MICROFINANCE IN ZAMBIA: TOWARDS A SOUND AND SUPPORTIVE REGULATORY AND SUPERVISORY FRAMEWORK.

By

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I recommend that the obligatory essay prepared under my supervision by Martha Mwenya Mukupa, entitled:

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be accepted for examination. I have checked it carefully and I am satisfied that it fulfills the requirements pertaining to format as laid down in the regulations governing obligatory essays.

Mumba Malita  
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29/12/03  
Date
Dedication

To my loving Mum, Felicita. Mum, thanks for all the love and sacrifice, and for always being there when I need you most. I thank God for giving me the best Mother I could ever have; and may He continue to shelter you in his love and mercies.

To my precious son, Marcus. You are the greatest gift that God has given me. I Love you so so much.....May the good Lord Guide and keep you and may he indeed cause his face to shine upon you all the days of your life.

...and we know that all things work together for good to them that love God and according to his will......

Romans 8:28
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"...in all things give thanks..."

The Lord is my Shepard; I shall not want...I would like to thank God Almighty my creator, who has provided for me all the days of my life: Lord, your mercies and faithfulness have seen me through and through, indeed. With you Oh Lord, I have completed that which I thought was impossible accomplish. I give you all the Glory, forever.

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Abstract

It is trite to say that microfinance is an important tool in the programs of poverty eradication. Microfinance means financial services for the poor and the very poor; diverse poor people enjoying permanent access to a wide range of financial services, delivered through a variety of convenient mechanisms by different types of institutions. These financial services include savings, loans, credit, payment service and insurance.

Until recently, microfinance has largely developed outside the realm of formal financial sector on a separate trade that seldom interacts with established financial actors. However, it became increasingly apparent that large-scale sustained microfinance could be achieved only if financial services for the poor are integrated into the overall financial system.

This means that, inter alia, governmental policies that promote financial sector deepening and expansion. Depending on their approach, governments can either undermine or encourage the development of microfinance. Special attention should be paid to building the capacity of bank regulators to evaluate, monitor, and supervise microfinance institutions in a way that ensures the overall soundness of the sector without stifling its growth.

This essay is based on the view that through the formulation of sound and supportive supervisory and regulatory framework, government policy makers concretely contribute to the establishment of appropriate enabling environment that would positively affect the development of microfinance institutions in Zambia. Thus bringing about national development through empowerment of the poor with various financial services.
The methodology for the paper will be essentially by secondary data sources such as necessary legislation, books, and other published and unpublished works on the topic. In addition, advanced opinions from experts in this field will be sought by way of interviews.
Chapter One

Introduction

Over a billion people lack access to essential financial services, especially the very poor, thus the challenge of providing financial services to them remains. The poor rarely access services through the formal sector. They address their need for financial services through a variety of financial relationships, mostly informal. Credit is available from commercial and non-commercial moneymakers but usually at a very high cost to borrowers. Savings services are available through a variety of informal relationships like savings clubs, rotating savings and credit associations, and mutual insurance societies that have a tendency to be erratic and insecure. Successful microfinance Non-Governmental Organizations have proved that financial services can be an effective and powerful instrument for poverty reduction by enhancing the ability of poor people to increase incomes, build assets, and reduce their vulnerability in times of economic stress. These institutions are motivated to provide sustainable financial services to the poor not only because it makes economic sense, but also with the objective of poverty alleviation and job creation. Thus, there is greater consensus than ever before about what is needed to make microfinance sustainable. Yet with most poor people still lacking access to basic financial services, microfinance has yet to reach its full potential.

Over the next decade, microfinance will either realize its vast potential for improving the lives of large numbers of the poor, or it shall remain an unfulfilled promise. Much largely depends on the extent to which the international development and financial communities

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can partner with social entrepreneurs and governments in developing countries to improve financial systems for the poor that are far broader than those that currently exist. This calls for National Policy makers understanding that financial systems can and should work for all levels of society, especially for the poor who constitute the overwhelming majority of their populations. This vision requires that we remove the walls that separate the microfinance community from the much broader world of financial systems, markets and development. It requires that we refuse to accept a status quo in which it is considered normal for a country’s financial systems to serve only a tiny minority of its population, while the vast majority remains outside the system. Further that we must recognize the vast differences between the poor people and understanding that very different organizations with the varied but complimentary objectives will be needed to serve them all. In this regard, several successful institutions have proved that even the poor can be reached sustainably.

At this point, it is important to address the basic questions of ‘what is microfinance?’, why it is important in poverty alleviation and thus contributing to national development.

**What is MicroFinance?**

Microfinance simply means financial services for the poor and the very poor⁵; diverse poor people enjoying permanent access to a wide range of financial services, delivered through a variety of convenient mechanisms by different types of institutions, through

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² Consultative Group to Assist the Poorest (CGAP) Phase III Strategy, 2003-2008,p5
microfinance therefore, the concept of financial services to the poor will no longer be
dominated by micro credit, as credit alone is clearly not enough, but recognizes the
importance of such other services as savings, payment services and insurance⁴. Providers
will include NGO microfinance institutions, consumer credit companies, insurance
companies and other financial institutions.

Sustainability is a cornerstone of sound microfinance. This term refers to the ability of a
microfinance Institutions (MFI), but also savings and credit cooperatives, commercial
banks, community finance institutions, consumer credit companies, insurance companies
and other financial institutions.

Sustainability is a cornerstone of sound microfinance. This tem refers to the ability of an
MFI to cover all of its costs through interest and other income paid by its clients⁵.
Financially sustainable MFIs can become a permanent part of the financial system: they
can continue to operate even after grants or soft loans are no longer available. When an
MFI becomes sustainable, it is no longer limited to donor funding, but it can draw on
commercial funding sources to finance massive expansion of its outreach to poor people.
Experience proves that microfinance can be sustainable, even with every poor client.

⁴ CGAP position paper: Regulation and Supervision of Microfinance,2002,p1
⁵ Ibid. Insurance is an important financial service that is often available to the lower income clients and can therefore also be considered to be a component of microfinance.
⁶ The www.cgap.org as updated April, 2002
The Role of Microfinance in Poverty Alleviation/Reduction.

Microfinance is about diverse institutions providing massive permanent access to a broad range of financial services for a broad range of clients. At the core of microfinance is a fundamental belief that access to financial services protects and empowers the poor by mitigating them from risks and giving them choices. Financial services help the poor cope with a common feature of their lives; vulnerability. When poor people have access to financial services, they usually choose to invest their savings or loans in a wide range of assets. These assets can be sending children to school, buying better medicines and more nutritious food, as well as meeting social and cultural obligations like paying for funerals and so on.

The Relationship between Microfinance and the Millennium Development Goals

In September 2000, the member states if the United Nations unanimously adopted the Millennium Development Goals (MDGs). The MDGs commit the international community to a common vision of development, one in which human development and poverty reductions have the highest priority. The objective of the MDGs is to serve as guideposts and focus the efforts of the world’s community on achieving significant,
measurable improvements in poor people’s lives. The goals grew out of the agreements and resolutions of various development conferences organized by the UN in the 1990s.

**Eradicate Extreme Poverty and Hunger**

The poor have physical assets food, clothing housing-and financial assets, such as income or savings, with which to acquire basic necessities. Access to financial services enables the poor to increase income and smooth consumption flows, and thus expand their asset base and reduce their vulnerability. Empirical evidence shows that, among the poor, those participating in microfinance programs who had access to financial services were able to improve their well-being both at the individual level and household level much more than those who did not have access to financial services. For instance

- In Bangladesh, Bangladesh Rural Advancement Committee (BRAC) clients increased household expenditures by 28% and assets by 112%. The incomes of Grameen members were 43% higher than incomes in non-program villages.

- Also in Ghana, 80% of clients of Freedom from Hunger had secondary income sources, compared to 50% for non-clients.

**Achieve Universal Primary Education**

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7 K. Shahidur, Microfinance and poverty: Evidence using panel Data from Bangladesh, 2003
Increased earning and savings provide poor people with some cushion from the day-to-say struggle of earning a living. This opens up the possibility on investing in their children’s future, and in education in particular. Empirical evidence indicates that, in poor households with access to financial services, children are not only sent to school in larger numbers. But they also stay in school longer. Even where children help out in family enterprises, the poverty-induced imperative of child labour decreases, and school dropout rates are much lower in client households than in non-client households. Studies on the impact of microfinance on children’s schooling show that⁸:

- In Bangladesh, almost all girls in Grameen client households had some schooling, compared to 60% of girls in non-client households. The schooling rate for boys was significantly higher-81% of boys in client households received some schooling, compared to 54% in non-client households. Basic competency in reading, writing, and arithmetic among children 11-14 years old in BRAC member households increased from 12% in 1992 to 24% in 1995, compared to only 14% for children in non-member households.

**Promote Gender Equality and Empower Women**

Overall, the experience of microfinance programs points to strong evidence that the access to financial services and the resultant transfer of financial resources to poor

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⁸ Ibid
women, over time, lead to women becoming more confident, more assertive, and better able to confront systematic gender inequalities. Access to finance enables poor women to become economic agents of change by increasing their income and productivity, access to markets and information, and decision-making power. Existing studies show that this empowerment is very real and can take different forms:

- In Indonesia, female clients of Bank Rakyat Indonesia (BRI) were more likely than non-clients to make joint decisions with their husbands concerning allocation of household money, children’s education, use of contraceptives, family size, and participation in community events.
- And in Bangladesh, a survey of 1,300 clients and non-clients showed that credit clients were significantly more empowered than non-clients in terms of their physical mobility, ownership and control of productive assets (including land), involvement in decision-making, and awareness of legal and political issues.

**Combat HIV/AIDS, Malaria, and Other Diseases**

Other than hunger, illness is generally the most important risk that poor people periodically face. Deaths due to illness, time taken off from work because of an illness, and health care-related expenses erode incomes and savings, often force the poor to sell assets and go into debt. Increases earnings and savings allow clients to seek out and pay

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for health care services when needed, rather than wait for conditions to deteriorate. In
addition, many microfinance institutions actively promote health education. This may
take the form of a few simple, preventative health care messages on immunization that
directly improve client’s living conditions. A few programs have also taken initiative to
promote health insurance for their clients.

- In Uganda, 32% of clients of the FOCCAS microfinance program had
  tried an AIDS prevention practice, twice the percentage for non-clients.
- In Bangladesh, a study of BRAC clients found that fewer members
  suffered from severe malnutrition than non-clients and that the extent of
  severe malnutrition declined the longer clients stayed with the BRAC.

Reduce Child Immortality and Improve Maternal Health

- In Bangladesh, Grameen clients showed a higher rate of contraceptive use
  (59%) than non-clients (43%). This is attributed to client’s increased
  awareness of contraceptive programs (gained from attending group
  meetings) and from increased mobility, which allowed women to seek out
  such services.
- In Ghana, Freedom from Hunger clients also demonstrated better breast-
  feeding practices, and their one-year old children were healthier in terms
  of weight-for-age and height-for-age, compared to children of non-clients.
- In Uganda, 95% of clients of the FOCCAS microfinance program had engaged in some practices for improved health and nutrition of their children compared to 72% of non-clients.

**Ensure Environmental Sustainability**

There has been very little study of the extent of the impact of financial services for the poor on safe drinking water, sanitation, or other forms of environmental sustainability. However, there is evidence that with increased earnings, the poor do invest in improved housing, water, and sanitation. Many microfinance programs provide specific loans for tube wells and for toilets. Other programs, such as SEWA in India, have creatively linked microfinance to slum improvement projects. Such projects help build community infrastructure (tap water, toilets, drainage, and paved roads) that are paid for by community residents through loans from microfinance institutions.

**Develop a Global Partnership for Development**

The last goal provides the means to achieve the other goals. Access to financial services enables the poor to fight the various dimensions of poverty and make improvements to their lives. Whether they save or borrow, evidence shows that when people have access to financial services, they choose to invest their loans, additional earnings, or savings in a wide range of activities and assets that benefit not only themselves but also their households. Thus access to financial services provides the poor with the means to make improvements in their lives- in other words, to achieve most of the MDGs-on their own terms, in a sustainable way. Access to credit, savings, or other financial services is only
one of a series of strategies needed to reduce poverty and achieve the MDGs. Financial services need to be complemented by access to education, health care, housing, transportation, markets, and information.

From the above, we see that financial services are put into the hands of the poor to pursue their own strategies for building human, physical, economic and social capital to escape poverty. Microfinance is an important foundation for poverty alleviation and the wider development agenda. It supports other development efforts and can make a significant difference in the way poor people address those development problems on their own terms.

**Current Actors in the Microfinance System**

Microfinance has largely developed outside the realm of the financial sector on a separate track that seldom interacts with established financial actors. However, it is becoming increasingly apparent that large-scale sustainable microfinance can be achieved only if financial services for the poor are integrated into the overall financial system. This means that microfinance of financial services for the poor becomes the lower end of the entire financial sector, opening up access and markets to increasingly poor and geographically remote clients.

The microfinance industry has grown to encompass many types of actors with different objectives, roles, and comparative advantages. Clearly, no single organization has the
means or the capacity to achieve the expanded vision of microfinance on its own. Developing financial systems that work for the poor requires improved dialogue, coordinations, and partnership among these different actors, as well as building better linkages with other development sectors, these are the following:

**A. Providers of Financial Services to the Poor.**

General Microfinance suppliers can be divided into three broad categories:

i) traditional and informal providers, such as money lenders, p shops, and rotating savings and credit associations.

ii) Formal intellectual institutions such as microfinance NGOs, and

iii) Licensed financial intermediaries, including commercial and owned banks, credit unions, community finance institutions, consumer credit companies, and finance companies.

**B. Networks**

Intermediary organizations have, and will continue to play a crucial role in microfinance. Such organizations include national associations of MFIs. Regional or global networks of MFIs or credit unions, and even some investments funds that provide governance and technical assistance to MFIs.

**C. Donors**
Virtually all donors, including private, local, bilateral, and multilateral donors, as well as local and international NGOs, support microfinance activities in some way:

Through grants, subsidized loans, guarantees, or technical assistance. The approach of donors and the requirements they set for MFIs to access their funds can significantly affect the development of the sector. However, there is widespread recognition that in order to reach scale, microfinance needs to move from dependence on donor funding to reliance on more abundant commercial funding and domestic savings.

D. Governments

Governments play a very crucial role in the development of microfinance as facilitators of financial services for the poor. Depending on their approach governments can either undermine or encourage the development of microfinance. In general, the government’s role in microfinance should be to maintain or create an enabling environment that permits the growth of financial services for the poor and the integration of the poor in the broader economy. Governments can do this by addressing broad legal and regulatory constraints, such as cumbersome business registration procedures, corruption, or inflexible property rights laws, which while not specific to the poor, may place undue burden on them.

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10 Ibid, p8
E. Technical Service Providers

As microfinance has evolved, a private industry of service providers to support MFIs has come into being. This service encompasses technical advisors, audit firms, credit bureaus, rating agencies, trainers or training institutes, technology and information systems specialists. The lack of local capacity to provide these services has resulted in over reliance on international expertise and thus high cost of these services.

F. The Consultative Group to Assist the Poorest (CGAP)

Compelled by the enormous potential of microfinance to evolve into a fully-fledged financial industry serving the poor, nine leading donors and practitioners formed CGAP in 1995 to develop and share best practices, set standards, and develop tools and models. CGAP operates in partnership with many actors in varied landscape through its operating arm, the CGAP secretariat has since grown to members, including bilateral and multilateral agencies, as well as private foundations.

Although microfinance in Zambia is still in its infancy stage, various key actors can be identified, firstly, the MFIs who the providers of financial services to the poor. MFIs in Zambia have developed an umbrella body called the Association for Microfinance Institutions in Zambia (AMIZ). AMIZ acts as a representative body for MFIs and its role is to provide technical assistance through its collaboration with CGAP and other international organizations associated with microfinance. Secondly, the role of the Government cannot be over emphasized. As the key policy makers, the government plays
a complex role in the development of the industry by putting in place a supportive regulatory and supervisory framework. The Bank of Zambia is the authoritative body that has been charged with the task of developing regulations and supervising the sector. Thirdly, the donors have also have their role to play, for instance the USAID. Its role has been that of financial assistance and also technical support. The European union also played a significant role by funding a study to examine the establishment of MFIs in Zambia.

MICROFINANCE IN ZAMBIA

Zambia is a third world country. Statistics reveal that over 80% of the population wallow in extreme poverty. This involves a condition of life so limited by malnutrition, illiteracy, disease, high infant mortality and low life expectancy. With most of its people living in rural areas, Zambia is faced with the challenge of creating wealth by empowering those people living in the rural areas. One of the most important aspects of poverty alleviation in rural areas is the introduction of diverse sources of income for the poor. As has been seen above, Micro-finance is one way in which a nation, and a country like Zambia can create wealth by affording the poor access to business financing.

Thus, in light with the aforesaid, in 1994 a nation wide study was carried out on the feasibility of establishing a safety net for a savings and credit facility for vulnerable people in Zambia under the auspices of the Republic of Zambia, through the Ministry of Community Development and Social Services (MCDSS)\textsuperscript{11}. This essentially resulted in the establishment of MFIs, created out of need to provide financial services for such

\textsuperscript{11} MCDSS is the focal point for Government’s community and social development interventions in Zambia
people in Zambia. Especially those who would have no access to formal financial institutions to borrow for enterprise development activities.

The Banking and Financial Services (Amendment) Act number 18 of 2000 effectively brings the supervision of MFIs under the ambit of the Bank of Zambia. The Bank of Zambia by virtue of the Banking and Financial Services (Microfinance) regulations, 2003, is the regulatory authority for MFIs in Zambia\textsuperscript{12}. The regulations are proposed to be issued under section 124 of the Banking and Financial Services Act (BFSA)\textsuperscript{13}, which empowers the Minister of Finance and National Planning to make regulations for the better performance of the Act. The regulations are designed to provide the necessary legal framework for the operation and development of the microfinance industry Zambia. Currently, there are approximately 98 known MFIs in the country of which 45 are affiliated to the Association of MFIs of Zambia (AMIZ) and only three that are registered under the Banking and Financial Services Act\textsuperscript{14}. This indicates that most of the MFIs in Zambia are operating in an unregulated market. Further, the lack of transparency within this market has isolated MFIs from mainstream financial institutions such as banks and non-banking financial institutions and limited MFIs operations largely to the provision of credit. This means that other important services to the less privileged poor such as savings, insurances and money transfer are not available.

\textsuperscript{12} This is to be found in section 3
\textsuperscript{13} CAP 387 of the Laws of Zambia
\textsuperscript{14} The Banking Financial Services (Microfinance) Regulations 2003, Explanatory Notes
Conclusion

Microfinance is the supply of loans, savings, and other basic financial services to the poor. People living in poverty, like everyone else, need a diverse range of financial instruments to run their businesses, build assets, stabilize consumption, and shield themselves against risk. Financial services needed by the poor include working capital loans, consumer credit, savings, pensions, insurance, and money transfer services. Suffice it to say, an important element of successful Microfinance is a regulatory framework that allows a wide array of financial intermediaries to serve the poor. Special attention should be paid to building the capacity of Bank regulator to evaluate, monitor, and supervise MFIs in a way that ensures the overall soundness of the sector without stifling its growth. For instance, the regulatory framework should be done with the various actors themselves.

Thus, having realized that the financial sector as it exists now cannot ably serve the micro and small enterprises because of its shallow depth and breadth, as evidenced by the lack of accessibility to financial services by the poor, there is need for an all inclusive regulatory framework or supervisory regime for MFIs in Zambia. It is therefore firstly important that we understand what Microfinance regulation is, why it is important, and what form of regulation and supervision would create an enabling environment for the operation of MFIs that afford financial services to the poor. This is addressed in the following chapter.
Chapter Two

Introduction

Many developing countries with transitional economies are considering whether and how best regulate microfinance. To this end governments play a complex role in microfinance. Many governments have realized that they cannot do a good job of lending to the poor\(^\text{15}\) however; they play an important role in setting appropriate policies. The key things that the government can do for microfinance are to maintain macroeconomic stability by putting in place a supportive regulatory framework and to avoid interest-rate caps that prevent MFIs from covering their costs and operating sustainably.\(^\text{16}\) In many countries, various factions are pushing for new laws to create a special, new type of financial license that is tailor-made for MFIs, especially those that are taking in deposits. Such laws need to be approached with much care.

‘What is Microfinance Regulation?’

Varying terminology is used in the discussion of microfinance regulation. For the purpose of this paper, regulation refers to the building rules governing the conduct of legal entities and individuals carrying on micro financing, whether they are adopted by a legislative body (laws) or an executive body\(^\text{17}\). Regulations are therefore the subset of regulation adopted by an executive body such as a ministry or a central bank. Supervision is the external oversight aimed at determining and enforcing compliance with

\(^{\text{15}}\) Short-term political gain is very tempting for politically controlled lending organizations; they disburse too quickly, and they collect too sporadically because they are unwilling to be tough on defaulters.

\(^{\text{16}}\) High license fees may also attract unnecessary costs for MFIs

\(^{\text{17}}\) Ibid, p2
regulation\textsuperscript{18}. Any discussion of providing an explicit new regulatory space in order to develop the microfinance sector and improve the performance of existing microfinance institutions, should weigh carefully the potential unintended consequences, such as, over specific regulation, which can limit innovation and competition in the market. Hence, developing a new regulatory regime for microfinance takes a great deal of analysis, consultation, and negotiation.

Advocacy for microfinance regulation should be well understood, it is important to be clear about which of the following is being pursued\textsuperscript{19};

a) enabling the formation and operation of non-bank micro lending institutions, which does not require prudential regulation and supervision;

b) enabling the formation and operation of non-bank financial intermediaries taking retail deposits, which generally does require prudential treatment; and

c) enabling some combination of these two.

Identifying the Purpose for Microfinance Regulation.

Banks are regulated to protect their depositors and to prevent risks to the system. Similarly when microfinance providers take up voluntary deposit services, then governments need to regulate it in order to protect depositors. Where the financial sector undergoes some difficulty this may lead to the closure of financial institutions such as commercial banks. Regulation by the financial authorities is needed for MFIs that do take deposits, for instance, savings-based financial cooperatives or credit-based MFIs that

\textsuperscript{18} In Zambia, the task of supervision has been placed with the Bank of Zambia
want to start taking deposits to finance their growth. MFIs that do not take deposits do not need intensive regulation and supervision, but they do need a certain minimum regulatory structure in order to operate. This may be effected by another body other the central bank. Thus two forms of regulation have been recognized as prudential and non-prudential regulation.

It is submitted that regulation is 'prudential' when it is aimed specifically at protecting the financial system as a whole as well as protecting the safety of small deposits in individual institutions\(^{20}\). This is because when a deposit-taking institution becomes insolvent, it cannot repay its depositors, and if it is a large institution; its failure can undermine confidence enough so that the banking system suffers a run on depositors. Therefore, prudential regulation involves the government in attempting to protect the financial soundness of the regulated institutions. Prudential regulations almost always require a specialized financial authority for their implementation. It is common practice in most countries to employ their central banks for this purpose. If prudential regulation does not focus closely enough on the above objectives, scarce supervisory resources can be wasted, licensed institutions can be saddled with unnecessary compliance burdens, and as a result development of the financial sector can be constrained. Indeed before deciding on regulatory reforms, much attention must be given to issues of likely effectiveness and cost of supervision so that the entire process is not bogged down due to lack of adequate financing. And even where regulation of normal commercial banking is well focused on these objectives, some of that regulation may need modification to

\(^{19}\) Ibid, p5
\(^{20}\) Ibid, p3
accommodate the risks and differing characteristics of microfinance activities and microfinance institutions.

Non-prudential regulation on the other hand is less complex, less difficult and less expensive than prudential regulation\textsuperscript{21}. Non-prudential regulation may often be self-executing and can often be dealt with by agencies outside the central bank or finance ministry.\textsuperscript{22} Regulatory issues of relevance to microfinance cover a wide spectrum. These issues include, among others, enabling the formation and operation of micro-lending institutions; protecting consumers; preventing fraud and financial crimes, setting up credit information services; policies with respect to interest rates; limitations on foreign ownership, management, and sources of capital; tax and accounting issues; and a variety of cross-cutting issues surrounding transformations from one institutional type to another. Thus, for instance, if the concern is only to keep persons with bad records from owning or controlling microfinance institutions, non-prudential regulation will suffice. It would therefore be sufficient to require registry and disclosure of the individuals owning or controlling any MFI, and to submit proposed individuals to a ‘fit and proper’ screening. Such screening would be dependant on what the regulators see as fit.

Where regulation of microfinance is ‘enabling’, its purpose is a positive one\textsuperscript{23}. Most of the microfinance regulation being proposed today is enabling. But what is the activity being enabled? Where the purpose is to enable MFIs to take deposits from the public, then prudential regulation is called for, because the return of depositor’s money cannot be guaranteed unless the MFI as a whole is financially solvent. If on the other hand the regulations purpose is to enable certain institutions to conduct a lending business legally,

\begin{footnotesize}
\footnotesub{\footnotemark[21] Ibid, p6}
\end{footnotesize}
then there is usually no reason to assume the burden of prudential regulation because there are no depositors to protect. This is not to say of course, that failure of a lending only MFI has no adverse consequences. Customers’ loss of access to loans from an MFI may be a severe problem if the failing micro lender is the only available source of the much-needed capital. Although the creation of a law for the purpose of regulating microfinancing is not a guarantee for successful microfinance,\textsuperscript{24} providing an explicit regulatory space for microfinance may very well have the effect of increasing the volume of financial services delivered and increasing the number of clients served.

**How Microfinance Regulation may be Effected**

If a new regulatory framework is to be established, should it be done by amendment of the existing financial sector laws and regulations, or should separate legislation or regulation be proposed?\textsuperscript{25} As a general proposition, incorporation within the existing framework will better promote integration of the new license and/or permit into the overall financial system. This indeed is what the Zambian government has proposed. The Regulations will be enacted by virtue of the powers given to the Minister under the Banking and Financial services Act. This approach may increase the likelihood that the regulatory changes are properly harmonized with the existing regulatory landscape. Inadequate attention to harmonization has often resulted in new ambiguities as to the intended interplay of different pieces of financial sector legislation and regulation.

\textsuperscript{22} For instance in the Zambian case this may be dealt with be AMIZ or any other such competent authority.

\textsuperscript{23} Ibid, p3

\textsuperscript{24} For instance in Bangladesh and Indonesia no such framework was present when microfinance reached massive clients.
Moreover, the exercise of adjusting the existing framework may be easier from a
technical point of view and may be more likely to facilitate the entry of existing financial
institutions into microfinance service delivery, by assuring them equal regulatory
treatment. However, local factors will determine the feasibility of this approach. In some
countries, for example, policy makers may be reluctant to open up the banking law for
amendment because it would invite reconsideration of a whole range of banking issues
that have nothing to do with microfinance.  

A look at the CGAP Recommended Regulation and Supervision of Microfinance.

Since its inception in 1995, CGAP has played a pivotal role in developing a common
language for the microfinance industry, catalyzing the movement towards best practice
performance standards, and building consensus among its many and varied
stakeholders. CGAP is a consortium of donors working together to build sustainable
financial service for the poor. The mission of CGAP III is to expand and to accelerate
their access to a broad range of convenient and sustainable financial services. It believes
that access to financial services is an essential building block for poverty alleviation and
economic development, and that financial services for the poor must be integrated into
the financial system of every country. To this end, the objective of CGAP in phase III is
to help build financial systems that serve the poor people with different needs. Thus, the
work of CGAP III will center on, *inter alia*, promoting a sound policy and legal

25 Ibid, p5
26 Uganda for instance came up with a new law independent of the existing financial law.
27 CGAP, Phase III Strategy 2003-2008, p10
framework for microfinance. It recognizes that, policy and legal framework will need to adapt so that government can play their appropriate role as facilitators, rather than direct providers of financial services for the poor. Its goals in this area will be to:

- Foster diversity of institutions and financial products through a policy and legal regime that gives them equal treatment and is not biased in favour of one institutional model or products.
- Establish a supportive legal and regulatory framework that safeguards poor people’s money and promotes competition, and
- Develop the technical expertise of government supervisory and regulatory authorities.

CGAP is in a strong position to support the development of a sound legal and regulatory environment for microfinance. Its comparative advantage in this area stems from its neutrality, its multi-donor platform, its relationship with the World Bank, the IMF and regional banks, and the leverage that these organizations have in addressing policy issues with the government policy makers. In phase III, CGAP will capitalize on these comparative advantages, working with and through its member donors to improve the policy and regulatory framework for financial services to the poor.

Having contended with that the subject of microfinance regulation is a complex one and filled with qualifications and caveats, CGAP comes up with some of the following key policy recommendations or conclusions.

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28 CGAP has divided its operations into phases in order to facilitate more effective solutions in micro financing. CGAP I and II were effected in 1995 and 1998 respectively, and 2003-2008 CGAP III

29 This is especially so because in the delivery of financial products or services to the poor, these systems become more integrated in the overall financial system.
• That powerful new 'microfinance' techniques are being developed that allow formal services to be delivered to low-income clients who have previously not had access to such services. Therefore, in order to reach its full potential, the microfinance industry must eventually be able to enter the arena of licensed prudentially supervised financial intermediation, and regulations must eventually be crafted that allow this development.

• From the onset, CGAP recommends the use of non-prudential regulation, including regulation under the commercial or criminal codes, to address problems that do not require the government to attest to the financial soundness of regulated institutions. This is because, relevant forms of non-prudential regulation tend to be easier to enforce and are less costly than prudential regulation. The issue of the capacity of the central bank to regulate all financial institutions arises. Indeed it would be a mammoth task and eventually render the system to be ineffective. Thus where cost-effective prudential supervision is impractical, consideration must be given to allowing very small community based intermediaries to continue taking deposits from members without being prudentially supervised, especially in cases where most members do not have access to safer deposit vehicles. And as much as possible, focus prudential regulation on the type of transaction being conducted rather than the type of institution conducting it.

• The policy makers must be careful about steps that might bring the topic of micro credit interest rates into public and political discussion. Micro credit needs high

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30 These are taken from the CGAP position paper on Regulation and supervision of microfinance as compiled in October 2003. They are to be viewed as the ideal form of regulation, whether they can be readily applied is dependant on various countries that seek to apply them.
interest rates. This is simply because it is very expensive to grant small loans and the only way that these institutions can compensate for this is charging higher interest than ordinary commercial banks. However in many countries, it may be impossible to get explicit political acceptance of a rate that is high enough to allow viable microfinance. In other contexts, concerned education of relevant policy makers may succeed in establishing the necessary political acceptance.

- That there is need to get a competent financial and institutional analysis of the leading MFIs before deciding the timing and design of prudential regulation. That policy makers must think twice before imposing prudential regulation on 'credit-only' MFIs that merely lend out their own capital, or whose only borrowing is from foreign commercial or non-commercial sources, or from prudentially regulated local commercial banks.

- That there is need for flexibility with limitations on foreign ownership or maximum shareholder percentages if local microfinance is at the stage where much of the investment will have to come from transforming NGOs and other socially-motivated investors. Also the use of simpler reporting requirements for microfinance institutions or programs rather than that used for normal commercial bank operations as this may adversely affect the operation of MFIs by increasing their operation costs for instance.

- That before deciding on regulatory reforms, much attention should be given to issues of likely effectiveness and cost of supervision than is usually done.

Financial intermediation licenses are promises. Before issuing them, a

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31 For instance a loan for K50,000 to 10 different clients would be more costly to service than one
government needs to be clear about the nature of the promises and its practical ability to honour them. And finally, whenever possible, adjust any regulations that would preclude existing financial institutions, i.e. banks, finance companies, etc from offering microfinance services.

To enable CGAP to play the role sought by its member donors and other stakeholders in policy work, a small team dedicated to policy and regulatory issues will be created in the near future. This team will focus on working with multilateral organizations and supporting in-country donors and other technical people to help sensitize governments and create supportive legal and regulatory environments for microfinance. Such technical support is only available upon request by the particular government. In addition governments are not obliged to consider such advice. In short the ultimate law relating to regulation of microfinance is largely dependant on individual governments who determine the shape and extent of the law.

**Conclusion**

The discussion of microfinance regulation is indeed necessarily complex. It is an area that calls for much attention from the policy makers. From this chapter, it has been seen that it will be important for policy makers to understand, firstly, that regulation basically refers to the legal framework within which microfinance institutions will conduct their operations and therefore needs to be enabling. Secondly, the purpose of regulation must be clear, that is, whether there is need for prudential regulation, which seeks to protect

individual loan for K500,000.
the entire financial sector, or whether non-prudential regulation will suffice. How regulation is to be effected is another area of consideration. It has been seen that amendment of the existing financial sector laws or regulations appeals more than the creation of a separate law. However, this may vary from one jurisdiction to another. Finally the chapter brought out some necessary guidelines in microfinance regulation as expertly compiled by CGAP whose aim in this area is to assist governments formulate supportive legal and regulatory environments for microfinance, in this regard, the next chapter will look at the Zambian scenario in terms of the microfinance industry under the current legal framework or regulations.
Chapter Three

Introduction

In Zambia, the legislative framework in place with regard to microfinance is the Banking and Financial Services Act (BFSA),\textsuperscript{32} By virtue of section 124, the Minister of Finance and National planning is empowered to make regulations for the better performance of the Act. In light of this, the Bank of Zambia is in the process of developing regulations for the microfinance industry, and hence the Draft Banking and Financial Services (Microfinance) Regulations 2003 came into being. The Banking and Financial Services (Amendment) Act Number 18 of 2000 effectively brings the supervision of MFI under the ambit of the Bank of Zambia.\textsuperscript{33}

The purpose of the regulations is to provide the necessary legal framework for the operation and development of the microfinance industry in Zambia. Of the 98 known MFIs in the country, 45 are affiliated to the Association of Microfinance Institutions of Zambia (AMIZ)\textsuperscript{34}. AMIZ is the umbrella body for MFIs in Zambia and was set up in March 1998. The major reasons that lead to the formation of this association was that the stakeholders in the Microfinance industry wanted a coordinating body with regard to various activities in the industry. There was also need to for a representative body in the field of Microfinance. The mission or vision of AMIZ is to create a sustainable industry, and to support and facilitate development of MFIs by providing business development

\textsuperscript{32} Cap 387 of the Laws of Zambia
\textsuperscript{33} This is also envisaged in the Regulations in part III
\textsuperscript{34} Explanatory notes on the Draft Regulations 2003
services and lobbying for a conducive environment. The major activities carried on by AMIZ include:

- Training
- Advocacy work
- Information dissemination
- Networking with stakeholders
- Development of databases useful for the industry
- Establishment of credit bureaus and information centers and libraries
- Working with the Bank of Zambia for the development of a sound and supportive supervisory and regulatory framework.

Although it has been purported by the Bank of Zambia that AMIZ has a membership of 45 MFIs, only 21 of these are currently affiliated to it. This is mainly due to the fact that most institutes have since gone under or are at a point of revival.

The key market players in the Microfinance Industry are under listed;

- Pulse Holdings Ltd
- Micro Bankers Trust
- Pride Zambia Ltd
- Cetzam Opportunity Microfinance Ltd
- FINCA Zambia Ltd
- Ecumenical Church Loan Fund (ECLOP)
- Credit Management Services Ltd
- Zambezi Youth Organisation (ZAYO)
• Women Finance Co-operative Zambia Ltd
• National Savings and Credit Bank
• Harmos MED Ltd
• Lutheran world Federation
• Africa Housing Fund
• Peoples Participation Service
• Young Women Christian Association, YWCA-Youth Skills Enterprise Project
• Evangelical Fellowship of Zambia
• Salvation Army-Lusumpuko Women’s Microcredit Fund
• Africa Enterprise Trust (ACT)
• Agricultural Support Programme
• Micro Projects Unit

In an effort to reach the vulnerable groups in our society, various products and services are offered by MFIs in Zambia. These include the following categories;

• Group loans
• Individual loans
• Agricultural loans
• Insurance services
• Group and individual savings products
• School fees savings and loans accounts and so on.

35 This is evidenced by AMIZ; list of members as compiled in 2003
Status of the Regulatory Framework in Zambia

The process for putting in place a legal and regulatory framework for the Microfinance industry started in the year 2000, when a survey was concluded for the mapping out of the industry. The need for putting in place regulations by the government of Zambia was prompted by the need to protect the deposits of the individuals being taken by the financial institutions as well as to safeguard the financial system as a whole. By regulating their operations the regulations should in effect give MFIs the right to undertake their business and ultimately result in an enabling environment for the development industry. Thus in September 2001, a project was set up to develop a supervisory and regulatory framework, which was given a two-year time frame. The Bank of Zambia held consultations with the various stakeholders, including AMIZ, which participated extensively in the process. By April 2003, the Bank of Zambia disseminated the Draft Regulations to the stakeholders who were given 60 days in which to review and make comments on the Draft Regulations, and thereafter submit their work to the Bank of Zambia. These regulations are still a subject of revision and therefore, have not yet come into force. This implies that most of the MFIs in the country are operating in an unregulated market. However, it is pointed out here that central banks have been urged to use a participatory approach in developing Regulations\textsuperscript{36}. This has been the case in Zambia where several stakeholders have been involved in a variety of workshops in an effort to come up with an effective framework. Another example of the effectiveness of the participatory approach is found in Tanzania where the Central Bank sponsored a workshop in which all the stakeholders were involved before the law was

\textsuperscript{36} Afraca’s 2\textsuperscript{nd} Microfinance Forum Report, p5
finalized. Yet another pertinent example is Uganda, where the Members of Parliament were involved right from the beginning. A participatory approach enables the stakeholders to understand the complexity of the issues at hand.

**Highlights of the Draft Regulatory Framework**

**Part I – Preliminary Provisions**

The Regulations are cited as the Banking and Financial Services (Microfinance) Regulations of 2003. Microfinance service is defined as the provision of services primarily to and from small or micro enterprises and low income customers, to include the following; the provision of credit facilities usually characterized by infrequent repayments; the acceptance of non-current account deposits, and the provision of remittance and any other service that the Bank of Zambia may designate, or approve.

**Part II – Authority of the Bank Of Zambia**

This part confers on the Bank of Zambia, the authority to give effect to the Regulations. It authorizes the Registrar to delegate any of the powers of the Bank where delegation is inevitable to any person or class of persons the performance of any of the powers conferred upon the Registrar in the regulations. It also empowers the Bank to call for any information from any person.

**Part III – Licensing**

This part addresses the issue of prohibition. It prohibits any person other than an MFI, a bank or any other financial institution licensed under the regulations, from conducting
any microfinance business. The part also incorporates the requirements for the licensing of microfinance institutions. It also identifies what information an applicant will have to furnish to the Bank of Zambia when applying for a license. The requirements to register an MFI under the Regulations will be as follows:

a) A non-refundable application fee shall accompany an application for a license, K1 million is payable for non-deposit taking MFIs and K5.4 for deposit taking, and the following documents;

b) Evidence of incorporation, that is the articles of association of the proposed MFI or rules as provided for under either the Societies or Cooperatives Acts;

c) Physical and postal address of its head office;

d) A completed directors questionnaire and vital statistics forms for prospective directors and shareholders as well as the chief executive officer and the chief financial officer in form MFI 2 set out in the appendix;

e) A copy of the business plan;

f) Curriculum vitae of the Chief Executive Officer and the Chief Financial Officer;

g) Completed MFI 1 form which should be collected from the Bank of Zambia;

h) Certificate from the Registrar of Companies, Registrar of Societies or Registrar of Cooperatives;

37 It provides that any person, bank or financial institution must be licenced under the Act in order to carry on microfinance business, and any person who contravenes this section shall be liable to pay a fine upon conviction

38 This will be provide in a prescribed form; section 7

39 this is a statement by individuals who are holding, or are to hold, the office of a director or an executive officer of an MFI or a controlling company.
i) Confirmation of capital by auditors/ proof of capital\textsuperscript{40}, minimum capital requirement of K250 million for deposit taking and K25 million for non-deposit taking.

This part will also obliges the Registrar to determine the suitability of an application within 180 days of the application, although the Bank of Zambia shall endeavor to process these applications within the shortest possible time, and the subsequent issue of a license where the Registrar is satisfied that the applicant is fit and proper to be licensed as an MFI and has complied with the requirements of these regulations. Part III also sets out the information applicants will be required to provide to the Bank of Zambia and in addition it provides for a process of appeal if an applicant is not satisfied with the Registrar’s decision not to grant a license.

The scope and duration of an MFI license will also be determined under this part. A license shall remain valid, unless it is revoked or surrendered to the Registrar. In addition, an MFI will be compelled to display a license in a conspicuous place on the approved premises where the microfinance institution conducts it’s business. This is as a means of allowing for the verification of authenticity of an MFI by the general public.

In addition, Part III will restrict the transfer of a license and prescribes a penalty for any person who contravenes this provision. The part will also provides grounds upon which a license may be suspended or revoked. This is to provide for an orderly exit upon surrender and revocation of license. Provisions under this part set out that a surrendered license must be delivered to the Registrar, within a specified time frame, by hand or by registered mail.

\textsuperscript{40} This may be in form of a bank statement.
Part IV - Categories of License

This part will provide for the categories of licenses that the Registrar may grant. The Registrar must grant a license for either a deposit taking MFI or a non-deposit taking MFI.

This part will also provide for a minimum capital requirement as follows;

The minimum capital requirement for a deposit taking MFI is two hundred and fifty million Zambian Kwacha (K250, 000,000.00), which is approximately US $ 50,000, while a non-deposit taking MFI’s minimum capital requirement has been pegged at twenty five million Zambian Kwacha (25,000,000.00), which is approximately US $5000.

Secondly, under these regulations, a deposit taking MFI will have an obligation to display its balance sheet and income statement in a conspicuous place where it conducts its business to enable the members of the public ascertain the financial soundness of the MFI.

In terms of services, the two categories of licenses are different. A non-deposit taking MFI is limited in terms of its services to provide credit facilitation only. A deposit taking MFI on the other hand may provide any of the following services;

- Credit facilitation
- Linkage Banking
- In country transfers
- Savings, and any other services that the Bank of Zambia may approve.
This part will also specify the conditions required for the changing of a license including the requirement to apply to the Registrar, which must include the reasons for the change, and such change cannot be effected without the approval of the Registrar.

Part V – Governance

This part will deal with the structures of MFIs. An MFI will be expected to have a governing body with a minimum of five members, the majority of whom should be permanent residents in Zambia. In terms of its structure, the management of an MFI must include a Chief Executive Officer and a Chief Financial Officer who should not be the same person. This in order to maintain a system of checks and balances within the institution and to provide a framework for sound corporate practice.

Part VI – Mode of Operation

The provisions of the Regulation under this part will outline the capital requirements of an MFI. It will also provides for the Bank of Zambia to take supervisory action against an MFI in breach of this part. Under this part, the regulations will provide for the insider lending regulations to apply in relation to connected lending. One important aspect is that an MFI that makes credit available to a person must at the same time disclose to that person the cost of borrowing in writing. Further, an MFI must display the customer rights and responsibilities in a conspicuous place in plain view in such form as the Bank of Zambia may prescribe.
Part VII – Supervision

Part VII will provide the Bank of Zambia authority to inspect an MFI. It also authorizes the Bank of Zambia to delegate this function to any person. This provision is designed to enable delegation of supervisory function by the Bank of Zambia in the event that the Bank of Zambia has inadequate resources to perform this function. In addition, this part will oblige the MFI to submit returns to the Bank of Zambia.

Part VIII – Miscellaneous

Part VIII will provide for the miscellaneous provisions. In the first instance it penalizes the offence of preparing or issuing false documents or taking part in the issuance of false documents. Secondly, it disqualifies certain persons from taking part in the management of an MFI. For example, if a person is below the age of 21, or if a person had been convicted of a felony of any offence involving dishonestly or if a person had been declared or otherwise adjudged in any official proceedings to be mentally incompetent to manage his affairs. This part will seek to encourage the preparations, retention or issuance of accurate financial and other information and also prescribes a penalty for individuals not complying with this requirement.

This part will further give the Bank of Zambia authority to suspend or remove any person from office for breach of these regulations by notice in writing, addressed to the person suspended. Under this part, an MFI is obliged to treat all its dealings in the strictest confidence. This part will also provide for general penalties as well as offences by body corporate.
Part IX – Transitional

Under this part, it will be provided that these regulations shall come into force on such day as the Minister of Finance and National Planning may prescribe.

Secondly, it will provide that an MFI in compliance with these regulations shall apply for the appropriate license 30 days immediately after the commencement of these regulations.

Further, except for the requirement on ownership and capital adequacy, existing MFIs working towards compliance with other requirements of these regulations have one year to comply with the provisions of these regulations.

In addition, existing internal MFI units within any legal person that is not a registered financial institution must be separately registered as a legal person in order to meet the provisions of these regulations and may pay a prescribed application fee to be determined by the Bank of Zambia.

Although these regulations have not yet received the force of law, it is emphasized that these regulations are not exhaustive and are therefore meant to be a framework that allows the Bank of Zambia the ability and flexibility to respond to changing circumstances and developments in the microfinance industry. This indeed will be done through the power conferred on it to make prescriptions, issue guidelines and other regulatory bulletins.
The Impact of the Draft Regulations on MFIs in Zambia

The impact of the draft regulations as they are, on the MFIs in Zambia will not be a positive one. Consequently the various stakeholders have raised a number of concerns in relation to the regulations, and at the same time have proposed a number of amendments to be made. In retrospect, the draft microfinance regulations were circulated to all stakeholders and other interested persons to solicit comments. The following are the comments that have been received by the Bank of Zambia. These comments and other issues will be discussed at various workshops throughout the country, which will be held by the Bank of Zambia at dates to be announced later.41 At the same time this document will be updated as and when additional information is received.

First and foremost the private sector is of the view that, in their current state the draft regulations could not apply well to the industry. In an interview conducted with a Mr. Webby Matae, Executive Secretary of AMIZ, he explicitly stated that;

"The impression that I get is that the people who developed the draft regulations did not understand the microfinance industry, and as such the regulations appear like commercial bank regulations trying to be watered down to microfinance regulations."

The stakeholders main concern is that the draft has not reflected the current set-up and causes of establishing MFIs. The original concept of establishing MFIs was to fight

41 These comments have been posted on the BOZ website; www.boz.zm, as updated on the 1st of July 2003
poverty and empowering Zambian economically, especially the youth and women. Conversely, the draft encourages MFIs to enter into profit making business which is not in line with the continuing their original ideas of helping the community, especially the economically disadvantaged.

Another important concern is that the draft purports to have all financial institutions carrying out financial services business to be registered with the Bank of Zambia. The broad applicability of the regulations to encompass all microfinance activity will render even the most informal lending mechanisms amongst the poor illegal. It suggests that even shylocks are to be registered, however, these are usually registered under other statutes. There is therefore significant danger that the growth of microfinance in Zambia will be hindered and not be enhanced by the regulations.

With regard to licensing, the Bank of Zambia suggests that all formal financial Institutions need to be licensed\(^2\). However, licensing should be limited to those taking voluntary deposits. This is for the simple reason that there is a concern of protecting deposits of individuals and ultimately the financial sector as a whole. In addition to this, the reporting requirement for deposit taking MFIs should not be so frequent as to significantly increase the operational costs of the MFIs. There is need to distinguish the reporting requirement of commercial Banks and MFIs, which require a simpler reporting system. Such simplicity is to be determined by the Bank of Zambia. The license application fee for both deposit and non-deposit MFIs is too high and may attract charges that will discourage borrowers from acquiring loans, which as a result will frustrate efforts made by MFIs to meet their goals. The following are the proposed changes;

\(^2\) Section 6 of Draft constitution 2003
Microfinance institutions proposed fees structure.

<table>
<thead>
<tr>
<th>LICENSE CATEGORY</th>
<th>DEPOSIT TAKING MFI</th>
<th>NON-DEPOSIT TAKING MFI</th>
</tr>
</thead>
<tbody>
<tr>
<td>License application fee</td>
<td>K 3,000,000.00</td>
<td>K 500,000.00</td>
</tr>
<tr>
<td>Annual license fee</td>
<td>K 1,000,000.00</td>
<td>K 300,000.00</td>
</tr>
<tr>
<td>Supervisory fee</td>
<td>0.02% of monthly average deposits over the preceding 12 month period</td>
<td>Fee proposed</td>
</tr>
</tbody>
</table>

The stakeholders also noted that the Draft encourages the Bank of Zambia to have a lot of powers and authority that may not favor MFIs. For instance, the Bank of Zambia should no be given powers to suspend governing officials of MFIs, unless it is deemed necessary and it should be done through a tribunal under part VII of the Banking and Financial services Act, nor should the regulatory authority propose the mode of how governing bodies should meet, this should be articulated in their articles of association in their articles of association. The registrar should not revoke MFI licenses on directives, but upon recommendations of the tribunal.

One the issue of ownership of MFIs this must be open to all who have money to invest and such ownership should not be particularly limited to Zambians. However, the Bank of Zambia may put in place particular safeguards or a form of screening process to ensure that the would be investors wish to do in good faith and not to defraud the depositors or to destruct the soundness of the financial sector as a whole.

Still under ownership, comes in the aspect of management. Stakeholders are of the view that the prescription to have MFIs run by Chief Executive Officers, a Managing Director,
Financial Managers and so on, is harsh and may be difficult to attain by most MFIs. These officers must have a certain level of qualifications, for instance, Association of Certified Chartered Accountants (ACCA), or a financial management degree. As such, these may be expensive to employ and MFIs may not afford these at this level. However, for the deposit taking institutions, these requirements may be met. This is because the institutions will be taking in voluntary deposits from clients, which need to be protected as well as safeguard the overall financial sector. In addition, auditors may not be necessary for non-deposit taking MFI.

**Conclusion**

Banks are regulated to protect their depositors and prevent risks to the financial system. Similarly, when microfinance providers take up voluntary deposit services, regulation by financial authorities is needed. MFIs that do not take deposits do not need intensive regulation and supervision, but they need a certain minimum regulatory structure in order to operate. The Government of Zambia, saw this need and thus through the Bank of Zambia developed the draft regulations. However, the draft regulations in part are far too stringent for a microfinance industry that is still in its nascent stages. It is difficult to envision how the majority of the microfinance institutions will be able to comply with the regulations as they stand. This is evidenced by the numerous concerns that have been raised by the MFIs themselves through its representative body AMIZ. The purpose of regulations should be to protect depositors and overall financial system and to ultimately create an enabling environment in which MFIs can operate. Drafters must be well acquainted with the purpose for regulation and how best this can be effected. This of course can be achieved through consultation and technical support accorded by the
experts of the field. AMIZ is one such organization through which the drafter will be able to draw the required enlightenment. It will therefore be prudent for the Bank of Zambia to take into account these concerns and thereby develop regulations based on the recommendations that have been proposed. In order to formulate regulations that will help develop the industry, it is not sufficient for Bank of Zambia to invite comments alone, it must take a step further and act on these concerns, as it under-takes its workshops with these interested persons.
Chapter Four

Introduction

In the previous chapter, mention was made to the fact that Uganda is one of the countries in which successful microfinance is taking shape. This chapter seeks to highlight the status of the microfinance legal framework in Uganda today. This is simply because it is identified that the legal and policy framework of the microfinance industry in Uganda has had a positive bearing on the development of this sector. Uganda, like Zambia is a third world country, located in East Africa. With a population of approximately 26 million people, the majority of people in Uganda live in abject poverty. This involves a life of malnutrition, poor health and sanitation, unemployment and so on and so forth. This has been a major concern for the government of Uganda which has put in place a number of programs, including micro financing in order to restore the country’s economy.

This chapter will particularly look at the brief background to the development of the legal framework in Uganda, its current status, which will be followed by the highlights of the Micro-Finance Deposit-taking Institutions Act (5) of 2003 (MFDTI), and will finally compare the above with the Zambian position.

Background

By 1996/97, microfinance practitioners in Uganda and other actors in the financial sector had realized that the financial sector as it was, could not adequately serve the micro and small enterprises (MSEs) because of its shallow depth and breadth. Yet every one was

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43 Policy Primer on microfinance for non-specialists, a presentation by Uganda, May 2003, p2
agreed that one of the major problems affecting the development of the MSEs was lack of accessibility to financial services.

By this time, the financial sector was going through a difficult time leading to the closure of several commercial banks. Consequently, the Central bank was not enthusiastic about bringing MFIs under its fold. The donors who had until then supported MFIs mainly through grants, were slowly but surely pulling out or reducing their subsidies. There was a need for broadening and deepening the financial sector and one of the ways of doing so was to bring the many who could save but had no access to financial services into formal financial sector in order to mobilize their resources.

MFIs were also aware that with an all inclusive regulatory framework or supervisory regime, they could access cheap sources of funds as well as other lines of credit best suited for their operations which they could not access because of being outside the ambit of the main stream financial system. Thus, the MFIs initialized dialogue with the government, donors, private sector representatives, academia and the Bank of Uganda, on the development of a regulatory and supervisory framework for the microfinance industry in Uganda. After this consultative process that spanned over two and a half years, a Microfinance Regulation policy statement was formulated which gave birth to the Microfinance Draft Bill, 2001⁴⁴.

**Status of the Regulatory Framework in Uganda Today**

*The Microfinance Deposit-taking Institutions Act (5) of 2003 (MFDTI)*

⁴⁴ Ibid
The Microfinance Deposit-taking Institutions Act, 2003, was enacted on the 11th of April 2003, to look into the issue of protecting those who are depositing their savings with MFIs in addition to receiving credit and other services. In that regard, three categories of deposit-taking institutions have been earmarked as capable of providing microfinance services and will be supervised by the Bank of Uganda for that purpose. These are Banks, Credit institutions (Tier 1 and 2) which are already covered by the Financial Institutions statute of 1993, which is currently under amendment, and microfinance deposit-taking institutions, which will be supervised under the new MFDTI law. The other categories, which include non-deposit taking institutions and very small member taking organizations of a given size will be categorized as tier 4 and will presumably be regulated under an umbrella body. This umbrella body, which is likely to play this role, is the Association of Microfinance Institutions of Uganda (AMIU).

The AMIU is a network of microfinance institutions throughout the country, which was established in November 1996, and officially registered under the NGO Act as a company limited by guarantee in 1999. Among its objectives is that of developing and implementing a performance monitoring system for MFIs that will set standards and increase professionalism in the industry.

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46 This body is similar to the Zambian AMIZ which is also an association for microfinance
Highlights of Regulatory Framework

Part I – Preliminary Provisions

This part covers the short title and provides that the Minister in Charge of Finance shall set the commencement date and also provides interpretation to key terminology in the micro-finance area.

Part II – Licensing

This part provides for the minimum entry requirements before an MFDTI can be licensed by the Bank and also provides for the orderly exit of those which fail to meet the required standards. In addition to licensing there are provisions for publication once every year, of all companies authorized to conduct micro-finance business in Uganda. The overriding concern for this was to protect the soundness of the financial system in Uganda.

(Micro-finance business is defined as acceptance of deposits and employing them for lending or extending credit and providing short term loans to small or mice enterprises, low income households, usually characterized by the use of collateral substitutes such as group guarantees of compulsory savings).

This part also provides for minimum capital requirements as follows;

- A minimum paid –up-capital of not less that 500,000,000 million Uganda shillings (approximately US $ 250,000)
- The minimum capital funds unimpaired by losses is not to be less that 700,000,000 million Uganda shillings (approximately US $ 350,000) at any one given time.

On-going Capital Adequacy Requirements;
• Core Capital-Not to be less than 15% of risk weighted assets.

• Total capital adequacy ratio greater than 20% of risk weighted assets.

• Liquid Assets to be prescribed by the Bank by issuing of regulations.

The requirements for capital adequacy are higher than those for commercial banks, which is in line with the recommendations in the CGAP paper.

Part III – Restrictions on Certain Transactions and Dealings by Microfinance Deposit Taking Institutions

• Places restrictions on certain transactions and dealings by Deposit Taking MFIs and also prohibits the dealing in certain types of transactions.

• Of particular mention is the limitations of amounts to be loaned out not to exceed 1% of core capital in case of an individual borrower and 5% for group borrowers.

• There are also limitations on the level of unsecured credit that may be granted. This is worth noting since most lending MFI's are compelled to inform their clients of the terms and conditions of paying back the loans.

Part IV – Ownership and Corporate Governance

Taking a leaf from the failure of several banks in Uganda, the new regulatory framework seeks to place a lot of emphasis on management and corporate governance issues. It seeks to limit control of MFIs by particular individuals or groups, which are related and restricts the transfer of shares to prevent any type of undesirable monopoly from emerging. The law places a very high standard of performance and integrity on Managers
and Officers of the MFI with requirement for Central Bank approvals for Board Directorship, Finance Management, Internal and External Auditor positions.

Some of the specific restrictions are pointed out below:

- No person/group of related persons to hold more than 30% shares.
- To reduce shareholding to prescribed minimum within 5 years.
- Present credible plan for reduction within 90 days from commencement of the Act.
- No one to hold more than 10% shares unless such a person had passed the fair and proper test.
- Restrictions on transfer of shares – 10% and above.
- Restrictions on who should become a Director.

Credit Rating Agency

The Act has also provided for MFI to provide the Credit Reference Bureau with information regarding non-performing loans with the prior notification to the customer. This was done in order to protect the clients who are usually the poor and who ultimately maybe affected by the high interest rates placed on the loans. This is in line with the proposal to have a credit rating agency or the equivalent of the Guatemala Credit Union Rating Agency. Thus in the Ugandan case, we see some aspects of other regulatory models being included in the main regulatory framework.
The Supervisory Authority

According to the law, this will be the Central Bank (Bank of Uganda). As has been stated in the CGAP paper, this will have the advantage of already existing skills and could minimize problems of regulatory arbitrage. This is a situation where conflict may arise due different institutions being employed for the similar purpose of supervision. However, the questions as to whether the supervision function as is now will be able to handle MFIs in addition to other existing financial institutions has been mooted. The Central Bank believes that they will have the capacity to handle these because there will not be many transformed MFDTIs. This goes to show that for supervision to be adequate and efficient, the number of institutions to be supervised must not be too numerous. That is why the credit-only institutions in Uganda will be monitored by AMIU and not the central bank.

Uganda also seeks the need to have specially trained supervisory staff to handle microfinance portfolios as they differ from those of commercial banks.

MDI – Deposit Protection Fund (S.80)

The law proposed to establish a Deposit Insurance Fund to which all MDIs will have to make contributions. The purpose of the fund is to compensate depositors for losses incurred by them in the event of insolvency it is not clear yet what the limits will be but it is very likely that they will mirror those of the financial institutions to a large extent.

It appears that in Uganda, the debate as to whether public deposit insurance encourages inappropriate risk seems to have been resolved in the proposed amendments to the Financial Institution Statute 1993 by proposing that the minimum contribution should be
a percentage of the average weighted deposit liabilities, which of course depends on the performance of the institution. It is yet to be seen how this will be applied to MFIs.

Transitional Provisions

MFIs who are already taking deposits (excluding compulsory savings which are used as insurance for loans) have 24 months (2 years) within which to comply with the requirements or wind-up the business within 6 months. This time frame gives ample time to the MFIs to comply with the law.47

Uganda’s Comments and Observations on the CGAP Position Paper on Regulation and Supervision of Microfinance

- Uganda has already taken the decision to regulate by licensing and prudentially supervising its micro-finance industry by the coming into force of the MFDTI law and the creation of an umbrella organization, AMFIU.

- Certain aspects on non-prudential regulations issues have been included in the law48. Examples are; the provisions relating to ownership suitability diversification, and certain aspects of corporate governance. Also, the provisions relating to the establishment of a Credit Reference Bureau.

- On the recommendation that credit only institutions should not be regulated; this was taken care of in the Policy framework for micro-finance regulation and has been adopted by the regulatory framework. All deposit-taking financial

47 Conversely the Zambian draft regulations only give the MFI 30 days to comply with the new license once it comes into force. A proposed amendment that this is extended to 6 months has been made.
institutions will be regulated under tiers 1-3, i.e. banks, credit institutions and MFIs, and the rest will not be regulated but may be monitored and or later “self-supervised” under the AMFIU. Thus, tier 4 includes credit only MFIs or those who are taking compulsory savings but not lending them.

- The proposal to establish a Credit Reference Bureau with the Bank of Uganda may be a step in the right direction, although this is likely to have technical complications with the fiduciary duty of confidentiality over certain privileged information that cannot be divulged without the customer’s consent.

- Judging form the proximity of the provisions in the current regulatory framework to most of the CGAP recommendations, and the fact that the regulatory framework was done with the involvement of the actors themselves, the presumption is that maximum caution had been exercised in terms of institutional analysis of the leading MFI in Uganda.

- The regulatory framework also seeks to exercise some flexibility on the limitations on ownership, particularly foreign or otherwise and on the maximum shareholding ceilings.

- Bearing in mind that it is very pertinent for a supervisory Authority to take into account the likely effectiveness and cost of supervision so that the process is not bogged down due to lack of adequate financing, the development partners in the industry are to lend a hand in putting up the necessary start-up infrastructure.

- In Uganda, the regulatory framework has allowed existing financial institutions to engage in microfinance so as to level the playing field. In addition to this, the
demand for simpler reporting mechanisms for MFIs has also been considered. Although this likely to depend on what the Regulatory Authority considers to be simple.

**Microfinance in Zambia and Uganda: A Comparative Analysis**

It has been seen that Uganda has initiated and come up with a law, which is currently in place with regard to regulation of Microfinance. Although the regulations have not yet been finalized here in Zambia, both Zambia and Uganda employed the participatory approach in formulating regulations dealing with microfinance. However, it appears that the drafters of the draft regulations in Zambia did not fully understand the purpose for the regulations as creating an enabling environment for the industry. As a result, the draft regulations have rightly been attacked by the concerned stakeholders. In Uganda, the parliamentarians who were the enactors of this law were well informed from inception, and thus this law has been well accepted among the various stakeholders. From the onset, we also recognize that whereas Uganda came up with a separate piece of legislation for the purpose of regulating MFIs, Zambia’s idea is to extend the current law by allowing the Minster of Finance and National Planning to come up with the said regulations. This indeed is a matter of preference for each government and may work well both ways.

The draft regulations in Zambia have purported to have all financial institutions regulated by the Bank of Zambia, whether such an institution is deposit-taking or non-deposit-taking. In Uganda, as the overriding purpose for the law is to protect the depositors as well as the overall financial sector, only those institutions that will be taking deposits form the public are to be prudentially regulated by the Central Bank. All other
institutions will be regulated by AMIU or alternatively, will be "self-regulated". This is an effective way of regulation in that it saves time and is of course cost effective. In any case, the Central Bank itself may not have the capacity to regulate all the financial institutions in a given country. This may conversely affect the MFI and could ultimately affect the beneficiaries of the financial services themselves. We have also seen that Uganda has further sought to align its regulatory framework with those recommended by CGAP. In retrospect, CGAP is a consortium of donors working together to build sustainable financial services for the poor. Among its objectives is promoting a sound policy and legal framework for micro-finance. Thus, CGAP is a group of experts that seeks to help sensitize governments and create supportive legal and regulatory environments for micro-finance. We are yet to undertake this in Zambia.

It was identified in the previous chapter that the overriding purpose of micro-finance regulation should be to create an enabling environment for the operation of the financial institutions and to ultimately reach the targeted groups who are the vulnerable in our society. Uganda is courting this process. Microfinance Regulation has never been known to be an opportunity for the would-be regulators or supervisors to exert unnecessary control by creating rigid rules and procedures and consequently stifling the growth of the industry. This is why it will be necessarily important for the Zambian regulators to look into the various concerns raised by the concerned stakeholders in the industry.

**Conclusion**

It is true that poverty is a multi-dimensional problem. Thus, there is no single approach to its eradication. Micro-finance is an important tool in the programs of poverty eradication.
It alone cannot improve roads, housing, water supply, education and health services. However, it can play an instrumental role in making the above mentioned achievable. By reducing vulnerability and increasing earnings and savings, financial services allow poor households to make the transformation from “every-day survival” to “planning for the future”. Households are able to send more children to school for longer periods and to make greater investments in their children’s education. Increased earnings from financial services lead to better nutrition and better living conditions, which translates into lower incidence of illness. Increased earnings also mean that clients may seek out and pay for health care services when needed, rather than go without or wait until their health seriously deteriorates. Realizing that micro-finance is a vehicle through which the vulnerable groups can improve their lives through the provision of various financial services, the government of Uganda issued a Micro-Finance Law. This was done in order to create an enabling environment for the industry and ultimately to enhance the growth of the dilapidated economy. Zambia is in a position to draw and learn from the Ugandan experience, particularly with regard to the supervisory and regulatory framework.
Chapter Five

General Conclusion

This dissertation attempted to show the role of Microfinance in poverty eradication. In establishing this it was emphasized that the need for a sound and supportive legal and regulatory framework was imperative to allow for the development of this industry. The paper sought to investigate whether the Zambian government through the banking regulators had employed an enabling environment that permits the growth of financial services for the poor and the integration of the poor in the broader economy through microfinance. Microfinance was defined as the supply of loans, savings, consumer credit, pensions, insurance and money transfer services. It was recognized that poor people living in poverty, like everyone else need a diverse range of financial instruments to run their business, build assets, stabilize consumption and shield themselves against risk. Poverty is a multi-dimensional problem. Thus there is no single approach to its eradication. The solutions to poverty are multi-faceted as are its causes. The need to address poverty has been the subject of many development programs, and indeed microfinance is one such program.

Zambia is currently facing critical economic hardships. Poverty levels continue to increase and at the same time, economic yields are decreasing. The majority of the poor people in Zambia who are rural based, have low income, which leads to low investment, and which in turn leads to low productivity and income. In Zambia, access to institutional credit, that is, formal institutions, such as commercial banks, is very limited. This can be attributed to the high interest rates offered by these institutions today. As the poor people make up the majority of the population in Zambia, there is an urgent need to
economically empower them. Microfinance is an important tool in the programs of poverty eradication, which the Zambian government can utilize. Of course microfinance alone cannot improve roads, housing, water supply, education and health services. However, it can certainly play a vital role in making the above interventions. By reducing vulnerability and increasing earnings and savings, financial services allow poor households to make the transformation from "every-day survival" to "planning for the future". Households are able to send more children to school for longer periods and to make greater investments in their children's education. Increased earnings from financial services lead to better nutrition and better living conditions, which translates into lower incidence of illness. Increased earnings also mean that clients may seek out and pay for health care services when needed, rather than go without or wait until their health seriously deteriorates.

For a successful microfinance to begin to take shape in Zambia, there is also a corresponding need to put in place a regulatory framework that will allow a wide array of institutions to reach the economically disadvantaged in our society and thus allowing them too, to take advantage of economic opportunities. Thus, before the proposed recommendations are under listed, a summary of each chapter will be given.

The first chapter of this paper, which gave a general introduction of the topic sought to emphasize the role of micro financing in poverty eradication and therefore, how developing nations across the glove can utilize it as a tool of economic development in addition to poverty eradication. This is especially so, in that microfinance shares a close relationship with Millennium Development Goals (MDGs). These were identified in chapter one as eradication of extreme poverty and hunger, achieving universal primary,
promoting gender equality and empowering women, combating HIV/AIDS, malaria, and other diseases, reducing child mortality and improving maternal health and ensuring environmental sustainability. Access to financial services provides the poor with means to make improvements in their lives, in other words, to achieve most of the MDGs on their own, in a sustainable way. Microfinancing in Zambia was introduced as a social safety net that would mitigate effects of Structural Adjustment Program (SAP) among the poor people of Zambia especially the women and youth. However, it was identified that of the ninety-eight known Institutions, only three MFI s are registered under the Banking and Financial Services Act. In addition, the microfinance regulations have not yet received the force of law, and as a result MFI s in Zambia are operating in an unregulated market. Thus there is need for an all-inclusive regulatory framework and supervising regime for MFI s in Zambia, which will ably serve the industry and accord financial services to the poor.

Chapter two which looked at microfinance regulation provided that microfinance regulation involves the rules governing the conduct of legal entities and individuals in this industry, whether adapted by a legislative body or an executive body. Regulation ought to be enabling. The purpose for enactment of regulations is to protect individual depositors where the MFI is taking the voluntary deposits and ultimately to safeguard the whole financial system. Thus, two forms of regulation were identified. Firstly, prudential regulation is aimed at protecting the financial of licensed businesses, in order to prevent financial system instability and losses to depositors. It involves the government in attempting to protect the financial soundness of the regulated institutions. Non-prudential regulation on the other had comes in to regulate and supervise credit-only institutions.
These institutions do not take in any deposits and thus require less burdensome regulation. Such non-prudential regulation can often be accomplished under general commercial laws, and administered by another body other than the central bank. When seeking to establish a new law for the purpose of microfinance regulation, as a general proposition, incorporation within the existing framework will better promote integration of the new licensed in the overall financial system. This approach may increase the likelihood that the regulatory changes are properly harmonized with the existing regulatory laws. However, local factors will determine the feasibility of this approach. Special attention must be devoted to the above factors by drafters of regulation of microfinance. The CGAP position in regulation and supervision of microfinance was also considered in this chapter.

The third chapter narrowed in to examine the situation on the ground, as it exists in Zambia. The key market players in the microfinance industry were identified and AMIZ was further identified as the representation body of MFIs in Zambia. Established out of the need for a coordinating body for the industry, AMIZ conducts various activities on behalf of MFIs registered under it. The Draft Microfinance Regulation which was drafted as an instrument to regulate all financial institutions in Zambia was highlighted in this chapter. However, this draft has raised a number of concerns among the concerned stakeholders, and the Bank of Zambia has thus invited comments to be made on the draft by the interested persons. It was suggested by the stakeholders that the draft as it exists will hinder and not enhance the growth of microfinance in Zambia, and therefore a number of amendments have since been proposed. The Bank of Zambia has under-taken
to look into the concerns of stakeholders at various workshops which it intends to conduct.

The fourth chapter sought to employ a comparative analysis of microfinance in Zambia and Uganda, with particular emphasis on the law regulating microfinance in the two countries. Uganda has come up with a law, which is currently in force for the purpose of regulating microfinance. Uganda, which has attempted to align its law with the CGAP recommendations on supervision and regulation of microfinance, has particularly provided that it’s Central Bank will be monitored by other institutions, such as AMIU or alternatively be ‘self-regulated’. It has recognized that the Central Bank may not have the financial capacity and manpower to regulate all institutions effectively. Indeed, Zambia can learn and draw from the Ugandan experience.

The challenge of coming up with microfinance regulations that will allow for a wide array of institutions to provide microfinance and not stifle the growth of the industry is incumbent on the Bank of Zambia who have the mandate of recommending the passing of the appropriate law. The Bank of Zambia is best suited and able to be the pacemaker in setting the parameters for sound and supportive microfinance regulation in Zambia.

In brief therefore and by way of emphasis, the following recommendations are proposed:

- Regulation by licensing and prudential supervision of financial institutions in Zambia should be restricted to those institutions that are taking in voluntary deposits from the public. Credit-only MFIs that merely lend out their own capital
should not be imposed with prudential regulation, as these institutions do not take in voluntary deposits. Such non-prudential regulation can be administered by other organisations other than the Bank of Zambia such as AMIZ. This is because the cost of effective supervision by the bank must also be taken into account. The bank may not have the capacity to regulate all financial institutions, which may result in an inadequate ineffective supervisory system. In addition to this the licence fees must not be too high as this may result in fewer institutions coming into the market as well as high interest rates being imposed on the lenders. Generally providing loans through microcredit is more expensive than the conventional means through the banks; this is because these institutions offer much smaller loans and at the same time need to cover the administrative costs. Consequently the poor will be unable to access these financial services;

- Registration of financial institutions with the Bank of Zambia should be restricted to formal institutions only. Informal institutions such as "shylocks" should not require to be registered with the bank. These are too remote to fall within the Bank of Zambia parameters; their success of failure is unlikely to affect the soundness of the financial sector;

- The authority and the powers of the Bank of Zambia should be limited. For instance, in matters relating to suspension and expulsion of institutions contravening the Act, this power should be subjected to a tribunal as provided for

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in the draft. This will allow for the affected MFI to make an appeal through the necessary authorities;

- The reporting system for MFIs to the bank should be distinguished from that required by the commercial banks. MFIs should not be subjected to tedious reporting systems as this may in effect increase the cost of operation of these institutions. MFIs should be allowed to focus on their clients who are the poor and vulnerable and not to be overburden with ensuring that they are keeping the supervisors informed of their manner of operation;

- Flexibility with limitations on foreign ownership or maximum shareholder percentages should be exercised. This will allow for the much needed investment especially in a liberated market economy as the microfinance business will attract conventional investors;

- The qualifications for those wanting to provide credit facilities to the poor should not be limited to individuals who have attained degree programs in accountancy and financial management as these institutions will not be taking in voluntary deposits from the public. Doing so will only limit the number of institutions offering this service and ultimately the number of beneficiaries. This high standard of performance and integrity on managers and officers of MFIs should be restricted to the institutions that are taking in deposits.
REPORTS AND ARTICLES


CGAP Position Paper: Regulation and Supervision of Microfinance, October 2002


LEGISLATION


WEBSITES

www.cgap.org

www.microserve.com