

BANKING SUPERVISION ANNUAL REPORT 2003

MISSION STATEMENT

The primary responsibility of the Bank of Botswana (the Bank), as Botswana's central bank, is to promote and maintain monetary stability, an efficient payments mechanism, and a sound and properly functioning domestic financial sector. Pursuant thereto, the Bank's mission is to promote and maintain a safe, stable, sound, efficient and competitive banking system.

In pursuit of its role, the Bank is guided by the Banking Act, 1995 and other various Acts of Parliament governing the establishment and conduct of the financial institutions over which it has supervisory authority, which include commercial banks, investment banks, collective investment schemes, offshore financial services and bureaux de change.

The Bank seeks to promote market integrity, fair-trading and encourage high standards of customer care through consultation and open communication with key players in the banking sector. Furthermore, the Bank is committed to uphold high standards of professionalism and practices consistent with international regulatory and accounting standards for effective banking supervision.

To realise its objectives the Bank will continue to:

- (a) set transparent criteria and guidelines for market entry. General surveillance will be maintained against unlicensed persons or illegal deposit taking activities to protect the integrity of the banking sector;
- (b) receive and process applications for licences against the established criteria;
- (c) establish and update on a regular basis, prudential policies and standards, to monitor solvency, liquidity, large exposures, insider loans, prudent provisioning, risk management strategies and related management structures for effective governance;
- (d) establish effective systems for off-site surveillance and on-site examinations, including reporting, accounting, auditing and disclosure standards; and
- (e) ensure timely supervisory action for effective compliance with banking and other related laws governing the operations of financial institutions.

FOREWORD

This Report sets out the state of the banking industry and other banking supervision issues in Botswana. It highlights key issues contained in the statutory report to the Minister of Finance and Development Planning for the year 2003, submitted in accordance with Section 28 of the Banking Act 1995.

As at the end of 2003, the Botswana banking sector remained relatively small by international standards, and comprised five commercial banks and two investment/merchant banks. That notwithstanding, and amid growing competition within and outside the sector, Botswana banks continue to improve with regard to a variety of products and service offerings.

For its part, the Bank continued to discharge its statutory responsibility of promoting safety and soundness of the banking system in the country, through off-site and on-site surveillance of licensed banks.

The overall assessment is that 2003 was another good year for banks in terms of profitability, solvency and liquidity. There were, however, some signs of deterioration in the asset quality of some banks resulting in increased levels of provisions. Arrangements are in place to redress the situation.

A major positive development was the increased involvement of the banking sector in the development of the capital markets, through issuance of debt and various other types of new financial instruments, intended to optimise their use of capital. Consistent with the central bank's generally restrictive monetary policy stance during the year, a slowdown in the rate of credit growth, especially to the household sector, was noted.

The Bank remains committed to constantly improving the level of banking supervision to cope with global and domestic changes in the banking sector. Accordingly, banking statutes and regulations will continue to be updated, staff trained and supervision procedures reviewed from time to time.

Linah K Mohohlo **GOVERNOR**

STRUCTURE OF THE REPORT

The purpose of this annual report is to disseminate information to the public about the structure and conduct of banking supervision in Botswana. It is based on the 2003 statutory report submitted to the Minister of Finance and Development Planning on the Bank's banking supervision activities.

Chapter 1 deals with an overview of the performance of the banking sector in 2003, while chapter 2 covers issues relating to consolidated supervision and supervision of banking groups. Consolidated supervision involves an evaluation of the qualitative and quantitative strengths of a holding group to which a bank belongs in order to assess the potential financial impact of other group companies on the bank under assessment. Globalisation and the breakdown of barriers between traditional banks and other financial institutions has led to the development of financial conglomerates, both domestically and across borders, resulting in consolidated supervision emerging as an important issue in banking supervision internationally. Chapter 3 provides an update on major operational activities and developments during 2003. Chapter 4 is an update on regional and international developments that directly and indirectly affect the approach to banking supervision in Botswana and globally.

There are technical appendices relating to the framework for banking supervision as applied by the Bank, institutions regulated and supervised by the Bank, definitions of technical banking supervision terms, and tables and graphs on various statistical information on the banking industry.

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CHAPTER 1

TRENDS IN THE PERFORMANCE OF THE BANKING SECTOR

This chapter details the financial position of the banking industry based on financial information received from licensed banks. Additional information in the form of charts is contained in Appendix 6.

1. Balance Sheet Structure

(a) Composition of Assets

Total banking assets as at December 2003 amounted to P14.1 billion, up from P12 billion in 2002 (Chart 1). This represented a growth of approximately 18 percent compared to the 3.5 percent growth recorded in 2002. The increase was funded through a 19.5 percent growth in deposits. As in the previous year, loans and advances constituted the highest portion of total assets at 54 percent, followed by Bank of Botswana Certificates at 18 percent (Chart 2).

Chart 1 AGGREGATE BALANCE SHEET

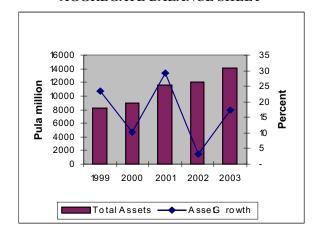
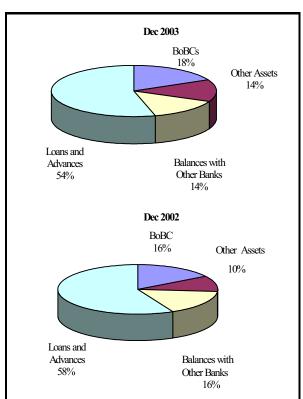


Chart 2
COMPOSITION OF ASSETS



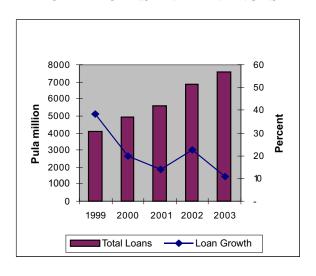
These comprise five commercial and two investment banks. See Appendix 3 for a complete list of financial institutions regulated and supervised by the Bank of Botswana.

(b) Composition of Advances

Total loans and advances increased from P6.9 billion in 2002 to P7.8 billion in 2003, representing a growth rate of 13.3 percent. A five year perspective, however, shows that credit has generally been growing at a declining rate, as Chart 3 shows. The upward growth registered in 2002 was reversed during 2003 as monetary policy was tightened in light of the continuing relatively high rate of growth of bank credit and Government expenditure. introduction of Government bonds in 2003 also provided an additional investment opportunity for some banks and, accordingly, there was a reduction in credit growth as banks channelled funds into the equity market.

A sectoral analysis indicates that the household sector continued to account for the largest share of total advances in the banking industry at 52.5 percent, almost unchanged from 52.9 percent registered in 2002. The business sector accounted for 42.3 percent of the industry advances, up from 40.5 percent in the preceding year. Between 2002 and 2003, household credit grew by 9.5 percent to reach P4 billion, while business sector credit increased to P3.3 billion, representing a 15.2 percent rise. This is a welcome development as it reflects a shift in credit allocation from consumption to income generating activities. Advances to Government and parastatal sector also continued to decline. Advances to parastatals declined by 14.7 percent on the 2002 figure of P462 million, and this is envisaged to drop further in future as privatisation is geared up.

Chart 3
TOTAL LOANS AND ADVANCES



The major component of advances was "other instalment loans", in both 2002 and 2003. Overdrafts continued to constitute a higher percentage of advances (25 percent) than mortgages (17 percent), in part because the banks compete for mortgage clientele with the Botswana Building Society.

Other instalment loans refers to any other loans excluding mortgage loans, vehicle loans, overdrafts, factoring debt and leasing.

Chart 4
STRUCTURE OF ADVANCES - 2003

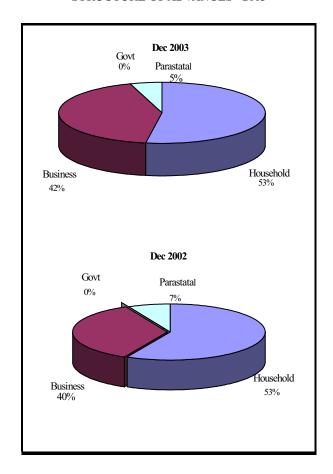
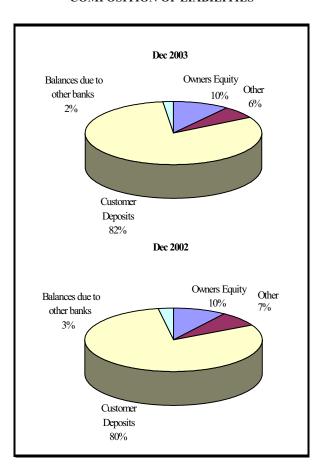


Chart 5
COMPOSITION OF LIABILITIES



(c) Composition of Liabilities

The banking industry was funded primarily by public deposits, loans and shareholders' equity. Customer deposits continued to account for the bulk of the liabilities at 82 percent. Shareholders funds increased by 16.4 percent from P1.2 billion in 2002 to P1.6 billion in 2003, and constituted 10 percent of total liabilities.

(d) Structure of Deposits

Chart 6 is a five-year trend in banking deposits, while Chart 7 shows an analysis structure of deposits by holder for 2003 and 2002. Total deposits in the banking industry increased by 18 percent From P9.7 billion in 2002 to P11.5 billion in 2003. The largest proportion of deposits of P5.5 billion (representing 47 percent of total deposits) was from the business sector, which when contrasted against advances outstanding to the sector at 42 percent (Chart 4) suggests the business sector as a net saver, compared to 31 percent by the household sector. Call deposits constituted the

highest proportion (47 percent) of total deposits, followed by current and fixed deposits.

Although the household sector contributed less than the business sector in absolute terms, the growth rate of its share contribution to total banking deposits, at 23.9 percent on the 2002 figure of P2.8 billion, was relatively higher, and was exceeded only by that of Government and parastatals. This is a positive development as it reflects an appropriate allocation of resources from households, Government and parastatals to the generally efficient business sector.

Chart 6
TOTAL DEPOSITS

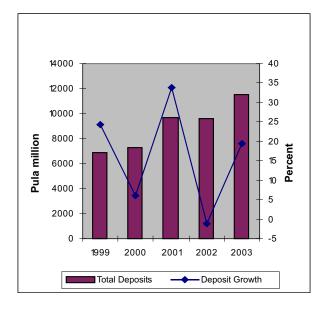
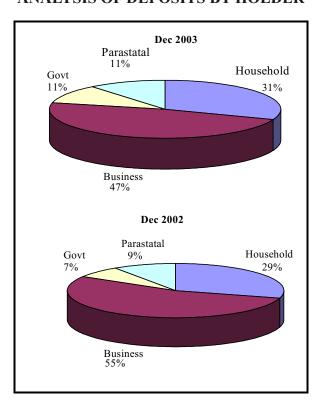


Chart 7

ANALYSIS OF DEPOSITS BY HOLDER

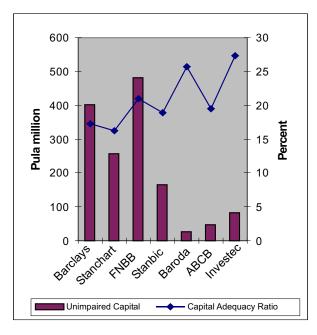


(e) Capital and Reserves

During 2003, the banking industry remained well capitalised with capital adequacy ratios well above the minimum statutory requirement of 8 percent and the 15 percent prescribed as the prudential minimum for banks in Botswana (Chart 8). The capital adequacy ratio of Baroda had declined from 43.8 percent in 2002 to a more realistic level of 17.3 percent in 2003, as the bank continued to build up its deposits and advances. Capital is measured against the total risk-weighted assets of both on and off-balance sheet categories. Thus, institutions with higher proportions of high risk assets are required to hold more capital in order to meet the capital adequacy requirements.

Chart 8

CAPITAL ADEQUACY - 2003



Shareholders' funds increased from P1.2 billion in 2002 to P1.6 billion in 2003, representing a 16.4 percent growth.

2. Levels, Trends and Sources of Profitability

(a) Profits

Table 1

EARNINGS AND PROFITABILITY

OF BANKS

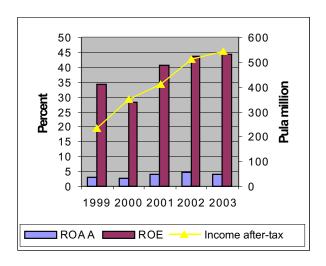
	Am (P'	Growth (Percent)	
	31/12/02	31/10/03	
Interest Income	1 544 842	1 790 653	15.91
Interest Expense	779 438	914 940	17.38
Net Interest Income	765 404	875 713	14.41
Non-Interest Income	452 158	487 912	7.91
Operating Expense	574 230	661 247	15.15
Profit Before Tax	594 856	627 266	5.45
Net Income After Tax	511 184	543 264	6.28
Performance Ratios	Percent	Percent	
Return on Average Assets	4.33	4.15	
Return on Equity	43.77	44.26	
Non -Interest Expense/ATA	4.86	5.05	
Return on Advances	17.48	19.08	
Non-Interest Income/ATA	3.83	3.73	
Interest Income/ Gross Income	77.36	78.59	
Net Interest Income/ATA	6.48	6.69	

^{*}ATA- Average Total Assets

The banking industry continued to be profitable during the year as shown by the increase in income before-tax from P594.9 million in 2002 to P627.3 million in 2003, a growth rate of 5.5 percent. Only one bank recorded a decline in the level of pre-tax profits. Net income after-tax for the industry increased by 6.3 percent compared to 24 percent in the prior year, on the backdrop of two banks that experienced a decline in after-tax profits. The bulk of the profit was derived from interest income.

Chart 9 shows the profitability levels for the banking industry in terms of Return on Average Assets (ROAA), Return on Equity (ROE) and Net Income Aftertax. Appendix 6, Chart 33 and 34 show the trend on individual banks' ROAA and ROE ratios.

Chart 9
PROFITABILITY INDICATORS



(b) Expenses

Total expenses, comprising interest expense and operating expense, increased by 16.4 percent from P1.4 billion in 2002 to P1.6 billion in 2003. Interest accounted for 58.5 percent of total expenses while the rest was operating expenses. Interest expense increased by 17.4 percent in 2003 compared to 15.1 percent in 2002. This increase was a result of the 19.5 percent growth in the industry's total deposit liabilities. Operating expenses increased by 15.2 percent in 2003 compared to 28.5 percent in 2002. This was due to a number of reasons varying across the banks, such as increased management fees, information technology costs and branch refurbishment costs.

(c) Efficiency

Table 2 shows various ratios used for measuring operating efficiency of the

banking industry. The banking industry's net spread decreased from 9.1 percent realised in the prior year to 7.4 percent in 2003, while the net interest margin decreased from 7 percent in 2002 to 6.7 percent in 2003. There was an improvement in efficiency as shown by the Net Income per Employee, which P204 470 to P214 730 increased from in 2003, and Assets per Employee from P4 798 040 in 2002 to P5 564 680 in This was, however, achieved at a higher Staff Cost per Employee, which increased from P104 970 in 2002 to P118 590 in 2003. The Cost to Income ratio followed the same trend and increased from 47.2 percent in 2002 to 48.5 percent in 2003 indicating a moderate decline in the overall efficiency of banks in terms of costs.

Table 2
MEASURES OF EFFICIENCY

Performance Ratio	1999	2000	2001	2002	2003
Net Spread (%)	6.71	7.58	9.42	9.12	7.36
Net Interest Margin (%)	6.46	6.25	6.81	7.03	6.69
Other Operating Income/Average Total Assets (%)	2.64	3.24	3.56	3.83	3.73
Net Operating Margin (%)	9.39	7.08	9.97	5.29	8.82
Net Income Per Staff (P'000)	127.39	156.49	170.03	204.47	214.73
Net Income To Staff Expense (%)	178.43	198.59	192.37	194.75	181.06
Staff Cost Per Employee (P'000)	70.18	78.80	70.80	104.97	118.59
Asset Per Employee (P'000)	4 079.41	4 006.53	4 805.17	4 798.04	5 564.68
Cost/Income (%)	44.43	41.73	44.21	47.16	48.49

(d) Market Share of Deposits and Advances

As shown in Charts 10 to 12, Barclays Bank of Botswana Limited (Barclays) continued to be the leading player in the market in terms of total banking assets, total advances and total deposits, followed by Standard Chartered Bank Botswana Limited (Stanchart) and First National Bank of Botswana Limited (FNBB). As in the previous year, Bank of Baroda continued to be the smallest bank in terms of market share of assets and liabilities. This is attributed to the fact that the bank is a relatively new entrant in the market.

Chart 10

MARKET SHARE OF VALUE OF DEPOSIT LIABILITIES

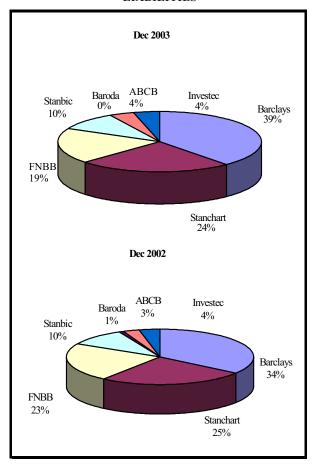


Chart 11

MARKET SHARE OF VALUE OF ADVANCES

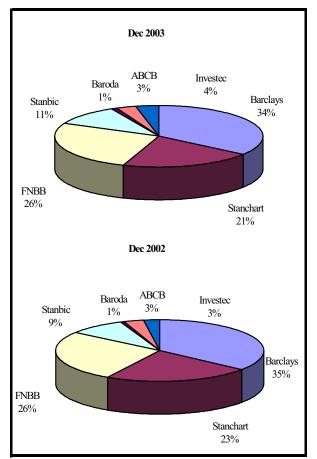
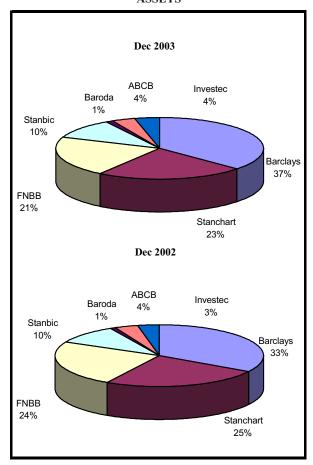


Chart 12

MARKET SHARE OF TOTAL BANKIING ASSETS



(e) Asset Quality

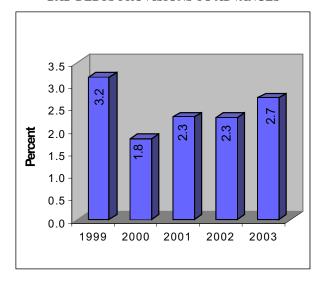
The quality of a bank's assets is assessed by tracking the levels, trends and composition of accounts in arrears, provisions and credit concentrations. A more comprehensive assessment of the asset quality of banks is done during onsite examinations.

(i) Provisions

Provisions for bad and doubtful debts amounted to P213 million as at December 31, 2003, against advances of P7.8 billion, compared to P155.3 million against advances of P7 billion in 2002. This represented an increase of 37.2 percent in provisions for bad and

doubtful debts vis-a-vis a 13.2 percent increase in advances, a trend indicating deterioration in the loans portfolio of the banking industry, which is also reflected by an increase in past due advances. Chart 13 shows the trend in the Bad Debt Provisions to Advances ratio. The ratio increased marginally from 2.3 percent in 2002 to 2.7 percent in 2003.

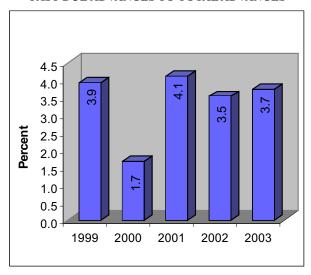
Chart 13
BAD DEBTS PROVISIONS TO ADVANCES



(ii) Past-Due Advances

Past-due advances refers to term loans that are in arrears for 30 days or more. A level of past due advances to total advances ratio of 3 percent or less is considered to be reasonable. During 2003, the Past-Due Advances to Total advances ratio increased slightly to 3.7 percent from 3.5 percent in 2002 as shown in Chart 14. The increase in the ratio was a result of problems encountered in loan portfolio administration by some banks.

Chart 14
PAST DUE ADVANCES TO TOTAL ADVANCES



(iii) Asset Concentration (Large Exposures)

Banks can incur large losses when their lending is concentrated in a particular country, sector, industry or group of borrowers when that market segment experiences problems, which make it difficult for such segment to service its debt obligations. The acceptable level of lending concentration will vary with resources and policy of a bank. However, a single exposure in excess of 10 percent of a bank's unimpaired capital is considered undesirable. The total of credit facilities (advances plus off-balance sheet items), which were 10 percent or more of the unimpaired capital of individual banks amounted to P4.6 billion as at December 31, 2003, compared to P4.5 billion recorded in the previous year. At 317 percent, the industry's large exposures to unimpaired capital was within the 800 percent prudential limit.

(f) Liquidity

Charts 15 and 16 show liquidity positions and financial intermediation. respectively, by banks over the past five A basic requirement of public confidence in the banking system is the ability of individual banks to meet depositors' demand to convert their deposits to cash. Thus, depositors and regulators are legitimately interested in the liquidity of banks. During 2003, all banks maintained healthy liquidity positions with Liquid Assets to Deposit ratios higher than the minimum statutory requirement of 10 percent. portion of the statutory liquid assets of the banking industry was held in Bank of Botswana Certificates. There was a reduction in financial intermediation as shown by a fall in the Advances to While this reflected a Deposit ratio. decline in the proportion of deposit funds lent out to the real economy for productive use, it was, nevertheless, a development that was consistent with the Bank's monetary policy goal of containing credit growth.

LIQUID ASSETS TO TOTAL DEPOSITS

Chart 15

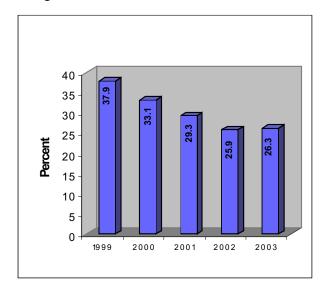
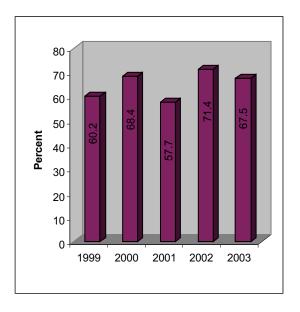


Chart 16
ADVANCES TO DEPOSITS RATIO



(g) Business Locations

The geographical representation of banks changed during the year in terms of branch network, encashment points and Automated Teller Machines (ATMs). One bank introduced mini-ATMs³ to expand its representation in areas without banking representation, in collaboration with some retail stores. The total number of ATMs at the end of December was 125, excluding mini-ATMs.

(h) Employment/Staffing

The total number of employees in the banking industry increased from 2 500 in 2002 to 2 530 in 2003. The small increase in staff numbers was due mostly to the continued efforts by banks to contain their staffing compliments, and the automation of certain banking functions.

Mini-ATMs enable bank customers with VISA badged cards to make cash withdrawals from retail stores against debits to their accounts and credits to the stores' accounts with the bank.

CHAPTER 2

CONSOLIDATED SUPERVISION AND SUPERVISION OF BANKING GROUPS

Introduction

This chapter has been adopted as the theme chapter for this Report because of the growing importance the Bank of Botswana attaches to consolidated supervision. Globalisation and the breakdown of barriers between traditional banks and other financial institutions has led to the development of financial conglomerates, both domestically and across borders. addition, the world economy has many holding companies whose subsidiaries transcend all sectors of economic activity and geographical boundaries. This has led to, inter alia, intercompany credit extension, common directorships and blurred lines of control, resulting in the need for supervisors to extend their scope of monitoring well beyond banks and across borders.

Consolidated supervision refers to a comprehensive approach to supervision of banks through an evaluation of the strength of the entire business group, taking into account all the inherent risk that may affect the bank. Such an approach, especially as applied to international banking groups, owes much to the work of the G10 Basel Committee on Banking Supervision. The emergence of consolidated supervision as it relates to banks began In 1975 when the Basel Committee recommended that supervisors of banks

with cross-border operations, joint ventures and branches, should monitor the risk exposures of such banks, on a consolidated basis to capture their total business operations. A further recommendation was made in subsequent years which stipulated that supervisory authorities may only allow foreign banks to establish in their jurisdiction if they are satisfied that the applicant bank's home country supervisor has the competence to regulate the existing and new establishment on a consolidated basis and, in addition, could meet the minimum standards laid down by the Basel Committee.

The 1990s were marked by increased mergers and acquisitions as institutions in Europe made profits as the region experienced years of successful As a result, economic growth. institutions garnered large financial resources to fund their expansion plans. The advent of a single integrated European Union in 1992 also acted as an incentive for companies to embark on mergers and acquisitions so as to enjoy the full benefits to be presented by the expanded market. emergence of the European Union community market and the heightened shift towards globalisation has attracted more and more entities to opt for mergers or acquire other entities so that they could maintain some foothold in the global economy. Against this backdrop, conglomerates, whose activities include all kinds of financial products with related manufacturing and industrial companies, have emerged.

Consolidated supervision and supervision of banking groups is based on the supervisory authority's appreciation of two factors: that banks often expand beyond their own areas of jurisdiction; and that they often carry out activities other than banking through subsidiaries or affiliates, which may not fall under the ambit of banking supervision. In some instances, a bank may be a subsidiary of a holding company, thus compelling supervisors to pay more attention to the activities of the holding company and its related subsidiaries. Supervision of banking groups presents several problems that are less significant in cases of single entity banks. These include, among others, the contagion effect, counterparty risks, quality and transparency of legal and managerial structures, access to information and issues of moral hazard.

In discussing the above, this chapter looks at issues common to consolidated supervision such as conglomerates, consolidated prudential requirements, international developments and best practice in consolidated supervision, supervision of banking groups, problems and concerns posed by consolidated supervision, the costbenefit analysis of consolidated supervision in Botswana and the adequacy of existing statutes in facilitating consolidated supervision in The chapter concludes with Botswana. a set of recommendations.

Financial Conglomerates

Corporate groupings with respect to financial conglomerates are defined as any group of companies under common control, whose exclusive activities predominantly encompass the provision of significant services in the financial sector (banking, securities, insurance). Studies undertaken by committees established under the joint auspices of the Basel Committee on Banking Supervision, the Technical Committee of the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervision (IAIS) have led to recognition of considerable overlaps between the issues relating to the supervision of financial conglomerates and consolidated supervision. The definition is, however, dependent on specific legislative provisions.

Financial conglomerates vary in terms of structure, range of activities and complexity. From a banking supervisory perspective, different financial services in banking, securities and insurance trading rendered by 'financial conglomerates' have traditionally been kept separate either by law or regulation in most countries. Studies have identified supervisory problems with banks that form part of corporate groupings, which are less significant in the case of single entity Some of the problems identified Banks. include the following:

Ronald MacDonald - "Consolidated Supervision of Banks". Handbooks in Central Banking Series. Bank of England Centre for Central Banking

(a) Contagion

This is the risk that financial and nonfinancial problems encountered by a non-bank member of a group can endanger the financial stability of a bank in the same group. This may be caused by financial and non-financial exposures on non-bank members of the The danger is greatest when a bank has credit exposure to a related company and its ability to repay the bank is threatened. However, even if there is no financial exposure, views of poor performance in such companies may weaken depositor's confidence in the bank consequently and bringing it under liquidity pressure and financial instability.

(b) Exposures to Particular Counterparties

Banking operations are generally subject to regulations that limit their credit exposures to individuals or group-related companies. Whereas non-bank members of the group are usually not regulated, their exposures (financial and non-financial) may have an impact on the overall performance of the corporate group. It is, therefore, important that similar prescriptions are applied to banking groups since in the absence of such exposure limits, individual banks could easily circumvent the limits that apply to themselves.

(c) Transparency of Legal and Managerial Structures

Business groups may have complex structures that hamper effective supervision of banks within the group. In some cases, the legal and managerial structures of a group may be different within companies that form part of the same group and in some cases, complex structures may have been chosen deliberately to obscure their operations or even the true ownership, thereby avoiding effective supervision of their activities. Such arrangements must be thoroughly analysed by supervisors so as to identify lines of accountability within the group.

(d) Management Quality

Management quality is particularly critical in cases where a corporate group is headed by a non-bank parent company since the directors and shareholders of the parent company have effective control over any bank within their group. In such instances, it could be assumed that the directors of the subsidiary bank will normally act in accordance with the wishes of their superiors. It is however, recognised that such a problem may be resolved in situations whereby supervisors have legal powers to vet the suitability of all persons and entities that either have direct or indirect control over the operations of a bank. Alternatively. supervisors would have to establish the precise degree of independence of the directors of such a bank.

(e) Rights of Access to Prudential Information

Supervisory authorities may, in the cause of ensuring effective consolidated supervision of corporate groupings, require information about related non-bank companies. While such information may be voluntarily availed

to supervisors, non-bank related companies may not always provide the required information to banks for onward transmission to the supervisors. To avoid such problems, supervisors should have legal powers to obtain information directly from related non-bank companies, and hence should also ensure that there are no legal barriers to the flow of information before they can authorise their banks to establish cross-border operations.

(f) Moral Hazard

It is important that supervisors should avoid sending any signals to regulated entities that would lead the management of associated non-bank companies to believe that supervisory authorities could render them financial support in the event of financial difficulties as a measure designed to curb erosion of depositor confidence in a related bank. It is imperative that in the process of conducting consolidated supervision, supervisors should take the necessary precautions to ensure that a perception is not created that the activities of the entire group may be bailed out when they encounter financial problems, or have access to the lender of last resort facilities provided by central banks to supervised banking entities.

Consolidated Prudential Requirements

Banks which are part of a corporate group present challenges that are not common in single entity banks. Apart from the problem of contagion mentioned above, group set-ups enable banks to circumvent exposure limits that apply to them through complicated

intra-subsidiary lending. In order to mitigate against exposure of banking operations to non-banking activities, supervisory authorities should be empowered to require banks to submit both their accounts and those of their related companies. In instances where related companies operate in other jurisdictions, the supervisory authorities should seek and obtain consent of the host supervisors that they will facilitate submission of consolidated accounts. The objective of consolidated accounting is to assess the extent to which any other operation may impact on the supervised bank irrespective of whether these risks are carried in the books of the bank or related entities.

In order for consolidated supervision to be carried out effectively, the supervisors have to stipulate the scope of consolidation, that is, the types of entities that should be included in the consolidation process. Supervisors should also give guidance on the accounting methods to be adopted so that the concerned banks can understand the types and methods of consolidation to be followed. Scope of consolidation will usually require that prudential returns reflect financial statements for the supervised entity and all relevant financial companies within the group. For purposes of consolidated supervision, financial companies of interest are usually those that are controlled by the same or similar shareholders as the bank itself. case of Botswana, financial institutions include money transfer companies, brokerage companies, leasing companies, financial advisory service companies, asset management companies, or any other entities whose

operations are perceived as involved in financial business during collection of national economic statistics. Insurance companies are not included in consolidated supervision because insurance risks essentially pertain to uncertainty in the values of assets and liabilities. Consolidating insurance and banking balance-sheets would result in misleading measurements of the supervised bank's risk exposure.

Supervisory authorities may consider a consolidated approach in cases where a holding company has a parental relationship with a banking group as the former might be directly responsible for raising capital from the capital market for the banking concern, which might in turn on-lend to its related companies. It is appropriate in cases where group companies are predominantly engaged in banking-related activities that a nontrading holding company be included in consolidated supervision approach. However, if the supervised bank is a subsidiary of a foreign bank from a country with a competent supervisory authority, it is not necessary to transmit the consolidated supervision process upward. In such cases, the supervisory authority should establish if effective consolidated supervision is undertaken on the parent-banking group.

There are particular instances when banks establish token subsidiaries so as to meet company law and regulatory requirements. This has been the trend in Botswana where some banks established nominees, insurance and property divisions whose purposes is to facilitate participation in the equity market, provision of insurance cover for the assets of the bank and

management of own properties. In the case of nominee entities, they are transitory bodies whose primary purpose is to be used by entities to engage in transactions or carry out associated activities and usually have no effect on the capital structure of the bank. Hence it is not important to have them included in consolidated supervision. As well, like in the case of insurance meant to cover own assets, own property management division typically account for an insignificant amount relative to the total capital of each of the respective banks, hence it is not cost effective to consolidate these accounts with those of the bank. general, the supervisory authorities may issue a cut-off-size below which a subsidiary may be taken to be too small for inclusion in the consolidation process.

Supervisors may establish whether an entity should be included under consolidated supervision through the use of company law and accounting definitions of what constitutes a subsidiary or an associate. where the existing company law statutes are found to be inappropriate, given prudential concerns, supervisors may establish their own definitions to work The Companies Act (Botswana) defines a subsidiary as any company that has no less than 50 percent of its equity held by another. An associate company is one where a company has less than 50 percent equity holding in another company. In this case an equity holding company has significant influence, but no control.

Some supervisory jurisdictions have regulations that require the publishing

of consolidated accounts. Those that do not generally rely on the International Accounting Standard No. 27, which provides a guide under which consolidated accounts should be presented to help reveal the full extent to which the group's profits are attributed to the bank and its related companies. In order to guard against an inflated figure for the group's capital, the share capital of subsidiaries included in the consolidation process should be excluded. The balance-sheet of the supervised bank and the related subsidiaries are added on a line-by-line basis (i.e. like items are added up) and, intra-group assets and liabilities are excluded. Also, minority interests in the net income of consolidated subsidiaries for the reporting period are identified and adjusted against the income of the group so as to get the net income attributable to the owners of the parent.

Some jurisdictions adopt merger accounting or pooling of interests to consolidate accounts when companies merge as a result of shareholders exchanging shares for shares in a new company emanating from the merger. In this approach of consolidated accounting, the reserves of the affected companies are included in the consolidated balance-sheet of the merger.

One method of consolidation that supervisors should be aware of is acquisition accounting. As the name suggests, this type of consolidation is employed when a company acquires or establishes an entity as a subsidiary. In this case the pre-acquisition reserves of the subsidiary are usually not included in the consolidation process, i.e., they

are not added to the balance-sheet of the group.

Given the above, supervisory authorities should exercise their prerogative to reject any applicant for a banking licence made by a company that is part of a group with an organisational structure that could impede effective supervision. Thus, cross-border banking operations may only be established with the prior consent of both the home and host supervisory authorities. In addition, there has to be a commitment by both supervisory authorities to exchange information relating to cross-border banking establishments. These are the key tenets upon which the minimum standards for supervision of international banking groups are formulated.

International Developments and Best Practices in Consolidated Supervision

The Basel Committee has established guidelines that define the minimum standards to be followed by countries pursuing consolidated supervision. These guidelines were endorsed by the supervisory authorities of the 10 largest economies and form the basis for a universally acceptable approach to consolidated supervision. The minimum standards are comprehensively covered under the "Supervision of Banking Groups" section below.

In order to assess progress made by members, the Basel Committee carries out a review of each supervisory authority represented on the Committee and identifies any implementation problems encountered. The progress review mechanism is meant to help supervisory bodies that plan to adopt consolidated supervision to have a better appreciation of the potential impediments which they may face as they embark on this type of supervision. Also, tracking progress of consolidated supervision pioneers give multilateral organizations such as the Basel Committee insight into what further refinements are needed as part of the international efforts to supervise banks with international representation.

In the Southern and East African region, concerted efforts are being undertaken to harmonise supervisory practices of member supervisory authorities through the East and Southern Africa Banking Supervisors Group (ESAF), with the aim of promoting the overall standard of supervision in accordance with international best practices. Currently there are no formal guidelines as to the modalities to adopt in case of crossborder supervision. However, there continues to be consultation and cooperation amongst the regional supervisory authorities on all matters relating to supervision including the supervision of international banks.

The supervision of international banking groups requires a great deal of cooperation and information sharing between the home and host countries. A host country's supervisory authority has to determine whether the home country supervisory authority of a bank or b anking group has the necessary capabilities to effectively supervise a bank on a solo and consolidated basis. There are four minimum standards that are to be applied by individual

supervisory authorities in their own assessment of their relations with supervisory authorities in other countries. These are critical to ensuring effective supervision of banking groups and enforcement of minimum standards as set out by the Basel Committee on Banking Supervision and are outlined below:

(a) All international banking groups and banks should be supervised by a home country authority that capably performs consolidated supervision.

To meet this minimum standard the home country supervisory authority should:

- (i) receive and analyse consolidated financial and prudential Information.
- (ii) have the capability to prevent corporate affiliates or structures that either undermine efforts to maintain consolidated information or hinder effective supervision of the bank or banking group.
- (iii) have the capability to prevent a bank or banking group from creating foreign banking establishments in the particular jurisdiction.
- (b) The creation of a cross-border banking establishment should receive the prior consent of both the home and host country supervisory authorities. A host country should only consent to an inward expansion of a cross-

border banking establishment if the home country authority has been given consent to the bank's or banking group's outward expansion.

- Supervisory authorities should (c) possess the right to gather information from the crossborder banking establishments of the banks or banking groups for which they are the home country supervisor. For giving either inward or outward consent for the creation of a cross-border banking establishment, a supervisory authority should establish an understanding with other authorities that they may each gather information necessary for effective home country supervision either through on-site examination or by other means. The ability to gather this information should also have a legal backing.
- If a host country authority (d) determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures as appropriate and consistent with these minimum standards, including prohibition of the creation of a banking establishment. If the minimum standards are not met and there is unwillingness to initiate measures to meet these standards, the host country can prevent the establishment of any cross-border establishment in its jurisdiction. At its discretion,

the host supervisory authority may alternatively choose to permit the creation of such establishments and put restrictions on the scope of the establishment's operations as it deems appropriate to address its concerns.

Common Constraints to Effective Consolidated Supervision

There are a number of problems that are invariably associated with consolidated supervision. The key ones are:

(a) Access to information

Consolidated supervision is based on the principle that supervisors will have access to the accounts and all the requisite information pertaining to the related companies. The age-old confidentiality and secrecy practices inherent in banking business serve as an impediment to consolidated supervision as those in possession of information are often reluctant to make it readily available to other parties. In some cases, the reluctance to disseminate information is due to lack of a clear position in the applicable statutes rather than a deliberate ploy to exploit supervisory gaps. In the case of Botswana, the Banking Act, 1995, gives the supervisory authority the power to request information from banks in Botswana and their affiliates abroad. The Bank of Botswana intends to also incorporate the supervision of bank holding companies in a proposed amendment to the Banking Act, 1995.

The issue of information sharing could be a major problem in cases where some jurisdictions do not confer upon supervisory authorities the legal right to information sharing. In such instances the supervisory authorities should consider and address this kind of impediment for effective prudential supervision at the licensing stage. In Botswana, the Banking Act empowers the Bank of Botswana to share information with other supervisory authorities.

(b) Lack of transparent and welldefined legal and managerial structures

Often group companies have structures that result in officers reporting to a range of superiors, which clouds reporting lines and consequently accountability. This is more so in cases where employees have to report to senior management and other principal officers based in other group companies. Therefore, supervisors should always determine whether or not the group structure to which the supervised entity belongs is not so complex as to make it difficult to identify ownership and operations and, consequently, difficult to supervise.

(c) Moral Hazard

Overall, the essence of moral hazard has been captured under the financial conglomerate topic above. This relates to the perception that the whole group to which a supervised entity belongs is being supervised, and that the supervisors may even bail out any of the group members should it experience any distress. This mistaken view is

often premised on the notion that the supervisory authority would rather financially support a non-bank associate than let it collapse and pose reputational risk to the supervised entities. At times the notion that the supervisory authority would be there to give support acts as an incentive for managerial imprudence within the non-bank entities of the group which otherwise would not be there. This could be manifested through management taking excessive risk than they would otherwise do if the supervisory authority were not interested in any of the group's entities. In order to guard against this type of moral hazard, it is incumbent upon the supervisors to clearly state their interest and the extent to which they might be involved in rescuing the group. Typically, supervisors will provide assistance to a banking group when its problems are perceived to be temporary or rectifiable such as liquidity shortfalls.

(d) Potential to circumvent the fitness and probity requirements

The probity of management is of significant importance in banking operations because, as custodians of public funds, such institutions should be owned and managed by trustworthy and The "fit and proper" credible people. issue becomes a concern where the group's controlling company or holding company is itself a non-banking operation, which means that people who might not directly qualify to own and run a bank are in fact in control. should be appreciated that, in general, it is the principal officers or directors in the holding company who have the ultimate mandate to determine the business strategies for the subsidiaries. Given the foregoing, it is imperative that supervisors should require complete independence of the board or principal officers of the banking operation from the directors of the holding company. Alternatively, the supervisors should seek and obtain the legal capacity to vet all persons that might directly and indirectly have influence on the decision-making processes of the bank.

Cost-Benefit Analysis of Consolidated Supervision

In order for supervisors to appreciate whether or not it is necessary to carry out consolidated supervision, they should consider the rate at which the global financial system is growing both in terms of banks' expansion of their core activities and evolution into other nonbanking activities. The obvious costs relating to consolidated supervision pertain to the need for capacity building. While the development of competent staff is necessary, it is equally more important to develop systems (including adequate legal provisions) and procedures that staff can use in consolidated supervision. As stated above, consolidated supervision requires that supervisors widen their assessment to include related companies whose performance might pose some risk to a In this respect, supervisors should have sufficient understanding of the underlying activities of the related companies. Therefore, before granting a licence to a bank whose parent or holding company has subsidiaries dealing in asset management, brokerage, money transfer or other related activities, the supervisory authority should consider if its supervisory personnel has adequate knowledge to evaluate the activities of the other businesses related to the supervised bank.

Botswana, like many emerging market countries, has many financial activities that are not regulated. This means the Bank of Botswana needs to have adequate resources to monitor the related businesses to which banks might be related. Banks in Botswana are allowed to invest in non-banking activities (as long as prior approval has been obtained from the Bank of Botswana), which makes it likely that banks will in future be related to getting non-bank operations.

Botswana has established an International Financial Services Centre (IFSC). Some of the entities expected to set up in the IFSC include mixed activity companies, which are expected to incorporate their parent structures in the Centre for purposes of warehousing group profits. Therefore, the existence of a consolidated supervision framework and the availability of support structures will not just be a fillip to fostering a competently regulated financial system but may also act as a stimulus to Botswana's diversification goal.

Introducing consolidated supervision will also ensure that Botswana is not left behind when other countries adopt consolidated supervision. Harmonisation of supervisory standards will help mitigate regulatory arbitrage and bargaining by market participants, and help ensure that entities establish in Botswana in response to genuine market

incentives rather than perceived regulatory gaps.

Adequacy of existing statutes in facilitating consolidated supervision

The need to consider consolidated supervision is only now becoming apparent in Botswana, as banks have only started to get involved in non-banking related activities. Though the statutes currently in use have provisions that can facilitate consolidated supervision, these require strengthening to make them more effective.

The requirement of the Banking Act, 1995 that all licensed banks must be fully incorporated entities has meant that the Bank has full supervisory powers over their operations, and thus, is able to regulate their exposures to their parents and fellow-subsidiaries. In as much as Botswana banks are fully incorporated subsidiaries of international banks, they are supervised on a consolidated basis by their home supervisory authorities, and supervised on solo basis by the Bank of Botswana. There is need, therefore, to formalise the host/home regulatory arrangements between the Botswana supervisory authority and the home regulatory authorities for Botswana licensed banks, through Memoranda of Understanding In addition, the legislation (MoU). needs to be reviewed and amended to give force and effect to such MoUs.

Conclusions and Recommendations

Although consolidated supervision is a demanding undertaking, it is considered necessary given the rapid emergence of cross-border activities, particularly of IFSC entities, and the increasing involvement of Botswana banks in non-traditional banking activities, as well as the general growth and sophistication of the financial system.

Although the Banking Act, 1995, permits banks to invest in other activities (with prior approval of the Bank), the existing legal framework is not adequate to facilitate effective consolidated supervision, and supervisors have to rely on Basel Committee guidelines, which are not supported by any legislative provisions.

Given the aforementioned, and the current trend towards globalisation and the erosion of barriers between different types of financial services, it is likely that financial institutions will assume even more complex structures. Banking supervisors must, therefore, respond to the challenge of such developments with respect to banks and, invariably, the risk they represent for depositors. Consolidated supervision, in as far as it relates to banking groups, is an essential It is, therefore, appropriate and timely that the Bank of Botswana takes preparatory steps to make itself ready for this overarching supervisory approach.

CHAPTER 3

MAJOR OPERATIONAL ACTIVITIES AND DEVELOPMENTS DURING 2003

The following are some of the major banking supervision related activities during 2003:

(a) International Financial Services Centre (IFSC)

During 2003, the IFSC Certification Committee considered and approved seven new project proposals, and these were referred to the Bank for regulatory approval. This brought the total number of projects approved since 1999 to 20. The seven new proposals were in risk management and loss control solutions, payroll and financial systems, corporate finance and asset management, cellular network, access to internet services and merchandising of telephones and accessories, wilderness safaris business, treasury management services, and investment fund management. applications were, as of year-end, at various stages of processing, while two were granted approval.

(b) Collective Investment Undertakings (CIUs)

Four proposals for establishment of CIUs were received during the period under review. The proposals were for investment management companies and investment funds. The proposals were at various stages of processing as of year-end.

Approval was granted to Hong Kong and Shanghai Banking Corporation International Limited (HSBC) to market two of its Irish registered sub-funds of

its umbrella fund, HSBC - Capital Secured Growth fund in the domestic market, bringing to 16 the total number of HSBC sub-funds marketed in Botswana as at the end of December 2003.

The Bank continued to monitor the performance of African Alliance unit trusts through monthly returns and the company had four unit trust funds at the end of 2003.

(c) On-site Examinations of Supervised Banks

Full-scope on-site examinations were carried out on Botswana Building Society (BBS) and Bank of Baroda in accordance with Section 24 of the Banking Act, 1995.

The examination of BBS covered an appraisal of assets, assessment of the Society's compliance with the provisions of the Building Societies Act, (Cap 42:03) and the Banking Act, 1995, proper maintenance of records and adequacy of systems and internal controls.

Bank of Baroda's examination included a review and analysis of capital and profitability, analysis of liquidity and asset quality, as well as a review of treasury operations, audit and internal controls. In addition to the full scope examinations, the Bank carried out limited scope on-site examinations of select branches of FNBB, Stanchart and Barclays Bank, with particular focus on internal controls.

Overall, all branches examined were prudently run in accordance with the banks' policies and procedures and internal controls were documented and appropriately enforced.

The Bank further conducted specialised consumer compliance and anti-money laundering examinations on Investec Bank and Bank of Baroda. The examinations focused on anti-money laundering procedures, implementation of the Policy on Disclosure of Bank Charges, administration of dormant accounts, and handling of consumer complaints. The banks were found to be generally in compliance with the policies and procedures.

(d) Licensing of New Banks

No new banks were licensed in 2003, although the Bank received a number of enquiries on the establishment of banking operations in Botswana.

(e) Acquisition of Investec Bank Botswana Limited (Investec) by Stanbic Bank Botswana Limited (Stanbic)

In November 2003, Investec Holdings Botswana Limited and Stanbic Bank reached an agreement for the latter to acquire 100 percent of the shareholding of Investec Bank. It was agreed between the two parties that Investec Bank be acquired as a going concern at a price of P92 million.

The Bank acceded to the merger/acquisition subject to the fulfillment by Stanbic Bank of all

regulatory and statutory requirements by March 31, 2004. The Bank granted Investec Bank permission, on December 31, 2003, to surrender its licence in accordance with Section 11(2) of the Banking Act, 1995 as the initial stage in the merger process.

(f) Micro Finance Establishments

A total of 185 enquiries from people and companies proposing to set up businesses in the informal moneylending sector were received and responded to by the Bank during 2003. The Bank does not license or regulate money lending operations. However, operators are expected to clear their proposals, particularly their names, with the Bank to ensure that they do not violate any restrictions of the Banking Act, 1995.

(g) Consultative Meetings with Banks and External Auditors

Besides examinations, regular supervisory and consultative meetings were convened with all supervised financial institutions throughout the year. Two Banking Committee meetings were held during the year, and matters deliberated upon included bank charges and the increasing level of fraud in the banking sector. Bilateral meetings were also held with the banks and their external auditors in accordance with Section 22(9) of the Banking Act, 1995. The meetings covered topics such as banks' audit programmes, internal controls and emerging developments in supervisory standards and requirements.

(h) Abandoned Funds

In accordance with Section 39 of the Banking Act, 1995, the Bank received and maintained records of abandoned funds during 2003. The total amount of funds currently held by the Bank is P2 954 513. The Bank has been receiving abandoned funds from commercial banks and publishing lists of dormant accounts since 1997. The response from potential claimants for 2003 was the lowest compared to previous years, with only P5 312 claimed.

(i) Bank Charges

The Bank continued to urge commercial banks individually and collectively, to ensure that the level of charges is commensurate with the quality of services provided, and that the charges do not unduly discourage the public from using the banking system.

(j) Bureaux de Change Operations

The total number of bureaux de change as at December 21, 2003 was 31. Of these, 15 were operating in Gaborone and most of the rest were situated at the main border gates and in Maun and Kasane. Seven bureaux de change were licensed and commenced operation during the year. Motswedi Bureau de Change voluntarily ceased operations and surrendered its licence to the Bank, while three opened new branches during the year.

The volume of foreign exchange transacted through bureaux de change has increased significantly over the years. In 2003, they handled sales and purchases equivalent to P184.5 million and P136.3 million, compared to P149.9

million and P115.2 million, respectively, in 2002. The trend is shown in Chart 17.

Chart 17

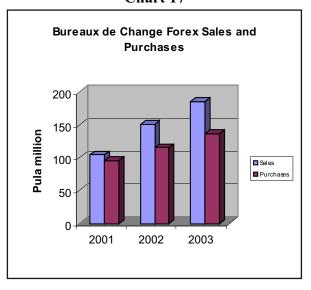


Chart 18 and 19 show the foreign currencies handled by bureaux de change in Botswana in 2003. Trading was mostly in South African rand and United States dollar, which accounted for 71 percent and 23 percent, respectively, in sales, and 67 percent and 27 percent, respectively, in purchases. Other currencies in which there were significant trades included the euro and the British pound. Some bureaux, particularly those operating in the tourist areas of Kasane and Maun, traded in other currencies such as the Namibian dollar, Canadian dollar, Zimbabwean dollar, Australian dollar, Zambian kwacha and the Thai bhat.

Chart 18

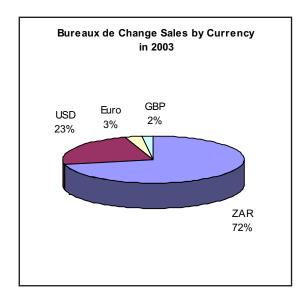
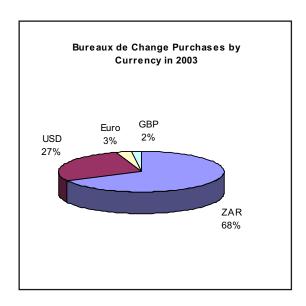


Chart 19



On-site inspections were carried out on some bureaux de change, mostly located in Gaborone. Other inspections were in Mahalapye, Molepolole and Francistown. In general, the bureaux were found to be operating satisfactorily.

(k) Capital Restructuring by Banks

During 2003, FNBB and Stanbic Bank applied for and were granted regulatory approval to raise their Tier II capital by issuing subordinated unsecured bonds. FNBB issued a P200 million callable bond whose initial issue was P100 million. Stanbic issued a debt instrument of P20 million; this was the second and last tranche of the P50 million bond for which the bank had applied and received approval in 2001. The first tranche of P30 million was issued in 2001.

(1) New Banking Products

A number of banks introduced new banking products during the year. FNBB introduced mini-ATMs, internet banking and Bankit, the latter being a corporate Internet banking service. Mini-ATMs, as the name suggests, are small automated teller machines situated in shops in areas where there are no bank branches.

Stanchart opened two new service centres during the year; a Call Centre and a Loan Centre. The Call Centre offers customers the ability to access a number of banking services by phone, free of charge, (except for normal telephone charges if the call is made from a private phone). Barclays introduced the Barclays Business Solution and the Prestige Plus Account. The Business Solution is an integrated range of products and services designed to help customers manage their business finances better.

CHAPTER 4

REGIONAL AND INTERNATIONAL COOPERATION

(a) East and Southern Africa Banking Supervisors Group (ESAF)

The Bank was represented at the 2003 ESAF annual general meeting held in Mangochi, Malawi, on June 26, 2003. Members were briefed on the SADC Committee of Central Bank Governors' (CCBG) desire to turn ESAF into a subcommittee of the CCBG on banking supervision. It was noted, however, that while CCBG comprised Governors of the SADC central banks, the country composition of ESAF was much broader. In this regard, the CCBG decided as follows:

- (i) that the ESAF representative at CCBG meetings had to be from a SADC member country;
- (ii) decisions taken by ESAF should not be in conflict with CCBG activities; and issues under consideration by ESAF should be brought to CCBG's attention at all times.

Other topics discussed at the meeting included projects undertaken by ESAF, Self Assessment on Basel Core Principles for Effective Banking Supervision, appointment of the ESAF Secretariat, election of the Executive Committee and the issue of Basel II implementation, which the Executive Committee was asked to look at for consideration at the next Annual General Meeting.

(b) Basel Committee Activities

The 2001 and 2002 Banking Supervision Reports covered in detail the initial Basel II developments. During 2003, the Basel Committee on Banking Supervision issued a third consultative paper on the Basel II for The comments were comments. received during the year and were published on the official website (www.bis.org) as part of the Committee's efforts to increase transparency on the Basel II consultative process and to help the Committee as it made final modifications to the new capital adequacy framework.



APPENDICES

BANKING SUPERVISION ANNUAL REPORT 2003

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REGULATION AND SUPERVISION OF BANKS IN BOTSWANA

FRAMEWORK FOR SUPERVISION

Introduction

This Appendix outlines the basic elements of the framework, standards and processes for banking supervision in Botswana. The Bank of Botswana (the Bank) is committed to the development of a sound, stable and competitive banking system which promotes savings mobilisation while responding, in a prudent and sustainable manner, to the credit requirements of the economy. The Bank also seeks to adhere to best international practice as enshrined in the Basel Committee's 25 Core Principles for Effective Banking Supervision (see Box 1).

Legal Framework

In general, it is considered that to be effective, a regulatory framework must have sufficient authority established by law, a high degree of independence or autonomy and adequate human and Financial resources. In Botswana, the primary legislation covering the supervision and regulation of licensed financial institutions is the Banking Act, This legislation has been through various phases of development since it was first promulgated as the Financial Institutions Act, in 1975. Important elements of the Banking Act, 1995 are: explicit provisions for the licensing and authorisation processes that give the Bank powers to regulate market entry; guidelines for the management and/or restructuring of banks in distress; the power to establish prudential supervisory standards and policies with respect to capital adequacy, liquidity, restrictions on large exposures, loans to insiders and quality of management; and rules governing accounting, auditing and disclosure of information.

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

Authority for Licensing Banks

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

The responsibility for licensing banks is exclusively conferred on the Bank by Section 3 of the Banking Act, 1995. This Section covers licensing of commercial banks, merchant/investment banks, credit institutions and discount houses.

Licensing Policy and Procedures for Establishing a Bank

The licensing requirements and procedures for establishing a bank in Botswana are set out in Sections 6(1) and 8 of the Banking Act, 1995, and detailed in Banking Regulations 3, 4 and 5.

For any institution to be licensed as a bank in Botswana, it must satisfy the following requirements:

- (a) be locally incorporated in Botswana;
- (b) have the prescribed initial minimum capital, currently
 P5 million, and its owners must demonstrate willingness and

- ability to provide additional financial support as and when required;
- (c) have adequate managerial capacity, which includes the appointment of "fit and proper" persons;
- (d) in the case of foreign banks, the parent bank must be subject to adequate home supervision, and a consent of the parent supervisor to operate in Botswana must be provided;
- (e) the proposed ownership and organisational structure must be acceptable to the Bank and the structure must be such that it allows effective consolidated supervision; and
- (f) the promoter must submit a business plan and five-year financial projections showing the establishment of branch network, products to be provided, and demonstrate ability to enhance effective competition.

Core Prudential Standards

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

1. Capital Adequacy Requirements

A bank must maintain a minimum capital adequacy (solvency) ratio of at least 8 percent, calculated as Unimpaired Capital divided by Total Risk Weighted Assets.1 However, this is regarded as the statutory Banks in Botswana are required to maintain their capital adequacy ratios at or above 15 percent which, in the current macroeconomic environment, is regarded as a safe and prudent level. The kev issue is that a bank must maintain sufficient capital and other financial resources to match the nature and scale of its operations and the risks associated with them.

2. Reserve Requirements

In terms of Section 39(1) of the Bank of Botswana Act, 1996, banks are required to maintain primary reserves against deposits and other similar liabilities as specified by the Bank. Currently, banks in Botswana are required to maintain primary reserves equivalent to 3.25 percent for banks and of their deposit liabilities.

Section 16(2) of the Banking Act, 1995, stipulates that every bank must maintain in Botswana, on a daily basis, liquid assets as a percentage of its deposit liabilities equal to 10 percent and 3 percent credit institutions, respectively.

In general, a licensed financial institution should establish appropriate and prudent policies for the management of its liquidity. It should ensure, to the satisfaction of the Bank, that adequate internal risk management systems exist to monitor and control maturity mismatches between its assets and liabilities.

3. Asset Quality

(a) Asset Concentrations (Large Exposures)

Section 17 of the Banking Act, 1995, restricts a bank from granting facilities that are in excess of 10 percent of a bank's unimpaired capital to a single or group of related customers without the specific approval of a bank's entire board of directors. Furthermore, a bank is required to seek prior approval of the Bank before granting loans and other credit facilities which, in aggregate, are in excess of 30 percent of a bank's unimpaired capital.

(b) Insider Lending

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

(c) Provisions

Section 14 of the Banking Act, 1995, deals with certain items, against which provisions must be held, that is, reserves against potential losses when determining a bank's capital adequacy. It establishes the legal framework for the Bank to assess adequacy of the provisions for non-performing assets.

¹ See Appendix 4 for definition of technical terms.

4. Main Supervisory Approaches

(a) On-site Examinations

The Bank conducts routine on-site examinations pursuant to Section 24(1) of the Banking Act, 1995. The Bank of Botswana may also conduct an examination of a bank if so petitioned by one fifth of depositors as provided for under Section 24(3) of the Banking Act, 1995.

Effective 2000, the Bank adopted a risk-based approach to supervision. This approach entails identification and understanding of the primary business risks of an individual financial institution, and then focusing examination work on these risk areas. The objectives of on-site examinations are to assess and evaluate the overall condition and financial soundness of the institution, its compliance with applicable laws and regulations, and to check the accuracy of statutory reports submitted to the Bank.

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

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

In order to ascertain the prudence of the practices and procedures adopted by a bank, an assessment is made of its risk

management policies and systems as well as its adherence to them. The practices and procedures adopted would reveal the extent to which the financial institution is employing adequate measures to protect depositor's funds, shareholders interests, deployment of resources, and effective measurement and control of risks that are inherent in any banking operation.

The internal control systems are also assessed to determine their effectiveness and the role of the internal audit function. Effective running of operations depends on the adequacy of records maintained, the adoption and implementation of appropriate systems and controls for its functioning and efficiency in preventing fraud and defalcations. Adequacy of supervision of management and effective participation in policy formulation and leadership by a bank's board of directors are important. The Bank of Botswana also reviews management letters from external auditors to ensure that recommendations are implemented expeditiously and effectively.

(b) Off-site Monitoring

Licensed financial institutions are required to submit statutory returns in a prescribed format to the Bank as per Section 20(1) of the Banking Act, 1995. The Act also provides for discussions between the Bank, respective licensed financial institutions, and their external auditors as per Sections 22(8) and 22(9) of the Banking Act, 1995. Banks also submit audited annual financial statements in a format and disclosure standard prescribed by the Bank in line with International Accounting Standard 30.

Off-site monitoring is used to collect and analyse information, on a regular basis, to determine financial performance of a bank. It is also used for early detection of signs of problems so that corrective measures could be taken in a timely manner. Individual institutions are compared with peers and historical trends are monitored. In case of signs of negative developments, the matter is brought to the attention of the management of the institution concerned.

As part of the Bank's early warning surveillance, the monthly and quarterly returns submitted to the Bank by licensed financial institutions are analysed in order to record changes in the CAMELS components. Any significant negative change in any of these components is investigated and the financial institution concerned is monitored in the affected area until there is an improvement. would normally include a special meeting to discuss the particular performance area, or the issue could be raised at any of the regular scheduled meetings. addition to monitoring absolute changes in the balance sheet items, common-sizing the balance sheet is used in order to identify proportions of risk areas and any change in the structure of the banks' balance sheets. For example, a significant change in "balances due from foreign banks" is monitored in order to ensure that the counterparty banks are of acceptable credit rating to minimise risks to the domestic banking industry. As part of its early warning surveillance, the Bank assesses non-adherence to sound banking principles, material changes in accounting policies, deterioration of a bank's asset quality, weakening of liquidity position, declining capital position, and any other circumstances of a bank which could ultimately endanger the safety of depositors' funds.

(c) Statutory Meetings

(i) Bilateral Meetings

In accordance with Section 22(9) of the Banking Act, 1995, the Bank holds bilateral meetings annually with the external auditors of the financial institutions it supervises. The meetings are part of the Bank's strategy to enhance complimentarily of its role as a supervisor and that of statutory auditors. meetings, bank auditors are expected to disclose to the Bank any material issues that may adversely affect the performance of a bank. It is also at such meetings that the Bank takes the opportunity to discuss with auditors, its expectations regarding the scope of statutory audits and other general issues of a prudential nature.

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

(ii) Trilateral Meetings

In addition to the separate bilateral meetings with both external auditors and the respective licensed financial institutions, the Bank, pursuant to Section 22(8) of the Banking Act, 1995, holds tripartite meetings with each financial institution and its external auditors. These meetings are convened to discuss matters relevant to the Bank's supervisory responsibilities that may have arisen in the course of a statutory audit of a bank's business, its accounting and internal control systems, and its draft audited annual balance sheet and profit and loss account. The forum is also used to share

information on the critical risk areas and/or any new developments in accounting and regulatory standards.

Accounting, Auditing and Disclosure Standards

Section 22 of the Banking Act, 1995, requires banks to annually appoint independent external auditors, acceptable to the Bank. Statutory audits are conducted annually, usually at financial year-end, and in instances when a bank intends to capitalise half-year interim profits. The Bank expects at least one monthly statutory return each year to be audited. A change of external auditors or financial year-end requires prior approval of the Bank.

Core Principles For Effective Banking Supervision

The Bank, like other supervisory authorities, is guided in its supervisory approach by the Basel Committee's Core Principles for Effective Banking Supervision. The Core Principles were released by the Basel Committee on Banking Supervision in 1997 for use in both G-10² and non-G10 countries. They comprise 25 Core Principles that need to be in place for a supervisory system to be effective and are used as a benchmark in the development of a country's supervision strategies.

The main objective of the Core Principles is to harmonise international supervisory standards. In Botswana, they are also used to introduce international best practice into banking supervision.

The Bank annually conducts a detailed self-assessment for compliance with the Core Principles using the methodology adopted by the international banking supervisors and recommended by the International Monetary Fund, and submits the report to the East and Southern Africa Banking Supervisors Group (ESAF). Box 1 below presents the 25 Core Principles for Effective Banking Supervision.

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

BOX 1: BASEL COMMITTEE: CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Pre-conditions for Effective Banking Supervision

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Licensing and Structure

- 2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.
- 3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or partner is a foreign bank, the prior consent of its home country supervisor should be obtained.
- 4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.
- 5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose a bank to undue risks or hinder effective supervision.

Prudential Regulations and Requirements

- 6. Banking supervisors must set minimum capital adequacy requirements for all banks. Such requirements should reflect the risk that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basel Capital Accord and its amendments.
- 7. An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.
- 8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.

- 9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.
- 10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.
- 11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate reserves against such risks.
- 12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
- 13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior manage oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.
- 14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
- 15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision

- 16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.
- 17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.
- 18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

- 19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examination or use of external auditors.
- 20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Information Requirements

21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Formal Powers of Supervisors

22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Cross-Border Banking

- 23. Banking supervisors must practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.
- 24. A key component of consolidated supervision is establishing contact and information exchange with various other supervisors involved, primarily host country authorities.
- 25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Source: Basel Committee on Banking Supervision

SUPERVISED FINANCIAL INSTITUTIONS AS AT DECEMBER 31, 2003

(a) BANKS AND OTHER DEPOSIT TAKING INSTITUTIONS

Institution	Postal Address	Business Location*	External Auditors
COMMERCIAL BANKS			
Barclays Bank of Botswana Limited	P O Box 478 Gaborone	39	PricewaterhouseCoopers
Standard Chartered Bank of Botswana Limited	P O Box 496 Gaborone	20	KPMG
First National Bank of Botswana Limited	P O Box 1552 Gaborone	13	Deloitte & Touche
Stanbic Bank Botswana Limited	Private Bag 00168 Gaborone	8	KPMG and PricewaterhouseCoopers
Bank of Baroda (Botswana) Limited	P O Box 21559 Gaborone	1	Grant Thornton Acumen
INVESTMENT BANKS			
Investec Bank (Botswana) Limited	P O Box 49 Gaborone	1	Ernst & Young
African Banking Corporation of Botswana Limited	P O Box 00303 Gaborone	2	KPMG
STATUTORY BANKS			
Botswana Savings Bank ³	P O Box 1150 Gaborone	1	PricewaterhouseCoopers
National Development Bank	P O Box 225 Gaborone	4	Deloitte & Touche
BUILDING SOCIETIES			
Botswana Building Society	P O Box 40029 Gaborone	9	Deloitte & Touche

^{*} Branches, sub-branches, agencies and encashment points.

³

The Botswana Savings Bank uses Post Offices as its agencies for provision of services to the public.

(b) BUREAUX DE CHANGE

Name	Postal Address	Business Location ⁴
Universal Bureau de Change	P O Box 2444 Gaborone	2
Garona Bureau de Change	P O Box 408 Gaborone	5
Kasane Bureau de Change	P O Box 55 Kasane	1
Sunny Bureau de Change	P O Box 370 Maun	1
Exim Bureau de Change	P O Box 1020 Gaborone	1
ASA Bureau de Change	P O Box 2 Lobatse	4
Prosper Bureau de Change	Private Bag B07 Gaborone	4
Kwa Nokeng Bureau de Change	P O Box 10 Sherwood	1
Proxy Bureau de Change	P O Box 404108 Gaborone	2
Edcom Bureau de Change	P O Box 502429 Gaborone	2
Tharil Bureau de Change	P O Box 40074 Gaborone	1
La Civette Tshipalore Bureau de Change	Private Bag 326 Maun	1
Sherwood Ranch Bureau de Change	P O Box 1 Sherwood	2

Name	Postal Address	Business Location
Madikwe Bureau de Change	P O Box 402885 Gaborone	1
Aldaph Bureau de Change	P O Box 41436 Gaborone	2
Counter Bureau de Change	Private Bag F388 Francistown	1
Kalahari Bureau de Change	P O Box 1116 Maun	1
Maeto Bureau de Change	P O Box 22 Mahalapye	1
Bellagio Bureau de Change	Private Bag BR 321 Gaborone	2
Ngina Bureau de Change	Private Bag 39 Francistown	1
SMI Bureau de Change	P O Box 201641 Sherwood	1
American Express Bureau de Change	P O Box 45140 Gaborone	1
Star Bureau de Change	P O Box 80491 Gaborone	1
Motswedi Bureau de Change	Private Bag BR 229 Gaborone	1
Unity Bureau de Change	P O Box 1586 Francistown	1
Royalty Bureau de Change	P O Box 1398 Francistown	2
Gorogang Bureau de Change	P O Box 46785 Gaborone	1

(c) COLLECTIVE INVESTMENT UNDERTAKINGS

Name	Postal Address
African Alliance Botswana Management Company	P O Box 2770 Gaborone
African Alliance International Limited	P O Box 2770 Gaborone

(d) ORGANISATIONS ISSUED WITH EITHER A BANKING LICENCE OR EXEMPTION CERTIFICATE UNDER THE INTERNATIONAL FINANCIAL SERVICES CENTRE

Name	Postal Address
SeedCo. International Limited	P O Box 478143 Gaborone
ABC (International) Limited	Private Bag 00303 Gaborone
African Alliance International	P O Box 270 Gaborone
ABC Holdings Limited	Private Bag 00303 Gaborone
RPC Data International Limited	Private Bag BR 42 Gaborone
Kingdom Bank Africa Limited	P O Box 45078 Gaborone

(e) MICRO-FINANCE INSTITUTIONS

Name	Postal Address
SeedCo. International Limited	P O Box 478143 Gaborone

DEFINITION OF TERMS

BANKING SUPERVISION ANNUAL REPORT 2003

(a) CAPITAL ELEMENTS

CORE CAPITAL+SUPPLEMENTARY CAPITAL LESS IMPAIRMENTS OF CAPITAL = UNIMPAIRED CAPITAL

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

- (a) Ordinary shares (issued and paid-up)
- (b) Perpetual (non-redeemable) non-cumulative preferred shares
- (c) Disclosed prior years' reserves (audited)
 - (i) Share premium
 - (ii) General reserves
 - (iii) Accumulated retained earnings
- (d) Published current year's retained earnings
- (e) Minority interests

less

- (f) Current year's unpublished losses
- (g) Goodwill and other intangible assets
- (h) Shareholders' equity funded through the capitalisation of unrealized gains arising from property revaluation

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

- (a) Current year's unpublished profits
- (b) 50% of fixed asset revaluation reserves
- (c) Unencumbered general provisions not to exceed 1.25% of Risk Weighted Assets
- (d) Hybrid (debt/equity) capital instruments (eligible for inclusion)
- (e) Subordinated term debt (eligible for inclusion)
- (f) Minority interests (in Tier 2 preference shares)
- (g) Shareholders' equity funded through the capitalisation of property revaluation reserves

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

- (a) Investments in unconsolidated subsidiaries and associated companies
- (b) Connected lending of a capital nature, including unlawful lending to directors, owners or their indirect interests
- (c) Capitalised establishment costs/pre-incorporating expenses
- (d) Underwriting commission

4. Total Capital Funds = Sum of 1 and 2

5. Total Unimpaired Capital: 4 - 3

(b) RISK WEIGHTS

ТҮРЕ	RISK FACTOR (%)
On-Balance Sheet Items	
Cash (Pula notes)	0
Balances of Accounts held at Bank of Botswana	0
Loans, advances and other credit facilities to the Government of Botswana or fully and unconditionally guaranteed by the Government of Botswana	0
Assets secured by a lien or pledge over fixed/notice or savings deposits (cash) held by the (same) bank	0
Central Bank Securities (Bank of Botswana Certificates)	0
Advances collateralized by Bank of Botswana Certificates or any securities issued by the Government of Botswana	0
Foreign currency notes	20
Advances to Local Government Authorities	20
Cash items in the process (course) of collection	20
Assets secured by cash investments held at another domestic bank/local financial institution	20
Due from other banks - demand or maturity under 1 year	20
Loans and other advances secured by first class bank guarantees acceptable to the Bank of Botswana	20
Loans secured by recognised multilateral development financial institutions (e.g. International Bank for Reconstruction and Development, African Development Bank, etc)	20
Claims to or credit facilities guaranteed by Statutory Corporations (Parastatals)	20
Claims to or credit facilities guaranteed by Debswana	20
Assets due from or guaranteed by other domestic public sector entities	50
Loans secured by owner occupied residential property	50
Loans secured by commercial and industrial property	100
Financial leases, factoring agreements and Hire Purchase contracts	100
Due from other banks maturing over 1 year	100
Credit facilities to subsidiaries of parastatals (claims on commercial companies owned by public sector entities (e.g. Botswana Development Corporation subsidiaries)	100

Eligible equity investments	100
All other private sector advances	100
All other assets	100
Off-Balance Sheet Items	
Direct credit substitutes (guarantees, Standby Letters of Credit, Banker Acceptances)	
	100
Asset securitized with recourse	100
Transaction related contingent items (performance bonds, bid bonds, etc.)	50
Formal commitments, credit lines (original maturity over 1 year-undrawn commitments) and underwriting and note-issuance facilities	50
Short-term self liquidating, trade related (documentary credits secured by shipment	20
Forward foreign exchange contracts (over 1 year)	5
Forward foreign exchange contracts (under 1 year)	1
Undrawn commitments, original maturity under 1 year or less or can be cancelled	0
Currency Swaps	0
BoBCs held on behalf of customers	0

(c) OTHER TERMS

- (i) Asset Concentration: Measures aggregate exposure to one borrower, an affiliated group of borrowers, or borrowers with a common controlling interest, common management, cross guarantees or financial interdependency that cannot be substituted in the short term. This exposure is usually expressed as a percentage of the bank's unimpaired capital and its various thresholds are subjected to prudential regulatory requirements. In terms of the Banking Act, 1995, exposure in excess of 10 percent of the bank's unimpaired capital is deemed an asset concentration requiring prior approval of the Board of Directors of the lending financial institution. Exposure in excess of 30 percent of the bank's unimpaired capital requires prior Bank of Botswana approval.
- (ii) **Asset Quality**: A relative measure of the performance of the bank's loan portfolio based on the appraisal of the asset, concerning the degree of risk and the likelihood of recovery, adherence to the terms of contracts and orderly liquidation of the account. Good quality asset means the loan, advance, or investment is producing cashflow as was expected and/or agreed upon.

(iii) Adverse Classifications:

- "Substandard" Assets A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardise the liquidation of the debt. They are characterised by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.
- "Doubtful" Assets An asset classified doubtful has all the weaknesses inherent in one classified substandard, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors which may work to the advantage and strengthening of the assets, its classification as an estimated loss is deferred until its more exact status can be determined.
- "Loss" Assets Assets classified as losses are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in future.

- (iv) **Core Capital**: an aggregate of share capital, share premium, general reserve and retained earnings, also called Tier 1 capital. It represents the most stable and permanent form of capital for supporting a bank's operations. (See Appendix 4 (a) for computations.)
- (v) **Total Risk Weighted Assets**: An aggregate of the total value of assets after adjusting for the risk inherent in each asset for both on-balance sheet and off-balance sheet items. A list of assets and the corresponding risk conversion factors used in risk weighting are presented on page 52.
- (vi) **Unimpaired Capital**: Unimpaired in relation to the capital of a bank means the absence of any legal or technical covenant, term, restriction or encumbrance which would otherwise render such capital not to be freely available for distribution to depositors or other creditors in the event of the liquidation or dissolution of the bank, and the absence of any condition or arrangement which would, in the opinion of the Central Bank, diminish the value of the whole or any portion of the capital of the bank. An outline of capital elements used to compute unimpaired capital is presented on page 51.
- (vii) **Weighted Classifications**: represents an aggregate of 20 percent of the value of accounts classified "Substandard", 50 percent of the value of accounts classified "doubtful" and a total of the value of accounts classified "Loss".

(d) RATIOS

- (i) **Return on Equity (ROE)**: Measures the after-tax profit against shareholders' funds. The ratio, however, tends to favour high leveraged banks in that the ratio tends to be higher for low capitalised banks than for large capitalised banks. It is of major interest to the shareholders of the bank; less so for banking supervisory authorities.
- (ii) Return on Average Total Assets (ROAA): Measures after-tax profits as a percentage of average total assets. This ratio is widely used by both banking supervisors and market analysts since assets are the base from which earnings are primarily derived. The ratio measures the earnings capacity of the assets of the financial institution. It measures profit earned against the amount invested in assets and is the key to profitability measurement as it shows how efficiently a financial institution's assets are employed. It is also used to measure the effectiveness of management's decisions with respect to resource utilisation. The higher the ratio, the more efficient the management is in its asset allocation decisions.
- (iii) **Dividend Pay-Out**: Measures the proportion of the after-tax income that is paid out to shareholders. This ratio is of greater interest to investors than for banking supervision. It is the inverse of this ratio, profit retention ratio, that is of greater interest to prudential supervision. Emphasis is on the adequacy of capital with reference to the quality of capital funds in relation to the balance sheet risk profile, i.e., core and unimpaired capital to risk weighted assets ratio. The rationale is that owners of banks must have sufficient own funds in a bank, though it is recognised that unnecessarily high capital levels could result in economic inefficiencies if not employed productively. However, for commercial and other strategic reasons, most banks will retain some of their income to build greater capacity by way of a larger capital base in order to take advantage of lending and/or investment opportunities in large projects.
- (iv) **Capital Growth**: Measures the impact of retained income and other capitalised funds on the capital base of a bank. Ideally, the bank's rate of income retention must keep pace with its asset growth, or risk exposure. Where there is a disparity in growth, especially with acceleration of the latter, the bank's solvency will be gradually weakened.
- (v) **Risk-Based Capital**: In November 1995, the Bank adopted the internationally recommended framework on capital adequacy standards and measurement for banks, commonly known as the Basle Committee framework. In terms of this framework, capital adequacy is measured by the ratio of Unimpaired Capital to Risk Weighted Assets. The move to this method of capital adequacy measurement has sensitised banks to the type of assets they hold and balance sheet risk profiles. It has also broadened and standardised the acceptable supplementary capital items such as unencumbered general provisions, fixed assets revaluation reserves (adjusted by a 50 percent factor) and interim profits (provided an audit had been carried out). It,

however, excludes any elements that are likely to impair a bank's capital such as investment in unconsolidated subsidiaries and associated companies, and connected lending of a capital nature. The use of risk weighted assets is to take into account the risk inherent in the different types of assets. If two banks with exactly the same size of assets and capital base are to be compared, their unadjusted capital ratio will be the same. However, if the inherent risk of the balance sheet is taken into consideration, the bank with less risky assets will enjoy a higher lending capital ratio and can, therefore, expand its business by lending to large borrowers, if opportunities arise. A good capital base ensures that adequate funds are freely available on a permanent basis to absorb risks inherent in the types of assets held by a bank, its off-balance sheet transactions, its foreign exchange dealing operations and all other risks associated with its business.

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

<u>Interest Earned</u> x 100 - <u>Interest Paid</u> x 100 Loans/Advances Interest Earning Deposits

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

<u>Interest Income - Interest Expense</u> x 100 Average Total Earning Assets

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

Other Operating Income x 100 Average Total Assets

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

```
{Yield on Related}

{Earning Assets + Fees x 100} - {Interest Expense x 100}

{All Financial Assets} {All Funding Liabilities}
```

(x) **Net Income Per Staff**: The ratio measures the average income generated by each staff member. Note that this ratio will be significantly different for a wholesale (investment) bank with relatively few but high paid staff compared to a retail bank with a large branch network and many lower paid clerical staff. It is calculated as follows:

Net Income After-Tax
Total Number of Staff

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

Net Income After-Tax
Total Expense

- (xii) **Cost to Income**: The ratio measure the non-interest expenses as a percentage of net interest income plus non-interest income (total operating income). It shows how well the non-interest expenses are managed by an institution relative to the level of total operating income.
- (xiii) **Average Cost of Deposits**: The ratio measures interest paid on deposits as a percentage of total average deposits. It shows the average cost of deposits.

DATA TABLES

BANKING SUPERVISION ANNUAL REPORT 2003

TABLE 3: AGGREGATE BALANCE SHEET OF LICENCED FINANCIAL INSTITUTIONS IN BOTSWANA (Pula million)

Total Assets in Local Currency	1999	2000	2001	2002	2003
1. Cash and balances with the Central Bank	328.4	350.6	471.6	628.2	776.3
a. Currency	229.1	207.9	258.7	327.8	315.8
aa. Hard currency and gold bullion	25.9	36.6	38.0	33.7	32.5
ab. Local currency	203.2	171.3	220.7	294.1	284.2
b. Balances with Central Bank	99.4	142.7	212.9	287.7	417.7
c. Other	0.0	0.0	0.0	17.4	248.5
2. Trading securities at market value (BoBCs)	1 719	1 300	2 0 1 5	1 947	2 518
3. Placements with other banks and credit institutions	1 434	1 534	2 997	1 960	2 004
4. Loans and advances to other customers (net of specific provisions)	4 124	4 964	5 609	6 863	609 /
5. Investment securities	192.5	151.0	78.4	82.9	532.6
6. Fixed assets net of depreciation	160.1	168.0	178.0	197.8	208.8
7. Other assets (net)	198.3	535.1	274.8	368.5	429.5
Total Assets	8 156.9	9 002.7	11 623.6	12 046.9	14 078.6
Liabilities in Local Currency					
1. Amounts owed to government institutions	125.6	121.9	0.1	0.1	0.1
a. Central Bank accounts		0.0	0.0	0.0	0.0
b. Direct Government credits (CB or MoF)	125.6	121 905	117.9	113.6	108.8
c. Other	0.0	0.0	0.0	0.0	0.0
2. Due to other banks and credit institutions	159.4	227.2	229.0	244.2	254.4
3. Securities sold under repurchase agreements	0.0	0.0	0.0	0.0	0.0
4. Due to other customers/depositors	6 851	7 258	9 7 1 8	9 701	11 488
5. Shareholders funds	658.0	829.8	1 014	1 220	1 436
6. Other liabilities	363.1	266.0	544.0	768.0	788.8
a. Taxes payable	61.8	79.3	116.7	126.4	61.7
b. Dividends payable	65.3	139.9	184.6	219.4	53.2
c. Accrued expenses	32.0	44.2	41.1	82.0	135.0
d. Other	203.9	302.6	201.6	340.3	540.7
7. Other borrowing incl. International lending agencies	0.0	0.0	0.0	48.5	
Total Liabilities	8 156.9	9 002.7	11 623.6	12 046.9	14 078.6

TABLE 4: AGGREGATE INCOME STATEMENT OF LICENCED FINANCIAL INSTITUTIONS IN BOTSWANA (Pula million)

	1999	2000	2001	2002	2003
1. Interest and similar income	886.2	1 101.7	1 320.2	1 544.8	1 790.7
2. Interest expense	450.8	565.2	6.929	779.4	914.9
3. Net interest income [1-2]	435.4	536.6	643.3	765.4	875.7
				0.0	0.0
4. Other operating income	224.3	278.0	367.5	452.2	487.9
5. Gross operating income/(loss) [3+4]	659.7	814.6	1 010.8	1 217.6	1 363.6
6. Bad and Doubtful Debts Provision	A/Z	7.5	44.0	46.5	74.7
	A/N	20.0	43.9	619	688
b) General loss provision	A/N	1.5	7.3	8.3	8.9
c) Releases and Recoveries of bad debts previously written off	67.3	5.6	-7.2	-23.8	-23.1
	0.0	0.0		0.0	0.0
7. Operating income/(loss) net of specific loss provisions	592.4	807.1	8.996	1.171.1	1 288.9
				0.0	0.0
8. Operating expenses	308.8	356.7	446.8	574.2	661.2
a) Salaries and employee benefits	140.1	177.1	213.0	262.4	300.0
b) Administration expenses	18.2	21.3	16.6	22.2	0.0
c) Auditing and consulting expenses	2.8	1.4	3.4	6.9	0.4
d) Rents paid	7.4	0.0	9.9	6.6	22.2
e) Depreciation and amortization	20.1	25.9	30.7	30.0	38.5
f) Other	120.1	131.1	176.5	243.4	300.2
					0.0
9. Other provisions and write-offs	0.0	0.0	0.0	0.0	0.0
a) Investments	0.0	0.0	0.0	0.0	0.0
b) Other balance sheet items	0.0	0.0	0.0	0.0	0.0
c) Off-balance sheet items	0.0	0.0	0.0	0.0	0.0
	0.0	0.0	0.0	0.0	0.0
10. Net operating income/(loss) [7-8-9]	283.6	0.5	520.0	596.8	627.7
				0.0	0.0
11. Extraordinary Gains/(losses)	0.0	0.7	0.0	-2.0	-0.4
a) Gains/losses on revaluation of assets (NET)	0.0	0.0	0.0	-2.0	0.0
b) Translation Gains/losses (NET)	0.0	0.0	0.0	0.0	0.0
c) Other Gains/losses	0.0	2.0	0.0	0.0	-0.4
			0.0	0.0	0.0
12. Net income/(loss) before tax [10+11]	283.6	451.1	520.0	594.9	627.3
13. Income tax	27.7	99.5	9.78	83.7	84.0
14. Net income/(loss) after tax [12-13]	225.9	351.6	432.4	511.2	543.3
15. Transfers from revaluation/to general provisions	-0.2	-0.5	6.0-	-0.8	0.0
16. Dividends declared (Paid and Proposed)	105.9	229.6	294.6	489.7	399.0
17. Retained earnings for the year [14-15-16]	120.2	122.6	138.8	22.3	144.3
	265.5	385.7	497.1	632.9	658.2
19. Retained earnings at the end of the year [17+18]	385.7	508.2	632.9	658.2	802.4

CHARTS OF KEY
PRUDENTIAL INDICATORS

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CHART 20
TOTAL CAPITAL

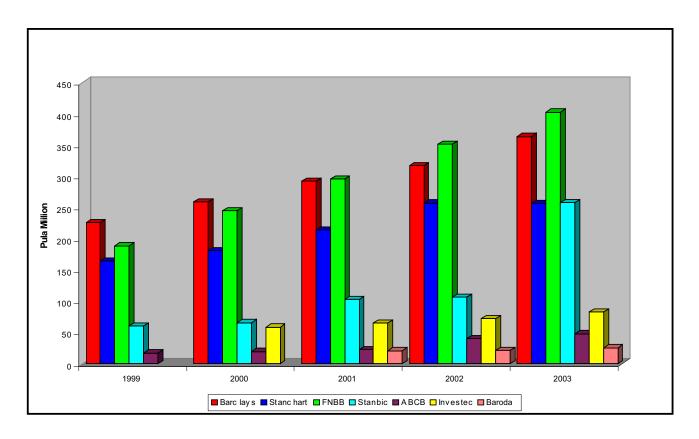


CHART 21
UNIMPAIRED CAPITAL

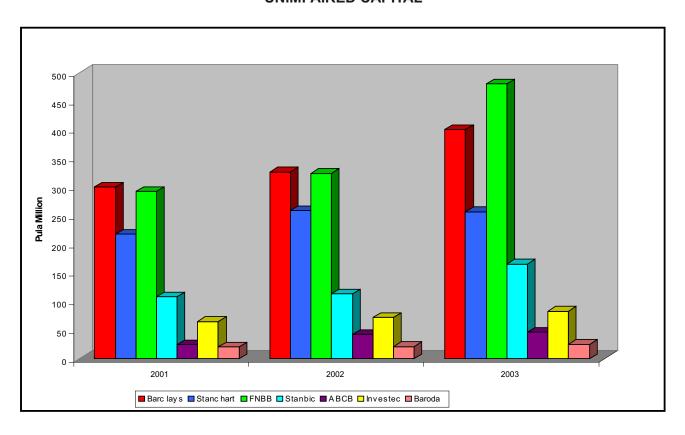


CHART 22

UNIMPAIRED CAPITAL TO RISK WEIGHTED ASSETS (CAPITAL ADEQUACY RATIO)

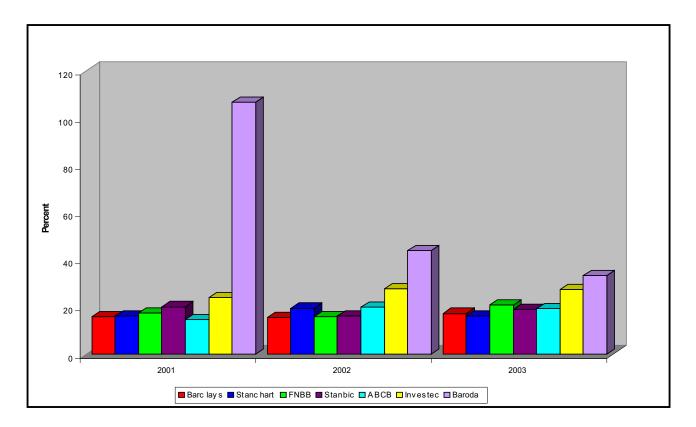


CHART 23

CORE CAPITAL TO TOTAL CAPITAL

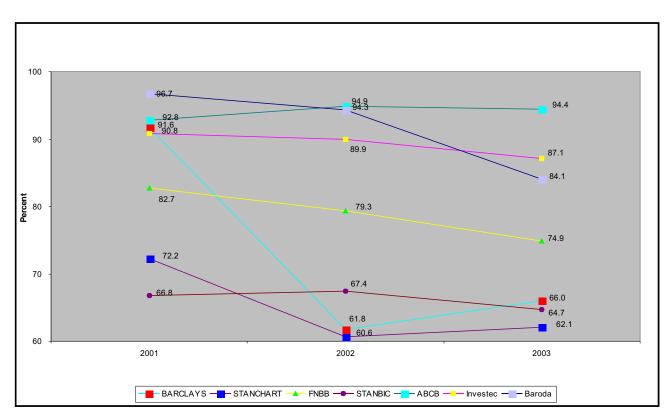


CHART 24

CORE CAPITAL TO RISK WEIGHTED ASSETS

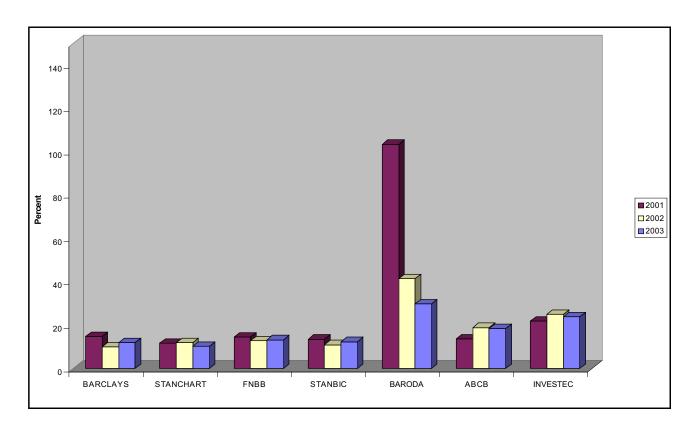


CHART 25

NET INCOME-AFTER TAX AND GROWTH

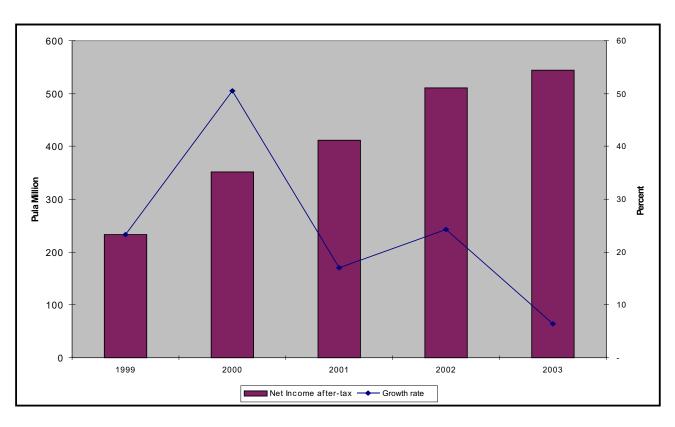


CHART 26
RETURN ON AVERAGE TOTAL ASSETS

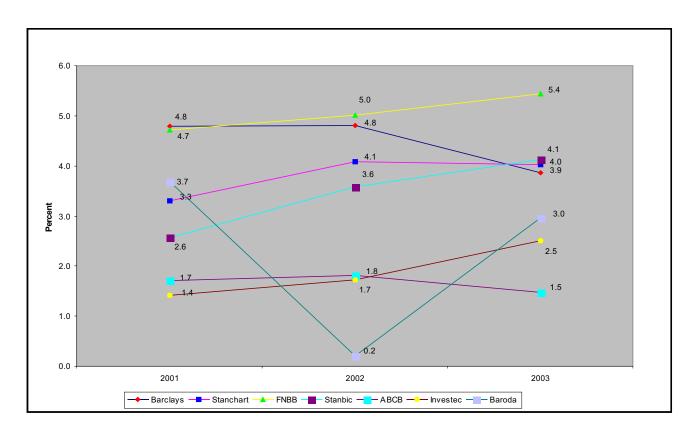


CHART 27
RETURN ON EQUITY

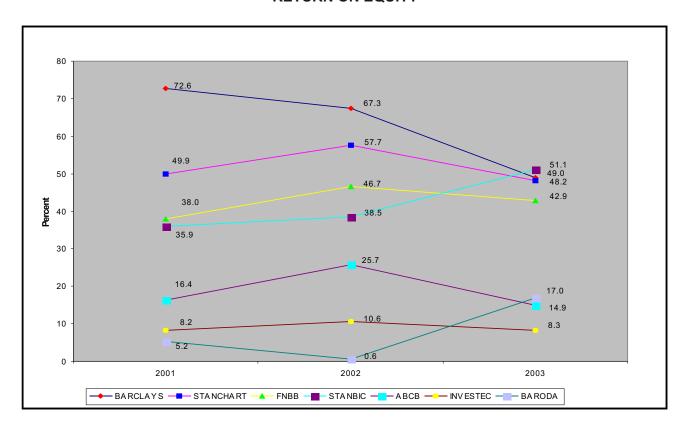


CHART 28

NON-INTEREST INCOME TO TOTAL INCOME

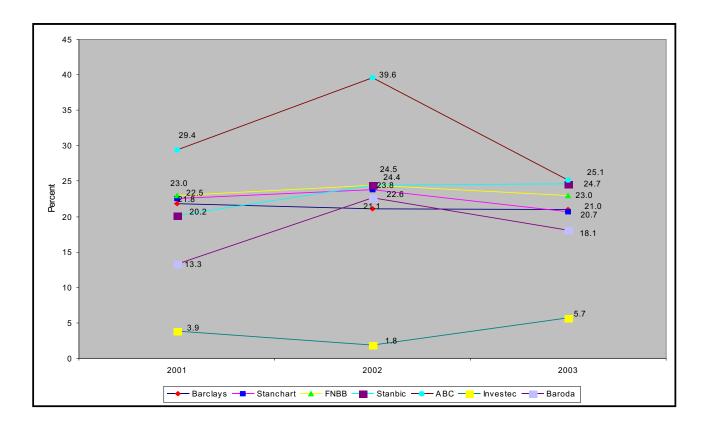


CHART 29

INTEREST INCOME TO AVERAGE TOTAL ASSETS

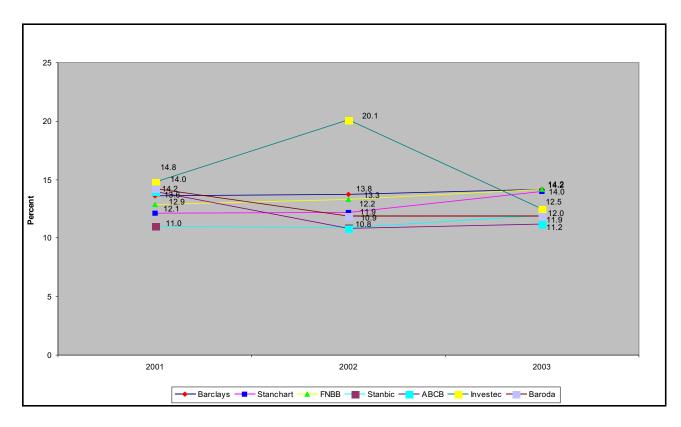


CHART 30

NON-INTEREST INCOME TO AVERAGE TOTAL ASSETS

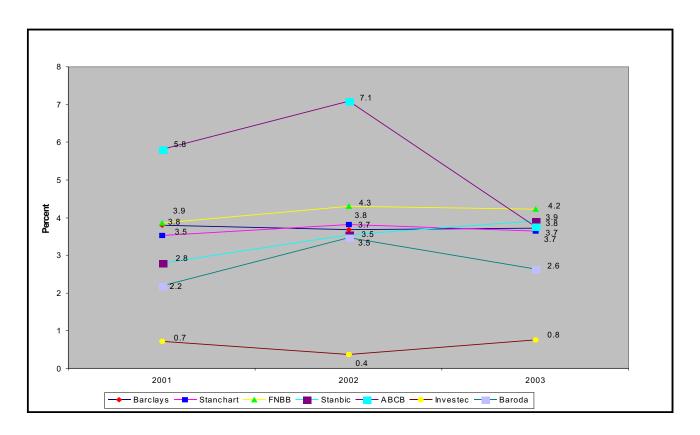


CHART 31

NON-INTEREST EXPENSE TO AVERAGE TOTAL ASSETS

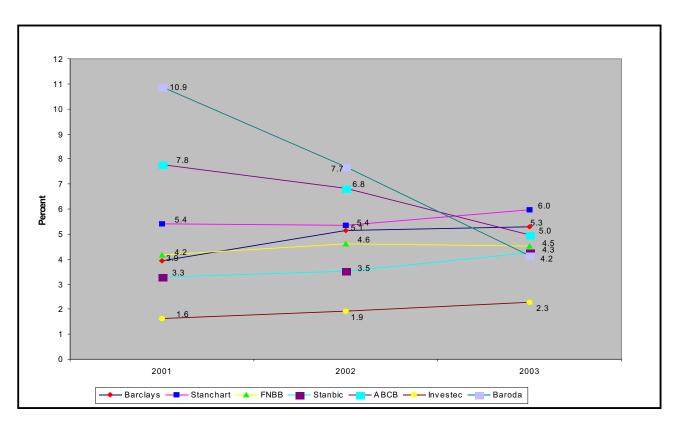


CHART 32
COST TO INCOME RATIO

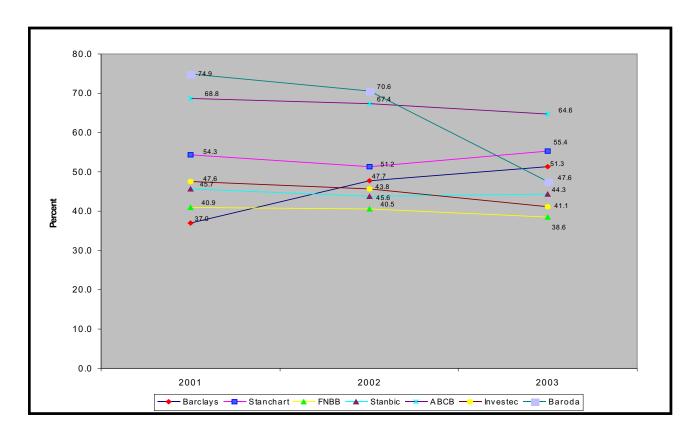


CHART 33

AVERAGE COST OF DEPOSIT

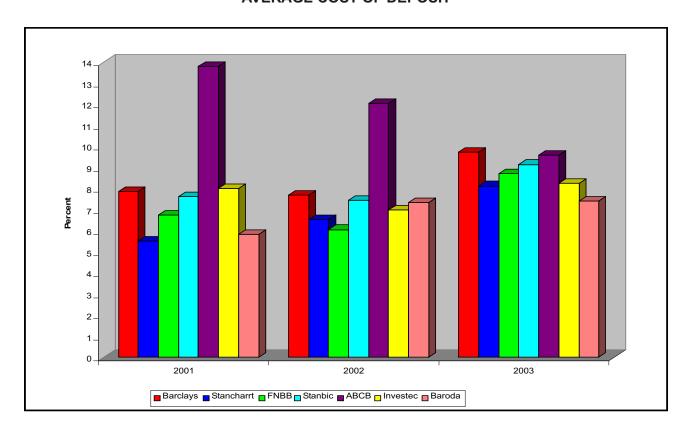


CHART 34
TOTAL PROVISIONS FOR BAD DEBTS

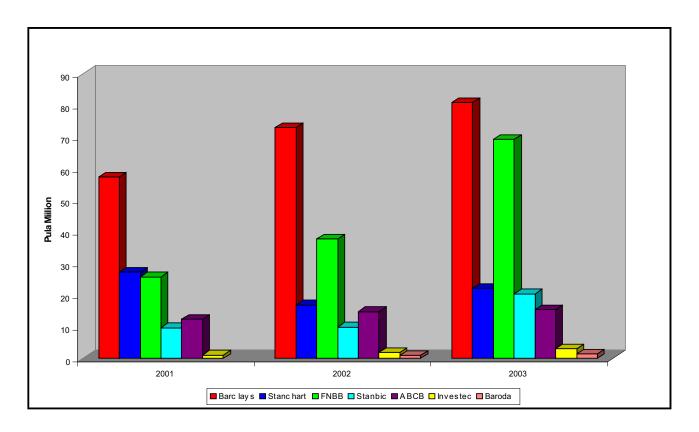


CHART 35
ADVANCES TO DEPOSITS RATIO

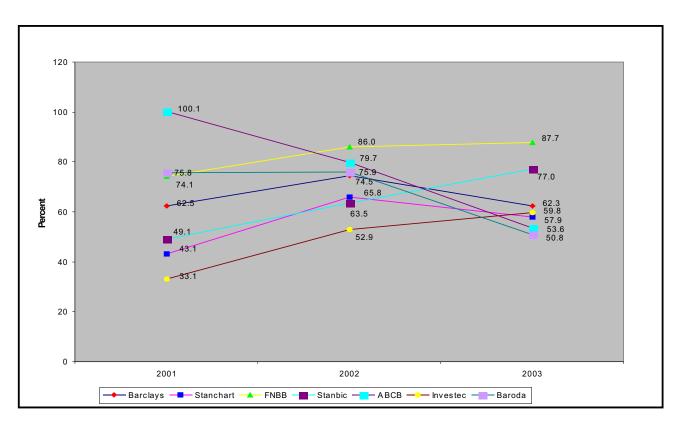


CHART 36

VALUE OF CURRENT ACCOUNTS IN BANKS

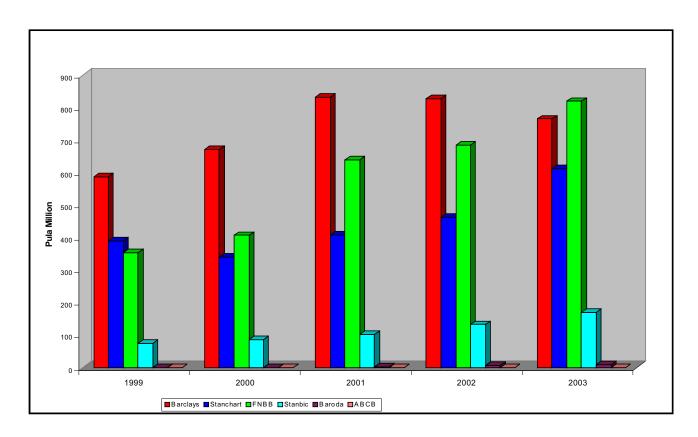


CHART 37

MARKET SHARE OF VALUE OF CURRENT ACCOUNTS (Percent)

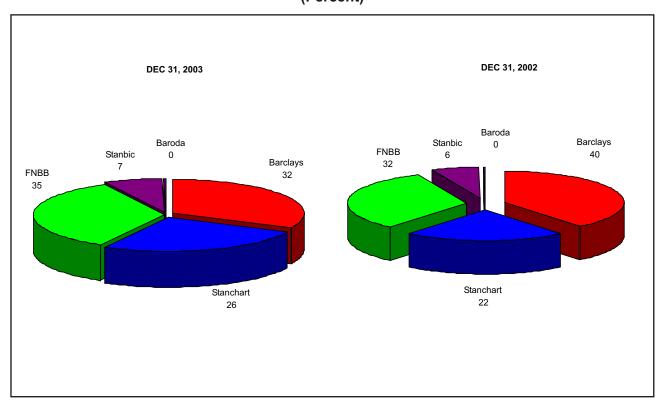


CHART 38

VALUE OF CALL ACCOUNTS

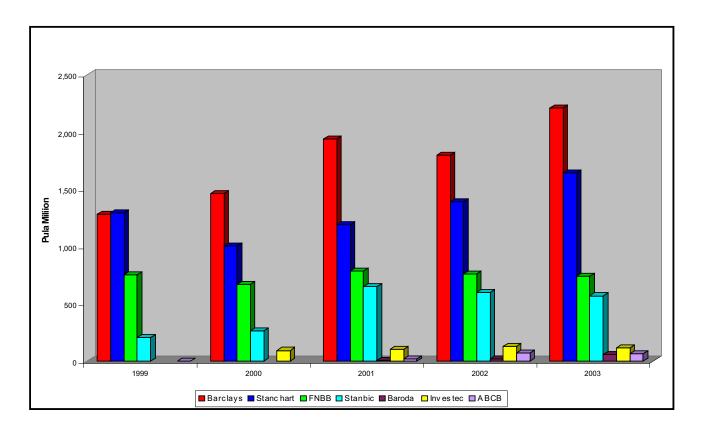


CHART 39

MARKET SHARE OF VALUE OF CALL ACCOUNTS (Percent)

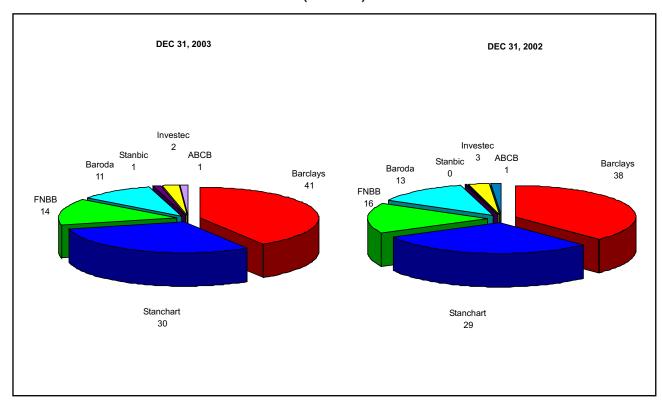


CHART 40
VALUE OF SAVINGS ACCOUNTS

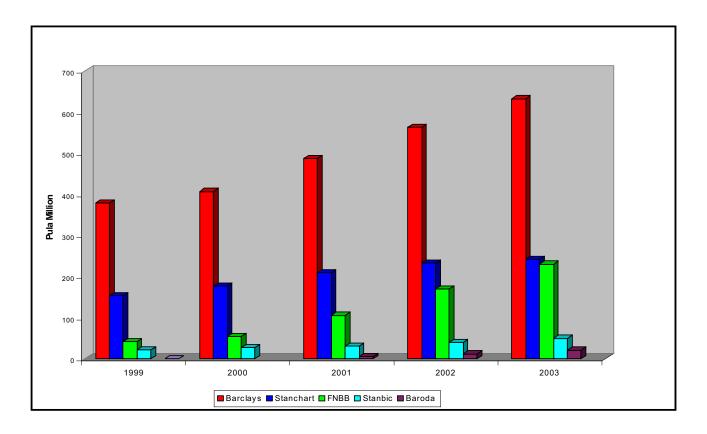


CHART 41

MARKET SHARE OF VALUE OF SAVINGS ACCOUNTS (Percent)

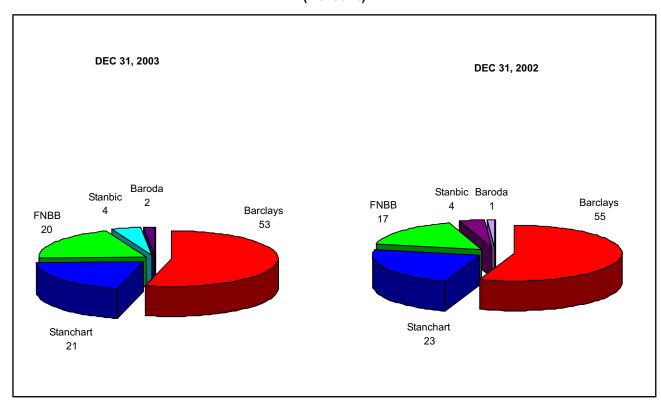


CHART 42

VALUE OF TIME DEPOSIT ACCOUNTS

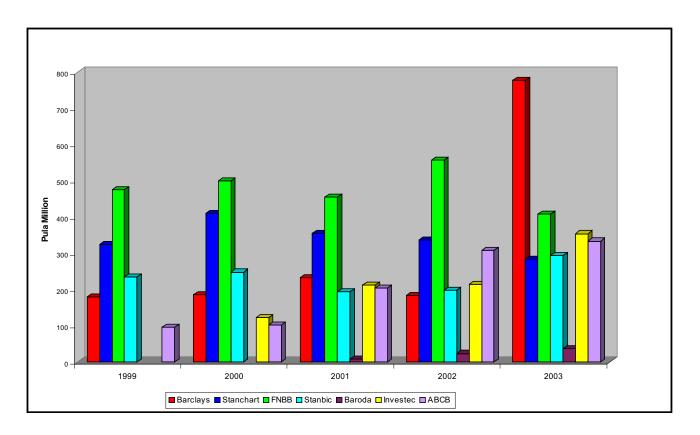


CHART 43

MARKET SHARE OF VALUE OF TIME DEPOSITS (Percent)

