The Regulation of Microfinance in Zambia

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ABOUT THE SERIES
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Introduction

UNTIL TWO DECADES ago, Zambia was one of the most prosperous countries in sub-Saharan Africa, but it now ranks as one of the least developed countries in the world. According to the World Bank, an estimated 86% of the population is living in poverty (World Bank, 2001). Thus, one of Zambia’s main challenges lies in creating an enabling environment that will provide opportunities for the poor to earn sustainable incomes that provide for their needs and take them out of poverty. The informal sector in Zambia, as in many other developing countries, remains the most dynamic in terms of employment generation. However, policies to support this sector need to be put in place. The Government perceives the role of microfinance to be crucial in this regard (MOF, 2002: 44).

Furthermore, economic reforms undertaken after the change in government in 1991, which included decentralization, privatization and liberalization of the financial market, as well as the failure of government owned financial institutions, resulted in a financial system that focused on meeting the needs of the corporate sector and the working class elite. This led to the proliferation of financial institutions, including microfinance institutions (MFIs) established to fill the gap that had been identified in the market vis-à-vis access to financial services by low income households (Maimbo, 2000). These developments led to calls by politicians, regulators and MFIs (through the microfinance association) for the microfinance sector to be regulated and supervised as part of the financial sector. The Government, through the Ministry of Finance and the central bank, the Bank of Zambia, sees its role as that of creating an enabling environment by developing an appropriate regulatory and supervisory framework for MFIs to achieve significant outreach on a sustainable basis.

Background

IN DEVELOPING a regulatory framework for microfinance, the Bank of Zambia initiated the ‘Development of the Microfinance Regulation’ Project. The Project had three main objectives. These were to develop regulations, prudential reports and the systems necessary for the effective supervision of MFIs; develop Bank of Zambia’s capacity to effectively supervise MFIs; and to educate MFIs to facilitate their understanding and compliance with regulatory and supervisory requirements.

The project was broken down into two phases. Phase I, undertaken in 1999, involved a survey of the microfinance sector covering key issues of governance, lending, financing, equity, accounting, staffing and legal status. The objective of this phase was to obtain an understanding of the market and its players to develop an

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1. The Project was funded jointly by the Swedish International Development Agency (SIDA), the United States Agency for International Development (USAID) and the Bank of Zambia.
appropriate regulatory and supervisory framework. The survey results revealed a number of weaknesses in the sector. Firstly, although MFIs were committed to serving the poor, this was not done in an efficient, transparent and sustainable manner. Secondly, external reporting to clients and investors was either erratic or non-existent. Thirdly, there had been instances in which the public had been defrauded by unscrupulous persons posing as MFI officers. Fourthly, there was insufficient monitoring of MFIs by investors to ensure institutional soundness and self-sufficiency. Lastly, there was inadequate disclosure to clients regarding services, requirements and costs (Mudenda, 2002). In the Bank of Zambia’s view, the lack of a legal and supervisory framework for MFIs meant that the sector’s stability was not guaranteed and regulation of this sector would achieve the goals of maintaining financial market stability, encouraging responsible growth and deepening financial services available to Zambians.

Phase II of the project commenced in September 2001. Phase II focused on (1) developing and implementing regulations and (2) establishing and commencing operation of a supervisory framework for MFIs based on the results of Phase I. Both phases involved extensive stakeholder consultation. The process culminated in the development of the Banking and Financial Services (Microfinance) Regulations (MFRs) which became law on 30 January 2006.

The Legal Framework

The Banking and Financial Services Act

The financial sector is governed principally by the Banking and Financial Services Act (BFSA) of 1994 as amended in 2000 and subsidiary legislation. The Act was amended in 2000 to cover all institutions that provide financial services as defined in the Act, including MFIs, as the provisions of the BFSA 1994 focused mainly on the banking sector and was not clear in its application to NBFIs. The amendments to the Act strengthened the ability of the Bank of Zambia to respond promptly and comprehensively to developments in the financial sector. The Act authorizes the Minister of Finance, on the recommendation of the Bank of Zambia, to issue regulations to facilitate implementation of the Act. Thus the Microfinance Regulations have been issued under the BFSA.

It is worth noting, however, that even in the absence of the Regulations, it was possible for MFIs to be licensed as non-bank financial institutions (NBFIs) under the BFSA. Consequently, three MFIs were licensed as NBFIs. However, it was felt that the regulations were needed to take into account the specific characteristics of MFIs. Because the provisions of the BFSA focused primarily on the banking sector, the Bank of Zambia was reluctant to actively enforce the provisions of the BFSA on the microfinance sector, even after the amendments and authority to

2. Section 124, BFSA 2000. Regulations are issued as ‘statutory instruments’ (SIs).
modify the provisions for NBFIs. Thus, MFIs were not obliged to become licensed institutions despite the fact that it is an offense to provide financial services as defined by the Act without a license.

The capital requirement for deposit-taking (DT) NBFIs is approximately US$598,000 (K2,000 million) and US$7480 (K25 million)\(^3\) for non deposit taking (NDT) financial institutions. Licenses permit financial institutions to provide a wide range of financial services, unless the institution is specifically prohibited or restricted from doing so by the Registrar. Financial institutions can take any legal form whether they accept deposits or not. There are no limitations for shareholders in terms of ownership or control for NBFIs, unless the NBFI is a company. In this case, ownership and control is limited to a maximum of 25% per shareholder and the board must have a minimum of five members. However, trusts are not allowed to own shares. Licensed financial institutions are required to submit prudential reports on a monthly basis and are subject to an inspection by the Bank of Zambia at least once a year. A review of the regulatory and supervisory practices in relation to the MFIs that were licensed revealed that there was uncertainty as to whether forced savings should be treated as deposits; those MFIs that did have compulsory savings as part of the lending methodology were classified as non deposit-taking NBFIs.

The Microfinance Regulations

Indications are that with the regulations now in place, the Bank of Zambia will enforce the provisions of the Act on the microfinance sector.\(^4\) Assuming this does happen, MFIs that continue to operate without a license will be prosecuted and closed. Those MFIs that have already been licensed as NBFIs will not have to apply for a license under the Microfinance Regulations. A review of the regulations reveals that they do not contain any provisions that radically modify the requirements of the principal Act, the BFSA 2000, and, more often than not, only serve to reiterate them. Where the regulations are silent on a particular matter, the provisions of the principal Act apply. The salient points to note are as follows.

MFIs have one month to apply for a license. In determining the license application, the Registrar will have to take into consideration the sustainability of the financial institution. Most MFIs are heavily reliant on donor grants or loans at interest rates that are generally lower than ruling market rates, and most are not financially viable. Those institutions that will not be financially self-sustainable in a ‘reasonable’ period will have to cease operating, as they will not be granted a license.\(^5\) Therefore, enforcement of the law will result in a number of MFIs going out of business.

The minimum capital requirement for a deposit taking (DT) MFI is US$74,760 (K250 million),\(^6\) as opposed to US$598,000 (K2,000 million) under the principal Act, and US$7480 (K25 million) for a non deposit-taking (NDT) MFI, the same as under the principal Act. The lowering of the capital requirement should have a positive impact on the microfinance sector in that more organizations will

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3. At the Bank of Zambia selling rate of K3,344/$ at 1 March 2006
4. Conclusions drawn by the author from interviews held with Bank of Zambia officials and review of documentation.
5. There has not been a definition of “reasonable” set forth in the regulations. Regulators will examine business plans provided during licensing to determine feasibility.
6. At the Bank of Zambia selling rate of K3,344/$ at 1 March 2006.
be able to satisfy the lower capital requirement and possibly a higher number of MFIs will enter the market than would be the case otherwise.

The services and products that can be provided under the MFRs are restricted to the provision of credit facilities, linkage banking, in-country transfers and compulsory savings for borrowers only for DT MFIs and credit facilities only for NDT MFIs. Thus, the range of services that can be provided is narrower than that provided for under the BFSA. This restriction may stifle service and product innovation in the microfinance sector.

The MFRs make a distinction between DT and NDT MFIs concerning registration and ownership. DT MFIs must be registered as companies and voting control is limited to a maximum of 25% per shareholder, unless Bank of Zambia approval is obtained to control more. NDT MFIs are permitted to have a number of different legal forms, including companies, non-governmental organisations (NGOs) registered with the Registrar of Societies, or cooperatives. However, if a NDT MFI is registered as a company, then voting control is limited to a maximum of 50% per shareholder, unless Bank of Zambia approval is obtained to control more. Furthermore, the MFRs are silent on matters of controlling interest in MFIs with a legal form other than that of a company. Under the principal Act, NBFIs, regardless of whether they provide deposit facilities, may take any legal form, including sole proprietorship. So, in relation to matters regarding the ownership and governance structure of MFIs, the MFRs are stricter. However, trusts are still not permitted to own shares or control MFIs. This provision will have a negative impact on the industry, as trusts are the preferred investment vehicle for most donors. There is still a requirement for MFIs that are companies to have a minimum of five board members and all MFIs to have separate individuals as the chief executive officer (CEO) and chief financial officer (CFO).

The main reasons for these provisions are to ensure transparency with regard to the ownership structure of MFIs and improve their governance by limiting the amount of control vested in a single individual. In the development of the regulations, it was felt that these were particularly important as MFIs served one of the most vulnerable segments of the population and these provisions would minimize the likelihood of exploitation and abuse of MFIs clients.

There is no variation in the definition of deposits contained in the principal Act. However, in addition to restricting the type of deposits that MFIs can accept to compulsory savings, as noted earlier, the MFRs make it clear that cash received as collateral, whether it is referred to as ‘forced savings’, ‘compulsory savings’ or ‘loan insurance fee’, is classified as a deposit. So although there has been no variation in the definition of deposits, the MFRs clarify the treatment of ‘cash collateral’. Both DT MFIs and NDT MFIs will have to submit prudential reports to the Bank of Zambia on a monthly and quarterly basis respectively. As licensed institutions, MFIs will be subject to inspection by the Bank of Zambia at least once a year.
Rationale for government regulation

A number of reasons were given for regulating and supervising the sector which justify the need to introduce microfinance specific regulations. Those given by Bank of Zambia officials included the following. Firstly, regulation was needed to maintain financial stability and secondly, to safeguard deposits and protect customers and investors. Thirdly, regulation was needed to ensure that donor funds were used efficiently and effectively for the purpose for which they were intended. Fourthly, regulation would improve the integrity and credibility of MFIs operating in the sector. It would set minimum performance standards, reporting requirements and provide checks and balances. Regulation would enhance confidence in the sector. The Bank also believes that regulation was necessary to promote the industry and encourage growth so that access to financial services by the majority of Zambians that currently do not have access can be increased, especially in rural areas. Lastly, the Bank of Zambia officials thought that regulation would reduce the amount of ambiguity that exists in the current regulatory environment, especially with regard to the classification and treatment of compulsory savings.

In addition to the above, other stakeholders consulted felt that the microfinance sector should be regulated to facilitate the mainstreaming of microfinance, the collection of data and the monitoring of developments in the sector. Furthermore, regulation was needed to ensure that the public was not exploited and in this respect, some stakeholders felt it was necessary to regulate interest rates.

Analysis of the regulations

Attainment of the objectives

As noted earlier, it was felt that these objectives could only be met by introducing microfinance specific regulations. This section, therefore, assesses the likelihood of these objectives being met with the microfinance regulations becoming law. With regard to the first objective of maintaining financial stability, the microfinance sector in Zambia is miniscule as a proportion of the financial sector which is dominated by the banking sector. Therefore the failure of even the largest MFI would not have any impact on the financial sector. Therefore, having this as an objective for regulating the microfinance sector is questionable. Some stakeholders felt that it was premature to have microfinance specific regulations at this stage of the industry’s development and that a simple registration procedure to facilitate data collection and monitoring of developments would suffice.

The second objective is that of safeguarding depositors’ funds. However, the MFRs do not specifically or directly address the issue of protecting depositors’ funds. All else being equal, regulation does not guarantee that institutions will not fail, although it may reduce the probability of failure through the requirement to
maintain adequate capital levels to absorb losses, adhere to minimum performance standards and the maintenance of internal control systems to monitor and manage risk. In order to protect clients from losing their forced savings in situations where they are net savers, there would have to be an alternative safety net mechanism in place, such as an explicit deposit insurance scheme or a requirement for MFIs to obtain private insurance, if available. The third objective is that of investor protection. However, as for depositors, investors would not necessarily be protected for the reasons outlined above. With respect to ensuring that public resources and donor funds are used effectively and for the purpose for which they were intended, this issue is not directly addressed by the MFRs and, therefore, this objective will not be met.

The fourth objective is that regulation will improve the integrity and credibility of MFIs that are licensed. Licensing implies that the supervisory authority is vouching for or is prepared to assume the responsibility for the financial soundness of the regulated financial institution which the public may be dealing with (Christen and Rosenberg, 2000), enhancing confidence in the microfinance sector. As MFIs will have to obtain a license, entrants will be vetted. This will make it more difficult for unscrupulous individuals to own and manage MFIs, reducing the probability of criminal and fraudulent activity. Thus it is likely that the integrity and credibility of MFIs will be improved.

The fifth objective relates to regulation setting minimum performance standards and reporting requirements. In relation to setting minimum performance standards, the MFRs do not specifically address this. Even if they did, being regulated and supervised does not automatically result in improved performance. This depends more on the implementation and enforcement of the regulations. Where enforcement is weak, regulation will have very little impact, if any at all. However, the regulations do set minimum reporting requirements which will increase transparency in the sector.

Regarding the promotion of the industry and encouraging growth, this objective is not likely to be met. If anything, in light of the comments made by the donor community that the MFRs were too restrictive, it may be concluded that regulation would serve to impede donor flows and more likely to stifle the microfinance sector than to encourage its growth. This is in complete contrast to the views expressed by the Bank which believes that regulation is needed to promote the industry and encourage growth, thus increasing access to financial services by the majority of the population which is not banked. Overall, the analysis suggests that the MFRs would have very limited impact in meeting the stated objectives.

**Benefits**

The main benefit of passing the MFRs is that the ambiguity and confusion that existed has been clarified, thus sending a clear signal to all participants in the microfinance sector, specifically MFIs, investors and, to some extent, customers on the legal
position and the treatment of compulsory savings. All MFI s now have to apply for a license or risk prosecution. MFIs that charge ‘loan insurance fees’ or require ‘forced savings’ as collateral will be deemed to be accepting deposits, and treated as DT MFIs for regulatory and supervisory purposes.

The other benefits are that more information is readily available to the public as well as the Bank of Zambia. MFIs now have to publish their financial statements on a quarterly basis. Additionally, MFIs are required to disclose their charges and interest rates in relation to the services and products being offered. The MFRs also require that MFIs have in place clear procedures for dealing with complaints. However, the regulations are not specific as to how disputes are to be resolved. Therefore, the issue of redress has not been dealt with comprehensively.

Capital levels in the industry will be higher, thus reducing the probability of failure and fostering financial system stability. However, access to funding would still be limited as MFIs are not permitted to mobilize public deposits, but can have forced savings. In relation to obtaining funding from other sources, such as the capital market, this will also be limited due to the broader constraints faced by the microfinance industry noted below.

**Effects on competition**

The requirement for all MFIs to obtain a license, however, is likely to result in fewer MFIs in operation for a number of reasons. Firstly, MFIs have to meet the higher capital requirements. MFIs in Zambia are relatively small. This was acknowledged by the Bank of Zambia when, in its preliminary study, it only identified four MFIs that would possibly qualify for licensing. Secondly, MFIs that are not financially sustainable can not be licensed, as the Registrar has to take into consideration the financial viability of the business when evaluating an application. Most MFIs would fail this requirement as they are heavily dependent on donor funding and are not self-sustainable.

Thirdly, a number of MFIs will not be able to comply with the ownership provisions which limit shareholding and prohibit trusts from owning shares. Considering the relatively poor performance of the microfinance sector, the high level of risks involved, the thin capital/equity markets in Zambia, and numerous other constraints faced by this sector such as poor infrastructure, finding private investors will not be easy. A significant portion of MFIs in Zambia is funded by donors whose preferred investment vehicle is a trust. The change may not be easy to implement. Where the changes are difficult to implement, MFIs may have to cease operating. The overall impact, therefore, of prohibiting trust ownership on the microfinance sector and enforcing the 25% shareholding limit will most likely be negative.

Fewer MFIs will mean less competition. The licensing criteria will act as barriers to entry, thereby reducing the (potential) number of participants in the sector. This will be compounded by the restrictions placed on the services that can be provided by MFIs.
under the regulations. There will be less choice for customers and reduced access to financial services.

**Compliance costs**

Compliance costs, considering the size of MFIs operating in the sector, will be significant. Firstly, there are the costs associated with obtaining the licence and the annual license fee. In addition to these costs, DT MFIs will incur the costs of converting into a limited company and having an annual audit; institutions with microfinance units will incur the costs of registering these units as separate legal entities, and MFIs will have to pay a fee for every new branch opened.

Secondly, there are the costs, in terms of time, effort and resources, associated with meeting the reporting requirements of publication and prudential reports. These will be substantial, especially for smaller MFIs and those located in rural areas which may have to upgrade and improve their management information systems (MIS). Thirdly, the annual inspections by the Bank of Zambia will increase the costs to MFIs, in terms of both time and resources, associated with preparing for the inspection, assisting inspectors during the inspection and the disruption caused to the business as a result.

MFIs will incur increased staff costs associated with training and with using two different individuals to cover the posts of CEO and CFO, regardless of their size. On an ongoing basis, DT MFIs would have to pay an annual supervision fee. And lastly, there is the opportunity cost of having to hold liquid non-interest earning assets in order to comply with the liquid assets ratio. These costs will have to be passed on to clients in one form or another. An increase in costs in a sector whose financial performance is already poor will most likely result in the closure of MFIs. The Bank of Zambia will also incur costs in supervising the sector, especially taking into consideration the geographical dispersion of MFIs, in addition to those already incurred in establishing the regulatory framework. Concerns have also been raised by various stakeholders as to whether the Bank of Zambia has the capacity to regulate the sector.

8. This ratio has not yet been prescribed by the Bank of Zambia.

**Summary and Conclusions**

**CALLS TO REGULATE** the microfinance sector resulted from the Government’s desire to create an enabling environment for MFIs to achieve significant outreach on a sustainable basis in order to increase access to financial services by low income households and reduce the poverty levels in Zambia. It was felt that the only way to achieve the objectives identified of regulating and supervising the microfinance sector would be to introduce microfinance specific regulations, despite the fact that there was ample provision in the existing regulatory framework to license MFIs as NBFIs under the BFSA. Thus, the process of developing
the regulations was started in 1999, culminating in the passing of the Banking and Financial Services (Microfinance) Regulations which became law on 30 January 2006.

A review of the provisions of the MFRs shows that they do not significantly modify the provisions of the principal Act. However, there had been a general reluctance on the part of the Bank of Zambia to apply the BFSA to the microfinance sector and indications were that this would change with the passing of the regulations. Therefore, it is anticipated that the greatest impact will lie in the change of the Bank of Zambia’s treatment of MFIs vis-à-vis regulation and supervision.

It is evident that a lot of faith has been placed in the MFRs to achieve the objectives of regulating the sector outlined above. However, the analysis of the impact of the regulations gives mixed results. On the one hand, there will be benefits, specifically, the clarification of the legal position of MFIs and the treatment of compulsory savings as deposits; increased confidence in the sector through improved credibility derived from being a licensed institution and the vetting of entrants; increased transparency through the disclosure of information; and increased capital levels which are likely to foster financial system stability.

On the other hand, the costs of implementation are quite high. A number of MFIs will have to cease operating, as they will not be able to meet the licensing requirements if they are strictly enforced. The compliance costs with regard to meeting reporting requirements, facilitating inspections, and governance are quite significant, especially for smaller or rural MFIs which may have to incur additional costs of upgrading their MIS. This will negatively affect the microfinance sector. Increased costs will have to be passed on to clients in one form or another.

Rather than promoting the growth of the microfinance sector and increasing access to financial services for low income households as intended, the results of the analysis indicate that the passing of the MFRs is more likely to have the opposite effect. The challenge, therefore, lies in weighing the costs of strictly enforcing the legislation in light of the expected benefits and achieving the desired outcomes. Only time will tell whether the current regulatory and supervisory framework will indeed fulfill these expectations.
References


