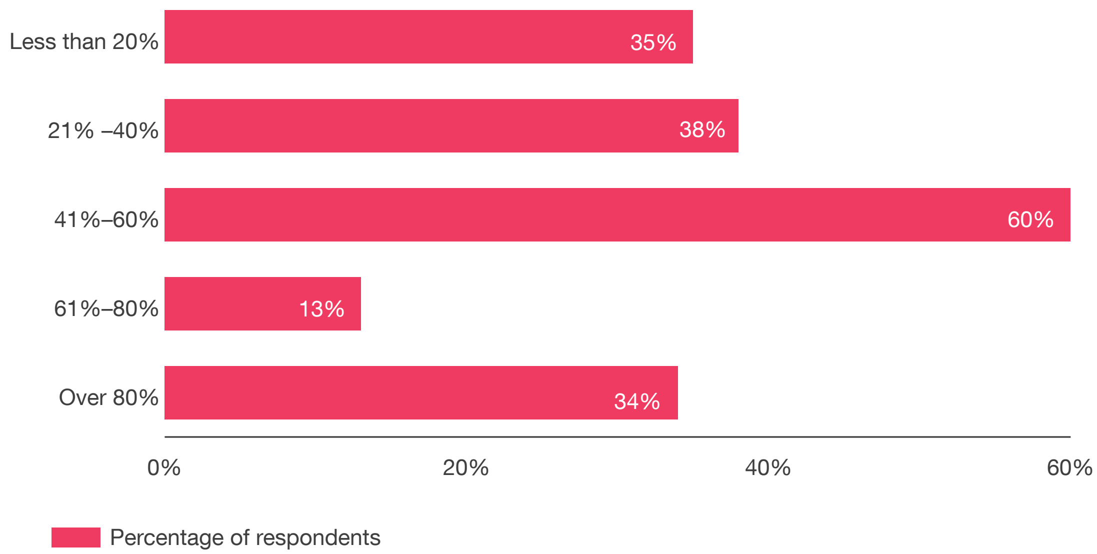
- The increased usage of a 'payments as a platform' model. This model connects mobile users with third-party vendors, which can range from utility companies, schools and universities to even small shop owners;
- The gap of digital to cash-based transactions has reduced since 2017; and
- There is more value circulating in the mobile money system than exiting.

According to their report, there were 3 million active accounts in Southern Africa with a total transaction value of US$2.5bn.

The volume of real-time data collected from mobile money transactions could be utilised to provide more affordable finance for SMEs that would otherwise be unable to obtain finances due to traditional risk management limitations.

The onset of the coronavirus pandemic in 2019 added an additional dimension to the use of technology. With public health professionals promoting social distancing to reduce transmission of the coronavirus disease, deliberate efforts are continually being made to promote digital financial solutions. Findings from our survey show that in 2019, 34% of respondents indicated that over 80% of customer transactions (deposits, payments, withdrawals) were undertaken using electronic channels (2018: 25%). This shows an upward trend in the use of electronic channels. Similarly, results from PwC's East Africa Banking Survey conducted in 2019 indicated that 36% of respondents reported that 25% to 50% of applicable transactions were made using digital channels. However, it is worth noting that PwC's Consumer Digital Banking Survey of 2019 shows that 61% of customers (down from 65% in our 2018 survey) still value the importance of having a branch in proximity.

Figure 39. Proportion of customer transactions undertaken using digital channels in Zambia



Source: PwC analysis

Emerging technologies hold great potential for the Zambian market. Both banking respondents (88%) and non-banking respondents (50%) mentioned a 'Focus on digital transformation and innovative products' as one of the top three strategic steps they are taking to be financial institutions of the future. In a similar vein, according to PwC's Global Fintech Report 2019, 37% of financial services (FS) companies have incorporated emerging technologies into the products and services they sell. When asked about the use of data analytics within their institutions, 63% of banking institutions indicated that they use them for diagnostic analytics (understanding why it happened) while 29% of non-banking respondents indicated they use them for descriptive analytics (understanding what happened). Furthermore, there remains great potential for financial institutions to take advantage of robotic process automation (RPA) solutions to automate routine and non-complex tasks. Examples of this include the use of chatbots and RPA bots to automate service helpdesk management. At present RPA solutions are only used frequently by 19% of banking respondents and 7% of non-banking respondents.

Cybersecurity

Over the last four years, we have seen a general decline in the financial sector's view of cybercrime as a significant threat. In 2016 and 2017, cybersecurity was ranked as the second and fourth most significant issue affecting the industry, respectively. However in 2018 and 2019 both commercial banks and NBFIs did not consider cybersecurity as one of their top five issues.

The most common types of cybersecurity attacks reported in the last 12 months were phishing attacks (80% of banking respondents and 28.57% of non-banking respondents), malware (33% of banking respondents and 16.7% of non-banking respondents) and hacking (27% of banking respondents and 21.43% of non-banking respondents). Commercial banks also identified the growing risk of cybersecurity threats from card fraud, while non-banking financial institutions identified them from outdated software.

The preferred options to mitigate cybersecurity risk continue to be education of employees and customers (50% of commercial banks and 14% of non-banking financial institutions) and increased investments in software and technology to enhance firewalls and antivirus software (35.7% of commercial banks and 25% of non-banking financial institutions).

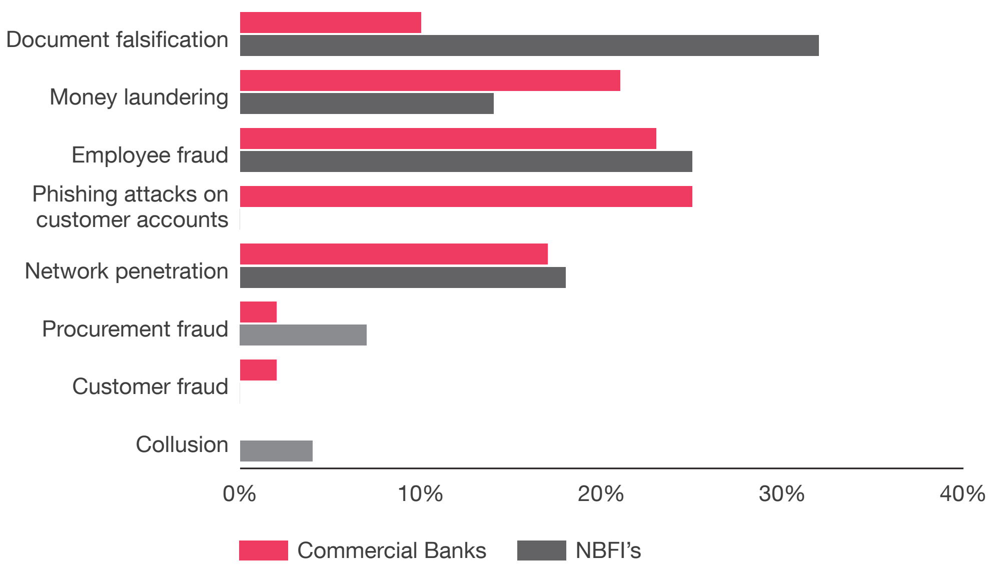
The general decrease in the ranking of the industry's perception of cybersecurity crime may suggest an increased risk of complacency. Financial institutions are encouraged to be more proactive in mitigating cybersecurity risk, especially with the increased use of technological platforms that the coronavirus pandemic has necessitated.

Financial crime

Following on from our 2018 Banking Survey findings, fraud and financial crime remain a topical issue, though they are not ranked among the top risks. 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?'

Similar to 2018, banking respondents indicated phishing attacks on customer accounts and employee fraud, respectively, as the top schemes fraudsters perpetrated, whereas non-banks reported document falsification during application of credit facilities and employee fraud.

Figure 40. Top fraud schemes used by fraudsters

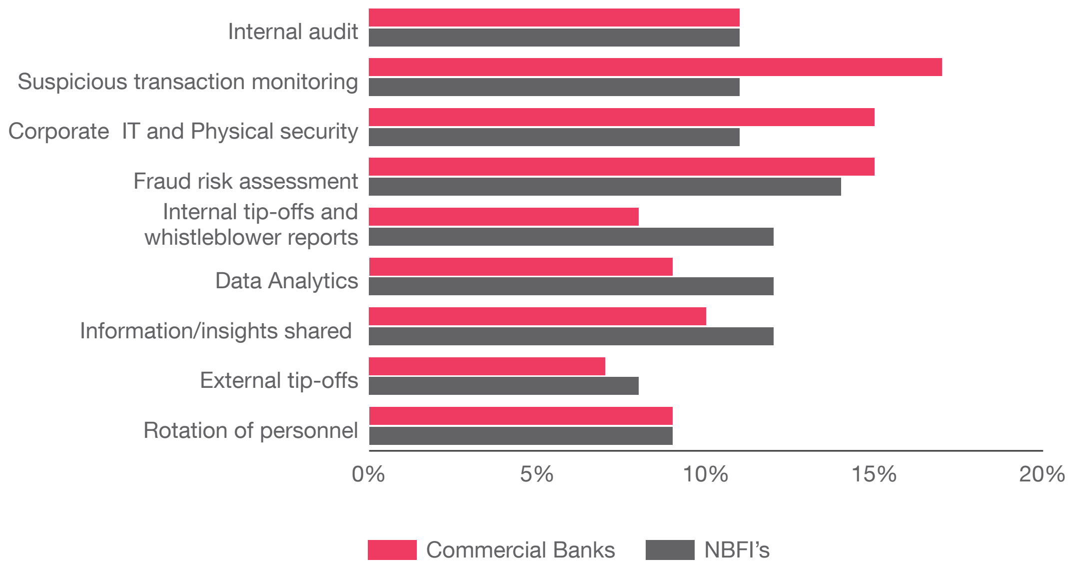


Source: PwC analysis

The PwC East African Banking Survey 2019 also revealed similar trends, with the top two most commonly reported financial crimes being document falsification during application of credit facilities and card fraud. Phishing attacks were exploited by less than 50% of the East African financial market.

There is a growing urgency for financial institutions to prioritise the management of anti-money laundering (AML), financial crime risk (FCR) and counter-terrorist financing (CTF). The survey results show that the measures found to be most effective in detecting and determining financial crime show similar trends for both banks and non-banks include: suspicious transaction monitoring using technology, corporate security (both IT and physical security), fraud risk assessment and internal audit.

Figure 41. Most effective methods in detecting and deterring financial crime



Source: PwC analysis:

Financial inclusion and banking: What you might be missing

Betty Wilkinson, CEO Financial Sector Deepening Zambia

The world has turned upside down. Covid-19 has created the most significant economic, well-being, and emotional turmoil in recent memory. So far internationally we have seen 25.4 million contract the disease and 850,000 die. Health services are overwhelmed, and people are mixed in their responses to quarantine, masks, and social distancing, which raises risks. The bottom line is, stay home and do your economic and social transactions by distance, and this is hard since humans are by nature gregarious. Nations have closed their borders, which has challenged both labour and trade. There have been economic collapses due to work slowdowns and consumption drops, especially in selected industries (tourism and travel, restaurants, sports and entertainment, manufacturing, mining).

Countries have gone deep into debt to provide money and food for the millions of unemployed, and to try to keep microenterprises, small businesses, and key industries afloat. Internationally, there have been slowdowns in trade of metals and other inputs. There have been strong shifts from global engagement to inward-looking issues at home. People are rethinking how global we have become in our economies and societies, and whether domestic production might be increased for safety and stability. Botswana has just legislated that certain businesses can be operated only by nationals.

In Zambia we have seen over 12,000 cases and 287 deaths,[10] with pressures on the health services to cope. This comes at a time when there are severe fiscal problems and large public debt. As an open economy with many goods coming from outside and lack of diversification, the pressures are intense. Since January 2020, the currency has experienced over 39% devaluation[11] as well as uncertainty on debt workouts, causing Eurobonds to slide to junk status. Despite important efforts from the Bank of Zambia and the government to provide debt finance, seek IMF assistance, and address the debt issues, challenges remain. Zambia is behind in digital finance, and despite a lot of work to expand cell towers over about 47% of adults do not own a cell phone, according to the ZICTA 2018 study.12 Donors and investors face their own challenges, and cannot provide new money to keep Zambia moving.

Going forward, Zambians are going to be a lot more conservative with their money, save more, and insure themselves. They will reach out to learn how they earn better and more stable business incomes, which means a lot more use of digital services, digital financial education, and fintech. Citizens will be diversifying income streams even more than they do now, and we can expect the trend of people having both formal and informal earning sources to grow. Customers will avoid formalisation and formal services when they are too costly and hard, and when their complaints are not addressed promptly or taken seriously.

What are banks doing to shift into the new normal? Both internationally and in Zambia, banks realise that digital services are vital to their survival. They are entering into key partnerships with mobile network operators and fintechs, as well as closing branches and seeing how they can set up or negotiate partnerships with networks of agents. Smart banks also realise that they have to reach downmarket, diversify their client base, listen carefully to what customers say, address their complaints responsibly, and deliver client-centric products and services. As the Bank of Zambia 2019 survey13 showed, reaching out to women is smart and profitable. In addition, banks are shifting to be one-stop shops for financial services. They are adding layers of products such as insurance plus loans plus savings plus transfers. Good recent examples of this are AB Bank's e-Tumba and Zanaco's Agripay.

In Zambia, lending needs to evolve and be far more creative. Data inside the banks and the Bank of Zambia's credit monitoring system are great examples of information banks need to use better. Sharing data on who pays and who does not and creating both strong delivery arrangements and penalty systems that work better are important, both in the financial services providers and socially. The history of non-repayment has caused such strong systems of older tradition asset guarantees that the Bank of Zambia K 10bn fund is undersubscribed. BCCET work on credit guarantee arrangements may help, as we hope the IFC work on expanded use of the collateral registry can do. And be sensitive to cashflow irregularities in your clients' businesses; other countries have put up a year loan with up to two months 'skips' when business is slow, and clients love these and pay on time!

As banks what else should you be doing? You heard me say this in 2018 and it is even more true now. You must digitise both your services and your data and actively learn from the patterns that emerge. Use national consultants for this; hiring ICT teams in-house makes them stale over time as this field evolves at the speed of light. Get better and more creative on savings products. As clients can be expected to do more comparison on competitor offer, be more innovative with collateral, cashflow-based lending, and links to savings groups. Bank staff need to learn to do more client-centric product design generally, and reach downmarket by listening to the needs of these groups. Finally, it is very important to proactively address complaints and be seen as responsive and reliable in this way.

We certainly live in interesting times, and adapt or die is our new normal. Good luck.

[10] Ministry of Health TV report 31.08.2020.

[11] https://freecurrencyrates.com/en/exchange-rate-history/USD-ZMW/2020 shows 14.04ZMW to the USD on 1 January and 19.50 to the USD end August.

[12] https://www.zamstats.gov.zm/phocadownload/Other_Institutions/ZICTA%20ICT%20Survey%20-%202018.pdf 2018 National Survey on Access and Usage of Information and Communication Technologies by Households and Individuals: A Demand Side Assessment of Access and Usage of ICTs in Zambia. ZICTA.

[13] https://www.boz.zm/Sex-disaggregated-data-speech.pdf

The fight against financial crime: Call for a holistic approach

By Brenda Guchu and Wendy Wambua

Anti-money laundering (AML) refers to the laws, regulations and procedures put in place to prevent criminals from disguising illegally obtained funds as legitimate income. The Government of Zambia has taken great strides in the fight against money laundering through putting in place AML frameworks and institutions – e.g. the Anti-Money Laundering Authority (AMLA), the Task Force of Senior Officials on AML/CFT matters, and the Financial Intelligence Centre (FIC), among others. In the most recent Zambia National Risk Assessment released on 22 September 2017, the national money laundering threat analysis rated corruption as the most prevalent predicate offence for money laundering. This was followed by tax evasion and fraud.

As with many jurisdictions across the world, banks are the most vulnerable institutions to money laundering in Zambia and constitute 78% of the financial sector. According to Zambian law and global leading standards, financial institutions, particularly banks, are required to put in place systems and processes to ensure that activities indicative of money laundering are detected and appropriately reported to the FIC. On the other hand, however, globalisation and rapid advancement in technology have increased the complexities of modern banking and often increased the difficulties for banks to effectively fulfil this requirement. Some of the relevant global trends in banking include:

- **Growing adoption of mobile transactions** – The transition to mobile commerce, financial transactions and services has increased the opportunities for fraud, money laundering and financing of terrorism, requiring banks to manage risks across a multitude of devices and platforms as well as work with mobile platform providers.
- Large volumes of transactions data, with many previously unbanked populations getting into the financial system and consequently requiring sophisticated data analytics tools.
- **Regulatory pressure** – Banks have faced increased regulatory pressure to report on typologies of increasing complexities, and the demand for real-time detection at point of origin has increased.
- **New wave of authentication** – Authentication has transitioned away from knowledge-based mechanisms to device profiling and biometric verification to improve threat detection without impacting the customer experience.
- **Consumer demand for faster and secure payments** – Digital wallets and other emerging payments have stretched the traditional rules of banking, with sophisticated customers who demand speed and security. This has driven the banks' appetite for flexible self-learning algorithms and other advanced analytics.

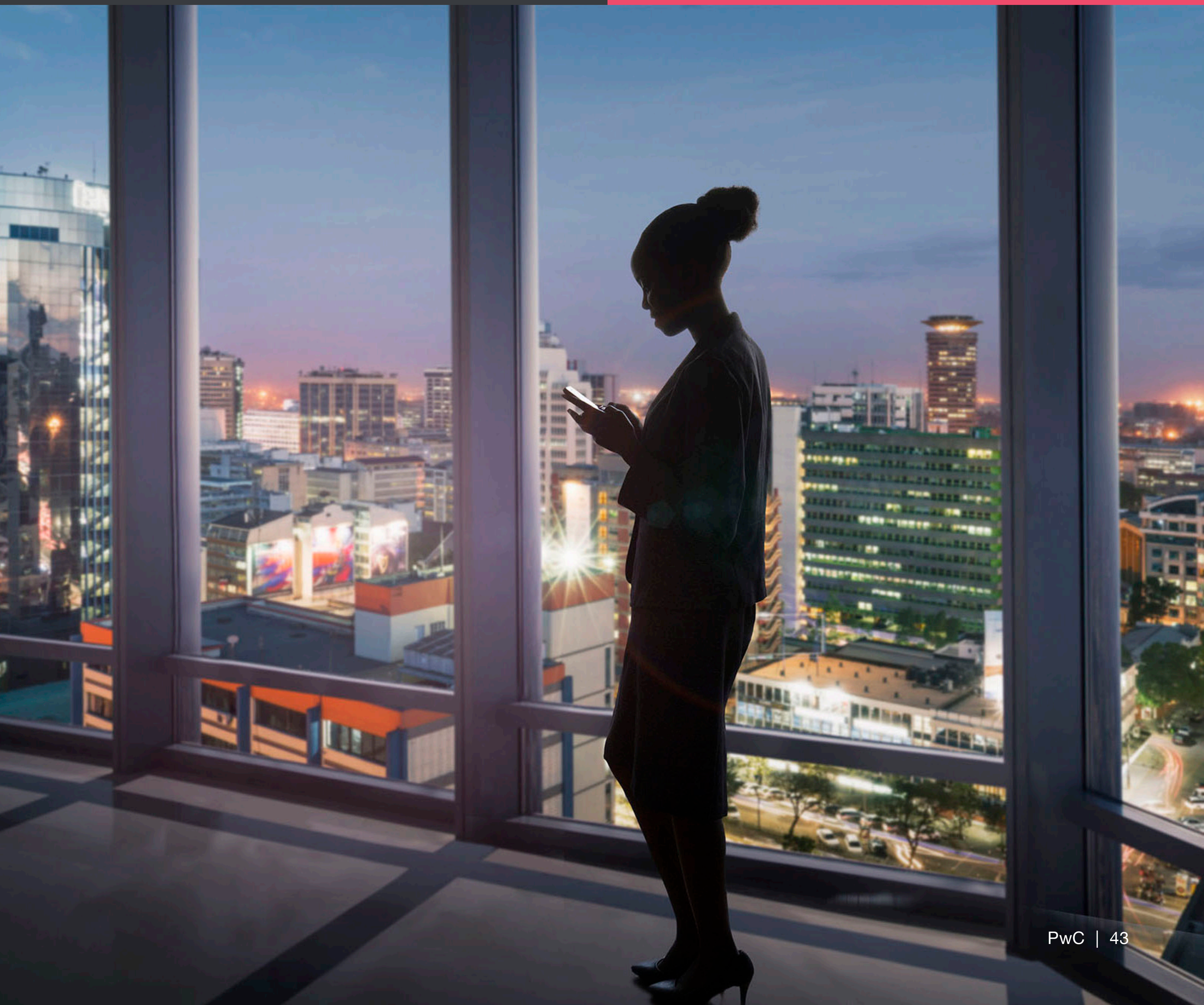
While in many cases these developments have improved customer experience and increased revenues for banks, many of them have opened up new channels for money laundering and reduced detection rates. To comply with regulatory requirements and respond to these threats, many banks have employed modern transactions monitoring technologies, although false positives and true negatives persist. This has not only brought to the fore the ineffectiveness of technology when used as the only tool for AML/CFT threat detection, but also the severe shortcomings of isolating AML/CFT programs from the bank's overall threat management arsenals.

To elevate financial crime risk management to the next level, banks should consider adopting a holistic view of managing financial crime risk without undermining customer experience. In an ideal scenario, this would mean that financial crimes such as AML/CFT, cybercrime, fraud and tax evasion are managed from the same lens with integrated people, processes, data and technology. To achieve this, and as a first step, the bank would need to perform a holistic gap analysis, identifying and ranking the various financial crime threats. This would be informed by various factors such as regulations, experience and operating environment, and should result in a risk register. Secondly, the bank would need to come up with an integrated framework to manage these risks, taking into account the required expertise, technologies and data and how that would be integrated into the enterprise-wide risk management framework. The third step is the implementation and execution of the framework, building on existing tools and processes so as to manage costs.

Currently, AML/CFT is widely viewed as purely the role of the risk department, and indeed in many banks there is a perception that their work is in conflict with business development initiatives. In a holistic fincrime management approach, the goal is to not only mitigate financial crime threats but also leverage on improved systems and processes for better customer experience, digital trust and to enhance product development. In this approach, therefore, risk management is a shared responsibility for all stakeholders in the bank.

With this in mind, banks should be asking themselves, are we assessing threats well enough? Is the siloed approach to financial crime management really working? Or is it time to turn the tide and deploy systems that will not only comply with compliance regulations but will also make a true impact on the bottom line?

Brenda Guchu and Wendy Wambua are Financial Crime Specialists in the PwC East Africa region



Conclusion

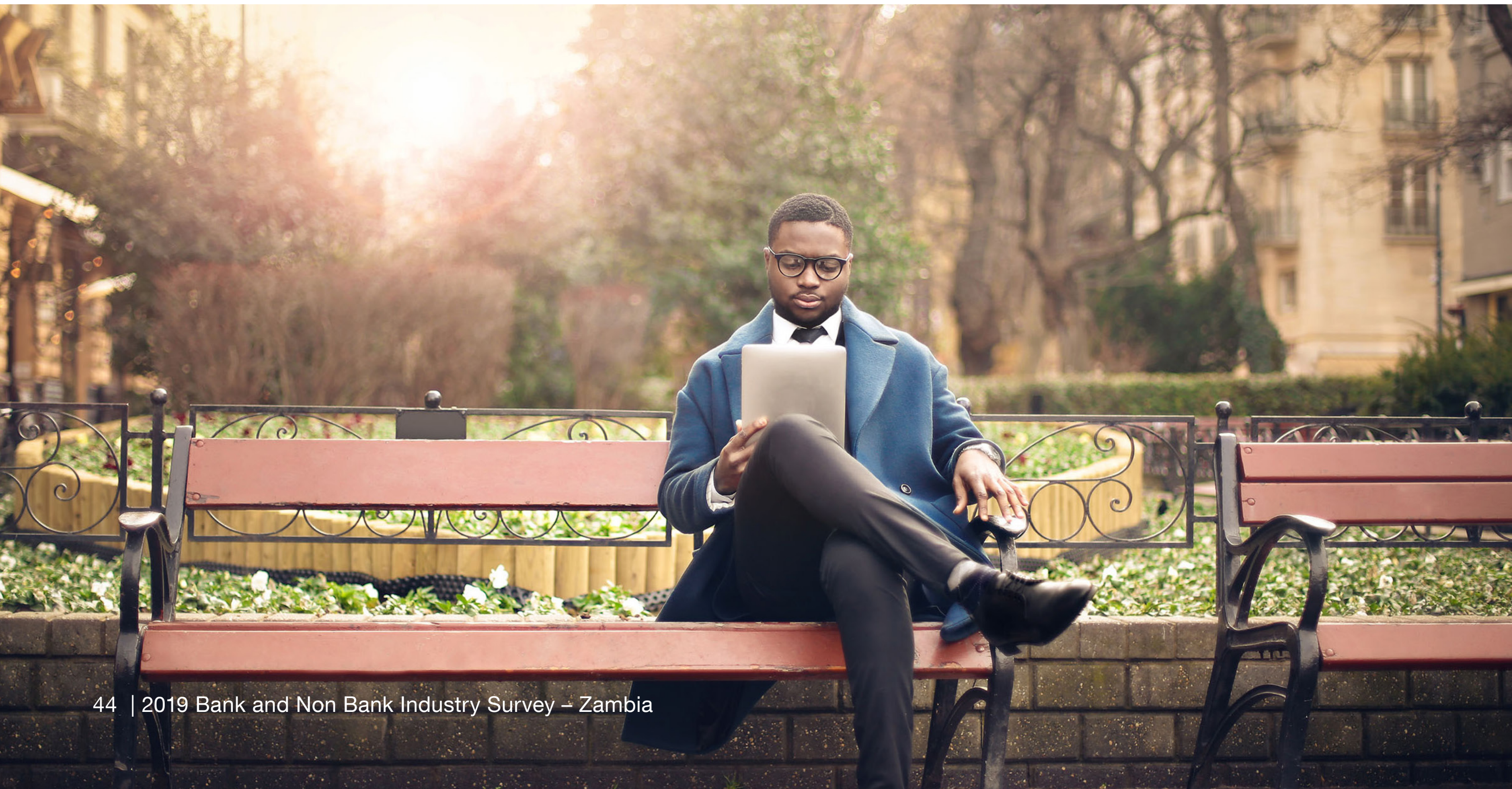
The future remains uncertain.

Stability of the economy and eventual return to sustained growth is dependent on several factors, including controlled government spending. Implementation of a debt management strategy in the absence of attaining fiscal consolidation targets is unlikely to deliver the desired outcomes. In 2021, the situation may be further complicated by a propensity towards loose fiscal policies that are not uncommon during an election year. At the same time, the Government's acknowledgement that it will be unable to meet its Eurobond debt obligations if the consent solicitation is not approved, and whether this will trigger sovereign default, adds to the uncertainty.

Globally, several European countries are reinstating stricter containment measures in preparation for a second wave of the Covid-19 pandemic. This is in sharp contrast with several African countries, Zambia inclusive, that were gradually relaxing restrictions and opening-up. How Zambia interacts with other regional/ global economies that are on contrasting ends of the spectrum of containment measures, and how this impacts our prospects of economic recovery, remains to be seen.

In the eye of this storm is the banking sector. Because of the casual relationship between economic growth and performance of financial institutions, the strength of the sector as a whole is likely to come under strain in the short to medium term – with smaller banks and NBFIs experiencing the impact more disproportionately.

However, within any crisis lies opportunities. How the industry responds to these unprecedented challenges, individually and collectively, will shape the nature and complexion of the sector going forward. The acceleration of digital transformation; reimagining product development; building more trust as banks support their clients through the crisis; and leaner operating structures occasioned by the adoption of new ways of working are all opportunities that the sector should seize.



One of the primary challenges of any organisation is how to best allocate its precious resources to enact the types of changes required to not only manage through the crises of today, but be successful tomorrow. As you think about the future, it may be helpful to have a structured way to think about your organisation, operating platform and overall business.

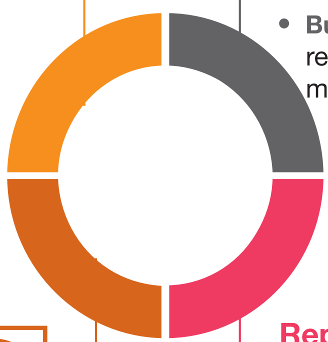
At PwC, as part of our Future of Industries project, we determined the four key categories and areas of focus to consider as you prepare for tomorrow. The graphic below shows examples of how financial services leaders can use this framework to determine gaps and priorities.

Repair

- **Portfolio management:** Prepare for restructuring and workouts
- **Fee-based revenue:** Develop new products, consider acquisitions
- **Trust:** Use the crisis to help regain the trust of society and regulators
- **New business capacity:** Rebuild capital, rationalise portfolios to rebuild capacity

Reconfigure

- **Cost structure:** Drive 25-30% additional reduction
- **Change budget and focus:** Re-evaluate and rationalise to improve ROI
- **Emerging technology:** Drive adoption of clouc and use of AI and SaaS solutions
- **M&A:** As needed to re-establish scale, enter growth markets, exist markets/poor-performing businesses
- **Partnerships:** Increase partnerships with non-traditional providers, technology companies and fintechs
- **Business lines and products:** Align front-office resources, service models and capital to the most profitable products
- **Compensation and incentives:** Accelerate digital labour and transformation initiatives



Rethink

- **Management:** Adopt a more agile and less structured organisation and approach
- **Ways of working:** Rationalise real estate footprint, formalise remote working, integrate productivity tools
- **Talent and innovation:** Increase crowdsourcing and use of gig economy, upskill talent
- **Customer and strategy:** Accelerate move to digital channels, align business strategy to new reality

Report

- **State aid:** SME assistance, capital, other support
- **Accounting standards:** IFRS 9
- **Regulatory:** Supervision and communication
- **Shareholders:** Enhanced disclosure
- **Society:** Purpose and value
- **Taxes:** Increasing transparency of tax contribution and strategy

Financial performance and analysis including for selected African countries

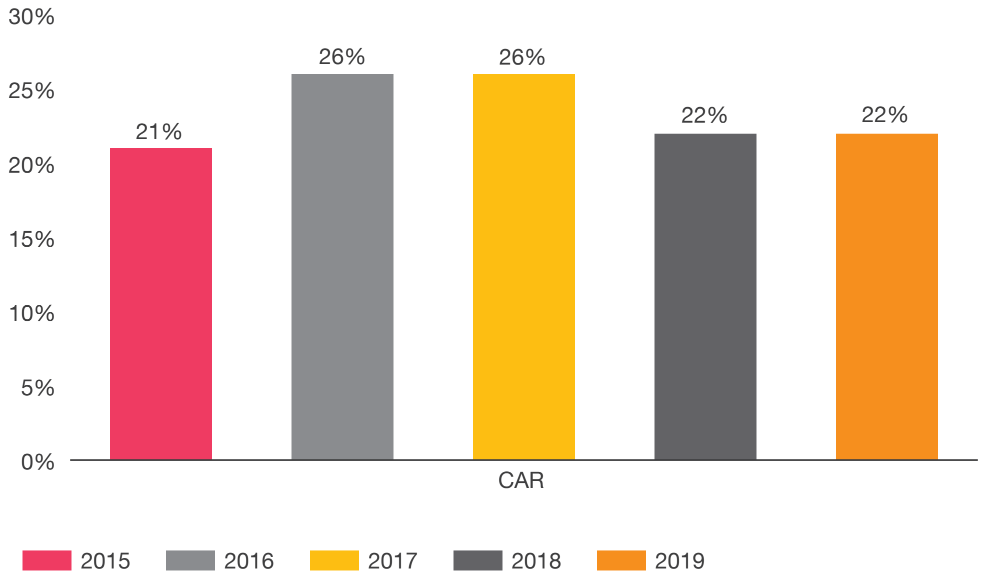
Capital Adequacy Ratio (CAR)

Banking Sector

In the current year, the CAR record remained static at 22% in 2019. This was mainly attributed to a relative increase in risk weighted assets and tier 2 capital. This was driven by increased industry lending of about K9.1bn and an increase in the tier 1 capital of about K1.2bn.

The average CAR of 22% for the industry is above the 10% minimum required by the regulator and hence it can be concluded that the industry as a whole continues to be well capitalised. Figure 42 below shows the trend in the industry CAR for the period 2015 to 2019.

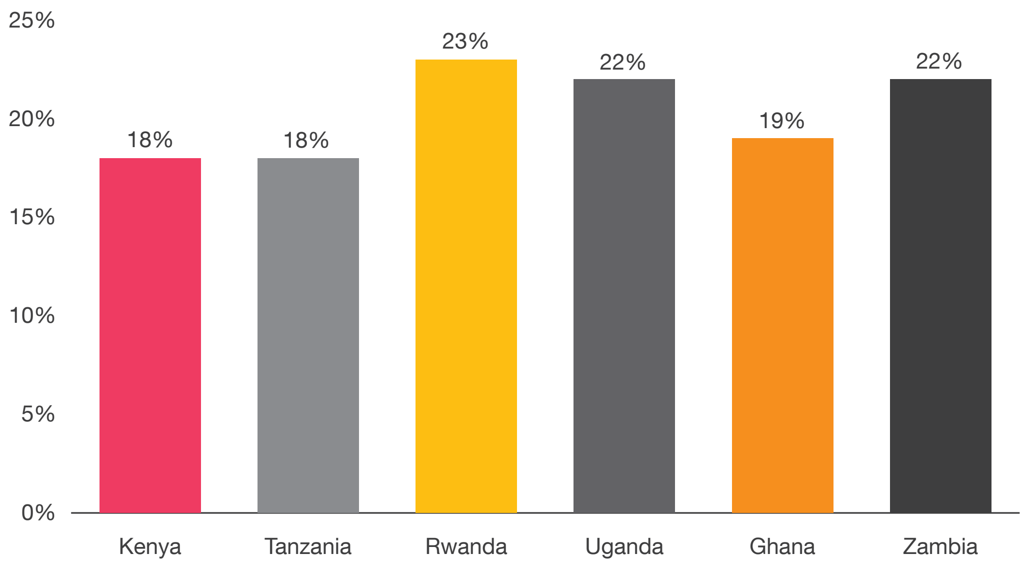
Figure 42. Capital adequacy ratio



Source: Bank of Zambia

Regional analysis

Figure 43. Capital adequacy ratio for selected African countries



Sources: Central Bank of Kenya, Bank of Tanzania, National Bank of Rwanda, Bank of Uganda, Bank of Ghana and Bank of Zambia

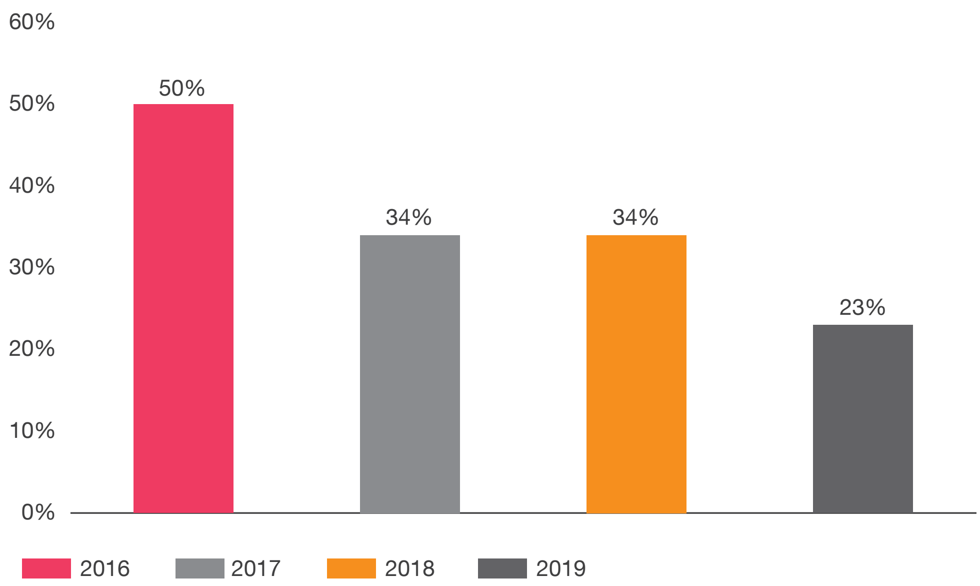
For the selected African countries, the CAR of the Zambian banking sector is higher than all the other countries other than Rwanda and Uganda, which are at 23% and 22% respectively. At 22% as at 31 December 2019, the CAR was higher than the banking sector Kenya (18%), Tanzania (18%) and Ghana (19%). It is noted that as countries such as Ghana and Kenya have fully implemented Basel II, they are not required to carry as much capital as other countries, hence the lower capital adequacy ratios.

* Due to limitations of data, the CAR for the comparative countries has been presented as at 30 June 2019.

Non-Bank Financial Institutions

The CAR reduced in the current year by 11% from 34% in 2018. The reduction in the CAR was driven by the increase in market assets such as loans and advances. At 23% the CAR is still above the minimum required position of 10% by the central bank.

Figure 44. Capital adequacy ratio



Source: Bank of Zambia

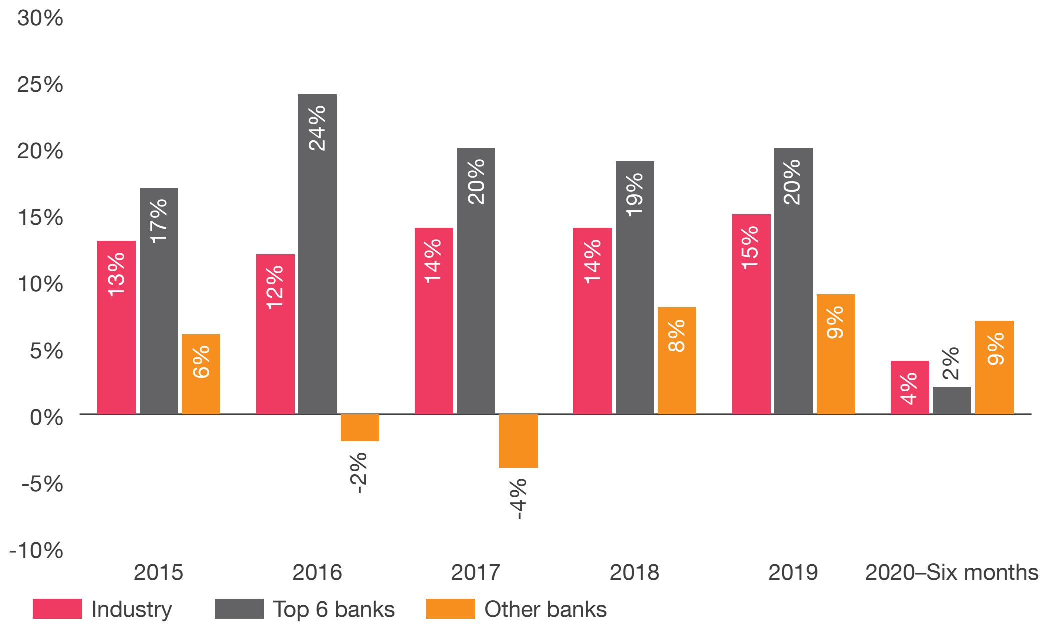
Return on Equity (RoE)

Banking Sector

The ROE increased by 1% to 15 % in 2019 from 14% in 2018. The marginal increase was mostly attributed to better industry profitability. There was an increase recorded on the ROE of the top six banks by 100bps. This was complemented by a similar increase in the ROE for the rest of the industry.

For the six-month period to 30 June 2020 ROE declined to 4%. The decrease was attributed to significant impairment charges during the period on account of the adverse impact of Covid-19 in the first half of the year. ROE for the top six banks declined by 18% while the rest of the industry fell by 2%.

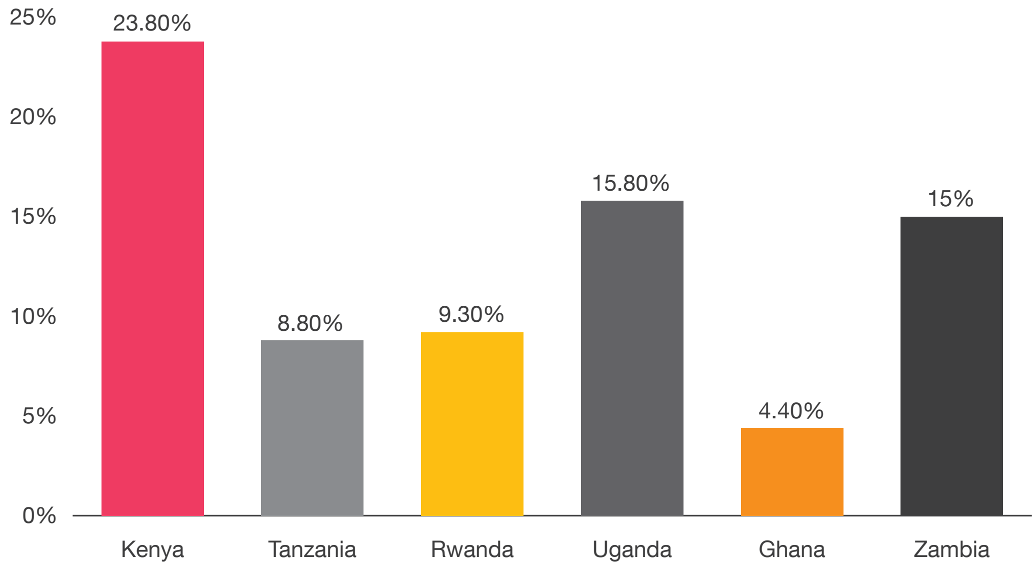
Figure 45. RoE



Source: Bank of Zambia

Regional analysis

Figure 46. RoE – selected countries



Sources: Central Bank of Kenya, Bank of Tanzania, National Bank of Rwanda, Bank of Uganda, Bank of Ghana and Bank of Zambia

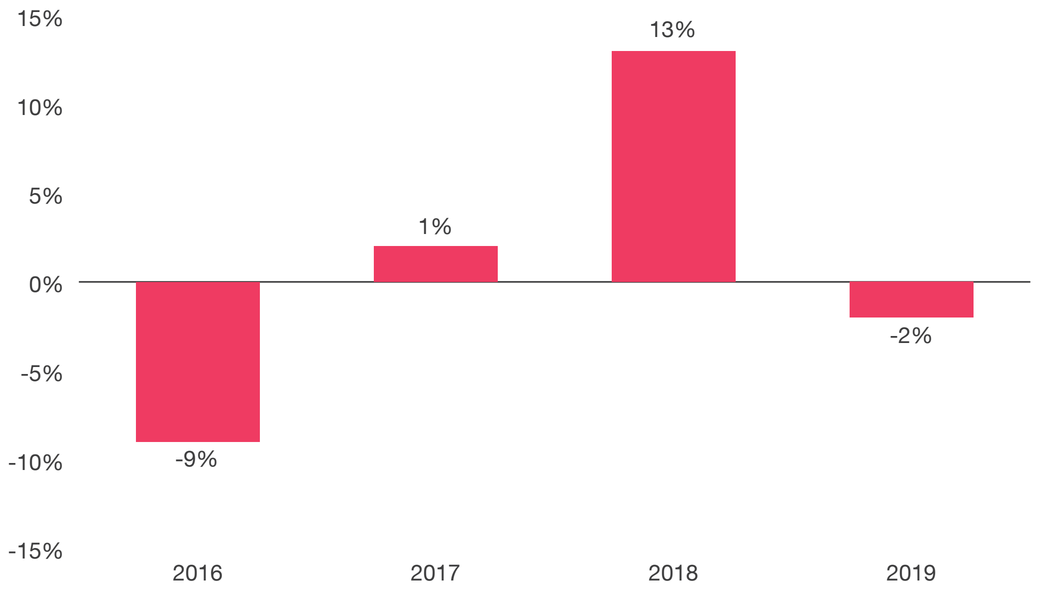
At 15%, the Zambian banking industry lies in the median range when compared with the selected countries. Of the countries selected for comparison, Kenya ranks the highest with 23.8% followed by Uganda at 15.8%. Ghana is the lowest at 4.4% while Tanzania (8.8%) and Rwanda (9.3%) are both below the median of 15%.

* Due to limitations of data, the CAR for the comparative countries has been presented as at 30 June 2019.

Non-Bank Financial Institutions

ROE reduced in the current year by 15% from 13% in 2018. The negative ROE of 2% in 2019 was mainly driven by high operational expenditure resulting in a combined loss in the industry. However, gross income, and particularly interest income, has steadily improved, with the industry recording positive growth in 2017, 2018 and 2019.

Figure 47. RoE



Source: Bank of Zambia

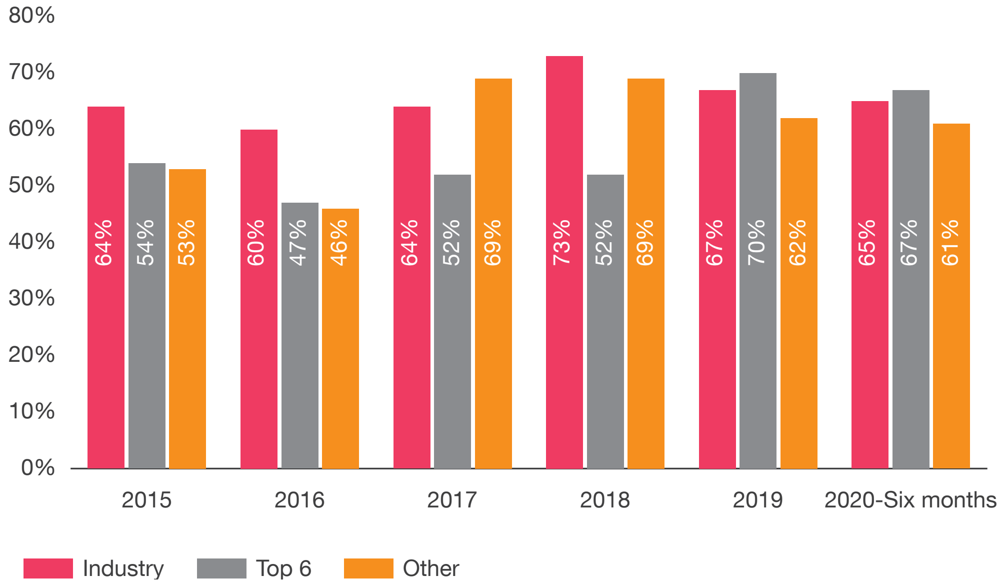
Net interest margin Zambia and for selected countries

Banking sector

The industry net interest margin decreased by 6% in 2019 from 73% in 2018 to 67% in 2019. This was despite the six largest banks recording an increase of 18%. This was countered by a decrease of 7% for the rest of the industry. The general decrease was mainly due to an increment in interest expense which reflected the increase in cost of funding and challenged the economic environment.

The half-year results to June 2020 show a decrease of 2%. This was on account of an increase in impairment expense during the period among the top six banks. Four of the top six banks recorded impairment expenses in excess of K100m for the half year. The results reflect a challenged economy with the effects of Covid-19 beginning to have an impact on credit risk.

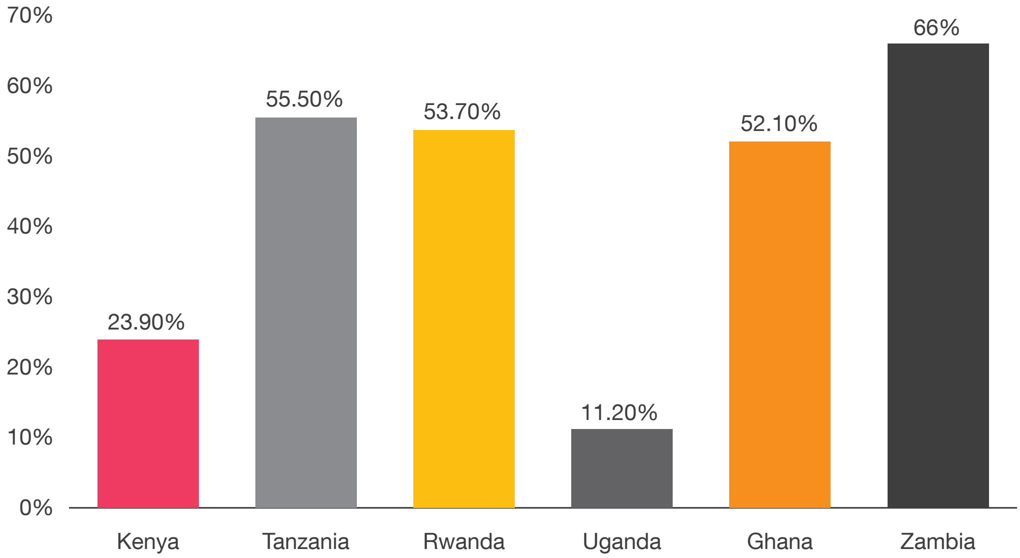
Figure 48. Net interest margin



Source: Bank of Zambia

Regional analysis

Figure 49. Net interest margin



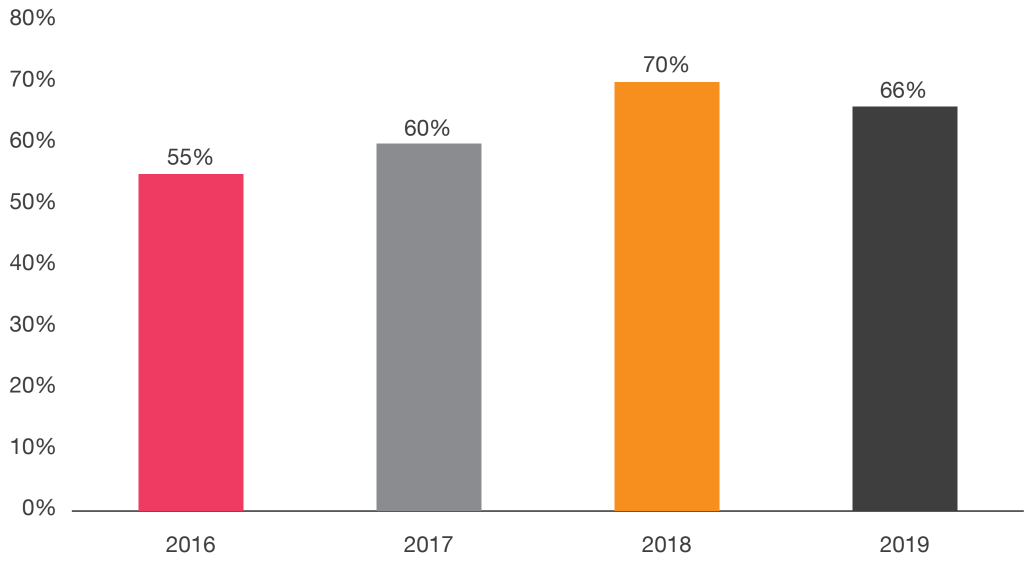
Sources: Central Bank of Kenya, Bank of Tanzania, National Bank of Rwanda, Bank of Uganda, Bank of Ghana and Bank of Zambia

At 66% in 2019, the net interest margin for the Zambian banking industry ranks quite high in comparison to other selected countries. This is followed by Tanzania at 55.5% and Rwanda at 53.70%. This is mainly due to the high interest rate environment on commercial loans prevailing in Zambia relative to other countries. This comparison is affected further by the interest rate capping regime which was applied in Kenya. However, this has since been scrapped.

Non-Bank Financial Institutions

The net interest margin has steadily increased from 55% in 2016 to 60% and 70% in 2017 and 2018 respectively. However, NIM declined by 4% to 66% in 2019. The decrease was driven by a slowdown in interest income growth at 12% relative to 59% increase in the prior period. In addition, the industry has seen a slowdown in growth of its loan book, which grew by only 7% in the period.

Figure 50. Net interest margin



Source: Bank of Zambia

Banks lending analysis (bank and NBFIs)

Both Kwacha and Dollar lending increased by 18% in 2018 and 17% in 2019 respectively. This was mainly due to the statutory reserve ratio (SRR) being maintained at 5% throughout the period. However, SRR was increased to 9% on 23 December 2019.

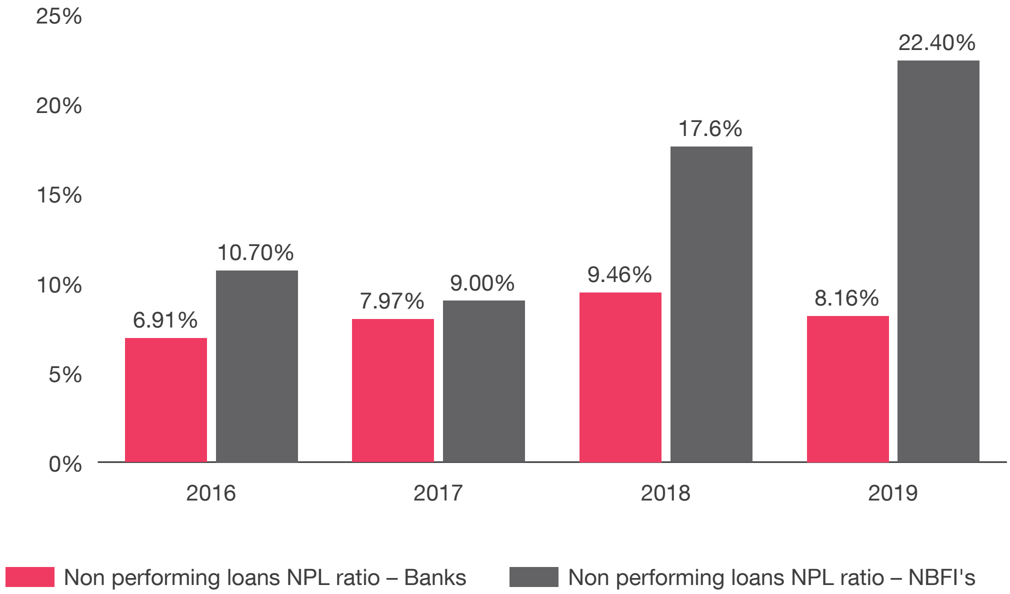
The tight liquidity position coupled with the depreciation of the kwacha against the dollar has led to dollar lending reducing by 12% as at May 2020. However, kwacha lending continues to show growth and increased by 12% as at May 2019. This is despite most businesses scaling back operations due to the Covid-19 outbreak.

Non-performing loans

The percentage of non-performing loans to gross loans in the banking sector decreased from 9.46% to 8.16% from 2018 to 2019. 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 NBFIs, the NPL ratio decreased from 17.6% in 2018 and 22.4% in 2019 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.

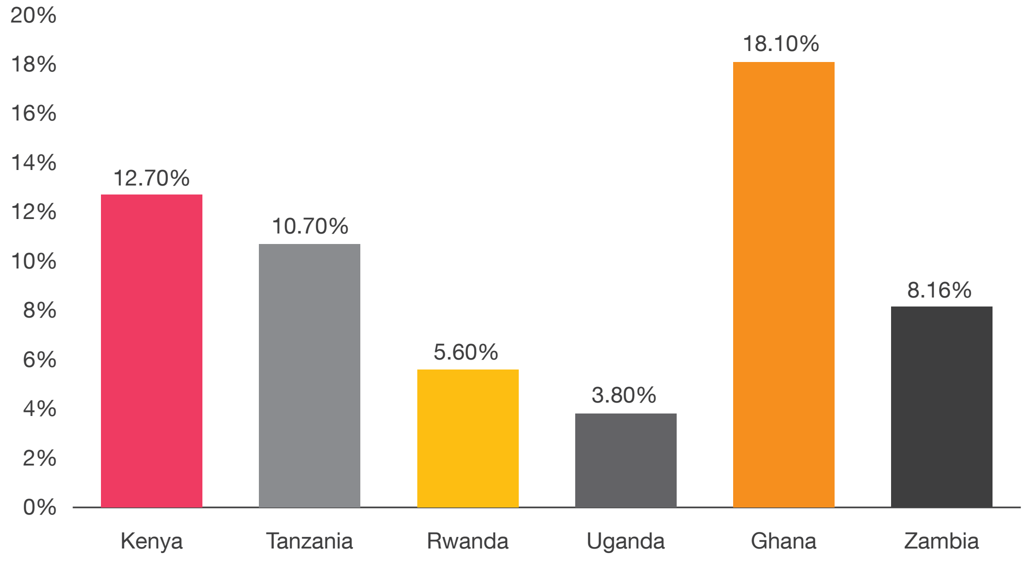
Figure 51. Non performing loans



Source: Bank of Zambia

Regional analysis

Figure 52. Banks NPL ratio – 2019



Sources: Central Bank of Kenya, Bank of Tanzania, National Bank of Rwanda, Bank of Uganda, Bank of Ghana and Bank of Zambia

At 8.16% in 2019, the NPL ratio for the Zambian banking sector is below the median NPL ratio for the selected African countries of 9.30%. This is comparable to Kenya (12.7%) and Tanzania (10.70%), but significantly lower than Ghana at 18.10%. In Ghana this was largely driven by the effect of the migration of legacy loans into NPL status, which continue to have a protracted effect on the NPL ratio. Zambia's NPL ratio still ranks higher than Uganda (3.80%) and Rwanda (5.6%), which have relatively lower NPLs.

*Note: We have included half-year figures to assess the impact of Covid-19 on the banking sector. The 2020 figures are unaudited as at 30 June 2020. Investrust and Zambia Industrial Commercial Bank (ZICB) had not yet published their results as at 30 June 2020.

Further, NBFI figures for 30 June 2020 were not available, so the analysis for non-banks is performed only up to 31 December 2019.

Glossary

- Capital adequacy ratio (CAR)

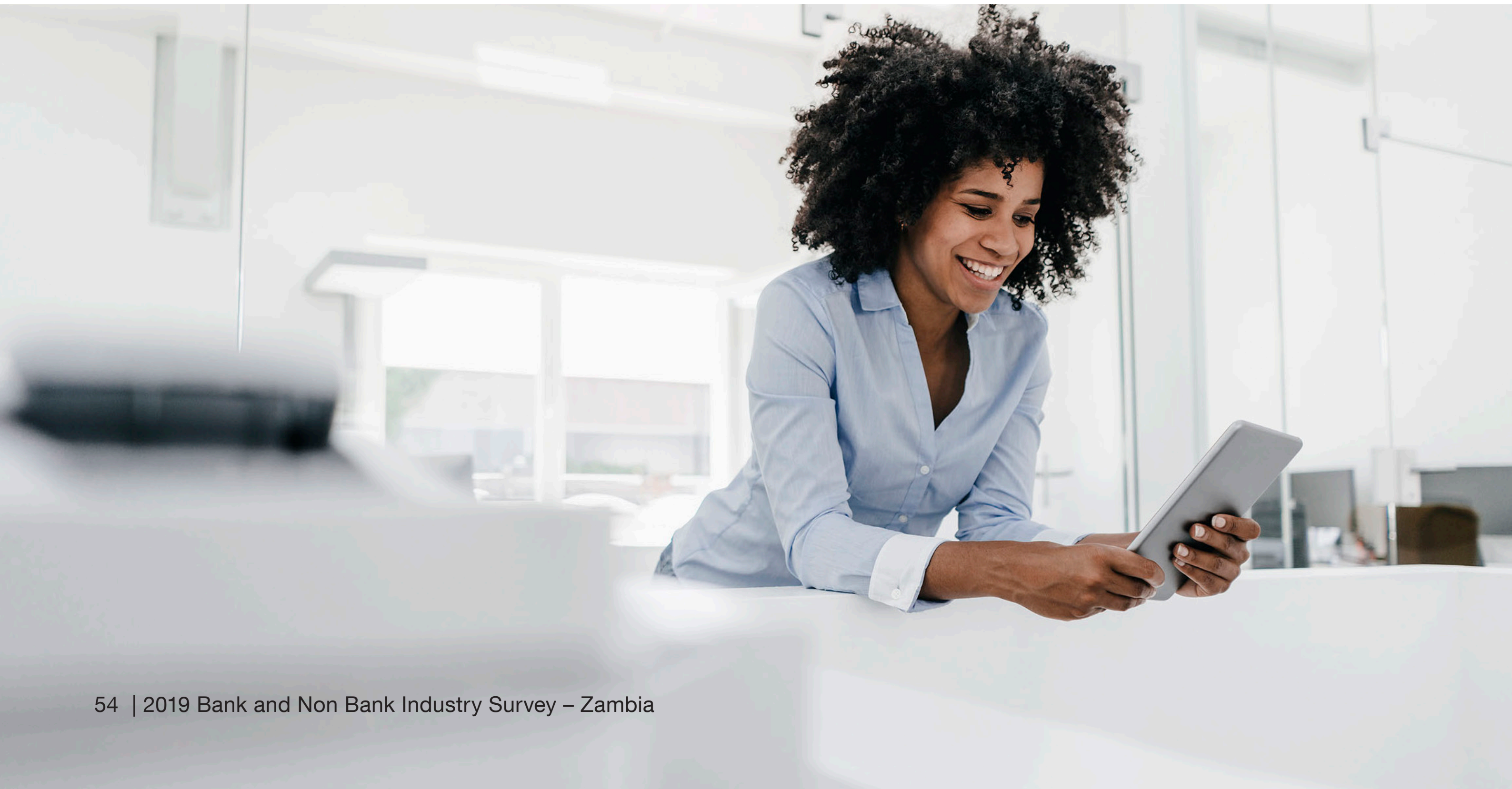
$$CAR = \frac{(\text{Tier 1 capital-goodwill}) + \text{Tier 2 capital}}{\text{Risk weighted assets}}$$

- Return on equity (RoE)

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

- Net interest margin (NIM)

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



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