NEW CLASSIFICATION AND PROVISIONING FOR MICROFINANCE LOANS

**Background**

In 2018, the Bank of Zambia introduced Microfinance classification and provisioning directives through Government Gazette Notice No. 892 dated 2nd November of 2018. The directives contained therein brought about a change in the way licensed microfinance institutions (MFIs) are to treat the classification and provisioning for loans. This was a change from the previous classification and provisioning regime based on Statutory Instrument No. 142 of 1996.

**The International Accounting Standards Board (IASB)**

It is important to note that the change was not driven by a decision arrived at the Bank of Zambia by itself, no. Rather, this was driven by a decision arrived at by the International Accounting Standards Board in 2014 (IASB, 2014). According to the International Accounting Standards Board (IASB, 2014), during the financial crisis of 2008-9, the incurred loss model that was in use in the recognition of credit losses in International Accounting Standard 39 (IAS 39) contributed to the delayed recognition of losses, because under the model credit losses were only recognised when a loss event occurred. The experiences during the financial crisis somehow brought to light recognised that this treatment of credit losses was a major weakness in accounting standards. Therefore, in order to address this shortcoming of IAS 39, the IASB developed a forward-looking expected credit losses (ECLs) model.

**International Financial Reporting Standards 9 (IFRS 9)**

To operationalise the new standard across the globe, the International Financial Reporting Standards No. 9 (IFRS 9) was issued in 2014.

A comparison between the old and new classification and provisioning regimes is demonstrated below:

Table 1: Classification & Provisioning

| **Classification** | **Provisioning** |
|---|---|
| Pass | At discretion of the concerned institution |
| Substandard | 20 per cent (90 – 119 days) |
| Doubtful | 50 per cent (120 – 179 days) |
| Loss | 100 per cent (180 days and beyond) |

Source: Statutory instrument No. 142, of 1996.

Table 2: IFRS 9 – Classification & Provisioning

| **Classification** | **Definition** | **Provisioning** |
|---|---|---|
| Pass | A credit facility which is up to date in payments. | 0 per cent |
| Special mention | A credit facility in which principal or interest is due but unpaid for one day or more, but still within 30 days. | 10 per cent |
| Substandard | A credit facility in which the principal or interest is due but remains unpaid for 30 | 25 per cent (30 – 59 days) |

| | | |
|---|---|---|
| | days or more but less than 60 days. | |
| Doubtful | A credit facility in which the principal or interest is due but remains unpaid for 60 days or more but less than 90 days. | 50 per cent (60 – 89 days) |
| Loss | A credit facility in which the principal or interest is due but remains unpaid for 90 days or more. | 75 per cent (90 – 119 days) |
| Loss | A credit facility in which the principal or interest is due but remains unpaid for 120 days or more. | 100 per cent and write off within 6 months of being identified as loss. |

Source: Classification & Provisioning Directives, 2018

A comparison between the two regimes shows that the new regime is a more tighter loan portfolio monitoring regime. This is what the norm should actually be for microfinance.

**Operationalisation**

According to the IASB, this new model was to be implemented by different jurisdictions at global level starting January 2018. However, there was also recognition of the circumstances prevailing in different jurisdictions and so some flexibility was allowed to jurisdictions in implementing the new regime.

**How Microfinance Industry in Zambia has received IFRS 9**

In line with the recognition by IFRS 9 of circumstances in different jurisdictions as rightly identified above, Bank of Zambia actually delayed implementation by one more year from 2018, until January 2019. The announcement of the new classification and provisioning directives was made by BoZ during November-December 2018 via a government gazette notice, number 892 of November 2018, for implementation in January 2019.

Just as acknowledged by IFRS 9, that the new requirements would require larger loss allowances, and in the short term would reduce equity and have an impact on regulatory capital, and that in most cases it might require changes to existing information management systems, the microfinance industry in Zambia expressed worry on the potential negative consequences on the financial health of institutions should the directives contained in the gazette notice be implemented without consideration of the negative effects. Immediately, a number of MFIs affiliated to the Association of Microfinance Institutions of Zambia (AMIZ) made a decision to engage the central bank. The first meeting was in February 2019 at which AMIZ presented a position taken by its member MFIs informing the central bank of the potential negative consequences of implementing the directives. Among the key arguments were that a number of factors were weighing down on the industry in Zambia, such as: the effects of the interest rate cap which some institutions were yet to fully recover; the depressed state of the economy which had created an environment not supportive to business, the fear that erosion of capital might put pressure on shareholders who ultimately would have to recapitalize affected MFIs, and also the threat to the sustainability of the businesses, among others. While this was so, AMIZ requested that BoZ consider an extension of 6 months to allow the industry to make assessments on the impact of the directive, and thereafter report back to.

The 6 months it would seem passed very swiftly, and it was time to report back to BoZ. A survey by AMIZ of its member MFIs suggested that most institutions were still struggling to implement IFRS 9.

**Suspension of the Directives by Bank of Zambia**

On 26th November 2019 the Bank issued a circular to heads of microfinance institutions suspending the Microfinance classification and provisioning directives with immediate effect, and until further notice. This was met with much relief to all concerned. In the meantime, the Bank has advised that Statutory Instrument No. 142 of 1996, would apply.

**Way forward**

While the step taken by BoZ is commendable in the short term, it will be important to recognise the spirit in which IFRS 9 was arrived at by the IASB, and that is for MFIs to recognise the importance of tighter monitoring of their credit portfolios to avoid incurring huge losses in present day economic volatility.

During the engagements on the directives during the past year, the Bank and the industry made quite some progress in working together to resolve the matter. The energy generated from working together should be used to continue the engagement to find a solution to the impasse rather than abandon the process. This is so because IFRS 9 is the new standard that must be supported by all concerned.

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**References**

Impairment of financial instruments under IFRS 9 (2014)

Gazette notice no. 892 (2018)

Statutory Instrument No. 142 of 1996