SUPPORT FOR BANK OF ZAMBIA IN RELATION TO CREDIT MARKET REGULATION

REVIEW OF CURRENT PAYROLL LENDING MARKET

Report for dissemination

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PlaNet Finance Southern Africa – Albury Office Park, Dunkeld West, Johannesburg

Tel. + 27 (0) 11 593 3101

www.planetfinancegroup.org

Contacts

PlaNet Finance

Mr. Xavier BERTRAND
Managing Director
PlaNet Finance
Paris – France (Headquarters)
xbertrand@planetfinance.org

Ms. Delphine BAZALGETTE
Director: Projects
PlaNet Finance
Paris – France (Headquarters)
dbazalgette@planetfinance.org

PlaNet Finance Southern Africa

Ms. Frances Fraser
Regional Director for Southern and East Africa
PlaNet Finance Southern Africa
Building 4, Albury Office,
Magalieszicht Ave,
Dunkeld West, 2196,
Johannesburg
South Africa
ffraser@planetfinance.org
Tel: +27 (0)83 454 8424

Mr. Bezant CHONGO
Regional Microfinance Expert
PlaNet Finance Southern Africa
Building 4, Albury Office,
Magalieszicht Ave,
Dunkeld West, 2196,
Johannesburg
South Africa
bchongo@planetfinance.org
Tel: +27 11 593 3146

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List of Acronyms

AMIZ	Association of Microfinance Institutions in Zambia
ATM	Automated Teller Machine
BAZ	Bankers Association of Zambia
BFSA	Banking and Financial Services Act
BFS Bill	Banking and Financial Services Bill
BoZ	Bank of Zambia
CBP	Code of Banking Practice
CCPC	Competition and Consumer Protection Commission
CSO	Central Statistics Office
CRB	Credit Reference Bureau
EFT	Electronic Funds Transfer
FSAP	Financial Sector Assessment Program
FSDA	Financial Sector Deepening Africa
FSDP	Financial Sector Development Plan
IMF	International Monetary Fund
GRZ	Government of the Republic of Zambia
HR	Human Resources
IT	Information Technology
LUSE	Lusaka Stock Exchange
MFRAF	Macro Financial Risk Assessment Framework
MFI	Microfinance Institution
MMP	Market Monitoring Programme
MOU	Memorandum of Understanding
MSME	Micro, Small and Medium Enterprise
NATSAVE	National Savings and Credit Bank
NBFI	Non-bank Financial Institution
NCR	National Credit Regulator
NPL	Non Performing Loan
PEN	Peruvian Nuevo Sol
PIA	Pensions and Insurance Authority

PMEC	Payroll Management and Establishment Control
PSMD	Public Service Management Division
RSA	Republic of South Africa
RWA	Risk Weighted Assets
SEC	Securities and Exchange Commission
SME	Small and Medium Enterprise
TSD	Technical Services Department
USD	United States Dollar
ZACLI	Zambia Association of Commercial Lending Institutions
ZamCRA	Zambia Credit Reporting Alliance
ZAR	South African Rand
ZMW	Zambian Kwacha

The exchange rates applied in this report are ZMW 1 = ZAR 1.80 and USD 1 = ZMW 6.

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I. Executive Summary

1. Overview

The purpose of this report is to document the results of an assessment of the payroll lending sector in Zambia. The study was commissioned by Financial Sector Deepening Africa (FSDA) on behalf of the Bank of Zambia (BoZ) and was carried out between July and November 2014. The study forms part of a broader theme of work initiated by FSDA on credit markets within the region and emanates from a rapid appraisal of the payroll lending market which was undertaken in Zambia in July 2013 following the introduction of interest rate caps.

FSDA's reason for commissioning this study was to understand and quantify the extent of systemic and operational risks that may have arisen as payroll lending has grown in prominence. Based on data collected from the largest payroll lenders, the assessment team estimates that payroll loans now account for one-third of all Zambian banking system loan value, up from 25% at the end of 2008. Personal loans, driven by payroll loans, have been the largest contributor to commercial bank loan portfolio growth every year since 2011, accounting for just under one-third of the total growth of the Zambian credit markets between June 2010 and June 2014.

Yet even though payroll lending is a key driver of Zambian credit market growth, information is scant and oversight and regulation is limited. To date, the most important initiative in regulating payroll lending has been a voluntary decision by leading lenders and employers to limit total payroll loan and non-loan deductions (taxes, allowances, etc.) to 60% of gross pay (e.g., employees must take home at least 40% of their gross pay) in line with the civil servant payroll deduction threshold. However, for many households this threshold is too high, and indebtedness levels are increasing.

Given the growing exposure of banks and microfinance institutions (MFIs) to payroll lending and the concentration of portfolio growth within particular market segments the assessment raises significant questions about the operational and systemic risks that have already been introduced into the Zambian financial sector, or that could become risks in the future.

2. Primary observations

Current estimates indicate that the total number of formally employed persons in Zambia is approximately 900,000, of which 500,000 work in the private sector and 270,000 work for central or local government. An additional 60,000 work for parastatals, with the remaining 70,000 working for non-governmental organisations (NGOs) or other entities (Labour Force Survey, 2012).

As at mid-2014, there were approximately 360,000 scheme loans outstanding, of which nearly three-quarters (270,000) were to government employees, with the remainder lent to employees of private sector companies and parastatals. Exposure is not as broad as these numbers imply. Although official figures are not available, the assessment team estimates that about half of all payroll borrowers have more than one loan outstanding, with the highest incidence of multiple borrowing found among government employees.

Financial institutions of all legal types engage in payroll lending in Zambia. Commercial banks dominate the segment with 79% market share in terms of value (Bank of Zambia, 2014). MFIs, building societies, leasing companies and the National Savings and Credit Bank (NATSAVE) are also involved. Exposure to the payroll lending market varies widely among financial institutions even of the same type.

Just as employees' exposure to payroll loans is still concentrated, lending is also still fairly concentrated. Twelve financial institutions account for 96% of all payroll loans. These institutions are among the largest in the country, and eight of them have more than half their entire loan book exposed to the sector. This extreme concentration of exposure among all the leading financial institutions in Zambia raises significant concerns about the potential for operational or systemic risk in the Zambian financial system.

Available data (gathered in this study) indicates that some subsectors of the financial system are inadequately capitalised and insufficiently liquid to withstand a crisis, most specifically the non-bank financial institutions. There are also specific commercial banks that face significant risk in the event of a crisis in the payroll sector due to the exposure in the market, within their portfolio or due to capital adequacy and/or liquidity. Several of the more prominent payroll lenders are affiliates of multinational financial institutions, with presumably better access to capital that could be brought to bear in a crisis. Most of Zambia's largest financial institutions have placed more than half their portfolio into one type of product (payroll loans), and mostly to one type of borrower (government employees). This exposes them to changes in policy by the executive, the legislature, and the government's payroll administrator (PMEC). With 47% of all payroll loans being administered through PMEC, and given the power they hold to adjust the threshold or stop payroll lending altogether, there is an evident systemic risk for the market.

3. Implications of payroll lending growth

Although some payroll lenders claim that their loans are being used to finance income-generating activities, there is no systematic collection of loan utilisation information to support this claim. Based on this research effort, observers (and borrowers) unanimously agree that the loans are being used for a variety of activities, from home/land purchase to home repair to purchasing large moveable assets such as a car to meeting daily needs as well as lifecycle expenditures such as school fees and funeral costs.

The lenders make credit decisions based more on the creditworthiness of the employer than of the borrower. Lenders pay little attention to the reasons for borrowing, nor do they conduct a loan utilisation check. An environment in which the credit assessment process is relatively straightforward and loan use monitoring is not done often creates incentives to over lend, especially if several years of low credit risk have provided lenders with the confidence to further expand their loan books. Indeed, one way in which payroll lenders maintained profitability after the introduction of the interest rate caps was to increase their loan sizes. As a result payroll lenders soon began extending loan tenures to 48 and even 60 months to make repayments of such large loans affordable. This market trend hints at the potential contradiction between profits and responsible lending and needs to be monitored.

Unfortunately, since payroll lending involves different types of institutions with different regulations, reporting requirements and reporting ability, no consolidated and comparable data on payroll lending exists. Payroll lenders are required to report to TransUnion Zambia, the credit reference bureau, but their data showed a very low proportion of non-performing loans, raising concerns that actual risk in current payroll lending portfolios is unknown.

Since payroll lenders operate under different regulations and the Bank of Zambia (BoZ) has not yet adopted any product-based approach to regulation, there is no specific supervision of payroll or consumer lending in

Zambia. The only initiative to manage the extent of payroll lending to date are the rules set by payroll administrators, notably PMEC (the payroll system for the civil service), and internal risk policies of credit providers which have become common to most payroll lenders. Since the introduction of the PMEC affordability threshold in May 2012, lenders have begun to apply the same limit of 60% on the proportion of loan repayments and other deductibles (taxes, allowances, etc.) as a percentage of gross pay as a general practice.

It is not clear if the 60% limit was arrived at through thorough analysis or if it is simply a "rule of thumb". Either way, the assessment team's analysis indicates that take-home income at 40% of gross pay is insufficient for the average government, private sector or parastatal employee to cover basic living expenses. Though it is understood that many of these households may have additional sources of income (although no data could be found to provide hard evidence of this), any secondary sources of income are not likely to be as large or as stable as the primary employment income. The implication, therefore, is that a growing number of middle class families in Zambia have reduced their relatively stable financial situation through increasing levels of debt.

4. Conclusion and Recommendations

In a country where access to credit cards and other forms of short-term and revolving debt is extremely limited, payroll loans are a primary source of credit for many Zambian households. Payroll loans have enabled borrowers to make large-ticket purchases as well as smooth their cash flow cycles. Payroll lending thus plays an important role in financial inclusion in Zambia.

As a result, regulators and other stakeholders confronting growing exposure to payroll lending must find ways to balance the requirement of eliminating systemic risk with the need to maintain adequate access to those who need and qualify for payroll loans.

The evidence suggests that the interest rate cap imposed in January 2013 did not achieve either of these goals. Although some loan providers reacted to the cap by reducing their exposure, it has not resulted in an overall reduction in the supply of payroll loans. Many providers, faced with lower interest rates, increased loan sizes and loan terms to maintain repayment affordability. Thus, an unintended consequence of the interest rate cap has been an increase in the level of indebtedness rather than a reduction.

Based on an analysis of the current situation in Zambia as well as case studies on payroll lending markets in South Africa, Peru and Brazil, the assessment team's recommendations are the following:

<u>Strengthen supervision through improved data gathering</u>

Sufficient data for monitoring payroll lending is a key issue that must be addressed. Standardised and more frequent reporting is crucial, especially on non-performing loans as per the work that is underway on the Market Monitoring Programme (MMP). The international case studies demonstrated the importance of registering and monitoring all consumer lenders that operate above a minimum threshold as defined by local conditions. Rather than just monitoring gross figures, personal (and thus payroll) loans also need to be monitored in terms of concentration in specific economic sectors and according to income levels of borrowers. Detailed reporting for non-performing loans is also required.

The BoZ's ability to enforce reporting may also need to be strengthened. For this assignment, a number of institutions did not (or could not) report the requested data. BoZ's internal database of each institution's financial statements needs to be complete and digitised. Data on the financial performance and position of all credit providers needs to be accessible in a comparable format with sufficient detail to identify network risk.

The team also recommends that the BoZ conducts annual research on over-indebtedness and abusive practices. Over-indebtedness is difficult to track quantitatively since it involves more than just measuring debt repayment levels against disposable income. For example, the flow of income and expenses including expenditure choices by households needs to be clearly understood. This information is best captured qualitatively (such as through focus group discussions with different client segments) to monitor the ability of borrowers to meet household expenditure requirements without cutting corners. To determine the scale of over-indebtedness, some quantitative data is also required. Such information in future will be useful to help inform the setting of the debt threshold for payroll loans.

Regulation

The international case studies show that it is important to regulate consumer lending in terms of market conduct, to make sure that borrowers are well informed on all components of pricing and other terms and conditions and that abusive practices are not tolerated. Transparency requirements designed to foster competition may benefit clients with better products and services while slowing the growth of supply as premium profits are reduced.

A more direct approach to regulating payroll lending is also possible. The current draft of the Banking and Financial Services Bill includes clause 67(2), which limits the total amount of debt repayments and other deductions to a certain percentage of monthly income: a client is presumed creditworthy if "the total monthly debts due on outstanding obligations, including amounts under the loan, do not exceed 70% of his or her monthly gross income." The assessment team recommends that this clause be revised to include a lower debt carrying threshold (based on a thorough analysis by BoZ) and a detailed definition of how the threshold should be calculated. It is also recommended that the law provide BoZ with the authority to change the threshold as a future risk management mechanism. (Since this report was drafted, these recommendations have been adopted). Furthermore, the law could also include a more explicit requirement for lenders to assess the affordability of borrowers with consequences for reckless lending when it is not adhered to.

Another regulatory reform that would address systemic risk would be to raise the capital adequacy and liquidity requirements of the banks and non-bank financial institutions with exposure in this market. Both need to be reviewed and reconsidered in light of the current solvency and liquidity positions and their exposure to the payroll loans.

Off-site inspection

Another way to monitor payroll lending is through off-site inspections, which should specifically consider the exposure of banks to payroll deducted loans. One area where BoZ could intensify its supervision is in the policies and procedures lenders use to categorise non-performing loans with spot-checks of loan books during on-site inspections for verification. The data collected for this assessment from lenders showed unreliably low values of non-performing loans. Similarly, data provided by TransUnion Zambia from their credit reference bureau also showed unreliably low reporting of non-performing loans (NPLs). Whether this is due to lax reporting or poor accounting standards for NPLs, requires further investigation.

The BoZ should also consider developing additional capacity to enable more hands-on supervision with regards to lending practices and affordability assessments. Inspections of institutions (including client random files) to enforce suitable affordability assessment standards and sound lending practices need to be considered.

Structural reform/financial sector development

Continued development of the Zambian financial sector is the long term solution to the concentration of risk in payroll lending. A more robust financial sector, which offers a variety of competitive specialised credit products, would likely lead borrowers to diversify their credit portfolios, using specific products for specific needs.

One of the key systemic risks emanating from payroll lending is due to the overexposure to PMEC, which leaves key financial institutions exposed to technical problems with PMEC's information system as well as changes in policy or administrative practices. Exposure to PMEC is unlikely to decline, as lenders target rural government workers, including teachers and health workers.

In the short term, increased communication and coordination between BoZ and PMEC is recommended through regular meetings, data monitoring and information sharing. In the longer term, the development of national payment systems, currently being addressed by BoZ, should contribute to reducing payroll lenders' exposure to PMEC and provide alternative payment mechanisms which would in turn diminish the risks linked to PMEC.

Naturally, monitoring, supervision and regulation should all be geared toward preventing a crisis. However, BoZ should also prepare for the worst case scenario. At a minimum, the BOZ should develop an appropriate strategy for dealing with banks where the exposure to payroll loans is deemed too high or when it is increasing too rapidly. If a debt crisis occurs, there will need to be some process for restructuring the loans or winding them up to avoid a collapse in the financial system. At least 50% of current payroll borrowers have more than one loan, but there does not appear to be a clear rule for how to apportion losses when a borrower defaults on multiple loans. A method for doing so should be clarified and communicated to the financial sector.

II. Background to the study

1. Background to the study

The purpose of this document is to report on the results of a comprehensive review of the payroll lending sector in Zambia. The study was commissioned by Financial Sector Deepening Africa (FSDA) on behalf of the Bank of Zambia (BoZ) and was carried out by PlaNet Finance between July and September 2014. The study forms part of a broader theme of work initiated by FSDA on credit markets within the region and emanates from a rapid appraisal of the impact of the interest rate caps on Zambia's credit market concluded in July 2013.

Box 1: Background on BoZ and FSDA collaboration

Financial Sector Deepening and Bank of Zambia collaboration

FSDA's programme of support to BoZ is comprised of three inter-related components, summarised below, which ultimately aim to build BoZ's capacity to regulate Zambia's credit markets based on good quality data and meaningful analysis and thereby promote developmental credit broadly (i.e. not just lending by MFIs, but also by other NBFIs and banks in sectors such as housing and SMEs). FSDA is working closely with BoZ throughout the implementation of this programme.

Component 1 – rapid assessment and short-term advice on regulatory and implementation options to mitigate any potential negative consequences to financial inclusion arising from the introduction of interest rate caps;

Component 2 - design and roll-out of a research programme to monitor and analyse the impact of regulatory changes on financial institutions in the credit market, as well as on financial inclusion more broadly, and;

Component 3 – co-ordination of a comprehensive assessment of Zambia's credit markets to identify structural problems and propose a regulatory strategy to enhance the capacity of the market to support Zambia's economic development strategy for the future.

In parallel with the research on the payroll lending market as contained in this report, the research programme described above includes the development of a detailed set of recommendations for the purpose of monitoring the credit market. The recommended reporting – encapsulated within the credit MMP - will enable the BoZ to have a clearer view of the trends that are occurring within the credit market thereby enabling improved market risk management and evidence-based regulation. Based on the experience of conducting this research, the proposed reports are highly relevant and necessary for ongoing monitoring of the possible systemic risks in the sector. Varying capacity across different credit providers to provide the requested information during this study was evident and will be an important consideration in terms of the effective implementation of the proposed reporting requirements.

In addition to the MMP, a further component of work is underway to recommend a range of credit policy options to the BoZ, including regulation related to pricing within the context of interest rate caps introduced in Zambia in early 2013. These policy recommendations are also highly pertinent to the payroll lending study. An overview of the policy and regulatory framework and how it relates to the payroll lending market specifically forms part of this report as well and forms a key component of how to manage identified systemic risks.

2. Objectives of the study

In 2004, the Government of Zambia introduced its financial sector reform strategy – namely the Financial Sector Development Plan (FSDP) as a mechanism for contributing to economic growth in Zambia. The FSDP identified a range of areas for improvement in the financial sector including: (i) levels of financial intermediation; (ii) credit culture in the market; (iii) the role of the Government in the financial sector; (iv) the regulatory framework for Non-Bank Financial Institutions (NBFIs), insurance and pension funds; (v) the development of the capital market; (vi) long term development and housing finance; and (vii) monetary policy instruments[1]. The second phase of the FSDP continues to focus on financial sector development in areas that influence the credit market.

In the region, South African payroll based lenders[2] have demonstrated increased outreach in countries within the region. This expansion has been driven by market opportunity but also by signs of saturation and increased regulation within South Africa. Zambia has experienced an influx of South African payroll-based lenders in the market. At the same time, in recent years, the drive to attain financial sustainability by some of the traditional micro-enterprise lenders (developmental MFIs) has also seen a few of them enter the payroll based lending market segment. This is primarily on the basis that payroll lending is more cost-effective and profitable than micro-enterprise lending.

Within the context of the Government of Zambia's plans to enable access to credit and other financial services within a stable and safe market, the influence of payroll-based lenders in the market has been identified as an area for attention.

The objective of the assignment is to gain a comprehensive view of the payroll lending market in Zambia with the view to understanding the systemic and operational risks emanating from this sub-sector. Ultimately, the outcome of the payroll lending market study will inform recommendations on the management of the risks emerging from this sub-sector including possible regulation, supervision, reporting and/or other mechanisms.

In summary, the objectives of this assignment are to:

i. Analyse the current structure, size, rules and operations of the payroll lending market to identify and assess operational weaknesses and systemic consequences of these weaknesses on Zambia's financial markets;
ii. Generate insights that might inform the credit MMP design and pilot testing, and;
iii. Provide recommendations to the BoZ on policy, regulatory and other measures intended to address weaknesses and mitigate risks identified and thereby strengthen the market.

[1] Financial Sector Development Plan, Ministry of Finance and Economic Planning, 2004.
[2] In South Africa these tend to be debit order-driven payday lenders and do not necessarily deduct from source (payroll).

3. Definition of payroll lending

The focus of this report is specifically on the payroll lending sector in Zambia. However, payroll lending occurs within the context of a broader credit market and financial sector and as such this report provides some background on the overall market.

For the purposes of this study the following dimensions of lending were taken into account in defining payroll lending:

- The purpose for which the credit is provided;
- The type of institution providing the credit;
- The duration of the credit;
- Unsecured credit, and;
- The means of collecting repayment for the credit.

1. **Purpose of credit**: A payroll loan is a general purpose loan, widely referred to as a personal or a consumer loan in which the access to credit is not determined by the intended use. This is in contrast to traditional microfinance loans which are only granted for pre-determined developmental purposes such as financing housing or microenterprises.

2. **Credit provider**: A payroll loan can be provided by a wide variety of financial institutions that provide credit including commercial banks and non-bank financial institutions such as microfinance institutions. For the purpose of this assessment payroll loans will also include the credit provided by an employer to its employees in partnership with other institutions that provide the capital for onward lending (such as pension schemes and insurance companies) for the purpose of predetermined purposes such as housing. This element is especially critical in understanding the systemic risk of payroll loans arising from inter-connectivity of the different financial sub-sectors.
3. **Duration of the credit:** Payroll loans in most of the literature are synonymous with pay-day loans which tend to be short term loans repaid over 1-3 months. However, for the purpose of this research payroll loans will not be restricted to short term loans. Instead the study will include long term loans which may have a tenure of several years provided the means of loan repayment is related to preferential access to the salary by the credit provider. In the past the short term loans (less than 3 months) were most prevalent. Now, longer term loans are increasing in popularity with borrowers and lenders (because they are more profitable). However, there is insufficient data to show exactly what the split is between short term and long term loans.
4. **Unsecured credit:** Payroll loans are not asset/collateral backed credits in the traditional sense as they do not require backing by perfected securities. The security undertaking is assured by the future income of the borrower hence they are granted on the basis that the borrower can prove that s/he is in employment and will remain so for the foreseeable future covering the duration of the loan. In some circumstances where the amount of credit involved is large and/or the tenure of loan relatively long, the gratuity could be taken as additional security.
5. **Means of collection:** In terms of the collection mechanism, the narrow definition of a payroll loan involves a deduction of the loan instalment from the borrower by the employer through the payroll prior to the pay-out of their salary. There are however other variants of this mechanism which are also loosely classified as payroll loans primarily because they all refer to preferential access to the borrower’s salary income to deduct the credit instalment. Some of the alternative methods in use in Zambia and

elsewhere include retaining bank card and pin, debit orders, direct debits and cash payments. In the case of this study the broader definition that encompasses all these mechanisms will be utilised.

Based on the above dimensions the definition of the payroll loan that will be used for the scope of this research encompasses the following elements:

Table 1: Definition of payroll lending

Purpose of credit	Credit provider	Duration	Unsecured credit	Means of collections
For undefined purpose but could also be for a specific purpose such as housing and provided by the employer hence deducted through payroll	Commercial banks Non-banking financial institutions Employers Hire purchase shops Retail shops	Traditionally short term but could also be long term (some institutions offer 48 or 60 month loans, especially for large amounts)	Relies on the future salary income for repayment In some circumstances – large and longer loans gratuity[3] used as additional security	Direct payroll deduction Debit orders Card and pin Direct debits Cash payments

The definition used here is broad, enabling the research team to determine the extent to which scheme arrangements (where the means of collection is strictly direct payroll deduction) feature in the broader personal loans market. Based on

Table 2 and

Table 3 it is evident that scheme loans form a significant proportion of all loans in the market:

Table 2: Scheme loans/ payroll loans as a proportion of all personal loans (by value)

Scheme loans as a % of all personal loans (value)						
Social MFIs	**Commercial MFIs**	**Banks**	**Building societies**	**NATSAVE**	**Leasing companies**	**TOTAL**
12%	74%	58%	10%	67%	73%	59%

Table 3: Scheme loans/ payroll loans as a proportion of all personal loans (by volume)

Scheme loans as a % of all personal loans (volume)						
Social MFIs	**Commercial MFIs**	**Banks**	**Building societies**	**NATSAVE**	**Leasing companies**	**TOTAL**
3%	65%	77%	4%	39%	81%	65%

[3] Gratuity in this context refers to a lump sum payment that employees on fixed term contracts receive at the end of the contract term. This is at time used as security for the loan, especially in cases where the duration of the loan is longer than the term of the employment contract.

4. Framework for the study

The study is based on exploratory work with a diversity of stakeholders to gain a view of the payroll lending sector through different lenses or perspectives. The following perspectives on the market were sought:

- Technical experts operating outside the Zambian market;
- Lenders or suppliers of payroll loans across different institutional structures;
- Payroll lending borrowers;
- Human resource departments of selected employers including government and private sector;
- The Payroll Management and Establishment Control (PMEC) responsible for administration of the majority of government employees' payroll;
- Regulators in different parts of the financial sector;
- Unions that represent employee interests;
- Consumer protection agencies that bring a view of the consumers, and;
- Meso level stakeholders that provide financial sector infrastructure, namely credit bureaus and industry associations.

5. Structure of the report

The report is made up of ten sections, as is detailed in the Contents page, starting with an Executive Summary and followed by the Background to the study in Section Two. The main body of the report starts with a high level mapping of the sector showing the different stakeholders and a view on their relative role in the sector. The aim of this section is to sketch a map that acts as the guide for the balance of the report. Section Four describes the policy and regulatory environment within the Zambian financial market. It includes a view of the historical development of the policy framework as well as plans for the future. Section 5 provides information and a few on the PMEC responsible for administering payroll deductions for civil servants in Zambia. Sections Six and Seven provide a detailed view of the demand and supply of the payroll loans market respectively. The section includes the quantification of the sector using a range of different measurements that were available through different sources approached during the study. The analysis of the payroll lending market as well as the identification and assessment of systemic risks is presented in Section Eight. The last section of the report provides recommendations to the BoZ on how to mitigate and manage the potential risks that were identified during the study. Three country case studies are described in Annex Seven which provide insights into risk management mechanisms that have been implemented by regulators in other countries that have prominent payroll lending markets. The measures used are considered as possible solutions in the Zambian context through considering both the differences and the similarities in the different markets.

This version of the report has been adapted for public dissemination to mask the names of the financial institutions that form part of the research and the generalise some information for the purposes of protecting confidentiality.

6. Research methods

A range of different research methods were used to collect the data. The investigation included:

Desk research: reviewing existing research that has been completed related to credit regulation and supervision in the payroll sector and information that exists within Zambia.

Key informant interviews: are the primary sources of data for the assignment. Interviews were conducted with a broad range of local and some international experts. Information gathered from the different interviews was compared and contrasted during the analysis process. Meetings with stakeholders were requested by BoZ and in some cases high level questions were sent to respondents on request ahead of the time. Additional portfolio data was also requested from all registered entities following the interviews with assistance from BoZ.

Mystery shopping: was carried out on a very limited basis given that accessing mystery shoppers with the right profile and necessary application data to access payroll loans was not feasible. A limited number of mystery shopping interactions were hence conducted to the point of finding out about payroll loan applications in branches and the requirements to access a loan.

Focus group discussions (FGDs): Groups of eight to 10 individuals were chosen across a range of different employers, namely the Zambia Army, Lusaka District Education Board, Lusaka District Community Medical Office, Zambia Sugar and Mopani Copper Mines Limited. They participated in a guided discussion to solicit opinions and perceptions on the impact of payroll loans, their experiences with regards to debt, their typical usage of payroll loans and the role it has played in their lives.

Secondary data analysis: Existing quantitative market research, reports on the financial sector, BoZ financial sector data and various government reports (Labour Force Survey, Living Standards Survey, employment earnings reports) were used to inform the study.

Following the data collection and report writing, the draft report was presented to Bank of Zambia and Financial Sector Deepening Africa for review and comment. Comments were also received from Gabriel Davel (former National Credit Regulator in South Africa). This version of the report includes the changes as a result of the feedback and validation received from these stakeholders.

A table providing a summary of the data collected from different sources using different methods is included in Annex One of the report. The detailed research tools are included in Annexes Three, Four and Five should further detail be required.

7. Limitations of the study

The following were limitations to the study:

Portfolio information in a standard format over the longer term was difficult to access. This was anticipated given that the MMP aims to address this precise gap in reporting from institutions. To overcome this the research team gathered data through different sources and approaches such as asking for high level information in the key informant interviews, credit bureau data, data requests to the lenders via BoZ and existing portfolio information from the BoZ. This approach enabled the research team to cross check information across different sources. Despite this, the information provided by institutions in response to the request was not always provided according to the template. This data gathering process provides some useful lessons for the MMP.

Mystery shopping was difficult to carry out because the research team did not have access to suitable mystery shoppers that would be able to carry out the loan application process from start to finish. The mystery shopping was therefore limited to the pre-application stage.

Quantitative study on loan usage: there may be a need for a follow-up study that explores the use of loans in much more detail than was possible in the scope of this research. Information on the utilisation of loans is important in terms of understanding the sustainability of the lending patterns emerging in the market. Varying levels of indebtedness might be tolerated depending on whether debt is being used for building assets or wealth as well as being invested in business or education. Little representative research or reliable information exists about what payroll loans are used for. There is a lot of speculation about it being used for housing, enterprise development, asset acquisition and education but this is mainly based on what the borrowers tell the lenders at the time of application or information from the lenders (both borrowers and lenders may be conflicted in terms of wanting to influence the credit decision or defending the positive social impact of loans).

III. Mapping the payroll lending sector in Zambia

1. Overall context

Payroll lending emerged in Zambia at the turn of the twenty first century. Following the privatisation of the copper mines and other former state-owned industries, there was an increasing need for new private owners of the industrial corporations to provide what was considered as an employment benefit in the form of employee loans. Unlike the previously stated owned firms, the new private owners were not prepared to tie-up scarce capital in employee loans that could otherwise be used for capital investment in the corporation. This was especially the case for the copper mines. This led to a business opportunity spearheaded by foreign investors from the financial services side, primarily from South Africa, who set-up the first payroll lending microfinance institution (MFI) scheme loans with the copper mines. These schemes involved the MFI entering into an agreement with the employer under which it would provide short-term credit to the employee with an undertaking from the employer to deduct the loan instalments on a monthly basis on behalf of the MFI.

This model proved very successful on the Copperbelt and was soon extended to other major employers in the country such as government and parastatals. The model was very favourably viewed and beneficial to all three key stakeholders:

Employee: Before the advent of payroll lending there was very limited access to personal credit on the market. The model enabled access to credit and financial empowerment for the average person in formal employment for the first time.

Employer: It released corporations from tying up capital in employee loans that could otherwise be reinvested in the company. In addition, more employees were able to access loans from MFIs than through their employer.

MFI: The credit provider was able to serve a market that had previously been considered too risky to lend to due to lack of a reliable collections mechanism. The payroll deduction provided a reliable collection mechanism.

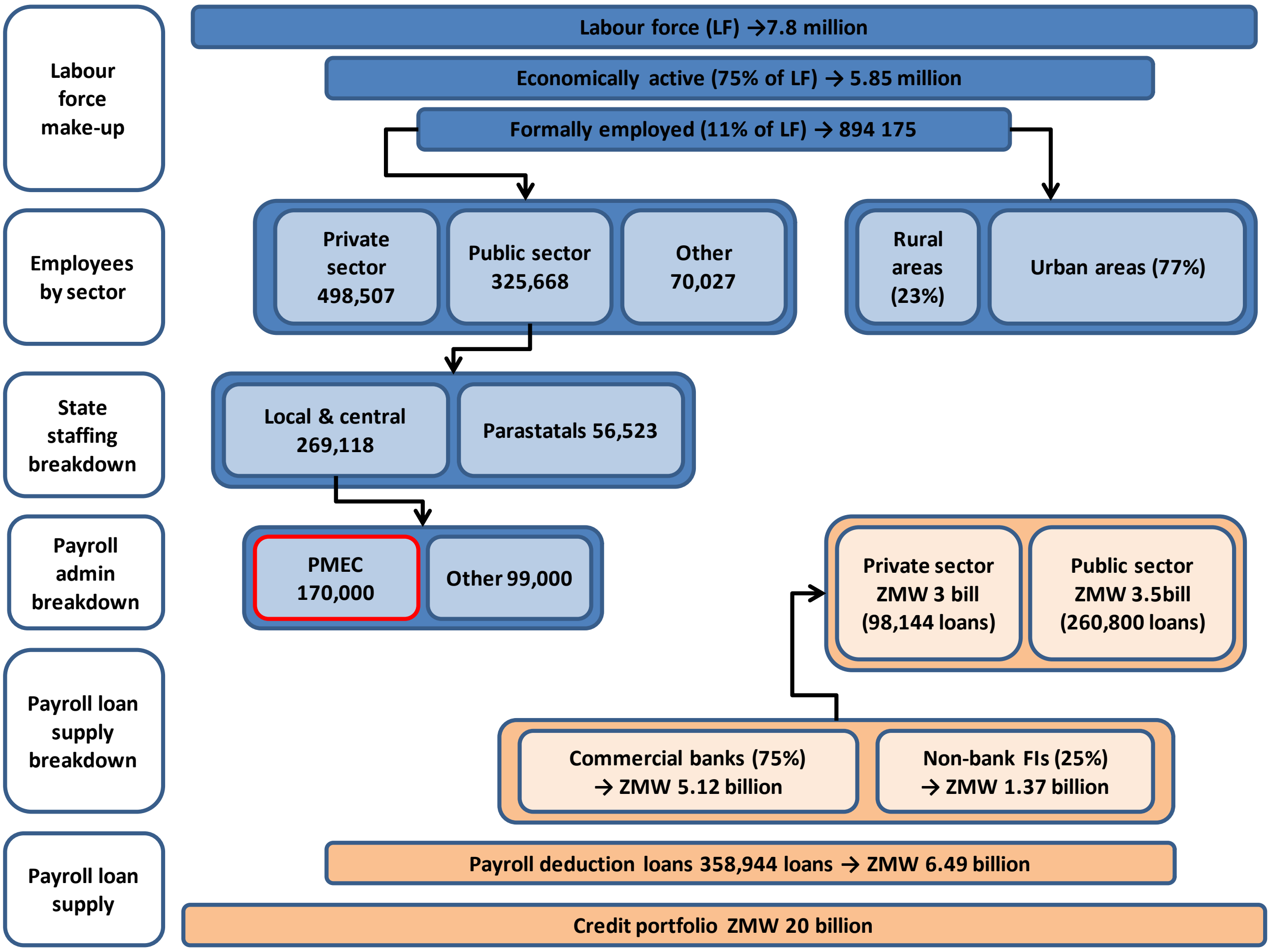
Once the viability of the payroll lending model had been proven it attracted the attention of mainstream commercial banks that then cautiously entered the market by providing on-lending capital to the MFIs at commercial rates. However, by the late 2000s a number of commercial banks had started providing payroll or scheme loans themselves by entering into agreement with key employers such as government, parastatals and large private corporations like the mines. While the MFIs continued to provide short-terms loans of up to six months, the entrance of the commercial banks saw payroll loans being extended to terms of up to 60 months. Zambian consumers were able to access large loans for the first time, making it possible to acquire high value assets like motor vehicles and residential properties (either through outright purchase with the payroll loans supplementing other funds or self-built homes through incremental building over several cycles of loans).

For the above reasons, payroll loans have been widely lauded as beneficial from a financial and economic empowerment perspective. However, the growth of the payroll lending market took place in a regulatory environment that was not geared towards an active consumer credit market and thus lacked adequate consumer protection and market conduct management mechanisms. As the sector has grown, so has the anecdotal evidence that borrowers are being subjected to exploitative pricing and over-indebtedness. This has led to the regulator developing a regulatory framework that seeks to limit the growth of payroll lending while encouraging more growth within other market segments such as enterprise and rural microfinance.

2. Map of the payroll lending market

The structure of the market will be described in more detail in the following sections of the report. However, Figure 1 provides a high level summary of the different stakeholders in the market, how they connect with one another and their relative size and power in the sector.

Figure 1: High level diagram of the Zambian payroll lending market



IV. Policy and regulatory review

1. Industry regulators

There are three specialised financial sector regulators in Zambia. These are the Bank of Zambia, the Pension and Insurance Authority and the Securities and Exchange Commission.

Bank of Zambia (BoZ)

The BoZ as the Central Bank is responsible for formulating monetary policy. In addition it is in charge of prudential regulation and licensing of the banking and microfinance sector, development banks, savings and credit banks, leasing companies and building societies. It is also in charge of managing the interbank payment and settlement system. The BoZ currently regulates and supervises 19 commercial banks, six Tier One (deposit taking) MFIs and 27 Tier Two (credit only) MFIs[4]. The framework for this is described in more detail later in this section of the report.

Pensions and Insurance Authority (PIA)

The PIA has regulatory and supervisory functions over insurance and reinsurance companies and intermediaries, claims agents, assessors, loss adjusters, pension schemes, fund managers, administrators and custodians. The PIA was interviewed in the scope of this research given the significant role of credit life insurance in the personal lending market and the interconnectivity between some of the microfinance institutions involved in payroll lending and some leading insurance companies.

Securities and Exchange Commission (SEC)

The SEC is the authority responsible for the supervision and the development of the capital market. It is also responsible for the licensing, regulation and supervision of its participants, including securities exchanges, securities brokers and dealers, investment advisors, and collective investment schemes. This is of relevance for this payroll lending study given that financial institutions are in a position to raise capital on the open market regulated by SEC.

Other than the three primary regulators, institutions that also play a role in regulating the financial sector include the:

Ministry of Finance

The Ministry of Finance is the authority in charge of licensing, regulating and supervising moneylenders.

Competition & Consumer Protection Commission (CCPC)

The CCPC, formed in 2010, is a body under the Ministry of Commerce Trade and Industry which is in charge of promoting competition and protecting consumers against unfair trading practices, misleading or unfair

[4] www.boz.zm

contracts, dishonesty and manipulation across the entire economy including the financial sector. The CCPC Act promotes information disclosure so that clients can make informed decisions when deciding to pay for a product or a service. The CCPC has received complaints from consumers regarding lack of financial product information disclosure and unfair contracts.

2. Overall context and historical development of the regulatory framework

In the 1990s, Zambia experienced financial sector distress. One of the causes of that crisis was that prudential regulation was not accorded sufficient priority. This resulted in adverse consequences for financial fragility in the banking system, especially when locally-owned private sector banks were set up in the 1980s and early 1990s[5].

The crisis resulted in the closure of nine banks. This led to a loss of consumer confidence and a shift of deposits from small, indigenous, locally owned institutions that catered for the average Zambian citizen to bigger, mostly foreign-owned banks which were perceived to be “safer” but whose products and services were outside the reach and affordability of most Zambians. This led to significant gaps in the provision of financial services, especially to populations in the rural areas, where a large proportion of the poor reside.

From 2006, there was a policy shift and the BoZ granted licenses to 10 new banks. The traditional banks saw their main market - high-income private clients and corporate clients - being courted by the newcomers. This resulted in a shift by the most established banks towards new products and more specifically to personal lending through agreement with employers and payroll deduction.

Regulatory reform in 2012 saw a significant increase in the capital reserves required for commercial banks to operate within the country. Locally owned banks are now required to have a capital base of ZMW 104 million (USD 17.3 million) whilst foreign owned banks are required to have a minimum capital base of ZMW 520 million (USD 86.67 million). The Minister of Finance, Mr. Chikwanda, declared at the time that he hoped that the measure “will mobilise additional resources to enable banks to participate effectively in national economic growth and provide more money for credit. The increase will also make the banks more resilient to economic shocks”.[6] However, in the short term we may see banks passing on the cost of raising the additional capital to their clients through higher interest rates.

At the same time, the BoZ became concerned with the high cost of credit. Work undertaken by Microfinance Transparency in 2011 showed effective annual interest rates for loans of between ZMW 5 million (USD 0.83 million) and ZMW 15 million (USD 2.5 million) that were on average around 100% per annum[7]. In April 2012, BoZ announced the introduction of a Policy Interest Rate. The Policy Rate was to be used to influence monetary and credit conditions, and allowed the BoZ to signal an increase or a decrease in the price of credit in the market. To announce changes to the BoZ Policy Rate, BoZ issues monthly communiqués that explain its monetary policy stance. The first BoZ Policy Rate was nine percent for the month of April 2012¸ and was increased to 9.25% at the start of 2013. As of July 2014 the Policy Rate was

[5] Financial Policies and the Banking System in Zambia, Martin Brownbridge, https://www.ids.ac.uk/files/Wp32.pdf
[6] Lusaka Times, 24 January 2014
[7] http://www.mftransparency.org/microfinance-pricing/zambia/#

12%. The purpose of the Policy Rate was to introduce a certain level of transparency in the pricing of credit in the financial sector. However, it did not have the expected effect of lowering the cost of credit through more open competition and persuasion.

In December 2012, interest rate ceilings were introduced for commercial banks, according to a set formula of the Policy Rate plus nine percent. Table 4 shows the different limitations on interest rates that were set initially and how these were adjusted as a result of the industry's lobbying efforts.

Table 4: Interest rate limits

	December 2012	June 2014 (after intense lobbying)
Commercial banks	18%	28%
Microfinance institutions	42%	64%
All other lenders (including consumer lenders)	30%	46%

Source: BoZ circulars, Interviews (2014)

According to several top tier lenders, the introduction of interest rate caps resulted in a significant contraction of the microfinance sector. Feedback received in the interviews was that some MFIs stopped lending completely while others would only grant new loans to existing clients. One institution saw a marked reduction in its portfolio, which according to its management, is as a result of the introduction of interest rate caps.

Table 5: MFI A portfolio decline

Portfolio value (ZMW '000)	Current: (31 July 2014)	18 months ago: (31 Dec 2013)	30 months ago: (31 December 2012)
Total value across business lines	17 382 088	19 990 456	24 392 753

Source: Interviews (2014)

One area of contention, especially for the NBFIs, around the introduction of interest rate caps arose from the fact that the cap for banks and MFIs refers to an effective annual interest rate, whilst the cap for other NBFI (commercial payroll MFIs) refers to the effective annual interest rate including insurance costs. This introduced different rules for different institutions, for the same product and market.

3. The current regulatory framework for retail financial services and credit markets

There is a clear distinction in Zambia between the banking sector regulation and supervisory authority and the regulation and supervisory authority for non-banking financial institutions such as pension funds, insurance companies and capital market players. Within this framework, the BoZ is in charge of prudential regulation and the licensing of the banking and microfinance sector. BoZ regulates and supervises the 19 commercial banks and is also in charge of the licensing of Tier One MFIs (six deposit taking institutions) and Tier Two MFIs (27 credit providers).

The existing banking regulatory framework is included in the Banking and Financial Services Act (BFSA) of 2006 and a series of guidelines and circulars published by BoZ. These laws and regulations do not include any specific rules that would apply to personal lending or to payroll loans. The BoZ currently regulates the *microfinance sector* under the BFSA (2006) and through subsidiary legislation including the Banking and Financial Services (Microfinance) Regulations which came into effect in 2006.

Definition of microfinance

There is no legal definition of microfinance in Zambia[8] under the current Microfinance Regulations of 2006. However the regulation does define *microfinance services* as per Box 2.

Box 2: Definition of microfinance services in Zambian Law

"The provision of services primarily to small or micro enterprises or low income customers and includes the following: (a) the provision of credit facilities usually characterised by frequent repayments; and (b) the acceptance of remittances and any other services that the Bank of Zambia may designate."

The regulations further define a low-income customer and micro-credit respectively as the following:

- *Low income customer* - "means a person who is economically active, receives low income and does not have access to formal financial institutions."
- *Micro-credit* "means a credit facility that does not exceed five percent of the primary capital of a licensed microfinance institution, as prescribed by the BoZ."

These definitions were meant to provide certainty as to what microfinance is as well as for the purpose of identifying what services the government would like to promote in its quest to promote financial inclusion and - not for regulatory purposes. This definition of microfinance is broad and includes microcredit for formally employed but low-income individuals. The definition has also not succeeded in limiting microcredit to small loan sizes only. Depending on the level of primary capital of an institution, five percent of primary capital of a large licensed MFI can be as much as several thousand dollars, significantly higher than the small loan size intended in the regulation.

These gaps in the definition of microfinance have resulted in the classification of services offered by commercial payroll lending institutions with individual loans of up to ZMW 70,000 (USD 11,666+) and with terms of up to 48 months as microfinance. As a result, the BoZ has provided further guidelines in the form of circulars to distinguish the MFIs that are predominantly involved in developmental microfinance and referred to as MFIs and the MFIs that are predominantly involved in commercial payroll lending and referred to as NBFIs. This was contained in Circular no. 8/2012 of January 2013. The criteria that is used for distinguishing MFIs (developmental) from NBFIs that provide personal loans for profit was and still are the:

1. Percentage of loans to micro and small scale enterprises should not be less than 80% of the total loan portfolio of the MFI;
2. Average loan size per borrower of the MFI shall not exceed ZMW 2,500, and;
3. Percentage of the loans to individuals in formal employment does not exceed 20% of the MFIs loan portfolio.

At the time of introducing this distinction, the main purpose was to make way for the introduction of interest rate caps with the developmental MFIs having a higher cap than the commercial personal lending MFIs. The rationale provided by the BoZ for making this distinction was due to their understanding and

[8] See definition proposed by the new Bills in the following section on the planned policy/regulatory initiatives

realisation that developmental microfinance has higher operating costs. In an attempt not to stifle the developmental MFI sector, developmental MFIs were therefore allowed to enjoy a higher interest rate cap.

Tiered regulatory structure for microfinance institutions

BoZ is responsible for the licensing of Tier One and Tier Two MFIs. The tiered classification is based on paid-up capital and the provision of deposit services.

- Tier One: Deposit-taking MFIs with minimum capital of ZMW 2.5 million (USD 416,666);
- Tier Two: Non-deposit taking MFI with capital ranging from ZMW 100,000 (USD 16,666) to ZMW 2.5 million (USD 416,666), and;
- Tier Three: Non-deposit taking MFIs with capital of less than ZMW 100,000 (USD 16,666).

Tier One deposit taking microfinance institutions may provide any of the following services:

- Credit facilities;
- Linkage banking;
- In-country transfers;
- Savings, and;
- Such other service as the BoZ may prescribe.

Tier Two and Tier Three – non-deposit taking MFIs can only be engaged in providing micro-credit facilities.

At the time of its enactment, the Microfinance Regulations of 2006 was primarily intended to bring microfinance institutions under the regulatory ambit of the Central Bank and provide them with a regulatory framework under which they could grow and extend their outreach to the country's rural areas and to low income clients. Consequently the regulatory framework provided for the existence of deposit taking MFIs. The provision of short-term personal loans was not an explicit objective of the microfinance regulatory framework but it was, to a certain extent, viewed positively as it provided credit to categories of the population (the middle and low salaried segments) which previously had almost no access to formal loans.

Registration and regulation of money lenders

The Ministry of Finance, in collaboration with Subordinate Courts, are also, in theory, responsible for supervising the moneylenders that are registered under the Money Lenders Act of 1964. It is mandatory for all entities seeking to engage in the business of money lending to be licensed under the Money Lenders Act (1964). To obtain a license, money lenders are required under the Act, to register with a Subordinate Court and to obtain a certificate. Based on the certificate, the Ministry of Finance will then issue a Money Lenders License (section 4.1 and section 4.2 of the Money Lenders Act).

However, this mandatory requirement to register is not enforced. A study commissioned by the BoZ in 2012 indicates that only 39 money lenders were registered countrywide whereas anecdotal evidence indicates that more than 100 money lenders were operating illegally especially in Lusaka and on the Copperbelt. Effectively this means that the majority of Tier Three institutions are unregulated.

A payroll loan is a product proposed by all tiers of the microfinance industry, primarily in Tier One and Tier Two, but anecdotally there are some micro-lenders that are lending to civil servants and that have a deduction code in the PMEC system which are not registered with BoZ.

4. Planned policy and regulatory initiatives

Microfinance Services Bill, 2014 and Banking and Financial Services Bill (BFS Bill), 2012

In light of recent developments in the microfinance and credit market in Zambia, the BoZ has started a regulatory reform process in order to ensure that the regulations remain current and relevant to banking and microfinance activities. A revision of the banking law was introduced under the BFSA 2012. That Act has been through several iterations and still needs to go through Parliament. The Microfinance Regulations of 2006 were first overhauled in the form of the Draft Banking and Financial Services (Microfinance) Regulations of 2014, which were later transformed into the Microfinance Service Bill, 2014.

Under the proposed new regulatory framework, the definition of microfinance will explicitly only apply to microfinance services aimed at the informal sector and micro, small and medium enterprises (MSMEs) that will then fall under the Microfinance Service Act. Financial services aimed at the formally employed will be regulated under the BFSA. The main purpose of this distinction will be to ensure that the two types of institutions offering the two micro-credit product categories fall under two different regulatory frameworks. The BoZ hopes that by distinguishing the MFIs involved in developmental microfinance from NBFIs involved in consumer lending, it will be able to better regulate and support each of these types of institutions. The BoZ's particular focus is to put in place an enabling and supportive regulatory environment that will lead to the extension of services to the informal sector and rural areas (that remain relatively excluded).

Under the Microfinance Services Bill of 2014, the tiered classification is maintained and the BoZ proposes a 'Delegated Supervision' regulatory framework for Tier Three MFIs under which they will be required to report to and be supervised by an entity yet to be identified or named by the BoZ. Commercial lenders will by default fall under the BFSA and any subsequent regulation. BFSA includes all categories shown in Box 3.

The BFS Bill includes clause 67(2), which limits the total amount of debt repayments and other deductions to a certain percentage of monthly gross income. Such limits are already being voluntarily applied among the majority of the major actors in the payroll market. That deduction limit is most commonly set at 60% of gross income and includes taxes, leaving a minimum of 40% of gross pay as take-home or disposable pay. Clause 67(2) says that a client is presumed creditworthy if "the total monthly debts due on outstanding obligations, including amounts under the loan, do not exceed 70% of his or her monthly gross income." Not only is this a 10% higher debt burden than the current industry norm, but it is also unclear whether or not the "outstanding obligations" includes income taxes. Because of these issues, this clause is has been reviewed by the BoZ.

Box 3: Categories of commercial lenders regulated under BFSA (2006)

1. **Banks**; the business of a bank is defined in a classic *manner as the business of-*
(a) receiving deposits from the public including chequeing account and current account deposits and the use of such deposits, either in whole or in part, for the account of and at the risk of the person carrying on the business, to make loans, advances or investments;
(b) providing financial services; and
(c) any custom, practice or activity prescribed by the Bank as banking business.
2. **Financial institutions** is the category under which Tier One commercial lenders are likely to fall, although capital requirements are not defined in the Bill -
"Financial institution" means a person other than a bank, providing a financial service which includes receiving deposits from the public but does not include chequeing accounts and current account deposits;
3. **Financial business** would regroup all **non-deposit taking commercial lenders**, now under Tier Two and possibly Tier Three[1].
"Financial business" means a person that provides a financial service but does not accept deposits.
The BFSA also maintains the obligation to acquire a licence for any financial institution. It seems therefore likely that all consumer lenders will be regulated under the BFSA and supervised by BoZ.
Finally, the definition of **financial services** explicitly mention consumer lending as well as microfinance.
"Financial service" means any one or more of the following services:
- *(a)* *commercial or consumer financing services;*
- *(b)* *micro-financing;*
- *(c)* *development financing; and*
- (d) *any other services as the Bank may designate (with some exclusions).*

5. Regulation of credit information sharing

There is one licensed private credit bureau operating in Zambia. It is called Credit Reference Bureau Africa Limited (CRBAL) and is trading as TransUnion Zambia. The Credit Reference Bureau Africa operates under the legal framework set out under the "Banking and Financial Services (Credit Reference Agency Licensing) Guidelines of 2006". The license was granted in 2006 with operations commencing in 2008. A directive was issued in December 2008 requesting all credit providers that are licensed by BoZ to submit their data to the credit bureau and to use the information available on the bureau for credit screening purposes before granting credit. Other than the commercial banks, this included the MFIs, building societies, leasing businesses and National Savings and Credit Bank (NATSAVE). The Credit Bureau Agency guidelines of 2006 also stipulate that micro lenders licensed under the Money Lenders Act, as well as any businesses that also provide credit through the leasing or purchase of goods on hire-purchase, are required to report to and utilise the credit bureau. However the BoZ only has jurisdiction over the entities it registers and it is thus unable to enforce compliance with these guidelines for the other credit providers.

As the volume of data has increased over the years, the quality of credit reports generated by the CRB has also improved. The sentiments expressed from the market on the role played by the credit bureau have been positive. This is primarily in comparison to the earlier years of existence of the CRB when the volume of records was very low. The common view is that the credit culture is improving as an increasing number of individuals develop their credit record and appreciate the consequences of having a negative credit listing – to the extent that historical NPLs have been paid back to enable access to future loans. For instance the Head of Credit at one bank that participated in the research stated that the use of the credit bureau has improved the bank's ability to manage risk especially with regards to client who change employer or pay point. Continued focus on building the credit bureau according to best practice will make this institution even more useful as is elaborated later on in this section.

Other than providing a standard credit report on an individual's repayment pattern for a 24 month period covering information such as full-payment, part payment, skipped payments, days in arrears, worst days in arrears, unpaid debit orders and cheques the bureau also provides value added services such as 'skip trace' (location of missing borrowers) and business reports. The credit bureau indicated that it will also be introducing credit scoring in the very near future.

One area that remains unresolved and could have increased significance for the credit bureau is the development of a regulatory framework that would require all credit providers including those not regulated by BoZ (such as the retail furniture stores and utility companies) to report to the credit bureau. A few of these businesses report to the credit bureau, on a voluntary basis at present.

As of June 2014 there were 60 institutions consistently providing data to the credit bureau. These include 25 MFIs, nine commercial banks, three building societies and six leasing companies. Others that provide data on a voluntary basis are the mobile operators, retail furniture stores, real estate agents and trade/sector cooperatives. It is not clear why there is such a low representation of the commercial banks (nine of 19) considering that they are required by the law to all submit data to the credit bureau.

There is currently a private sector led initiative to encourage information and data sharing by all credit providers beyond what is currently reported to the credit bureau. With the financial support of FinMark Trust, a coordinator for the Zambia Credit Reporting Alliance (ZamCRA), has recently been appointed and will be responsible for leading the development of this credit information sharing platform. At the time of the study there seemed to be very little awareness by the credit providers and even by TransUnion Zambia on the role and benefits of ZamCRA. If its benefits are to be realised significant effort and resources will need to be applied on advocacy and lobbying for the intended members. For credit providers such as banks and MFIs involved in payroll lending, the ZamCRA initiative is a welcome one as they currently have only a partial view of their borrowers' credit behaviour as reported by institutions currently reporting on the credit bureau. ZamCRA, when fully operational, will provide access to the complete credit profile of borrowers - not only financial institutions but retail/trade accounts and utilities.

In the context of the payroll study, credit information sharing does play an important role in managing risk and could be more effective with increased participation and improved accuracy of data sharing. In particular, complete and accurate data about the credit market (including institutions not regulated by the BoZ) could provide the BoZ with a more comprehensive view of trends in the credit market, including institutions outside of their purview. Furthermore, the data available through the bureau is an important tool for managing levels of indebtedness in the market.

V. Public Service Management Division (PSMD) and Payment Management and Establishment Control (PMEC)

1. Introduction

This section of the report was a key component of the scope of work given the concerns raised during the rapid appraisal about the PMEC system. Subsequent to the rapid appraisal, PMEC introduced a new IT system for the processing of payroll deductions. This system appears to have had a very positive impact on the general environment as evidenced by feedback from the financial institutions interviewed during the research process. The assessment of PMEC was limited to only two meetings with PMEC management and with little to no access to additional information requested. Therefore, much of this assessment is based on feedback received from other stakeholders, observations by the research team and what could be derived from the meetings.

The Public Service Management Division (PSMD) is a unit under government's Cabinet Office. PSMD is responsible for all matters related to human resources of the civil service and central government. Some of the government departments that are considered sensitive such as the security, defences forces and intelligence units are not administered from Cabinet office but through independent units in the respective ministries. These units have their own different payroll systems that they utilise.

The PSMD comprises of five directorates dealing with different elements related to human resources. These include:

1. Recruitment and placement —responsible for recruitment, placement and promotion of all civil servants;
2. Technical services department - responsible for a wide range of functions including Industrial relations, conditions of service, disciplinary cases and separation. This is also the department responsible for entering into MoUs with financial institutions that provide credit and collect payments through the PMEC by issuing of the payroll deduction code;
3. Department of Human Resources Development which is responsible for training and training related scholarships;
4. Human Resource information and planning – custodian of all human resources information relating to civil servants. Responsible for staff compliment and establishment, succession planning and costing and budgeting of human resources structure, and;
5. *Payment Management and Establishment Control (PMEC)* is responsible for managing the entire government payroll of the civil service and ensuring that civil servants are paid correctly and on time.

2. Payroll administration within government - the role of PMEC

Prior to the establishment of PMEC in 2005, the civil service payroll was administered centrally at the Ministry of Finance headquarters in Lusaka. The centrally administered payroll was fraught with irregularities particularly with relation to the number of civil servants on the payroll versus the total civil service establishment as reported by different ministries and departments. There was a high incidence of 'ghost workers' on the payroll leading to significant losses of funds through fraud.

The establishment of PMEC involved decentralising the payroll function by allowing individual ministries and government departments to be responsible for managing their own payroll and only relying on PMEC for the use of the centralised payroll IT infrastructure.

The PMEC payroll infrastructure comprises the software and hardware that is hosted at the Ministry of Finance and the staff who implement it based at PSMD. PMEC is responsible for providing training to the relevant officers from the different ministries that are responsible for entering the payroll data on a monthly basis. Under the decentralised payroll administration system the user units are responsible for the actual payroll transaction management. This involves initiating, preparing, verifying, auditing and approving the payroll on a monthly basis. For the user units to be able to utilise the PMEC system and enter the relevant information, PSMD has to ensure that system is available and running. PSMD also has to ensure that it has provided adequate training to the two nominated officers from the user units that will be responsible for managing the payroll. The two officers normally would be the Human Resource Officer and the Accountant. Having at least two officers per unit trained on the PMEC system ensures continuity of service in the event that one of the two may not be available or in the case of resignation.

There are two levels of decentralisation that determine the level by which the payroll of different ministries will be managed:

- The Ministry of Health and Ministry of Education are decentralised to the district level. This means for these two ministries each district has a Human Resource Officer and Accountant that are trained to interact with PMEC system and are responsible for providing the monthly payroll inputs.
- The other ministries are decentralised to the provincial level. It is therefore at the provincial level that the Human Resource Officer and Accountant will have access to the PMEC system to administer the payroll.

According to PSMD of the total government establishment of approximately 270,000 (including defence forces), the payroll of 170,000 is administered through PSMD and PMEC. The balance of payroll is administered by the respective government departments directly.

3. Third party payroll deductions

The Technical Services Department (TSD) of the PSMD is responsible for reviewing and approving applications for payroll deduction. They are also responsible for entering into Memoranda of Understanding (MoUs) with institutions that are granted access to the payroll system. Once an application has been approved by the TSD, it requests PMEC to issue a deduction code to the third party institution.

A deduction code is a unique identifier that PMEC uses for allocating funds deducted from civil servants to the intended recipient. As of July 2014 PMEC had issued 194 deduction codes to third parties. These ranged from financial institutions such as banks and MFIs to retail and furniture stores. Table 6 provides a summary of the breakdown of the 194 deduction codes that had been granted at the time of the research.

Table 6: Summary of institutions with payroll deduction codes

Banks	MFIs	Insurance	Building Societies	Other NBFI	Credit Unions	Retail/ Trade	Others/ Unknown	Total
7	20	19	31	5	51	41	20	194

Source: PMEC Interview (2014)

Further scrutiny of the list of the 194 institutions with deduction codes reveals that the aggregate figure does not provide a realistic view of the number of individual institutions that have entered into MoUs with PSMD for payroll deductions:

a) Several institutions, especially the building societies, have more than one deduction code. Some have a deduction code for their branches in different towns;
b) Some institutions have different deduction codes for different products/ services they offer;
c) Some institutions on the list have ceased operations through being wound up or merging with others. This is the case with several of the MFIs on the list.

After making the above adjustments to the list to account for these factors, there are approximately 152 individual institutions that use PMEC for deductions as below.

Table 7: Adjusted summary of institutions with payroll deduction codes

Banks	MFIs	Insurance	Building Societies	Other NBFI	Credit Unions	Retail/ Trade	Others/ Unknown	Total
6	19	9	3	2	51	41	21	152

4. A description of PMEC Operations

In May 2012 the PSMD issued a circular to microfinance institutions and hire purchase companies. The circular defined all requirements to be met to qualify for a payroll deduction code and guidelines for the credit products for civil servants collected through the payroll. The guidelines on interest rates also applied to institutions that already had deduction codes. A one month notice period was given for implementation. The circular was issued as result of some civil servants being over-indebted and having their whole salary deducted in loan recoveries by credit providers.

1. Requirements for applying for a deduction code:

Companies applying for a deduction code need to supply PSMD with the following:

a) Certificate of registration from the Registrar of Companies;
b) In case of MFIs, Certificate of Registration with the BoZ;
c) Tax Certificate from Zambia Revenue Authority, and;
d) Pricing structure of credit products in a stipulated format.

2. PSMD guidelines on pricing and affordability

In the abovementioned circular, PSMD required credit providers using PMEC for loan recoveries to adjust their interest rates downwards and to meet affordability guidelines as follows:

Interest rates: Interest rates charged by the MFIs should not exceed the average interest rate of the top five lending banks in Zambia as advised by the BoZ. It should be noted that this rule was put in place prior to the introduction of interest rate caps. Based on the key informant interviews, all financial institutions providing payroll loans charge the maximum allowable under the interest rate regulations (at the time of the research).

Affordability: The net take home pay of employees should not be less than 40% of the basic salary after taking into account all deductions including statutory obligations.

The circular also informed the credit providers that the monthly commission charged by PSMD for administering the payroll deductions had been pegged at two percent of the recoveries and charged upfront each month to the credit provider. The commission fee is designed to cover the administrative cost and fees of the loan recoveries such as bank charges and Electronic Funds Transfers (EFTs).

5. Operational rules for credit providers that use PMEC for loan recoveries

PMEC is in a very strong position to define the rules that apply to credit providers using the payroll deduction system. The following rules have hence played a significant role in managing the levels of indebtedness amongst civil servants in Zambia:

- PMEC introduced an affordability rule for civil servants, that stated that employees must have 40% of basic salary as net take home pay after all deductions including statutory deductions and loan recoveries. Loan recoveries that lead to the breach of the 40% threshold will automatically be dropped off the deduction in the given month and the payment request will need to be resubmitted once the employee can afford the additional deduction. Credit providers who are repeat offenders risk having their deduction code withdrawn. There is no conclusive information to support how the "40% rule" was arrived at, except that this appears to be the threshold that the civil service used to use when it provided staff loans in the past. It is our view that this mechanism has played a key role in curbing more severe indebtedness but that 40% take home pay level is insufficient. Based on evidence from the focus group discussions, scenario testing and country case studies limiting deductions to this threshold will not curb over-indebtedness;
- Payroll files from government departments, with details on deductions, can be submitted either manually or electronically to PMEC in a predefined format:
    - For manual deductions the files are to be handed to the relevant department or ministry for them to validate and to enter the deductions into the PMEC system. Manual files are not processed by PSMD or PMEC, and;
    - Electronic files are submitted directly to PMEC in the predefined format. When a credit provider uses electronic submission it should be a single file for the whole institution and not separate files for different branches.
- The maximum duration for a credit facility that can be loaded on PMEC is 60 months (5 years);
- PMEC does not carry out any validation with regards to the accuracy of the information especially the employee number. It is the responsibility of the credit provider and the respective government departments to ensure that the data received for processing on PMEC is accurate;
- Statutory and government related deductions take priority over any third party deductions. It is the responsibility of the credit provider to ensure that as part of their affordability check they do not take into account any irregular income;
- Credit providers are required to submit quarterly reports to PSMD indicating the pricing of the credit facilities being recovered through PMEC, and;
- PSMD and the government in general do not take any liability for an employee failing to pay back a credit facility.

Based on interviews with both PMEC and financial institutions, there do not appear to be any recent significant or persistent infringements of the above rules and hence, there has been no reported withdrawal or suspension of deduction codes. PMEC stated that when any infringement of the rules occurs, they contact the financial institution concerned and they almost always correct the situation.

6. Challenges of administering loan recoveries through PMEC

There are a number of challenges related to processing the loan recoveries through PMEC that were raised during the key informant interviews, namely:

- For financial institutions that still provide their payroll inputs manually this creates immense workload on the human resource staff in the decentralised ministries at district and provincial level. The volume of data they have to capture increases the likelihood of error;
- Smaller financial institutions have less internal controls which lead to more errors on their submissions whether they are manual through the ministries or electronically to PMEC directly;
- Restructuring of loans especially when it involves extending the loan terms usually leads to one of two problems:
    - The financial institution restructures the loan on its system but does not provide input to PMEC for it to make adjustments to the payroll schedule, and;
    - The financial institution informs PMEC of the required changes and it in turn affects them correctly but the client is not informed of the change.

There are situations that result in queries involving the three parties that could be avoided. These include:

- Breaching of the 40% threshold by individual borrowers who deliberately obtain multiple loans within a one month period. This leads to more than one credit provider loading a loan into the system in a given month. The PMEC system will reject the loan that breaches the 40% limit. Ordinarily, loan deductions are processed on a first come first served basis. But in these circumstances, the loan that is rejected might be the one that borrower obtained first and the later loan is the one that is accepted through the payroll system;
- The automation of the submission of payroll deductions has increased efficiency but has also led to the responsibility of data accuracy being solely up to the credit provider. This has led to problems of loans being deducted against the wrong person in cases where the wrong employee number has been used. All the banks and the larger MFIs are submitting their payroll deductions automatically in electronic format directly to PMEC, and;
- Changes to the interest rate caps have led to lenders adjusting the interest rate on loan contracts - in line with a variable interest agreement. Given the threshold for deductions, the instalments have been left unchanged but the loan terms extended to recover the additional interest income. This has not been explained to borrowers.

These challenges exist but are not regarded as systemic risks in terms of the functional operations of the PMEC payroll deduction system.

7. Outlook for payroll lending and PMEC

For the foreseeable future PSMD intends to continue having PMEC available to financial institutions for the collection of loan repayments. They view access to credit by civil servants as a means for financially empowering individuals. The condition for this to continue is that the credit supply is not exploitative.

When payroll lending first became available, PSMD was willing to enter into exclusive MOUs with selected financial institutions. On the basis of these agreements, MFIs agreed to provide credit at a lower cost than available on the market if dealing directly between the employees and the credit provider. This initial objective has not been retained as no preferential interest rates exist for civil servants accessing payroll loans. Given this, PSMD has instead opened PMEC to various other financial institutions, in the hope that the competition between the financial institutions with deduction codes will keep the cost of credit low for civil servants.

Resources and infrastructure: As more financial institutions provide payroll lending the move towards automated submission of payroll inputs will be necessary to increase efficiency and avoid human error. PMEC also intends to increase their focus on stakeholder engagement to ensure that the financial institutions providing payroll deduction inputs have sufficient controls and checks in place to avoid errors in the inputs. PMEC may want to consider the ability of a financial institution to make an automated submission for payroll deductions as a prerequisite for obtaining or retaining a deduction code. Allowing manual submissions increases the likelihood of error.

Affordability: PSMD intends to continue enforcing the affordability rule (40% of basic pay as minimum take home net pay). In this regard, PSMD felt that the original proposed regulation in the Microfinance Services Bill of 2014, of setting the limit at 30% was too lenient and that it would lead to over-indebtedness. As a consequence, it was PSMD's intention to continue enforcing the 40% rule even if the proposed regulation with the 30% threshold was passed into law (this is not longer an issue given the BoZ revisions to the Bill). It is our view that PSMD and BoZ should have a formal engagement on the issue of the threshold and come to an agreement to ensure consistency between the regulation and the PMEC guidelines. This engagement needs to extend beyond the rule to a collaborative relationship around monitoring trends, clamping down on bad market practices and the avoidance of any political fall-out that could affect the stability of the financial market.

Multiple borrowing and over-indebtedness: Over the years PSMD has engaged with the private sector and financial institutions on how the problem of multiple borrowing (leading to over-indebtedness) could be addressed. One proposal was the development of an online database system with all potential borrowers that is accessible to the different credit providers. The purpose of the system would be to allow credit providers a facility where they could update the status in real-time if a borrower's loan was approved making it visible to other credit providers. This would then prevent the borrower from obtaining another loan from other unsuspecting lenders that would extend the total debt beyond the 40% threshold. Although this initiative seemed to have been well received by PSMD and financial service providers that utilise PMEC it has not moved beyond the concept phase due to lack of resources to develop it. PSMD indicated a willingness to host and manage the system, so that they could safe-guard the confidential payroll data of the civil servants and ensure equal and fair access to the data by all participating credit providers. The proposed system would serve a similar purpose as a credit bureau, although this concept is intended to resolve the problem of the time lag between when a loan is approved by a service provider to when it is loaded in the credit bureau (and when it becomes visible to other credit providers). The alternative would be to change the credit bureau reporting practices and capability to require more frequent reporting when loans are approved and disbursed (that is real time instead of daily batch processing). This would be much more efficient than creating a new system.

8. Conclusions on PMEC

Based on the interviews held with PSMD and the feedback from the financial institutions currently using PMEC, the recent changes (e.g. the introduction of affordability guidelines and the new system enabling the automation payroll deduction submissions) have had a significant improvement on the operations of PMEC. This is primarily measured by the positive feedback that financial institutions provided during the key informant interviews on their engagement and transactions with PMEC. Several institutions specifically indicated satisfaction with the service they are currently obtaining from PMEC.

The level of satisfaction of financial institutions with services provided by PMEC and vice-versa seem correlated with the financial institutions' IT capability (both their system and skills). As a consequence the larger MFIs and commercial banks which have the resources to ensure that their IT systems interface seamlessly with that of PMEC, regarding data formats and submission processes, have less challenges working with PMEC. However, smaller MFIs either still use manual submissions or their electronic submissions are not yet well integrated into PMEC's system, hence are prone to errors and delays.

One area where PSMD and the financial institutions still seem to experience challenges is when loans are restructured. In this instance all three parties need to be involved (i.e. the borrower, the credit provider and PSMD (PMEC)) and kept well informed of the changes to ensure accurate and up to date information is recorded on the respective records and system. The miscommunication and delays lead to missed repayment instalments and as a result the loans run longer than initially agreed. The restructuring involves increasing the term of a loan. Information gathered in the key informant interviews suggests that, this information is not being communicated to the borrower, leading to them raising queries with PMEC when the loan runs longer than they thought it should. The change to the loan terms is often due to changes in variable interest rate in line with loan agreements or an adjustment to ensure that the monthly deduction remains within the 40% threshold.

Based on interviews conducted with PSMD they remain committed to overcoming the challenges they are still facing with credit providers through stakeholder meetings. Their willingness to contribute towards finding a solution to avoid over-indebtedness is a further indication of their commitment to improving the role that PMEC can play in the payroll lending sector. PSMD can also be commended for the affordability guidelines that they provided in May of 2012 that have become the industry standard. Greater collaboration and consensus on this with the BoZ would be useful going forward.

Given the high level of debt and the large number of institutions with access to PMEC, one area in which PMEC may still play a role is by returning to its initial premise for providing deduction codes to selected financial institutions on the basis that they would provide credit at a relatively lower cost. Considering that payroll lending does to a great extent reduce the risk and operating costs for the financial institutions the assessment team feels that financial institutions who use PMEC should transfer this benefit to the borrowers by charging an interest lower than the maximum allowed by the interest rate cap.

PMEC could also play a significant role in supporting BoZ with monitoring the payroll lending sector through tracking and reporting better statistics on the use of its payroll system by credit providers, portfolio information and other trends. In general, given the power and importance of PMEC as a stakeholder in this landscape, a much closer working relationship between the two stakeholders is recommended.

VI. Demand side analysis of the payroll lending market

1. Description of the payroll lending market segment

Payroll loan clients are formally employed by the government, parastatals and private sector companies. In most cases they are on permanent employment contracts and would fulfil different positions in an organisation.

Demographics

Zambia's total population is estimated to be 14.4 million, of which 5.5 million are between 20-60 years of age (Labour Force Survey, 2012). The Government of Zambia estimates the total size of the labour force to be 7.8 million, of which 75% are economically active. Only 15% of those economically active adults, however, are formally employed, an estimated 894,175. 77% of these employees work in urban areas, with Lusaka contributing almost half of all urban employees. The largest concentration of employees outside Lusaka is in the Copperbelt, which presumably is the source of 23% of employees working in rural areas.

The breakdown of formal employment by type is shown in Table 8.

Table 8: Employment composition in Zambia

	Number	%
Total employed	**894,175**	**100%**
Private sector	498,507	56%
Of which:		
Mining	*74,254*	*8%*
Manufacturing	*77,408*	*9%*
Central and local government	269,118	30%
Of which:		
Central government	*237,756*	*27%*
Local government	*31,362*	*4%*
Parastatals	56,523	6%
Others	70,027	8%

Source: Labour Force Survey (2012)

A breakdown of public sector employment by type is not provided in the preliminary results of the Labour Force Survey (2012), but through applying some assumptions to the detailed information, the broad categories of public sector employment are derived as shown in Table 9.

Table 9: Breakdown of public sector employment

	Number	%
Total public sector employees	**269,118**	**100%**
Public Administration and Defence, and Compulsory Social Security	59,771	22%
Education	141,672	53%
Human Health and Social Work	57,469	21%
Other	10,206	4%

Source: Derived from the Labour Force Survey (2012)

Information gathered during the key interviews showed that, typical salaries in the civil service range from ZMW 3,000 (USD 500) to ZMW 18,000 (USD 3,000) per month. Some employees undertake extra income generating activities in order to supplement their low salaries. Medical doctors, for instance, may run a private clinic in addition to working for a government hospital so that they can earn extra income because the government salary is inadequate to support a decent living. Non-skilled workers may run an informal business (such as a bar, grocery shop or a farm). The extent of this secondary income is unknown and will be an important area for future research given the current levels of indebtedness within the employed market segment.

Usage of payroll loans

Reliable, statistically representative data on the usage of payroll loans is not available. Credit providers would not typically ask applicants for the intended loan purpose either (even though it would not be very reliable anyway). However, key informant interviews and focus group discussions did explore this topic of discussion.

In a country where access to credit cards and other forms of short-term and revolving debt is extremely limited, payroll loans are a primary source of credit for many Zambian households. Based on key informant interviews with financial institutions and focus group discussions with payroll loan clients (2014), the usage varies considerably, from financing purchases of big-ticket expenses (land, house construction/repair, motor vehicles, household furniture and electrical goods) to making basic consumption purchases or paying for school fees or funeral expenses.

The most common usage of payroll loans indicated by borrowers during the focus groups discussions in order of priority include: housing construction; purchase of motor vehicles; investment in an enterprise; and education for self and children. Household goods (such as furniture and electronic goods) are mostly purchased on credit from retail shops, such as Radian, Home Corp and Carnivals, where a buyer must pay a deposit of about 30% of the purchase price and pay the balance over a period of up to 18 months at approximately 45% interest. Some retail credit providers may charge higher interest rates depending on the credit period. No information is available regarding the size of the retail credit sector.

Housing Construction

There is a critical shortage of housing in Zambia, which is partly due to lack of long-term financing mechanisms. According to the Housing Finance Scoping Study undertaken by FinMark Trust in 2012[9], the housing supply backlog was estimated to be between 1.3 million and 2 million houses, taking into account existing stock, new construction and demographic changes. However, house ownership has expanded in the past decade despite the limited supply of suitable housing loan products. Based on the same study, most of the housing construction in urban and peri-urban areas is through incremental – self building using unsecured loans. Interviews undertaken during this payroll study have also confirmed that much of the housing growth has been financed through payroll loans. Because loan amounts provided by payroll lenders

[9] Drummond, Chongo, Mususa (2012) Housing Finance Scoping Study, Zambia, FinMark Trust Zambia.

are often inadequate to allow for the full construction of a house, housing construction is generally carried out on an incremental basis making use of multiple loans from one or more lenders borrowed over several periods until the construction of a house is finalised. Typical loan amounts provided by credit providers for housing construction depend on the borrowers' salary level. Most lenders have no specific loan products for housing construction and borrowers use loans that are not designed for housing construction for incremental house construction and improvements. According to the Housing Finance Study (2012), rates between secured and unsecured lending are not always that significant, suggesting that financial institutions do not differentiate according to risk and hence do not price their products accordingly.

Box 4: Housing Construction Case Study from Mopani Copper Mine Focus Group Discussion

"I bought a piece of land from my own savings but I could not build a house for many years due to lack of funds. I then got a loan through the loan scheme with Barclays Bank of ZMW 10,000 and managed to put up a foundation and build up to window level. I got a second loan and built up to roof level and a third loan enabled me to complete roofing of the house. It has taken more than four years to complete building my house, but I am now happy because I live in my own house and do not have to fear being evicted for not paying rentals on time".

According to the Living Conditions Monitoring Survey conducted by the Central Statistics Office, between 2006 and 2010, spending on housing rose from 20.9% to 25.8% of total nominal household expenditures. Total nominal consumer spending rose 75% over the same period, but spending on housing rose by 117%, contributing one-third of all the growth in consumer spending. The large increase was consistent across all rural and urban socio-economic strata, with larger percentage increases among the most affluent rural and urban households.

In terms of the total amount of Kwacha spent by households, however, spending on housing in urban areas accounted for three-quarters of all the growth in spending. Of this growth, more than half of the increase in spending on housing in the country came from households living in low-cost and medium-cost residential areas.

The rise of payroll lending may be one reason why spending on housing increased so significantly between 2006 and 2010, and may have increased further over the ensuing four years. This is especially true for low- and middle-income households who previously lacked access to credit for home building or improvement.

More spending on housing has not, however, crowded out spending on basic necessities. Spending on education increased 152%, contributing seven percentage points to the overall growth in household spending. Moreover, spending on food increased from 41.5% of total household expenditures to 48.9% - a larger increase than for housing in both relative and absolute terms. Food price inflation particularly affected rural areas, but spending on food increased in urban areas as well.

As spending on food, housing and education rose, all other categories of spending declined. Zambians mostly cut back on clothing and remittances.

Motor Vehicle Purchase

Purchase of used motor vehicles, mostly from Japan, is another common use of payroll loans. One participant in a focus group discussion at the Zambia Army mentioned that "Most government employees could not afford to buy a motor vehicle before the introduction of salary loans. I bought a motor vehicle for the first time in my life though a payroll loan". Further information obtained from several focus group discussions, particularly with mining employees, indicate that peer pressure more than necessity tends to persuade people to own a new car and other luxury items, such as flat screen televisions. . Other considerations, such as fuel and car maintenance costs are not taken into account at the time of buying a car and some workers end up in financial stress.

Box 5: Vehicle purchase Case Study from Zambia Army Focus Group Discussions

""I bought a used car from Japan using the loan I borrowed through the loan scheme at work. I was involved in road accident just after a few months later and the car insurance had expired. The car was damaged beyond repair and now I have no car but the bank continues deducting the loan from my pay. I have to wait another 18 months until the loan is recovered in full before I can borrow again from the same bank."

Investment in an Enterprise

A number of borrowers invest their loans in an enterprise with the aim of generating additional income to supplement their low salaries. The range of different enterprises that have been invested in include poultry businesses, bars, vegetables gardening, transport, grocery shops and others. Because the borrower is in full time employment, these enterprises may be managed by a spouse or another family member. Some borrowers have used earnings from an enterprise to construct a house or buy a car.

Box 6: Micro-enterprise Case Study from Zambia Army Focus Group Discussion

"I used my loan to invest in a bar business and I used the earnings from the business to restock the bar, buy land for a house, and even managed to buy a used car. I now need to borrow again to expand the business and continue generating more income to supplement my low salary."

Education

Government in the past sponsored selected employees for further education. This is no longer common due to budgetary constraints and as a result most government employees that want to further their education now resort to borrowing to pay their fees. Also due to deteriorating standards in government schools, parents who can afford to do so, prefer sending their children to private schools where fees are generally significantly higher. Parents sometimes have to borrow in order to pay school fees for their children. Most people regard sending their children to school as an "investment" and a guarantee for a better future life for their children. School fees can constitute a big portion of expenditure for a low paid worker, forcing them to borrow every other term when it is time to pay for school fees.

Levels of financial literacy

Financial literacy levels are generally low in Zambia. This prompted the BoZ to develop the National Strategy on Financial Education for Zambia in 2012. Most payroll loan borrowers may understand basic concepts such as 'interest rates' for example but not concepts like the 'effective cost of borrowing'. Borrowers do not comprehend why banks sometimes change interest rates during the loan period and do not know what the BoZ policy rate means and its influence on interest rate levels for borrowers.

Many people consider home or car ownership as a symbol of status and well-being and may not appreciate the need for wealth creation before spending money on a house or a car. Aspirational goals related to home and vehicle ownership are therefore a contributing factor to the rising levels of indebtedness amongst the employed market segment.

Lack of knowledge about financial products is common. Most people accessing financial services use credit and savings products and very few have any form of insurance (life and general insurance). According to FinScope Zambia (2009) 24% of adults aged 16 years and above admitted to having borrowed within the last 12 months, while 48% claimed to have saved in one way and only four percent had an insurance policy.

Most of the people that participated in the focus group discussions appreciate the repercussions of over indebtedness. However, over borrowing is said to be common because sometimes people follow trends within their communities, for instance, "my peers own a BMW (car) and I should also own one."

Culture of repayment

Access to credit, particularly from the employer, has been regarded as an employment benefit by most workers in Zambia. Because the government faces budgetary constraints and has stopped extending salary advances to its employees, some trade unions have advocated for loan schemes between employers and lenders so that their members can access credit for different purposes. Indeed, employers also welcomed the intervention of payroll lenders, since it has allowed them to reduce and eventually end the practice of salary advances.

Credit discipline has generally been poor in Zambia. This is the reason most banks and consumer lenders target mostly formally employed workers and use payroll deduction as a preferred method for loan repayment. Cases where banks have used stop orders and deducted loan repayments from a borrower's account at the bank have sometimes been abused as borrowers have, in some cases, changed "pay points".[10] Some banks now require an employer to make an undertaking that they would remit the employee's salary to the bank until the borrower has repaid the loan in full, but some employers are reluctant to make such undertakings.

The poor loan repayment culture is partly due to government sponsored credit schemes where borrowers that have previously defaulted on their loans were 'forgiven'. There was also a lack of information sharing among credit providers until a few years ago when the credit bureau began operating. People tended to borrow from multiple lenders and in some cases defaulted on their loans with impunity. However, the creation of the credit bureau has created fear among borrowers. They now realise that their credit report would show adverse information and lenders would be reluctant to lend to them in future.

As previously mentioned, the credit bureau is still maturing and many credit providers do not yet subscribe to the bureau, particularly lenders not supervised by the BoZ that are not mandated to do so and several of the banks. In spite of considerable improvements in the reporting, there is still room for development. For

[10] The nominated bank account where employers pay employees salaries

example, lapses or delays in updating information at the credit bureau can provide a loophole for borrowers to borrow from multiple lenders within a short period before information reaches the credit bureau and their record is updated. The timely delivery of accurate information related to credit provision and the borrowers' repayment behaviour to the BoZ would help to reduce indebtedness and improve the capacity of the BoZ to effectively monitor and regulate the market.

Responsible borrowing practices

A number of respondents understand the difficulties they would face if they engaged in irresponsible borrowing. However, peer pressure particularly among low-income workers has contributed to borrowing for unproductive purpose, such as the purchase of a car or expensive furniture. People have in many cases borrowed for the sake of wanting to buy something because their neighbour has done so. This has led to low-income earners getting trapped into debt.

The focus groups revealed cases of individuals that have multiple loans from different lenders and inadequate disposable income to make ends meet after the loan repayments have been made. Some resort to borrowing from informal lenders to supplement low incomes and roll over loans each month. This was the case with an employee of the Ministry of Community Development, Mother and Child as revealed in focus group discussions.

Although employers have measures in place to discourage their workers from irresponsible borrowing by adhering to the 40% affordability threshold, some workers have borrowed from moneylenders and informal sources. These lenders do not recover loans from the payroll but use other means, such as keeping their debit card and withdrawing cash from the borrower's account through an ATM on pay day and/or the use of assets as collateral (and will sell these assets if the client misses payment). In many cases assets are pre-sold to the lender at time of borrowing and the value of the asset is several times larger than the loan amount, including the interest amount.

Awareness about any available recourse mechanisms

Most borrowers are not aware of recourse mechanisms regarding disputes arising from credit contracts. A number of people complain about variations in interest rates within a loan term, but have done nothing to get more information from either the lender, the BoZ or the Competition and Consumer Protection Commission (CCPC) so that they understand their legal rights. None of the people who participated in the focus group discussions were aware that they could use the CCPC as a recourse mechanism if they had complaints against a lender.

The most common dispute for payroll loans is related to deductions of loan instalments. There are cases when PMEC and employers may erroneously make double deductions in a month from the salary of an employee. The main recourse mostly used is the Human Resources Department or trade union and lenders sometimes have to refund the client after protracted negotiations.

Some lenders have been aggressive in recruiting clients, to the extent of offering clients new loan agreements to refinance loans with the competition (they will take over an existing loan or switch the client from the competition to themselves). In some cases borrowers have ended up with more expensive debts, particularly from consumer lending companies. This has primarily been due to the non-disclosure of hidden costs, such as arrangement fees than can be as high as 16% of the loan amount in some cases.

Borrower practices

Multiple borrowing from different lenders is common. This is largely due to regulations that do not allow for a borrower to access another (top-up) loan from the same lender when they still have an outstanding loan. Borrowers have been compelled to seek a loan from another lender mostly for emergency needs, such as for paying hospital bills.

For instance, according to one of the focus group discussion participants, a borrower got a loan of ZMW 10,000 (USD 1,667) from a commercial bank under a loan scheme arranged by the employer to buy a piece of land. He also got a loan of ZMW 15,000 (USD 2,500) from the Workers Cooperative at a 16% interest rate to pay school fees for his children. Both loans are repaid through payroll deductions. This significantly reduced his net pay, thereby reducing his ability to provide decent food for his/her family.

Information from focus group discussions indicates that many of the participants know of colleagues at work or in their communities that struggle financially because their net income is too low to make ends meet and resort to borrowing from money lenders each month. Money lenders do not assess affordability and use household goods as collateral. Interest rates can be as high as 50% per month, making the cost of borrowing exorbitant. One of the focus group discussion participants indicated that "Yes, I know many people that struggle to make ends meet and resort to borrowing from money lenders because they do not want to face reality and borrow for luxury".

2. Debt levels amongst borrowers

According to FinScope Zambia 2009 there was an increase in access to formal financial services between 2005 and 2009 which can be attributed to MFIs providing consumer credit (in part although this is also due to increased access to formal transaction services). While there has been no in-depth demand side study on the scale of FinScope since 2009 to provide empirical evidence of the trends since then, information gathered as part of this research process provides evidence that access to payroll loans has continued to grow steadily. This is evidenced by the growth in the portfolios of not only MFIs but also commercial banks in last five years. Based on the consolidated portfolio report submitted to the BoZ by banks and MFIs as of July 2014:

- 28% of all personal loans stem from the microfinance sector and 58% from banks, and;
- 64% of all loans are scheme loans or lending to the formal sector. Of these scheme loans 31% are by MFIs and 63% by commercial banks.

Loans by sector of employment

Access to formal credit by the formally employed has increased significantly in Zambia in the past five years. Initially, commercial banks were hardly involved in scheme loans but now they supply more than half of scheme loans in the market. According to the information gathered from credit providers during this payroll lending study, there were approximately 360,000 scheme loans supplied into the market. According to the Labour Force Survey (2012), the total formally employed work force in Zambia consists of 894,175 people. If each individual was only accessing one loan (which is not the case) 40% of all employed individuals would have a payroll loan. However, there is a much higher concentration of debt amongst government employees. Of the total government work force of 325,668 there are a total 260,773 loans.

Table 10 shows the number of scheme loans by sector of employment.

Table 10: Scheme loan access by type of employment

Sector of employment ↓	Number of employees	Number of scheme loans	% of employees with scheme loans (assuming one loan per person)
Government (local and central) & Parastatals	325,668	260,773	80%
Private companies	498,507	97,703	17%
Other (NGOs, churches, donor agencies, embassies)	70,027		
Total	**894,175**	**358,476**	**40%**

Source: Labour Force Survey (2012) and data collected from credit providers during the PlaNet Finance payroll lending study (2014).

Multiple borrowing

The above analysis assumes one loan per borrower, but in reality this is not the case, as observed in random spot checks of files during the visits to selected lenders (2014). We were unable to identify reliable secondary data on the number of loans per borrower - which is an important area to be addressed in the MMP process. However, short questionnaires were conducted with focus group discussion participants on levels of indebtedness as part of the focus group discussion screening process. There were 79 respondents that participated. The responses on multiple borrowing are shown in Table 11. More than half of the participants had more than one loan. Whilst it is not possible to extrapolate this result to the entire population given the sample size, it is sufficient evidence to suggest that the BoZ needs to monitor indebtedness levels and multiple borrowing very closely going forward.

Table 11: Findings on multiple loans (n = 79)

Number of Loans	Number of Respondents	Frequency (%)
1	38	48.1%
2	26	32.9%
More than 2	15	19.0%
Totals	**79**	**100%**

Source: Screening questionnaires from focus group discussions (2014)

This information suggests that the earlier estimate of payroll loan penetration (40% of formally employed individuals) is overstated and that we can assume a lower level of penetration across the board. This suggests that certain market segments have no access to payroll loans whilst others are faced with rising debt stress and potentially unsustainable debt levels.

A number of borrowers that participated in the focus group discussions also indicated borrowing from informal lenders. The reasons provided for borrowing from informal lenders included:

- "Because of bureaucracy by banks, including CRB searches";
- "Because my net pay is too little and salary scheme lenders are not ready to provide an additional loan", and;
- "Quick access to cash due to few procedures".

This suggests that borrowers are turning to informal lenders once they have reached the prescribed deduction threshold. Again this raises concerns about indebtedness levels.

Box 7 shows the recreation of an actual example of a payslip for someone that has accessed multiple loans. These levels of debt are within the legal limit and the threshold set by PMEC. This individual has a housing loan and three payroll loans. On a salary of approximately ZMW 5,000, s/he is only taking home ZMW 1,500.

Box 7: Sample payslip of a civil servant with multiple loans

Pay Month: October 31, 2013	**Position:** Instructor	
Description	**Payments**	**Deductions**
Basic Salary	3,901.79	
Housing Allowance	780.26	
Transport Allowance	390.18	
PAYE		511.10
Pension		282.88
Loan Household - interest repayment		9.81
Loan Household – principal repayment		98.13
FSP A		823.34
FSP B		643.06
Zambia State Insurance		90.00
Zambia National Union of Teachers		78.04
Premium Med Family Member		62.50
Ndola Cusa		200.33
FSP M		697.93
Totals	**5,072.33**	**3,497.12**
Net Pay	**1,575.21**	
Net Pay as % of Total Earnings	**31.05%**	

Source: Payslips viewed during Key Informant Interview (2014)

Affordability scenario testing

This section of the report contains three affordability calculation scenarios, in both a rural and urban context, for illustrative purposes. Based on these scenarios we recommend that more comprehensive work is conducted around the establishment of the deduction threshold in the BFS Bill.

A comparison is made between average income levels across four categories of formal employment and the average household expenses as reported by the Central Statistics Office (CSO) in 2011. This comparison begins to provide insights into disposable incomes and how disposable income is related with affordability and access to credit. The income and expenses are drawn from the Employment and Earnings Enquiry Report (CSO, 2011) and the Living Conditions Monitoring Survey (2011) respectively. As the living expenses vary quite significantly between rural and urban areas, two different sets of data are used as shown in Table 12 and Table 13 respectively.

Table 12: Rural household monthly income and expenses

Employment category	Central govt.	Local govt.	Parastatal	Private
Net pay (ZMW)	2 835	2 500	4 178	2380
Rural: Food expenses (ZMW)	*465*	*465*	*465*	*465*
Rural: Non-food expenses (ZMW)	*276*	*276*	*276*	*276*
Total expenses (ZMW)	741	741	741	741
Balance after household obligations (ZMW)	**2 094**	**1 759**	**3 437**	**1 639**

Source: Employment and Earnings Enquiry Report (CSO, 2011) and the Living Conditions Monitoring Survey (2011)

Table 13: Urban household monthly income and expenses

Employment category	Central govt.	Local govt.	Parastatal	Private
Net pay (ZMW)	2 835	2 500	4 178	2380
Urban: Food expenses (ZMW)	*1 617*	*1 617*	*1 617*	*1 617*
Urban: Non-food expenses (ZMW)	*914*	*914*	*914*	*914*
Total expenses (ZMW)	2 531	2 531	2 531	2 531
Balance after household obligations (ZMW)	**304**	**(31)**	**1 647**	**(151)**

Source: Employment and Earnings Enquiry Report (CSO, 2011) and the Living Conditions Monitoring Survey (2011)

Even without any debt commitments, the information in Table 13 shows that relatively high food prices in urban areas have a considerable financial impact on households. In fact due to the higher costs in urban areas the data indicates that on average most households would not be able to meet their monthly household living expenses without a dual income, except for those employed by parastatals. Understanding household income and expenses in far more detail would be highly useful and necessary in determining the extent of the affordability issues faced by Zambian households. Based on the feedback from focus group discussions and the fact that no information to the contrary was received, this suggests that households have a secondary source of income. This could be from a spouse who is also in formal employment and receives a salary or who runs a small business that generates an income. However, in most cases it is likely that this secondary income will be quite small and sometimes irregular. Further research is needed to confirm these hypotheses.

Scenario testing for affordability and over indebtedness

Based on the household income and expenditure data three loan scenarios are simulated below to test the affordability of the loans and their impact on a hypothetical household's ability to meet its monthly expenses. The three scenarios make the following four assumptions:

- The household only has one source of income;
- The financial institution makes its credit decision based on the 40% rule set by PMEC and that has been generally adopted by both MFIs and banks;
- Loan pricing is based on an existing MFI pricing structure using the prevailing interest rate limit of 46%. Commercial bank pricing would be lower so in terms of this the scenarios depict a slightly more conservative view of indebtedness, and;
- Loan scenarios of ZMW 5,000 for 12 months, ZMW 20,000 for 24 months and ZMW 30,000 for 36 months are used on the basis that these are representative of loans that the majority of payroll

loan clients are currently accessing based on information gathered in the key informant interviews and data requests to the financial institutions.

(i) Loan scenario 1: ZMW 5,000 over 12 months by an MFI

Based on the net pay of all four employment categories in Table 14 for the rural setup, all four would qualify for the loan as the instalment amount is less than 60% of the net pay. In all four cases there is also sufficient income remaining to meet all the household expenses even after the loan deduction through payroll.

Table 14: Scenario 1A - Rural household

Employment category	Central govt.	Local govt.	Parastatal	Private
Net pay (ZMW)	2 835	2 500	4 178	2380
60 % of basic (ZMW)	1 701	1 500	2 507	1 428
Instalment (ZMW)	581	581	581	581
Balance after loan deduction (ZMW)	2 254	1 919	3 597	1 799
Rural: Food expenses (ZMW)	465	465	465	465
Rural: Non-food expenses (ZMW)	276	276	276	276
Total expenses (ZMW)	741	741	741	741
Balance after all obligations (ZMW)	**1 513**	**1 178**	**2 856**	**1 058**

In Table 15 the scenario is the same as in Table 14 except that the employees are now based in an urban area and therefore incur higher household expenses especially for food. Based on the 40% affordability rule, all four individuals would qualify to obtain the loan. However, when it comes to meeting the household monthly expenses, only the individual with the highest income, employed by the parastatal, will be able to meet all obligations. A further consideration is the cost of credit depending on the credit provider. If the same loan under scenario one was availed by a commercial bank it would have cost approximately ZMW 50 less per month. Over a 12 month period this would amount to a saving of ZMW 600. Although significant, this would still have the same overall result in terms of the affordability position for households. That is urban employees would still not being able to afford the loan.

Table 15: Scenario 1B - Urban household

Employment category	Central govt.	Local govt.	Parastatal	Private
Net pay (ZMW)	2 835	2 500	4 178	2 380
60 % of basic (ZMW)	1 701	1 500	2 507	1 428
Instalment (ZMW)	581	581	581	581
Balance after loan deduction (ZMW)	2 254	1 919	3 597	1 799
Urban: Food expenses (ZMW)	1 617	1 617	1 617	1 617
Urban: Non-food expenses (ZMW)	914	914	914	914
Total expenses (ZMW)	2 531	2 531	2 531	2 531
Balance after all obligations (ZMW)	**(277)**	**(612)**	**1 066**	**(732)**

(ii) Loan scenario 2: ZMW 20, 000 over 24 months by an MFI

Table 16 shows the second loan scenario of a 24 month, ZMW 20,000 loan, in a rural setting. Again we find that all the four individuals would qualify for the loan based on the 40% rule. That is the monthly instalment does not exceed 60% of their net take home pay. The four individuals are also able to meet all of their household expenses.

Table 16: Scenario 2A - Rural household

Employment category	Central govt.	Local govt.	Parastatal	Private
Net pay (ZMW)	2 835	2 500	4 178	2380
60 % of basic (ZMW)	1 701	1 500	2 507	1 428
Instalment (ZMW)	1 419	1 419	1 419	1 419
Balance after loan deduction (ZMW)	1 416	1 081	2 759	961
Rural: Food expenses (ZMW)	465	465	465	465
Rural: Non-food expenses (ZMW)	276	276	276	276
Total expenses (ZMW)	741	741	741	741
Balance after all obligations (ZMW)	**675**	**340**	**2 018**	**220**

However when scenario two is applied in an urban setup (as per Table 17), even though all four will qualify for the loan based on the 40% rule, other than the one employed by the parastatal, the other three categories of employees will not able to meet their household expenses by more than ZMW 1,000. Without the loan the central government employee would be able to cover household expenses whereas the local government and private employee would still fall short.

Table 17: Scenario 2B - Urban household

Employment category	Central govt.	Local govt.	Parastatal	Private
Net pay (ZMW)	2 835	2 500	4 178	2 380
60 % of basic (ZMW)	1 701	1 500	2 507	1 428
Instalment (ZMW)	1 419	1 419	1 419	1 419
Balance after loan deduction (ZMW)	1 416	1 081	2 759	961
Urban: Food expenses (ZMW)	1 617	1 617	1 617	1 617
Urban: Non-food expenses (ZMW)	914	914	914	914
Total expenses (ZMW)	2 531	2 531	2 531	2 531
Balance after all obligations (ZMW)	**(1 115)**	**(1 450)**	**228**	**(1 570)**

(iii) Loan scenario 3: ZMW 30, 000 over 36 months by an MFI

In scenario three represented in Table 18 and Table 19, due to the large loan amount and the larger repayment instalment amount only the parastatal employee would qualify for the loan on the basis of the 40% rule. For the other three profiles the instalment of ZMW 1,706 is higher than 60% of their net pay.

For the two government employees in the rural areas, Table 18 shows that even if they did not qualify for the loan according to the 40% rule, had they received the loan they would have been able to afford the monthly instalment and would have still managed to cover their household expenses.

Table 18: Scenario 3A - Rural household

Employment category	Central govt.	Local govt.	Parastatal	Private
Net pay (ZMW)	2 835	2 500	4 178	2380
60 % of basic (ZMW)	1 701	1 500	2 507	1 428
Instalment (ZMW)	1 706	1 706	1 706	1 706
Balance after loan deduction (ZMW)	1 129	794	2 472	674
Rural: Food expenses (ZMW)	465	465	465	465
Rural: Non-food expenses (ZMW)	276	276	276	276
Total expenses (ZMW)	741	741	741	741
Balance after all obligations (ZMW)	**388**	**53**	**1 731**	**(67)**

In the urban setup, even though the parastatal employee qualifies for the loan under the 40% rule, he/she is not able to cover all his obligations taking into account the high household expenses as per Table 19. No urban households are able to avoid the loan in scenario three.

Table 19: Scenario 3B - Urban household

Employment category	Central govt.	Local govt.	Parastatal	Private
Net pay (ZMW)	2 835	2 500	4 178	2 380
60 % of basic (ZMW)	1 701	1 500	2 507	1 428
Instalment (ZMW)	1 706	1 706	1 706	1 706
Balance after loan deduction (ZMW)	1 129	794	2 472	674
Urban: Food expenses (ZMW)	1 617	1 617	1 617	1 617
Urban: Non-food expenses (ZMW)	914	914	914	914
Total expenses (ZMW)	2 531	2 531	2 531	2 531
Balance after all obligations (ZMW)	**(1 402)**	**(1 737)**	**(59)**	**(1 857)**

Conclusions on affordability and over-indebtedness

The rise of payroll lending may be one reason why spending on housing increased by five percent between 2006 and 2010, and may have increased further over the ensuing four years, especially for low- and middle-income households who previously lacked access to credit for home building or improvement.

However looking at the method payroll lenders (both banks and MFIs) use in assessing affordability the scenario tests above clearly show that the current method of assessing affordability is insufficient to ensure that the borrower has enough income to meet their monthly financial obligations. The method focuses only on the obligations indicated on the payslip i.e. statutory obligations and other payroll deductions. It does not take into account other financial commitments that the borrower may have. The scenario testing indicates that the majority of individuals employed by the government and private sector are barely able to meet their household obligations. When the loan instalments are taken into account, even a relatively small loan of ZMW 5,000 for 12 months, means that many of them will not be able to meet their monthly obligations unless the household has a reliable secondary source of income. It would appear that the 40% rule currently serves the interests of the payroll lenders more than the borrowers, allowing them to extend loans that draw on a significant portion of income without considering the borrowers' ability to meet their basic household needs. Based on these scenarios, as a majority of borrowers are not able to meet their household needs from their take home pay this leads to employees obtaining additional loans to survive from month to month until they reach the 40% threshold due to multiple loans.

3. Loan repayment performance

Considering the payroll lending methodology, the prevalence of poor loan repayment performance by an individual is relatively low. This is mainly because once a loan is disbursed and the first instalment has been received there is very little reason for an instalment to be missed. It is for this reason that it is a preferred recovery mechanism by lenders. Specific circumstances under which an individual may miss instalments and fall into arrears are:

- Delays in loading the loan on the payroll of the employer. This might lead to a loan running one or two months in arrears;
- An irregular deduction from the pay of an individual that leads to the loan instalment breaching the 40% rule and the transaction being dropped of in the given month. This happens in circumstances where the individual owes the employer some funds (E.g. accountable imprest[11]) and these are recovered given a higher priority than third party payroll deductions;
- Facing of disciplinary action that may lead to an employee receiving reduced or no pay;
- Resignation and change of employer, and;
- Retirement.

The above are all exceptional, isolated cases and usually do not affect a financial institution's portfolio performance at a wholesale level. They can also be addressed through cooperation with the payroll and human resources department of the employees.

However there are some other types of events that affect payroll lenders portfolios at a wholesale level when they occur:

- Unremitted funds: Sometimes companies, especially medium sized ones, have run into cash-flow problems and do not remit the loan instalments they have deducted from their employees to the payroll lenders. Depending on the level of exposure of a payroll lender to such a company and the duration of the delay is it can have significant impact on the performance of the payroll lender, and;
- Mass lay-offs and retrenchments: Due to economic reasons some industries have had to restructure and retrench workers in large numbers. If a payroll lender is highly exposed to such an industry they could be adversely affected as the retrenched workers will be unable to service their loans when they lose employment. This was the case with the copper mining sector in the late 2000s. One of the banks that had significant exposure in the sector made significant losses.

[11] Funds that an employee is given in advance for a work mission/trip that they need to account for at real cost and refund any remaining funds

Most payroll lenders have internal credit policies that try to limit their exposure to the above risks. These include limiting the total portfolio exposure for individual companies and sectors and reviewing these on an ongoing basis in response to market and economic trends.

The banks and MFIs surveyed generally indicated that their payroll lending portfolios were doing just as well or in most cases better than their other portfolios. However there was quite a variation in the levels of non-performing loans (NPLs) for different institutions. Data on the portfolio performance was particularly difficult to collect and is an important metric for future monitoring by the BoZ. This can be attributed to the fact that the NPL was influenced more by an individual institution's risk appetite and internal control procedures than by the payroll lending methodology itself. Some of the non-performing loan rates provided in the interviews is shown in Table 20.

Table 20: Non-performing loan figures

CETZAM	Bayport	Zanaco	StanChart	BancABC	Investrust
4%	5%	4.5%	0.4%	5-10%	2%

Source: Interviews, 2014

Unfortunately, it is not clear how reliable these NPL figures are, since methods for determining non-performance varies, and financial institutions have an incentive to under-report NPLs. Standardisation of NPL accounting practices is a necessary inclusion in the BoZ's MMP and its ability to monitor credit markets.

4. Demand-side conclusions

The role of payroll lending in financial inclusion

Payroll lending plays an important role in financial inclusion in Zambia. Before the introduction of payroll lending in Zambia, the majority of formal workers had no access to credit from banks and other lenders, who considered personal loans too risky. The only access to credit came from retailers for household goods (e.g. furniture, electrical items).

Previously, the underdevelopment of the financial sector in Zambia left a considerable number of creditworthy households unable to access loans. In the past, this demand was partially met through salary advances, but these were too small to finance large expenditures.

The introduction of payroll lending has enabled many households to own or repair their homes or purchase a new car for the first time. Since employers have completely stopped advancing salaries, employees use payroll lenders to meet short-term cash shortfalls as well.

A large number also use payroll loans to cover the expenses of starting or expanding an income generating activity to supplement their salaries. Using their future earnings as loan collateral, they can access credit without having traditional collateral.

Advantages and disadvantages

The key benefits of payroll loans include: payroll loans are the primary source of credit where other sources are extremely limited, enabling households to make large expenditures as well as smooth cash flow.

The pitfalls of payroll loans include: relatively easy access to payroll loans may discourage saving; ease of access may also increase the temptation to borrow unnecessarily; loan terms and conditions are generic and not geared sufficiently to the borrowing needs of the clients; there is almost no client monitoring; and all of these factors can create the conditions in which a debt crisis can occur.

Another key disadvantage of payroll lending is that some households face financial difficulties as a result of over borrowing, as indicated above.

Most affected consumer groups

Consumer groups most likely to be affected by poor lending practices among payroll lenders are low-income earners, whose relative lack of financial literacy creates the possibility of over-borrowing or exploitation. Based on the income levels the most affected will be private sector employees, followed by local government employees especially those found in urban areas where the cost of living is higher. As a consequence the highest incidents of over-indebtedness are found in Lusaka, the Copperbelt province and the newly industrialised North Western province. Money lenders, especially in the Copperbelt, use unprofessional collection practices, such as keeping a client's debit card and PIN to collect on loans or making borrowers pre-sell the property they pledged as collateral, which the lender can dispose of if the borrower misses payment by just a few days. In some cases the value of items pledged as collateral are several times higher than the loan amount. For instance, some borrowers have pledged title of land or houses valued as much at ZMW 200,000 for a loan of ZMW 10,000.

Impact of payroll lending practices on clients' trust in formal financial institutions

The big gap between interest rates on loans and interest rates on deposits discourages clients from saving with banks, especially if the rate of inflation is high. Clients prefer to spend their surplus income now than to save it in a savings account. Clients feel that banks are more interested in making profits than promoting financial inclusion. As a result most people are net borrowers instead of net savers.

Clients sometimes resort to borrowing from informal lenders because of the short turnaround time. Some money lenders approve and disburse a loan within 48 hours while banks may take up to 30 days to approve a payroll loan. Borrowers sometimes want money to invest in a business opportunity and delayed loan disbursement means a lost business opportunity.

The lack of a close relationship between borrower and lender characterised by payroll lending can also act as a deterrent regarding building clients' confidence in formal financial institutions. Clients feel that formal lenders are more interested in recovering their loans at all costs and care less about the impact on the client. Few formal lenders ask their clients about loan use.

Payroll disincentivises prudent affordability assessment

In conventional credit methodology, the credit provider as part of its credit risk mitigation makes considerable effort to ensure that the borrower can afford to repay the loan. This is usually done through cash-flow analysis, to ensure that even with the credit instalment being paid, the borrower will still be able to meet other obligations. This is especially so in unsecured lending. However, with payroll lending there is no longer a strong incentive for the lender to ensure that borrower can afford the loan instalment as the lender's interest is secured through preferential access to the income that payroll deduction provides, regardless of whether or not remaining income will be sufficient for the borrower to survive on or what other commitments he has post salary disbursal.

Based on the interviews conducted, anecdotal evidence from borrowers in focus group discussions and affordability scenario testing conducted that the current 40% rule adopted by the industry as the main practice to safeguard over-indebtedness is inadequate. It merely provides a false sense of security on the basis that 40% of one's income will be sufficient to cover all other off pay-slip obligations. Depending on one's net pay, 40% can vary greatly, hence a better means of measuring affordability would be to consider a minimum disposable income in absolute terms that is needed to survive for different typologies of households. This minimum amount should, for instance, be based on the size of one's household and related costs of such a household as calculated by the CSO's living conditions survey or the Bread Basket Survey conducted by the Jesuit Centre for Theological Reflection.

Very few countries have developed detailed guidelines on affordability. In general, rules are similar in Zambia for limiting loans repayments as a proportion of net salary. The percentage varies from country to country between 30% and 50%. For instance, the Namibia Labour Act specifies that loan instalments should not exceed one third of disposable income (after all statutory deductions). Senegal limits deduction to 35% of salary. In a Circular dated 23rd July 2014, the Government of Uganda has limited loan repayments through payroll deductions for civil servants to 50% of net salary.

One country that has gone further in the development of detailed affordability rules is South Africa. In August 2014, the Department of Trade and Industry published (for public comment) the Draft National Credit Regulation for Affordability Assessment. The principle as stated in Chapter 3 says that, "a credit provider must take practical steps to assess the consumer or joint consumer allocatable income[12] as well as their discretionary income to determine whether the consumer has the financial means and prospects to pay the proposed credit instalments". In defining necessary expenses, the draft regulation proposes a table where necessary expenses vary according to the gross income level as follows

Table 21: South Africa's proposed affordability guidelines

Monthly Gross Income		Minimum Monthly Fixed Factor	Monthly Fixed Factor +% of Income Above Band Minimum
Minimum	Maximum		
ZAR 0.00	ZAR 800.00	ZAR 0.00	100%
ZAR800.01	ZAR 6,250.00	ZAR 800.00	6.75%
ZAR 6,250.01	ZAR 25,000.00	ZAR 1,541.67	9.00%
ZAR 25,000.01	ZAR 50,000.00	ZAR 3,375.00	8.20%
ZAR 50,000.01	Unlimited	ZAR 5,425.00	6.75%

Source: Draft National Credit Regulation for Affordability Assessment (2014)

This is a highly sophisticated system which effectiveness will only be tested if and when these norms are adopted in South Africa. In particular the implementation of these rules will need to be tested in terms of the capacity and ability of the regulator to enforce these and the impact on responsible credit access.

[12] Gross salary minus statutory deductions and necessary expenses.

As the payroll lending market does not have a sufficient incentive to put in place such affordability measures itself, the regulator is best placed to provide such guidelines and ensure adherence. Any such guidelines on affordability, provided by the regulator, need to be explicit enough to enable uniform interpretation and enforcement.

VII. Supply side analysis

1. Retail payroll lenders by institutional type

Payroll lending makes up approximately one third of the credit portfolio (ZMW 6.49 billion of ZMW 20 billion) in Zambia, the balance primarily being corporate, business and some alternative personal credit provision (very limited supply of credit cards, vehicle finance, housing finance and non-payroll loan personal loans). Financial institutions, of all legal types, engage in payroll lending in Zambia including commercial banks, MFIs (socially and commercially orientated), building societies, leasing companies and NATSAVE. The commercial banking sector has the largest number of payroll lenders with the largest portfolios, dominating with 79% market share (by value). Three commercial banks have more than half their loan books in payroll loans. A further three commercial banks have more than 25% of their loan books exposed to payroll lending.

The NBFIs account for almost 17.7% of payroll lending. Nearly 75% of this sector's loans are in payroll, but their exposure varies widely. Three specialised payroll lenders, account for almost all the payroll loans by NBFIs. The other significant payroll lender is NATSAVE, which has approximately three percent market share by value. Two-thirds of NATSAVE's portfolio is in payroll loans.

Although some enterprise-lending MFIs, leasing companies and building societies engage in payroll lending, exposure varies widely across those sectors, and the total value of payroll loans by these sectors is an insignificant share of the overall market. Public Services Microfinance Company (MFC), which is currently unlicensed, has been issued a deduction code by PMEC.

2. Market conduct and consumer protection context

Methods of repayment

To date, no rules have been issued to regulate methods of repayment. This section describes the methods of repayment used by banks and non-banks lenders for consumer loans.

The commercial MFIs and banks involved in consumer lending predominantly use payroll deductions for the collections of loans. The financial institutions enter into scheme loan arrangements with employers who deduct the loan instalment from the salary of borrowers each month and remit the loan repayment funds to the financial institution.

Some of the banks also propose another method of repayment. They require that the borrower's salary be transferred to the transactional account which they maintain with the bank and the loan repayment is deducted from the bank account by debit order. In some cases the lenders are still required to sign an agreement with the employer under which the latter commits to not changing the pay point and bank of the borrower without informing the bank. However, employers are reluctant to commit to not changing the pay point since it remains the right of each employee to request such a change.

There is a strong preference for payroll deduction amongst lenders, including by banks that have direct access to customer accounts. This creates a context where the race to the front is the main objective, meaning that even banks perceive that they need to have a way to be paid first (before any other lender or creditor). Clearly, the lenders presume that any borrower with multiple commitments will not able to honour all of them. Ironically, non-bank lenders had the first mover advantage in this market and opted for payroll lending as they did not have the option that banks had available to them through the use of debit orders. When banks entered the sector, they obtained the same advantage as MFIs by also gaining access to the front of the queue or risking receiving salaries in the bank accounts that would be insufficient to service the loans after MFI loan repayments had been deducted. Payroll lending also resolves the risk of clients switching their bank accounts.

Importantly, even while using payroll lending, a number of the banks stated that they insist that the salary still be channelled through their bank accounts as a backup measure in case something goes wrong with the payroll deduction. It is also a means of retaining the client's savings and monitoring their transactional behaviour even if the loan deduction is through payroll.

In some anecdotal cases, instances of taking the borrower's debit card as well as his/her PIN to draw money for repayment at an ATM were reported but they were not publicised. There are reported cases of this type of practice, especially in the Copperbelt province, with moneylenders (informal) providing loans to mineworkers.

Affordability and adequacy of product

Affordability rules are crucial for preventing over-indebtedness and to prevent deterioration of loan books.

At the moment, there is no legal requirement to undertake an assessment of the suitability and affordability of a financial product or service. The Risk Management Guidelines for Financial Service Providers Regulated by the BoZ indicates that "financial institutions must assess the risk profile of the customer/transaction, taking into consideration, amongst others, the borrower, borrower's industry and macro-economic factors; the purpose of credit and source of repayment; the track record/repayment history of borrower; the repayment capacity of borrower, […]".

Furthermore, since 2008, according to the BoZ Directive on Submission of Credit Data and Utilisation of Credit Reference Agencies, all licensed financial service providers are required to use the services of a credit reference agency at all times before granting credit to any customer. Failure to do so constitutes an unsafe and unsound practice as defined in the BFSA. This is an important requirement in terms of affordability assessments.

The BFS Bill, as outlined in section 67, includes a general obligation for financial services providers to assess affordability. Importantly it also spells out some specific affordability rules. These are outlined below.

"A financial service provider shall not extend credit to a consumer unless a reasonable financial service provider would believe at the time the loan is agreed that the consumer or consumers will be able to make the scheduled payments associated with the loan, based upon a consideration of the consumers' current and expected income, current obligations, employment status, and other financial resources;

For purposes of this subsection, there shall be a rebuttable presumption that a consumer is able to make the scheduled payments to repay the obligation if, at the time the extension of credit is approved, the consumers total monthly debts due on outstanding obligations, including amounts under the loan, do not exceed 70% of his or her monthly gross income as verified by:

a) The consumer's credit application and a credit report; and

b) Tax returns, payroll receipts, or other third-party income verification."

However, the rule initially proposed establishing a total monthly debt due at 70% of gross income is, surprisingly more relaxed than the current industry practice and the rules applied by the civil service for deductions through the PMEC system, whereby 'take home pay' should not be less than 40% of the 'basic salary'. Since drafting this report, this section has been revised back to the 60:40 rule and giving the BoZ explicit powers to enable them to issue more stringent directives, should the need arise.

Disclosure of terms and conditions, including pricing

While there are limited guidelines that set standards on the calculation of the cost of credit but there is no standard form or requirement on how the components of these costs should be communicated clearly to borrowers. The introduction of interest caps has put more scrutiny on the cost of lending but it has also led to inconsistent and less transparent pricing because different types of institutions use different methods of calculating total cost of credit.

The BFS Bill empowers the BoZ to prescribe the manner in which interest rates and charges are disclosed. Section 64 states that "a financial service provider shall disclose the interest rate and charges in a manner to be prescribed by the Bank."

Effectiveness of legal contract enforcement

Legal contract enforcement in Zambia is not very effective due to high legal costs and the long period it takes for trial and judicial enforcement to occur. According to the World Bank Report of Doing Business of June 2013, it takes a total of 611 days from case filing to enforcement of judgement (21 days for filing and service; 470 days for trial and judgement; and 120 days for enforcement of judgement). The cost as a percentage of a claim is estimated at 38.7% (23.7% attorney cost; five percent court cost; and 10% enforcement cost).

As a result, the majority of lenders therefore generally only use courts for contract enforcement as a last resort and primarily for larger loans. This simultaneously discourages the supply of credit and somewhat encourages a bad credit culture in society.

Debt recovery

The current legislation does not cover debt recovery. However, the BFS Bill contains provisions in section 73 prohibiting certain debt collection practices. It states that "a financial service provider shall not engage in any conduct, the natural consequence of which is to harass, oppress, or abuse any person in connection with the collection of a debt; a financial service provider may not use any false, deceptive, or misleading representation or means in connection with the collection of any debt."

The BoZ might consider at some point to provide further guidance as to the specific practices which constitute harassment or other prohibited conduct.

3. Estimation of the size of the retail payroll lending market

As mentioned above, estimates suggest that scheme (payroll) loans account for one-third of all financial system loan value, up from 25% at the end of 2008 (BoZ, 2014). However, accurate data on payroll lending is difficult to obtain. BoZ does not regularly collect data on payroll loans specifically. Even if it did, the fact that different types of financial institutions engage in payroll lending, make standardised reporting difficult due to the difference in reporting formats between lenders as well as their reporting frequency and thoroughness (reporting capacity). The MMP expects to improve reporting through standardisation of reporting formats, but gaps in the capacity of some NBFIs' information systems may also need to be addressed in order to ensure timely and accurate reporting.

As part of this assignment, the consulting team asked the BoZ to request data from all financial institutions engaged in payroll lending. The data was neither as complete nor as thorough as it could have been. This necessitates the need for ongoing monitoring of the data and identification of potential risks by the BoZ as this research effort was not as exhaustive or as accurate as is required for high confidence results. A number of institutions did not respond to the BoZ's request for data, either because they could not (due to weaknesses in their information systems) or because they are not involved in payroll lending and thus did not feel the need to respond. Nevertheless, the main players did report, and the data was sufficient to conduct an analysis, provide insights and draw conclusions based on what was available.

Based on the information that was provided in this data collection exercise, the consulting team calculates that total outstanding payroll loans as of mid-2014 stood at ZMW 6.5 billion (USD 1.08 billion), up from ZMW 4 billion (USD 666 million) in 2012, a growth of 63%. Total credit provided by financial institutions grew from ZMW 14 billion (USD 2.3 billion) to ZMW 20 billion (USD 3.3 billion) over the same period, an increase of 44%. The differential in growth rates caused payroll loans to rise to 32% of total loans outstanding in 2014 from 29% in 2012 and 25% in 2008.

Table 22: Loan values (ZMW '000) as of mid-2014

	Commercial Banks	Enterprise-lending MFIs	Consumer-lending MFIs	Building Societies	NATSAVE	Leasing companies	Total
Total portfolio value (all different business lines)	**17,924,233**	**131,088**	**1,542,180**	**276,683**	**274,095**	**2,477**	**20,150,757**
Corporate/wholesale portfolio value	9,177,417	0	908	0	759	0	9,179,084
Retail/ household portfolio value	8,746,817	131,088	1,505,856	252,029	268,874	2,477	10,907,141
Personal loan portfolio value (non-scheme)	1,946,188	114,481	393,588	227,375	85,989	657	2,768,279
Other retail loan portfolio value	1,732,342	1,307	0	0	2,406	0	1,736,055
TOTAL Scheme loan portfolio value	**5,123,372**	**15,300**	**1,147,294**	**24,654**	**180,479**	**1,820**	**6,492,919**
Government scheme arrangements	2,478,452	0	845,817	23,630	180,479	1,796	3,530,174
Private sector scheme arrangements	2,644,921	0	301,477	1,024	0	24	2,947,445

Source: Data collected from financial institutions (2014)

Table 22 shows the value of the total credit portfolio and payroll loan portfolio by institution type.

Commercial banks account for nearly 79% of all reported outstanding payroll loans (by value). The five leading lenders, together account for 73% of all payroll loans outstanding. Consumer-lending MFIs account for nearly 18% of all payroll loans. The other large player in the payroll market is NATSAVE, with three percent market share.

The consulting team also asked the BoZ to collect data from TransUnion Zambia. Unfortunately, credit bureau data is not consistent with the self-reported data of the financial institutions and is a definite area for development (although it has reportedly improved). The credit bureau data shows total credit outstanding of ZMW 20 billion in personal loans, which is in line with what the financial institutions reported as total credit outstanding. The self-reported figures are generally consistent with the BoZ sources. However, within the ZMW 20 billion in outstanding personal loans, TransUnion Zambia says ZMW 16.4 billion make up non-scheme loans, leaving ZMW 3.6 billion in scheme loans vs. the ZMW 6.5 billion reported by the financial institutions. This inconsistency in data appears to be as a result of unclear data and definitions related to the loans that constitute a scheme loan and those that do not. Furthermore, although there has been an improvement in reporting, TransUnion Zambia also reported that some institutions (including large banks) are not reporting as required. The bureau data is therefore possibly understated. Overall, the research team was unable to ascribe a high level of confidence in the data reported by the bureau. This could be an important source of data for the BoZ to monitor market conditions and trends. As a registered entity with the BoZ, the central bank has the ability to influence and bring about more clarity and rigour in terms of the definitions, classifications of loans, reporting deadlines and more.

As shown in Table 23, there were almost 360,000 payroll loans reported as of mid-2014, up 36% from 265,000 loans reported in 2012. In terms of loan volume, banks are somewhat less dominant, accounting for 63% of all reported payroll loans. Consumer-lending MFIs account for 31% of payroll loans in volume, and NATSAVE six percent. Again, data reported by TransUnion Zambia is inconsistent with these figures: TransUnion Zambia reports a total of 1 million personal loans, of which 65,000 are scheme loans.

Table 23: Loan volume (number of loans) as of mid-2014

	Banks	Enterprise-lending MFIs	Consumer-lending MFIs	Building societies	NATSAVE	Leasing companies	Total
Total	**299,789**	**15,222**	**174,719**	**18,510**	**52,561**	**699**	**561,500**
Corporate/wholesale portfolio	8,768	0	27	0	407	0	9,202
Retail/ household portfolio	293,236	15,222	123,740	18,510	51,827	699	503,234
Personal loan portfolio (non-scheme)	29,463	12,754	61,781	17,692	30,073	133	151,896
Other retail loan portfolio	38,501	2,000	0	0	1,608	0	42,109
TOTAL Scheme loan portfolio	**224,453**	**468**	**112,492**	**818**	**20,146**	**566**	**358,943**
Government scheme arrangements	161,053	0	78,239	777	20,146	558	260,773
Private sector scheme arrangements	63,400	468	34,253	41	0	8	98,171

Source: Data collected from financial institutions (2014)

Based on the reported value and volume of outstanding loans, the average size of outstanding loans can be derived. Banks make the largest loans with an average outstanding balance on payroll loans of nearly ZMW

23,000. This is more than twice the total average payroll loan outstanding (ZMW 10,251). The average outstanding amount of all other types of institutions is less than ZMW 10,000.

4. Institutional level analysis

This section describes the relative exposure to payroll lending by different financial institutions in Zambia (the data is masked) and is based on information collected by the BoZ in September 2013. Aside from being more than a year old, no detailed information on domestic borrowing was available. Collecting this data and monitoring these trends in the payroll lending market will be a crucial area for future development. Nevertheless, the data shows some concerning concentration of payroll lending portfolios within a few institutions and low levels of capital adequacy and liquidity in others – particularly for non-bank financial institutions.

Twelve institutions account for 96% of all payroll loans in Zambia. Although some have relatively small payroll portfolios, their exposure to payroll loans relative to their total loan book is extremely high. These institutions are thus most at risk if there is a crisis in the payroll lending market, but if adversely affected would be unlikely to have a systemic impact on the sector as a whole given the size of their loan books. Table 24 provides an overview of the value of scheme loan portfolios and the relative concentration of these loan portfolios within the institution as well as the payroll sector in Zambia. Financial Service Providers (FSPs) were randomly assigned letters of the alphabet and these names were consistently applied throughout this version of the report.

Table 24: Summary of institutional level loan exposure

Institution	Total value of scheme loans (ZMK '000)	% of all scheme loans in Zambia	Scheme loans % total loan book
FSP A	888,918	13%	26%
FSP B	1,370,845	20%	38%
FSP C	358,975	5%	100%
FSP D	647,537	9%	16%
FSP E	3,851	0.06%	100%
FSP F	256,661	4%	29%
FSP G	742,174	11%	73%
FSP H	81,260	1%	55%
FSP I	27,170	0.40%	100%
FSP J	168,739	2%	100%
FSP K	970,563	14%	100%
FSP L	1,091,082	16%	64%
	6,583,322	**97%**	

Source: BoZ (2013)

The consulting team analysed the level of risk associated with these institutions from three perspectives: capital adequacy, liquidity, and network (inter-lending) risk.

In terms of capital adequacy FSP F and FSP D are the only banks that have larger Tier One capital than their payroll loans, since they engage in other types of lending. FSP I and FSP E, which are reducing their exposure to payroll loans, also have more capital than their scheme loan exposure.

In contrast, FSP G, FSP K, FSP C and FSP J have the least Tier One or Tier Two capital relative to their scheme loan exposure, leaving them most at risk of bankruptcy should a crisis hit the scheme loan market. Table 25 provides the detail on the capital structure of these institutions.

Table 25: Capital structure by institution

Institution	Tier One capital (ordinary shares + retained earnings) (ZMW'000)	Tier One capital, % scheme loans	Total capital ZMW '000	Total value of scheme loans (ZMK '000)	Total capital, % scheme loans
FSP A	655,079	74%	816,870	888,918	92%
FSP B	692,932	51%	692,932	1,370,845	51%
FSP C	25,029	7%	58,275	358,975	16%
FSP D	726,181	112%	747,690	647,537	115%
FSP E	50,360	1308%	50,360	3,851	1308%
FSP F	447,839	174%	563,470	256,661	220%
FSP G	84,372	11%	277,021	742,174	37%
FSP H	37,576	46%	81,498	81,260	100%
FSP I	46,530	171%	46,530	27,170	171%
FSP J	25,267	15%	61,987	168,739	37%
FSP K	222,477	23%	222,477	970,563	23%
FSP L	641,455	59%	659,868	1,091,082	60%

Source: BoZ (2013)

Despite the solvency position outlined above, almost all of the banks have sufficient liquid assets to cover all their scheme loans should a crisis arise. The liquidity position of the different institutions is outlined in Table 26.

Table 26: Liquidity data by institution

Institution	Liquid assets (cash, reserves, T-bills) (ZMW '000)	Total value of scheme loans (ZMK '000)	Liquid assets, % scheme loans
FSP A	2,334,893	888,918	263%
FSP B	1,926,800	1,370,845	141%
FSP C	23	358,975	0%
FSP D	2,425,516	647,537	375%
FSP E	38	3,851	1%
FSP F	1,166,658	256,661	455%
FSP G	337,889	742,174	46%
FSP H	661,801	81,260	814%
FSP I	16	27,170	0%
FSP J	1,790	168,739	1%
FSP K	29,318	970,563	3%
FSP L	2,313,900	1,091,082	212%

Source: BoZ (2013)

The NBFIs have almost no liquid assets and are thus the most at risk in a crisis.

Should a crisis occur at any one institution, it could have repercussions for other financial institutions exposed to it. Four institutions have significant loans outstanding from domestic institutions and a crisis in their loan portfolio would affect their ability to repay their domestic creditors. The interbank lending figures are shown in Table 27.

Table 27: Interbank lending data

Institution	Loans outstanding from domestic institutions and other borrowed funds* (ZMW '000)	Interbank exposure, % scheme loans
FSP A	275	0%
FSP B	115	0%
FSP C	337,749	94%
FSP D	15,390	2%
FSP E	2,922	76%
FSP F	25,083	10%
FSP G	360,660	49%
FSP H	17,607	22%
FSP I	17,831	66%
FSP J	30,632	18%
FSP K	150,452-421,259**	16-43%
FSP L	99,339	9%

Source: BoZ (2014)

*Other borrowed funds includes subordinated loans and other subordinated debt, such as bonds outstanding

**This institution's liability data does not include a specific category of "Balances due to domestic institutions"

In addition to interbank lending, a few institutions have raised bonds on the Lusaka Stock Exchange to finance their business. In the case of banks, the extent of the allocation of these funds to payroll lending is unknown. However, with the consumer lending institutions the bonds are directly financing the payroll lending business (as this is their sole business line). There are some concerning network risks emerging that need to be monitored in future. These details have been provided to the BoZ.

An institutional-level analysis thus reveals that some institutions are highly exposed while having limited capital bases and high levels of borrowings from other domestic financial institutions. Other institutions need to be closely monitored given their significant payroll loan market share or due to the significance of their payroll lending book relative to the rest of their credit portfolio). The importance of monitoring the entire sector and being close to the relevant stakeholders to monitor and manage these risks is once again reiterated.

VIII. Analysis of risks and potential consequences

1. Framework for analysis

As discussed above, payroll loans constitute a large and growing share of total credit outstanding in Zambia. A dozen institutions, among them the most prominent banks and consumer-lending MFIs, account for almost all of the loans, and many of them have more than half their total portfolios in payroll lending.

Among borrowers, government employees outnumber private sector employees 2.6:1, although in value terms total government and private sector payroll loans are comparable. A significant portion of all borrowers, possibly as many as 50%, have more than one loan outstanding.

The leading lenders and employers signalled their awareness of the potential for over-lending by voluntarily imposing a limit on how much debt and other obligations an employee could take on. However, affordability analysis suggests that current lending limits are too high, and the assessment team heard first-hand accounts from borrowers struggling to manage their debt burden.

Data on non-performing loans provided by the lenders through a survey conducted for this assignment, as well as data from the credit bureau, suggests that delinquency rates are less than one percent. This may be because over-indebted households are reducing expenses at home to carry their debt or turning to informal moneylenders to make ends meet. The way NPLs are calculated and reported may also be a factor. The upshot is that the underlying quality of payroll lending portfolios cannot be evaluated with certainty. The accuracy and availability of data on NPLs requires urgent attention.

Even if portfolio performance is lower than officially reported, many lenders say that non-performance is lower than for other types of loans. With administrative costs low, relative to the maximum allowable interest rate, payroll lending remains an attractive business line and growth in payroll lending seems set to continue. It is likely that some of this new growth will be generated from targeting lower income employees, such as rural health workers and teachers.

With at least part of the sector's growth coming from an intensification of lending to existing clients (second/third loans or longer/larger loans) combined with an extension of outreach to lower-income new clients, risk profiles are likely increasing. Added to this is the fact that most lenders work through a limited number of employers, which means that they carry two levels of counterparty risk - for both the employer and the employee/client.

This kind of exposure has been taken, to varying degrees, by many of the leading financial institutions in the country. This increases the possibility that if a crisis in payroll lending were to occur it would not be easily contained, and if it spread the crisis could become systemic.

The fact that so many large institutions are exposed to the same risks increases the likelihood that a crisis could spread. Multiple lending also multiplies the number of institutions carrying the same risk. The relatively high proportion of loans made in the Copperbelt region exposes lenders to changes in the copper market that might affect wages and employment of many of their clients at once.

The biggest concentration of risk involves PMEC, through which the majority of loans are administered. PMEC itself is unlikely to unilaterally halt loan repayments, but government and mining employees have a relatively strong voice in Zambia. Pressure on PMEC to alter repayment terms if over-indebtedness becomes a major political issue cannot be ruled out. With nearly 47% of all payroll loans being processed through PMEC and the current low levels of collaboration between the BoZ and PMEC around managing the risks within this market segment, this is one of the more serious risks facing the industry.

The important consequence of the fact that so many institutions are exposed to the same risks is that a crisis is not likely to be isolated to a single institution. Multiple lenders are affected when an over-indebted client defaults or when an employer goes bankrupt or stops collecting loan instalments. Even if the size of the default is manageable for each institution, the fact that multiple institutions could be affected simultaneously raises questions of systemic stability.

There are as yet very few signs that a crisis is developing. However, the extent of the over-indebtedness levels and the growth in over-indebtedness levels is unknown. Some unhealthy signs, such as extended loans over longer terms to enable affordability, are starting to emerge. At the same time, incentives to continue lending are strong, and lenders may consider taking on greater risk in order to increase their loan books. A crisis is only one possible outcome, but its likelihood will increase if the tendency to over-lend is not curtailed and risk concentrations are not reduced.

The BoZ's ability to monitor these issues easily is impeded by the quality and consistency of the data that is reported by different institution types. The importance of the MMP cannot be overstated in terms of monitoring all of the above mentioned risks on an ongoing basis, identifying trends, raising red flags and taking the necessary actions when required.

There are a number of scenarios in which a crisis could spread. These are detailed in Table 28:

Table 28: Risk analysis summary

Scenario	Description	Likelihood (Low, Med, High)	Impact (Low, Med, High)	Description of impact
Reckless lending	One or more lenders target employers who do not limit lending	**Low** As higher-income employees in government, mining and manufacturing become saturated with debt, the market may move down to SMEs whose managers may not enforce the 60/40 rule. SME employees are likely to have lower income and could over-borrow to finance consumption. Alternatively, a lender could bribe an human resources official to override the 40% rule. While either scenario is possible, it is unlikely that a lender who consistently ignores the agreed-upon threshold will go unnoticed or unpunished for long. In addition, with the BFS Bill under development, there will be legal consequences for not adhering to the final threshold ruling.	**Low** The scale of the impact will depend on how many reckless loans are made. This could lead to the credit culture within the market becoming increasingly unhealthy. This needs to be closely monitored.	Employees who were not protected by the 40% rule borrow too much from payroll lenders and default. If many have more than one payroll loan, numerous lenders will be affected.
Black swan	A significant macro-economic shock occurs, such as a security crisis in a neighbouring country or a global collapse in copper prices	**Low** By their nature, such events are extremely unlikely	**High** A major impact on private sector employment or the real purchasing power of employee's income would trigger widespread over-indebtedness	Private sector employment collapses and/or government salaries, and/or employment collapses as tax revenues decline, leading to widespread default on payroll loans

Scenario	Description	Likelihood (Low, Med, High)	Impact (Low, Med, High)	Description of impact
Minsky moment"	Extended period of credit market stability leads to complacency in borrowing habits and underwriting standards. Lenders rely too heavily on the 60/40 rule or even relax it. Credit affordability is poorly understood, creating the potential for bad loan decisions or over-indebtedness. No further extensive affordability assessment is conducted.	**Medium** This seems to be the current path for the sector, but affordability calculations and the evidence of over-indebtedness from focus group discussions should be validated to gauge the breadth and depth of over-indebtedness among payroll borrowers and their households. Incentives for conducting comprehensive affordability assessments of borrowers low as loan repayments can be collected through payroll (if within the threshold).	**High** A delinquency crisis begins to spread as over-indebted clients default on multiple loans at once.	Portfolios weaken simultaneously at multiple institutions. A systemic impact could well emerge given the capital position and liquidity position of non-bank financial institutions and selected banks. Even if they remain solvent, concerns about the exposure of other institutions grows, reducing confidence in the banking system as a whole. Weakening of the loan repayment culture with long term consequences for the sector.
Political pressure to curtail payroll lending	Increasing over-indebtedness becomes a social issue, leading politicians to impose lower interest rate caps, more conservative affordability thresholds or even a debt moratorium through PMEC	**Medium** This potential outcome would potentially occur before a widespread debt crisis erupts as in the Minsky moment. Again, further analysis of the extend of over-indebtedness should be conducted to determine likelihood	**High** Changes in PMEC's administration of payroll loans or any other broad policy changes would significantly impact all lenders simultaneously given the concentration of loans processed through PMEC. PMEC could also institute a more conservative affordability threshold without consulting the BoZ.	Portfolios weaken simultaneously at multiple institutions. A systemic impact could well emerge given the capital and liquidity positions of non-bank financial institutions and selected banks. Even if they remain solvent, concerns about the exposure of other institutions grows, reducing confidence in the banking system as a whole. A reduction in the affordability threshold could negatively impact NPLs through loan repayments dropping of the deduction priorities. There is no ubiquitous alternative national payment system to replace this in the event this risk occurs.

Scenario	Description	Likelihood (Low, Med, High)	Impact (Low, Med, High)	Description of impact
Policy change negatively affects private sector employment	Employment in mining or other industries declines. For example, the government's plan to impose a windfall tax on mining companies or increase their royalties leads to a decline in mining employment	**Low** Increased taxes will probably not slow mining activity as long as demand for raw materials remains strong The most extreme case, whereby the government attempts to nationalise the mines, seems extremely remote	**Low** Loans to miners are not insignificant, but since total private sector loans are only 16% of total payroll loans, the impact is likely to be limited.	Private sector employment declines sharply, leading to default on payroll loans.

2. Conclusion on risks

The assessment considered a range systemic risks that could arise within the Zambian market as a result of the payroll lending sector undergoing rapid or significant change or experiencing a shock.

Based on the assessment, the following is observed:

1. The sector is at risk in terms of a broad-based macro-economic or socio-political shock that would affect the entire financial system, although, there is adequate solvency and liquidity to survive even a severe shock to the payroll lending market.
2. There is limited network risk given the structure of ownership and the sources of capital funding available to the providers of payroll loans.
3. There is a significant concentration of risk associated with PMEC given the number of borrowers that form part of the payroll deduction system and the power that the PSMD holds. Should there be a change of direction in terms of how government views payroll lending with a resultant tightening or halt on payroll deductions this could have a severe impact on the sector. The banks have mitigated this risk to some extent through requiring borrowers to bank with them so they have an alternate mechanism for collection. In the long term, development of an open, transparent and randomised national payments system would help to manage this.
4. Debt levels have been kept under control due to the threshold imposed by PMEC and the fact that industry is using this as a benchmark for affordability. However, as the market matures, this could become insufficient with rising levels of debt and the presence of the informal money lending sector. There is definitely a need to revisit this threshold. Further considerations in terms of the threshold are considering an absolute net take home pay minimum, limiting this further with only one credit repayment deduction per person similar to measures in Peru or limiting payroll deductions for specific use (such as for purchasing land, housing loans or for moveable assets). Given the important role that payroll lending currently plays in terms of enabling credit access a careful balance needs to be struck in developing these rules.
5. Increased monitoring of the practices and trends associated with payroll loans is highly recommended including trends in loan terms, loan sizes, practices around rolling over loans, multiple borrowing, borrowing outside of the payroll deduction context, pricing, disclosure, loan utilisation and more. The proposed MMP will go some way towards addressing the ability of the BoZ to monitor this, but other methods should also be considered. For example, the establishment of a debt help line or co-operation with relevant consumer rights organisations that are close to social issues, representative research on loan utilisation and indebtedness, ongoing engagement with stakeholders and stricter requirements and enforcement of reporting between financial institutions and TransUnion Zambia and between TransUnion Zambia and the BoZ.
6. There is a diversity across different lending institutions and their capacity to report to the BoZ making consistent monitoring and supervision of payroll lending more challenging for the BoZ. The BFS Bill and the structures within the BoZ will need to consider how to bring about some uniformity to ensure that the suitable structure and capacity exists. Depending on the outcomes of this, the BoZ may also need to develop additional capacity to conduct inspections and to enforce the rules and regulations within the payroll lending sector.

IX. Recommendations

In light of recent developments in the credit markets in Zambia, the BoZ has started a reform process in order to ensure that the regulations remain current and relevant to banking and microfinance activities. A revision of the banking law was introduced under the BFS Bill in 2012. That Bill continues to be revised and has yet to be taken to Parliament. In parallel, the BoZ is overhauling the Microfinance Regulations of 2006 with its Draft Banking and Financial Services (Microfinance) Regulations of 2014.

The revisions currently under consideration do not address payroll loans specifically because the BoZ is not adopting a product-based approach to regulation. Nevertheless, with the bills still being revised, an opportunity exists to amend existing clauses or add new ones to address the particular risks around payroll lending.

Care should be taken, however, to ensure that the growth of payroll lending is sustainable. In a country where access to credit cards and other forms of short-term and revolving debt is extremely limited, payroll loans are a primary a source of credit for many Zambian households. Payroll loans have enabled borrowers to make large-ticket purchases as well as smooth to cash flow.

Payroll lending thus plays an important role in financial inclusion in Zambia. The majority of workers have no access to credit cards or did not previously have access to loans from banks and other formal lenders, who considered personal loans too risky. Other than informal lenders (Kaloba, for example), before payroll lending the only access to credit came from retailers for household goods (such as for furniture and electrical items), and even these forms of credit are relatively new in Zambia.

As a result, regulators and other stakeholders confronting growing exposure to payroll lending must find ways to balance the requirement of eliminating systemic risk with the need to maintain adequate access to those who need and qualify for a payroll loan.

The evidence suggests that the interest rate cap imposed in January 2013 did not reduce the supply of payroll loans or its demand, nor did it reduce the risk of over-indebtedness. Although some providers reacted to the cap by reducing their exposure, many providers, faced with lower interest rates, increased loan sizes to improve profitability, and then increased loan terms to maintain repayment affordability. As far as payroll lending is concerned, therefore, the unintended consequence of the interest rate cap was to increase indebtedness rather than to reduce it. Furthermore, the cap may inadvertently be acting as an anchor, with lenders pricing their products close to if not at the limit. As a consequence, price competition has largely been eliminated.

The caps also encouraged previously non-payroll lenders to enter the market. Payroll loans are more profitable than microfinance loans, especially since the interest rate cap reduced the profitability of microfinance loans considerably. Unlike the expensive administration of microfinance loans, credit assessment for payroll loans is extremely inexpensive since it is largely automatic (based largely, if not solely, on the affordability threshold) and largely outsourced to the employer. Similarly, repayment is received through electronic transfer rather than collected in person.

Based on an analysis of the current situation in Zambia as well as case studies on payroll lending markets in South Africa, Peru and Brazil, the assessment team recommends strengthening supervision through improved data gathering, imposing a higher affordability threshold and prudential requirements through regulation, closer inspection of payroll lenders' policies and procedures and their adherence to them, and continuing structural reform of the financial sector.

1. Strengthen supervision through improved data gathering

Sufficient data for monitoring payroll lending is a key issue that must be addressed. The fact that payroll lenders span a wide variety of institutional types—each with their own reporting formats and frequencies––makes it difficult to track trends in payroll lending at present. Standardised and more frequent reporting is crucial, especially on non-performing loans as per the work that is underway on the MMP. Data collection should be used to monitor the aggregated exposure of the banking sector to payroll loans as well as the exposure of each individual bank to payroll loans in order to monitor the potential impact on each bank if there were to be an interruption in the payroll loan payments. Payroll loan portfolio reports should also include a breakdown by economic sector and by the income level of borrowers to monitor whether exposures are too concentrated in certain areas. Detailed reporting of non-performing loans is also necessary.

The international case studies demonstrate the importance of registering and monitoring all consumer lenders that operate above a minimum threshold as defined by local conditions. All personal loans (not just payroll loans) need to be monitored in terms of concentration in specific economic sectors and according to income levels of borrowers. It should be mentioned, however, that many non-banks appear to need assistance with their reporting to the BoZ. This is possibly because their information systems are inadequate. In requiring greater reporting requirements, the BoZ should recognise the need of some lenders to invest in improved information systems.

The BoZ's ability to enforce reporting may also need to be strengthened. For this assignment, a number of institutions did not (or could not) report the requested data. The BoZ's internal database of each institution's financial statements needs to be completed and digitised so that it can be easily monitored and updated as required.

The team also recommends that the BoZ conduct annual research on over-indebtedness and abusive practices. Over-indebtedness is difficult to track quantitatively since it involves more than just measuring debt repayment levels versus disposable income. For example, the flow of income and expenses including expenditure choices by households needs to be understood. This information is best captured qualitatively (such as through focus group discussions with various client segments) to monitor the ability of borrowers to meet household expenditure requirements without cutting corners. To determine the scale of over-indebtedness some quantitative data is also required.

Client research will also assist in closing another important data gap which is the extent to which households are indebted to unregulated lenders in addition to their payroll loans. It is unrealistic to expect that a reliable system for gathering data from the myriad of unregulated lenders can be developed. Researching the demand side is the next best option.

The BoZ supervisors should regularly brief BoZ's senior management on the trends and risks in payroll lending. The Minister of Finance and other government officials should also be briefed to make sure that they are aware of the risk in case there is a need for a discussion of potential policy or rule changes in this area.

2. Regulation

Although interest rate caps do not appear to have reduced the risks associated with payroll lending, the BoZ has a number of regulatory tools at its disposal to manage growth in the sector.

The international case studies show that it is important to regulate consumer lending in terms of market conduct, making sure that borrowers are well informed on all components of pricing and other terms and conditions. Transparency requirements designed to foster competition may benefit clients with better products and services while slowing the growth of supply as premium profits are reduced.

A more direct approach to regulating payroll lending is also possible. The draft of the Banking and Financial Services Bill at the time of this assessment included clause 67(2), which limited the total amount of debt repayments and other deductions to a certain percentage of monthly income. As noted throughout this report, the industry's self-imposed standard is that take-home pay must be at least 40% of gross pay. The initial proposed clause 67(2) stated that a client is presumed creditworthy if "the total monthly debts due on outstanding obligations, including amounts under the loan, do not exceed 70% of his or her monthly gross income." Not only was this a 10% higher debt burden than the prevailing industry norm, but it was not clear whether "outstanding obligations" include income taxes (if taxes are not included, the amount of take-home pay subject to the 70% rule would be higher).

The assessment team recommended that this clause be revised to include a lower debt carrying threshold (such as 40-50% of gross pay) and that a detailed definition of how the threshold should be calculated be provided. It is also recommended that the law provide the BoZ with the authority to change the threshold through regulation as a future risk management mechanism as required. These recommendations have already been considered as part of the revisions to the BFS Bill.

While lowering the debt threshold can reduce individual credit risk, it does not address covariant risk. Here, the BoZ must choose carefully. Placing limits on lenders' exposure to their most lucrative client-employers risks pushing lenders to seek newer (and possibly less financially stable) employers to lend through. Limiting the number of loans an employee can have at one time risks encouraging lenders to offer larger—and longer term - loans, increasing risk on both sides.

Without defining in detail the nature of a more sophisticated affordability assessment, the BoZ could require that payroll lenders take steps to ensure that borrowers can afford the loans that they take up. This could include credit bureau checks, a few questions related to income and expenses in the application form, some guidelines on reasonable living expenses that need to be considered for different household constructs or other such measures.

Another regulatory reform that would address systemic risk, is to raise the capital adequacy and liquidity requirements of the banks and non-bank financial institutions with exposure in this market. Both need to be reviewed and reconsidered in light of the current solvency and liquidity positions and their exposure to payroll loans.

3. Off-site inspection

Another way to improve monitoring of payroll lending is through off-site inspections, which should specifically consider lending institutions' exposure to payroll deducted loans. For example, checking whether lenders adhere to affordability rules and are carrying out prudent affordability assessments is an important area of development for the BoZ. Inspections of registered bank and non-bank financial institutions to enforce the relevant legislation is an important mechanism that appears to be limited at present due to capacity constraints.

Another area where the BoZ could intensify its supervision is in the policies and procedures lenders use to categorise non-performing loans, with spot-checking of loan books during on-site inspection for verification. The data collected for this assessment from lenders showed unreliably low values of non-performing loans.

Data provided by TransUnion Zambia from their credit reference bureau also showed unreliably low reporting of non-performing loans. Whether this is due to lax reporting or poor accounting standards for NPLs requires further investigation.

The network risk associated with both interbank loans and bonds also needs to be closely monitored. A close working relationship with the Securities and Exchange Commission to monitor trends in this sector and to address any risks is also recommended.

4. Structural reform/financial sector development

In the long run, reducing the mounting risks in payroll lending due to increasing concentration of exposure will require addressing the systemic gaps that cause the lending to concentrate. Payroll lenders concentrate on employees because they can be put into a system that almost always guarantees full repayment with minimal administrative costs relative even to the capped interest rate. They concentrate particularly on government employees because they are perceived to have the most job and income stability, they can avoid fraud or other economic conditions that could lead to the company going bankrupt and because through PMEC large numbers of potential clients can be reached.

Borrowers concentrate, too as payroll loans are their primary, if not only, source of credit. They use those loans for everything from meeting daily spending needs to purchasing consumer durables to home improvement because revolving credit and loan products specially designed to meet those various needs are not available.

Thus, continued development of the Zambian financial sector is the long term solution to the concentration of risk in payroll lending. A more robust financial sector, which offers a variety of competitive specialised credit products, would likely lead borrowers to diversify their credit portfolios, using specific products for specific needs. Sufficient competition between the various providers would improve service and reduce costs. The offer of such products, however, would necessarily be predicated on the lenders having the products and the systems to offer them profitably.

One of the key systemic risks emanating from payroll lending is due to the overexposure to PMEC, which leaves key financial institutions exposed to technical problems with PMEC's information system as well as changes in policy or administrative practices. Exposure to PMEC is unlikely to decline, as lenders target rural government workers, including teachers and health workers.

In the short term, perhaps the best the BoZ can do to manage this situation is to open a dialogue with PMEC to ensure risks are understood and either addressed or monitored. The evaluation team finds that a strong channel for communication and coordination between the BoZ and PMEC is not yet in place. This approach may need to be supported by the Minister of Finance or other suitably influential political bodies.

In the medium term, the development of alternative payment systems might reduce payroll lenders' exposure to PMEC such as a ubiquitous, open national payment system that processes payments on a randomised basis. Instead of getting ahead of the queue, the incentive will be more focused on ensuring affordability as the place in the queue would not be assured.

Naturally, monitoring, supervision and regulation should all be geared toward preventing a crisis. However, the BoZ should also prepare for the worst case scenario. At the very least, the BoZ should develop an appropriate strategy for dealing with banks where the exposure to payroll loans is too high or where it is increasing rapidly.

If a debt crisis occurs, there will need to be some process for restructuring the loans or winding them up. At least 50% of current payroll borrowers have more than one loan, but there does not seem to be a clear rule for how to apportion losses when a borrower defaults on multiple loans. A method for doing so should be clarified and communicated to the financial sector after their input and considerations on the topic have been received. The impact on lending behaviour from this rule should be anticipated when considering which methodology to use.

Table 29 demonstrates how the risk mitigation actions relate to the risk scenarios outlined above.

Table 29: Summary of proposed mitigating actions and recommendations

Scenario	Description	Mitigating action/policy recommendation
Reckless lending	One or more lenders target employers who do not limit lending	1) Include the affordability threshold in law (as per bill) rather than leaving it to be a voluntary practice, ideally with detailed instructions regarding how the threshold is calculated and the ability for BoZ to adjust the threshold in response to identified market risks 2) Include strong penalties for violating the legal affordability threshold in law and develop sufficient internal capacity to enforce these rules 3) BoZ to revisit the threshold calculation to ensure that it is adequate 4) Consider alternative more sophisticated mechanisms for assessing affordability 5) Borrowers also need to take responsibility for their levels of indebtedness. It is recommended that debt awareness and management be an integral part of the future financial education implementation of the FSDP.
Black swan	A significant macro-economic shock occurs, such as a security crisis in a neighbouring country or a global collapse in copper prices	Regulations to limit exposure (a high debt threshold, tighter prudential regulations, etc.) may help but it depends on the extent of the impact of the macro-economic crisis. Lenders seem to be managing this already.
"Minsky moment"	Extended period of credit market stability leads to complacency in borrowing habits and underwriting standards. Lenders rely too heavily on the 60/40 rule or even relax it, and do not monitor loan usage. Credit affordability is poorly understood, creating the potential for bad loan decisions or over-indebtedness	1) BoZ should require all payroll lenders to report quarterly on the size and quality of their payroll portfolio in order to monitor the growth of the sector 2) BoZ could make a detailed analysis of payroll NPLs a regular part of its annual on-site inspection activities 3) While a one-time study of over-indebtedness would be useful, a better approach would be to include data gathering on over-indebtedness as a regular (annual) part of BoZ's market oversight functions. This will build in an "early warning" system, giving BoZ time to act before a potential credit crisis erupts 4) Set a more conservative affordability threshold (higher than 40%) to reduce the risk of over-indebtedness <u>and</u> enable the adjustment of the threshold as it deems necessary (in law). Consider other mechanisms for managing affordability. 5) BoZ could consider higher reserve requirements or otherwise tighter prudential ratios for payroll loans (product-based regulation approach)
Political pressure to curtail payroll lending	Increasing over-indebtedness becomes a major issue, leading politicians to impose lower interest rate caps or even a debt moratorium through PMEC	Same as above, as well as: 1) There is a significant concentration of risk around PMEC and the power held by PSMD in terms of instituting rules related to payroll deductions. Strengthening the relationship between BoZ and PMEC could help ensure that changes in these rules take into account the potential impact of the change on the financial system.

Scenario	Description	Mitigating action/policy recommendation
		2) Share data and reporting for validation of information received from lending institutions and to track trends in debt levels, loan performance, rescheduling, etc. 3) Longer-term, further development of the national payments system would help reduce the concentration of risk around PMEC
Policy change negatively affects private sector employment	Employment in mining or other industries declines. For example, the government's plan to impose a windfall tax on mining companies or increase their royalties leads to a decline in mining employment	Regulations to limit exposure (a low debt threshold; product-specific prudential regulations, etc.) may help but there isn't much BoZ can do about a policy decision that negatively impacts private sector employment.

X. Annex One: Summary of data gathered from different sources

Table 30: Summary of data collected from different sources

Method of collection	Source/s of information	Type of information gathered
Desk research	Financial Sector Deepening Africa BoZ Financial Sector Deepening Zambia FinMark Trust Consultative Group to Assist the Poorest Alliance for Financial Inclusion Banking and finance laws and regulations Financial sector consolidated financial statements (BoZ) Labour Force Survey (2006 and 2010) Living Conditions Monitoring Survey (2010) Central Statistics Office employment earnings reports	Historical development of the payroll sector Legislation and regulation Case studies from other countries (notably South Africa and Peru) Industry statistics
Key informant interviews	Industry associations: Bankers Association of Zambia (BAZ) Association of Microfinance Institutions in Zambia (AMIZ)	Portfolio information Regulatory information – history, current thinking, planned regulatory reforms Insights on current supervisory capacity and role Structure and role players within the payroll lending sector Insights into consumer protection regulations and structures Possible risks that they have already identified Observed trends in terms of payroll lending Structure of the payroll sector (size, volume, stakeholders) Role in terms of payroll lenders (if any) Market segments accessing payroll loans
	Financial Sector Deepening Africa	Historical developments Research previously conducted Perspectives on the challenge and the solutions Best practice on credit regulation from the credit thematic programme
	Public Service Management Division (PSMD) Payroll Management and Establishment Control (PMEC)	Rules around payroll deductions Operational processes and procedures Volume and value of transactions Systems Monitoring mechanisms Governance structures Perspectives on levels of indebtedness/ take home salaries Market segments accessing payroll loans
	Employers processing payroll deductions	Feedback on payroll lending and impact on staff Observed trends in terms of payroll lending Payroll lenders (names they have come across) Volume and value of loan payments each month Proportional value of staff salaries deducted on loan repayments

Method of collection	Source/s of information	Type of information gathered
	Service providers e.g. Credit Reference Bureau (CRB) Zambia, IT service providers, payment services	Role of service providers in terms of supporting the sector Observed trends in credit approval and collections practices Status of financial infrastructure available to the sector (indicative)
	Banks, MFIs offering payroll loans, payroll lenders of different profiles.	Portfolio information (size, quality, composition, market segments) Perspectives on levels of indebtedness Lending processes and practices (affordability assessment, contract/ disclosure, pricing) Perspectives on borrower behaviour (rights and obligations)
	International, regional and local experts	Expert perspectives on additional areas to interrogate in terms of legislation, regulation, financial infrastructure, lending practices and consumer protection Risks that could result from the payroll lending sector Possible solutions to managing the risks
	Key informants in case study countries e.g. Hennie Ferreira (Micro Finance South Africa (MFSA)), Gabriel Davel, IEMAS (largest RSA payroll lender – deduction code)	Validate secondary information and gain key insights from selected key informants
Mystery shopping	Banks, MFIs offering payroll loans, payroll lenders of different profiles	Credit sales process and stated requirements – documents required
Focus group discussions	Groups of payroll borrowers	Insight into market segments accessing payroll loans Perceptions on the impact of payroll loans Experiences with regards to debt Typical usage of payroll loans Role payroll loans have played in their lives
Secondary data analysis	FinScope, credit bureau or other data sources (BoZ data)	Market segments Value and volume of loans/ portfolio information Loan portfolio quality

XI. Annex Two: Background information on financial inclusion in Zambia

Box 8: Financial Inclusion Levels in Zambia

- There has been a decrease in the percentage of adults that are financially excluded – 62.7% in 2009 compared to 66.3% in 2005
- The slight decrease (14.6% (2005) to 13.9% (2009)) in the banked population implies that the banked population has remained stagnant at around 14% of adults. Further analysis indicates that interventions have resulted in an increased depth of access within the banking sector (i.e. more products per served adults, increased cross-selling to existing bank customers) rather than a greater breadth of access (i.e. more people served):
    - In 2005 each banked adult had on average two bank products – this has increased to three in 2009
    - There has been a significant increase in the use of transactional products (ATM/Cashpoint cards and Visa Electron accounts) from 2005 to 2009
    - There has also been an increase in the uptake of lower cost bank transactional products, which suggests that existing banked customers are switching to these lower cost products
- The proportion of adults who rely on formal financial products not provided by commercial banks increased from 7.8% in 2005 to 9.3% in 2009 – illustrating a notable growth in the population served by non-bank financial institutions. This growth was mainly driven by an increased uptake in MFI credit
- The significance of the role of the informal sector in pushing out the boundaries of financial inclusion has

XII. Annex Three: Key Informant Interview guide

The key informant interview guides were adapted depending on the stakeholder being interviewed. This is the example used for Credit Providers.

Introduction

Introduce the study

Background

Please provide a background to the focus of your business, how long you have been operating in Zambia, your outreach

What products do you offer to which market segments?

Portfolio information

- Size of book over the past 3 years (number of loans, portfolio size, average loan size)
- Segmental analysis of book (method of extension, method of collection, target market, portfolio quality)
- Product mix at institutional level - understand portion of book on payroll loans
- Portion of payroll loans deducted through PMEC
- Portfolio composition (size, concentration)

- Is there any required reporting that you need to do to a Regulator? Association? Credit bureaus?

Payroll administrators

- Do you rely on PMEC for any payroll deductions?

- How many of your loans in a given month would have payments deducted through PMEC?

- How many payroll deduction transactions did you have processed last month? Can you give us a view as to how this evolved over time? (Explore for a trend).
- Have you faced any challenges with this process recently? What?
- Have you experienced any delays in processing deductions? How long?
- Do you have any defined turnaround time for receipt of the deductions from PMEC?
- Who pays for the mechanism of deduction?
- How are payroll administrators regulated if at all?
- If loans are disbursed and deducted through PMEC - do they hold the funds on their balance sheet? How long is cash held for? Are there any guarantees?
- Are any of their risks underwritten? Which ones? By whom?
- What is the flow of funds between employers and employees?
- What standards are in place in terms of communicating around salary deductions to employees? Pay slips? How? How often? Effective? What info is provided?
- How cost effective is the PMEC?

Scheme arrangements

- Do you have any direct relationships with employers – scheme arrangements?
- What is the basis and level of formality of relationships with them?

- What are the key terms and conditions of the agreement between the employer and the payroll lender?
- Are there any administration or facilitation fees that need to be paid to employers for administering the payroll deductions? How are these determined?
- Are there any circumstances under which a company could stop a payroll deduction?
- What are the consequences if any?
- Are there any savings, insurance or other financial products for employees?
- What trends have you observed related to loans amongst your staff?

- Any challenges

Credit policies and practices

- Credit application and assessment policy and process (inc affordability)
- Distribution channel / point of origination
- Methods of deduction of payment in detail including costs, preferential vs. open, mechanisms
- Write-off policy
- Effectiveness of legal contract enforcement
- Emolument attachment orders? Effectiveness? Cost? How long does it take?
- Typical collections policies, processes, procedures and practices
- Repayment through NPS? If so, who regulates this? Under what law?

Institutional financial information

- How is your organisation funded?
- What proportion of deposits are kept in reserve (for deposit taking institutions)?
- Different characteristics of banks vs. non-bank credit providers

- Can you share copies of your audited financial statements for the last three years? (if we do not have them already or if not publicly available)

Levels of indebtedness

- Number of credit lines per credit active individual
- Disposal income remaining
- Late payments (# of people with at least one late payment)

Policy, legislation and regulation

- What are the licensing requirements for non-bank credit providers?
- What requirements need to be met by registered institutions?
- What rules apply to registered institutions?
- Are there any specific rules related to affordability assessment?
- Are there any specific laws or rules related to the payroll lending sector?
- Capacity of regulator/s
- Legislation and regulation of payroll lending vs. other credit markets
- What are the pricing guidelines or rules exactly?
- Are these disclosed in a standard format to clients for easy comparison and transparency? Have there been any changes in this disclosure over the last few years?

- How is legislation and regulation enforced?
- To what extent does any labour legislation address lending to staff?

Borrowers

- Is there any risk of social or other unrest as a result of debt?
- Levels of financial literacy (are there any organisations that provide financial education programs?)
- Any consumer rights organisations? Or complaints departments?
- Culture of repayment
- Responsible borrowing practices
- Awareness about any available recourse mechanisms
- Attitudes toward credit
- Borrower practices
- Do borrowers state a specific loan purpose when applying for loans? Is this perceived to be accurate?
- Use of payroll loans (does it flow into productive use)
- Any variations between private and government employees in terms of their borrowing practices

Case study - example files

- Sample files of over-indebted clients
- Sample of credit bureau reports
- Detailed insight in to the affordability assessment

XIII. Annex Four: Focus group discussion screening questionnaire

This questionnaire was completed by focus group discussion participants in parallel with the focus group discussions to gather more information about the sample of participants.

Full name						
Location of interview (town)						
Telephone number						
Employer						
Nature of employment	Full time		Part time/ seasonal			
How long have you worked for your current employer (years & months)?		Job title/role				
Do you currently have any scheme loans?	Yes		No			
If yes, how many scheme loans do you have at present (still repaying)?						
For each scheme loan you have had in the past 24 months, please provide the following information:	Lender (e.g. Bayport, Barclays)	Loan amount (ZMW)	Loan term (months)	What is the cost of the loan? (e.g. interest and fees)	Loan purpose (e.g. education, housing)	Outstanding or paid off
What are the requirements for accessing a scheme loan?						
Do you have any loans or store accounts that are not deducted from your payroll?	Yes			No		
For each non-scheme loan you have had in the past 24 months, please provide the following information:	Lender (e.g. Employer, Money lender, store account)	Loan amount (ZMW)	Loan term (months)	What is the cost of the loan?	Loan purpose (e.g. education, housing)	Outstanding or paid off
What are the requirements for accessing						

these loans?				
Do you have any other non-statutory deductions from your payroll?	Yes		No	
Please provide the details of these deductions?	Institution (e.g. Madison Life)	Nature of deduction (e.g. Savings, insurance)	Value of deduction (ZMW)	

Thank you for the time to assist with this important study!!

XIV. Annex Five: Focus group discussion guide

Good day, my name is xxx and I work for PlaNet Finance. We are here today to discuss your financial wellbeing and your plans for the future. The information you share will help me to understand the financial situation of employees. There is unlikely to be any specific or immediate outcome from this that we can promise you – we really want to just learn from you. The outcomes of the discussion will be shared with the Bank of Zambia so they can understand your situation. I would like to record this discussion to ensure that I remember everything you have told me and to make my notes after this meeting. The information will be treated confidentially.

Questions	Probes
Please can you introduce yourself and tell us how long have you been working for xxxxx (company)?	
What are your financial goals for the future?	How are you working towards these? What financial services do you use to help you achieve these goals? Savings? Insurance? Loans? Where? How often? What for? (probe probe probe)
What has your experience been with regards to accessing scheme loans since working at xxx (company)?	What loans have you accessed? What are the loans for? How much do the loans cost you? How do these loans help you to meet your goals? What role does your company play in this loan process? How does this work for you? What would you change about the loans if you could? What aspects of the loan facilities meet your needs? Do you face any challenges with the loans you have? What is the nature of these challenges? What impacts have these loans had on your life?
How confident are you about making financial choices and decisions?	Are there any areas where you would like to know more about or learn more that would help you make decisions?
Do you have any questions?	

XV. Annex Six: Background information on household expenses

Box 9: Notes on CSO calculation of household expenses used in the affordability calculations

The 2010 Living Conditions Monitoring Survey (LCMSV) collected data on the following household expenditures:

- **Expenditure on food**: Expenses on bread, meat, milk, nuts, etc, including own produce consumed
- **Expenditure on alcoholic and non-alcoholic beverages, cigarettes and tobacco.**
- **Expenditure on housing**: rent, water charges, electricity bills, purchase of candles, paraffin, charcoal and firewood including value of own produce consumed, and house maintenance costs, etc,
- **Educational expenditure**: school fees, purchases of school uniforms, contributions to Parent, Teachers' Association, private tuition fees, expenses on school stationery etc,
- **Medical expenses**: expenses on medicines, fees to doctors, expenses under prepayment schemes etc,
- **Expenditure on consumer goods**: purchase of clothing and footwear, etc,
- **Remittances in cash or in kind,**
- **Expenditure on public and private transport**: transport expenses to and from work or school, fuel and vehicle maintenance expenses, etc,
- **Expenditures on personal services**: laundry, entertainment, hairdressing expenses, etc.

The data collected on consumption of own produce included both food and non-food items. The amounts of own produced food and non-food stuffs were converted to cash values by multiplying their respective quantities used by the household and food stuffs consumed by their respective unit prices. The amounts were then added to the corresponding cash expenditure to give total expenditure on the items.

According to the Living Conditions Monitoring Survey conducted by the Central Statistics Office, between 2006 and 2010 spending on housing rose from 20.9% to 25.8% of total nominal household expenditures. Total nominal consumer spending rose 75% over that period, but spending on housing rose by 117%, contributing one-third of all the growth in consumer spending. The large increase was consistent across all rural and urban socio-economic strata, with larger percentage increases among the most affluent rural and urban households.

In terms of the total amount of Kwacha spent, however, spending on housing in urban areas accounted for three-quarters of all the growth, and within that it was households living in low-cost and medium-cost residential areas that accounted for more than half of the increase in spending on housing in the country.

Source: Living Conditions Monitoring Survey 2011, CSO

XVI. Annex Seven: International case studies

1. Introduction

The rise of consumer lending has been significant in many emerging economies from Russia to China, Latin American countries and South Africa. This has, in most cases, coincided with rising income and the development of a formally employed middle class. This growing market has attracted *new providers from international and national-level retail chains to local consumer lenders, eager to capture market share in a population often underserved by traditional financial institutions in the past*[13]. Now the same phenomenon is happening in several sub Saharan countries, such as Zambia.

Obtaining the facility to deduct loan instalments by direct payroll deduction is one of the features that favour rapid growth of consumer lending targeting the low and middle income employees. Payroll deduction is present in different environment such as Brazil, Peru and several African countries (South Africa, and Namibia for instance). For the purpose of this project, we looked at three different countries, South Africa, Peru and Brazil where regulators and governments have looked closely at the effects of payroll lending and have taken measures to mitigate its potentially negative effects. In the case of South Africa, we also mentioned some banking crises which were linked to consumer lending and provide a case study on the recent African Bank failure.

2. South Africa

South Africa has a two-decade history of unsecured consumer micro lending. This case study includes elements on the evolution of the sector, the various crises that have affected the sector, the regulatory measures taken over time and the current regulatory framework.

Unsecured lending started to grow in South Africa from 1992 when an exemption was granted for small, short-term loans, from the regular pricing limitation on credit imposed by the Usury Act. Loans below or equal to ZAR 6,000 (ZMW 3,300) (this limitation became ZAR 10,000 (ZMW 5,500) in 1999) and no longer than 36 months did not have any price limitation. This allowed the microloan industry to develop rapidly in South Africa. In 1999, the total micro lending consolidated assets had reached ZAR 15 billion (ZMW 8.3 billion). However, many practices in the industry were deemed abusive: charging high interest that did not seem to be in line with the risk level, collecting loans by using debit cards and PIN of the borrowers, lack of transparency and limited rules. Another sensitive issue was the concentration of loans in the civil service. "A focal point for the industry became the civil service, from which repayments could be collected through deductions from the central government payroll, which had been allowed from 1993. Some civil servants found themselves with no take-home pay after deductions had been made[14]."

13 Rafe Mazer and Sergio Navajas, Consumer Lending and Overindebtedness in Latin America, CGAP 2012.
14 The Risk of Unsecured Lending in South Africa, Stuart Theobald, Leriba Consulting, June 2013.

In 1999 the Micro Finance Regulatory Council (MFRC) was established as a regulatory body. To operate under the Usury Act exemption all micro lenders had to be registered and supervised by the MFRC and follow the associated market conduct rules.

In 2000 the government decided to follow an additional course of action: stopping the access to deductions from civil servants' salaries for micro lenders and others, such as insurance companies. This had a catastrophic impact on the banking system and several small banks either collapsed (Saambou, Unifer) or closely avoided such a disaster (African Bank).

In 2001, the National Treasury imposed strict limitations on payroll deductions[15] from government employee salaries, as well as on the interest that could be charged on such loans: There is a strict vetting and oversight process (section 23.3.3 Treasury Regulations 2005, see footnote 10 for full reference)

Box 10: Limitations on payroll deductions in South Africa

A person applying for a deduction code must certify in the application that -

(a) the code is required by –

(i)a department;

(ii)an insurance company (for insurance deduction codes) approved by the Financial Services Board;

(iii)a company (for loan deduction codes) that is registered under the Banks Act (Act 94 of 1990) or with the Micro Finance Regulatory Council (MFRC);

(iv)a public higher education institution; or

(v)a private higher education institution approved by the national Department of Education.

(b)third parties, including brokers, will not be allowed access to the code;

(c)the person consents to 8

(i) entering into an agreement with the Accountant General, which is subject to annual review;

(ii) the oversight of the Financial Services Board and the National Treasury to monitor compliance with the agreement and this regulation; and

(iii) an audit, at own expense, by parties determined by the Accountant General;

(d) the person is in good standing with the South African Revenue Services and will annually provide the Accountant General with proof of such good standing

Specific rules on loan terms and conditions (Section 23.3.5 Treasury Regulations 2005)

The National Treasury may, for a discretionary loan deduction, determine the maximum loan period, the maximum loan amount and the interest rate (this will form part of the agreement with the Accountant General)

(a)for loans over R10 000, the Usury Act limit is the maximum, all inclusive interest rate;

(b) for loans below R10 000, the maximum is 27 per cent plus an administrative cost subject to a limit set out in the agreement with the Accountant General.

Rules on affordability (section 23.3.6 Treasury Regulations 2005)

Discretionary deductions may not exceed 40 per cent of the official's basic salary, provided that

(a) deductions for insurance premiums do not exceed 15 per cent;

(b) other discretionary deductions do not exceed 25 per cent; and

(c)the minimum take home pay is as specified in the agreement with the Accountant General.

Limitation on the number of deduction codes (section 23.3.8 treasury Regulation 2005)

The Minister of Finance may determine the future of the discretionary deductions system and the number of deduction codes on the Persal system.

[15] Treasury Regulations 2005 **Issued in terms of the** Public Finance Management Act, 1999

The National Credit Act

In 2005, the National Credit Act (NCA) which broadly regulated consumer credit came into force. All lending to individuals in South Africa is now governed by the NCA and all lenders (no matter what institution type) have to be registered with the National Credit Regulator.
Some of the features of the NCA framework include:

- Interest rate caps are in force but differentiate various credit types.
- Consumer rights are in place in terms of:
  - Applying for credit
  - Being protected against discrimination in the granting of credit
  - Being informed why credit has not been granted
  - Receiving a free copy of the credit agreement in plain and simple language
  - Personal and financial information being treated confidentially
  - Understanding all fees, costs, interest rates, the total instalment and any other details
  - Refusing increases on credit limit
  - Refusing marketing on products or services via telephone, SMS, mail or e-mail campaigns
  - Applying for debt counselling
- The concept of reckless lending comes into play if the consumers' ability to afford loan repayments is not assessed before granting credit. Credit providers may be subject to severe penalties and may even forfeit their right to recover the debt if they are judged guilty of reckless lending. Specific guidelines are now in place on how to assess affordability.

Due to the stricter regulatory framework and to the world-wide financial crisis in 2007 the provision of consumer credit slowed down. Growth began accelerating in 2010 as consumer confidence returned to the market. According to Stuart Theobald[16], this growth was also driven by a number of other factors including:

- Large banks and other lenders entered the market
- Formal employment, particularly in the civil service, widened the borrower pool
- More stringent borrowing criteria for home loans forced many borrowers into the unsecured market

In the process the unsecured credit market evolved from a microloan market into a large, middle-class focused credit business. The nature of the typical loan and borrower shifted dramatically over this period. Unsecured loans range up to ZAR 230,000 (ZMW 128,000) of value and 84 months in repayment terms.

Some newspapers and authors have been warning of another potential crisis for more than a year, led by increased competition without any reduction of cost of lending but rather to a "race to the bottom" in credit vetting criteria. In order to grow their book, many lenders will accept lower quality clients than their competitors[17].

16 The Risk of Unsecured Lending in South Africa, Stuart Theobald, Ieriba Consulting, June 2013

17 Idem

In August 2014, African Bank was placed under curatorship. Further information on African Bank is provided here.

3. African Bank Case Study

A Brief History

African Bank (ABIL) was formed in 1998 when Theta Investment Group acquired the African Bank licence from the regulator and merged it with King Finance Corporate, Unity Financial Services and Alternative Finance. Prior to 1998 African Bank had operated for 24 years as a small commercial bank.

ABIL's vision is to "improve quality of life through affordable, convenient and responsible credit''[18]. With the belief that credit should work to improve an individual's life ABIL ''say yes more often''[19] because they believe they take everything into consideration. Not only do they look at what a person earns but they consider at "who you are and where you're going."

On 10 August 2014 ABIL was placed under administration amid record losses and rising bad debts[20]. At the time of its failure it had more than three million customers across South Africa[21]. Advocate John Myburg has been appointed by the South African Reserve Bank to launch an independent investigation[22]. However, at this early stage of investigation it is difficult to know whether any type of fraud or illegal activity has taken place. Despite it being placed under curatorship, ABIL will continue to remain open throughout the curatorship process in the interests of promoting the best interests of creditors and the banking sector as a whole. Employees have been informed that the new measures will not immediately negatively affect their jobs and that their salaries will continue to be paid[23]. Advocate Myburg has five months to compile his report into ABIL's activities and to determine whether they were reckless or not.

Ownership

ABIL is a publicly owned holding company listed on the Johannesburg Stock Exchange Limited with wholly owned subsidiaries primarily within the South African unsecured credit and furniture and appliances retail

18 African Bank website, Heritage and values, https://www.africanbank.co.za/about-us/heritage-and-values, Accessed 29 September 2014.
19 Ibid.
20 Bloomberg Business Week, 'Capitec CEO Sees Influx of Customers From African Bank', http://www.businessweek.com/news/2014-09-29/capitec-first-half-profit-rises-as-fee-income-gains-33-percent. Accessed 29 September 2014.
21 Ibid.
22 Mail & Guardian, 'African Bank: the rot stops here', http://mg.co.za/article/2014-09-04-african-bank-the-rot-stops-here. Accessed 29 September 2014.
23 Times Live, 'African Bank doors remain open: Curator', http://www.timeslive.co.za/local/2014/08/11/african-bank-doors-remain-open-curator. Accessed 29 September 2014.

environment[24]. Its ownership structure is diverse and includes a 12.5% ownership stake by the South African government pension fund administrator and several other large investment holding companies that invest retirement funds for individuals employed in the private sector[25]: As its largest shareholder, the Public Investment Corporation (PIC) has a vested interest in ensuring as much of ABIL's bad debt is reclaimed as possible. ABIL's collapse sees government employees stand to lose portions of their pension and retirement funds.

Causes of Collapse

The aggressive issuing of unsecured loans is being viewed as a major reason for the demise of ABIL. Despite having pulled back on lending over the past 12 months, the demand for credit has remained strong and ABIL has continued to disburse loans despite rejection rates for credit by retailers remaining persistently high (due to affordability challenges). Speculation exists that there is an element of reckless lending involved backed up by the National Credit Regulator (NCR) finding ABIL guilty of reckless lending at 25 of its branches countrywide[26]. In total 699 loans sampled at these branches were found to be reckless[27].

In 2001, when payroll deduction codes were retracted by government, ABIL was forced to recover monies owed to it from the distribution of unsecured loans through cash repayments. ABIL was also in a position where it was unable to accept direct debit repayments. Set against a backdrop of a tight economic climate for many of ABIL's customers, once they had been paid their monthly salary, the servicing of an unsecured ABIL loan was often not a very high priority. The need to receive cash repayments also compelled the Bank to set up and maintain a very large number of branches country wide (510 outlets in total[28]) which is very expensive to maintain. It also maintains a 1000 seat call centre[29]. Problems also arise around the issues of theft and security when cash is involved.[30]

Further challenges arose due to ABIL's unique position of holding a banking license (and therefore forming part of SARBs supervision domain) but being strictly a credit only institution. This posed a regulatory 'loophole' in which the NCR and SARB were both responsible for overseeing different parts of ABIL's activities. As a result the question was raised as to whether the authorities took sufficient pre-emptive actions to forestall ABIL's demise. According to South Africa's Trade and Industry Minister, Rob Davies,

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[24] African Bank website, Group profile, http://africanbank.investoreports.com/about-us/group-profile/. Accessed 29 September 2014.

[25] African Bank website, Major shareholders, http://africanbank.investoreports.com/major-shareholders/. Accessed 29 September 2014.

[26] Fin 24, 'Cash repayments part of African Bank Collapse', http://www.fin24.com/Companies/Financial-Services/Cash-repayments-part-of-African-Bank-collapse-20140915. Accessed 29 September 2014.

[27] Business Day Live, 'NCR defends action taken over African Bank woes', http://www.bdlive.co.za/business/financial/2014/08/25/ncr-defends-action-taken-over-african-bank-woes. Accessed 29 September 2014.

[28] African Bank website, Group profile, http://africanbank.investoreports.com/about-us/group-profile/. Accessed 29 September 2014.

[29] Times Live, 'African Bank doors remain open: Curator', http://www.timeslive.co.za/local/2014/08/11/african-bank-doors-remain-open-curator. Accessed 29 September 2014.

[30] Fin 24, 'Cash repayments part of African Bank Collapse', http://www.fin24.com/Companies/Financial-Services/Cash-repayments-part-of-African-Bank-collapse-20140915. Accessed 29 September 2014.

speaking before the Trade and Industry Portfolio Parliamentary Committee, he outlined that the NCR was only responsible for consumer protection while the Reserve Bank was responsible for credit providers' prudential regulation including overseeing the capital adequacy and financial soundness of all banks operating in South Africa[31].

Portfolio and way forward

To date ABIL has distributed over ZAR 61.6 billion (ZMW 34.2 billion) in advances since its inception[32]. However, prior to being placed under curatorship it announced that it had estimated losses of ZAR 6.4 billion (ZMW 3.6 billion) and that it needed to raise at least a further ZAR 8.5 billion (ZMW 4.7 billion) through a second rights offer in less than a year to survive[33]. This led to a dramatic fall in its share price. The Reserve Bank's rescue plan will look to strip away ABIL's bad debts by purchasing its bad debt loan book worth approximately ZAR 17 billion (ZMW 9.4 billion) for ZAR 7 billion (ZMW 3.9 billion).

The balance of the loan book (representing the good loans) will have a nominal value of approximately ZAR 26 billion[34] (ZMW 14.4 billion). This is meant to represent the base of a new bank that will continue trading. The new and good bank will also take over the funding that ABIL had been receiving from commercial funders while about ZAR 36 billion (ZMW 20 billion) worth of liabilities will be transferred to the new bank along with some other assets that the curator may inject into the new bank[35]. ZAR 10 billion (ZMW 5.6 billion) will be underwritten by a consortium incorporating the Public Investment Corporation, Absa, Capitec Bank, FirstRand, Investec, Nedbank and Standard Bank Limited and will then be relisted[36]. The Reserve Bank has not yet disclosed what the obligations of the consortium members will be but the old shareholders of ABIL will be allowed to subscribe to these new shares although they may decide not to[37]. Other details still remain unclear at his stage in the process. According to the Bank's last interim results it

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[31] Business Day Live, 'NCR defends action taken over African Bank woes', http://www.bdlive.co.za/business/financial/2014/08/25/ncr-defends-action-taken-over-african-bank-woes. Accessed 29 September 2014.

[32] African Bank website, Group profile, http://africanbank.investoreports.com/about-us/group-profile/. Accessed 29 September 2014.

[33] Mail & Guardian, 'African Bank: the rot stops here', http://mg.co.za/article/2014-09-04-african-bank-the-rot-stops-here. Accessed 29 September 2014.

[34] Business Day Live, 'ON THE MONEY: Numbers in rescue of African Bank are the devil in the detail', http://www.bdlive.co.za/opinion/columnists/2014/09/01/on-the-money-numbers-in-rescue-of-african-bank-are-the-devil-in-the-detail. Accessed 29 September 2014.

[35] Business Day Live, 'ON THE MONEY: Numbers in rescue of African Bank are the devil in the detail', http://www.bdlive.co.za/opinion/columnists/2014/09/01/on-the-money-numbers-in-rescue-of-african-bank-are-the-devil-in-the-detail. Accessed 29 September 2014.

[36] Mail & Guardian, 'African Bank: the rot stops here', http://mg.co.za/article/2014-09-04-african-bank-the-rot-stops-here. Accessed 29 September 2014.

[37] Business Day Live, 'ON THE MONEY: Numbers in rescue of African Bank are the devil in the detail', http://www.bdlive.co.za/opinion/columnists/2014/09/01/on-the-money-numbers-in-rescue-of-african-bank-are-the-devil-in-the-detail. Accessed 29 September 2014.

was reported that the median term for new loans is 54 months, the average loan size is just over ZAR 20,000 (ZMW 11,000) and there are over 2.4 million customers[38].

Lessons from the African Bank Case Study

1. **Credit only institutions do require supervision**

The failure of African Bank has also led to the downgrading of South Africa's four biggest banks (Absa, FNB, Nedbank and Standard Bank) by ratings agency Moodys[1]. This is likely to make the cost of accessing finance for all banks more expensive. The systemic risk of this bank failing has impacted on the market as a whole.

2. **Supervisory fragmentation can cause gaps**

Enforcement of the provisions in the NCA (2005) was challenged given the split regulatory responsibility between the SARB and the NCR. This is an important lesson for the region facing growing levels of indebtedness particularly with aggressive bank participation in the personal loans market. Clarity on the accountability for regulation and supervision is essential.

3. **Monitoring of market trends**

The rising average loan amount and loan terms offered by ABIL and the lending practices that were being implemented should have received close attention from the regulators. Even though information was readily available to regulators through detailed quarterly reports and information on various credit bureau systems, adverse trends and red flags were not observed and acted on. BoZ needs to collect, analyse and act on the information to be gathered as part of the MMP process.

[38] Business Day Live, 'ON THE MONEY: Numbers in rescue of African Bank are the devil in the detail', http://www.bdlive.co.za/opinion/columnists/2014/09/01/on-the-money-numbers-in-rescue-of-african-bank-are-the-devil-in-the-detail. Accessed 29 September 2014.

4. Peru

Payroll lending in Peru has shown considerable growth in the past four years. Lenders consider payroll lending as a lower risk than any other type of personal loan because the contract signed between the employer and the financial institution stipulates that the financial institution is the creditor with the first priority for collection. Also, the financial institutions usually evaluate the financial strength of the employer. Although this type of loan is seen to provide advantages to both the lender (lower risk level) and the borrower (lower interest rates), it can also lead to specific risks that must be properly analysed and managed by financial institutions.

Personal loans have contributed a stable share of the total credit market, at around 20% during the period 2009-2014, while the representation of the payroll loans increased from 2.9% in 2010 to 4.1% in 2013. Even if this proportion is small, growth in payroll loans is at a significantly higher rate than the rest of the market during the period 2010 – 2013 (121% vs. 54%). However, the high level of informal economic activity in Peru somehow limits the growth of the payroll lending. The market is small and the institutions therefore compete for the same customers. In addition, the level of financial literacy is limited.

Between December 2010 and December 2012, the total number of customers with payroll loans increased by 45% (from 378,000 to 549,000). During this period, the proportion of borrowers with payroll loans in a single financial institution decreased from 93% to 89%; while the proportion of borrowers who had this type of loan in two or more financial institutions rose from 7% to 11%. Moreover, in this period the outstanding amount of payroll loans increased by 98%, a growth rate significantly higher than the number of debtors. This shows an increase in the average outstanding loan amount per borrower: from PEN9,802 (USD 3,491) to PEN 13,333 (USD 5,231). This increase, observed during this period, may constitute a potential risk of over-indebtedness, as it implies the possibility that the borrowers exceed their repayment capacity.

Another indicator to evaluate the risk of over-indebtedness is the share of borrowers that have other additional personal loans. As at December 2012, 66% of payroll loan borrowers also had another type of personal loan.

Even though a debt crisis has not occurred in the Peruvian credit market, the supervisory body (Superintendencia – Central Bank) has adopted some prudential measures to manage the potential risks highlighted above. One of the measures adopted in November 2012, was raising the weighting assigned to payroll loans within the calculation of risk weighted assets, to ensure that financial institutions internalise the risks that could be generated by payroll loans, through higher capital requirements.

A second measure implemented is the provisioning policy. If financial institutions want to apply lower provisioning rates for payroll loans, provisioning has to follow certain rules. First, the employer with whom the financial institution has an agreement for payroll lending has to have been classified as "Normal[39]" for

[39] The debtor has sufficient liquidity to serve immediately its reimbursements and shows low levels of equity indebtedness with an efficient management to generate profits; besides, he complies with his payment obligations on date. In addition, debtors could have efficient system information, which allows knowing their real financial and economic situation; decisions makers with

the past 3 months or the employer has to be a public sector institution with budget directly from the Public Treasury. Second, the contract signed between the employer and the financial institution stipulates that this institution is the creditor with the first priority for collection or the borrower has the guarantee of the employer. Finally, the agreement signed ensures that the maximum instalment to net monthly income does not exceed a ratio of 30%.

Currently, a plan is underway to change the legislation so that any employee would only access one payroll loan with one institution. If this new regulation is approved, the borrower would only be allowed to access a single payroll loan but could also access other types of consumer loans (e.g. vehicle) or a housing loan. The objective of this measure is to prevent over-indebtedness and to promote competition among institutions who offer this type of credit.

All regulated financial institutions must report information on borrowers to the supervisory body on a monthly basis. The supervisor consolidates this information and shares it with all regulated financial institutions through a specific report. The supervisory body also has the right to sell this information to third parties. Three credit bureaus (Sentinel, Datacredito and Equifax/Infocorp) have bought this information. While non-regulated institutions are not required to report information to the supervisory body, some of them report information voluntarily to Infocorp in the framework of an agreement established between COPEME (a microfinance network) and the bureau. The reliability of the credit bureau information is good and provides extensive detail (e.g. includes information on debt with the tax authorities, telephone companies, cable, etc.).

Since 2009, a specific regulation has been implemented to prevent the borrowers' risk of over-indebtedness in Peru. Based on this, a rigorous analysis of the repayment capacity, the quarterly monitoring of the risk of over-indebtedness and a report to the Board of Directors, are compulsory in each institution. Nevertheless, the measures adopted are not always satisfactory. For example, incentive systems for loan officers can be aggressive, and the clients may still have multiple loans from a number of institutions (up to four or five). As a result, as of December 2013, 50.4% of the borrowers within the total market have loans with more than one institution (53% have a loan with two institutions, 27% with three institutions, 13% with four institutions and seven percent with five or more institutions).

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sufficient technical and managerial skills, besides being located in an increasing economic sector and their products or services are highly competitive. The classification of the employer is performed by the financial institution (the Risk Department applies the provisioning policy which is reviewed by Internal Audit and it can also be reviewed by the Superintendence of Banks in its annual visit)

Lessons for Zambia

There are some similarities between the case of Peru and Zambia in terms of the scale of the market as well as the rapid growth in the payroll lending sector in the past few years. However, there are other loan products available to consumers in Peru (e.g. vehicle and housing finance) possibly enhancing the need for managing levels of indebtedness. Important lessons from Peru are:

1. Lenders perform a detailed risk analysis on each employer before starting payroll lending to the staff. For each lender, a specific risk weighting is defined associated to payroll loans (as per the risk linked to the type of employer).
2. The required provisioning is linked to the weighted risk
3. Instalments should not be more than 30% of net income – much more conservative threshold than proposed in Zambia.
4. The Superintendencia (Central Bank) actively monitor trends in the market; for instance, value and volume of payroll loans, number of customers with one or several payroll loans, number of customers with payroll loans and other loans,. average outstanding loan. In Zambia the MMP will address this need.
5. The reliability of credit information is good and aids the central bank in monitoring trends in the market and payroll lenders to have a fuller view of the affordability of potential borrowers. In Zambia, some work in required to enhance the data accuracy and completeness, definitions and the enforcement of data submissions.

5. Brazil

Payroll lending is called *credito consignado* in Brazil and has played an important role in the steady growth of personal lending. All credit categories have experienced strong growth rates but especially personal credit, which represented 46% of total credit in 2012 (compared to 43% in 2005 and 23% in 2002). This dramatic increase in personal credit has led to an accumulation of debt and high debt service ratios in the household sector. Consumer indebtedness (as a percentage of disposable income) has steadily increased and in 2012 exceeded 40% of income (or 23% of disposable income) according to estimates by the Brazil Central Bank.

Payroll deduction loans are used by public and private sector employees as well as pensioners[40]. While employees of private firms are legally eligible for these loans, they tend to be more available to government employees where job stability is stronger so unemployment is considered as a minimal risk by lenders. According to the International Monetary Fund (IMF), during the 2010-2011 period, two-thirds of the consumer credit was in the form of payroll deduction loans[41].

Payroll deduction loans are provided by banks or NBFIs (financeiras) for a term up to six years (72 months). There is no cap on pricing but transparency in pricing is facilitated by government. For example, the Ministry of Social Protection publishes pricing of all institutions lending to pensioners. There are some affordability limits as well – no more than 30% of income or pension payments can be committed to payroll deduction loans.

40 The target market for Credito Consegnado was clarified by the following Acts: 10,820 of September 2003 (medida provisoria / temporary measure) and 10,953 of September 2004

41 Brazil: Technical Note on Consumer Credit Growth and Household Financial Stress, IMF 2013

Credito consignado is seen as a contributor to financial inclusion and a relatively affordable type of credit in Brazil. A World Bank paper explains[42]:

"By reducing the risk to lenders, crédito consignado have resulted in a significant reduction in the interest rates charged. According to data from the Central Bank, the average interest rate on loans obtained through the crédito consignado program was 27.2% per year in November 2011 compared to more than 70% per year for non consigned personal loans. This significant differential in rates, which was present from the beginning of the program, allowed some borrowers to substitute loans obtained through the crédito consignado program for more expensive credits they were previously holding. The shift from high cost to lower cost credit provides an unambiguous welfare improvement for consumers and there is both anecdotal evidence and recent research which suggests that this occurred during the early years of the program (through 2007). At the same time, by creating a solid guarantee credit became available to some low income workers or pensioners who were previously unable to obtain a loan. A 2005 survey by the Brazilian Federation of Banks (FEBRABAN) found that 51% of people taking a crédito consignado had never borrowed before."

Government has also pushed for more competition in the payroll lending area. In 2012, the Administrative Council for Economic Defence ended the ability of some public banks to have exclusive rights to the crédito consignado business of government employees whose payroll they administer or pensioners who receive benefits through a particular public bank.

However like in other countries, some researchers have raised the fact that *"the risk of non-payment may be so low that it may be creating perverse incentives for sometimes aggressive overselling of crédito consignado loans. [… } Going forward attention should be paid to how government workers and pensioners are marketed these loans and the impact on their welfare should be evaluated"*[43].

The risk however appears more at the level of over-indebtedness for consumers than at a systemic level as according to stress analysis performed during the last Financial Sector Assessment Program (FSAP) by the IMF in 2012, the vast majority of Brazilian banks are in a position to withstand substantial levels of stress including sizable credit shocks.

Lessons for Zambia

The Brazil case has several similarities with Zambia, namely:

1. The biggest risk relates to over-indebtedness and associated potential risks
2. Strong predominance of payroll lending in the civil service (as well as for pensioners) as lenders perceive the public sector as low risk
3. Dramatic growth in consumer lending has led to high debt level for households.

The government and regulator monitor the level of indebtedness closely for various categories of the population.
There is a strong focus on transparency in pricing, encouraging consumers to compare loans and encouraging lenders to compete on price. Government agencies publish pricing of different lenders in comparative tables on a regular basis.

[42] Financial Sector Assessment Program Update Brazil. Financal Inclusion in Brazil: Building on Success, Technical Note, World Bank 2013
43 Idem.

6. Conclusion

The first point that arises from these three case studies and the experience of other countries is that consumer lending needs to be properly monitored; for doing that, there is a need to identify and register all personal lenders that operate above a minimum threshold. Given the sensitivity of payroll deduction, all lenders using this type of repayment should also be registered. Growth of personal lending needs to be monitored in terms of concentration in specific economic sectors, income levels of borrowers and levels of indebtedness.

It is also important to regulate personal lending in terms of market conduct, making sure that borrowers are well informed on all components of pricing, making sure that the interest rate caps and other lending rules are enforced if such rules are in place. The Peruvian and Brazilian experiences suggest that payroll deduction bears less risk than other consumer loans and should therefore be priced at a lower level. Making sure that borrowers are properly assessed for affordability is also crucial. The process used by lenders for applications to payroll deduction loans needs to be regularly checked by the regulator, as there is an obvious temptation by lenders to rely only on priority in the repayment rank rather than proper affordability assessment.

For deposit-taking institutions, prudential supervision needs to have some focus on the specific risks of personal lending. As shown in South Africa, a severe crisis cause by deteriorating portfolio quality can lead to rapid fall out and bankruptcy which in turn can lead to real systemic issue in the banking system.

XVII. Annex Eight: Background information on industry stakeholders

1. Association of Microfinance Institutions in Zambia (AMIZ)

The Association of Microfinance Institutions in Zambia (AMIZ) is a member-owned and run organisation. AMIZ has been in operation since 1998. Since its inception, it has focused on improving the policy framework for microfinance in Zambia through advocacy and promoting best practices. The organisation is run on a day-to-day basis by an Executive Secretary who reports to the Board. The Board consists of elected members from the senior management of member MFIs.

Membership to AMIZ is open to both developmental lending and consumer-payroll lending MFIs. As of July 2014 of the 33 MFIs registered with BoZ, 20 were active members of AMIZ. Over the last two years the membership (as evidenced by the fully paid subscriptions) fluctuated between 20 and 27 members. The developmental MFIs dominate the membership of AMIZ holding 12 of the 20 memberships.

Following the introduction of the interest rate caps in 2012, AMIZ has experienced the emergence of a chasm between the developmental lenders and the consumer lenders. This is primarily because the developmental lenders perceived the relatively high interest rates that consumer lenders used to charge before the interest rate caps as the main reason behind BoZ introducing them. This was also a view expressed by the Bankers Association of Zambia Secretariat. This in turn has led to some of the more dominant developmental lending MFIs pushing for the 'expulsion' of consumer lending MFIs from AMIZ thereby leaving it as a developmental lending MFI association only. As a consequence some of the consumer-payroll lending MFIs are contemplating setting up a new association for consumer-payroll lending MFIs only.

The split within AMIZ has made it challenging for the sector to effectively lobby BoZ not only on the interest rate cap policy but also the Microfinance Service Bill of 2014. As a consequence some of the consumer-payroll lending MFIs have setup a Zambia Association of Commercial Lending Institutions (ZACLI new association). Founding members include Madison Finance, Bayport and Izwe Loans.

The breakaway and formation of ZACLI from AMIZ has made it challenging for the sector to effectively lobby BoZ not only on the interest rate cap policy but also the Microfinance Service Bill of 2014. In-fact the obvious split can be seen as contributing factor to the regulatory approach taken by BoZ in the draft regulation of basing the regulatory framework around institutional type as opposed to products and services being offered.

2. Bankers Association of Zambia

The Bankers Association of Zambia (BAZ) is a voluntary membership organisation for commercial banks operating in Zambia. In September 2010 BAZ members ratified a new voluntary code of conduct aimed to set harmonized standards that the association's members should follow when dealing with customers. The voluntary industry Code of Banking Practice (CBP) is comprehensive and deals with a number of the identified disclosure and business practice issues such as product suitability, ability to repay, electronic banking products, financial difficulties, data transparency, and complaints. However, the effectiveness of the CBP has been very limited due to challenges with enforcement mechanisms and very poor public visibility. Self-regulation has generally not been very effective. As per the CGAP guidelines on regulation and supervision of microfinance: “Self-regulation of financial intermediaries in developing countries has been tried many times, and has rarely been effective in protecting the soundness of the regulated organisations”[44]. Although the same document indicated that it might occasionally be more successful when related to consumer protection.

[44] Consultative Group to Assist the Poor (CGAP), (2012) “Guide to Regulation and Supervision of Microfinance: Consensus Guidelines”