2020 Zambia Bank and Non-Bank Industry Survey

August 2021

pwc

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Foreword

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Welcome to PwC's 2020 Bank and Non-Bank Financial Industry Survey.

This is our fifth edition of the survey and we are extremely excited to have been able to produce this report during a very difficult time for the industry.

Businesses in Zambia have faced unprecedented challenges over the last 18 months. The scale of problems brought about by the Covid-19 pandemic has tested the resilience of financial institutions unlike anything encountered in living memory. This coupled with an already weak domestic economy has affected almost every aspect of business operations and exposed a plethora of risks – both old and new – for banks and non-bank organisations.

Despite these recent challenges, it encouraging to see that financial institutions are increasingly positive in their outlook for the sector over the short, medium and long-term. We at PwC share this optimism.

This year, we have expanded our report to include insights from the chief executive officers of Zambia's commercial banks. This valuable information supplements the responses we receive from the banks' chief financial officers and sits alongside those from non-bank financial institutions. Each year, the feedback on this survey gets more positive and we will continue to enhance our report in subsequent editions.

We would like to take this opportunity to thank all the respondents, our guest contributors, the Bank of Zambia and the Bankers Association of Zambia for their valuable input into this report. Last, but not least, we would like to thank the dedicated PwC team members who make this important report happen.

We hope our findings and analysis will help banks and non-bank institutions make more informed decisions on matters of policy and strategy going forward. We look forward to your feedback.

Andrew and Martin

1. Executive summary

1.1 Survey background

The bank and non-bank sectors have faced a cocktail of challenges during the last 18 months which have tested the resilience and flexibility of businesses across the board.

Just as financial institutions were adapting to the impact of a prolonged decline in the domestic economy, the onset of the Covid-19 pandemic in March 2020 thrust the industry into the brutal reality of the unknown. Many of Zambia's pre-Covid economic challenges have been exacerbated by the pandemic and financial institutions have had to think on their feet in order to survive in this new environment.

It is against this backdrop that we are proud to present the fifth edition of our report, The Bank and Non-Bank Industry Survey 2020. We have looked at six areas in this year's survey, five of which we have covered in previous years, but with the addition in 2020 of a section on the impact of Covid-19. The areas are:

- The state of the economy
- The impact of Covid-19 on banks' operations
- Technology and the future of banking
- Financial inclusion
- Cybersecurity
- Taxation

This year we have expanded our survey to include feedback from the chief financial officers (CEOs) of Zambia's commercial banks. The CEOs were asked in the questionnaire to pick the top ten most pressing issues affecting financial institutions from a list provided and rank the issues in order of importance, with ten being the most important and one being the least important. In previous years, we have only sent one questionnaire to the chief financial officer (CFO) at both the banks and non-bank financial institutions (NBFIs) for our survey. By including insights from banks' CEOs, we hope to offer readers valuable insight into the thinking of Zambia's financial business leaders.

The survey questionnaire was sent to all 17 commercial banks and 35 of the 47 NBFIs operating in Zambia. We received responses from 16 of the 17 CEOs of commercial banks, the equivalent of a 94% response rate. Of the CFOs, 88% of CFOs from commercial banks responded, while 30% of the CFOs of NBFIs approached replied to the survey. It is important to note, however, that the NBFIs that did respond were microfinance institutions, which constitute a significant part of the NBFI market in terms of revenue and asset share.

We therefore believe that the 30% of NBFIs that did respond is well representative of the overall non-bank financial sector. Furthermore, microfinance institutions are more closely related to banks than other NBFIs, and have a similar risk profile and business activities. By focusing on microfinance institutions within the NBFI group we hope to offer more meaningful analysis of NBFIs this year.

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

In addition to the survey responses, we analysed consolidated industry performance statistics compiled from the prudential returns that financial institutions submit quarterly to the Bank of Zambia (BoZ) and used the results of this analysis to extract further insights from the survey responses.

Finally, as in previous surveys, we have enhanced our analysis of the domestic banking sector by comparing its performance with other countries in the region.

1.2 Summary of survey results – banks and NBFIs

Given recent events, it is unsurprising that the state of the Zambian economy and the impact of Covid-19 on businesses were the two main concerns for respondents of this year's survey.

The Ministry of Finance estimates that Zambia's economy contracted by 3% in 2020 compared to GDP growth of 1.4% in 2019, largely due to a slowdown in economic activity brought about by the global pandemic[1]. This has added pressure to an already deteriorating domestic economy, which has been weighed down by a depreciating Kwacha, inflationary pressures and the country's ballooning debt burden.

The economy has bounced back to some extent this year, with GDP growth expected to be 1.6% in 2021[2]. However, the domestic economy remains far from robust. The Kwacha has again depreciated this year on the back of falling international reserves and forex earnings, averaging K21.6 to the US dollar during the first quarter of 2021 compared to a K20.7 average during the fourth quarter of 2020 – a drop of 4.4%. Inflation meanwhile has continued to rise, particularly food inflation, with overall inflation averaging 22% in the first quarter of the year compared to 17.5% in the fourth quarter of 2020.

Underlying all this, the country's debt obligations continue to grow and there is mounting pressure on government to action the policy needed to address this pressing issue. As at the end of May 2021, official figures from the Ministry of Finance show that the domestic debt burden stood at K148.7 billion, up 14% on the end of December 2020, while external debt stood at US$12.75 billion.

It is not surprising given this environment that respondents from both banks and NBFIs identified heightened credit risk and the threat of non-performing loans (NPLs) as the third most pressing issue affecting financial institutions over the last year.

The fourth biggest issue of concern for banks was cybersecurity, followed by erosion of fees and service charges in fifth. Meanwhile, NBFIs identified improving revenue growth and the continued depreciation of the Kwacha as the fourth and fifth most pressing issues respectively.

Figure 1. Survey results across banks and NBFIs

Banks	Rating	Common Issues	Banks	NBFIs	NBFIs	Rating
Cyber security	4.1	State of the local economy	8.6	8.4	Improving revenue growth	5.0
Fee and service charge erosion	3.2	Impact of Covid 19 on operations	8.2	7.3	Depreciation of the Kwacha	4.2
		High credit risk and NPL's	4.4	6.0		

Source: PwC analysis

1. Ministry of Finance, 2020 Annual Economic Report
2. Ministry of Finance, 2020 Annual Economic Report

1.3 Top five issues – banks but not NBFIs

The state of the local economy remained the biggest issue of concern among commercial banks for the third year running. The impact of Covid-19 on operations was the second most important issue for banks.

The decline in the domestic and global economies has pushed credit risk and the threat of NPLs into the spotlight for the second year running, with high credit risk and NPLs ranked as the third most pressing issue for commercial banks in 2020. However, fewer banks rated it as an important issue this year than they did in 2019: the issue scored 4.4[3] iInflation meanwhile has continued to rise, particularly food inflation, with overall inflation averaging 22% in the first quarter of the year compared to 17.5% in the fourth quarter of 2020[4].

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Figure 2. Top five issues for banks, 2018–2020

	2018		2019		2020
State of the local economy	5.6	State of the local economy	9.0	State of the local economy	8.6
Improving revenue growth	5.3	Impact of Covid-19	8.9	Impact of Covid -19	8.2
Implementation of IFRS 9	5.2	Credit risk	6.5	High credit risk and NPLs	4.4
Abolishment of unwarranted fees and charges	4.8	Capital management	6.5	Cyber security	4.1
Credit risk	4.7	Improving revenue growth	5.6	Fees and service charge erosion	3.2

Source: PwC analysis

3. Ministry of Finance, Quarterly Report, First Quarter 2021
4. Ministry of Finance, Quarterly Report, First Quarter 2021
5. Ministry of Finance, Quarterly Report, First Quarter 2021

1.4 Top five issues – six largest banks vs the rest of the industry

This year's results show greater convergence around the issues affecting the six largest banks in the market (by asset size) and the rest of the industry.

In 2019, there were only two common issues amongst all respondents: the state of the local economy and credit risk. In 2020, four of the most pressing issues were the same for both groups, albeit with higher scores among the six largest banks. The four common issues are: the state of the local economy; the impact of Covid-19 on operations; high credit risk and NPLs; and cybersecurity.

The only issues not common to both groups were fee and service charge erosion and liquidity risk. Fee and service charge erosion was seen as the fifth most pressing issue among the six largest banks, while liquidity risk was the fourth most pressing issue for other banks.

Figure 3. Six largest banks vs industry vs other banks

Top 6 banks	Rating	Common issues	Top 6 banks	Other banks	Other banks	Rating
Fee and service charge erosion	3.5	State of the local economy	9.0	8.3	Liquidity risk	3.6
		Impact of Covid 19 on operations	7.8	8.4		
		High credit risk and NPL's	5.3	3.8		
		Cyber security	5.3	3.3		

Source: PwC analysis

1.5 Trend analysis of top five issues for the six largest banks

Three of the top five issues of concern for the six largest banks have remained unchanged since 2018: the state of the local economy; high credit risk and NPLs; and fee and service charge erosion. In 2020, cybersecurity returned to the top five for the first time since 2017. Meanwhile, the impact of Covid-19 on operations, while identified as a top five issue in 2019, has risen in ranking as more banks have had to rethink their operating models and accelerate digital transformation in response to challenges and opportunities presented by the pandemic[6].

Figure 4. Top five issues for top six banks

	2018		2019		2020
State of the local economy	6.3	State of the local economy	9.3	State of the local economy	9.0
Managing costs	5.8	Credit risk	6.2	Impact of Covid-19	7.8
Credit risk	5.2	Escalating costs of doing business	4.6	High credit risk and NPLs	5.3
Improving revenue growth	4.8	Fee and service charge erasion	4.5	Cyber security	5.3
Fee and service charge erasion	4.5	Increased competition from non-traditional players	4.4	Fee and service charge erosion	3.5

Source: PwC analysis

1.6 Top five issues – rest of the banks

With the exception of fee and service charge erosion, four of the top five issues faced by the rest of the banks are the same as the issues identified by the industry as a whole.

The other issue reported as an area of concern was liquidity risk.

Capital management has dropped in ranking from fourth in 2019 to ninth in 2020. In addition to the lower ranking, there was also a decrease in its score from 6.6 to 2.7, demonstrating a wider divergence in views on the significance of the issue.
The increase in importance of liquidity risk is presumably linked to the challenges faced by the wider banking industry in accessing affordable liquidity in the current Covid-19 environment, the importance of which has superseded capital management as a top five issue.

Figure 5. Top five issues – other banks

	2018		2019		2020
Implementation of IFRS 9	6.1	Impact of Covid-19	9.4	Impact of Covid-19	8.4
Improving revenue growth	5.5	State of the local economy	8.8	State of the local economy	8.3
State of the local economy	5.3	Credit risk	6.7	High credit risk and NPLs	3.8
Fee and service charge erasion	5.0	Capital management	6.6	Liquidity risk	3.6
Credit risk	4.5	Improving revenue growth	5.4	Cyber security	3.3

Source: PwC analysis

6. Due to the onset of Covid-19, our 2019 survey questionnaire was sent out in mid-2020. It is for reason that Covid-19 is listed as a pressing issue in 2019 even though the virus did not become a global issue

1.7 Top five issues – NBFIs

Three of the top five issues facing NBFIs are the same as banks. These are: the state of the local economy; the impact of Covid-19 on operations; and high credit risk and NPLs. These three issues remain the same as 2019, although the order of importance has changed.

Completing the list of the top five most pressing issues are improving revenue growth and the depreciation of the Kwacha. These replace liquidity risk and the escalating cost of doing business. Considering that NBFIs ranked the depreciation of the Kwacha as one of the top five issues, this may suggest that respondents believe this issue is the main driver of increasing costs.

Figure 6. Top five issues for NBFIs

	2018		2019		2020
Credit risk	6.0	Impact of Covid-19	8.7	State of the local economy	8.1
State of the local economy	4.5	State of the local economy	8.2	Impact of Covid-19	7.5
Liquidity risk	4.6	Credit risk	6.8	High credit risk and NPLs	5.9
Implementation of IFRS 9	4.1	Liquidity risk	6.6	Improving revenue growth	5.3
Client retention	4.0	Escalating cost of doing business	5.8	Depreciation of the Kwacha	4.5

Source: PwC analysis

1.8 Looking ahead

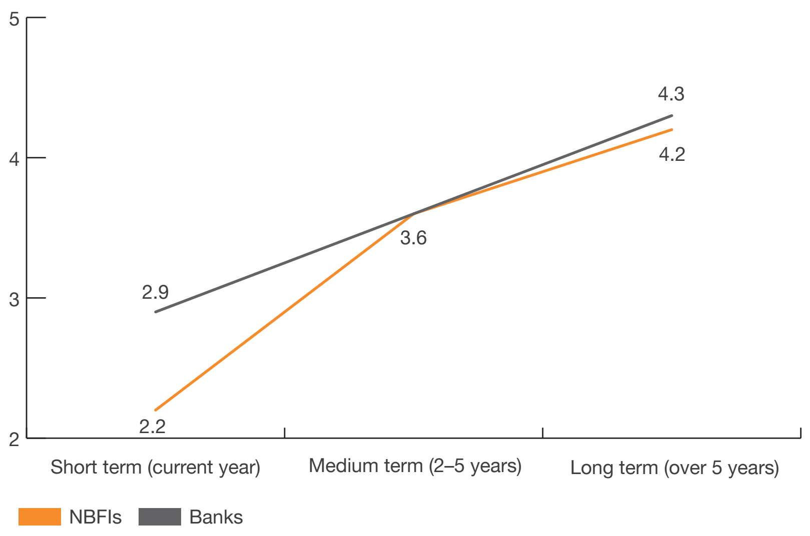
As in previous surveys, we also sought to assess the level of optimism within the industry. Respondents were asked to indicate their level of optimism on a five-point Likert scale, with one being least optimistic and five being very optimistic.

Overall, respondents were mildly optimistic about the short-term outlook, with the level of optimism improving over the medium to long-term horizon. However, it is worth noting that NBFIs exhibited a considerably lower level of optimism over the short to medium-term compared to banks.

Respondents' level of optimism remains largely unchanged from 2018, and for similar reasons. In the medium-term, respondents' optimism was fuelled by expectations of an economic recovery, the restructuring of the country's debt and the possibility of an IMF programme.

Interestingly, NBFIs did not highlight any unique reasons for their comparatively lower level of optimism. They simply reported the same set of concerns, but from a less optimistic viewpoint. In the long-term, financial institutions said they were optimistic about growth prospects for the Zambian economy.

Figure 7. Level of optimism regarding the prospects of the Zambian financial sector



Source: PwC analysis

2. State of the economy

2.1 Sub-Saharan Africa outlook

The impact of the Covid-19 pandemic caused economic output in Sub-Saharan Africa (SSA) to shrink by 2.4% during 2020, a milder recession than initially predicted. Many of the countries that rely on industrial and agricultural commodity exports saw large contractions during the year, with countries reliant on tourism still experiencing slow growth in 2021 as international arrivals remain low. However, growth in global economic activity during the second half of 2020 has had a positive impact on the region and is causing regional growth to slowly resume. There has also been progress in containing the disease, specifically in central and western Africa. This progress could further reduce restrictions, increase tourist arrivals, movement of people for employment and leisure, and business activities.

Although economic growth in the regional has not been affected by the pandemic as much as was initially expected, the risk of debt distress has increased in some countries as budget deficits widen and governments take on more debt. Consumer price inflation fluctuations have also varied across the region. Countries such as Nigeria and Angola saw rising inflation driven by currency depreciation and increasing energy and food prices. In contrast, subdued demand for goods in countries such as South Africa and Kenya has helped curb inflation. Also, foreign direct investment has recovered to almost its pre-pandemic levels during 2021, according to the World Bank, while worker remittances have proven to be more resilient than expected.[7]

Sub-Saharan Africa's GDP is forecast by the World Bank to grow by 2.8% in 2021 and 3.3% in 2022. Baseline projections assume stronger external demand for goods and services from countries such as the US and China, along with higher global commodity prices.

Containment of the impact of the Covid-19 pandemic is also expected to contribute to this growth, despite the region facing challenges with its vaccine rollout. However, logistical and other challenges in some countries could delay vaccinations even further. Decreased oil prices could reduce revenues for oil exporters, while increased food prices from events such as droughts and floods pose additional food security risks. Increasing conflicts and borrowing costs could also weigh on growth.[8]

7. World Bank, 2021. Global Economic Prospects – Sub-Saharan Africa, June 2021. https://thedocs.worldbank.org/en/doc/600223300a3685fe68016a484ee867fb-0350012021/related/Global-Economic-Prospects-June-2021-Regional-Overview-SSA.pdf

8. World Bank, 2021. Global Economic Prospects – Sub-Saharan Africa, June 2021. https://thedocs.worldbank.org/en/doc/600223300a3685fe68016a484ee867fb-0350012021/related/Global-Economic-Prospects-June-2021-Regional-Overview-SSA.pdf

2.2 The state of the local economy

Private sector activity during Covid-19

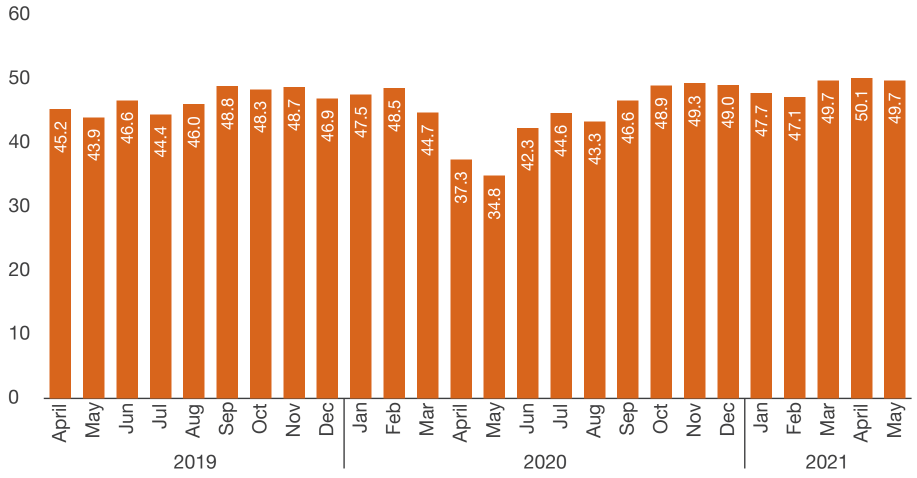
Zambia implemented less stringent lockdown restrictions and social containment measures compared to some other African economies. Nonetheless, the country still experienced sharp contractions in sectors such as accommodation, wholesale and retail trade, arts and entertainment, and education due to decreased consumer activity and lower tourist arrivals. This offset the strong performances of sectors such as agriculture and mining.[9]

Local businesses reported a decline in sales volumes in March and April 2020 due to subdued consumer demand caused by pandemic-induced economic disruptions.[10] There was some recovery in the Stanbic Bank Zambia Purchasing Managers' Index (PMI)[11] during May and June. Nonetheless, the BoZ 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 businesses during the second quarter.[12]

By August and September, the PMI was back to pre-pandemic levels. A number of sub-indices in the September edition of the PMI were at their highest level since the outbreak of Covid-19.

At the time, the 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, the PMI remained below the key 50 level, indicating that private sector activity continued to decline — albeit at a much slower pace.[13]

Figure 8. Zambia's PMI has been slowly recovering since May 2020 (index)



Sources: IHS Markit, Trading Economics

9. Fitch Solutions, 2021. Zambia country risk report. http://www.fitchsolutions.com/
10. Bank of Zambia (BoZ), 2020. Quarterly Survey of Business Opinions and Expectations, June. https://www.boz.zm/QSBOEQ22020RREPORT19082020.pdf
11. 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 above 50 indicates that business activity improved compared to the preceding month, while a reading below 50 signals a deterioration.
12. Bank of Zambia (BoZ), 2020. Quarterly Survey of Business Opinions and Expectations, June. https://www.boz.zm/QSBOEQ22020RREPORT1908202
13. IHS Markit, 2020. Stanbic Bank Zambia PMI September. https://www.markiteconomics.com/Public/Home/PressRelease/ec599ef0156e4a6590ae1cab8df031d0

October and November 2020 saw a further improvement in business conditions as pressures from the pandemic continued to ease.[14] December saw a slight moderation in business conditions as the country still faced challenges from the Covid-19 pandemic along with a weaker currency.

Despite showing signs of stabilisation by the end of 2020, increased Covid-19 disruptions in January and February 2021 caused a deterioration in business conditions for the private sector at the start of the current year. These included disruptions to supplier delivery times, which lengthened markedly due to travel restrictions. Purchase costs once again increased as the Kwacha weakened, although a lack of demand for inputs (raw materials such as steel) softened the blow. businesses also reported reduced output and new orders, along with continued reductions in staffing levels as businesses found paying workers difficult.[15]

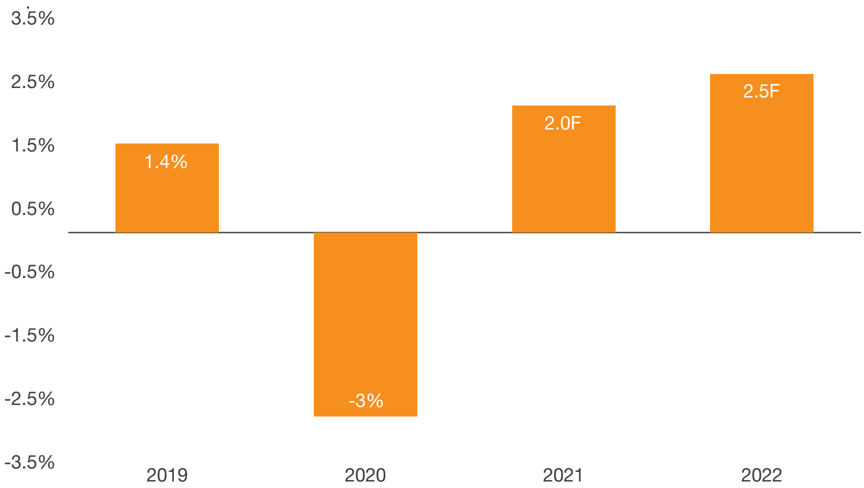
By the end of the 2021 first quarter, however, the Zambian private sector moved close to stabilisation as customer demand showed signs of improvement, with the March PMI close to the key 50 level. New orders and employment were relatively stable, while the agriculture sector saw rising staff levels. However, increased staff costs were also reported for the first time in 13 months, with companies passing the costs on to consumers. As a result, there was a sharp increase in output costs, with manufacturers posting the most significant rise in selling prices. There was also a fall in output and still low customer numbers.

A return to growth in April 2021 was noted when the PMI reached above the key 50 level, and a return to growth in output during May 2021 saw the end of a 26-month long decline. Despite business conditions remaining difficult for many firms, some reported increased output alongside improvements in customer demand.

Economic growth trends

Zambia has been experiencing weakening economic growth over the last few years due to falling copper prices, as well as declining hydro-electric power generation and agricultural output from insufficient rains. Covid-19 added additional pressures on the economy during 2020.[16] The services and mining sectors were particularly affected due to social distancing measures and lower global demand. However, activity picked up during the second half of the year as global copper prices rose and containment measures were eased.[17] Ministry of Finance figures show that real GDP contracted by 3% in 2020 due to disruptions to global supply chains, along with decreased investment and consumption spending.[18] However, relaxed Covid-19 restrictions during the second half of the year will have seen a less severe contraction compared to the first half of 2020.[19]

Figure 9. From slow real GDP growth in 2019 to a recession in 2020 (%)



Sources: Bank of Zambia, PwC (forecast)

14. IHS Markit, 2020. Stanbic Bank Zambia PMI December. https://www.stanbicbank.co.zm/static_file/Zambia/filedownloads/ZM_PMI_ENG_2012_PR.pdf

15. IHS Markit, 2021. Stanbic Bank Zambia PMI February. https://www.stanbicbank.co.zm/static_file/Zambia/Downloadable%20files/ZM_PMI_ENG_2102_LITE.pdf

16. Fitch Solutions, 2021. Zambia 10-year forecasts. http://www.fitchsolutions.com

17. The World Bank, 2021. The World Bank in Zambia. https://www.worldbank.org/en/country/zambia/overview

18. The Ministry of Finance, Annual Economic Report 2020, May 2021

19. Bank of Zambia (BoZ), 2021. Monetary Policy Committee Statement, February. https://www.boz.zm/monetary_policy_committee_statement_february_2021.pdf

The fiscal challenges caused by the impact of Covid-19 have been a key constraint for the government of Zambia. In response to the pandemic, the state suspended import duties on mineral concentrate – which was permanently extended with the 2021 budget – as well as export duties on precious metals. This was aimed at supporting the mining sector. The government also waived tax penalties and fees on outstanding tax liabilities resulting from the pandemic. The government issued a K8 billion bond to help finance Covid-19 related expenses, including health spending, arrears clearance and grain purchases.

In 2020, the Ministry of Finance communicated to government bondholders that the country's macroeconomic situation necessitated immediate external debt relief. This was due to the drain of debt service payments on the fiscus causing arrears in payments to domestic service providers. The sharp depreciation of the Kwacha also significantly inflated the foreign-currency debt payments. The added negative impacts of Covid-19 on an already-strained fiscus ultimately contributed to the country defaulting on a Eurobond coupon payment in November 2020 – Africa's first Covid-era default. Zambia skipped another coupon payment in January 2021 on its 2027 Eurobond.[20] The budget deficit reached an estimated 12.7% of GDP in 2020.[21]

The central bank lifted interest rates by 50 basis points in February 2021 to 8.5%.[22] The BoZ started monetary policy tightening due to escalating inflation pressures – with headline inflation having accelerated from 12.5% year-on-year in January 2020 to 24.6% year-on-year in June 2021 due largely to a depreciation in the currency. Interest rates are expected to continue to be higher in the next few years due to continued upside pressure on consumer prices.[23]

Nonetheless, the BoZ expects the country's economy to recover and projects it will grow by 1.5% in 2021.[24] This is slightly lower than PwC's forecast of 2% growth.[25] According to the central bank, this growth will be driven by policy support, as well as an easing of restrictions as the Covid-19 vaccination drive picks up. Positive growth in the electricity, mining, gas and water, and information and communication (ICT) sectors will also support this growth. Sector growth will be driven by, among others, stronger copper prices and demand, favourable rainfall, leveraging of digital payments and infrastructure, and the expected commencement of electricity generation at the Kafue Gorge Lower HydroPower Station.[26]

20. Bloomberg, 2021. Zambia Skips 2027 Eurobond Coupon Payment, Finance Ministry Says. https://www.bloomberg.com/news/articles/2021-01-31/zambia-skips-2027-eurobond-coupon-payment-finance-ministry-says

21. Fitch Solutions, 2021. Zambia 10-year forecasts. http://www.fitchsolutions.com/

22. Bank of Zambia (BoZ), 2021. Monetary Policy Committee Statement, February. https://www.boz.zm/monetary_policy_committee_statement_february_2021.pdf

23. Trading Economics, 2021. Zambia Inflation Rate. https://tradingeconomics.com/zambia/inflation-cpi

24. Bank of Zambia (BoZ), 2021. Monetary policy report January to June 2021. https://www.boz.zm/MPSReportJanJune2021.pdf

25. PwC calculations

26. Bank of Zambia (BoZ), 2021. Monetary policy report January to June 2021. https://www.boz.zm/MPSReportJanJune2021.pdf

The budget deficit is set to narrow to 6.8% during the year, according to Fitch Solutions, with government expenditure falling. This is attributed to cuts in foreign-financed infrastructure projects, as well as increasing mining receipts which is set to boost growth in revenue. An easing of post-election pressures on spending will also help further narrow the budget deficit in 2022 to 4.3% of GDP. Negotiations with foreign bondholders and the International Monetary Fund (IMF) will be challenging in the short term, with the country remaining very much reliant on domestic financing.[27] The medium-term growth is also highly uncertain and will be dependent on the effectiveness of policy support, the extent of the economic damages, as well as the intensity of the health shock.[28] PwC forecasts a growth of 2.5% in real GDP during 2022.[29]

2.3 Survey results on the state of the economy

For the third consecutive year, banks ranked the state of the local economy as the most pressing issue they face. Furthermore, the state of Zambia's economy has become a growing concern for banks during that time, with its level of importance increasing from a rating of 5.6 in 2018 to 8.6 in 2020.

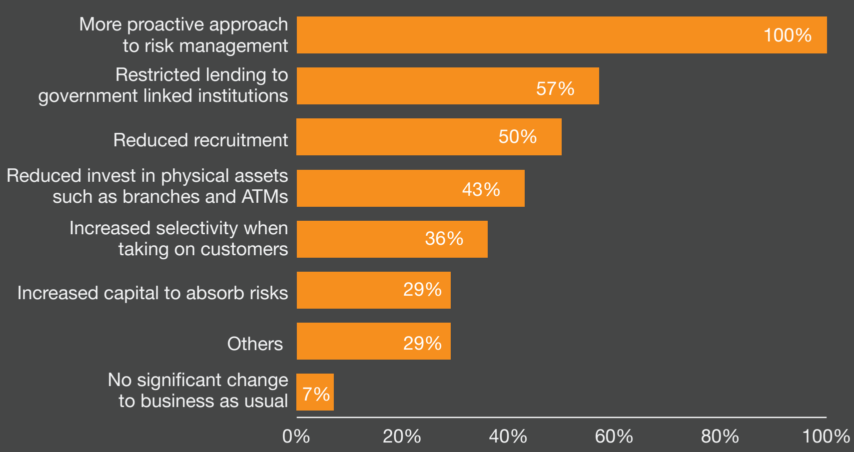
Among NBFIs, this issue has changed from being the third most important issue in 2018, with a rating of 5.3, to being the most important issue in 2020, with a rating of 8.4.

Convergence around the state of the economy has increased during this period due to the continued decline in Zambia's economy coupled with the impact of the COVID-19 pandemic.

All respondents from banks and 73% of NBFI respondents indicated that they had adopted a more proactive approach to risk management as a response to the challenges posed by the economy.

Other commonly applied strategic responses by both banks and NBFIs included the restriction of lending to government-linked institutions, reduced recruitment and a reduction in investment in physical assets including branches and ATMs.

Figure 10. Strategic responses to current economic challenges – Banks



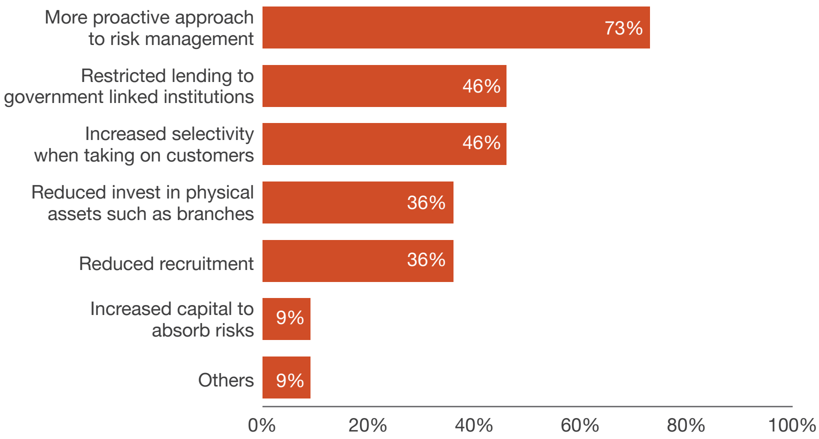
Source: PwC analysis

27. Fitch Solutions, 2021. Zambia 10-year forecasts. http://www.fitchsolutions.com/

28. Bank of Zambia (BoZ), 2021. Monetary Policy Committee Statement, February. https://www.boz.zm/monetary_policy_committee_statement_february_2021.pdf

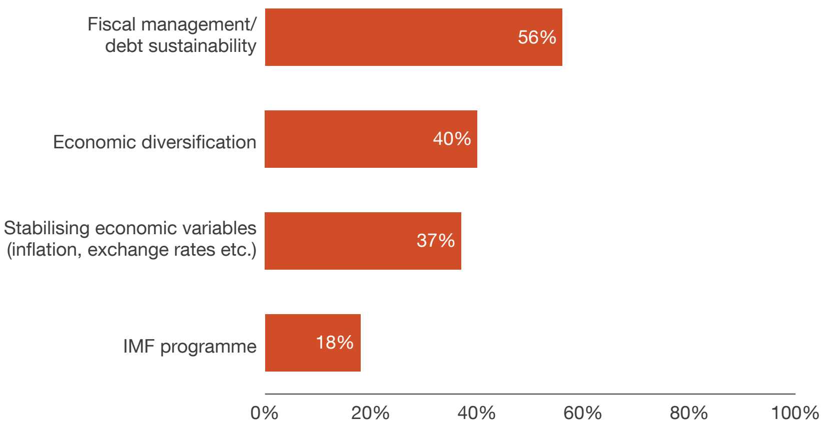
29. PwC calculations

Figure 11. Strategic responses to current economic challenges – Non-banks



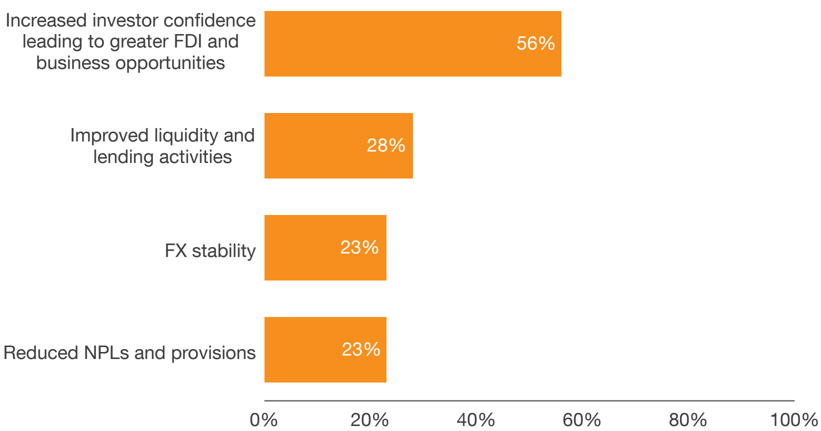
Source: PwC analysis

Figure 12. Most effective actions to stabilise the economy



Source: PwC analysis

Figure 13. Impact of IMF on the banking sector



Source: PwC analysis

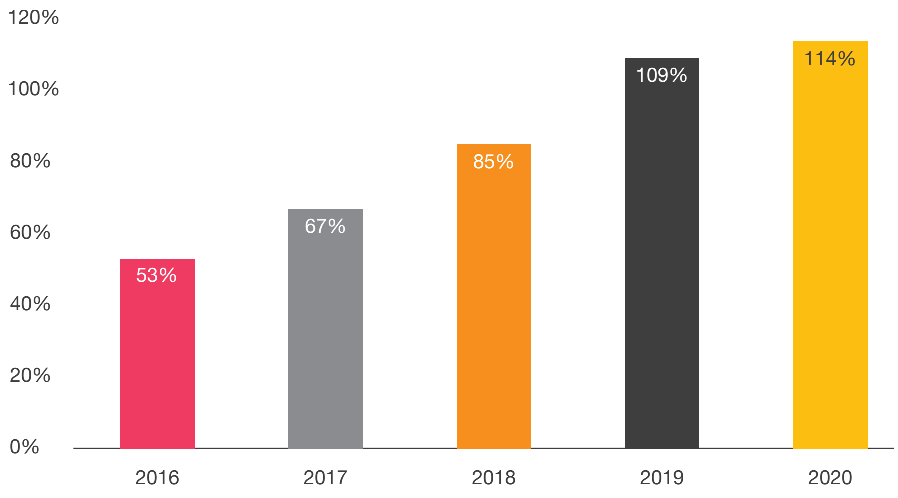
With regards to what actions should be taken to stabilise the economy, 56% of respondents proposed better fiscal management and debt sustainability, both of which respondents believe have contributed significantly to recent sluggish economic growth in Zambia.

Given the recent progress made in discussions regarding an Extended Credit Facility (ECF), and the level of importance that government has attached to the role the IMF will play in stimulating economic recovery, it is surprising that only 18% of respondents identified an IMF programme as a necessary intervention to stabilise the economy.

2.4 IF programme

An ECF is designed as a tool to support countries that have experienced protracted balance of payment problems. Despite the relatively low consensus around the need for this programme, 56% of respondents noted that IMF intervention would have a positive impact on the banking sector by improving investor confidence, which would in turn result in greater foreign direct investment and increase in business opportunities.

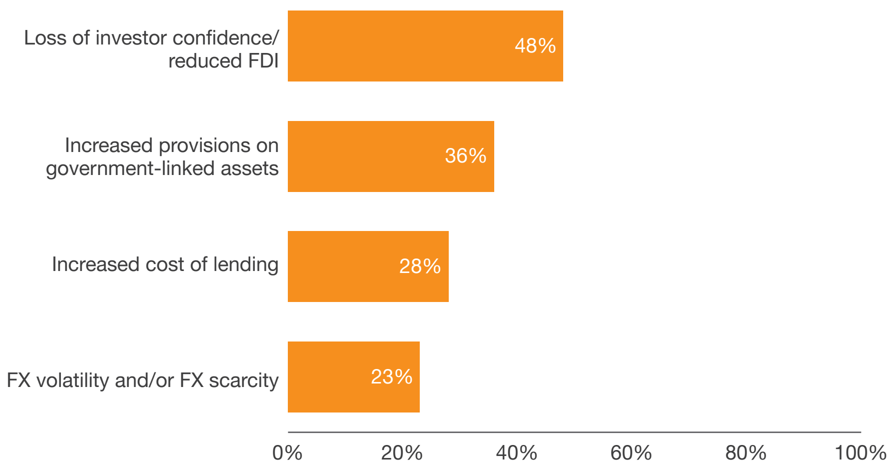
Figure 14. Zambia Debt to GDP ratio



*Note that 2020 figures are projected

Source: Fitch Report 2021

Figure 15. Impact of sovereign default on the banking sector



Source: PwC analysis

Disentangling the potential impact of an IMF programme in stimulating economic recovery from other necessary measures within the government's Economic Recovery Plan is a difficult task. However, critical to any sustained economic recovery are interlinked objectives of debt sustainability and fiscal consolidation.

As the above chart shows, Zambia's debt to GDP ratio has steadily increased to over 100% and at the current level is unsustainable. In 2020, the impact of Covid-19 exacerbated an already-strained fiscus that ultimately contributed to the country defaulting on a Eurobond coupon payment on its 2027 Eurobond in November 2020 and again in January 2021. Meanwhile, the budget deficit reached an estimated 12.7% of GDP in 2020.

Some 48% of all respondents (banks and NBFIs) noted that this default led to a loss of investor confidence and contributed to a reduction in foreign direct investment. Thirty-six percent of respondents also attributed a significant increase in impairments of loans and advances and government securities to the related downgrade in Zambia's sovereign credit rating.

Other impacts of the sovereign default on the banking sector include the increased cost of lending, FX volatility and a tightening of US dollar liquidity.

3. Impact of Covid-19 on banking operations

The impact of the pandemic is being felt by all businesses around the world. Economies are in deep distress because of the disruption to work and operations Covid-19 has brought about. As banks brace for further economic uncertainty and a potential increase in customer defaults, provisions for the associated expected losses continue to mount. However, economic recovery remains conditional on equitable access to Covid-19 therapeutics and vaccines, a continued rise in commodity prices, and a sustainable resolution to Africa's growing debt burden.

According to the World Bank Group report (2021) on the impact of Covid-19 on firms in Zambia, the key issues noted were:

- Nearly 5% of businesses are reported to have permanently closed in Zambia since the onset of the pandemic. Small and medium-sized firms are the most likely to have ceased operations entirely, while medium-sized firms are most likely to have suspended operations temporarily.

- More than 70% of Zambian firms report that they are still experiencing depressed demand for their goods or services compared to the situation before the pandemic. On the input supply side, the largest firms have been far more able to source input materials than small and medium enterprises.

- The recovery of employment in firms has been bimodal – around 40% of firms have increased their permanent workforce since the middle of 2020, and around 40% have decreased their permanent workforce with large (100+) firms having been the most successful at raising permanent workforce numbers, while medium (20-99) firms have been the most likely to have shed permanent workers.

- The share of Zambian firms in direct exporting activities fell in the second half of 2020, as did the share of total sales coming from exports. The drop has been most significant for large firms. In mid-2020, the share of total sales that came from exports was around 22% for large firms. By the end of the calendar year this had dropped to around 8%.

- Around one quarter of Zambian firms are concerned about falling into arrears on outstanding liabilities. Only 3% report receiving government support of any kind.

Many African nations including Zambia rely on the global vaccine sharing scheme COVAX or donations from countries like China and India. Access to vaccine doses on the continent is incredibly limited and many countries continue to experience new waves of the pandemic, leading to increases in hospital admissions and shortages in oxygen and intensive care beds. Only 1.5% of the population across the continent is fully vaccinated. While developed countries are beginning to open-up on the back of high vaccination rates, this is unlikely to happen in less developed countries given the extremely low vaccination rates. As a result, the pandemic is likely to be around for a while so banks need to plan for this as it will negatively affect operations in the short, medium to long-terms.

The respondents listed the good, the bad and the ugly of Covid-19:

The Good	The bad	The Ugly
Digital acceleration	Culture erosion	Economic disruption
New ways of work and diversity	Lower productivity	Deterioration of employee well-being
Business continuity management validation	Assets under-utilisation and impairment	Default
	Lower recruitment	Heightened risk

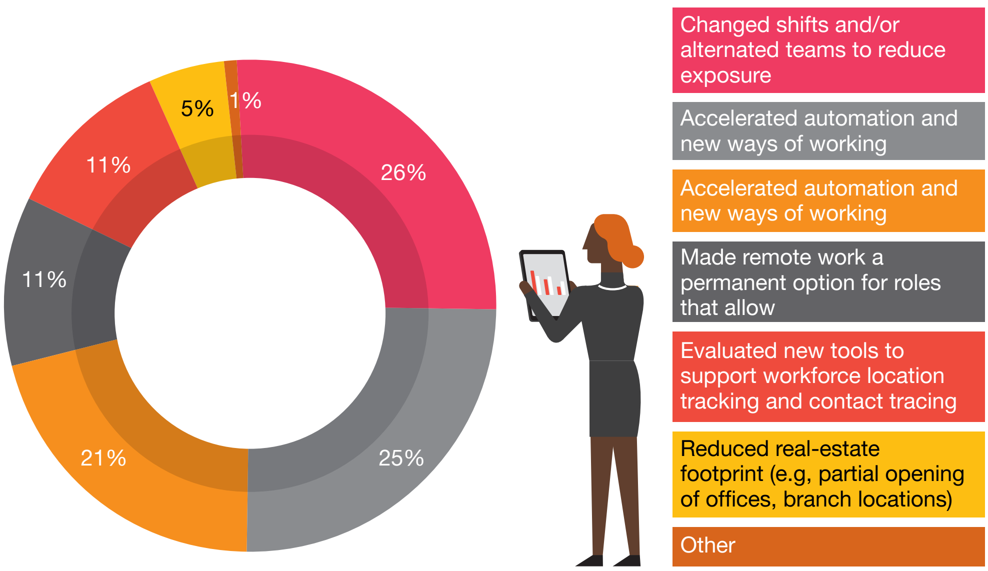
3.1 Adapting to changes in the working environment

The country's response to Covid-19 has resulted in a rapid transformation of the workplace. In an effort to ensure uninterrupted service to customers, companies have put in place a variety of measures including: working from home, reconfiguring work sites to promote physical distancing; changing shifts and/or alternated teams to reduce exposure; evaluating new tools to support workforce location tracking and contact tracing; and reducing their real-estate footprint (e.g, partial opening of offices, branch locations).

As seen from Figure 16 below, 26% of respondents indicated that changing shifts and/or alternating teams was the most adapted preventive measure to ensure a safer working environment for employees. This is expected because not all jobs can be done remotely. Twenty-five percent of respondents were in support of accelerated automation and new ways of working. Banks have gone from digitising the relationship between firm and customer to digitising the relationship between employer and employee. A further 21% of respondents indicated that they have reconfigured work sites to promote physical distancing.

Banks need to simultaneously keep their businesses running today and fundamentally rethink their strategy for tomorrow so that they can emerge from the pandemic ready to reconfigure their business to thrive in a very different world. In addition to thinking about the change in society accelerated by Covid-19 and the rising expectations of their broader stakeholders, banks need to also think about other issues that are going to reshape the future of business, including rethinking operating models and alternative modes of service delivery.

Figure 16. Strategic responses to Covid-19 that will make the companies better in the long run – Banks and Non-banks



Source: PwC analysis

The long-term implications of Covid-19 on financial markets and the banking industry are unclear. However, when normality returns, or at least a new, post-Covid normality returns, these institutions will likely have learned many lessons.

These lessons include how to retain operational resilience when confronted with future pandemics, the design of new operational models which incorporate remote working arrangements, and the need to accelerate the migration to digital channels.

3.2 Impact of Covid-19 on banking in other African countries

- **Botswana** – The Botswana economy was hit hard by the Covid-19 pandemic due to its dependence on discretionary spending by the global rich on diamonds and high-end tourism. With the local recession (GDP declined by 10.7%), growth in domestic bank assets slowed down considerably and borrowing flattened out.

- **Ghana** – Operating conditions in Ghana's banking and financial services industry were made more challenging by the Covid-19 pandemic. Banks faced higher loan loss provisions and subdued lending growth. An increase in delinquencies resulted in the NPLs ratio rising to 15.8% in September 2020 from 14% at the start of the year.

- **Kenya** – The East African country's banking sector continued to grow in 2020 on the back of accommodative monetary policy, marginal positive economic growth, as well as the November 2019 removal of the cap on commercial bank interest rates. However, credit growth was constrained by the Covid-19 pandemic, disrupting key economic sectors.

- **Malawi** – Covid-19 adversely affected banks' operations and profitability levels. NPLs increased from 6.2% at the end of 2019 to 6.6% in June 2020, before easing back to 6.2% by December. However, according to the Reserve Bank of Malawi, the banking sector continued to be resilient and sound in the six-month period to December 2020.

- **Mozambique** – The weak local economy and softer demand for exports weighed on the Mozambican banking sector in 2020. Nonetheless, client loan growth increased by 14.6% last year from 4.8% in 2019. This reflected a short-term increase in credit demand from recession-hit businesses and families struggling to meet operating costs or pay for essential needs.

- **Namibia** – Bank asset quality deteriorated in 2020 due to unfavourable economic conditions and their resultant impact on household disposable income and business performance. The NPLs ratio, which increased from 1.5% in 2016 to 4.6% in 2019, climbed to 6.4% in the third quarter of 2020. On a positive note, credit loan growth of 1.7% was actually better than a reading of -0.5% seen in 2019.

- **South Africa** – The second half of 2020 saw credit performance and bank business volumes faring better than expected compared to the first half of the year as lockdown restrictions eased, although it was far worse than pre-pandemic levels. Driven by a steep increase in credit impairment charges, the major banks' combined headline earnings and ROEs fell to 2012 levels.

- **Tanzania** – Weaker economic growth pressured household disposable income and reduced consumers' willingness to take on new debt. While credit growth slowed, a more severe loan growth slowdown was prevented by 1) a favourable monetary policy stance of the Bank of Tanzania and 2) acceleration in the shift towards mobile and online banking.

- **Uganda** – The decline in business activity due to the Covid-19 pandemic translated into a slowdown in both asset and loan growth in the banking market. However, the financial sector remained resilient to the economic disruption and most financial institutions maintained adequate capital and liquidity buffers to absorb the shock.

- **Rwanda** – Containment measures reduced activity in the tertiary sector which is reliant on face-to-face service delivery. This weakened the debt service capacity of services firms and increased credit risk. The adverse impact also weakened demand for loans and other financial services.

4. Credit risk and NPLs

Since the inception of this survey in 2016, credit risk has remained among the top five most pressing issues for both banks and NBFIs each year.

Figure 17. Ranking and scores of credit risk over the years

Year	Bank's ranking	Bank's score	NBFIs ranking	NBFIs score
2020	3	4.4	3	6.0
2019	3	6.5	3	6.8
2018	5	4.7	1	6.0
2017	2	5.5	Not applicable	Not applicable
2016	2	4.4	Not applicable	Not applicable

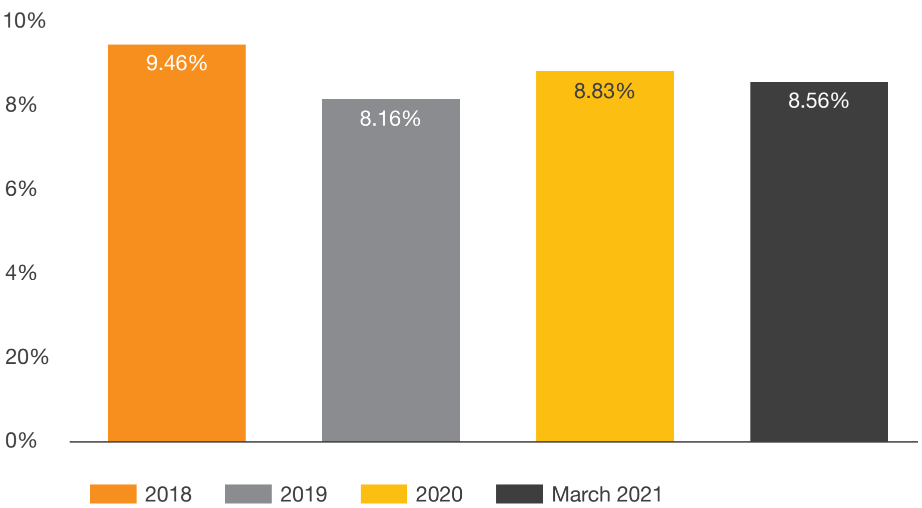
Source: PwC analysis

4.1 NPLs and advances – banks

Commercial banks' NPL ratio increased slightly from 8.2% in 2019 to 8.8% at the end of 2020, within the 10% industry target set by the BoZ. The 2020 ratio is also broadly in line with the five year trend.

Given the state of the economy in the wake of the pandemic and the Euro bond defaults, it is surprising that the NPL ratio only increased marginally in 2020 and more or less in line with the pre-Covid years. Further analysis reveals that NPL performance across commercial banks was mixed and increases for some banks were partly offset by decreases in others.

Figure 18. Trend of NPL for commercial banks



Source: PwC analysis

The banks identified Covid-19, the economic downturn and rising unemployment as reasons for the increase in NPLs in 2020. The marginal improvement in the industry NPL to 8.6% as at March 2021 can be attributed to:

- Softening in the BoZ provisioning guidelines
- Issuance of the Targeted Medium-Term Refinancing Facility (TMTRF), which was also used to refinance any struggling loans and advances
- Enhanced underwriting measures for new loans in the wake of Covid-19 and economic challenges.

Aggregate loans and advances issued to customers as at 31 December 2020 increased by K7.7 billion to K43.2 billion, from K35.5 billion in 2019. This is partially reflective of the impact of the issuance of the TMTRF and the impact of the depreciation of the Kwacha on foreign currency denominated credit.

Credit risk arising from government securities

The impact of the sovereign default on Eurobond payments and the subsequent downgrading by international rating agencies has resulted in impairments in government securities as the probability of default increased. Those banks that invested significantly in government securities saw the high returns offered being partially eroded by subsequent impairments when IFRS 9 impairment principles were applied.

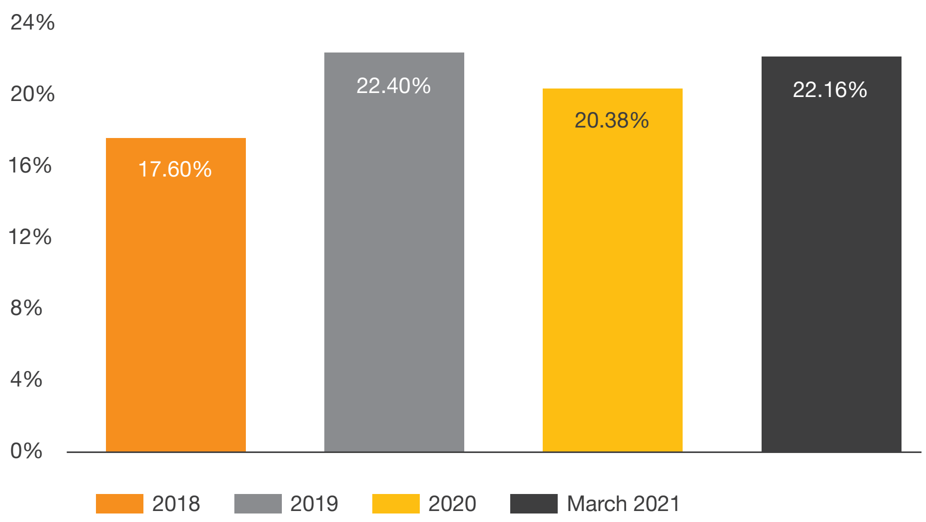
4.2 NPLs and advances – NBFIs

The NPL ratio among NBFIs decreased marginally from 22.4% in 2019 to 20.4% in 2020, but was still well above the prudential benchmark of 10%. As at 31 March 2021, it was noted that the NPL ratio increased slightly by 2% to 22.2%. The impact of Covid-19, government arrears on payroll loan remittances, and the general economic downturn were highlighted as key factors impacting the NPLs by respondents.

While still high, the improvement in the NPL ratio in 2020 compared to 2019 was attributed to:

- The issuance of loans from the TMTRF resulting in increased aggregate loans issued. As is the case with banks, the NBFIs are also granted a one-year moratorium before any impairment is recognised on these funds
- A number of NBFIs undertook an exercise to write off their non-performing loans
- The government entered into an agreement with NBFIs to convert arrears on deductions on civil servant loans into government securities

Figure 19. Non-performing loan ratio – NBFIs

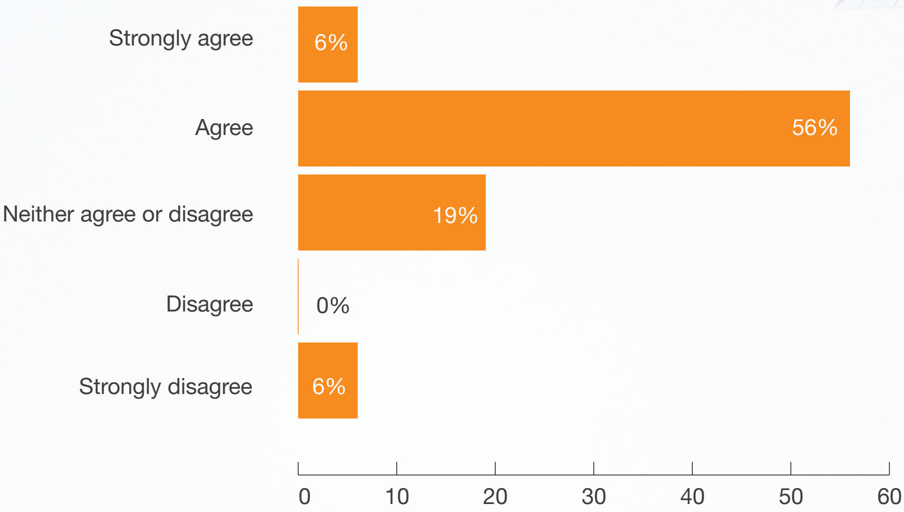


Source: PwC analysis

4.3 TMTRF – survey response

Overall, the results show that the majority of respondents in the banking sector believe that the facility has been effective in its stated aim of alleviating the challenges faced by the targeted sectors, as shown in the graphs below.

Figure 20. Effectiveness of TMTRF in responding to Covid-19 – banks

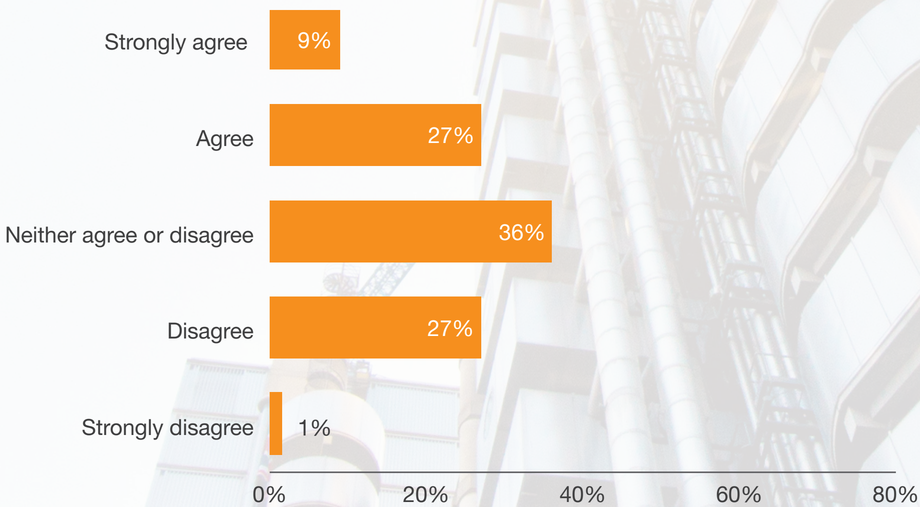


Source: PwC analysis

However, the results are more mixed among NBFIs.

Non-bank financial institutions

Figure 21. Effectiveness of TMTRF in responding to Covid-19 – Non-bank financial institutions

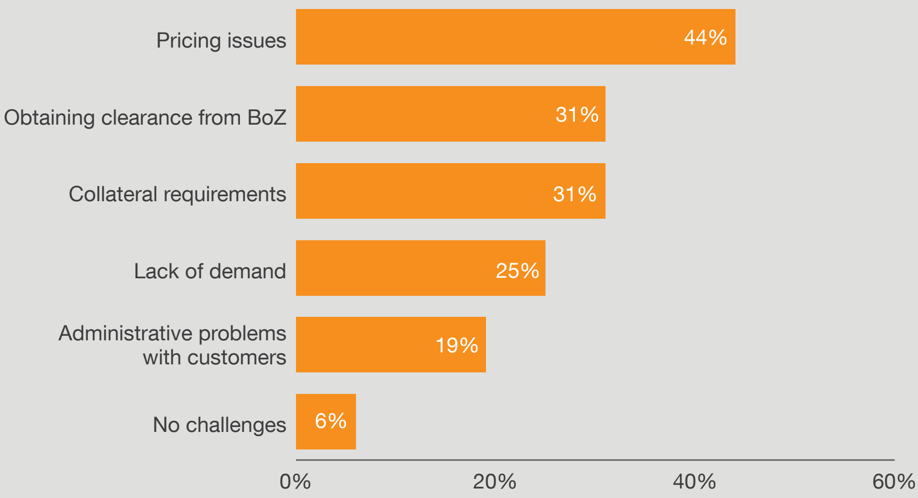


Source: PwC analysis

4.4 Challenges relating to the facility

When respondents were asked what were the main challenges relating to the facility, the single greatest challenge for banks was problems with the pricing guidelines associated with the facility. Obtaining clearance from the BoZ and stringent collateral requirements were also cited as challenged faced with the TMTRF.

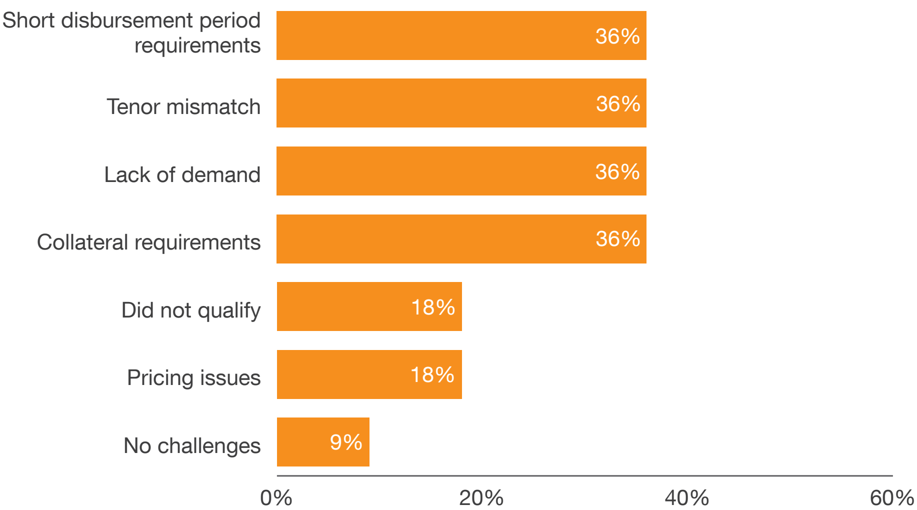
Figure 22. Challenges faced with access and disbursements – banks



Source: PwC analysis

NBFIs reported different challenges. The main challenges relating to the facility among NBFIs included: the requirement for disbursements within 48 hours of receiving funds from the BoZ; matching the tenor of customer facilities with that of the TMTRF; a lack of demand from customers; and stringent collateral requirements.

Figure 23. Challenges faced with access and disbursements – Non-bank financial institutions



Source: PwC analysis

The survey results indicate that the stringent collateral requirements in particular were a source of concern amongst both banks and NBFIs.

Unsurprisingly, most respondents (44%) in both sectors felt that the current collateral and administrative requirements needed to be eased in order to allow a more effective use of the facility. Respondents also felt that more flexibility in determining the customer criteria, pricing requirements and tenor was essential in order for the facility to be more effective.

As at 30 June 2021, the BoZ had received applications to the value of K10.5 billion, of which K9.1 billion had been approved. Of the approved balance, K6.9 billion relates to applications from banks, while the remaining K2.2 billion relates to applications from NBFIs.

5. Fee and service charge erosion and improving revenue growth

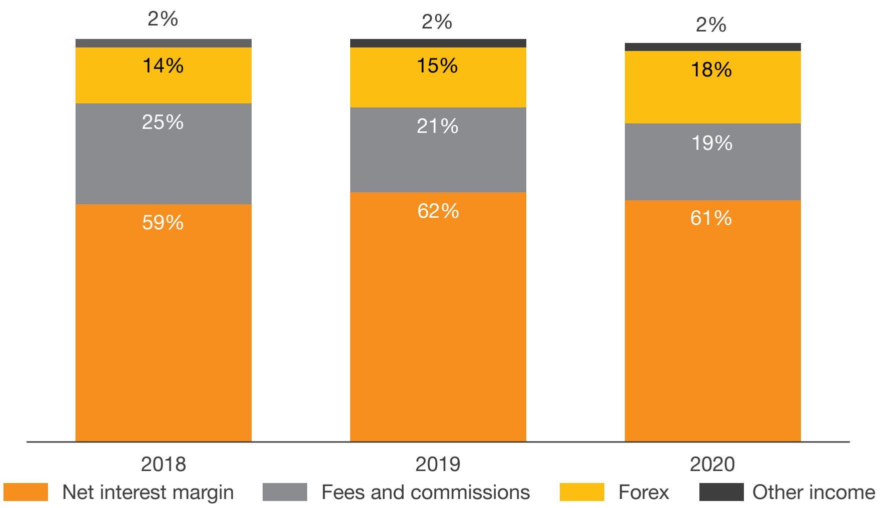
5.1 Banks

Improving revenue growth has dropped out of the top five pressing issues and has been replaced by concerns around fee and service charge erosion. However, concerns around fees and service charge erosion, interest rates and improving revenue growth can be viewed as individual components of a wider conversation around revenue generation. Analysing these three aspects together reveals an aggregate score of 5.3 compared to 5.6 in 2019. This implies that concerns about revenue in a broader context persist.

Fee and service charge erosion

The banking sector has recorded a reduction in profit before tax despite increases in total income since 2019. The 2018 directive for banks regarding unwarranted charges has played a role in the current trend and our analysis shows that income from fees and service charges reduced in comparison to other income sources.

Figure 24. Composition of total revenue, 2018–2020



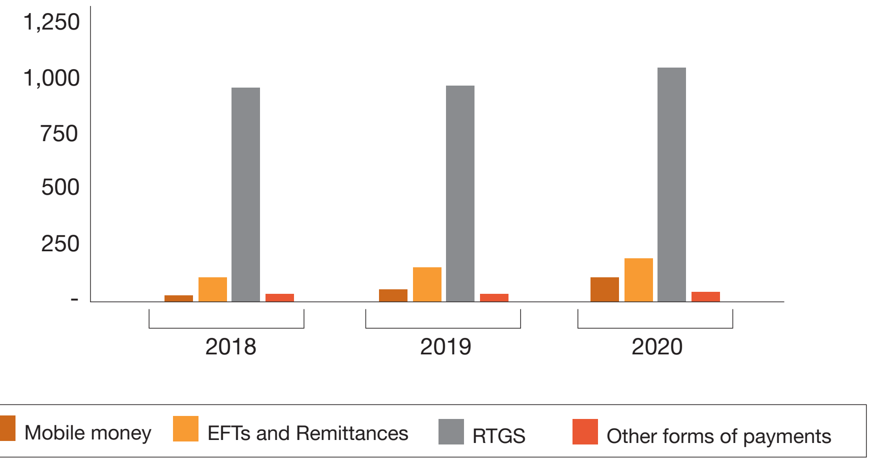
Source: Bank of Zambia

The question that remains is how can existing players mitigate the current headwinds in an environment that is not only experiencing economic recession, but is facing increased competition from non-traditional players such as mobile money operators?

Real Time Gross Settlement (RTGS) account for the largest proportion of transactions, with fees determined as a percentage of the transaction value.

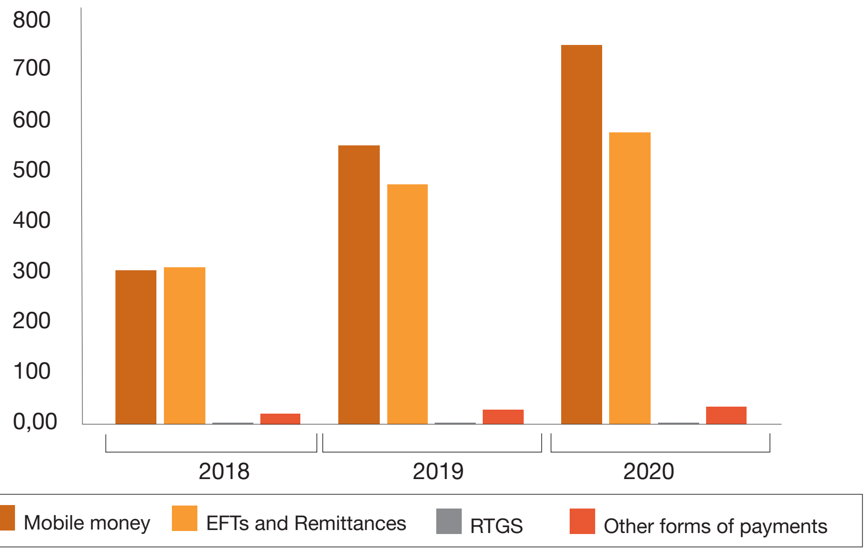
However, the rise in the volume and value of mobile money as an alternative to traditional banking payment solutions, coupled with the recent directives by the BoZ to increase mobile money limits due to the Covid-19 pandemic, have contributed to the increase in the value of mobile money transactions and pose further constraint on the banks' ability to grow income earned from fees and service charges.

Figure 25. Value of transactions, 2018–2020 (ZMW'bn)



Source: Bank of Zambia

Figure 26. Volume of transactions, 2018–2020 (millions)



Source: Bank of Zambia

5.2 NBFIs

Improving revenue growth

Generally, NBFIs continue to have limited sources of income, with most NBFIs relying entirely on interest income earned from salary-backed loans mostly from government employees. In the year under review, most NBFIs experienced delays in receipt of remittances from the government and this left them assessing opportunities to diversify their sources of revenue. In addition, the pandemic may have limited the NBFIs' ability to grow their revenue base through new facilities as a result of the contraction in the local economy and the reduction in aggregate demand.

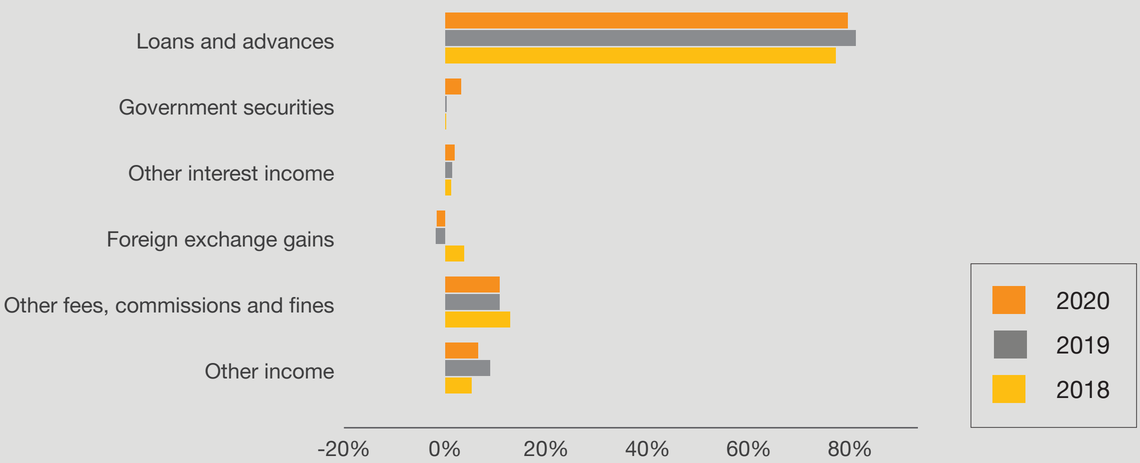
Given this background, it is not surprising that for the first time since the inclusion of NBFIs in our survey, improving revenue growth was ranked the fourth most pressing issue, with an average score of 5.0. In 2019, improving revenue was ranked as the seventh biggest issue facing NBFIs, with a rating of 5.25 out of 10.

Despite the concerns noted in 2020, our survey showed that NBFIs recorded growth in income of 0.28% (K3.55 million from K3.54 million in 2019). This was in comparison to the 2% reduction in revenue recorded between 2019 and 2018. A further analysis of the 2020 growth rate indicates that while the total revenue growth rate increased, the interest income growth rate was stable at 2.8% (2019: 2.8%), while non-interest income reduced by 12% (2019: 21% reduction).

The recent reduction in non-interest income could be attributed to the impact of Covid-19 on NBFIs' operations, the depreciation of the Kwacha and high inflation rates. The full impact of these factors is included in separate sections of this report.

As a result of changes in the operating landscape for NBFIs brought about by the Covid-19 pandemic, NBFIs need to reconfigure their business models and embrace innovation to boost growth in non-interest income. As demonstrated in the revenue analysis shown in Figure 27, the composition of revenue has remained unchanged year-on-year, with interest income from loans and advances representing the bulk of total revenue.

Figure 27. Revenue source by type

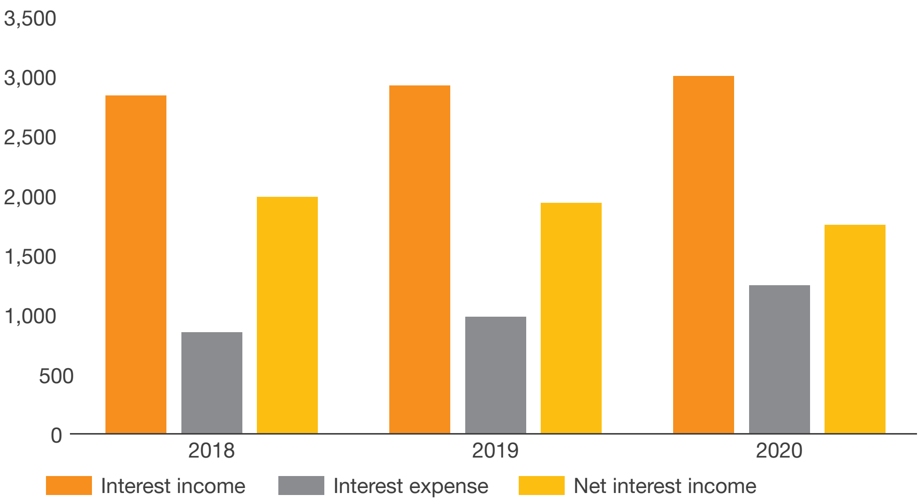


Source: Bank of Zambia

Interest income from loans and advances

As depicted in Figure 27 above, the major source for NBFIs' revenue is interest income from loans and advances (78%), representing a year-on-year growth rate of 2.8% (2019: 2.8%).

Figure 28. Comparison of interest income, interest expense and net interest income



Source: Bank of Zambia

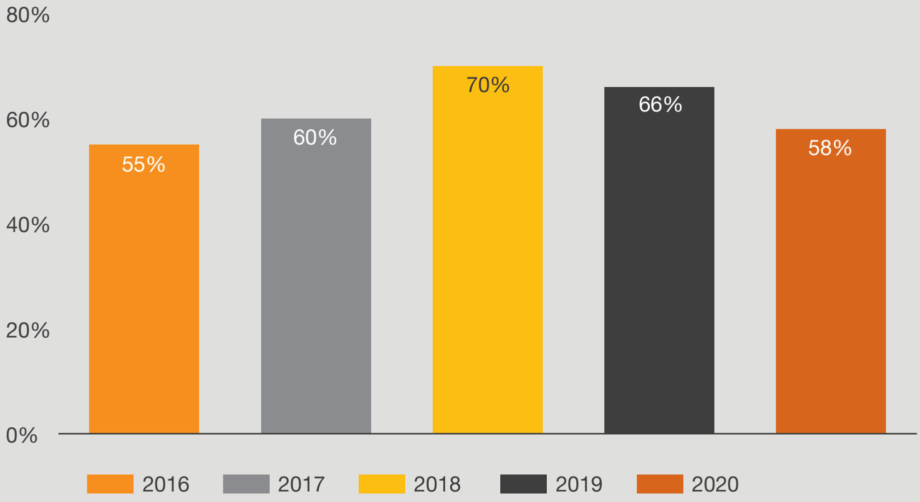
Figure 29. Comparison of gross interest income, gross interest expense and net interest income

Description	2020	2019	2018	2020% movement	2019% movement
Gross interest income	3,003,907	2,922,521	2,841,887	2.8%	2.8%
Gross interest expense	1,247,427	981,763	853,626	27.1%	15%
Net interest income	1,756,479	1,940,759	1,988,261	-9.5%	-2.4%

Source: PwC analysis

The 9.5% reduction in net interest income is attributed to the increase in the interest expenses, which increased by 29.1% in 2020 compared to 15% in 2019. This implies that NBFIs were unable to pass on the increase in the cost of funding to their customers. As shown in Figure 30, the NBFIs industry-wide net interest margin (NIM) reduced by 8% year-on-year.

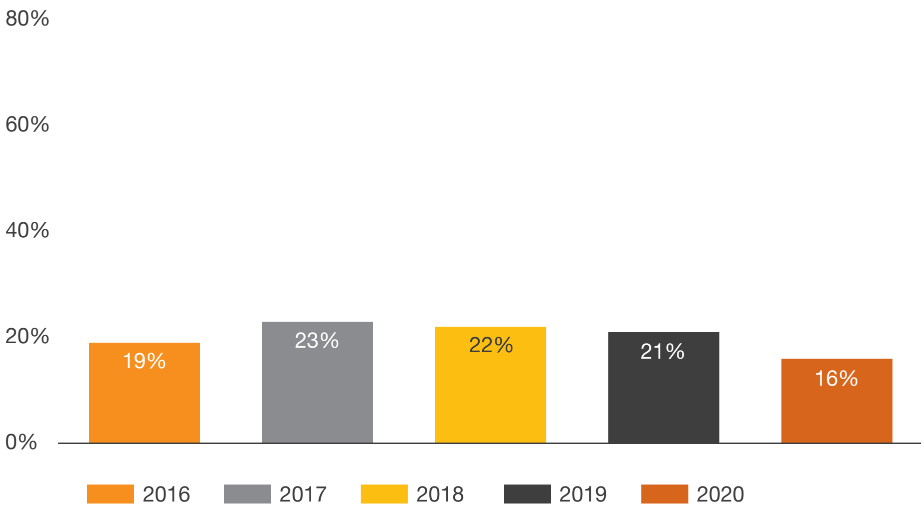
Figure 30. Net interest income ratio



Source: Bank of Zambia

As Figure 31 shows, it is evident that when non-interest income is taken as a ratio of total interest income, the industry continues to struggle to make headway with this revenue stream, with the 2020 financial year representing the lowest ratio to total interest income for the five year period at 16%.

Figure 31. Non-interest income to income ratio



Source: PwC analysis

6. Cybersecurity

Cybersecurity was ranked the fourth most pressing issue facing commercial banks in 2020 with a score of 4.07 out of 10, while NBFIs scored it 1.22 out of 10. Interestingly, this is the first time since our 2017 survey that cybersecurity has been ranked among the top five issues for banks. The growing importance of cybersecurity reflects the impact of the continued expansion of digital solutions across the industry, working from home considerations, and the introduction of the Cyber Security and Cyber Crimes Act 2021.

As the financial sector continues to expand its digital footprint and the number of ways in which it interacts with customers increases, the risk of cyber-attacks has also increased. The continued integration between banks, mobile network operations and service providers has further increased possible points of vulnerability.

The global disruptions brought about by Covid-19 saw a sharp increase in cybersecurity attacks and cybercrime activities around the world – and in Zambia. Remote working has meant threats around offsite access and infrastructure have come to the forefront, offering new challenges to organisations' information security. Unfortunately, not all organisations have adequately adapted their security protocols and 2020 saw a global rise in ransomware attacks. The denial of service, data protection and regulatory issues that are raised have made this a popular option for threat actors.

Phishing also remains an increasingly popular method of attack within Zambia. This was confirmed by a report in 2020 by the Financial Intelligence Centre which indicated an increase in the value of suspicious transactions reports received related to phishing. Phishing schemes tend to utilise current affairs and news concerning the Covid-19 pandemic was no exception, with many threat actors quickly adapting their material to incorporate pandemic-related themes in their campaigns. The uncertainty caused by working from home and the general pandemic has meant that the healthy skepticism and regular reminders from IT that would normally prevail lapsed.

6.1 PwC perspective on cybersecurity and cybercrime law – 2021

The enactment of the Cyber Security and Cyber Crimes Act 2021 by Zambia's parliament will help address key aspects related to cybersecurity, including securing Zambia's critical information infrastructure in the face of disruption and the proliferation of technologies and digital channels.

Some of the key highlights include:

Collaboration among private and public institutions to secure critical infrastructure

We agree with the government's move to securing critical infrastructure as outlined in the bill. However, we do believe there is also an opportunity to classify which sectors are considered to have critical infrastructure and, if disrupted, how potentially it can impact the future economic prosperity of Zambia.

Building and strengthening cyber-defence and deterrence

Given the diversity of industry sectors which may fall under critical infrastructure, people are an important element of building a strong organisational cyberculture. Adequate cyber skills development programmes and awareness campaigns will be critical to drive a cyber culture that is focused on prevention and regulatory compliance.

Enhanced cybersecurity obligations

To better protect the nation's critical infrastructure, the government requires much closer partnerships with the relevant critical infrastructure owners/operators. This may entail government establishing agreements with operators or via industry regulating bodies that extend its reach into the private networks where these critical assets sit for the purposes of detection and/or response capabilities.

Our survey responses from the banks and NFBIs raised a number of concerns regarding the recently enacted Cyber Security and Cyber Crimes Act of 2021 as seen in Figure 32.

The main areas of concern are:

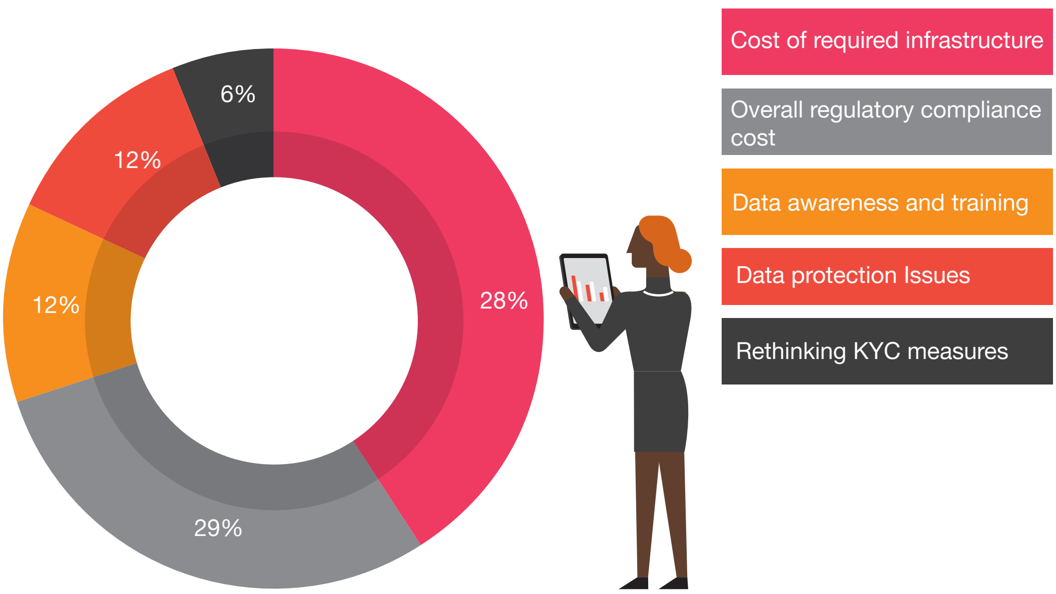
- Cost of required infrastructure – There may be substantial costs to uplift the various critical information infrastructure and systems to meet the security obligations including ongoing monitoring of traffic by the authorities. Our experience indicates that there are those who have invested in cybersecurity and those that lag significantly behind.

- Overall regulatory compliance – Market participants will be required to comply with the requirements of the Act and this will require developing policies aimed at putting in adequate measures.

- Staff awareness and training – Financial institutions will need to organise industry-specific awareness programmes and ensure staff understand the implications of the Act.

- Data protection considerations – Data protection issues will inevitably arise from the implementation of the Act. Organisations will need to be aware of the issues that come up in their day-to-day operations as well as the disclosures that will need to be made to customers.

Figure 32. Impact of Cyber Security and Cyber Crimes Act of 2021



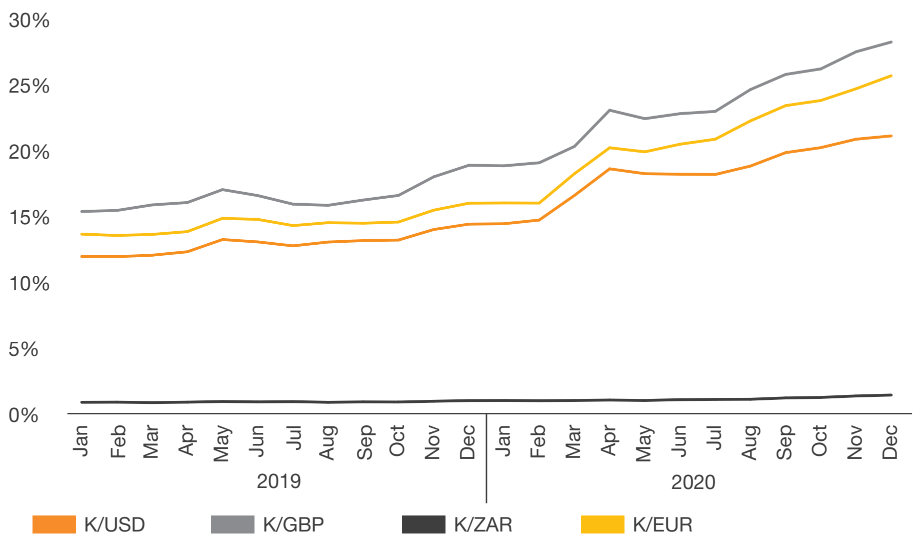
Source: PwC analysis

7. Other issues of concern – NBFIs

7.1 Depreciation of the Kwacha

NBFIs ranked the depreciation of the Kwacha as the fifth most pressing issue, with an average rating of 4.22 out of 10. As the graph below shows, between January 2019 and December 2020 the Kwacha lost 46% of its value, depreciating to K21.1 from K14.4 to the US dollar.

Figure 33. Movement in the Kwacha against major currencies



Source: Bank of Zambia

Several factors have contributed to the deep and sustained depreciation of the Kwacha including persistent fiscal deficits, high debt distress and a recession triggered by the onset of the Covid-19 pandemic. These factors, in addition to a historically heavy dependence on copper export earnings, have continued to expose the fragility of the local currency.

The government's default on Eurobond coupon payments in the last quarter of 2020 resulted in a sovereign downgrade and a deterioration in investor confidence, piling more pressure on the already weak currency.

In order to moderate exchange rate pressures and maintain financial market stability, the central bank continued to provide measured support. Some of the short-term measures included:

- market currency activity. According to BoZ statistics as of the first quarter of 2021, on a net basis it sold US$259.7 million compared to US$339.8 million in the preceding quarter. This largely reflected the receipts of tax obligations from the mining companies, which were sold back to the market.

- Statutory reserve requirements. The central bank also raised the statutory reserve ratio to 9%, with statutory reserve requirements on both local and foreign currency liabilities on a daily basis as opposed to weekly compliance.

These monetary operations targeted short-term volatilities in the exchange rate with some level of success, stabilising between K22.31 and K22.60 during the months of May and June in 2021.

Without a doubt, the sharp depreciation of the Kwacha has led to increased operational costs and impacted NBFIs disproportionately. In addition, any institution that has foreign currency denominated liabilities would have experienced an escalation of costs without any additional economic activity. Being relatively smaller in size, NBFIs are less equipped to hedge against the depreciating currency.

Recent developments

In the week commencing 20 July 2021, the Kwacha appreciated sharply against the US dollar (and other major currencies) from about K22.5 to around K19.3 to one US dollar as at 24 July 2021. The BoZ issued a press statement outlining the reasons for the sharp appreciation of the currency. According to the statement, this was attributed to the following:

- Significant improvement of the copper prices on the London Metal Exchange to the current level of US$9,521 per metric tonne from the low of US$4,745 in March 2020, which has contributed to strong export earnings and improved foreign exchange flows from the mining sector.
- Expectations of further improvements in supply associated with the forthcoming IMF Special Drawing Rights allocation.
- Foreign exchange inflows from non-resident investors purchasing government securities have significantly increased, further providing liquidity to the foreign exchange market.
- On the back of the above, the BoZ was able to sell increased amounts of US dollars into the market in order to reduce the amounts of excess demand.

While the recent upturn in performance offers some reasons for optimism, sustained recovery will require more extensive interventions to resolve the underlying challenges in macroeconomic fundamentals that caused the fragility of the Kwacha in the first place.

8. Other topical matters

8.1 Tax compliance

Tax compliance continues to be of significant importance to entities in this sector. Due to its high risk and importance, we asked all the banks and NBFIs what was the impact of the various tax items that affected them. With a total of 15 banks and nine NBFIs giving their responses, we summarised these in the table below.

What were the issues?

In our survey, we asked a number of questions on critical tax matters that affect the sector and solicited responses on how these affected the participants.

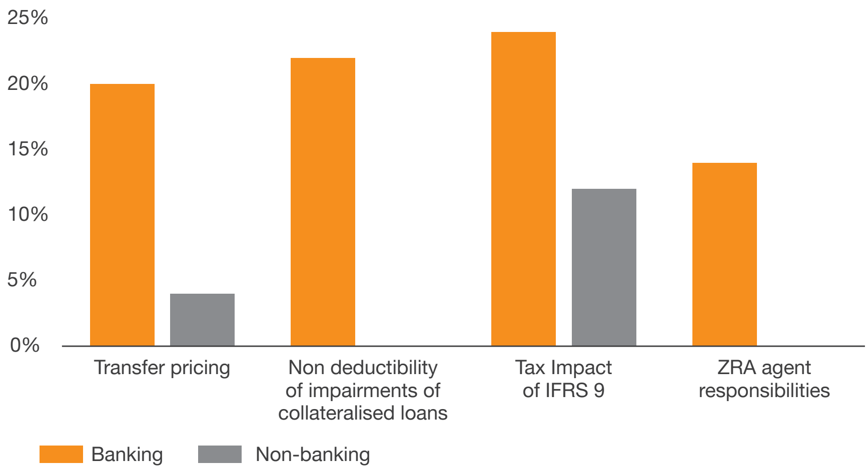
From the above, it is clear that the adverse tax impact of impairments appears to be the greatest source of concern for both banks and NBFIs from a tax perspective. A combined 59% of the responses were attributable to concerns around the tax implications of impairments, with 22% of the responses being in respect of the non-deductibility of impairments on collateralised loans, and another 37% being attributable to the increased current tax liability resulting from the change of impairment provisions under IFRS 9. This is a 3% increase from last year's survey indicating that this still remains a critical issue in the financial services sector.

8.1.1 Non-deductibility of impairments on collateralised loans

In computing taxable profit or loss, banks and NBFIs are required to effectively add back impairment provisions recognised using IFRS, as is the case with other general provisions. However, a claim is allowable against the impairment provisions based on the BoZ's prudential regulations for loans. The 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 BoZ provisions, this results in additional income tax liability.

Given that 22% of responses from banks and NBFIs were attributed to this matter, this is clearly still a concern.

Figure 34. Tax compliance – survey results



Source: Bank of Zambia

8.1.2 Transfer pricing

Transfer pricing continues to be one of the main issues that affects banks and NBFIs.

Contextualising transfer pricing risk

The advent of globalisation and the interdependency and integration of businesses have resulted in transfer pricing becoming one of the most important issues to both business and tax authorities in the jurisdictions in which those businesses operate.

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 which 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 Zambian subsidiaries of multi-national entities (MNEs) as well as local Zambian companies that are members of a Zambian group with annual revenue above K20 million and K50 million from the 2021 charge year going forward. Non-compliance with transfer pricing regulations may attract a penalty of up to K24 million and the possible imprisonment of directors.

On an annual basis, the Zambia Revenue Authority (ZRA) expects taxpayers to have in place transfer pricing documentation demonstrating that transfer prices are consistent with the arm's length. Documentation should be in place at the time of submitting the corporate income tax return, i.e. by 21 June. On ZRA's request, the documentation should be submitted within 30 days. Furthermore, 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, they 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 as the second most impactful tax matter by banks and NBFIs, with 24% of the respondents saying it was the one tax matter that impacted them the most.

Administrative responsibility relating to the appointment of banks as agents of ZRA

Under the various principal tax acts, banks or NBFIs 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.

This results in an additional administrative responsibility for the banks. As a result, 14% of the banks surveyed said this was a matter of concern.

This matter appears not to affect NBFIs as none of them highlighted it as a concern.

8.1.3 Other tax matters of interest

General tax compliance in the Covid-19 environment

The Covid-19 pandemic has had an impact on tax compliance and administrative processes, with a cascading impact on all entities in the wider economy, including entities operating in financial services.

One area particularly impacted is the people function within organisations responsible for government revenue collection, including the ZRA. In order to limit the risk of infection for staff, the ZRA, like every other organisation, has had to adjust working practices. This has included limiting the number of people at its premises at any one time and the implementation of rotational work schedules. In some instances this, as for all organisations, has impacted service delivery including the delay of audits etc.

Transfer pricing – country-by-country reporting

A new set of transfer pricing compliance rules and requirements have been introduced and, as of 1 January 2021, Zambia joined around 90 countries worldwide which have already enacted country-by-country reporting (CbCR) rules in their domestic legislation by enacting the Income Tax (Transfer Pricing) (Amendment) (the Zambian CbCR Regulations). These rules are aimed at increasing tax transparency for multinational entities (MNEs), including banks and financial institutions.

Country-by-country reports provide information on where the economic value is generated and where profits are allocated and taxed among the jurisdictions in which a multinational enterprise operates. More specifically, the report requires the following information to be reported for each entity in the group:

- Revenue from related and unrelated parties
- Profit or loss before income tax
- Income tax paid and accrued
- Stated capital (nominal share capital plus share premium accounts)
- Accumulated earnings
- Number of employees
- Tangible assets oth
- Listing the tax residence of every entity in the group

With CbCR reporting now being applicable in Zambia, in-scope entities will need to ensure that they are compliant with reporting rules.

CbCR will provide tax administrations with unprecedented access to information on large MNEs which are in scope. This will affect some banks in Zambia. But which entities are in-scope?

In-scope entities

Under the Zambian CbCR Regulations, CbC reporting only applies to MNE groups with business entities in two or more states and an annual consolidated revenue exceeding €750 million or approximately K4,795m during the immediately preceding accounting year.

The filing requirements under the Zambian CbCR Regulations are applicable to Zambia tax resident entities of MNE groups for tax years ending on 31 December 2021 and each subsequent tax year. Zambia-resident ultimate parent entities of MNE groups must file a CbC report with respect to their immediately preceding accounting year on or before 12 months after the last day of the MNE group's accounting year. CbC reporting provides for the automatic exchange of the CbC reports among tax administrations in jurisdictions in which the MNE group operates.

Next steps for in-scope banks in Zambia

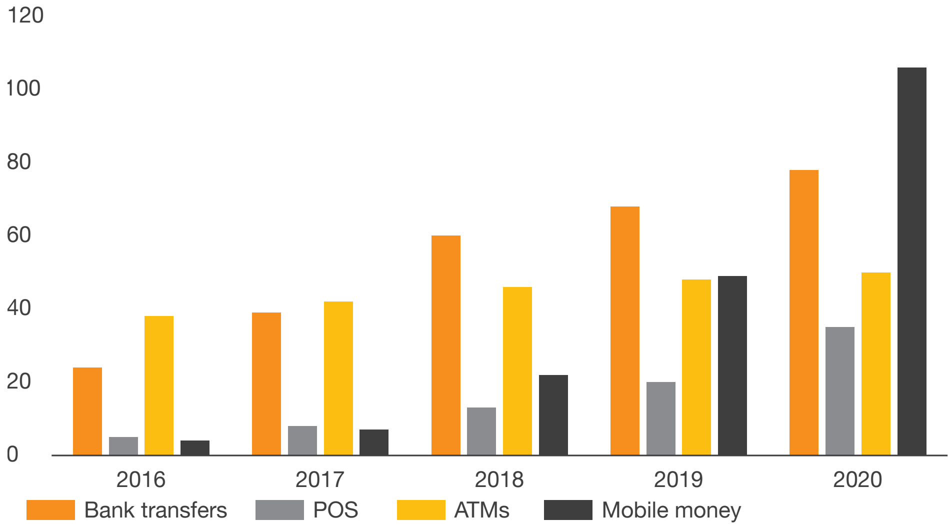
The key next steps for Zambia tax resident entities of MNE groups are:

- **In-scope:** assessing whether they are in scope and are required to file a full CbC report in Zambia or solely required to submit a notification.
- **Deadlines:** taking cognisance of the reporting and notification deadlines under the Zambian CbCR regulations.
- **Information collection:** collect and analyse the necessary information and assess the ability to disclose the information.
- **Process and governance:** analyse whether additional resources or external assistance are needed to comply with the CbC requirements, master file and local file implementation.
- **Data and technology:** the CbC report requires a specific format for filing the template. Preparations will need to be undertaken in this regard.

8.2 The growth of mobile money

Technology continues to be an important enabler in the provision of services to customers in the financial sector and in Zambia mobile money is at the forefront of this enablement. The Finscope 2020 survey indicated that 58.5% of adults used mobile money, while 20.7% used physical banks. This is very different from five years ago when only 14% used mobile money and 24.8% used physical banks. By volume, mobile money transactions now account for 55% of total banking transactions, up from 3% in 2019.

Figure 35. Mobile money vs traditional payment methods



Source: Bank of Zambia

This growth has been driven by the following:

- Efforts by the BoZ and financial institutions to highlight the importance of using formal financial services.
- Broader efforts by commercial banks, electronic money issuers (e.g. mobile money) and other financial services providers to integrate payment systems. The second phase of the National Financial Switch implementation has significantly increased integration and interoperability.
- Particularly in response to the Covid-19 pandemic, the BoZ eased restrictions on mobile money transactions to encourage cashless transactions.
- Review of the regulatory space by the BoZ in order to promote innovation, increased use of modern payment mechanisms, and financial safety and security.

Regulation of mobile money

The rapid growth of mobile money has led to some concerns, largely from the banking sector, that the relatively lax regulatory landscape of mobile money does not allow the banks to compete.

There exists various regulations that allow the central bank to develop and implement payment, clearing and settlement systems policy to ensure the efficiency, stability and safety of the Zambian financial systems, mobile money included.

Below is a comparison of applicable legislation:

Figure 36. Laws and regulations

Laws and Regulations	Banks	E-money institutions
The Banking and Financial Services Act No 7 of 2017	√	
The Prohibition and Prevention of Money Laundering Act, 3 Jan 2007	√	√
The Bank of Zambia anti-money laundering and combating the financing of terrorism or proliferation directives, 2017	√	√
Revision to minimum start-up capital for banks, 1 June 2015	√	
The National Payment Systems Act of April 2007	√	√

Know your client – KYC

The ability to onboard a client quickly is a key differentiator in the retail space. As depicted in Figure 37 below, the regulators have implemented more flexible know your client (KYC) processes and relaxing onboarding requirements for e-money institutions.

Figure 37. KYC requirements

	KYC Requirements	Tier	Maximum Limit (K)	Account Maintenance fees (K)
Banks	1. Application form 2. Copy of NRC 3. Proof of income 4. Proof of residence 5. Recommendation from employer. If student, letter of admission into education institution 6. Credit Reference Bureau report 7. Introductory letter	N/A	Varies – depends on the type of account and customer	Varies – depends on the type of account and customer
Mobile Money Institutions	8. Formal identification: copy of NRC or driving licence or passport	Tier 1	100,000	0
	9. Formal identification: copy of NRC or driving licence or passport 10. Proof of residence 11. Reference from employer or professional body 12. Confirmation from a reputable individual (i.e. civic leader, headmaster, traditional ruler)	Tier 2	500,000	0

Source: Bank of Zambia circular, 19 March 2020, Revision of transactions and balance limits for electronic money issuers and money transfer businesses.

9. The end of banking?

Betty Wilkinson, with collaborators David Cracknell and Charity Chikumbi

The most recent article using this title was written by Marc Rubenstein in October 2020 (https://www.netinterest.co/p/the-end-of-banking) and touches on a few, but not all, of the issues which we mention here. Banks everywhere are facing some form of trouble, but the depth of the issues in Zambia requires much more radical and fast action to avoid possible bank closures and mergers. Look at, for example, worldwide stock prices in banks. Many of them are at the same price in nominal terms as 25 years ago, as Rubenstein discusses in his article. This shows investor views of bank value.

Finscope 2020 shows that while the use of traditional banks by Zambians dropped from 24% to 20% between 2015 and 2020, during the same period the use of digital financial services accelerated from 14% to 59% of the total population. There have been forced bank mergers in the last two years. Banks are shifting away from expensive branches and to mobile money operations, but the timelines, mechanisms, and attention to the range of different client bases and their changing needs has been slow and inadequate.

More money and time needs to be spent on the analytics of data, in better market data, and in the use of data to create better, simpler, easier services. As David suggests: "Data is the new gold. Without it you cannot develop." The BoZ 2018 survey on the gender composition of clients and staff of regulated financial institutions showed that even in something as simple as the gender composition of clients, bank data was erratically collected and not used for product and service analysis or development.

Banks seem to fear that doing such analysis will give away their secrets, but we have found that they do not conduct sufficient analysis themselves internally and use it to improve their businesses. The BoZ might need to push harder with regulatory technology use, and then encourage the banks to engage in and use BoZ segmented analysis (such as the credit market monitoring analysis) to see their own data and use it better.

The second problem, linked closely to data, is banking strategy. Zambia is considered by some leaders in other regional banking markets to be lazy. That means banks focus on creating products in the boardroom, rather than using their own or market data to seek trends and apply them to changing their approaches and creating successful new products. Banks here are concentrating on corporates and higher-end individuals. It appears that they think that clients want relationship bankers rather than the ability to handle their needs online or by text.

The rest of the world is providing a wider range of data system-based services for large, clearly and carefully segmented groups of customers, and building medium-term market relationships.
A good example is Equity Bank in Kenya. In contrast, Zambian banks are focused on short-term, higher income levels and older, vanilla-style products such as standard monthly repayments for loans. The banks largely are ignoring potential clients' erratic income streams, and not building and retaining wider groups of clients as they grow and change.

As Rubenstein accurately notes, that is worldwide and is also true in Zambia. "The problem banks face is that whatever value that can be derived from complexity has diminished," he says. "No one wants it anymore. Customers now have the tools identify it and to circumvent it. In fact, it's those tools that are creating the most value." In addition, innovation generally comes from the coal face: from people who deal regularly with clients and understand their needs and what they complain about. But local ownership and empowerment at the mid-level staff level to actively innovate and improve products and services, which is increasingly common in successful businesses generally, is largely missing in Zambian banks.

The third challenge is developing channels and client streams by engaging in a more local vision of longer-term Zambian needs. A lot of potential clients are out there ignoring banks and using (largely) mobile money or other services for their financial needs. Onboarding a client can take days and requires a lot of paperwork. Some customers have complaints about their relationship bankers and are sometimes forced to use up to, on average, three to four banks to meet their business needs.

Banks have never escaped the public vision of themselves as for wealthy people who are "not like us" – not women, not smallholder farmers, not small businesses, not anyone who lives outside a major city. And yet we are discovering that billions of Kwacha is out there with these very groups, and they are saving in their houses, and increasingly in mobile money accounts and savings groups. Given that so much of Zambian bank lending is financed by the banks' wholesale borrowing, moving the potential savings money outside these alternative systems and into banks can only benefit the latter. Zambian banks have relatively high rates of financing lending by wholesale borrowing, rather than client savings; this means it is expensive to lend.

Banks, with a few exceptions, are not paying attention to the range of available channels and products and how they can be interlinked. Agent banking facilitates cash-in and cash-out processes, but further facilitates digital lending against savings, cultivating small loans and moving those good payers into next phases. Banks must pay much closer attention to liquidity management, removing long queues in their branch halls, and creating products with cashflow-based repayment systems. They are also not developing packages of services that are targeted effectively to specific groups.

For example, microenterprises need cashflow, information support, fire and theft insurance, keyman insurance, working capital lending, and mobile money transfer systems. Banks are only concentrating on providing these clients with traditional products and facilities such as loans and savings, and do not understand the customers or their other market players enough to see the need to also offer the untraditional products and facilities too. Regulators may also need to play a better role in the disclosure of non-payers; the legal and regulatory system does not address the issue of defaults effectively, which is why there are high interest rates, high collateral requirements and low lending.

Fourthly, banks have no choice but to engage effectively with their market counterparts in finance, particularly those offering a range of agent banking, mobile money and digital financial services. Regrettably this is not happening to the degree needed. Interoperability in banking gets lost in the commerce, and generally it is too costly and does not work well.
While the National Financial Switch is developing this and fintechs are quickly gaining ground, banks had a great opportunity to engage closely with nonbanks to enable their own systems to be integrated into mobile money and other options, and now they have lost that chance. The next key in interoperability is to make the process cheap enough so that it pays off for digital finance services providers to support integration instead of pushing for universal use of their own specific systems.

Some steps to consider:

First, turn around the strategy arrangements from serving the elite to serving Zambia. Show the market evidence that you are keen on a relationship over time that can grow with people from a small villager upward. Spend time and resources looking at needs across different groups in residences and businesses and markets, and what you are willing to do to meet them. Get aggressive about dealing with client complaints and demonstrate publicly how you are dealing with problems to create durable and consistent trust. This will be particularly important with expanding challenges in digital finance fraud.

Second, sort out your data. Invest heavily in the analysis of your data, in segmentation of client groups in terms of financial situation and needs, and monitoring of trends. Hire fintechs and participate in fintech challenges. Pull apart the Finscope 2020 data (and use upcoming provincial and market-specific analysis from the BoZ and FSD Zambia) to answer your key questions on what clients need and what other services they are seeking.

Third, get more predictive. Closely watch the fintechs and mobile money operators and spend more on data analysis and market assessments to see trends. Watch how infrastructure is changing and how people are using it. Recognise that business is transforming into a new world in which transforming into and getting creative and anticipating change is critical to success.

10. Business resilience

A view of the region

Much has been written about how financial services organisations, regionally and globally, are experiencing an extraordinary period – one in which the world confronted one ofthe greatest biological threats in a generation and which spiralled into significant public health, social and economic challenges.

At the onset of the Covid-19 crisis and the associated lockdown measures adopted by governments around the world, many financial services organisations shifted strategic focus to ensuring their resilience – operationally and financially – while supporting customers, colleagues and communities.

The 4 Rs

Many of the immediate responses by financial services organisations align with the response framework ('the 4 Rs', as depicted below) based on our global thought leadership, The future of financial services. Here, we expand these concepts further:

Figure 38. Repair. Rethink. Reconfigure. Report

Repair the damage The damage from Covid-19 to the real economy — and, by extension, the financial system — is only beginning to manifest itself in various ways. This damage will require deliberate activities to repair the balance sheets and reputations of financial institutions.	The following 'repair' activities have been top priorities for financial institutions globally: • Preparing for restructurings, workouts and wind-downs. • increasing the proportion of fee-based revenue. • Accelerating 'trust-building' activities. • Creating new business capacity.
Rethink the organisation Many of the questions about organisational structures and talent that existed before COVIDovid-19 — the efficacy of remote working and the productivity of agile teams — have been answered. These and related tools and approaches are now being deployed, – and are succeeding –, on a massive global scale.	'Rethinking' the organisation requires a focus on at least the following priorities: • Adopting a modern management approach. • Embracing new ways of working and digital upskilling. • Crowdsourcing talent and innovation. • Redesigning the customer journey and strategy.
Reconfigure the business and operating platform Along with the repair and rethink activities, many financial services institutions will need to reconfigure the business and operating platform, in some cases making profound changes in order to succeed in the future. To be sure, the post-global financial crisis changes were also profound, as the industry grappled with increased regulatory costs by selling businesses, reducing workforces, increasing offshoring and taking many other important actions. The CovidOVID-19 crisis is only accelerating trends well underway in each sector and underscores how much work remains to be done.	There are a myriad of 'reconfigure' activities, with critical areas, including: • Doubling down on cost reduction, digitisation and reshaping the change portfolio. • Increasing cloud adoption and the use of emerging technologies. • Using M&A to bolster strategic position. • Partnering with non-bank financial institutionsNBFIs and embracing change in market structures. • Optimising business/product mix and aligning incentives.
Report the results As various stakeholders demand more transparency and accountability from financial institutions, the focus will increasingly turn to complete and accurate reporting in a range of areas, including financial performance, Environmental Social Governance (ESG), regulatory compliance and the like. In addition, it will be critical not to miss perhaps the most important attribute of any successful financial institution in the future: being able to articulate its unique culture, story and value to society.	• Environmental, Social Governance (ESG). • Accounting standards. • Regulatory. • Shareholders. • Society. • Taxes.

In our estimation, many of the larger financial services organisations on the continent have been primarily focused and operating between the 'repair' and 'recover' phases in the response framework outlined above, with an eye towards how best to 'reconfigure' the organisation.

Purpose led

The idea that corporate entities should have a sense of purpose that not just guides or shapes their strategic vision but serves as the driving force for their activities, has been well described in recent years.

In a financial services context, organisations' corporate mission statements often reflect their purpose.

Yet purpose, when properly defined, transcends the day-to-day of what financial services organisations are or what they do. Purpose is beyond product development, risk management, actuarial valuations and regulatory compliance – financial stability, external reporting, internal controls, or financial metrics – but straddles and influences all of them.

When considered with meaning, instead of marketing, it is easy to imagine how an organisation's purpose can be multi-tiered: a galvanising corporate ambition translated into a sharp focus on a particular customer segment or demographic at business unit level.

One area in which purpose is often usually associated, and which the Covid-19 pandemic has made the world more attuned towards, is in the domain of ESG considerations.

Since the creation of the Equator Principles in 2003, the concept of sustainability has gained relevance, with momentum and social awareness significantly accelerated in recent years. wThe banking industry globally and locally is increasingly aware of the ESG risks and their growing importance. Investors and businesses are increasingly committing to ESG goals and criteria.

Figure 39. Why should banks care about ESG?

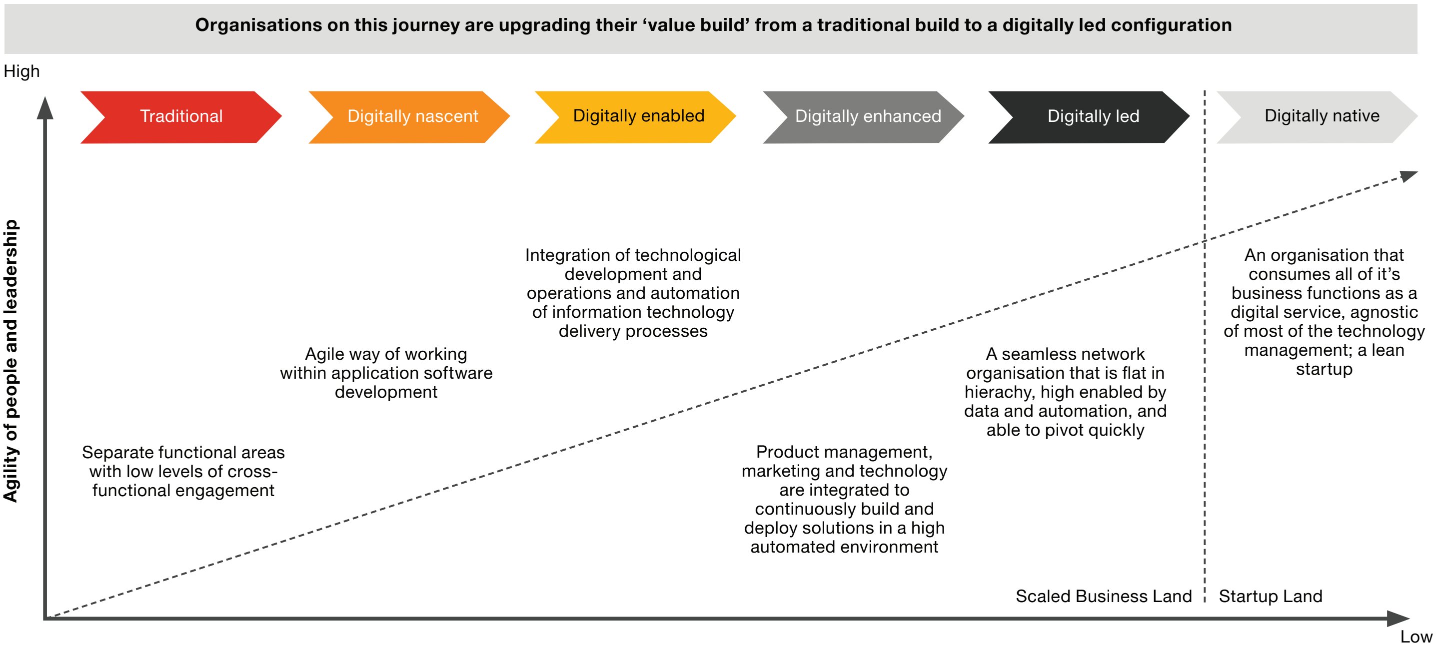
Customer acquisition	Attracting a new pool of customers (B2B and B2C) in sustainable industries and attracting customers that like to transact with an organisation with purpose and sustainable products
Physical / transition	Mitigating the direct impacts from environmental events on the existence of assets and the risks arising from the transition to more environmentally sustainable economies
Reduced regulatory / legal interventions	Reducing companies' risk of regulatory non-compliance and adverse government/ legal actions amidst garnering potential government support and guidance by adopting ESG as part of an organisation's strategy, operations and governance
New revenue generation	Understanding ESG implications and incorporating these into strategy and operations gives banks the ability to offer more sustainable finance solutions to the market with more purpose, incentives and profitability
Reputational risk	Integrating ESG practices into core business activities through sustainable developments, solutions, improving social injustices and policy changes can improve one's brand and positioning in the community
Productivity uplift	Boosting employee motivation and attracting talent by building stronger environmental and social credibility in its values and operations

Platform driven

The pandemic and mobility restrictions of 2020 and 2021 to date resulted in new ways of working and accelerated customer acceptance of technologically-enabled platforms to conduct banking.

It therefore goes without saying that a robust digital banking strategy – across customer segments and business models – is likely to feature at the center of thinking as banks attempt to leverage learnings from the crisis towards reimagining their purpose, structure and strategies. Real digital transformation – applied toward a specific set of objectives, from boosting productivity to increasing employee engagement and creating a better customer experience – will result in profound change in the way an institution is organised and operated. These capabilities will likely be built up in stages over time, as depicted below.

Figure 40. Agile methods and the digital maturity continuum



In our most recent global report, Productivity 2021 and Beyond, PwC observed that central to the success of financial services organisations in the future will be a digitally upskilled workforce that will drive the productivity gains banks will need to defend their competitive position against non-traditional financial services players. This will also enable them to respond to changing, digitally-enabled customer expectations and unlock productivity gains. In our view, these are the key pillars of financial services productivity in the medium term.

Figure 41. The five pillars of FS productivity

With some financial services organisations – and banks in particular – commenting on astounding statistics regarding the increase in digitally-active customers seen during 2020, the focus on leveraging technological trends to establish robust digital platforms and ecosystems is clearer than ever before.

As The Banker noted in a recent article, Platforms vs. ecosystems, which reflected on whether it is necessary to choose between being either a platform or an ecosystem, with the value of being both at once highlighted: "Today, most banks are neither platforms nor ecosystems, though many have ambitions to head in that direction."

Purpose led, platform driven

The common theme running across all of the best literature on the future of financial services is that, depending on the perspective selected, the future of the industry could be either perilous or promising, ominous or optimistic.

We choose to focus on promising and optimistic. Significant upheavals create new opportunities for innovation. The challenge for leadership teams is to look forward, understand the scope of changes underway and be bold in responding to them. The future of banking is purpose led, platform driven.

11. Conclusion

The resilience of the banking sector suggests that the industry, in the immediate term at least, has exhibited a degree of herd immunity from the challenges presented by a weak domestic economy and the impact of the Covid-19 pandemic. Whether this immunity can withstand the different types of challenges that the future will present remains to be seen.

However, further analysis of the performance of the sector indicates that this resilience is partly informed by a heavy reliance on direct and indirect lending to the government. This is not sustainable in the long-term. Not only does it stifle investment in the private sector, it denies banks the opportunity to build enduring relationships with enterprises that will form the engine of future economic growth. Therefore, while the sector may exhibit resilience in the short-term, this model is likely to leave some financial institutions vulnerable in the future.

The pandemic has presented financial institutions with the opportunity to rethink and reconfigure the way they do business, and where the eye focuses, the mind follows. As it turns out, necessity is not only the mother of invention but also is also a catalyst for rapid transformation. To varying degrees, financial institutions have seized the opportunity to revisit their operating models, build strategic alliances and alter service delivery in response to the changing landscape.

Given the relatively low vaccination rates and ongoing uncertainty regarding the path of the pandemic, disruption to the operating environment is expected to persist. Some of the changes that banking has experienced will endure beyond the pandemic as sustained alterations to consumer behavior are likely to result in lasting changes to their expectations, consumption patterns and, more fundamentally, a reconfiguration of their understanding of the role of banking itself.

How banks – both individually and collectively – respond to the changing landscape will determine whether they emerge from the pandemic weary and weak or eager with expectation for a reimagined future.

12. Financial performance and analysis

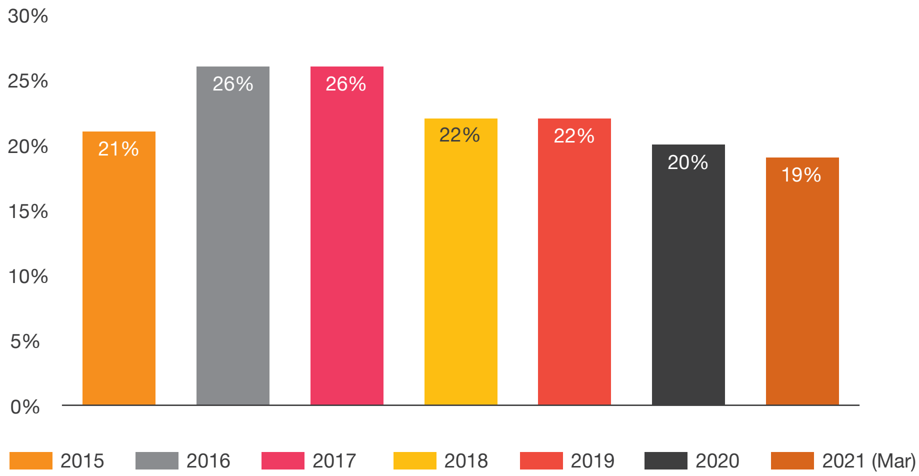
Capital adequacy ratio

Banking sector

In the current year, the capital adequacy ratio (CAR) recorded a marginal decrease from 22% in 2019 to 20% in 2020. The CAR further declined by 1% as at 31 March 2021. The decrease was mainly attributed to a reduction in aggregate industry profit. This decrease in profits was mainly driven by an increase in provisions for loan losses resulting from the Covid-19 impact. This was despite a significant increase in risk weighted assets.

The average CAR of 20% for the industry still remains above the minimum 10% required by the BoZ and hence it can be concluded that the industry as a whole continues to be well capitalised.

Figure 42. Capital Adequacy Ratio – Banks

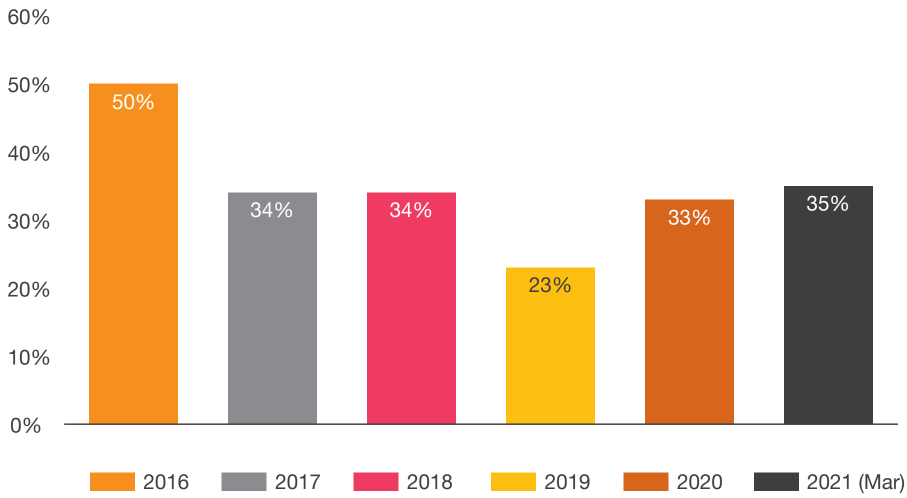


Source: Bank of Zambia

NBFIs

The CAR increased in the current year by 10% to 33% from 23% in 2019. The CAR further increased to 35% as at 31 March 2021. The increase in the CAR was driven by the aggregate industry profit. This was mainly attributed to an increase in revenue from government securities during the year. At 33%, the CAR is well above the minimum required position of 10% by the central bank.

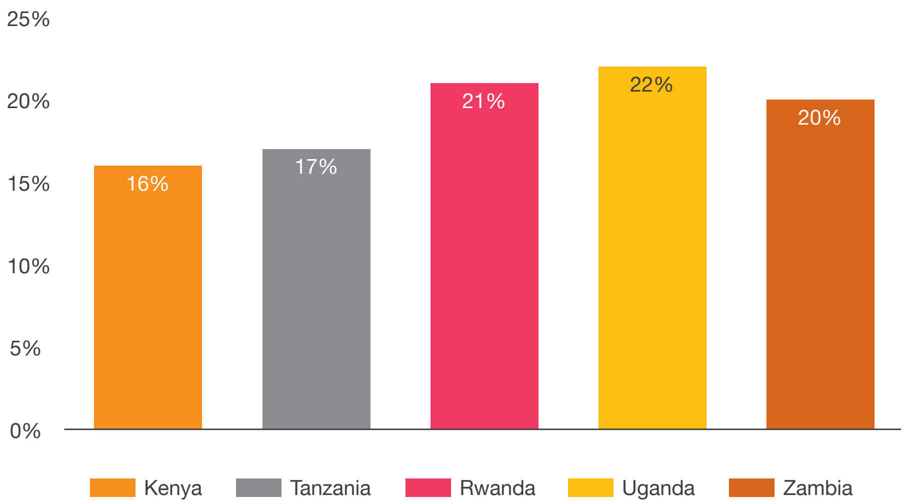
Figure 43. Capital Adequacy Ratio – NBFIs



Source: Bank of Zambia

Regional analysis

Figure 44. Capital adequacy ratio for selected African countries



Source: Bank of Zambia

The CAR of the Zambian banking sector is higher than all the other selected countries, other than Uganda and Rwanda, which are at 22% and 21% respectively. At 20% as at 31 December 2020, the CAR was higher than the banking sector in Kenya (16%) and Tanzania (17%). It is noted that for Kenya, the Covid-19 pandemic eroded most of the banks' asset quality gains made in 2019, while the NPL ratio deteriorated to 13.1% in June 2020 from 12% in 2019. Hence, the lower CAR.

*Due to limitations of data, the CAR for Kenya has been presented as of 30 June 2020.

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

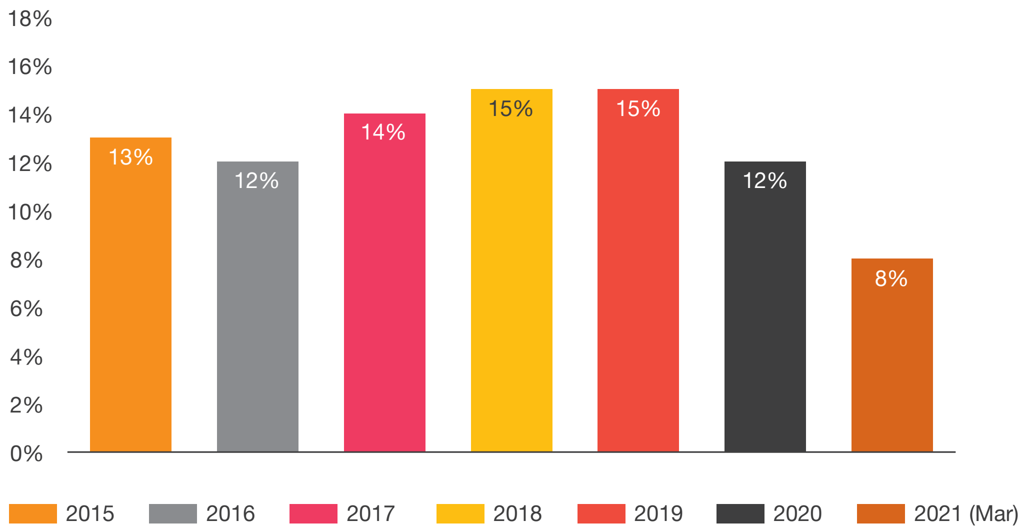
Return on equity

Banking Sector

The return on equity (ROE) decreased by 3% to 12% in 2020 from 15% in 2019. The marginal decrease was attributed to a decline in industry profitability. There was a decrease recorded of the top six banks by 4%. However, this was countered by an increase of 3% for the rest of the industry.

For the three month period to 31 March 2021, the ROE declined to 8%. The decrease was attributed to significant impairment charges during the period on account of the continued adverse impact of the Covid-19 pandemic. The ROE for the top six banks declined by 6%, which is similar to the decrease by the rest of the industry.

Figure 45. Return on Equity

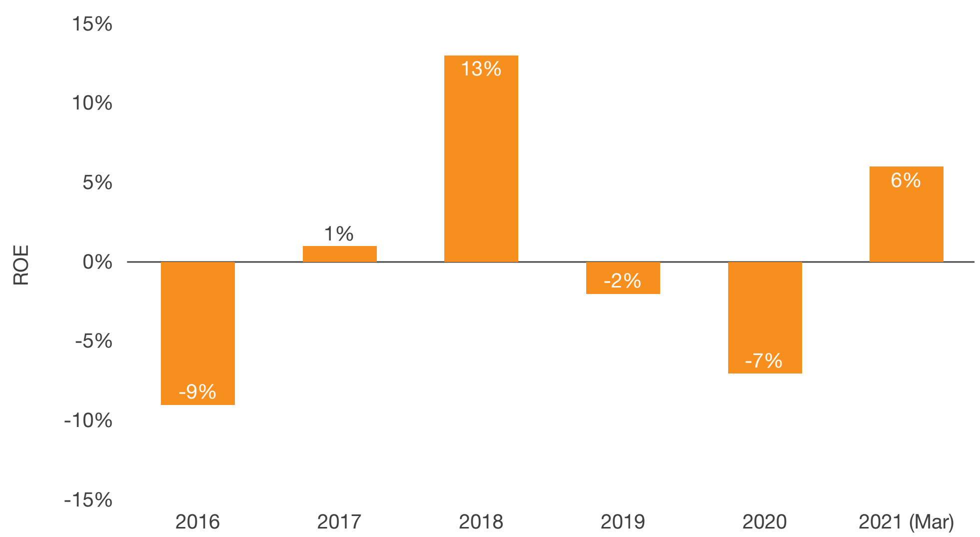


Source: Bank of Zambia

NBFIs

The ROE reduced in the current year by 5% to – 7% from -2% in 2019. The negative ROE of 7% in 2020 was mainly driven by high operational costs and a reduction in gross income, resulting in a combined loss in the industry. However, gross income improved in the first quarter of 2021, recording positive growth.

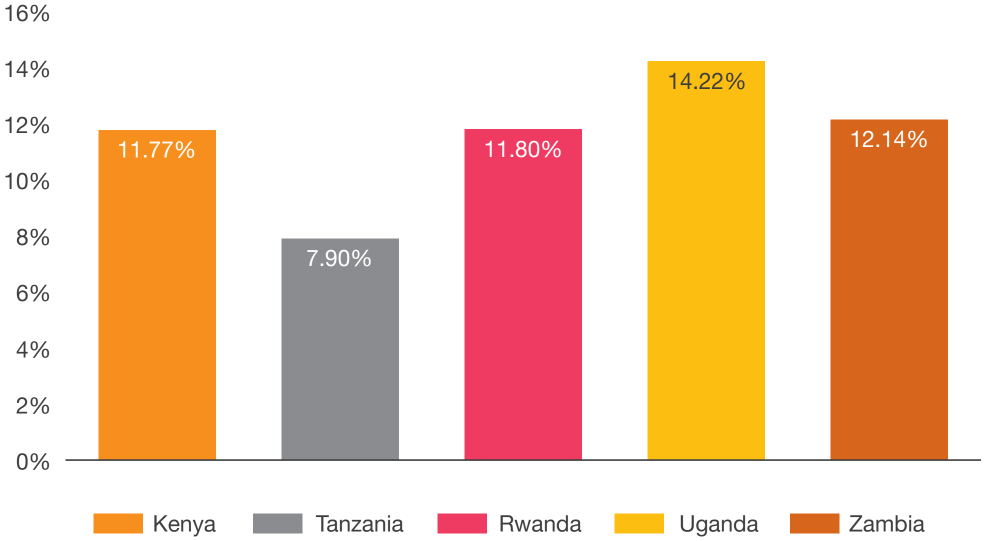
Figure 46. Return on Equity – NBFIs



Source: Bank of Zambia

Regional comparison

Figure 47. ROE for selected African countries



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

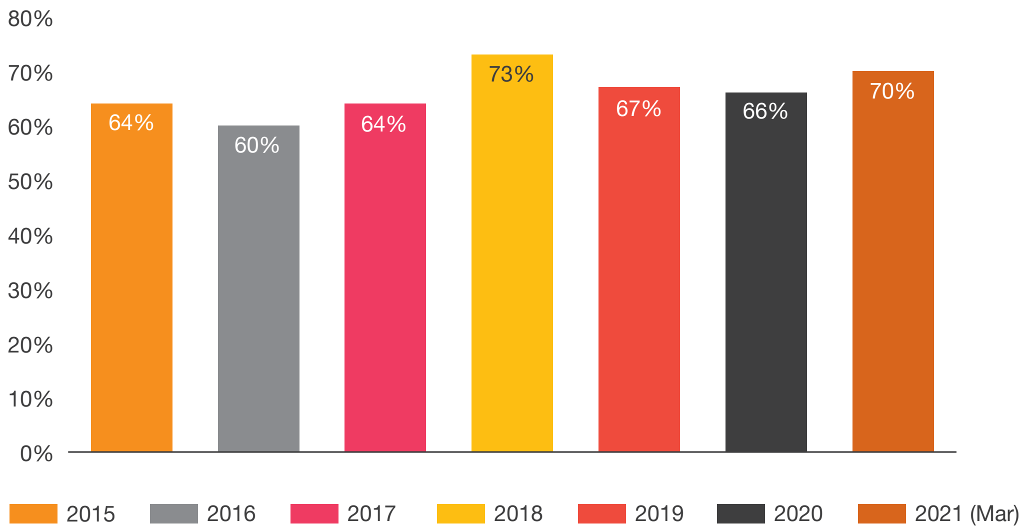
The Zambian banking industry lies in the median range at 12% when compared with the selected countries. Of the countries selected for comparison, Uganda ranks the highest with 14.22%. Tanzania is the lowest at 7.9%, while Rwanda and Kenya are at 11.8% and 11.77% respectively.

Banking sector

The industry net interest margin decreased in 2020 from 67% in 2019 to 66% in 2020.This was mainly due to the six largest banks recording a decrease of 2%. This was countered by an increase of 2% for the rest of the industry. The minimal decrease continued to highlight the impact that high interest expense and Covid-19 have had on a challenged economic environment.

The quarter results to March 2021 show an increase of 4%. This was on account of a minimal decrease in the cost of finance with interest expense on time, retail and corporate deposits reducing in the period.

Figure 48. Net Interest Margin

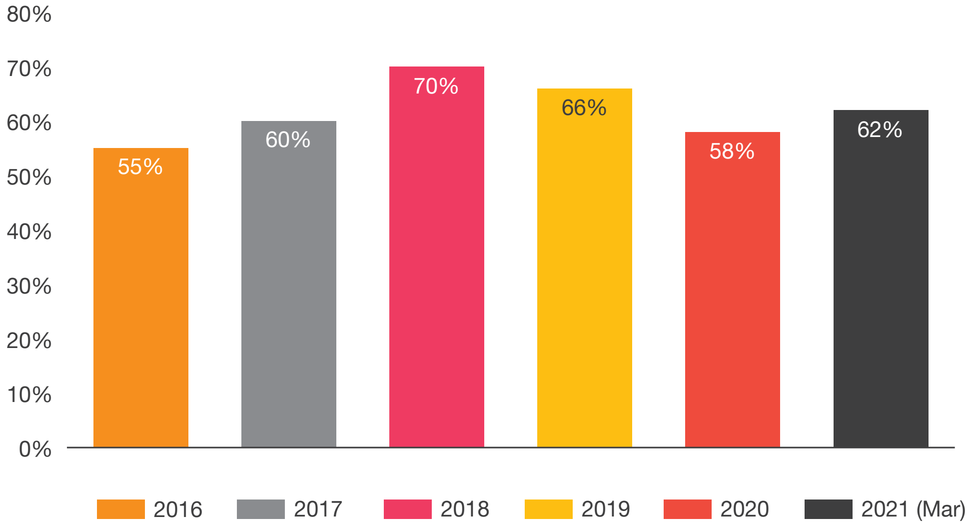


Source: Bank of Zambia

NBFI

The net interest margin decreased in 2020 by 4% to 62% from 66% in 2019. The decrease was driven by a contraction of 19% in interest income growth. In addition, the industry has seen a slowdown in the growth of its loan book.

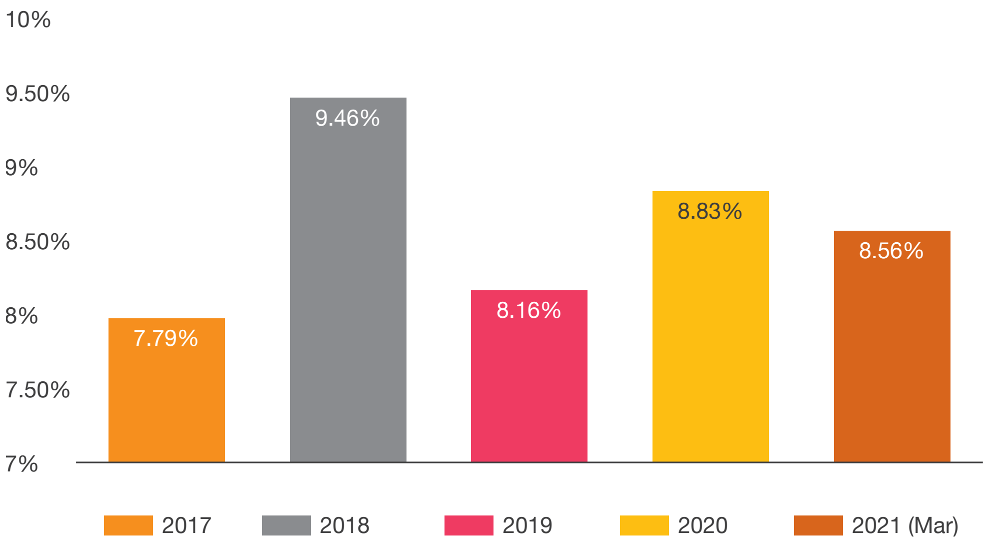
Figure 49. Net Interest Margin – NBFIs



Source: Bank of Zambia

Regional comparison

Figure 50. NIM for selected African Countries



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

At 66% in 2020, the net interest margin for the Zambian banking industry ranks second in comparison to other selected countries. First is Kenya at 67% following the scrapping of the rate capping regime. This is followed by Tanzania at 56% and Rwanda at 54%. This is mainly due to the high interest rate environment on commercial loans prevailing in Zambia relative to other countries.

*Due to limitations of data, the net interest margin (NIM) of Tanzania and Rwanda has been presented as at 31 December 2019

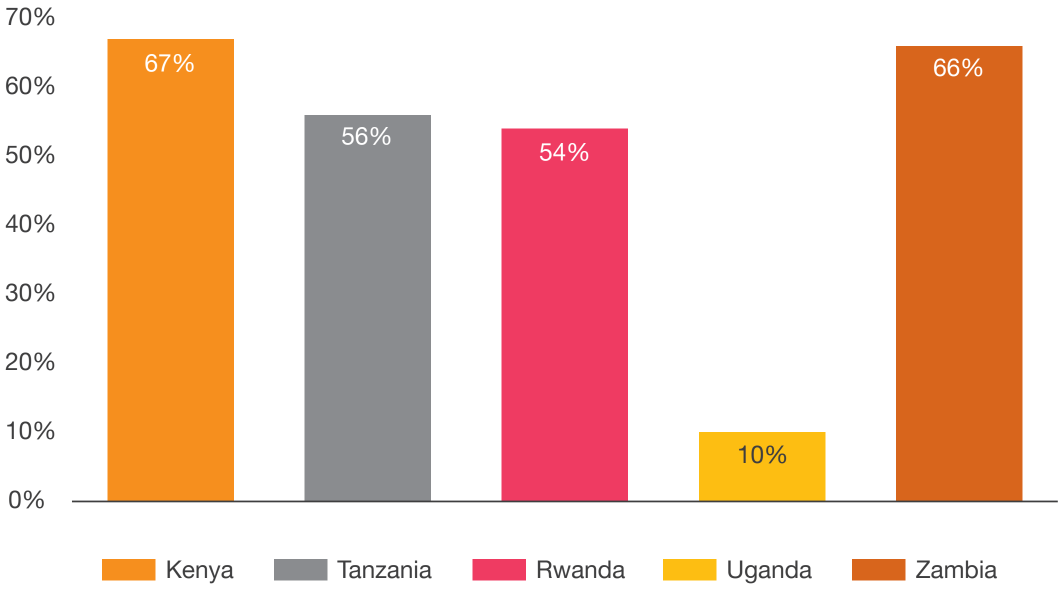
Banking sector – growth

Overall, Zambia's GDP growth rate is projected to recover in 2021, according to the BoZ. In 2020, net profit margin and the loans-to-deposit ratio both declined to 11.22% and 37.42% from 16.15% and 47.26% in 2019 respectively. However, the cost to income ratio in the period under review increased to 72.47% from 66.22% in 2019.

The performance indicators reflect the challenged economic environment and adverse impact of Covid-19 as new loan subscriptions declined and interest expense increased. Growth in net profit margin was below inflation, reflecting the first decrease in real growth since 2015.

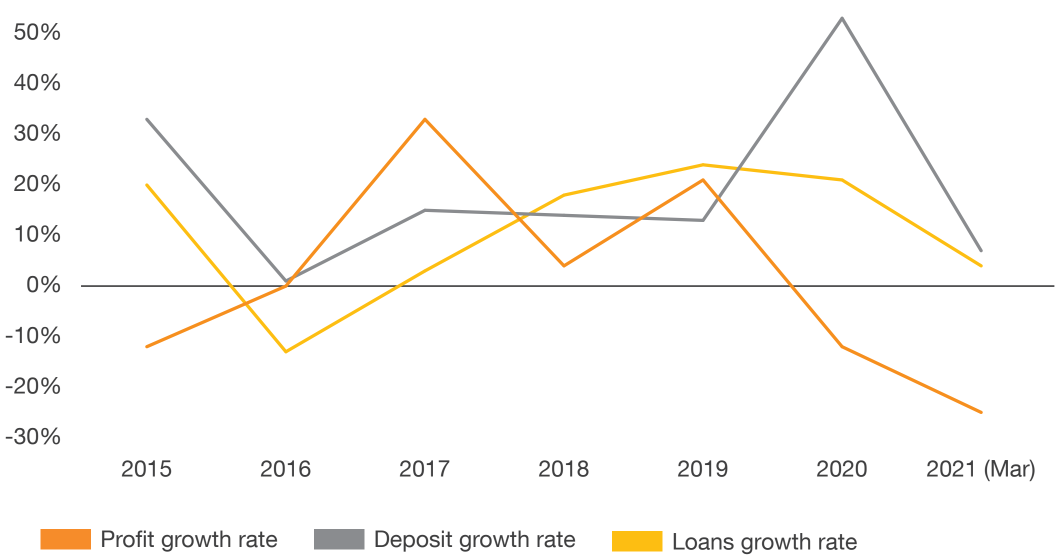
The three month period to March 2020 shows a recovery in the banking sector as the domestic economy recovers and markets stabilise.

Figure 51. Financial performance metric comparisons



Source: Bank of Zambia

Figure 52. Growth Rates



Source: Bank of Zambia

Glossary

1. Capital adequacy ratio (CAR)

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

2. Return on equity (RoE)

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

3. Net interest margin (NIM)

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

4. Net profit margin

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

5. Cost to income ratio (CIR)

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

6. Non-performing loans ratio (NPLR)

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

7. Loans to deposits ratio (LDR)

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

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