

BANKING SUPERVISION

ANNUAL REPORT 2006

BANK OF BOTSWANA

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FOREWORD

Under the Bank of Botswana Act (CAP. 55:01), one of the responsibilities of the Bank is to regulate and supervise banks and other financial institutions. The importance of ensuring a sound and stable financial sector derives from the critical role played by these institutions in general, and commercial banks in particular, in the country's economy. They promote economic growth by mobilising savings that are, in turn, invested productively; they facilitate payments, both domestically and with the rest of the world; as well as act as conduits through which monetary policy signals are transmitted to all economic agents. For these reasons, the Bank is required to submit a *Statutory Report* each year on the state of the financial sector to the Minister of Finance and Development Planning (Minister) under Section 28 of the Banking Act (CAP. 46:04) and Section 85(4) of the Collective Investment Act (CAP. 56:09) (CIU Act).

This is a public version of the *2006 Annual Statutory Report* which was submitted to the Minister in June 2007. It is published in fulfillment of the Bank's accountability obligation to the wider cross-section of its stakeholders, with respect to the discharge of its financial sector supervisory and regulatory mandate during the year ended December 31, 2006. The *Report* highlights the structure of the banking industry,¹ its operational and financial performance, as well as other activities that took place during the review period. It also covers the activities of other financial institutions, especially those in the International Financial Services Center (IFSC) and bureaux de change.

As pointed out in the *Report*, the financial sector faced a difficult business environment during the year. There was a downturn in economic activity during 2005/06 due to the decline in mining output. Business activity also slowed down, especially in manufacturing and construction, due to a combination of factors including a lower rate of spending by the Government than was originally anticipated in the 2006/07 Budget, and tight monetary policy as the Bank aimed at reducing inflation which had far exceeded the desired level. All these factors presented challenges to financial sector business activities during the year.

Despite these unfavourable business conditions during 2006, the financial institutions expanded their activities, remained broadly sound, were prudently managed, solvent and stable. Besides the Bank's overall supervisory vigilance, the performance of commercial banks benefited largely from a structural shift in their financial resources, and this provided impetus to credit expansion at growth rates that exceeded the Bank's desired range. As a result, profitability remained high and liquidity and capital adequacy ratios were maintained above statutory prudential requirements. Moreover, access to banking services expanded further through increases in branch and Automated Teller Machine (ATM) networks country-wide. There was also business expansion in the operations of bureaux de change and the activities of the IFSC.

Nevertheless, the Bank continued to engage this vital sector of the economy throughout the year, on the need for continued expansion in cost-effective quality service delivery, which should also be increasingly more accessible to Botswana.

Linah Mohohlo



GOVERNOR

¹ Banks licensed under the Banking Act (CAP. 46:04)

LIST OF ABBREVIATIONS

AAB	African Alliance Botswana
AAI	African Alliance International
AABMC	African Alliance Botswana Management Company (Pty) Ltd
ABCB	African Banking Corporation of Botswana Limited
ADB	African Deveopment Bank
AGM	Annual General Meeting
AML	Anti-Money Laundering
ATA	Average Total Assets
ATM	Automated Teller Machine
BBS	Botswana Building Society
BDC	Botswana Development Corporation
BDVC	Botswana Diamond Valuing Company
BG	Bank Gaborone
BoBCs	Bank of Botswana Certificates
BSB	Botswana Savings Bank
BVI	British Virgin Island
CB	Central Bank
CFT	Combating the Financing of Terrorism
CIU	Collective Investment Undertaking
CRB	Credit Reference Bureau
DCEC	Directorate on Corruption and Economic Crime
ESAAMLG	Eastern and Southern African Anti-Money Laundering Group
FATF	Financial Action Task Force
FCA	Foreign Currency Account
FNBB	First National Bank of Botswana Limited
FSAP	Financial Sector Assessment Programme
FSI	Financial Soundness Indicator
GDP	Gross Domestic Product
IAS	International Accounting Standards
IBRD	International Bank for Reconstruction and Development
IFSC	International Financial Services Centre
IMF	International Monetary Fund
IT	Information Technology
LHS	Left Hand Scale
MFI	Micro-Finance Institution
MFDP	Ministry of Finance and Development Planning
NAV	Net Asset Value
NBFIRA	Non-Bank Financial Institutions Regulatory Authority
NDB	National Development Bank
RHS	Right Hand Scale
ROAA	Return on Average Total Assets
ROE	Return on Equity
RTGS	Real-Time Gross Settlement System
SADC	Southern African Development Community
SIMS	Stanbic Investment Management Services
SSBS	SADC Sub-committee of Banking Supervisors
SWIFT	Society for Worldwide International Financial Telecommunications
WFHB	Women's Finance House Botswana

STRUCTURE OF THE REPORT

This *Report* is a public version of the Bank's statutory submission made to the Minister of Finance and Development Planning. Its objective is to disseminate information on the structure, operational and financial performance, as well as related activities of the banking sector in 2006.

After a general overview of the macroeconomic environment and monetary conditions under which banks operated in 2006, Chapter 1 provides a brief description of the structure of the banking system during the year under review. The major operational activities of supervised institutions and other developments pertaining to the financial sector are discussed in Chapters 2 and 3. It should be noted, however, that performance comparisons are, in some instances, affected by revisions to previously reported data. Detailed information is contained in technical appendices relating to institutions licensed and supervised by the Bank, especially definitions of technical banking supervision terms as well as tables and charts on various aspects of the banking industry.

OVERVIEW

1. MACROECONOMIC ENVIRONMENT

The unfavourable economic conditions during 2006 had the potential to adversely affect the financial performance of the banking sector. Overall, the GDP declined by 0.8 percent in 2005/06 compared to a growth rate of 9.2 percent a year ago, due largely to a 4.4 percent fall in the *mining* sector output and, to a lesser extent, in the output of the *manufacturing* and *construction* sectors of 3.3 percent each. There were also other developments that had the potential to undermine demand for retail and corporate credit, as well as adversely impact credit quality. The Bank maintained a tight monetary policy stance throughout 2006, which was mirrored by relatively high lending interest rates by banks. Furthermore, the year began with a high level of inflation which, despite a decline by year-end, was nevertheless high. Government spending was slower than had been envisaged in the 2006/2007 Budget Speech, a factor which slowed downstream private sector activities.

While these developments negatively affected the banks' asset quality, as reflected in increasing non-performing assets, overall, the banks were resilient, as demonstrated by the banking sector's expanded role in the economy measured by the proportion of total banking assets to GDP, which stood at 53 percent at the end of 2006 compared to 37 percent in 2005. Furthermore, credit extension to both households and corporates accelerated in 2006. The annual growth rate for bank credit rose from 7.4 percent in December 2005 to 18.8 percent in 2006.

The better-than-expected performance of the banking sector appears to be a result of three factors. First, the banks' exposure to the *mining* sector was minimal (about 0.5 percent of total bank credit in 2006) while *manufacturing* and *construction* sectors ranked fourth and seventh, respectively, in terms of shares in total bank credit and, therefore, credit defaults from these sectors were within acceptable limits. Second, other sectors experienced positive growth, among them those to which the banks were moderately exposed, particularly *transport and communications* (which grew by 18.2 percent), *trade* (5.9 percent), and *water and electricity* (3.6 percent). These sectors contributed to growth of bank credit. Bank lending to the *trade, finance* and *business services* sectors increased by 42 percent, 31 percent and 24 percent, respectively, over 2005. Furthermore, lending to the *manufacturing* and *construction* sectors (the output of which declined in 2005/06) rose faster than in the previous year by 25 percent and 7 percent, respectively. As a result, banks' exposures to *business services* constituted 17 percent of total bank credit, *trade* about 6.8 percent, *transport* 2.7 percent and *water and electricity* 0.6 percent at the end of 2006. Third, the 8 percent civil service salary increase in 2006 increased household income and, by extension, retail demand for bank credit. Data suggests that household credit increased at a more rapid pace (17 percent) than in 2005 and its share in total bank credit was stable at approximately 55 percent.

2. MONETARY CONDITIONS

During 2006, the economy continued to be faced by excess liquidity which was mainly reflected in the rise in BoBCs by 197.2 percent as the Bank mopped the excess liquidity. The absorption of these excess funds from the system was aimed

at ensuring that short-term interest rates were consistent with the Bank's restrictive monetary stance. On the other hand, the industry average lending rates slightly increased from 16 percent to 16.5 percent between 2005 and 2006, while short-term deposit rates increased from 8.8 percent to about 9 percent for the same years, but remained significantly lower than the lending rates, thus creating significant margins for the banks. During 2006, the Bank increased the Bank Rate by 50 basis points to 15 percent. As expected, the commercial banks responded appropriately by increasing their prime lending rates by the same amount to 16.5 percent. The measure was taken in view of headline inflation, which averaged 11.6 percent in 2006 (8.6 percent in 2005). The inflation rate rose as high as 14.2 percent in April 2006 and ended the year at 8.5 percent, but still beyond the Bank's desired range of 4 to 7 percent. Despite the higher than expected inflation, relative stability was maintained.

Banks were well capitalised, liquid and profitable. Growth in liabilities significantly exceeded asset growth due to a major shift of wholesale funds from institutional investors to the banking sector, as a result of a change in rules governing eligibility for holdings of BoBCs with effect from March 2006. The total banking system assets grew by 64 percent to reach P30.4 billion in 2006 compared to a 79 percent rise in deposit liabilities to P24.9 billion. As a result, the financial intermediation ratio of most banks fell below 50 percent.

The combined balance sheet of the three statutory banks, (NDB, BSB and BBS) increased by 21 percent to P2.3 billion in 2006. The three banks were also profitable, recording a net profit after-tax of P75 million in 2006; a 173.7 percent increase on the P27.4 million recorded in 2005. The increase was mainly attributable to the 18 percent and 33.6 percent increases in interest income and other operating income, respectively. Operating expenses of statutory banks remained almost the same in 2005 and 2006 at P104.4 million and P103.8 million, respectively.

CHAPTER 1

INDUSTRY STRUCTURE

1. TYPES OF FINANCIAL INSTITUTIONS

The financial industry in Botswana comprises the central bank, commercial banks, an investment/merchant bank, development financial institutions, a building society, insurance companies, bureaux de change, a micro-finance institution, International Financial Services Centre (IFSC) companies, asset management institutions, medical aid societies, stock broking companies, a stock exchange, money transfer institutions and money lenders. Of all these institutions, only commercial banks (6), investment/merchant bank (1), micro-finance institution (1), IFSC Companies (17) and bureaux de change (42) are directly licensed and regulated by the Bank.

2. REGULATORY/SUPERVISORY STRUCTURE AND APPROACHES

The Bank is responsible for the licensing and supervision of banking institutions operating under the Banking Act, CIUs registered and regulated under the CIUs Act, bureaux de change and IFSC companies regulated under the Bank of Botswana Act (CAP. 55:01). The Bank also has supervisory/oversight responsibilities over Botswana Building Society (BBS), Botswana Savings Bank (BSB) and National Development Bank (NDB), on behalf of the Minister. The insurance and pensions industry and the Botswana Stock Exchange are supervised by the Ministry of Finance and Development Planning (MFDP). Other than being incorporated and registered under the Companies Act (CAP. 42:01), the remaining entities, including fund management companies, investment advisory service providers and money lending activities, remain largely unsupervised. However, the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) law has been passed by Parliament and it is expected that the entity to regulate and supervise most of these institutions will be established by the end of 2007.

Both the off-site monitoring and on-site examination approaches are employed by the Bank in carrying out its supervisory activities. The off-site surveillance approach involves structured collection and analysis of

quantitative information through weekly, monthly, quarterly and annual statutory returns submitted to the Bank by supervised institutions. On-site examination involves visits to the banks to assess and evaluate financial statements, governance arrangements, operational procedures, risk management systems and internal controls to ensure banks' compliance with required supervisory guidelines. It facilitates independent verification by the Bank Examination Teams that adequate governance practices exist and the information provided by banks is reliable. In addition, the Bank holds annual bilateral meetings with the management of supervised institutions, as well as trilateral discussions that include their external auditors. Thus, a combination of off-site surveillance and on-site work, as well as regular contact with banks through bilateral and trilateral meetings, allow the Bank to have a thorough understanding of each supervised institution's operations.

3. BANKING BUSINESS DELIVERY CHANNELS

Commercial banks expanded their branch and ATM networks across the country during 2006 (see Table 1 overleaf). Six new branches (compared to none in 2005) were opened, bringing the total number of branches and sub-branches countrywide to 66. However, the number of agencies was unchanged from that of the previous year, while encashment points were reduced from 2 to 1.

The ATM network of the banking sector expanded rapidly with the addition of 41 ATMs and mini-ATMs (compared to an increase of 7 in 2005). As a result, the total number of ATMs increased to 222. The expansion of both branch and ATM infrastructure increased access by the general public to banking services.

4. EMPLOYMENT

Despite the significant increase in the branch network, employment in the banking industry grew by only 4 per cent, compared to 6 per cent in 2005.

TABLE 1: LICENSED BANKS' REPRESENTATION: 2005–2006

Bank	Branches and Sub-Branches		Agencies		Encashment Points		ATMs	
	2005	2006	2005	2006	2005	2006	2005	2006
Barclays	26	30	5	5	2	1	44	45
Stanchart	11	11	6	6	0	0	36	36
FNBB	12	14	0	0	0	0	88*	125**
Stanbic	8	7	0	0	0	0	13	13
Baroda	1	1	0	0	0	0	0	0
ABCB	2	2	0	0	0	0	0	0
Bank Gaborone	0	1	0	0	0	0	0	3
Total	60	66	11	11	2	1	181	222

Notes: * Comprises 45 ATMs and 43 mini-ATMs

** Comprises 57 ATMs and 68 mini-ATMs

TABLE 2: STAFFING LEVELS FOR LICENSED BANKS: 2005–2006

Bank	2005			2006		
	Citizens	Expatriates	Total	Citizens	Expatriates	Total
Barclays	972	8	980	957	8	965
Stanchart	511	11	522	572	12	584
FNBB	710	29	739	735	21	756
Stanbic	374	9	383	397	13	410
Baroda	13	6	19	13	6	19
ABCB	36	4	40	31	4	35
Bank Gaborone	0	0	0	28	4	32
Total	2 616	67	2 683	2 733	68	2 801

STATUTORY COMPLIANCE AND OPERATIONAL PERFORMANCE OF THE BANKING SECTOR

1. ON-SITE EXAMINATIONS AND OFF-SITE MONITORING

In 2006, a full scope on-site examination of Barclays Bank of Botswana Limited (Barclays) and limited scope on-site examinations of African Banking Corporation of Botswana Limited (ABCB) and First National Bank of Botswana Limited (FNBB) were conducted by the Banking Supervision Department of the Bank. The scope of the examinations included an appraisal of asset quality, review of the adequacy of systems and internal controls and an assessment of the banks' compliance with prudential and regulatory standards of the Banking Act.

The institutions were found to be performing well, adequately capitalised and profitable.

2. CONSULTATIVE AND PRUDENTIAL MEETINGS WITH BANKS AND EXTERNAL AUDITORS

The Bank held bilateral and trilateral meetings with each supervised financial institution and its external auditors in accordance with Sections 22(8) and (9) of the Banking Act. The meetings covered the review of the 2005 draft financial statements, strategic plans and risk management strategies for 2006. Two Banking Committee meetings were also held during the year to address, among others, preparations for implementation of the revised Capital Adequacy Measurement and Standards Framework (Basel II), cost of financial services, access to banking and National Payments System and Real-Time Gross Settlement (RTGS) projects.

The financial condition of all banks was generally satisfactory as assessed through regular bilateral and trilateral meetings and "early warning" reports. The banking sector recorded significant balance sheet growth resulting from a large increase in customer deposits as funds shifted from non-banks to banks following a restriction of BoBC trading to banks only. Generally, the overall asset quality of the industry remained good, and this is indicative of strong credit risk management policies.

3. CORPORATE GOVERNANCE ISSUES (RISK MANAGEMENT, AUDIT AND BOARD)

The majority of banks were prudently managed and had good risk management strategies which, for some banks, were reflected in declining bad debt provisions despite rapid growth in loan books. Overall, audit reports also reflected no significant findings with respect to management and board oversight. As required, the Bank was informed about the appointment of senior management and Board members of various banking institutions and all complied with the prescribed "fit and proper" requirements. Most boards of banks were found to exercise effective judgement on corporate governance issues and, generally, the commitment to good governance by senior management was evident. Similarly, most of the management and Board members had appropriate qualifications and diverse backgrounds.

4. PERFORMANCE OF STATUTORY BANKS²

The combined assets of all statutory banks grew by 21 percent from P1.9 billion in 2005 to P2.3 billion in 2006, mainly due to a 24 percent increase in loans and advances. By the end of 2006, statutory banks were in compliance, not only with the Bank's supervisory requirements and standards, but also with their own statutory provisions.

5. BALANCE SHEET STRUCTURE OF THE BANKING INDUSTRY AS AT DECEMBER 31, 2006

The banking industry experienced a rapid accumulation of assets from P18.5 billion in 2005 to P30.4 billion in 2006. This represents a 64 percent increase, compared to the 19 percent rate of growth in 2005. Commercial bank deposits grew by 79 percent in 2006, compared to 12 percent in the previous year. The banks partly dealt

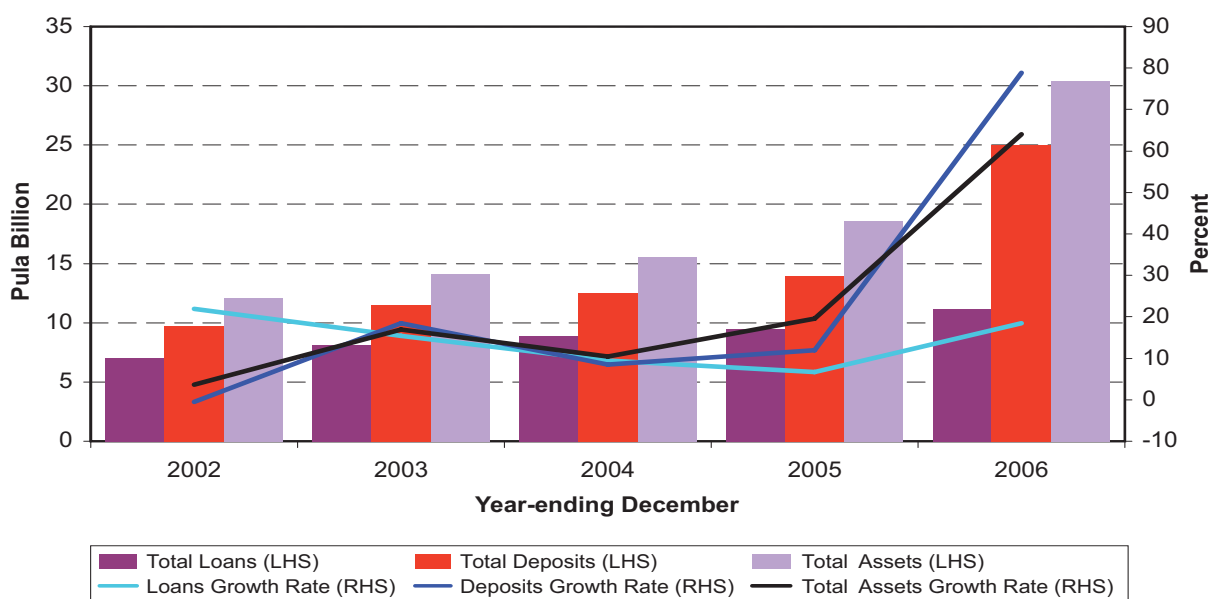
² Statutory banks are financial institutions established under their respective Acts of parliament and not licensed by the Bank. These institutions are only subjected to prudential supervision as provided for under Section 53(2) of the Banking Act. In 2006, these were National Development Bank, Botswana Building Society and Botswana Savings Bank.

with these large deposit inflows by investing in BoBCs, as reflected in the three-fold increase in the market value of BoBCs held by the banking sector to over P14 billion, from about P5 billion in 2005. The banks also took advantage of the expanded deposit base and more than doubled their advances growth rate from 7 percent in 2005 to 18 percent in 2006.

75.6 percent in 2006 compared to 80.9 percent in 2005. The trends and changes in advances, deposits and total assets are shown in Chart 1.

Chart 2 shows the structure of deposits in the banking system for 2005 and 2006. In 2005, most of the deposits were concentrated in call accounts (40 percent) followed by current accounts (20 percent) and foreign cur-

CHART 1: LEVELS AND GROWTH RATES OF DEPOSITS, TOTAL ASSETS AND LOANS AND ADVANCES

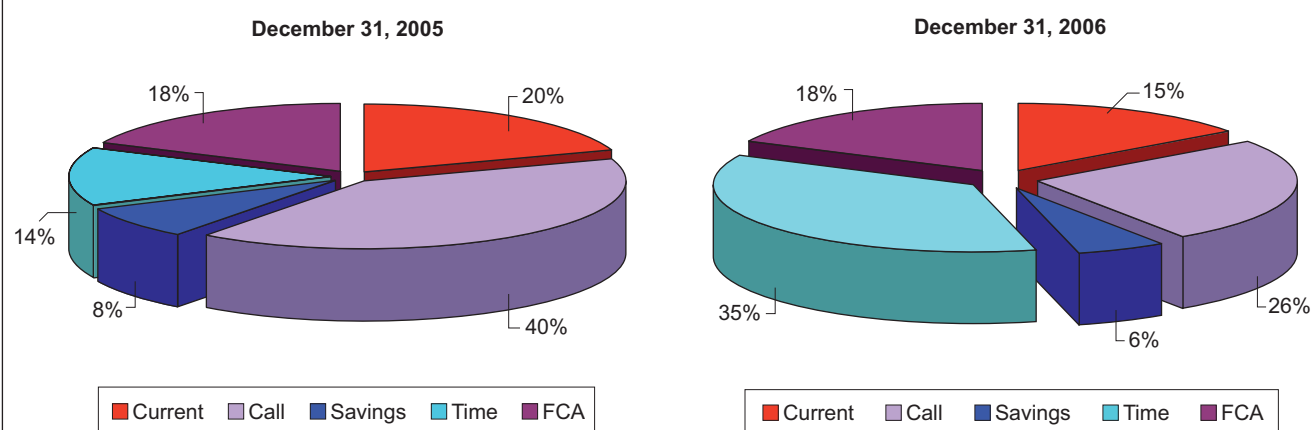


Both banking sector assets and liabilities have been increasing since 2002. On the asset side, BoBCs constituted 46 percent of the total banking sector assets in 2006 compared to 25.8 percent in 2005. Loans and advances to customers (net of specific provisions) were only 35.9 percent of total banking sector assets compared to 49.2 percent in 2005, whilst customer deposits continued to constitute a large share of banking sector liabilities of

rency accounts (FCA) (18 percent). In 2006, there was a significant migration of deposits from call (26 percent) to time deposits (35 percent).

Data suggest that the extent to which banks intermediated between surplus and deficit economic units declined during the reporting period, as shown by a drop in the ratio of Advances to Deposits to 45 percent from 68 percent

CHART 2: STRUCTURE OF INDUSTRY DEPOSITS



in 2005, making it the lowest in the five-year period to December 2006 (Chart 3). While factual, this is a statistical property that should be interpreted with caution, primarily because the increase in the deposit base reflects a shift of liquidity from non-banks to banks as a result of a policy change and, therefore, does not indicate a substantial increase in organic growth of banking business.

As noted above, the lower intermediation levels have been accompanied by a substantial growth in BoBC holdings by individual banks, which is partly explained by the Bank's March 2006 policy directive, but may

CHART 3: ADVANCES TO DEPOSITS RATIO (INDUSTRY)

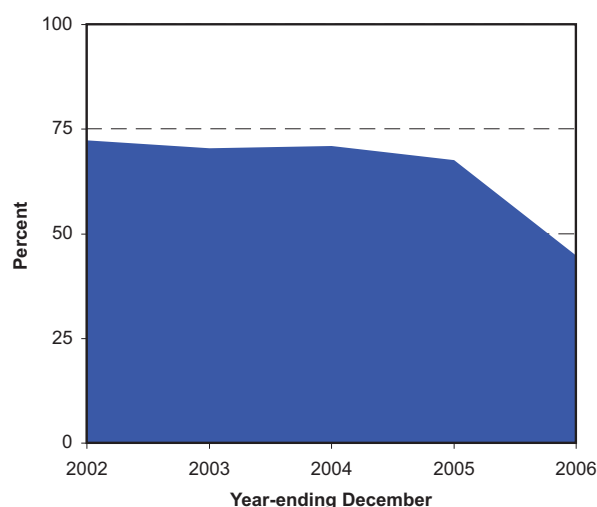
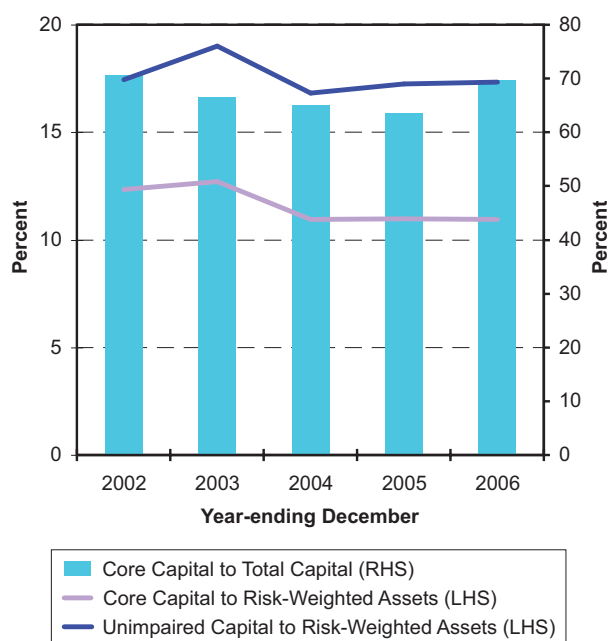


CHART 4: CAPITAL RATIOS



also be reflective of either growing conservatism in some banks or, alternatively, lack of lending opportunities. The contraction of the economy in 2006 by 0.8 percent could have led to greater caution in both lending and provisioning practices.

6. CAPITAL ADEQUACY (SOLVENCY) AND TRENDS

The banking industry remained well capitalised and solvent, with capital adequacy ratios well above the minimum statutory requirement of 8 percent (statutory floor) and 15 percent prescribed as the prudential minimum for banks in Botswana.

Chart 4 shows the ratios of core capital³ to total capital, core capital to risk-weighted assets and unimpaired capital to risk-weighted assets (capital adequacy) for the banking industry. The ratio of core capital to total capital for the industry was well above the 50 percent minimum statutory requirement, an indication of the existence of high quality capital. However, the ratio slightly declined between 2004 and 2005 as banks issued subordinated debt, which qualified for inclusion in Tier II capital. Unimpaired capital to risk-weighted assets and core capital to risk-weighted assets ratios remained fairly stable at the levels of the previous year.

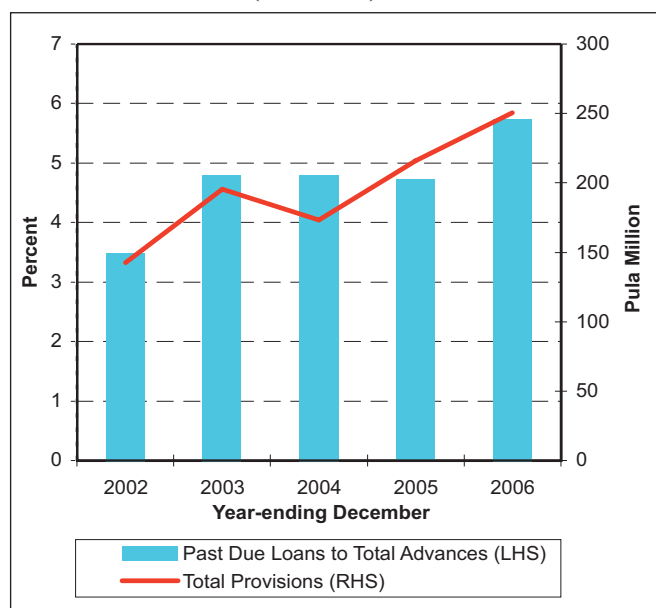
7. ASSET QUALITY AND TRENDS

The economy experienced a general erosion of purchasing power across all sectors due to the effects of inflation and the devaluation of the Pula in 2005, both of which are likely to have affected customers' repayment ability. The proportion of non-performing loans⁴ (past due loans) relative to the industry's loan portfolio increased slightly to almost 6 percent in 2006 from nearly 5 percent in 2005 (Chart 5 overleaf). The rapid increase in past due loans did not prompt significant increases in specific bad debt provisions in most banks (Chart 6). Notwithstanding, the level of non-performing assets was within historical norms.

Concentration risk was well within tolerable limits as banks operated within the stipulated regulatory asset concentration limits as measured by the industry's

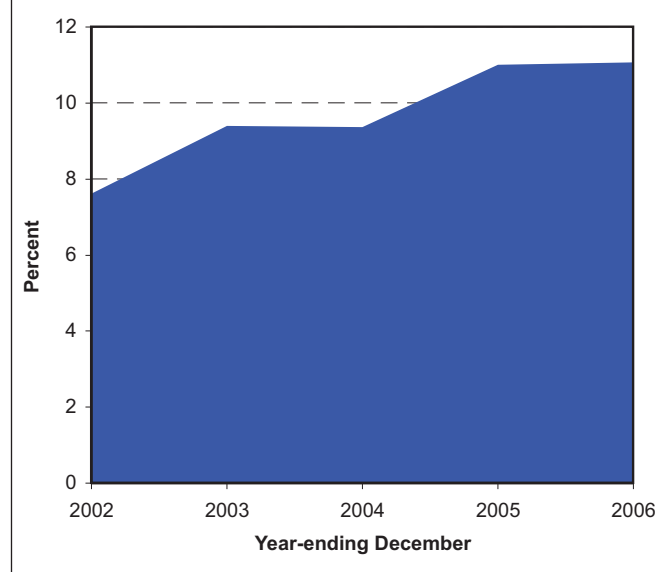
³ See page 34 for the method of calculation of the different types of capital items.

⁴ Non-performing loans are term loans that are 30 days or more in arrears, including non-accrual loans.

CHART 5: PAST DUE LOANS TO TOTAL ADVANCES AND TOTAL PROVISIONS (INDUSTRY)

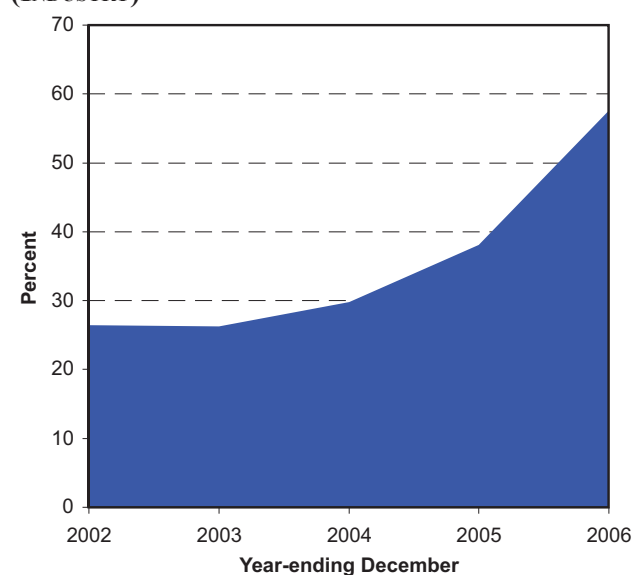
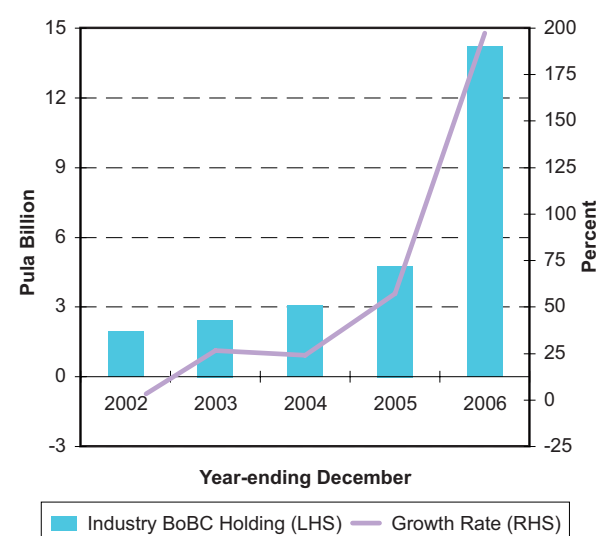
ratio of large exposures (i.e., more than 10 percent of unimpaired capital) to unimpaired capital. The industry recorded a ratio of 338 percent of unimpaired capital, which was well below the 800 percent prudential maximum limit set by the Bank.

The industry's residential loans as a proportion of total loans increased slightly from 12.9 percent in 2005 to 13.3 percent in 2006 due to the moderate growth of real estate loans. The proportion of household loans⁵ to total loans fell to 55.1 percent in 2006 from 57.1 percent in 2005. The decline was evident at most banks.

CHART 6: AGGREGATE SPECIFIC PROVISIONS TO UNIMPAIRED CAPITAL

8. LIQUIDITY AND HOLDINGS OF BANK OF BOTSWANA CERTIFICATES (BoBCs)

The banking sector continued to be highly liquid as reflected by liquidity ratios that far exceeded the statutory minimum limit of 10 percent, with most of the liquidity held in BoBCs. Liquid assets grew nearly three-fold to P14.3 billion from P5.3 billion in 2005, resulting in the banking sector liquid assets to deposits ratio of 57 percent (almost six times the required ratio) in the reporting period, compared to 38 percent in the previous

CHART 7: LIQUID ASSETS TO DEPOSITS RATIO (INDUSTRY)**CHART 8: LEVEL AND GROWTH RATE OF INDUSTRY BoBC HOLDINGS**

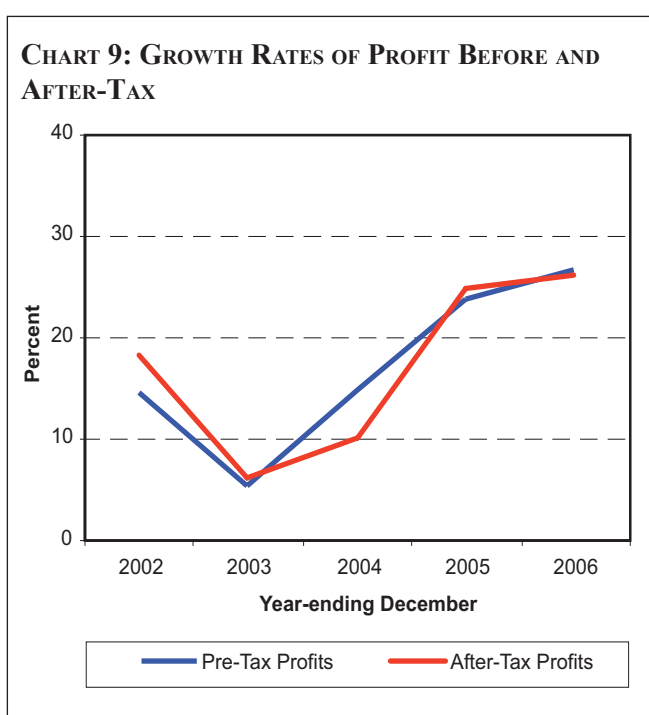
⁵ Total household loans are inclusive of total residential loans.

year (Chart 7). Other liquidity ratios, such as liquid assets to total assets and liquid assets to total loans, improved significantly to 47 percent (29 percent in 2005) and 128 percent (56 percent in 2005), respectively. All three ratios suggest that the banking sector's ability to cover short-term obligations as they arise was greatly enhanced during 2006.

As a result of the change in policy on BoBC trading in March 2006, there were no BoBCs held on behalf of customers by year-end. Banking sector BoBC holdings increased sharply by 197 percent to P14.2 billion in 2006 from P4.8 billion in 2005 (see Chart 8 on page 6).

9. PROFITABILITY TRENDS

All banks recorded positive growth in after-tax profits compared to those reported in 2005 (Chart 9). Tables 3 and 4 on page 8 show additional key financial performance indicators on the industry's earnings and profitability. As in the previous year, the profitability of banks in 2006 was largely driven by interest income from loans and advances, which constituted 82 percent of gross income. Interest income also benefited greatly from earnings from large BoBC holdings. As expected, interest expenses were a major cost component during the year. Interest expense grew by 93 percent compared to 13 percent in 2005, largely due to interest paid on additional deposits acquired by the banking sector post-March 2006 as explained above. The largest component of banks' non-interest expense was staff costs, which constituted 43 percent of total non-interest expense.



The Return on Average Total Assets (ROAA) and Return on Equity (ROE) were at 3.8 percent and 56.8 percent, respectively, in 2006, compared to 4.4 percent and 52.9 percent in 2005 (Table 4). The decrease in ROAA in 2006 indicates that banks did not employ the resources at their disposal efficiently and productively to generate income. To some extent, this may have been due to unexpected rapid inflow of funds from liquidation of BoBCs by non-banks thus making it difficult for all resources to be efficiently allocated within a short period of time and in the process weakening ROAA for most banks. However, the return on equity for the Botswana banking industry of about 57 percent in 2006 compared to 53 percent in 2005 is very high by international standards.

10. OPERATING EFFICIENCY

Table 5 overleaf shows a five-year trend in operational and allocative efficiency ratios for the banking industry. In general, banks improved their operational efficiency as reflected by the industry's higher net spread from 7.7 percent in 2005 to 9.5 percent in 2006. Net Interest Margin, however, decreased due to the relatively higher growth in interest expenses on deposits.

On the efficiency of staff, the Net Income to Staff Expense ratio increased from 219 percent in 2005 to 255 percent in 2006, showing that the returns made by the banks were also shared with staff in the form of increased salaries and benefits. Net Income Per Staff Member improved from P278 000 to P336 000 in the same period. Furthermore, the Cost to Income ratio decreased from 46 percent to 41 percent in 2006.

While these operational and allocative efficiency ratios are positive and indicative of improved productivity, they also suggest under-investment in the banking infrastructure. Against the background of high return on equity and low cost of operations, banks are expected to continue to explore opportunities for improved access and quality of banking services.

TABLE 3: BANKING INDUSTRY EARNINGS AND PROFITABILITY: 2005–2006

	Amount (P million)		Growth (Percent)
	Dec 2005	Dec 2006	2005–2006
Gross Interest Income	2 171.0	3 422.0	57.6
Interest Expense	1 094.0	2 105.6	92.5
Net Interest Income	1 076.9	1 316.4	22.2
Non-Interest Income	659.7	757.2	14.8
Operating Expense	790.3	852.9	7.9
Total Expense	1 884.3	2 958.5	57.0
Net Income Before-Tax	892.1	1 130.3	26.7
Net Income After-Tax	746.3	939.9	25.9

TABLE 4: INDUSTRY PERFORMANCE RATIOS (PERCENT)

	Dec 2004	Dec 2005	Dec 2006
Return on Average Total Assets (ROAA)	4.1	4.4	3.8
Return on Equity (ROE)	44.8	52.9	56.8
Interest Income to Total Income	79.2	76.7	81.9
Non-Interest Income to Total Income	22.3	23.4	17.9
Interest Income to ATA	14.4	12.8	14.0
Non-Interest Income to ATA	3.8	3.9	3.1
Interest Expense to ATA	6.8	6.5	8.6
Interest Expense to Total Expense	57.9	58.1	71.2
Operating Expense to Total Expense	42.1	41.9	28.8
Non-Interest Expense to ATA	4.9	4.7	3.5
Average Return on Advances	16.9	16.9	17.8
Net Interest Income to ATA	7.6	6.4	5.4
Average Cost of Deposits	7.7	7.4	7.6

Note: ATA = Average Total Assets

TABLE 5: BANKING INDUSTRY EFFICIENCY MEASURES

Performance Ratios (Percent)	2002	2003	2004	2005	2006
Net Spread	7.3	7.6	7.4	7.7	9.5
Net Interest Margin	6.5	6.7	7.6	6.4	5.4
Other Operating Income to Average Total Assets	3.8	3.7	3.8	4.0	3.1
Net Operating Margin	10.9	9.4	9.2	9.6	10.3
Net Income Per Employee (P'000)	205.1	214.7	235.0	278.2	335.6
Net Income to Employee Expense	195.4	181.1	190.8	219.1	254.8
Cost to Income	47.2	48.5	43.1	45.5	41.1
Staff Cost Per Employee (P'000)	105.0	118.6	123.2	127.0	131.7
Asset Per Employee (P'000)	4 818.8	5 564.7	6 102.1	6 911.1	10 858.1

CHAPTER 3

OTHER DEVELOPMENTS IN THE FINANCIAL SYSTEM

1. LICENSING OF NEW BANKS

During 2006, the Bank received and processed two applications for domestic investment and commercial banking licences. The investment banking license application was rejected on the basis that it failed to meet all the licensing requirements, while the commercial banking application was at an advanced stage of processing by year-end.

2. ABANDONED FUNDS

In accordance with Section 39 of the Banking Act, the Bank continued to receive, process and maintain abandoned funds records from commercial banks during 2006. The Bank transferred to the Guardian's Fund P543 723 that had remained unclaimed for five years. The total funds received and claims processed during the year are summarised in Table 6 below. The Bank advertised these unclaimed funds in local newspapers and the Government Gazette during the last quarter of 2006.

TABLE 6: SUMMARY OF ABANDONED FUNDS BALANCES (PULA)

	Barclays	Stanchart	FNBB	Total
Balance brought forward	2 568 159	1 308 404	392 389	4 268 952
Funds received in 2006	415 205	143 159	11 683	570 047
Claims paid out in 2006	(109 730)	(94 206)	(15 500)	(219 436)
Transfer to Guardian's Fund	(352 960)	(190 763)	–	(543 723)
Balance at year-end 2006	2 520 674	1 166 594	388 572	4 075 840

3. BANK CHARGES

Commercial and statutory banks advised the Bank of their plans to review bank charges during 2006. A significant development was that not all proposed adjustments involved increases in the tariffs, as some charges had been reduced while others were not changed. The new tariff schedules included charges for new products and services. The Bank reviewed the tariff schedules taking into consideration broader public policy issues pertaining to affordable access to banking services, promotion of effective intermediation and facilitation of economic activities and development, in general. Banks

were encouraged to continue observing and ensuring compliance with the provisions of the Disclosure of Bank Charges Notice of 2001.

4. NEW BANKING PRODUCTS AND SYSTEMS

In line with international norms, the major banks in Botswana introduced (or were in the process of applying to the relevant authorities) bancassurance business, which involves the provision of both banking and insurance products and services from the same distribution channel. However, the banks were advised to ensure that the insurance or any insurance brokerage business was “ring-fenced” from the banking business and capitalised, including separating the administrative infrastructure to ensure that banking customers exercised choice as to whether to take insurance with (or through) a bank subsidiary or an independent broker/insurer. Other initiatives included new IT systems and other technologies for efficient processing of loans, better risk

management and more convenient delivery of banking services, such as telephone and internet banking.

5. BUREAUX DE CHANGE ACTIVITIES

Bureaux de Change

During 2006, a total of six new bureaux de change were licensed, while one bureau de change had its licence revoked due to non-compliance with the Bank of Botswana (Bureaux de Change) Regulations, 2004, bringing to 42 the number of licensed bureaux de change as at December 31, 2006. The industry also experienced

growth through the opening of new branches by the existing bureaux de change.

Bureaux de Change Foreign Currency Sales and Purchases

Chart 10 shows the total value and growth rates of foreign exchange transactions for the five-year period 2002 to 2006. The value of foreign exchange transacted through bureaux de change continued to increase with sales and purchases reaching P375 million and P338 million in 2006. Both sales and purchases grew faster in 2006 than in 2005, recording growth rates of 49 percent and 42 percent compared to 24 percent and 35 percent in the previous year, respectively. The value increased largely due to growth in business and opening up of new branches by the existing operators.

CHART 11: BUREAUX DE CHANGE SALES OF FOREIGN CURRENCY: 2005–2006

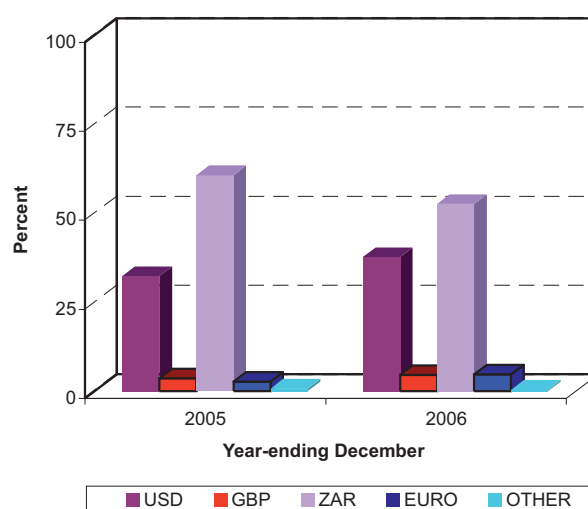
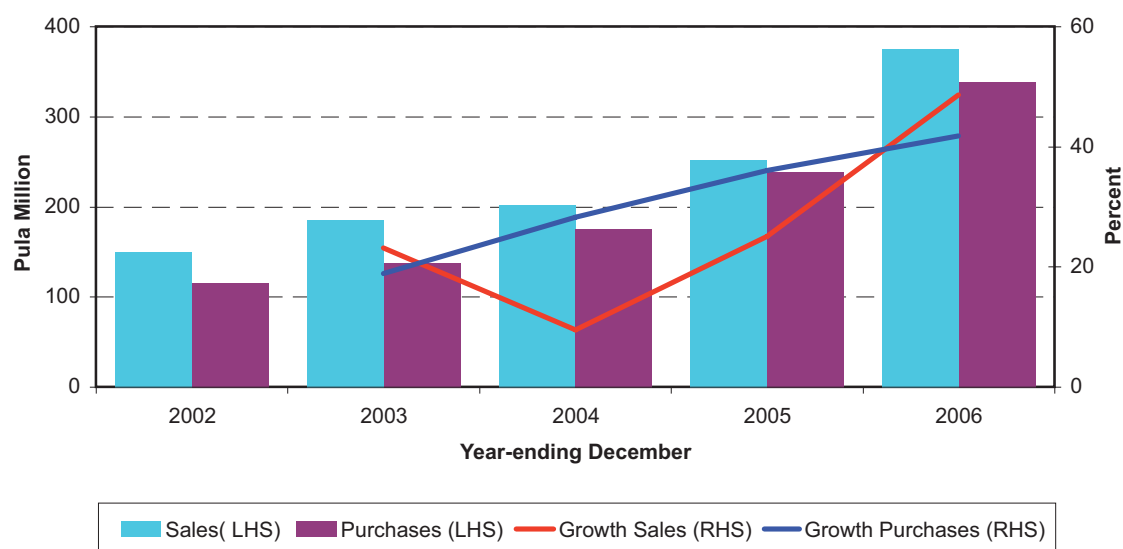


CHART 10: BUREAUX DE CHANGE SALES AND PURCHASES OF FOREIGN CURRENCY

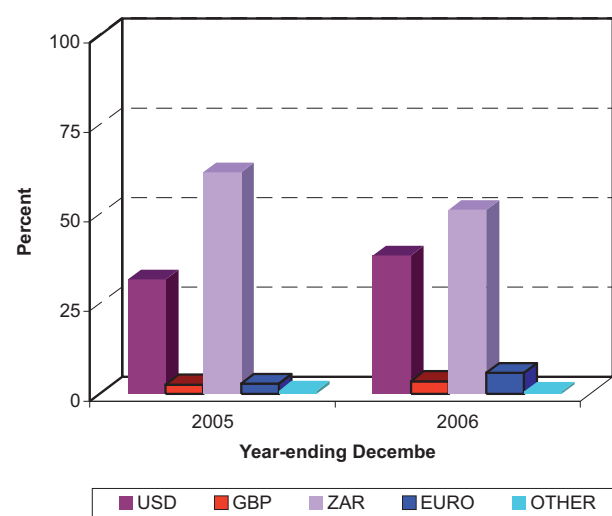


Charts 11 and 12 show foreign exchange sales and purchases by currency (in Pula) in 2005 and 2006. In 2006, foreign exchange transactions were conducted mainly in South African rand and, to a lesser extent, the US dollar. Notwithstanding, the proportion of rand denominated transactions dropped to 52 percent in 2006 from 61 percent in 2005, while the proportion of US dollar denominated transactions increased from 32 percent to 38 percent, in the same years.

On-Site Examinations of Bureaux de Change

In 2006, eight bureaux de change were examined

in Francistown, Gaborone, Kasane, Lobatse, Mahalapye, Ramokgwebana, Ramatlabama, Ramotswa and Sherwood. While in general the examined bureaux de change complied with the Bank of Botswana (Bureaux de Change) Regulations, 2004, a number of the examined institutions were found to have violated some aspects of the regulations. The violations included failure to maintain the required minimum balance of P5 000 in a deposit account; allowing cash transactions in excess of P10 000; not recording all the details of customers in the receipt books; submitting inaccurate returns; changing directors, shareholders and principal officers without prior written authorisation of the Bank; and failure to submit audited financial statements. Appropriate super-

CHART 12: BUREAUX DE CHANGE PURCHASES OF FOREIGN CURRENCY: 2005–2006

visory sanctions were imposed on defaulting bureaux.

The licence fees due in 2006 and associated application processing fees were all paid on time. However, a number of bureaux de change did not submit audited financial statements on time on grounds that they could not afford what they considered exorbitant audit fees. With respect to auditing of financial statements by bureaux de change, the Bank is currently considering reviewing the legal auditing requirement to give recognition to the financial statements prepared by firms of accountants.

6. MONEY-LENDING BUSINESS

During the reporting period the Bank received 53 licensing enquiries from promoters of money-lending business entities. The Bank handled the enquiries in order to ensure that these entities did not violate requirements of Section 3(2)(a) of the Banking Act, which prohibits the use of the words, 'bank', 'finance', 'credit' or 'savings', or any of their derivatives in a name or advertising material without approval by the Bank of Botswana. The regulation of money-lending businesses will be subsumed under the new legislation establishing the NBFIRA.

7. COLLECTIVE INVESTMENT UNDERTAKINGS (CIUs)

Table 7 below shows that as at December 31, 2006, there were three (3) management companies licensed under Section 12 of the Collective Investment Undertakings Act, with a total of twelve (12) funds under their administration. The three companies are African Alliance Botswana Management Company (Pty) Limited (AAB), African Alliance International Limited (AAI) and Stanbic Investment Management Services (SIMS).

One management company, Imara Asset Management Limited (British Virgin Islands) (Imara BVI), was authorised in terms of Part VIII of the Collective Investment Undertakings Regulations ((CAP. 56:09) (CIU Regulations)) to market its fund, the Imara

TABLE 7: MANAGEMENT COMPANIES AND THEIR FUNDS

Management Company	Funds Managed
African Alliance Botswana Management Company (Pty) Limited	Botswana Global Income Fund Botswana Value Fund Botswana Liquidity Fund African Alliance Private Equity Fund Botswana Global Allocation Fund
African Alliance International (Pty) Limited	Global Managed Fund African Alliance Euro Fund African Alliance Dollar Fund Global Fixed Income Fund Global Equity Fund
Stanbic Investment Management Services (Pty) Limited	Stanbic Money Market Fund Stanbic Managed Fund

TABLE 8: EXTERNALLY LICENSED FUNDS MARKETED IN BOTSWANA

Management Company	Funds Managed
Orbis Investment Management Limited (Bermuda)	Orbis Global Equity Fund Orbis Africa Equity Fund Orbis Japan Equity (USD) Fund Orbis Optimal (EUR) Fund Orbis Optimal (USD) Fund Orbis Leveraged (EUR) Fund Orbis Leveraged (USD) Fund
Standard Chartered Bank London PLC	Standard Chartered USD Liquidity Fund
Imara Asset Management Limited (BVI)	Imara African Opportunities Fund

African Opportunities Fund, in Botswana (Table 8). This brought to 9 externally licensed funds marketed in the country. Imara BVI is licensed and regulated by the BVI Financial Services Commission. The Facilities Agent for the Fund is the Botswana registered Imara Asset Management (Pty) Limited. In addition, 8 funds which have been authorised for inward marketing in Botswana are being administered by two entities, Standard Chartered Bank London PLC (licensed and regulated in Jersey, Channel Islands (1 fund)) and Orbis Investment Management Limited (licensed and regulated in Bermuda (7 funds)).

The total net asset value (NAV) of the domestic funds in the CIU sector (excluding AAI funds) amounted to P5.6 billion in December 2006, an increase of 27 percent from P4.4 billion in December 2005 (Chart 13). This

was a slower growth rate compared to the 69 percent in 2005 and was largely attributable to the exclusion of non-banks in the BoBC market since March 2006, which resulted in the liquidation of their BoBC positions and movement of cash into bank deposits. Chart 13 shows the growth of the total NAV for the five-year period to 2006.

Chart 14 shows that by December 2006, out of the P5.6 billion total funds invested, 69 percent was invested outside the country and 31 percent invested in the domestic market. The higher percentage of offshore investments reflects the absence of suitable investment opportunities in the domestic market.

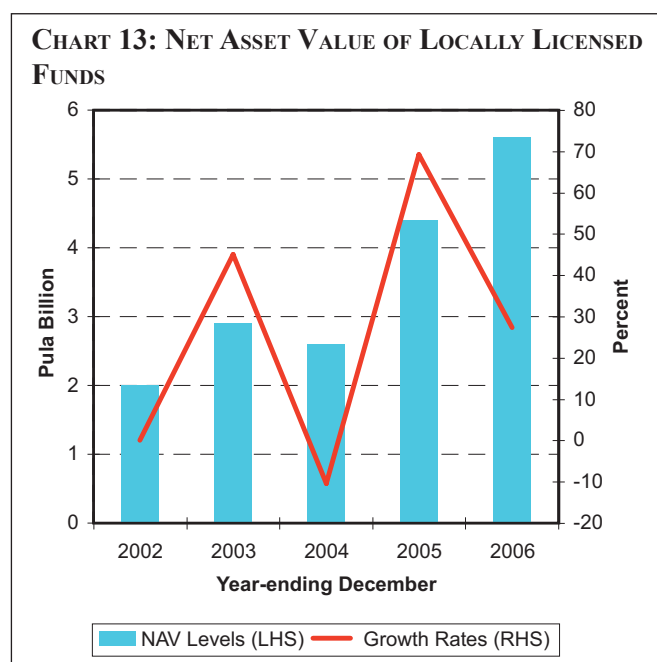
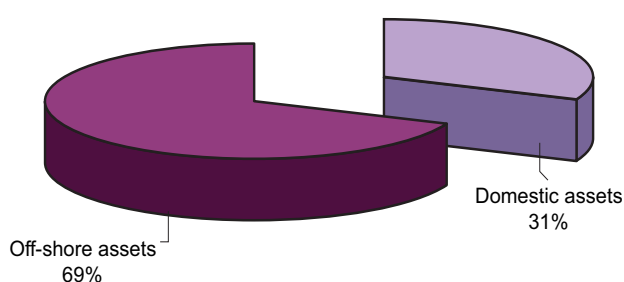


CHART 14: DECEMBER 2006 – OFF-SHORE AND DOMESTIC INVESTMENTS OF FUNDS



8. INTERNATIONAL FINANCIAL SERVICES CENTRE AND MICRO-FINANCE INSTITUTIONS ACTIVITIES

International Financial Services Centre Activities

During 2006, four IFSC companies were issued with Exemption Certificates, namely, Island View

(Proprietary) Limited, Global Credit Ratings Holdings Limited, Property and Asset Management International (Proprietary) Limited, all of which are holding companies, and Bergstan Investments (Proprietary) Limited which will provide corporate financial and management services. The total number of IFSC companies granted regulatory approval by the Bank increased to 17 as at the end of December 2006 compared to 13 at the end of December 2005. Out of the 17 companies, 10 were operational at the end of the reporting period.

Micro-Finance Institutions (MFIs) Activities

Women's Finance House Botswana (WFHB) remained the sole MFI operating in Botswana. Its main objective is to assist women in the low-income bracket who have no access to financial institutions' credit and savings facilities. During the 2005/06 financial year, WFHB made a loss, the largest since 2002/03 and a more than four-fold increase compared to the loss reported in 2004/05. This was due to an increase in administrative costs and a reduction in sundry income. Furthermore, during 2005/06, WFHB did not receive any interest, compared to 2004/05 when it received significant interest income. These developments are of concern as they threaten the viability of the institution.

BORAVAST Revolving Fund Scheme

During the year, the Bank processed a proposal for licensing of BORAVAST Revolving Fund Scheme from the Ministry of Agriculture. The main objective of the Scheme is to improve the livelihood of the rural communities of Bokspits, Rappelspan, Struizendum and Valhoek through the establishment of a community based revolving fund. The Scheme intended using donor funds to finance development projects. After a careful review, it was concluded that the Revolving Scheme's business did not constitute banking business as defined in Section 2 of the Banking Act as no depositors' funds would be solicited to finance the project. Therefore, issuance of an Exemption Certificate was not considered appropriate.

9. ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM (AML/CFT)

The Bank participated at the 6th Eastern and Southern

Africa Anti-Money Laundering Group (ESAAMLG) Annual General Meeting (AGM) and the 12th Meeting of the Task Force of Senior Officials, which were held in Harare, Zimbabwe, from August 21 to 26, 2006. The Task Force recommended to the Council of Ministers that an application for associate membership of ESAAMLG should be submitted to the Financial Action Task Force (FATF).⁶ An associate member enjoys certain rights and also has obligations to fulfill to FATF. The rights include access to all FATF meetings and documents. ESAAMLG, as an associate, would be obliged to effectively implement the 40+9 FATF standards, offer FATF access rights to its meetings and documents, as well as give FATF assessors the right to participate in ESAAMLG mutual evaluation teams.

The Task Force concluded that the country holding the presidency of ESAAMLG would chair the Mutual Evaluation and Development Strategy Implementation Working Group while the country to take the presidency the following year would co-chair. This effectively meant that Botswana would co-chair the Working Group for the next twelve months before assuming chairmanship in August 2007.

The Bank participated in four meetings of the National Task Force on AML/CFT during the year. The issues discussed at the meetings included preparations for the ESAAMLG Annual General Meeting to be hosted by Botswana in August 2007 and drafting of the AML/CFT legislation.

10. INTERNATIONAL SUPERVISORY ISSUES

In October 2006, the Basel Committee on Banking Supervision published the revised Core Principles for Effective Banking Supervision (The Core Principles). The Core Principles are a framework of minimum standards for sound supervisory practices and have been accepted by countries as a benchmark against which the quality and effectiveness of supervisory practices are assessed. The International Monetary Fund (IMF) and the World Bank use the Core Principles for the assessment of any country's banking supervision system and practices in conducting what is known as the Financial Sector Assessment Programme (FSAP). The Bank has embraced these universally accepted Core Principles

⁶ Financial Action Task Force is an inter-governmental body, the purpose of which is the development and promotion of national and international policies to combat money laundering and terrorist financing.

and, on a regular basis, conducts self-assessments to determine compliance to identify any regulatory/supervisory deficiencies and setting priorities to address them.

During 2006, supervisory authorities in the region held seminars and workshops in preparation for, and to assess progress made so far on the implementation of Basel II. The Bank participated in a seminar that was held in Pretoria, South Africa in May 2006 on “Basel II and its Implementation”. It emerged at the seminar that home supervisory authorities from developed and emerging markets were at an advanced stage in the preparation for the implementation of Basel II, while most of the Southern African Development Community (SADC) countries, except South Africa, were either still at the early stages of or had not started preparing for implementation of Basel II. SADC host supervisory authorities observed that other home supervisors of banking institutions in their jurisdictions did not involve them in preparations for Basel II implementation and yet it was apparent that the foreign subsidiaries in their jurisdictions intended to adopt various aspects of Basel II as defined by their home supervisors.

The Bank also took part in a conference held in Nairobi, Kenya in November 2006, with the theme “Africa and the Road to Basel II”. The conference was organised by the IMF in response to requested assistance in the implementation of Basel II by African countries. The conference concluded that prior to Basel II implementation, countries must ensure full compliance with the Core Principles and full implementation of Basel I and risk-based supervision. Countries were advised that the transition to Basel II should proceed in the following four stages: determining the scope of Basel II application in the banking industry, assessing banks’ capabilities, assessing supervisory authorities’ preparedness and setting out a clear timetable for implementation of the revised Capital Adequacy Measurement and Standards.

In an effort to pave the way for the transition to, and implementation of Basel II, the Bank has been committing resources to internal capacity building and appraising itself of the economic and legal implications of adopting and implementing Basel II. A consensus has been reached with the banking industry to constitute an industry-wide Basel II implementation Task Force in 2007.

The Bank attended the third meeting of the SADC Subcommittee of Banking Supervisors (SSBS) in

Pretoria, South Africa in February 2006. The main purpose of the meeting was to review and finalise the draft Memorandum of Understanding on the cooperation and coordination in the area of banking regulatory and supervisory matters, which was to be submitted to the SADC Committee of Central Bank Governors for endorsement. The issue of compilation of financial soundness indicators (FSIs) and subsequent creation of a regional database was also discussed. Consensus was reached that member countries would regularly provide updates of FSIs for the purpose of developing a database that would assist the SSBS to monitor progress in member states on various supervisory and prudential matters.

11. CONCLUSION

In 2006, the economic downturn which was led by a decline in mining output, was exacerbated by the slower-than-expected rate of increase in government spending and the restrictive monetary policy stance, the objective of which was to reduce inflation to the desired level. Together, these factors presented a challenging business environment to the financial sector. However, despite the adverse situation, financial sector business performance, especially that of the banking system, expanded further and was robust during the year.

Within the overall difficult macroeconomic business environment, financial sector activities benefited from increased liquidity, which stimulated bank lending, encouraged further product diversification and provided an incentive for nation-wide infrastructure network expansion during the year. With regard to lending, although its share declined in relation to other assets on the balance sheets of commercial banks, credit rose at a rate that exceeded the Bank’s desired range for 2006. Overall, therefore, although non-performing loans increased compared to the previous year, the banks’ profitability rose further, while remaining prudently managed and solvent, with liquidity and capital adequacy ratios that were above the regulatory requirements.

As was the case with the banks, the companies operating under the IFSC improved their overall financial performance, increased their activities and diversified their services during the year. Similarly, bureaux de change transactions rose further alongside an expansion in their countrywide infrastructure network.

Notwithstanding the significant overall performance

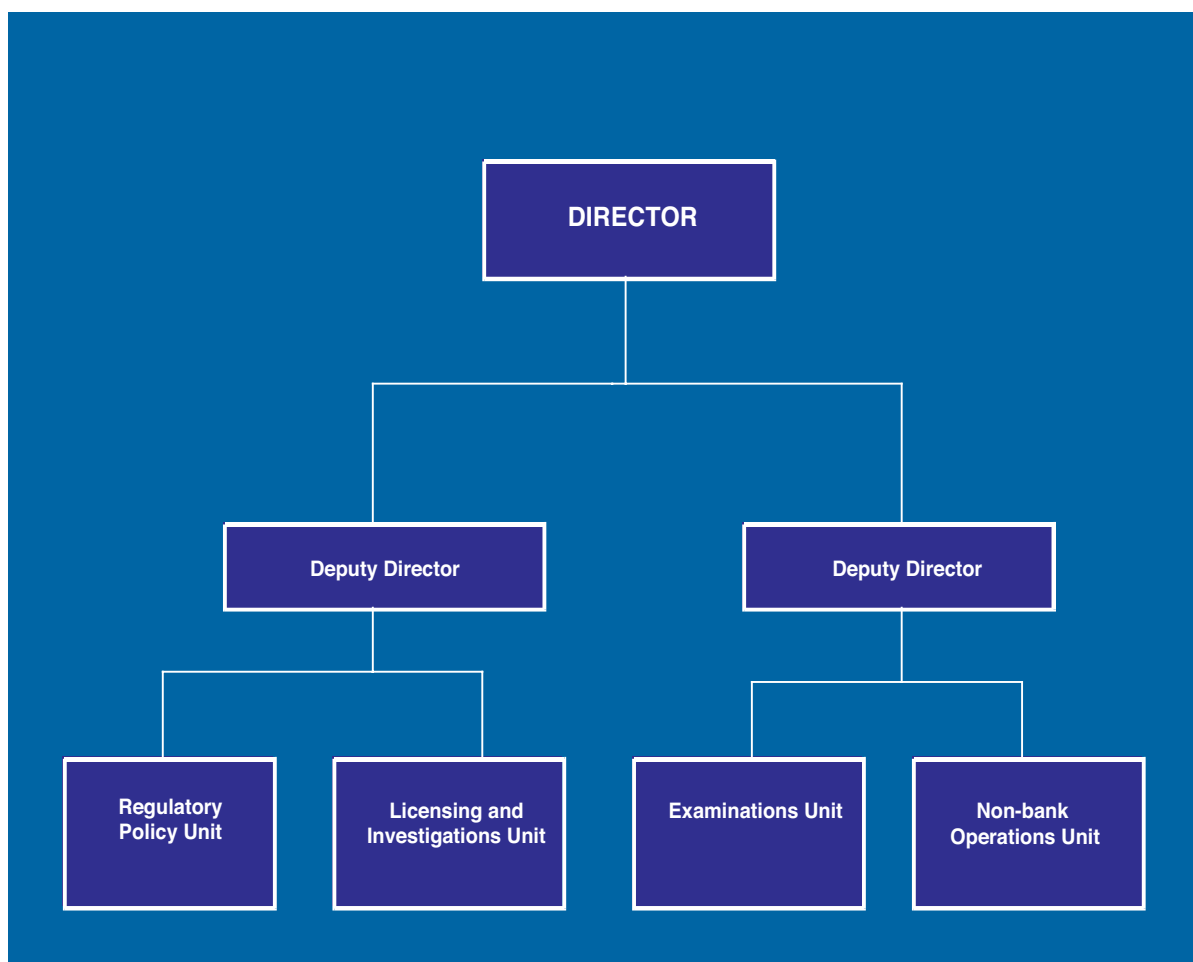
gains of the financial sector, especially the banking system, the major challenges continued to be the need to improve financial intermediation, as well as delivery of increased financial services that would be cost-effective and more accessible to a wider cross section of Botswana. It is expected that this goal will be progressively addressed by encouraging competition through increased prudent entry into the financial sector, within a robust regulatory and stable overall macroeconomic environment. Furthermore, competition in service delivery will be encouraged by enhanced public awareness of the existing financial services which should increase informed consumer choices by the public at large.

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APPENDIX 1: FRAMEWORK FOR BANKING SUPERVISION

BANKING SUPERVISION DEPARTMENT ORGANISATIONAL CHART



APPENDIX 2: APPROACHES TO REGULATION AND SUPERVISION OF BANKS IN BOTSWANA

1. INTRODUCTION

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

2. LEGAL FRAMEWORK

In general, it is considered that to be effective, a regulatory framework must have sufficient authority established by law, high degree of operational autonomy and adequate human and financial resources. In Botswana, the primary legislation covering the supervision and regulation of licensed financial institutions is the Banking Act. This legislation has been through various phases of development since it was first promulgated as the Financial Institutions Act, in 1975. Important elements of the Banking Act are: explicit provisions for the licensing and authorisation processes, which 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. It is recognised that, primarily, the responsibility for bank soundness lies with owners and managers who have an incentive to operate banks prudently. Market discipline provides further pressure and incentives for good internal governance and imposes sanctions for failures, particularly for institutions listed on the stock exchange. Official supervision is essential to provide external incentives for management and owners of banks to rec-

tify inadequacies in governance and impose control where market behaviour could lead to imprudent conduct, which could have adverse systemic repercussions. These three aspects are subsumed within the legislation and prudential requirements. Thus, the continuing stability and soundness of the banking system and the extent to which it is effective in facilitating intermediation between savers and borrowers as well as operating the payment system, is a reflection of efficiency in all these three areas.

3. AUTHORITY FOR LICENSING BANKS

A central feature of banking supervision is establishing criteria for licensing of banks. Banking is a heavily regulated industry because banks take deposits from the public, the critical role of banks in the country's payments system and, related to both of these functions, the 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 of Botswana by Section 3 of the Banking Act. This section covers licensing of commercial banks, merchant/investment banks, credit institutions and discount houses.

4. LICENSING POLICY AND PROCEDURES FOR ESTABLISHING A BANK

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

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

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

strate 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.

5. CORE PRUDENTIAL STANDARDS

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

(a) Capital Adequacy Requirements

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

(b) Statutory Reserve and Liquid Asset Requirements

In terms of Section 40(1) of the Bank of Botswana Act, 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 5 percent of their deposit liabilities in domestic currency.

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

In general, a licensed financial institution should establish appropriate and prudent policies for the management of 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.

(c) Asset Quality

(i) Asset Concentrations (Large Exposures)

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

(ii) 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. Furthermore, banks are restricted from granting facilities to officers or employees (other than the director) unsecured loans, advances or credit facilities, the amount of which, in aggregate, exceed one year’s emoluments of such officer or employee.

(iii) Provisions

Section 14 of the Banking Act, deals with certain items, which should be provided for, that is, reserves to be made to take into account potential losses when determining a bank’s capital adequacy. It establishes the legal framework for the Bank of Botswana to assess adequacy of the provisions for non-performing assets. In addition, banks are required to adhere to sound in-

ternational accounting standards for timely recognition and reporting of impaired assets.

6. MAIN SUPERVISORY APPROACHES

(a) On-site Examinations and Budgeting Meetings

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

With effect from 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 issues that may adversely affect the

performance of a bank for which they are responsible. 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.

(b) 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, arranges tripartite meetings with each financial institution and its external auditors. These meetings are convened to discuss matters relevant to the Bank's supervisory responsibilities that may have arisen in the course of a statutory audit of a bank's business, its accounting and internal control systems, and its draft audited annual balance sheet and profit and loss account. The forum is also used to share information on the critical risk areas and/or any new developments in accounting and regulatory standards.

7. ACCOUNTING, AUDITING AND DISCLOSURE STANDARDS

Section 22 of the Banking Act requires banks to annually appoint independent external auditors acceptable to the Bank. Statutory audits are conducted annually, usually at financial year-end, except that when a bank intends to capitalise half-year interim profits, it must call for an audit of the accounts. Change of external auditors or financial year-end requires prior approval of the Bank. In general, Botswana banks are required to adhere to international accounting standards, including mandatory audits and disclosure requirements.

8. 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 (revised in October 2006)

for use in both G10 (comprising United States, Japan, Germany, Canada, Britain, France, Italy, Netherlands, Belgium, Sweden and Switzerland) and non-G10 countries. They comprise 25 “Core Principles” that need to be in place for a supervisory system to be effective and are used as a benchmark in the development of a country’s supervision strategies. The main objective of the Core Principles is to harmonise international supervisory

standards. In Botswana, they are also used to reinforce international best practices in banking supervision.

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 IMF. Box 1 presents the 25 Core Principles for Effective Banking Supervision.

BOX 1: THE 25 CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

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

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

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

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

Principle 5: Major acquisitions: The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

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

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

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

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

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

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

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

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

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

Principle 15: Operational risk: Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

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

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

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

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

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

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

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

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

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

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

APPENDIX 3: SUPERVISED FINANCIAL INSTITUTIONS AS AT DECEMBER 31, 2006

(a) BANKS AND OTHER DEPOSIT-TAKING INSTITUTIONS

Institution	Postal Address	Business Locations	External Auditors
COMMERCIAL BANKS			
Barclays Bank of Botswana Limited	P O Box 478, Gaborone	30	PricewaterhouseCoopers
Standard Chartered Bank Botswana Limited	P O Box 496, Gaborone	11	KPMG
First National Bank of Botswana Limited	P O Box 1552, Gaborone	14	Deloitte & Touche
Stanbic Bank Botswana Limited	P/Bag 00168, Gaborone	7	KPMG
Bank of Baroda (Botswana) Limited	P O Box 21559, Gaborone	1	PricewaterhouseCoopers
Bank Gaborone Limited	P O Box 471244, Gaborone	1	PricewaterhouseCoopers
MECHANT BANKS			
African Banking Corporation of Botswana Limited	P/Bag 00303, Gaborone	2	KPMG
STATUTORY BANKS			
Botswana Savings Bank ⁷	P O Box 1150, Gaborone	1	PricewaterhouseCoopers
National Development Bank	P O Box 225, Gaborone	4	KPMG
BUILDING SOCIETY			
Botswana Building Society	P O Box 40029, Gaborone	9	PricewaterhouseCoopers

⁷ 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 Locations
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	3
Exim Bureau de Change	P O Box 1020, Gaborone	1
ASA Bureau de Change	P O Box 2, Lobatse	3
Prosper Bureau de Change	P/Bag BO7, Gaborone	3
Kwa Nokeng Bureau de Change	P O Box 10, Sherwood	2
Proxy Bureau de Change	P O Box 404108, Gaborone	2
Edcom Bureau de Change	P O Box 502429, Gaborone	2
Thari Bureau de Change	P O Box 40074, Gaborone	1
Sherwood Ranch Bureau de Change	P O Box 1, Sherwood	1
Madikwe Bureau de Change	P O Box 402885, Gaborone	1
Aldaph Bureau de Change	P O Box 41436, Gaborone	2
Counter Bureau de Change	P/Bag F388, Francistown	1
Kalahari Bureau de Change	P O Box 1116, Gaborone	1
Maeto Bureau de Change	P O Box 22, Mahalapye	1
Bellagio Bureau de Change	P/Bag BR 321, Gaborone	3
Open Door Bureau de Change	P O Box 839, Maun	2
SMI Bureau de Change	P O Box 201641, Gaborone	1
American Express Bureau de Change	P O Box 45140, Gaborone	1
Star Bureau de Change	P O Box 80491, Gaborone	1
The Silver Bureau de Change	P O Box 1894, Ramotswa	1
Blondie Bureau de Change	P O Box 21712, Gaborone	1
FX Africa Bureau de Change	P O Box 20537, Gaborone	1
Cape to Cairo Bureau de Change	P O Box 5, Kasane	1
Business Towers Bureau de Change	P O Box 40943, Gaborone	4
Nsundano Bureau de Change	P O Box 243, Kasane	1
Theo Bureau de Change	P O Box 20918, Maun	1
Unity Bureau de Change	P O Box 1586, Francistown	1
Royalty Bureau de Change	P/Bag BO 259, Gaborone	2
Gorogang Bureau de Change	P O Box 46785, Gaborone	1
Limpopo Bureau de Change	P O Box 8, Sherwood	1
Palapye Bureau de Change	P O Box 10408, Palapye	1
Rennies Bureau de Change	P O Box 2482, Gaborone	1
Investors View Bureau de Change	P O Box 266, Nata	1
Crystal Diamond Bureau de Change	P O Box 20554, Gaborone	1
Buttercup Bureau de Change	P O Box 402084, Gaborone	1
River Ride Bureau de Change	P O Box 301106, Francistown	1
Goodrate Bureau de Change	P O Box 923, Ghanzi	1
Genesis Bureau de Change	P/Bag BR 225, Gaborone	1
Apijoe Bureau de Change	P O Box 458, Mogoditshane	1

(c) COLLECTIVE INVESTMENT UNDERTAKINGS

Name	Postal Address
African Alliance Botswana Management Company (Pty) Ltd	P O Box 2770, Gaborone
African Alliance International Limited	P O Box 2770, Gaborone
Stanbic Investment Management Services (Pty) Limited	P/Bag 00168, Gaborone

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

Name	Postal Address
Seedco. International Limited	P O Box 478143, Gaborone
ABC (International) Limited	P/Bag 00303, Gaborone
ABC Holdings Limited	P/Bag 00303, Gaborone
RPC Data International Limited	P/Bag BR 42, Gaborone
Kingdom Bank Africa Limited	P O Box 45078, Gaborone
Nugen (Pty) Limited	P O Box 408, Gaborone
Imara Holdings Limited	P/Bag 00186, Gaborone
Cherubin Ventures (Pty) Limited	P O Box 1444, Gaborone
Enterprise Banking Group (Pty) Limited	P/Bag 351, Gaborone
Island View (Pty) Limited	P O Box 41029, Gaborone

(e) MICRO-FINANCE INSTITUTIONS

Name	Postal Address
Women's Finance House Botswana	P/Bag 124, Gaborone

APPENDIX 4: DEFINITION OF TERMS

DEFINITION OF BANKING SUPERVISION TERMINOLOGY

- (a) **Asset Concentration:** Measures aggregate exposure to one borrower, an affiliated group of borrowers, or borrowers with a common controlling interest, common management, cross guarantees or financial interdependency which cannot be substituted in the short term. This exposure is usually expressed as a percentage of the bank's unimpaired capital and its various thresholds are subjected to prudential regulatory requirements. In terms of the Banking Act (CAP. 46:04), exposure in excess of 10 percent of the bank's unimpaired capital is deemed an asset concentration requiring prior approval of the Board of Directors of the lending financial institution. Exposure in excess of 30 percent of the bank's unimpaired capital requires prior Bank of Botswana approval.
- (b) **Asset Quality:** A relative measure of the performance of the bank's loan portfolio based on the appraisal of the asset, concerning the degree of risk and the likelihood of recovery, adherence to the terms of contracts and orderly liquidation of the account. Good quality asset means the loan, advance, or investment is producing cashflow as was expected and/or agreed upon.
- (c) **Adverse Classifications:**
- (i) **"Substandard" Assets** – A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified 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.
 - (ii) **"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 that 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.
 - (iii) **"Loss" Assets** – Assets classified as losses are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this potentially worthless asset even though partial recovery may be effected in future.
- (d) **Core Capital:** An aggregate of share capital, share premium, general reserve and retained earnings, also called Tier 1 capital. It represents the most stable and permanent form of capital for supporting a bank's operations. (See page 34 for computations).
- (e) **Total Risk-Weighted Assets:** An aggregate of the total value of assets after adjusting for the risk inherent in each asset for both on-balance sheet and off-balance sheet items. A list of assets and the corresponding risk conversion factors used in risk-weighting are presented on page 35.
- (f) **Unimpaired Capital:** Unimpaired in relation to the capital of a bank means the absence of any legal or technical covenant, term, restriction or encumbrance which would otherwise render such capital not to be freely available for distribution to depositors 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 34.

- (g) **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”.

RATIOS

- (a) **Return on Equity (ROE):** The ratio measures the after-tax profit against shareholders' funds. The ratio, however, tends to favour high leveraged banks in that the ratio tends to be higher for low capitalised banks than for large capitalised banks. It is of major interest to the shareholders of the bank, and less so for banking supervisory authorities.
- (b) **Return on Average Total Assets (ROAA):** The ratio measures after-tax profits as a percentage of average total assets. This ratio is widely used by both banking supervisors and market analysts since assets are the base from which earnings are primarily derived. The ratio measures the earnings capacity of the assets of the financial institution. It measures profit earned against the amount invested in assets and is the key to profitability measurement as it shows how efficiently a financial institution's assets are employed. It is also used to measure the effectiveness of management's decisions with respect to resource utilisation. The higher the ratio the more efficient the management is in its asset allocation decisions.
- (c) **Dividend Pay-Out:** The ratio measures the proportion of the after-tax income that is paid out to shareholders. This ratio is of greater interest to investors than for banking supervision. It is the inverse of this ratio, profit retention ratio that is of greater interest for prudential supervision. Emphasis is on the adequacy of capital with reference to the quality of capital funds in relation to the balance sheet risk profile, i.e., core and unimpaired capital to risk-weighted assets ratio. The rationale is that owners of banks must have sufficient own funds in a bank, though it is recognised that unnecessarily high capital levels could result in economic inefficiencies, if not employed productively. However, for commercial and other

strategic reasons, most banks will retain some or a portion of their income to build greater capacity by way of a larger capital base, in order to take advantage of lending and/or investment opportunities in large projects, or to support organic growth of the bank.

- (d) **Capital Growth:** The ratio measures the impact of retained income and other capitalised funds on the capital base of a bank. Ideally, the bank's rate of income retention must keep pace with its asset growth, or risk exposure. Where there is a disparity in growth, especially with acceleration of the latter, the bank's solvency will be weakened.
- (e) **Risk-Based Capital:** In November 1995, the Bank adopted the internationally recommended framework on capital adequacy measurement and standards for banks, commonly known as the Basel Committee 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 excludes, however, any elements that are likely to impair a bank's capital such as investment in unconsolidated subsidiaries and associated companies, and connected lending of a capital nature. The use of risk-weighted assets is to take into account the risk inherent in the different types of assets. If two banks with exactly the same size of assets and capital base are to be compared, their unadjusted capital ratio will be the same. However, if the inherent risk of the balance sheet is taken into consideration, the bank with less risky assets will enjoy a higher capital adequacy ratio and 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.

- (f) **Net Spread (Percent):** This ratio covers only those assets and liabilities that have an interest rate attached to them. Thus, it excludes the impact of non-interest-bearing demand deposits, capital and non-remunerated reserve requirements on net interest earned and thus on bank profits. This is helpful in that it isolates the effect of interest rates on bank profits and thereby enables a better understanding of the sources of bank profitability and, consequently, of vulnerability of bank earnings.
- (g) **Net Interest Margin (Percent):** This ratio identifies the core earnings capability of the bank – its interest differential income as a percentage of average total earning assets.
- (h) **Other Operating Income to Total Assets (Percent):** The ratio shows the dependence on “non-traditional” income. Growth in this ratio can indicate diversification into fee-based financial services or a reaching for speculative profits to make up for deficiencies in the bank’s core interest differential income.
- (i) **Net Operating (or Intermediation) Margin (Percent):** The intermediation margin can be defined as the differential between the cost of funds and the yield on earning assets plus related fee income. The differential quantifies the cost extracted by the banking system for intermediating between the providers and the users of funds.
- (j) **Net Income Per Staff:** The ratio measures the average income generated by each staff member. Note that this ratio will be significantly different for a wholesale (investment) bank with relatively few but highly paid staff compared to a retail bank with a large branch network and many lowly paid clerical staff.
- (k) **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 a different type to be compared to some degree. It looks at the effect of staffing decisions, regardless of whether these are low cost, low expertise clerical staff, or high cost and highly qualified professionals.
- (l) **Cost to Income:** The ratio measures the non-interest expenses as a percentage of net interest income plus non-interest income (total operating income). It shows how well the non-interest expenses are managed by the institution relative to the level of total operating income.
- (m) **Average Cost of Deposits:** The ratio measures interest paid on deposits as a percentage of total average deposits. It shows the average cost of deposits. Institutions with a large customer base operating transaction accounts (demand deposits) relative to interest earning savings accounts tend to report low average cost of deposits. In turn, banks that tend to rely on wholesale deposits (call and other highly volatile money) for funding will have relatively high average cost of deposits. Similarly, banks that start to engage in aggressive marketing for deposits, either due to liquidity concerns and/or to fund expansion of their lending business, will exhibit high average cost of deposits.

CAPITAL ELEMENTS

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

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

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

less

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

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

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

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

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

4. Total Capital Funds = Sum of 1 and 2**5. Total Unimpaired Capital = 4 less 3**

RISK WEIGHTS APPLIED ON VARIOUS ASSETS FOR PURPOSES OF CAPITAL ADEQUACY MEASUREMENT

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

APPENDIX 5: AGGREGATE FINANCIAL STATEMENTS OF LICENSED BANKS: 2002–2006 DATA TABLES

TABLE 5.1: AGGREGATE BALANCE SHEET OF LICENSED COMMERCIAL BANKS: 2002–2006 (PULA MILLION)

Assets	2002	2003	2004	2005	2006
1. Cash and balances with the Central Bank	628.2	776.3	820.5	722.3	1 109.1
a. Currency	327.8	315.8	314.1	375.2	387.6
aa. Hard currency and gold bullion	33.7	32.5	35.1	80.8	80.0
ab. Local currency	294.1	284.2	279.0	294.4	307.6
b. Balances with Central Bank	287.7	417.7	432.1	347.1	721.6
c. Other	17.4	248.5	232.1	51.5	0.0
2. Trading securities at market value (BoBCs)	1 946.9	2 462.5	3 047.7	4 784.7	14 218.3
3. Placements with other banks and credit institutions	1 959.7	2 004.5	1 942.6	3 003.0	3 067.2
4. Loans and advances to other customers (net of specific provisions)	6 862.9	7 609.2	8 684.8	9 129.5	10 916.0
5. Investment securities	82.9	587.9	386.1	280.5	226.3
6. Fixed assets net of depreciation	197.8	208.8	212.2	199.8	213.2
7. Other assets (net)	368.5	429.5	429.8	422.8	663.4
Total Assets	12 046.9	14 078.6	15 523.8	18 542.6	30 413.4
Liabilities					
1. Amounts owed to government institutions	0.1	0.1	0.1	0.1	0.0
a. Central Bank accounts	0.0	0.0	0.0	104.8	49.8
b. Direct Government credits (CB or MFDP)	113.6	108.8	104.2	0.0	0.0
c. Other	0.0	0.0	0.0	0.0	0.0
2. Due to other banks and credit institutions	244.2	254.4	410.4	1 467.3	1 654.2
3. Securities sold under repurchase agreements	0.0	0.0	0.0	0.0	0.0
4. Due to other customers/depositors	9 701.3	11 488.4	12 559.1	14 008.7	24 943.0
5. Shareholders funds	1 219.7	1 436.4	1 273.6	1 412.2	1 654.6
6. Other liabilities	768.0	788.8	856.4	1 549.6	2 111.8
a. Taxes payable	126.4	61.7	104.1	114.8	90.1
b. Dividends payable	219.4	53.2	118.3	33.3	80.8
c. Accrued expenses	82.0	135.0	85.8	166.7	83.4
d. Other	340.3	540.7	551.9	1 234.8	1 857.6
7. Other borrowing including international lending agencies	48.5	0.0	0.0	0.0	0.0
Total Liabilities	12 046.9	14 078.6	15 523.8	18 542.6	30 413.4

TABLE 5.2: AGGREGATE INCOME STATEMENT OF LICENSED COMMERCIAL BANKS: 2002–2006 (PULA MILLION)

	2002	2003	2004	2005	2006
1. Interest and similar income	1 544.8	1 790.7	1 919.6	2 171.0	3 422.0
2. Interest expense	779.4	914.9	982.2	1 094.0	2 105.6
3. Net interest income [1–2]	765.4	875.7	937.4	1 077.0	1 316.4
4. Other operating income	452.2	487.9	547.5	655.1	752.0
5. Gross operating income/(loss) [3+4]	1 217.6	1 363.6	1 484.9	1 732.1	2 068.5
6. Bad and Doubtful Debts Provisions	46.5	74.7	50.6	53.0	90.5
a. Specific loss provision expenses	61.9	88.9	92.2	66.1	105.5
b. General loss provision	8.3	8.9	(22.6)	5.9	(0.5)
c. Releases and Recoveries of bad debts previously written off	(23.8)	(23.1)	(19.0)	(18.4)	(13.4)
d. Share of Associate Company Profit	0.0	0.0	0.0	(0.6)	(1.1)
7. Operating income/(loss) net of specific loss provisions	1 171.1	1 288.9	1 434.3	1 679.1	1 978.0
8. Operating expenses	574.2	661.2	713.5	785.7	847.7
a. Salaries and employee benefits	262.4	300.0	313.8	340.7	368.8
b. Administrative expenses	22.2	0.0	77.7	21.7	28.8
c. Auditing and consulting expenses	6.9	0.4	17.5	2.8	2.0
d. Rents paid	9.3	22.2	37.5	16.6	17.5
e. Depreciation and amortization	30.0	38.5	42.0	9.9	12.1
f. Other	243.4	300.2	225.1	394.0	418.4
9. Other provisions and write-offs	0.0	0.0	0.0	1.3	0.0
a. Investments	0.0	0.0	0.0	1.3	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
10. Net operating income/(loss) [7–8–9]	596.8	627.7	720.7	892.1	1 130.3
11. Extraordinary Gains/(Losses)	(0.5)	(0.4)	(2.1)	0.0	0.0
a. Net Gains/(Losses) on revaluation of assets	0.5	0.0	0.0	0.0	0.0
b. Other Gains/(Losses)	0.0	(0.4)	2.1	0.0	0.0
12. Net income/(loss) before tax [10+11]	596.3	627.3	718.6	892.1	1 130.3
13. Income tax	83.7	84.0	120.7	145.7	190.4
14. Net income/(loss) after tax [12–13]	512.6	543.3	597.9	746.3	939.9
15. Transfers from revaluation/to general provisions	(0.8)	0.0	(0.3)	0.0	0.0
16. Dividends declared (paid & proposed)	489.7	399.0	476.9	642.6	716.2
17. Retained earnings for the year [14-15-16]	23.8	144.3	121.3	103.7	223.7
18. Retained earnings at the beginning of the year	635.9	658.2	774.5	895.7	999.4
19. Retained earnings at the end of the year [17+18]	659.6	802.4	895.7	999.4	1 223.1

TABLE 5.3: AGGREGATE BALANCE SHEET OF STATUTORY BANKS IN BOTSWANA (PULA MILLION)

Assets	2005	2006
1. Cash and balances with the Central Bank (a+b+c)	11.7	1.9
a. Currency	6.6	0.4
aa. Hard currency and gold bullion	0.0	0.0
ab. Local currency	6.6	0.4
b. Balances with Central Bank	5.1	1.5
c. Other	0.0	0.0
2. Trading securities at market value (BoBCs)	183.1	0.0
3. Placements with other banks and credit institutions	264.6	493.0
4. Loans and advances to other customers (net of specific provisions)	1 361.5	1 692.5
5. Investment securities	1.7	0.0
6. Fixed assets net of depreciation	103.6	112.8
7. Other assets (net)	27.2	27.8
Total Assets	1 953.4	2 328.1
Liabilities		
1. Amounts owed to government institutions	0.0	0.0
a. Central Bank accounts	0.0	0.0
b. Direct Government credits (CB or MFDP)	0.0	0.0
c. Other	0.0	0.0
2. Due to other banks and credit institutions	0.0	0.0
3. Securities sold under repurchase agreements	0.0	0.0
4. Due to other customers/depositors	367.5	407.4
5. Shareholders funds	1 110.2	1 380.3
6. Other liabilities	39.7	65.0
a. Taxes payable	0.0	0.0
b. Dividends payable	9.5	12.8
c. Accrued expenses	0.0	0.0
d. Other	30.2	52.3
7. Other borrowing including international lending agencies	436.0	475.3
Total Liabilities	1 953.4	2 328.1

TABLE 5.4: AGGREGATE INCOME STATEMENT OF STATUTORY BANKS IN BOTSWANA (PULA MILLION)

	2005	2006
1. Interest and similar income	218.7	259.0
2. Interest expense	65.5	82.7
3. Net interest income [1–2]	153.2	176.3
4. Other operating income	22.3	29.8
5. Gross operating income/(loss) [3+4]	175.5	206.1
6. Bad and Doubtful Debts Provisions	32.0	27.3
a. Specific loss provision expenses	19.3	28.7
b. General loss provision	12.3	(1.4)
c. Releases and Recoveries of bad debts previously written off	11.7	0.0
7. Operating income/(loss) net of specific loss provisions	131.8	178.8
8. Operating expenses	104.4	103.8
a. Salaries and employee benefits	55.2	50.4
b. Administrative expenses	0.0	0.0
c. Auditing and consulting expenses	0.0	0.0
d. Rents paid	0.8	0.0
e. Depreciation and amortization	8.4	7.4
f. Other	39.9	45.9
9. Other provisions and write-offs	0.0	0.0
a. Investments	0.0	0.0
b. Other balance sheet items	0.0	0.0
c. Off-balance sheet items	0.0	0.0
10. Net operating income/(loss) [7–8–9]	27.4	75.0
11. Extraordinary Gains/(Losses)	0.0	0.0
a. Net Gains/(Losses) on revaluation of assets	0.0	0.0
b. Net Translation Gains/(Losses)	0.0	0.0
c. Other Gains/(Losses)	0.0	0.0
12. Net income/(loss) before tax [10+11]	27.4	75.0
13. Income tax	0.0	0.0
14. Net income/(loss) after tax [12–13]	27.4	75.0
15. Transfers from revaluation/to general provisions	0.0	0.0
16. Dividends declared (Paid & Proposed)	0.0	27.0
17. Retained earnings for the year [14–15–16]	27.4	48.0
18. Retained earnings at the beginning of the year	0.0	0.0
19. Retained earnings at the end of the year [17+18]	27.4	48.0

APPENDIX 6: CHARTS OF KEY PRUDENTIAL AND OTHER FINANCIAL INDICATORS

CHART 6.1: AGGREGATE NET INCOME AFTER-TAX AND GROWTH

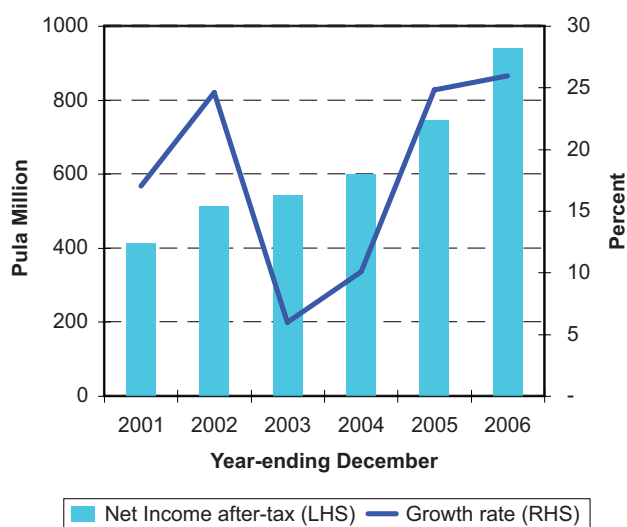


CHART 6.3: AGGREGATE RETURN ON EQUITY

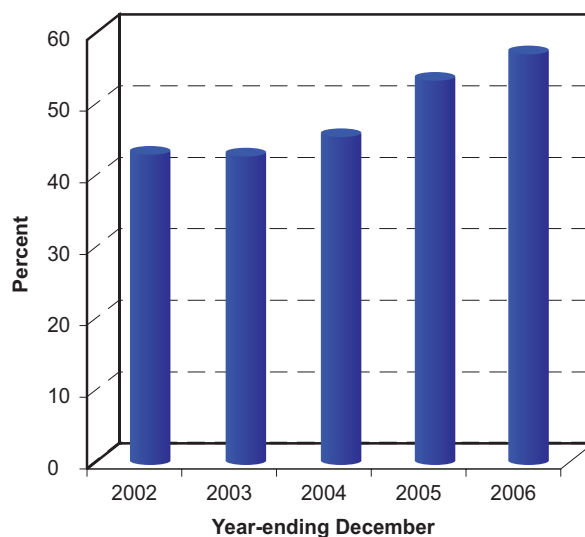


CHART 6.2: AGGREGATE RETURN ON AVERAGE TOTAL ASSETS

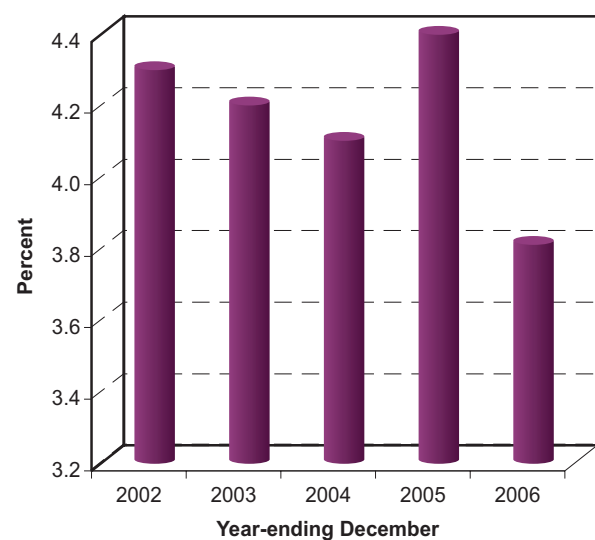


CHART 6.4: AGGREGATE NON-INTEREST INCOME TO GROSS INCOME

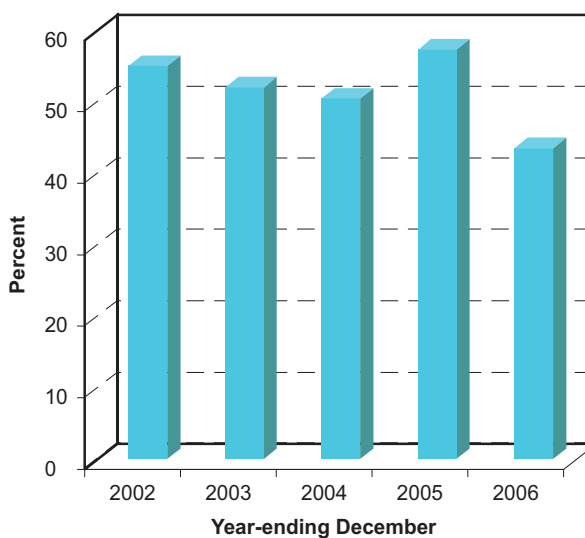


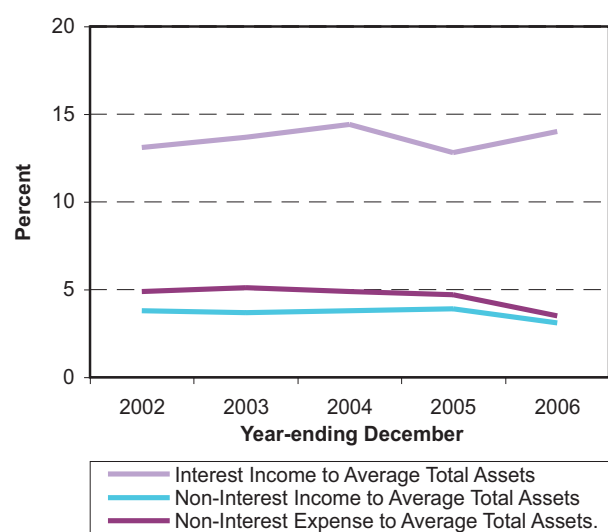
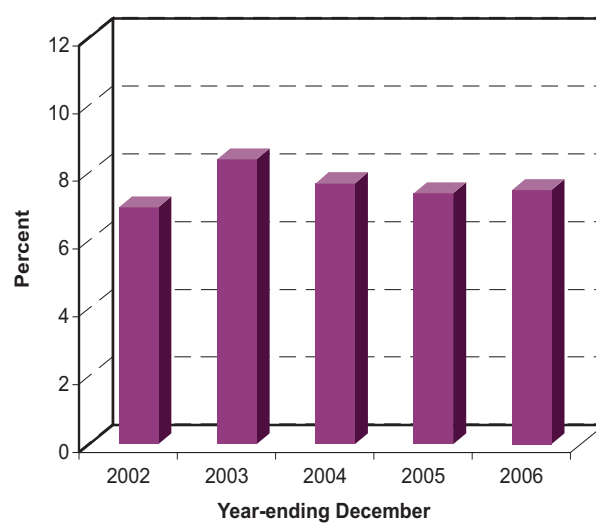
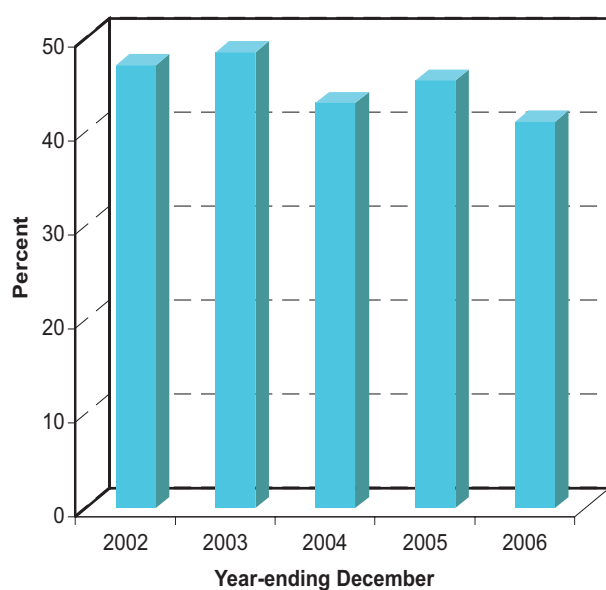
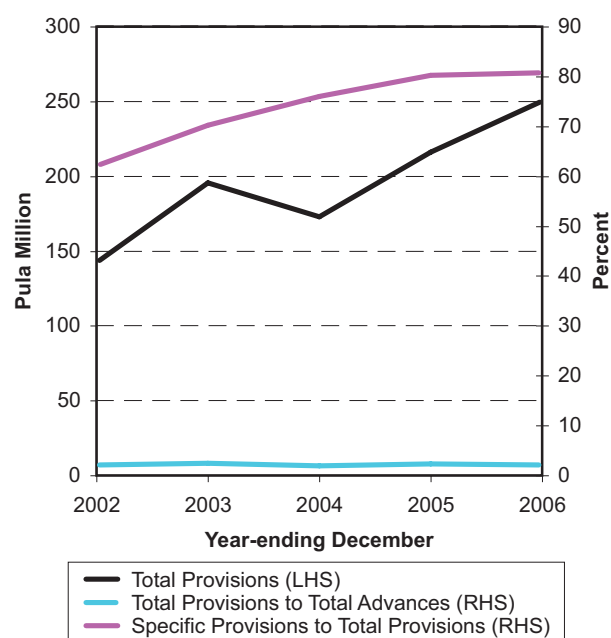
CHART 6.5: AGGREGATE GROSS INTEREST INCOME, NON-INTEREST INCOME AND NON-INTEREST EXPENSE TO AVERAGE TOTAL ASSETS**CHART 6.7: AGGREGATE AVERAGE COST OF DEPOSITS****CHART 6.6: AGGREGATE COST TO INCOME RATIO****CHART 6.8: TOTAL PROVISIONS, TOTAL PROVISIONS TO TOTAL ADVANCES, AND SPECIFIC PROVISIONS TO TOTAL PROVISIONS**

CHART 6.9: AGGREGATE ADVANCES TO DEPOSITS RATIO

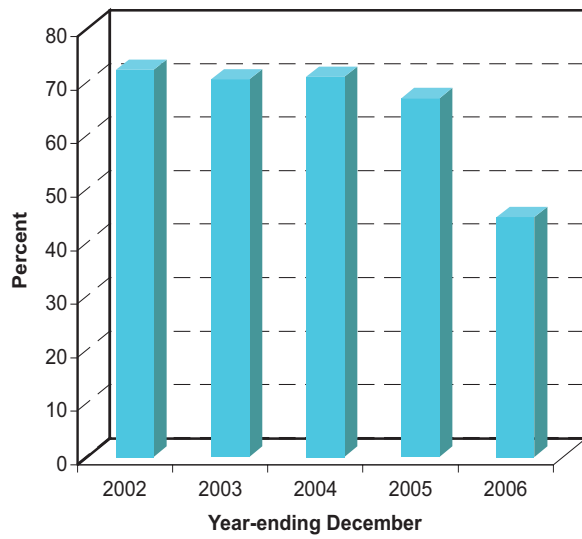


CHART 6.10: AGGREGATE DEPOSITS BY TYPE

