

**BANK
OF
BOTSWANA**

ANNUAL REPORT

2013



BOARD MEMBERS
as at December 31, 2013



Linah K Mohohlo
Governor and Chairman



G K Cunliffe



S Sekwakwa



C S Botlhole-Mmopi



Prof H Siphambe



R N Matthews



Dr J Sentsho



Prof P Collier

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ABBREVIATIONS USED IN THE REPORT

AACB	Association of African Central Banks
AC	Audit Committee
ATM	Automatic Teller Machine
BCWIS	Botswana Core Welfare Indicators Survey
BDC	Botswana Development Corporation
BISS	Botswana Inter-bank Settlement System
BMC	Botswana Meat Commission
BoBCs	Bank of Botswana Certificates
BPOPF	Botswana Public Officers Pension Fund
BSE	Botswana Stock Exchange
BTC	Botswana Telecommunications Corporation
CCBG	Committee of Central Governors
CLI	Credit Life Insurance
CMC	Cash Management Centre
DPF	Debswana Pension Fund
DTC	Diamond Trading Company
ECMISA	Enterprise Cash Management Inventory Stock Accounting
EU	European Union
FSDS	Financial Sector Development Strategy
FSI	Financial Soundness Indicators
FY	Fiscal Year
GDP	Gross Domestic Product
GEMVAS	Government Employee Motor Vehicle and Residential Property Advance Scheme
GNS	Gross National Saving
HIES	Household Income and Expenditure Survey
IFRS	International Financial Reporting Standards
IIP	International Investment Position
IMF	International Monetary Fund
KYC	Know-Your-Customer
LHS	Left Hand Scale
NBFIRA	Non-Bank Financial Institutions Regulatory Authority
NDB	National Development Bank
NDP	National Development Plan
NEER	Nominal Effective Exchange Rate
NRPB	Non-Resource Primary Balance

NEER	Nominal Effective Exchange Rate
NPLs	Non-performing Loans
OBA	Office of the Banking Adjudicator
ODCs	Other Depository Corporations
OECD	Organisation for Economic Co-operation and Development
OMO	Open Market Operations
PMP	Privatisation Master Plan
REER	Real Effective Exchange Rate
REMCO	Remuneration Committee
RHS	Right Hand Scale
RMCI	Real Monetary Conditions Index
RSA	Republic of South Africa
SA	South Africa
SACU	Southern African Customs Union
SADC	Southern African Development Community
SDR	Special Drawing Rights
SIPS	Systemically Important Payment Systems
SWIFT	Society for Worldwide Interbank Financial Telecommunication
UK	United Kingdom
UN	United Nations
USA	United States of America
USD	United States Dollar
VAT	Value Added Tax
WEO	World Economic Outlook
WUC	Water Utilities Corporation

PART A

STATUTORY REPORT ON THE OPERATIONS AND FINANCIAL STATEMENTS OF THE BANK FOR 2013

BANK OF BOTSWANA

SENIOR MANAGEMENT AS AT DECEMBER 31, 2013



O A Motshidisi

DEPUTY GOVERNORS



M D Pelaelo

GENERAL MANAGER



R H Nlebesi

HEADS OF DEPARTMENT



E T Rakhudu

Payments & Settlement



A M Motsomi

Banking Supervision



J Ghanie

Information Technology



R E K Somolekae

Human Resources



S A Matala

Banking & Currency



Dr K S Masalila

Monetary and Financial Stability



P D Siwawa-Ndai

Secretariat



D Loeto

Finance



S M Sealetsa

Financial Markets (Acting)

FOREWORD

The *Annual Report* for 2013 is published in accordance with Section 68(1) of the Bank of Botswana Act (CAP 55:01). In fulfilling the statutory requirements, the Report highlights major operational achievements and the Bank's financial performance for the year.

The *Report* outlines global and domestic economic and financial developments for 2013, as background to the Bank's formulation and implementation of monetary and exchange rate policies and in fostering financial stability and efficient payment systems. The *2013 Annual Report* theme topic, *Household Participation in the Financial Sector, Debt Sustainability and Impact on Financial Stability*, is of particular relevance in this context, given concerns on the need to encourage household inclusion in the financial sector while avoiding excessive accumulation of household debt.

In the course of 2013, the conduct of monetary and other policies was in the context of gradually improving prospects for the world economy, as led by recovery in the United States of America. The emerging market and developing economies also contributed positively to global growth. However, relative to productive capacity, output was subdued and, given stable commodity prices, inflationary pressures were generally benign. In Botswana, economic growth moderated in the non-mining sector; however, recovery in mining output boosted economic growth overall.

Low global inflation was transmitted to domestic price movements, in the absence of major upward adjustments to administrative prices and given the impact of the monetary policy stance on demand and underlying pressures on inflation. The result is that inflation fell from 7.4 percent in December 2012 to 4.1 percent at year-end, and was within the Bank's 3 – 6 percent objective range since June 2013. The Bank Rate was reduced by a cumulative two percentage points in the course of the year to 7.5 percent, and this led to a reduction in market interest rates and was supportive of growth of the domestic economy.

The banking sector was regulated and supervised in line with international best practice. Banks continued to be prudently managed and profitable, as they expanded the combined sectoral balance sheet by 5.3 percent to P61.1 billion. Two new banks commenced operations and a range of new products were introduced. Overall, credit growth slowed sharply in 2013, from 23.6 percent in 2012 to 15.1 percent. However, there was a divergence in trends between the business and household sectors, with growth in lending to households increasing from 21 percent to 24.2 percent, compared to a decline in the growth of business credit, from 26.8 percent to 4.6 percent. The increase in household credit was led by mortgage lending, which grew by 43.3 percent, while some improvement in financial services provision and financial inclusion was evident. Although current indicators, such as low default ratios, suggest that widespread default risks are not imminent, the level of household debt, which is dominated by personal loans in an environment of slow growth in incomes, warrants close monitoring.

The foreign exchange reserves increased from P59.3 billion at the end of 2012 to P67.8 billion at the end of 2013 (equivalent to 16.5 months of import cover). This was due to improved foreign currency receipts as demand for exports strengthened and import growth slowed; there was also the depreciation of the Pula against major international currencies. Export competitiveness continued to be supported by the 0.16 percent downward crawl of the nominal effective exchange rate, and the resultant marginal 0.4 percent appreciation of the real effective exchange rate. Bilateral exchange rate movements were pronounced, with the Pula appreciating significantly against the rand and depreciating against the Special Drawing Rights.

Both Moody's Investors Service and Standard & Poor's retained the country's "A" sovereign credit ratings in



2013. The ratings affirmed the country's strong financial position, which is underpinned by prudent macro-economic policies.

The Bank continues to implement projects in support of enhancing the efficiency and security of its operations. Among other projects, the new Cash Management Centre commenced operations in 2013. The efficiency of the national and regional payments systems was improved in line with the increasing importance of electronic payments.

In fulfilment of statutory obligations, the Bank's 2012 publications, *Annual Report* and *Banking Supervision Annual Report* for 2012 were submitted to the Minister of Finance and Development Planning on March 31, 2013 and June 30, 2013, respectively. The monthly *Botswana Financial Statistics*, biannual *Business Expectations Survey* and *Research Bulletin* were also published.

As usual, the Board of the Bank provided invaluable guidance to Management as the Bank's work programme for 2013 was implemented. Expectations are that the contents of this *Report* will make interesting reading.



Linah K Mohohlo

GOVERNOR

STATUTORY REPORT ON OPERATIONS AND FINANCIAL STATEMENTS OF THE BANK – 2013

THE BANK'S MISSION AND OBJECTIVES

As provided in Section 4 (1) of the Bank of Botswana Act (CAP 55:01), the Bank's mission and primary objectives are:

- to promote and maintain monetary stability, which primarily requires the maintenance of a low, predictable and sustainable level of inflation;
- to ensure that the overall financial system is safe and sound;
- to regulate and oversee the payments system and ensure that it is secure and efficient; and
- in so far as it would not be inconsistent with monetary stability, to promote the orderly, balanced and sustainable economic development of the country.

Figure 1 shows the strategies, activities and supportive infrastructure that are utilised to achieve the Bank's mission and objectives. Monetary stability is attained through the formulation and implementation of monetary policy. Banks are regulated and supervised to foster operational safety and soundness; financial sector performance is monitored and evaluated to promote financial stability. Oversight, regulation and currency management entrench confidence in the payments and settlement system in addition to mitigating against systemic risks. The Bank also provides efficient banking services to the Government, commercial banks and selected public institutions. The management of foreign exchange reserves enables the country to meet international financial obligations, and the Bank provides advice to Government on macroeconomic and financial policy matters. The governance structure coordinates and creates synergies between policy-oriented activities and supportive corporate services, including human resource management and training, adoption of efficiency-enhancing technology, risk mitigation, and enforcement of a code of conduct and institutional values.

GOVERNANCE AND ORGANISATIONAL STRUCTURE

The Board is at the apex of the governance structure of the Bank and has two Committees, the Audit Committee (AC) and Remuneration Committee (REMCO), that are chaired by non-Executive Board Members. The Governor chairs the Board and is Chief Executive Officer of the Bank, overseeing nine Departments and four Divisions, supported by two Deputy Governors and the General Manager (Figure 2). The Bank's organisation was reviewed with a view to reinforce synergies in the work of different Departments/Divisions as the Bank's delivery of its mandate is enhanced.

Board Functions, Membership and Appointments

The Board is responsible for the oversight of the Bank's general policy direction and operations in accordance with the Bank of Botswana Act and Bye-Laws. It comprises the Governor (*ex-officio* Chairman), Permanent Secretary of the Ministry of Finance and Development Planning (*ex-officio*) and seven other members (in their individual capacity). Five Board meetings (with the minimum legally required by the Act being four) were held during the year (Table 1). As at year-end, the Board had one vacancy. The Governor and two Deputy Governors (who are not Board members) are appointed by the President, while the Minister of Finance and Development Planning appoints the other seven Board members, two of whom may be public officers. The two Committees of the Board are constituted and chaired by non-executive Board members. The Committees consider issues pertaining to their respective mandates and make recommendations to the Board.

FIGURE 1: MISSION, OBJECTIVES, STRATEGIES AND ACTIVITIES

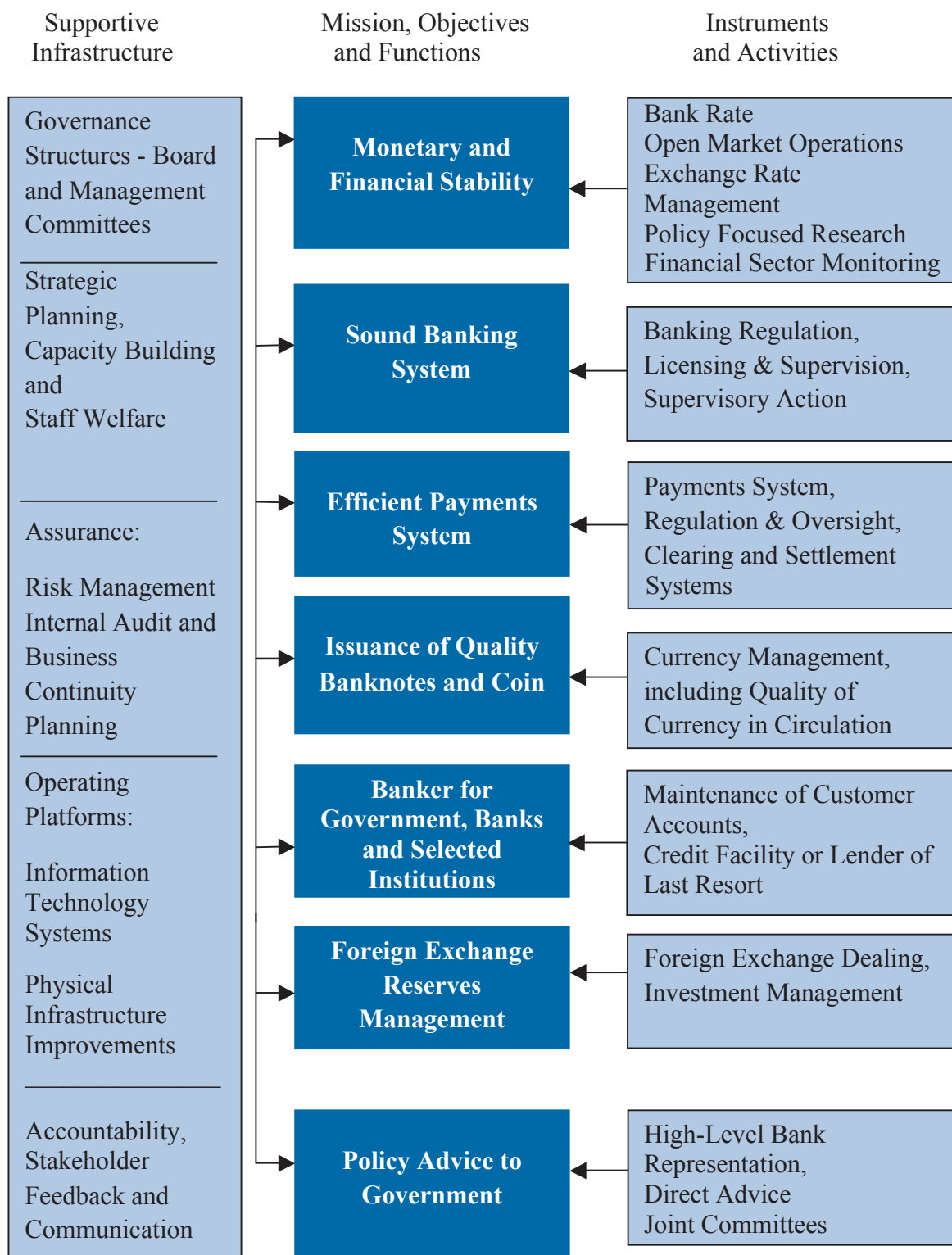


FIGURE 2: GOVERNANCE AND ORGANISATIONAL STRUCTURE AS AT DECEMBER 31, 2013

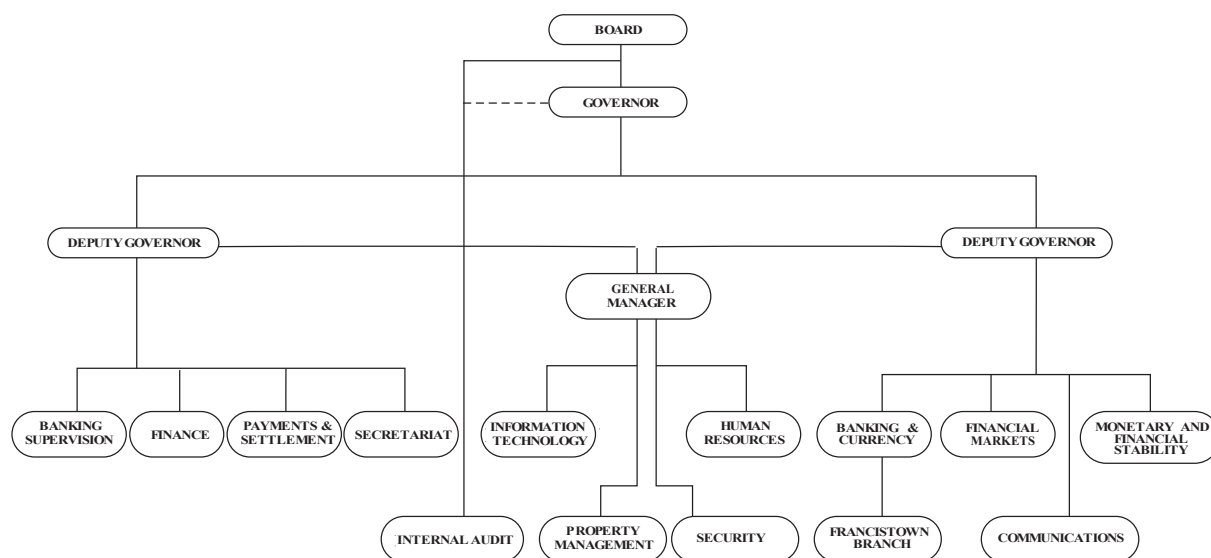


TABLE 1: BOARD MEETINGS AND ATTENDANCE 2013

Meeting	Mohohlo (Chairman Board)	Sekwakwa (Ex-officio)	Cunliffe (Chairman AC)	Matthews (AC)	Botlhole- Mmopi (AC)	Sentsho (REMCO)	Collier (REMCO)	Siphambe (Chairman, REMCO)
BB 1/13 (Feb 15)	✓	✓	✓	✓	✓	✓	×	✓
BB 2/13 (Mar 27)	✓	×	✓	✓	×	✓	×	✓
BB 3/13 (Jun 20)	✓	×	✓	✓	×	✓	×	✓
BB 4/13 (Sep 9)	✓	✓	✓	✓	✓	×	×	✓
BB 5/13 (Dec 9)	✓	×	✓	✓	×	✓	✓T	✓

Key: ✓ Attended
 × Not attended
 ✓T Participation through video & tele-conferencing
 BB Board Meeting

Governor, Deputy Governors and General Manager

The Governor implements Board decisions and, as stipulated in the Bank of Botswana Act, submits the *Annual Report* on the operations and financial performance (including audited financial statements) of the Bank to the Minister of Finance and Development Planning within three months of the end of the financial year. In turn, the Minister presents the *Annual Report* to Parliament within 30 days following receipt of the Report. The *Banking Supervision Annual Report* is submitted to the Minister by the end of June each year. The Governor represents the Bank at relevant local, regional and international meetings, and is the country's representative on the Board of Governors of the International Monetary Fund (IMF).

Executive Committee

The Executive Committee, which is chaired by the Governor, includes Deputy Governors, General Manager and Heads of Department. Senior advisors may be co-opted as members. The Committee meets once a week to monitor and review the implementation of the Bank's work programme(s).

Departments and Divisions

Five policy Departments fulfil the Bank's core mandates, while the other four provide auxiliary support and corporate services.

The Monetary and Financial Stability Department undertakes data collection, macroeconomic analysis, monitors the financial sector and evaluates emerging risks and other developments emanating from the macroeconomic environment, conducts macro-prudential assessments, and facilitates coordination with other relevant external entities to ensure macroeconomic and financial stability. The Department undertakes macroeconomic forecasting and policy review in support of the Bank's conduct of monetary policy, implementation of exchange rate policy and advising the Government. Production and dissemination of the contents of the Bank's *Annual Report* and other publications are also the responsibility of the Monetary and Financial Stability Department.

The Banking Supervision Department regulates and supervises banks and other financial institutions that fall under the Bank's purview and publishes the *Banking Supervision Annual Report*. The management of foreign exchange reserves, foreign exchange dealing, open market operations and other money and capital market activities, which include government bond issuance, are undertaken by the Financial Markets Department. The oversight and regulation of payments and settlement transactions is carried out by the Payments and Settlement Department.

The Banking and Currency Department provides banking services to the Government, commercial banks and selected institutions and is a repository for the country's financial relations with the International Monetary Fund (IMF). The Department is also responsible for the custody and issuance of the national currency.

The Finance Department is responsible for reporting on the Bank's financial activities, including production of monthly and annual financial statements of the Bank, in accordance with the Bank of Botswana Act and International Financial Reporting Standards (IFRS), and coordinates strategic planning and the formulation and implementation of risk and business continuity management. The Human Resources Department is responsible for staff recruitment, training, remuneration and welfare. The Information Technology Department ensures that the Bank's information technology systems and infrastructure are robust and effective in meeting the needs of the Bank.

The Secretariat discharges the Board and Executive Committee functions and is also responsible for the library, records management and protocol services. The other support services are undertaken through the specialised activities of four Divisions, viz, Internal Audit, Security, Communications and Property Management. The Internal Audit Division ensures that the Bank's operations are sound and comply with established internal controls and governance structures, in line with the Bank of Botswana Act and international best practice. The Security Division has the primary responsibility of managing all safety and security related risks within the Bank and all its facilities. The Communications Division is responsible for the coordination of communications activities and effective transmission of information on the Bank's mandate, policies and practices to stakeholders in a timely and efficient manner. The Division also coordinates the Bank's Public Education Programme and policies with the aim of promoting financial literacy as well as improving public understanding of the Bank's role in the economic development of the country. The Property Management Division undertakes procurement, custody and maintenance of immovable and movable assets, including the Bank's real estate and related equipment.

REVIEW OF THE BANK'S MAIN ACTIVITIES IN 2013

Monetary Policy, Money and Capital Market Activities and Exchange Rate Policy

Monetary Policy

The 2013 Monetary Policy Statement and its Mid-Term Review maintained the medium-term inflation objective range of 3 - 6 percent. Domestic inflation fell in 2013 and was within the Bank's medium-term objective range from June 2013. In the context of modest underlying demand pressures (reflected in lower price changes for most categories of goods and services), inflation decreased from 7.4 percent in December 2012 to 4.1 percent in December 2013. In the circumstances, and given a positive outlook for inflation, the Bank Rate was reduced by a cumulative 200 basis points during the year to 7.5 percent, and this resulted in lower market interest rates. Business expectations of inflation, as reflected in the September 2013 biannual Business Expectations Survey, were lower, in line with lower inflation.

Money and Capital Markets

Monetary policy was implemented using open market operations to absorb excess liquidity in the banking system, and interest rates were kept at levels that are consistent with the policy stance. As a result of the decline in excess liquidity, Bank of Botswana Certificates (BoBCs) fell from P8.7 billion at the end of 2012 to P5.5 billion in December 2013. Repurchase agreements (repos) and reverse repos were used to manage liquidity between auctions (Table 2 and Chart 1).

TABLE 2: MONEY MARKET 2012-2013

	End-2012			End-2013		
	Outstanding balances ² (P Billion)	Interest rate (Percent)		Outstanding balances ² (P Billion)	Interest rate (Percent)	
		Nominal	Real		Nominal	Real
3-month Treasury Bills ¹	0.36	5.14	-2.10	0.34	2.88	-1.17
6-month Treasury Bills ¹	0.32	5.06	-2.18	0.34	3.16	-0.90
14-day BoBCs ¹	3.44	4.64	-2.57	2.27	3.06	-1.00
3-month BoBCs ¹	5.24	5.36	-1.90	3.23	3.58	-0.50
Reverse repos	1.00	4.50	-2.70	0	3.00	-1.06
Repos	0	8.50	1.02	0.30	7.00	2.79
88-day deposits	4.83	3.70	-3.45	4.91	2.58	-1.46
Prime rate		11.00	3.35		9.00	5.02

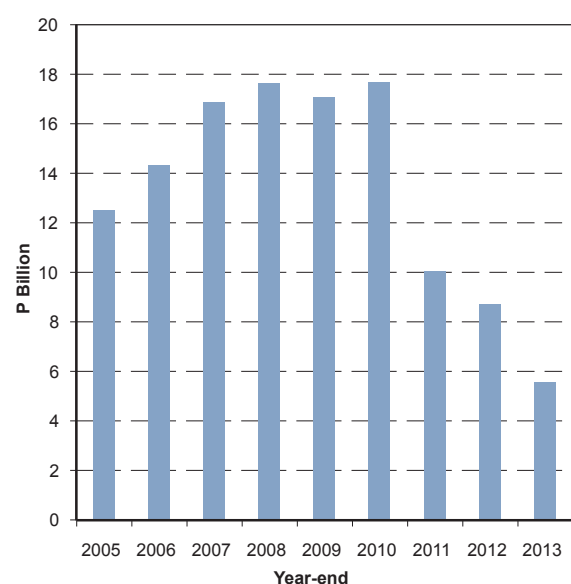
Notes: 1 Stop-out yield is used for Treasury Bills, while weighted average yield is used for 14-day and 91-day BoBC yields.

2. Book value

Source: Bank of Botswana

Following the reduction of the Bank Rate, the 14-day BoBC stop-out yield decreased from 4.66 percent at the end of 2012 to 3.18 percent in December 2013, while the yield on the 91-day paper fell from 5.39 percent to 3.63 percent in the same period. The prime lending rate for commercial banks decreased from 11 percent at the end of 2012 to 9 percent at the end of 2013. Moreover, the nominal 3-months deposit interest rate declined from 3.7 percent at the end of 2012 to 2.58 percent in December 2013. On the other hand, and in a bid to encourage savings, commercial banks were directed to offer and publish a 91-day deposit or equivalent deposit product which pays an interest rate that, at a minimum, is 3.5 percentage points below the prevailing Bank Rate,¹ with commensurate higher interest rates for longer-dated deposits. Real interest rates on deposits generally increased in 2013 due to the reduction in inflation.

1 Given the Bank Rate of 7.5 percent, the minimum deposit interest rate is 4 percent for the 91-day deposit.

**CHART 1: BANK OF BOTSWANA CERTIFICATES
2005 – 2013**

Source: Bank of Botswana

The P15 billion Government Bond Programme has remained in place and affords an opportunity for development of the capital market, while providing an alternative source of government funding. The Government increased borrowing from the domestic market in 2013 and, as a result, outstanding government securities (bonds of various maturities and Treasury Bills) increased from P6 billion at the end of 2012 to P6.7 billion in December 2013 (Table 3).

Exchange Rate Policy

The Pula basket weights were maintained at 55 percent South African rand and 45 percent Special Drawing Rights (SDR), and the Bank implemented a 0.16 percent downward crawl of the Pula in 2013. In the circumstances, the nominal effective exchange rate (NEER) of the Pula depreciated by the same magnitude as the rate of crawl. However, the rate of depreciation of the NEER was slightly lower than the

differential between domestic and trading partner countries' inflation, thus resulting in a marginal 0.4 percent appreciation of the real effective exchange rate (REER) by year-end.

TABLE 3: GOVERNMENT BONDS 2012–2013

Bond Code	Outstanding (P Million)	End 2012		Outstanding (P Million)	End 2013	
		Market Yields ³ (Percent)			Market Yields ³ (Percent)	
		Yield	Real		Yield	Real
BW009 (11/09/2013)	433	4.85	-2.37	-	-	-
BW003 (31/10/2015)	1 642	5.50	-1.77	1 642	4.21	0.11
BW010 (14/03/2017)	368	6.06	-1.25	618	4.64	0.52
BW005 (12/09/2018)	1 233	6.44	-0.89	1 233	4.86	0.73
BW008 (08/09/2020)	558	6.93	-0.44	858	5.46	1.31
BW007 (10/03/2025)	1 095	7.61	0.20	1 295	5.85	1.68
BW011 (10/09/2031)	-	-	-	399	6.24	2.06
	5 329			6 045		

Notes: 1. Where outstanding values differ for the same bond code between the two years, it means the bond was reopened for issuing an additional amount after the initial issue.

2. Book value

3. Market yields are indicative yields

Source: Bank of Botswana

Supervision and Regulation of Banks and Bureaux de Change

The banking system was healthy during 2013. Bilateral and trilateral meetings, off-site monitoring and on-site examination processes confirmed that banks were prudently managed, profitable, liquid, safe and sound, with most banks satisfying prudential and regulatory requirements (Table 4).² However, non-performing loans in-

2 In 2013, a full scope examination of one bank was conducted and two limited-scope examinations were conducted to review the level of operational risk and adequacy of the risk management systems and controls. In addition, on-site consumer compliance examinations of two banks were carried out.

TABLE 4: FINANCIAL SOUNDNESS INDICATORS AND RANGE OF PRUDENTIAL STANDARDS FOR LICENSED BANKS (2010 - 2013)

	Prudential Standard	Range of Prudential Standard for Local Banks			
		(Percent)			
		2010	2011	2012	2013
Capital Adequacy	≥15	16.3 – 33.4	16.0 – 28.5	17.3 – 24.2	16.2 – 24.3
Liquid Asset Ratio	≥10	28.5 – 77.3	10.0 – 52.4	12.4 – 51.4	12 – 36
Profitability (Return on Assets)	Positive	0.3 – 5	0.6 – 5.0	0.8 – 4.5	0.7 – 4
Profitability (Return on Equity)	Positive	2.5 – 38.2	7.2 – 39.0	9.2 – 39.1	6 – 31
Asset Quality (Non-performing Loans/ Total Term Loans)	≤2.5	2.0 – 10.5	0.6 – 6.3	1.7 – 14.4	1.7 – 8.1
Financial Intermediation (Advances/ Deposits)	≥50	37 – 71.8	49.3 – 86.4	52.5 – 84.4	63 – 86

Source: Bank of Botswana

creased from 2.6 percent in 2012 to 3.1 percent in December 2013 due, in part, to difficult economic conditions and over-leveraged household sector.

Fifteen enquiries were received from potential investors that were interested in establishing a banking business in Botswana. However, no applications for a banking licence were received during 2013. Two banking licence applications by State Bank of India (Botswana) Limited and Bank of India (Botswana) Limited that were received in 2012 were approved and both banks commenced operations before year-end, bringing the number of banks to 16. Two other applications for a banking licence that were submitted in 2012 were not successful.

The banking sector continued to expand its outreach in an effort to improve service quality and market coverage. Eight new branches were opened across the country. Employment increased by 2.9 percent to 4 577 at the end of 2013, following faster growth of 3.4 percent in 2012. Banks introduced a number of new products and/or services during the year; and all of the applications for new products and/or services, except two, were approved and/or referred for assessment. In this regard, the Bank also evaluated and responded to proposals for adjustment of bank charges by banks. This was before the Bank declared a two-year moratorium in December 2013 on upward adjustment of bank charges, effective January 2014. This was in response to growing public concerns on the high level and number of bank charges that are not consistent with the quality of service. Relevant studies to determine the appropriateness and level of charges and compliance with the Bank's related Directives will be undertaken during 2014.

Preparations for the implementation of Basel II/III were at an advanced stage. The Bank concluded the consultative process with the market and issued a draft Directive on Capital Adequacy Measurement and Standards to guide the parallel run of Basel I and the Basel II/III.

Abandoned funds were administered in accordance with Section 39 of the Banking Act (CAP. 46:04) and amounted to P8.2 million as at December 31, 2013.

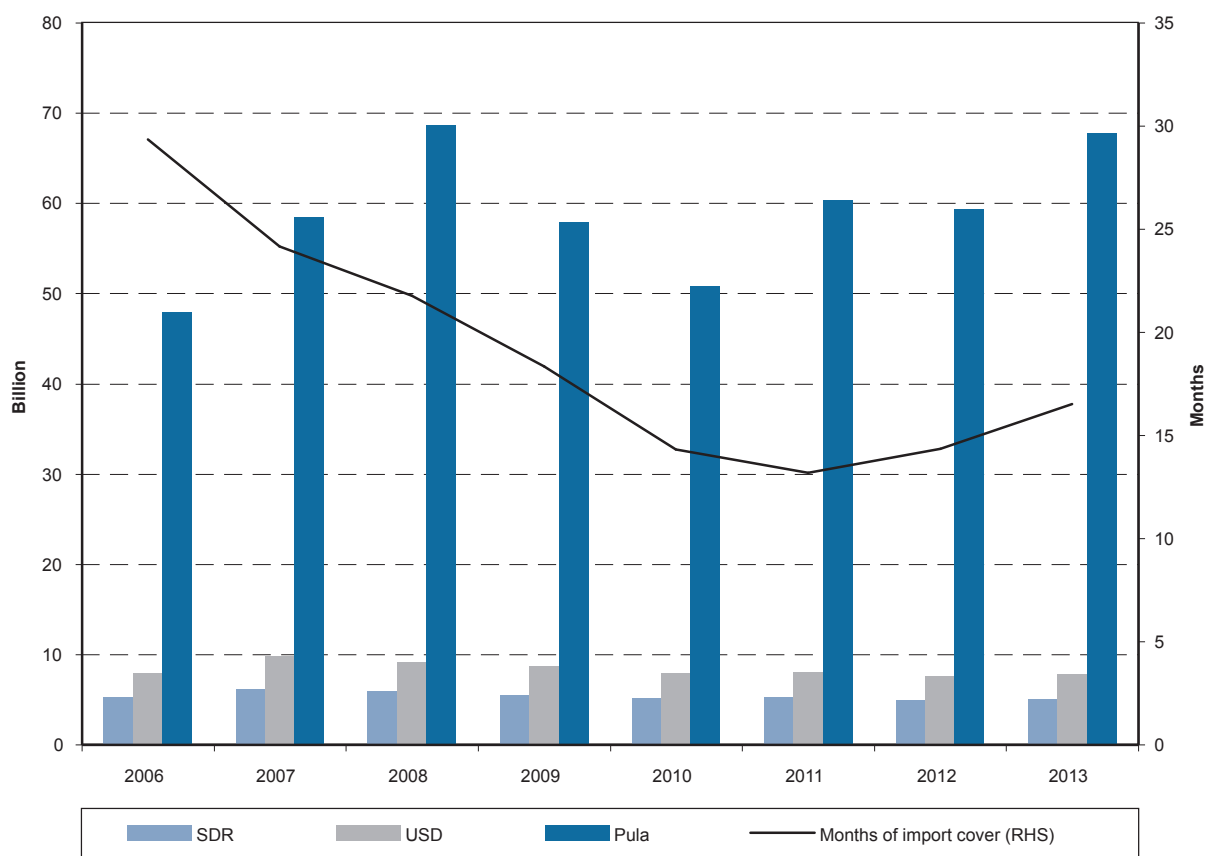
Four bureaux de change were given permission to commence operations during the year, while seven bureaux de change ceased operations for various reasons, including non-payment of annual licence fees. The total number of bureaux de change is now 57 as at December 31, 2013. Ten on-site examinations carried out during the year revealed that some bureaux de change violated several provisions of the Bank of Botswana (Bureaux de Change) Regulations, 2004, and were either cautioned and/or fined.

Foreign Exchange Reserves Management

The foreign exchange reserves increased by 14.3 percent from P59.3 billion in December 2012 to P67.8 billion as at the end of December 2013. The increase in foreign exchange reserves reflected improvement in foreign

exchange receipts and depreciation of the Pula against major international currencies. In terms of months of import cover, the reserves were equivalent to 16.5 months in December 2013, up from 14 months in December 2012 (Chart 2).

CHART 2: FOREIGN EXCHANGE RESERVES



Source: Bank of Botswana

Currency Operations and Issues

Currency operations were relocated to an automated and more technically advanced Cash Management Centre (CMC) in 2013. The number of banknotes in circulation increased by 3.3 percent, mainly due to net issuance of P200 banknotes, followed by the P20 and P10 banknotes (Charts 3a and 3b). The net issuance of all coin denominations declined by 12.2 percent in 2013 compared to an increase of 8.5 percent in 2012 (Charts 3c and 3d). The largest decrease was in the net issuance of 10 thebe coin followed by the 25 thebe coin.

Payments and Settlement

The Bank continued to provide oversight functions and monitor the operations of Systemically Important Payment Systems (SIPS) which are in place to enhance the provision of payments and financial services. All systems were found to be compliant with most of the Principles for Financial Market Infrastructures issued by the Bank for International Settlements.

The Botswana Inter-bank Settlement System (BISS) continued to provide real-time settlement service in an efficient and secure manner. In this regard, the Botswana Unified Revenue Service and the Office of the Accountant General were linked to the BISS in December 2013. The link enables the two entities to transact directly on BISS on a real-time basis and this facilitates timely reconciliation of accounts. Another notable development is that the Cheque Imaging and Truncation System project for Botswana is expected to be com-

CHART 3A: NET ISSUANCE OF BANKNOTES BY DENOMINATION (MILLION) 2012 – 2013

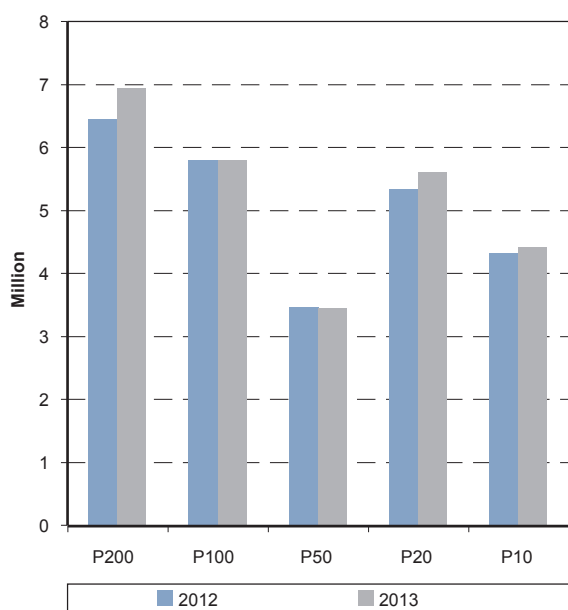


CHART 3B: SHARE OF NET ISSUANCE OF BANKNOTES BY DENOMINATION (PERCENT) 2012 – 2013

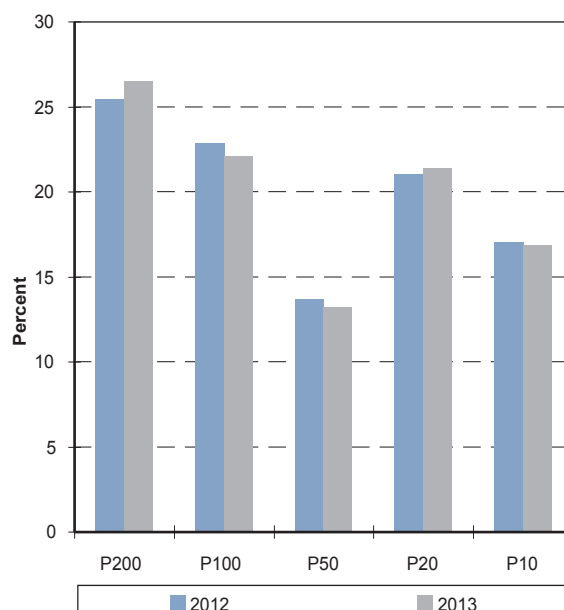


CHART 3C: NET ISSUANCE OF COIN BY DENOMINATION (MILLION) 2012 – 2013

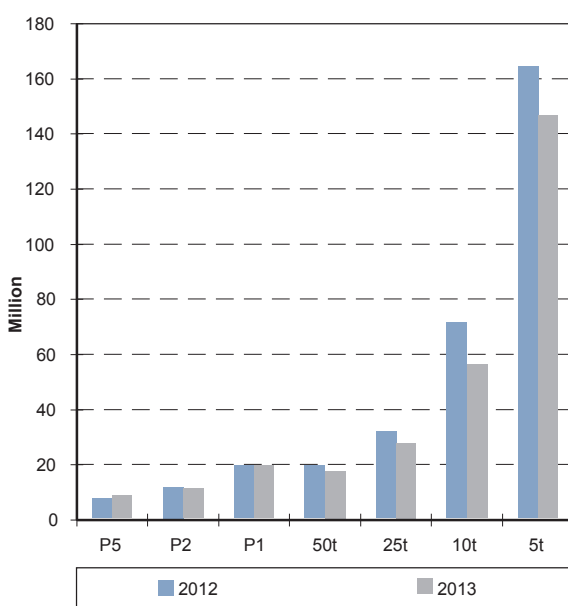
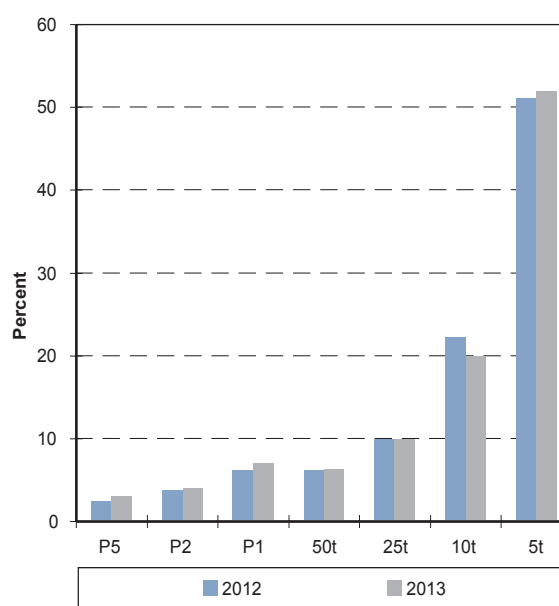


CHART 3D: SHARE OF NET ISSUANCE OF COIN BY DENOMINATION (PERCENT) 2012 - 2013



Source: Bank of Botswana

pleted and become operational soon. There was an increase in the utilisation of electronic means of payment in 2013, as cheque transactions declined, while both Electronic Funds Transfer (EFT) and BISS payments increased (Charts 4 - 6).

CHART 4: BOTSWANA INTER-BANK SETTLEMENT SYSTEM (BISS) TRANSACTIONS: (2007 - 2013)

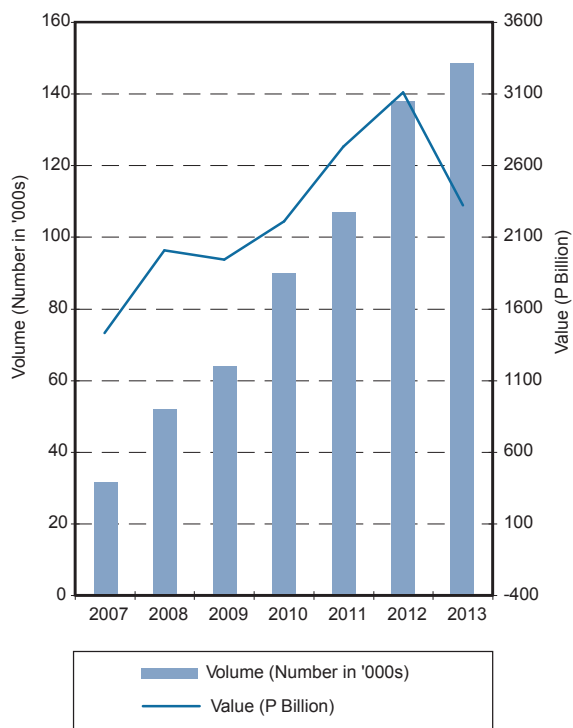
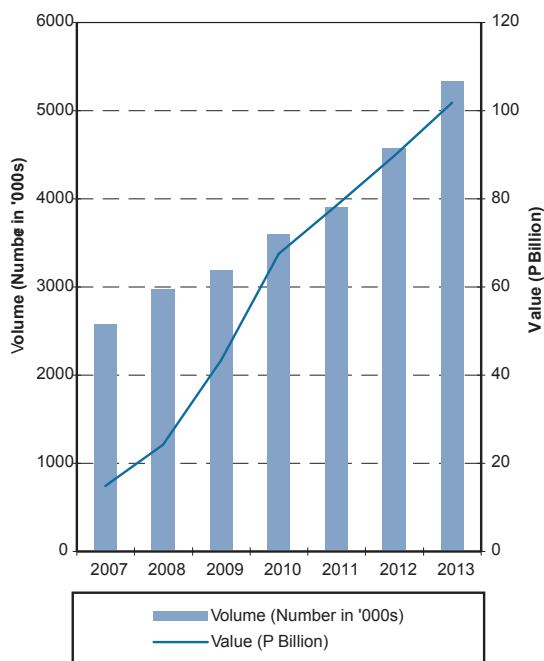


CHART 6: ELECTRONIC CLEARING HOUSE: ELECTRONIC FUNDS TRANSFERS (2007-2013)

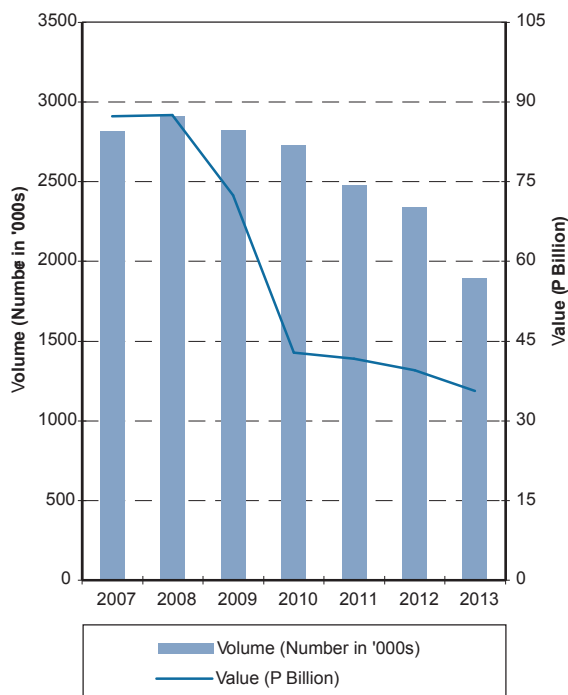


Source: Bank of Botswana

Information Technology

The Bank has installed a new vault management system called the Enterprise Cash Management Inventory Stock Accounting (ECMISA), which is used for managing money movement in the vaults. It also enables commercial banks to pre-advise the Bank of their intended deposits and withdrawals.

CHART 5: ELECTRONIC CLEARING HOUSE: CHEQUE PROCESSING (2007-2013)



Source: Bank of Botswana

Human Resources, Staff Welfare and Information Technology

Human Resources and Staff Welfare

As at December 31, 2013, the Bank's Staff Establishment was 593. Recruitment during the year resulted in a decrease in the vacancy rate from 12.4 percent at the end of 2012 to 10.1 percent in December 2013. The Bank continues to address staff development through enabling access to both short- and long-term training programmes.

Staff Pension Fund

The Bank of Botswana Defined Contribution Staff Pension Fund declared an investment return for the year ended September 30, 2013, of 30.69 percent and 30.13 percent, for active members and deferred members respectively. This represented an increase of 33.7 percent from the 2012 declared return of 22.96 percent for active members and 22.40 percent for the deferred members.

A holistic review of the Society for Worldwide Interbank Financial Telecommunication (SWIFT) system and infrastructure was undertaken in 2013 and this enabled the meeting of new SWIFT Standards.

External Relations and Communication

External Relations

External relations activities during the year included participation at relevant regional and international meetings, as well as hosting consultation, surveillance and technical assistance missions. At regional level, the Bank was represented at meetings of Southern African Customs Union (SACU), SADC Committee of Central Bank Governors (CCBG) and the Association of African Central Banks (AACB). The Bank also hosted the sovereign credit rating agencies, Moody's Investors Service and Standard & Poor's for their annual economic, financial and political assessment and credit rating. In addition, the Bank participated at meetings and conferences of the World Economic Forum and Bank for International Settlements (BIS), World Bank and International Monetary Fund (IMF).

Publications, Communications and Public Education

In accordance with statutory requirements, the *2012 Annual Report* on the Bank's operations and financial statements and the *2012 Banking Supervision Annual Report* were submitted to the Minister of Finance and Development Planning by March 31, 2013 and June 30, 2013, respectively; these were subsequently published. The 2013 Monetary Policy Statement (and Mid-Term Review), monthly *Botswana Financial Statistics* and *Research Bulletin* were also published, while the Bank's website provided timely access to data, publications, press releases and Bank's policies.

In fulfilment of accountability and transparency, and in implementation of the public outreach programme, the Bank conducted economic briefings following the publication of the *2012 Annual Report*. Among the key stakeholders briefed were the Cabinet, heads/representatives of diplomatic missions, heads of public and private sector institutions, senior government officials and the media/press. Other public relations activities included participation at exhibitions and career fairs.



ANNUAL FINANCIAL STATEMENTS

2013

BANK OF BOTSWANA

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STATEMENT OF RESPONSIBILITY OF THE BOARD AND APPROVAL OF THE ANNUAL FINANCIAL STATEMENTS

The members of the Board are responsible for the preparation and fair presentation of the annual financial statements of the Bank, comprising the Statement of Financial Position at December 31, 2013, Statement of Profit or Loss and Other Comprehensive Income, Statement of Distribution, Statement of Cash Flows and Statement of Changes in Shareholder's Funds for the year then ended, and the notes to the financial statements which include a summary of significant accounting policies and other explanatory notes, in accordance with International Financial Reporting Standards, and in the manner required by the Bank of Botswana Act (CAP 55:01).

The members are also responsible for such internal control as the members determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error, and for maintaining adequate accounting records and an effective system of risk management.

The members have made an assessment of the ability of the Bank to continue as a going concern and have no reason to believe that the Bank will not be a going concern in the year ahead.

The auditor is responsible for reporting on whether the annual financial statements are fairly presented in accordance with the applicable financial reporting framework.

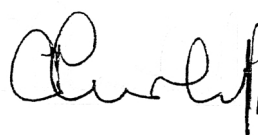
Approval of Annual Financial Statements

The annual financial statements of the Bank, as identified in the first paragraph, were approved by the Board on March 27, 2014 and signed on behalf of the Board by:



Linah K Mohohlo

Governor



Gordon K Cunliffe

Board Member

(Audit Committee Chairman)



**KPMG, Chartered Accountants
Audit**
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Fax +267 397 5281
Web <http://www.kpmg.com/>

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF THE BOARD OF BANK OF BOTSWANA

We have audited the financial statements of the Bank of Botswana, which comprise the Statement of Financial Position at December 31, 2013, Statement of Profit or Loss and Other Comprehensive Income, Statement of Distribution, Statement of Cash Flows and Statement of Changes in Shareholder's Funds for the year then ended and the notes to the financial statements which include a summary of significant accounting policies and other explanatory notes as set out on pages 33 to 64.

Board Members' Responsibility for the Financial Statements

The members of the Board are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and in the manner required by the Bank of Botswana Act (CAP 55:01), and for such internal control as the members determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements, plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, these financial statements give a true and fair view of the financial position of the Bank of Botswana at December 31, 2013, and its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards, and in the manner required by the Bank of Botswana Act (CAP 55:01).

Certified Auditors

Practicing Member: A.G Devlin (19960060.23)

Gaborone

March 27, 2014

KPMG, a partnership domiciled in Botswana and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity.

Partners: AG Devlin* NP Dixon-Warren FJ Roos**
*British ** South African
VAT Number: P03623901112

STATEMENT OF FINANCIAL POSITION

December 31, 2013

	Notes	2013 P'000	2012 P'000
ASSETS			
Foreign Assets			
Liquidity Portfolio	1.1	16 845 007	18 511 972
Pula Fund	1.2	49 326 918	39 352 679
International Monetary Fund (IMF)			
Reserve Tranche	2.1	422 311	335 823
Holdings of Special Drawing Rights	2.2	1 157 062	1 023 668
General Subsidy Account	2.3	20 531	18 188
Administered Funds	2.4	–	74 375
Total Foreign Assets		67 771 829	59 316 705
Domestic Assets			
Property and Equipment	3	412 089	392 394
Government of Botswana Bonds	4	24 942	24 006
Repurchase Agreements	9.1	302 078	–
Other Assets	5	88 389	106 080
Total Domestic Assets		827 498	522 480
TOTAL ASSETS		68 599 327	59 839 185
LIABILITIES AND SHAREHOLDER'S FUNDS			
Foreign Liabilities			
Allocation of IMF Special Drawing Rights	6	778 784	689 001
Liabilities to Government (IMF Reserve Tranche)	7	356 703	270 215
Total Foreign Liabilities		1 135 487	959 216
Domestic Liabilities			
Notes and Coin in Circulation	8	2 381 516	2 274 816
Bank of Botswana Certificates	9	5 490 723	8 663 540
Reverse Repurchase Agreements	9.1	–	999 020
Deposits	10	6 957 393	6 621 819
Dividend to Government	11	780 655	2 304 770
Other Liabilities	12	145 861	108 134
Total Domestic Liabilities		15 756 148	20 972 099
Total Liabilities		16 891 635	21 931 315
Shareholder's Funds			
Paid-up Capital	14	25 000	25 000
Government Investment Account			
Pula Fund and Liquidity Portfolio		26 463 736	18 386 638
Currency Revaluation Reserve		18 750 076	14 408 783
Market Revaluation Reserve		4 868 880	3 487 449
General Reserve	15	1 600 000	1 600 000
Total Shareholder's Funds		51 707 692	37 907 870
TOTAL LIABILITIES AND SHAREHOLDER'S FUNDS		68 599 327	59 839 185
FOREIGN ASSETS IN US DOLLARS ¹ (000)		7 739 543	7 628 128
FOREIGN ASSETS IN SDR ² (000)		5 021 893	4 958 877

¹ United States dollar/Pula – 0.1142 (2012: 0.1286)

² SDR/Pula – 0.0741 (2012: 0.0836)

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
Year ended December 31, 2013

	Notes	2013 P'000	2012 P'000
INCOME			
Interest – Foreign exchange reserves	16	1 073 446	1 181 675
Dividends – Foreign exchange reserves	17	394 783	312 781
Interest – Government of Botswana bonds		2 000	2 003
Net gains from fair value changes on disposal of securities	18	1 003 790	2 234 911
Net realised currency gains	19	2 413 870	3 208 293
Net unrealised currency gains	20	3 100 846	–
Net unrealised gains from fair value changes	21	–	74 149
Profit on domestic foreign exchange deals		30 535	25 953
Other income		10 981	12 523
		8 030 251	7 052 288
EXPENSES			
Interest expense	22	368 552	551 439
Administration costs		465 611	402 387
Depreciation expense	3	15 498	13 990
Net unrealised currency losses	20	–	562 742
Net unrealised losses from fair value changes	21	169 041	–
		1 018 702	1 530 558
NET INCOME FOR THE YEAR		7 011 549	5 521 730
OTHER COMPREHENSIVE INCOME			
Items that may be reclassified subsequently to profit or loss			
Net unrealised currency gains/(losses) on non-monetary “available-for-sale” financial instruments		1 162 362	(233 138)
Net unrealised gains from fair value changes on “available-for-sale” financial instruments		2 886 528	588 489
Other comprehensive income for the year		4 048 890	355 351
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		11 060 439	5 877 081

STATEMENT OF DISTRIBUTION
Year ended December 31, 2013

	Notes	2013 P'000	2012 P'000
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		11 060 439	5 877 081
Net unrealised currency (gains)/losses on non-monetary "available-for-sale" financial instruments		(1 162 362)	233 138
Net unrealised gains from fair value changes on "available-for-sale" financial instruments		(2 886 528)	(588 489)
NET INCOME FOR THE YEAR		7 011 549	5 521 730
TRANSFER TO CURRENCY REVALUATION RESERVE	23	(5 425 058)	(2 631 960)
NET INCOME AVAILABLE FOR DISTRIBUTION		1 586 491	2 889 770
TRANSFER TO GOVERNMENT INVESTMENT ACCOUNT		(430 836)	–
APPROPRIATIONS		1 155 655	2 889 770
DISTRIBUTION TO GOVERNMENT		(1 155 655)	(2 889 770)
Dividend to Government		(500 000)	(780 000)
Residual Net Income	11	(655 655)	(2 109 770)

STATEMENT OF CASH FLOWS
Year ended December 31, 2013

	Notes	2013 P'000	2012 P'000
OPERATING ACTIVITIES			
Cash (used in)/generated from operations	26	(2 482 825)	1 677 203
INVESTING ACTIVITIES			
Net withdrawals from foreign exchange reserves		1 194 160	3 991 748
Interest received from Government of Botswana bonds		2 000	2 000
Proceeds from disposal of property and equipment		47	354
Purchase of property and equipment	3	(35 350)	(135 890)
NET CASH GENERATED BY INVESTING ACTIVITIES		1 160 857	3 858 212
FINANCING ACTIVITIES			
Dividend to Government	11	(2 679 770)	(1 055 029)
Government investments/(withdrawals)		3 895 038	(4 666 044)
NET CASH GENERATED FROM/(USED IN) FINANCING ACTIVITIES		1 215 268	(5 721 073)
NET INCREASE IN CURRENCY IN CIRCULATION		(106 700)	(185 658)
CURRENCY IN CIRCULATION AT THE BEGINNING OF THE YEAR		(2 274 816)	(2 089 158)
CURRENCY IN CIRCULATION AT THE END OF THE YEAR		(2 381 516)	(2 274 816)

STATEMENT OF CHANGES IN SHAREHOLDER'S FUNDS
Year ended December 31, 2013

	Paid-up Capital	Currency Revaluation Reserve	Market Revaluation Reserve	General Reserve
	P'000	P'000	P'000	P'000
Balance at January 1, 2012	25 000	12 688 088	3 136 652	1 600 000
Total profit and other comprehensive income for the year	–	(233 138)	588 489	–
Net unrealised currency losses on non-monetary “available-for-sale” financial instruments	–	(233 138)	–	–
Net unrealised gains from fair value changes on “available-for-sale” financial instruments	–	–	588 489	–
Net income for the year	–	–	–	–
Transfers to/from Government Investment Account:				
Net unrealised gains from fair value changes for the year	–	–	(237 692)	–
Net unrealised currency gains for the year	–	(678 127)	–	–
Government withdrawals	–	–	–	–
Transfer to Currency Revaluation Reserve	–	2 631 960	–	–
Dividend to Government	–	–	–	–
Residual net income	–	–	–	–
Balance at December 31, 2012	25 000	14 408 783	3 487 449	1 600 000
Total profit and other comprehensive income for the year	–	1 162 362	2 886 528	–
Net unrealised currency gains on non-monetary “available-for-sale” financial instruments	–	1 162 362	–	–
Net unrealised gains from fair value changes on “available-for-sale” financial instruments	–	–	2 886 528	–
Net income for the year	–	–	–	–
Transfers to/from Government Investment Account:				
Net unrealised gains from fair value changes for the year	–	–	(1 505 097)	–
Net unrealised currency gains for the year	–	(2 246 127)	–	–
Excess of Government's Share of net income from Pula Fund over dividend	–	–	–	–
Government investments	–	–	–	–
Transfer to Currency Revaluation Reserve	–	5 425 058	–	–
Dividend to Government	–	–	–	–
Residual net income	–	–	–	–
Balance at December 31, 2013	25 000	18 750 076	4 868 880	1 600 000

The Government Investment Account, which was established on January 1, 1997, represents the Government's portion of the Pula Fund and the Liquidity Portfolio.

Government Investment Account	Accumulated Profit	Total	
P'000	P'000	P'000	
22 136 863	–	39 586 603	Balance at January 1, 2012
–	5 521 730	5 877 081	Total profit and other comprehensive income for the year
–	–	(233 138)	Net unrealised currency losses on non-monetary “available-for-sale” financial instruments
–	–	588 489	Net unrealised gains from fair value changes on “available-for-sale” financial instruments
–	5 521 730	5 521 730	Net income for the year
237 692	–	–	Transfers to/from Government Investment Account:
678 127	–	–	Net unrealised gains from fair value changes for the year
(4 666 044)	–	(4 666 044)	Net unrealised currency gains for the year
–	(2 631 960)	–	Government withdrawals
–	(780 000)	(780 000)	Transfer to Currency Revaluation Reserve
–	(2 109 770)	(2 109 770)	Dividend to Government
18 386 638	–	37 907 870	Residual net income
–	7 011 549	11 060 439	Balance at December 31, 2012
–	–	1 162 362	Total profit and other comprehensive income for the year
–	–	2 886 528	Net unrealised currency gains on non-monetary “available-for-sale” financial instruments
–	7 011 549	7 011 549	Net unrealised gains from fair value changes on “available-for-sale” financial instruments
1 505 097	–	–	Net income for the year
2 246 127	–	–	Transfers to/from Government Investment Account:
430 836	(430 836)	–	Net unrealised gains from fair value changes for the year
3 895 038	–	3 895 038	Net unrealised currency gains for the year
–	(5 425 058)	–	Excess of Government’s Share of net income from Pula Fund over dividend
–	(500 000)	(500 000)	Government investments
–	(655 655)	(655 655)	Transfer to Currency Revaluation Reserve
26 463 736	–	51 707 692	Dividend to Government
			Residual net income
			Balance at December 31, 2013

SIGNIFICANT ACCOUNTING POLICIES

December 31, 2013

REPORTING ENTITY

The Bank of Botswana (the Bank) is the central bank of Botswana established under the Bank of Botswana Act (CAP 55:01). The address of the Bank's registered office is 17938 Khama Crescent, Gaborone. These financial statements apply to the financial year ended December 31, 2013. The Government is the Bank's sole shareholder.

BASIS OF PRESENTATION OF FINANCIAL STATEMENTS

Statement of Compliance

The principal accounting policies applied in the preparation of the financial statements are stated below. These policies have been consistently applied to all the years presented and comply with International Financial Reporting Standards in all material respects.

The Financial Statements were authorised for issue by the Board on March 27, 2014.

Basis of Measurement

The financial statements are prepared on a historical cost basis, modified by fair value accounting for available-for-sale financial assets, all derivative contracts, financial assets and liabilities that are held at fair value through profit or loss.

Functional and Presentation Currency

The financial statements are presented in Pula, which is the Bank's functional currency. Except as otherwise indicated, financial information presented in Pula has been rounded to the nearest thousand.

ADOPTION OF REVISED STANDARDS AND INTERPRETATIONS

As at the date of finalisation of the financial statements, the following standards, relevant to the Bank's operations and available for adoption in the year, were adopted.

Standard	Effective for annual periods beginning on or after
<p>IFRS 7 – Financial Instruments: Disclosures – Offsetting financial assets and liabilities. The amendments to IFRS 7 require entities to disclose information about rights of offset and related arrangements, for financial instruments subject to an enforceable master netting agreement or similar agreement.</p> <p>The Bank did not have any enforceable netting arrangements for the year ended December 31, 2013.</p>	January 1, 2013
<p>IFRS 13 – Fair Value Measurement – Definition and measurement of fair value and disclosure requirements. The standard provides a single source of guidance on how fair value is measured and requires disclosures about fair value measurements. Subject to limited exceptions, IFRS 13 is applied when fair value measurements or disclosures are required or permitted by other IFRSs.</p> <p>IFRS 13 seeks to standardise fair value measurement and related disclosures through a 'fair value hierarchy'. The hierarchy categorises the inputs used in valuation techniques into three levels.</p> <p>The Bank has adopted the standard by making additional disclosures, through a fair value hierarchy, for each class of assets and liabilities measured at fair value.</p> <p>Other than additional disclosures in the financial statements the application of IFRS 13 has not had any material impact on the amounts recognised in the financial statements.</p>	January 1, 2013

SIGNIFICANT ACCOUNTING POLICIES (Continued)

December 31, 2013

STANDARDS AND INTERPRETATIONS IN ISSUE NOT YET ADOPTED

As at the date of finalisation of the financial statements, the following standards, relevant to the Bank's operations, are in issue and have not yet been adopted in the financial statements.

Standard	Effective for annual periods beginning on or after
<p>IAS 32 – Financial Instruments: Disclosures – Amendments enhancing disclosures about the effect of offsetting arrangements. These amendments require entities to disclose information that will enable the users of the financial statements to evaluate the effect or potential effect of netting arrangements of financial assets and liabilities, including rights of set-off associated with the entity's recognised financial assets and liabilities, on the entity's financial position.</p> <p>The adoption of these amendments is expected to have no impact on the financial statements of the Bank.</p>	January 1, 2014
<p>IFRS 9 – Financial Instruments – In November 2009, the standard was issued covering classification and measurement of financial assets as first part of the project to replace IAS 39. In October 2010, the standard was reissued incorporating new requirements on accounting for financial liabilities and carrying over the requirements for derecognition of financial assets and financial liabilities from IAS 39. The financial assets and liabilities are to be classified and measured based on the entity's business model on which they are held and the characteristics of their contractual cash flows.</p> <p>In November 2013, IFRS 9 was reissued, introducing a chapter on hedge accounting and removing the mandatory effective date of January 1, 2015. The impairment, classification and measurement requirements are yet to be finalised.</p> <p>The Bank will determine the potential financial impact of adoption of IFRS 9 when the standard is finalised.</p>	To be determined

FINANCIAL INSTRUMENTS

General

Financial instruments carried on the Statement of Financial Position include all assets and liabilities, including derivative instruments, but exclude property and equipment, prepayments, VAT receivables, sundry receivables and sundry receipts.

Fair Value Measurement

“Fair value” is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date in the principal or the most advantageous market to which the Bank has access at that date. The fair value of a liability reflects its non-performance risk.

The Bank measures the fair value of a financial instrument using the quoted price in an active market for that particular instrument. A market is regarded as active if transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.

When quoted prices in an active market are not available, the Bank uses valuation techniques that maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

SIGNIFICANT ACCOUNTING POLICIES (Continued)**December 31, 2013****FINANCIAL INSTRUMENTS (Continued)****Financial Assets**

Financial assets are classified into the following specified categories: financial assets “at fair value through profit or loss” (FVTPL) (including held for trading), “available-for-sale” and “loans and receivables”. The classification depends on the nature and purpose of the financial assets and is determined at the time of initial recognition as detailed below.

Loans and Receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Bank provides a service directly to a counterparty. Loans and receivables (including prepayments, advances to banks and staff advances) are measured at amortised cost using the effective interest method less any identified impairment losses at the end of each reporting period.

Financial Assets at Fair Value through Profit or Loss

Financial assets are classified as fair value through profit or loss when the financial asset is either held-for-trading or it is designated as fair value through profit or loss. The Bank holds short-term investments as held for trading.

A financial asset is classified as held for trading if it is acquired principally for the purpose of selling it in the short-term or if so designated by management. Financial assets at fair value through profit or loss are stated at fair value, with any realised and unrealised gains and losses arising from changes in the fair value of financial assets recognised in profit or loss in the year in which they arise.

The realised and unrealised gains and losses recognised in profit or loss excludes interest and dividend income. Derivatives are classified as held-for-trading.

Available-for-sale

Available-for-sale assets are non-derivative financial assets that are either designated as available-for-sale or are not classified as loans and receivables or fair value through profit or loss.

Available-for-sale instruments are intended to be held for long periods of time but may be sold in normal course of business of the Bank.

Bonds and equities invested under the Pula Fund portfolio classified as available-for-sale are traded in active markets and are carried at fair value at the end of each reporting period.

The fair value of quoted investments in active markets is based on current bid prices. In other cases the Bank establishes fair value by using appropriate valuation techniques.

All realised currency gains or losses from available-for-sale instruments are recognised in profit or loss. Unrealised currency gains on monetary available-for-sale items are also recognised in the profit or loss.

The unrealised currency gains or losses on non-monetary available-for-sale items are recognised in other comprehensive income under the heading “net unrealised currency gains or losses on non-monetary “available-for-sale” financial instruments”.

When investments are disposed off or determined to be impaired, the cumulative unrealised currency gains or losses previously accumulated are reclassified to profit or loss.

Interest income on all assets is calculated using the effective interest method and is recognised in profit or loss.

Dividends on available-for-sale equity instruments are recognised in profit or loss when the right to receive payment is established.

SIGNIFICANT ACCOUNTING POLICIES (Continued)

December 31, 2013

FINANCIAL INSTRUMENTS (Continued)

Short-term Investments (Liquidity Portfolio)

The Bank has designated the Liquidity Portfolio as a fund in which money market instruments and bonds are invested to facilitate payments for regular transactions.

Securities invested in this portfolio are measured “at fair value through profit or loss” and are classified as held for trading. They are initially recognised at fair value and are subsequently remeasured at fair value based on bid prices. All related realised and unrealised gains and losses are recognised in profit or loss.

All purchases and sales of investment securities in the portfolio are recognised at trade date, which is the date the Bank commits to purchase or sell the investments.

Long-term Investments (Pula Fund)

This is a long-term fund intended to maximise returns and is invested in foreign financial instruments. These investments, which may be sold in response to needs for liquidity, changes in interest rates, exchange rates, etc., are classified as “available-for-sale”, except for derivatives. These securities are initially recognised at fair value (which includes transaction costs) and are subsequently remeasured at fair value, based on bid prices.

All realised currency gains/losses are recognised in profit or loss. Unrealised currency gains/losses on monetary items are also recognised in profit or loss. The unrealised currency gains/losses on non-monetary items are recognised in other comprehensive income. However, in line with the Bank’s policy, all currency gains/losses for this fund are not distributable and are, therefore, appropriated to the Currency Revaluation Reserve.

Realised fair value changes are recognised in profit or loss. Unrealised fair value changes are recognised in other comprehensive income. Unrealised gains and losses arising from fair value changes of the instruments classified as “available-for-sale” are non-distributable as per the Bank’s policy and are appropriated to the Market Revaluation Reserve. When these instruments are disposed of or impaired, the related accumulated fair value or impairment adjustments are included in profit or loss as gains or losses from investment securities.

All purchases and sales of investment securities in the portfolio are recognised at trade date, which is the date the Bank commits to purchase or sell the investments.

Government of Botswana Bonds

The Bank acquires Government of Botswana bonds for purposes of facilitating orderly trading in the local bond market. The bonds, which may be sold in response to the need to intervene in the market, are classified as “available-for-sale” securities.

The bonds are initially recognised at fair value and are subsequently remeasured at fair value, based on bid prices. All unrealised gains and losses arising from changes in the fair value are recognised in the Market Revaluation Reserve. When these instruments are disposed of or impaired, the related accumulated fair value adjustments are included in profit or loss as gains or losses from Government of Botswana bonds.

All purchases and sales of bonds are recognised at trade date, which is the date that the Bank commits itself to purchase or sell the bonds.

Derivative Financial Instruments

The Bank uses a variety of derivative financial instruments to manage its exposure to interest rate and foreign exchange risks, including interest rate futures, foreign exchange forward contracts, cross-currency swaps and options.

Derivative financial instruments are initially recognised at fair value (including transaction costs) and are subsequently remeasured at fair value, based on bid prices for assets held or liabilities to be issued, and ask/offer prices for assets to be acquired or liabilities held. The resulting gain or loss is recognised in the profit or loss.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
December 31, 2013**FINANCIAL INSTRUMENTS (Continued)****Impairment of Financial Assets**

Financial assets other than loans and receivables are carried at fair value. "Loans and receivables" are assessed for any evidence of impairment at each Statement of Financial Position date. Financial assets are impaired when there is objective evidence that as a result of one or more events that have occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been adversely impacted. For financial assets carried at amortised cost, the amount of the impairment is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate. In respect of "available-for-sale" equity securities, any increase in fair value subsequent to an impairment loss is recognised directly in other comprehensive income.

Financial Liabilities

All the Bank's financial liabilities are classified as other financial liabilities at amortised cost. Financial liabilities are initially recognised at fair value and subsequently measured at amortised cost using the effective interest method.

Bank of Botswana Certificates

As one of the primary tools for maintaining monetary stability in the economy, the Bank of Botswana issues its own paper, Bank of Botswana Certificates (BoBCs), to absorb excess liquidity in the market and thereby influence short term interest rates. BoBCs are issued at a discount to counterparties. They are classified as "other financial liabilities".

The Bank's liability in respect of BoBCs is stated at offer prices on auction date, adjusted for movements in matured and unmatured discount recognised in profit or loss.

Other Financial Liabilities

Other financial liabilities are initially measured at fair value, net of transaction costs.

Other financial liabilities are subsequently measured at amortised cost using the effective interest method, with interest expense recognised on the effective yield basis. The effective interest method is a method of calculating the amortised cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts future cash payments through the expected life of the financial liability, or where appropriate, a shorter period.

CREDIT FACILITY

Under the Credit Facility, the Bank provides emergency and intermittent funding to solvent banks, intended to bridge intra-day and overnight liquidity shortages. The advances are secured by Government of Botswana bonds and Bank of Botswana Certificates (BoBCs), valued at fair value prices on the date of the transaction. Only high quality, marketable and freely transferable paper with a minimum amount of risk is acceptable as collateral at the discretion of the Bank. Government bonds and Government guaranteed securities of any maturity and other eligible paper with a remaining maturity of 184 days or less are also acceptable as security. The Bank has the right to call for additional collateral, should the value of the security decline during the tenure of the facility. Interest earned on the advances is credited to profit or loss, while advances outstanding as at the Statement of Financial Position date are recorded under "other assets".

SECURITIES LENDING PROGRAMME

The Bank takes part in a Securities Lending Programme. Where securities are lent, the Bank holds collateral in the form of cash or other securities. The securities lent continue to be recorded in the Bank's Statement of Financial Position.

The Bank's global custodian administers the Securities Lending Programme and monitors the securities lent and related collateral against requirements agreed by the Bank.

The Bank records income from lending securities as it accrues.

SIGNIFICANT ACCOUNTING POLICIES (Continued)

December 31, 2013

FINANCIAL INSTRUMENTS (Continued)

REPURCHASE AND REVERSE REPURCHASE AGREEMENTS

This facility is one of the mechanisms designed to deal with short-term liquidity fluctuations in the domestic money market. It is available to primary counterparties who are solvent institutions licensed and supervised by the Bank.

The term of a repurchase agreement and reverse repurchase agreement can vary from overnight to one month, depending on the liquidity conditions in the domestic market.

Interest earned by the Bank on repurchase agreements and interest paid by the Bank on reverse repurchase agreements is recognised in profit or loss.

OFFSETTING FINANCIAL INSTRUMENTS

The Bank offsets financial assets and liabilities and reports the net balance in the Statement of Financial Position where:

- (a) There is a legally enforceable right to set off;
- (b) There is an intention to settle on a net basis or to realise the asset and settle the liability simultaneously;
- (c) The maturity date for the financial assets and liability is the same; and
- (d) The financial asset and liability are denominated in the same currency.

FOREIGN CURRENCIES

All transactions denominated in foreign currencies are translated to Pula at the mid exchange rate at the transaction date.

Where amounts denominated in one foreign currency are sold in order to buy another foreign denominated currency such that neither profit nor loss is realised on the transaction, mid exchange rates are used.

All assets and liabilities denominated in foreign currencies are translated to Pula using the bid and offer rates of exchange, respectively, at the close of the financial year. Foreign currency differences arising on translation are recognised in profit or loss, except for unrealised exchange differences arising on translation of non-monetary "available-for-sale" financial instruments, which are recognised in other comprehensive income. However, all gains and losses relating to disposals whose proceeds are reinvested in foreign assets, and all the unrealised gains/losses arising on financial instruments are not considered distributable in terms of Bank policy; they are appropriated to the Currency Revaluation Reserve.

ASSETS, LIABILITIES AND RECOGNITION OF PROVISIONS

Assets

Assets are recognised when the Bank obtains control of a resource as a result of past events, and from which future economic benefits are expected to flow to the Bank.

Contingent Assets

The Bank discloses a contingent asset arising from past events where it is probable that economic benefits will flow from it, but this will only be confirmed by the occurrence or non-occurrence of one or more uncertain future events outside the control of the Bank.

Liabilities and Provisions

The Bank recognises liabilities (including provisions) when:

- (a) It has a present legal obligation resulting from past events;
- (b) It is probable that an outflow of resources embodying economic benefits will be required to settle this obligation; and
- (c) A reliable estimate of the amount of the obligation can be made.

Derecognition of Assets and Liabilities

The Bank derecognises a financial asset when it loses control over the contractual rights that comprise the asset and transfers substantially all the risks and benefits associated with the asset. This arises when the rights are realised, expire or are surrendered. A financial liability is derecognised when it is legally discharged.

SIGNIFICANT ACCOUNTING POLICIES (Continued)
December 31, 2013

INCOME AND EXPENSE RECOGNITION

Interest income and expense are recognised in profit or loss on an accrual basis. Dividend income is recognised in profit or loss when the right to receive payment is established.

GENERAL RESERVE

Under Section 7(1) of the Bank of Botswana Act, (CAP 55:01), the Bank of Botswana is required to establish and maintain a General Reserve sufficient to ensure the sustainability of future operations of the Bank. The Bank may transfer to the General Reserve funds from other reserves, which it maintains, for the purposes of maintaining the required level of the General Reserve.

CURRENCY REVALUATION RESERVE

Any changes in the valuation, in terms of Pula, of the Bank's assets and liabilities in holdings of Special Drawing Rights and foreign currencies as a result of any change in the values of exchange rates of Special Drawing Rights or foreign currencies and in realised currency gains reinvested in foreign assets are transferred to the Currency Revaluation Reserve.

The proportion directly attributable to the Government Investment Account is transferred to such investment account.

MARKET REVALUATION RESERVE

Any changes in the value of the Bank's long-term investments as a result of any change in the fair values of such investments are transferred to the Market Revaluation Reserve.

The proportion directly attributable to the Government Investment Account is transferred to such investment account.

GOVERNMENT INVESTMENT ACCOUNT

The Government Investment Account represents the Government's share of foreign exchange reserves.

PROPERTY AND EQUIPMENT

Property and equipment are stated at cost less related accumulated depreciation and any accumulated impairment losses.

Land and buildings are valued on a fair value basis every two years, and the recoverable (revalued) amounts disclosed by way of a note to the Financial Statements, providing that revalued amounts are in excess of the carrying amounts. Where the carrying amounts are more than the revalued amounts, an impairment loss is recognised in profit or loss.

At each Statement of Financial Position date, the Bank reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any).

Any impairment loss is recognised immediately in profit or loss.

Where an impairment loss subsequently reverses, the carrying amount of the asset is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset in prior years.

SIGNIFICANT ACCOUNTING POLICIES (Continued)

December 31, 2013

PROPERTY AND EQUIPMENT (Cont'd)

Depreciation

Depreciation is charged so as to write-off the cost of assets less residual values, other than land and buildings under construction, over their estimated useful lives, using the straight-line method. The estimated useful lives, residual values and depreciation methods are reviewed at each year end, with the effect of any changes in estimate accounted for on a prospective basis.

The annual depreciation rates used in the calculation of depreciation are as follows:

	Percent
Buildings	2.5 – 6
Other Assets	
Furniture, fixtures and equipment	5 – 25
Computer hardware	25
Computer software	20
Motor vehicles	5 – 25

A gain or loss arising on disposal or retirement of an item of property and equipment is determined as the difference between the net sales proceeds and the carrying amount of the asset and is recognised in profit or loss.

RETIREMENT BENEFITS

Pension benefits are provided for employees through the Bank of Botswana Defined Contribution Staff Pension Fund, which is governed in terms of the Pension and Provident Funds Act (CAP 27:03). The contribution per pensionable employee is at the rate of 21.5 percent of pensionable salary, which comprises 16 percent and 1.5 percent payable by the Bank as its contribution to the Fund and for administration costs of the Fund, respectively, and a 4 percent contribution by each pensionable employee. Other than the contributions made, the Bank has no commitments or obligations to this Fund. Obligations for contributions to the pension fund are recognised in profit or loss in the periods during which services are rendered by employees.

SHORT-TERM EMPLOYEE BENEFITS

Short-term employee benefits obligations are measured on an undiscounted basis and are expensed as the related service is provided.

FINANCE LEASES

Assets held by the Bank under leases that transfer to the Bank substantially all of the risks and rewards of ownership are classified as finance leases. The leased asset is initially measured at an amount equal to the lower of its fair value and the present value of the minimum lease payments. Subsequent to initial recognition, the asset is accounted for in accordance with the accounting policy applicable to that asset.

Assets held under other leases are classified as operating leases and are not recognised in the Bank's statement of financial position.

RELATED PARTY TRANSACTIONS

The Bank enters into various transactions with other wholly owned or partly owned Government institutions and its key management personnel (related parties). All related party transactions are entered into at arm's length in the ordinary course of business. The transactions with key management personnel are staff benefits provided under the General Conditions of Service of the Bank.

SIGNIFICANT ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING ACCOUNTING POLICIES

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgments are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

Useful Lives of Property and Equipment

Management reviews the estimated useful lives of property and equipment at the end of each annual reporting period. In this financial year, no change was made to the useful lives, hence the depreciation rates provided are similar with the prior year.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS
December 31, 2013

	2013	2012
	P'000	P'000
1. FOREIGN EXCHANGE RESERVES		
1.1 Liquidity Portfolio		
Bonds – held for trading	9 941 332	7 745 590
Amounts due from Pula Fund	576 127	848 111
Short-term deposits	6 327 548	9 918 271
	<u>16 845 007</u>	<u>18 511 972</u>
1.2 Pula Fund		
Equities – available-for-sale	21 409 042	14 627 891
Bonds – available-for-sale	27 352 573	24 525 029
Derivative financial instruments – assets (Note 13)	18 017	21 719
Amounts due to Liquidity Portfolio	(576 127)	(848 111)
Derivative financial instruments – liabilities (Note 13)	(6 117)	(16 871)
Short-term deposits	1 129 530	1 043 022
	<u>49 326 918</u>	<u>39 352 679</u>
Statement of Financial Position		
<i>Capital Employed</i>		
Government	26 161 289	18 231 037
Bank of Botswana	23 165 629	21 121 642
	<u>49 326 918</u>	<u>39 352 679</u>
<i>Employment of Capital</i>		
Investments	49 326 918	39 352 679
Investments expressed in US dollars ('000)	5 633 134	5 060 755
Investments expressed in SDR ('000)	3 655 125	3 289 884
Statement of Profit or Loss and Other Comprehensive Income		
<i>Income</i>		
Interest and dividends	1 104 298	1 314 900
Realised currency revaluation gains	1 658 801	3 304 515
Unrealised currency revaluation gains/(losses)	1 934 968	(1 030 848)
Realised gains from fair value changes	1 021 749	2 341 900
Sundry income	198	172
	<u>5 720 014</u>	<u>5 930 639</u>
<i>Expenses</i>		
Administration charges	141 174	108 650
	<u>141 174</u>	<u>108 650</u>
Net income for the year	5 578 840	5 821 989
<i>Other Comprehensive Income</i>		
<i>Items that may be reclassified subsequently to profit or loss</i>		
Net unrealised currency gains/(losses) on non-monetary “available-for-sale” financial instruments	1 162 363	(233 138)
Net unrealised gains from fair value changes on “available-for-sale” financial instruments	2 885 592	588 847
Other comprehensive income for the year	4 047 955	355 709
Total comprehensive income for the year	<u>9 626 795</u>	<u>6 177 698</u>

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

	2013 P'000	2012 P'000
2. INTERNATIONAL MONETARY FUND (IMF)		
2.1 Reserve Tranche		
<p>This asset represents the difference between Botswana's Quota in the IMF and IMF Holdings of Pula. Botswana's Quota is the membership subscription, of which at least 25 percent was paid for in foreign currencies and the balance in Pula. The holding of Pula by the IMF, which initially was equal to 75 percent of the quota, has changed from time to time as a result of the use of the Pula by the IMF in lending to member countries.</p>		
Quota (SDR 87 800 000; 2012: SDR 87 800 000)	1 184 885	1 050 239
Less: IMF Holdings of Pula	(762 574)	(714 416)
Reserve Position in IMF	422 311	335 823
<p>The IMF Holdings of Pula are represented by the Non-Interest Bearing Note of P353 179 294 (2012: P353 179 294) issued by the Government of Botswana in favour of the IMF, maintenance of value currency adjustments and the amount in the current account held at the Bank (included in other deposits in Note 10).</p>		
2.2 Holdings of Special Drawing Rights		
<p>The balance on the account represents the value of Special Drawing Rights (SDR) allocated and purchased less utilisation to date.</p>		
	1 157 062	1 023 668
2.3 General Subsidy Account		
Face Value (SDR 1 520 000)	20 524	18 182
Interest	7	6
	20 531	18 188
<p>This is an investment with the International Monetary Fund, the purpose of which is to augment the resources of the Poverty Reduction and Growth Trust Fund. The investment is expected to generate SDR 0.2 million over five years. It matures on August 22, 2017.</p>		
2.4 Administered Funds		
Face value (SDR 6 142 590)	–	73 476
Interest	–	899
	–	74 375

This relates to the Poverty Reduction Growth Facility/Heavily Indebted Poor Countries (PRGF/HIPC) Trust. The amount represents SDR 6 142 590 (and interest accrued thereon) lent on May 20, 2008, to the Poverty Reduction Growth Facility/Heavy Indebted Poor Countries Trust Fund, a fund administered in trust by the IMF. This matured on May 20, 2013.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

3. PROPERTY AND EQUIPMENT	Freehold Land P'000	Leasehold Land P'000	Buildings P'000	Capital Works in Progress P'000	Other Assets P'000	Total P'000
Cost – December 31, 2013						
Balance at the beginning of the year	2 065	3 083	161 187	253 532	117 122	536 989
Additions	–	–	–	28 552	6 798	35 350
Disposals	–	–	–	–	(2 083)	(2 083)
Transfers from WIP	–	–	224 522	(278 727)	54 205	–
Balance at year–end	2 065	3 083	385 709	3 357	176 042	570 256
Accumulated Depreciation						
Balance at the beginning of the year	–	–	60 107	–	84 488	144 595
Charge for the year	–	–	4 967	–	10 531	15 498
Disposals	–	–	–	–	(1 926)	(1 926)
Balance at year–end	–	–	65 074	–	93 093	158 167
Net book value at December 31, 2013	2 065	3 083	320 635	3 357	82 949	412 089
Cost – December 31, 2012						
Balance at the beginning of the year	2 065	3 083	151 894	135 219	110 929	403 190
Additions	–	–	–	128 682	7 208	135 890
Disposals	–	–	–	–	(2 091)	(2 091)
Transfers from WIP	–	–	9 293	(10 369)	1 076	–
Transfers	–	–	–	–	–	–
Balance at year–end	2 065	3 083	161 187	253 532	117 122	536 989
Accumulated Depreciation						
Balance at the beginning of the year	–	–	55 941	–	76 540	132 481
Charge for the year	–	–	4 166	–	9 824	13 990
Disposals	–	–	–	–	(1 876)	(1 876)
Balance at year–end	–	–	60 107	–	84 488	144 595
Net book value at December 31, 2012	2 065	3 083	101 080	253 532	32 634	392 394

Valuation of Properties

Freehold and leasehold land and buildings were valued by an independent professional property valuer in December 2012 at an open market value of P353 699 000 (2010: P263 943 000).

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

	2013 P'000	2012 P'000
4. GOVERNMENT OF BOTSWANA BONDS		
Government Bond BW005, maturing on September 12, 2018, bearing interest at the rate of 10 percent, receivable semi-annually in arrears:		
Fair value	24 329	23 393
Interest accrued	613	613
	24 942	24 006
5. OTHER ASSETS		
Staff loans and advances	52 614	63 164
Prepayments	2 633	2 055
Other	33 142	40 861
	88 389	106 080
6. ALLOCATION OF IMF SPECIAL DRAWING RIGHTS		
This is the liability of the Bank to the IMF in respect of the allocation of SDRs to Botswana.	778 784	689 001
7. LIABILITIES TO GOVERNMENT (IMF RESERVE TRANCHE)		
This balance represents the Bank's liability to the Government in respect of the Reserve Tranche position in the IMF (Note 2.1).	356 703	270 215
8. NOTES AND COIN IN CIRCULATION		
Notes	2 265 599	2 166 080
Coin	115 917	108 736
	2 381 516	2 274 816
Notes and coin in circulation held by the Bank as cash in hand at the end of the financial year have been netted off against the liability for notes and coin in circulation to reflect the net liability to the public.		
9. BANK OF BOTSWANA CERTIFICATES		
Face value	5 498 760	8 685 080
Unmatured discount	(8 037)	(21 540)
Carrying amount	5 490 723	8 663 540
Bank of Botswana Certificates are issued at various short-term maturity dates and discount rates.		
9.1 (REPURCHASE)/REVERSE REPURCHASE AGREEMENTS		
Fair value	(302 078)	999 020
The repurchase agreements reversed on January 3, 2014 (2012: January 3, 2013).		

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

	2013 P'000	2012 P'000
10. DEPOSITS		
Government	954 930	1 341 481
Bankers – current accounts	177 535	51 934
– statutory reserve accounts	4 186 721	4 116 109
Other	1 638 207	1 112 295
	6 957 393	6 621 819
<p>These deposits are various current accounts of Government, commercial banks, parastatal bodies and others, which are repayable on demand and are interest free, except for the statutory reserve requirement, which is also interest free, but not repayable on demand.</p>		
11. DIVIDEND TO GOVERNMENT		
Balance due at the beginning of the year	2 304 770	470 029
Dividend to Government from Pula Fund	500 000	780 000
Paid during the year	(2 679 770)	(1 055 029)
Residual net income	655 655	2 109 770
Balance due at the end of the year	780 655	2 304 770
<p>The final instalment of the pre-set dividend of P125 000 000 and the residual net income of P655 655 000 unpaid as at December 31, 2013 was provided for in accordance with Section 6 of the Bank of Botswana Act (CAP 55:01); which requires that all profits of the Bank be distributed to the shareholder, the Government. The high residual net income recorded for the year ended December 31, 2012 was a result of the net fair value gains of P1.8 billion realised from the portfolio rebalancing exercise undertaken in that year.</p>		
12. OTHER LIABILITIES		
Accounts payable	47 113	18 632
Other payables and accruals	98 748	89 502
	145 861	108 134
13. CATEGORIES OF FINANCIAL INSTRUMENTS		
13.1 Financial Assets		
Held for trading		
Bonds	9 941 332	7 745 590
Derivative financial instruments (Note 1.2)	18 017	21 719
Available-for-sale		
Bonds	27 352 573	24 525 029
Equities	21 409 042	14 627 891
Government bonds	24 942	24 006
Loans and Receivables		
IMF Reserves	1 599 904	1 452 054
Repurchase Agreements	302 078	–
Staff loans and advances	52 614	63 164
Short-term deposits	7 457 078	10 961 293
Total Financial Assets	68 157 580	59 420 746
<p>The above is disclosed in the Statement of Financial Position as follows:</p>		
Total Foreign Exchange Reserves	67 771 829	59 316 705
Add: Derivative financial instruments (liabilities)	6 117	16 871
Government of Botswana bonds	24 942	24 006
Repurchase Agreements	302 078	–
Other Assets – staff loans and advances (Note 5)	52 614	63 164
	68 157 580	59 420 746

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

	2013 P'000	2012 P'000
13. CATEGORIES OF FINANCIAL INSTRUMENTS (Cont'd)		
13.2 Financial Liabilities		
Held for trading		
Derivative financial instruments (Note 1.2)	6 117	16 871
Other Financial Liabilities – at amortised cost		
Bank of Botswana Certificates	5 490 723	8 663 540
Reverse Repurchase Agreements	–	999 020
Allocation of SDR (IMF)	778 784	689 001
Liabilities to Government (IMF)	356 703	270 215
Deposits	6 957 393	6 621 819
Dividend to Government	780 655	2 304 770
Other liabilities	145 861	108 134
	14 516 236	19 673 370

13.3 Derivative Financial Instruments

The Bank's investment guidelines authorise the use of derivative instruments. The derivatives are held for managing risk.

The Table below shows the market values and the total notional exposures of derivative financial instruments as at year end.

		Asset	Liabilities	Notional Amount	Assets	Liabilities	Notional Amount
		2013	2013	2013	2012	2012	2012
		(P'000)	(P'000)	(P'000)	(P'000)	(P'000)	(P'000)
Fixed Income Futures	–Buy	14 162	–	1 288 393	18 800	–	725 671
	–Sell	–	(2 563)	(363 096)	–	(10 613)	669 756
Currency Futures	–Buy	1 887	–	257 328	–	(5 569)	488 021
Other Options	–Buy	1 267	–	(1 546)	1 740	–	3 213
	–Sell	–	(316)	(2 649)	–	–	–
Swaps	–Buy	701	–	3 929	1 179	–	3 105
	–Sell	–	(3 238)	–	–	(689)	–
		18 017	(6 117)	1 182 359	21 719	(16 871)	1 889 766

The above derivatives are classified by type of asset and derivative instruments. The assets and liabilities reflect the net position between the market values and the notional amounts.

Futures

A futures contract is an agreement executed on the floor of an exchange to buy or sell a specific amount of a security or cash at a specified price and time. A fixed income futures contract would be an agreement to either buy or sell a specified amount of a fixed income security at a specified price and date, while a currency futures contract will be an agreement to either buy or sell a specified amount of currency at a specified exchange rate and date. Futures contracts are collateralised by cash or marketable securities and changes in the futures contract value are settled daily.

Options

An option is an exclusive right, usually obtained for a fee, but not the obligation to buy or sell a specific financial instrument within a specified time. A fixed income option is the exclusive right to either buy or sell specified units of a fixed income security by a specific date. A currency option is an option to either buy or sell a specified currency by a specific date.

Swaps

A swap is an agreement between two or more parties to exchange sets of cash flows over a period in the future, typically either in the form of interest rate swaps or currency swaps. The cash flows that the counterparties make are linked to the value of the underlying debt financial instrument or the foreign currency, as the case may be.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)

December 31, 2013

	2013 P'000	2012 P'000
14. PAID-UP CAPITAL		
Authorised and Paid-up Capital	25 000	25 000
The capital is the amount subscribed by the Government in accordance with Section 5 of the Bank of Botswana Act (CAP 55:01). The Bank is not subject to any externally imposed capital requirements. Therefore, capital is not actively managed. Management considers the Paid-up Capital and the General Reserve to be capital.		
15. GENERAL RESERVE		
In the opinion of the Board, the General Reserve, taken together with other reserves which the Bank maintains, is sufficient to ensure the sustainability of future operations of the Bank.		
	1 600 000	1 600 000
16. INTEREST – FOREIGN EXCHANGE RESERVES		
Liquidity Portfolio		
Short-term deposits	165 091	111 077
Bonds – held for trading	198 196	66 874
IMF Reserves – loans and receivables	446	1 427
Pula Fund		
Short-term deposits	17 966	19 956
Bonds – available-for-sale	691 747	982 341
	1 073 446	1 181 675
17. DIVIDENDS – FOREIGN EXCHANGE RESERVES		
Pula Fund		
Equities – available-for-sale	394 783	312 781
18. NET GAINS/(LOSSES) FROM FAIR VALUE CHANGES ON DISPOSAL OF SECURITIES		
Liquidity Portfolio		
Bonds – held for trading	(17 958)	(106 989)
Pula Fund		
Derivative instruments – held for trading	(5 667)	(3 838)
Bonds – available-for-sale	117 514	1 920 725
Equities – available-for-sale	909 901	425 013
	1 003 790	2 234 911
Included above are net fair value gains of P1 027 415 000 (2012: P2 345 738 000) which have been reclassified from equity to profit or loss on disposal of investments classified as available-for-sale.		
19. NET REALISED CURRENCY GAINS/(LOSSES)		
Liquidity Portfolio		
Short-term deposits	493 211	142 865
Bonds – held for trading	261 858	(239 086)
Pula Fund		
Derivative instruments – held for trading	15 747	(578)
Short-term deposits	22 930	21 963
Bonds – available-for-sale	1 230 098	2 620 809
Equities – available-for-sale	390 026	662 320
	2 413 870	3 208 293
Included above are net currency gains of P1 620 124 000 (2012: P3 283 129 000) which have been reclassified from equity to profit or loss on disposal of investments classified as available-for-sale.		

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

	2013 P'000	2012 P'000
20. NET UNREALISED CURRENCY GAINS/(LOSSES)		
Liquidity Portfolio		
Short-term deposits	182 905	17 280
Bonds – held for trading	933 858	432 336
IMF reserves – loans and receivables	49 115	18 491
Pula Fund		
Short-term deposits	3 929	1 440
Bonds – available-for-sale	1 925 505	(1 022 863)
Derivative instruments – held for trading	5 534	(9 426)
	<u>3 100 846</u>	<u>(562 742)</u>
21. NET UNREALISED (LOSSES)/GAINS FROM FAIR VALUE CHANGES		
Liquidity Portfolio		
Bonds – held for trading	(164 494)	79 159
Pula Fund		
Derivative instruments – held for trading	(4 547)	(5 010)
	<u>(169 041)</u>	<u>74 149</u>
22. INTEREST EXPENSE		
Bank of Botswana Certificates (BoBCs)	341 003	479 998
Reverse Repurchase Agreements	27 549	71 441
	<u>368 552</u>	<u>551 439</u>
23. NET CURRENCY REVALUATION GAINS/(LOSSES) RETAINED IN PROFIT OR LOSS		
Total net realised gains (Note 19)	2 413 870	3 208 293
Total net unrealised gains/(losses) (Note 20)	3 100 846	(562 742)
Total net currency revaluation gains	<u>5 514 716</u>	<u>2 645 551</u>
Appropriated to Currency Revaluation Reserve:		
Net realised currency gains and reinvested in foreign assets	(2 324 212)	(3 194 702)
Net unrealised currency (gains)/losses (Note 20)	(3 100 846)	562 742
Transfer to Currency Revaluation Reserve	(5 425 058)	(2 631 960)
Net currency revaluation gains retained in profit or loss	<u>89 658</u>	<u>13 591</u>

24. CONTRIBUTION TO THE BANK OF BOTSWANA DEFINED CONTRIBUTION STAFF PENSION FUND

The Bank's contribution to the Bank of Botswana Defined Contribution Staff Pension Fund for the year ended December 31, 2013 is P21 838 000 (2012: P17 102 000).

25. STATEMENT OF CASH FLOWS

The definition of cash in IAS 7 is not wholly appropriate to the Bank. Due to its role in the creation and withdrawal of currency in circulation, the Bank has no cash balances on its Statement of Financial Position (see Note 8). However, the Bank has the ability to create cash when needed.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

	2013 P'000	2012 P'000
26. CASH GENERATED BY OPERATIONS		
Net income for the year adjusted for:	7 011 549	5 521 730
Net realised and unrealised exchange gains	(5 425 058)	(2 631 960)
Depreciation expense	15 498	13 990
Loss/(Profit) on disposal of Property and Equipment	109	(139)
Interest – Government of Botswana bonds	(2 000)	(2 003)
	1 600 098	2 901 618
Increase in Deposits – banks and other	722 125	426 268
(Decrease)/Increase in Deposits – Government	(386 551)	96 552
Decrease in Bank of Botswana Certificates	(3 172 817)	(1 318 250)
Decrease in Reverse Repurchase Agreements	(999 020)	(498 391)
Increase in Repurchase Agreements	(302 078)	–
Decrease in other assets	17 691	32 583
Increase in other liabilities	37 727	36 823
Cash (used in)/generated from operations	(2 482 825)	1 677 203
27. CAPITAL COMMITMENTS		
Approved and contracted for	50 356	59 235
Approved, but not contracted for	17 352	25 533
	67 708	84 768

These capital commitments will be funded from internal resources.

28. COLLATERAL

(a) Credit Facility

There were no open positions as at December 31, 2013 (2012: Nil) under the Credit Facility accounted for as “Advances to banks”.

(b) Securities Lending Programme

Under the Bank’s Securities Lending Programme, the Bank has lent securities with a fair value of P8.5 billion (2012: P9.6 billion). The Bank has accepted securities with a fair value of P8.7 billion (2012: P10 billion) as collateral for the securities lent under this programme.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)

December 31, 2013

29. GOVERNMENT OF BOTSWANA BONDS AND TREASURY BILLS

In accordance with Sections 56 and 57 of the Bank of Botswana Act (CAP 55:01), the Bank acts as agent of the Government for the issuance and management of the Government Bonds and Treasury Bills. An analysis of the bonds and treasury bills issued during the financial year ended December 31, 2013 is provided below:

Government of Botswana Bonds and Treasury Bills issued during the year 2013

Bond/ Treasury Bill Detail	BW007	BW008	BW010	BW11	BW120613	BW110913	BW111213	BW110614	BW120314	Total
Date of Issue	March 13, 2013	Sept/Dec 11, 2013	Sept/Dec 11, 2013	Sept/Dec 11, 2013	March 13, 2013	March 13, 2013	June 12, 2013	Dec 11, 2013	Sept 11, 2013	
Date of Maturity	March 10, 2025	Sept 8, 2020	Mar 14, 2017	Sept 10, 2031	June 12, 2013	Sept 11, 2013	Dec 11, 2013	June 11, 2014	March 12, 2014	
Interest Rate Percent (per annum)	8.00	7.75	7.75	7.75	–	–	–	–	–	
	P'000	P'000	P'000	P'000	P'000	P'000	P'000	P'000	P'000	P'000
Nominal Value	200 000	300 000	250 000	399 000	340 000	339 000	340 000	340 000	340 000	2 848 000
Net (Discount)/ Premium	16 180	41 293	26 005	60 039	(4 417)	(8 170)	(8 245)	(5 586)	(6 627)	110 472
Net Proceeds	216 180	341 293	276 005	459 039	335 583	330 830	331 755	334 414	333 373	2 958 472
Interest Paid to date	8 000	–	–	–	4 417	8 170	8 245	–	–	28 832
Interest Accrued	4 994	7 386	5 834	9 652	–	–	–	1 040	4 787	33 693

- (a) Net proceeds realised from the issue of the bonds of P2 958 472 000 (2012: P2 678 619 000) were invested in the Government Investment Account. The nominal value of holdings of total outstanding Government bonds and treasury bills as at December 31, 2013, was P6 725 000 000 (2012: P6 010 000 000).
- (b) Interest is payable on all bonds on a semi-annual basis in arrears. During the year to December 31, 2013, total interest payments of P523 440 370 were made (2012: P537 833 170) and were funded from the Government's current account maintained with the Bank.
- (c) Government bonds and treasury bills are liabilities of Government; and they are, therefore, not accounted for in the Statement of Financial Position of the Bank.

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS

Risk is inherent in the Bank's management of financial instruments which comprised primarily foreign exchange reserves, which are held in various financial instruments. This risk is managed through a process of ongoing identification, measurement and monitoring that is subject to an extensive framework of risk limits and other controls. The process of risk management is critical to the Bank's ongoing operations, with the day to day management of the financial instruments being conducted by the Financial Markets Department. A key element in the risk management of the foreign exchange reserves is safety, defined as the preservation of purchasing power of the foreign exchange reserves. To this end, the Bank has continued to pursue a conservative and diversified investment strategy, with an SDR weighted currency allocation as the benchmark. The Bank's objectives, policies and procedures for managing the risk exposures and the method used to measure the risks have remained consistent with the prior year. The risk management framework remains sound and effective.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)

December 31, 2013

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

Risk Management Governance Structure

The Bank's risk management governance structure is broadly as follows:

(a) Board

The Board is responsible for the Bank's overall risk management and for approving investment policies and guidelines. The Bank's management reviews the risk management policies from time to time.

(b) Investment Committee

The Investment Committee, which is chaired by the Governor and comprises representatives from relevant areas of the Bank, meets regularly to review developments in the international financial and capital markets. Where necessary, the Investment Committee makes decisions on Bank managed portfolios. The Investment Committee also monitors the performance of the external fund managers.

(c) Financial Markets Department

The Financial Markets Department is responsible for the management of the foreign exchange reserves and has a specialised Risk Management Unit focusing on the risks associated with all the investment portfolios and ensures compliance with Investment Guidelines.

(d) Segregation of Duties

At an operational level, the main feature of risk control is the segregation of duties relating to dealing, settlement, risk monitoring and recording. These responsibilities are split among three Departments: Financial Markets, Payments and Settlement and Finance.

Tranching of Foreign Exchange Reserves – Liquidity Portfolio and Pula Fund

The Bank of Botswana Act (CAP 55:01) requires the Bank to maintain a primary international reserve, that is, the Liquidity Portfolio, while Section 35 provides for the establishment and maintenance of a long-term investment fund, the Pula Fund. In compliance with the statutory requirements, a major feature of the foreign exchange reserves management strategy is, therefore, to allocate a certain level of reserves to the Liquidity Portfolio, with the remaining amount invested in the Pula Fund.

Pula Fund

Investments of the Pula Fund comprise long-term assets, such as long-dated bonds and equities actively traded in liquid markets, with the expectation of earning a higher return than could be achieved on conventionally managed investments. The asset allocation between bonds and equities is determined using a combination of historical data and assumptions. Exercises are also conducted in respect of the Pula Fund risk/return sensitivity analysis, using different portfolio options, where risk is measured by a standard deviation on the rate of return.

Liquidity Portfolio

In terms of the investment guidelines, the Liquidity Portfolio gives priority to liquidity over return given the constant need to provide foreign exchange to finance transaction payments. While the eligible investment currencies are similar to those of the Pula Fund, the Liquidity Portfolio is largely invested in the Bank's transaction currencies.

There are no equities in the Liquidity Portfolio and investment instruments include government bonds of eligible grade currencies issued by AAA-rated supranational and AAA-rated US agencies in eligible currencies; other liquid money market instruments are also eligible.

Types of Risk Exposure

The Bank's investment guidelines cover basic types of risk exposures, namely, market risk (currency risk, interest rate risk and equity price risk), credit risk, liquidity and instrument risk. These types of risk apply to the foreign assets and liabilities.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

(a) Currency Risk

The foreign exchange reserves are invested in currencies that are freely convertible, less susceptible to frequent and sharp exchange rate fluctuations and are used in well developed financial markets. The Bank's policy is to invest only in currencies with high ratings assigned by Moody's Investors Service and Standard and Poor's. Through a diversified currency allocation relative to an SDR weighted benchmark, the Bank ensures that the purchasing power of the foreign exchange reserves is preserved. In terms of the investment guidelines, a maximum deviation from the neutral level (using the SDR weights as a benchmark) for USD and EUR of 10 percentage points is permitted, while a deviation of up to 5 percentage points on all other currencies is permitted. At the end of 2013, the Bank's total exposure to SDR and related currencies was P64.7 billion (2012: P55.2 billion). The Bank is also exposed to SDR currency risk on net IMF balances amounting to P464 417 000 (2012: P492 838 000).

(b) Interest Rate Risk

Interest rate risk is the possible loss in the value of a fixed income asset resulting from an unexpected and adverse movement in interest rates and a consequent change in price. Interest rate risk is measured by modified duration, which measures the sensitivity of the price of a bond to changes in interest rates expressed in years. The Bank benchmarks the interest rate risk for the Pula Fund (fixed income assets) to reflect the long-term nature of the portfolio, with emphasis on higher return. The higher interest rate risk is generally compensated by higher returns expected from longer maturity bonds. The modified duration benchmark will vary over time, as changing market conditions and index weights impact the global modified duration of the index. At the end of 2013, the average modified duration of the fixed income portion of the Pula Fund was 6.1 years (2012: 6.4 years). As the Liquidity Portfolio gives priority to liquidity over return, given the constant need to provide foreign exchange to finance transaction payments, from the Bank's perspective, this portfolio is exposed to minimum interest rate risk. At the end of 2013, the Liquidity Portfolio's average modified duration was 1.5 years (2012: 1.7 years).

(c) Equity Price Risk

Equity price risk is the risk that the value of equities decrease as a result of changes in the level of equity indices and diminution of value of individual stocks. The geographic allocation of equity exposure follows generally the market capitalisation among the major markets. The investment guidelines stipulate the holding levels of equities. Holdings of more than 5 percent in one company are not permitted. A reasonable spread among the industry sectors is maintained in the portfolio. There are no investments in private placements or unquoted stocks. At the end of 2013, the equity portion of the Pula Fund was P21.4 billion (2012: P14.6 billion).

Market Risk Sensitivity Analysis

The set of assumptions used for each of the risk factors hereunder are not forecasts, but merely "what if" scenarios and the likely impact on the current portfolio, based on selected changes in risk variables over a one year horizon.

The Table below gives an indication of the risk sensitivities of the portfolio to various risk parameters. Assuming that the probability of the beneficial change in the risk variables are as likely to happen as an adverse change, both potential increase and decrease are shown for the indicated scenarios.

December 31, 2013

Risk Variable	Adverse market change			Beneficial market change	
		Scenario	Effect on Statement of Profit or Loss and Other Comprehensive Income (P'000)	Scenario	Effect on Statement of Profit or Loss and Other Comprehensive Income (P'000)
Interest Rate Risk		Increase in yields by 50 basis points	(937 764)	Decrease in yields by 50 basis points	937 764
Currency Risk	SDR currencies	Strengthening of the Pula by 1 percent	(662 522)	Weakening of the Pula by 1 percent	662 522
	South African rand	Strengthening of the Pula by 1 percent	(15 196)	Weakening of the Pula by 1 percent	15 196
Equity Risk	Global equities	Decline in global equity prices by 5 percent	(1 070 452)	Increase in global equity prices by 5 percent	1 070 452

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

30. **RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)**

December 31, 2012

Risk Variable	Adverse market change			Beneficial market change	
		Scenario	Effect on Statement of Profit or Loss and Other Comprehensive Income (P'000)	Scenario	Effect on Statement of Profit or Loss and Other Comprehensive Income (P'000)
Interest Rate Risk		Increase in yields by 50 basis points	(786 193)	Decrease in yields by 50 basis points	786 193
Currency Risk	SDR currencies	Strengthening of the Pula by 1 percent	(566 676)	Weakening of the Pula by 1 percent	566 676
	South African rand	Strengthening of the Pula by 1 percent	(26 491)	Weakening of the Pula by 1 percent	26 491
Equity Risk	Global equities	Decline in global equity prices by 5 percent	(731 395)	Increase in global equity prices by 5 percent	731 395

The market risk estimates as presented in the Tables above are based on sensitivities to the individual risk factors. The correlation between the risk variables is not reflected in the effect on the Statement of Profit or Loss and Other Comprehensive Income.

(d) Credit risk

This is the risk that would arise if an entity that the Bank conducts business with is unable to meet its financial obligations or in the event of an adverse credit event or default. This may be a commercial bank accepting a deposit, a sovereign, supranational or corporate entity issuing a bond or a counterparty with whom the market participant has contracted to buy or sell foreign exchange or money or capital market instruments. In the Bank's endeavour to control credit risk, it deals with only the best quality institutions or counterparties, as determined by international rating agencies.

Consistent with the investment guidelines, the Bank withdraws the invested funds if there has been a downgrade of any institution. In cases where the new lower rating necessitates a lower exposure, funds are withdrawn to ensure that the new limit is not exceeded.

The Bank mitigates credit risk by addressing the following underlying issues:

- Defining eligible investment instruments;
- Pre-qualifying counterparties (financial institutions, brokers/dealers, and intermediaries) doing business with the Bank; and
- Diversifying investment portfolios so as to minimise potential losses from securities or individual issuers.

The Bank has not impaired any of its assets in the current and previous period.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

Exposure to Credit Risk

The Table below shows the maximum exposure to credit risk for the components of the Statement of Financial Position, including derivatives. The maximum exposure is shown gross, before the effect of the above mitigation factors.

	Notes	2013 P'000	2012 P'000
Financial Assets			
Liquidity Portfolio			
Bonds – held for trading	1.1	9 941 332	7 745 590
Short-term deposits		6 903 675	10 766 382
Pula Fund			
Bonds – available-for-sale	1.2	27 352 573	24 525 029
Derivative financial instruments – held for trading		18 017	21 719
Short-term deposits		553 403	194 911
International Monetary Fund – loans and receivables			
Reserve tranche	2.1	422 311	335 823
Holdings or Special Drawing Rights	2.2	1 157 062	1 023 668
General Subsidy Account	2.3	20 531	18 188
Administered Fund	2.4	–	74 375
Government of Botswana bonds – available-for-sale	4	24 942	24 006
Repurchase Agreements	9.1	302 078	–
Other Assets – staff loans and advances – loans and receivables	5	52 614	63 164
Total		46 748 538	44 792 855
Analysis of Credit Exposure by class:			
Measured at fair value			
Bonds		37 293 905	32 270 619
Derivatives		18 017	21 719
Government of Botswana bonds		24 942	24 006
Repurchase Agreements		302 078	–
Measured at amortised cost			
IMF Reserves		1 599 904	1 452 054
Staff advances		52 614	63 164
Short-term deposits		7 457 078	10 961 293
Total		46 748 538	44 792 855

While financial instruments are recorded at fair value, the amounts shown above represent the current credit risk exposure, but not the maximum risk exposure that could arise in future as a result of changes in values. The Tables below reflect the credit exposure based on the fair value of the assets with counterparties as at December 31, 2013.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)**Credit Exposure on Bonds**

Moody's/S&P Rating	Government (P'000)	Corporate (P'000)	2013	2012
			Total (P'000)	Total (P'000)
AAA	12 817 297	785 440	13 602 737	25 925 390
AA+	16 179 962	222 578	16 402 540	647 010
AA	3 550 266	173 534	3 723 800	26 047
AA-	1 179 383	-	1 179 383	-
AA1	-	-	-	2 481 554
AA2	-	-	-	120 228
AA3	-	-	-	1 785 453
A+	22 949	-	22 949	45 826
A	383 837	72 808	456 645	-
A-	286 924	63 747	350 671	-
A1	-	27 170	27 170	-
A2	-	-	-	89 704
Other ¹	1 471 566	56 444	1 528 010	1 149 407
	35 892 184	1 401 721	37 293 905	32 270 619

Credit Exposure to Banks (Short-term deposits)

Fitch Rating	2013	2012
	(P'000)	(P'000)
AAA ²	2 812 020	3 951 682
A+ ²	-	42 445
A1	659 223	-
aa1	1 362 066	2 009 816
aa5	114 788	8 918
a1	849 504	1 678 965
BBB ²	1 657 814	1 728 691
bbb1/bbb2/bbb3	1 663	1 540 776
	7 457 078	10 961 293

Credit Exposure on Securities Lending Programme

The Bank's global custodian manages a securities lending programme as agent of the Bank. Due to the short term nature of the securities lending transactions, the collateral received under this programme changes on a short term basis. The securities lending is regulated by a securities lending agreement with the global custodian and follows the general criteria for the Bank's credit exposure. The global custodian monitors the market value of the collateral and, where necessary, obtains additional collateral in line with the underlying agreement.

(e) Instrument Risk**Sovereign Bonds**

In accordance with the investment guidelines, the Bank invests in eligible instruments that are direct obligations or obligations explicitly guaranteed by governments or local governments of 13 selected sovereign countries that are highly rated by Standard and Poor's and Moody's Investors Service. Exposure limits are assigned to the specific sovereign countries in accordance with the ratings assigned by the credit rating agencies.

Corporate Bonds

The Bank invests in a small proportion of corporate bonds rated A1 or higher, with the issuer being incorporated and tax resident in a country whose sovereign debt is eligible for investment by the Bank. A reasonable geographical spread of issuers is maintained.

¹ Other includes investments rated below A-, but still rated investment grade as per the investment guidelines.

² Included in AAA, A+ and BBB are deposits held with central banks, while the deposits held by the custodian are rated aa5.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

30. **RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)**

Credit Exposure to Banks (Short-term deposits) (Continued)

(f) Liquidity risk

Liquidity risk is the risk that the Bank will be unable to meet its payment obligations when they fall due, hence liquidity is an integral part of the Bank's foreign exchange reserves policy. To limit this risk, the Management manages the assets with liquidity in mind and monitors future cash flows and liquidity on a daily basis. The Bank is exposed to daily Pula liquidity requirements on the deposits it holds on behalf of the shareholder, Government of Botswana, the banking system and other clients holding deposits with the Bank (mainly parastatals). For the purpose of managing foreign exchange reserves, the Bank keeps some of its assets in short-term deposits and other liquid money market instruments to enable the availability of liquidity to meet outflows without incurring undue capital loss and to provide flexibility to respond effectively to changing market requirements.

Financial Liabilities at Undiscounted Cash Flows

The table below summarises the maturity profile of the Bank's financial liabilities as at December 31, 2013, based on contractual undiscounted repayment obligations.

December 31, 2013	Less than 3 months (P'000)	3–12 months (P'000)	1–5 years (P'000)	Over 5 years (P'000)	Total (P'000)
Bank of Botswana Certificates	5 498 760	–	–	–	5 498 760
Deposits	6 957 393	–	–	–	6 957 393
Allocation of SDR – IMF	–	–	–	778 784	778 784
Liabilities to Government – IMF	–	–	–	356 703	356 703
Dividend to Government	780 655	–	–	–	780 655
Other Liabilities	145 861	–	–	–	145 861
	13 382 669	–	–	1 135 487	14 518 156

December 31, 2012	Less than 3 months (P'000)	3–12 months (P'000)	1–5 years (P'000)	Over 5 years (P'000)	Total (P'000)
Bank of Botswana Certificates	8 685 080	–	–	–	8 685 080
Reverse Repurchase Agreements	999 020	–	–	–	999 020
Deposits	6 621 819	–	–	–	6 621 819
Allocation of SDR – IMF	–	–	–	689 001	689 001
Liabilities to Government – IMF	–	–	–	270 215	270 215
Dividend to Government	2 304 770	–	–	–	2 304 770
Other Liabilities	108 134	–	–	–	108 134
	18 718 823	–	–	959 216	19 678 039

(g) External Fund Managers and Custody

External fund managers are engaged to complement the Bank's reserve management activity. The Bank uses the services of a custodian which provides custodial services for the Bank's assets.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)

December 31, 2013

30. RISK MANAGEMENT IN RESPECT OF FINANCIAL INSTRUMENTS (Continued)

(h) Operational Risk

Operational risk is the risk of loss arising from systems failure, human error, fraud or external events. When controls fail to perform, operational risks can cause damage to reputation, have legal or regulatory implications or lead to financial loss. The Bank cannot expect to eliminate all operational risks, but through a control framework and by monitoring and responding to potential risks, the Bank is able to manage the risks. The Bank has a Risk Management and Planning Division within the Finance Department which focuses primarily on operational risk and coordination of the business continuity management.

31. FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair value of financial instruments carried at amortised cost

The Board considers that the carrying amounts of financial assets and liabilities recognised in the financial statements at amortised cost approximate their fair values.

For financial instruments that trade infrequently and have little price transparency, fair value is less objective and requires varying degrees of judgement depending on liquidity, concentration, uncertainty of market factors, pricing assumptions and other risk affecting the specific instrument.

Valuation models & techniques

The fair values of financial assets and financial liabilities with standard terms and conditions and traded on active liquid markets are determined with reference to quoted market prices (includes listed redeemable notes, bills of exchange, debentures and perpetual notes).

The fair values of other financial assets and financial liabilities (excluding derivative instruments) are determined in accordance with generally accepted pricing models and valuation techniques. The fair values are based on net present value, discounted cash flow models and comparison with prices from observable current market transactions and dealer quotes for similar instruments.

The objective of valuation techniques is to arrive at a fair value measurement that reflects the price that would be received to sell the asset or paid to transfer the liability in an orderly transaction between market participants at the measurement date.

The Bank uses widely recognised valuation models for determining the fair value of financial instruments, such as interest rates yields, that use only observable market data and require little management judgement and estimation.

The fair value of Government bonds is derived from market quotations. These are prices dealers will be willing to pay for similar instruments.

The Bank uses discounted cash flow analysis to value Bank of Botswana Certificates (BoBCs). The valuation is based on observable market prices, with the yield curve providing the discount factors needed.

The fair values of derivative instruments are calculated using quoted prices. Where such prices are not available, a discounted cash flow analysis is performed using the applicable yield curve for the duration of the instruments for non-optional derivatives, and option pricing models for optional derivatives.

Foreign currency forward contracts are measured using quoted forward exchange rates and yield curves derived from quoted interest rates matching maturities of the contracts. Interest rate swaps are measured at the present value of future cash flows estimated and discounted based on the applicable yield curves derived from quoted interest rates.

Fair values are categorised into different levels in a fair value hierarchy, which reflects the significance of the inputs used in making the measurements.

Level 1 fair value measurements are those derived from quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2 fair value measurements are those derived from inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices). This category includes instruments valued using: quoted market prices in active markets for similar instruments; quoted prices for identical or similar instruments in markets that are considered less active; or other valuation techniques in which all significant inputs are directly or indirectly observable from market data.

Level 3 fair value measurements are those derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)

December 31, 2013

31. FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

If the inputs used to measure the fair value of an asset or a liability are categorised in different levels of the fair value hierarchy, then the fair value measurement is categorised in its entirety in the same level of the fair value hierarchy as the lowest level input that is significant to the entire measurement.

Fair Value Measurements recognised in the Statement of Financial Position

The following Table provides an analysis of financial instruments that are measured at fair value, including their levels in the fair value hierarchy.

December 31, 2013	Note	Level 1 P'000	Level 2 P'000	Total P'000
Financial Assets				
Held for trading				
Bonds	13.1	9 941 332	–	9 941 332
Derivative financial instruments	13.1	–	18 017	18 017
Available-for-sale				
Bonds	13.1	27 352 573	–	27 352 573
Equities	13.1	21 409 042	–	21 409 042
Government Bonds	13.1	–	24 942	24 942
Loans and Receivables	13.1	–	9 411 674	9 411 674
		58 702 947	9 454 633	68 157 580
Financial Liabilities				
Held for trading				
Derivative financial instruments	13.2	–	6 117	6 117
Other financial liabilities				
Bank of Botswana Certificates	13.2	–	5 490 723	5 490 723
Other liabilities	13.2	–	9 019 396	9 019 396
		–	14 516 236	14 516 236
December 31, 2012				
Financial Assets				
Held for trading				
Bonds	13.1	7 745 590	–	7 745 590
Derivative financial instruments	13.1	–	21 719	21 719
Available-for-sale				
Bonds	13.1	24 525 029	–	24 525 029
Equities	13.1	14 627 891	–	14 627 891
Government Bonds	13.1	–	24 006	24 006
Loans and Receivables	13.1	–	12 476 511	12 476 511
		46 898 510	12 522 236	59 420 746
Financial Liabilities				
Held for trading				
Derivative financial instruments	13.2	–	16 871	16 871
Other financial liabilities				
Bank of Botswana Certificates	13.2	–	8 663 540	8 663 540
Other liabilities	13.2	–	10 992 959	10 992 959
		–	19 673 370	19 673 370

There were no transfers between levels during the year.

NOTES TO THE ANNUAL FINANCIAL STATEMENTS (Continued)
December 31, 2013

32. RELATED PARTY BALANCES AND TRANSACTIONS

Balances and Transactions with the Government

The Bank provides several services to its shareholder, the Government. The main services during the year to December 31, 2013, were:

- (a) provision of banking services, including holding of the principal accounts of the Government;
- (b) management of the Notes and Coin in issue, including printing and minting of notes and coin; and
- (c) being the Government agent for government bonds and treasury bills.

The aggregate balances in Government accounts are disclosed in Note 10.

No charge is made to the Government for provision of these services.

The Bank earned interest on its holding of the Government of Botswana bonds (as described in Note 4) of P2 000 000 (2012: P2 003 000).

Other Related Party Balances and Transactions

- (a) Amounts due to related parties.

Included in the balance of outstanding "Deposits – Other" in Note 10 are the following balances with Government-owned institutions.

	2013	2012
	P'000	P'000
Botswana Savings Bank	2 983	610
Botswana Unified Revenue Service	652 071	141 066
Total	<u>655 054</u>	<u>141 676</u>

The amounts outstanding are unsecured and have no fixed repayment terms.

- (b) Remuneration of Key Management Personnel

Key management personnel comprise the Governor, Board Members, Deputy Governors, General Manager and Heads of Department.

Gross emoluments of the key management personnel are:

	2013	2012
	P'000	P'000
Non-Executive Board members	74	90
Executive Management		
Salaries, allowances and other short term benefits	10 402	9 464
Post-employment benefits	1 854	1 537
	<u>12 330</u>	<u>11 091</u>

Of the Staff Loans and Advances per Note 5, P1 244 000 (2012: P1 539 000) are attributable to Executive Management.

33. EVENTS AFTER THE REPORTING DATE

At the date of finalisation of the annual financial statements, there were no material events that occurred subsequent to the statement of financial position date that require adjustment to or disclosure in the financial statements.

PART B

THE BOTSWANA ECONOMY IN 2013 AND THEME CHAPTER

BANK OF BOTSWANA

1. OUTPUT, EMPLOYMENT AND PRICES

(a) National Income Accounts

Overview

1.1 Real output growth for the twelve-month period to September 2013 is estimated at 5.9 percent compared to 4.2 percent in 2012.¹ The faster increase in gross domestic product (GDP) was mostly attributable to the mining sector which grew by 11 percent, following the 7 percent contraction in 2012. The growth occurred in the context of improved global demand. Non-mining GDP grew by 5.1 percent (Chart 1.1), which was a deceleration from 6.2 percent recorded in the previous year. Mining remains the largest sector in the economy, accounting for 22.1 percent of total output at current market prices, compared to the 19.9 percent share in 2012.²

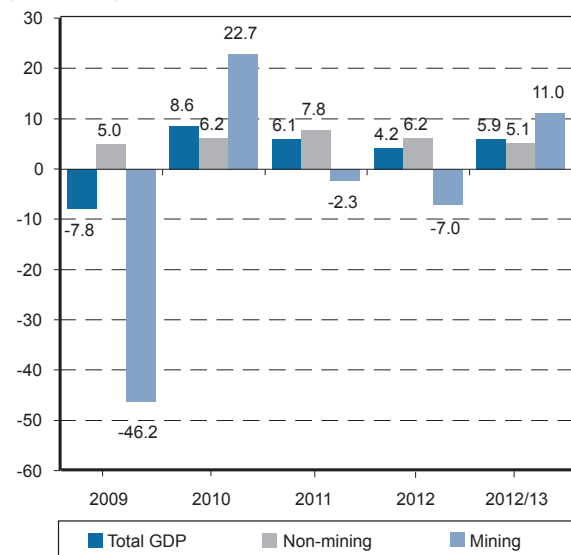
Sectoral Performance

1.2 Expansion in *mining* was mainly due to recovery of the diamond sub-sector, with Debswana producing 22.7 million carats during 2013, up by 12.4 percent from the previous year. The increase in diamond production was underpinned by improved demand from the United States of America (USA), China and other markets. The Karowe mine operated by Lucara Diamonds also performed well, while Gem Diamonds' Ghaghoo underground mine is on course to commence production in mid-2014. On the other hand, production at the BK 11 and Lerala mines remained suspended during 2013, although the latter is expected

to resume operations under new ownership in 2014. Copper-nickel production also grew in 2013, boosted by expansion of the new Boseto mine (which also produces silver). However, output of coal by the expanded Morupule Colliery was disrupted by recurring operational failures at the colliery's main customer, Morupule B Power Station.

1.3 *Agriculture* expanded by a marginal 0.8 per-

CHART 1.1: REAL GDP GROWTH 2009 – 2013 (PERCENT)



Note: Data for 2012/13 are for the 12-month period to September 2013

Source: Statistics Botswana

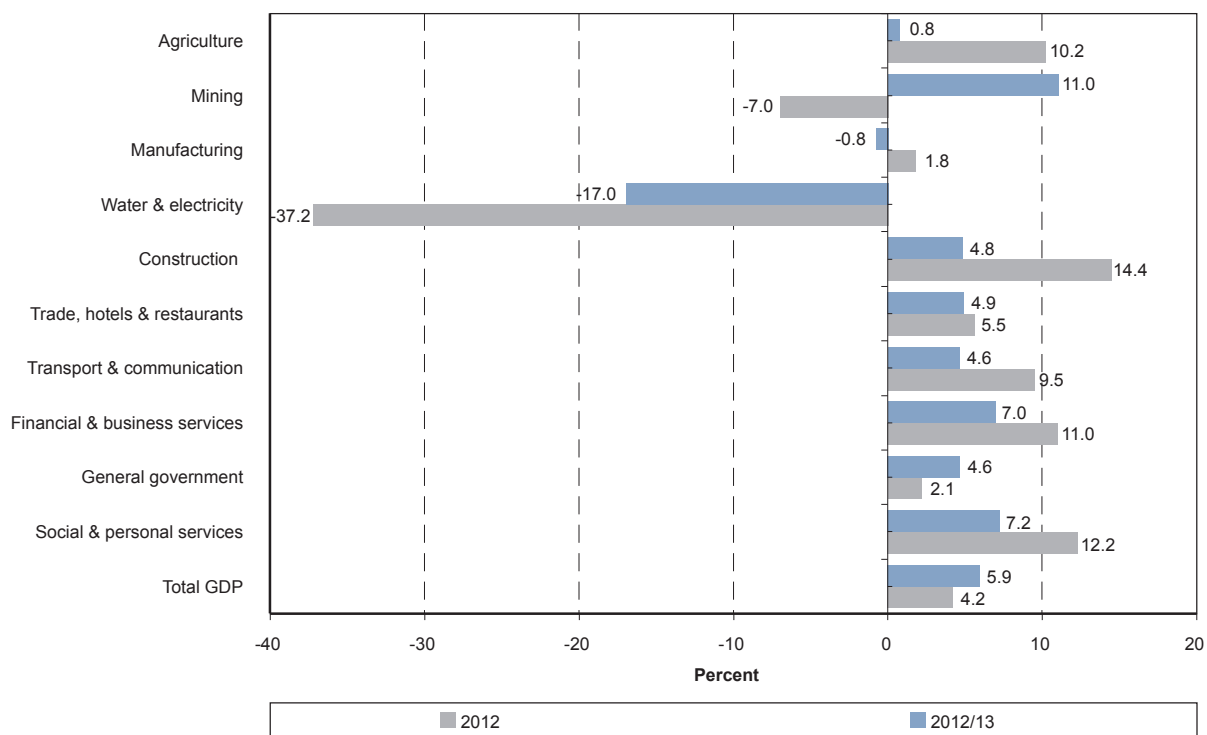
cent, as drought conditions continued to prevail (Chart 1.2). Slow progress in adopting modern farming practices also contribute to low productivity of the sector. *Manufacturing* contracted by 0.8 percent, as key sub-sectors faced challenging trading conditions. Notably, production of *textiles*, which did not benefit from government subsidy shrank by 59.6 percent.³ Continuing operational problems at the Botswana Meat Commission (BMC) and en-

1 Estimates for the final quarter of 2013 are yet to be published. Comparison between the twelve months to September 2013 with the calendar year 2012 includes an overlap of one quarter.

2 The share had fallen due to the contraction in output that commenced in mid-2011 and started to reverse during 2013.

3 An earlier subsidy programme to the industry expired at the end of 2011 and a new scheme was only introduced in November 2013.

CHART 1.2: REAL GDP GROWTH BY SECTOR (PERCENT)



1. Data for 2012/13 are for the 12-month period to September 2013

Source: Statistics Botswana

hanced regulations on the sale of alcohol (and higher prices) resulted in output of the *meat and meat products* and *beverages* sub-sectors falling by 7.3 percent and 8.2 percent, respectively. However, the *other manufacturing* sub-sector is estimated to have expanded by 6.4 percent.

- 1.4 *Water and electricity* contracted by 17 percent in the twelve months to September 2013. Sectoral output continues to be negatively affected by erratic domestic electricity production and the high cost of emergency power supplies, including imports. The *water* sub-sector was also constrained by poor rainfall, and this resulted in the introduction of restrictions on the use of potable water in the southern part of the country.
- 1.5 *Construction* was supported by on-going government projects, private sector construction in the Gaborone Central Business District, retail developments and construction of residential properties. However, growth in the year to September 2013 slowed to 4.8 percent, com-

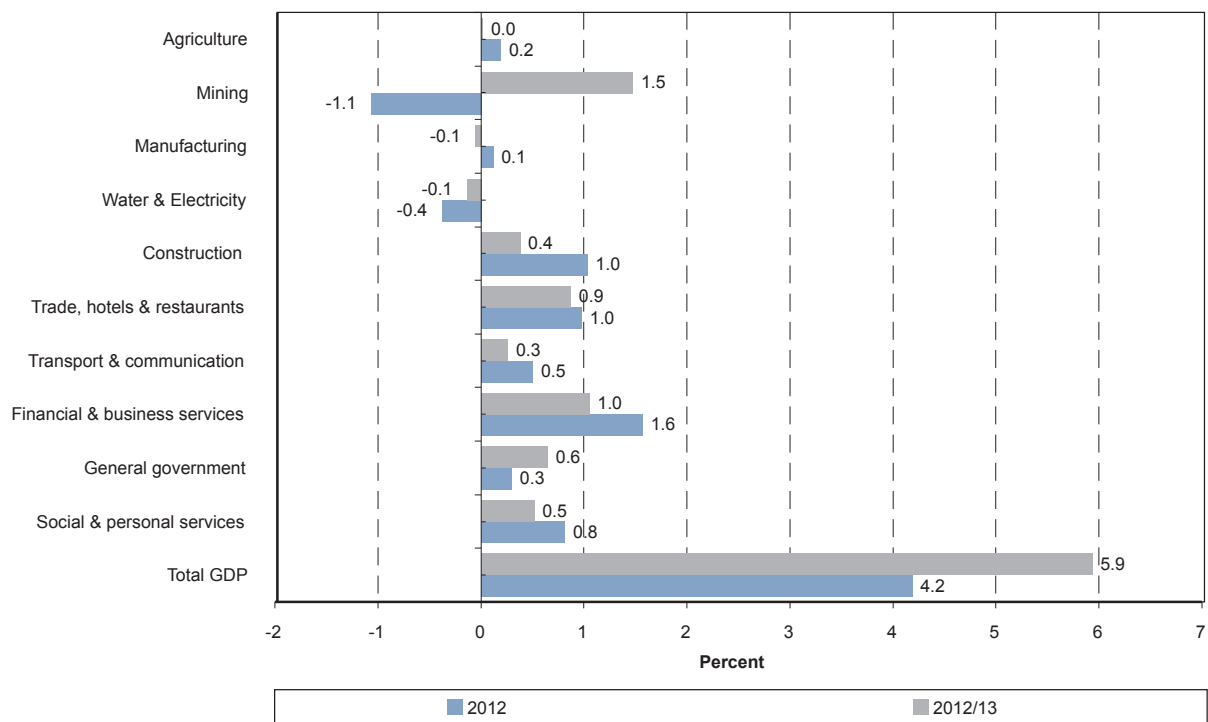
pared to 14.4 percent in 2012, mainly reflecting reduced government spending and fewer private sector developments.

- 1.6 *Trade, hotels and restaurants* grew by 4.9 percent compared to 5.5 percent in 2012. However, overall sectoral performance benefitted from increased retail trade activity, which expanded by 7.6 percent compared to 4.7 percent the previous year. Growth of 7 percent in the *finance and business services* sector mainly reflected buoyant business services activity, including real estate, while the banking and insurance sub-sectors experienced subdued growth rates in line with slower growth in domestic economic activity, including personal incomes.

(b) Domestic Economic Outlook

- 1.7 Growth in the world economy gathered momentum, strengthening in the second half of 2013 and prompting upward revisions to earlier forecasts, which is positive for growth prospects in Botswana. However, there continues to be uncertainty regarding the strength

CHART 1.3: CONTRIBUTION TO REAL GDP GROWTH BY SECTOR (PERCENT)



1. Data for 2012/13 are for the 12-month period to September 2013
 Source: Statistics Botswana

of global recovery. Even then, world output growth is projected at 3.7 percent in 2014, higher than the 3 percent estimated for 2013 (Table 1.1).⁴ Indications are that growth in the USA, Europe, and emerging market countries will strengthen, thus providing a broad base for recovery in demand for Botswana’s mineral exports. However, downside risks include projected slower growth in China, albeit only marginally and from previously high levels.

1.8 Output expansion for the domestic economy is forecast to be 5.1 percent in 2014 compared to an estimate of 5.4 percent in 2013, with activity restrained by modest growth in incomes. However, the budgeted increase in government spending will provide some stimulus to the economy as will the expected maintenance of an accommodative monetary policy. The relocation of diamond sales by the Diamond Trading Company from the United Kingdom to Botswana will be positive for growth across several sec-

tors. However, disruptions in water and electricity supply may dampen growth prospects, particularly if they could be prolonged.

(c) Employment

1.9 The latest employment survey is from estimates of formal sector employment in September 2012 (Chart 1.4). Since the previous survey in June 2011, total formal employ-

TABLE 1.1: GLOBAL GROWTH ESTIMATES AND FORECASTS 2013 – 2015 (PERCENT)

	2013	2014	2015
Global	3.0	3.7	3.9
Advanced economies, of which,	1.3	2.2	2.3
USA	1.9	2.8	3.0
Euro area	-0.4	1.0	1.4
Japan	1.7	1.7	1.0
Emerging markets, of which,	4.7	5.1	5.4
Sub-Saharan Africa	5.1	6.1	5.8
China	7.7	7.5	7.3
India	4.4	5.4	6.4

Source: International Monetary Fund, *World Economic Outlook*, January 2014 update

4 World Economic Outlook (WEO) Update, January 2014, International Monetary Fund.

ment increased by 0.6 percent from 335 156 to 337 045⁵, which mostly occurred in the public sector. Employment in central government grew by 3 percent to 104 925 and by 2.9 percent to 17 484 in parastatals; it increased marginally by 0.3 percent to 188 531 for the private sector. Expansion in parastatal employment can be attributed to, among other factors, the transfer of responsibility for water supply from local government; employment in local government which previously had authority for supply of water in villages and rural areas declined by 7.7 percent. The private sector accounts for the largest share of formal sector employment at 55.9 percent, followed by central government with 31.1 percent and local government and parastatals with 7.7 percent and 3.1 percent, respectively.

- 1.10 The most recent data for unemployment in Botswana are from the Botswana Core Welfare Indicators Survey (BCWIS) for 2009/10, which estimates a national rate of unemployment of 17.8 percent of the active labour force.⁶ Unemployment was higher for women than for men (21.4 percent compared to 14.5 percent); it was also higher outside major urban areas and for those without tertiary qualifications.⁷ It is noted that, for more effective monitoring and policy-making, more up-to-date estimates on unemployment in Botswana are necessary.

(d) Inflation

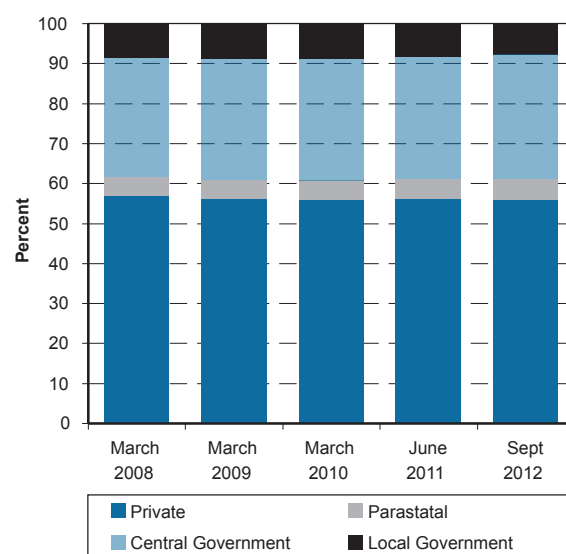
- 1.11 Global inflationary pressures were benign during 2013, in this way reflecting modest growth in world economic activity shown by persistent capacity underutilisation and

5 Employment figures in this section do not include people engaged in the Ipelegeng labour intensive public works programme.

6 This is based on standard international definitions where the labour force includes all persons aged 15 and above who are working or actively looking for work. It does not take account of the extent of underemployment within the working population; nor does it include so-called "discouraged workers", i.e., those who are available for work but not actively looking for employment.

7 For more information, see Stats Brief: Botswana Core Welfare Indicators Survey 2009/10, Statistics Botswana, July 2013.

CHART 1.4: SECTORAL COMPOSITION OF FORMAL SECTOR EMPLOYMENT (EXCLUDING IPELEGENG)

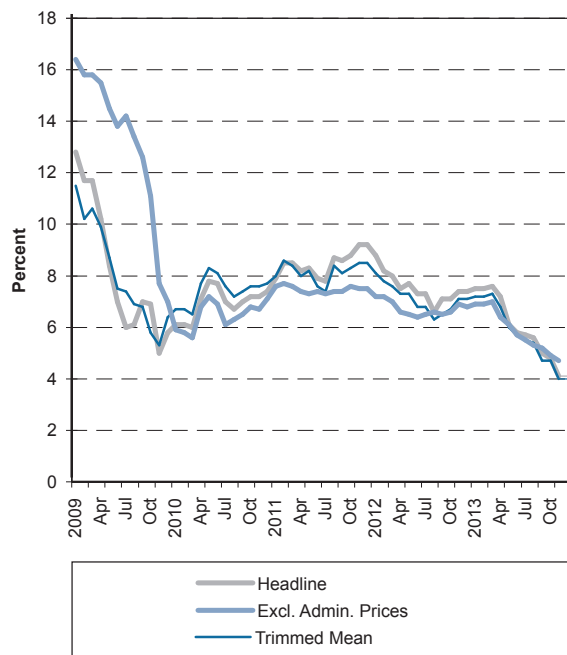


Source: Statistics Botswana

high unemployment rates in major economies. International oil prices stabilised in the first half of the year due to sluggish demand and an increase in supply. However, for the latter half of the year, prices were mostly higher and only trended downwards close to the end of 2013, as geopolitical tensions in the Middle East and North Africa eased. Global food prices were largely restrained during the course of the year owing to increased grain production. As a result, global inflation eased from 4 percent in 2012 to 3.8 percent in 2013.

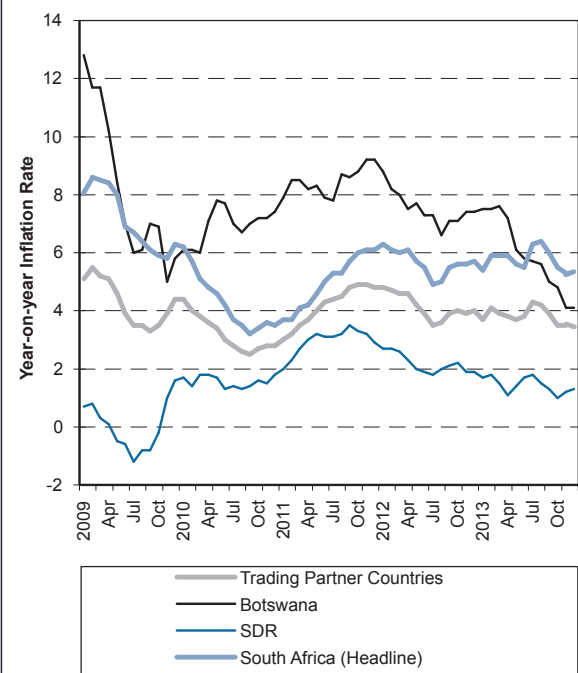
- 1.12 The trade-weighted average inflation for Botswana's trading partner countries fell from 4 percent in December 2012 to 3.4 percent in December 2013.⁸ For the SDR countries (USA, UK, Japan and euro area) inflation declined from 1.9 percent to 1.3 percent in the same period, while headline inflation in South Africa eased from 5.7 percent to 5.4 percent, remaining within that country's target range of 3 – 6 percent (Chart 1.5).

8 The trade-weighted average inflation comprises South Africa's headline inflation and SDR countries' inflation. The SDR is constituted by the US dollar, euro, British pound and Japanese yen.

CHART 1.5: BOTSWANA AND TRADING PARTNER COUNTRIES' INFLATION (2009 – 2013)

Source: Statistics Botswana, Bank of Botswana and Bloomberg

1.13 Domestic inflation maintained a downward trend and was within the Bank's medium-term objective range of 3 – 6 percent since June 2013. In the context of modest underlying demand pressures (reflected in lower price changes for most categories of goods and services), inflation fell from 7.4 percent in December 2012 to 4.1 percent in December 2013, as the impact of the previous year's increase in administered prices dissipated (Chart 1.6). Moreover, the adjustments in administered prices and government levies of 2013 were more or less to the same extent as that of the previous year, thus not exerting upward pressure in inflation. On average, the increase in administered prices added approximately 0.34 percentage points to inflation in 2013 compared to 1.95 percentage points in 2012. Inflation excluding administered prices decreased from 6.8 percent in December 2012 to 4.7 percent in December 2013, while the 16 percent trimmed mean measure of core inflation fell from 7.1 percent to 4 percent in the same period.

CHART 1.6: BOTSWANA HEADLINE AND CORE INFLATION (2009 – 2013)

Source: Statistics Botswana

(e) Inflation Outlook

1.14 Global inflation is projected to be 3.8 percent in 2014 (unchanged from 2013) in the context of stable commodity prices and persistence of capacity underutilisation, including high rates of unemployment in major economies. In Botswana, it is anticipated that demand pressures on inflation will be modest in 2014, mostly due to the projected below-trend economic activity and moderate growth in disposable incomes. Therefore, inflation is forecast to remain within the objective range of 3 – 6 percent in the medium term. However, any substantial upward adjustment in administered prices and government levies and increases in international oil and food prices beyond current forecasts present upside risks to the inflation outlook. A substantial wage increase could also generate inflationary pressures through higher demand and an increase in inflation expectations. Nevertheless, there are downside risks arising from weaker global economic activity that could result in lower inflation than currently projected.

2. PUBLIC FINANCE AND THE 2014/15 BUDGET

2.1 Along the lines of the budget for 2013/14, the 2014/15 budget retains the fiscal consolidation features through maintaining an overall surplus, although buoyant revenues means that additional expenditure can also be accommodated. In seeking ways to optimise the allocation of resources in line with national priorities, the 2014 Budget Speech emphasised seven key themes that balanced development initiatives with social cohesion and stability, viz., growing the economy and employment creation; improving productivity and sustaining sovereign rating; investing in infrastructure development to support economic growth; investing in human resources to support sustainable growth; enhancing people's welfare and livelihoods; strengthening the judicial system and combating crime; and strengthening local governance.

(a) Budget Performance: 2012/13 and 2013/14

2012/13 Budget Outturn

2.2 The budget outturn for the 2012/13 financial year recorded a surplus of P922 million, which was larger than the revised estimate of a P835 million due to a combina-

tion of higher revenue and underspending of the development budget (Table 1.2).

2.3 Revenue⁹ increased by P3.2 billion (8.2 per cent) in 2012/13 to P41.7 billion, mainly as a result of higher Southern African Customs Union (SACU) receipts and value added tax (VAT), which increased by P5.8 billion and P0.4 billion, respectively. Total expenditure and net lending increased from P38.7 billion in the previous year to P40.7 billion, but was below the revised estimate of P41.1 billion. Development spending was P1.1 billion below the revised estimate, while recurrent expenditure exceeded the revised estimate by P334 million.

2013/14 Revised Estimates

2.4 The revised budget estimates for 2013/14 showed a surplus of P386 million, which was lower than the original budget projection of P779 million. Revenue was revised upwards from the original budget of P44 billion to P45.4 billion, due mainly to an additional payment of P1.4 billion from the Bank of Botswana arising from exceptional profits realised in 2012.

2.5 The estimate for expenditure and net lending was also revised upwards, from P43.2 billion to P45 billion, largely reflecting an increase in the

TABLE 1.2: GOVERNMENT BUDGET 2012/13 – 2014/15 (P MILLION)

	2012/13			2013/14		2014/15
	Budget	Revised	Final	Budget	Revised	Budget
Revenue	42 906	41 911	41 658	44 022	45 426	50 183
Mineral Revenue	12 038	12 038	12 076	13 254	13 257	15 241
Non-mineral Revenue	30 868	29 873	29 582	30 768	32 169	34 942
Expenditure	41 755	41 076	40 736	43 242	45 039	48 857
Recurrent Expenditure	31 751	31 772	32 106	32 194	32 977	36 693
Personal Emoluments	12 128	14 290	14 548	14 481	15 128	15 749
Grants & Subventions	...	7 049	8 088	8 350	8 350	9 809
Public Debt Interest	1 592	1 592	672	778	778	907
Other Charges	18 032	8 842	8 798	8 586	8 721	10 228
Development Expenditure	10 058	9 357	8 280	11 103	12 118	12 240
Net Lending	-54	-54	351	-55	-55	-76
Balance	1 151	835	922	779	386	1 326

Source: Ministry of Finance and Development Planning

⁹ Total revenue includes grants.

development budget by P1 billion to fund additional support for the energy sector. The projection for the recurrent budget also increased, from P32.2 billion to P33 billion. However, after nine months of the financial year (April to December, 2013), total expenditure amounted to 68 percent of budgeted funds, indicating underspending as in the previous years.

(b) The 2014/15 Budget Proposals

2.6 The budget for the 2014/15 financial year is the first since the adoption by Parliament of the Mid-Term Review of National Development Plan 10 (NDP 10), which underscored the overarching fiscal objective of continuing to rebuild the net financial position of Government through budget surpluses in the second half of the plan period. Healthy fiscal buffers provide flexibility to respond to negative shocks without substantially increasing public debt. A surplus of P1.3 billion is, therefore, projected for 2014/15 (Table 1.2).

Revenue

2.7 Revenue for 2014/15 is expected to be P50.2 billion, 10.4 percent higher compared to the revised budget for 2013/14 (Table 1.3) and reflects the more positive outlook for domestic and global economic performance. It is ex-

pected that SACU receipts, which are projected to increase from P13.7 billion in 2013/14 to P16 billion in 2014/15, will be the largest source of revenue, representing 31.8 percent of the total. Mineral revenue is estimated to increase from P13.3 billion to P15.2 billion, equivalent to 30.4 percent of total revenue. Non-mineral income tax is projected to grow by 7.2 percent to P9.6 billion, thus accounting for 19.2 percent of budgeted revenue. Following a downward revision in 2013/14, it is anticipated that VAT collections will grow rapidly in 2014/15, by 27.4 percent to P6.1 billion. It is estimated that grants will amount to P403 million in 2014/15.

Expenditure

2.8 Total expenditure and net lending for 2014/15 is budgeted to be P48.9 billion, which is an increase of 8.5 percent from P45 billion in the revised estimates for 2013/14 (Table 1.3). Recurrent expenditure is projected to grow by 11.3 percent, from P33 billion to P36.7 billion, equivalent to 75.1 percent of total spending. In contrast, development spending is budgeted to increase by 1 percent from the revised estimate of P12.1 billion in 2013/14 to P12.2 billion in 2014/15.

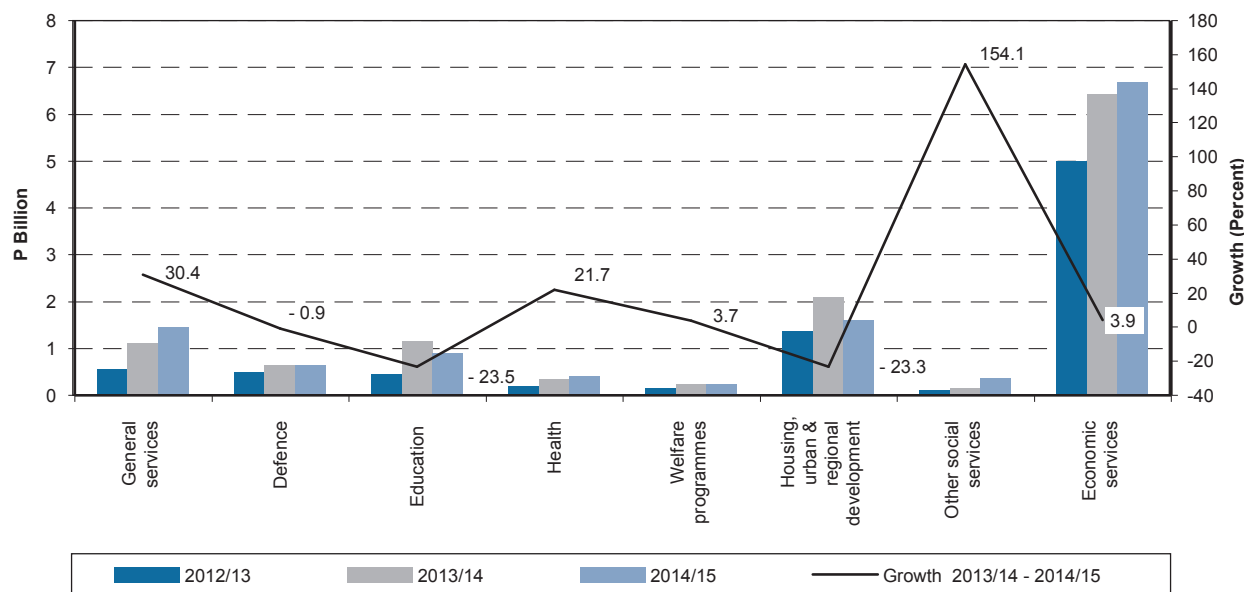
2.9 The bulk of recurrent spending P15.7 billion, (42.9 percent) is for personal emoluments,

TABLE 1.3: GOVERNMENT BUDGET 2009/10 – 2014/15

Fiscal Years (FY)	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
GDP, current prices, (P Million)	76 753	96 411	107 042	112 855	127 227	136 140
Growth rate (Percent)	3.0	25.6	11.0	5.4	12.7	7.0
Budget					Revised Budget	Budget
Revenue & Grants	30 023	31 909	38 486	41 658	45 426	50 183
Recurrent Expenditure	25 732	27 089	28 836	32 106	32 977	36 693
Development Expenditure	13 006	11 372	9 956	8 280	12 118	12 240
Net Lending	752	-44	-124	351	-55	-76
Expenditure & Net Lending	39 489	38 417	38 667	40 736	45 039	48 857
Balance	-9 466	-6 508	-181	922	386	1 326
Share of GDP (Percent)						
Revenues & Grants	39.1	33.1	36.0	36.9	35.7	36.9
Recurrent Expenditure	33.5	28.1	26.9	28.4	25.9	27.0
Development Expenditure	16.9	11.8	9.3	7.3	9.5	9.0
Expenditure & Net Lending	51.4	39.8	36.1	36.1	35.4	35.9
Balance	-12.3	-6.8	-0.2	0.8	0.3	0.1

Source: Ministry of Finance and Development Planning

CHART 1.7: DEVELOPMENT SPENDING BY ECONOMIC SECTOR (2012/13 – 2014/15)



Source: Ministry of Finance and Development Planning

which includes wages and salaries, as well as pensions and gratuities. The balance is accounted for by “other charges” at P10.2 billion (27.9 percent), grants and subventions at P9.8 billion (26.7 percent) and interest on public debt at P1 billion (2.5 percent). Compared to the previous year, there is a notable 17.5 percent growth in grants and subventions, reflecting increased support by government for parastatals and local authorities. By sector, education is allocated the highest share of the recurrent budget at 27.8 percent. Health, local government, defence and transport account for 15.7 percent, 14.7 percent, 12.5 percent and 5.9 percent, respectively, of recurrent expenditure.

- 2.10 The development budget has significant allocations for completion of on-going projects and maintenance of existing infrastructure (Chart 1.7). As such, the largest share at P3.6 billion is allocated to the Ministry of Minerals, Energy and Water Resources, which accounts for 29 percent of the development budget. Of this, P2.1 billion is for electricity generation and transmission, including financial support for the Botswana Power Corporation (BPC), while the rest is for enhancing water supply. The share for the Ministry of Transport and

Communications is 15.3 percent and amounts to P1.9 billion and will mostly finance road and air transport infrastructure. The Ministry of Local Government and Rural Development has the third largest budget of P1.3 billion, the bulk of which is for Ipelegeng, village infrastructure and the primary school backlog eradication programme.

Debt Management

- 2.11 Government and government-guaranteed debt at the end of 2013/14 is projected at P30.9 billion (an increase of 4.8 percent compared to the amount outstanding at the end of 2012/13), of which P23.4 billion is accounted for directly by the Government’s own debt, while the balance is government-guaranteed (Table 1.4). External obligations amount to P22.3 billion, while the P8.6 billion internal debt includes P7.6 billion government securities, with the balance consisting of guarantees. Total debt is equivalent to 24.3 percent of forecast GDP, comfortably within the statutory ceiling of 40 percent of GDP.

(a) Fiscal and Other Legislation

- 2.12 In line with the objective of expanding the

TABLE 1.4: GOVERNMENT DEBT AND GUARANTEES FOR 2012/13 – 14 (P MILLION)

Debt & Liabilities as at March 31, 2013	External	Internal	Total
External Debt	15 544		
External Contingent Liabilities	6 460		
Internal Debt		6 358	
Internal Contingent Liabilities		1 208	
Total Debt & Contingent Liabilities as at March 31, 2013	22 019	7 566	29 585
GDP for FY 2012/13			112 255
Debt as percentage of GDP	19.6	6.7	26.3
Total Debt & Contingent Liabilities anticipated March 31, 2014	22 333	8 589	30 922
GDP forecast for FY 2013/14			127 227
Debt as percentage of GDP	17.6	6.8	24.3

Source: Ministry of Finance and Development Planning

revenue base and simplifying the tax system, the VAT Act will be amended to exempt all farming equipment and basic foodstuffs which are currently zero rated. In addition, the range of basic foodstuffs will also be extended to include vegetables, milk and rice.¹⁰ The Act will further be amended to increase the threshold for compulsory VAT registration from P500 000 to P1 million in order to relieve small businesses from the burden of filing VAT returns. Furthermore, the Transfer Duty Act will be amended, with a view to encouraging homeownership, especially by first-time buyers.

3. EXCHANGE RATES, BALANCE OF PAYMENTS AND INTERNATIONAL INVESTMENT POSITION

(a) Exchange Rates

3.1 The exchange rate policy aims at supporting competitiveness of domestic industries in the international and domestic markets, thus contributing to the national objectives of eco-

nomics diversification and employment creation. This is achieved through maintaining a stable real effective exchange rate (REER)¹¹ of the Pula against a basket of currencies of major trading partner countries. The weights of these currencies in the Pula basket are 55 percent South African rand and 45 percent SDR, based on estimated pattern of trade. During 2013, the Bank implemented a modest downward crawl of the Pula exchange rate (0.16 percent) in line with the policy objective of maintaining a stable REER of the Pula. As a result, the nominal effective exchange rate (NEER) depreciated by a similar magnitude in the twelve months to December 2013.

3.2 The downward crawl, and the resultant depreciation of the NEER, was slightly smaller than the differential between inflation in Botswana and the average inflation for the trading partner countries. Hence, the REER of the Pula appreciated marginally by 0.4 percent in 2013. The modest rate of crawl should mitigate the potential inflation impact of a more rapid depreciation of the nominal exchange rate. Moreover, it is recognised that REER stability alone is not sufficient to ensure the competitiveness of local producers. The best way of achieving durable improvement in competitiveness of domes-

¹⁰ An exempt supply is where VAT is not charged on goods and services supplied, hence such supplies are not entitled to recover the attributable input tax. In contrast, attributable VAT on zero rated supplies is recoverable. The switch from zero-rated to exempt supplies allows for a degree of relief from tax to be provided without unduly undermining the revenue base. At the same time, exemption simplifies administration compared to zero-rating, for both suppliers (especially small businesses) and the tax authorities.

¹¹ The REER is a trade-weighted exchange rate of the Pula (against a fixed basket of currencies, after allowing for relative inflation). It is used as an indicator of the relative competitiveness of a country's tradeable goods and services.

tic producers is through gains in productivity, which also contribute to lower inflation.

- 3.3 Bilaterally, the Pula depreciated in nominal terms against most of the SDR composite currencies in 2013, by 14.7 percent, 12.6 percent and 10.9 percent against the euro, British pound and United States dollar, respectively, but appreciated by 8.8 percent against the Japanese yen. The overall depreciation against the SDR was 11.1 percent. The Pula appreciated by 9.7 percent against the South African rand during the same period (Table 1.5).

TABLE 1.5: PULA EXCHANGE RATES AGAINST SELECTED CURRENCIES

Nominal Exchange Rates (foreign currency per Pula)			
As at end of Currency	2012	2013	Percentage Change
SA rand	1.0901	1.1963	9.7
US dollar	0.1286	0.1147	-10.9
British pound	0.0796	0.0696	-12.6
Japanese yen	11.07	12.04	8.8
SDR	0.0836	0.0744	-11.1
Euro	0.0975	0.0832	-14.7
NEER (index, Sept. 2006 = 100)	85.6	85.5	-0.2
Real Pula Exchange Rate Indices ¹ (Sept. 2006 = 100)			
	2012	2013	
SA rand	101.0	109.4	8.4
US dollar	119.7	109.5	-8.6
British pound	129.5	115.5	-10.8
Japanese yen	99.8	111.2	11.4
Euro	114.8	101.1	-12.0
SDR	115.3	105.4	-8.6
REER	106.0	106.3	0.4

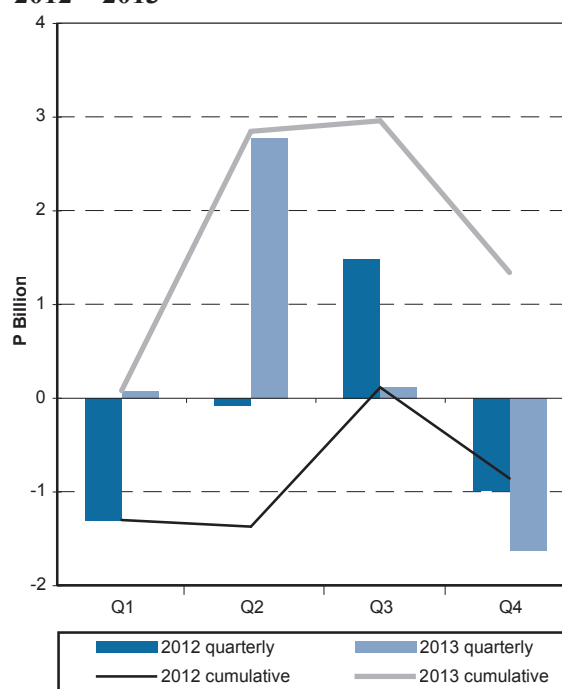
1. All real indices calculated using headline inflation.

Source: Bank of Botswana

(b) Overview of the Balance of Payments

- 3.4 The balance of payments was in overall surplus of P1.3 billion in 2013, compared to a revised deficit of P862 million in 2012. The positive outcome was attributable to a substantial increase in export earnings during the year, while growth of imports slowed. Chart 1.8 shows quarterly balances in 2012 and 2013, while Table 1.6 summarises the main components of the balance of payments from 2009.

CHART 1.8: QUARTERLY BALANCE OF PAYMENTS 2012 – 2013



Source: Bank of Botswana

Current Account¹²

- 3.5 Preliminary estimates for 2013 indicate a current account surplus of P12.9 billion compared to the revised deficit of P4.3 billion in 2012. The positive outcome emanates from improvements in the merchandise trade account, together with buoyant inflows from SACU.

Merchandise Trade¹³

- 3.6 Botswana's pattern of merchandise trade in 2013 continued to be driven by the transfer of major functions of De Beers' Diamond Trading Company (DTC) from London to Gaborone. Since July 2012, aggregation of rough diamonds has been undertaken in Botswana, and this has resulted in a major re-export trade as local production is combined with that of De

¹² The current account comprises trade in goods and services, the income account and the net current transfers.

¹³ Note that the trade data used in preparing the balance of payments does not fully match the monthly trade statistics prepared by Statistics Botswana. For some exports, the trade statistics are supplemented by additional information collected directly from exporters.

TABLE 1.6: BALANCE OF PAYMENTS: 2009 – 2013 (P MILLION)

	2009	2010*	2011*	2012#	2013#
Current Account	-8 152	-5 602	-605	-4 331	12 890
Of which:					
Merchandise trade	-9 480	-6 825	-4 982	-4 772	2 027
Services	-3 070	-2 985	-2 317	-3 129	-2 098
Income	-1 703	-3 733	-770	175	-892
Net current transfers	6 101	7 942	7 463	13 395	13 853
Financial account	1 409	-1 886	6 284	-667	-7 715
Capital account	-	23	3	-	-
Net errors and omissions	2 181	954	-2 251	4 135	-3 835
Overall balance	-4 563	-6 511	3 430	-862	1 340

* Revised

Provisional

Source: Bank of Botswana

BOX 1.1: DIAMOND TRADE 2013 (P MILLION)

Period	Rough		Polished Exports	Total (Rough and Polished)	Imports	Net Re-Exports	
	Botswana Exports	Total Exports					
2012	Total	23 237	30 754	5 389	36 143	16 512	-8 995
2013Q1		5 747	13 449	825	14 274	6 059	1 643
Q2		9 374	9 744	1 755	11 499	4 846	-4 477
Q3		7 233	10 715	2 110	12 825	4 106	-614
Q4		6 115	12 227	1 943	14 170	2 643	3 469
Total		28 469	46 135	6 633	52 768	17 655	12

Source: Bank of Botswana

Botswana exports: refers to the value of rough diamonds mined in Botswana, and are important for balance of payments purposes, as such sales are accompanied by financial inflows.

Total exports: represents the value of rough diamonds from Botswana, including re-exports. Subtracting Botswana diamonds from this total approximates the gross value of re-exports. However, this is subject to distortions due to time lags, which mean that the two sets of data are not fully comparable, especially over short time periods.

Net re-exports of rough diamonds: this is important for balance of payments purposes and is approximated by subtracting the value of imports from the gross value of re-exports. It is subject to similar limitation as the gross measure.

The negative figures over this period reflect the dominance of imports of rough diamond to supply the local diamond polishing industry, together with acquisition of stocks necessary for the process of aggregation prior to re-exports.

Beers' mines in other countries.¹⁴ However, the impact on the trade balance resulting from aggregation can be limited as the additions to imports and exports of rough diamonds are largely offsetting, although there can be transitional lags that affect the statistics. Initially, the aggregated diamonds were exported to the United Kingdom to be sold to DTC customers. However, since November 2013, DTC sales

have also been conducted in Botswana, resulting in a further transformation of the country's diamond trade. This includes the extent of value addition in the country, and hence a major positive impact on the trade account.

3.7 In addition, the direction of trade for exports has also been altered, with the United Kingdom being replaced by other countries as the major destination of Botswana's merchandise exports since November 2013; Belgium and

14 Other countries where De Beers has mining operations are Canada, Namibia and South Africa.

TABLE 1.7: MAJOR EXPORT DESTINATION IN 2013: THE IMPACT OF MOVING DIAMOND SALES FROM LONDON TO GABORONE (PERCENT)

	Jan-Oct	Nov-Dec
United Kingdom	58.5	1.8
Belgium	9.3	30.4
Hong Kong	0.4	2.7
United Arab Emirates	0.3	4.9
Israel	5.3	9.9
India	1.1	12.7
United States of America	1.0	3.1
Other	24.1	34.5
Total	100.0	100.0

Source: Bank of Botswana

India, in particular (Table 1.7). The successful transfer of operations by the DTC to Botswana has also added further impetus to downstream cutting and polishing activities, which adds to economic activity and exports. At the same time, the government-owned Okavango Diamond Company commenced sales operations in 2013, providing an alternative marketing

3.8 The merchandise trade surplus was P2 billion in 2013, which is an improvement from the revised deficit of P4.8 billion in 2012. It is estimated that total exports (Table 1.8) increased by 39.2 percent in 2013 compared to an increase of 2 percent in imports. In particular, exports of diamonds rose by 46 percent, from P36.1 billion to P52.8 billion, due to higher volumes and prices, as well as the impact of the Pula depreciating against the US dollar. Sales of cut and polished diamonds, which led manufactured exports, increased by 22.2 percent from P5.4 billion in 2012 to P6.6 billion in 2013, thus accounting for 12.6 percent of total diamond exports. Exports of copper and nickel increased by 35.7 percent, beef rose by 90.5 percent and soda ash by 12.2 percent, while exports of textiles, vehicles and gold declined by 40.9 percent, 33.5 percent and 27.1 percent, respectively.

3.9 Imports for 2013 are estimated at P61.8 billion, which is an increase of 2 percent

TABLE 1.8: EXPORTS, 2012 – 2013 (P MILLION)

	2012	2013	Percentage Share		Percentage Change
			2012	2013	
Total Exports	45 861	63 859			39
<i>of which:</i>					
Diamonds	36 143	52 768	78.8	82.6	46.0
Copper-Nickel	3 393	4 604	7.4	7.2	35.7
Beef	523	996	1.1	1.6	90.5
Soda Ash	645	723	1.4	1.1	12.2
Gold	618	451	1.3	0.7	-27.1
Textiles	613	362	1.3	0.6	-40.9
Vehicles	989	658	2.2	1.0	-33.5
Other Goods	2 937	3 297	6.4	5.2	12.2

Source: Bank of Botswana

channel independent of the DTC for a portion of production by Debswana. Other independent mines are accounting for an increasing proportion of rough diamond production in Botswana. Box 1.1 provides a presentation of all diamond trade flows in Botswana.¹⁵

from the revised estimate of P60.6 billion in 2012 (Table 1.9). Significant growth in imports was with respect to fuel, diamonds, chemical and rubber products, as well as food. However, this was offset by a decline

¹⁵ It should be noted, however, that some aspects of the statisti-

cal treatment of these trade flows continue to be reviewed and, as such, may be subject to further revision.

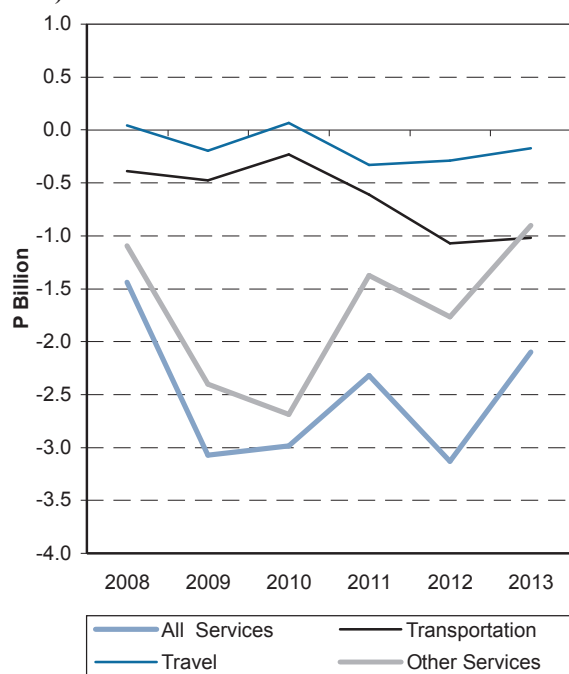
TABLE 1.9: IMPORTS, 2012 – 2013 (P MILLION)

	2012	2013	Percentage Share		Percentage Change
			2012	2013	
Total Imports	60 633.0	61 832.3			2.0
<i>of which:</i>					
Diamonds	16 512.4	17 654.6	27.2	28.6	6.9
Fuel	10 005.3	10 832.7	16.5	17.5	8.3
Food	6 125.0	6 377.4	10.1	10.3	4.1
Machinery & Electrical Equipment	9 091.3	7 535.4	15.0	12.2	-17.1
Chemicals & Rubber Products	5 432.4	5 811.6	9.0	9.4	7.0
Metals & Metal Products	2 914.6	2 935.5	4.8	4.7	0.7
Textile & Footwear	1 893.2	1 894.5	3.1	3.1	0.1
Vehicle & Transport Equipment	5 505.0	5 124.7	9.1	8.3	-6.9
Other	4 480.3	4 971.9	7.4	8.0	11.0

Source: Bank of Botswana

in other goods, specifically machinery and equipment, reflecting completion of some major infrastructure projects in the country.

CHART 1.9: BALANCE OF TRADE IN SERVICES (2008 – 2013)



Source: Bank of Botswana

Services

3.10 In 2013, the services account recorded a deficit of P2.1 billion, compared to the revised deficit of P3.1 billion of the previous year

(Chart 1.9). Exports of services increased by 124 percent to P4.4 billion due, mainly to higher exports recorded in the insurance and other business service categories. Imports of services increased by 27.8 percent to P6.5 billion, as they continued to be boosted by demand for transport, communications, as well as business and mining services.¹⁶

Income Account

3.11 The income account registered a deficit of P892 million in 2013, compared to the revised surplus of P175 million in 2012. The credit side of this account comprises mainly earnings from foreign exchange reserves which were stable at P1.5 billion. The debit component consist of dividends and retained earnings¹⁷ of foreign companies operating in Botswana and interest payments on external debt, which were higher in 2013 at P2.7 billion compared to P1.2 billion in 2012.

Current Transfers

3.12 Net current transfers increased from a surplus

¹⁶ Estimates should be interpreted with caution due to challenges relating to data collection.

¹⁷ Retained earnings by foreign-owned businesses are treated as an imputed outflow on the income account matched by an offsetting inflow for foreign direct investment.

of P13.4 billion in 2012 to P13.9 billion in 2013. Net Government transfers registered an increase of 6.1 percent to P13.6 billion, mainly because of SACU receipts that increased by 5.4 percent to P13.5 billion in 2013. Net private transfers also registered a surplus of P291 million, although lower than the P611 million in 2012.

Capital and Financial Accounts

- 3.13 The capital account records transfers of assets by migrants and, as in previous years, such transfers were insignificant in 2013.
- 3.14 The financial account, which is made up of direct investment, portfolio investment and “other” investment,¹⁸ registered a net outflow of P7.7 billion in 2013 compared to the revised net outflow of P667 million in 2012.¹⁹ The larger outflows in 2013 were a result of an increase in offshore investment (mainly by pension funds), from P23.9 billion in 2012 to P34.1 billion in 2013 (end November).

Foreign Exchange Reserves

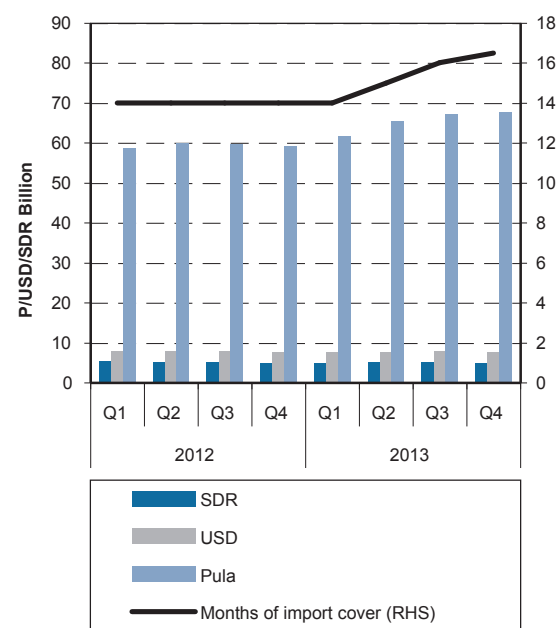
- 3.15 At the end of 2013, the foreign exchange reserves increased by 14.3 percent from P59.3 billion in December 2012 to P67.8 billion (Chart 1.10). The increase in foreign exchange reserves reflects net inflows mainly SACU receipts, together with market and currency valuation gains. The currency valuation gains resulted from the depreciation of the Pula against currencies in which the reserves are held. In foreign currency terms, the level of reserves increased marginally by 1.3 percent to USD7.7 billion and were unchanged at SDR5 billion. This was equivalent to 16.5 months of import cover²⁰ in December 2013, compared to 14 months in December 2012.

18 Other investment comprises borrowing from and lending to foreign entities.

19 The 2013 position is based on preliminary estimates and is subject to revision following the completion of the 2013 Balance of Payments Survey.

20 The calculation of import cover excludes imports of rough diamonds, as these are mainly for re-export.

CHART 1.10: LEVEL OF FOREIGN EXCHANGE RESERVES – QUARTERLY (2012 – 2013)



Source: Bank of Botswana

(c) Balance of Payments Outlook

- 3.16 The current account is expected to remain in surplus in the medium term, supported by growth in merchandise exports and in line with the global economic recovery, while the increase in imports should slow down with the improvement in domestic supply of electricity and a less rapid growth in government spending. However, persistence of a narrow export base makes the economy vulnerable to external shocks. Similarly, SACU revenues continue to provide a major source of inflows. Inflows on the financial account will, to a large extent, finance private sector investment, especially the mining sector.

(d) International Investment Position (IIP) and Foreign Investment

- 3.17 Detailed estimates for the IIP, which records the stock of foreign assets and liabilities, are only available up to 2012. For 2013, preliminary estimates are available for the major aggregates only.

TABLE 1.10: LEVEL OF FOREIGN INVESTMENT IN BOTSWANA BY INDUSTRY 2012 (P MILLION)

Industry	Foreign Direct Investment	Other Investment	Total
Mining	15 805	803	16 608
Manufacturing	106	104	210
Finance	4 905	1 801	6 706
Retail and Wholesale	312	292	604
Electricity, Gas and Water	0	406	406
Real Estate and Business Services	207	22	229
Transport, Storage and Communication	157	0	157
Construction	0	0	0
Hospitality	1	0	2
Public Administration	0	13 810	13 810
Other	401	789	1 190
Total	21 893	18 027	39 921

Source: Bank of Botswana

TABLE 1.11: LEVELS OF FOREIGN INVESTMENT IN BOTSWANA BY COUNTRY 2012 (P MILLION)

Country	Foreign Direct Investment	Other Investment	Total
North and Central America	222	122	344
<i>Of which</i>			
United States	0	53	53
Europe	16 418	528	16 946
<i>Of which</i>			
United Kingdom	1 192	30	1 222
Netherlands	17	39	56
Luxembourg	15 036	401	15 437
Other Europe	173	58	230
Asia Pacific	240	806	1 047
Africa	4 794	2 616	7 410
<i>Of which</i>			
South Africa	3 171	1 474	4 645
Middle East	68	101	168
Other	151	13 855	14 006
Total	21 893	18 027	39 921

Source: Bank of Botswana

(i) International Investment Position²¹

3.18 On the basis of preliminary estimates for 2013, Botswana's net international investment stood at P64.6 billion, which is an increase of 37.4 percent from P47 billion in 2012. Foreign assets increased by 19 percent from P101.3 billion in 2012 to P120.5 billion. The stock of direct investment outside Botswana was stable,

but portfolio investment abroad and reserve assets expanded by 41.3 percent and 16.5 percent, respectively. Other investment declined by 8.9 percent and this is explained by the decrease in offshore/foreign currency deposits by residents. Total foreign liabilities at the end of 2013 amounted to P55.9 billion, which is an increase of 3 percent from P54.3 billion in 2012. The stock of foreign direct investment in Botswana increased by 5.6 percent, with an increase in both retained earnings and eq-

21 There have been substantial revisions to the data to align it with balance of payments flows.

uity capital. Portfolio and other investment by foreigners was unchanged from the previous year.

(ii) Investment in Botswana by Industry and Country Classification in 2012

3.19 Tables 1.10 and 1.11 show Botswana's stock of foreign liabilities at the end of 2012 classified by industry and country.²² Mining continues to dominate total foreign direct investment, at 72.2 percent, followed by the finance sector at 22.4 percent. Europe remains the principal source of direct investment, accounting for 75 percent, with Luxemburg at 68.7 percent, thus reflecting the residence of the major mining investors in Botswana. This is followed by Africa at 21.9 percent, with South Africa leading at 66 percent.

3.20 In 2012, government external debt classified under "public administration" constituted 76.6 percent of "other" investment, making it the largest component. This is followed by finance and mining with 10 percent and 4.5 percent, respectively, of other investment. By country, unidentified source (other) constitute the largest contributor of "other" investment with 76.9 percent,²³ followed by South Africa (8.2 percent) and Asia (4.5 percent – includes a loan drawdown for Morupule B plant).

4. MONEY AND CAPITAL MARKETS

(a) Monetary Policy and Liquidity Management

4.1 The Bank's monetary policy objective is to achieve price stability, defined as a sustained level of inflation within the medium-term objective range of 3 – 6 percent. The policy is formulated with a view to safeguarding stability of the financial system. A low and predictable inflation and a conducive financial environ-

ment foster savings mobilisation, productive investment and international competitiveness of domestic producers, in this way contributing to the broader national objective of sustainable economic growth and development.

4.2 The monetary policy framework is forecast-based, with a medium-term outlook that guides the Bank's response to movements in inflation, while taking into account prospects for economic growth and developments with respect to financial indicators. The main elements of the policy framework are as follows:

- (i) generation of a broad-based medium-term inflation forecast, including an estimation of the "output-gap,"²⁴ assessment of "real monetary conditions"²⁵ and the impact of changes in administered prices and government levies;
- (ii) assessment of additional information not incorporated in the inflation forecast, including responses to the twice-yearly Business Expectations Survey and other supplementary data sources;
- (iii) evaluation of financial and other indicators that can impact on the stability of the financial system, including credit, liquidity conditions and property market developments, as well as economic growth and employment prospects; and
- (iv) use of interest rates and open market operations to affect demand conditions in the economy and, ultimately, the rate of increase in prices.²⁶ In general, the Bank

22 These figures are based on the 2011 Balance of Payments Survey conducted by the Bank of Botswana.

23 The bulk of this component is public sector debt from multilateral organisations and development partners and is not attributable to countries.

24 The output gap refers to the difference between long-term trend output (as an indicator of productive capacity) and actual output. A negative output gap means the actual level of output for a given period is below the trend level for that period, thus indicating the economy is operating below its estimated potential.

25 The real monetary conditions index (RMCI) measures the relative looseness or tightness of monetary conditions and gauges the likely effect that monetary policy has on the economy through changes in the exchange rate and interest rates. The real monetary conditions are measured by the RMCI that combines, through a weighted average, the deviations of the real exchange rate and real interest rate from their respective trend values.

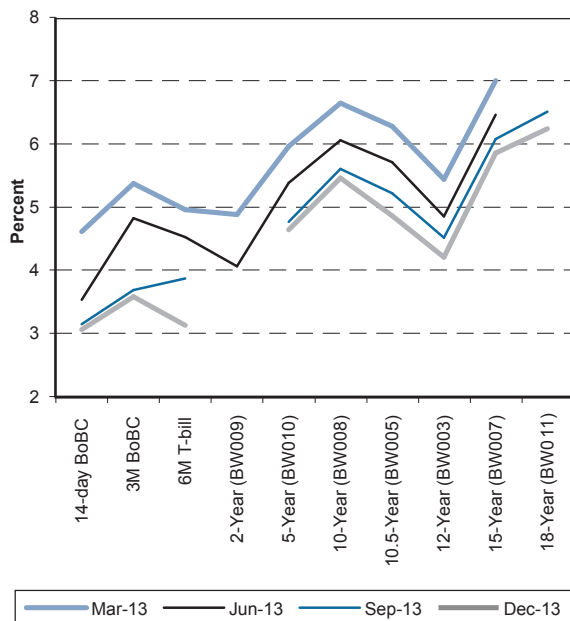
26 For example, a sustained level of economic performance above trend is potentially inflationary and could signal the

responds to a sustained deviation of inflation from the objective range, and where the causal factors could be influenced by domestic monetary policy.

(b) Interest Rates and Bank of Botswana Certificates

4.3 In 2013, monetary policy was conducted in the context of below-trend domestic economic activity characterised by high unemployment and subdued, albeit gradually improving global economic prospects. The weak domestic demand and benign external price developments contributed to the positive inflation outlook in the medium term. With inflation falling and non-mining output growth showing signs of slowing, the Bank Rate was reduced by a cumulative 200 basis points, from 9.5 percent to 7.5 percent. The banks' prime lending rate also decreased from 11 percent to 9 percent in the same period, while bank lending rates followed suit. The 14-day Bank of Botswana Certificate (BoBC) yield decreased

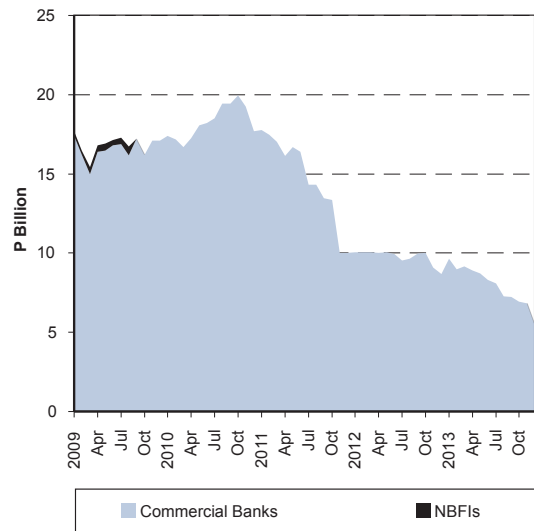
CHART 1.11: YIELD TO MATURITY ON BANK OF BOTSWANA CERTIFICATES AND GOVERNMENT BONDS



Source: Bank of Botswana.

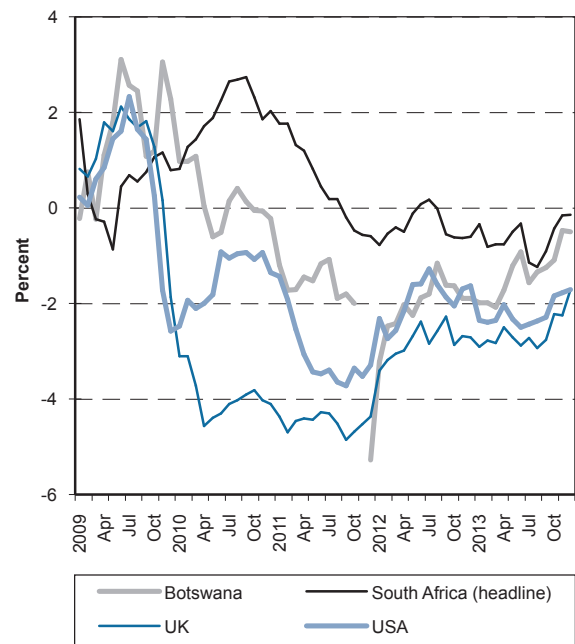
need to increase interest rates to dampen inflationary pressures, while output below trend could require a reduction of interest rates to stimulate economic activity.

CHART 1.12: OUTSTANDING BANK OF BOTSWANA CERTIFICATES



Source: Bank of Botswana.

CHART 1.13: REAL INTEREST RATES - INTERNATIONAL COMPARISONS



Source: Bank of Botswana.

from 4.64 percent in December 2012 to 3.06 percent in December 2013, while the 3-month BoBC yield fell from 5.36 percent to 3.52 percent.²⁷

4.4 In view of declining inflation, real interest

²⁷ The quoted yields for papers of both the 14-day and 3-month maturities are based on the weighted average of the winning bids at auction; as such they reflect the bidding preferences of OMOs counterparties at auctions.

rates increased during 2013. The real 14-day BoBC rate increased from -2.57 percent in December 2012 to -1 percent in December 2013, while the 3-month BoBC rate also increased from -1.9 percent to -0.5 percent.

4.5 The conduct of monetary policy was largely through open market operations. Thus, in 2013, excess liquidity was absorbed through the sale of BoBCs to achieve interest rates consistent with the monetary policy stance. At the end of December 2013, the outstanding value of BoBCs was P5.5 billion, having decreased from P8.7 billion in 2012 (Chart 1.12). Reverse repos and repos were used to manage intra-auction liquidity; in December 2013, the injection of liquidity through repos was P302 million compared to P1 billion absorbed through reverse repos in the previous year.

(c) Banking System

Domestic Credit

4.6 Annual growth in commercial bank credit fell from 23.6 percent in December 2012 to 15.1 percent in December 2013. The significant decline in credit expansion was due to a marked

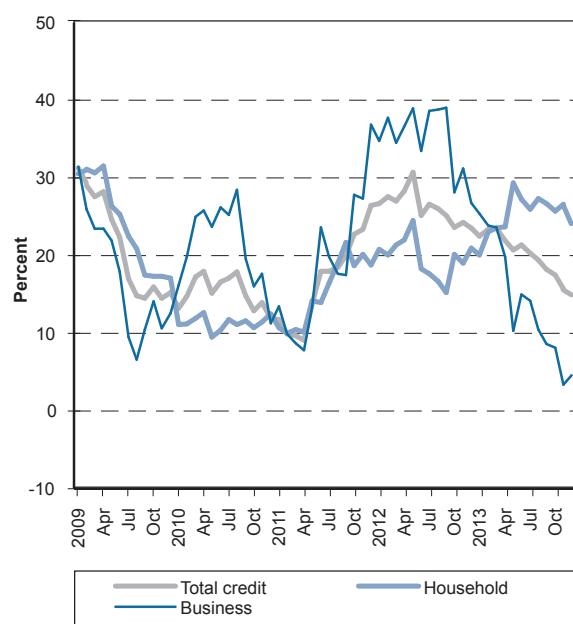
deceleration in year-on-year growth in lending to the business sector, from 26.8 percent in December 2012 to 4.6 percent in December 2013. This low credit disbursement is consistent with the slowdown of growth in the non-mining sectors for this period. In contrast, the year-on-year increase in credit to the household sector accelerated from 21 percent in December 2012 to 24.2 percent in December 2013 (Chart 1.14), driven by growth in mortgages (43.3 percent) and personal loans (19.1 percent). As at December 2013, the share of household credit in total private commercial bank credit was 57.7 percent compared to 53.5 percent in December 2012.

4.7 The increase in credit to households, which is much larger than the growth in nominal GDP reflects, in part, improvements in provision of financial services and greater financial inclusion; hence the increase in the intermediation ratio from 73 percent (December 2012) to 82 percent in December 2013. However, the rate of credit expansion to households, which is dominated by personal loans in an environment of slow growth in incomes, could increase the debt repayment problems. This development needs close attention and, accordingly, the Bank continues to monitor credit developments in order to address any threats to financial stability. However, current indicators, including low and stable default ratios for household borrowing, suggest that widespread default risks are not imminent.

Monetary Aggregates

4.8 Year-on-year, broad money supply increased by 4 percent in December 2013 compared to the 9 percent increase of 2012. The growth in money supply was driven by expansion in credit and the increase in net foreign assets, partially offset by the contractionary effect of larger government deposits at the Bank of Botswana. With regard to components of the money supply, currency outside depository corporations increased by 1.7 percent, while transferable deposits (current account) grew by 21.5 percent, and other deposits remained

CHART 1.14: YEAR-ON-YEAR COMMERCIAL BANK CREDIT GROWTH



Source: Bank of Botswana.

virtually unchanged (0.01 percent). The Pula value of deposits in foreign currency accounts (FCAs) contracted by 6.2 percent in the same period and accounted for 13 percent of total deposits at commercial banks.

Bank of Botswana

- 4.9 Total assets and liabilities of the Bank of Botswana grew by 15.7 percent, from P59.8 billion in December 2012 to P68.6 billion in December 2013. The expansion of the balance sheet in 2013 was due to the 14.3 percent increase in the foreign exchange reserves, supported mainly by the 36.4 percent increase in shareholders' funds from P37.9 billion to P51.7 billion. In this regard, the government investment account grew by 44 percent from P18.4 billion in December 2012 to P26.5 billion in December 2013. Commercial bank deposits at the Bank of Botswana (including primary reserve balances) increased from P5.2 billion to P5.8 billion in the same period, while the value of outstanding BoBCs fell by 36.8 percent to P5.5 billion, in the context of strong growth in commercial bank lending.

Commercial Banks

- 4.10 Total banking sector assets stood at P60.4 billion in December 2013; this is an increase of 3.7 percent from P58.3 billion in December 2012, driven by growth in loans and advances, as BoBCs held by banks fell markedly by 32.4 percent.²⁸ Deposits of local banks held in foreign banks also declined by 3.8 percent and "other" assets fell by 7.3 percent. On the liabilities side, public deposits at commercial banks increased by only 2.7 percent. A notable feature of commercial banks' balance sheet is that funding is constituted by bulky business deposits (72 percent of total deposits), which supports the net debtor position of households (accounting for 58 percent of total credit). The ratio of commercial bank assets to nominal GDP was stable at around 50 percent in 2012 and in 2013.

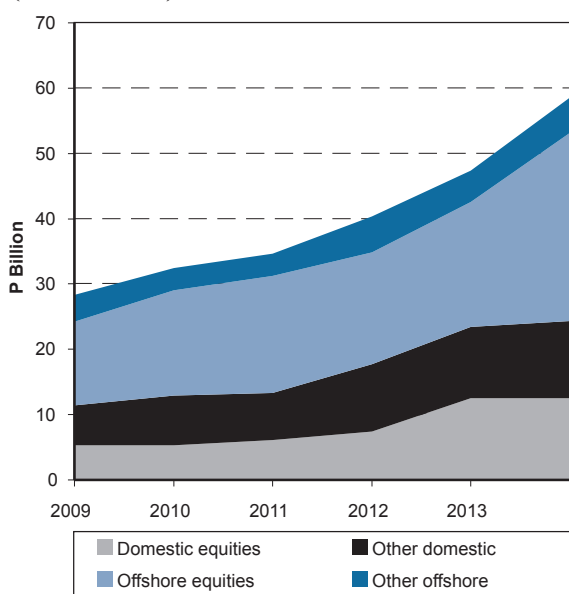
(d) Other Financial Institutions

- 4.11 Assets and liabilities of the Botswana Building Society increased by 9.9 percent in 2013 compared to the 14.8 percent increase of 2012. Loans and advances grew by 12.5 percent to P2.6 billion, while the Society's cash and deposits held at other banks declined by 4.3 percent. Total assets and liabilities of the National Development Bank increased by 33.2 percent, which is substantially higher than the 2012 growth of 6 percent. This reflected growth in lending of 20.4 percent on the asset side, compared to 10.4 percent of the previous year. The balance sheet of the Botswana Savings Bank grew by 14.6 percent in 2013, (59.9 percent in 2012), as lending grew by 16.5 percent (25.1 percent in 2012). Savings mobilisation was also sustained; it increased by 15.4 percent following the 69.5 percent expansion in 2012. Assets of the Botswana Development Corporation (BDC) fell by 8.3 percent to P2 billion in 2013 (year to September) as the combined impact of a decline in bank deposits and loans, advances and leasing, offset increased investments in related companies.
- 4.12 With respect to the Botswana Stock Exchange, the Domestic Companies Index trended upwards during 2013 and gained 1 513.9 points (20.2 percent); this is significantly higher than the gain of 539.3 points (7.7 percent) of 2012. Trading was active, with 709.8 million shares valued at P2.3 billion traded, while the market capitalisation of domestic companies grew by 21.6 percent to P43.3 billion. There were 24 listed domestic companies, unchanged from the year before. The Foreign Companies Index declined by 1.1 percent (thus losing 18.3 points) compared to the fall of 6.1 percent in the previous year, as global economic prospects gradually improved. Two foreign companies were delisted and one (Shumba Coal Limited) listed, bringing the total number of foreign companies listed on the Exchange to 12.
- 4.13 Assets of pension funds increased by 23.6 percent from P47.4 billion in December 2012 to P58.7 billion in December 2013 (Chart 1.15). Holdings of domestic bonds increased by 28

²⁸ The BoBC figure for Bank of Botswana in 2012 included reverse repos and it is the main difference in growth rates.

percent to P8.3 billion while the value of domestic equities decreased by 0.5 percent to P12.5 billion. Offshore equities and bonds increased by 51 percent to P28.9 billion and 18.3 percent to P4.3 billion, respectively. The proportion of total assets invested offshore moved from 50.3 percent in 2012 to 58.3 percent in December 2013, thus reflecting improvement in global economic prospects.

CHART 1.15: BOTSWANA PENSION FUND ASSETS (2009 – 2013)



Source: Ministry of Finance and Development Planning and NBFIRA

4.14 The Government continued to support capital market development through sale of securities under the Bond Issuance Programme. In 2013, 3-months²⁹ and 6-months Treasury Bills were auctioned, as well as bonds of different maturities. As at December 2013, the total par value of outstanding bonds and Treasury Bills was P6.7 billion (P6 billion in 2012) in relation to the approved ceiling of P15 billion, with 20.5 percent and 79.2 percent held by primary dealers (banks) and their clients, respectively. The Bank of Botswana held a balance of P20 million (0.3 percent of total domestic government securities) for potential secondary market activity.

(e) Credit Rating

4.15 Both Moody's Investors Service (Moody's) and Standard & Poor's Ratings Services (S & P) maintained the investment grade sovereign credit ratings for Botswana of A2 and A-/A-2 (short/long term), respectively; the stable outlook was also maintained. The ratings reflect the strong financial position of the Government that is underpinned by prudent macro-economic policies and a long record of political stability. Nevertheless, concerns remained that, despite efforts to diversify the economy, the rating agencies were concerned about the country's vulnerability to shocks and the fact that not much progress had been achieved in diversifying the economy.

²⁹ The 3-month Treasury Bill was auctioned only once at the beginning of the year.

HOUSEHOLD PARTICIPATION IN THE FINANCIAL SECTOR, DEBT SUSTAINABILITY AND IMPACT ON FINANCIAL STABILITY

1. INTRODUCTION

- 1.1 It is generally accepted that the financial sector plays a pivotal role in support of economic activities undertaken by both businesses and households, through provision of intermediation services (the efficient channelling of funds between savers and borrowers). At the same time, the nature and degree of participation by various entities reflects the strategic objectives of financial institutions and financial sector policies. The interaction between users and providers of financial services can have important implications for profitability, soundness and stability of financial institutions, as well as potential benefit to users and the broader economy. Through savings, pension and insurance contributions, and holdings of corporate and government securities, households are normally the main source of funds borrowed by businesses and government. With respect to borrowing trends, asset-backed loans, including mortgages, tend to dominate household liabilities, but with overall saving typically larger than borrowing. As such, in many instances, households are net creditors, as they save more than they borrow, although the net position and the concentration of financial assets differ across jurisdictions.
- 1.2 In aggregate, households are net creditors to the financial system in Botswana, but are net debtors with respect to interaction with commercial banks. The net debtor position to commercial banks reflects mostly unsecured lending and significantly lower proportions of loans allocated to asset-backed financing for housing and motor vehicle loans. A broader perspective would suggest that such borrowing is at least implicitly secured against other assets, such as securities and pension funds (future income). However, the overall net creditor position tends to deteriorate for households at lower income levels.
- 1.3 In addition to the balance between borrowing and lending (intermediation), household participation in the financial sector can also be analysed in terms of the relative costs and benefits of access to financial services. For example, a review of sources of income for commercial banks shows that interest paid by households is a large and growing proportion of banks' earnings, compared to a relatively smaller contribution by interest income from loans to businesses and Bank of Botswana Certificates. Similarly, other charges for banking services are a significant cost for households, while the returns from savings in commercial banks are relatively low. However, returns on long-term savings in pension funds and securities appear to be an important contributor to growth in household wealth. In turn, knowledge of relative costs and benefits of alternative financial instruments, which could be acquired through increased financial literacy, could help households maximise the benefits of using financial products.
- 1.4 Ultimately, the saving and borrowing decisions of households and resilience of the household sector are important for overall soundness and stability of commercial banks and the broader financial sector. This is in the context of the potential for households to act as a reliable and stable source of funds, while unsustainable household debt can endanger the stability of the financial sector. Sustainable debt levels among households are monitored through assessment of trends in household credit from formal sources relative to movements in incomes. Such an assessment is increasingly important given anecdotal evidence that significant growth in household credit may result in unsustainable debt. This is particularly relevant in cases where, despite the application of maximum debt-to-income ratios by individual banks, borrowers access credit from multiple sources, including micro-lenders, without disclosing existing exposures. Moreover, even

when borrowing is for asset acquisition, the cost of loans in terms of interest and other charges is high and unlikely to be covered by returns (at least as conventionally measured) generated from investment. In addition, there is also a growing trend of offering pension savings either directly or indirectly as security for borrowing and refinancing mortgages, which can erode household wealth and also jeopardise financial stability. This suggests the need to identify the main sources of risk and vulnerabilities of households, with a view to infusing consumer protection and targeted risk mitigation strategies in the supervisory process. In this context, there is a need for reliable basic data on the level and trends for debt and income relative to specific benchmarks.

1.5 Overall, the interaction of the financial sector with households in terms of intermediation, access to financial services, relative costs and benefits, as well as debt sustainability, needs to be assessed in relation to envisaged structural and policy developments.

1.6 This Chapter is organised as follows: Section 2 examines household participation in the financial sector in general. Section 3 specifically analyses financial sector development and household participation in Botswana, while Section 4 addresses trends in debt sustainability and links to financial stability. Future influences on household use of financial services are considered in Section 5 and Section 6 concludes the chapter. The analysis benefited from a special survey of all the deposit-taking institutions, which covered banks' policies with respect to lending and pricing of credit and trends in household borrowing.

2. HOUSEHOLD PARTICIPATION IN THE FINANCIAL SECTOR

2.1 Household participation in the financial sector refers to saving and borrowing activities involving different types of financial institutions and instruments. Normally, growth in such participation that matches or exceeds the increase in incomes and the economy would signify an improvement and a symbiotic, as

well as mutually beneficial relationship between households and the financial sector that could have a positive impact on economic performance. However, there are also costs emanating from household involvement in the financial sector that need to be managed through a combination of good market conduct, financial literacy, consumer protection and regulatory oversight. In this regard, the authorities pay attention to the impact of performance and conduct of financial institutions on welfare of customers and stability of the financial system.

(a) Household Participation in the Financial Sector and Contribution to Economic Activity

2.2 Economies require significant investment in order to grow and develop. Such investment raises the productivity of labour and quality of output, resulting in higher living standards. However, the funds required are often larger than what is readily available from an investor's own resources. The financial sector promotes economic activity by channelling funds from surplus sectors (savers) to those in deficit (borrowers). In a sound financial system, this intermediation function also incorporates assessment and efficient allocation of risk and determination of the cost of financial resources. Households participate in the financial system through their pool of savings (bank deposits) and other financial assets (pension funds and ownership of shares and other securities). Such savings provide a sufficient pool of resources (intermediated through the financial system) for businesses and government to undertake investment in support of growth in production, employment and incomes. Households may also borrow from the financial sector for consumption and investment and the resultant demand contributes further to economic activity.

2.3 Thus, the main function of the financial system is to mobilise savings and allocate funding, as a result of which the costs and returns of financial products are determined. Other re-

lated functions of the financial system include the following:

- (i) repository of accumulated savings held in various instruments constituting a stock of assets, which increases in value as it is deployed for productive use;
- (ii) provision of liquidity through timely conversion of financial assets into cash at low risk of loss;
- (iii) facilitating payments for goods and services through various means, including cash, cheque, debit and credit cards, and electronic transfers;
- (iv) provision of products for insurance to cover potentially adverse events, enabling risk sharing and reduction; and
- (v) transmission of monetary and financial policies. Through their capacity to influence interest rates and the availability of loanable funds, monetary authorities can guide borrowing and spending behaviour of households and other economic agents, thus affecting consumption, investment, production, employment and price developments.

2.4 The participation of households in the financial sector occurs through two broad categories of intermediaries, that is, depository and non-depository financial institutions. The former group, which includes commercial banks, building societies and credit unions, performs saving and lending functions, as well as undertaking the payments and policy transmission roles. Conventionally, commercial banks are the largest and most common depository institutions. Non-depository institutions of relevance to households include insurance companies, pension funds, mutual funds or unit trusts and micro-lenders. With the exception of micro-lenders, the distinguishing feature is that these institutions do not take deposits, but aggregate the pool of long-term contractual savings by households. The pooled funds are then available for supporting large investments, including the purchase of shares, funding infrastructure projects, ownership of real estate and lending to governments. In turn,

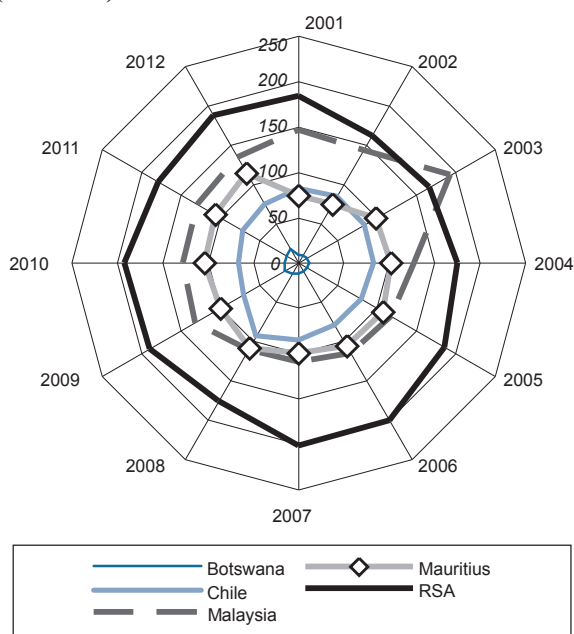
these investments also yield financial returns that ultimately accrue to households.

2.5 However, households participating in the financial sector also face costs as financial institutions seek to generate income and, ultimately, profits. These costs include banks charging higher interest rates for lending than they pay to depositors, together with fees for specific services, including processing of transactions, funds management and provision of insurance.

(b) Household Saving and Borrowing – Trends and Country Comparisons

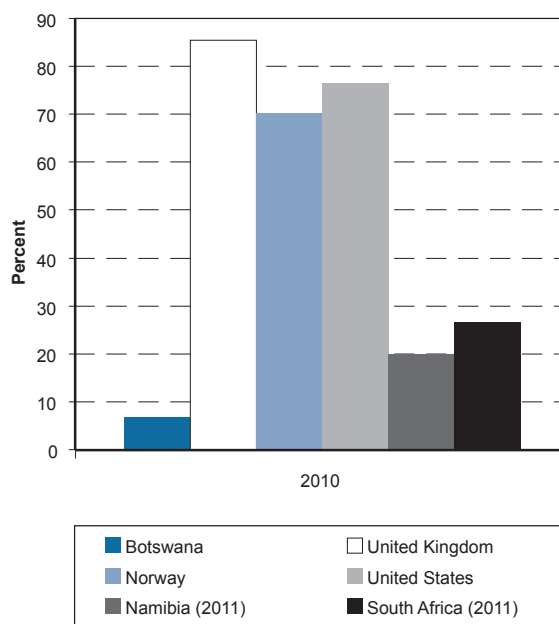
2.6 Trends in household saving and borrowing are among the indicators for monitoring household participation in the financial sector and the degree of financial inclusion. Data for selected countries (Botswana, Chile, Malaysia, Mauritius and South Africa), show significant variation in the private sector credit/GDP ratio, which is indicative of different levels of financial development. In turn, the level of financial development can be influenced by aspects of household participation, including: the extent of household saving and consumption and asset-backed financing in economic activity; the relative importance of deposit-taking institutions compared to non-depository institutions; and structural features such as the policy and regulatory position regarding household borrowing and saving. At an average of about 13 percent, the ratio of household credit to nominal GDP in Botswana is much lower than the 183 percent in South Africa, 132 percent in Malaysia, as well as the 99 percent and 79 percent in Mauritius and Chile, respectively (Chart 2.1a). This is even more so in respect to the ratio of mortgage debt to GDP (Chart 2.1b). The data suggest that, for Botswana, the key issue surrounding prospective developmental and stability concerns is not so much the overall level of credit, which is low relative to national income, but the rate of increase in household indebtedness relative to personal incomes. In other words, issues of debt service capacity and debt sustainabil-

CHART 2.1A: HOUSEHOLD CREDIT-TO-GDP RATIO (PERCENT)



Source: The World Bank and Statistics Botswana

CHART 2.1B: MORTGAGE DEBT-TO-GDP RATIO



ity need to be managed alongside initiatives aimed at supporting financial inclusion, and encouraging financial saving.

2.7 In total, financial intermediation (transformation of deposits into credit) is lower in Botswana compared to the comparator countries. However, considering household participation alone, the intermediation ratio in Botswana is over 100 percent, which means that households borrow more from banks than they save. It is notable, however, that the intermediation ratio for households is similarly high in South Africa and Chile, where the credit to deposit ratio is substantially above 100 percent, but much lower in Malaysia and Mauritius (Chart 2.2).

2.8 Given the importance of household savings as a source of funding for investment, a comparative analysis of household savings across countries would be instructive. However, due to data limitations, empirical studies that analyse cross-country savings use aggregate savings, which masks the role of household saving. Using gross national saving¹ (GNS)

as a percentage of GDP from 2001 to 2012, Botswana saved the most at an average of 40 percent, compared to lower saving rates for Chile, Malaysia, Mauritius and South Africa (Chart 2.3). However, Botswana’s favourable performance is predominantly because of the historical surplus position of the Government, in contrast to the experience of many countries, where net saving by households helps support government operations and private sector activity. As a result, there has been no saving constraint to investment in Botswana, as gross savings are adequate to meet overall investment needs. In addition, Botswana has been able to attract private capital inflows from abroad, including debt (although on a limited scale, especially outside the mining sector).

2.9 Globally, households mainly save through contractual payments (non-discretionary) into pension funds and life insurance plans which, in several markets, tend to equal or exceed bank deposits (Charts 2.4 and 2.5). For example, in developed countries like the USA, the ratio of contractual savings to GDP exceeds 100 percent; in turn, pension funds comprise the bulk of contractual savings. The impor-

¹ Gross national savings are calculated as gross national income less total consumption, plus net transfers.

CHART 2.2: HOUSEHOLD CREDIT TO-DEPOSIT-RATIO (PERCENT) 2001 – 2012

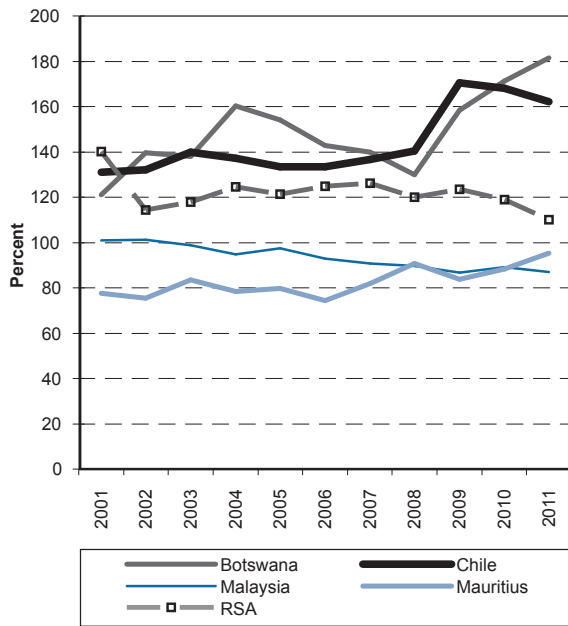
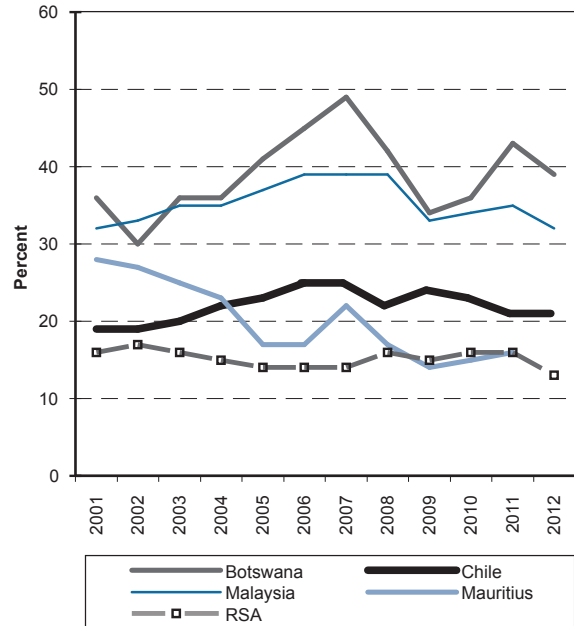


CHART 2.3: GROSS NATIONAL SAVINGS AS A PERCENTAGE OF GDP 2001 – 2012



Source: FinanceByCountry.com, the World Bank and Bank of Botswana

tance of pension funds and life insurance contributions is expected to grow further as fiscal constraints and demographic trends lead to reforms in pension systems in many countries. The reforms, which are driven by longer life

expectancy, are geared towards increasing the funding ratio of mandatory national pension systems and to encourage voluntary long-term saving through private pension funds and life insurance instruments. Growth in contractual

CHART 2.4: CONTRACTUAL SAVINGS TO GDP RATIO IN SELECTED COUNTRIES

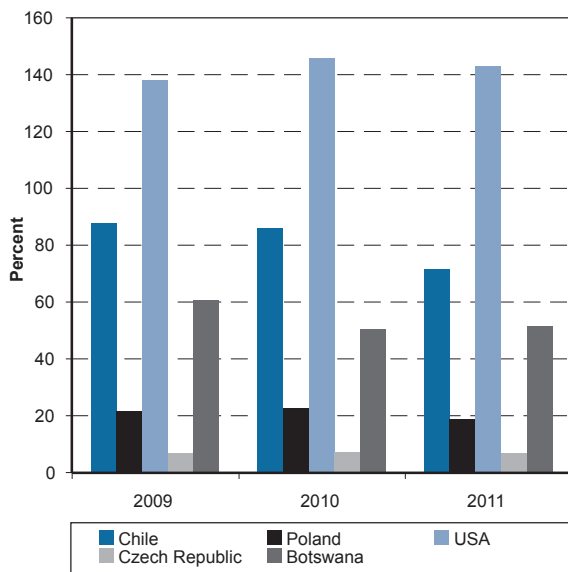
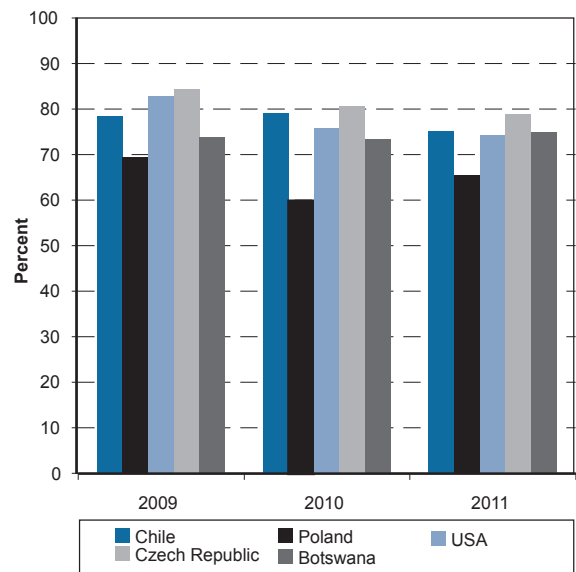


CHART 2.5: PENSION ASSETS TO CONTRACTUAL SAVINGS ASSETS RATIO IN SELECTED COUNTRIES



Notes: Contractual savings are the assets of pension funds and life insurance companies.

Source: Organisation for Economic Co-operation and Development (OECD), the World Bank and Bank of Botswana.

savings is beneficial to economic performance in that a higher rate of national saving generates a greater pool of resources that is available for productive investment. In addition to availing resources for investment and economic activity, contractual savings contribute to welfare improvement and could reduce the need for social support by governments. The development of contractual savings institutions may also have an impact on domestic financial markets and expand financing options for businesses and projects, including the time scale of any borrowing, with potential for lowering the cost of finance in the economy.

- 2.10 In particular, the existence of contractual savings institutions may reduce interest rate and liquidity risks associated with maturity transformation in a banking system reliant on short-term funds. It is also possible that contractual savings institutions could provide resources to the banking system (by way of loans, deposits or purchase of securities issued by banks) and, therefore, alleviate banks' liquidity risks by matching the maturity of long-term assets with similar liabilities. Ultimately, this would contribute to an increased supply of long-term loans while, at the same time, supporting the stability of the system.

(c) Financial Inclusion Considerations

- 2.11 Household participation in the financial sector

reflects the extent of financial access and inclusion. According to the World Bank,² there are disparities in the use of financial services between developed and developing economies and across demographic groups within countries. For example, in 2011, about half of all adults globally had an account with a formal financial institution. By income level, the share of adults with such accounts was 89 percent in high-income economies, more than twice the level for developing economies (41 percent). As a result, more than 2.5 billion adults in developing economies had no formal accounts with financial institutions. The gap in bank account usage between demographic groups is also substantial in developing economies; for example, 46 percent of men compared to 37 percent of women had bank accounts. Furthermore, households categorised in the highest income quintile were, on average, more than twice as likely to have a formal bank account as those in the lowest quintile.

- 2.12 Financial inclusion is also determined by variables such as age, level of education and geographical location (i.e., rural or urban). Tables 2.1 – 2.3 below show financial inclusion indicators for selected countries with respect to a number of criteria. Across the selected countries, older people and males have better access to financial services, while urbanisation and level of education are also positively correlated with financial inclusion. Data for

TABLE 2.1: FINANCIAL INCLUSION BY AGE AND GENDER (PERCENT OF ALL ADULTS) – 2011

Country	Age (Years)		Gender	
	Younger (15-24)	Older (Above 24)	Male	Female
Mauritius	73.1	81.7	85.8	74.7
Malaysia	57.1	70.2	69.2	63.1
South Africa	40.8	58.7	56.4	51.0
Chile	38.9	43.3	43.4	41.0
Botswana	20.3	35.8	32.2	28.4
Mozambique	24.9	47.1	45.0	35.5
Kenya	40.3	43.3	45.6	39.2
Zambia	12.8	25.1	19.4	23.3

Note: The data are subject to a margin of error. For example, the figures for Botswana appear to differ from the 2009 Finscope Survey, which estimated that 41 percent of adults were banked.

Source: World Bank

TABLE 2.2: FINANCIAL INCLUSION BY LEVEL OF EDUCATION, INCOME AND GEOGRAPHICAL LOCATION (PERCENT OF ALL ADULTS) – 2011

Country	Education		Income		Location	
	Primary or <	Secondary or >	Low	High	Rural	Urban
Mauritius	73.8	86.0	69.9	87.1	81.7	77.8
Malaysia	39.7	74.1	50.1	76.9	51.8	77.6
South Africa	42.6	58.3	41.1	62.9	46.3	67.7
Chile	24.4	51.1	25.8	53.6	30.7	47.4
Botswana	18.5	39.1	13.8	44.5	21.8	49.2
Mozambique	23.7	54.7	26.0	49.9	40.1	39.3
Kenya	19.4	62.2	18.9	61.6	37.9	76.0
Zambia	9.2	32.2	8.7	31.3	22.4	13.9

Source: World Bank

TABLE 2.3: PROPORTION OF ADULTS BORROWING FROM AND SAVING WITH FORMAL FINANCIAL INSTITUTIONS (PERCENT) AND GROSS NATIONAL INCOME PER CAPITA (USD) – 2011

Country	Saved	Borrowed	GNI per capita
Mauritius	30.8	14.3	7 750
Malaysia	35.4	11.2	7 760
South Africa	22.1	8.9	6 090
Chile	12.4	7.8	10 120
Botswana	16.5	5.6	6 790
Mozambique	17.5	5.9	440
Kenya	23.3	9.7	790
Zambia	11.8	6.1	1 070

Source: World Bank

selected countries show that Botswana ranks low in virtually all the measures of financial inclusion used in the study. Notably, the extent of saving and borrowing relative to per capita is also much lower (Table 2.3).

- 2.13 While the potential benefits arising from enhanced financial inclusion and sophistication of the financial sector are readily apparent, it should be recognised that there may also be challenges, including threats to financial stability. For example, the global financial crisis of 2007 – 2008 was partly precipitated by excessive borrowing by less credit-worthy households (in the USA in particular) and faster growth of household debt than income. The resulting increase in non-performing loans (NPLs) arising from lending to “sub-prime” borrowers, destabilised the financial sector, leading to economic contraction. This buttresses the point that the level of indebtedness relative to income and savings, as well as the

nature of debt (secured or unsecured), are important considerations for financial inclusion and household participation in the financial sector. In this regard, it is necessary to monitor key indicators of debt sustainability, which include the ratios of credit and debt service to disposable income.

(d) Relative Costs and Benefits of Financial Products in Selected Countries

- 2.14 In addition to interest on borrowing, charges for transactions and management fees, there are risks to holding or use of financial instruments that can materialise as costs. For example, financial savings would lose real value (purchasing power) if the nominal return is lower than the inflation rate. Weak economic performance or deliberate policy change leading to local currency depreciation would similarly undermine the ability to afford foreign

goods and services. The amount of dividends and value of corporate shares is determined by business operations such that poor company performance or broad-based weakness of the economy could result in diminution of the value of investment/savings. Also, the failure of a financial institution could result in loss of savings, while more widespread weaknesses could lead to instability and financial crisis that destabilises the economy and reduces employment and other income generating opportunities.

- 2.15 The net benefits of financial services are enhanced when there is transparency and “informed” expectations surrounding policy related variables such as interest rates and economic growth, which would influence appropriate placement of resources and risk taking. At the same time, supervisory oversight fosters sound performance of institutions and helps engender confidence among households to participate in the financial system.

(e) Consumer Protection and Mitigating Over-Indebtedness

- 2.16 Apart from the immediate costs of borrowing and for other uses of financial services, authorities are concerned about market conduct and behaviour by credit institutions that induce chronic and excessive indebtedness that can have a detrimental effect on welfare of individuals/households. Moreover, there can be concerns relating to skewed allocation of credit to households and/or high risk borrowers that can undermine productive use of resources. Following the sub-prime crisis in the USA, regulatory and policy reform in the area of credit market development gained momentum, with several countries implementing measures to curb over-indebtedness.
- 2.17 Therefore, a comprehensive regulatory strategy would also cover regulation of market conduct and address practices that undermine assessment of the borrower’s capability to repay the loan as the main criterion for lending. Additionally, regulation should eschew situations where failure to maintain the re-

payment schedule rewards the lender, such as excessive late payment penalties or extortionate debt collection measures. There is also a need to guard against unsustainable growth in credit that could arise from unsolicited offers of credit or automatic increase in credit limits (e.g., for credit cards and overdrafts). At the same time, a regulatory strategy should facilitate improvement in market infrastructure through credit bureaux and information sharing. Equally, it is important to require mandatory disclosure of information that helps prospective borrowers better understand total loan costs and repayment obligations so that they can make informed decisions. Furthermore, there is need to address debt enforcement rules or debt counselling, including relief measures for debt-distressed households.³

- 2.18 Aspects of these measures could be relevant for Botswana, where a large proportion of household credit is unsecured short-term loans which tend to be costly in terms of high interest rates, administration costs and mandatory credit life insurance. Moreover, regulation of credit in Botswana is limited to monetary policy variables that affect demand and disclosure requirements to inform and protect consumers. This is unlike in other jurisdictions such as South Africa, where there is dedicated legislation (National Credit Act) and institutional framework focusing on social and economic welfare of borrowers and the promotion of fairness and transparency, as well as guidelines on debt sustainability. Exit opportunities from chronic indebtedness are also limited in Botswana. In the circumstances, the high rates of increase in household credit could, in addition to basic demand, reflect captive and unsolicited components, including continuous restructuring and interest charges on loan arrears.
- 2.19 In general, implementation of market conduct and consumer protection measures require recognition of the state of credit market development, profile of credit providers and products,

³ The EU Consumer Credit Directive 2008/48/EC (European Union, 2008) provides insights in this regard.

level of credit penetration and regulatory capacity. There may also be heterogeneity of the credit market within countries. For example, a certain population segment (salaried workers) or geographic area (urban or rural) may be well provided for in terms of availability of financial services, while others struggle with basic financial access, thus presenting a challenge for a uniform approach. There is also a potential trade-off between regulatory mechanisms aimed at curbing over-indebtedness and the need to enhance financial inclusion. For instance, a strategy that aims to prevent over-indebtedness, but sets such high standards that low-income households and those with irregular sources of income do not qualify for credit can be counterproductive.

3. FINANCIAL SECTOR DEVELOPMENT AND HOUSEHOLD PARTICIPATION IN BOTSWANA⁴

3.1 The rapid development of Botswana's financial sector since the late 1980s was underpinned by the Financial Sector Development Strategy of 1989 that was developed jointly by the Government of Botswana and the World Bank. The strategy contributed to better financial sector regulation, product innovation and increased competition, as well as enhanced financial access and inclusion. These developments have supported economic growth and diversification as reflected in robust sectoral growth rates, increasing contribution to GDP and stronger linkages between the financial sector and other sectors of the economy. Moreover, financial sector development generally surpassed average growth in national output, hence the upward trend in the relevant indicators. However, as shown in Section 2, there is considerable scope for further financial development as Botswana's indicators remain well below those of comparator countries. The need for further development is addressed in the Financial Sector Development

4 Sections 3 and 4 benefited from a special survey conducted among all the commercial banks, as well as Botswana Building Society and Botswana Savings Bank, on various aspects of household borrowing and institutional lending practices.

Strategy (FSDS) of 2012 – 2016, which was developed with support from the World Bank.

3.2 As a related matter, there has been an increase in the number of financial institutions, which provide a growing number and diversity of products; and this has had a significant impact on the saving and borrowing trends for households. In general, the saving aspect of household participation in the financial sector is viewed positively and deemed to pose low risks to financial and economic stability, while availing resources for productive activity. It is also acknowledged that borrowing affords consumption-smoothing and bulky purchases/investments, and that such demand stimulates innovation and economic growth. However, unmitigated credit extension, weak assessment of risk and a high level of indebtedness⁵ can potentially undermine the soundness of financial institutions and generate financial and macroeconomic instability.⁶

(a) Households Flow of Funds

3.3 The flow of funds accounts depict financial flows between different sectors of the economy, and thus provide insight into savings-investment dynamics. A broad perspective of the households' flow of funds that covers the formal financial institutions shows that households in Botswana are net savers. Moreover, follow-up work on the flow of funds analysis undertaken by the Bank of Botswana in 1993 and 2001 indicates some progress in diversifying the sources of savings in the economy. In particular, there has been an increase in financial assets of households invested offshore through pension funds, while the role of government in the financial system has diminished (Tables 2.4 and 2.5). However, the

5 According to the Bank for International Settlements, over-indebtedness is a situation where a household or individual is in arrears or is at the risk of getting into arrears on a structural basis. Common basic indicators of over-indebtedness are arrears, cost of servicing debt, number of loans and subjective perception of burden.

6 Christian Beer and Martin Schurz, Characteristics of Household Debt in Austria: Does Household Debt Pose a Threat to Financial Stability? Oesterreichische National Bank (2007).

aggregate position that combines short- and long-term savings masks the potential for a liquidity constraint that affects the ability of households to respond to immediate financial pressures, which can be a source of instability. Indeed, the net saver position mostly reflects pension funds, which are long-term funds with restricted access compared to bank deposits, while households are net borrowers vis-à-vis deposit taking institutions.

agreements and a relatively small credit card business. Total lending to households by these institutions stood at P21.7 billion at the end of 2012, and had increased at an annual average rate of 20 percent, compared to only 11 percent growth in nominal GDP since 2006 (Chart 2.6).

3.5 In contrast, household deposits at other depository corporations amounted to P10.3 billion at

TABLE 2.4: HOUSEHOLD FINANCIAL ASSETS (P MILLION)

Year	Institutional Investors			Other Depository Corporations	Bonds	Equities	External	Total
	Pensions	Life Insurance	Mutual Funds					
2009	32 411	–	–	7 747	1.6	–	–	40 160
2010	34 662	12 585	–	8 553	39.8	159	–	55 999
2011	40 448	13 511	–	9 230	24.7	199	–	63 413
2012	47 449	13 541	–	12 529	48.5	1 065	–	74 633

Note: – Data not available

Source: Bank of Botswana and NBFIRA

TABLE 2.5: HOUSEHOLD FINANCIAL LIABILITIES (P MILLION)

Year	Institutional Investors			Other Depository Corporations	Micro- lenders ¹	External	Total
	Pensions	Insurance	Mutual Funds				
2009	–	–	–	13 297	954	–	14 251
2010	–	–	–	15 066	1 174	–	16 240
2011	–	–	–	18 373	1 609	–	19 982
2012	–	–	–	21 730	1 870	–	23 600

Note: – Data not available

Source: Bank of Botswana and NBFIRA

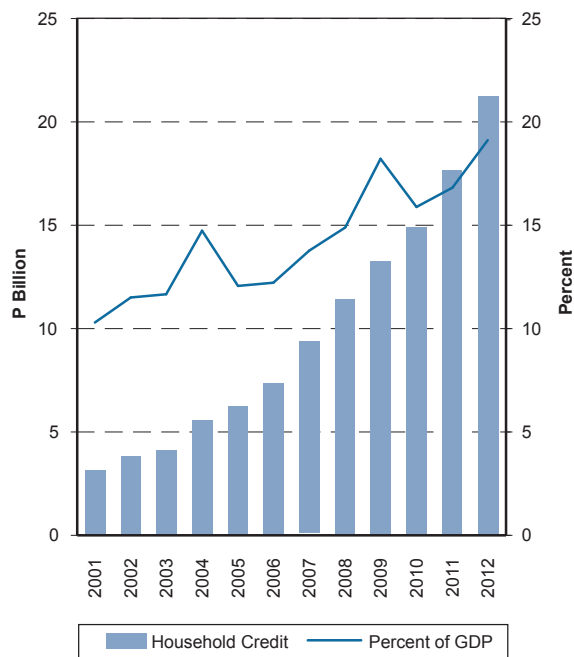
Household Assets and Liabilities at Other Depository Corporations⁷

3.4 Other Depository Corporations traditionally dominate the household credit market, the main categories being unsecured personal loans, asset finance (mostly motor vehicle loans), mortgage loans and hire-purchase

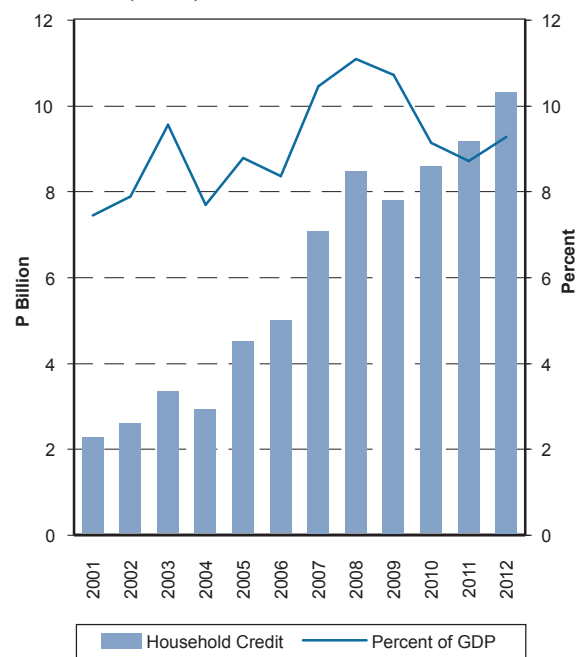
the end of 2012 and have grown by an average of 13 percent per annum from 2006, broadly in line with nominal GDP growth (Chart 2.7). The moderate growth in bank deposits is more apparent in recent years and could reflect a slower increase in disposable incomes given relatively small wage adjustments following the 2007-08 economic crisis. Lower interest rates on deposits relative to inflation could also account for slower growth in deposits.

3.6 Unlike in many other jurisdictions, on a

⁷ Other depository corporations are deposit taking financial institutions (excluding Bank of Botswana). These are commercial banks, Botswana Building Society and Botswana Savings Bank.

CHART 2.6: OUTSTANDING HOUSEHOLDS CREDIT-VALUE (LHS) AND PERCENTAGE OF GDP (RHS)


Source: Bank of Botswana

CHART 2.7: OUTSTANDING HOUSEHOLDS DEPOSITS – VALUE (LHS) AND PERCENTAGE OF GDP (RHS)


net basis, business (and parastatal) deposits at banks finance household borrowing in Botswana. Between 2006 and 2012,

household credit was just below 60 percent of total lending by commercial banks, while deposits held by households aver-

TABLE 2.6: AVERAGE ADDITIONAL COST OF BORROWING (PERCENT)

Average Additional Cost of Borrowing					
Period	Loan Types	Credit Life Insurance (CLI)	Arrangement Fee	CLI and Arrangement Fees	Other
2000	Personal loans	3.6	1.0	4.6	
	Vehicle Asset Finance	3.0	1.0	4.0	
	Mortgages	1.0	1.9	2.9	
	Credit cards	1.6	1.0	2.6	
2006	Personal loans	2.5	0.9	3.3	Documentation fee P300
	Vehicle Asset Finance	3.0	0.8	3.8	Documentation fee P300
	Mortgages	1.0	1.7	2.7	Documentation fee P300
	Credit cards	1.6	1.0	2.6	Joining fees P121 Annual fees P121 Handling fees P19
2012	Personal loans	2.6	1.1	3.7	Documentation fee P1300
	Vehicle Asset Finance	3.2	1.0	4.2	Documentation fee P1300
	Mortgages	0.7	1.3	2.0	Documentation fee P1300
	Credit cards	1.6	1.0	2.6	Joining fees P125 Annual fees P150 Handling fees P23

Source: Bank of Botswana

CHART 2.8A: COMMERCIAL BANKS: SOURCES OF LOAN INCOME (SHARE IN TOTAL)

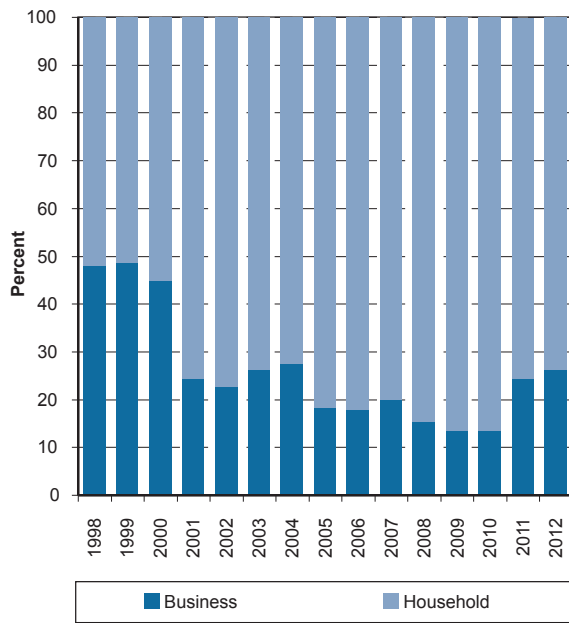


CHART 2.8B: COMMERCIAL BANKS: SOURCES OF LOAN INCOME

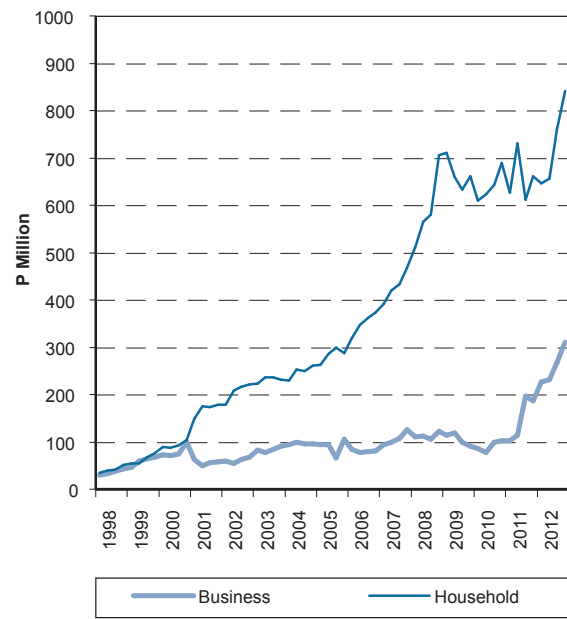


CHART 2.9A: COMMERCIAL BANKS: SHARE OF INCOME BY TYPE OF HOUSEHOLD LOAN

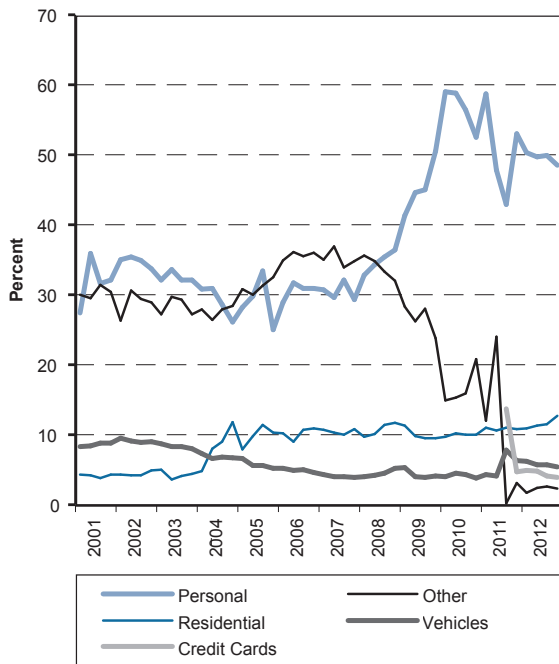
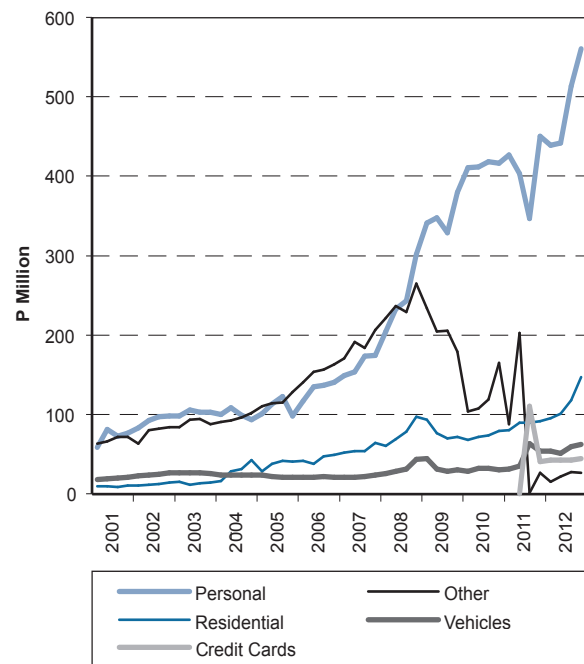


CHART 2.9B: COMMERCIAL BANKS: AMOUNT OF INCOME BY TYPE OF HOUSEHOLD LOAN INCOME



Note: For Charts 9a and 9b, the income includes interest amount and fees.

Source: Bank of Botswana

aged 20 percent of total deposits. The average household deposit balance of about P7 000 at the end of 2012 compared with an average outstanding household loan of approximately P58 000.

(b) Contribution by Households to Banks' Income

3.7 It is also the case that the bulk of household deposits are unremunerated current accounts and savings, which earn relatively low or no interest, while activity fees and other charges associated with operation of these accounts

CHART 2.10A: COMMERCIAL BANKS: SOURCES OF INTEREST INCOME (SHARE)

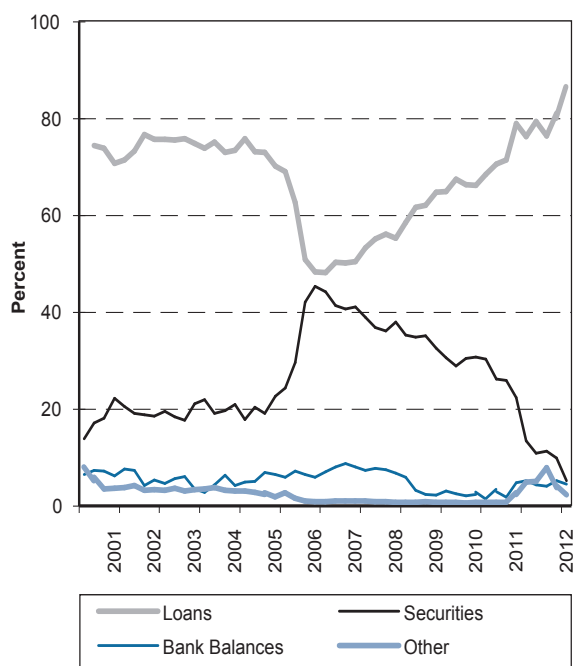
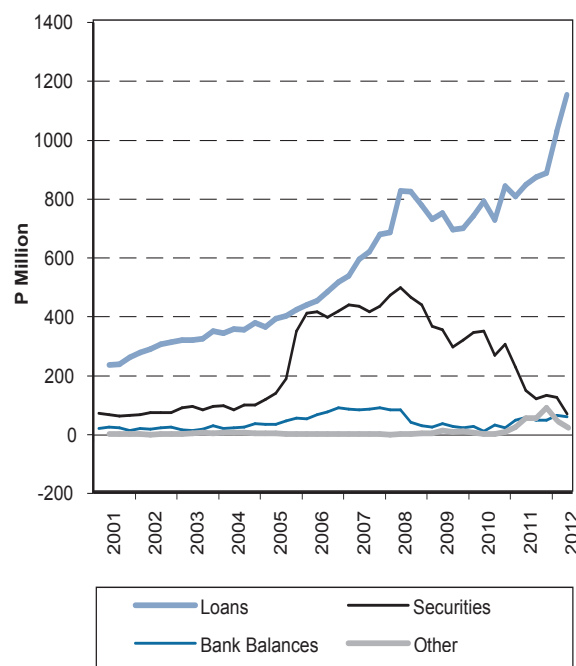


CHART 2.10B: COMMERCIAL BANKS: SOURCES OF INTEREST INCOME



Source: Bank of Botswana

are significant. As a result, households are a major source of bank profits (Charts 2.8a – 2.10b), and this stems from a substantial margin between deposit rates and effective lending rates, as well as bank charges. The results of the survey of banks for this review indicate that maximum interest rates for residential mortgage and motor vehicle loans are prime plus 3 percent, personal loans are at about prime plus 18 percent and credit cards charge an interest rate of prime plus 20 percent. Table 2.6 shows the level and trends in other related bank charges. Overall, there is some evidence that households allocate a significant part of their income to banking costs.

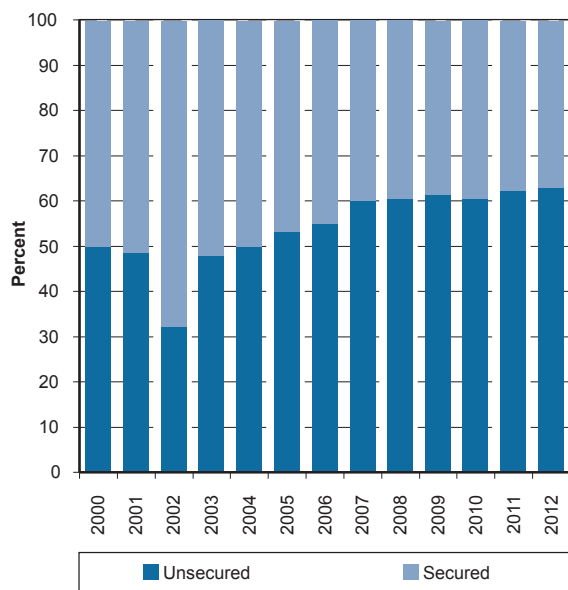
(c) Types of Household Credit and Trends

3.8 The trend growth in household borrowing (and larger share in total lending) can be explained by factors related to both supply and demand. It appears, however, that, given growth in supply engendered by, among others, excess liquidity, increase in the number of financial

institutions and competition, and employer guarantees, demand is mostly influenced by income and debt-service capability. The relatively high costs of bank loans appear not to deter borrowers, as indicated by the large share of more expensive, unsecured personal loans in total household credit (Chart 2.11). Nevertheless, changes in interest rates (cost of credit) affect demand to the extent that it generates an income effect. Thus, a higher (lower) interest rate, which increases (reduces) the repayable amount and monthly instalments, would tend to reduce (increase) the maximum amount of credit that can be obtained within the overall debt-service ratio constraint.

3.9 The growing dominance since the mid-2000s of unsecured lending (personal loans and credit cards) in household debt is in contrast to many other countries, where residential mortgages are a major component of household debt. Table 2.7 provides a comparison between Botswana and other countries of the share of mortgage loans in total household

CHART 2.11: SECURED AND UNSECURED LENDING IN BOTSWANA



Source: Bank of Botswana

loans. This raises concerns about productive use of resources, crowding out of business funding, likelihood of widespread defaults (arising from a pervasive and common shock to household wealth and incomes), which could potentially result in financial instability, rising expenses for households and erosion of a culture of savings. Unsecured credit increased at an annual rate of 22 percent between 2006 and 2012, while growth in mortgage loans was 19 percent per annum (from a very low level); both rising at a more rapid rate than the increase in national income and inflation.

3.10 Overall, there has been an increasing share of

TABLE 2.7: SHARE OF MORTGAGE LOANS IN TOTAL HOUSEHOLD LOANS

Country	Share of Mortgage Loans in Total Household Loans (Percent)
Botswana (2013)	34.7
Kenya (2010)	15.0
Canada (Dec 2013)	70.1
USA (2013)	70.0

Source: Bank of Botswana, World Bank, Federal Reserve Bank of New York, Bank of Canada

unsecured credit for all-but-one of the lending institutions between 2008 and 2012 (Chart 2.12a). However, the extent of unsecured borrowing differs significantly across lending institutions from less than 40 percent and rising to more than 80 percent for five of the banks. The rapid growth in mortgages has also been

CHART 2.12A: UNSECURED CREDIT: SHARE IN INDIVIDUAL BANKS

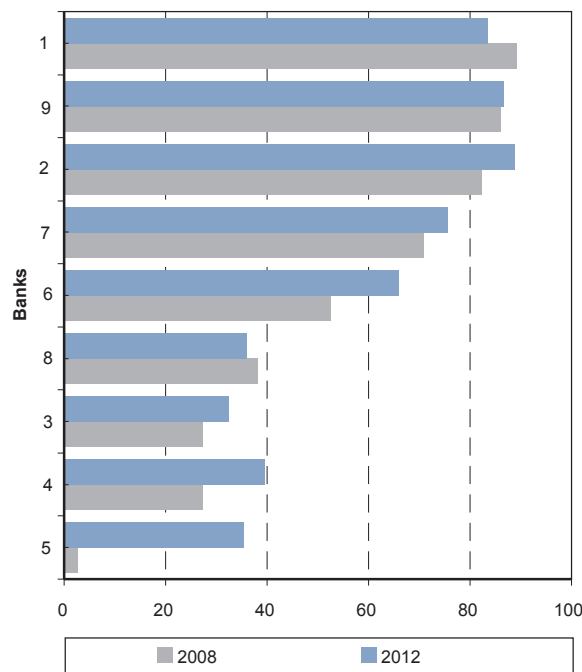
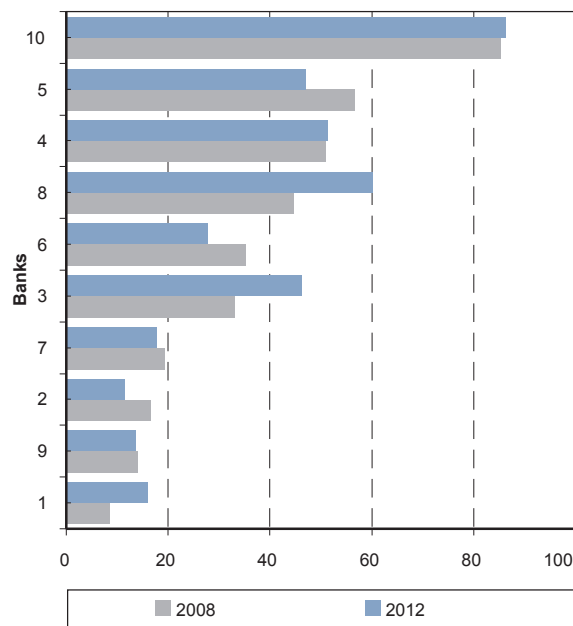


CHART 2.12B: PROPERTY LOANS: SHARE IN INDIVIDUAL BANKS



Note: Numbers are used in place of names of banks in the vertical axis.

Source: Bank of Botswana

accompanied by an increasing share in total household borrowing. Even then, the relative share of mortgages in total credit fell with respect to five banks, with a commensurate increase in the proportion of unsecured loans (Chart 2.12b).

3.11 The rapid growth in total household borrowing is reflected in both the value and number of loan accounts (Charts 2.13a – 2.13b). How-

ever, growth in the number of loan accounts, at 109 percent, is much lower than the 192.3 percent expansion of household credit between 2006 and 2012, which suggests that the increase in lending to this sector has more to do with larger amounts being lent to a modestly growing pool of borrowers. Nevertheless, it is also notable that, in 2011, the 274 443 loan accounts at banks represent 81 percent of the estimated 335 226 formal sector employees,⁸

CHART 2.13A: LOAN TYPES BY NUMBER OF ACCOUNTS ('000)

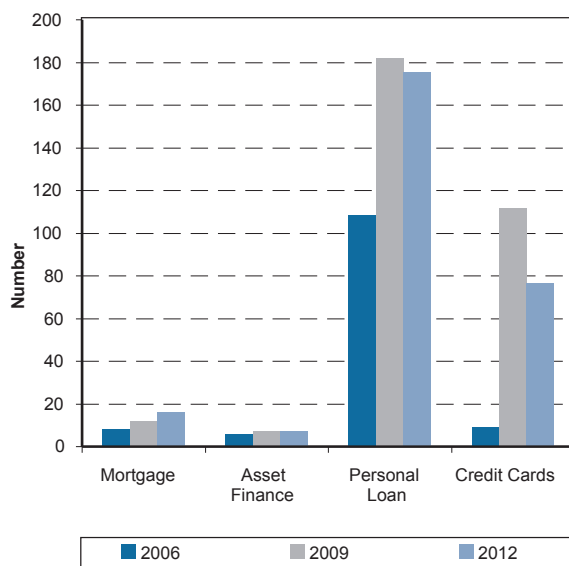


CHART 2.13B: AVERAGE VALUE PER LOAN ACCOUNT (P'000)

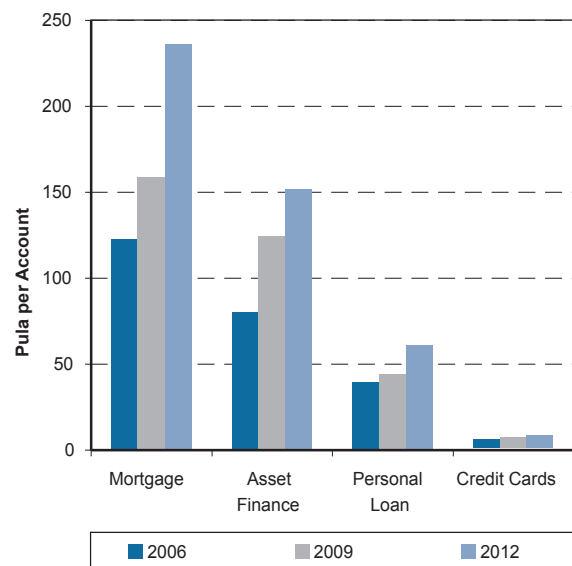


CHART 2.13C: INDICES OF NUMBER OF ACCOUNTS AND VALUE OF LOANS (2006 = 100) – MORTGAGE

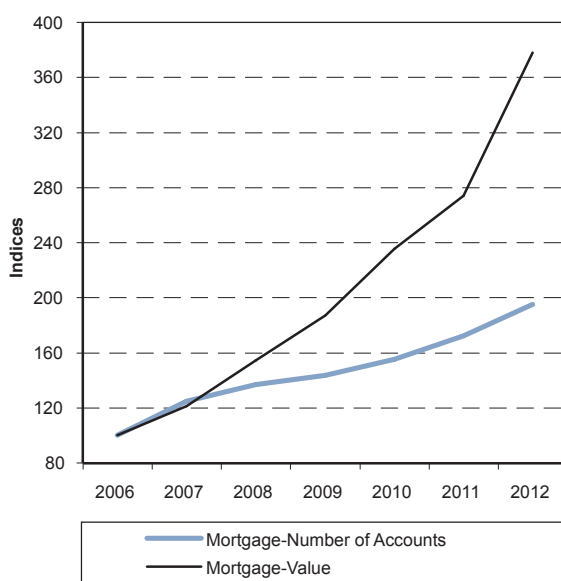
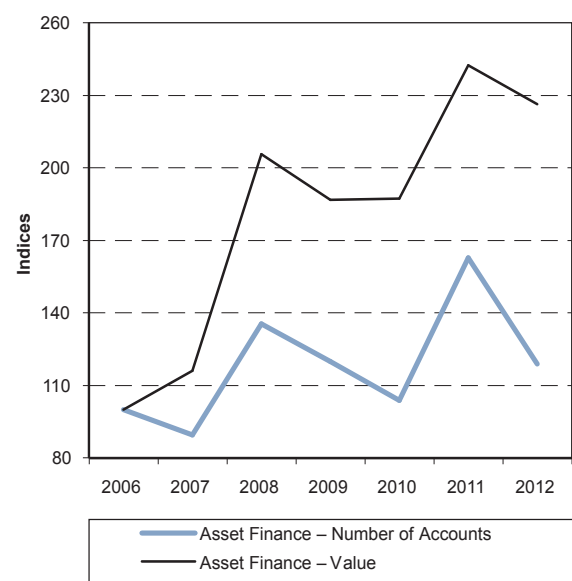


CHART 2.13D: INDICES OF NUMBER OF ACCOUNTS AND VALUE OF LOANS (2006 = 100) – ASSET FINANCE



Source: Bank of Botswana

⁸ Estimates are based on Statistics Botswana survey of formal sector employment.

CHART 2.13E: INDICES OF NUMBER OF ACCOUNTS AND VALUE OF LOANS (2006 = 100) – PERSONAL LOANS

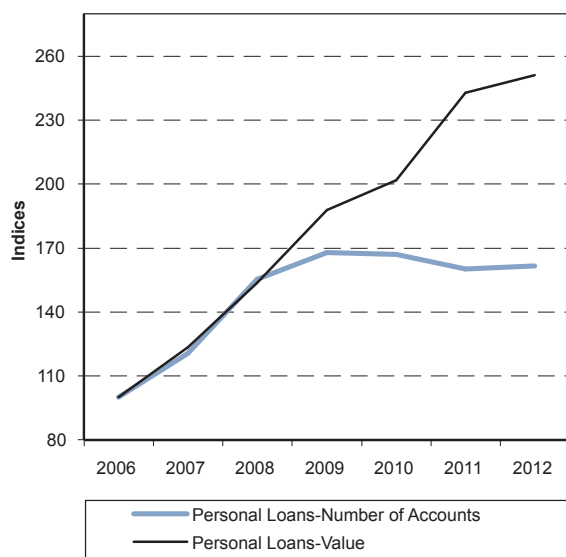


CHART 2.13F: INDICES OF NUMBER OF ACCOUNTS AND VALUE OF LOANS (2007 = 100) – CREDIT CARDS

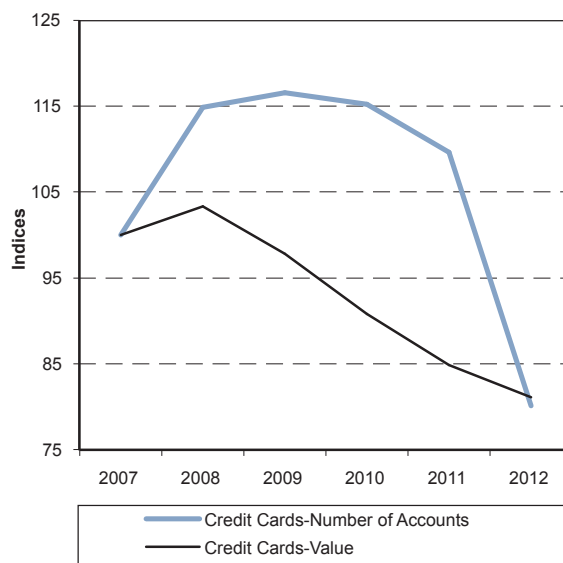
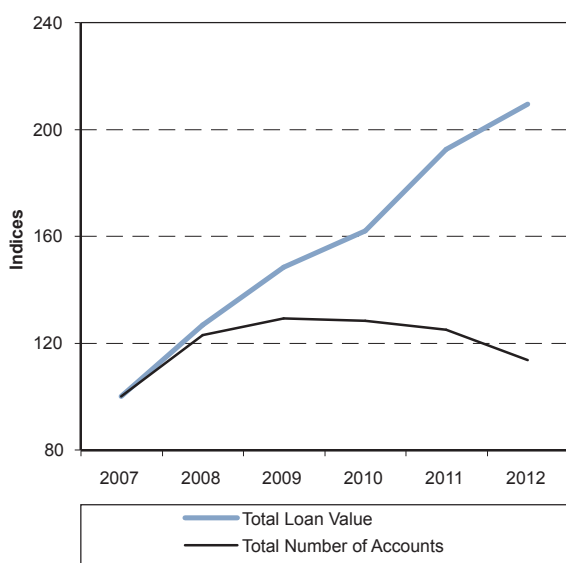


CHART 2.13G: INDICES OF TOTAL NUMBER OF ACCOUNTS AND TOTAL VALUE OF LOANS



Source: Bank of Botswana

which indicates significant loan usage by wage income earners. The faster growth in household credit compared to the number of account holders is common across all types of lending, except credit cards (Charts 2.13c – 2.13g).

3.12 As would be expected, the average balance in mortgage loan accounts is much higher and increased by 94 percent, from about P122 000 in 2006 to just above P236 000 at the end of

2012. Moreover, the 96 percent increase in the number of mortgage accounts in the same period represents a respectable contribution to development of residential property. Unsecured loans are more numerous, but had a smaller average value of P60 000. However, the relatively large loan limits for unsecured credit of up to P250 000 could partly explain stagnation in the number of motor vehicle loans at less than 10 000 (with annual growth of 6.4 percent between 2006 and 2012), albeit with a much higher average value of approximately P152 000 at the end of 2012. It raises the possibility of personal loans being used to finance vehicles (including second-hand vehicles not eligible for bank funding), smaller residences or home improvements, farming and other business inputs. There is, nevertheless, a concern relating to the cost of such funding relative to prospects for returns. For property, it is appreciated that a sense of full ownership can be included in the non-pecuniary benefits that may also be set against the costs of borrowing, including for unsecured loans. However, where borrowed funds are meant to finance small business operations and farming, a focused approach based on financial costs and returns is more relevant.

3.13 Given other indicators, it is evident that the

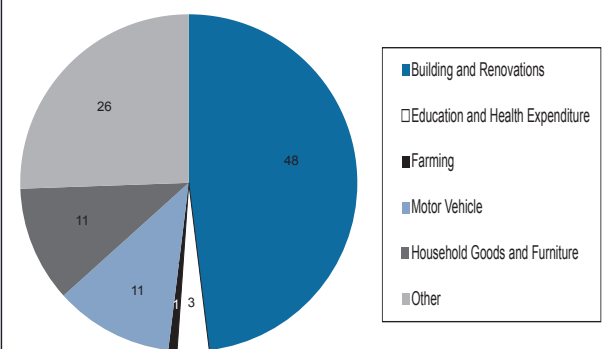
number of outstanding mortgage accounts does not fully explain the trend and scale of residential property development in the country. It is more likely that a combination of savings, current earnings and non-mortgage finance are used for residential property development and acquisition. Indeed, survey data shows that about 48 percent of unsecured credit provided by lending institutions is allocated for “building and renovations” (Chart 2.14).

- 3.14 The land tenure system that slows the process of obtaining legal title to land/property appears to contribute to the relatively low proportion of mortgages in lending and customers’ preference for unsecured loans. Currently, only urban land is originally registered as common law grant with concurrent issuance of title deed. Land allocated by tribal authorities in villages is under customary law grant and has to be converted to common law grant and registration of title deed undertaken. Nevertheless, it is also the case that banks in Botswana have traditionally not carried out significant mortgage financing, such that the rapid growth in property finance is a recent phenomenon. It can be expected that the associated marketing could also stimulate the desire by households to convert land/property from customary to common law in order to benefit from the relatively low cost of mortgage finance.

(d) Banks’ Lending Policies and Credit Assessment Criteria

- 3.15 Developments in household credit also reflect financial goals of the lending institutions. In part, the rapid growth in lending to households is driven by competition within the banking sector, including the desire to increase market share and maintain profitability. Nevertheless, survey responses point to a strategy of diversifying the loan portfolio and raising the share of secured credit. The competitive appetite for lending to households is indicated by a generalised easing of administrative processes and marketing, which include dedicated products

CHART 2.14: DECLARED USES OF UNSECURED LOANS



Source: Bank of Botswana

and schemes, deployment of sales agents and unsolicited pre-approval of facilities.⁹

- 3.16 The key household credit customer base comprises employed wage and salary earners. In order to enhance risk management, lenders increasingly institute code sharing arrangements to facilitate deduction of loan instalments at the source of employment income. As such, there is a general gravitation towards scheme-based lending to employees of organisations with a sizeable staff establishment, including the Government, parastatals and large corporates, as well as members of trade unions. For example, the Government Employee Motor Vehicle and Residential Property Advance Scheme (GEMVAS), which involves an 80 percent guarantee for loans, covers government employees borrowing from financial institutions. The coverage of loans under this scheme is, however, modest at P629.5 million or 3.1 percent of total lending to households. Overall, GEMVAS and related arrangements augment the risk management strategies of lending institutions while, at the same time, generating a captive customer base. In turn, the lower risk converts to reduced interest rates on loans for participating employees compared to out-of-scheme borrowers.
- 3.17 In general, conscientious application of the Know Your Customer (KYC) requirements for detailed customer information, including

⁹ Clients are, however, notified and given the choice to accept or reject the offer.

proof of residence, helps in establishing the *bona fide* of clients and screening them for creditworthiness. Customers are also routinely required to provide their credit and financial history and credit references undertaken through credit bureaux to pick up any negative data/information. Additionally, financial institutions insist that, for both secured and unsecured borrowing, clients must obtain credit life insurance so that in the event of death prior to settlement, the outstanding balance is cleared by the insurer.

3.18 Lending conditions of financial institutions also incorporate key risk mitigation measures, such as stipulation of loan-to-value and debt-service ratios, which help preserve asset quality and safeguard stability of the financial system. However, the relatively high loan-to-value ratio indicates a generous approach to mortgage financing by some of the lenders. Two of the bigger banks have also raised the loan-to-value ratio compared to earlier periods. Nevertheless, it is assumed that substantial coverage of the mortgage takes into account adequate mitigation of risk by other measures. In this regard, four of the banks have a range for the loan-to-value ratio and this indicates customer segmentation or consideration of other risk mitigation measures in determining the amount to be lent. In contrast to the terms and conditions for mortgage loans, the requirement for down-payment is more stringent with respect to vehicle/asset financing where a minimum of 10 percent is common. However, depending on circumstances, sev-

eral lenders indicate ranges where, in the case of one bank, up to 50 percent down-payment can be required. Only one bank reported offering 100 percent funding in vehicle/asset loans. Similar to mortgage loans, there are cases of an increase in loan coverage (reduction in required deposits) over time.

3.19 Financial institutions commonly use the debt-to-income ratio to determine the amount of credit individual customers can access and in order to regulate the debt burden and retain capability of borrowers to repay loans. Varying ratios for different types of loans/credit limits are applied, with a range between 30 percent and 60 percent reported by lenders. Overall, the average limit of debt-to-income ratio has increased from about 40 percent in 2000 to 50 percent in 2012. Importantly, proof of employment and wages is required by all banks for applications for all types of credit. Other sources of income are factored in various ways, but cannot by themselves be the basis of the criteria for granting a loan (Table 2.8). There is greater consideration by almost all banks of spousal and rental income in applications for mortgages, but these are less important for all other types of credit. It is also notable that only four institutions include pensions in the determination of debt-service ratio and credit limit, thus limiting access to credit for those that are reliant on pensions as a source of income.

3.20 The requirement for collateral/security is a further risk mitigation measure used by banks, which also regulates the amount of credit that can be accessed (Table 2.9). All financial in-

TABLE 2.8: INCOME CONSIDERED FOR DEBT-TO-INCOME RATIO AND CREDIT CEILING BY HOUSEHOLDS

Income	Number of Financial Institutions			
	Mortgage	Assets/vehicle	Personal	Credit Card
Wages/salary	10	9	9	5
Pension	4	2	4	2
Rental income	8	5	5	1
Spouse income	9	4	2	1
Other				
Permanent allowances	1	1	1	1
Housing allowance	1			
Financial statements	1			

Note: Some of the institutions do not offer all the types of credit.

Source: Bank of Botswana

stitutions take residential property as security, while business/commercial property and bank deposits are also accepted as collateral by most lenders. Other financial instruments and assets, such as pension funds, sureties and farming/agriculture equipment, are considered by only a few banks.

TABLE 2.9: COLLATERAL SECURITY CONSIDERED IN LENDING TO HOUSEHOLDS

Forms of Security	Number of financial institutions	
	Yes	No
Residential Property	10	
Business/Commercial Property	8	2
Shares	5	4
Bank Deposits	9	
Pension Funds	2	7
Farm/Agriculture (property, equipment, implements, livestock)	3	5
Insurance Investment Policy	4	3
Other		
Surety	1	
Vehicles	2	
Other, not specified	1	

Source: Bank of Botswana

Retirement Funds - Pension Funds and Annuities

3.21 Households invest in retirement funds through employer stand-alone funds, commercial umbrella funds,¹⁰ retirement annuity funds and various individual investments. Pension funds (employer-based occupational pensions) have grown in importance (in terms of both membership and asset size) in the context of conversion to defined contribution pension schemes from defined benefit schemes by government and other large employers, as well as generally higher returns. In particular, the introduction of the Botswana Public Officers Pension Fund (BPOPF) in 2001 initially added P2 billion to the pension industry; this increased to

P11 billion in three years.¹¹ The incorporation of public sector industrial class employees into the permanent and pensionable cadre also contributed to the increase in pension funds. These employees were previously paid gratuity and severance benefits at the end of every 5-year contract. Tax law is also supportive of growth in pension funds, as current pension contributions are deductible from taxable income, thus lowering the tax obligation of employees. However, employees appear not to be taking advantage of the tax benefit as their contributions largely match the basic obligatory amount. Notably, the 2002/03 Household Income and Expenditure Survey (HIES) and the 2009/10 Botswana Core Welfare Indicators Survey (BCWIS) show that the trend growth in long-term investment funds is common across the various income cohorts. Assets of pension funds grew from approximately P1.5 billion in 2000 to P47 billion in 2012, with their share of total financial sector assets having increased from 5.1 percent in 2000 to 42.5 percent in 2012.

3.22 The expansion of pension funds has generated corresponding growth in support services, such as asset management, fund administration and related consultancies and custody business. In this regard, it is presumed that households with investments in pension funds benefit from professional management and advice, thereby, realising higher returns overall. The professional aspects include pooling of funds, portfolio allocation across domestic and offshore markets as well as allocation to a variety of asset classes, as part of risk management and maximisation of return in the interest of incremental future cash flow for retirees. There is some evidence that households generally earn higher real returns on their pension funds (Table 2.10).

3.23 The costs of running retirement funds are sizeable and, if not well managed or in the absence of adequate oversight, they could

¹⁰ NBFIRA 2011 Annual Report indicates that the umbrella funds consist of 168 small-sized funds, which are pooled together. The advantage of pooling the funds together is to facilitate cost savings.

¹¹ Debswana Pension Fund (DPF) which, prior to the establishment of the BPOPF, was the largest fund by membership and asset size, was established in 1984.

TABLE 2.10: INVESTMENT RETURNS ON SELECTED PENSION FUNDS (PERCENT)

Year	Declared Interest			Annual Inflation (December)
	Bank of Botswana	BPOPF	Debswana	
2001		7.5	32.5	5.8
2002		-14.8	-12.1	10.6
2003		17.1	6.5	6.4
2004		-	10.9	7.8
2005		29.6	31.0	11.4
2006	39.4	33.0	31.4	8.5
2007	28.1	11.3	16.8	8.1
2008	-12.8	-	-12.9	13.7
2009	-5.9	7.8	15.7	5.8
2010	9.4	7.5	7.4	7.4
2011	20.1	6.8	-	9.2
2012	-	19.0	-	7.4

Source: Bank of Botswana, Botswana Public Officers Pension Fund Annual Report, and Debswana Pension Fund Annual Report

erode benefits accruing to retirees. The main determinants of the costs are the size of the fund, asset class choices (a portfolio with a high proportion of equities has higher costs than one comprised of fixed-interest securities), the differences in service quality (use of a higher quality expertise is more expensive), and competition in the industry. In general, the engagement of external fund managers raises costs of management, but this should be offset by the benefits of professionalism, including higher returns and fund sustainability.

3.24 Cost escalation in management of pension funds is also associated with stricter supervision and adherence to relevant accounting principles and compliance rules requiring employment of more expensive skilled personnel.¹² Administration fees for employer stand-alone defined contribution pension and annuity funds range from 0.01 percent to 0.32 percent of funds under management, while investment management charges will add between 0.47 percent and 1.01 percent in some developed countries.¹³ In Botswana, compa-

able ratios range from 0.06 percent to 0.13 percent for administration and 0.56 percent to 0.64 percent for investment management fees. Chart 2.15 shows a comparison of management fees for selected pension funds and for the foreign exchange reserves managed by the Bank of Botswana.¹⁴

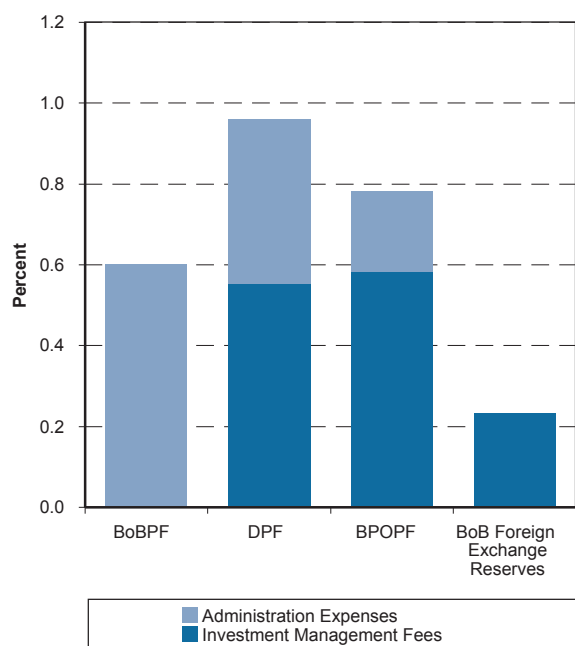
3.25 The legal provision limiting to one third the initial withdrawal of pension funds upon retirement, and requiring the use of the balance to purchase an annuity could also be challenged on the basis that it constrains investment options (and indeed consumption preferences) of retirees. Moreover, there are only two annuity providers in Botswana and their payments vary markedly, with some of the conditions deemed to erode the extent to which pensioners benefit from their savings. Alternatively, the two largest pension funds give their retirees the option of investing their pension with them or purchasing annuities from the market, thus, to some extent, addressing issues of lack of competition. However, for retirees of other pension funds there is effectively no choice as there are only two service providers

12 These regulations have benefited individual savers by increasing transparency of the investments in retirement funds.

13 According to the South African National Treasury technical discussion paper A for public comment on charges in South

Africa retirement funds (2013), the average cost in the USA, Japan and Australia are in that range.

14 Some fund managers could report zero asset management fees because they report asset returns net of charges.

CHART 2.15: FUND MANAGEMENT FEES RELATIVE TO TOTAL ASSETS (2011)

Source: Bank of Botswana; Botswana Public Officers Pension Fund Annual Report; and Debswana Pension Fund Annual Report

for annuities. Thus, market participants highlight the lack of competition in the market for annuity products, which undermines service and potential benefits to retirees. At the same time, annuity providers pointed to heightened credit risk in the annuity market due to lack of long-term debt instruments, which limits investment options (and appropriate portfolio balance) and could result in suppression of potential payments to retirees.

- 3.26 There are other concerns relating to possible diminution of benefits and weakening of pension funds as a source of future income. This could arise where pension benefits are used as security for loans and in instances of early withdrawal of accumulated pension benefits, while the law also accommodates some deductions from pension benefits to pay outstanding obligations, mostly due to employers.¹⁵ The Non-Bank Financial Institutions

¹⁵ These are provided for under Section 2 of the Pension and Provident Funds (Amendment) (No. 2) Regulations, 2008 and are subject to authorisation by NBFIRA. In particular, the use of pensions as security is intended to promote financing of residential property. These challenges were outlined by NBFIRA at the Botswana Pensions Society Annual Con-

Regulatory Authority (NBFIRA) has also at times queried the weak governance structures of some main stand-alone pension funds and instances of inadequate skills of pension fund trustees to effectively oversee pension fund management. Thus, it would appear that well-intended legislation and other policies could disadvantage savers/pensioners, while weak oversight by trustees, as well as possible inadequate attention to potential cost-saving opportunities by pension fund executives, could reduce expected returns. In the circumstances, there are on-going discussions to reform the Pensions and Provident Funds Act in order to enhance administrative efficiency, fairness and sustainability of the pension industry.

Capital Markets

- 3.27 Direct equity shareholding by the household sector through the Botswana Stock Exchange (BSE) amounted to 16.9 percent of total market capitalisation at the end of 2012. Going forward, household participation in the BSE could, in addition to listing of private corporate securities, increase given the envisaged involvement in privatisation of parastatals and any increase in government securities.¹⁶ Notably, privatisation is already at an advanced stage with respect to Botswana Telecommunications Corporation (BTC) and the National Development Bank (NDB), while the P15 billion government bonds issuance programme remains in place with only P6.7 billion issued as at the end of December 2013.
- 3.28 Households also invest indirectly in the BSE through pension funds and unit trusts. For instance, the pension industry had invested a total of P17.8 billion in both equities and bonds as at the end of 2012. Therefore, performance of the BSE or constituent corporations and issuers of securities has a significant bearing on asset holding and welfare of households.

ference in October 2013.

¹⁶ Government bonds are not formally listed on the BSE, but information on trading is provided by the Bank of Botswana and reported by the Exchange.

TABLE 2.11: MATURITY STRUCTURE OF BONDS AND AMOUNT ISSUED (P MILLION)

Year	Tenure			
	3 - 5 years	6 - 12 years	13 - 15 years	>15 years
2006	1 170	2 630	100	90
2013	150	6 437	2 278	494

Source: Bank of Botswana and Botswana Stock Exchange

(a) Equities

- 3.29 The BSE domestic market capitalisation grew more than five-fold between 2000 and 2012; it grew from 17.8 percent to 32.2 percent of GDP. The Exchange had been performing well, with sustained good returns, a significant amount of which ultimately accrues to households and compares well with other international markets.
- 3.30 The financial sector represents a large share of the market value of listed securities, while there is also a significant property/real estate representation; hence, the stock market does not offer consumers an optimal portfolio diversification (and does not match the structure of the economy). This is pertinent given that households would also have exposure to individual financial sector institutions as well as being invested in property through home ownership and mortgages. Households are, therefore, likely to be heavily invested in correlated markets and any instability would affect a large portion of their assets and could have a direct adverse impact on their wealth. In general, diversification of capital markets facilitates wider risk sharing opportunities among investors. The dual listing of foreign companies on the BSE also helps achieve some diversity. Apart from limited diversity, capital markets in Botswana are characterised by lack of liquidity for both equities and bonds, including an inactive secondary market, which can limit entry and exit by household investors. A related significant dimension is that share ownership of the banks listed on the BSE is dominated by controlling parent companies; as such, only a limited amount of equity is available as “free float”, which lim-

its investment opportunities in one of the most profitable industries. Households are limited in terms of the extent to which they can offset high costs of banking by having a share in the profits of banks.

(b) Government and Corporate Bond Markets

- 3.31 Households also have an opportunity to participate in the bond market, which had a nominal value of P9.4 billion at the end of 2013, representing more than 35 bonds, an increase from a smaller number of bonds and a nominal value of P4 billion in 2006. The debt market is dominated by government securities accounting for 67 percent of market share in 2013. Other participants are parastatals with 16 percent and corporate entities at 17 percent. The direct involvement of households in the bond market is negligible, while pension funds held more than 95 percent of government securities in 2013. The maturity profile of the listed bonds has improved over time in terms of coverage of segments (maturity buckets) and length of term structure, but intermediate maturities (6-12 years) still dominate (Table 2.11). Ideally, a term structure that covers maturities of more than 15 years should match the needs of most savers, including institutional investors.

Finance Companies¹⁷ and Micro-lenders

- 3.32 This sub-sector has grown significantly and there are about 106 micro-lenders that have applied to be licensed by NBFIRA.¹⁸ The total assets for these entities amounted to about P2 billion as at end of 2012 and the number of customers is estimated at approximately 52 000, the majority of them being public sector employees. Most of the lending is by Letshego Financial Services, which is even bigger than some commercial banks and is listed on the

17 The Financial Sector Development Strategy for 2012-2016 defines finance companies as institutions that lend for more than one year.

18 Following the implementation of the Micro-Lending Regulations, all businesses in the micro-lending industry were given a deadline of June 30, 2012 to register with NBFIRA, otherwise sanctions would be imposed.

BSE. As with banks and other depository corporations, micro-lenders mostly target wage earners in major locations, with the bigger ones having deduction codes with employers (Government). Unlike experience elsewhere, there is no evidence for Botswana that micro credit is focused on low-income households that are developing small businesses. Rather, it appears that micro-lenders augment borrowing for consumption, with the larger players in competition with commercial banks. Credit by micro-lenders has been growing, as reflected in lending trends for three of the larger micro-lenders (Letshego, Blue and Thito Holdings) and the increase in the number of lenders. However, the value of loans by micro-lenders is relatively small, accounting for just over 9 percent of total household borrowing in 2012.

- 3.33 The smaller micro-lenders have been associated with unsavoury business practices, such as retaining customer bank ATM cards as security, and in order to facilitate first access to funds, as well as non-transparent and excessive charges,¹⁹ which increase the amount of debt, and leads to chronic indebtedness. The recently promulgated Micro-Lending Regulations require a certain level of professionalism with a provision to revoke a licence for non-compliance. Micro-lenders are expected to have loan underwriting criteria, well-documented procedures, and should exercise due diligence to ensure that borrowers are not over-indebted. In addition, the total amount that is ultimately paid to the lender cannot, by law, be more than twice the original loan (the interest payments cannot exceed the principal), which relieves clients from perpetual indebtedness due to compounding interest on outstanding loans.
- 3.34 In order to curb instances of over-indebtedness of their members, some of the major trade unions have partnered with a private entity to establish BOTUSAFE in order to limit risks for

multiple borrowing from micro-lending businesses. Thus, there is a central registry that facilitates the vetting of applications by participating lenders (Letshego Financial Services and six others), to assess whether the applicant still meets specified affordability criteria. However, to the extent that there is no sharing of credit information and the determination of debt service is not coordinated across lenders, it is possible that some households could be over-borrowed. Indeed, the effectiveness of the BOTUSAFE arrangement is questionable as incidents of individuals with take-home pay well below acceptable debt-service ratios are reportedly prevalent in the public service.

4. ASSESSMENT OF DEBT SUSTAINABILITY – TRENDS AND LINKS TO FINANCIAL STABILITY²⁰

- 4.1 Extreme indebtedness can lead to financial instability as a high level of non-performing loans erodes capital buffers set up by banks. In instances where household indebtedness is considered high, unsustainable and a threat to financial stability, macro-prudential measures may be applied to mitigate credit risk. This is meant to prevent possible extreme cases of bank insolvency and collapse. Financial instability can also arise from excessive caution and unwillingness of banks to lend, which could be detrimental to sustainable economic growth prospects. However, even in the absence of direct risks to financial stability from the macro-prudential perspective, there is also a need to pay attention to consumer protection and welfare considerations, which requires finding solutions to increasing levels of indebtedness. Thus, it is recognised that if not addressed, high levels of indebtedness can risk financial, economic and social instability.
- 4.2 Financial stability is maintained by adherence to core prudential standards such as mainte-

¹⁹ Regulations now compel micro-lenders to show both total monthly cost of credit as well as annual interest rates in order to enhance transparency; formulae have been defined for these calculations.

²⁰ According to the South African Reserve Bank, financial stability can be defined in terms of requirements to achieve it, such a system can be characterised as having the ability to prevent, predict and withstand shocks under all types of domestic and international market conditions.

TABLE 2.12: NON-PERFORMING LOANS AS A PERCENTAGE OF ALL BANK LOANS

Country	2010	2011	2012
Botswana	4.3	5.0	3.8
Ghana	17.6	14.1	–
Kenya	6.3	4.4	5.6
Namibia	2.0	1.5	1.4
RSA	5.8	4.7	4.6
Norway	1.5	1.7	–
Chile	2.7	2.4	2.4
USA	4.9	4.1	3.9

Source: World Bank

nance of adequate capital and liquidity, as well as proper management, oversight and risk mitigation measures with a view to sustained good asset quality and profitability. Enforcement of prudential standards and operations of the banking sector in Botswana is undertaken through an oversight and regulatory approach that includes on-site examinations, bilateral and trilateral (i.e., also including banks' external auditors) meetings, as well as off-site monitoring. Regular assessments of the banking system, undertaken both internally by the Bank of Botswana and by external observers,²¹ have shown that there is a high level of statutory compliance, hence lowering the risks to financial stability.

- 4.3 However, there is some concern that the extent of household indebtedness in Botswana has reached, or will soon reach, critical levels. This view is premised on rapid growth of unsecured lending to the household sector, particularly at a time when incomes are estimated to be growing at a much slower pace. Moreover, there is some evidence of households borrowing from multiple sources, and this result in very low levels of take-home pay (breaching the acceptable debt service ratio). In addition, resort to the large number of micro-lenders, despite the exorbitant cost and conditions attached to such borrowing, points to existence of cases of financial distress. Indeed, this scenario can potentially generate

21 Such as the regular surveillance by IMF's Article IV Consultation missions.

debt sustainability challenges and such concerns must be taken seriously. In this regard, it is important to evaluate debt sustainability and potential challenges by examining standard/conventional indicators of excessive debt (and stress) and soundness of the financial system.

- 4.4 In addressing the level of indebtedness and sustainability issues, it should be noted that aggregate data on household debt are quite comprehensive and cover all the formal financial institutions, while the additional credit provided by "unregistered" micro-lenders, major retail outlets and other hire-purchase arrangements is relatively small. The Household Income and Expenditure Surveys conducted by Statistics Botswana give a reasonable indication of developments with respect to incomes and employment.²² However, the paucity of data on credit by micro-lenders, hire-purchase, rental and utility arrears²³ and employer loans implies that the analysis of the debt situation and potential distress among households can be incomplete. The information collected by the three credit bureaux in the country is also partial and only covers negative data.
- 4.5 A common indicator of vulnerability to excessive debt is the delinquency ratio which, as applied to households, refers to the proportion of the total consumer loan book that is "past due" (i.e., behind in scheduled payments) by between one month and three months (Chart 2.16). A complementary measure is the non-performing loan (NPL) ratio, which shows loans that are past due by more than three months as a proportion of total loans outstanding. In Botswana, the NPL ratio of the household sector increased sharply from 1.5 percent in 2005 to 5 percent in 2011, before falling back to 3.8 percent in 2012 (Chart

22 Previously known as Household Income and Expenditure Surveys (HIES), more recently this information was included as part of the Botswana Core Welfare Indicators Survey 2009/10.

23 The accumulation of utility arrears is, however, constrained given that providers cut off service when payment is not made for an extended period of time.

2.17).²⁴ Such an overall increase would appear to indicate rising stress levels among household borrowers, even though this was from an initially very low level. By comparison with other countries (Table 2.12), such a level is well within the range that can be regarded as normal, and far below those associated with acute financial distress among households. However, this macro perspective does not discount the distress for the individuals involved and/or the possibility of concentration with respect to categories of borrowers, type of loans, as well as individual or group of financial institutions; thus, it does not adequately capture potential structural and transmission aspects that can generate contagion.²⁵

4.6 An important consideration in explaining the relative stability of the NPL ratio is the changing maturity structure of lending by commercial banks in Botswana. In 2005, loans with maturity of 5 - 7 years comprised 8 percent of total loans; however, by 2012, this proportion had risen to 21.7 percent. Likewise, recent rapid growth in mortgage lending may reflect borrowers consolidating existing debts through loans secured on existing property or refinancing (i.e., rather than using mortgages for new property acquisitions). Such an extension of repayment periods and reduction of monthly instalments can provide scope to meet the required debt-to-income ratio at increasingly higher levels and longer duration of indebtedness. Nevertheless, as highlighted in Section 3, there is potential benefit from a reduction in the short-term cost of credit in moving from an unsecured loan to a mortgage.

4.7 The other financial soundness indicators (FSIs) used to assess the resilience of the household sector to adverse shocks (Table 2.13)²⁶ are also generally favourable for Bot-

24 A decline in NPLs may be attributable to debt restructuring, write-off or close monitoring of such loans by financial institutions. Currently, there is no commentary to account for the behavior of this ratio in Botswana.

25 It should be noted, however, that the Bank's oversight with respect to performance of individual financial institutions adequately addresses potential problem areas.

26 These are based on IMF Financial Soundness Indicators:

CHART 2.16: PAST DUE FOR UNSECURED HOUSEHOLDS LOANS (END OF YEAR)

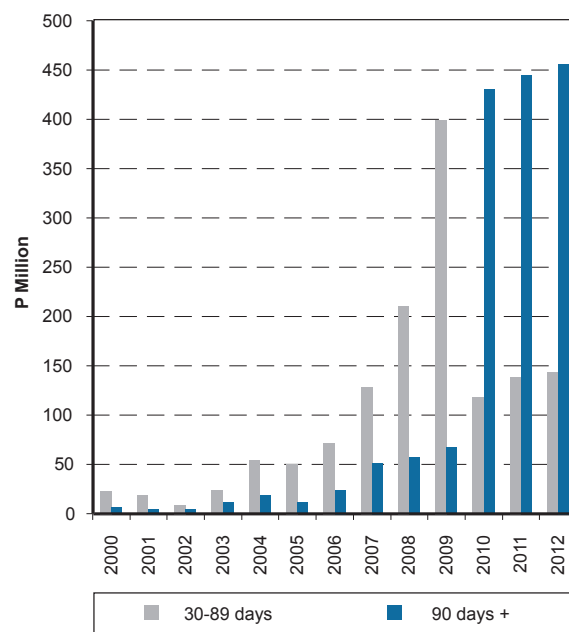
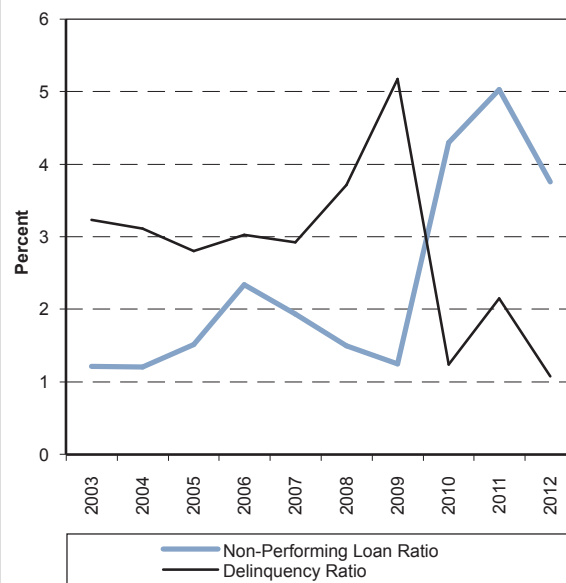


CHART 2.17: OTHER DEPOSITORY CORPORATIONS – HOUSEHOLD NON-PERFORMING LOANS AND DELINQUENCY RATIOS



Source: Bank of Botswana

swana (although there is some evidence of deterioration) relative to vulnerability triggers, as well as to selected comparator countries. The ratio of household assets to household debt continues to exceed one (i.e., the gearing ratio is low), and this indicates that, overall, households have enough financial buffers

to cover accumulated debts. However, the liquidity of households in the banking sector has been gradually declining since 2009, partly reflecting subdued wage increments. This could negatively impact on future capacity to service debt. At the same time, the indebtedness of households relative to GDP has trended upwards during the period, albeit at a slower pace than is the case with comparator countries. Overall, the financial soundness indicators suggest that increasing household indebtedness is not yet a major risk to financial stability. However, these aggregate indicators may obscure the extent to which individual households may be afflicted by excessive debt, which is a concern from the consumer welfare perspective.

does not, appear to have generated an untenable debt burden, even though it is higher than the increase in incomes. However, median income levels are estimated to have increased by 70 percent (i.e., a real decline), which suggests that those on lower incomes are more constrained in adding to their existing debt.

- 4.9 The regulatory infrastructure for micro-lenders being developed by NBFIRA has not yet generated comprehensive data on the amount of lending and relevant indicators of asset quality and debt service situation. However, published data by the largest micro-lender (Letshego) show non-performing loans²⁷ at 1.8 percent in 2012. Reports by the other main micro-lenders; Blue and Thito Holdings, show

TABLE 2.13: FINANCIAL SOUNDNESS INDICATORS FOR HOUSEHOLDS

Household (HH) Sector Indicator	As at end			
	2009	2010	2011	2012
Financial Assets to Total Financial Debt (ratio)	...	3.9	3.7	3.3
Debt ¹ to GDP (percent)	...	15.0	16.1	19.6
Liquidity of Financial Assets ² to Financial Debt (percent)	61.5	60.4	56.2	49.4
Debt Repayment ³ (percent)	7.9	7.0	7.5	9.3
NPLs (percent)	1.2	4.3	5.0	3.8

1 This refers to debt to the Other Depository Corporations (ODCs).

2 Households' liquid financial assets consist of deposits in the banking sector and debt refers to outstanding banking sector loans.

3 The debt repayment ratio consists of outstanding loan payments of principal and interest to Gross Domestic Product at current prices. Debt repayment figures were obtained from the 2013 Special Banking Survey.

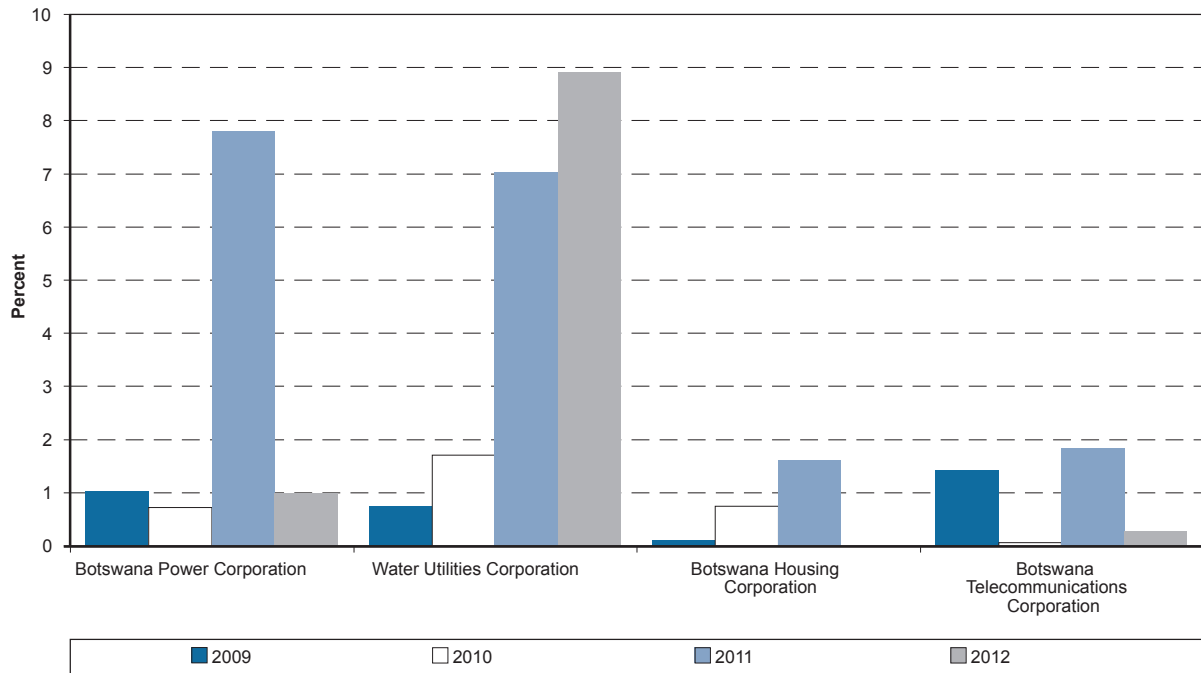
Source: Bank of Botswana

- 4.8 The household income and expenditure surveys conducted in 2002/03 and 2009/10 by Statistics Botswana indicate that the loan repayment burden has been increasing over time for households. There was significant growth in nominal incomes during this period, which increased on average by 119 percent compared to a cumulative inflation of 80.3 percent and an increase in household credit of 270 percent. The faster growth in credit compared to incomes signals the possibility of increasingly unsustainable debt. However, the debt repayment ratio remains modest at 9.3 percent (7.9 percent in 2009), and is in addition to the low gearing ratio indicated above. The increase in the debt service ratio is consistent with significant growth in household credit which

outstanding loans of P17.4 million and P28.3 million, respectively, but they do not indicate default rates. Even then, taking an extreme view of a delinquency rate of 50 percent for all micro-lenders would add marginally to the overall delinquency ratio. Delays in payments of utilities and delinquent values shown by the credit reference agencies also provide insight into the extent of debt distress situation and resulting sustainability challenges. Chart 2.18 shows indicative data on trends in provisions relative to revenue for selected utility and housing providers and, therefore, the scale and direction of delinquency. The data sug-

²⁷ Defined as impairment charge to advances in the Letshego Annual Report, 2012.

CHART 2.18: PROPORTION OF DEBT PROVISION TO REVENUE



Source: Bank of Botswana

gest generally low levels of delays in paying for utilities, although there was a substantial surge in 2011 with respect to all the selected corporations (possibly due to sluggish wages), before a tapering off in 2012.²⁸

- 4.10 The lack of comprehensive data to enable adequate assessment of debt sustainability is, nevertheless, a concern as there is a risk of underestimating the extent and concentration of indebtedness. In addition, incomplete credit referencing could undermine risk mitigation by individual lenders. In the circumstances, there is likely to be careless multi-sourcing of credit and/or borrowing to pay debt, thus resulting in a debt trap for individuals. If it is widespread, it could threaten the stability of the financial system. In this regard, there is some risk in basing the conclusion of low prospects for instability on the assumption that the absent data is neither significant nor critical. It is, therefore, important to address data and analytical deficiencies.

²⁸ The continuance of large and increasing provisions for Water Utilities Corporation (WUC) can be attributed to the administrative challenges associated with taking over responsibility for all water management that was previously shared with the Government's Department of Water Affairs and District Councils.

(a) Stress Testing of the Banking Sector

- 4.11 The impact of the 2007 – 2008 financial crisis and subsequent global recession provides a useful litmus test of the resilience of the banking system in Botswana and some indication of vulnerabilities. This was mostly felt through the second-round effects of reduced demand for exports on domestic economic performance. The muted effect on the banking system was due to the low foreign exposure of domestic banks given that they are locally incorporated subsidiaries and not branches. Economic recession affected the mining sector significantly due to lower demand for mineral exports, which led to temporary closure of the country's main diamond mines. As a result, banks adopted a more cautious approach to extending loans to employees of the mining industry. Government revenues were also adversely affected. However, the Government adopted a counter-cyclical posture at the time, but subsequently instituted expenditure restraint measures which led to subdued growth in wages and a lower contribution of government spending to private sector activity. Notably, however, the counter-cyclical approach protected both private sector and government employment, and economic growth in these sec-

CHART 2.19A: SPECIFIC PROVISIONS TO GROSS LOANS



CHART 2.19B: CAPITAL ADEQUACY RATIOS

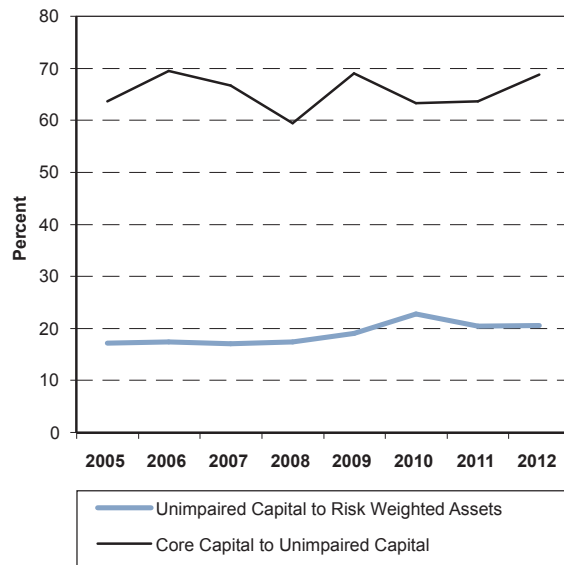


CHART 2.19C: LIQUIDITY RATIOS

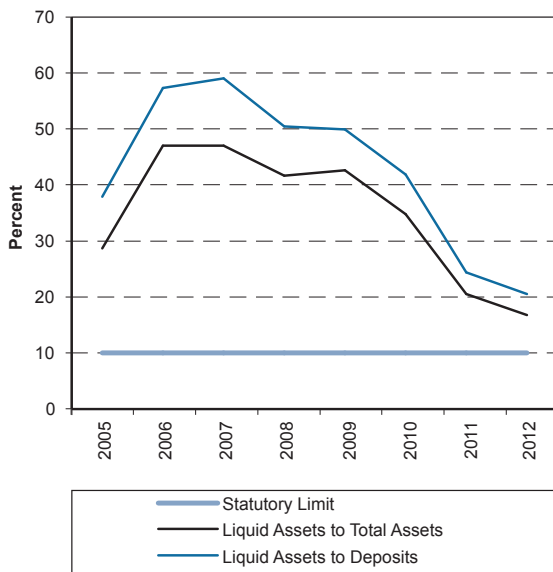
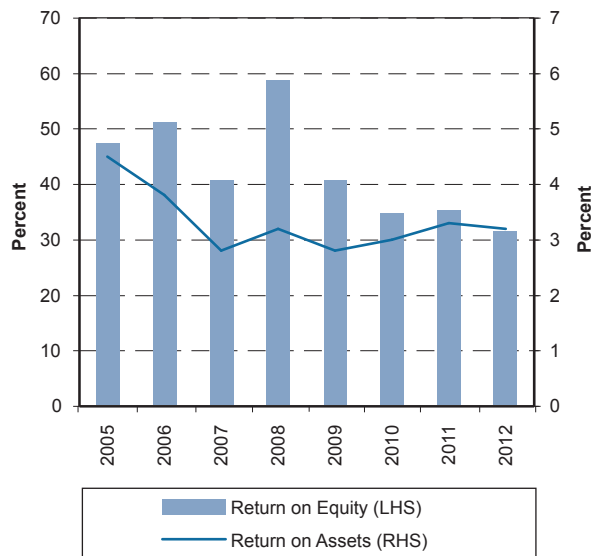


CHART 2.19D: PROFITABILITY INDICATORS



Source: Bank of Botswana

tors remained positive, with the result that there was a marginal impact of recession on financial institutions lending book.

4.12 As a result of the general macroeconomic weakness brought about by the economic recession, there was a rapid increase in specific provisions to gross loans ratio (Charts 2.19a – 2.19b); this suggested that banks were in control of the situation. Indeed, provisions fell markedly thereafter, while there was resur-

gence in credit growth, initially led by a faster increase in lending to businesses. Subsequently, there was a marked acceleration in lending to households in the context of aggressive marketing by banks and higher demand for credit to compensate for the slower increase in personal incomes. In the circumstances, banks were resilient in terms of maintenance of robust capital and liquidity ratios and sustained profitability (Charts 2.19c – 2.19d).

- 4.13 Much as there are concerns about risks of concentration of lending to the household sector, the probability of widespread defaults occasioned by the potential loss of employment is low. Widespread loss of employment usually occurs due to economic weakness and contraction; however, growth prospects are positive for Botswana (Section 5). It is, nevertheless, possible that there could be sector-specific, idiosyncratic shocks affecting a sizeable number of workers. The export-oriented mining sector is particularly vulnerable to external developments, while the construction/property sector is prone to asset price bubbles and has strong links to the financial sector, including through participation by households and pension funds. Any tightening of monetary policy and related higher interest rates is likely to add to household debt burden.
- 4.14 Sectoral lending by financial institutions is diversified (Chart 2.20), with most lending going to the retail/trade sector, while concentration with respect to individual borrowers is closely monitored through the supervisory framework. It is noted, however, that the combination of exposure to households and the increase in lending to the construction and real estate sector could represent potential vulnerability; there is, therefore, need for close

monitoring. Exposure of banks to the mining sector is modest. Some loss of employment could also occur as a result of privatisation and generalised rationalisation by the Government and other significant employers. In this regard, it may be relevant that implementation of privatisation should take place at a measured pace and should take account of concerns about related job losses.

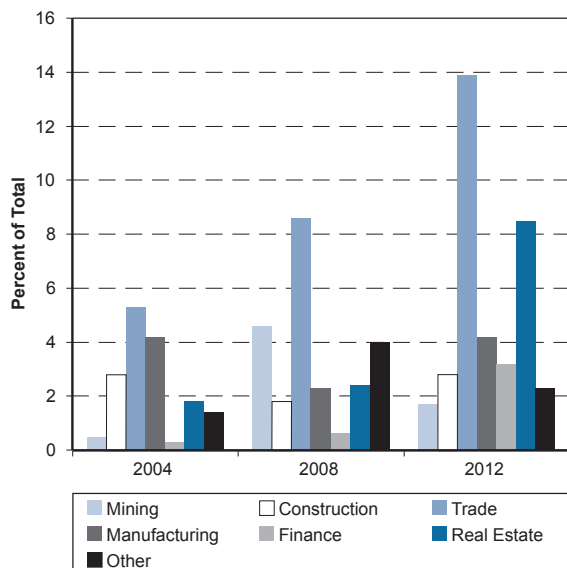
(b) Market Conduct and Consumer Protection

4.15 In Botswana, there is greater reliance on consumer literacy and bank disclosure to affect consumer choices. In a macroeconomic environment that is conducive for profits and business growth, banks are unlikely to be restrained in offering credit where there is a positive assessment of the borrower's ability to repay. Therefore, there is need for diligence by individual borrowers and regulators to forestall emergence of unsustainable debt and financial instability. Such considerations inform the mitigating or remedial measures adopted by several countries.

4.16 Similar to other regulatory authorities, the Bank of Botswana has powers to regulate fees and charges in the banking sector. However, in the context of an economy where prices are predominantly determined through the free market, the Bank has chosen a monitoring approach and enforcement of disclosure and transparency requirements. In this regard, the Bank evaluates tariff proposals by banks to guard against excessive fees and charges that may not reflect costs incurred by the banks or where financial inclusion could be undermined. Furthermore, banks are required to fully disclose charges to their customers, including the total cost of borrowing (annual percentage rate), inclusive of all other costs, such as arrangement fees, insurance and others. Similarly, banks are obliged to publish interest rates payable on deposits on a monthly basis.

4.17 The regular bilateral meetings with individual banks and the industry-wide Banking Committee provide fora for deliberating on market

CHART 2.20: COMMERCIAL BANK SECTORAL LOANS AND ADVANCES



Source: Bank of Botswana

conduct, consumer protection issues, projecting the policy and regulator's perspective and consumers' concerns. Moreover, if there is evidence suggesting that any bank does not comply with certain requirements, an on-site compliance examination may be instituted. In the past, such examinations focused on the implementation of the policy on disclosure of bank charges, administration of dormant accounts, electronic banking activities, anti-money laundering programmes and handling of consumer complaints.

- 4.18 Regarding customer complaints, the Office of the Banking Adjudicator (OBA) was established in 2002 at the initiative of the banking sector to provide a forum for resolving disputes between banks and their clients. The OBA operates within the internal complaints procedures of individual banks and the Adjudicator intervenes when these are exhausted.

(c) Credit Market and Information Sharing

- 4.19 Sharing of comprehensive credit information helps encourage discipline among borrowers, thus limiting default risks to the banking sector leading to lending conditions that are better aligned to actual risk. With such credit information, banks can evaluate the concentration of risk exposure and regulators can monitor the industry more effectively, thus enhancing financial stability and associated policy responses.
- 4.20 In the context of Botswana, a formal credit register would need to be established because the current private credit registries have been ineffective in terms of providing relevant information to guide decision making. The credit bureaux share predominantly negative data, as credit providers are currently less willing to share more positive information about their clients. This is perhaps understandable (they do not wish to risk losing good clients to their competitors), but undermines the potential benefits of effective information sharing for the economy as a whole. Moreover, there is a large number of credit providers, especially

outside the banking sector, who do not provide any data to the credit bureaux; thus, the sharing of complete credit information is undermined. The Government is working with the World Bank to formulate legal, regulatory and institutional framework needed for credit reporting systems to operate effectively in Botswana.

5. INFLUENCES ON HOUSEHOLD USE OF FINANCIAL SERVICES GOING FORWARD

- 5.1 Households' use of financial services is determined by factors that can broadly be categorised into macroeconomic policy and regulatory framework, market structure and conduct, type of financial institutions, instruments and operational strategies, and consumer behaviour. Current and prospective developments in these areas will influence future trends in household participation in the financial sector.

(a) Macroeconomic Policies

Monetary Policy

- 5.2 Typically, the primary objective of monetary policy is price stability. An environment of low, sustainable and predictable inflation encourages saving that, in turn, finances investment, feeding through into additional income-earning opportunities. Households, especially those with lower incomes, are particularly vulnerable to the negative effects of high and volatile inflation where the value of financial savings is easily eroded.
- 5.3 Guiding interest rates is a key channel for the transmission of monetary policy and its impact on the choice between borrowing and saving. The current monetary policy framework encompasses transparency, a clear objective and guidance on future trends that should continue to facilitate the formation of expectations conducive to household participation in the financial sector.

Fiscal Policy

- 5.4 By setting the appropriate balance between public revenue and expenditure, fiscal policy determines the government's position as a saver or borrower within the economy. In turn, the positioning of government as either a borrower or saver within the economy is likely to affect significantly the characteristics of domestic financial markets and saving options for households. Most notably, government borrowing is relatively low-risk and involves instruments with different maturities and can, therefore, underpin capital market development. Such investments are often well-suited to the requirement of savings by households, either directly if there are readily accessible markets for government debt at the retail level, or indirectly through institutional investors such as pension funds.
- 5.5 Conversely, in cases where the surplus position of the budget has limited the need for public debt, this may pose a challenge for matching household savings with appropriate investments. This has historically been the case in Botswana, and a positive fiscal position will continue to imply limited opportunities for such long-term investments, which suggests that foreign, domestic equity and property markets will be the main choice for asset portfolios of institutional investors. At the same time, favourable government finances imply discretion with respect to expenditure, the pace of the rationalisation and ability to respond to shocks and maintain stability.

Exchange Rate Policy

- 5.6 The exchange rate is key to many financial decisions that have an international dimension, including by households. In turn, the mechanism through which the exchange rate is determined can influence the development of related financial services. Botswana has adopted a crawling band exchange rate policy in a fully liberalised environment,²⁹ where the

Pula is fixed to a basket of currencies to moderate bilateral currency fluctuations. The relative stability of the exchange rate and absence of exchange controls offers opportunities, albeit more limited for households, to borrow and invest abroad. At the same time, however, to the extent that the current exchange rate policy framework helps reduce risk, the need for financial instruments that are intended to offset currency risks is also reduced.

(b) Financial Sector Policies

- 5.7 The policy objectives for the financial sector are set out in the tenth National Development Plan (NDP 10)³⁰ and elaborated further in the subsequent Financial Sector Development Strategy of 2012 – 2016. The overarching policy objective is to broaden financial services, increase the efficacy of the supporting infrastructure and safeguard financial sector stability. This is in recognition of the facilitative role the sector plays in economic growth and development, including poverty alleviation. The key policy areas include the licensing policy, privatisation of development finance institutions, the legal framework, developing financial infrastructure, broadening access to finance, modernisation of payment systems and improvement in financial education.

Licensing Policy

- 5.8 It is important that the licensing policy continues to promote competitive markets, while also embracing the need for a diversity of institutions to meet specialised needs and promote local ownership and geographic spread, thereby, increasing productive utilisation of resources across income levels and localities. Such a combination of factors, complemented by increased financial literacy, should improve access to financial services, with the potential to reduce Government interventions and subsidised finance.

²⁹ That is, there are no restrictions on the amount or purpose of foreign exchange transactions (provided, of course, that the transaction is not otherwise illegal).

³⁰ Ministry of Finance and Development Planning, National Development Plan 10, April 2009 - March 2016.

Privatisation

- 5.9 Privatisation, as envisaged in the Privatisation Policy of 2000 and subsequently developed within the framework of the 2005 Privatisation Master Plan (PMP), is consistent with increased participation by households in the financial sector. Such privatisation is expected to affect financial services available to households in two main ways. First, through the opportunities for households to make investments by acquiring shareholdings in these enterprises, which may also then make greater use of capital markets for sourcing additional funding requirements.
- 5.10 Second, in the case where the entity to be privatised is itself a financial institution, the range of financial services that are provided might be expected to change. In such instances, there may be a case for mechanisms that safeguard the original developmental mandate of these institutions. For this reason, the option of privatising the Botswana Savings Bank is not currently being considered,³¹ while the Government is to maintain majority control of the NDB. Such safeguards must be implemented with care, however, as they risk diluting the benefits of commercialisation, including for innovation and quality of service, which is an important aspect of financial inclusion.

Modernisation of Payment Systems

- 5.11 The systemic importance of the payments and settlement necessitates sufficient adaptability to accommodate the evolving needs of a growing economy, while mitigating opportunities for fraud. In this regard, the Bank of Botswana continues to ensure that the national currency meets the requirements for secure and efficient cash-based transactions. The Bank also works with other stakeholders, including financial institutions and regulators in other jurisdictions, to maintain a secure and efficient environment for domestic and international transactions. Recent and on-going de-

³¹ Rather, it is to be strengthened and strategically repositioned through a merger with BotswanaPost, which will enhance service provision utilising the post office network.

velopments include facilitating use of mobile phone banking technology for payments and other services; increased use of card-based payment instruments; improving the security of payments and settlement systems; upgrading the cheque processing infrastructure and enacting the supporting legislation. Moreover, Government is taking the lead in financial innovation through use of the smartcard-based payments systems and facilitating improved and timely availability of data.

Enhancing Public Financial Education

- 5.12 For the efficient provision of financial services, it is important to reduce the degree of information asymmetry between financial institutions and their customers.³² The risk of credit default and, hence, the cost of borrowing can be reduced if lenders have better knowledge of borrowers' creditworthiness. Similarly, customers' access to financial services is more effective when they have adequate information of financial products and can make comparisons between alternative service providers. Financial literacy is, therefore, of critical importance to households including, *inter alia*, information on credit and saving instruments (costs and benefits), knowledge of dispute resolution mechanisms, awareness of obligations of financial institutions, as well as capacity to use technology-based transactions. It is in this context that the FSDS advocates for development of a consumer protection framework, which will strengthen information disclosure, consumer awareness and avail opportunities for redress mechanisms with in-built response to aggressive competitive marketing of risky financial products such as personal credit and insurance.

(c) Supervisory Developments

- 5.13 The significant transformation of the financial sector since enactment of the current Banking

³² Information asymmetry refers to a situation where one party in a transaction has inadequate information about the other's behaviour, which may expose them to unforeseen risks. This problem is common across a wide range of financial services, for both financial institutions and their customers.

Act in 1995 warrants legislative review in order to address current and prospective needs of the financial system. The proposed review would facilitate conduct of national and cross-border consolidated supervision; allow the sharing of all credit data to promote development of an effective credit information system; facilitate effective regulation and supervision of statutory banks; cater for the introduction of a deposit protection system; and strengthen the central bank's powers to deal with problem bank resolution and systemic banking crises.

- 5.14 In addition, a new Securities Act is anticipated to provide for a comprehensive legal foundation for developing the capital market, while allowing for the effective deployment of modern technologies. Also in the pipeline is the enactment of legislation for Insurance, Retirement Funds and Collective Investment Undertakings, which are critical for ensuring fulfilment of NBFIRA's regulatory and supervisory responsibilities over non-bank financial institutions. Operationally, prospective establishment of a financial Ombudsman's office that will concentrate on sectoral consumer protection codes should address the welfare concerns relating to the use of financial services.
- 5.15 One critical dimension of regulation and supervision is fostering competition in the financial services market and encouraging the development of markets that are "contestable" as indicated by low barriers to entry and exit.³³ Related to this is the requirement that all service providers, both current and potential, have equal access to the supporting infrastructure, such as payments systems necessary for the effective supply of such services. At the same time, there is a need to ensure adequate "harmonisation" of regulations across institutions such that there is no differential treatment (for instance, regulation and taxation) for functionally similar

products.³⁴ Regulatory harmony also limits opportunities for "regulatory arbitrage", thus promoting systemic stability.

- 5.16 The Competition Authority complements the regulatory bodies (Bank of Botswana and NBFIRA) where such a separation of responsibilities ensures that the objective of promoting competition is applied uniformly across the economy, and distinct from prudential regulation. Moreover, there is scope for collaboration and coordination between the institutions for effective delivery of their mandates. This is as exemplified by signing of memoranda of understanding between the Competition Authority and regulatory authorities, which recognises the mutually beneficial relationship between regulation and competition. In an environment of increased competition, deficiencies that lead to higher costs of intermediation and restrict access to financial services become apparent. As such, regulatory responses tend to reinforce competition. Nevertheless, it is also recognised that although competition in the provision of financial services has beneficial consequences, when uncontrolled it may produce undesirable outcomes, particularly in a situation of weak regulation and supervision, and dysfunctional consumer protection mechanisms. Furthermore, competitiveness in an undisciplined market can reduce banks' incentive to invest in obtaining information about their clients.³⁵

(d) Economic Growth Prospects

- 5.17 The medium- to long-term growth prospects for the economy appear to be well supported by a combination of conducive macroeconomic policies, economic diversification ini-

³³ Contestability means that there are neither prohibitive barriers to entry into a market nor high enough withdrawal costs from it to prevent new entrants, either of which can limit competition.

³⁴ Where non-banks provide traditional banking services, such as loans, for example. Such "shadow banking", of which lending to households is a common manifestation, is also a significant and growing concern in developed economies.

³⁵ In cases where such information can become easily available to other banks, they may reduce lending to those borrowers about whom they do not have the necessary information. This is a challenge, for example, in establishing credit bureaux which require the sharing of positive as well as negative information about banks' customers.

tiatives, financial sector development strategy and recovery of the world economy from the hardships engendered by the 2007 – 2008 crises. Inclusive and broad-based growth and enhancement of living standards will also benefit from efforts to improve the infrastructure, eliminate skills gaps and address the incidence of poverty. Thus NDP 10 envisages GDP growth averaging 5.8 percent per annum from 2010 to 2016 covering output expansion in both the mining and non-mining sectors. Growth is also facilitated by development of the financial sector, while a balanced increase in economic activity also helps to sustain financial stability. Therefore, broad-based and inclusive growth, alongside expansion and deepening of the financial sector, should enhance financial inclusion.³⁶

- 5.18 On the supply side, there is potential for an increase and improvements in institutions and instruments serving diverse localities and income groups. In turn, demand is driven by security of employment income and wealth generating opportunities. Such progress promotes the development of infrastructure and other operational processes highlighted above. All in all, positive growth should increase household participation in the economy, as well as enhance the associated benefits.

6. CONCLUSION

- 6.1 Active participation by households in the financial sector is essential for sustained growth, development and improved living standards. This is because households are a principal source of funding for productive investment, while they benefit from a range of financial services that enhance welfare. The experience varies from country to country, but a well-developed financial sector, accessible

to households from across all income groups and locations, is a feature of successful and mature economies. Conversely, persistent exclusion of households from the financial sector, due to limited and/or costly services, is a challenge faced by many developing countries. Although Botswana is a middle-income country, it faces similar challenges of modest financial inclusion and development, as well as relatively high costs of services.

- 6.2 Looking at the extent of household participation in the financial sector in Botswana, there are many positive signs, as evidenced by progress with respect to financial inclusion and the emergence of a wide range of financial services, over and above those provided by traditional commercial banking. Among the important developments are the growth of the contractual savings industry and the opportunities to participate in the securities market, as well as the increase in mortgage lending by banks. Moreover, the beneficial impact of increased competition, in terms of products, innovation and service provision, is also clear. Such developments cover both the intermediation (savings and loan products) and the transactions processing and money transfer functions.
- 6.3 Nonetheless, there are a range of challenges that need to be addressed if households are to maximise the benefits from access to financial services. These provide the basis for much of the agenda for action, as set out in the FSIDS. The absence of long-term domestic investment instruments is a structural feature of the financial sector in Botswana, in large part reflecting the surplus position of the Government that has limited the need to access domestic savings to finance public spending. As a result, long-term household savings, mainly held in the form of pension funds, are effectively driven offshore or concentrated in a limited range of domestic assets, including equity and property, thus adding to the risks associated with such savings. It is not suggested that the Government should relax the commitment to fiscal prudence to provide an outlet for such savings; but the desirability, for

³⁶ The UN System Task Team on the Post-2015 UN Development Agenda in the 'Macroeconomic Stability, Inclusive Growth and Employment' Thematic Think Piece of May 2012 define inclusive growth as 'growth that provides broadly shared opportunities to accumulate assets like education, that allows people to utilise these assets in growth-enhancing activities and to benefit from such activities and that it provides for those that do not benefit directly from growth.'

- savers and borrowers alike, of further developing the long end of the market should be readily apparent.
- 6.4 The extent of household debt and, in particular, whether it is approaching crisis proportions, is a matter of topical concern in Botswana, as it is elsewhere. This is understandable in the context of an environment of subdued growth in personal incomes. Nonetheless, there is little evidence that, overall, household debt is close to levels that are unsustainable in Botswana. Indeed, using standard metrics, the extent of household debt in Botswana compared to many other countries appears quite moderate. Moreover, measures of financial development, including the amount of credit relative to the size of the economy, suggests very low levels compared to other countries, with significant room for further growth.
- 6.5 However, it is recognised that any increase in credit should be supported by growth in personal incomes and subject to judicious affordability criteria and prudential oversight. Moreover, it should not threaten macroeconomic and financial stability. In this regard, it is notable that, even with the large increase in credit to households, stable conditions continue to prevail, while individual financial institutions are sound, with prudent provisions for non-performing loans and adequate capital to support sustainable operations.
- 6.6 This assessment should, however, not detract from a balanced consideration of potential vulnerabilities of the household debt situation, especially because it is future outcomes that are more relevant. Among other factors, it is recognised that there are clearly instances, as in many other countries, where individual households, typically on lower incomes, have succumbed to debt traps. Therefore, there is a need, from the consumer welfare and protection perspective, to address credit assessment and referencing mechanisms to guard against widespread chronic and over-indebtedness. From a macro-prudential perspective, the authorities need to be alert to circumstances in which the situation could deteriorate, including the impact of a sudden increase in borrowing costs, fiscal constraints, erosion of asset values and economic weakness.
- 6.7 At the same time, as highlighted in this review, there is currently inadequate information regarding the extent of household debt outside the banking sector. This relates to the overall levels of such debt, patterns of delinquency and how this can impact on debt-related distress among households. Simply assuming that the impact is negligible would not be prudent, and collecting information necessary to fill this gap should be an important priority for the regulatory authorities. Furthermore, it is recognised that households can be both a source and victim of the negative consequences of financial instability. This was seen clearly in the fallout from the recent global financial crises, for which excessive bank lending to sub-prime household borrowers was a major cause. In the wake of this traumatic experience, there has been a new focus on the dangers of financial instability and, therefore, development of appropriate regulatory measures to ameliorate such risks.
- 6.8 A further concern relating to household borrowing in Botswana is the extent to which it is skewed toward unsecured, short-term loans, which come at much higher costs and are more likely to be used for funding consumption. In contrast, and unlike the situation prevailing in many other countries, mortgage financing for residential property is very low. In this regard, there seems to be some misalignment between the demand for and supply of housing finance, as indicated by the extent to which unsecured loans are, in fact, used for this purpose. However, this does not suggest reluctance on the part of banks to lend in this category, as indeed it has recently been the fastest growing segment, accompanied by increasing competition. Rather, the supply of affordable housing that is also suitable for mortgage finance is influenced by a range of other factors, notably high costs of construction and limited availability of serviced land and property that can be offered as security.

- 6.9 Regarding the costs of financial services in Botswana, the Bank of Botswana has, in general, opted not to directly control the level of bank charges. However, the Bank has used both moral suasion and a system of “review of bank charges for reasonableness” to contain the cost of financial intermediation. The benefits of encouraging competition among banks, as a means to control costs, restrain growth in fees and encourage innovation are evident, although progress can easily be stifled by a heavily regulated banking system. Nonetheless, it would not be appropriate to maintain a dogmatic stance on this in the face of continuing negative comments regarding the quality of banking services, together with the seeming reluctance of banks in Botswana to streamline their charges. For this reason, the Bank introduced a system where all increases in bank charges are subject to approval and this can be applied more strictly if required. The more stringent approach could include requirements to streamline the range of fees and maintain charges for a set period and would send a powerful signal³⁷ to banks on the need to regulate the cost of banking, such that it is commensurate with service.
- 6.10 It is also recognised that the regulator may not be well positioned to undertake all the functions related to consumer welfare. For this reason, the Bank welcomes the recent establishment of the Competition Authority and proposals to strengthen the operation of credit bureaux and for a Financial Sector Ombudsman. There is also a need for increased cooperation among regulators, both within the country and with other jurisdictions, to afford a comprehensive appreciation of the state of affairs of the financial sector and to ensure that opportunities for regulatory arbitrage are minimised.
- 6.11 The efforts by the regulatory authorities to streamline costs and ensure good market conduct do not, however, absolve consumers from their responsibilities to actively and intelligently exercise their right to choose, and reject if necessary, from among the range of available financial services. For this reason, programmes to promote financial literacy remain central to influencing effective household participation in the financial sector.
- 6.12 Finally, the analysis in this report was supported to a significant extent by a special survey of commercial and statutory banks operating in Botswana to provide more details on their interactions with households, particularly regarding lending activities. The survey proved to be insightful, and the Bank will consider the practicality of updating it on a more regular basis.

³⁷ Indeed the Bank has been increasingly concerned about the proliferation and rate of increase in bank charges that do not appear to match the quality of service and that could also discourage public access to financial services. Banks have also generally failed to respond to moral suasion. The Bank has, therefore, imposed a two-year moratorium on increase of bank charges effective January 2014 to December 2015. In the meantime, a qualified firm/person will be appointed to validate charges and advise on appropriate policies.