Banking Supervision Annual Report 2013

Bank of Botswana

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Contents

List of Abbreviations

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
ATA	Average Total Assets
ATMs	Automated Teller Machines
Banking Act	Banking Act (CAP. 46:04)
BancABC	African Banking Corporation of Botswana Limited
Barclays	Barclays Bank of Botswana Limited
Baroda	Bank of Baroda (Botswana) Limited
BCBS	Basel Committee on Banking Supervision
BBS	Botswana Building Society
Bank Gaborone	Bank Gaborone Limited
BIS	Bank for International Settlements
BoBCs	Bank of Botswana Certificates
BSB	Botswana Savings Bank
BSE	Botswana Stock Exchange
CAMELS	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to Market Risk
Capital	Capital Bank Limited
CIUs	Collective Investment Undertakings
DSAs	Direct Sales Agents
FNBB	First National Bank of Botswana Limited
GDP	Gross Domestic Product
HHI	Herfindahl–Hirschman Index
ICAAP	Internal Capital Adequacy Assessment Process
IMF	International Monetary Fund
IT	Information Technology
KBAL	Kingdom Bank Africa Limited
KYC	Know Your Customer
LCs	Letters of Credit
LHS	Left Hand Scale
MFDP	Ministry of Finance and Development Planning
MoU	Memorandum of Understanding
NBFIRA	Non-Bank Financial Institutions Regulatory Authority
NDB	National Development Bank
NPLs	Non-Performing Loans
OECD	Organisation of Economic Cooperation and Development
Pty Ltd	Proprietary Limited
RAS	Risk Assessment System
RHS	Right Hand Scale

ROAA	Return on Average Total Assets
ROE	Return on Equity
RWA	Risk-Weighted Assets
SACCOS	Savings and Credit Co-operative Society
SMEs	Small and Medium Enterprises
Stanbic	Stanbic Bank Botswana Limited
Stanchart	Standard Chartered Bank Botswana Limited
STR	Suspicious Transactions Reports
SWIFT	Society for Worldwide Interbank Financial Telecommunication
USD	United States dollar
ZAR	South African rand

Foreword

The global economic recovery continued to be weak during 2013, and this impacted negatively on the domestic economic performance in terms of sluggish economic growth. As a result, the financial performance and profitability of Botswana banking industry showed a deceleration of growth rates. Notwithstanding the unfavourable economic conditions, the banking sector was stable and remained broadly sound, prudently managed and solvent, as shown by positive growth rates of most of the industry financial soundness indicators. The capital and liquidity ratios of most industry players remained well above the statutory prudential requirements and the industry maintained satisfactory asset quality. Moreover, access to banking services expanded further through an increase in branches, Automated Teller Machines (ATMs) and other service delivery channels such as mobile phone and internet-based banking. Two new banks, Bank of India (Botswana) Limited and State Bank of India (Botswana) Limited, were licenced and commenced operations in 2013.

A gradual improvement in the competitiveness of the Botswana banking sector was noted, and it is anticipated that the entrance of the two banks in the market will further enhance competition and competitiveness in the market as well as access to finance.

Banks' transparency with regard to the disclosure and monthly publication of deposit interest rates and other pricing information in domestic newspapers has improved, and this is reflective of banks' continued responsiveness to supervisory and policy signals. However, the high cost of banking services vis-à-vis the quality of financial services continues to be a source of public concern. To address the issue of high cost of banking services, the Bank imposed a two-year moratorium on an increase in bank charges, commissions and other non-interest fees, effective January 1, 2014. This does not apply to monetary policy or Bank Rate linked interest charges.

The Bank continued to review banking regulatory and supervisory policies and practices in order to be in line with the recommendations on financial architecture reforms made during the year by multilateral agencies such as the International Monetary Fund (IMF), World Bank, Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS). In particular, the Bank completed and issued the draft Capital Measurement and Capital Standards for Botswana in preparation for the full implementation of Basel II/III in 2015, as well as the commencement of the Risk-Based Supervision Framework project.

The Bank will continue supervisory surveillance to closely monitor the performance of the financial sector given the continued uncertainties surrounding the state of the world economy, and the likely adverse effects on the Botswana economy and the health of banking institutions.

The objective of this report is to inform the public and other stakeholders about the objectives, structure, form and process of banking supervision and regulation in Botswana, as well as financial performance of the banking industry during 2013.

Linah K Mohohlo

GOVERNOR

Introduction

The safety and soundness of the banking sector in Botswana during 2013 was not adversely affected by weak recovery in the global economy. Botswana's banking sector recorded modest growth as the total industry balance sheet grew by 3.5 percent during the year. The banks' total assets grew marginally to P60 billion as at December 31, 2013 compared to P58 billion as at December 31, 2012. This growth was somewhat unbalanced throughout the banking sector, given the large loan growth by some large banks while deposits from customers at some banks grew at a slower rate. Based on the key financial soundness indicators, the banking sector remained safe, sound and stable in 2013.

The banking sector remained profitable, with after-tax profits amounting to P1.8 billion, which is more or less the same as in 2012. The sector's Liquid Asset ratio continued to fall during the year owing to an improvement in the financial intermediation ratios for most banks. It nevertheless, remained above the 10 percent statutory minimum requirement. The aggregate banking sector Large Exposures to Unimpaired Capital Ratio of 148.2 percent was well within the 800 percent prudential maximum limit. This signifies banks' prudent management of credit concentration risk.

The number of commercial banks were 13 in 2013, following the licensing of two banks. Furthermore, 2013 was marked by an increase in banking business delivery channels, such as mobile phones and internet-based banking services. In an effort to reach out to a wider clientele, banks continued to strengthen their strategic partnerships with mobile network operators to provide financial services to the unbanked population.

In consultation with the banking industry, the Bank finalised the draft Capital Measurement and Capital Standards for Botswana, and commissioned the parallel-run of Basel I and Basel II/III on January 1, 2014. The implementation of these new capital measurement and standard in Botswana will be in phases, commencing with simple approaches on December 31, 2014 and culminating in the adoption of advanced approaches by qualifying banks on December 31, 2016.

This Banking Supervision Annual Report is structured as follows: Chapter 1 outlines the structure of the financial sector, while Chapter 2 covers the assessment of the financial performance of the banks. Chapter 3 addresses licensing, financial inclusion and consumer protection issues. Chapter 4 describes approaches to Basel II/III implementation in Botswana. The 2013 on-site examinations and off-site surveillance activities are outlined in Chapters 5 and 6. The appendices are in the last part of the Report.

Chapter 1: Botswana Financial System and Selected Indicators

Structure of the Banking Industry and Other Supervised Financial Institutions

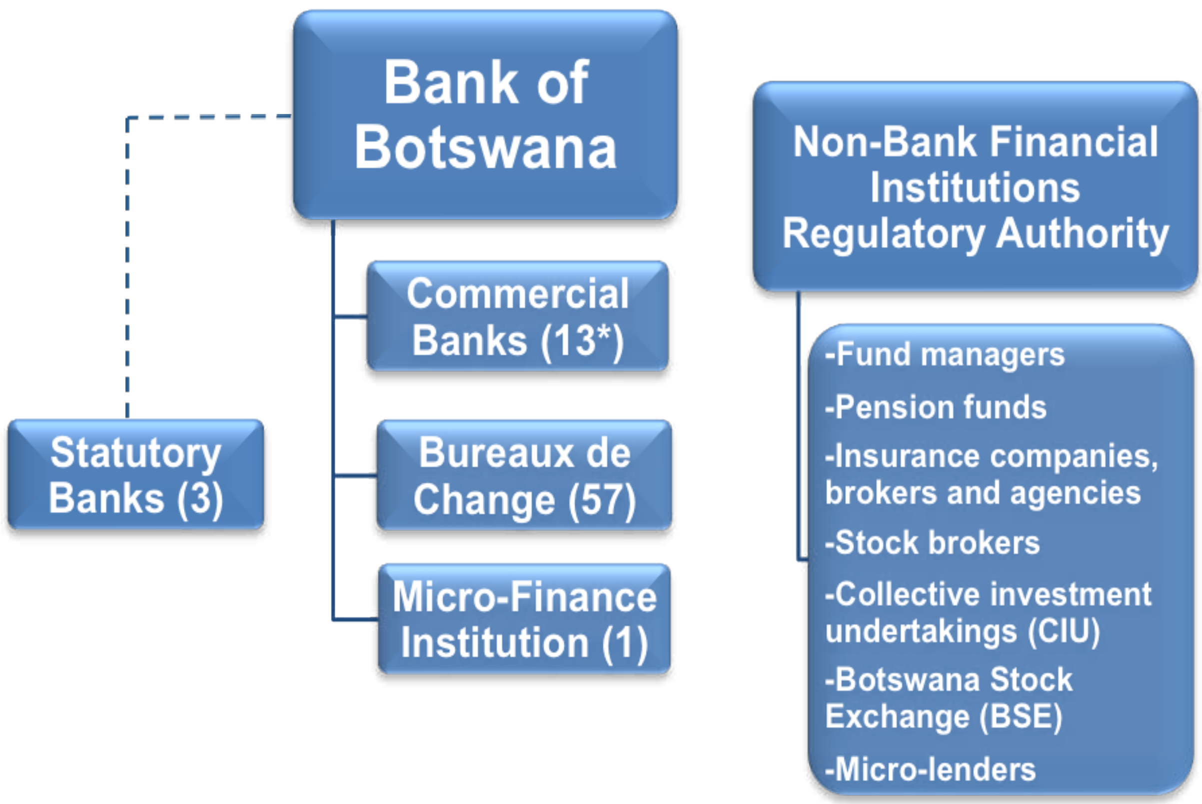
(Commercial Banks, Statutory Banks and Related Entities)

Diagram 1.1 outlines the financial sector regulatory structure as at December 31, 2013. The Bank is responsible for the regulation and supervision of commercial banks, statutory banks, bureaux de change and a deposit-taking micro-finance institution, while the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) supervises the insurance industry, pension funds, Collective Investment Undertakings (CIUs), Botswana Stock Exchange (BSE), fund managers and other investment advisory services, as well as micro-lending businesses. There were 13 licensed commercial banks and 3 statutory banks in 2013. Operational bureaux de change decreased from 61 to 57 during the period under review.

The Bank and NBFIRA signed a Memorandum of Understanding (MoU) on March 2, 2013, to facilitate supervisory collaboration and exchange of information between the two authorities to the extent permissible by law. The MoU will assist the parties to collaborate and leverage on each other for effective and efficient performance of their respective functions. The key tenets of the MoU are to:

(a) limit the scope of regulatory arbitrage and gaps which pose a threat to the safety, integrity and stability of the financial sector;
(b) set common minimum standards for governance of financial institutions;
(c) establish means of access to prudential information necessary for prudential supervisory purposes;
(d) foster supervisory cooperation and high level consultation on sectoral trading and undertaking activities which traditionally have been the remit for either banks and/or insurance com-

Diagram 1.1: Regulatory Architecture



*Includes two offshore commercial banks

panies, as well as for minimum standards for credit risk transfers, including derivative products and similar financial contracts;

(e) facilitate smooth functioning of the financial system infrastructure; and

(f) in general, promote consolidated supervision.

However, the MoU does not abrogate the powers, responsibilities and any legally binding obligations or supersede any laws and regulations of the two authorities as enshrined in either the Bank of Botswana Act (CAP. 55:01), Banking Act (CAP. 46:04) or the NBFIRA Act, 2006.

Employment Trends in the Banking Sector

Employment levels in the banking sector are presented in Table 1.2. The banking industry recorded a 3 percent growth in employment[1] in 2013, resulting in a staff complement of 4 582, compared to 4 447 in 2012. This growth was, in the main, accounted for by the 26.6 percent and 17.1 percent increase in the staff complement of two small banks. Most banks posted marginal staff increases, while three banks recorded a decline in staff complement. The number of expatriate staff employed by the banking industry decreased from 91 to 80 in 2013.

Table 1.1: Representation of Licensed Domestic Banks: 2011 – 2013

	Branches and Sub-Branches			ATMs		
Bank	**2011**	**2012**	**2013**	**2011**	**2012**	**2013**
ABN AMRO (On-shore & Off-Shore)	1	1	1	–	–	–
BancABC	4	6	8	4	7	10
Bank Gaborone	5	6	6	15	19	27*
Bank of India**	–	–	1	–	–	–
Barclays	40	40	42	103	104	112
Baroda	2	2	3	4	4	5
Capital	2	4	4	2	4	4
FNBB	19	21	22	157	159	141*
Kingdom	1	1	1	–	–	–
Stanbic	9	11	11	18	25	26
Stanchart	14	15	15	54	57	65
State Bank of India**	–	–	1	–	–	–
Total	**97**	**107**	**115**	**357**	**379**	**390**

* Of the 141 FNBB ATMs and 27 Bank Gaborone ATMs, 136 and 17 are full ATMs, whereas 5 and 10 are mini ATMs, respectively.

** Newly licensed banks that are majority owned by the government of India.

Banking Business Distribution Channels

During 2013, banks increased delivery channels by way of establishing branches and installing ATMs. The commencement of business by two new banks, and the opening of five new branches by four of the existing banks, resulted in an increase in the number of commercial banks branches around the country from 107 in 2012 to 115 in 2013. An additional 29 ATMs were installed around the country during the year. However, this increase was partially offset by First National Bank of Botswana Limited (FNBB) decision to discontinue the operation of 18 ATMs, bringing the total number of the industry's ATMs to 390 in 2013 from 379 in 2012 as shown in Table 1.1.

New Banking Products and Services

In 2013, banks improved service delivery and increased outreach through electronic banking offerings. Most notable was the expansion of internet-based services which allow merchants to accept credit and debit card payments through the internet. A cash send service, which allows customers to send money through mobile telephones and ATMs, and a remote customer on-boarding service, which provides for account opening through electronic devices, [2] were also introduced to the market.

1 The official statistics on employment do not include Direct Sales Agents (DSAs), since DSAs are treated as temporary staff.

2 Images of all mandatory Know Your Customer (KYC) documents, as well as digital signatures, will be captured at the time of customer engagement and stored within the bank's IT system for ease of retrieval and possible future reviews.

TABLE 1.2: EMPLOYMENT LEVELS FOR LICENSED DOMESTIC BANKS: 2012 – 2013

	2012			2013		
Bank	**Citizens**	**Expatriates**	**Total**	**Citizens**	**Expatriates**	**Total**
ABN AMRO*	2	3	5	1	3	4
BancABC	294	8	302	230	6	236
Bank Gaborone	210	8	218	268	8	276
Bank of India	0	0	0	6	3	9
Barclays	1 190	8	1 198	1 211	4	1 215
Baroda	24	11	35	28	13	41
Capital	106	7	113	112	8	120
FNBB	1 071	10	1 081	1 137	7	1 144
Kingdom	11	8	19	11	7	18
Stanbic	563	13	576	600	5	605
Stanchart	885	15	900	895	14	909
State Bank of India	0	0	0	3	2	5
Total	**4 356**	**91**	**4 447**	**4 502**	**80**	**4 582**

* Includes the off-shore bank

Market Share

Commercial banks continued to account for the dominant share of total banking industry assets, deposits, loans and advances, compared to statutory banks. Despite improvements in financial and operational aspects of statutory banks over the years, Chart 1.1 demonstrates that their market share has remained relatively small in aggregate terms, relative to the size of the banking industry. However, there was a marginal improvement in the statutory banks' market share of total assets and deposits of 9 percent and 4 percent, respectively, in 2013, compared to 8 percent and 3 percent, respectively, in the previous year.

CHART 1.1: BANKING INDUSTRY MARKET SHARE OF TOTAL ASSETS, TOTAL DEPOSITS AND TOTAL LOANS

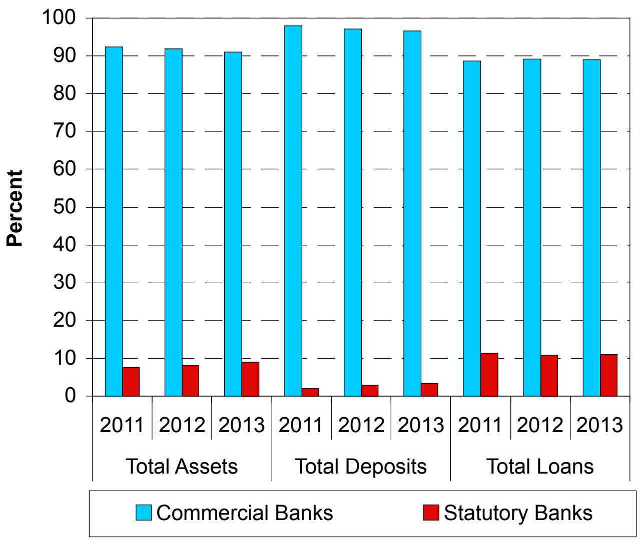
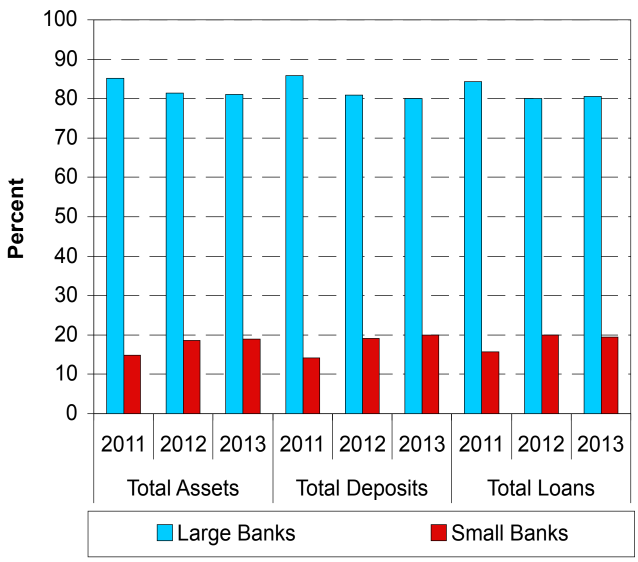


CHART 1.2: COMMERCIAL BANKS MARKET SHARE OF TOTAL ASSETS, TOTAL DEPOSITS AND TOTAL LOANS



The four large banks[3] continued to dominate the

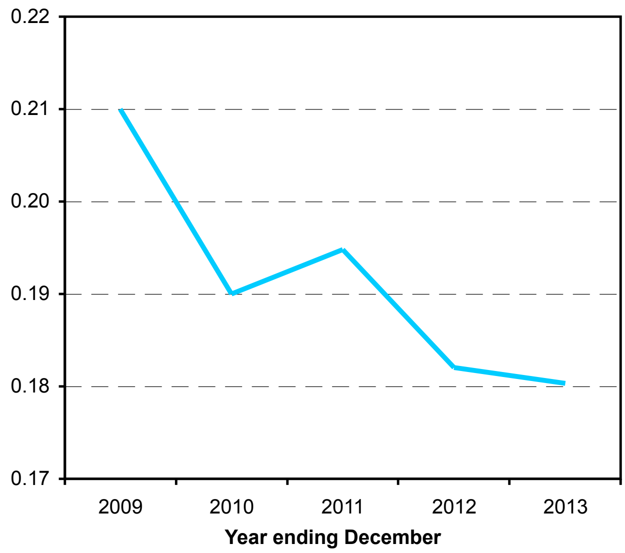
3 A large bank, is one with total assets that constitute 10 percent or more of the aggregate banking industry total assets as at December 31, 2013. These large banks are Barclays Bank of Botswana Limited, First National Bank of Botswana Limited, Stanbic Bank Botswana Limited and Standard Chartered Bank Botswana Limited.

commercial banks' market share, as in the previous years. Chart 1.2 shows that the four largest banks accounted for more than 80 percent of each of industry total assets, deposits, loans and advances, respectively. The marginal increase in the market share of smaller banks indicates that large banks lost a portion of business to smaller banks.

Competition

Increased competition in the banking sector is desirable as it is expected to enhance institutional efficiency, innovation and contribute to superior service delivery. Concentration, which is a measure of market dominance, is often used as an indicator of the degree of competition in an industry. The most widely used measure of concentration is the Herfindahl-Hirschman Index[4] (HHI). Evidence drawn from the results of the analysis based on the HHI over a five-year period shows a modest decline in the index, from 0.21 in 2009 to 0.18 in 2013 as shown in Chart 1.3. This provides some evidence that competitiveness in the Botswana banking sector is gradually improving, as the ratio is at the theoretical threshold of 0.18 for moderate concentration.

Chart 1.3: Herfindahl-Hirschman Index (HHI) for the Botswana Banking Sector



Note: 2012 figures have been re-stated

Therefore, it can be concluded that smaller banks have had some effect in diluting concentration over the five-year period to 2013, which is a welcome development.

Financial Deepening and Development

This section aims to measure the size of the banking sector (financial depth) relative to the size of the economy, and the degree to which different sectors of the economy used financial services (access) in Botswana during 2013, with particular focus on the banking sector. Thus, it aims to measure the extent at which the Botswana banking sector exerts influence on economic development. Empirical evidence suggests that a well-developed financial system promotes economic growth through mobilisation and pooling of savings, as well as optimising the allocation of capital. In addition, a developed financial sector broadens access to finance by all, including the remote area dwellers and small and medium enterprises (SMEs), thus contributing to SME growth.

The assessment was based on the following commonly used indicators that tend to adequately approximate financial deepening and development: the ratios of Banking Assets to Gross Domestic Product (GDP[5]); Banking Credit to GDP; Bank Deposits to GDP; Cash[6] to M2 (measure of liquidity preference); Private Sector Credit to GDP[7]; and M2[8] to GDP. Chart 1.4 presents the trends in these ratios.

The ratios of Bank Deposits and Banking Assets to GDP, which measure the degree of contribution of the financial sector to economic activity through mobilisation of savings and channelling them towards productive capital investments, declined from 65 percent and 79 percent in 2012 to 62 percent and 77 percent in 2013, respectively. On the other hand, the Cash to M2 ratio, which is a measure of liquidity preference, increased from 22 percent in 2012 to 25 percent in 2013, implying that the public had an increased preference to hold cash as opposed to savings at banks. Overall, the combined movement of the three ratios could imply a

4 The HHI (calculated as the sum of squares of market shares of all banks) threshold levels determining the level of concentration in an industry are as follows: below 0.01 suggests a highly competitive market; below 0.1 indicates an unconcentrated market; between 0.1 and 0.18 indicates a highly concentrated market; with a monopolist, the HHI=1; with an industry of 100 equal size firms, the HHI=0.01.

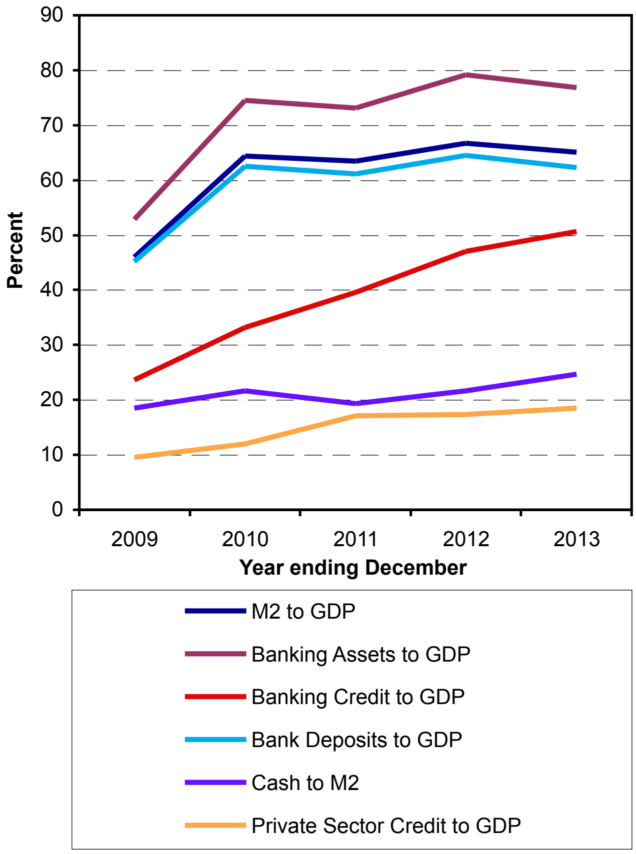
5 GDP figure (constant at 2006 prices). For 2013 this was P78billion.

6 Coins and notes in circulation and other money equivalents that are easily convertible into cash.

7 The Private Sector Credit to GDP ratio as defined by World Bank excludes credit issued to government; government agencies; and public enterprises.

8 M2 (P50.8 billion) comprises all liabilities of financial corporations included in a country's definition of broad money. In the case of Botswana, M2 comprises currency outside depository corporations, transferable deposits (demand deposits) and other deposits included in broad money (time and fixed deposits).

CHART 1.4: FINANCIAL SECTOR DEEPENING



Note: The Private Sector Credit figures (2009-2013) have been re-stated to exclude credit issued to government; government agencies; and public enterprises.

slight deterioration in the depth of the financial system in Botswana.

Financial depth and development, as approximated by the ratio of private sector credit to GDP, improved marginally from 17 percent in 2012 to 18 percent in 2013. When benchmarked against the 39 percent average private sector credit to GDP ratios across countries as reported by the World Bank's 2013 Global Financial Development Report, the Botswana banking system's financial depth is still very shallow at 18 percent, although slightly above the Sub-Saharan average of 17 percent. This ratio, in comparison to other measures of financial depth, has been found to have a strong statistical link to long-term economic growth.

The ratio of banking credit to GDP, another proxy variable that determines the ability of banks to mobilise savings in the economy, increased from 47 percent in 2012 to 51 percent in 2013, which translated into a slight improvement of the sector's financial depth. The M2 to GDP ratio, a measure of the degree of intermediation (money supply) relative to the size of the economy, slightly dropped from 67 percent in 2012 to 65 percent in 2013 due to the slower growth rate of M2 (4 percent) in comparison to GDP (6.6 percent).

Based on the foregoing, while there is a slight improvement in most measures of financial depth, the Botswana banking sector remains shallow relative to global benchmarks of financial depth. In deep financial markets, these ratios are usually more than 100 percent. Therefore, the banking sector remains small relative to the size of the economy, albeit growing. In particular, the improvement in financial intermediation ratios in response to a deliberate policy decision of reducing the amount of excess liquidity absorption through the BoBCs, has added impetus to the growth of the banking sector.

Chapter 2: Performance of the Banking Industry

Composition of the Statement of Financial Position (Balance Sheet)

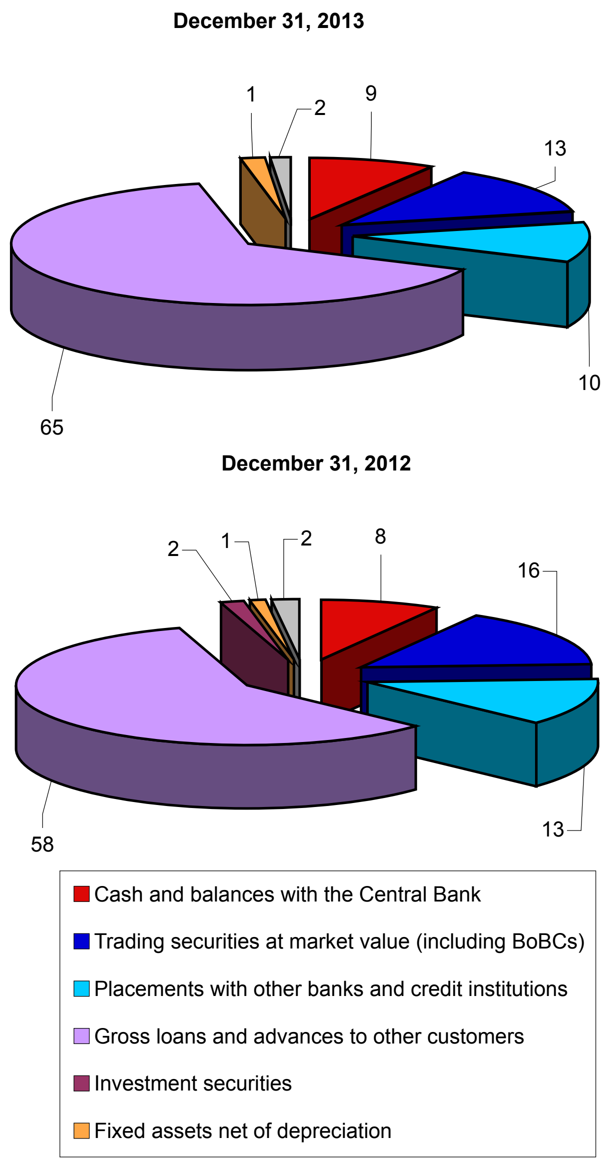
In 2013, there was a marginal improvement in the aggregate financial performance of the banking sector. The overall profitability of the banking industry increased at a slower rate of 2.9 percent compared to the previous year's 14 percent. The market value of trading securities (including BoBCs), declined to P7.8 billion (December 2012: P9.3 billion). The industry liquid asset ratio also declined to 15.3 percent (December 2012: 20.5 percent), due to an improved industry financial intermediation ratio. This notwithstanding, the liquid assets ratio remained above the minimum statutory requirement of 10 percent.

Cash and balances with the central bank increased by 6.8 percent to P5.3 billion (December 2012: P4.9 billion). Two banks, whose cash and balances with the central bank grew by 33.8 percent and 17.4 percent, were the main contributors to the increase.

The total industry balance sheet, as shown in Table 1 of Appendix 6, recorded a marginal growth of 3.5 percent to P60 billion (December 2012: P58 billion). The total loan and advances grew by 14.8 percent to P39.5 billion (December 2012: P34.4 billion). Consequently, the intermediation ratio rose to 81.3 percent from 72.9 percent in the previous year. Lending to the household sector constituted 57.9 percent of total loans and advances, a slight decline from 58.1 percent in 2012. The share of credit to the private business sector declined to 36 percent of total loans and advances, while lending to the public sector accounted for 6 percent of the total loan book compared to 4 percent in the previous year.

On the liabilities side, total customer deposits amounted to P48.6 billion from P47.2 billion in 2012. Nevertheless, at 81 percent, customer deposits continued to constitute the banking industry's main liability item, which is primarily used to finance the banking sector assets. Shareholders' funds which accounted for 10.8 percent, increased by 16.1 percent to P6.5 billion from P5.5 billion in 2012, whereas subordinated debt declined by 22.1 percent to P0.85 billion in 2013 (December 2012: P1.1 billion).

Chart 2.1: Composition of Banking Industry Assets: 2012 – 2013 (Percent)



Charts 2.1 and 2.2 below show the composition of assets and liabilities between 2012 and 2013, while Chart 2.3 shows the growth rates of loans and advances, total assets and total deposits.

The proportions of deposit type by maturity continued to be almost the same in 2013 as in the prior year. Chart 2.4 indicates that volatile deposits (call and current) and core deposits (time and savings) were 49 percent and 51 percent of total deposits in 2013, respectively. The shares of value

Chart 2.2: Composition of Banking Industry Liabilities: 2012 – 2013 (Percent)

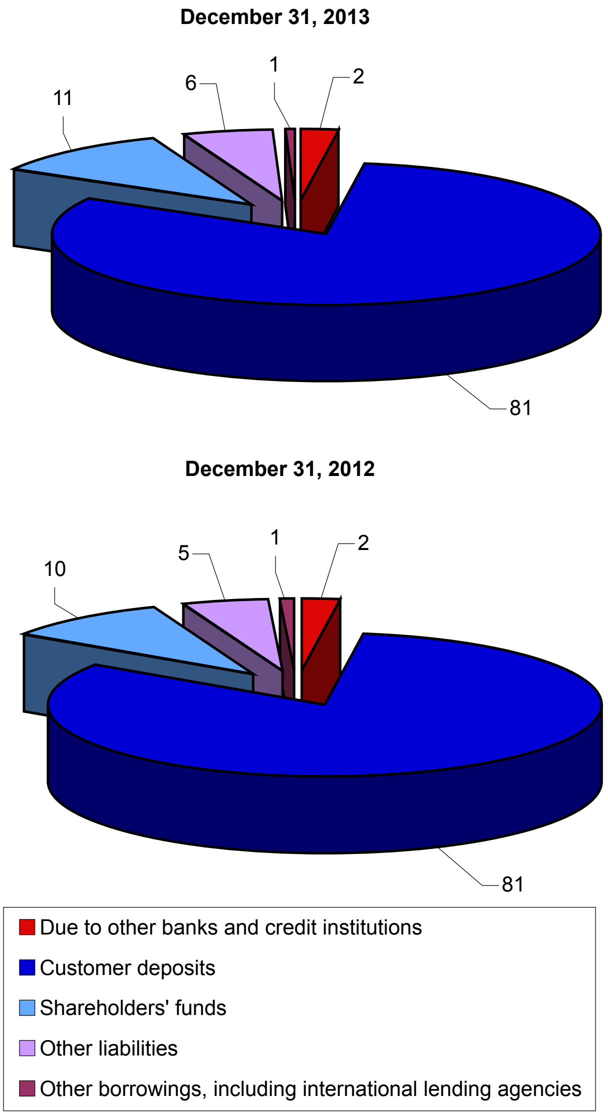


Chart 2.3: Industry Growth Rates of Deposits, Total Assets, Loans and Advances

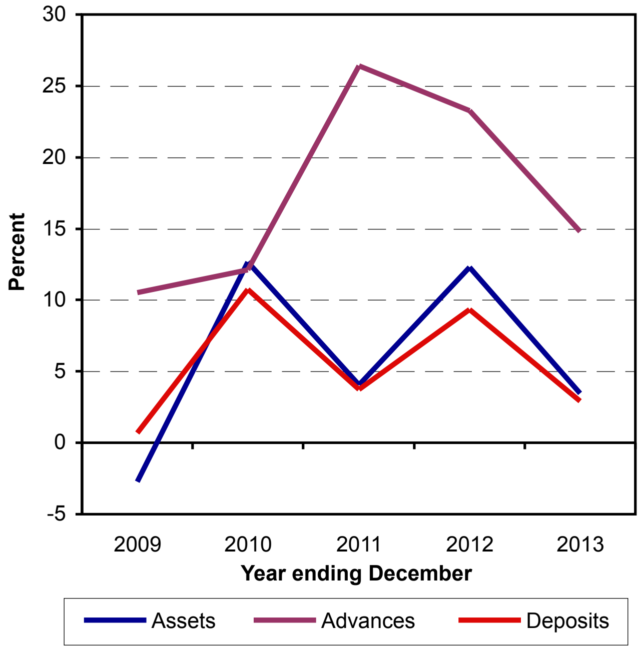
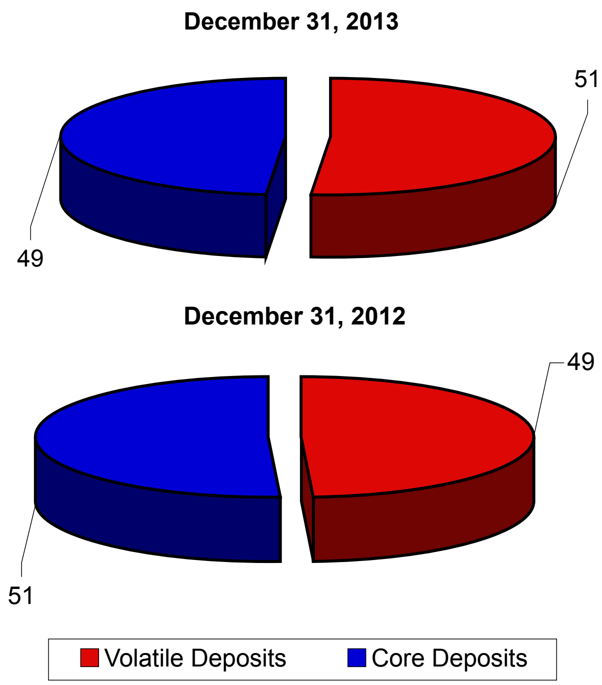


Chart 2.4: Deposits Type by Maturity (Percent)



for current, call, time and savings deposits are shown in Chart 2.5. Time deposits declined marginally to P17 billion from P17.2 billion in the period under review.

As shown in Chart 2.6, bank deposits continued to be largely Pula denominated in 2013. These deposits increased marginally by 4.9 percent to P42.4 billion (December 2012: P40.4 billion). Foreign currency deposits amounted to P6.4 billion as at December 31, 2013 (December 2012: P6.8 billion), making up 13 percent of total deposits, which is a small decrease from 14 percent of 2012. The United States Dollar (USD), followed by the South African Rand (ZAR), dominated the foreign currency deposits mainly due to their importance in the country's trading relations.

Chart 2.7 shows the financial intermediation ratio, which has been increasing over a five-year period to reach 81.3 percent in 2013. At 81.3 percent, the ratio signalled "excessive lending" by the industry during the year. The ratio had surpassed the upper limit of the recommended range for the intermediation ratio of 50 percent and 80 percent, given the relatively low level of development of capital markets in Botswana.

CHART 2.5: SHARE OF VALUE OF DEPOSITS BY TYPE

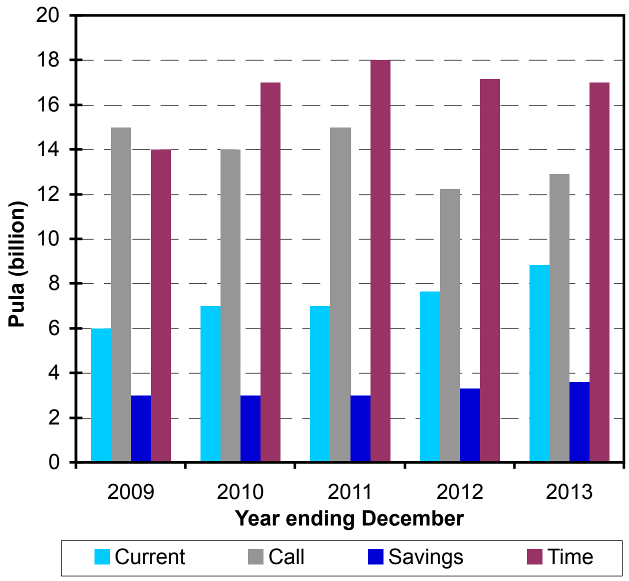


CHART 2.7: INDUSTRY LOANS TO DEPOSITS RATIO (FINANCIAL INTERMEDIATION)

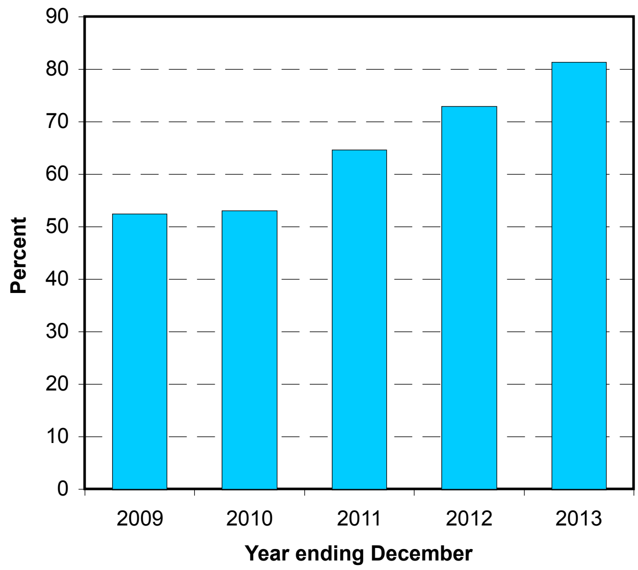
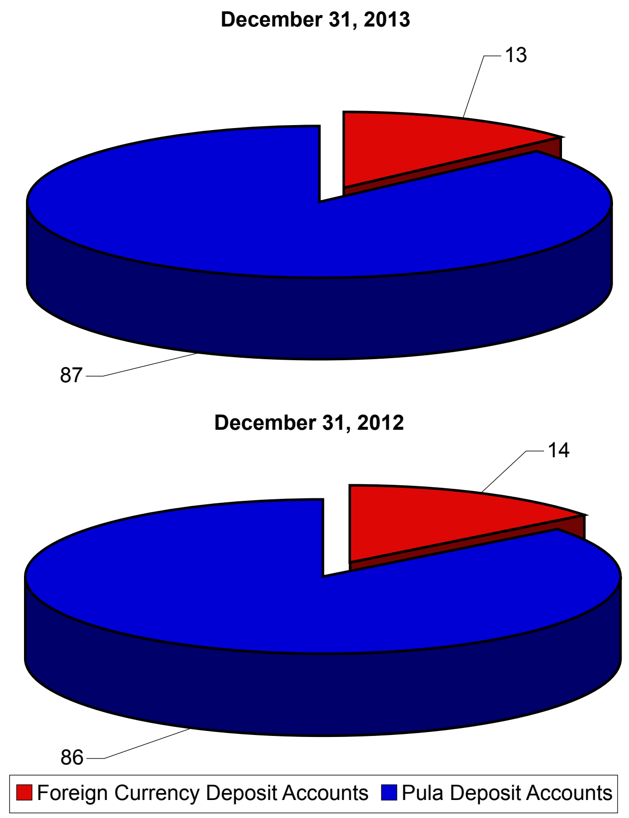


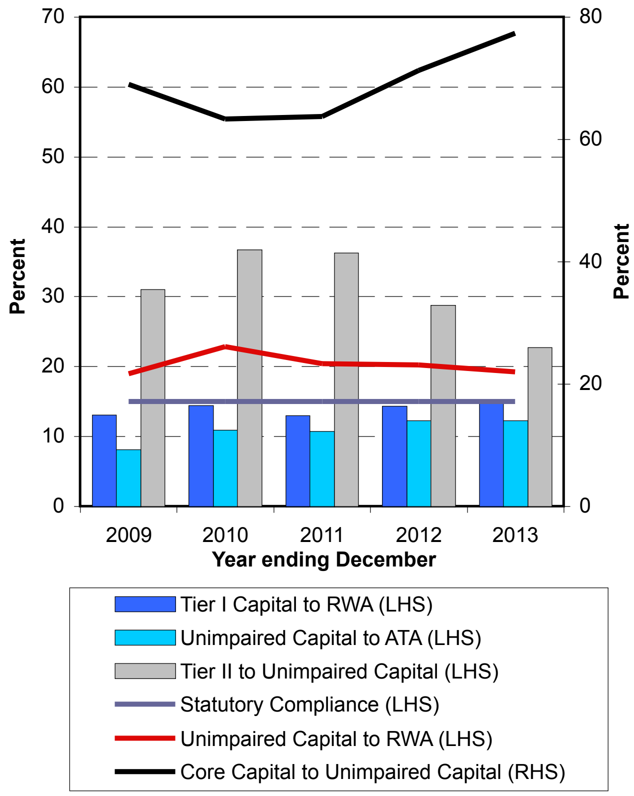
CHART 2.6: FOREIGN CURRENCY AND PULA DENOMINATED DEPOSITS TO TOTAL DEPOSITS (PERCENT)



CAPITAL ADEQUACY (SOLVENCY): LEVELS, QUALITY AND TRENDS

Banks remained adequately capitalised in 2013, with solvency ratios well in excess of the minimum statutory and prudential capital adequacy requirements. The total industry unimpaired capital increased by 7.7 percent to P7.2 billion (December 2012: P6.7 billion); the general reserves increased by 67.2 percent, while the subordinated term debt declined by 22.3 percent, respectively, as reflected in Table 5 of Appendix 6. The banking system core capital increased by 16.8 percent to P5.6 bil-

CHART 2.8: CAPITAL ADEQUACY RATIOS



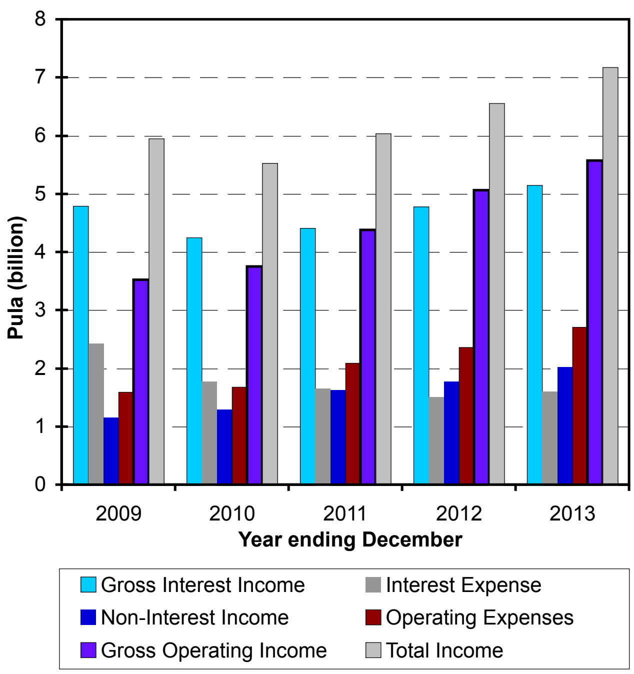
lion (December 2012: P4.8 billion). The capital adequacy ratios are illustrated at Chart 2.8. The Core Capital to Risk-Weighted Assets ratio and Capital Adequacy ratio recorded marginal decreases to reach 14.9 percent and 19.3 percent, respectively, in 2013. The Core Capital to Unimpaired Capital ratio increased from 71.2 percent in 2012 to 77.3 percent.

Earnings and Profitability

Composition of Income and Expenses

The banking industry total income (interest income and non-interest income) increased by 9.3 percent to P7.2 billion in 2013 (December 2012: P6.6 billion). Interest income, which is the main contributor to the sector's total income, increased by 7.6 percent in the same period. Interest income as a proportion of total income stood at 71.7 percent compared to 72.9 percent in the prior year. Nevertheless, non-interest income increased by 14.1 percent in 2013 to P2 billion (December 2012: P1.8 billion). Similarly, interest expenses increased by 6.5 percent to P1.6 billion, after declining consistently for the past four years. Chart 2.9 outlines the trends and composition of income and expenses for the banking industry over a five-year period.

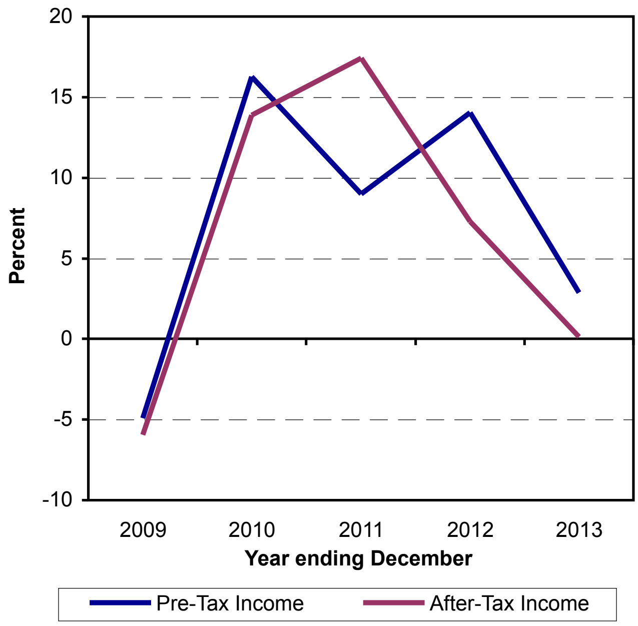
Chart 2.9: Composition of Income and Expenses



Levels and Trends of Profitability

The growth in the banking industry's profitability was subdued in 2013. Chart 2.10 indicates that the growth rate of pre-tax profits increased by 2.9 percent (December 2012: 14.0 percent). There was an increase in operating cost, (albeit at a slower rate) due to increased staff salaries and employee benefits from some banks, which contributed to the deceleration in the growth rates of profits. One major bank registered a 29 percent decline in profitability in 2013 contributing significantly to the subdued banking industry profitability. Lower interest rates and reduced BoBCs also had an impact on profitability. Nevertheless, after-tax profits remained unchanged (compared to previous year profit) at P1.77 billion in 2013.

Chart 2.10: Industry Growth Rates of Income Before and After-Tax

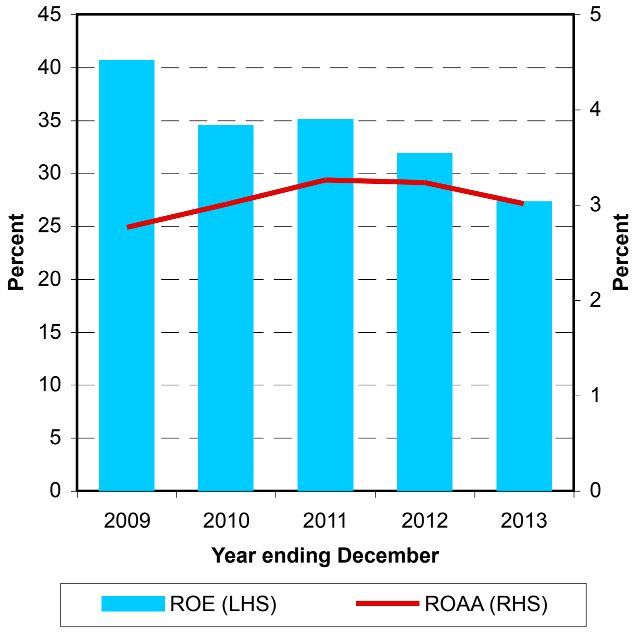


Profitability Indicators

Key Industry profitability indicators maintained downward trends over the past three years. Chart 2.11 indicates that Return on Equity (ROE) decreased from 31.9 percent in 2012 to 27.4 percent, as a result of an increase of 16.8 percent in total equity (December 2012: 18.1 percent), on the backdrop of declining net income after-tax by 0.1 percent. Return on Average Total Assets (ROAA), declined from 3.2 percent in 2012 to 3 percent in 2013. However, these profitability ratios remain strong and above international norms for banks of comparable size.

The banking Industry Net Interest Income to Average

Chart 2.11: Profitability Indicators



Total Assets (ATA) ratio remained unchanged from last year's 6 percent. Table 2.1 shows that the Non-Interest Income to Total Income ratio increased to 28.3 percent compared to 27.1 percent of 2012. The Earnings Retention ratio, which indicates the percentage of a company's earnings not paid out as dividends, declined noticeably from 92.8 percent in 2012 to 69.9 percent in 2013, thus reflecting a reduction in the banking industry's earnings retention. Dividend pay-out was increased in the period under review.

Operating Efficiency Indicators

The overall industry operating efficiency indicators displayed mixed performance, as reflected in Table 2.2. The Net Spread ratio declined to 7.9 percent in 2013 (December 2012: 8.6 percent). The ratio generally indicates that the sector experienced a reduction in the average cost of funding compared to a yield

Table 2.1: Other Financial Performance Ratios (Percent)

	2009	2010	2011	2012	2013
Ratio:					
Trading Income to Total Income	28.1	17.4	15.8	6.4	8.7
Non-Interest Income to Total Income	19.4	23.3	27.0	27.1	28.3
Return on Equity (ROE)	40.7	34.6	35.2	31.9	27.4
Return on Average Total Assets	2.8	3.0	3.3	3.2	3.0
Net Interest Income to Average Total Assets	5.3	5.3	5.4	6.0	6.0
Interest Income to Average Earnings Assets	13.6	11.2	11.5	11.9	11.8
Non-Interest Income to Average Total Assets	2.6	2.8	3.2	3.2	3.4
Interest Expense to Average Total Assets	5.4	3.8	3.3	2.7	2.7
Earnings Retention	61.2	57.1	48.0	92.8	69.9
Interest Income on Loans to Average Total Assets	7.4	6.2	6.6	7.5	7.7
Non-Interest Expense to Average Total Assets	3.6	3.6	4.1	4.3	4.6
Gross Interest Income to Average Total Assets	10.7	9.1	8.7	8.7	8.7

Table 2.2: Banking Industry Efficiency Measures

	2009	2010	2011	2012	2013
Measure:					
Average Cost of Deposits*	5.0	3.5	3.4	3.0	3.0
Return on Loans and Advances*	17.7	13.9	13.4	13.3	12.4
Net Interest Margin*	6.7	6.5	7.2	8.2	8.2
Net Spread*	11.3	9.6	8.3	8.6	7.9
Cost to Income*	45.2	44.8	47.9	46.7	48.6
Net Income to Employee Costs *	184.2	178.1	168.7	156.4	142.2
Net Income Per Employee (P'000)	313.3	346.9	387.0	404.9	390.4
Staff Cost Per Employee (P'000)	170.1	194.8	229.4	258.8	274.5
Asset Per Employee (P'000)	11 162	12 226	12 090	13 238	13 190

* Percent

on loans and advances. The Net Interest Margin, which shows how well banks are performing based on the level of interest on their earning assets, was flat compared to last year's Net Interest Margin at 8.2 percent. The Net Income to Employee Costs ratio continued to decline, and recorded a five-year low at 142.2 percent in 2013, due to an increase in costs associated with staff recruitment and retention as well as subdued income generated during the year. The Cost to Income ratio of 48.6 percent in 2013 is an indication that banks maintained adequate cost control measures as the ratio was below the 50 percent to 60 percent range, which is considered to be a sound level for retail banking institutions, globally.

Credit Risk Assessment and Asset Quality

Default Risk

Asset Quality: Levels and Trends

Chart 2.12 presents industry asset quality measures during the year under review. Past due loans[9] increased by 62 percent from P1.3 billion in 2012 to P2.1 billion. However, the Past Due Loans to Total Loans and Advances ratio remained almost unchanged at 3.6 percent (December 2012: 3.7 percent). Aggregate non-performing loans[10] (NPLs) increased significantly by 58.8 percent to P1.43 billion compared to P901 million in the previous year; this is an indication of a deterioration in asset quality. Consequently, the ratio of NPLs to Total Loans and Advances rose to 3.6 percent from 2.6 percent in the prior year, as shown on Chart 2.12. Four banks contributed significantly to this increase, at a range of 110 percent to 370 percent. Sectors with the highest non-performing loan ratios were community, personal services, trade, restaurants and bars.

Two banks increased their specific provisions in response to the rapid deterioration of asset quality. Nevertheless, the Industry Specific Provisions to NPLs ratio dropped to 49.8 percent in 2013 compared to 67.8 percent in 2012. The portion of NPLs that was not provided for was adequately collateralised.

Chart 2.12: Asset Quality Measures

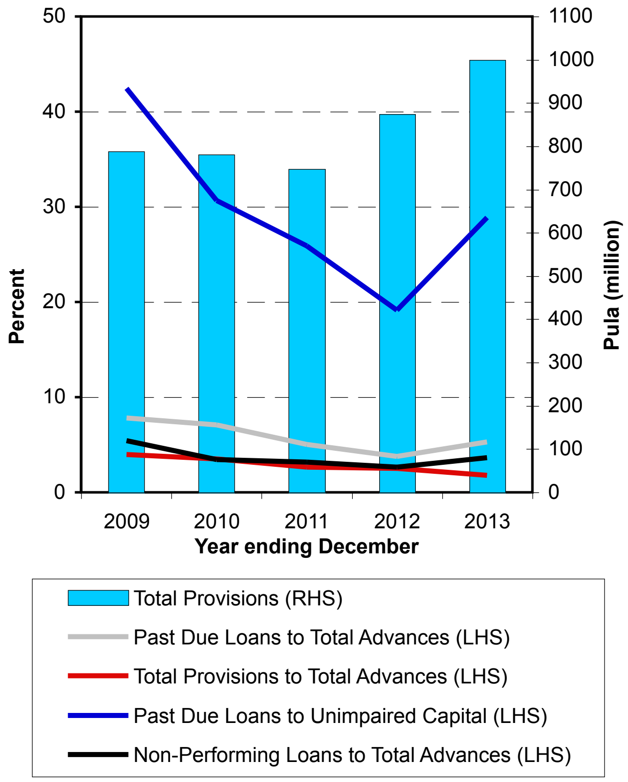
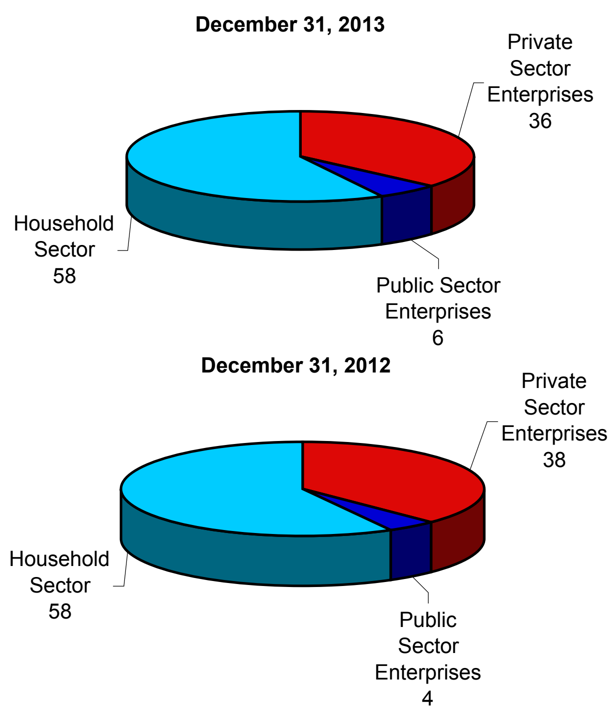


Chart 2.13: Industry Sectoral Distribution of Loans and Advances: 2012 – 2013 (Percent)



Concentration Risk

Sectoral Distribution of Loans and Advances

The Industry total loans and advances grew by 14.8 percent to P39.5 billion in 2013 (December 2012: P34.5

9 Loans that are at least 30 days in arrears

10 Loans that are at least 90 days in arrears

billion). The sectoral distribution of loans and advances remained almost the same as in the previous period, with the household sector accounting for the largest market share of 58 percent, which is the same as last year's. The public sector gained 2 percent market share, more or less from the private sector. The shifts and movement in the market share could be an initiative by banks to diversify their loan portfolios. Chart 2.13 compares Industry sectoral distribution of loans and advances between 2012 and 2013.

The banking industry Large Exposures[11] to Unimpaired Capital ratio has been declining since 2011 to reach 148.2 percent in 2013, as shown in Chart 2.14. The decline in the ratio was as a result of an increase of 7.7 percent in unimpaired capital, while large exposures remained unchanged. The large exposures for large banks accounted for 82.4 percent of the total, while small banks accounted for the remainder. All banks maintained their Large Exposures to Unimpaired Capital ratios within the recommended 800 percent prudential limit.

CHART 2.14: INDUSTRY LARGE EXPOSURES TO UNIMPAIRED CAPITAL RATIO

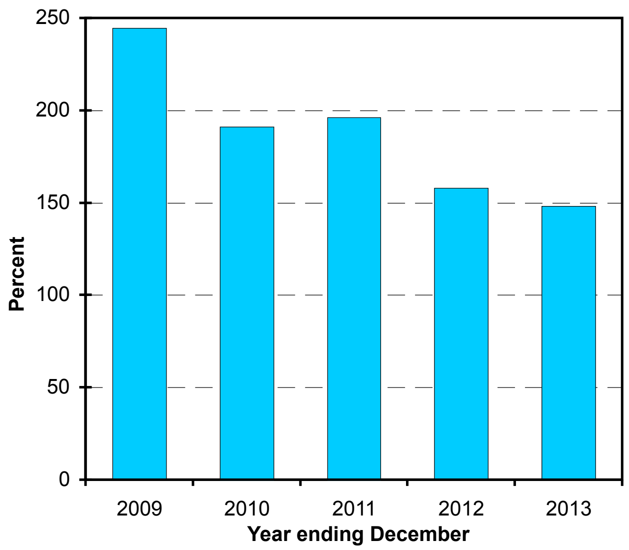


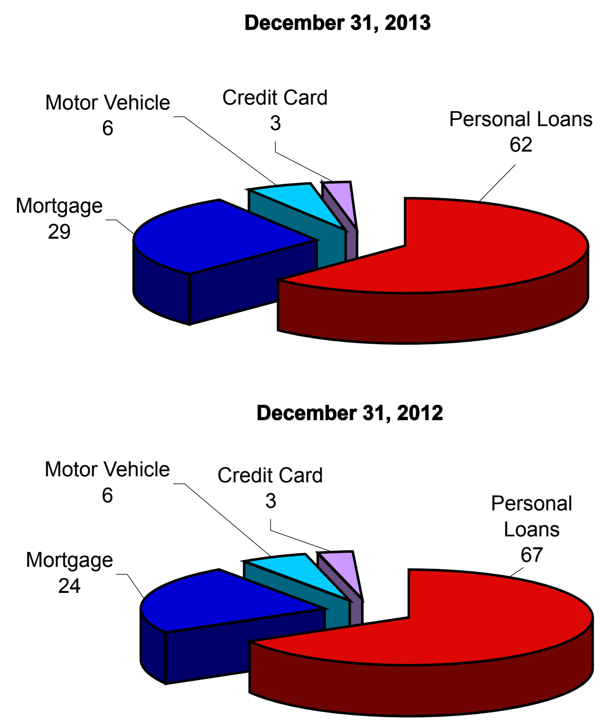
Chart 2.15 (overleaf) is a presentation of sectoral distribution of industry private sector enterprises loans and advances as at December 31, 2013 and December 31, 2012. Trade, restaurants and bars, and commercial real estate continued to dominate market share of private sector enterprise loans, at 32 percent and 27 percent, respectively.

Other sectors either gained or lost between 1 percent and 3 percent in market share, while some remained unchanged.

THE STRUCTURE OF HOUSEHOLD LOANS AND ADVANCES

The structure of household loans and advances shown in Chart 2.16 indicates that personal loans maintained the largest share of household loans at 62 percent; credit cards remained unchanged, while "Other" household loans[12] and advances went down by 1 percent. In value terms, mortgage loans increased by 43.3 percent from P4.6 billion to P6.6 billion. The proportion of unsecured loans (credit card, personal loans and 'other' loans) to household loans and advances decreased from 71 percent in 2012 to 65 percent in 2013.

CHART 2.16: STRUCTURE OF HOUSEHOLD LOANS AND ADVANCES: 2012 – 2013 (PERCENT)



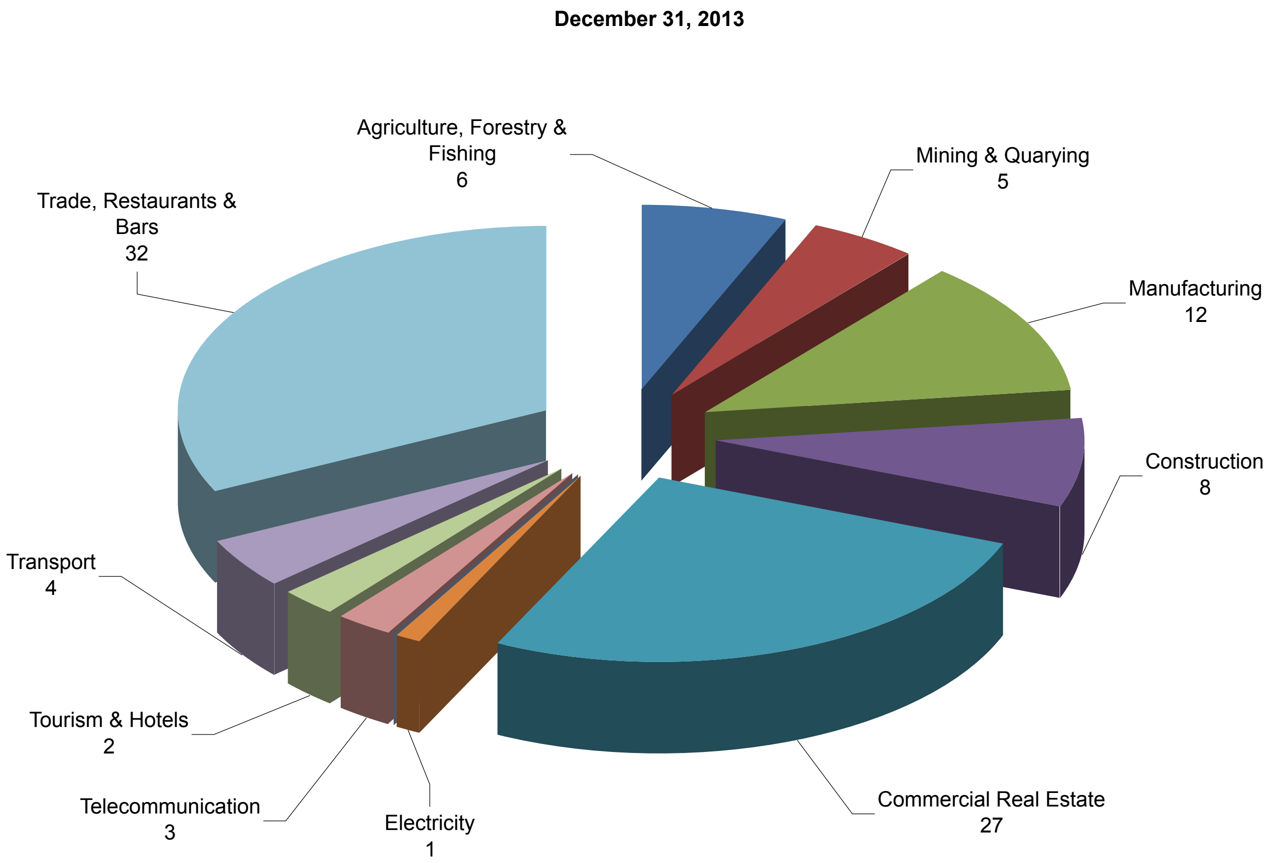
Liquidity Risk

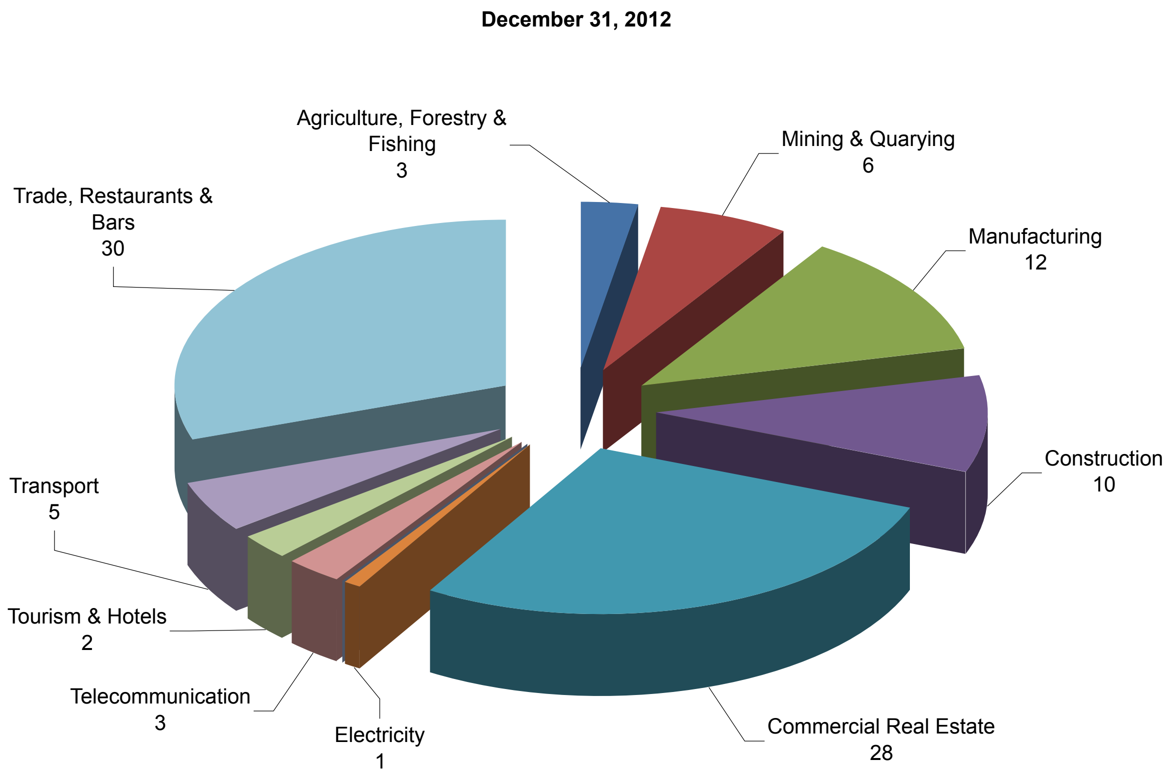
The banking industry liquidity ratios shown on Chart 2.17 indicate a declining trend in liquidity; this signals potential for high liquidity risk with an increasing trend in the next 12 months period. The Liquid Assets to

11 These are loans and advances of 10 percent and above of a bank's unimpaired capital.

12 Other household loans consist of overdrafts and credit extended for household goods and services

Chart 2.15: Distribution of Industry Private Sector Enterprise Loans: 2012 – 2013 (Percent)

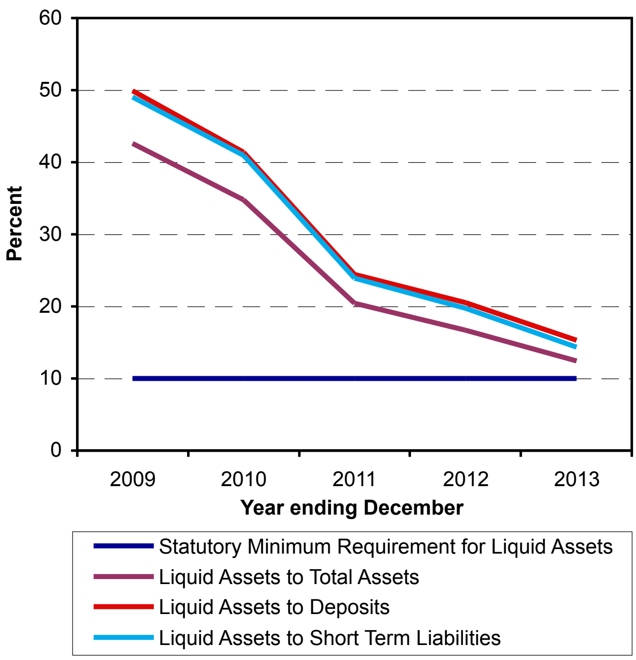




Short Term Liabilities and Liquid Assets to Total Assets ratios have been declining over the years, and stood at 14.3 and 12.4 percent, respectively, as at December 31, 2013.

The Liquid Assets to Total Deposits ratio decreased to 15.3 percent, thus continuing the downward trend that has prevailed in the past few years. However, the ratio was above the prudential minimum limit of 10 percent. The decrease in these ratios was due to the continued decline in BoBC holdings by banks, which historically constituted a larger proportion of banks' liquid assets. Funds initially invested in BoBCs were channeled to loans and advances and other investment assets (which do not qualify as liquid assets).

CHART 2.17: INDUSTRY LIQUIDITY RATIOS



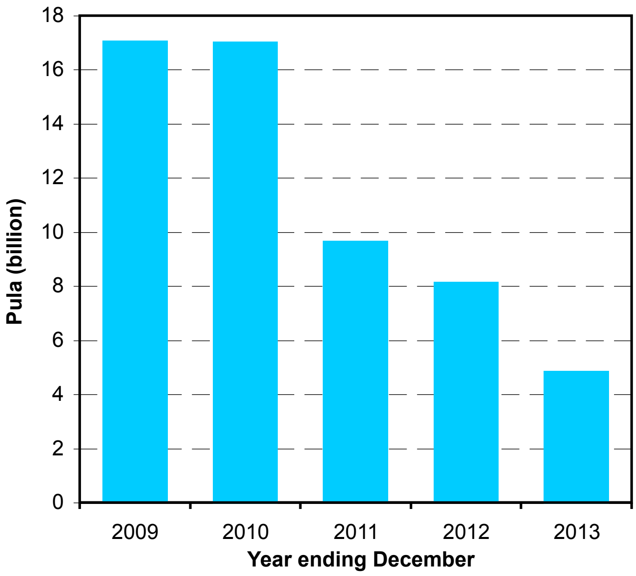
During 2013, BoBCs (excluding pledged BoBCs) accounted for 65.5 percent of the banking sector liquid assets, which is a much lower proportion compared to 84.2 percent of 2012. BoBCs have been in a downward trajectory in the past 5 years as shown in Chart 2.18 overleaf; the level of BoBCs declined from P17.1 billion in 2009 to P4.9 billion in December 31, 2013.

The basis for sound liquidity risk management is, among others, a sound funding structure that reduces the probability of liquidity stress. Table 2.3 indicates that the banks' funding structure remained unchanged over the five-year period ending December 31, 2013. Customer deposits remained as the main source of funding. Share capital experienced a substantial growth of 16.8 percent, thereby increasing its funding share to 10.8 percent from 9.6 percent in the prior year. Other borrowings remained the least preferred source of funding at 0.6 percent.

TABLE 2.3: BANKING INDUSTRY FUNDING TRENDS (P' MILLION)

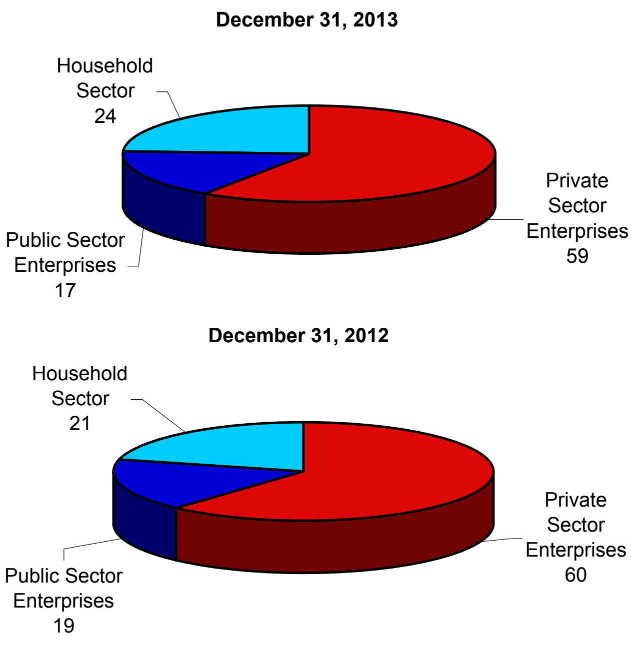
Funding Structure	2009	2010	2011	2012	2013
Deposits	37 590	41 628	43 178	47 219	48 589
Growth Rate (Percent)	0.7	10.7	3.7	9.4	2.9
Share of Total Funding	85.4	83.9	83.7	81.5	81.0
Other Liabilities	1 099	1 977	1 827	2 925	1 202
Growth Rate (Percent)	(61.8)	79.9	(7.6)	60.1	(58.9)
Share of Total Funding	2.5	4.0	3.5	5.0	2.0
Share Capital	3 035	4 069	4 696	5 548	6 479
Growth Rate (Percent)	25.4	34.1	15.4	18.1	16.8
Share of Total Funding	6.9	8.2	9.1	9.6	10.8
Due to Other Banks	680	460	990	1 320	1 394
Growth Rate (Percent)	(35.8)	(32.3)	115.4	33.3	5.6
Share of Total Funding	1.5	0.9	1.9	2.3	2.3
Other Borrowings	1 621	1 457	908	422	332
Growth Rate (Percent)	3.5	(10.1)	(37.7)	(53.5)	(21.2)
Share of Total Funding	3.7	2.9	1.8	0.7	0.6
Total Funding	**44 023**	**49 590**	**51 600**	**57 954**	**59 962**

Chart 2.18: Outstanding Market Value of BoBCs Held by Banks



The Industry sectoral distribution of total deposits, as shown on Chart 2.19 remained concentrated in the private enterprises sector. However, its market share reduced marginally to 59 percent compared to 60 percent in the prior year. The household sector share of total deposits increased from 21 percent to 24 percent in 2013, while public sector deposits declined from 19 percent in 2012 to 17 percent.

Chart 2.19: Sectoral Distribution of Deposits: 2012 – 2013 (Percent)



Market Risk

Foreign Exchange Risk

Overall, all banks observed the prescribed limit of the foreign Net Open Position to Unimpaired Capital ratio of 30 percent, with an aggregate industry ratio of 9.6 percent as at December 31, 2013. All dealing currencies and other currency exposures were within the prescribed maximum limits of 15 percent and 5 percent of unimpaired capital, respectively, during the period under review. The USD dominated trade as at December 31, 2013. Large banks had an average of 12.1 percent, and small banks had an average net Open Position to Unimpaired Capital ratio of 7.1 percent.

Operational Risk

Internal Control Environment

The full-scope and limited on-site examinations, carried out at two banks in 2013, revealed that both banks' operational risk management and Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) activities needed improvement. One bank had a number of branch managers and other key positions at branch level that were vacant or filled on a temporary basis across the branch network, including the Risk Director and Head of Operational Risk positions. Staff shared codes for accessing restricted areas and there was non-adherence to the two week mandatory leave. This resulted in compromised segregation of duties, a weakened control environment, and increased absence from work.

On AML/CFT issues, one bank compromised account opening procedures, by delaying capturing of account opening information until the end of the business day. This compromised the accuracy and completeness of records, as well as the need for enhanced due diligence on high risk customers. The other bank did not have a properly structured training programme for new and existing staff and relied heavily on ad-hoc on-the-job training. Junior staff interacting with customers were found to be inadequately trained and lacked knowledge on basic banking matters. Of particular concern was that bank staff were not adequately trained on AML/CFT matters. Staff members that were interviewed at the bank's branches were not sufficiently conversant with AML/CFT issues.

Information Technology (IT) Infrastructure Issues

One bank's IT systems operated on a stand-alone basis and this resulted in high levels of manual intervention, which posed data integrity risk, human error and fraud. The other bank's branch did not have a disaster recovery site and, therefore, business continuity could be hampered in the event of disaster. In addition, the other bank's server and associated data back-up and testing were located and maintained outside Botswana. Although the Bank appreciates the advantages associated with centralising the Group server, the bank was advised to consider having a server housed at one of its branches in Botswana. This could minimise the risks to the bank, should a catastrophic disaster strike in a foreign country where the server is located.

Fraud and Other Criminal Activities Prevalent in the Banking Sector

The Bank noted reported incidences of fraud at one bank between June 2012 and September 2013. These involved internal and external fraud related to a customer withdrawing funds against uncleared cheques, which were later dishonored. It was also noted that the bank's loan application requirements had some lapses, which resulted in some customers presenting falsified copies of salary information slips so as to qualify for higher loans.

The examined banks were directed to address all issues of supervisory concern promptly, within specified timelines. Follow up on-site examinations were to be conducted at these banks within twelve months from the dates of their examination reports.

Performance of Statutory Banks

Statement of Financial Position Structure

Appendix 6 shows the aggregate statement of financial position for the three statutory banks. The financial position of the statutory banks continued to improve as shown by a 16.5 percent increase in total assets to P5.9 billion in 2013 (December 2012: P5.1 billion). The growth in assets was largely funded by deposits, which grew by 22 percent, and to a lesser extent by other borrowings, including from international lending agencies, which grew significantly by 36.9 percent from P0.7 billion in 2012 to P0.9 billion in 2013. The improvements in the statements of financial position translated into cash and balances with the central bank of P19 million in 2013 (December 2012: –P20 million). The statutory banks' credit growth slowed down to 15.6 percent in 2013 compared to 17.9 percent in 2012.

Earnings and Profitability

The aggregate profits of the statutory banks remained flat at P121 million, during the period under review. There was an increase in interest expenses and operating expenses, of 26.4 percent and 28.4 percent, respectively (December 2012: 2.6 percent and 7.4 percent, respectively). Similarly, interest income and other operating income improved by 23.3 percent and 8.5 percent, respectively, compared to the prior year's data. Key profitability ratios decreased to 2.2 and 6.5 percent for ROAA and ROE, respectively, in 2013. Table 2.4 (overleaf) shows key performance indicators for statutory banks over the period 2009 – 2013.

The Cost to Income ratio of statutory banks increased to 58.6 percent, compared to 54.7 percent in 2012, which is an indication that banks' expenses have increased significantly compared to income growth. However, the ratio has been fluctuating between 50 percent and 60 percent recommended level for retail banks, in the last five years, as shown on Chart 2.20.

Chart 2.20: Cost to Income Ratio (Percent)

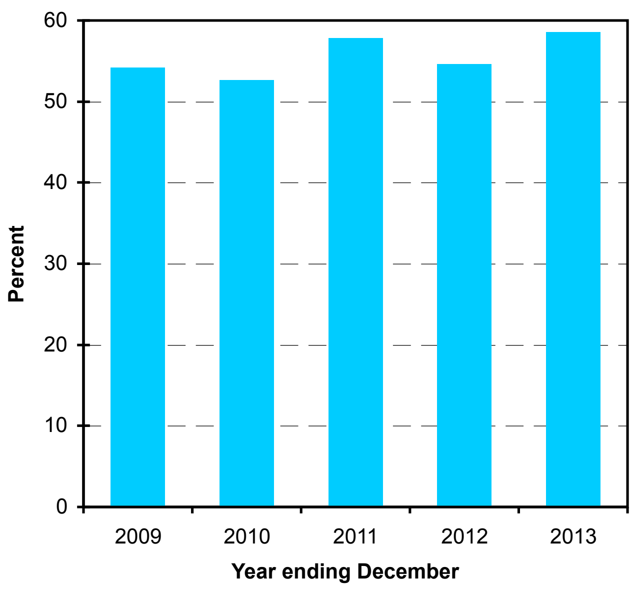


Table 2.4: Performance Indicators for Statutory Banks

Indicator	2009	2010	2011	2012	2013
ROAA (Percent)	3.1	2.9	2.1	2.6	2.2
ROE (Percent)	5.6	7.1	4.7	7.4	6.5
Interest Income to ATA (Percent)	12.5	11.1	9.4	9.7	10.2
Interest Income to Average Earnings (Percent)	33.3	29.8	25.6	26.4	27.9
Cost to Income (Percent)	54.2	52.7	57.8	54.7	58.6
Average Total Assets (P' million)	3 303	3 613	4 007	4 675	5 518
Unimpaired Capital (P' million)	1 815	1 461	1 815	1 634	1 860
Interest Income (P' million)	413	402	377	455	561
Average Earning Assets (P' million)	1 239	1 350	1 470	1 722	2 007
Net Income (P' million)	102	103	86	121	121

Chapter 3: Licensing, Financial Inclusion and Consumer Protection Issues

Market Entry Enquiries and Licensing of New Banks

In the year under review, the Bank received fifteen (15) enquiries from potential investors regarding establishment of banking business in Botswana. Except for two applications received in 2012, none of the enquiries neither materialised into granting of a banking licence nor reached a stage of a formal application for a banking licence.

The Bank completed the processing of two bank licence applications submitted in 2012. These two banking licence applications were rejected because, on assessment, they were found to be materially deficient. Two other banks which were granted approval in 2012, were issued with banking licences and both commenced operations in mid-2013.

Electronic-Money and Financial Inclusion

The objective of financial inclusion is to promote access, at a reasonable cost, for all households, to a full range of financial services, including saving or deposit services, payment and transfer services, credit and insurance. The services should be offered by sound and safe financial institutions governed by clear regulation and industry performance standards. In addition, there should be financial and institutional sustainability, to ensure continuity and certainty of investment, and competition to provide choice and affordability for clients.

During 2013, the Bank approved mobile banking applications from two commercial banks. These services will enable the banked and unbanked mobile phone subscribers to carry out bill payments, funds transfers, mobile recharges or airtime top-ups and micro-finance loan repayments using mobile handsets. The partnership with mobile banking service providers also allowed customers to make deposits and withdrawals at the banks' banking outlets in Botswana. The sector introduced a prepaid VISA banking card that will enable Insurance policy holder's beneficiaries to access their claim payouts using the banks VISA enabled ATMs.

Policy on Bank Charges and Selected Banking Industry Charges

Four banks submitted proposals for the review and endorsement of revised banking tariffs, citing increased cost of providing banking services and inflationary pressures. The proposed 2013 tariff structures for two banks were assessed and approved during the year, while those for the other two banks could not be processed following the imposition of a moratorium on upward adjustment of banking changes effective January 1, 2014.

On December 19, 2013, the Bank decided that no bank shall make any upward adjustment of banking tariffs (bank charges, commissions, and other non-interest fees) for a period of two years effective January 1, 2014, with the exception of monetary policy or Bank Rate linked interest rate changes. In the case of any new product/service to be availed during the period in question, the related fee/charge will not exceed the fee(s) applicable for existing similar products; such fees will be subject to the Bank's prior approval. During the moratorium period, the Bank has undertaken to appoint an independent third party, at the expense of banks, to ascertain that the fees and charges levied by banks are as approved and in accordance with published tariffs. Any bank found to have imposed a charge for which there was no prior Bank approval, and/or that may have been wrongly levied to customers, will attract a pecuniary fine; accordingly, the wrongly levied charge/fee will be reimbursed to customers.

The freeze on any upward adjustment in bank charges is in response to the growing public concern about the perceived high level of bank charges and other fees, which are deemed not to be commensurate with the quality of banking services. The current high cost of financial intermediation, including onerous bank charges on savings discourage public savings and, in general, the use of the banking system. These charges are deemed to be a disincentive to savings mobilisation in the country.

Notwithstanding the foregoing, banks continued to be largely compliant with the minimum public disclosure and statutory requirements on bank charges by publishing interest rates payable on deposits on their websites, as well as in at least two newspapers widely circulating in Botswana each month. This is intended to enhance information dissemination, transparency and the promotion of public awareness on the cost of banking services in Botswana. The selected banking industry average charges indicate that, in the period under review, the cost of financial services has, on average, increased as shown on Table 3.1.

Table 3.1: Banking Industry Average Charges: 2012 – 2013 (Pula)

Service Charge Category	2012	2013
Accessibility Facilitation		
ATM Charges		
Cash withdrawal (own account)	2.76	2.17
Lost card replacement	50.16	59.86
Internet Banking Charges		
Monthly fees	139.89	167.55
Transfers	3.46	3.48
Investment/Intermediation		
Personal loan - Arrangement fee (Max)	1 969.86	2 345.54
Vehicle/Asset finance - Arrangement fee	631.24	652.91
Trade Facilitation		
Commission on purchase of foreign currency	21.59	21.16
International SWIFT transfer	290.53	305.71
Advisory fees on Letters of Credit	205.04	216.96
Payment and Clearing Charges		
Bank cheque	47.33	73.49
Unpaid cheque due to lack of funds	231.15	220.38

Consumer Complaints Management

In recognition of the importance of a fair and effective response to customer complaints, the Bank encourages a fair, visible and accessible complaints management system. It is a requirement that each bank displays, in a conspicuous place in its banking hall, its procedure for lodging a complaint. The procedure should include, as the final contact, the Banking Adjudicator's Office and his contact details. In case of an unresolved case, the Banking Adjudicator will refer the unsatisfied customer to the Bank for further mediation.

In 2013, the Bank received and processed various consumer complaints, some of which were referred back to the Banking Adjudicator, as the customers had not followed the complaints procedure. Most complaints were related to unauthorised ATM transactions, which were common across the industry. There was a complaint against one bank, for using some phrases in Latin in its loan application forms instead of English. Most of the complaints were resolved, while some were still being investigated, as at December 31, 2013.

Abandoned Funds

The Bank continued to receive, process and administer abandoned funds from commercial banks in accordance with Section 39 of the Banking Act. As shown in Table 3.2, the abandoned funds balances amounted to P8 151 262 in 2013, compared to P8 238 254 in 2012. Abandoned Funds received from commercial banks increased sharply by 140 percent from P644 076 in 2012 to P1 547 175 in 2013. Similarly abandoned funds claims increased from P195 808 to P262 652 during the period under review. Abandoned funds transferred to the Guardian Fund in terms of Section 39 of the Banking Act declined by 31 percent to P1 371 515 in 2013 (December 2012: P1 986 466).

Table 3.2: Abandoned Funds (Pula)

	2012 Pula	2013 Pula
Balance Brought forward	9 776 074	8 238 254
Funds Received	644 076	1 547 175
Refund from Guardian's Fund*	398	–
Claims paid out	(195 808)	(262 652)
Rounding off difference	(20)	–
Transfer to Guardian's Funds	(1 986 466)	(1 371 515)
Balance at year-end	**8 238 254**	**8 151 262**

* Funds which were claimed and erroneously transferred to the Guardian's Fund

Chapter 4: Basel II/III Implementation

The Bank, in consultation with the banking industry, completed the draft Capital Measurement and Capital Standards for Botswana (Basel II/III) on December 31, 2013, in time for the parallel-run of the Basel I and Basel II/III on January 1, 2014. The document sets out the proposed approach to be used in Botswana for the implementation of the Revised International Convergence of Capital Measurement and Capital Standards (Basel II) and selected enhancements under Basel III: A Global Regulatory Framework for more Resilient Banks and Banking Systems (Basel III).

While Basel II is intended for large internationally active banks, it is regarded as the global de-facto bank regulation and capital management standard. Since its pronouncement as the new revised international framework for capital adequacy measurement and capital standard, various jurisdictions have initiated preparatory arrangements for its implementation, with Basel Committee members, notably in Europe, taking the lead. Given the significant benefits of Basel II and Basel III, Botswana has committed to adopting Basel II and selected enhancements under Basel III. The implementation of these new capital measurement standards in Botswana will be in phases, commencing with simple approaches on December 31, 2014, and culminating in the adoption of the advanced approaches by qualifying banks in 2017. Pillar III implementation shall also commence on December 31, 2014, while the implementation of Pillar II will start in 2016, where banks will be required to submit to the Bank of Botswana their first set of board-approved Internal Capital Adequacy Assessment Process (ICAAP) reports based on the 2015 audited financial statements.

The impetus to migrate from Basel I (which is the current capital measurement standard applicable in Botswana) to Basel II/III was premised upon the fact that, although Basel I rightly recognises credit risk in computing regulatory capital, its crude allocation of risk-weights at portfolio level, without recognising individual or firm level performance differences and internal variations within portfolios, makes it less risk sensitive. Basel I is, therefore, deficient in its ability to recognise, quantify and stratify other risks in banking business and, consequently, allocates a capital amount that is not commensurate with the level of risk assumed by a bank in all its operations.

In contrast to Basel I, the Basel II framework was introduced to make regulatory capital more reflective of the underlying economic risks in a bank. The direct trade-off between the two frameworks is that Basel II provides incentives to a bank to adopt the best risk management and governance practices by allotting such a bank lower capital requirements for holding higher quality assets and vice versa. From a macro perspective, the greater risk sensitivity of Basel II, and the inclusion of a wider range of risks, will further enhance the safety and stability of the banking sector, a feature that could enhance a country's global competitive advantage.

Basel II provides a menu of options for calculating minimum regulatory capital requirements, ranging from the simple, standardised approaches to more complex and highly quantitative measurement techniques, driven mainly by internal risk management models used by a bank in calculating economic capital.[13]

The primary objective of the menu of options under Basel II is to allow a bank, with the approval of its supervisory authority, to select approaches that are most appropriate to its operations and its ability to measure and quantify risk. However, national discretions are also built into the framework so that countries would have flexibility to customise select rules to country specific circumstances.

Basel II is anchored on three mutually reinforcing pillars, namely, the Minimum Capital Requirements (Pillar I), Supervisory Review Process (Pillar II) and Market Discipline (Pillar III). While Basel I explicitly covered credit risk and market risk (1996 Amendment) in the definition and computation of risk-weighted assets, Basel II has introduced a capital charge for both

13 Economic capital is the amount of capital, assessed on a realistic and orward-looking basis, which a bank requires to cover all the risks that it is exposed to and/or acquiring, as a going concern. The concept of economic capital differs from regulatory capital in the sense that regulatory capital is the mandatory capital the regulators require to be maintained by a bank, while economic capital is the best estimate of the required capital that a bank must hold, reasonably reflecting potential future and/or unexpected losses of a bank.

market risk and operational risk. Consistent with the Basel II requirements, the Bank will henceforth require a bank to have explicit and separate capital charges for credit risk, market risk and operational risk under Pillar 1.

The Pillar 1 minimum capital adequacy requirements are supported by the Pillar II (supervisory review process), which emphasises the need for a bank to continuously hold capital levels that are reflective of its risk profile, and are above the minimum regulatory requirements. Supervisors are expected to review and take appropriate supervisory action based on these assessments. Similarly, Pillar III (Market Discipline) complements both Pillar I and Pillar II through a set of disclosure requirements that provide market participants with key information about a bank's risk profile, capitalisation and other pertinent information.

Notwithstanding the positive elements of Basel II, the global financial crisis of 2008 revealed deficiencies in the form of poor liquidity risk management, inadequate level (quality and quantity) of bank capital, excessive leverage in the banking system, corporate governance shortcomings, disorderly deleveraging by banks, high levels of interconnectedness and inappropriate handling of cross-border issues and resolution. On the basis of the foregoing, the Basel Committee on Banking Supervision (BCBS) promulgated "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" in December 2010. Specifically, the Basel III reforms, which are an enhancement of Basel II, aim to raise the resilience of the banking sector by:

(a) improving a bank's ability to absorb shocks arising from financial and economic stress, irrespective of the source;
(b) raising the quality, quantity, consistency and transparency of a bank's capital base (including the introduction of the leverage ratio, capital conservation buffer and a counter-cyclical capital buffer);
(c) strengthening liquidity risk regulation;
(d) improving a bank's risk management and governance processes; and
(e) strengthening a bank's transparency and disclosure systems.

Given these developments, and the importance of adhering to current international regulatory best practices, the Bank has opted to adopt the simple approaches of Basel II and some aspects of Basel III. In particular, the Bank has adopted the definitions of capital elements as set out in the Basel III capital framework (which focuses on common equity); new liquidity standards; and elected to defer the adoption of the capital buffers and leverage ratio to a future date. In addition, instead of the 8 percent minimum regulatory capital requirement recommended by the BCBS, the Bank has retained the 15 percent prudential minimum capital adequacy ratio applicable in Botswana since 1995.

The banking industry has been consulted and remains an integral and important stakeholder throughout the implementation of the Basel II/III project. The Bank is, therefore, confident that compliance with these international standards will improve the global competitiveness of the Botswana banking sector, which has worked collaboratively with the Bank, and the sector will derive the benefits of improved risk management practices espoused by Basel II/III.

Box 1: Market Sensitisation on the Basel II Pillar III Disclosure Requirements by Banks in Botswana

Introduction

This article aims to sensitise market participants on the new disclosure requirements by banks in Botswana following the decision by the Bank and the banking industry to implement Basel II/III in Botswana. To encourage market discipline and enhance transparency, the Basel Committee on Banking Supervision (BCBS) has developed a set of disclosure requirements that constitute Pillar III of Basel II. The BCBS has, however, ensured that these Pillar III disclosure requirements do not conflict with the already existing broader accounting requirements. Therefore, in certain circumstances where Pillar III disclosures are to be in accordance with accounting and/or listing requirements of security regulators, a bank should rely on them to fulfill the Pillar III requirements.

Objectives of Pillar III Disclosure Requirements

The primary purpose of Pillar III (market discipline), as outlined in the draft Capital Measurement and Capital Standards for Botswana, is to complement the minimum capital requirement (Pillar I) and supervisory review process (Pillar II) by introducing a set of disclosure requirements that provide market participants with key pieces of information about a bank's risk profile, risk assessment processes, capitalisation and other pertinent information. These disclosures should be consistent with the scale, complexity and sophistication of a bank's approaches to risk management and capital adequacy assessments. The disclosures include qualitative and quantitative aspects with respect to credit risk, market risk, operational risk and interest rate risk in the banking book and other material risks to which a bank is exposed.

Structure of the Disclosure Requirements

According to the draft Capital Measurement and Capital Standards for Botswana, the nature, type of information, format and frequency of disclosure, should meet the following requirements:

(a) Medium and Location of Disclosures

A bank should publish the required information on a publicly accessible bank's internet website as well as audited annual financial statements on a timely basis. The disclosure templates should contain detailed information on, inter alia, a bank's capital structure, risk management processes, qualitative and quantitative information about its remuneration practices and policies.

(b) Materiality of the Disclosures

A bank should decide which disclosures are relevant for it, based on the materiality concept. An item would be considered to be material if its omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making informed and/or economic decisions.

(c) Frequency of Disclosure

These public disclosures shall be carried out on an annual basis, except for regulatory capital disclosures which must be disclosed on a quarterly basis. This notwithstanding, any material change of information on risk exposures or other items prone to rapid change, must be reported in the interim.

(d) Disclosure of Propriety and Confidential Information

A bank is required to strike an appropriate balance between the need for meaningful disclosure, and the protection of proprietary and confidential information. Where a bank perceives that disclosure of proprietary and confidential information might prejudice its position, a bank may not disclose such information. However, it shall disclose the fact that some information was not disclosed, and the reasons for non-disclosure.

(e) Disclosure of Comparative Information
Comparative information regarding quantitative disclosures for the preceding financial year, must be reported, except for the first time adoption, where there are no corresponding disclosures in the previous reporting periods. Where there has been a material restatement of prior period figures, the nature of and the reason for the restatement must also be highlighted and form part of the disclosure.

A bank must also make available on its website or on publicly available regulatory reports, an archive of at least 5 years, of all templates relating to prior reporting periods.

(f) The Disclosure Policy
A bank must have a written disclosure policy, approved by the Board of Directors, that addresses its approach for determining the content (including the appropriateness), materiality, frequency of public disclosures and internal controls over the disclosure process. These internal controls must include a process for verifying and reviewing the accuracy of the disclosures. Such verification should ensure that a bank's disclosures are consistent with the manner in which a bank assesses and manages its risks.

(g) Scope of Application
The disclosure requirements shall apply to all banks on a solo and consolidated basis.

(h) Effective Date of Implementation of the Disclosures
The effective implementation date of the Disclosure Requirements is January 1, 2015, coinciding with the implementation of Basel II/III in Botswana.

Conclusion
These market disclosures, if properly implemented, would instill and enhance market discipline, efficiency and confidence through improved transparency and thus providing market driven incentives for banks to conduct business in a safe and sound manner. In addition, the enhanced disclosures will strengthen incentives for banks to implement robust risk management systems to identify, measure, monitor, control and mitigate risks.

Chapter 5: Summary of Salient Issues Arising from On-Site Examinations and Off-Site Surveillance Activities

(a) Examinations of Commercial Banks

The Bank carried out a full scope on-site examination and limited scope on-site examination of two banks, (a large bank and a small bank) respectively, in 2013. The Bank also conducted follow-up limited scope examinations of two other banks; the purpose of the follow-up examinations was to review progress made by the banks in addressing the outstanding findings from earlier full scope on-site examinations.

In general, the large bank complied satisfactorily with the statutory and prudential requirements relating to capital adequacy, asset quality, earnings and profitability, liquidity and sensitivity to market risk. Nevertheless, the bank needs to improve its governance structures and operational risk management. Overall, the bank was assigned a composite CAMELS rating of 3 (satisfactory), and a Risk Assessment System (RAS) rating of moderate, with an increasing trend over a twelve months period.

The overall assessment of governance structures at the large bank, including the composition of the Board and its sub-committees, showed that the Board exercised an effective oversight role over the bank's business operations and activities, save for the use of Group policies that had neither been approved by the local Board nor adequately customised for the local market.

The small bank's operational risk was considered high on account of incidents of fraudulent transactions by some personnel and customers, which was an indication of lack of effective internal controls; inadequate staff complement in critical areas, such as the finance/accounting division and internal audit division; absence or lack of a human resources division, which exerted an adverse impact on staff welfare; and frequent senior management staff rotation, which affected the bank's leadership continuity. In addition, the unavailability of an AML/CFT programme compromised measures and practices to be used to detect and prevent money laundering and terrorist financing. On the other hand, the bank had comprehensive policies and procedures for other key financial risk areas in place.

The insufficiency of Board members from August 2013 to December 2013 undermined the effective Board oversight role over the bank's business operations and activities. Three Board members resigned on account of ineligibility, as per Clause 3.1(1) of the Circular on Board Membership Eligibility in Botswana Banks, issued by the Bank on August 1, 2013, which made civil servants and specified public sector employees ineligible for board memberships of private banking institutions. Furthermore, the Chairman of the Board of the small bank had his Board membership terminated, following his resignation from the bank. The bank was advised to address the following: ensure that all its current policies are date stamped and signed by designated members of the Board; increase staff in the accounting and internal audit division; set up a human resource division; establish a training programme for staff on AML/CFT issues and other key banking matters; and ensure that all Know Your Customer (KYC) requirements are fully complied with for all bank accounts.

(b) Consultative and Prudential Meetings and Salient Features from Off-Site Monitoring

The two semi-annual Banking Committee[14] meetings scheduled for 2013 were duly held with good attendance. Discussions at these meetings centred mainly on the growing public concern about the perceived high level of bank charges and other fees (including insurance costs on loans), which were deemed not to be commensurate with the quality of banking services.

The Bank held all bilateral and statutory trilateral meetings with supervised banks scheduled for 2013. These meetings discussed banks' strategic plans, financial performance and preparatory work for the introduction of Basel II/III. ABN AMRO (on-shore and off-shore banks) announced that as part of a major strategic review of global areas of operations, they would cease operations in Botswana on June 30, 2014.

14 The Banking Committee comprises the Governor, Deputy Governors, General Manager, Advisors, Director Banking Supervision Department, Managing Directors and/or Chief Executive Officers of supervised financial institutions.

The bank cited the shareholder prerogative as the reason for the surrender of the licence.

The Banking Supervision Department continued to monitor the performance of the banking industry through statutory returns that are submitted on a weekly, monthly and quarterly basis. Overall, the banks were found to be financially sound, adequately capitalised, liquid and in compliance with other minimum regulatory and prudential requirements for banks.

Notwithstanding the foregoing, two banks contravened Section 20 (3) of the Banking Act, by submitting incorrect statutory returns to the Bank, in this way resulting in monetary penalty fines of P100 800 and P120 000, respectively. Another bank was fined P81 640.70 for violation of Section 16 (6) of the Banking Act, by failing to maintain the minimum liquid assets requirement. The Bank withheld approval for a dividend payment by that bank for 2013 as the transaction would have had an offsetting effect on the capital injected by the parent company and the dividend payment would also have resulted in perpetuating violations of capital and liquidity requirements by the bank.

Box 2: Effective Board of Directors for Banks

It is well established that banks play the important role of financial intermediation in an economy, and are tasked with safeguarding depositors' funds. As such, banks are highly sensitive to ineffective corporate governance. This was clearly illustrated in the 2008 financial crisis, as stated in (Grant Kirkpatrick, "The Corporate Governance Lessons from the Financial Crisis", Organisation of Economic Cooperation and Development (OECD), Vol. 2009/1) that, " the financial crisis can be, to a certain extent, attributed to failures and weaknesses in corporate governance arrangements".

The Board of Directors (the Board) is the highest body of authority in an organisation and is responsible for the overall well-being of a business. Some of the Board's responsibilities include: establishing the vision, mission, and goals of the business; overseeing the performance of the Chief Executive Officer; developing a governance system for the business to guide the Board and senior management actions; setting the operating strategy and direction, and protecting the organisation's assets and shareholder's interests.

As stipulated in Section 29 and 30 of the Banking Act (CAP. 46.04) and the OECD principles on corporate governance, Board members should be "fit and proper" to exercise oversight on the affairs of the bank. Fitness and propriety covers a wide range of aspects ranging from integrity, uprightness, honesty, probity and competence, previous conduct and activities in business and academic qualifications.

An important backdrop from the OECD principles on corporate governance indicates that Board members should be qualified for their positions. Qualifications of Board members should cover a diversified spectrum of requirements necessary for the type of bank they will be overseeing. They must have fundamental understanding of the various types of risks associated with different aspects of the banking business. For example, a bank that specialises in financing the agricultural sector, or mining sector, should have an expert from the same sector sitting on the Board. In addition, as the bank grows in size and complexity, it is necessary that the level of expertise match the expansion, so that the Board keeps abreast with developments to promote efficiency and effective strategic direction. It is also important for a Board to include one or more advisory directors as they generally do not vote, but provide additional information or advice to voting directors. Banks should have an adequate number of Board members. The preferred minimum number of board members for banks is five and the maximum number will be determined by the size and complexity of the bank.

Given that the Board is a body of persons which should exercise independent judgement without undue influence by any person, the majority of Board members should be independent directors/non-executive directors. The Bank's Guidelines state that the representation of related persons on the Board should be restricted to one-third of the Board composition.

In addition to the independence of directors, the Board should comprise individuals who do not have a potential conflict of interest, to ensure they are not impeded from properly fulfilling their duties and responsibilities to the bank. Conflict of interest could arise from Board members who, by virtue of their positions, are likely to receive and have access to information or insight, which is unknown to others in that line of business or is not publicly available, e.g. politically exposed persons or government officials, auditors, lawyers, etc. It is also important that Board members have a cooling off period after resigning from one bank and being appointed to the Board of another bank, as the Board member will be privy to the strategies, weaknesses and strengths of the previous bank. Board members should not be financially dependent on their bank, as this would weaken their independence and usefulness as directors.

Board members are expected to understand the regulatory environment so as to ensure compliance with the laws, regulations and directives issued to banks. For this reason, a bank should have a lawyer on the Board, to ensure compliance with laws and regulations of the jurisdiction in which the bank operates. Also, it would benefit the bank to include nationals or citizens of the jurisdiction in which the bank operates as they have the advantage of knowing the market in which the bank operates.

Furthermore, Board members should be appointed on a contractual basis, subject to regular reviews of fitness and probity, on an ongoing basis, and contribution to the governance of the bank. As such, reviews should be undertaken at appropriate intervals and at the end of their respective contracts, which could generally range from one to three years, or until their successors are elected and have qualified.

In view of the factors discussed above, it is of utmost importance, to have and adopt a corporate governance framework, that is consistent with the rule of law, and that clearly articulates the division of responsibilities and promotes transparency within the governance structures of a supervised bank.

References

1. Grant Kirkpatrick, "The Corporate Governance Lessons from the Financial Crisis", Organisation of Economic Cooperation and Development, Vol. 2009/1.
2. Mike Boland and Don Hofstrand, "The Role of the Board of Directors", Iowa State University, File C5-71, 2009.
3. Basel Committee on Banking Supervision, "Enhancing corporate Governance for Banking Organisations", Bank for International Settlements, 2006.
4. Guidelines on the Appointment of New Directors and Senior Management Officials of Banks, RG 01/01/2008.
5. Board of Governors, Federal Reserve System, "Commercial Bank Examination Manual", 2013

Chapter 6: Performance of Non-Bank Financial Institutions

Licensing of Bureaux de Change

During 2013, four bureaux de change were licensed and commenced operations, out of which three were located in Gaborone and one in Lobatse. The number of newly licensed bureaux de change was the same as in the previous year. The Bank revoked the licences of eight bureaux de change, five of them due to violations of the provisions of the Bank of Botswana (Bureaux de Change) Regulations, 2004, while the other three voluntarily surrendered their licences. These changes brought the number of operational bureaux de change to 57 in 2013, compared to 61 in 2012.

On-site Examinations of Bureaux de Change

The Bank carried out on-site examinations of ten bureaux de change during 2013. The examinations revealed generally satisfactory operational performances by the respective bureaux de change, although violations of some of the requirements of the Bureaux de Change Regulations, 2004, were noted in some instances. Such violations included failure to:

(a) observe daily cash transaction limits (Regulation 13);
(b) submit or late submission of audited annual accounts (Regulation 18);
(c) maintain minimum bank deposits (Regulation 5);
(d) adhere to anti-money laundering measures (Regulation 14); and
(e) seek the Bank's prior approval before effecting changes in the composition of shareholding structures (Regulation 5).

All the affected bureaux de change were given supervisory warnings, except for two bureaux de change, which were fined monetary penalties.

Off-site Examinations of Bureaux de Change

Charts 6.1 and 6.2 show the market share of foreign exchange sales and purchases by currency in 2012 and 2013 by the operating bureaux de change. The ZAR and the USD continued to dominate the bureaux de change foreign currency transactions of the foreign exchange market.

Chart 6.1: Bureaux de Change Sales of Foreign Currency

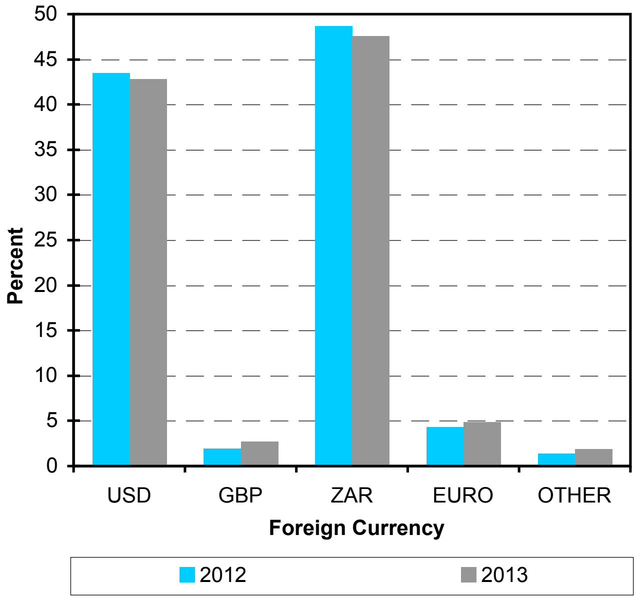


Chart 6.2: Bureaux de Change Purchases of Foreign Currency

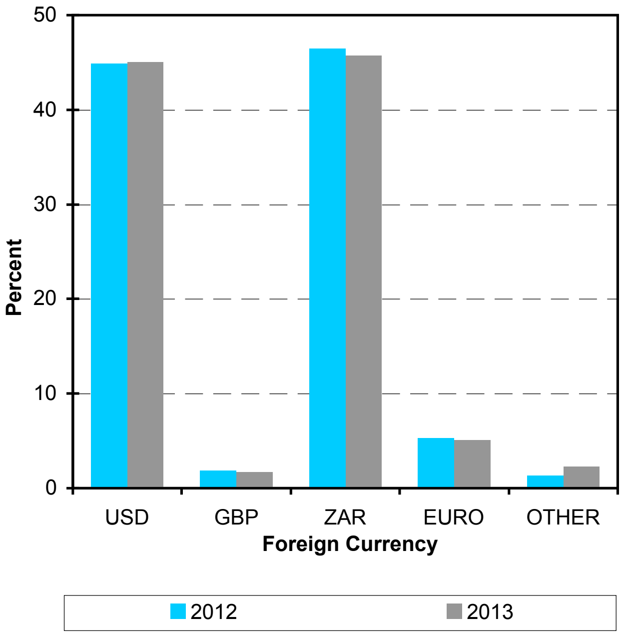
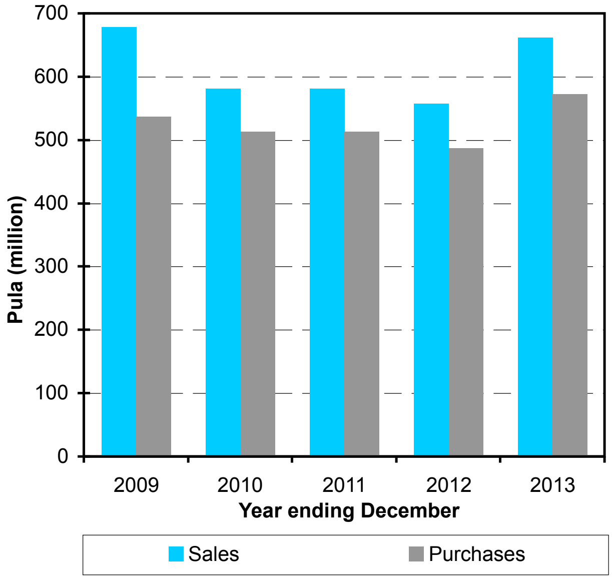


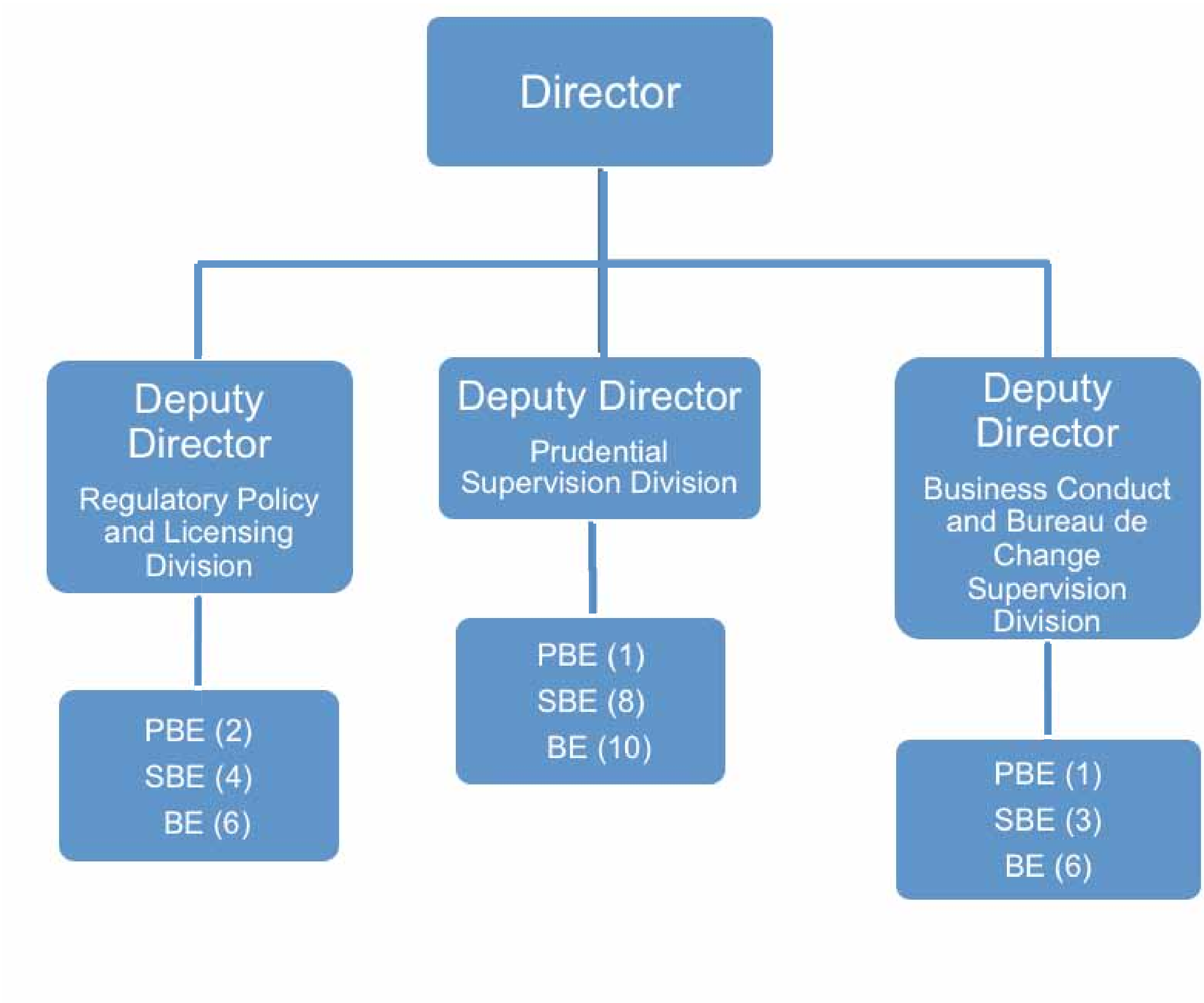
Chart 6.3 displays the aggregate value and growth pattern of the industry's volumes of foreign exchange sales and purchases over the past five years. Both sales and purchases for 2013 have increased, reversing the declining trend that prevailed from 2009 to 2012. Total foreign currency sales and purchases increased by 18.6 percent and 17.3 percent in 2013, compared to the decrease of 3.9 percent and 5.1 percent in 2012, respectively.

Chart 6.3: Aggregate Bureaux De Change Sales and Purchases of Foreign Currency



Appendices

Appendix 1: Banking Supervision Department Organisation Chart



Key:

PBE: Principal Bank Examiner

SBE: Senior Bank Examiner

BE: Bank Examiner

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 29 Core Principles for Effective Banking Supervision.

2. Legal Framework

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

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

3. Authority for Licensing Banks

A central feature of banking supervision is establishing criteria for licensing of banks. Banking is a regulated industry because banks take deposits from the public, and play a critical role in the country's payments system. As a result, there are regulatory barriers to entry that importantly influence the structure of the banking industry in terms of the number, size and ownership of banks in the country. These market entry requirements must be carefully balanced with the public policy objective of a competitive and efficient banking system.

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

4. Licensing Policy and Procedures for Establishing a Bank

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

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

(a) The firm must be locally incorporated in Botswana (branch banking is not permitted).

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

(c) The applicant must have adequate managerial capacity, which includes the appointment of "fit and proper" persons, as well as sound risk management and other governance structures.

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

(e) The proposed ownership and organisational struc ture must be acceptable to the Bank, and the structure must be such that it does not deter effective supervision, or where necessary and appropriate, consolidated supervision.

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

5. Core Prudential Requirements

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

Capital Adequacy Requirements

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

Reserve Requirements

Section 40 of the Bank of Botswana Act (CAP. 55:01) empowers the Bank of Botswana to require financial institutions to hold primary reserves, including marginal primary reserves, in the form of cash holdings or deposits with the Bank or both, against such deposits and similar liabilities as may be specified by the Bank. The current primary reserve requirement ratio is 10 percent of Pula denominated deposits, held in a non-interest bearing account of the Bank. This is primarily a monetary policy tool intended to regulate the ability of a bank to use deposit liabilities for lending purposes.

Liquid Assets Requirements

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

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

Asset Quality

Asset Concentrations (Large Exposures)

Section 17 of the Banking Act read together with Regulation 9 restricts a bank from granting facilities that are in excess of 10 percent of a bank's unimpaired capital to a single or group of related customers without the specific approval of a bank's entire board of directors. Further, a bank is required to seek prior approval from the Bank before granting loans and other credit facilities to a single entity or group of related companies which, in aggregate, are in excess of 30 percent of a bank's unimpaired capital. This is an asset quality ratio intended to avoid vulnerabilities arising from excessive concentration of credit risk, or, put more positively, to encourage diversification of the loan portfolio of a bank.

Insider Lending

Section 17 of the Banking Act read together with Banking Regulation 9 also restricts banks from granting credit facilities to directors and their related interests in excess of the higher of P50 000 or 1 percent of a bank's core capital without the approval of a bank's entire board of directors. In addition, no bank may grant facilities, direct or indirect, to a member of its board of directors in excess of 25 percent of its unimpaired capital. This provision seeks to avoid possibilities of insider abuse, self-dealing or over-reliance on related party business. Any lending in violation of this requirement is deemed to be a withdrawal of capital and, therefore, deducted from the unimpaired capital in computing the capital adequacy ratio of a bank.

Non-Performing Loans and 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 to assess adequacy of the provisions for non-performing assets. Accordingly, the Bank has statutory power to assess, in consultation with the bank's independent statutory auditors, the level of impairments in a bank's loan portfolio and the amount of charges to the bank's profit and loss as an expense for non-performing assets.

6. Main Supervisory Approaches

On-Site Examinations

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

A full scope on-site examination is one that is sufficient in scope to assess an institution's Capital Adequacy (C), Asset Quality (A), Management and Effectiveness of Board Oversight (M), Earnings and Profitability (E), Liquidity (L) and Sensitivity to Market Risk (S) components (referred to as CAMELS) and the risk management systems and make a conclusion about its safety and soundness. Full scope on-site examinations should be conducted at least every 18 months. A limited scope examination is an on-site examination which does not cover all the CAMELS components, but rather focuses on a specific product, area, or risk, e.g., consumer loans, treasury or operational risk. An ad hoc on-site examinations is usually a limited scope designed to test a specific area of supervisory concern; e.g., compliance with laws and regulations, liquidity, capital adequacy, etc.

The objectives of on-site examinations are to assess and evaluate the overall condition and financial soundness of a bank, its compliance with applicable laws and regulations, the quality and effectiveness of governance structures, including the internal control environment, as well as to check the accuracy of statutory reports submitted to the Bank.

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

The evaluation of the financial soundness of the institution is achieved by assessing CAMELS, and the Risk Assessment Systems (RAS) rating. CAMELS and RAS ratings were awarded on a scale of 1 to 5. A rating of 1 indicates strong performance and strong risk management practices, while a rating of 5 signifies weak performance and inadequate risk management practices. Consistent with the Risk-Based Supervision (RBS) methodology applied by the Bank, CAMELS ratings are used as a guide to determine, inter alia, the frequency of on-site examinations and intensity of supervisory programmes for each bank. A CAMELS rating of 1 (sound/strong bank) requires a bank to be examined within 24 months; a CAMELS rating of 2 within 18 months; a CAMELS rating of 3 within 12 months; and CAMELS ratings of 4 and 5, suggesting poor risk management and/or unsound banking operation, require that a bank should be examined within six (6) months.

In order to ascertain the soundness and prudence of the bank's practices and procedures, an assessment is made of its inherent risks, and the adequacy of its risk management systems and controls. The practices and procedures adopted would reveal the extent to which the financial institution is employing adequate measures to protect depositors' 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 and the adoption and implementation of issues that may adversely affect the performance of a bank for which they are responsible.

Bilateral and Trilateral Meetings

Bilateral meetings are held once a year with each supervised bank. Prudential meetings with the institution's management are meant to discuss its financial performance, risk profile, strategies, the market in which it operates, and/or any other issues of supervisory concern. These meetings provide a forum for exchange of views on matters affecting the supervised banks and serve to improve communication and information flow between the Bank and the supervised banks. Bilateral meetings are also held once a year with each of the four (4) auditing firms engaged by the supervised banks. The meetings are arranged to discuss supervisory issues that might need attention of both the external auditor and the supervisor. It is also at such meetings that the Bank takes the opportunity to discuss with auditors their expectations regarding the scope of statutory audits and other general issues of a prudential nature.

In addition to the separate bilateral meetings with both external auditors and the respective supervised banks, the Bank, pursuant to Section 22(8) of the Banking Act, arranges tripartite meetings with each financial institution and its external auditors. These trilateral 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 statement of financial position and income statement. The forum is also used to share information on the critical risk areas and/or any new developments in accounting and regulatory standards. Trilateral meetings have an added advantage of fostering effective collaboration and communication between the Bank (as regulatory authority) and external auditors of banks in the application of accounting standards and ensuring effective disclosure in financial statements and related reports of material risks in a bank's statement of financial position.

Off-Site Monitoring and Surveillance

Off-site surveillance involves off-site monitoring of the supervised institution regarding its performance and condition, together with progress on implementation of various directives and/or recommendations from the supervisor. All banks are required to submit statutory returns as prescribed under Section 20 of the Banking Act. The foreign exchange statutory return, which shows the bank's net foreign exchange position, is submitted every week to the Bank. The monthly and quarterly statutory returns should be submitted on the 10th day of the month following the reporting month. Instructions on how to complete the returns are contained in the statutory returns availed to each bank upon being granted a licence.

The Banking Supervision Department analyses financial data from banks continuously to determine their financial conditions, soundness and viability. The specific objectives of the analyses are: to determine the levels, trends and sources of banks' profits; to compare each bank's performance for the period with that of prior periods, and against that of other banks; to note changes in the banks' capital accounts and the causes thereof (monthly, quarterly and annual performance review); to determine whether the banks have complied with the Banking Act, Banking Regulations, Directives, Circulars and Guidelines pertaining to prudential requirements.

The outcome of the off-site analysis is used for preparing early warning reports, which also serve as an input into the on-site examination work, including planning, scope of on-site examination work and resourcing of the on-site examination teams. Furthermore, this regular off-site monitoring, surveillance and analysis serves an important function of risk profiling of banks, continuous engagement with bank management and, as may be necessary, any targeted supervisory interventions.

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 the financial year-end requires prior approval of the Bank.

Appendix 3: Supervised Financial Institutions as at December 31, 2013

(a) Commercial and Statutory Banks

Institution	Postal Address	Business Locations	External Auditors
Commercial Banks[1]			
Barclays Bank of Botswana Limited	P O Box 478, Gaborone	47*	PricewaterhouseCoopers
Standard Chartered Bank Botswana Limited	P O Box 496, Gaborone	18**	KPMG
First National Bank of Botswana Limited	P O Box 1552, Gaborone	21	Deloitte & Touche
Stanbic Bank Botswana Limited	P/Bag 00168, Gaborone	11***	KPMG
Bank of Baroda (Botswana) Limited	P O Box 21559, Gaborone	2	Grant Thornton
Bank Gaborone Limited	P/Bag 00325, Gaborone	16****	PricewaterhouseCoopers
Capital Bank Limited	P O Box 5548, Gaborone	4	KPMG
African Banking Corporation of Botswana Limited	P/Bag 00303, Gaborone	6	KPMG
ABN AMRO Bank (Botswana) Limited	P O Box AE 510 AEH, Gaborone	1	KPMG
Bank of India (Botswana) Limited	P O Box 00111, Gaborone	1	Grant Thornton
State Bank of India (Botswana) Limited	P O Box 505243, Gaborone	1	Grant Thornton
Off-shore Banks			
ABN AMRO Bank (Botswana) OBU Limited	P O Box AE 510 AEH, Gaborone	1	KPMG
Kingdom Bank Africa Limited	P O Box 45078, Gaborone	1	KPMG
Statutory Banks			
Botswana Savings Bank	P O Box 1150, Gaborone	2	KPMG
National Development Bank	P O Box 225, Gaborone	5*****	PricewaterhouseCoopers
Building Society			
Botswana Building Society	P O Box 40029, Gaborone	9	KPMG

* Includes 42 branches and 5 agencies

** Includes 15 branches and 3 agencies

*** Includes 9 branches and 2 sub-branches

**** Includes 6 branches and 10 agencies

***** Includes 4 branches and 1 agency

(b) Bureaux de Change as at December 31, 2013

Name	Postal Address	Business Locations
Aldaph Bureau de Change	P O Box 404845, Gaborone	2
American Express Bureau de Change	P O Box 45140 , Gaborone	3
Apijoe Bureau de Change	P O Box 458, Mogoditshane	2
Ban Mo Bureau de Change	P O Box 99, Sherwood	1
Bellagio Bureau de Change	P/Bag BR 321, Gaborone	1
Beni Fame Bureau de Change	P O Box 41654, Gaborone	3
Boitekanelo Bureau de Change	P O Box 27698, Gaborone	1
Cape to Cairo Bureau de Change	P O Box 799, Kasane	2
Crystal Diamond Bureau de Change	P O Box 20554, Gaborone	1
CSS Bureau de Change	P O Box 45168, Gaborone	1
Currency Exchange Bureau de Change	P O Box 80981, Gaborone	2
Dollar Wave Bureau de Change	P O Box 1054, Bobonong	1
Elite Bureau de Change	P/Bag 0028, Mogoditshane	1
Exim Bureau de Change	P O Box 1020, Gaborone	1
Fanz Bureau de Change	P O Box 617, Lobatse	1
Fundex Bureau de Change	P O Box 401547, Gaborone	3
FX Africa Bureau de Change	P O box 20537, Gaborone	4
Garona Bureau de Change	P O Box 408 , Gaborone	4
Genesis Bureau de Change	P/Bag BR 225, Gaborone	1
Gorogang Bureau de Change	P O Box 46785, Gaborone	1
Hyper Bureau de Change	P O Box AE 27 AEH, Gaborone	1
Investors View Bureau de Change	P O Box 2381, Francistown	1
Kalahari Bureau de Change	P O Box 1116, Gaborone	1
Kaycy Bureau de Change	P O Box 1693, Lobatse	1
Kwanokeng Bureau de Change	P O Box 10, Sherwood	2
Limpopo Bureau de Change	P O Box 8, Sherwood	2
Madikwe Bureau de Change	P O Box 268, Sikwane	1
Maeto Bureau de Change	P O Box 22, Mahalapye	1
Masa Bureau de Change	P O Box AC 166 ACH, Gaborone	1
Master Bureau de Change	P/Bag F199, Francistown	1
Min-C Bureau de Change	P O Box 26513, Gaborone	1
Mochudi Bureau de Change	P O Box 202147, Mochudi	1
Monty Cristo Bureau de Change	Private Bag 00254, Gaborone	1
Open Door Bureau de Change	P O Box 839, Maun	2
Ozair Bureau de Change	P O Box 4862, Gaborone	2
Premier Bureau de Change	P O Box AD 490 ADD, Gaborone	1
Prosper Bureau de Change	P/Bag B O7, Gaborone	1
Proxy Bureau de Change	P O Box 404108, Gaborone	2

Rennies Bureau de Change	P O Box 2482, Gaborone	1
River Ride Bureau de Change	P O Box 301106, Francistown	3
Rose of Sharon Bureau de Change	P O Box 404338, Gaborone	1
Royalty Bureau de change	Private Bag BO 259 , Gaborone	3
Sherwood Bureau de Change	P O Box 1 , Sherwood	1
Simba Bureau de Change	P O Box 402129, Gaborone	1
Simple Forex Bureau de Change	P O Box 81384, Gaborone	1
Sunny Bureau de Change	P.O Box 370, Maun	2
Thari Bureau de Change	P O Box 40074, Gaborone	2
The Silver Bureau de Change	P O Box 1894, Ramotswa	1
Thunda Bureau de Change	P O Box 4470, Gaborone	1
Trans Fronter Bureau de Change	P O Box 183, Pitsane	1
Travellers Bureau de Change	P O Box 20909, Maun	1
Travellers' Choice Bureau de Change	P O Box 26725, Gaborone	3
TRL Money Link Bureau de Change	Private Bag F333, Francistown	1
UAE Exchange Bureau de Change	P O Box 26398, Gaborone	2
Unity Bureau de Change	P O Box 1586, Francistown	1
Universal Bureau de Change	P O Box 2444, Gaborone	1
West Bureau de Change	P O Box 779, Gaborone	1
Total	**57**	**87**

(C) MICROFINANCE INSTITUTIONS

Institution	Postal Address	Business Locations	Auditors
Women's Finance House	P/Bag 124, Gaborone	1	Sharma & Associates

Appendix 4: List of Guidelines Issued and Other Statutory Amendments

1. The draft Capital Measurement and Capital Standards for Botswana was issued to the market on December 31, 2013 and Basel II/III statutory returns for use during the parallel run period from January 1 to December 31, 2014.

2. Circular to Banks Regarding Eligibility for Board Membership in Banks: This circular was issued to banks, on August 1, 2013 and the amendment resulted in the following persons not being eligible:

   (a) Government officials, employees and board members of Parastatal entities;

   (b) Partners and other Senior Auditors of Audit Firms (public accounting firms);

   (c) Sitting Board members of an Oversight Authority; and

   (d) Politically Exposed Persons- Including but not limited to: elected officials either at National Parliament level, Cabinet or Council/local authority.

3. The Banking (Anti-Money Laundering) Regulations, 2003 were amended as follows:

   (i) Amendment of regulation 3

      (a) By substituting for the definition of the word "Financial Intelligence Agency", the following new definition- "Financial Intelligence Agency" means the Financial Intelligence Agency established under the Financial Intelligence Act"

      (b) Under the definition of the word "money laundering", by substituting for the words "in section 14 of", the word "under"; and

      (c) By substituting for the definition of the word "suspicious transactions", the following new definition -"suspicious transactions" has the same meaning assigned to it under the Financial Intelligence Act, and includes activities listed in the First Schedule to these Regulations"

   (ii) The Regulations are amended by deleting Regulation 14.

   (iii) Regulation 15 amended by substituting for the words:

      (a) "in terms of regulation 14" appearing in subregulation (1), the words "in terms of the Financial Intelligence Act"; and

      (b) "in regulation 14" appearing in subregulation (5), the words "under the Financial intelligence Act".

   (iv) The schedule to the Regulations is amended by deleting the Second Schedule.

Appendix 5: Definitions of Banking Supervision Terminology as Used in the Report

1. Definitions of Banking Supervision Terminology as Used in the Report

(a) **Asset Concentration:** Measures aggregate exposure to one borrower, an affiliated group of borrowers, or borrowers with a common controlling interest, common management, cross-guarantees or financial interdependency which cannot be substituted in the short term. This exposure is usually expressed as a percentage of the bank's unimpaired capital and its various thresholds are subjected to prudential regulatory requirements. In terms of Section 17 of the Banking Act (CAP. 46:04), an 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. Exposures in excess of 30 percent of the bank's unimpaired capital require the Bank's approval.

(b) **Asset Quality:** A relative measure of the performance of the bank's loan portfolio based on the appraisal of the asset, in terms of the degree of risk and the likelihood of recovery, adherence to the terms of contracts and orderly liquidation of the account. A good quality asset means the loan, advance or investment is producing cashflows as was expected and/or agreed upon. A non-performing asset or loan is a loan where payment of interest and principal are past due by 90 days or more.

(c) **Loan Classifications:**

(i) **"Pass" Assets** - Assets under "Pass" category are those that are found to have no material or significant performance problems, or technical and/or legal documentation deficiencies.

(ii) **"Specially" Mention Assets** - Advances in this category are currently protected but are potentially weak. These advances constitute an undue and unwarranted credit risk but not to the point of justifying a classification of substandard. The credit risk may be relatively minor yet constitute an unwarranted risk in the light of the circumstances surrounding a specific advance. Special mention rating is not a classification, and should not be used as a compromise between a "Pass" and "Substandard".

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

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

(v) **"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 revenue reserve and retained earnings, also called Tier 1 capital. It represents the most stable and permanent form of capital for supporting a bank's operations. (See Appendix 5 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 at Appendix 5.

(f) **Unimpaired Capital:** Unimpaired in relation to the capital of a bank means the absence of any legal or technical covenant, term, restriction or encumbrance, which would otherwise render such capital not to be freely available for distribution to depositors and/or other creditors in the event of the liquidation or dissolution of the bank, and the absence of any condition or arrangement which would, in the opinion of the central bank, diminish the value of the whole or any portion of the capital of the bank. An outline of capital elements used to compute unimpaired capital is presented at Appendix 5.

2. Prudential Ratios

(a) **Return on Equity (ROE):** The ratio measures the after-tax profit against shareholders' funds. The ratio, however, tends to favour highly 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 banking 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 and for prudential supervision. Emphasis is on the adequacy of capital with reference to the quality of capital funds in relation to the statement of financial position risk profile, i.e., the core and unimpaired capital to risk weighted assets ratio. The rationale is that owners of banks must have sufficient own funds in a bank, though it is recognised that unnecessarily high capital levels could result in economic inefficiencies, if not employed productively. However, for commercial and other strategic reasons, most banks will retain some or a portion of their income to build greater capacity by way of a larger capital base, in order to take advantage of lending and/or investment opportunities in large projects, or to support organic growth of the bank.

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

(e) **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 the vulnerability of bank earnings.

(f) **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.

(g) **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.

(h) **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.

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

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

(k) **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.

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

3. Risk-Weights Applied on Various Asset Exposures for Purposes of Capital Adequacy Measurement

ASSETS	Amount Risk Factor (%)
1. Total Assets (Sum of lines 2 to 24)	
2. Cash (Pula)	0
3. Due from Bank of Botswana (current)	0
4. Bank of Botswana Certificates	0
5. Loans and Advances Secured by Cash	0
6. Loans and Advances guaranteed by Government of Botswana	0
7. Loans and advances guaranteed by other sovereign states	0
8. Treasury Bills	0
9. Other Government of Botswana obligations	0
10. Due from domestic banks (under 1 year)	20
11. Local Government	20
12. Due from foreign banks (under 1 year)	20
13. Foreign banknotes (cash)	20
14. Cash items in process of collection	20
15. Loans and advances rated AAA to AA- (Fitch Rating)	20
16. Loans and advances to public financial and non-financial corporations	20
17. Real estate (residential-owner occupied)	50
18. Due from domestic banks (over 1 year)	100
19. Private sector advances (loans and overdrafts)	100
20. Due from foreign banks (over 1 year): sum of lines (a) to (d):	
(a) Rated AAA to AA(-)	20
(b) Rated A to A (-)	50
(c) Rated less than A (-) and non-rated	100
(d) Rated BBB	150
21. Bank premises	100
22. Other real estate	50
23. Other assets	100
24 Past Due Loans (in line 15 to 20)	150

	Credit Conversion* Factor	Risk Factor (%)**
25. Total Off-Balance Sheet Items (sum of lines 26 to 36)		
26. Commitments under 1 year or can be cancelled	0	
27. Guarantees/performance bonds secured by cash	0	
28. LCs and guarantees to public financial and non-financial corporations	20	
29. Guarantees and bonds secured by first class banks	20	
30. Self-liquidating-trade related LCs (commercial LCs)	20	
31. Securities underwriting	50	
32. Formal commitments, credit lines and bills endorsed (includes promissory notes with original maturity over 1 year)	50	
33. Other unsecured performance bonds, etc. (transaction related)	50	
34. Other off-statement of financial position exposure (specify)	100	

35. Assets securitisation with recourse	100	
36. Other standby letters of credit and other guarantees	100	
Maturity* **	**Conversion Factors - Interest Rate Contracts (%)**	
37. Forwards, Swaps, Purchased Options and Similar Derivatives Contracts (sum of lines 39 to 43)		
38. One Year or Less	0.50	
39. Over One Year to Two Years	1.00	
40. For Each Additional Year	1.00	
	Exchange Rate Contracts and Gold (%)	**Risk Factor (%)****
41. One Year or Less	2.00	
42. Over One Year to Two Years	5.00	
43. For each Additional Year	3.00	
44. TOTAL RISK-WEIGHTED ASSETS AND OFF-BALANCE SHEET ITEMS (SUM OF LINES 1, 25 AND 37)		

* The credit conversion factor converts the off-statement of financial position items to their on-statement of financial position equivalence, before they can be risk-weighted by the weights applicable to the category of counter party, i.e., Government-percent, Multilateral Banks and Public Financial and Non-Financial Corporations – 20 percent and Private Sector - percent.

** For the purposes of calculating RWA, the exposure amount should be such that it is no less than the amount by which the bank's regulatory capital would be reduced if the exposure were to be written-off.

*** Use residual maturity for interest rate contracts and original maturity for exchange rate contracts.

4. Capital Elements

1. Total Tier 1 Capital (sum of lines 2 to 7, less line 8(a) to (f)):
2. Stated capital
3. Perpetual (non-redeemable) non-cumulative preferred shares
4. General reserves
5. Retained earnings
6. Minority interests
7. Buffer capital
8. Less:
(a) Goodwill and other intangible assets
(b) Cumulative losses below original cost of own use investment properties
(c) Shareholders' equity funded through the capitalisation of unrealised gains arising from revaluations
(d) Current year unpublished loss
(e) Impairment losses (including those resulting on available for sale)
(f) Supervisory capital charges
9. Total Tier 2 Capital (sum of lines 10 and 18)
10. Upper Tier 2 (sum of lines 11 to 17)
11. Current year's unpublished profits
12. 50 percent of fixed asset revaluation reserves
13. 50 percent of unrealised gains on available for sale revaluations
14. Unencumbered collectively assessed (General) allowances not to exceed 1.25 percent of risk-weighted assets
15. Hybrid (debt/equity) capital instruments eligible for inclusion in Tier 2
16. Minority interests in Tier 2 preference shares
17. Shareholders' equity funded through the capitalisation of property revaluations
18. Lower Tier 2 (sum of lines 19 and 20)
19. Subordinated term debt eligible for inclusion (not exceeding 50 percent of Core Capital)
20. Other dated capital instruments eligible for inclusion in Tier 2
21. Total Capital (sum of lines 1 and 9)
22. Total Impairments of Capital (sum of lines 23 to 30)
23. Investments in unconsolidated subsidiaries and associated companies
24. Connected lending of a capital nature, including unlawful lending to directors, owners or their indirect interest
25. Capitalised establishment costs/pre-incorporating expenses
26. Underwriting commission
27. Shortfalls in provisions for losses
28. Pre-paid expenses
29. Deferred charges
30. Leasehold rights
31. TOTAL UNIMPAIRED CAPITAL FUNDS (LINE 21 LESS 22)

Appendix 6: Financial Statements of Licensed Banks: 2009 – 2013

Table 1: Aggregate Statement of Financial Position for Licensed Commercial Banks: (P' million) as at December 31st

Total Assets in Local Currency	2009	2010	2011	2012	2013
1. Cash and balances with the Central Bank	2 238	3 269	4 766	4 933	5 268
a. Currency	595	707	721	824	976
aa. Hard currency	174	56	76	86	159
ab. Local currency	421	651	645	738	816
b. Balances with Central Bank	1 638	2 562	4 045	4 109	4 292
c. Other	5	0	0	0	0
2. Trading securities at market value (including BoBCs)	17 415	17 617	11 083	9 319	7 813
3. Placements with other banks and credit institutions	4 028	5 778	6 187	7 407	6 410
4. Gross loans and advances	19 700	22 087	27 920	34 410	39 499
4.1 Specific provisions	649	720	574	617	718
4.2 Interest in suspense	0	43	213	257	339
5. Net loans and advances	19 051	21 324	27 133	33 537	38 442
6. Investment securities	311	210	38	880	246
7. Fixed assets net of depreciation	399	492	482	665	872
8. Other assets (net)	580	900	1 911	1 213	911
Total Assets	**44 023**	**49 590**	**51 600**	**57 954**	**59 962**
Liabilities in Local Currency					
1. Amounts owed to government institutions	0	0	0	0	0
a. Central Bank accounts	0	0	0	0	0
b. Direct Government credits (CB or MFDP)	0	0	0	0	0
c. Other	0	0	0	0	0
2. Amounts due to other banks and credit institutions	680	460	990	1 320	1 394
3. Securities sold under repurchase agreements	0	0	0	520	1 960
4. Amounts due to other customers-depositors	37 590	41 628	43 178	47 219	48 589
5. Shareholders' funds	3 035	4 069	4 696	5 548	6 479
6. Other liabilities	1 099	1 977	1 827	2 925	1 202
a. Taxes payable	213	168	156	132	177
b. Dividends payable	0	0	0	20	0
c. Accrued expenses	2	42	243	0	0
d. Other	884	1 767	1 429	2 774	1 025
7. Other borrowing, including. international lending agencies	1 621	1 457	908	422	332
Total Liabilities	**44 023**	**49 590**	**51 600**	**57 954**	**59 962**

*Figures restated

Table 2: Aggregate Statement of Comprehensive Income for Licensed Commercial Banks (P' million) for the period ended Dember 31st

	2009*	2010	2011	2012	2013
1. Interest and similar income	4 796	4 244	4 407	4 784	5 146
2. Interest expense	2 427	1 778	1 663	1 502	1 600
3. Net interest income (1-2)	2 369	2 466	2 745	3 282	3 546
4. Other operating income	1 156	1 288	1 631	1 777	2 028
5. Gross operating income/(loss) (3+4)	3 525	3 754	4 376	5 059	5 575
6. Bad and doubtful debts provisions	384	272	301	455	579
(a) Specific loss provision expenses	414	318	305	445	588
(b) General loss provision	20	8	37	55	45
(c) Releases and recoveries	(50)	(54)	(41)	(46)	(53)
7. Operating income/(loss) net of specific loss provisions	3 141	3 482	4 075	4 604	4 995
8. Operating expenses	1 594	1 681	2 096	2 364	2 709
(a) Salaries and employee benefits	671	790	979	1 133	1 248
(b) Auditing and consulting expenses	13	12	33	6	17
(c) Rental/lease expenses	65	53	84	129	105
(d) Depreciation and amortisation	77	69	110	107	152
(e) Other	768	756	890	989	1 186
9. Other provisions and write-offs	0	0	14	0	0
(a) Investments	0	0	0	0	0
(b) Other balance sheet items	0	0	14	0	0
(c) Off-balance sheet items	0	0	0	0	0
10. Net operating income/(loss) (7-8-9)	1 547	1 801	1 964	2,240	2,287
11. Extraordinary gains/(losses)	3	1	0	0	0
(a) Gains/Losses on revaluation of assets (net)	0	0	0	0	18
(b) Translation gains/losses (net)	0	0	0	0	18
(c) Other gains/losses	3	1	0	0	0
12. Net income/(loss) before tax (10+11)	1 550	1 802	1 964	2 240	2 305
13. Income tax	315	396	313	468	530
14. Net income/(loss) after tax (12-13)	1 236	1 407	1 652	1 772	1 775
15. Proceeds from discontinued operations	4	80	13	0	0
16 Transfers from revaluation/to general provisions	8	(14)	16	0	0
17. Dividends declared (paid and proposed)	480	603	858	128	535
18. Retained earnings for the year (14-15-16-17)	748	898	790	1 645	1 240
19. Retained earnings at the beginning of the year	1 349	2 796	3 035	3 830	5 474
20. Retained earnings at the end of the year (18+19)	2 097	3 694	3 825	5 474	6 715

*Figures restated

TABLE 3: AGGREGATE STATEMENT OF FINANCIAL POSITION FOR STATUTORY BANKS IN BOTSWANA (P' MILLION) AS AT DECEMBER 31ST

Total Assets in Local Currency	2009	2010	2011	2012	2013
1. Cash and balances with the Central Bank	5	10	14	(20)	19
a. Currency	2	7	20	(21)	15
aa. Hard currency	0	0	0	0	0
ab. Local currency	2	7	20	(21)	15
b. Balances with Central Bank	4	3	(7)	1	3
c. Other	0	0	0	0	0
Trading securities at market value (BoBCs)	0	0	0	0	0
Placements with other banks and credit institutions	574	613	579	874	948
4. Gross loans and advances to other customers	2 813	3 052	3 573	4 214	4 873
5. Specific provisions	(113)	(112)	(129)	(199)	(242)
6. Loans and advances to other customers (net of specific provisions)	2 701	2 940	3 445	4 015	4 631
7. Investment securities	0	0	27	0	0
8. Fixed assets net of depreciation	150	157	176	184	217
9. Other assets (net)	33	42	11	46	124
Total Assets	**3 463**	**3 762**	**4 252**	**5 099**	**5 938**
Liabilities in Local Currency					
1. Amounts owed to government institutions	0	0	0	58	75
a. Central Bank accounts	0	0	0	0	75
b. Direct government credits (CB or MFDP)	0	0	0	0	0
c. Other	0	0	0	0	0
Amount due to other banks and credit institutions	0	0	0	0	0
3. Securities sold under repurchase agreements	0	0	0	0	0
4. Amount due to other customers/depositors	720	756	879	1 430	1 740
5. Shareholders' funds	1 819	1 957	2 031	2 162	2 350
6. Other liabilities	55	90	744	758	177
a. Taxes payable	0	0	0	0	1
b. Dividends payable	13	14	12	1	0
c. Accrued expenses	0	0	13	0	0
d. Other	42	76	719	757	176
7. Other borrowing, incl. international lending agencies	869	960	598	691	946
Total Liabilities	**3 463**	**3 762**	**4 252**	**5 099**	**5 938**

Table 4: Aggregate Statement of Comprehensive Income for Statutory Banks in Botswana (P' million) for the period ended Dember 31st

Statutory Banks	2009	2010	2011	2012	2013
1. Interest and similar income	413	402	377	455	561
2. Interest expense	150	132	137	167	211
3. Net interest income (1-2)	263	271	239	288	350
4. Other operating income	44	43	50	47	51
5. Gross operating income/(loss) (3+4)	306	313	289	355	401
6. Bad and doubtful debts provisions	33	45	36	31	45
(a) Specific loss provision expenses	33	43	36	31	0
(b) General loss provision	0	2	0	0	0
(c) Releases and recoveries of bad debts previously written off	0	0	0	0	0
7. Operating income/(loss) net of specific loss provisions	274	268	253	305	356
8. Operating expenses	166	165	167	183	235
(a) Salaries and employee benefits	80	88	88	95	126
(b) Auditing and consulting expenses	0	0	0	0	0
(c) Rental/lease expenses	0	0	0	0	0
(d) Depreciation and amortisation	6	10	6	7	9
(e) Other	79	68	73	81	100
9. Other provisions and write-offs	0	0	0	0	0
(a) Investments	0	0	0	0	0
(b) Other balance sheet items	0	0	0	0	0
(c) Off-balance sheet items	0	0	0	0	0
10. Net operating income/(loss) (7-8-9)	108	103	86	121	121
11. Extraordinary gains/(losses)	6	0	0	0	0
(a) Gains/losses on revaluation of assets (net)	0	0	0	0	0
(b) Translation gains/losses (net)	0	0	0	0	0
(c) Other gains/losses	0	0	0	0	0
12. Net income/(loss) before tax (10+11)	102	103	86	121	121
13. Income tax	0	0	0	0	0
14. Net income/(loss) after tax (12-13)	102	103	86	121	121
15. Transfers from revaluation to general provisions	0	5	0	0	0
16. Dividends declared (paid and proposed)	37	37	42	44	44
17. Retained earnings for the year (14-15-16)	65	61	44	77	77
18. Retained earnings at the beginning of the year	90	155	216	259	337
19. Retained earnings at the end of the year (17+18)	155	216	259	337	413

TABLE 5: AGGREGATE CAPITAL STRUCTURE OF COMMERCIAL BANKS IN BOTSWANA (TIER 1 CAPITAL, TIER 2 CAPITAL AND TOTAL CAPITAL) (P' MILLION) AS AT DECEMBER 31ST

Tier 1	Capital Elements	2009	2010	2011	2012	2013
1	Stated capital*	352	583	712	977	977
2	Preference (non-redeemable) non-cumulative shares	0	229	255	229	229
3	General reserves	355	105	70	93	376
4	Undivided profits (audited current year retained earnings/loss)	1 837	2 463	2 558	3 515	4 112
5	Minority interests	0	0	0	0	0
6	Less					
	(a) Goodwill and other intangible assets	(41)	(144)	(134)	(104)	(92)
	(b) Shareholders' equity funded through the capitalisation of unrealised gains arising from property revaluation	0	0	0	0	0
7	**Total Tier 1 Capital (Sum of lines 1-5 less lines 6 (a) and (b)**	**2 503**	**3 236**	**3 461**	**4 710**	**5 603**
Tier 2						
8	Current year's unpublished profits	127	875	976	760	384
9	Fifty percent of fixed asset revaluation reserves	16	30	36	32	57
10	Unencumbered general provisions not to exceed 1.25 percent of risk weighted assets	166	181	202	259	359
11	Hybrid (debt/equity) capital instruments eligible for inclusion	0	1	37	0	0
12	Subordinated term debt eligible for inclusion	815	793	715	966	846
13	Minority interest in Tier 2 preference shares	0	0	1	1 084	0
14	Shareholders' equity funded through the capitalisation of property revaluation reserves	0	0	0	0	0
15	Total Tier 2 Capital (sum of lines 8 to 14)	1 125	1 879	1 969	2 134	1 646
16	Total Capital (sum of lines 7 and 15)	3 627	5 115	5 429	6 844	7 249
	Impairments					
17	Investments in unconsolidated subsidiaries and associated companies	(1)	0	0	0	30
18	Total impairments of capital	(1)	0	0	0	0
19	**Total unimpaired capital**	**3 627**	**5 115**	**5 429**	**6 844**	**7 279**

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

Appendix 7: Charts of Key Prudential and Other Financial Indicators

Chart 7.1: Average Cost of Deposits

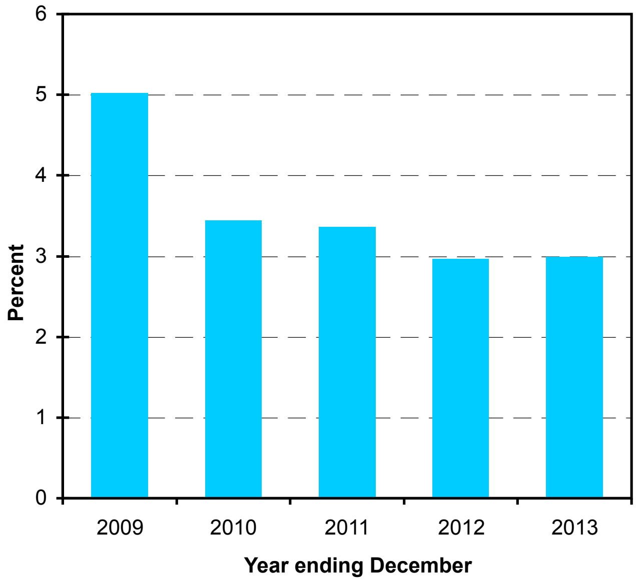


Chart 7.2: Return on Loans and Advances

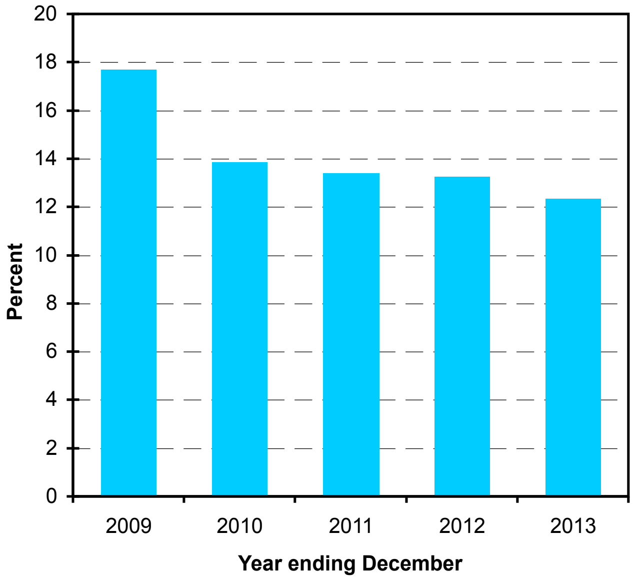


Chart 7.3: Residential Real Estate Loans to Total Loans

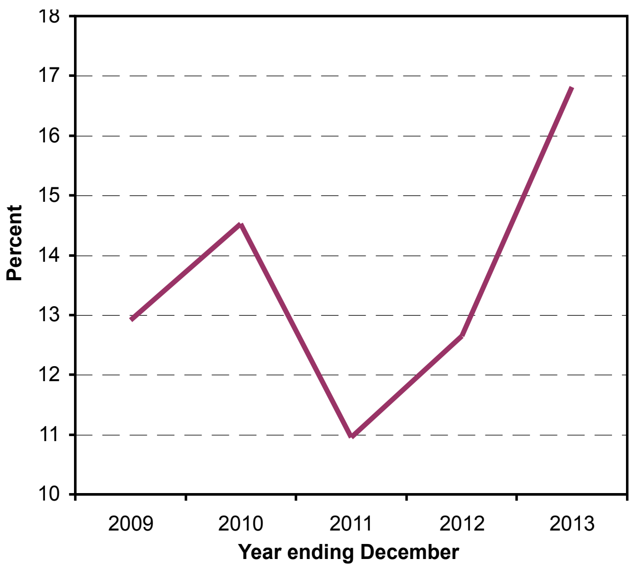


Chart 7.4: Household Loans to Total Loans

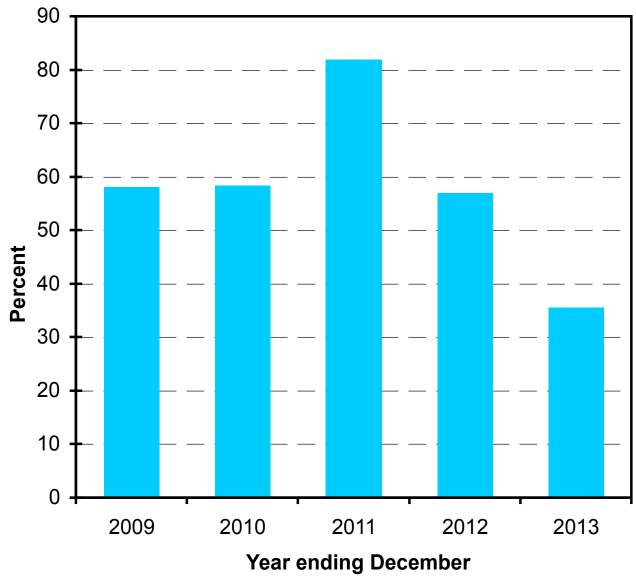


Chart 7.5: Non-Performing Loans Growth Rate

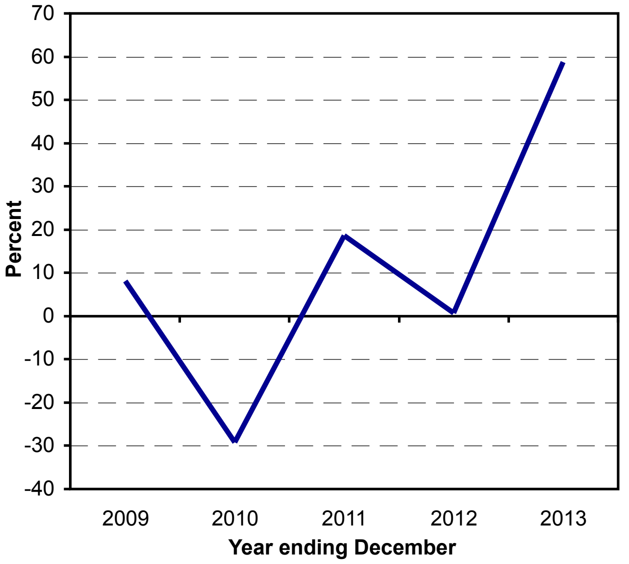


Chart 7.6: Share of Value of Total Deposits by Type (including FCAs)

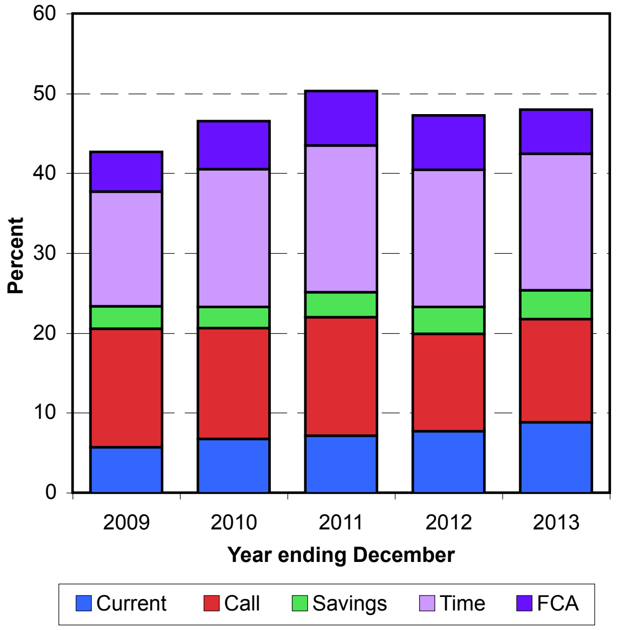
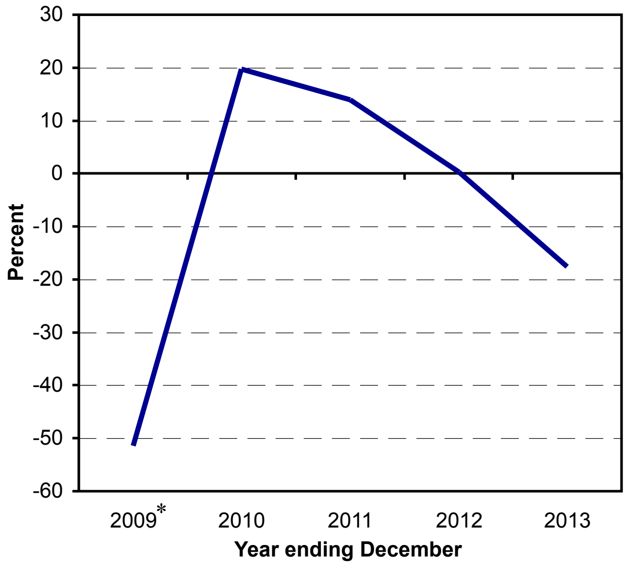


Chart 7.7: Growth Rate of Foreign Currency Accounts



* The foreign currency deposits dropped by 51 percent in 2009 due to nominal appreciation of the Pula against major currencies, save for the South african rand.

Chart 7.8: Industry Efficiency Ratios