Banking and Micro-finance Regulation and Supervision:
Lessons from Zambia

Kenneth Kaoma Mwenda
Editor

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by

Kenneth K. Mwenda, PhD

About the contributors

This book brings together Zambia's leading scholars on the legal and institutional framework for banking and micro-finance regulation and supervision. There are three contributors to the book and they are all Zambians. The contributors have individually undertaken substantial research on the various aspects of banking and micro-finance regulation and supervision in Zambia. Thus, this book attempts to draw from the research of these Zambian scholars on banking and micro-finance supervision and regulation.

Two of the contributors are Rhodes Scholars and currently with the World Bank in Washington DC, while the other is a Fulbright Scholar and currently with the International Monetary Fund in Washington DC. All three contributors hold doctorate degrees from leading international universities. There can be no better placed persons to offer such valuable international and local insights into the legal and practical aspects of banking and micro-finance regulation and supervision in Zambia. Following below are some short biographical notes on the contributors.

Dr. Kenneth Kaoma Mwenda, a Rhodes Scholar, and formerly Law Lecturer in the University of Warwick (UK), is presently with the World Bank, Washington DC, USA. Dr. Mwenda holds, among other qualifications, a Bachelor of Laws degree (LLB) from the University of Zambia; a postgraduate double Masters degree in Law from the University of Oxford (BCL/MPhil); a Master of Business Administration degree (MBA) from the University of Hull; and a Doctor of Philosophy degree in Law (PhD) from the University of Warwick. Dr. Mwenda is an Advocate of the High Court for Zambia and a Fellow of the Royal Society of

Arts (UK). He has also been Visiting Professor of Law at universities in Europe and Africa. In addition, Dr. Mwenda has been recipient of several academic awards and honours from institutions such as Yale University Law School. Dr. Mwenda is listed in several elite biographical listings, including *Who's Who in the World*. A widely published scholar, Dr. Mwenda is author of six other books on corporate law, banking law and reform, securities regulation and business law. He has also authored more than fifty articles in leading academic and professional journals worldwide, and is currently working on two other books.

Dr. Samuel Munzele Maimbo, a Rhodes Scholar, and formerly Senior Banking Inspector at Bank of Zambia, is presently with the World Bank, Washington DC, USA. Dr. Maimbo holds a Bachelor of Accountancy degree (BAcc) from Copperbelt University, Zambia; a Master of Business Administration degree (MBA) from Nottingham University, UK; and a Doctor of Philosophy degree (PhD) in Banking Regulation and Supervision from Manchester University, UK. He is also a qualified chartered accountant (ACCA). Dr. Maimbo's work appears in leading academic and professional journals.

Dr. Stuart Makanka Yikona, a Fulbright Scholar, and formerly Law Lecturer at Copperbelt University, Zambia, is presently with the International Monetary Fund, Washington DC, USA. Dr Yikona holds a Bachelor of Laws degree (LLB) from the University of Zambia; a Master of Laws degree (LLM) from the University of London; a second Master of Laws degree (LLM) from the University of Virginia Law School; and Doctor of Juridical Science degree (SJD) from the University of Virginia Law School. Dr. Yikona is an Advocate of the High Court for Zambia and has authored several books and articles.

Preface

This book examines contemporary legal and policy issues facing banking and micro-finance supervision and regulation in Zambia. The book sets out an interdisciplinary exposition of the law. It provides an interface of financial services law and practice. Relevant aspects of business management and economic theory are examined as well. The book attempts to permeate intellectual spheres that have not been explored in depth before. In essence, this is not a simple textbook on the introductory aspects of a particular field of law, as is often the case with many books that have titles such as 'Introduction to Business Law' or 'Fundamentals of Tort Law', and so forth. By contrast, the book breaks new ground in the area of financial services regulation. Indeed, a law in context approach is presented, giving added value to the field of knowledge in the book.

The editor brings together fresh and original contributions from leading scholars on banking and micro-finance regulation and supervision in Zambia. Each chapter is written by an expert in the field. The book provides refreshing breath on Zambian jurisprudence on subjects that have hitherto been hardly explored with intellectual zeal and insightfulness. Each chapter has its own format of references, footnotes and endnotes, depicting the diversity of the disciplines from which the various chapter contributors come from.

By design, the book takes a purposeful slant towards Zambian jurisprudence. In spite of this, the book provides analyses which are of wider application to many other parts of the world. Comparative studies are set out in the book. Chapters in the book cover, among other things, the design and development of the Zambian banking regulatory and supervisory frameworks from 1970 to 2000, the regulation and supervision of micro-finance institutions in Zambia, the economic philosophy of banking in Zambia and the United States, the efficacy of the legal and regulatory framework for banking and financial services supervision in Zambia, and the legal and institutional framework for bank insolvency in Zambia.

The interpretations and conclusions expressed in this book are entirely those of the respective chapter contributors. The views in the chapters do not necessarily represent the views of the editors, the publisher, or any of the institutions to which the editor or the chapter contributors are affiliated or attached.

Kenneth Kaoma Mwenda, PhD
Washington DC, USA

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Chapter 1

Design and development of the Zambian banking regulatory and supervisory frameworks (1970-2000)

by

Samuel Munzele Maimbo

1.0 Introduction

This chapter details the recent history of the Zambian regulatory and supervisory framework between 1970 and 1998. Firstly, Section 2 traces how government interference during the 1970s and early 1980s resulted in the absence of an appropriate regulatory and supervisory framework for financial sector development. It evaluates how the political and economic environment influenced BOZ's regulatory and supervisory practices. Section 3 documents the 1992/93 financial sector reforms introduced as part of Zambia's Structural Adjustment Programme. Then, Section 4 discusses the financial sector's response to those reforms. Importantly, it documents each of the 1995 and 1997/8 bank failures. In conclusion, the Section 5 reviews the available literature on the causes of the bank failures. It also reviews the available literature on BOZ's regulatory and supervisory effectiveness during that period. The chapter notes that the recent studies still leave a number of unanswered questions that are at the core of establishing the fundamental weaknesses in the design, development and implementation of banking regulation and supervision practices in Zambia.

1.1. The financial system before the 1992/93 reforms

1.1.1 Macro-economic environment

Since independence in 1964, Zambia has been dependent on the copper industry. High copper prices and production levels in the 1960's placed Zambia amongst the wealthiest nations in the region. The annual average rate of gross domestic product (GDP) growth between 1964 and 1968 was 2.4%. The manufacturing and agricultural sectors grew at an impressive rate of 9.8% and 2% respectively (Kani, 1996:20). Yet, despite the impressive economic growth rates between 1964 and 1970, there remained significant differences in the quality of financial services available to people working in the formal and informal sectors, and between those living in urban and rural areas. In an attempt to address these imbalances, the government implemented the 1968 Matero reforms, which resulted in government control of a significant proportion of the economy (Kaunda, 1968:27). Between 1965 and 1975, the government established nearly 80 state firms that accounted for more than 50% of manufacturing and transport output, and dominated the services industry (Kaunda, 1968:39, Kani, 1996:20). Sadly, that change in internal economic policy and the external macro-economic shocks, especially in oil prices, in the 1970's, ended the rather promising rate of economic growth.

By the mid 1970's Zambia had become a classic case of a public sector-led economy with excessive controls, state monopolies and a pro-urban, anti-agricultural bias. The introduction of price controls and the nationalisation of the domestic industry had a negative effect on the economic efficiency of Zambia's industries. The rapid expansion of state firms, coupled with a growth of government employment and public spending, particularly on wages and consumption subsidies, created an unfavourable economic environment. Increased government spending on consumption, price controls and a protectionist trade regime led to strong incentives for growth of import substitution industries and a bias against exports. Externally, declining international copper prices and rising oil prices compelled Zambia to seek external borrowings to sustain its budget deficit. Other external shocks that Zambia included: a severe deterioration in the terms of trade; maize harvest failures due to drought; transport dislocations due to the Unilateral Declaration of Independence by Southern Rhodesia; and rising military activities related to its support for independence struggles in neighbouring countries.

Between 1970 and 1990, Zambia's current account was in deficit for all but three years, averaging $315 million, 11% of GDP. Between 1975 and 1984, the external debt grew from 46% of GDP to 94% (Kani, 1996:20). Economic growth was not export-oriented and the economy still relied on copper for its foreign exchange earnings despite the mining sector's decline in its contribution to GDP. Jones (1994a: 27) identified eight structural problems affecting the Zambian economy at the time, namely:

1. An extremely high level of debt in relation to exports and GDP. By 1980 the capita per debt burden was the highest in the developing world;
2. A real effective exchange rate whose level had remained almost constant at the pre-1975 level implying no additional incentive to promote non-traditional exports;
3. An agricultural sector whose development had been neglected and was characterised by extreme dualism

between large scale capital intensive commercial farming, and subsistence farming;

4. Continued dependence on the mining sector to generate foreign exchange and government revenues and consequent extreme vulnerability to world price fluctuations and to the exhaustion of mineral deposits;
5. A relatively large manufacturing sector of doubtful economic viability enjoying high external variable rates of effective protection dependent on receiving rationed foreign exchange at a price well below its scarcity value, and intermittently crippled by foreign exchange shortages, and depending on state financial injection;
6. A highly urbanised and rapidly-growing population, with a stagnant formal sector employment and a high degree of dependence on subsidised consumer goods and welfare services;
7. An extremely skewed income distribution, with the richest 5% receiving a third of total income and the poorest 60% only a fifth, and;
8. A political system, which to a considerable degree entrenched the interests of those who had most to lose from reform.

By 1990, the debt burden amounted to 216% of GDP and reached US$7Bn, making Zambia one of the most indebted nations in the world, relative to GDP, especially with GDP declining from 3.7% per annum in the early 1970s to an average of only 1% during the 1974-90 (Mwinga, 1998). By the following year living standards had further declined - 70% of the population was living below the level sufficient to provide for their basic needs, GDP had significantly declined, the external debt increased to 231% of GDP and the current account deficit averaged 12.5% of GDP (Kani, 1996:21; Mwinga, 1998).

1.2 Banks in the financial system before the 1992/93 reforms

Before the 1992/93 financial reforms, the banking sector consisted of four distinct groups – old foreign banks, state banks, new foreign banks and the local banks. The old foreign banks - Barclays Bank (1918), Standard Chartered Bank (1906) and Grindlays Bank (1956) - primarily served the interests of foreign corporate entities. In his 1968 Economic Reforms speech, President Kaunda (1968:27) charged that they '…have not been willing to assist the Zambian Businessman'. National sentiments, as expressed in the national papers, at the time (see Box 1) were highly critical of the foreign banks. In lieu of public pressure, it was '…time to take more drastic steps to assist the People's business to bridge the gap that exists between it and the resident expatriate business' (Kaunda, 1968:27).

Although the state did not nationalise commercial banks, it established its own financial savings institutions, notably the Zambian National Commercial Bank in 1969 (Brownbridge, 1996:2) and the National Savings and Credit Bank (NSCB) in 1972. State intervention continued into the 1980's with the creation of Lima Bank in 1987 and the Co-operative Bank in 1989 (Brownbridge and Harvey, 1996:38-43).

Government intervention, however, was even more dominant in the non-bank financial sector (NBFI) where nationalisation resulted in a small number of monolithic government-owned NBFIs, the most notable institutions being the Zambia National Building Society, which, until the early 1990's was the only source of long term mortgage finance, and the Zambia National Provident Fund (ZNPF) which was the was the sole social security provider in Zambia (Brownbridge and Harvey, 1996:38). As a matter of policy, the former restricted its loans to the amount of its deposits and shares, and in consequence, it actively engaged in savings mobilisation. Even though its deposit rates were below market rates, it offered easy account opening procedures and was accessible with over 200 branches. Consequently, it managed to attract public deposits through the 1970's and 1980's. ZNPF, on the other hand, was eligible to compulsory contributions. Legislation required all employers to deduct a monthly contributions from employees on which the ZNPF then provided annuity benefits roughly represented by the contributions made and an annual interest rate of 6.5%. Yet, the ZNPF never provided any meaningful benefits to its contributors. The Government often used funds from the ZNPF to finance low interest loans to the public sector.

Box 1 Newspaper reports on the banking sector from the early 1970's

Some commercial banks with foreign interests have been accused of sabotaging the economic reforms by refusing to grant loans and overdrafts to Zambian Businessmen. At a meeting of businessmen in Ndola, the banks were accused of mounting a systematic financial war against Zambians by restricting overdrafts on which some of the businesses were being run. Alex Shapi, backed the claim and confirmed that many Zambians had complained about the conduct of certain banks

- *Zambia Daily Mail, 18 August, 1972*

Zambian Shop Owners in Mufulira have bitterly complained about the difficulties they face in obtaining loans from commercial banks. They made their complaints to Copperbelt Minister of State, Mr Joseph Mutale, when he visited shops taken over by Zambians during the economic reforms

- *Times of Zambia, 14th August 1972*

A small committee of Zambians who should look into the whole structure of banking in this country over the next 10 to 15 years has been suggested by Mr Antony Tuke, Chairman Barclays Bank International, following his four day visit here

- *Zambia Daily Mail, 1 August, 1972*

The Development BOZ should be fully operational next year. The MoFs permanent Secretary has already invited application from Zambians to study abroad in the techniques of development banking. Applicants should have university degree or accountancy qualifications and experience in banking. He also said it was impossible to estimate how many expatriate experts would be engaged but it was certain that in the bank's early days the Government would rely on experts from all over the world.

- *Times of Zambia, 1 August, 1972*

Moves to boost personal savings - including an increase of interest rates by a half percent – have been taken by Zambia's five commercial banks. The moves, announced through Standard Bank (Zambia) Limited on behalf of all the commercial banks, are already being warmly welcomed by the man-in-the-street. The chief change is the increase, in interest rates for customers' savings accounts from three and a half percent to four percent. The announcement issued by Standard Bank on behalf of others, said; in conjunction with BOZ, the commercial banks have revamped their interest approach to savings and this is aimed at the man in the street. This also supports the National Savings Campaign.

- *Zambia Daily Mail, 4th August 1972*

Banks in Zambia were yesterday accused of preserving the image of colonialism. The general secretary of the Zambia National Council of Commerce and Industry (ZNCCI), Mt Thomas Chomba, said banks underrated the borrowing power of Zambian Businessmen. He accused banks of taking over where colonialism had left off by regarding a Zambian Businessman as worthless and useless. He called for the formation of an all Zambian commercial Bank. He suggested that each trader should deposit K100 per year with the MoF to establish an all Zambian Bank within 10 to 15 years. "With such a bank you would be assured of a loan when you need it", he said. "The practice today is that loans are given only to expatriates and or naturalised Zambians".

- *Times of Zambia, 17th April 1972*

Until the 1990's, the government also took the lead in providing finance to micro, small and medium scale enterprises in the economy. In the early 1980s, for example, BOZ set up the Credit Guarantee Scheme as a means of encouraging financial institutions to extend more credit to small-scale industries. Other important organizations that the government created included the Small Industries Development Organisation (SIDO), Village Industries Service and the Small Enterprise Promotion Unit. Policymakers thought that banks did not extend credit to this group of entrepreneurs because of their inability to raise adequate collateral. This scheme, like many others before it, relied on government and donor funds for their operations, which precluded the need to raise funds directly from the public (Maimbo, 2001).

Overall, government involvement in the financial sector resulted in an inefficient and non-competitive market. Like other developing countries at the time, before the 1990's government placed greater emphasis on protecting the real sector, with the financial sector only playing an ancillary role. The belief then was that governments could support the real sector through direct involvement in the financial sector, partly by creating their own financial institutions, and by selective credit allocation and price control mechanisms for the entire financial sector. Mehran *et al* (1998) noted five debilitating effects of these trends on the development of financial systems of sub-Saharan African countries during the 1970's and 1980's that are applicable to Zambia's financial sector:

1. There was a low return on capital in the real sector due to the inefficiency of state-managed companies, which were allocated cheap credit by financial institutions as directed by the government. Despite the high levels of credit the

state firms received, Zambia's rate of development was not commensurate with the level of investment.

2. Credit allocation directives resulted in high levels of loan portfolio concentrations, particularly in the agricultural sector. The un-diversified loan portfolios of banks, especially state-owned banks, exposed them to increasing levels of financial vulnerability. Furthermore, the allocation of credit led to the erosion of financial discipline, which in turn left many financial institutions unprofitable, and some insolvent. The ability to borrow at low interest rates encouraged investments in projects with low rates of return. Later, when interests rate ceilings were removed, such borrowers, mostly the state-owned companies, failed to repay their loans because the low rates of return would not match the increased levels of interest.
3. As the economy deteriorated, the government resorted to increased borrowings from the central bank to finance its rising fiscal deficit. Given the small size of the commercial banking system, the central bank was the only institution capable of providing the government with the much-needed liquidity. This resulted in high inflation. Volatility in economic growth and rising inflation made it difficult for banks to evaluate borrowers' credit worthiness, leading to the granting of more bad loans.
4. Negative real interest rates undermined the economic efficiency of the financial system and led to capital flight. Although capital controls were still in place in Zambia during the 1980's, it was common practice to physically smuggle out foreign currency by a variety of means. Furthermore, interest rate ceilings on loans led to an excess demand for credit, which forced banks to ration credit, a process which encouraged rent-seeking behaviour amongst economic agents.
5. Interest rate ceilings and credit allocation directives also undermined liquidity management by banks, resulting in disintermediation and the reduction of the banking systems' client base and overall profitability.

Additionally, the emphasis on credit allocation, rather than domestic savings mobilisation weakened savings mobilisation efforts. Since the government heavily subsidised its financial institutions, management had little incentive to actively encourage savings mobilisation. Neither was there much effort on ensuring that borrowers repaid their loans. Many borrowers considered government loans as the 'fruits of independence.' In fact, lending practices in state banks and public financial institutions ignored the basic commercial principles concerning a loan applicant's character, capital, capacity, collateral and economic conditions. For the above reasons, very few banks entered the banking sector between 1970 and 1990, and those that did occupied niche markets without a significant impact in the deposit market, dominated by the old foreign banks and the state institutions.

Except for Citibank (1979), the 'new foreign banks' – Meridien Bank[1] (1984), Bank of Credit and Commerce (1979) and Indo-Zambia Bank (1985) were primarily retail banks and increased the level of private savings. Citibank concentrated on corporate finance while the Bank of Credit and Commerce expanded rapidly by offering innovative services and attracting business from other banks to capture 7.5% of total bank deposits by 1989. Union Bank purchased the bank in 1991 after the bank's parent company failed (Brownbridge, 1996:8). Unfortunately, Union Bank entered the sector when policies were not particularly conducive to private investment. Interest rate controls, which, together with high reserve requirements, deteriorating macro-economic conditions, political

[1] Although Meridien was lauded as a local bank since its most public shareholder was a Zambian national and the bank had its headquarters in Zambia, the thesis found that the bank's shareholding and control structure makes it impossible to ascertain the origins of its ultimate owners. Meridien International owned the bank and like other Merdien subsidiaries, had its headquarters in an offshore centre.

interference, negative interest rate policies and directed credit policies, depressed profit margins (Brownbridge 1996:9). Further, an inefficient payments system and inadequate legal and accounting standards reduced the banking system's efficiency and its ability to perform its financial intermediation function. The local banks - Finance Bank (1988), African Commercial Bank (1987), New Capital Bank (1989) and Manifold Investment Bank (1987) - had comparatively small deposit and asset bases. They were attracted to the financial sector by the high returns on average investments (ranging from 1.2 to 10.5% in 1990). Moreover, the un-regulated nature of banking entry by the MoF, which required low capital requirements, permitted easy access for the new banks.

1.3 Financial sector reforms

1.3.1 Structural Adjustment Programme

Attempts to restructure the economy with the aid of the IMF and the World Bank during the late 1970s and 1980s failed to yield the desired results due to the lack of adequate political will to implement the prescribed economic policies. As Table 1 shows, the first major attempt at restructuring the economy was made in 1983, when the main thrust of reforms was the removal of regulatory controls, to ease administrative restrictions on the economy. The reforms included the part liberalisation of trade and the foreign exchange markets and the decontrol of interest rates and commodity prices.

However, on several occasions, the government defaulted on its IMF/World Bank agreements (Table 1.3.1.2). This culminated in the government's decision to completely abandon all IMF and World Bank support programmes in 1987, following public riots over the reduction of maize meal subsidies (Jones, 1994a: 31). Debt service payments were unilaterally restricted to no more than 10% of all foreign exchange receipts. However, the subsequent suspension of all external economic aid by IMF, the World Bank and the donor community forced the government to reconsider its position and resume the agreed economic programmes.

Table 1.3.1.1 Chronology of Zambia's Economic Policy Changes

Period	Economic Regime
❑ Before Dec. 1982	❑ Controlled planning and controlled regime
❑ Dec. 1982 - Oct. 1985	❑ Decontrol and deregulation
❑ Oct. 1985 – Apr. 1987	❑ Highly liberalised regime
❑ May 1987 – Nov. 1988	❑ Return to controlled regime
❑ Nov. 1988 – June 1989	❑ Relaxation of some controls
❑ July 1989 – Apr. 1991	❑ Return to highly flexible regime with movement towards full scale liberalisation
❑ May 1991 – Oct. 1991	❑ Political transition with both government and opposition supporting liberalisation
❑ 31 October 1991	❑ New government of President Chiluba took over power from that of Kaunda during elections
❑ Nov. 1991 - 1996	❑ Fully fledged structural adjustment programme (SAP) and stabilisation policies

Source: Saasa (1996)

Table 1.3.1.2 Policy agreements between Zambia and the IMF/World Bank

Period	Policy agreement
1981-85	Attempted stabilisation and limited liberalisation, initially under an IMF extended fund facility, and then under a stand-by agreement.
1985-86	An intensive reform effort during which the foreign-exchange auction operated and the abolition of food subsidies was attempted
1986-87	A period of disintegration of the IMF and the World Bank programme, culminating in the formal break in May 1987
1987-89	An attempt to go it alone under the Interim National Development Plan from May 1987 to June 1987
1989-91	Rapprochement with the Bretton Woods institutions, a phase beginning formally in June 1989 and lasting up to September 1991 when the programme broke down as food subsidies were increased following drought and the collapse of the marketing system in the run-up to elections

Source: Stephen Jones (1994a)

The key areas of reform were External Sector Adjustment, Financial and Fiscal Reform, Agricultural Pricing and Food Subsidy Reform (Jones 1994b:32). The economic reform programme emphasised the need to reduce the government deficit, improve its balance of payments position and develop a more balanced approach to economic growth. Although the government implemented some of the reforms, it was not until after the change of government in 1991 that the State showed the necessary political-will to fully implement the economic reform programme. In October 1991, the government commenced the implementation of the Structural Adjustment Programmes (SAP) agreed with the IMF and the World Bank. This enabled the World Bank to resume disbursements in January 1992. In July 1992, the government signed the Rights Accumulation Programme with the IMF, enabling Zambia to pay back arrears to the IMF by accumulating rights to future borrowing as long as Zambia continued with the Structural Adjustment Programme and met the agreed benchmarks. The government/World Bank/IMF designed the 1992-1994 SAP to achieve a real GDP growth of 2% in 1992, 3% in 1993