BANK OF BOTSWANA

DIRECTIVE ON THE REVISED INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS FOR BOTSWANA (BASEL II)

Issue Date: **September 8, 2015**

Effective Date: **January 1, 2016**

DIRECTIVE ON THE REVISED INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS (BASEL II)

Table of Contents

1. **AUTHORITY, PURPOSE AND SCOPE** 1
   (a) Authority 1
   (b) Purpose 1
   (c) Effective Date 1
   (d) Scope 1
2. **THE REVISED CAPITAL STRUCTURE** 2
3. **MINIMUM CAPITAL ADEQUACY RATIO** 13
4. **PILLAR I: MINIMUM REGULATORY CAPITAL REQUIREMENTS** 14
5. **PILLAR II: THE SUPERVISORY REVIEW PROCESS** 21
6. **PILLAR III: MARKET DISCIPLINE** 21
7. **ABOLISHMENT OF LIMITS AND MINIMA** 21
8. **REPEAL OF THE BASEL I FRAMEWORK** 21

APPENDICES 23
   Appendix 1 24
   (a) Summary of Risk-weights under Standardised Approach for Credit Risk 24
   (b) Credit Conversion Factors: Off-balance Sheet Items 25
   Appendix 2 26
   Eligible Collateral for Credit Risk 26
   Appendix 3 27
   The Legal Criteria for Netting Arrangements and Bilateral Netting Rules (Set-off Principle) 27

1. AUTHORITY, PURPOSE AND SCOPE

(a) Authority

1.1 This Directive is issued by the Bank of Botswana (Bank) pursuant to its authority set forth in Section 13 of the Banking Act (CAP. 46:04) (hereinafter referred to as the "Act") and Regulation 7 of the Banking Regulations, 1995 (hereinafter referred to as "Regulations").

(b) Purpose

1.2 The purpose of this Directive is to prescribe the "Revised International Convergence of Capital Measurement and Capital Standards (Basel II) as a basis for the determination of the capital adequacy requirements for banks in Botswana.

1.3 In accordance with Section 13(1) of the Act, "every bank shall maintain paid up unimpaired capital at least equal to such percentage of such bank's total assets as may be prescribed for the purpose". Furthermore, the Act empowers the Bank to set the minimum prudential capital adequacy requirements for licensed banks in Botswana and define qualifying components of capital, taking into account the ability of such owners' funds and/or long-term debt instruments to absorb losses.

1.4 While retaining the meaning of capital and unimpaired capital, as set out in Sections 13(3) and 13(4) of the Act, the determination of eligible capital, method of computation and composition of regulatory capital shall be as specified in the Directive on the Revised International Convergence of Capital Measurement and Capital Standards (Basel II). This is an abridged version of the more detailed guidelines set out in the Basel Committee on Banking Supervision (BCBS) Basel II document (www.bis.org).

(c) Effective Date

1.5 Effective January 1, 2016, a bank shall maintain paid up unimpaired capital of at least 15 percent of the bank's total risk-weighted assets. The total risk-weighted assets are determined by multiplying the capital requirements for market risk and operational risk by 6.7 (that is, the reciprocal of the minimum capital ratio of 15 percent) and adding the resulting amount to the sum of risk-weighted assets for credit risk. This new framework is explained in paragraphs 2 to 5 below.

(d) Scope

1.6 This Directive applies to a bank licensed by the Bank under the Act, to statutory banks and other financial institutions established under separate Acts of Parliament, which fall under the purview of the Bank's supervision in terms of Section 53(2) of the Act and/or their respective statutes.

2. THE REVISED CAPITAL STRUCTURE

2.1 The capital components, for the purpose of this Directive, shall be as set out under Section 13(3) of the Act. Additionally, consistent with Section 13(5) of the Act, the new definition of total regulatory capital (also referred to as adjusted capital) comprises the following elements:

Tier I Capital (Going-concern Capital)

2.2 Tier I Capital is the portion of capital which is permanently and freely available to absorb unanticipated losses on a "going concern" basis. This form of capital, in turn, comprises both Common Equity Tier I (CET1) Capital and Additional Tier I Capital. CET 1 Capital is the purest and most predominant form of capital and includes common shares and retained earnings. The new definition of regulatory capital introduces stricter criteria for determining the constituents of Additional Tier I Capital to ensure that these instruments can also absorb losses of a bank on a "going-concern" basis.

Common Equity Tier I (CET1 Capital)

2.3 CET1 capital consists of the sum of the following elements:

(a) Common shares issued by a bank that meet the criteria for classification as common shares for regulatory purposes;

(b) Share premium (stock surplus) resulting from the issue of instruments included in CET1 capital;

(c) Retained earnings, cumulative general reserves set aside as part of the appropriation from net profit in any given financial year, including interim profits, provided such interim profits are audited. Furthermore, any proposed dividends not yet paid should be deducted from the retained earnings for that year;

(d) Accumulated other comprehensive income[1] and other disclosed reserves;

(e) Common shares issued by consolidated subsidiaries of a bank and held by third parties (i.e., minority interest) that qualify for inclusion in CET1 capital; and

(f) Regulatory adjustments[2] applied in the calculation of CET1 capital.

[1] Accumulated other comprehensive income, relating to unrealised gains/(losses) from bonds and treasury bills held as available for sale, will not be recognised as part of capital elements, since these instruments do not form part of capital, and therefore, any associated gains/losses from them are disqualified as well. However, gains on equity investments should be restricted to equity investments in banking, financial and insurance entities.

[2] See paragraph 4.6.

Criteria for Classification as part of CET1 Capital

2.4 For purposes of paragraph 2.3 above, CET1 capital shall have the following characteristics:

(a) Represents the most subordinated claim in the liquidation of a bank;

(b) It is entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e., has an unlimited and variable claim, not a fixed or capped claim);

(c) The principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under the relevant law);

(d) A bank does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled nor do the statutory or contractual terms provide any feature which might give rise to such an expectation;

(e) Distributions are paid out of distributable items (retained earnings included). The level of distribution is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items);

(f) There are no circumstances under which the dividend payment or distributions are obligatory. Non-payment is, therefore, not an event of default;

(g) Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital;

(h) It is the issued capital that takes the first and proportionately greatest share of losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis, proportionately and *pari passu* with all the others;

(i) The paid in amount is recognised as equity capital (i.e., not recognised as a liability) for determining the statement of financial position insolvency;

(j) The paid-in amount is classified as equity under the relevant accounting standards;

(k) It is directly issued and paid-in and a bank cannot directly or indirectly have funded the purchase of the instrument;

(l) The paid-in amount is neither secured nor covered by a guarantee of the issuer or related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim;

(m) It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners; and

(n) It is clearly and separately disclosed on a bank's statement of financial position.

Regulatory Adjustments in the CET1 capital

2.5 The following items shall be deducted from the CET1 capital of a bank, subject to threshold deductions, as outlined under paragraph 2.6;

(a) Goodwill and other intangible assets[3];

(b) Advances of a capital nature[4] granted to connected persons[5];

(c) Deferred tax assets (DTA) that rely on the future profitability;

(d) Investments in own shares, whether directly or indirectly;

(e) Unrealised revaluation losses on investments in securities;

(f) Defined benefit pension fund assets;

(g) Reciprocal holdings in the capital of banking, financial and insurance entities;

(h) Cash flow hedge reserve; and

(i) Gains on sales related to securitisation transactions.

Threshold Deductions

2.6 Instead of a full deduction, the following items may each receive limited recognition when calculating the CET1 capital of a bank, with recognition capped at 10 percent of a bank's common equity (after the application of all regulatory adjustments set out under paragraph 2.5):

(a) Significant investments in the common shares of unconsolidated financial institutions (banks, insurance and other financial entities);

(b) Deferred tax assets that arise from temporary differences;

(c) Mortgage servicing rights[6];

[3] A bank may use IFRS 3 for the definition of goodwill and IAS38 for the definition of intangible assets to determine which assets are to be classified as such and are thus deductible.

[4] Defined as injection of risk capital to an entity owned, directly or indirectly, by a connected person, other than the provision of a loan.

[5] Includes all of the following without limitations: (1) Significant shareholder; (2) Member of a board of directors or audit committee; (3) Principal Officer and senior management officials; (4) Any person who is related to such significant shareholder, member of the board of directors or audit committee, Principal Officer or senior management official by family or business interest; (5) Subsidiary of a bank; (6) Company or undertaking in which at least a 5 percent interest is held by a bank; (7) Parent company of a bank; (8) Company that is under common control with a bank; and (9) A company that holds at least a 5 percent interest of another company in which a bank holds at least a 5 percent interest.

[6] A contractual agreement where the right, or rights, to service an existing mortgage are sold by the original lender to another party who specialises in the various functions of servicing mortgages. Common rights included are the right to collect mortgage payments monthly, set aside taxes and insurance premiums in an escrow account[6], and forward interest and principle

(d) Aggregate investments by a bank or its subsidiary in the equity of other banks and financial institutions, where the aggregate investment is equal to or greater than 10 percent of the capital of the institutions in which the investment is made. The amount above the 10 percent threshold shall be deducted from CET1 capital, and the amount below the threshold shall be appropriately risk-weighted. That is, the excess above the 10 percent threshold must be deducted and the threshold amount shall be risk-weighted as appropriate; and

(e) The amount of the three items (a,b,c) not deducted in the calculation of CET1 capital (threshold amounts) will be treated as other assets and risk-weighted at 250 percent.

Additional Tier I Capital of a Bank

2.7 Additional Tier I capital consists of the sum of the following elements:

(a) Instruments issued by a bank that meet the criteria for inclusion in Additional Tier I capital (and are not included in CET1 capital);

(b) Share premium (stock surplus) resulting from the issue of instruments included in Additional Tier I capital;

(c) Instruments issued by consolidated subsidiaries of a bank and held by third parties that meet the criteria for inclusion in Additional Tier I capital, and are not included in CET1 capital. Such instruments may receive recognition in Additional Tier I capital of a bank, only if issued by a bank.

(d) Regulatory adjustments applied in the calculation of Additional Tier I capital.

Criteria for Classification as Additional Tier I Capital

2.8 For purposes of paragraph 2.7 above, qualifying instruments shall be subject to the following conditions:

(a) Issued and paid-in;

(b) Subordinated to depositors, general creditors and subordinated debt of a bank;

(c) Is neither secured nor covered by a guarantee of the issuer or related entity, or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis bank creditors;

(d) Is perpetual, i.e., there is no maturity date and there are no step-ups or other incentives to redeem;

---

to the mortgage lender. Mortgage servicing may be performed by the original lender, or the lender may sell the right to service a mortgage to another company, which performs the service for a fee.

(e) May be callable at the initiative of the issuer only after a minimum of five years:

   (i) To exercise a call option, a bank must receive prior supervisory approval; and

   (ii) A bank must not do anything which creates an expectation that the call will be exercised;

(f) A bank must not exercise a call unless:

   (i) It replaces the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of a bank[7]; or

   (ii) A bank demonstrates that its capital position will be well above the prescribed minimum capital requirement, following the exercise of the call option.

(g) Any repayment of principal (e.g., through repurchase or redemption) must be with prior supervisory approval and a bank should not assume or create market expectations that supervisory approval will be given;

(h) Dividend/coupon discretion:

   (i) The bank must have full discretion at all times to cancel distributions/payments;

   (ii) Cancellation of discretionary payments must not be an event of default;

   (iii) A bank must have full access to cancelled payments to meet obligations as they fall due; and

   (iv) Cancellation of distributions/payments must not impose restrictions on a bank, except in relation to distributions to common stockholders;

(i) Dividends/coupons must be paid out of distributable items;

(j) The instrument cannot have a credit sensitive dividend feature, that is, a dividend/coupon that is reset periodically, based in whole or in part, on a bank's credit standing;

(k) The instrument cannot contribute to liabilities exceeding assets, if such statement of financial position test forms part of national insolvency law;

(l) Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the

[7] Replacement issues can be concurrent with, but not after the instrument is called.

instrument at a pre-specified trigger point. The write-down will have the following effects:

(i) Reduce the claim of the instrument in liquidation;

(ii) Reduce the amount re-paid when a call is exercised; and

(iii) Partially or fully reduce coupon/dividend payments on the instrument;

(m) Neither a bank nor a related party over which a bank exercises control or significant influence can have purchased the instrument, nor can a bank directly or indirectly have funded the purchase of the instrument;

(n) The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame; and

(o) If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g., a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity[8] or the holding company in the consolidated group, in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier I capital.

Regulatory Adjustments in Additional Tier I Capital

2.9 The following items shall be fully deducted from Additional Tier I Capital:

(a) Direct investments in own Additional Tier I capital, net of any short positions, if the short positions involve no counterparty risk;

(b) Indirect investments in own Additional Tier I capital (e.g., through holdings of index securities in which the bank itself is a constituent), net of any short positions;

(c) Any own Additional Tier I capital, which the bank could be contractually obliged to purchase;

(d) Reciprocal cross holdings and the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation[9]; and

(e) Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation (i.e., where the bank owns more than 10 percent of the issued common share capital or where the entity is an affiliate).

---

[8] An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

[9] Holdings of Additional Tier 1 capital or similar instruments that are part of a reciprocal cross holding arrangement.

Additional Tier I Capital Threshold Deductions

2.10 Instead of a full deduction, aggregate amount of non-significant investments in Additional Tier I capital of unconsolidated financial institutions (banks, insurance and other financial entities), shall receive limited recognition when calculating Additional Tier I capital, with recognition capped at 10 percent of the bank's common equity (after the application of all regulatory adjustments set out under paragraph 2.9). That is, the excess above the 10 percent threshold must be deducted and the threshold amount shall be risk-weighted as appropriate.

Tier II Capital (Gone-concern Capital)

2.11 Tier II Capital is capital that can absorb losses on a "gone-concern" basis, or capital that absorbs losses in insolvency, before losses can be incurred by general creditors and depositors. That is, it helps to ensure that general creditors and depositors get repaid if the bank fails. It includes instruments issued by a bank that meet the criteria for inclusion in Tier II Capital, general provisions and current year's unpublished profits.

2.12 Tier II capital consists of the sum of the following elements:

(a) Instruments issued by a bank that meet the criteria for inclusion in Tier II capital (and are not included in Tier I capital);

(b) Share premium (stock surplus) resulting from the issue of instruments included in Tier II capital;

(c) Instruments issued by consolidated subsidiaries of a bank and held by third parties that meet the criteria for inclusion in Tier II capital, and are not included in Tier I capital (minority interests);

(d) General provisions/general loan loss reserves - Provisions or loan-loss reserves held for future, presently unidentified losses, which are freely available to meet losses which subsequently materialise. NB: Provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, do not qualify to be included in Tier II capital. Furthermore, general provisions/general loan-loss reserves eligible for inclusion in Tier II capital will be limited to a maximum of 1.25 percentage points of credit risk-weighted assets;

(e) Current year's unpublished profits; and

(f) Regulatory adjustments applied in the calculation of Tier II Capital.

Criteria for Inclusion in Tier II Capital

2.13 An instrument shall meet or exceed the following minimum set of criteria in order for it to be included in Tier II capital:

(a) Issued and paid-in;

(b) Subordinated to depositors and general creditors of a bank;

(c) Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general bank creditors;

(d) Maturity:

(i) Minimum original maturity of at least five years;

(ii) Recognition in regulatory capital in the remaining five years before maturity will be amortised on a straight line basis. That is, during the last five years to maturity, a cumulative discount factor (amortisation) of 20 percent per annum will be applied to reflect the diminishing value of these instruments as a continuing source of financial strength, and

(iii) There are no step-ups or other incentives to redeem.

(e) May be callable at the initiative of the issuer only after a minimum of five years:

(i) To exercise a call option, a bank must receive prior supervisory approval;

(ii) A bank must not do anything that creates an expectation that the call will be exercised[10];

(iii) A bank must not exercise a call unless:

- It replaces the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the bank[11]; or
- A bank demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised[12].

---

[10] An option to call the instrument after five years, but prior to the start of the amortisation period, will not be viewed as an incentive to redeem, as long as the bank does not do anything that creates an expectation that the call will be exercised at this point.

[11] Replacement issues can be concurrent with, but not after the instrument is called.

[12] Minimum refers to the regulator's prescribed minimum requirement, which may be higher than the Basel III Pillar 1 minimum requirement.

(f) The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation;

(g) The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the banking organisation's credit standing;

(h) Neither the bank nor a related party over which the bank exercises control or significant influence can have purchased the instrument, nor can the bank directly or indirectly have funded the purchase of the instrument; and

(i) If the instrument is not issued out of an operating entity or the holding company in the consolidated group (eg a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity[13] or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier II Capital.

Regulatory Adjustments in Tier II Capital

2.14 The following items shall be deducted in full from Tier II Capital:

(a) Direct investments in own Tier II capital, net of any short positions, if the short positions involve no counterparty risk;

(b) Indirect investments in own Tier II Capital (e.g., through holdings of index securities in which a bank itself is a constituent), net of any short positions;

(c) Any own Tier II capital, which the bank could be contractually obliged to purchase;

(d) Reciprocal cross holdings and the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation; and

(e) Significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation (i.e., where a bank owns more than 10 percent of the issued common share capital or where the entity is an affiliate).

Tier II Capital Threshold Deductions

2.15 Instead of a full deduction, the aggregate amount of non-significant investments in Tier II capital of unconsolidated financial institutions (banks, insurance and other financial entities), shall receive limited recognition when calculating Tier II capital, with recognition capped at 10 percent of the bank's common equity (after the application of all regulatory adjustments set out under paragraph 2.13). That is, the excess above 10 percent threshold must be deducted and the threshold amount shall be risk-weighted as appropriate.

---

[13] An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

Capitalisation of Interim Profits

2.16 During the year, a bank licensed under the Act is authorised to capitalise its mid-year audited interim profits, net of proposed interim dividends and an auditor's certificate to that effect must be issued.

2.17 It is expected that in deciding to capitalise half year's net profits, a bank would take a "whole year" view of the performance to avoid capitalisation of interim profits only to be eroded by losses in the second half of the year.

2.18 A bank must notify Bank of Botswana of any subsequent dividend payout, which would result in the reduction of the latest audited capital position of the institution.

Capital Adequacy Assessment

2.19 A bank shall be required to establish appropriate systems, which will enable them to accurately determine the adequacy of its levels of capital, for the existing business risks. Through its oversight function, a bank's Board will also be expected to ensure that annual tests to obtain independent assurance about the adequacy of a bank's capital are carried out. Furthermore, all banks must be able to demonstrate the adequacy of their capital bases to the Bank, as may be required, either during an on-site examination and/or through the off-site monitoring process, using statutory returns.

Provisions to be made for Certain Items

2.20 In accordance with Section 14 of the Act, in making any calculations necessary to ascertain whether or not the capital of a bank is adequate for the purpose of complying with the requirements of Section 13 of the Act, account shall be taken, to the satisfaction of the Bank, and in accordance with International Financial Reporting Standards, of the following items:

(i) collectively and individually assessed impairments for bad and doubtful debts;
(ii) depreciation of assets (to be calculated at least once in each financial year);
(iii) operating and accumulated losses;
(iv) preliminary expenses relating to the organisation or extension of the purchase of any business or goodwill; and
(v) such other items as may be prescribed.

2.21 Each bank shall either:

(a) maintain a primary reserve account that is, in the opinion of the Bank, adequate, and which is reserved exclusively for the purpose of making good any loss resulting from the negligence or dishonesty of any director, principal officer or any other officer or employee of the bank; or

2.22 Subject to the minimum provisioning requirements set by the Bank and provisioning methodology adopted by a bank, the Bank's examination team shall assess the level and adequacy of provisions for impairments based on the performance status of loans and advances using a methodology determined by the Bank.

2.23 If the Bank concludes, based on its review of the reports of a bank or the results of an examination of a bank, that the bank's provisions for losses and impairments and other items identified in Section 14 of the Act are inadequate to provide for the realistic probability of loss or reduction, then the Bank may order the bank to establish additional provisions for such losses and other items identified in Section 14 of the Act.

Transitional Arrangements

Non-qualifying Capital Instruments

2.24 A bank will phase out, over a period of five years, beginning January 1, 2016, capital instruments that no longer qualify as Tier I capital or Tier II capital. Fixing the base at the nominal amount of such outstanding instruments on January 1, 2016, their recognition will be capped at 80 percent from January 1, 2016, with the cap reducing by 20 percentage points in each subsequent year. This cap applies to each tier of capital separately and refers to the total amount of outstanding instruments that no longer meet the relevant qualifying criteria. To the extent that the instrument is redeemed, or its recognition in capital is amortised, after January 1, 2016, the nominal amount serving as a base shall not reduced.

2.25 Only hybrid capital instruments issued before January 1, 2016 qualify for the above transitional arrangements.

New Regulatory Adjustments

2.26 Regulatory adjustments introduced by the new rules (i.e., items not currently required to be deducted in the existing capital framework), shall be gradually **phased in** over a period of five years, beginning January 1, 2016. In particular, regulatory adjustments will begin at 20 percent of the required adjustments to the relevant tier on January 1, 2016, 40 percent on January 1, 2017, 60 percent on January 1, 2018, 80 percent on January 1, 2019 and 100 percent in January 1, 2020. During this transition period, the balance not deducted from capital will continue to be subject to the existing treatment.

3. MINIMUM CAPITAL ADEQUACY RATIO

3.1 Under the current Basel I capital structure, there are only two tiers of capital, namely, Tier I Capital (core capital) and Tier II Capital (supplementary capital). While the Basel I prudential minimum capital adequacy ratio of 15 percent is retained, under Basel II, (Table 1 below), the core capital element is further apportioned into two components, CET 1 Capital (4.5 percent) and Additional Tier I Capital (3 percent). In accordance with Section 13(6) of the Act, which prescribes that core capital shall constitute a minimum of 50 percent of the total capital of a bank, the two constituents of core capital must be at least 7.5 percent of the total risk-weighted assets of a bank. The remaining 7.5 percent of a bank's risk-weighted assets may either be in the form of eligible supplementary capital funds (Tier II Capital) or Tier I Capital. That is, there is nothing that prevents any bank from holding all or the majority of its capital as Tier I Capital.

Table 1: Capital Adequacy Requirements (Percent)

	Common Equity Tier1	Additional Tier I	Tier I Capital	Tier II Capital	Total Capital
Prudential Minimum	4.5	3	7.5	7.5	15

3.2 If, as a consequence of a review of capital adequacy, both with regard to risk assets and other activities which entails risk, undertaken by the Bank as part of its examinations under Section 24(1) of the Act, the Bank determines that the capital and reserves of a bank are inadequate, the Bank may call for corrective measures as authorised by Section 27 (a) of the Act.

3.3 Consistent with Section 13(2) of the Act, where a bank fails to maintain its unimpaired capital at the level required in accordance with paragraph 3.1 above, the Bank may impose on and collect from it a levy not exceeding 0.1 percent of the amount by which such unimpaired capital falls short of the amount prescribed.

3.4 A bank's audited financial statements and statutory returns should show the unimpaired capital elements. Furthermore, the Bank's on-site examination reports must include a page measuring capital through the capital convergence method of risk-weighting for on-balance and off-balance sheet items.

4. PILLAR I: MINIMUM REGULATORY CAPITAL REQUIREMENTS

4.1 Under Pillar I of the Basel II framework, in addition to credit risk, a separate and explicit computation of the regulatory capital for market risk and operational risk is introduced. Therefore, the minimum amount of regulatory capital is derived through the summation of capital charges for credit risk, operational risk and market risk. The computation of the regulatory capital adequacy requirements by a bank shall be based on an approach prescribed by the Bank for credit risk, market risk and operational risk. Where applicable, capital charges for other types of risks not included in the calculation of the regulatory capital adequacy ratio (e.g., liquidity risk, interest rate risk in the banking book, business risk and credit concentration risk) shall be assessed under Pillar II.

4.2 Each bank shall compute its capital adequacy requirements based on the Standardised Approach (SA) for credit risk, a choice between the Basic Indicator Approach (BIA) and Standardised Approach (SA) for operational risk, and Standardised Measurement Method (SMM) for market risk. These methods are explained in the Basel II document.

4.3 The formula for the computation of the regulatory capital adequacy ratio shall be:

CAR[14] = UC/(RWA for CR + (Capital Charge for OR + Capital Charge for MR) * 6.7) * 100 ≥ 15 percent

It must be noted that the risk-weighted on- and off-balance sheet assets for credit risk will be determined by multiplying the credit exposures by the appropriate risk-weights, dependent on the counterparty's risk rating, as applicable. However, the amount of the risk-weighted assets for both operational risk and market risk shall be determined by multiplying the respective capital requirements by 6.7[15], the result of which is added to the risk-weighted assets for credit risk, to come up with the total risk-weighted assets of a bank.

(a) Capital Charge for Credit Risk: Standardised Approach

4.4 The computation of the credit risk capital charge of a given bank will be based on risk-weights assigned for each borrower and other exposures (Appendix 1), on- and off-balance sheet, calibrated by allowable credit risk mitigation techniques (CRMs). The SA (which is closest to Basel I) is the simplest approach for calculating the capital charge for credit risk. The main distinguishing factors of this approach, in comparison to Basel I, is that it is more risk sensitive and counterparty risk-weights are based on external credit ratings. It also entails eligibility and qualification criteria for different types of exposures and external credit rating agencies. However, where external credit ratings do not exist for an exposure (unrated), a bank must allocate a 100 percent risk-weight for such an exposure. This approach also allows for the capital of a bank to be adjusted (reduced) by the amount of the eligible CRMs (e.g., collateral in the form of cash or securities, third party guarantees,

[14] Capital Adequacy Ratio (CAR); Unimpaired Capital (UC); Risk-weighted Assets (RWA); Credit Risk (CR); Operational Risk (OR); Market Risk (MR).

[15] The 6.7 is the inverse of the 15 percent prudential minimum CAR (1/0.15).

derivative financial instruments and/or set-off/on-balance sheet netting of a loan by the amount of deposit held by the bank for the same customer in the same currency).

4.5 The other major highlights of the SA approach for credit risk are the lower risk-weights for qualifying retail exposures and residential mortgages. For example, under Basel I, all unsecured private sector loans and advances (corporate and retail exposures) were assigned a blanket risk-weight of 100 percent. Under the Basel II framework, retail exposures, which meet the set qualifying criteria, are risk-weighted at 75 percent. Owner-occupied residential mortgages or rented for residential purposes, meeting the set qualifying criteria, are assigned a 35 percent risk-weight, compared to 50 percent under Basel I.

External Credit Assessment

4.6 For purposes of assigning risk-weights for claims on counterparties, a bank shall recognise the ratings of Standard & Poors Ratings Services, Moodys Investors Service and Fitch Ratings. The Bank shall also, at its discretion, recognise the ratings of any other external credit assessment institution (ECAI) upon application by the ECAI, or the bank on behalf of the ECAI, provided that they meet the eligibility criteria specified in the Basel II document.

4.7 A bank must use the chosen ECAIs and their ratings consistently for each type of claim, for both risk-weighting and risk management purposes. A bank will not be allowed to "cherry-pick" the assessments provided by different ECAIs. In the case of unrated exposures, the applicable risk-weight shall be 100 percent or more, as may be prescribed by the Bank from time to time.

4.8 A bank shall only be permitted to use solicited ratings.

4.9 External assessments for one entity within a corporate group cannot be used to risk-weight other entities within the same group.

Multiple Assessments

4.10 If there are two assessments by ECAIs chosen by a bank, which map into different risk-weights, the higher risk-weight will be applied.

4.11 If there are three or more assessments with different risk-weights, the assessments corresponding to the two lowest risk-weights should be referred to and the higher of those two risk-weights will be applied.

Domestic Currency and Foreign Currency Assessments

4.12 Where a borrower's domestic currency ratings are separate from the foreign currency ratings, a bank shall use a borrower's domestic currency rating for exposures denominated in domestic currency and foreign currency ratings for exposures denominated in foreign currency. For example, for an exposure to a South African bank denominated in rand, use

South Africa's domestic/local currency rating; and for an exposure to a South African bank denominated, say, in US dollars, use South Africa's foreign currency rating.

4.13 For risk-weighting purposes, only long-term assessments shall be allowed in this capital standard.

Criteria for Inclusion in the Regulatory Retail Portfolio

4.14 Claims that are included in the retail portfolio, which meet the qualifying criteria, shall attract a risk-weight of 75 percent, except as provided under the paragraph for past due loans (paragraph 4.18). Such claims must meet the following criteria:

(a) **Orientation criterion:** The exposure is to an individual person or persons or to a small business;

(b) **Product criterion:** The exposure takes the form of any of the following: revolving credits and lines of credit (including credit cards and overdrafts), personal term loans and leases[16] and small business[17] facilities and commitments. Mortgage loans and securities (such as bonds and equities) are excluded from this category;

(c) **Granularity criterion:** No aggregate exposure to one counterparty[18] should be allowed to exceed 0.2 percent of the overall retail portfolio;

(d) **Low value of individual exposures:** The maximum aggregated retail exposure to one counterparty and groups of related counterparties must not exceed P10 million; and

(e) Other retail portfolio not meeting any of the criteria under (a) to (d) above, will be risk-weighted at 100 percent.

4.15 On an ongoing basis, the Bank will evaluate the risk-weights assigned to the retail portfolio based on the default experience of these exposures and accordingly determine if these exposures warrant a risk-weight higher than 75 percent. Where this discretion is executed by the Bank of Botswana, it would apply to the banking industry as a whole.

---

16 A lease is a contractual arrangement calling for the lessee (user) to pay the lessor (owner) for use of an asset.

17 Small business classification should be done in relation to turnover/revenue per annum up to a maximum of P4 million (as defined in the revised statutory returns).

18 Aggregate exposure means gross amount (i.e., not taking any credit risk mitigation into account) of all forms of debt exposures (e.g., loans or commitments) that individually satisfy the three other criteria. In addition, "to one counterpart" means one or several entities that may be considered as a single beneficiary (e.g., in the case of a small business that is affiliated to another small business, the limit would apply to the bank's aggregated exposure to both businesses).

Criteria for Inclusion as Claims Secured by Residential Property (owner-occupied residential mortgages)

4.16 Claims secured by residential property, up to P10 million or such other figure as may be determined by the Bank from time to time, shall be risk-weighted at 35 percent, except as set out at paragraph 4.18 of the Basel II document for past due loans. This preferential risk-weight is subject to the following conditions:

(a) Lending must be fully-secured by mortgage on the financed residential property;

(b) The residential property must be owner-occupied or rented by the borrower to a third party, but used for residential purposes;

(c) The residential property must be valued according to strict valuation rules[19] and a the bank must ensure that the value of the property is assessed at least once every three years, or more frequently, if market conditions show signs of volatility;

(d) A bank must not only rely on the underlying property provided as collateral, but rather on the borrower's capacity to repay the debt from other sources;

(e) The property must be insured by a recognised third party insurer for fire and other perils throughout the lifespan of the loan;

(f) The Loan-to-Value ratio[20] must not exceed 90 percent. Where the LTV ratio exceeds 90 percent, the excess shall be risk-weighted at 75 percent; and

(g) Other "owner-occupied)" residential property not meeting any of the criteria under (a) to (e) above, will be risk-weighted at 75 percent.

4.17 On an ongoing basis, the Bank will evaluate the risk-weights assigned to claims secured by residential property based on the default experience of these exposures and accordingly determine if these exposures warrant a risk-weight higher than 35 percent. Where this discretion is executed by the Bank of Botswana, it would apply to the banking industry as a whole.

Treatment of Past Due Loans (more than 90 days, net of specific provisions)

4.18 For any unsecured portion of any loan (other than a qualifying residential mortgage loan) that is past due for more than 90 days, net of specific provisions (including partial write-offs), shall be assigned risk-weights in line with the table below:

[19] The valuation should be carried out by accredited valuers who are members of the Real Estate Institute. This includes but is not limited to a person who possesses the necessary qualifications, experience and is independent from the credit decision process.

[20] The loan-to-value ratio is defined as outstanding loan amount divided by the open market property value multiplied by 100.

Specific Provision (SP)	Risk-weight (Percent)
SP < 20 percent of outstanding loan amount	150
SP between 20 percent and 50 percent of outstanding loan amount	100
For loans secured by residential property, where such loans are past due for more than 90 days, and their SP < 20 percent	100
SP more than 50 percent of outstanding loan amount	50
For loans secured by residential property and SP is greater than 20 percent of outstanding loan amount	50

Minimum Requirements for the Recognition of Credit Risk Mitigation (CRM) Techniques

4.19 Consistent with the SA for credit risk, banks in Botswana will be permitted to take into account CRMs, as shown in Appendix 2.

4.20 In order for a bank to obtain regulatory capital relief for the use of any CRM technique, the following conditions shall be met:

4.21 A bank should meet the CRM disclosure requirements as detailed under Pillar III - Market Discipline[21];

4.22 All documentation used in collateralised transactions and for documenting on-balance sheet netting, guarantees and credit derivatives, must be binding on all parties and legally enforceable in all relevant jurisdictions. A bank must have undertaken sufficient legal review to verify this and have a sound legal basis to reach this conclusion, and undertake such further reviews as necessary to ensure ongoing enforceability;

4.23 The legal mechanism by which collateral is pledged or transferred must ensure that a bank has the right to liquidate or take legal possession of it, in a timely manner, in the event of default, insolvency or bankruptcy of the counterparty (and where applicable, take legal action on the custodian holding the collateral or legal possession of collateral);

4.24 A bank shall take all steps necessary to fulfill those requirements under the law applicable to a bank's interest in the collateral for obtaining and maintaining an enforceable security interest, i.e., by registering it or for exercising a right to net or set-off in relation to title transfer collateral (see Appendix 3 for legal criteria and bilateral netting rules);

4.25 In order for collateral to provide protection, the credit quality of the counterparty and the value of the collateral must not have a material positive correlation. For example, securities issued by the counterparty, or by any related group entity, would provide little protection and so would be ineligible;

---

[21] See Basel II document

4.26 A bank must have clear and robust procedures for the timely liquidation of collateral to ensure that any legal conditions required for declaring the default of the counterparty and liquidating the collateral are observed and that the collateral can be liquidated promptly;

4.27 Where the collateral is held by an independent custodian or an equally independent third party, a bank must take reasonable steps to ensure that the custodian segregates the collateral from its own assets;

4.28 When cash on deposit, certificates of deposit or comparable instruments issued by a lending bank are held as collateral at a third-party bank, in a non-custodial arrangement, if they are openly pledged/assigned to a lending bank, and if the pledge/assignment is unconditional and irrevocable, the exposure amount covered by the collateral (after any necessary haircuts for currency risk), will receive the risk-weight of the third-party bank;

4.29 A capital requirement will be applied to a bank on either side of the collateralised transaction: For example, both repos and reverse repos will be subject to capital requirements. Likewise, both sides of a securities lending and borrowing transaction will be subject to explicit capital charges, as will the posting of securities in connection with a derivative exposure or other borrowing and;

4.30 Where a bank, acting as an agent, arranges a repo-style transaction (i.e., repurchase/reverse repurchase and securities lending/borrowing transactions) between a customer and a third party, and provides a guarantee to a customer that the third party will perform on its obligations, then the risk to a bank is the same as if the bank had entered into the transaction as a principal. In such circumstances, a bank shall be required to calculate capital requirements as if it were itself the principal.

CRM Approaches[22]

4.31 A bank shall select one, but not both of the following approaches, and apply that approach to its entire on- and off-balance sheet banking book exposures that are subject to credit risk mitigation:

(a) The Simple Approach; or

(b) The Comprehensive Approach to credit risk mitigation.

4.32 A bank shall advise the Bank, which of the above CRM approaches it has chosen to use for its banking book exposures. With respect to trading book exposures, only the Comprehensive Approach will be allowed.

4.33 A bank shall also use the Comprehensive Approach to calculate the counterparty risk charges for over-the-counter (OTC) derivatives and repo-style transactions in the trading book.

---

22 See Basel II document

4.34 Partial collateralisation shall be recognised in both approaches.

4.35 Mismatches in the maturity[23] of the underlying exposure and the collateral shall only be allowed under the Comprehensive Approach.

4.36 Where there is a maturity mismatch and the CRM has an original maturity of less than one year, the CRM is not recognised for regulatory capital purposes, i.e., hedges with maturity mismatches will only be recognised when their original maturities are greater than or equal to one year. In addition, partial recognition for maturity mismatches shall be given to the CRM for regulatory capital purposes.

(b) **Capital Charge for Operational Risk**[24]

4.37 The new capital framework has introduced a separate capital charge for operational risk using either the Basic Indicator Approach, Standardised Approach or Advanced Measurement Approaches (AMA). In Botswana, banks will be permitted to use either the BIA or SA. The use of SA by a bank is subject to prior approval by the Bank, while the BIA is the default entry approach for all banks. For both approaches, gross profit is used as a proxy for the computation of the operational risk capital charge.

(c) **Capital Charge for Market Risk**[25]

4.38 The capital charge for market risk shall be computed using the SMM. Banks are required to assess, measure and apply capital charges in respect of market risk in the trading book; this section does not apply to the banking book. For purposes of this framework, risks subject to this requirement are those arising from interest rate related instruments, foreign exchange risk, commodities risk and equity positions risk.

---

23 For the purpose of calculating risk-weighted assets, a maturity mismatch occurs when the residual maturity of a hedge is less than that of the underlying exposure.

24 See Basel II document for computation.

25 See Basel II document for computation.

5. PILLAR II: THE SUPERVISORY REVIEW PROCESS[26]

5.1 Pillar II - the Supervisory Review Process (SRP), aims to ensure that a bank has adequate capital to support its operations at all times. It also promotes the adoption of a more forward looking approach to capital management. In addition, it covers capital for other risks not fully captured or factors not taken into account under Pillar I (concentration risk, interest rate risk in the banking book and liquidity risk), factors external to a bank (business cycle effects) and encourages a bank to develop and employ more rigorous risk management techniques. Furthermore, Pillar II requires a bank to always operate above the prescribed minimum prudential capital requirements. Thus, the underlying aim of the SRP is to enhance the link between a bank's risk profile, its risk management systems and capital, at all times. Banking supervisory authorities are required to assess and take appropriate action to ensure that the risk-based capital management of any bank is robust and effective.

5.2 The SRP has four principles, namely that:

(i) Banks should have processes for assessing the adequacy of capital in relation to their risk profiles, commonly referred to as the Internal Capital Adequacy Assessment Process (ICAAP);

(ii) The supervisory authority should review and evaluate banks' internal capital adequacy assessments and strategies;

(iii) The supervisory authority should expect banks to operate above the regulatory minimum capital requirements, where the minimum statutory requirement is the floor;

5.3 The supervisory authority must intervene, at an early stage, and take remedial action to prevent capital falling below minimum levels required to support the risk characteristics of a particular bank. This implies that the supervisory authority must have highly skilled and knowledgeable staff members to be able to provide the required guidance to banks and ensure that their internal capital assessments are comprehensive and proportionate to the nature and scale of the business operations of a particular bank.

5.4 Every bank is required to ensure that, at all times, it manages its capital over a planning horizon of at most three years. The capital planning process must be dynamic and forward-looking in relation to a bank's risk profile. A bank should, therefore, ensure that capital levels remain above the minimum regulatory capital requirements, as well as the capital required to support its overall risk profile. The size of the required additional capital should take into account current and anticipated changes in a bank's risk profile and business plan and/or strategy. A bank should also be cognisant of the stage of the business cycle in which it is operating, given the potential changes in the external environment. Therefore, rigorous and forward-looking stress testing should form an integral part of a bank's ICAAP.

[26] See Basel II document.

6. PILLAR III: MARKET DISCIPLINE[27]

6.1 The purpose of Pillar III is to complement the minimum capital requirements (Pillar I) and the SRP (Pillar II) by introducing a set of disclosure requirements, which will allow market participants to influence the level of capital, risk assessment processes, capital adequacy and remuneration practices of a bank. Thus, this Pillar is designed to reinforce market discipline on a bank's capital management process, by imposing mandatory disclosures of relevant details of a bank's calculation of its capital amount, which includes the level and composition of capital, trends and related risks. It is intended to provide a strong incentive for banks to conduct business in a safe and sound manner.

6.2 Most of the disclosure requirements under Pillar III may be met by the existing accounting disclosure requirements under the International Financial Reporting Standards. The materiality, frequency and format of disclosures in Botswana will be prescribed by the Bank, taking into account the circumstances prevailing in Botswana.

7. ABOLISHMENT OF LIMITS AND MINIMA

7.1 The following limits have been abolished:

(a) Tier II capital of a bank limited to 100 percent of Tier I capital

(b) Subordinated Debt of a bank limited to 50 percent of Tier I capital

8. REPEAL OF THE BASEL I FRAMEWORK

8.1 The Directive on the "Measurement of Capital – Implementation of Basel Committee's International Convergence on Capital Measurement and Capital Standards in Botswana" of July 29, 1997, is hereby repealed.

Issued this 8TH day of SEPTEMBER 2015

DIRECTOR
BANKING SUPERVISION DEPARTMENT

APPENDICES

Appendix 1

(a) Summary of Risk-weights under Standardised Approach for Credit Risk

	Credit Rate						
Claims on Exposure	AAA to AA-	A+ to A-	BBB+ to BBB-	BBB+ to B-	Below B-/BB	Unrated	**Risk-Weight / CCF percentage**
Government of Botswana and Bank of Botswana							0
Cash							0
Cash items in the process of collection							20
Sovereigns and Central Banks	0	20	50	100	150	100	
Bank for International Settlements, IMF							0
Domestic Public Sector Entities							20
Foreign Public Sector Entities	20	50	100	100	150	100	
Domestic banks							20
Foreign banks	20	50	100	100	150	100	
Security firms	20	50	100	100	150	100	
Eligible Retail							75
Other retail							100.
Mortgages[27]							35
Corporates /insurance companies	20	50	100	100	150	100	100
Multilateral Development Banks	20	50	50	100	150	50	0/100
Commercial Real Estate	100	100	100	100	100	100	100
Other Assets[28]							100
Off-balance Sheet Items							CCF as approved by central bank
Past Due Items							100(20); 100(20); 150(20)
Other Non-Qualifying Residential Property							75
Investments in equity and regulatory capital instruments issued by unconsolidated financial institutions							250
Mortgage Servicing Rights							250
Deferred Tax Assets							250
Investments in commercial entities							1250
Venture capital and private equity investment							150

27 Owner occupied or rented by the borrower to a third party but used for residential purposes
28 Excludes cash items in the process of collection

(b) Credit Conversion Factors: Off-balance Sheet Items

Maturity/Commitment	Credit Conversion Factor (CCF) Percentage
Commitments: • Original maturity up to 1 year • Original maturity over 1 year • Unconditionally cancellable commitments without notice	 20 50 0
Direct credit substitutes: • Acceptances and endorsements • Guarantees on behalf of customers • Letter of credit issued by the bank with no title to underlying shipment; • Letter of credit confirmed by the bank; and Standby letters of credit serving as financial guarantee	100
Repo style transactions: • Sales and repurchase agreements and asset sales with recourse, where the credit risk remains with the bank.	100
Lending of banks securities or posting of securities as collateral: • Repurchase/reverse repurchase agreements and securities/borrowing transactions.	100
Forward asset purchases: • Commitment to purchase at a specified future date on prearranged terms, a loan, security or other asset from another party, including written put options on specified assets with the character or a credit enhancement.	100
Placements of forward deposits: • An agreement between a bank and another party where the bank will place a deposit at an agreed rate of interest at a predetermined future date.	100
Partly paid shares and securities: • Amounts owing on the uncalled portion of partly paid shares and securities held by a bank representing commitments with certain draw down conditions by the issuer at a future date.	100
Certain transaction related contingent items: • Performance bonds, warranties and indemnities • Bid or tender bonds; • Advance payment guarantees; • Customs and excise bonds; • Standby letter of credit related to particular contracts and non-financial transactions.	50
Note issuance facilities and revolving underwriting securities: • An arrangement whereby a borrower may draw down funds up to a prescribed limit over a predetermined period by making repeated note issues to the market. If the issue is unable to be placed in the market, the unplaced amount is to be taken up or funds made available by a bank being committed as an underwriter of the facility.	50
Short-term self-liquidating trade LCs/Trade related contingent items with an original maturity below 6 months: • These are contingent liabilities arising from trade-related obligations, secured against an underlying shipment of goods for both issuing and confirming bank.	20

Appendix 2

Eligible Collateral for Credit Risk

Eligible Collateral Under the Simple Approach
Cash (including CoDs) deposit with the bank which is incurring the counterparty exposure or similar products issues by the lending bank.
Debt securities rated by a recognised external credit assessment institution where either: • At least BB- if issued by sovereigns or PSEs that are treated as sovereigns; • At least BBB- if issued by other entities, including banks and securities firms; or • At least A-3/P-3 for short-term debt instruments.
Securities that are issued by: • Government of Botswana (Treasury bills, bonds) • Bank of Botswana (Bills)
Debt securities not rated by a recognised external credit assessment institution where these are: • Issued by a bank; • Listed on recognised stock exchange; • Classified as senior debt; • All rated issues of the same seniority by the issuing bank must be rated at least BBB-/P-3 by a recognised credit assessment institution; and • The bank holding the debt has no information that suggests that the debt security justifies a rating below the above level. Bank of Botswana approval must be sought before recognising these as eligible collateral.
Undertakings for Collective Investment in Transferable Securities (UCITS) and mutual funds where: • A price for the units is publicly quoted daily; and • The UCITS/mutual fund is limited to investing in instruments listed above.
Equities (including convertible bonds) included in a main index

Eligible Collateral Under the Comprehensive Approach

All of the instruments in Eligible Collateral Under The Simple Approach;
Equities (including convertible bonds) which are not included in a main index but which are listed on a recognized exchange;
UCITS/mutual funds which include such equities.

Eligible Guarantors/Protection Providers for Credit Risk

1. Sovereigns[29], PSEs, banks[30] and security firms with a risk-weight of 20 percent or better and a lower risk-weight than the counterparty.
2. Other entities rated A- or better. This would include credit protection provided by parent, subsidiary and affiliate companies when they have a lower risk weight than the obligor**.**

[29] This includes the Bank for International Settlements, the International Monetary Fund, the European Central Bank and the European Community, as well as those MDBs currently eligible for a 0 percent risk weight.

[30] This includes other MDBs.

Appendix 3

The Legal Criteria for Netting Arrangements and Bilateral Netting Rules (Set-off Principle)

To get approval for netting arrangements, a bank must satisfy the Bank that:

(i) it has executed a written, bilateral netting agreement with the counterparty that creates a single legal obligation, covering all included bilateral master agreements and transactions, such that a bank would have either a claim to receive or obligation to pay only the net sum of the positive and negative (a) closeout values of any included individual master agreements and (b) marked-to-market values of any included individual transactions, in the event a counterparty fails to perform due to any of the following: default, bankruptcy, liquidation or similar circumstances;

(ii) it has written and reasoned legal opinions[31] that conclude, with **a high degree of certainty** that, in the event of a legal challenge, relevant courts or administrative authorities would find a bank's exposure under the Netting Arrangement to be the net amount under the laws of Botswana. In reaching this conclusion, legal opinions must address the validity and enforceability of the entire Netting Arrangement under its terms and the impact of the Netting Arrangement on the material provisions of any included bilateral master arrangement;

(iii) it has internal procedures to verify that, prior to including a transaction in a netting set, the transaction is covered by the legal opinions that meet the above criteria;

(iv) the bank undertakes to update the legal opinions, as necessary, to ensure continuing enforceability of the Netting Arrangement, in light of possible changes in the relevant law;

(v) the Netting Arrangement does not include a walkaway clause. A walkaway clause is a provision which permits a non-defaulting counterparty to make only limited payments, or no payment at all, to the estate of the defaulter, even if a defaulter is a net creditor;

(vi) both transactions (debit and credit balances) must be denominated in the same currency;

(vii) counterparty(ies) prompting the debit and credit balances (netting) must have local resident status;

(viii) deposits must be blocked until the liability (loan) is fully discharged;

(ix) the accounts can only be off-set against each other provided that the account is held in the same right. Thus, a bank cannot set-off a debit balance against a credit balance of a

[31] A legal opinion must be generally recognised as such by the legal community in the firm's home country or a memorandum of law that addresses all relevant issues in a reasoned manner.

customer which, to the banker's knowledge, is held in a representative or fiduciary capacity or for a special purpose;

(x) each included bilateral master agreement and transaction included in the Netting Arrangement satisfies applicable legal requirements for recognition of bilateral netting of derivative contracts in the main text;

(xi) a bank maintains all the required documentation in its files; and

(xii) the net position will be used in assessing compliance with the capital adequacy requirements only. Primary and liquidity reserve requirements, as well as the level of provisions, should be assessed on the basis of the actual balances. However, where money in a fixed deposit account is pledged as a security, the amount of this cash security will continue to be deducted from the amount of loans, before determining the required level of specific provisions.