Zambian Laws Affecting Microfinance: Review and Recommendations for Reform

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Abbreviations and Exchange Rate

ADF	**African Development Fund**
AMIZ	**Association of Microfinance Institutions in Zambia**
APR	**Annual percentage rate**
BoZ	**Bank of Zambia, the national central bank**
MFI	**Microfinance institution**
NGO	**Non-government organization**
NBFI	**Non-bank financial institution**
ROSCA	**Revolving savings and credit association**
UNZA	**University of Zambia**
US	**United States**

Exchange rate used: Zambian Kwacha 2400 = US$1.00

Executive Summary

Microfinance institutions (MFIs) have emerged around the world in response to the need for deeper financial service provision in developing economies. While many individual organizations are growing and thriving, the legal and regulatory environment in which they operate has not caught up. Typically, not only are laws outmoded and sometimes detrimental to the responsible growth of microfinance services, but there is also much confusion regarding the need for supportive legislation. In many cases, the assumption has wrongly been made that any changes to microfinance-related legislation and regulation means more control. In fact, worldwide, financial market legal reforms have resulted in freer, more open markets with less restriction and an explosion of innovative growth. If properly considered, there is no reason to think that microfinance-related legal reform will be any different.

This paper analyzes the impact of Zambia's legal framework on microfinance activities, and identifies the major legislative changes suggested by the analysis in order to provide legal recognition and room to expand. More generally, the paper offers the reform-minded an approach toward determining which legislative provisions support MFI growth, and which create obstacles to it, and what kinds of changes would be useful to liberalize the sector. The key principle is that microfinance institutions must be able to integrate into local financial markets and mobilize private capital at some point in their organizational lives. In order to make this possible on a broad scale, an appropriate and flexible legislative environment is mandatory.

The best starting point is the review of the existing corpus of relevant laws, regulations, court decisions, to consider their content, implementation, and their impact on microfinance. On this basis, stakeholders and experts can identify areas where law or regulation limits (or potentially limits) responsible MFI growth, and propose amendments accordingly, in order to open up the sector. The areas of legislation to be covered include prudential regulation and supervision, price and operating regulations, form and entry requirements, and financial transactions. The paper applies this approach to the operating environment for microfinance in Zambia. A detailed review and identification of issues, with suggested legislative responses, forms the body of this paper.

The laws and regulations reviewed in Zambia include:

- Financial sector legislation such as the Banking and Financial Institutions Act, the Bank of Zambia Act, the Money Lenders Act, and the Building Societies Act.
- Legislation governing the establishment, form, and incentive structure of financial entities, such as the Business Names, Corporations, Cooperatives, and Societies, Investment, and Income Tax Acts.
- Commercial legislation that impacts MFIs, including the Acts on Agricultural Credits, Hire-Purchase, and Bankruptcy, along with laws and policies affecting impacting lien and credit information.
- Statutes, regulations, and case law concerning enforcement of judgements, debt collection, and alternative forums such as small claims courts and arbitration.

The recommended reforms are of two types, immediate and long-term. The immediate changes proposed are:

- To revise the Cooperatives Act in order to bring credit unions under central bank supervision
- To exempt MFIs from the usury controls contained in the Money Lenders Act; and
- To revise the Banking and Financial Services Act in order to define the status of MFIs within the formal financial markets. This includes the specification of supervisory authority over market tiers, defined on the basis of expansion plans, financial self-sufficiency, and products and services that the institution wishes to deliver.

Suggested longer-term legal reforms would deal with central bank autonomy, protections for low-end borrowers, secured transactions legislation, bankruptcy rules, and debt enforcement. The annexes to the paper include a recommended design for the regulatory system to govern microfinance activities in Zambia, with illustrative tier definitions, as well as the text of proposed legislation that would enable the establishment of such a system.

The legal changes recommended here are currently under consideration by the Government of the Republic of Zambia. This paper in no way indicates the Government's official stance, and the Government is free to accept, reject, or otherwise alter the suggested options herein.

1 Introduction

Growth in the scale of microfinance activities in most parts of the world is limited by a wide variety of existing laws, including those dealing with organizational forms, prudential standards, interest rate limits, and secured finance. Most microfinance firms are able to operate due to selective non-application of such rules with the tacit agreement of government, or they function inefficiently while adhering to the existing laws. Such limiting rules can be amended to make legislation and regulation consistent, facilitative, and transparent, rather than unclear or even obstructive. Making such changes is consistent with the emergent worldwide modernization of financial market legislation. This process, far from creating a more rules-bound and restrictive environment, is liberalizing and opening up financial markets, and making their participants much more creative in service development and provision. Improvements in the legal and regulatory environment for microfinance are a natural next step in enhancing these overall market environments.

In a bold step, Zambia has begun to establish a facilitative legal and regulatory framework for microfinance. Such an undertaking requires open give-and-take between stakeholders and government, a core group of reform champions to drive the process ahead, and a willingness by government to integrate feedback from the public into the reform package. It also demands a thorough review and possible amendment of a host of rules on banking, business and cooperative organizations, and commercial transactions, with careful consideration of a host of options. This paper will take a detailed look at the current legal environment in Zambia, so that the findings may be used to identify and address any such problems in ways that ease restrictions and make responsible microfinance growth more feasible.

Formal microfinance services in Zambia prior to the 1990's were dominated by cooperative societies registered as Credit Unions under the Cooperative Societies Act. The liberalization of the economy under the Third Republic, starting in 1991, facilitated a resurgence of microfinance institutions, both in the rural and urban areas. This new development is an attempt both to raise the standard of living in Zambia, given a per-capita income of about $380, and to create access for the poor to small capital pools, since an estimated 86% of the population is under the poverty line[1] Both credit unions and other, newer models of small credit and savings provision are being promulgated, and there is a great degree of innovation. However, the actual market is still very small, with an estimated eight organizations of any size in operation, and a client base of less than 20,000 as of the end of 1998.[2]

The Government has reaffirmed its commitment to reduce poverty from the current level to 50% by the year 2004. Given the significant role of microfinance in this poverty alleviation effort, it is essential to ensure a supportive environment for microfinance institutions (MFIs), and this in turn requires a careful review of applicable legislation. The Association of Microfinance Institutions (AMIZ) has acknowledged that there is no provision for microfinance institutions in the Banking and Financial Services Act, the core legislation governing the Zambian financial sector. The requirements for banks and financial institutions under the Act are inappropriate and

[1] World Bank Country at a Glance, Zambia, October 1998, page 1.

[2] B. Wilkinson, discussions with the Board, Association of Microfinance Institutions in Zambia, and personal observation. A field survey will be undertaken in late 1999 to provide accurate statistics on the market.

overly burdensome for microfinance institutions if applied without modification. Indeed, only one microfinance institution qualifies[3] and is registered under the Act, while other MFIs have obtained their formal organizational status under other laws, and their status as financial institutions is vague. In short, the operations of microfinance institutions are subject to inconsistent regulatory standards and supervision and in some cases none at all.

This paper proceeds as follows. First, we present a brief conceptual framework for identifying and analyzing legislation relevant to microfinance activities. This provides a context, rationale, and structure for the review of Zambian legislation that follows, and a potential model for other countries to consider. Next, we review several categories of legislation, and in some cases implementing regulations as well, to determine their application and potential impact on microfinance activities. Sections three to six of the paper will be taken up with this review, which includes legislation covering financial sector regulation, commercial transactions, business organizations and investment, and enforcement of loan agreements.[4]

The concluding section of the paper summarizes our findings from the review and suggests changes aimed at improving the legal basis of microfinance in Zambia. There, we take up three categories of changes. First, we review legislative changes needed immediately in order to legalize microfinance and to enhance responsible growth. Second, we consider the outlines of a possible regulatory framework for implementing these first-priority legal changes. Finally, we discuss complementary legal/regulatory changes needed in the long term to ensure the commercial viability and sustainability of microfinance. The suggestions made here focus on the creation of enhanced options for MFIs of all kinds, rather than restricting operations unduly. These changes are further specified in a series of Appendices, which include legislative drafts designed to effect those legal changes deemed immediately necessary.

We have noticed that there has been, in work to date, insufficient attention to the difference between legislation and regulations. For the purposes of analyzing the institutional setting for microfinance, we propose the following working definitions. *Legislation* broadly defines the market structure, setting forth the basic rights and entitlements of the participants, in ways that are relatively difficult to change (e.g. legislative repeal). Some of this legislation takes the form of private law, i.e. legal rules (such as contract law) setting the norms by which private parties interact. *Regulation* is based on public law legislation, defining the relationship of government agencies to private parties and to each other. It involves one or more ministries or agencies, acting under a limited delegation of authority, setting more specific rules and standards that may need to be revised from time to time based on the evolution of the market. In the financial sector, carrying out any policy direction inevitably involves the development of a complex of tightly connected laws and regulations, in a context already shaped by existing rules. *Supervision* is the mechanism by which some disinterested outsider monitors the market, watching to ensure that all the players are abiding by the rules of the game, or suffer consequences when they do not follow the rules.

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[3] Credit Management Services, which has registered as a non-bank financial institution, and was able to be confirmed due to good planning and its owners' history as an accounting and assets management firm.
[4] Appendix A provides a full list of all legislation reviewed in the process.

This paper and its companion papers deal largely with the legislative aspects of the microfinance sector of the financial market. A sound legal structure is a necessary condition for good regulation and sound supervision, and therefore contributes importantly to healthy sectoral development and integration.

2 Conceptual Framework for Legislative Review

The shape of financial services markets in Zambia and other low-income countries evidences the need for special policy measures and institutional reforms that are unfamiliar in industrial economies. Traditional Western-style banking systems operating in developing countries serve no more than 20% of the adult population, a much smaller percentage than in industrial societies. Indeed, formal banks are estimated to serve no more than 5 percent of the population in Africa (Aryeetey et al. 1997 and Steel et al. 1997, cited in Berenbach, Churchill, Steel and Randhawa 1998, p.3). By contrast, estimates put the percentage of "banked" adult population in the United States at about 95 percent (interview with Scott Birdwell, Legal Counsel, FDIC). Financial deepening in countries such as Zambia will come about through economic development and systemic financial reform, but more is needed.

The essential premises of any effort to establish a legal/regulatory framework for microfinance are the following:

- ✓ In order to reach significant scale and to provide adequate service to clients, microfinance institutions need to attract private capital and to mobilize savings. While many MFIs have grown to an important scale with international donor support, sustainable financial intermediation in this sector requires private capital and savings.
- ✓ In order for MFIs to achieve this goal, they need a stable institutional environment that increases the credibility of MFIs and thus their ability to attract funds. This environment can be provided by an appropriate regulation and supervisory regime and a facilitative legal and regulatory structure.
- ✓ At the same time, standard banking regulation and supervision tend to impose ineffective and overly burdensome requirements on MFIs if they are applied without modification. It is equally important to allow for innovation in financial products, methodologies, and management mechanisms at the lower levels, especially among small informal organizations, by exempting them, in whole or in part, from full registration and regulation.
- ✓ Some tailored forms of law, regulation, and supervision – ideally within a multi-tier institutional structure contiguous with formal banking and finance – are needed to cope with the special features of microfinance. Several of these areas are unique to the microfinance market, and may justify different legal treatment for MFIs than for banking services and other, higher-value financial services:

    (a) its attempt to deepen financial markets to serve microenterprises and poor households, and the management orientation is not always profit alone;
    (b) its high unit costs of lending,
    (c) its approach of physically taking banking services to clients who have few other options,

(d) the relatively undiversified and sometimes volatile nature of MFI credit and voluntary savings portfolios,
(e) the fact that most MFIs began as unregulated credit non-government organizations (NGOs), and may sometimes continue operating on a non-profit basis,
(f) the fact that MFIs deal in savings and credit transactions with relatively low value in relation to the system as a whole -- and as a result are unlikely to have problems that cause broad systemic instability (Jansson 1997, pp. 1-6), and
(g) the market risk posed within the microfinance sector itself when MFIs (especially large ones) are not properly managed and monitored.

Before reviewing relevant Zambian legislation, it is useful to inventory the main issues to be addressed by a legal and regulatory framework for microfinance, as follows:

2.1 Prudential Regulation and Supervision

Regulatory provisions aimed at prudent financial management standards include: liquid reserve ratios, loan loss provisioning and audit, capital adequacy ratios, limits on concentration of risk, and requirements concerning loan security such as mortgage, moveable security, and group guarantees. Leading analysts of these systems suggest that the formal aspect of prudential standards matters less than the extent to which they embody principles of "risk-based" regulation and supervision (Vogel, Gomez and Fitzgerald 1999). This means that the legal requirement to meet reporting requirements of certain types, and to conform to a specific market model, is less critical than the degree to which those reports enable supervisors to keep track of the level of risk the firms run, and whether they in turn pose risks to their savers and to the market as a whole. It is important for Zambian regulators to keep this in mind when framing rules for the microfinance sector, because MFIs come in many forms, and reporting alone without relative market analysis will not ensure appropriate microfinance growth.

Concerning the reporting of portfolio quality and loan provisioning, the system needs to deal appropriately with microfinance credits, i.e. in a way that corresponds to their particular repayment cycles (e.g. weekly or monthly). This usually requires the application to microcredit of special treatment usually reserved for consumer loans or small commercial loans – with micro-loans fitting either or both of these categories. Microfinance methodologies also pose a challenge for auditing both in terms of location and audit rules, for example where existing systems focus on the largest loans and therefore would ignore portfolios of small loans altogether (Jansson 1997, pp. 17-22). There is a good case to be made for treating microenterprise loans in the same way or similarly to consumer loans, i.e. requiring careful monitoring and a more rapid provisioning schedule than commercial loans. Episodes like the Finansol crisis in Peru show that badly managed microfinance portfolios can deteriorate rapidly (Rock and Otero 1997, p. 96). This results in liquidity crises and a self-feeding collapse of the very confidence that enables repayment. The slow movement of cash and information in most developing countries can exacerbate these problems. At a minimum, monthly account statements, and perhaps biweekly reports for the largest MFIs, would be needed in order to monitor potentially volatile movements in asset quality.

Central bank requirements of physical collateral for commercial bank loans pose an additional problem, and ways need to be found to accommodate the group solidarity and unsecured individual lending modalities of MFIs. Most financial systems do not officially consider group liability to be valuable as security. The key difference of approach appears to be whether the system imposes aggregate limits for unsecured loans by financial institutions, or uses single borrower percentage limits, and below what threshold, if any, loans are exempt from such rules (Jansson pp. 27-8). On the other hand, MFIs may decide to take physical collateral where possible, particularly on larger loans. In this context, a credible threat of rapid repossession, whether through court order or self-help, should help keep risk premia and transaction costs low. A supportive legal environment for secured finance, which is especially important at the medium and small end of the enterprise spectrum, is critically important in this regard.

Capital adequacy ratios pose a challenge for microfinance in many countries. In most, the ratios are at least arguably set too low for purposes of MFIs. Stricter capital adequacy standards would be justified where the reduction of risk is greater than or equal to the consequent reduction in expected social and private returns. It is quite likely that MFIs are or would be viewed as too risky by potential investors under Basle or similar system-wide standards. The alternative approaches here include the following: (i) base capital adequacy on selected proxies of the riskiness of each loan; (ii) require more capital for all loans below a certain amount; and (iii) require smaller financial institutions to maintain higher capital adequacy than larger ones (Jansson 1997, pp. 25-6). A simpler approach that would capture most of these types of risks would be to provide for graduated capital adequacy standards based on the size, age and experience, and financial self-sufficiency of the institution. All of these approaches in different ways take the special nature of microfinance into account, but they all would likely be viewed as containing certain biases against MFIs and would therefore need to be explained thoroughly.

Two other important issues in this connection are: who regulates, and who is regulated? It has already been suggested that small-scale organizations such as rotating savings and credit associations (ROSCAs) should perhaps be left out of the scheme of registration and regulation, in order to avoid the stifling of financial innovation at the lowest levels. Many commentators take a further step, suggesting that institutions that do not take savings do not warrant regulation. This, of course, is inconsistent with the pervasive practice of regulating non-bank financial institutions. Both for purposes of permitting innovation and of conserving regulatory resources, it may make sense to apply no more than minimal requirements to MFIs that do not have significant deposit balances (net of loans) from their members and do not accept deposits from non-members. However, this should be the case only if they have not grown significantly large in terms of membership, loan balance, and market share, because in such cases, their instability can affect the entire microfinance market.

As to who regulates, there has been discussion in the literature about phased or hybrid regulation approaches (e.g. Churchill 1997). Here, it is recognized that central banks have neither the training nor the resources to supervise the entire MFI sector. Assuming appropriate capacity development in the banking supervision departments, one might envision a division of labor in which central bank supervisors retain ultimate responsibility for the entire sector. However, they would only take on direct supervision (and possibly even in these cases, delegate much of the field checks) of apex institutions such as Microbankers' Trust and the very largest

one or two MFIs, such as Credit Management Services. Below this level, several approaches are possible, from benign neglect to delegation of supervisory powers to a private institution or organizations such as a microfinance industry association, accounting firm or organization, or others with demonstrated capacity.

It is also important to bear in mind that the market plays a potentially significant role here. For example, MFIs borrowing from apexes, commercial banks, or other formal entities for on-lending to their clientele are (or should be) subject to creditor monitoring by such wholesale lenders. Central bankers could either leave this segment to be governed by market incentives, or could require these large-scale creditors to report on their MFI debtors, perhaps in return for a share of regulation fees or some other incentive. Finally, given the strength of credit unions in many countries, and the fact that they largely remain outside the authority of bank supervisors, a coordinated and consistent approach to this sector would require transfer of supervisory powers from the cooperatives' registrars to the central bank.[5]

2.2 Price and Operating Regulations

These regulations place limits on several aspects of day-to-day operations, and include: usury laws and interest rate caps, loan documentation requirements, and operational restrictions affecting, for example, branch openings and business hours. Interest rate regulations are often relics of criminal usury standards, but some have been developed in recent times and restrict interest rates to a particular band for specified sectors, or limit interest rates to a certain percentage above average commercial rates or prime rates. In either case, such rules, if enforced, can make sustainable operation difficult for MFIs, given their operational costs and methodologies. It appears that in many cases these limits are not enforced, which creates space for MFI viability in the near term, but also creates the risk of shut-down, or at least extortion and bribery, where enforcement becomes a real possibility. Similarly, many countries specify loan documentation, which can include notarial and other fees. These are also a potentially significant constraint on MFI operations, except in systems that exempt micro or consumer loans from documentation requirements and let the parties determine these. Branching and business hour regulations have obvious impacts on the extent to which MFIs can take their operations to the client.[6]

Operating regulations also include rules for fair treatment and information disclosure to borrowers. Microfinance involves relatively vulnerable borrowers such as poor households and microentrepreneurs. This raises the importance of fair disclosure rules such as those applied to consumer transactions in industrial countries. The main issues here are truth-in-lending standards and fair credit reporting standards. These rules impose transparency on the documentation and procedures of lenders and credit rating agencies, in order to reduce informational constraints that often plague low-end finance markets. For example, these rules often require clear documentation and explanation of interest and fees, such as their presentation in the form of a consolidated annual percentage rate (APR). Credit reporting may be subject to the debtor’s consent and the debtor’s right to review and challenge any report. These systems

[5] Indeed, this is one of the key recommendations for Zambia presented in the discussion below.
[6] The latter do not appear to pose a problem currently in Zambia.

vary from highly formalized systems to essentially informal information-sharing networks, and sometimes confront obstacles in the form of strict confidentiality standards and expectations.

2.3 Form and Entry Requirements

This refers to rules affecting MFI start-up or conversion into regulated entities. These requirements include: minimum capital requirements, institutional form and governance requirements, and ownership (e.g. foreign investment) restrictions. High minimum capital requirements pose a significant obstacle to the entry or conversion of MFIs, although requirements set too low would create the supervisor's nightmare of too many entrants, with resulting painful exit and consolidation. One proposal aimed at meeting supervisors' need for rigor and MFIs' need for flexibility in this area is to use the net present value of a microfinance NGO's existing credit portfolio in calculating initial capital, at the point where the NGO applies for *conversion* to a regulated MFI (Jansson, pp.9-13). Prior to such conversion, worldwide experience suggests the wisdom of a highly liberal approach in which no attempt is made to require the incorporation, registration, or regulation of small informal microfinance organizations, such as ROSCAs, for example within a social group or firm. Also, newly-emerged MFIs (e.g. village banks and NGOs that plan to expand their service area and client base) might well be subjected to relaxed entry standards under provisional registration, until such time as they reach the rapid growth stage, and face more demanding requirements.

With respect to institutional form and ownership, these rules must balance concerns about governance, asset ownership, foreign control and money laundering against flexible entry and the ability to draw on substantial sources of funds. Often, the balance is struck on the side of rigidity, with negative results – for example, in Honduras, the limitation of financial institution shareholding to individuals, enacted due to money laundering concerns, makes it virtually impossible for NGOs to become regulated MFIs (Jansson, p. 16). The trade-off between safety and the flexibility to innovate must be carefully drawn in every context. At a later point in the life of an MFI, expanded services and client bases would justify stricter rules, guarantees, and supervision.

A related issue is whether corporate form is required, which is the case for financial institutions in most countries, and what this entails in terms of ease of capital calls vs. difficulty of transitional structures. A requirement of corporate form may be ideal if company formation is cheap and flexible, or if simplified options are available (such as S corporations in the U.S.). However, many company statutes are unduly rigid, with costly requirements and highly regulatory approaches to company purposes and governance. These kinds of company laws may, in effect, pose obstacles to market entry by MFIs.

2.4 Financial Transactions

This category refers to the commercial legal environment for the financial sector, which has a significant impact on MFIs' sources of funds. The components of this include: mortgage and secured transactions laws, bankruptcy laws and regulations, corporate governance and

securities laws, the combination of these and other laws that affect onlending operations and debt securitization, the institutions that provide for credit rating and reporting, and the system of courts and other mechanisms for enforcing loan agreements.

The legal regime for moveable security is especially important here. Microenterprises and poor households frequently do not have titled land to mortgage. A legal framework containing the following elements would enable these clients to pledge machines and other moveables efficiently: clear standards for the creation, perfection (i.e. becoming effective upon publication), and enforcement (including priority rules and expedited procedures) of security interests. This framework also critically depends on the quality of contract enforcement, hence the effectiveness of the court system, procedural rules, and legally-sanctioned alternatives such as self-help and arbitration.

Where security interests are sufficiently broadly defined and contract enforcement is effective, this legal framework also facilitates commercial bank lending to apex organizations and MFIs for onlending to their clients. Here, loan portfolios could be used to secure the credits. Moreover, with the addition of facilitative corporate and securities laws, unsecured microloan portfolios could be securitized and offered on the money markets, thereby opening up much larger sources of funding and bringing the efficiencies of equity markets to bear in the micro-credit sector. In Zambia as in most other developing countries, it will be quite some time before this can become a serious possibility, but it should certainly be contemplated. Also, securitization may also have to overcome restrictions on the range of intermediation activities available to various types of licensed financial institutions.

3 Banking and Financial Services Legislation

The most obvious and immediate concern with respect to the legal basis of microfinance anywhere in the world, including Zambia, is the regulatory environment for microfinance operations. Under what terms and conditions can MFIs be licensed? What prudential standards apply? Under what conditions, if any, are they regulated and supervised, and by whom? In other words, how (if at all) do MFIs fit within the overall financial market as defined by banking laws and regulations? The Zambian legislation was carefully reviewed with an eye to these key questions. The detailed results follow.

3.1 The Bank of Zambia Act 1996

Ultimate authority for regulation and supervision of financial institutions rests with the Bank of Zambia. This authority, however, is delimited by definitions and standards contained in other legislation, with the result that this authority is not truly comprehensive at the moment. The Bank of Zambia Act (Act No. 43 of 1996) defines the Bank's authority to carry out monetary policy, and to regulate and supervise all financial institutions. Specifically, the functions of the Bank of Zambia are to -

(a) license, supervise and regulate the operations of banks and financial institutions for the safety, efficiency and development of the financial system;

(b) act as banker and fiscal agent to the Republic; and
(c) determine by Gazette notice the minimum ratio of liquid assets that each financial institution is required to hold and the minimum reserve balance that each financial institution shall maintain with the Bank of Zambia.

If, as we suggest below, the Bank of Zambia determines that it should provide for some form of regulation of microfinance operations, it has been recommended (by AMIZ and others) that the Bank delegate some of its powers to other institutions in order to ensure effective performance of this function. Any effort to establish such a delegated or hybrid form of regulation will need to carve this authority out of the central bank's jurisdiction. The Act does acknowledge the Bank of Zambia's power to delegate tasks to others, at its discretion – the Bank's Board has the power to appoint agents and correspondents.[7]

Also potentially important is the fact that the Bank of Zambia is not fully autonomous, but takes policy direction from the Ministry of Finance. Appointment of the director by the President, with parliamentary approval, is consistent in theory with central bank autonomy – but whether it is so in practice is another question that cannot be answered here. This affects the potential for politicization in this sphere, a problem that has plagued the credit union sector in Zambia at least since independence (see below).

3.2 The Banking and Financial Services Act, Cap. 387, 1994

This statute applies modern financial regulatory methodology to banks and other financial institutions. The Act, oriented as it is toward contemporary and future financial development, explicitly mentions credit reference services, credit cards, factoring, and financial leasing as types of financial services with which it is concerned (Banking and Financial Services Act, Sec. 2). While, as such, it does not directly facilitate microfinance services, it does provide a strong foundation on which to build a graduated regulatory structure that accommodates MFIs.

The Act's approach to governance, competition, and prudential standards appears quite sound (Id., ch. III-VI). Rules prescribe limits to cross-shareholding and self-dealing by financial institutions and their boards, and also require disclosure of potential conflicts of interest. Reporting and prudential rules provide for monthly and annual statements, transparency in the form of newspaper publication of these statements, maximum 50 percent liquid reserves, and a limitation of advances to single borrowers to a ceiling of 25 percent of regulatory capital.[8] They also provide for prohibition of unsecured advances to officers or employees of the institution, a minimum capital adequacy ratio of 6 percent (but higher in the implementing regulations), and limits on equity investment proportions.[9]

Importantly, the Banking and Financial Services (Capital Adequacy) Regulations, 1995 provide for a graduated scheme of minimum capital requirements applicable to:

[7] The Bank may appoint agents on such terms and conditions as it determines, except that no remuneration paid to any agent or correspondent shall be computed by reference to the profits of the Bank.
[8] Oddly, the rules define a higher ceiling on advances to entities controlled by a bank officer.
[9] The maximum for any investment is 15 percent of regulatory capital and 75 percent of the entity's equity.

(a) banks and depositary institutions (2 billion kwacha, nearly U.S. $825,000);
(b) leasing companies (250 million kwacha, U.S. $103,000); and
(c) other financial institutions (at least 25 million kwacha, U.S. $10,300, or as determined by BoZ).

The Bank of Zambia has discussed an upward adjustment of these levels that has not yet been implemented as of this writing. A capital adequacy ratio of ten percent of risk-weighted assets applies to all institutions, but is implemented on a sliding scale, depending on the:

(a) size of the institution;
(b) diversification of assets and liabilities;
(c) degree of risk exposure;
(d) level of profitability; and
(e) management strength, including liquidity management.

This scheme of financial regulation does not, as such, accommodate MFIs. In fact, the only MFI to register under the Act as a financial institution, Credit Management Services, has had to contend with inflexible prudential rules and reporting requirements that have contributed to an increase in its costs of operation. For start-up MFIs wishing to register under the Act, licensing fees ranging from 3 million to 25 million kwacha (approximately U.S. $1,200 to $10,000) may prove to be an obstacle.

At the same time, the Act does provide a good basis for further development. The applicable statutory and regulatory provisions also indicate that Zambia has the choice of developing its scheme of MFI regulation through Bank of Zambia regulation or through statutory enactment. The latter, in principle, is the more credible option and is embodied in the draft legislation included in Appendix D to this paper, but circumstances may dictate consideration of either option. If the mandate of BoZ were to be extended to microfinance, the building and conservation of supervisory capacity would soon become an issue, since the Bank's supervision staff now numbers only 40 for all of Zambia.

Some additional aspects of the Banking and Financial Services Act merit consideration, though perhaps not immediate reform. While the Act provides wide discretion to the Bank of Zambia (BoZ) to set conditions for the award of particular licenses ("such conditions as the Bank of Zambia thinks fit to specify"), it also provides for appeal against such conditions and decisions (Id., art. 13). However, the route of appeal is, first, to the Registrar of the Bank of Zambia, then to the Minister of Finance, who is empowered to empanel an appeal tribunal, whose decision shall be final (Id., ch. VIII). Unless this is subject to modification in case law or administrative law, this means that appeals come under the authority of the Minister and appellants do not have the right of appeal to the regular court system. As a result, central bank discretion in this area is essentially unconstrained, which could give rise to problems of arbitrariness and political intrusion.

The Act also provides useful standards for information disclosure and confidentiality. Art. 47 and the implementing regulations spell out the form in which interest rates, finance charges, and fees must be disclosed in written statements to borrowers, and in which complaint mechanisms must be advertised to clients and potential borrowers. The Banking and Financial

Services (Cost of Borrowing) Regulations, 1995, set out detailed standards on the categories of charges to be disclosed as well as the manner, timing, and formula to be used for disclosure. Similar regulations provide for disclosure of deposit interest and fees. These standards provide the essential protections of truth-in-lending laws. Sec. 50 of the Act makes the following information confidential, although it can be divulged where the interests of the financial institution require it, and with the customer's consent: payments made and received by the client; assets, liabilities and resources; and business or family relation (presumably this means the relation of the borrower to the lender). These provisions appear on their face to provide a reasonable balancing of institutional and borrower interests, and make possible the establishment of a credit reporting system. However, there is evidence that in practice, this has been made more difficult by litigants who have successfully blocked or punished disclosure.

3.3 The Money Lenders Act, Cap. 398, 1938 (as amended)

The Money Lenders Act (Cap. 398) aims to rein in the potential for abuse by moneylenders. It requires licensing, clear disclosure of lending terms in the form of an APR, disclosure of loan status upon request, and written agreements stating essential terms. There are three main aspects of this Act which affect the microfinance market. First, the Act empowers the courts to review the terms of money lending agreements in order to determine whether the interest rates, fees, and other provisions are unreasonable, and to substitute what it determines to be fair provisions. An annual percentage rate of 48 percent is deemed by the statute to be *per se* unconscionable (Money Lenders Act, arts. 14-15). This does not accord with the needs of low-end financial markets to set rates that cover the rate of inflation, lending costs, and risk premia. Furthermore, the charging of costs or expenses relating to the negotiations for or granting of loans is illegal.[10]

Second, a money lender cannot legally require payment of compound interest, or for the rate or amount of interest to be increased upon default. In this regard, the Act is on the same ground as the Union Bank Judgement (Supreme Court Judgement No.7 of 1997) and the Judgements Act (see below). However, a contract may provide that in cases of payment default, the money lender is entitled to charge simple interest on the sum borrowed, from the date of default until the sum is paid (but not at higher rate than that originally agreed). In some countries where this colonial-era English-derived statute is still in application, debtors have taken advantage of the incentive thereby provided to default on their debts, at least when they experience difficulty. In addition, the Act fixes a limitation on legal proceedings in respect of money lent by money lenders, to twelve months from the date the cause of action accrued or from the date of acknowledgement of the debt by the borrower.

Third, the statute exempts from its application the following: pawnbrokers, corporations authorized to lend money (i.e. banks and financial institutions), persons *bona fide* carrying out banking or insurance business or extending loans for reasons incidental to a business having a different purpose, building societies, and any companies declared exempt by the Ministry of Finance (Id., sec. 2). This last provision exempts banks, non-bank financial institutions (NBFIs),

[10] If any sum is paid to a money-lender by a borrower or intending borrower on account of such costs, the sum paid can be recovered as a debt due to the borrower or deducted from the amount owed by the borrower.

and building societies, but does not seem to provide clear guidance as to NGO-MFIs or cooperatives. On its face, the statute potentially applies to these organizations, with the result that most if not all are in violation of the key provisions described above. As NGOs and cooperatives are not corporations, they do not have the option of obtaining an exemption. Avoiding application of the statute depends on either a court's interpretation of sec. 2 of the statute, or incorporation and licensing as an NBFI. This is, in principle, potentially an important rationale for the formalization of the MFIs under a clearly defined regulatory regime. We therefore suggest a legislative amendment to this Act, as discussed in the concluding section and Appendix D to this paper.

3.4 The Building Societies Act, Cap 412, 1968

In a slightly different way, the Building Societies Act sets some possible precedents for the Zambian approach to structuring a financial sub-sector. A "building society" is defined as an institution created to raise funds in order to provide credit against mortgages of real property, in the form of freeholds or leaseholds. While the Act and implementing regulations do not fix interest rates, they do determine in considerable detail the operating rules of building societies, including ratios of loan to value in mortgage transactions and a list of authorized banks. They also provide for a state-owned building society and a union of building societies. This is perhaps an example of approaches taken under the Kaunda government, and admittedly in a sector largely distinct from microfinance, but the precedent that it sets is highly statist and therefore not ideal for more open market development.

4 Legislation on Organizational Forms and Investments

In addition to banking laws, the panoply of legislation concerning the formation, governance, regulation, and taxation of various types of legal entities has a significant bearing on the viability of microfinance institutions. To these bodies of legislation we now turn.

4.1 The Companies Act 1994

The Companies Act (Cap. 388) provides for the formation, administration, and winding up of registered corporate bodies. Many microfinance institutions are registered under the Companies Act as corporate institutions. Such a corporate body has legal personality, i.e. is capable of suing and of being sued in its corporate name, limits the liability of its members, and has its own powers as defined by its articles of association. A microfinance institution registered under the Companies Act will have such legal status, along with the duty to comply with all the provisions of the Act dealing with registration, management administration and winding up of its operations.

As distinct from certain other forms in which MFIs exist, a registered corporation engaged in microfinance operations has reasonably clear responsibility for purposes of accountability to creditors, regulation of its activities, and ownership of assets. According to the

Companies Act, the nominal capital of a private company cannot be less than 2 million kwacha (The Companies (Fees) Regulations 1998 S.I. No. 99 of 1998). The fees payable on registration is 2.5 percent of the nominal capital. The amounts required for incorporation are thus not prohibitive to small and MFI enterprises, although the motivation for fees and consequent control over minimum capital by the Registrar of Companies has been identified as a potential risk. The documents required for incorporation of a Company under the Companies Act include the Articles of Association, which require some professional input to formulate. This makes it more complicated for small MFI enterprises that cannot afford the professional fees, and such organizations may prefer registration under the Registration of Business Names Act and the Building Societies Act.

4.2 The Registration of Business Names Act, Cap. 389, 1931

This Act provides for the registration of business enterprises that are not corporations. These include sole proprietorships and partnerships. Microfinance institutions registered under this Act are able to conduct business legally, but the owners are personally liable. Since these firms do not benefit from limited liability and corporate personality, as they would under the Companies Act, they are not attractive to outside investors. However, they may be of interest as an initial mechanism for MFI start-ups.

4.3 The Cooperative Societies Act 1998

The Cooperative Societies Act (Act No. 20 of 1998) provides for the formation and registration of Cooperative Societies as corporate bodies with perpetual succession and limited liability. These entities have authority to act as legal persons, subject to the provisions of the Act and the bylaws of the particular society. A number of microfinance institutions are registered as cooperative societies under the Act. Cooperative Societies that are formed for the promotion of savings and provision of financing to their members are registered as credit unions. The Act provides that the Banking and Financial Services Act does not apply to credit unions registered under the Cooperative Societies Act, which are therefore not supervised by the Bank of Zambia.

The Act contains specific norms governing membership and lending activities. The membership of a credit union is restricted to groups of persons having a common interest or occupation, or to persons living in a well-defined neighborhood or community. The amount of a loan to any single member is limited to eight per cent of the paid up capital of the credit union, unless the bylaws of the credit union authorize the lending of higher amounts.[11] Furthermore, a credit union cannot lend money if the aggregate of its reserves comprising cash on hand and deposits with a bank or other similar organizations is less than ten per cent of its combined paid up capital and deposits. The credit union board of directors determines the interest rates. The Act also provides for charges created by a cooperative society to be registered by the Registrar of Agricultural Charges in order for the charges to be effective.[12]

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[11] However, this cannot exceed one quarter of paid up capital, surplus and deposits.

[12] See the discussion, below, of the laws and registries pertaining to secured finance.

Perhaps the most significant aspect of the Act as it concerns microfinance is that it places credit unions under the supervision of the Registrar of Cooperatives, which has insufficient capacity to carry out this function. In practice, the Registrar handles this supervisory responsibility essentially alone, with only marginal office support and no staff of inspectors or supervisors. This leaves the credit unions and other cooperatives to their own self-monitoring – not an ideal arrangement for attracting outside resources to this sub-sector of microfinance. The history of government interference in the cooperative movement, in particular with both loan channeling and forgiveness, has not encouraged strong self-management. In part as a result, cooperative societies have long been plagued by problems of mismanagement and failed accountability. This is the background to the enactment of the 1998 Act, which aimed to remove government participation from the management and administration of cooperative societies, and to provide only the regulatory framework for these societies.

4.4 The Societies Act 1958

The Societies Act (Cap. 119) provides for the registration and supervision of any club, company, partnership or other association of ten or more persons except those registered under laws such as the Companies Act or Registration of Business Names Act. NGOs engaged in microfinance operations are registered under the Societies Act. In this case, the institutions have no legal personality, as is also the case for those registered under the Business Names Act. The important difference here is that these societies, as such, are subject to neither corporate nor owner liability, and they are not required to meet any minimum capital requirement. As a result, where these societies are engaged in microfinance (or other business) activities, there are in effect no company assets or responsible parties. This creates uncertainty with respect to regulatory and contractual liability, and bankruptcy, hence a deterrent to investment.[13]

What are the other areas of legislation that affect the viability of microfinance operations? It would be difficult to conduct a truly exhaustive study of all such areas, but two that merit consideration are investment incentives and taxation.

4.5 The Investment Act 1993

The Investment Act (Cap. 385) provides a scheme of incentives for investment in Zambia, focusing on such areas as agriculture, industry, tourism, non-traditional exports, and small-scale enterprise. However, the Act does not recognize financial institutions in general, or microfinance institutions in particular, as requiring incentives. In recognition of the importance of microfinance institutions, particularly for business enterprises in rural areas where formal banking services are scarce and generally beyond the reach of the rural entrepreneurs, a case could be made for incentives under the Investment Act for the operators of microfinance institutions.[14]

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[13] For this reason, it is suggested below that all recognized MFIs be subject to minimum capital requirements, no matter what their legal form.

[14] In effect, the current tax structure favors MFIs over banks and in some cases non-bank corporations (see below).

4.6 The Income Tax Act 1963, as amended

The Income Tax Act (Cap. 323), as amended by the 1999 Amendment Act (No. 6 of 1999), provides the following tax schedule:

(a) 30 percent for companies listed on the Stock Exchange;
(b) 35 percent for companies other than banks;
(c) 35 percent for banks whose income does not exceed one hundred million kwacha; and
(d) 45 percent for banks whose income exceeds one hundred million kwacha.

Microfinance institutions in theory could fit any of these categories, although in practice, Zambian MFIs fit into category (b) as non-bank companies. This suggests that a potentially strong disincentive exists for the conversion of credit unions and NGO-MFIs into banks. In addition, once such a conversion is made, incorporated MFIs face a higher tax rate than those companies and banks that list shares on the stock exchange. As a result, potentially significant disparities exist in the tax status of MFIs (and banks) competing with each other in the credit market. These issues will need to be addressed as the microfinance market develops.

5 Commercial Legislation Affecting Credit Transactions

Another set of relevant acts and practices defines important aspects of debtor-creditor relations that affect the potential for the microfinance market. These laws touch on the contractual basis of loan transactions, creditor interests in cases of default and bankruptcy, and lien and credit information.

5.1 The Agricultural Credits Act 1995

The Agricultural Credits Act (Cap. 224) facilitates the borrowing of money on security in farming stock or other agricultural assets, and provides for the registration of these security interests. The Act enables the farmer to create a charge on farming assets as security for inputs or other items required for cultivation, for the sums of money advanced to the farmer, or for sums paid on behalf of the farmer. The charge may be fixed, floating, or both. For the charge to be effective, it must be recorded with the Register of Lands and Deeds. The Arbitration Act applies to the settlement of any dispute arising as a result of the interpretation or application of the provisions of the Act.

Thus, the Act sets up a regime for secured lending against moveable collateral in the agricultural sector. Helpfully, the Act provides for standard contract provisions in this area, a requirement of notice to subsequent buyers of pledged assets, a registration requirement, some mechanisms of enforcement, and a simple first-in-time scheme of priorities among agricultural security interests (Sections 3-5, 8, 11). The main problem with the Act is the fact that it establishes a free-standing secured finance regime whose relationship to the charge provisions of the company law, the rights created under the Hire Purchase Act, and the security provisions of

the Bills of Sale Acts of 1878 and 1882 is entirely unclear based on available information. Moreover, the Act provides a period of 30 days for registration, which would not be considered either commercially reasonable or useful in most contexts, and prohibits the publication of agricultural charges, thereby undercutting any potential support for credit reporting systems (Arts. 8, 9). The fees for the registration of charges are also high at ten thousand kwacha per charge, negating some of the effect, especially for large-scale lenders. In effect, the Act attempts to facilitate credit for agricultural production, but in doing so, further complicates the rather confused and uncertain state of secured finance law. This general problem especially compromises the ability of MFIs and apexes to engage in wholesale commercial borrowing against their assets, for on-lending to MFIs and clients.

5.2 The Hire-Purchase Act, Cap. 399, 1957

The Hire-Purchase Act provides statutory recognition of leasing-type transactions under which sellers transfer possession and retain title until repayment, and buyers have the right to obtain title through regular or accelerated repayment. Unfortunately, the Act has the following defects that limit its utility. First, hire-purchase transactions, as under English law, are not brought within a general scheme of secured finance. They therefore interpose potentially significant uncertainties and transaction costs in the way of an efficient and modern secured finance system. Second, a number of provisions undercut the economic viability of these types of transactions. This is notable in provisions on the control of interest rates, now fixed by regulation at a maximum of 7.19 and 9.54 percent per annum for new and used goods respectively (compared to current bank prime rates of well over 35% p.a.)

The Act's provision of repayment exemptions for military personnel, and the prohibition of self-help enforcement, also raise potential difficulties. As mentioned above, the Agricultural Credits Act (despite its problems) helpfully provides for modern secured finance techniques in the context of rural finance, but the Hire-Purchase Act provisions provide little or no support to microfinance in the form of consumer credit, and indeed sets an unhelpful precedent of over-regulation.

5.3 The Bankruptcy Act, Cap.82, 1967

The Bankruptcy Act (Cap. 82) sets out procedures for insolvent debtors. Many of the procedures reflect modern practice and are spelled out in sufficient detail. However, the Act represents an older generation of bankruptcy statutes. It does not go far enough in bringing the rules into alignment with contemporary understanding of financial market incentives. One glaring problem is that, in bankruptcy, all debts are treated as being payable *pari passu*, unless otherwise specified in legislation (Bankruptcy Act, art. 36). As discussed above, agricultural and other secured finance-related laws set up separate free-standing schemes of security rules and priorities, rather than an integrated approach that clarifies priorities across categories. In this regard, the Bankruptcy Act does nothing to clarify priorities and may actually muddy the waters. Indeed, the problem of clarity and predictability is intensified by other legislation on bankruptcy (see the next subsection).

5.4 The Preferential Claims in Bankruptcy Act 1995

The Preferential Claims in Bankruptcy Act (Cap 83) provides a special scheme of priorities in bankruptcy for unsecured debts. The order of priorities is as follows -

(a) all amounts due by way of wages or salary or paid absence accruing to any employee within a period of three months before the date of a receiving order;
(b) all amounts due in respect of leave accruing to any employee within a period of two years before the date of the receiving order;
(c) recruitment expenses or other amounts reimbursable under any contract of employment;
(d) government rents not more than five years in arrears due to the Government on the date of the receiving order;
(e) rates due to a local authority.

However, subject to these provisions, section 2 (8) of the Act provides that all debts proved in bankruptcy or death shall be paid *pari passu*, as under the Bankruptcy Act.

In effect, the Act creates five additional priority categories of creditors who take precedence over secured creditors in the liquidation of debts in bankruptcy. In principle, where such special priorities are clearly defined and reasonably delimited, this need not prove a necessary disincentive to potential lenders. However, some of these categories (e.g. the last) are vague, and others are not sufficiently delimited, recognizing debts accrued as long as five years before bankruptcy. These provisions introduce unnecessary problems of uncertainty for potential lenders. In addition, the applicability of bankruptcy rules to NGO-MFIs is unclear in light of doubts that Zambians have voiced as to whether NGOs "own" the assets that would become part of an estate in bankruptcy. As a result, unincorporated MFIs present potential investors with a two-fold problem of uncertainty.

5.5 Lien and Credit Information

The informational dimension of credit markets is of primary importance. In Zambia as elsewhere, information flow is supported by disclosure and sharing arrangements concerning liens and credit records. These arrangements have not fully performed their function of facilitating efficient, low-cost credit allocation.

Registries of mortgages, debentures, floating and specific charges appear to be under-utilized for both registration and search purposes – perhaps due to limited lending activities, but also as a result of perceptions that registering liens in the current environment is simply not useful. At the same time, there are indications that collateral registration is used to a greater extent outside than inside Lusaka, by MFIs and other small actors who, unlike the banks, have a stronger incentive to expand their portfolios and encourage debtors to pay, than to ration credit conservatively.

Another important problem has been identified with respect to the potential for credit rating and reporting, a major issue with respect to the future of the microfinance market. This is the obstacle potentially presented by bank secrecy and confidentiality rules mainly derived from the common law. It is difficult to see how this would present an insoluble problem in this area. First, much credit reporting in industrial countries (or at least the U.S.) does not relate to bank credits but to installment sales or accounts receivables – and therefore banking confidentiality is not an issue. Second, some combination of legislative enactment and mandatory disclosure provisions in loan agreements (after the pattern of U.S. credit card agreements) would eliminate the problem. Third, the alternative of inter-bank information flows as a limited exception to confidentiality could diminish the problem, if Zambia were to evolve in the direction of a German-style bank-centered financial structure. In short, the problem – on paper – is easily remedied. Indeed, banks are attempting to impose disclosure consent clauses on their borrowers, although the more powerful clients are said to resist successfully.

If, as there is some reason to believe, much of the disclosure problem comes from non-meritorious civil suits for breach of confidentiality, this is a matter to be taken up in the context of procedural reform and court system governance. This is discussed below.

6 Debt Enforcement

The last area that we will consider in this paper is dispute resolution and enforcement. This field is defined at least as much by the capacities and practices of public institutions as it is by legislation. Therefore, we begin with a discussion of practical constraints, then take up the main relevant bodies of legislation.

The quality of adjudication and judicial enforcement has a major impact on the market for financial services, most notably with respect to the enforcement of financial agreements and the attachment and seizure of assets. Throughout Africa, outside observers lament the existence of political influence in cases involving powerful litigants. Some observers see direct political influence on the courts at work. Others say that political influence is not exercised at the level of the courts, but in other arenas, by powerful defendants seeking to retaliate for having been sued. To the extent such retaliation involves exerting pressure via government, this also represents a weakness in the rule of law, but not a problem *per se* of private litigation.

With respect to litigation itself in Zambia, important difficulties arise from the limited availability of streamlined procedures where there is little or no factual dispute. Methods such as judgement on the pleadings and summary judgement are either not available or not used, with the result that case backlogs have built up and civil cases take 2 to 5 years to resolve. Easy availability of appeals is also said to be a frequent cause of delay. Once judgement is reached, delays in execution, also in part a result of backlogs and staff shortages, can reach one to two months or beyond – not the ideal, but still reasonably good in comparison to similarly situated countries. Agricultural lenders have experienced particular difficulties due to the problems involved in monitoring and repossessing pledged crops, hence their inability to restrain farmers from selling collateralized produce in violation of crop financing or input supply agreements.

The combination of these time lags, the stringent limits set by statute and case law on penal damages imposed upon default (see below), and rates of inflation above 30 percent reduce the expected value of any judgement against a loan defaulter by a substantial amount. The legal discipline imposed by the court system (at least at the higher levels – the Supreme Court, High Court, and Subordinates Court levels) has apparently not created a sufficiently strong deterrent to default. This provides financial institutions with a strong incentive to maintain a highly conservative credit policy, to arrange self-enforcing transactions (e.g. using possessory collateral), and to settle any disputes as quickly as possible.

There are some simpler alternatives available or under development in Zambia, such as small claims courts, arbitration, and, possibly in future, commercial courts. The lowest level subordinate courts operate under simplified rules that have proven useful to microfinance providers seeking enforcement against debtors. These issues are further discussed below.

6.1 The Judgements Act 1961

The Judgements Act (Cap. 81) provides for the payment of interest on judgement debts. The 1997 Judgements (Amendment) Act altered the interest standard from 6 percent to the level determined by the courts, but the latter cannot exceed the current base lending rate fixed by the Bank of Zambia (Act No. 16 of 1997). The passage of this Act in Parliament was tenuous, due to populist concerns about bank profiteering. The limited reform provided by the Act, along with the surrounding anti-creditor political sentiment, means that MFIs face continued uncertainty with respect to their ability to enforce their loan agreements and preserve the value of their assets. This is particularly important because most MFIs charge interest at rates far above those sanctioned by the Judgements Act.

In this connection, it is also important to note that in the case of Union Bank Zambia Limited and Southern Province Cooperative Marketing Union Limited (Supreme Court Judgement No. 7 of 1997), the Supreme Court ruled that even though a banker has a right to charge simple interest at a reasonable rate of interest on overdrafts or loans, unusual interest such as compound interest requires express agreement, or evidence of consent or acquiescence. The court further ruled that penal interest is a penalty objectionable at common law. This is confirmed by The Banking and Financial Services (Cost of Borrowing Regulations) 1995 Statutory Instrument No. 179 of 1995, made under the Banking and Financial Services Act. This Instrument prohibits banks or financial institutions from making any charge or penalty as a result of failure by the borrower to repay in accordance with the loan agreement. This provision does not apply to a loan of less than 250,000 kwacha, which excludes only the smallest of micro loans.

6.2 The Civil Courts (Attachment of Debts) Act 1940

The Civil Courts (Attachment of Debts) Act (Cap. 78) provides for the attachment of debts by a court order for any debts owing to the debtor. The person owing the debtor has to pay forthwith into the court the amount due from him to the judgement debtor. However, the Act prohibits attachment of wages or salaries except for purposes of enforcing affiliation or maintenance orders. This legislation, in principle, provides a mechanism for creditors of microfinance institutions to attach amounts owed under these institutions' micro-loan portfolios. In practice, it is not entirely clear how effective this mechanism can be on its own.

6.3 The Subordinate Courts Act 1934

The Subordinate Courts Act (Cap. 28) provides for the constitution, jurisdiction and procedure of subordinate courts, which are adjudged by magistrates. The jurisdiction of subordinate courts is up to thirty million kwacha, while the maximum for the lowest class of magistrate is ten million kwacha. The Subordinate courts are therefore the relevant jurisdiction within the regular court system for purposes of claims in relation to microfinance, and there are examples of MFIs pursuing repayment from their clients in these courts.

Some microfinance lenders such as Credit Management Services have successfully used the subordinate courts to sue (or threaten suit) for repossession of collateral from defaulting debtors. These courts, which exist in most clusters of villages throughout Zambia, are constituted and staffed by lay judges without legal training, often traditional chiefs. Court personnel and local police are used to repossess collateral. The rules of decision combine traditional law with common sense and broad legal principles learned second-hand. The use of these tribunals alternates with self-help enforcement in which members of a credit group will appear at the home of a defaulter for the purposes of taking possession of collateral and selling it to liquidate the debt. However, where there are important issues of fact in dispute, and where contract documentation and loan amounts reach significant levels, the financial institutions and debtors are more likely to use courts at the district level. Appeal from Local to Subordinates Court level is available to microfinance firms and their clients.

6.4 The Small Claims Courts Act 1992

The Small Claims Courts Act (Cap. 47) provides for the establishment, constitution, jurisdiction, powers and procedure of small claims courts. The jurisdiction of Small Claims Courts is limited to an amount in controversy of 4,000 fee units, equal to 720,000 kwacha. Small claims proceedings are designed to be simple and informal. The courts are not bound by formal rules of evidence, and parties appear in person without legal counsel. The small claims courts are thus a fast track system of justice and are appropriate for the first few rounds of microfinance institutions. If the fee unit value is changed, they could cover all microfinance transactions for some time to come. However, these courts are not yet operational.

6.5 The Arbitration Act 1933

The Arbitration Act (Cap. 40) provides for settlement of disputes by arbitration with the consent of the High Court. The arbitrator or arbitrators may be appointed by a third person who is named in the arbitration agreement, or in some cases by the High Court. Awards are signed and filed in the High Court. This Act dates from 1933, and does not reflect more recent approaches to arbitration, as evidenced by its strong emphasis on court intervention rather than party autonomy. Moreover, the Act is oriented toward large commercial arbitration, as suggested by its vesting of jurisdiction in the High Court. This type of proceeding would not be useful in cases of disputes between MFIs and their clients, whereas simpler arbitration and mediation procedures available for smaller disputes might be appropriate. Where more traditional commercial arbitration might be appropriate, as in disputes between MFIs and investors or wholesale lenders, the outdated provisions of the Act diminish its usefulness.

6.6 The Debtors Act, (Cap. 77) 1938

The Debtors Act (Cap. 77) eliminates most causes of debtor imprisonment, with such exceptions as the use of post-dated checks and civil contempt. Imprisonment does not operate as satisfaction or extinguishment of the debt due, and creditors may pursue execution against the land or goods of the person imprisoned. In other countries, these (albeit limited) possibilities of debtor imprisonment are used for their *in terrorem* effect on secured and judgement debtors, and sometimes do result in long-term imprisonment of defaulters who thereby lose the opportunity to work toward repayment of their debts. It is not clear that this is a significant problem in Zambia, although this issue needs to be borne in mind as markets for secured finance and microfinance develop.

7 Policy Implications for Zambia

What implications arise from the preceding analysis with respect to the development of microfinance-related laws and regulations in Zambia? In this chapter, we discuss the main institutional reforms suggested by our review. We take these up in the following order: immediate legislative changes, development of microfinance-related regulations following the initial legislative amendments, and longer-term reforms. All of the recommendations are summarized in a table appearing in Appendix B.

7.1 Immediate Legal Reforms Recommended

At a minimum, the liberal market structure suggested for microfinance in this paper would require amendment of the Banking and Financial Services Act, 1994; the Cooperative Societies Act, 1998; and the Money Lenders Act, 1938. Amendments to these acts have been put forward by the Chief Parliamentary Draftsperson, Department of Legal Affairs, and are included in Appendix D to this paper. We recommend early action on these draft bills.

Banking and Financial Services: The Banking and Financial Services Act authorizes the Bank of Zambia to set minimum capital levels, and to apply its ten percent risk-weighted capital adequacy rules differentially to institutions of different types and sizes. This provides a basis for developing a more complete scheme of multi-tier regulation that would encompass MFIs of various kinds. Microfinance institutions as such are not regulated or recognized under the Act, and virtually none of them currently fit the Act's criteria for registration as either a bank or a non-bank financial institution. To provide a complete and credible legal basis for developing a microfinance regulatory scheme, the Banking and Financial Services Act must be broadened in scope to provide specifically for treatment of the different categories of microfinance institutions.

Concerning the problem of credit information, the Banking and Financial Services Act provides legal grounds for release of debtor information. Unfortunately current practice, abetted by case law jurisprudence, has created a higher expectation with respect to confidentiality. The result is that credit information disclosure tends to be deterred due to fears of litigation. Amended legislation also needs to address this point.

In light of the above, the main provisions needed in reform legislation in this area are those that:

(a) identify the categories of microfinance institutions requiring regulation and registration;
(b) specify entry conditions for each category of microfinance institution, e.g. minimum capital, portfolio size, self-sufficiency;
(c) provide for the regulation and supervision of specified categories of microfinance institutions;
(d) recognize associations of microfinance institutions and their role in promoting a secure economic environment for the operation of microfinance institutions; and
(e) provide for information sharing on client credit records and liens among microfinance institutions.

These recommendations are contained in the draft Banking and Financial Services (Amendment) Bill, 1999.

Cooperative Societies: The credibility of the microfinance market strongly indicates the need to bring all MFIs under the supervisory purview of the Bank of Zambia. This requires amendment of the Cooperative Societies Act to bring credit unions under Bank of Zambia authority. The draft Bill to amend the Cooperative Societies Act removes the provision in the Act that excludes the application of the Banking and Financial Services Act to credit unions, and substitutes a provision in the Banking and Financial Services Act on microfinance institutions, which applies to credit unions.

Money Lenders: To allow for the viability of microfinance operations, MFIs must be made exempt from application of the interest rate regulations and sanctions in the Act, as has been done for banks, insurance companies and building societies. The draft Money Lenders (Amendment) Bill revises the Act to ensure that it does not apply to MFIs in any form, whether

they are fully regulated, provisionally registered, or simply notifying the authorities of their existence.

Steps Toward Enactment: For the provisions of the draft amendment Acts proposed in this document to become law, the following steps must be taken:

(a) the Bank of Zambia and the Ministry of Finance adopt the provisions in relation to the Banking and Finance Services Act and the Money Lenders Act;
(b) the Ministry of Agriculture Food and Fisheries adopt the amendment to the Cooperative Societies Act;
(c) the Ministry of Finance and the Ministry of Agriculture obtain Cabinet approval in principle for the amendment legislation by preparing and circulating Cabinet Memoranda to all Ministries on the provisions and submitting the memorandum with the comments of the Ministries to Cabinet;[15]
(d) when Cabinet approval in principle has been obtained, the Legislative Drafting Department of the Ministry of Legal Affairs finalizes the draft bills for presentation to Parliament through the Internal Legislation Committee, Cabinet Legislation Committee of Cabinet, and the Cabinet to approve the bills for publication; and
(e) Parliament enacts the bills into law.

7.2 Developing the Regulatory Framework

It should be clear from the preceding discussion that Zambia, with its level of per capita income, financial sector and MFI development, and liquidity, would benefit from a deep multi-tiered structure of banks, non-banks, and MFIs. The legislative reforms recommended in this paper are aimed at providing the legal foundations for such a regulatory model. In Appendix C, we provide guidelines,[16] including an illustrative tier structure, for developing such a regulatory framework, and we put these forward for consideration by Zambian policymakers. Each tier is defined according to the institution's size, scope of financial activities, and level of financial self-sufficiency. The tiers are graduated, in the sense that moving from lower to higher tiers entails broader authority to engage in financial activities, but also stricter standards and supervision. All regulated tiers in this scheme would be subject to either direct Bank of Zambia supervision, delegated supervision (perhaps by an MFI association or accounting firm), or simple notification and reporting. Each regulated MFI in turn would be required to defray some of the overall costs of supervision. The guidelines provided in Appendix C are merely suggested and illustrative; actual regulations applicable to MFIs would need to be further studied and spelled out in detail by the Bank of Zambia.

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[15] At the time of this writing, the Ministry of Finance and Economic Development was in the process of obtaining Cabinet Approval in principle of the draft bill, having circulated a Cabinet Memorandum supporting amendment of the Banking and Financial Services.
[16] This table was developed by the full team, which consisted of the authors, Charles Sichangwa, and Betty Wilkinson, as an illustrative example for use in discussing this option with key stakeholders.

7.3 Longer-Term Reforms Suggested

The recommendations discussed above relate to the laws and regulations that define the financial market and govern financial institutions. Our further recommendations, to be taken up on a longer-term basis, touch on the panoply of other rules that apply to financial transactions and to the operations of financial institutions. This set of recommendations is briefly discussed here, and summarized in the table appearing in Appendix C.

Regulation and Form: A number of issues will need eventually to be dealt with in these areas. There remain some legal uncertainties about the formal independence of the Bank of Zambia, and hence the regulators of financial institutions, that should be resolved. Protections for micro and other low-end borrowers continue to be a concern in practice, although the disclosure provisions contained in implementing regulations to the Banking and Financial Services Act are reasonably strong. The sanctions for failure to comply with these prescriptions are somewhat less clear, and the appeal rights of aggrieved clients do not provide for an independent channel of complaint. With respect to organizational form, Zambia should consider providing the option of simplified incorporation for small companies, which many MFIs are likely to be for the foreseeable future. Other areas of law and regulation, such as investment incentives, tax, labor, and social insurance, also impinge on this market and therefore merit further consideration and possible amendment.

Commercial/Credit Legislation: The Zambian legal and regulatory framework is perhaps at its weakest with respect to the commercial financial laws and mechanisms that can support a vibrant microfinance market with ample investment, wholesale lending, and other resources. Secured finance does function, but within a patchwork system that does not encourage confidence or efficient practice. Furthermore, the combination of weak bankruptcy laws, with the lack of effective NGO "ownership" of institutional assets, makes investment in most MFIs unattractive. Securitization does not appear to be much, if at all, in evidence, even at the highest levels. In addition, credit information is not effectively disseminated, due to a combination of legal obstacles and underdeveloped systems for sharing such information. All of these issues will require attention and intervention in the future.

Debt Enforcement: All other things equal, confidence by potential investors and wholesale lenders in the microfinance market should increase with the proportion of MFI loan portfolios that are secured and (realistically) enforceable at law. This means that addressing the manifold weaknesses of debt enforcement is an important long-term priority. There are several items on this agenda, the first being to reduce the need for judicial intervention *ex ante* through substantive law provisions on such matters as creditor self-help in the context of collateral repossession. The other necessary long-term reforms include streamlining civil court procedure, strengthening debt execution and attachment provisions, and expanding dispute resolution and enforcement options for small debt cases through such means as arbitration and small claims courts.

A perhaps larger and more difficult area to tackle is the improvement of court capacity with respect to civil matters, particularly those concerning commercial and debt transactions. As

part of a broader effort to promote confidence in the microfinance sector and to undergird the value of MFI loan portfolios, some capacity building at the Local and Subordinates Court level may be warranted. One could, for example, set up short courses on finance, contract law, and enforcement at the University of Zambia (UNZA) Law Faculty. Alternatively, guidebooks and training programs could be provided to the courts at district and local levels. Such a program might also include training and materials for MFIs, perhaps on a fee-paying basis, concerning loan documentation and enforcement.

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Appendix A: Laws and Regulations Cited and Reviewed

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Appendix B: Matrix of Suggested Legal Reforms for Microfinance

Legal Field	***Immediate Reforms***	***Longer-Term Reforms***
Banking and Financial Services	Amend *Banking and Financial Services Act* to include MFI regulation; Amend *Money Lenders Act* to exclude MFIs	Amend *Bank of Zambia Act* to guarantee independent supervision of MFIs and other financial institutions; Strengthen monitoring of adherence to disclosure rules protecting low-end borrowers
Organizational Forms and Investments	Amend *Cooperative Societies Act* to exclude credit union regulation	Provide cheap and simple incorporation option for small entities, e.g. by amending *Companies Act*; Amend *Income Tax* and *Investment Acts* to provide appropriate incentives to MFIs
Commercial/Credit Transactions	Include provision allowing for MFI sharing of client credit record information in amendments to *Banking and Financial Services Act*	Amend secured finance laws (*Agricultural Credits, Hire-Purchase,*etc.) to create uniform system and to support MFI lending and wholesale credit; Amend *Bankruptcy* and *Preferential Claims in Bankruptcy Acts* to protect secured creditors, e.g. MFIs and wholesale lenders; Support strengthened lien registries and credit reporting
Debt Enforcement		Expand self-help options and limit court intervention provided in commercial laws; Streamline civil judicial procedure; Amend enforcement rules (e.g. *Judgements Act, Debtors Act*) to improve civil debt enforcement; Strengthen court capacities, especially subordinate level; Expand alternatives, e.g. commercial/debt tribunals, small claims, arbitration—including amendment of *Arbitration Act*

Appendix C: Regulatory Framework for Microfinance—Suggested Guidelines

Building on the legal review, in this appendix we present suggested initial guidelines for building a microfinance regulatory framework in Zambia.[17] These guidelines reflect current theory and practice around the world in tailoring regulatory regimes to support development of the microfinance market. These guidelines have been thoroughly researched and discussed in the Zambian context, with consideration and discussion with Zambian central bankers, financial sector specialists, and MFIs. Numbers are indicative only, and need further research in order to enable determination of the most appropriate levels, particularly those influencing liquidity. They are suggested only as illustrative of the type of regulatory model that appears to be needed in Zambia at the current time. It is important for Zambian policymakers to keep elements such as these in mind, since the objective of the legal reforms recommended in this paper is to make it possible to establish such a supportive regulatory framework for microfinance. In other words, the specification of necessary legal reforms depends in large measure on the type of regulatory model being contemplated.

Definition of Market Tiers:

As suggested in the paper, tailoring the legal and regulatory structure to support microfinance development means creating a multi-tiered structure of financial institutions. Following is a description of a suggested tier structure for the microfinance sector of Zambia's financial market. This information is also summarized in a table appearing at the end of this appendix.

Informals: Informal financing groups with up to 20 members, no growth plan, and no affiliation with apex organisations would be completely exempt from regulation. These include entities such as traditional savings associations (also known as *chilimbas*,) ROSCAs, and savings and/or credit groups internal to a firm or organisation having some other purpose. Such organisations would be recognised, but not required to register, and would be subject to no supervision or guarantees.

Emergent and Expanding MFIs: Of a total of four regulated tiers, the first two would comprise MFIs that have not yet reached *financial self-sufficiency*, defined as able to meet all costs from interest and fees on financial services (loans, savings, and transfers). These two tiers would include group solidarity lenders, village banks, "transformational" lenders (i.e. business-oriented individual credit), and hybrids of these.

Tier 1 would include start-up organisations with growth plans and up to 100 members. These MFIs would be required to obtain provisional registration, under liberal rules, from BoZ. No guarantees regarding quality of assets, information, savings guarantees, or bailouts would be provided in return. Minimum capital would be set at U.S. $250. At this level, one might expect

[17] These recommendations were worked out in partnership with Betty Wilkinson and Charles Sichangwa, and reflect much of their thinking. Any faults in the presentation of these recommendations here are purely the responsibility of the authors.

delegated supervision handled by an MFI association or other body. Donors could also facilitate supervision and find their best candidates for financing in this and second tier organizations.

Tier 2 would comprise MFIs with growing geographic coverage and loan portfolios, and continuing declining operational deficits, but which may be credit-worthy under certain conditions. These organisations would have to obtain full registration as Tier 2 entities for up to 8 years before financial self-sufficiency must have been reached. The BoZ in return might provide limited guarantees for savers who do not have offsetting outstanding loans. Minimum capital at this level would be U.S. $10,000. Supervision would become slightly more stringent, and would be handled directly by BoZ at the top end, as one moves from A to C in the following typology as an example drawn from the specific current sector conditions:

- Type A: operating in one to three districts, membership of up to 500;
- Type B: operating in three to ten districts, membership of up to 3,000;
- Type C: operating in over ten districts, membership over 3,000, or comprising a significant portion of the MFI market, defined as 20 percent or more of the client base.

Financially Self-Sufficient MFIs: This top category of institutions would include those that have reached financial self-sufficiency and have more than 100 members. These groups would be considered credit-worthy for wholesale bank borrowing, and would have to be fully registered for the life of the organisation. *Tier 3* would comprise credit union groups pooled at the district level or higher, in addition to the types of entities found in Tiers 1 and 2. Minimum capital at this level would be fixed at U.S. $100,000. *Apex* institutions that provide financing to MFI membership would comprise the top tier. These organisations (e.g. Micro Bankers Trust) supply wholesale financing to their member agencies, accept savings from members, and provide other support in the form of training, information, and perhaps advocacy. MFI membership organisations that do not provide finance to their members (e.g. the Association of Microfinance Institutions of Zambia or AMIZ) would not come under the regulations. Regulated apexes would be required to maintain a minimum capital of U.S. $500,000.

Prudential Regulation:

The prudential rules applicable to regulated MFIs would be defined in graduated fashion, by tier, up to the Apex level.

First, what credit and savings services should be permitted for each tier?

- Tier 1 institutions would be able to take forced savings, but with the requirement that any member's savings in excess of loans taken by that member be deposited in a commercial bank. At this level, loans would be permitted up to a maximum of 0.75 percent of per capita income (as defined by the Central Statistics Office), with a limit of one loan outstanding per client at any time.
- Tier 2 entities could take any savings from members, but must arrange some form of deposit insurance or other funds security acceptable to BoZ. Maximum loan size at this level increase by the equivalent of per capita income each year, up to a Tier 2

maximum of 8.75 times per capita income. Borrowers would be limited to one loan each.

- Tier 3 MFIs would be permitted to take savings from the general public and to provide money transfer services, subject to BoZ requirements to safeguard the savings, and to the same or greater reserve and liquidity requirements as commercial banks. Maximum loan size would be the lower of: 60 times per capita income or 20 percent of paid-in capital.
- At the Apex level, savings would be permitted, but also would be required be deposited in a commercial bank. Maximum loan size would be 20 percent of paid-in capital.
- In addition to member loans and commercial bank deposits, regulated MFIs would be permitted to invest in government bonds as well. Apex organisations would also be able to extend loans to constituent MFIs.

Other prudential rules relate to capital, liquidity, and loan provisioning. The suggested standards for preliminary discussion are as follows:

- Capital adequacy: The requirements would be 33 percent for Tier 1, 17 percent for Tier 2, and 10 percent for Tier 3 and Apexes.
- Liquidity ratios: Tier 1 and 2 MFIs would be required to hold the equivalent of three months' operating costs plus anticipated loan disbursements in cash. Tier 3 and Apexes would have to meet the same requirements as commercial banks.
- Loan loss provisioning: Tiers 1, 2, and 3 would be required to provision 25 percent for loans 90 days overdue, 75 percent at 180 days, 100 percent at one year, and full write-off at 18 months. Apexes would provision at 100 percent at 90 days, and to write off at 180 days.

Form, Ownership and Governance:

Financial sector laws around the world specify the possible legal forms for banks and other entities. In the MFI arena, this has been a special concern because of the predominance of NGOs to date. The difficulty here is that NGOs have usually not been regulated by central banks, nor have they been perceived as being either able to cover their liabilities when they face setbacks, or as being subject to normal bankruptcy procedures. In Zambia, as elsewhere, any outstanding assets of NGO associations revert to the state upon their winding up.

This presents an obvious difficulty to potential creditors, who would prefer clear corporate lines of responsibility, or a guarantee from a third party. In light of this, we would recommend that any regulated MFI could be a corporation, a cooperative, or an NGO, but that any NGO be required, as a condition of its license, to enter guarantee agreements with two named *responsible entities*. Under such agreements, these responsible entities would guarantee competent management oversight, capital pay-ins in case of shortfalls, and payments of cash to depositors in case of liquidity constraints. In addition, organisations in Tiers 1 to 3 could alternatively be firms (sole proprietorships or partnerships) registered under the Business Names Act, Tier 3 entities may be cooperative credit unions, and Apexes could take the form of a trust.

Two additional governance issues would be covered under the suggested regulatory scheme. First, in all cases, BoZ should approve the owners, board of directors, and the most senior-level staff of a regulated MFI. Second, in no case would MFIs be permitted to extend loans to owners, board members, staff, or their relatives. The sole exception to this would be credit unions, in Tier 3, which are allowed to lend to members under their rules.

Suggested Regulatory Guidelines for Microfinance: Summary Matrix

	MFIs: Not Financially Self-Sufficient	MFIs: Financially Self-Sufficient
Entry, Registration	*General:* Includes village banks, group solidarity and transformational lenders *Tier 1:* Start-ups with growth plans, up to 100 members. Minimum capital: $250. Provisional registration for up to 2 years. *Tier 2:* Expanding MFIs. Minimum capital: $10,000. Full registration for up to 8 years before self-sufficiency.	*General:* More than 100 members, credit-worthy. Full registration for life of entity. *Tier 3:* Same types as 1 and 2, plus credit unions. Minimum capital: $100,000. *Apex:* Supply wholesale finance, savings, training, and support services to MFI members. Minimum capital: $500,000.
Permitted Activities*	*Tier 1:* Forced savings, net savings to be deposited in commercial bank. One loan per client, up to 0.75 times per capita income. *Tier 2:* All member savings, but with insurance acceptable to Bank of Zambia. One loan per client; maximum rises 1 times per capita income per year up to 8.75 times.	*Tier 3:* Savings from general public, and transfers, subject to safeguard requirements agreed by Bank of Zambia. Maximum loan size: lower of 60 times per capita income or 20 percent of paid-in capital. *Apex:* Member savings, deposited in commercial bank. Member loans up to 20 percent of paid-in capital.
Prudential Regulation	*Capital adequacy:* *Tier 1:* 33 percent *Tier 2:* 17 percent *Liquidity ratios:* Hold 3 month's operating costs plus anticipated loan disbursements in cash. *Loan provisioning:* 25 percent for loans 90 days overdue, 75 percent at 180 days, 100 percent at 1 year, write-off at 18 months.	*Capital adequacy:* 10 percent. *Liquidity ratios:* Same as commercial banks. *Loan provisioning:* *Tier 3:* Same as tiers 1 and 2 *Apex:* 100 percent for loans 90 days overdue, write-off at 180 days.
Supervision	*Tier 1:* loose or delegated *Tier 2:* graduated Bank of Zambia supervision: *A (low):* 1-3 districts, up to 500 members *B (intermediate):* 3-10 districts up to 3,000 members *C (high):* over 10 districts, over 3,000 members, or at least 20% of the market	Bank of Zambia
Ownership Form	Corporation, firm registered under Business Names Act, NGO with 2 named responsible entities**	Same as tiers 1 and 2, plus – *Tier 3*: cooperative credit union *Apex:* trust

EXEMPT: Informals, i.e. groups up to 20 members with no growth plan and no Apex affiliation, including ROSCAs, employee credit, "chilimbas".
REGULATORY/SUPERVISORY AUTHORITY: Bank of Zambia, unless delegated to an agent.
GOVERNANCE: Bank of Zambia approves all owners, boards of directors, senior managers. No loans to owners, board members, staff, or relatives (except credit unions lend to members).
*PERMITTED ACTIVITIES: All MFIs can invest in government bonds, cannot take demand deposits.
**RESPONSIBLE ENTITY: capable individual or firm that agrees in writing to guarantee: (I) competent management oversight, (ii) capital pay-ins in case of shortfall, and (iii) payments of cash to depositors in case of illiquidity. Responsibility must be demonstrated on a financial basis.

Appendix D: Draft Legislation for Suggested Immediate Reforms

THE BANKING AND FINANCIAL SERVICES (AMENDMENT) BILL, 1999

MEMORANDUM

The object of this Bills is to amend the Banking and Financial Services Act so as to provide for:

(a) microfinance institutions;

(b) different categories of microfinance institutions and their registration;

(c) the regulation of microfinance institutions" and

(d) matters connected with or incidental to the foregoing.

B C MUTALE
Attomey--General

A BILL
ENTITLED

An Act to amend the Banking and Financial Services Act.

Enactment

ENACTED by the Parliament of Zambia

Short title Cap. 387

1. This Act may be cited as the Banking and Financial Services (Amendment) Act and shall be read as one with the Banking and Financial Services Act, in this Act referred to as the principal Act.

Amendment of section 2

2. Section two of the principal Act is amended by the insertion in the appropriate places of the following new definitions: "microfinance services" means the provision of microloans and collection of micro savings targeted at low income rural and urban households or small entrepreneurs, with frequent repayments; "microfinance institution" means any person or group of individuals providing microfinance services; "microloans or savings" means loans or savings whose amounts do not exceed sixty times the annual per capita income; and savings" means a sum of money paid or to be paid with or without interest at a time and in circumstance agreed by or on behalf of the person making the payment and the person receiving it.

Amendment of Chapter II

Chapter 11 of the principal Act is amended -

(a) by the deletion of the heading "LICENSING OF BANKS AND FINANCIAL INSTITUTIONS" and the substitution here for of the following heading "LICENSING OF BANKS, FINANCIAL INSTITUTIONS AND MICROFINANCE INSTITUTIONS";

(b) in section seventeen-

   i) in subsections (1) and (2) by the insertion of the words "subject to the other provisions of this Act" before the words "A person" respectively;

   ii) in subsection (3) by the deletion of the words "bank or financial institution" and the substitution therefor of the words "bank, financial institution or microfinance institution"; and

(c) by the insertion immediately after section *eighteen* of the following new Part:

PART IVA
REGULATION OF MICROFINANCE INSTITUTIONS

Microfinance Institutions

18A. A microfinance institution may be -

Cap. 119

(a) a society registered under the Societies Act;

Cap. 389

(b) a business registered under the Registration of Business Names Act;

Act No. 20 of 1998

(c) a credit union registered under the Cooperative Societies Act;

Cap. 388

(d) a company registered under the Companies Act; or

Cap. 185

(e) a trust registered under the Lands and Deeds Registry Act.

Licensing of microfinance institutions

18B. (1) A microfinance institution –

(a) whose total annual costs exceed its total annual income derived from interest payments and loan fees;
(b) whose total annual income derived from interest payments and loan fees is greater than or equal to its total costs, including credit unions registered under the Cooperative Societies Act, 1998;

Act No. 20 of 1998

(c) which provides wholesale funds or operational shortfall funds to other microfinance institutions; or
(d) any other category of microfinance institution which the Bank of Zambia may by statutory order specify;

shall apply for a license to the Registrar to conduct its business of providing microfinance services.

(2) Notwithstanding subsection (1), that subsection shall not apply to

(a) a microfinance institution which is formed by groups of twenty persons or less for the purpose of savings and lending amongst the members, which may include a practice commonly known as "chilimba";
(b) a social club that is not a microfinance, institution which makes small loans or keeps small amounts of savings from members to facilitate club operations;
(c) employers who make small loans to employees;
(d) any other person who in the opinion of the Bank of Zambia operates an informal microfinance institution.

(3) Subject to the classification of microfinance institutions under subsection (1) and the rules made under section *eighteen F* , a microfinance institution may-

(a) provide small loans with frequent repayments at interest rates determined by the microfinance institution which may be higher than the rates prevailing at commercial banks;
(b) accept savings and use them in accordance with regulations made under this Part;
(c) borrow money for its purposes against the security of its assets or otherwise;
(d) provide counseling services to its clients;
(e) encourage income generating projects by its clients and render managerial, marketing technical and administrative advice to them; and
(f) do all such acts and things as are incidental to or conducive to the foregoing.

(4) The Bank of Zambia may specify the conditions to be complied with by the different categories of microfinance institutions stipulated by or under subsection (1).

Application of sections 5,6 and 7 to microfinance institutions

18C. The provisions of sections *five, six* and *seven* shall apply with necessary modification to microfinance institutions.

Capital, reserves and liquid assets of microfinance institutions

18D. The Bank shall by *Gazette* notice, determine -

(a) the minimum initial capital required for each category of microfinance institution;
(b) the minimum reserves and liquid assets which the categories of microfinance institution stipulated by or under subsection (1) of section *eighteen B* *will* be required to maintain with the Bank of Zambia.

Association of microfinance institutions

18E. (1) Any two or more microfinance institutions may form an association of microfinance institutions.

(2) The responsibilities of the members of an association of microfinance institutions shall be governed by the rules of the association.

(3) The functions of an association of microfinance institutions may include but shall not be limited to -

(a) promoting microfinance services and advocating policy and best practice concerning microfinance services in Zambia;
(b) coordinating the common approach of the members of the association to compliance with the provisions of this Act and any regulations made thereunder-,
(c) liaising with the Bank of Zambia on operations and conditions relating to the different categories of microfinance institutions; and
(d) any other functions delegated to an association by the Bank of Zambia under subsection (4) of section *three of* the Bank of Zambia Act.

Act No. 43 of 1996

Information sharing on credit rating

18F. (1) Notwithstanding any other law on confidentiality, -

(a) a microfinance institution may share information with one or more microfinance institutions, banks or other financial institutions on borrowers; and
(b) an association of microfinance institutions may constitute a credit rating database for the purpose of sharing information amongst its members on borrowers.

Rules for microfinance institutions

18G. (1) The Bank of Zambia shall, by statutory order, make rules for the better carrying out of the purposes of this Part.

(2) Without prejudice to the generality of subsection (1), rules under this section may, in general or for the different categories of microfinance institutions specified by or under section *eighteen B,* provide for -

(a) the taking of savings from the members and from the public and the use to which the savings may be applied;
(b) the capital or equity requirements of the different categories of microfinance institutions;
(c) the maximum loan or savings account size for the different categories of microfinance institutions;
(d) the intermediation of funds;
(e) the securitisation of microloan
(f) the furnishing of information to the Bank and to the public as required by the Bank;
(g) the pre-requisite qualifications for officers in charge of certain categories of microfinance institutions;
(h) reporting requirements, including the submission of externally audited accounts to the Bank;
(i) the conditions for information sharing on credit rating of borrowers from microfinance institutions and associations of microfinance institutions;

(j) the forms of ownership and governance of the different categories of microfinance institutions;
(k) regulation and supervision of microfinance institutions by the Bank of Zambia or by associations of microfinance institutions as delegated to the associations by the Bank of Zambia;
(l) mergers, acquisitions and reorganisation of microfinance institutions;
(m) the winding up of microfinance institutions,
(n) insolvency and liquidation of microfinance institutions;
(o) the fees payable for licensing of microfinance institutions;
(p) the form of application and license for microfinance institutions; and
(q) any other matter which customarily relates to the supervision of activities of microfinance institutions.

Application of Chapter VIII to microfinance institutions

18H. Chapter VIII shall apply with necessary modification to microfinance institutions stipulated by or under section *eighteen B*.

Amendment of section 19

4. Section *nineteen* of the principal Act is amended by the deletion of the words, "Banks and Financial Institutions" and the substitution therefor of the words, "Banks, Financial Institutions and Microfinance Institutions".

Amendment of section 20

5. Section twenty of the principal Act is amended in subsection (1) by the deletion of the words, "Banks and Financial Institutions" wherever they appear in that subsection and the substitution therefor of the words, "Banks, Financial Institutions and Microfinance Institutions".

Amendment of section 47

6. Section *forty-seven of* the principal Act is amended -

(a) in subsection (1) -

(i) by the deletion *of* "bank or financial institution" and the substitution therefor of "bank, financial institution or microfinance institution";

(ii) in paragraphs (b) and (c) by the deletion of "bank or institution" and the substitution therefor *of* "bank, institution or microfinance institution" wherever the words appear; and

(b) in subsection (2) by the deletion of the words "bank or financial institution" and the substitution therefor of "bank, financial institution or microfinance institution".

THE MONEY LENDERS (AMENDMENT) BILL, 1999

MEMORANDUM

The object of this Bill is to amend the Money Lenders Act so as to -

(a) exempt microfinance institutions from the provisions of the Act; and

(b) provide for matters connected with or incidental to the foregoing,

B C MUTALE
Attorney-General

THE MONEY LENDERS (AMENDMENT) BILL, 1999

MEMORANDUM

The object of this Bill is to amend the Money Lenders Act so as to

(a) exempt Microfinance institutions from the provisions of the Act, and

(b) provide for matters connected with or incidental to the foregoing.

(c) any person carrying on the business of a licensed or registered banking, financial or insurance business or any microfinance institution.

B C MUTALE
Attorney-General

A BILL
ENTITLED

An Act to amend the Cooperative Societies Act.

Enactment

ENACTED by the Parliament of Zambia

Short title

1. This Act may be cited as the Cooperative Societies (Amendment) Act, 1999 and shall be read as one with the

Act No 20 of 1998

Cooperatives Act, 1998 in this Act referred to as the principal Act.

Repeal of section 76

2. The principal Act is amended by the repeal of section seventy-six and the substitution therefor of the following section:

Application of part of the Banking and Financial Services Act Cap. 387 to Credit Unions

76. Part 4A of chapter 11 of the Banking and Financial Services Act shall apply to Credit Unions under this Act.

THE COOPERATIVE SOCIETIES (AMENDMENT) BILL, 1999

MEMORANDUM

The object of this Bill is to amend the Cooperative Societies Act so as to provide for the application of microfinance provisions of the Banking and Financial Services Act to Credit Unions established under the Cooperative Societies Act.

B C MUTALE
Attorney-General