# Banking Supervision Annual Report 2012

Bank of Botswana

## Mission Statement

The principal objective of the Bank of Botswana (Bank) is to promote and maintain monetary stability, an efficient payments mechanism, solvency and proper functioning of a soundly based monetary, credit and financial system in Botswana.

Pursuant thereto, the Bank's mission is to promote and maintain a safe, stable, sound, efficient and competitive banking system. In carrying out this role, the Bank is guided by the Banking Act (CAP. 46:04) (Banking Act), various legislations and policies, viz., Bank of Botswana Act (CAP. 55:01), Banking Regulations 1995, Licensing Policy under the Banking Act and Bureaux de Change Regulations 2004, governing the establishment and conduct of financial institutions over which it has supervisory authority.

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

In order to achieve these objectives, the Bank:

(a) sets a transparent criteria and guidelines for market entry and applications for licences are received and processed against established criteria, as set out in the Licensing Policy for Banks;

(b) establishes and updates, on a regular basis, prudential policies and standards; monitors solvency, liquidity, large exposures, insider loans, provisioning and risk management strategies, as well as the adequacy of management and governance structures for the sound operation of banks;

(c) establishes effective systems for off-site surveillance and on-site examinations, including reporting, accounting, auditing and disclosure standards; and

(d) ensures timely supervisory action and compliance with banking and other related laws governing the operations of banks in Botswana.

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# List of Abbreviations

| | |
|---|---|
| ABCH | African Banking Corporation Holdings Limited |
| ADC | African Development Corporation |
| AML | Anti-Money Laundering |
| ATA | Average Total Assets |
| ATM | Automated Teller Machine |
| Banking Act | Banking Act (CAP. 46:04) |
| BancABC | African Banking Corporation of Botswana Limited |
| Barclays | Barclays Bank of Botswana Limited |
| Baroda | Bank of Baroda (Botswana) Limited |
| BCBS | Basel Committee on Banking Supervision |
| BCPs | Basel Core Principles for Effective Banking Supervision |
| BBS | Botswana Building Society |
| BCIF1 | BIFM Capital Investment Fund 1 |
| BG | Bank Gaborone Limited |
| BIFM | Botswana Insurance Fund Managers |
| BIS | Bank for International Settlements |
| BoBA | Bank of Botswana Act |
| BoBCs | Bank of Botswana Certificates |
| BMC | Botswana Meat Commission |
| BSA | Building Societies Act |
| BSB | Botswana Savings Bank |
| BSE | Botswana Stock Exchange |
| CAMELS | Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to Market Risk |
| CAR | Capital Adequacy Ratio |
| CBL | Capital Bank Limited |
| CFT | Combating the Financing of Terrorism |
| CIUs | Collective Investment Undertakings |
| CPSS | Committee on Payment and Settlement Systems |
| DCEC | Directorate on Corruption and Economic Crime |
| DMTNP | Domestic Medium-Term Note Programme |
| DRS | Disaster Recovery Site |
| DSAs | Direct Sales Agents |
| ESAAMLG | Eastern and Southern Africa Anti-Money Laundering Group |
| FATF | Financial Action Task Force |
| FIA | Financial Intelligence Agency |
| FNBB | First National Bank of Botswana Limited |
| FSB | Financial Stability Board |

| | |
|---|---|
| FSIs | Financial Soundness Indicators |
| GBP | United Kingdom Pound Sterling |
| GDP | Gross Domestic Product |
| G-SIFIs | Globally Systemically Important Financial Institutions |
| HHI | Herfindahl–Hirschman Index |
| IAIS | International Association of Insurance Supervisors |
| IFSC | International Financial Services Centre |
| IMF | International Monetary Fund |
| IOSCO | International Organisation of Securities Commissions |
| IT | Information Technology |
| KBAL | Kingdom Bank Africa Limited |
| KYC | Know Your Customer |
| LCs | Letters of Credit |
| LHS | Left Hand Scale |
| MFDP | Ministry of Finance and Development Planning |
| NBFIRA | Non-Bank Financial Institutions Regulatory Authority |
| NCCFI | National Coordinating Committee on Financial Intelligence |
| NDB | National Development Bank |
| NMD | Namibian Dollar |
| NPLs | Non-Performing Loans |
| OMO | Open Market Operations |
| OTA | Office of Technical Assistance |
| PRR | Primary Reserve Requirement |
| PTY | Proprietary Limited Company |
| RHS | Right Hand Scale |
| ROAA | Return on Average Total Assets |
| ROE | Return on Equity |
| RWA | Risk-Weighted Assets |
| SWIFT | Society for Worldwide Interbank Financial Telecommunication |
| Stanbic | Stanbic Bank Botswana Limited |
| Stanchart | Standard Chartered Bank Botswana Limited |
| STR | Suspicious Transactions Reports |
| USD | United States dollar |
| ZAR | South African rand |

# Foreword

The difficult economic conditions experienced in 2012 were manifested in the slower growth in credit and subdued mining sector output. Notwithstanding the foregoing, the banking sector statement of financial position recorded improved growth, underpinned by aggressive deposit mobilisation and injection of additional capital by some banks. The impact of the Bank's decision to progressively reduce the amount of Bank of Botswana Certificates (BoBCs) to be issued for the purpose of mopping excess liquidity continued to be felt in 2012, as the quantum of BoBCs held by banks plummeted to a six-year low. This is evidence of the positive response by banks to the Bank's call to focus more on the core business of fostering productive intermediation.

The profitability of the banking industry grew at a slower rate than in 2011, partly due to the accelerated increase in provisions for loans and advances as part of prudent banking practices, as well as relatively higher operating expenses. As a result of high profits of some banks, the industry income tax charges also increased. Banking industry asset quality indicators showed an improvement, while provisions for impaired loans and credit facilities increased, as banks became more stringent in recognising and writing off non-bankable assets/uncollectable loans. Consistent with the preceding years, past due loans were concentrated in the household sector, a trend that will continue to cast a shadow over the safety and soundness of the banking sector. The banking sector experienced a decline in liquidity, as banks improved their financial intermediation ratios. However, the liquidity ratio for most banks remained above the minimum statutory threshold.

There has been a significant increase in the number of potential investors making enquiries on banking licence application procedures. Two new banks were licensed during the year; they brought the number of licensed commercial banks in Botswana from 11 in 2011 to 13. On the other hand, the number of bureaux de change declined, as some had their licences revoked, while some voluntarily surrendered their licences. Access to banking continued to be a focal point for some banks, through the use of e-money products, which has benefited the previously unbanked section of the population, particularly in the rural areas; branches and Automated Teller Machines (ATMs) were also increased by banks during the year.

Despite overall compliance with statutory regulatory requirements by most banks, instances of non-compliance were noted at some banks. These were, however, resolved without endangering the safety and soundness of the operations of concerned banks. To ensure regulatory compliance going forward, the Bank will continue to monitor the performance of the banking sector, through on-site and off-site monitoring, in addition to scheduled bilateral, trilateral and Banking Committee meetings.

The objective of this report is to inform the public and other stakeholders about the objectives, structure, form and process of banking supervision and regulation in Botswana, as well as financial performance of the banking industry during 2012.

Linah K Mohohlo
GOVERNOR

# Introduction

The banking sector remained resilient and grew significantly during 2012, compared to the prior year, despite the challenging trading conditions. Total assets of the banking industry rose by 12.3 percent, a significant improvement on the 4 percent growth recorded in 2011. However, credit growth slowed down to 23.2 percent from 26.4 percent. In contrast, deposit liabilities only grew at a rate of 9.4 percent in 2012, which is an improvement compared to only 3.7 percent in 2011. Notwithstanding the slowdown in the growth rate of credit over the past three years, the share of household borrowing increased to 60.2 percent and continued to account for a larger proportion of total borrowing. In contrast, the share of household savings was smaller than that of private sector enterprises, and the former remained a net borrower,[1] while the private sector enterprises were a net saver. Even though there was a slight improvement in asset quality of the banking sector as reflected in the decline of the Past Due Loans to Total Loans ratio from 5 percent to 3.5 percent in 2012, banks were prudent and continued to increase provisions for loan losses, as a cushion for unexpected future losses.

The banking sector remained profitable in 2012, with after-tax profits increasing by a slower rate of 6.7 percent, compared to 17.4 percent recorded in the prior year. Banks were well capitalised and complied with minimum capital adequacy requirements. Despite the banks' observance of prudential limits, which included liquidity ratios above the 10 percent statutory limit, the liquidity ratio declined during 2012, due to substitution of BoBCs, which have historically constituted a larger proportion of liquid assets, for additional lending. The prudential ratio of aggregate Large Exposures to Unimpaired Capital was within the statutory limit, but it declined due to a faster growth in unimpaired capital in contrast to the slower growth rate in aggregate large exposures. The branch network, customer service centres and agencies were increased; banking services to the previously unbanked members of the public expanded further through partnerships with mobile service providers.

The Bank continued to embrace the new global regulatory reforms such as the International Convergence of Capital Measurement and Capital Standards and a Global Regulatory Framework for more Resilient Banks and Banking Systems, commonly known as Basel II and Basel III, respectively, as well as the revised International Financial Reporting Standards. Consultations with the market are currently on-going in preparation for the implementation of Basel II/III effective December 31, 2014. In order to ensure a sound legal footing for the implementation of Basel II/III, the Bank has initiated a review of banking legislation, existing policies, guidelines and directives, so that they are in line with the new reforms.

This statutory Banking Supervision Annual Report is structured as follows: The first chapter outlines the structure of the banking sector, while Chapter 2 provides an assessment of the operational performance of the banks in 2012. The summary of statutory compliance in the banking sector and operational performance of non-bank financial institutions are covered in Chapters 3 and 4, respectively. International best practices on banking supervision are provided in Chapter 5, and Chapter 6 covers other banking system developments. Concluding remarks on the overall banking sector performance are in Chapter 7.

1 This excludes pension funds held on behalf of households.

# Chapter 1: Banking Sector Overview

## Structure of the Banking Industry and Other Supervised Financial Institutions

### Commercial Banks, Statutory Banks and Related Entities

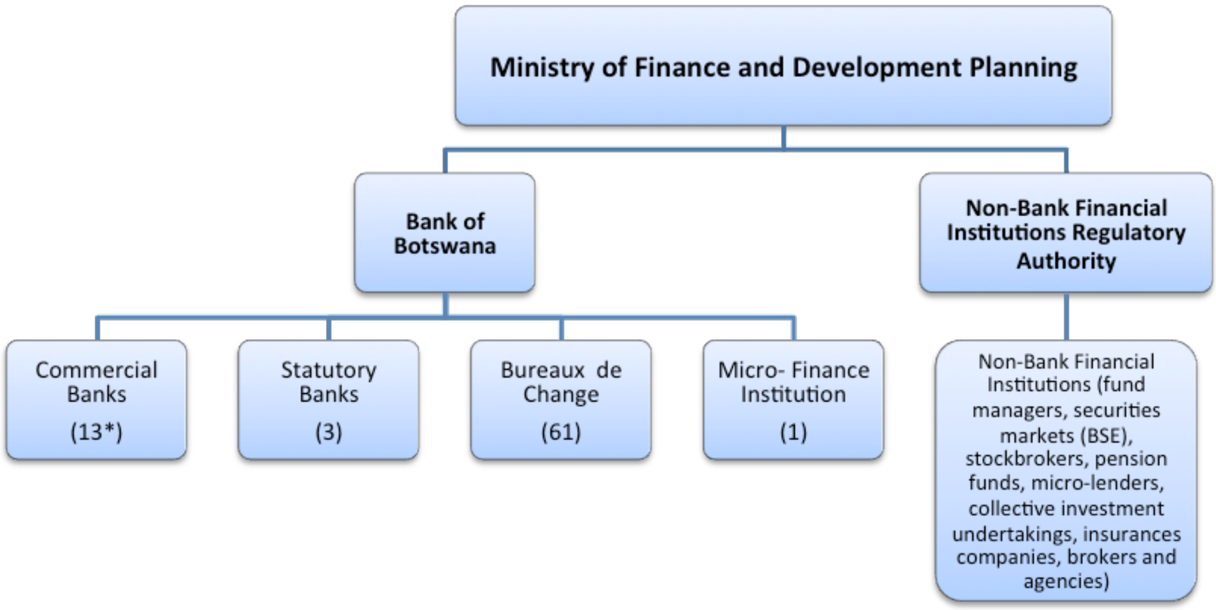
Diagram 1 shows the structure of the Botswana financial sector, which has largely been unchanged in the past two years. The Bank is responsible for regulation and supervision of commercial banks, statutory banks, bureaux de change and deposit-taking micro-finance institutions. The Non-Bank Financial Institutions Regulatory Authority (NBFIRA) has supervisory responsibility over the non-bank financial sector, comprising mainly the insurance industry, pension funds, stock exchange, fund managers and other investment advisory services, as well as micro-lending businesses. The number of banks regulated by the Bank increased from 11 in 2011 to 13, while operational bureaux de change decreased from 68 in 2011 to 61.

### Banking Business Distribution Channels

Banking services are provided through diverse delivery channels, viz, branches, service centres, agencies, ATMs, internet and mobile money services (cellphone banking). The service centres focus on opening new bank accounts, issuing ATM cards, account balance enquiries and loan applications, and this has immensely eased congestion at the banking halls of branches. Electronic banking services have also expanded significantly, especially point of sale technologies, ATMs, internet banking and use of mobile phones.

A total of 10 new branches were opened countrywide during the year, compared to two in 2011; and the number of ATMs increased by 22 in 2012. Stanbic led the industry with the installation of seven new ATMs, thus increasing the number from 18 in 2011 to 25 in 2012. Table 1 (overleaf) shows the distribution channels by bank:

**Diagram 1: The Structure of the Botswana Financial System/Sector**




*Includes two offshore commercial banks

**Table 1: Commercial Banks' Distribution Channels: 2010 – 2012**

| | Branches and Sub-Branches | | | ATMs | | |
|---|---|---|---|---|---|---|
| Bank* | 2010 | 2011 | 2012 | 2010 | 2011 | 2012 |
| Barclays | 40 | 40 | 40 | 99 | 103 | 104 |
| Stanchart | 13 | 14 | 15 | 46 | 54 | 57 |
| FNBB | 18 | 19 | 21 | 201 | 157 | 159** |
| Stanbic | 9 | 9 | 11 | 18 | 18 | 25 |
| Baroda | 2 | 2 | 2 | 3 | 4 | 4 |
| BancABC | 3 | 4 | 6 | 0 | 4 | 7 |
| BG | 5 | 5 | 6 | 12 | 15 | 19 |
| Capital | 2 | 2 | 4 | 2 | 2 | 4 |
| **Total** | **93** | **95** | **105** | **381** | **357** | **379** |

* Excludes two off-shore banks, and two commercial banks, namely ABN AMRO (Botswana) OBU Limited and Kingdom Bank Africa Limited; ABN AMRO (Botswana) Limited (domestic bank); Bank of India (Botswana) Limited and State Bank of India (Botswana) Limited, which have not yet commenced operations.

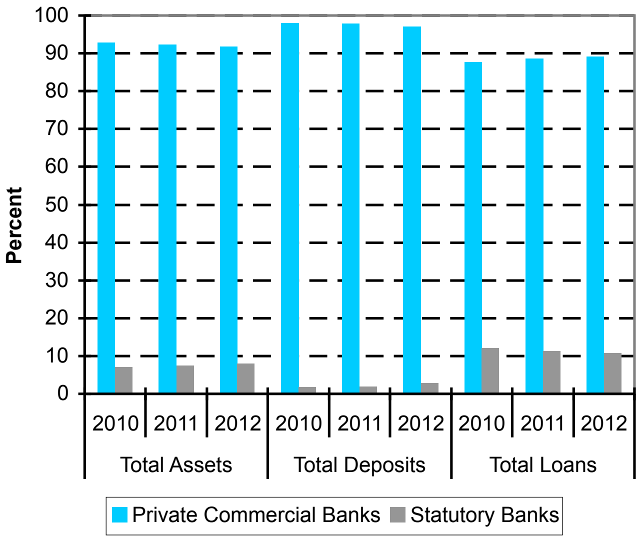
** Of the 159 ATMs, 132 are full ATMs and 27 are mini-ATMs. A mini-ATM is similar to a normal one, except that in place of cash, the machine issues a voucher redeemable for cash in the store where it is purchased.

## Market Share

Commercial banks maintained their dominance of market share as measured by total assets, total loans and advances and total deposits. In addition, there was an improvement in statutory banks'[2] share of banking sector assets and deposits, which accounted for 8.09 percent and 2.94 percent, compared to 7.61 percent and 1.99 percent in 2011, respectively. The statutory banks' share of loans and advances has been declining in the past three years (Chart 1(a)), a trend which may suggest inability to effectively compete against privately owned banks.

Although the four large banks[3] continued to dominate the private commercial bank market share in the past three years, the smaller banks[4] have maintained an upward trend in market share of the industry total assets, total loans and advances, and total deposits, which stood at 19 percent, 19 percent and 20 percent, respectively (Chart 1(b)). This has resulted in the market share of "the four" large private commercial banks declining in the past three years; this is a welcome development signalling increased competition between small and big banks. Within the smaller bank segment, two banks contributed significantly more to the 19 percent and 20 percent total market share of loans and deposits, respectively.

**Chart 1 (a): Banking Industry Market Share of Total Assets, Total Deposits and Total Advances**




## Competition

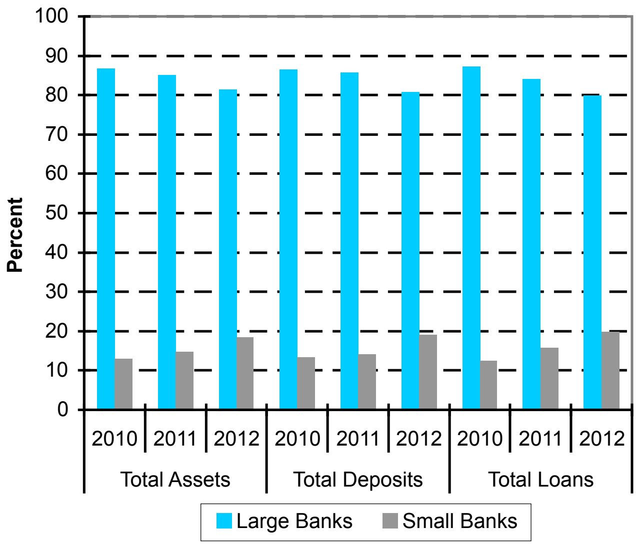
Increased competition in the banking sector is desirable as it is expected to spur institutional efficiency, innovation and superior service delivery. The Herfindahl-Hirschman Index (HHI) measures the degree of competition in an industry, and it takes into account the relative size and distribution of firms in a market. The measure approaches zero when a market consists of a large number of firms of relatively equal size. In 2012, the HHI for the banking sector trended upwards to 0.22

2 Statutory banks are National Development Bank, Botswana Savings Bank and Botswana Building Society.

3 A large bank, in this case, is a bank with total assets that constitute 10 percent or more of the aggregate sector's Statement of Financial Position. These large banks are Barclays Bank of Botswana Limited, First National Bank of Botswana Limited, Stanbic Bank Botswana Limited and Standard Chartered Bank Botswana Limited.

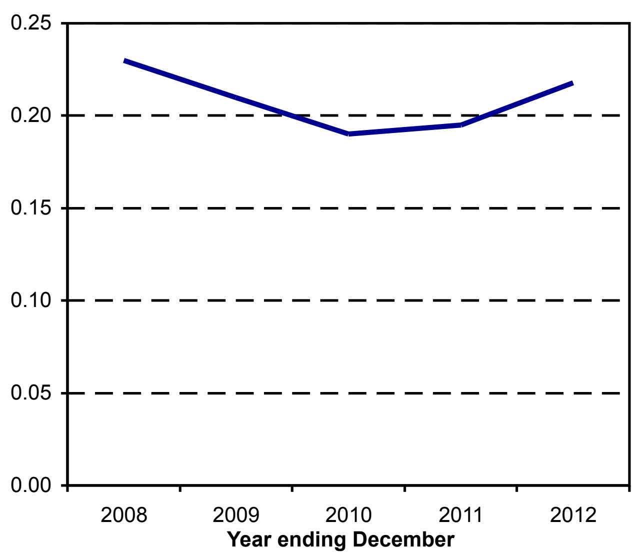
4 A smaller bank is a bank whose total assets constitute less than 10 percent of the aggregate sector's Statement of Financial Position. The smaller banks are Bank of Baroda Limited, African Banking Corporation of Botswana Limited, Bank Gaborone Limited and Capital Bank Limited.

**Chart 1 (b): Private Banks Market Share of Total Assets, Total Deposits and Total Advances**




compared to 0.19 recorded in 2011. The HHI has been on an upward trajectory since 2010, in line with this observation. Notwithstanding the foregoing, the four largest banks still dominated in terms of market share, and the result is an imperfect oligopolistic competitive market structure, similar to banking structures in many emerging market economies and some developed economies.

**Chart 2: Herfindahl-Hirschman Index (HHI)**




## Financial Deepening and Development

In the period under review, financial deepening indicators displayed an upward trend, in line with the economic recovery. The broad measure of money supply, M2[5] to GDP ratio, which is a measure of money supply relative to the size of the economy, increased to 67 percent in 2012 (63 percent in 2011), due to marginal growth rates of M2 and GDP, at 9 percent and 3.7 percent, respectively. The ratio of Cash to M2 (measure of liquidity preference) increased to 22 percent (19 percent in 2011); this implies that the public increased their preference for holding cash possibly due to low interest rates offered by banks for deposits. The Private Sector Credit to GDP ratio, which is a measure of the quantum of credit to the private sector and banking depth, increased during the year, this is a sign of improved intermediation by banks. Banking Assets, Banking Deposits and Banking Sector Credit to GDP ratios, which are indicators of banking industry development and a measure of access to finance, displayed an upward trend. All these developments suggest that there was an improvement in financial sector effectiveness and access to finance in the banking industry. Comparison with 2011 shows that the ratios are increasing and signals a level of confidence by the public in the financial system and enhanced financial sector depth (Chart 3 overleaf).

## Licensing of New Banks and Enquiries on Banking Licence Procedures

The Bank received enquiries from potential investors to establish banking business in Botswana. Following these enquiries, two banks were licensed in 2012. However, one application for a banking licence was turned down as it was found to be materially deficient. As at year-end 2012, three applications for banking licences were at various stages of processing.

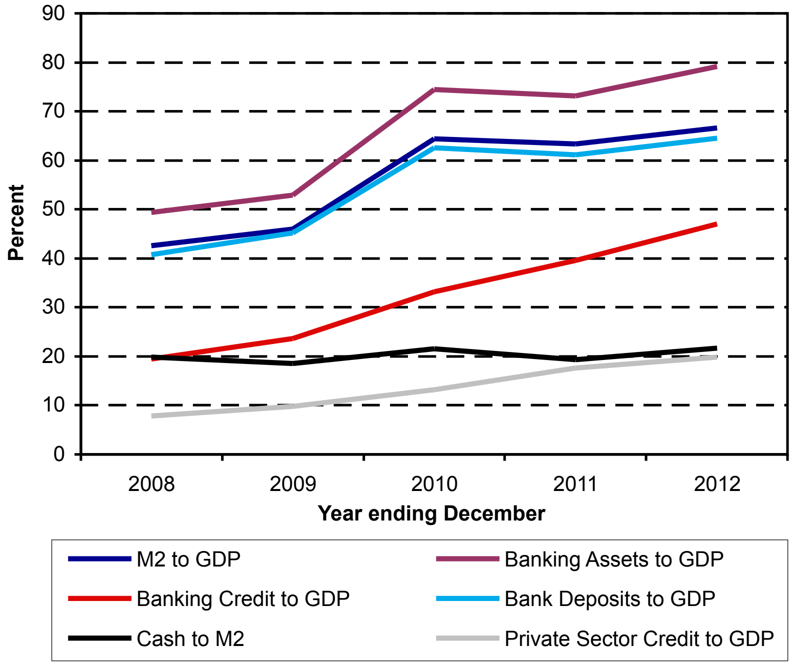
## Employment

The staff complement of the banking industry increased slightly by 3.4 percent (5 percent in 2011) to 4477[6] at the end of 2012. The lower growth rate was affected mainly by the decline in employment levels of Kingdom Bank Africa Limited (KBAL) and Barclays Bank of Botswana Limited (Barclays) by 32.1 percent and 13.4

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

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

**Chart 3: Financial Sector Deepening**




Source: Botswana Financial Statistics and the December 2012 Statutory Returns.

percent, respectively. However, the employment data was bolstered by BancABC, whose staff increased from 132 in 2011 to 302 in 2012 (128.8 percent) due to the commencement of retail banking operations; followed by Capital Bank Limited (CBL) at 54.9 percent (from 73 in 2011 to 113 in 2012) as a result of its branch network expansion. There was marginal employment data change at other banks.

**Table 2: Employment Levels for Commercial Banks: 2011 – 2012**

| | 2011 | | | 2012 | | |
|---|---|---|---|---|---|---|
| **Bank*** | **Citizens** | **Expatriates** | **Total** | **Citizens** | **Expatriates** | **Total** |
| **Barclays** | 1 374 | 9 | 1 383 | 1 190 | 8 | 1 198 |
| **Stanchart** | 758 | 16 | 774 | 885 | 15 | 900 |
| **FNBB** | 1 060 | 13 | 1 073 | 1 071 | 10 | 1 081 |
| **Stanbic** | 556 | 6 | 562 | 563 | 13 | 576 |
| **Baroda** | 24 | 10 | 34 | 24 | 11 | 35 |
| **BancABC** | 125 | 7 | 132 | 294 | 8 | 302 |
| **BG** | 229 | 8 | 237 | 210 | 8 | 218 |
| **CBL** | 69 | 4 | 73 | 106 | 7 | 113 |
| **KBAL** | 19 | 9 | 28 | 11 | 8 | 19 |
| **ABN AMRO**** | 2 | 2 | 4 | 2 | 3 | 5 |
| Total | 4 216 | 84 | 4 300 | 4 356 | 91 | 4 447 |

* Excludes Bank of India (Botswana) Limited and State Bank of India (Botswana), which have not yet commenced operation.

** Includes the off-shore bank

**Box 1: The Importance of Cooperation by Global Supervisory Authorities as a Mechanism of Ensuring Global Financial Sector Safety and Soundness**

## Introduction

The recent global financial crisis has demonstrated that it is no longer only about the "too big to fail" institutions, but rather more about the interconnectedness of financial institutions, markets and financial systems. In addressing the crisis, supervisory authorities underestimated the probability and costs of systemic risk, and failed at the international level to cooperate to prevent and contain the transmission and impact of the crisis. There were also no clear procedures for the resolution of global financial institutions, at national, regional and international levels. This brought to the fore the importance of cooperation by global supervisory authorities to promote financial safety and soundness.

The regulatory responses to the global financial crisis differed from country to country but converged on a broad set of principles aimed at minimising future vulnerabilities to future crises. At sovereign levels, the immediate responses included, inter-alia, government bailout and/or recapitalisation of struggling financial institutions, fiscal stimulus packages and regulatory reforms. It is in this respect that there were bailouts of both Northern Rock in the United Kingdom and AIG in the United States of America; fiscal stimulus in the form of an increase in public spending to boost economic activity; regulatory pronouncements in the form of Basel III and consolidated supervision; and increased focus on the regulation and supervision of Global Systemically Important Financial Institutions (G-SIFIs) and the shadow banking sector.

## Financial Integration and Interconnectedness

One of the lessons of the crisis was that the world economy will increasingly continue to be integrated across boundaries through trade, financial and other channels; thus indicating that a crisis in any systemically important country will have global effects. With the intensification of financial integration, cross-border gross positions have vastly increased due to capital account openness and financial market reforms. Foreign intermediaries in several banking systems (including in many emerging markets) have also increased. This has resulted in increases in international risk sharing, competition and efficiency, as well as the risk of transmitting financial shocks across borders. The increase in interconnectedness of financial institutions, markets and more highly correlated financial risks also increased cross-border spillovers through many channels, including liquidity pressures, global sell-off in equities (particularly financial stocks) and depletion of bank capital.

## Importance of Cooperation by Global Supervisory Authorities

Given the integration and interconnectedness of markets, it is apparent that countries cannot deal with large, complex and globally active financial institutions on their own. It is important, therefore, that global supervisory authorities should cooperate to come up with better cross-border crisis management arrangements and a more universal approach to the regulation and supervision of these institutions. Improved crisis management will require better international liquidity provision to both financial institutions and countries, to prevent spillovers from becoming solvency issues. This would help to adequately address market disruptions as they arise, and forestall policy measures that have adverse spillovers.

Global supervisors should be able to share all the necessary information to assess systemic risks to the macro-economy and the payments system, and assess counterparty risks for monetary and emergency liquidity operations. They should also have access to information on events in payments and settlement systems or in liquidity provision, which are necessary for their role in monitoring systemic risk.

Supervisory authorities also need to have clear mandates and tools (especially in the area of ensuring financial safety and soundness), sufficient resources, close communication and a flow of information among all parties responsible for oversight and financial crisis management, including central banks and finance ministries. International cooperation in prudential supervision could be further enhanced through Memoranda of Understanding and by introducing provisions in central bank and banking supervision laws that effectively authorise cross-border cooperation and exchange of information.

## Regulatory and Supervisory Standards on International Cooperation and Information Exchange

Following the special meeting held in November 2008 in Washington DC on the global financial crisis, the G-20 under its Declaration of the Summit on Financial Markets and the World Economy, identified the causes of the global financial crisis succinctly as follows: “During a period of strong global growth, growing capital flows, and prolonged stability earlier this decade, market participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system. Policy-makers, regulators and supervisors in some advanced countries, did not adequately appreciate and address the risks building up in financial markets, keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions. Major underlying factors to the current situation were, among others, inconsistent and insufficiently coordinated macro-economic policies, inadequate structural reforms, which led to unsustainable global macro-economic outcomes. These developments, together, contributed to excesses and ultimately resulted in severe market disruption”.

This was an acknowledgement by the G-20 that a global response to the crisis was critical. Consequently, the global regulatory fraternity, which includes institutions such as the Basel Committee on Banking Supervision (BCBS), Financial Stability Board (FSB), International Organisation of Securities Commissions (IOSCO), Committee on Payments and Settlement Systems (CPSS) and International Association of Insurance Supervisors (IAIS), elevated their level of cooperation in order to have a global perspective on the risks permeating the crisis. This cooperation among the institutions aims to encourage adherence by all countries and jurisdictions to financial regulatory and supervisory standards on international cooperation and information exchange in the areas of banking supervision, insurance supervision, payments and settlements and securities regulation, to ensure global financial safety and soundness. It was for this reason that the International Monetary Fund, World Bank and Board of Governors of the Federal Reserve System co-sponsored the 12th Annual Seminar for Policy Challenges for the Financial Sector, held on June 6 - 8, 2012 in Washington DC, under the theme, Raising the Bar: Implementing Higher Standards for the Financial Sector. The global regulatory fraternity was represented at the seminar, where the mandates of each regulator were discussed and how the level of cooperation between the regulators could be enhanced, as a mechanism of preventing a recurrence of the crisis.

The BCBS, whose objective is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide, provides a forum for regular cooperation on banking supervisory matters. The IAIS promotes effective and globally consistent supervision of the insurance industry to develop and maintain fair, safe and stable insurance markets for the benefit and protection of policyholders. IOSCO regulates the world securities and futures markets, by assisting its members to cooperate and promote high standards of regulation. CPSS, on the other hand, contributes to strengthening the financial market infrastructure through promoting sound and efficient payment, clearing and settlement systems, and serves as a forum for central banks to monitor and analyse developments in the domestic payment, clearing and settlement systems, as well as in cross-border and multi-currency settlement schemes.

## Conclusion

Weaknesses in international cooperation and information exchange can undermine the efforts of regulatory and supervisory authorities aimed at ensuring that the global operations of financial institutions are adequately supervised. Cooperation and information exchange among financial supervisors and regulators are, therefore, essential for global financial sector safety and soundness given the backdrop of the integrated world economy and financial systems. Following the crisis, world leaders have realised and acted on ensuring that national, regional and continental financial institutions and markets are regulated and supervised on a consolidated basis. It is for this reason that prominence is being given to regulation and supervision of not only G-SIFIs, the Global Systemically Important Non-Bank Financial Institutions (shadow banking) as well. The emerging consensus, post the crisis, is that the response to the crisis has to be a global one; and this has been reflected in the heightened level of cooperation and information exchange between global regulators across countries and financial systems. The efforts of the FSB, BCBS, CPSS, IAIS and IOSCO in entrenching cooperation and information exchange is viewed as an important arrangement that can ensure financial system safety and soundness, and forestall a recurrence of the crisis.

Given the increasing number of financial institutions now active in two or more countries or continents, Botswana needs to develop a regulatory regime that fits better into the global financial architecture; examine whether there are regulatory gaps in financial supervision; and strengthen global-level cooperation. It will be necessary to check for regulatory loopholes in banking oversight, and to work closely with authorities of home countries to share information.

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# Chapter 2: Operational Performance of the Banking Industry

## Composition of the Statement of Financial Position (Balance Sheet)

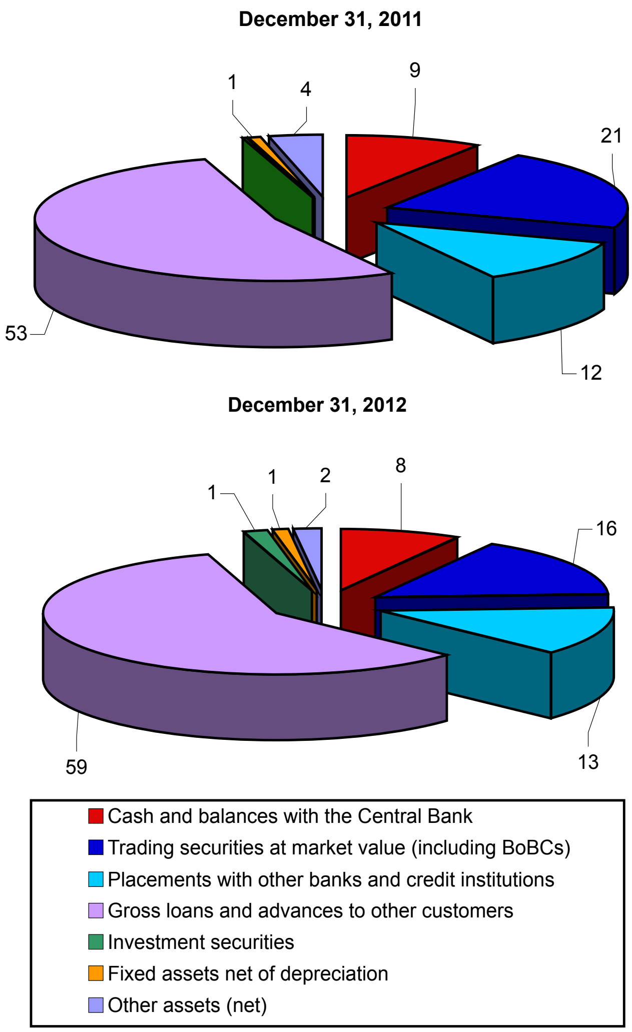
The financial performance of the banking sector improved significantly in 2012. The statement of financial position increased by 12.3 percent, to P58 billion; this compares with the 4.1 percent growth rate of 2011. The 2012 growth rate was mainly due to the increase in deposits and shareholders' funds, which was partly used to fund the 23.2 percent growth in loans and advances. Nevertheless, market value of trading securities (including BoBCs), declined by 15.9 percent to reach a six-year low of P9.3 billion, compared to P11.1 billion in 2011. The fall was explained by the reduction in BoBC holdings by banks. Funds previously held in BoBCs were used to finance additional lending and, to a lesser extent, placements with other banks and other credit institutions.

Counterparty confidence in the banking sector has continued to strengthen, as shown by the increase in inter-bank deposits and other credit institutions, which rose by 19.7 percent in 2012, a much faster growth rate compared to 7.1 percent in 2011. Cash and balances with the central bank increased moderately by 3.9 percent, which is a much lower increase compared to 45.8 percent in the previous year, when banks had to comply with a higher primary reserve requirement of 10 percent.

In 2012, credit growth was lower than in 2011, as total loans and advances grew by 23.2 percent (26.4 percent in 2011) to P34.4 billion. The slower growth rate in credit in 2012 was due the tightening of underwriting standards by banks, as well as base effects. The faster growth rate in loans and advances of 23.2 percent, compared to the growth of customer deposits (9.4 percent), raised the intermediation ratio to 72.9 percent from 64.7 percent in 2011. Inversely, the industry liquid asset ratio declined from 24.4 percent in 2011 to 20.5 percent in 2012.

Total customer deposits grew by 9.4 percent from P43.2 billion in 2011 to P47.2 billion in 2012. The growth rate reflected the impact of new products and improved service delivery through the use of electronic and cell-phone banking (where customers can conduct banking through cell phones and computers), additional ATMs and opening of new branches, as well increases in income. Although deposits, as a component of total liabilities, declined in 2012 to 81.5 percent, deposits continued to be the banks' main liability item, and primarily financed banking sector assets. Charts 4 and 5 below show the composition of assets and liabilities between 2011 and 2012, while Chart 6 shows the growth rates of loans and advances, total assets and total deposits.

### Chart 4: Composition of Assets: 2011 – 2012 (Percent)




Note: Investment securities were insignificant in 2011.

**Chart 5: Composition of Liabilities: 2011 – 2012 (Percent)**

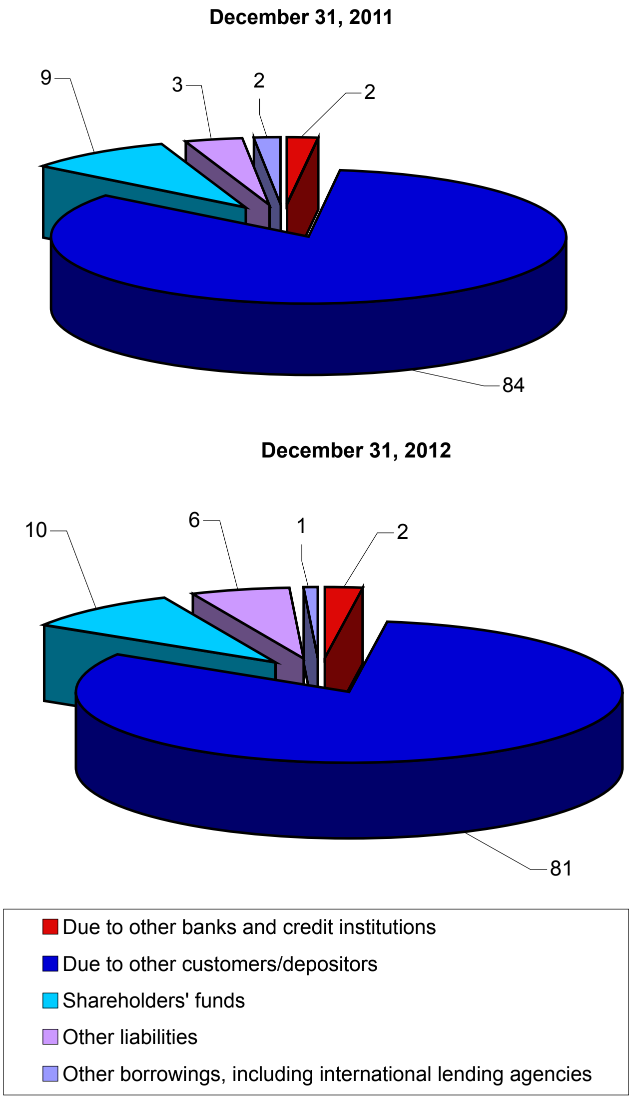
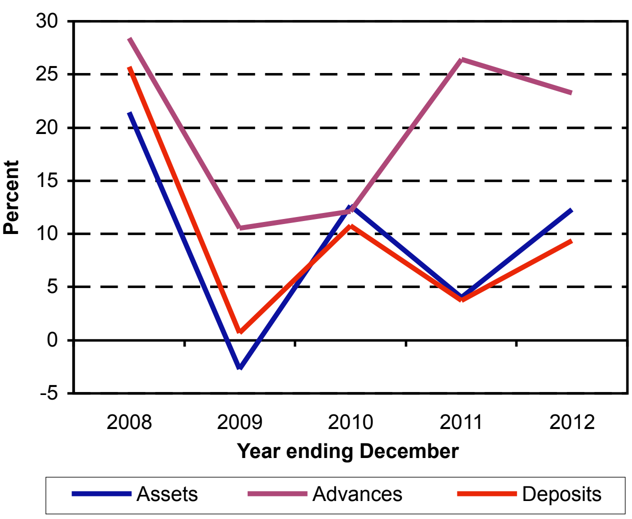
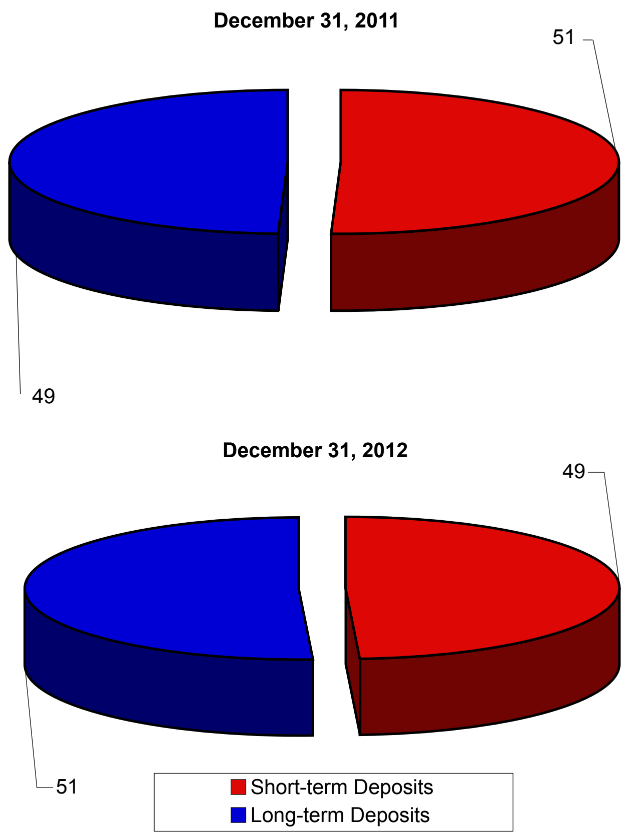



**Chart 6: Growth Rates of Deposits, Assets and Loans and Advances**




The composition of deposits by maturity shifted towards the longer term in 2012. During the year under review, the proportion of short-term deposits (call and current) and long-term deposits (time and savings) were 49.3 percent and 50.7 percent, respectively, which was a reversal of the 50.6 percent and 49 percent composition in 2011 (Chart 7). The selective preference for longer-term deposits could be due to efforts to address maturity mismatches between sources of funds and their uses. Current and savings deposits rose marginally from P7.1 billion and P3.1 billion to P7.7 billion and P3.3 billion, respectively, whereas time and call deposits fell to P17.2 billion and P12.3 billion, respectively (Chart 8).

**Chart 7: Deposits by Type (Percent)**




Deposits continued to be largely Pula denominated in 2012, and constituted 85.6 percent of total deposits. This was an increase over the 84.4 percent of 2011 (Chart 9). Pula denominated deposits rose by 10.1 percent, from P36.7 billion in 2011 to P40.4 billion in 2012, with an increase of 14 percent in the number of accounts compared to 10 percent a year earlier. Foreign currency deposits, as a percentage of total deposits, declined marginally from 15.6 percent recorded in 2011 to 14.4 percent in 2012.

**Chart 8: Deposit Accounts by Type**

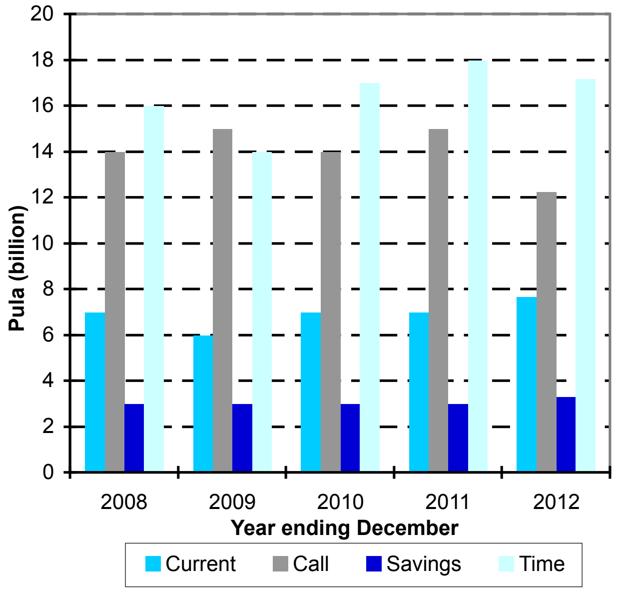
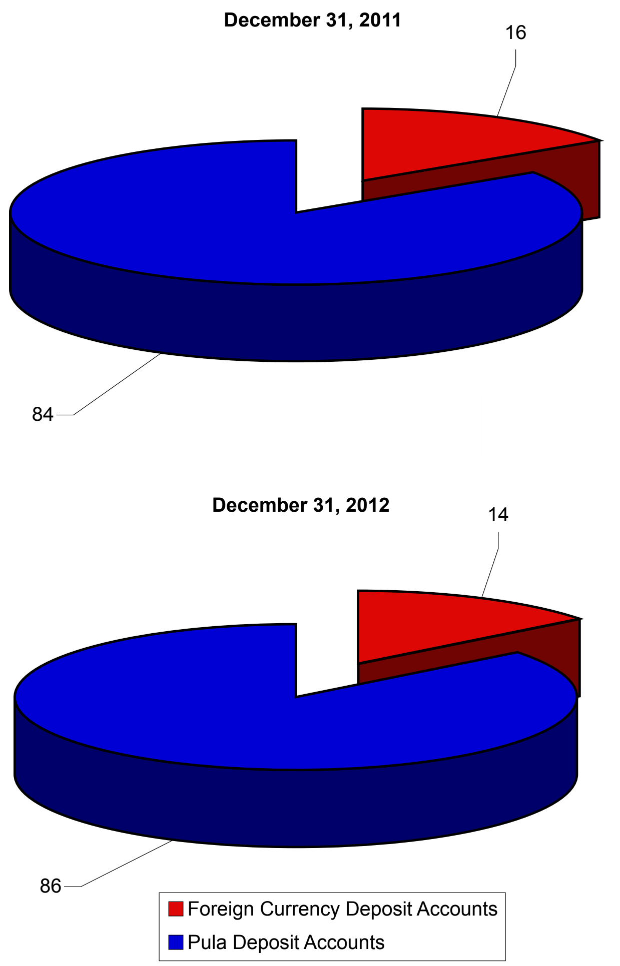
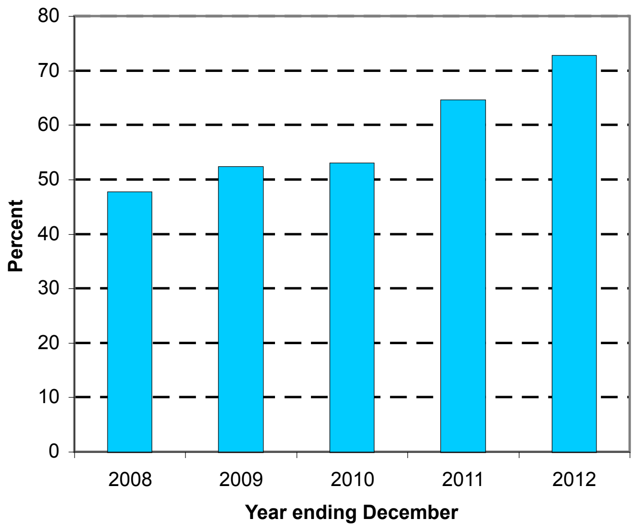



**Chart 9: Foreign Currency and Pula Denominated Deposits (Percent)**




The financial intermediation ratio maintained a five-year upward trend, with a higher ratio of 72.9 percent in 2012, than the 64.7 percent in 2011, thus reflecting a faster growth rate in loans and advances (23.2 percent) compared to a slower growth rate in customer deposits of 9.4 percent (Chart 10). The share of lending to the household sector was 60.2 percent of total loans and advances, which is an increase on 53.4 percent registered in 2011. The increase in household lending was influenced mainly by one bank's aggressive business model, which resulted in its loans and advances increasing by 105 percent as it entered the retail banking space. The share of lending to the private business sector declined from 43 percent in 2011 to 35.9 percent of total loans and advances, which could be attributed to the slower growth of the economy as well as the repayment of loans by parastatal organisations. The share of lending to the public sector was only 4 percent.

**Chart 10: Industry Advances to Deposit Ratio (Financial Intermediation Ratio)**

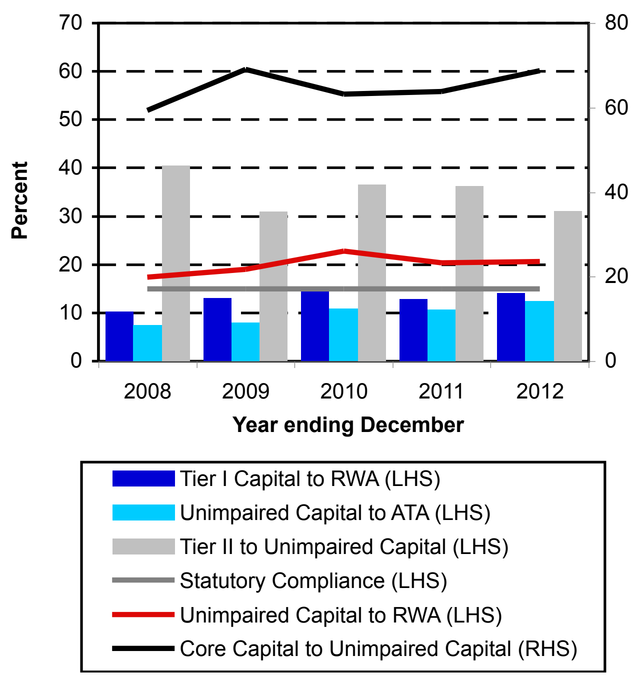



## Capital Adequacy (Solvency): Levels, Quality and Trends

Banks were adequately capitalised, with solvency ratios well in excess of the minimum statutory and prudential requirements. The total unimpaired capital increased by 26.1 percent, from P5.4 billion in 2011 to P6.8 billion in 2012, mainly due to additional capital injection of P38.8 million, P58 million and P30 million by three banks. Other contributors to the growth are the increase in general reserves and subordinated term debt at 32 percent and 44 percent, respectively. Consequently, overall banking system core capital rose by 36.1 percent from P3.5 billion in 2011 to P4.7 billion in 2012.

The capital elements were satisfactory in 2012, as reflected by the industry Capital Adequacy Ratio (CAR) of 20.6 percent; this compared to 20.4 percent recorded in 2011. The Core Capital to Risk-Weighted Assets ratio was 14.2 percent (13 percent in 2011) and Unimpaired Capital to Average Total Assets (ATA) ratio was 12.5 percent (10.7 percent in 2011) (Chart 11). The Core Capital to Unimpaired Capital ratio remained above the prescribed 50 percent threshold, at 68.8 percent in 2012 (63.7 percent in 2011). The higher ratio was attributable to the 37.2 percent increase in core capital, compared to the lower growth rate of 26 percent in unimpaired capital.

**Chart 11: Capital Adequacy Ratios**

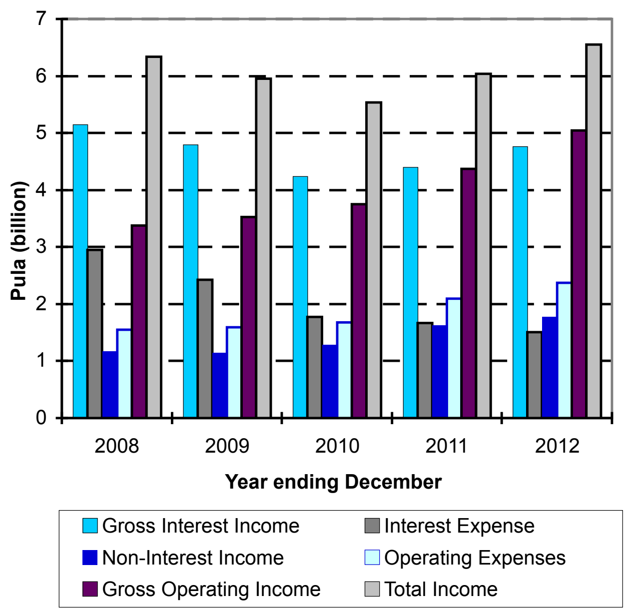



# Earnings and Profitability

## Composition of Income and Expenses

The banking industry total income (interest income and non-interest income) rose by 8.4 percent in 2012, from P6 billion in 2011 to P6.5 billion. The slower income growth was explained by the 14.3 percent decline in interest income from loans and advances, and the 54.5 percent decrease in interest earned on BoBCs. The major income source was interest from loans and advances (households), which accounted for 61.5 percent, followed by interest on lending to private business enterprises (20.3 percent). Interest income, as a proportion of total income, remained unchanged at 72.8 percent. Interest expenses maintained the three-year downward trend since 2009, and fell by 9.6 percent during the year. The decrease in interest expenses occurred on the backdrop of relatively low deposit rates in the country. On the other hand, non-interest income increased from P1.6 billion in 2011 to P1.8 billion in 2012. This reflected increased bank charges and related fees brought about by technological developments in the provision of banking services and products, which has compelled banks to recover the cost of the IT infrastructure. Chart 12 shows the trends and composition of income and expenses for the banking industry.

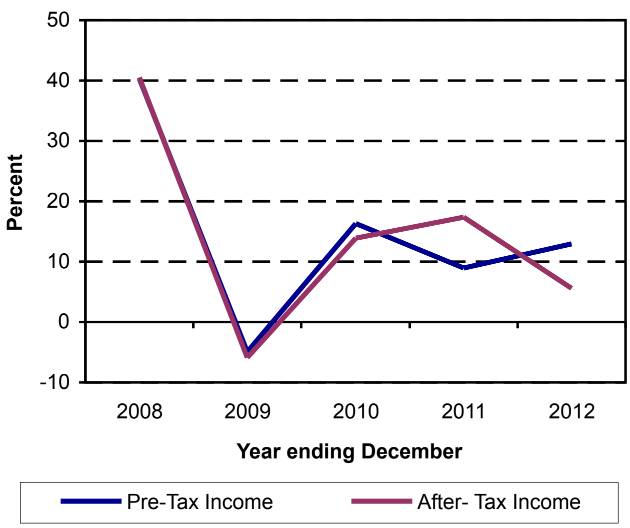
**Chart 12: Composition of Income and Expenses**




## Levels and Trends of Profitability

Profitability of the banking industry improved in 2012, as pre-tax profits increased by 12.9 percent (9 percent in 2011) to P2.2 billion in 2012 (Chart 13). Growth in profits was attributed to the 9.6 percent decline in interest expenses and the much slower growth rate of 13.2 percent in operating expenses, compared to 24.7 percent in the previous year. Rental costs were a major contributor to the increase in operating costs, in the view of the 63.4 percent growth to P137 million; this was the result of the increase in the number of bank branches, some of which are located in high priced prime areas. After-tax profits grew at a slower rate of 5.5 percent compared to 17.4 percent in 2011.

**CHART 13: GROWTH RATES OF PROFIT BEFORE AND AFTER-TAX**

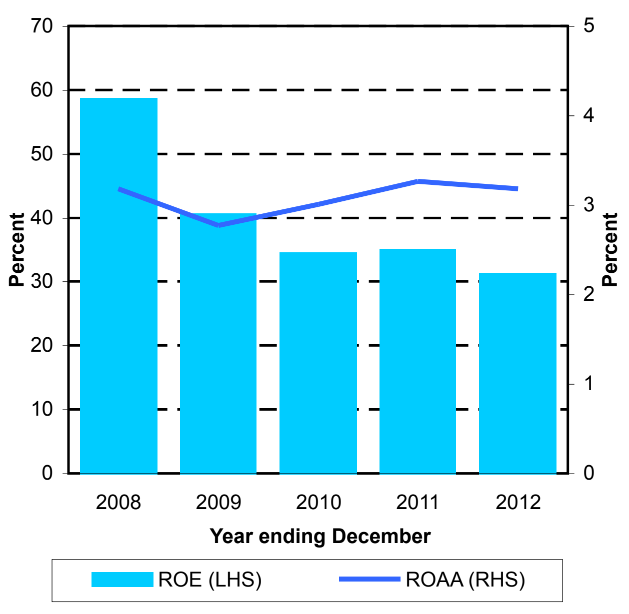



## Profitability Indicators

Key profitability indicators experienced a downward trend in the year under review. Return on Equity (ROE) declined from 35.2 percent in 2011 to 31.4 percent in 2012 and Return on Average Assets (ROAA) marginally declined from 3.3 percent in 2011 to 3.2 percent in 2012 (Chart 14). The decline in ROE was as a result of a growth rate of 18.1 percent (15.4 percent in 2011) in total equity, compared to a marginal increase of 5.5 percent in net income after-tax.

Net Interest Income to ATA ratio increased slightly from 5.4 percent in 2011 to 6 percent, thus reflecting improved efficiency in the employment of banks' assets

**CHART 14: PROFITABILITY INDICATORS**




to generate income. The Non-interest Income to Total Income ratio was virtually unchanged at 27.2 percent in 2012, due to slower growth rates in both non-interest income and total income at 9.2 percent (26.6 percent in 2011) and 8.4 percent (9.1 percent in 2011), respectively (Table 3 overleaf). The Earnings Retention ratio, which indicates the percentage of a company's earnings not paid out as dividends, but redeployed in the business (retained earnings), increased from 48 percent in 2011 to 83.5 percent in 2012. A higher ratio indicates retention of a significant portion of income, as part of capital augmentation and/or ploughed back into banks' operations to fund growth opportunities.

## Operating Efficiency Indicators

The overall industry operating efficiency and competitiveness continued to deteriorate for a third consecutive year, as reflected by the decline in the net spread, from 8.3 percent in 2011 to 4.9 percent in 2012. The deterioration in the net spread was largely a reflection of the sustained low interest rates in the banking sector, on the backdrop of the faster decline in interest on loans and advances, compared to a slower decline in interest paid on deposits. Net interest margin grew by 8.3 percent in 2012, compared to 7.2 percent in 2011, largely due to the 18.9 percent increase in net interest income for 2012. Net interest margin shows how well a bank is earning income on its assets, as a high net interest income and margin indicates a well-managed bank and also indicates future profitability. The marginal drop in the Cost to Income ratio from 47.9 percent to 47 percent in 2012 was attributable to cost control measures implemented by some banks in response to lower margins.

The Net Income to Employee Costs ratio maintained a declining trend in 2012, dropping from P168.7 million in 2011 to P152.6 million due to an increase in staff costs necessitated by additional staff recruitment and development by some banks, while others increased salaries to match market pay levels as part of a staff retention strategy (Table 4 overleaf).

# ANALYSIS OF RISK CATEGORIES

## Credit Risk

### Asset Quality: Levels and Trends

Past due loans declined by 8.1 percent, which is a

### Table 3: Other Performance Ratios (Percent)

| | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| **Ratio** | | | | | |
| Trading Income to Total Income | 5.9 | 28.3 | 13.5 | 15.5 | 7.3 |
| Non-Interest Income to Total Income | 18.6 | 19.4 | 23.3 | 27.0 | 27.2 |
| Return on Equity (ROE) | 58.8 | 40.7 | 34.6 | 35.2 | 31.4 |
| Return on Average Assets | 3.2 | 2.8 | 3.0 | 3.3 | 3.2 |
| Net Interest Income to Average Total Assets | 5.3 | 5.3 | 5.3 | 5.4 | 6.0 |
| Interest Income to Average Earnings Assets | 16.0 | 13.6 | 11.2 | 11.5 | 12.1 |
| Non-Interest Income to Average Total Assets | 2.9 | 2.6 | 2.8 | 3.2 | 3.3 |
| Interest Expense to Average Total Assets | 7.2 | 5.4 | 3.8 | 3.3 | 2.7 |
| Earnings Retention | 42.0 | 61.2 | 57.1 | 48.0 | 83.5 |
| Interest Income on Loans and Advances to Average Total Assets | 12.5 | 10.7 | 9.1 | 8.7 | 8.7 |

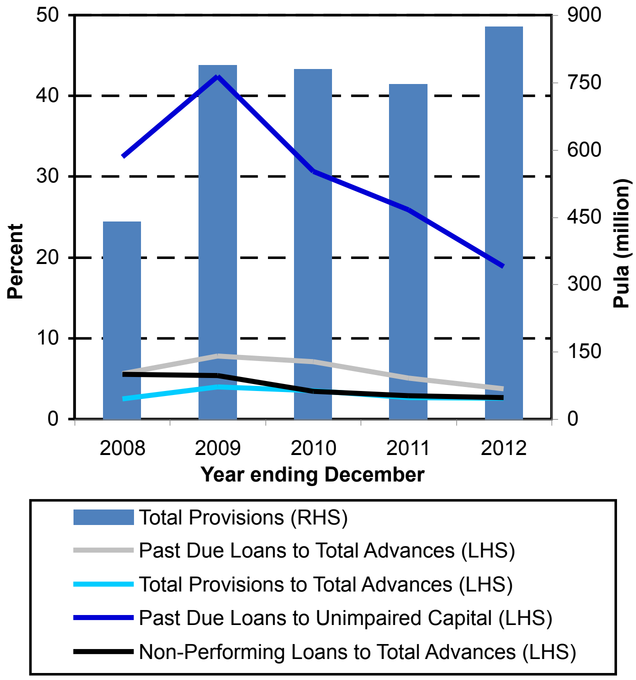
### Table 4: Banking Industry Efficiency Measures (Percent)

| Measure | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| Average Cost of Deposits | 6.1 | 5.0 | 3.5 | 3.4 | 2.9 |
| Return on Loans and Advances | 19.1 | 7.7 | 13.9 | 13.4 | 9.2 |
| Net Interest Margin | 6.8 | 6.7 | 6.5 | 7.2 | 8.3 |
| Net Spread | 10.4 | 11.3 | 9.6 | 8.3 | 4.9 |
| Cost to Income | 45.6 | 45.2 | 44.8 | 47.9 | 47.0 |
| Net Income to Employee Costs (P'000) | 195.1 | 184.2 | 178.1 | 168.7 | 152.6 |
| Net Income Per Employee (P'000) | 342.3 | 313.3 | 346.9 | 387.0 | 398.2 |
| Staff Cost Per Employee (P'000) | 175.5 | 170.1 | 194.8 | 229.4 | 260.9 |
| Asset Per Employee (P'000) | 11 793 | 11 162 | 12 226 | 12 090 | 13 238 |

slower rate than the 10.5 percent decline in the previous year (P1.4 billion in 2011 to P1.3 billion in 2012). The decline in past due loans was a result of recoveries and improvement in the credit appraisal monitoring standards by banks. During the year under review, Past Due Loans to Total Advances and Past Due Loans to Unimpaired Capital ratios fell to 3.7 percent (5 percent in 2011) and 18.9 percent (25.9 percent in 2011) (Chart 15), respectively. Consistent with past trends, the bulk of past due loans were highly concentrated in the household sector, which increased from 60.1 percent in 2011 to 69.4 percent of the industry total past due loans.

Non-Performing Loans (NPLs) increased by 10.8 percent from P813.4 million in 2011 to P901.4 million in 2012. The proportion of non-performing loans to total loans and advances declined from 2.9 percent in 2011 to 2.6 percent. Provisions for bad and doubtful debts increased by 17 percent, to P0.87 billion (P0.74 billion in 2011) during the year; this was a prudent move by banks as they cater for potential and unexpected future asset quality problems.

### Chart 15: Asset Quality Measures



## Liquidity Risk

The funding structure of the banking sector remained largely unchanged in the five-year period to 2012. Customer deposits remained the main source of funding, albeit slightly declining as a proportion of total funding, from 83.7 percent to 81.5 percent in 2012. There was a notable increase in the share of shareholder funds and other liabilities as alternative sources of funding, which grew by 9.6 percent (9.1 percent in 2011) and 5.9 percent (3.5 percent in 2011), respectively. Other borrowings constituted the least preferred source of funding with a share of 0.7 percent; thus declining from 1.8 percent share recorded in 2011 (Table 5).

Deposits remained highly concentrated in private sector enterprises during the period under review, despite a drop in market share to 51.5 percent, compared to 57.9 percent in the prior year. It is notable, however, that the market share of private sector enterprises has been declining in the last two years. The market share of public sector enterprises in deposits remained unchanged at 22 percent (P7.1 billion), while the household sector recorded an increase in market share of deposits to 26 percent (P8.4 billion), compared to 20 percent in 2011 (Chart 16 overleaf).

The banking industry liquidity, which represents the banks' ability to fund increases in assets and meet obligations as they fall due, continued to fall in 2012. This is mainly reflected by a decline in the Liquid Assets to Deposits ratio (Chart 17 overleaf), which has been on a downward trajectory since 2008. The banking industry liquid assets, which have been declining for the past four years, declined by 8.2 percent to a five-year low of P9.7 billion in 2012. The Liquid Assets to Deposits ratio dropped to 20.5 percent from 24.4 percent in 2011, but remained well above the statutory requirement of 10 percent. The Liquid Assets to Total Assets ratio also dropped to 16.7 percent (20.5 percent in 2011). The decline in these ratios were due to the continued reduction of the portfolio holdings of BoBCs by banks, which has historically constituted a larger proportion of banks' liquid assets.

**Table 5: Banking Industry Funding Trends (P' million)**

| Category | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| **Deposits** | 37 239 | 37 590 | 41 628 | 43 178 | 47 219 |
| ***Growth Rate (Percent)*** | 25.7 | 0.7 | 10.7 | 3.7 | 9.4 |
| ***Share of Total Funding (Percent)*** | 82.5 | 85.4 | 83.9 | 83.7 | 81.5 |
| **Other Liabilities*** | 2 877 | 1 099 | 1 977 | 1 827 | 3 445 |
| ***Growth Rate (Percent)*** | (0.1) | (61.8) | 79.9 | (7.6) | 88.5 |
| ***Share of Total Funding (Percent)*** | 6.4 | 2.5 | 4.0 | 3.5 | 5.9 |
| **Share Capital** | 2 420 | 3 035 | 4 069 | 4 696 | 5 548 |
| ***Growth Rate (Percent)*** | 28.5 | 25.4 | 34.1 | 15.4 | 18.1 |
| ***Share of Total Funding (Percent)*** | 5.3 | 6.9 | 8.2 | 9.1 | 9.6 |
| **Owed to Government Institutions** | 0.0 | 0.0 | 0.0 | 20 | 0.0 |
| ***Growth Rate (percent)*** | (100.0) | 0.0 | 2.0 | 2.0 | 0.0 |
| ***Share of Total Funding (Percent)*** | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **Due to Other Banks** | 1 058 | 680 | 460 | 990 | 1 320 |
| ***Growth Rate (Percent)*** | (13.6) | (35.8) | (32.3) | 115.4 | 33.3 |
| ***Share of Total Funding (Percent)*** | 2.3 | 1.5 | 0.9 | 1.9 | 2.3 |
| **Other Borrowings** | 1 566 | 1 621 | 1 457 | 908 | 422 |
| ***Growth Rate (percent)*** | 5.7 | 3.5 | (10.1) | (37.7) | (53.5) |
| ***Share of Total Funding (Percent)*** | 3.5 | 3.7 | 2.9 | 1.8 | 0.7 |
| **Total Funding** | **45 251** | **44 023** | **49 590** | **51 600** | **57 954** |

*Includes: Taxes, dividends payable and accrued expenses

CHART 16: SECTORAL DISTRIBUTION OF DEPOSITS: 2011 – 2012 (PERCENT)

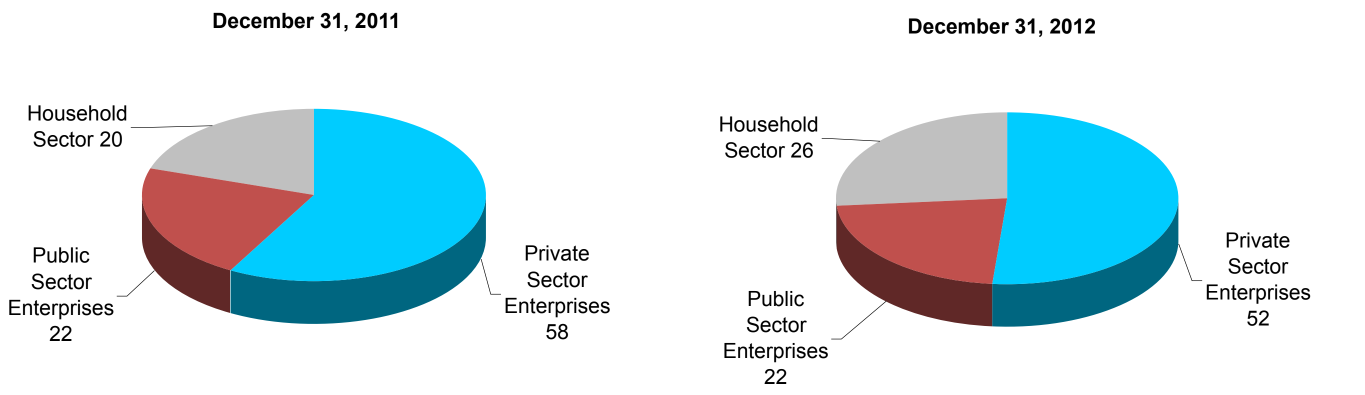



CHART 17: LIQUIDITY RATIOS

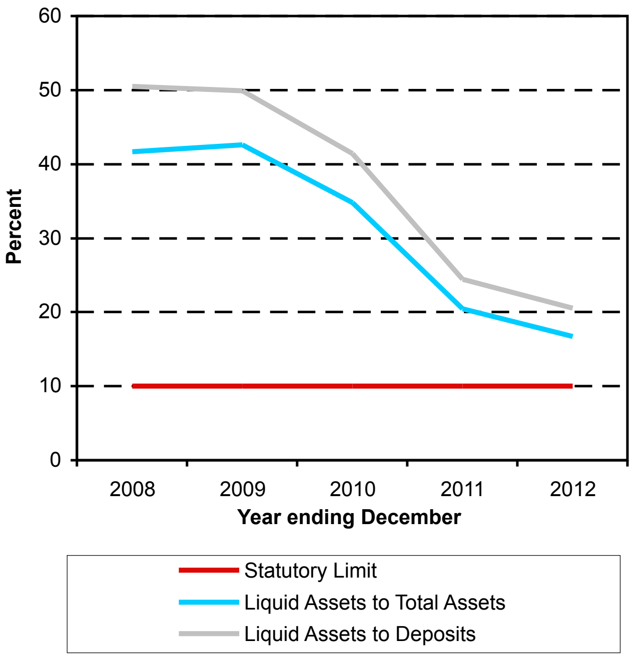
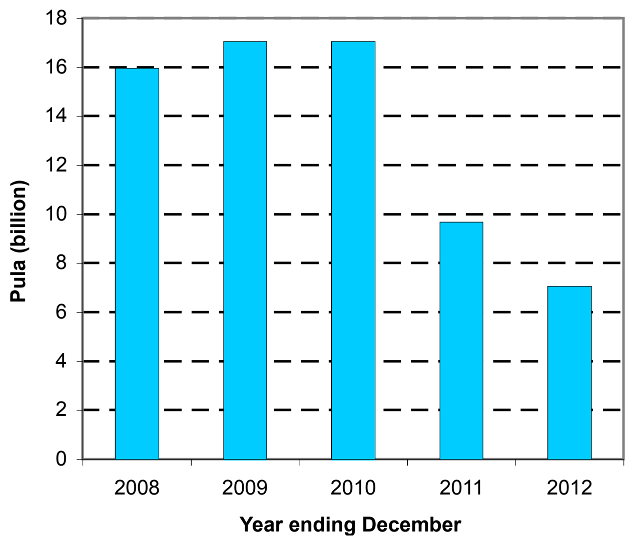



CHART 18: OUTSTANDING MARKET VALUE OF BoBCs HELD BY BANKS




As indicated in the preceding paragraph, BoBCs continued to account for 73 percent (91.7 percent in 2011) of the banking sector liquid assets, despite a decline of 30.7 percent (Chart 18) in 2012.

## Concentration Risk

### Sectoral Distribution of Loans and Advances

Chart 19 below shows the relative market share of loans and advances held by the public, private and household sectors. The household sector accounted for the largest proportion of banking industry loans and advances in 2012, at 60.2 percent compared to 53.4 percent in 2011. The share of loans and advances to the private sector business declined to 35.9 percent (43 percent in 2011); and the proportion of loans and advances to the public sector remained unchanged at 4 percent. The decline in the share of lending to the private sector business was due to the government exercising restraint in spending and focusing on national priority areas, as a precautionary measure to reduce fiscal deficits. Lending to the household sector grew by 30.9 percent to P19.6 billion in 2012 (P15 billion in 2011), which is a faster growth rate compared to the 16 percent increase in the previous year. This increase was mainly driven by the rapid increase of 105 percent in household loans by one bank in 2012, as the bank aggressively entered the retail banking segment.

All banks maintained Large Exposures to Unimpaired Capital ratios below the 800 percent prudential limit, as the banking industry ratio fell from 196.2 percent in 2011 to 155.5 percent in 2012 (Chart 20). The decline in the ratio was due to the faster growth of the banks' aggregate unimpaired capital, compared to the banking industry negative growth rate of large exposures.

**CHART 19: SECTORAL DISTRIBUTION OF ADVANCES: 2011 – 2012 (PERCENT)**

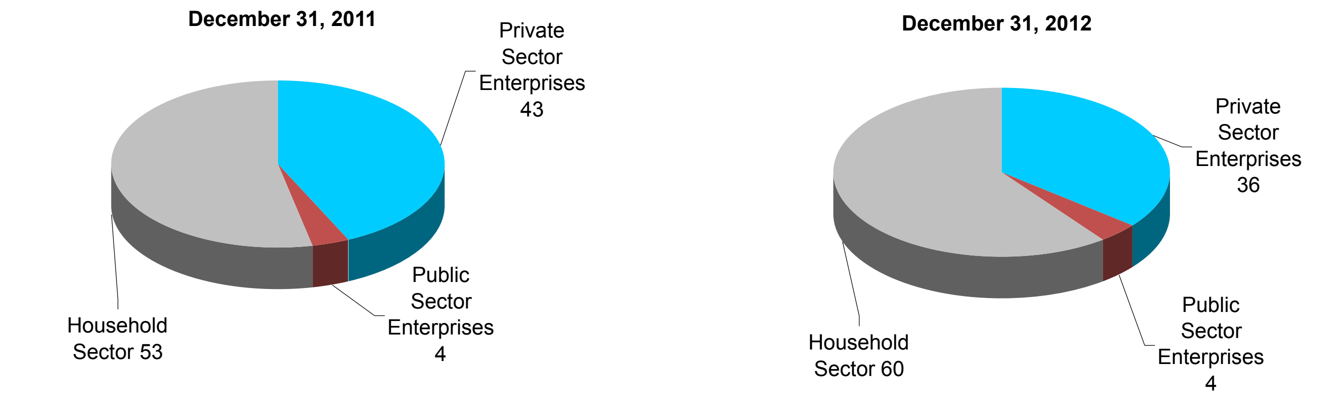
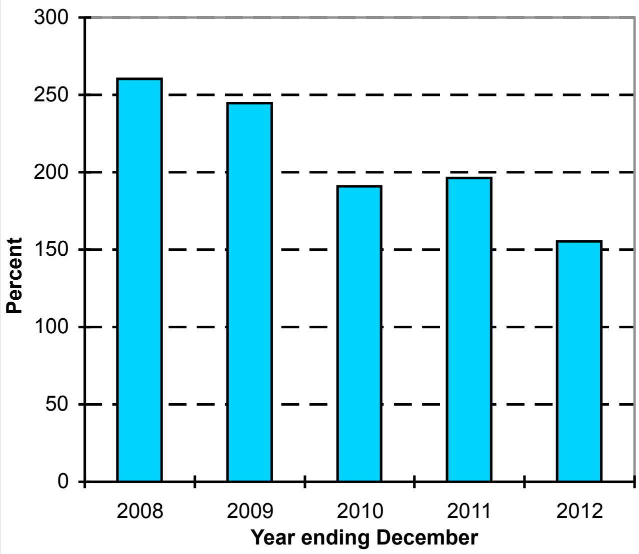



**CHART 20: LARGE EXPOSURES TO UNIMPAIRED CAPITAL**

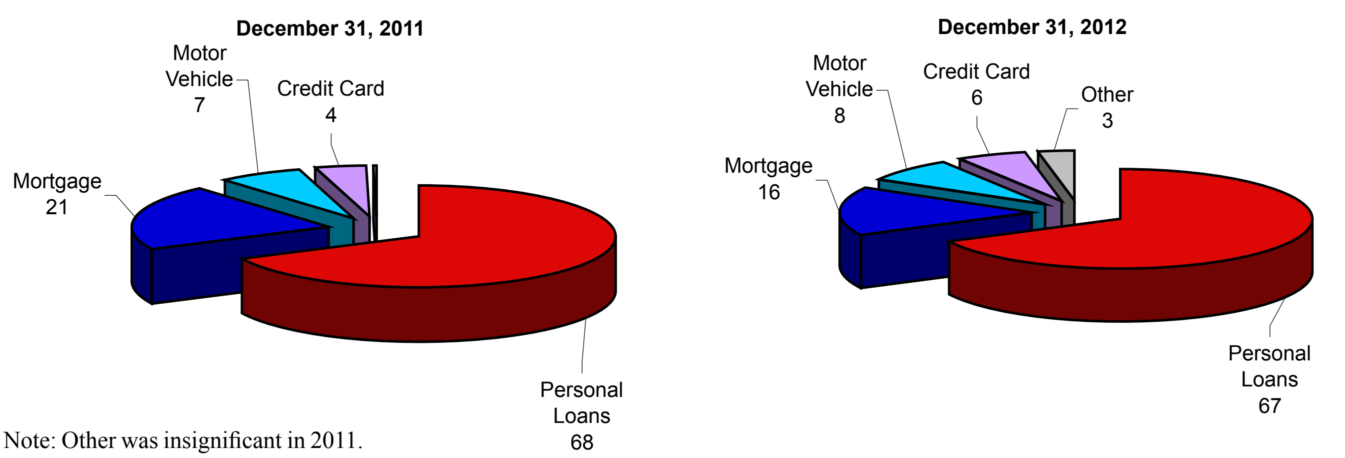



Banks' exposure was diversified further during the year (Chart 21 overleaf). Five sectors lost market share, with the highest loss of market share recorded by the mining and quarrying sector, which registered a decline of 5.1 percent in 2012 (9.7 percent in 2011). This decline could be attributed to the lacklustre performance of the mining sector, which contracted by 8.1 percent in 2012. Manufacturing, trade, restaurants and bars, and construction sectors also registered a decrease in market share, ranging between 1 percent and 2 percent. The business services, community and personal services, real estate and other sectors gained an increase in market share.

## THE STRUCTURE OF HOUSEHOLD LOANS AND ADVANCES

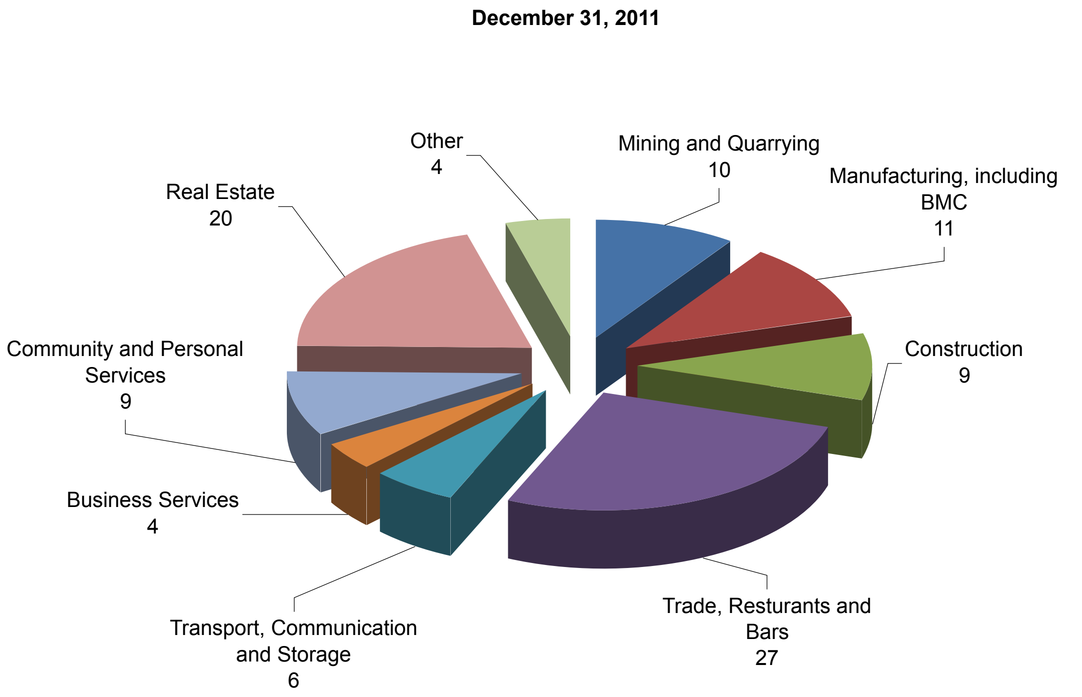
As shown in Chart 22, the share of personal loans in household borrowing was 67.1 percent in 2012; which is a small decrease from the 68 percent of 2011. This is a historical pattern due to banks' main focus on retail lending, as opposed to corporate lending, as evidenced by the ratio of Household Loans to Total Loans of 60.2 percent. Mortgage loans accounted for 15.9 percent of total household loans and advances (20.7 percent in 2011), while the share for credit cards, motor vehicle and other loans increased slightly in 2012.

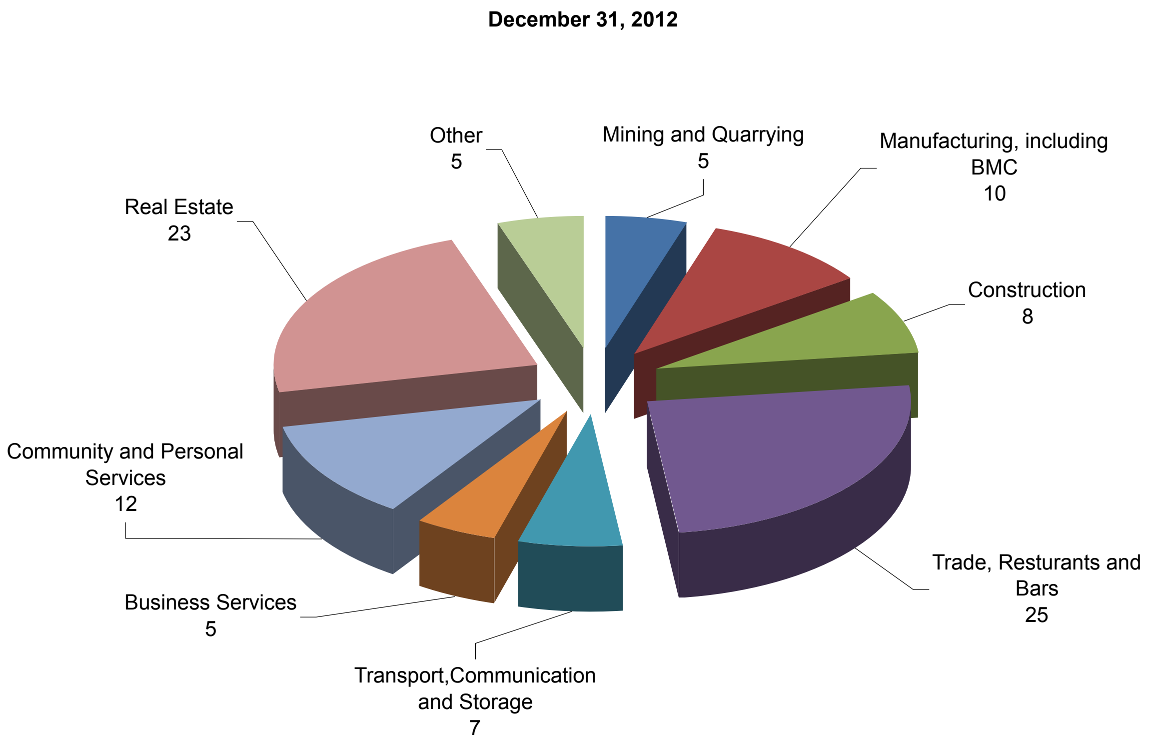
**CHART 22: STRUCTURE OF HOUSEHOLD LOANS AND ADVANCES: 2011 – 2012 (PERCENT)**




Note: Other was insignificant in 2011.

**Chart 21: Distribution of Private Sector Enterprises Loans: 2011 – 2012 (Percent)**




Note: The "Other" sectors includes agriculture, electricity and water, tourism, as well as hotels and insurance.

## Market risk

### Foreign Exchange Risk

All banks observed the foreign exchange exposure limits, with the exception of one bank, which continued to breach the foreign exchange limit. Consequently, the Bank has placed a moratorium on granting supervisory exemptions to that bank, until it complies with the Foreign Currency Exposure Directive BOBA 1/99. The breach by that bank is caused by Letters of Credit

(LCs) on behalf of a government department. The bank maintains that there is minimal credit risk associated with these LCs/Guarantees, since they are in favour of a government department, which the bank considered a zero credit risk counterparty.

## Operational Risk

### Internal Control Environment

The full scope on-site examinations carried out at two banks in 2012, revealed that the internal control environment at one of the two banks was satisfactory, while the findings at another bank were not satisfactory, thus necessitating a planned targeted on-site examination of that bank in August 2013. One of the banks has to implement a comprehensive Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) programme, while the other bank was found to have an unsatisfactory AML/CFT regime. Other operational risk problems at one bank related to tellers exceeding overnight cash holdings. The two banks were urged to rectify these anomalies promptly, failing which supervisory action will be taken against them.

## IT Infrastructure Issues

One bank did not have the necessary IT policy to guide its operations, while the other bank was to set up a disaster recovery site, as a matter of priority.

## Performance of Statutory Banks

## Statement of Financial Position Structure

The financial position of the statutory banks continued to improve, as shown by the 19.9 percent increase in total assets (13 percent in 2011) to P5.1 billion in 2012. The growth in assets was largely funded by customer deposits, which grew significantly by 62.7 percent. The major contributor to the growth of the statement of financial position (balance sheet) was placements with other banks, which increased by 50.9 percent to P0.9 billion in 2012. Credit growth for statutory banks has been on an upward trend for the past three years. It increased from 17.1 percent in 2011 to 17.9 percent in 2012, which is an increase in absolute terms from P3.6 billion to P4 billion.

## Profitability

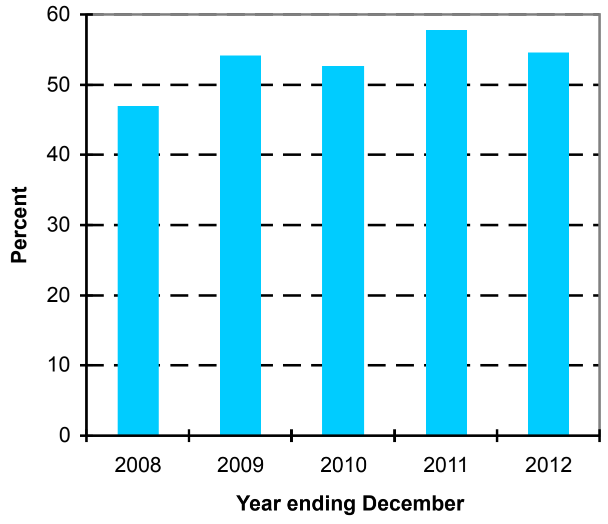
In 2012, after-tax profits of statutory banks recorded a substantial increase of 41.4 percent, compared to a decline of 17 percent in 2011. This surge in profitability was attributable to an increase of 20.7 percent in interest income. Key profitability ratios also trended upwards with the ROE and ROAA ratios increasing to 7.4 percent and 2.6 percent, respectively (Table 6). The Interest Income to ATA ratio increased from 9.4 percent to 9.7 percent in 2012, on account of a faster growth rate (20.7 percent increase) of interest income, compared to a slower growth rate of ATA (16.7 percent).

The Cost to Income ratio of statutory banks decreased to 54.7 percent, against an increase of 57.8 percent in the past year, thus indicating efforts to contain operating costs. However, this ratio has been fluctuating in the last five years (Chart 23 overleaf).

**Table 6: Performance Indicators for Statutory Banks**

| Indicator | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| ROAA (Percent) | 4.0 | 3.1 | 2.9 | 2.1 | 2.6 |
| ROE (Percent) | 5.5 | 5.6 | 5.7 | 4.7 | 7.4 |
| Interest Income to ATA (Percent) | 13.4 | 12.5 | 11.1 | 9.4 | 9.7 |
| Interest Income to Average Earnings (Percent) | 40.9 | 33.3 | 29.8 | 25.6 | 26.4 |
| Cost to Income (Percent) | 47.0 | 54.2 | 52.7 | 57.8 | 54.7 |
| Average Total Assets (P' million) | 2 925 | 3 303 | 3 613 | 4 007 | 4 675 |
| Unimpaired Capital (P' million) | 2 114 | 1 815 | 1 461 | 1 815 | 1 634 |
| Interest Income (P' million) | 392 | 413 | 402 | 377 | 455 |
| Average Earning Assets (P' million) | 959 | 1 239 | 1 350 | 1 470 | 1 722 |
| Net Income (P' million) | 117 | 102 | 103 | 86 | 121 |

**Chart 23: Cost to Income Ratio of Statutory Banks**



# Chapter 3: Statutory Compliance

## Examinations of Commercial Banks

The Bank carried out full scope on-site examinations of three commercial banks in 2012. Overall, the composite CAMELS ratings for each of the banks were 3, denoting a satisfactory rating with moderate weaknesses. The examined banks also obtained an overall high risk rating, with an increasing trend. There were instances of violations of some Sections of the Banking Act pertaining to capital adequacy requirements, liquidity requirements, limitations on specified operations and activities (Section 17 of the Banking Act) at two banks. Of the three banks, two complied satisfactorily with prudential requirements relating to capital, foreign exchange, liquidity, earnings and profitability, while one bank showed weaknesses on capital adequacy and liquidity. All the examined banks had weak AML/CFT regimes, and were advised to conduct a detailed AML/CFT risk assessment and enhance compliance with the Banking (Anti-Money Laundering) Regulations, 2003.

Consumer compliance on-site examinations were also conducted at three commercial banks. The examinations were focused on consumer protection relating to unfair banking practices and concerns about high bank charges. All the banks were found to have satisfactorily complied with most of the consumer-related requirements, with a few exceptions.

## Corporate Governance Issues

The assessment of the effectiveness of Board oversight and, in general, the governance framework of three examined commercial banks showed that Board members had the necessary skills and experience to exercise effective oversight of banks' operations. The Boards met quarterly, with good membership attendance. With the exception of one bank, other banks had relevant committees in place for the furtherance of corporate governance. All Board sub-committees met regularly and presented detailed progress reports at each Board meeting. However, the Board of two of the banks did not have structures in place for the Board self-assessment and training, which would enhance Board members' strategic decision making skills. In addition, Boards of these two banks did not have policies and procedures in place for the appointment, performance of self-assessment and renewal of Board membership.

## Consultative and Prudential Meetings

All bilateral, trilateral and Banking Committee meetings scheduled for 2012 were duly held. The meetings showed that the banks were stable, financially sound, and in compliance with minimum regulatory and prudential requirements. In addition, these forums discussed prospects for the domestic economy and the preparatory work for the introduction of Basel II/III. All banks had positive returns with expanded business, except for two banks, which made losses during the period under review.

# Chapter 4: Operational Performance of Bureaux de Change Institutions

## Bureaux de Change Activities

During the year under review, four bureaux de change were licensed and commenced operations. The Bank revoked the licences of 11 bureaux de change, six of them due to violations of the provisions of the Bank of Botswana (Bureaux de Change) Regulations, 2004; the other five voluntarily surrendered their licences. The net effect of the changes brought the number of bureaux to 61 in 2012, compared to 68 in 2011.

As shown in Charts 24 and 25, the South African rand (ZAR) and United States dollar (USD) continued to dominate the bureaux de change foreign currency transactions. Except for 2011, there has been a downward trend in both sales and purchases since 2008 (Chart 26). Total foreign currency sales and purchases declined by 3.9 percent and 5.1 percent in 2012, compared to the increase of 8.2 percent and 5.3 percent in 2011, respectively. The reduced activity could be attributable more to the closure of some bureaux operations during the year.

## On-site Examinations of Bureaux de Change

In 2012, on-site examinations of eight bureaux de change were carried out. The examination findings were generally satisfactory, except for the contravention of some provisions of the Bank of Botswana (Bureaux de Change) Regulations, 2004. Regulation 5 (2)(e) relates to a change in the composition of directors/ shareholders; Regulation 5 (2)(c) is with regard to maintenance of minimum balances; Regulation 15 (1)(f) pertains to maintenance of daily summary registers; Regulation 15(2) is about the maintenance of documents in the bureaux's premises; Regulation 16(2) deals with

Chart 24:Bureaux de Change Sales of Foreign Currency

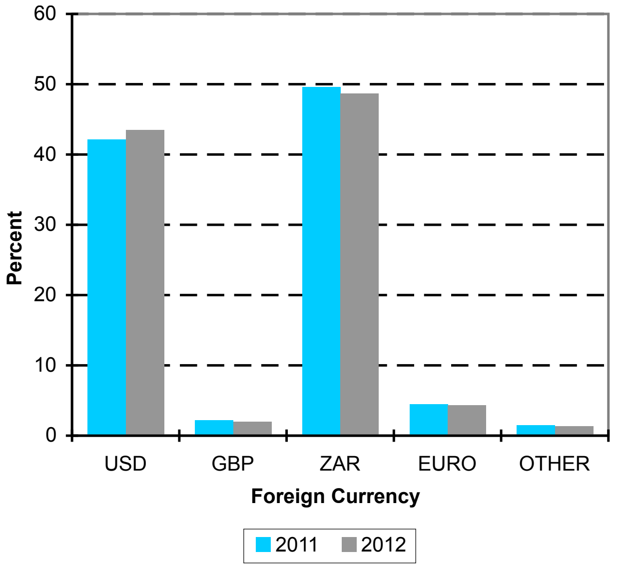



Chart 25: Bureaux de Change Purchases of Foreign Currency

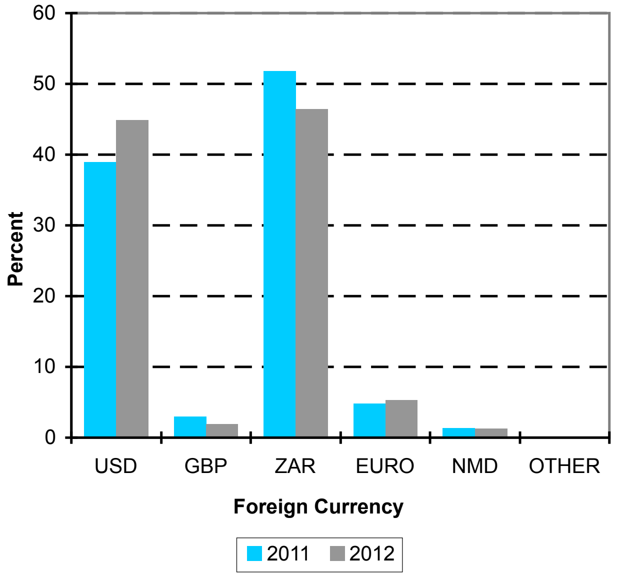
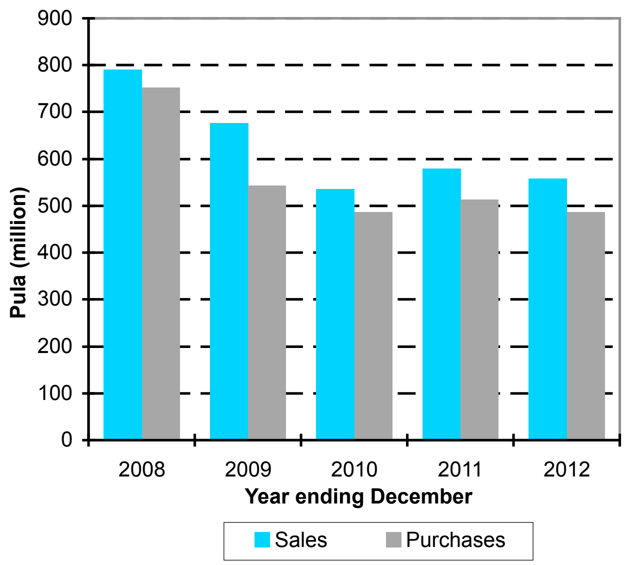



Chart 26: Aggregate Bureaux De Change Sales and Purchases of Foreign Currency



the timely submission of accurate statutory returns; and Regulation 18 contains requirements for auditing of books of accounts. Bureaux operators continued to raise concerns relating to illegal activities (parallel marketing), which has driven some operators out of business.

Measures to curb foreign currency trading by unauthorised persons have so far not been successful. Although Section 30(4) of the Bank of Botswana Act (CAP. 55:01) prescribes penalties for persons who trade in foreign currencies illegally, there has been an established need to engage law enforcement authorities, specifically, the Botswana Police Service, who had not been able to satisfactorily address the matter, due to ineffective and/or gaps in the legal system. However, it appears most such illegal traders are individuals at border crossings and bus ranks. While the actual amounts are hard to measure, the estimated volume and trade is unlikely to undermine the exchange rate and/or undermine public confidence in the currency.

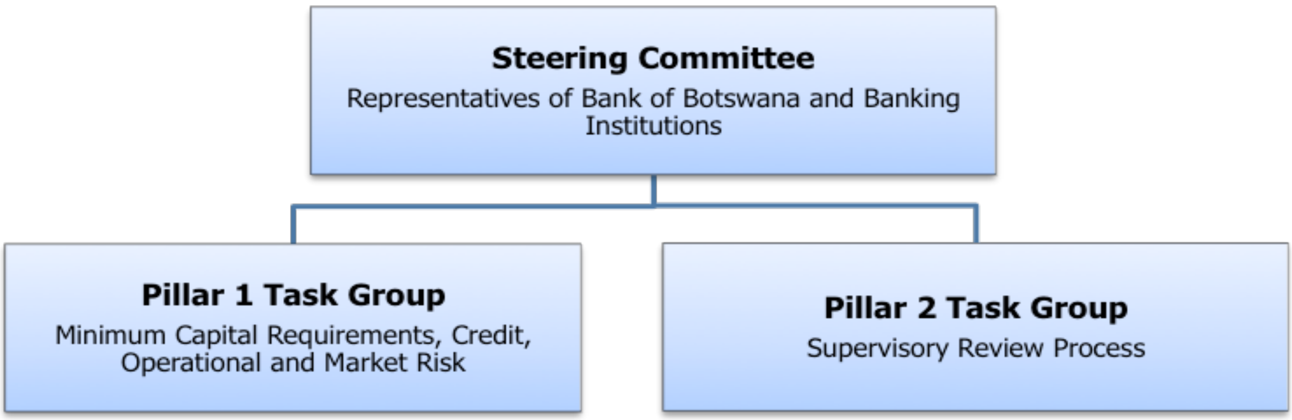
# Chapter 5: International Best Practices on Banking Supervision

## Basel II/III Implementation Strategy

The Bank has adopted a phased approach for the implementation of Basel II/III, in consultation with the banking industry, and preparatory work progressed well during 2012. The Consultative Paper on Basel II/III implementation is being prepared and is expected to be finalised by mid-2013; and all prerequisites for Basel II/III implementation will be finalised by the end of 2013. Parallel running of Basel I and Basel II/III is scheduled for 2014 and full implementation will commence on December 31, 2014.

A Project Charter was prepared, the objective of which is to ensure that the Bank and the banking industry should adopt a consultative approach for the successful implementation of Basel II/III and beyond. The Charter establishes a two-tier structure consisting of the Steering Committee and two Task Groups which will oversee, coordinate and manage the project, as indicated in the organogram below.

**Diagram 2: The Structure of Basel II/III Committees**




The Steering Committee provides strategic direction, including overall responsibility for effective delivery of the Project, while the Task Groups deal with the technical details of Basel II/III, including matters of national discretion, such as appropriate risk-weights for various asset classes/exposures/obligors, external rating agencies and data problems

## Anti-Money Laundering, Suspicious Transaction Reporting, Combating the Financing of Terrorism

The Bank continued to monitor the banks' compliance with AML/CFT requirements in 2012, through on-site examinations and analysis of suspicious transactions reports submitted by banks to the Bank and the Directorate on Corruption and Economic Crime (DCEC).

The Bank participated in meetings of the high level consultative forum, the National Coordinating Committee on Financial Intelligence (NCCFI), the objective of which is to reinforce mechanisms for the combating of money laundering and terrorism financing activities. Furthermore, the Bank attended annual meetings and participated in peer review forums, under the auspices of the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG), which is the Financial Action Task Force-style regional body, which assists member states to set up institutions, laws, policies and procedures to identify and combat money laundering and terrorist financing.

During 2012, the Financial Intelligence Agency (FIA), in conjunction with the Office of Technical Assistance (OTA) of the Treasury Department of the Government of the United States of America, organised three training workshops on AML/CFT for the Banking Supervision Department, compliance officers for banks and bureaux de change. The purpose of the workshops was to build capacity of the Bank Examiners on AML/CFT examinations, sensitise compliance officers of the banks regarding their roles in AML/CFT matters, and familiarise participants with the provisions of the Anti-Money Laundering and Countering the Financing of Terrorism Act, 2009. Overall, stakeholders in the banking industry took preventative measures to minimise prospects of being used as conduits for money laundering and terrorist financing.

## Revised Core Principles for Effective Banking Supervision

The BCBS finalised the review of the Basel Core Principles for Effective Banking Supervision (BCPs) in September 2012. As a result of this review, the number of BCPs increased from 25 to 29 (Appendix 8). The revised set of BCPs has also been reorganised to ensure logical implementation; highlighting the different roles played by supervisors and supervised banks. The reorganisation resulted in BCPs 1 to 13 covering supervisory powers; responsibilities and functions of supervisors; effective risk-based supervision; and the need for early intervention and timely supervisory actions. BCPs 14 to 29 deal with supervisory expectations of banks; the importance of good corporate governance and risk management; and compliance with supervisory standards.

### BOX 2: CORPORATE GOVERNANCE IN THE BANKING INDUSTRY

Corporate governance is the process and structure used to direct and manage the business and affairs of a financial institution, with the objective of ensuring its safety and soundness, and enhancing shareholder value. The process covers the overall environment in which a financial institution operates; this includes a system of checks and balances and promoting a healthy balance between risk and return. It revolves around the basic principles of fairness, transparency and accountability.

Corporate governance calls for market discipline and transparency, by ensuring regular, timely and accurate disclosure of operating and financial results, as well as information on ownership, board of directors, key executive officers and their remuneration, related party transactions, governance structures and internal controls. The main components of corporate governance are the board of directors and senior management officials, as well as Committees such as Audit, Asset and Liability and Risk Management and the Internal/External Auditors.

From a banking perspective, weak corporate governance will inevitably lead to bank failures due to deficient corporate policies and processes, which negatively impact the control environment. In an endeavour to strengthen good corporate governance, Section 29 of the Banking Act ensures that directors and senior management officials of banks undergo a fit and proper test before being appointed. This is to ensure that such persons are competent and can diligently discharge their duties as expected.

Consistent with the above expectation, Section 30(1) of the Banking Act disqualifies a board member, principal officer or any officer associated with the management of a bank, if such a person has been declared bankrupt or convicted of an offence involving fraud or any other act of dishonesty.

Section 29 (2) of the Banking Act also empowers the Bank to direct a bank to remedy a situation, where the Bank believes that a person, by virtue of his/her shareholding in a bank, can influence the principal officer or the board of directors of that bank in a manner which is likely to be detrimental to the interests of depositors. In an effort to augment efforts of both directors and senior management of banks, Section 22(1) of the Banking Act requires every bank to appoint, on an annual basis, external auditor(s), who shall report to the bank's shareholders, the bank's financial performance in accordance with the requirements of the Companies Act (CAP 42:01) and International Financial Reporting Standards.

The role of the supervisory authorities is not to run banks, but rather to ensure that banks have robust risk management processes in place that will guarantee the banks' safety and soundness, and protection of depositors' funds. This can only be achieved if the banks have best practices of corporate governance in place. To achieve this, Principle 14 of the Core Principles for Effective Banking Supervision (Prudential Regulations and Requirements), requires supervisors of banks to ensure that banks have robust corporate governance policies and processes covering group and organisational structures.

It is critical, therefore, that a bank is not only profitable; it also needs to demonstrate the existence of good corporate governance through ethical behavior, in line with international best practices.

# Chapter 6: Other Banking System Developments

## Abandoned Funds

Pursuant to Section 39 of the Banking Act, the Bank received, processed and maintained abandoned funds records from commercial banks. As at December 31, 2012, the abandoned funds balances amounted to P8.2 million compared to P9.8 million in 2011 (Table 8). Funds received from commercial banks increased by 2.34 percent, while abandoned funds claims decreased from P250 835 in 2011 to P195 808 in 2012. Funds transferred to the Guardian's Fund rose sharply by 445.7 percent, from P364 018 in 2011 to P1 986 466.

### Table 8: Abandoned Funds: 2011 – 2012

| | 2011<br>Pula | 2012<br>Pula |
|---|---|---|
| Balance Brought forward | 9 761 587 | 9 776 074 |
| Funds Received | 629 340 | 644 076 |
| Refund from Guardian's Fund* | – | 398 |
| Claims paid out | (250 835) | (195 808) |
| Rounding off difference | – | (20) |
| Transfer to Guardian's Fund | (364 018) | (1 986 466) |
| **Balance at year-end** | **9 776 074** | **8 238 254** |

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

## New Banking Products

As competition in the banking sector intensified, banks continued to introduce innovative products and services, in an effort to attract and retain customers, improve and increase convenience in providing banking services to customers and diversifying products and services offered. The products launched in 2012 included enhancement of the existing card products to cover roadside assistance services, emergency medical transport, discount for travel, shopping, local and international dining benefits and internet access via smart phones. Other developments included an arrangement to enable customers to access credit card balances in the form of cash advances payable over a period of time. One bank introduced the Motshelo account to cater for groups of savers, using a traditional concept of *motshelo*, which is a collective community saving scheme for a defined group of persons, whose benefit include free funeral insurance cover for members. Most of these newly introduced products and services and/or enhancement to existing products, were either free of charge or attracted minimal fees from customers. Mobile banking services were improved to include extension of the service to non-bank customers. Overall, banks continued to embrace the use of mobile payment systems to facilitate delivery of services (funds transfer and payments) to both the banked and unbanked sections of the population. In furtherance of this initiative, the Bank approved another partnership of one commercial bank with a mobile phone provider in 2012.

The Bank assessed fees associated with these new products for their reasonableness, in order to ensure that the cost is not unduly high. In cases where fees were considered to be too onerous, the Bank required the concerned banks to reduce such fees to a reasonable level.

## The Structure of Banking Tariffs and Cost of Financial Services

Banks continued to submit proposals for review and to seek endorsement of tariffs, using the standardised format which was introduced by the Bank in 2011. Reasons for revision of tariffs included increased cost of providing banking services and inflationary adjustments. Tariff proposals for three banks were assessed and approved in 2012. Fee increases were approved on a case-by-case basis, taking into consideration, inter-alia, avoidance of high charges which may adversely impact on the promotion of savings. On average, banks were allowed a 6 percent increase in most of the proposed hikes, on the basis of the upper end of the Bank's inflation objective range of 3 - 6 percent. In 2012, the Bank introduced minimum public disclosure and statutory reporting requirements, in consultation with banks, in which all banks were expected to publish interest rates payable on deposits on their websites. This is in addition to publishing the same information monthly in at least two newspapers widely circulating in Botswana. The intervention was intended to enhance information dissemination, transparency and the promotion of public awareness on the cost of banking services in

Botswana. The selected banking industry average charges, indicated below, show that the cost of financial services has, on average, increased (Table 9).

**TABLE 9: BANKING INDUSTRY AVERAGE CHARGES: 2011 – 2012 (PULA)**

| Service Charge Category | 2011 | 2012 |
|---|---|---|
| **Accessibility Facilitation** | | |
| ATM Charges: | | |
| (i) Cash withdrawal (own account) | 1.80 | 2.76 |
| (ii) Lost card replacement | 49.65 | 50.16 |
| Internet Banking Charges: | | |
| (i) Monthly fees | 63.29 | 139.89 |
| (ii) Transfers | 2.41 | 3.46 |
| **Investment/Intermediation** | | |
| (i) Personal loan - Arrangement fee (Max) | 918.44 | 1 969.86 |
| (ii) Vehicle/Asset finance - Arrangement fee | 489.79* | 631.24 |
| **Trade Facilitation** | | |
| (i) Commission on purchase of foreign currency | 16.94 | 21.59 |
| (ii) International SWIFT transfer | 266.34 | 290.53 |
| (iii) Advisory fees on Letters of Credit | 269.79 | 205.04 |
| **Payment and Clearing Charges** | | |
| (i) Bank cheque | 44.09 | 47.33 |
| (ii) Unpaid cheque due to lack of funds | 223.79 | 231.15 |

*Revised figures for vehicle/asset finance for 2011.

## Handling of Consumer Complaints

The Bank received and processed various consumer complaints during the year. The complaints related to unsettled loan facilities; irregularity regarding the processing of endorsed cheques; unauthorised ATM and over-the-counter transactions; exorbitant charges relating to finance or interest rates and insurance; account closure without valid reasons; and disputed settlement balances with respect to loan facilities. The most recurring complaints across the industry was in respect of unauthorised ATM transactions. Some of the complaints were referred to the Banking Adjudicator and NBFIRA, while others were referred to the concerned banks for resolution. Those complaints with legal connotations were referred for legal redress.

# Chapter 7: Conclusion

Despite unfavorable global economic developments, which culminated in under-performance of the mining sector, the banking industry posted good financial results in 2012. Total banking assets grew rapidly, enhanced by a rise in deposits and shareholders' funds, albeit slightly slower than in 2011. Customer deposits continued to be the major source of funding for banking operations in 2012, and were partly deployed to fund the increase in loans and advances. As was the case in previous years, the bulk of lending was to the household sector, most of which was unsecured. Although the market share of deposits by corporates has been declining in the last two years, this segment of depositors remained the major contributors on a net basis to bank deposits.

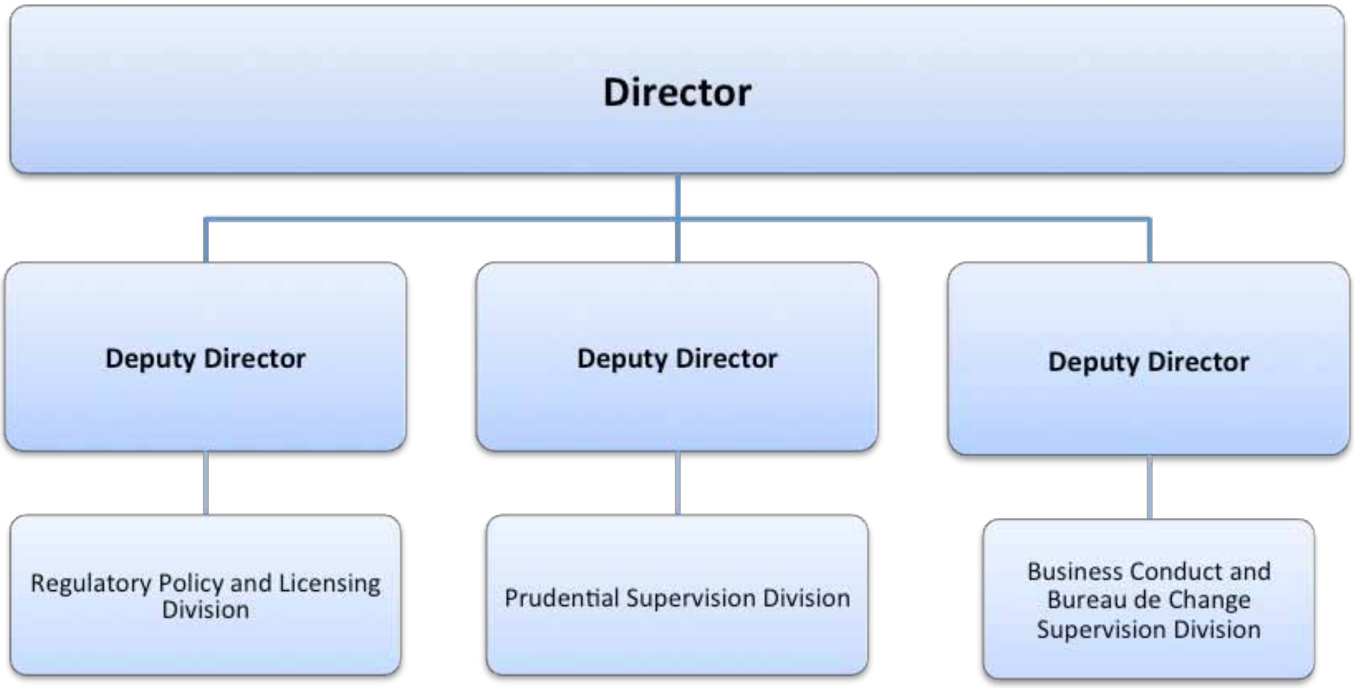
The intermediation efforts of banks continued to increase, particularly against the backdrop of reduced yields from Bank of Botswana Certificates (BoBCs), following the decision by the Bank to cap the BoBC holdings. Although the banking sector remained profitable, the slowdown in general economic activity impacted negatively on the quality of the banks' asset portfolios, as shown by an increase in provisions for loan losses. The share of past due loans was skewed towards the household sector.

Access to banking services improved in 2012. This was due to key players engaging in aggressive marketing strategies in order to retain or increase market share, through branch and ATM network expansion, introduction of more customer-tailored products and increased use of electronic and cell-phone banking. However, the larger banks continued to dominate the market, although the relative share of smaller banks improved to approximately 23 percent for both deposits and lending. The decline in the number of bureaux de change reflected a challenging business environment, which led to some business closures.

In order to improve the country's regulatory framework, the Bank has committed to embracing the latest international regulatory standards. In this regard, significant progress has been made towards the implementation of Basel II/III.

# Appendices

# Appendix 1: Banking Supervision Department - Organisational Chart



# Appendix 2: Approaches to Regulation and Supervision of Banks in Botswana

## 1. Introduction

This Appendix outlines the basic elements of the framework, standards and processes for banking supervision in Botswana. The Bank is committed to the development of a sound, stable and competitive banking system which promotes savings mobilisation while responding, in a prudent and sustainable manner, to the credit requirements of the economy. The Bank also seeks to adhere to best international practices as enshrined in the Basel Committee's 29 Core Principles for Effective Banking Supervision.

## 2. Legal Framework

In general, it is considered that, to be effective, a regulatory framework must have sufficient authority established by law, a high degree of independence or operational autonomy and adequate human and financial resources. In Botswana, the primary legislation covering the supervision and regulation of licensed financial institutions is the Banking Act (CAP. 46:04) (Banking Act). This legislation has undergone various phases of development since it was first promulgated as the Financial Institutions Act in 1975. Important elements of the Banking Act are: explicit provisions for licensing and authorisation processes, which give the Bank powers to regulate market entry; the power to establish minimum prudential supervisory standards and policies with respect to capital adequacy, liquidity, restrictions on large exposures, loans to insiders and quality of management; rules governing accounting, auditing and disclosure of information; and guidelines for the management and/or restructuring of banks in distress.

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

## 3. Authority for Licensing Banks

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

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

## 4. Licensing Policy and Procedures for Establishing a Bank

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

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

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

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

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

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

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

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

## 5. Core Prudential Standards

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

### Capital Adequacy Requirements

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

### Reserve Requirements

Section 39 of the Bank of Botswana Act (CAP. 55:01) empowers the Bank of Botswana to require financial institutions to hold primary reserves, including marginal primary reserves, in the form of cash holdings or deposits with the Bank or both, against such deposits and similar liabilities as may be specified by the Bank. The current primary reserve requirement ratio is 10 percent of Pula denominated deposits, held in a non-interest bearing account of the Bank. This is primarily a monetary policy tool intended to regulate the ability of a bank to use deposit liabilities for lending purposes.

### Liquid Assets Requirements

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

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

### Asset Quality

#### Asset Concentrations (Large Exposures)

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

**Insider Lending**

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

**Non-Performing Loans and Provisions**

Section 14 of the Banking Act deals with certain items, which should be provided for; that is, reserves to be made to take into account potential losses when determining a bank's capital adequacy. It establishes the legal framework for the Bank of Botswana to assess adequacy of the provisions for non-performing assets. Accordingly, the Bank of Botswana has statutory power to assess, in consultation with the bank's independent statutory auditors, the level of impairments in a bank's loan portfolio and the amount of charges to the bank's profit and loss as an expense for non-performing assets.

## 6. Main Supervisory Approaches

### On-Site Examinations

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

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

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

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

In order to ascertain the soundness and prudence of the bank's practices and procedures, an assessment is made of its risk management policies and systems. The practices and procedures adopted would reveal the extent to which the financial institution is employing adequate measures to protect depositors' funds, shareholders' interests, deployment of resources and effective measurement and control of risks that are inherent in any banking operation.

The internal control systems are also assessed to determine their effectiveness and the role of the internal audit function. Effective running of operations depends on the adequacy of records maintained and the adoption and implementation of issues that may adversely affect the performance of a bank for which they are responsible.

### Bilateral and Trilateral Meetings

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

In addition to the separate bilateral meetings with both external auditors and the respective licensed financial institutions, the Bank, pursuant to Section 22(8) of the Banking Act, arranges tripartite meetings with each financial institution and its external auditors. These trilateral meetings are convened to discuss matters relevant to the Bank's supervisory responsibilities that may have arisen in the course of a statutory audit of a bank's business, its accounting and internal control systems, and its draft audited annual statement of financial position and income statement. The forum is also used to share information on the critical risk areas and/or any new developments in accounting and regulatory standards. Trilateral meetings have an added advantage of fostering effective collaboration and communication between the Bank (as regulatory authority) and external auditors of banks in the application of accounting standards and ensuring effective disclosure in financial statements and related reports of material risks in a bank's statement of financial position.

It is also at such meetings that the Bank of Botswana takes the opportunity to discuss with auditors their expectations regarding the scope of statutory audits and other general issues of a prudential nature.

### Off-Site Monitoring and Surveillance

All banks are required to submit statutory returns as prescribed under Section 20 of the Banking Act. The weekly foreign exchange return, which shows the bank's net foreign exchange position, is submitted every week to the Bank. The monthly and quarterly returns should be submitted on the 10th day of the month following the reporting month. Instructions on how to complete the returns are contained in the statutory returns availed to each bank upon being granted a licence.

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

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

## 7. Accounting, Auditing and Disclosure Standards

Section 22 of the Banking Act requires banks to annually appoint independent external auditors acceptable to the Bank. Statutory audits are conducted annually, usually at financial year-end, except that when a bank intends to capitalise half-year interim profits, it must call for an audit of the accounts. Change of external auditors or the financial year-end requires prior approval of the Bank.

# Appendix 3: Supervised Financial Institutions as at December 31, 2012

## (A) Banks and Other Supervised Financial Institutions

| Institution | Postal Address | Business Locations | External Auditors |
|---|---|---|---|
| **Commercial Banks**[1] | | | |
| Barclays Bank of Botswana Limited | P O Box 478, Gaborone | 45* | PricewaterhouseCoopers |
| Standard Chartered Bank Botswana Limited | P O Box 496, Gaborone | 18** | KPMG |
| First National Bank of Botswana Limited | P O Box 1552, Gaborone | 21 | Deloitte & Touche |
| Stanbic Bank Botswana Limited | P/Bag 00168, Gaborone | 11*** | KPMG |
| Bank of Baroda (Botswana) Limited | P O Box 21559, Gaborone | 2 | Grant Thornton |
| Bank Gaborone Limited | P/Bag 00325, Gaborone | 16**** | PricewaterhouseCoopers |
| Capital Bank Limited | P O Box 5548, Gaborone | 4 | KPMG |
| African Banking Corporation of Botswana Limited | P/Bag 00303, Gaborone | 6 | PricewaterhouseCoopers |
| ABN AMRO Bank (Botswana) Limited | P/Bag 254, Gaborone | 1 | KPMG |
| **Off-shore Banks** | | | |
| ABN AMRO Bank (Botswana) OBU Limited | P/Bag 254, Gaborone | 1 | KPMG |
| Kingdom Bank Africa Limited | P O Box 45078, Gaborone | 1 | KPMG |
| **Statutory Banks** | | | |
| Botswana Savings Bank | P O Box 1150, Gaborone | 2 | KPMG |
| National Development Bank | P O Box 225, Gaborone | 5***** | KPMG |
| **Building Society** | | | |
| Botswana Building Society | P O Box 40029, Gaborone | 9 | KPMG |

* Includes 40 branches and 5 agencies

** Includes 15 branches and 3 agencies

*** Includes 9 branches and 2 sub-branches

**** Includes 6 branches and 10 agencies

***** Includes 4 branches and 1 agency

[1] Bank of India Botswana (Pty) Limited and State Bank of India (Botswana) Limited have been licensed, but are not yet operational

## (B) Bureaux de Change as at December 31, 2012

| Name | Postal Address | Business Locations |
|---|---|---|
| Aldaph Bureau de Change | P O Box 404845<br>Gaborone | 2 |
| American Express Bureau de Change | P O Box 45140<br>Gaborone | 3 |
| API Bureau de Change | P O Box 1108<br>Mogoditshane | 1 |
| Apijoe Bureau de Change | P O Box 458<br>Mogoditshane | 2 |
| Ban Mo Bureau de Change | P O Box 99<br>Sherwood | 1 |
| Bellagio Bureau de Change | P/Bag BR 321<br>Gaborone | 1 |
| Beni Fame Bureau de Change | P O Box 41654<br>Gaborone | 2 |

| | | |
|---|---|---|
| Boitekanelo Bureau de Change | P O Box 2768<br>Gaborone | 1 |
| Cape to Cairo Bureau de Change | P O Box 799<br>Kasane | 2 |
| Crystal Diamond Bureau de Change | P O Box 20554<br>Gaborone | 1 |
| CSS Bureau de Change | P O Box 45168<br>Gaborone | 3 |
| Currency Exchange Bureau de Change | P O Box 80981<br>Gaborone | 2 |
| Dignity Bureau de Change | P O Box 201809<br>Gaborone | 1 |
| Dollar Wave Bureau de Change | P O Box 1054<br>Bobonong | 1 |
| Edcom Bureau de Change | P O Box 502429<br>Gaborone | 1 |
| Elite Bureau de Change | P/Bag 0028<br>Mogoditshane | 1 |
| Exim Bureau de Change | P O Box 1020<br>Gaborone | 1 |
| Fanz Bureau de Change | P O Box 617<br>Lobatse | 1 |
| Fundex Bureau de Change | P O Box 401547<br>Gaborone | 1 |
| FX Africa Bureau de Change | P O Box 20537<br>Gaborone | 4 |
| Garona Bureau de Change | P O Box 408<br>Gaborone | 4 |
| Genesis Bureau de Change | P/Bag BR 255<br>Gaborone | 1 |
| Goodrate Bureau de Change | P O Box 848<br>Ghanzi | 1 |
| Gorogang Bureau de Change | P O Box 46785<br>Gaborone | 1 |
| Investors View Bureau de Change | P O Box 2381<br>Francistown | 1 |
| Kalahari Bureau de Change | P O Box 1116<br>Gaborone | 1 |
| Kays Bureau de Change | P O Box 1873<br>Francistown | 1 |
| Kwanokeng Bureau de Change | P O Box 10<br>Sherwood | 2 |
| Limpopo Bureau de Change | P O Box 8<br>Sherwood | 2 |
| Madikwe Bureau de Change | P O Box 268<br>Sikwane | 1 |
| Maeto Bureau de Change | P O Box 22<br>Mahalapye | 1 |
| Masa Bureau de Change | P O Box AC 166 ACH<br>Gaborone | 1 |
| Master Bureau de Change | P/Bag F199<br>Francistown | 1 |

| | | |
|---|---|---|
| MDN Bureau de Change | P O Box 41436<br>Gaborone | 1 |
| Merci Bureau de Change | P O Box 30209<br>Francistown | 2 |
| Mochudi Bureau de Change | P O Box 202147<br>Mochudi | 1 |
| Monty Cristo Bureau de Change | Private Bag 00254<br>Gaborone | 2 |
| Open Door Bureau de Change | P O Box 839<br>Maun | 3 |
| Ozair Bureau de Change | P O Box 4862<br>Gaborone | 2 |
| Prosper Bureau de Change | P/Bag B O7<br>Gaborone | 3 |
| Proxy Bureau de Change | P O Box 404108<br>Gaborone | 2 |
| Rennies Bureau de Change | P O Box 2482<br>Gaborone | 2 |
| River Ride Bureau de Change | P O Box 301106<br>Francistown | 3 |
| Rose of Sharon Bureau de Change | P O Box 404338<br>Gaborone | 1 |
| Royalty Bureau de change | Private Bag BO 259<br>Gaborone | 3 |
| Sherwood Bureau de Change | P O Box 1<br>Sherwood | 1 |
| Simba Bureau de Change | P O Box 402129<br>Gaborone | 1 |
| Simple Forex Bureau de Change | P O Box 81384<br>Gaborone | 1 |
| Sunny Bureau de Change | P.O Box 370<br>Maun | 2 |
| Thari Bureau de Change | P O Box 40074<br>Gaborone | 3 |
| The Silver Bureau de Change | P O Box 1894<br>Ramotswa | 1 |
| Thunda Bureau de Change | P O Box 4470<br>Gaborone | 1 |
| Trans Fronter Bureau de Change | P O Box 183<br>Pitsane | 1 |
| Travellers Bureau de Change | P O Box 20909<br>Maun | 1 |
| Travellers' Choice Bureau de Change | P O Box 26725<br>Gaborone | 3 |
| TRL Money Link Bureau de Change | Private Bag F333<br>Francistown | 1 |
| Tsogo Bureau de Change | P O Box 502095<br>Gaborone | 1 |
| UAE Exchange Bureau de Change | P O Box AD 749 ADD<br>Gaborone | 1 |
| Unity Bureau de Change | P O Box 1586<br>Francistown | 1 |

| | | |
|---|---|---|
| Universal Bureau de Change | P O Box 2444 | |
| | Gaborone | 1 |
| West Bureau de Change | P O Box 779 | |
| | Gaborone | 1 |
| **Total** | **61** | **96** |

## (c) Microfinance Institution

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

# Appendix 4: Definition of Banking Supervision Terminology as used in this Report

(a) **Asset Concentration:** Measures aggregate exposure to one borrower, an affiliated group of borrowers, or borrowers with a common controlling interest, common management, cross-guarantees or financial interdependency which cannot be substituted in the short term. This exposure is usually expressed as a percentage of the bank's unimpaired capital and its various thresholds are subjected to prudential regulatory requirements. In terms of the Banking Act (CAP. 46:04), exposure in excess of 10 percent of the bank's unimpaired capital is deemed an asset concentration requiring prior approval of the Board of Directors of the lending financial institution. Exposure in excess of 30 percent of the bank's unimpaired capital requires prior Bank of Botswana approval.

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

(c) **Adverse Classifications:**

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

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

(iii) **"Loss" Assets** - Assets classified as losses are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this potentially worthless asset even though partial recovery may be effected in future.

(d) **Core Capital:** An aggregate of share capital, share premium, general revenue reserve and retained earnings, also called Tier 1 capital. It represents the most stable and permanent form of capital for supporting a bank's operations. (See Appendix 5 for computations)

(e) **Total Risk-Weighted Assets:** An aggregate of the total value of assets after adjusting for the risk inherent in each asset for both on-balance sheet and off-balance sheet items. A list of assets and the corresponding risk conversion factors used in risk-weighting are presented at Appendix 5.

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

(g) **Weighted Classifications:** Represents an aggregate of 20 percent, 50 percent and 100 percent of the value of accounts classified "Sub-standard", "Doubtful" and "Loss", respectively.

## Prudential Ratios

(a) **Return on Equity (ROE):** The ratio measures the after-tax profit against shareholders' funds. The ratio, however, tends to favour highly leveraged banks in that the ratio tends to be higher for low capitalised banks than for large capitalised banks. It is of major interest to the shareholders of the bank, and less so for banking supervisory authorities.

(b) **Return on Average Total Assets (ROAA):** The ratio measures after-tax profits as a percentage of average total assets. This ratio is widely used by both banking supervisors and market analysts since banking assets are the base from which earnings are primarily derived. The ratio measures the earnings capacity of the assets of the financial institution. It measures profit earned against the amount invested in assets and is the key to profitability measurement as it shows how efficiently a financial institution's assets are employed. It is also used to measure the effectiveness of management's decisions with respect to resource utilisation. The higher the ratio the more efficient the management is in its asset allocation decisions.

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

(d) **Capital Growth:** This ratio measures the impact of retained income and other capitalised funds on the capital base of a bank. Ideally, the bank's rate of income retention must keep pace with its asset growth, or risk exposure. Where there is a disparity in growth, especially with acceleration of the latter, the bank's solvency will be weakened overtime.

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

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

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

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

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

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

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

(l) **Cost to Income:** The ratio measures the non-interest expenses as a percentage of net interest income plus non-interest income (total operating income). It shows how well the non-interest expenses are managed by the institution relative to the level of total operating income.

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

# Appendix 5: Risk Weights Applied on Various Asset Exposures and Capital Elements

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

| | Credit Conversion* Factor | Risk Factor (%)** |
|---|---|---|
| **25. Total Off-Balance Sheet Items (sum of lines 26 to 37)** | | |
| 26. Commitments under 1 year or can be cancelled | **0** | |
| 27. Guarantees/performance bonds secured by cash | **0** | |
| 28. Forward foreign exchange contracts (over 7 days and under 1 year) | **1** | |
| 29. LC's and guarantees to public financial and non-financial corporations | **20** | |
| 30. Guarantees and bonds secured by first class banks | **20** | |
| 31. Self-liquidating-trade related LCs (commercial LCs) | **20** | |
| 32. Securities underwriting | **50** | |
| 33. Formal commitments, credit lines and bills endorsed (includes promissory notes with original maturity over 1 year) | **50** | |
| 34. Other unsecured performance bonds, etc. (transaction related) | **50** | |
| 35. Other off-statement of financial position exposure (specify) | **100** | |
| 36. Assets securitisation with recourse | **100** | |
| 37. Other standby letters of credit and other guarantees | **100** | |

| Maturity*** | Conversion Factors - Interest Rate Contracts | Risk Factor (%)** |
|---|---|---|
| **38. Forwards, Swaps, Purchased Options and Similar Derivatives Contracts (sum of lines 39 to 44)** | | |
| 39. One Year or Less | 0.50% | |
| 40. Over One Year to Two Years | 1.00% | |
| 41. For Each Additional Year | 1.00% | |
| | **Exchange Rate Contracts and Gold** | **Risk Factor (%)**** |
| 42. One Year or Less | 2.00% | |
| 43. Over One Year to Two Years | 5.00% | |
| 44. For each Additional Year | 3.00% | |
| **45. TOTAL RISK-WEIGHTED ASSETS AND OFF-BALANCE SHEET ITEMS (SUM OF LINES 1, 25 AND 38)** | | |

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

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

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

## CAPITAL ELEMENTS

**1. Total Tier 1 Capital (sum of lines 2 to 7, less line 8(a) to (f)):**

2. Stated capital
3. Perpetual (non-redeemable) non-cumulative preferred shares
4. General reserves
5. Retained earnings
6. Minority interests
7. Buffer capital
8. Less:
   - (a) Goodwill and other intangible assets
   - (b) Cumulative losses below original cost of own use investment properties
   - (c) Shareholders' equity funded through the capitalisation of unrealised gains arising from revaluations
   - (d) Current year unpublished loss
   - (e) Impairment losses (including those resulting on available for sale)
   - (f) Supervisory capital charges

**9. Total Tier 2 Capital (sum of lines 10 and 18)**

**10. Upper Tier 2 (sum of lines 11 to 17)**

11. Current year's unpublished profits
12. 50 percent of fixed asset revaluation reserves
13. 50 percent of unrealised gains on available for sale revaluations
14. Unencumbered collectively assessed (General) allowances not to exceed 1.25 percent of risk-weighted assets
15. Hybrid (debt/equity) capital instruments eligible for inclusion in Tier 2
16. Minority interests in Tier 2 preference shares
17. Shareholders' equity funded through the capitalisation of property revaluations

**18. Lower Tier 2 (sum of lines 19 and 20)**

19. Subordinated term debt eligible for inclusion (not exceeding 50 percent of Core Capital)
20. Other dated capital instruments eligible for inclusion in Tier 2

**21. Total Capital (sum of lines 1 and 9)**

**22. Total Impairments of Capital (sum of lines 23 to 30)**

23. Investments in unconsolidated subsidiaries and associated companies
24. Connected lending of a capital nature, including unlawful lending to directors, owners or their indirect interest
25. Capitalised establishment costs/pre-incorporating expenses
26. Underwriting commission
27. Shortfalls in provisions for losses
28. Pre-paid expenses
29. Deferred charges
30. Leasehold rights

**31. TOTAL UNIMPAIRED CAPITAL FUNDS (LINE 21 LESS 22)**

# Appendix 6: Aggregate Financial Statements of Licensed Banks: 2008 – 2012

## Table 6.1: Aggregate Statement of Financial Position of Licensed Commercial Banks (P' million)

| Total Assets in Local Currency | 2008 | 2009* | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| 1. Cash and balances with the Central Bank | 2 125 | 2 238 | 3 269 | 4 766 | 4 933 |
| a. Currency | 593 | 595 | 707 | 721 | 824 |
| aa. Hard currency and gold bullion | 137 | 174 | 56 | 76 | 86 |
| ab. Local currency | 456 | 421 | 651 | 645 | 738 |
| b. Balances with Central Bank | 1 399 | 1 638 | 2 562 | 4 045 | 4 109 |
| c. Other | 133 | 5 | 0 | 0 | 0 |
| 2. Trading securities at market value (BoBCs) | 15 654 | 17 415 | 17 617 | 11 083 | 9 319 |
| 3. Placements with other banks and credit institutions | 5 894 | 4 028 | 5 778 | 6 187 | 7 407 |
| 4. Gross loans and advances | 17 823 | 19 700 | 22 087 | 27 920 | 34 410 |
| 4.1 Specific provisions | 326 | 649 | 720 | 574 | 629 |
| 4.2 Interest in suspense | | | 43 | 213 | 245 |
| 5. Net loans and advances | 17 497 | 19 051 | 21 324 | 27 133 | 33 537 |
| 6. Investment securities | 2 406 | 311 | 210 | 38 | 880 |
| 7. Fixed assets net of depreciation | 364 | 399 | 492 | 482 | 665 |
| 8. Other assets (net) | 1 311 | 580 | 900 | 1 911 | 1 213 |
| **Total Assets** | **45 251** | **44 023** | **49 590** | **51 600** | **57 954** |
| **Liabilities in Local Currency** | | | | | |
| 1. Amounts owed to government institutions | 0 | 0 | 0 | 0 | 0 |
| a. Central Bank accounts | 0 | 0 | 0 | 0 | 0 |
| b. Direct Government credits (CB or MFDP) | 0 | 0 | 0 | 0 | 0 |
| c. Other | 0 | 0 | 0 | 0 | 0 |
| 2. Amounts due to other banks and credit institutions | 1 058 | 680 | 460 | 990 | 1 320 |
| 3. Securities sold under repurchase agreements | 0 | 0 | 0 | 0 | 0 |
| 4. Amounts due to other customers/depositors | 37 329 | 37 590 | 41 628 | 43 178 | 47 219 |
| 5. Shareholders' funds | 2 420 | 3 035 | 4 069 | 4 696 | 5 548 |
| 6. Other liabilities | 2 877 | 1 99 | 1 977 | 1827 | 3 445 |
| a. Taxes payable | 94 | 213 | 168 | 156 | 132 |
| b. Dividends payable | 115 | 0 | 0 | 0 | 20 |
| c. Accrued expenses | 27 | 2 | 42 | 243 | 0 |
| d. Other | 2 642 | 884 | 1 767 | 1 429 | 3 293 |
| 7. Other borrowing, including international lending agencies | 1 566 | 1 621 | 1 457 | 909 | 422 |
| **Total Liabilities** | **45 251** | **44 023** | **49 590** | **51 600** | **57 954** |

*Figures restated

### Table 6.2: Aggregate Income Statement of Licensed Commercial Banks (P' million)

| | 2008 | 2009* | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| 1. Interest and similar income | 5 154 | 4 796 | 4 244 | 4 407 | 4 767 |
| 2. Interest expense | 2 954 | 2 427 | 1 778 | 1 663 | 1 502 |
| 3. Net interest income [1-2] | 2 200 | 2 369 | 2 466 | 2 744 | 3 265 |
| 4. Other operating income | 1 180 | 1 156 | 1 288 | 1 631 | 1 781 |
| 5. **Gross operating income/(loss) [3+4]** | 3 379 | 3 525 | 3 754 | 4 375 | 5 046 |
| 6. Bad and doubtful debts provisions | 193 | 384 | 272 | 301 | 455 |
| (a) Specific loss provision expenses | 202 | 414 | 318 | 305 | 406 |
| (b) General loss provision | 23 | 20 | 8 | 37 | 55 |
| (c) Releases and recoveries of bad debts previously written off | (32) | (50) | (54) | (41) | 0 |
| 7. **Operating income/(loss) net of specific loss provisions** | 3 186 | 3 141 | 3 482 | 4 074 | 4 591 |
| 8. Operating expenses | 1 553 | 1 594 | 1 681 | 2 096 | 2 373 |
| (a) Salaries and employee benefits | 673 | 671 | 790 | 979 | 1 142 |
| (b) Administrative expenses | 260 | 0 | 0 | 0 | 0 |
| (c) Auditing and consulting expenses | 9 | 13 | 12 | 33 | 0 |
| (d) Rental/lease expenses | 59 | 65 | 53 | 84 | 137 |
| (e) Depreciation and amortisation | 76 | 77 | 69 | 110 | 98 |
| (f) Other | 476 | 768 | 756 | 890 | 996 |
| 9. Other provisions and write-offs | 0 | 0 | 0 | 14 | 0 |
| (a) Investments | 0 | 0 | 0 | 0 | 0 |
| (b) Other balance sheet items | 0 | 0 | 0 | 14 | 0 |
| (c) Off-balance sheet items | 0 | 0 | 0 | 0 | 0 |
| 10. Net operating income/(loss) [7-8-9] | 1 633 | 1 547 | 1 801 | 1 964 | 2 218 |
| 11. Extraordinary gains/(losses) | (2) | 3 | 1 | 0 | 0 |
| (a) Gains/Losses on revaluation of assets (net) | 0 | 0 | 0 | 0 | 0 |
| (b) Translation gains/losses (net) | 0 | 0 | 0 | 0 | 0 |
| (c) Other gains/losses | (2) | 3 | 1 | 0 | 0 |
| 12. **Net income/(loss) before tax [10+11]** | 1 631 | 1550 | 1 802 | 1 964 | 2 218 |
| 13. Income tax | 317 | 315 | 396 | 313 | 475 |
| 14. Net income/(loss) after tax [12-13] | 1 313 | 1 236 | 1 407 | 1 652 | 1 743 |
| 15. Proceeds from discontinued operations | 0 | 4 | 80 | 13 | 2 |
| 16. Transfers from revaluation/to general provisions | 0 | 8 | (14) | 16 | 0 |
| 17. Dividends declared (paid and proposed) | 762 | 480 | 603 | 858 | 288 |
| 18. Retained earnings for the year [14-15-16-17] | 551 | 748 | 898 | 790 | 1 457 |
| 19. Retained earnings at the beginning of the year | 1 380 | 1 349 | 2 796 | 3 035 | 3 830 |
| 20. **Retained earnings at the end of the year [18+19]** | 1 932 | 2 097 | 3 694 | 3 825 | 5 287 |

## Table 6.3: Aggregate Statement of Financial Position of Statutory Banks in Botswana (P' million)

| Total Assets in Local Currency | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| 1. Cash and balances with the Central Bank | 3 | 5 | 10 | 20 | 1 |
| a. Currency | 3 | 2 | 7 | 20 | 0 |
| aa. Hard currency and gold bullion | 0 | 0 | 0 | 0 | 0 |
| ab. Local currency | 3 | 2 | 7 | 20 | 0 |
| b. Balances with Central Bank | 0 | 4 | 3 | 0 | 1 |
| c. Other | 0 | 0 | 0 | 0 | 0 |
| 2. Trading securities at market value (BoBCs) | 0 | 0 | 0 | 0 | 0 |
| 3. Placements with other banks and credit institutions | 482 | 574 | 613 | 579 | 874 |
| 4. Gross loans and advances to other customers | | 2 813 | 3 052 | 3 573 | 4 214 |
| 5. Specific provisions | | (113) | (112) | (129 | (199) |
| 6. Loans and advances to other customers (net of specific provisions) | 2 479 | 2 701 | 2 940 | 3 445 | 4 015 |
| 7. Investment securities | 0 | 0 | 0 | 27 | 0 |
| 8. Fixed assets net of depreciation | 153 | 150 | 157 | 176 | 184 |
| 9. Other assets (net) | 26 | 33 | 42 | 11 | 46 |
| **Total Assets** | **3 143** | **3 463** | **3 762** | **4 258** | **5 120** |
| **Liabilities in Local Currency** | | | | | |
| 1. Amounts owed to government institutions | 3 | 0 | 0 | 0 | 58 |
| a. Central Bank accounts | 3 | 0 | 0 | 6 | 0 |
| b. Direct government credits (CB or MFDP) | 0 | 0 | 0 | 0 | 0 |
| c. Other | 0 | 0 | 0 | 0 | 0 |
| 2. Amount due to other banks and credit institutions | 0 | 0 | 0 | 0 | 21 |
| 3. Securities sold under repurchase agreements | 0 | 0 | 0 | 0 | 0 |
| 4. Amount due to other customers/depositors | 618 | 720 | 756 | 879 | 1 430 |
| 5. Shareholders' funds | 1 674 | 1 819 | 1 957 | 2031 | 2 162 |
| 6. Other liabilities | 27 | 55 | 90 | 744 | 758 |
| a. Taxes payable | 0 | 0 | 0 | 0 | 0 |
| b. Dividends payable | 0 | 13 | 14 | 12 | 1 |
| c. Accrued expenses | 0 | 0 | 0 | 13 | 0 |
| d. Other | 27 | 42 | 76 | 719 | 757 |
| 7. Other borrowing, including international lending agencies | 821 | 869 | 960 | 598 | 691 |
| **Total Liabilities** | **3 143** | **3 463** | **3 762** | **4 258** | **5 120** |

### Table 6.4: Aggregate Income Statement of Statutory Banks in Botswana (P' million)

| Statutory Banks | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| 1. Interest and similar income | 392 | 413 | 402 | 377 | 455 |
| 2. Interest expense | 126 | 150 | 132 | 137 | 167 |
| 3. Net interest income [1-2] | 266 | 263 | 271 | 239 | 288 |
| 4. Other operating income | 32 | 44 | 43 | 50 | 47 |
| **5. Gross operating income/(loss) [3+4]** | 298 | 306 | 313 | 289 | 355 |
| 6. Bad and doubtful debts provisions | 37 | 33 | 45 | 36 | 31 |
| (a) Specific loss provision expenses | 33 | 33 | 43 | 36 | 31 |
| (b) General loss provision | 4 | 0 | 2 | 0 | 0 |
| (c) Releases and recoveries of bad debts previously written off | 0 | 0 | 0 | 0 | 0 |
| **7. Operating income/(loss) net of specific loss provisions** | 261 | 274 | 268 | 253 | 304 |
| 8. Operating expenses | 140 | 166 | 165 | 167 | 183 |
| (a) Salaries and employee benefits | 73 | 80 | 88 | 88 | 95 |
| (b) Administrative expenses | 0 | 0 | 0 | 0 | 0 |
| (c) Auditing and consulting expenses | 0 | 0 | 0 | 0 | 0 |
| (d) Rental/lease expenses | 0 | 0 | 0 | 0 | 0 |
| (e) Depreciation and amortisation | 6 | 6 | 10 | 6 | 7 |
| (f) Other | 60 | 79 | 68 | 73 | 81 |
| 9. Other provisions and write-offs | 0 | 0 | 0 | 0 | 0 |
| (a) Investments | 0 | 0 | 0 | 0 | 0 |
| (b) Other balance sheet items | 0 | 0 | 0 | 0 | 0 |
| (c) Off-balance sheet items | 0 | 0 | 0 | 0 | 0 |
| **10. Net operating income/(loss) [7-8-9]** | 122 | 108 | 103 | 86 | 121 |
| 11. Extraordinary gains/(losses) | (5) | 6 | 0 | 0 | 0 |
| (a) Gains/losses on revaluation of assets (net) | 0 | 0 | 0 | 0 | 0 |
| (b) Translation gains/losses (net) | 0 | 0 | 0 | 0 | 0 |
| (c) Other gains/losses | (5) | 0 | 0 | 0 | 0 |
| **11. Net income/(loss) before tax [10+11]** | 117 | 102 | 103 | 86 | 121 |
| 12. Income tax | 0 | 0 | 0 | 0 | 0 |
| 14. Net income/(loss) after tax [12-13] | 117 | 102 | 103 | 86 | 121 |
| 15. Transfers from revaluation reserve/to general provisions | 0 | 0 | 5 | 0 | 0 |
| 16. Dividends declared (paid and proposed) | 27 | 37 | 37 | 42 | 44 |
| 17. Retained earnings for the year [14-15-16] | 90 | 65 | 146 | 128 | 77 |
| 18. Retained earnings at the beginning of the year | 0 | 90 | 61 | 44 | 172 |
| 19. **Retained earnings at the end of the year [17+18]** | 90 | 155 | 207 | 172 | 249 |

## Table 6.5: Commercial Banks Capital Structure (Tier 1 Capital, Tier 2 Capital and Total Capital) (P' million)

| Tier 1 | Capital Elements | 2008 | 2009** | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|---|
| 1 | Stated capital* | 314 | 352 | 583 | 712 | 977 |
| 2 | Preference (non-redeemable) non-cumulative shares | 0 | 0 | 229 | 255 | 229 |
| 3 | General reserves | 3 | 355 | 105 | 70 | 93 |
| 4 | Undivided profits (audited current year retained earnings/loss) | 1 559 | 1 837 | 2 463 | 2 558 | 3 515 |
| 5 | Minority interests | 0 | 0 | 0 | 0 | 0 |
| 6 | Less | | | | | |
| | (a) Goodwill and other intangible assets | (41) | (41) | (144) | (134) | (104) |
| | (b) Shareholders' equity funded through the capitalisation of unrealised gains arising from property revaluation | 0 | 0 | 0 | 0 | 0 |
| 7 | **Total Tier 1 Capital (Sum of lines 1-5 less lines 6 (a) and (b)** | **1 836** | **2 503** | **3 236** | **3 461** | **4 710** |
| **Tier 2** | | | | | | |
| 8 | Current year's unpublished profits | 479 | 127 | 875 | 976 | 760 |
| 9 | Fifty percent of fixed asset revaluation reserves | 18 | 16 | 30 | 37 | 32 |
| 10 | Unencumbered general provisions not to exceed 1.25 percent of risk weighted assets | 114 | 166 | 181 | 202 | 259 |
| 11 | Hybrid (debt/equity) capital instruments eligible for inclusion | 1 | 0 | 1 | 37 | 0 |
| 12 | Subordinated term debt eligible for inclusion | 645 | 815 | 793 | 753 | 1 084 |
| 13 | Minority interest in Tier 2 preference shares | 0 | 0 | 0 | 1 | 0 |
| 14 | Shareholders' equity funded through the capitalisation of property revaluation reserves | 0 | 0 | 0 | 0 | 0 |
| 15 | **Total Tier 2 Capital (sum of lines 8 to 14)** | **1 257** | **1 125** | **1 879** | **1 969** | **2 135** |
| 16 | **Total Capital (sum of lines 7 and 15)** | **3 093** | **3 627** | **5 115** | **5 430** | **6 844** |
| | Impairments | | | | | |
| 17 | Investments in unconsolidated subsidiaries and associated companies | 1 | (1) | 0 | 0 | 0 |
| 18 | Total impairments of capital | 1 | (1) | 0 | 0 | 0 |
| 19 | **Total Unimpaired Capital (line 16 minus line 18)** | **3 092** | **3 627** | **5 115** | **5 430** | **6 844** |

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

** Figures restated

# Appendix 7: Charts of Key Prudential and Other Financial Indicators

**Chart 7.1: Average Cost of Deposits**

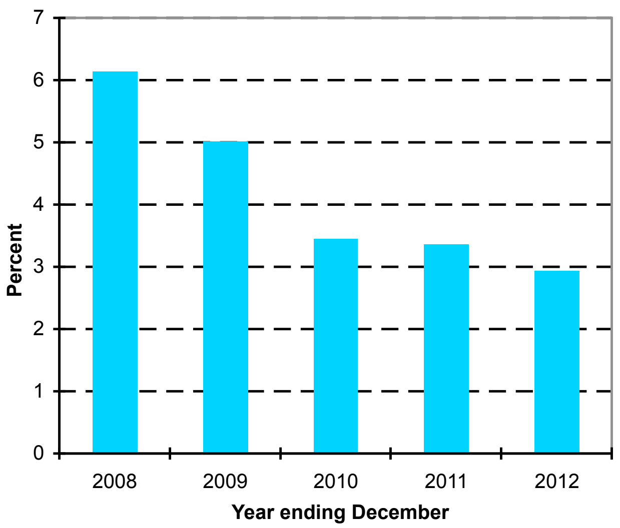



**Chart 7.2: Return on Advances**

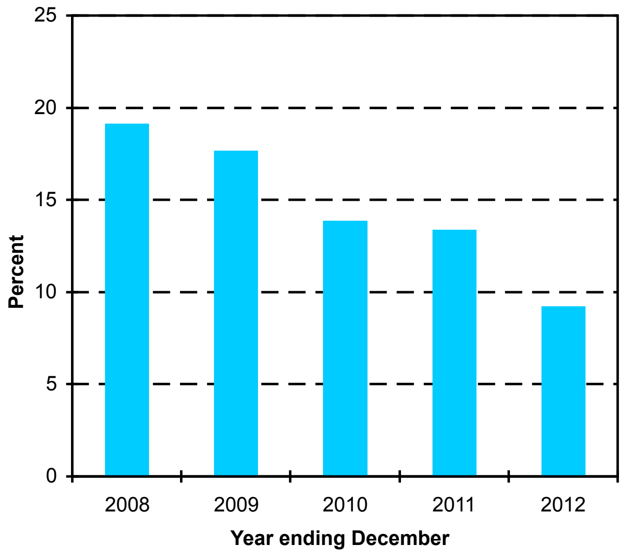



**Chart 7.3: Residential Real Estate Loans to Gross Loans**

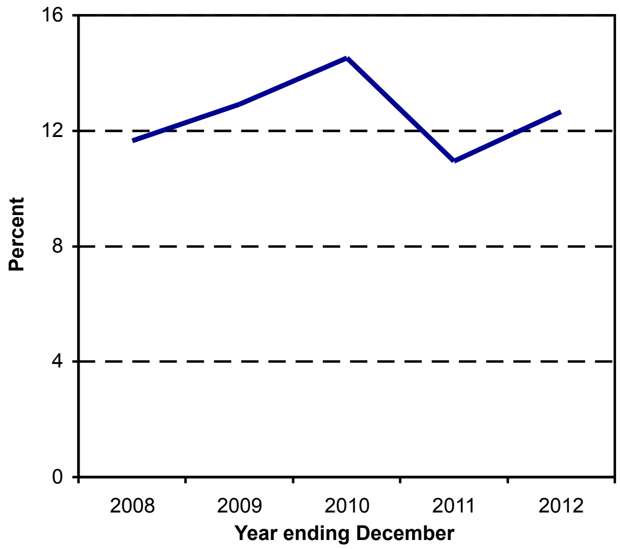



**Chart 7.4: Household Loans to Gross Loans**

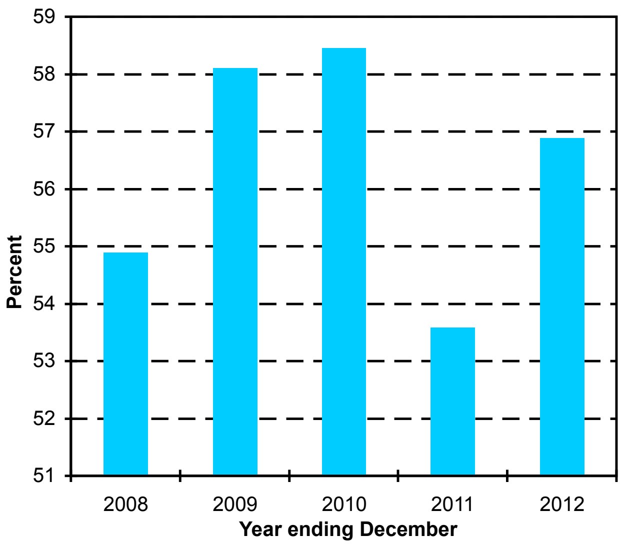


**Chart 7.5: Past Due Loans Growth Rate**

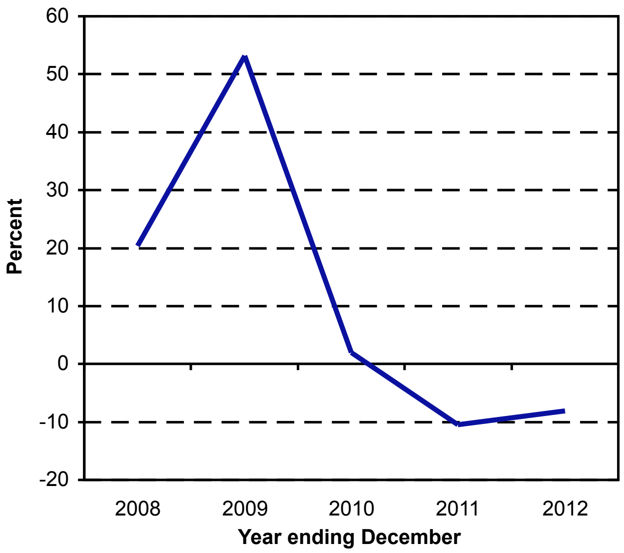



**Chart 7.6: Share of Value of Total Deposits by Type (including FCAs)**

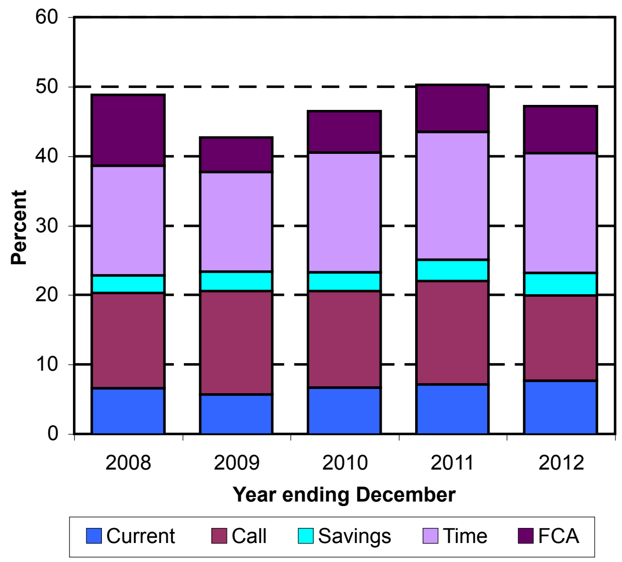



**Chart 7.7: Growth Rate of Foreign Currency Accounts**

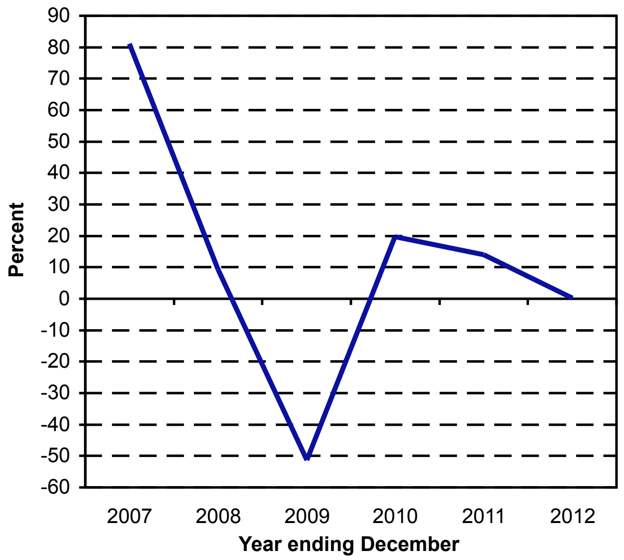
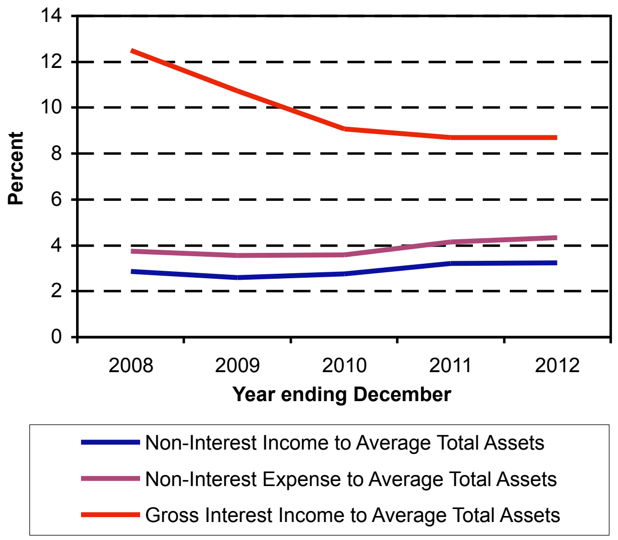



**Chart 7.8: Gross Interest Income to ATA, Non-Interest Income to ATA and Non-Interest Expense to ATA**



# Appendix 8: The 29 Core Principles for Effective Banking Supervision

**SUPERVISORY POWERS, RESPONSIBILITIES AND FUNCTIONS**

***Principle 1 – Responsibilities, objectives and powers:*** An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups. A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorise banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns.

***Principle 2 – Independence, accountability, resourcing and legal protection for supervisors:*** The supervisor possesses operational independence, transparent processes, sound governance and adequate resources, and is accountable for the discharge of its duties. The legal framework for banking supervision includes legal protection for the supervisor.

***Principle 3*** – Cooperation and collaboration: Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors. These arrangements reflect the need to protect confidential information.

***Principle 4 – Permissible activities:*** The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined and the use of the word "bank" in names is controlled.

***Principle 5 – Licensing criteria:*** The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of Board members and senior management) of the bank and its wider group, and its strategic and operating plan, internal controls, risk management and projected financial condition (including capital base). Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home supervisor is obtained.

***Principle 6 – Transfer of significant ownership:*** The supervisor has the power to review, reject and impose prudential conditions on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

***Principle 7 – Major acquisitions:*** The supervisor has the power to approve or reject (or recommend to the responsible authority the approval or rejection of), and impose prudential conditions on, major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and to determine that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

***Principle 8 – Supervisory approach:*** An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.

***Principle 9 – Supervisory techniques and tools:*** The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks.

***Principle 10 – Supervisory reporting:*** The supervisor collects reviews and analyses prudential reports and statistical returns from banks on both a solo and a consolidated basis, and independently verifies these reports, through either on-site examinations or use of external experts.

***Principle 11*** – Corrective and sanctioning powers of supervisors: The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability to revoke the banking licence or to recommend its revocation.

***Principle 12 – Consolidated supervision:*** An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide.

***Principle 13 – Home-host relationships:*** Home and host supervisors of cross-border banking groups share information and cooperate for effective supervision of the group and group entities, and effective handling of crisis situations. Supervisors require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks.

**PRUDENTIAL REGULATIONS AND REQUIREMENTS**

***Principle 14 – Corporate governance:*** The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organisational structure, control environment, responsibilities of the banks' Boards and senior management, and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the bank.

***Principle 15 – Risk management process:*** The supervisor determines that banks have a comprehensive risk management process (including effective Board and senior management oversight) to identify, measure, evaluate, monitor, report and control or mitigate all material risks on a timely basis and to assess the adequacy of their capital and liquidity in relation to their risk profile and market and macroeconomic conditions. This extends to development and review of robust and credible recovery plans, which take into account the specific circumstances of the bank. The risk management process is commensurate with the risk profile and systemic importance of the bank.

***Principle 16 – Capital adequacy***: The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses.

***Principle 17 – Credit risk:*** The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk (including counterparty credit risk) on a timely basis. The full credit lifecycle should be covered including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios.

***Principle 18 – Problem assets, provisions and reserves:*** The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves.

***Principle 19 – Concentration risk and large exposure limits:*** The supervisors determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

***Principle 20 – Transactions with related parties:*** In order to prevent abuses arising in transactions with related parties and to address the risk of conflict of interest, the supervisor requires banks to enter into any transactions with related parties on an arm's length basis; to monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes.

***Principle 21 – Country and transfer risks:*** The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate country risk and transfer risk in their international lending and investment activities on a timely basis.

***Principle 22 – Market risks:*** The supervisor determines that banks have an adequate market risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions and the risk of a significant deterioration in market liquidity. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate market risks on a timely basis.

***Principle 23 – Interest rate risk in the banking book:*** The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate interest rate risk in the banking book on a timely basis. These systems take into account the bank's risk appetite, risk profile and market and macroeconomic conditions.

***Principle 24 – Liquidity risk:*** The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons.

***Principle 25 – Operational risk:*** The supervisor determines that banks have an adequate operational risk management framework that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, assess, evaluate, monitor report and control or mitigate operational risk on a timely basis.

***Principle 26 – Internal control and audit:*** The supervisor determines that banks have adequate internal controls to establish and maintain a properly controlled operating environment for the conduct of their business taking into account their risk profile. These include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

***Principle 27: Financial reporting and external audit:*** The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function.

***Principle 28 – Disclosure and transparency:*** The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes.

***Principle 29 – Abuse of financial services:*** The supervisor determines that banks have adequate policies and processes, including strict customer due diligence rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

[1]Source: www.bis.org (Basle Committee on Banking Supervision).