MMLP
Mulenga Mundashi
Legal Practitioners

Celebrating 25 Years of Excellence

Protecting Financial Institutions Against Non-Performing Loan Exposure: Lessons from the Chilola Intertrade v CEEC Court of Appeal Decision

15th May 2024

1. Introduction

1.1. Non-performing loans ("**NPLs**") pose a significant risk to the financial health and stability of lending institutions. These are loans where the borrower has failed to make scheduled payments for an extended period, typically 90 days or more. As NPLs accumulate, they erode the institution's profitability, tie up capital that could be used for fresh lending, and may ultimately threaten solvency if not managed properly.

1.2. In a recent landmark judgment, the Court of Appeal of Zambia provided guidance on the issue of charging interest on NPLs. The article provides a brief overview of the decision, its potential implications for lending institutions in Zambia, and potential strategies to mitigate exposure to NPLs.

2. Court of Appeal Decision

2.1. On 16 February 2024, the Court of Appeal of Zambia provided the much-needed clarity on the contentious issue of charging interest on NPLs. In the case of Chilola Intertrade and Others ("Chilola") v. Citizens Economic Empowerment Commission ("CEEC"), CAZ Appeal No. 282/2022 (the "**CEEC Case**") involved an appeal against a High Court decision that had allowed CEEC to recover the full extent of interest on a loan facility that had fallen into default.

2.2. The key facts were that Chilola had obtained a ZMW 2 million loan from CEEC in 2010, secured by mortgages and guarantees from the company's irectors. The loan was to be repaid over 54 months, but Chilola failed to make the required instalments. By the time CEEC commenced recovery proceedings in 2021, the outstanding debt had grown to over ZMW 3.3 million due to the accumulation of interest.

2.3. In its defence, Chilola argued that CEEC was not entitled to continue charging interest on the defaulted loan indefinitely, as this was contrary to Section 110 of the Banking and Financial Services Act, 2017 (the "**Banking Act**"). This provision stipulates that when a loan becomes non-performing (i.e., repayments are more than 90 days overdue), the lender can only recover interest up to the point of default and not exceeding the principal amount then outstanding. The Court of Appeal agreed with this interpretation, holding that Section 110 of the Banking Act applied to CEEC notwithstanding that it was not a commercial bank, but a statutory body established pursuant to the Citizens Economic Empowerment Commission Act. The Court directed that the recoverable amount be reassessed to ensure that interest did not exceed the principal debt as at the date of default in July 2015.[1]

3. Strategies for Financial Institutions to Mitigate Non-Performing Loan Exposure

3.1. The CEEC Case has significant implications for lending institutions. It highlights the need for proactive management of NPLs to prevent the accumulation of interest that may ultimately prove irrecoverable. Drawing from the CEEC Case, outlined below are some examples of the key steps financial institutions could take to protect themselves against NPLs:

(a) Firstly, the foundation of any lending relationship is a clearly drafted loan agreement that comprehensively stipulates the terms of the facility, repayment schedule, interest rates, and the consequences of default. Ambiguity in loan contracts can lead to disputes and make recovery efforts more challenging. Therefore, it is important that transaction documents are properly drafted upfront.

(b) Secondly, lenders should strive to disburse funds in a timely manner in accordance with the agreed drawdown schedule. Delays in making the loan available can hamper the borrower's ability to execute their plans, which in turn impacts their cash flows and ability to repay. If there are conditions precedent to

1 Although this ruling remains subject to potential appeal by CEEC before the Supreme Court, the current status is that the decision of the Court of Appeal stands as law until it is reversed or overturned.

disbursement, these should be clearly communicated, and any challenges addressed promptly.

(c) Thirdly, once the loan is active, the lender must closely monitor the account and the borrower's financial health. Early warning signs of distress, such as missed payments, should be addressed promptly for the simple reason that allowing multiple instalments to fall into arrears without intervention compounds the problem. If a loan does become non-performing, it is critical to engage the borrower in dialogue to understand the underlying issues and formulate a plan to get back on track. Simply letting the situation deteriorate exposes lenders.

(d) Fourthly, lenders also need to be cognizant of the regulatory landscape concerning non-performing assets. For instance, Section 110 of the Banking Act limits the charging of interest on NPLs to the principal amount outstanding at the time of default. Continuing to apply interest to the whole debt indefinitely will fall afoul of such provisions and could lead to the exclusion of a portion of the accrued interest should the matter end up in litigation, as was decided in the CEEC Case.

(e) Fifthly, lenders need to be extremely categorical when employing strategies that inform the nature of the borrower's collateral. Facilities should be backed by guarantees, mortgages on property, debentures on assets, and/or other forms of collateral wherever possible. Doing so provides the lender with recourse if the borrower's cash flows are unable to service the debt. It is also important to perfect the security in line with legal requirements to ensure enforceability. Insurance on key assets should also be in place, as uninsured losses can quickly turn a performing loan into an NPL, as was the case in the CEEC Case when fire gutted the borrower's premises.

(f) Lastly, when attempts at rehabilitating a non-performing facility have failed, lenders should move decisively to recover. This may involve restructuring the loan on more favourable terms if the underlying business is still viable, or pursuing liquidation if there is no realistic path to turnaround. Delay and indecision allow the problem to fester.

4. Conclusion

4.1. In conclusion, NPLs pose significant risks to the financial health and stability of lending institutions. As NPLs accumulate, they erode profitability, tie up capital that could be used for fresh lending, and may ultimately threaten solvency if not managed properly. The CEEC Case provided clarity on the issue of charging interest on NPLs, emphasizing the importance of compliance with regulatory requirements such as Section 110 of the Banking Act, which limits interest to the principal amount outstanding at the time of default.

4.2. To protect themselves against the risks associated with NPLs, financial institutions must implement proactive strategies. These include drafting clear and comprehensive loan agreements, ensuring timely disbursement of funds, closely monitoring accounts and borrowers' financial health, securing loans with robust collateral and insurance, and taking decisive action to recover NPLs through restructuring or liquidation when necessary. By proactively managing NPLs, financial institutions can mitigate their impact and maintain their financial stability. The key to successfully navigating the challenges posed by NPLs lies in a combination of prudent lending practices, early detection of potential issues, and swift, decisive action when problems arise. Financial institutions that adopt these strategies will be better positioned to weather the storm of NPLs and emerge stronger on the other side.

Disclaimer:

The information provided in this article is intended for general informational purposes only and does not constitute legal advice. Transmission or receipt of the information contained in this article does not create a lawyer-client relationship. Readers should not act upon this information without seeking professional counsel.

Authors:

Mike Chilufya
Partner
T: +260-211-254248/50 M: +260 972 897 883
E: mike@mmlp.co.zm

Constance N. Mwango
Associate
T: +260-211-254248/50
E: constance@mmlp.co.zm

About

Mulenga Mundashi Legal Practitioners is a forward-thinking legal firm that merges the realms of law, business, and innovation to offer our clients highly effective solutions. Our core objective is to provide solutions that truly make a positive difference in our clients' business ventures. We have invested significant resources in shaping our firm to ensure that our size, structure, and operational processes do not limit our ability to provide the agility and adaptability that our clients require in navigating an ever-changing business landscape.

Call us on: +260-211-254248/50
info@mmlp.co.zm