Caleb M Fundanga: Innovative financial products on the Zambian market in relation to credit interest rates and the private sector development

Remarks by Dr Caleb M Fundanga, Governor of the Bank of Zambia, at the Zambia International Trade Fair Symposium on "Innovative financial products on the Zambian market in relation to credit interest rates and the private sector development", Ndola, 30 June 2011.

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1.0 Introduction

Financial development contributes to economic growth in a very significant way and it has been demonstrated that countries with more developed financial systems tend to grow faster. Therefore, the financial sector is key to economic development and policies aimed at developing the sector would be expected to contribute to economic growth.

2.0 The current financial sector policy environment in Zambia

During the 1970s and 1980s Zambia pursued a policy of fixing interest rates for long periods and at relatively low levels, with the ostensible purpose of promoting growth. However, these administrative actions introduced economic distortions into the financial structure of the economy including the following:

- The hindrance to economic growth arising from the inefficiency in the allocation of resources (with credit controls and distorted price indicators). These controls resulted in both low levels of domestically generated savings and investment, thereby reducing the economy's growth rates.
- The financial system remained generally under-developed with inefficient lending patterns that failed to achieve their distributional goals. With interest rates set at low levels, financial repression curtailed domestic resource mobilization thus making the economy dependent on foreign savings as reflected in huge foreign debt at the time.
- Low interest rates provided an incentive for fiscal indiscipline as the government obtained almost zero-interest-denominated resources to finance its deficit. In the state-owned banking sector, poor lending decisions (often politically influenced) and low repayment rates ultimately led to large budgetary bailouts.
- In the face of high inflation rates and fixed nominal interest rate, real interest rates remained negative for the larger part of the period, leading to low domestic savings and other forms of capital flight.

A growing awareness of these economic costs led to financial "liberalization" as the dominant policy paradigm. Zambia embraced financial-sector liberalization policy prescription and embarked on a fairly ambitious reform program. This program entailed a variety of measures including the liberalization of interest rates; the establishing of the freedom and the procedures for entry into and orderly exit from the financial sector; the reduction of commercial banks' reserves and liquidity requirements; the elimination of credit allocation directives; the elimination of preferential credit at concessional interest rates; the liberalization of the exchange rate; and the removal of controls on the current and capital accounts of the balance of payments.

Due to liberalisation, the banking environment in Zambia has become competitive as banks compete for the share of the customer deposits and good quality credit. Prior to 2005, the banking industry's balance sheet was largely concentrated in Government Securities. This was because Government Securities offered highly attractive yield rates (with zero credit risk) compared to other asset classes. Recently Government has maintained prudent fiscal policies and has reduced its borrowing to 1.8% of GDP leading to a significant fall in Government Securities yield rates.

The reduction in yields rates on government securities has made it increasingly difficult for banks to sustain their profitability. Therefore, in order to remain profitable, banks have had to become innovative and resorted to riskier banking activities. This resulted in a shift in the asset structures of most banks from government securities holdings to an expanding loan portfolio, which offers higher returns.

3.0 The role of financial innovation in promoting the private sector

Innovation can generally be defined as a continuous process where enterprises and individuals seek new and improved products, processes, and organisation structures in order to reduce costs of production, better satisfy customer demands, and yield greater profits for themselves.

When specifically referred to banks and other financial institutions, innovation, commonly is known as ***financial innovation***, refers to any change in the scale, scope and delivery of financial services. Financial innovations can therefore be grouped as *new products* (e.g. adjustable rate mortgages; personal loans); *new services* (e.g., internet banking); and *new production processes* (e.g., electronic record-keeping for securities; credit scoring); or *new organisational forms* (e.g., Internet-only banks).

Whereas the need for better risk management has been the main driving force behind the recent wave in innovation in more advanced financial markets, this is not the case in less developed markets. The drive towards financial innovation in some instances can largely be attributed to the need to improve or maintain profitability.

When talking about financial innovation, an important aspect that one needs to consider is whether or not the process is resulting in a reduction in the cost of doing business and providing banking services, on one hand, and whether it is translating into better pricing, on the other hand. We should therefore, not be surprised that innovation does not always yield the expected benefit of reduced prices.

Innovation is clearly an important phenomenon of any sector of a modern economy. Successful financial innovation must reduce costs and result in the provision of improved services and affordable financial resources to users, particularly to the productive sector. A low level of innovation and development in the financial sector produces a weak impact of financial intermediation on economic growth.

The right kind of innovation obviously would help the financial sector fulfill its core functions; and if the financial sector fulfilled its functions better and at lower cost, it would almost surely contribute to growth and societal well-being. It is essential to realise that for the most part, the financial system is not an end in itself but a means to an end and the measure of the success of the financial system must relate to its success in accomplishing broader societal functions. Innovations in the financial system that help it perform these tasks better and at lower cost almost surely lead to increased societal well-being, and to the extent that our GDP measures capture these benefits, in higher measured growth.

Notwithstanding the benefits of innovation, it is important to note that the opening up to new activities and products, particularly the expansion of the credit portfolio, brings in a myriad of new risks associated with the new activities. Studies have shown that increasing financial innovation and deepening of financial markets brings with it challenges and risks, which if not well addressed, can threaten the health of the financial system and may cause havoc to the stability of a financial system.

4.0 The role of the Bank of Zambia in promoting innovation and competition

The Bank of Zambia (BoZ) acknowledges that a stable, sound and efficient financial sector has to be underpinned by infrastructure development. The BoZ achieves this by creating an enabling environment through the legal and regulatory frameworks that promote financial systems stability and development. The BoZ also regulates the conduct of the banks to ensure that players in the sector have a level play-field in order to safeguard the interests of both investors and customers of the banks.

It is against this background that one of the key functions of the Bank of Zambia is to regulate the activities of banks and financial institutions so as to promote safe, sound and efficient operations of financial institutions and the development of the financial system.

- In 2004 the BoZ and the Government in consultation with other stakeholders, formulated the Financial Sector Development Plan (FSDP), which is a long term vision and development strategy aimed at addressing major constraints to the development of the financial sector.
- Among the constraints that the FSDP seeks to address is high cost of banking services and unattractive interest rates, low savings, insufficient access to financial services by the vast majority especially in rural areas, insufficient access to credit, lack of long term credit, etc. The vision of the FSDP is to develop a stable, sound and market-based financial system which would support efficient mobilisation and allocation of resources necessary for economic diversification, sustainable growth and poverty reduction.
- The FSDP, which is currently in its second phase of implementation, has three components, namely:
  - Increasing Market infrastructure;
  - Increasing Competition; and
  - Access to Finance.

Over the years, the number of financial institutions under the supervisory ambit of the BoZ has increased significantly. In 2008, the Bank of Zambia issued banking licences to 5 new banks to operate in Zambia. As at 31 May 2011, Institutions under Bank of Zambia supervision as at 31 May 2011 were:

- 18 commercial banks,
- 10 leasing finance companies,
- 3 building societies,
- 51 bureaux de change,
- 1 savings and credit bank,
- 1 development finance institution,
- 26 microfinance institutions (MFIs) and
- 1 credit reference bureau (CRB).

The sector has also recorded tremendous growth in business with growth witnessed in various innovative activities carried out by the banks in order to meet the needs of increasing number of customers. Some of the innovations include:

- An increase in automated teller machines (ATMs) including deposit taking ATMs;
- E-banking;
- Telephone banking services;

- In-store banking services – banks can provide some banking services within the premises of stores;
- Mobile top-up services – banks can sell airtime on behalf of mobile phone providers through ATMs;
- Truck-banking services – the model entails engagement of agents for provision of cash-in/cash-out transactions for clients where banks have no footprint;
- Bancassurance – banks can sell insurance products on behalf of insurance companies; and
- Introduction of Visa debit and credit cards.

These innovations have resulted in notable developments in the financial sector, such as:

(i) ***Growth in Investments in Loans and Leases:*** total loans and leases have increased to K10,182 billion as at 31st May 2011 from K1,079 billion as at 31st December 2001. The 843% increment has resulted in the introduction of various credit facilities, for example employer backed salaried loans, trade finance products, vehicle finance leasing, SME loans, invoice discounting, mortgages, etc;

(ii) ***Growth in Bank's Total Assets:*** total assets have increased by 614% to K24,693 billion as at 31st May 2011 from K3,460 billion as at 31st December 2001.

(iii) ***Growth in Deposits:*** total deposits have increased by 661% to K18,297 billion as at 31st May 2011 from K2,405 billion as at 31st December 2001.

(iv) ***Growth in Branch Network:*** currently there are 237 branches and agencies countrywide. Ten years ago, there were a total of 161 outlets.

(v) ***Continuous Improvement of Risk Management Systems*** resulting in the creation and update of the range and quality of the products and services; for example hedging products, derivatives, credit risk rating systems, interest rate risk management.

(vi) ***Introduction of the Credit Reference Bureau*** is expected to provide key information to lenders on borrower's credit history.

(vii) ***Access to credit*** has been further enhanced through the Country's membership in international multilateral financial institutions such as the African Development Bank, the African Export-Import Bank, PTA Bank and the International Finance Corporation (IFC). Access to other institutions like the European Investment Bank is also possible.

(viii) ***Development of the capital markets*** has also made it possible for corporates to raise long term finance. Stock markets enable firms to acquire much needed capital at relatively lower cost, hence facilitating capital allocation, investment and growth.

(ix) ***Other innovative financial products*** introduced on the international capital markets include diaspora bonds and carbon credit financial instruments. There is need for Zambian businesses to take advantage and understand these financial products in order to access funding from multilateral institutions.

5.0 Competition in the Zambian financial sector

The BoZ recognises that competition is an essential element in the effective and efficient operation of a market economy. In this regard, the licensing regime encourages entry of players that will foster integrity, innovation and competition while deepening and widening the financial sector.

The presence of reputable financial intermediaries is expected to increase competition, which in turn would lead to an improvement in the quality of domestic financial services and allocative efficiency, reflected by lower operating costs and narrower margins. The increased efficiency of financial intermediation would eventually be translated into higher returns for domestic savings and greater efficiency in the pricing of credit and other risks and in the allocation of credit.

However, despite the growth in number of financial institutions in Zambia, this development has not had a very significant impact on promoting competition, as most of the banks are small in terms of size. A few banks continue to enjoy an oligopolistic position and this in a way explains why some inefficiency remains in the provision of services.

The banking sector has remained fragmented, with insufficient and distorted competition, thereby rendering it rigid in its activities. Competition is not strong enough to lead to a convergence of prices, which would ensure that banks have more or less the same prices for their services and products, affordable to most people. This could also partially explain why finance service providers are not revising their interest rates and charges in tandem with the movements in key macroeconomic indicators such as inflation.

Whereas the Bank of Zambia is conscious to the fact that the financial institutions are in business and are therefore expected to make profits, there is a need to make financial services more affordable in order to provide an impetus to promote economic growth and reduce poverty levels in the country. Low interest rates reduce the cost of doing business and encourage investments in key sectors of the economy.

6.0 Legislative provisions on interest rates and the cost of borrowing

The Banking and Financial Services Act (BFSA) does not have any provision for the regulation of interest rates that financial service providers can charge. This is in line with the principles of liberalisation and a market driven economy.

However, in accordance with the Banking and Financial Services (Cost of Borrowing) Regulations of 1995, all credit providers are mandated to disclose their costs of borrowing in full before issuing a loan. Credit providers are required to disclose the annual interest rate charged on a loan.

Although, interest rates on loans and charges on services and products may vary significantly from one institution to another, it is incumbent upon all financial services providers to provide clear information and full disclosure on the costs and options available. It is also important for institutions to sensitise customers on what products may best suit their incomes and to educate them to borrow prudently. In this way, transparency is enhanced and consumers would have a clear picture of precisely how much they need to borrow relative to their income levels. This would result in responsible lending and a more competitive and transparent financial industry.

However, financial education needs in Zambia are many and varied. They stem from inadequate understanding, by a good proportion of the population, of basic financial terms and concepts on the one hand, and a lack of knowledge of financial products and services that are increasingly available, on the other. To this end the Bank of Zambia through the FSDP in collaboration with stakeholders has developed a national financial education strategy for Zambia. The proposed national strategy for Zambia clearly identifies all the possible financial education delivery channels and responsible institutions in order to avoid duplication and waste of efforts during the implementation stage of the strategy.

7.0 Measures to reduce interest rates

Although interest rates have trended downwards in the recent past with commercial banks average lending rate at 26.2% in March 2011 from 54.5% in 2001, the reduction is not in tandem with the fall in inflation and yield rates on government securities. The Government and the Bank of Zambia continue to take measures to provide macroeconomic stability necessary for the reduction of interest rates in Zambia. Some of the measures undertaken so far include the following:

(i) ***Inflation:*** the other challenge with regard to lowering lending rates is to attain and sustain low (preferably single digit) annual inflation. An upward trend in inflation is undesirable, as it raises inflationary expectations causing banks to increase their lending rates. Prior to 2006 inflation in Zambia was persistently high and above single digit. However, from 2006 inflation has been contained in single digit except from the 2008 when the financial crisis resulted in the increase of inflation to 16.6%. Inflation was recorded at 7.9% in December 2010 from 30.1% in January 2001. This has resulted in a fall in interest rates with banks Average Lending Rate coming down to 26.2% in March 2011 from 54.5% in December 2001.

(ii) ***Domestic financing:*** to contribute to efforts aimed at lowering lending interest rates, the Government has adopted prudent fiscal policies with domestic borrowing significantly reducing over the recent years. The reduction of borrowing by the Government reduces the crowding out effect and more resources are available to lend to the private sector. This has also contributed to the lowering of yield rates on Government securities which is the opportunity cost for loanable funds. The composite yield rate for Treasury bills was 8.2% at end-December 2010, down from 49.1% recorded at the end of 2001. The fall in yield rates on government securities reflected reduced inflationary expectations and improved fiscal management.

(iii) ***Reduction of Statutory Reserve Ratios:*** banks argue that statutory reserve ratio is a critical in determining interest rates as a high ratio tend to raise the operating cost for banks by locking up loanable funds in a non-interest earning asset. The opportunity cost of these funds is therefore included in the cost of conducting banking business. On 1st October 2007, Bank of Zambia reduced the statutory reserve ratios on both Kwacha and foreign currency deposits from 14.0% to 8.0%. This followed the earlier reduction in October 2003 from 17.5%. The reduction in statutory reserve ratios entails a release of more liquidity into the financial system which is expected to provide more loanable funds to banks and contribute to lowering interest rates.

(iv) ***Establishment of Credit Reference Bureau:*** the first and only credit reference bureau (CRB) in Zambia, Credit Reference Bureau Africa Limited (CRBAL) was licensed in 2006 and commenced operations in 2008. The CRB is expected to enhance positive credit behaviour by providing lenders with information on borrowers' payment histories. The CRB provides an essential service that aids lenders to be able to evaluate and price loans better. Good borrowers with a perceived low risk premium should have access relatively cheaper credit while bad borrowers can be denied credit thus reducing default rates and ultimately the price of credit.

(v) ***Sovereign Credit Rating:*** Fitch Rating and Standard and Poors both assigned the country with a B+ Sovereign Credit Rating. The rating is expected to provide an opportunity for both the Government and the private sector to access cheaper funds on the international financial markets.

8.0 Conclusion

The Bank of Zambia acknowledges that there has been remarkable development in the financial sector over the past years, as evidenced by the various new products and innovations. However, despite the growth in products and services being offered, customers are still faced with high costs of borrowing. The challenge for the financial sector therefore is to improve on their operations by engaging in innovative activities that will reduce their cost of operations and pass on the efficiencies to borrowers.

From the foregoing, it is clear that the challenges of reduction of interest rates to levels that would facilitate economic development through an efficient savings mobilisation and credit allocation system are numerous. However, they are not insurmountable. The solutions are in the hands of all stakeholders in the financial sector.

The Government and the Bank of Zambia have implemented initiatives aimed at lowering the cost of borrowing, specifically, inflation has been reduced, yield rates on Government securities are low due to reduced rate of Government borrowing and falling inflation rates, statutory reserve ratios have been reduced to low levels and a credit reference bureau is in place to deal with perceived high default risks. International access to funding has also been improved.

The Bank of Zambia continues to engage commercial banks to come up with measures that will lower the cost of credit. Whereas blue chip corporate customers are getting favourable rates, usually below lending base rates, other categories of borrowers still face high lending rates. Accordingly commercial banks prudential returns are being revised to show different rates to various categories of borrowers.

Support to the productive sectors by the financial system is critical to spur the economy to further growth and development. In this regard, banks are challenged to continue playing their part by reducing lending rates to affordable levels.