



BOTSWANA

FINANCIAL SECTOR ASSESSMENT PROGRAM

DETAILED ASSESSMENT OF OBSERVANCE—BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

March 2024

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 January 18, 2024.

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

BOTSWANA

January 18, 2024

DETAILED ASSESSMENT OF OBSERVANCE

BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

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This report was prepared in the context of a joint IMF-World Bank Financial Sector Assessment Program (FSAP) mission in Botswana from October 12–November 2, 2022, led by Thor Jonasson, IMF and Harish Natarajan, World Bank, and overseen by the Monetary and Capital Markets Department, IMF, and the Finance, Competitiveness and Innovation Global Practice, World Bank. Further information on the FSAP program can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>, and www.worldbank.org/fsap.



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Glossary

| | |
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| AC | Additional Criterion |
| ALCO | Asset Liability Management Committee |
| AML/CFT | Anti-Money Laundering/Combating The Financing of Terrorism |
| BAOA | Botswana Accountancy Oversight Authority |
| BCBS | Basel Committee on Banking Supervision |
| BCPs | Basel Core Principles for Effective banking Supervision |
| BIA | Basic Indicator Approach |
| BoB | Bank of Botswana |
| BoBAA | Bank of Botswana Amendment Act, 2022 |
| BoB Act | Bank of Botswana Act, 1995 |
| BSD | Banking Supervision Department |
| BWP | Pula (Currency of Botswana) |
| C | Complaint |
| CAMEL | Capital adequacy, Asset quality, Market sensitivity, Earnings, Liquidity |
| CCA | Competition and Consumer Agency |
| CDD | Customer due diligence |
| CEO | Chief Executive Officer (Principal officer) |
| CET1 | Common Equity Tier 1 |
| CFP | Contingency funding plan |
| CI Act | Credit Information Act, 2021 |
| CP | Core principle |
| CRO | Chief Risk Officer |
| D-SIB | Domestic Systemically Important Bank |
| D-SIFIs | Domestic Systemically Important Financial Institutions |
| EaR | Earnings at risk |
| EC | Essential Criterion |
| ERTP | Economic Recovery and Transformation Plan |
| EU | European Union |
| FATF | Financial Action Task Force |
| FIA | Financial Intelligence Agency |
| FSAP | Financial Stability Assessment Program |
| FSC | Financial Stability Council |
| GDP | Gross Domestic Product |
| ICAAP | Internal Capital Adequacy Assessment Process |
| IFRS | International Financial Reporting Standards |
| IRRBB | Interest rate risk in the banking book |

| | |
|--------|--|
| ISA | International Standard on Auditing |
| ISF | Industry Support Facility |
| IT | Information technology |
| LAR | Liquid assets ratio |
| LC | Largely compliant |
| LE | Large exposures |
| MOF | Ministry of Finance |
| MIS | Management information systems |
| MNC | Materially non-compliant |
| MoUs | Memorandum of Understandings |
| NBFIRA | Non-Bank Financial Institutions Regulatory Authority |
| NC | Non-compliant |
| NPL | Non-performing loan |
| OTC | Over-the-counter |
| RWA | Risk-weighted assets |
| SREP | Supervisory Review and Evaluation Process |
| USD | US Dollar |
| VaR | Value at risk |
| ZAR | South African Rand |

EXECUTIVE SUMMARY

Despite significant progress improving supervisory frameworks since the last assessment in 2007, supervisory powers remain underdeveloped. The current Banking Act was adopted in 1995 and has several deficiencies such as an absence of provisions for consolidated supervision, major acquisitions, and changes in significant shareholding. There is need for a more frequent and comprehensive review of the regulatory framework to ensure they remain relevant to changing industry and regulatory practice. The regulatory framework needs to be updated to align closer with recent Basel norms, guidance, and principles, particularly in the risk management areas specified below. Supervision tools and methodologies and guidance to supervisors need to be augmented as specified below to make supervision more forward-looking and effective. The planned revision of the Banking Act should aim to address gaps and help strengthen powers and support more intrusive supervision.

Legislative changes for safeguarding operational independence are needed. Legislative measures to remove certain ministerial powers in relation to supervisory matters is needed to achieve the independence of the BoB in matters of supervision. For example, the Banking Act provides for several circumstances where Ministerial approval is required which may interfere with the BoB's operational independence. Other provisions of the Banking Act allow the Minister to overrule BoB's decision, in the case of appeals for banking license rejections. Finally, Government/Ministries representatives are sitting at the BoB Board which is another feature of the institutional setting that needs to be amended.

While the BoB's Banking Supervision Department (BSD) has experienced and highly committed staff, the BSD is under resourced and lacks risk expertise to adequately deliver on its mandate. BSD staff dedicate considerable attention to assessing banks' financial condition on a regular basis ensuring compliance with minimum prudential requirements. The onsite examination process is an in-depth process that evaluates the adequacy and effectiveness of bank internal controls. The addition of risk specialists is needed to help complement BSD staff in the identification of emerging risks and to promote ongoing standards of risk management in the banking sector. Risk specialists will help meet the challenges of increasing complexity of banks and banking groups. Examples of risk areas where additional specialism is needed include liquidity, market risks, interest rate risk in banking book, and information technology.

The supervisory methodology and bank rating framework requires a review to be a forward-looking assessment of risk. The BSD adopts a structured approach to onsite examinations and offsite surveillance supported by internal guidelines and manuals. Offsite analysis of banks' financial condition and compliance with prudential requirements is supported by high frequency reporting. Nonetheless, the supervisory methodology needs to be reviewed to ensure supervisors can accurately profile bank risk and to determine supervisory activities based on a forward-looking assessment of risk.

The supervision approach can be strengthened with greater use of qualitative information as inputs for offsite analysis together with a shorter onsite examination cycle. A greater suite of qualitative information should be used as part of offsite analysis. Information such as bank policies and processes, business plans and risk tolerances should be collected and evaluated on at least an annual basis. There is also scope for more in-depth analysis of bank Internal Capital Adequacy Assessment Program document (ICAAPs) and stress testing results. BSD should schedule more frequent onsite examinations to test and evaluate bank risk management and governance. A more differentiated approach to supervision for large banks is needed to reflect systemic importance.

The capital adequacy framework for banks is largely aligned with the Basel framework and proportionate to the risks and complexities of the local banking industry, with minimum capital requirements being set significantly higher than under the Basel framework. 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. This reflects a high level of Tier 2 capital in the system (about 32 percent of total regulatory capital). All banks are required to submit ICAAP assessments annually and the Bank of Botswana (BoB) has not yet felt the need to require a bank to hold additional capital as a Pillar 2 requirement. BoB should consider developing appropriate supervisory methodologies to assess Pillar 2 risks (e.g., concentration risk, interest rate risk in banking book, liquidity risk) and the additional capital that banks might need to hold to make the additional capital more sensitive to individual banks' specific risk profiles. All banks are required to make their Pillar 3 disclosures annually on their websites and with their published financial statements.

The supervisory approach to management of problem assets, provisions and reserves by banks needs revision. Banks in Botswana are implementing IFRS 9. BoB has issued prudential norms for credit classification that acts as a backstop to accounting standards. For provisioning, BoB places reliance on accounting standards and external auditors. This involves the extensive use of internal models for provisioning where the model outputs could be influenced by non-availability of appropriate data, their quality and history, assumptions, and model risks. In this background, the absence of prudential backstop for provisioning affects supervisory oversight on provisioning adequacy. BoB guidelines need to be improved to provide clarity on eligible collateral, in particular movable and immovable physical collaterals, their valuation, and governance around valuation. Development of additional guidance for supervisors, supervisory tools/methodologies and more granular offsite data is needed to improve supervisory effectiveness. BoB should supplement this with periodic system-level analyses of trends and concentrations in relation to banks' problem assets, risk mitigants and risk mitigation strategies to inform system level policy and response.

Regulation and supervision of transactions with related parties need substantial improvement and supervision of country and transfer risks need to be explicitly established. Definitions, prudential exposure limit, and governance requirements for transactions with related parties are not fully aligned with Basel requirements and expectations. BoB has issued a regulation that requires banks to establish appropriate risk management policies, procedures, and arrangements for managing country and transfer risks, but is missing a few elements such as grading and provisioning

of country risk. The absence of appropriate offsite reporting and analyses, and absence of adequate guidance to supervisors for conducting supervision needs to be addressed in both areas.

Regulatory and supervisory frameworks for some key risk areas need significant improvement and BoB's expectations regarding banks' risk management framework needs clarification. The key risk areas needing improvement include: credit concentration (expectations on industry, geographic, collateral concentrations are not adequately explicit or detailed; prudential limit for exposure to single counterparty or group of inter-connected counterparty is too liberal – effectively at 44 percent of Tier 1 capital, with scope for assuming higher exposure with BoB approval), IRRBB (need for greater clarity on measurement of risk with reference to economic value impact on equity), market risk (need clarity on trading book and related discipline, marking to model, derivative activities, stress testing), and operational risk (clarity on requirements related to outsourcing and operational risk event and loss database). Offsite reporting and analyses and more detailed guidance to supervisors are needed to make supervision more effective for these risks.

There is a need to develop guidance for supervisors and supervisory methodologies to encourage higher standards of liquidity risk management. While all banks are meeting the liquid assets ratio (a stock measure) set by the BoB, there is a maturity mismatch which is causing stress on bank liquidity management. The intermediation ratio and deposit concentration ratio, which can help detect funding risks, are monitored by BoB but are not used effectively in the absence of formal supervisory thresholds. Inclusion of a flow approach to liquidity risk management, establishing supervisory thresholds for ongoing monitoring, enhanced reporting requirements can help strengthen liquidity risk management in banks, and their supervision. These need to be supported by suitable modifications to supervisory reporting and analyses.

Material deficiencies exist in relation to regulations for corporate governance. Board and senior management responsibilities regarding corporate governance are not explicitly established in the regulations. Risk, nomination and remuneration committees or responsibilities are not mandated even for large banks, and the nomination process for board members is unclear. BoB does not have clear power to remove a board member or the entire board, for poor performance. Although the Board is assessed under individual risks in BoB's risk-based supervisory framework that supplements the CAMEL framework – there is no formal assessment of governance policies, or compliance with duty of care and duty of loyalty, or an evaluation of Board's overall effectiveness. While some of these deficiencies are expected to be addressed through the proposed Banking Bill and draft regulation on corporate governance, additional guidance to supervisors is needed to improve ongoing supervision.

INTRODUCTION¹

- 1. The BCP assessment was conducted in Gaborone, Botswana from October 12 – November 2, 2022.** The mission met with various departments of the BoB involved in supervision and regulation, and financial stability. The mission also met with other financial sector supervisors including the Non-bank Financial Institutions Regulatory Authority and Financial Intelligence Agency. They met with several external stakeholders including Bankers Association of Botswana, Botswana Accountancy Oversight Association, and a selection of commercial and statutory banks.
- 2. The assessors had the full cooperation from the Botswana authorities and received all information necessary for the assessment.** The team extends its thanks to the management and staff of the various agencies and institutions for their openness and participation in the process. The authorities provided comments on a draft version of this assessment, which are reflected in the final assessment.

INSTITUTIONAL AND MARKET STRUCTURE— OVERVIEW

- 3. The principal objective of the 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.**² In pursuit of a key aspect of this objective, the BoB established the Banking Supervision Department with a specific mandate and mission to promote and maintain a safe, stable, sound, efficient and competitive banking system. In its supervisory role, the BoB is guided by the Bank of Botswana Act, 1996 (BoB Act), Banking Act, 1995 (Cap. 46:04) (Banking Act), Banking Regulations of 1995, Bureau de Change Regulations of 2004 and relevant directives, policies and guidelines issued pursuant to the Banking Act, all of which govern the establishment and conduct of financial institutions over which the BoB has supervisory mandate. The BoB also seeks to promote market integrity, competition, fair-trading practices and a high standard of governance through consultation and open communication with financial market players. Furthermore, the BoB is committed to upholding a high standard of professional conduct in line with international regulatory and accounting standards for effective banking supervision.
- 4. The BoB regulates and supervises commercial banks, statutory banks, bureaux de change, and one deposit-taking microfinance institution (Women's Finance House).** As of December 31, 2021, the number of licensed commercial banks decreased from nine to eight, following the exit of Bank SBI (Botswana) Limited (Bank SBI) from the market, while that of statutory

¹ This Detailed Assessment Report has been prepared by Christopher Wilson (IMF Short-Term Expert) and Damodaran Krishnamurti, Lead Financial Sector Specialist, World Bank.

² The Bank of Botswana (Amendments) Act, 2022 (BoBAA) which was passed by the Parliament in July 2022 came into effect in February 2023, and contains a number of revisions to key provisions related to supervision and financial stability, including the BoB objectives and functions, BoB governance, and statutory establishment of the Financial Stability Council.

banks remained at three. During the year under review, two bureaux de change were licensed, while seven had their licenses revoked; of the seven, six voluntarily closed business, while one failed to comply with the Bank of Botswana Bureaux de Change Regulations. Therefore, the resultant number of operating bureaux de change decreased from 58 in December 2020 to 53 in December 2021. The Bank granted permission to eight bureaux de change that had requested permission to temporarily cease business operations citing adverse effects of the COVID-19 pandemic on their businesses.

5. The role of the Non-bank Financial Institutions Regulatory Authority (NBFIRA) is to regulate and supervise the non-bank financial institutions to foster the: safety and soundness of non-bank financial institution, highest standard of conduct of business by non-bank financial institutions, fairness, efficiency and orderliness of the non-bank financial sector, stability of the financial system, reduction and deterrence of financial crime (<https://www.nbfira.org.bw/>).

6. The Business Conduct and Bureaux de Change Supervision Division, within the Banking Supervision Department, is responsible for consumer protection in as far as it relates to the market conduct of banks. There is a market conduct operating manual which includes coverage of consumer protection issues (disclosure, approval of bank products, off-site and on-site supervision of banks on good market conduct). Also, there are guidelines and directives issued to enforce disclosure and transparency in dealing with customers across the banking industry. It should be noted that the Competition and Consumer Authority (CCA) is responsible for anti-competitive conduct. Therefore, to minimise regulatory arbitrage or weaknesses that might result from loopholes between the BoB and the CCA, the two regulators have a formalised arrangement where meetings are periodically held to address issues of mutual interests.

7. The Financial Intelligence Agency (FIA) is statutorily mandated to act as a central agency responsible for requesting, receiving, analysing and disseminating to an investigatory authority, supervisory authority or comparable body, disclosures of financial information, concerning suspicious transactions, required by or under any enactment in order to counter financial offenses; or concerning the financing of any activities or transactions related to money laundering, terrorism and the proliferation of weapons of mass destruction in order to protect the integrity and stability of the financial system at national and international level. The FIA is also mandated to coordinate Anti-Money Laundering, Combating the Financing of Terrorism and counter the financing of proliferations of weapons of mass destruction (AML/CFT/CPF) activities in the Country. The FIA informs policy direction by conducting research on trends of money laundering, terrorist financing the financing of proliferation of and educate and inform the public about trends in money laundering and related crimes.

8. Relative to GDP, the banking sector size (measured by total industry assets) declined in 2021, with the ratio of banking assets to GDP decreasing from 65.2 percent in 2020 to 61.0 percent in 2021 (Table 1). The financial sector that comprises commercial banks has sizeable non-bank financial institutions. Access to banking services, indicated by the ratio of the number of depositors to the adult population, rose from 76.9 percent to 78.9 percent in the same period. Overall estimates indicate that the financial sector development and depth were sluggish between 2020 and 2021. Total assets for the banking industry increased by 5.2 percent from P103.3 billion in

2020 to P108.6 billion in 2021 mainly driven by the growth in loans and advances of 5.1 percent from P65.6 billion to P68.9 billion in the same period. Customer deposits grew by 4.8 percent from P80.5 billion in 2020 to P84.4 billion in 2021. Deposits remain a major source of funding for banks as they constituted 77.7 percent of the total liabilities as at the end of 2021.

**Table 1. Botswana: Structure of Financial System
as at December 2021**

| Financial Institutions | Number of Institutions | Assets in (in BWP millions) | Percent of Total Assets | Percent of GDP |
|-------------------------------|-------------------------------|------------------------------------|--------------------------------|-----------------------|
| Banking Sector | 13 | 115,879 | 42.3 | 61.0 |
| Commercial Banks | 10 | 107,452 | 39.2 | 56.6 |
| Statutory Banks | 2 | 4,278 | 1.6 | 2.2 |
| Building Societies | 1 | 4,149 | 1.5 | 2.2 |
| Non-Bank Sector | 786 | 158,207 | 57.7 | 82.2 |
| Life Insurance | 8 | 18,321 | 6.7 | 9.6 |
| General Insurance | 12 | 2,514 | 0.9 | 1.3 |
| Re-Insurer | 4 | 536 | 0.2 | 0.3 |
| AUM for Retail and Private | ... | 7,346 | 2.7 | 3.9 |
| Retirement Funds | 87 | 117,549 | 42.9 | 61.9 |
| Capital Markets | 37 | 721 | 0.3 | 0.4 |
| Microlenders (Top 20) | 20 | 6,316 | 2.3 | 3.7 |
| Others | 618 | 4,904 | 1.8 | 1.1 |
| Grand Total | 799 | 274,086 | 100.0 | 143.2 |

Sources: Bank of Botswana Financial Stability Report, NBFIRA, and authors.

9. The average financial intermediation ratio for the banking industry increased marginally from 81.4 percent in December 2020 to 81.7 percent in 2021. The ratio shows that banks sustained their intermediation role and were able to retain and attract customers, despite the negative effect of the coronavirus disease (COVID-19) pandemic. That notwithstanding, the core indicators of financial sector depth and development continue to demonstrate that the banking sector is relatively small in relation to the gross domestic product (GDP). However, the digital transformation and product innovation on which banks have embarked, changes in consumer

demands and improvement in financial infrastructure have the potential to contribute to the growth of the financial sector.

10. The banking industry was adequately capitalized and complied with minimum prudential standards for regulatory capital requirements. The aggregate unimpaired capital for the banking industry declined by 2.7 percent from P14 billion in 2020 to P13.6 billion in 2021. 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.

11. Total past due loans (loans with repayment arrears) decreased by 8.3 percent from P3.9 billion in 2020 to P3.6 billion in 2021. Despite the reduction in past due loans, non-performing loans (NPLs) increased by 3.5 percent from P2.8 billion to P2.9 billion, while the ratio of NPLs to total loans and advances decreased from 4.3 percent in 2020 to 4.2 percent in 2021. Specific provisions decreased by 3.4 percent from P1.71 billion in 2020 to P1.65 billion in 2021. The reduction in the level of provisions was due largely to recoveries and loan write-offs, which resulted in the removal of the associated amount from the reserves accounts. As a result, the specific provisions to NPLs ratio decreased from 60.7 percent in 2020 to 56.6 percent in 2021. The ratio of banks' large exposures to unimpaired capital increased from 149.7 percent in 2020 to 179.7 percent in 2021 but remained below the 800 percent prudential maximum limit for banks in Botswana. NPLs have remained with the levels of the pre-pandemic period and banks remain adequately capitalized with sizeable liquidity buffers. However, some COVID-19 relief measures, notably the 6-month loan repayment moratorium (in some cases been extended for a longer period), loans restructuring, and guaranteed loans to affected sectors, may have delayed the deterioration in asset quality and related provisioning³. Similarly, non-bank financial institutions introduced a package of measures that included rescheduling of loan installments, reduction of interest rates and deferred premium contributions. Such measures may impact profitability of the sector in the short term.

12. The banking industry net after-tax profit increased by 25 percent from P1.5 billion for the 12 months to December 2020 to P1.8 billion in the corresponding period in 2021. The banking industry's operational efficiency improved, as both aggregate return on equity and return on average assets increased from 12.9 percent and 1.4 percent to 16.9 percent and 1.7 percent, respectively, in the same period. Notwithstanding, the level of banking profits has trended downwards over the last three years, reflecting increased operating costs resulting from investment in technology to adapt to the technologically advanced operating environment, as well as subdued income on account of the low interest-rate environment.

13. The liquid assets to total deposits ratio (LAR) for banks, which was above the 10 percent minimum prudential requirement, at 16.6 percent, as of December 31, 2021, a decrease from 19.1 percent in 2020. Statutory liquid assets declined by 9.1 percent from P15.4 billion in 2020 to P14 billion in 2021. There was a notable improvement in the structure of the

³ In support of the allowances for loan moratoria that was initially granted for 6-months, the Bank of Botswana suspended the requirements for provisioning against loans qualifying for the payment moratorium. As of December 2020, the loans granted loan moratorium amount to P5.6 billion, (representing 8.5 percent of total loans).

balance sheet of the banking sector, as long-term deposits constituted 52 percent, while short-term deposits accounted for 48 percent of total deposits. If this trend is sustained, the maturity mismatch risk, an enduring feature of the Botswana banking sector, will ease.

14. Annual growth in bank credit was 5.1 percent in 2021 compared with 4.4 percent in 2020. On the other hand, customer deposits grew annually by 4.7 percent, while the average cost of deposits ratio was unchanged between 2020 and 2021, at 1.9 percent. The banking industry's cost-to-income ratio fell slightly to 60.3 percent from 61 percent in the previous year. The banking sector asset quality slightly improved as shown by the decrease in the ratio of non-performing loans to total loans and advances from 4.3 percent in 2020 to 4.2 percent in 2021.

15. At its October 2021 plenary meeting, the Financial Action Task Force (FATF) determined that Botswana had strengthened its anti-money laundering and combating the financing of terrorism and proliferation regime and addressed related technical deficiencies. Consequently, FATF removed the country from the list of countries subject to FATF enhanced-monitoring regime. The European Union (EU) also removed Botswana from the EU blacklist of high-risk third countries on January 7, 2022. The removal from the grey list is expected to have a positive effect on the domestic financial system and, more broadly, on the economic development of the country. In addition, the removal of Botswana from the FATF 'grey list' and EU blacklist, should help restore the reputation of Botswana as a transparent and credible investment destination as well as reduce the cost of correspondent banking relationship and access to global markets for Botswana-based economic agents. However, the specific FATF measures regarding AML/CFT risk-based supervision of financial institutions is still not effective since the latest Mutual Evaluation Report and first Follow-up Report from April 2019. Thus, it is crucial that all stakeholders ensure continuing compliance to minimize the risk of adverse listing of the country.

PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION

16. According to BoB's Financial Stability Report of May 22, 2022, over the twelve months to December 2021, the domestic economy expanded by 11.4 percent, compared with a contraction of 8.7 percent in the same period in 2021. Real GDP is projected to expand by 4.3 percent and 4.2 percent in 2022 and 2023, respectively. The prevailing accommodative monetary conditions, reforms to further improve the business environment, Government interventions against COVID-19, including vaccine roll-out to the productive population, implementation of the Economic Recovery and Transformation Plan (ERTP) and the Industry Support Facility (ISF) are key inputs in the growth projections for 2021 and beyond. The domestic macroeconomic environment will, however, continue to be shaped by the economic and price effects of the Russia-Ukraine war, COVID-19 profile and related containment measures and associated supply disruptions (<https://www.bankofbotswana.bw/>). The macroeconomic environment is conducive for the safety and soundness of the financial sector.

17. There is a well-established framework for financial stability policy formulation. The Financial Stability Council was officially launched in February 2019 and comprises the leadership of the Ministry of Finance, the BoB, Non-Bank Financial Institutions Regulatory Authority, and Financial Intelligence Agency (FIA) is involved in developing legislation and regulations, policymaking, and supervision with respect to the whole or facets of the financial sector.

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

19. There is a well-developed system of laws and regulations, including corporate, bankruptcy, and consumer protection laws as evidenced by the existence of the Competition and Consumer Authority intended for consumer protection. The court system structured as follows: Court of Appeal; High Court and Industrial Court (of the same status but the industrial court is exclusively a labor issues/matters court); Magistrates Courts; Customary Court of Appeal; Paramount Chief's Court/Urban Customary Court; Senior Chief's Representative Court; Chief's Representative's Court; and Headman's Court. A high-quality legal, accounting, and other business services are available as evidenced by the existence of the Institute of Internal Auditors dedicated to the professional development of internal audit profession in Botswana, and Statistics Botswana as the National statistical bureau of Botswana. The environment provides an enabling environment for the BoB to take prompt corrective action when it observes deterioration in bank solvency levels, to restructure and reorganize a troubled bank and in extreme circumstances, declare a seriously troubled bank insolvent. The BoB power is derived from Sections 11 and 33–34 of the Banking Act.

20. There are four credit bureaus in operation. A regulated environment for credit information sharing has been put in place following operationalization of the Credit Information Act, 2021(CI Act), which mandates the Bank to regulate the credit bureaus. Following commencement of the CI Act, the BoB, as the regulatory authority, engaged the four credit bureaus operating in the domestic market to formally apprise them of their obligations under the Credit Information Act and the Data Protection Act, 2018. There are four independent credit bureaus that have been operating before commencement of the CI Act, namely: Credit Reference Botswana (Pty) Limited; Experian Botswana; TransUnion Botswana; and, Micro Finance Credit Botswana.

21. The BoB maintains the capability to analyze all key economic policy issues that impact on the economy of Botswana, including both domestic and international developments. As well as detailed policy analysis, this includes the collection of necessary statistical data and conducting relevant research. The main focus is on the core mandate of the Bank. As with other central banks, this includes monetary policy; this in line with the principal objective of monetary

stability, as set out in the BoB Act. The same legislation also stipulates that the Bank shall advise on exchange rate policy, which it is also responsible for implementing on behalf of the Government.

22. Monetary policy entails the formulation and implementation of policies aimed at influencing interest rates and/or growth of the money supply to affect economic performance. This is particularly in relation to inflation; although monetary policy also has an impact on output growth, inflation, employment and the balance of payments. Implementation is typically entrusted to central banks, as is the case in Botswana where, under the BoB Act, the BoB has the principal statutory objective of maintaining monetary stability. Insofar as it is not inconsistent with this primary objective, the Bank is also expected to use its available policy instruments in support of orderly, balanced and sustained economic development in Botswana, as well as the attainment of broader national development goals.

23. Monetary policy in Botswana has evolved over time with an increasing focus on the goal of price stability. Price stability preserves the value of money. The current policy framework entails price stability as the main goal of monetary policy, indirect policy instruments, a framework for forecasting inflation, regular policy review meetings of the BoB's Monetary Policy Committee. Notwithstanding the similarity with the inflation targeting framework, the Bank does not as yet formally target inflation, as some of the essential pre-requisites are not in place. Implementation of monetary policy decisions is principally through open market operations conducted by the Financial Markets Department. The basics of monetary policy provide users with explanations of major concepts and essential terminology. The policy stance over the course of the year is publicly announced in the annual Monetary Policy Statement (MPS), that is released in February each year and reviewed in the Mid-Term Review of the MPS conducted in mid-year. Discussion and data relating to recent monetary policy developments are also included in other Bank publications, including Annual Reports.

24. The BoB implements monetary policy within a crawling peg arrangement that has been effective in maintaining macroeconomic and financial stability. The authorities recently introduced the new monetary policy rate that is expected to strengthen monetary transmission and help contain inflation pressures if properly applied. The authorities are considering the merits of further rate increases but are of the view that most inflation reflects higher import prices and that the non-diamond economy is still recovering. The BoB expects inflation to fall within the 3–6 percent target range by the first quarter of 2023.

DETAILED ASSESSMENT

25. The assessment of compliance of each principle will be made based on the following four-grade scale: compliant, largely compliant, materially noncompliant, and non-compliant.

A “not applicable” grading can be used under certain circumstances. While gradings in self-assessments may provide useful information to the authorities, these are not mandatory as the assessors will arrive at their own independent judgment.

- **Compliant:** a country will be considered compliant with a Principle when all essential criteria⁴ applicable for this country are met without any significant deficiencies. There may be instances, of course, where a country can demonstrate that the Principle has been achieved by other means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the Principle, and therefore other measures may also be needed in order for the aspect of banking supervision addressed by the Principle to be considered effective.
- **Largely compliant:** A country will be considered largely compliant with a Principle whenever only minor shortcomings are observed that do not raise any concerns about the authority’s ability and clear intent to achieve full compliance with the Principle within a prescribed period of time. The assessment “largely compliant” can be used when the system does not meet all essential criteria, but the overall effectiveness is sufficiently good, and no material risks are left unaddressed.
- **Materially non-compliant:** A country will be considered materially non-compliant with a Principle whenever there are severe shortcomings, despite the existence of formal rules, regulations and procedures, and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority’s ability to achieve compliance. It is acknowledged that the “gap” between “largely compliant” and “materially non-compliant” is wide, and that the choice may be difficult. On the other hand, the intention has been to force the assessors to make a clear statement.
- **Non-compliant:** A country will be considered non-compliant with a Principle whenever there has been no substantive implementation of the Principle, several essential criteria are not complied with, or supervision is manifestly ineffective.

26. In addition, a Principle will be considered not applicable when, in the view of the assessor, the Principle does not apply given the structural, legal and institutional features of a country.

⁴ For the purpose of grading, references to the term “essential criteria” in this paragraph would include additional criteria in the case of a country that has volunteered to be assessed and graded against the additional criteria.

27. The BoB has explicitly opted to be assessed against the essential and additional criteria but graded only with reference to the essential criteria.

A. Summary of Main Findings

Principles 1–2 Responsibilities, Objectives, and Powers

28. The BoB lacks adequate powers for effective supervision. The Banking Act has not changed since 1995 and despite recommendations of FSAP 2007 to amend the Banking Act for broader and stronger powers, progress had not been completed at the time of the mission. Many international regulatory and supervisory developments have occurred during the intervening period which have not been reflected in Botswana’s primary legislation. The Banking Act does not contain relevant prudential requirements for banks’ corporate governance, risk management, transactions with related parties, change of control etc. and does not provide enough powers to BoB on consolidated supervision, supervisory review process and other supervisory areas necessary for effective banking supervision. The recent passage of the BoBAA is the start of a necessary reform agenda to strengthen BoB powers.

29. While the legal framework provides the BoB with the powers to apply prudential requirements on an individual bank basis, in practice prudential requirements for capital and liquidity are uniform across all commercial banks. 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 will strengthen the BoB’s powers and set minimum prudential requirements for banks and banking groups based on their risk profile and systemic importance. There is need for a more frequent and comprehensive review of the regulatory framework to ensure they remain relevant to changing industry and regulatory practice. The current Banking Act was implemented in 1995 and has deficiencies such as an absence of provisions for consolidated supervision, major acquisitions and change in significant shareholding.

30. As for operational independence, although there is no evidence of political interference, multiple provisions within the legislation may impede operational independence of the BoB. The Banking Act empowers the minister to overrule BoB’s decision, in the case of appeals for banking license rejections. The Banking Act provides for several circumstances where ministerial approval is required which may interfere with the BoB’s operational independence. Additionally, ministerial representatives are sitting in the BoB Board, no legal protection for supervisors against legal costs which are specific areas within the BCP methodology needed to achieve operational independence. At the time of the mission, the Banking Act is being revised and at an advanced stage. Though Sections 15(2) to (5) of the Banking Act 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. While the Banking Act is being reviewed, the Banking Bill does not address appointments or removal thereof of Governors and

Deputy Governors. Rather, the provision would be in the BoB Act, implying that even after enactment of the Banking Bill, the law would not address the concerns.

31. The primary legislation does not specify the BoB’s primary responsibility for promoting safety and soundness of banks and the banking system. 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.

Principle 3 Cooperation and Coordination

32. Effective cooperation and coordination are particularly important in Botswana given the structure of the banking system with eight of nine commercial banks subsidiaries of foreign banks. Arrangements are in place for domestic cooperation and coordination, such as the FSC with MoUs executed with all participants. Cooperation and coordination at a foreign supervisor level was evidenced and contributing to the effective supervision of banks mainly the supervisory college process. With the banks diversifying their business models through exploring bancassurance and wealth management activities (e.g., capital markets, broking etc.), greater cooperation and collaboration in routine supervision is warranted, although the mission acknowledges the relatively minor contribution to group revenue from the non-bank activities.

Principles 4 & 5 Permissible Activities and Licensing

33. Permissible activities are clearly defined in the Banking Act. The legislation is clear and consistent in its determination of what constitutes a bank, limitations on firms not using the word “bank” and the activities undertaken by a bank are clearly defined in the legislation. Permissible activities are also clearly defined. To complement the legislation is the Licensing Policy which is strict in terms of what activities can be licensed as a bank.

34. The Banking Act empowers BoB to be the sole licensing authority of institutions intending to conduct banking business, while statutory banks derive mandate from statutes established by Acts of Parliament. Over the last five years, BoB has received four bank license applications from domestic entities. Of those, two applications were withdrawn, one was rejected, and one application was granted with conditional approval. BoB demonstrated a structured approach to assessing license applications supported by a comprehensive licensing policy that specifies the tests to be carried out to ensure that banks appoint directors and senior management officials that are fit and proper. The policy also specifies the need for applicants to submit suitable operating plans, sound systems of corporate governance and disclose the sources of initial capital as well as the applicant’s ability to provide additional capital should the need for capital injection arise. Processes for assessing the suitability of ultimate beneficiary owners are not sufficiently robust and need to be strengthened.

35. After licensing, however, there are no special requirements for newly established banks in terms of an enhanced prudential cycle and reporting requirements. While the BoB conducts a pre-operation inspection of the bank to ensure adequacy of systems, an onsite

examination should be scheduled ideally within the first 12 months to verify the effective implementation of the bank's internal controls, risk management framework and governance functions. Internal guidelines should be developed to assist supervisors to detect early signals of emerging weakness or stress for a newly licensed bank.

Principles 6 and 7 Transfer of Significant Ownership and Major Acquisitions

36. The Banking Act has no definition of significant ownership. In practice, the BoB relies on the Guidelines on Significant Shareholding to assess a change of significant shareholding (which is made public on the BoB website). The minimum threshold for an assessment starts at 5 percent with the next threshold at 20 percent, then 33 and finally 50 percent. Over 50 percent shareholding, a control change is assessed. In practice, the BoB applies the licensing framework to assess proposed changes in significant shareholding which are relatively complete for licensing and can be adapted to assess changes in shareholding. However, there are also no requirements to obtain the Bank's approval for change of control or voting rights in a bank. Notification is only done at the initial licensing stage. 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.

37. A framework for major acquisitions is not provided for in the primary legislation, and while the Banking Act contains countervailing measures, it is questionable whether the supervisor has the necessary powers to fulfil the specificities (and often unique) circumstances of a merger acquisition. It is understood that the new Banking Act will address these deficiencies with explicit references to mergers and acquisitions. Additionally, internal guidance has been developed to provide greater support for supervisors when assessing these applications.

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

38. The BSD adopts a risk-based supervision framework with a mix of onsite and offsite surveillance tools and techniques. The BSD conducts offsite analysis of statutory returns (submitted on daily, weekly, monthly, quarterly and annually) which provides an opportunity to regularly assess the financial condition of banks and evaluate compliance with prudential requirements. On an annual basis, the BSD meets with bank senior management through a range of structured meetings and on an ad hoc basis if necessary. Onsite examinations are performed according to the RBS methodology on a maximum three-year cycle. The full scope onsite examination is a deep-dive assessment of all material risk categories (e.g., credit, market, operational risks etc.). Onsite and offsite activities are well structured and supported by internal guidance and thorough manuals that describe the intended inputs, outputs, procedures, timelines, and approvals.

39. The mission suggests that a quality assurance assessment and back-testing be undertaken to evaluate the effectiveness of the methodology to support a risk-based approach to supervision. The BSD has implemented a hybrid approach which combines the CAMEL risk rating methodology (which is purely quantitative) with a qualitative assessment of the bank's risk management. Factors include: (i) how well the methodology identifies risk; (ii) the effectiveness

of forward-looking analysis; (iii) that offsite and onsite assessments are integrated to provide a forward-looking assessment of risk; (iv) how effective is the methodology calibrated for risk and impact.

40. Further work is needed to strengthen the supervisory approach and tools. There is scope to apply a differentiated approach to supervision for banks and banking groups proportionate to risk profile and systemic importance. Greater differentiation in supervisory approach is warranted for larger more systemically important banks such that they receive more proportionally more attention and heightened expectations for risk management and governance. There is scope for more forward-looking analysis to identify early emerging risks, especially with more frequent contact with the non-executive independent directors to discuss issues relevant to risk governance and the effective implementation of risk management. Finally, greater attention dedicated to the assessment of bank ICAAPs as a comprehensive assessment of risks and capital adequacy.

41. Other measures to strengthen supervision include developing internal guidelines for the handling of distressed or weak banks. Guidelines would help support supervisors to identify signs of emerging weakness and act more swiftly using targeted measures. In terms of the supervision cycle, more periodic meetings with management and Board of Directors could be used to support the onsite examination timetable. These type of formal routine engagements could be used to update changes in business model and risk management. Finally, use of system-wide stress tests to identify the build-up of systemic risks and outliers of individual banks could be used. At present, these types of exercises are not used.

42. An automated system to perform validation checks should be implemented. Currently validation checks are performed manually which is time intensive. The BSD is in the process of implementing a new system that will free up time for supervisors to concentrate on risk assessments. The reporting requirements should also be adjusted for the systemic importance of banks. Finally, reporting instructions should be comprehensively reviewed on a regular basis to ensure they remain commensurate with the needs of the BSD and the changing nature of banks and the banking system.

43. In relation to group-wide analysis, the awareness of the insurance activities could be expanded in the first instance and subsequently other activities within the group. While immaterial from a revenue or asset perspective, there are potential non-financial risks which could expose the group to risk (e.g., contagion). There was limited evidence that inputs regarding non-bank activities had a material impact on the risk assessment of banks in the routine supervisory cycle i.e., materials, data, risk information etc. that would inform the BoB regarding broader indicators of risk across the group.

CP 11 and 12 – Corrective Measures and Consolidated Supervision

44. **The BoB has traditionally used moral suasion to enforce prudential standards.**

Supervisory concerns are typically communicated to bank management and in the case of onsite examination findings to the Board. In practice, there has been limited experience using sanctioning powers provided for in the Banking Act. Equally, there is limited experience restricting bank licenses and applying more conservative prudential requirements on individual banks (such as higher minimum capital requirements). Formal guidelines for handling problem and weak banks have not been developed and there is also no formal framework for supervisors linking the CAMEL risk rating system and approaches to corrective actions. BoB does not have a formulated corrective action policy framework for distressed banks, although it has some of its elements in the form of regular prudential requirements.

45. The Banking Act does not provide for consolidated supervision which gives the supervisor power 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. Reforms to the Banking Act are intended to provide for consolidated supervision. The BoB participates in supervisory college meetings that provide platforms to understand the risk profiles of banks and other issues of supervisory interests. In addition, the bank holds bilateral supervisory meetings with and host supervisors to discuss key issues. The MOUs allows sharing of information between the BoB and other supervisors of the entity of interest. In addition, the Bank has concluded Guidelines on Supervision of Financial Conglomerates which will be issued to the market after the enactment of the Banking Bill. While the activities of bank subsidiaries are minimal (measured in terms of total revenue and assets), greater attention to consolidated supervision will be needed as banks diversify their business models into non-bank activities.

CP 13 – Home/Host

46. BoB actively participates in supervisory colleges for at group level with effective two-way sharing of information. Until recently (mid2022) BoB was not a home supervisor to any bank or banking group with all eight commercial banks foreign bank subsidiaries. The recent demutualization of a building society and re-licensing as a commercial bank, means BoB is the home supervisor for one bank. In relation to the foreign bank subsidiaries, BoB has signed MoUs with most home supervisors of parent entities. Planning and conducting onsite examinations are one example where the BoB could be more proactive and deepen their collaboration with home supervisors. While there have been examples of joint supervisory activities, the number of examples is limited across the population of banks.

47. Group resolution plans have been developed by the parent groups; however, resolution plans have not been prepared for the commercial banks supervised by BoB. BoB has recently developed a D-SIB framework which includes resolution. The framework designates two banks are D-SIBs. In addition, two the D-SIB framework, the Banking Act is under revision which has explicit provisions for resolution planning. BoB has not participated in supervision cross border does not coordinate and plan supervisory activities with any home supervisors.

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

48. Material deficiencies exist in relation to regulations for corporate governance. 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. 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. 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. BoB reviews the continued fitness and propriety of the board members every year. Although the Board is assessed under individual risks in BoB’s risk-based supervisory framework that supplements CAMEL framework – BoB does not undertake formal documented assessment of the board members’ effectiveness or if they exercise their duty of care and duty of loyalty, 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. BoB is yet to assess availability and adequacy of these. 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. While some of these deficiencies are expected to be addressed through the proposed Banking Bill and draft guidelines on corporate governance, additional guidance to supervisors is needed to improve ongoing supervision.

49. 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 Basel Core Principles by making internal audit risk-based, requiring internal audit functions to review the resources in control functions, and expanding supervisory assessments to explicitly include assessment of adequacy of staff assigned to compliance function, their skillsets, experience, and training. BoB should obtain legal 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 the power to access the working papers of external auditors, as that might be required in rare but extreme situations.

Capital (CP 16)

50. The capital adequacy framework for banks is largely aligned with the Basel framework and proportionate to the risks and complexities of the local banking industry, with minimum capital requirements being set significantly higher than under the Basel framework. The definition of capital and components of capital are aligned with Basel III requirements, while the methodologies/ approaches for determining the risk weighted assets for the Pillar 1 risks (credit market and operational) are as per Basel II. No bank is implementing the advanced approaches for computing risk weights. 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. This reflects a high level of Tier 2 capital in the system (about 32 percent of total regulatory capital). All banks are required to make their Pillar 3 disclosures annually on their websites and with their published financial statements.

51. All banks are required to submit their ICAAP assessment annually, however, BoB needs to develop appropriate methodologies to assess Pillar 2 risks and the additional capital that banks might need to hold for such risks. BoB supervisors review the ICAAP documents annually but have not yet felt the need to require a bank to hold additional capital as a Pillar 2 requirement. BoB should consider developing appropriate supervisory methodologies to assess ICAAP documents and Pillar 2 risks (e.g., concentration risk, interest rate risk in banking book, liquidity risk) and the additional capital that banks might need to hold to make the additional capital more sensitive to individual banks' specific risk profiles.

Risk Management (CP 15, 17–25)

52. BoB has established regulatory and supervisory frameworks that promote a culture of overall risk management among banks. Supervisory guidance for assessing risk management in banks is available at a high level. Supervisors can benefit from more detailed and specific guidance on, among others, how they can undertake closer or more focused supervision on banks' risk management, 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. Thanks to technological developments, advances made in quantifying risks, accepted practice of conducting stress tests at least annually, implementation of IFRS-9, and the importance of adopting a forward-looking approach to business and capital planning, banks are deploying financial models in increasing numbers. This exposes banks to model risks, which is an area where BoB can articulate explicitly the regulatory requirements and supervisory expectations.

53. The supervisory approach to management of problem assets, provisions and reserves by banks needs revision. Banks in Botswana are implementing IFRS 9. BoB has issued prudential norms for loan classification that acts as a backstop to accounting standards. For provisioning, BoB places reliance on accounting standards and external auditors. This involves the extensive use of internal models for provisioning where the model outputs could be influenced by non-availability of appropriate data, their quality and history, assumptions, and model risks. In this background, the absence of prudential backstop for provisioning affects supervisory oversight on provisioning adequacy. BoB guidelines on capital adequacy establish the list of eligible collateral for capital adequacy purposes, which is mainly financial collaterals. These guidelines do not cover physical collaterals (such as movable and immovable collateral). BoB guidelines need to be improved to provide clarity on all eligible collateral, their valuation, and the governance around valuation. Development of additional guidance for supervisors, supervisory tools/methodologies and more granular offsite data is needed to improve supervisory effectiveness. BoB should supplement this

with periodic system-level analyses of trends and concentrations in relation to banks' problem assets, risk mitigants and risk mitigation strategies to inform system level policy and response.

54. Regulation and supervision of exposures to and transactions with related parties need substantial improvement. 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, gaps in the governance requirements related to assumption and management of related party exposures and transacting with related parties, 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.

55. Supervision of country and transfer risks need to be explicitly established. BoB has issued a regulation that requires banks to establish appropriate risk management policies, procedures, and arrangements for managing country and transfer risks, but is missing a few elements such as grading and provisioning of country risk. Laws or regulation do not explicitly require banks to assess country and transfer risks from both immediate risk and ultimate risk perspectives, Supervision of banks' management of country and transfer risks is not explicit in the current onsite and offsite frameworks. The absence of appropriate offsite reporting and analyses, and absence of adequate guidance to supervisors for conducting supervision needs to be addressed in both areas.

56. Regulatory and supervisory frameworks for some key risk areas need significant improvement and BoB's expectations regarding banks' risk management framework needs clarification. The key risk areas needing improvement include: credit concentration (expectations on industry, geographic, collateral concentrations are not adequately explicit or detailed; prudential limit for exposure to single counterparty or group of inter-connected counterparty is too liberal – effectively at 44 percent of Tier 1 capital, with scope for assuming higher exposure with BoB approval), IRRBB (need for greater clarity on measurement of risk with reference to economic value impact on equity), market risk (need clarity on trading book and related discipline, and marking to model, derivative activities, stress testing), and operational risk (clarity on requirements related to outsourcing and operational risk event and loss database). Offsite reporting and analyses and more detailed guidance to supervisors are needed to make supervision more effective for these risks.

57. There is a need to develop guidance for supervisors and supervisory methodologies to encourage higher standards of liquidity risk management. While all banks are meeting the liquid assets ratio (a stock measure) set by the BoB, there is a maturity mismatch which is causing stress on bank liquidity management. The intermediation ratio and deposit concentration ratio, which can help detect funding risks, are monitored by BoB but are not used effectively in the absence of formal supervisory thresholds. Inclusion of a flow approach to liquidity risk management, establishing supervisory thresholds for ongoing monitoring, enhanced reporting requirements can help

strengthen liquidity risk management in banks, and their supervision. These need to be supported by suitable modifications to supervisory reporting and analyses.

Abuse of Financial Services (CP 29)

58. AML/CFT has received heightened attention by the BoB designed to strengthen standards of risk management. The FI Act (and its Regulations) is the main piece of legislation setting out anti-money laundering and countering the financing of terrorism. A dedicated team within the BoB BSD consisting of five staff) undertaken onsite and offsite analysis of bank compliance with AML/CFT obligations as stated in the FI Act. The BoB undertakes a range of supervisory activities throughout the supervisory cycle that include risks associated with AML/CFT (see also CPs 8 & 9 for a description of BoB's supervisory tools, techniques, and approaches). In relation to the efforts of BoB's supervisory framework, the move to a risk-based approach has commenced with a newly implemented early warning tool. Effective implementation of the tool will help better profile higher risk banks and adjust the supervision cycle accordingly. The mission saw evidence of greater attention being allocated to AML/CFT and integrated into risk-based activities including annual bilateral meetings, on-site examinations, and follows up on quarterly updates of supervisory concerns until all shortcomings are adequately addressed.

59. There is scope for further progress to raise standards of risk management to detect and prevent money laundering and countering terrorist financing. Full implementation of the supervision methodology will help support a risk-based approach to supervision. More frequent data should be collected as inputs into offsite surveillance (currently STR data is submitted by the FIA to the BoB every six months). Addressing outstanding issues identified in the most recent FATF follow-up report (April 2021) will be important. In addition, offsite analysis of bank policies and procedures could complement data reported. Lastly, closer feedback loop between BSD risk assessments and staff responsible for AML/CFT would help identify early group-wide weaknesses in risk management. Transition to a formal framework for consolidated supervision will also help strengthen supervision and help encourage greater compliance with this Principle.

B. Supervisory Powers, Responsibilities and Functions

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| Principle 1 | Responsibilities, objectives and powers. An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups. ⁵ A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorize banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns. ⁶ |
| Essential criteria | |
| EC1 | The responsibilities and objectives of each of the authorities involved in banking supervision ⁷ are clearly defined in legislation and publicly disclosed. Where more than one authority is responsible for supervising the banking system, a credible and publicly available framework is in place to avoid regulatory and supervisory gaps. |
| Description and findings re EC1 | <p>The authority for bank supervision in Botswana is established in the Bank of Botswana Act, 1996 (BoB Act). The BoB has primary responsibility for the prudential supervision of banks in Botswana. The Financial Intelligence Agency (FIA), empowered by the Financial Intelligence Act, 2022, also supervises banks on anti-money laundering and combatting the financing of terrorism and proliferation of proceeds of crime.</p> <p>The banking system is comprised of nine commercial banks (a building society demutualized in 2022 and became licensed as a commercial bank), three statutory banks and one micro-finance lender which all come under the supervision authority of the BoB. Non-bank financial institutions are supervised separately from the BoB by the Non-Bank Institutions Regulatory Authority (NBRA) which has oversight for the following institutions: pension funds, insurance companies, brokers and agencies, stockbrokers, collective investment undertakings, and Botswana Stock Exchange.</p> <p>A multi-agency Financial Stability Council (FSC) was established to, among others, discuss policy issues on how the financial system could be strengthened and made more robust, in order to mitigate financial stability risks, and take prompt action in response to a perceived build-up of systemic risks; ensure a coordinated response to financial stability issues that may require cross-agency collaboration; and to request information from any financial institution, exchange information on financial stability issues, and communicate systemic risk warnings. The FSC is not a decision-making body; it is a coordinating and cooperation mechanism. It is the responsibility of the</p> |

⁵ In this document, “banking group” includes the holding company, the bank and its offices, subsidiaries, affiliates and joint ventures, both domestic and foreign. Risks from other entities in the wider group, for example non-bank (including non-financial) entities, may also be relevant. This group-wide approach to supervision goes beyond accounting consolidation.

⁶ The activities of authorising banks, ongoing supervision and corrective actions are elaborated in the subsequent Principles.

⁷ Such authority is called “the supervisor” throughout this paper, except where the longer form “the banking supervisor” has been necessary for clarification.

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| | <p>respective entities to ensure that relevant macroprudential instruments are timeously activated to combat vulnerabilities, with a view to maintaining long-term financial stability.</p> <p>The FSC comprises senior officials of the Ministry of Finance (MoF), the BoB, Non-Bank Financial Institutions Regulatory Authority (NBFIRA) and the Financial Intelligence Agency (FIA). The FSC is chaired by the Governor, while the Bank acts as the secretariat. The work of the FSC is governed by a memorandum of understanding (MoU), which underscores the FSC’s commitment to ensuring a stable and resilient domestic financial system.</p> <p>The primary objective of the macroprudential policy framework is to limit systemic risk and its transmission to the broader economy. This is predicated on the observation that the financial system is interconnected and vulnerable to contagion risk, with the result that financial crises can spill over more rapidly to the real economy. At the same time, sectoral or broader economic weaknesses could adversely affect the financial system and trigger instability or crisis. In turn, this can cause widespread disruption to the provision of financial services, with serious negative consequences for macroeconomic stability and the real economy.</p> <p>Regarding credit bureaus, the Credit Information Act, 2021 and the Credit Information Regulations, 2022, empowers the BoB to regulate these entities. In that regard, following commencement of the statutes, the BoB had a meeting with the four credit bureaus in the market to formally communicate to them their statutory obligation.</p> <p>In terms of public disclosure and transparency of financial sector oversight responsibilities, the BoB Act is publicly disclosed through the Ministry of Finance.</p> |
| <p>EC 2</p> | <p>The primary objective of banking supervision is to promote the safety and soundness of banks and the banking system. If the banking supervisor is assigned broader responsibilities, these are subordinate to the primary objective and do not conflict with it.</p> |
| <p>Description and findings re EC2</p> | <p>Section 4 of the BoB Act set out the principal objectives of the BoB which is inconsistent with this EC, namely to promote the safety and soundness of banks and banking systems. Instead, the legislation stipulates that the principal objective of the BoB shall be to first and foremost promote and maintain monetary stability, an efficient payments mechanism and the liquidity, solvency and proper functioning of a soundly based monetary, credit and financial system in Botswana. This is not fully aligned with the requirements of this EC as safety and soundness is not the principal objective. A broader definition of the BoB’s mandate is a meaningful departure from the requirements of CP1.</p> <p>To achieve these goals, the BoB undertakes the following:</p> |

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| | <ul style="list-style-type: none"> - sets transparent criteria, guidelines and other requirements for market entry as stipulated in licensing policies; - establishes and updates on a regular basis, prudential policies and standards; - monitors solvency, liquidity, large exposures, insider loans, provisioning and risk management, as well as the adequacy of risk management and governance structures for the safe and sound operation of banks; - establishes effective systems for offsite surveillance and on-site examinations, including reporting, accounting auditing and disclosure standards; - ensure timely enforcement of supervisory actions and compliance with the banking sector and other related laws governing the operations of banks in Botswana; and - maintains general market surveillance, monitors and investigates unlicensed or illegal deposit-taking activities and practices to protect the public and integrity of the banking system. <p>The supervision activities listed above are not directly transposed in the primary legislation. While the activities are consistent with the supervision of banks, the activities are not formally codified and are subject to change.</p> |
| EC3 | <p>Laws and regulations provide a framework for the supervisor to set and enforce minimum prudential standards for banks and banking groups. The supervisor has the power to increase the prudential requirements for individual banks and banking groups based on their risk profile⁸ and systemic importance.⁹</p> |
| Description and findings re EC3 | <p>BoB is empowered to set prudential rules in respect of institutions it licenses and supervises. Sections 13 – 17 of the Banking Act gives the BoB powers to set and enforce prudential standards for banks. The BoB Act establishes provisions for powers to authorize banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness. In addition to the primary legislation, the regulatory architecture developed by the BoB includes: regulations, directives, circulars and guidelines. These secondary rules augment the primary legislation with greater specificity regarding prudential requirements and guidance for governance and risk management including calculating capital adequacy, liquidity risk management, large exposures, fit and proper assessments of boards etc.</p> <p>With regards to systemically important banks, the BoB has designated two commercial banks as domestic systemically important banks (D-SIBs) and is in the process of implementing a framework that will govern its approach to supervision commensurate with their size, scale, risk profile and systemic importance. At the time of the mission, the framework is currently in the early stages of implementation. While a comprehensive assessment of the D-SIB framework was not conducted, a brief review</p> |

⁸ In this document, “risk profile” refers to the nature and scale of the risk exposures undertaken by a bank.

⁹ In this document, “systemic importance” is determined by the size, interconnectedness, substitutability, global or cross-jurisdictional activity (if any), and complexity of the bank, as set out in the BCBS paper on *Global systemically important banks: assessment methodology and the additional loss absorbency requirement*, November 2011.

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| | <p>suggests it is based on international standards and will give the BoB an operational approach to differentiating its supervision for systemic banks.</p> <p>While the legal framework provides the BoB with the necessary powers to increase the prudential requirements, in practice BoB uses moral suasion to enforce prudential requirements with few examples where the Banking Act was needed. All prudential requirements for capital and liquidity are applied consistently across the banks despite their size, scale, risk profile or systemic importance. At the time of the mission, revisions to the Banking Act were at an advanced stage which are designed to strengthen BoB's powers. Furthermore, the planned implementation of the D-SIB framework should help support the application of minimum prudential requirements to reflect the systemic importance of banks and banking groups.</p> |
| EC4 | <p>Banking laws, regulations and prudential standards are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices. These are subject to public consultation, as appropriate.</p> |
| Description and findings re EC4 | <p>The Banking Act has not been subject to regular review and essential updates have been omitted for a significant period leading to material deficiencies in the regulations and prudential standards. The primary legislation was last revised in 1995 and while the Banking Act and its regulations are currently being reviewed and amended to accommodate new developments, material deficiencies exist in several areas, such as: corporate governance, risk management, transactions with related parties etc. These deficiencies in the Act undermines the BoB's ability to effectively supervise banks and the banking system.</p> <p>The review of the Act, regulations and relevant standards are subject to public consultations, as appropriate. Typically, guidelines and directives are reviewed when the Bank for International Settlements reviews standards and principles on which the BoB regulatory framework endeavors to follow. For example, circulars have been added to adapt to new accounting standards (IFRS).</p> <p>As mentioned above, there is need for a more frequent and comprehensive review of the regulatory framework. The current Banking Act was implemented in 1995 and has extensive deficiencies which have been addressed in later CPs; for example, an absence of provisions for consolidated supervision (see also CP12), major acquisitions (see CP7) and change in significant shareholding (see CP6).</p> |
| EC5 | <p>The supervisor has the power to:</p> <p>(a) have full access to banks' and banking groups' Boards, management, staff and records in order to review compliance with internal rules and limits as well as external laws and regulations;</p> |

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| | <p>(b) review the overall activities of a banking group, both domestic and cross-border; and</p> <p>(c) Supervise the activities of foreign banks incorporated in its jurisdiction.</p> |
| Description and findings re EC5 | <p>(a) Section 47 and 48 of the BoB Act empowers the BoB to have full access to banks' and banking groups' boards, management, staff and records in order to review compliance with internal rules and limits as well as external laws and regulations. Section 24 of the Banking Act empowers the BoB to conduct on-site examination of the operations and affairs of every bank licensed in Botswana. The assessors saw evidence of free access to banks' Boards, management, staff and records.</p> <p>(b) Eight of the nine commercial banks operating in Botswana are foreign owned, but BoB does not practice consolidated supervision. The Banking Act is being reviewed to include a section on consolidated supervision.</p> <p>(c) BoB has powers to ensure compliance with prudential rules and takes steps to ensure that banks operate prudentially.</p> |
| EC6 | <p>When, in a supervisor's judgment, a bank is not complying with laws or regulations, or it is or is likely to be engaging in unsafe or unsound practices or actions that have the potential to jeopardize the bank or the banking system, the supervisor has the power to:</p> <p>(a) take (and/or require a bank to take) timely corrective action;</p> <p>(b) impose a range of sanctions;</p> <p>(c) revoke the bank's license; and</p> <p>(d) cooperate and collaborate with relevant authorities to achieve an orderly resolution of the bank, including triggering resolution where appropriate.</p> |
| Description and findings re EC6 | <p>BoB has discretion in exercising powers to ensure compliance with its prudential rules. Section 33 – 34 of the Banking Act empowers BoB to take temporary management responsibility for a bank and ultimately revoke the license (Section 11 of the Banking Act) and petition courts for a winding-up (Section 35 – 38 of the Banking Act).</p> |
| EC7 | <p>The supervisor has the power to review the activities of parent companies and of companies affiliated with parent companies to determine their impact on the safety and soundness of the bank and the banking group.</p> |
| Description and findings re EC7 | <p>The existing legal and regulatory framework does not establish the legal powers for the BoB to review the activities of parent companies and of companies affiliated with parent companies. However, the legal framework is being revised and is at an advanced stage of drafting. The draft of the new Banking Act explicitly provides for consolidated supervision and will establish legal powers for the BoB to review the</p> |

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| | <p>activities of parent companies and their affiliates consistent with this criteria (see also CP12).</p> <p>In practice, the BoB takes into account the risk profile of parent companies in their routine supervision and risk assessments.</p> |
| Assessment of Principle 1 | Materially non-compliant |
| Comments | <p>There are material deficiencies in CP1. Firstly, the primary legislation does not specify the BoB's primary responsibility for promoting safety and soundness of banks and the banking system (see EC2). 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).</p> <p>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 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.</p> <p>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</p> |

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| | 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. |
| Principle 2 | Independence, accountability, resourcing and legal protection for supervisors. The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor. |
| Essential criteria | |
| EC1 | The operational independence, accountability and governance of the supervisor are prescribed in legislation and publicly disclosed. There is no government or industry interference that compromises the operational independence of the supervisor. The supervisor has full discretion to take any supervisory actions or decisions on banks and banking groups under its supervision. |
| Description and findings re EC1 | <p>Sections 3 – 12 of the Banking Act gives BoB the authority to grant and withdraw banking licenses of banks. Statutory banks are authorized to conduct banking business in accordance with specific statutes, although they fall within the supervisory purview of the BoB under delegated powers of the Ministry of Finance (MoF) with respect to business prudential matters only. On other matters related to statutory banks, BoB uses moral suasion. Although there is no political interference in BoB’s supervisory work, Section 7 of the Banking Act empowers the Minister to overrule BoB’s decision, in the case of appeals for banking license rejections. There was no evidence that the BoB is not able to exercise its full discretion in supervision of banks.</p> <p>As to the composition of the BoB, as per section 9 (1) of the BoB Act, the BoB Board consists of the Governor as Chairman. And eight other members with a total of nine. The Deputy Governors are entitled to attend as non-voting unless acting as Chairman or unless they are appointed to the Board (per Section 10 of the BoB Act). The current Board consists of the following members:</p> <ul style="list-style-type: none"> • Board Chairman and Governor BoB; • Permanent Secretary MoF • Industry background • Private sector, consultant • Private sector, Okavango Diamond Company • Government affiliated, Chair of Competition and Consumer Authority, Academic • Private sector, legal • Industry, Botswana Export Development and Investment Authority <p>The appointment of the other BoB board members is provided for in section 10 of the BoB Act. Appointments are for a term of four years (Section 10(3)). No more than two</p> |

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| | <p>members shall be public offers (section 10(2)). Currently, only one member of the BoB Board is serving in public office.</p> <p>In terms of supervisory accountability the BoB produce an annual report which presents information on the structure, performance and general state of the banking industry as well as banking regulation and supervision developments in Botswana during the year. In accordance with Section 28 of the Banking Act (Cap. 46:04), the Bank of Botswana (Bank) is required to submit to the Minister of Finance, by June 30 each year, a report on the business affairs of all banks and of all persons or institutions whose affairs were examined by the Bank and all other pertinent matters, which the Bank dealt with during the year under review. The Bank has consistently complied with this statutory requirement. The report contains a range of details to engender supervisory accountability including:</p> <ul style="list-style-type: none"> • Licensing; • BoB’s supervision activities and highlights of the onsite examination of banks and prudential meetings; • Regulatory developments, • Participation in international and domestic regulatory and supervisory forums such as supervisory colleges; and • Banking system data. <p>The BoB adopts a structured approach to decision-making. The Banking Supervision Department organizational structure consists of a Director with four direct reports:</p> <ul style="list-style-type: none"> • Deputy Director Regulatory Policy and Licensing Division; • Deputy Director Prudential Supervision Division; • Deputy Director Business Conduct; and • Deputy Director Bureaux de Change Supervision Division. <p>Within each of the four Divisions are Principal Bank Examiners, Senior Bank Examiners and Bank Examiners. Offsite supervision processes are structured around the delegation framework with approval, oversight and sign-off. Approvals such as licensing are made via committees consisting of delegated members with experience and expertise.</p> |
| EC2 | <p>The process for the appointment and removal of the head(s) of the supervisory authority and members of its governing body is transparent. The head(s) of the supervisory authority is (are) appointed for a minimum term and is removed from office during his/her term only for reasons specified in law or if (s)he is not physically or mentally capable of carrying out the role or has been found guilty of misconduct. The reason(s) for removal is publicly disclosed.</p> |
| Description and findings re EC2 | <p>BoB Governor and Deputy Governors are appointed by the President for a term not exceeding 5 years as outlined in Section 13 of the BoB Act. Section 15(2) of the BoB Act disqualifies the Governor and Deputy Governors for inability to perform the</p> |

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| | <p>functions of the office or for gross misconduct and other ills. Such ills include officers' insolvency, being convicted of criminal offence. The Banking Act is however silent in terms of disclosure requirements in the case of the Governor being removed from that position. The BoB Act is being reviewed to specify and publicly disclose reasons for dismissal of a Governor and Deputy Governors.</p> <p>Appointing Governor is under Section 13(1) appointment by President and eligibility criteria of "person recognized experienced in financial matters" per Section 13(2). Who appoints is clear, and their eligibility reasonably clear. The process to appoint not prescribed.</p> <p>Removal is set out in Section 15 of the BoB Act. It is the President that can remove the Governor (Section 15(3)) based on criteria such as: becomes disqualified (Section 14); insolvent or declared bankrupt (Section 15(1)(b)); convicted of an offense; has been disqualified from a professional qualification. The process is via a tribunal set up by the President see Section 15(3) with the Tribunal chaired by a judicial officer, not less than two other people, experienced in banking and finance with authority for the President to remove the Gov or DG under Section 15(4).</p> <p>The relevant sections of the BoB Act do not prescribe the process to be publicly disclosed so this CP is not fully met.</p> |
| EC3 | The supervisor publishes its objectives and is accountable through a transparent framework for the discharge of its duties in relation to those objectives. ¹⁰ |
| Description and findings re EC3 | The principal objectives of the BoB are contained in Section 4(1) of the BoB Act. BoB is accountable for the discharge of its duties in relation to those objectives (see also CP1). The BoB website details the BoB's objectives. Furthermore, the Supervision Department of the BoB publishes an annual report containing a comprehensive description of its activities throughout the year. |
| EC4 | The supervisor has effective internal governance and communication processes that enable supervisory decisions to be taken at a level appropriate to the significance of the issue and timely decisions to be taken in the case of an emergency. The governing body is structured to avoid any real or perceived conflicts of interest. |
| Description and findings re EC4 | <p>Section 17(1) of the BoB Act mandate that the appointment of the Bank's employees be done according to positions sanctioned by the Bank's Board, on terms and conditions prescribed by the Board. There is effective segregation of duties throughout all structures of the Bank, with elaborate job descriptions.</p> <p>Section 18 deals with conflicts of interest with clear prohibitions on members being subject to direction, from receiving financial benefits. Requirements to disclose any interests (Section 18(2)) and this extends to every officer and employee of BoB. The Banking Supervision Department (BSD) has in place an effective framework for</p> |

¹⁰ Please refer to Principle 1, Essential Criterion 1.

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| | <p>decision making at each level together with escalation requirements and delegations. Evidence of this was seen throughout the BSD with respect to analysis of statutory reporting, decisions from onsite examinations and licensing.</p> <p>In terms of structure, the Head of BSD reports to the Deputy Governor which in turn reports to the Governor. Within the BSD, there is a clear structure of reporting which supports decision making. Internal guidelines and manuals stipulate the responsibilities of staff for the production of reports, and associated signoffs as well as timelines. A structured and clear decision-making framework was evidenced for example with respect to offsite analysis and onsite examination reports.</p> |
| EC5 | The supervisor and its staff have credibility based on their professionalism and integrity. There are rules on how to avoid conflicts of interest and on the appropriate use of information obtained through work, with sanctions in place if these are not followed. |
| Description and findings re EC5 | The minimum entrance qualification for bank supervisors is a bachelor's degree in specified fields appropriate for the job, in accordance with Section 17(1) of the BoB Act. There is a code of conduct to be observed by all staff members. Section 43(7) of the Banking Act and Section 19(1) of the BoB prohibit disclosure of information obtained through work to any person unless required by a court of any competent jurisdiction to do so. In addition, Section 18 of the BoB Act outlines rules on how to avoid conflict of interest by employees of BoB. |
| EC6 | <p>The supervisor has adequate resources for the conduct of effective supervision and oversight. It is financed in a manner that does not undermine its autonomy or operational independence. This includes:</p> <ul style="list-style-type: none"> (a) a budget that provides for staff in sufficient numbers and with skills commensurate with the risk profile and systemic importance of the banks and banking groups supervised; (b) salary scales that allow it to attract and retain qualified staff; (c) the ability to commission external experts with the necessary professional skills and independence, and subject to necessary confidentiality restrictions to conduct supervisory tasks; (d) a budget and program for the regular training of staff; (e) a technology budget sufficient to equip its staff with the tools needed to supervise the banking industry and assess individual banks and banking groups; and (f) a travel budget that allows appropriate on-site work, effective cross-border cooperation and participation in domestic and international meetings of significant relevance (e.g., supervisory colleges). |
| Description and findings re EC6 | According to the BoB Act, the BoB has discretion to meet its budget as it sees fit. See below to address the EC: |

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| | <p>(a) The supervisory budget is part of the Bank-wide budget as well as the remuneration package for bank supervisors. BoB is subject to the Government Wages Policy requirements and thus constrained in attracting skills commensurate with the size and complexity of supervised institutions and remuneration that could enable it to attract and retain qualified staff.</p> <p>(b) BOB faces challenges in attracting and retaining qualified staff owing to lack of independence from Government Incomes Policy, with respect to salaries.</p> <p>(c) BoB can engage external experts when it lacks specific expertise. Such people are subjected to the duty of confidentiality regarding supervisory work they are tasked with.</p> <p>(d) BoB's supervisory activities are financed from a budget allocated to the Banking Supervision Department (BSD). This budget is always fully utilized. When the budget gets exhausted and funds are available in other departments, such funds can be used to carry out supervisory work.</p> <p>(e) A travel budget is prepared annually to enable BoB staff to undertake onsite examinations and participate in meetings.</p> <p>(f) Short-and long-term training is extended to staff with the view to enabling them to keep pace with developments in banking business and financial matters in general</p> |
| EC7 | As part of their annual resource planning exercise, supervisors regularly take stock of existing skills and projected requirements over the short- and medium-term, taking into account relevant emerging supervisory practices. Supervisors review and implement measures to bridge any gaps in numbers and/or skill sets identified. |
| Description and findings re EC7 | Short- and long-term training is extended to staff with the view to enabling them to keep pace with developments in banking business and financial matters in general. There is a demonstrated need to augment staffing with the addition of risk specialists, such as in the area of market risk (traded and non-traded), and operational risks such as operational resilience. This EC is not fully met. |
| EC8 | In determining supervisory programmes and allocating resources, supervisors take into account the risk profile and systemic importance of individual banks and banking groups, and the different mitigation approaches available. |
| Description and findings re EC8 | BoB implemented risk-based supervision (RBS) in January 2015. RBS stresses the process of risk identification, measurement, monitoring and control on an ongoing basis. In this regard, RBS designs a customized supervisory program for each bank and focuses much attention on banks that are considered to have potentially high systemic risk. It enables the supervisor to prioritize efforts and focus on significant risks by channeling available resources to banks where risk profile warrants greater attention (see also CPs 8 and 9). |
| EC9 | Laws provide protection to the supervisor and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith. The |

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| | supervisor and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith. |
| Description and findings re EC9 | This EC is not met. There is no section in the Banking Act that clearly states that the BoB will protect its staff against costs of defending their actions and/or omissions made while discharging their duties in good faith. |
| Assessment of Principle 2 | Materially non-compliant |
| Comments | <p>BoB has full authority to grant and withdraw commercial banking licenses. Statutory banks are authorized to conduct banking business by separate statutes, although they fall within the supervisory purview of the BoB under delegated powers of the minister (minister) responsible for the Ministry of Finance (MoF). On other matters related to statutory banks, BoB uses moral suasion.</p> <p>As for operational independence, although there is no political interference in BoB's supervisory work, the BoB Act empowers the minister to overrule BoB's decision, in the case of appeals for banking license rejections (EC1). Throughout the Banking Act, there are multiple ministerial touchpoints which could inhibit BoB's operational independence in the discharge of its mandate. Specifically, (i) Ministerial interventions for appeals of supervisory actions; (ii) Several circumstances where ministerial approval is required; (iii) ministerial representatives are sitting in the BoB Board, (iv) no requirement for public disclosure of the reasons for removal of BoB's executive management, and (v) no legal protection for supervisors against costs. The draft Banking Act gives BoB full supervisory powers over statutory banks and supervisory authority to issue regulations independent of MoF.</p> <p>Though Sections 15(2) to (5) of the BoB Act 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. The BoB Act is being reviewed to specify that upon dismissal of a Governor and Deputy Governors, reason(s) for removal should be publicly disclosed (EC2).</p> <p>There is no section in the Banking Act that clearly states that the Bank will protect its staff against costs of defending their actions and/or omissions made while discharging their duties in good faith. The draft Banking Act includes a section that clearly states that the Bank will protect its staff against costs of defending their actions and/or omissions made while discharging their duties in good faith (EC9).</p> <p>Short- and long-term training is extended to staff with the view to enabling them to keep pace with developments in banking business and financial matters in general. There is a demonstrated need to augment staffing with the addition of risk specialists, such as in the area of market risk (traded and non-traded), and operational risks such as operational resilience. The annual resource planning exercise should take stock of</p> |

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| | existing skills and projected requirements over the short- and medium-term, taking into account relevant emerging supervisory practices (EC7). |
| Principle 3 | Cooperation and collaboration. Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors. These arrangements reflect the need to protect confidential information. ¹¹ |
| Essential criteria | |
| EC1 | Arrangements, formal or informal, are in place for cooperation, including analysis and sharing of information, and undertaking collaborative work, with all domestic authorities with responsibility for the safety and soundness of banks, other financial institutions and/or the stability of the financial system. There is evidence that these arrangements work in practice, where necessary. |
| Description and findings re EC1 | <p>A multi-agency Financial Stability Council (FSC) was established to, among others, discuss policy issues on how the financial system could be strengthened and made more robust. The FSC was established with the following objectives:</p> <ul style="list-style-type: none"> - to mitigate financial stability risks, and take prompt action in response to a perceived build-up of systemic risks; - ensure a coordinated response to financial stability issues that may require cross-agency collaboration; and - to request information from any financial institution, exchange information on financial stability issues, and communicate systemic risk warnings. <p>The FSC is primarily a coordinating and cooperation mechanism and not designed for decision-making. The FSC comprises senior officials of the Ministry of Finance (MoF), the BoB Non-Bank Financial Institutions Regulatory Authority (NBFIRA) and the Financial Intelligence Agency (FIA). The FSC is chaired by the Governor and the BoB acts as the secretariat. The work of the FSC is governed by a memorandum of understanding (MoU).</p> <p>In addition to cooperation and coordination of the FSC, MoUs have been signed with Botswana Accountancy Oversight Authority and the Competition and Consumer Authority. The mission verified examples of the MoUs.</p> <p>The outcomes of the FSC deliberations are communicated through a press release, shortly after a meeting. The press release informs the public of the discussions and conclusions regarding the stability of the domestic financial system. It further highlights the key risks in the financial system and recommendations to address such vulnerabilities. Any issue regarding policy action is communicated through a circular to all affected financial institutions by the relevant agency i.e., the BoB, MoF, NBFIRA or FIA. The circular provides a brief description that links the identified risk with the intermediate objective and explains how measures taken are expected to mitigate the</p> |

¹¹ Principle 3 is developed further in the Principles dealing with “Consolidated supervision” (12), “Home-host relationships” (13) and “Abuse of financial services” (29).

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| | <p>risk. In addition, the FSC publishes a biannual Financial Stability Report (FSR) that assesses of the vulnerabilities to the stability and resilience of the Botswana financial system. The FSR provides analytical and performance updates for the financial sector and its impact on economic activity and welfare; encourages informed engagement on financial stability issues; and helps provide information that major participants in the Botswana financial industry and elsewhere may use as input into their own financial risk assessment processes.</p> <p>In addition to the arrangements for cooperation with domestic agencies, the BoB has arrangements with offshore regulators relevant given the ownership structure of the commercial banks (see CP13). The following are some of the regional bodies and international financial institutions with which the Bank of Botswana has regular involvement:</p> <p>Regional Bodies</p> <ul style="list-style-type: none"> • Association of African Central Banks (AACB): The AACB was established in 1965 as a means of cooperation between African central bank. As currently constituted, the Association has a council of governors and regional sub-committees for the five sub-regions of Africa as defined by the African Union. Its work is supported by a secretariat based in Dakar, Senegal. • SADC Committee of Central Bank Governors (CCBG): the CCBG was established in August 1995 as part of the Finance and Investment Sector of SADC, where it operates alongside, but independently of, the Committee of Treasury Officials. Its objective is to achieve closer co-operation among central banks within SADC. • Macroeconomic and Financial Management Institute of Eastern and Southern Africa (MEFMI): MEFMI is owned by its eleven regional member countries, including Botswana. Headquartered in Harare, Zimbabwe, it provides training and other capacity building programs to ministries of finance and central banks. • International Financial Institutions include: (i) International Monetary Fund (IMF); (ii) Bank for International Settlements (BIS); and The Financial Stability Board (FSB). |
| <p>EC2</p> | <p>Arrangements, formal or informal, are in place for cooperation, including analysis and sharing of information, and undertaking collaborative work, with relevant foreign supervisors of banks and banking groups. There is evidence that these arrangements work in practice, where necessary.</p> |
| <p>Description and findings re EC2</p> | <p>One of the areas where cooperation with foreign supervisors is evidenced is at the time of licensing. BoB’s Licensing Policy prescribes specific internal processes which address foreign ownership (see Section 5 of the policy). The Policy states that subsidiaries of foreign financial institutions shall be licensed subject to the following:</p> |

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| | <ul style="list-style-type: none"> • the home supervisory authority gives a report that it is satisfied with respect to the prudent management and overall financial soundness of the applicant; and, • the Bank is satisfied as to the nature and scope of the supervision exercised by the home supervisory authority. <p>The Policy states that despite assurances from the home supervisory authority, the BoB must satisfy itself of the prudence of the applicant’s operations as regards business plan, internal controls, accounting and other records, staffing and management arrangements. Once a foreign subsidiary is licensed, supervision shall be a shared responsibility between the Bank, as “host supervisor”, and the relevant “home supervisor” in accordance with Basel principles set out in the (see also CP13).</p> <p>In addition to licensing, the BoB actively participates with each of the relevant home supervisors primarily through the supervisory college process. Structured processes have been developed around the colleges in terms of frequency and their contribution to the supervision of commercial banks. The mission saw evidence of the process working successfully with examples of sharing of risk analysis, analysis of group structures and discussion of resolution and recovery plans. The BoB showed examples of participation in colleges where there was effective two-way sharing of information (see also CP13).</p> |
| EC3 | The supervisor may provide confidential information to another domestic authority or foreign supervisor but must take reasonable steps to determine that any confidential information so released will be used only for bank-specific or system-wide supervisory purposes and will be treated as confidential by the receiving party. |
| Description and findings re EC3 | The legal framework makes provisions for the transmission of confidential information to foreign supervisors. Information passed to another agency is required by Section 43(10) of the Banking Act to remain confidential. However, in relation to domestic information sharing and confidentiality provisions, there is no legal provision for information sharing with domestic supervisors (NBFIRA and the Ministry of Finance), except for the Botswana Unified Revenue Services (BURS). |
| EC4 | The supervisor receiving confidential information from other supervisors uses the confidential information for bank-specific or system-wide supervisory purposes only. The supervisor does not disclose confidential information received to third parties without the permission of the supervisor providing the information and is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession. In the event that the supervisor is legally compelled to disclose confidential information it has received from another supervisor, the supervisor promptly notifies the originating supervisor, indicating what information it is compelled to release and the circumstances surrounding the release. Where consent to passing on confidential information is not given, the supervisor uses |

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| | all reasonable means to resist such a demand or protect the confidentiality of the information. |
| Description and findings re EC4 | Confidential information in the hands of supervisor is adequately protected in accordance with Section 43 of the Banking Act. This section of the Banking Act is comprehensive in terms of confidentiality and the supervisory process. Such information can only be divulged where there is a court order or statutory request by authority which qualifies to receive such information. |
| EC5 | Processes are in place for the supervisor to support resolution authorities (e.g., central banks and finance ministries as appropriate) to undertake recovery and resolution planning and actions. |
| Description and findings re EC5 | No provisions in the current legislation to support resolution. The Banking Act is being reviewed and the revised Banking Act is intended to address these deficiencies. |
| Assessment of Principle 3 | Largely compliant |
| Comments | <p>Effective cooperation and coordination are particularly important in Botswana given the structure of the banking system with eight of nine commercial banks subsidiaries of foreign banks. Arrangements are in place for cooperation and coordination, such as the FSC with MoUs executed with all participants. In practice, however, the sharing of risk analysis and undertaking collaborative work between the domestic agencies, mainly between the NBFIRA and BoB was at a limited stage. With the banks diversifying their business models through exploring bancassurance and wealth management activities (e.g., capital markets, broking etc.), greater cooperation and collaboration in routine supervision is warranted.</p> <p>Cooperation and coordination with foreign supervisors were evidenced and contributing to the effective supervision of banks mainly the supervisory college process. Home and Host supervisors shared information and analysis of risk profiles and discussed topics such as group resolution policies.</p> |
| Principle 4 | Permissible activities. The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined and the use of the word “bank” in names is controlled. |
| Essential criteria | |
| EC1 | The term “bank” is clearly defined in laws or regulations. |
| Description and findings re EC1 | Section 2 of the Banking Act clearly defines the interpretation of “bank” in Botswana. It is defined as “a company, incorporated in accordance with the provisions of the Companies Act, which is licensed under this Act to conduct banking business;” which hinges on the taking of deposits and provision of traditional intermediation services (i.e., taking of deposits and extending credit (“loans”). Specifically, Section 2 of the Banking Act defines business banking in this way: |

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| | <p>(i) the business of accepting deposits of money repayable on demand or after fixed periods or after notice, as the case may be, by cheque or otherwise; and/or</p> <p>(ii) the employment of deposits in the making or giving of loans, advances, overdrafts or other similar facilities and in the making of investments or engagement in other operations authorized by law or under customary banking practice, for the account of, and at the risk of, the person or persons accepting such deposits, and includes the discounting of commercial paper, securities and other negotiable instruments, for the purpose of extending loans or other credit facilities.</p> |
| EC2 | The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations. |
| Description and findings re EC2 | <p>As stated in EC1, Section 2 of the Banking Act clearly defines banking business. In addition to Section 2, the following provisions of the Banking Act are relevant to permissible activities:</p> <ul style="list-style-type: none"> - Section 5 of the Banking Act provides for investigation of unlicensed banking business. - Section 17 of the Banking Act outlines the limitations on specified operations and activities of licensed institutions and Part II of the Licensing Policy also outlines permissible activities for institutions licensed and supervised by the Bank. <p>In addition to the definition of banks and banking business, the Banking Act articulated specific prohibitions. For example, Section 17 is relatively exhaustive in terms of limitations on specified operations and activities of banks. Relevant provisions of section 17 are as follows:</p> <p>“No bank shall directly or indirectly acquire, hold any part of the share capital of any financial commercial agricultural industrial or other undertaking, except such shareholding as may be acquired in the course of the satisfaction of a debt (where the shareholdings shall be disposed of at the earliest possible moment)” (see Paragraph 10).</p> <p>“No bank shall, directly or indirectly purchase acquire or take a lease on immovable property, except where may be necessary for the purpose of conducting its business” see (Paragraph 11).</p> <p>The Banking Act contains additional prohibitions. For example, the imitations are extensive in relation to related persons, treating exposures as group exposures. Other explicit prohibitions of permissible activities are as follows:</p> |

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| | <p>shall not apply-</p> <p>(a) to any shareholding in any company approved by the Central Bank and set up for the purpose of insuring deposits, or of promoting the development of a money market or securities market in Botswana, or of improving the financial mechanism for the financing of economic development;</p> <p>(b) to any shareholdings in other undertakings the aggregate amount of which does not at any time exceed such percentage of the sum of its unimpaired capital as may be determined by the Central Bank; or</p> <p>(c) to any shareholdings acquired in the course of the administration of the estate of a deceased person.</p> <p>(11) No bank shall, directly or indirectly, purchase, acquire or take a lease on immovable property, except as may be necessary for the purpose of conducting its business, including provision for any future expansion or for housing its staff, or in such other circumstances as the Central Bank may determine.</p> <p>(12) A bank may secure an accommodation on any immovable property and, in default of repayment, may acquire such property for resale as soon as possible, and in any event within four years of acquisition.</p> <p>(13) No bank shall, without the written permission of the Central Bank, encumber its assets in any way, and every bank shall hold its assets in its own name.</p> <p>(14) For the purposes of this section "accommodation" means a loan, advance or other credit facility, financial guarantee or other liability granted or incurred by a bank to or on behalf of any person.</p> <p>Also, within the legislation, is the power to investigate of unlicensed banking. Section 5 is relatively comprehensive to investigate activities that may constitute banking business by unlicensed firms. An investigations unit within the BoB is responsible for examining potential uses of the word "bank" by unlicensed operators. In the circumstance where a violation of the Act is identified, the BoB is able to issue a cease-and-desist order. No examples were available at the time of the mission where such powers had been exercised where firms had used the term "bank" without a license.</p> |
| <p>EC3</p> | <p>The use of the word "bank" and any derivations such as "banking" in a name, including domain names, is limited to licensed and supervised institutions in all circumstances where the general public might otherwise be misled.</p> |
| <p>Description and findings re EC3</p> | <p>Section 3(2) of the Banking Act restricts the use of the word "bank" and its derivatives to use by banks. However, the same section empowers BoB to allow the use of the word and its derivative in instances where the public cannot be misled into thinking that the business, whose name contains this word, is a bank. These are instances where the use of the term "bank" cannot typically be interpreted as a financial institution. Examples include "blood bank".</p> |

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| | Section 5 of the Banking Act provides BoB with powers to investigate unlicensed banking activities (see Section 5 (1) to (9). This section is comprehensive in terms of granting BoB powers. |
| EC4 | The taking of deposits from the public is reserved for institutions that are licensed and subject to supervision as banks. ¹² |
| Description and findings re EC4 | Deposit taking is strictly reserved for banks (commercial and statutory banks). Banks, including some statutory banks, are the only institutions that accept deposits in Botswana. |
| EC5 | The supervisor or licensing authority publishes or otherwise makes available a current list of licensed banks, including branches of foreign banks, operating within its jurisdiction in a way that is easily accessible to the public. |
| Description and findings re EC5 | The BoB publishes a list of licensed institutions in its Banking Supervision Annual Report and announces in the Government Gazette any licences granted or revoked. The BoB also publishes a Directory of Financial Institutions through their website. |
| Assessment of Principle 4 | Compliant |
| Comments | The legislation is clear and consistent in its determination of what constitutes a bank, limitations on firms not using the word “bank’ and the activities undertaken by a bank is clearly defined in the legislation. Permissible activities are also clearly defined. To complement the legislation is the Licensing Policy which is strict in terms of what activities can be licensed as a bank. |
| Principle 5 | Licensing criteria. The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of Board members and senior management) ¹³ of the bank and its wider group, and its strategic and operating plan, internal controls, risk management and projected financial condition-(including capital base). Where the proposed owner or parent organization is a foreign bank, the prior consent of its home supervisor is obtained. |
| Essential criteria | |

¹² The Committee recognizes the presence in some countries of non-banking financial institutions that take deposits but may be regulated differently from banks. These institutions should be subject to a form of regulation commensurate to the type and size of their business and, collectively, should not hold a significant proportion of deposits in the financial system.

¹³ This document refers to a governance structure composed of a board and senior management. The Committee recognizes that there are significant differences in the legislative and regulatory frameworks across countries regarding these functions. Some countries use a two-tier board structure, where the supervisory function of the board is performed by a separate entity known as a supervisory board, which has no executive functions. Other countries, in contrast, use a one-tier board structure in which the board has a broader role. Owing to these differences, this document does not advocate a specific board structure. Consequently, in this document, the terms “board” and “senior management” are only used as a way to refer to the oversight function and the management function in general and should be interpreted throughout the document in accordance with the applicable law within each jurisdiction.

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| EC1 | The law identifies the authority responsible for granting and withdrawing a banking license. The licensing authority could be the banking supervisor or another competent authority. If the licensing authority and the supervisor are not the same, the supervisor has the right to have its views on each application considered, and its concerns addressed. In addition, the licensing authority provides the supervisor with any information that may be material to the supervision of the licensed bank. The supervisor imposes prudential conditions or limitations on the newly licensed bank, where appropriate. |
| Description and findings re EC1 | <p>Section 3(1) of the Banking Act authorises Bank of Botswana to grant a banking licence. Specifically, that section states no person, other than a bank licensed under this Act, shall, without the prior approval of the Central Bank to use the term bank or to conduct banking business.</p> <p>In addition, Section 6 of the Banking Act empowers Bank of Botswana to be the sole licensing authority of institutions intending to do banking business. Although statutory banks are licensed by a different legislation, Section 53(2) of the Banking Act empowers the Bank to supervise statutory banks. Furthermore, Section 8(3) of the Banking Act empowers BoB to consult with the Ministry of Finance to determine prudential requirements for different classes of banks.</p> <p>The Banking Act (see Section 6(b) stipulates that the applicant will furnish the BoB with certified copies of:</p> <ul style="list-style-type: none"> - Applicant's certificate of incorporation in Botswana; - the memorandum and articles of association; and, - financial documents and data. <p>Furthermore, the Banking Act allows the BoB to call for supplemental information "as it may require" and "conduct an investigation as it deems necessary". The provisions in the Banking Act therefore fulfil the requirements of this CP for the necessary authority to grant a license.</p> <p>The Banking Regulations (Section 3) further define what is required to be submitted at licensing to support the application.</p> |
| EC2 | Laws or regulations give the licensing authority the power to set criteria for licensing banks. If the criteria are not fulfilled or if the information provided is inadequate, the licensing authority has the power to reject an application. If the licensing authority or supervisor determines that the license was based on false information, the license can be revoked. |
| Description and findings re EC2 | Section 6 of the Banking Act provides criteria for licensing a bank or rejecting an application for a bank licence. Section 6 stipulates the following minimum criteria: |

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| | <ul style="list-style-type: none"> - incorporated under the Companies Act in Botswana and limited by share capital; - fit and proper; and - complies with such requirements as may be prescribed. <p>The Licensing Policy is a thorough compendium for assessing license applications.</p> <p>Section 10 of the Banking Act gives the Bank of Botswana powers to impose conditions on licenses and to subsequently vary those conditions. Section 11 of the Banking Act provides criteria for licence revocation.</p> <p>Section 6 requires banking applications to be: (a) in the format decided by the Bank of Botswana and made in writing to it; with the application to be gazetted. (b) be accompanied with information including (i) certificate of incorporation; (ii) memorandum of association, (c) and any other documents that the BoB requires. It specifies some information but goes further to have a capture all that all information needed by the BoB to be made available.</p> <p>Within 30 days after it has received the application the BoB shall inform the Minister that it has been received, and that it is being duly processed. The BoB can also call for supplementary information (section 6(3) to conduct its investigation.</p> |
| EC3 | The criteria for issuing licenses are consistent with those applied in ongoing supervision. |
| Description and findings re EC3 | <p>The criteria for issuing licences are consistent with those applied in ongoing supervision. Compliance with licensing criteria is checked through on-site examination. In addition, prudential and regulatory compliance is assessed on a regular basis through off-site surveillance.</p> <p>The Bank of Botswana uses the Licensing Policy and the Guidelines on appointments of board and senior management officials to assess new licenses, evaluate business models and apply fit and proper tests.</p> <p>The licensing assessment processes was demonstrated to work as follows (as per the Licensing Policy) - A preliminary meeting is held with an applicant and requirements for applying for a banking license are explained. An application package is given to an applicant who is expected to submit a complete application package accompanied by an application fee of P15 000 (VAT exclusive). Within 30 days after receiving an application, the BoB informs the Minister that it has been received a banking licence application, and that it is being duly processed. An application is also gazetted.</p> |

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| | <p>Assessing a banking licensing application encompasses evaluating the following aspects:</p> <ul style="list-style-type: none"> - ownership structure and governance, - start-up capital, - financial strength of the shareholders and ability to provide additional capital if required, - strategic and operating plans for the bank, technical partnership, - product offering, - staffing arrangements, - risk management and internal controls, - branch network, - infrastructure and projected financial condition of the proposed bank. <p>The assessment of the application also encompasses evaluation of the likely effect of the proposed bank on the existing domestic financial sector and potential contribution to the development of Botswana. These considerations are consistent with the broader macroeconomic policy objectives of sustained inclusive economic growth and diversification, financial sector development and employment creation. Therefore, the objective is to ensure that a licensed bank is adequately capitalised, likely to be prudently managed and possesses a business strategy that can add value to local economic and social needs, such as effective competition and financial inclusion. An application is processed within 6 months after which the BoB can reject or grant a banking licence.</p> |
| EC4 | <p>The licensing authority determines that the proposed legal, managerial, operational and ownership structures of the bank and its wider group will not hinder effective supervision on both a solo and a consolidated basis.¹⁴ The licensing authority also determines, where appropriate, that these structures will not hinder effective implementation of corrective measures in the future.</p> |
| Description and findings re EC4 | <p>The BoB’s Licencing Policy requires that the proposed structure of a banking group should not hinder effective supervision both on a solo and on a consolidated basis.</p> |
| EC5 | <p>The licensing authority identifies and determines the suitability of the bank’s major shareholders, including the ultimate beneficial owners, and others that may exert significant influence. It also assesses the transparency of the ownership structure, the sources of initial capital and the ability of shareholders to provide additional financial support, where needed.</p> |
| Description and findings re EC5 | <p>Section 8(1) of the Banking Act stipulates conditions for issuing a banking licence (see EC 1-2). The Licensing Policy specifies the tests to be undertaken to ensure that directors and senior management are fit and proper and ensures that applicants</p> |

¹⁴ Therefore, shell banks shall not be licensed. (Reference document: BCBS paper on shell banks, January 2003.)

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| | <p>submit suitable operating plans, sound systems of corporate governance and disclose the sources of initial capital as well as the ability to provide additional capital.</p> <p>In terms of the suitability assessment of the bank's major shareholders and ultimate beneficial owners, the Licensing Policy (Clause 4.19) sets out the process for the BoB to conduct background investigations of the directors, executive officers and controlling shareholders as it deems fit. At the licensing stage applicants are required to provide the list of all shareholders who directly or indirectly hold shares or other interest in the applicant bank, which represents 5 percent or more of the capital or voting rights. These beneficial owners are assessed to ensure that they are fit and proper to own a bank, in accordance with the Directive on Significant Shareholding in Banks. The assessment of the ultimate beneficial owners conducted by BoB staff at the licensing stage extends only as far as the corporate level and does not go behind the corporate structure to individual shareholders. In the case of the larger systemic banks (where the major shareholders are widely-held globally active investment firms such as in the case of ABSA and Standard Chartered) a look-through the corporate structure is inherently more challenging. However, for the regionally active banks the share registry includes privately held corporate structures where the potential for individual shareholders to exert a significant influence is greater and thus the BoB should be undertaking suitability assessments of the ultimate beneficial owner. This is a weakness in the BoB's licensing processes that should be rectified so that future license applications are vetted adequately.</p> <p>With respect to BoB's analysis of an applicant's ownership structure, transparency of the legal entities is assessed adequately and takes into consideration the sources of initial capital and the ability of shareholders to provide additional financial support, where needed.</p> |
| EC6 | A minimum initial capital amount is stipulated for all banks. |
| Description and findings re EC6 | <p>The BoB legislation is clear in regard to the stipulation for minimum initial capital for a bank to be licensed. Section 13(9) and Regulation 7(3) of the Banking Act require commercial banks to have a minimum capital of the higher of P5 million or 8 percent of the bank's risk weighted assets. Thresholds are also stipulated under Regulation 7(3) for credit institutions, investment banks/merchant banks and discount houses. Section 7(3) of the Banking Regulations stipulates the minimum capital requirements for the different categories of banks that are licensed by the Bank of Botswana. The capital requirements are as follows:</p> <ul style="list-style-type: none"> (a) Commercial banks – greater of P5 000 000; (b) Credit Institutions – greater of P2 500 000; (c) Investment Banks/Merchant Banks – greater of P5 000 000; and (d) Discount Houses – greater of P2 500 000. |

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| | <p>The initial funds should be own funds and unencumbered. However, subsequent injections of capital can be done with assets other than cash after the bank has begun operations. At licensing, the BoB will evaluate the source of funds requesting financial statements for groups, existing companies and individuals. The concept of “unimpaired capital” is referenced throughout the Banking Act, conferring that the minimum capital must be free to meet the financial needs of the bank without exception or impediment.</p> |
| <p>EC7</p> | <p>The licensing authority, at authorization, evaluates the bank’s proposed Board members and senior management as to expertise and integrity (fit and proper test), and any potential for conflicts of interest. The fit and proper criteria include: (i) skills and experience in relevant financial operations commensurate with the intended activities of the bank; and (ii) no record of criminal activities or adverse regulatory judgments that make a person unfit to uphold important positions in a bank.¹⁵ The licensing authority determines whether the bank’s Board has collective sound knowledge of the material activities the bank intends to pursue, and the associated risks.</p> |
| <p>Description and findings re EC7</p> | <p>Part V of the Banking Act requires a Board and Principal Officers of a bank (essentially the senior leadership team) to have requisite skills, integrity and competence. In addition, the evaluation of proposed directors and senior management’s expertise and integrity is enshrined in the Licensing Policy and the Guidelines on Appointment of New Directors and Senior Management Officials of Banks that are published on BoB website.</p> <p>Section 29 of the Banking Act is generally prescriptive requiring the following:</p> <p>(1) No person shall become the principal officer, by whatever name called, of any bank, unless upon the determination of the board of directors of such bank he is a fit and proper person, for such position, having regard to-</p> <p>(i) his probity and competence;</p> <p>(ii) the diligence with which he is likely to fulfil his responsibilities; and</p> <p>(iii) his previous conduct and activities in business, particularly whether he has been guilty of any fraud or other act of dishonesty.</p> <p>(2) Where the Central Bank has reason to believe that any person, by virtue of his shareholding in a bank or otherwise, is in a position to influence the principal officer, or the board of directors of that bank, and is exercising his influence in a manner which is likely to be detrimental to the interests of depositors, the Central Bank may request the bank to remedy the situation.</p> <p>(3) Where a bank fails to comply with the instructions of the Central Bank following a request made under subsection (2), the Central Bank may, with the</p> |

¹⁵ Please refer to Principle 14, Essential Criterion 8.

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| | <p>approval of the Minister, revoke the license of such bank in accordance with section 11 of this Act.</p> <p>(4) No person shall become a director of a bank unless he is a fit and proper person in accordance with such criteria as may be determined by the Central Bank.</p> <p>The Banking Act gives the BoB the authority to assess appointments of board members and senior management officials of banks and the assessment is done in accordance with the Guidelines on the Appointment of New Directors and Senior Management Officials of Banks and the Circular to Banks Regarding Eligibility for Board Membership in Banks. The requirements for determination of fitness and probity of board and senior management officials includes requiring the following documents:</p> <ol style="list-style-type: none"> a. personal questionnaire – requires provision of personal details, employment history, answers to questions that enable assessment of an individual’s reputation and character and references that may be contacted for verification of information. b. police clearance and security vetting and authorization form – individuals seeking to be appointed as board members or senior management officials of banks are required to provide a report from the police department in the jurisdiction in which an individual resides, indicating that the proposed board or senior management official has not committed or is being investigated for committing any crimes. Furthermore, for board members, principal officers and senior management officials in core positions, such as chief financial officer and treasurer, the Bank requires them to fill a security vetting and authorization form that is sent to relevant stakeholders to check if the individual is not being investigated in different jurisdictions for committing crimes, or has committed a crime in a different jurisdiction; and c. Board resolution – this is required to ensure that the bank has assessed and agreed on the fitness and probity of an individual for appointment as a board member or senior management official of a bank. <p>It is worth noting that the BoB conducts assessment of significant shareholders of banks. The assessment, however, is only conducted at the application stage or where there is a proposed change in the significant shareholder, in accordance with the Guidelines on Significant Shareholding in Banks.</p> |
| EC8 | <p>The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance, risk management and internal controls, including those related to the detection and prevention of criminal activities, as well as the oversight of proposed outsourced functions, will be in place. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.¹⁶</p> |
| Description and findings re EC8 | <p>BoB makes an in-depth evaluation of an application by assessing the proposed bank’s five-year financial projections, business plan/strategy, completed personal</p> |

¹⁶ Please refer to Principle 29.

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| | questionnaires and police clearance certificates for the proposed members of the Board of Directors and Principal Officer. |
| EC9 | The licensing authority reviews pro forma financial statements and projections of the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank. |
| Description and findings re EC9 | Pro forma financial statements and projections for proposed banks are reviewed against the business plan and statements of parent bank and business strategy, to ascertain how realistic they are. |
| EC10 | In the case of foreign banks establishing a branch or subsidiary, before issuing a license, the host supervisor establishes that no objection (or a statement of no objection) from the home supervisor has been received. For cross-border banking operations in its country, the host supervisor determines whether the home supervisor practices global consolidated supervision. |
| Description and findings re EC10 | BoB requests a "letter of consent from the primary supervisory authority" (Annexure II) of the licence application package) and verifies that the home supervisor has no objection (Annexure III of licence application package information) and can undertake effective consolidated supervision of the group. |
| EC11 | The licensing authority or supervisor has policies and processes to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the license approval are being met. |
| Description and findings re EC11 | <p>The monitoring of progress of new entrants in meeting their business and strategic goals is done through bilateral and trilateral meetings and the review of the periodic reports.</p> <p>What is looked for here is the integration of the licensing process with the BAU supervision strategy (offsite and onsite). A connection between the functions internally so that the hand off from licensing to BAU is handled well.</p> <p>There are no special requirements for newly established banks. After the license assessment and license approval, a bank is expected to comply once licensed. Before licensing, the BoB conducts a pre-operation inspection of the bank to ensure adequacy of systems. The uniform supervisory cycle and other prudential requirements are applied consistently to newly licensed banks such as offsite reporting requirements, regular onsite engagements (such as bilateral with banks, bilateral with auditors and trilaterals – see also CPs 8 & 9). The cycle for the onsite examination is not adjusted for a newly licensed bank, it is determined by the outcomes of the risk assessments.</p> |

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| Assessment of Principle 5 | Largely compliant |
| Comments | <p>Over the last five years, BoB has received four bank license applications from domestic entities. Of those, two applications were withdrawn, one was rejected, and one application was granted conditional approval. The Bank of Botswana has had two commercial bank licenses being surrendered in the past 5 years, and the Bank has not imposed any conditions on licenses in the last 5 years.</p> <p>The Banking Act empowers BoB to be the sole licensing authority of institutions intending to conduct banking business, while statutory banks derive mandate from statutes established by Acts of parliament. If unsuccessful, the applicant may appeal to the Minister. In this regard, Section 8(3) of the Banking Act stipulates conditions for issuing a banking licence and empowers BoB to consult with MoF to determine prudential requirements for different classes of banks. The licensing policy specifies the tests to be carried out to ensure that banks appoint directors and senior management that are fit and proper. The policy also specifies the need for applicants to submit suitable operating plans, sound systems of corporate governance and disclose the sources of initial capital as well as the applicant's ability to provide additional capital should the need for capital injection arise. The BoB evidenced a relatively robust licensing assessment process applying the policy appropriately.</p> <p>The suitability assessment of ultimate beneficial owners at licensing does not extend past the corporate ownership structure to the individual level. In the case of the larger systemic banks the major shareholders are typically widely-held and globally active investment firms. However, for the regionally active banks the mix of major shareholders comprises privately held corporate structures which should be subject to an assessment of the individual shareholder.</p> <p>After licensing, however, there are no special requirements for newly established banks in terms of an enhanced prudential cycle, reporting requirements etc. While the BoB conducts a pre-operation inspection of the bank to ensure adequacy of systems, an onsite examination should be scheduled ideally within the first 12 months to verify the effective implementation of the bank's internal controls, risk management framework and governance functions. Internal guidelines should be developed to assist supervisors to detect early signals of emerging weakness or stress for a newly licensed bank (EC11).</p> |
| Principle 6 | Transfer of significant ownership. The supervisor ¹⁷ has the power to review, reject and impose prudential conditions on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties. |
| Essential criteria | |
| EC1 | Laws or regulations contain clear definitions of "significant ownership" and "controlling interest". |

¹⁷ While the term "supervisor" is used throughout Principle 6, the Committee recognizes that in a few countries these issues might be addressed by a separate licensing authority.

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| <p>Description and findings re EC1</p> | <p>A definition of “significant ownership” and “controlling interest” is not included in the primary legislation. The Act, however, is being revised and the current version of the Banking Bill makes provision for the transfer of significant ownership or controlling interest. Significant shareholding is defined in a guideline – ‘<i>Guidelines on Significant Shareholding of Banks</i>’. Within the Guidelines, significant shareholding (as stated in the Guidelines on Significant Shareholding in Banks) is a person (physical or juridical) holding, directly or indirectly:</p> <p>(1) 5 percent or more of the equity or voting rights of a bank; or</p> <p>(2) an equity or other interest in a bank that enables the holder to exercise significant influence over its management or activity.</p> <p>The Bank has approved two requests for transfer of significant ownership in banks in the past five years. The experience in the last several years with transfer of significant ownership:</p> <ul style="list-style-type: none"> a. Absa Bank Botswana Limited – Barclays sold its shareholding in Barclays Bank of Botswana Limited to Absa Group Limited. The bank was thereafter renamed and rebranded as Absa Bank Botswana Limited. b. Access Bank Botswana Limited– African Banking Corporation Holdings sold its shareholding in African Banking Corporation of Botswana Limited to Access Bank Plc, thereafter the bank was renamed and rebranded as Access Bank Botswana Limited. |
| <p>EC2</p> | <p>There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership, including beneficial ownership, or the exercise of voting rights over a particular threshold or change in controlling interest.</p> |
| <p>Description and findings re EC2</p> | <p>As per the Guidelines, any person who proposes to hold a significant shareholding (directly or indirectly) requires the prior written authorization (See Section 3.1). Below the 5 percent threshold no approval is required. If a significant shareholder seeks to increase shareholding past 20 percent, the shareholder needs to provide the BoB with a written notice. Written notice is needed for subsequent increases in shareholding by a significant shareholder to exceed 33 percent and 50%. To exceed 50%, a significant shareholder requires prior authorization by the BoB (see Section 3.2). The Guideline contains a comprehensive description of supporting materials that need to be submitted to the BoB aligned closely with materials needed for license applications (see Annex 1).</p> <p>The BoB does not include explanations in the primary legislation how to aggregate share or voting rights for individuals, affiliated companies, relatives, etc., to assess significance of ownership. Equally, internal guidance material has not been developed. The BoB’s internal Licensing Policy (Annexure II) of the licence application information</p> |

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| | <p>pack require banks to obtain BoB's approval for change of control or voting rights in a bank. Clause 4.29 of the Licensing Policy requires prior approval of BoB for registration of any transfer of shares exceeding 5 percent of the shares or of the voting rights attached to shares in a financial institution.</p> <p>The Guidelines describe timeframes for decision-making (see Section 3.7).</p> <p>The BoB requires banks to report, annually, the names of all significant shareholders, who own 5% or more of a bank's shares or equity, in the bank (including the identities of beneficial owners of shares held by custodians), the number and type of shares held, and the number of shares held as a percentage of total shares outstanding in accordance with Section 5.1 of the Guidelines on Significant Shareholding in Banks.</p> <p>A change in ultimate beneficial ownership of one of the commercial banks was initiated in 2018, the BoB was made aware of the intention of the proposed change in ownership at the group level. It was apprised of progress throughout the sale process but ultimately BoB did not approve the change in the ultimate beneficial owner.</p> |
| EC3 | <p>The supervisor has the power to reject any proposal for a change in significant ownership, including beneficial ownership, or controlling interest, or prevent the exercise of voting rights in respect of such investments to ensure that any change in significant ownership meets criteria comparable to those used for licensing banks. If the supervisor determines that the change in significant ownership was based on false information, the supervisor has the power to reject, modify or reverse the change in significant ownership.</p> |
| Description and findings re EC3 | <p>The Guideline on Significant Shareholding sets out the 'decision factors' to assess the authorization of a significant shareholding in a bank or to object to a notice to transfer shareholding, including (see 3.9):</p> <ul style="list-style-type: none"> - The proposed significant shareholder is suitable so as not to influence the principal officer or the board of directors of a bank to carry on banking business in a manner detrimental to the interests of depositors; - (b) The technical knowledge, integrity, experience, financial condition, and history of the proposed significant shareholder are satisfactory; - (c) The capital structure of the bank is adequate in relation to the nature and scale of the proposed banking business subsequent to the proposed acquisition; - (d) The proposed significant shareholder is satisfactory regarding the character of its business, the experience and qualifications of its management and the adequacy of its capital or net worth; - (e) Any proposed new directors or senior management officials are fit and proper persons; - (f) The convenience [and] needs of the community and market will remain satisfactorily served by the bank subsequent to the proposed acquisition; and |

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| | <ul style="list-style-type: none"> - (g) The proposed significant shareholder has not contravened any provision of the Act. <p>The Guidelines contain further provisions restricting significant shareholding, including Section 4.3 which states:</p> <ul style="list-style-type: none"> - In case a person does not receive the prior written authorisation of the Bank to acquire a significant shareholding in a bank pursuant to Section 3.1 or does not provide the proper advance notice to the Bank to increase shareholding to any of the thresholds designated in Section 3.2, the transfer(s) of shareholding in a bank shall have no legal effect. <p>While the Guidelines state that the transfer will have no legal effect, it is unclear the mechanism by which BoB could reverse the change in shareholding. BoB has not had experience exercising this section of the Guidelines.</p> <p>Equally, Section 4.4 states</p> <ul style="list-style-type: none"> - The Bank may prohibit a significant shareholder in a bank from acquiring additional shares in that bank, if any information comes to its attention which would serve as a basis for the Bank to deny an application or to object to a notice of a proposed transfer of shareholding. <p>Similarly, it is uncertain whether the BoB could rely on this Section of the Guidelines to reverse a change in ownership ex post.</p> <p>Guidelines on Significant Shareholding are available in the Bank's website and makes provision for supervisory approval to indirectly, or directly, hold significant shareholding in a bank or notice of intent to transfer shareholding.</p> <p>Section 21(2) of the Banking Bill which is designed to replace the existing Banking Act outlines the conditions under which BoB shall not approve an application of transfer of significant or controlling interest and Section 21(3) empowers the Bank to reject any proposal for change in significant ownership. Section 21(4) empowers the Bank to reverse any change of control or significant shareholding done without regulatory approval.</p> <p>The definition for ultimate beneficial owners is provided in the Financial Intelligence Act, 2022. The definition of the beneficial owner is a natural person who ultimately owns or controls a customer or a natural person on whose behalf a transaction is being conducted, including a natural person who exercises ultimate effective control over a legal person or arrangement. To identify the beneficial owners of a bank, the Bank requests bank to annually submit the shareholding structure of the banks, which</p> |
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| | includes names of significant shareholders and beneficial owners of the bank, and a clear indication of percentage shareholdings and the group ownership structure. |
| EC4 | The supervisor obtains from banks, through periodic reporting or on-site examinations, the names and holdings of all significant shareholders or those that exert controlling influence, including the identities of beneficial owners of shares being held by nominees, custodians and through vehicles that might be used to disguise ownership. |
| Description and findings re EC4 | Banks provide an annual report of all significant shareholders. This material is assessed by the Licensing Team. Internal guidance for supervisors covers what is to be assessed. Clause 4.27 of the Licensing Policy requires banks to provide annually, full particulars of shareholders or beneficial owners of 5 percent or more of a bank's share capital. That assessment is included in the banks institutional profile and overall risk assessment (see also CPs 8 & 9). In addition, supervisors request banks to provide details of all significant shareholders during on-site examinations. |
| EC5 | The supervisor has the power to take appropriate action to modify, reverse or otherwise address a change of control that has taken place without the necessary notification to or approval from the supervisor. |
| Description and findings re EC5 | At the time of licensing and in the course of business, institutions are required by the licensing Policy and Banking Regulation 3(1) (c) to notify the Bank of any proposed change in the shareholding structure before implementation. Clause 4.3 of the Licensing Policy require the Bank to be notified of ultimate beneficial ownership of a shareholding constituting more than 5 percent of the shares or voting rights in a financial institution. The Guidelines on Significant Shareholding in Banks contains restrictions to the effect that the transfer would have no legal effect (see EC3). However, whether this has the legal enforceability is uncertain and in doubt. |
| EC6 | Laws or regulations or the supervisor require banks to notify the supervisor as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder or a party that has a controlling interest. |
| Description and findings re EC6 | Not explicitly covered in the primary legislation. There is a good faith expectation that banks would notify. |
| Assessment of principle 6 | Materially non-compliant |
| Comments | The Banking Act has no definition of significant ownership and controlling interest. In practice, the BoB relies on the Guidelines on Significant Shareholding to assess a change of significant shareholding (which is made public on the BoB website). The minimum threshold for an assessment starts at 5 percent with the next threshold at 20 percent, then 33 and finally 50 percent. Over 50 percent shareholding, a control |

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| | <p>change is assessed. In practice, the BoB applies the licensing framework to assess proposed changes in significant shareholding which are relatively complete for licensing and can be adapted to assess changes in shareholding.</p> <p>However, there are also no requirements to obtain the Bank's approval for change of control or voting rights in a bank. Notification is only done at the initial licensing stage. The lack of provisions in the primary legislation means that there is no direct legal remedy to reject or reverse a change in significant ownership ex post. The revisions to the Banking Act (contained in the Bill) makes provision for the transfer of significant or controlling interest with the terms also defined. The Banking Bill outlines the conditions under which BoB shall not approve an application of transfer of significant or controlling interest. The issue is not addressed in the Banking Bill. The Bank will therefore continue to be non-compliant with this criterion once the new draft bill is enacted into law.</p> |
| Principle 7 | Major acquisitions. The supervisor has the power to approve or reject (or recommend to the responsible authority the approval or rejection of), and impose prudential conditions on, major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and to determine that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision. |
| Essential criteria | |
| EC1 | <p>Laws or regulations clearly define:</p> <ul style="list-style-type: none"> (a) what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need prior supervisory approval; and (b) cases for which notification after the acquisition or investment is sufficient. Such cases are primarily activities closely related to banking and where the investment is small relative to the bank's capital. |
| Description and findings re EC1 | <p>A framework for major acquisitions is not provided for in the primary legislation, that is the Banking Act. However, countervailing powers are contained in the Banking Act. The first is to power to amend conditions of bank licenses and to restrict activities (see also CP5). Second, the requirement that no bank shall establish a subsidiary in Botswana or cross-border without the prior approval of the BoB (Banking Act, Sections 6 & 7 respectively). Third, the Banking Act prohibits a bank from directly or indirectly acquiring or holding shares of any financial, commercial, agricultural, industrial or other undertaking (Section 10). Lastly, there is the requirement that activities other than banking must be undertaken in a separate corporate entity as a subsidiary of the bank (such as insurance) which requires BoB approval.</p> <p>BoB has an MoU with the Consumer and Competition Authority (CCA), established under the Competition Act as the primary enforcement agency for competition law and policy, which includes control of mergers and acquisitions. The authority is</p> |

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| | <p>empowered by the Competition Act to monitor, control and prohibit anti-competition trade or business practices in the economy of Botswana. The Competition Act (Section 73) allows the authority and other regulators, including BoB, to establish a mechanism through which they can maintain regular contact regarding the exercise of their respective responsibilities, hence a signed MoU between BoB and CCA, which serves to establish arrangements with the intention of prevention of, and redress for anti-competitive practices in the banking sector, and the removal of constraints on the free play of competition in the domestic economy. In fostering competition among banks, BoB is guided by the Banking Act. In addition, BoB is responsible for the evaluation and analysis of mergers and acquisition transactions (other than in the normal course of business) in terms of Section 9(9), Section 17(10) and Section 34 of the Banking Act. The draft Guidelines on Mergers & Acquisitions and Significant Shareholding in Banks has been completed and awaits the enactment of the Banking Bill.</p> <p>Outside of formal powers, there is the demonstrated ability of the BoB to employ moral suasion and the good faith of industry to seek BoB approvals and notification requirements. The requirements of this EC are not met, however. Laws or regulations do not clearly define what types and amounts of investments and acquisitions can be made with respect to bank capital. Notwithstanding the above, major acquisitions by banks' controlling shareholders or by their group entities do not require prior approval of the BoB or notification of the Bank.</p> |
| EC2 | Laws or regulations provide criteria by which to judge individual proposals |
| Description and findings re EC2 | There is no provision within the primary legislation that contains criteria by which to judge individual proposals. The draft Banking Bill includes a Section on Mergers and Acquisitions. The draft Guidelines on Mergers & Acquisitions and Significant Shareholding in Banks has been completed and awaits the enactment of the draft Banking Act. Internal guidance is available to supervisors in terms of assessing license applications which are applicable to using as a framework for assessing major acquisitions. |
| EC3 | Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor also determines, where appropriate, that these new acquisitions and investments will not hinder effective implementation of corrective measures in the future. ¹⁸ The supervisor can prohibit banks from making major acquisitions/investments (including the establishment of cross-border banking operations) in countries with laws or regulations prohibiting information flows deemed necessary for adequate consolidated supervision. The supervisor takes into consideration the effectiveness of supervision in the host country and its own ability to exercise supervision on a consolidated basis. |

¹⁸ In the case of major acquisitions, this determination may take into account whether the acquisition or investment creates obstacles to the orderly resolution of the bank.

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| Description and findings re EC3 | <p>In routine supervision, the BoB allocates significant attention to assessing risks. BoB demonstrated a rigorous assessment of new licenses which uses a framework that would be applied to new acquisitions and investments.</p> <p>The draft Banking Bill includes a section on mergers and acquisitions. The draft Guidelines on Mergers & Acquisitions and Significant Shareholding in Banks has been completed and awaits the enactment of the Banking Bill.</p> |
| EC4 | The supervisor determines that the bank has, from the outset, adequate financial, managerial and organizational resources to handle the acquisition/investment. |
| Description and findings re EC4 | The process to assess the adequacy of financial, managerial and organizational resources is undertaken using a comprehensive framework developed for licensing. |
| EC5 | The supervisor is aware of the risks that non-banking activities can pose to a banking group and has the means to take action to mitigate those risks. The supervisor considers the ability of the bank to manage these risks prior to permitting investment in non-banking activities. |
| Description and findings re EC5 | <p>Banks have expanded their business models (most commonly in the area of insurance) with the aim of expanding their product offering, enhancing the customer experience and, from a financial risk management perspective, diversify their revenue away from a reliance on interest income. To date the focus of the BoB on non-bank activities has been on insurance activities, which represents the major source of income.</p> <p>Nonetheless, the awareness of the insurance activities could be expanded in the first instance and subsequently other activities within the group. While immaterial from a revenue or asset perspective, there are potential non-financial risks which could expose the group to risk (e.g., contagion). There was limited evidence that inputs regarding non-bank activities had a material impact on the risk assessment of banks in the routine supervisory cycle i.e., materials, data, risk information etc. that would inform the BoB regarding broader indicators of risk across the group.</p> |
| AC1 | The supervisor reviews major acquisitions or investments by other entities in the banking group to determine that these do not expose the bank to any undue risks or hinder effective supervision. The supervisor also determines, where appropriate, that these new acquisitions and investments will not hinder effective implementation of corrective measures in the future. ¹⁹ Where necessary, the supervisor is able to effectively address the risks to the bank arising from such acquisitions or investments. |
| Description and findings re AC1 | There are provisions within the Banking Act that require banks to seek the BoB's prior approval to establish a subsidiary. In this way, the BoB becomes aware of a proposed new business line or change in business model. The mission saw examples where commercial banks sought the approval to establish an insurance subsidiary seeking the BoB's prior approval. The development of a consolidated supervision framework will help enhance this aspect of BoB's supervisory framework and internal procedures (see also CP12). In the event the BoB evaluates the risk of an investment by a subsidiary or |

¹⁹ Please refer to Footnote 33 under Principle 7, Essential Criterion 3

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| | an acquisition as excessive, the BoB has powers in the Banking Act to prohibit such an activity. |
| Assessment of Principle 7 | Materially non-compliant |
| Comments | <p>A framework for major acquisitions is not provided for in the primary legislation, and while the Banking Act contains countervailing measures, it is questionable whether the supervisor has the necessary powers to fulfil the specificities associated with major acquisitions and investments (and often unique). As a result, full compliance with this Principle is not met. It is understood that the new Banking Act will address these deficiencies with explicit references to mergers and acquisitions. Additionally, internal guidance has been developed to provide greater support for supervisors when assessing these applications.</p> <p>In relation to group-wide analysis, the awareness of the insurance activities could be expanded in the first instance and subsequently other activities within the group. While immaterial from a revenue or asset perspective, there are potential non-financial risks which could expose the group to risk (e.g., contagion). There was limited evidence that inputs regarding non-bank activities had a material impact on the risk assessment of banks in the routine supervisory cycle i.e., materials, data, risk information etc. that would inform the BoB regarding broader indicators of risk across the group (EC5)</p> |
| Principle 8 | Supervisory approach. An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable. |
| Essential criteria | |
| EC1 | <p>The supervisor uses a methodology for determining and assessing on an ongoing basis the nature, impact, and scope of the risks:</p> <ul style="list-style-type: none"> (a) which banks or banking groups are exposed to, including risks posed by entities in the wider group; and (b) which banks or banking groups present to the safety and soundness of the banking system <p>The methodology addresses, among other things, the business focus, group structure, risk profile, internal control environment and the resolvability of banks, and permits relevant comparisons between banks. The frequency and intensity of supervision of banks and banking groups reflect the outcome of this analysis.</p> |
| Description and findings re EC1 | BoB has adopted the RBS framework. The framework details the methodology for determining and assessing the nature, impact, and scope of the risks. BoB uses off-site and on-site surveillance to identify risks in the banking industry. Risk management |

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| | <p>guidelines was also issued for adoption by banks. The Department also use the '<i>Risk-Based Supervision Methodology</i>' as well as the ICAAP document to assess the risk profile of banks and the capacity of banks' capital to withstand the current and future risks assumed by the bank.</p> <p>The Banking Act does not provide for consolidated supervision which gives the supervisor power 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 (see also CP12). Consolidated supervision is provided for under the revised Banking Act. However, the Bank participates in Supervisory college meetings that provides platforms to understand the risk profiles of banks and other issues of supervisory interests. In addition, the bank holds bilateral supervisory meetings with and host supervisors to discuss key issues. The MOUs allows sharing of information between the Bank and other supervisors of the entity of interest.</p> |
| EC2 | The supervisor has processes to understand the risk profile of banks and banking groups and employs a well-defined methodology to establish a forward-looking view of the profile. The nature of the supervisory work on each bank is based on the results of this analysis. |
| Description and findings re EC2 | <p>BoB applies an RBS methodology, which applies tools such as the CAMEL rating system and offsite surveillance (OSS) system. There are also supervisory colleges that aim at understanding the risks profile of banks and banking groups.</p> <p>The scope and frequency of the onsite examination is determined by the risk profile and/or the size of the bank. For riskier banks, the cycle is 18 months while for large banks it is 3 years. The onsite examinations are risk based. As for off-site activities, the supervisory approach is uniform for all banks and doesn't take into consideration the size or risk level of the Bank.</p> |
| EC3 | The supervisor assesses banks' and banking groups' compliance with prudential regulations and other legal requirements. |
| Description and findings re EC3 | <p>The BoB has a strong focus on compliance with prudential regulations and legal requirements. Multiple processes are built into offsite analysis to verify compliance with key prudential requirements. For example, compliance with liquidity requirements is verified on a daily basis. Confirmation of compliance with the other prudential requirements is also verified:</p> <ul style="list-style-type: none"> - Daily liquidity checked daily - Weekly forex - LE returns on a monthly basis verified for compliance with limits - MCR 15% (reduced temporarily to 12.5% during COVID) is confirmed |

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| | <p>On a monthly basis, BoB produces an early warning report for the banking system, analyses the balance sheet and income statement structure by evaluating capital adequacy, asset quality, liquidity, and prudential ratios are prepared for the banking system. In addition, risk profiling is carried out every quarter and an annual report of the status of the banking sector is produced. Internal control environment is viewed during on-site examinations.</p> <p>The onsite examination assesses the financial condition of banks and evaluates the accuracy of data submitted in the statutory returns. In addition to the assessment of quantitative data, the BSD assess the adequacy of risk management using the RBS manual.</p> |
| EC4 | The supervisor takes the macroeconomic environment into account in its risk assessment of banks and banking groups. The supervisor also takes into account cross-sectoral developments, for example in non-bank financial institutions, through frequent contact with their regulators. |
| Description and findings re EC4 | BoB considers macroeconomic environment in which banks operate and monitors developments in the various sectors. BoB has signed MoUs with various market regulators. |
| EC5 | The supervisor, in conjunction with other relevant authorities, identifies, monitors, and assesses the build-up of risks, trends and concentrations within and across the banking system as a whole. This includes, among other things, banks' problem assets and sources of liquidity (such as domestic and foreign currency funding conditions, and costs). The supervisor incorporates this analysis into its assessment of banks and banking groups and addresses proactively any serious threat to the stability of the banking system. The supervisor communicates any significant trends or emerging risks identified to banks and to other relevant authorities with responsibilities for financial system stability. |
| Description and findings re EC5 | BoB identifies and monitors risks monthly and quarterly and proactively addresses any serious threats to the banking system's stability. BoB communicates to banks, significant risk trends and emerging risks identified. The BoB conducted a thematic review of bank exposures to a single name after it identified the potential build-up of concentration risk in banks' loan portfolios. A monthly report produced by BSD aggregates individual bank results to form an industry-wide view of bank financial conditions. Analysis of individual bank outliers is supported through this report and others. |
| EC6 | Drawing on information provided by the bank and other national supervisors, the supervisor, in conjunction with the resolution authority, assesses the bank's resolvability where appropriate, having regard to the bank's risk profile and systemic importance. When bank-specific barriers to orderly resolution are identified, the supervisor requires, where necessary, banks to adopt appropriate measures, such as changes to business strategies, managerial, operational and ownership structures, and internal procedures. Any such measures take into account their effect on the soundness and stability of ongoing business. |

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| Description and findings re EC6 | Sections 33 and 34 of the Banking Act empowers BoB to manage or dissolve a bank should need arise. However, there is no resolution and recovery plan framework in place. |
| EC7 | The supervisor has a clear framework or process for handling banks in times of stress, such that any decisions to require or undertake recovery or resolution actions are made in a timely manner. |
| Description and findings re EC7 | There are provisions within the existing Banking Act that empower the BoB to take temporary management of a bank if it deems it necessary. Section 33(3) of the Banking Act empowers BoB to take temporary management of an ailing bank. Section 34 of the Banking Act requires that BoB temporarily manages such a bank for a period of 90 days, within which time BoB ought to restore the bank to its board or owners or take any other measures as stipulated under this section. However, there is no resolution and recovery plan framework in place. While the primary legislation contains these provisions, internal processes are not fully documented to support the handling of banks in times of stress. Equally, no formal arrangements are in place to undertake recovery or resolution. |
| EC8 | Where the supervisor becomes aware of bank-like activities being performed fully or partially outside the regulatory perimeter, the supervisor takes appropriate steps to draw the matter to the attention of the responsible authority. Where the supervisor becomes aware of banks restructuring their activities to avoid the regulatory perimeter, the supervisor takes appropriate steps to address this. |
| Description and findings re EC8 | The primary legislation is relatively clear in terms of strict prohibitions regarding activities that are outside of banking business to be undertaken in a separately incorporated subsidiary. The NBFIRA has responsibility for regulating the activities of non-banks. Communication strategies are developed between the BoB and NBFIRA to exchange information about group entities that are within their respective mandates. In addition, Sections 3 and 5 of the Banking Act empower BoB to investigate unlicensed banking business. Sections 11, 17 and 27 of the Banking Act empowers BoB to take appropriate action where a bank is conducting its business in an unlawful and/or unsound manner. |
| Assessment of Principle 8 | Largely compliant |
| Comments | BoB has adopted the risk-based supervision framework. The framework details the methodology for determining and assessing the nature, impact, and scope of the inherent risks. There are also supervisory college meetings that aim at understanding the risk profiles of banks and banking groups, and facilitate cooperation, coordination and information sharing among supervisors. On a monthly basis, BoB produces an early warning report of the banking industry. The report gives an analysis of the balance sheet and income statement structure by evaluating capital adequacy, asset quality, earnings and profitability and liquidity. In addition, risk profiling of the individual banks is carried out every quarter and an annual report of the status of the banking sector is produced. The Internal control environment is reviewed during on-site examinations. |

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| | <p>The Banking Act does not provide for consolidated supervision which gives the supervisor power 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. Consolidated supervision is provided for under the revised Banking Act. However, the Bank participates in Supervisory college meetings that provides platforms to understand the risk profiles of banks and other issues of supervisory interests. In addition, the bank holds bilateral supervisory meetings with and host supervisors to discuss key issues. The MOUs allows sharing of information between the BoB and other supervisors of the entity of interest. In addition, the Bank has concluded Guidelines on Supervision of Financial Conglomerates which will be issued to the market after the enactment of the Banking Bill.</p> <p>The BSD is transitioning away from a CAMEL risk rating methodology (which is purely quantitative) to a hybrid approach which combines a quantitative assessment of the bank's financial condition with an assessment of risk management. The mission suggests that a quality assurance assessment and back-testing be undertaken to evaluate the effectiveness of the methodology to support a risk-based approach to supervision. Factors include: (i) How well the methodology identifies risk; (ii) The effectiveness of forward-looking analysis; (iii) that offsite and onsite assessments are integrated to provide a forward-looking assessment of risk; (iv) How effective is the methodology calibrated for risk and impact.</p> <p>While the primary legislation contains these provisions for handling a bank in temporary management, internal processes are not fully documented to support the handling of banks in times of stress. Equally, no formal arrangements are in place to undertake recovery or resolution (EC 7). No framework for early intervention and resolution.</p> <p>Inclusion of risks within the broader banking group needs to be enhanced. At the time of the mission, banks are expanding their business models into non-bank activities of insurance and capital markets. While nascent, these activities will likely increase as the economy and banking system matures where customers seek more sophisticated products such as wealth management.</p> |
| Principle 9 | Supervisory techniques and tools. The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks. |
| Essential criteria | |

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| EC1 | <p>The supervisor employs an appropriate mix of on-site²⁰ and off-site²¹ supervision to evaluate the condition of banks and banking groups, their risk profile, internal control environment and the corrective measures necessary to address supervisory concerns. The specific mix between on-site and off-site supervision may be determined by the particular conditions and circumstances of the country and the bank. The supervisor regularly assesses the quality, effectiveness and integration of its on-site and off-site functions, and amends its approach, as needed.</p> |
| Description and findings re EC1 | <p>The BSD applies a structured approach to onsite and offsite analysis utilizing a number of internal tools, processes and guidelines/manuals. The BSD has a range of onsite and offsite activities that it applies to evaluate the financial condition of banks, assess risk management and the adequacy of governance (for a full description see EC of this CP). BoB conducts off-site monitoring of banks by using tools such as the CAMEL rating system which is a mainly quantitative analysis of the financial condition of banks across five categories: capital adequacy, asset quality, market risks, earnings, and liquidity. To complement the quantitative methodology, the BSD is in the process of transitioning away from a purely CAMEL-based rating system to a ratings approach that is risk-based.</p> <p>The current system is a hybrid where CAMEL ratings are combined with a risk-based assessment framework that assess risk across eight inherent risk categories:</p> <ul style="list-style-type: none"> - Credit - Liquidity - Interest rate - Foreign exchange - Operational - Legal and compliance - strategic - reputational <p>The system produces a risk matrix which is then combined with the CAMEL rating to produce a combined risk profile. The overall risk profile will then determine a supervisory plan which includes the frequency and intensity of onsite supervisory activities. The offsite activities are typically standardized across banks. It is the frequency of the full onsite examination that will be adjusted based on the outcomes of the risk rating system (composite score of the risk matrix and CAMEL rating).</p> |

²⁰ On-site work is used as a tool to provide independent verification that adequate policies, procedures, and controls exist at banks, determine that information reported by banks is reliable, obtain additional information on the bank and its related companies needed for the assessment of the condition of the bank, monitor the bank's follow-up on supervisory concerns, etc.

²¹ Off-site work is used as a tool to regularly review and analyze the financial condition of banks, follow up on matters requiring further attention, identify and evaluate developing risks and help identify the priorities, scope of further off-site and on-site work, etc.

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| | <p>The BSD is organized in that onsite and offsite supervision is performed within the same unit and there is no separation. The bank examiners within the BSD are responsible for offsite analysis and for conducting onsite examinations. This structure achieves a high degree of integration between the onsite and offsite processes.</p> |
| EC2 | <p>The supervisor has a coherent process for planning and executing on-site and off-site activities. There are policies and processes to ensure that such activities are conducted on a thorough and consistent basis with clear responsibilities, objectives, and outputs, and that there is effective coordination and information sharing between the on-site and off-site functions.</p> |
| Description and findings re EC2 | <p>The BSD has a strong approach to planning on-site and off-site activities. The BSD's '<i>Operating Manual</i>' is a comprehensive set of procedures for on-site and off-site activities including internal timelines, responsibilities, and approvals. The assessors sampled supervisory files to evidence the outputs of supervision activities that align with the manual.</p> <p>To complement the Operating Manual, the BSD employs the '<i>Risk-Based Supervision Policy Framework</i>' which guides supervisors through a risk assessment process.</p> <p>For offsite activities, four offsite surveillance reports are prepared by the BSD:</p> <ul style="list-style-type: none"> i. Daily liquidity returns ii. Weekly foreign exchange returns iii. Monthly returns iv. Quarterly returns <p>For onsite supervision, the BoB employs a range of activities: The first is three annual statutory meetings including: (i) Trilateral meeting with banks; (ii) Bilateral meeting with external auditor; and (iii) Bilateral meeting with banks (see EC7 of this CP for a discussion of the topics and meeting objectives).</p> <p>In terms of onsite examinations there are three broad types:</p> <ul style="list-style-type: none"> I. Full scope examination; II. Follow-up/ limited scope examination; and III. Thematic onsite examinations. <p>Liaison with home/host supervisors is another activity that is undertaken in the supervisory cycle and participation at supervisory colleges.</p> <p>The following diagram depicts the activities, outputs and interlinkages of the supervisory cycle:</p> |

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| | <p style="text-align: center;">Activities, Outputs, and Interlinkages of the Supervisory Cycle</p> <p>The assessors saw evidence of planning to achieve consistency in process.</p> <p>The supervisory plan is established every calendar year with results obtained from prudential meetings with banks, OSS using CAMEL and risk assessment rating systems (RAS) assigned to a bank during the previous on-site examination. OSS report is produced quarterly with indicators developed for capital adequacy; asset quality; market risk; earnings and liquidity. The supervisory plan incorporates supervisory tools to be used, which include, inter-alia, on-site examination; off-site monitoring; prudential meetings with senior management or the board of the bank; meetings with external auditors and exchange of information with other regulators. The supervisory plan is reviewed half-yearly to reflect new risk trends. The on-site and off-site activities are conducted by the same division which enhances coherence.</p> <p>BoB has an operating manual and work program to plan and execute on-site and off-site activities of banks. The Bank plans the on-site examinations and specifies the entities to be examined on an annual basis.</p> <p>BSD is structured such that there is no separation between on-site and off-site supervision teams. The sharing of information across the teams was demonstrated to be effective.</p> |
| <p>EC3</p> | <p>The supervisor uses a variety of information to regularly review and assess the safety and soundness of banks, the evaluation of material risks, and the identification of necessary corrective actions and supervisory actions. This includes information, such as</p> |

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| | <p>prudential reports, statistical returns, information on a bank's related entities, and publicly available information. The supervisor determines that information provided by banks is reliable²² and obtains, as necessary, additional information on the banks and their related entities.</p> |
| Description and findings re EC3 | <p>The primary inputs for the reports generated by offsite surveillance are the statutory returns that banks submit. The returns support the analysis of the banks' financial condition and compliance with prudential requirements (e.g., MCR, LAR, LE and FX). The statutory returns are signed by the Principal Officer (CEO equivalent and in practice CFO) and two directors which provides a degree of comfort in the veracity of the data. The statutory returns are also audited at the end of the financial year providing an independence assurance of the data accuracy. Lastly, bank examiners check for information accuracy when they receive it, and the on-site examination will verify the accuracy of data and regulatory reporting.</p> <p>To complement the routine financial analysis, banks will submit quarterly reports on remediation of onsite examination findings.</p> <p>The full scope onsite examination is the main opportunity bank examiners are able to assess the quality of bank policies and processes, the adequacy of controls and governance.</p> |
| EC4 | <p>The supervisor uses a variety of tools to regularly review and assess the safety and soundness of banks and the banking system, such as:</p> <ul style="list-style-type: none"> (a) analysis of financial statements and accounts; (b) business model analysis; (c) horizontal peer reviews; (d) review of the outcome of stress tests undertaken by the bank; and (e) analysis of corporate governance, including risk management and internal control systems. <p>The supervisor communicates its findings to the bank as appropriate and requires the bank to take action to mitigate any particular vulnerabilities that have the potential to affect its safety and soundness. The supervisor uses its analysis to determine follow-up work required, if any.</p> |
| Description and findings re EC4 | <p>The BSD uses a range of onsite and offsite surveillance tools. See below:</p> <ul style="list-style-type: none"> (a) Analysis of financial statements is the core element of BSD's offsite surveillance and is a component of the onsite examination. (b) bank business models are mainly evaluated during onsite examinations. |

²² Please refer to Principle 10.

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| | <p>(c) There BSD makes limited use of horizontal peer analysis. The BSD recently conducted an analysis of banks' exposures to a single counterparty.</p> <p>(d) Banks submit ICAAPs which include stress testing outcomes to measure the adequacy of capital.</p> <p>(e) the BSD evaluates corporate governance as part of the onsite examination including risk management and internal controls.</p> <p>BoB carries out routine bank reviews or other inputs, including (this list is not exhaustive):</p> <ul style="list-style-type: none"> - At the licensing stage, the Bank focuses on analysis of monthly financial statements and annual accounts, business models and corporate governance practices and risk management systems and agenda items at bilateral and trilateral meetings with supervised banks; - The Bank assesses consumer complaints and products/services to review to check if banks have appropriate risk management strategies in place to reduce risks associated with the introduction of the products and/or services. This enables the division to approve fees that would not be considered exorbitant; - Outputs from supervisory colleges; - Pillar 3 reports; and, - Quarterly reporting from banks' remediation of onsite examination findings. <p>The supervisory communicates results from onsite and offsite analysis in a timely and structured way. The BSD evidenced strong commitment to communicating findings from surveillance.</p> |
| EC5 | <p>The supervisor, in conjunction with other relevant authorities, seeks to identify, assess and mitigate any emerging risks across banks and to the banking system as a whole, potentially including conducting supervisory stress tests (on individual banks or system-wide). The supervisor communicates its findings as appropriate to either banks or the industry and requires banks to take action to mitigate any particular vulnerabilities that have the potential to affect the stability of the banking system, where appropriate. The supervisor uses its analysis to determine follow-up work required, if any.</p> |
| Description and findings re EC5 | <p>BoB uses the off-site surveillance tool to assess risks in the market and communicate accordingly to banks. However, there is still need for supervisory stress tests to be performed.</p> |
| EC6 | <p>The supervisor evaluates the work of the bank's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk.</p> |
| Description and findings re EC6 | <p>Section 22(3) (b) of the Banking Act require banks' auditors to submit auditor's report to BoB. BoB reviews banks' internal audit, staffing levels, qualifications, job descriptions</p> |

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| | and reports. BoB also considers the quality of the Board and its management during the on-site examination process. BoB also vets Head of Internal Audit for fitness and probity. |
| EC7 | The supervisor maintains sufficiently frequent contacts as appropriate with the bank's Board, non-executive Board members and senior and middle management (including heads of individual business units and control functions) to develop an understanding of and assess matters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems and internal controls. Where necessary, the supervisor challenges the bank's Board and senior management on the assumptions made in setting strategies and business models. |
| Description and findings re EC7 | <p>The BSD undertakes routine engagement with banks as part of a structured supervisory plan as well as ad hoc meetings as necessary.</p> <p>There are three annual meetings for all commercial banks, the structure and objective discussed below:</p> <p>Trilateral meetings with banks. This meeting is attended by the BoB, External auditor, and the bank. The main purpose of this meeting is to discuss the bank's audited financial accounts and other aspects of the bank's business such as the effectiveness of internal controls. The BSD's Supervisory Manual contains instructions for how this meeting should be undertaken which was evidenced.</p> <p>Bilateral meeting with external auditors. This meeting is held between BoB and the external auditor. The purpose is to discuss issues pertaining to the audit relevant to BoB's supervisory responsibilities and the financial condition of the bank.</p> <p>Bilateral meeting with the regulated bank. This meeting is held between the BoB and the bank. The objective is to discuss issues at a more strategic level such as business mode, three-year strategy and risk management. The meeting will discuss the BoB's risk assessment of the bank and discusses issues such as capital adequacy, Pillar 1 risks (credit, market and operational risks) as well as Pillar 2 risks (concentration risks).</p> <p>BoB also holds ad-hoc meetings and correspondence, when necessary, with a bank's Board, non-executive board members and senior and middle management.</p> <p>The BoB engages with the banks at the senior manager level including the senior leadership team. However, engagement with the Board is not a typical part of the BoB's supervisory cycle in practice.</p> |
| EC8 | The supervisor communicates to the bank the findings of its on- and off-site supervisory analyses in a timely manner by means of written reports or through discussions or meetings with the bank's management. The supervisor meets with the bank's senior management and the Board to discuss the results of supervisory |

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| | examinations and the external audits, as appropriate. The supervisor also meets separately with the bank's independent Board members, as necessary. |
| Description and findings re EC8 | <p>The BSD undertakes a structured approach to the onsite examination process in accordance with the 'Supervisory Manual' which describes all necessary steps in the process to communicate findings to banks at the conclusion of the onsite. At the conclusion of the onsite, a preliminary exit meeting is held with the bank where to the bank's relevant divisional heads the examination findings. This is typically very timely and completed after the branch inspections and before exiting the bank. The next steps are to prepare the examination report which will go through an internal process and a draft exam report is shared with the bank and comments requested. Internally a draft report is submitted to the Deputy Director within two weeks of the preliminary exit meeting.</p> <p>The examiners have an exit meeting where they present to the bank senior management. The BSD will submit a report addressed to the Board which contains the main findings and financial condition of the bank. To complete the process, the BSD will conduct follow-up onsite reviews as a way to monitor progress through verification of implementation of onsite findings.</p> |
| EC9 | The supervisor undertakes appropriate and timely follow-up to check that banks have addressed supervisory concerns or implemented requirements communicated to them. This includes early escalation to the appropriate level of the supervisory authority and to the bank's Board if action points are not addressed in an adequate or timely manner. |
| Description and findings re EC9 | <p>Banks are expected to respond to the findings of an examination report, and/or other areas of supervisory concern within a reasonable time. BSD's internal operating manual indicates that banks provide an update on a quarterly basis. However, there is no specific time required to respond.</p> <p>The implementation of the recommendations of the onsite examination is monitored by BoB on a quarterly basis and progress is included in the quarterly institutional profile produced by the BSD. The progress against onsite examination findings informs part of the BSD's assessment of risk management.</p> |
| EC10 | The supervisor requires banks to notify it in advance of any substantive changes in their activities, structure, and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements. |
| Description and findings re EC10 | There are several provisions within the Banking Act where banks are required to notify the BoB in the event of a material/substantive changes. Examples include incorporating a subsidiary to undertake new business (such as insurance or capital markets), change in significant shareholding, large exposures etc. Nonetheless, there is no legal provision covering this criterion. However, in practice, BoB encourages banks to notify it of any material changes in their activities, structure, and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements. |

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| EC11 | The supervisor may make use of independent third parties, such as auditors, provided there is a clear and detailed mandate for the work. However, the supervisor cannot outsource its prudential responsibilities to third parties. When using third parties, the supervisor assesses whether the output can be relied upon to the degree intended and takes into consideration the biases that may influence third parties. |
| Description and findings re EC11 | The BoB has the power to engage independent third parties contained in the primary legislation. Section 27(b) of the Banking Act empowers BoB to appoint a third party to advise a bank on how to rectify its situation, following an examination of a bank. Section 22(6) of the Banking Act also empowers BoB to entrust an auditor to carry out additional investigations or carry out other remedial duties. The BoB has not utilized third parties to carry out supervisory tasks. |
| EC12 | The supervisor has an adequate information system which facilitates the processing, monitoring and analysis of prudential information. The system aids the identification of areas requiring follow-up action. |
| Description and findings re EC12 | Historically banks had submitted statutory returns both manually and automated. During the COVID pandemic, the majority of banks transitioned to an automated approach which has remained usual practice. Nonetheless, BSD does not have an automated MIS system which performs quality testing on data to identify outliers. This process is conducted manually by bank examiners. The BoB is actively moving toward an automated system and has engaged FIS Global for the provision of a management information system, which is expected to process, monitor, and analyze prudential information as well as identify areas which require follow-up action. The project is scheduled for completion in late 2022. While the process of analyzing the data is manual and time consuming, the process to identify areas for follow-up action appeared to be effective. |
| Additional criteria | |
| AC1 | The supervisor has a framework for periodic independent review, for example by an internal audit function or third-party assessor, of the adequacy and effectiveness of the range of its available supervisory tools and their use, and makes changes as appropriate. |
| Description and findings re AC1 | The BSD is subject to internal audit, however, a formal framework for periodic independent reviews of the adequacy and effectiveness of the range of supervisory tools and their use is not in place. The BSD would benefit from an independent review of its supervisory tools and their use. |
| Assessment of Principle 9 | Largely compliant |
| Comments | The assessors observed an overly elongated cycle for full-scope onsite examinations. The mission recognizes the disruptions owing to COVID has disrupted normal cycles, nonetheless, in several cases the last full-scope onsite examination was undertaken performed approximately four to five years. |

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| | <p>A more differentiated approach to supervision activities is warranted. In terms of the onsite examination, a greater differentiation in scope and frequency. This would allow more frequent targeted onsite examinations on specific risk areas that could complement the full-scope onsite examination. In terms of offsite analysis, there is an opportunity to augment the quantitative information with more qualitative information associated to risk management such as policies and procedures, risk appetite, business plans and funding plans.</p> <p>A greater frequency of meeting with the independent non-executive directors is suggested. In the case of the structure of the banking system where group structures exist, this could be a critical part of the process to communicate findings from onsite examinations and obtain the input and feedback from independent non-executive directors to remediate deficiencies identified.</p> <p>System-wide stress tests should be used with greater emphasis and integrated into the assessment of bank's ICAAPs. The system-wide stress tests would help to identify emerging systemic risks and outliers at individual banks.</p> |
| Principle 10 | Supervisory reporting. The supervisor collects, reviews and analyses prudential reports and statistical returns ²³ from banks on both a solo and a consolidated basis, and independently verifies these reports through either on-site examinations or use of external experts. |
| Essential criteria | |
| EC1 | The supervisor has the power ²⁴ to require banks to submit information, on both a solo and a consolidated basis, on their financial condition, performance, and risks, on demand and at regular intervals. These reports provide information such as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, risk concentrations (including by economic sector, geography, and currency), asset quality, loan loss provisioning, related party transactions, interest rate risk, and market risk. |
| Description and findings re EC1 | <p>The Banking Act empowers BoB to require supervised banks to submit information on annual accounts, returns and any information which it may require, from any bank, concerning its operations (see Sections 19, 20 and 21). The relevant sections of the Act are clear in terms of banks' responsibilities to report and the timeliness of returns.</p> <p>As per the Banking Act, banks are required to submit monthly returns of a statement of assets and liabilities using generally accepted accounting principles (in the case of Botswana IFRS has been adopted – see also CP27) no later than 21 days after the end of month. The monthly statement of assets and liabilities gives the BSD an opportunity</p> |

²³ In the context of this Principle, “prudential reports and statistical returns” are distinct from and in addition to required accounting reports. The former are addressed by this Principle, and the latter are addressed in Principle 27.

²⁴ Please refer to Principle 2.

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| | <p>to assess the growth in the balance sheet, changes in risk-weighted assets and credit quality (see Section 20 of the Banking Act).</p> <p>On a quarterly basis, banks submit a more complete suite of statutory returns (regulatory reporting) which extend beyond the balance sheet to profit and loss, trading returns, changes in risk-weight assets, and generally a more complete picture of the financial condition of the bank. The quarterly submission of returns is the most complete submission upon which the responsible supervisor conducts analysis of the financial condition to identify emerging risks. Pillar 3 statements are also submitted by banks to complement the statutory returns (see also CP28).</p> <p>To complement the monthly and quarterly submission of financial information, banks submit the following:</p> <ul style="list-style-type: none"> - Daily liquidity ratios (Liquid Asset Ratio) to confirm compliance with Section 16 of the Banking Act; - Weekly foreign exchange reports; - Monthly large exposure returns <p>Since 2017, banks have been submitting ICAAP documents which contain a comprehensive assessment of the bank's Pillar 1 and Pillar 2 risks and the adequacy of capital to support the risks in the business. The assessment of ICAAPs is evolving and the contribution to offsite analysis and the overall risk assessment process is maturing (see also CP16).</p> <p>Banks submit solo returns, however in the case of one bank, reporting commenced in January 2022 of consolidated returns.</p> |
| EC2 | The supervisor provides reporting instructions that clearly describe the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that are widely accepted internationally. |
| Description and findings re EC2 | <p>All banks have adopted IFRS and report to the BoB on that basis. An independent association is responsible for enforcing accounting standards in Botswana (BAOA).</p> <p>Reporting standards are published and available on BoB's website. The reporting instructions clearly refer to the requirements for regulatory reporting/statutory returns to be reported using IFRS (see also CP26 and 27). The BoB has also provided industry with training as to how to interpret reporting instructions.</p> |
| EC3 | The supervisor requires banks to have sound governance structures and control processes for methodologies that produce valuations. The measurement of fair values maximizes the use of relevant and reliable inputs and is consistently applied for risk management and reporting purposes. The valuation framework and control procedures are subject to adequate independent validation and verification, either internally or by an external expert. The supervisor assesses whether the valuation used for regulatory purposes is reliable and prudent. Where the supervisor determines that |

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| | valuations are not sufficiently prudent, the supervisor requires the bank to make adjustments to its reporting for capital adequacy or regulatory reporting purposes. |
| Description and findings re EC3 | From a governance perspective, statutory returns are required to be signed by one principal officer (Chief Financial Officer) and two directors. This level of attestation ensures a high degree of risk governance and control as to the veracity of the report information. In addition, the external auditor is required to audit the last quarter of a banks' financial year which is intended to provide another layer of assurance as to the overall processes that are used to produce financial returns that are submitted to the supervisor. |
| EC4 | The supervisor collects and analyses information from banks at a frequency commensurate with the nature of the information requested, and the risk profile and systemic importance of the bank. |
| Description and findings re EC4 | <p>Banks are required to submit data to the BoB for offsite analysis on a daily, weekly, monthly, quarterly and annual basis. The frequency reflects the nature of the risk: for example, banks report to the BoB daily compliance with the Liquid Assets Ratio (LAR) given the liquidity profile of a bank can change rapidly (see also CP24).</p> <p>The reporting requirements of banks are not adjusted for the systemic importance of banks. Notwithstanding there is a set of large banks and smaller banks, reporting requirements are uniform with no change in reporting requirements for a larger bank and a smaller bank. Equally, two banks have recently been identified as D-SIBs, yet their reporting requirements have not been adjusted to reflect their size and scale and systemic importance.</p> |
| EC5 | In order to make meaningful comparisons between banks and banking groups, the supervisor collects data from all banks and all relevant entities covered by consolidated supervision on a comparable basis and related to the same dates (stock data) and periods (flow data). |
| Description and findings re EC5 | The BoB collects data from all commercial banks on the same frequency using the same reporting instructions and based on the same auditing standards. To this extent, comparable data is available to help inform offsite analysis and identify weak banks and outliers requiring attention. As mentioned above, statutory returns are typically submitted using solo data. |
| EC6 | The supervisor has the power to request and receive any relevant information from banks, as well as any entities in the wider group, irrespective of their activities, where the supervisor believes that it is material to the condition of the bank or banking group, or to the assessment of the risks of the bank or banking group or is needed to support resolution planning. This includes internal management information. |
| Description and findings re EC6 | The Banking Act empowers BoB to request any information from the banks concerning its operations or its affiliates in Botswana and subsidiaries abroad. Management information is used as inputs to analysis of the financial condition of banks and publicly available materials are used to complement statutory returns. |

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| EC7 | The supervisor has the power to access ²⁵ all bank records for the furtherance of supervisory work. The supervisor also has similar access to the bank's Board, management, and staff, when required. |
| Description and findings re EC7 | Section 25(1) of the Banking Act empowers examiners to examine all documents it deems fit to examine, while carrying out an on-site examination. Section 18 of the Banking Act requires banks to maintain records in Botswana, while Section 21 of the Banking Act empowers BoB to request information from banks when necessary. |
| EC8 | The supervisor has a means of enforcing compliance with the requirement that the information be submitted on a timely and accurate basis. The supervisor determines the appropriate level of the bank's senior management is responsible for the accuracy of supervisory returns, imposes sanctions for misreporting and persistent errors, and requires that inaccurate information be amended. |
| Description and findings re EC8 | The Banking Act contains explicit fines for non-compliance with reporting. To wit, any bank that fails to supply any information called for by the BoB, or fails to supply it within the time, or extended time, shall be guilty of an offence and liable to a fine of BWP 10 000. Sections 19 and 20 of the Banking Act require banks to provide the supervisor with accurate information, while sections 20(3) and 25(2) provides for penalties for non-compliance. The Bank requires that all statutory returns should be signed by either CEO or CFO. |
| EC9 | The supervisor utilizes policies and procedures to determine the validity and integrity of supervisory information. This includes a program for the periodic verification of supervisory returns by means either of the supervisor's own staff or of external experts. ²⁶ |
| Description and findings re EC9 | Sections 20(2) and 21(2) of the Banking Act empowers BoB to require banks to audit returns and any other information prior to submission to the BoB. Accordingly, each bank is required to audit its year-end statutory return. The Bank also relies on external auditors to determine the validity of the submitted information |
| EC10 | The supervisor clearly defines and documents the roles and responsibilities of external experts, ²⁷ including the scope of the work, when they are appointed to conduct supervisory tasks. The supervisor assesses the suitability of experts for the designated task(s) and the quality of the work and takes into consideration conflicts of interest that could influence the output/recommendations by external experts. External experts may be utilized for routine validation or to examine specific aspects of banks' operations. |
| Description and findings re EC10 | Section 27(b) of the Banking Act empowers BoB to appoint qualified external persons to conduct supervisory task, after an examination of a bank. BoB specifies the terms of |

²⁵ Please refer to Principle 1, Essential Criterion 5.

²⁶ Maybe external auditors or other qualified external parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions.

²⁷ Maybe external auditors or other qualified external parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions. External experts may conduct reviews used by the supervisor, yet it is ultimately the supervisor that must be satisfied with the results of the reviews conducted by such external experts.

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| | reference for each external expert it engages to conduct supervisory tasks. Section 22 (6) of the Banking Act empowers the Bank to influence the scope of the external audit. |
| EC11 | The supervisor requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes. |
| Description and findings re EC11 | The Banking Act clearly requires the external auditor to bring to the attention of the BoB a breach of the Act or non-compliance and other associated malfeasance (see Section 22(7)). In addition to this provision, the BoB undertakes an annual trilateral meeting between the bank, the external auditor and the BoB whereby the annual accounts are discussed, and the external auditor's opinions are sought to identify any potential issues (see also CP28). |
| EC12 | The supervisor has a process in place to periodically review the information collected to determine that it satisfies a supervisory need. |
| Description and findings re EC12 | Two reviews of the reporting instructions conducted. The first in 2014 as part of the Basel II implementation process and the second more recent review to prepare for the implementation of IFRS. There is a need to conduct a comprehensive review of the reporting framework to align with the changes in the primary legislation and to align with changes in the financial system, bank business organizational approaches and supervisory needs. |
| Assessment of Principle 10 | Largely compliant |
| Comments | <p>Financial statements are not required to be submitted in both solo and consolidated formats. The mission is aware that one commercial bank commenced reporting on a consolidated basis January 2022. However, this has not been accompanied with broader guidance for all commercial banks to report on a consolidated basis potentially creating differences in balance sheets impacting a meaningful comparative analysis (EC1 and EC5).</p> <p>The reporting requirements of banks are not adjusted for the systemic importance of banks. Notwithstanding there is a set of large banks and smaller banks, reporting requirements are uniform with no change in reporting requirements for a larger bank and a smaller bank. Equally, two banks have recently been identified as D-SIBs, yet their reporting requirements have not been adjusted to reflect their size and scale and systemic importance (EC4).</p> <p>Reporting instructions should be comprehensively reviewed on a more frequent basis. The revision to the Banking Act should provide the BSD an opportunity to revise the adequacy of supervisory returns to support risk identification. (EC12).</p> |
| Principle 11 | Corrective and sanctioning powers of supervisors. The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability to revoke the banking license or to recommend its revocation. |

| Essential criteria | |
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| EC1 | The supervisor raises supervisory concerns with the bank's management or, where appropriate, the bank's Board, at an early stage, and requires that these concerns be addressed in a timely manner. Where the supervisor requires the bank to take significant corrective actions, these are addressed in a written document to the bank's Board. The supervisor requires the bank to submit regular written progress reports and checks that corrective actions are completed satisfactorily. The supervisor follows through conclusively and in a timely manner on matters that are identified. |
| Description and findings re EC1 | <p>BoB has established practice, where supervisory concerns that require prompt corrective action are communicated directly to a bank's board. BoB follows through such issues of supervisory concern on a regular basis when it meets with a bank, be it during on-site examination or in a prudential meeting. The Banking Act prescribes penalties for non-compliance with prudential requirements, e.g., Section 11; Section 13(2); Section 16(6); Section 20(3); Section 21(5); Section 25(2)-(3); Section 26(c); Section 29(3) Section 32 and Section 52.</p> <p>The BoB undertakes offsite analysis of statutory returns which are submitted daily, weekly, monthly, quarterly, and annually. If issues are identified, the BSD raises with bank points of contact and if necessary, senior bank management. Supervisory concerns are escalated according to the severity of the issue.</p> <p>The supervisory plan includes an annual meeting with bank senior management. During these meetings, supervisory concerns are raised.</p> <p>Following onsite examinations, BoB communicates findings to the bank via a letter addressed to the Board. The bank reports quarterly progress against onsite examination findings and the BSD incorporates the results into the bank's institutional profile (see also CPs 8 & 9).</p> |
| EC2 | The supervisor has available ²⁸ an appropriate range of supervisory tools for use when, in the supervisor's judgment, a bank is not complying with laws, regulations or supervisory actions, is engaged in unsafe or unsound practices or in activities that could pose risks to the bank or the banking system, or when the interests of depositors are otherwise threatened. |
| Description and findings re EC2 | <p>The Banking Act provides for several supervisory tools that the BoB can deploy where banks are not complying with laws, regulations or if the bank is engaged in unsound practices. In addition to moral suasion, the BoB can impose conditions on banks restricting their activities. The tools include:</p> <ul style="list-style-type: none"> - Section 11 of the Banking Act empowers the BoB to revoke a banking license of a bank, |

²⁸ Please refer to Principle 1.

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| | <ul style="list-style-type: none"> - Section 13 (2) of the Banking Act empowers BoB to take regulatory action against a bank for failure to comply with minimum capital requirements, - Section (20) empowers the Bank to charge a bank if it fails to submit statutory returns, and - Section 27 empowers the Bank to vary licensing conditions or revoke if a business is conducted in an unlawful or unsound manner. <p>Section 12 of the Banking Act also allows BoB to amend, add to or vary the license conditions which could be used broadly. In practice, however, the BoB has not used this section of the Banking Act.</p> |
| EC3 | The supervisor has the power to act where a bank falls below established regulatory threshold requirements, including prescribed regulatory ratios or measurements. The supervisor also has the power to intervene at an early stage to require a bank to take action to prevent it from reaching its regulatory threshold requirements. The supervisor has a range of options to address such scenarios. |
| Description and findings re EC3 | Sections 10, 11, 12 and 33 of the Banking Act specify several measures that the BoB can use to ensure correction of deficiencies noted in the operation of banks. Section 27 empowers the Bank to vary licensing conditions or revoke if a business is in an unlawful or unsound manner. |
| EC4 | The supervisor has available a broad range of possible measures to address, at an early stage, such scenarios as described in essential criterion 2 above. These measures include the ability to require a bank to take timely corrective action or to impose sanctions expeditiously. In practice, the range of measures is applied in accordance with the gravity of a situation. The supervisor provides clear prudential objectives or sets out the actions to be taken, which may include restricting the current activities of the bank, imposing more stringent prudential limits and requirements, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from the banking sector, replacing or restricting the powers of managers, Board members or controlling owners, facilitating a takeover by or merger with a healthier institution, providing for the interim management of the bank, and revoking or recommending the revocation of the banking license. |
| Description and findings re EC4 | <p>Sections 10, 11, 12 and 33 of the Banking Act specify several measures that the BoB can use to ensure correction of deficiencies noted in the operation of banks. Sections 33 and 34 of the Banking Act empower BoB to take action when necessary (temporary management).</p> <p>a) restricting the current activities of the bank - the Banking Act permits the BoB to vary license conditions which can restrict their activities of banks. However, no experience exercising this power.</p> |

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| | <p>b) imposing more stringent prudential limits and requirement - the Banking Act permits the BoB to place restrictions on banking licenses, which can restrict the activities of banks. However, no experience exercising this power.</p> <p>c) withholding approval of new activities or acquisitions, Section 41 of the Bank of Botswana Act empowers the Bank to approve the pricing and not the product.</p> |
| EC5 | The supervisor applies sanctions not only to the bank but, when and if necessary, also to management and/or the Board, or individuals therein. |
| Description and findings re EC5 | Sections 26, 30 and 32 of the Banking Act prescribes sanctions to be imposed on directors, principal officer and other employees when they fail to take reasonable steps to ensure compliance with the provisions of the Act. The Banking Act also empowers BoB to operate effectively as per prescribed criteria (Section 11, 12, 33,34, 35 of the Banking Act). |
| EC6 | The supervisor has the power to take corrective actions, including ring-fencing of the bank from the actions of parent companies, subsidiaries, parallel-owned banking structures and other related entities in matters that could impair the safety and soundness of the bank or the banking system. |
| Description and findings re EC6 | No legal provision for ring-fencing of the bank from its related parties in matters that could impair the safety and soundness of the bank or the banking system. However, a draft policy on the supervision of distressed banks is in place. |
| EC7 | The supervisor cooperates and collaborates with relevant authorities in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution). |
| Description and findings re EC7 | <p>Not covered in the Banking Act or any guideline. However, BoB cooperates and collaborates with relevant authorities when dealing with problem banks in accordance with the provisions of Section 33 of the Banking Act. However, BoB does not have a clear framework of dealing with problem banks.</p> <p>As banks enter bancassurance, particularly insurance subsidiaries, resolution may require cooperation with NBFIRA, which is not occurring. Arrangements are in place at the FSC where the BoB and NBFIRA meet (see also CP3).</p> |
| Additional criteria | |
| AC1 | Laws or regulations guard against the supervisor unduly delaying appropriate corrective actions. |
| Description and findings re AC1 | Not covered in the Banking Act or any guideline currently in place. |
| AC2 | When taking formal corrective action in relation to a bank, the supervisor informs the supervisor of non-bank related financial entities of its actions and, where appropriate, coordinates its actions with them. |

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| Description and findings re AC2 | BoB has signed an MoU with the NBFIRA, which calls for exchange of information on regulatory matters. The BSD does not have formal internal procedures in place that address the exchange of information with regards to formal corrective action with the non-bank supervisor NBFIRA. |
| Assessment of Principle 11 | Largely Compliant |
| Comments | <p>The BoB has traditionally used moral suasion to enforce prudential standards. Supervisory concerns are communicated to bank management and in the case of onsite examination findings to the Board. In practice, there has been limited experience using sanctioning powers provided for the Banking Act. Equally, there is limited experience restricting bank licenses and applying more conservative prudential requirements on individual banks such as higher minimum capital requirements.</p> <p>Formal guidelines for handling problem and weak banks have not been developed. There is also no formal framework for supervisors linking the CAMEL risk rating system and approaches to corrective actions. BoB does not have a formulated corrective action policy framework for distressed banks, although it has some of its elements in the form of regular prudential requirements.</p> <p>EC6 ring fencing not developed in the Banking Act and no experience in practice.</p> <p>EC7 not met with regards to resolution of problem banks.</p> <p>AC1 not met. Laws or regulations guard against the supervisor unduly delaying appropriate corrective actions.</p> <p>AC2 not met. When taking formal corrective action in relation to a bank, the supervisor informs the supervisor of non-bank related financial entities of its actions and, where appropriate, coordinates its actions with them.</p> |
| Principle 12 | Consolidated supervision. An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide. ²⁹ |
| Essential criteria | |
| EC1 | The supervisor understands the overall structure of the banking group and is familiar with all the material activities (including non-banking activities) conducted by entities in the wider group, both domestic and cross-border. The supervisor understands and assesses how group-wide risks are managed and takes action when risks arising from the banking group and other entities in the wider group, in particular contagion and reputation risks, may jeopardize the safety and soundness of the bank and the banking system. |

²⁹ Please refer to footnote 19 under Principle 1.

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| Description and findings re EC1 | <p>Banks have begun to diversify their business models through the addition of insurance which is required to be undertaken via the establishment of a subsidiary. NBFIRA is the insurance regulator.</p> <p>The Banking Act also requires the establishment of a subsidiary to be approved by the BoB. An application to the BoB for establishment of a subsidiary includes all relevant material about the new subsidiary.</p> <p>The group structure is included in the institutional profile which is updated quarterly where bank business models are discussed (see CP8 and 9). During supervisory colleges the BoB evaluates group structure and risks across the entire group, including from other regulators (see also CP13).</p> <p>At the time of licensing, BoB requires information about a bank's group structure during the licensing stage to determine potential risks associated with the group. All the banks operating in Botswana are subsidiaries of foreign-owned entities. However, BoB does not practice consolidated supervision. The supervised banks are subsidiaries of international and regional banks. BoB is a host supervisor. The revised Banking Bill includes a section on consolidated supervision.</p> <p>The Banking Act has no provision for consolidated supervision. In addition, all banks in Botswana are subsidiaries of foreign banks. However, BoB has memorandum of understanding with home supervisors of the parent banks of the subsidiaries operating in Botswana. The new Banking Bill covers consolidated supervision.</p> |
| EC2 | <p>The supervisor imposes prudential standards and collects and analyses financial and other information on a consolidated basis for the banking group, covering areas such as capital adequacy, liquidity, large exposures, exposures to related parties, lending limits and group structure.</p> |
| Description and findings re EC2 | <p>The BoB does not have the power to apply prudential standards across a banking group such as a non-operating holding company parent entity to a bank and affiliates. Currently all prudential requirements are applied at the solo (Level 1) bank level. Analyses of the banking system suggests that minor sources of revenue and assets and activities are operated outside of the solo bank (Level 1). As of January 2022, there is one bank that is submitting its statutory return on a consolidated basis.</p> <p>During bilateral and trilateral meetings held annually with the banks' management, corporate governance policies and practices are discussed to determine if they are robust. Among others, the following are discussed: the board composition, board committees, board's role in risk oversight, succession planning and evaluation, directors' compensation, training and self-assessment. These processes are also verified during an on-site examination through the review of board packs and minutes. The draft Banking Act includes a section on consolidated supervision.</p> |
| EC3 | <p>The supervisor reviews whether the oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding</p> |

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| | company) is adequate having regard to their risk profile and systemic importance and there is no hindrance in host countries for the parent bank to have access to all the material information from their foreign branches and subsidiaries. The supervisor also determines that banks' policies and processes require the local management of any cross-border operations to have the necessary expertise to manage those operations in a safe and sound manner, and in compliance with supervisory and regulatory requirements. The home supervisor takes into account the effectiveness of supervision conducted in the host countries in which its banks have material operations. |
| Description and findings re EC3 | BoB is not a home-regulator to the eight commercial banks operating in Botswana. Home regulators of the commercial banks operating in Botswana have access to all the material information from their subsidiaries. Local management of these banks has the necessary expertise to manage these subsidiaries in a safe and sound manner and in compliance with supervisory and regulatory requirements. For statutory banks, they have only domestic operations and no cross-border activities. |
| EC4 | The home supervisor visits the foreign offices periodically, the location and frequency being determined by the risk profile and systemic importance of the foreign operation. The supervisor meets the host supervisors during these visits. The supervisor has a policy for assessing whether it needs to conduct on-site examinations of a bank's foreign operations, or require additional reporting, and has the power and resources to take those steps as and when appropriate. |
| Description and findings re EC4 | The BoB participates in supervisory colleges on an annual and two-year cycle. Within the college process, the BoB evidenced active communication of risk information in a two-way exchange that helped inform the supervision of the subsidiary. Outside of the supervisory college, no formal ongoing interaction with the home supervisor is undertaken. Ad hoc and issues-based communication takes place and there is no obstacle for BoB to share information with home supervisors. The BoB evidenced onsite examinations with home supervisors (e.g. Zimbabwe) and prior to the disruption to the supervision cycle caused by COVID-19, the BoB had planned a joint onsite examination with the South African Reserve Bank. |
| EC5 | The supervisor reviews the main activities of parent companies, and of companies affiliated with the parent companies, that have a material impact on the safety and soundness of the bank and the banking group, and takes appropriate supervisory action. However, there is no ongoing or periodic analysis of group structure as part of offsite analysis. |
| Description and findings re EC5 | The BoB takes into account the risks associated with the parent banks in their assessments. Information about the foreign parent banks is included in the institutional profiles which is a key part of the supervisory process. (See also CP13 for a discussion of supervisory colleges). |
| EC6 | The supervisor limits the range of activities the consolidated group may conduct and the locations in which activities can be conducted (including the closing of foreign offices) if it determines that: |

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| | <p>(a) the safety and soundness of the bank and banking group is compromised because the activities expose the bank or banking group to excessive risk and/or are not properly managed;</p> <p>(b) the supervision by other supervisors is not adequate relative to the risks the activities present; and/or</p> <p>(c) the exercise of effective supervision on a consolidated basis is hindered.</p> |
| Description and findings re EC6 | The revised Banking Act permits the BoB these powers and addresses deficiencies. |
| EC7 | In addition to supervising on a consolidated basis, the responsible supervisor supervises individual banks in the group. The responsible supervisor supervises each bank on a stand-alone basis and understands its relationship with other members of the group. ³⁰ |
| Description and findings re EC7 | The BoB supervises banks on an individual basis. Total value of activities is small compared with the bank. |
| Additional criteria | |
| AC1 | For countries which allow corporate ownership of banks, the supervisor has the power to establish and enforce fit and proper standards for owners and senior management of parent companies. |
| Description and findings re AC1 | Corporate ownership of banks is not prohibited by the Banking Act; however the ownership structure of the commercial banks is by non-operating holding companies which are in turn owned by banks and part of a banking group. The BoB undertakes fit and proper analysis of parent companies. |
| Assessment of Principle 12 | Materially non-compliant |
| Comments | The Banking Act does not have a section on consolidated supervision. However, draft guidelines on the Supervision of Financial Conglomerates have been completed and will be issued to the market after the enactment of the Banking Bill. |
| Principle 13 | Home-host relationships. Home and host supervisors of cross-border banking groups share information and cooperate for effective supervision of the group and group entities, and effective handling of crisis situations. Supervisors require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks. |
| Essential criteria | |
| EC1 | The home supervisor establishes bank-specific supervisory colleges for banking groups with material cross-border operations to enhance its effective oversight, taking into account the risk profile and systemic importance of the banking group and the corresponding needs of its supervisors. In its broadest sense, the host supervisor who has a relevant subsidiary or a significant branch in its jurisdiction and who, therefore, has a shared interest in the effective supervisory oversight of the banking group, is |

³⁰ Please refer to Principle 16, Additional Criterion 2.

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| | included in the college. The structure of the college reflects the nature of the banking group and the needs of its supervisors. |
| Description and findings re EC1 | <p>Eight of the nine commercial banks are subsidiaries of foreign banks. BoB actively participates in supervisory colleges on a regular basis. While there was a temporary disruption in 2020 and 2021 owing to COVID, the frequency of colleges typically every two years and in the case of one larger bank an additional arrangement on an annual basis. Participation in supervisory colleges was evidenced for Firstrand Group, Absa group, Standard Bank, Standard Chartered Bank UK, Capricorn Group, Bank of Baroda, and FMB Capital Holding Group.</p> <p>The college provides for the sharing of risk assessments and communication of relevant information and exchange of materials. The BoB is able to effectively communicate its risk assessment to the home supervisor and raise awareness. Group structure and business models were discussed. Presentations made by executives from the parent bank to discuss strategy and management priorities. In the example of Absa bank - where there was a change in ownership of the ultimate parent bank – discussions regarding the processes and associated risks were communicated.</p> <p>The supervisory college represents the main mechanism by which the BoB interacts with home supervisors and the mission saw evidence of the college process working effectively as a two-way exchange of information and risk assessments. Typically, there is limited interaction with home supervisors outside of the college process.</p> <p>The statutory banks are domestically owned and have no cross-border activities or subsidiaries.</p> |
| EC2 | Home and host supervisors share appropriate information on a timely basis in line with their respective roles and responsibilities, both bilaterally and through colleges. This includes information both on the material risks and risk management practices of the banking group ³¹ and on the supervisors' assessments of the safety and soundness of the relevant entity under their jurisdiction. Informal or formal arrangements (such as memoranda of understanding) are in place to enable the exchange of confidential information. |
| Description and findings re EC2 | <p>The BoB has executed formal MoUs with the following home supervisors:</p> <ul style="list-style-type: none"> (a) Bank of Mozambique (b) Reserve Bank of Malawi (c) Reserve Bank of India |

³¹ See Illustrative example of information exchange in colleges of the October 2010 BCBS Good practice principles on supervisory colleges for further information on the extent of information sharing expected.

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| | <p>(d) Reserve Bank of Zimbabwe</p> <p>(e) South African Reserve Bank</p> <p>(f) Bank of Namibia</p> <p>An MoU is being developed for Nigeria which is the home supervisor for one of the commercial banks. For one commercial bank, the BoB has not signed a MoU.</p> <p>The types of information include financial performance, regulatory and supervisory issues of concern, particularly in relation to risk management and corporate governance.</p> <p>Examples of joint supervisory work with foreign supervisory authorities include the following:</p> <ul style="list-style-type: none"> • South African Reserve Bank – FNBB – 2016 (AML/CFT On-site with Financial Intelligence Authority) • South African Reserve Bank – 2017 Prudential meeting • Reserve Bank of Zimbabwe BancABC - 2017 <p>There was limited evidence of joint supervisory work with foreign supervisors in the normal supervision cycle and limited information exchange on a bilateral basis with home supervisors.</p> |
| EC3 | Home and host supervisors coordinate and plan supervisory activities or undertake collaborative work if common areas of interest are identified in order to improve the effectiveness and efficiency of supervision of cross-border banking groups. |
| Description and findings re EC3 | <p>The BoB actively participates in the supervisory college to understand and evaluate the risks associated with parent banks. The college process enables the BoB to understand the key risk drivers of the group and uses this information in its risk assessment. Changes in group structure and strategy are taken into account and included in the institutional profile as a comprehensive risk assessment. The change in group ownership and the transition process were examples where home-host collaboration was demonstrated.</p> <p>The framework exists for BoB to participate in cross-border on-site examinations of parent banks; however this has not occurred in practice. BoB has not participated in supervision cross border does not coordinate and plan supervisory activities with any home supervisors. Planning and conducting onsite examinations is one example where the BoB could be more proactive and deepen their collaboration with home supervisors. While there have been examples of joint supervisory activities, the number of examples is limited across the population of banks.</p> |

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| EC4 | The home supervisor develops an agreed communication strategy with the relevant host supervisors. The scope and nature of the strategy reflects the risk profile and systemic importance of the cross-border operations of the bank or banking group. Home and host supervisors also agree on the communication of views and outcomes of joint activities and college meetings to banks, where appropriate, to ensure consistency of messages on group-wide issues. |
| Description and findings re EC4 | The BoB is the home supervisor for one commercial bank. It does not operate cross-border and was recently licensed after demutualizing as a building society. The main channel of communication is via the supervisory college. |
| EC5 | Where appropriate, due to the bank's risk profile and systemic importance, the home supervisor, working with its national resolution authorities, develops a framework for cross-border crisis cooperation and coordination among the relevant home and host authorities. The relevant authorities share information on crisis preparations from an early stage in a way that does not materially compromise the prospect of a successful resolution and subject to the application of rules on confidentiality. |
| Description and findings re EC5 | BoB evaluates and assesses resolution plans at a Group level. The analysis is undertaken jointly with the home supervisors and discussed during supervisory colleges which are conducted frequently. |
| EC6 | Where appropriate, due to the bank's risk profile and systemic importance, the home supervisor, working with its national resolution authorities and relevant host authorities, develops a group resolution plan. The relevant authorities share any information necessary for the development and maintenance of a credible resolution plan. Supervisors also alert and consult relevant authorities and supervisors (both home and host) promptly when taking any recovery and resolution measures. |
| Description and findings re EC6 | Group resolution plans have been developed by the parent groups; however, resolution plans have not been prepared for the commercial banks supervised by BoB. BoB has recently developed a D-SIB framework which includes resolution. The framework designates two banks as D-SIBs. In addition to the D-SIB framework, the Banking Act is under revision which has explicit provisions for resolution planning. Group resolution planning is discussed at supervisory colleges. |
| EC7 | The host supervisor's national laws or regulations require that the cross-border operations of foreign banks are subject to prudential, inspection and regulatory reporting requirements similar to those for domestic banks. |
| Description and findings re EC7 | BoB's laws and regulations are applied uniformly to all banks operating in Botswana. All cross-border operations of foreign banks are required to be subsidiaries by practice. In effect, this means that all banks are treated uniformly in terms of prudential, inspection and regulatory reporting. |
| EC8 | The home supervisor is given on-site access to local offices and subsidiaries of a banking group in order to facilitate their assessment of the group's safety and |

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| | soundness and compliance with customer due diligence requirements. The home supervisor informs host supervisors of intended visits to local offices and subsidiaries of banking groups. |
| Description and findings re EC8 | Section 43(4) of the Banking Act has a provision which would permit a home supervisor on-site access to local offices to assess the subsidiary's safety and soundness. However, at the time of the mission, there was no examples where this had occurred. We were made aware that an onsite examination by a foreign supervisors had been planned but had not taken place owing to the disruption by COVID. |
| EC9 | The host supervisor supervises booking offices in a manner consistent with internationally agreed standards. The supervisor does not permit shell banks or the continued operation of shell banks. |
| Description and findings re EC9 | BoB does not permit booking offices or shell banks. The BoB has demonstrated a preference for the banking system not to have branches of foreign banks, but that foreign bank operations are under subsidiaries. |
| EC10 | A supervisor that takes consequential action on the basis of information received from another supervisor consults with that supervisor, to the extent possible, before taking such action. |
| Description and findings re EC10 | Information sought from other supervisors detail the purpose for which it is going to be used. Therefore, consequential action taken based on information received from other supervisors will be made aware. The supervisory college is the main channel whereby the BoB communicates with home supervisors, in particular exchange of risk assessments and the BoB's supervisory stance and supervision activities. Outside of the supervisory college, however, there has not been an example of communication with home supervisors regarding material actions taken with banks. |
| Assessment of Principle 13 | Largely compliant |
| Comments | <p>BoB is not a home supervisor to any bank or banking group. Nevertheless, BoB participates in supervisory colleges for supervised banks. Moreover, BoB has signed MoUs with most home supervisor of subsidiaries incorporated in Botswana. The revision of the Banking Bill has specific provisions regarding cross-border supervision and bank resolution which will address current deficiencies.</p> <p>Formal MoUs are in place and BoB permit the sharing of information with have not been entered into for one large commercial bank, however BoB demonstrated While there were some examples of joint supervisory work with foreign supervisors, there is an opportunity to expand home-host cooperation in this regard. Equally, as the non-bank activities of banks expand, the BoB will need to strengthen coordination of supervisory activities with NBFIRA.</p> <p>The framework exists for BoB to participate in cross-border on-site examinations of parent banks; however this has not occurred in practice. BoB has not participated in</p> |

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| | <p>supervision cross border does not coordinate and plan supervisory activities with any home supervisors. Planning and conducting onsite examinations is one example where the BoB could be more proactive and deepen their collaboration with home supervisors. While there have been examples of joint supervisory activities, the number of examples is limited across the population of banks. EC3</p> <p>Group resolution plans have been developed by the parent groups; however, resolution plans have not been prepared for the commercial banks supervised by BoB. BoB has recently developed a D-SIB framework which includes resolution. The framework designates two banks are D-SIBs. In addition, two the D-SIB framework, the Banking Act is under revision which has explicit provisions for resolution planning. EC6</p> |
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C. Prudential Regulations and Requirements

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| <p>Principle 14</p> | <p>Corporate governance. The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organizational structure, control environment, responsibilities of the banks’ Boards and senior management,³² and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the bank.</p> |
| <p>Essential criteria</p> | |
| <p>EC1</p> | <p>Laws, regulations or the supervisor establish the responsibilities of a bank’s Board and senior management with respect to corporate governance to ensure there is effective control over the bank’s entire business. The supervisor provides guidance to banks and banking groups on expectations for sound corporate governance.</p> |
| <p>Description and findings re EC1</p> | <p>The Banking Act establishes the requirements for audit committee of the board (S.23), fit and proper requirements for the principal officer (CEO) (S.29), disqualifications of directors, principal officers, and senior management (S.30), disclosure of interest by director (S.31), offences by directors, CEO and senior management (S.32).</p> <p>Laws or regulations do not explicitly assign each bank’s board and senior management the responsibility with respect to corporate governance.</p> <p>The current requirements relating to corporate governance that are established in laws and regulations, relate to fit and proper requirements for appointment of new directors, principal officer (CEO), and senior management³³, role, and responsibilities of the audit committee of the board, risk management and disclosure and transparency. Though there are references to risk management committee in the risk</p> |

³² Please refer to footnote 27 under Principle 5.

³³ Senior management includes, Deputy Managing Director, Deputy CEO, Chief Financial or Operations Officer, Chief Lending Officer, Chief Internal Auditor, Chief Treasury Officer (or their equivalents), and other Heads of Department (core banking functions).

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| | <p>management guidelines, banks are not required to establish one and the guidelines do not elaborate on the role or duties of the risk management committee.</p> <p>The guidance to the banks from BoB is limited to the expectations around fit and proper requirements for senior management. BoB is in the process of issuing comprehensive guidelines on corporate governance, that are expected to address these gaps.</p> |
| EC2 | The supervisor regularly assesses a bank's corporate governance policies and practices, and their implementation, and determines that the bank has robust corporate governance policies and processes commensurate with its risk profile and systemic importance. The supervisor requires banks and banking groups to correct deficiencies in a timely manner. |
| Description and findings re EC2 | <p>Sections 22(8) and (9) of the Banking Act empowers BoB to, at least once a year, arrange trilateral and bilateral meetings with each bank and its auditors, at which, among others, corporate governance policies and practices are discussed. Among other things that are discussed are the board composition, board committees, board's role in risk oversight, succession planning and evaluation, directors' compensation, training, and self-assessment. These processes are also verified during on-site examinations through the review of board packs, board minutes and interviews with senior management of the bank. BoB assesses annual declarations of board of directors and senior management officials to review their fit and proper status.</p> <p>BoB is, however, yet to undertake a formal and structured assessment of a bank's corporate governance framework, policies, processes, and practices. It is yet to develop supervisory guidance for undertaking such assessments.</p> |
| EC3 | The supervisor determines that governance structures and processes for nominating and appointing Board members are appropriate for the bank and across the banking group. Board membership includes experienced non-executive members, where appropriate. Commensurate with the risk profile and systemic importance, Board structures include audit, risk oversight and remuneration committees with experienced non-executive members |
| Description and findings re EC3 | <p>As per section 29(4) of the Banking Act (1995), no person shall serve as a director of a bank without the prior written consent of the BoB. In its guideline on the appointment of new directors and senior management officials of banks, BoB has laid down that no person shall serve as a senior management official of a bank unless a bank informs the BoB of the intended appointment.</p> <p>The guideline also stipulates that to enhance the effective diversification and independence of the board of directors, the representation of related persons on the board of a bank shall be restricted to one-third of the board membership. A person in full-time employment of the holding company or its subsidiaries, other than the bank in question, may also serve as a non-executive director, unless such individual, by his/her conduct or executive authority could be construed to be directing the day-to-day management of the company and/or its subsidiaries.</p> |

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| | <p>BoB decision to approve or not a proposed director or not to object to the appointment of a senior management official of a bank shall be based upon whether the person has been determined to be “fit and proper” for such a position.</p> <p>Section 23 of Banking Act (1995) and Section 3 of the BoB guidelines on Banks’ audit committees, annual independent external audit and publication of audited financial statements (2009) lay down the role, responsibilities and requirements of each bank’s audit sub-committee of the board. These include, among others, the following:</p> <ul style="list-style-type: none">• Each bank shall have an Audit Committee, consisting of at least three members of the board of directors, the majority of which must be independent non-executive directors.• At a minimum, members of the Audit Committee should have relevant experience and should possess a balance of skills and expert knowledge, commensurate with the complexity of banking organizations, and duties performed in financial reporting, accounting, and auditing.• The functions of the Audit Committee shall, as a minimum, include the following:<ul style="list-style-type: none">○ recommend to the board appropriate accounting policies, standards and controls for the bank and supervise compliance therewith,○ assist the board of directors in its evaluation of the adequacy, efficiency and effectiveness of the bank’s internal control systems, accounting practices, information systems and auditing processes,○ facilitate communication between the board of directors, senior management, internal auditor and the external auditor regarding capital adequacy, risk management or any other related matters,○ recommend to the board of directors the appointment, dismissal, and compensation of external auditors,○ provide oversight of the internal and external auditors and take appropriate measures to enhance their independence by ensuring that the auditors’ report is sent directly to the Audit Committee,○ introduce such measures as, in the Audit Committee assessment, may serve to enhance the integrity of financial statements, including appropriateness, relevance and reliability of operational control environment, financial disclosures and, in general, financial reporting,○ review and approve the audit scope,○ receive and review internal and external audit reports including the management letter, ensure that senior management officials take appropriate, and timely action to correct weaknesses in internal control, non-compliance with policies, laws, regulations and directions, and other problems uncovered by the auditor, |
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| | <ul style="list-style-type: none"> ○ receive and review the audited financial statements and recommend these financial statements to the board of directors; and ○ establish procedures for confidential submissions by employees regarding inappropriate accounting and other business matters. <p>Currently laws and regulations require only the constitution of the audit committee of the board in all banks. The other board sub-committees (such as the remuneration committee, risk committee and nomination committee) are optional. Currently laws and regulations do not explicitly establish the nomination procedures to be followed by the board, while identifying and nominating new directors.</p> |
| EC4 | Board members are suitably qualified, effective and exercise their “duty of care” and “duty of loyalty”. ³⁴ |
| Description and findings re EC 4 | BoB’s guidelines on the appointment of new directors and senior management officials of Banks provides for BoB vetting and review of the prospective board or senior management candidates before their appointments to the banks’ board. During this process, BoB determines the candidates’ compliance/ fulfilment of the “fit and proper” requirements. While the BoB reviews the continued fitness and propriety of the board members every year, it does not undertake formal documented assessment of the board members’ effectiveness or if they exercise their duty of care and duty of loyalty. |
| EC5 | The supervisor determines that the bank’s Board approves and oversees implementation of the bank’s strategic direction, risk appetite ³⁵ and strategy, and related policies, establishes and communicates corporate culture and values (e.g. through a code of conduct), and establishes conflicts of interest policies and a strong control environment. |
| Description and findings re EC5 | While offsite, BoB supervisors review, among others, each banks’ risk management strategies, risk appetite, risk management policies and processes during the annual bilateral meetings with the bank and the annual trilateral meetings with the bank’s auditor and the bank. Ahead of the onsite examinations, banks are expected to share with BoB, board approved strategies and policies, which are reviewed by the supervisors during on-site examination to assess senior management’s execution of board strategies. Supervisors also review board minutes to assess the attendance and contributions by each director during the board meetings. |

³⁴ The OECD (OECD glossary of corporate governance-related terms in “Experiences from the Regional Corporate Governance Roundtables”, 2003, www.oecd.org/dataoecd/19/26/23742340.pdf.) defines “duty of care” as “The duty of a board member to act on an informed and prudent basis in decisions with respect to the company. Often interpreted as requiring the board member to approach the affairs of the company in the same way that a ‘prudent man’ would approach their own affairs. Liability under the duty of care is frequently mitigated by the business judgment rule.” The OECD defines “duty of loyalty” as “The duty of the board member to act in the interest of the company and shareholders. The duty of loyalty should prevent individual board members from acting in their own interest, or the interest of another individual or group, at the expense of the company and all shareholders.”

³⁵ “Risk appetite” reflects the level of aggregate risk that the bank’s Board is willing to assume and manage in the pursuit of the bank’s business objectives. Risk appetite may include both quantitative and qualitative elements, as appropriate, and encompass a range of measures. For the purposes of this document, the terms “risk appetite” and “risk tolerance” are treated synonymously.

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| | 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 are not explicitly assessed and recorded in supervisory assessments. |
| EC6 | The supervisor determines that the bank's Board, except where required otherwise by laws or regulations, has established fit and proper standards in selecting senior management, maintains plans for succession, and actively and critically oversees senior management's execution of Board strategies, including monitoring senior management's performance against standards established for them. |
| Description and findings re EC6 | <p>Section 29 of the Banking Act (1995), lays down that no person shall become the principal officer, by whatever name called, of any bank, unless upon the determination of the board of directors of such bank he is a fit and proper person, for such position, having regard to-</p> <ul style="list-style-type: none"> • his propriety and competence, • the diligence with which he is likely to fulfil his responsibilities, and • his previous conduct and activities in business, particularly whether she/ he has been guilty of any fraud or other act of dishonesty. <p>Where the BoB has reason to believe that any person, by virtue of her/his shareholding in a bank or otherwise, is able to influence the principal officer, or the board of directors of that bank, and is exercising her/his influence in a manner which is likely to be detrimental to the interests of depositors, the BoB may request the bank to remedy the situation.</p> <p>Where a bank fails to comply with BoB's instructions following the above request, the BoB may, with the approval of the Minister, revoke the license of such bank in accordance with section 11 of this Act.</p> <p>No person shall become a director of a bank unless she/he is a fit and proper person in accordance with such criteria as may be determined by the Central Bank. Section 4 of the BoB guideline on the appointment of directors and senior management of banks establishes the criteria that must be met for a person to be considered "fit and proper" to hold the position of director or to be a senior management official of a bank. These criteria include the following:</p> <ul style="list-style-type: none"> • The person's technical knowledge and experience (as determined by the BoB) are appropriate to the nature, scale and risk of a bank's actual operations and the planned activities. • The person's background evidences integrity, uprightness, and honesty. • The person has not declared bankruptcy or been declared bankrupt. • The person's financial condition and history, including past employment, are satisfactory. |

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| | <ul style="list-style-type: none"> • The person has not been a significant shareholder, director, or senior management official of a “problem bank,” that is, a bank with formal enforcement action currently in effect or pending, or for which a receiver, conservator, liquidator, or similar official has been appointed. • There is no evidence that any other person is exercising an influence over the prospective senior management official or director in a manner which is likely to be detrimental to the interests of depositors. • There is no evidence that the person has supplied false or misleading information to the bank regarding his/her qualifications, experience, or ability to serve the bank or any other acts of impropriety. <p>During the annual bilateral meeting with each bank and the annual trilateral meetings with each bank and its external auditor, BoB supervisors review the bank board’s succession plans, and if the board actively and critically oversees senior management’s execution of board strategies. While onsite, supervisors review boards’ fit and proper standards for senior management, succession plans, senior management execution of board strategies and the framework for monitoring the performance of senior management against the standards established for them.</p> |
| EC7 | The supervisor determines that the bank’s Board actively oversees the design and operation of the bank’s and banking group’s compensation system, and that it has appropriate incentives, which are aligned with prudent risk taking. The compensation system, and related performance standards, are consistent with long-term objectives and financial soundness of the bank and is rectified if there are deficiencies. |
| Description and findings re EC7 | Section 8.5 of BoB guideline on risk management (2018) lays down that bank’s compensation policies should be aligned to the bank’s statement of risk appetite and tolerance, long-term strategic direction, financial goals and overall safety and soundness. They should also appropriately balance risk and reward. At least once a year, during the trilateral and bilateral meetings with banks, supervisors try to review/confirm if the pay structure was reviewed by a banks’ board to align it to the job requirements and ensure that it is at the same time sustainable. Currently, laws and regulations do not require the establishment of a remuneration committee of the board, and hence these responsibilities are discharged by the board or any of its delegated committee. |
| EC8 | The supervisor determines that the bank’s Board and senior management know and understand the bank’s and banking group’s operational structure and its risks, including those arising from the use of structures that impede transparency (e.g. special-purpose or related structures). The supervisor determines that risks are effectively managed and mitigated, where appropriate. |
| Description and findings re EC8 | The board and senior management of a bank are expected to be familiar with the banks and banking group structure at the licensing stage and on a continuous basis. Any bank that establishes a special purpose vehicle or a subsidiary requires prior regulatory approval in terms of Section 9(6) of the Banking Act. In addition, the BoB |

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| | <p>has adopted the risk-based supervision framework, which requires board and senior management to be abreast of their institution's risk profiles.</p> <p>The structure of the bank and consolidated bank operating in Botswana are simple and easy to comprehend. Currently, no bank has established SPVs and related structures.</p> |
| EC9 | The supervisor has the power to require changes in the composition of the bank's Board if it believes that any individuals are not fulfilling their duties related to the satisfaction of these criteria. |
| Description and findings re EC9 | <p>Section 30 of the Banking Act (1995) lays down that without prejudice to anything contained in the Companies Act, any person who is a director, a principal officer or other officer concerned with the management of a bank, shall cease to hold office if he is (i) declared bankrupt or makes a composition with his creditors; or (ii) convicted of an offence involving fraud or any other act of dishonesty.</p> <p>No person who has been a director of, or indirectly concerned in the management of, a bank that has been liquidated shall, without the written authorization of the Central Bank, act or continue to act as a director of, or be directly or indirectly concerned in the management of, a bank.</p> <p>Any person who acts in breach of this section shall be guilty of an offence and liable to a fine of BWP 5000 and to imprisonment for two years.</p> <p>While BoB can use these powers to remove a director when she/ he does not meet the minimum eligibility criteria stipulated in the Act, this section does not empower the BoB 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.</p> |
| Additional criteria | |
| AC1 | Laws, regulations or the supervisor require banks to notify the supervisor as soon as they become aware of any material and bona fide information that may negatively affect the fitness and propriety of a bank's Board member or a member of the senior management. |
| Description and findings re AC1 | Laws or regulations do not currently have such requirement. The draft Banking Bill under consideration also does not address this gap. |
| Assessment of Principle 14 | Materially non-compliant |
| Comments | 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 |

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| | <p>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.</p> <p>BoB should initiate changes to law to obtain the powers that they might not have for requiring, supervising and enforcing good corporate governance in banks, 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.</p> <p>The BoB is in the process of issuing a dedicated guideline on corporate governance and the Banking Bill is also in an advanced stage of being enacted. These two are expected to address some of the gaps that have been flagged above.³⁶</p> |
| Principle 15 | <p>Risk management process. The supervisor determines that banks³⁷ have a comprehensive risk management process (including effective Board and senior management oversight) to identify, measure, evaluate, monitor, report and control or mitigate³⁸ all material risks on a timely basis and to assess the adequacy of their capital and liquidity in relation to their risk profile and market and macroeconomic conditions. This extends to development and review of contingency arrangements (including robust and credible recovery plans where warranted) that take into account the specific circumstances of the bank. The risk management process is commensurate with the risk profile and systemic importance of the bank.³⁹</p> |
| Essential criteria | |

³⁶ The Guidelines on Corporate Governance for Banks/Financial Institutions Licensed and Supervised by the Bank of Botswana approved in November 2022 (after the assessment mission) broadly address the gaps identified at (i), (iii) and (v) in the Comments Section. The guidelines lay down the role and responsibilities of risk, audit, compliance, remuneration and credit committees.

³⁷ For the purposes of assessing risk management by banks in the context of Principles 15 to 25, a bank's risk management framework should take an integrated "bank-wide" perspective of the bank's risk exposure, encompassing the bank's individual business lines and business units. Where a bank is a member of a group of companies, the risk management framework should in addition cover the risk exposure across and within the "banking group" (see footnote 19 under Principle 1) and should also take account of risks posed to the bank or members of the banking group through other entities in the wider group.

³⁸ To some extent the precise requirements may vary from risk type to risk type (Principles 15 to 25) as reflected by the underlying reference documents.

³⁹ It should be noted that while, in this and other Principles, the supervisor is required to determine that banks' risk management policies and processes are being adhered to, the responsibility for ensuring adherence remains with a bank's Board and senior management.

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| EC1 | <p>The supervisor determines that banks have appropriate risk management strategies that have been approved by the banks' Boards and that the Boards set a suitable risk appetite to define the level of risk the banks are willing to assume or tolerate. The supervisor also determines that the Board ensures that:</p> <ul style="list-style-type: none"> (a) a sound risk management culture is established throughout the bank; (b) policies and processes are developed for risk-taking, that are consistent with the risk management strategy and the established risk appetite; (c) uncertainties attached to risk measurement are recognized; (d) appropriate limits are established that are consistent with the bank's risk appetite, risk profile and capital strength, and that are understood by, and regularly communicated to, relevant staff; and (e) senior management takes the steps necessary to monitor and control all material risks consistent with the approved strategies and risk appetite. |
| Description and findings re EC1 | <p>BoB guideline on risk management (2018) lays down, among others, the following supervisory expectations, and requirements from banks with regards to risk management, risk management strategies, risk management policies, risk control and risk reporting.</p> <ul style="list-style-type: none"> • The board should approve the overall business strategies and significant policies of the bank, including those related to taking and managing risks, and should also ensure that management have skills, expertise, and competence commensurate with the nature, scale and complexity of the bank's business. • The board should comprise individuals with diversified skills and work experience. Within the board, there should be a member or members designated or assigned specific responsibilities for risk-management oversight activities. Board members should continually enhance their skills so that they are able to understand the types of risks to which banks are exposed. • The board provides effective oversight on management's actions to ensure that the actions of the latter are consistent with the risk strategy, risk appetite framework and policies of a bank. • The board should demand to be furnished with periodic reports by a bank, for it to identify, in a timely manner, the nature and significance of the risks a bank is exposed to. The board should use this information to provide clear guidance regarding the level of exposures suitable for a bank and have the responsibility to ensure that management implements the procedures and controls necessary to comply with adopted policies. • Management is responsible for ensuring that the day-to-day activities of a bank are consistent with the bank's risk strategy. This includes risk appetite |

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| | <p>and policies approved by the board; establishing and communicating a strong awareness of an effective internal control environment and high ethical standards; as well as establishing clear guidance regarding the business and risk strategy such as risk limits, in order to ensure that activities undertaken by a bank are within the risk appetite prescribed by the board of the bank.</p> <ul style="list-style-type: none"> • The board and Management of a bank should tailor the risk-management policies and procedures to the types of risks that arise from the activities of the bank. The bank's policies and procedures should provide detailed guidance for the day-to-day implementation of broad business strategies and, generally, include limits designed to shield the bank from excessive and imprudent risks. Senior management is expected to modify these tools when necessary to respond to changes in a bank's activities or business conditions. Every bank should ensure that: <ul style="list-style-type: none"> ○ policies, procedures, and limits provide for the adequate identification, measurement, monitoring, and control of the risks posed by a bank's significant activities, ○ established limits are understood by, and regularly communicated to, relevant staff, ○ policies clearly delineate accountability and lines of authority across the bank's activities, ○ risk-management strategic policies, processes and limits are properly documented, regularly reviewed, and appropriately adjusted to reflect changing risk appetites, risk profile, market and macroeconomic conditions; and communicated within the bank, and ○ policies provide for the review of activities which are new to the bank to ensure that the infrastructure necessary to identify, measure, monitor and control risks associated with the activity are in place before the activity is adopted. • To ensure effective measurement and monitoring of risk and management information systems, the following should be observed: <ul style="list-style-type: none"> ○ a bank's risk monitoring practices and reports should address all the material risks, ○ key assumptions, data sources and procedures used in monitoring risk should be appropriate, adequately documented and tested for reliability on an ongoing basis, ○ reports and other forms of communication should be consistent with a bank's activities, structured to monitor exposures and compliance with established limits, goals, objectives; and, as |
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| | <p>appropriate, compare actual versus expected performance,</p> <ul style="list-style-type: none"> ○ reports to the bank's board and management should be accurate and timely and contain sufficient information for decision makers to identify any adverse trends and to evaluate adequately the level of risk faced by a bank, ○ risk monitoring activities must be supported by an information system that provides the board and management with timely reports on the financial condition, operating performance and risk exposure of a bank, as well as with regular and sufficiently detailed reports for line managers engaged in the day- to-day management of the bank's activities, ○ The sophistication of the bank's information system must keep pace with developments in the bank's risk profile, increased business complexity and new products or business lines. <p>BoB supervisors normally review and assess the risk management framework, strategies, policies and board and senior management oversight during onsite examinations. During such examinations, supervisors review the strategies, policies and processes for their adequacy and implementation. They review the board packs and the minutes of the board meetings to better understand the extent of reporting to the board, board oversight and senior management performance with reference to risk management, Supervisors also rely on banks' compliance functions, and internal audit functions, to be able to obtain feedback on the implementation of the risk management strategies, policies, and processes across the institution.</p> <p>At times, based on offsite surveillance and review of the ICAAP documents received from banks, supervisors identify specific risks or risk themes that need a closer look or understanding. Such issues are normally taken up for discussion during the annual bilateral meeting with the banks and the annual trilateral meeting with the banks and their external auditors. Review of risk management strategies is a standing agenda item at all trilateral meetings with supervised banks.</p> <p>Supervisors also rely on the banks' external auditors to understand banks' risk management strategies and policies and where required these are discussed during the annual bilateral meeting with the banks' external auditors.</p> <p>Supervisors can benefit from more detailed and specific guidance on, among others, how they can undertake closer or more focused supervision on banks' risk management, risk governance, risk management policies and processes, information systems and risk reporting.</p> |
| <p>EC2</p> | <p>The supervisor requires banks to have comprehensive risk management policies and processes to identify, measure, evaluate, monitor, report and control or mitigate all material risks. The supervisor determines that these processes are adequate:</p> |

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| | <p>(a) to provide a comprehensive “bank-wide” view of risk across all material risk types;</p> <p>(b) for the risk profile and systemic importance of the bank; and</p> <p>(c) to assess risks arising from the macroeconomic environment affecting the markets in which the bank operates and to incorporate such assessments into the bank’s risk management process.</p> |
| Description and findings re EC2 | <p>As described under EC 1 of this CP, banks are required to establish comprehensive risk management strategies, policies and processes that address their bank wide risk exposures. The expectations from banks’ information systems are that these are amenable to identify and aggregate risk exposures across the bank.</p> <p>BoB guidelines on risk management requires banks to use stress testing as part of their risk management frameworks. Banks use stress testing to factor-in the risks that might arise from the macroeconomic environment, to understand their impact on their business and finances. BoB guideline also requires banks to use the stress test results to inform risk management and setting of risk limits. (Please see description and finding under EC 13 of this CP for more details on stress testing).</p> <p>Please see description and finding under EC 1 of this CP for more details on banks’ risk management strategies, policies, and processes, board and senior management oversight, and offsite and onsite supervision by BoB.</p> |
| EC3 | <p>The supervisor determines that risk management strategies, policies, processes and limits are:</p> <p>(a) properly documented;</p> <p>(b) regularly reviewed and appropriately adjusted to reflect changing risk appetites, risk profiles and market and macroeconomic conditions; and</p> <p>(c) communicated within the bank</p> <p>The supervisor determines that exceptions to established policies, processes and limits receive the prompt attention of, and authorization by, the appropriate level of management and the bank’s Board where necessary.</p> |
| Description and findings re EC3 | <p>As described under EC1 of this CP, banks are required to properly document their risk management strategies, policies and processes, review and appropriately adjust these to reflect changing risk appetites, risk profile, market and macroeconomic conditions; and are communicated within the bank.</p> <p>BoB guidelines also explicitly require that each bank's MIS should monitor actual exposures against established limits and all exposures should be included in a risk-limit measurement system. The exposures approaching risk limits should be brought to the attention of senior management, and exceptions to risk limits should be reported to senior management, on a meaningful and timely basis.</p> |

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| | Please see description and finding under ECs 1 and 2 of this CP for more details on banks' risk management strategies, policies, and processes, board and senior management oversight, and offsite and onsite supervision by BoB. |
| EC4 | The supervisor determines that the bank's Board and senior management obtain sufficient information on, and understand, the nature and level of risk being taken by the bank and how this risk relates to adequate levels of capital and liquidity. The supervisor also determines that the Board and senior management regularly review and understand the implications and limitations (including the risk measurement uncertainties) of the risk management information that they receive. |
| Description and findings re EC4 | <p>Please see description and finding re EC1 and EC 2 that provides details of the regulatory requirements, supervisory expectations and onsite inspections conducted by supervisors regarding banks' risk management frameworks and practices. These cover the specific elements flagged in this EC.</p> <p>Banks are required to undertake ICAAP annually to, among others, understand the risks to which the bank is exposed, the extent to which these are adequately supported by capital and if the bank may need to hold higher capital or liquidity than required under regulations, in proportion to its risk appetite, business plan and risk exposures. Banks prepare the ICAAP documents annually and share these with supervisors. Banks' ICAAP documents are usually discussed by the supervisors at the annual bilateral meeting with banks to understand these better.</p> <p>While onsite, in addition to the techniques explained above, supervisors assess through interviews, whether senior management understand the nature and level of risk undertaken by the banks in relation to its profile and complexity of the institution. Supervisors also review reports submitted to the board regarding risks being taken by the bank and any deviations from limits and any exceptions approved by the board. The onsite inspection team also review the board's minutes of meetings to assess discussions during the meetings and if the board reviews the reports submitted to it.</p> |
| EC5 | The supervisor determines that banks have an appropriate internal process for assessing their overall capital and liquidity adequacy in relation to their risk appetite and risk profile. The supervisor reviews and evaluates banks' internal capital and liquidity adequacy assessments and strategies. |
| Description and findings re EC5 | <p>Please see description and finding under EC4 of this CP for details of supervisory requirements and supervisory review of banks' ICAAP documents.</p> <p>While the supervisors review the ICAAP documents offsite discuss and discuss these with the bank management during the annual bilateral meetings and during the onsite examinations, due to lack of adequate guidance and supervisory tools to validate or challenges the conclusions arrived at by banks, supervisors are yet to undertake detailed reviews or evaluations of the ICAAP documents received from banks, and their capital and liquidity strategies.</p> <p>BoB has not required banks to undertake internal liquidity adequacy assessments or share these assessments with the BoB. Instead, BoB relies on banks' stress testing of liquidity risk and liquidity contingency plans.</p> |

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| | Please also see description and finding in CP 16 (capital adequacy) and 24 (Liquidity risk) for more details. |
| EC6 | <p>Where banks use models to measure components of risk, the supervisor determines that:</p> <ul style="list-style-type: none"> (a) banks comply with supervisory standards on their use; (b) the banks' Boards and senior management understand the limitations and uncertainties relating to the output of the models and the risk inherent in their use; and (c) banks perform regular and independent validation and testing of the models. <p>The supervisor assesses whether the model outputs appear reasonable as a reflection of the risks assumed.</p> |
| Description and findings re EC6 | <p>Banks generally use models in connection with IFRS 9 implementation to determine the probability of defaults and the expected credit losses over a one-year time horizon or through the life of the exposure, as relevant. Banks also use models to fair value their financial instruments that are in fair value through profit and loss or in fair value through other comprehensive income. Another area where banks commonly use models are for internal credit risk rating and for stress testing.</p> <p>BoB has not issued any directive, guideline, or circular to banks articulating the regulatory requirements and supervisory expectations about the use of financial models by banks. It is yet to establish supervisory standards on the use of models and is yet to undertake review or assessment of the models that the banks are using. BoB's framework for offsite supervision does not capture banks' inherent exposure to this risk and the supervision manual does not include guidance for supervisors for reviewing or assessing the models and model risks.</p> <p>As banks are using models widely, the BoB should develop appropriate guidelines and standards for models used by banks; periodically obtain information on the types of models in use and the areas where they are used; and develop supervisory guidance and skills to understand and review or assess the models used by banks, and the adequacy of the arrangements in banks for managing the model risk that they might be exposed to.</p> |
| EC7 | The supervisor determines that banks have information systems that are adequate (both under normal circumstances and in periods of stress) for measuring, assessing and reporting on the size, composition and quality of exposures on a bank-wide basis across all risk types, products and counterparties. The supervisor also determines that these reports reflect the bank's risk profile, capital, and liquidity needs; and are provided on a timely basis to the bank's Board and senior management in a form suitable for their use. |
| Description and findings re EC7 | BoB guideline on risk management (2018) requires each bank to put in place an effective management information system (MIS) to monitor risk levels and facilitate the timely review of risk positions and exceptions. Monitoring reports should be frequent, timely, accurate and informative. Such reports should be |

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| | <p>distributed to appropriate individuals for implementation, to be specifically identified in the bank's procedures.</p> <p>To ensure effective measurement and monitoring of risk and management information systems, the following should be observed:</p> <ul style="list-style-type: none"> • a bank's risk monitoring practices and reports should address all the material risks, • key assumptions, data sources and procedures used in monitoring risk should be appropriate, adequately documented and tested for reliability on an ongoing basis, • reports and other forms of communication should be consistent with a bank's activities, structured to monitor exposures and compliance with established limits, goals, objectives; and, as appropriate, compare actual versus expected performance, • reports to the bank's board and management should be accurate and timely and contain sufficient information for decision makers to identify any adverse trends and to evaluate adequately the level of risk faced by a bank, • risk monitoring activities must be supported by an information system that provides the board and management with timely reports on the financial condition, operating performance and risk exposure of a bank, as well as with regular and sufficiently detailed reports for line managers engaged in the day- to-day management of the bank's activities, • The sophistication of the bank's information system must keep pace with developments in the bank's risk profile, increased business complexity and new products or business lines. <p>BoB guideline on risk management also establishes the specific expectations from banks' MIS in each key risk area that banks in Botswana are exposed to, such as credit risk, liquidity risk, and market risks.</p> <p>Through the BoB review of banks' IT and information security risks management frameworks, supervisors gain comfort and insights into banks' IT systems that generate MIS. Supervisors also assess adequacy of information systems through the review of system output reports produced by the banks, the reports and analyses submitted to senior management and board. At the same time, supervisors will benefit from explicit supervisory guidance on how they should assess banks' MIS and how these systems can be tested to be available during stress or crisis situations.</p> |
| <p>EC8</p> | <p>The supervisor determines that banks have adequate policies and processes to ensure that the banks' Boards and senior management understand the risks inherent in new products,⁴⁰ material modifications to existing products, and major management initiatives (such as changes in systems, processes, business model and major</p> |

⁴⁰ New products include those developed by the bank or by a third party and purchased or distributed by the bank.

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| | <p>acquisitions). The supervisor determines that the Boards and senior management are able to monitor and manage these risks on an ongoing basis. The supervisor also determines that the bank's policies and processes require the undertaking of any major activities of this nature to be approved by their Board or a specific committee of the Board.</p> |
| Description and findings re EC8 | <p>New products and major management initiatives are submitted to the BoB for approval once approved by the respective boards or specific committees. Through this exercise BoB seeks to determine the effect of the initiatives on the bank's risk profile and capital and will expect the bank to share the following details in their consideration:</p> <ul style="list-style-type: none"> • Where other banks offer similar products, the charges associated with the products are compared across the industry, • monthly maintenance if any, minimum and maximum amount expected, • benefits associated with the products; the riskiness of the product to customers and how the bank will curb those risks, and • the target group or customers. <p>BoB reviews, however, do not extend to the review or assessment of banks' internal policies and processes, the involvement and understanding of the board and senior management of the risks, and the adequacy of the improvements or the changes in the risk management frameworks made in relation to those that might be required. This is another area where supervisors can benefit from more explicit guidance.</p> |
| EC9 | <p>The supervisor determines that banks have risk management functions covering all material risks with sufficient resources, independence, authority and access to the banks' Boards to perform their duties effectively. The supervisor determines that their duties are clearly segregated from risk-taking functions in the bank and that they report on risk exposures directly to the Board and senior management. The supervisor also determines that the risk management function is subject to regular review by the internal audit function.</p> |
| Description and findings re EC9 | <p>BoB guideline on risk management requires that each bank should establish a risk management function headed by a senior management official (executive level), which oversees risk-management strategies employed by a bank. The function should be independent of those that take or accept risks on behalf of a bank and should report directly, functionally to the board or relevant sub-committee of the board.</p> <p>The risk management function should ensure that effective processes are put in place for:</p> <ul style="list-style-type: none"> • identifying current and emerging risks, • developing risk assessment and measurement systems, • establishing policies, practices and other control mechanisms to manage risks, • developing risk-tolerance limits for senior management and board approval, |

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| | <ul style="list-style-type: none"> • monitoring positions against approved risk-tolerance limits, and • reporting results of risk monitoring to senior management and the Board. <p>BoB’s risk-based framework that guides supervisors to conduct onsite supervision requires that each bank must develop an appropriate risk management system, tailored to its specific needs and circumstances. All sound risk management programs regardless of their designs, must have specific fundamental focus on risk identification, measurement, control, and monitoring on an ongoing basis. In addition, in the process of evaluation of the risk management systems, the following key elements must stand out distinctly:</p> <ul style="list-style-type: none"> • adequacy of board and senior management oversight, • comprehensive risk management tools and techniques for identification, measurement and controlling of risks, • credible policies, procedures, and limits, and • effective internal audit and robust management information system. <p>Please see description and finding under ECs 1 and 2, where BoB’s offsite and onsite supervisory tools and approaches for assessing risk management systems have been explained. In brief, BoB assesses risk management policies, controls and strategies during on-site examinations and offsite bilateral and trilateral meetings.</p> |
| <p>EC10</p> | <p>The supervisor requires larger and more complex banks to have a dedicated risk management unit overseen by a Chief Risk Officer (CRO) or equivalent function. If the CRO of a bank is removed from his/her position for any reason, this should be done with the prior approval of the Board and generally should be disclosed publicly. The bank should also discuss the reasons for such removal with its supervisor.</p> |
| <p>Description and findings re EC10</p> | <p>Please see description and finding under EC 9 of this CP where it is explained that BoB guideline on risk management requires that each bank should establish a risk management function headed by a senior management official (executive level), which oversees risk-management strategies employed by a bank. Though the designation could be different across banks, this executive is seen as the chief risk officer of the bank.</p> <p>Section 3.2 of the BoB guidelines on appointment of new directors and senior management officials of banks stipulates that no person shall serve as a senior management official of a bank unless the bank informs the BoB of the intended appointment, and the BoB conveys it’s no objection to such appointment. Laws or regulations do not explicitly provide that if the CRO of a bank is removed from his/her position for any reason, this should be done with the prior approval of the Board, generally should be disclosed publicly and the bank should also discuss the reasons for such removal with its supervisor. However, in practice, supervisors assert that the banks discuss with BoB all cases of transfer, resignation and removal of CROs.</p> |

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| EC11 | The supervisor issues standards related to, in particular, credit risk, market risk, liquidity risk, interest rate risk in the banking book and operational risk. |
| Description and findings re EC11 | BoB's guidelines on risk management, risk-based supervision and capital adequacy collectively establish the requirements for banks and supervisory expectations in all areas listed in the EC. BoB is working on a new guideline on cybersecurity risk management which will supplement the current set of risk-oriented guidelines. |
| EC12 | The supervisor requires banks to have appropriate contingency arrangements, as an integral part of their risk management process, to address risks that may materialize and actions to be taken in stress conditions (including those that will pose a serious risk to their viability). If warranted by its risk profile and systemic importance, the contingency arrangements include robust and credible recovery plans that take into account the specific circumstances of the bank. The supervisor, working with resolution authorities as appropriate, assesses the adequacy of banks' contingency arrangements in the light of their risk profile and systemic importance (including reviewing any recovery plans) and their likely feasibility during periods of stress. The supervisor seeks improvements if deficiencies are identified. |
| Description and findings re EC12 | Please see description and finding in CP 25 (operational risk) and 24 (liquidity risk) which provide details on the regulatory and supervisory requirements/ expectations on contingency plans including business continuity plans and contingency funding plan, and related supervision activities. BoB is the resolution authority for banks. However, the Banking Act and the BoB Act do not explicitly establish the framework for recovery and resolution of banks. |
| EC13 | <p>The supervisor requires banks to have forward-looking stress testing programs, commensurate with their risk profile and systemic importance, as an integral part of their risk management process. The supervisor regularly assesses a bank's stress testing program and determines that it captures material sources of risk and adopts plausible adverse scenarios. The supervisor also determines that the bank integrates the results into its decision-making, risk management processes (including contingency arrangements) and the assessment of its capital and liquidity levels. Where appropriate, the scope of the supervisor's assessment includes the extent to which the stress testing program:</p> <ul style="list-style-type: none"> (a) promotes risk identification and control, on a bank-wide basis (b) adopts suitably severe assumptions and seeks to address feedback effects and system-wide interaction between risks; (c) benefits from the active involvement of the Board and senior management; and (d) is appropriately documented and regularly maintained and updated. <p>The supervisor requires corrective action if material deficiencies are identified in a bank's stress testing program or if the results of stress tests are not adequately taken into consideration in the bank's decision-making process</p> |
| Description and findings re EC13 | BoB's guideline on risk management (2018) lays down clearly the expectations from banks with regard to their stress testing programs with reference to each key risk, |

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| | <p>namely credit, liquidity, market, interest rate, operational and country and transfer risks.</p> <p>These requirements establish that, among others, the stress test output be reviewed periodically by senior management and appropriate action taken in cases where the results exceed agreed tolerances. Stress test analyses should include contingency plans regarding actions management might take given certain scenarios. The output should also be incorporated into the process for assigning and updating policies and limits.</p> <p>While onsite, supervisors review the banks' use of stress testing as part of their risk management frameworks, review the stress test results with reference to their impact on liquidity and/or liquidity and how the results have been used to inform risk management and the setting or modification of risk limits.</p> <p>In the absence of detailed guidance to supervisors on the elements of stress testing that need to be reviewed and how they should undertake such reviews, supervisors have not assessed stress testing frameworks in banks for their adequacy, appropriateness of the scenarios, the underlying assumptions and the extent of board and senior management involvement and oversight.</p> |
| EC14 | The supervisor assesses whether banks appropriately account for risks (including liquidity impacts) in their internal pricing, performance measurement and new product approval process for all significant business activities. |
| Description and findings re EC14 | Laws or regulations in Botswana do not explicitly require banks to account for risks in their internal pricing, performance measurement and new product approval process. |
| Additional criteria | |
| AC1 | The supervisor requires banks to have appropriate policies and processes for assessing other material risks not directly addressed in the subsequent Principles, such as reputational and strategic risks. |
| Description and findings re AC1 | <p>BoB has issued explicit requirements from banks on management of reputational risk and strategic risk (included in BoB guideline on risk management).</p> <p>The guideline provides detailed guidance to banks on strategic risk management across the following sub-topics, namely, strategic planning process, strategic risk identification, strategic risk measurement, strategic risk mitigation, monitoring, and control, and strategic risk reporting.</p> <p>The guideline provides detailed guidance to banks on reputational risk management across the following sub-topics, namely, reputation risk identification, reputation risk measurement, reputation risk mitigation, monitoring, and control, and reputation risk reporting.</p> <p>BoB guideline on risk-based supervision framework provides a reasonably high-level guidance to supervisors on what they should be focusing on during onsite examinations, particularly with reference to strategic risk management. Supervisors do not have the benefit of guidance on how they can conduct supervision of reputation</p> |

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| | risk. At the same time, supervisors have yet to undertake or perform detailed review or assessment of bank's strategic and reputation risks. |
| Assessment of Principle 15 | Largely compliant |
| Comments | <p>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. Supervisory guidance for assessing risk management in banks is available at a high-level. Supervisors can benefit from more detailed and specific guidance on, among others, how they can undertake closer or more focused supervision on banks' risk management, 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.</p> <p>Thanks to technological developments, advances made in quantifying risks, accepted practice of conducting stress tests at least annually, implementation of IFRS-9, and the importance of adopting a forward-looking approach to business and capital planning, banks are deploying financial models in increasing numbers. This exposes banks to model risks, which is an area where BoB can articulate explicitly the regulatory requirements and supervisory expectations. Other areas that can be explicitly articulated in regulations and in supervisory practice are (i) the need for establishing linkages between product pricing, performance measurement and compensation and risk, (ii) requiring banks to obtain board approval for the removal of the CRO and inform or discuss with BoB the reasons for the removal.</p> |
| Principle 16 | Capital adequacy. ⁴¹ The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards. |
| Essential criteria | |
| EC 1 | Laws, regulations or the supervisor require banks to calculate and consistently observe prescribed capital requirements, including thresholds by reference to which a bank might be subject to supervisory action. Laws, regulations or the supervisor define the qualifying components of capital, ensuring that emphasis is given to those elements of capital permanently available to absorb losses on a going concern basis. |
| Description and findings re EC1 | Section 13 of the Banking Act, read with Banking Regulation 7, prescribes the Capital levels and qualifying components of capital. BoB has issued a Directive on the Revised International Convergence of Capital Measurement and Capital Standards for Botswana |

⁴¹ The Core Principles do not require a jurisdiction to comply with the capital adequacy regimes of Basel I, Basel II and/or Basel III. The Committee does not consider implementation of the Basel-based framework a prerequisite for compliance with the Core Principles, and compliance with one of the regimes is only required of those jurisdictions that have declared that they have voluntarily implemented it.

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| | <p>(Basel II) and a Guideline on the Revised International Convergence of Capital Measurement and Capital Standards for Botswana (Basel II) that sets the structure of capital, the qualifying criteria for capital components, details of risk weighting by asset classes, the pillar 2 and pillar 3 requirements (please see EC1, CP28 for details of Pillar 3 disclosures).</p> <p>Brief details of the statutory and prudential minimum capital requirements are as below.</p> <ul style="list-style-type: none"> • The minimum statutory capital requirement for banks operating in Botswana is the greater of BWP 5 million and 8 percent of the bank's risk weighted assets. • The minimum prudential capital requirements for banks operating in Botswana is 15 percent of the bank's risk weighted assets (reduced to 12.5 percent in the wake of COVID 19). • The components of capital, their qualifying features and deductions and adjustments are aligned with Basel III norms. • The minimum common equity tier 1 (CET1) capital ratio is 4.5 percent, the minimum Additional tier 1 capital ratio is 3 percent, and the minimum Tier 1 ratio is 7.5 percent (4.5 + 3). • Consistent with Section 13(2) of the Banking Act (1995), where a bank fails to maintain its unimpaired capital total regulatory capital at the level of 15 percent (now reduced to 12.5 percent), the BoB may impose on and collect from the defaulting bank a levy not exceeding 0.1 percent of the amount by which such unimpaired capital falls short of the amount prescribed. <p>As an outcome of the structuring of the regulatory capital, banks in Botswana have substantial Tier 2 capital. At the level of the banking system, Tier 2 capital is about 32 percent of total regulatory capital. At the level of individual banks, this ranges from 18.8 to 46.5 percent of total regulatory capital.</p> <p>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. This reflects a high level of Tier 2 capital in the system.</p> |
| EC2 | At least for internationally active banks, ⁴² the definition of capital, the risk coverage, the method of calculation and thresholds for the prescribed requirements are not lower than those established in the applicable Basel standards. |
| Description and findings re EC2 | The capital adequacy requirement established by BoB is applied uniformly to all banks operating in Botswana. As explained in the description and finding under EC1 of this |

⁴² The Basel Capital Accord was designed to apply to internationally active banks, which must calculate and apply capital adequacy ratios on a consolidated basis, including subsidiaries undertaking banking and financial business. Jurisdictions adopting the Basel II and Basel III capital adequacy frameworks would apply such ratios on a fully consolidated basis to all internationally active banks and their holding companies; in addition, supervisors must test that banks are adequately capitalized on a stand-alone basis.

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| | <p>CP, the capital adequacy framework in Botswana is largely aligned with Basel II framework, with definition of capital being aligned closer to Basel III framework.</p> <p>While the minimum risk-weighted capital requirement under Basel framework is 8 percent, banks in Botswana were required to maintain a minimum risk-weighted capital at 15 percent. The minimum requirement has since been reduced to 12.5 percent, in response to COVID pandemic and related developments, and remains there. The capital adequacy framework requires banks to maintain capital for both on- and off-balance sheet exposures.</p> <p>As per BoB guideline, banks are required to maintain capital under Pillar 1 for their exposures to credit risk, market risk and operational risk. The requirements established in regulations for assessing the exposures to these risks and computing the risk weighted assets are clear and in alignment with those established under Basel II. All banks maintain capital as per the standardized approach for credit risk, standardized maturity method for interest rate risk in trading book, and basic indicator approach for operational risk. The approaches laid down for computing exposures and risk weights are in alignment with Basel II norms.</p> |
| EC3 | <p>The supervisor has the power to impose a specific capital charge and/or limits on all material risk exposures, if warranted, including in respect of risks that the supervisor considers not to have been adequately transferred or mitigated through transactions (e.g., securitization transactions)⁴³ entered into by the bank. Both on-balance sheet and off-balance sheet risks are included in the calculation of prescribed capital requirements.</p> |
| Description and findings re EC3 | <p>Please see description and finding under EC 1 of this CP, where it is mentioned that the banks in Botswana are required to comply with the risk-based capital adequacy requirements established by BoB, which includes both on- and off-balance sheet risks. Banks in Botswana have not undertaken any securitization activities.</p> <p>Sections 13(1), 13(7) and 13(9) of the Banking Act (1995) (expanded below), empower the BoB to impose capital charges on risk exposures as and when necessary. BoB has used these powers to require a higher minimum capital for all banks, and on the other hand, has required a non-deposit taking development bank to maintain capital as per Basel 1 norms.</p> <ul style="list-style-type: none"> • 13(1) Every bank shall maintain paid up unimpaired capital at least equal to such percentage of such bank's total assets as may be prescribed for the purpose. • 13(7) The unimpaired capital and liabilities of any bank shall be of such kinds, and computed in such manner, as may be determined by the BoB. • 13(9) The minimum capital required in respect of any bank shall be the greater of such amount as may be prescribed, or such percentage of its assets, or |

⁴³ Reference documents: Enhancements to the Basel II framework, July 2009 and: International convergence of capital measurement and capital standards: a revised framework, comprehensive version, June 2006.

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| | <p>groups of assets, and other risk exposures as may, from time to time, be determined by the BoB.</p> <p>Please see description and finding under CP 19 and 20, where it is mentioned that the BoB has the power to establish risk limits and has established prudential limits for large exposures, exposure to single counterparty and group of connected counterparties, and related party exposures.</p> |
| EC4 | <p>The prescribed capital requirements reflect the risk profile and systemic importance of banks⁴⁴ in the context of the markets and macroeconomic conditions in which they operate and constrain the build-up of leverage in banks and the banking sector. Laws and regulations in a particular jurisdiction may set higher overall capital adequacy standards than the applicable Basel requirements.</p> |
| Description and findings re EC4 | <p>Please see description and finding under ECs 1 to 3 of this CP for the minimum capital requirements established by BoB. These clearly indicate that the capital requirements are uniform for all banks. The framework reflects the risk profile of each bank through the differentiated risk-weighting of the bank's risk portfolio. Taking into consideration that banks in Botswana are primarily operating in Botswana and do not have any foreign branches or subsidiaries, and the macro-economic environment in Botswana, BoB decided to require a higher minimum capital ratio of 15 percent of risk weighted assets compared to the 8 percent required under Basel norms. The minimum requirement has been reduced to 12.5 percent, in response to COVID pandemic and related developments.</p> <p>For supervisory purposes, BoB uses a soft leverage ratio of 3 percent of Tier 1 capital to grade banks under the CAMEL framework for its quarterly offsite surveillance. This is to help BoB in flagging any build-up of leverage in the banking system.</p> |
| EC5 | <p>The use of banks' internal assessments of risk as inputs to the calculation of regulatory capital is approved by the supervisor. If the supervisor approves such use:</p> <ul style="list-style-type: none"> (a) such assessments adhere to rigorous qualifying standards; (b) any cessation of such use, or any material modification of the bank's processes and models for producing such internal assessments, are subject to the approval of the supervisor; (c) the supervisor has the capacity to evaluate a bank's internal assessment process in order to determine that the relevant qualifying standards are met and that the bank's internal assessments can be relied upon as a reasonable reflection of the risks undertaken; |

⁴⁴ In assessing the adequacy of a bank's capital levels in light of its risk profile, the supervisor critically focuses, among other things, on (a) the potential loss absorbency of the instruments included in the bank's capital base, (b) the appropriateness of risk weights as a proxy for the risk profile of its exposures, (c) the adequacy of provisions and reserves to cover loss expected on its exposures and (d) the quality of its risk management and controls. Consequently, capital requirements may vary from bank to bank to ensure that each bank is operating with the appropriate level of capital to support the risks it is running and the risks it poses.

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| | <p>(d) the supervisor has the power to impose conditions on its approvals if the supervisor considers it prudent to do so; and</p> <p>(e) if a bank does not continue to meet the qualifying standards or the conditions imposed by the supervisor on an ongoing basis, the supervisor has the power to revoke its approval.</p> |
| Description and findings re EC5 | Currently no bank in Botswana is using the internal assessment approaches for computing risk inputs for the calculation of regulatory capital. |
| EC6 | <p>The supervisor has the power to require banks to adopt a forward-looking approach to capital management (including the conduct of appropriate stress testing).⁴⁵ The supervisor has the power to require banks:</p> <p>(a) to set capital levels and manage available capital in anticipation of possible events or changes in market conditions that could have an adverse effect; and</p> <p>(b) to have in place feasible contingency arrangements to maintain or strengthen capital positions in times of stress, as appropriate in the light of the risk profile and systemic importance of the bank.</p> |
| Description and findings re EC6 | <p>BoB guidelines on the revised international convergence of capital measurement and capital standards for Botswana (Basel II) (2015) set out the requirements on forward looking capital planning by banks. These include the following:</p> <ul style="list-style-type: none"> • Based on the material risks identified, a bank should assess its overall capital adequacy, and develop a strategy for maintaining capital levels consistent with its risk profile and business plans. This should be reflected in a bank's capital planning process and the setting of internal capital targets. • A bank must ensure that well-defined processes are in place to assess its capital adequacy in relation to its risk profile. For risks that are not easily quantifiable or related to capital, focus should be directed at ensuring the effectiveness of their management and mitigation. Adequate systems and processes for managing these risks should be put in place and implemented effectively, with consideration for providing appropriate capital for any residual risks that cannot be reduced to satisfactory levels. • The capital planning process must be dynamic and forward-looking in relation to a bank's risk profile. A bank should, therefore, ensure that capital levels remain above the minimum regulatory capital requirements, as well as the capital required to support its overall risk profile (as implied by the ICAAP), over a capital planning horizon of at most three years. The size of the additional capital should consider current and anticipated changes in a bank's risk profile and business plan and/or strategy. |

⁴⁵ "Stress testing" comprises a range of activities from simple sensitivity analysis to more complex scenario analyses and reverses stress testing.

- A bank should also be cognizant of the stage of the business cycle in which it is operating, given the potential changes in the external environment. Therefore, rigorous, forward-looking stress testing should form an integral part of a bank's ICAAP.
- The results of the stress tests should be considered when evaluating the appropriateness of a bank's capital plans and internal capital targets, with remedial actions identified to address any potential deficiencies in capital. These may include a review of earnings retention policies, to gradually build up additional capital, or an infusion of additional capital by shareholders, or any other remedial actions, which can be realistically carried out in a period of stress. This recognizes the fact that accommodating additional capital needs may require time, and can be costly or difficult, especially at times when market conditions are unfavorable.
- In assessing its capital adequacy, a bank should also evaluate the quality and capacity of its capital to absorb losses. The BoB expects a bank to clearly state the definition of capital used in any aspect of its ICAAP. Since components of capital have varying capacities to absorb losses, a bank should demonstrate how capital, as defined in its ICAAP, is able to absorb losses, both on a going concern and gone concern basis, particularly when internal definitions are broader than that employed for regulatory capital purposes. This should include an explanation of such differences, and analyses and reasons to support the use of any capital instrument not recognized for regulatory purposes. To facilitate supervisory reviews by the BoB, a bank should disclose internal capital targets expressed in the form of regulatory capital ratios, which include total capital (regulatory capital base), Tier-1 (core capital) and common equity (core Tier-1) ratios.
- Banks must conduct formal planning and assessment of capital by senior management, at least annually. This review should include an analysis of how the internal capital adequacy measures (e.g., economic capital), if any, compare with regulatory capital, as well as whether existing additional capital held, and internal capital targets continue to be appropriate. More frequent reviews should be undertaken if there are material changes in a bank's business strategy, scale of activities or when changes in the business environment suggest that current internal capital targets are no longer appropriate. The results of the reviews by senior management should be reported to the Board.

In practice, banks in Botswana are encouraged by BoB to have a capital plan that includes capital buffers and capital-raising initiatives as part of a bank's forward-looking approach to capital management. In some cases, these may include a letter of comfort from the parent banks.

Banks in Botswana are also required to establish ICAAPs and submit their ICAAP documents and results to the BoB every year, commencing from 2019. Though BoB

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| | <p>receives the ICAAP documents from banks, supervisors have not made much use of these documents for want of guidance on how these are to be assessed and how such assessments can feed into supervision on an ongoing basis. Onset of COVID and the implications arising therefrom has impacted the progress in using the ICAAP or SREP as effective supervisory inputs/ tools.</p> <p>As regards the power to set capital requirements in anticipation of events please see description and finding under EC 3 of this CP.</p> |
| AC1 | For non-internationally active banks, capital requirements, including the definition of capital, the risk coverage, the method of calculation, the scope of application and the capital required, are broadly consistent with the principles of the applicable Basel standards relevant to internationally active banks. |
| Description and findings re AC1 | As mentioned in the description and finding under the ECs above of this CP, the capital adequacy requirements are applied uniformly to all banks in the system. |
| AC2 | The supervisor requires adequate distribution of capital within different entities of a banking group according to the allocation of risks. ⁴⁶ |
| Description and findings re AC2 | BoB guideline requires banks to maintain capital adequacy at the level of solo bank. Notwithstanding, the group entities within a consolidated bank are not material accounting for less than 0.02 percent of the bank's total assets at the level of the banking system and the largest share for a single bank is 0.14 percent of the bank's total assets. |
| Assessment of Principle 16 | Largely compliant |
| Comments | <p>The capital adequacy framework in Botswana can be seen as Basel II – plus, as the definition of capital and components of capital are aligned with Basel III requirements, while the methodologies/ approaches for determining the risk weighted assets for the Pillar 1 risks (credit market and operational) are as per Basel II.</p> <p>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. All banks are required to submit ICAAP assessments annually and the BoB has not yet felt the need to require a bank to hold additional capital as a Pillar 2 requirement. As the current higher Pillar 1 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.</p> <p>To improve compliance, BoB should develop guidance and tools for reviewing and assessing banks' ICAAP documents and feeding these into ongoing supervision. BoB</p> |

⁴⁶ Please refer to Principle 12, Essential Criterion 7.

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| | should 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. BoB should consider working with banks to reduce their reliance on Tier 2 capital, to improve the overall quality of capital. |
| Principle 17 | Credit risk. ⁴⁷ The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk ⁴⁸ (including counterparty credit risk) ⁴⁹ on a timely basis. The full credit lifecycle is covered including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios. |
| Essential criteria | |
| EC1 | Laws, regulations or the supervisor require banks to have appropriate credit risk management processes that provide a comprehensive bank-wide view of credit risk exposures. The supervisor determines that the processes are consistent with the risk appetite, risk profile, systemic importance and capital strength of the bank, take into account market and macroeconomic conditions and result in prudent standards of credit underwriting, evaluation, administration and monitoring. |
| Description and findings re EC1 | <p>At the banking system level, loans and advances account for about 65 percent of total assets, investment and trading securities account for about 13 percent and placement with other banks and credit institutions account for about 17 percent of total assets.</p> <p>The banking system loan portfolio is dominated by lending to households (66 percent). Lending to private businesses accounts for 28 percent and lending to public sector entities and to the financial sector account for the remaining 6 percent.</p> <p>BoB guideline on risk management requires each bank to formulate and implement a structured credit risk management strategy, which will include credit-risk policies and related processes. The strategy should be approved and reviewed regularly (at least annually) by the board of directors. The strategy and policies should cover the various activities of the bank in which credit exposure is a significant risk and should reflect the bank's risk appetite, risk profile and capital strength.</p> <p>The guideline requires a bank's comprehensive credit risk management program to:</p> |

⁴⁷ Principle 17 covers the evaluation of assets in greater detail; Principle 18 covers the management of problem assets.

⁴⁸ Credit risk may result from the following: on-balance sheet and off-balance sheet exposures, including loans and advances, investments, inter-bank lending, derivative transactions, securities financing transactions and trading activities.

⁴⁹ Counterparty credit risk includes credit risk exposures arising from OTC derivative and other financial instruments.

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| | <ul style="list-style-type: none"> • identify existing or potential credit risks to which the bank is exposed in conducting its business activities and developing and implementing sound and prudent credit policies to effectively manage and control these risks, • develop and implement effective credit granting, documentation and collection processes; and • develop and implement comprehensive procedures to effectively monitor and control the nature, character, and quality of the credit portfolio. <p>The Management of a bank should implement the credit strategy approved by the board of directors. The board should ensure that senior management is fully capable of managing the credit activities conducted by the bank and that such activities are conducted based on the risk strategy, policies and tolerance levels approved by the board.</p> <p>The senior management of a bank should develop policies and procedures for identifying, measuring, monitoring, and controlling credit risk. The policies should be designed and implemented in the context of internal and external factors such as the bank's level of capital, management and staff capabilities, credit needs in the bank's market area, anticipated future growth and technology.</p> <p>Policies and procedures that are properly developed and implemented should enable the bank to:</p> <ul style="list-style-type: none"> • maintain sound credit-granting standards, • identify, measure, monitor and control credit risk at both individual and portfolio levels, • properly evaluate new business opportunities; and • identify and administer problem credits. <p>For a bank's credit policy to be considered adequate, it should, at a minimum, address the following:</p> <ul style="list-style-type: none"> • types of credit offered by the bank, by exposure type (commercial, consumer, real estate, etc.), economic sector, geographic location, currency, maturity, target markets and desired portfolio mix, • guidelines which, at a minimum, address the goals for portfolio mix and risk diversification, and the bank's plans for monitoring and taking appropriate corrective action, if deemed necessary, on any concentrations that may exist, • detail the structure of the credit approval authority and process, approval limits and approval lending authority of each loan officer, management or board credit committee, including procedures for granting exceptions, • responsibility of the board of directors in reviewing, ratifying or approving |
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| | <p>loans,</p> <ul style="list-style-type: none"> • indicate acceptable collateral and terms and conditions under which unsecured loans would be granted, • terms and conditions for both price and non-price related items, including maturity and payment structure, interest rate, fees, and collateral, • limitations on the maximum volume of credits, individually and by exposure type, • credit documentation, monitoring, and classification, • appropriate and adequate collection procedures, including, but not limited to, actions to be taken against borrowers who default, and • reporting and internal communication of exceptions. <p>During onsite examinations, supervisors review the minutes of the board, its audit committee, and its risk committee to understand the progress made, and issues and challenges in implementing the board approved strategies, policies, and processes for credit risk management. They also use these reviews to obtain better understanding of the board oversight over senior management and the effectiveness of such oversight, and implementation by the senior management.</p> <p>Offsite, the supervisors follow-through on the onsite assessments and banks' ICAAP submissions and update themselves of the developments during the two annual bilateral meetings (one with the bank and another with the external auditors) and the annual trilateral meeting with the bank and the external auditors jointly. Supervisors obtain periodic updates on implementation of BoB recommendations made during the onsite examination. They also undertake follow-up short onsite visits to verify the progress made by the bank in implementing BoB recommendations.</p> |
| EC2 | <p>The supervisor determines that a bank's Board approves, and regularly reviews, the credit risk management strategy and significant policies and processes for assuming,⁵⁰ identifying, measuring, evaluating, monitoring, reporting and controlling or mitigating credit risk (including counterparty credit risk and associated potential future exposure) and that these are consistent with the risk appetite set by the Board. The supervisor also determines that senior management implements the credit risk strategy approved by the Board and develops the aforementioned policies and processes.</p> |
| Description and findings re EC2 | <p>Please see description and finding under EC1 of this CP regarding the approval and periodic (annual) reviews of the credit risk management strategy by the board, its consistency with the bank's risk appetite and capital strength, and its implementation by the bank's senior management.</p> |

⁵⁰ "Assuming" includes the assumption of all types of risk that give rise to credit risk, including credit risk or counterparty risk associated with various financial instruments.

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| | <p>These elements are reviewed and assessed by the supervisors primarily while onsite, but they also undertake follow-up and updates through their offsite periodic bilateral and trilateral meetings.</p> |
| EC3 | <p>The supervisor requires, and regularly determines, that such policies and processes establish an appropriate and properly controlled credit risk environment, including:</p> <ul style="list-style-type: none"> (a) a well-documented and effectively implemented strategy and sound policies and processes for assuming credit risk, without undue reliance on external credit assessments; (b) well defined criteria and policies and processes for approving new exposures (including prudent underwriting standards) as well as for renewing and refinancing existing exposures, and identifying the appropriate approval authority for the size and complexity of the exposures; (c) effective credit administration policies and processes, including continued analysis of a borrower's ability and willingness to repay under the terms of the debt (including review of the performance of underlying assets in the case of securitization exposures); monitoring of documentation, legal covenants, contractual requirements, collateral and other forms of credit risk mitigation; and an appropriate asset grading or classification system; (d) effective information systems for accurate and timely identification, aggregation and reporting of credit risk exposures to the bank's Board and senior management on an ongoing basis; (e) prudent and appropriate credit limits, consistent with the bank's risk appetite, risk profile and capital strength, which are understood by, and regularly communicated to, relevant staff; (f) exception tracking and reporting processes that ensure prompt action at the appropriate level of the bank's senior management or Board where necessary; and (g) effective controls (including in respect of the quality, reliability and relevancy of data and in respect of validation procedures) around the use of models to identify and measure credit risk and set limits. |
| Description and findings re EC3 | <p>Please see description and findings under the other ECs of this CP regarding the credit risk strategy, credit policies, their implementation and supervisory arrangements, and delegation of powers for granting approvals for new exposures.</p> <p>BoB guideline on risk management (2018), among others, require banks to include the following in their credit risk management strategies, processes, and practices. Consequently, these attract the focus of supervisors during onsite examinations, and during offsite reviews, to the extent feasible.</p> <ul style="list-style-type: none"> • A bank that participates in loan syndications or other such loan consortia should not place undue reliance on the credit risk analysis done |

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| | <p>by the lead underwriter or on external commercial loan credit ratings. All syndicate participants should perform their own due diligence, including independent credit risk analysis and review of syndicate terms prior to committing to the syndication. Each bank should analyze the risk and return on syndicated loans in the same manner as directly sourced loans.</p> <ul style="list-style-type: none">• While a bank could utilize techniques to mitigate credit risk, transactions should, however, be entered into primarily on the strength of the borrower's credit worthiness and ability to repay the facility in accordance with the agreed terms.• Collateral should neither be a substitute for a comprehensive assessment of the borrower or counterparty, nor should it compensate for insufficient information. A bank should have policies covering the acceptability of various forms of collateral, procedures for the ongoing valuation of such collateral and a process to ensure that collateral is, and continues to be, enforceable and realizable. Regarding guarantees, a bank should evaluate the level of coverage being provided in relation to the credit quality and legal capacity of the guarantor.• A bank is encouraged to develop and utilize an internal credit risk rating system in managing and monitoring credit risk. The rating system should be consistent with the nature, size and complexity of a bank's activities. Large loans, as determined by the board, must be individually assessed, and rated using the internal credit grading (rating) system. Other smaller loans or groups of smaller loans (i.e., schemes), may be classified based on either a credit risk grading system, payment delinquency status or credit scoring system.• Where internal ratings are assigned to an individual borrower or counterparty at the time the credit is granted, such rating should be reviewed on a periodic basis and be assigned a new rating when conditions either improve or deteriorate. It is also important that the consistency and accuracy of ratings is examined periodically by a function such as an independent credit review group.• A bank must validate internally generated credit ratings/scoring by mapping such ratings to the ratings of the recognized external credit rating agencies.• A bank should establish a system of independent, on-going assessment of its credit risk management processes and the results of such reviews should be communicated directly to senior management and the board of directors.• A bank should have an efficient internal credit review and reporting system to effectively manage the bank's various portfolios. Internal |
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audits of the credit risk processes should be conducted on a periodic basis, and it should assess compliance with the bank's credit policies and procedures.

- A bank should put in place an effective management information system (MIS) to monitor risk levels and facilitate the timely review of risk positions and exceptions. Monitoring reports should be frequent, timely, accurate and informative. Such reports should be distributed to appropriate individuals for implementation, to be specifically identified in the bank's procedures.
- A bank should establish and communicate risk limits through policies, standards, and procedures which define responsibility and authority. These limits should serve to control exposure to risks associated with the bank's activities; they should have a process to authorize and document exceptions or changes to risk limits when warranted. A bank may also apply various mitigating tools in minimizing exposure to various risks.
- Where a bank uses models to measure components of risk, such a bank should ensure that the board and Management understand the limitations and uncertainties relating to the output of the models and the risks inherent in their use. In addition, the output of such models should be a reasonable reflection of the risks assumed. A bank should perform regular and independent validation; and testing of the models used. For example, an internal credit risk-rating system and/or modelling should be validated using well-established external rating system/methodology.

BoB's guideline on risk-based supervision framework (section 4.5) provides guidance on supervision of credit risk management frameworks in banks. The guidance lists some of the key factors to be considered by the supervisors when assessing the adequacy of a bank's credit risk management systems of a bank. These are:

- Active board and senior management credit committees to strengthen oversight on credit risk management.
- Existence of board and senior management approved discretionary lending powers to facilitate the credit approval and disbursement process.
- Existence of board and senior management instituted credit review mechanism by a party not involved in routine credit administration.
- A functioning internal credit rating system duly approved by board and senior management to foster credit appraisal and monitoring.
- Existence of skilled and competent staff to oversee credit risk management.
- Existence of a robust management information system able to generate periodic reports for monitoring performance of the credit portfolio.

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| | <ul style="list-style-type: none"> • Active board and senior management involvement in developing and approval of credible policies, procedures and limits to mitigate excessive credit risk appetite and foster compliance with regulatory requirements. • Periodic application of appropriate stress tests to assess the supervised financial institution’s potential to withstand shocks on their credit portfolios and resultant impact on earnings and capital. <p>As part of offsite supervision, supervisors review, among others, banks’ compliance with prudential limits established for single counterparties, large exposures, and related party transactions.</p> <p>During onsite examinations, supervisors also review credit policies, processes, and credit files to evaluate the bank’s strategy, policy, and processes for approving new exposures and for renewing and refinancing existing exposures. They also review adherence to set approval limits, adequacy, and effectiveness of information systems. Supervisors review and verify credit documentation maintained by banks such as legal covenants, collateral, and other forms of credit risk mitigants, and loan grading systems.</p> |
| EC4 | <p>The supervisor determines that banks have policies and processes to monitor the total indebtedness of entities to which they extend credit and any risk factors that may result in default including significant unhedged foreign exchange risk.</p> |
| Description and findings re EC4 | <p>Three credit information bureaus are operating in Botswana, one of which contain data reported by banks and the others include data from non-banks. Banks tend to use more than one credit information bureau to obtain a better picture of the borrower client’s financial performance and total indebtedness. For corporates, in addition to reliance on credit information bureaus, banks place reliance on their audited financial statements to have a good idea of the borrower’s total indebtedness.</p> <p>Banks in Botswana generally lend in foreign currency to those that have an income in foreign currency. Normally, foreign currency lending is available to corporates who have foreign currency incomes. In short, supervisors and banks confirm that unhedged foreign currency is unusual and limited in Botswana.</p> <p>Please see description and finding re EC 3 for details of on-site inspection review of credit risk exposures, credit origination and credit administration.</p> |
| EC5 | <p>The supervisor requires that banks make credit decisions free of conflicts of interest and on an arm’s length basis.</p> |
| Description and findings re EC5 | <p>Please see description and finding under CP 20 that describe the regulatory and supervisory frameworks and the gaps for related party transactions. It can be seen therefrom that there are some serious gaps in the definition of related parties and related party transactions.</p> <p>Section 3.2 of BoB guidelines on transactions with related parties of a bank requires that a bank’s board of directors shall establish and ensure that senior management officials implement a written policy covering all transactions, including deposit-taking and credit-granting, between the bank and its related persons. Processes should be</p> |

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| | <p>established in each bank to allow board of directors to monitor compliance with policy. Board of directors shall review the policy on at least an annual basis.</p> <p>The 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.</p> |
| EC6 | <p>The supervisor requires that the credit policy prescribes that major credit risk exposures exceeding a certain amount or percentage of the bank's capital are to be decided by the bank's Board or senior management. The same applies to credit risk exposures that are especially risky or otherwise not in line with the mainstream of the bank's activities.</p> |
| Description and findings re EC6 | <p>Section 17(1) read with Banking Regulation 9(1) of the Banking Act requires banks to obtain the permission of the board for credit facilities that exceed 10 percent of the bank's unimpaired capital. Section 17(3) requires banks to obtain prior approval from BoB for credit facilities that exceed 30 percent of the bank's unimpaired capital.</p> <p>Section 5.13(iii) of the BoB guideline on risk management require that each bank's credit policy should detail the structure of the credit approval authority and process, approval limits and approval lending authority of each loan officer, management, or board credit committee, including procedures for granting exceptions. Law or regulations do not explicitly provide for a similar framework for credit risk exposures that are risky or otherwise not in line with the bank's activities.</p> <p>Supervisors generally rely on the banks' internal control, compliance, and internal audit frameworks to be assured about the availability of these controls on credit granting and compliance with these controls. During onsite examinations, supervisors review compliance with these controls and treatment of exceptions.</p> <p>During onsite examinations, supervisors review the minutes of the Board, its audit committee, and its risk committee to understand the progress made, and issues and challenges in implementing the board approved strategies, policies, and processes for credit risk management.</p> |
| EC7 | <p>The supervisor has full access to information in the credit and investment portfolios and to the bank officers involved in assuming, managing, controlling and reporting on credit risk.</p> |
| Description and findings re EC7 | <p>Section 21(1) of the Banking Act (1995) provides that the BoB may, for the purpose of the administration of this Act, call for any information which it may require, from any bank, concerning its operations in Botswana or those of its affiliates in Botswana and subsidiaries abroad, if any.</p> <p>Section 25 of the Act provides that BoB supervisors are entitled to examine all books, minutes, accounts, cash, securities, vouchers and any other documents in the possession or custody of the bank or any of its affiliates, and to require such information concerning its business or that of its affiliates in Botswana or abroad, if</p> |

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| | <p>any, as is considered necessary or desirable, and the bank concerned shall comply with all requests made pursuant to this subsection.</p> <p>Through these powers BoB supervisors have full access to all relevant information and bank officers involved in assuming, managing, controlling and reporting on credit risk.</p> |
| EC8 | The supervisor requires banks to include their credit risk exposures into their stress testing programs for risk management purposes. |
| Description and findings re EC8 | <p>Sections 5.7 to 5.9 of the BoB guideline on risk management (2018) provide that:</p> <ul style="list-style-type: none"> • Each bank should periodically employ stress testing and back testing in evaluating the quality of its credit risk-assessment models and establish internal tolerance limits for differences between expected and actual outcomes; and have processes for updating limits, as conditions warrant. • Stress testing of the credit portfolio should involve identifying possible events or future changes in economic conditions that could have unfavorable effects on a bank's credit exposures and assessing the bank's ability to withstand such changes. Three areas that a bank could usefully examine are: (i) economic or industry downturns (both in the whole economy and in particular sectors), (ii) market risk events (interest rate risk and foreign exchange risk); credit-risk events higher than expected levels of delinquencies and defaults, and (iii) liquidity conditions. • Stress testing could range from relatively simple alterations in assumptions about one or more financial, structural or economic variables to the use of highly sophisticated financial models. • The output of the tests should be reviewed periodically by senior management and appropriate action taken in cases where the results exceed agreed tolerances. Stress test analyses should include contingency plans regarding actions management might take given certain scenarios. The output should also be incorporated into the process for assigning and updating policies and limits. <p>During onsite examinations, supervisors review adequacy and appropriateness of the stress factors and scenarios used by banks in stress testing their credit risk portfolio, the stress test results and how these are used for risk management.</p> |
| Assessment of Principle 17 | Largely compliant |
| Comment | <p>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.</p> <p>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.</p> |

| | To improve compliance, law or regulations should 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 | Problem assets, provisions and reserves. ⁵¹ The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves. ⁵² | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Essential criteria | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| EC1 | Laws, regulations or the supervisor require banks to formulate policies and processes for identifying and managing problem assets. In addition, laws, regulations or the supervisor require regular review by banks of their problem assets (at an individual level or at a portfolio level for assets with homogenous characteristics) and asset classification, provisioning and write-offs. | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Description and findings re EC1 | <p>The level of non-performing loans (NPLs) has gradually declined over the past four years and specific provisions held by bank towards these NPLs have also declined in the past two years. Details are furnished in Table below.</p> <table border="1"> <thead> <tr> <th colspan="5">Non-performing loans and Specific Provisions</th> </tr> <tr> <th></th> <th>2018</th> <th>2019</th> <th>2020</th> <th>2021</th> </tr> </thead> <tbody> <tr> <td>BWP million</td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td>Gross loans and advances</td> <td>58,332</td> <td>62,770</td> <td>65,554</td> <td>68,920</td> </tr> <tr> <td>Non-performing loans (NPLs)</td> <td>3,166</td> <td>3,051</td> <td>2,824</td> <td>2,922</td> </tr> <tr> <td>Specific provisions</td> <td>1,352</td> <td>1,775</td> <td>1,713</td> <td>1,654</td> </tr> <tr> <td>Net NPLs</td> <td>1814</td> <td>1276</td> <td>1111</td> <td>1268</td> </tr> <tr> <td>Percent</td> <td></td> <td></td> <td></td> <td></td> </tr> <tr> <td>NPLs to gross loans and advances</td> <td>5.4%</td> <td>4.9%</td> <td>4.3%</td> <td>4.2%</td> </tr> <tr> <td>Specific provisions to NPLs</td> <td>42.7%</td> <td>58.2%</td> <td>60.7%</td> <td>56.6%</td> </tr> <tr> <td>Net NPLs</td> <td>3.2%</td> <td>2.1%</td> <td>1.7%</td> <td>1.9%</td> </tr> </tbody> </table> <p>Source: Bank of Botswana</p> <p>The level of loans classified as special mention accounts in the banking system was around 1.3 percent in December 2021 and the range among individual banks was 0.6 to 4.7 percent.</p> <p>In response to the COVID pandemic, BoB allowed banks, among others, (a) to grant repayment moratoria on loans with a good repayment history for up to six months, and (b) to restructure loans for entities adversely affected by COVID-19. In addition, the government guaranteed loans extended to affected sectors. The BoB generally exercised regulatory forbearance in relation to loans that benefited from above COVID</p> | Non-performing loans and Specific Provisions | | | | | | 2018 | 2019 | 2020 | 2021 | BWP million | | | | | Gross loans and advances | 58,332 | 62,770 | 65,554 | 68,920 | Non-performing loans (NPLs) | 3,166 | 3,051 | 2,824 | 2,922 | Specific provisions | 1,352 | 1,775 | 1,713 | 1,654 | Net NPLs | 1814 | 1276 | 1111 | 1268 | Percent | | | | | NPLs to gross loans and advances | 5.4% | 4.9% | 4.3% | 4.2% | Specific provisions to NPLs | 42.7% | 58.2% | 60.7% | 56.6% | Net NPLs | 3.2% | 2.1% | 1.7% | 1.9% |
| Non-performing loans and Specific Provisions | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| | 2018 | 2019 | 2020 | 2021 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| BWP million | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Gross loans and advances | 58,332 | 62,770 | 65,554 | 68,920 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Non-performing loans (NPLs) | 3,166 | 3,051 | 2,824 | 2,922 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Specific provisions | 1,352 | 1,775 | 1,713 | 1,654 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Net NPLs | 1814 | 1276 | 1111 | 1268 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Percent | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| NPLs to gross loans and advances | 5.4% | 4.9% | 4.3% | 4.2% | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Specific provisions to NPLs | 42.7% | 58.2% | 60.7% | 56.6% | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Net NPLs | 3.2% | 2.1% | 1.7% | 1.9% | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

⁵¹ Principle 17 covers the evaluation of assets in greater detail; Principle 18 covers the management of problem assets.

⁵² Reserves for the purposes of this Principle are "below the line" non-distributable appropriations of profit required by a supervisor in addition to provisions ("above the line" charges to profit).

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| | <p>support measures regarding assessment of non-performing loans and determination of expected credit losses, for regulatory and compliance purposes. These measures have been extended and are still in force.⁵³ Reportedly, COVID related restructuring and moratorium measures were extended to about 8.5 percent of total loans as of December 2021.</p> <p>In June 2022, NPLs represented 3.7 percent of total loans. Deterioration in asset quality and related provisioning may have been delayed by COVID-19 relief measures that remain in place, in particular, the 6-month loan repayment moratorium which in some cases has been extended for a longer period. However, discussion with two largest banks indicate that the size of rescheduled loans attributed to COVID forbearance measures have declined.</p> <p>BoB guideline on risk management (2018) requires each bank to develop and implement comprehensive procedures and information systems to monitor the quality of its loan portfolio. These procedures should define criteria for identifying and reporting potential problem credits and other transactions to ensure that they are subject to more frequent monitoring, as well as possible corrective action, classification and/or provisioning. The other requirements established in the guideline are:</p> <ul style="list-style-type: none"> • A loan should be identified as a problem asset when there is reason to believe that all amounts due, including principal and interest, will not be collected in accordance with the contractual terms of the loan agreement. A loan should be re-classified as performing when all arrears have been cleared and the loan has been brought fully to 'current' status, repayments have been made in a timely manner over a continuous period (with evidence of continued collection), in accordance with the agreed contractual terms. • A loan shall be classified as impaired if the bank considers that the obligor is unlikely to pay its credit obligations to the bank in full, without recourse by the bank to the legal actions allowed under the agreement and law, such as realizing collateral (if held); and/or the obligor is past due for more than 90 days on any material credit obligation to the bank. Overdraft facilities will be considered as being impaired once the customer has breached an advised limit. • A bank's provisioning policy should clearly set out how the bank will manage problem credits. Responsibility for such credits may be assigned to the originating business function, a specialized workout section, or a combination of the two, depending upon the size and nature of the credit and the reason for its problems. |
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⁵³ On 15 Dec 2022, BoB withdrew the regulatory forbearance on the classification and provisioning of exposures that benefitted from COVID related moratorium.

- Loan accounting policies and practices should be selected and applied in a consistent way that reasonably ensures that the loan and loan loss provisioning information is reliable and verifiable.
- The provisioning policy and processes should ensure that the bank maintains adequate provisions for identified and expected losses in accordance with the prevailing applicable accounting standards. In addition, a bank must provision for expected credit losses (ECL) from the time a loan is originated, rather than awaiting "trigger events" signaling imminent losses. Such provisioning should be forward looking (based on reasonable and supportable information that includes historical, current, and forecast information). Furthermore, a bank must hold adequate capital to absorb unexpected losses. The bank's policies and process for grading and classifying its loans and provisioning should consider off-balance sheet exposures as well.

The above BoB guideline also requires each bank to ensure that valuation, classification, and provisioning for significant exposures are conducted on an individual item basis. It requires that a bank should set an appropriate threshold for the purpose of identifying significant exposures and to regularly review set thresholds. The remainder of the portfolio should be segmented into groups of loans with similar credit risk characteristics for evaluation and analysis on a collective basis. A bank may use different methods on group loans for the purpose of assessing credit risk and valuation. For example, loans may be grouped based on one or more of the following characteristics: estimated default probabilities or credit risk grades, loan type, product type, market segment, geographical location, collateral type or past-due status.

The guideline requires that a bank should be able to demonstrate, for individually assessed loans that are, or likely to be impaired, how the amount of any impairment is determined and measured. This includes proof of existence of procedures describing the impairment measurement techniques available and steps performed to determine which technique is most appropriate in each situation. If a bank determines that observable data does not indicate that impairment exists for an individually assessed loan, the bank should include the loan in a group of loans with similar credit risk characteristics for collective impairment evaluation.

For groups of loans that are collectively assessed for impairment, estimated credit losses should reflect consideration of the bank's historical net charge-off rate of the groups, adjusted upward or downward for changes in trends, conditions and other relevant factors that affect repayment of the loans in these groups as of the evaluation date.

Supervisors conduct periodic off-site review of classification of credit facilities, and impairment loss provisions held by banks based on the limited aggregate data and information received from them on periodic basis. This does not support

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| | <p>assessment of classification and provisioning for individual significant exposures.</p> <p>During on-site inspection, supervisors review the efficiency and effectiveness of bank’s policies and processes for their adequacy of grading and classifying assets and establishing appropriate and robust provisioning levels.</p> <p>In the absence of explicit requirement in guideline and guidance to supervisors, the threshold set by banks for undertaking valuation, classification, and provisioning for significant exposures on an individual item basis is not adequately reviewed and ensured by BoB. The broad approach acceptable to supervisors is for banks to undertake valuation, classification, and provisioning at an individual level for large exposures (10 percent of bank’s total regulatory capital), which may be too high and can exclude material exposures from individual assessment. This could have implications for effectiveness of identification of problem assets, their appropriate classification and consequently on the level of provisions held by banks.</p> |
| <p>EC2</p> | <p>The supervisor determines the adequacy of a bank’s policies and processes for grading and classifying its assets and establishing appropriate and robust provisioning levels. The reviews supporting the supervisor’s opinion may be conducted by external experts, with the supervisor reviewing the work of the external experts to determine the adequacy of the bank’s policies and processes</p> |
| <p>Description and findings re EC2</p> | <p>The prudential norms for classification are laid down in BoB guideline on risk management (2018). Banks are also required to implement International financial reporting standards (IFRS) and therefore be compliant with the IFRS 9 requirements. Though BoB guidelines do not state explicitly, supervisors confirm that banks are expected to comply with the more stringent of the prudential classification requirements and the IFRS 9 requirement. Consequently, in effect, each bank’s internal policies and processes are required to produce an outcome that meets the minimum classification requirements laid down in BoB regulations. BoB guidelines, however, do not lay down the minimum provisioning requirements. BoB guidelines also do not explicitly require banks to classify all exposures to a counterparty in the same lowest classification category assigned to any of these exposures. These gaps could have implications for accuracy of grading and provisioning for NPLs.</p> <p>Banks’ compliance with IFRS 9 requirements is ensured through the conduct of independent external annual audits of banks’ financial statements. Supervisors review banks’ compliance with the prudential classification requirement through a limited off-site review while reviewing the audited financial statements ahead of their publication and a more detailed review during onsite examinations. Where supervisors detect a divergence in banks’ classification, they require the bank to reclassify. As the offsite data obtained from banks are not sufficiently granular, supervisors conduct such reviews onsite.</p> <p>Banks are required to classify all credit facilities in five prudential asset quality categories namely standard, special mention/ watch, substandard, doubtful and</p> |

| | <p>loss based on qualitative factors that will be controlled prudentially with reference to the number of days the exposures are in arrears (days past due). Banks are required to review the asset classification status of exposures every month. The first two prudential categories are performing exposure grades and the last three are non-performing exposure grades. In terms of alignment of prudential classification categories with the IFRS-9 categories, these are as follows:</p> <ul style="list-style-type: none"> • Stage 1: standard exposures and special mention/ watch exposures without significant credit risk, • Stage 2: special mention/ watch exposures with significant credit risk • Stage 3: substandard, doubtful and loss exposures <p>Please see table below for an overview of the mapping of classification norms for credit facilities.</p> <table border="1"> <thead> <tr> <th>Prudential classification</th> <th>Standard</th> <th>Special mention/ Watch</th> <th>Substandard</th> <th>Doubtful</th> <th>Loss</th> </tr> </thead> <tbody> <tr> <td>Day past due</td> <td>No arrears</td> <td>Not specified</td> <td>90 to 120</td> <td>121 to 180</td> <td>>180</td> </tr> <tr> <td>Performing status</td> <td colspan="2">Performing</td> <td colspan="3">Non-Performing</td> </tr> <tr> <td>IFRS 9 classification</td> <td>Stage 1</td> <td>Stage 2</td> <td>Stage 2</td> <td colspan="2">Stage 3</td> </tr> </tbody> </table> <p>BoB guideline on risk management explicitly states that collateralization or received guarantees should have no direct influence on the classification of an exposure as nonperforming. That is, the collateralization or guarantee status does not influence the past-due status, including the counting of past-due days and the determination of the exposure as nonperforming, once the materiality and overdue days threshold have been met. When the relevant criteria are met, an exposure should be classified as non-performing even if the collateral value exceeds the amount of the past-due exposure.</p> <p>External auditors are required to audit/ certify each bank's statutory returns submitted by banks for the quarter-end that coincides with the end of the bank's financial year. The statutory returns include, among others, the return on loan classification and provisioning.</p> <p>Please see description and finding under EC4 for supervisory determination of adequacy of provisions held by banks for non-performing exposures. It can be seen from that discussion that the supervisory determination of adequacy of provisions is unclear.</p> | | | | | Prudential classification | Standard | Special mention/ Watch | Substandard | Doubtful | Loss | Day past due | No arrears | Not specified | 90 to 120 | 121 to 180 | >180 | Performing status | Performing | | Non-Performing | | | IFRS 9 classification | Stage 1 | Stage 2 | Stage 2 | Stage 3 | |
|---------------------------------|--|------------------------|----------------|------------|------|---------------------------|----------|------------------------|-------------|----------|------|--------------|------------|---------------|-----------|------------|------|-------------------|------------|--|----------------|--|--|-----------------------|---------|---------|---------|---------|--|
| Prudential classification | Standard | Special mention/ Watch | Substandard | Doubtful | Loss | | | | | | | | | | | | | | | | | | | | | | | | |
| Day past due | No arrears | Not specified | 90 to 120 | 121 to 180 | >180 | | | | | | | | | | | | | | | | | | | | | | | | |
| Performing status | Performing | | Non-Performing | | | | | | | | | | | | | | | | | | | | | | | | | | |
| IFRS 9 classification | Stage 1 | Stage 2 | Stage 2 | Stage 3 | | | | | | | | | | | | | | | | | | | | | | | | | |
| EC3 | The supervisor determines that the bank's system for classification and provisioning takes into account off-balance sheet exposures. ⁵⁴ | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Description and findings re EC3 | BoB guideline on risk management explicitly require from banks that non-performing exposures should always be categorized for the whole exposure, including | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

⁵⁴ It is recognized that there are two different types of off-balance sheet exposures: those that can be unilaterally cancelled by the bank (based on contractual arrangements and therefore may not be subject to provisioning), and those that cannot be unilaterally cancelled.

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| | <p>when non-performance relates to only a part of the exposure, for instance, unpaid interest. For off-balance sheet exposures, such as loan commitments or financial guarantees, the whole exposure is the entire non-cancellable nominal amount.</p> <p>During off-site reviews and on-site inspections supervisors review the processes in banks for identification, measurement, classification, and provisioning of exposures, to confirm if they include off-balance sheet exposures.</p> <p>(Please also see description and finding re EC1 for additional details)</p> |
| EC4 | <p>The supervisor determines that banks have appropriate policies and processes to ensure that provisions and write-offs are timely and reflect realistic repayment and recovery expectations, taking into account market and macroeconomic conditions.</p> |
| <p>Description and findings re EC4</p> | <p>BoB guideline on risk management (2018) requires each bank to, among others, have the following regarding provisioning for loans and advances portfolio:</p> <ul style="list-style-type: none"> • Loan accounting policies and practices should be selected and applied in a consistent way that reasonably ensures that the loan and loan loss provisioning information is reliable and verifiable. • The provisioning policy and processes should ensure that the bank maintains adequate provisions for identified and expected losses in accordance with the prevailing applicable accounting standards. In addition, a bank must provision for expected credit losses (ECL) from the time a loan is originated, rather than awaiting "trigger events" signaling imminent losses. Such provisioning should be forward looking (based on reasonable and supportable information that includes historical, current, and forecast information). Furthermore, a bank must hold adequate capital to absorb unexpected losses. The bank's policies and process for grading and classifying its loans and provisioning should consider off-balance sheet exposures as well. <p>Currently banks' provisioning is determined by IFRS 9 requirements. Since banks' provisioning under IFRS 9 is dependent on internal models, since loan default data (probability of default – PD), data on collateral realization, and data on recoveries are not systematically compiled, and since the data, where available, are for limited periods, the provisioning numbers generated by banks' internal models can, at best, be tentative.</p> <p>Given the likely tentative internal model outputs for determining expected credit loss under IFRS 9, the absence of explicit and enforceable prudential provisioning requirement can have implications.</p> <p>The provision coverage ratio (provision for NPLs as a percentage of total NPLs) for the banking system is moderate at around 57 percent at end December 2021. This ratio has declined from about 58 percent in 2019 and about 61 percent in 2020. BoB is yet</p> |

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| | <p>to undertake an analyses or study to independently assess the adequacy of the provisions held by banks after withdrawal of the prudential requirement.</p> <p>BoB has not established the prudential requirements for periodic valuation of collateral and the applicable haircuts for different types of collateral. Banks establish their own policies. BoB has yet to undertake a thematic review of the collateral policies and practices to be assured about the adequacy and appropriateness of these policies and practices, from prudential perspective.</p> <p>BoB has not established minimum requirements or expectations regarding write-off of non-performing exposures. Banks establish their own write-off policies. BoB has yet to undertake a thematic review of the write-off policies and practices to be assured about the adequacy and appropriateness of these policies and practices, from a prudential perspective.</p> <p>The offsite data obtained by BoB on asset quality are not granular to allow it to determine the adequacy of provisions held by banks and the timeliness of the write-offs on an ongoing basis. For example, the offsite database does not include (i) the breakdown of NPLs by age for periods longer than 12 months, (ii) the borrower level details of the top 50 or 100 non-performing exposures, and (iii) details of collateral available in non-performing loans.</p> <p>BoB supervisors rely on an internal guideline for assessing adequacy of provisioning for NPLs to assess the adequacy of capital. As per this internal guideline, the expected provisioning levels are 1 percent for performing loans, 20 percent for substandard loans, 50 percent for doubtful loans and 100 percent for loss loans. They use the internal guidelines to review or assess the adequacy of provisions held by banks for their non-performing loans and advances. However, supervisors are not well equipped with appropriate skills to assess IFRS 9 models and model risks and the internal guidelines might not be adequate to enforce as a minimum requirement, if a bank were to be holding less provisions. BoB supervisors review write-offs from a compliance perspective, with reference to the banks' internal policies.</p> |
| EC5 | <p>The supervisor determines that banks have appropriate policies and processes, and organizational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past due obligations. For portfolios of credit exposures with homogeneous characteristics, the exposures are classified when payments are contractually in arrears for a minimum number of days (e.g. 30, 60, 90 days). The supervisor tests banks' treatment of assets with a view to identifying any material circumvention of the classification and provisioning standards (e.g. rescheduling, refinancing or reclassification of loans).</p> |
| Description and findings re EC5 | <p>As mentioned in the description and finding under EC1 of this CP, banks in Botswana are implementing IFRS 9 and are also guided by BoB's prudential norms for identifying and classifying loans and advances under five prudential classification categories. The combination helps banks to identify asset quality deterioration at an early stage.</p> |

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| | <p>BoB reviews and assesses banks' classification under the prudential categories and the external auditors review and assess their classification as per IFRS 9 requirements.</p> <p>BoB guidelines on prudential treatment of rescheduled loans and advances are aligned with the Basel norms, but it is unclear if this is being monitored and enforced effectively. As at end December 2021, rescheduled and restructured loans and advances were about 2.1 percent of total loans at the sector level, and the range for individual banks was zero to 8.9 percent. The offsite data obtained by BoB on rescheduled and renegotiated loans, do not include details of loan classification, provisions held, and loan level details for rescheduled loans, and therefore not adequate for assessing compliance on an ongoing basis. Onsite examinations do not always include review of rescheduled loans and advances and their compliance with the BoB requirements. Besides, there is no explicit guidance to supervisors on how they should review or assess the rescheduling and restructuring (forbearance) granted by banks.</p> |
| EC6 | The supervisor obtains information on a regular basis, and in relevant detail, or has full access to information concerning the classification of assets and provisioning. The supervisor requires banks to have adequate documentation to support their classification and provisioning levels. |
| Description and findings re EC6 | <p>BoB's offsite reporting requirement for banks include the following reports relevant for asset classification and provisioning:</p> <ul style="list-style-type: none"> • Monthly schedule of recoveries, write-offs and new charges by type of counterparty • Quarterly schedule of past due and non-accrual loans by type of counterparty, indicating no of days past due (30 to 90 days, 90 to 180 days and more than 180 days) and value of collateral available from each counterparty type. • Quarterly schedule of renegotiated and repossessed loans and advances by type of counterparty, indicating original amount, foreclosure amount, value of collateral available and the carrying amount. <p>Please see description and finding under ECs 4 and 5, which have identified specific areas where the data obtained by the supervisor from the banks on asset classification and provisioning are not adequate for verifying asset classification and provisioning.</p> <p>Though BoB has not explicitly required banks to have adequate documentation to support their classification and provisioning levels, supervisors are able to seek and obtain any requisite details or documents pertaining to the classification of and provisioning for credit exposures, while onsite.</p> |
| EC7 | The supervisor assesses whether the classification of the assets and the provisioning is adequate for prudential purposes. If asset classifications are inaccurate or provisions are deemed to be inadequate for prudential purposes (e.g. if the supervisor considers existing or anticipated deterioration in asset quality to be of concern or if the provisions do not fully reflect losses expected to be incurred), the supervisor has the power to require the bank to adjust its classifications of individual assets, increase its |

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| | levels of provisioning, reserves or capital and, if necessary, impose other remedial measures. |
| Description and findings re EC7 | <p>Please see description and finding in ECs 1 to 4 which provide details of supervisors' ability to assess classification and provisioning. As mentioned there, BoB can verify and assess classification, but not provisioning. Where supervisors observe deviation in classification, they can require banks to make the relevant adjustments in classification and related provisioning.</p> <p>BoB evaluates the loans and advances portfolio of a bank during an on-site examination to determine, among others, whether the level of specific provisions is adequate. If deemed not adequate, BoB requires a bank to increase its level of provisions in terms of Section 14(1)(i) of the Banking Act. The assessors were provided examples where BoB identified shortfall in provisioning for non-performing exposures and pursued with banks to raise additional provisions.</p> |
| EC8 | The supervisor requires banks to have appropriate mechanisms in place for regularly assessing the value of risk mitigants, including guarantees, credit derivatives and collateral. The valuation of collateral reflects the net realizable value, taking into account prevailing market conditions. |
| Description and findings re EC8 | <p>As mentioned in description and finding under EC 4, BoB has not established clear and explicit requirements on permissible collateral, their valuation approach, prudential haircuts, and the need to reckon the net realizable value based on prevailing market conditions. The BoB guideline on capital adequacy allows banks to reckon certain items of financial collateral and guarantees for the purposes of capital adequacy. Real estate collateral and some movable collaterals are the main forms of collateral that banks are understood to be holding for their loan portfolio, which are not adequately covered by the BoB guideline on capital adequacy.</p> <p>BoB guideline on risk management requires a bank to establish its own policies covering the acceptability of various forms of collateral, procedures for the ongoing valuation of such collateral and processes to ensure that collateral is, and continues to be, enforceable and realizable. As regards guarantees, the guideline requires the bank to evaluate the level of coverage being provided in relation to the credit quality and legal capacity of the guarantor.</p> <p>Verification for assessing the value of credit mitigants is conducted during on-site examinations by requesting and reviewing valuation reports, guarantee letters, and financial information of the counterparty, but such verification is not explicitly documented in the onsite examination reports.</p> |
| EC9 | <p>Laws, regulations or the supervisor establish criteria for assets to be:</p> <p>(a) identified as a problem asset (e.g., a loan is identified as a problem asset when there is reason to believe that all amounts due, including principal and interest, will not be collected in accordance with the contractual terms of the loan agreement); and</p> |

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| | <p>(b) reclassified as performing (e.g., a loan is reclassified as performing when all arrears have been cleared and the loan has been brought fully current, repayments have been made in a timely manner over a continuous repayment period and continued collection, in accordance with the contractual terms, is expected).</p> |
| <p>Description and findings re EC9</p> | <p>BoB guideline on risk management explicitly lay down the following exposures shall be considered as non-performing:</p> <ul style="list-style-type: none"> (a) all exposures that are "defaulted" under the Basel II framework, (b) all exposures that are credit-impaired (having experienced a downward adjustment to their valuation due to deterioration of their creditworthiness) according to the applicable accounting framework, (c) all other exposures that are not defaulted or impaired but nevertheless <ul style="list-style-type: none"> (i) are material exposures that are more than 90 days past due, or (ii) where there is evidence that full repayment based on the contractual terms, original or, when applicable, modified (e.g., repayment of principal and interest) is unlikely without the bank's realization of collateral, whether or not the exposure is current and regardless of the number of days the exposure is past due. (d) forbore exposures should be identified as non-performing when they meet the specific criteria. (e) Collateralization or received guarantees should have no direct influence on the categorization of an exposure as non-performing. <p>BoB guideline on risk management explicitly lay down the conditions governing re-categorization of non-performing exposures as performing. An exposure ceases to be non-performing and can be re-categorized as performing when all the following criteria are simultaneously met:</p> <ul style="list-style-type: none"> • the counterparty does not have any material exposure more than 90 days past due, • repayments have been made when due over a period of at least three continuous months as specified by the supervisor. A longer repayment period shall be required for non-performing forbore exposures, • the counterparty's situation has improved to the extent that the full repayment of the exposure is likely, according to the original or, when applicable, modified conditions; and • the exposure is not "defaulted" according to the Basel II standard or "impaired" according to the applicable accounting framework. <p>BoB guideline also clear stipulates that the following situations will not lead to the re-categorization of a non-performing exposure as performing:</p> |

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| | <ul style="list-style-type: none"> • partial write-off of an existing non-performing exposure, (i.e., when a bank writes off part of a non-performing exposure that it deems to be uncollectible), • repossession of collateral on a non-performing exposure, until the collateral is actually disposed of, and the bank realizes the proceeds (when the exposure is kept on balance sheet, it is deemed non-performing), or • extension or granting of forbearance measures to an exposure that is already identified as non-performing subject to the relevant exit criteria for non-performing exposures. The re-categorization of a non-performing exposure as performing should be made at the same level (i.e., at counterparty or transaction level) as when the exposure was originally categorized as non-performing. <p>The above comply with Basel norms.</p> <p>The offsite data obtained by BoB on rescheduled and renegotiated loans, do not include details of loan classification, provisions held, and loan level details for rescheduled loans, and therefore not adequate for assessing compliance on an ongoing basis. Onsite examinations do not always include review of rescheduled loans and advances and their compliance with the BoB requirements. Besides, there are no explicit guidance to supervisors on how they should review or assess the rescheduling and restructuring (forbearance) granted by banks.</p> |
| EC10 | <p>The supervisor determines that the bank's Board obtains timely and appropriate information on the condition of the bank's asset portfolio, including classification of assets, the level of provisions and reserves and major problem assets. The information includes, at a minimum, summary results of the latest asset review process, comparative trends in the overall quality of problem assets, and measurements of existing or anticipated deterioration in asset quality and losses expected to be incurred.</p> |
| Description and findings re EC10 | <p>BoB guideline on risk management require that each bank should establish a system of independent, on-going assessment of its credit risk management processes and the results of such reviews should be communicated directly to senior management and the board of directors. Each bank should have an efficient internal credit review and reporting system to effectively manage the bank's various portfolios. Internal audits of the credit risk processes should be conducted on a periodic basis, and it should assess compliance with the bank's credit policies and procedures.</p> <p>However, law or regulations do not explicitly require the bank boards to obtain timely and appropriate information on the condition of the asset portfolio, classification and provisioning of credit facilities, major problem assets, comparative trends in overall quality of problem assets, and measurement of existing or anticipated deterioration in asset quality and losses expected to be incurred.</p> |

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| | During on-site examination, BoB supervisors determine through the review of board packs and minutes whether the board obtains timely and appropriate information on the condition of the bank's asset portfolio, and the level of board oversight. |
| EC11 | The supervisor requires that valuation, classification and provisioning, at least for significant exposures, are conducted on an individual item basis. For this purpose, supervisors require banks to set an appropriate threshold for the purpose of identifying significant exposures and to regularly review the level of the threshold. |
| Description and findings re EC11 | <p>BoB guidelines on risk management requires each bank to ensure that valuation, classification, and provisioning for significant exposures are conducted on an individual item basis. It requires that a bank should set an appropriate threshold for the purpose of identifying significant exposures and to regularly review set thresholds. The remainder of the portfolio should be segmented into groups of loans with similar credit risk characteristics for evaluation and analysis on a collective basis.</p> <p>The guideline requires that a bank should be able to demonstrate, for individually assessed loans that are, or likely to be impaired, how the amount of any impairment is determined and measured. This includes proof of existence of procedures describing the impairment measurement techniques available and steps performed to determine which technique is most appropriate in each situation. If a bank determines that observable data does not indicate that impairment exists for an individually assessed loan, the bank should include the loan in a group of loans with similar credit risk characteristics for collective impairment evaluation.</p> <p>For groups of loans that are collectively assessed for impairment, estimated credit losses should reflect consideration of the bank's historical net charge-off rate of the groups, adjusted upward or downward for changes in trends, conditions and other relevant factors that affect repayment of the loans in these groups as of the evaluation date.</p> <p>Supervisors conduct periodic off-site review of classification of credit facilities, and impairment loss provisions held by banks based on the limited aggregate data and information received from them on periodic basis. This does not support assessment of classification and provisioning for individual significant exposures.</p> <p>During on-site inspection, supervisors review the efficiency and effectiveness of bank's policies and processes for their adequacy of review, grading and classifying significant exposures and establishing appropriate and robust provisioning levels.</p> <p>In the absence of explicit requirement in guideline and guidance to supervisors, the threshold set by banks for undertaking valuation, classification, and provisioning for significant exposures on an individual item basis is not adequately reviewed and ensured by BoB. The broad approach acceptable to supervisors is for banks to undertake valuation, classification, and provisioning at an individual level</p> |

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| | for large exposures (10 percent of bank's total regulatory capital), which may be too high a threshold and can exclude material exposures from individual assessment. This could have implications for the effectiveness of identification of problem assets, their appropriate classification and consequently on the level of provisions held by banks. |
| EC12 | The supervisor regularly assesses any trends and concentrations in risk and risk build-up across the banking sector in relation to banks' problem assets and takes into account any observed concentration in the risk mitigation strategies adopted by banks and the potential effect on the efficacy of the mitigant in reducing loss. The supervisor considers the adequacy of provisions and reserves at the bank and banking system level in the light of this assessment. |
| Description and findings re EC12 | BoB does not undertake regular or periodic system-level analyses of trends over the past few years (the reviews are currently focused on the evolution during the previous 6 months). The reviews do not consider geographical concentrations in relation to banks' problem assets, concentration in risk mitigants or risk mitigation strategies and the extent of provision coverage in individual banks or in the banking system. |
| Assessment of Principle 18 | Materially non-compliant |
| Comments | <p>Banks are required to comply with IFRS 9 which governs banks' classification and provisioning requirements for credit risk. BoB's prudential requirements for classification of credit facilities, that serves as a backstop for the IFRS classification, include loans and advances and off-balance sheet exposures but do not include other forms of credit risk exposure, namely placements, investments and counterparty credit exposures arising through OTC derivatives. There is no explicit and enforceable prudential backstop to IFRS 9 provisioning requirements in BoB's prudential framework. In the absence of adequate guidance and in the light of complexities involved (model-based determination of expected credit losses over the life of the exposure for stage 2 and stage 3 assets) supervisory oversight over provisioning for credit risk is considered inadequate.</p> <p>The other gaps observed in regards to the requirements under this CP 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 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</p> |

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| | <p>across banking system in relation to banks' problem assets and risk mitigation strategies.</p> <p>BoB should consider reviewing and revising the regulatory framework, data and information obtained from banks through offsite statutory reports, and supervisory guidance and tools to address the specific gaps identified above. BoB should also consider undertaking 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.</p> |
| Principle 19 | Concentration risk and large exposure limits. The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties. ⁵⁵ |
| Essential criteria | |
| EC1 | Laws, regulations or the supervisor require banks to have policies and processes that provide a comprehensive bank-wide view of significant sources of concentration risk. ⁵⁶ Exposures arising from off-balance sheet as well as on-balance sheet items and from contingent liabilities are captured. |
| Description and findings re EC1 | <p>Section 2 of BoB guideline on large exposures (2009) define the terms exposure, large exposures and group of inter-related persons as below:</p> <p>Exposure: The amount of a bank's exposure is calculated as follows:</p> <ul style="list-style-type: none"> • The sum of loans and credit facilities granted, either directly or indirectly, to a person or group of inter-related persons, such as: <ul style="list-style-type: none"> ○ term loans, overdrafts, credit lines and other credit facilities, ○ trade bills discounted, invoice discounted and factoring, ○ credit substitutes, such as guarantees, acceptances, letters of credit and bills, and finance lease receivables, ○ underwriting of debt and equity securities, and other forms of participation, ○ securitized assets and other transactions with recourse, |

⁵⁵ Connected counterparties may include natural persons as well as a group of companies related financially or by common ownership, management or any combination thereof.

⁵⁶ This includes credit concentrations through exposure to: single counterparties and groups of connected counterparties both direct and indirect (such as through exposure to collateral or to credit protection provided by a single counterparty), counterparties in the same industry, economic sector or geographic region and counterparties whose financial performance is dependent on the same activity or commodity as well as off-balance sheet exposures (including guarantees and other commitments) and also market and other risk concentrations where a bank is overly exposed to particular asset classes, products, collateral, or currencies.

- credit derivatives, futures and forwards, swaps and option contracts such as credit default swaps and other derivatives,
- contingent liabilities, such as commitments to extend credit, performance bonds and warranties.
- **Less** the amount by which the above-listed accommodations are irrevocably secured by:
 - collateral in the form of cash deposits placed with a bank that granted the accommodation (the lending bank),
 - collateral in the form of cash deposit placed with another bank in Botswana,
 - an eligible guarantee by any sovereign with a credit rating of AA or better, issued by a recognized external credit rating agency,
 - any listed financial instrument of a company listed in Botswana (treasury bills, listed bonds, etc.).

The above definition does not include the counterparty credit exposures that arise in outstanding over-the-counter derivatives, and exposures on account of placements and investment in the bonds and equity issued by the counterparty.

Group of Inter-related Persons - Two or more persons holding exposures from the bank, whether on a joint or separate basis, who are mutually associated with at least one of the following: (1) a controlling interest (fifty percent of voting shares plus one); (2) common ownership or control; (3) common management; (4) common directors; (5) cross guarantees; or (6) direct financial interdependence which cannot be substituted in the short-term. *(Where banks are uncertain on grouping connections for large exposure reporting, clarity and guidance may be sought formally and in writing from the Bank.)*

Large Exposure - A bank's aggregate exposure, direct or indirect and net of eligible collateral, to any person or group of inter-related persons which equals or exceeds 10 percent of the bank's unimpaired capital (total regulatory capital).

Section 3 of the BoB guideline on large exposures lay down the requirements for banks' **policies and procedures** relating to large exposures, which are as below:

- The Board of Directors of a bank shall formulate a policy on large exposures and put in place measures to ensure effective implementation by management. This policy shall constitute an integral part of the bank's overall credit policy. The policy, at a minimum, shall:
 - address concentrations of risk arising from individual large exposures and total large exposures, including those to groups of inter-related persons; and

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| | <ul style="list-style-type: none"> ○ impose strict and binding limits on large exposures, including those to groups of inter-related persons, which do not exceed the limitations contained in BoB guideline. • If the interests of two or more persons are such that they are deemed to be a “group of inter-related persons”, then the total exposures of all persons in that group shall be combined for purposes of applying the limitations of large exposures. • If the BoB designates a group of inter-related persons that has not been so designated by a bank, and if the total exposure of that group of interrelated persons exceeds the limitations of the BoB or of the bank’s own credit policy, then the bank shall be permitted to dispose of the excess exposure within such reasonable period as the BoB shall determine, in any case within a period of not more than 12 months. • In accordance with Section 17(1) of the Banking Act (1995), any large exposure to any counterparty must be approved by the bank’s Board of Directors or a duly authorized Sub-Committee thereof. <p>Laws or regulations do not explicitly require banks to have policies and processes for comprehensive bank-wide view of significant sources of concentration risk other than the concentration arising from large exposures and single counterparty or group of inter-connected counterparties. Section 3 of the BoB guidelines on large exposures require the board of directors of a bank to formulate a policy on large exposures and put in place measures to ensure effective implementation by management. This policy must constitute an integral part of the bank’s overall credit policy and, at a minimum, shall:</p> <ul style="list-style-type: none"> • address concentrations of risk arising from individual large exposures and total large exposures, including those to groups of inter-related persons, and • impose strict and binding limits on large exposures, including those to groups of inter-related persons, which do not exceed the limitations contained in BoB guideline on large exposures. |
| EC2 | The supervisor determines that a bank’s information systems identify and aggregate on a timely basis, and facilitate active management of, exposures creating risk concentrations and large exposure ⁵⁷ to single counterparties or groups of connected counterparties. |
| Description and findings re EC2 | BoB guideline on risk management (2018) lay down the requirements and expectations regarding banks’ information systems. Please see the description and finding re EC 7 |

⁵⁷ The measure of credit exposure, in the context of large exposures to single counterparties and groups of connected counterparties, should reflect the maximum possible loss from their failure (i.e. it should encompass actual claims and potential claims as well as contingent liabilities). The risk weighting concept adopted in the Basel capital standards should not be used in measuring credit exposure for this purpose as the relevant risk weights were devised as a measure of credit risk on a basket basis and their use for measuring credit concentrations could significantly underestimate potential losses (see “*Measuring and controlling large credit exposures*, January 1991).

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| | of CP 15 which summarizes the regulatory and supervisory requirements and the onsite activities of supervisors regarding banks' information systems. |
| EC3 | The supervisor determines that a bank's risk management policies and processes establish thresholds for acceptable concentrations of risk, reflecting the bank's risk appetite, risk profile and capital strength, which are understood by, and regularly communicated to, relevant staff. The supervisor also determines that the bank's policies and processes require all material concentrations to be regularly reviewed and reported to the bank's Board. |
| Description and findings re EC3 | <p>As mentioned in the description and finding re EC1, laws and regulations do not explicitly establish a set of supervisory requirements or expectations regarding banks' concentration risk management framework (governance, policies, processes, controls, oversight, and assurance), except for credit concentrations arising from large exposures, exposures to single counterparty and group of inter-connected counterparties.</p> <p>Please also see description and finding under EC4 of this CP that explains the BoB's ongoing monitoring of concentrations arising from concentration among depositors (top 20 depositors), concentration in economic sectors and currency-wise concentration in banks' loan portfolios. BoB is yet to establish prudential limits on these types of concentrations.</p> <p>During onsite inspections, supervisors review risk concentrations and management of such concentration by the banks.</p> <ul style="list-style-type: none"> - Accordingly, supervisors verify if the bank complies with the prudential ratios established in BoB regulations that are relevant for credit concentration. This review includes (i) assessment of the bank's systems and procedures to identify and aggregate exposures across the bank, (ii) the availability of a clear methodology or mechanism to identify relevant customers and their interconnectedness, (iii) gaps, if any, in bank's identification of groups of connected counterparties, - Review the bank's risk appetite, its internal limits (if any) on concentration to the counterparty, the economic sector, and among depositors to determine the extent to which the bank is exposed to concentration risk and how it is managing the concentration. <p>Review the extent of senior management and board oversight over risk concentrations and management of concentration risks.</p> |
| EC4 | The supervisor regularly obtains information that enables concentrations within a bank's portfolio, including sectoral, geographical and currency exposures, to be reviewed. |
| Description and findings re EC4 | <p>Section 6 of the BoB guideline on large exposures requires each bank to submit to the BoB a report on all large exposures, as at the end of each quarter and in the format prescribed by the Bank.</p> <p>In addition, BoB obtains every month details of:</p> |

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| | <ul style="list-style-type: none"> (i) banks' loans and advances exposure to each economic sector, (ii) bank's reliance on top 20 depositors, (iii) bank's loans and advances exposure by currency <p>Supervisors use the data in these reports, including the report on large exposures to review the extent of concentration risks in bank portfolios, and prepare a quarterly consolidated analyses for the banking system indicating the extent of different kinds of concentration risks in each bank. These reviews serve as inputs to the relevant bank supervisors to plan their onsite activities and for discussion during the annual bilateral and trilateral meetings with each bank.</p> |
| EC5 | In respect of credit exposure to single counterparties or groups of connected counterparties, laws or regulations explicitly define, or the supervisor has the power to define, a "group of connected counterparties" to reflect actual risk exposure. The supervisor may exercise discretion in applying this definition on a case-by-case basis. |
| Description and findings re EC5 | <p>Please see description and finding under EC1 for details.</p> <p>BoB has defined group of connected counterparties (inter-related persons) explicitly in regulations, as below. The regulation also advises banks to seek BoB guidance if banks are having doubts about the inclusion or exclusion of any counterparty, while determining inter-connected counterparties.</p> <p>Group of Inter-related Persons - Two or more persons holding exposures from the bank, whether on a joint or separate basis, who are mutually associated with at least one of the following: (1) a controlling interest; (2) common ownership or control; (3) common management; (4) common directors; (5) cross guarantees; or (6) direct financial interdependence which cannot be substituted in the short-term. (Where banks are uncertain on grouping connections for large exposure reporting, clarity and guidance may be sought formally and in writing from the Bank.)</p> |
| EC6 | Laws, regulations or the supervisor set prudent and appropriate ⁵⁸ requirements to control and constrain large credit exposures to a single counterparty or a group of connected counterparties. "Exposures" for this purpose include all claims and transactions (including those giving rise to counterparty credit risk exposure), on-balance sheet as well as off-balance sheet. The supervisor determines that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis. |
| Description and findings re EC6 | Section 4 of the BoB guideline on large exposures sets the prudential limit for exposure on a single or a group of interconnected counterparties at 30 percent of a bank's unimpaired capital (i.e., total regulatory capital). A bank may, however, exceed this limit with the prior approval of BoB. This Section also establishes an aggregate limit for all large exposures at 800 percent of the bank's unimpaired capital. |

⁵⁸ Such requirements should, at least for internationally active banks, reflect the applicable Basel standards. As of September 2012, a new Basel standard on large exposures is still under consideration.

Section 3(b) of the above guideline lays down the treatment of exposures to two or more interconnected counterparties. If the interests of two or more persons are such that they are deemed to be a "group of inter-related persons", then the total exposures of all persons in that group shall be combined for purposes of applying the limitations of large exposures. If the BoB designates a group of inter-related persons that has not been so designated by a bank, and if the total exposure of that group of interrelated persons exceeds the limitations of the Bank or of the bank's own credit policy, then the bank shall be permitted to dispose of the excess exposure within such reasonable period as the Bank shall determine, in any case within a period of not more than 12 months.

Section 5 of the BoB guideline lays down the process and criteria to be applied when a bank approaches the BoB for prior approval to exceed the prudential exposure limit of 30 percent. It states that with the prior written approval of the BoB for good cause shown, a bank may, in unusual circumstances, grant an accommodation that would result in a large exposure exceeding 30 percent of the bank's unimpaired capital; provided, however, that such large exposure shall be reduced to an amount equal to 30 percent or less of the bank's unimpaired capital within 12 months, and the bank remains within the 800 percent total large exposure limit.

While considering a bank's application to exceed the prudential limit for a single counterparty or a group of connected counterparties, the BoB would consider the following criteria:

- the bank is currently meeting its minimum requirement for unimpaired capital and maintains a ratio of unimpaired capital to total risk-weighted assets of at least 15 percent,
- including the subject accommodation, the total notional amount of large exposures do not exceed 800 percent of its unimpaired capital,
- there is no supervisory enforcement action outstanding or pending against the bank, nor is the bank otherwise subject to a specific supervisory program on account of deficiency on a matter of prudent banking practice,
- the bank's existing credit risk management system and management information system are adequate, and the bank has adequate financial, managerial and organizational resources to handle the increased concentration risk,
- the bank has a history of properly reporting and managing large exposures,
- the extent to which the accommodation will be secured by cash in whole or in part, Government of Botswana securities, bills eligible for discounting at the BoB, assets eligible for liquidity support pursuant to the Bank's Guideline on Managing Liquidity Risk, or other assets as may be acceptable to the Bank,
- the person(s) incurring the subject accommodation has made full disclosure of any "group of inter-related persons" in which the person(s) is included, and

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| | <p>which also has exposure to the bank. The bank has properly included the person(s) in such group(s) for purposes of calculating compliance with the limitations on large exposures,</p> <ul style="list-style-type: none"> • apart from exceeding the 30 percent limit on large exposures, the accommodation meets all of the bank's credit-granting standards based on current audited financial information as stipulated in the bank's written application, • the Board of Directors or its duly authorized sub-committee has approved the large exposure, subject to the approval of the Bank, and • the aggregate amount of the large exposure will be reduced to a level below 30 percent of the bank's unimpaired capital within 12 months, in accordance with a specific plan of reduction presented by the bank in its application. <p>Please see description and finding under EC1, where the BoB definitions of the term exposure, large exposure, and group of inter-connected counterparties have been provided. The BoB definition of exposure includes off-balance sheet exposures but does not include the counterparty credit exposures that arise in outstanding over-the-counter derivatives, and exposures on account of investment in the bonds and equity issued by the counterparty.</p> <p>The prudential limits established by BoB are at variance from the Basel norms in two aspects:</p> <ol style="list-style-type: none"> a. the BoB limit is set at 30 percent compared to the Basel norm of 25 percent; b. the base for the limit in Botswana is total regulatory capital compared to Tier 1 capital used in the Basel norm. <p>As Tier 2 capital is a material part of total regulatory capital for banks in Botswana, the effective prudential limit, computed at the system level would be about 44 percent of tier 1 capital, which is a significant deviation from Basel norm. The concentration will be higher in banks where BoB has allowed exposures higher than 30 percent of unimpaired capital.</p> <p>At the system level, aggregate large gross exposure is about 95 percent of total regulatory capital (138 percent of Tier 1 capital), with range for individual banks being 11 to 165 percent of total regulatory capital (15 to 329 percent of Tier 1 capital). At the system level, aggregate exposure to top 20 counterparties is 75 percent of total regulatory capital (111 percent of Tier 1 capital), with range for individual banks being similar to the aggregate large exposures (that is 11 to 165 percent of total regulatory capital (15 to 329 percent of Tier 1 capital)).</p> <p>BoB supervisors monitor bank exposures to single and group of inter-connected counterparties based on the quarterly offsite reports / data received from banks. They rely on the risk management, compliance and internal audit functions in banks to confirm the incidence of excesses over prudential limits, if any, and the efficiency of</p> |
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| | the internal processes for detecting and flagging such excesses, and the internal approval processes. |
| EC7 | The supervisor requires banks to include the impact of significant risk concentrations into their stress testing programs for risk management purposes. |
| Description and findings re EC7 | BoB has not explicitly articulated its supervisory expectation with regards to banks stress testing their risk concentrations. |
| Additional criteria | |
| AC1 | <p>In respect of credit exposure to single counterparties or groups of connected counterparties, banks are required to adhere to the following:</p> <p>(a) ten per cent or more of a bank's capital is defined as a large exposure; and</p> <p>(b) twenty-five per cent of a bank's capital is the limit for an individual large exposure to a private sector non-bank counterparty or a group of connected counterparties.</p> <p>Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialized banks.</p> |
| Description and findings re AC1 | Please see description and finding under EC1 and EC6, which cover these elements in detail. In short, the regulatory framework in Botswana is compliant with (a) but has set a higher limit (30 percent of total regulatory capital) for exposure to single or group of inter-connected counterparties. The framework also allows banks to exceed the 30 percent prudential limit with the prior approval of the BoB. |
| Assessment of Principle 19 | Materially non-compliant |
| Comments | <p>Laws and regulations have established a set of prudential requirements aimed at addressing concentration risk in banks arising from credit concentration (large exposures, single counterparty, and group of inter-connected counterparties), and have required banks to establish appropriate policies and procedures for managing these concentrations. BoB has not explicitly established a set of supervisory requirements or expectations regarding bank concentration risk management framework (e.g., governance, policies, processes, controls, oversight, and assurance) for other types of concentrations. However, BoB is regularly monitoring concentration among economic sectors and among depositors, through its offsite framework.</p> <p>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</p> |

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| | <p>assessed with reference to net exposures (net of collateral and bilateral netting), but gross exposures are not monitored.</p> <p>BoB should consider reviewing and revising its regulations to introduce a more comprehensive approach to supervision of concentration risk management in banks, that addresses the gaps identified above. The regulatory and supervisory frameworks can make explicit the expectations for management of other types of concentrations in greater detail—for example, by industry, geographic region, markets, products, and collateral. BOB should reconsider allowing case-by-case exemptions to exceed the prudential single counterparty or group of connected counterparty limits, which exposes banks to higher concentrations. These changes may need to be supplemented by corresponding changes to the supervision manual, offsite reporting, and analyses, including guidance to strengthen SREP with reference to concentration risk management by banks.</p> |
| Principle 20 | Transactions with related parties. In order to prevent abuses arising in transactions with related parties ⁵⁹ and to address the risk of conflict of interest, the supervisor requires banks to enter into any transactions with related parties ⁶⁰ on an arm's length basis; to monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes. |
| Essential criteria | |
| EC1 | Laws or regulations provide, or the supervisor has the power to prescribe, a comprehensive definition of "related parties". This considers the parties identified in the footnote to the Principle. The supervisor may exercise discretion in applying this definition on a case-by-case basis. |
| Description and findings re EC1 | <p>A definition of "Related Interests" is provided under Section 17(7) of the Banking Act (1995) and Regulation 2 of the Banking Act. A more detailed and comprehensive definition of related persons and group of inter-related persons is provided in the Guidelines on Transactions with Related Persons.</p> <p>Section 17(7) of the Banking Act (1995) lays down the broad restrictions on lending to related parties. It states that "No bank shall, directly or indirectly, except with the prior approval in writing of the Central Bank, grant or permit to be outstanding unsecured loans, overdrafts, or any other advances or credit facilities of an aggregate amount in excess of such percentage of its unimpaired capital as may be prescribed from time to time:</p> |

⁵⁹ Related parties can include, among other things, the bank's subsidiaries, affiliates, and any party (including their subsidiaries, affiliates and special purpose entities) that the bank exerts control over or that exerts control over the bank, the bank's major shareholders, Board members, senior management and key staff, their direct and related interests, and their close family members as well as corresponding persons in affiliated companies.

⁶⁰ Related party transactions include on-balance sheet and off-balance sheet credit exposures and claims, as well as, dealings such as service contracts, asset purchases and sales, construction contracts, lease agreements, derivative transactions, borrowings, and write-offs. The term transaction should be interpreted broadly to incorporate not only transactions that are entered into with related parties but also situations in which an unrelated party (with whom a bank has an existing exposure) subsequently becomes a related party.

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| | <p>(a) to its directors, or any of them, whether severally or jointly together with any other person,</p> <p>(b) to any person in which it or any one or more of its directors is interested as owner, shareholder, director, partner, manager, agent, or member, and</p> <p>(c) to any person of whom or of which it or any one or more of its directors is a guarantor: Provided that the Central Bank may determine a percentage of the unimpaired capital of a bank as being the maximum exposure to any direct or indirect interest permitted for a member or members of the bank's board of directors.”</p> <p>BoB Guidelines on transactions with related parties of a bank (2008) defines related person to include all of the following without limitations: (1) significant shareholder⁶¹; (2) member of a board of directors or audit committee; (3) principal officer and senior management officials; (4) any person who is related to such significant shareholder, member of the board of directors or audit committee, principal officer or senior management official by family or business interest; (5) subsidiary of a bank; (6) company or undertaking in which at least a 5 percent interest is held by a bank; (7) parent company of a bank; (8) company that is under common control with a bank; and (9) a company that holds at least a 5 percent interest of another company in which a bank holds at least a 5 percent interest.</p> <p>While the above definitions of a related party in laws, regulations and guidelines include several related parties that are included in the Basel Committee definition provided in the foot note to this CP, some of the parties included in the Basel Committee definition are not included in the BoB definition. These include (a) subsidiaries, affiliates and special purpose entities of any party that exerts control over the bank, (b) bank's key staff (other than directors, principal officer, and senior management), (c) direct and related interests of board members, senior management, and key staff, (d) close family members of key staff, (e) board members, senior management and key staff in affiliated companies, their direct and related interests, and their close family members.</p> <p>Laws or regulations do not explicitly allow BoB to exercise its discretion in applying this definition of related party on a case-by-case basis.</p> |
| EC2 | <p>Laws, regulations or the supervisor require that transactions with related parties are not undertaken on more favorable terms (e.g. in credit assessment, tenor, interest rates, fees, amortization schedules, requirement for collateral) than corresponding transactions with non-related counterparties.⁶²</p> |

⁶¹ A person who holds (directly or indirectly): (1) 5 percent or more of either the equity or the voting rights of a bank; or (2) Such other interest in a bank that enables a person to exercise significant influence over its strategic management or activity.

⁶² An exception may be appropriate for beneficial terms that are part of overall remuneration packages (e.g. staff receiving credit at favorable rates).

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| Description and findings re EC2 | <p>Section 3.2 of BoB guidelines on transactions with related parties of a bank requires that a bank's board of directors shall establish and ensure that senior management officials implement a written policy covering all transactions, including deposit-taking and credit-granting, between the bank and its related persons. Processes should be established in each bank to allow the board of directors to monitor compliance with policy. The board of directors shall review the policy on at least an annual basis. The policy shall, at a minimum, among others:</p> <ul style="list-style-type: none"> • prohibit a bank from providing favorable treatment to related persons and require that all such transactions be on an arm's-length basis. Prohibited favorable treatment includes, but is not limited to: <ul style="list-style-type: none"> ○ reduction of credit-granting standards, collateral requirements, collection efforts or any other policies of a bank, ○ providing preferential rates on deposits or credits, ○ covering trading losses, and ○ waiving fees. • impose strict and binding limits on exposures to related persons which do not exceed the limitations as set out in these Guidelines. (please see description and finding under EC5 of this CP for details on limits) • prohibit related persons who have an interest in an accommodation or other transaction with a bank from being involved in the administration, assessment or decision-making process relating to the transaction. • require that transactions with related persons, including all deviations from a board approved policy, be reported to the board of directors on a regular basis. <p>The Banking Act (1995) and BoB regulations are, however, silent on transactions between the bank and other related parties who are included in footnote 73 in the CP, but not explicitly included in BOB's definition of related parties (please see description and finding re EC1). Laws and regulations have not defined related party transactions and are not explicit about the other elements where there can be scope for preferential treatment or favorable consideration. These include, among others, tenor, amortization schedules, and terms of evaluation or haircuts applied to collateral.</p> <p>The Banking Law and BoB regulations are also silent on the framework for handling the conflicts of interest and arms' length elements with reference to related party transaction other than those related to credit facilities, deposit taking and trading losses. The core principle requires the prudential frameworks to be applied to the following types of transactions, namely, on-balance sheet and off-balance sheet credit exposures and claims, dealings such as service contracts, asset purchases and sales, construction contracts, lease agreements, derivative transactions, borrowings, and write-offs. The footnote 74 to the core principle clarifies that the term "transaction" should be interpreted broadly to incorporate not only transactions that are entered</p> |
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| | into with related parties but also situations in which an unrelated party (with whom a bank has an existing exposure) subsequently becomes a related party. |
| EC3 | The supervisor requires that transactions with related parties and the write-off of related-party exposures exceeding specified amounts or otherwise posing special risks are subject to prior approval by the bank's Board. The supervisor requires that Board members with conflicts of interest are excluded from the approval process of granting and managing related party transactions. |
| Description and findings re EC3 | <p>Section 3.2 of BoB guidelines on transactions with related parties of a bank require that transactions with related persons, including all deviations from a board approved policy, be reported to the board of directors on a regular basis. This, however, does not explicitly include write-off of related party exposures.</p> <p>In terms of Section 17(1) of the Banking Act (1995) and Section 2(l) and 3(c) of the BoB guidelines on large exposures, any exposure, direct or indirect, of the bank to any person or group of inter-related persons which equals or exceeds 10 percent of the unimpaired capital of the bank must be approved by the bank's Board of Directors or a duly authorized Sub-Committee thereof. Thus, effectively, all exposures to related parties which equal or exceed 10 percent of the bank's unimpaired capital must be approved by the bank's board of directors.</p> <p>The BoB guidelines on transactions with related parties of a bank prohibit related persons who have an interest in an accommodation or other transaction with a bank from being involved in the administration, assessment or decision-making process relating to the transaction.</p> <p>Laws or regulations do not explicitly require that transactions with related parties (including write-off of related party exposures) that are otherwise posing special risks be approved by the bank's board of directors. As currently formulated, write-offs of related party exposures need not be reported to the board of directors.</p> <p>BoB supervisors review board oversight and compliance with internal policies during onsite visits and tend to place reliance on the bank's compliance and internal audit functions and their finding to obtain a comprehensive view of the handling and management of related party transactions and exposures.</p> |
| EC4 | The supervisor determines that banks have policies and processes to prevent persons benefiting from the transaction and/or persons related to such a person from being part of the process of granting and managing the transaction. |
| Description and findings re EC4 | <p>Section 3.2 of BoB guidelines on transactions with related parties of a bank prohibit related persons who have an interest in an accommodation or other transaction with a bank from being involved in the administration, assessment or decision-making process relating to the transaction.</p> <p>The bank's policies and processes are generally obtained offsite, ahead of an onsite examination, by the supervisors and reviewed for adequacy and compliance with BoB's regulatory and prudential requirements. When BoB supervisors go onsite, they review the board policies and their implementation. They review the periodic reports</p> |

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| | <p>submitted to the board or board committees on the related party exposures/ transactions. They also review the internal audit reports and compliance reviews with reference to the related party exposures and transactions to verify if there were any excesses or weakness in policies and procedures.</p> <p>Law and regulations are not explicit about the framework for dealing with the conflicts of interest and arms' length elements with reference to related party transactions that are covered under the footnote 74 to this CP but not covered by BoB guidelines, and those with related parties that are covered under footnote 73 of this CP but not covered by BoB guidelines. Please also see description and finding re EC 2.</p> |
| EC5 | <p>Laws or regulations set, or the supervisor has the power to set on a general or case by case basis, limits for exposures to related parties, to deduct such exposures from capital when assessing capital adequacy, or to require collateralization of such exposures. When limits are set on aggregate exposures to related parties, those are at least as strict as those for single counterparties or groups of connected counterparties.</p> |
| Description and findings re EC5 | <p>In terms of Section 9(3) of Banking Regulations (1995), for the purposes of section 17(7) of the Banking Act (1995), the prescribed maximum unsecured amount of aggregate loans, advances and other credit facilities made to bank's own directors and their related interests without the permission of the Central Bank shall be 10 per cent of a bank's core capital, provided that:</p> <ul style="list-style-type: none"> • no bank may extend, or allow to be outstanding, to any of its directors or their related interests, facilities which in aggregate exceed the higher of P50,000 or 1 per cent of the core capital, without the approval of the majority of its entire board of directors, • no bank may extend or permit to be outstanding, to any of its own directors or their related interests, facilities which in aggregate exceed 25 per cent of the bank's unimpaired capital, even if such facilities are secured by tangible security acceptable to the Bank of Botswana. <p>In terms of Section 4 of the BoB guidelines on transactions with related parties of a bank,</p> <ul style="list-style-type: none"> • The unsecured amount of a bank's exposures to a senior management official or employee (other than a director) shall not exceed one-year's emoluments of such senior management official or employee. • The unsecured amount of a bank's exposure to any related person other than a senior management official, including a group of inter-related persons, shall not exceed 10 percent of the bank's core capital. • A bank's total exposure to any related persons, including groups of inter-related persons, shall not exceed 25 percent of the bank's unimpaired capital. |

| Related Party Exposures - Prudential limits | | | |
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| Type of exposure | % of Core capital | % of unimpaired capital | Remarks |
| Maximum unsecured amount of aggregate loans, advances and other credit facilities made to bank's own directors and their related interests without the permission of the Central Bank | 10 | | |
| Extend, or allow to be outstanding, to any of its directors or their related interests, without the approval of the majority of its entire board of directors, facilities which in aggregate exceed the higher of | BWP 50,000 or 1% | | |
| Extend or permit to be outstanding, to any of its own directors or their related interests, facilities - even if such facilities are secured by tangible security acceptable to the BoB | | 25 | |
| The unsecured amount of a bank's exposures to a senior management official or employee (other than a director) | | | One-year's emoluments |
| The unsecured amount of a bank's exposure to any related person other than a senior management official, including a group of inter-related persons | 10 | | |
| Bank's total exposure to any related persons, including groups of inter-related persons | | 25 | |
| Note 1: Core Capital is same as Tier 1 capital Note 2: Unimpaired capital is total regulatory capital. | | | |
| <p>As can be seen from the Table providing the compilation of the prudential limits for related party exposures, the prudential sub-limits are applied at the level of unsecured exposures, implying that the actual exposures (including secured exposures) can be higher. However, the prudential limit for aggregate exposure to all related parties, including secured exposures is capped at 25 percent of bank's unimpaired capital. However, as described under EC6 of CP 19, the effective prudential limit for aggregate related party exposures is around 44 percent of banks' Tier 1 capital, which is a significant deviation from Basel expectations of around 25 percent of Tier 1 capital. Further, the related party exposures reckoned for prudential purposes do not include exposures through placements and investment in debt and equity instruments.</p> <p>Section 2(i)(ii) of BoB regulation on related party exposures allow the following items of collateral to set off the exposure on related parties:</p> | | | |

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| | <ul style="list-style-type: none"> • collateral in the form of cash deposits placed with a bank that granted the accommodation, and • an eligible guarantee by any sovereign with a credit rating of AA or better, issued by a recognized external credit rating agency. <p>BoB obtains data every quarter on each bank’s exposures to related parties. Analyses of the offsite data show that the banking system’s gross exposure to related parties as at end December 2021 was 4.6 percent of total regulatory capital (unimpaired capital), while the net exposure was 1.3 percent. At the level of individual banks, the gross exposure was in the range of 0.4 to 12.3 percent, and the net exposure was in the range of zero to 8.8 percent.</p> <p>Section 17(4) of the Banking Act (1995) allows BoB to deduct exposures to large borrowers that are more than the prudential requirement, if such excess exposure was taken without BoB approval. However, a similar provision for related party exposures is not explicit.</p> |
| EC6 | <p>The supervisor determines that banks have policies and processes to identify individual exposures to and transactions with related parties as well as the total amount of exposures, and to monitor and report on them through an independent credit review or audit process. The supervisor determines that exceptions to policies, processes and limits are reported to the appropriate level of the bank’s senior management and, if necessary, to the Board, for timely action. The supervisor also determines that senior management monitors related party transactions on an ongoing basis, and that the Board also provides oversight of these transactions.</p> |
| Description and findings re EC6 | <p>Section 3.2 of BoB guidelines on transactions with related parties of a bank requires that a bank’s board of directors shall establish and ensure that senior management officials implement a written policy covering all transactions, including deposit-taking and credit-granting, between the bank and its related persons. Processes should be established in each bank to allow the board of directors to monitor compliance with policy. The board of directors shall review the policy on at least an annual basis. The policy shall, at a minimum, among others:</p> <ul style="list-style-type: none"> • prohibit a bank from providing favorable treatment to related persons and require that all such transactions be on an arm’s-length basis. Prohibited favorable treatment includes, but is not limited to: <ul style="list-style-type: none"> ○ reduction of credit-granting standards, collateral requirements, collection efforts or any other policies of a bank, ○ providing preferential rates on deposits or credits, ○ covering trading losses, and ○ waiving fees. • impose strict and binding limits on exposures to related persons which do not exceed the limitations as set out in these Guidelines. (please see description and finding under EC5 of this CP for details on limits) |

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| | <ul style="list-style-type: none"> • prohibit related persons who have an interest in an accommodation or other transaction with a bank from being involved in the administration, assessment or decision-making process relating to the transaction. • require that transactions with related persons, including all deviations from a board approved policy, be reported to the board of directors on a regular basis. <p>Section 3.4 of BoB guidelines on transactions with related parties of a bank requires that each bank must have an approved policy on extension of credit to related persons. Any director who has an interest in a transaction between a bank and its related persons shall abstain from a board’s consideration and decision-making process. The official minutes of a board of directors’ meeting shall document approval of the transaction, the terms and conditions of the transaction, and the determination by a board of directors that the transaction was at arm’s-length. A board of directors shall ensure that transactions with related persons are monitored in a manner independent of the related person.</p> <p>Section 5.1 of BoB guidelines on transactions with related parties of a bank requires that each bank shall submit to the BoB a quarterly report in the format prescribed by the BoB, showing all exposures to related persons and evidencing compliance with the Guidelines.</p> <p>Laws or BoB guidelines have not required banks to establish a framework whereby banks monitor and report on individual related party exposures and transactions with related parties through an independent credit review or audit process. During onsite examinations, supervisors review processes to determine exceptions to policies and verify if senior management monitors these transactions on an ongoing basis and if these are appropriately escalated to obtain approvals as needed.</p> <p>Based on off-site analyses of periodic statements and data received from banks on their exposures to related parties and large exposures, supervisors pursue with banks for corrective actions when they observe or become aware of a breach of prudential limits. During on-site examinations supervisors review the internal control reports, compliance reports and internal audit reports to identify the frequency of breaches, if any, and the related exception reporting and approval processes. They also review implementation of board approved policies and procedures by the senior management and the oversight exercised by the board.</p> <p>The above information system and internal control arrangements suffer from the gaps in definition of related party and the definition/ scope of related party transaction. Please see description and finding re EC1 and EC2 for details.</p> |
| EC7 | The supervisor obtains and reviews information on aggregate exposures to related parties. |
| Description and findings re EC7 | BoB obtains a quarterly report from each bank indicating the bank’s exposures (type of facility, approved limit, outstanding amount, excess over limit, loan performance classification, provisions held, collateral held and value of collateral) to each type of |

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| | <p>related party (namely, associates, subsidiaries, affiliates, joint ventures, senior officials, significant shareholders, executive directors, and non-executive directors). These are reviewed by the supervisors and a gist is included in the quarterly institutional profile prepared in the Banking Supervision Department, and where necessary used to pursue with the bank, in case of observance of any breach.</p> <p>In addition, BoB supervisors will be aware of an exposure on any related party when the exposure to that related party exceeds 10 percent of unimpaired capital, through the prudential reporting on large exposures (please see description and finding under CP19 for details on the prudential framework for large exposures).</p> <p>The offsite data and information obtained by BoB suffer from the gaps in definition of related party and the definition/ scope of related party transaction. Please see description and finding re EC1 and EC2 for details.</p> |
| Assessment of Principle 20 | Materially non-compliant |
| Comments | <p>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.</p> <p>The regulatory and supervisory framework for related party transactions will benefit from a review and revision to bring it on par with the requirements and expectations articulated in this core principle, which will bring the regime on par with the requirements of this CP and thus make the regime more comprehensive and robust. This would involve appropriate revisions to the regulatory framework, offsite reporting and analyses, and guidance provided in supervision manuals for conducting onsite supervision of transactions with related parties.</p> |
| Principle 21 | Country and transfer risks. The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate country risk ⁶³ and transfer risk ⁶⁴ in their international lending and investment activities on a timely basis. |

⁶³ Country risk is the risk of exposure to loss caused by events in a foreign country. The concept is broader than sovereign risk as all forms of lending or investment activity whether to/with individuals, corporate, banks or governments are covered.

⁶⁴ Transfer risk is the risk that a borrower will not be able to convert local currency into foreign exchange and so will be unable to make debt service payments in foreign currency. The risk normally arises from exchange restrictions imposed by the government in the borrower's country. (Reference document: *IMF paper on External Debt Statistics – Guide for compilers and users*, 2003.)

| Essential criteria | |
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| EC1 | <p>The supervisor determines that a bank's policies and processes give due regard to the identification, measurement, evaluation, monitoring, reporting and control or mitigation of country risk and transfer risk. The supervisor also determines that the processes are consistent with the risk profile, systemic importance and risk appetite of the bank, take into account market and macroeconomic conditions and provide a comprehensive bank-wide view of country and transfer risk exposure. Exposures (including, where relevant, intra-group exposures) are identified, monitored and managed on a regional and an individual country basis (in addition to the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate countermeasures.</p> |
| Description and findings re EC1 | <p>BoB guidelines on risk management (2018) defines country risk as the risk assumed by a bank when it engages in granting credit internationally, by assuming the risk associated with conditions in the home country of a foreign borrower or counterparty (country and transfer risk). Country or sovereign risk encompasses the entire spectrum of risks arising from the economic, political, and social environments of a foreign country that may have potential consequences for foreigners' debt and equity investments in that country. Transfer risk focuses more specifically on a borrower's capacity to obtain the foreign exchange necessary to service its cross-border debt and other contractual obligations.</p> <p>The guidelines require a bank that engages in granting credit outside Botswana to</p> <ul style="list-style-type: none"> • have adequate policies and procedures, approved by the bank's board of directors, that identify, measure, evaluate, monitor, report and control country and transfer risk in their international lending and investment activities. • have processes that are consistent with the risk profile, systemic importance, and risk appetite of the bank, consider market and macroeconomic conditions and provide a comprehensive bank-wide view of country and transfer-risk exposure. • identify country exposures (including intra-group exposures), monitor, and manage these on a regional and individual country basis and ensure adherence to established limits. • monitor and evaluate developments in country and transfer risk and apply appropriate counter measures. The monitoring of country and transfer risk factors should incorporate (i) the potential default of foreign private sector counterparties arising from country-specific economic factors, and (ii) the enforceability of loan agreements and timing and ability to realize collateral under national legal frameworks. • have information systems, risk-management systems and internal control systems that accurately aggregate, monitor, and report country exposures (including intra-group exposures) on a timely basis and ensure adherence to established country-exposure limits. |

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| | <ul style="list-style-type: none"> • include appropriate scenarios into its stress-testing program to reflect country and transfer-risk analysis for risk-management purposes. Such stress tests should be performed to identify potential vulnerability to exceptional but plausible events on a bank's exposure to country and transfer risks and assess the bank's ability to withstand such changes. The results of stress testing should alert bank management to any adverse unexpected outcomes and provide an indication of how much capital might be needed to absorb losses should large shocks occur. • submit sufficient information to the BoB for its review, on a timely basis, on country and transfer risk. <p>BoB's supervisory approach and banks' understanding seem to be oriented towards the direct or immediate risk perspective (for example, the country in which the borrower or the bank branch is located). However, for achieving effective management of country and transfer risks banks must identify and measure these risks from both immediate risk perspective and ultimate risk perspective (for example, the country, which is the source of repayment of banks' dues, including location of collateral where relevant). To achieve this, regulation and supervision need to adopt a comprehensive approach.</p> <p>BoB has yet to establish offsite reporting requirements to obtain details of bank's exposures, though the risk management guidelines require banks to submit "sufficient information".</p> <p>BoB's risk-based supervision framework provides high level guidance for the supervision of risks in general and some specific risks, except the country and transfer risks.</p> <p>Banks do not include country and transfer risks in their Pillar 2 – ICAAP assessments.</p> <p>In this background, supervisors are not alert to banks' exposures to country and transfer risks, and the risk management and governance frameworks established by banks.</p> <p>Anecdotal evidence suggests that banks have limited exposure to country and transfer risks through their loan portfolio, but this does not include lending to exporters, where the ultimate risk exposure is to another country. Banks have material exposures through their investments, placements and nostro balances, though these may be limited to jurisdictions that have a good rating. In the absence of offsite reporting on these exposures, BoB is unable to have a comprehensive view on banks' country and transfer risk exposures.</p> |
| <p>EC2</p> | <p>The supervisor determines that banks' strategies, policies and processes for the management of country and transfer risks have been approved by the banks' Boards and that the Boards oversee management in a way that ensures that these policies and processes are implemented effectively and fully integrated into the banks' overall risk management process.</p> |

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| Description and findings re EC2 | Please see the description under EC1 on the regulatory and supervisory approach towards the management of country and transfer risks by the banks in Botswana. Due to the gaps in supervision of country and transfer risks, the achievement of the requirements in this EC is not explicitly or documented. |
| EC3 | The supervisor determines that banks have information systems, risk management systems and internal control systems that accurately aggregate, monitor and report country exposures on a timely basis; and ensure adherence to established country exposure limits. |
| Description and findings re EC3 | <p>The BoB is yet to issue specific regulations or establish specific requirements for the measurement or grading of exposure to country and transfer risks and for the periodical reporting of these exposures to the BoB.</p> <p>During on-site inspections, the BoB assesses and reviews the information system risk, the internal control system and risk management systems for credit risks. However, the supervisory focus on the assessment of the adequacy and appropriateness of these systems for the management of country and transfer risks is less evident.</p> |
| EC4 | <p>There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices that are all acceptable as long as they lead to risk-based results. These include:</p> <ul style="list-style-type: none"> (a) The supervisor (or some other official authority) decides on appropriate minimum provisioning by regularly setting fixed percentages for exposures to each country taking into account prevailing conditions. The supervisor reviews minimum provisioning levels where appropriate. (b) The supervisor (or some other official authority) regularly sets percentage ranges for each country, taking into account prevailing conditions and the banks may decide, within these ranges, which provisioning to apply for the individual exposures. The supervisor reviews percentage ranges for provisioning purposes where appropriate. (c) The bank itself (or some other body such as the national bankers' association) sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The adequacy of the provisioning will then be judged by the external auditor and/or by the supervisor. |
| Description and findings re EC4 | Please see description under EC1 and EC3. There are no explicit requirements for establishing provisions for country and transfer risk exposures. As mentioned in the description and finding under CP 18, BoB has not established prudential provisioning requirements for credit risk exposures. BoB has not established provisioning requirements for country and transfer risks as well. |
| EC5 | The supervisor requires banks to include appropriate scenarios into their stress testing programs to reflect country and transfer risk analysis for risk management purposes. |
| Description and findings re EC5 | BoB's regulations on risk management (2018) have required banks to include appropriate scenarios into their stress-testing program to reflect country and transfer-risk analysis for risk-management purposes. Such stress tests should be performed to |

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| | <p>identify potential vulnerability to exceptional but plausible events on a bank's exposure to country and transfer risks and assess the bank's ability to withstand such changes. The results of stress testing should alert bank management to any adverse unexpected outcomes and provide an indication of how much capital might be needed to absorb losses should large shocks occur.</p> <p>Please also see description and finding re EC1 where it is observed that banks do not include their country and transfer risk exposures in their ICAAP assessments. They also do not share separately with the supervisors the results of the stress tests that they may be conducting with reference to country and transfer risks. In the absence of specific and explicit guidance, supervisors do not review banks' stress testing frameworks from a country and transfer risk perspective.</p> |
| EC6 | The supervisor regularly obtains and reviews sufficient information on a timely basis on the country risk and transfer risk of banks. The supervisor also has the power to obtain additional information, as needed (e.g. in crisis situations). |
| Description and findings re EC6 | BoB is yet to establish periodic reporting requirement for country and transfer risks. As the supervisor does not obtain data and information on banks' exposures to country and transfer risks on a regular basis, they are constrained from effectively monitoring bank exposures to these risks or their management. |
| Assessment of Principle 21 | Materially non-compliant |
| Comments | <p>The supervisory approach and banks' understanding seem to be oriented towards the direct or immediate risk perspective of country and transfer risks. However, for achieving effective management of country and transfer risks banks must identify and measure these risks from both immediate risk and ultimate risk perspectives. To achieve this, regulation and supervision need to adopt a comprehensive approach.</p> <p>Supervision of banks' management of country and transfer risks is not explicit in the current onsite and offsite frameworks. BoB is yet to issue specific guidance or establish specific requirements for the measurement and grading of exposure to country and transfer risks and for the periodical reporting of these exposures and banks' stress test results to the BoB. There are no explicit requirements for establishing provisions for country and transfer risk exposures.</p> <p>In this background, BoB must (a) issue explicit regulations and guidance on grading these risk exposures and provisioning therefor as a distinct risk from counterparty risk, (b) require explicit adoption of the 'ultimate risk' approach to these risks, (c) introduce appropriate prudential reporting requirements to monitor the banks' exposure to these risks and the stress testing results, (d) introduce appropriate corresponding improvements to the supervisory manual, (e) amend the supervisory methodology to include an explicit and dedicated component on management of country and transfer risks by banks, (f) as required, supplement these changes with appropriate training and capacity building to enhance the supervisory skills relevant for regulating and supervising management of country and transfer risks by banks.</p> |

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| Principle 22 | Market risk. The supervisor determines that banks have an adequate market risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions and the risk of a significant deterioration in market liquidity. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate market risks on a timely basis. |
| Essential criteria | |
| EC1 | Laws, regulations or the supervisor require banks to have appropriate market risk management processes that provide a comprehensive bank-wide view of market risk exposure. The supervisor determines that these processes are consistent with the risk appetite, risk profile, systemic importance and capital strength of the bank; take into account market and macroeconomic conditions and the risk of a significant deterioration in market liquidity; and clearly articulate the roles and responsibilities for identification, measuring, monitoring and control of market risk. |
| Description and findings re EC1 | <p>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). Banks maintain capital for these exposures as per the Basel II norms. The risk weighted assets (RWA) for market risk for the banking system was 1.04 percent of total RWA as at end December 2021, which reduced to 1.02 percent as at end June 2022.</p> <p>At the level of individual banks, the proportion of RWA for market risk in total RWA was in the range of 0.04 percent to 4.5 percent as at end December 2021 (all except two banks were below 1 percent), which moved to 0.01 percent to 2.5 percent as at end-June 2022 (all except two banks were below 0.5 percent). At end-June 2022, foreign currency risk and IRR-TB had almost equal share in the capital maintained for market risk.</p> <p>Banks did not have any commodity or equity exposures as at end December 2021. Supervisors confirm that banks do not engage in trading in commodities or equity.</p> <p>In the light of the above, the assessors do not consider market risks as a material risk for the banks and the banking system in Botswana.</p> <p>BoB guidelines on (i) risk management and (ii) revised international convergence of capital measurement and capital standards for Botswana (Basel II) have established the regulatory framework around market risk management and capital adequacy for market risk exposures respectively.</p> <p>BoB guidelines on risk management (2018) establish the supervisory expectations and requirements for overall risk management which also apply to the management of market risks by banks. (Please see description under EC1, CP 15 for details)</p> <p>The BoB guidelines on risk management (2018) require banks to, among others, comply with the following regarding market risk management:</p> <p><u>Market risk identification</u></p> <p>A bank should</p> <ul style="list-style-type: none"> • establish a sound and comprehensive process for the identification of |

market risk, which should, among other things, include the following (i) a framework to identify market risk, (ii) an appropriately detailed structure of risk limits, guidelines and other parameters used to govern market risk taking, (iii) an appropriate management information system (MIS) for measuring, monitoring, and controlling market risk, including transactions between and with related parties, and accounting policies on the treatment of market risk.

- incorporate a market risk management process into its overall risk management system, to enable it to understand and manage its consolidated risk exposure more effectively. Where a bank is part of a financial services group, the risk management process should also be integrated with that of the group, where practical.
- The market-risk management system should be commensurate with the scope, size and complexity of a bank's trading and other financial activities and the market risks assumed. It should also enable the various market risk exposures to be accurately and adequately measured, monitored, and controlled.

Market risk measurement

A bank's risk management system should be able to quantify risk exposures and monitor changes in market risk factors (e.g., changes in interest rates, foreign exchange rates and equity prices) and other market conditions daily. The risk management system should, wherever feasible, be able to assess the probability of future losses.

A bank must perform stress tests to identify potential vulnerability to exceptional but plausible events or changes in economic conditions on a bank's market risk exposures and assess its ability to withstand such changes. Stress-testing should alert bank management to any adverse unexpected outcomes related to market risk and provide an indication of how much capital might be needed to absorb losses, should large shocks occur.

A bank should ensure that its treasury and financial derivative valuation processes are robust and independent of its trading function. Models and supporting statistical analyses used in valuations and stress tests should be appropriate, consistently applied and have reasonable assumptions. These should be validated before deployment. Staff involved in the validation process should be adequately qualified and independent of the trading and model development functions. Models and analyses should be periodically reviewed to ascertain the position data, the accuracy of volatility, valuation, and risk factor calculations, as well as the reasonableness of the correlation and stress test assumptions. More frequent reviews may be necessary if there are changes in models or in the assumptions resulting from developments in market conditions.

The market risk management process should, where appropriate, include regular scenario analysis and stress tests. Scenario analysis and stress tests should be both

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| | <p>quantitative and qualitative. Scenario analysis and stress testing should, as far as possible, be conducted on a bank-wide basis, considering the effects of unusual changes in market and non-market risk factors. Such factors include prices, volatilities, market liquidity, historical correlations and assumptions in stressed market conditions, the bank's vulnerability to worst case scenarios or the default of a large counterparty and maximum cash inflow and outflow assumptions.</p> <p><u>Market risk monitoring and control</u></p> <p>A bank should have a business unit dedicated to the management of market risks. Typically, monitoring of market risk is also the responsibility of the asset-liability management committee (ALCO). The ALCO should meet on a frequency that is commensurate with the bank's business activities. The terms of reference, composition, quorum, and frequency of meetings should also be formalized, and clearly documented.</p> <p>The board and senior management should regularly review the results of scenario analyses and stress testing for market risk, including the major assumptions that underpin them.</p> <p><u>Market Risk Reporting</u></p> <p>Reports detailing the market risk exposure of the bank should be produced using a reliable management information system and reviewed by the board on a regular basis. These reports should, at a minimum, include the following:</p> <ul style="list-style-type: none"> • summaries of the bank's aggregate market risk exposures by product, market, currency, and duration (e.g., interest rate and foreign exchange exposures and/or any other types of market risk the bank may be exposed to); results of stress tests for market risk, including those assessing breakdowns in key assumptions and parameters, and • summaries of the findings of reviews of market risk policies, procedures, and the adequacy of the market-risk measurement systems, including any findings of internal and external auditors or any other independent reviewer, reports demonstrating compliance with internal policies and prudential limits on market risk, including exceptions. <p>Please see description and finding under EC2 for details of BoB's supervision of market risk management in banks</p> |
| EC2 | <p>The supervisor determines that banks' strategies, policies and processes for the management of market risk have been approved by the banks' Boards and that the Boards oversee management in a way that ensures that these policies and processes are implemented effectively and fully integrated into the banks' overall risk management process.</p> |
| Description and findings re EC2 | <p>As per BoB's risk-based supervision framework, the following are some of the key factors the BoB may consider when undertaking onsite assessment of adequacy of banks' foreign currency risk management systems and processes:</p> |

- Implementation of board approved comprehensive foreign exchange risk management policies, procedures, and guidelines.
- Existence of board approved internal foreign exchange exposure limits for dealers regarding various currencies and counterparties.
- Implementation of clear segregation of duties between the front, middle and back offices in the foreign exchange department.
- Existence of a monitoring mechanism to ascertain the effect of foreign exchange fluctuations on the assets and liabilities of a supervised financial institution.
- Timely reconciliation of nostro accounts to minimize long outstanding items.
- Ascertain that correspondent accounts are held with rated banks in accordance with the prudential guidelines governing foreign exchange business.
- Ascertain that periodic stress tests are conducted to assess the impact of fluctuations of foreign exchange rates on the supervised financial institution's earnings and capital.

As per BoB's risk-based supervision framework, the following are some of the key factors the BoB may consider when undertaking onsite assessment of adequacy of banks' interest rate risk management systems and processes:

- Implementation of board approved comprehensive interest rate risk management policy and procedural guidelines for managing interest rate risk.
- Board and senior management instituted Asset and Liability Management Committee (ALCO) to provide oversight upon interest rate risk management and to monitor the effects of interest rate movements on the supervised financial institution's assets and liabilities.
- Implementation of periodic stress tests to establish the impact of interest rate fluctuations on the supervised financial institution's earnings and capital and reliance on interest rate sensitive assets to generate income in line with its size and risk profile.

BoB supervisors review, besides other areas, banks' risk policies and strategies, including for market risks, during the annual bilateral meetings with each bank's external auditors. During the annual bilateral meetings with banks and the annual trilateral meetings with banks and their external auditors, BoB discusses key risk management strategies and policies, including market risks, and reviews bank compliance with the onsite examination finding pertaining to market risks.

BoB has required banks to submit their ICAAP reports annually, which includes details of bank's market risk exposures and its market risk management strategies. Though BoB receives the ICAAP documents from banks, supervisors have not made much use

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| | <p>of these documents for want of guidance on how these are to be assessed and how such assessments can feed into supervision on an ongoing basis.</p> <p>A review of the onsite examination reports for four banks between 2015 and 2021 showed that market risks were included within the scope of examination in two banks. In both banks' onsite examination reports, supervisors presented an assessment of the significance of market risk exposures of the bank, reviewed the segregation of duties with reference to bank's trading activity (separation of dealing, back-office and mid-office functions) and the risk management systems and oversight.</p> <p>Supervisors assess banks' market risk management within "M" (Market sensitivity) of the CAMEL framework, "interest rate risk" and "foreign exchange risk" components of the risk-based assessment that supplements the CAMEL framework. In practice, under these assessments, supervisors focus on interest rate risk across the bank/ balance sheet and not on interest rate risk in the trading book. While supervisors are familiar with the supervision of foreign exchange risk management, they seemed less familiar with the management and supervision of interest rate risk in the trading book. Supervisors tend to place reliance on the bank's compliance and internal audit finding on market risk management.</p> <p>The knowledge and skill gaps among supervisors regarding derivatives and the management of risks arising from derivative activities were evident. Supervision of interest rate risk in trading book and derivative activities are relevant areas where the supervisory methodologies, tools and guidance need to be improved to make supervision of market risks effective.</p> <p>Offsite reports on market risk exposures are limited to those obtained for capital adequacy, which are at aggregated levels and not adequate to obtain a comprehensive view on banks' activities that expose them to market risks.</p> |
| EC3 | <p>The supervisor determines that the bank's policies and processes establish an appropriate and properly controlled market risk environment including:</p> <ul style="list-style-type: none"> (a) effective information systems for accurate and timely identification, aggregation, monitoring and reporting of market risk exposure to the bank's Board and senior management; (b) appropriate market risk limits consistent with the bank's risk appetite, risk profile and capital strength, and with the management's ability to manage market risk and which are understood by, and regularly communicated to, relevant staff; (c) exception tracking and reporting processes that ensure prompt action at the appropriate level of the bank's senior management or Board, where necessary; (d) effective controls around the use of models to identify and measure market risk, and set limits; and (e) sound policies and processes for allocation of exposures to the trading book. |

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| Description and findings re EC3 | <p>Please see description and finding under EC1 and EC2 for details of the regulatory and supervisory frameworks for the management of market risks by banks operating in Botswana. These cover the items at sub items (a) to (c) in the EC.</p> <p>BoB guidelines on the revised international convergence of capital measurement and capital standards for Botswana (Basel II) (2015) defines that trading book consists of positions in financial instruments and commodities held either with trading intent or to hedge other elements of the trading book. Positions held with trading intent are those held intentionally for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits, and may include proprietary positions, positions arising from client servicing and market making. All other on- and off-balance sheet positions that are not defined as trading book positions should be classified as exposures in the banking book. Generally, all derivative instruments should be classified in the trading book, except for those which have hedged a banking book position. However, certain credit derivative instruments and structured investments may be classified as banking book positions, particularly long-term investments which are illiquid and/or have significant credit risk elements.</p> <p>The above guidelines require that a bank must have a trading book policy statement with clearly defined policies and procedures for determining which exposures to include in, and to exclude from, the trading book, for purposes of calculating regulatory capital. The Board and senior management of a bank should ensure compliance with the trading book criteria set forth below, considering a bank's risk management capabilities and practices. In addition, compliance with these policies and procedures must be fully documented and subjected to periodic internal audit. The bank's policy statement and material changes to it would be subject to the BoB's review. These policies and procedures should, at a minimum, address the following general considerations:</p> <ul style="list-style-type: none"> • The activities which a bank considers to be trading, and what constitutes part of the trading book, for regulatory capital purposes, • The extent to which an exposure can be marked-to-market daily by reference to an active, liquid two-way market, • For exposures that are marked-to-model, the extent to which a bank can: <ul style="list-style-type: none"> ○ identify the material risks of the exposure, ○ hedge the material risks of the exposure and the extent to which hedging instruments would have an active and liquid two-way market, and ○ derive reliable estimates for the key assumptions and parameters used in the model. • The extent to which a bank can and is required to generate valuations for exposures that can be validated externally in a consistent manner, |
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| | <ul style="list-style-type: none"> • The extent to which legal restrictions or other operational requirements would impede a bank’s ability to effect an immediate liquidation of the exposure, • The extent to which a bank is required to, and can actively manage the risk exposure within its trading operations, and • The extent to which a bank may transfer risk or exposures between the banking and the trading books, and the criteria for such transfers. <p>The guidelines also clarify that the above considerations should not be treated as an exhaustive and rigid set of tests that a product or group of related products must pass for eligibility in the trading book. Rather, the list should serve as minimum or most fundamental areas for considerations for overall management of a bank’s trading book. It should also be supported by detailed policies and procedures.</p> <p>Compliance with the above primarily rests on the bank managements, their verification is the responsibility of each bank’s compliance and internal audit functions. Supervisors primarily rely on these functions.</p> <p>While the regulatory requirements for classification and movement of trading book exposures are broadly in place, supervisors do not adequately review the related policies and the actual classification and movement. Instead, they place reliance on the banks’ internal control, compliance, and internal audit functions.</p> <p>Please also see description under EC2 of this CP with regards to supervision of interest rate risk in trading book and derivative activities of banks and EC6 of CP 15 with regards to the gaps in supervision of model risk.</p> |
| EC4 | <p>The supervisor determines that there are systems and controls to ensure that banks’ marked-to-market positions are revalued frequently. The supervisor also determines that all transactions are captured on a timely basis and that the valuation process uses consistent and prudent practices, and reliable market data verified by a function independent of the relevant risk-taking business units (or, in the absence of market prices, internal or industry-accepted models). To the extent that the bank relies on modeling for the purposes of valuation, the bank is required to ensure that the model is validated by a function independent of the relevant risk-taking businesses units. The supervisor requires banks to establish and maintain policies and processes for considering valuation adjustments for positions that otherwise cannot be prudently valued, including concentrated, less liquid, and stale positions.</p> |
| Description and findings re EC4 | <p>BoB guidelines on the revised international convergence of capital measurement and capital standards for Botswana (Basel II) (2015) require that each bank must establish and maintain procedures for considering valuation adjustments, which should be deducted in the calculation of CET1 capital. The following valuation adjustments shall be formally considered where relevant: unearned credit spreads, close-out costs, operational risks, early termination, investing and funding costs, future administrative costs and, if appropriate, model risk.</p> <p>In addition, a bank must consider the need for establishing an appropriate</p> |

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| | <p>adjustment for less liquid positions. The appropriateness of the adjustments must be subjected to an ongoing review. Reduced liquidity could arise from structural and/or market events. In addition, close-out prices for concentrated positions and/or stale positions are more likely to be adverse. A bank must, at the minimum, consider several factors when determining whether a valuation adjustment is necessary for less liquid items. These factors include the amount of time it would take to hedge out the risks within the position, the average volatility of bid/offer spreads, the availability of market quotes (number and identity of market makers), and the average and volatility of trading volumes.</p> <p>BoB guidelines on risk management and capital adequacy require banks to mark-to-market their market risk exposures on a daily basis, and where market prices may not be readily available, they may mark-to-model, subject to requirements established in regulations. In the absence of a deep and liquid market for fixed income securities, banks tend to mark-to-model their interest rate risk positions in the trading book. In the absence of adequate guidance, tools and skills, supervisors accept the valuations produced by the internal models and do not review the related assumptions and internal processes. (please see description and finding under EC2 and EC3 of this CP, and EC 6 of CP 15 with regards to supervision of model risks).</p> |
| EC5 | The supervisor determines that banks hold appropriate levels of capital against unexpected losses and make appropriate valuation adjustments for uncertainties in determining the fair value of assets and liabilities. |
| Description and findings re EC5 | <p>Banks in Botswana maintain capital for market risk exposures as per Basel II norms, in compliance with BoB guidelines on the revised international convergence of capital measurement and capital standards for Botswana (Basel II) (2015). Banks maintain capital on the larger of the net aggregate open short position and the net aggregate open long position, by assigning such open position a 100 percent risk weight. Bank's follow the standard maturity method for maintaining capital for IRR-TB positions. Please see description under EC4 that flags the gaps in supervision and supervisory skills as relevant for valuation of trading book positions in interest rate instruments.</p> <p>BoB directive on foreign exchange exposure imposes restriction on net open position to 5 percent and 15 percent of a banks' unimpaired capital for minor and major trading currencies, respectively. The overall net open position is limited to 30 percent of a bank's unimpaired capital</p> |
| EC6 | The supervisor requires banks to include market risk exposure into their stress testing programs for risk management purposes. |
| Description and findings re EC6 | <p>BoB guidelines on risk management (2018) require banks to, among others,</p> <ul style="list-style-type: none"> • A bank must perform stress tests to identify potential vulnerability to exceptional but plausible events or changes in economic conditions on a bank's market risk exposures and assess its ability to withstand such changes. Stress-testing should alert bank management to any adverse unexpected outcomes related to market risk and provide an indication of |

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| | <p>how much capital might be needed to absorb losses, should large shocks occur.</p> <ul style="list-style-type: none"> • The market risk management process should, where appropriate, include regular scenario analysis and stress tests. Scenario analysis and stress tests should be both quantitative and qualitative. • Scenario analysis and stress testing should, as far as possible, be conducted on a bank-wide basis, considering the effects of unusual changes in market and non-market risk factors. Such factors include prices, volatilities, market liquidity, historical correlations and assumptions in stressed market conditions, the bank's vulnerability to worst case scenarios or the default of a large counterparty and maximum cash inflow and outflow assumptions. <p>During on-site examination, supervisors verify if banks conduct market risk stress tests under various scenarios as required in the guidelines. Supervisors review offsite the market stress test scenarios and results shared by banks in their annual ICAAP documents to assess the banks' resilience to stressed market situations. Where required, BoB discusses the issues related to bank's stress testing results during the bilateral meetings with banks, bilateral meetings with their external auditors and the trilateral meetings with banks and their external auditors. In the absence of adequate guidance to supervisors on stress testing and financial models, and due to lack of hands-on experience in reviewing and assessing stress testing models and assumptions, supervisors tend to accept banks' stress testing results without a challenge.</p> |
| Assessment of Principle 22 | Largely Compliant |
| Comments | <p>BoB's risk management and capital adequacy guidelines establish the broad requirements relating to capital adequacy and management of market risks. BoB guidelines require banks to mark-to-market their market risk exposures daily, and where market prices may not be readily available, they may mark-to-model, subject to requirements established in regulations.</p> <p>While the regulatory requirements for management of market risks are broadly in place, there are significant gaps in supervision. The main gaps include the following:</p> <ul style="list-style-type: none"> (i) Inadequate supervisory review of the related policies, classification of trading exposures, and transfers into and out of trading book. Instead, supervisors tend to place reliance on the banks' internal control, compliance, and internal audit functions. (ii) In the absence of a deep and liquid market for fixed income securities, banks tend to mark-to-model their interest rate risk positions in the trading book. In the absence of adequate guidance, tools and skills, supervisors accept the valuations produced by the internal models and do not review the related assumptions and internal processes. |

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| | <p>(iii) Due to knowledge and skills gaps, supervisors were shy of engaging with banks on their derivative activities and the management of risks arising from such activities.</p> <p>(iv) In the absence of adequate guidance to supervisors on stress testing and financial models, and due to lack of hands-on experience in reviewing and assessing stress testing models and assumptions, supervisors tend to accept banks' stress testing results without a challenge.</p> <p>(v) Offsite reports on market risk exposures are limited to those obtained for capital adequacy, which are at aggregated levels and not adequate to obtain a comprehensive view on banks' activities that expose them to market risks.</p> <p>Supervision of market risk management in banks must be improved significantly to make it effective. Supervisory tools and guidance to supervisors are required to improve supervisory skills and capacities for conducting effective supervision of market risk management in banks. The main areas where these are needed include assessment of banks' market risk management strategies and policies, classification of exposures in the trading book, monitoring the boundaries of trading book, reclassification of exposures between the banking book and trading book, measurement of market risk exposures, valuation of illiquid positions, valuation adjustments, marking to model, understanding financial derivatives and their inherent risks, understanding model risks and their management, and understanding stress testing of market risks and ability to challenge assumptions and scenarios. The offsite reports should be modified to obtain more granular details, including, where relevant details of turnover.</p> <p>In the light of the above significant gaps in supervision of market risk management, a materially non-compliant grade may seem appropriate. However, in the light of the non-materiality of market risk exposures of banks operating in Botswana (as brought out in description and findings under EC 1), this core principle is graded as largely compliant.</p> |
| <p>Principle 23</p> | <p>Interest rate risk in the banking book. The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate interest rate risk⁶⁵ in the banking book on a timely basis. These systems take into account the bank's risk appetite, risk profile and market and macroeconomic conditions.</p> |
| <p>Essential criteria</p> | |
| <p>EC1</p> | <p>Laws, regulations or the supervisor require banks to have an appropriate interest rate risk strategy and interest rate risk management framework that provides a comprehensive bank-wide view of interest rate risk. This includes policies and processes to identify, measure, evaluate, monitor, report and control or mitigate material sources of interest rate risk. The supervisor determines that the bank's</p> |

⁶⁵ Wherever "interest rate risk" is used in this Principle the term refers to interest rate risk in the banking book. Interest rate risk in the trading book is covered under Principle 22.

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| | <p>strategy, policies and processes are consistent with the risk appetite, risk profile and systemic importance of the bank, take into account market and macroeconomic conditions, and are regularly reviewed and appropriately adjusted, where necessary, with the bank's changing risk profile and market developments.</p> |
| <p>Description and findings re EC1</p> | <p>BoB guidelines on risk management (2018) establish the supervisory expectations and requirements for overall risk management which also apply to the management of interest rate risk in the banking book. These include the following:</p> <ul style="list-style-type: none"> • The board should approve the overall business strategies and significant policies of the bank, including those related to taking and managing risks, and should also ensure that management have skills, expertise, and competence commensurate with the nature, scale, and complexity of the bank's business. • Each bank's board must provide effective oversight on management's actions to ensure that the actions of the latter are consistent with the risk strategy, risk appetite framework and policies of the bank. • Board members should continually enhance their skills so that they are able to understand the types of risks to which banks are exposed. The board should demand to be furnished with periodic reports by a bank, for it to identify, in a timely manner, the nature and significance of the risks a bank is exposed to. The board should use this information to provide clear guidance regarding the level of exposures suitable for a bank and have the responsibility to ensure that management implements the procedures and controls necessary to comply with adopted policies. • Management is responsible for ensuring that the day-to-day activities of a bank are consistent with the bank's risk strategy. • The board and management of a bank should tailor the risk-management policies and procedures to the types of risks that arise from the activities of the bank. The bank's policies and procedures should provide detailed guidance for the day-to-day implementation of broad business strategies and, generally, include limits designed to shield the bank from excessive and imprudent risks. Senior management is expected to modify these tools when necessary to respond to changes in a bank's activities or business conditions. • Risk-management strategic policies, processes and limits are properly documented, regularly reviewed and appropriately adjusted to reflect changing risk appetites, risk profile, market and macroeconomic conditions; and communicated within the bank. • Every bank should ensure that: <ul style="list-style-type: none"> ○ policies, procedures, and limits provide for the adequate identification, measurement, monitoring, and control of the risks posed by a bank's significant activities, |

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| | <ul style="list-style-type: none"> ○ established limits are understood by, and regularly communicated to, relevant staff, ○ policies clearly delineate accountability and lines of authority across the bank's activities, and ○ policies provide for the review of activities which are new to the bank to ensure that the infrastructure necessary to identify, measure, monitor and control risks associated with the activity are in place before the activity is adopted. <p>In accordance with the BoB's risk-based supervision framework, the following are some of the key factors the supervisors consider when undertaking onsite assessment of adequacy of banks' interest rate risk management systems and processes:</p> <ul style="list-style-type: none"> ● Implementation of board approved comprehensive interest rate risk management policy and procedural guidelines for managing interest rate risk. ● Board and senior management instituted Asset and Liability Management Committee (ALCO) to provide oversight upon interest rate risk management and to monitor the effects of interest rate movements on the supervised financial institution's assets and liabilities. ● Implementation of periodic stress tests to establish the impact of interest rate fluctuations on the supervised financial institution's earnings and capital and reliance on interest rate sensitive assets to generate income in line with its size and risk profile. ● Ascertain whether the structure and maturity profile of the supervised financial institution's rate sensitive assets and liabilities and the resultant rate sensitivity gap are reasonable given the supervised financial institution's risk profile. <p>BoB supervisors review, besides other areas, banks' risk policies and strategies, including for IRR, during the annual bilateral meetings with each bank's external auditors. During the annual bilateral meetings with banks and the annual trilateral meetings with banks and their external auditors, BoB discusses key risk management strategies and policies, including IRR, and reviews bank compliance with the onsite examination finding pertaining to IRR.</p> <p>BoB has required banks to submit their ICAAP reports annually, which includes details of the significance of IRRBB for the bank and its risk management strategies.</p> <p>Through the above supervisory avenues, BoB supervisors try and understand the significance of IRR for the bank, confirm availability of the related risk management strategies and policies, and their consistency with the bank's risk appetite, risk profile, and systemic importance, and adequacy and effectiveness of board and senior management oversight.</p> |
| EC2 | The supervisor determines that a bank's strategy, policies, and processes for the management of interest rate risk have been approved, and are regularly reviewed, by |

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| | the bank's Board. The supervisor also determines that senior management ensures that the strategy, policies, and processes are developed and implemented effectively. |
| Description and findings re EC2 | While onsite, supervisors confirm that the IRR strategy, policies, and processes are developed by the management, approved and regularly reviewed by the bank's board, and are implemented. Supervisors review the agenda notes on IRR prepared for Asset and Liability Management Committee (ALCO), the risk management committee and the board, and the minutes of these meetings to assess the effectiveness of implementation. Please see description and finding under EC 1 of this CP for details. |
| EC3 | The supervisor determines that banks' policies and processes establish an appropriate and properly controlled interest rate risk environment including: <ul style="list-style-type: none"> (a) comprehensive and appropriate interest rate risk measurement systems; (b) regular review, and independent (internal or external) validation, of any models used by the functions tasked with managing interest rate risk (including review of key model assumptions); (c) appropriate limits, approved by the banks' Boards and senior management, that reflect the banks' risk appetite, risk profile and capital strength, and are understood by, and regularly communicated to, relevant staff; (d) effective exception tracking and reporting processes which ensure prompt action at the appropriate level of the banks' senior management or Boards where necessary; and (e) effective information systems for accurate and timely identification, aggregation, monitoring and reporting of interest rate risk exposure to the banks' Boards and senior management. |
| Description and findings re EC3 | BoB guidelines on risk management (2018) establish the supervisory expectations and requirements for the management and supervision of interest rate risk. These include the following: Measurement <ul style="list-style-type: none"> • Each bank should have interest rate-risk measurement systems that capture all sources of interest rate risk and that assess the effect of interest rate changes in ways that are consistent with the scope of its activities. • Banks should ensure that all material positions stemming from both on, and off-balance sheet positions are incorporated into the measurement system on a timely basis. • Interest rate-risk measurement systems should assess the effects of interest rate changes on both earnings and economic value. • The methodology for measuring interest rate risk should be based on adequate information on current positions, market conditions and |

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| | <p>instrument characteristics.</p> <ul style="list-style-type: none"> • A bank should have at least two techniques for measuring interest rate risk. The techniques that can be used to measure interest rate risk include gap analysis (repricing schedule), duration, simulation and value at risk (VaR). <p>Monitoring and Control</p> <ul style="list-style-type: none"> • Interest rate risk management policies and procedures should (i) be clearly defined and consistent with the nature and complexity of a bank's activities, (ii) specify limits for all types of interest rate sensitive instruments, portfolios, and activities, (iii) delineate lines of responsibility and accountability over interest rate-risk management decisions, (iv) clearly define authorized instruments, either specifically or by their characteristics, hedging strategies and position-taking opportunities, (v) delineate a clear set of procedures for acquiring specific instruments, managing portfolios and controlling a bank's aggregate interest rate risk exposure; and (v) clearly define approvals necessary for exceptions to policies, limits and authorizations. • At a minimum, a bank should have limits in the following categories (i) change in the net portfolio value, (ii) value at risk (VaR), (iii) factor sensitivity, (iv) interest rate sensitivity gap, (v) impact on earnings; and (vi) impact on capital. • Interest rate-risk limits should be linked to specific scenarios of movements in market interest rates. Specified scenarios should take account of the full range of possible sources of interest rate risk to a bank. <p>Reporting</p> <ul style="list-style-type: none"> • The board should review interest rate risk reports on a regular basis to assess whether such risk exposures are detailed and, at a minimum, include (i) summaries of a bank's aggregate exposures, (ii) bank's compliance with policies and limits, (iii) key assumptions, such as non-maturity deposit behavior and prepayment information, (iv) results of stress tests, including those assessing breakdowns in key assumptions and parameters, (v) adequacy of internal controls, and (vi) summaries of the findings of reviews of interest rate-risk policies, procedures and the adequacy of the interest rate-risk measurement systems, including any findings of internal and external auditors. • Reports produced by the bank and external auditors or other outside parties on interest rate risk exposures, should be made available to the BoB. |
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| | <p>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.</p> <p>Supervisors receive bank-wise data on distribution of rate sensitive assets (RSA) and rate sensitive liabilities (RSL) by their repricing maturity, but do not have the supervisory tools to analyze the available data to determine the extent of individual bank's exposure to IRRBB. This also 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. Please also see description under EC6 of CP 15 on the gaps in supervision of model risk.</p> <p>A quick assessment by the assessors, based on certain assumptions, suggests that banks in Botswana have significant exposure to IRRBB. The impact of a 200-basis point shock on the interest rates is likely to be more than 100 percent of banks' CET 1 capital at the level of the banking system. The minimum impact for a bank is 34 percent of its CET1 capital. The above assessment is subject to the caveat that supervisors suspect this could be on account of incorrect data reported by banks.</p> <p>Supervisors are able to review the availability and adequacy of qualitative elements through the offsite and onsite supervision mechanisms described under EC1 of this CP. For example, during annual trilateral meetings between a bank, its external auditors and BoB, interest rate risk management is a standing agenda item. The discussion covers the interest rate gap, the drivers of the interest rate risk, the magnitude of the risk considering the structure of the balance sheet and the measures in place to mitigate the risk.</p> |
| EC4 | The supervisor requires banks to include appropriate scenarios into their stress testing programs to measure their vulnerability to loss under adverse interest rate movements. |
| Description and findings re EC4 | <p>BoB guidelines on risk management (2018) establish the supervisory expectations and requirements around stress testing as relevant for the management and supervision of interest rate risk. These include the following:</p> <ul style="list-style-type: none"> • Banks must perform stress testing to identify potential vulnerability to exceptional but plausible events on interest rate risk exposures to assess the bank's ability to withstand interest rate changes or shocks. • Stress testing should alert bank management to any adverse unexpected outcomes related to interest rate risk and provide an indication of how much capital might be needed to absorb losses, should large shocks occur. • The following are typical factors that must be considered when stress-testing for interest rate risk: all likely sources of interest rate risk, including re-pricing risk; basis risk; yield curve risk and optionality risk. • Stress scenarios to be used for interest rate risk should include (i) historical scenarios in which sharp changes in interest rates were experienced, (ii) hypothetical changes in the general level of interest rates, (iii) changes |

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| | <p>in the relationships between key market rates (i.e., basis risk), for example, an increase in term and savings deposit rates and interbank rate, but no change in the prime lending rate, and a drop in the prime lending rate, but no change in term and savings deposit rates and the interbank rate, (iv) changes in interest rates in individual time bands to different relative levels (i.e., yield curve risk), and (v) changes in the liquidity of key financial markets or changes in the volatility of market rates.</p> <ul style="list-style-type: none"> • Management and the board should periodically review both the design and results of such stress tests and ensure that appropriate contingency plans are in place. <p>Supervisors review the stress test results, their use in establishing or revising risk limits, and adequacy of Board and senior management oversight mainly while onsite. These are also discussed during the annual bilateral meetings with banks or during the annual trilateral meeting with banks and their external auditors.</p> |
| Additional criteria | |
| AC1 | The supervisor obtains from banks the results of their internal interest rate risk measurement systems, expressed in terms of the threat to economic value, including using a standardized interest rate shock on the banking book. |
| Description and findings re AC1 | The supervisors receive inputs on banks' exposure to IRRBB through the ICAAP documents. Banks invariably tend to assess their exposure and resilience (stress testing) with reference to the impact of a standardized interest rate shock (generally 200 basis points) on their earnings. Banks' public disclosures on the impact of interest rate shock is also generally from the earnings perspective. |
| AC2 | The supervisor assesses whether the internal capital measurement systems of banks adequately capture interest rate risk in the banking book. |
| Description and findings re AC2 | <p>Please see description and finding under EC 3 and AC 1 of this CP.</p> <p>As banks tend to measure their exposure to IRRBB from the earnings perspective and do not consider the economic value perspective, and in the absence of appropriate supervisory tools to validate or challenge the banks' measurement and stress testing results, the supervisors tend to accept banks' assessments. No bank is explicitly stating that it is holding additional capital for its IRRBB exposures.</p> |
| Assessment of Principle 23 | Materially non-compliant |
| Comments | <p>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.</p> <p>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</p> |

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| | <p>confirm the availability and adequacy of qualitative elements through the offsite and onsite supervision mechanisms.</p> <p>Supervisors receive bank-wise data on distribution of rate sensitive assets (RSA) and rate sensitive liabilities (RSL) by their repricing maturity, but do not have the supervisory tools to analyze the available data to determine the extent of individual bank's exposure to IRRBB. This also 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.</p> <p>As mentioned in the description and finding re EC4, banks have material exposure to IRRBB. In the light of materiality of banks' exposure to IRRBB, BoB must consider improving the offsite reporting, development of supervisory methodologies for assessment of banks' exposure to IRRBB and the potential impact on banks' capital to better inform supervision and strengthen SREP. BOB must 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. As required, these changes must be accompanied by appropriate training and capacity building to enhance the supervisory skills relevant for regulating and supervising management of IRRBB by banks.</p> |
| Principle 24 | Liquidity risk. The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons. At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards. |
| Essential criteria | |
| EC1 | Laws, regulations or the supervisor require banks to consistently observe prescribed liquidity requirements including thresholds by reference to which a bank is subject to supervisory action. At least for internationally active banks, the prescribed requirements are not lower than, and the supervisor uses a range of liquidity monitoring tools no less extensive than, those prescribed in the applicable Basel standards. |
| Description and findings re EC1 | Section 16(2) of the Banking Act (1995) stipulates that every bank in Botswana must maintain daily, specified eligible "liquid assets" as a percentage of its "deposit liabilities". Currently, this requirement is equal to 10 percent. Section 16(5) elaborates on components of liquid assets and deposit liabilities as: "Liquid assets" shall mean freely transferable assets, unencumbered by any charge or lien whatsoever, including treasury bills and other securities issued by the Government of Botswana or the BoB and maturing within 370 days, negotiable instruments of such types as the BoB may approve and payable within a period of 184 days, and generally such other assets as |

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| | <p>the BoB may, from time to time, approve. "Deposit liabilities" include total deposits, and other liabilities maturing in less than one year.</p> <p>In terms of Section 16(6) of the Banking Act (1995), Where a bank fails to maintain liquid assets in accordance with the requirements of this section, the BoB may impose on and collect from it a levy not exceeding 0.1 percent of the amount by which such assets fall short of the amount required in accordance with section 16(2).</p> <p>The liquid assets to deposit ratio (LAR) decreased from 19.1 percent in 2020 to 16.6 percent in 2021 but remained above the 10 percent prudential minimum. The ratio varied across banks, within a range of 14 to 21.3 percent.</p> <p>BoB has not defined or identified any bank as internationally active.</p> |
| EC2 | The prescribed liquidity requirements reflect the liquidity risk profile of banks (including on- and off-balance sheet risks) in the context of the markets and macroeconomic conditions in which they operate. |
| Description and findings re EC2 | <p>The LAR is applied uniformly to all banks and reflects the liquidity risk profile from a stock-perspective. BoB considers the LAR to be appropriate for the liquidity risk profile of banks operating in Botswana.</p> <p>While the LAR appears to have served the prudential requirements, there are a few elements of liquidity risk that are not adequately captured in this prudential requirement. The areas for improvement in the prudential liquidity requirement are the following:</p> <ul style="list-style-type: none"> • The LAR reflects a partial view of liquidity risk as it does not include off-balance sheet liabilities (commitments) that are expected to result in outflows in the next one year. • The LAR is applied at the aggregate level and does not consider liquidity position in foreign currency both for all foreign currencies and at the level of individual material foreign currencies. As a result, while a bank might be compliant with the LAR requirement, it might not be compliant with LAR in foreign currency. <p>The LAR approaches liquidity risk from a stock perspective. As a result, it does not capture or reflect liquidity risk from a flow (liquidity gap) perspective. As a result, while a bank might be compliant with the LAR requirement, it might be illiquid (negative liquidity gap) in certain near time-bands (like 1 to 7 days and 8 to 15 days). BoB's guidelines on liquidity risk management partially addresses this gap (please see description under EC3 of this CP) but regulatory requirement, guidance to banks, supervisory tools and guidance to supervisors to assess liquidity risk from a flow perspective are required to make supervision of liquidity risk more effective.</p> |
| EC3 | The supervisor determines that banks have a robust liquidity management framework that requires the banks to maintain sufficient liquidity to withstand a range of stress events, and includes appropriate policies and processes for managing liquidity risk that have been approved by the banks' Boards. The supervisor also determines that these |

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| | policies and processes provide a comprehensive bank-wide view of liquidity risk and are consistent with the banks' risk profile and systemic importance |
| Description and findings re EC3 | <p>BoB has established a comprehensive set of requirements relevant for liquidity risk management framework in banks through its guidelines on risk management (2018).</p> <p>These guidelines require banks to, among others,</p> <ul style="list-style-type: none"> • define, identify, and manage the liquidity risks to which it is exposed for all legal entities, branches, and subsidiaries in the jurisdictions in which it is active, • evaluate each major on- and off-balance sheet position, including the effect of embedded options and other contingent exposures that may affect the bank's sources and uses of funds, and determine how it can affect liquidity risk, • consider the interactions between exposures to funding liquidity risk and market liquidity risk, • fully factor into its risk management the consideration that asset values may deteriorate under market stress, and take this into account in assessing the feasibility and impact of asset sales during stress on its liquidity position, • recognize and consider the strong interaction between liquidity risk and other types of risks to which it is exposed (for example, market, interest rate, credit, operational and reputational risks), • effectively manage and monitor its net funding requirements, (For this, a bank should have the ability to calculate liquidity positions on an intra-day basis, on a day-to-day basis for the shorter time horizons, and over a series of more distant time periods.), • set limits to control its liquidity risk exposure and vulnerabilities (such limits should be relevant to the business in terms of its location, complexity of activity, nature of products, currencies and markets served), • design a set of early warning indicators to identify the emergence of increased risk or vulnerabilities in its liquidity risk position or potential funding needs, • establish a funding strategy that provides effective diversification in the sources and tenor of funding (it should maintain an on-going presence in its chosen funding markets and strong relationships with funds providers to promote effective diversification of funding sources), • regularly gauge its capacity to raise funds quickly from each source, • limit concentration in any one funding source or tenor, • ensure that wholesale funding sources are sufficiently diversified, |

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| | <ul style="list-style-type: none">• maintain a relatively higher proportion of unencumbered, highly liquid assets, if bank is reliant on wholesale funding,• have access to diverse sources of liquidity in each currency as required, where bank is active in multiple currencies,• maintain market access,• actively manage its collateral positions, differentiating between encumbered and unencumbered assets and monitor the legal entity and physical location where collateral is held and how it may be mobilized in a timely manner• conduct stress tests on a regular basis for a variety of short-term and protracted bank-specific and market-wide stress scenarios to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity-risk tolerance• use stress test outcomes to adjust its liquidity-risk management strategies, policies, and positions and to develop effective contingency plans• have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations, (A CFP should outline policies to manage a range of stress environments, establish clear lines of responsibility, include clear invocation and escalation procedures, and be regularly tested and updated to ensure that it is operationally robust.)• establish and maintain an MIS that provides senior management officials, the risk management committee, and the board of directors with adequate and timely information to:<ul style="list-style-type: none">○ monitor a bank's liquidity positions, including trends, in all currencies in which the bank has material activity,○ project a bank's liquidity position and future cash flows over different time periods, including daily and longer term, minimum three months, ideally six months, and under alternative scenarios, including stress scenarios,○ review liquidity risk exposures on a timely basis,○ compare current liquidity exposures with limits established by the board of directors,○ determine compliance with a bank's board-approved policies, procedures and limits and the bank's liquidity requirements, as prescribed in the Act and Banking Regulations 1995,○ ensure that the information system enables management to evaluate the level and trends of the bank's aggregate liquidity exposure; and |
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| | <ul style="list-style-type: none"> ○ report compliance with prudential regulatory liquidity requirements. <p>BoB guidelines on risk management (2018) also require that the board provides effective oversight on management's actions to ensure that the actions of the latter are consistent with the risk strategy, risk appetite framework and policies of a bank. The board should approve the overall business strategies and significant policies of the bank, including those related to taking and managing risks, and should also ensure that management have skills, expertise, and competence commensurate with the nature, scale, and complexity of the bank's business.</p> <p>In short, each bank should establish appropriate and prudent policies for the management of liquidity risk. It should ensure, to the satisfaction of the BoB, that adequate internal risk management systems exist to monitor and control maturity mismatches between its assets and liabilities, that the bank has the capacity to meet maturing obligations and/or fund balance sheet expansion in a sound and effective manner, and that the level, trend and quality of bank funding sources, including cash flow from earning assets, support the bank's growth strategy.</p> <p>BoB supervisors closely monitor each bank's compliance with daily LAR requirement through the offsite reports received from banks. Adequacy and appropriateness of banks' liquidity risk management strategies, policies, and processes, board and senior management oversight and compliance with the requirements established in the BoB guidelines on risk management are generally assessed onsite. Supervisors review the MIS and reviews submitted to the Board and senior management, and the discussions at the board, Board Audit Committee and Asset-Liability Management Committee (ALCO) to understand and assess senior management and board oversight on liquidity risks to which the bank is exposed and the quality and effectiveness of their management. These are also reviewed during the annual bilateral meeting with banks, the annual bilateral meetings with the external auditors and the trilateral meetings with banks and their external auditors.</p> <p>BoB Supervisors also review banks' contingency funding plans during onsite examinations, particularly with regards to their feasibility and if these are updated to reflect market evolution.</p> |
| EC4 | <p>The supervisor determines that banks' liquidity strategy, policies and processes establish an appropriate and properly controlled liquidity risk environment including:</p> <ul style="list-style-type: none"> (a) clear articulation of an overall liquidity risk appetite that is appropriate for the banks' business and their role in the financial system and that is approved by the banks' Boards; (b) sound day-to-day, and where appropriate intraday, liquidity risk management practices; |

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| | <ul style="list-style-type: none"> (c) effective information systems to enable active identification, aggregation, monitoring and control of liquidity risk exposures and funding needs (including active management of collateral positions) bank-wide; (d) adequate oversight by the banks' Boards in ensuring that management effectively implements policies and processes for the management of liquidity risk in a manner consistent with the banks' liquidity risk appetite; and (e) regular review by the banks' Boards (at least annually) and appropriate adjustment of the banks' strategy, policies and processes for the management of liquidity risk in the light of the banks' changing risk profile and external developments in the markets and macroeconomic conditions in which they operate. |
| <p>Description and findings re EC4</p> | <p>Please see description and finding under EC 3 of this CP, which indicate that the BoB's regulatory and supervisory requirements, and their onsite and offsite activities allow them to review the banks' liquidity risk strategies, policies, and processes to determine if these meet with expectations articulated in this EC. Supervisors follow-up on their onsite finding through follow-up onsite visits and periodic receipt of compliance reports from banks until the identified shortcoming are addressed or resolved.</p> |
| <p>EC5</p> | <p>The supervisor requires banks to establish, and regularly review, funding strategies and policies and processes for the ongoing measurement and monitoring of funding requirements and the effective management of funding risk. The policies and processes include consideration of how other risks (e.g. credit, market, operational and reputation risk) may impact the bank's overall liquidity strategy, and include:</p> <ul style="list-style-type: none"> (a) an analysis of funding requirements under alternative scenarios; (b) the maintenance of a cushion of high quality, unencumbered, liquid assets that can be used, without impediment, to obtain funding in times of stress; (c) diversification in the sources (including counterparties, instruments, currencies and markets) and tenor of funding, and regular review of concentration limits; (d) regular efforts to establish and maintain relationships with liability holders; and (e) regular assessment of the capacity to sell assets. |
| <p>Description and findings re EC5</p> | <p>The BoB monitors banks' funding risk with reference to the intermediation ratio and the concentration of deposits with reference to the share of the top 20 depositors.</p> <p>The intermediation ratio is computed as the ratio of banks' total loans and advances to total deposits. The ratio for all commercial banks as at end December 2021 was about 82 percent and the ratio for individual banks was in the range of 63 to 107 percent. A ratio higher than 100 percent suggests that the bank is relying on borrowing to grow its loans and advances portfolio. The supervisors have not set a prudential limit for this ratio, but where the ratio is above 80 percent, supervisors engage with the bank to address its funding risk.</p> |

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| | <p>BoB also monitors the concentration in deposits with reference to the share of top 20 depositors in total deposits. As at end June 2022, the average for all commercial banks was about 39 percent. It was higher for the four smaller banks at about 48 percent and lower for the top four banks at about 37 percent. For all commercial banks, the range was from about 26 percent to about 54 percent. The supervisors have not set a prudential limit for this metric, and it is unclear if the BoB response is uniform where the ratio exceeds, for example 40 or 50 percent, and how supervisors engage with the bank to address its funding concentration risk.</p> <p>BoB can consider undertaking an analysis of these ratios and consider establishing clear supervisory thresholds (internal) which can trigger specific supervisory responses to be able to respond to potential funding stress in banks.</p> |
| EC6 | <p>The supervisor determines that banks have robust liquidity contingency funding plans to handle liquidity problems. The supervisor determines that the bank's contingency funding plan is formally articulated, adequately documented and sets out the bank's strategy for addressing liquidity shortfalls in a range of stress environments without placing reliance on lender of last resort support. The supervisor also determines that the bank's contingency funding plan establishes clear lines of responsibility, includes clear communication plans (including communication with the supervisor) and is regularly tested and updated to ensure it is operationally robust. The supervisor assesses whether, in the light of the bank's risk profile and systemic importance, the bank's contingency funding plan is feasible and requires the bank to address any deficiencies.</p> |
| Description and findings re EC6 | <p>BoB guidelines on risk management (2018) require banks to, among others,</p> <ul style="list-style-type: none"> • conduct stress tests on a regular basis for a variety of short-term and protracted bank-specific and market-wide stress scenarios to identify sources of potential liquidity strain and to ensure that current exposures remain in accordance with a bank's established liquidity-risk tolerance, • use stress test outcomes to adjust its liquidity-risk management strategies, policies, and positions and to develop effective contingency plans, • have a formal liquidity contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. Banks' CFP should outline policies to manage a range of stress environments, establish clear lines of responsibility, include clear invocation and escalation procedures and be regularly tested and updated to ensure that it is operationally robust. <p>During onsite examination, BoB determines whether (i) banks conduct liquidity stress tests under various scenarios as required in the guidelines, (ii) stress test results are used to inform liquidity risk management strategies, policies, risk appetite, and developing robust CFPs, and (iii) banks have robust liquidity contingency funding that are tested periodically. Supervisors review offsite the liquidity stress test scenarios and results shared by banks in their annual ICAAP documents to assess the banks' resilience to liquidity stress. Supervisors assess the</p> |

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| | CFPs for their adequacy and feasibility and review their testing results to assess their robustness. While doing this, supervisors also place reliance on the reviews conducted by the banks' compliance and internal audit functions. Where required, BoB discusses the issues related to bank's liquidity contingency funding plans during the bilateral meetings with banks, bilateral meetings with their external auditors and the trilateral meetings with banks and their external auditors. |
| EC7 | The supervisor requires banks to include a variety of short-term and protracted bank-specific and market-wide liquidity stress scenarios (individually and in combination), using conservative and regularly reviewed assumptions, into their stress testing programmes for risk management purposes. The supervisor determines that the results of the stress tests are used by the bank to adjust its liquidity risk management strategies, policies and positions and to develop effective contingency funding plans. |
| Description and findings re EC7 | Please see description and finding under EC 6 of this CP, which explains the BoB's regulatory and supervisory requirements, and their onsite/ offsite supervision in this area. |
| EC8 | The supervisor identifies those banks carrying out significant foreign currency liquidity transformation. Where a bank's foreign currency business is significant, or-the bank has significant exposure in a given currency, the supervisor requires the bank to undertake separate analysis of its strategy and monitor its liquidity needs separately for each such significant currency. This includes the use of stress testing to determine the appropriateness of mismatches in that currency and, where appropriate, the setting and regular review of limits on the size of its cash flow mismatches for foreign currencies in aggregate and for each significant currency individually. In such cases, the supervisor also monitors the bank's liquidity needs in each significant currency and evaluates the bank's ability to transfer liquidity from one currency to another across jurisdictions and legal entities. |
| Description and findings re EC8 | BoB supervisory focus is on liquidity management at the aggregate level, irrespective of the currencies. For almost all banks, US Dollar (USD) is a significant foreign currency, for a few the South African Rand (ZAR) and Euro are significant currencies as well. At an aggregate level, about 20 percent of bank deposits are in foreign currency and about 4 percent of loans are in foreign currency. Banks generally maintain about 15 percent of their total assets in nostro accounts. Discussion with banks suggest that they prefer to keep their foreign currency deposits in nostro accounts and do not undertake material foreign currency liquidity transformation for two reasons – the deposits are invariably short term (less than 3 months) and banks do not generally lend to borrowers who do not have a natural hedge. The extent of foreign currency liquidity risk in the banking system is not clear and would warrant a detailed analysis. BoB can obtain data on foreign currency composition of banks' assets, liabilities and off-balance sheet commitments, undertake a detailed analyses to determine the materiality of foreign currency liquidity transformation in the banking system. Based on the finding, BoB can consider establishing liquidity risk management requirements at the level of foreign currencies in general and for significant foreign currencies, as relevant, including appropriate offsite reporting and analyses. |

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| Additional criteria | |
| AC1 | The supervisor determines that banks' levels of encumbered balance-sheet assets are managed within acceptable limits to mitigate the risks posed by excessive levels of encumbrance in terms of the impact on the banks' cost of funding and the implications for the sustainability of their long-term liquidity position. The supervisor requires banks to commit to adequate disclosure and to set appropriate limits to mitigate identified risks. |
| Description and findings re AC1 | Deposits are the main source of funding for banks in Botswana, followed by borrowing through Tier 2 bonds and other borrowing from parent banks or group entities. Normally banks do not encumber their assets to borrow. Interbank borrowing is largely on unsecured basis. Further, section 17(13) of the Banking Act (1995) requires banks to seek regulatory approval to encumber their assets. The encumbered assets are not included as part of the liquid assets. |
| Assessment of Principle 24 | Materially non-compliant |
| Comments | As described under each of the ECs of this CP, the BoB has established a prudential liquidity requirement (Liquid Assets Ratio - LAR) that is a stock measure of liquidity, and 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 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. To improve compliance with this CP, BoB should consider including flow-based liquidity measures in its toolkit (namely, liquidity gap approach using contractual residual maturity and behavioral residual maturity), introducing explicit regulatory and/or supervisory limits for the intermediation and deposit concentration ratios, assessing liquidity and funding risks at the level of each significant foreign currency (for example, each currency where bank's assets or liabilities account for more than 5 percent of total liabilities) in addition to assessing these risks at the aggregate level (for all currencies), improving the off-site reporting and analyses to better capture these risks, and providing more guidance to supervisors to assess these dimensions of liquidity and funding risks and reflecting these adequately in the supervised bank's liquidity risk profile. |
| Principle 25 | Operational risk. The supervisor determines that banks have an adequate operational risk management framework that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes |

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| | to identify, assess, evaluate, monitor, report and control or mitigate operational risk ⁶⁶ on a timely basis. |
| Essential criteria | |
| EC1 | Law, regulations or the supervisor require banks to have appropriate operational risk management strategies, policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk. The supervisor determines that the bank's strategy, policies and processes are consistent with the bank's risk profile, systemic importance, risk appetite and capital strength, take into account market and macroeconomic conditions, and address all major aspects of operational risk prevalent in the businesses of the bank on a bank-wide basis (including periods when operational risk could increase). |
| Description and findings re EC1 | <p>Section 8 of BoB guidelines on risk management (2018) establish the following requirements, among others, for operational risk management in banks:</p> <ul style="list-style-type: none"> • Every bank should establish a comprehensive system, which will enable it to identify, assess, monitor, and control or mitigate operational risk. This includes, codifying all policies and procedures for risk management controls, designing the operational-risk assessment methodology and establishing a risk-reporting system for operational risk. • The board of directors should approve and review a risk appetite and tolerance statement for operational risk that articulates the nature, types, and levels of operational risk that the bank is willing to assume. • The board should establish a code of conduct, which sets clear expectations for the integrity and ethical values of the highest standard and identify acceptable business practices and prohibited conflicts. • Senior management should ensure that all staff members of the bank are accorded training on operational risk. The training should reflect the seniority, role, and responsibilities of the individuals for whom it is intended. • Senior management should identify and assess the operational risk inherent in all material products, activities, processes, and systems to make sure that the inherent risks and incentives are well understood. • The board and senior management should implement a process to regularly monitor operational-risk profiles and material exposures to losses. • A bank should systematically track and record the frequency, severity, and other information on individual loss events. Such data could provide meaningful information for assessing the bank's exposure to operational risk and developing a policy to mitigate or control that risk. |

⁶⁶ The Committee has defined operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk but excludes strategic and reputational risk.

BoB's risk-based supervisory framework that supplements the CAMEL framework, guides the supervisors, among others, in supervising operational risk management in banks. The following are some of the key factors BoB supervisors consider when assessing the adequacy of operational risk management systems of supervised financial institutions:

- Existence of a board approved set of credible and comprehensive policies, procedures and limits in all key operational areas including credit, banking, treasury, foreign exchange, asset/liability management, human resource etc.
- Existence of an active Board Audit Committee with well-defined terms of reference and approved comprehensive annual audit program.
- Existence of a full-fledged, independent, and adequately staffed internal audit function with clear reporting lines to the Board Audit Committee.
- Existence of a robust Management Information System (MIS) that can facilitate generation of accurate and timely management reports.
- Existence of an operational Business Continuity Plan (BCP) and a Disaster Recovery Site (DRS) to avert disruption of business in the event of any major disaster.
- A credible and well-communicated organizational structure that clearly spells out positions of authority and effective reporting lines of communication throughout the organization.
- Existence of clear job descriptions, objective periodic performance appraisals, appraisal instruments, coupled with an ongoing pro-active and comprehensive training program for all categories of staff to enhance their skills and develop their career path.
- Existence of a board approved risk management coordination framework through a Risk Manager or Risk Management Committee.
- Prompt senior management compliance with internal and external auditors' reports.
- Implementation of laws/regulations/procedural guidelines regarding Know Your Customer (KYC), Anti-Money Laundering (AML) practices and Combating Financing of Terrorism (CFT).

Ahead of onsite visits, supervisors obtain copies of each bank's risk management strategies, policies, and processes, including those for operational risk. Supervisors study these documents offsite to identify gaps or areas for improvement. While onsite, supervisors review the implementation of these strategies, policies, and processes to test their adequacy and effectiveness. Supervisors also assess if these strategies and policies are aligned to the bank's operations, and are commensurate with the bank's risk appetite, risk profile, systemic importance, and capital strength. The onsite assessments are followed-through and updated by the supervisors during the two

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| | <p>annual bilateral meetings (one with the bank and another with the external auditors) and the annual trilateral meeting with the bank and the external auditors jointly.</p> <p>Section 8.32 to 8.37 of BoB guidelines on risk management (2018) set out the requirements for business continuity and resilience planning for banks (please see description and finding under EC4 for details). The requirements established by BoB help banks prepare themselves for handling of major disruptive events or remaining resilient during stress situations. These requirements also help supervisors to review the plans formulated by banks for their adequacy and effectiveness.</p> |
| EC2 | <p>The supervisor requires banks' strategies, policies and processes for the management of operational risk (including the banks' risk appetite for operational risk) to be approved and regularly reviewed by the banks' Boards. The supervisor also requires that the Board oversees management in ensuring that these policies and processes are implemented effectively.</p> |
| Description and findings re EC2 | <p>Section 3.16 of the BoB guideline on risk management stipulates that the board should approve the overall business strategies and significant policies of the bank, including those related to taking and managing risks, and should also ensure that management have skills, expertise, and competence commensurate with the nature, scale, and complexity of the bank's business. This section also requires that the board provides effective oversight on management's actions to ensure that the actions of the latter are consistent with the risk strategy, risk appetite framework and policies of a bank.</p> <p>Please also see description and finding under EC1 of this CP, where it is mentioned that laws/ regulations require the board of directors to approve and review a risk appetite and tolerance statement for operational risk that articulates the nature, types, and levels of operational risk that the bank is willing to assume.</p> <p>During onsite examinations, supervisors review the minutes of the Board, its audit committee, and its risk committee to understand the progress made, and issues and challenges in implementing the board approved strategies, policies, and processes for operational risk management. They also use these reviews to obtain better understanding of the board oversight over senior management and the effectiveness of such oversight, and implementation by the senior management.</p> <p>Offsite, the supervisors follow-through on the onsite assessments and banks' ICAAP submissions and update themselves of the developments during the two annual bilateral meetings (one with the bank and another with the external auditors) and the annual trilateral meeting with the bank and the external auditors jointly. Supervisors obtain periodic updates on implementation of BoB recommendations made during the onsite examination. They also undertake follow-up short onsite visits to verify the progress made by the bank in implementation of the BoB recommendations.</p> |

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| EC3 | The supervisor determines that the approved strategy and significant policies and processes for the management of operational risk are implemented effectively by management and fully integrated into the bank's overall risk management process. |
| Description and findings re EC3 | <p>Please see description and finding under EC2 of this CP which clearly articulates BoB's supervisory approach, both onsite and offsite, to assess adequacy and effectiveness of implementation of bank's strategies, policies, and processes for the management of operational risk. These assessments and updates/ follow-up allow the supervisors to better understand the extent to which the operational risk management arrangements and outcomes feed into the bank's overall risk management.</p> <p>The offsite and onsite assessments pertaining to operational risk management also inform the BoB's view on the adequacy and effectiveness of the bank's overall risk management. These collectively inform the supervisor's grading of the bank's operational risk management, and the overall risk management.</p> |
| EC4 | The supervisor reviews the quality and comprehensiveness of the bank's disaster recovery and business continuity plans to assess their feasibility in scenarios of severe business disruption which might plausibly affect the bank. In so doing, the supervisor determines that the bank is able to operate as a going concern and minimize losses, including those that may arise from disturbances to payment and settlement systems, in the event of severe business disruption. |
| Description and findings re EC4 | <p>Section 8.32 to 8.37 of BoB guidelines on risk management (2018) set out the requirements for business continuity and resilience for banks. Among others, banks are mainly required to:</p> <ul style="list-style-type: none"> • have business resiliency and continuity plans in place to ensure an ability to operate on an ongoing basis and limit losses in the event of severe business disruption, • establish business continuity plans commensurate with the nature, size, and complexity of its operations. Such plans should consider different types of likely or plausible scenarios to which the bank may be vulnerable, • identify critical business operations, key internal and external dependencies, and appropriate resilience levels, • have continuity plans that establish contingency strategies, recovery and resumption procedures and communication plans for informing management, employees, regulatory authorities, customers, suppliers, and, where appropriate, civil authorities, • periodically review its continuity plans to ensure that contingency strategies remain consistent with current operations, risks, threats, resiliency requirements and recovery priorities, • test the business continuity and resiliency plans periodically to ensure that recovery and resumption objectives and timeframes can be met. Where |

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| | <p>possible, a bank should participate in disaster recovery and business continuity testing with key service providers.</p> <ul style="list-style-type: none"> • report the results of formal testing activity to senior management and the board. <p>At the licensing stage, BoB determines if a bank has disaster recovery site and existence of business continuity plans. Banks' internal auditors also participate as observers in the periodic disaster recovery drills and testing of business continuity plans. Supervisors verify the conduct of the testing of business continuity and resiliency plans and their results during the annual bilateral and trilateral meetings with banks, and during onsite examinations. Supervisors indicate that they also rely on the internal audit who review the bank's disaster recovery drill results.</p> |
| EC5 | <p>The supervisor determines that banks have established appropriate information technology policies and processes to identify, assess, monitor and manage technology risks. The supervisor also determines that banks have appropriate and sound information technology infrastructure to meet their current and projected business requirements (under normal circumstances and in periods of stress), which ensures data and system integrity, security and availability and supports integrated and comprehensive risk management.</p> |
| Description and findings re EC5 | <p>Section 8.18 to 8.20 of BoB guidelines on risk management (2018) set out the requirements for IT risk management in banks.</p> <ul style="list-style-type: none"> • The guidelines mention that while the effective use and sound implementation of technology can contribute to an effective control environment, they also introduce risks that must be addressed by banks through sound technology governance and infrastructure risk management programs. • The use of technological products, activities, processes, and delivery channels exposes a bank to strategic, operational, and reputational risks, and the possibility of material financial loss. Therefore, a bank should have an integrated approach to identifying, measuring, monitoring, controlling, and managing technology risks. The integrated approach should encompass the following key aspects: <ul style="list-style-type: none"> ○ governance and oversight controls that ensure that technology and outsourcing arrangements are aligned with and supportive of a bank's business objectives, ○ policies and procedures that facilitate identification and assessment of risk, establishment of a risk appetite and tolerance statement, as well as performance expectations, to assist in controlling and managing risk, ○ implementation of an effective control environment and the use of risk- transfer strategies that mitigate risk; and |

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| | <ul style="list-style-type: none"> ○ monitoring processes that test for compliance with policy thresholds or limits. ● Management should ensure that a bank has a sound technology infrastructure, which meets current and long-term business requirements by providing sufficient capacity for normal activity levels, as well as peaks during periods of market stress, ensuring data and system integrity, security, and availability, and supporting integrated and comprehensive risk management. <p>BoB is in advanced stage of issuing a new guideline that is focused on cybersecurity risk management which articulates BoB expectations and provides guidance for banks to (i) enhance their cyber posture and resilience, (ii) create a common approach for addressing cyber risk within the banking system, (iii) achieve minimum and acceptable levels of cyber resilience, (iv) ensure that systemic cyber risk is properly managed within the banking system, and (v) comply with Principle 7 of Principles for Operational Resilience issued by the Basel Committee on Banking Supervision.</p> <p>BoB undertakes supervision of IT risk and information security risk with the support of BoB's IT specialists. The team of supervisors and IT specialists review the IT policies and processes based on inputs obtained from banks ahead of the onsite visit and during onsite examinations. BoB supervision identify relevant issues that are pursued with the bank until these are satisfactorily addressed or resolved. Some of the key finding in this area include unsatisfactory management of back-up tapes at disaster recovery site; inadequate data center replication technology to meet recovery time objective, or to support data growth, or to respond to unexpected disasters; ineffective deployment of patches and upgrades in information technology systems; unavailability of hot site for mission-critical servers/services; slow response time for consultants/contractors; inadequate change management process; insufficient testing facility for locally available servers; bank's operations being anchored on complex IT infrastructure which posed risk to the operational resilience as there were more than 200 systems and applications; information technology infrastructure was compromised by lack of system interfaces between the retail banking credit origination system, and intermittent failed processing of internet banking and instant money transactions.</p> |
| EC6 | <p>The supervisor determines that banks have appropriate and effective information systems to:</p> <ul style="list-style-type: none"> (a) monitor operational risk; (b) compile and analyze operational risk data; and (c) facilitate appropriate reporting mechanisms at the banks' Boards, senior management and business line levels that support proactive management of operational risk. |
| Description and findings re EC6 | BoB's guidelines on risk management require that each bank should put in place an effective management information system (MIS) to monitor risk levels and facilitate |

the timely review of risk positions and exceptions. These guidelines are to be observed with respect to each individual risk area as well.

Banks are required to observe the following to ensure effective measurement and monitoring of risk and management information systems:

- a bank's risk monitoring practices and reporting should address all the material risks,
- key assumptions, data sources and procedures used in monitoring risk should be appropriate, adequately documented and tested for reliability on an ongoing basis,
- reports and other forms of communication should be consistent with a bank's activities, structured to monitor exposures and compliance with established limits, goals, objectives; and, as appropriate, compare actual versus expected performance,
- reports to the bank's board and management should be accurate and timely and contain sufficient information for decision makers to identify any adverse trends and to evaluate adequately the level of risk faced by a bank,
- risk monitoring activities must be supported by an information system that provides the board and management with timely reports on the financial condition, operating performance, and risk exposure of the bank, as well as with regular and sufficiently detailed reports for line managers engaged in the day- to-day management of the bank's activities. The sophistication of the bank's information system must keep pace with developments in the bank's risk profile, increased business complexity and new products or business lines; and
- the board and management must put in place reporting formats, which clearly delineates the likely occurrence (frequency) and impact, to be signed at regular intervals by relevant senior management officers and board members.

Monitoring reports should be frequent, timely, accurate and informative. Such reports should be distributed to appropriate individuals for implementation, to be specifically identified in the bank's procedures.

To ensure the adequacy of a bank's internal controls and audit procedures, banks should adequately test and review the internal controls and information systems, the coverage, procedures, findings and responses to audits and review tests should be adequately documented, identified material weaknesses should be given appropriate and timely high-level attention; and management's actions to address material weaknesses should be objectively verified and reviewed.

BoB supervisors rely on the banks' internal control and internal audit frameworks to be assured about the availability and adequacy of the information systems for risk identification, reporting and aggregation. This is also a topic that is discussed during

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| | <p>the annual bilateral meetings with the bank’s external auditors and during the trilateral meetings with the bank management and external auditors. During an on-site examination, BoB assesses the bank’s processes for monitoring operational risk, reporting, and aggregating operational risk data and use of the data and information for operational risk management. Supervisors review the reporting to and discussion in the bank’s board, sub-committees of the board (audit committee, risk management committee), and in management committees as relevant for each bank to assess the adequacy and effectiveness of banks’ information systems.</p> <p>Some of the weaknesses identified by the supervisors in a recent onsite inspection include inadequate or ineffective incident reporting processes, non-aggregation of operational risk events reported through sub-systems, and non-estimation of operational losses on several incidents that were reported, which collectively resulted in incomplete data on operational risk events and understating of internal loss. Supervisors pursue such weaknesses with the banks until these are resolved or satisfactorily addressed.</p> |
| EC7 | <p>The supervisor requires that banks have appropriate reporting mechanisms to keep the supervisor apprised of developments affecting operational risk at banks in their jurisdictions.</p> |
| Description and findings re EC7 | <p>BoB has required banks to submit every quarter the prudential reporting on capital adequacy that include the computation of capital maintained by banks for operational risk. Banks in Botswana maintain capital for operational risk using the Basic Indicator Approach, and at least one bank is using the standardized approach for management reporting.</p> <p>BoB guidelines on risk management establish the minimum requirements for internal reporting as part of the operational risk management framework. In terms of these requirements banks are required to comply with the following:</p> <ul style="list-style-type: none"> • Operational-risk reports should include (i) breaches of the bank’s risk appetite and tolerance statement, as well as thresholds or limits, (ii) details of recent significant internal operational risk events and losses; and (iii) relevant external events and any potential impact on the bank and operational risk capital. • Data capture and risk-reporting processes should be analyzed periodically with a view to continuously enhancing risk management performance, as well as advancing risk-management policies, procedures, and practices. • Appropriate reporting mechanisms should be in place at the board, senior management and business line levels that support proactive management of operational risk. • Each bank should continuously improve the quality of operational-risk reporting by ensuring that its reports are comprehensive, accurate, consistent, and actionable across business lines and products. Risk reports |

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| | <p>should be manageable in scope and volume because effective decision-making can be impeded by deficient or excessive amounts of data.</p> <ul style="list-style-type: none"> • Reporting should be timely, and a bank should be able to produce reports in both normal and stressed-market conditions. The frequency of reporting should reflect the risks involved and the pace and nature of changes in the operating environment. • Reports generated by (and/or for) supervisory authorities should also be reported internally to senior management and the board, where appropriate. • A bank should systematically track and record the frequency, severity, and other information on individual loss events, as such data could provide meaningful information for assessing the bank's exposure to operational risk and developing a policy to mitigate or control that risk. <p>Section 22(7) of the Banking Act (1995) requires that the external auditor shall report to the BoB if the auditor, in the course of the performance of duties as auditor of a bank, is satisfied that (i) there has been a serious breach of, or non-compliance with, the provisions of the Banking Act, the Bank of Botswana Act, the Companies Act, or any regulations issued under those Acts, or any directions or guidelines issued by the BoB, (ii) a criminal offence involving fraud or other dishonesty has been committed, (iii) losses have been incurred which reduce the paid-up capital of the bank by fifty per cent or more, (iv) serious irregularities have occurred in the affairs of the bank, particularly such irregularities that jeopardize the security of depositors and creditors, or the auditor is unable to confirm that the claims of depositors and creditors are still covered by the assets of the bank.</p> <p>While the BoB is yet to introduce formal supervisory reporting on operational risk events and losses, banks reportedly apprise BoB of any developments regarding operational risk, e.g., major operational lapses or events (for example, internal and external frauds), changes in information technology systems, and changes in key management positions. BoB supervisors also tend to rely on the bank's internal data base, reporting by external auditors, internal audit finding, internal reports submitted to management and board reports on operational risk events and losses, and review of banks' resolution of unresolved sources of operational risk to keep themselves informed about the operational risk profile of each bank.</p> <p>While relying on secondary information is allowing BoB to perform some of its operational risk analyses and assessments, this can happen with a lag and may be inadequate for handling highly sensitive or high magnitude events and developments. Hence, BoB should establish formal and periodic, structured, and unstructured, reporting by banks on operational risk events and losses. This should also be supplemented with guidance to banks on identification of events and losses, tracking resolution of events, appropriate categorization of events, and measurement of losses. This supervisory initiative would not only help in establishing a good database within</p> |
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| | each bank, but also in establishing a good sector-level database and promoting more informed supervision/ SREP. |
| EC8 | <p>The supervisor determines that banks have established appropriate policies and processes to assess, manage and monitor outsourced activities. The outsourcing risk management program covers:</p> <ul style="list-style-type: none"> (a) conducting appropriate due diligence for selecting potential service providers; (b) structuring the outsourcing arrangement; (c) managing and monitoring the risks associated with the outsourcing arrangement; (d) ensuring an effective control environment; and (e) establishing viable contingency planning. <p>Outsourcing policies and processes require the bank to have comprehensive contracts and/or service level agreements with a clear allocation of responsibilities between the outsourcing provider and the bank.</p> |
| Description and findings re EC8 | <p>BoB guidelines on risk management require banks to have governance and oversight controls that ensure that technology and outsourcing arrangements are aligned with and supportive of a bank's business objectives.</p> <p>As outsourcing can expose a bank to strategic, operational and reputational risks and the possibility of material financial loss, BoB is holding bank's board and senior management responsible for understanding the operational risks associated with outsourcing arrangements and ensuring that effective risk-management policies and practices are in place to manage the risk in outsourcing activities. BoB requires banks' outsourcing policies and risk management activities to encompass, among others, the following:</p> <ul style="list-style-type: none"> • procedures for determining whether and how activities can be outsourced, • processes for conducting due diligence in the selection of potential service providers, • sound structuring of the outsourcing arrangement, including ownership and confidentiality of data, as well as termination rights, • programs for managing and monitoring the risks associated with the outsourcing arrangement, including the financial condition of the service provider, • establishment of an effective control environment within a bank and the service provider, • development of viable contingency plans; and • execution of comprehensive contracts and/or service level agreements with a clear allocation of responsibilities between the outsourcing |

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| | <p>provider and the bank.</p> <p>BoB has not explicitly required banks to seek its approval for outsourcing their activities, but it is understood that banks inform BoB in advance and seek its approval or no objection. BoB shared the example of a bank seeking its prior approval/ no objection for outsourcing the processing of government bond trades through one of its group entities in another jurisdiction. The BoB reviewed the request and accorded no objection subject to compliance with the following principles for outsourcing:</p> <ul style="list-style-type: none"> • The bank’s board of directors retains responsibility for the activities undertaken under the service agreement. • Bank should establish a comprehensive outsourcing risk management program to address the outsourced activities and the relationship with the bank’s group offices (as relevant). • Bank should ensure that this outsourcing arrangement neither diminishes its ability to fulfil its obligations to customers and regulators nor impedes effective supervision by the BoB. • The outsourcing contract between bank and the bank group offices should clearly describe all material aspects of the outsourcing arrangement, including the rights, responsibilities and expectations of both parties. <p>In the absence of explicit guidance on supervision of outsourcing activities and outsourcing risks, supervisors informed the assessors that they are guided by the Basel Committee guidelines on Outsourcing in Financial Services. They use these guidelines to review outsourcing policies and processes for supervised banks. BoB requires banks to have contracts and service level agreements between banks and service providers. Though not required, banks reportedly submit their service level agreements for review to BoB before the contract is signed.</p> <p>BoB should issue explicit guidelines and requirements to banks to formalize some of the current practices around outsourcing and prepare guidance for supervisors to be used while assessing banks’ outsourcing arrangements and supervising their management of outsourcing risks. While BoB may not be approving the outsourcing arrangements or the relevant service level agreements, it can consider introducing reporting requirements whereby banks periodically submit to the BoB the key details of their outsourcing arrangements.</p> |
| <p>Additional criteria</p> | |
| <p>AC1</p> | <p>The supervisor regularly identifies any common points of exposure to operational risk or potential vulnerability (e.g., outsourcing of key operations by many banks to a common service provider or disruption to outsourcing providers of payment and settlement activities).</p> |
| <p>Description and findings re AC1</p> | <p>BoB has not required banks to submit details of their outsourcing arrangements. Despite this gap, the BoB can informally identify common points of exposure to operational risk through internal coordination amongst supervisors. Thus, it has</p> |

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| | recently become aware of potential concentration amongst service providers in the areas of cash management, cash handling services, records management, and disaster recovery arrangements. |
| Assessment of Principle 25 | Largely compliant |
| Comments | <p>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.</p> <p>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. Issue of the proposed guidelines on cybersecurity risk will strengthen the regulation and supervision of this key component of operational risk. More detailed guidance to supervisors and articulation of supervisory expectations in the supervision manual can further improve scope and depth of onsite supervision of the above areas of operational risk management in banks.</p> <p>To improve compliance, BoB can 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. As required, these changes must be supplemented by appropriate training and capacity building to enhance the supervisory skills relevant for regulating and supervising operational risk management by banks.</p> |
| Principle 26 | Internal control and audit. The supervisor determines that banks have adequate internal control frameworks to establish and maintain a properly controlled operating environment for the conduct of their business taking into account their risk profile. These include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent ⁶⁷ internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations. |
| Essential criteria | |
| EC1 | Laws, regulations or the supervisor require banks to have internal control frameworks that are adequate to establish a properly controlled operating environment for the |

⁶⁷ In assessing independence, supervisors give due regard to the control systems designed to avoid conflicts of interest in the performance measurement of staff in the compliance, control and internal audit functions. For example, the remuneration of such staff should be determined independently of the business lines that they oversee.

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| | <p>conduct of their business, taking into account their risk profile. These controls are the responsibility of the bank’s Board and/or senior management and deal with organizational structure, accounting policies and processes, checks and balances, and the safeguarding of assets and investments (including measures for the prevention and early detection and reporting of misuse such as fraud, embezzlement, unauthorized trading and computer intrusion). More specifically, these controls address:</p> <ul style="list-style-type: none"> (a) organizational structure: definitions of duties and responsibilities, including clear delegation of authority (e.g. clear loan approval limits), decision-making policies and processes, separation of critical functions (e.g. business origination, payments, reconciliation, risk management, accounting, audit and compliance); (b) accounting policies and processes: reconciliation of accounts, control lists, information for management; (c) checks and balances (or “four eyes principle”): segregation of duties, cross-checking, dual control of assets, double signatures; and (d) safeguarding assets and investments: including physical control and computer access. |
| <p>Description and findings re EC1</p> | <p>Sections 3.22 to 3.26 of BoB guidelines on risk management (2018) lay down the requirements pertaining to internal control systems and procedures in banks, which include the following:</p> <p>A bank should establish and maintain an effective system of controls, including the enforcement of official lines of authority and appropriate separation of duties, such as trading, custody and back-office. A sound internal control process consists of the following interrelated elements: management oversight and control culture; risk recognition and assessment; control activities and segregation of duties; information and communication; and monitoring activities and correcting deficiencies.</p> <p>Failure to implement and maintain an adequate separation of duties can lead to serious losses, compromise the financial integrity of a bank, and may warrant formal enforcement action by the BoB.</p> <p>A bank’s audit and risk management committees should review the adequacy and effectiveness of internal control systems and means through which risk exposures are managed.</p> <p>Internal controls should be tested by an independent internal auditor, who reports directly either to a bank’s board or its audit committee.</p> <p>To ensure the adequacy of a bank’s internal controls and audit procedures, the following should be observed:</p> <ul style="list-style-type: none"> • the system of internal controls should be appropriate to the type and level |

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| | <p>of risks posed by the nature and scope of a bank's activities,</p> <ul style="list-style-type: none"> • the bank's organizational structure should establish clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits, • reporting lines should provide sufficient independence of the control areas from the business lines and adequate separation of critical functions throughout the bank, such as those relating to trading, custodial and back-office activities (For example: business origination, payments, reconciliation, risk management, accounting, audit, and compliance), • official bank structures should reflect actual operating practices, • financial, operational, and regulatory reports should be reliable, accurate and timely; wherever applicable, exceptions should be noted and promptly investigated, • adequate procedures for ensuring compliance with applicable laws and regulations should be in place, • internal audit or other control review practices should provide for independence and objectivity, • internal controls and information systems should be adequately tested and reviewed; the coverage, procedures, findings and responses to audits and review tests should be adequately documented; identified material weaknesses should be given appropriate and timely high-level attention; and management's actions to address material weaknesses should be objectively verified and reviewed, and • the bank's audit committee or board of directors should review the effectiveness of internal audits and other control review activities on a regular basis. <p>Section 3.3 of BoB guidelines on banks' audit committees, annual independent external audit and publication of audited financial statements (2009) require, among others, that each bank's audit committee of the board</p> <ul style="list-style-type: none"> • recommend to the board appropriate accounting policies, standards and controls for the bank and supervise compliance therewith, • assist the board of directors in its evaluation of the adequacy, efficiency and effectiveness of the bank's internal control systems, accounting practices, information systems and auditing processes, • introduce such measures as, in the audit committee assessment, may serve to enhance the integrity of financial statements, including appropriateness, |
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| | <p>relevance and reliability of operational control environment, financial disclosures and, in general, financial reporting, and</p> <ul style="list-style-type: none"> • receive and review internal and external audit reports including the management letter, ensure that senior management officials take appropriate and timely action to correct weaknesses in internal control, non-compliance with policies, laws, regulations and directions, and other problems uncovered by the external auditor. |
| EC2 | <p>The supervisor determines that there is an appropriate balance in the skills and resources of the back office, control functions and operational management relative to the business origination units. The supervisor also determines that the staff of the back office and control functions have sufficient expertise and authority within the organization (and, where appropriate, in the case of control functions, sufficient access to the bank’s Board) to be an effective check and balance to the business origination units.</p> |
| Description and findings re EC2 | <p>Though the RBS framework does not explicitly address the specific elements flagged in this EC, supervisors informed the assessors that they review the staffing and balance of skills and resources at the level of the bank and the key functional units, but they do not systematically undertake reviews of the staffing and skills in control functions and back/ middle offices.</p> <p>Please also see description and finding under EC1 for details about independence and access to board.</p> |
| EC3 | <p>The supervisor determines that banks have an adequately staffed, permanent and independent compliance function⁶⁸ that assists senior management in effectively managing the compliance risks faced by the bank. The supervisor determines that staff within the compliance function are suitably trained, have relevant experience and have sufficient authority within the bank to perform their role effectively. The supervisor determines that the bank’s Board exercises oversight of the management of the compliance function.</p> |
| Description and findings re EC3 | <p>Section 10 of BoB guidelines on risk management (2018) establishes BoB’s expectations and requirements around banks’ compliance risk management. These cover the definition of compliance risk management, identification, measurement, monitoring, control and mitigation, and reporting.</p> <p>BoB guidelines on risk management establish the following requirements for banks’ compliance function:</p> <ul style="list-style-type: none"> • It should be independent, with sufficient resources and clearly specified activities. • The compliance staff, especially the head of compliance, should not be |

⁶⁸ The term “compliance function” does not necessarily denote an organizational unit. Compliance staff may reside in operating business units or local subsidiaries and report up to operating business line management or local management, provided such staff also have a reporting line through to the head of compliance who should be independent from business lines.

in a position where conflict of interest between his/her compliance responsibilities may arise.

- The head of the compliance function should be a member of senior management and should not have direct business line responsibilities.
- Compliance risk should be included in the risk-assessment methodology of the bank.
- The audit program should cover the adequacy and effectiveness of a bank's compliance function, including testing of controls commensurate with the perceived level of risk. This principle implies that the compliance function and the internal audit function should be separate to ensure that the activities of the compliance function are subject to independent review. The audit function should, however, keep the head of compliance informed of any audit findings related to compliance risk management.
- Compliance responsibilities may be discharged by staff in different departments, or all compliance responsibilities may be conducted by the compliance unit/department.

The guidelines also lay down that each banks' compliance-risk management policies and procedures should be clearly defined and consistent with the nature and complexity of the bank's activities. The compliance policy should address the following issues:

- define responsibilities and ultimately ensure that the board and senior management are fully acquainted with material compliance events,
- its relationship with other risk-management functions within the bank and with the internal audit function,
- in cases where compliance responsibilities are carried out by staff in different departments, how these responsibilities are to be allocated among the departments,
- express the compliance function's right to obtain access to information necessary to carry out its responsibilities and the corresponding duty of bank staff to cooperate in supplying this information,
- compliance function's right to conduct investigation of possible breaches of the compliance policy,
- compliance function's right to freely express and disclose its findings to senior management, and
- compliance function's right of direct access to the board of directors or a sub-committee of the board.

As part of BoB's risk-based supervision framework, supervisors assess inherent risks by their impact on the supervised financial institution's earnings and capital and set goals/objectives. Quantitative and qualitative factors are both applied in the process of risk assessment. BoB has identified and defined eight risk categories, that are deemed to be the most prevalent ones in the business operations of the supervised financial institutions under its regulatory jurisdiction. These include, amongst others, compliance risk.

The key factors the BoB considers when assessing the adequacy of compliance risk management systems of supervised financial institutions include,

- adequacy, soundness, reasonableness and completeness of the supervised financial institution's policies and procedures governing compliance risk.
- consistency in the supervised financial institution's track record of compliance with applicable laws, implementing regulations, prudential requirements, guidance notes, supervisory recommendations and directives, internal policies and limits, internal and external audit,
- recommendations, statutory requirements, codes of practice promoted by industry associations and internal codes of conduct applicable to staff members of the bank.
- Existence of an independent compliance function and whether the compliance risk management is reviewed by internal audit function.

As compliance function in banks is a recent requirement and thanks to COVID-19 related disruptions, the BoB is yet to establish formal supervisory guidelines for conducting a comprehensive or thematic review of the compliance function in banks. Notwithstanding the above, supervisors undertake the following activities in relation to compliance function:

- As part of BoB's fit and proper framework, supervisors conduct due diligence with reference to the head of compliance, as she/he is a senior management personnel.
- During the annual bilateral and trilateral meetings with banks, supervisors review board oversight of risk management, compliance, and internal audit functions.
- Supervisors review banks' compliance function during onsite examinations. In two large banks, arising from onsite examinations, supervisors have required greater independence for head of compliance and therefore required that they should be reporting to the CEO instead of to the CRO.

Supervisory assessments can be expanded to explicitly include assessment of adequacy of staff assigned to compliance function, their skillsets, experience, and training.

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| EC4 | <p>The supervisor determines that banks have an independent, permanent and effective internal audit function⁶⁹ charged with:</p> <p>(a) assessing whether existing policies, processes and internal controls (including risk management, compliance and corporate governance processes) are effective, appropriate and remain sufficient for the bank's business; and</p> <p>(b) ensuring that policies and processes are complied with.</p> |
| Description and findings re EC4 | <p>S 23 of Banking Act (1995) and Section 3 of the BoB guidelines on Banks' audit committees, annual independent external audit and publication of audited financial statements (2009) lay down the role, responsibilities and requirements of each bank's audit sub-committee of the board that meet the requirements of this EC. These include, among others, the following:</p> <ul style="list-style-type: none"> • Each bank shall have an Audit Committee, consisting of at least three members of the board of directors, the majority of which must be independent non-executive directors. • At a minimum, members of the Audit Committee should have relevant experience and should possess a balance of skills and expert knowledge, commensurate with the complexity of banking organizations and duties performed in financial reporting, accounting, and auditing. • The functions of the Audit Committee shall, as a minimum, include the following: <ul style="list-style-type: none"> ○ recommend to the board appropriate accounting policies, standards and controls for the bank and supervise compliance therewith, ○ assist the board of directors in its evaluation of the adequacy, efficiency and effectiveness of the bank's internal control systems, accounting practices, information systems and auditing processes, ○ facilitate communication between the board of directors, senior management, internal auditor and the external auditor regarding capital adequacy, risk management or any other related matters, ○ recommend to the board of directors the appointment, dismissal and compensation of external auditors, ○ provide oversight of the internal and external auditors and take appropriate measures to enhance their independence by ensuring that the auditors' report is sent directly to the Audit Committee, |

⁶⁹ The term "internal audit function" does not necessarily denote an organizational unit. Some countries allow small banks to implement a system of independent reviews, e.g. conducted by external experts, of key internal controls as an alternative.

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| | <ul style="list-style-type: none"> ○ introduce such measures as, in the Audit Committee assessment, may serve to enhance the integrity of financial statements, including appropriateness, relevance and reliability of operational control environment, financial disclosures and, in general, financial reporting, ○ review and approve the audit scope, ○ receive and review internal and external audit reports including the management letter, ensure that senior management officials take appropriate, and timely action to correct weaknesses in internal control, non-compliance with policies, laws, regulations and directions, and other problems uncovered by the auditor, ○ receive and review the audited financial statements and recommend these financial statements to the board of directors; and ○ establish procedures for confidential submissions by employees regarding inappropriate accounting and other business matters. <p>While onsite, BoB supervisors review the responsibilities assigned to each bank’s internal audit function and if those comply with the EC requirements. While offsite, if the need arises, supervisors discuss during the annual bilateral and trilateral meetings with the bank or with the bank and the external auditors respectively.</p> |
| <p>EC5</p> | <p>The supervisor determines that the internal audit function:</p> <ul style="list-style-type: none"> (a) has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing; (b) has appropriate independence with reporting lines to the bank’s Board or to an audit committee of the Board, and has status within the bank to ensure that senior management reacts to and acts upon its recommendations; (c) is kept informed in a timely manner of any material changes made to the bank’s risk management strategy, policies or processes; (d) has full access to and communication with any member of staff as well as full access to records, files or data of the bank and its affiliates, whenever relevant to the performance of its duties; (e) employs a methodology that identifies the material risks run by the bank; (f) prepares an audit plan, which is reviewed regularly, based on its own risk assessment and allocates its resources accordingly; and (g) has the authority to assess any outsourced functions. |
| <p>Description and findings re EC5</p> | <p>Please see description and finding under EC4 of this CP that describes the requirements regarding Audit Committee.</p> <p>BoB guidelines on risk management (2018) establish the following requirements, among others, pertaining to the bank’s internal audit function:</p> <ul style="list-style-type: none"> • A bank's audit and risk management committees should review the |

adequacy and effectiveness of internal control systems and means through which risk exposures are managed.

- Internal Auditors should have appropriate skills, knowledge, and authority as well as independence within a bank to ensure that senior management reacts to and acts upon their recommendations.
- Internal auditors and other risk control functions should be adequately staffed and have sufficient expertise and authority for reviewing the various risks assumed by the bank and the related risk management functions.
- A bank's internal audit function should, among other things, perform periodic checks on whether the bank's risk-management system is properly implemented and the established policies and control procedures in respect of risk management are complied with.
- Internal audits of the credit risk processes should be conducted on a periodic basis, and it should assess compliance with the bank's credit policies and procedures.
- The validation of internal credit risk assessment models should be subject to periodic review by qualified, independent individuals (e.g., internal, external auditors and bank supervisors)
- Particular attention should be drawn to irregularities in profit and loss, abnormal foreign exchange trading patterns or trends (e.g., unusually large gross positions) and frequent excesses of limits. Internal auditors should ensure that such incidents are properly followed through.
- An audit program that covers the adequacy and effectiveness of a bank's compliance function should be established, including testing of controls commensurate with the perceived level of risk.
- All aspects of reputational-risk management should be subject to an internal audit review.

Discussion with supervisors, review of public disclosures by banks and discussions with a representative sample of banks indicate that banks have set up internal audit functions that report directly to the Board Audit Committee. The commercial banks operating in Botswana that are subsidiaries of foreign banks, invariably rely on the support from group compliance and internal audit frameworks, particularly in areas where they lack local skills. BoB has been working with these banks to transfer or develop the relevant skills to local staff. Where BoB finds inadequate staffing of the internal audit function, supervisors pursue with the bank for rectification.

BoB's risk management guidelines require that banks' compliance and internal audit functions have unfettered access to information, board or sub-committees of the board; they are informed in a timely manner about any developments or changes relating to bank's strategy, policies, processes. Though BoB has not explicitly required

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| | banks to implement risk-based internal audits, supervisors informed the assessors that the internal audit plans are risk-based, based on the internal audit's grading of riskiness of the assessed function or business area, aspects such as key emerging risks, process changes, launch of new products or services, or modification of existing products, structural or functional reorganization, operational risk events and losses, and developments that could have potential impact on the banks financial statements. Since almost all banks are subsidiaries of foreign banks, they largely rely on their respective group entities for outsourcing. Banks' internal audit functions are authorized to review the services provided by the other service providers. |
| Assessment of Principle 26 | Largely compliant |
| Comments | <p>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.</p> <p>To improve compliance, BoB can 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.</p> |
| Principle 27 | Financial reporting and external audit. The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function. |
| Essential criteria | |
| EC1 | The supervisor ⁷⁰ holds the bank's Board and management responsible for ensuring that financial statements are prepared in accordance with accounting policies and practices that are widely accepted internationally and that these are supported by recordkeeping systems in order to produce adequate and reliable data. |
| Description and findings re EC1 | As per Section 18(1) of the Banking Act 1995, every bank shall keep such records in Botswana as are necessary to exhibit clearly and accurately the state of its affairs and to explain its transactions and financial position so as to enable the BoB to determine whether the bank concerned has complied with the provisions of this Act, and it shall preserve every such record for a period of at least five years as from the date of the last entry therein. |

⁷⁰ In this Essential Criterion, the supervisor is not necessarily limited to the banking supervisor. The responsibility for ensuring that financial statements are prepared in accordance with accounting policies and practices may also be vested with securities and market supervisors.

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| | <p>As per Section 18(2) of the Banking Act 1995, the Central Bank may, from time to time, issue directives as to the minimum standards applicable to the financial records referred to in subsection (1), and all banks shall comply with such directives.</p> <p>As per Section 18(3) of the Banking Act 1995, any bank that contravenes or fails to comply with the provisions of this section, or which fails to comply with any directive issued under subsection (2), shall be guilty of an offence and liable to a fine of P1000 for each day on which the offence occurs or continues to occur.</p> <p>As per Section 19(1) of the Banking Act 1995, not later than three months after the expiration of its financial year, every bank shall prepare, in respect of all business transacted by it in that year, a balance sheet and profit and loss account, as of the last working day of that year, in accordance with generally accepted accounting practices in Botswana and in such form as the BoB may approve, audited in accordance with the provisions of section 22, and under the joint signatures of the principal officer of the bank and two of its directors.</p> <p>As per Section 22(1) of the Banking Act every bank shall appoint, annually, and at its own expense, an independent auditor, acceptable to the Central Bank, who shall make a report to the bank's shareholders on the annual balance sheet and profit and loss account, in accordance with the requirements in the Companies Act relating to the auditing of company accounts, and with generally accepted accounting standards in Botswana, and such other directives and guidelines as the Central Bank may, from time to time, issue.</p> <p>In terms of section 4.4 of the BoB guidelines on Banks' audit committees, annual independent external audit and publication of audited financial statements (2009), the independent auditor shall (i) fulfil the requirements of Sections 19 and 22 of the Act; (ii) conduct the audit and prepare the audit report, audit opinion and management letter in accordance with the requirement in the Companies Act 2003 relating to the auditing of company accounts, International Financial Reporting Standards (IFRS) and International Standard on Auditing (ISA).</p> <p>Though the laws or regulations do not explicitly state that the BoB will hold the bank's board and management responsible for compliance with the above requirements established in law and regulations, it is implicit in the provisions of Section 19(1) of the Banking Act (1995). BoB supervisors informed assessors that, if there were any instance of breach of the above requirements, the BoB will hold the Board and/or senior management responsible.</p> |
| EC2 | The supervisor holds the bank's Board and management responsible for ensuring that the financial statements issued annually to the public bear an independent external auditor's opinion as a result of an audit conducted in accordance with internationally accepted auditing practices and standards. |
| Description and findings re EC2 | Please see description and finding in EC1 of this CP which explains the requirements binding on the bank's board and senior management with regards the preparation of |

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| | <p>the bank's financial statements and their audit by a qualified and professional independent external auditor as per the Companies Act, the IFRS and the ISA.</p> <p>BoB supervisors informed assessors that, if there were any instance of breach of the above requirements, the BoB will hold the Board and/or senior management responsible.</p> |
| EC3 | <p>The supervisor determines that banks use valuation practices consistent with accounting standards widely accepted internationally. The supervisor also determines that the framework, structure and processes for fair value estimation are subject to independent verification and validation, and that banks document any significant differences between the valuations used for financial reporting purposes and for regulatory purposes.</p> |
| Description and findings re EC3 | <p>Please see description and finding under EC1 of this CP that lay out that banks must comply with the IFRS while preparing their financial statements, which include IFRS 9 that lays down the requirements for recognition and measurement, impairment, de-recognition and general hedge accounting. The description also lays out that bank's financial statements must be audited by a qualified and professional independent external auditor as per the Companies Act, the IFRS and the ISA. By complying with these requirements banks ensure that their valuation practices are consistent with widely accepted accounting and auditing processes, and the fair value estimation are subject to independent verification and validation.</p> <p>Section 7.1 of BoB guidelines on Banks' audit committees, annual independent external audit and publication of audited financial statements (2009) require that each bank's statutory auditor must, as part of the statutory audit of a bank, certify that the information contained in the Statutory Returns submitted by banks to the BoB as at the end of the financial year is in agreement with the audited books of accounts. This provides assurance to the BoB about the consistency of the valuation practices followed by banks for accounting and regulatory reporting.</p> |
| EC4 | <p>Laws or regulations set, or the supervisor has the power to establish the scope of external audits of banks and the standards to be followed in performing such audits. These require the use of a risk and materiality-based approach in planning and performing the external audit.</p> |
| Description and findings re EC4 | <p>As per Section 22(6) of the Banking Act the BoB may impose all or any of the following additional duties on a bank's independent external auditor: (a) a duty to submit such additional information in relation to the financial audit as the BoB considers necessary, (b) a duty to carry out any other investigation or establish any procedure in any particular case, and (c) a duty to submit a report on any of the matters referred to in (a) and (b), and the bank concerned shall remunerate the auditor in respect of the discharge by the auditor of all or any of these additional duties.</p> <p>In terms of the above, BoB has required the external auditors of all banks to review and certify the statutory regulatory reports submitted by banks and their Pillar 3 disclosures each year, in addition to the conduct of the financial audit.</p> |

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| | As described above under EC1 and EC2, the tasks to be performed by the external auditor shall follow the IFRS and ISA, which require the use of risk and materiality-based approach in performing the tasks assigned to them. |
| EC5 | Supervisory guidelines or local auditing standards determine that audits cover areas such as the loan portfolio, loan loss provisions, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitizations, consolidation of and other involvement with off-balance sheet vehicles and the adequacy of internal controls over financial reporting. |
| Description and findings re EC5 | <p>Please see description and finding under ECs 1, 2 and 4 of this CP. As explained there, banks in Botswana are complying with the IFRS requirements, and the independent external audits in banks are conducted in accordance with the ISAs. The BAOA, the independent oversight authority, verifies compliance with the above, and enforces compliance. Thus, bank audits in Botswana cover the specific areas identified in the EC and more.</p> <p>Section 4.8 of BoB guidelines on Banks' audit committees, annual independent external audit and publication of audited financial statements (2009) requires each bank to submit to BoB the following within 15 days from the date that its year-end audited financial statements have been prepared: the audit report, audit opinion, management letter and other documents required under Sections 19 and 22 of the Banking Act (1995).</p> <p>The management letter is separate from the audit opinion contained in the audit report, is addressed to the management of the bank and discloses weaknesses and the limitations found in the internal control structure and operating procedures of the bank. The management letter, among others, (i) provides comments and observations on the accounting records, operating systems, and internal controls that were examined during the audit; and (ii) identifies specific deficiencies and areas of weaknesses in operating systems and internal controls and makes recommendations for their improvement.</p> |
| EC6 | The supervisor has the power to reject and rescind the appointment of an external auditor who is deemed to have inadequate expertise or independence, or is not subject to or does not adhere to established professional standards. |
| Description and findings re EC6 | <p>As per Section 22(1) of the Banking Act every bank shall appoint, annually, and at its own expense, an independent auditor, acceptable to the Central Bank.</p> <p>Sections 4.2 and 4.3 of BoB guidelines on Banks' audit committees, annual independent external audit and publication of audited financial statements (2009) lay down that the independent external auditor must be professionally qualified and acceptable to the BoB. Among others, the auditor must:</p> <ul style="list-style-type: none"> (i) be a member of the Botswana Institute of Accountants (BIA) and/or equivalent body and in good standing, (ii) have relevant professional experience and competence, |

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| | <p>(iii) be subject to a quality assurance program by BIA,</p> <p>(iv) demonstrate objectivity and impartiality,</p> <p>(v) comply with ethical standards for auditing and the “Code of Ethics for Professional Accountants” of the BIA and International Federation of Accountants, and</p> <p>(vi) not have any interest in the bank other than as a depositor or borrower in the ordinary course of business. The guidelines also specify persons that are not qualified for appointment as independent auditor of a bank.</p> <p>In addition, BoB has the power under the Banking Act section 22(4) to appoint an auditor if a bank fails to appoint an auditor in accordance with section 22(1), or if the BoB is not satisfied with the report of the auditor appointed by the bank.</p> <p>Laws or regulations do not explicitly empower BoB 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.</p> |
| EC7 | The supervisor determines that banks rotate their external auditors (either the firm or individuals within the firm) from time to time. |
| Description and findings re EC7 | Section 4.5 of BoB guidelines on banks’ audit committee, annual independent external audit and publication of audited financial statements (2009) requires banks to rotate their lead external auditor or coordinating partner or the partner responsible for reviewing the audit after every five years. The BoB would not approve the appointment of the auditor until this is complied with. |
| EC8 | The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations. |
| Description and findings re EC8 | <p>Sec 22(8) of the Banking Act (1995) and section 6.1 of BoB guidelines on banks’ audit committee, annual independent external audit and publication of audited financial statements (2009) provide that the BoB shall arrange a trilateral meeting with officials from each bank and the independent auditor for that bank to discuss matters relevant to the BoB’s supervisory responsibilities, which would have arisen in the course of the annual independent audit of the bank. The main topics discussed during the trilateral meetings include (i) relevant aspects of the bank’s business; accounting and internal control systems, and annual balance sheet and profit and loss statement; (ii) major auditing issues, appropriate accounting policies, current accounting problems, new instruments, products and transactions, financial innovations, etc.; and (iii) other issues of mutual concern.</p> <p>Section 22(9) of Banking Act (1995) and section 6.3 of BoB guidelines on banks’ audit committee, annual independent external audit and publication of audited financial statements (2009) provide that the BoB may, if it considers it desirable or necessary in the interests of depositors, from time to time arrange bilateral meetings with auditors of banks. The main topics discussed during the bilateral meetings include (i) the audit strategy, the main audit matters and issues raised in the management letter, (ii) the bank’s risk profile (corporate governance, risk management strategies and compliance</p> |

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| | <p>matters), (iii) updates on auditing and accounting standards, and (iv) updates on supervisory developments.</p> <p>BoB holds these bilateral and trilateral meetings annually.</p> |
| EC9 | <p>The supervisor requires the external auditor, directly or through the bank, to report to the supervisor matters of material significance, for example failure to comply with the licensing criteria or breaches of banking or other laws, significant deficiencies and control weaknesses in the bank's financial reporting process or other matters that they believe are likely to be of material significance to the functions of the supervisor. Laws or regulations provide that auditors who make any such reports in good faith cannot be held liable for breach of a duty of confidentiality.</p> |
| Description and findings re EC9 | <p>Section 22(7) of the Banking Act (1995) requires that the external auditor shall report to the BoB, and the BoB shall thereafter take all necessary actions pursuant to this Act if an auditor, in the course of the performance of his duties as auditor of a bank, is satisfied that-</p> <p>(a) there has been a serious breach of, or non-compliance with, the provisions of the Banking Act, the Bank of Botswana Act, the Companies Act, or any regulations issued under those Acts, or any directions or guidelines issued by the BoB,</p> <p>(b) a criminal offence involving fraud or other dishonesty has been committed,</p> <p>(c) losses have been incurred which reduce the paid-up capital of the bank by fifty per cent or more,</p> <p>(d) serious irregularities have occurred in the affairs of the bank, particularly such irregularities that jeopardize the security of depositors and creditors, or the auditor is unable to confirm that the claims of depositors and creditors are still covered by the assets of the bank.</p> <p>Sec 22(10) of the Banking Act (1995) lays down that no duty of confidentiality to which an auditor may be subject shall be regarded as contravened by reason of the auditor's communication, in good faith, to the BoB, whether or not in response to a request made by it, any information or opinion which is relevant to the BoB's functions under the Banking Act (1995).</p> |
| Additional criteria | |
| AC1 | <p>The supervisor has the power to access external auditors' working papers, where necessary.</p> |
| Description and findings re AC1 | <p>Laws or BoB regulations do not explicitly provide that BoB shall have access to the external auditors' working papers. BoB supervisors have also not felt the need to seek access to auditors' working papers.</p> |
| Assessment of Principle 27 | Compliant |
| Comments | <p>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.</p> |

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| | To further improve compliance with the essential criteria and the additional criterion, BoB should 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 | Disclosure and transparency. The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes. |
| Essential criteria | |
| EC1 | Laws, regulations or the supervisor require periodic public disclosures ⁷¹ of information by banks on a consolidated and, where appropriate, solo basis that adequately reflect the bank's true financial condition and performance, and adhere to standards promoting comparability, relevance, reliability and timeliness of the information disclosed. |
| Description and findings re EC1 | <p>Section 19 (2) of the Banking Act 1995 and Section 5 of the BoB guidelines on Banks' audit committees, annual independent external audit and publication of audited financial statements (2009) require every bank to (i) send copies of its audited statement of financial position and statement of income, on both an individual and consolidated basis as applicable, and an audit opinion to the BoB, (ii) publish these in at least two newspapers of general circulation in Botswana, and (iii) exhibit these in each place of business in Botswana, excluding mobile sites within 15 days from the date that its year-end audited financial statements have been prepared, but not later than the 15th day of the 4th month following a bank's financial year-end (after receiving consent from the BoB). Banks must always display these throughout the year in a conspicuous position in each of the bank's places of business in Botswana. As mentioned in EC1, CP27, these financial statements must be prepared in compliance with the IFRS, and audited in compliance with the ISA.</p> <p>In addition to the above, banks are also required to make periodic public disclosures under Pillar 3 of the capital adequacy requirements. BoB guidelines on the revised international convergence of capital measurement and capital standards for Botswana (Basel II) (2015) require banks to publish the Pillar 3 disclosures in the prescribed formats on their publicly accessible website as well as in their published financial statements. (S 12.8) The Pillar 3 disclosures set out by the BoB should be made on an annual basis, except for regulatory capital disclosures which must be disclosed on a quarterly basis. This notwithstanding, any material changes of information on risk exposures or other items prone to rapid change, must be disclosed in the interim. The main areas of Pillar 3 disclosures include regulatory capital requirements, risk</p> |

⁷¹ For the purposes of this Essential Criterion, the disclosure requirement may be found in applicable accounting, stock exchange listing, or other similar rules, instead of or in addition to directives issued by the supervisor.

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| | management processes, remuneration, scope of application of capital requirements, Common equity Tier 1 instruments and reserves, main features of capital instruments, capital adequacy, credit risk – general disclosures, credit risk – standardized approach disclosures, credit risk mitigation disclosures for standardized approach, general disclosures for exposures related to counterparty credit risk, market risk disclosures for banks using standardized approach, operational risk, equity disclosures for banking book, and interest rate risk in the banking book. |
| EC2 | The supervisor determines that the required disclosures include both qualitative and quantitative information on a bank's financial performance, financial position, risk management strategies and practices, risk exposures, aggregate exposures to related parties, transactions with related parties, accounting policies, and basic business, management, governance and remuneration. The scope and content of information provided and the level of disaggregation and detail is commensurate with the risk profile and systemic importance of the bank. |
| Description and findings re EC2 | <p>As mentioned in EC1, CP27, banks' financial statements must be prepared in compliance with the IFRS, and audited in compliance with the ISA. Accordingly, banks in Botswana comply with disclosures required under IFRS 7 (Financial Instruments: Disclosures), IFRS 12 (Disclosure of Interests in Other Entities) and BoB's Pillar 3 of Basel II. These disclosures include qualitative and quantitative information on the areas specified in the EC and are commensurate with the risk profile and systemic importance.</p> <p>The disclosure templates prescribed by BoB require banks to disclose their risk management strategies and processes for managing risks, the structure and organization of the relevant risk management function, including the title or position of Board and senior management official that oversees risk management, Additional Pillar III disclosure requirements on remuneration cover the main components of sound compensation practices, and the governance and committee structures. In the absence of explicit BoB disclosure requirements regarding corporate governance policies and processes and related party transactions, bank disclosures are determined by the requirements established under the accounting standards. With the implementation of the recommendations under CP 14 (Corporate governance) and CP 20 (Related party transactions), BoB can consider establishing explicit disclosure requirements in these two areas that reflect prudential requirements and expectations.</p> |
| EC3 | Laws, regulations or the supervisor require banks to disclose all material entities in the group structure. |
| Description and findings re EC3 | As mentioned above (EC2), banks in Botswana are required to comply with IFRS 12, where the objective is to require the disclosure of information that enables users of financial statements to evaluate (i) the nature of, and risks associated with, its interests in other entities, and (ii) the effects of those interests on its financial position, financial performance and cash flows. IFRS 12 is required to be applied by an entity that has an interest in any of the following, namely, subsidiaries, joint arrangements (joint operations or joint ventures), associates and unconsolidated structured entities. |

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| EC4 | The supervisor or another government agency effectively reviews and enforces compliance with disclosure standards. |
| Description and findings re EC4 | <p>Botswana Accountancy Oversight Authority (BAOA) reviews and enforces compliance with accounting standards, and the BoB reviews and enforces disclosures required by the Banking Law, BoB's directives, guidelines and circulars, including the Pillar 3 disclosures and the disclosure of audited financial statements and auditors' opinion. BoB has a memorandum of understanding (MoU) with BAOA, that includes cooperation, coordination, and exchange of information.</p> <p>Banks external auditors are required to review and certify banks' Pillar 3 disclosures, which provides additional assurance about the consistency and credibility of the Pillar 3 disclosures.</p> |
| EC5 | The supervisor or other relevant bodies regularly publishes information on the banking system in aggregate to facilitate public understanding of the banking system and the exercise of market discipline. Such information includes aggregate data on balance sheet indicators and statistical parameters that reflect the principal aspects of banks' operations (balance sheet structure, capital ratios, income earning capacity, and risk profiles). |
| Description and findings re EC5 | <p>BoB regularly publishes every month financial statistics (Botswana Financial Statistics) on the banking sector based on the statutory returns received from each bank. This is the principal vehicle for disseminating aggregate data to the public on several items including assets, liabilities, off-balance sheet items, income and expenses, liquid assets, reserves, deposits (by type, by holder, foreign currency deposits), loans and advances (by maturity, by interest rates, by economic sector, in arrears), and liquid assets ratio. These are available on the BoB's website.</p> <p>BoB also publishes the aggregate financial performance and conditions of the banking industry annually through the Banking Supervision Report, which is also available on BoB's website.</p> |
| Additional criteria | |
| AC1 | The disclosure requirements imposed promote disclosure of information that will help in understanding a bank's risk exposures during a financial reporting period, for example on average exposures or turnover during the reporting period. |
| Description and findings re AC1 | <p>Please see description and finding re ECs 1 and 2 above on the disclosure requirements for banks.</p> <p>Bank's public disclosures are usually annual as part of the financial statements in conformity with the IFRS which require qualitative and quantitative disclosures on a bank's financial performance and financial position, the nature and extent of risks to which the entity is exposed at the reporting date, and how the entity manages those risks.</p> <p>Banks' quantitative disclosures in public domain provide a point in time perspective. Disclosure requirements under law, regulations or accounting standards do not</p> |

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| | explicitly require banks to disclose data on average exposures or turnover during a financial reporting period. |
| Assessment of Principle 28 | Compliant |
| Comments | <p>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.</p> <p>To achieve compliance with the additional criterion, BoB can review and revise laws and regulations to promote disclosure of average exposures or turnover during the reporting period or other information that will help in understanding a bank's risk exposures during a financial reporting period.</p> <p>To supplement the disclosures under the accounting standards, with the implementation of the recommendations under CP 14 (Corporate governance) and CP 21 (Related party transactions), BoB can consider establishing explicit disclosure requirements in these two areas that reflect prudential requirements and expectations.</p> |
| Principle 29 | Abuse of financial services. The supervisor determines that banks have adequate policies and processes, including strict customer due diligence (CDD) rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities. ⁷² |
| Essential criteria | |
| EC1 | Laws or regulations establish the duties, responsibilities and powers of the supervisor related to the supervision of banks' internal controls and enforcement of the relevant laws and regulations regarding criminal activities. |
| Description and findings re EC1 | <p>The BoB, as a supervisory authority for banks, bureau de change, money and value transfer services and electronic payment system, is required to regulate and supervise the institutions for compliance with the Financial Intelligence Act (FI Act), including through on-site inspections (see Section 49(1)(b)). The FI Act (and its Regulations) is the main piece of legislation setting out anti-money laundering and countering the financing of terrorism (AML/CFT). Banks and other specified entities in the FI Act are obliged to comply with the Act. The Financial Intelligence Act, 2022, (FI Act) prescribes customer due diligence rules. Section 14 and 16 requires banks to implement and maintain a customer acceptance policy, internal rules, programs, policies, processes, procedures to protect its system from financial offences and conduct customer due diligence.</p> <p>Additionally, the BoB has issued the following Guidelines to the industry:</p> |

⁷² The Committee is aware that, in some jurisdictions, other authorities, such as a financial intelligence unit (FIU), rather than a banking supervisor, may have primary responsibility for assessing compliance with laws and regulations regarding criminal activities in banks, such as fraud, money laundering and the financing of terrorism. Thus, in the context of this Principle, "the supervisor" might refer to such other authorities, in particular in Essential Criteria 7, 8 and 10. In such jurisdictions, the banking supervisor cooperates with such authorities to achieve adherence with the criteria mentioned in this Principle.

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| | <ul style="list-style-type: none"> (a) Guidelines on Identification, Monitoring and Reporting of Suspicious Transactions. (b) Guidelines on Identification of Beneficial Owners of Legal Persons and Arrangements (c) Guidance for Specified Parties and Accountable Institutions in Detecting Terrorist Financing (FIA). (d) Trend Report and Study on Cross-Border Cash Declarations in Botswana (FIA) <p>The BoB supervises its entities to ensure that they comply with the FI Act. The FI Act requires institutions to identify customers (Section 16 and 20), conduct enhanced due diligence (Section 21, 22, 23), conduct ongoing monitoring (Section 19). To discharge its supervision responsibilities, the BoB undertakes onsite and offsite supervision. The analysis is used to make assessments of the effectiveness of banks' internal controls as per requirements set out in the FI Act. Section 49 (1) (e) sets out the requirements for the BoB to supervise bank's and conduct risk-based AML/CFT of entities they supervise; in that regard, the BoB conducts on-site inspections of its supervised entities to determine that they have adequate AML/CFT policies and processes that are commensurate with the money laundering and terrorist financing risks within an entity.</p> |
| <p>EC2</p> | <p>The supervisor determines that banks have adequate policies and processes that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, for criminal activities. This includes the prevention and detection of criminal activity, and reporting of such suspected activities to the appropriate authorities.</p> |
| <p>Description and findings re EC2</p> | <p>The FIA Act sets out banks' obligations to have policies and processes to prevent financial crime, including:</p> <ul style="list-style-type: none"> - Section 38 of the FIA requires entities to report suspicious transactions to the Financial Intelligence Agency (FIA) – (STRs). The FIA is the central entity responsible for requesting, receiving, analyzing and disseminating to an investigatory authority, supervisory authority or competent authority, disclosures of financial information concerning suspicious transactions. - Section 29 requires entities to monitor complex transactions, unusual transactions or unusual pattern of transactions that have no apparent or economic purposes. - Section 30 requires entities to terminate an existing business relationship with a customer where an entity is unable to conclude a transaction or obtain customer due diligence information. An entity that terminates a relationship shall report such business relationship to FIA. |

- Section 14 of the FI Act requires entities to designate a compliance officer. The compliance officer designated under subsection shall — (a) be a fit and proper person; (b) not have been convicted of a serious offence in Botswana; (c) not have been convicted outside Botswana of a serious offence, which, if committed in Botswana would have been a serious offence; (d) not be an unrehabilitated insolvent; (e) not be the subject of an investigation by a supervisory authority or an investigatory authority; and (f) not have been a person holding a senior management position in a company which is disqualified from trading by a professional body or supervisory authority.

The BoB undertakes a range of supervisory activities throughout the supervisory cycle that include risks associated with AML/CFT (see also CPs 8 & 9 for a description of BoB's supervisory tools, techniques and approaches). A dedicated team within the BoB BSD consisting of four staff, undertaken onsite and offsite analysis of bank compliance with AML/CFT obligations as stated in the FI Act. Offsite involves analysis of data submitted by banks. Onsite examinations are conducted to assess bank's policies and processes, risk management and verify the effectiveness of the control environment.

Following an on-site inspection, the BoB makes recommendations on deficiencies identified. The BoB require banks to report quarterly remediation of issues identified during the onsite. To complement onsite and the subsequent follow-up, the BoB receives AML/CFT data from banks in June and December. The information is used for purposes of assessing money laundering and terrorist financing risks in the institutions supervised by bank. It is also used for purposes of identifying banks to conduct an onsite examination.

In order to enhance the risk-based AML/CFT supervisory process, the BoB is developing an AML/CFT supervisory model/tool to operate as an early warning system. The tool aims to identify which banks have the highest ML/TF risks and areas that require immediate action. The results also act an early warning system, which will allow the BoB to take proactive measures where identified risks are higher. In addition, the off-site analysis will inform the scope of an on-site examination by identifying the most relevant and prioritized risk areas that should be examined. The tool is yet to be fully implemented.

To achieve the above, the AML/CFT data-gathering template is being developed and implemented to be used for collecting financial data from financial institutions supervised by banks. The data gathering template has been designed to take into account all the elements required for developing an understanding of the inherent risk of money laundering and terrorist financing (ML/TF) in an institution. The information requested covers customer base, products and services, delivery channels, and business activities taking into consideration the geographic location (i.e., branch network). Therefore, the information requested from banks, through the template,

includes customer deposits by type, risk profile, business type, business or economic activity and residence status. The template also requests credit information and other banking products, and services such as wire transfers, remittances and prepaid cards. Financial institutions submit the required information twice in a year.

The information submitted by institutions is captured in the risk-based model (risk matrix) (sample attached) which is used for the identification, measurement, and monitoring of ML/TF risks for the institutions. The risk matrix provides the basis for the development of institutional risk profiles in accordance with the exposure to potential ML/TF risks; the development of supervisory strategies; the formulation of the annual program of inspections; and the allocation of supervisory resources. The matrix has been developed using a three-component model:

- (a) structural factors,
- (b) business factors, and
- (c) internal controls.

Structural factor is a category that captures non-business sources of ML/TF risks. In the context of Botswana banking sector, for structural factors the following elements are taken into consideration: (i) size of a bank (total assets); (ii) corporate ownership; (iii) holding company location; (iv) branch network; (v) customer risk categories; and (vi) turnover in key positions. A relative weight is assigned to each of them.

Business factors is a category that captures the four traditional sources of well-identified ML/TF risks by international standards– type of costumers, products and services, geographic location, and delivery channels. A relative weight is assigned to each of them. The current working model comprises core banking and other exposures.

1. Core banking includes deposits and credits while other banking exposure includes wire transfers, foreign exchange, prepaid cards and mobile banking.
2. The risk of non-compliance is assessed during the AML/CFT on-site examination. The full-scope examination covers all the AML/CFT requirements and compliance with the Financial Intelligence Act.

Given the above the BoB reviews the institutions' ML/TF risk profile, periodically (twice a year) and assesses risks of non-compliance during on-site examinations. The on-site examinations are informed by risks identified in the AML/CFT Risk-based tool which is updated twice a year; as well as when there are major events in the operations of the financial institution.

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| EC3 | In addition to reporting to the financial intelligence unit or other designated authorities, banks report to the banking supervisor suspicious activities and incidents of fraud when such activities/incidents are material to the safety, soundness or reputation of the bank. ⁷³ |
| Description and findings re EC3 | <p>In accordance with Section 6 of the FI Act, STRs are filed with FIA, for analyzing and disseminating to an investigatory authority or supervisory authority. The FIA implemented an automatic system for bank reporting of large transactions and STRs – goAML.</p> <p>In the case of banks licensed and regulated by the BoB, STRs are transmitted from the banks to the FIA and in turn to the BoB. Therefore, the BoB does not receive any reporting of suspicious transactions from the entities; however, FIA, can disseminate any suspicious transactions to the BoB where such activities are material to the safety, soundness or reputation of an institution.</p> <p>STRs are submitted to the BoB on a semi-annual basis. The mission saw example of the reporting and the number of STRs appeared low compared with the size, scale and risk profile.</p> <p>To facilitate the transmittal of reporting between the BoB and FIA, a memorandum of understanding has been signed for cooperation and coordination domestically with each other concerning the development and implementation of AML/CFT policies.</p> <p>Banks are expected to conduct ongoing monitoring and review of transactions to be able to identify suspicious transactions. All suspicious transactions are to be reported to FIA through the go-AML reporting system or using a prescribed form. Guidance has been provided to banks through the Guideline on Identification, Monitoring and Reporting of Suspicious Transactions for the implementation of Section 38 of the FI Act.</p> |
| EC4 | If the supervisor becomes aware of any additional suspicious transactions, it informs the financial intelligence unit and, if applicable, other designated authority of such transactions. In addition, the supervisor, directly or indirectly, shares information related to suspected or actual criminal activities with relevant authorities. |
| Description and findings re EC4 | <p>In the first instance, STRs are reported by banks to the FIA (see EC3). The reporting of STRs to the BoB is semi-annual.</p> <p>Through the on-site inspection process, BoB will assess whether processes are in place to prevent and detect STRs. The FIA will not typically inform the BoB immediately.</p> |

⁷³ Consistent with international standards, banks are to report suspicious activities involving cases of potential money laundering and the financing of terrorism to the relevant national center, established either as an independent governmental authority or within an existing authority or authorities that serves as an FIU.

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| | The second step of the onsite examination is to determine whether a bank has identified all reportable suspicious activities, if not, the bank is directed to report such a transaction to FIA. |
| EC5 | <p>The supervisor determines that banks establish CDD policies and processes that are well documented and communicated to all relevant staff. The supervisor also determines that such policies and processes are integrated into the bank's overall risk management and there are appropriate steps to identify, assess, monitor, manage and mitigate risks of money laundering and the financing of terrorism with respect to customers, countries and regions, as well as to products, services, transactions and delivery channels on an ongoing basis. The CDD management program, on a group-wide basis, has as its essential elements:</p> <ul style="list-style-type: none"> (a) a customer acceptance policy that identifies business relationships that the bank will not accept based on identified risks; (b) a customer identification, verification and due diligence program on an ongoing basis; this encompasses verification of beneficial ownership, understanding the purpose and nature of the business relationship, and risk-based reviews to ensure that records are updated and relevant; (c) policies and processes to monitor and recognize unusual or potentially suspicious transactions; (d) enhanced due diligence on high-risk accounts (e.g., escalation to the bank's senior management level of decisions on entering into business relationships with these accounts or maintaining such relationships when an existing relationship becomes high-risk); (e) enhanced due diligence on politically exposed persons (including, among other things, escalation to the bank's senior management level of decisions on entering into business relationships with these persons); and (f) clear rules on what records must be kept on CDD and individual transactions and their retention period. Such records have at least a five-year retention period. |
| Description and findings re EC5 | <p>The obligation for banks to develop and implement CDD policies is stipulated in the FIA. The BoB will assess the adequacy of those policies and the effective implementation of those policies, which is undertaken during an onsite examination. In relation to EC5 we address each point:</p> <ul style="list-style-type: none"> (a) a customer acceptance policy that identifies business relationships that the bank will not accept based on identified risks – Institutions are required to implement and maintain a customer acceptance policy, internal rules, program, policies, processes, procedures or such controls as may be prescribed to protect its system from financial offences (Section 14 (1)(e). (b) a customer identification, verification and due diligence program on an ongoing basis - Section 16 and 20 of the FI Act deal with customer identification, |

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| | <p>verification and due diligence program, Section 19 deals with duty to conduct ongoing customer due diligence.</p> <p>Section 16 – An institution shall conduct customer due diligence measures — (a) when establishing a business relationship with a customer; (b) carrying out an occasional transaction equal to or in excess of the prescribed amount; (c) when carrying out a transaction or occasional transaction equal to or in excess of the prescribed amount on behalf or on the instruction of a customer or any person, whether conducted as a single transaction or several transactions that appear to be linked; (d) when carrying out a domestic or international wire transfer; (e) when there is doubt about the veracity or adequacy of previously obtained customer identification data; and (f) where there is suspicion of the commission of a financial offence.</p> <p>(1) An institution shall, in complying with the requirements to conduct customer due diligence measures, ensure that the extent of the measures taken reflect (a) the risk assessment carried out by the bank; and (b) its assessment of risk arising in any particular case.</p> <p>Section 20 – An institution shall, where required to conduct customer due diligence when establishing a business relationship or carrying out a transaction establish and verify the identity of a customer, unless the identity of that customer is known and has been verified by the specified party; establish and verify the identity of the beneficial owner; collect information to enable understanding of the anticipated purpose and intended nature of the business relationship or transaction; and obtain approval of senior management where the business relationship or transaction is established in a high risk jurisdiction or involves a high risk business.</p> <p>Section 19 – An institution shall, on an ongoing basis, conduct customer due diligence with respect to an existing business relationship which is subject to the requirements of customer identification and verification, including periodic review of accounts to maintain current information and records relating to the customer and beneficial owners</p> <p>(c) policies and processes to monitor and recognize unusual or potentially suspicious transactions - Section 38 requires entities to report suspicious transactions to the Financial Intelligence Agency (FIA). The FIA is the central entity responsible for requesting, receiving, analyzing and disseminating to an investigatory authority, supervisory authority or competent authority, disclosures of financial information concerning suspicious transactions.</p> <p>(d) enhanced due diligence on high-risk accounts (e.g. escalation to the bank’s senior management level of decisions on entering into business relationships with these accounts or maintaining such relationships when an existing relationship</p> |
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| | <p>becomes high-risk) – Section 21, 22, 23, and 24 requires entities to conduct enhanced due diligence where a bank has identified through its risk assessment that a customer is a high risk, for any business relationship or relationship or transaction established in high risk jurisdiction or at the instance of an international organization, for prominent influential person</p> <p>(e) enhanced due diligence on politically exposed persons (including, among other things, escalation to the bank’s senior management level of decisions on entering into business relationships with these persons) - Where a specified party determines, in accordance with its risk management systems and compliance program, that a customer with whom it engages to establish a business relationship or the beneficial owner of that customer is a prominent influential person, the institution shall —</p> <ul style="list-style-type: none"> • obtain senior management approval before establishing the business relationship; • take reasonable measures to establish the source of wealth and source of funds of a customer and beneficial owner identified as a prominent influential person; and • conduct enhanced ongoing monitoring of the business relationship. <p>(f) clear rules on what records must be kept on CDD and individual transactions and their retention period-Such records have at least a five-year retention period – Section 31 requires entities to maintain records obtained through customer due diligence measures, accounts files and business correspondence and results of any analysis undertaken. Records kept in terms of subsection (1) may be kept in electronic form.</p> |
| <p>EC6</p> | <p>The supervisor determines that banks have in addition to normal due diligence, specific policies and processes regarding correspondent banking. Such policies and processes include:</p> <p>(a) gathering sufficient information about their respondent banks to understand fully the nature of their business and customer base, and how they are supervised; and</p> <p>(b) not establishing or continuing correspondent relationships with those that do not have adequate controls against criminal activities or that are not effectively supervised by the relevant authorities, or with those banks that are considered to be shell banks.</p> |
| <p>Description and findings re EC6</p> | <p>Section 24 of the FI Act provides requirements for financial institutions that provides cross-border correspondent banking services. Specifically in relation to cross-border correspondent banking arrangements the Act requires the following:</p> |

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| | <p>(1) A financial institution that provides cross-border correspondent banking services shall, in addition to measures required under section 20 —</p> <p>(a) gather sufficient information about a respondent bank to understand the nature of the respondent's bank business</p> <p>(b) determine, from publicly available information from credible sources, the reputation of the respondent bank it proposes to enter into a correspondent banking relationship with, including:</p> <p>(i) the quality of supervision to which the respondent bank is subject, and</p> <p>(ii) whether the respondent bank has been subject to an investigation with respect to the commission of a financial offence, or regulatory action for non-compliance with counter financial offence measures;</p> <p>(c) assess the respondent institution's counter financial offence controls;</p> <p>(d) be satisfied that the respondent bank has conducted customer due diligence on the customers having direct access to accounts of the correspondent financial institution;</p> <p>(e) be satisfied that a respondent bank does not permit its accounts to be used by a shell financial institution.</p> <p>Section 26 of the FI Act prohibits banks from establishing or maintaining accounts with a shell bank.</p> <p>The BoB examines the nature and adequacy of bank policies during the onsite examination.</p> |
| EC7 | The supervisor determines that banks have sufficient controls and systems to prevent, identify and report potential abuses of financial services, including money laundering and the financing of terrorism. |
| Description and findings re EC7 | <p>During an on-site inspection, the supervisor determines if an institution has sufficient controls and systems to identify, monitor and report suspicious transactions.</p> <p>The Bank issued guidelines on identification, monitoring and reporting of suspicious transaction to provide guidance to banks for implementation of section of the FI Act, which requires banks to report suspicious transactions to FIA.</p> |
| EC8 | The supervisor has adequate powers to take action against a bank that does not comply with its obligations related to relevant laws and regulations regarding criminal activities. |
| Description and findings re EC8 | <p>The FI Act provides a range of criminal, civil and administrative sanctions, that deal with natural or legal persons that fail to comply with requirements of the FI Act. Administrative sanctions are imposed by the supervisor.</p> <p>There is one case at Directorate of Public Prosecution STATE V CARTER MORUPISI. The case is set for judgement on October 31, 2022</p> |

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| EC9 | <p>The supervisor determines that banks have:</p> <ul style="list-style-type: none"> (a) requirements for internal audit and/or external experts⁷⁴ to independently evaluate the relevant risk management policies, processes and controls. The supervisor has access to their reports; (b) established policies and processes to designate compliance officers at the banks' management level, and appoint a relevant dedicated officer to whom potential abuses of the banks' financial services (including suspicious transactions) are reported; (c) adequate screening policies and processes to ensure high ethical and professional standards when hiring staff; or when entering into an agency or outsourcing relationship; and (d) ongoing training programs for their staff, including on CDD and methods to monitor and detect criminal and suspicious activities. |
| Description and findings re EC9 | <p>(a) Requirements for internal audit - Section 14(1) (d) of the FI Act requires the development and maintenance of independent audit function to evaluate any policies, processes to ensure compliance with Act.</p> <p>(b) Requirements for compliance officers - Section 14 (1) (a) of the FI Act requires banks to designate an anti-money laundering and counter financing of terrorism compliance officer, at management level, who will be in charge of the implementation of internal programs and procedures, including maintenance of records and reporting of suspicious transactions, and ensure that the compliance officer has at all times, timely access to customer identification data, transaction records and other relevant information.</p> <p>(c) Requirements for screening of employees - Section 14(1) (b) of the FI Act requires banks to establish procedures to ensure high standards of integrity of employees and a system to evaluate the personal, employment and financial history when hiring employees.</p> <p>(d) Requirements on staff training – Section 14(1)(c) requires banks to maintain on-going employee training program with regard to the specified party's obligations under the FI Act.</p> |
| EC10 | <p>The supervisor determines that banks have and follow clear policies and processes for staff to report any problems related to the abuse of the banks' financial services to either local management or the relevant dedicated officer or to both. The supervisor</p> |

⁷⁴ These could be external auditors or other qualified parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions.

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| | also determines that banks have and utilize adequate management information systems to provide the banks' Boards, management and the dedicated officers with timely and appropriate information on such activities. |
| Description and findings re EC10 | <p>The FIA Act requires banks to appoint a staff member responsible for coordinating the identification of suspicious transactions and fulfilling reporting obligations typically referred to as the Money Laundering Management Officer (MLRO). During an on-site inspection, the supervisor determines that banks have and follow clear policies and processes for staff to report suspicious transactions to the Money Laundering Reporting Officer, who analyses the reports and submits to the FIA, where relevant.</p> <p>The Bank issued guidelines on identification, monitoring and reporting of suspicious transaction to provide guidance to banks for implementation of section of the FI Act, which requires banks to report suspicious transactions to FIA. The guideline at paragraph 3.19 requires a bank to have a monitoring system that detects unusual or suspicious transactions or patterns of activity. The system should be commensurate with the size, activities and complexity of the business activities.</p> <p>During an onsite examination, the Bank assess whether institutions have adequate MIS, including the system used for monitoring suspicious transactions, sanctions screening systems, CDD systems, and others.</p> |
| EC11 | Laws provide that a member of a bank's staff who reports suspicious activity in good faith either internally or directly to the relevant authority cannot be held liable. |
| Description and findings re EC11 | <p>In accordance with Section 47(1) of the FI Act - any civil or criminal proceedings shall not lie against any person for having reported in good faith, any suspicions he or she may have had, whether or not the suspicion proves to be well founded following investigations.</p> <p>In terms of Section 47(2), no evidence concerning the identity of a person who has made, initiated, or contributed to a report or has furnished additional information concerning suspicious transactions shall be admissible as evidence in proceedings before court unless the person testifies at the proceedings.</p> |
| EC12 | The supervisor, directly or indirectly, cooperates with the relevant domestic and foreign financial sector supervisory authorities or shares with them information related to suspected or actual criminal activities where this information is for supervisory purposes. |
| Description and findings re EC12 | Section 43(10) of the Banking Act requires the Central Bank to disclose information to a central bank in a foreign country for purposes of assisting in exercising functions corresponding to those of a central bank. Furthermore, the BoB has signed memorandum of understanding (MOU) with other central banks or supervisory authorities which holds majority shares in banks in Botswana. Sharing of information relating financial activities is prescribe in the MOU. |

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| | BoB has also signed an MOU with the Non-Bank Financial Institutions Regulatory Authority and the Financial Intelligence Agency to enable exchange of information relating to financial crime, among others. |
| EC13 | Unless done by another authority, the supervisor has in-house resources with specialist expertise for addressing criminal activities. In this case, the supervisor regularly provides information on risks of money laundering and the financing of terrorism to the banks. |
| Description and findings re EC13 | <p>BoB has a dedicated unit within the Banking Supervision Department that deals with supervision of AML/CFT in the banking sector. The Unit has a staff compliment of four technical staff reporting to a Deputy Director. Staff have extensively been trained on AML/CFT issues, to enable them to conduct AML/CFT supervision.</p> <p>The FIA does trends reports, providing information on risks of money laundering and terrorist financing and shares the reports with the supervisor (the Bank); the report is cascaded to banks for their information.</p> <p>To assist institutions with their obligations of AML/CFT issues, the Bank has issued the following Guidelines to the industry:</p> <ul style="list-style-type: none"> a) Guidelines on Monitoring and Reporting of Suspicious Transactions; and b) Guidelines on Identification of Beneficial Owners of Legal Persons and Arrangements. |
| Assessment of Principle 29 | Materially non-compliant |
| Comments | <p>The FI Act (and its Regulations) is the main piece of legislation setting out anti-money laundering and countering the financing of terrorism. The BoB undertakes a range of supervisory activities throughout the supervisory cycle that include risks associated with AML/CFT (see also CPs 8 & 9 for a description of BoB's supervisory tools, techniques and approaches). A dedicated team within the BoB BSD consisting of four staff) undertaken onsite and offsite analysis of bank compliance with AML/CFT obligations as stated in the FI Act.</p> <p>AML/CFT has received heightened attention by the BoB after ESAAMLG's initial mutual examination report which identified significant weaknesses. Subsequent actions by the authorities have remediated recommendations with work ongoing to fill gaps. In relation to the efforts of BoB's supervisory framework, the move to a risk-based approach has commenced with a new early warning tool. Effective implementation of the tool will help better profile higher risk banks and adjust the supervision cycle accordingly. The mission saw evidence of greater attention being allocated to AML/CFT and integrated into risk-based activities including annual bilateral meetings, on-site examinations, and follows up on quarterly updates of supervisory concerns until shortcomings are adequately addressed.</p> |

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| | <p>Not all aspects of this CP are met. There is scope for greater sharing of risk information between the BSD supervisors and those responsible for AML/CFT.</p> <p>According to the FIA Act, a STR must be reported within five-days. There is a lack of clarity in the interpretation of the FIA's guidance regarding the five-day reporting threshold for STRs. This is impairing the ability for the BoB to sanction banks if the five-day threshold is not met.</p> <p>Lastly, analysis of data shared with the BoB from the FIA indicates a relatively low number of STRs reported by banks to the FIA. This may suggest that more follow-up is needed to ensure banks' have fully implemented customer due diligence programs and KYC.</p> |
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SUMMARY COMPLIANCE WITH THE BASEL CORE PRINCIPLES

| Core Principle | Grade | Comments |
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| 1. Responsibilities, objectives and powers | MNC | <p>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 promoting safety and soundness of banks and the banking system (see EC2). 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).</p> <p>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 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</p> |

| Core Principle | Grade | Comments |
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| | | <p>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.</p> <p>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.</p> |
| 2. Independence, accountability, resourcing and legal protection for supervisors | MNC | Lack of operational independence from potential ministerial interference in supervisory oversight. Inadequate resources to fulfill BoB's mandate. |
| 3. Cooperation and collaboration | LC | Further reform of legal framework needed to facilitate sharing of confidential information with domestic supervisory agencies. |
| 4. Permissible activities | C | Definition of 'bank' clear. The term 'bank' is restricted. |
| 5. Licensing criteria | LC | Newly licensed banks are not subject to an enhanced supervision plan. Analysis of ultimate |

| Core Principle | Grade | Comments |
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| | | beneficial ownership is not undertaken to identify the individual shareholder. |
| 6. Transfer of significant ownership | MNC | 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. |
| 7. Major acquisitions | MNC | 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 | LC | No internal guidelines for the handling of distressed or weak banks. |
| 9. Supervisory techniques and tools | LC | System-wide stress tests not conducted. Limited engagement with independent non-executive directors on a routine basis. |
| 10. Supervisory reporting | LC | No reporting requirements for banks on a solo and group basis. |
| 11. Corrective and sanctioning powers of supervisors | LC | Develop the range of corrective measures. Link the risk rating methodology with processes to handle weak and distressed banks. |
| 12. Consolidated supervision | MNC | No provisions for consolidated supervision in the primary legislation. |
| 13. Home-host relationships | LC | Implement MoUs with all home supervisors. Implement more frequent sharing of information with home supervisors in addition to supervisory colleges. |
| 14. Corporate governance | MNC | 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 |

| Core Principle | Grade | Comments |
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| | | <p>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.</p> |
| 15. Risk management process | LC | <p>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 CRO and inform or discuss with BoB the reasons for the removal.</p> |
| 16. Capital adequacy | LC | <p>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</p> |

| Core Principle | Grade | Comments |
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| | | 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 | LC | <p>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.</p> <p>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.</p> |
| 18. Problem assets, provisions, and reserves | MNC | <p>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 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</p> |

| Core Principle | Grade | Comments |
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| | | <p>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.</p> |
| 19. Concentration risk and large exposure limits | MNC | <p>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.</p> |
| 20. Transactions with related parties | MNC | <p>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.</p> |

| Core Principle | Grade | Comments |
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| 21. Country and transfer risks | MNC | 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 of banks' management of country and transfer risks is not explicit in the current onsite and offsite frameworks. |
| 22. Market risk | LC | 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 | MNC | 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 |

| Core Principle | Grade | Comments |
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| | | 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 | MNC | BoB's prudential liquidity requirement (Liquid Assets Ratio - 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 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 | LC | 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 | LC | 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. |

| Core Principle | Grade | Comments |
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| 27. Financial reporting and external audit | C | 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 | C | 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 | MNC | 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. |

RECOMMENDED ACTIONS AND AUTHORITIES' COMMENTS

A. Recommended Actions

| Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks | |
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| Reference Principle | Recommended Action |
| Principle 1 | <ul style="list-style-type: none"> 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. 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. |
| Principle 2 | <ul style="list-style-type: none"> 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. 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 | <ul style="list-style-type: none"> Conduct regular quality assurance assessments of the supervision framework and methodology. |

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| | <ul style="list-style-type: none"> • Develop internal guidance for the handling of weak and distressed banks. |
| Principle 9 | <ul style="list-style-type: none"> • Greater differentiation of supervisory activities for systemic banks. More frequent engagement with independent non-executive directors. • Perform regular system-wide stress tests to identify areas of vulnerability. |
| Principle 10 | <ul style="list-style-type: none"> • Develop reporting requirements for banks on a solo and group basis. • Refresh reporting instructions on a regular basis. • Greater depth of detail for risk areas such as: IRRBB, credit risk and market risks. |
| Principle 11 | <ul style="list-style-type: none"> • Broaden the range of corrective measures. • Link the risk rating methodology with processes to handle weak and distressed banks. |
| Principle 12 | <ul style="list-style-type: none"> • Revise the Banking Act to contain provisions for consolidated supervision. • Expand prudential guidance for banks and internal guidance to support supervision in addition to staff training. |
| Principle 13 | <ul style="list-style-type: none"> • Implement MoUs with all home supervisors. • Implement more frequent sharing of information with home supervisors in addition to supervisory colleges. |
| Principle 14 | <p>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.</p> |
| Principle 15 | <ul style="list-style-type: none"> • 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. • 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 |

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| | to obtain board approval for the removal of the CRO and inform or discuss with BoB the reasons for the removal. |
| Principle 16 | <ul style="list-style-type: none"> • Develop guidance and tools for reviewing and assessing banks' ICAAP documents and feeding these into ongoing supervision. • 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. • 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 | <ul style="list-style-type: none"> • 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. • 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. |
| Principle 19 | <ul style="list-style-type: none"> • 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. • 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. • Make the regulatory requirements and supervisory expectations more explicit and detailed for management of other types of concentrations (e.g., industry, geographic, collateral, products). |

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| | <ul style="list-style-type: none"> • Make corresponding changes to the supervision manual, offsite reporting, and analyses, to strengthen SREP with reference to concentration risk management by banks. |
| Principle 20 | <ul style="list-style-type: none"> • 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. • 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 | <ul style="list-style-type: none"> • 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. • Introduce appropriate prudential reporting requirements, and revisions to supervisory manual. • Provide appropriate training and capacity building to enhance relevant supervisory skills. |
| Principle 22 | <ul style="list-style-type: none"> • Improve the offsite reporting. Develop supervisory tools, and guidance for assessment of banks' exposure to market risks and their management of these risks. • 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. • 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 | <ul style="list-style-type: none"> • 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. • Incorporate the above and other specific elements relevant for supervision of IRRBB in the supervision manual and include an |

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| | <p>explicit and dedicated component on management of IRRBB by banks.</p> <ul style="list-style-type: none"> • 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 | <ul style="list-style-type: none"> • Include flow-based liquidity measures in BoB toolkit, • Introduce explicit regulatory and/or supervisory limits for the intermediation and deposit concentration ratios, • 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), • Improve off-site reporting and analyses to better capture liquidity and funding risks, and • 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 | <p>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.</p> |
| Principle 26 | <p>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.</p> |
| Principle 27 | <p>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</p> |

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| | 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 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 STR reporting. Increase the frequency of data for inclusion in offsite surveillance (e.g., STRs). |

B. Authorities' Response to the Assessment⁷⁵

61. The Bank of Botswana (Bank) has received the Financial Sector Assessment Programme (FSAP) Report, which was conducted by a joint International Monetary Fund/World Bank Team between October 12 and November 2, 2022.

62. The Botswana 2022 FSAP took place within the context of a significant financial sector reform agenda. Legal changes aimed at strengthening financial sector supervision, including the Bank of Botswana Amendment Act and the Banking Act, both of which enhance the supervisory powers of the Bank of Botswana, had been implemented by the time of the FSAP. It is essential to note that the BCP assessment methodology does not provide detailed information on regulations or laws that were not in effect during the BCP Assessment. Consequently, such regulations and laws were not taken into account in the assessment of various principles. Looking ahead, Botswana is dedicated to continuously improving its regulatory framework and financial sector supervision practices to further strengthen its financial sector.

63. The Botswana FSAP report fairly reflects Botswana's compliance position, the state of the financial market infrastructure, the operational and financial performance of financial institutions, and the operating environment for these institutions. Furthermore, the report has largely incorporated comments made on earlier drafts that were submitted to the FSAP Team.

64. The Bank extends its gratitude to the IMF and the World Bank assessment team for their valuable assessment. Botswana remains strongly committed to the FSAP process and recognizes the valuable insights it provides into a country's financial system.

⁷⁵ If no such response is provided within a reasonable time frame, the assessors should note this explicitly and provide a brief summary of the authorities' initial response provided during the discussion between the authorities and the assessors at the end of the assessment mission ("wrap-up meeting").