FINANCIAL STABILITY REPORT

BANK OF BOTSWANA
BANKA YA BOTSWANA

PULA
REPUBLIC OF BOTSWANA
MINISTRY OF FINANCE AND ECONOMIC DEVELOPMENT

NBFIRA
Non-Bank Financial Institutions Regulatory Authority

OCTOBER 2020

FINANCIAL STABILITY COUNCIL

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ABBREVIATIONS

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
AUM	Assets Under Management
BACH	Botswana Automated Clearing House
BES	Business Expectations Survey
BIHL	Botswana Insurance Holdings Limited
BIS	Bank for International Settlements
BISS	Botswana Interbank Settlement System
BoBCs	Bank of Botswana Certificates
BoE	Bank of England
BPOPF	Botswana Public Officers Pension Fund
BSEL	Botswana Stock Exchange Limited
CMB	Capital Management Botswana
CPF	Counter Proliferation Financing
DB	Defined Benefit
DC	Defined Contribution
DCI	Domestic Companies Index
DPF	Deposit Protection Fund
D-SIBs	Domestic Systemically Important Banks
D-SIFIs	Domestic Systemically Important Financial Institutions
EFTs	Electronic Funds Transfers
ERTP	Economic Recovery and Transformation Plan
ESG	Environmental, Social and Governance
ETF	Exchange Traded Funds
EU	European Union
FATF	Financial Action Task Force
FCI	Foreign Companies Index
FIA	Financial Intelligence Agency
FSB	Financial Stability Board
FSC	Financial Stability Council
FSR	Financial Stability Report
GDP	Gross Domestic Product
GFSR	Global Financial Stability Report
ICRG	International Cooperation Review Group
IDR	Issuer Default Rating
IMF	International Monetary Fund
LTV	Loan-to-Value
Mancos	Management Companies
MFED	Ministry of Finance and Economic Development
MoU	Memorandum of Understanding
NAV	Net Asset Value
NBFIs	Non-Bank Financial Institutions
NBFIRA	Non-Bank Financial Institutions Regulatory Authority
NGFS	Network of Central Banks and Supervisors for Greening the Financial System
NPLs	Non-Performing Loans
NPS	National Payment System
RIA	Regulatory Impact Assessment
ROAA	Return on Average Assets
ROE	Return on Equity
RPC	Regulatory Policy Committee
SACU	Southern African Customs Union
SARB	South African Reserve Bank
SOEs	State Owned Enterprises
S&P	S&P Global Ratings
SRO	Self-Regulatory Organisations
TCFD	Task Force on Climate-related Financial Disclosures
WEO	World Economic Outlook

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The October 2020 issue of the Financial Stability Report (FSR) was prepared by the Bank of Botswana in collaboration with the Non-Bank Financial Institutions Regulatory Authority (NBFIRA) and Financial Intelligence Agency (FIA). The Report was approved for publication by the Financial Stability Council (FSC), a multi-agency body launched in February 2019 to collaborate and exchange information on financial stability issues affecting Botswana's financial system. The FSC comprises senior officials from the Ministry of Finance and Economic Development (MFED), Bank of Botswana, NBFIRA and FIA. These Authorities have signed a Memorandum of Understanding (MoU) for the purpose of information sharing, cooperation and communication in the implementation of macroprudential policy for Botswana.

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PREFACE

Purpose of the Report

The Financial Stability Report (FSR) is an assessment of the vulnerabilities to the stability and resilience of the Botswana financial system by the Financial Stability Council (FSC). The Report provides analytical and performance updates for the financial sector and its impact on economic activity and welfare; encourages informed engagement on financial stability issues; and helps provide information that major participants in the Botswana financial industry and elsewhere may use as input into their own financial risk assessment processes.

Macroprudential Policy Framework

The primary objective of the macroprudential policy framework is to limit systemic risk and its transmission to the broader economy. This is predicated on the observation that the financial system is interconnected and vulnerable to contagion risk, with the result that financial crises can spill over more rapidly to the real economy. At the same time, sectoral or broader economic weaknesses could adversely affect the financial system and trigger instability or crisis. In turn, this can cause widespread disruption to the provision of financial services, with serious negative consequences for macroeconomic stability and the real economy.

In order to limit systemic and spillover or contagion risks, financial sector regulators pursue a number of key intermediate objectives, among others: minimising and mitigating excessive credit growth and leverage; mitigating and preventing significant maturity mismatches and market illiquidity; controlling structural vulnerabilities in the financial system that arise through interlinkages; limiting direct and indirect exposure concentrations from domestic systemically important financial institutions (D-SIFIs); reducing the systemic impact of misaligned incentives with a view to reducing moral hazard; monitoring systemic risks from activities outside the banking system and implementing appropriate policy responses to contain such risks; and strengthening the resilience of the financial system and related infrastructure to mitigate aggregate shocks.

The macroprudential policy framework identifies the external sector of the domestic economy, through trade shocks and capital outflows, as having the greatest potential for elevated financial stability risks. In addition, the COVID-19 pandemic and the necessary disease containment measures have elevated the risk of a macroeconomic shock, a result of depressed global diamond market and disruption of the tourism and related hospitality industries. The FSR provides an analysis of these domestic vulnerabilities, how they interact internally, as well as the potential impact and response to spillovers from regional and global financial stability developments and trends. Financial soundness and macroeconomic indicators are used to assess risks to and within the financial system. Relevant and appropriate policy instruments and tools have been identified for possible use as intervention measures during periods of financial instability. These instruments and policy tools would be adjusted accordingly to mitigate the envisaged threats. Macroprudential interventions in this regard would be communicated through circulars issued from time to time.

Decision-making process

The Financial Stability Council of Botswana, a multi-agency body, was established to, among others, collaborate and share information on policy and other related issues on how the financial system could be strengthened and made more robust, in order to mitigate financial stability risks, and take prompt action in response to a perceived build-up of systemic risks; ensure a coordinated response to financial stability issues that may require cross-agency collaboration; and to request information from any financial institution, exchange information on financial stability issues, and communicate systemic risk warnings. The FSC is not a statutory body; it is a coordinating and cooperation mechanism. It is the responsibility of the respective entities to ensure that relevant macroprudential instruments are timeously activated to combat vulnerabilities, with a view to maintaining long-term financial stability.

The FSC comprises senior officials of the Ministry of Finance and Economic Development (MFED), the Bank of Botswana (Bank), Non-Bank Financial Institutions Regulatory Authority (NBFIRA) and the Financial Intelligence Agency (FIA). The FSC is chaired by the Governor, while the Bank acts as the secretariat. The work of the FSC is governed by a memorandum of understanding (MoU), which underscores the FSC’s commitment to ensuring a stable and resilient domestic financial system.

Announcement of macroprudential policy decisions

Proceedings of the FSC are communicated through a Press Release, shortly after a Council meeting. The Press Release informs the public of the discussions and conclusions regarding the stability of the domestic financial system. It further highlights the key risks in the financial system and recommendations to address such vulnerabilities. Policy decisions will be communicated through a circular to all affected financial institutions. The circular provides a brief description that links the identified risk with the intermediate objective and explains how measures taken are expected to mitigate the risk.

1. EXECUTIVE SUMMARY

1.1 **Global financial conditions have eased further since June 2020, as aggressive policy responses continue to support sentiment and prevent further amplification of the COVID-19 shock through the financial system.** Decisive actions by central banks, intended to address severe market stress have boosted market sentiment, including in emerging markets where asset purchases have been deployed in several countries, helping to bring about the easing of financial conditions. Meanwhile, the real economy continued to perform below potential, although robust recoveries are expected in the third and fourth quarters of 2020; this disconnect between financial markets and the evolution of the real economy, presents a vulnerability that could pose a threat to economic recovery, should investor risk appetite fade. Other financial system vulnerabilities, such as high levels of debt that may become unmanageable for some borrowers and losses from insolvencies that could test bank resilience in some countries, could also be magnified by the outbreak of COVID-19 pandemic and the containment measures that governments have adopted in response. Authorities must, therefore, while continuing to support the real economy, closely monitor financial vulnerabilities and safeguard financial stability.

1.2 **The global economy has begun to emerge from the deep slump resulting from the outbreak of the COVID-19 pandemic and the containment measures employed to curb its spread, although the recovery is expected to be uneven and prone to setbacks**. Global economic activity picked up in May and June 2020, as many economies reopened from the Great Lockdown. Thus, second quarter GDP outturns were generally better than was anticipated in the June 2020 World Economic Outlook (WEO) Update. The October 2020 WEO projects a contraction of 4.4 percent in global growth in 2020, an improvement of 0.5 percentage points on the June 2020 WEO Update estimate. For 2021, global GDP is projected to grow by 5.2 percent, some 0.2 percentage points lower than the June 2020 WEO forecast, and 6.7 percentage points lower than pre-COVID-19 projections.

1.3 **Meanwhile, Botswana's financial system continues to be resilient, characterised by strong capital and liquidity buffers, as well as continued profitability and buoyed by accommodative monetary conditions**. The vulnerabilities relating to potential for excessive and rapid credit growth, liquidity and funding risk, corporate leverage, inflated asset valuations and interlinkages between banks and non-bank financial institutions (NBFIs) have, thus far, been generally contained but the protracted COVID-19 pandemic could elevate risk of financial instability. Stress tests also suggest some degree of resilience that would, however, be weakened by the full effects of the coronavirus, especially if global infections continue in the absence of a vaccine. Therefore, the financial system has not amplified the shock but continued to support the real economy, while market infrastructures remain robust.

1.4 **Domestic economic activity contracted by 4.2 percent in the second quarter of 2020, compared to a growth of 3.9 percent experienced in the corresponding period of 2019. Growth for 2020 is further expected to be significantly lower than the earlier (pre-COVID-19) forecast of 4.4 percent**. The growth outlook was revised downwards on account of the country's openness and integration with the regional and global economies, hence its vulnerability to external shocks, which in the current circumstances, is exacerbated by the outbreak of COVID-19 and the containment measures being implemented. It is expected that weaker global demand will affect exports, particularly of diamonds, tourism, hospitality (hotels and restaurants), manufacturing, transport and communications. Notably, the initially anticipated recovery and continuing robust performance of the mining and tourism sectors were key inputs in the earlier optimistic growth projections for 2020. In addition, global supply chain disruptions will constrain domestic production and consumption, further dampening the growth forecast, which was to benefit from improved performance of the non-mining sectors. It is, therefore, certain that the sectors that would have been the drivers of economic growth have been adversely affected, consequently, the domestic economy is now projected to contract by 9.6 percent in 2020 before rebounding by 8.7 percent in 2021 (WEO, October 2020). The Ministry of Finance and Economic Development (MFED) projects a contraction of 8.9 percent in GDP in 2020 and growth of 7.7 percent in 2021.

1.5 **Domestic credit growth remains moderate posing minimal risk to financial stability.** Annual growth in commercial bank credit decelerated to 4.4 percent in September 2020, from 6.1 percent in the corresponding period in 2019. The growth was also subdued in comparison to the 10.7 percent recorded in March 2020, partly reflective of the effects of COVID-19 on the supply and demand for loans as the economy was on lockdown during that time. The growth in credit in September 2020 was mainly attributable to the 7.4 percent increase, annually, in lending to households. Business credit contracted by 0.8 percent over the twelve months to September 2020, as compared to a contraction of 2.0 percent in September 2019. Commercial bank credit continued to be dominated by household borrowing, which accounted for the largest proportion, at 64.8 percent in September 2020. The level of household indebtedness in Botswana is, however, considered low by international standards, at 21.7 percent of GDP (in June 2020), compared to, for example, 21.8 percent and 43.3 percent in Mauritius and South Africa, respectively.[1] Moreover, household borrowing appears to be in line with trends in personal incomes (reflected in the low debt to income ratio), representing a relatively stronger debt servicing capacity. A concern would arise when levels of borrowing are out of line with growth in personal incomes, which could amplify the risk or exposure of households and related businesses to economic shocks; thus, adversely affecting their ability to repay debt. Household credit is, however, overly concentrated within the inherently expensive unsecured lending at 70.8 percent, which makes the sector vulnerable to tightening of financial conditions. These risks are, however, moderated to the extent that the loans are widely distributed to a large number of households employed in different sectors of the economy, a large proportion of which are employed in the public sector. The ratio of non-performing loans (NPLs) to total bank credit, however, remained modest at 4.3 percent in September 2020, from 4.8 percent in December 2019. Overall, there is no indication of excessive and rapid credit growth that could threaten the stability of the financial system.

1.6 **There was a significant increase in market liquidity**, with average daily liquidity in the banking system increasing by P1.7 billion, from P10.8 billion in August 2020 to P12.5 billion in September 2020. Market liquidity during this period was mainly boosted by increased government spending. As such, banks continued to be compliant with the minimum liquid asset requirement of 10 percent and were able to support lending, with a financial intermediation ratio of 84.3 percent in September 2020. The commercial banks' funding structure, however, continues to be concentrated in a few depositors, mainly businesses, reflecting an imbalance in the market and the potential increase in funding costs due to the volatile nature of business deposits.[2]

1.7 **In terms of macro financial interlinkages and contagion risk, banks continue to have significant linkages with the rest of the financial system and the real sector**. As a result, risks emanating from other sectors could adversely affect banks and easily spread to the rest of the financial system (contagion risk). The strong interconnectedness between the banking system and the non-bank financial institutions (NBFIs) sector elevates the risk of contagion in the domestic financial system, although effective regulation across the system, as well as proper governance and accountability structures, moderate the risk. A large proportion of banking deposit liabilities are highly volatile funds and placements by institutional investors, asset management companies, pension funds and insurance companies. Furthermore, the bulk of the retail and household loans have credit life protection, mortgage repayment policies and retrenchment cover policies provided by the insurance companies. Therefore, a significant portion of banking risks are warehoused by the insurance sub-sector, which increases contagion risk.

1.8 **The Bank conducted stress tests on the liquidity profiles and profitability of banks to establish their resilience to shocks propagated by the outbreak of COVID-19 and related containment measures (the "COVID Event")**. The COVID Event was presented as the most extreme stress scenario in the local market and resulted in strained liquidity profiles and subdued profitability of domestic banks. However, alternative policy measures adopted by the Bank, such as reducing the primary reserve and capital requirements, increasing the eligible collateral pool for access to central bank Credit Facility as well as the tenure of the repo transactions and reduction in the cost of the Credit Facility should be able to cushion the industry from possible financial constraints due to the COVID Event. Overall, these measures are expected to support domestic economic activity in terms of reducing borrowing costs in the economy and provide a sound springboard for future recovery; sustain, in the short term, the cashflow position and balance sheets of businesses and households; and allow commercial banks to perform the necessary financial intermediation to support economic activity.

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1 Bank of Mauritius, Financial Stability Report (October 2019) and South African Reserve Bank, Financial Stability Review (Second Edition 2019).

2 Business deposits tend to attract higher interest rates.

1.9 **Overall, vulnerabilities and risks to financial stability are elevated in the short term**. The heat map (Appendix Chart A1), which is the FSC's vulnerability indicator, shows moderate sovereign vulnerabilities; slightly elevated levels of risks to the corporate and household sectors; stable housing prices and stock market valuations; low funding costs and sufficient market liquidity; and elevated risk of contagion in the domestic market. These conditions could be worsened by protracted developments related to the COVID Event.

1.10 **Strategic anti-money laundering and combating the financing of terrorism (AML/CFT) deficiencies, corporate governance and accountability concerns in the non-bank financial sector and adverse media reports** on unsubstantiated missing government funds, however, continue to dent the integrity of financial institutions in Botswana. Furthermore, the European Union placement of Botswana in the list of high-risk third countries poses additional risks, especially relating to enhanced due diligence in establishing correspondent banking relationships and investing in offshore markets. Concerted efforts are ongoing to implement the required action plans to address the identified deficiencies.

2. FINANCIAL STABILITY DEVELOPMENTS AND TRENDS

(a) Global Financial Stability Developments

Global economic activity has begun to recover from the slump experienced in April 2020, but the ascent is expected to be long, uneven and uncertain

2.1 The global economy has begun to emerge from the deep slump resulting from the outbreak of the COVID-19 pandemic and the containment measures employed to curb its spread, although the recovery is expected to be uneven and prone to setbacks. Global economic activity picked up in May and June 2020, as many economies reopened from the Great Lockdown. Thus, second quarter GDP outturns were generally better than was anticipated in the June 2020 WEO Update. Therefore, the October 2020 WEO projects 2020 global growth at a contraction of 4.4 percent in 2020, an improvement from the 4.9 percent contraction forecast in June.

2.2 For 2021, global GDP is projected to grow by 5.2 percent, lower than the June 2020 International Monetary Fund (IMF)'s WEO forecast, but 1.8 percentage points higher than the pre-COVID-19 projections.

2.3 The expected growth path remains uncertain, and is based on factors that are inherently difficult to predict, such as the progression of the pandemic; the adjustment costs it imposes on the economy; the effectiveness of the economic policy responses; and the evolution of market and investor sentiments, as well as prospects for a vaccine.

2.4 Meanwhile, the Global Financial Stability Report (GFSR) of October 2020 notes that, while short-term risks have been contained by timely policy responses, vulnerabilities have continued to rise since the outbreak of COVID-19. The GFSR notes a potential increase in corporate bankruptcies due to excessive leverage as companies took in more debt to cope with the cash shortages. Bank capital buffers could also be eroded by looming credit losses once policy support ceases. Moreover, market expectation for continued policy support could fuel excessive risk-taking in the non-bank financial sector, while external financing challenges experienced by emerging and frontier markets could drive them into debt distress.

2.5 Notably, policy interventions have sustained the rebound in asset valuations for some time, but a protracted recovery as well as fading market expectations about policy support present a possibility of a sharp market adjustment. As such, the GFSR cautions against an abrupt withdrawal of policy support which could disrupt the recovery and exacerbate financial instability risks. However, concerted efforts should be made in the post-pandemic period to strengthen the regulatory framework for the non-bank financial sector and revamp prudential supervision to contain excessive risk taking in the low interest rate environment. Overall, there remains uncertainty relating to COVID-19 including its financial and economic impact, globally.

(b) Regional Financial Stability Developments and Trends

Sub-Saharan Africa's growth outlook for 2020-21 considerably worse than earlier expected

2.6 The October 2020 WEO projects a contraction of 3 percent in Sub-Saharan Africa's 2020 output, much lower than the revised growth of 3.2 percent in 2019 and 0.2 percentage points higher than the June 2020 WEO Update projection of -3.2 percent. Growth is expected to recover to 3.1 percent in 2021, subject to the continued gradual easing of restrictions across countries, and the region being able to avoid the same epidemic dynamics playing out elsewhere in the world. Downside risks could emanate from overwhelmed health systems, given that many economies reopened before the level of infections peaked. For the two largest economies in the region, Nigeria and South Africa, output is expected to fall significantly, before recovering in 2021. GDP is expected to contract by 4.3 percent in 2020 in Nigeria, owing to plummeting oil prices, lower oil production quota and declining activity, before recovering by 1.7 percent in 2021 as oil prices rise and production increases.

2.7 Meanwhile, the IMF projects economic activity in South Africa to contract by 8 percent in 2020 and rebound by 3.3 percent in 2021 as business activity and confidence improve. Fiscal space in the region remains constrained by elevated debt levels and low external buffers.

South African economy runs deep into recession

2.8 The South African Reserve Bank (SARB) reported a revised and lower estimate for GDP in the second quarter of 2020, citing challenges with forecasting both domestic and global activity associated with uncertainty due to the pandemic. According to the SARB's September 2020 monetary policy statement, potential growth estimates have been lowered due to a sharp decline in investment. Consequently, the SARB expects a smaller output gap over the forecast period with a forecast GDP contraction of 8.2 percent in 2020 while some growth of 3.9 percent and 2.6 percent is expected in 2021 and 2022, respectively. Meanwhile, recently released annualised quarterly data show that South Africa's GDP shrank by an annualised 51 percent in the three months to June 2020, as the impact of COVID-19 extended the country's recession into the fourth quarter.

2.9 In other economic developments, Moody's Investor Service (Moody's) downgraded South Africa's sovereign credit rating to "junk" status in March 2020. According to Moody's, the downgrade was due to continued deterioration in the country's fiscal strength and structurally weak growth. Moody's does not expect the country's current policy settings to address the underlying problems effectively. Developments in South Africa have implications for economic growth in Botswana, given the strong economic linkages between the two countries.

(c) Domestic Economic Developments

Uncertain macroeconomic environment could heighten financial stability risks

2.10 Real GDP declined by 4.2 percent in the twelve months to June 2020, compared to an expansion of 3.9 percent in the year to June 2019. The lower rate of increase in output is attributable to the contraction in mining output and deceleration in output growth of the non-mining sector. Mining output contracted by 18.6 percent compared to a growth of 1.5 percent in the corresponding period of June 2019, mainly due to weaker performance of the diamond, soda ash, copper and coal subsectors. In addition, all other sectors, except Agriculture, Water and Electricity, Finance and General government experienced a contraction mainly due to ongoing measures taken to contain the COVID-19 pandemic. Going forward, output is expected to contract in 2020[3] on the back of developments related to the spread of COVID-19. Given the country's openness and integration with regional and global economies, it is expected that weaker global demand will affect exports, particularly diamonds and tourism services. In addition, global supply chain disruptions as well as measures imposed domestically to help curb the spread of COVID-19 will constrain domestic production and consumption, further dampening economic activity going forward.

2.11 The Government budget was in a deficit amounting to P4.1 billion in the third quarter of the 2019/20 fiscal year, with a cumulative deficit of P6.4 billion for the nine months to September 2020. Government expenditure is budgeted to increase faster than revenue and grants, resulting in a budget deficit of 3.5 percent of GDP in the fiscal year 2019/2020. It is expected that the deficit will be funded through domestic[4] and external debt as well as drawdown of Government savings. However, the accelerated drawdown of reserves is likely to erode the country's traditionally strong fiscal and external buffers in the medium term, posing potential fiscal risks to the local economy. Botswana should, therefore, continue to pursue a policy mix that supports growth and promotes economic and revenue diversification.

2.12 Table A1 in the Appendix shows macroeconomic and financial vulnerability indicators. The proportion of Government debt and guarantees to GDP was 17.9 percent in 2018/2019 and is projected to drop marginally to 17.6 percent in 2019/20. Effectively, government exposure remains within the statutory limit of 40 percent of GDP. This notwithstanding, the country's long-term borrowing costs are likely to be affected by the recent revision of the economic outlook by S&P Global Ratings (S&P). The rating agency revised the outlook on Botswana's credit rating from 'Stable' to 'Negative' citing the anticipated higher pressures on the country's economic, external, and fiscal performance over the next two years, stemming from the impact of the global pandemic, notably on diamond exports. S&P further affirmed the 'BBB+/A-2' ratings for long- and short-term foreign and local currency. The affirmation is underpinned by stable and predictable institutional frameworks, positive impact of the monetary policy framework, adherence to rule of law and effective policy making, all of which contribute to macroeconomic stability. As such, the domestic macroeconomic environment remains conducive for financial stability, notwithstanding the likely rise in sovereign vulnerabilities due to depressed global economic prospects.

3 Projections by IMF indicate that the domestic economy will contract by 9.6 percent in 2020, before rebounding to 8.7 percent.

4 The National Assembly approved an increase of the Government bond issuance programme from P15 billion to P30 billion on September 15, 2020 in order to fund the national budget.

3. DOMESTIC MACROPRUDENTIAL ANALYSIS

(a) Sovereign Vulnerabilities

External sector risks elevated in the near term and could rise further in the medium term

3.1 The projected contraction in global output and the deceleration in output growth of the mining sector (due to weaker global demand for diamonds) could increase Botswana's susceptibility to risks emanating from the external sector. The country's overdependence on external trade and related revenue i.e., Southern African Customs Union (SACU) and mineral exports revenue, could further amplify vulnerability from external macroeconomic developments.[5] Mineral exports revenue directly supports government expenditure and household consumption indirectly; hence, it is filtered through to the rest of the economy. Given the narrow export base, external shocks, especially in the diamond markets, could, therefore, undermine the external balance outcome in the near to medium-term.

3.2 Meanwhile, external buffers (foreign exchange reserves) decreased by 9.3 percent from P68.9 billion in April 2020 to P62.4 billion in August 2020. Measured in terms of foreign currency, the reserves amounted to USD 5.4 billion and SDR 3.8 billion in August 2020, respectively, translating to 11.6 months of import cover. The overall balance of payments was in deficit of P19.3 billion for the twelve months to August 2020, compared to a deficit of P6.3 billion in the twelve months to August 2019. The deficit mainly resulted from increased government obligations.

(b) Credit Growth and Leverage

Commercial Banks

Bank credit growth modest

3.3 Annual growth in commercial bank credit increased by 4.4 percent to P63.8 billion in the year to September 2020, lower than the 6.1 percent in the corresponding period in 2019. The credit was largely driven by lending to households which experienced an annual increase of 7.4 percent, supported by an accommodative monetary policy stance during 2019, and in the first half of 2020.[6] This notwithstanding, the growth was subdued in comparison to the 10.7 percent recorded in March 2020, partly reflective of the effects of COVID-19 on the supply and demand for loans. Policy measures undertaken by the Bank, such as the reduction in the Bank Rate and primary reserve requirement are, however, expected to facilitate financial intermediation by commercial banks to support economic activity during the course of the COVID-19 pandemic.

3.4 Table 3.1 shows the distribution of commercial bank credit to businesses, households and Government. Credit to households increased to P41.3 billion in September 2020, from P38.5 billion in September 2019, driven mainly by a significant increase of 9.9 percent in personal loans. Business loans, on the other hand, declined by 0.8 percent over the one-year period to September 2020. There was an increase in the uptake of loans by parastatals and mining, which was offset by the significant reduction in credit to the "Manufacturing", "Construction" and "Transport and Communications" industries. The share of business credit in total credit decreased from 37 percent in September 2019 to 35.2 percent in September 2020, while the contribution of household credit increased to 64.8 percent in September 2020 from 63 percent in September 2019.

3.5 Total credit to GDP has been growing steadily between 2009 and 2019, recording an average growth of 29.8 percent over the 11-year period (Table A2). Overall, the modest increase in credit growth does not reflect indications of overheating of the economy, but rather suggests some scope for increased disciplined and prudent credit extension to support economic activity. The scope for credit extension is further evidenced in the proportions of credit to GDP of various industries (Table 3.1). Furthermore, the measures of assessing excessive credit growth discussed in Box 3.1 indicate that credit growth remains moderate, with room for healthy expansion.

Commercial banks are adequately capitalised

3.6 Commercial banks were adequately leveraged as per the international standard of 3 percent. The leverage ratio was 8.9 percent in September 2020, an increase from 6.2 percent in December 2019, which was indicative of the banking

[5] Diamonds accounted for 90 percent of total exports in 2018.

[6] The Bank Rate was reduced from 5 percent to 4.75 percent in August 2019, 4.25 percent in April 2020 and further to 3.75 percent in October 2020.

sector's relative strength to withstand negative shocks to the balance sheet. Furthermore, the average commercial banks' capital adequacy ratio was 19.8 percent in September 2020, an improvement from 18.4 percent registered in December 2019, thus indicating the sector's resilience to unexpected losses (Table 3.8). The industry's strong capital base is further augmented by the modest level of NPLs to total loans, which was 4.3 percent as at the end of September 2020, signifying a marginal decline from 4.8 percent in December 2019. The current economic conditions presented by the COVID-19 pandemic are, however, expected to put pressure on the capital position of domestic banks through a potential increase in NPLs and, in turn, amplifying specific provisions. To counter these effects, commercial banks granted customers with a good repayment history a 3 months repayment holiday, with a possibility for extension to 6 months,[7] while the Bank is exercising regulatory forbearance in relation to the assessment of NPLs and determination of expected credit losses for regulatory and compliance purposes.

COVID-19 affected businesses benefit most from loan moratoria

3.7 Since the implementation of the discretionary loan repayment holiday by banks, loans that have benefited from this measure accounted for 11.4 percent of the aggregate commercial banks' loans and advances, which translates into P7.3 billion (74 percent of which was business loans), as at the end of June 2020. Business loans given moratoria were mainly concentrated on those extended to commercial real estate (33 percent), "restaurants and bars" (16 percent) and "Tourism and Hotels" (13 percent), industries. On the other hand, banks restructured loans amounting to P5.8 billion (9.1 percent of total credit extended by commercial banks), with private businesses accounting for the largest share (73 percent). These actions further cushioned affected businesses and economy at large, from the consequences of the COVID-19 pandemic, in turn, moderating the risk instability in the domestic financial system.

[7] Banks are currently engaging customers on a case-by-case basis to establish their need for a longer repayment holiday.

Table 3.1: Sectoral Distribution of Commercial Bank Loans[1]

Sector	QUARTERLY											
	2019Q2		2019Q3		2019Q4		2020Q1		2020Q2		2020Q3	
	Credit to Total GDP (Per-cent)	Percent of Total	Credit to Total GDP (Percent)	Percent of Total	Credit to Total GDP (Percent)	Percent of Total	Credit to Total GDP (Per-cent)	Percent of Total	Credit to Total GDP (Percent)	Percent of Total	Amount (P'million)	Percent of Total
Business	**11.9**	**38.7**	**11.5**	**37.0**	**11.6**	**36.3**	**12.0**	**37.0**	**12.6**	**36.6**	**22 434**	**35.2**
Parastatals	0.9	7.7	0.7	6.2	0.9	8.1	1.1	9.3	1.2	9.7	1 535	6.8
Agriculture	0.7	6.0	0.8	6.8	0.8	6.6	0.7	6.2	0.7	5.8	1 391	6.2
Mining	0.3	2.2	0.3	2.4	0.3	2.7	0.3	2.7	0.3	2.7	637	2.8
Manufacturing	1.5	13.0	1.3	11.2	1.0	8.6	1.3	10.5	0.8	6.1	1 670	7.4
Construction	0.7	5.6	0.6	5.3	0.6	4.8	0.5	4.1	0.6	4.5	1 029	4.6
Trade	2.3	19.3	2.3	20.1	2.3	19.9	2.4	20.3	2.7	21.6	4 626	20.6
Transport[2]	0.3	2.7	0.3	2.7	0.3	2.9	0.3	2.5	0.3	2.5	580	2.6
Finance[3]	2.2	18.5	2.3	19.6	2.3	20.2	3.3	19.7	2.7	21.6	4 837	21.6
Real Estate	2.3	19.2	2.2	19.5	2.3	19.7	2.2	18.5	2.4	19.1	4 649	20.7
Electricity and Water	0.05	0.4	0.05	0.4	0.05	0.4	0.05	0.4	0.05	0.4	98	0.4
Other[4]	0.7	5.5	0.7	5.8	0.7	6.2	0.7	5.9	0.8	6.0	1 382	6.2
Households	**18.8**	**61.3**	**19.6**	**63.0**	**20.3**	**63.7**	**20.5**	**63.0**	**21.7**	**63.4**	**41 340**	**64.8**
Unsecured Lending	12.9	68.3	13.6	69.5	14.2	70.1	14.4	70.4	15.3	69.3	29 285	70.8
Motor Vehicle	1.0	5.1	1.0	5.0	1.0	5.1	1.0	5.0	1.1	4.9	2 024	4.9
Mortgage	5.0	26.7	5.0	25.6	5.0	24.9	5.0	24.5	5.3	24.5	10 031	24.3
Total Commercial Bank Credit	**30.8**		**31.1**		**31.8**		**32.5**		**34.3**		**63 774**	

Source: Commercial Banks

[1]Sectoral contributions are calculated as percentage of total commercial banks loan, and subsector contributions are calculated as percentage of sector loans.

[2]Transport and Communications.

[3] Finance and Business Services.

[4] Includes non-resident businesses.

The Household Sector

Households remain vulnerable to sudden and sharp increase in borrowing costs

3.8 Annual growth in household credit was 7.4 percent in the twelve months to September 2020, lower than 11.5 percent in September 2019 (Chart 3.1). Commercial bank household credit continued to account for a larger proportion of credit at P41.3 billion in September 2020, constituting 64.8 percent of total bank credit. Household credit was mostly concentrated in unsecured lending (70.8 percent), which is considerably high when compared to 18.6 percent and 35.4 percent for South Africa and Mauritius, respectively. The significant share of unsecured loans and advances has the potential to cause financial distress for households, given the inherently expensive nature of such credit. Therefore, households remain vulnerable to sudden and sharp tightening of financial conditions.

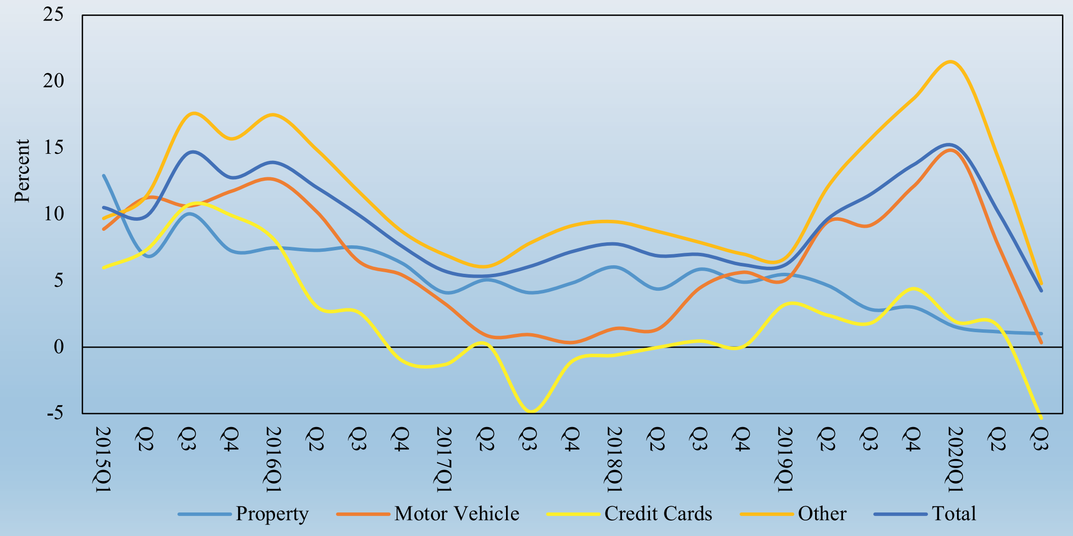
Household borrowing in line with trends in personal incomes

3.9 Household debt as a proportion of household income was 47.3 percent in March 2020, a decrease from 48.2 percent at the end of the first quarter in 2019 (Chart 3.2). The ratio remains relatively low when compared to 78.7 percent and 72.7 percent for Namibia and South Africa, respectively.[8] In this respect, domestic household borrowing appears to be in line with trends in personal incomes, representing a relatively stronger debt servicing capacity. Consequently, the ratio of household NPLs to total household credit was modest, at 3.9 percent in June 2020 (Chart 3.2).

3.10 Moreover, Table 3.2 indicates that households are net savers when considering contractual savings (pension funds). Other household assets such as cattle, commercial farmland and shareholding in listed companies could substantially increase the saving position of households but have not been included due to data limitations.

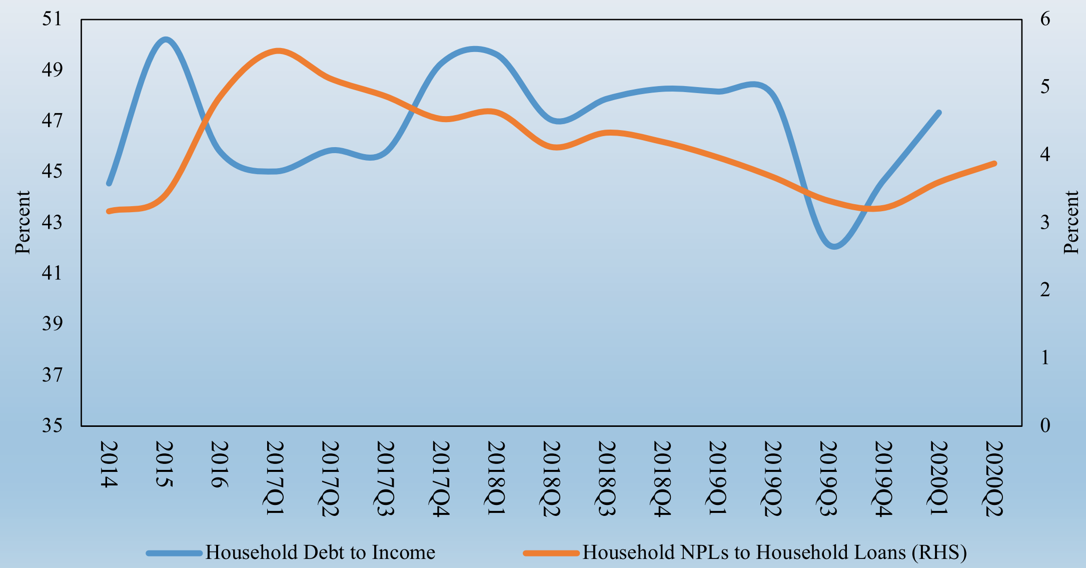
[8] Namibia Financial Stability Report – April 2020 and SARB Financial Stability Review – Second Edition 2019.

Chart 3.1: Growth in Household Debt (Year-on-Year)



Source: Commercial Banks

Chart 3.2: Household Debt to Income and NPLs



Source: Statistics Botswana and Bank of Botswana

Table 3.2: Household Net Wealth

Asset	2018 (P'million)	2019 (P'million)	2020Q1 (P'million)	2020Q2 (P'million)	2020Q3 (P'million)	Percentage Growth (2019Q4/2020Q3)
Retail deposits	13 843.9	15 384.2	15 258.5	16 669.5	17 152.0	11.5
Pensions	78 971.9	93 133.2	87 906.2	92 898.2	97 616.3	4.8
Insurance contracts	12 874.7	13 423.6	*13 423.6*	*13 423.6*	*13 423.6*	0.0
Mortgage property	9 639.9	9 929.5	9 984.5	9 941.8	10 030.1	1.0
Motor vehicles	1 799.7	2 017.5	2 057.5	2 003.4	2 024.3	0.3
Total assets (a)	117 130.1	133 888.0	128 630.3	134 936.5	140 247.1	4.7
Total household debt (b)	40 571.2	45 490.5	46 273.0	46 200.2	47 275.7	4.0
Total household net wealth (a) – (b)	76 558.9	88 397.5	82 357.3	88 736.3	92 971.6	5.2

Source: Bank of Botswana
Note: Figures in italics are estimates

Box 3.1: Tools for Assessing Excessive Credit Growth

Background
One of the objectives of macroprudential policy is to mitigate systemic financial stability risks, which are sometimes precipitated by excessive credit growth. Credit growth that is out of line with trends in economic growth often leads to the build-up of systemic risks to financial stability, which may trigger systemic banking crises. It is, therefore, important to monitor growth in credit. In this regard, the Bank is continually developing and adopting means and tools of assessing whether credit growth is excessive. Early tools included the desired objective range for credit, which the Bank specified annually. Following the development of better forecasting techniques and the adoption of the inflation forecasting framework, the bank discontinued the use of this tool. Currently, the Bank calculates some measures based on the Credit-to-GDP ratio, including the Credit to GDP Gap.

The Desired Range for Credit Growth
This desired range (objective range) was deemed to be compatible with the inflation objective. The calculation of the range took into account the inflation objective (target), the projected GDP growth rate, and a measure to account for financial deepening. In 2004, the range was calculated as:

Assuming (in percent):

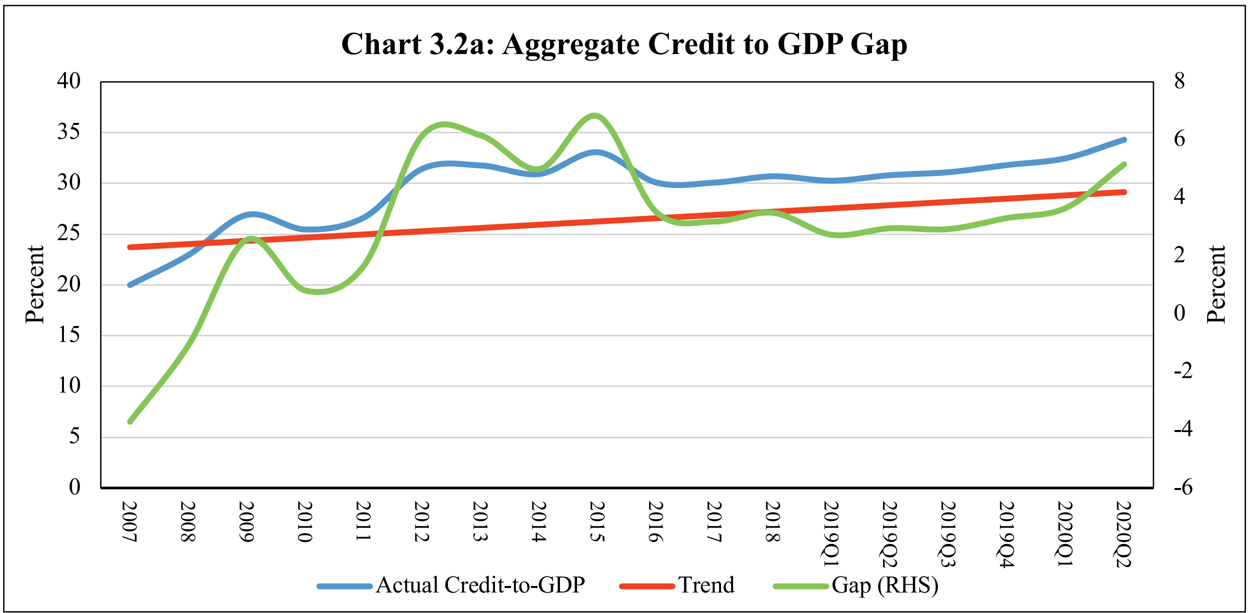
Inflation Target	**3.0 – 4.5**
+ GDP Growth Rate	5.0 – 5.5
+ Financial deepening	2.0 – 2.0
= Credit Growth Rate Target	10.0 – 12.0

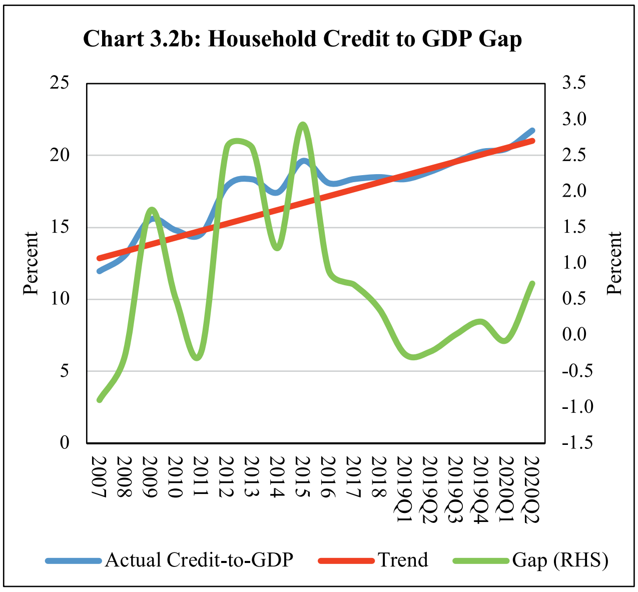
Judgement was also taken on-board, and the range was ultimately set at 12 – 15 percent, as inflation was higher during that period.

Given the current 3 – 6 percent inflation objective, and assuming a GDP growth rate of 4 – 5 percent (excluding COVID-19 effects), and with the same factor for financial deepening, the desired range would be 9 – 13 percent. Credit growth was 7.6 percent in December 2019, and 6.4 percent in June 2020, thus below the lower bound of the desired range.

The Credit to GDP Gap
The Bank for International Settlements (BIS) defines the Credit-to-GDP gap ("credit gap") as the difference between the Credit-to-GDP ratio and its long-term trend. Borio and Lowe (2002 and 2004) first documented the property of the Credit-to-GDP gap as a very useful early warning indicator for banking crises. This finding has been subsequently confirmed for a number of countries over a long time span that includes the most recent global financial crisis.

Commercial bank credit growth is moderate, as measured by the Credit-to-GDP gap, which was below the 10 percent threshold at the end of June 2020 (see Chart 3.2a). The low Credit-to-GDP gap reflects room for sustained economic expansion from positive shocks to financial conditions. Furthermore, the gap has been positive since the global financial crisis, mainly reflecting the decline in the rate of GDP growth, which in the main, was due to the overall subdued performance of the mining sector. A Credit-to-GDP gap that moves significantly above its trend or exceeds some critical threshold (typically 10 percent) portends emerging financial imbalances and risk of financial distress.





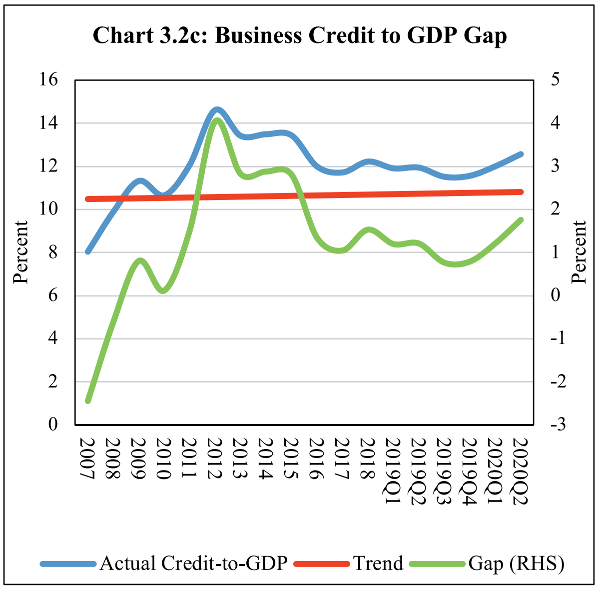


Chart 3.2b shows a negative, but very close to zero Credit-to-GDP gap for households in June 2020, indicating that there remains room enough for healthy credit expansion in the sector.

The Non-Financial Corporate Sector

Corporate sector borrowing grows marginally

3.11 The non-financial corporate sector contributes to the health and soundness of the financial system. Non-financial corporates are linked to the financial sector through credit from the banking system and, in turn, the deposits, equity and bonds they hold in the bank's balance sheets. In addition, non-financial corporates influence households' debt repayment capability through labour market conditions and prospects (employment and wage growth).

3.12 Total commercial bank credit to the non-financial corporate sector was P21.4 billion in July 2020, a marginal increase from P21.2 billion in December 2019, as firms continue to target the domestic market for their funding needs (Business Expectations Survey (BES), September 2020). The exposure to the sector constituted 33.3 percent of total commercial bank credit in July 2020, marginally lower than 33.7 percent in December 2019.

Financial health of the corporate sector remains good

3.13 Selected financial soundness indicators of the 14 domestic non-financial corporates listed on the Botswana Stock Exchange Limited (BSEL) show that the financial health of the corporate sector was good during the period January 1, 2020 to June 30, 2020, as shown by a good price/earnings ratio and an above average dividend yield (Table 3.3). This notwithstanding, risks associated with governance, accountability and compliance failures remain elevated in parastatal corporations that fail to produce audited annual financial statements. Generally, environmental, social and governance (ESG) issues remain prominent and require close monitoring. Climate-related issues, in particular, have the potential to impose losses on the financial system, with far reaching consequences for financial stability (See Box 3.2).

Corporate sector NPLs have decreased but are likely to rise

3.14 The ratio of non-performing corporate loans to the sector's total bank loans decreased to 7.3 percent in June 2020 compared to 9 percent in December 2019, on account of the reduction in NPLs of agriculture and manufacturing sectors. However, the ratio remained higher than the banking sector average of 4.5 percent. Corporate NPLs are likely to rise further, with companies forced to shut down or reduce production due to lockdown and other measures aimed at fighting COVID-19, and notwithstanding commitment to reschedule loans and offer repayment holidays for affected companies.

3.15 Nevertheless, the sector's stable profitability and low level of bankruptcies in the period under review suggest that corporates should be able to continue servicing their loans. The profitability ratio, as measured by the return on equity (ROE), was relatively stable, averaging 12.6 percent between 2016 and 2019 (Table 3.3).

Industries primarily affected by COVID-19 are likely to drag down economic performance

3.16 The virus containment measures that were implemented from April 2020 have severely disrupted economic activity in some sectors, mainly Trade, Hotels and Restaurants, Mining, Construction, Manufacturing, and Transport and Communications, which are expected to decline by 27.4 percent, 24.5 percent, 6 percent, 3.9 percent and 2.5 percent, respectively. The three sectors (Manufacturing, Trade, Hotels and Restaurants and Transport and Communication), contributed a combined average of 29.5 percent to GDP over the period 2014 to 2019 (Table A3) and, therefore, have the potential to significantly affect future economic performance if the virus does not abate. Notably, some state-owned corporates were already experiencing some operational and financial challenges before the outbreak of COVID-19. These include National Development Bank, Botswana Meat Commission and Air Botswana. The latter announced restructuring plans in November 2019 and suspended flights from 27 March 2020. The airline, however, resumed domestic flights on July 17, 2020 and would gradually reintroduce all operations, while continually exploring possible recovery strategies meant to address its commercial viability and business sustainability. In essence, the supply chain disruption and slowdown caused by COVID-19 is expected to affect freight and passenger transport business at a significant cost to the national airline.

Firms less optimistic about economic activity in the second half of 2020

3.17 The September 2020 Business Expectations Survey (BES) shows that firms were less optimistic about economic activity in the third quarter of 2020 compared to the second quarter of the year. Businesses expect a deterioration in all business condition indicators as a result of the ongoing crisis caused by the COVID-19 pandemic and related containment measures. Firms, therefore, expect overall output to contract by 0.2 percent in 2020, although favourable than a contraction of 8.9 percent projected by MFED. In light of these developments, potential vulnerabilities from the corporate sector are assessed to pose moderate to high risk to financial stability in the medium term.

Table 3.3: Non-Financial Corporates' Financial Soundness Indicators (Percent)

Ratios	2017	2018	2019	2020Q2
Non-Financial Corporates Credit-to-GDP[9]	10.7	11.2	10.7	11.5
Cost-to-Income Ratio	60.0	60.3	65.1	65.3
Total Debt to Equity Ratio	42.1	46.9	46.3	45.7
Return on Equity	13.8	15.7	12.0	12.0
Price/Earnings Ratio (times)	13.3	11.2	12.4	10.7
Dividend Yield	4.4	5.1	4.8	5.8

Source: Botswana Stock Exchange Limited, Statistics Botswana, Financial Statements of Corporates

The Real Estate Sector

Developments in the real estate industry have a bearing on the stability of the financial system

3.18 Trends and developments in the property market are important to financial stability as they reflect the public's perception of the state of the economy. In addition, the banking sector may have large exposures to this sector that could be affected by movement in house prices. Most importantly, real estate assets represent household and private sector wealth, which often serves as collateral for bank loans. Hence, these assets represent future income prospects. On these grounds, developments in the real estate industry have a bearing on the financial system and, therefore, require continuous monitoring and assessment.

Commercial real estate lending poses minimal risk to financial stability

3.19 Credit to the commercial real estate sector grew, on average, by 22.7 percent over the five-year period from September 2015 to September 2020 (i.e., from P4.1 billion to P5 billion). However, the proportion of commercial real estate loans to total loans has remained relatively low over the years, averaging 7 percent between 2015 and 2020 (Chart 3.3). As such, commercial real estate lending poses minimal risk to financial stability. Moreover, the level of NPLs in the sector remains moderate, constituting 4.2 percent of total commercial real estate loans in June 2020. There are, however, some concerns about concentration risk in the real estate sector, with most loans (about 90 percent) originating in Gaborone and the surrounding areas.[10]

Growth trends in mortgage loans not commensurate with housing needs

3.20 In the residential real estate sector, mortgage loans amounted to P14.2 billion in September 2020, an increase of 1.8 percent from P13.9 billion recorded in September 2019. However, as a ratio of household credit, mortgage loans constituted 30.2 percent of total loans in September 2020, compared to 32.0 percent in September 2019 (Chart 3.4). This development suggest that housing finance is not commensurate with the needed development and growth path to fill the apparent need for housing, as well as the financing gap.[11] Thus, the size of housing finance, as estimated by mortgages, is low by regional standards, for example in Namibia, where the ratio was 66 percent in April 2020.[12] These stagnant ratios might be reflective of the restrained growth in incomes relative to the increase in residential house prices over the years (itself reflective of limited housing stock in various categories). Mortgage lending is, however, expected to rise in the medium term with the amendments of Deeds Registry and Tribal Land Acts in 2017 as well as introduction of sectoral deeds. These developments are expected to facilitate acquisition of mortgage loans country-wide and transferability of property rights in tribal land areas.

3.21 Credit risk in the mortgage sub-sector remains low, with commercial banks maintaining a Loan-to-Value (LTV) ratio ranging between 45 percent and 85 percent. The low to medium LTV ratios limit the exposure of banks to mortgage credit default.

9 Calculated using total credit to the non- financial corporations from commercial banks.

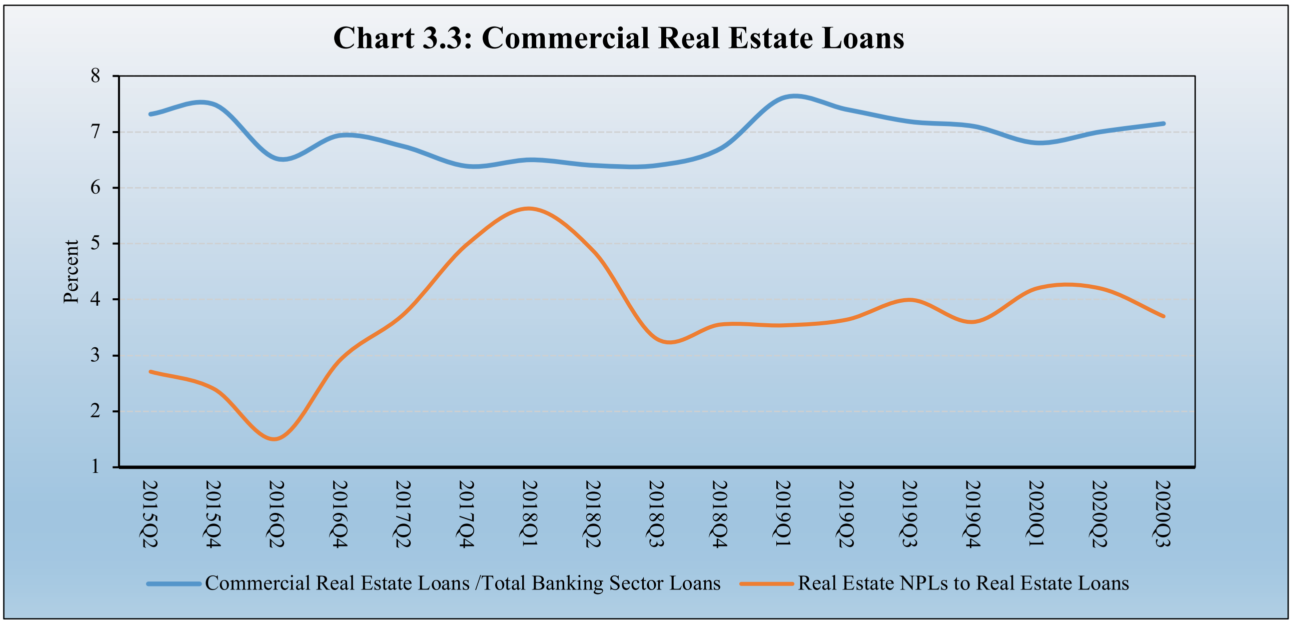
10 Bank of Botswana Residential Property Survey Report, 2017.

11 The challenges in accessing mortgages viz., land tenure, relatively low average incomes and strict funding requirements have, however, shifted house financing to unsecured personal loans.

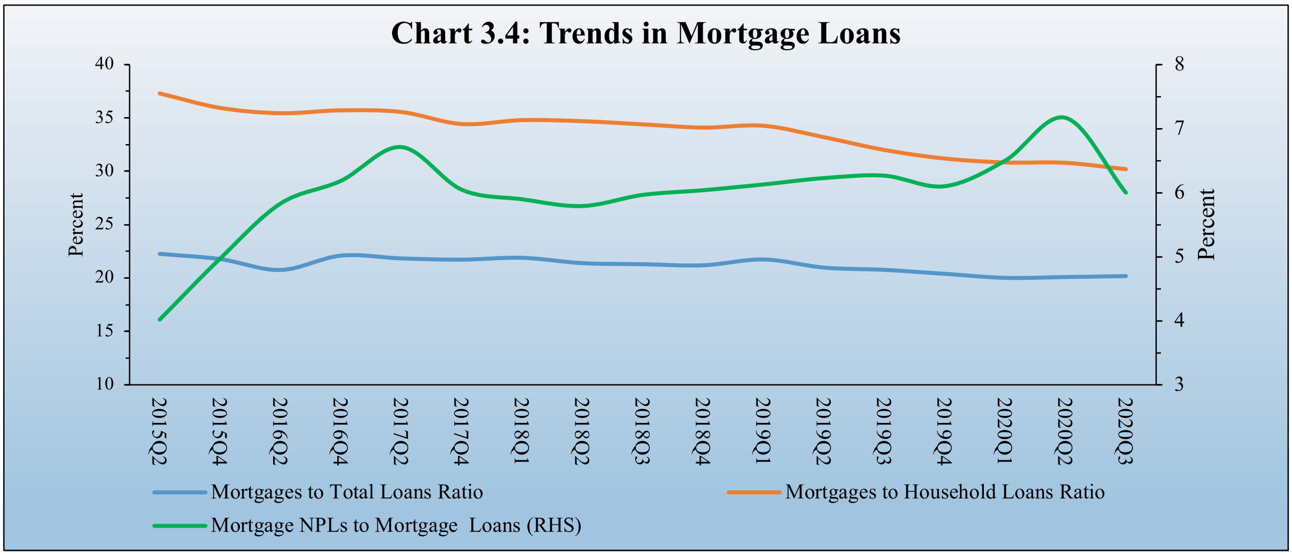
12 Namibia Financial Stability Report (April 2020).

Residential market weakened in the second quarter of 2020

3.22 According to the Riberry Report for the second quarter of 2020[13], property market activity was severely affected by COVID-19 lockdown (partly due to the closure of Deeds Registry). The number of transactions recorded decreased by 53 percent from 700 in 2020 Q1 to 329 in 2020 Q2, which is the lowest number of sales since the Report was produced in 2013. The total value of transactions in the second quarter of 2020 declined by 33 percent to P440 million from P660 million in the previous quarter. The average price for residential properties sold in the second quarter of 2020 increased by 5.7 percent to P847 987 (March 2020: P802 000), although 154 properties were sold compared 365 properties in the first quarter of 2020. The property market enjoyed good demand and supply for low-end houses while middle-end houses for rent experienced weaker market. Riberry forecasts an improvement in the demand for low and medium-end houses located in prime areas, while demand for upper-end houses would continue to weaken in the short term. Overall, vulnerabilities from the real estate sector posed minimal risk to financial stability during the period under review, but prospective developments require continuous monitoring and assessment.



Source:Bank of Botswana and Commercial Banks[14]



Source: Bank of Botswana

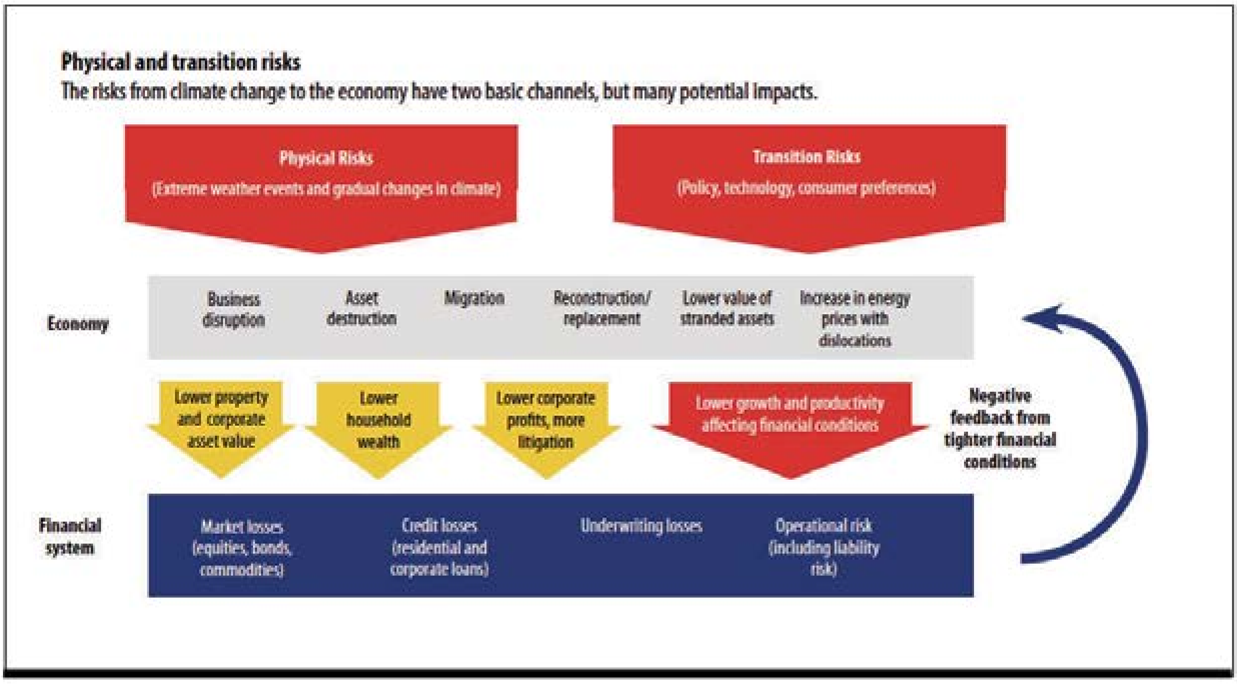
13 This is a quarterly report produced by independent valuers, Riberry Botswana (Pty) Ltd.

14 Real Estate NPLs to Real Estate Loans Ratio is calculated using commercial banks data only.

Box 3.2: Climate Change and Financial Stability

The consequences of the 2007–09 global financial crisis have triggered an unprecedented level of regulatory reforms to ensure that banks are adequately capitalised and liquid. While these reforms have promoted resilience in the banking system, there remains concerns that climate-related risks are not fully reflected in asset valuations nor are they being recognised as a source of systemic risk to the financial system (Gelzinis and Steele, 2019). The intensity and severity of adverse weather events have the potential to disrupt the order of markets; imposing credit losses on lenders, market losses for investors and underwriting losses for insurers (Bank of England (BoE), 2019). Similarly, the broader financial markets are likely to collapse as a result of the high degree of interconnectedness in the financial system, hence, climate-related risks are non-linear, not sector-specific and are geographically spread. In this instance, the changing climatic patterns have far reaching consequences for financial stability and the economy at large. For example, the US suffered a total economic loss of USD535.6 billion from the 69 natural disasters that occurred between 2015 and 2019.[1]

Risks from climate change are propagated to the financial system through two main channels: physical risks, whereby severe weather patterns impose losses on the financial system through physical damage to assets, infrastructure and business disruptions, and; transition risks, which are changes in public policy, technology and market sentiments necessary to decarbonise the economy (Grippa et al., 2019). The figure below summarises the economic and financial implications of climate change.



Ref: Grippa et al., (2019)

While the physical costs from climate-related risks are quantifiable, based on the extent of assets damaged, estimating the costs of transitioning to a low carbon economy is challenging and onerous. Information transparency is, therefore, critical in managing an orderly transition and, more importantly, an abrupt resolution towards a carbon-neutral economy is in itself a financial stability risk (Carney, 2015). The revaluation of carbon assets could create price shocks, in turn, destabilising the financial system through asset liquidation and exposure channels (Gelzinis and Steele, 2019). As such, efficiently tackling climate-related risks require consistent, comparable, reliable and clear disclosures around the carbon intensity of assets to create a carbon price corridor. These principles underpinned the establishment of Financial Stability Board (FSB) Task Force on Climate-related Financial Disclosures (TCFD) in 2015 to encourage the assessment, measurement,

[1]The losses represent 3 percent of US average annual GDP over the period (see National Oceanic and Atmospheric Administration, 2020).

pricing and management of climate-related risks, in turn, smoothening the transition towards a lower-carbon economy. Moreover, the need for collective leadership and globally coordinated action in addressing climate change risks resulted in the creation of a Network of Central Banks and Supervisors for Greening the Financial System (NGFS) in December 2017. NGFS provides a roadmap on how regulators, policy makers and financial institutions can integrate climate-related risks into their mandates.

Within this context, central banks have been driving the integration of climate-related risks into financial stability monitoring and micro-prudential supervision. BoE, in particular, has designed a stress testing framework to assess and quantify financial risks from climate change. The 2021 biennial exploratory scenario will explore the resilience of the UK financial system to climate-related risks by exposing it to different possible climate pathways (see BoE, 2019b). In addition, and as part of its efforts to integrate climate-related risks into its financial stability mandate, BoE conducted market-wide insurance stress tests that included climate-related risks scenarios in 2019. Overall, these attempts close data gaps on measurement of financial risks related to climate change and avail critical resources that other central banks can adapt to integrate climate-related risks into their prudential and financial stability mandates.

For Botswana, these lessons present a pathway for considering climate-related risks within public and prudential policy frameworks. The country is vulnerable to the effects of climate change, in particular, the likely adverse impact on agriculture and tourism, which can affect economic performance, export earnings and livelihoods. Moreover, extreme weather occasionally devastates infrastructure and disrupts the provision of utilities, thus disrupting economic activity. There is also a likely adverse effect on the financial sector in terms of asset quality and insurance pay-outs, in turn presenting vulnerabilities to the domestic financial system. In addition to the direct impact, going forward, Botswana will, like other countries, face the adjustment costs to climate-friendly infrastructure, technology, policies and economic activity, which might also involve imposition of global standards and prescriptions and market preferences or choices. As such, the local transition to a low-carbon economy could be smoothened by incorporating the possible climate pathways into existing stress test frameworks. National policy development on climate change could also be accelerated, since the ratification of the Paris Agreement already provides a sound basis for Botswana's commitment towards sustainable economic development. Moreover, policy development could anchor on the Vision 2036 roadmap, which seeks to attain prosperity for all by pursuing a sustainable development pathway that balances social, economic and environmental objectives (Botswana Government, 2016).

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Non-Bank Financial Institutions (NBFIs)

Lending by NBFIs is minimal and presents low risk to financial stability

3.23 The NBFIs comprise a large group of diverse institutions that include retirement funds, insurance companies, capital markets and non-bank lenders (including microlenders, pawnshops and finance and leasing companies). Although insurance, microlenders, pawnshops, as well as finance and leasing companies engage in lending activities, credit information is currently available for microlenders only.

3.24 The top 20 (by asset size) microlenders' loan book grew from P3.5 billion in 2017 to P4.7 billion in the second quarter of 2020, dominated by Letshego Financial Services (Pty) Ltd (Botswana) which accounts for approximately 65 percent of the industry. By December 2019, Letshego had a loan book value of P2.6 billion.[15] The microlending industry is, therefore, small relative to the financial system assets of just under P234 billion in 2019, to pose significant financial stability risk. However, there are concerns that the sector exposes households to high levels of indebtedness and has consistently recorded annual asset growth of 10 percent; hence warrants regular monitoring. Moreover, the larger microlenders are also linked to the real economy and financial sectors through equity and other exposures by pension funds and commercial banks. Lending by the other NBFIs, which is otherwise referred to as shadow banking, is minimal and presents low risk to financial stability. Botswana Insurance Holdings Limited (BIHL), in particular, advanced P50 million to clients in December 2019, representing 0.1 percent of the combined commercial banking and microlending loan book value of P68 billion.

NBFIs maintain high solvency ratios

3.25 Trends in solvency ratios (assets to liabilities) show that pension funds in Botswana are highly solvent at 405 percent in 2018. The high solvency ratios are a result of prudent and profitable investment management, which has led to significant growth in assets. The life insurance industry recorded high solvency ratios at 119 percent in 2019, unchanged from 2018, while the general insurance sector was similarly solvent at 152 percent during the same period. Microlenders were also highly solvent at 170 percent in 2019 compared to 165 percent in 2018. Overall, the risk to financial stability from the pension and insurance sectors is considered low.

(c) Liquidity and Funding Risk

Banking Sector

The banking sector continues to have sufficient liquidity

3.26 Average daily liquidity in the banking system increased by P1.7 billion, from P10.8 billion in August 2020 to P12.5 billion in September 2020, boosted mainly by increased government spending. As a result, banks continued to have adequate liquid assets and met the 10 percent minimum Liquid Assets Ratio requirement. In addition, banks held, or had access to, highly marketable instruments to meet collateral needs (Chart 3.5). Banks held Bank of Botswana Certificates (BoBCs) worth P11.4 billion in September 2020, an increase from P9.8 billion in August 2020, and representing 91.3 percent of average liquidity.

3.27 The industry, however, remains vulnerable to funding risk arising from a concentrated deposit base, and the feed-effects of the COVID-19 pandemic. The ratio of large deposits to total deposits averaged 40 percent over the last three years and presents potential volatile and unstable source of funding. In spite of the concentrated deposit base, and the predominantly short-term nature of deposits, the industry continues to experience high levels of credit intermediation. The financial intermediation ratio was 84.3 percent in September 2020, being above upper limit of 50 – 80 percent preferred range. This pace of intermediation could exacerbate maturity mismatches in banks' balance sheets, further amplifying liquidity risk in the sector.

The Bank introduces temporary policy measures to stimulate economic activity

3.28 In view of the threats imposed by the COVID-19 pandemic on economic activity in general, including the financial system, the Bank implemented temporary policy measures to allow banks to perform the necessary financial intermediation during this adverse condition. The capital adequacy ratio was reduced from 15 percent to 12.5 percent, while the primary

[15] Letshego Holdings Limited Group financial results for the period ended December 31, 2019.

reserve requirement was slashed from 5 percent to 2.5 percent. In addition, the cost of borrowing through the discount window (Credit Facility) by licensed banks was reduced to the prevailing Bank Rate, without the additional 6 percent surcharge. The Bank also expanded the pool of eligible collateral against its credit facilities to include all bonds listed and traded in the BSE and extended the tenure of overnight repo facilities. An assessment of average liquidity shows that these policy interventions resulted in an injection of P2.1 billion into the market in May 2020, thereby ensuring that banks remained unconstrained in supporting economic activity during the COVID-19 crisis.

Money Market

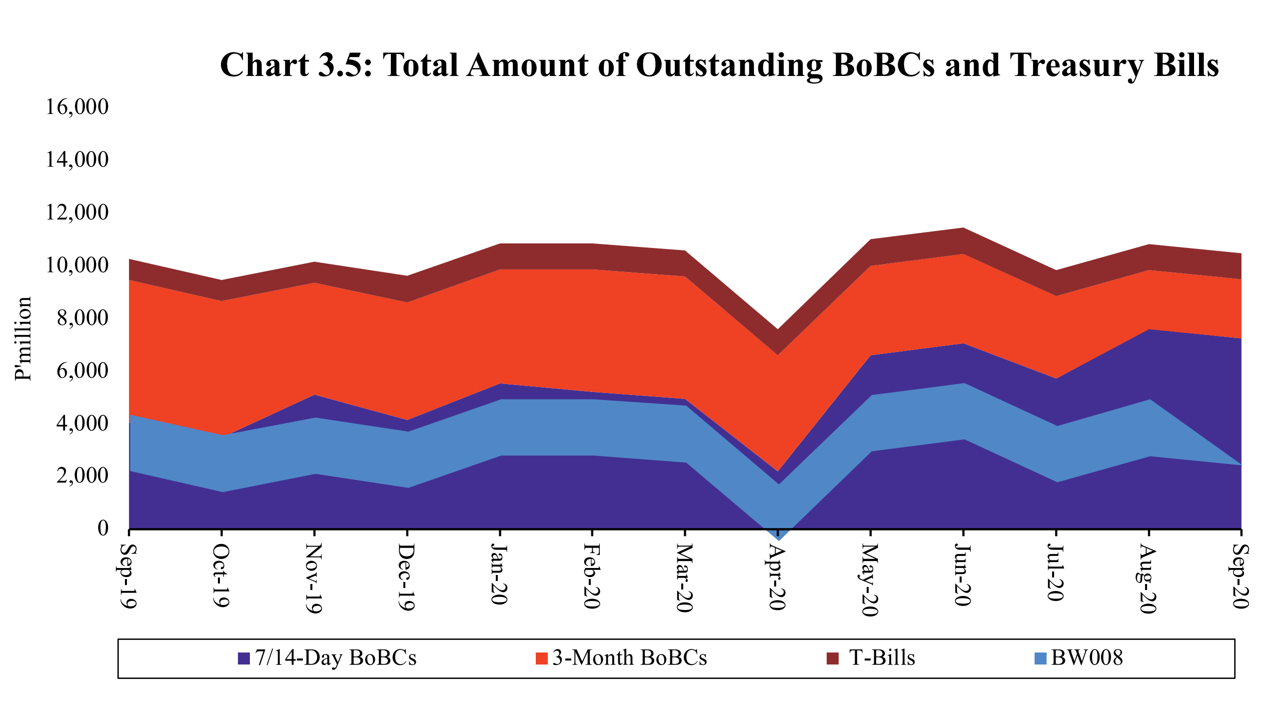
Money market interest rates drop in line with interest rate policy decisions

3.29 Money market interest rates declined in September 2019 and May 2020 in line with the reduction in the Bank Rate (Chart 3.6). The yield on the 91-day BoBCs also dropped to 1.04 in September 2020 from 1.49 percent in December 2019 to reflect the easing of financial conditions (Chart 3.6).

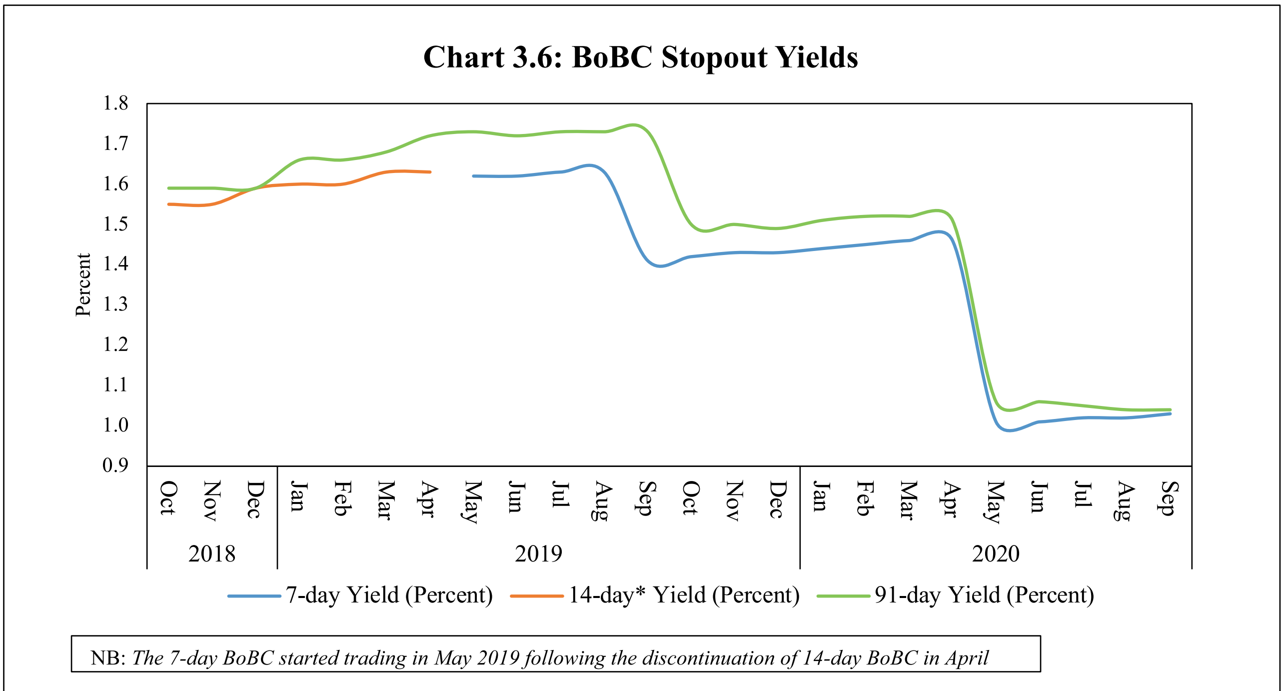
Large banks dominate the interbank lending market

3.30 As at end of September 2020, interbank trades by large banks represented 96.8 percent (December 2019: 97 percent) of the P2.8 billion interbank borrowing and 59.3 percent (December 2019: 87 percent) of interbank lending.[16] Notably, banks seem to actively monitor risks of insolvency, leading to limited participation of small banks in the interbank market. This possibly reflects the reluctance by large banks to lend to small ones due to their perceived high counterparty risk. The resulting market rationing, however, limits small banks' sources of funds in cases of liquidity shortages, in turn pushing them to expensive and volatile wholesale funding.

[16] Banks with a share of total banking assets greater than 9 percent.



Source: Bank of Botswana
Note: Only short-term bonds are included.



Source: Bank of Botswana

Foreign Exchange Market

Banks remain marginally exposed to foreign exchange risk

3.31 Domestic banks were marginally exposed to foreign exchange risk. The industry net open foreign exchange position was P112 million in September 2020 (December 2019: -P328 million), translating to 1 percent of the industry's unimpaired capital (December 2019: 2.5 percent) and, thus, within the 30 percent prudential limit (Chart 3.7a). Notably, concerns of vulnerabilities from US dollar funding remain limited in the domestic banking system despite an increase in the Pula equivalent net exposure to the US dollar, from P24 million in December 2019 to P40 million in September 2020.

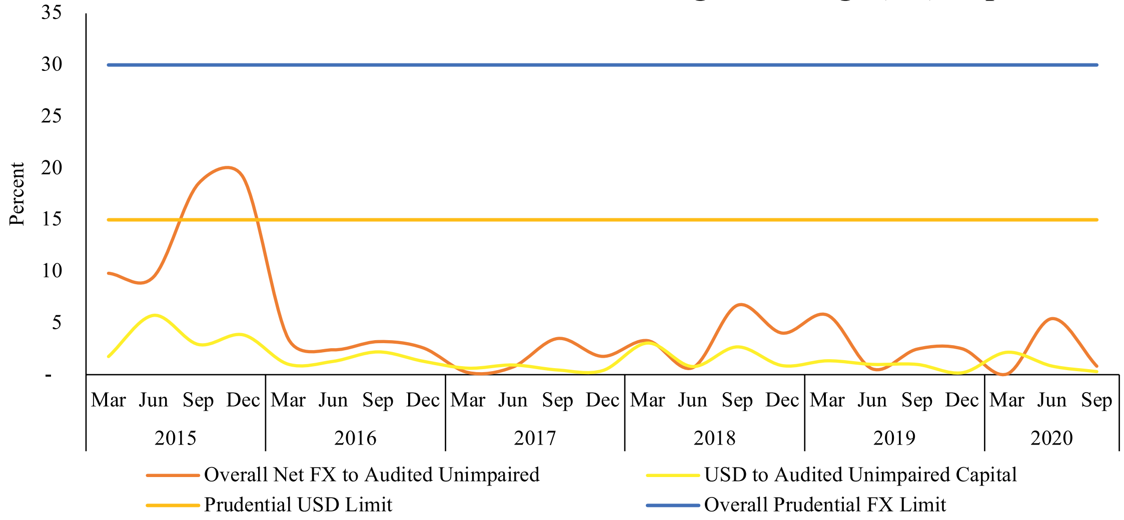
Exchange rate generally stable

3.32 The exchange rate provides another channel through which adverse developments in international markets could destabilise the domestic financial system. As such, the volatility of the Pula against major trading partner currencies was monitored to establish the vulnerability of local economic agents to exchange rate movements as well as the competitiveness of the domestic goods and services in the local and international markets. In this sense, a highly volatile exchange rate can increase output volatility, in turn, become a source of vulnerability.

3.33 Since 2014, the Pula has been stable relative to the basket of trading partner currencies, the US dollar in particular (Chart 3.7b). Volatility in the BWP/ZAR exchange rate has, however, been rising, peaking at 0.04 in March 2020.[17] The deterioration in South Africa's fiscal strength and structurally weak growth put pressure on the South African rand during the first half of 2020. Similarly, the downgrading of the South African credit rating to "junk" status by Moody's in March 2020, and Fitch Ratings' decision to downgrade the country's Long Term Foreign-Currency Issuer Default Rating (IDR) from BB+ to BB in April 2020 as well as the improvement in the risk appetite for emerging market assets in August 2020, which strengthened the South African rand, also contributed to the BWP/ZAR exchange rate volatility. Overall, volatility in the exchange rate was muted since May 2020, hence presented limited risks to the domestic financial system and economy.

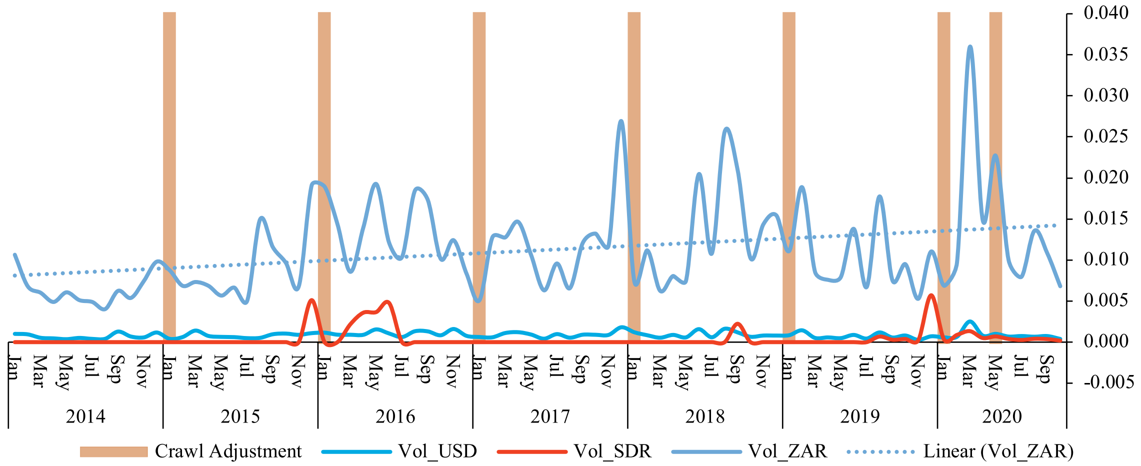
[17] Volatility is measured as the standard deviation of daily exchange rates.

Chart 3.7a: Commercial Banks' Foreign Exchange (FX) Exposure



Source: Bank of Botswana, Commercial Banks

Chart 3.7b: Exchange Rate Volatility



Source: Bank of Botswana

Capital Markets

Stock market capitalisation and liquidity on the decline

3.34 Total equity market value of domestic listed companies decreased by 6.4 percent in September 2020 to record a market capitalisation of P36.2 billion compared to P38.7 billion reported in December 2019 (Table 3.4). Relative to the corresponding period of September 2019, the main board lost 5.9 percent of the market value amid weakening corporate fundamentals caused by the COVID-19 pandemic. The market losses between December 2019 and September 2020 were mainly driven by significant downward revaluations of banking counters. The sector lost P1.4 billion over the first 9 months of 2020, representing 57 percent of the total market losses. In general, the market paints a deem picture on commercial banking profitability, possibly reflecting the effects of the collective COVID-19 relief measures undertaken by the banks to limit the burden of the pandemic on the economy.

3.35 The domestic bourse also experienced declining liquidity in the 9-month period to September 2020, attributable to a significant reduction in the value of shares traded. The value of shares traded dropped to P0.5

billion in September 2020 from P1.8 billion in December 2019 and P1.2 billion in the corresponding period in 2019. As a result, the liquidity ratio (Value of Shares Traded-To-Average Market Capitalisation) declined to 1.4 percent in September 2020 compared to 3 percent and 4.5 percent in September 2019 and December 2019, respectively.

Choppies shares have resumed trading on the BSE

3.36 The shares of Choppies Enterprises Limited resumed trading on the local bourse. The BSE lifted the suspension of the trading of the company's shares in July 2020 following the publication of the company's audited financial statements; thus in compliance with section 5.6 of the Listing Requirements. This development would increase the pool of tradeable stocks on the main board, potentially contributing to increased liquidity in the local stock market.

Stock market volatility rising

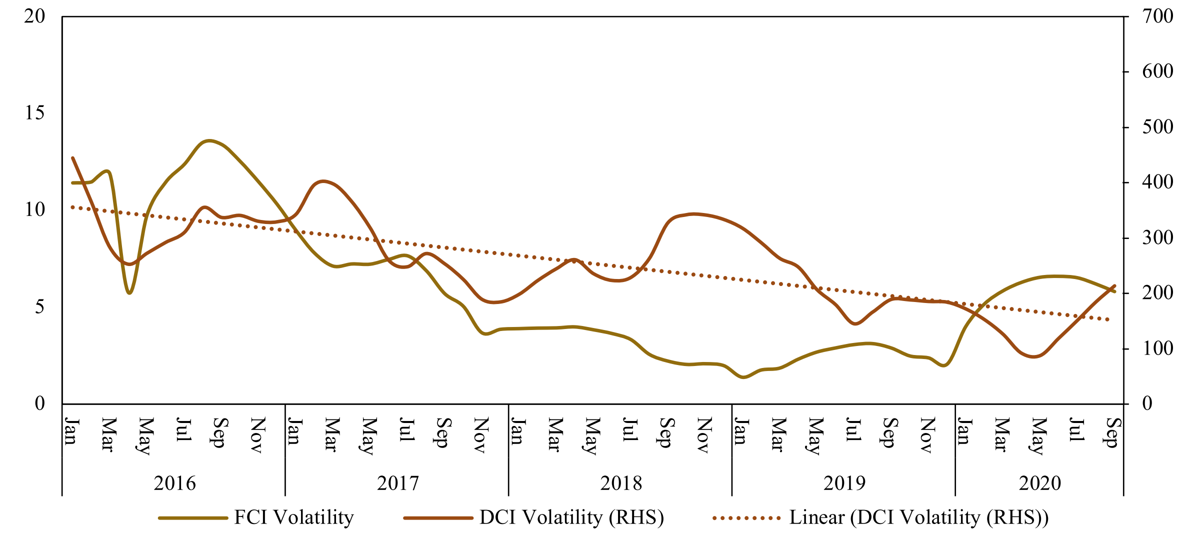
3.37 The developments in market capitalisation translated into a weaker performance of the domestic company index (DCI) in September 2020, which fell by 6.7 percent from December 2019 to record 7005. The index was 6.1 percent lower than in the corresponding period of September 2019. The variation in the DCI translated into increased volatility, measured as the standard deviation of monthly index values (Chart 3.8). In this respect, investor confidence could be tainted by the economic and financial consequences of COVID-19 while, at the same time, rising volatility could be reflecting the inherently risky nature of the equity markets. Nonetheless, the currently low interest rate environment is expected to push investors to high-yielding assets such as equity, in turn sustaining equity index values.

Table 3.4: Selected Botswana Stock Exchange Indicators

Period	Shares Traded		Domestic Stock Market Capitalisation (P'Million)	Liquidity Ratio (Percent)†	Equity Indices			
	Volume (Million)	Value (P'Million)			Domestic Company Index (DCI)	DCI Growth (Percent)	Foreign Company Index (FCI)	FCI Growth (Percent)
2015	834	3 034	49 993	6.2	10 602	11.5	1 572	-0.4
2016	784	2 573	46 304	5.3	9 401	-11.3	1 586	0.8
2017	775	2 477	44 408	5.5	8 860	-5.8	1 575	-0.7
2018	583	1 862	42 406	4.4	7 854	-11.4	1 570	-0.3
2019	628	1 811	38 709	4.5	7 495	-4.6	1 562	-0.5
2020Sep	290	537	36 224	1.4	7 005	-6.5	1 547	-1.0

Source: Botswana Stock Exchange
† Liquidity ratio is calculated as turnover divided by average market capitalisation.

Chart 3.8: Twelve-Month Equity Indices Volatility



Source: Botswana Stock Exchange Limited

Bond market capitalisation rises as Government issues additional tranches

3.38 The number of listed bonds rose to 47 in October 2020 from 46 in December 2019, as a result of the issuance of five new bonds worth P0.6 billion, against four maturing bonds worth P2.4 billion. The number of corporate bonds, therefore, increased to 41, while government bonds reduced to six as a result of the maturity of the P2.1 billion BW008 bond (Table 3.5). Bond market capitalisation, however, increased by a significant 12.2 percent to P19.4 billion (December 2019: P17.3 billion) as the issuance of additional tranches on Government bonds and one corporate bond largely offset the nominal value of matured bonds.[18]

3.39 The additional tranches on Government bonds increased their dominance in the fixed income market to 70.6 percent compared to 29.4 percent for corporate bonds. This trend continues to demonstrate Government's efforts to deepen and develop the domestic bond market. Notably, current sovereign borrowing presents minimal fiscal risks given that Government Debt to GDP ratio remains well within the statutory threshold.

[18] A total of P4 billion additional tranches were issued out of the existing Government bonds, while an additional tranche worth P20.7 million was issued out of the existing Letshego Holdings Limited bond (LHL006) during 2020.

Average bond yields declining

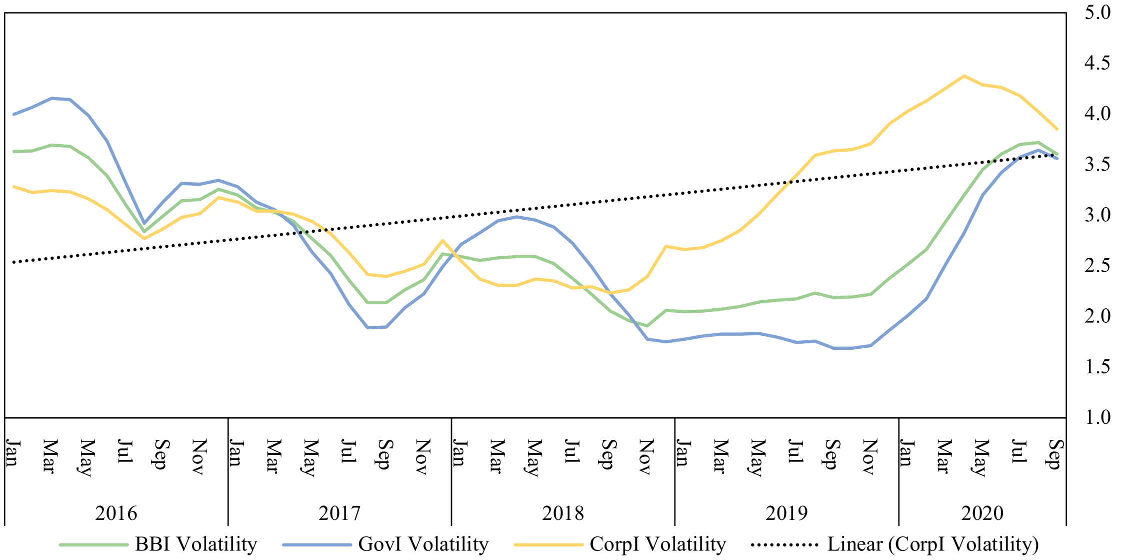
3.40 Average corporate bond yields declined from 8.1 percent in December 2019 to 7.2 percent in October 2020, possibly reflecting an improvement in the risk profile of issuers. Similarly, investors could be outbidding each other in the race for relatively safer securities, compared to equities, amid the weakening economic and corporate fundamentals due to the COVID-19 pandemic. Investor participation in corporate bond trades could also be spurred by the reduction in corporate bond risk. The risk in corporate bonds, as reflected in the volatility of the corporate bond index (CorpI), declined to 3.8 in September 2020 from 3.9 in December 2019 (Chart 3.9). The risk of corporate bonds, however, remains relatively high and, as such, there remains a potential for tightening of corporate funding in the bond market, although the associated consequences are currently judged to be minimal due to accommodative financial conditions. In that sense, funding opportunities in money markets would augment any decline in capital market funding.

Net asset value of exchange traded funds rising

3.41 Developments in international financial markets have a significant bearing on domestic asset valuations. Asset classes that reference on international commodities or indices in other countries, therefore, have the potential to transmit instability to local asset classes. More specifically, exchange traded funds (ETFs) present a conduit for transmission of shocks into local asset prices.

3.42 The net asset value (NAV) of ETFs listed on the BSE increased by 4.3 percent to P21.2 billion in October 2020 from P20.3 billion in December 2019. In terms of market capitalisation, ETF valuations represented 5.4 percent of equity market capitalisation (December 2019: 5 percent),[19] hence pose little threat to the stability of the capital markets.

Chart 3.9: Twelve-Month Bond Indices Volatility



Source: Botswana Stock Exchange Limited

19 The representation of ETF's to equity valuation was restated on account of a previous computational error.

Table 3.5: Selected Bond Market Indicators

Period	Government			Corporate†			Total Number of Bonds	Total Value of Bonds (P'Million)	Government Bonds Value /Total (Percent)	Corporate Bonds Value / Total (Percent)	Bond Indices		
	Number of Bonds	Nominal Value (P'Million)	Average Yield* (Percent)	Number of Bonds	Nominal Value (P'Million)	Average Yield* (Percent)					Botswana Bond Index	Government Bond Index	Corporate Bond Index
2016	6	8 258	4.5	35	3 888	7.2	41	12 146	68.0	32.0	170.1	169.6	170.6
2017	5	9 083	4.5	38	5 129	7.1	43	14 212	63.9	36.1	179.4	178.1	180.7
2018	7	9 588	4.6	42	5 446	8.8	49	15 034	63.8	36.2	185.1	184.4	186.7
2019	7	11 859	4.7	39	5 429	8.1	46	17 288	68.6	31.4	193.5	191.1	200.1
2020Oct	6	13 682	4.4	41	5 707	7.2	47	19 389	70.6	29.4	203.4	201.1	209.5

Source: Botswana Stock Exchange

† Includes bonds listed by corporate, quasi-government, parastatal and supranational institutions.

* The average of daily implied yields calculated by the BSE.

Table 3.6: Selected Exchange Traded Fund Indicators

ETF	EWT40†			NewGold			NewPlat			NewFunds^		
Underlying Asset	Johannesburg Stock Exchange Top 40 Companies			Gold			Platinum			South African Government Bonds		
Period	Units Traded (Million)	Turnover (P'Million)	Net Asset Value (P'Million)	Units Traded (Million)	Turnover (P'Million)	Net Asset Value (P'Million)	Units Traded (Million)	Turnover (P'Million)	Net Asset Value (P'Million)	Units Traded (Million)	Turnover (P'Million)	Net Asset Value (P'Million)
2016	0.02	0.6	229	1.02	137.6	13 152	0.90	95.7	7 471	–	–	143
2017	3.11	121.6	132	0.08	10.0	12 525	0.14	13.1	7 174	–	–	59
2018	0.01*	0.4*	124*	0.28	33.7	7 906	2.75	246.4	5 742	0.00	0.00	45
2019			0.00	0.00	166.2	10 007	0.34	29.9	10 279	0.00	0.02	46
2020Oct			60.6	15 387	0.00	39.7	5 772	0.00	0.00	43		

Source: Botswana Stock Exchange

† CoreShares Equally Weighted Top 40 (EWT40) was delisted in August 2018.

* EWT40 was delisted in August 2018, hence the information used is for the period January to August 2018.

^ NewFunds was listed in 2015 but only started trading in 2018.

Non-Bank Financial Institutions (NBFIs)

Gross insurance premiums and pensions contributions increased

3.43 NBFIs, particularly pension funds and insurance firms, are funded by contractual savings in the form of pension contributions and gross insurance premiums. The gross premiums for life insurance increased by 10 percent from P3.7 billion in 2017 to P4.1 billion in 2018. All life insurance companies maintained adequate capital levels as at December 31, 2019.[20] The insurance penetration ratios remained low and relatively unchanged, at 2.9 percent and 2.7 percent in 2018 and 2019, respectively, but in line with industry trends across Sub-Saharan Africa. In contrast, pension penetration ratios averaged 45 percent over the period December 2015 to December 2019. The ratio increased to 49.8 percent in June 2020 (Table 3.7). Given the high levels of disposable income, there are opportunities for further development and growth in these sectors.

Pension industry safe and sound

3.44 Annual pension contributions increased from P4.3 billion in 2018 to P4.6 billion in 2019. The pension funds industry was financially sound and stable as at December 31, 2019. In Botswana, the majority of pension funds' assets are under the defined contribution pension schemes (DC) as opposed to defined benefit pension schemes (DB), indicating that the public sector and major private sector businesses do not have contingent liabilities to cater for future retirees, but rather pay pension obligations on a continuing basis. In this regard, the industry continued to match current assets to current liabilities. The pensions liquidity ratio (current assets to current liabilities) was 97 percent in 2018, demonstrating the industry's ability to meet short-term pension obligations. In addition, the pensions industry held cash of P10.1 billion in December 2019 and P9.2 billion in August 2020, translating into a prudent liquidity ratio (Cash and near cash-to-Assets) of 13.5 percent in June 2019 and 12.5 percent in August 2020. Moreover, in August 2020, 79.4 percent of the cash was held in domestic currency, further enhancing the liquidity profile of the pension industry.

COVID-19 will affect NBFIs negatively with repercussions for households

3.45 Botswana Public Officers Pension Fund (BPOPF) has made an assessment that investment markets for pension funds are currently volatile, citing COVID-19 as the major source of instability in global financial markets.[21] This instability could negatively impact NBFI financial performance in the short-term.

3.46 To mitigate the negative economic effects of COVID-19 on households, while also ensuring sustainability, NBFIs introduced temporary policy responses that include: restructuring and rescheduling of loan installments, life premium and retirement contributions for at least 3 months; discount on insurance products; reduction of interest rates on non-bank lending; and provision of quick turnaround time for processing insurance and medical aid claims.

(d) Macro Financial Linkages and Contagion Risk

Banks have significant linkages with the rest of the financial system and the real sector

3.47 Financial stability vulnerabilities could also arise from risk concentrations and interlinkages between different sectors of the economy through different transmission channels, such as the macro-financial channel, the bond demand channel, and the bank lending channel. These linkages are assessed with a view to determining the possible impact of a financial crisis or shock on macroeconomic developments and vice versa. Figure 3.1 shows the interlinkages.

3.48 Total banking sector assets as a proportion of total financial sector assets are estimated to have risen to 46 percent in 2019 compared to 45 percent in 2018, whereas NBFIs assets as a ratio of total financial sector assets were 54 percent in 2019 (2018: 55 percent).[22] A larger proportion of commercial banking assets are facilities to households (63.7 percent of total bank credit), while the sector's share of bank deposits was 21.5 percent in July 2020. Meanwhile, NBFI deposits form a significant portion of bank funding, at 22.7 percent of total deposits in July 2020. Thus, the sudden withdrawal of these funds presents a risk to banks and calls for diversification of the deposit base. The interlinkages also extend to state owned enterprises (SOEs) which hold

[20] The solvency ratio for life insurers was 118.9 percent calculated as assets/liabilities. For solvency, assets must exceed liabilities as according to the Insurance Industry Act.

[21] BPOPF press release dated March 30, 2020.

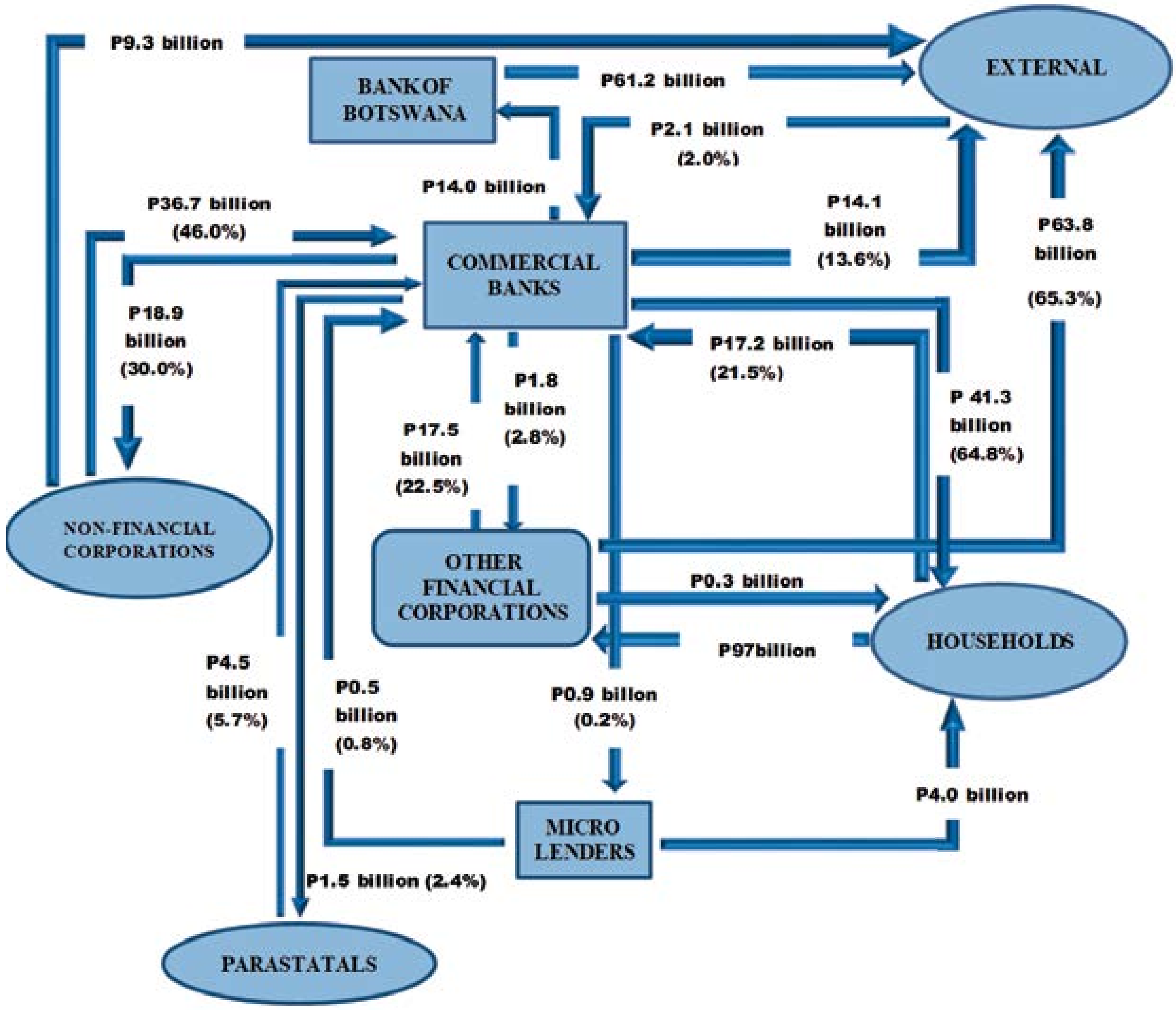
[22] The financial results for most NBFIs are not yet published hence a few, but large, NBFIs were used to estimate the relative size of the financial system in 2019.

6.2 percent of bank deposits, while loans to the sector account for 2.3 percent of total bank lending.

Financial sector assets are significant as a percentage of GDP

3.49 Banking sector assets as a percentage of GDP increased from 48 percent in 2018, to 50 percent in 2019, and further to 59.9 percent in June 2020. The combined assets of banks and NBFIs (financial sector assets) to GDP averaged 117 percent between 2015 and 2018, and were estimated at 106.8 percent and 113.3 percent in 2019 and June 2020, respectively; demonstrating the significance and importance of the financial system to the economy. The risk of contagion within the financial system, and to the rest of the economy is, therefore, rising in view of the strong interconnectedness and sheer size of the financial system.

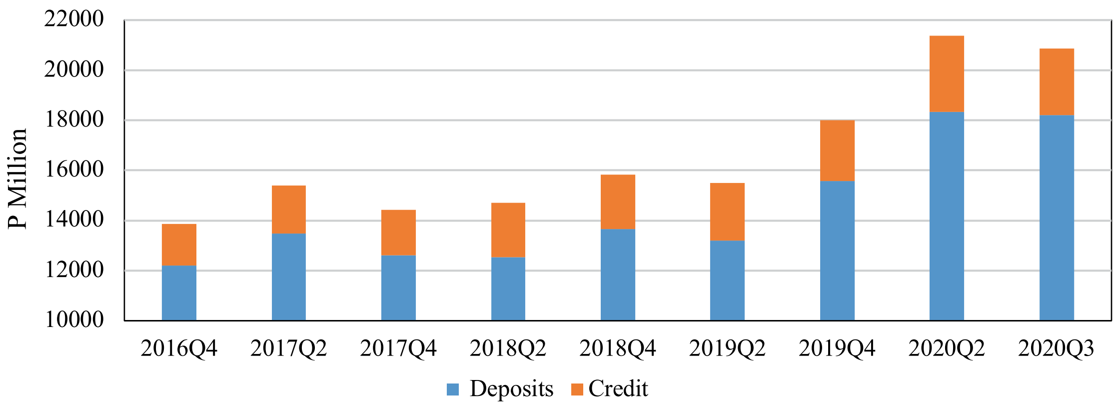
Figure 3.1: Macro-Financial Linkages (September 2020)



Source: Bank of Botswana and NBFIRA

Notes: The percentages indicate shares of loans/deposits for the sector.
Balances from the Bank to the external sector represents net foreign assets.
Balances from other financial corporations to the external sector are pension fund assets invested offshore.
Balances from commercial banks to the external sector are commercial banks' balances due from foreign banks.
Balances from the Bank to commercial banks are insignificant.

Chart 3.10: Commercial Banks' Exposure to NBFIs



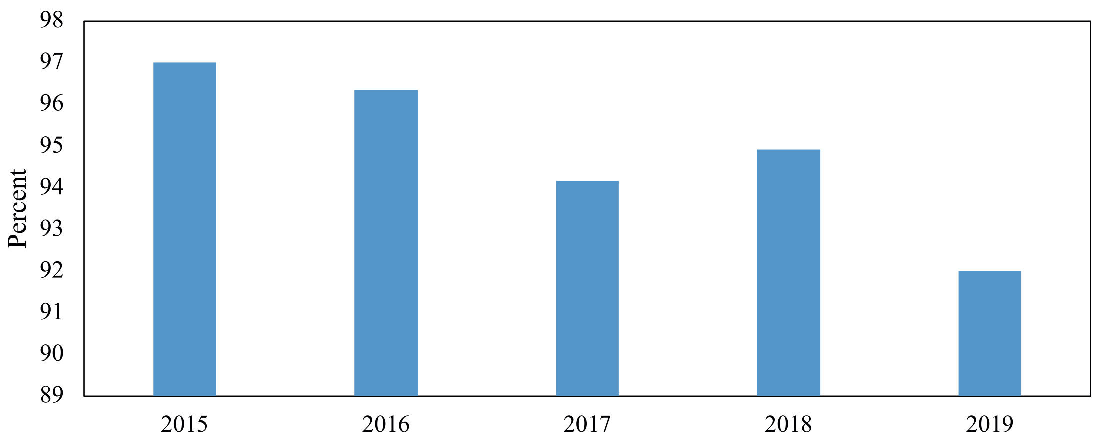
Source: Commercial banks

(i) Risk Concentrations

Insurance and pensions sectors highly concentrated

3.50 Insurance companies could affect financial stability and contribute to systemic risk through three potential transmission channels, namely failure to provide critical services; inability to mitigate risk and compensate for loss with respect to systemically important counterparties; and with regard to risk to systemically important financial institutions.[23] In a highly concentrated market, failure by a dominant insurance company may leave a significant gap in the provision of critical risk mitigation services to the economy as remaining companies may not have the capacity to fill the void. Lack of alternative service providers could amplify the effect of an insurance company's distress on the real economy. The dominance of BIHL in the local insurance sector exacerbates these risks and warrants enhanced supervision of the institution. The top three life insurance companies have a market share of over 90 percent of the assets of the life insurance sector and consequently dominate in gross premiums written (Chart 3.11).

Chart 3.11: Share of Top 3 Life Insurers Assets to Total Life Insurance Assets



Source: NBFIRA

Pension fund assets increased amid COVID-19

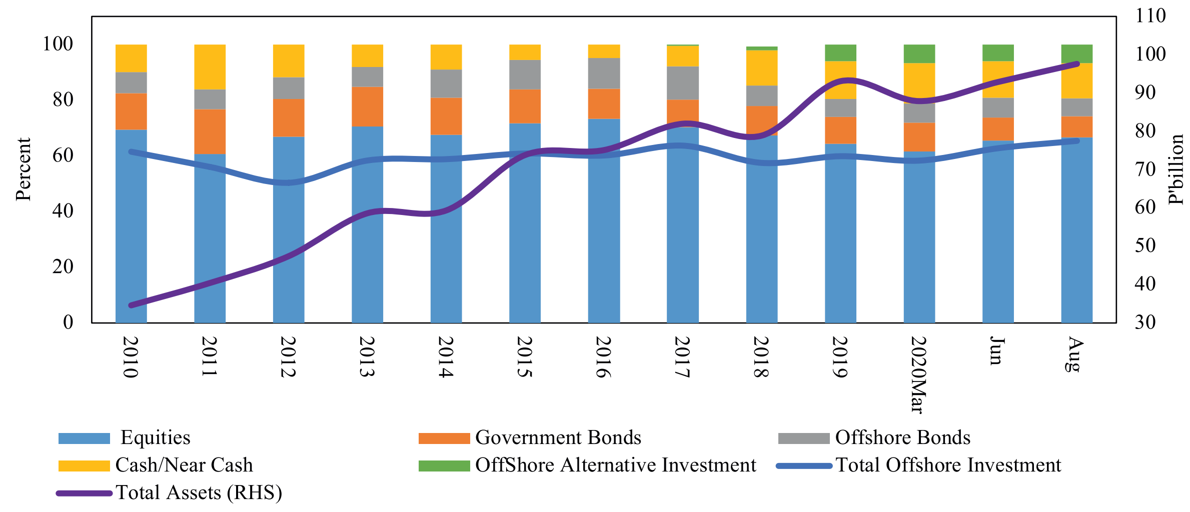
3.51 Pension funds play a vital role in the financial system and could potentially affect its stability. First, stability in the performance of funds preserves the wealth of retirees, confidence and anchors positive expectations about future prospects, thus sustains economic activity. Second, pension funds have an impact on the liquidity of banks because of the large deposits they hold, and lastly, related thereto, they could impact the financial system through their investment behavior and sentiments. Withdrawal of significant amounts of pension funds deposits from commercial banks may cause liquidity challenges especially for smaller banks due to their dependence on this source of funding.

3.52 Over the last 11 years, pension funds' assets have grown by 187 percent from P32 billion in 2009 to P93 billion in December 2019. In the first quarter of 2020 pension assets had declined to P88 billion but rebound to P97 billion in August 2020. Investment in equities increased from P51 billion in the first quarter of 2020 to P65 billion in August 2020 and accounted for the biggest share (66.5 percent) in the portfolio investment allocation of pension funds. Furthermore, 65.3 percent of the funds were invested offshore in July 2020, compared to 58.3 percent in the first quarter of 2020. Generally, the investment allocation of pension funds remained broadly unchanged with an average of 60 percent invested offshore since 2009. This is in line with the retirement funds prudential regulations that require that at least 30 percent of assets should be invested locally. The regulations also require that annuities must be purchased exclusively from insurance providers operating in Botswana, but there is a concern that the annuity market is too shallow to benefit consumers due to limited competition and shortage of annuity related products.

[23] French et al., (2015): Insurance and Financial Stability, Bank of England Quarterly Bulletin.

3.53 Noteworthy is that more than 80 percent of total industry pension funds are accounted for by, or attributed to the BPOPF. Measured in relation to the size of the domestic economy (GDP), the total assets of pension funds amounted to 52.3 percent in the second quarter of 2020 compared to 47.2 percent of GDP in December 2019.

Chart 3.12: Investment Allocation of Pension Funds



Source: NBFIRA

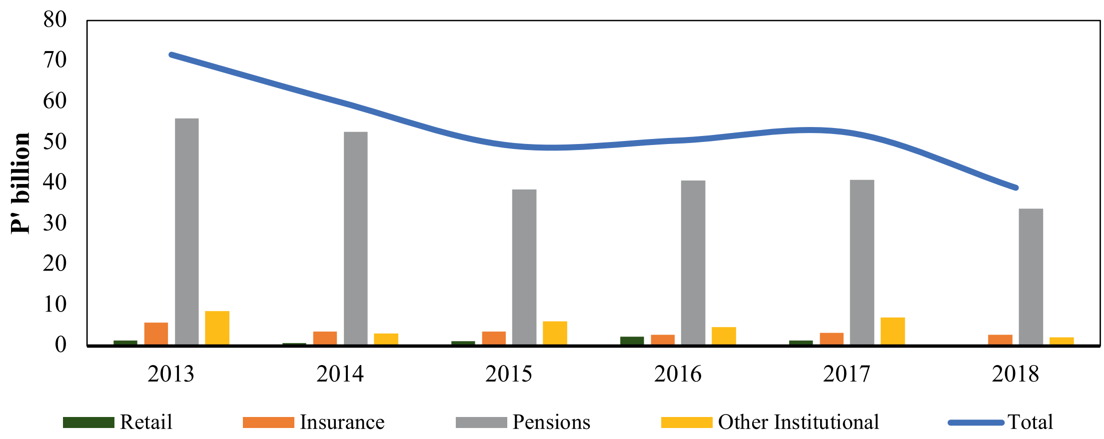
Pension funds constitute the largest share of assets under management

3.54 Asset managers play a vital role in the intermediation of funds in the financial system. They provide investors with an opportunity to invest in a diversified portfolio of securities. By pooling funds from a large group of investors, asset managers reduce investment risk through diversification.

The asset management sub-sector is highly interconnected with other parts of the financial system

3.55 At the end of 2019, there were 19 asset managers and management companies (Mancos) with a total balance sheet of P6 billion. Total Assets Under Management (AUM) of local asset managers, excluding Mancos, were P38.9 billion in December 2018, a significant fall from P53.2 billion in December 2017 (Chart 3.13). The decline was attributable to the recent decision by pension funds to directly place assets with offshore fund managers in a bid to cut fund management costs. In December 2018, 77 percent of these assets were invested domestically, while 23 percent were invested offshore. It is important to note that institutional pension investors constituted the largest share of AUM, at 75 percent, followed by other institutional investors and insurance investors at 14 percent and 8 percent, respectively. As such, the asset management sub-sector is highly interconnected with other parts of the financial system through ownership linkages, common asset exposures and the provision of wholesale funding to banks. Therefore, the sub-sector poses some level of systemic risk. Asset management companies, however, remained profitable and adequately capitalised, presenting little risk to financial stability.

Chart 3.13: Assets Under Management by Local Asset Managers



Source: NBFIRA

3.56 The medical insurance industry remains relatively small when compared to other types of risk insurance, with a penetration ratio of 0.56 percent in 2019 compared to 47.2 percent and 2.7 percent for pension funds and insurance sectors, respectively (Table 3.7). This suggests that financial vulnerabilities from medical aid schemes have a much smaller macro impact.

Table 3.7: Penetration Ratios of Selected Non-Bank Financial Institutions

	2016	2017	2018	2019	2020Q1	2020Q2
Insurance Penetration Ratio (Percent)[1]	2.6	2.9	2.9	2.7	-	-
Pension Penetration Ratio (Percent)[2]	44.0	46.1	41.6	47.2	44.2	49.8
Medical Aid Penetration Ratio (Percent)[3]	0.51	0.52	0.56	-	-	-

Notes: [1] Calculated as gross written premiums as a share of GDP
[2] Calculated as pension funds' assets as a share of GDP
[3] Calculated as medical aid funds' assets as a share of GDP

3.57 Of concern in the non-bank financial institutions sector are corporate governance, accountability and integrity issues relating to some companies such as Bona Life, Capital Management Botswana (CMB) and the CMB/BPOPF on-going court case. Bona Life was placed under statutory management on January 20, 2020, after failing to meet regulatory requirements. Despite its small size relative to the size of the financial system, accounting for 0.38 percent of total financial system assets, BPOPF's exposure to Bona Life as a majority shareholder puts the members' investment returns at risk. Meanwhile, CMB and one of its subsidiaries, CMB F1, have been put in liquidation. In terms of size, CMB is relatively small (P500 million) compared to total assets of the BPOPF (P73.6 billion) and should not pose much risk to financial stability. To counteract these governance and misconduct issues in the sector, NBFIRA developed and introduced Corporate Governance Guidelines in 2019. The Guidelines are currently being implemented on a regulatory impact assessment (RIA) basis to cater for different levels of sophistication in NBFIs.

(e) Banking Sector Stress Test Results

COVID-19 poses a significant threat to the banking system

3.58 The Bank continues to monitor and assess the potential impact of the COVID-19 pandemic on the banking sector, and the economy as a whole. To support this diagnosis, the Bank conducted some stress test on the liquidity and profitability of the domestic banking system to determine banks' resilience to the COVID Event. The analysis relied on statutory returns as at June 2020 and the Bank continued to impose stricter assumptions to reflect the daunting effects of the COVID Event (see Box 3.3).

3.59 The analysis covered three main areas: liquidity stress test, to determine the ability of a bank to survive unexpected liquidity drain without recourse to external liquidity support; an interest rate stress test to establish the impact of policy rate reductions on bank profitability; and credit risk shocks to assess the impact of non-performing loans and credit concentration shocks on the level and adequacy of a bank's capital. Prospects for the alleviation of the pandemic and economic recovery are uncertain. In this regard, slow income growth and weak business conditions could add to existing vulnerabilities in the banking sector and elevate credit risks.

3.60 Under normal conditions, the banking sector continues to be adequately capitalised, liquid and profitable, with high-quality assets (Table 3.8). In addition, baseline conditions also suggest that banks are hoarding capital, based on the relatively large capital buffer above the minimum requirement and modest intermediation, in anticipation of further economic slowdown and growing expected losses as a result of COVID-19.

Banking sector could be weakened by credit shocks

3.61 The June 2020 stress tests assess the resilience of banks when subjected to a moderate as well as a severe credit shock. Under the moderate scenario (Table 3.9), bank capital adequacy levels decline to 11.1 percent, thus breaching the prudential capital adequacy requirement of 12.5 percent. The industry capital position worsens to 2 percent in the COVID-19 scenario, where 20 percent of performing loans are assumed to become NPLs. Resultantly, asset quality declines under assumed stress conditions, with the ratio of NPLs to total loans rising from a baseline of 4.7 percent to 14.3 percent and 23.8 percent under moderate and severe scenarios, respectively.

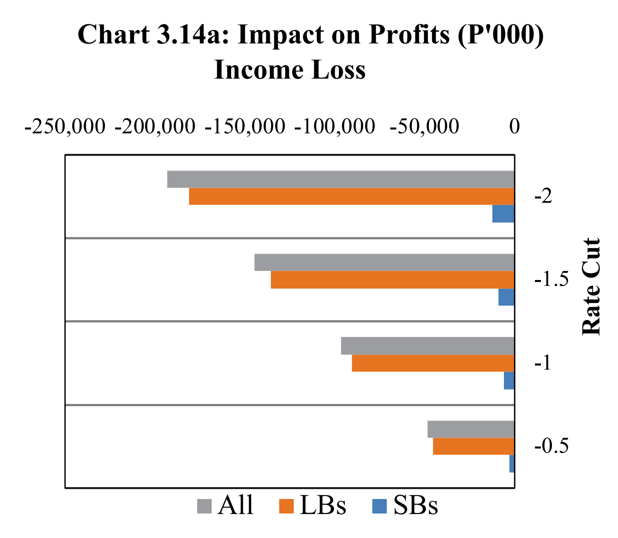
3.62 Overall, credit risk tests show that the COVID-19 NPL shock has a significantly negative impact on the capital and asset quality position of banks. Nevertheless, credit concentration stress test does not take into account credit mitigation measures such as underlying collateral, which could cushion the banks against such a shock.

Large banks are more resilient to liquidity shocks

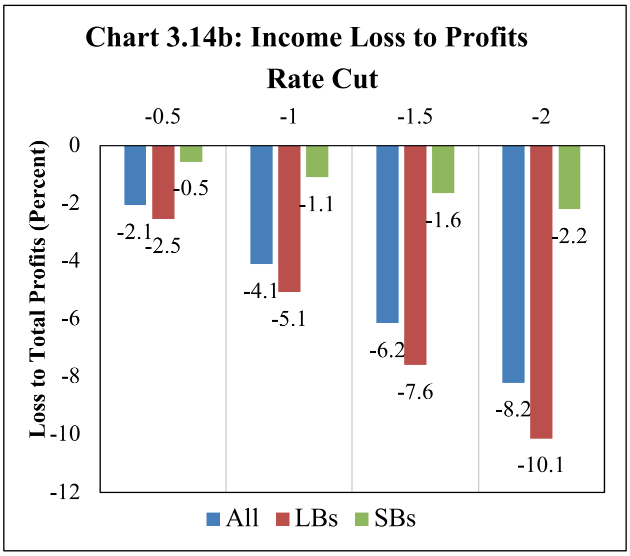
3.63 In the liquidity risk test, banks show resilience to a liability run in the moderate scenario (Table 3.9), especially large banks, which survive for 21 days (March 2020: 22 days). Small banks, however, experience considerable liquidity squeeze and would only survive for 14 days (March 2020: 13 days). All banks are vulnerable to the COVID-19 liquidity stress condition. Shorter survival horizons for small banks reflect the large proportion of illiquid assets in their portfolios, being loans and advances, relative to a highly liquid deposit base that is dominated by wholesale deposits. On average, modest credit growth (6.4 percent) in the twelve months to June 2020 also explains the overall deterioration of liquidity stress test results between December 2019 and June 2020 in addition to COVID Event. Notably, these scenarios do not consider the availability of liquidity support provided by the Bank of Botswana through the Credit Facility. Accordingly, the stress results should not be interpreted to mean that the banks would default under these scenarios.

Banks are resilient to interest rate shocks

3.64 Large banks (LBs) are generally more susceptible to interest rate shocks than smaller ones given their dominant lending position (80 percent of total lending). In general, banks hold more interest sensitive assets than liabilities and would incur interest income losses as a result of a cut in the policy rate (Charts 3.14a and 3.14b).



Source: Bank of Botswana



Source: Bank of Botswana

Table 3.8 Banking Sector Financial Soundness Indicators

Capital Adequacy (Percent)	Jun 2019	Sep 2019	Dec 2019	Mar 2020	Jun 2020	Sep 2020
Core Capital to Unimpaired Capital	69.0	68.9	67.9	66.3	68.3	68.0
Tier 1 Capital to Risk-Weighted Assets[1]	13.0	12.8	13.3	12.9	13.9	13.4
Capital Adequacy Ratio[2]	17.7	18.6	18.4	19.6	20.3	19.8
Asset Quality (Percent)						
NPLs to Gross Loans	4.7	5.2	4.8	4.5	4.8	4.3
NPLs Net of Specific Provisions to Unimpaired Capital	10.6	12.1	9.4	8.5	8.5	8.1
Specific Provisions to NPLs	52.8	52.7	59.0	62.3	62.0	59.4
Liquidity (Percent)						
Liquid Assets to Deposits (Liquidity Ratio)[3]	17.7	18.7	18.3	16.3	22.4	21.6
Advances to Deposits (Intermediation Ratio)	84.1	81.1	82.9	87.0	81.7	80.6
Profitability/Efficiency (Percent)						
Return on Average Assets (ROAA)	2.8	1.7	2.3	0.9	2.2	1.4
Return on Equity (ROE)	22.9	14.3	19.4	7.7	21.5	15.7
Cost to Income	56.3	58.3	58.1	44.8	69.3	60.6

Notes: [1] Prudential lower limit is 7.5 percent -Basel II/III
[2] Prudential lower limit is 15 percent
[3] Minimum statutory requirement is 10 percent

Table 3.9: June 2020 Commercial Banks' Stress Test Results

SCENARIOS	RISK CATEGORY		
	Credit	Liquidity	Interest
BASELINE SCENARIO: (BANKING CONDITIONS AS AT JUNE 2020)	Capital Adequacy Ratio (CAR) of 20.3 percent. 4.8 percent NPLs/Total loans.	Perfect Asset Liability match, leading to 30 days survival.	Banks start off with a CAR of 20.3 percent.
MODERATE SCENARIO			
DESCRIPTION OF SHOCK	*NPL Shock:* 10 percent of Performing loans become Non-Performing or Largest Exposure Defaults *Credit Concentration Shock:* Largest Exposure defaults or becomes non-performing.	Bank run simulation based on Assets' Haircuts and Liabilities' Run-off Rates.	150 basis point cut in Policy Rate.
RESULTS	*NPL Shock:* Banking system breaches the prudential limit with CAR of 11.6 percent. NPLs/Total Loans ratio increases to 14.3 percent, a sign of increasing vulnerability. *Credit Concentration Shock:* Banking system breaches the prudential limit with CAR of 8.7 percent. NPLs/Total Loans ratio increases to 15.3 percent, a sign of increasing vulnerability.	On average banks survive for 21 days Large banks survive 22 days. Small banks survive 14 days.	19.9 percent CAR (change in CAR not significant at -0.4 percentage points). Loss of P144.5 million in interest income**.**

SCENARIOS	RISK CATEGORY		
	Credit	Liquidity	Interest
DESCRIPTION OF SHOCK	*NPL Shock:* 20 percent of previously performing loans become non-performing. Credit Concentration Shock Two Largest Exposure defaults or become non-performing.	Bank run simulation based on higher Assets' Haircuts and Liabilities' Run-off Rates than in moderate scenario.	350 basis points cut in policy rate.
RESULTS	*NPL Shock:* Banking system breaches the prudential limit with CAR of 2.0 percent. NPL/Total Loans ratio increases to 23.8 percent, a sign of increasing vulnerability. *Credit Concentration Shock:* Banking system breaches the prudential limit with CAR of 4.9 percent. NPLs/Total Loans ratio increases to 20.5 percent, a sign of increasing vulnerability.	On average banks survive for 9 days Large banks survive 10 days. Small banks survive 6 days.	19.7 percent CAR (change is -0.7 percentage points). Loss of P338 million in interest income.

Source: Bank of Botswana

Box 3.3: Stress Test Assumptions

Credit Risk

Credit risk is the potential that a borrower or counterparty to a credit transaction will fail to meet obligations in accordance with the agreed terms (default rate). The level of Non-Performing Loans (NPLs) is an indicator of credit risk for a bank. In the Stress Testing Model, the credit shock scenario models a general decline in the asset quality of individual banks subject to calibrated shocks. Generally, the increase in NPLs can be a certain percentage of either existing NPLs or existing performing loans. In the moderate scenario, the stress tests assume ten percent of existing performing loans become non-performing, while the shock applied in the COVID-19 scenario is 20 percent. In this context, depletion of households' incomes and businesses' revenues due to the COVID-19 pandemic are expected to impair households and businesses' ability to meet their debt obligations.

An increase in NPLs means that the bank has to undertake additional provisioning; the increased provisioning requirements will reduce the value of Risk Weighted Assets as well as capital. This assumed transmission mechanism would lead to a decline in the Capital Adequacy Ratio (CAR).

Liquidity Risk

Liquidity risk refers to lack of cash and other liquid assets to meet maturing obligations and/or funding an increase in assets. The purpose of the liquidity stress is to test the ability of banks to meet near-term payment obligations when faced with the loss of funding and counterparty cash drains. The test uses haircuts for asset holdings and run-off rates for liabilities to estimate the number of days a bank is likely to survive a bank run without assistance of the central bank or any other sources of financing.

In the case of liquidity stress testing, a haircut refers to a percentage of asset value that a bank cannot access within a short period to meet urgent and high value customer demands. A run-off rate is the value of a liability that a bank has to meet within a short period. Different haircuts and run-off rates are assumed for different categories of assets and liabilities, respectively. In the severe shock, the magnitudes of haircuts and run-off rates are higher than in the moderate scenario for some asset and liabilities classes. The survival horizon is given as number of days out of 30 days.

The test uses varying haircuts and run-offs for the moderate scenario and the COVID-19 scenario. The financial condition of the industry as at March 2020 is the baseline scenario while the Moderate scenario introduces some element of sensitivity on assets and liabilities. The COVID-19 scenario adds extreme sensitivity to wholesale deposits run-offs and the Bank of Botswana Certificates, among others, to reflect significant tightening of the financial environment to show liquidity challenges imposed by the pandemic. The haircuts and run-off rates are incrementally sensitive under this scenario as it is assumed that the financial environment in the COVID-19 environment will impair effective market functioning at the expense of bank liquidity.

Interest Rate Risk

This test considers the direct interest risk, incurred by a financial institution when the interest rate sensitivities of assets and liabilities of banks are mismatched.[1] The calculation of the risk consists of two parts reflecting flow and stock impacts of interest rate changes. The test works with the repricing gap information. It calculates the changes in interest income and interest expenses resulting from the gap between the flow of interest on the holdings of assets and liabilities in each category. The gap in each time band or repricing category shows how net interest income will be affected by a given change in interest rates. The model extends to assessing how this change in interest rate will affect capital.

A prominent policy reaction to the COVID-19 pandemic has been the easing of policy rates to stimulate economic activity. Such policy decisions, however, bear consequences for bank profitability due to reduced interest income. In the local context, this policy response is projected through a series of Bank Rate reductions ranging from 0.5 percentage points to 3.5 percentage points, where 1 percentage point deduction and 3.5 percent deduction represent the moderate, and COVID-19 scenarios, respectively.

[1] This is interest rate risk in the banking book.

4. FINANCIAL MARKET INFRASTRUCTURE AND REGULATORY DEVELOPMENTS

(a) Payments and Settlement Systems

The National Payment System Vision and Strategy 2020-2024 has been published

4.1 The strategy outlines the essential characteristics of Botswana's future national payment system (NPS), which encompasses all payment related activities, processes, mechanisms, infrastructure, institutions and users in the country. The strategy is anchored on ten pillars. It reflects the way forward and identifies key strategic priorities under each pillar, which should be attained by 2024.

Value and volume of cheques show a declining trend

4.2 The value and volume of cheque transactions show a declining trend between 2016 and August 2020 (Table 4.1). The clearing systems were largely resilient in handling large volumes of transactions without any major disruption during the period under review.

4.3 The Botswana Interbank Settlement System (BISS) (owned and operated by the Bank of Botswana) and the Botswana Automated Clearing House (BACH) (owned and run by the Bankers Association of Botswana) are the two systemically important payments systems in Botswana. Table 4.1 shows BISS transactions by value and volume from 2016 to September 2020. Developments and trends in the payments and settlement platforms point to an economy that is increasingly becoming digitilised, with growing usage of electronic funds transfers (EFTs) as compared to cheque clearances.

4.4 While payment and settlement platforms are becoming more reliable and efficient in terms of timeliness and finality, they are generating different types of risks. Hence, it is imperative that the country guards against system failure due to faults in operations and cybersecurity risk.

(b) Regulatory Developments

Regulatory Policy Committee approves D-SIBs framework for Botswana

4.5 The Regulatory Policy Committee (RPC) met on July 23, 2020 and approved the framework for the designation of domestic Systemically Important Banks in Botswana (D-SIBs). D-SIBs are institutions whose failure could have a disruptive effect on the domestic financial system.

4.6 The RPC also held its second meeting of the year on September 18, 2020 to discuss the guidelines on supervision of financial conglomerates and corporate governance of banks. The guidelines are expected to contribute towards a safer and sound financial system, particularly addressing risks emanating from operations of diverse and complex group of companies and misconduct in the banking system. Both guidelines were approved and will be circulated to the market in due course.

Financial Stability Council holds second meeting of the year

4.7 The Financial Stability Council (FSC) held its second meeting of the year on August 25, 2020 to discuss recent financial sector developments, as well as address market, regulatory and public interest issues relating to the stability, performance and prospects for the domestic financial sector. The FSC noted that the domestic financial system continues to be resilient, characterised by strong capital buffers, liquidity position and profitability, despite the challenges engendered by the onset of the COVID-19 pandemic. In considering prospects for financial stability going forward, the FSC observed that the COVID-19 pandemic and the necessary disease containment measures will continue to

Table 4.1: Selected Payment and Settlement Systems Indicators

Period	BISS Transactions		Cheques		EFTs	
	Volume ('000)	Value (P'billion)	Volume '000)	Value (P'billion)	Volume ('000)	Value (P'billion)
2016	183	1 690	1 204	26	7 507	166
2017	178	1 273	1 038	22	8 135	165
2018	175	1 414	929	20	8 513	180
2019	183	1 899	810	19	9 161	209
2020 Jan-Sep	102	1 556	373	8	7 120	151

Source: Bank of Botswana

have an adverse effect on economic performance in the short term and could, if protracted, further elevate risks to financial stability. The country's blacklisting by the European Union (EU), as well as the identified AML/CFT deficiencies could also heighten financial stability risks within the financial system. Box 4.1 discusses blacklisting and its implications on the economy. Nevertheless, proactive regulatory policy responses as well as expansionary fiscal support measures will continue to anchor soundness of the financial sector.

4.8 The FSC further noted the receptive feedback from stakeholders with respect to the establishment of a deposit protection fund (DPF) for Botswana. The Bank has henceforth started work on formulating the operational framework and elements of the DPF towards implementation, while also giving due consideration to comments and suggestions from stakeholder to strengthen the proposal.

BSEL declared self-regulatory organisation

4.9 The BSEL was granted self-regulatory organisations (SRO) status by MFED during the first quarter of 2020. As a self-regulating entity, the BSEL is expected to align industry interests with public interest, with limited intervention from the Government. As such, BSEL would be unconstrained in establishing effective capital markets regulatory environment and accelerating developments in the sector. In this regard, BSEL commenced the process of reviewing its equity listing requirements in the third quarter of 2020.

Box 4.1: Blacklisting and its Implications on the Economy and Standing Policies that Govern Bilateral/International Relations

The Financial Action Task Force (FATF)

The FATF is an inter-governmental body aimed at protecting the financial system from abuse by criminals. The FATF produced 40 recommendations which have become de-facto global standards and embraced by almost all jurisdictions around the globe. These recommendations provide a comprehensive framework and measures designed to combat money laundering, terrorism financing and financing of proliferation of weapons of mass destruction. The FATF has a compliance programme where countries are assessed, through mutual evaluations, to establish the extent to which they implement Anti Money Laundering, Counter Financing of Terrorism and Counter Proliferation Financing (AML/CFT/CPF) global standards. FATF mutual evaluations are peer reviews where members from different countries assess another country. FATF may conduct mutual evaluations with FATF-Style Regional Bodies such as the Eastern and Southern Anti-Money Laundering Group. Mutual evaluations have two components:

- Technical compliance – assesses whether the necessary laws, regulations or other required measures are in force and effect, and whether the institutional framework for supporting AML/CFT/CPF is in place.

- Effectiveness – this is the main component of a mutual evaluation; it is the focus of the on-site visit to the assessed country. During this visit, the assessment team will require evidence that demonstrates that the assessed country's measures are working and deliver the right results. What is expected from a country differs, depending on the money laundering/terrorist financing and other risks it is exposed to. To ensure consistent and fair assessments, the FATF has developed an elaborate assessment methodology, to guide the process.

The findings and recommendations of a mutual evaluation are captured in a Mutual Evaluation Report which is published on the FATF website. Jurisdictions whose mutual evaluation reveals a significant number of key deficiencies are referred to the International Co-operation Review Group (ICRG), an organ of the FATF for monitoring. Each jurisdiction under review has the opportunity to participate in face-to-face meetings with the ICRG to discuss the report, including developing an action plan with the FATF to address the deficiencies identified.

On the basis of the results of its reviews, the FATF publishes two statements at each plenary meeting which reflect the seriousness of the risks posed by the country, and the level of political commitment to address them. The FATF specifically requests high-level political commitment from each reviewed jurisdiction to implement these action plans.

FATF Grey Lists

The grey list is officially referred to as jurisdictions under increased monitoring. Countries on the FATF grey list are considered, under the FATF standard, to be having a higher risk of money laundering and terrorism financing but have formally committed to working with the FATF to develop action plans that will address their AML/CFT/CPF deficiencies. The current FATF grey list, issued on 21st February 2020, includes the following countries: Albania, the Bahamas, Barbados, Botswana, Cambodia, Ghana, Iceland, Jamaica, Mauritius, Mongolia, Myanmar, Nicaragua, Pakistan, Panama, Syria, Uganda, Yemen and Zimbabwe.

Grey listing allows the FATF to monitor the implementation of the Action Plan agreed between the FATF and the country to address strategic deficiencies, the monitoring is done by the ICRG. Countries that failed to address the strategic deficiencies within the agreed period, might, depending on the level of risk, be escalated to the FATF blacklist where the FATF calls for member countries to take enhanced due diligence or strict measures when dealing with the blacklisted country.

FATF Blacklists

Officially known as High-Risk Jurisdictions subject to a Call for Action, the FATF blacklist sets out the countries that are considered deficient in their anti-money laundering and counter-financing of terrorism regulatory regimes. By issuing the list, the FATF hopes to encourage countries to improve their regulatory regimes and establish a global set of AML/CFT/CPF standards and norms. The current FATF blacklist includes two countries: North Korea and Iran.

Once a country is blacklisted, the FATF calls on its members and urges all jurisdictions to advise their financial institutions to give special attention to business relationships and transactions with the listed country. In addition to enhanced scrutiny, the FATF further calls on its members and urges all jurisdictions to apply effective counter-measures, and targeted financial sanctions in accordance with applicable United Nations Security Council Resolutions.

The European Union Blacklists

The European Union (EU) identifies and lists third country jurisdictions which have strategic deficiencies in their AML/CFT/CPF regimes (high-risk third countries). The objective of the EU list of high-risk third countries is to protect the Eurozone through application of enhanced due diligence measures. The listed countries are encouraged to rapidly address their identified strategic deficiencies and the Commission is committed to support them where appropriate. The EU’s methodology leading to a country's identification as a "high-risk third country" includes:

- Countries publicly listed by the FATF - any third country representing a risk to the international financial system, as identified by the FATF, is presumed to represent a risk to the EU internal market.

- Countries assessed as posing significant threats to the EU’s financial system as a result of strategic deficiencies in their AML/CFT/CPF regimes based on external sources of information. Whilst its methodology builds on the listing process followed by FATF, it considers that the FATF findings should be drawn upon together with other sources of information to further inform the Commission services' analysis of third countries' AML/CFT regime.

As a result of the listing, banks and other entities covered by EU anti-money laundering rules are required to apply increased checks (due diligence) on financial operations involving customers and financial institutions from these high-risk third countries to better identify any suspicious money flows.

Disadvantages of being on the Lists

It is possible that a country may experience:

- Reputational risk – the affected country’s image to the global community may be tainted.

- Negative effects on correspondent banking which would lead to a delay in international transactions, for example, delay in completion of transactions due to application of enhanced due diligence measures.

- Reduction in capital flows due to reduced ability to attract investors.

- Overall reduction in international trade – blacklisting may affect imports and exports.

To what extent does blacklisting affect international investors looking to do business in a country that has been blacklisted?

- Given the increased risk of money laundering, terrorism financing and proliferation financing that blacklisted Countries present, the FATF calls on its members to apply enhanced due diligence measures to business relationships and transactions from the listed Countries. Enhanced due diligence measures include obtaining additional information on the customer, obtaining information on the source of funds and source of wealth of the customer, and enhanced monitoring of the business relationship. This tends to delay completion of business transactions.

- Countries, especially developing ones, depend on international investors and blacklisting may affect their access to global markets and relationships with international investors. Attracting international investors may be difficult because some investors may have policies that provide for avoiding the risk of dealing with listed countries or de-risking by terminating an existing relationship where the country is considered to be at high risk for money laundering, terrorism financing and proliferation financing abuse. In addition, investors who are already doing business in the country may withdraw their investments due to frustrations caused by delay in completion of transactions caused by application of enhanced due diligence.

What interventions can a country employ to exit the adverse listing?

- The country must make a high-level commitment to address the identified deficiencies within the set timelines which are presented in the form of an action plan. This involves, domesticating the international standards through the passing of laws and putting in place the structures and mechanisms to effectively implement the laws.

- The country is further required to fully implement the action plan within the set timeframe and to demonstrate effectiveness of the measures it has put in place to combat money laundering, terrorism financing and proliferation financing.

5. CONCLUSION AND OUTLOOK

Financial sector continues to be resilient but COVID-19 and related containment measures present emerging vulnerabilities and elevated risks

5.1 Overall, notwithstanding the challenges engendered by the onset of COVID-19 pandemic, the domestic financial system continues to be resilient, characterised by generalised institutional strength and good business performance across the industry, as manifested by strong capital buffers, liquidity position and profitability. The enduring stability of the financial system is supported by sound macroeconomic environment, efficient and robust market infrastructure, prudently managed banks, effective regulation and supervision. Therefore, the environment and performance of the industry provide for unconstrained capacity of the financial sector to perform its role and support economic activity.

5.2 There are, however, emerging vulnerabilities and elevated risks relating to the structure and performance of the economy that need close attention. Notably, the dependence on the external sector and, in particular, reliance on a single commodity for export earnings, presents fiscal risks and exposes the country to exogenous shocks that could undermine the external balance. In addition, sectoral interlinkages that involve a relatively large exposure of banks to non-bank financial institutions in terms of significant sources of funding elevates the risk of contagion in the domestic financial system, although effective regulation and the strength of institutions significantly mitigate the risk. Bank lending that is dominated by credit to the household sector, including a significant proportion of the inherently expensive unsecured personal loans, also makes the sector vulnerable to tightening of financial conditions. Nevertheless, the rate of credit growth was moderate, thus did not present any indication of excessive and rapid credit increase and, household credit, in particular, appeared to be in line with trends in personal incomes.

5.3 Vulnerabilities to the financial system are exacerbated by the COVID-19 pandemic and the necessary disease containment measures that continue to have an adverse effect on economic performance in the short to medium term. Specifically, potential increase in bank loan defaults and insurance premiums payments or contributions to pension funds, as well as early pension withdrawals emanating from loss of employment and, constrained liquidity, profits and investment returns for some institutions could further elevate risks to financial stability especially if global COVID-19 infections continue in the absence of a vaccine.

5.4 While economic performance is severely constrained by the impact of COVID-19, proactive policy actions, including prevailing accommodative real monetary conditions, injection of additional liquidity into the banking system, other measures instituted by non-bank financial institutions to mitigate the negative effects of COVID-19 and expansionary fiscal policy support measures continue to anchor soundness of the financial sector. Moreover, the recently unveiled Economic Recovery and Transformation Plan (ERTP) bodes well for economic recovery in the medium-term.

5.5 The likelihood of elevated risk to financial stability due to ongoing strategic AML/CFT deficiencies remains. Moreover, the decision by the EU to include Botswana in its list of high-risk third countries could further exacerbate these risks. Nevertheless, concerted efforts are ongoing to implement the FATF required action plan to address the identified deficiencies.

APPENDIX

Table A1: Macroeconomic and Financial Stability Indicators

Financial Sector (Percent)	Dec 2017	Dec 2018	Jun 2019	Sep 2019	Dec 2019	Mar 2020	Jun 2020
Relative Size of Financial Sector (percent of GDP)[1]	113.5	110.2	100.2	102.8	117.6	111.4	122.2
Botswana Public Officers Pension Fund (percent of GDP)	32.5	31.8	34.3	34.7	36.0	33.7	39.4
Pension Funds Offshore Investments (percent of GDP)	29	23.9	27.2	27.5	28.3	25.7	31.2
Corporate Sector (Percent)							
Corporate Sector Debt to GDP	11.7	12.2	11.9	11.5	11.6	12.0	12.6
Debt to Equity	42.1	46.9	…	…	46.3	…	45.7
Household (Percent)							
Household Debt to GDP	18.4	18.5	18.9	18.9	21.7	20.5	21.7
Household Debt to Income	49.3	48.3	48	42.2	45.0	47.3	…
NPL (household)	4.5	4.2	3.3	3.2	3.2	3.6	3.9
Real Estate (Percent)							
Mortgage Loans to Total Loans	21.7	21.2	21	20.8	20.4	20.0	20.2
NPL (mortgages)/Total mortgage loans	6	6	6.2	6.2	6.1	6.5	7.2
Total Mortgage Loans/GDP	7.3	7.2	7.1	7.1	7.1	7.1	7.5
General Economic Indicators							
Economic growth	2.9	4.5	3.9	3.6	3.0	2.6	(4.2)
Inflation	3.2	3.5	2.8	3.0	3.2	2.2	0.9
Foreign Exchange Reserves (percent of GDP)	40.2	36.7	36.0	35.9	32.3	30.3	34.1
Current Account Balance (P'Million)	10 987	4 014	846	(6 499)	(6 581)	(3 984)	(8 244)
Months of Import Cover	17.1	14.7	14.7	14.8	12.1	11.5	11.8
Exports (percent of GDP)	39.1	45.7	40.8	27.0	38.2	32.2	26.2
Imports (percent of GDP)	40	44.4	38.2	35	35	40.3	40.5
Government							
Government Debt to GDP	13.6	17.9	13.4	13.6	13.9	…	…
Government Debt to Revenue	43.4	64.4	49.4	47.5	50.1	…	…
Government Guaranteed Debt/GDP	4.7	4.4	…	…	…	…	…
Government Net Financial Position to GDP	-0.6	-6.2	-4,3	10.2	8.7	…	4.1
Government Interest Payments to Revenue	1.8	1.7	2.6	2.3	2.3	…	1.0
Government Interest Payments to GDP	0.5	0.5	0.1	0.2	0.2	…	0.3
Government Lending to State-Owned Enterprises (P'Million)	2 444.2	2 530.6	2209.6	2209.6	2209.6	…	…
General Government to GDP	14.4	14.5	14.7	14.7	14.7	13.3	15.8
Government Deposits to GDP	16.9	18.9	16.7	16.3	16.3	15.0	15.8
Government Expenditure to GDP	32.4	32.8	30.3	36.2	32.2	…	33.2
Government Employment to Total Employment	47.9	48.5	45.0*	33.3	32.3	32.3	40.3

Source: Bank of Botswana, Statistics Botswana, MFED, NBFIRA, BSEL and Commercial Banks.

Note:Numbers in Italics are as at December 2018

… denotes data not available - Government Cash Flow for March 2020 (2019/20 Final) not yet released.

Numbers in parenthesis denote a negative figure.

[1]Figures include Commercial Banks, Statutory Banks and Pension fund Assets only.

* are estimated figures.

Table A2: Selected Banking Sector Indicators

Number of Licensed Institutions, Branches and ATMs											
	2009	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
Commercial Banks	11	11	11	13	13	11	10	10	10	10	9
Branches	91	94	96	105	115	114	114	115	127	128	136
Agencies	18	26	18	14	19	18	15	18	20	23	26
Statutory Banks	2	2	2	2	2	2	2	2	2	2	2
Building Society	1	1	1	1	1	1	1	1	1	1	1
ATMs	352	381	357	379	390	432	427	455	473	523	542
Assets of the Banking System (in millions of Pula)											
Commercial Banks	44 148	49 590	51 600	57 954	59 962	67 994	76 605	80 640	83 475	91 341	98 677
Statutory Banks	1 590	1 689	1 839	2 329	2 893	3 267	3 229	3 871	3 660	3 465	4 184
Building Society	1 874	2 073	2 413	2 770	3 045	3 422	4 264	3 765	4 261	4 017	4 641
Selected Ratios											
Market Share (Top 4 Banks)	89.8	87.0	85.2	81.4	81.0	81.0	79.2	79.4	79.8	78.6	78.7
Private Sector Credit/GDP	11.0	9.2	25.0	26.0	29.6	29.1	31.6	29.4	28.5	29.0	30.1
Total Credit/GDP	27.2	25.4	26.0	30.5	31.4	31.7	32.4	30.1	30.1	30.7	32.0
Total Deposits/GDP	52.0	47.9	40.3	41.9	38.6	36.1	40.2	36.6	35.3	36.5	38.6

Table A3: GDP of Primary COVID-19 Affected Economic Sectors

Year	Manufacturing (P'million)	Trade, Hotels and Restaurants (P'million)	Of Which Hotels and Restaurants (P'million)	Transport and Communications (P'million)	of which Air Transport (P'million)	of which Road Transport (P'million)	GDP (P'million)
2014	7 740.3	26 182.3	*7 956.9*	7 788.2	*2 015.9*	*1 494.4*	145 868.6
2015	8 441.7	23 711.4	*8 856.7*	8 559.3	*2 155.1*	*1 665.3*	146 066.2
2016	8 859.5	30 997.2	*9 970.3*	9 642.7	*2 452.0*	*1 775.4*	170 564.0
2017	9 214.5	35 059.1	*10 916.9*	10 622.7	*2 762.7*	*1 996.1*	180 102.6
2018	9 794.7	36 652.6	*11 965.7*	11 508.7	*2 947.1*	*2 144.5*	190 365.3
2019	10 352.6	38 765.9	*12 886.4*	12 129.7	*2 866.5*	*2 331.2*	197 268.8
2020q1	10 512.9	39 378.6	*12 959.4*	12 308.8	*2 874.2*	*2 590.6*	198 980.8
2020q2	9 970.8	35 470.7	*11 008.6*	11 476.2	*2 189.2*	*2 478.7*	186 667.3
Percent of GDP							**Sectors to GDP**
2014	5.3	17.9	*5.5*	5.3	*1.4*	*1.1*	28.6
2015	5.8	16.2	*6.1*	5.9	*1.5*	*1.2*	27.9
2016	5.2	18.2	*5.8*	5.7	*1.4*	*1.2*	29.0
2017	5.1	19.5	*6.1*	5.9	*1.5*	*1.2*	30.5
2018	5.1	19.3	*6.3*	6.0	*1.5*	*1.2*	30.4
2019	5.2	19.7	*6.5*	6.1	*1.5*	*1.3*	31.0
2020Q1	5.3	19.8	*6.5*	6.2	*1.4*	*1.3*	31.3
2020Q2	5.3	19.0	*5.9*	6.1	*1.2*	*1.3*	30.5

Chart A1: Financial Systems Vulnerabilities' Heat Map

	GLOBAL ECONOMY	2018	2019	2020	2021	2022
RISK CATEGORY	UNDERLYING INDICATOR	RISK LEVEL				
	Output (year)					
Global	Inflation (Year)					
	Financing Conditions*					
	DOMESTIC ECONOMY	**2019Q1**	**2019Q2**	**2019Q3**	**2019Q4**	**2020Q1**
RISK CATEGORY	**UNDERLYING INDICATOR**	**RISK LEVEL**				
	Economic growth					
	Foreign exchange reserves					
MACRO	Month of imports					
	Current account balance					
	Public Debt to GDP					
	Business confidence index					
	Pensions Assets TO GDP					
	Credit to GDP gap					
	Total Credit to GDP					
	Household Debt to GDP					
	Household Debt to Income					
	NPL (household)					
	NPL (banking sector)					
CREDIT	Large Exposures to Bank Capital					
	Large Exposures to Total Deposits					
	Mortgage Loans To Total Loans					
	Total Mortgage Loans/GDP					
	NPL (mortgages) To Total Mortgage Loans					
	Commercial Real Estate Loans To Total Loans					
	Corporate Sector Debt to GDP					
	NBFIs Credit to Total Credit					
SOLVENCY	Leverage ratio					
	Insurance capital adequacy					
	Corporate cost to income ratio					
FUNDING	Intermediation ratio (loans to deposits)					
	Stock market: Domestic capitalisation growth					
	Stock market: Domestic capitalisation/ GDP					
	Insurance concentration – Top 5					
CONTAGION	Pension fund concentration					
	Micro Lender concentration					
	NBFIs Deposits to Total Deposits					
KEY	Very Low	Low	Medium	High	Very High	

NOTES