

**BOTSWANA
FINANCIAL SECTOR OVERVIEW
2010/11**



INDEX

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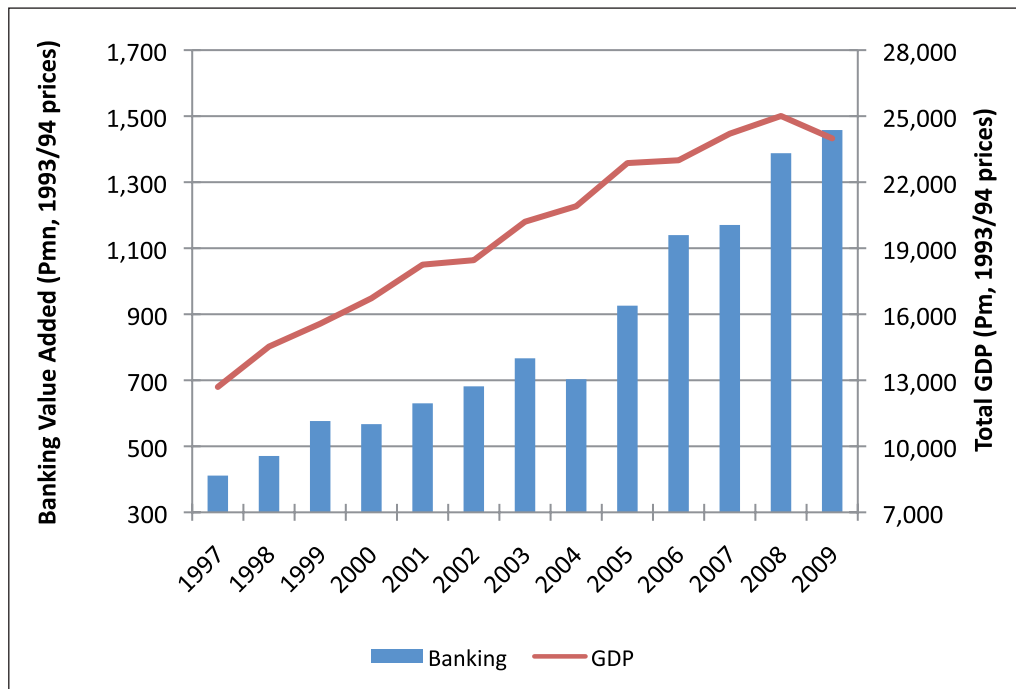
ABBREVIATIONS

AML/CFT	Anti-Money Laundering/Countering the Financing of Terrorism
BBS	Botswana Building Society
BoB	Bank of Botswana
BoBCs	Bank of Botswana Certificates
BSB	Botswana Savings Bank
BSE	Botswana Stock Exchange
CEDA	Citizen Entrepreneurial Development Agency
CIU	Collective Investment Undertaking
DCI	Domestic Companies Index
DPCF	Debt Participation Capital Funding
GDP	Gross Domestic Product
IFSC	International Financial Services Centre
MFDP	Ministry of Finance and Development Planning
NBFI	Non-Bank Financial Institution
NBFIRA	Non-Bank Financial Institutions Regulatory Authority
NDB	National Development Bank
PDSF	Public Debt Service Fund
RoA	Return on Assets
RoE	Return on Equity

1. INTRODUCTION

The Botswana Banking industry is an increasingly important sector of the economy, both in its own right and in terms of the supporting role it plays in the development of other sectors of the economy. The growth of the sector has been good – over the period from 1994 to 2009 it grew in real terms by 11.2% a year on average, while overall real economic growth averaged only 6.1% a year over this period (see Figure 1). Over that period of time, the banking sector’s share of GDP has doubled, from 3% to 6%.

Figure 1: Banking Sector & GDP



Source: Central Statistics Office

The sector also plays a very important role in the Botswana Stock Exchange, where it dominates market capitalisation and has been a driving force in the growth of the BSE in recent years. This in turn reflects the high level of profitability, and sustained profits growth in the sector. The banking sector continues to dominate the financial sector more broadly, notwithstanding the rapid growth of other segments of the financial sector, such as pension funds, over the past decade.

As the banking sector has grown in importance, scrutiny of the sector has become more intense. In the process, concerns have been raised regarding the activities of the banking sector and its wider economic role, with perceived shortcomings such as a focus on lending to households rather than businesses, high levels of bank charges and spreads between deposit and lending rates, reliance on Bank of Botswana Certificates (BoBCs) for assets and income, and reluctance to extend banking services to some areas of the country and the population. There are also perceptions of a lack of competition, poor service and a lack of innovation. While some of these concerns are real, others are misplaced, and there have been important positive developments in the banking sector in recent years, with enhanced competition, innovations in product and service delivery, and greater choices for customers, especially savers, both within and outside of the banking sector.

The coming years hold considerable challenges for the banking sector, as well as for policy makers who determine aspects of the environment in which the sector operates. Banks will be looking for sources of growth and to maintain the high profit rates that they have become accustomed to, while competition intensifies, and technological changes impact on the way that banking operations are carried out.

2. BACKGROUND TO THE FINANCIAL SECTOR: THE EVOLUTION OF STRUCTURE AND POLICY

2.1 THE DEVELOPMENT OF THE BANKING SECTOR

Botswana's banking sector has grown and changed considerably over the period since 1990. Historically, the sector was relatively small, and dominated by Barclays and Standard Chartered banks. Both of these banks' operations in Botswana date back to the 1950s, and were originally run as branches of the groups' South African subsidiaries. In the 1970s they were both incorporated in Botswana as independent operations within the overall international structures of Barclays and Standard Chartered banks, in line with the requirements of the Financial Institutions Act, and came under the supervisory purview of the Bank of Botswana (BoB), which was established in 1975.

The two banks co-existed as a comfortable duopoly, with limited competition between them. The situation changed somewhat in 1982, when the Bank of Credit and Commerce Botswana (BCCB) was established; however, this bank remained relatively small, and did not fundamentally challenge the dominance of the two major existing banks.

The other financial institutions existing during this time were largely government-owned. These included:

- the Botswana Savings Bank (originally the Post Office Savings Bank, this was established in 1911 as a branch of the South African Post Office Savings Bank, and has the longest continuous existence of any financial institution in Botswana);
- the National Development Bank (established in 1964, initially with a focus on lending to agriculture);
- the Botswana Development Corporation (BDC), established in 1970, to invest in commercial and industrial projects through the provision of loans and equity finance;
- the Financial Services Company (FSC), established as a subsidiary of BDC and NDB, mostly offering property loans;
- the Botswana Building Society (BBS), originally established as a branch of the South African United Building Society in 1970, and locally incorporated in 1977, with majority government shareholding.

Unlike many other countries, there has never been a government-owned commercial bank in Botswana. However, the government has been an extensive provider of finance in the economy, through the above institutions and also through the Public Debt Service Fund (PDSF), which lent directly from government funds to state-owned (parastatal) enterprises, and for many years the PDSF was the largest lending entity in Botswana.

During the 1980s, Botswana boasted a banking sector that was sound and reasonably well-run in narrow banking terms but which was unadventurous and not actively developing financial intermediation in the economy. The complacency that resulted from the lack of effective competition was reinforced by rising levels of liquidity in the economy, as mineral revenues rose sharply and the government budget moved into surplus.

The policy framework did little to encourage competition in the banking sector. The licensing of new banks was restrictive, in that market capacity issues were taken into account and the existing banks could object to the licensing of new banks. In return for the maintenance of this market power, the BoB required banks – or at least the two main banks – to keep a nationwide network of branches, including some in the rural areas that would probably not be justified on a commercial basis.

Interest rates were controlled by the BoB, and interest rate policy aimed to keep interest rates low to encourage borrowing and investment. The rising excess liquidity was absorbed through a call deposit mechanism at the BoB which was open to banks and other large depositors.

By the late 1980s it was realised that this policy was having a range of negative impacts:

- the policy of low interest rates was leading to disintermediation, as the banks were turning away large deposits on which they could not earn a profit given minimum public deposit rates and the call rates offered by the BoB;
- artificially low interest rates were encouraging borrowing for unproductive projects;
- restrictions on the licensing of new banks reinforced the duopoly of Barclays and Standard Chartered, and inhibited competition and efficiency;
- the dominant role of Government meant that market forces played only a limited role in the allocation of credit;
- the loose monetary policy – with negative real interest rates – made control of inflation difficult, especially given rapid fiscal expansion.

These issues were summarised in a Government of Botswana/World Bank report entitled “Financial Sector Policies for Diversified Growth”, published in 1989. The report noted that:

The commercial banking system, while sound and profitable, is very conservative. With only three banks (and one of these very small) the degree of competitiveness is low. In the tradition of the last century of British commercial banking, these banks emphasize overdraft lending and do not offer much in the way of longer-term resources to fund investment. The banks have not had to be particularly entrepreneurial to earn good profit . . . [and] . . . their capital bases are small in relation to the financing needs of some major clients (p.46).

The report provided the impetus for an extensive set of financial sector reforms. These included:

- encouraging the establishment of new banks, so as to encourage competition and efficiency in the banking sector, through a liberalisation of bank licensing policy;
- a reduction in the role of government as a direct lender to parastatals (notably through the Public Debt Service Fund), alignment of PDSF interest rates with market rates, and commercialisation of government-owned financial institutions;
- promoting the development of the capital market;
- changes to monetary policy and the introduction of a policy of positive real interest rates;
- the introduction of market-based interventions for monetary policy purposes and the absorption of excess liquidity, through Bank of Botswana Certificates.

Also consistent with the above policy reforms, but implemented slightly earlier, was the ending of formal controls on bank interest rates¹.

These reforms encouraged the establishment of new banks (see timeline in Figure 2). The first was Zimbank Botswana, licensed in 1990. This was shortly followed by the establishment of FNB Botswana, the licensing of which coincided with the problems faced by BCCB as a result of the collapse of its parent company, and BCCB was taken over by FNB and used as basis for establishment of the new Botswana operation. The early 1990s also saw the establishment of ANZ-Grindlays and Union Bank (a subsidiary of Standard Bank of South Africa). With four new banks and one closure, the number of commercial banks in Botswana doubled in a short period of time. Even though several of the new banks were quite small - the new licensing policy did not require a nationwide presence and rural branches – the banking environment changed dramatically, with more competition, and pressure on the dominant position of the long-established banks.

¹ Some controls were reintroduced in March 2009; see section 5.3 below for further information.

Figure 2: Banks Timeline

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	
BARCLAYS																					
STANCHART																					
BCCB		TAKEN OVER BY FNBB																			
FNB																					
ANZ-GRINDLAYS				TAKEN OVER BY STANBIC																	
ZIMBANK						TAKEN OVER BY FNBB															
B. CO-OP. BANK							LIQUIDATED														
STANBIC																					
BARODA																					
BANK GABORONE																					
CAPITAL BANK																					
ABN AMRO																					
BANCABC																					

Source: Econsult

After this rapid expansion, a period of consolidation followed: ANZ-Grindlays was taken over by Union Bank, which was subsequently renamed Stanbic Bank, while Zimbank was taken over by FNBB, and hence the number of banks fell to four. Subsequently five more banks were established, the Bank of Baroda (2000), Bank Gaborone (2006), Capital Bank (2008), ABN Amro (2009) and BancABC (2009).

All banks have full commercial banking licences. In general, they all provide a full range of banking services. However, ABN Amro was established specifically to cater for the growing range of diamond-related businesses.

Investec Bank was licensed as a merchant bank in September 1998, and was taken over by Stanbic Bank in April 2004. African Banking Corporation (ABC) evolved from a credit institution, ulc, and was granted a merchant banking licence in December 2001. In 2009 ABC was granted a commercial banking licence and is now trading as BancABC

Botswana's banking sector is now relatively liberalised. In principle there are no direct controls over interest rates, credit allocation or product pricing. In practice, however, the BoB imposes restraints on the level of bank charges and spreads between deposit and lending rates. The bank licensing regime aims to encourage the establishment of new banks, although as will be discussed below, it may be argued that it is now somewhat outdated.

The banking sector has also been affected by changes in the broader policy environment. The liberalisation of exchange controls through the 1990s, while not specifically focused on the banking sector, had an important impact on banks, e.g. through permitting them to open foreign currency accounts for customers and offer foreign currency loans. The subsequent abolition of exchange controls in 1999 permitted residents to open bank accounts outside of the country (which had previously been prohibited) and more generally, to hold a full range of offshore financial assets, thereby exposing the local banks to more competition.

The banks are also strongly affected by the macroeconomic environment and the monetary policy framework. An important characteristic of the macroeconomic environment is a surplus of savings over investment, leading to excess liquidity, while the BoB's monetary policy aims to keep interest rates positive in real terms, which is not always easy in an environment of excess liquidity.

The monetary policy framework includes an eclectic mix of both active monetary policy and a managed exchange rate through the Pula basket mechanism. In recent years monetary policy has focused on dealing with the high levels of liquidity in the banking system, implementing monetary policy through indirect instruments, and keeping interest rates high to control inflation. The BoB's main instrument is the issue of short-term paper (Bank of Botswana Certificates), sold through weekly auctions with maturities ranging from 14 days to 12 months. The BoB also operates a repo/reverse repo system for managing short-term liquidity fluctuations. The BoBC system is the main channel for transmitting interest rate signals from the central bank to the market; although there is also a Bank Rate charged by the BoB on loans to the banks, the persistence of excess liquidity means that there is little such borrowing and hence the Bank Rate has little practical impact, although it is important for signalling purposes.

Until early 2006, BoBCs were available for direct purchase by both banks and other entities, such as major corporates and other financial institutions, and could be held indirectly (through banks and stockbrokers) by any firm or individual. Since March 2006, however, BoBCs have been restricted to banks only, and this has had a major impact on the inflow of deposit funds to the banks, which will be discussed further below.

2.2 THE PRESENT STRUCTURE OF THE FINANCIAL SECTOR

Botswana's financial sector can be divided broadly into two segments: the banking sector (largely regulated and supervised by the Bank of Botswana), and the non-bank financial sector (largely regulated by the Non-Bank Financial Institutions Regulatory Authority (NBFIRA)).

Within the banking sector², there are:

- Nine commercial banks, of which three (Barclays Bank of Botswana, Standard Chartered Bank Botswana, & First National Bank Botswana) are listed on the BSE, while the other six (ABN Amro, BancABC, Stanbic Bank, Bank Gaborone, Bank of Baroda and Capital Bank) are unlisted;
- two offshore banks, Kingdom Bank Africa Ltd (KBAL) and ABN Amro Offshore, and one offshore bank holding company (ABCH), which are registered in the IFSC; ABCH is also listed on the BSE;
- One statutory deposit-taking institution (BSB) and one building society (BBS).

The Non-Bank Financial Institutions (NBFi) sector includes:

- the Botswana Stock Exchange and stockbroking firms (registered in terms of the BSE Act);
- Insurers: short-term (casualty) insurance and long-term (life insurance) (registered in terms of the Insurance Industry Act, and supervised by NBFIRA);
- Pension funds (registered in terms of the Pension and Provident Funds Act, and supervised/regulated by NBFIRA);
- Asset managers (previously unregulated, but now regulated by NBFIRA);
- Credit institutions (non-bank lenders), which include "term" lenders such as Letshego (listed on the BSE), Penrich, Blue, Peo etc., which make medium-term loans against the security of payroll deductions, and short-term "cash loan" lenders (previously unregulated, but now regulated by NBFIRA);
- Microfinance institutions (e.g. Womens Finance House) (granted exemptions from the Banking Act by BoB);
- Collective Investment Undertakings (CIUs) (established under the CIU Act, previously regulated by the BoB, but now regulated by NBFIRA);
- three statutory development finance institutions (NDB³, BDC & Citizen Entrepreneurial Development Agency (CEDA));
- statutory funds (e.g. Motor Vehicle Accident Fund, National Petroleum Fund);
- the Public Debt Service Fund (PDSF⁴).

² Defined as deposit-taking institutions, in line with Banking Act

³ Although called a bank and supervised by the BoB, NDB is not a deposit-taking institution.

⁴ The majority of PDSF loans were transferred to a new special purpose vehicle, Debt Participation Capital Funding Ltd (DPCF), and securitised, in 2004. However, a few loans remained with PDSF, although the fund is no longer active.

2.3 THE REGULATORY STRUCTURE OF THE FINANCIAL SECTOR

Banks are regulated by the BoB in terms of the Banking Act (Cap. 46:04) and the associated Banking Regulations⁵. BoB issues banking licences and undertakes prudential supervision.

The minimum capital requirement to establish a bank is P5 million. In practice, however, much more than this is likely to be required in view of ongoing capital adequacy requirements. The statutory capital adequacy ratio stipulates that unimpaired capital must equal at least 8% of risk-weighted assets, while the BoB imposes a “safe and prudent” capital adequacy ratio of 15% for all banks in Botswana. It is also required that core capital constitutes at least 50 percent of total capital.

Consideration of applications for banking licences focuses on:

- (a) the technical knowledge, integrity, experience, financial condition and history of the applicant;
- (b) the adequacy of its capital;
- (c) the character of its business, and the experience and qualifications of its management;
- (d) the convenience and needs of the community and market to be served;
- (e) the ability and willingness of the applicant to comply with any conditions the BoB may impose pursuant to the Banking Act.

The BoB does not concern itself with market issues in considering licence applications (other than reviewing the viability of the prospective bank’s business plan), and is in general supportive of new banks from the perspective of enhancing competition.

Decisions on applications for banking licences are made independently by the Board of the BoB, although there is provision in the Banking Act for dissatisfied applicants to appeal to the Minister of Finance.

Prudential supervision follows conventional practice, and is essentially risk based. Supervisory regulations and practices evolve in line with international norms, and are currently being reviewed with a view to updating them to comply with Basel II principles. While Botswana is not obligated to comply with Basel II, the fact that most of Botswana’s banks are subsidiaries of major regional or international banking groups, which will be implementing Basel II in their home jurisdictions, means that in practice it will be necessary.

Besides capital adequacy requirements, there are also regulatory requirements relating to:

- reserve asset holdings;
- minimum liquid asset holdings;
- concentration of lending;
- foreign currency exposure;
- significant changes of shareholding;
- appointments of Board members and Chief Executive Officer.

The system of prudential supervision has four main functions:

- (i) protection of depositors;
- (ii) systemic stability;
- (iii) anti-money laundering and countering the financing of terrorism (AML/CFT); and
- (iv) consumer protection.

There is no system of statutory deposit insurance, although the option of introducing such a system has been considered in the past and may be reconsidered in the future.

⁵ Available at www.bankofbotswana.bw and www.laws.gov.bw

The BoB is a respected supervisor, and has in the past shown good judgement in assessing banking licence applications. It has also balanced firm regulation with flexibility in allowing banks to pursue their commercial interests in the context of a sound and stable financial sector. Botswana has never had a banking crisis, and where banks have faced problems these have been dealt with without threatening the integrity of the banking system. Past banking problems have included:

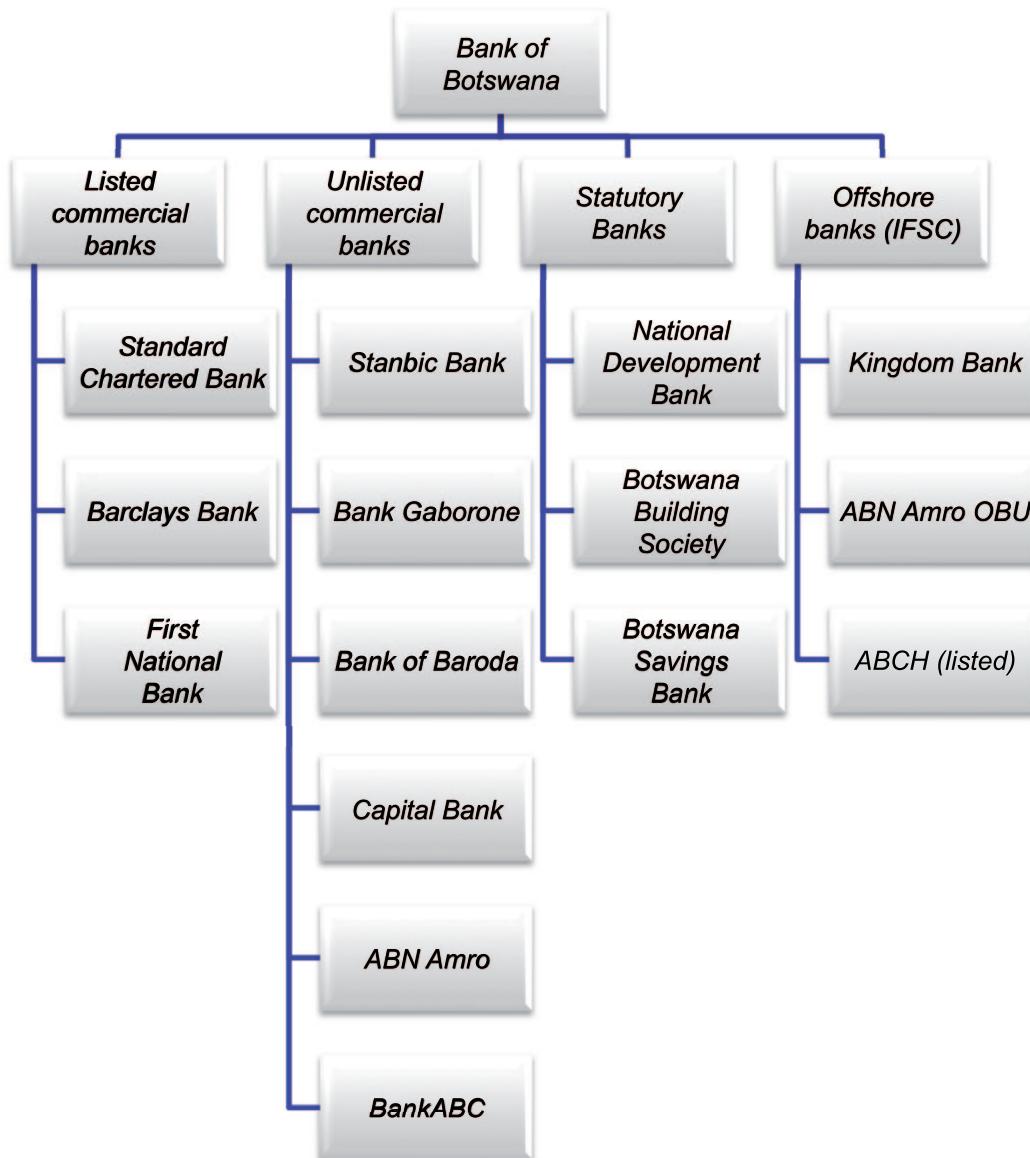
- the BCCI crisis (1991): when the Bank of Credit and Commerce International was closed by the Bank of England, its Botswana subsidiary (Bank of Credit and Commerce Botswana) was taken over temporarily by the BoB, and was eventually sold as a going concern to the newly-licensed First National Bank of Botswana;
- Zimbank Botswana (1993): this subsidiary of a Zimbabwean bank was unprofitable, and with an eroding capital base, and the BoB co-ordinated a takeover by FNB in order to pre-empt the collapse of the bank.
- Botswana Co-operative Bank (1995): originally established in 1974 to serve the co-operative sector of the economy, it obtained a commercial banking licence but never operated profitably. Over the years, the BCB suffered from a range of problems – mistaken policies, inadequate management and poor performance of its loan portfolio. After several bank examinations, audits and policy reviews, Government decided that the BCB could not be saved, and the bank was placed into liquidation in August 1995. The government, which had given the Botswana Cooperative Bank loans from the PDSF, was the only creditor;
- Kingdom Bank Africa Limited (2005): the offshore bank's capital base was eroded due to unprofitable operations, and the bank was taken under temporary BoB management while it was restructured and recapitalised. This was achieved successfully, and the bank was returned to its management and owners within three months.

Statutory banks do not require banking licences and are ultimately under the control of the Minister of Finance and Development Planning. However, the Banking Act gives the BoB powers to supervise such banks, as well as building societies established under the Building Societies Act. Hence the BoB carries out regular examinations of the Botswana Savings Bank, the National Development Bank and the Botswana Building Society.

The International Financial Services Centre (IFSC). The BoB plays an important role in administering the IFSC regulations. All IFSC companies have to receive either a banking licence from the BoB, a CIU licence or an insurance licence from NBFIRA, or an exemption certificate. The requirements for an IFSC (offshore) banking license are slightly less demanding than for a domestic banking licence. As offshore banks are restricted to non-pula business, there is no risk to the domestic financial system; the main risk is reputational risk. The IFSC is now in the process of merging with Botswana Export Development and Investment Authority (BEDIA)

Some small deposit-taking microfinance institutions have received banking licence exemptions from the BoB, on the basis that they have community benefits and are too small to have any effect on the financial system. More generally, however, unlicensed deposit-taking operations (such as pyramid schemes) are dealt with firmly under the provisions of the Banking Act.

Figure 3: Institutions Regulated by the Bank of Botswana



Source: Econsult

Until early 2008, the Ministry of Finance and Development Planning housed the Registrars of Insurance, Pension Funds and the Stock Exchange, under the relevant legislation. Many other types of financial institutions were then unregulated. These included the so-called “cash lenders”, who use their own funds and hence are not involved in deposit taking, and asset managers, for which there was no specific legislation.

However, a new Non-Bank Financial Institution Regulatory Authority (NBFIRA) was established in April 2008, which provides a new regulatory and institutional framework for all non-bank financial institutions, including previously unregulated ones (the NBF sector is described in more detail below).

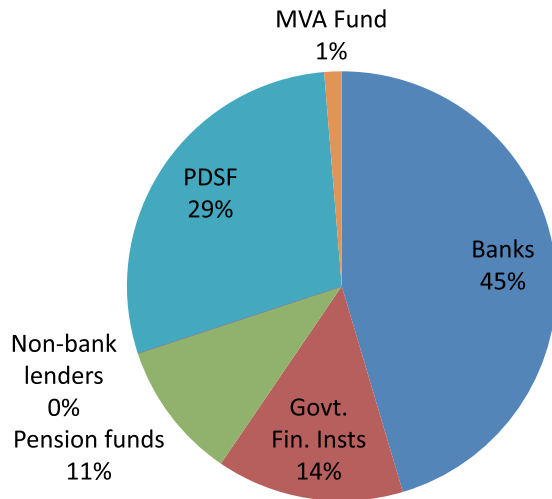
2.4 THE ECONOMIC IMPORTANCE OF THE BANKING SYSTEM

Financial intermediaries can be classified into four main groups depending primarily on the nature of their balance sheets, viz: banks, statutory financial institutions, pension funds and non-bank lenders⁶. It is estimated that banks control over half of total financial sector assets, while pension funds control around one-third. For much of the past decade, pension funds have been larger than the banks when measured by total assets, although the inflow of funds into the banks following changes to the BoBC regulations in early 2006 (discussed below) have enabled the banks collectively to overtake pension funds in terms of size of balance sheets.

While the pension funds are almost as important as the banks as a destination for savings, they are of course much more important as a destination for household savings. As at December 2009, pension funds had total assets (all ultimately attributable to households) of P32.4 billion, while household deposits in the banking system amounted to only P7.0 billion.

The structure of the financial sector has changed considerably since the mid-1990s (see Figures 4 and 5). The share of the banks in total assets has not changed a great deal, although it has grown slightly; the most striking changes have been the growth of the pension funds, and the relative decline in the importance of government-owned financial institutions, and of direct lending by government. In 1996, the Government's Public Debt Service Fund (which used to make loans to parastatals) was by far the largest financial institution in Botswana, with a balance sheet exceeding that of any of the individual banks, and accounted for 29% of total financial sector assets. By 2009, the combined assets of the PDSF and DPCF⁷ amounted to only 2% of total financial sector assets. The share of government financial institutions has also fallen, from 14% to 7% of financial sector assets. Over the same period, the share of assets held by the pension funds rose from 11% to 32%, which was mainly driven by the establishment of a new pension scheme for government employees⁸.

Figure 4: Assets of the Financial System (1996)



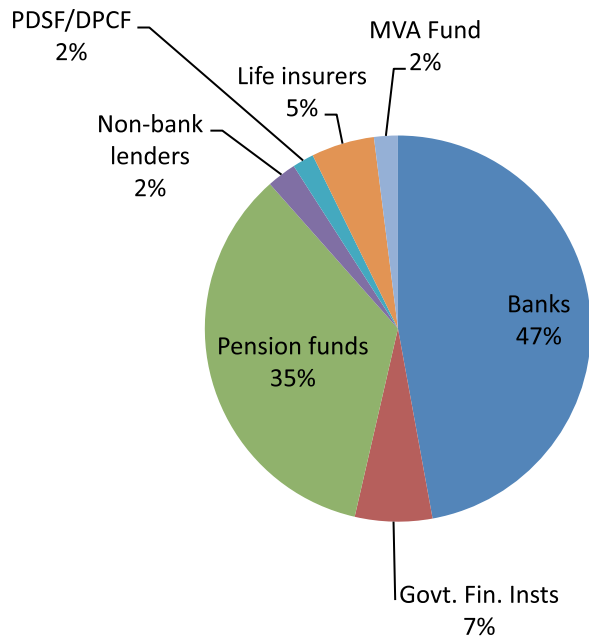
Source: Bank of Botswana; Econsult

⁶ Short-term insurers are excluded as they are not strictly financial intermediaries.

⁷ DPCF is a special purpose vehicle established to securitise and sell notes based on PDSF loans

⁸ The Botswana Public Officers Pension Fund (BPOPF) is a funded, defined contribution scheme, managed by private sector asset managers, and replaced the previous unfunded, defined benefit scheme.

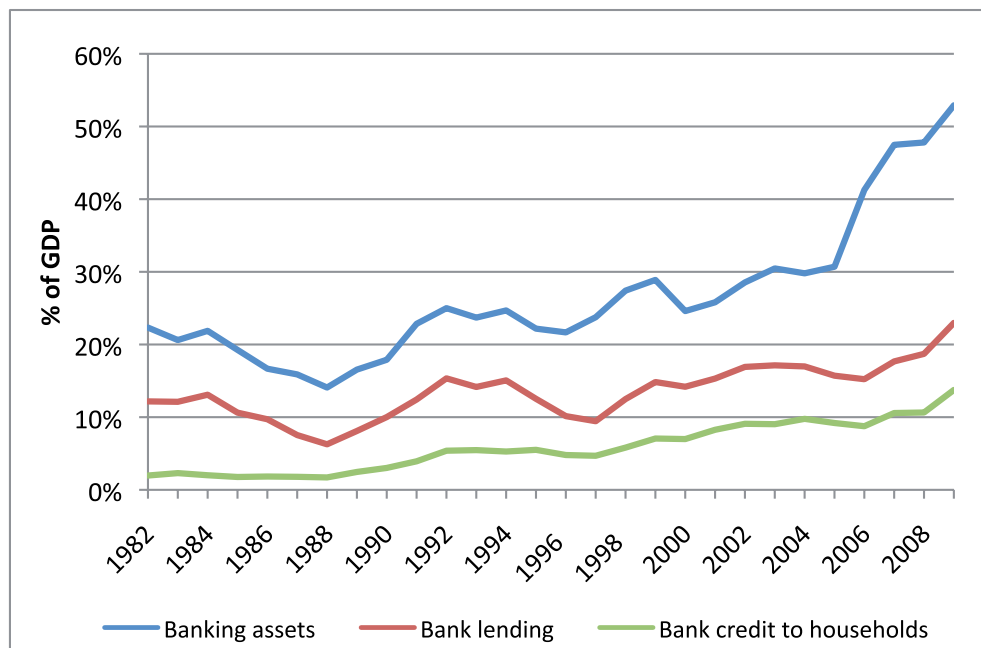
Figure 5: Assets of the Financial System (2009)



Source: Bank of Botswana; Econsult

Although the relative position of the banking sector in the broader financial sector has not changed much over the past decade, banks have nevertheless been growing rapidly, supported by the liberalisation measures undertaken during the 1990s. Over the decade from 1997 to 2009, the total assets of the banking system grew at an average annual rate of 20.6%, while (nominal) GDP grew on average by 13.2% a year over the same period. Relative to the size of the economy, therefore, the size of the banking sector – measured for instance by the ratio of banking assets to GDP – has been rising steadily (see Figure 6).

Figure 6: Size of Banks Relative to the Economy

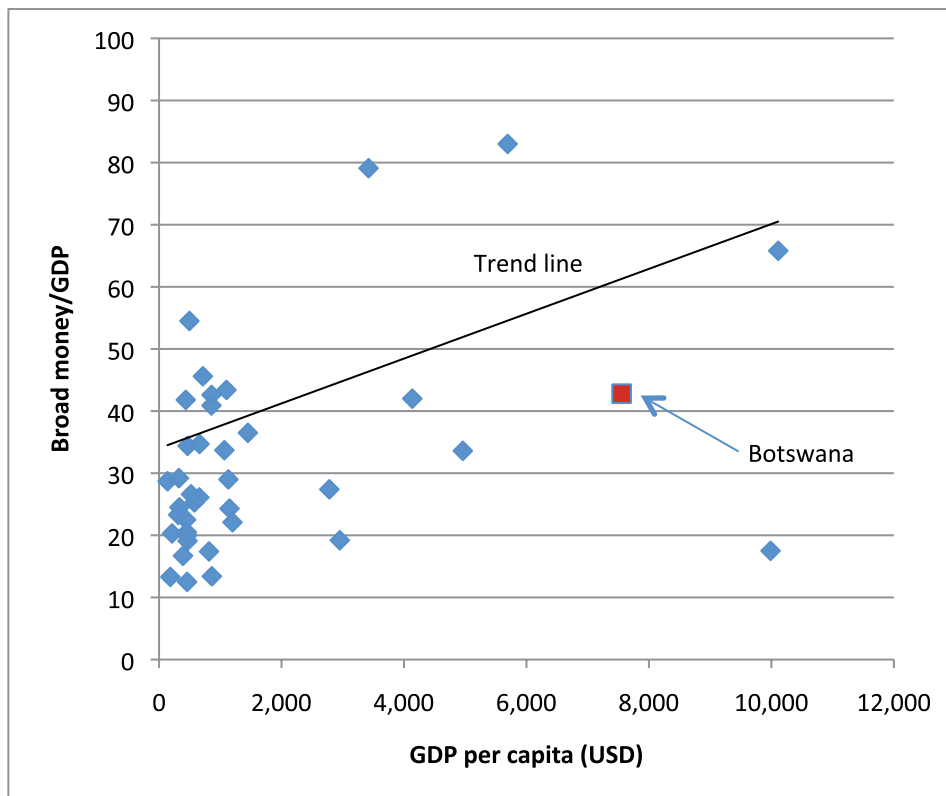


Source: BoB; CSO; Econsult

Bank balance sheets expanded considerably in 2006, as a result of the changed rules regarding the holding of BoBCs and their restriction to banks alone. This caused a major inflow of funds from entities which had held BoBCs in their own right (whether directly, as in the case of Debswana and some parastatals, or indirectly through banks and stockbroking firms), but which were no longer able to do so. The total assets of the banking sector grew by around 50% as a result of this change.

Notwithstanding this rapid growth, the banking sector remains relatively small by the standards of countries with similar income levels. Measuring the size of the banking sector by the ratio of broad money supply (comprising cash and bank deposits) to GDP shows that this ratio – sometimes termed financial depth – tends to rise with GDP. However, financial depth in Botswana is relatively small for a country of its income level; a country with Botswana’s GDP per capita level of around US\$7 500 would be expected to have a financial depth ratio of around 60%, compared to Botswana’s 43% at the end of 2008. Both South Africa and Mauritius have similar per capita income levels, but have financial depth measures of 83% and 169% respectively. On this measure at least, this suggests that there is considerable growth potential left for the banking system. It is interesting to note, however, that many of the countries that tend to have low levels of financial depth relative to GDP are, like Botswana, resource-based economies, such as Angola and Gabon.

Figure 7: Financial Depth & GDP per capita (2008)



Source: IMF

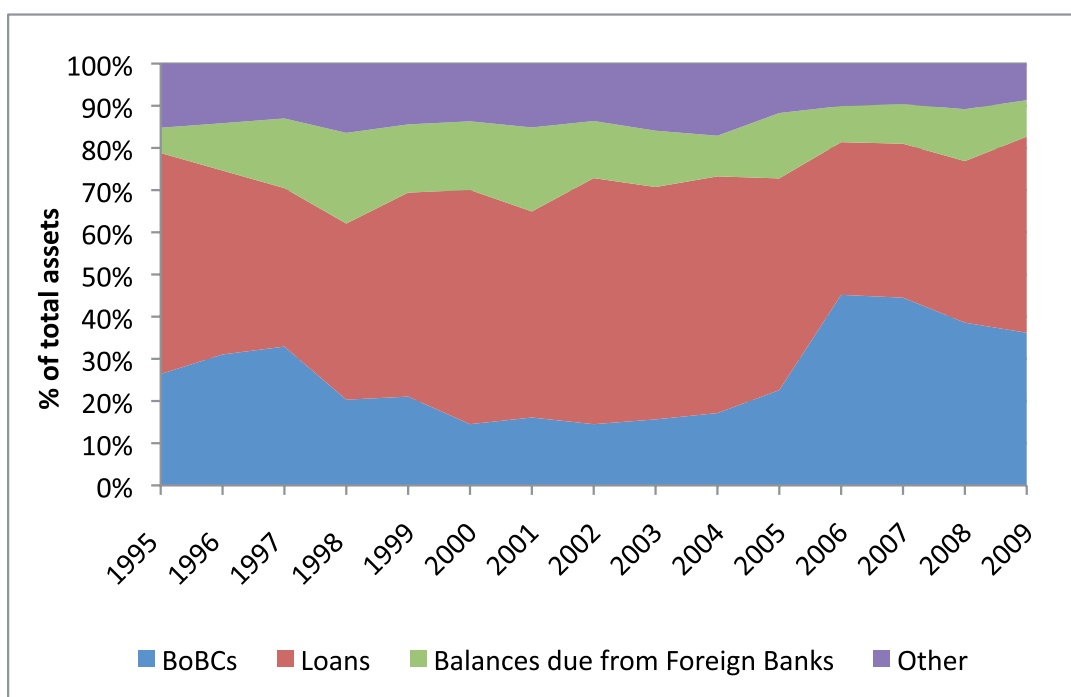
3. BANKING SECTOR GROWTH AND DEVELOPMENT

3.1 BANK BALANCE SHEETS: DEPOSITS, LENDING AND BOBCS

As noted above, the Botswana financial system has long been characterised by excess liquidity, due in part to the structural surplus of savings (over investment). This has had a major impact on the structure of banks' balance sheets; in particular, lending-to-deposit ratios tend to be somewhat low, and assets other than loans and advances make up a considerable portion of the balance sheet. Furthermore, policies relating to the absorption of excess liquidity have an important impact on bank operations and profits.

Over the decade to 2005, loans & advances made up approximately 50% of banking sector assets, with the other 50% comprising BoBCs (21%), balances due from foreign banks⁹ (15%) and other assets (14%) (see Figure 8). However, the inflow of funds in 2006 following the changes in BoBC regulations has had a major impact, however; besides causing balance sheets to grow rapidly, the share of BoBCs in total assets rose (to 45% at the end of 2007) and that of loans fell (to 37%). At the end of 2009, BoBCs accounted for 34% of assets and loans 43%.

Figure 8: Structure of Banking Sector Balance Sheet

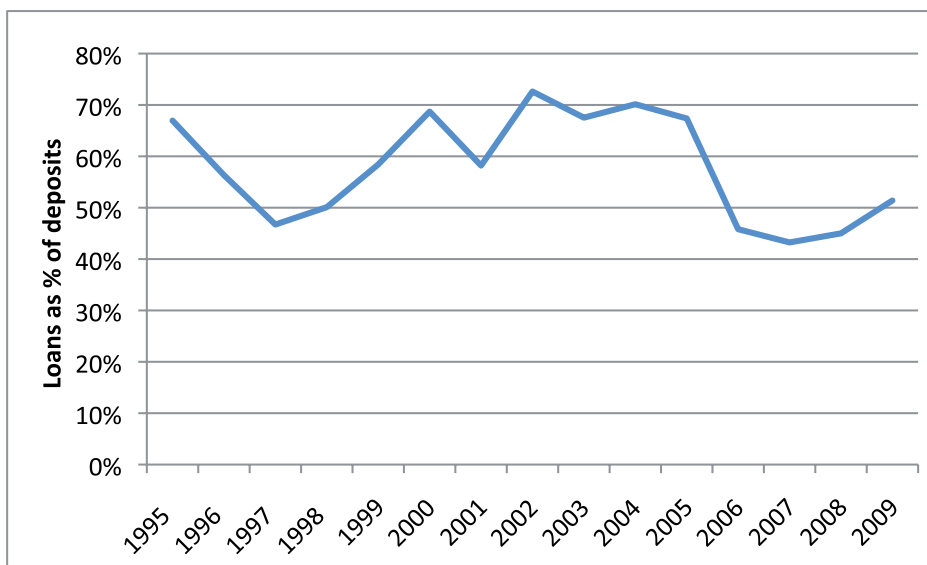


Source: BoB

Loan-to-deposit ratios rose steadily over the decade to 2005, and averaged around 61% over this period (see Figure 9). This is seen in some quarters as a relatively low figure, and the banks have been criticised for not lending sufficiently and not properly carrying out their intermediation function; however, it also reflects a lack of viable lending opportunities. The upward trend in the loan-to-deposit ratio over the decade to 2005 does reflect concerted efforts by banks to expand their lending, although – as will be discussed below – this has been much more to individuals/households than to businesses. More recently, the substantial inflow of funds into the banking system in 2006 has caused the ratio to fall, as the additional deposits were – in the short term at least – invested directly in BoBCs rather than being used to expand lending; by the end of 2009 the loan-to-deposit ratio was only 51%.

9 Comprising mostly deposits with parent banks offsetting FCA liabilities

Figure 9: Loan-to-Deposit Ratio



Source: BoB; Econsult

Foreign currency accounts (FCAs) - mostly US dollars - have been important at certain times in the past, and accounted for 37% of total deposits in mid-2008. The main user of FCAs is the diamond mining industry, and with the problems affecting the industry in 2009 the use of FCAs fell sharply. At the end of 2009, FCAs accounted for only 13% of deposits.

3.2 CREDIT GROWTH & THE COMPOSITION OF LENDING

Bank credit has been growing rapidly in recent years, after a sluggish period in the early-to-mid-1990s. In nominal terms credit grew by 22% a year between 1999 and 2009, and rose from 15% to 23% of GDP over this period.

The composition of credit has changed significantly over time. Back in 1993, 55% of credit was to private businesses and 39% was to households; by 2009, however, the proportions were more or less reversed, with 59% of credit to households and 41% to private business and parastatals. Hence recent credit growth has been driven much more by the growth of lending to households than by lending to businesses.

Bank Lending to Households

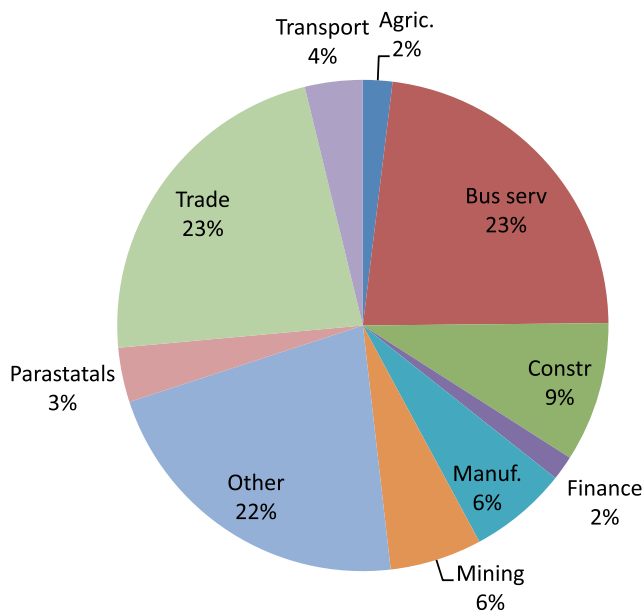
As noted, the proportion of total bank lending going to households has been rising. However, while bank lending to households is high by the standards of low income countries, it is not unusual by the standards of middle and upper income countries – for instance it is close to the values for South Africa and Namibia. Furthermore, household lending is not particularly high relative to GDP, which suggests there is still scope for further growth.

In other countries lending to households tends to be dominated by lending for mortgages. In Botswana, however, mortgages account for a relatively small share of household borrowing (22% at the end of 2009), which is dominated by general unsecured borrowing; from an economic point of view, therefore, the majority of household borrowing is for consumption purposes rather than for investment.

Bank Lending to Businesses

It is striking that the structure of bank lending to businesses does not reflect the structure of the economy (see Figure 10). Perhaps most notably, mining is under-represented, accounting for only 6.1% of bank lending to businesses, compared to its 28.3% share of GDP¹⁰. By contrast, 24.5% of bank lending to businesses is accounted for by lending to the business services and finance, in contrast to those sectors' 13% share of GDP. Relative to shares of GDP, bank lending to businesses is also disproportionately large to the manufacturing and trade sectors.

Figure 10: Structure of Business Lending (December 2009)



Source: BoB

Credit to the public sector

In contrast to many other countries, there is virtually no lending by banks to government. This is due to the budget surpluses experienced by government in most years, and the resulting government balances accumulated at the BoB, as a result of which there has been no need for government to borrow from the banks. Despite fiscal surpluses until 2007/08 the Government issued Treasury Bills and Bonds for the purposes of developing the capital market. In 2009 the issuance programme was expanded to help fund the budget deficits caused by the economic downturn. The banks hold around 14% of these instruments directly, and another 86% off-balance sheet on behalf of clients. Own account T-Bills and Bonds make up a very small proportion (less than 1.5%) of commercial bank assets, and are equivalent to around 3% of bank lending. Currently, the banking sector holds BoBCs to the value of approximately P16bn.

Over the next five years it is likely that more government bonds will be issued for the purposes of financing the budget. The downturn in the global economy and in government revenues from the diamond sector is likely to lead to prolonged fiscal deficits. The deficit will continue to be financed by a combination of drawing down Government's financial reserves that have been built up over the years, and by borrowing both domestically and internationally¹¹.

Lending to parastatals has been important at some times in the past, but is now insignificant (1.3% of total lending in 2009), due to a combination of direct borrowing from government funds by some parastatals and the accumulation of large cash balances by others¹².

¹⁰ Share of 2009 GDP at constant prices.

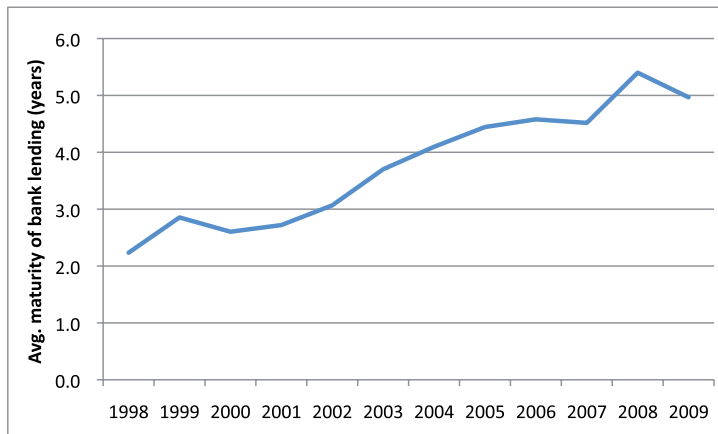
¹¹ Budget Speech 2009-2010 – MFDP

¹² In principle, government lending to parastatals was brought to an end in the late-1990s when lending from the PDSF was terminated. However, several parastatals have subsequently managed to negotiate loans from government, although the criteria for granting such loans is unclear.

Maturity of Lending

There has also been concern that the banks focus on short-term lending only, with a reluctance to provide longer-term loans. While there may have been some truth in this in the past, there has been some improvement in recent years, and the average maturity of bank lending has risen from 2.2 years in 1998 to 5.4 years in 2008, although it fell to 5.0 years in 2009. This may be because of the economic downturn, which left many entities financially vulnerable and led to more cautious lending behaviour by the banks.

Figure 11: Maturity of Bank Lending

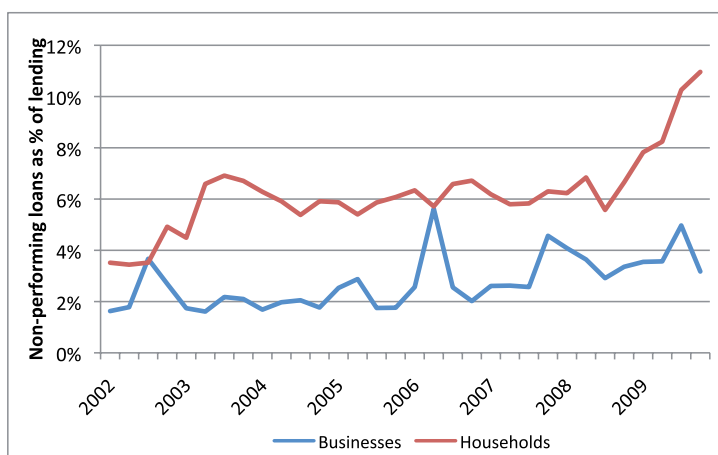


Source: BoB; Econsult

Quality of Lending (Bad debts/arrears)

Generally the level of non-performing loans (NPLs) in Botswana is low. However, bad debt & arrears levels have been rising in recent years, with total arrears and specific provisions up from 2.6% of lending in early 2002 to 7.8% in December 2009 (see Figure 12). Most of the increase is due to rising arrears on personal (household) borrowing, which have generally been far higher than arrears on business lending. However, arrears on business lending experience occasional spikes, such as that at the end of 2007 due to the extensive losses incurred by the collapse of transport company Lobtrans. The rise in arrears on lending to households during 2009 is particularly striking, and illustrates the pressure on household budgets resulting from the economic crisis, which led to the temporary shutdown of the diamond mines and other job losses, as well as pressure on public sector pay and real incomes.

Figure 12: Arrears on Bank Lending (2002-2009)



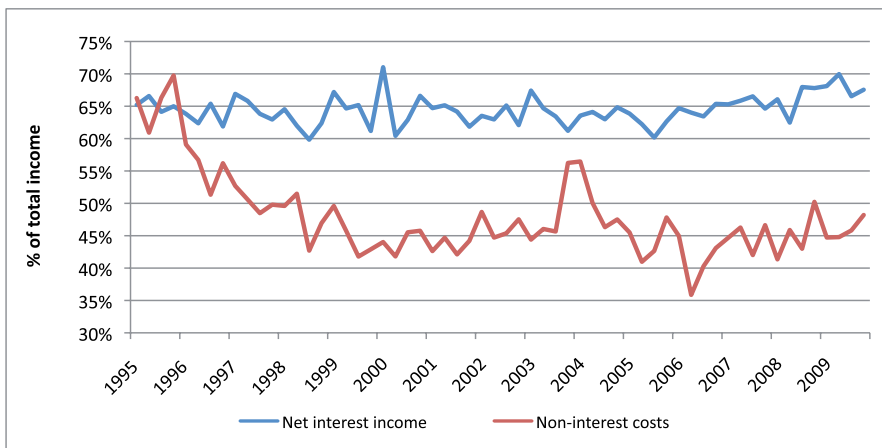
Source: BoB; Econsult

3.3 BANKING INCOME AND PROFITABILITY

The bulk of bank income comprises net interest income, accounting for a consistent 65% of the total, with little trend variation. The remaining 35% comprises fee income of various kinds. Despite concerns about the levels of bank charges (discussed further below), there is no evidence that the share of income derived from charges (broadly defined) is rising.

What is more striking is the success that the banks have had in bringing their costs down, relative to income. The sector's cost-to-income ratio fell from 65% in the mid-1990s to around 45% since 2000, which has resulted in increased profitability.

Figure 13: Bank Income and Costs



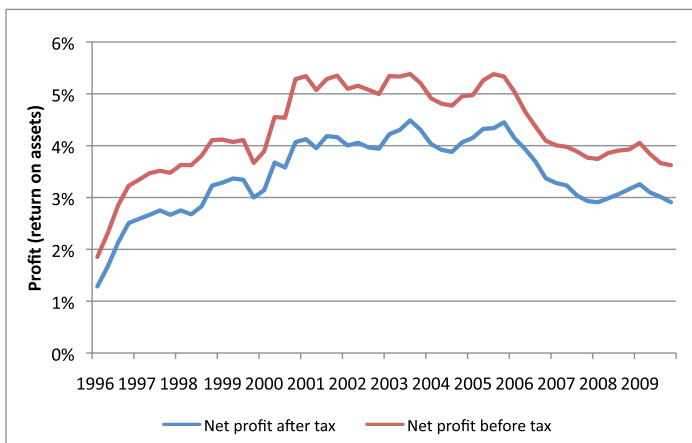
Source: BoB; Econsult

Return on assets (RoA) rose steadily over a long period, and more than doubled between 1995 and 2005 (Net Profit Before Tax rose from 1.7% of assets in 1995 to 5.3% in 2005, while Net Profit After Tax rose from 1.2% to 4.5%) (see Figure 14). Falling relative costs have been associated with an intensive programme of automation and more efficient use of labour.

Over the past three years, however, the trend has been reversed. RoA has fallen significantly, to 3.7% and 2.9% before and after tax, respectively, in 2009.

Similar trends have been apparent with regard to the banks' return on equity, which rose from 27% (after tax) in 1996 to 55% in 2006, although it fell to 48% in 2009. It is clear that profits rose for many years despite increased competition in the banking sector. The reduced profitability over the last two years may be an indication that competition is finally having the expected results.

Figure 14: Return on Assets



Source: BoB; Econsult

3.4 OTHER BANKS

The above discussion relates primarily to commercial banks. In addition, there are offshore banks (Kingdom Bank Africa Ltd and ABN Amro Bank OBU Ltd), one building society (Botswana Building Society), and one statutory bank (Botswana Savings Bank).

Kingdom Bank Africa Ltd (KBAL) is an offshore investment bank registered in the International Financial Services Centre (IFSC). As an IFSC-registered offshore bank, it can provide services only for non-resident clients in currencies other than pula. KBAL has been in operation since 2003. KBAL has a subsidiary, Kingdom Finance, engaged in debt factoring and trade financing in the Botswana market. ABN Amro OBU serves international diamond operations in the Southern African region, and complements ABN Amro's domestic banking operations.

The Botswana Savings Bank (BSB) was established by Act of Parliament in 1992, as successor to the long-established Post Office Savings Bank. It derives its deposit-taking authority from the Act and hence does not require a banking licence; BSB is the only statutory deposit-taking bank in Botswana. Nevertheless, BSB is required to carry out its business according to sound commercial principles and in accordance with the Banking Act of 1995. The bank's aim is to cultivate a strong savings habit among Botswana and to promote the culture of self-development. BSB plays an essential role of mobilizing savings and providing banking services throughout the country. This service is consolidated by a bilateral Agreement between the Bank as provided for by Section 3 of the BSB Act of 1992 and the Botswana Postal Services, where the service is primarily delivered. In the 2010 Budget Speech, it was announced that Botswana Post and BSB will be merged.

The Botswana Building Society (BBS) was established in 1976. During its first ten years of operation, BBS was restricted by law to lend only against the security of immovable urban property. The Act was amended in April 1986 to permit lending in rural areas. Up until 1986, BBS restricted its lending only to residential properties, but since that time it has also ventured into commercial property lending. BBS is established under the Building Societies Act, from which it derives its deposit-taking authority. It is owned by members, who have voting power in relation to the number of shares they hold. BBS is considering de-mutualising and applying for a banking licence and converting itself to a bank.

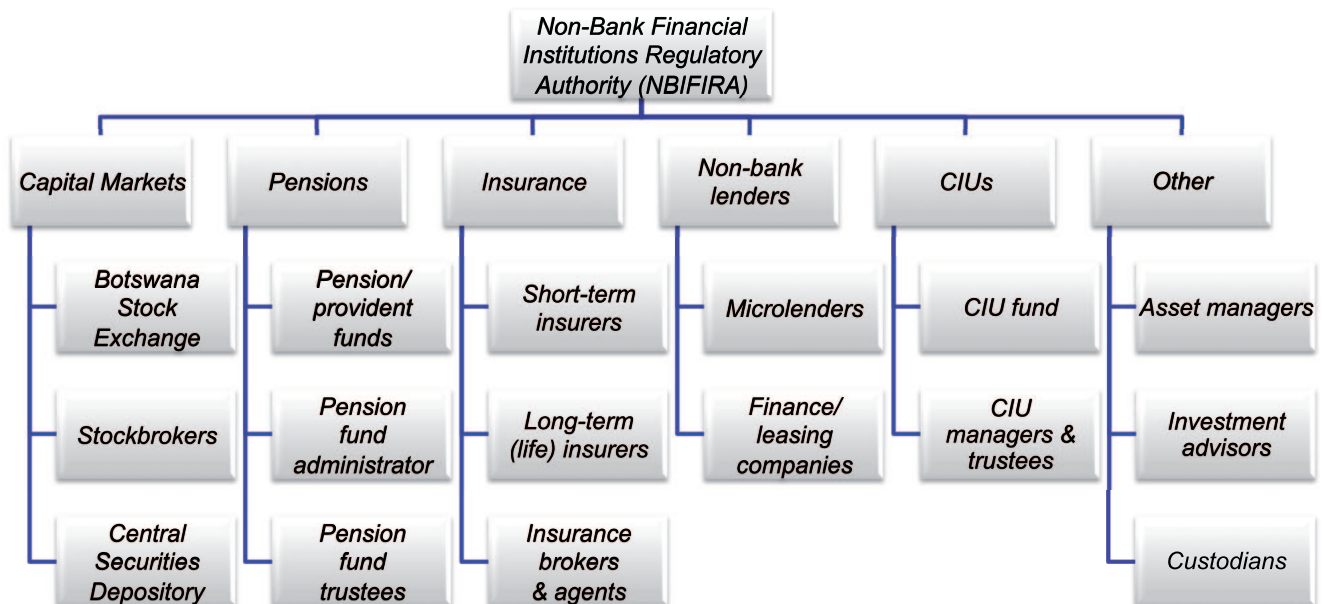
4. THE NON-BANK FINANCIAL SECTOR

The remainder of the financial sector comprises the non-bank financial sector, which falls under the regulatory purview of the Non-Bank Financial Institutions Regulatory Authority (NBIFIRA), and which can be divided into the following segments (see Figure 15):

- Capital market institutions
- Pension & Provident Funds
- Insurance (short- and long-term)
- CIUs
- Non-bank lenders
- Other

These segments are discussed below.

Figure 15: Structure of the Non-bank Financial Sector



Source: Econsult

4.1 CAPITAL MARKET INSTITUTIONS

The Botswana Stock Exchange (BSE) was formally established in 1995 with the passing of the BSE Act. Between 1989 and 1995 the market operated informally as the Botswana Share Market, having been established with five listed companies. The number of listed companies has grown steadily over the years, helped by the introduction of a venture capital board and a foreign board comprising secondary (dual) listings of companies listed in other jurisdictions. The BSE has four stock broking members; at present the BSE has mutual ownership, but there are plans to de-mutualise.

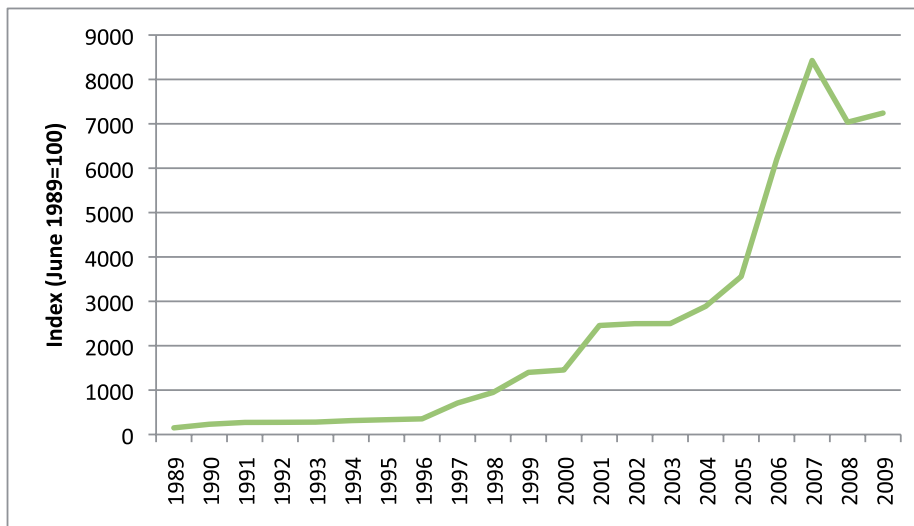
As at May 2009, the following companies were listed:

Table 1: BSE Listed Equities

Company	Sector	Market Cap (P mn, May2009)
DOMESTIC – MAIN BOARD		
African Banking Corporation Holdings (ABCH)	Financial services	146
Barclays Botswana	Financial services	4 943
Botswana Insurance Holdings Ltd (BIHL)	Financial services	2 240
Chobe Holdings	Tourism	262
Engen	Fuel distribution	859
First National Bank of Botswana (FNBB)	Financial services	6 486
Funeral Services Group (FSG)	Personal services	270
Furnmart	Distribution - Retail/wholesale	637
G4S	Security	212
Letshego	Financial services	3 540
Olympia	Services	13
Primetime	Property	331
RDC Properties	Property	178
RPC Data	IT services	6
Sechaba	Brewing	1 463
Sefalana	Distribution - Retail/wholesale	605
Sefcash	Distribution - Retail/wholesale	296
Standard Chartered Botswana	Financial Services	4 753
Turnstar	Property	714
Wilderness Safaris	Tourism	924
DOMESTIC – VENTURE BOARD		
Imara	Financial Services	284
Foreign – Main Board		
Anglo American	Mining/Resources	362 012
Blue	Financial Services	160
Iamgold	Mining/Resources	32 824
Investec	Financial Services	14 137
FOREIGN – VENTURE BOARD		
A-Cap Resources	Mining/Resources	243
African Copper	Mining/Resources	88
African Diamonds	Mining/Resources	312
Aviva	Mining/Resources	65
CIC Energy	Mining/Resources	626
Diamonex	Mining/Resources	58
Discovery Metals	Mining/Resources	859

The Domestic Board is dominated by financial institutions (mainly banks), which account for 93.4% of total capitalisation. The Foreign Board comprises mainly mining & resources companies. The largest is Anglo-American Corporation; although Anglo does not have any direct operations in Botswana, it is listed as a result of its shareholding in De Beers, and indirectly in Debswana. Other dual-listed mining companies all have prospecting or mining operations in Botswana, and for all except lamgold, Botswana is their main location of activity.

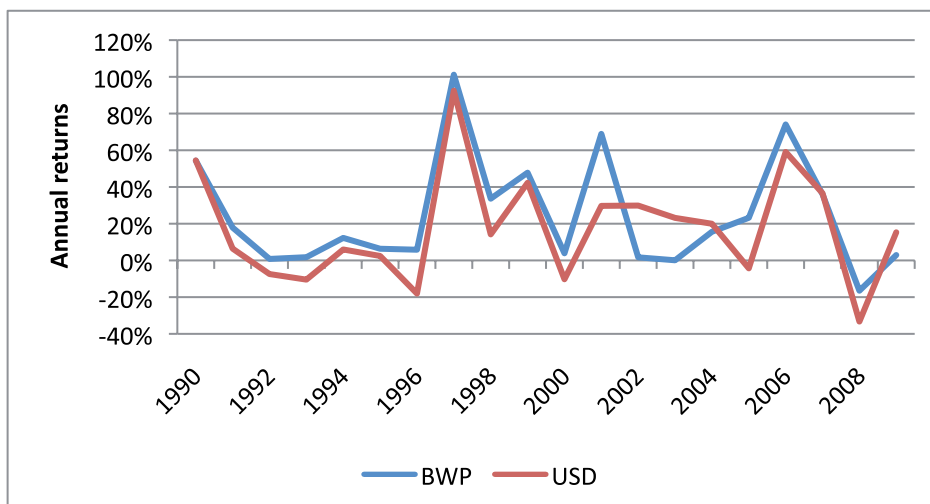
Figure 16: Botswana Stock Exchange DCI



Source: BSE

BSE performance over the years has generally been good. In local currency terms, annual returns on the Domestic Board averaged 24% a year (excluding dividends) from 1990 to 2009, while returns in US dollar terms averaged 15% a year. Dual listed mining companies also showed strong growth in the period to 2007. However, in common with stock markets around the world, the BSE had a bad year in 2008, although this was the first full year of negative performance in local currency terms since the market was established. In USD terms the market fell by 33% in 2008, a major decline but smaller than most other emerging markets; for instance, the MSCI Emerging Markets Index fell by 54% during 2008. By the end of 2009 however, the markets had improved and the DCI saw a growth of 2.9% in pula terms and 15% in US dollar terms as the currency strengthened.

Figure 17: BSE annual returns (Pula and USD, %)



Source: BSE; Econsult

The BSE remains relatively small, with market capitalisation estimated at 34% of GDP at the end of 2009, and illiquid.

There is also an embryonic bond market. Like the equity market, it is small (bond market capitalisation is equivalent to some 7% of GDP), but has been growing steadily in recent years. The development (or potential development) of the bond market was constrained for many years by the lack of government paper – given the many years of budget surpluses and large accumulated savings balances, the government had no need to borrow from the markets and hence there were no government bonds in issue. However, the government recognised that it had a role to play in capital market development, and 2003-4 issued a range of government and quasi-government bonds. These bonds provided the basis for a risk-free yield curve, which in turn prompted the issuance of a range of corporate bonds. These included bonds issued by the banks to enhance their capital structures (Tier II capital), and others issued by financial parastatals (as a source of funds for credit activities), non-financial parastatals and major corporates. By the end of 2009, a total of 32 bonds from 10 issuers were listed on the BSE, and as well there were a number of unlisted bonds in issue. A distinctive feature of the market is that non-government (corporate and parastatal) bonds outnumber government bonds in terms of number and value (although not in liquidity), which is highly unusual.

Although the bond market has grown in terms of number of bonds in issue, it faces a number of problems. Liquidity is low for government bonds and almost non-existent for non-government bonds. As a result the yield curve is insensitive to changing market conditions, and price formation is mainly dependent upon primary auctions. Government bonds are issued through primary dealers (commercial banks), and despite their responsibility for market-making, there is little secondary market activity. Low liquidity also reflects the “buy and hold” strategy of institutional investors, who are the main bondholders; this in turn reflects the low level of government bond issuance, resulting in a serious imbalance between supply and demand, and the fear by bondholders that if they trade more actively they will be unable to re-establish their positions. There are also few foreign investors in the bond market; in other markets a substantial foreign presence is a major contributor to liquidity. For the bond market to become more active and liquid, a substantial increase in the level of government bond issuance is required. In 2008, the government announced a P5 billion bond issuance programme, with regular (six-monthly) auctions, which would approximately double the value of government bonds in issue. Given the likelihood of budget deficits in the coming years as the global financial and economic crisis reduces mineral revenues, it is possible that even larger bond issues will be required, which would have the positive effect of boosting the bond market.

The BSE is undertaking a number of development initiatives to boost the capital market. A new Securities Bill is being drafted, which would modernise the legal and regulatory structure for the market. A Central Securities Depository (CSD) has been introduced, which will help improve settlement processes, and an Automated Trading System (ATS) is being planned. Both the CSD and ATS can handle bonds as well as equities. The BSE also has a Bond Market Development Programme.

4.2 PENSION & PROVIDENT FUNDS

Pension funds are governed by the Pension and Provident Funds Act (Cap 27:03), and until March 2008 were regulated by the Registrar of Pension Funds at the Ministry of Finance and Development Planning. They now fall under the NBFIRA, and new legislation is planned. The most recent report of the Registrar, giving details of pension fund operations, only covers the period to the end of 2006. As at June 2008, there were 97 registered pension funds; six of these were umbrella funds which administer pensions for a further 123 funds. The pension fund sector is dominated by the Botswana Public Officers Pension fund (BPOPF), a funded, defined contribution scheme for public officers. Other significant funds include those of Debswana, the banks and major parastatals. Around 40% of the formal sector labour force are members of pension funds, although membership is much higher in the public sector than in the private sector.

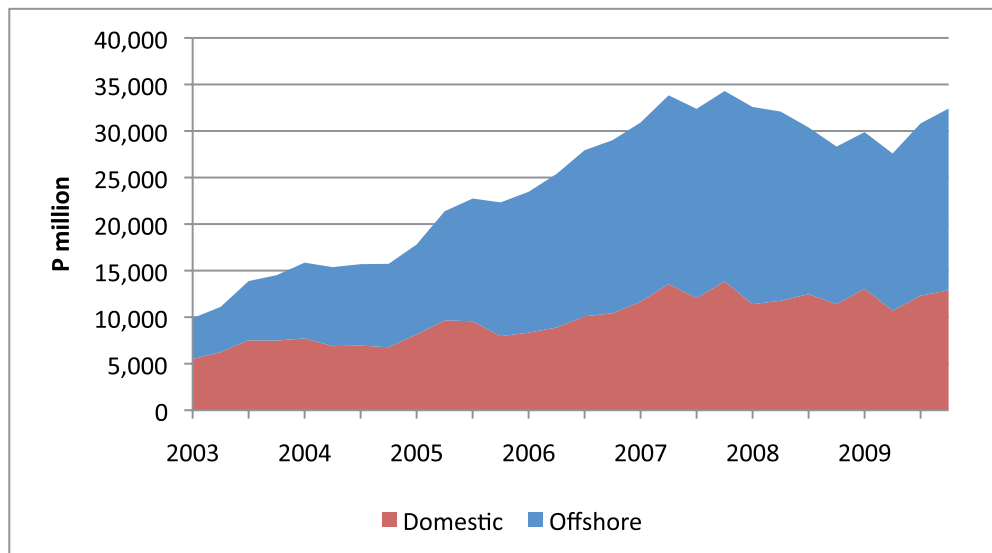
The establishment of the BPOPF transformed the pension fund sector, as well as the asset management industry. There are at present no specific regulations for the asset management sector, although it falls under the general purview of the NBFIRA. Almost all pension funds contract out their investment management to

domestic asset management companies (although two of them contract directly with offshore managers for the offshore portion of their funds). The major asset managers, ranked approximately by the magnitude of assets under management, are: Botswana Investment Fund Management (BIFM); Investec Asset Management; Fleming Asset Management; Stanbic Investment Management (SIMS); Coronation Fund Managers; Allan Gray; African Alliance; Metropolitan; and Legae Investors.

BIFM is a subsidiary of Botswana Insurance Holdings Ltd (BIHL), which is listed on the BSE and is 54% owned by Sanlam of South Africa. Fleming is majority owned by local investors. Investec, SIMS, Coronation, Allan Gray, African Alliance and Metropolitan are subsidiaries of South African asset management companies, while Legae is locally owned. The first six manage portions of the BPOPF portfolio, which is by far the most important client among pension funds. Besides pension funds, asset managers also handle the assets of long-term insurance companies. Most pension funds are now Defined Contribution funds, having converted from (or replaced) Defined Benefit funds over the past decade.

Pension funds have experienced a rapid growth of assets under management (AUM), from P9 billion in December 2002 to P34 billion in December 2007, driven by the funding of the BPOPF and good investment returns during the bull market – both domestically and offshore - over this period. AUM fell in 2008, as both domestic and offshore equity markets declined, although there was some recovery in 2009.

Figure 18: Growth of Pension Fund Assets, Domestic & Offshore, 2002-09



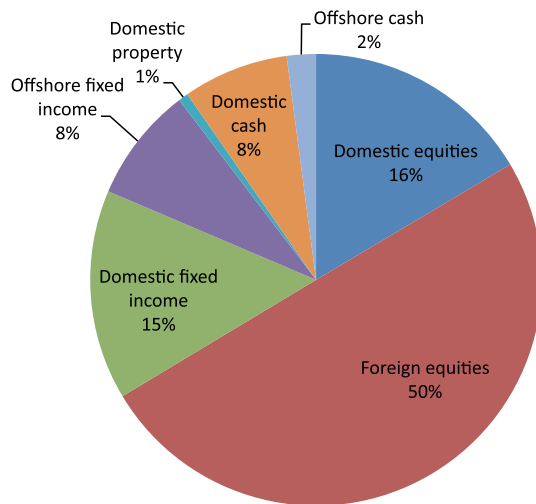
Source: Bank of Botswana

Pension funds are entitled to hold up to 70% of their assets offshore. This reflects the lack of absorptive capacity in domestic financial markets; concerns that requiring too much to be held locally could cause asset price bubbles; and a desire to secure the greatest returns for pension fund members by allowing asset managers as much freedom as possible to invest in a range of assets. With very high savings rates in Botswana, high levels of liquidity in the banking system, and extensive investment by pension funds in the domestic equity and bond markets, there have been relatively few concerns about savings being invested offshore. The share of assets held offshore has been gradually rising, from 45% at the end of 2002 to 60% at December 2009. Offshore investments are attractive both because of the much greater range of assets available compared to domestic markets - and hence diversification benefits - as well as exchange rate gains.

Given the relatively young age of most pension fund members, asset managers have invested predominantly in equities, which accounted for 66% of total assets at the end of 2009. The remainder is split between bonds (23%), cash/near cash (10%) and property (1%). The high proportion of domestic cash investments (mostly in BoBC-linked accounts) reflects the lack of other domestic investment opportunities.

One of the major problems facing local asset managers relates to life insurers and annuity providers. Obtaining matching assets for annuity liabilities requires domestic government bond-type assets; any other assets incur either credit risk (for non-government issuers), currency risk (for non-pula assets), or duration risk (for shorter-term assets). Given the shortage of government bonds in issue, asset managers have to take on more risk than is desirable, and face a tricky task in balancing the various risks.

Figure 19: Structure of Pension Fund Assets (December 2009)



Source: Bank of Botswana

4.3 INSURANCE

The insurance industry is regulated by the Insurance Industry Act, and is defined as comprising insurers, reinsurers, brokers, agents, insurance surveyors, risk managers, loss adjusters and claims settlement agents. However, detailed regulation and monitoring is only carried out on insurance companies, brokers and agencies. Regulation and supervision of the industry is the responsibility of the Registrar of Insurance; as of April 2008, this function was transferred from the MFDP to the NBFIRA.

One of the main requirements of the Insurance Industry Act is that companies are not permitted to offer both long-term (life) and short-term (non-life) insurance; hence the main distinction in the industry is between these two types of insurance companies. As at the end of 2008, there were 16 registered insurance companies, of which 7 were long term and 9 were short term. There were also 36 insurance brokers (which can transact business on behalf of any insurance company), 149 corporate insurance agencies and over 1000 individual agents (agents represent specific insurers).

Table 2: Insurance companies operating in Botswana as at December 2008

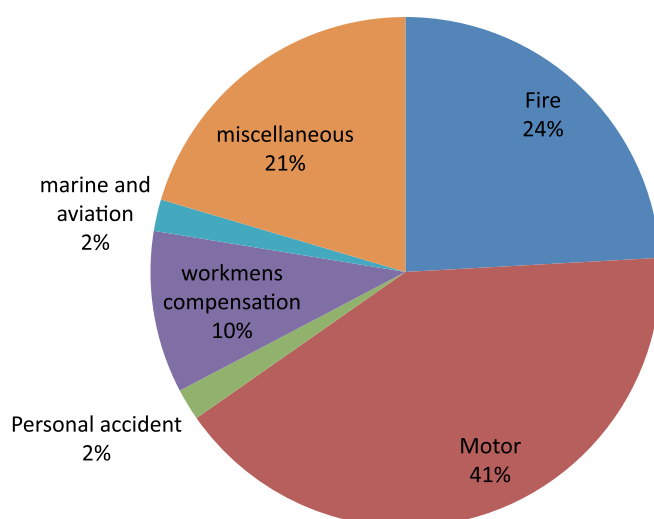
Long-term (Life)	Short-term (Non-life)
Botswana Life Insurance Ltd (BLIL)	Hollard Insurance Company of Botswana
Metropolitan Life of Botswana	Botswana Eagle Insurance
Regent Life Botswana	Botswana Insurance Co. Ltd (BIC)
Firstlife Assurance	Mutual and Federal Insurance Co of Botswana
Botswana Insurance Fund Management (BIFM)	Prefsure
Liberty Life	Regent Insurance
Letshego Life	Export Credit Insurance & Guarantee Co.(BECI – Botswana Export Credit Insurance)
	Sesiro Insurance
	Letshego Guard

Source: Registrar of Insurance (MFDP)

Of the 16 insurers as at December 2008, 14 are majority foreign owned. BLIL and BIFM are subsidiaries of Botswana Insurance Holdings Ltd (BIHL), which is listed on the BSE. Although BIFM is primarily an asset manager, it offers insurance-based products that enable the pooling of investors' funds. BECI is owned by the Botswana Development Corporation and Sesiro is a captive insurer for Debswana.

Gross premium income for the insurance industry was P2 098 million in 2008; of this, P1 391 million (70%) was for life insurance premiums and P707 million for non-life premiums. Short-term insurance is dominated by motor insurance, accounting for 44% of non-life gross premium income, whilst fire premiums accounted for 26%.

Figure 20: Sources of Premium Income - Non-life Insurers (2008)



Source: NBFIRA

One of the major costs facing Botswana insurers is reinsurance; given the small size of the market, it is essential to lay off risks elsewhere. For short-term insurers, reinsurance premiums represented 32% of gross premium income, while for life insurers it was only 7%. Reinsurers do not fall within Botswana's jurisdiction and efforts to have them establish offices here have not borne fruit. Since most of the insurers are subsidiaries of foreign owned companies, they use reinsurers chosen by their holding company.

Table 3: Insurers Income and Expenses (P mn, 2008)

	Non-life	Life	Total
Premiums	707	1391.2	2098
Claims	240	589.3	829.3
Reinsurance Premiums	222.7	91.6	314.3
Management expenses	80.8	163.1	243.9

Source: NBFIRA

The Motor Vehicle Accident Fund (MVAf) is a statutory fund providing third party motor vehicle accident cover. It was established in 1987, and is funded by a levy on fuel sales. Although it is effectively a short-term insurer, it has accumulated substantial assets, which amounted to some P1.9 billion at the end of 2008. As a statutory fund with its own legislation, the MVAf is not covered by the insurance industry legislation.

4.4 NON-BANK LENDERS

The non-bank lending sector is divided into statutory financial institutions and private credit institutions. The statutory institutions include the National Development Bank (NDB), the Botswana Development Corporation (BDC), and the Citizen Entrepreneurial Development Agency (CEDA), each established under dedicated legislation. The private credit institutions are lenders that fund their activities out of equity funds or loans; because they are not deposit-taking entities, they are not subject to the Banking Act.

Statutory financial institutions

NDB was established for the purpose of promoting the economic development of Botswana in terms of the National Development Bank Act, 1963, and offers project finance loans to Botswana or Botswana registered companies. It is a government-owned establishment operating under the direct control of the Board of Directors, appointed by the Minister of Finance and Development Planning. NDB provides financial services to businesses and entrepreneurs in the agriculture, commerce, tourism, manufacturing and real estate sectors. It has recently introduced a range of retail products such as mortgages and unsecured personal loans, thus moving beyond its traditional focus on business lending. NDB is currently being considered for privatisation.

BDC is the principal development finance institution in Botswana, and was established in 1970 as the main agency for the financing of commercial and industrial development. It can provide equity participation, loan financing, guarantees, and the provision of factories or office space or commercial land. Like NDB, it is a government-owned establishment operating under the direct control of a Board appointed by the Minister of Finance and Development Planning. BDC can assist local, joint venture or foreign-owned companies. It has made over 100 investments in subsidiary, associate and affiliate companies.

CEDA was established in 2001, following the winding up of the Financial Assistance Policy (FAP). CEDA was formed to provide subsidised credit to SMMEs along with training and mentoring services. It is restricted to fully citizen-owned enterprises. There are no restrictions on the types of businesses that may be assisted (it therefore contrasts with FAP which provided non-repayable grants but was restricted to manufacturing enterprising and selected agricultural and service activities). CEDA also has a Venture Capital Fund which provides assistance to larger businesses, and which can also assist joint ventures between citizens and foreign investors. It also has a Credit Guarantee Fund that provides partial guarantees for commercial bank loans to SMMEs, and a dedicated Young Farmers Fund, which was established to provide easy access to capital by young people to engage in sustainable primary agricultural projects. Unlike NDB and BDC, which aim to operate as primarily commercial entities, CEDA is heavily dependent upon continued government subsidies. It has a high level of non-performing loans and this, combined with interest subsidies and the costs of training and mentoring services, means that it does not yet have a viable business model. It is also subject to a high level of political intervention in its lending criteria and decisions.

Credit institutions

There are a number of formal credit institutions in Botswana that primarily engage in consumer lending against the security of payroll deductions (sometimes described as “term lenders”). The largest of these is Letshego (Micro Provident Botswana Ltd). The company commenced trading in 1998 and was listed on the Botswana Stock Exchange in 2002. Letshego’s clients are employees of the central and local governments, parastatals or quasi government and some private companies. The business model has proved highly successful, and Letshego now has subsidiaries operating in a number of African countries, including Swaziland, Tanzania, Zambia and Uganda, with plans to roll out into many more. A second term lender, Blue Financial Services, operates in a number of countries in Sub-Saharan Africa and is listed on the JSE in South Africa. Other term lenders include Penrich Employee Benefits, which operates in collaboration with various trade unions and provides loans to employees and members; its associated company Peo Micro; and First Funding. These latter entities are not strictly speaking independent credit institutions, although they may operate independently. Penrich and Peo Micro are part of Capricorn Investment Holdings, which also owns Bank Gaborone, and their loans have now been incorporated into the bank’s operations, while a similar relationship exists between First Funding and FNBB.

There are also a large number of small “cash lenders”. Some of them are members of the Microlenders Association of Botswana (MAB), which is self regulated. This was founded in 1998 to promote the interests of small-scale lenders and to make sure that there was at least some control over their business practices. Rules governing members of the Association include that they must trade from proper business, and must not charge more than 30 percent interest per month. Also, they must all use Compuscan, a central database of loans that operates out of South Africa. They are meant to check all potential borrowers with Compuscan to make sure that they don’t already have an outstanding loan from another lender. Finally they must all adhere to the Association’s Code of Conduct, which should be displayed openly in their premises.

NBFIRA is in the process of drawing up rules and regulations of business operation for microlenders. This will cover interest rates charged, capital requirements, formation of a national loans registry, auditors and accountants, levies and fees payable, and aims to make a level playing field for microlenders and banks. The rules are being benchmarked on those from South Africa and Namibia. Estimates are that there are about 125 micro lenders registered with Micro Lenders Association of Botswana and about 75 non members.

The relative sizes (assets) of a range of financial institutions, including commercial banks, other banks, non-bank lenders and pension funds are shown in Table 4.

Table 4: Major Financial Institutions - Assets, 2009

Name	Date	Type	Assets (P mn)
ABC	Dec-09	Commercial bank	1 374
Bank Gaborone	Jun-09	Commercial bank	1 046
Barclays	Dec-09	Commercial bank	11 798
Baroda	Mar-09	Commercial bank	860
Capital Bank	Dec-09	Commercial bank	576
FNBB	Dec-09	Commercial bank	12 449
Stanbic	Dec-09	Commercial bank	7 180
Standard Chartered	Dec-09	Commercial bank	8 326
BBS	Dec-09	Building society	1 874
BSB	Dec-09	Statutory bank	564
NDB	Dec-09	Development finance institution	1 026
BDC	Dec-09	Development finance institution	1 718
CEDA	Dec-09	Development finance institution	906
Letshego	Jan-10	Credit institution	1 195
MVAF	Aug-09	Statutory insurer	1 862
Life insurance (all)	Dec-08	Insurance companies	4 350
Pension funds (all)	Dec-09	Pension funds	28 326
Total			85 429

Source: Bank of Botswana, CEDA, Company reports

5. KEY ISSUES FACING THE FINANCIAL SECTOR

There are a number of key issues facing the financial sector going forward, which we discuss in more detail below. These include issues of bank ownership (including those related to local and foreign ownership, and privatisation); bank charges and profitability; competition and efficiency; potential sources of future growth; changes in the monetary policy framework; and potential changes in the regulatory regime. We also discuss the impact of the 2007-8 credit crunch and the global financial and economic crisis on the Botswana banking sector.

5.1 THE IMPACT OF THE GLOBAL FINANCIAL AND ECONOMIC CRISIS

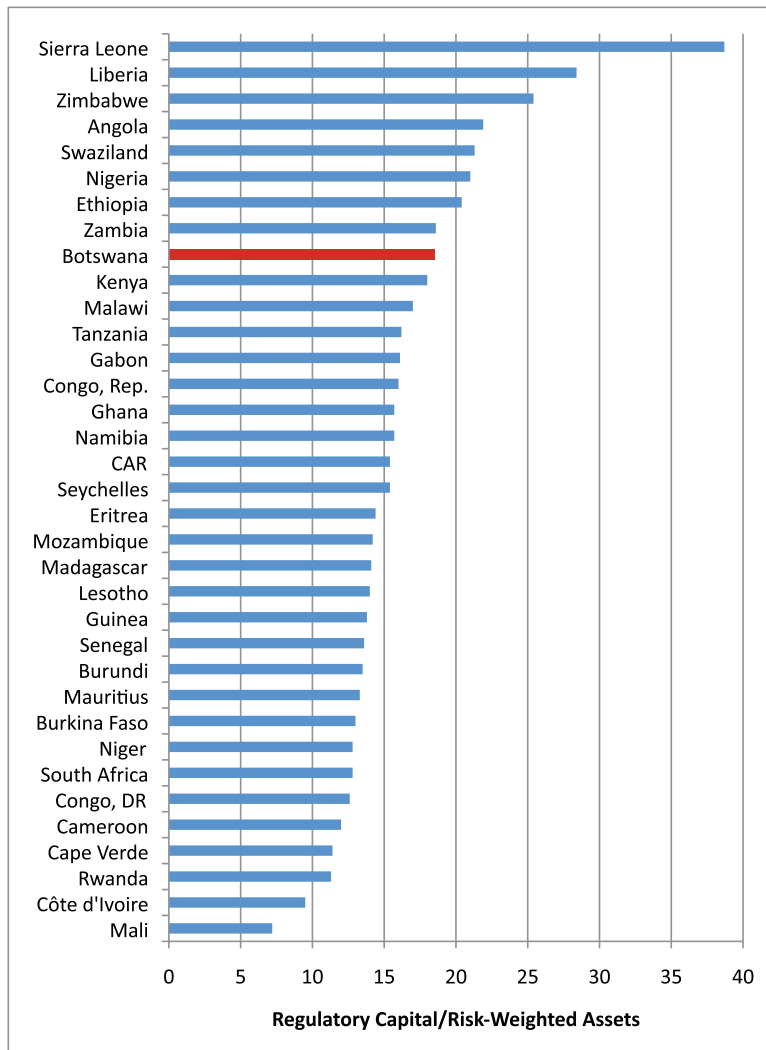
In common with banks in most developing countries, the “credit crunch” and subsequent global financial and economic crisis had little direct impact on the Botswana banking system. There were a number of reasons for this, including the structure of the banks’ balance sheets, bank profitability, and the level of regulatory oversight.

The basic structure of the Botswana banks’ balance sheet was sound: as discussed earlier, the loan-to-deposit ratio only around 50%, and there is relatively little use of wholesale markets or offshore funding sources. Hence the banks have not been vulnerable to outflows of funds – while deposits may move to other banks, the deposit base of the banking system as a whole is relatively stable unless there are significant capital outflows from the economy as a whole. Hence the granting of loans has not been constrained due to lack of funds.

As also discussed earlier, the banks have been extremely profitable, and even with an increasing level of non-performing loans, general asset quality has remained good and there have been minimal losses; hence banks have not had to use their capital and reserves to finance losses, unlike banks in major developed economies. In Botswana, the financial sector with the other non mining domestic market has been a leading force in the economic growth during the global economic crises unlike in the developed countries.

Finally, the Bank of Botswana has maintained an effective risk-based regulatory and supervisory system that has prevented the banks from taking on excessive risks. Botswana has been implementing the Basel I rules regarding capital requirements, and in fact the general level of capital requirements in relation to risk-weighted assets has been in excess of the internationally agreed minimum. As Figure 21 shows, going into the crisis, the Botswana banking system was one of the better capitalised banking systems in Africa.

Figure 21: Bank Capitalisation in Sub-Saharan Africa (2007)

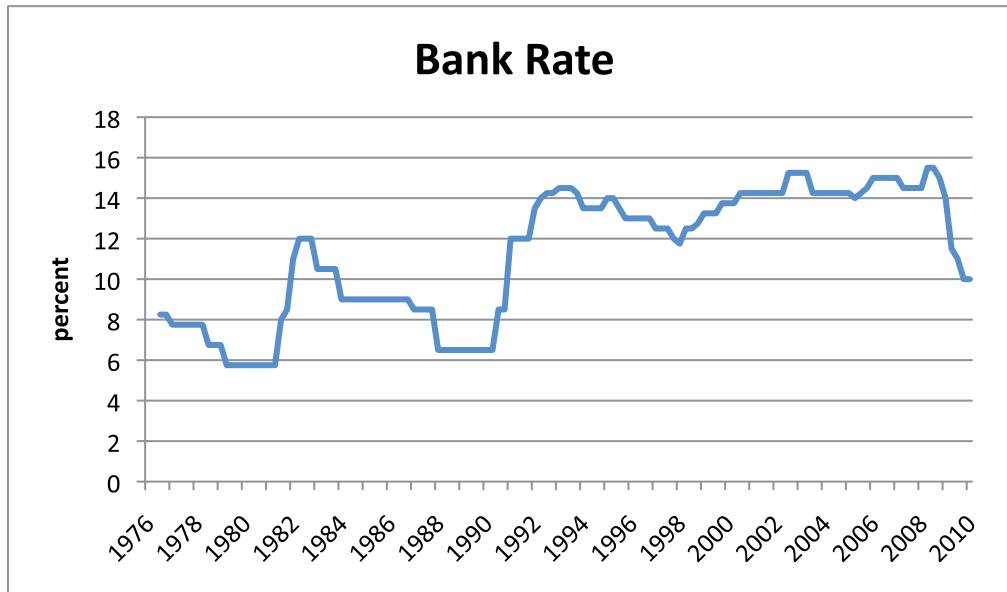


Source: IMF

Although there has been no direct impact of the global crisis on the Botswana financial system, there are indirect impacts. First, Botswana banks are subsidiaries of international banking groups that have generally tightened credit criteria and reduced their risk appetite in response to the crisis; hence there was a reduction in new credit approval in late 2008 and 2009, and a slowdown in the rate of credit growth. These external pressures were driven by a second dynamic, i.e. the impact of the global economic slowdown on the Botswana economy. For instance, the banks had begun to extend credit to mining companies and related activities such as diamond cutting, but these were amongst the sectors worst affected by the global crisis, and there were some loan losses in these sectors. However, as global conditions have improved, concerns about credit quality have eased. Nevertheless, there may still be problems resulting from cutbacks in government spending in response to fiscal pressures, which impact on businesses that are dependent upon government-financed activities (such as private educational institutions).

One of the major results of the global crisis was sharply reduced interest rates in Botswana. The Bank Rate was cut from 15.5% in November 2008 to 10% in December 2009 – the lowest it had been since the early 1990s. This reflected the severity of the crisis and its impact on the Botswana economy, as well as subdued global inflation pressures. But it was also long overdue – interest rates in Botswana had been too high for too long, with no clear evidence that this was effective in bringing inflation down. As noted by the World Bank and IMF in their 2007 Financial Sector Assessment report – discussed further in Section 5.6 below – high interest rates also caused economic distortions. The reduction in interest rates as a result of the global crisis, if maintained, should prove beneficial for the economy.

Figure 22: Interest Rate (Bank Rate) (1976-2010)



Source: IMF

5.2 BANK OWNERSHIP, AND PRIVATISATION OF STATE-OWNED FINANCIAL INSTITUTIONS

All nine commercial banks are either wholly or majority foreign owned¹³. This has had some advantages; most of the banks are part of large, well capitalised international banking groups, and this has provided stability, as well as access to capital, resources and management expertise (this is one reason why Botswana has no system of deposit insurance). There have also been gains with regard to access to technology and improved efficiency.

At the same time, the dominant role of foreign ownership in the banking sector has exposed the banks to criticism that they are insensitive to local conditions. It has often been said that while the banks are happy to do business within the narrow confines of medium and large scale businesses, and wealthier individuals, they do not make enough effort to broaden access to banking (to SMMEs and low-income individuals), and that they apply lending conditions that are too strict. Various local groups have considered making applications for a banking licence, although none have successfully completed the process, with concerns arising about access to the necessary technical and management expertise. Nevertheless, the predominance of foreign ownership in the banking sector will remain a topical issue, and there will continue to be concern.

The only local financial or “quasi-banking” institutions are state-owned. NDB is due to be privatised in the near future, and this could provide the basis for a locally-owned bank. Alternatively, the conversion of BBS to a bank could achieve this. In both cases, they would still have to go through the process of obtaining a banking licence.

5.3 THE COST OF BANKING: CHARGES AND INTEREST RATE SPREADS

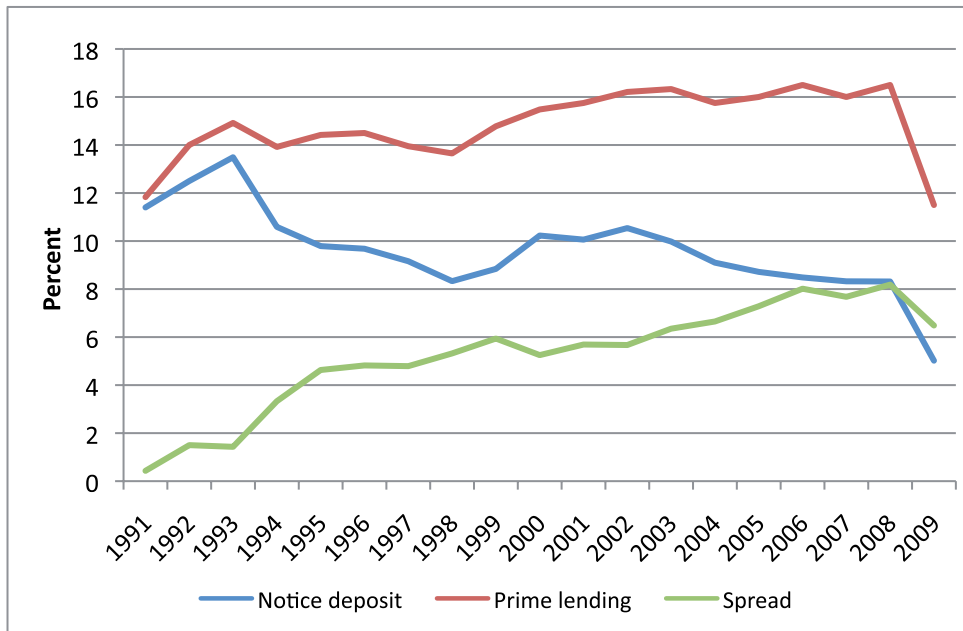
Over the years there have been consistent complaints about the level of bank charges in Botswana, but to what extent is this justified? Available research on bank charges in the region suggests that there may be some truth in this, although surveys of banking charges are now several years old and there is no recent comparative information. Nevertheless, concern about the level of bank charges is likely to persist, especially when combined with continued high profits. And while it is unlikely that statutory price controls on bank charges will be introduced, “moral suasion” is applied to the banks by both the Bank of Botswana and the Government to restrain the growth of bank charges.

¹³ Three have a portion of local shareholding through being quoted on the BSE, and two are joint ventures with minority local partners.

A related issue concerns interest rate spreads (lending minus deposit rates), which are also considered by some to be excessive. Spreads have been widening over the years (see Figure 22). What is clear is that as the level of policy interest rates has been rising over the years, lending rates have been going up, as would be expected. What is surprising is that the level of deposit rates has been declining, even as policy rates have been rising. The spread between the prime lending rate and the average notice deposit rate has therefore widened considerably, from less than 2% in the early 1990s to over 8% in 2008. The widening of spreads may reflect insufficient competitive pressures, especially in an environment of structural excess liquidity where there is little competition to attract deposits. A lack of competition could also be the result of an oligopolistic structure in the banking sector. Widening spreads could also reflect the changing structure of lending, such as the rising proportion of unsecured household debt in total lending, which tends to attract higher interest rates than secured debt.

Due to concerns about high and rising interest rate spreads, the Bank of Botswana has reintroduced controls on interest rates; as of March 2009, a maximum spread of 4% is permitted between the Bank Rate and a benchmark (91 day) deposit rate. As a result of this intervention, combined with the general decline in interest rates in 2009, the spread had fallen to around 6.5% by the end of 2009.

Figure 23: Interest Rate Spreads (1991-2009)

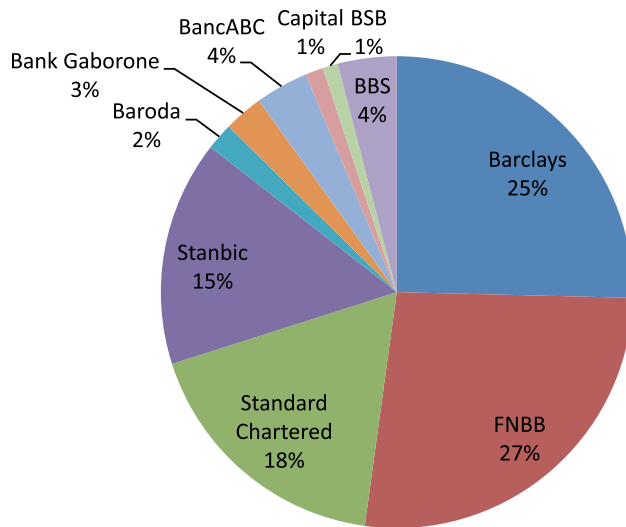


Source: BoB; Econsult

5.4 TRENDS IN BANKING CONCENTRATION AND COMPETITION

The reform and liberalisation measures adopted over the past two decades have had some positive impacts on banking competition. As discussed above, several new banks have been established, and – notwithstanding the consolidation that followed the earlier round of new entry in the 1990s – the industry has become more competitive. FNBB has grown to a size that is comparable with that of Barclays and Standard Chartered, and whereas Stanbic was initially content to be a niche player, it has recently been taking on the three larger banks more directly. The net result is that the dominance of the industry by the two oldest banks, Barclays and Standard Chartered, has gradually been whittled away. For instance, while these two banks accounted for well over 95% of total banking assets in the late 1980s, by the end of 2009 they accounted for less than 50% of banking sector assets, loans and deposits. While Barclays remains Botswana’s largest bank in terms of credit, FNBB is now the largest in terms of assets and deposits.

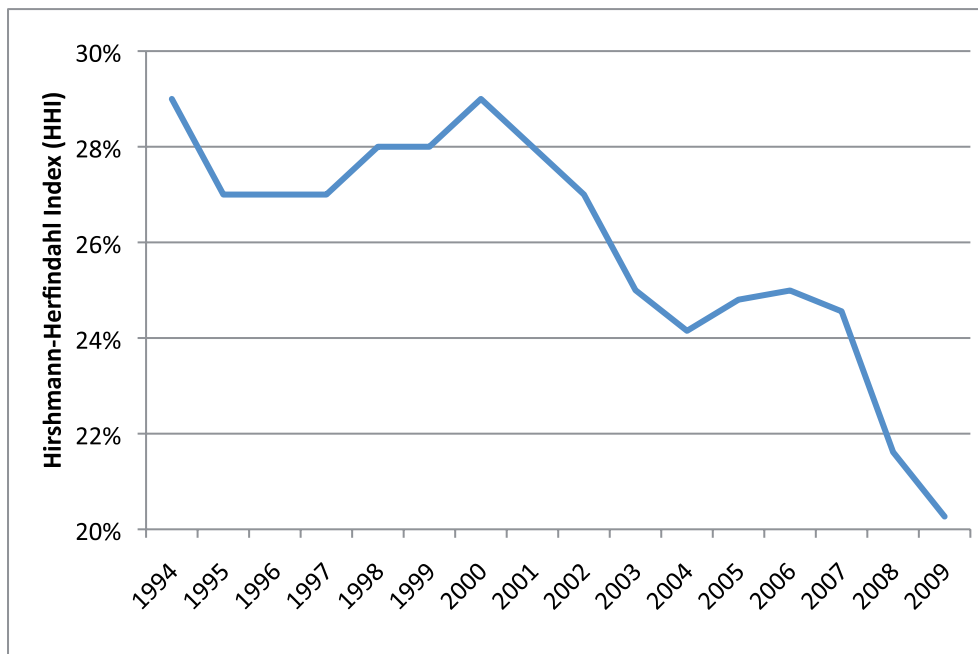
Figure 24: Assets by Bank, December 2009



Source: Company reports; Econsult

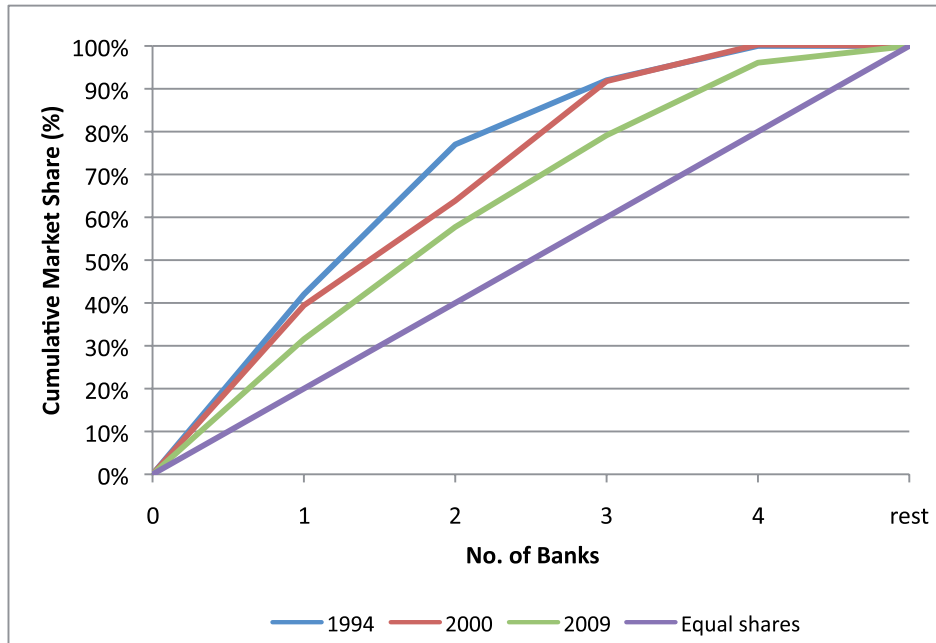
Competition is a complex phenomenon that cannot be directly measured. However, the degree of concentration in an industry – the extent to which it is dominated by a small number of large firms – is often used as a proxy. Concentration measures for Botswana show that the level of concentration has been declining, as FNBB and Stanbic have grown relative to Barclays and Standard Chartered (see Figure 24). Figure 25 shows how market shares have become more equally distributed over time. These developments are supportive of rising competition amongst the banks. Nevertheless, despite new entrants to the banking sector, concentration remains high, although perhaps not excessively so by regional standards.

Figure 25: Banking Sector Lending Concentration (1994-2009)



Source: Company reports; Econsult

Figure 26: Distribution of Banking Deposits – Shares of Largest Banks



Source: Company reports; Econsult

Competition has increased further during 2009, with the conversion of ABC to a commercial bank and its intention to roll out a retail network. ABN Amro has been established as a specialised diamond-financing bank to support the growth and diversification of the diamond sector.

More qualitative indicators also suggest that the degree of competition has been rising over the past fifteen years. The banks have been actively introducing new products, making use of technology, with FNBB typically the frontrunner in this regard (it was the first to introduce internet and cellphone banking, and to link up with retail stores for its “mini-ATM” service). While interest rate spreads as recorded by “headline” rates remain high, there are reports of very competitive markets for certain products that enable larger customers to negotiate rates that are much more favourable than advertised rates (with, for instance, loans available at well below prime rates). Nevertheless, competitive pressures appear to be much stronger with regard to non-price competition than for interest rates and bank charges.

5.5 COMPETITION, PROFITABILITY AND LICENSING POLICY

As discussed above, the profitability of Botswana banks is extremely high, despite evidence that the banking sector has become more competitive (it is “contestable” in the terminology of the economics of competition). Indeed, this is one of the perennially controversial issues regarding the banking system, especially given concerns relating to the level of bank charges and access issues. Banks in Botswana are extremely profitable, even by African standards where returns on assets and equity are high by world standards. Lending in Botswana is not particularly risky, so high returns cannot be explained by risk.

Part of the explanation for high profits is that technological advances have enabled banks to bring unit costs down – with most of the banks taking advantage of being part of large international groups and hence having access to such developments – while competition has not brought prices down commensurately.

Persistently high profits are indicative of market failure. Nevertheless there is some evidence that competition is having its desired effect, and that the entry of new banks and increased competition in the banking sector is beginning to bring profits down, as would be expected.

The fact that the licensing regulations permit new entrants, subject to modest capital requirements and prudential

conditions, should provide an important check on profits. The small size of the market, however, may pose a limit on new entry, in that the Botswana banking market may not be big enough to accommodate very many full-service commercial banks. Potential competition, however, may increasingly come from different types of banks, not necessarily offering a full range of commercial banking services. Technological developments (such as cellphone banking and e-money) also have implications for the traditional banking model, and enable some banking and money transmission services to be conducted by other entities. Whether alternatives to traditional banks will enter the market depends on, amongst other things, bank licensing policy. As a result, there may be arguments for making the bank licensing regulations more flexible, in order to accommodate the entry of new types of banking services into the market.

5.6 MONETARY POLICY AND THE FUTURE OF BOBCS

The Monetary Policy Framework

The Bank of Botswana's monetary policy framework is based on an inflation objective, to be achieved through the management of short-term interest rates. The inflation objective is determined in relation to the forecast inflation rates of trading partners, with the objective of keeping the real effective exchange rate constant. Since 2008, the stance of monetary policy has been determined on the basis of the deviation between forecast medium-term inflation and the medium-term objective, i.e. policy is adjusted in order to bring the medium-term inflation forecast in line with the inflation objective.

For the changes in monetary policy to be effective, however, there are several key requirements:

- given that the divergence between the medium-term inflation forecast and the medium-term inflation objective is a crucial determinant of monetary policy, the quality of the inflation forecast becomes crucial, and this in turn depends on the quality of the Bank's medium-term inflation forecasting model;
- while short-term inflation modelling and forecasting is quite easy, being primarily momentum driven, medium-term forecasting is much more difficult; it depends upon both high quality modelling (i.e. a model which can be shown to perform well in forecasting on the basis of historical data) and the ability to accurately forecast a range of real activity variables (e.g. the rate of future economic growth, the level of capacity utilisation in the economy, productivity growth, government spending, and real and nominal economic shocks); it also depends on the quality of the statistical data on which the model is estimated;

More fundamentally, the effectiveness of monetary policy depends on whether interest rates have a significant impact on inflation, and this needs to be substantiated empirically.

Botswana's monetary policy framework contains some elements of inflation targeting. In particular, the adoption of a medium term inflation target/objective, and the use of a model and medium-term forecasts to determine policy changes, are a common feature of inflation targeting regimes. However, there are key differences between the monetary policy framework and a fully-fledged inflation-targeting (FFIT) regime. One of the most crucial aspects of FFIT is that the inflation target must dominate all other macroeconomic policy objectives, including exchange rate or fiscal policy objectives. Botswana of course maintains a pegged exchange rate, determined by government, and BoB does not have control over this important component of monetary policy and determinant of inflation. FFIT countries all have floating exchange rates. In addition, fiscal policy is not managed so as to minimise its inflationary impact. Furthermore, there is no clear mandate for BoB to pursue price stability above all other objectives (whether a statutory objective or a statement of government policy), and BoB cannot at present be held fully accountable for achieving the target.

Inflation targeting has generally been quite successful in achieving low inflation across a wide range of countries, although the current environment of cost-driven increases in global inflation will provide inflation targeting regimes with a severe test. However, it has generally been adopted by medium or large economies, and there is limited experience of its use in small open economies such as Botswana where inflation is primarily imported and hence determined by external factors.

The 2008 monetary policy changes in Botswana can be seen as a “halfway house” towards the adoption of full inflation targeting. Whether it works depends crucially on the performance of the inflation forecasting model and its modelling of the monetary transmission mechanism, which will become apparent over the next 2-3 years. However, the adoption of FFIT would depend on much more than this, as it would require reform of the Bank of Botswana Act, and an explicit commitment to the framework from government. It would also require a move towards much greater exchange rate flexibility, with either a market-determined floating exchange rate, or at the very least an acceptance that in the event of conflict between exchange rate and inflation objectives, the latter would take precedence. A more flexible exchange rate policy would in turn require a new mechanism for building up foreign exchange reserves and saving mineral revenues, and would also run the risk that the exchange rate would appreciate, leading to competitiveness problems of the kind that emerged prior to the devaluations of 2004 and 2005. Further movement along the route to inflation targeting would therefore have major implications for the economic and monetary environment within which the banks operate.

BoBCs

The role of BoBCs in the banking sector has been important and controversial. Their fundamental purpose has been to absorb excess liquidity in the financial sector. In doing so, they have provided the banks with an alternative asset, and have meant that banks have not had to pursue unduly risky or potentially low return (on a risk-adjusted basis) lending opportunities. Because BoBC interest rates have been relatively high, earnings on BoBCs have been an important contributor to bank profits.

BoBCs also provide a benchmark interest rate, by influencing deposit interest rates as well as the opportunity cost of loanable funds. Hence they have been an important mechanism for implementing monetary policy, both by enabling the BoB to transmit interest rate policy preferences to the market, and by restraining credit growth and hence aggregate demand growth and inflationary pressures. BoBCs are one of the main instruments used by the BoB to implement monetary policy.

The banks have been subject to extensive criticism in the context of BoBCs, notably that they invest in BoBCs rather than seeking out lending opportunities or taking risks, and that they are too reliant for their profits on income from BoBCs. Some of the criticism is misplaced, in that banks are simply responding to the prices and incentives that have been intentionally offered through the BoB's monetary policy, which has – at least until 2009 - had the objectives of keeping interest rates high and, through absorbing excess liquidity, restraining credit growth. Lending opportunities that provide the banks with a better return than BoBCs can secure funds, but the “hurdle” rate of return that such opportunities need to pass is high as a result of the risk-free rate on BoBCs. To that extent, the banks have been fortunate beneficiaries of monetary policy and its implementation, especially since the changes introduced in March 2006 which restricted BoBCs to banks only, and strengthened their position vis a vis the holders of liquidity.

A Financial Sector Assessment carried out in 2008 by the IMF and the World Bank included a review of the BoBC system, and reached some quite critical findings¹⁴. In particular the assessment concluded that:

- by maintaining high interest rates in an environment of excess liquidity, monetary policy has “resulted in high interest rates on credit and potential allocative distortions, discouraging productive investments” (p.3);
- “the effectiveness of BoBCs as the main monetary policy instrument is questionable” and “they prevent further development of the financial sector” (p.6)
- “Botswana incurs large costs in the conduct of its monetary policy ... if BoBCs were to continue to grow at the current pace, the BoB would eventually have to show losses” (p.6)
- “BoBCs act as a conduit for the transfer of public resources to the holders of these certificates” (p.6);

The IMF/World Bank report concluded that “current approach to liquidity management through the BoBCs should be jointly reexamined by the MFDP and the BOB” (p.3), that there was a need for the two institutions to “enhance coordination and transparency of monetary and exchange rate policy”, and to “streamline the structure of policy interest rates and further encourage market-determined interest rates”(p.5).

14 World Bank (2008)

The Financial Sector Assessment Report was prepared before the global financial and economic crisis, but clearly took the view that interest rates were too high and not a very effective tool for controlling inflation. Since that time interest rates have been cut significantly. The volume of BoBCs in issue has also declined. Nevertheless, excess liquidity is likely to persist for some time, even if not to the same extent as previously, and as a result some kind of instrument will be necessary to absorb excess liquidity and influence interest rates. While BoBCs are likely to continue to exist, the interest rates paid on BoBCs – and their contribution to bank profitability – may not return to previous levels.

5.7 SOURCES OF FUTURE GROWTH FOR THE FINANCIAL SECTOR

One of the key issues facing the banking sector is, after years of relatively fast growth, what are sources of potential future growth? One of the main sources of recent growth – lending to the household sector – may be saturated (albeit perhaps temporarily), given rising arrears rates and concern about over-borrowing and the levels of household debt burdens, even if by international standards household debt ratios may not be high. Three areas of potential growth may be considered: the low income/unbanked market; new opportunities resulting from technological change; and under-served business sectors.

a. Potential of low-income/underbanked market

“Access to banking” is a topical issue in Botswana, as in many other countries, reflecting concerns that the banking system only services a relatively small proportion of the population. Data on access to banking is available from the Botswana FinScope surveys carried out in 2004 and 2009, and show that¹⁵:

- just over 40% of the population are “banked”, in that they use at least one banking product, and nearly 60% are “unbanked”;
- there was no significant improvement in access to banking between 2004 and 2009;
- there are major differences between the characteristics of the banked and the unbanked;
- there is relatively higher usage of banking amongst urban residents, heads of households, well-educated people the employed and those with higher incomes;
- males are more likely to use banks than females;
- usage of banking is relatively low amongst the rural population, the unwaged, the young and the elderly, and those with less education.

While the result on access to banking indicate that more than half of the population do not make use of banks, it is useful to place the result in comparative perspective. FinScope surveys in South Africa and Namibia give higher levels of access to banking, at 63% and 45% respectively. Elsewhere in sub-Saharan Africa, banking penetration is much lower, especially in low income countries: the proportion of the population with a formal bank account is estimated in various FinScope surveys at 23% in Kenya, 21% in Nigeria, 19% in Malawi, 18% in Uganda, 15% in Zambia, 12% in Mozambique and 9% in Tanzania.

In Botswana as elsewhere there is pressure to extend banking to a greater proportion of the population. However, this is not just a social and political issue, as international evidence shows that greater financial depth, and enhanced access to finance, improves economic growth potential and can contribute to poverty alleviation.

South Africa has been one of the most active countries in the region in terms of improving access to banking, and a “Financial Access Charter” has been agreed between the government and various financial institutions, with commitments to various policies and targets. One of the first initiatives under the Charter was to introduce the “Mzansi” account, a low cost standardised product available across the banking sector, aimed at first-time customers. Similar initiatives may be relevant in Botswana and other countries of the region.

¹⁵ FinScope is a representative nationwide survey of financial usage and related issues, co-ordinated by FinMark Trust (www.finmark.org.za).

The conventional branch banking model is unlikely to be a suitable vehicle for extending access to banking, given the different characteristics of the unbanked; the costs of branch banking are too high (both in terms of infrastructure and personnel), and the resulting cost-covering fee levels would make banking unaffordable to low income groups. Hence other options may need to be considered, including partnerships with other entities that have a distribution network (such as the Post Office or retail stores), or taking advantage of new technology. In Botswana, access is particularly a problem in the less densely populated areas, and providing banking services through alternative distribution mechanisms may be one way of addressing this.

b. Technology (e.g. cellphone banking)

Mobile or cellphone banking is seen as one important way to extend the reach of banking in low income countries. Mobile banking platforms provide way of reaching large numbers of customers on a low unit cost basis, and can provide a range of services, including bill payment, account transfers, person-to-person (p2p) transfers, government transfers (such as social welfare payments, pensions etc.), cash withdrawals (via merchants or ATMs), and e-money (cash loaded onto smartcards or cellphone SIM cards). Under conventional licensing legislation such facilities may be restricted to banks only (because of restrictions on deposit taking), in collaboration with mobile companies and merchants. The interpretation of bank regulations in respect of mobile payments and banking tends to vary a great deal between one country and another. There is a need for greater consistency and clarity in regulatory approaches to mobile payments and banking, and changes in licensing regulations, or exemptions, may be required to enable these products to be offered by non-bank providers.

Considerable success has been achieved in the Philippines, where Globe Telecom's G-Cash service, established in 2004, now provides mobile banking services offering money remittance, donations, loan settlement, disbursement of salaries or commissions, and payment of bills, products and services. Safaricom's M-Pesa money transfer service in Kenya has been a runaway success since its launch in 2007. Both G-Cash and M-Pesa are provided by cellphone companies and not banks, with the agreement of banking regulators in both countries. Also in Kenya, Safaricom and Equity Bank launched a cellphone-based savings product (M-Kesho) early in 2010. There are several cellphone banking services available in South Africa, including WIZZIT and MTN Banking which primarily target the unbanked, while the four main banks also offer cellphone banking channels for their existing customers.

Cellphone banking may have considerable potential in Botswana, where cellphone penetration is amongst the highest in sub-Saharan Africa. According to FinScope 2009, even among the unbanked a majority of adults have access to cellphones. The high take up of cellphones in Botswana suggests that the population is ready to adopt new technology, a point that is reinforced by findings from the FinScope surveys the majority of respondents were prepared to learn how to use new technology. FNB established a cellphone banking operation in late 2006, although this was targeted (at least initially) at existing customers rather than the unbanked.

Smartcards also offer considerable potential for payments services, especially for social welfare payments such as old-age pensions, and virtual bank accounts.

c. Under-served sectors

One notable feature of the Botswana banking sector is that historically it has not lent any significant amounts to the two largest sectors of economy, mining and government. Government itself has generally run budget surpluses and, in contrast to many other countries, has not had to raise funds from the banking system, or from the financial sector more generally. In the mining sector, diamond production has been highly profitable, and there has been little or no need for bank funds, with capital investment financed from cash flow or by shareholders. By contrast, in the copper-nickel sector, the largest mining company – BCL – has been unprofitable and has generally relied upon government for funding.

This situation is changing, with new mining projects being developed. While exploration projects are predominantly funded by risk/equity capital rather than bank loans, as projects move towards the production stage then bank loans may be needed. Furthermore, mining-related projects such as minerals processing may also be suitable for bank financing. Unfortunately the experiences of newly-established mining and processing

firms has not been encouraging, with new copper and diamond mining operations suffering as a result of the global recession, with losses for both loan and equity financiers. There has been a similar story with diamond cutting operations. Nevertheless, the longer-term future for mining in Botswana is bright, and there will undoubtedly be opportunities for lending opportunities to the sector, whether for established commercial banks or specialised entities such as diamond banks.

There is also change in Government's financial needs. The sharp deterioration in public finances in 2009-10 has resulted in large budget deficits and further borrowing through bond issuance, supplementing earlier bond issues that were undertaken purely for capital market development purposes.

5.8 REGULATORY ISSUES

Botswana has established an effective system of bank regulation through the Bank of Botswana, which has contributed to the stability of the banking system over the years. However, a number of regulatory issues have emerged in recent years that may lead to changes in the regulatory structure for banks. In addition, the NBFIRA is introducing new regulations for previously-unregulated activities. The key issues and possible changes in coming years are summarised below:

Deposit insurance: Botswana does not have a system of formal deposit insurance, and there has never been a situation of bank failure that would have led to a call on such a system. Furthermore, there has been a requirement that parent companies would back their Botswana subsidiaries in the event of financial distress. However, the events of 2008-9 and the collapse of banks and financial institutions that were previously thought to be sound, plus the entry of new, smaller banks into the Botswana market, may lead to a reconsideration of this position. A deposit insurance system would need to be funded by an initial capital contribution (most likely from banks and government) and ongoing premiums from insured banks, and would therefore lead to an increase in the cost of banking. Besides the need to bring all institutions on board, a great deal of preparatory work would be needed to establish a deposit insurance system suited to Botswana, and hence it would take some time to get such a system up and running.

Contingency plans for systemic financial distress: recent events also show the need for contingency plans, prepared in advance, that can be activated in the event of the distress or failure of a systemically important financial institution, which could potentially threaten the stability of the entire financial system.

International regulatory framework: most countries employ a risk-based system of banking regulation and supervision, which entails identifying the most important risks facing financial institutions and ensuring that adequate measures are in place to deal with such risks. It also entails risk-weighted capital requirements, whereby the level of regulatory capital that banks are required to provide depends on the level of risk associated with various assets on their balance sheet. Banking supervision is generally based around the "Basel Core Principles", drawn up under the auspices of the Bank for International Settlements (BIS). In recent years a new set of rules – Basel II – for capital requirements and risk assessment has been drawn up, and most countries are in the process of implementing, or preparing to implement, these new rules. However, the financial crisis has exposed some potential flaws in the Basel II system, and these may now need to be revised. More generally, the acknowledgement that gaps in the system of financial regulation contributed to the global financial crisis means that new regulations are likely to be introduced covering previously-unregulated activities such as investment banks and hedge funds. This could eventually have implications for the structure of financial regulation in Botswana.

Non-bank regulation: the new non-bank regulatory authority, NBFIRA, has initially taken over pre-existing regulations covering the capital markets (stock exchange, brokers etc.), insurance and pension funds. Amongst NBFIRA's many tasks are the modernisation of these regulations and the introduction of new regulations for previously unregulated activities. For instance, a new Securities Bill is under preparation, which will replace the BSE Act and deal with capital market regulation. New regulations will cover asset managers, pension fund trustees, and non-bank lenders. While the form of these new regulations is as yet unclear, it is likely that it will follow international best practice and will bring more stability to the respective industries, and will focus particularly on consumer protection.

6. CONCLUSIONS

The Botswana banking sector has been growing in both size and scope in recent years. From being a relatively uncompetitive duopoly in the late 1980s, the entry of new banking institutions during the 1990s transformed the competitive environment and introduced considerable product and service innovation. By 2009, the banking sector comprised four reasonably large banks (at least by Botswana standards), and five smaller ones. In addition, several other financial institutions play an important role in segments of the banking market, including government-owned financial institutions, non-bank lenders, and pension funds, each providing various kinds of competition.

Increased competition in the banking sector has been stimulated by a number of changes over the years, including a more liberal licensing regime, broader macroeconomic policy changes (such as the abolition of exchange controls) and technological changes. The growth of the economy, and rising income levels, have also provided more opportunities for banks. The fact that value added generated by the banking sector has been growing faster than the economy as a whole is exactly what would be expected as both the economy and the financial sector become more dynamic and diversified.

Notwithstanding increased competition, the banking sector has remained exceptionally profitable, results that may appear to be inconsistent with increased competition. One explanation may be that technological developments that the banks have benefited - as part of large international banking groups - have enabled them to bring costs down, but competition in what remains a relatively small market has not been sufficient to bring prices down commensurately. Profits have also been supported by the high interest rates that prevailed until 2009 - focused on bringing down inflation to internationally comparable levels - which enhance the margin that banks earn between low cost deposits (especially non-interest bearing current account deposits) and interest-earning assets. Other changes, especially the change in the BoBC regulations in early 2006 that restricted BoBC holdings to banks only, have also provided the banks with a windfall profits gain. However, there is some evidence that banking profitability has been reduced since 2007 as competition has intensified.

To what extent will the profitability of the Botswana banking system be maintained over the coming years? It is likely that there will be a range of pressures tending to reduce profitability¹⁶:

- (i) competition is likely to increase further; the Bank of Botswana receives a steady stream of enquiries from both local and international groups regarding banking licences, and it is likely that new banks will be licensed - albeit not in large numbers - over time. The establishment of new financial institutions will be even more likely if the licensing regulations are revised to accommodate a broader variety of types of banks;
- (ii) government-owned financial institutions may be privatised, and could form the basis for a new financial services/banking group;
- (iii) while technological change has provided opportunities for banks to improve their efficiency and offer innovative services, it also changes the banking landscape and offers opportunities for new competitors who may not look like conventional banks, such as specialised cellphone banking operations and e-money providers, especially if the licensing regulations are made more accommodative;
- (iv) finally, lower interest rates will also tend to reduce bank profits.

¹⁶ That is, profitability in terms of the Rate of Return on Assets or Return on Equity is likely to be pressurised. Profits in Pula terms are, however, likely to keep on rising as banking balance sheets continue to grow.

Banks are also under pressure to extend their services to the “unbanked” population, comprising nearly 60% of adults. There are expectations that banking will become more inclusive, especially given high profits, and assist in bringing poorer segments of the population into the economic mainstream. In doing so, banks will have to move away from branch-based banking and utilise innovative service delivery mechanisms that can work efficiently in areas of lower incomes and/or lower population densities.

Other potential weaknesses of the banking sector include the high proportion of their balance sheets made up of BoBCs, and the probable saturation – at least in the short term – of the consumer lending market that has been one of the fastest growing segments of the market in recent years. But, over time there should be considerable scope for growth, given that the Botswana banking sector is still small in economic terms for an upper-middle income country.

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