Banking Supervision Annual Report 2009

Bank of Botswana

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List of Abbreviations

AABMC	African Alliance Botswana Management Company
AAI	African Alliance International
ABCB	African Banking Corporation of Botswana Limited
AML	Anti-Money Laundering
ATA	Average Total Assets
ATM	Automated Teller Machine
Barclays	Barclays Bank of Botswana Limited
Baroda	Bank of Baroda (Botswana) Limited
BAB	Bankers Association of Botswana
BBS	Botswana Building Society
BCBS	Basel Committee on Banking Supervision
BCPs	Basel Core Principles for Effective Banking Supervision
BG	Bank Gaborone Limited
BIS	Bank for International Settlements
BITF	Basel II Implementation Task Force
BoBCs	Bank of Botswana Certificates
BSB	Botswana Savings Bank
CAMELS	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to Market Risk
CBL	Capital Bank Limited
CFT	Combating of the Financing of Terrorism
CIUs	Collective Investment Undertakings
DSAs	Direct Sales Agents
ESAAMLG	Eastern and Southern African Anti-Money Laundering Group
FNBB	First National Bank of Botswana Limited
FSAP	Financial Sector Assessment Programme
FSIs	Financial Soundness Indicators
GBP	British Pound Sterling
GDP	Gross Domestic Product
HHI	Herfindahl–Hirchman Index
IFRS	International Financial Reporting Standards
IFSC	International Financial Services Centre

IMF	International Monetary Fund
IT	Information Technology
LHS	Left Hand Scale
NBFIRA	Non-Bank Financial Institutions Regulatory Authority
NDB	National Development Bank
NMD	Namibian dollar
QIS	Quantitative Impact Survey
RHS	Right Hand Scale
ROAA	Return on Average Total Assets
ROE	Return on Equity
RWA	Risk-Weighted Assets
SADC	Southern African Development Community
SIMS	Stanbic Investment Management Services
SMS	Short Messaging Services
Stanbic	Stanbic Bank Botswana Limited
Stanchart	Standard Chartered Bank Botswana Limited
USD	United States dollar
ZAR	South African rand

Foreword

The global economy faced a challenging year in 2009, and plunged into the most severe recession since the Great Depression before commencing a tentative recovery later in the year, with support of accommodative fiscal and monetary policies. This pattern was reflected in the domestic economy, principally because of a sharp contraction of the mining sector, but also more widely through uncertainty in economic fundamentals due to global financial developments and depressed confidence in the domestic corporate sector. The impetus from a combination of accommodative fiscal and monetary policies provided timely support in stabilising business activity and restoring confidence.

Notwithstanding these challenges, the banking sector remained strong, with most banks reporting high levels of liquidity and capital adequacy ratios. The pace of profit growth for most banks declined significantly on account of a sharp rise in provisions for impaired loans. Many banks continued to retain a significant portion of their profits in order to bolster capital positions, which was a welcome development that should place banks in a better position to respond to any increase in demand for credit as the economic recovery gains momentum. In this respect, an indication of the banking sector's positive outlook on prospects for business recovery and its confidence in the potential for a market upturn is reflected by an improvement in the industry's financial intermediation ratio, which increased by 5 percentage points. The increase in financial intermediation, as partly bolstered by monetary policy easing, provided a measure of reassurance that banks had effective risk management practices and proactively identified and made provisions for non-performing loans.

The financial sector landscape changed during 2009; the licensing of ABN AMRO N.V., together with the expansion of the branch network operated by existing banks, further broadened the reach of the financial sector, thus resulting in a welcome improvement in access to banking services by both businesses and households. This will also improve the quality and efficiency of service delivery.

With the operations of the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) continuing to gather pace during 2009, several institutions previously regulated by the Bank were transferred to the Authority. The resulting challenge, as clearly underlined by the global financial crises, is the continuing need to ensure that there are no regulatory gaps that lead to the emergence of unregulated financial service providers that, either individually or collectively, could potentially pose systemic risk to the financial system. For this reason, effective collaboration, cooperation and communication between the Bank and NBFIRA are key to effective financial sector supervision in Botswana.

Regulatory compliance remained high, consistent with the responsiveness of the sector to supervisory and policy signals. The level of transparency has also been heightened, as indicated by the quality of disclosures in the banks' financial statements and monthly publication of deposit interest rates, at the behest of the Bank, and other pricing information in domestic newspapers. However, despite a discernible improvement in disclosure practices, the achievement of a proper alignment of pricing changes between bank assets and liabilities remains a challenge. It is the Bank's expectation that the market will continuously refine its practices to ensure timely and balanced transmission of monetary policy signals. Furthermore, the cost of financial services vis-à-vis the quality of such services continues to be a source of public concern. The Bank has continued to implore the banking industry to be responsive to these understandable concerns about the high cost of banking services, as well as to promote policies and practices that foster further improvements in access to financial services.

The Bank will continue to monitor progress on the global financial reform agenda and review banking regulatory and supervisory policies and practices as may be justified by prevailing financial and economic developments at both the international and domestic levels. Indeed Botswana pays attention to the recommendations made by multilateral agencies, such as the International Monetary Fund, World Bank, Financial Stability Board and Basel Committee on Banking Supervision (BCBS) and would adopt those considered appropriate and in line with international best practice. The recommendations tend to focus on financial architecture reforms and policy responses relating to dealing with systemic risk and systemically important institutions; broad risk vis-à-vis institution specific risks; risks posed

by “shadow banking” activities; revision of capital and liquidity standards; and international cooperation and cross-border regulatory issues. Even though the Botswana financial system was less adversely affected by the crises than the major global financial centres for which some of these proposed reforms are particularly relevant, the adoption of international standards can only bring advantage to the domestic banking/financial sector.

Linah K. Mohohlo

GOVERNOR

Introduction

Performance of the Banking Sector

The soundness, stability and liquidity of the Botswana banking industry has confirmed the assessment that it emerged relatively safe from the difficult operating environment occasioned by the global financial and economic crises that characterised the year 2009. The domestic banking sector remained relatively resilient throughout the period to the extent that the sector did not require any form of supervisory intervention and/or financial support to restore public confidence in the financial system in the same way that other countries have had to do. However, this does not mean that there were no consequences of the global financial and economic crises for the sector and country's economy. The crises impacted the banking sector through constrained corporate and retail demand for credit as incomes were curtailed. On the retail side, real incomes came under pressure due to a civil service salary freeze for the second consecutive year and job losses in the private sector as struggling businesses retrenched employees. Also, a more direct impact came through the mining sector, which was heavily affected by the crises, though the translation into reduced demand for credit was minimal because bank exposures to the sector were, and have historically been, fairly small relative to the industry balance sheet size. But there was an additional factor, unrelated to the crises, that put a brake on growth of banks' revenues; this was the easier monetary conditions aided by benign inflation, both domestically and globally, which translated into lower lending interest rates and, consequently, reduced revenues from the core financial intermediation activities.

Although the overall level of banking sector assets showed a modest decline, most of the constituent elements grew, although at rates lower than those recorded the previous year. Bank lending to households increased, resulting in households accounting for more than half of the banks' total loan portfolio. Put against the background of shrinking real household incomes, this development may well be considered perverse. However, households are known to smoothen their expenditure patterns over time, and in this case, they were able to borrow in spite of the erosion of their capacity to service debt, which could mean the erosion was not severe. This notwithstanding, the amount of buffer that household incomes may have provided could come under serious pressure if economic recovery gets underway at a pace much slower than expected. This could impact negatively on households' capacity to service loans, thus resulting in a deterioration of asset quality of banks. Private corporate sector borrowing declined marginally, reflecting the reduction in credit to the mining sector and this is in line with the substantial contraction in mining Gross Domestic Product (GDP) during the year. The non-mining corporate sector continued to dominate corporate borrowing; this is consistent with the robust growth of non-mining private sector GDP in 2009.

In view of the deterioration in global and domestic economic conditions, the quality of banking assets suffered, and banks responded by significantly increasing provisions for non-performing loans and other impaired assets.

Overall banking sector deposits were barely changed in 2009; but corporate deposits continued to serve as a major funding source for banks' operations, albeit at a reduced level compared to 2008. Consistent with past trends, households contributed less than a fifth of industry deposits and were net borrowers from the banking system.

Notwithstanding the global financial crises, the banking sector continued to be profitable and well capitalised and complied with both statutory and other prudential requirements. The aggregate large exposures of the banking sector to unimpaired capital not only satisfied the prudential requirement, but declined, an indication that banks prudently managed concentration risk. The banking sector continued to maintain a healthy liquidity position, with liquidity ratios significantly in excess of the minimum statutory requirement of 10 percent.

Furthermore, the banking system expanded in terms of branch network, new channels of service delivery and products. This may be indicative of banks taking a long-term view of their investments beyond the short-term impact of the global financial and economic crises. However, even with the nascent signs of economic recovery, the effects of the crises will take long

to dissipate. The Bank, in cooperation with banks and other stakeholders, will continue to ensure that robust risk management processes are entrenched in banks' operations, including timely recognition and adequate provisioning for non-performing loans.

The detailed assessment of the state of the banking sector has been made as follows: Chapter 1 highlights the structure of the banking sector, while Chapter 2 provides an assessment of the operational performance of the banks in 2009. A summary of statutory compliance in the banking sector is provided in Chapter 3 and Chapter 4 covers the operational performance of non-bank financial institutions. International best practices on banking supervision and other banking system developments are covered in Chapters 5 and 6, respectively. Concluding observations on the overall position of supervised institutions are summarised in Chapter 7.

The appendices provide a list of institutions licensed and supervised by the Bank, definitions of banking supervision terms and approaches to regulation and supervision of banks in Botswana. Aggregate financial data and charts of key prudential and financial soundness indicators (FSIs) are also included.

Chapter 1: Banking Sector Overview

1. Structure of the Banking Industry and Other Supervised Institutions

Commercial Banks, Statutory Banks and Other Entities

A number of changes occurred in the regulatory and supervisory landscape of the financial sector entities during 2009. The commencement of operations by the Non-Bank Financial Institutions Regulatory Authority (NBFIRA)[1] led to the transfer by the Bank of its regulatory and supervisory mandate under the Collective Investment Undertakings Act (CIUs) and its custodial role under the International Financial Services Centre (IFSC) in September 2009.[2] As a result, the composition of institutions regulated by the Bank at the end of 2009 was as follows: commercial banks (11),[3] bureaux de change (53) and a micro-finance institution.[4] In addition to the supervision of these institutions, the Bank continued to supervise development finance institutions (3), on an agency basis.

Banking Business Networks for Licensed Institutions

Mounting competitive pressures and the desire to protect and grow market share made banks, especially smaller ones, to strengthen delivery channels by way of branch and automated teller machine (ATM) network expansion. Four new branches commenced operations during the year, of which 3 were for smaller banks and one for a large bank. This resulted in the number of commercial bank branches increasing from 87 in 2008 to 91 in 2009 (Table 1).

However, the number of ATMs decreased from 360 in 2008 to 352 in 2009 (Table 1), as a result of the closure of 32 mini-ATMs by Bank Gaborone Limited (BG). The decline in the number of ATMs was moderated by an increase in new ATMs (24) installed, mostly by First National Bank Botswana (FNBB)

Table 1: Licensed Banks' Representation: 2008–2009*

Bank	Branches and Sub-Branches		Agencies		Sales Centres		ATMs	
	2008	2009	2008	2009	2008	2009	2008	2009
Barclays	40	40	2	0	12	12	100	100
Stanchart	13	13	3	3	0	0	42	43
FNBB	17	18	0	0	0	0	164	185
Stanbic	9	9	0	0	0	0	16	16
Baroda	2	2	0	0	0	0	0	2
ABCB	2	2	0	0	0	0	0	0
BG	2	4	0	0	0	0	38	6
Capital	1	2	0	0	0	0	0	0
Kingdom	1	1	–	–	–	–	–	–
Total	87	91	5	3	12	12	360	352

'–' Means not applicable

* Botswana Savings Bank (BSB), Botswana Building Society (BBS) and National Development Bank (NDB) are not included in Table 1. If these institutions are included the total numbers of bank branches and ATMs are 112 and 362, respectively, as at December 31, 2009. BSB had 2 branches; BBS 9 branches and 10 ATMs; NDB 4 branches.

2. New Banking Products

In an effort to enhance customer service, some banks introduced electronic banking (e-banking) services. The e-banking services included the electronic transfer of funds between accounts, utility bills payments, balance enquiries and cheque book requests. In addition, some of the facilities offered through e-banking included the

1 NBFIRA is a body responsible for the regulation and supervision of non-bank financial services providers such as asset management companies, insurance companies and pension funds.

2 Oversight responsibility for 22 IFSC entities and 4 CIUs was transferred to the NBFIRA.

3 This includes Kingdom Bank Africa Limited (KBAL), an offshore bank and two newly licensed banks that had not commenced operations by the end of the year. Data for KBAL are not included in the industry data analysed in the Report.

4 The only registered micro-finance institution in the country is Women's Finance House Botswana.

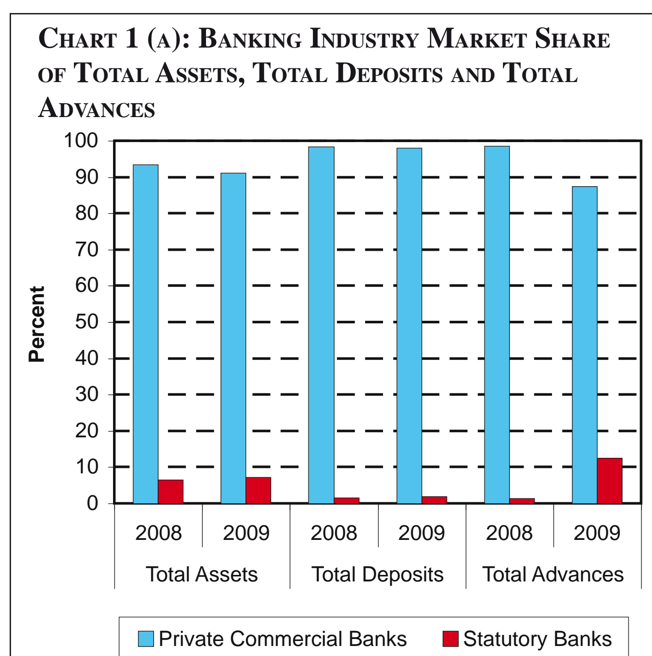
electronic retrieval of bank statements for bank customers with access to e-mail and SMS alerts for notification on withdrawals and purchases made from customer accounts.

One bank expanded its business into bancassurance by establishing a wholly-owned insurance brokerage company with the objective of tapping into the growing insurance market.

3. Market Share

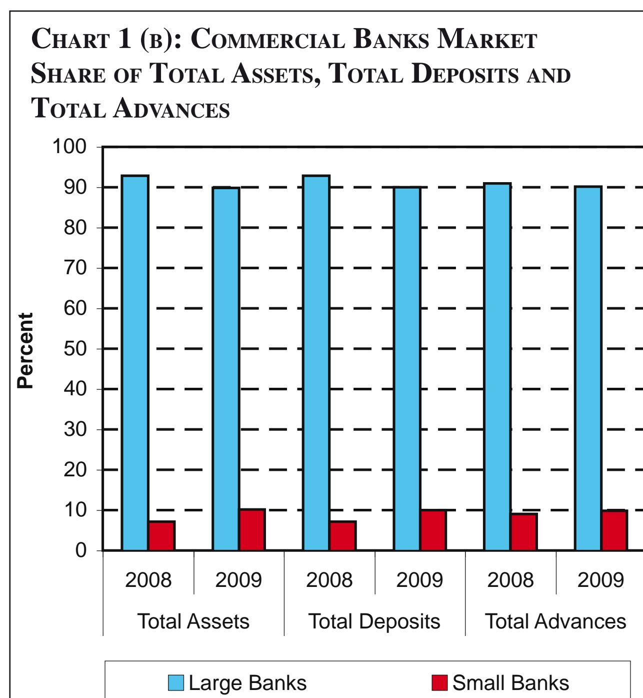
In a reversal of a four-year trend, statutory banks gained market share during 2009. While private commercial banks held 94 percent and 97 percent of industry assets and loans in 2008, this had dropped to 91 percent and 88 percent, respectively, in 2009 (Chart 1(a)). The privately owned commercial banks market share of total deposits remained unchanged at 98 percent.

Chart 1 (a): Banking Industry Market Share of Total Assets, Total Deposits and Total Advances



Within the category of privately owned commercial banks, the four large banks[5] accounted for about 90 percent of total assets, total deposits and total loans in 2009. In each case, that proportion was slightly lower than in the previous year, an indication that 'other banks' had made inroads, albeit marginally, into the dominant market share. This suggests that the entry of new banks into the local market and the introduction of new services, including electronic banking (which small banks also offer), improved the competitiveness of smaller banks in 2009. However, as a group, the 'other banks' category remains fairly small.

Chart 1 (b): Commercial Banks Market Share of Total Assets, Total Deposits and Total Advances



4. Competition

The degree of competitiveness in the banking industry is dependent on the structure and size of the industry. Competitiveness ranges from highly competitive market conditions with many banks (of about the same size) to uncompetitive monopolistic conditions where the industry is dominated by one bank. More often, however, markets are oligopolistic, the main feature of which is a few players in the market. A monopolistic market will have high concentration levels which would result in an increase in market power, a factor that can lead to anti-competitive behaviour and, consequently, higher cost of banking services for customers. In an oligopolistic situation, the market will also be highly concentrated in a few large banks, with such banks having substantial market control, although not to the same extent as in a monopoly. In general, a higher number of banks of comparable size in the market causes banks to price competitively, thus reducing the degree of market power and collusion among banks.

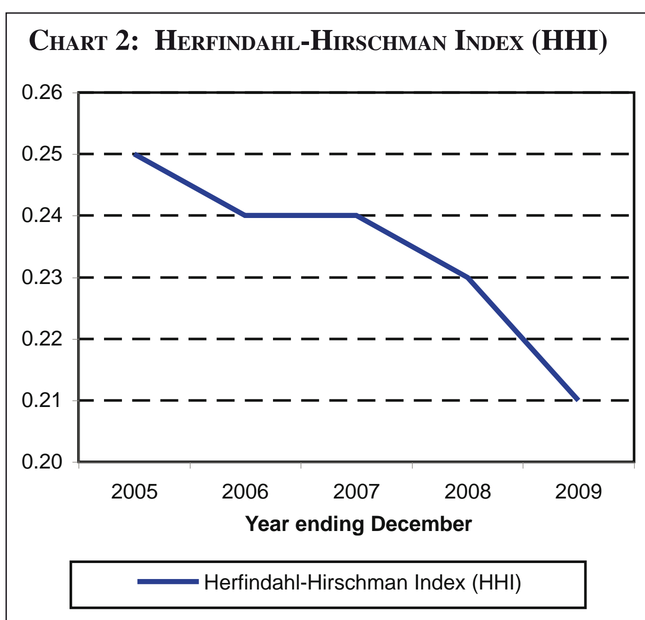
Although there is no universally accepted measure of bank competition, concentration, which is a measure of market dominance, is often used as an indicator of bank competition or lack of it. The analysis that follows will adopt the most widely used measure of concentration, the Herfindahl-Hirschman Index (HHI).[6]

5 The large banks are Barclays, Stanchart, FNBB and Stanbic; and the small banks are Baroda, ABCB, BG and Capital Bank Limited (CBL).

6 The HHI (calculated as the sum of squares of market shares of all banks)

The Botswana banking industry is dominated by four large banks in terms of market share of the customer base, total assets, deposits and loans and advances. Since these large banks have competitive advantage in terms of balance sheet size, market entrance by smaller banks has had little effect in diluting concentration. Evidence drawn from the results of sector analysis based on the HHI index over a five-year period shows a modest decline in the index, from 0.25 in 2005 to 0.21 in 2009 (Chart 2). The ratio remains above the theoretical threshold of 0.18 for moderate concentration, denoting a highly concentrated industry, despite the increase in the number of operational banks from 6 in 2005 to 9[7] in 2009. However modest the actual movement in the index is, the HHI curve provides some reassurance that competitiveness in Botswana's banking industry is gradually improving.

CHART 2: HERFINDAHL-HIRSCHMAN INDEX (HHI)

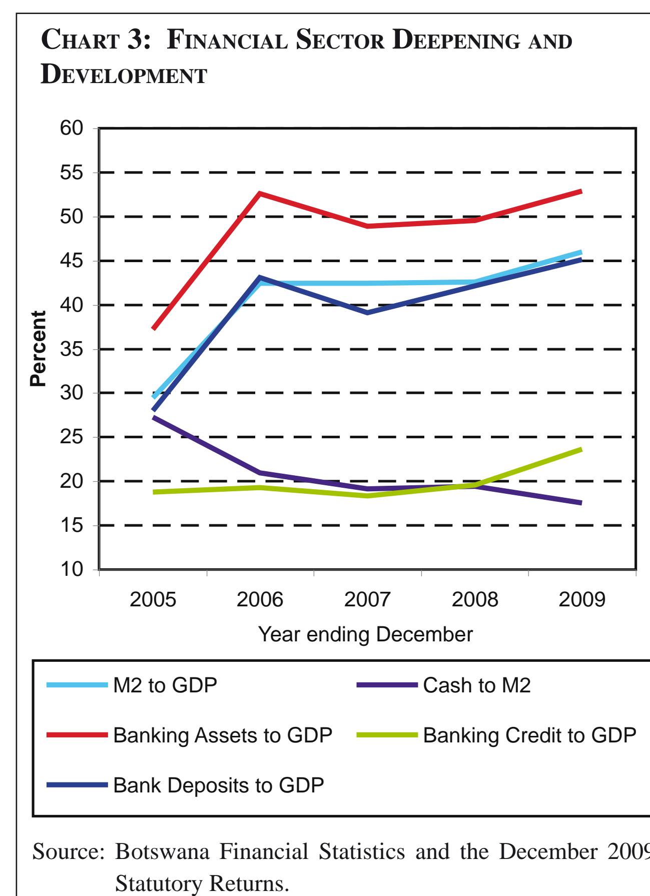


5. FINANCIAL DEEPENING AND DEVELOPMENT

Data suggest that financial deepening, as measured by M2[8] to GDP and financial development, as measured by private sector credit to GDP and banking assets and deposits to GDP continued to occur in 2009. The M2 to GDP ratio (a measure of money supply relative to the size of the economy) increased from 43 percent in 2008 to 46 percent in 2009, thus signifying an improvement in financial sector depth. In addition, the ratio of private sector credit to GDP, which is an indicator of banking industry development and a measure of access to finance by the private sector, also increased from 8 percent in 2008 to 10 percent in 2009.

Banking assets and banking deposits to GDP ratios continued to rise, albeit slightly, thus suggesting that bank market penetration and banks' facilitation of financial sector development were increasing. Total bank credit to GDP ratio also increased during the period, from 20 percent in 2008 to 24 percent in 2009, this way indicating improved financial development (Chart 3).

CHART 3: FINANCIAL SECTOR DEEPENING AND DEVELOPMENT



Source: Botswana Financial Statistics and the December 2009 Statutory Returns.

Cash to M2 ratio, which is a proxy for a measure of public confidence in the banking industry, declined from 19 percent in 2008 to 18 percent in 2009; this reflected a strengthening in the role of the banking industry in the payments intermediation process and the corresponding public willingness to hold more of their liquid assets in the form of bank deposits.

threshold levels determining the level of concentration in an industry are as follows: below 0.01 suggests a highly competitive market; below 0.1 indicates an unconcentrated market; between 0.1 and 0.18 indicates moderate concentration and above 0.18 indicates a highly concentrated market.

7 Two newly licensed banks were not operational at the end of the year.

8 M2 comprises all liabilities of financial corporations included in a country's definition of broad money. In the case of Botswana, M2 comprises the following: currency outside depository corporations, transferable deposits (demand deposits) and other deposits included in broad money (time and fixed deposits).

Table 2: Staffing Levels for Licensed Banks: 2008 – 2009

	2008			2009		
Bank	Citizens	Expatriates	Total	Citizens	Expatriates	Total
Barclays	1 434	14	1 448	1 370	12	1 382
Stanchart	643	11	654	636	10	646
FNBB	948	16	964	1 016	15	1 031
Stanbic	456	15	471	526	9	535
Baroda	21	8	29	22	9	31
ABCB	63	6	69	63	7	70
BG	147	6	153	165	9	174
CBL	45	4	49	70	4	74
Total	**3 757**	**80**	**3 837**	**3 868**	**75**	**3 943**

Other indicators of financial sector development, such as broad access to bank finance by individuals and firms, the quality of bank services and efficiency of providing banking services, also do show an improvement. This is evidenced by an increase in the number of banks and bank branches, as well as the number of bureaux de change. There was a slight improvement in accessibility of physical banking facilities from 19 300 customers per branch in 2008 to 18 500 in 2009. This shows that banks have increased their ability to serve a wider market through the expansion of their branch networks. Some banks ventured into providing electronic banking and mobile phone banking services in an effort to improve the quality and efficiency of their services.

6. Licensing of New Banks and Enquiries on Banking Licence Procedures

Four banking licence applications were received and processed during 2009. Two of the applications were from ABN AMRO N.V (a bank incorporated and headquartered in the Netherlands). One of these applications was for an onshore commercial banking operation specialising in diamond financing, while the other was for an offshore commercial banking business to be located in the Botswana IFSC. Both applications were approved and the licences issued in September 2009. However, both entities had not commenced business operations as at December 31, 2009. The third licence application was for an investment/merchant bank within the IFSC. The application was unsuccessful as the minimum standards and requirements for an offshore banking licence were not met. The fourth application was by an existing merchant bank, ABCB, which sought to upgrade its merchant banking licence to a full commercial banking licence. The application was approved and the licence issued in August 2009.

7. Employment

Employment growth in the banking industry slowed down significantly in 2009 compared to the previous year; it increased by only 3 percent to 3 943[9] compared to the 27 percent increase in 2008 (Table 2). Barclays, which led employment growth in 2008, was the drag in 2009 as its staff complement fell by 5 percent. During the review period, the main contributor to employment growth was Capital Bank Limited (CBL), whose staff level rose by 51 percent, mainly due to the opening of a new branch in Francistown, but it must be noted that this rise is from a very low base and the magnitudes are relatively small. Stanbic Bank Botswana Limited (Stanbic) and BG increased their staffing levels by 14 percent each, followed by FNBB (7 percent), while other banks recorded marginal changes in staffing positions. The number of expatriate staff for the banking industry decreased from 80 in 2008 to 75 in 2009.

9 The official statistics on staffing do not include Direct Sales Agents (DSAs), who are treated as temporary staff.

Chapter 2: Operational Performance of the Banking Industry

1. Composition of the Balance Sheet

The banking industry balance sheet remained fundamentally robust and healthy during 2009, despite a small drop in asset growth reflective of unfavourable global and domestic financial and economic developments during the year. The asset base dropped by 3 percent from P45.3 billion in 2008 to P44.1 billion in 2009. This compares adversely with the 21 percent increase in the previous year. The underlying reason for the contraction in the asset base was not so much linked with the restriction on credit extension because lending increased; it was linked more to portfolio adjustments aimed at moderating the impact of the global financial crises. Counterparty confidence dropped significantly as banks reduced their placements with other banks and credit institutions by 32 percent and 'other investments' by 87 percent. One bank, in particular, reduced its 'other investments' by 99 percent, from P2.3 billion to P12 million. Banks continued to invest in central bank paper (BoBCs), with the value of outstanding BoBCs in 2009 rising by 6.9 percent compared to a 6.4 percent increase recorded in 2008. This was also the third successive year of moderate growth in BoBC holdings, an indication that banks were still able to find other investment avenues with acceptable risk/return profiles.

Although credit growth maintained an upward trend, the growth momentum was, not surprisingly, much less than that recorded in 2008; total loans and advances increased by 11 percent in 2009 to P19.7 billion, which is a significant deceleration from the 28 percent increase in the previous year. In addition, but also not surprising, non-performing loans rose sharply (53 percent), thus reflecting a deteriorating industry loan book during 2009. This is indicative of the delayed crystallisation of the effects of the global financial and economic crises.

Banks were less successful at attracting deposits in 2009 relative to the previous year. Industry deposits, which amounted to P37.6 billion in 2009, increased marginally by 0.7 percent, compared to the growth of 26 percent in 2008. A combination of monetary policy easing during the year and reduced personal and corporate incomes may have worked against deposit mobilisation. This notwithstanding, the financial intermediation ratio (loans and other advances to deposit ratio) increased from 48 percent in 2008 to 53 percent in 2009, consistent with the fact that credit grew faster than deposits in the review period.

Charts 4 and 5 below show trends in levels of deposits, total assets and loans and advances, as well as associated growth rates.

Chart 4: Levels of Deposits, Total Assets and Loans and Advances

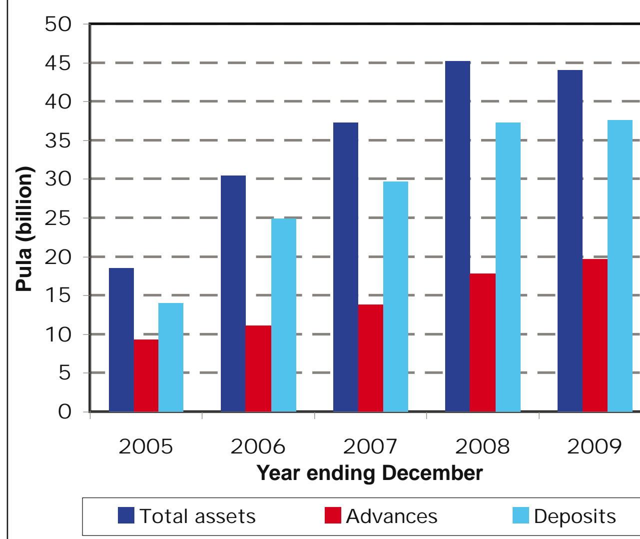
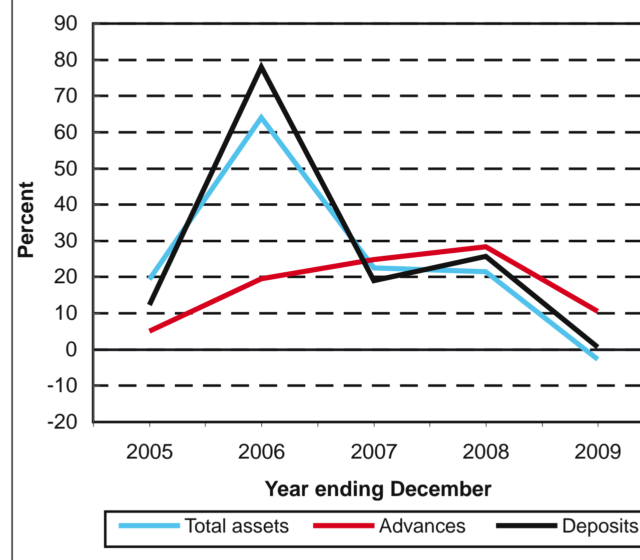
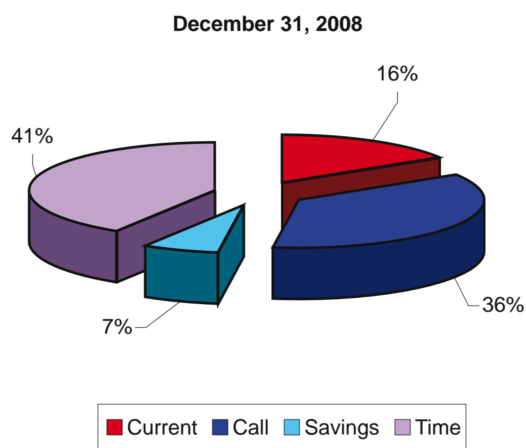


Chart 5: Growth Rates of Deposits, Total Assets and Loans and Advances



The challenge of managing the structural mismatch in bank assets and liabilities was, once again, apparent despite the Bank's efforts towards ensuring that banks offer attractive instruments for long-term investment. The maturity structure of bank deposits continued to be overwhelmingly short-term in 2009, with the value of short-term deposits (call and current) constituting 54 percent of total deposits, compared to 52 percent in 2008 (Charts 6 and 7). The volume (number) of short-term deposit accounts (call and current) to the total number of deposit accounts stood at 47 percent in 2009, down from 55 percent in 2008. In contrast, the number of long-term (time) deposit accounts as a proportion of the total number of deposit accounts was 2 percent in both 2009 and 2008, whereas in monetary terms the share of long-term deposits in aggregate deposits was 38 percent in 2009 and 41 percent in 2008. Furthermore, the four largest banks held nearly 90 percent of all deposit accounts in the banking industry, half of these was held by one bank. Similar proportions can be observed in relation to the distribution of short- and long-term deposit accounts across banks.

Chart 6: Share of Value of Deposits by Type



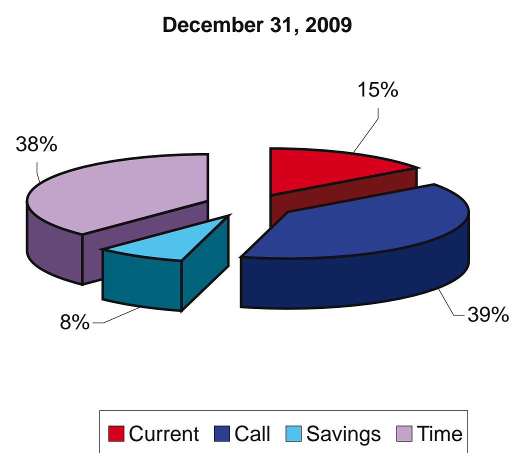
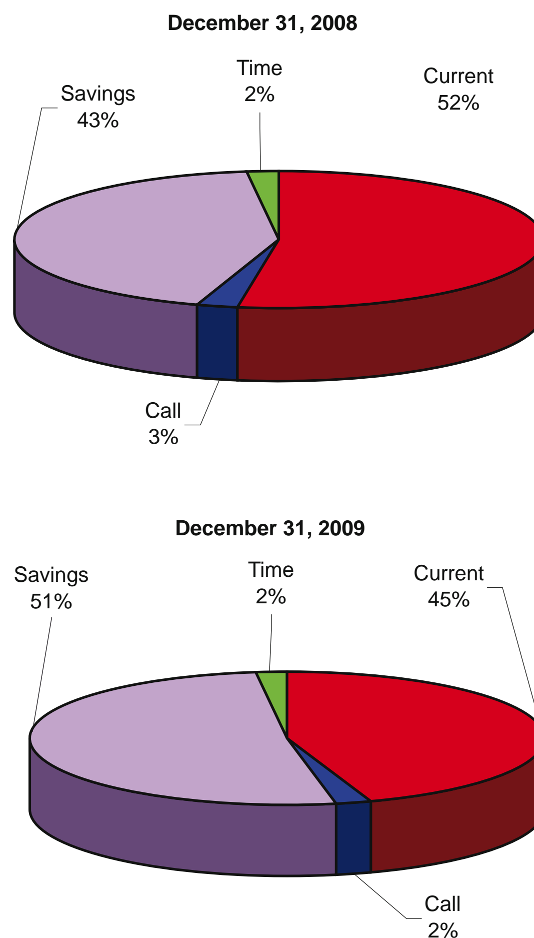


Chart 7: Share of Number of Deposit Accounts by Type



These observations have important implications for policy, especially when viewed against the backdrop of low remuneration of deposits by banks. Interest rate data indicate that short- and long-term deposits are poorly remunerated, the exception being instruments such as negotiable certificates of deposit which attract interest rates linked to the BoBC rate. The policy challenge is to ensure that the bulk of deposits at the short-end of the deposit maturity spectrum shift towards the longer end and that longer-dated deposits attract an appropriate return that is reflective of their maturity. With the Bank's persuasion, the banking industry has shown support for the savings mobilisation objective by re-pricing deposit products to achieve an upward sloping yield curve. There is, however, more still to be done by banks in this area and, in time, depositor behaviour should change in response to this realignment of deposit interest rates.

During 2009, the nominal appreciation of the Pula against all major currencies except the South African rand triggered a conversion of foreign currency denominated deposits into Pula denominated deposits, as

investors searched for better yields. Thus, foreign currency deposits dropped by 51 percent from P10.2 billion in 2008 to P5 billion in 2009. The fact that total deposits remained almost unchanged in 2009 was the result of an offsetting effect of the increase in Pula deposits of 21 percent, from P27.1 billion in 2008 to P32.7 billion in 2009 (Chart 8).

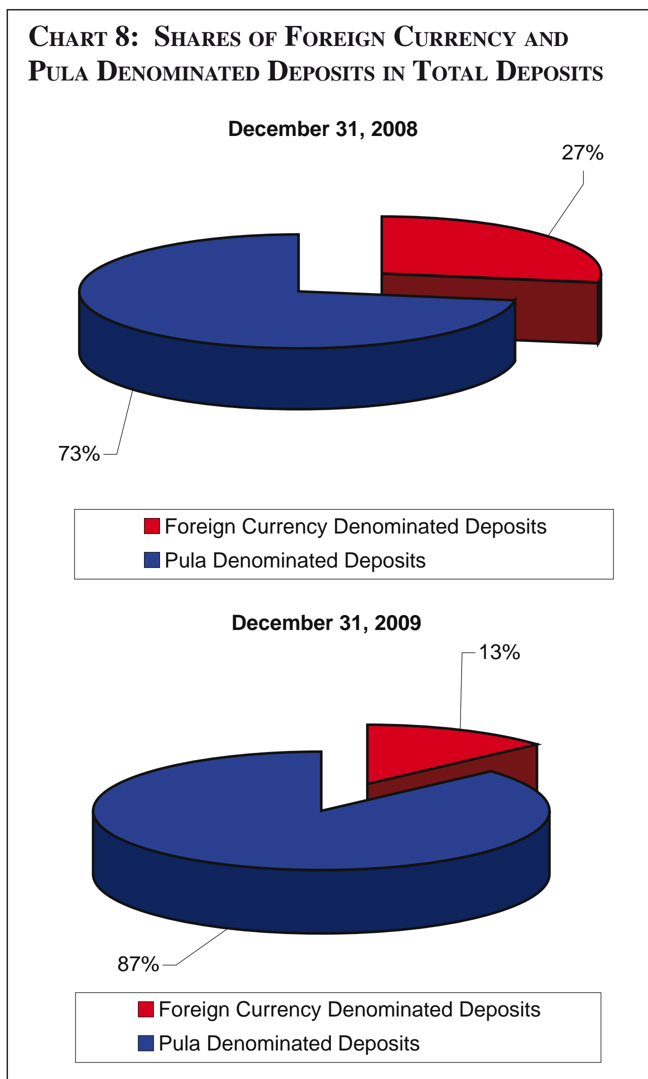


Chart 8: Shares of Foreign Currency and Pula Denominated Deposits in Total Deposits

As indicated above and in Chart 9 below, the industry financial intermediation ratio improved in 2009 as a result of fast growth in lending relative to the funding base. Much of this lending was to the household sector and, to a lesser extent, to public sector enterprises. Borrowing by the household sector grew by 17 percent to reach P11.4 billion in 2009, up from P9.8 billion in 2008, while public sector enterprises borrowing more than doubled from P0.15 billion to P0.32 billion. Credit to the private corporate sector fell slightly, by 0.3 percent to P7.98 billion in 2009.

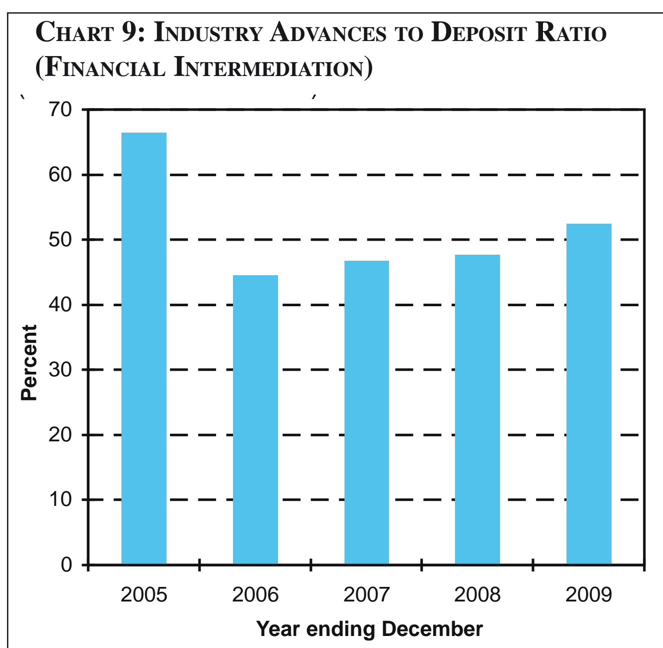


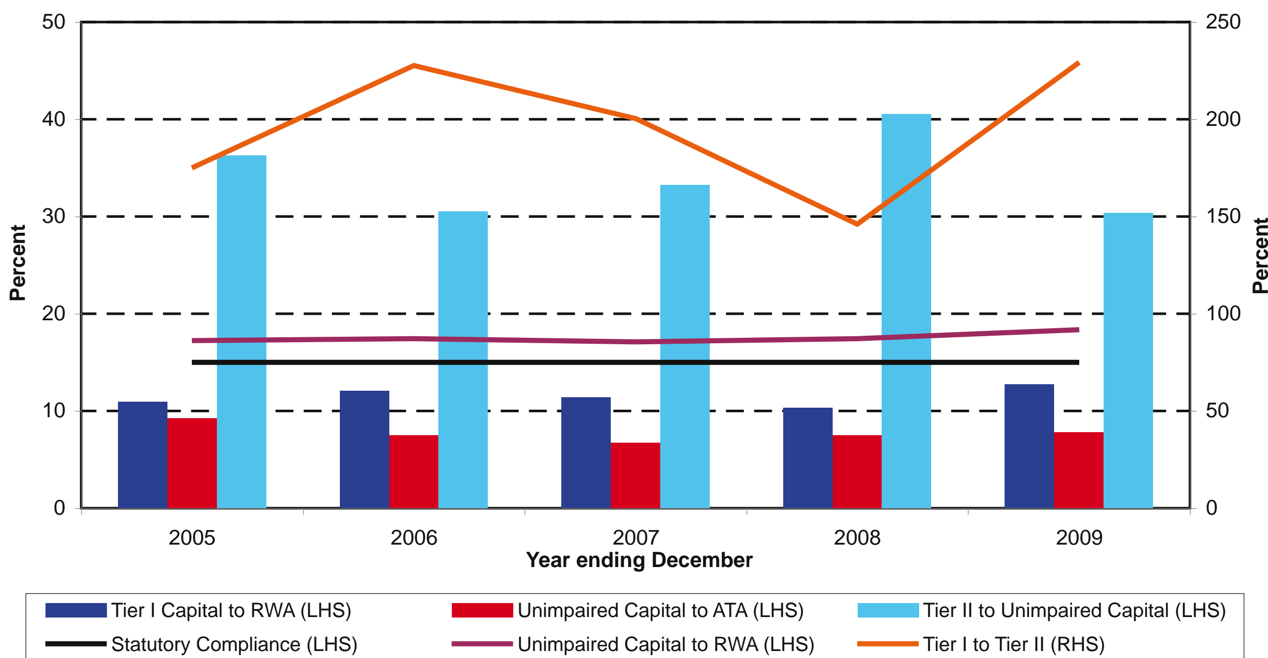
Chart 9: Industry Advances to Deposit Ratio (Financial Intermediation)

2. Capital Adequacy (Solvency): Levels, Quality and Trends

Trends in banking industry capital remained healthy as evidenced by the consistently high level of good quality capital maintained by the banks. As has been the case in past years, banks recorded capital ratios that were above the prescribed prudential limits. Total unimpaired capital of banks rose to P3.6 billion in 2009 from P3.1 billion in the previous year, while core capital was P2.5 billion in 2009, up from P1.8 billion in 2008. The quality of capital elements was satisfactory during the year under review: the Core Capital to Unimpaired Capital ratio of 69 percent was above the prescribed 50 percent threshold; the Core Capital to Risk-Weighted Assets (RWA) ratio was 13 percent, significantly above the 4 percent statutory minimum; and the Total Capital to Average Total Assets (ATA) ratio grew slightly, from 7.5 percent in 2008 to 8.1 percent in 2009. At the industry level, the capital adequacy ratio was 19 percent, 1 percentage point higher than the 2008 figure (Chart 10, overleaf).

While it is evident from Chart 10 that, between 2006 and 2008, banks had taken to raising more Tier II capital for funding, as it is considered uneconomic and expensive to hold excessive levels of core capital (Tier I), that inclination changed in 2009. Due to a strong injection of Tier I capital in 2009, the Tier I Capital to Tier II Capital ratio rose sharply to 221 percent, up from 146 percent in the previous year. Even though banks have a strong capital base as boosted by a 69.5 percent profit retention ratio, the Bank will continue to be vigilant in monitoring the banks' solvency ratios to foster stability in the banking industry.

Chart 10: Capital Adequacy Ratios



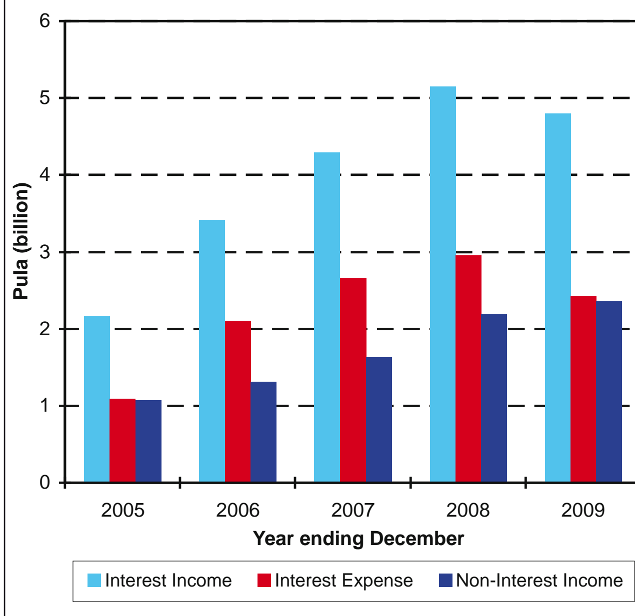
3. Earnings and Profitability

Composition of Income and Expenses

Growth in earnings during 2009 was depressed by the near doubling (94 percent) of specific provisions for bad and doubtful debts. Otherwise, unadjusted revenue and expenditure performance, as shown in Chart 11, indicates a healthy spread, despite the general shrinkage in the growth levels of assets and liabilities that have interest accruing to them. Gross operating income, which is the sum of net interest income and non-interest income, increased by 5 percent from P3.38 billion in 2008 to P3.54 billion in 2009. The major sources of income continued to be interest income from loans and advances, which constituted 63 percent of total interest income, followed by income from BoBCs at 26 percent.

Interest expense registered a reduction of 18 percent between 2008 and 2009, and this is the result of monetary policy easing which led banks to lower interest rates in general, in line with the reduction of the Bank Rate.

Chart 11: Composition of Income and Expenses



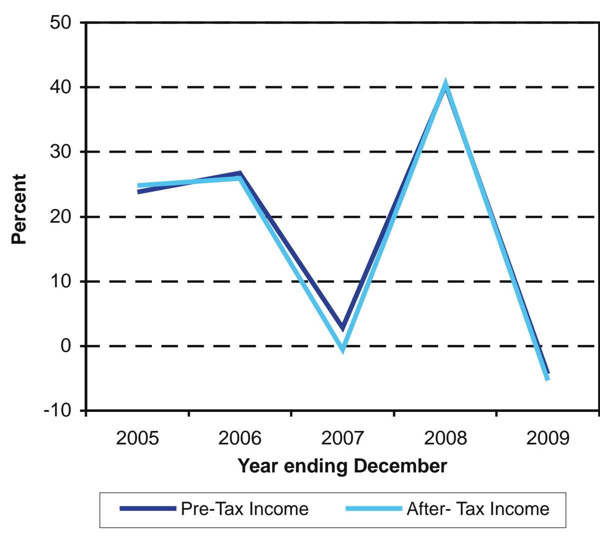
Levels and Trends of Profitability

The decline in total interest income, as well as other income, against the increase in provisions for non-performing loans and operating expenses, led to a decrease in banking industry profitability. The pre-tax profits declined from P1.63 billion to P1.56 billion (4 percent reduction), while after-tax profits declined from P1.31 billion to P1.24 billion (5 percent fall) in 2008 and 2009, respectively (Chart 12).

Profitability Indicators

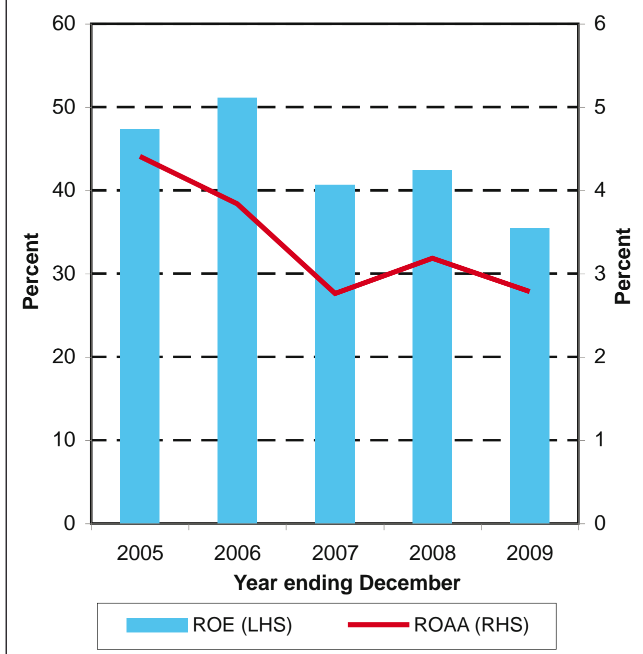
Consistent with the decrease in overall profitability, some key profitability indicators recorded significant declines. Return on Average Assets (ROAA) decreased from 3.2 percent in 2008 to 2.8 percent in 2009, while

Chart 12: Growth Rates of Profit Before and After-Tax



Return on Equity (ROE) declined from 43 percent in 2008 to 34 percent in 2009. In the case of ROE, the slowdown in performance was compounded by the strong (18 percent) increase in total capital (Chart 13) as a result of the significant increase in Earnings Retention ratio from 42 percent in 2008 to 69.5 percent in 2009.

Chart 13: Profitability Indicators



This enhancement of the capital base demonstrates that the banking industry takes a balanced view of maximising shareholder value and building balance sheet resilience through organic capital growth. This is particularly important in the context of an increasing level of non-performing assets; a strong capital base would provide the much needed cushion to absorb trading losses.

The Net Interest Income to ATA ratio remained the same at 5.3 percent between 2008 and 2009, while Non-Interest Income to ATA declined to 2.6 percent in 2009 from 2.9 percent in the previous year. Interest income remains the major source of income for banks. Similarly, the relative contribution of non-interest income to total income has remained the same.

Table 3 below shows additional key financial indicators on banks' earnings and profitability.

Table 3: Other Performance Ratios (Percent)

Ratio	2006	2007	2008	2009
Trading Income to Total Income	6.3	6.0	5.9	7.1
Non-Interest Income to Total Income	17.9	17.0	18.6	19.6
Return on Equity (ROE)	51.2	40.7	42.5	35.4
Return on Average Assets (ROAA)	3.8	2.8	3.2	2.8
Net Interest Income to Average Total Assets	5.4	4.8	5.3	5.3
Interest Income to Average Earning Assets	6.7	6.0	6.8	6.7
Non-interest Income to Average Total Assets	3.1	2.0	2.9	2.6
Interest Expense to Average Total Assets	8.6	7.9	7.2	5.4
Earnings Retention	26.1	40.6	42.0	69.5
Interest Income on Loans to Average Total Assets	14.0	12.7	12.5	10.7

Operating Efficiency Indicators

Table 4 below shows a five-year trend of the banking industry's operating efficiency indicators. The banks' operating efficiency slightly increased in 2009 as indicated by the increase in the industry's net spread (which is expressed as interest yield on earning assets minus interest paid on borrowed funds) from 10.4 percent in 2008 to 11.3 percent. This ratio helps to isolate the effect of interest rates on bank profits and enables a better understanding of the sources of bank profitability and, consequently, the sustainability and vulnerability of bank earnings. The rise in the net spread resulted from two issues: the increase in interest on loans and advances of 9.4 percent, compared to a decline in interest paid on deposits of 8.7 percent between 2008 and 2009; and the 10.6 percent growth in total loans and advances, compared to a 0.7 percent growth in total deposits over the same period. The net interest margin decreased slightly to 6.7 percent in 2009 from the 2008

level of 6.8 percent. The cost to income ratio has been fluctuating for the past five years and recorded a high of 49.4 percent in 2007. As cost containment became entrenched in 2008 and 2009 due to the financial and economic crises, the ratio reduced to around 45 percent in the same period, which was below the international norms of about 55 – 60 percent.

Table 4: Banking Industry Efficiency Measures

Measure	2005	2006	2007	2008	2009
Average Cost of Deposits (Percent)	11.6	9.4	8.6	9.1	8.9
Return on Loans and Advances (Percent)	17.0	17.8	19.1	19.1	17.7
Net Interest Margin (Percent)	8.3	6.7	6.0	6.8	6.7
Net Spread (Percent)	7.7	9.5	8.8	10.4	11.3
Cost to Income (Percent)	45.5	41.1	49.4	45.6	45.1
Net Income to Employee Costs (P'000)	219.1	254.8	201.4	195.1	184.9
Net Income Per Employee (P'000)	278.2	335.5	310.2	342.3	315.2
Staff Cost Per Employee (P'000)	127.0	131.7	154.0	175.5	170.5
Asset Per Employee (P'000)	6 911	10 858	12 389	11 793	11 169

With the continuing financial crises, both staff complement and staff costs growth rates were expected to be low in 2009. Therefore, not surprisingly, staff costs per employee declined from P175 500 to P170 500. In addition, Net Income to Employee Costs ratio fell from 195 percent in 2008 to 185 percent in 2009 as a result of a 5 percent decline in net income during 2009, in contrast to the 41 percent growth in 2008.

Table 5: Performance Indicators for Statutory Banks

Indicator	2006	2007	2008	2009
ROAA (Percent)	3.5	2.0	4.0	3.1
ROE (Percent)	7.0	3.2	5.5	5.6
Interest Income to ATA (Percent)	12.1	11.6	13.4	12.5
Interest Income to Average Earnings Assets (Percent)	38.0	34.6	40.9	33.3
Cost to Income (Percent)	50.5	48.0	47.0	54.2
Average Total Assets (P'000)	2 141	2 517	2 925	3 303
Unimpaired Capital (P'000)	1 067	1 557	2 114	1 815
Interest Income (P'000)	259	293	392	413
Average Earning Assets (P'000)	681	846	959	1 239
Net Income (P'000)	75	50	117	102

Performance of Statutory Banks

Balance Sheet Structure

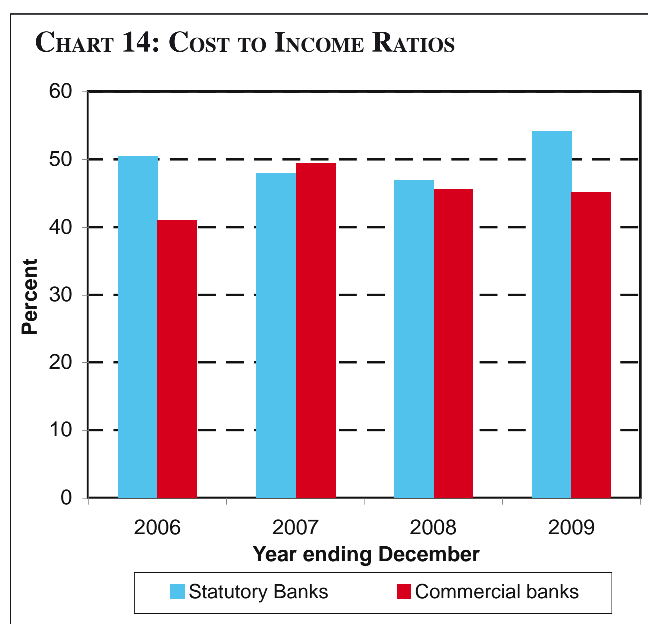
Similar to the performance of commercial banks, the aggregate balance sheet of statutory banks expanded less rapidly in 2009 compared to the growth rates recorded in 2008; total assets rose by 10 percent, compared to 16 percent in 2008, to reach P3.46 billion, and up from P3.14 billion in 2008. The positive growth was mainly due to an increase of 51 percent in cash and balances with the Bank. The loans and other advances to customers rose from P2.5 billion to P2.7 billion in 2009, compared with an increase of 29.3 percent in the previous year. Total deposits grew by 17 percent to reach P719.7 million in 2009 (P617.7 million in 2008), compared to the 2008 growth rate of 19 percent.

Profitability

Statutory banks' net income for 2009 fell by 13 percent, from P116.9 million in 2008 to P101.8 million, largely on account of an increase (19 percent) in operating expenses. As a result, the ROAA ratio dropped slightly, while the ROE ratio increased marginally (Table 5). The Cost to Income ratio increased from 47 percent to 54 percent in 2009, thus implying that more than half of the income generated financed operating costs of these banks. In comparison to commercial banks, statutory

banks recorded higher cost to income ratios since 2006, with the exception of 2007 (Chart 14).

CHART 14: COST TO INCOME RATIOS



RISK MANAGEMENT BY THE BANKING INDUSTRY

Risk is defined as uncertainty that an asset will earn an expected rate of return or that a loss may occur. It is the likely adverse impact on profitability, earnings and/or cash flow from a number of sources. Banks are vulnerable to a range of risks due to the nature of banking business. These numerous risks have a direct impact on the profitability of banks. In the past, banking business operations used to simply involve collecting economic resources (deposits) and lending them out in the form of loans. The risks inherent in banking business under this traditional model of narrow banking operations were also limited. However, changes in the immediate external environment as characterised by financial globalisation, increased competition, deregulation and technological changes, brought about a shift from the traditional banking model to provision of advisory services, asset securitisation and the introduction of derivatives and other sophisticated products. The result was that the menu of risks faced by banks expanded, thus calling for closer attention by banking regulators in a bid to secure depositor interests. The principal banking risks are credit risk, liquidity risk, market risk, interest rate risk, foreign exchange risk, operational risk, and legal and reputational risk.

Box 1 below provides definitions of some of the most important risk categories in banking. Their significance to the Botswana banking system is covered in the section that follows.

BOX 1: DEFINITIONS OF KEY BANKING RISKS

Credit Risk: Credit risk is the potential that a bank borrower, obligor, issuer or counterparty will not meet the contractual obligations to repay both the principal and interest. Thus, it is the risk of incurring losses on account of counterparty default. Default triggers a total or partial loss of the amount lent to the counterparty. Credit risk occurs also as a result of the decline in the credit standing of the counterparty. Such a decline may at the time not result in default, but could signal that the probability of default has increased. The quantum of credit risk is determined through the use of ratings or credit risk scores at a simplistic level. Such ratings may be determined by the bank or external rating agencies. Such ratings enable the bank to quantify the probability of default plus the likelihood of recoveries in the event of default. Credit risk occurs mainly on-balance sheet, but it can also be found off-balance sheet in the form of letters of credit and securitisations. Credit risk indicators include non-performing loans to total loans, specific provisions as a percentage of total loans and distribution of loans among different economic sectors. The central bank devotes much of its supervisory approach to the management of credit risk in the banking industry, as the bulk of depositor funds (the 57 percent intermediation ratio) are expended in lending assets. In this respect, the Bank seeks to obtain assurance that the banking industry's policies, systems and resources for allocating credit and managing it on an on-going basis meet prudent business and regulatory requirements at all times.

Liquidity Risk: Liquidity is the ability of a bank to fund an increase in assets and meet obligations as they fall due without incurring unacceptable losses. The fundamental role of banks in the maturity transformation of short-term deposits into long-term loans makes banks inherently vulnerable

to liquidity risk, both of an institution-specific nature and that which affects the market as a whole. Virtually every financial transaction or commitment has implications for a bank's liquidity. Effective liquidity risk management helps ensure a bank's ability to meet cash flow obligations which are uncertain as they are affected by external events and the behaviour of other agents. Liquidity risk management is very important because a liquidity shortfall affecting a single institution carries the potential of triggering a bank run which an illiquid bank would not be able to manage. Liquidity risk can also have system-wide repercussions due to exposure inter-linkages between banks through the clearing system and the interbank market. In addition to monitoring the manner in which banks manage their liquidity risk, prudential supervisory ratios and replenishment triggers are used as a means towards restoring and enhancing liquidity risk. These regulatory preventive measures in managing liquidity risk are also aimed at forestalling a systemic spiral which can have costly implications for supervisory resources and the economy at large.

Concentration Risk: Concentration risk denotes the overall spread of a bank's assets and liabilities over a number or variety of counterparties with whom a bank conducts business. It can take many forms, including exposures to individual large depositors or borrowers; groups of individual counterparties or related entities; counterparties in specific geographical locations; industry sectors; and specific products. These types of exposures have the potential to produce losses large enough to threaten a financial institution's health or ability to maintain its core operations. Risk concentrations can arise in a financial conglomerate's assets, liabilities or off-balance sheet items through the execution or processing of transactions (either product or service) or through a combination of exposures across these broad categories. The potential for loss reflects the size of the position and the extent of loss given a particular adverse circumstance. The central bank encourages banks to diversify their balance sheets as mitigation strategies against single-entity or single-portfolio adverse shocks. From a prudential perspective, the supervisory concentration limits only serve as a baseline for banks' own elaborate internally developed risk management strategies for concentration risk.

Market Risk: This is the risk of loss in on- or off-balance sheet positions arising from unfavourable movements in market prices. It belongs to the category of speculative risks, wherein price movements can result in a profit or loss. The risk arises not only because markets change, but also because of the actions taken by traders who can take on or get rid of those risks. Market risk results from changes in prices of equity instruments, commodities and currencies. Its major components are, therefore, equity position risk, commodities risk, interest rate risk and currency (foreign exchange) risk. In addition to standard instruments, market risk applies to various derivative instruments, such as options, equity derivatives or currency and interest rate derivatives.

For a combination of reasons, which include the historical low level of foreign currency trading by Botswana banks and high level of sophistication and dynamism in trading markets, the Bank adopted a universal approach to addressing market risk in the banking system. A seven percentage points supervisory enhancement, was imposed on the statutory minimum capital adequacy rate as a quid pro quo for the active management of market risk. While this arrangement has worked well for the banking system, it will be subject to review as the Bank prepares for the implementation of Basel II, which espouses the calculation of economic capital.

Operational Risk: This is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk, but excludes reputational and strategic risk. Operational risk is present in virtually all bank transactions and activities. It includes losses that arise from events such as internal or external fraud, employment practices and workplace safety, clients, products and business practices, damage to physical assets, business dis-

ruption and system failures, execution, delivery and process management and natural disasters. The Bank has traditionally followed a qualitative approach to monitoring the management of operational risk in the banking system; the supervisory judgment has been premised on reviews of board and management integrity and their management of the entire business, the quality of internal procedures, business processes and systems, as well as banks' approaches to managing public opinion.

Source: www.bis.org

Thomas Fitch (1997), Dictionary of Banking Terms, Barron's, New York

Joel Bessis (1998), Risk Management in Banking, John Wiley & Sons, West Essex, England

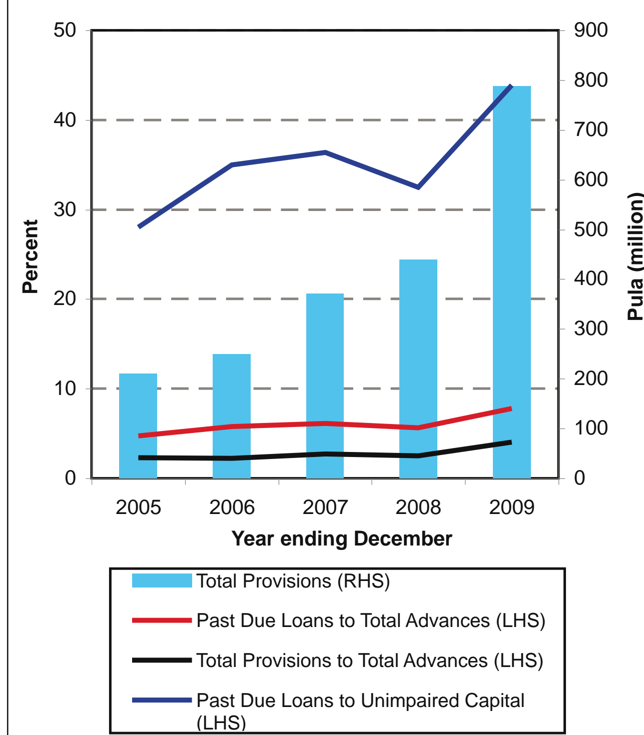
ANALYSIS OF RISK CATEGORIES

Credit Risk

Asset Quality: Levels and Trends

During 2009, past due loans increased by 53 percent, from P1 billion in 2008 to P1.5 billion, with much of the past due loans concentrated in the household sector. Total household past due loans to total past due loans ratio increased from 69.1 percent in 2008 to 77.1 percent in 2009. This is a manifestation of the difficult economic conditions occasioned by the lagged effects of the global financial crises and consequent economic recession which started to be felt by the Botswana financial sector in the last quarter of 2008. The banking industry asset quality, as measured by the ratio of Past Due Loans to Total Advances and Past Due Loans to Unimpaired Capital, increased significantly. Past Due Loans to Unimpaired Capital increased from 32.5 percent in 2008 to 42.1 percent in 2009. Consistent with prudent and sound banking practices, the banks raised provisions for bad and doubtful debts by 79 percent, from P0.44 billion to P0.79 billion over the same period (Chart 15).

CHART 15: BANKING INDUSTRY TOTAL PROVISIONS, PAST DUE LOANS TO TOTAL ADVANCES, PAST DUE LOANS TO UNIMPAIRED CAPITAL AND TOTAL PROVISIONS TO TOTAL ADVANCES



Going forward, there is a possibility of increased write-offs given the increase in adverse loan classifications as a result of a cash flow squeeze experienced by households and private sector enterprises associated with the slow recovery of the economy and the reduction in spending by government. Accordingly, the Bank continues to closely monitor the banking industry to ensure that banks take appropriate measures to manage credit risk, including proactive monitoring of loan performance and timely recognition of problem credits.

Liquidity Risk

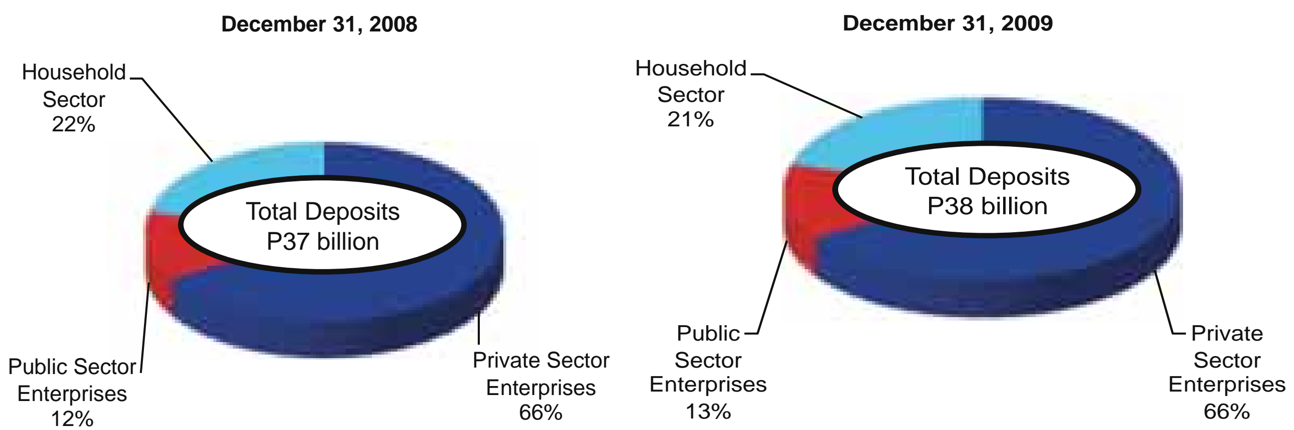
Strong reliance on deposits as a funding source was evident in the banking industry during 2009, as bank deposits accounted for 85 percent of total industry funding sources. Balances due to other banks declined by 36 percent between 2008 and 2009, and this suggests reluctance by individual banks to be exposed to one another under circumstances of uncertainty in global financial markets (Table 6 overleaf).

Chart 16 below shows the distribution of deposits among the private, public and household sectors. It is evident that bank deposits are highly concentrated in private sector enterprises at 66 percent of total deposits, while households and public sector enterprises hold 21 percent and 13 percent, respectively. In addition, the aggregate amount of the fifteen largest deposits, owned mainly by corporate customers, totalled P11.3 billion in 2009. This constituted 30 percent of total banking industry deposits.

Table 6: Banking Industry Funding Trends (P' million)

Category (Percent)	2005	2006	2007	2008	2009
Deposits	14 009	24 943	29 695	37 329	37 587
Growth Rate	12	78	19	26	1
Share of Total Funding	76	82	80	82	85
Other Liabilities	1 550	2 112	2 881	3 145	1 901
Growth Rate	81	36	36	9	–65
Share of Total Funding	8	7	8	7	2
Share Capital	1 412	1 657	1 883	2 420	3 073
Growth Rate	11	17	14	29	27
Share of Total Funding	8	5	5	5	7
Owed to Govt. Institutions	105	50	100	0	0
Growth Rate	–5	–53	101	–100	0
Share of Total Funding	0.57	0.16	0.27	0.00	0.00
Due to other Banks	1 467	1 652	1 224	1 058	680
Growth Rate	258	13	–26	–12	–36
Share of Total Funding	8	5	3	2	2
Other Borrowings	0	0	1 481	1 566	1 621
Growth Rate	0	0	0	6	3
Share of Total Funding	0	0	4	3	4
Total Funding	**18 543**	**30 413**	**37 328**	**45 252**	**44 051**

Chart 16: Sectoral Distribution of Deposits: 2008 – 2009



Although liquid assets decreased by 0.4 percent, from P18.86 billion in 2008 to P18.77 billion in 2009, the stability of core deposits continued to reinforce the ability of the banking industry to absorb any liquidity shocks that may occur. In 2009, liquid assets constituted 43 percent of total assets and covered 50 percent of total deposits. The Liquid Assets to Deposits ratio was well above the minimum statutory requirement of 10 percent, signifying that the portion of total assets that is readily convertible into cash by banks in order to repay deposits on demand was high for Botswana banks in 2009 (Chart 17).

A large proportion (91 percent) of the liquid assets of the banks was accounted for by BoBCs, with a value of P17.1 billion at the end of 2009, or 6.9 percent above the P15.9 billion recorded in the previous year (Chart 18). It is evident that the Government's decision to have a regular bond and treasury bill issuance programme is having an impact on market behaviour regarding the holding of BoBCs, given the much slower growth in the value of outstanding BoBCs compared to the growth rates of prior years.[10]

Chart 17: Liquidity Ratios

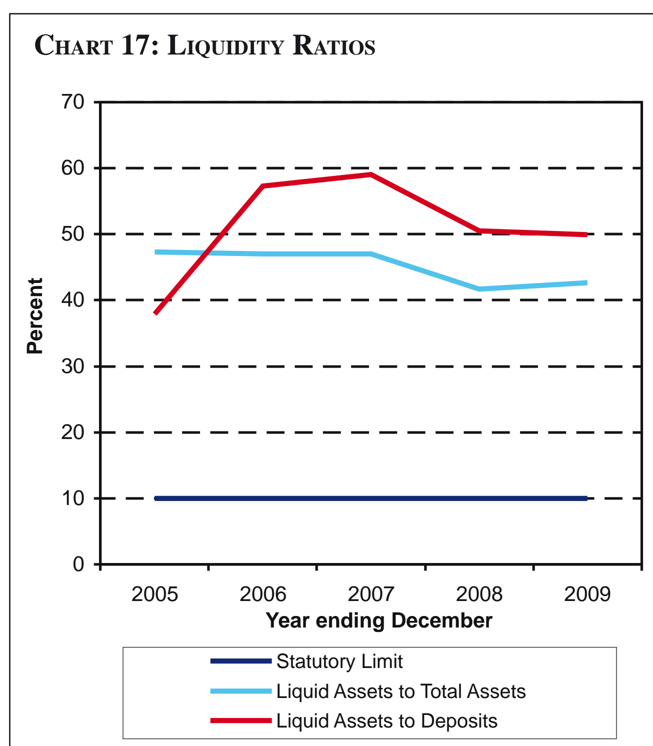
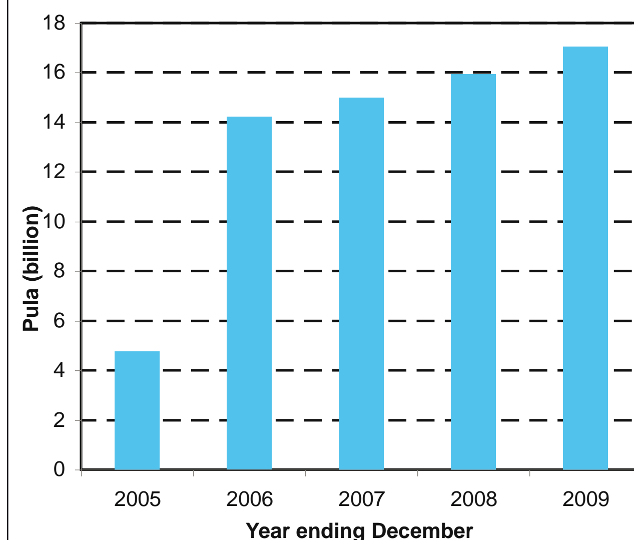


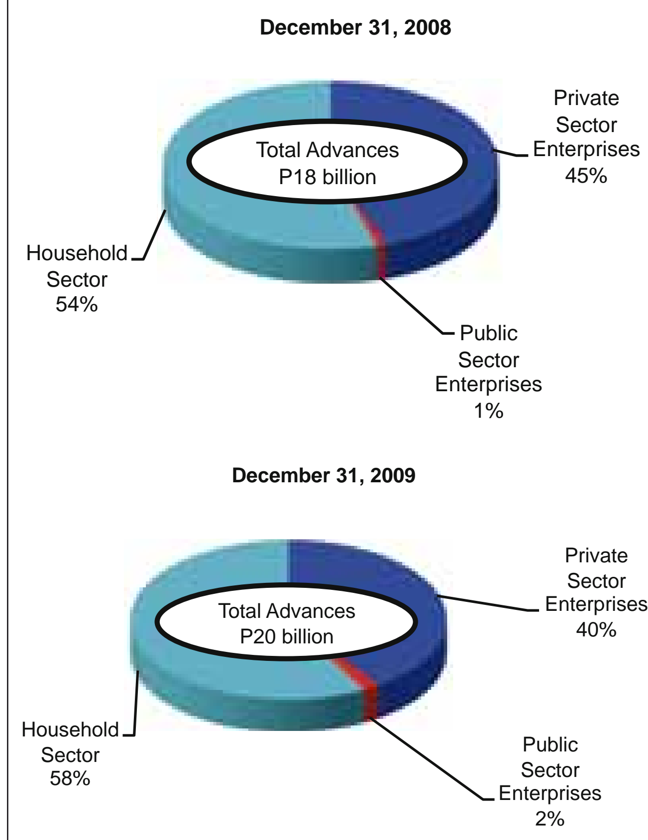
Chart 18: Outstanding Market Value of BoBCs Held by Banks



Concentration Risk

Chart 19 below shows the distribution of loans among private (corporates) and public sector enterprises (parastatals), and the household sector. As was the case in 2008, the household sector accounted for the largest share of the banking industry's loan portfolio (58 percent in 2009 compared to 54 percent in 2008), while loans to private and public sector enterprises constituted 40 percent and 2 percent, respectively. Despite the

Chart 19: Sectoral Distribution of Advances: 2008–2009



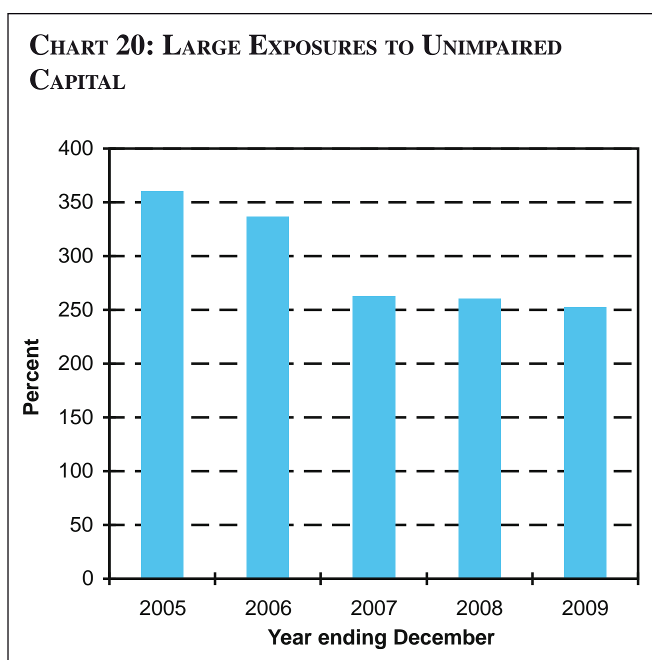
10 2006 was an exception as the high growth rate was due to a policy change that restricted the holding of BoBCs to primary counterparties only.

slowdown in economic growth, loans and other advances to the household sector increased from P9.8 billion in 2008 to P11.4 billion in 2009 (17 percent).

In order to mitigate the risk of concentration of loans in a few borrowers, the banks' aggregate Large Exposures (exposures in excess of 10 percent of unimpaired capital) to Unimpaired Capital ratio is limited to a maximum of 800 percent. All banks maintained ratios well below the 800 percent prudential limit, with the overall ratio for 2009 being 244 percent, down from 260 percent in 2008. In fact, the ratio has been declining since 2006 mainly due to the high growth rate in unimpaired capital vis-à-vis the lower growth rate in large exposures between 2006 and 2008 (Chart 20).

It is important for banking institutions to spread their

Chart 20: Large Exposures to Unimpaired Capital



risk across sectors of the economy such that performance and/or default problems in one sector do not adversely impact their respective balance sheets in an excessive manner. Chart 21 shows a sectoral breakdown of the banking industry loans to private sector enterprises.

Total private (corporate) sector loans barely increased, having grown from P7.66 billion in 2008 to P7.76 billion in 2009. Loans to the business services sector[11] and to the trade, restaurants and bars sector, each accounted for 25 percent of loans to private sector enterprises during 2009; from 20 percent in 2008, while the share of credit to the business services sector declined from 33 percent in 2008 to 25 percent in 2009. It is worth noting that, over the years, the proportion of loans to the business services sector has been declining, thus reducing concentration in the sector. Mining and quarrying sector's share of loans decreased from 11 percent in 2008 to 7 percent in 2009. The construction sector and the trade, restaurants and bars sector benefited the most from the sectoral loan re-distribution as their shares increased by 5 percent each in 2009.

Market Risk

Foreign Exchange Exposure

Banks take positions in foreign exchange trading and are, therefore, exposed to foreign exchange risk when their net positions are not in balance; that is, when their assets and liabilities in any given currency are not equal. Foreign exchange exposure is determined in two successive steps: measuring exposure in each single major currency, then measuring overall foreign exchange exposure from all the currencies traded. Although instances of non-compliance were noted during 2009, the banks generally continued to adhere to the set limits. The non-compliant entities had to implement corrective measures.

Operational Risk

Internal Control Environment

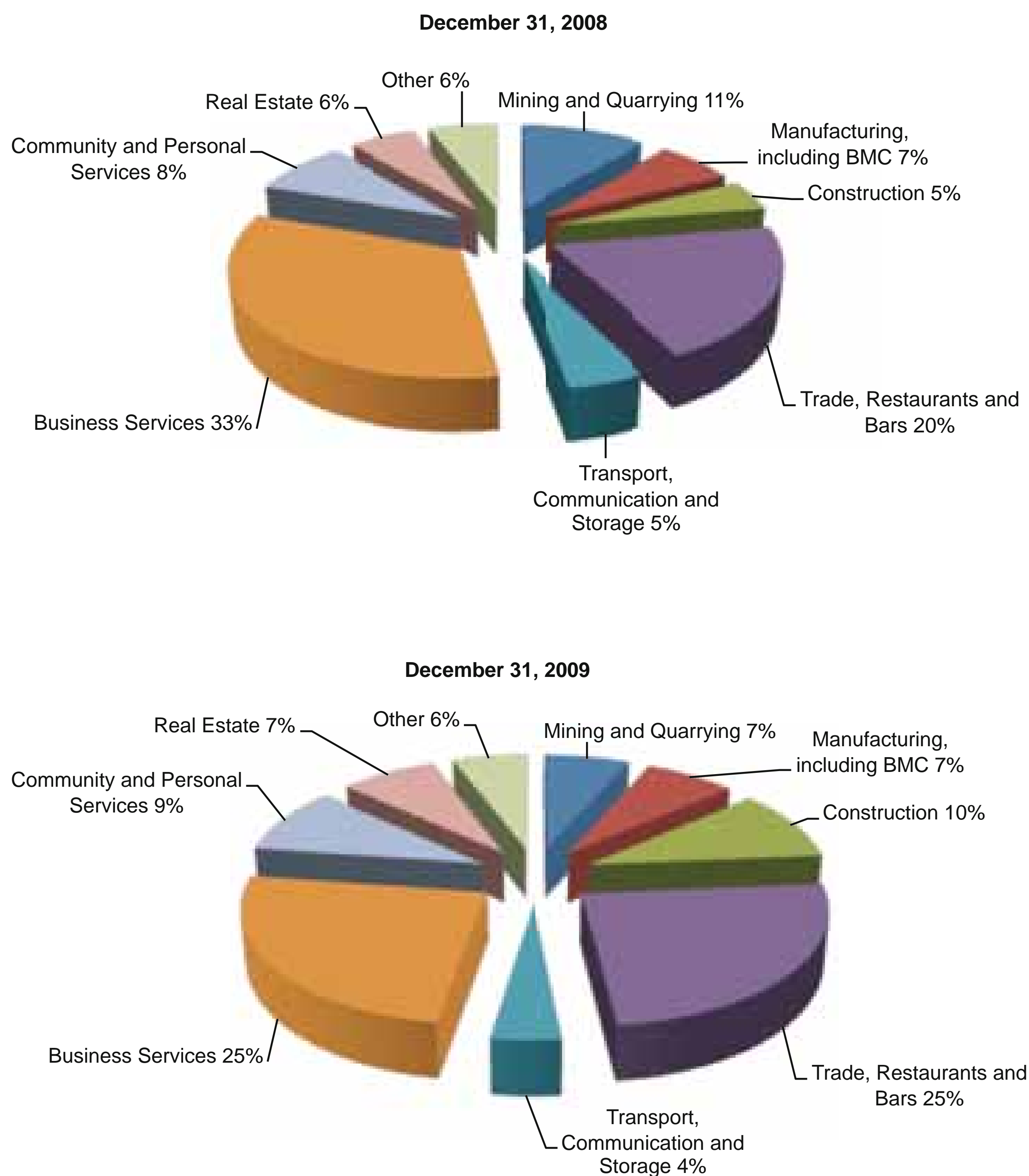
Overall, banks that were examined had appropriate internal control structures; furthermore, the boards and senior management were involved in the approval of business strategies of banks. The banks also had documented organisational structures that showed clear lines of responsibility and authority. Senior management was adequately qualified and had the necessary experience and technical capability to run respective banks.

Infrastructure Issues

Information Technology (IT) systems of banks were deemed satisfactory and there were disaster recovery sites located at places sufficiently distant from places of operation. The role of technology as a competitive differentiator was very apparent in the banking industry because banks were generally expending substantial levels of resources towards the adoption of new systems. This placed a challenge on banks' resource ca-

11 Business services include legal, advisory, accounting, auditing, data processing, consulting, engineering, surveying, advertising, renting and leasing of machinery and equipment.

Chart 21: Distribution of Private Sector Enterprises Loans: 2008 – 2009



Note: The "Other" category includes the agriculture, electricity and water, tourism and hotels, and insurance sectors.

pabilities to efficiently manage normal business whilst implementing technology transitions.

In accordance with Section 14(2)(b) of the Banking Act, all banks had in place insurance policies for, among other things, cash in transit, cash in vault, all fixed assets, fire and theft, as a way of reducing operational risk.

Risk Management Strategies of Statutory Banks

In general, risk management practices of the statutory banks were satisfactory. However, routine evaluations identified system weaknesses at one statutory bank; the weaknesses were manifest in the bank's failure to properly reconcile balances between the core banking and

financial reporting systems following a major change in the core banking system.

Chapter 3: Statutory Compliance

1. Corporate Governance Issues

Sound corporate governance practices remain critical to effective banking supervision. Globally, banking regulators continue to require supervised financial institutions to enhance their governance structures in accordance with internationally recommended principles and practices. Botswana is no exception; banks are encouraged to adopt best practices of corporate governance focused on the role and composition of boards, audit committees, internal audit, management structures and oversight framework, and effective risk management.

In this regard, reviews of records of deliberations at bank board meetings carried out during 2009 were aimed at ascertaining the effectiveness of the oversight role of the boards of supervised institutions. The reviews were conducted in line with international best practice and the *Guideline on the Appointment of New Directors and Senior Management Officials of Banks* issued by the Bank during 2008. The Guideline stipulates minimum requirements on the composition of boards of directors, board self-assessment programmes and continuing compliance with the 'fit and proper' criteria. No adverse issues of concern were noted regarding the composition of boards; board and senior management of banks were found to be 'fit and proper' for their respective responsibilities. However, banks were advised to introduce performance reviews for board members where such a practice had not been adopted. The banking industry has generally heeded the Bank's call for greater citizen representation on bank boards, where it made business sense to do so, in order to be able to appreciate domestic market conditions.

Banks' practices concerning insider lending exposure to directors of boards, management and staff were closely monitored against the requirements of Sections 17(7) and 17(8) of the Banking Act. All banks complied with the stipulated provisions and observed the requisite statutory disclosures.

2. Consultative and Prudential Meetings

A total of 21 Bilateral and Trilateral meetings were held with most licensed financial institutions during 2009, compared to 19 meetings in 2008. These meetings provided the opportunity for exchanging views on matters affecting the supervised institutions, namely, banks' financial performance, strategic plans and intent, provisioning policies and methodologies, risk management strategies, management structures and, in general, business practices. The meetings also served to improve communication and information flow between the Bank and the supervised institutions.

Overall, most banks' strategies remained unchanged in 2009. In line with the general dominance of retail portfolios on banks' balance sheets, most banks' strategies included improvement in customer service through the introduction of new products, improved customer interfacing, product re-designing, expansion of the branch network, review of policies and strengthening of internal controls.

The Bank also held Bilateral meetings with commercial banks' external auditors during the year under review. The meetings reviewed weaknesses identified in the past year's audit (2008/09) and remedial strategies adopted by banks' management, as well as areas of strength and opportunities available to banks. In addition, the meetings discussed audit plans for the 2009/10 Financial Year. These Regulator/External Auditor meetings have evolved to serve a very useful complementary role for better coordination and information sharing between the Bank and statutory independent auditors of banks. The Bank has always used these meetings to raise issues requiring detailed investigations by external auditors. Similarly, auditors have provided pertinent information to the Bank about emerging risks which may require supervisory intervention, thus reinforcing the inherent complementarity in the interface.

3. On-Site Examinations and Other Monitoring Measures of Commercial and Statutory Banks

The Bank carried out full and limited scope on-site examinations of the books and records of three banks. The examinations covered, among others, asset appraisal

and an assessment of the banks' compliance with prudential and regulatory standards as per the provisions of the Banking Act.

The examinations revealed that in general, the commercial banks were in a sound financial condition and complied satisfactorily with key CAMELS and prudential regulatory requirements. However, one bank's asset quality was considered unsatisfactory and warranted enhanced supervisory surveillance. The deterioration in the bank's asset quality was aggravated mainly by inadequate credit appraisal and substandard risk management processes. The challenges of recruiting and retaining skilled staff contributed to these operational and internal control weaknesses. The Bank continued to monitor the financial condition and performance of the concerned bank with emphasis on credit risk management, prudent provisioning policy and, in general, enhanced risk management practices.

CHAPTER 4: OPERATIONAL PERFORMANCE OF NON-BANK FINANCIAL INSTITUTIONS

1. BUREAUX DE CHANGE ACTIVITIES

There was a net increase of two in the number of licensed bureaux de change during 2009. Four bureaux de change were licensed and eight branches opened. One bureau de change ceased operation in February 2009 and surrendered its licence as per Regulation 11 of the Bank of Botswana (Bureaux de Change) Regulations, 2004. One licence was revoked for failure to pay the annual licence fee, thus bringing the total number of operating bureaux de change from 51 in 2008 to 53 as at December 31, 2009.

While a generally high degree of compliance was observed at all the nine bureaux de change that were examined during 2009, some were found to be in violation of the requirements of the Bureaux de Change Regulations. Common among the violations were failure to submit or late submission of audited annual accounts and lack of staff training on anti-money laundering procedures. Appropriate supervisory warnings were issued and one bureau de change was fined for ineffective anti-money laundering measures and exceeding transaction limits.

Chart 22 below shows the industry's aggregate value of foreign exchange sales and purchases over a five year period from 2005 to 2009. Despite the increase in the number of bureaux de change and opening of more branches, the aggregate value of foreign currencies sold and purchased through the bureaux fell by 14 percent and 28 percent, respectively. This was a reversal of the increasing trend observed over the years and the very rapid increase in sales and purchases of foreign currencies in 2008, at 41 percent and 70 percent, respectively. The decline is considered to be consistent with the general slowdown in economic activity.

Charts 23 and 24 below show the market share of foreign exchange sales and purchases by currency in 2008

CHART 22: AGGREGATE BUREAUX DE CHANGE SALES AND PURCHASES OF FOREIGN CURRENCY (P' MILLION)

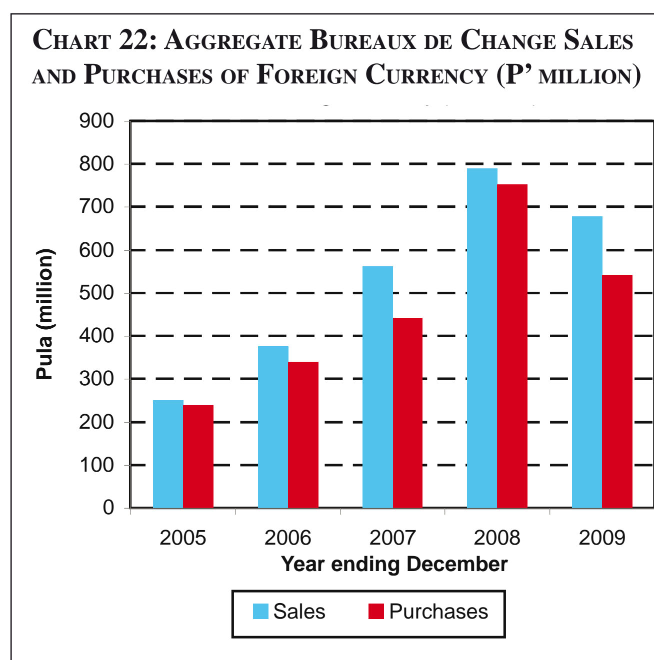


CHART 23: BUREAUX DE CHANGE PURCHASES OF FOREIGN CURRENCY

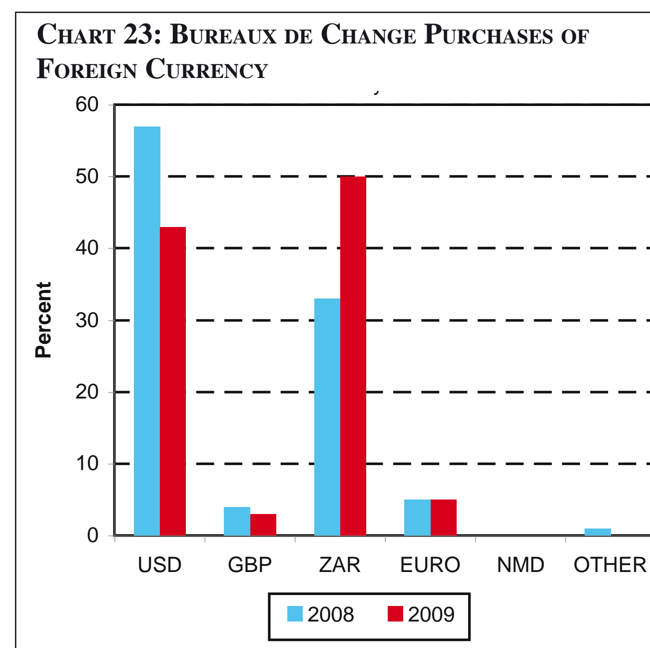
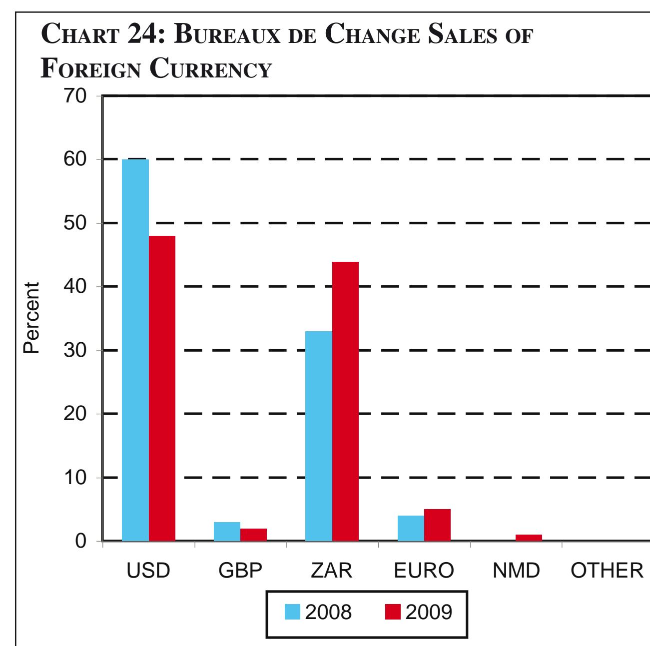


CHART 24: BUREAUX DE CHANGE SALES OF FOREIGN CURRENCY



and 2009. The United States dollar (USD) and the South African rand (ZAR) continued to dominate foreign currency transactions. The market share of ZAR sales and purchases increased by 17 percent and 11 percent, respectively, while market share for other currencies remained unchanged or declined.

The combined assets of the bureaux de change industry amounted to P19.8 million in 2009; this is an increase of 17 percent over the past year's P17 million. As was the case in 2008, the bulk of the assets was in the form of current assets, which constituted 79 percent of total assets. The industry made a loss of P0.8 million in 2009 against a profit of P1.8 million in 2008. This was due mainly to a large loss of P3.75 million reported by one bureau de change.

2. Collective Investment Undertakings (CIUs)

At the time of the handover of functional responsibilities of CIUs to NBFIRA, on-site examinations had been conducted on two domestically licensed investment management companies and a trustee company, namely, African Alliance Botswana Management Company (Pty) Limited (AABMCo), African Alliance International Limited (AAI) and Stanbic Bank Botswana Limited, respectively. The examinations revealed general compliance with prudential supervisory requirements. Pre-operation inspections were conducted on the fund management company, Investec Fund Managers Botswana (Pty) Limited, and the fund's trustee, First National Bank of Botswana Limited. Total assets managed by four domestically licensed investment management companies, namely, AABMCo, AAI, Stanbic Investment Management Services (Pty) Limited (SIMS) and Investec Fund Managers Botswana (Pty) Limited increased by 22 percent, from approximately P2.8 billion as at June 2008 to P3.5 billion as at June 2009. Investec Global Strategy Fund was granted permission to market in Botswana, thereby bringing the total number of inward marketed funds to twenty three (23).

3. International Financial Services Centre (IFSC) Activities

No new non-bank entities were granted regulatory approval to operate in the International Financial Services Centre (IFSC) at the time of the handover of the functional responsibility to NBFIRA in September 2009.

Chapter 5: International Best Practice on Banking Supervision

1. Basel II Implementation Strategy

Following consultative meetings with the stakeholders and a market readiness survey, a commitment has been made to adopt Basel II by the Basel II Implementation Task Force (BITF). During 2009, the Bank made arrangements for the conduct of a Quantitative Impact Survey (QIS) and prepared a draft Capital Directive that will be circulated to the BITF for comments and approval during 2010. The Bank has begun an in-house process of reviewing the legislative framework in order to identify loopholes which may prevent the effective implementation of Basel II. Lessons learned from this exercise will contribute towards the review of the Banking Act.

While preparations for Basel II implementation are ongoing, the Bank pays close attention to the pronouncements by the Basel Committee on Banking Supervision (BCBS) with regard to further refinements to the Revised Capital Adequacy framework. In this respect, the BCBS has published enhancements to the June 2006 Basel II framework. The aim of the revisions are to strengthen the framework as a response to the lessons from the global financial crises. Internationally active banks are expected to comply with the enhancements by December 31, 2010. Under Pillar 1, higher risk-weights for re-securitised exposures are introduced in order to better reflect inherent risks in such products and to conduct more rigorous credit analysis of externally rated securities exposures. For Pillar 2, the focus is mainly on bank risk management processes from firm-wide governance and risk management to managing risk concentrations, capturing risk of off-balance sheet and securitised exposures and providing incentives for better risk management. Pillar 3 enhancements have been in areas relating to securitised exposures in the trading book and re-securitised exposures.

2. Anti-money Laundering, Combating the Financing of Terrorism and Other International Supervisory Issues

The Bank participated in measures to combat and prevent money laundering and the financing of terrorism, both in Botswana and regionally. The Bank participated in the process leading to the drafting of the Financial Intelligence Bill,[12] which is a legislative framework providing for the establishment of a Financial Intelligence Agency. The Agency, which is expected to be established during 2010, will be the central unit responsible for requesting, receiving, analysing and disseminating financial information on suspicious activities; information required by or under enactment in order to counter financial offences; or information concerning the financing of any activities or transactions related to terrorism.

Botswana participated in all the major activities of East and Southern African Anti-Money Laundering Group (ESAAMLG) during 2009.

12 The Financial Intelligence Bill was enacted in 2009.

Chapter 6: Other Banking System Developments

Consumer Protection Issues

1. Abandoned Funds

Pursuant to Section 39 of the Banking Act, the Bank received, processed and maintained abandoned funds records from commercial banks during 2009. Funds amounting to P1 million were transferred by the Bank to the Guardian's Fund in 2009 compared to P0.7 million in 2008. Claims made by the public increased significantly compared to 2008; this is an indication that the Bank's system of advertising abandoned funds is relatively successful. However, there were unclaimed balances as indicated below (Table 7). The unclaimed funds are advertised in the local newspapers and the Government Gazette, annually.

Table 7: Summary of Abandoned Funds (Pula)

	2008	2009
Balances brought forward	5 103 430	5 846 571
Funds received	1 584 794	4 681 603
Claims paid out	(65 383)	(315 102)
Transfer to Guardian's Fund	(776 270)	(1 001 922)
Balances at Year-end	5 846 571	9 211 150

2. Structure of Banking Tariffs

A number of banks sought regulatory approval to amend their tariff structures during the year in accordance with Clause 15 of the Disclosure of Bank Charges Notice. The proposed changes varied across banks in terms of magnitude and category and were ascribed to higher banking costs, such as increased systems support costs, cost of labour and other supplies, as well as enhancements in product quality and inflation. In cases where some tariffs appeared to be exorbitant, these were either rejected or adjusted appropriately. Overall, the Bank continued to encourage banks to ensure that basic banking service charges are not out of line with the quality of services provided.

Below are examples of banking industry charges that were increased:

Card Charges

This category of fees consists of different types of fees for withdrawing funds at ATMs, card issuance and replacement and over-the-counter cash withdrawal using credit cards. The highest proposed increase in this category was for over-the-counter international cash withdrawals; the increase proposed by different banks ranged from 6 percent to 82 percent by different banks.

Penalty Charges

These fees are levied on consumers as a deterrent against certain behavioural practices. Included in penalty charges are the following:

(i) stopping encashment of cheques (as a way to prevent customers from writing out cheques without the intention to pay);
(ii) dishonoured cheques due to lack of funds (to prevent customers from writing out cheques against inadequately funded accounts);
(iii) debit orders returned due to lack of funds and post-dated cheques returned.

As indicated above, the general aim of these punitive charges is to instil discipline and inculcate proper banking behaviour. Most of these charges are avoidable through careful planning and good personal financial management. It is also advisable that the public should shop around and compare prices. The banks are required to disclose changes of frequently used services to customers through tariff guides.

Payment Transfer Fees/Standing Orders

These are charges for instructing a bank to transfer funds on behalf of a customer to an account within the bank or to other banks within the country or internationally. The proposed fee increase, which ranged between 12 percent and 20 percent, was for fees of external debit orders.

Foreign Exchange Transaction/Service

Charges in this category include all fees levied on international trade activities. The associated services comprise, among others, SWIFT transfer, purchase and sale

of foreign notes, purchase and sale of travellers cheques and advisory fees on letters of credit. The highest proposed fee increase in the category was for the purchase of foreign notes and this ranged from 12 percent to 23 percent.

Loan Processing Charges

The category covers intermediation charges such as arrangement fees for loans and overdrafts and fees for ITC credit history checks. The only fee proposed to be increased was for home loans and the increase ranged from 10 percent to 12 percent.

3. Credit Reference Bureau Services

The Bankers Association of Botswana (BAB), which is the body representing licensed commercial banks in Botswana, initiated a project in 2006 to develop a credit reference bureau which would help banks in the assessment of customer credit worthiness. Consistent with this principle and the requirements of Section 43 of the Banking Act, BAB was granted regulatory approval to establish a credit bureau, subject to conditions precedent, which were mainly in relation to the observance of statutory customer confidentiality clauses. Data confidentiality is a key obligation for any bank, as well as the service provider for credit bureau services, to ensure that customer information is not disclosed to unauthorised persons.

The mandate of the credit bureau is to collect and store data and information relating to the credit worthiness of bank customers. Such data may include information on loan default, bounced cheques, unauthorised overdraft, fraud, loans, credit card usage and all accounts in customer names. The bureau collects such information from banks, records a person's credit history and assigns a credit rating based on a set criterion.

The credit reference bureau services became available in 2009 and some banks have begun sharing data and relevant customer credit information as part of the assessment criteria when granting credit facilities.

4. Regulatory Guidelines Issued

The Bank issued two new Regulatory Guidelines for adoption by banks during the year. These were the *Guideline on Banks' Audit Committee, Annual Independent Audit, and Publication of Audited Financial Statements and Guideline on Disclosure Framework for Deposit and Lending Interest Rates.* The *Guidelines* issued in the past are available on the Bank's website.

Chapter 7: Conclusion

The resilience of the Botswana financial system was significantly tested by the adverse effects of the global financial and economic crises during 2009, as the growth of some key financial aggregates slowed down considerably. Healthy growth in the non-mining GDP sector helped to avert a potentially negative impact of the global crises on the banking sector. Consequently, the banking industry balance sheet contracted only slightly, largely due to a combination of no change in deposit levels and slower growth in total credit.

The slowdown in general economic activity impacted negatively on the quality of banks' asset portfolios, as shown by the rising level of past due loans and bad debts. In mitigation, credit risk, market risk and operational risk management practices of banks remained satisfactory during 2009. Banks also maintained sound corporate governance practices.

While all the banks were profitable, liquid, adequately capitalised and satisfied all the minimum prudential requirements, these indicators trended downwards, with the exception of capital adequacy. Deposits, the bulk of which were from corporates, continued to be the dominant funding source for banks in 2009. Corporates remained net savers while households were net borrowers.

Access to banking and other financial services improved as exemplified by the addition of two banks and four bureaux de change to the market, branch expansion by existing banks and further expansion of the ATM network. To enhance customer service and competitiveness, more banks ventured into electronic banking and telephone banking.

The global economic outlook has improved and the Botswana mining sector is recovering along with the global economy despite uncertainties in international demand for diamonds and copper in particular. As such, the Bank continues to closely monitor the banking industry to ensure that the level of credit remains within acceptable levels, while the associated risk is appropriately managed.

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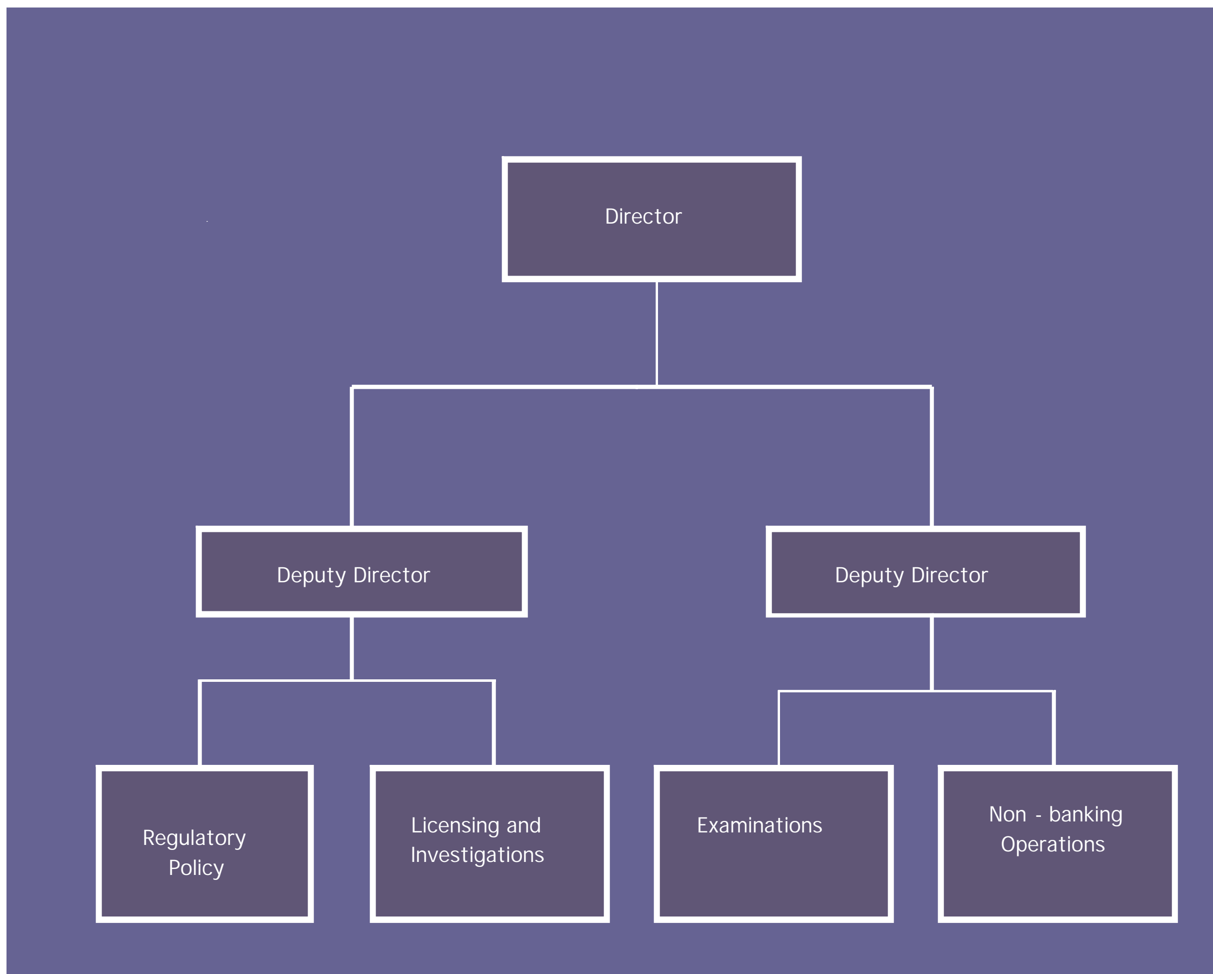
Appendix 1: Banking Supervision Department Organisation Chart



Appendix 2: Approaches to Regulation and Supervision of Banks in Botswana

1. Introduction

This Appendix outlines the basic elements of the framework, standards and processes for banking supervision in Botswana. The Bank is committed to the development of a sound, stable and competitive banking system which promotes savings mobilisation while responding, in a prudent and sustainable manner, to the credit requirements of the economy. The Bank also seeks to adhere to best international practices as enshrined in the Basel Committee's 25 Core Principles for Effective Banking Supervision (see Box 2).

2. Legal Framework

In general, it is considered that, to be effective, a regulatory framework must have sufficient authority established by law, a high degree of independence or operational autonomy and adequate human and financial resources. In Botswana, the primary legislation covering the supervision and regulation of licensed financial institutions is the Banking Act (CAP. 46:04). This legislation has been through various phases of development since it was first promulgated as the Financial Institutions Act, in 1975. Important elements of the Banking Act are: explicit provisions for licensing and authorisation processes, which give the Bank powers to regulate market entry; the power to establish prudential supervisory standards and policies with respect to capital adequacy, liquidity, restrictions on large exposures, loans to insiders and quality of management; rules governing accounting, auditing and disclosure of information; and guidelines for the management and/or restructuring of banks in distress.

The banking law also extensively covers matters of governance, market discipline within the banking system, and official supervision of the banking system. It is recognised that, primarily, the responsibility for banking soundness lies with owners and managers who have a commercial incentive to operate banks prudently. Market discipline provides further pressure and incentives for good internal governance and imposes sanctions for failures, particularly for institutions listed on the stock exchange. Official supervision is essential to provide external incentives for management and owners of banks to rectify inadequacies in governance and impose appropriate level of control where market behaviour could lead to imprudent conduct, which could have adverse systemic repercussions. These three aspects are subsumed within the legislation and prudential requirements. Thus, the continuing stability and soundness of the banking system and the extent to which it is effective in facilitating financial intermediation between savers and borrowers, as well as operating the payment system, is a reflection of efficiency in all these three areas.

3. Authority for Licensing Banks

A central feature of banking supervision is establishing criteria for licensing of banks. Banking is a heavily regulated industry because banks take deposits from the public, play a critical role in the country's payments system and, related to both of these functions, have the potential for introducing systemic risk in the event of banking problems. There are, as a result, regulatory barriers to entry that importantly influence the structure of the banking industry in terms of the number, size and ownership of banks in the country. These market entry requirements must be carefully balanced with the public policy objective of a competitive and efficient banking system.

The responsibility for licensing banks is exclusively conferred on the Bank by Section 3 of the Banking Act. This section covers licensing of commercial banks, merchant/investment banks, credit institutions and discount houses.

4. Licensing Policy and Procedures for Establishing a Bank

The licensing requirements and procedures for establishing a bank in Botswana are set out in Sections 6(1) and 8 of the Banking Act, and detailed in Banking Act Regulations 3, 4 and 5.

In order to be licensed as a bank in Botswana, an applicant must satisfy the following requirements:

(i) be locally incorporated in Botswana (branch banking is not permitted);

(ii) have the prescribed initial minimum capital, currently P5 million, and the owners must demonstrate willingness and ability to provide additional financial support as and when required. In case of applicants that are majority owned by holding companies or a part of a financial conglomerate, the parent entity should demonstrate capacity to be a source of financial strength;

(iii) have adequate managerial capacity, which includes the appointment of "fit and proper" persons, as well as sound risk management and other governance structures;

(iv) in the case of foreign banks, the parent bank must be subject to adequate home supervision, and documentary evidence of consent by the parent supervisor to operate in Botswana must be provided;

(v) the proposed ownership and organisational structure must be acceptable to the Bank, and the structure must be such that it allows effective consolidated supervision, if necessary; and

(vi) the promoter must submit a business plan and five-year financial projections showing the establishment of branch network, products to be provided, and demonstrate ability to enhance effective competition.

5. Core Prudential Standards

Among the most significant prudential regulations on banks are capital adequacy requirements, statutory reserve, liquid asset requirements, legal lending or large exposure limits, and asset quality requirements. Each of these are described briefly below:

Capital Adequacy Requirements

A bank must maintain a minimum capital adequacy (solvency) ratio of at least 8 percent, calculated as Unimpaired Capital divided by Total Risk-weighted Assets. However, the 8 percent is regarded as the statutory floor. Banks in Botswana are required to maintain a capital adequacy ratio at or above 15 percent which, in the context of the current macroeconomic and financial environment, is regarded as a safe and prudent level. The key issue is that a bank must maintain sufficient capital and other financial resources to be commensurate with the nature and scale of its operations and the risks associated with them.

Reserve Requirements

Section 39 of the Bank of Botswana Act empowers the Bank of Botswana to require financial institutions to hold primary reserves, including marginal primary reserves, in the form of cash holdings or deposits with the Bank or both, against such deposits and similar liabilities as may be specified by the Bank. The current primary reserve requirement ratio is 5 percent.

Liquid Assets Requirements

Section 16(2) of the Banking Act stipulates that every bank must maintain in Botswana, on a daily basis, liquid assets as a percentage of its deposit liabilities currently equal to 10 percent and 3 percent for commercial banks and credit institutions, respectively.

In general, a licensed financial institution should establish appropriate and prudent policies for the management of liquidity risk. It should ensure, to the satisfaction of the Bank, that adequate internal risk management systems exist to monitor and control maturity mismatches between its assets and liabilities; that the bank has the capacity to meet maturing obligations and/or fund the expansion of its balance sheet in a sound and effective manner; that the level, trend and quality of bank funding sources, including cash flow from earning assets, are supportive of the bank's growth strategy.

Asset Quality

Asset Concentrations (Large Exposures)

Section 17 of the Banking Act restricts a bank from granting facilities that are in excess of 10 percent of a bank's unimpaired capital to a single or group of related customers without the specific approval of a bank's entire board of directors. Further, a bank is required to seek prior approval from the Bank before granting loans and other credit facilities to a single entity or group of related companies which, in aggregate, are in excess of 30 percent of a bank's unimpaired capital.

Insider Lending

Section 17 also restricts banks from granting credit facilities to directors and their related interests in excess of the higher of P50 000 or 1 percent of a bank's core capital without the approval of a bank's entire board of directors. In addition, no bank may grant facilities, direct or indirect, to a member of its board of directors in excess of 25 percent of its unimpaired capital. This

provision seeks to avoid possibilities of insider abuse, self-dealing or over-reliance on related party business.

Provisions

Section 14 of the Banking Act, deals with certain items, which should be provided for; that is, reserves to be made to take into account potential losses when determining a bank's capital adequacy. It establishes the legal framework for the Bank of Botswana to assess adequacy of the provisions for non-performing assets. Accordingly, the Bank of Botswana has statutory power to assess, in consultation with the bank's independent statutory auditors, the level of impairments in a bank's loan portfolio and the amount of resources to be charged to the bank's profit and loss as an expense for non-performing assets.

Main Supervisory Approaches

On-Site Examinations

The Bank of Botswana conducts regular on-site examinations of banks pursuant to Section 24(1) of the Banking Act. The Bank may also conduct an examination of a bank if so petitioned by one fifth of depositors as provided for under Section 24(3) of the Banking Act.

Effective 2000, the Bank adopted a risk-based approach to supervision. This approach entails identification and understanding of the primary business risks of an individual financial institution and, on the basis thereof, the Bank determines the priorities and resources for on-site examination work. The objectives of on-site examinations are to assess and evaluate the overall condition and financial soundness of the institution, its compliance with applicable laws and regulations, the quality and effectiveness of governance structures, including internal control environment, as well as to check the accuracy of statutory reports submitted to the Bank.

During an on-site examination, examiners have direct access to the books and records of the financial institution being examined. This enables examiners to make a fair and realistic assessment of the condition of the institution in various risk areas.

The evaluation of the financial soundness of the institution is achieved by assessing Capital Adequacy (C), Asset Quality (A), Management (M), Earnings (E), Liquidity (L) and Market Risk Sensitivity (S) components (referred to as CAMELS), and adherence to statutory and prudential limits in each of these areas.

In order to ascertain the soundness and prudence of the bank's practices and procedures, an assessment is made of its risk management policies and systems. The practices and procedures adopted would reveal the extent to which the financial institution is employing adequate measures to protect depositor's funds, shareholders interests, deployment of resources, and effective measurement and control of risks that are inherent in any banking operation.

The internal control systems are also assessed to determine their effectiveness and the role of the internal audit function. Effective running of operations depends on the adequacy of records maintained, the adoption and implementation of issues that may adversely affect the performance of a bank for which they are responsible.

Bilateral and Trilateral Meetings

Bilateral meetings are held once a year with all supervised financial institutions. These meetings provide a forum for exchange of views on matters affecting the supervised institution and serve to improve communication and information flow between the Bank and the supervised financial institutions.

In addition to the separate bilateral meetings with both external auditors and the respective licensed financial institutions, the Bank, pursuant to Section 22(8) of the Banking Act, arranges tripartite meetings with each financial institution and its external auditors. These meetings are convened to discuss matters relevant to the Bank's supervisory responsibilities that may have arisen in the course of a statutory audit of a bank's business, its accounting and internal control systems, and its draft audited annual balance sheet and profit and loss account. The forum is also used to share information on the critical risk areas and/or any new developments in accounting and regulatory standards. Trilateral meetings have an added advantage of fostering effective collaboration and communication between the Bank (regulatory authority) and external auditors of banks in the application of accounting standards and ensuring effective disclosure in financial statements and related reports of material risks in a bank's balance sheet.

It is also at such meetings that the Bank takes the opportunity to discuss with auditors its expectations regarding the scope of statutory audits and other general issues of a prudential nature.

6. Accounting, Auditing and Disclosure Standards

Section 22 of the Banking Act requires banks to annually appoint independent external auditors acceptable to the Bank. Statutory audits are conducted annually, usually at financial year-end, except that when a bank intends to capitalise half-year interim profits, it must call for an audit of the accounts. Change of external auditors or the financial year-end requires prior approval of the Bank.

7. Core Principles for Effective Banking Supervision

Bank of Botswana, like other supervisory authorities, is guided in its supervisory approach by the Basel Committee's Core Principles for Effective Banking Supervision. The Core Principles were issued by the Basel Committee on Banking Supervision in 1997 (revised in October 2006) for use in both G-10[13] and non-G10 countries. They comprise 25 "Core Principles" that need to be in place for a supervisory system to be effective and are used as a benchmark in the development of a country's supervision strategies. The main objective of the Core Principles is to harmonise international supervisory standards. In Botswana, they are also used to reinforce international best practices in banking supervision.

Bank of Botswana annually conducts a detailed self-assessment for compliance with the Core Principles using the methodology adopted by the international banking supervisors and recommended by the International Monetary Fund (IMF). Box 2 below presents the 25 Core Principles for Effective Banking Supervision.

13 G10 comprises 11 countries: United States, Japan, Germany, Canada, Britain, France, Italy, Netherlands, Belgium, Sweden and Switzerland.

Box 2: The 25 Core Principles for Effective Banking Supervision

Principle 1: Objectives, independence, powers, transparency and cooperation: An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Principle 2: Permissible activities: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.

Principle 3: Licensing criteria: The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Principle 4: Transfer of significant ownership: The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

Principle 5: Major acquisitions: The supervisor has the power to review major acquisitions or invest-

ments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Principle 6: Capital adequacy: Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

Principle 7: Risk management process: Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

Principle 8: Credit risk: Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

Principle 9: Problem assets, provisions and reserves: Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

Principle 10: Large exposure limits: Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

Principle 11: Exposures to related parties: In order to prevent abuses arising from exposures (both on-balance sheet and off-balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

Principle 12: Country and transfer risks: Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

Principle 13: Market risks: Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Principle 14: Liquidity risk: Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

Principle 15: Operational risk: Supervisors must be satisfied that banks have in place risk management

policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

Principle 16: Interest rate risk in the banking book: Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

Principle 17: Internal control and audit: Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 18: Abuse of financial services: Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

Principle 19: Supervisory approach: An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

Principle 20: Supervisory techniques: An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

Principle 21: Supervisory reporting: Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

Principle 22: Accounting and disclosure: Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

Principle 23: Corrective and remedial powers of supervisors: Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

Principle 24: Consolidated supervision: An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

Principle 25: Home-host relationships: Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

Appendix 3: Supervised Financial Institutions as at December 31, 2009

(A) Banks and Other Deposit-taking Institutions

Institution	Postal Address	Business Locations	External Auditors
Commercial Banks			
Barclays Bank of Botswana Limited	P O Box 478, Gaborone	66*	PricewaterhouseCoopers
Standard Chartered Bank Botswana Limited	P O Box 496, Gaborone	16*	KPMG
First National Bank of Botswana Limited	P O Box 1552, Gaborone	18	Deloitte & Touche
Stanbic Bank Botswana Limited	P/Bag 00168, Gaborone	9	KPMG
Bank of Baroda (Botswana) Limited	P O Box 21559, Gaborone	2	PricewaterhouseCoopers
Bank Gaborone	P/Bag 00325, Gaborone	4	PricewaterhouseCoopers
Capital Bank Limited	P O Box 5548, Gaborone	2	KPMG
African Banking Corporation of Botswana Limited	P/Bag 00303, Gaborone	2	PricewaterhouseCoopers
ABN AMRO Bank (Botswana) Limited	P/Bag 254, Gaborone	1	KPMG
Statutory Banks			
Botswana Savings Bank	P O Box 1150, Gaborone	2	PricewaterhouseCoopers
National Development Bank	P O Box 225, Gaborone	4	KPMG
Building Society			
Botswana Building Society	P O Box 40029, Gaborone	9	KPMG

* Includes branches, sub-branches, agencies and sales centres.

(B) Bureaux de Change as at December 31, 2009

Name	Postal Address	Business Locations
Aldaph Bureau de Change	P O Box 41436 , Gaborone	2
Amah Bureau de Change	P O Box 11829, Francistown	2
American Express Bureau de Change	P O Box 45140,Gaborone	1
Apijoe Bureau de Change	P O Box 458, Mogoditshane	1
Bellagio Bureau de Change	P/Bag BR 32, Gaborone	3
Boitekanelo Bureau de Change	P O Box 486, Gaborone	1
Business Towers Bureau de Change	P O Box 40943, Gaborone	1
Cape to Cairo Bureau de Change	P O Box 5, Kasane	1
Counter Bureau de Change	P/Bag F388,Francistown	2
Crystal Diamond Bureau de Change	P O Box 20554,Gaborone	1
CSS Bureau de Change	P O Box 45168,Gaborone	2
Currency Exchange Bureau de Change	P O Box 80881,Gaborone	1
Dollar Wave Bureau de Change	P/Bag 0024,Bobonong	1
Edcom Bureau de Change	P O Box 502429,Gaborone	2
Exim Bureau de Change	P O Box 1020,Gaborone	1
Fundex Bureau de Change	P O Box 401547,Gaborone	1
FX Africa Bureau de Change	P O Box 20537,Gaborone	3
Garona Bureau de Change	P O Box 408 ,Gaborone	5
Genesis Bureau de Change	P/Bag BR 225,Gaborone	1
Goodrate Bureau de Change	P O Box 923,Ghanzi	1
Gorogang Bureau de Change	P O Box 46785,Gaborone	1
Investors View Bureau de Change	P O Box 2381,Francistown	1
Kalahari Bureau de Change	P O Box 1116,Gaborone	1
Kwanokeng Bureau de Change	P O Box 10,Sherwood	2
Limpopo Bureau de Change	P O Box 8,Kasane	1
Madikwe Bureau de Change	P O Box 402885,Gaborone	1
Maeto Bureau de Change	P O Box 22,Mahalapye	1
Money Quest Bureau de Change	P O Box 2748,Gaborone	1
Nsundano Bureau de Change	P O Box 243,Kasane	1
Open Door Bureau de Change	P O Box 839,Maun	3
Ozair Bureau de Change	P/Bag 149,Gaborone	1
Palapye Bureau de Change	P O Box 10408,Palapye	1
Prosper Bureau de Change	P/Bag B O7,Gaborone	3
Proxy Bureau de Change	P O Box 404108,Gaborone	2
Rennies Bureau de Change	P O Box 2482,Gaborone	2
River Ride Bureau de Change	P O Box 301106,Francistown	6
Rose of Sharon Bureau de Change	P O Box 404338,Gaborone	1
Royalty Bureau de Change	P/Bag BO 259 ,Gaborone	1
Sango Bureau de Change	P O Box 1873,Francistown	1
Segodi Bureau de Change	P O Box 80991,Gaborone	1
Sherwood Ranch Bureau de Change	P O Box 1,Sherwood	1
Star Bureau de Change	P O Box 80491,Gaborone	1
Sunny Bureau de Change	P O Box 370,Maun	3
Ten-Tab Bureau de Change	P O Box 301576,Francistown	3
Thari Bureau de Change	P O Box 40074,Gaborone	2
The Silver Bureau de Change	P O Box 1894,Ramotswa	1
Trans Frontier Bureau de Change	P/Bag 002,Pitsane	1
Travellers' Choice Bureau de Change	P O Box 26725,Gaborone	2
Tsogo Bureau de Change	P O Box 502095,Gaborone	1
Unity Bureau de Change	P O Box 1586,Francistown	1
Universal Bureau de Change	P O Box 2444,Gaborone	2
Vintage Bureau de Change	P O Box 4594,Gaborone	1
West Bureau de Change	P O Box 779,Gaborone	1

Appendix 4: Definition of Banking Supervision Terminology as Used in this Report

(a) **Asset Concentration:** Measures aggregate exposure to one borrower, an affiliated group of borrowers, or borrowers with a common controlling interest, common management, cross guarantees or financial interdependency which cannot be substituted in the short term. This exposure is usually expressed as a percentage of the bank's unimpaired capital and its various thresholds are subjected to prudential regulatory requirements. In terms of the Banking Act (CAP. 46:04), exposure in excess of 10 percent of the bank's unimpaired capital is deemed an asset concentration requiring prior approval of the Board of Directors of the lending financial institution. Exposure in excess of 30 percent of the bank's unimpaired capital requires prior Bank of Botswana approval.

(b) **Asset Quality:** A relative measure of the performance of the bank's loan portfolio based on the appraisal of the asset, concerning the degree of risk and the likelihood of recovery, adherence to the terms of contracts and orderly liquidation of the account. Good quality asset means the loan, advance or investment is producing cashflow as was expected and/or agreed upon.

(c) **Adverse Classifications:**

(i) **"Substandard" Assets** –A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified have a well-defined weakness or weaknesses that jeopardise the liquidation of the debt. They are characterised by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

(ii) **"Doubtful" Assets** – An asset classified doubtful has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until its more exact status can be determined.

(iii) **"Loss" Assets** – Assets classified as losses are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this potentially worthless asset even though partial recovery may be effected in future.

(d) **Core Capital:** An aggregate of share capital, share premium, general reserve and retained earnings, also called Tier 1 capital. It represents the most stable and permanent form of capital for supporting a bank's operations. (See page 40 for computations)

(e) **Total Risk-Weighted Assets:** An aggregate of the total value of assets after adjusting for the risk inherent in each asset for both on-balance sheet and off-balance sheet items. A list of assets and the corresponding risk conversion factors used in risk-weighting are presented on page 41.

(f) **Unimpaired Capital:** Unimpaired in relation to the capital of a bank means the absence of any legal or technical covenant, term, restriction or encumbrance which would otherwise render such capital not to be freely available for distribution to depositors and, or other creditors in the event of the liquidation or dissolution of the bank, and the absence of any condition or arrangement which would, in the opinion of the central bank, diminish the value of the whole or any portion of the capital of the bank. An outline of capital elements used to compute unimpaired capital is presented on page 40.

(g) **Weighted Classifications:** Represents an aggregate of 20 percent, 50 percent and 100 percent of the value of accounts classified "Sub-standard", "Doubtful" and "Loss", respectively.

Ratios

(a) **Return on Equity (ROE):** The ratio measures the after-tax profit against shareholders' funds. The ratio, however, tends to favour high leveraged banks in that

the ratio tends to be higher for low capitalised banks than for large capitalised banks. It is of major interest to the shareholders of the bank, and less so for banking supervisory authorities.

(b) **Return on Average Total Assets (ROAA):** The ratio measures after-tax profits as a percentage of average total assets. This ratio is widely used by both banking supervisors and market analysts since assets are the base from which earnings are primarily derived. The ratio measures the earnings capacity of the assets of the financial institution. It measures profit earned against the amount invested in assets and is the key to profitability measurement as it shows how efficiently a financial institution's assets are employed. It is also used to measure the effectiveness of management's decisions with respect to resource utilisation. The higher the ratio the more efficient the management is in its asset allocation decisions.

(c) **Dividend Pay-Out:** The ratio measures the proportion of the after-tax income that is paid out to shareholders. This ratio is of greater interest to investors than for banking supervision. It is the inverse of this ratio, profit retention ratio that is of greater interest for prudential supervision. Emphasis is on the adequacy of capital with reference to the quality of capital funds in relation to the balance sheet risk profile, i.e., the core and unimpaired capital to risk-weighted assets ratio. The rationale is that owners of banks must have sufficient own funds in a bank, though it is recognised that unnecessarily high capital levels could result in economic inefficiencies, if not employed productively. However, for commercial and other strategic reasons, most banks will retain some or a portion of their income to build greater capacity by way of a larger capital base, in order to take advantage of lending and/or investment opportunities in large projects, or to support organic growth of the bank.

(d) **Capital Growth:** This ratio measures the impact of retained income and other capitalised funds on the capital base of a bank. Ideally, the bank's rate of income retention must keep pace with its asset growth, or risk exposure. Where there is a disparity in growth, especially with acceleration of the latter, the bank's solvency will be weakened.

(e) **Risk-Based Capital:** In November 1995, the Bank adopted the internationally recommended framework on capital adequacy measurement and standards for banks, commonly known as the Basel Committee Capital Accord. In terms of this framework, capital adequacy is measured by the ratio of Unimpaired Capital to Risk Weighted Assets. The move to this method of capital adequacy measurement has sensitised banks to the type of assets they hold and balance sheet risk profiles. It has also broadened and standardised the acceptable supplementary capital items such as unencumbered general provisions, fixed assets revaluation reserves (adjusted by a 50 percent factor) and interim profits (provided an audit had been carried out). It excludes, however, any elements that are likely to impair a bank's capital such as investment in unconsolidated subsidiaries and associated companies, and connected lending of a capital nature. The use of risk-weighted assets is intended to take into account the risk inherent in the different types of assets. If two banks with exactly the same size of assets and capital base are to be compared, their unadjusted capital ratio will be the same. However, if the inherent risk of the balance sheet is taken into consideration, the bank with less risky assets will enjoy a higher capital adequacy ratio and is better able, therefore, to expand its business by lending to large borrowers, if opportunities arise. A good capital base ensures that adequate funds are freely available on a permanent basis to absorb risks inherent in the types of assets held by a bank, its off-balance sheet transactions, its foreign exchange dealing operations and all other risks associated with its business.

(f) **Net Spread (Percent):** This ratio covers only those assets and liabilities that have an interest rate attached to them. Thus, it excludes the impact of non-interest-bearing demand deposits, capital and non-remunerated reserve requirements on net interest earned and thus on bank profits. This is helpful in that it isolates the effect of interest rates on bank profits and thereby enables a better understanding of the sources of bank profitability and, consequently, of vulnerability of bank earnings.

(g) **Net Interest Margin (Percent):** This ratio identifies the core earnings capability of the bank - its interest differential income as a percentage of average total earning assets.

(h) **Other Operating Income to Total Assets (Percent):** The ratio shows the dependence on "non-traditional" income. Growth in this ratio can indicate diversification into fee-based financial services or a reaching for speculative profits to make up for deficiencies in the bank's core interest differential income.

(i) **Net Operating (or Intermediation) Margin (Percent):** The intermediation margin can be defined as the differential between the cost of funds and the yield on earning assets plus related fee income. The differential quantifies the cost extracted by the banking system for intermediating between the providers and the users of funds.

(j) **Net Income per Staff:** The ratio measures the average income generated by each staff member. Note that this ratio will be significantly different for a wholesale (investment) bank with relatively few, but highly paid staff compared to a retail bank with a large branch network and many less highly paid clerical staff.

(k) **Net Income to Staff Expense:** Measures the return on investment in staffing costs. This ratio is probably a better measure than net income per staff since it enables institutions of a different type to be compared to some degree. It looks at the effect of staffing decisions, regardless of whether these are low cost, low expertise clerical staff, or high cost, high qualified professionals.

(l) **Cost to Income:** The ratio measures the non-interest expenses as a percentage of net interest income plus non-interest income (total operating income). It shows how well the non-interest expenses are managed by the institution relative to the level of total operating income.

(m) **Average Cost of Deposits:** The ratio measures interest paid on deposits as a percentage of total average deposits. It shows the average cost of deposits. Institutions with a large customer base of operating transaction accounts (demand deposits) relative to interest earning savings accounts tend to report low average cost of deposits. In turn, banks that tend to rely on wholesale deposits (call and other highly volatile money) for funding will have relatively high average cost of deposits. Similarly, banks that start to engage in aggressive marketing for deposits, either due to liquidity concerns and/or to fund expansion of their lending business, will exhibit a high average cost of deposits.

Capital Elements

Core Capital + Supplementary Capital Less Impairments of Capital = Unimpaired Capital

1. Tier 1 [Core Capital = Sum of 1(a) to (e) less (f) to (h)]

(a) Ordinary shares (issued and paid-up)

(b) Perpetual (non-redeemable) non-cumulative preferred shares

(c) Disclosed prior years' reserves (audited)

(i) Share premium

(ii) General reserves

(iii) Accumulated retained earnings

(d) Published current year's retained earnings

(e) Minority interests

less

(f) Current year's unpublished losses

(g) Goodwill and other intangible assets

(h) Shareholders' equity funded through the capitalisation of unrealised gains arising from fixed property revaluation

2. Tier 2 Capital [Supplementary Capital = Sum of 2(a) to 2(g)]

(a) Current year's unpublished profits

(b) 50% of fixed asset revaluation reserves

(c) Unencumbered general provisions not to exceed 1.25% of Risk-Weighted Assets

(d) Hybrid (debt/equity) capital instruments (eligible for inclusion)

(e) Subordinated term debt (eligible for inclusion)

(f) Minority interests (in Tier 2 preference shares)

(g) Shareholders' equity funded through the capitalisation of fixed property revaluation reserves

3. Impairments of Capital = Sum of 3(a) to 3(d)

(a) Investments in unconsolidated subsidiaries and associated companies

(b) Connected lending of a capital nature, including unlawful lending to directors, owners or their indirect interests

(c) Capitalised establishment costs/pre-incorporating expenses

(d) Underwriting commission

4. Total Capital Funds = Sum of 1 and 2

5. Total Unimpaired Capital: 4 – 3

Risk-Weights Applied on Various Assets for Purposes of Capital Adequacy Measurement

Type	Risk Factor (Percent)
On-Balance Sheet Items	
Cash (Pula notes)	0
Balances of accounts held at Bank of Botswana	0
Loans, advances and other credit facilities to the Government of Botswana or fully and unconditionally guaranteed by the Government of Botswana	0
Assets secured by a lien or pledge over fixed/notice or savings deposits (cash) held by the (same) bank (cash collateralised loans)	0
Central Bank Securities (BoBCs)	0
Advances collateralised by BoBCs or any securities issued by the Government of Botswana	0
Foreign currency notes (dealing currencies)	20
Advances to Local Government Authorities	20
Cash items in the process (course) of collection	20
Assets secured by cash investments held at another domestic bank/local financial institution	20
Due from other banks – demand or maturity under 1 year	20
Loans and other advances secured by first class bank guarantees acceptable to the Bank of Botswana	20
Loans secured by recognised multilateral development financial institutions (e.g., IBRD, ADB, etc.)	20
Claims to or credit facilities guaranteed by Statutory Corporations (Parastatals)	20
Claims to or credit facilities guaranteed by Debswana	20
Assets due from or guaranteed by other domestic public sector entities	50
Loans secured by owner occupied residential property	50
Loans secured by commercial and industrial property (R/E)	100
Financial leases, factoring agreements and hire purchase contracts	100
Due from other banks maturing over 1 year	100
Credit facilities to subsidiaries of parastatals (claims on commercial companies owned by public sector entities, e.g., BDC subsidiaries)	100
Eligible equity investments	100
All other private sector advances	100
All other assets	100
Off-Balance Sheet Items	
Direct credit substitutes (guarantees, Standby Letters of Credit, Bankers Acceptances)	100
Asset securitisation with recourse	100
Transaction-related contingent items (performance bonds, bid bonds, etc.)	50
Formal commitments, credit lines (original maturity over 1 year – undrawn commitments) and underwriting and note-issuance facilities	50
Short-term self liquidating, trade related (documentary credits secured by shipment)	20
Forward foreign exchange contracts (over 1 year)	5
Forward foreign exchange contracts (under 1 year)	1
Undrawn commitments, original maturity under 1 year or less or can be cancelled	0
Currency Swaps	0

Appendix 5: Aggregate Financial Statements of Licensed Banks

Table 5.1: Aggregate Statement of Financial Position of Licensed Commercial Banks 2005 – 2009 (P' million)

	Total Assets in Local Currency	**2005**	**2006**	**2007**	**2008**	**2009**
1.	Cash and balances with the Central Bank	773	1 109	1 851	2 125	2 238
	a. Currency	375	388	496	593	595
	aa. Hard currency and gold bullion	81	80	123	137	174
	ab. Local currency	294	308	373	456	421
	b. Balances with Central Bank	347	722	1 339	1 399	1 638
	c. Other	0	0	16	133	5
2.	Trading securities at market value (BoBCs)	4 785	14 218	15 013	15 654	17 421
3.	Placements with other banks and credit institutions	3 003	3 067	3 751	5 894	4 028
4.	Gross loans and advances	9 303	11 118	13 878	17 823	19 712
	(a) Specific provisions	174	202	291	326	649
5.	Net loans and advances	9 130	10 916	13 587	17 497	19 062
6.	Investment securities	280	226	1 609	2 406	305
7.	Fixed assets net of depreciation	200	213	295	364	399
8.	Other assets (net)	423	663	1 159	1 311	597
	Total Assets	**18 543**	**30 413**	**37 265**	**45 251**	**44 051**
	Liabilities in Local Currency					
1.	Amounts owed to government institutions	105	50	100	0	0
	a. Central Bank accounts	105	50	100	0	0
	b. Direct Government credits (CB or MFDP)	0	0	0	0	0
	c. Other	0	0	0	0	0
2.	Amounts due to other banks and credit institutions	1 467	1 654	1 224	1 058	680
3.	Securities sold under repurchase agreements	0	0	0	0	0
4.	Amounts due to other customers/depositors	14 009	24 943	29 695	37 329	37 587
5.	Shareholders' funds	1 412	1 655	1 883	2 420	3 073
6.	Other liabilities	1 550	2 112	2 881	2 877	1 091
	a. Taxes payable	115	90	89	94	208
	b. Dividends payable	33	81	0	115	0
	c. Accrued expenses	167	83	28	27	2
	d. Other	1 235	1 858	2 764	2 642	881
7.	Other borrowing incl. international lending agencies	0	0	1 481	1 566	1 621
	Total Liabilities	**18 543**	**30 413**	**37 265**	**45 251**	**44 051**

TABLE 5.2: AGGREGATE INCOME STATEMENT OF LICENSED COMMERCIAL BANKS: 2005 - 2009 (P' MILLION)

	2005	2006	2007	2008	2009
1. Interest and similar income	2 171	3 422	4 295	5 154	4 796
2. Interest expense	1 094	2 106	2 660	2 954	2 427
3. Net interest income [1–2]	1 077	1 316	1 635	2 200	2 369
4. Other operating income	655	752	868	1 180	1 170
5. Gross operating income/(loss) [3+4]	**1 732**	**2 068**	**2 503**	**3 379**	**3 539**
6. Bad and doubtful debts provisions	53	90	218	193	384
(a) Specific loss provision expenses	66	105	236	202	414
(b) General loss provision	6	0	11	23	20
(c) Releases and recoveries of bad debts previously written off	–18	– 13	–29	– 32	–49
7. Operating income/(loss) net of specific loss provisions	1 679	1 978	2 285	3 186	3 154
8. Operating expenses	786	848	1 124	1 553	1 596
(a) Salaries and employee benefits	341	369	464	673	672
(b) Administrative expenses	22	29	0	260	0
(c) Auditing and consulting expenses	3	2	3	9	13
(d) Rental/lease expenses	17	18	43	59	65
(e) Depreciation and amortisation	10	12	43	76	77
(f) Other	394	418	570	476	769
9. Other provisions and write-offs	1	0	0	0	0
(a) Investments	1	0	0	0	0
(b) Other balance sheet items	0	0	0	0	0
(c) Off-balance sheet items	0	0	0	0	0
10. Net operating income/(loss) [7–8–9]	892	1 130	1 161	1 633	1 558
11. Extraordinary gains/(losses)	0	0	1	– 2	3
(a) Gains/Losses on revaluation of assets (net)	0	0	0	0	0
(b) Translation gains/losses (net)	0	0	0	0	0
(c) Other gains/losses	0	0	1	– 2	3
12. Net income/(loss) before tax [10+11]	892	1 130	1 162	1 631	1561
13. Income tax	146	190	228	317	317
14. Net income/(loss) after tax [12–13]	746	940	935	1 313	1 244
15. Transfers from revaluation/to general provisions	0	0	0	0	0
16. Dividends declared (paid & proposed)	643	716	555	762	380
17. Retained earnings for the year [14–15–16]	104	224	387	551	864
18. Retained earnings at the beginning of the year	896	999	1388	1 380	1 932
19. Retained earnings at the end of the year [17+18]	999	1 223	1775	1 932	2 796

Table 5.3: Aggregate Statement of Financial Position of Statutory Banks in Botswana: 2006 –2009 (P' million)

Total Assets in Local Currency	2006	2007	2008	2009
1. Cash and balances with the Central Bank	2	2	3	5
a. Currency	0	2	3	2
aa. Hard currency and gold bullion	0	0	0	0
ab. Local currency	0	2	3	2
b. Balances with Central Bank	2	0	0	4
c. Other	0	0	0	0
2. Trading securities at market value (BoBCs)	0	0	0	0
3. Placements with other banks and credit institutions	493	650	482	574
4. Gross loans and advances to other customers				2 813
5. Specific provisions				113
6. Loans and advances to other customers (net of specific provisions)	1 693	1 917	2 479	2 701
7. Investment securities	0	0	0	0
8. Fixed assets net of depreciation	113	109	153	150
9. Other assets (net)	28	28	26	33
Total Assets	**2 328**	**2 706**	**3 143**	**3 463**
Liabilities in Local Currency				
1. Amounts owed to government institutions	0	0	3	0
a. Central Bank accounts	0	0	3	0
b. Direct government credits (CB or MFDP)	0	0	0	0
c. Other	0	0	0	0
2. Amount due to other banks and credit institutions	0	0	0	0
3. Securities sold under repurchase agreements	0	0	0	0
4. Amount due to other customers/depositors	407	517	618	720
5. Shareholders' funds	1 380	1 513	1 674	1 819
6. Other liabilities	65	63	27	55
a. Taxes payable	0	0	0	0
b. Dividends payable	13	6	0	13
c. Accrued expenses	0	0	0	0
d. Other	52	58	27	42
7. Other borrowing incl. international lending agencies	475	613	821	869
Total Liabilities	**2 328**	**2 706**	**3 143**	**3 463**

TABLE 5.4: AGGREGATE INCOME STATEMENT OF STATUTORY BANKS IN BOTSWANA: 2007 – 2009 (P' MILLION)

Statutory Banks	2007	2008	2009
1. Interest and similar income	293	392	413
2. Interest expense	95	126	150
3. Net interest income [1–2]	198	266	263
4. Other operating income	31	32	44
5. Gross operating income/(loss) [3+4]	229	298	306
6. Bad and doubtful debts provisions	74	37	33
(a) Specific loss provision expenses	17	33	33
(b) General loss provision	57	4	0
(c) Releases and recoveries of bad debts previously written off	0	0	0
7. Operating income/(loss) net of specific loss provisions	155	261	274
8. Operating expenses	110	140	166
(a) Salaries and employee benefits	52	73	80
(b) Administrative expenses	0	0	0
(c) Auditing and consulting expenses	0	0	0
(d) Rental/lease expenses	0	0	0
(e) Depreciation and amortisation	6	6	6
(f) Other	52	60	79
9. Other provisions and write-offs	0	0	0
(a) Investments	0	0	0
(b) Other balance sheet items	0	0	0
(c) Off-balance sheet items	0	0	0
10. Net operating income/(loss) [7–8–9]	45	122	108
11. Extraordinary gains/(losses)	5	–5	6
(a) Gains/losses on revaluation of assets (net)	0	0	0
(b) Translation gains/losses (net)	0	0	0
(c) Other gains/losses	0	–5	0
12. Net income/(loss) before tax [10+11]	50	117	102
13. Income tax	0	0	0
14. Net income/(loss) after tax [12–13]	50	117	102
15. Transfers from revaluation/to general provisions	0	0	0
16. Dividends declared (paid & proposed)	33	27	37
17. Retained earnings for the year [14–15–16]	17	90	65
18. Retained earnings at the beginning of the year	0	0	90
19. Retained earnings at the end of the year [17+18]	17	90	155

Table 5.5: Licensed Banks* Capital Structure (Tier 1 Capital, Tier 2 Capital and Total Capital) 2006 – 2009 (P' million)

Tier 1 Capital Elements		2006	2007	2008	2009
1	Stated capital**	231	236	314	352
2	Preference (non-redeemable) non-cumulative shares	0	0	0	0
3	General reserves	58	58	3	355
4	Undivided profits (audited current year retained earnings/ loss)	1 044	1 292	1 559	1 837
5	Minority interests	0	0	0	0
6	Less				
	(a) Goodwill and other intangible assets	43	41	41	41
	(b) Shareholders' equity funded through the capitalisation of unrealised gains arising from property revaluation	13	13	0	0
7	Total Tier 1 Capital (Sum of lines 1 to 5 less lines 6 (a) and (b)	1 277	1 532	1 835	2 503
Tier 2					
8	Current year's unpublished profits	71	172	479	110
9	Fifty percent of fixed asset revaluation reserves	12	17	18	16
10	Unencumbered general provisions not to exceed 1.25 percent of risk weighted assets	76	96	114	166
11	Hybrid (debt/equity) capital instruments eligible for inclusion	0	0	1	0
12	Subordinated term debt eligible for inclusion	402	480	645	840
13	Minority interest in Tier 2 preference shares	0	0	0	0
14	Shareholders' equity funded through the capitalisation of property revaluation reserves	0	0	0	0
15	Total Tier 2 Capital (sum of lines 8 to 14)	561	765	1 257	1 132
16	Total Capital (sum of lines 7 and 15)	1 838	2 297	3 092	3 635
Impairments					
17	Investments in unconsolidated subsidiaries and associated companies	0	1	1	–1
	Total impairments of capital	0	1	1	–1
	Total unimpaired capital	1 838	2 296	3 091	3 634

*Excluding statutory banks

**Ordinary shares (issued and paid up) plus surplus – share premium

Appendix 6: Charts of Key Prudential and other Financial Indicators (Aggregate)

Chart 6.1: Average Cost of Deposits

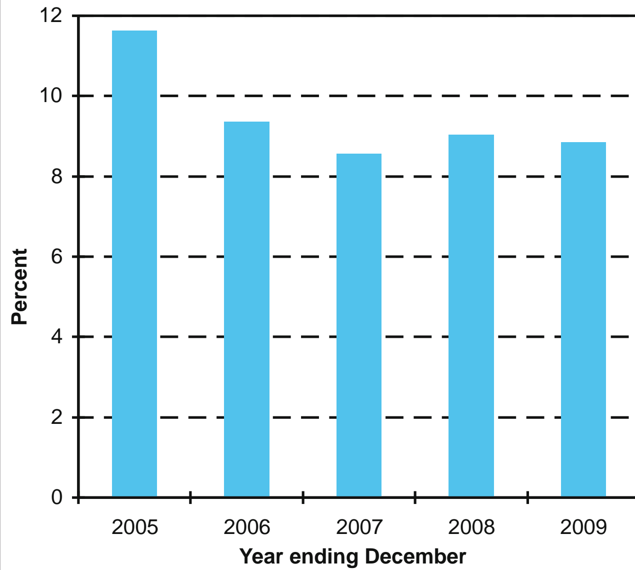


Chart 6.2: Return on Advances

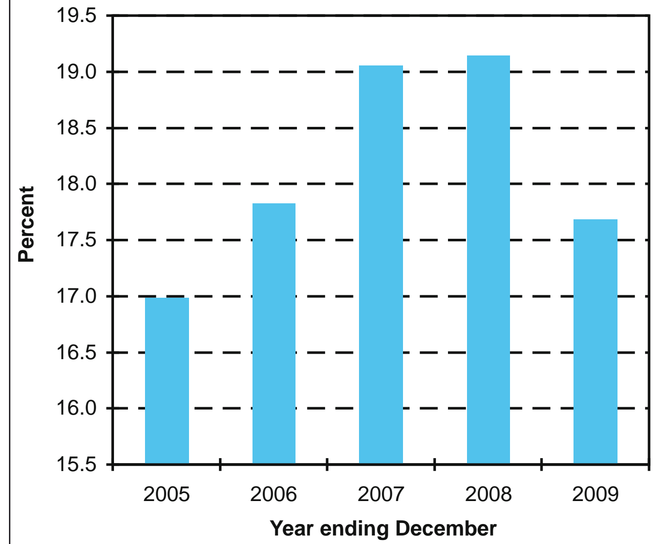


Chart 6.3: Residential Real Estate Loans to Gross Loans

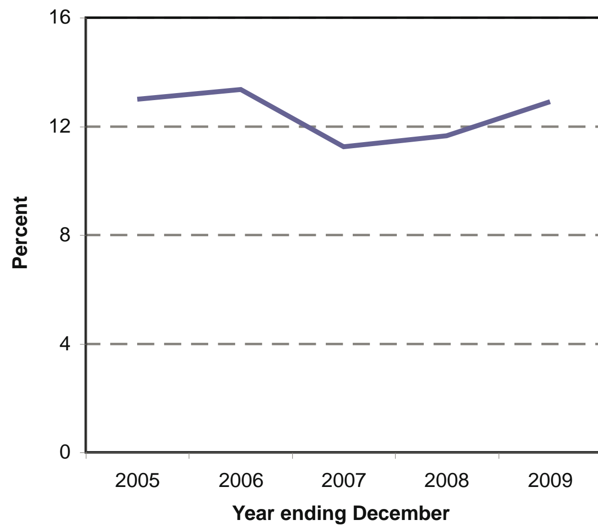


Chart 6.4: Household Loans to Gross Loans

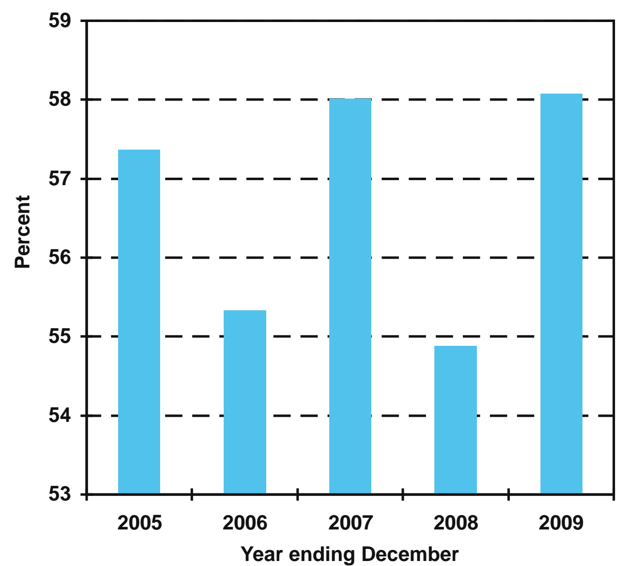


Chart 6.5: Growth Rate of Past Due Loans

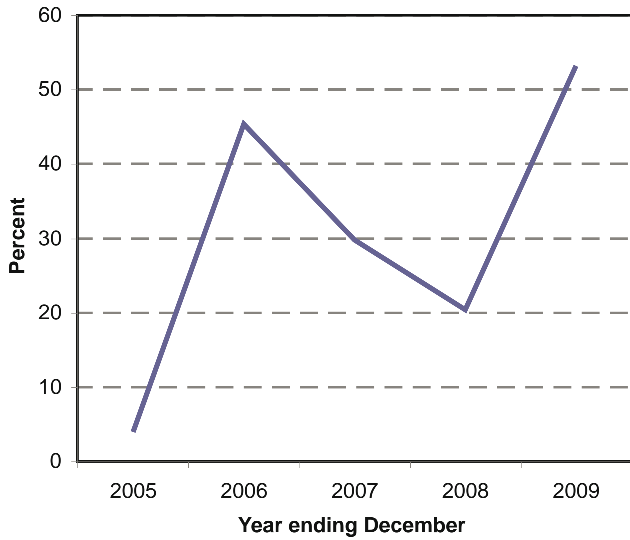


Chart 6.6: Share of Value of Total Deposits by Type (including FCAs)

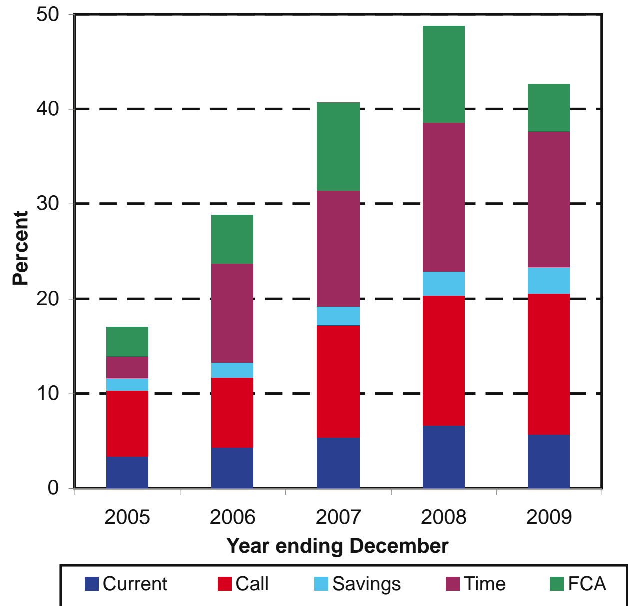


Chart 6.7: Foreign Currency Accounts by Type

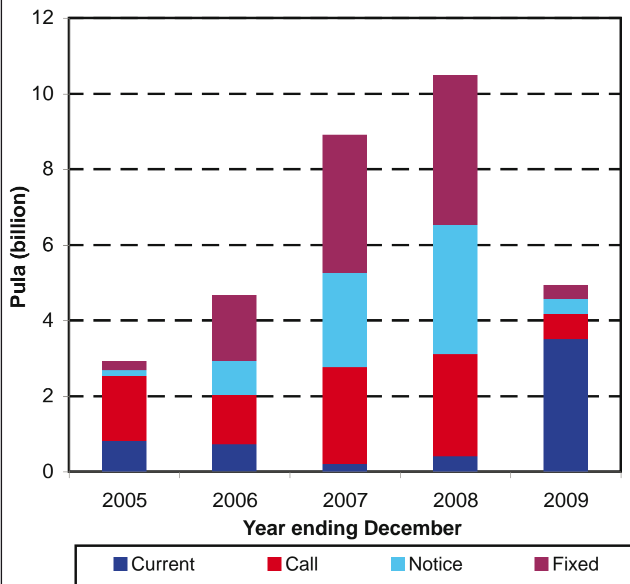


Chart 6.8: Gross Interest Income to ATA, Non-Interest Income to ATA and Non-Interest Expense to ATA