INTERNATIONAL MONETARY FUND

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# BOTSWANA

## FINANCIAL SYSTEM STABILITY ASSESSMENT

September 2023

This paper on Botswana was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on July 27, 2023.

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**International Monetary Fund**
**Washington, D.C.**

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## FINANCIAL SYSTEM STABILITY ASSESSMENT

July 27, 2023

## KEY ISSUES

**Context:** Botswana's financial sector, which exhibits high integration between banks and non-bank financial institutions, withstood the pandemic well. The economic recovery continues to be strong, but inflation remains high with risks tilted to the upside. Overall, the authorities have made notable progress in strengthening their financial supervisory and regulatory frameworks since the 2007 FSAP.

**Findings:** The financial sector appears broadly stable, sound, and resilient. Main risks relate to banks' high concentration of lumpy short-term deposits from retirement funds and insurance companies, volatility in diamond prices, geo-political developments, and the tightening of global financial conditions. The financial system appears resilient to a wide range of shocks relating to these risks, although pockets of vulnerabilities exist. Under a severe risk scenario, two banks fell below the prescribed capital ratio. The elevated level of banking sector liquidity allows most banks to withstand liquidity shocks. However, contagion risk from banks to non-bank financial institutions could be material.

**Policy advice:** The challenging risk environment underscores the need to address the existing gaps in the financial stability framework and the supervisory regime that could impede BoB's operational independence in supervisory matters. The banking supervision approach should be more risk-based and forward-looking, with more skilled staff who can identify emerging risks in the more complex banking sector. Specific regulations for material risks should be issued and Pillar 2 supervisory assessments developed for more risk-sensitive capital requirements. Data gaps should be addressed to enable the implementation of stress tests on a globally consolidated basis, perform more granular analyses of household and corporate sector vulnerabilities, and activate macroprudential tools. To enhance the system's resilience, strengthening decision-making and refining the strategy for the calibration of capital buffers and borrower-based macroprudential tools should be considered. Risk-based AML/CFT supervision, legal reforms to address gaps in the supervisory framework, and implementation of financial safety nets are needed. It is essential to make clear plans for financing an operationally independent deposit insurance scheme. The Financial Stability Council has an important role in developing and coordinating a comprehensive framework for crisis management and resolution.

Approved By
**May Khamis and Andrea Richter Hume**

Prepared By
**Monetary and Capital Markets Department**

This report is based on the work of the Financial Sector Assessment Program (FSAP) mission that visited Botswana in January 2023. The FSAP findings were discussed with the authorities during the Article IV consultation mission in July 2023.

- The FSAP team was led by Thor Jonasson (IMF) and Harish Natarajan (World Bank, WB) and included Claney Lattie (IMF) and Rinku Chandra (WB) as Deputy Mission Chiefs. The team also included Dan Cheng, Ian Stuart, Yuan Gao Rollinson, and Adrian Wardzynski (all IMF), Krishnamurti Damodaran, Fiona Stewart, Peter Lohmus, Ivor Istuk, Francesco Di Salvo, Claudia Meek, and Wuraola Fanimokun (all WB), along with Timo Broszeit, David Parker, and Christopher Wilson (all IMF Experts). Christie Chea (IMF) provided valuable administrative support and input.

- The mission met the Minister of Finance, the Governor of the Bank of Botswana, the Chief Executive Officer of the Non-Bank Financial Institutions Regulatory Authority, the Director of the Financial Intelligence Agency, and technical staff in their agencies. Fruitful discussions were also held with other official agencies, financial sector representatives, and other stakeholders.

- The FSAP assesses the stability of the financial system as a whole and not that of individual institutions. It is intended to help countries identify key sources of systemic risk in the financial sector and recommend policies to enhance its resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational, legal, and risk related to fraud, are not covered in the FSAP.

- This report was prepared by Thor Jonasson and Claney Lattie with contributions from the Botswana FSAP team.

# Glossary

| | |
|---|---|
| AML/CFT | Anti-money laundering and Counterterrorist Financing |
| BA | Banking Act, 1995 |
| BBS | Botswana Building Society |
| BCP | Basel Core Principles |
| BoB | Bank of Botswana |
| BoBA | Bank of Botswana Act, 1996 |
| BoBAA | Bank of Botswana Amendment Act, 2022 |
| BoBC | Bank of Botswana Certificates |
| BDIS | Botswana Deposit Insurance Scheme |
| BDISR | Botswana Deposit Insurance Scheme Regulation |
| BSB | Botswana Savings Bank |
| BSD | Banking Supervision Department |
| BWP | Botswana pula |
| CAR | Capital Adequacy Ratio |
| CI Act | Credit Information Act, 2021 |
| CPs | Core Principles |
| CRO | Chief Risk Officer |
| DFIs | Development Finance Institutions |
| DRBA | Draft Revised Banking Act |
| D-SIBs | Domestic Systemically Important Banks |
| EC | Essential Criteria |
| ELA | Emergency Liquidity Assistance |
| ERTP | Economic Reform and Transformation Plan |
| FI Act | Financial Intelligence Act, 2022 |
| FIA | Financial Intelligence Agency |
| FSC | Financial Stability Council |
| HQLA | High-quality Liquid Assets |
| ICAAP | Internal Capital Adequacy Assessment Process |
| IRRBB | Interest rate risks in the banking book |
| LAR | Liquid Assets Ratio |
| LCR | Liquidity Coverage Ratio |
| MoF | Ministry of Finance |
| MSMEs | Micro, small, and medium enterprises |
| NBFIs | Non-bank financial institutions |
| NBFIRA | Non-bank Financial Institutions Regulatory Authority |
| NII | Net interest income |
| NPLs | Non-performing loans |

| | |
|---|---|
| PRR | Primary Reserve Requirement |
| RAM | Risk Assessment Matrix |
| RBS | Risk-based Supervision |
| RBSS | Risk-based Supervision System |
| RFA | Retirement Funds' Act, 2022 |
| ROSC | Report on the Observance of Standards and Codes |
| SOFIs | State-Owned Financial Institutions |
| SREP | Supervisory Review and Evaluation Process |
| STeM | Stress Testing Matrix |

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**APPENDICES**

# EXECUTIVE SUMMARY

**Botswana had a strong post-pandemic economic recovery.** The recovery, which was supported by robust growth in diamond exports, enabled a narrowing of the current account deficit and stabilized the import coverage ratio. However, global conditions have played a dominant role in driving domestic inflation, which remains at elevated levels.

**The financial system has remained broadly resilient since the last FSAP (2007), and notable progress has been made in strengthening the financial supervisory and regulatory frameworks.** The financial sector withstood the pandemic well, thanks in part to policy measures and the sector's strong financial position. Banks hold adequate capital and maintain ample liquidity, while they show moderate profitability. The banking system remains highly integrated with a sizeable share of non-bank financial institutions. Banks exhibit a high concentration of lumpy short-term deposits from corporates and non-bank financial institutions. Other risks to financial stability are high volatility in diamond prices, geo-political developments, and the tightening of global financial conditions. Realization of risks could delay economic recovery and fiscal stability, weaken the external position, and depreciate the pula.

**The financial system appears resilient to a wide range of shocks and most banks would withstand severe stress.** Two banks would face a mild capital shortfall under an adverse risk scenario. Most banks are expected to meet the prescribed liquidity ratios under a baseline scenario. However, some show vulnerabilities when subjected to an adverse scenario. For the non-bank financial sector, insurance companies appear well capitalized and do not face a shortfall under a severe scenario.

**The authorities have implemented most previous FSAP recommendations and others are at an advanced stage of completion (Appendix I).** Legal reforms to strengthen the Bank of Botswana's (BoB) mandate for financial stability are included in the Bank of Botswana (Amendment) Act, 2022 (BoBAA)[1] and the Draft Revised Banking Act (DRBA) is fairly advanced.[2] Key elements of the Basel III Framework are at an advanced stage of implementation and Domestic Systemically Important Banks (D-SIBs) have been identified. Furthermore, the anti-money laundering and counterterrorist financing (AML/CFT) framework has been upgraded since the 2017 Financial Action Task Force (FATF) assessment. The Bank of Botswana's (BoB) stress testing capacity has also been enhanced.

**Further steps are warranted to strengthen the financial stability framework and enhance financial sector resilience, including for:**

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[1] At the time of the FSAP, the prevailing Banking Act (BA), 1995, and the Bank of Botswana Act (BoBA), 1996 were in force. The Bank of Botswana Amendment Act (BoBAA), 2022, was passed by the Parliament in August 2022 and its effective date is February 2023.

[2] The Draft Revised Banking Act (DRBA) was published via the Botswana Government Gazette on January 13, 2023.

- **Banking regulation and supervision.** The supervisory framework should become more risk-based and forward looking, and implemented on a consolidated basis. The regulatory guidance for the treatment of problem assets and provisioning as well as for liquidity and interest rate risk should be strengthened. The operational independence of BoB supervision should be strengthened, the framework for the oversight of banks' corporate governance should include concentration risk and transactions with related parties, and tools for reviewing and assessing banks' internal capital adequacy assessment and Pillar II risks should be incorporated into the supervisory review and evaluation process (SREP).

- **Macroprudential policy framework.** The authorities have made considerable progress in strengthening the macroprudential framework. Once implemented, the BoBAA will include an explicit reference to financial stability with an expanded role for the Financial Stability Council (FSC).

- **Management of systemic liquidity.** To strengthen the funding liquidity of banks, it is advisable to transition to the Basel III framework for liquidity monitoring and enhance the development of money and bond markets.

- **Financial integrity.** The authorities should continue strengthening AML/CFT risk-based supervision (RBS) for banks and non-bank financial institutions. They should ensure that information on the beneficial ownership of legal persons is available on a timely basis and complement the implementation of AML/CFT measures by increasing public awareness and capacity building.

- **Financial safety net and crisis management.** Existing modalities in the crisis management framework and financial safety net arrangements should be strengthened and operationalized. The Botswana Deposit Insurance Scheme (BDIS) should be established by legislation and the emergency liquidity framework should be operationalized. The FSC should be expanded to include a crisis preparedness and management mandate and should establish crisis management protocols.

**Addressing development issues is also essential.** A well-coordinated financial sector development strategy is necessary to deepen the sector and channel resources. However, interventions through Development Finance Institutions (DFIs) have not delivered expected results despite significant financial resources. Additionally, the DFIs currently have high levels of non-performing assets. Digital financial services have driven financial inclusion, and further advancements such as the introduction of fast payment services, open banking, and digital ID would enable progress. Private sector credit to micro, small, and medium enterprises (MSMEs) remains limited, while data gaps on access to credit exist due to lack of standardization and gaps in the regulatory framework for non-bank lenders. The substantial source of long-term, local currency financing from retirement funds and insurance companies is not being fully utilized and the capital markets are small and illiquid. Regulatory and policy actions should be aimed at deepening the listed and unlisted debt market and supporting the development of alternative asset classes.

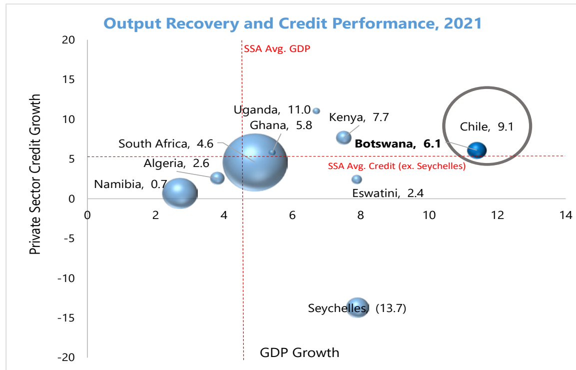
| Table 1. Botswana: FSAP Key Recommendations | | |
|---|---|---|
| **Recommendation** | **Time*** | **Agency** |
| **Systemic Risk Analysis** | | |
| Introduce the Basel III liquidity standards to strengthen systemic liquidity monitoring [¶16] | MT–LT | BoB |
| Conduct regular stress testing of large insurers' and retirement funds' concentrated bank exposures to monitor and detect financial stability risks [¶18] | MT | NBFIRA, BoB |
| Implement data management systems for stress testing and interconnectedness; updated and standardized reporting frameworks for both banks and non-bank financial institutions [¶19] | ST | BoB, NBFIRA |
| Develop data quality and granularity to enhance stress-testing framework to include sensitivity tests for credit risk, including to household debt and corporate indebtedness [¶19] | ST–MT | BoB |
| Strengthen the liquidity management framework to include upgraded forecasting tools, streamlined access to refinancing facilities [¶30] and comprehensive collateral schedule [¶31] | ST | BoB |
| Develop the interbank repo market by ensuring the legal framework supports enforceability and title transfer of securities under relevant Master Agreement [¶30] | MT | BoB |
| **Financial Sector Oversight** | | |
| Align prudential requirements for corporate governance and management of risks with Basel principles, and improve offsite and onsite tools [¶25] | ST | BoB |
| Revise risk-based supervision approach and bank rating methodology, making them more forward-looking and adaptive to emerging risks [¶25] | MT | BoB |
| Establish legal basis and set-up regulatory and supervisory frameworks to implement consolidated supervision for banks and banking groups [¶25] | MT | BoB, MoF |
| Enhance supervisory methodologies and build capacity for covering Pillar 2 risks in the Supervisory Review and Evaluation Process [¶25] | MT | BoB |
| Augment supervisory resources and strengthen supervisory capacity by increasing the number of risk specialists [¶25] | MT | BoB |
| Operationalize AML/CFT risk-based toolkit for banks and NBFIs, including for covering novel risks from virtual assets [¶26] | MT | BoB, NBFIRA |
| Impose tailored Pillar II capital buffer requirements for banks with low capital and high dividends payout ratios [¶21] | ST | BoB |
| Enhance macroprudential tool kit to address liquidity vulnerabilities in financial institutions, to consider credit-based household sector tools, and to establish capital buffers [¶28]. | MT | BoB |
| **Financial Safety Net and Crisis Management** | | |
| Establish the operational framework for emergency liquidity assistance once the Bank of Botswana Amendment Act comes into effect [¶32] | ST–MT | BoB |
| Elevate Botswana Deposit Insurance Regulation to a law and address gaps in the regulatory framework to develop strategic and operational plan for implementation of an effective deposit insurance [¶32–33] | ST–MT | BoB, MoF |
| Expand supervisory memoranda of understanding with all home country regulators to include resolution plans and issues, and prepare a contingent resolution plan for foreign subsidiaries [¶32] | MT | BoB |
| Expand the remit of the Financial Stability Council to coordinate and develop the framework for crisis preparedness and management; oversee recovery and resolution planning, to conduct stress testing and simulations, develop contingency planning, and implement a communications strategy [¶33] | ST–MT | FSC, MoF, BoB |

| Table 1. Botswana: FSAP Key Recommendations (concluded) | | |
|---|---|---|
| **Recommendation** | **Time*** | **Agency** |
| **Financial Development Issues** | | |
| Strengthen line-ministries oversight of development finance institutions (DFIs) by: (i) improving performance monitoring, (ii) establishing a results framework to track outcomes, and (iii) introducing a regulatory framework specifically designed for DFIs [¶37] | ST | Ministries responsible for SOFIs |
| *ST = short term (1–3 years), MT = medium term (3–5 years) | | |

# BACKGROUND

## A. Macrofinancial Context

**1. Botswana's strong economic recovery continues, with real GDP growth of 5.8 percent in 2022.** The upturn in the global economy supported robust growth in diamond exports, enabled a narrowing of the current account deficit, and stabilized the foreign reserves import coverage ratio. A comprehensive policy package at the onset of the COVID pandemic supported economic recovery. Private sector credit growth, at 5.4 percent (y-o-y, Q2 2022), compares favorably with regional peers and other emerging markets (text chart).



Sources: Bank for International Settlements, IMF, World Bank, central bank websites, IMF staff calculations.
Note: SSA = Sub-Saharan Africa. Bubbles represent the share of domestic credit in GDP as of 2020.

**2. With economic recovery underway, inflation risks are tilted to the upside.** Global conditions have contributed to rising domestic inflation, which peaked at 14.6 percent (y/y) in August 2022. The BoB increased the monetary policy rate by a combined 151 basis points between December 2021 to August 2022 (Figure 1). Second-round effects could dominate future inflation developments and could keep it above the medium-term inflation objective of 3–6 percent over the next 12 months. Despite the increase in interest rates, conditions remain conducive to credit growth. Inflation risks over the medium term will be largely dependent on global developments.

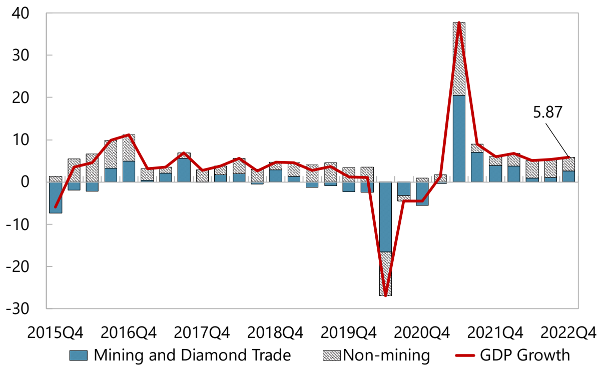
**3. The pandemic emphasized the urgency for the Economic Reform and Transformation Plan (ERTP)[3] to diversify the economy and promote growth.** The financial sector is shaped by the strong current account and fiscal surpluses based on diamond exports. Initiatives aimed at increasing domestic resource mobilization, deepening financial markets, strengthening the regulatory and supervisory framework, and leveraging technology to increase efficiency and inclusiveness are under way. Policies to improve medium and small enterprises' access to finance, developing options for long-term financing, and streamlining the role of the state should enhance private sector growth. Rebuilding fiscal buffers remains a priority to ensure sustainability and reduce vulnerability to shocks and preserve the sovereign credit ratings.

[3] The ERTP has developed structural transformation plans in: (i) traditional sectors such as agriculture and mining, (ii) sectors geared towards import substitution for local content and protection, (iii) economic program support to small and medium enterprises, and (iv) digitalization.

## Figure 1. Botswana: Macrofinancial Context

*Strong, broad-based economic recovery continued in 2022*

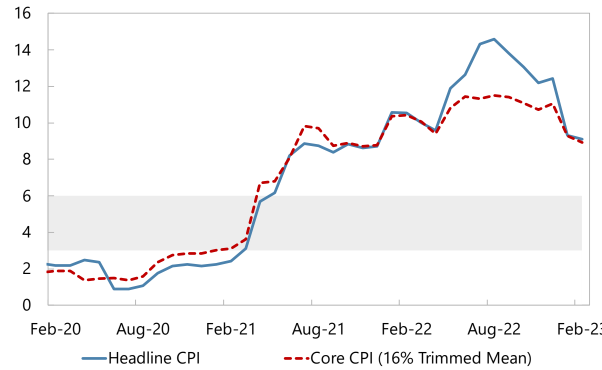
### Real GDP Growth Breakdown
(Percent)




Sources: GDP Quarterly Release in Statistics Botswana, and IMF staff calculation.

*...although inflation remains above the 3–6 percent target range.*

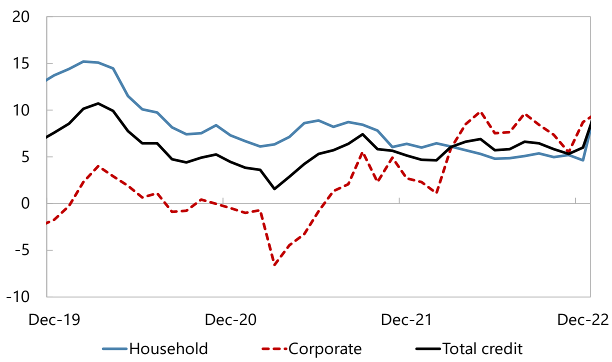
### Consumer Price Index
(Percent change, yoy)




Sources: Haver Analytics, and IMF staff calculation.

*Credit growth has recovered since the pandemic...*

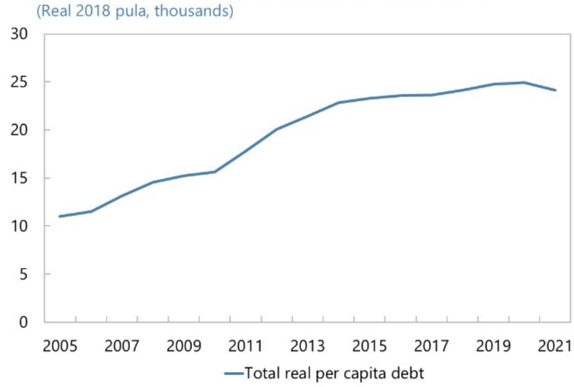
### Credit Growth
(Percent change, yoy)




Sources: Haver Analytics.

*...and remains at sustainable levels.*

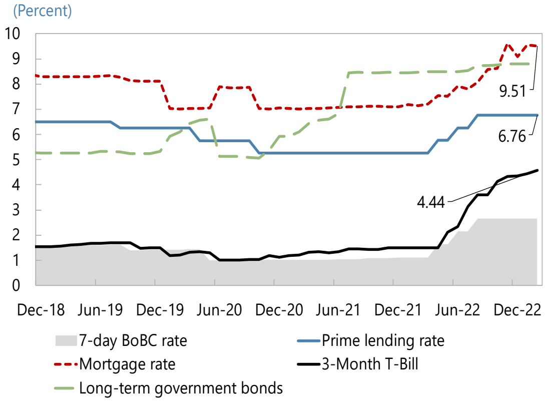
### Total Real Per Capita Commercial Bank Debt
(Real 2018 pula, thousands)




Sources: IMF staff calculation.

*Loan rates have risen with the monetary policy rate...*

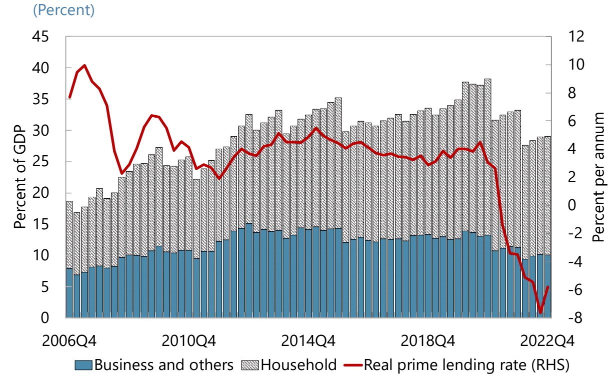
### Lending Rates
(Percent)




Sources: Haver Analytics/Bank of Botswana.

*...but conditions remain conducive to credit growth.*

### Credit-to-GDP and Real Prime Lending Rate
(Percent)




Sources: Bank of Botswana/Haver Analytics.

## B. Financial Sector Structure

**4. Botswana's financial sector accounts for close to 130 percent of GDP and comprises commercial banks and non-bank financial institutions that are well integrated (Figure 2).** The banking model is centered on intermediation of domestic deposits for credit provision and the non-bank financial sector includes retirement funds and insurance companies. The banking sector comprises nine commercial banks,[4] with the three largest banks accounting for 64 percent of banking sector assets, of which, two are D-SIBs[5] that account for 46 percent of banking sector assets. Banks are largely foreign-owned subsidiaries of pan-African banks that operate as conglomerates and hold subsidiaries in non-bank financial institutions (NBFIs). Domestic ownership of banks is mainly through the largest pension fund that holds 22 percent of bank shares.[6] The bulk of the NBFI sector consists of retirement funds (43 percent of financial system assets). The remainder of the financial system accounts for 15 percent of financial sector assets, comprising insurance companies, microlenders, and brokers.

**5. The retirement funds sector has been a key driver of financial sector growth.** Retirement funds' assets represent 54 percent of GDP, with the largest share of assets invested in offshore equities that account for 61 percent of total assets.[7] The rest of retirement funds' assets are invested in the domestic economy, 40 percent of which in domestic bonds (of which, approximately 55 percent in outstanding government bonds). The domestic capital markets are small and illiquid.

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[4] The Botswana Building Society (BBS) was licensed as a commercial bank in October 2022, and is not included in the stress testing exercises.

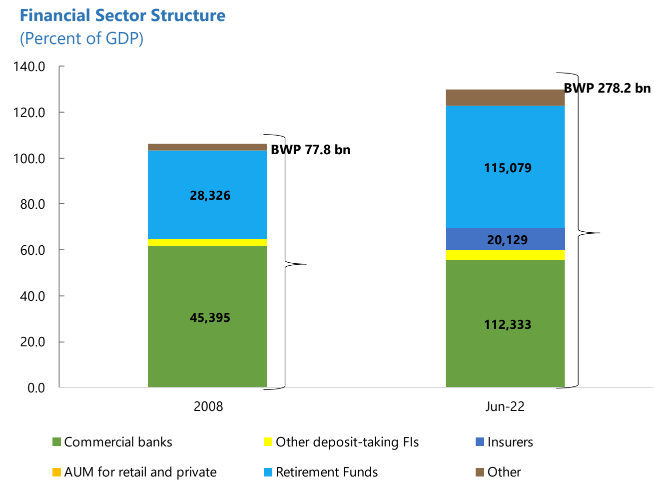
[5] The BoB has developed a framework for identifying D-SIBs based on the Basel Committee for Banking Supervision methodology. Based on the weighted combination of factors—size, interconnectedness, substitutability, complexity, and domestic sentiment—two banks were assessed as being above the set threshold.

[6] Based on mission calculations from commercial banks' financial statements.

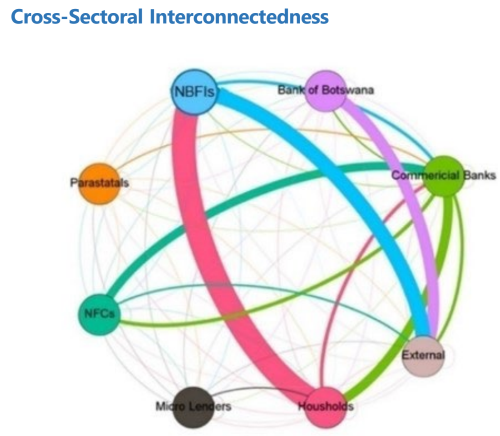
[7] Up until Q3 2022, retirement funds could invest up to 70 percent of assets offshore. Changes in the Retirement Fund Act (2022) require retirement funds to bring the maximum offshore investments down to 50 percent.

## Figure 2. Botswana: Financial Sector Structure

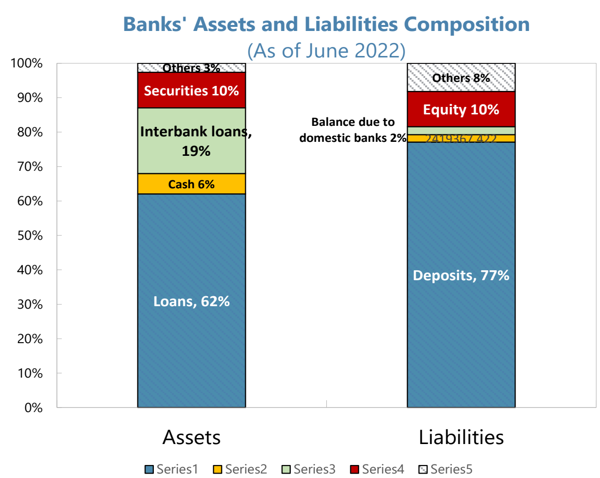
*Banks and retirement funds dominate the financial sector…*



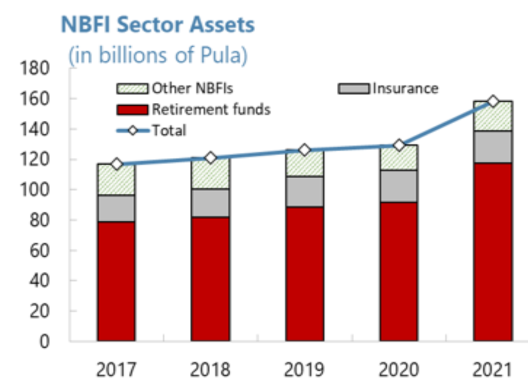

*…with strong interlinkages across the economy.*




*Asset and liability distribution for banks remain broadly stable…*




*…while assets for non-bank financial institutions (NBFIs) grew strongly.*




Sources: Bank of Botswana, Non-Bank Financial Institutions Regulatory Authority; IMF calculations.

Note: AuM = Assets under management; BWP = Botswana pula; FIs = Financial Institutions; NBFIs = non-bank financial institutions; NFCs = non-financial corporations.

Interbank loans include placements with foreign affiliated banks.

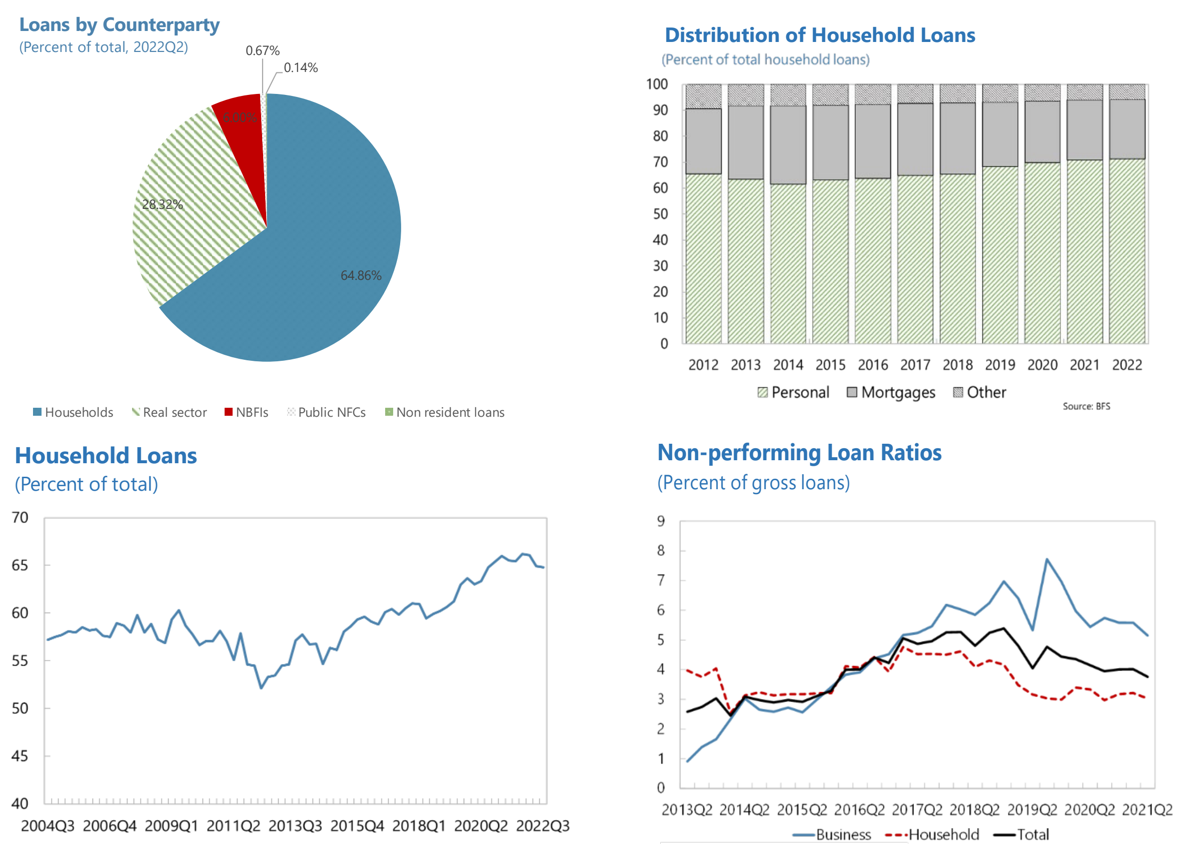
Intra-sectoral exposures are not included in Interconnectedness assessment. Edge thickness proportionally reflects financial linkages between sectors. Edges have the same color as the node to capture the exposure from that sector to the connecting sector. Retirement funds account for over 90 percent of NBFIs' total assets.

# SYSTEMIC RISK ASSESSMENT

## A. Key Risks, Assessment Methods, and Scenarios

**6. Credit risk forms the largest risk in Botswana's banking system.** Risk-weighted assets (RWAs) of credit risk account for 89 percent of total risk-weighted assets. The largest part of total assets comprises loans (83 percent).[8] Loans are concentrated in the household sector (41 percent of commercial bank assets), followed by the non-financial corporate (real) sector. Bank loans to households are largely personal loans (70 percent), mainly in the form of unsecured consumer credit, for which a large share of lenders collect repayments through direct salary deduction, contributing to generally low level of non-performing household loans. Mortgages comprise 23 percent of household loans (Figure 3).

**Figure 3. Botswana: Banking System Credit Risk Profile and Asset Quality**




Sources: Bank of Botswana, and IMF staff calculations.
Notes: NBFIs = non-bank financial institutions; NFCs = non-financial corporations.

**7. Banks are vulnerable to liquidity and funding risks due to concentrated funding profiles—short-term deposits of corporations and NBFIs (Figure 4).** Total deposits of NBFIs in the banking sector account for 23 percent of deposits and comprise sizeable deposits from a few

---

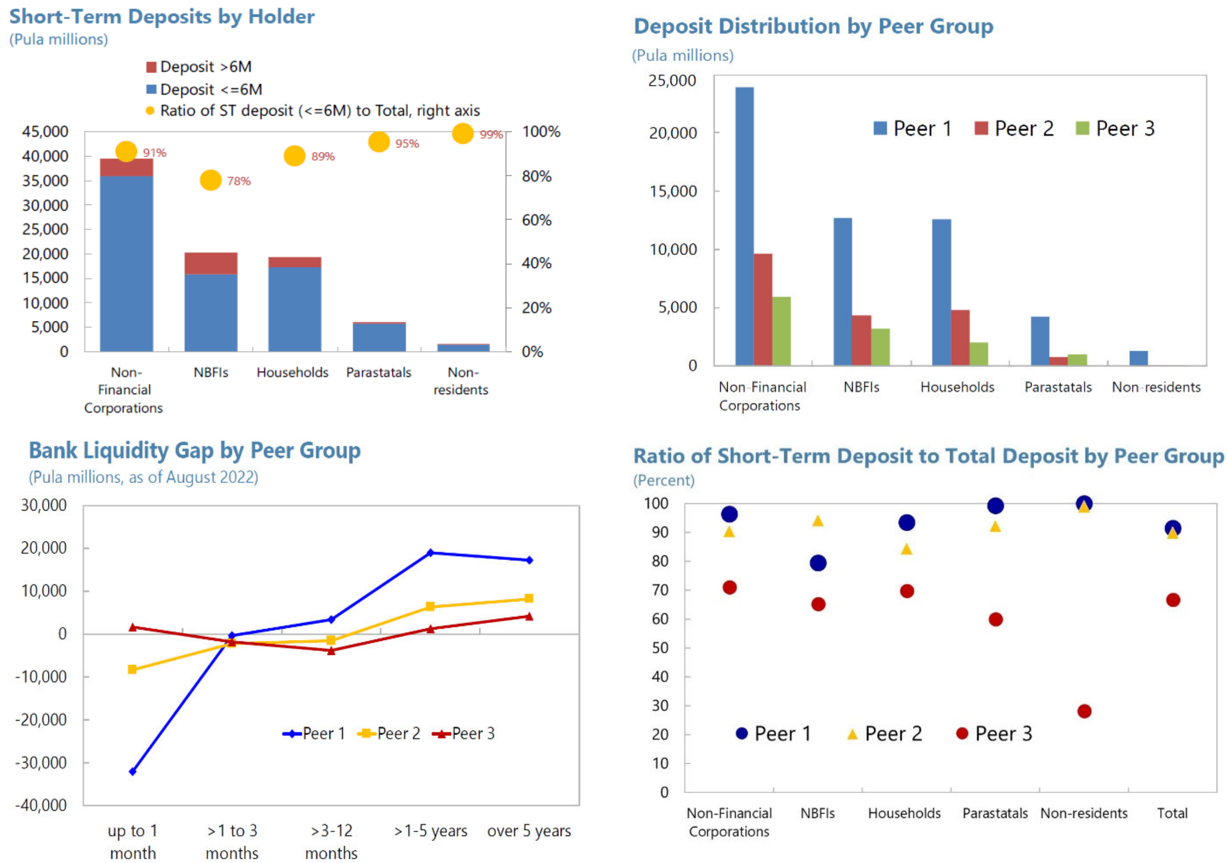
[8] Loans are defined as gross loans, advances, and balances due from other banks.

large depositors. The largest banks hold close to 68 percent of total household and corporate call and savings deposits,[9] leaving smaller banks to rely largely on price-sensitive fixed-deposits or access interbank funding from larger banks.

### Figure 4. Botswana: Bank Deposits by Maturity and Holder, June 2022

*Deposits are dominated by short-term tenors.*

*The banking system's deposits are concentrated in Peer 1 banks.*




Sources: Bank of Botswana; IMF staff calculation.

Notes: NBFIs = non-bank financial institutions. Peer groups are determined by the banks' share of total assets to banking system assets, Peer groups are determined by the banks' share of total assets to banking system assets, and Peer 1-2-3 represent 64-22-14 percent, respectively, as of end-June 2022.

8. **Non-bank financial institutions are increasingly exposed to the banking sector with related liquidity risks.** Recent regulatory changes to the Retirement Funds' Act, 2022 (RFA)[10] may amplify financial stability risks as the repatriation of foreign investments could stretch the absorption

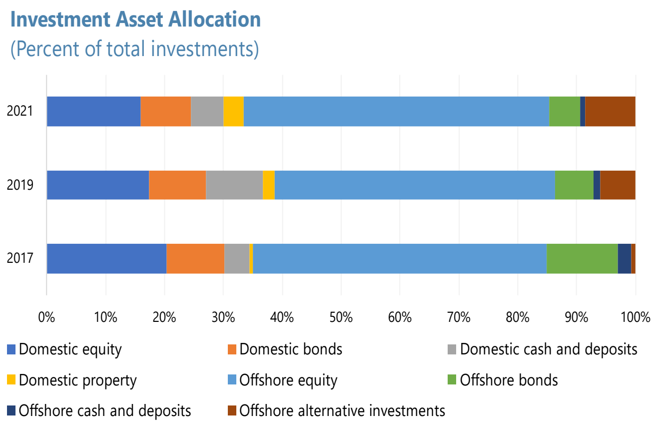
[9] Deposits of the top seven insurance companies account for approximately one third of their capital and deposits from retirement funds account for close to 46 percent of the banking sector total capital (NBFIRA 2022 Annual Report and Banking Sector Financial Statistics, 2021 data).

[10] The new RFA requires retirement funds to reduce the maximum share of offshore investments from 70 percent to 50 percent of total assets. Additionally, the regulations will allow members 'early access' to pensions (before retirement) and raise the lump sum payout upon retirement from 30 percent of accumulated savings to 50 percent and additional (lump-sum) withdrawal options for beneficiaries, transferring liquidity from retirement funds to households, and potentially compromising the ability to accumulate long-term retirement savings.

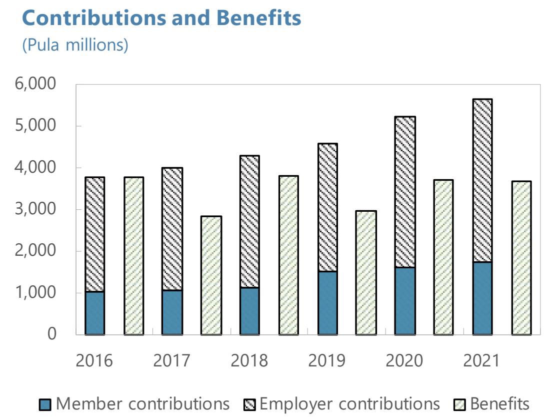
capacity of domestic capital markets and banks. Additionally, retirement funds' liquidity could come under pressure—already, the share of payments upon retirement have reached 80 percent of all payouts; out of which, around 40 percent are paid as a lump-sum (Figure 5).[11]

## Figure 5. Botswana: Retirement Funds—Investments, Contributions, and Payouts[1/]

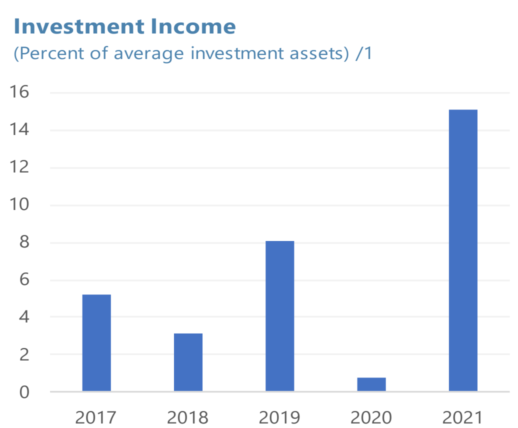
*Investments are very growth oriented. Allocations to domestic equity have slightly decreased since 2017, similar to offshore bonds, while offshore alternative investments have expanded, accounting now for almost 9 percent. With 52 percent of total assets, offshore equity is the dominant asset class.*



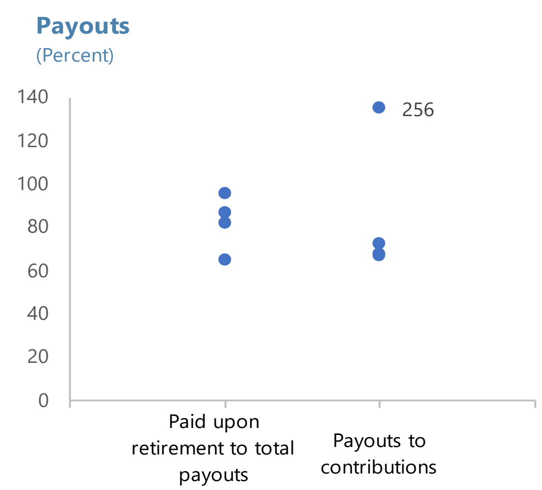

*Contributions have increased by around 8 percent per year, and while benefits have fluctuated considerably, they have not changed significantly since 2016.*




*Investment income of retirement funds is extremely volatile given the valuation regime for asset—unrealized gains and losses are included in the valuations— with a massive decline in 2020 and rebound in 2021 (when investment income reached BWP 17bn).*




*Payments upon retirement range from 65 to 95 percent of all payouts. With one exception, payouts are still considerably lower than contributions.*



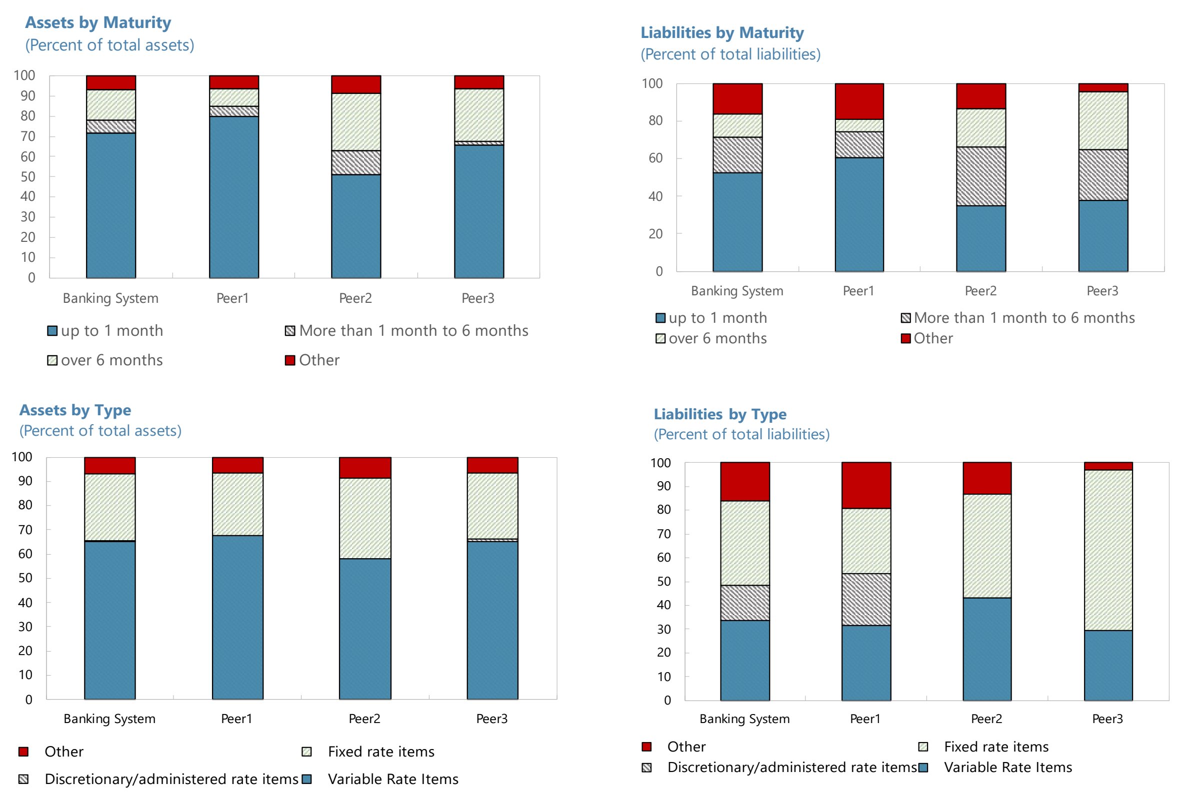

Source: IMF staff calculations based on NBFIRA data and company submissions.
Note: All data as of 2021.
[1/] The statistics on payouts are based on a survey conducted by the FSAP mission with a select group of retirement funds that account for 81 percent of market assets.

[11] Numbers differ considerably between retirement funds, depending *inter alia,* on the age and salary of members and the cyclicality of the employer's industry. For smaller funds—and those where benefits already exceed contributions—a robust liquidity risk assessment will be critical.

**9. Banks may face financial exposures to interest rate risks in the banking book (IRRBB) due to interest rate and maturity mismatches (Figure 6).** Over 65 percent of bank assets are floating rate, while approximately 35 percent of liabilities are fixed rate and are subject to administered rates that typically lag policy rate changes. Bank assets also have significantly shorter maturities than liabilities. However, in an environment of rising interest rates banks may experience a spike in net interest income (NII) and positive IRRBB exposures.

**Figure 6. Botswana: Maturity Structure of Assets and Liabilities in the Banking Book**

(As of June 2022)



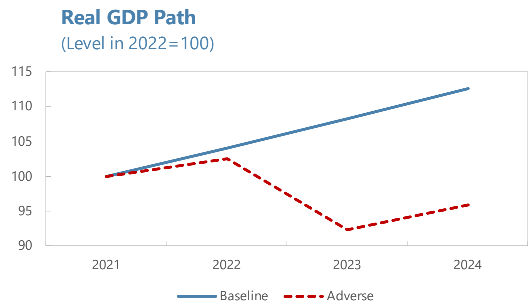

"Other" refers to financial assets and liabilities that are not directly influenced by changes in interest rates.

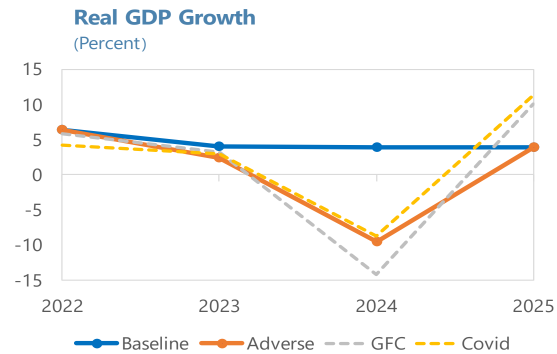
Note: Peer groups are determined by the banks' share of total assets to banking system assets, and Peer 1-2-3 represent 64-22-14 percent of assets, respectively, as of end-June 2022.

Sources: Bank of Botswana; IMF staff calculations.

## Figure 7. Botswana: Macro Scenarios

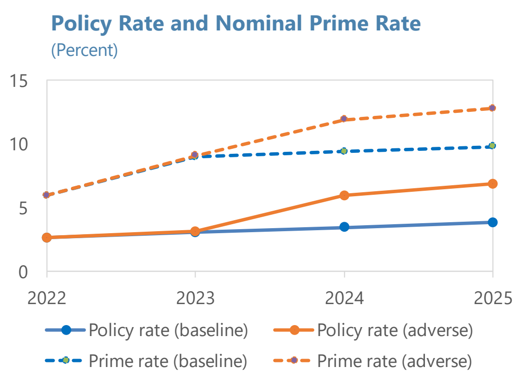
*The global and local adverse shocks entail a sharp decline in real GDP growth in 2024 and recovery by 2025. The GDP path is more severe than the outcome from the COVID pandemic and less severe than the Global Financial Crisis.*

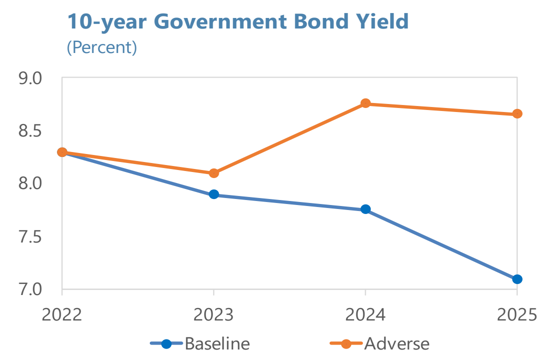



*Policy rates will keep increasing and factor into higher prime rates on credit. This assumes a 1:1 adjustment ratio...*

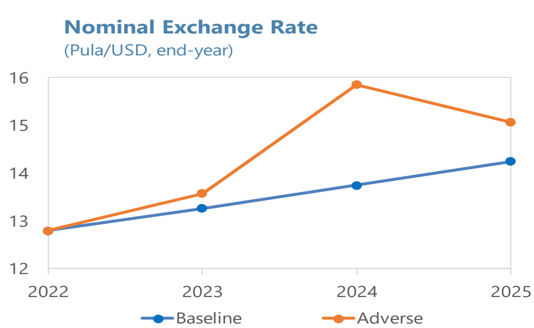
*...and long-term bond yields initially spiking as the economy goes into recession and government borrowing rises, and gradually declining as the economy recovers.*

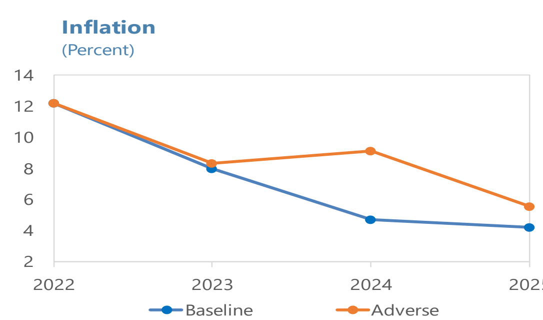



*The pula will depreciate against the U.S. dollar due to high domestic inflation relative to trading partners.*

*Inflation spikes in 2024 before returning to the downward baseline trend.*




Sources: World Economic Outlook; IMF estimates.
Notes: GFC = global financial crisis. The real GDP path was estimated based on the “two standard deviations” rule and adjusted using past recessions. Other variables’ shocks relied on scenario narratives and The Flexible System of Global Models output, which have considered shocks from Botswana’s major trading partners. The details for the macro scenario and assumptions are presented in Appendix IV.

**10. The financial sector systemic risk assessment covered:**

- **Bank solvency stress tests, which assessed bank capital adequacy using a balance sheet approach to identify recapitalization needs.** Sensitivity analysis complemented scenario stress tests, targeting the concentration of credit risk in the household sector and changes in the pass-through of policy rates to loan rates.

- **Liquidity stress tests for banks using cash flow analyses and assessed banks' observance of a proxy-liquidity coverage ratio (LCR) under stressed assumptions, for pula currency positions**. Stress tests were supplemented by sensitivity analyses.

- **Solvency assessment for the insurance sector and the vulnerability of future pension values to changing asset values.** For the insurance sector, a sensitivity assessment to interest rate, currency shocks and the default of the largest banking counterparty was conducted. Incomplete reporting and limited data hampered a comprehensive assessment of financial stability risks among NBFIs, highlighting gaps in the supervisory and oversight framework.

## B. Bank Solvency Stress Tests

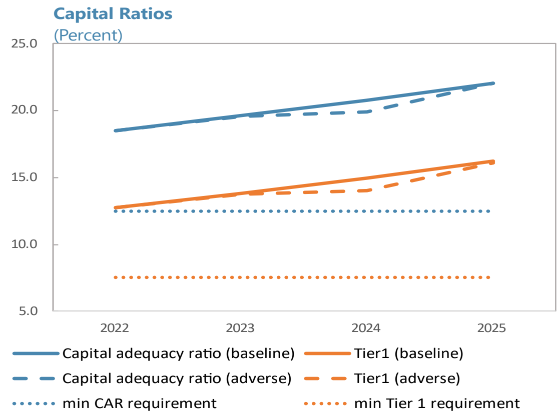
**11. The banking system remains broadly profitable and appears resilient to severe macro-financial shocks (Figure 8).** The solvency stress test shows the aggregate capital depletion in the adverse scenario is relatively small (less than 0.02 percent of GDP). Under both baseline and adverse scenarios, the net interest income in a rising interest rate environment contributes positively to capital due to the combination of shorter maturities, a higher share of variable-rate assets, and a greater pass-through from the policy rate on assets compared to liabilities. Credit risk increases significantly under the adverse scenario in 2024 but the increase in net interest income outweighs the impact on the capital ratio from rising non-performing loans (NPLs). Banks present low market risk given the limited exposure to securities.

**12. The significant net interest income in banks result from full pass-through assumptions applied to the lending rate.**[12] A lower pass-through rate would imply lower profitability and capital buffers (Figure 8). The sensitivity analyses show that the sector's capital adequacy ratio (CAR) could drop by up to 6 percentage point to 16 percent in 2025. Even under the worst assumption, where no pass-through to lending rates is assumed (pass-through rate is zero), the aggregate CAR would still remain above the regulatory thresholds. However, three banks would face challenges in meeting their minimum capital requirements by 2025 (aggregate recapitalization needs reach to 0.4 percent of GDP).

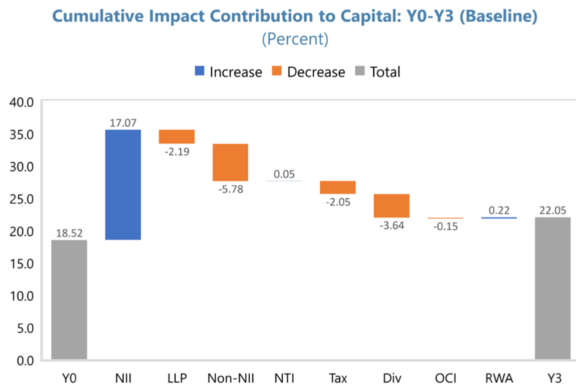
[12] The assumption reflects the prevailing trend as practiced by commercial banks and corroborated from BoB's feedback.

## Figure 8. Botswana: Solvency Stress Test Results

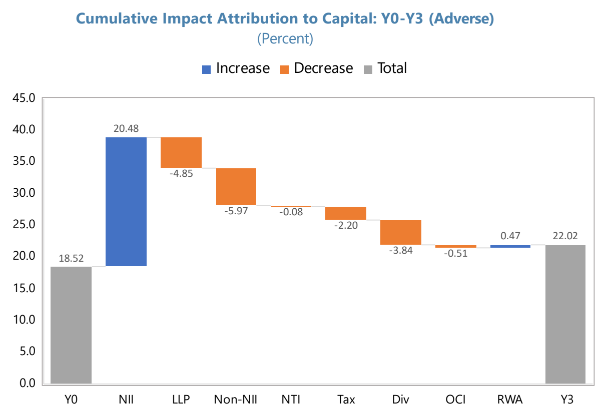
*The banking sector has sufficient buffers under both the baseline and adverse risk scenarios, despite a small reduction in capital in 2024 under the adverse scenario.*



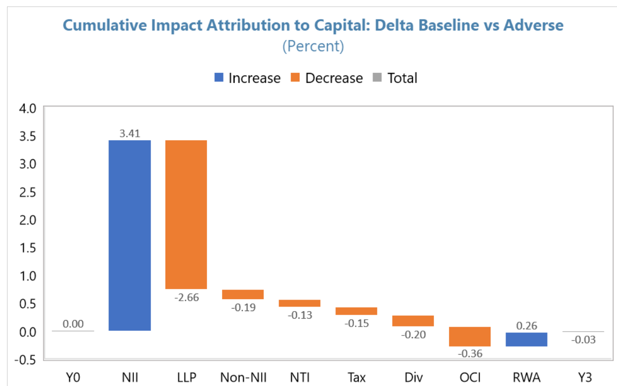

*Dividends, credit risk and non-NII are the largest contributors to capital under the baseline scenario.*



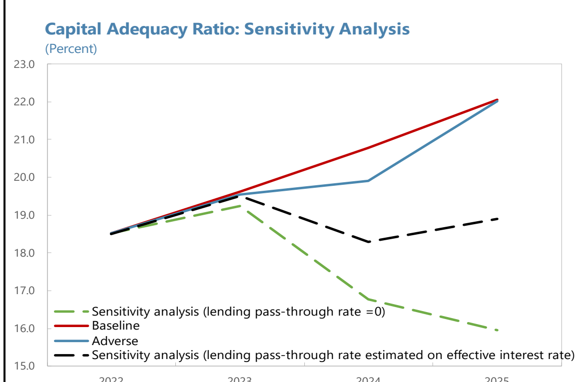

*The strong positive impact on NII outweighs credit losses in the adverse scenario*



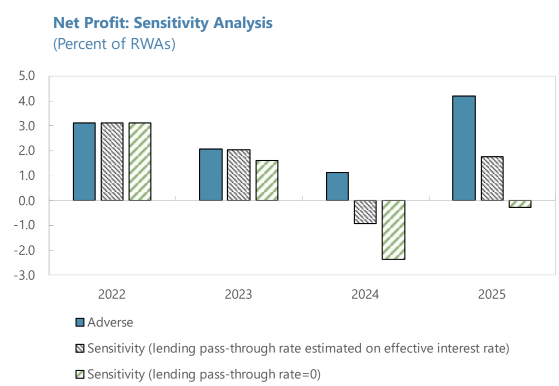

*Accordingly, the two scenarios result in largely similar outcomes.*




*Different pass-through assumptions on lending rate could further reduce capital buffers…*




*… and contract net profit for banks due to lower NII over the medium term.*

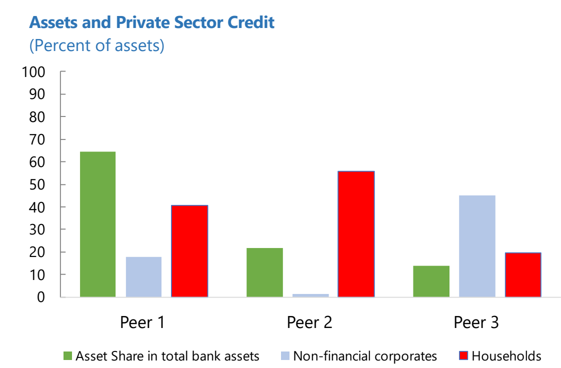



Source: IMF staff estimates.
Note: CAR = capital adequacy ratio; Div = dividends; LLP = loan loss provision; NII= net interest income; Non-NII= non-interest income; NTI = net trading income; OCI = other comprehensive income; RWA = risk-weighted assets.

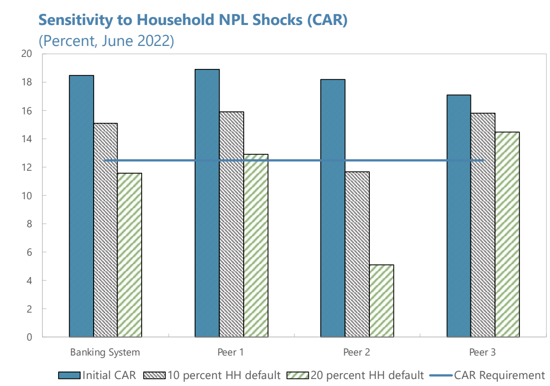
**13. Risks could arise due to a homogenous structure of concentrated exposures to household loans.** Assuming 20 percent of household performing loans transit into non-performing loans,[13] some banks would encounter a significant capital shortfall, resulting in the aggregated CAR falling below to minimum capital requirements (Figure 9). Nevertheless, the majority of the banks possess robust total capital buffers and would remain unaffected by severe shocks to household loans.

**Figure 9. Botswana: Sensitivity to Household Loan NPL Shocks**

*Homogenous structure in credit exposures exists across banks…*




*…which may create pockets of credit risks from household loans.*




Source: Bank of Botswana; IMF staff estimates.
Note: CAR = capital adequacy ratio; NPL = non-performing loans. Peer groups are determined by the banks' share of total assets to banking system assets. Peer 1-2-3 represent 64-22-14 percent, respectively, as of end-June 2022.

## C. Bank Liquidity Stress Tests

**14. The liquidity framework applies prudential requirements to commercial banks through the statutory liquid assets ratio (LAR).** The LAR is an *ex-ante* risk mitigant for liquidity risks but does not monitor the susceptibility to liquidity flows as comprehensively as the LCR—estimated under stressed assumptions—[14] which identifies latent risks from losing core funding sources. Banks' local currency funding sources include large and concentrated wholesale deposits that were compared against different run-off rates against the stock of unencumbered high-quality liquid assets (HQLA) over a 30-day stress period. The risk assessment applied the restrictive definition of HQLA, similar to current regulatory liquid assets definition, which excludes certain assets that are included under the Basel III standard, as well as short-term interbank deposits.[15]

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[13] NPL provisioning ratio has been applied.

[14] The assumptions for the mapping from current statutory returns and the run-off rates per category of deposits are presented in the Stress Testing Matrix (SteM) in Appendix III.

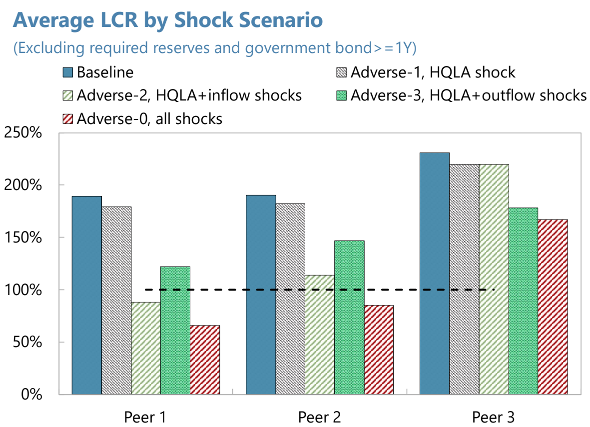
[15] The BOB regulatory framework excludes the primary reserve requirement (PRR) and government bonds with maturities beyond one year from its statutory liquid assets. This is different from Basel III requirements, although banks have access to the PRR through full averaging and government bonds with more than 1-year to maturity are

(continued)

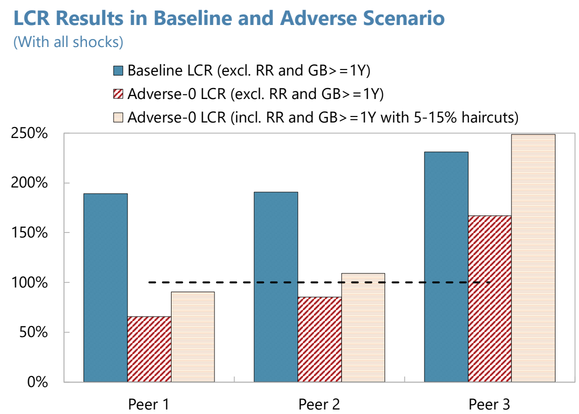
**15. All banks demonstrated strong liquidity positions under the baseline scenario, but some banks were vulnerable to liquidity shocks under adverse scenarios (Figure 10).** When adopting a definition of HQLA more reflective of the current liquidity regulations, all banks were well above the 100 percent LCR ratio. Peer 1 banks were vulnerable to short-term inflow shocks given sizeable assets with long-term maturities and showed lower vulnerability to outflow shocks.[16] Under an extreme scenario of aggregated inflow and outflow shocks—Peer 1 and Peer 2 banks fell below the 100 percent LCR ratio. Peer 3 banks were resilient under all scenarios. LCR ratios remained adequate when an expanded definition of eligible liquid assets (in line with the Basel III definition that includes required reserves and government bonds with maturity in excess of one year) is considered (Figure 10).

## Figure 10. Botswana: LCR Sensitivity Analysis

*Peer 1 banks are more vulnerable to inflow shocks, while Peer 3 banks are more resilient to inflow shocks.*




*The banking system is vulnerable to wholesale deposits run-off but expanding the list of eligible liquid assets improves liquidity.*




Source: Bank of Botswana; IMF staff calculation.
Note: HQLA = high-quality liquid asset; GB = government bonds; LCR = liquidity coverage ratio; RR = reserve requirement. Peer groups are determined by the banks' share of total assets to banking system assets, and Peer 1-2-3 represent 64-22-14 percent of assets, respectively.

**16. The BoB should develop a plan to transition to the Basel III liquidity framework by:** (i) revising statutory reports to permit the reporting granularity required for Basel III liquidity monitoring (e.g., net loans and advances to different counterparties in different maturity buckets; (ii) developing guidance for banks on the application of the Basel III liquidity ratios; (iii) appropriately calibrating and setting regulatory weights (haircuts rates, run-off rates, and cap ratio of inflows/outflows) relevant for Botswana's financial sector; and (iv) defining a plan for supervisors to gain material experience with the ratios, including on reporting and validating, allowing banks to report ratio calculations for monitoring purposes, prior to imposing prudential limits.

eligible as collateral. The BoB's regulatory framework includes the demand and short-term interbank deposits, which are excluded from HQLA under Basel III (rather are considered inflows).

[16] See STeM in Appendix III for the definition of shocks under the adverse scenarios.

## D. Non-Bank Risk Analysis: Insurers and Retirement Funds[17]

**17. Asset valuations of insurance companies were largely unchanged even under an adverse scenario.** The low sensitivity to market rates can be attributed to large cash holdings of short-term insurers and a depreciation of the pula increasing the value of foreign assets. The risk analysis did not indicate capital shortfalls.

**18. Pension values of retirement fund members decline under an adverse scenario.[18]** Retirement funds are defined contribution schemes and the risk analysis identified that fund members with less than 10 years to retirement could face a reduction in excess of 15 percent (pre-retirement stage)—switching these members to a more conservative asset allocation would be recommended. The findings of the risk analysis also highlight the need for NBFIRA to monitor vulnerabilities.

## E. Interconnectedness

**19. Financial system intersectoral linkages are significant.** Financial networks among banks and NBFIs identified common exposures among financial institutions that could lead to contagion, particularly for insurance companies that place large deposit holdings compared to their capital. In the absence of complete data on the bilateral exposures, measuring potential spillovers across the financial sector was not possible. The BoB and NBFIRA should enhance data quality and granularity to monitor intersectoral contagion risks and set appropriate limits for intermediation and deposit concentration ratios.

**20. A credit and funding shock would not lead to a system wide failure.** Interbank positions are small relative to banks' capital, as larger banks are the major lenders in the domestic interbank market. The dispersion of the contagion index in Peer 1 banks and of the vulnerability index among Peer 3 banks are reflective of their different degrees of bilateral interbank exposures (Figure 11).[19] The failure of any bank in the Peer 1 group would result in a potential capital reduction of up to 12.7 percent for the counterparty bank, increasing the risk of affected banks falling below the minimum capital requirement. In case of a simultaneous credit and funding shock and the failure of all banks in Peer 1, the remaining banking system would experience a total capital loss of 12 percent. The vulnerability index indicates Peer 3 banks are among the most vulnerable, as evidenced by their capital loss of 11 percent attributed to other banks' defaults.

**21. Banks with a high vulnerability index concurrently fail to meet the capital requirement under the adverse scenario in the solvency stress test.** These banks typically exhibit low capital

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[17] The insurance sector risk analysis focused on solvency. The retirement funds risk analysis consisted of a long-term projection of future pension values. The non-bank sample comprises four life insurers, four short-term insurers and four retirement funds, with a market coverage between 80 percent and 95 percent for each sector, respectively.

[18] The risk analysis focused on future pension values, for representative members 10 and 30 years to retirement.

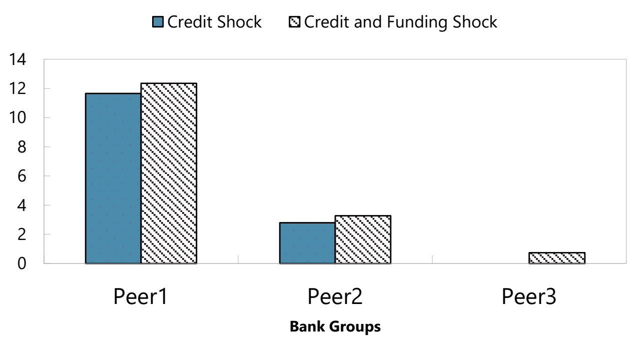
[19] Vulnerability index is the percentage losses of a bank due to the default of other banks. Contagion index is the weighted average percentage losses of other banks due to the failure of a given bank.

ratios and have historically paid high dividends. As a prudential measure to enhance the sector's resilience, it is recommended to impose tailored Pillar II capital buffer requirements on these banks.

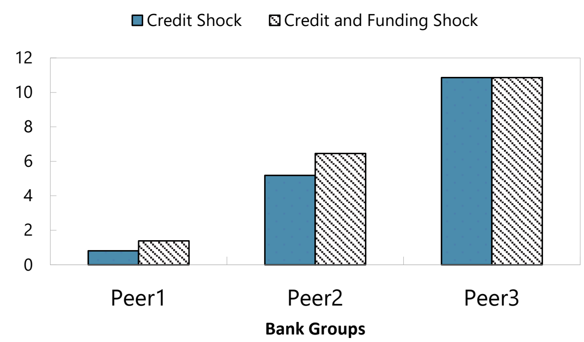
## Figure 11. Botswana: Contagion Analysis Across Banking Sector

*Based on their relatively larger size, Peer 1 banks pose contagion risks, and Peer 3 and Peer 2 banks appear to be most vulnerable in the interbank system.*

### Index of Contagion 1/



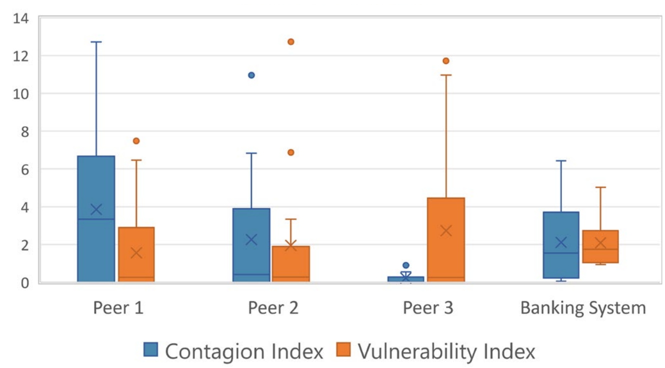

### Index of Vulnerability 1/




### Bilateral Exposures

| | | Vulnerability Index | | |
|---|---|---|---|---|
| | | Peer 1 | Peer 2 | Peer 3 |
| Contagion Index | Peer 1 | -- | 11.58 | 13.34 |
| | Peer 2 | 2.20 | -- | 8.39 |
| | Peer 3 | 0.58 | 1.33 | -- |

### Contagion and Vulnerability Indices Distribution
(Credit and Funding Shock)




Sources: Bank of Botswana; IMF staff calculations.
Notes: Peer groups are determined by the banks' share of total assets to banking system assets; Peer 1-2-3 represent 64-22-14 percent of assets, respectively, as of end-June 2022. Top two and bottom left panels use group level simulation, excluding exposures within bank groups. Bottom right panel uses bank level simulation, including all banks and intra-group exposure.
1/ Index of contagion (of index of outward spillover risks): the average loss of other banks due to the failure of a bank i (or a bank group); Index of vulnerability (or index of inward spillover risks): the average loss of a bank i (or a bank group) due to the failure of all other banks.

# FINANCIAL SYSTEM OVERSIGHT

## A. Supervision and Bank Regulation

22. **Financial regulation has strengthened since the 2007 FSAP.** Financial sector oversight is shared across multiple agencies, comprising: the BoB, NBFIRA and the Financial Intelligence Agency (FIA) that oversees anti-money laundering activities. The mandates for supervising financial institutions are within their respective laws, the BoB Act,[20] and the Banking Act, 1995 (BA) for the supervision of deposit-taking activity, the Bureaus de Change Regulations (2004), and the Credit Information Act (CI Act), 2021. The NBFIRA Act, 2022, establishes the context and oversight for the safety, soundness, and stability of NBFIs. The FIA is empowered under the Financial Intelligence Act (FI Act), 2022. Additionally, the agencies issue supporting directives, policies, and guidelines to discharge functions under respective laws and have direct reporting lines to the Ministry of Finance (MoF).

23. **Implementing the BoBAA and prioritizing the planned revisions to the BA should aim to strengthen supervision and financial stability.** The BoBAA will establish legal basis for key components for effective financial safety nets, oversight, and operations for ensuring financial stability, e.g., emergency liquidity assistance (ELA), deposit insurance, crisis management and resolution. The planned revisions for the outdated BA are expected to address supervisory gaps identified in graded Basel Core Principles (BCP)[21] (Appendix V) and resolve the legal limitations on the BoB's power to implement effective crisis preparedness, crisis management, and emergency response and resolution.

24. **Yet, the BoB's operational independence in supervisory matters could be enhanced in line with Basel norms.** The current allowances for Ministerial representatives on the BoB's Board, and the involvement of the Minister in licensing and supervisory appeals could undermine BoB's operational independence. Moreover, remaining provisions suggest that the BoB has to refer to the MoF in order to exercise direct control over some regulatory matters, e.g., interest rate and credit regulations. Though there is no evidence that the current allowances under the law have been tested, the material gap in the operational independence of the BoB, relative to Basel norms may require additional legislative changes to safeguard BoB's operational independence in supervisory oversight.

[20] While the BCP assessment references the BoB Act,1996, the BoB Amendment Act, 2022 (BoBAA) contains important provisions for strengthening financial stability oversight with Section 3 of the BoBAA indicating that objectives have been prioritized to have a primary objective of price stability, with other secondary objectives, including to contribute to stability of the financial system.

[21] This is the first graded assessment of banking supervision under the 2012 standards, as the last BCP assessment was conducted in the 2007 FSAP.

**25. Additionally, the planned revisions to the BA are important to strengthen bank supervision and align the framework with Basel norms; and should be considered alongside upskilling for staff in specific areas.** Key next steps include:

- Strengthening the supervisory approach and tools to develop a risk-based, forward-looking framework that is implemented by supervisors and risk specialists that can identify emerging risks among banks and banking groups that are becoming more complex.

- Instituting an integrated risk management framework. The BoB should articulate the regulatory requirements, limits, and supervisory expectations, including reviewing financial models used by banks in internal risk modeling, liquidity risk, and interest rate risk in the banking book. It also needs to develop guidance for banks in other areas, such as credit concentration by industry and geographic location, collateral concentrations, and prudential limit for exposure to single counterparty or group of an inter-connected counterparty.

- Establishing corporate governance standards to include regulations that facilitate ongoing oversight of board accountability for promoting corporate culture and values through codes of conduct and conflict of interest policies; and an upscaled regulation for transactions with related parties.

- Introducing consolidated supervision. Planned legal reforms that give powers to the BoB for consolidated supervision (2007 FSAP recommendation) supported by enhancements to internal procedures for monitoring the financial conglomerates would be beneficial. Once the revised BA comes into force, the planned circulation of Guidelines on Supervision of Financial Conglomerates should proceed as a priority.

- Establishing collateral valuation, problem assets, and provisioning requirements. Guidelines need to provide clarity to banks and supervisors on collateral treatment and valuation for different types of assets. Additionally supervisory tools/methodologies and more granular offsite data is needed to improve supervisory effectiveness and support periodic system-level analyses of trends and concentrations in banks' problem assets.

- Developing the framework for country and risk transfer. To effectively manage country and transfer risks, a comprehensive approach to measure these risks is needed.

**26. Efforts to improve the effectiveness of the AML/CFT regime should continue.** The regime has undergone significant improvements that led to the removal of Botswana from the FATF gray listing in October 2021 and the European Union blacklist of high-risk third countries in January 2022. Yet, operationalizing the risk-based supervisory toolkit and implementing a framework to oversee novel AML/CFT risks from virtual asset service providers (VASPs) should be prioritized to improve supervisory effectiveness. Clarifying reporting requirements of the new AML/CFT implementation framework under the revised legal framework should be complemented by increased public awareness and capacity building to ensure consistency in interpretation.

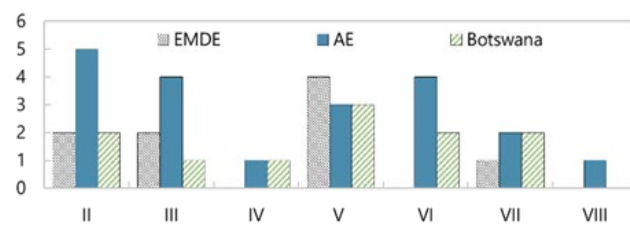
Additionally, ensuring that beneficial ownership is adequate, accurate, up-to-date, and available on a timely basis will bolster oversight.

## B. Macroprudential Policy

**27. Steady progress has been made in implementing operational changes, and these should be complemented with the planned legal reforms to set a good foundation for systemic risk oversight.** Once the BoBAA is in force, the status of FSC that operates as a key touchpoint for collective identification and consideration of risks across the regulatory spectrum will be elevated to a statutory committee.[22] The statutory FSC has a specific legal mandate, helpful for establishing strong *willingness to act* within its expanded remit using semi-hard powers. The FSC's membership that comprises the chief technical heads for respective regulatory agencies with oversight for the financial sector should facilitate the smooth activation of policies as needed—enhancing its *ability to act*. Emphasizing the role of this now statutory FSC by publishing the memorandum of understanding that sets the scope for collaboration across regulatory agencies[23] and their use of macroprudential tools in stemming vulnerabilities, should rouse the focus on financial stability.

**28. The BoB's financial stability report plays a central role in macroprudential risk analysis through its consolidated assessment from all FSC members.** The report could however benefit from a more forward-looking analysis on key systemic risks that may be latent in the real estate sector; NPLs across business sectors; and for the homogenous credit exposures to households; which may warrant a broader use of credit-based household sector or corporate sector macroprudential tools. Enhancing data quality on full credit exposures through a comprehensive credit information registry[24] can provide the granularity in data to improve sensitivity assessments in the stress-testing framework, and improve decisions about using macroprudential measures. Many tools are available, although few new measures have been implemented recently (text chart). Given the

**Macroprudential Measures in Botswana and Peers**
(Median number of measures)




| Category | Description |
|---|---|
| II | Broad-Based Tools Applied to the Banking Sector (2018/2020) |
| III | Household Sector Tools (2015) |
| IV | Corporate Sector Tools (2001) |
| V | Liquidity Tools Applied to the Banking Sector (1995/1997/2022) |
| VI | Tools to Address Systemic Liquidity Risk and Fire Sale Risk in the Nonbank Sector (2019) |
| VII | Tools to Address Risks from Systemically Important Institutions and Interconnectedness within the Financial System (2016/2019) |
| VIII | Tools to Address Other Sources of Systemic Risks |

Source: IMF Macroprudential Survey, 2020

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[22] The FSC was instituted in 2019 and includes MoF, BoB, NBFIRA, FIA and Botswana Deposit Insurance Scheme of (BDIS), with the Botswana Stock Exchange Limited (BSEL) as an observing member.

[23] The BoB within its expanded mandate and in its role as secretariat for the FSC should seek to improve transparency about its role in financial stability. The IMF Central Bank Transparency Code provides a framework for developing such transparency practices.

[24] The BoB is designated as the regulator for the oversight and implementation of requirements for the Credit Information Act, 2021. Streamlining requirements to enforce the reporting of positive and negative information from all credit providers, including micro lenders, should create a comprehensive and systematic data repository of household indebtedness, NPLs and debt service to income (DSTI) ratios.

uncertain global macroeconomic environment, regulators should be prepared for a more active use of tools going forward.

# SYSTEMIC LIQUIDITY MANAGEMENT, SAFETY NETS, AND CRISIS PREPAREDNESS

## A. Systemic Liquidity Management

**29. Enhancing the BoB's liquidity management framework and liquidity regulations could encourage banks to use the primary reserves requirement (PRR) actively in their liquidity management strategy.** With banks' core funding sources skewed to short-term wholesale deposits, liquidity uncertainty is mainly managed using large liquidity buffers. Volatile excess reserves and limited funding options in the underdeveloped interbank market potentially raise the cost for liquidity shortfalls. Furthermore, although there is full reserve averaging of the PRR, banks typically front-load or retain fixed reserve balances throughout the reserve maintenance period (Figure 12). Improving liquidity forecasts would enable the BOB to calibrate its liquidity operations and stabilize system wide liquidity.

**30. Streamlining the refinancing operations would improve banks' liquidity management.** Initially, the BoB should simplify the numerous refinancing operations. Other refinements—adjusting the penalty rate for shortfalls on the PRR and allowing access to the standing credit facility (SCF) after the closure of interbank market trading—[25] can better support the operational objective to maintain stable short-term interest rates. The BoB should also use the credit facility (CF) for daylight credit to support ongoing settlement in the Botswana Interbank Settlement Systems. A master repurchase agreement would support the development of the money markets.

**31. The management of the collateral for accessing monetary refinancing facilities should be simplified.** Banks' holdings of short-term government treasury bills and bonds appear adequate to meet liquidity needs on a short-term basis. However, current arrangements for BoB's monetary refinancing facilities require banks to hold different collateral pools of liquid assets, with a portion of securities permanently pledged to the BoB. Under this arrangement, pledged securities cannot be easily redeployed for immediate access to other financing options such as the interbank market. Further, the BoB should publish a comprehensive haircut schedule[26] for eligible collateral to allow banks to compare various funding options.

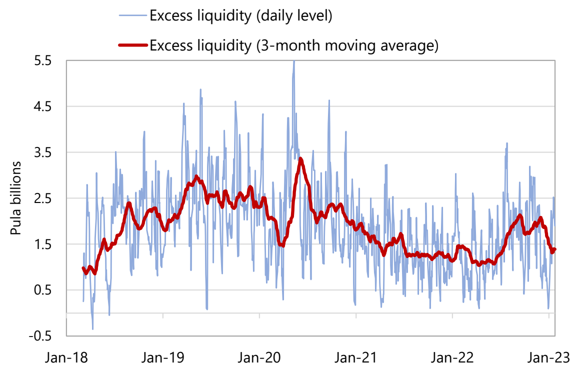
[25] The rate for under fulfillment of reserve requirements should not be punitive because (i) it can result in reserve hoarding and (ii) it mixes liquidity management with supervisory objectives. Repeated infractions of the RR fulfilment could reveal a need for supervisory actions and possible need for ELA.

[26] For example, with the inclusion of corporate bonds as eligible collateral, the schedule should be updated with haircuts reflecting maturity, credit, and liquidity risk; priced to ensure risk equivalence.

### Figure 12. Botswana: Structural Excess Liquidity[1] and Bank Liquidity Risks

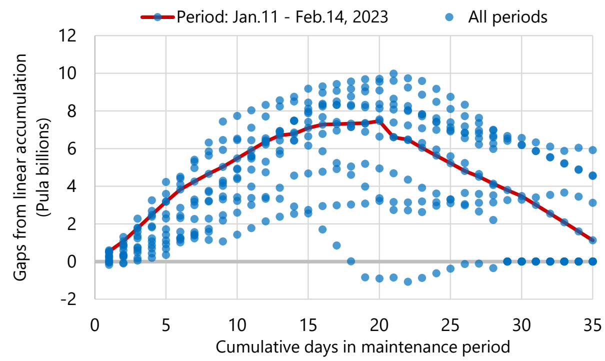
*Excess liquidity and its volatility persist in the banking system…*

**Excess Liquidity of Commercial Banks**



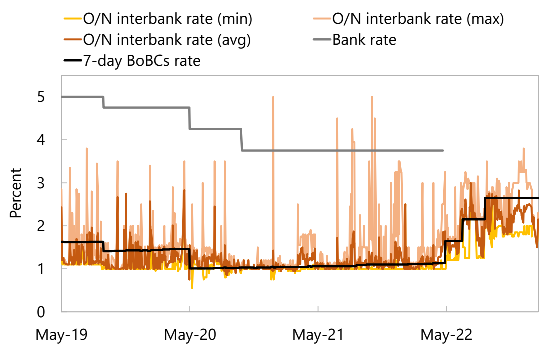

*…yet banks prefer not to use primary reserve requirement (PRR) averaging to internalize temporary liquidity shortfalls.*

**Required Reserves Fulfillment Pattern in Botswana**
(12 maintenance periods from Feb 10, 2022 to Feb 14, 2023)




*Volatile interbank rates reflect the high cost of liquidity shortfalls, but there is potential to reduce interbank rate volatility within the BoB's new operational framework…*

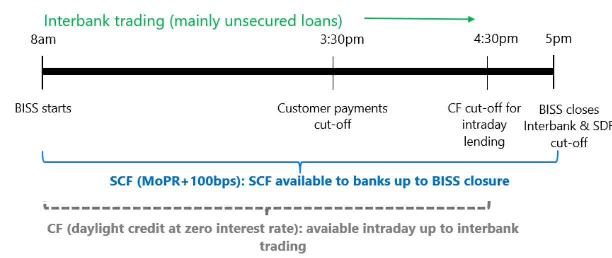
**BoB Interest Rate and Interbank Rates**




Source: Bank of Botswana and IMF staff calculation
Note: The bank rate was discontinued as of April 28, 2022.

*…if the cost and time for access to BoB's refinancing facilities are streamlined, by adjusting the PRR penalty rate, retaining the credit facility only for daylight credit, and allowing overnight credit at the standing credit facility rate*

**Recommendations on Streamlining Refinancing Facilities**




Sources: Bank of Botswana; IMF staff calculation.
Note: BoBC = Bank of Botswana Certificates; BISS = Botswana Interbank Settlement Systems; CF = credit facility; O/N = overnight; PRR = primary reserve requirement; SCF = standing credit facility; SDF = standing deposit facility.
[1] Structural excess liquidity is measured as the sum of banks' current account balances at the BoB, net repo position, as well as the access to the standing deposit facility SDF (positive) and credit facilities (negative).

## B. Financial Safety Nets, Crisis Management, and Bank Resolution

**32. Implementing legal reforms to provide the mandate for the BoB to fully oversee financial safety nets and crisis management should be a priority.** The revised laws—BoBAA and DRBA—should pave the way for the BoB to operationalize the crisis management and bank resolution frameworks through: (i) establishing a special bank resolution regime, including expanded resolution powers for the BoB; (ii) instituting the Deposit Insurance Scheme of Botswana (BDIS); and (iii) allowing the BoB to conduct emergency liquidity operations. In the interim, the BoB needs to build related capabilities and has so far drafted a Botswana Deposit Insurance Regulation (BDISR).

Establishing an effective BDIS, however, requires the elevation of the BDISR to a law to ensure alignment with good international practices. Developing other regulations, manuals, and procedures for the operationalization of remaining safety nets is yet to start.

**33. Advancing the reform process for operationalizing safety nets and crisis preparedness and management can proceed with the implementation of the BoBAA.** Pursuant to that, key building-blocks include:

- Improving the DRBA by addressing identified deficiencies, mainly to ensure preemption in bankruptcy matters, and then push for prompt enactment;
- Developing policies and procedures and manuals for bank intervention and resolution;
- Implementing a suitable law for the BDIS and preparing the action plan for its operationalization, including clear funding arrangements through bank contributions and a public backstop. Importantly, the operational independence of the BDIS should be assured by establishing a separate and independent unit that reports directly to the BoB Board, with the Board overseeing the fund's activities and ensuring that resources are used as prescribed in a future BDIS law;
- Establishing technical working groups within the FSC to develop the framework for crisis preparedness, including stress testing, simulations, development of contingency plans, and an effective communication strategy;
- Expanding supervisory MOUs with all home countries that include alternative options of bank resolution; and
- Developing policies and procedures for the ELA framework. ELA should be reserved as a funding source of last resort for solvent but temporarily illiquid banks that are adequately regulated by the BoB. Solvency assessments should be forward-looking accompanied by anticipated funding plan; with the BoB having a sufficiently wide range of eligible collateral with a suitable risk management framework. Recommendations from the 2007 FSAP and past IMF technical assistance remain relevant.

**34. Developing these safety nets that characterize good international practices in the financial regulatory architecture will require the FSC to prioritize work over the near- to medium-term.** The FSC is uniquely positioned to engage in crisis preparedness and management activities and should develop an effective and comprehensive implementation framework, including for communicating on these activities.

# FINANCIAL SECTOR DEVELOPMENT

**35. Botswana has a significant source of long-term, local currency financing to support economic growth and development but is unable to absorb these productively.** The assets of the retirement funds and life insurance companies are significant at 50 percent to GDP, and two-thirds of assets are invested off-shore. Domestic capital markets are small and domestic government debt issuance is constrained due to a strong fiscal position and the non-government debt market is less developed. The Debt Management Office should start with providing an updated Medium-term Debt Management Strategy and a more detailed annual borrowing plan, which would assist investment planning by local investors together with developing an investor relations capacity.

**36. The repo market is inactive, partly due to a lack of legal certainty and documentation**. The legal framework to support the repo market should be clarified, including improving enforceability of contracts and clarification of systemic resolution processes in the event of insolvency. Introducing close-out netting will improve market confidence.

**37. Weak financial performance by some state-owned financial institution (SOFIs) is a concern and should be addressed.**[27] The oversight of SOFIs by the government and respective line ministries should be strengthened. To overcome the lack of government oversight functions in respect to SOFIs the MoF should create a unit with adequate capacity and authority, with a particular focus on OECD guidelines on corporate governance of SOEs (including on the selection process for the Board and management). The government should also refrain from directly intervening in operational decisions for the DFIs.

**38. All SOFIs should be subjected to an independent oversight, subject to proportionality rules, either by BoB or NBFIRA.** The separation of regulation and supervision from the ownership function and respect of the independent judgment of the prudential supervisor are essential to realize the benefits of prudential supervision. SOFIs will need to operate on a financially sustainable basis with properly defined objectives and mandates. It is important to preserve the independence of a supervisor by minimizing political interference to achieve financially unsustainable policy objectives. In this context, the authorities may also consider introducing a regulatory framework for SOFIs, including for licensing, regulation, and supervision.

**39. Financial inclusion slightly lags regional peers and with notable gaps in coverage and usage.** The MoF has the mandate for advancing financial inclusion and the regulatory authorities play a supporting role. The digital financial services market is constrained by lack of a clear regulatory framework and the 2022–2027 Financial Inclusion Roadmap has ambitious targets and is expected to drive the strategic focus of financial inclusion and digital financial services.

[27] SOFIs were established with the intention to address perceived market failures in financing of small and medium enterprises, agriculture, and housing. The combined asset size of the four most relevant SOFIs covered by FSAP is BWP 10.4 billion, or approximately 8.5 percent of the size of the banking sector.

**40. The deduction at source loan repayment process should be modernized, focusing on accessibility to all credit providers and small businesses, and the related disclosure practices.** Smaller businesses and the self-employed, and smaller credit institutions are unable to participate in the loan deduction at source. The authorities should develop a roadmap for the modernization of the service in terms of operational capacity, openness, and consumer protection.

**41. DFIs are the main source of credit for MSMEs, though their focus is on retail and large corporates by the private sector lenders, leaving a financing gap for MSMEs.** Credit offered by public sector lenders is subsidized, unsustainable and is competing for the market usually served by the non-bank lenders. Expanding lending to MSMEs requires well-designed credit enhancements, complemented by wholesale facilities for NBFIs and updated regulatory framework for non-bank lenders. The implementation of effective credit risk assessment requires credit infrastructure reforms.

# AUTHORITIES' VIEWS

**42. The authorities appreciated the open and constructive discussions with the FSAP team and found the comprehensive assessment and recommendations useful.** They highlighted the enhancements to the financial stability framework since the 2007 FSAP and the anticipated benefits of the BoBAA. They also underlined the resilience of the domestic financial system to global and regional shocks over the past decade and a half, as recognized by the FSAP team.

**43. The authorities agreed with the systemic risk assessment.** They agreed with the need to fill the identified data gaps, noting that closing some of them would require time. They welcomed the bank solvency stress test results, further noting banks' high levels of capital, conservative business model, and prudent lending standards that are focused on households in government employment. They also pointed to the effectiveness of their policy response to the COVID-19 crisis as evidenced by the smooth flow of credit to the private sector and the lack of deterioration in loan quality. The authorities were in agreement that the lumpy deposit structure had resulted in a volatile funding base for the banks and needed careful monitoring. In that context, they recalled the BoB's commitment to prudent monetary policy, the recent changes to the monetary policy framework and ongoing plans to implement an LCR-based regime.

**44. The authorities welcomed the FSAP's acknowledgement of progress in financial sector oversight.** They highlighted the breadth of their systemic risk monitoring and macroprudential policy toolkit and observed that they would review their macroprudential policy framework based on the FSAP recommendations. The authorities noted their commitment to implement the Basel III framework, they also indicated their openness to addressing the FSAP findings in banking supervision and regulation, noting substantial improvement in the supervision of non-banks by the NBFIRA. Finally, they underscored the significant progress made in strengthening the AML/CFT framework since the last Financial Action Task Force assessment.

**45. The authorities welcomed the assessment of the non-bank sector and the need to monitor ongoing regulatory changes that will impact retirement funds.**

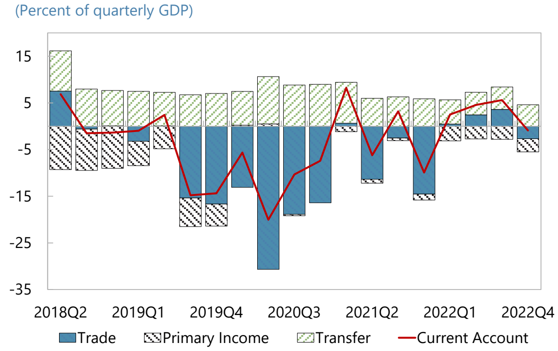
**46. The authorities also appreciated the financial safety net and crisis management assessment.** They welcomed the FSAP's recognition of the progress and helpful feedback on their framework that includes the establishment of the BDIS. They acknowledged the early steps they have taken in resolution planning for large banks would need more attention. The authorities underscored that: (i) the current high level of solvency in the banking sector; (ii) the ability and willingness of the main bank shareholders to support their institutions if the need arises; and (iii) the high levels of bank capital, would not only lower the probability of crisis but also lower the need to use public resources to deal with any future crisis.

## Figure 13. Botswana: External Sector

*The external balance continues to improve…*

**Current Account**

(Percent of quarterly GDP)

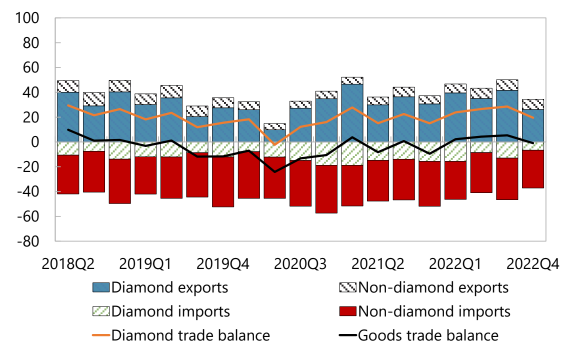



Sources: Haver Analytics/Bank of Botswana and Statistics Botswana, and IMF staff calculation.

*…on the back of strong diamond exports and culminate in strong diamond net exports.*

**Goods and Diamond Trade**

(Percent of GDP)

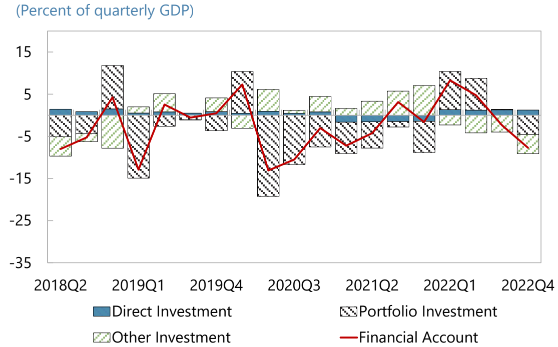



Sources: Haver Analytics/Statistics Botswana, and IMF staff calculation.

*The financial account also moved into surplus, on the back of portfolio inflows…*

**Financial Account**

(Percent of quarterly GDP)

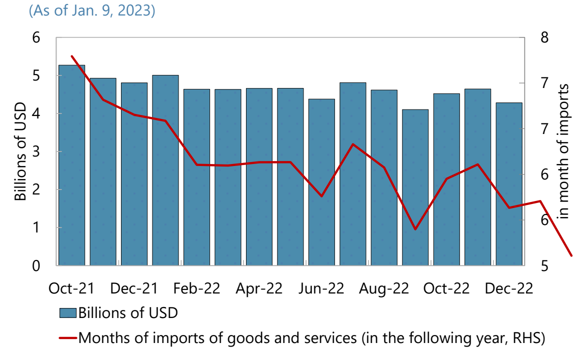



Sources: Haver Analytics/Bank of Botswana and Statistics Botswana, and IMF staff calculation.

*…resulting in stabilizing foreign exchange reserves cover in months of imports.*

**Monthly Foreign Reserve**

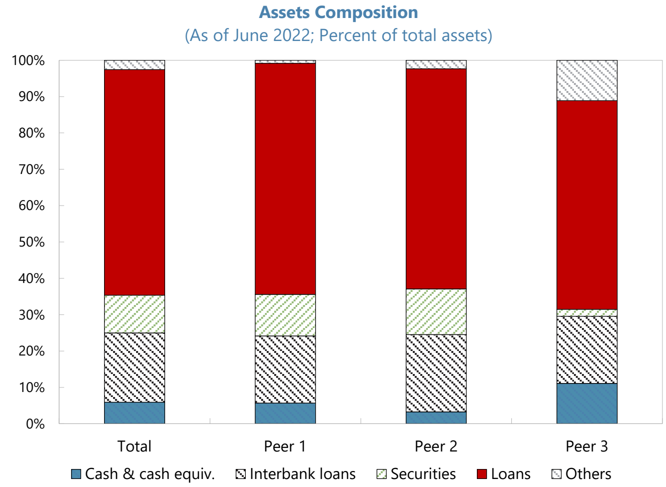
(As of Jan. 9, 2023)



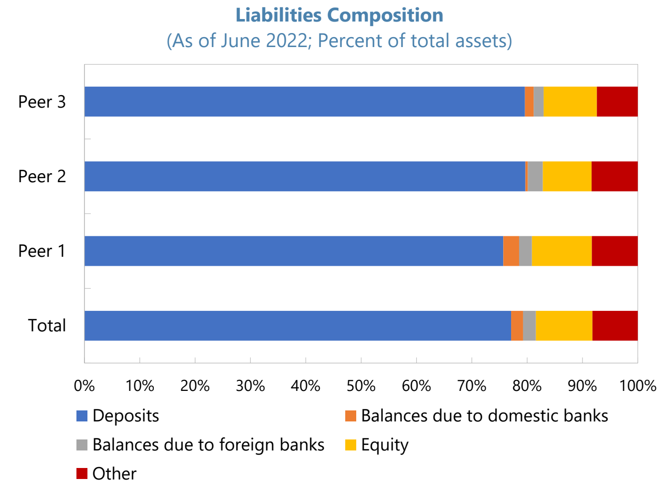

Sources: Haver/Botswana Financial Statistics, International Merchandise Trade Statistics, and annual import numbers from team's framework.

## Figure 14. Botswana: Composition of Assets and Liabilities by Peer Group

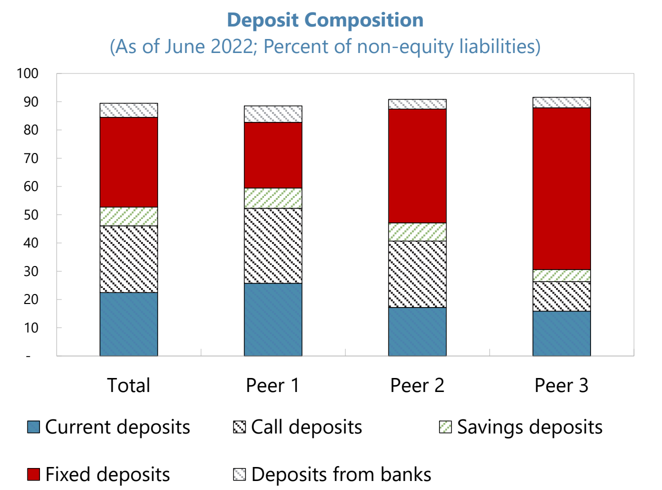
*Loans dominate the asset portfolio across all banks…*



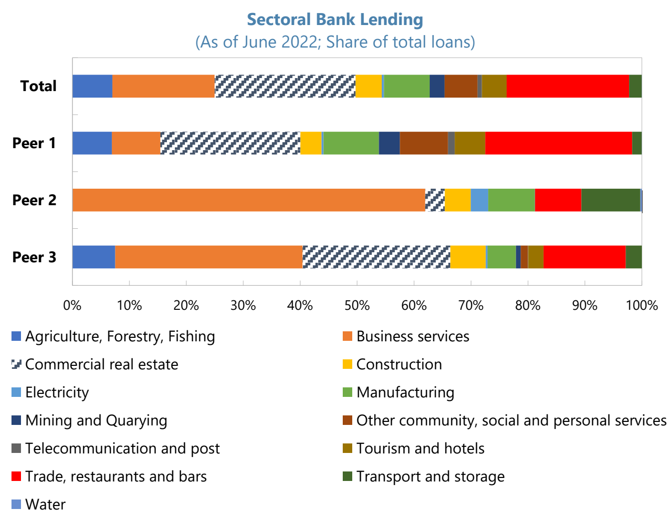

*…which are funded mainly by deposits.*




*Short-term deposits provide the most funding, except for Peer 3 banks using price-sensistive fixed-term deposits…*



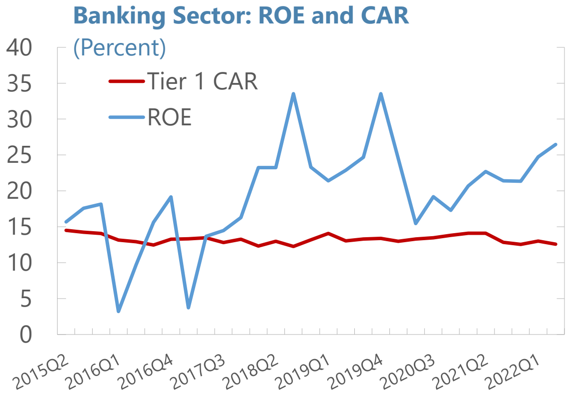

*…which provide substantial loans mainly to business/ professional services and the commercial real estate sector.*



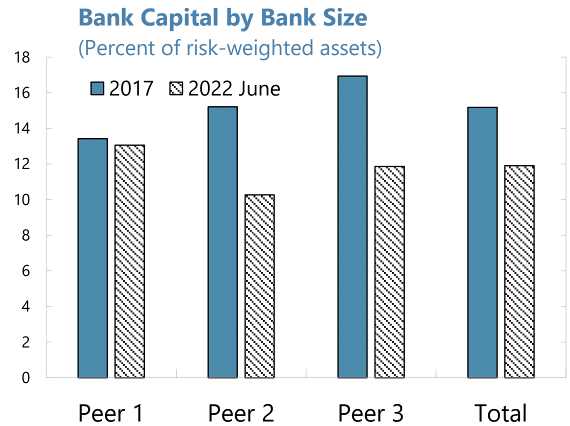

Sources: Bank of Botswana; IMF staff.
Note: Peer groups are determined by the banks' share of total assets to banking system assets; Peer 1/2/3 represent 64/22/14 percent, respectively, as of end-June 2022.

## Figure 15. Botswana: Banking Sector Capital and Performance

*Capital adequacy ratios have been stable, and profitability is recovering from the COVID-shock.*



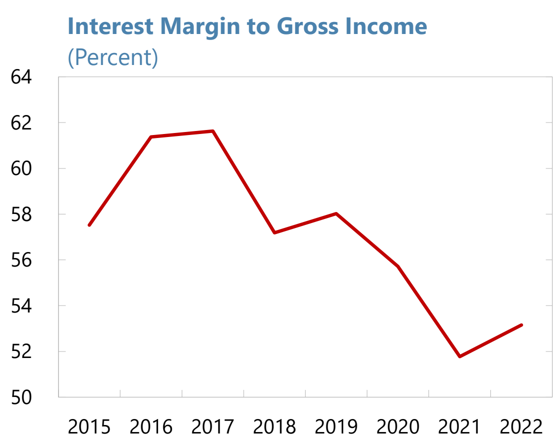

*Banks hold capital well-above the prudential requirement.*



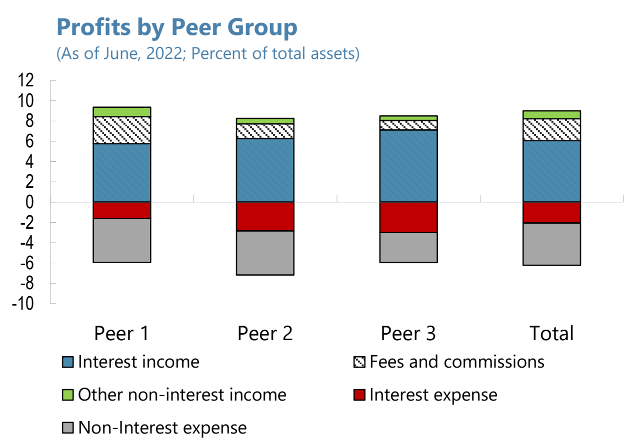

Sources: Bank of Botswana; IMF; World Economic Outlook; Financial Soundness Indicators database; IMF staff estimates.
Note: CAR = capital adqaucy ratio; ROE = return on equity.

## Figure 16. Botswana: Income and Profitability Indicators

*The interest margin share of gross income has declined…*




*…contributing to moderate bank profitability.*

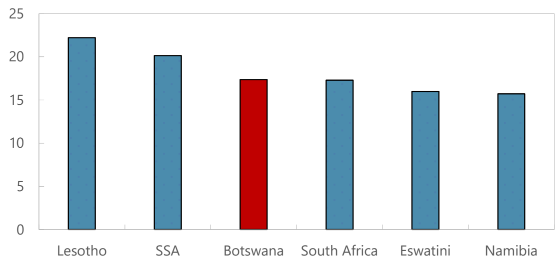



Sources: Bank of Botswana; IMF staff estimates.
Note: Peer groups are determined by the banks' share of total assets to banking system assets; Peer 1/2/3 represent 64/22/14 percent, respectively, as of end-June 2022.

## Figure 17. Botswana: Financial Soundness Indicators, Cross-Country Comparison

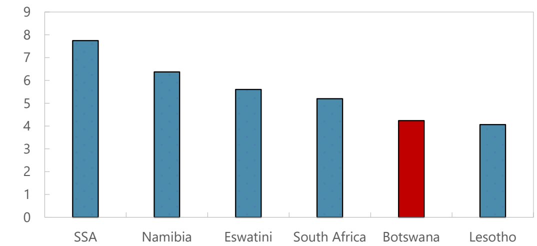
*Botswana's banking system is relatively well-capitalized…*

**Regulatory Capital to Risk-Weighted Assets**
(Percent)



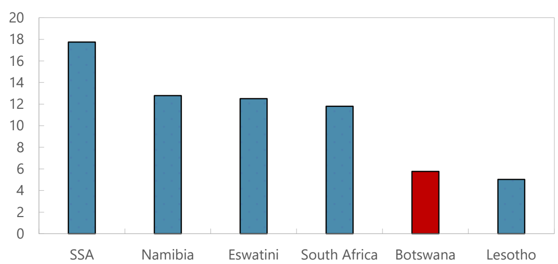

*…with good asset performance.*

**Nonperforming Loans to Total Gross Loans**
(Percent)

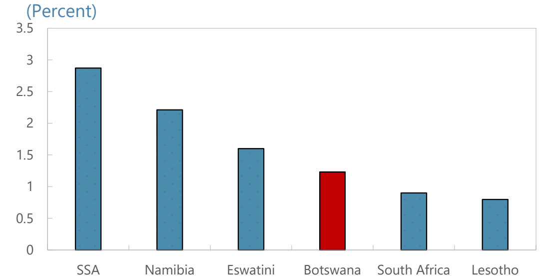



*Profitability indicators suggest modest outcomes that reflect…*

**Return on Equity**
(Percent)

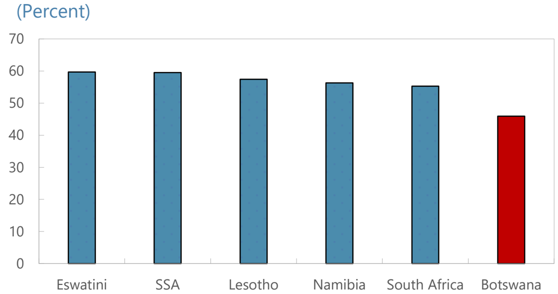



**Return on Assets**
(Percent)



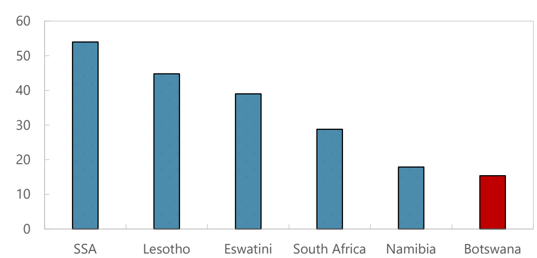

*…small interest margins…*

**Interest Margin to Gross Income**
(Percent)




*…and weak liquidity.*

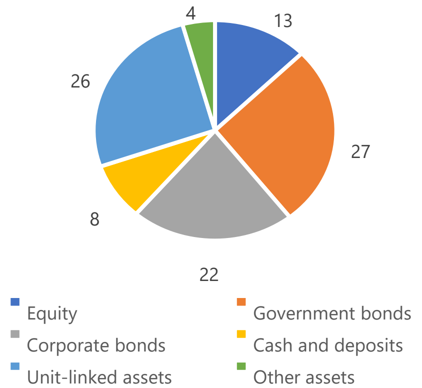
**Liquid Assets to Short-Term Liabilities**
(Percent)



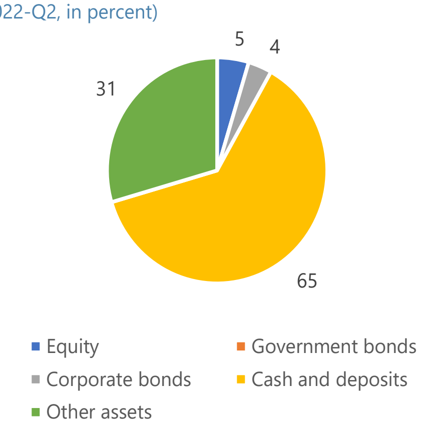

Source: Financial Soundness Indicators database, IMF as of 2021.
Note: SSA = Sub-Saharan Africa. The grouping includes Botswana, Ghana, Guinea, Kenya, Lesotho, Madagascar, Mauritius, Mozambique, Namibia, Seychelles, Uganda, and Zambia. Ratios are calculated as simple average.

## Figure 18. Botswana: Structure of Assets and Liabilities for Insurers and Retirement Funds

### Asset Allocation - Life
(2022 -Q2, in percent)



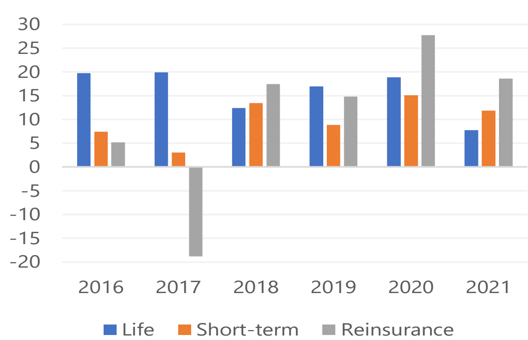

### Asset Allocation - Short-term
(2022-Q2, in percent)



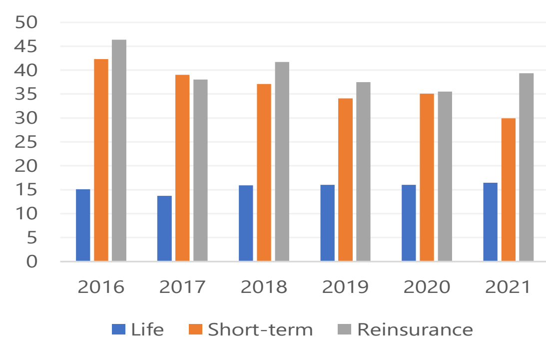

*Between 2016 and 2021, life insurers achieved an average return on equity of 16 percent, while the averages for short-term insurers and reinsurers were 10 and 11 percent, respectively.*

*Capital ratios have been very stable in the life insurance sector, at around 16 percent. For short-term insurers and reinsurers, the ratios declined since 2016, but are still significantly above those of life insurance firms, mainly due to their more volatile risk profile.*

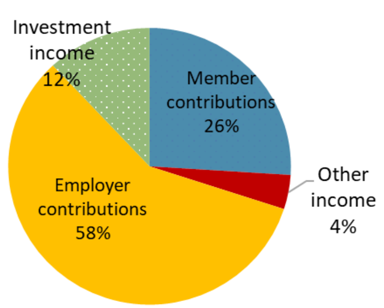
### Return on Equity
(in percent)



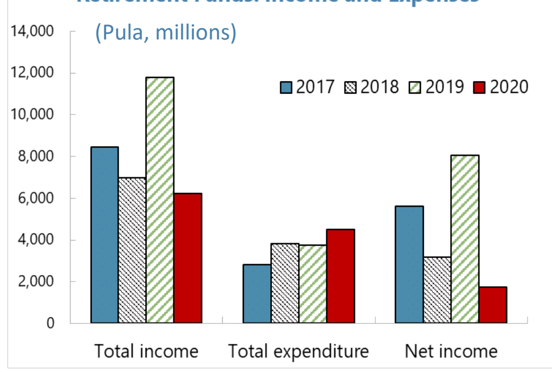

### Capital Ratio
(shareholder equity to assets, in percent)




### Retirement Funds: Funding and Income Sources 2020




### Retirement Funds: Income and Expenses[1/]

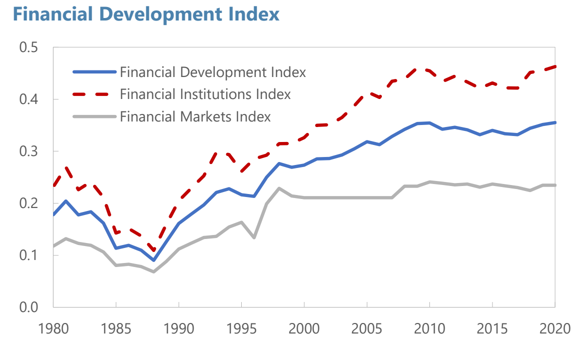



1/ Based on audited statements for the financial year, and not calendar year-end.

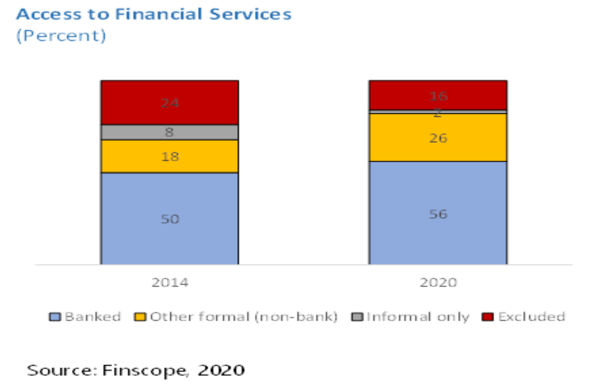
Sources: NBFIRA; IMF staff calculations.

## Figure 19. Botswana: Financial Development Indicators and Cross-Country Comparisons

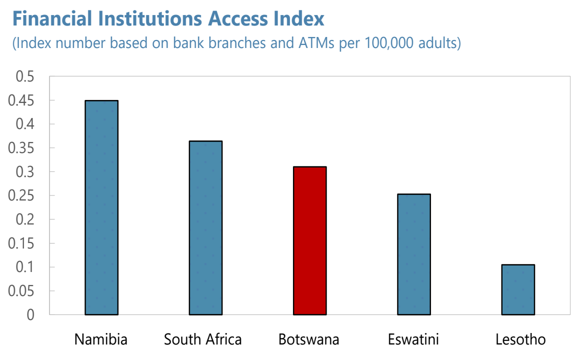
*Reforms introduced in the late-1980s boosted the financial development index, particularly of financial institutions…*



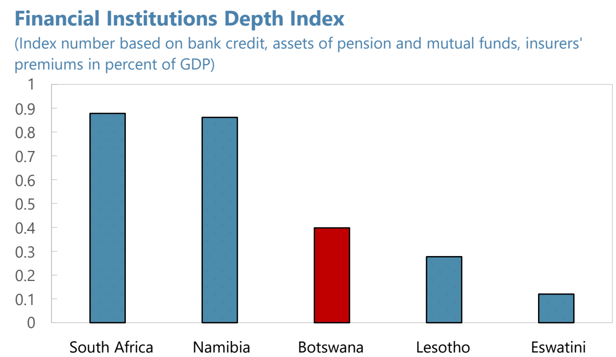

*…thus providing Batswana with greater access to formal financial services.*



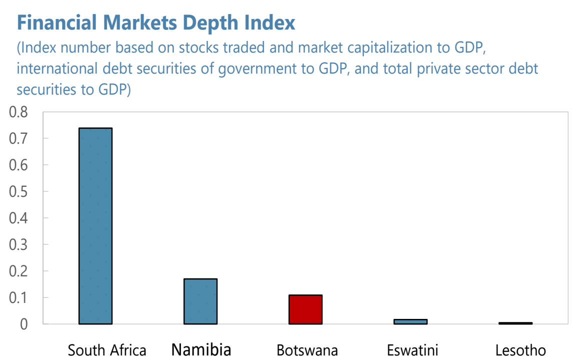

*Access to banking services is comparable to other front-runners in the region…*



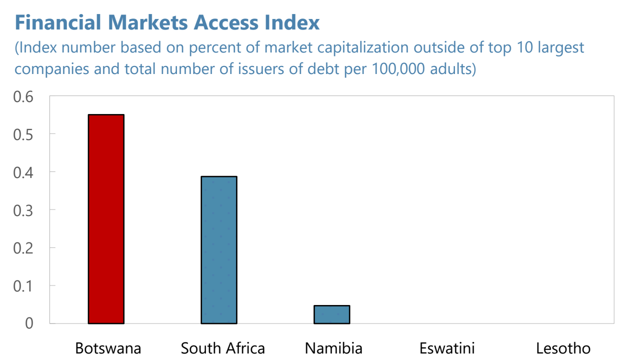

*…although financial institutions' depth lags regional peers.*




*Overall market development lags peers…*




*…yet Botswana outperformed its peers in the region in terms of financial market access.*




Sources: Financial Development Index Database, IMF; Finscope, IMF staff calculations.

## Table 2. Botswana: Selected Economic and Social Indicators, 2019–2028[1]

| | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | 2026 | 2027 | 2028 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | Projection | | | | | |
| | (Annual percent change, unless otherwise indicated) | | | | | | | | | |
| National Income and Prices | | | | | | | | | | |
| Real GDP | 3.0 | -8.7 | 11.9 | 5.8 | 3.8 | 4.1 | 4.3 | 4.0 | 4.0 | 4.0 |
| Mineral[2] | -3.7 | -26.5 | 29.8 | 7.5 | 0.6 | 2.6 | 3.5 | 2.4 | 2.1 | 2.3 |
| Nonmineral | 5.2 | -3.5 | 7.8 | 5.3 | 4.7 | 4.5 | 4.6 | 4.4 | 4.5 | 4.5 |
| GDP per capita (US dollars) | 6,679 | 5,863 | 7,239 | 7,738 | 7,741 | 8,013 | 8,417 | 8,943 | 9,446 | 10,034 |
| GNI per capita (US dollars)[3] | 6,329 | 5,868 | 7,169 | 7,515 | 7,538 | 7,793 | 8,188 | 8,693 | 9,193 | 9,761 |
| Consumer prices (average) | 2.7 | 1.9 | 6.7 | 12.2 | 5.9 | 4.7 | 4.5 | 4.5 | 4.5 | 4.5 |
| Diamond production (millions of carats) | 23.7 | 16.9 | 22.7 | 24.5 | 24.5 | 25.1 | 25.9 | 26.6 | 27.1 | 27.8 |
| Money and Banking | | | | | | | | | | |
| Monetary Base | 5.7 | -3.8 | -8.8 | 14.0 | 9.7 | 7.6 | 8.9 | 8.4 | 9.2 | 9.2 |
| Broad money (M2) | 8.0 | 5.9 | 5.0 | 12.0 | 9.7 | 7.6 | 8.9 | 8.4 | 9.2 | 9.2 |
| Credit to the private sector | 7.1 | 5.3 | 5.4 | 14.7 | 8.9 | 8.4 | 8.7 | 8.8 | 8.7 | 8.7 |
| | (Percent of GDP, unless otherwise indicated) | | | | | | | | | |
| Investment and Savings | | | | | | | | | | |
| Gross investment (including change in inventories) | 30.9 | 32.8 | 27.4 | 25.0 | 29.9 | 30.7 | 32.5 | 32.8 | 32.6 | 32.7 |
| Public | 7.8 | 6.5 | 5.5 | 5.4 | 7.2 | 7.3 | 7.1 | 6.8 | 6.6 | 6.6 |
| Private | 23.0 | 26.3 | 21.9 | 19.5 | 22.8 | 23.4 | 25.4 | 26.0 | 26.0 | 26.1 |
| Gross savings | 23.8 | 26.5 | 28.2 | 28.4 | 30.8 | 32.2 | 33.6 | 33.5 | 33.2 | 33.2 |
| Public | 0.5 | -4.3 | 0.7 | 4.0 | 4.5 | 5.4 | 6.6 | 6.3 | 6.1 | 6.1 |
| Private | 23.3 | 30.8 | 27.5 | 24.4 | 26.2 | 26.8 | 27.0 | 27.2 | 27.1 | 27.1 |
| Central Government Finances[4] | | | | | | | | | | |
| Total revenue and grants | 28.3 | 25.6 | 29.0 | 28.9 | 29.8 | 28.7 | 28.6 | 28.4 | 28.3 | 28.4 |
| SACU receipts | 7.9 | 9.1 | 6.5 | 5.4 | 8.7 | 7.5 | 7.2 | 7.0 | 7.0 | 7.0 |
| Mineral revenue | 8.2 | 5.3 | 10.6 | 13.2 | 9.7 | 9.6 | 9.8 | 9.9 | 9.7 | 9.6 |
| Total expenditure and net lending | 36.9 | 36.5 | 31.4 | 28.9 | 31.7 | 29.7 | 28.1 | 27.9 | 27.8 | 27.9 |
| Overall balance (deficit –) | -8.6 | -10.9 | -2.4 | 0.0 | -1.9 | -1.0 | 0.5 | 0.5 | 0.5 | 0.5 |
| Non-mineral primary balance[5] | -19.0 | -18.5 | -15.9 | -16.3 | -13.6 | -12.5 | -10.8 | -10.9 | -10.6 | -10.5 |
| Total central government debt[6] | 21.5 | 23.5 | 22.1 | 20.8 | 21.3 | 20.3 | 18.9 | 18.4 | 18.2 | 17.9 |
| Net Debt | 5.3 | 15.3 | 12.8 | 11.6 | 13.0 | 13.1 | 11.7 | 10.3 | 9.2 | 8.0 |
| External Sector | | | | | | | | | | |
| Exports of goods and services, f.o.b. (% change) | -17.3 | -25.3 | 70.3 | 11.9 | -8.8 | 10.6 | 5.8 | 9.2 | 5.7 | 6.0 |
| *o/w* diamonds | -19.8 | -21.8 | 80.0 | 7.9 | -13.3 | 10.4 | 5.2 | 10.6 | 4.0 | 4.5 |
| Imports of goods and services, f.o.b. (% change) | 4.5 | -2.3 | 23.1 | -6.4 | 2.8 | 7.8 | 5.6 | 9.6 | 6.1 | 6.1 |
| Current account balance | -6.9 | -10.4 | -1.4 | 2.9 | 0.8 | 1.5 | 1.1 | 0.6 | 0.6 | 0.5 |
| Overall Balance | -6.7 | -11.7 | -1.4 | 1.8 | 2.5 | 1.8 | 0.7 | 0.6 | 0.7 | 0.7 |
| Nominal effective exchange rate (2018=100)[7] | 98.2 | 94.0 | 94.1 | 90.8 | - | - | - | - | - | - |
| Real effective exchange rate (2018=100)[7] | 98.8 | 94.4 | 97.7 | 99.1 | - | - | - | - | - | - |
| Terms of trade (2005=100) | 143.4 | 140.6 | 178.9 | 161.2 | 145.5 | 150.5 | 150.5 | 159.1 | 158.5 | 156.7 |
| External public debt[8] | 12.5 | 11.8 | 11.1 | 9.6 | 10.0 | 8.6 | 7.2 | 6.5 | 5.9 | 5.3 |
| o/w public and publicly guaranteed | 3.9 | 4.0 | 2.9 | 2.2 | 1.9 | 1.6 | 1.4 | 1.2 | 1.1 | 1.0 |
| | (Millions of US$, unless otherwise indicated) | | | | | | | | | |
| Gross official reserves (end of period) | 6,172 | 4,944 | 4,806 | 4,281 | 4,800 | 5,196 | 5,369 | 5,516 | 5,692 | 5,884 |
| Months of imports of goods and services[9] | 9.8 | 6.4 | 6.7 | 5.8 | 6.0 | 6.1 | 5.8 | 5.6 | 5.5 | 5.5 |
| Months of non-diamond imports[9] | 13.4 | 9.3 | 8.9 | 7.7 | 8.2 | 8.4 | 8.2 | 8.0 | 7.7 | 7.4 |
| Percent of GDP | 36.5 | 31.2 | 27.2 | 21.7 | 23.6 | 24.1 | 23.3 | 22.0 | 21.4 | 20.3 |

Sources: Botswana authorities and IMF staff estimates and projections.

[1] This table is based on calendar years unless otherwise indicated.

[2] The projection is based on current value added and projected growth rates by different types of minerals.

[3] Based on Atlas method from the World Bank.

[4] Fiscal variables are based on fiscal years (starting on April 1).

[5] The non-mineral primary balance is computed as the difference between non-mineral revenue and expenditure (excluding interest receipts and interest payments), divided by non-mineral GDP.

[6] Includes guarantees.

[7] For 2019-2022, both effective exchange rate are from IMF INS database.

[8] External debt data measured in fiscal years.

[9] Based on imports of goods and services for the following year.

## Table 3. Botswana: Core Financial Soundness Indicators, 2018–September 2022

| | 2018 | 2019 | 2020 | 2021 | Sep-22 |
|---|---|---|---|---|---|
| | (Percent, unless otherwise indicated) | | | | |
| **Banking Indicators** | | | | | |
| **Capital Adequacy** | | | | | |
| Capital to assets | 9.4 | 9.3 | 9.4 | 8.9 | 8.7 |
| Regulatory capital to risk weighted assets | 17.9 | 18.5 | 20.0 | 17.3 | 17.2 |
| Regulatory Tier 1 capital to risk-weighted assets | 13.2 | 13.4 | 13.8 | 12.5 | 12.4 |
| Non-performing loans net of provisions to capital | 16.2 | 14.9 | 9.2 | 10.2 | 7.4 |
| **Asset Quality** | | | | | |
| Large exposure to capital | 112.7 | 83.4 | 72.2 | 85.1 | 82.4 |
| Non-performing loans to total gross loans | 5.4 | 4.8 | 4.3 | 4.3 | 3.4 |
| **Earnings and Profitability** | | | | | |
| Trading income and total income | 3.6 | 4.2 | 5.3 | 6.3 | 6.3 |
| Return on assets | 2.6 | 5.1 | 1.8 | 2.1 | 2.8 |
| Return on equity | 23.3 | 33.5 | 17.3 | 21.3 | 29.2 |
| Interest margin to gross income | 57.2 | 58.0 | 55.7 | 51.8 | 52.5 |
| Non-interest expenses to gross income | 58.5 | 55.7 | 61.6 | 62.0 | 57.8 |
| Personnel expenses to noninterest expenses | 44.4 | 45.4 | 45.2 | 46.4 | 45.4 |
| **Liquidity** | | | | | |
| Liquid assets to total assets | 6.1 | 6.0 | 5.4 | 6.1 | 3.9 |
| Liquid assets to short-term liabilities | 7.2 | 7.0 | 6.5 | 7.2 | 4.6 |
| Customer deposits to total (non-interbank) loans | 118.8 | 120.6 | 122.9 | 122.4 | 125.5 |
| **Exposure to Foreign Exchange (FX) Risk** | | | | | |
| Net open position in FX to capital | 8.1 | 5.1 | 4.3 | 2.4 | 2.5 |
| Foreign currency-denominated loans to total loans | 7.8 | 6.2 | 4.9 | 3.5 | 4.5 |
| Foreign currency-denominated liabilities to total liabilities | 26.1 | 23.0 | 12.6 | 19.4 | 30.9 |

Sources: Botswana authorities and IMF staff calculations.

# Appendix I. Implementation of 2007 FSAP Recommendations

| Number | Recommendation | Status |
| --- | --- | --- |
| 1 | Draw up a comprehensive financial sector strategy reform plan under the guidance of a high-level inter-agency committee | **Implemented.** A 2012–2016 Financial Sector Development Strategy was prepared under the guidance of a high-level inter-agency coordinating committee. |
| 2 | Develop a strategy for lowering the stock of Bank of Botswana Certificates (BoBCs), in a manner consistent with maintaining the monetary policy stance and the price stability objectives of the BoB | **Implemented.** Abolishing of the 91-day BoBC; introduction of the 3-month and 12-month BoBCs and increase in the Government Note Program from P15 billion to P30 billion. |
| 3 | Pending full implementation of the NBFI RA Act, introduce measures mentioned below in pension and insurance sectors | **Implemented.** (See #13) |
| 4 | Develop, publish, and implement a strategy for building the capacity of the NBFIRA within the framework of the NBFIRA Act. | **Implemented**. The NBFIRA's first strategic plan was for the period 2010–2013 and it focused on the development of rules and regulations and also development and implementation of operating policies and guidelines. During this period the Authority also got the approval of the levy structure.<br><br>The second strategic plan spanned the period 2013 to 2016 and it focused on the development of legal and regulatory frameworks and introduction of the risk based supervisory approach. During the period the Authority reviewed the NBFIRA Act which was enacted in 2016.<br><br>The third strategic plan ran from 2016 to 2021 and it entailed the implementation of the new NBFIRA Act. The strategy also focused on ensuring financial stability as it pertains to the non-banking sector as well ensuring good market conduct.<br><br>The fourth strategy which covers the period 2021 to 2026 is focusing on developing and implementing a robust |

| Number | Recommendation | Status |
|---|---|---|
| | | regulatory framework and strengthening NBFIs resilience and Governance. The strategy also covers the enrichment of the stakeholder engagement.<br><br>The NBFIRA's manpower over the period of fourteen years grew from 18 at the time of inception to just above 100 at present. This was to assist the Authority to effectively carryout its mandate. Moreover, NBFIRA mandate has since grown to cover regulation and supervision of virtual assets service providers over and above the capital markets, retirement funds, insurance and lending activities. |
| | **Banking** | |
| 5 | As a prelude to privatization, give full supervisory authority to BoB for statutory banks and license these institutions. | **Not Implemented**. BoB still does not have full authority over statutory banks. It does not have powers to license statutory banks but derives its power to supervise them from Section 3 of the revised Banking Act (BA). |
| 6 | Give powers to BoB to supervise banking groups on a consolidated basis. Set basis for improved cooperation domestically and cross-border and further develop relationships. | **In progress**. The BA is being revised to empower the Central Bank to supervise a banking group or conglomerate (Section 42 of the revised BA) |
| 7 | Amend the Banking Act so that the BoB has the powers to vet "significant" and "controlling" shareholders. | **In progress.** The BA is being revised to strengthen the BoB powers to vet the significant and controlling shareholders (Section 21). |
| | **Pension** | |
| 8 | Introduce licensing and on-going supervision of pension fund administrators, and asset managers under the new NBFI RA Act. | **Implemented**. Fund administrators regulation and supervision now specifically covered in the new Retirement Funds Act 2022.<br>Asset managers specifically licensed and supervised under Securities Act 2014 |
| 9 | Expand the range of information collected by the registrar, such as foreign asset holdings, including "non-traditional" assets. | **Implemented**. PFR2 (2012) – Pension Funds Investment Rule provides the spilt between traditional and non-traditional assets, off-shore and on-shore split |

| Number | Recommendation | Status |
|---|---|---|
| 10 | Develop and implement broad investment, governance, and custodian guidelines. | **Implemented.** In terms of pension funds governance and investment, PFR2 and PFR10 were implemented from 2012 |
| | **Insurance** | |
| 11 | Develop an on-going supervision plan and prudential requirements, such as risk assessment and management, and liability management. | **Implemented.** Following the establishment of NBFIRA, entities licensed under the insurance industry Act would submit limited information as required then by the Insurance Industry Act 1987. To address the shortfalls of the Act 13 prudential rules were issued from March 2012 and beyond as follows;<br>1. Classes of Business – defined 2012<br>2. GR2 – Financial Condition Report General Insurance 2012<br>3. GR3 Approved Person's Annual Report General Insurance 2012<br>4. IICR – Intermediary Conduct Rule 2014<br>5. IPR1G - Prescribed Valuation Method General Insurance Liabilities<br>6. IPR1L – Prescribed Valuation Method Long Term Insurance Liabilities<br>7. IPR2G – Prescribed Valuation Method & Admissibility Restrictions General Insurance Assets<br>8. IPR2L - Prescribed Valuation Method & Admissibility Restrictions for Long-Term Insurance Assets 2012<br>9. IPR3G Prescribed Capital Target General Insurance 2012<br>10. IPR3L Prescribed Capital Target for Long Term Insurers 2012<br>11. LR2 Financial Condition Report 2012<br>12. LR3 Valuator's Annual Report Long Term Insurance<br>13. PPR Policyholder Protection Rules 2012<br><br>The above was premised on the RBS Model that was adopted replacing the prior compliance-based monitoring |

| Number | Recommendation | Status |
|---|---|---|
| | | system. The introduction of risk-based supervision was in response to a growing industry supervised with limited resources.<br><br>RBS caters for the continuous monitoring of licensed entities under the Insurance Industry Act and further assists with the allocation of resources to the entities and areas where they are most needed. |
| 12 | Collect and analyze statutory returns and analyze relevant information on solvency, detailed re-insurance, claims, and expenses for off-site monitoring. | **Implemented.** The introduction of Prudential Rules brought about receipt of both annual and quarterly statutory returns from insurers as with the previous regulatory regime NBFIRA was only receiving statutory returns from insurers and insurance brokers. The returns are received through an online based system, the Risk Based Supervision System (RBSS) and also analyzed on the same platform. |
| 13 | Implement regulations on intermediaries and issue guidelines on market conduct. | **Implemented.** NBFIRA introduced the Insurance Intermediaries Conduct Rules in 2014 which focus on market conduct issues for intermediaries where a lot of misconduct issues arise. Further, Policyholder Protection Rules were introduced to improve disclosure requirements and to better protect policyholders from unfair practices in the industry. |
| | **Financial and Capital Markets, Financial Infrastructure** | |
| 14 | Establish a group to consider the issuance of government and parastatals securities. | **Implemented.** The Bond Auction Technical Committee comprising officials from the MoF, and BoB spearheaded the reforms. Consequently, the Government Note Issuance Program increased from P15 billion to P30 billion following approval by Parliament in September 2020. Government also introduced the 3-month Treasury bills in October 2020 and 12-month Treasury bills in January 2021. |

| Number | Recommendation | Status |
|---|---|---|
| 15 | Assess the costs and benefits of supporting OTC trading in government securities. | **Implemented.** A hybrid model adopted for trading of Government securities, i.e., use of both OTC and ATS. |
| 16 | Conduct a review of the legislative and regulatory framework to identify reforms needed to promote securitization. | **Not Implemented** |
| 17 | To address shortfalls in the BISS-RTGS, define the type of actions that would warrant penalties and the specifics of the penalties to be levied. | **Not Implemented** |
| 18 | Formalize and publicize the BISS system governance arrangements. | **Not Implemented** |
| | **Systemic Liquidity** | |
| 19 | Enhance coordination and transparency of monetary and exchange rate policy. | **Implemented**. The crawling band exchange rate regime is implemented through continuous and gradual adjustment (crawling) of the trade weighted NEER of the pula to correct for any misalignment of the exchange rate. The rate of crawl is based on the forecast inflation differential between Botswana and her trading partner countries. The rate of crawl is thus determined using a forward-looking approach and is revised annually. In this forward-looking arrangement, the authorities periodically determine the rate of crawl for the subsequent period. The rate of crawl is determined based on comparison of the mid-point of Botswana's medium-term inflation objective range of 3–6 percent and the mid-point of the forecast of trading partners' inflation. This is an ideal approach that recognizes the need to use monetary policy to achieve the inflation objective, rather than accommodate the inflation outcome/path and resultant rate of crawl (inflation differential).<br><br>The Bank of Botswana's current monetary policy framework was adopted in 2008. Prior to 2008, the Bank's price stability was |

| Number | Recommendation | Status |
|---|---|---|
| | | specified in terms of a range to be achieved over the coming year. However, from 2008, it has been defined as a range to be achieved over a medium-term horizon and is currently set at 3 –6 percent. In this framework, the policy horizon is a rolling 3-year period, which is considered appropriate given the long lags in the transmission of monetary policy decision to affect price developments. The medium-term horizon satisfies three conditions for the effectiveness of monetary policy; it anchors inflation expectations around the objective; it is consistent with the period covered by the inflation forecast; and it is a reasonable period for policy action to take effect. |
| 20 | Streamline the structure of policy interest rates and further encourage market-determined interest rates. | **Implemented.** Reforms to monetary operations were introduced on April 28, 2022. The reforms, among others, introduced the adoption of the yield on the main monetary operations instrument (currently the 7-day BoBC) as the anchor policy rate, called the Monetary Policy rate; established an interest rate corridor with a 200-basis points margin and allowed commercial banks to independently determine their own prime lending rate. |
| 21 | Strengthen systemic liquidity forecasting and undertake and disseminate analytical work on monetary transmission channels. | **Implemented.** New liquidity forecasting unit established and resourced with relevant staff, i.e., Assistant Manager and Supervisor. New analytical and forecasting tools in use, which were developed the help of the IMF TA missions.<br><br>The Monetary Policy Statement is published at the beginning of the year and specifies the framework, some instruments and targets used to pursue the primary objective. |

| Number | Recommendation | Status |
|---|---|---|
| | **Enhancing Access to Financial Services** | |
| 22 | Update the legislation from the Cooperative Societies Act to ensure their safety and soundness. | **In progress.** The revised Cooperative Societies Act is currently undergoing review within the Ministry of Entrepreneurship. It is expected to be submitted for legal drafting in 2023 and to become law in 2024. In addition, the re-drafted Banking Bill has given BoB powers in terms of Sections 3 and 4 of the Bill to grant authority to any person to transact banking business or engage in deposit taking activities. This provision therefore extends to SACOOs as deposit taking institutions. |
| 23 | Proceed with the privatization of government-owned financial institutions. | **Partially Implemented.** BBS Limited was granted a commercial banking licence by BoB in 2022 while Botswana Savings Bank (BSB) Lesedi 2022–2025 strategy is premised on the expected implementation of the BSB (Transition) Act, 2012 or possible review of the BSB Act. The Transition Act is perceived as a legal instrument that will result in the transformation of BSB into a company with a banking licence issued by BoB. National Development Bank is being transformed into an Agribank following the pronouncement by government in April 2022. |
| | **AML/CFT** | |
| 24 | Intensify implementation of the existing framework, including the setting up of a FIU, and involving active coordination and information sharing. | **Implemented.** The FIA was established by Section 3 of the Financial Intelligence Act, 2009 that came into force in March 2010.<br><br>Terrorist financing was criminalized in 2014 by the Counter Terrorism Act, 2014. |
| 25 | Criminalize terrorist financing by law. | **Implemented.** Terrorist financing is criminalized under Section 5 of the Counter Terrorism Act, 2014. |
| | **Crisis Management and Resolution** | |
| 26 | Issue guidelines for the management of problem financial institutions and a | **In progress.** Guidelines on Managing Financial instability at a Macro Level are |

| Number | Recommendation | Status |
|---|---|---|
| | financial crisis, and a framework for the provision of emergency liquidity assistance (ELA). | developed, and these guidelines are continuously reviewed.<br><br>Regarding ELA, Section 38 A of BoBAA provides that BoB may act as Lender of Last Resort for a bank by providing ELA. |

# Appendix II. FSAP Risk Assessment Matrix

| Botswana: FSAP Risk Assessment Matrix[1] | | |
|---|---|---|
| **Risk** | **Overall Level of Concern** | |
| | **Relative likelihood** | **Impact and transmission channels** |
| **Abrupt global slowdown or recession.** Global and idiosyncratic risk factors combine to cause a synchronized sharp growth slowdown, with outright recessions in some countries, spillovers through trade and financial channels, and downward pressures on some commodity prices. | Medium | High<br>• Lower demand for diamond, and other commodity exports could slow the rebound in tourism.<br>• A slowdown in neighboring countries could lower SACU revenue, affecting external and fiscal balances, foreign reserves and putting pressure on the pula. |
| **Rising and volatile food and energy prices.** Commodity prices are volatile and trend up amid supply constraints, war in Ukraine, export restrictions, and currency depreciations. This leads to short-run disruptions in the green transition, bouts of price and real sector volatility, food insecurity, social unrest, and acute food and energy crises (especially in EMDEs with lack of fiscal space). | High | Medium<br>• Higher inflation caused by rising food and energy prices has a spillover effect, translating to higher interest rates across economy.<br>• Retirement funds and insurance could suffer loss of premium payments—either through moratoria requests or policy surrenders—impact on institutions' liquidity. |
| **De-anchoring of inflation expectations and stagflation.** A fast recovery in demand (supported by stimulus policies, combined with COVID-19 related supply constraints, leads to sustained above-target inflation, and a de-anchoring of inflation expectations, and triggering a wage-price spiral in tight labor markets. Central banks tighten monetary policy more than envisaged leading to weaker global demand, currency depreciations in EMDEs, and sovereign defaults. Together, this could lead to the onset of stagflation. | High | High<br>• Increases in funding costs could impose additional stresses on banks, households and leveraged firms.<br>• Tighter financial conditions could leave consumer and businesses with deteriorating balance sheets that could pose a credit risk to banks, and underperforming assets.<br>• Loan re-pricing due to higher monetary policy rate could impact large share of unsecured household loans, posing credit risks to banks'/financial institutions' balance sheet.<br>• Falling asset prices and/or valuation losses on portfolios of retirement funds could erode financial institutions' capital buffers.<br>• Non-bank sector that is heavily invested in offshore equites face sharp decline in income, face large valuation losses and weakened capital positions. |

| Botswana: FSAP Risk Assessment Matrix | | |
|---|---|---|
| **Risk** | **Overall Level of Concern** | |
| | **Relative likelihood** | **Impact and transmission channels** |
| **Natural disasters related to climate change.** Higher frequency of natural disasters causes severe economic damage to smaller vulnerable economies and accelerate emigration. Severe events in large economies hitting key infrastructure reduce global GDP, cause further supply chain disruptions and inflationary pressures, and prompt a recalculation of risk and growth prospects. | **Low** | **Medium**<br>• Natural disasters would damage infrastructure and amplify supply chain disruptions causing water and crop productions disruptions, and slow the domestic economy growth. Weaker economy growth and increased unemployment rate would increase NPLs and lead to higher loan loss impairment, weighing on banks' profitability, which could weaken contribution to banks' capital buffers.<br>• Growth remains anemic amid competitiveness problems, and financial development goals not realized. |
| **Cyber attacks** | **Medium** | **High**<br>• An incident could result in loss of confidential and critical data, financial losses, business disruption and reputational damage for financial institution/sector. |
| **Delays in implementing fiscal consolidation** due to political economy constraints, capacity limitations or lack of effort on medium-term outcomes. | **Medium** | **Medium**<br>• Effects amplified if coupled with a sovereign credit rating downgrade.<br>• Increased demand for the financial sector to finance the government potentially crowding out credit to the private sector. Lower growth and higher NPLs. |

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 percent and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff's views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. Reflects the October 2022 G-RAM.

## Appendix III. Stress Test Matrix for Banks

### A. Bank Solvency

| Banking Sector: Solvency Test | | |
|---|---|---|
| Domain | | Framework |
| | | Top-down by FSAP Team |
| 1. Institutional Perimeter | Institutions Included | • Eight commercial banks (including two D-SIBs) |
| | Market Share | • 93.2 percent of assets in the Botswana banking system as of June 2022 |
| | Data and baseline date | • Supervisory data (balance sheet and income statements)<br>• Commercial Bank Survey (bank- level average duration of securities in banking book and trading book, dividend payout ratio by banks in the past 10 years).<br>• Starting position: June 2022 |
| 2. Channels of Risk Propagation | Methodology | • IMF Solvency Stress Test Workbox (Balance-sheet model) |
| | Satellite Models for Macro-Financial Linkages | • **Credit Risk:** Satellite models that link credit risk variables with macroeconomic variables by banks to estimate loan losses.<br>• **Market risk:**<br>Mark to Market (MtM) approach is used to calculate valuation losses for Held for trading (HfT) and available for sales (AfS) securities when shocks to risk-free rates and credit spread.<br>*Repricing risk:*<br>$Value\ Changes_t = -\frac{duration}{(1 + rf_{t-1} + cs_{t-1})} * B_t * \Delta r_t$<br>*Credit spread risk:*<br>$Value\ Changes_t = -\frac{duration}{(1 + rf_{t-1} + cs_{t-1})} * B_t * \Delta cs_t$ |

| Banking Sector: Solvency Test | | |
|---|---|---|
| **Domain** | | **Framework** |
| | | **Top-down by FSAP Team** |
| | | Where *rf* is the risk-free rate (policy rates), *cs* is credit spread (sovereign spread, which is the difference government bond yield and policy rates), *B* is government bond and *duration* is the remaining duration of the portfolio of securities.<br><br>Apply FX shocks on banks open foreign exchange positions<br><br>• **Net Interest Income:** interest rate risk in the banking book (IRRBB) is assessed by using interest income rate/ interest expense rate satellite models and maturity gap analysis, which is based on supervisory data on interest sensitive assets and liabilities by repricing buckets.<br>$\underset{(IIR,\ IER)}{Y} = \underset{(inflation,\ nominal\ prime\ rate,\ exchange\ rate)}{f\,(macroeconomic\ variables)}$<br><br>$Interest\ Income\ Rate_{bt} = \frac{Interest\ Income_{bt}}{Total\ Earning\ Assets_{bt} - NPL_{bt}}$<br><br>$Interest\ Expense\ Rate_{bt} = \frac{Interest\ Expense_{bt}}{Total\ Liabilities_{bt}}$ |
| | Stress Test Horizon | 3 years (2022–2024) |
| 3. Tail Shocks | Scenario Analysis | • Two macro scenarios: baseline scenario and adverse scenario<br>• The **baseline** scenario follows October 2022 WEO. Botswana continues to recover from the COVID-19 pandemic, growing by approximately 4 percent on average over the medium term. Inflation will remain outside of the target band in 2022, mainly because of higher import prices (particularly fuel and food). The MPR is expected to continue increasing, leading to tighter financial conditions. As domestic and global economy recovers, however, portfolio outflows are expected to decline, while strong demand for diamonds will also support the replenishing of foreign exchange |

| Banking Sector: Solvency Test | | |
|---|---|---|
| Domain | | Framework |
| | | Top-down by FSAP Team |
| | | reserves. Inflation expectations are expected to remain anchored, with inflation falling back towards to the target band over the course of 2023.<br>• The **adverse** scenario:<br>o Use IMF's Flexible System of Global Models[1] for the external context and calibrated based on previous crisis episodes with country team for the domestic impact.<br>o Driven by a combination of external shocks amplified by domestic characteristics (see RAM).<br>o The Botswana economy experiences a U-shaped growth path with a stagflation scenario. It assumes a lower growth in 2022 (1.52 percent below the baseline) and a drop in GDP of -9.47% in 2023. This is equivalent to a shock to 2-year cumulative growth of 2.3 standard deviation from historical mean (estimated from 1990 to 2021). GDP growth returns to its potential in year three.<br>o The economy slowdown will be accompanied by unemployment rate rising to 25.77 percent, 30.58 percent, and 30.5 percent over the 3-year horizon. pula depreciates against USD most significantly in year 2, with 13.25 percent depreciation below baseline.<br>o Inflation will remain high in the first two years at 14.72 percent and 12.39 percent respectively due to high volatility in food and energy prices and will drop to 6.03 percent in year 3. Monetary policy will stay high to fight against inflation.<br>o The economic slowdown in Botswana will also be associated with diamond price deterioration, with 9 percent, 24.1 percent, and 11.5 percent below baseline over the 3-year horizon. |

[1] It is a multi-region, forward-looking, semi-structural dynamic stochastic general equilibrium (DSGE) model.

| Banking Sector: Solvency Test | | |
|---|---|---|
| **Domain** | | **Framework** |
| | | **Top-down by FSAP Team** |
| 4. Risks and Buffers | Risks/ factors assessed (How each element is derived, assumptions). | • Credit risk (provision costs): determined by changes in estimated new NPL flows.<br>$$Expected\ Loss = Proxy\ PD * LGD * EAD$$<br>• Market risk: impact of financial variable's evolution on sovereign bonds and FX open positions.<br>• Interest rate risk in the banking book<br>• Net fee and commission income, other income and non-interest expense evolve with macroeconomic conditions. |
| | Behavioral adjustments | • Balance sheet growth assumption: Static balance sheet assumption (Balance sheet growth is zero) |
| 5. Regulatory and Market- Based Standards and Parameters | Calibration of risk parameters | • PDs: proxy based on estimated new NPL flows over performing loans. PD is derived in following steps:<br>$$New\ NPL_t = NPl_t - NPl_{t-1} + Recoveries_t + Writeoffs_t$$<br>$$\Delta NPL_t = NPl_t - NPl_{t-1} = New\ NPL_t - Recoveries_t - Writeoffs_t$$<br>$$\Delta NPL_t = NPl_t - NPl_{t-1} = New\ NPL_t - \alpha_t * NPL_{t-1}$$<br>$$New\ NPL_t = NPl_t - (1 - \alpha_t)NPl_{t-1}$$<br>$$New\ NPL_t = NPl_t - (1 - \bar{\alpha})NPl_{t-1}$$<br>$$Proxy\ PD_t = [NPl_t - (1 - \bar{\alpha})NPl_{t-1}] / Performing\ Loans_{t-1}$$<br>Where α ̄= (recoveries+ write-offs)/ 〖NPL〗_(t-1)), and it is bank specific parameter. As write-off and recoveries data is only available for shorter period, average alpha is calculated by using existing data and apply to historical NPLs to estimate PDs.<br>• LGDs: proxy based on average historical provision coverage ratio by banks (provisions/ NPLs)<br>• EADs: proxy as performing loans in t-1 |
| | Regulatory/ Accounting and | • Basel II standardized approach<br>• The hurdle rates are based on minimum capital requirements: 7.5 percent for Tier1 Capital, 4.5 percent for CET1, and 12.5 percent for total capital |

| Banking Sector: Solvency Test | | |
|---|---|---|
| **Domain** | | **Framework** |
| | | **Top-down by FSAP Team** |
| | Market- Based Standards | • RWAs evolve with credit growth, net of increase in provisions. |
| 6. Reporting Form | Output presentation | • Capital ratios pre- and post-shock and capital shortfall for the aggregate banking system<br>• Decomposition of the key drivers of changes in capital ratios system wide<br>• Distribution of capital ratios system wide over the scenario horizon |

| Banking Sector: Liquidity Test | | |
|---|---|---|
| **Domain** | | **Framework** |
| | | **TD by FSAP Team** |
| Institutional Perimeter | Number of banks: | Eight commercial banks (including two D-SIBs) |
| | Market share: | 93.4 percent of assets in the Botswana banking system as of end-August 2022 |
| Methodology | | • LCR (Liquidity Coverage Ratio) – proxy test, using the bank-level Basel II statutory reports data at end of August 2022.<br>• To be consistent with standard Basel III LCR framework, necessary assumptions are made particularly when breakdown data are unavailable from the regulatory Basel II reports (e.g., proportions of breakdown items).<br>• Banks' 30-day "Net loans and Advances" (M-LIQGAP) doesn't have breakdown data by counterparties, therefore, ratios of "Gross Loans and Advances" of all maturities were applied to proxy the breakdown data.<br>• Inflow shocks were capped at 75 percent of outflows for smaller banks in all adverse scenarios 0-3 under ST scenarios. |
| Scenarios | | • The baseline scenario considers a coverage of HQLA that is close to the BoB's statutory liquid assets, by excluding required reserves and government bonds with maturities beyond one year. |

## Banking Sector: Liquidity Test

| Domain | Framework |
|---|---|
| | TD by FSAP Team |

- The severe scenario adopts the same coverage of HQLA as in the baseline but considers larger haircuts on HQLA, lower inflows from retail and non-financial corporations, and larger run-off on banks' wholesale and retail deposits funding as per assumptions below:

| | Category | Basel III Factor | Baseline Factor | Adverse Factor | *Adverse-0, all shocks* | *Adverse-1, HQLA shock* | *Adverse-2, HQLA +inflow shocks* | *Adverse-3, HQLA +outflow shocks* |
|---|---|---|---|---|---|---|---|---|
| HQLA | HQLA_l1: CB reserves (RR) | 100% | 100% | 95% | ✓ | ✓ | ✓ | ✓ |
| | HQLA_l1: CB reserves (current/repo/SDF) | 100% | 100% | 95% | ✓ | ✓ | ✓ | ✓ |
| | HQLA_l1: coins and banknotes | 100% | 100% | 100% | ✓ | ✓ | ✓ | ✓ |
| | HQLA_l1: marketable securities (BoBCs, T-bill, other clai | 100% | 100% | 95% | ✓ | ✓ | ✓ | ✓ |
| | HQLA_l1: marketable securities (GB<1Y) | 100% | 98.5% | 95% | ✓ | ✓ | ✓ | ✓ |
| | HQLA_l1: marketable securities (GB>=1Y) | 100% | 96% | 85% | ✓ | ✓ | ✓ | ✓ |
| | HQLA_l2A: corporate debt securities | 85% | 85% | 70% | ✓ | ✓ | ✓ | ✓ |
| | HQLA_l2A: marketable securities | 85% | 85% | 70% | ✓ | ✓ | ✓ | ✓ |
| Inflows | if_counterparty: households | 50% | 50% | 25% | ✓ | | ✓ | |
| | if_counterparty: domestic banks | 100% | 100% | 50% | ✓ | | ✓ | |
| | if_counterparty: domestic banks' subsidiaries | 100% | 100% | 50% | ✓ | | ✓ | |
| | if_counterparty: foreign banks | 100% | 100% | 50% | ✓ | | ✓ | |
| | if_counterparty: parastatals (govt & dev banks) | 100% | 100% | 50% | ✓ | | ✓ | |
| | if_counterparty: corporations | 50% | 50% | 25% | ✓ | | ✓ | |
| | if_counterparty: NBFIs | 50% | 100% | 50% | ✓ | | ✓ | |
| | if_derivative: net derivative inflows | 100% | 100% | 50% | ✓ | | ✓ | |
| Outflows | of_retail: household deposits | 10% | 10% | 15% | ✓ | | | ✓ |
| | of_wholesale: domestic banks | 100% | 100% | 100% | ✓ | | | ✓ |
| | of_wholesale: foreign banks | 100% | 100% | 100% | ✓ | | | ✓ |
| | of_wholesale: parastatals (govt & dev banks) | 40% | 25% | 40% | ✓ | | | ✓ |
| | of_wholesale: corporations | 40% | 40% | 50% | ✓ | | | ✓ |
| | of_wholesale: NBFIs | 100% | 40% | 50% | ✓ | | | ✓ |
| | of_secured: CB or backed by level1 (bal due to BoB) | 0% | 0% | 0% | ✓ | | | ✓ |
| | of_secured: backed by 2A (Debt < 5Y) | 15% | 15% | 20% | ✓ | | | ✓ |
| | of_secured: non-level1 or non-level 2A (repo with FI) | 25% | 25% | 50% | ✓ | | | ✓ |
| | of_secured: other borrowings | 100% | 100% | 100% | ✓ | | | ✓ |
| | of_additional: Net derivate cash outflows | 100% | 100% | 100% | ✓ | | | ✓ |

# Appendix IV. Stress Testing Matrix for Insurers and Retirement Funds

| **Insurance and Pensions: Solvency Risk** | | |
|---|---|---|
| 1. Institutional perimeter | Number of institutions | Life insurance: 4; short-term insurance: 4; retirement funds: 4 |
| | Market Share | Life insurance: ~93 percent of balance sheet assets<br>Short-term insurance: ~80 percent of gross written premiums<br>Retirement funds: ~80 percent based on balance sheet assets |
| | Data | Statutory returns |
| | Reference date | June 30, 2022 |
| 2. Channels of risk propagation | Channels of risk propagation | • Investment assets: market value changes of assets and liabilities after price shocks, affecting the solvency position (future pension values for retirement funds)<br>• Sensitivity analysis: effect on available capital and solvency position. |
| 3. Time horizon | | • Instantaneous shock (for insurers) |
| | | • Mid-2022 to mid-2024 (for retirement funds) |
| 4. Scenario Analysis | Scenario analysis | Global market and emerging markets stress scenario: interest rates continuing to rise, sovereign bond spreads increasing, and equity prices decline.<br>• Share prices: -25.1 percent (domestic, and offshore emerging markets), -28.7 percent (offshore advanced economies)<br>• Bond prices: -9.2 percent (domestic short-term), -7.3 percent (domestic long-term), -15.0 percent (offshore)<br>• Property prices: -15 percent<br>• Currency: +20.6 percent (BWP appreciation) Global market and emerging markets stress scenario: interest rates continuing to rise, sovereign bond spreads increasing, and equity prices decline. |
| | Sensitivity analysis | • Market shocks: increase in domestic interest rates, and BWP depreciation<br>• Default of largest bank counterparty |
| 5. Risk factors assessed | | • Market risks: bond prices, share prices, property prices, FX rates<br>• Credit risks: default of largest bank counterparty<br>• Summation of risks |
| 6. Regulatory/ accounting standards | | National GAAP |
| 7. Reporting Formats for results | Output presentation | • Impact on valuation of assets<br>• Impact on available capital and solvency position (insurance); Impact on future pension values (retirement funds)<br>• Dispersion across companies<br>• Contribution of individual shocks |

# Appendix V. Report on Observance of Standards and Codes: Basel Core Principles for Effective Supervision

## A. Introduction

**1. At the request of the Batswana authorities, the IMF and the World Bank assessed the state of the implementation of the Basel Core Principles for Effective Banking Supervision (BCP) in Botswana.**[1] This Report on the Observance of Standards and Codes (ROSC) summarizes the main findings in relation to the regulatory and supervisory framework in place as of the date of the completion of the graded BCP assessment. The BCP assessment is based on the prevailing Banking Act (BA), 1995, and the Bank of Botswana Act (BoBA), 1996. At the time of the mission a draft revised Banking Act was at an advanced stage and the Bank of Botswana Amendment Act (BoBAA), 2022 was passed by the Parliament, with the latter coming into effect in February 2023.

**2. This was the first graded assessment for Botswana's bank supervision and regulation under the 2012 BCP standards.** The previous 2007 FSAP conducted a graded BCP assessment, and highlighted gaps in relation to: (i) the independence and legal protection of the supervisors; (ii) corporate governance, board oversight and accountability, (iii) supervision on a consolidated basis; and (iv) bank resolution and crisis management.

**3. The BCP assessors observed that despite significant improvements in supervisory frameworks, supervisory powers remain underdeveloped and legislative changes for safeguarding operational independence are needed.** The Banking Supervision Department (BSD) discharges supervisory oversight and responsibilities for the banking sector, with the specific mandate to promote and maintain a safe, stable, sound, efficient and competitive banking system.[2] Staff are highly committed, yet outdated laws, limited resources and capacity in assessing key banking risks, constrain adequate delivery of its mandate. Upskilling of staff to monitor risks on a forward-looking basis is needed to complement planned revisions to the BA. Specific areas for improvement include: (i) strengthening the overall risk management framework; (ii) establishing prudential requirements for corporate governance standards and supervision; (iii) developing regulations on classification and provisioning; (iv) enhancing regulations for transactions with related parties and supervision of country risk transfer; and (v) instituting powers for consolidated supervision and change of control.

[1] The assessment was conducted onsite during October 2–November 12, 2022.

[2] The principal objective of the Bank of Botswana (BoB) is to promote and maintain price stability, contribute to the stability of the financial system and foster and maintain a stable, sound and competitive market-based financial system. As of February 2023, as per Section 3 of the Bank of Botswana Amendment Act, 2022, the BoB's objectives have been prioritized to have a primary objective of price stability, with other secondary objectives, including to contribute to stability of the financial system.

## B. Methodology

**4. The ratings for this assessment are not directly comparable to previous assessments due to updates to the methodology.** The authorities opted to be assessed against essential criteria and additional criteria, but graded only with reference to the essential criteria.

**5. The assessors reviewed relevant laws, regulations, and guidance, and held extensive meetings with officials and other relevant stakeholders.** The mission met with departments of the BoB involved in supervision and regulation, and financial stability; and other financial sector supervisors including the NBFIRA and FIA. Meetings were conducted with external stakeholders, including Bankers Association of Botswana, Botswana Accountancy Oversight Association, and a selection of commercial and statutory banks.

**6. The assessors appreciated the cooperation of the authorities, including the BoB management and staff, and staff of the other agencies and institutions.** Their openness and full participation in the process – to provide all information necessary for the assessment— were important in completing the assessment. The authorities provided a self-assessment of the CPs, as well as responded to additional questionnaires, and facilitated access to supervisory documents, files and systems on a confidential basis.

**7. The standards were evaluated in the context of Botswana's financial system.** In its supervisory role, the BoB is guided by the BoBA and the BA. The financial sector comprises eight commercial banks[3] and has a sizeable non-bank financial institutions. The core indicators of financial sector depth and development reflects that the banking sector is small (relative to regional peers) and offer standard intermediation products.

## C. Market Structure and Financial Infrastructure—Overview

**8. Banking sector assets represent approximately 61.0 percent of GDP in 2021.** Access to banking services, indicated by the ratio of the number of depositors to the adult population is around 78.9 percent in the same period, although other indicators suggest that financial sector development and depth have been sluggish. The average financial intermediation ratio has remained stable, averaging about 81 percent, with banks operating standard intermediation business.

**9. Banks typically comply with minimum prudential standards for regulatory capital requirements**. All banks reported capital adequacy and common equity Tier 1 capital ratios of more than the respective prudential minimum limits of 12.5 percent and 4.5 percent. The aggregate unimpaired capital for the banking industry stood at P13.6 billion in 2021.

[3] After the assessment, an additional bank was licensed, bringing the total banks in Botswana to nine as at the publication date of this report.

**10. Banks show moderate profitability and liquidity risks remain low.** Though trending lower over the past three years, net after-tax profit increased by 25 percent (y/y) in 2021. Operational efficiency also improved in 2021, as aggregate return on equity and return on average assets increased from to 16.9 percent and 1.7 percent, respectively. In addition, liquid asset holdings generally exceed the minimum 10 percent liquid assets ratio.

**11. Credit risks remain largely contained, as non-performing loans to total loans and advances in 2021 was 4.2 percent.** Total past due loans declined in 2021 on account of recoveries and loan write-offs. Yet, some COVID-19 relief measures (including the 6-month loan repayment moratorium) remained for an extended period, and may have delayed the deterioration in asset quality and related provisioning.[4] Credit risk oversight is enhanced through the existence of a regulated environment for credit information sharing under the Credit Information Act, (CI Act) 2021. The BoB has responsibility to regulate the credit bureaus.

**12. There is a well-developed system of laws and regulations, including corporate, bankruptcy, and consumer protection laws to support supervisory actions.** The BoB can take corrective action when it observes deterioration in bank solvency, to restructure and reorganize a troubled bank and in extreme circumstances, declare a seriously troubled bank insolvent.

## D. Summary of Main Findings

### Principles 1–2 Responsibilities, Objectives, and Powers

**13. There are material deficiencies with respect to the BoB's responsibilities, objectives and powers within its primary legislation for bank supervision.** The outdated legal framework weakens effective supervision. The BA does not specify the BoB's primary responsibility for promoting safety and soundness of banks and the banking system. Instead, the BA specifies a broader suite of objectives which are not subordinated to the primary objective of safety and soundness. Moreover, there are no prudential requirements for banks' corporate governance; risk management, transactions with related parties, change of control in significant shareholding, etc.; powers for consolidated supervision; major acquisitions. In addition, the supervisory review process other supervisory areas necessary for effective banking supervision need upgrading.

**14. Ministerial involvement in cases of appeals for banking license rejections, and representation on the BoB Board may impede BoB's operational independence.** Moreover, legal protection for supervisors against legal costs, which are specific areas within the BCP methodology needed to achieve operational independence, are absent. Though Sections 15(2) to (5) of the BA outlines circumstances under which the Governor and Deputy Governors can be removed from office, there is no provision in the law requiring that reason(s) for their removal be publicly disclosed. Although the BA is being reviewed, the revisions do not address appointments or removal

[4] These COVID-relief regulatory measures were withdrawn effective January 2023, after being instituted in April 2020. Loans treated under the COVID relief measures, e.g., loan moratorium amount to P5.6 billion, (representing 8.5 percent of total loans) as of December 2020.

thereof of Governors and Deputy Governors. Rather, the provision would be in the BoBA, implying that even after enactment, the revised BA would not address these concerns.

**Principle 3 Cooperation and Coordination**

**15. Arrangements are in place for domestic cooperation and coordination, such as the FSC with MoUs executed with all participants.** Cooperation and coordination with foreign supervisors is achieved through the supervisory college. With banks diversifying their business models through exploring bancassurance and wealth management activities (e.g., capital markets, broking etc.), further legal reform may be warranted to facilitate sharing of confidential information with domestic supervisory agencies and for greater cooperation and collaboration in routine supervision.

**Principles 4 and 5 Permissible Activities and Licensing**

**16. The BA empowers the BoB as the sole licensing authority for banks, with permissible activities clearly defined in legislation.** The Licensing Policy, issued by the BoB, is strict in terms of what activities can be licensed as a bank, complements the legislation on what constitutes a bank, sets limitations on using the word "bank' and the activities undertaken by a bank. Outside of banks licensed by the BoB, statutory banks derive their mandates from statues established by Acts of Parliament.

**17. BoB demonstrates a structured approach to assessing license applications, including ensuring that banks appoint directors and senior management officials that are fit and proper.** The policy also specifies the need for applicants to suitable operating plans, sound systems of corporate governance and disclose the sources of initial capital as well as the applicant's ability to provide capital injection as needed. Further analysis of ultimate beneficial ownership should be undertaken to identify the individual shareholder.

**18. After licensing, however, there are no requirements for enhanced prudential review and reporting requirements newly licensees.** While the BoB conducts a pre-operation inspection to ensure adequacy of systems, newly licensees should be subject to an enhanced supervision plan – ideally within the first 12 months – to verify the effective implementation of internal controls, risk management framework and governance functions.

**Principles 6 and 7 Transfer of Significant Ownership and Major Acquisitions**

**19. The BA has no definition of significant ownership, and there are no requirements to obtain the BoB's approval for change of control or voting rights in a bank.** In practice, the BoB relies on the Guidelines on Significant Shareholding (which is published on the BoB's website) to assess a change of significant shareholding. The lack of provisions in the primary legislation means there is no direct legal remedy to reject or reverse a change in significant ownership *ex-post*. Additionally, a framework for major acquisitions is not provided for in the legislation, and while the BA contains countervailing measures, it is questionable whether the supervisor has the powers to fulfil the specificities circumstances of a merger acquisition.

**Principles 8, 9 and 10 Supervisory Approach, Tools, and Reporting**

**20. A risk-based supervision (RBS) framework exists, comprising a mix of onsite and offsite surveillance tools and techniques that are appropriately embedded in the supervisory guidance and procedures.** The main components include: (i) full-scope onsite examinations that are performed on a three-year cycle, (ii) statutory returns, submitted at various intervals, that provide an opportunity to regularly assess the financial condition of banks and evaluate compliance with prudential requirements; and (iii) meetings with banks' senior management that are held at least annually, and on an ad hoc basis, if necessary.

**21. Yet, strengthening the RBS supervisory framework and tools should be considered.** These principal areas include having differentiated supervisory requirements for banks, banking groups and systemically important banks; conducting on-going evaluation of the effectiveness of the supervisory methodology; developing the framework for system-wide stress testing and analysis to comprehensively assess risk and capital adequacy.

**CP 11 and 12 – Corrective Measures and Consolidated Supervision**

**22. Use of sanctioning powers provided for in the BA has been limited, with the BoB traditionally using moral suasion to enforce prudential standards.** Supervisory concerns are typically communicated to the management and Board for action. Similarly, there is limited experience restricting bank licenses and applying more conservative prudential requirements on individual banks (such as higher minimum capital requirements). BoB does not have a formulated corrective action policy framework, so the framework to link the risk rating system and approaches to corrective actions is absent.

**23. The BA does not provide for consolidated supervision.** The BoB is therefore not legally positioned to evaluate the soundness of an entire group considering all the risks that may affect a bank, emanating from the bank and its affiliated entities. This has so far been managed through participation in supervisory colleges and bilateral meetings with and host supervisors.

**CP 13 – Home/Host**

**24. BoB actively participates in supervisory colleges at the group level with effective two-way sharing of information**. Given that banks are foreign bank subsidiaries, the BoB has signed MoUs with most home supervisors of parent entities and resolution plans exist at for the parent groups. Beyond information sharing, planning, and conducting onsite examinations in conjunction with home supervisors could be improved. Until now, the BoB has not operated as the home supervisor to any bank or banking group.

**Corporate Governance, Audit, and Financial Reporting (CP 14, 26–28)**

**25. Material deficiencies exist in relation to regulations for corporate governance in respect of key areas:** (i) regulations do not explicitly assign responsibility or hold management and boards accountable for instituting sound corporate governance, including through codes of conduct, and instituting policies to address conflicts of interest; (ii) BoB is yet to undertake a formal and structured assessment of a banks' corporate governance framework, policies, processes, and practices, and develop supervisory guidance for undertaking such assessments; (iii) laws and regulations do not require key internal committees for effective internal risk oversight; and (iv) regulations requiring formal assessment of the board members' effectiveness in exercising their duty of care and duty of loyalty, or the power to address director or board ineffectiveness are absent.

**26. The regulatory and supervisory frameworks for internal control, internal audit, external audit, financial reporting, and disclosures are well established and effective.** At the same time, these can be further aligned with the BCPs to facilitate greater risk focus for audit functions and integrating audit, internal risk control and compliance oversight. Additional legal powers for BoB to ensure the suitability of the external auditor and overseeing their work might also be considered, as needed in rare, and extreme situations.

### Capital (CP 16)

**27. The definition of capital and components of capital are aligned with Basel III requirements, while the approaches for determining the risk weighted assets for the Pillar 1 risks (credit market and operational) are as per Basel II.** The capital adequacy framework for banks is proportionate to the risks and complexities of the banking industry. All banks maintain capital in accordance with the standardized approach for credit risk and standardized maturity method for interest rate risk in trading book, and Basic Indicator Approach for operational risk. As at end December 2021, the average CET1 and Tier 1 ratios for the banking sector in Botswana was comfortably above the minimum requirements at 12.0 percent and 12.5 percent respectively and the total capital adequacy ratio was 18.5 percent. In addition, all banks are required to make their Pillar 3 disclosures annually with published financial statements. While the review the ICAAP documents occurs annually, so far, this has not resulted in a requirement for a bank to hold additional capital against Pillar 2 risks.

### Risk Management (CP 15, 17–25)

**28. BoB has established regulatory and supervisory frameworks that promote a culture of overall risk management among banks.** Banks are deploying financial models in increasing numbers, using technology in quantifying risks, conducting stress testing, implementing IFRS-9, and adopting a forward-looking approach to business and capital planning. This exposes banks to model risks, which should be reviewed more closely by the BoB.

**29. The supervisory approach to management for a number of risk areas can be improved.** The areas include: (i) reviewing the approach for problem assets, provisions and reserves; (ii) enhancing guidelines for defining exposures to and transactions with related parties to close significant gaps in the prudential regime; and (iii) establishing appropriate risk management policies, procedures, and arrangements for managing country and transfer risks**.** Development of additional guidance for supervisors, supervisory tools/methodologies and more granular offsite data in these areas are needed to improve supervisory effectiveness.

30. **There is a need to develop supervisory guidance and methodologies to encourage higher standards of liquidity risk management.** Some key risk areas need BoB's clarification of the expectations regarding banks' risk management framework, while in other areas the prudential norms could be upgraded to include more appropriate approaches for liquidity risk management and strengthening liquidity risk management.

**Abuse of Financial Services (CP 29)**

31. **AML/CFT has received heightened attention with a dedicated team of supervisors undertaking onsite and offsite analysis of bank compliance with AML/CFT obligations as stated in the FI Act.** There was evidence of greater attention allocated to AML/CFT supervision and integrated into risk-based activities to address outstanding issues identified in the most recent FATF follow-up report (April 2021). To complement data reported, offsite analysis of bank policies and procedures and closer feedback between supervisors would help identify group-wide weaknesses in risk management.

32. **Table V.1 offers a principle-by-principle summary of the assessment findings and conclusions.**

**Table V.1. Botswana: Summary of Findings for BCP Assessment**

| Core Principle | Comments |
|---|---|
| 1. Responsibilities, objectives, and powers | There are material deficiencies with respect to the BoB's responsibilities, objectives and powers. Firstly, the primary legislation does not specify the BoB's primary responsibility for banking supervision. Instead, the Banking Act specifies a broader suite of objectives which are not subordinated to the primary objective of safety and soundness resulting in potential conflicts for the BoB. Secondly, the legal framework has not been subject to regular review and as a result has significant deficiencies eroding the BoB's ability to supervise effectively. There is need for a more frequent and comprehensive review of the regulatory framework to ensure financial sector legislation remains relevant to changing industry and regulatory practice. While the Banking Act was under review at the time of the mission (and at an advanced stage of approval) a review had not been undertaken since 1995. Deficiencies exist in multiple areas in terms of inadequate powers, with examples including: an absence of provisions for consolidated supervision (see also CP12); major acquisitions (see CP7); corporate governance standards (CP14); risk management standards (CP15) and change in significant shareholding (see also CP6).<br><br>In addition to the above, while the legal framework provides the BoB with the necessary powers to increase prudential requirements, in practice these powers have not been exercised. There are examples |

| Table V.1. Botswana: Summary of Findings for BCP Assessment (continued) | |
|---|---|
| **Core Principle** | **Comments** |
| | where the BoB has exercised its powers using the Banking Act, more often the BoB relies on moral suasion to enforce prudential requirements. Confidence in the legislation to support the exercise of supervisory judgement is essential for effective supervision and is considered a weakness in the current regime. While the BoB has the power to set and enforce prudential requirements for individual banks and banking groups based on their risk profile and systemic importance, prudential requirements for capital and liquidity are uniform across all commercial banks. The planned implementation of the new D-SIB framework combined with the revisions to the Banking Act may strengthen the BoB's powers and set minimum prudential requirements for banks and banking groups based on their risk profile and systemic importance. However, at the time of the mission, there was insufficient evidence that the BoB was able to exercise powers in this regard.<br><br>Lastly, while the legislation covers individual banks, but it does not extend to banking groups. Given the structure of the banking system this is a crucial deficiency with eight of nine commercial banks currently licensed by BoB foreign owned. A draft bill is currently being drafted which addresses this deficiency. The BoB does not meet several aspects of this CP which require the supervisor to have the necessary powers to set prudential requirements for banking groups and review the activities of parent companies and their affiliates. In terms of the grading for this CP, this deficiency will be treated under CP12 Consolidated Supervision. |
| 2. Independence, accountability, resourcing and legal protection for supervisors | Lack of operational independence from potential ministerial interference in supervisory oversight. Inadequate resources to fulfill BoB's mandate. |
| 3. Cooperation and collaboration | Further reform of legal framework needed to facilitate sharing of confidential information with domestic supervisory agencies. |
| 4. Permissible activities | Definition of 'bank' clear. The term 'bank' is restricted. |
| 5. Licensing criteria | Newly licensed banks are not subject to an enhanced supervision plan. Analysis of ultimate beneficial ownership is not undertaken to identify the individual shareholder. |
| 6. Transfer of significant ownership | No provision for significant shareholding in the primary legislation with no legal remedies to reject, modify or reverse a transfer of significant ownership ex post. |

| Table V.1. Botswana: Summary of Findings for BCP Assessment (continued) | |
|---|---|
| **Core Principle** | **Comments** |
| 7. Major acquisitions | No provision for significant shareholding in the primary legislation with no legal remedies to reject, modify or reverse a major acquisition ex ante. |
| 8. Supervisory approach | No internal guidelines for the handling of distressed or weak banks. |
| 9. Supervisory techniques and tools | System-wide stress tests not conducted. Limited engagement with independent non-executive directors on a routine basis. |
| 10. Supervisory reporting | No reporting requirements for banks on a solo and group basis. |
| 11. Corrective and sanctioning powers of supervisors | Risk rating methodology is not linked with processes to handle weak and distressed banks and used to develop the range of corrective measures. |
| 12. Consolidated supervision | No provisions for consolidated supervision in the primary legislation. |
| 13. Home-host relationships | Implement MoUs with all home supervisors. Implement more frequent sharing of information with home supervisors in addition to supervisory colleges. |
| 14. Corporate governance | The current gaps with regard to the regulatory and supervisory frameworks on corporate governance are: (i) Laws or regulations do not explicitly assign each bank's board and senior management the responsibility with respect to corporate governance or provide guidance to banks on expectations for sound corporate governance. (ii) BoB is yet to undertake a formal and structured assessment of a bank's corporate governance framework, policies, processes, and practices, and develop supervisory guidance for undertaking such assessments. (iii) Laws and regulations do not currently require nomination committee, remuneration committee or risk committee even in large banks. They do not establish the nomination procedures to be followed by the board, while identifying and nominating new directors. (iv) BoB reviews the continued fitness and propriety of the board members every year, but does not undertake formal documented assessment of the board members' effectiveness or if they exercise their duty of care and duty of loyalty. (v) Laws or regulations have not explicitly required banks or their boards to promote corporate culture and values through code of conduct, conflict of interest policies (other than related party exposures and other related party transactions), or whistle blower policies. The availability and adequacy of these have not been assessed. (vi) BoB does not have the power to remove one or more directors, or remove the entire board, if they do not operate in the best interest of the bank or its depositors, or do not perform well. |

| Table V.1. Botswana: Summary of Findings for BCP Assessment (continued) | |
|---|---|
| **Core Principle** | **Comments** |
| 15. Risk management process | BoB has established regulatory and supervisory frameworks that promote a culture of overall risk management, as well as management of individual risks among banks and allows supervision to assess the banks' risk management frameworks. Guidance to supervisors for supervision of risk management is at high-level, needs to be elaborated. Regulations and supervisory expectations not articulated on model risk management, establishing linkages between product pricing, performance measurement and compensation and risk, and requiring banks to obtain board approval for the removal of the Chief Risk Officer (CRO) and inform or discuss with BoB the reasons for the removal. |
| 16. Capital adequacy | BoB has established a capital adequacy framework for banks operating in Botswana that is compliant with the Basel requirements and yet requires banks to hold much higher minimum capital. As the higher capital is not explicitly linked to specific risks or risk elements, BoB should consider establishing a linkage between the higher minimum capital required in the framework and the pillar 2 risks, and/or risk profile of banks. This can allow it to better articulate the need for the higher minimum capital and provide inbuilt flexibility to recalibrate/ modulate the higher capital required of banks commensurate to risks and risk profile of banks, without imposing additional capital burden on the banks. |
| 17. Credit risk | BoB's regulatory and supervisory framework with reference to credit risk management, at the broad level, is largely in place and is seen to be implemented.<br><br>BoB requirements established through risk management guidelines (section 5.28) and the related onsite and off-site supervision generally address banks' credit policy framework from a conflict-of-interest perspective, except for the gaps in relation to related party exposures and transactions, which are discussed in CP 20. |
| 18. Problem assets, provisions, and reserves | The prudential framework for asset classification does not cover all forms of credit exposures, and there is no explicit and enforceable prudential framework for provisioning for credit risk, that back-stops the accounting framework. The other gaps observed include the inadequate articulation of supervisory expectations and/or inadequate supervisory oversight on (i) banks' framework for individual assessment of significant exposures; (ii) banks' framework for eligible collateral/ risk mitigants, their periodic valuation, estimation of their net realizable value based on market and macro-economic conditions and their |

| Table V.1. Botswana: Summary of Findings for BCP Assessment (continued) | |
|---|---|
| **Core Principle** | **Comments** |
| | recognition for provisioning; (iii) classification and provisioning of multiple exposures to same borrower where one of them become non-performing; (iv) ongoing oversight and compliance with BoB requirements on rescheduled / restructured loans and advances; and (v) banks' framework for timely write-offs reflecting realistic repayment and recovery expectations, considering market and macro-economic conditions. The other areas where there is room for improvement are (i) inadequacy of off-site data obtained by BoB to be able to exercise ongoing and effective supervision of asset classification, provisioning, recovery and write-off; and (ii) lack of periodic assessment of trends and concentrations in risk and risk build-up across banking system in relation to banks' problem assets and risk mitigation strategies. |
| 19. Concentration risk and large exposure limits | BoB's prudential requirement for concentration risk management has a few gaps. In brief, these are: (a) the regulatory and supervisory framework cover only limited types of concentrations and do not explicitly cover concentration to industry, geographical regions, collateral, product and markets; (b) definition of exposures is not comprehensive; (c) prudential limit for single counterparty and group of inter-connected counterparties is at significant variance from Basel norm of 25 percent of Tier 1 capital; (d) regulations allow banks to seek exemptions from BoB to exceed the prudential limits and the BoB allows it; and (e) compliance with prudential limits are assessed with reference to net exposures (net of collateral and bilateral netting), but gross exposures are not monitored. |
| 20. Transactions with related parties | The key divergence from the Basel norms are the gaps in the definition of exposure on related parties (these do not include exposure through placements and investment), definition of related parties, absence of an explicit and comprehensive definition of related party transactions for prudential purposes, prudential limits on aggregate related party exposures, explicit provision for deducting from capital exposures in excess of the prudential limits, the gaps in the governance requirements, and the absence of explicit and comprehensive supervisory (prudential) reporting requirement for transactions with related parties. These collectively result in significant gaps in the prudential regime for transactions with related parties. |
| 21. Country and transfer risks | Laws or regulation do not explicitly require banks to assess country and transfer risks from both immediate risk and ultimate risk perspectives, grade and provision exposure to country and transfer risks. Supervision |

| Table V.1. Botswana: Summary of Findings for BCP Assessment (continued) | |
|---|---|
| **Core Principle** | **Comments** |
| | of banks' management of country and transfer risks is not explicit in the current onsite and offsite frameworks. |
| 22. Market risk | Banks' exposures to market risks are not material (0.01 percent to 2.5 percent of total risk-weighted assets as at end-June 2022; all except two banks were below 0.5 percent). Banks in Botswana are having market risk exposures through their exposure to foreign currency risk and interest rate risk in the trading book (IRR-TB). They do not engage in trading in commodities or equity. Regulatory requirements for management of market risks are broadly in place, however, there are significant gaps in supervision. These arise mainly due to knowledge and skills gap specific to these risks and their management, lack of adequate guidance and supervisory tools, and inadequate offsite reporting requirements. As a result, supervision tends to be less intrusive, and supervisors tend to place reliance on banks' assurance functions. |
| 23. Interest rate risk in the banking book | Regulations, guidance available to supervisors and the supervision of interest rate risk do not explicitly distinguish between interest rate risk in the trading book (that is a component of market risks) and interest rate risk in the banking book. Banks are not adequately complying with some key elements of regulation (namely, measuring interest rate impacts with reference to impact on economic value of equity, and banks should have at least two techniques for measuring interest rate risk (gap analysis, duration, simulation and VaR), and supervisors are not systematically encouraging or enforcing compliance. Supervisors are, however, able to review and confirm the availability and adequacy of qualitative elements through the offsite and onsite supervision mechanisms. Supervisors do not have the tools to determine the extent of individual bank's exposure to IRRBB, which hinders their ability to validate or challenge the banks' internal measurement of IRRBB including for the purpose of ICAAP, and the adequacy and appropriateness of the internal limits established by banks. |
| 24. Liquidity risk | BoB's prudential liquidity requirement LAR is a stock measure of liquidity. BoB supplements these with a couple of metrics namely the intermediation ratio and the deposit concentration ratio. However, the above measures do not assess liquidity risk from a flow perspective, do not adopt a nuanced approach to currency-wise liquidity risk, and do not consider the liquidity risk arising from off-balance sheet commitments. The two metrics supplementing the LAR are used mainly for monitoring funding risk and funding concentration risk, but in the |

| Table V.1. Botswana: Summary of Findings for BCP Assessment (concluded) | |
|---|---|
| **Core Principle** | **Comments** |
| | absence of explicit thresholds either in the form of regulatory requirement or as supervisory threshold that triggers supervisory responses, these may not be adequately effective. |
| 25. Operational risk | The current legal, regulatory and supervisory frameworks and the BoB's offsite and onsite supervisory frameworks and practices, demonstrate that these are largely compliant with the requirements established through the ECs in this CP. In the absence of specific more detailed requirements in laws or regulations that deal with outsourcing, and supervisory reporting on operational risk events and related losses, supervisors rely on alternative sources internal to the banks. |
| 26. Internal control and audit | The legal, regulatory, and supervisory frameworks established in Botswana and actual practice, indicate that these are generally in compliance with the requirements of this core principle. |
| 27. Financial reporting and external audit | The legal, regulatory, and supervisory frameworks established in Botswana and actual practice, indicate that these are generally in compliance with the requirements of this core principle. |
| 28. Disclosure and transparency | The legal, regulatory, and supervisory frameworks established in Botswana and actual practice, indicate that these are in compliance with the requirements of this core principle. |
| 29. Abuse of financial services | Greater sharing of risk information between the BSD staff and those responsible for AML/CFT. Ambiguity on the legal interpretation of the five-day reporting threshold for STRs impairs sanctions. |

## E. Recommended Actions

**33. Table V.2 provides suggested actions for improving compliance with the BCPs and the effectiveness of the regulatory and supervisory frameworks.**

| Table V.2. Botswana: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks | |
|---|---|
| **Reference Principle** | **Recommended Action** |
| Principle 1 | • Revise the Banking Act to broaden supervisory powers to contain relevant provisions to cover existing gaps e.g., corporate governance, risk management, transactions with related parties, change of control.<br>• Implement a regular program to undertake a comprehensive review of the regulatory framework to ensure financial sector legislation remains relevant to changing industry and regulatory practice. |

| Table V.2. Botswana: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (continued) | |
|---|---|
| **Reference Principle** | **Recommended Action** |
| Principle 2 | • Revise Banking Act to remove the need for ministerial approvals when exercising BoB powers. Multiple provisions in the Banking Act need to be addressed to reduce Ministerial involvement. Other amendments to legislation needed include protections for supervisors in the case of legal action to cover staff legal costs.<br>• Undertake a regular program (e.g., annual) to determine the adequacy of skills, such as risk specialists. |
| Principle 3 | Implement a regular program of information sharing whereby the BoB exchanges risk analysis and undertaking collaborative work with NBFIRA where appropriate. |
| Principle 4 | No recommendation |
| Principle 5 | Implement an enhanced supervision program for newly licensed banks such as a targeted onsite examination within the first twelve months from licensing. Undertake more rigorous suitability assessment of the ultimate beneficial owner during licensing. |
| Principle 6 | Revise the Banking Act to include an explicit definition of 'significant shareholding'. Publish standards for criteria that a change in significant shareholding will be assessed against. |
| Principle 7 | Revise the Banking Act to include explicit provisions for major acquisitions. |
| Principle 8 | • Conduct regular quality assurance assessments of the supervision framework and methodology.<br>• Develop internal guidance for the handling of weak and distressed banks. |
| Principle 9 | • Greater differentiation of supervisory activities for systemic banks. More frequent engagement with independent non-executive directors.<br>• Perform regular system-wide stress tests to identify areas of vulnerability. |
| Principle 10 | • Develop reporting requirements for banks on a solo and group basis.<br>• Refresh reporting instructions on a regular basis.<br>• Greater depth of detail for risk areas such as: IRRBB, credit risk and market risks. |
| Principle 11 | • Broaden the range of corrective measures.<br>• Link the risk rating methodology with processes to handle weak and distressed banks. |
| Principle 12 | • Revise the Banking Act to contain provisions for consolidated supervision.<br>• Expand prudential guidance for banks and internal guidance to support supervision in addition to staff training. |
| Principle 13 | • Implement MoUs with all home supervisors.<br>• Implement more frequent sharing of information with home supervisors in addition to supervisory colleges. |

**Table V.2. Botswana: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (continued)**

| Reference Principle | Recommended Action |
|---|---|
| Principle 14 | Initiate changes to law to obtain the powers that BoB might not have for requiring, supervising, and enforcing good corporate governance in banks, including power to remove a board member or the entire board, for poor performance; issue guideline on corporate governance that address the identified gaps, and provide more and specific guidance to supervisors to be able to conduct effective supervision of corporate governance arrangements in banks. |
| Principle 15 | • Improve guidance to supervisors on, among others, how they can undertake closer or more focused supervision on banks' risk management systems, risk governance, risk management policies and processes, management of risks surrounding new products or material modification to existing products, stress testing, information systems and risk reporting.<br>• Explicitly articulate the regulatory requirements and supervisory expectations in the areas of model risk management, the need for establishing linkages between product pricing, performance measurement and compensation and risk, and requiring banks to obtain board approval for the removal of the CRO and inform or discuss with BoB the reasons for the removal. |
| Principle 16 | • Develop guidance and tools for reviewing and assessing banks' ICAAP documents and feeding these into ongoing supervision.<br>• Consider developing appropriate supervisory methodologies to assess Pillar 2 risks and the additional capital that banks might need to hold thereagainst. Such methodologies can equip the supervisors to challenge or validate the internal assessments of capital by banks in their ICAAP documents. These can also help the BoB in linking the higher minimum capital to specific risks as recommended in the previous paragraph.<br>• Work with banks to reduce their reliance on Tier 2 capital, to improve the overall quality of capital. |
| Principle 17 | Explicitly require that credit risk exposures that are risky or otherwise not in line with the bank's activities should also be subjected to extra due-diligence and where required, approved by the board or its committee. |
| Principle 18 | • Review and revise the regulatory framework, data and information obtained from banks through offsite statutory reports, and supervisory guidance and tools to address the specific gaps identified.<br>• Undertake periodic, say on semi-annual basis, a system-level analyses of trends and concentrations in relation to banks' problem assets or risk mitigants or risk mitigation strategies to be able to initiate any system level response measures that may be relevant to address any negative trends or build-up of risk concentrations. |

**Table V.2. Botswana: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (continued)**

| Reference Principle | Recommended Action |
|---|---|
| Principle 19 | • Review and revise regulations to introduce a more comprehensive approach to supervision of concentration risk management in banks, that addresses the gaps identified in the assessment.<br>• Review and revise the prudential limits on single and group of inter-connected counterparties to comply with the Basel norm of 25 percent of Tier 1 capital; and avoid allowing case-by-case exemptions to exceed the prudential limit.<br>• Make the regulatory requirements and supervisory expectations more explicit and detailed for management of other types of concentrations (e.g., industry, geographic, collateral, products).<br>• Make corresponding changes to the supervision manual, offsite reporting, and analyses, to strengthen Supervisory Review and Evaluation Process (SREP) with reference to concentration risk management by banks. |
| Principle 20 | • Review and comprehensively revise the regulation and supervision of exposures to and transactions with related parties to bring these on par with the specific requirements of this core principle.<br>• Make corresponding improvements to the offsite reporting and analyses, and guidance provided in supervision manuals for conducting onsite supervision of transactions with related parties. |
| Principle 21 | • Explicitly establish regulatory requirements and supervisory expectations on identification, measurement, monitoring and management of country and transfer risks from immediate and ultimate risk perspectives, including grading these risk exposures and provisioning therefor.<br>• Introduce appropriate prudential reporting requirements, and revisions to supervisory manual.<br>• Provide appropriate training and capacity building to enhance relevant supervisory skills. |
| Principle 22 | • Improve the offsite reporting. Develop supervisory tools, and guidance for assessment of banks' exposure to market risks and their management of these risks.<br>• Incorporate the above and other specific elements relevant for supervision of market risks in the supervision manual and include an explicit and dedicated component on management of market risks by banks.<br>• Supplement the above by appropriate training and capacity building to enhance the supervisory skills relevant for regulating and supervising management of market risks by banks. |
| Principle 23 | • Improve the offsite reporting, develop supervisory methodologies for assessment of banks' exposure to IRRBB and the potential impact on banks' capital to better inform supervision and strengthen SREP. |

| Table V.2. Botswana: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (continued) | |
|---|---|
| **Reference Principle** | **Recommended Action** |
| | • Incorporate the above and other specific elements relevant for supervision of IRRBB in the supervision manual and include an explicit and dedicated component on management of IRRBB by banks.<br>• Supplement the above by appropriate training and capacity building to enhance the supervisory skills relevant for regulating and supervising management of IRRBB by banks. |
| Principle 24 | • Include flow-based liquidity measures in BoB toolkit,<br>• Introduce explicit regulatory and/or supervisory limits for the intermediation and deposit concentration ratios,<br>• Assess liquidity and funding risks at the level of each significant foreign currency in addition to assessing these risks at the aggregate level (for all currencies),<br>• Improve off-site reporting and analyses to better capture liquidity and funding risks, and<br>• Provide more guidance to supervisors to assess these dimensions of liquidity and funding risks and reflect these adequately in the supervised bank's liquidity risk profile. |
| Principle 25 | Review and revise laws, regulations, and supervisory manual / guidance in the following areas: (a) issue explicit regulations on outsourcing, cybersecurity (currently in draft stage), and operational resilience, (b) suitably modify the offsite framework to systematically obtain periodic and structured and unstructured data/reports on operational risk events (including near-misses) and related losses, promote analyzes of this data to better inform supervision and strengthen SREP, (c) incorporate additional guidance to supervisors on the above and other specific elements relevant for supervision of operational risk management in banks in the supervision manual, (d) supplement the above with adequate training and capacity building. |
| Principle 26 | Review and revise laws, regulations, and supervisory manual / guidance to address the following (a) Explicitly require the internal audit function to adopt a formal framework of risk based internal audit, (b) explicitly review the staffing and skills in control functions and back/ middle offices, and (c) expand supervisory assessments to explicitly include assessment of adequacy of staff assigned to compliance function, their skillsets, experience, and training. |
| Principle 27 | Seek amendment to the Banking Act (1995) (and any other relevant law(s)) to (i) have explicit powers to reject and rescind the appointment of an external auditor who is deemed to have inadequate expertise or independence, or does not adhere to established professional standards, and (ii) have the power to access the working papers of external auditors, as that might be required in rare but extreme situations. |
| Principle 28 | To supplement the disclosures under the accounting standards, with the implementation of the recommendations under CP 14 (Corporate governance) and |

**Table V.2. Botswana: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (concluded)**

| Reference Principle | Recommended Action |
|---|---|
| | CP 21 (Related party transactions), BoB can consider establishing explicit disclosure requirements in these two areas that reflect prudential requirements and expectations |
| Principle 29 | Address legal interpretation of the five-day threshold for suspicious transaction report submission. Increase the frequency of data for inclusion in offsite surveillance (e.g., STRs). |