Regulatory Framework of Financial Institutions

A Zambian Perspective

Dr. Lubinda Haabazoka



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REGULATORY FRAMEWORK OF FINANCIAL INSTITUTIONS: A ZAMBIAN PERSPECTIVE

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Regulatory Framework of Financial Institutions: A Zambian Perspective
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Peer review by Dr. P. Kamanga, Lecturer and Head of Department – Business Administration and Marketing, Copperbelt University, Kitwe, Zambia
Dr. S. Kapena, Senior Lecturer and Dean of the School of Business, Copperbelt University, Kitwe, Zambia
Prof. T.K. Taylor, Professor and Dean of the School of Graduate Studies, Copperbelt University, Kitwe, Zambia

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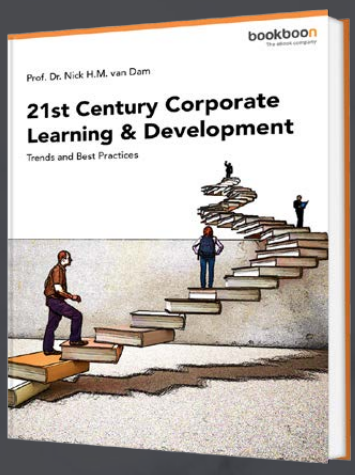

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PREFACE

Regulatory Framework for Financial Institutions – a Zambian Perspective introduces, illustrates, and discusses the many aspects of financial institution regulation. This book is unique in that it explains how all the different segments of financial markets are regulated. It first introduces the financial system and explains the various boundaries that exist within the financial system. This book is also rich on financial institution regulation theory as it explains objectives, principles and tools for financial institution regulation. It also uses the Zambian legal framework to explain how various institutions like banks, insurance companies, security markets and pension funds are formed, regulated and dissolved.

The main purpose of this book is to explain the structure and purpose of the financial system from a regulatory perspective, explain the theories and objectives of financial institution regulation, examine the principles of financial institution regulation, explain the structure of regulation of financial markets in Zambia, give an understanding on the formation, operations and winding up of major types of financial institutions and to examine the prevention of financial crime and money laundering .

This book is intended for undergraduate and post graduate scholars taking courses such as Banking Law, Business Law, Regulatory Framework for financial institution or any other related subjects. It can also act as a guide for students taking courses such as “Insurance”, “Banking Operations” and “Money and Capital Markets”. This book can also be of interest to investors wishing to set up financial institutions in developing countries whose law is based on the British law. It can also be used by researchers in the field of financial institution regulation.

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1 OVERVIEW OF THE FINANCIAL SYSTEM

1.1 INTRODUCTION

This introductory chapter explores the roles and contributions that different types of financial institutions make to the efficiency and effectiveness of an economy. This Chapter discusses the following:

- Structure of the financial system
- Financial Markets
- Financial Market promises
- Financial Market Participants
- financial system boundaries

1.2 STRUCTURE OF THE FINANCIAL SYSTEM

Financial Systems

The financial system of a country can be defined as a collection of financial institutions, regulatory framework and financial market infrastructure that enables financial resources to move from individuals and companies with surplus resources to those with deficit ones. The overall contribution of the financial system to the economy is that of channeling or converting savings into investments.

Financial systems consist of markets and participants:

Markets

A market in any economy provides for goods and services to be exchanged or traded. Financial Markets can be defined as the economic relationship between buyers and sellers with regards to the buying and selling of financial instruments. In financial markets, instruments that are traded can be characterized as promises because any financial claim can be viewed as a promise to deliver specified payments at specified times, under specified circumstances. The promises traded in financial markets can be classified into 4 generic types:

a) Debt promises.
b) Equity promises.
c) Contingent promises.
d) Derivate promises.

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a) *Debt promises* – involve promises to pay fixed kwacha amounts at fixed dates in the future. Debt promises include: deposits, government treasury bills, commercial paper, corporate bonds, mortgages, loans etc.
b) *Equity promises* – are claims over the residual earnings of a business. Equity promises include common stock, partly paid shares and preference shares.
c) *Contingent promises* – are promises to make specified payments under specified circumstances. Contingent promises include all forms of insurance, warranties and guarantees.
d) *Derivative promises* – are promises to enter into transactions involving physical commodities, debt or equity promises at a future point in time at prices determined at the time of entering the derivative contract, e.g. options, futures, swap, forwards.

Participants

Participants of both the local and international financial markets include households, business entities, Central governments and their agents, international financial organizations like the World Bank, International Monetary bank etc. A broader perspective of financial market participants would also include regulators such as the Bank of Zambia, Securities Exchange Commission, Insurance and Pensions Authority, Basel Committee on Bank Supervision etc.

For the purpose of this book, it will be helpful to classify institutions by the services they provide:

i. Deposit taking institutions.
ii. Risk pooling institutions.
iii. Contractual savings institutions.
iv. Market makers.
v. Specialized sectoral financers.
vi. Financial service providers.

i. *Deposit taking institutions* are institutions that accept demand and fixed term deposits from households, business entities, governments etc. These include: Commercial banks, Building societies, credit union. Commercial banks are the only deposit taking financial institutions that can provide a group of services which include:

- Taking or accepting deposits from legal entities and citizens;
- Converting deposits into loans;
- Debiting or crediting clients' accounts on their instruction.

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ii. *Risk pooling institutions* are institutions which specialize in providing contingent promises by underwriting economic risks associated with death, illness, damage to or loss of property, and other exposure to loss. Insurance companies are an example of a risk pooling institution. Insurance companies issue contingent liabilities against themselves in the form of insurance policies. Insurance companies can be divided into life insurance and general insurance (non-life or property and casualty insurance).

iii. *Contractual savings institutions* are vehicles that provide contractual saving services in a fiduciary rather than principal role. Also known as collective investment vehicles, contractual savings institutions invest pooled resources of individuals and firms into a wide range of equity, debt and derivative promises. There are two main types of collective investment vehicles:

- Open – end mutual funds whose participation is open to anyone.
- Closed-end mutual funds which are not open to everyone.

Pension funds are simply mutual funds that satisfy legislated conditions for retirement savings.

Unlike deposit taking institutions, collective vehicles provide equity promises rather than debt promises.

iv. *Market makers* are participants in financial markets who make secondary markets in securities such as equities, government and corporate debt and derivatives by taking principal positions as buyers and sellers of existing securities. Security dealers include: investment banks, stock brokers and other financial institutions.

v. *Specialized sectoral financers* are financial institutions that provide a limited range of financial services to specialized target of promisors and promises. For example, General finance companies raise funds via debt promises from the wholesale finance market and on-lend them to borrowers. Real estate finance companies specialize in channeling funds to home ownership. Leasing companies specialize in providing finance for equipment. The distinguishing characteristic of leasing companies is that they retain ownership of the leased assets. They also benefit from the preferred tax treatment that is often conferred on the investment treatment. In each of the cases, financial institutions provide a highly specialized service that concentrates on informationary efficiency. Their promises are generally of a debt nature, although equity components are not uncommon.

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vi. *Financial service providers* unlike other financial institutions are service providers that tend not to intermediate between promisors and promisees. They rather provide their services on a fee-for-service basis in form of advice, brokering etc. This group includes: specialized securities brokers, Mortgage brokers, management consultants, and investment advisors.

Table 1.1 summarizes the relationship between the financial institution groupings and their provision of core financial services.

Core financial services	Deposit Takers	Risk poolers	Contractual Savers	Market markers	Sectoral financers	Service providers
Payments	√					
Liquidity	√		√	√	√	√
Divisibility	√	√	√		√	
Store of value	√	√	√			
Information	√	√	√	√	√	√
Risk pooling	√	√				

Table 1.1: Summary of Institutional groups and core financial services
Source: Carmicheal and Pomerleano (2002)

1.3 FINANCIAL SYSTEM BOUNDARIES

Many economists argue that boundaries between the insurance industry, banking sector, pension industry and the securities market no longer exist because financial institutions belonging to these separate different industries are increasingly engaging in each other's activities as competition grows and the appetite to make profits increase. However it should be noted that these boundaries continue to exist because you find different regulators for each category of financial institutions in many countries including Zambia. Table 1.2 below outlines the difference between these institutions.

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Category:	Finance	Credit
Distinguishing feature	Involves one way movement of resources. Second way is optional depending on the occurrence of certain conditions.	Two way movement of resources
Instruments	Common stock, Preferred Stock, Insurance, Pensions,	Loans, Bonds, Leases, Treasury bills, Commercial paper, Mortgages
Market Participants	Pension Funds, Insurance Companies, Stock Markets	Banks, Leasing Companies, Credit Unions, Building Societies, Microfinance Institutions
Notable Regulators	Pension and Insurance Authorities, Security exchange commissions.	Central Banks

Table 1.2: Differences between different financial groups
Source: Author



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All financial institutions sell instruments that fall under any of the two categories of Finance and Credit. Financial instruments are characterized by a one way movement of resources with the second movement depending on the occurrence of certain circumstances. For example, when insurance companies sell insurance to a car owner, the owner of the car pays the insurance company a premium. Money moves from the insured to the insurance company. The money will only go back to the insured from the insurance company in the event that something stipulated under the insurance contract occurs to the car otherwise, the insurance company will keep the premium as profit. In the credit category for example, it is mandatory for money to move two ways. First, the lender (bank) gives the borrower a loan. The borrower is mandated to pay back both the principal and the interest at stipulated times to the lender. The same is true for bonds, treasury bills, leases and even commercial paper. For equity that falls under the finance category, the investor gives a company their money in form of investments into that company. The condition for that investor receiving back their money is when the company makes a profit and the company pays out dividends. The other option is for the investor to sell their shares on the stock market provided there are people willing to buy those shares.

1.4 REVISION QUESTIONS

1. Explain the nature of financial systems
2. Explain the structure of the financial system
3. Explain what financial markets are and the financial market promises they make
4. Mention and discuss the different financial market participants
5. Explain for the purpose of regulation the financial system boundaries

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2 OVERVIEW OF FINANCIAL INSTITUTION REGULATION

2.1 INTRODUCTION

Regulation of financial institutions remains one of the most important tools for safeguarding economic stability in any country's economy. This chapter provides an understanding of the following:

- Definitions of regulation
- Principles of financial institution regulation
- Theory regarding the objectives of financial institution regulation
- Structure of financial institution regulation
- Regulatory backing and tools needed by a regulator to implement financial institution regulation

2.2 THE PRICIPLES OF REGULATION

Definition of regulation

A regulation is a rule designed to control the conduct of those to whom it applies. Regulations are fundamentally rules of behavior. Regulations of financial institutions therefore are rules that are designed to control bank and non bank financial institutions' conducts. Regulations of financial institutions differ between countries; nonetheless, the main objective of regulation is to control activities taking place in a country's financial market.

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Principles of financial institution regulation

The regulatory principles followed by regulators of financial institutions in different countries include:

i. *Role of management:* regulatory measures on the senior management of the financial institutions so that they do not take decisions that are detrimental to the financial market.
ii. *Innovation:* innovation should be facilitated with restriction so that the financial products and services launched are compliant to the rules and regulations.
iii. *International aspects:* strict monitoring should be there to see whether the internal standards are maintained or not.
iv. *Efficiency and economy:* the financial resources of a country should be used in the most prudent and effective way.
v. *Proportionality:* the financial regulations that are imposed should be proportional to the advantages that are anticipated from the regulations.
vi. *Competition:* there should be strict supervision on the financial market for the purpose of minimizing harmful effects of competition.



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2.3 REGULATORY STRUCTURE

The regulatory framework for financial institutions has four main components:

1. ***Regulatory objectives***

There exist different theories relating to regulatory framework objectives. Merton (1990) stated that, regulation is fundamentally about promotion of economic efficiency since the core function of the financial system is to facilitate the allocation and deployment of economic resources. Conventional wisdom recognises that while theory may identify economic efficiency as the overriding objective of financial regulation, in practice regulators usually attempt to achieve multiple objectives; for example, Herring and Santomero (1999) identified four broad objectives for financial regulation which include:

a) Safeguarding the system against systemic risk.
b) Protecting consumers against opportunistic behavior by suppliers of financial services.
c) Enhancing the efficiency of the financial system.
d) Achieving a range of social objectives, e.g., increasing homeownership or channeling resources to particular sectors of the economy or population.

Against the 4 objectives, Herring and Santormero outlined a rage of measures or tools that regulators use in th`eir efforts to meet objectives. The measures include: Antitrust/competition policy, disclosure standards, conduct of business rules, conflict of interest rules, capital adequacy standards, fit and proper entry tests, Liquidity requirements, reporting requirements, Restrictions on services, deposit insurance, Asset restrictions, Reserve requirements, etc.

Another view of regulatory framework objectives known as the alternative framework acknowledges that financial markets work effectively although some failures can exist hence regulation exists only to reduce market failures. In broad terms according to this alternative framework, financial markets fail to produce efficient, competitive outcomes because of the following reasons:

a) Anticompetitive behaviour.
b) Market misconduct.
c) Information asymmetry.
d) Systemic instability.

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a) *Anticompetitive behaviour*

Market forces are the main determinant of competition. The role of competition regulation is to ensure that market forces operate effectively and are not circumvented by market participants. The following key measures are used in competition policy:

- Rules designed to deal with the structure of industries e.g. merger or antitrust laws.
- Rules designed to prevent anticompetitive behavior such as collusion.
- Rules designed to ensure that markets remain contestable (by ensuring that there is relatively free entry and exit).

b) *Market misconduct*

The two areas of misconduct in financial markets are fraudulent conduct by market participants and inadequate disclosure on which to base investment decisions. Regulation to address these sources of market failure is usually referred to as market integrity regulation. Market integrity focuses on the following:

- Disclosure of information.
- Conduct of business rules, e.g., prohibiting insider trading, market manipulation, false and misleading advertising.
- Entry restrictions through licensing.
- Governance and fiduciary responsibilities.
- Some conditions of minimal financial strength like capital requirements.

c) *Information Asymmetry*

Information asymmetry arises where products or services are sufficiently complex that disclosure by itself is insufficient to enable consumers to make informed choices. It arises when one party has more information than the other.

The form of regulation for asymmetric information counteracting is referred to as prudential regulation. Prudential regulation is an appropriate legal framework for financial operations aimed at preventing or minimizing financial sector problems. Prudential or preventive regulation involves the imposition of prescriptive rules or standards governing the prudential behavior of financial institutions making certain types of promises. These rules may be directed at specific areas of concern or directed more towards minimizing the risk that financial institutions may be unable to honor the financial promises that they have made.

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Most modern prudential regulators use the following measures:

- Entry requirements;
- Capital requirements;
- Balance sheet restrictions, e.g., reserve requirement;
- Restrictions on associations among financial institutions;
- Liquidity requirements;
- Accountability requirements;
- Customer support schemes such as deposit insurance and industry guarantee funds.

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d) *Systemic instability*

The fourth main source of market failure is systemic instability. Systemic instability arises where failure of one institution to honour its promises leads to a general panic as individuals fear that similar promises made by other institutions may also be dishonored. The primary defense against systemic instability is the maintenance of a sustainable macroeconomic environment with reasonable price stability in both product and asset markets. Measures used to combat systemic instability include both macroeconomic and prudential measures, lenders-of-last-resort facility and direct regulation of the payment systems. Lender of last resort facility provides an external source of liquidity funding to the financial system. Regulation of the payment systems enables proper per settlements among banks, settlement of securities, settlements of foreign exchange etc.

2. *Regulatory structure*

The regulatory structure discusses the models or structures of agencies that carry delegated regulatory responsibilities of the community.

There are two different models of regulatory structure:

a) *Institution based regulatory structure*: involves the establishment of separate agencies to regulate different institutional groups.
b) *Function based regulatory structure*: involves the establishment of separate agencies to regulate different sources of market failure.

a) **Institutional based model**

The traditional approach to regulation has been institutional, assigning separate agencies to each of the prudentially regulated institutional groups such as banks, insurance companies, securities dealers and in some cases pension's funds. In this model, the institutional regulator is responsible for:

- Regulating the prudential behavior of the institutions in its group.
- Regulating their market conduct.
- Competition regulation.

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The challenges facing the institutional based model include among others:

i. The emergence of financial conglomerates in which bank and non bank institutions establish conglomerate company structures or group of companies. The holding company structures that controls the subsidiaries become difficult to regulate.
ii. Regulatory arbitrage where different institutional regulators cannot coordinate to regulate financial institutions with overlapping operations.
Responses to the challenges of conglomerates and regulatory arbitrage have seen the emergency of 3 main regulatory models:

- The lead regulator model
- The integrated institutional regulator model
- The functional regulator model (which is the *Function based regulatory structure*).

Lead regulator model: This model calls for one institutional regulator who takes responsibility for the group as a whole as well as coordinating amongst the regulators involved, thereby becoming the defacto conglomerate regulator.

Integrated regulator model: This model calls for the covering of a wide range of regulatory structures that combine all prudential regulation, market conduct regulation and systemic regulation under one roof. The integrated regulator institution (also called super regulator), minimizes regulatory arbitrage. Singapore is one such country with a super regulator for all institutions – the Monetary Authority of Singapore.

b) ***The functional regulator model (Function based regulatory structure)****:* This form of regulation is in response to the four sources of market failure, which calls for separate regulators:

- one for competition;
- one for market conduct;
- one for asymmetric information;
- one for systemic stability.

The distinguishing feature for this model is that each regulator regulates a single function regardless of the institutions involved. For example, the competition regulator is responsible for competition issues for banks, insurance companies and security dealers as well as for all other sectors in the economy. Austria is the only country to adopt this model in full.

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Selecting the appropriate regulatory structure

There is no ideal regulatory structure that fits all financial systems. Where financial systems are largely bank based, the lead regulator model is appropriate because the regulator is unlikely able to face institutional blurring. Where financial systems have bank and non-bank institutions with overlapping operations, the integrated model is most appropriate.

3. *Regulatory backing*

Regulatory effectiveness refers to how well and how cost effectively the regulator of a particular intermediary group meets its objective of counteracting market failure. There are two issues that effectiveness of regulation depends on:

i. The backing or support available to the regulator.
ii. Regulatory implementation.



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Regulatory backing

The critical support issues that affect a regulators capacity to function effectively includes: political support, appropriate legislation backing, adequate funding, appropriate skills and appropriate review process. These backing requirements constitute a set of preconditions for effective regulation.

Political support: It is fundamentally important that government and regulators share a common philosophy. This means that:

- Sharing a common view about roles and objectives of regulation.
- Keeping open the channels of communications so government is aware of issues facing the regulator.
- Having clear lines of responsibility and accountability between the regulator and the government.

Legislative backing: The fundamental backing that any regulator needs is the legal power to carry out its functions effectively. The powers required by a regulator to meet its objectives may vary according to nature of the market failure involved. For legislative backing of a regulator whose primary focus is market integrity, the powers include:

- Regulate disclosure for securities and retail investment products;
- Regulate market conduct to promote orderly and efficient price discovery, trading and securities settlements;
- Determine the incensing and oversight conditions of financial institutions and organized exchanges;
- Regulate investment advice and market participants;
- Regulate the establishment and compliance of collective investment schemes;
- Regulate the conduct dealings with consumers and the prevention of fraud;
- Take injunctive action against the operations of suspected fraud;
- Seize and dispose of assets acquired by fraud;
- Approve and oversee industry codes of conduct;
- Delegate accreditation and disciplinary functions to self-regulatory bodies where appropriate;
- Set benchmarks for the performance of self-regulatory bodies.

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The legislative backing for a regulator whose primary focus is competition regulation typically includes the following powers:

- Establish rules dealing with the competitive structure of industries;
- Prevent mergers of financial institutions;
- Force divestiture where industry concentration becomes uncompetitive;
- Prohibit collusion on the price or nature of promises made by financial institutions.

With prudential regulation, the cost of market failure due to asymmetric information needs effective power of enforcement which includes:

- To inspect;
- To request information;
- To direct;
- To remove directors and auditors;
- To suspend operations;
- To appoint an administrator;
- To transfer engagements.

Funding*:* A fundamental precondition for effectiveness is adequate funding. Without adequate resources, the regulator will be unable to attract staff, undertake inspections etc. There are two main models for funding regulatory agencies:

i. Allocating resources to the regulator through the government's budget.
   Advantage
   Imposes the cost of regulation on tax payers who are the beneficiaries of regulation.

   Disadvantage
   Regulators are forced to compete with social programs for funding in every budget.

ii. Recovering the cost of regulation from industry levy.
   Advantage
   It removes regulator's funding from budget process hence creating consistency in funding.

   Disadvantage
   The cost of regulation falls not on the beneficiaries but not on the regulated industry itself.

Skill base – An effective regulator requires sound regulatory culture among its staff and an appropriate set of skills to deal with extremely complex issues.

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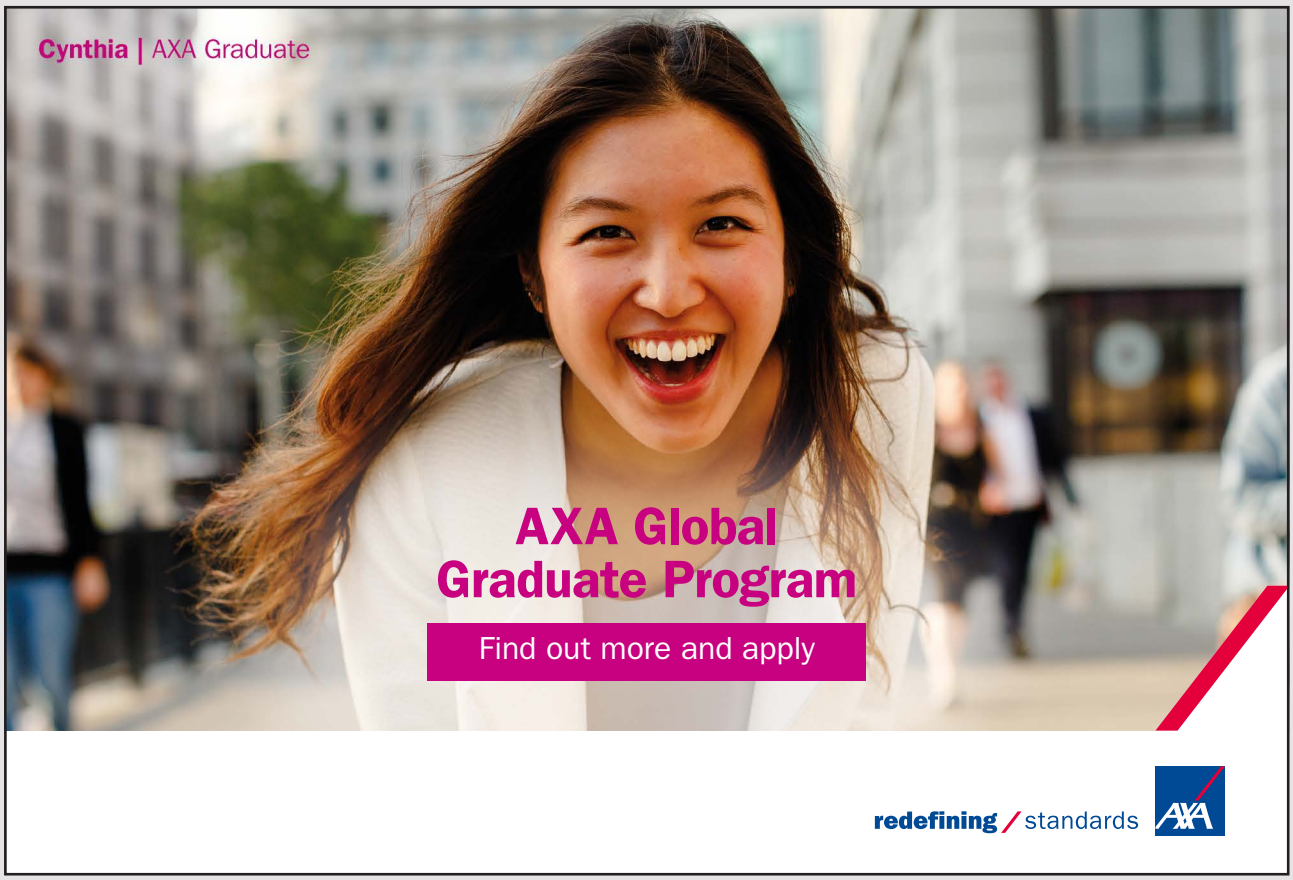
Regular review – The most important steps that can be taken towards maintaining an appropriate balance between effectiveness and efficiency are to include efficiency as an explicit objective in the regulators charter and to mandate a process of periodic reviews possibly including representatives from the regulator the industry and the government.

4. *Regulatory implementation*

Regulatory effectiveness depends both on the backing available to the regulator and the methods or tools used by the regulator to implement its regulatory powers and responsibilities. Tools used by the regulator can be broken down into 4 main categories:

i. Preconditions for entry into the market (licensing ownership restrictions and capital requirements).
ii. Ongoing conditions for continued participation in the industry (market structure requirements, liquidity requirements etc.).
iii. Surveillance methods (complaint mechanisms, monitoring, inspectors).
iv. Enforcement practices (prosecution, problem resolution, support schemes).



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i. Preconditions for entry

There are three tools used for implementation in this category:

Licensing

Licensing is the most basic form of entry restriction and provides a minimum level of assurance to consumers of institutions services that institutions will not take advantage of them through manipulation of the institutions' activities. Licenses safeguard by providing traceable record of the firm's location, owners and management. Licensing restricts through the following:

- Requiring professional qualifications or accreditation of staff and management;
- Requiring a detailed business plan;
- Requiring enforceable undertakings by directors with respect to certain actions or situations;
- Requiring the license holder to submit to various forms of ongoing regulation;
- Imposing "fit and proper" tests on directors, management or staff;
- Imposing ownership restrictions, including limiting or prohibiting the issue of licenses to certain groups;
- Imposing minimum size restrictions.

Ownership restrictions

As a form of entry requirement, ownership restrictions are often imposed as a means of counteracting the anticompetitive effects of the other elements of entry restrictions particularly in the case of high – intensity promises.

Many countries for example restrict the issue of banking licenses to institutions that do not hold other financial service licenses; others prohibit the issue of licenses to foreign entities. Some counties limit ownership of a financial institution by a single regulator (so that one bank is not controlled by a small group to benefit themselves). Some countries limit direct shareholding by commercial enterprises.

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Capital requirements

Capital requirements generally take one of the two forms:

- Minimum size requirements (they save as a deterrent to fraud by putting a high cost on the loss of a license);
- Variable capital adequacy requirements (to absorb unexpected losses).

ii. Ongoing regulatory requirements

These requirements include continuous observance of license conditions, including any ownership and capital requirements.

Additional ongoing regulatory tools include:

1. *Market structure requirements:* These are requirements which are primarily needed for the preserve of competition regulation and include controlling mergers, forcing divestiture to break up existing institutions and granting exemptions from these measures for prudential purposes.
2. *Anti-collision rules*: These are rules aimed at reducing price fixing, predatory pricing or collusion among buyers or sellers to set the price.
3. *Contestability rules:* These are rules aimed at providing free entry and exit for participants.
4. *Disclosure:* General disclosure regulation includes ongoing disclosure of material information, disclosure of fees and commissions. It also includes:
    - Rules governing the release of accounting data disclosing the general financial health of institutions;
    - Prospectus provisions governing the information required for capital raising;
    - Special reporting to regulatory bodies.

5. *Market conduct rules:* These are regulatory tools that are to meet objectives which include placing prohibitions on prosecuting those who engage in insider trading, market manipulation, false and misleading advertising and fraud.
6. *Governance and fiduciary rules:* This regulation uses tools which encourage good governance, e.g.:
    - Independent auditors;
    - Appointment of a minimum percentage or number of directors who are independent of management;
    - Appointment of an independent custodian with clear hypothecation and segregation of customer/client assets;

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- Independent valuation of assets;
- Limits on pricing and fees that can be charged for certain services;
- Rules to limit other conflicts of interest, including limits on related party transactions.

7. *Balance sheet restrictions*: These are restrictions used to reduce net exposure of the total balance sheet. Restrictions include:
   - Limits on assets/liability mismatches;
   - Prohibitions on particular classes of assets or liabilities;
   - Restrictions on the type of assets held;
   - Mandated maximum or minimum holdings of particular assets.

8. *Associations among financial institutions*: These are regulations that limit associations among financial institutions to interfere with the natural workings of the market. Many countries attempt to segregate the following:
   - Deposit taking from insurance;
   - Deposit taking from securities dealing;
   - Securities dealing from securities brokering;
   - Various combinations of these and other segregation.

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9. *Liquidity requirements:* These are requirements designed to ensure that a regulated institution has funds available to meet any undertakings it has made concerning the liquidity of its promises.
10. *Accountability requirements:* These are requirements that usually take the form of restricting on the valuation of assets and liabilities.

iii. Surveillance

In addition to establishing rules of behaviour, regulators need to monitor industry's compliance with the rules. There are 3 basic methods for monitoring compliance with rules:

1. Consumer complaints mechanisms;
2. Off-site monitoring;
3. On-site inspections.

1. *Consumer complaints mechanism* is least intrusive and less costly approach to surveillance and relies on direct complaints by consumers.
2. *Off-site monitoring* – involves statistical and other reviews of data provided by the regulated institutions. The general objective of off-site analyses is to detect deterioration in an institutions financial position by comparing its current position to its historical experience and to that of its peer. Some prudential regulators use statistical techniques including linear regression, logit and and probit analysis, discriminant analysis, and even artificial neural networks to detect the probability of financial distress.
3. *Inspections* – on-site inspections are a time and resource intensive way of testing an institution's compliance with regulations. There are two types of approaches used in on-site inspections:

    - United States Approach – in which large teams of inspectors spend long periods of time sifting through a comprehensive review of most areas of regulatory compliance.
    - British Approach – where small teams spend relatively short periods of time reviewing specific issues identified by off-site analysis.

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iv. Enforcement

Techniques available to regulators to resolve problems with regulated institutions range from prosecution of those that fail to observe regulations through to preemptive action to change behavior or force mergers and industry exists. The three tools used to enforce regulation include:

1. Prosecution of the offender.
2. Preemptive problem resolution – where the regulator intervenes and demands to the financial institution to solve raised problems.
3. Support schemes – where deposit insurance and statutory guarantee funds for insurance or securities firms are employed by many regulators to back up the promises made by regulated institutions in the event that other preventive measures fail.

2.4 REVISION QUESTIONS

1. Give definitions of regulation
2. Explain the principles of financial institution regulation
3. Discuss various theories regarding the objectives of financial institution regulation
4. Explain the structure of financial institution regulation
5. Explain the types of regulatory backing and tools needed by a regulator to implement regulation

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3 CENTRAL BANK REGULATION

3.1 INTRODUCTION

Central banks remain an important participant of any modern economy. Central banks together with government have a responsibility to ensure that the economy is running smoothly by using both administrative and economic tools at their disposal. This chapter provides and understanding of the following:

- Definitions of Central Banks
- Rationale for Central Bank Regulation
- Central Bank Independence
- Central Banking around the World
- Functions of Central Banks
- The Bank of Zambia Act



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3.2 RATIONALE FOR CENTRAL BANK REGULATION

Definitions of Central Bank

A Central Bank is a generic term given to a country's primary monetary authority. It is the entity responsible for overseeing the monetary system of a nation (or group of nations in the case of the European Union) and has a wide range of responsibilities such as issuing currency, regulating the credit system, managing exchange reserves etc.

Rationale for Central Bank regulation

There are two classic arguments for Central Bank regulation:

1. First, Central Bank regulation protects small and unsophisticated depositors. Given their small size and fragmentation, individual depositors do not have the ability to monitor whether bank managers are acting prudently and on their behalf. The regulator in such cases represents the depositors. Capital regulation and the requirement to inject new capital when necessary or face closure may be a way to create the incentives present in non-financial firms for managers to act on behalf of shareholders.
2. The second rationale stems from the need to protect the payments systems and the financial systems more generally. For example, on certain occasions, otherwise solvent banks may be subject to pure liquidity runs. If depositors run against a weak bank, they may also run against a healthier bank in the system, in what is known as contagion. One way to prevent such runs is for the Central Bank to promise liquidity to solvent banks – that is for the Central Bank to provide lender of last resort services.

Central Bank Independence

Central Bank independence can be defined as the Central Bank's operational and management independence from government. There are many arguments regarding the rationale for Central Bank independence. The first school of thought against Central Bank independence postulates that too much freedom given to a Central Bank can lead to its inability to perform regulatory functions because:

- Freedom (independence) puts too much power in the hands of unelected Central Bank directors;
- Independence has no provision to replace bad directors;
- Independence makes it difficult to coordinate fiscal and monetary policy as the Central Bank and parliament can have different agendas.

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The school of thought in favour of the Central Bank's independence posits the following reasons:

- Politicians may lack the economic expertise of bankers;
- The Minister of Finance may pressure the Central Bank to buy new treasury bills financed by printing new money (common in third world countries);
- Since the Central Bank does not worry about re-election, it can pursue unpopular but wise policies.

There are four types of Central Bank Independence:

1. *Operational Independence* – provides the Central Bank the right to determine the best way of achieving its policy goals, including the types of instruments used and the timing of their use. This is the most common form of Central Bank independence.
2. *Legal Independence* – is the independence of the Central Bank backed and defined by law. In democratic states, this type of independence is limited because the Central Bank is accountable at some level to government and parliament.
3. *Management Independence* – provides the Central Bank the authority to run its own operations like appointing staff without excessive involvement of the government.
4. *Goal Independence* – provides the Central Bank the right to set its own policy goals, whether inflation targeting, control of money supply, or maintaining a fixed exchange rate. While this type of independence is more common, Central Banks prefer to announce their policy goals in partnership with the appropriate government departments. This helps avoid situations where monetary and fiscal policy are in conflict.

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3.2 CENTRAL BANKING AROUND THE WORLD

For hundreds of years, central banks have been evolving in their assigned tasks, their relationship to the state, their interaction with financial market participants, and their internal management and decision-making processes. The world's oldest existing central bank, Sweden's Riksbank, opened its doors in 1668. The Bank of England began operating in 1694. But although evolution of central banking is nothing new, the past two decades have seen enormous changes in central banks and their practices, especially in reforms of how those banks are governed. The reforms have differed across countries. In some countries like the United Kingdom, for example, older institutions have been fundamentally restructured. In other countries, entirely new central banks have been established. For instance, since the fall of the Berlin Wall in 1989, central banks have been created in countries that were formerly part of the Soviet Union. In Europe, the member countries of the European Union created a supranational central bank that oversees a monetary union. In all of these situations, central bank law was either revised or re-written while institutional objectives, practices, and structures were amended or created from scratch. The following are some of the major Central Banks around the world:



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- U.S. Federal Reserve System (The Fed)
  The Federal Reserve is probably the most influential central bank in the world. With the U.S. dollar being on the other side of approximately 90% of all currency transactions, the Fed›s sway has a sweeping effect on the valuation of many currencies. The group within the Fed that decides on interest rates is the Federal Open Market Committee (FOMC), which consists of seven governors of the Federal Reserve Board plus five presidents of the 12 district reserve banks. The Fed's mandate is to maintain long term price stability and sustainable growth.

- European Central Bank (ECB)
  The European Central Bank was established in 1999. The Governing Council of the ECB is the group that decides on changes to monetary policy. The Council consists of the six members of the executive board of the ECB, plus the governors of all the national central banks from the 12 euro area countries. As a central bank, in planning on making changes to interest rates, the ECB will generally give the market ample notice by warning of an impending move through comments to the press. The mandate of the ECB is to maintain price stability and sustainable growth. However, unlike the Fed, the ECB strives to maintain the annual growth in consumer prices below 2%. As an export dependent economy, the ECB also has a vested interest in preventing against excess strength in its currency because this poses a risk to its export market.

- Bank of England (BoE)
  The Monetary Policy Committee of the Bank of England is a nine-member committee consisting of a governor, two deputy governors, two executive directors and four outside experts. The Bank of England is frequently touted as one of the most effective central banks in the world. Its mandate is to maintain monetary and financial stability. The BoE's monetary policy mandate is to keep prices stable and to maintain confidence in the currency. To accomplish this, the central bank has an inflation target of 2%. If prices breach that level, the central bank will look to curb inflation, while a level far below 2% will prompt the central bank to take measures to boost inflation.

- Bank of Japan (BoJ)
  The Bank of Japan's Monetary Policy Committee consists of the BoJ Governor, two deputy governors and six other members. Because Japan is very dependent on exports, the Bank of Japan has an even more active interest than the European Central Bank does in preventing an excessively strong currency. The central bank has been known to come into the open market to artificially weaken its currency by selling it against U.S. dollars and euros. The Bank of Japan is also extremely vocal when it feels concerned about excess currency volatility and strength. The main mandate of the Bank of Japan is to maintain price stability and to ensure stability of the financial system, which makes inflation the central bank's top focus.

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- Swiss National Bank (SNB)
  The Swiss National Bank has a three-person committee that makes decisions on interest rates. Unlike most other central banks, the Swiss National Bank determines the interest rate band rather than a specific target rate. Like Japan and the euro zone, Switzerland is also very export dependent, which means that the Swiss National Bank also does not have an interest in seeing its currency become too strong. Therefore, its general bias is to be more conservative with rate hikes.

  The SNB's mandate is to ensure price stability while taking the economic situation into account.

- Bank of Canada (BoC)
  Monetary policy decisions within the Bank of Canada are made by a consensus vote in the Governing Council, which consists of the Bank of Canada Governor, the senior deputy governor and four deputy governors. The mandate of the BoC is maintaining the integrity and value of the currency. The central bank has an inflation target of 1–3%, and it has done a good job of keeping inflation within that band since 1998.

- Reserve Bank of Australia (RBA)
  The Reserve Bank of Australia's Monetary Policy Committee consists of the central bank governor, the deputy governor, the secretary to the treasurer and six independent members appointed by the government. The mandate of the RBA is to ensure stability of currency, maintenance of full employment and economic prosperity and welfare of the people of Australia. The central bank has an inflation target of 2–3% per year.

- Reserve Bank of New Zealand (RBNZ)
  Unlike other central banks, decision-making power on monetary policy ultimately rests with the central bank governor. The mandate of the RBNZ is to maintain price stability and to avoid instability in output, interest rates and exchange rates. The RBNZ has an inflation target of 1.5%. It focuses hard on this target, because failure to meet it could result in the dismissal of the governor of the RBNZ.

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3.3 FUNCTIONS OF CENTRAL BANKS

Most Central and Reserve Banks perform the following functions:

1. *Sole right of note issue* – The Central Bank in every country (except for countries in economic unions like European Union) has the monopoly to issue bank notes. The issue of bank notes is governed by regulations enforced by the state.
2. *Banker to the state* – The Central Bank acts as banker to the government. It holds cash balances of the government free of charge.
3. *Banker's bank* –the Central Bank acts as a banker to the commercial banks.
4. *Banker's clearing house* – the Central Bank acts as a clearing house for settlement of mutual obligations of different commercial banks.
5. *Lender of last resort* – the Central Bank helps commercial banks in times of crisis.
6. *Financial agent* – the Central Bank acts as financial agent for the government. It is an agent for the government in purchasing and selling of gold and foreign in exchange.
7. *Other functions include:* registry provision, debt management, asset management, development functions, research, statistics and consumer services.

Central bank functions can be grouped as shown in Table 3.1.



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1. Monetary stability functions	**Monetary policy**
	Exchange rate policy
2. Financial stability & regulatory functions	Prudential policy development
	Supervision oversight
3. Policy operation functions	FX intervention
	FX reserves
	Liquidity management
	Lender of last resort
4. Financial infrastructure provision functions	Currency provision
	Banking /account management services
	Payment systems (inter banking)
	Settlement system for Central Bank money
	Other settlement systems
	Registry provision
5. Other public good functions	Debt management
	Asset management
	Development functions
	Research
	Statistics
	Consumer services

Table 3.1: Classification of Central Bank Functions
Source: Pomerleano M., Carmicheal J., 2002

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In Zambia, Central Bank functions are performed by the Bank of Zambia established under section 3 of the Bank of Zambia Act, 1985. The functions performed by the Bank of Zambia are stipulated in the Bank of Zambia Act of 1996 enacted by parliament. These functions include:

1. License, supervise and regulate the activities of banks and financial institutions so as to promote the safe, sound and efficient operations and developments of the financial system;
2. Promote efficient payment mechanisms;
3. Issue notes and coins to be legal tender in the Republic and regulate all matters relating to the currency of the Republic;
4. Act as banker and fiscal agent to the Republic;
5. Support the efficient operation of the exchange system;
6. Act as advisor to the government on matters relating to economic and monetary management.

3.5 THE BANK OF ZAMBIA ACT

The current Bank of Zambia Act was revised and enacted by parliament on 12 December 1996. The Bank of Zambia Act is the legislative piece on which the Bank of Zambia was formed. It contains eight parts which can be broken down as follows:

Part 1: PRELIMINARY

This is the preliminary part and contains two sections:

1. Short title and commencement – which says that the act can be cited as the Bank of Zambia Act, 1996, and shall come into operation on such date as the Minister may, by and statutory instrument, appoint.
2. Interpretation – This outlines the meaning of the main terminology used in the Act.

Part 2 discusses:

1. Establishment of the Bank – the Act stipulates that BoZ shall be a body corporate with perpetual succession and a common seal, capable of suing and of being suited in its corporate name, and with power subject to the provisions of the Act;
2. Functions of the Bank of Zambia;
3. The powers of the minister;
4. Capital of the bank which is K 10 billion
5. Profit and loss determination and how to share it;
6. General reserve funds and other funds;
7. Policy statement (BoZ should every 6 months publish policy statement in government gazette).

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Part 3 – this part discusses the administration of the BoZ and looks at the appointment of the:

1. Governor – the governor is appointed by the president on a period of 5 years. The governor should be qualified and experienced in financial and economic matters.
2. It also discusses appointment of deputy governors, board of directors, composition of board, immunity of directors, oath or declaration of secrecy, financial year etc.

Part 4 discusses the monetary units, coins and notes. It states that the currency of the Republic is the Zambian kwacha and the ngwee. 1K = 100 ngwee. The right to issue notes and coins is vested exclusively in the Bank of Zambia. Any person found forging currency can be imprisoned for a period of up to 10 years or pay 1 million fine units.

Part 4 also discusses exchange of notes and coins, counterfeit notes and coins and penalty for mutilation of currency (imprisonment of up to 2 years).

Part 5 discusses international reserves and foreign exchange operations of the Bank of Zambia.

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The BoZ as the Board determines shall maintain an international reserve of:

1. Gold;
2. Foreign exchange in form of notes or coins or bank balances held abroad;
3. Any internationally recognized reserve asset like special drawing rights;
4. Bill of exchange and promissory notes denominated and payable in foreign currency;
5. Treasury bills and other securities denominated in foreign currency and approved by the boards;

The Bank of Zambia shall also be able to make operations in gold and foreign exchange.

Part 6 discusses the BoZ's relationship with banks and other financial institutions.

1. The bank by gazette notice determine:
   - The minimum ratio of liquid asset's which each financial institution is required to hold;
   - The minimum reserve balance which each financial institution shall maintain with the bank;

2. The BoZ by gazette shall determine the class or classes of assets which shall qualify to be liquid assets, and specify the class or classes of liabilities against which ratio requirement may be calculated.
   Banks should have accounts with the BoZ and the board of the BoZ shall determine how much interest they will pay on such accounts.

   The BoZ also arranges the clearing of cheques and other instruments and for this purpose organize a clearing house in Lusaka.

Part 7 discusses the Bank of Zambia's relationship with government. The BoZ shall:

1. Be the banker and fiscal agent of the government and through the minister act as financial advisor to government.
2. The bank shall be the official depository of government funds. The bank shall not advance funds to the government except in special circumstances. The bank shall not lend to government an amount exceeding 15% of the ordinary revenue of government in previous financial year.
3. The bank can act as an agent for government in any organization where the republic is a member and may also underwrite, purchase or sell ordeal in securities issued or guaranteed by government.

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Part 8 discusses general issues like:

1. Prohibited business – the BoZ cannot:
   - engage in any trade, purchase stock or shares, have a direct interest in any commercial, agricultural, industrial business.
   - make unsecured advances or accept for discount for any advance, bills, notes signed by a director or by a member of staff etc.

2. Right to call for information (can ask for information from banks).
3. Inspection (BoZ can inspect any commercial bank when necessary).
4. Exemptions from taxes (BoZ does not pay taxes on any of its projects).
5. Regulations – the BoZ will regulate banks as stipulate by the minister.
6. Property – the BoZ can buy lease or sell property as deemed necessary.
7. The bank shall not be subject to the Banking and financial services Act except in so for as that act imposes a duty on the bank.
8. Any assets, liabilities of the BoZ shall continue to vest in the BoZ.

3.6 REVISION QUESTIONS

1. Explain the nature of Central Banks
2. Discuss the rationale for Central Bank regulation
3. Define and explain the main types of Central Bank Independence
4. Discuss the structure and mandate of the major Central Banks
5. Give the main functions performed by Central Banks
6. Discuss the main contents of the Bank of Zambia Act

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4 COMMERCIAL BANK REGULATION

4.1 INTRODUCTION

Commercial banks in any market economy are at the center of any financial system. They help market participants by not only safeguarding their resources but also in providing debt finance which is a major factor of the growth of any business. The regulation of commercial banks is very important because commercial banks mostly operate on depositors' money and any default by any bank can trigger an economic crisis. This chapter provides an understanding of the following:

- Overview of commercial banking
- Objectives of commercial bank regulation
- Formation and registration of commercial banks
- Prudential supervision of commercial banks
- Taking possession of banks and financial institutions
- Insolvency dissolution and liquidation of banks and financial institutions
- International aspects of commercial bank regulation



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4.2 OVERVIEW OF COMMERCIAL BANKING

A bank is a financial institution that performs all of the following three (3) main functions:

- Accepts deposits from the public;
- Provides loans from depositors' money to the public; and
- Performs financial transactions on depositors' accounts on behalf of and on the instructions of the depositors.

As depository institutions, significant proportions of commercial bank funds come from customer deposits. Commercial banks play a key role in the transmission of monetary policy for the central bank to the rest of the economy. There are various types of commercial banks. The necessity for the variety among these banks is because each bank is specialized in their own field. Each bank has its own principles and policies. Different rates of interests are also noted among commercial banks. The different types of banks are listed as below:

Savings Banks: These are financial institutions whose primary purpose is accepting savings deposits and paying interest on those deposits. Savings banks are suited for employees with a monthly salary. Low waged people may open an account in the savings bank.

Commercial Banks: These are banks whose main business is deposit-taking and making loans. Commercial banks accumulate deposits from different individuals and corporations with the aim of extending the same as loan to households and corporations to make profits from interest.

Industrial Development Bank: These are banks that are committed towards enhancing the growth of industries by providing loans for a very long period of time. This is vital for the long term growth of the industries.

Land Development Bank: These are banks that promote growth in the food sector by giving loans to farmers at a relatively lower interest rate. These loans are normally provided with land acting as collateral.

Mortgage Banks: These are banks that specialize in providing mortgages.

Federal or National Banks: These are banks that control the principles and policies of other banks across the country. These banks are managed and run by the government. These banks provide benchmarks which other banks should follow.

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Consumer's Bank: These are consumer friendly banks which specialize in the provision of consumer loans.

Credit Unions: These are institutions that act just like cooperative banks except they provide services to only employees belonging to a specific union in the community. Low interest rates and easy installment paybacks are features of these unions.

Offshore Banks: These are banks that operate in countries whose banking system provides complete freedom from domestic laws.

Internet Bank: These are banks that provide banking services via the internet.

Investment Banks: These are banks that provident investment banking services.

Universal Banks: These are banks that perform a wide spectrum of financial services.

Islamic Banks – These banks whose operations are based on the principles of the religion Islam. They charge no interests for loans they extend. They only charge service and handling fees.

Table 4.1 below outlines assets and liabilities of a typical commercial bank.

Commercial Bank Balance Sheet	
Assets	**Liabilities**
Cash, Loans	Equity
Non financial assets like buildings	Time and Demand Deposits
Equity and debt securities	Loans (interbank, central bank overnight loans, subordinate loans, etc.)
Other assets	Other debt instruments issued like commercial paper

Table 4.1: Assets and Liabilities of a Commercial Bank

It is very important to note that banks convert liabilities into assets so as to earn profits. Some of the liabilities incurred by banks are acquired for the purpose of meet short term liquidity.

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In Zambia authorised activities of banks in addition to taking of deposits include:

1) Except where the conditions attached to a particular license otherwise provide, a banking license shall be taken to authorize its holder to engage in any of the following activities in addition to banking business:

a) making loans and extending credit to any person on the security of property of any kind or unsecured;
b) dealing as a principal or as an agent in –

i) bills of exchange, promissory notes, cheques, travelers' cheques and like instruments;
ii) the currency of Zambia and, subject to the regulations, guidelines, bulletins and regulatory statements made under this Act, in the currency of any other country and foreign exchange transactions; and
iii) gold, silver or platinum bullion or coins;



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c) providing money transfer services and facilities;
d) the issue and administration of payment, credit or debit cards and, in cooperation with others, the operation of payment, credit card and debit card systems;
e) providing guarantees, letters of credit and other assurances of payment;
f) finance leasing;
g) factoring, with or without recourse;
h) acting as a trustee of any trust, executor or administrator of any estate or in any fiduciary capacity for any person;
i) acting as a financial agent for any person;
j) provide safekeeping and custodial services for financial assets and securities;
k) providing merchant banking services including the arrangement and underwriting of shares, trade financing, corporate financing and the provision of financial advice; and
l) dealing as a principal or as an agent for its customers in financial futures and options and in exchange, currency and interest rate swap agreements.
m) dealing as a principal or as an agent for its customers in financial futures and options and in exchange, currency and interest rate swap agreements.

4.3 OBJECTIVES OF COMMERCIAL BANK REGULATION

In every country, commercial banks are regulated so as to provide safeguards for investors in and customers of banks and financial institutions and to provide for matters connected with or incidental to the foregoing. Commercial banks in Zambia are regulated by the Bank of Zambia under the "Banking and Financial services Act of 1994".

Licensing of Banks and Financial Institutions

One of the ways in which the Bank of Zambia regulates commercial bank is through licensing. Licensing helps the BoZ to properly scrutinize banks willing to enter the market hence safeguarding the interests of depositors. Companies not meeting the conditions set by BoZ are not allowed to offer banking services. This also helps BoZ keep an optimal number of banks to operate in the financial system. Too many banks can bring in efficiency because:

1. High liquidity in banking sector encourages subprime lending.
2. Too many banks come with unhealthy competition which leads to market "over flooding". Over flooding brings about reduced profits and bank failures.
3. Too many banks can bring in new attractive products which can cause a loan crisis in the economy, e.g., too many credit card overdrafts can lead to a high indebtness among citizens for example the USA mortgage crisis of 2008.

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Too few banks can lead to:

1. Reduced innovation in the banking sector because of luck of competition.
2. Reduced financial inclusion due to banks not being able to cope with the demand for banking services.
3. Increase lending rates which can affect economic growth etc.

4.4 FORMATION AND REGISTRATION OF COMMERCIAL BANKS

In Zambia, before applying for a banking license, individuals have to incorporate as companies under the Companies Act. Upon application by a company, the Registrar, in consultation with the Minister, may grant a license authorizing the company to conduct banking business. The application shall be in such form and accompanied by such fees as may be prescribed by regulation, and the form of application shall require at least the following particulars to be supplied:

a) the articles of association of the company;
b) the physical and postal addresses of its head office and the permanent residential addresses of its directors, chief executive officer, managers and shareholders;
c) the name and permanent residential address of every subscriber for any class or series of shares issued by the company in a number that will exceed one per centum of all the shares of that class or series, whether such shares carry the right to vote in all circumstances or not;
d) the addresses of each branch proposed to be opened by the company and, in the case of a mobile office, the area proposed to be served;
e) full particulars of the business it proposes to conduct under the authority of the license;
f) the amount of its capital; and
g) such assurances and evidence of the foregoing as the Registrar may require to be given by the applicant.

A banking license for a subsidiary of a foreign company may be granted if:

a) the foreign company is a bank and is authorized to engage in banking business in the country where its head office is located; and
b) the Bank of Zambia is satisfied that the foreign bank is adequately supervised by the competent authorities in the country where its head office is located.

The Registrar shall, within one hundred and eighty days of the receipt of an application for a banking license, make a decision whether to grant the license.

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Application for license to be refused in certain cases:

1) If the applicant does not meet the requirements prescribed by the Bank of Zambia.
2) An applicant for a license aggrieved by the refusal of the Registrar to grant a license may appeal against that decision in accordance with the Banking and Financial Services Act.

A bank shall not, whether of itself or by a subsidiary, open a branch, subsidiary or other establishment within or outside Zambia without the prior written approval of the Bank of Zambia. A bank or subsidiary proposing to open a branch, subsidiary or other establishment shall make an application in the form prescribed by the Bank of Zambia and accompanied by such fees as may be prescribed by the Minister on the recommendation of the Bank of Zambia. At least sixty days before closing a branch, a bank shall notify the Bank of Zambia in writing of its intention to do so.



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Investigation of applicants for bank licenses

In deciding whether or not to grant a banking license, and it deciding what conditions should be attached to such a license, the Registrar shall have regard to –

a) the capital adequacy of the applicant;
b) the financial condition, resources and history of the applicant and the applicant's associates and affiliates;
c) the character and experience of the directors and major shareholders and of persons proposing to be concerned in the management of the business to be undertaken under the authority of the license;
d) the convenience and needs of the community intended to be served by that business;
e) the prospects for profitable operation of that business.

Duration of licenses

A license remains in force until revoked by the Registrar. Licenses not transferable. There is no property in a license, and a license is not capable of being bought, sold, leased, and mortgaged or in any manner transferred, demised or encumbered.

Revocation of licenses

The Registrar may revoke a license if it appears to the Registrar that –

a) the application for the license was fraudulent or contained a materially false statement;
b) the licensee has failed to comply any condition or qualification of its license or with any order of the Bank of Zambia under this Act;
c) the licensee is seriously or persistently in breach of any provision of this Act or the regulations, bulletins or other regulatory statements under this Act or any of the conditions of its license; or
d) the licensee fails to commence to conduct the business authorized by the license within a period of twelve months following the grant of the license or ceases or announces its intention to cease to conduct that business.

Register of Licenses

The Registrar shall create and maintain a register, to be known as the Register of Banks and Financial Institutions, in which shall be entered the particulars of all licensees and of the licenses they hold.

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The Minister, on the recommendation of the Bank of Zambia, shall appoint a Registrar of Banks and Financial Institutions to administer the Register and to exercise and perform such other functions as are conferred or imposed upon him.

The Registrar and Deputy Registrar shall each hold office for a term of five years unless for negligence of duty or misconduct, and shall be eligible for reappointment. The Registrar shall enter into the Register the name, the head office address and such other particulars as the Registrar considers appropriate concerning each person granted a license, and shall remove from the Register the name and particulars of every person whose license is revoked.

Except as otherwise provided by the Banking Act, the Registrar and Deputy Registrar, in the exercise and performance of their powers and functions, are subject to the control and direction of the Bank of Zambia.

Ownership and Control of Banks

Limitation on voting control

Shares issued by a bank shall be only of such classes or series as may be approved by the Bank of Zambia. A person shall not, without prior approval in writing of the Bank of Zambia –

a) acquire any beneficial interest in the voting shares of a bank; or
b) enter into any voting trust or other agreement that would enable that person or another person to control more than twenty-five per centum of the total votes that could be cast on any general resolution at a general or special meeting of the bank. This does not apply to a company which is publicly listed on a securities exchange in a jurisdiction outside the Republic acceptable to the Bank of Zambia.

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4.5 PRUDENTIAL SUPERVISION OF COMMERCIAL BANKS

For prudential regulation, the following are the provisions relating to banks and other nonbank financial institutions:

a) Reserves

A bank or financial institution shall maintain a reserve account and before declaring any dividend shall transfer to its reserve account, out of the net profits of each year after due provision has been made for taxation, the minimum amount prescribed by the Bank of Zambia. The Bank of Zambia may by regulation prescribe the amount required to be transferred to the reserve account, the method of computing that amount, the form of the reserve account and any other matter it considers necessary to give effect to this section. No bank or financial institution shall declare credit or pay any dividend or make any other transfer from surplus if to do so would result in an impairment of the capital adequacy requirements of the Banking Act. The Bank of Zambia may permit a reduction of the reserve account when the relevant payment or transfer is made for the purpose of increasing the capital, and when the Bank of Zambia is satisfied that is the only practicable means of preventing an impairment of the bank's or financial institution's capital or of enabling the bank or financial institution to make provisions that the Bank of Zambia considers to be necessary.



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b) Liquid assets

Liquid assets means assets that are transferable free of any charge or lien whatsoever. Every bank or financial institution shall at all times maintain liquid assets amounting to not less than such percentage of its total liabilities to the public in Zambia as the Bank of Zambia may by instrument in writing prescribe specifically for it or, in default of such prescription, as the Minister, on the recommendation of the Bank of Zambia, may by regulation prescribe for banks of its class or description:

Provided that –

a) the percentage in either manner prescribed shall not be greater than fifty per centum;
b) the distribution of amounts between the various classes of liquid assets may be made at the discretion of each bank; and
c) no bank may be required to maintain any higher percentage than any other bank of the same class or type.

Where the liquid assets of a bank are, or the prudential liquidity ratio of a financial institution is, less than the amount for the time being prescribed in respect of it, the Bank of Zambia may order the bank or financial institution to pay to the Bank of Zambia, as a fine, interest on the amount of the deficiency, with respect to each day or part of a day that the deficiency continues, at an annual rate not exceeding the highest annual rate fixed, at the time of the deficiency, by the Bank of Zambia under the Bank of Zambia Act for any of its operations.

c) Prohibition of unsecured borrowing

A bank or financial institution shall not –

a) mortgage, charge or grant security to any person over any asset of the bank otherwise than –
    i. in the ordinary course of business; or
    ii. to the Bank of Zambia to secure short-term liquidity advances made by it under the Bank of Zambia Act; or

b) acquire an asset that is subject to a mortgage, charge or other security interest in favour of any person, except to satisfy a debt or other liability to it.

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d) Limitations on granting advances

A bank or financial institution shall not, directly or indirectly, grant any advance, or make any guarantee of the debts of any person or common enterprise so that the total value of any such advances and guarantees with or in respect of any one person or common enterprise is at any time more than twenty-five per centum of the regulatory capital of the bank or financial institution.

e) Limitations on equity investments

A bank or deposit-taking financial institution shall not invest in an equity interest in any person, property or undertaking in an amount exceeding fifteen per centum of the total of all equity interests in the person, property or undertaking.

The aggregate investment in equity interests of persons, properties or undertakings by a bank or deposit taking financial institution shall not exceed twenty-five per centum of its regulatory capital.

A bank or deposit-taking financial institution shall not acquire an equity interest in any single person, property or undertaking where the value of the bank's or deposit-taking financial institution's equity exceed twenty-five per centum of its regulatory capital. A bank or deposit-taking financial institution shall not acquire an equity interest in any single person, property or undertaking in which an insider has a related interest that exceeds ten per centum of the bank's or deposit-taking financial institution's regulatory capital.

f) Unsafe and unsound practices

Where, in the opinion of the Bank of Zambia, a bank or financial institution is committing or pursuing or is about to commit or pursue on behalf of the bank or financial institution any act or course of conduct that is considered by the Bank of Zambia as unsafe or unsound practice, the Bank of Zambia may enter into one or more written agreements with the bank or financial institution or its board of directors to establish a program of action to counteract the unsafe or unsound practice and to establish or maintain safe and sound practices in the conduct of the business of the bank or financial institution.

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g) Inspection of banks and financial institutions

The Bank of Zambia may cause an inspection to be made of a bank or financial institution to determine whether it is in a sound financial condition and operating safely and that the requirements of the Banking Act, the Bank of Zambia Act and other laws of Zambia have been complied with in the conduct of its business.

A bank or financial institution shall during inspection:

a) produce, and cause each company that is a subsidiary affiliate or associate of the bank or financial institution to produce, for the inspection of any inspector appointed by the Bank of Zambia, at such times as the inspector specifies, all books, accounts and records relating to its business in Zambia or elsewhere; and
b) supply all information concerning its business in Zambia as may reasonably be required by the inspector within such time as the inspector specifies.

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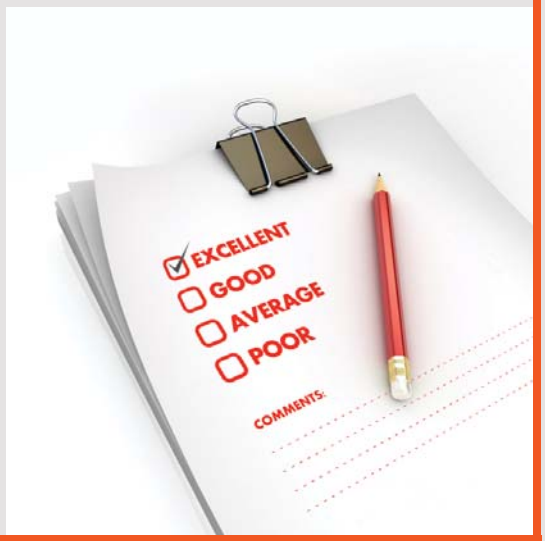

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h) Supervisory actions

Where:

a) a bank or financial institution refuses to comply with an order or directive of the Bank of Zambia under this Act;
b) a bank or financial institution refuses to permit an inspection to be made as provided by the law or obstructs an inspection;
c) in the opinion of the Bank of Zambia, an inspection instituted under the Banking Act shows –

i. that the bank or financial institution concerned conducts its business in breach of any written law or engages in a course of conduct that is unsafe or unsound;
ii. that for any reason the bank or financial institution is unable, or is likely to become unable, to continue its operations in the ordinary course of its business;
iii. the bank or financial institution's capital is less than the prescribed minimum;
iv. the bank or financial institutions is insolvent; the Bank of Zambia shall take supervisory action against the bank or financial institution. The supervisory action the Bank of Zambia may take includes –

a) taking possession of the bank or financial;
b) suspending the bank's or financial institution's license for a period not exceeding six months;
c) restricting the bank's or financial institution's license; and
d) revoking the bank's or financial institution's license.

i) Special reserve or liability insurance

A bank or financial institution shall maintain a special reserve account, to an amount which the Bank of Zambia considers adequate, reserved exclusively for the purpose of making good any loss resulting from the negligence or dishonesty of any of its directors, chief executive officer, chief financial officer, manager, or employees. It shall also insure itself against such loss, to an amount which the Bank of Zambia considers adequate, with a person approved by the Bank of Zambia carrying on insurance business or the business of guaranteeing against such loss.

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j) Capital adequacy

The Bank of Zambia shall, by Gazette Notice prescribe the minimum required primary capital for banks and for every category of financial institution. Every bank or financial institution shall maintain primary capital in an amount at least equal to the minimum amount prescribed by the Bank of Zambia. The minimum required regulatory capital to be prescribed by the Bank of Zambia shall not be less than six per centum of a bank's or financial institution's assets, contingent liabilities and other exposures and shall be calculated as may be prescribed by the Bank of Zambia.

4.6 TAKING POSSESSION OF BANKS AND FINANCIAL INSTITUTIONS

When taking possession of a bank or financial institution the Bank of Zambia shall post in each branch of the bank or financial institution a notice announcing its action and specifying the date, hour and minute at which the possession takes effect; and if the taking of possession is attributable to insolvency, the Bank of Zambia shall transmit a copy of the notice to the court.

Powers and duties of the Bank of Zambia upon taking possession

The Bank of Zambia upon taking possession of a bank or financial institution shall be vested with full and exclusive powers of management and control of the bank or financial institution, including the power –

a) to continue or discontinue any operations;
b) to borrow money, whether or not on the security of the assets of the bank or financial institution;
c) to stop or limit the payment of any obligation, including interest;
d) to employ, re-employ or retain in employment any officer, employee or professional advisor the Bank of Zambia considers necessary;
e) to execute any instrument in the name of the bank or financial institution and to initiate or defend and conduct in the name of the bank or financial institution any action or legal proceedings;
f) to terminate the employment of any director, chief executive officer, chief financial officer, manager or employee;
g) to terminate the interests of the shareholders at a value to be determined by the court; and
h) to enforce the individual liability of the directors and of the shareholders of the bank or financial institution incurred in the ordinary course of business and on unpaid shares.

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Upon taking possession of a bank or financial institution, the Bank of Zambia shall prepare a statement of affairs of the assets and liabilities and shall within ninety days from the effective date of taking possession take any of the following action:

a) where the statement of affairs of the assets and liabilities shows the bank or financial institution to be solvent –
   i. to restructure or reorganize the bank or financial institution;
   ii. to sell the bank or financial institution as a going concern;
   iii. to close the bank or financial institution;
   iv. to take any action which is necessary to enable the Bank of Zambia to carry out its functions under this Act;

Appeal for termination of possession

Within a period of twenty-one days after the date on which the Bank of Zambia takes possession of a bank or financial institution, the bank or financial institution or any interested person acting on its behalf may institute proceedings in Court to require the Bank of Zambia to show cause why the possession should not be terminated.



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4.7 INSOLVENCY DISSOLUTION AND LIQUIDATION OF BANKS AND FINANCIAL INSTITUTIONS

A bank or financial institution is insolvent when it ceases to be able to meet its obligations as they fall due or when its assets are insufficient to meet its liabilities or the amount of its regulatory capital requirement prescribed by the Bank of Zambia of is nil or lower.

A bank or financial institution shall not, while insolvent:

a) receive any deposit; or
b) enter into any new, or continue to conduct any existing, banking or financial service business, as the case may be, except that which is incidental to the orderly realization, conservation and preservation of its asset.

Where a financial institution licensed under the Zambian Banking Act becomes insolvent –

a) if it is a company under the Companies Act, the Bank of Zambia shall take possession of the institution in accordance with the provisions of the Banking and Financial Services Act.
b) if it is not a company under the Companies Act but is subject to the supervision or control of another authority, the Bank of Zambia shall revoke its license and give directions to the appropriate authority to place the institution into liquidation or dissolution; or
c) if it is a body established by written law, the Bank of Zambia shall revoke its license and may recommend to the relevant authority that the institution be placed into liquidation or dissolution.

Voluntary Winding up and Liquidation

A bank or financial institution shall not, except with the approval of the Bank of Zambia, pass any resolution for voluntary winding up or dissolution under the Companies Act; or under any other written law; and where a bank or financial institution passes a resolution for its voluntary winding up or dissolution, it shall record the date, hour and minute of the passing of the resolution.

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Rights of depositors and creditors

The approval by the Bank of Zambia under this Part for the voluntary winding up or dissolution of a bank or financial institution shall not prejudice the rights of a depositor or other creditor to payment in full of a claim nor the right of an owner of funds or other property held by the bank or financial institution to the return thereof. All lawful claims shall be paid promptly and all funds and other property held by the bank or financial institution shall be returned to their rightful owners within such maximum period as the Bank of Zambia may in writing direct.

Compulsory liquidation, winding up or dissolution

The Bank of Zambia may, by resolution, order the compulsory liquidation, winding up or dissolution of a bank or financial institution; and where the Bank of Zambia makes an order record the date, hour and minute of the passing of the resolution. The Bank of Zambia shall notify each director, shareholder, other owner, depositor and other creditor of the bank or financial institution and every other interested party of the order by Power of Bank to appoint agent written notice to such of those persons for whom the Bank of Zambia discovers a name and address, and by published or other form of public notice. The decision to liquidate a bank or financial institution can only be made by the courts of law.

Priority of creditors

In any compulsory liquidation, winding up or dissolution of a bank or financial institution there shall be paid in priority to all other debts in the following order –

a) necessary and reasonable expenses incurred by the Bank of Zambia in the application of the law;
b) taxes and rates due, whether payable to the Government or to a local authority;
c) wages and salaries of officers and employees of the bank or financial institution for the three-month period preceding the effective date of seizure, within the limit of an amount not exceeding one hundred thousand kwacha per person or such higher amount as may be prescribed by regulation;
d) fees and assessments due to the Bank of Zambia;
e) claims established under a deposit protection scheme;
f) other deposits; or
g) other claims against the bank in such order of priority as the Court may determine upon application by the Bank of Zambia.
h) any assets remaining after all claims have been paid upon compulsory liquidation of a bank or financial institution shall be distributed among the owners in accordance with their respective rights and interests

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4.8 INTERNATIONAL ASPECTS OF COMMERCIAL BANK REGULATION

When banking systems in a number of industrial countries weakened in the late 1980s, pressure developed for harmonizing bank regulation among industrial countries, at least for large internationally active banks in these countries. Prior to 1988, bank regulators tended to regulate bank capital by setting minimum levels for the ratio of capital to total assets. However, definitions of capital and the ratios considered acceptable varied from country to country. Some countries enforced their regulations more diligently than other countries. Increasingly, banks were competing globally, and a bank operating in a country where capital regulations were slack was considered to have a competitive edge over one operating in a country with tighter and more strictly enforced capital regulations. In addition, the huge exposures of the major international banks to less developed countries such as Mexico, Brazil, and Argentina, as well as the accounting games sometimes used for those exposures, were starting to raise questions about the adequacy of capital levels.

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Another problem was that the types of transaction entered into by bank were becoming more complicated. The over-the-counter derivatives market for product such as interest rate swaps, currency swaps, and foreign exchange options was growing fast. These contracts increase the credit risks being taken by a bank. Consider, for example, an interest rate swap. If the counterparty in the interest rate swap transaction defaults when the swap has a positive value to the bank and a negative value to the counterparty, the bank is liable to lose money. Many of these newer transactions were "off balance sheet". This means that they had no effect on the level of assets reported by a bank. As a result, they had no effect on the level of assets reported by a bank. As a result, they had no effect on the amount of capital the bank was required to keep. It became apparent to regulators that total assets were no longer a good indicator of the total risks being taken. A more sophisticated approach than that of setting minimum levels for the ratio of capital to total balance-sheet assets was needed.

The design of the cross border or transnational regulations was delegated to a newly established Basel Committee on Bank Supervision. The Basel Committee on Banking Supervision consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. It usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its permanent Secretariat is located.

Basel I

The 1988 BIS Accord was the first attempt to set international risk-based standards for capital adequacy. It has been subject to much criticism as being too simple and somewhat arbitrary. In fact, the Accord was a huge achievement. It was signed by all 12 members of the Basel Committee and paved the way for significant increases in the resources banks devote to measuring, understanding, and managing risks.

The BIS Accord defined two requirements that bank capital had to satisfy. The first was that the ratio of a bank's assets to its capital had to be less than 20. This requirement was similar to that existing prior to 1988 in many countries. The second requirement involves what is known as the Cooke ratio. For most banks there was no problem in satisfying the capital multiple requirements. The Cooke ratio was the key regulatory requirement.

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The Cooke Ratio

In calculating the Cooke ratio, both on-balance-sheet and off-balance-sheet items are considered. They are used to calculate what is known as the bank's total *risk-weighted assets* (also sometimes referred to as the *risk-weighted amount*). It is a measure of the bank's total credit exposure.

Risk weight (%)	Asset category
0	Cash, gold bullion, claims on OECD governments such as Treasury bonds or insured residential mortgages.
20	Claims on OECD banks and OECD public sector entities such as securities issued by US government agencies or claims on municipalities
50	Uninsured residential mortgage loans
100	All other claims such as corporate bonds and less-developed country debt, claims on non-OECD banks Real estate, premises, plant, and equipment

Table 4.1: Risk weights for on-balance-sheet items

Example

The assets of a bank consist of \$100 million of corporate loans, \$10 million of OECD government bonds, and \$50 million of residential mortgages. The total of risk-weighted assets is

$$1.0 \times 100 + 0.0 \times 10 + 0.5 \times 50 = 125$$

or \$125 million.

Capital Requirement

The Accord required banks to keep capital equal to at least 8% of the risk-weighted assets.

$$Minimum\ ratio = \frac{Capital}{Risk\ weighted\ assets} \geq 8\%$$

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The capital had two components:

1. *Tier 1 capital.* This consists of items such as equity and noncumulative perpetual preferred stock net of goodwill.
2. *Tier 2 capital.* This is sometimes referred to as *supplementary capital.* It includes instruments such as cumulative perpetual preferred stock, certain types of 99 year debenture issues, and subordinated debt (i.e., debt subordinated to depositors) with an original life of more than five years.

The 1996 Amendment

In 1995, the Basel Committee issued a consultative proposal to amend the 1988 Accord. This became known as the "1996 Amendment". It was implemented in 1998 and was then sometimes referred to as "BIS 98". The amendment involves keeping capital for assets and liabilities that are held for trading.



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Basel II

In June 1999, the Basel Committee proposed new rules that have become known as Basel II. These were revised in January 2001 and April 2003. A number of Quantitative Impact Studies (QISs) were carried out to test application of the new rules and the amount of capital that will be required. A final set of rules agreed to by all members of the Basel committee was published in June 2004. This was update in November 2005. Implementation of the rules began in 2007 after a further QIS.

The Basel II capital requirements apply to internationally active banks. In the United States, there are many small regional banks and the US regulatory authorities have decided that Basel II will not apply to them (these banks are regulated under what is termed Basel IA, which is similar to Basel I). Some of the larger regional banks are voluntarily implementing Basel II, possibly to signal to their shareholders that they manage risks in a sophisticated way. In Europe, all banks, large or small, are regulated under Basel II. Furthermore, the European Union requires the Basel II rules to be applied to securities companies as well as banks.

Basel II is based on three pillars:

1. Minimum capital requirements
2. Supervisory review
3. Market discipline

In Pillar 1 the minimum capital requirement for credit risk in the banking book is calculated in a new way that reflects the credit ratings of counterparties. The capital requirement for market risk remains unchanged from the 1996 Amendment and there is a new capital charge for operational risk. The general requirement in Basel I that banks hold a total capital equal to 8% of risk-weighted assets (RWA) remains unchanged. When the capital requirement for a risk is calculated in a way that does not involve RWAs, it is multiplied by 12.5 to convert it to an RWA. As a result, it is always the case that:

$$Total\ capital = 0.08 \times (Credit\ risk\ RWA + Market\ risk\ RWA + Operational\ risk\ RWA)$$

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Pillar 2, which is concerned with the supervisory review process, allows regulators in different countries some discretion in how rules are applied (so that they can take account of local conditions), but seeks to achieve overall consistency in the application of the rules. It places more emphasis on early intervention when problems arise. Supervisors are required to do far more than just ensuring that the minimum capital required under Basel II is held. Part of their role is to encourage banks to develop and use better risk management techniques and to evaluate these techniques. They should evaluate risks that are not covered by Pillar 1 enter into an active dialogue with banks when deficiencies are identified.

Pillar 3, market discipline, requires banks to disclose more information about the way they allocate capital and the risks they take. The idea here is that banks will be subjected to added pressure to make sound risk management decisions if shareholders and potential shareholders have more information about those decisions.

Credit risk capital under Basel II

For credit risk, banks have three choices under Basel II:

1. The standardized approach
2. The foundation internal ratings based (IRB) approach
3. The Advanced IRB approach

For the standardized approach, risk weights are largely a function of external ratings.

Credit assessment	AAA to AA-	A+ to A-	BBB+ to BB-	Below BB-	Unrated
Risk weight	20%	50%	100%	150%	100%

Table 4.2: Credit Risk Rating

For the IRB approaches:

- Risk weights a function of internal credit ratings
- Theoretically unlimited number of grades (minimum 7 for performing loans)
- Foundation IRB – banks estimate of probability of default
- Advanced IRB – banks also estimate loss given default and exposure at default

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Basel III

One of the main reasons the economic and financial crisis, which began in 2007, became so severe was that, the banking sectors of many countries had built up excessive on and off-balance sheet leverage. This was accompanied by a gradual erosion of the level and quality of the capital base. At the same time, many banks were holding insufficient liquidity buffers. The banking system therefore was not able to absorb the resulting systemic trading and credit losses nor could it cope with the reinter mediation of large off-balance sheet exposures that had built up in the shadow banking system. The crisis was further amplified by a procyclical deleveraging process and by the interconnectedness of systemic institutions through an array of complex transactions. During the most severe episode of the crisis, the market lost confidence in the solvency and liquidity of many banking institutions. The weaknesses in the banking sector were rapidly transmitted to the rest of the financial system and the real economy, resulting in a massive contraction of liquidity and credit availability. Ultimately the public sector had to step in with unprecedented injections of liquidity, capital support and guarantees, exposing taxpayers to large losses.



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In response to the shortcomings, the Committee in July 2009, completed a number of critical reforms to the Basel II framework. The new framework is what is now known as Basel III. The reforms are expected to raise capital requirements for the trading book and complex securitization exposures, a major source of losses for many internationally active banks. The enhanced treatment introduces a stressed value-at-risk (VaR) capital requirement based on a continuous 12-month period of significant financial stress.

In addition, the Committee introduced higher capital requirements for so-called resecuritisations in both the banking and the trading book. The reforms also raised the standards of the Pillar 2 supervisory review process and strengthen Pillar 3 disclosures. The Pillar 1 and Pillar 3 enhancements were to be implemented by the end of 2011; the Pillar 2 standards became effective when they were introduced in July 2009. The Committee is also conducting a fundamental review of the trading book. The work on the fundamental review of the trading book is targeted for completion by year-end 2011. It is critical that banks' risk exposures are backed by a high quality capital base. The crisis demonstrated that, credit losses and write-downs come out of retained earnings, which is part of banks' tangible common equity base. It also revealed the inconsistency in the definition of capital across jurisdictions and the lack of disclosure that would have enabled the market to fully assess and compare the quality of capital between institutions. To this end, the predominant form of Tier 1 capital must be common shares and retained earnings. This standard is reinforced through a set of principles that also can be tailored to the context of non-joint stock companies to ensure they hold comparable levels of high quality Tier 1 capital. Deductions from capital and prudential filters have been harmonized internationally and generally applied at the level of common equity or its equivalent in the case of non-joint stock companies. The remainders of the Tier 1 capital base must be comprised of instruments that are subordinated, have fully discretionary noncumulative dividends or coupons and have neither a maturity date nor an incentive to redeem. Innovative hybrid capital instruments with an incentive to redeem through features such as step-up clauses, currently limited to 15% of the Tier 1 capital base, will be phased out. In addition, Tier 2 capital instruments will be harmonized and so-called Tier 3 capital instruments, which were only available to cover market risks, eliminated. Finally, to improve market discipline, the transparency of the capital base will be improved, with all elements of capital required to be disclosed along with a detailed reconciliation to the reported accounts.

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4.9 REVISION QUESTIONS

1. Explain the nature of banks
2. Explain the main types of banks
3. List the major assets and liabilities of banks
4. Discuss the main activities of banks
5. Discuss the main objectives of commercial bank regulation
6. Explain the formation and registration of commercial banks
7. Explain the measures for the prudential supervision of commercial banks
8. Discuss the process of taking possession of banks and financial institutions
9. Explain the insolvency dissolution and liquidation of banks and financial institutions
10. Discuss the international aspects of commercial bank regulation

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5 INSURANCE INDUSTRY REGULATION

5.1 INTRODUCTION

The existence of insurance companies in economies has been necessitated by the existence of risks. Risks for both households and businesses pose a major threat because their occurrence can cause major financial loss. It is therefore important for market players to hedge their risks so as to not only safeguard their assets but also to ensure continuation of steady income inflows after loss has occurred. Because insurance companies are the most common professionals whose purpose is to hedge risks, many businesses and households tend to go to them for risk management. It is therefore very important for governments to regulate insurance companies so as to ensure that insurance companies that manage risks on behalf of others operate in a prudent manner themselves. This chapter provides an understanding of the following:

- Overview of the insurance industry
- The legal framework and regulatory body for insurance industry regulation
- Formation and registration of insurers
- Regulation of management and shareholding of insurers
- Transfer of insurance business
- Winding up of insurers

5.2 OVERVIEW OF THE INSURANCE INDUSTRY

Insurance companies (Insurers) are businesses that provide coverage in form of compensation resulting from loss, damages, injury, treatment or any other negative occurrence in exchange for premium payments. The company calculates the risk of occurrence then determines the cost to replace (pay for) the loss to determine the premium amount. Insurance companies are classified into two categories:

i) Life insurance companies. These companies offer protection in the event of untimely death, illness and retirement for the insured and their beneficiaries. Life insurance companies are increasingly offering annuity contracts, pension plans and providing accident and health insurance.
ii) General insurance companies. These companies offer protection against injury and liability due to accidents, theft, fire and other catastrophes.

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According to the Pension and Insurance Authority, Zambia's insurance industry has also been steadily growing from 1971 when the industry became a monopoly under the Zambia State Insurance Corporation following the 1968 Economic Nationalisation Reforms. Therefore, between 1971 and 1991 Zambia only had one insurance company and broker. Following the liberalization of the economy in 1992 the number of insurance companies has significantly increased from 11 in 2008 to 33 in 2015. However the number of insurance brokers has also increased to 39. Zambia currently has two local reinsurance companies, 2 reinsurance brokers, 222 insurance agents and a number of other players. With increased competition has emerged choice of company and products for policy holders and relatively affordable premiums. Players are also being constantly challenged to be innovative and come up with new products that meet the demands of Zambians.

Significant growth has also been recorded in volume of business underwritten and as at December 2014, the volume of general insurance stood at K1,216 billion from K1.022 billion in 2013 (PIA, 2016). On the long term side of insurance, the GWP turnover as at December 2014, stood at K650 million from K450 million in 2013 (PIA, 2016).

The Zambian insurance industry had the following players as at July 31st, 2015:

- 2 Reinsurance Companies
- 2 Reinsurance Brokers
- 22 General Insurance Companies
- 11 Long Term Insurance Companies
- 39 Insurance Brokers (from 48 in 2014)
- 222 Insurance Agents (from 279 in 2014)
- 6 Claims Agents
- 8 Motor Assessors
- 6 Loss Adjusters
- 1 Risk Surveyors

5.3 THE LEGAL FRAMEWORK AND REGULATORY BODY

The Pensions and Insurance Authority (PIA) is the regulatory and supervisory authority for the pensions and insurance industry in Zambia. It was created by the Pension Scheme Regulation Act of 1996 and the Insurance Act of 1997 as amended in 2005. Prior to the enactment of the Acts in 2005, PIA existed as the office of the registrar of pensions and insurance under the ministry of finance and national planning. After the enactment the PIA became a corporate body.

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The core functions of the PIA as a regulatory authority for the pensions and insurance industry include:

1. Licensing and regulation;
2. Prudential regulation and supervision;
3. Formulation and enforcement of standards of conduct for the industry;
4. Protection of pension members and policy holders;
5. Advising government on insurance of national properties and assets.

The insurance business in Zambia is regulated by the PIA under the insurance act as amended in 2005. The insurance act has 13 parts. Part one is the preliminary part that discuses different definitions of terms that are used throughout the Act. Part one also outlines the title and commencement of the Act, its interpretation and classification of the insurance business.

Under the Insurance Act:

- Assessor means a person who, where a claim is made against an insurer for loss or damage, assesses the extent of the loss or damage;
- General insurance business means insurance business other than life insurance business;
- Insurance agent means a person who, not being a salaried employee of an insurer –

  a) initiates insurance business; or
  b) does any act in relation to the receiving of proposals for insurance, the issue of temporary insurance cover-notes, or the collection of premiums;

- Insurance brokerage means the business of acting as a broker;
- Insurance business means the business of issuing policies of insurance, and includes re-insurance business;
- Insurer means a company that carries on insurance business;
- Life insurer means a company that carries on life insurance business;
- Life policy means a policy under which the insurer assumes a contingent obligation dependent on human life, and includes any contract of insurance customarily regarded as a life insurance contract;
- loss adjustor means a person who makes assessments of liability, or settle claims, on behalf of an insurer;
- Policy means an insurance contract of any kind;
- Re-insurance means the transfer, whether in whole or in part, of a risk assumed by an insurer, to another insurer;
- Registrar means the Registrar of Pensions and Insurance appointed under the Pensions Scheme Regulation Act, 1996.

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A person shall not carry on insurance business unless the person is a company licensed under the Insurance Act as an insurer a person shall not engage in insurance brokerage unless the Person is a company or partnership licensed under this Act as a broker.

An insurer shall not engage a person, otherwise than under a contract of employment, to act as a loss adjustor unless the person is licensed under the Insurance Act as a loss adjustor.

An insurer shall not engage a person, otherwise than under a contract of employment, to act as an assessor unless the person is licensed under the Insurance Act as an assessor.

A person shall not carry on claims agency business unless the person –

a) is licensed under the Insurance Act as a broker or as a claims agent; or
b) Is a registered legal practitioner.

A person shall not carry on an insurance agency business Insurance unless the person is licensed under the Insurance Act as an insurance agent. An insurance agent's license shall allow the holder of the license to act as an insurance agent for only one registered insurer named in the license.

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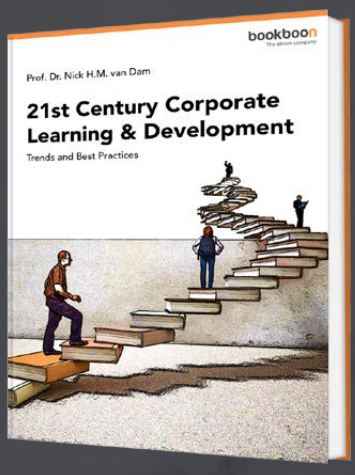

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5.4 FORMATION AND REGISTRATION INSURERS

Application of Insurance license

A company having share capital may apply for an insurer's license with an application being in a form approved by the Registrar and shall specify –

a) the name and address of the company;
b) the class or classes of insurance business for which the applicant seeks authorization under the license;
c) such other matters, including any matters relating to the assets and liabilities of the company and its ability to meet its obligations, as may be required to complete the form.

The application shall be accompanied by copies of:

a) the certificate of incorporation of the company;
b) the certificate of share capital of the company;
c) the articles of the company;
d) each proposal and policy form that is to be used by the company;
e) a detailed statement of assets and liabilities of the company, and their locations if not located in Zambia;
f) such other documents as to the manner in which the applicant proposes to carry on business, and such financial forecasts and other documents and information the Registrar may require.

Granting of insurance license

The Registrar shall issue the applicant with a license authorizing the applicant to engage in insurance business in the classes for which licensing is sought if on the lodgment of an application by the applicant for an insurer's license, the Registrar is satisfied that:

a) the business to be authorized by the license will be carried on the applicant in accordance with the Insurance Act and with generally accepted and prudent insurance principles and practices;
b) the applicant's articles will not prevent compliance by the applicant with any of the requirements of the Act that are applicable to the license and are in all other respects satisfactory;
c) the applicant will protect the interest of policy holders in preference to, but not to the exclusion of, the interests of shareholders or other providers of its capital;

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d) the applicant is likely to be at all times capable of meeting its obligation to policy holders;
e) the applicant is able to meet such minimum financial, solvency and liquidity requirements, or other criteria, as may be prescribed by or under the Act in respect of insurance business of the kind authorized by the license; and
f) The applicant is generally competent to conduct insurance business in the classes for which licensing is sought.

Refusal of License

The Registrar may refuse to license an individual as a loss adjustor, assessor, or insurance agent or broker under the Insurance Act on the ground that:

a) he has not provided the Registrar with such information relating to him or any person employed by or associated with him, or to any circumstance likely to affect his method of conducting business, as may be prescribed by regulations made under the Act;
b) he has become mentally or physically incapable of performing the duties that are to be performed under the license;
c) he is an undischarged bankrupt;
d) it appears to the Registrar that the applicant should not be licensed because the applicant or any of his employees has been convicted, whether in Zambia or elsewhere, of an offence, involving fraud or dishonesty, or has been convicted of an offence against the Act or any regulations made under this Act;
e) it appears to the Registrar that, by reason of any other circumstances which either are likely to lead to improper conduct of business, or reflect discredit on the method of conducting business of the applicant, the applicant should not be licensed; or
f) the Registrar has reason to believe that the applicant will not efficiently, honestly and fairly perform the duties that are to be performed under the license.

5.5 REGULATION OF MANAGEMENT AND SHAREHOLDING OF INSURERS

The regulation of management and shareholding of an insurance company is outlined in part III of the Insurance Act. Under the Act, a licensed insurer or broker shall maintain a principal office in Zambia. The office shall only be used for the address purpose of transacting insurance business.

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Appointment of Principle officer

A licensed insurer or broker shall be represented in Zambia by a chief executive officer who shall be the principle officer of the insurer or broker and shall be appointed in writing subject to the prior approval of the Registrar. Every notice to the Registrar regarding the appointment of a person as chief executive officer shall contain the following particulars:

a) the person's full name;
b) his date and place of birth;
c) his citizenship;
d) his academic and professional qualifications;
e) his work experience, giving dates and nature of previous employment
f) whether he has ever been convicted of an offence involving fraud or dishonesty, and if so, the date, place and full details of the offence; and
g) whether he has ever been adjudged bankrupt, applied to take the benefit of any law for the relief of bankrupt or insolvent debtors, compounded with his creditors or made any assignment of his remuneration for their benefit and, if so, full details thereof.



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Financial Regulation of Insurers

The financial regulation of insurers is outline in part IV of the Insurance Act. Part IV outlines stresses that, in assessing liabilities for the purposes of its annual accounts, an insurer transacting general insurance business shall set aside reserves for unearned premium, to meet liabilities on the unexpired risk as at the end of the financial year, using:

a) the 24th method or fifty per centum of the net premium income in respect of all classes of business, whichever is higher;
b) the total uncollected premium in addition to forty per centum of the premium income received in respect of policies or renewals issued during the year; or
c) any other method approved in writing by the Registrar.

Unearned premium means that part of a premium collected under a policy that, at any particular time, is attributable to the unexpired risk or the unexpired period of insurance. An insurer shall make adequate provision in its accounts for liabilities in respect of claims incurred but not settled at the end of the financial year, including provision for claims incurred but not reported Computed in accordance with a method not less than that prescribed by the Minister. As from the date on which it commences to carry on life insurance business in Zambia, an insurer shall established and maintain A fund, under, under an appropriate name, in respect of the life Insurance business carried on by it, with assets identifiable to that fund.

An insurer shall not carry on life insurance business unless the admitted assets of the insurer, so far as they are identifiable with the statutory fund maintained in respect of life insurance, exceed the admitted liabilities in respect of that fund, or exceed it by such margin as may be prescribed by regulations made under this Act in relation to life insurance.

An insurer shall, within one hundred and twenty days after every financial year, submit to the Registrar as solvency statement as at the end of the financial year. A solvency statement means:

a) in relation to general insurance business, a statement, made in a manner approved by the registrar, that sets out the admitted assets and liabilities in respect of each class of insurance business of an insurer and, if the insurer satisfies the requirements of the Act; and
b) in relation to the life insurance business, an actuary's report on the state of the statutory fund maintained in respect of life insurance.

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The Minister may, on recommendation of the Board, by statutory instrument, prescribe the minimum paid-up share capital to be maintained by a licensed insurer. An insurer shall not publish a statement o issue a document in which a statement of its authorized capital is mentioned, unless the statement also mentions the amount of its subscribed capital and of its paid-up capital.

Investment program

An insurer shall, after the commencement of the Insurance Act, prepare and furnish to the Registrar a statement of the investment policy. The investment policy shall be reviewed annually and the update statement shall be filed with the Registrar. An insurer may invest in such type of investment as may be The Minister may, on the recommendation of the Board, by statutory instrument issue investment guidelines to insurers relating to the limits for investment categories.

Accounts and Balance Sheet

An insurer shall, within ninety days after the end of each financial year, cause to be prepared in accordance with the regulations –

a) a balance sheet as at the end of that financial year;
b) a profit and loss account for that financial year; and
c) a revenue account for that financial year; in relation to the insurance business of the insurer, and shall effect a reconciliation between them and the company accounts for that year.

5.6 TRANSFER OF INSURANCE BUSINESS

The transfer of insurance business is regulated under Part V of the Insurance Act.

Amalgamation or transfer of insurance business

Notwithstanding any other law, an insurer shall not –

a) amalgamate with another insurer; or
b) transfer his insurance business or part of his insurance business to another insurer; unless the amalgamation or transfer has been approved by the Registrar in accordance with this Part. Where it is proposed to amalgamate two or more insurers, or otherwise to transfer insurance business from one insurer to another, the insurers concerned shall lodge with the Registrar an application for approval of the amalgamation or transfer, together with:

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a) the proposed agreement under which the amalgamation or transfer will take will take place
b) either:

i. an application for a new license, where an amalgamation will result in the formation of a new company; or
ii. an application for an amendment of an existing license, in the case of a transfer of any insurance business that will require an amendment of the license of the transferee insurer so as to authorize it to conduct the insurance business to be transferred.

Where an insurer that is party to the amalgamation is a life insurer or the business to be transferred includes life insurance business, each insurer concerned shall send to each of its life policy holders:

a) a statement of the nature of the amalgamation or transfer;
b) an abstract of the material facts in the agreement for the amalgamation or transfer; and
c) an abstract of each of the actuary's reports.



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Winding-up of Insurers

A court that makes any order for the winding-up of an insurer shall give such directions to the liquidator as appear to it necessary or desirable with respect to the winding up. The Registrar is entitled to be informed and to be heard in connection with winding up of insurer. The Liquidator of an insurer shall give the Registrar such information as the Registrar may require in connection with the winding-up of any insurer, and shall report to the Registrar whenever he intends to apply to the court for instructions and shall furnish the Registrar with a copy of any application intended to be lodged. Where an insurer is being wound, the liquidator shall ascertain, in such manner and upon such basis as the court may approved, the value of the liability of the insurer to every person appearing by its books to be the holder of, or interested in, policies of the insurer, and shall in such manner as he thinks appropriate give notice to every such person of the value so ascertained, and every person to whom notice is so given shall be bound by the value so ascertain, unless he disputes the valuation in such manner and within such time as is prescribed by rules of the court as the court may in a particular case allow.

Preferred creditors of an insurer

Notwithstanding any provision of the Companies Act to the contrary, in the distribution, for the purposes of a winding-up of a licensed insurer, of assets of the insurer other than those identified with a statutory fund:

a) the holders of life policies issued by the insurer shall have preference against all other unsecured creditors of the insurer; and
b) the owners of all other policies issued by the insurer shall rank before any other unsecured creditors of the insurer after the holder of life policies.

Returns to be made by Insurers

An insurer shall prepare at the end of each financial year of the insurer, in respect of that year, statements in the prescribe form relating to the business carried on during the year and the business in force at the end of the year and shall furnish those statements to the Registrar within three months after the end of the financial year.

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Disciplinary Action

The powers conferred on the Registrar by this part may only be exercise in relation to any person licensed under this Act if it appears to the Registrar that –

a) the person is not a fit and proper person to be the holder of this license;
b) the person has contravened or failed to comply with any provision of, or requirement under, this Act or regulations made under this Act or, in purported compliance with any such provision or requirement, has furnished the Registrar with information that is false, inaccurate or misleading; or
c) the exercise of the power is otherwise necessary for the protection of current or future policy holders;

Restriction of Business

The Registrar may by notice in writing prohibit a person licensed under the Insurance Act from doing any one or more of the following:

a) entering into transactions of a class or description specified in the notice or entering into them otherwise than in circumstances so specified or to an extent so specified;
b) soliciting business from persons of a class or description specified in the notice or from persons other than persons of such a class or description; or
c) carrying on business in a specified manner or otherwise than in a specified manner

Restriction on dealings with assets

The Registrar may, as regards any assets, whether they are the assets of a person licensed under the Insurance Act or not, by notice in writing –

a) prohibit a person so licensed from disposing of such assets or prohibit him from dealing with them in a manner specified in the notice; or
b) require a person so licensed to deal with such assets in, and only in; a manner specified in the notice.

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Suspension or revocation of license

The Registrar may suspend or revoke a license held under the Act by any person, or may refuse to renew such a license, if

a) the licensee, after being reminded of his failure; has continued to fail to comply with any requirement made of him by;
b) the licensee has become mentally or physically incapable of performing his duties under the license;
c) the licensee has become bankrupt;
d) the licensee or any employee of the licensee, where the licensee was a party to the crime committed, has been convicted, whether in Zambia or elsewhere, of an offence involving fraud or dishonesty, or has been convicted of an offence against this Act or any regulations made under the Act;

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e) it appears to the Registrar that, by reason of any other circumstance which either are likely to lead to improper conduct of business by, or reflect discredit on the method of conducting business of, the applicant, the license:

   i. should be revoked; or
   ii. should be suspended, or remain unrenowned, until the licensee takes such action as the Registrar may specify;

f) the Registrar has reason to believe that the applicant is no longer efficiently, honestly and fairly performing the duties that are to be performed under the license.

5.7 WINDING UP OF INSURERS

Insolvency and liquidation of insurers

Chapter VII of the Banking and Financial Services Act, 1994, shall apply to the insolvency and liquidation of the insurers with the necessary modifications, so however that the words "insurer", "premium", "insurance business", "chief executive officer", "twenty million penalty units" and "Registrar" shall be substituted for the words "bank", "deposit", "banking or financial services business", "officer' "ten million penalty units" and "Bank of Zambia", respectively.

Registrar of Insurance Companies

The Registrar shall have the functions and powers conferred on him by the Insurance Act or any other written law. In the performance of functions under the Act, the Registrar:

a) Shall be subject to the direction of Pensions and Insurance Authority Board; and
b) Shall at all times have regard to the need to protect the rights, benefits and other interests of policy holders and any beneficiaries of policies of insurance.

The Registrar may by notice in writing:

a) require a member, to produce, at such time and place as he may specify, such books or documents as he may specify; or
b) authorized any person, on producing, if required to do so evidence of his authority to require a member to produce to him any books or documents which that person may specify.

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The Registrar may also:

a) call upon an insurer to submit for his examination at his office all reinsurance treaties and other re-insurance contracts entered into by the insurer; and
b) by notice in writing, require and insurer to supply him with copies of any of the documents referred to in paragraph
c) certified by a principal officer of the insurer

The Insurance Fidelity Fund

The Minister shall, by statutory instrument, establish an Insurance Fidelity Fund for the purpose of indemnifying or otherwise protecting policy holders and other persons interested in the policies prejudiced by the inability of an insurer carrying on business in Zambia to meet its liabilities. The Fidelity Fund shall consist of:

a) all monies paid to the Authority by way of annual or other periodic license fees charged under the Insurance Act;
b) all monies recovered by, or on behalf of, the Registrar by the exercise of any right action conferred by the law; and
c) all other monies accruing to the Fund.

The Fidelity Fund shall be held and applied on such terms and conditions as the Minister may on recommendation of the Board, by regulation determine, for the purpose of compensating persons who suffer pecuniary loss occasioned by any default of an insurer or broker licensed under this Act or any employee of such an insurer or broker in the course of, or in connection with, any insurance brokerage or related business.

5.8 REVISION QUESTIONS

1. Explain the nature of insurance companies
2. Give a classification of insurance business
3. Discuss the structure of Zambia's insurance industry
4. Explain the legal framework and regulatory body for insurance industry regulation in Zambia
5. Explain the process of formation and registration insurers in Zambia
6. Explain the regulation of management and shareholding of insurers in Zambia
7. Explain the characteristics of the transfer of insurance business in Zambia
8. Explain the process of winding up insurers in Zambia

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6 PENSION FUND REGULATION

6.1 INTRODUCTION

The main function of pension funds is to provide a stable income to citizens when they are no longer in employment. Pension funds pool resources from citizens with a promise to pay the same citizens after retirement. The fact that pension funds and schemes pool resources from citizens is justification for the government to regulate them so as to ensure that retired workers actually get their money. In simple terms, pension funds help citizens save for retirement. This chapter provides an understanding of the following:

- Role of pension funds in an economy
- Legal framework for pension fund regulation in Zambia
- Registration of pension funds in Zambia
- Prudential regulation and supervision of pension funds
- The role of the Pension and Insurance authority in the regulation of pension funds
- Deregistration of pension funds



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6.2 ROLE OF PENSION FUNDS IN AN ECONOMY

A pension is an arrangement to provide people with an income when they are no longer earning a regular income from employment.

A pension fund or scheme is any plan or scheme which provides retirement income. It is a fund established by employers or government to pay retirement benefits to employees. Pension funds are major institutional investors. Pension Funds are pooled contributions from pension plans of employers or organizations set up to provide employee retirement benefits.

Functions of Pension funds

Pension funds perform the following functions:

1. Mobilizing and managing savings of citizens;
2. Providing income stability to retired workers;
3. Making labour laws more efficient. This implies that social security laws can be put into practice by government because of the availability of funds collected from social security taxes;
4. Pension funds are a source of resources for investments as they turn the pooled resources from citisens into investments.

Classification of Pension Funds

The following is the classification of pension funds:

1. *Open versus closed pension funds*
   - An open pension fund is a fund that supports at least one pension plan with no restriction on membership.
   - A closed pension funds is a fund that supports only pension plans that are limited to certain employees.

Closed pension funds can also be:

- Individual pension fund;
- Single employer pension fund;
- Multi employer pension fund;
- Related member pension fund.

2. *Public versus private pension funds.*
   - A public pension funds is one which is regulated under public law;
   - A private pension fund is one which is regulated under private sector law.

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Types of Pension Funds

The following are the types of pension funds:

- Pension Fund: This is where two thirds of the final benefit must be paid as pension for the rest of the pensioner's life and the remaining one third as lamp sum.
- Provident Fund: This is where the full amount is available at retirement.
- Retirement Annuity Fund: This is a financial product sold by financial institutions designed to grow funds from an individual then at a later time make streams of payments.
- Preservation Fund: This is an investment fund which is used as a place to "park" the pension or provident fund payout you get when you resign from your job before reaching normal retirement age.

Pension fund investments include conventional securities, such as stocks and bonds, real estate and alternative investments such as hedge funds and structured securities. Pension fund investment portfolios also include financial derivatives.

6.3 LEGAL FRAMEWORK FOR PENSION FUND REGULATION

Pension funds were for a long time unregulated until the Pension Scheme Regulations Act came into being in 1996. The Act is flawed and has a lot of areas that require streamlining. Prior to its enactment, pension schemes were only required to register with Zambia Revenue Authority for tax exemption purposes but their operations were largely unregulated. With the establishment of the PIA, there is now some limited supervision being undertaken albeit ineffectively due to the limited capacity of the regulatory body itself. Areas of conflict exist in the pensions arena, as there are multiple regulators and organs concerned with the management of pension funds.

The following are the various acts of parliament that regulate the pension industry:

1. *Pension Scheme Regulation Act of 1996 № 28* – This Act serves to provide prudential regulation and supervision of all pension schemes except for NAPSA. It has a bearing on both public and private pension schemes. It ensures that they operate in a prudential manner and protects scheme member's rights and benefits.
2. *Local Authorities Superannuation Fund Act CAP 286 of 1996* – This Act establishes the local authorities superannuation fund and defines the way it will be managed and all aspects dealing with finance, membership and benefits. Members of this scheme include Local Authorities, ZESCO, water utilities and National Housing Authority.

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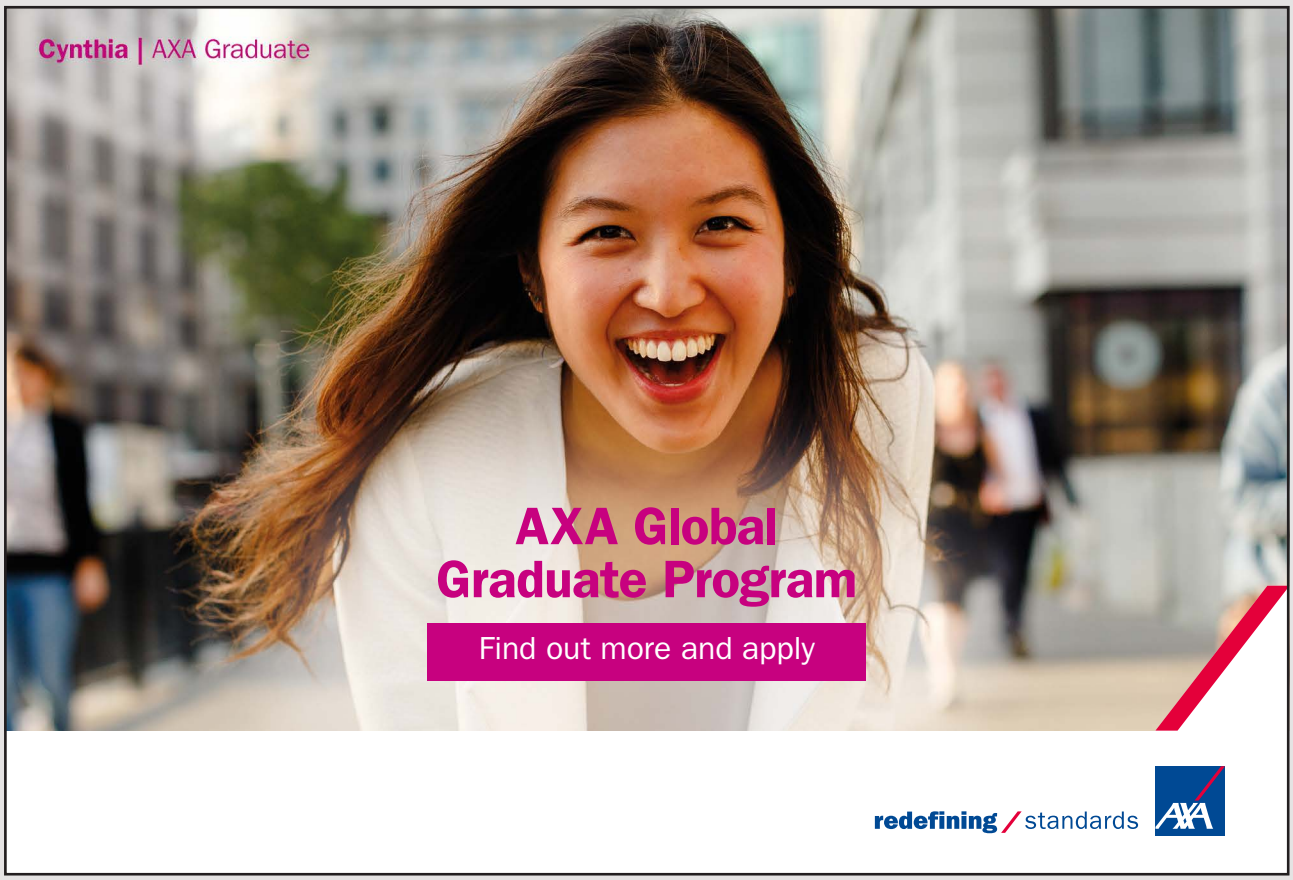
3. *Public Service Pension Fund Act of 1996 № 35* – This Act operates in a similar manner as previous act but deals with members of the public service commission, defense forces, teaching service commission, the Judiciary service commission, police and prisons service commission and the Zambia Security and intelligence service.
4. *National Pension Scheme Act of 1996 № 40* – This Act establishes the National Pension Scheme (NAPSA). NAPSA is a compulsory state scheme for all Zambian citizens in formal employment within Zambia. This Act exempts no one though the Ministry of Finance exercised its power to exempt privatized ZCCM companies.
5. *Land (Perpetual) Succession Act cap 188* – This establishes a trust through incorporation of a pension scheme into a legally establishes institution through trust deed executed by the trustees of the scheme. This only applies to private occupational pension schemes.
6. *Income Tax Act cap 323* – This Act affects the entire pension arrangements enacted by acts of parliament. It deals with taxation issues beginning with treatment of the contributions made into the pension scheme by any party concerned, the investment income and the pay outs.



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It should be noted that the Pension Scheme Regulation Act of 1996 superintends on the whole pension industry for supervision purposes except for NAPSA. It requires both the public and private occupational pension schemes to:

- Register with the Registrar of Pensions and Insurance (Pensions and Insurance Authority) in order to operate.
- Need to adhere to their Acts (Public Service Pension Fund Act and Local Authorities Superannuation Fund Act) for day to day operations.
- Need to adhere to their trust deeds and rules (i.e., for the private pension scheme) for the day to day operations with respect to general administration, contributions, formulae of benefits, qualifications to benefits etc.
- Deregistration of pension schemes for noncompliance.

6.4 REGISTRATION OF PENSION FUNDS

A person shall not establish a pension scheme in Zambia except in accordance with the Pension Act and under the authority of a certificate of registration of a pension scheme. Every pension scheme, other than a scheme established by a written law,

shall be established under an irrevocable trust. The rules of the scheme or fund shall make provisions for:

a) the manner of appointment or election of trustees and their term of office;
b) the functions, powers and duties of the trustees which shall include the general supervision and administration of the scheme or fund;
c) the number of trustees of whom one half shall be appointed or elected by the members and the remainder shall be appointed by the sponsoring employer;
d) the method of and ground for removal from the office of trustees;
e) the election and appointment of the chairperson of the Board of trustees and the functions, powers and duties of such chairperson provided that the chief executive officer of a sponsoring company shall not be chairperson of the Board of Trustees
f) the quorum at any meeting of the board of trustees shall be 50% of the total number of Trustees
g) the procedure of convening any meeting;
h) the manager, administrator or custodian shall attend the meeting of the board of Trustees as ex-officio members and address the meeting but shall have no vote

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Application as trustee for registration

A person shall not be appointed as trustee of any scheme fund if that person:

a) has been sentenced to imprisonment by a court of competent jurisdiction for fraud or dishonesty for a period of six months or more;
b) is adjudged bankrupt;
c) was previously involved in the management or administration of a scheme which was deregistered for any failure on the part of the management or the administration thereof;
d) is disqualified under any other written law, from holding office as such; or
e) is considered by the Board to be, in any way, detrimental to the scheme.

A person may apply to the Registrar for a certificate to establish or manage a pension scheme and the application shall be in such a form as may be prescribed by the Minister, by statutory instrument, and shall specify:

a) the name and address of the applicant;
b) the physical address of the place where the scheme is to be established or managed or administered;
c) a certified up to date extract from the register of companies;
d) a description of the applicant's qualifications enabling him to manage or administer a pension scheme;
e) the name and address of the appointed actuary and auditor;
f) the latest annual account established in compliance with generally accepted accounting principles and report of the auditor,
g) the latest actuarial valuation containing the confirmation that the pension fund's assets sufficiently cover the accrued benefit obligations;
h) the applicant has supplied such other information as the registrar considers necessary in determining the application

The Registrar shall issue the applicant with a certificate of registration authorizing the applicant to establish, manage or administer a pension scheme, if the Registrar is satisfied that:

a) the applicant shall carry out the scheme in accordance with the Pension Act and in accordance with general accepted actuarial principles;
b) the applicant shall protect the interests of the members;
c) the applicant is likely to be at all times capable of meeting its obligations to members in accordance with the pension plan rules;

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d) the applicant has the capacity and the necessary facilities to conduct and manage a pension fund professionally; and
e) the applicant is capable of keeping the individual accounts of the members, and collecting the contributions and paying out the benefits.

Creation of fund

No scheme, other than a scheme established by a written law, shall be registered under this Act unless:

a) it is proposed to be established under an irrevocable trust;
b) the proposed scheme rules adequately protect the rights and interests of the sponsors and members thereof; and
c) the trustees thereof satisfy the requirement for appointment specified in the Pension Act.

Each pension scheme registered under this Act shall have a fund established in a separate single-employer trust or multi – employer trust into which shall be paid all contributions, investment earnings, surpluses from insurance and other moneys, as may be required under the relevant pension plan rules or under this Act.

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6.5 PRUDENTIAL REGULATION AND SUPERVISION OF PENSION FUNDS

In the prudential regulation of pension schemes, the PIA ensures that all registered Pension schemes:

a) make adequate arrangements for the preservation of pension rights so as to protect the interest of its members;
b) lay down the rights and obligations of the members in writing in the pension plan rules, a copy of which shall be given to each member;
c) each year give to every member a benefit statement showing the member's actual benefits and the member's accrued portable benefits;
d) If it is a defined benefit scheme during the first four years after registration, carry out an actuarial valuation every two years, thereafter at least every three years so as to review and determine the sound funding of the pension scheme;
e) in managing its assets, aim to maintain at any time the real value of its members' accrued portable benefits; and
f) grant to members leaving the scheme before a benefit has become payable full portability of the accrued retirement benefits at the time the member leaves the scheme.

The Board of Trustees shall after the end of each financial year cause to be prepared:

a) an audited balance sheet;
b) an audited statement of income and expenditure;
c) and audited statement of the administration cost
d) an audited statement that the individual account for the members are duly established in accordance with the pension rules under this Act;
e) such other information as the Registrar may require in order to ensure compliance with the pension rules.

The trustees of a pension scheme shall appoint an auditor for each financial year. A person shall not be qualified for appointment as an auditor unless he is a member in good standing of a professional association of accountants in Zambia under the Accountant's Act.

The **trustees** shall lodge a copy of its accounts in accordance with the Act and the auditor's report to the Registrar within three months after the end of its financial year.

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Investment Policies of Pension Funds

Each pension scheme shall have an investment policy so as to:

a) achieve secure and profitable investments; and
b) maintain at any time the real value of its members' accrued portable benefits.

The trustees of a pension scheme shall, at such times as the Registrar may require, prepare and furnish to the Registrar, a statement of existing and proposed investments for the pension scheme.

The trustees may invest in such type of investment as may be approved by the Registrar. A pension fund shall not make unsecured loans to an affiliated employer. The Minister may on recommendation of the Board, by statutory instrument, issue investment guidelines relating to the limits for investment categories, provided that the Minister may, on the recommendation of the Board, by statutory order, permit a pension fund to invest and maintain outside Zambia for the benefit of members not more than 30 per cent of the net assets of the pension fund subject to agreement between the trustees and the fund managers. The trustees shall prepare quarterly returns in the prescribed form relating to the investment of pension funds, and shall furnish the returns to the Registrar within fourteen days after the end of each quarter and the quarterly returns shall be recorded in the register, made available for inspection by the public and inspection shall be free of charge to the members.

Unsafe and unsound practices

Where in the opinion of the Registrar, the auditor, the actuary and the trustees are pursuing any act or course of conduct that the Registrar considers as unsafe or of unsound business practice, the Registrar shall direct the manager of such a pension scheme to refrain from adopting or pursuing a particular course of action. The trustees shall comply with the directions given by the Registrar and shall be given by notice in writing to the trustees of a pension scheme and may in like manner be varied or revoked.

The trustees acting in contravention of this section shall be guilty of an offence and shall be liable, on conviction, to a fine not exceeding fifty thousand penalty units, or to imprisonment for a term not exceeding three years, or to both.

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On-site inspections

The Registrar may cause an on-site examination to be made of a pension scheme's books of accounts so as to determine the viability of the fund and to determine whether the pension fund is operating prudently. An examination shall be made by the Registrar if:

a) he has reasonable cause to believe that the trustee is contravening the Act;
b) the trustee has continued to contravene any requirement under the Act after notice has been given to him by the Registrar,
c) the trustee has failed to carry out the recommendations made by an actuary under this Act; or
d) he has received a complaint from a member under a pension scheme.

The Registrar shall publish his findings in the Gazette within thirty days after he has concluded the examination and shall furnish a copy to the trustees. The Registrar may give such directions as he sees fit to the trustee so as to protect the members' interest.



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6.6 THE ROLE OF THE PENSION AND INSURANCE AUTHORITY IN THE REGULATION OF PENSION FUNDS

The Pensions and Insurance Authority is a corporate body with perpetual succession and a common seal, capable of suing and being sued in its corporate name and with power, subject to provisions of the Pension Scheme Regulation Act, to do all such acts and things as a body corporate may by law do or perform.

The functions of the Authority include:

a) register and deregister pension schemes in accordance with this Act and in consultation with the Minister responsible for labour and social security;
b) register and deregister managers, administrators and custodians of pension schemes;
c) regulate and supervise the establishment and management of occupational pension schemes and insurance businesses;
d) protect the interests of members and sponsors of occupational pension schemes and shareholders and policy holders;
e) license re-insurers insurers insurance brokers, insurance agents loss adjusters loss assessors, claims agents and insurance risk surveyors;
f) administer and manage the Fidelity Fund established pursuant to section one hundred and nine of the Insurance Act and settle claims against the Fund;
g) formulate and enforce standards in the conduct of the business of insurance with which a member of the insurance industry must comply;
h) monitor the solvency of insurers and ensure the observance of sound insurance principles and practices by the insurers in the conduct of insurance business;
i) monitor and periodically review premium rates and scope of cover of policies that provide insurance cover in satisfaction of legal requirements;
j) in consultation with the competition commission, formulate and implement measures calculated to encourage healthy competition and eliminate unfair practices in the insurance and pensions industries;
k) advise the Minister and the Minister responsible for Labour and Social Security in policies relating to the pensions and insurance industries;
l) advise the government on adequate insurance protection of national assets and properties;
m) implement policies relating to the insurance and pensions industries;
n) promote the development of insurance and pensions industries;
o) set and enforce standards for the conduct of the business of insurance and occupational pensions schemes; and
p) undertake such other activities as are conducive or incidental to the performance of its functions under the Act;

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Role of Registrar

The Board the PIA shall, with the approval of the Minister, in consultation with the Minister responsible for labour and social security appoint a Registrar who shall be the Chief Executive Officer of the Authority and who shall subject to the control and direction of the Board, be responsible for the implementation of the decisions of the Board and the day to day administration of the Authority.

A person shall not be qualified for appointment as Registrar unless the Minister is satisfied that the person has qualifications and experience in actuarial analysis, business management, law or accounting. The Board shall with the approval of the Minister determine the terms and conditions of service of the registrar. The Registrar shall attend meetings of the Board and may attend meetings of any committee of the Board and may address the meeting but shall have no vote. The Registrar shall, subject to the direction of the Board:

a) ensure that the pension fund is established in form of a single employer trust or multi-employer trust separate from the employers business;
b) ensure that the pension scheme is laid down in pension plan rules covering the contribution formula, all the benefits, type of plan, option provided and deadline for choosing, calculation of portability rights and members rights for participation in management of the pension fund;
c) examine the certificate of incorporation of the trust;
d) ensure that the auditor and an actuary are appointed in accordance with this Act;
e) examine the annual accounts, the report of the Manager of pension fund and the auditors' report;
f) examine the actuarial evaluation and ensure it is done periodically according to this Act;
g) ensure that re-insurance arrangements are entered into in accordance with the actuary's recommendation;
h) ensure that, in the case of a multi employer trust, a written affiliation agreement exists, which adequately protects the pension fund's rights, the members' rights and the portability of accrued rights;
i) enforce any condition imposed under this Act on a pension fund, trust or the manager, administrator or custodian of such a fund or trust;
j) direct insurers and re-insurers on the standardization of the contracts of compulsory insurance;

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k) direct an insurer or re-insurer where the Registrar is satisfied that the contract of reinsurance issued by the insurer or re-insurers is obscure or contains ambiguous terms or terms and conditions which are unfair or oppressive to the policy holders, to clarify, simplify amend or delete the wording, terms or conditions as the case may be, in respect of future contracts; and
l) exercise and perform such other powers and functions as may be conferred on the registrar by or under this Act and the Insurance Act.

The Registrar, shall at all times –

a) protect the rights of benefits and other interest of the members in accordance with their corresponding pension scheme; and
b) monitor the viability of a pension scheme and ensure that the pension scheme is operating on sound financial and actuarial principles.



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6.7 DEREGISTRATION OF PENSION FUNDS

The Board of the PIA, on the recommendation of the Registrar may deregister a pension scheme if:

a) it appears to the Board that the manager has contravened or failed to comply with any provision of, or requirement under, this Act or regulations made under this Act or the pension plan rules; or
b) it is wound in accordance with such regulation as the Minister may, on the recommendation of the board, prescribe;

The Board shall, before taking any action, satisfy himself so far as the Board reasonably can, that the action would not unfairly operate to the detriment of a contributor of a pension scheme. The Board may appoint a curator who in the opinion of the actuary and of the auditor has had training and experience in pension fund management, to advise the manager on the implementation of such measures as may be specified by the Board after consultation with the actuary and the auditor to restore the pension scheme to a sound financial and operating condition. When a curator is appointed under this section, the manager and any of his employees shall act in accordance with every instruction given by the curator concerning the pension scheme of any part of the pension scheme's administration and operations that is regulated by or under this Act. If a manager fails to comply with any instructions of a curator, it shall be guilty of an offence and liable, upon conviction, to a fine not exceeding one hundred thousand penalty units or to imprisonment for a term not exceeding five years, or to both. The curator shall comply with any written instruction of the Board, and in all other matters shall act honestly and in good faith so as to restore the pension scheme to a sound financial and operating condition. The Board shall within fourteen days after its' decision to de-register a pension scheme notify, in writing:

a) the manager, the actuary and the auditor;
b) the members of such a pension scheme;
c) the employer of a member and any other person otherwise entitled to any funds held by the pension fund of the decision to de-register the pension scheme.

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The decision of the Board for de-registration of a pension scheme shall not prejudice the rights of a contributor or other creditor to payment in full of a claim against the scheme. If the Board finds that the assets of a pension scheme that is de-registered shall not be sufficient for the full discharge of its obligations to its members, the Registrar may take over the distribution of the assets and the supervision of the pension fund so as to protect contributors' interest under the pension scheme so de-registered and such distribution shall take place only after a corresponding distribution plan has been established by the Board.

6.8 REVISION QUESTIONS

1. Explain the nature and purpose of pension funds in a country
2. Explain the role of pension funds in an economy
3. Discuss the legal framework for pension fund regulation in Zambia
4. Explain the process of the formation and registration of pension funds in Zambia
5. Explain the measures for the prudential regulation and supervision of pension funds in Zambia
6. Explain the role of the Pension and Insurance Authority in the regulation of pension funds in Zambia
7. Explain the process of deregistration of pension funds in Zambia

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7 REGULATION OF BUILDING SOCIETIES

7.1 INTRODUCTION

Building societies were mostly formed as vehicles to help different groups of citizens to collectively save money for the purpose of enhancing homeownership. With time, building sources have turned into fully fledged financial institutions offering services to entire populations in various countries. The increased role of building societies has necessitated the need for their strict regulation. This chapter provides an understanding of the following:

- Definitions and features of building societies
- Formation and registration of building societies
- Regulation of building society management
- Roles of the registrar and minister of finance in the regulation of building societies
- Winding-up and dissolution of building societies



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7.2 OVERVIEW OF BUILDING SOCIETIES

A building society is a financial institution that offers savings accounts and mortgages as its main business. A building society is a mutual institution. This means that most people who have a savings account or mortgage are members and have certain rights to vote and receive information as well as to attend and speak at meetings. Each member has a vote regardless of how much they have invested or borrowed. The difference between banks and societies ideally is that banks are companies while societies are not. Building Societies not owned by shareholders but by their members. Because of financial innovation and the need to tighten financial regulation, the boundaries between banks and building societies have been erased. Building societies have increasingly been allowed to perform activities that were in the past reserved only for commercial banks. By their very nature, building societies are supposed to be involved in long-term housing finance and mortgage products such as long-term bonds.

7.3 FORMATION AND REGISTRATION OF BUILDING SOCIETIES

Regulation

In Zambia, building societies are regulated by the Bank of Zambia under the Banking and Financial Services Act of 1994, though they are formed in accordance with the Building Societies Act №23 as amended in 2005. They are currently three building societies in Zambia namely; Zambia National Building Society formed by an Act of parliament (Building Societies Act of 1968 as amended in 1970), Finance Building Society and Pan African Building Society.

Formation and Registration of a building society in Zambia

Any number of persons not being less than 5 may establish a building society under the Building Societies Act. The persons willing to set up a building society shall furnish the Registrar of Banks and Financial Institutions with the following:

- After agreeing upon the rules of governing the society, the stakeholders shall send to the Registrar two copies of rules signed by all persons and secretary an application form in prescribed forms.
- Each of those persons shall subscribe the minimum subscription fee satisfying the Registrar that the total sum subscribed by way of shores, deposits or negotiated loans is not less than the amount prescribed by BoZ and that the total amount shall remain as fixed term investments with the society for a period not less than 5 years.

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- After depositing with BoZ the prescribed amount the persons shall obtain a license to conduct a financial service business under the banking and financial services Act. The application should be accompanied by such a fee as may be prescribed.
- If the Registrar is satisfied that the application and rules comply with the requirements of the Building Societies Act and that minimum subscription of members, total subscription and deposits also comply with regulations and that he determines to grant the applicants a banking license, he shall:

    a) enter in the register the prescribed particulars relating to the application and the license;
    b) Retain and register one copy of the rules and return the other copy to the secretary or other officer together with a certificate of registration;

A building society which is registered under this Act shall be deemed to be a financial institution for purposes of the Banking and financial services Act and shall be subject to the supervisory and regulatory of the BoZ. Building societies are corporate bodies. Rules every building society shall set out include:

a) the name of the society and the address of its chief office or place of meeting:
b) the manner in which the stock or funds of the society is or are to be raised;
c) the manner in which a person may become a member of the society and the manner in which he may cease to be a member;
d) the purposes to which the funds of the society are to be applied;
e) provision that the society shall not, except with the approval of the Minister, make advances on the security of freehold or leasehold estate or in respect of any development, lands or buildings, situated outside the territorial limits of Zambia;
f) the classes of shares to be issued and the preferential and other rights and conditions attached to each class of shares;
g) the terms and conditions on which deposits are to be accepted and repaid;
h) provision that the society reserves the right to make all repayments, whether of shares, deposits, loans or otherwise, in Zambian currency;
i) the manner in which advances are to be made and repaid and the conditions on which a borrower can redeem the amount due from him before the end of the period for which the advance was made;
j) the manner in which losses are to be ascertained and provided for;
k) whether the society intends to borrow money, and if so, within what limits, not exceeding those prescribed by this Act;
l) the manner of appointing, remunerating and removing the board of directors and other officers, their powers and duties, and the manner of remunerating auditors;

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m) the manner of calling and holding meetings, the giving of notice thereof, form of notice, quorum, voting rights, right to requisition meetings, procedure to be observed at meetings, the right to demand a poll, and the manner in which a poll is to be taken;
n) the manner of settling disputes, subject to the provisions of this Act;
o) provision for an annual or more frequent audit and the inspection by the auditors of the titles, mortgage deeds and other securities held by the society;
p) provision for the custody of the titles, mortgage deeds and other securities belonging to or held by the society;
q) provision for the device, custody and use of the society's common seal;
r) the fines and forfeitures, if any, to be imposed on members of the society;
s) the manner in which the society may be dissolved. Contents of rules The rules of a building society are binding upon each member and officers of the society.

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Membership and commencement of business

The rules of a building society may allow a person to become a member without holding a share in the society. A person under the age of twenty-one years, if the rules do not otherwise provide, may be admitted as a member of a building society, and can give all necessary receipts, but, while he is under that age, he cannot vote or hold any office in the society. Members under the age of twenty-one. Two or more persons may jointly own shares in a building society and in respect of such shares the following provisions shall have effect, that is to say:

a) except where the rules of the society otherwise provide, any notice or other document may be given or sent by the society to the joint holders by being given or sent to that one of the joint holders who is named first in the books of the society;
b) for the purposes of voting rights, shares which are jointly owned shall be treated as held by the first named holder alone;
c) for the purposes of any sections of this Act which refer to the consent of the members, or of a proportion of the members, of a society, shares which are jointly owned shall be treated as held by the first named holder alone and the other joint holders shall not be regarded as members of the society for such purposes;
d) any references in this Act to total membership of a building society shall be construed as if the first named holder (but none of the other joint holders) is a member of the society;
e) the entry in the register of members to be kept under section twenty of the name and address of a person who is one of the joint holders (other than the first named holder) of shares shall indicate that he is a joint holder who is not the first named holder;
f) the joint holders of shares shall be entitled to choose the order in which they are named in the books of the society.

Except in the case of existing societies no building society, and no persons representing themselves to be a building society, shall commence business without having first obtained a certificate of registration under the Building Societies Act.

All persons who commence business without a license shall be guilty of an offence and liable on conviction to a fine not exceeding seven hundred and fifty penalty units for every day on which business is carried on without a certificate of registration having been obtained. Except with the prior approval of the Minister, a building society shall not make advances on the security of freehold or leasehold estate, or in respect of any development, lands or buildings, situated outside the territorial limits of Zambia.

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7.4 REGULATION OF BUILDING SOCIETY MANAGEMENT

Every building society shall keep the following books:

a) a register of members;
b) minute books for recording proceedings of general meetings and directors' meetings;
c) a record of advances made by the society; and
d) such books of account as may be necessary to enable the society to comply with the provisions of section thirty-two. Books and records to be kept by building society

A building society shall supply to any person who requires it a complete copy of its rules with a copy of the society's certificate of registration annexed to it and shall be entitled to charge a sum not exceeding four fee units for each such copy of its rules; and if a building society fails to comply with this section the society, and every officer of the society who is in default, shall be guilty of an offence.

Directors and other Officers

A building society shall have a Board of Directors consisting of not less than three and not more than ten persons. The remuneration payable to the Chairman and Directors of a building society shall be paid only out of the surplus of the society for the financial year to which the remuneration relates and shall be limited to the following sums or such other sums as the Minister may from time to time prescribe.

Remuneration of Directors

a) if the total assets of the society do not exceed ten million kwacha, the maximum sum payable in any one year to each director shall be one thousand kwacha and to the chairman of the board of directors one thousand five hundred kwacha;
b) if the total assets of the society exceed ten million kwacha but do not exceed twenty million kwacha, the maximum sum payable in any one year to each director shall be one thousand five hundred kwacha and to the chairman of the board of directors two thousand five hundred kwacha;
c) if the total assets of the society exceed twenty million kwacha, the maximum sum payable in any one year to each director shall be two thousand kwacha and to the chairman of the board of directors three thousand five hundred kwacha.

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In calculating the remuneration paid to a director of a building society, for the purposes of this section there shall be excluded:

a) any salary, bonus or other emoluments paid to a director in respect of his employment as an executive officer of the society; and
b) the reimbursement to a director by the society of expenses properly incurred by him while engaged in the business of the society or in attending its meetings.

The directors of a building society shall be elected in such manner and, shall hold office for such period as may be prescribed by the society's rules.



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A building society's rules shall make provision for at least two of the society's directors to retire annually and they shall be eligible for re-election without nomination. Whenever a casual vacancy occurs a person may be appointed by the remaining directors to fill the vacancy until the next annual general meeting. Vacancies in the board of directors shall be filled in such manner as may be prescribed by the society's rules. No person shall become a director of a building society until after he has given his consent in writing to his being elected or appointed as such. A director of a building society may, if the rules of the society so permit, appoint an alternate director to act in his stead during any period or periods when he is unable to act and may revoke such appointment at any time. The appointment or revocation must be in writing and be lodged at the society's chief office in the manner prescribed by the rules.

The acts of a director of a building society shall be valid notwithstanding any defect that may afterwards be discovered in his election or appointment or qualification; but any acts which occur after the date of discovery of such defect shall not be valid. The following persons shall be disqualified from being a director of a building society:

a) a person who is not a member of the society;
b) a member who does not hold the minimum share qualification, if any, prescribed in the society's rules as a qualification for holding office as a director;
c) a body corporate;
d) a minor or any other person under legal disability;
e) any person who at any time has been adjudged bankrupt by a competent court, whether in Zambia or elsewhere, or who, whether in Zambia or elsewhere, has made an arrangement or composition with his creditors;
f) any person who has at any time been convicted, whether in Zambia or elsewhere, of theft, any offence involving an element of fraud, forgery, uttering a forged document, perjury, or any offence of a like nature, by whatever name called, and has been sentenced therefore to a term of imprisonment or to a fine exceeding one thousand five hundred penalty units;
g) any person who has been removed by a competent court, whether in Zambia or elsewhere, from an office of trust on account of misconduct or breach of that trust;
h) a person who is not a resident in Zambia.

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Directors' report to AGM

The directors of a building society shall prepare and submit at the annual general meeting a report on the state of affairs of the society and such report shall include a statement setting out for the financial year last ending before the annual general meeting at which the report is submitted:

a) the total amount advanced by the society during the financial year;
b) the number and total amount of ordinary advances made by the society during the financial year;
c) the number and total amount of special advances made by the society during the financial year;
d) the number and total amount of collective advances made by the society during the financial year;
e) the total amount of money received during the financial year by way of investments in and loans to the society from members, depositors and others;
f) the total amount of money paid out during the financial year by the society by way of repayment of shares or repayment of sums lent to the society by depositors and others.

The directors' report shall be attached to the balance sheet and, if any copy of a balance sheet is issued, circulated or published without having attached to it a copy of the directors' report, the building society, and every officer of the society who is in default, shall be guilty of an offence.

Every building society in addition to other meeting should hold on AGM with the first 4 months of the year.

7.5 ROLES OF THE REGISTRAR AND MINISTER OF FINANCE IN THE REGULATION OF BUILDING SOCIETIES

Role of the Minister of Finance

The Minister of Finance plays a vital role in the regulation of building societies. As regards to the Zambia national building society, the minister shall appoint:

- not less than 7 persons to constitute the board of directors;
- the secretary of the society;
- approves the rules of the society.

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For the private building societies the Minister:

- appoints the registrar who registers and monitors them;
- can suspend by statutory instrument registration of new building societies so as to control competition;
- the Minister approves investments of building societies abroad and set limits within;
- approves how much advances building societies advance to government.
- may authorize any building society to lend any society in financial difficulties.
- might designate banks with whom society can bank.

Role of Registrar

The Registrar of Banks and Financial Institutions performs the following functions as regards to Building Societies' regulation:

- registers private building societies;
- with consent of the Minister makes regulations as to the formation of a building society's balance sheet;
- keeps records of building societies (rules, balance sheet, etc.);
- keeps truck of the financial position of building societies;



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- approves certain advances like special advances;
- keeps records of collective advance loan agreements of building societies (syndicates);
- approves unions and transfers of building societies etc.;
- appoints and insures inspections of societies.

Investment and banking of surplus funds

Surplus funds in relation to a building society means funds of the society which are not immediately required for its purposes.

A building society may invest any of its surplus funds in-authorized investment by

a) establishing and managing unit trust schemes;
b) establishing and managing pension schemes; and
c) establishing subsidiary companies.

A building society shall not invest any part of the surplus funds in projects other than those outlined above except as authorized by an order made by the Minister.

The Minister may vary or revoke an order made provided that a society which at the time when an order comes into operation, has funds invested in what, by virtue of such order, has ceased to be an authorized investment, may, with the approval of the Registrar retain such investment and the Registrar shall give his approval to such retention for so long as he is satisfied that the realization of the investment would not be detrimental to the interest of the society.

In so far as any surplus funds of a building society are not invested and are not kept in cash in the custody of officers of the society, the society shall keep them on current account with, or otherwise on loan to, a bank which is for the time being authorized under law to hold funds of building societies.

The Minister shall make an order, designating the banks with which building societies are authorized to keep money; and the Minister may vary or revoke an order made, provided that where a bank ceases to be an authorized bank and any funds of a building society on loan to that bank thereupon cease to be kept in the manner permitted.

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General reserve fund

Every building society shall establish a fund to be known as the General Reserve fund, appropriations to which shall be made only out of the realized surpluses of the society. No dividend, bonus or donation shall be paid out of the general reserve fund. Moneys standing to the credit of the General Reserve Fund shall be invested in authorized investments or in advances. A society may charge against the general reserve fund any net loss remaining to the society in any year after applying to such loss any undistributed surpluses brought forward from previous years.

Liquid Funds

The Governor of the Bank of Zambia shall by statutory instrument direct, from time to time, the minimum amount of liquid funds to be maintained by building societies and every building society shall be bound by such direction, which shall be expressed in terms of a percentage of the total amount of a society's assets reduced by any amount by which the total book value of the society's investments exceeds their total market value.

Every building society shall make a monthly return in the prescribed form to the Governor of the Bank of Zambia to enable him to give directions. A direction given shall specify the date from which it is to take effect which shall not be earlier than three months from the date of publication of the Gazette in which it appears.

Liquid funds shall be held by building societies in any or all of the following:

a) notes and coin which are legal tender in Zambia;
b) balances and money at call with registered discount houses, registered acceptance houses, or registered commercial banks;
c) treasury bills issued by the Government;
d) local registered securities issued or guaranteed by the Government of which not more than fifty per centum may be in securities of a final maturity date of more than six years;
e) such other assets as the Governor of the Bank of Zambia may, with the consent of the Minister, from time to time prescribe by statutory instrument.

No building society shall pay any dividend or interest on any of its shares otherwise than out of surpluses earned by the society during the financial year to which the dividend or interest relates, and undistributed surpluses.

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7.6 WINDING-UP AND DISSOLUTION OF BUILDING SOCIETIES

A building society may be dissolved in the manner prescribed by its rules. A building society may be dissolved by an instrument of dissolution with the consent (testified by their signature of that instrument) of the members holding not less than two-thirds of the number of shares in the society. An instrument of dissolution shall set out:

a) the liabilities and assets of the society in detail;
b) the number of members and the amount standing to their credit in the books of the society;
c) the claims of depositors and other creditors and the provision to be made for their payment;
d) the intended appropriation or division of the funds and property of the society;
e) the names of one or more persons to be appointed as trustees for the purposes of the dissolution, and their remuneration.



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An instrument of dissolution made with consent given and testified as mentioned may be altered with like consent, testified in the like manner. Every instrument of dissolution, and every alteration of such an instrument, shall be registered in the manner provided by law for the registration of the rules of a building society; and every such instrument or alteration shall be binding upon all members of the building society.

On the application in writing of at least one hundred members of a building society having a total membership of more than one thousand, or, in the case of any other building society, of one-tenth of the whole number of members of the society, stating that the society is unable to meet the claims of its members and that it would be for their benefit that it should be dissolved, and requesting an investigation into the affairs of the society with a view to its being dissolved, the Registrar may investigate the affairs of the society.

Before commencing an investigation, the Registrar shall give not less than one month's written notice to the building society at its registered chief office or place of meeting. If on such investigation it appears that the building society is unable to meet the claims of its members and that it would be for their benefit that it should be dissolved, the Registrar shall so advise the Minister who:

a) if he considers it expedient to do so, may, by statutory order, direct that the society be dissolved, and shall in that case direct in what manner the affairs of the society are to be wound up; or
b) may suspend such order for such period as he thinks fit to enable the society to make such alterations of its rules as, in the judgment of the Minister, will make such an order unnecessary.

Where an order for dissolution is made, the Registrar, within twenty-one (21) days of the making thereof, shall cause notice of the order to be advertised in one or more newspapers circulating in the place in which the registered office or place of meeting of the building society is situated.

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Within twenty-eight (28) days from the date of termination of the dissolution the liquidators, trustees or other persons having the conduct of the dissolution shall send to the Registrar an account and balance sheet signed and certified by them as correct and showing the assets and liabilities of the society at the commencement of the dissolution, and the way in which those assets and liabilities have been applied and discharged; and if they fail to do so they shall each be guilty of an offence and liable on conviction to a fine not exceeding three hundred penalty units for every day during which the default continues. Except with the consent of the Registrar, no resolution, instrument or dissolution or other proceeding for the dissolution of a building society under and no alteration of an instrument of dissolution, shall be of any effect if the purpose of the proposed dissolution or alteration is to effect or facilitate the transfer of the society's engagements to any other society.

Any provision in a resolution or document that members of a building society proposed to be dissolved shall accept investments in another society (whether in shares, deposits or any other form) in or towards satisfaction of their rights in the dissolution shall be conclusive evidence of such a purpose. The High Court on the petition of-Winding-up by or under the supervision of the High Court

a) the Registrar in the exercise of any power conferred by this Act; or
b) any member of a building society authorized by all members present and voting at a meeting especially called for the purpose to present the same on behalf of the society; or
c) any creditor holding an unsatisfied judgment or decree for a sum in excess of the amount as prescribed by law;

may order that a building society be dissolved, either voluntarily under the supervision of the Court, or by the Court, and the provisions of the law for the time being in force in regard to the winding-up of a company shall apply to the dissolution of a building society under this section, with such adaptations or modifications as may be ordered by the Court.

Liability of members on winding-up or dissolution

Where a building society is being wound up or dissolved, a member to whom an advance has been made under a mortgage or other security, or under the rules of the society, shall not be liable to pay the amount payable there under except at the time or times and subject to the conditions set out in the mortgage or other security, or in the rules, as the case may be.

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Notice of the commencement and of the termination of the winding-up or dissolution of a building society shall be sent to the Registrar and registered by him. If a building society fails to send to the Registrar a notice which it is required to send to him, the society, and every officer of the society who is in default, shall be guilty of an offence and liable on conviction to a fine not exceeding seven thousand five hundred penalty units.

7.8 REVISION QUESTIONS

1. Explain the nature and features of building societies
2. Explain the process of the formation and registration of building societies in Zambia
3. Discuss the regulation of building society management
4. Explain the roles of the registrar and Minister of Finance in the regulation of building societies in Zambia
5. Explain the process of winding-up and dissolution of building societies in Zambia



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8 CAPITAL MARKET REGULATION

8.1 INTRODUCTION

Capital Markets are a major source of long term finance for businesses and governments around the world. Capital markets enable market participants invest in large infrastructure projects and also execute other capital expenditure. The fact that capital markets are based on long term funds pooled from citizens and other businesses, there is need for governments to ensure that this segment of the financial market is regulated especially that long term investments can represent life savings for many. This chapter provides an understanding of the following:

- Definitions and nature of capital markets
- Objectives and principles of capital market regulation
- Role of corporate governance in capital market regulation
- Legal framework for securities markets regulation
- Improper trading practices and the compensation fund
- Roles of institutions involved in securities market regulation

8.2 OVERVIEW OF CAPITAL MARKETS

A capital market is a market for securities where business enterprises and governments can raise long term funds. Capital markets are also markets where people, companies, and governments with more funds than they need (because they save some of their income) transfer those funds to people, companies, or governments who have a shortage of funds (because they spend more than their income). Stock equity securities and bond markets are two major capital markets. Capital markets promote economic efficiency by channeling money from those who do not have an immediate productive use for it to those who do. Capital markets carry out the desirable economic function of directing capital to productive uses. The savers (governments, businesses, and people who save some portion of their income) invest their money in capital markets like stocks and bonds. The borrowers (governments, businesses, and people who spend more than their income) borrow the savers' investments that have been entrusted to the capital markets. When savers make investments, they convert cash or savings (risk-free assets) into risky assets with the hopes of receiving enhanced benefits in the future. Since all investments are risky, the only reason a saver would put cash at risk is if returns on the investment are greater than returns on holding risk-free assets. Buying stocks and bonds and investing in real estate are common examples. The savers hope that the stock, bond, or real estate will "appreciate," or grow in value.

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Primary and Secondary Capital Markets

The primary market is the market in which new securities are issued. Corporations or Central Governments that needs funds issue securities to purchasers in the primary market. Investment banks assist in this issuance process in a process known as underwriting. Underwriting is a process where banks guarantee a minimum price for a business's securities and sell them to the public. Since the primary market is limited to issuing new securities only, it is of lesser importance than the secondary market. The secondary market includes stock exchanges (like the Lusaka Stock Exchange, New York Stock Exchange and the Tokyo Nikkei), bond markets, and futures and options markets, among others. All of these secondary markets deal in the trade of securities. The term "securities" encompasses a broad range of investment instruments. Investors have essentially two broad categories of securities available to them: equity securities (which represent ownership of a part of a company) and debt securities (which represent a loan from the investor to a company or government entity). Savers who purchase debt instruments are creditors. Creditors, or debt holders, receive future income or assets in return for their investment. The most common example of a debt instrument is a bond. When investors buy bonds, they are lending the issuers of the bonds their money. In return, they will receive interest payments (usually at a fixed rate) for the life of the bond and receive the principal when the bond expires. National governments, local governments, global, national, and local companies, and many other types of institutions sell bonds. Stock is the type of equity security with which most people are familiar. When investors (savers) buy stock, they become owners of a "share" of a company's assets and earnings. If a company is successful, the price that investors are willing to pay for its stock will often rise and shareholders who bought stock at a lower price than stand to make a profit. If a company does not do well, however, its stock may decrease in value and shareholders can lose money. Stock prices are also subject to both general economic and industry-specific market factors.

Capital markets in Zambia

The importance of a well functioning capital market cannot be overemphasized as it improves financial market efficiency and is the missing link in Zambia's long quest and search for economic development, sustainable economic growth and poverty reduction.

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Prior to the liberalization era, Zambia had no formal capital market. Firms relied mainly on retained earnings and loans from development financial institutions, such as DBZ, LIMA Bank and Co-operative Bank, for sourcing long-term finance. Hence, only firms in certain prioritized sectors and those with close ties (informal or formal) to these institutions were in a position to easily expand their activities. In the reform process, the development of capital markets was considered as key in enhancing the rate of capital formation and of importance in facilitating privatization. There was no organized market for long term instruments hence most stocks were traded on over the counter basis with no formal rules and regulations.

Following the enactment of the Securities Act, the Government, with the assistance of the International Finance Corporation (IFC), established the Lusaka Stock Exchange (LuSE) in February 1994. This broadened the sources of finance for companies through the issuance of equity and/or debt instruments. Business houses can now source cheaper funds from investors by listing their shares on the LuSE instead of borrowing from commercial banks, often at high rates of interest.

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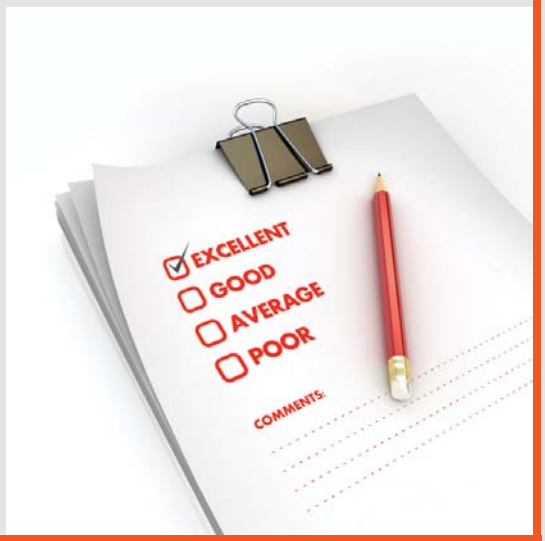

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The LuSE was organized as a single market with an upper tier, or Official List, and lower tier, or quoted sector. The upper tier comprises larger companies that have more than 300 shareholders and have complied with both SEC registration requirements and LuSE listing criteria. The lower tier is simply companies that have been registered with the SEC but have not sought admittance to the LuSE Official List.

Bond Market in Zambia

The bond market is important for the capital market because it serves as a pricing benchmark and, in particular, promotes the development and growth of financial instruments and products. Currently, the bond market is rudimentary and narrow. The main challenge is to develop broad and deep primary and secondary bond markets.

In the absence of a well-functioning bond market, savers face a diminished array of financial assets. Savers will hold more substitute assets such as bank deposits and possibly less likely, equity and probably more non-financial assets such as property that reduce the supply of savings that can be mobilized for productive investments. This is true for Zambia. More people hold most of their savings in the form of deposits and to a certain extent hold the funds in dollar accounts. Savers are forced to accept lower return in the absence of competitive financial instruments. In Zambia, most firms rely more on the short term bank financing. These types of funds cannot finance long term investment projects that will in the medium to long term increase employment and economic growth.

Without serious competition from the bond market, the banking sector will be larger than it would otherwise be. Banks tend to have more deposits at lower cost because their customers have limited financial assets alternatives and, as such, banks have more corporate loans because the firms have few other sources of finance.

Government Bonds

The development of the government bond market in any economy is very important in that, it is the sure way the Government deficits can be covered in a less inflationary way. It is therefore imperative that, the Zambian Government is encouraged to finance its budget deficits through borrowing from the bond market. The only way it would successfully fund itself through the market is by developing the market for long-term financial instruments.

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Prior to 1995, government bonds were sold at a fixed interest rate and on an ad hoc tap basis. In 1998, the BoZ in collaboration with LuSE took steps to enhance and develop the secondary market in long term instruments by listing government bonds on the LuSE for secondary market trading. It was expected that, the establishment of a formal central market in bonds would produce a number of benefits to the Zambian financial system and the economy such as the following:

i. Enhanced liquidity in the secondary market;
ii. Price discovery and improved price formation as reflected in yields of bonds;
iii. Broader and much wider participation by both large (institutional) and small (individual) investors due to use of modern book entry system which eliminates the use of physical certificates;
iv. Better and improved transparency in all market dealings
v. Creation of financial markets depth; and
vi. Development and emergence of longer dated capital market instruments.

Currently, Government bonds are of three maturity categories of 12, 18 and 24 months, offered to the public on a competitive basis through tender and also through the non-competitive window for amounts less than K30 million.

Corporate Bond Market

The corporate bond market in Zambia remains relatively underdeveloped. There have been about four corporate bonds on the market of varying tenure ranging from 3–12 years. These include Farmers House for US $1million issued in 1999; Barclays Bank for K30 billion issued in 2003; Lunsemfwa Hydro Power US $7 million issued in 2003; and Arcades US $1.5 million issued in 2003. All these bonds are quoted or listed on the LuSE but are not traded actively. This situation reflects the nascence state of the corporate bond market.

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Municipal and Utility Bonds

There have been no municipal bonds issued in Zambia to date.

Equity Markets

As of January 2012, 23 companies had listed their shares on the Lusaka Stock Exchange and these are: African Explosives Zambia Plc, Zambia Bata Shoe Company Plc, British American Tobacco Zambia Plc, BP Zambia Plc, Cavmont Capital Holdings Zambia Plc, Copperbelt Energy Corporation Plc, Zain, Lafarge Cement Zambia Plc, Farmers House Plc, Farmers House Preference Shares, Investrust Bank Trust Plc, National Breweries Plc, Pamodzi Hotel Plc, Standard Chartered Bank Plc, Shoprite Holdings Ltd, Zambeef Products Plc, Metal Fabricators of Zambia Plc, Zambian Breweries Plc, ZCCM Investments Holdings Plc, Zambia National Commercial Bank, Zambia Sugar Plc, Zambia Sugar and First Quantum Minerals Zambia.



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8.3 OBJECTIVES AND PRINCIPLES OF CAPITAL MARKET REGULATION

Throughout the twentieth century, capital markets have played an increasingly important role in the development of market economies. Governments around the world are recognizing that efficient securities market regulation is critical to the development of any market based economy. There are basically 3 objectives of capital market regulation:

- To project investors;
- To assure that markets are fair, efficient and transparent;
- To reduce systematic risk.

In order for countries to regulate capital markets effectively, Corporate Governance is very vital. Corporate Governance tackles the agency problem which exists in companies where ownership and management is separate. The following are the principles of good corporate governance that help in securities markets' regulation:

- The right of shareholders which entails that the corporate governance framework of each country should protect shareholder's rights.
- The equal treatment of shareholders whether foreign, minority or majority.
- The role of stakeholders in corporate governance which entails that corporate governance framework of each country should recognize the rights of stakeholders (employees, government, suppliers).
- Disclosure and transparency.
- The responsibility of the board to ensure effective management and monitoring of the business.

A corporate governance code for listed and quoted companies on the Lusaka Stock Exchange exist effective 1 January 2005. The code is also endorsed by the Zambia Institute of Directors where Lusaka Stock Exchange is a member.

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Key to a successful securities trading system is that all investors share equally in the risks and opportunities of investment. Although internationally agreed standards are not new, in the past few years, considerable effort has been made to address the development of internationally recognized standards to provide policymakers with benchmarks of good practice in key areas. The adopted standards (benchmarks of good practice) are designed to offer a roadmap to improve economic policymaking and strengthen the financial system. Standards and codes cover a number of economic and financial areas, including data dissemination; fiscal, monetary, and financial policy transparency; banking regulation and supervision; securities and insurance regulation; accounting, auditing, and bankruptcy; and corporate governance.

Among international standards aimed at improving security markets around the world are the objectives and principles of securities regulation issued by the International Organization of Securities Commissions (IOSCO), the global forum for securities regulators. In September 1998, IOSCO released 30 principles of securities regulation, which IOSCO members believe from the basis for an effective system of regulation of securities and derivatives markets. The document sets sound prudential principles and practices for the regulation and supervision of securities regulators and a yardstick against which progress toward effective regulation can be measured. The 30 principles are grouped into eight categories as follows:

a) *Principles relating to the regulator*
   1. The responsibilities of the regulator should be clear and objectively stated;
   2. The regulator should be operationally independent and accountable in the exercise of its functions and powers;
   3. The regulator should have adequate powers, proper resources, and the capacity to perform its functions and exercise its powers;
   4. The regulator should adopt clear and consistent regulatory processes;
   5. The staff of the regulator should observe the highest professional standards, including appropriate standards of confidentiality.

b) *Principles for self-regulation*
   6. The regulatory regime should make appropriate use of self-regulatory organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, to the extent appropriate to the size and complexity of the markets;
   7. SROs should be subject to the oversight of the regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.

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c) *Principles for the enforcement of securities regulation*

8. The regulator should have comprehensive inspection, investigation, and surveillance powers;
9. The regulator should have comprehensive enforcement powers;
10. The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance, and enforcement powers and implementation of an effective compliance program.

d) *Principles for cooperation in regulation.*

11. The regulator should have authority to share both public and foreign counterparts;
12. Regulators should establish information sharing mechanisms that set out when and how they will share both public and confidential information with their domestic and foreign counterparts;
13. The regulatory system should allow for assistance to be provided to foreign regulators who need to make inquiries in the discharge of their functions and exercise of their powers.

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e) *Principles for issuers*

14. There should be full, timely, and accurate disclosure of financial results and other information that is material to investor's decisions;
15. Holders of securities in a company should be treated in a fair and equitable manner;
16. Accounting and auditing standards should be of a high and internationally acceptable quality.

f) *Principles for collective investment schemes*

17. The regulatory system should set standards for the licensing and regulation of those who wish to market or operate a collective investment scheme;
18. The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection on client assets;
19. Regulation should require disclosure, as set forth under the principles for issuers, of information that is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme;
20. Regulation should ensure that there is a proper and disclosed basis for the valuation of assets and the pricing and redemption of units in a collective investment scheme.

g) *Principles for market intermediaries*

21. Regulation should provide for minimum entry standards for market intermediaries;
22. There should be initial and ongoing capital and other prudential requirements for market intermediaries;
23. Market intermediaries should be required to comply with standards for internal organization and operational conduct that aim to protect the interests of clients and under which management of the intermediary accepts primary responsibility for these matters;
24. There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.

h) *Principles for the secondary market*

25. The establishment of trading systems, including securities exchanges, should be subject to regulatory authorization and oversight;
26. Ongoing regulatory supervision of exchange and trading systems should aim to ensure that the integrity of trading is maintained through fair equitable rules that strike an appropriate balance between the demand of different market participants;
27. Regulation should promote transparency of trading;

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28. Regulation should be designed to detect and deter manipulation and other unfair trading practices;
29. Regulation should aim to ensure the proper management of large exposures, default risk, and market disruption;
30. The system for clearing and settlement of securities transaction should be subject to regulatory oversight and designed to ensure that it is fair, effective, and that it reduces systemic risk.

8.4 LEGAL FRAMEWORK FOR SECURITIES MARKETS REGULATION

There are three main Acts of parliament that govern capital market regulation in Zambia and these include:

a) The Bank of Zambia Act that gives the Bank of Zambia the mandate to act as the fiscal agent for the Government. With this authority, the central bank administers the primary issuance of government securities.
b) The Securities Act that provides for the regulation of the securities industry and the establishment of the regulatory body, the SEC.
c) The Companies Act that provides the legal framework for the formation and management of companies.

In addition to the above Acts, the following Acts of parliament guide securities market regulation in Zambia:

- The Treasury Bills Act and the Local Loans (Registered Stock and Securities) Act that empowers the Government to borrow from the public through the issuance of treasury bills, government bonds, stocks and debentures,
- The Development Bond Act that provides for the issuance of bonds for development purposes (Private-Public Partnership).

SECURITIES ACT OF 1993

The Securities Act is the main Act for the regulation of the securities industry in Zambia. The Act discuses among other things: the Securities and Exchange Commission; Securities Exchanges, registration of securities, conduct of securities business, improper trading practices, powers of intervention, the compensation fund and the collective investment schemes. The securities industry is regulated by the Securities Exchange Commission (SEC) established under the Securities Act of 1993.

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Securities Exchanges

A person shall not establish or assist in establishing or maintaining, or hold himself out as providing or maintaining, a securities market that is not the securities market of a securities exchange established by a company licensed under this Act to do so. A company may apply in the prescribed form and manner to the Commission for a license to establish and operate a securities exchange. Any such application shall be accompanied by the prescribed fee. Upon receipt of an application by a company under the act, the Commission may grant a license to that company if the Commission is satisfied that:

a) the establishment of the securities exchange is necessary in the public interest having regard to the nature of the securities industry; and
b) the applicant satisfies the requirements of the law.



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Registration of Securities

If a registration statement in the prescribed form relating to a security, signed by the issuer of the security or its representative and accompanied by the prescribed fee, has been filed with and approved by the Commission, the Commission may register the security. Securities should be registered any security of a public company is publicly traded, or directly or indirectly promoted or advertised or offered for sale to the public. Securities of a public company shall be treated as being publicly traded if

a) the company has more than fifty shareholders; or
b) the Commission, by notice in writing to the issuer, has declared that, after ninety days, those securities would be treated as being publicly traded, and ninety days has elapsed since that notice was given.

Prospectus

A prospectus prepared for the purposes of any public offer to be made in relation to any securities that are registerable shall contain or be accompanied by all such information as investors and their professional advisers would reasonably require, and reasonably expect to find there, for the purpose of making an informed assessment of the assets and liabilities, financial position, profits and losses and prospects of the issuer of the securities and the rights attaching to the securities; and shall contain or be accompanied by such other information and particulars. A person who deals in any listed, registered securities otherwise than through a securities exchange shall be guilty of an offence and shall be liable on conviction to a fine not exceeding one hundred thousand penalty units or to imprisonment for a term not exceeding five years or to both.

Any person who deals in any unlisted, registered securities otherwise than through a securities exchange and who does not forthwith report that dealing to the prescribed securities exchange shall be guilty of an offence and shall be liable on conviction to a fine not exceeding one hundred thousand penalty units or to imprisonment for a term not exceeding five years or to both. Registered securities to be traded through licensed dealers. Once registered securities are issued, the issuer must inform and keep the public informed of all matters which affect the value of the securities immediately upon their becoming known to the directors of the issuer, by placing an advertisement in a newspaper of general circulation and by reports to any securities exchange on which they are listed. Rules made under this Act may prescribe further obligation to be met by the issuers of registered securities.

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Conduct of Securities Business

A person shall not make or pursue an offer in respect of a takeover or substantial acquisition of the securities of any company except in accordance with the conditions prescribed by the rules made under this Act. Substantial acquisition means acquisition of at least twenty per cent of the issued securities of the company concerned. The Securities Exchange Commission may by statutory instrument make rules prescribing a code of conduct for the securities business. Where any contract for the sale of securities is entered into in contravention of the code of conduct, the contravention is actionable at the suit of any person who suffers loss as a result of the contravention. Every dealer shall in respect of every contract for the purchase, sale or exchange of securities entered into by him (whether as principal or agent), not later than the end of the next trading day after the contract was entered into, make out a contract note.

The Commission may, with the approval of the Minister, make rules requiring licensed dealers and licensed investment advisers to have and maintain, in respect of the business in relation to which they are licensed, such financial resources as are required by the rules made under this Act.

Rules made under this section may:

a) impose requirements which are absolute or which are to vary from time to time by reference to factors which are either specified in, or are to be determined in accordance with, the rules;
b) impose requirements which take account of any business carried on by the person concerned in conjunction with, or in addition to, the business in relation to which he is licensed; and
c) make provision as to the assets, liabilities and other matters to be taken into account in determining a person's financial resources for the purposes of the rules and the extent to which, and the manner in which, they are to be taken into account for that purpose.

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An investment adviser shall not enter into an investment advisory contract with any person in Zambia, or extend or renew any such contract, or in any way perform any such investment advisory contract entered into, extended or renewed after the commencement of this Act, if the contract:

a) provides for remuneration to be paid by the client to the investment adviser on the basis of a share of capital gains of the funds or any part of the funds of the client;
b) does not include a provision to the effect that an assignment of the contract by the investment adviser shall be made only with the consent of the client; or
c) does not include a provision to the effect that the investment adviser:
   i) if he practices in partnership with one or more other investment advisers, will notify the client of any change in the partnership; or
   ii) if a company, will notify the client of any change in the directors of the company, within a reasonable time after the change.



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8.5 IMPROPER TRADING PRACTICES AND THE COMPENSATION FUND

The Securities Act is aimed at regulating the Securities Industry so as to reduce the following defined improper trading practices:

1. False trading and manipulation of the market

A person shall not create or cause to be created, or do anything with the intention of creating:

a) a false or misleading appearance of the volume of trading in any securities on any securities exchange; or
b) a false or misleading appearance of the market for, or the price of, any such securities.

A person shall not, by means of the purchase or sale of any securities that does not involve a change in the beneficial ownership of those securities, or by any fictitious transaction or device, maintain, inflate, depress or cause fluctuations in the market price of any securities. A purchase or sale of securities does not, involve a change in the beneficial ownership if a person who had an interest in the securities before the purchase or sale, or a person associated with him in relation to those securities, and holds an interest in the securities after the purchase or sale.

A person who contravenes this shall be guilty of an offence and shall be liable on conviction to a fine not exceeding two hundred thousand penalty units or to imprisonment for a term not exceeding five years or to both.

2. Use of deceptive statements

Use of deceptive statement means a person who induces or attempts to induce another person to deal in securities:

a) by making or publishing any statement, promise or forecast that he knows to be misleading, false or deceptive;
b) by any dishonest concealment of material facts; or
c) by recklessly or dishonestly making or publishing any statement, promise or forecast that is false or misleading.

A person who shall be guilty of the above offence shall be liable to a fine not exceeding two hundred thousand penalty units or to imprisonment for a term not exceeding five years or to both.

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3. Fraudulent transactions

A fraudulent transaction occurs when a person, directly or indirectly, in connection with any transaction with any other person involving the purchase, sale or exchange or securities:

a) employs any device, scheme or artifice to defraud that other person; or
b) engages in any act, practice or course of business which operates as a fraud or deception, or is likely to operate as a fraud or deception, of that other person.

A person shall be liable on conviction of the above offence to a fine not exceeding two hundred thousand penalty units or to imprisonment for a term not exceeding five years or to both.

4. False or misleading statement in connection with sale of securities

False or misleading statement in connection with sale of securities occurs if a person who, directly or indirectly, for the purpose of inducing the sale or purchase of the securities of any company, makes with respect to those securities, or with respect to the operations or the past or future performance of the company:

a) any statement which is, at the time and in light of the circumstances in which it is made, false or misleading with respect to any material fact and which he knows or has reasonable grounds to believe to be false or misleading; or
b) any statement which is, by reason of the omission of a material fact, rendered false or misleading and which he knows or has reasonable grounds to believe is rendered false or misleading by reason of omission of that fact.

A person shall be liable on conviction of the above crime to a fine not exceeding two hundred thousand penalty units or to imprisonment for a term not exceeding five years or to both.

5. Insider dealing

Insider Dealing is when a person to whom this section applies who deals, or counsels or procures another person to deal, in securities of a company concerning which he has any knowledge that:

a) is not publicly available; and
b) would, if it were publicly available, materially affect the price of the securities.

A person shall be liable on conviction of insider dealing to a fine not exceeding two hundred thousand penalty units or to imprisonment for a term not exceeding five years or to both.

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This section applies to:

a) any director, officer or employee of the company concerned;
b) any person associated in a professional capacity with that company; and
c) any person who obtains such information from any of the persons mentioned in paragraph (a) or (b).

COMPENSATION FUND

The Minister establishes the compensation fund applied for the purpose of compensating persons who suffer pecuniary loss occasioned by any default of a licensed dealer or licensed investment adviser, or any employee of such a dealer or adviser, in the course of or in connection with any dealing in securities, being a loss in relation to any money, securities or other property which, in the course of or in connection with the business of any such licensee, was entrusted to or received by the licensee or any such employee for and on the person's behalf.

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The compensation fund consists of:

a) all moneys paid to or deposited into it by any licensed dealer or licensed investment adviser in accordance with the Securities Act;
b) all moneys recovered by or on behalf of the Commission by the exercise of any right of action conferred by this Act; and
c) all other moneys accruing to the fund.

The Minister may make regulations prescribing all such matters and things as are necessary or expedient to be prescribed for or with respect to the administration, management and application of any compensation fund Payment from the compensation fund shall be limited, in respect of each licensee in default, to such amount as the Minister may be regulation provide. Any disbursement from the compensation fund that is accountable to the default of any licensed person is a debt due to the fund and is recoverable at the suit of the Commission in any court of competent jurisdiction.

8.6 THE ROLES OF INSTITUTIONS INVOLVED IN SECURITIES MARKET REGULATION

There are three main institutions that play a vital role in the regulation of stock markets in Zambia and these include:

1. Securities exchange commission (SEC)

The Securities Exchange Commission was established in 1993 and is responsible for the supervision and development of the capital markets as well as the licensing, registration and authorizations for financial intermediaries, issuer's debt and equity instruments and collective investment schemes respectively. The Securities Exchange Commission mostly conducts off-site supervision on-site inspections are divided into ad-hoc and statutory. The former is conducted when an undesirable practice is observed in the activities of a supervised concern while the latter is performed to test compliance with SEC rules and regulations. The Securities Exchange Commission oversees the key participants in the securities / capital markets including securities exchanges, securities brokers and dealers, investment advisors and collective investment schemes.

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The Securities Exchange Commission performs the following functions:

a) to take all available steps to ensure that the Securities Act and any rules made under this Act are complied with;
b) to supervise and monitor the activities of any securities exchange and the settlement of transactions in securities;
c) to license and monitor the activities of securities exchanges, dealers, investment advisers and their respective representatives and of persons who, within the meaning of rules made under this Act, are non-bank custodians or service registrars;
d) to approve the constitutions, charters, articles, by-laws, rules and regulations governing and pertaining to any securities exchange;
e) to make, issue, monitor and enforce rules for the conduct of participants in the securities industry and for the supervision and investigation of that conduct, including rules relating to licensing and for the revocation and suspension of licenses;
f) to promote and encourage high standards of investor protection and integrity among members of any securities exchange;
g) to support the operation of a free, orderly, fair, secure and properly informed securities market;
h) to regulate the manner and scope of securities on any securities exchange, the exchange rules, listing requirements, margin requirements, capital adequacy requirements, disclosure and periodic reporting requirements, trade settlement and clearing requirements;
i) to take all reasonable steps to safeguard the interest of persons who invest in securities and to suppress illegal, dishonorable and improper practices in relation to dealings in securities, whether on the securities exchange or otherwise;
j) to take all reasonable steps to promote and maintain the integrity of persons licensed under the Securities Act and encourage the promulgation by such persons of balanced and informed advice to their clients and to the public generally;
k) to consider and suggest proposals for the reform of the law relating to the securities industry;
l) to encourage the development of securities markets in Zambia and the increased use of such markets by investors in Zambia and elsewhere;
m) to promote and develop self-regulation by securities exchange;
n) to co-operate, by the sharing of information and otherwise, with other supervisory bodies in Zambia and elsewhere;
o) to exercise and perform such other powers, authorities, duties and functions as may be conferred or imposed upon it by or under this or any other Act.

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2. Lusaka stock exchange (LUSE)

The Lusaka Stock Exchange (LuSE) was established with preparatory technical assistance from the International Finance Corporation (IFC) and the World Bank in 1993. The Exchange opened on 21st February 1994. In it's first two years of operation the LuSE and Securities and Exchange Commission (SEC) were funded by the UNDP and Government of Zambia as a project on financial and capital market development in Zambia under the multi component private sector development program.

The LuSE is made up of stock broking corporate members and is incorporated as a non-profit limited Liability Company.

The formation of the Exchange is part of the government's economic reform program aimed at developing the financial and capital market in order to support and enhance private sector initiative. The Lusaka Stock Exchange is also expected to attract foreign portfolio investment through recognition of Zambia and the region as an emerging capital market with potentially high investment returns. Another important role of the Exchange is to facilitate the divestiture of Government ownership in parastatals and realization of the objectives of creating a broad and wide shareholding ownership by the citizenry via a fair and transparent process.

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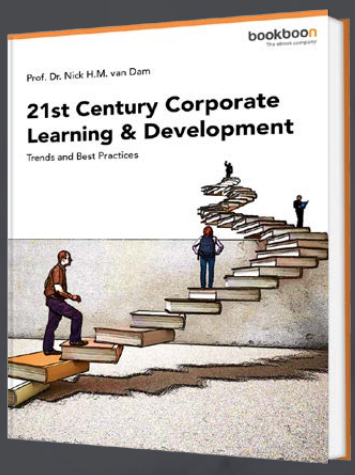

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Lusaka Stock Exchange has been set up as a modern stock exchange based on the most current international standards and practices:

- Use of a central share depository system;
- Trade-for-trade netting clearing and settlement process;
- Rolling settlement 3 days after the trade (T+3);
- Meets G30 recommendations for clearing and settlements system design and operation.

The rules and listing requirements of the LuSE are backed up by supporting legislation enacted as the Securities Act No 38 of 1993. The Securities Act regulates the entire Zambian securities market and is specifically designed to ensure adequate investor protection and support the operation of a free, orderly, fair, secure and properly informed securities market. The Act creates and defines a central market in which both unlisted and listed securities trade on exchange as opposed to the dual market system

The LUSE has 4 sets of rules for the regulation of the market:

- Rules of the exchange provide for membership requirements and conduct of members as well as disciplinary matters;
- Trading rules which regulate the manner in all trades and market transactions should be conducted;
- Clearing and settlement procedural riles which provide for the processes and procedures required for clearing and settlement for market transactions;
- Listing rules which provide for the criteria of listing securities on the LUSE as well as prescribe the conduct of listed backbone of investor protection guidelines and sets disclosure standards of price sensitive information by listed companies.

3. Central securities Depository (CSD)

The Lusaka Stock Exchange Central Securities Depository (LuSE CSD) is a subsidiary of the LuSE. The CSD runs a computer system which provides book based clearing, settlement and depository capabilities for the processing of securities transactions. The system main components are:

- Network Multi-user Access
- User Access Control
- On-line maintenance functions for brokers, clients and securities
- Trade entry
- On-line trade inquiry and update

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- On-line ledger balance inquiry
- On-line ledger adjustments, deposits, withdraws and pledging
- Book based, trade for trade settlement
- Hard copy reporting
- Customized report generation
- Data upload and download capability
- Full Audit Trails and Reporting

The LUSE central securities depository is a subsidiary of the LUSE. It is owned 50% by LUSE and 50% by Sub-custodian banks – Barclays bank and Stanbic.

The Lusaka Stock Exchange Central Securities Depository (LUSE CSD) bill due to be presented in parliament for ratification provides the legal framework for the operations of the LUSE, CSD.

The bill provides for:

a) Depository, clearing and settlement services.
b) Development of systems in which securities can be issued and transferred without certificates.
c) Use of the Bank of Zambia to act as the clearing bank for settlement of trades through the Electronic clearing house.
d) Establishment and maintenance of a guarantee fund.
e) Confidentiality as regards information available in the LUSE CSD system.
f) Lusaka Stock Exchange Central Securities Depository to operate as a self-regulatory organize and to be guided in its day to day management by the LUSE CSD rules and procedures.

The securities exchange commission is the regulatory body responsible for monitoring all activities of the securities market and approves CSD rules and amendments.

The services being provided by the LUSE CSD include:

1. Depository of securities (material/electronic)
2. Clearing of transactions.
3. Settlement of transactions.
4. Deposit/withdraw of certificates of title.
5. Processing of pledge transactions. A pledge is a form of possessory security. Assets that are being pledged need to be physically delivered to the beneficiary of the pledge.

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8.7 REVISION QUESTIONS

1. Give definitions and explain the nature of capital markets
2. Explain the structure of capital markets in Zambia
3. Give the objectives and principles of capital market regulation
4. Explain the role of corporate governance in capital market regulation
5. Outline the legal framework for securities market regulation in Zambia
6. List and explain the improper trading practices on the Lusaka Stock Exchange
7. Describe the compensation fund, its formation and purpose
8. Explain the main role of institutions involved in securities market regulation in Zambia



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9 MONEY LAUNDERING AND FINANCIAL CRIME PREVENTION

9.1 INTRODUCTION

Financial crime and money laundering has the potential to collapse any economy because it creates an alternative economy within an economy that cannot be monitored or controlled by government. Such alternative economies cannot be taxed by government therefore reducing government tax revenues. Alternative economies can also be used to fund criminal activities like terrorism hence the need for strong regulatory framework and regulatory bodies. This chapter provides an understanding of the following:

- Definitions and nature of money laundering and financial crime
- Prohibition and prevention of money laundering legislation
- Various types of suspicious financial activities
- Measures to reduce financial crime

9.2 OVERVIEW OF MONEY LAUNDERING AND FINANCIAL CRIME

There are various definitions which are used to describe the phrase 'Money Laundering'. Article 1 of the draft European Communities (EC) Directive of March 1990 defines it as: the conversion or transfer of property, knowing that such property is derived from serious crime, for the purpose of concealing or disguising the illicit origin of the property or of assisting any person who is involved in committing such an offence or offences to evade the legal consequences of his action, and the concealment or disguise of the true nature, source, location, disposition, movement, rights with respect to, or ownership of property, knowing that such property is derived from serious crime. Money laundering is also the process by which large amounts of illegally obtained money (from drug trafficking, terrorist activity or other serious crimes) is given the appearance of having originated from a legitimate source.

If done successfully, it allows criminals to maintain control over their proceeds and ultimately provide a legitimate cover for the source of their income. Money laundering plays a fundamental role in facilitating the ambitions of the drug trafficker, the terrorist, the organized criminal, the insider dealer, the tax evader as well as the many others who need to avoid the kind of attention from the authorities that sudden wealth brings from illegal activities. By engaging in this type of activity it is hoped to place the proceeds beyond the reach of any asset forfeiture laws.

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9.3 PROHIBITION AND PREVENTION OF MONEY LAUNDERING LEGISLATION

In Zambia, money laundering and financial crime are regulated under the:

i) The Prohibition and Prevention of Money Laundering Act 2001
ii) The Bank of Zambia anti-money laundering directives of 2004
iii) Narcotic Drugs and Psychotropic Substances Act

The Prohibition and Prevention of Money Laundering Act 2001

The Prohibition and Prevention of Money Laundering Act 2001 (PPMLA) was promulgated in the year 2001. Under this Act, money laundering means:

a) engaging, directly or indirectly, in a business transaction that involves property acquired with proceeds of crime;
b) receiving, possessing, concealing, disguising, disposing of or bringing into Zambia, any property derived or realized directly or indirectly from illegal activity; or
c) he retention or acquisition of property knowing that the property is, derived or realized, directly or indirectly, from illegal activity.

The Act provides for the creation of an Anti-Money Laundering Authority to be chaired by the Attorney General and an Anti-Money Laundering Investigations Unit to be chaired by the Commissioner (who is a member of Anti-Money Laundering Authority). The Act defines that the Commissioner is a person appointed as Commissioner under the Narcotic Drugs and Psychotropic Substances Act.

The Anti-Money Laundering Authority is composed of the following members appointed by the Minister:

a) the Attorney-General, who shall be the chairman;
b) the Inspector-General of the Zambia Police Force;
c) the Commissioner;
d) the Director-General of the Anti-Corruption Commission;
e) the Governor, Bank of Zambia;
f) the Commissioner-General, Zambia Revenue Authority; and
g) two other persons.

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The functions of the Anti-money Laundering Authority are:

a) to provide general or specific policy directives to the Commissioner and the Commissioner shall give effect to such directives: and
b) to advise the Minister on measures required to prevent and detect money laundering in the Republic.

The Anti-Money Laundering Investigations Unit comprises of the Commissioner and such other officers as the Commissioner shall appoint.

The functions of the Anti-Money Laundering Investigations Unit shall be –

a) to collect, evaluate, process and investigate financial information including that from regulated institutions and Supervisory Authorities, relating to financial and other business transactions suspected to be part of money laundering for the purpose of preventing and suppressing money laundering offences,
b) to conduct investigations and prosecutions of money laundering offences;
c) to liaise with other law enforcement agencies in the conduct of investigations and prosecutions of money laundering offences;



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d) to supervise the reporting requirements and other administrative obligations imposed on regulated institutions and Supervisory Authorities under this Act;
e) to assist, in developing, training. Programs for use by regulated institutions and Supervisory Authorities in the implementation of this Act; and
f) to cooperate withdraw enforcement agencies and institutions in other jurisdictions responsible for investigations and prosecution of money laundering offences.

The Bank of Zambia anti-money laundering directives of 2004

In exercise of the powers contained in section 12(4) (i.e. Duties of supervisory authorities in prevention of money laundering) of the Prohibition and Prevention of Money Laundering Act Number 14 of 2001, the Directives were made by the Bank of Zambia.

Under the directives, anti-money laundering measures and practice includes policies, procedures and controls put in place by a regulated institution to prevent and detect money laundering as prescribed in these Directives and by the Bank of Zambia from time to time.

Suspicious transaction means a transaction which is inconsistent with a customer's known legitimate business or personal activities or with the normal business for the type of account which the customer holds.

Anti money laundering measures calls for regulated institutions putting in place such anti-money laundering measures and adopt such practices as are necessary for the detection and prevention of money laundering as set out in these directives.

A regulated institution shall require its individual customers, when opening an account, establishing business relations, or conducting business transactions, with it, to produce the following documents for identification purposes –

a) in the case of a Zambian national, a National Registration Card or valid Passport or Driver's License; or
b) in the case of a foreign national, a National Registration Card and a valid Passport with, where applicable, a duly issued visa.

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When a regulated institution has doubts as to the identity of a customer in the course of its business relationship with that customer, the regulated institution shall require that customer to renew that customer's identification or provide further identification documents. A regulated institution shall identify the beneficial owner of an account opened with it and any person using remittance and safe custody facilities, and if the regulated institution fails to ascertain the identity of such owner or person, it shall make a report to the Anti-Money Laundering Investigations Unit.

Money Laundering Reporting Officer

A regulated institution is supposed to have a Money Laundering Reporting Officer who shall be a person at management level.

The Money Laundering Reporting Officer shall:

a) keep a register of all reports made by employees of the regulated institution and of all reports that the officer makes to the Anti-Money Laundering Investigations Unit;
b) on written request by the law enforcement agencies,
   i. give to them an acknowledgment receipt of the reports, from the Anti-Money Laundering Investigations Unit;
   ii. make available to the law enforcement agencies copies of reports he/she makes to the Anti-Money Laundering Investigations Unit and those made to the Money

Cooperation with law enforcement agencies

A regulated institution shall:

a) cooperate with the law enforcement agencies to facilitate the exchange of information relating to money laundering; and
b) with any law which requires the provision of information to the law enforcement agencies to assist in an investigation.

Staff training

A regulated institution shall, with the assistance of the Unit, train its employees, irrespective of the level of seniority, on what money laundering is and the importance of reporting any suspicious transactions to its Money Laundering Reporting Officer, and shall draw up a program for the training of its employees.

The following are the examples of suspicious behavior that the Bank of Zambia has included in its money laundering directives of 2004:

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Suspicious Customer Behavior

a) Customer has an unusual or excessively nervous demeanor during the business transaction;
b) Customer discusses the regulated institution's record keeping or reporting duties with the apparent intention of avoiding them;
c) Customer threatens an employee of a regulated institution attempting to deter a record keeping or reporting duty;
d) Customer is reluctant to proceed with a business transaction after being told it must be reported;
e) Customer suggests payment of a gratuity to an employee of the regulated institution;
f) Customer appears to have a hidden agenda or behaves abnormally, such as passing the opportunity to obtain a higher interest rate on a large account balance; or
g) Customer opens an account in the name of a family member who begins making large deposits not consistent with the known legitimate sources of income of the family.

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Suspicious Customer Identification Circumstances

a) Customer claims to be a law enforcement agent conducting an undercover operation when there are no valid indications to support that;
b) Customer furnishes unusual or suspicious identification documents and is unwilling to provide personal background information;
c) Customer is unwilling to provide personal background information when opening an account;
d) Customer opens or attempts to open an account without identification, references or a local address;
e) Customer's permanent address is outside the bank's service area or outside Zambia;
f) Customer's home or business telephone is disconnected;
g) Business customer is reluctant to reveal details about the business activities or to provide financial statements or documents about a related business entity; or
h) Customer provides no record of past or present employment on a loan application.

Suspicious Cash Transactions

a) Customers who together, and simultaneously, use separate tellers to conduct large Kwacha cash transactions or foreign exchange transactions;
b) Customer opens several accounts in one or more names, and then makes several cash deposits;
c) Customer conducts unusual cash transactions through night deposit boxes, especially large sums that are not consistent with the customer's business;
d) Customer makes frequent deposits or withdrawals of large amounts of currency for no apparent business reason, or for a business that generally does not generate large amounts of cash;
e) Customer conducts several large cash transactions at different branches on the same day, or orchestrates persons to do so on his/her behalf;
f) Customer deposits cash into several accounts and then consolidates the funds into one account and wire transfers them outside of Zambia;
g) Customer attempts to take back a portion of a cash deposit after learning that a currency transaction report will be filed on the transaction;
h) Customer conducts several cash deposits at automated teller machines;
i) Corporate account has deposits or withdrawals primarily in cash rather than cheques;
j) Customer's cash deposits often contain counterfeit or musty or suspicious dirty notes;
k) Customer frequently deposits large sums of cash wrapped in currency straps stamped by other banks;
l) Customer makes frequent purchases of monetary instruments for cash; or
m) Customer conducts an unusual number of foreign currency conversion transactions.

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Suspicious Wire Transfer Transactions

a) Non-account holder sends wire transfer with funds that include numerous monetary instruments;
b) An incoming wire transfer has instructions to convert the funds to cashier's cheques and mail them to a non-account holder;
c) A wire transfer that moves large sums to secrecy havens such as the Cayman Islands, Hong Kong, Luxembourg, Panama or Switzerland;
d) An incoming wire transfer followed by an immediate purchase by the beneficiary of monetary instruments for payment to another party;
e) An increase in international wire transfer activity in an account with no history of such activity or where the stated business of the customer does not warrant it;
f) Customer frequently shifts purported international profits by wire transfer to another country;
g) Customer receives many small incoming wire transfers and then orders a large outgoing wire transfer to another country; or
h) Account in the name of a currency exchange house receives wire transfers or cash deposits of a substantial amount.

Suspicious Safe Deposit Box Activity

a) Customer's activity increases in the safe deposit box area, possibly indicating the safekeeping of large amounts of cash; or
b) Customer rents multiple safe deposit boxes.

Suspicious Activity in Credit Transactions

a) Customer's financial statement makes representations that do not conform to generally accepted accounting principles;
b) Transaction is made to appear more complicated than it needs to be by use of impressive but unnecessary terms such as "emission rate," "prime bank notes," "standby commitment," "arbitrage" or "hedge contracts," etc.;
c) Customer requests loans to offshore companies or loans secured by obligations of offshore banks;
d) Customer suddenly pays off a large problem loan with no plausible explanation for the source of funds;
e) Customer collateralizes a loan with cash deposits;
f) Customer uses cash collateral located offshore to obtain a loan; or
g) Customer's loan proceeds are unexpectedly transferred offshore.

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Suspicious Commercial Account Activity

a) Business customer presents financial statements noticeably different from those of similar businesses;
b) Large business presents financial statements that are not prepared by an accountant;
c) Retail business that provides cheque cashing service does not make large withdrawals of cash against cheque deposits, possibly indicating that it has another source of cash;
d) Customer maintains an inordinately large number of accounts for the type of business purportedly being conducted;
e) Corporate account shows little or no regular or periodic activity; or
f) Transaction includes circumstances that would cause a banker to reject a loan application because of doubts about the collateral's validity.

Suspicious Trade Financing Transactions

a) Customer seeks trade financing on the export or import of commodities whose stated prices are substantially more or less than those in a similar market situation;
b) Customer makes changes to a letter of credit beneficiary just before payment is to be made;
c) Customer changes the place of payment in a letter of credit to an accountant in a country other than the beneficiary's stated location; or
d) Customer's standby letter of credit is used as a bid or performance bond without the normal reference to an underlying project or contract, or in favour of unusual beneficiaries.

Suspicious Investment Activity

a) Customer uses an investment account as a pass-through vehicle to wire funds particularly to off-shore locations;
b) Investor seems unconcerned about the usual decisions to be made about an investment account such as fees or suitable investment vehicles;
c) Customer wants to liquidate a large position through a series of small transactions; or
d) Customer deposits cash, money order, traveler's cheques or counter cheques to fund an investment account.

Suspicious Deposits

a) Customer deposits a large number of traveler's cheques often in the same denomination and in sequence without a reasonable explanation; or
b) Customer deposits money orders bearing unusual markings.

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Miscellaneous Suspicious Customer Activity

a) Customer who is a student uncharacteristically transfers or exchanges large sums of money;
b) Account shows high velocity in the movement of funds, but maintains low beginning and ending daily balances;
c) Transaction includes correspondence received that is a copy rather than original letterhead;
d) Transaction involves offshore institutions whose names resemble those of well known legitimate banks;
e) Transaction involves unfamiliar countries or islands that cannot be found on a world atlas or map; or
f) Agent, attorney or financial advisor acts for another person without proper documentation such as a power of attorney.

Suspicious Employee Activity

a) Employee exaggerates the credentials, background or financial ability and resources of a customer in written reports the bank requires;
b) Employee is frequently involved in unresolved exceptions or recurring exceptions on exception reports;
c) Employee lives a lavish lifestyle that cannot be supported by his or her salary;
d) Employee frequently overrides internal controls or established approval authority or circumvents policy;
e) Employee uses company resources to further private interests;
f) Employee assists transactions where the identity of the ultimate beneficiary or counter party is undisclosed; or
g) Employee deliberately avoids taking vacations.

9.4 REVISION QUESTIONS

1. Give definitions and explain the nature of money laundering and financial crime
2. Give an overview of prohibition and prevention of money laundering legislation in Zambia
3. Explain the various types of suspicious financial activities
4. Explain measures regulators use to reduce financial crime

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