



FINANCIAL STABILITY REPORT

MAY | 2024



FINANCIAL STABILITY COUNCIL



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ABBREVIATIONS

| | |
|---------|--|
| ABSA | ABSA Bank Botswana Limited |
| AI | Artificial Intelligence |
| AML | Anti-Money Laundering |
| AUM | Assets Under Management |
| BBI | Botswana Bond Index |
| BCBS | Basel Committee on Banking Supervision |
| BES | Business Expectations Survey |
| BFTP | Bank Funding Term Program |
| BIHL | Botswana Insurance Holdings Limited |
| BIS | Bank for International Settlements |
| BISS | Botswana Interbank Settlement System |
| BoBCs | Bank of Botswana Certificates |
| BPOPF | Botswana Public Officers Pension Fund |
| BSEL | Botswana Stock Exchange Limited |
| CAR | Capital Adequacy Ratio |
| CDD | Customer Due Diligence |
| CIUs | Collective Investments Units |
| CFT | Combating the Financing of Terrorism |
| CorpI | Corporate Bond Index |
| CPF | Counter Proliferation Financing |
| CRE | Commercial Real Estate |
| DCI | Domestic Company Index |
| DCTRI | Domestic Company Total Return Index |
| DIC | Deposit Insurance Committee |
| DIF | Deposit Insurance Fund |
| DISB | Deposit Insurance Scheme Botswana |
| D-SIBs | Domestic Systemically Important Banks |
| D-SIIs | Domestic Systemically Important Insurers |
| D-SIFIs | Domestic Systemically Important Financial Institutions |
| DTI | Debt-to-Income |
| EFTs | Electronic Funds Transfers |
| EMDEs | Emerging markets and Developing Economies |
| EPS | Electronic Payment Service |
| ERTP | Economic Recovery and Transformation Plan |
| ESG | Environmental, Social and Governance |
| ETF | Exchange Traded Funds |
| EU | European Union |
| FATF | Financial Action Task Force |
| FCI | Foreign Company Index |
| FIA | Financial Intelligence Agency |
| FMI | Financial Market Infrastructures |
| FNBB | First National Bank of Botswana |
| FPC | Financial Policy Committee |
| FSB | Financial Stability Board |
| FSC | Financial Stability Council |
| FSR | Financial Stability Report |
| FX | Foreign Exchange |
| GCF | Green Climate Fund |
| GDP | Gross Domestic Product |
| GFC | Global Financial Crisis |

| | |
|--------|--|
| GFSR | Global Financial Stability Report |
| GovI | Government Bond Index |
| G-SIB | Global Systemically Important Bank |
| IAIS | International Association of Insurance Supervisors |
| IMF | International Monetary Fund |
| IOSCO | International Organisation of Securities Commissions |
| ISO | International Organisation for Standardization |
| IT | Information Technology |
| LAR | Liquid Asset Ratio |
| LHS | Left Hand Side |
| LTV | Loan-to-Value |
| ME | Mutual Evaluation |
| ML | Money Laundering |
| MMFs | Money Market Funds |
| MoF | Ministry of Finance |
| MoPR | Monetary Policy Rate |
| MPC | Monetary Policy Committee |
| MSMEs | Micro-Small and Medium Enterprises |
| MVTSP | Money Value Transfer Service Providers |
| NAV | Net Asset Value |
| NBFIs | Non-Bank Financial Institutions |
| NBFIRA | Non-Bank Financial Institutions Regulatory Authority |
| NDP | National Development Plan |
| NFCs | Non-Financial Corporates |
| NFS | Non-Financial Sector |
| NIIP | Net International Investment Position |
| NMMF | Non-Money Market Funds |
| NPL | Non-Performing Loans |
| NPS | National Payment System |
| OFCs | Other Financial Corporations |
| PFR | Pension Fund Investment Rule |
| RSA | Republic of South Africa |
| RHS | Right Hand Side |
| RMCI | Real Monetary Conditions Index |
| RPC | Regulatory Policy Committee |
| SACU | Southern African Customs Union |
| SARB | South African Reserve Bank |
| SSA | Sub-Saharan Africa |
| SCF | Standing Credit Facility |
| SDR | Special Drawings Rights |
| SDF | Standing Deposit Facility |
| SOEs | State Owned Enterprises |
| STR | Suspicious Transactions Report |
| SSA | Sub-Saharan Africa |
| TF | Terrorist Financing |
| TNDP | Transitional National Development Plan |
| UK | United Kingdom |
| USA | United States of America |
| USD | United States Dollar |
| VASPS | Virtual Asset Service Providers |
| WEF | World Economic Forum |
| WEO | World Economic Outlook |

ACKNOWLEDGEMENT

The May 2024 issue of the Financial Stability Report (FSR) was prepared by the Bank of Botswana (the Bank) in collaboration with the Ministry of Finance (MoF), the Non-Bank Financial Institutions Regulatory Authority (NBFIRA), the Financial Intelligence Agency (FIA), the Deposit Insurance Scheme of Botswana (DISB) and the Botswana Stock Exchange Limited (BSEL). The Report was approved for publication by the Financial Stability Council (FSC/Council), a statutory body established by the Bank of Botswana (Amendment) Act, 2022. The Council consists of five members, being the Governor of the Bank of Botswana (Chairperson); Permanent Secretary of the Ministry of Finance; Chief Executive Officer, NBFIRA; Director General, FIA; and Director, DISB; while the Chief Executive Officer, BSEL is an observer member, thus a non-voting member.



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PREFACE

Purpose of the Report

The Financial Stability Report (FSR) provides an assessment of the vulnerabilities that could elevate risks to the stability and resilience of the Botswana financial system by the Financial Stability Council (FSC/Council). The Report provides analytical and performance updates for the financial sector and its impact on economic activity and welfare; encourages public discourse and 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. The FSR is published twice a year (that is May and October) following discussion and approval at the FSC meetings.

Macroprudential Policy Framework

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, and understanding, that the financial system is interconnected and vulnerable to contagion risk, with the result that crises emanating from the financial sector can spill-over rapidly to the real economy. At the same time, sectoral or broader economic weaknesses could adversely affect the financial system and trigger instability or cause a systemic financial 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.

In order to limit systemic and spill-over or contagion risks, financial sector regulators pursue a variety of key intermediate objectives, among others: minimising 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 mitigate aggregate shocks.

Given the structure of the Botswana economy, the macroprudential policy framework views the external sector vulnerabilities of the domestic economy through trade shocks and capital outflows, as having the greatest potential for elevated financial stability risks. There are also potential risks to the stability of the domestic financial system emanating from economic and trade disruptions induced by geopolitical tensions and economic fragmentation; continued exposure to cyber threats due to increasing usage of technology, as well as climate-related financial risks. The FSR provides an analysis of these vulnerabilities where they persist - their interaction, as well as the potential impact and response to spill overs from regional and global financial stability developments and trends. Financial soundness and macroeconomic indicators are used to assess risks to and within the financial system. Relevant and appropriate policy instruments and tools are available for use as intervention measures during periods of financial instability. The instruments and policy tools would be adjusted accordingly and timeously to mitigate the envisaged threats. Macroprudential interventions in this regard would be communicated through circulars issued, periodically, by the FSC.

Decision-making process

The FSC of Botswana, a multi-agency body, was established to, among others, collaborate and share information on policy and other related issues on strengthening the financial system and making it 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; request information from any financial institution, exchange information on financial stability issues, and communicate systemic risk warnings.

The FSC is a statutory body as per Section 20 (54B) of the Bank of Botswana (Amendment) Act, 2022. It is responsible for (a) preserving the stability of the financial system; (b) ensuring cooperation between its members with respect to the assessment of the build-up of economic and financial sector systemic risks in Botswana; (c) developing coordinated policy responses to risks including crisis management; and (d) making recommendations, issuing warnings or opinions addressed to regulatory bodies regarding financial institutions.

The FSC is chaired by the Governor, and the Bank acts as the secretariat. The work of the FSC used to be governed by a memorandum of understanding signed in February 2019, and has since been subsumed into the FSC Charter.

Announcement of macroprudential policy decisions

Proceedings of the FSC are communicated through a Press Release, shortly after a Council meeting, to inform the public of the discussions and conclusions regarding the stability of the domestic financial system. The Press Release further highlights the key risks in the financial system and recommendations to address such vulnerabilities. Policy decisions are communicated through a circular to all affected financial institutions. The circular provides a brief description that links the identified risk with the intermediate objective and explains the way measures taken are expected to mitigate the risk.

1. EXECUTIVE SUMMARY

- 1.1 **Global financial conditions have eased** on the back of a faster pace of disinflation, in turn, supporting higher equity valuations, lower interest rate volatility, narrowing corporate bond spreads and buoyant financial markets sentiments (International Monetary Fund (IMF), April 2024 Global Financial Stability Report). The April 2024 outlook further dampens earlier concerns of elevated risks to global financial stability raised in the Financial Stability Board (FSB) Chair's letter to the G20 on 5 September 2023, and the 2023 FSB Annual Report, which related to the high interest rate environment owing to the long and sustained monetary policy tightening and higher debt servicing costs. Financial stability threats are further muted in the March 2024 Basel III monitoring exercise by the Bank for International Settlements, which reported that Basel III leverage ratios for a sample of the largest global banks (mostly global systemically important banks, G-SIBs) were largely stable, well leveraged and liquid.
- 1.2 **The domestic financial system continues to be resilient to a wide range of shocks**, including vulnerabilities emanating from credit, liquidity and funding concentrations and interest rate adjustments. The latest stress tests for banks, based on the December 2023 data, as well as a series of solvency and liquidity stress tests, validate this strong solvency and resilience. Strong leverage and capital position, liquidity buffers, profitability and effective regulatory and supervisory framework anchor this stability. There is also some notable recovery in the domestic capital market as reflected in the appreciation of key market indices, while financial market infrastructures remain stable and robust, thus promoting domestic financial stability. In the circumstances, macroprudential policy responses are not warranted.
- 1.3 **The macroeconomic environment is supportive of financial stability**, particularly, positive economic growth prospects, low domestic inflation, improving balance of payments and foreign exchange reserves, and low public debt that is supported by favourable credit ratings. According to Statistics Botswana (SB), real gross domestic product (GDP) growth decelerated from 5.5 percent in 2022 to 2.7 percent in 2023, on account of a decline in diamond production and prices as well as the impact of weaker global growth on other exports. Economic activity, however, is expected to rebound and grow by 4.2 percent and 5.4 percent in 2024 and 2025, respectively, underpinned by recovery in the world economy and government interventions to facilitate productive capacity, accelerate structural transformation and an expansive Transitional National Development Plan (TNDP). Meanwhile, sovereign vulnerabilities presented by reduced fiscal and external buffers persist because of the prevailing subdued global economic environment and long-term structural trends.
- 1.4 **Domestic credit growth accelerated and is aligned with the pace of economic growth**, thus posing minimal risk to financial stability. Commercial bank credit grew by 8 percent in February 2024 and was higher than the 6 percent growth in the corresponding period in 2023, driven largely by the increased pace of lending to both households and businesses. That notwithstanding, credit to households continued to dominate commercial banks' loan book at 64.5 percent. The credit-to-GDP gap, which measures credit growth against its long-term trend, is negative, indicating limited risks of overheating of the economy from credit developments.
- 1.5 **Average daily market liquidity in the banking system was P12 billion in February 2024**, driven by continued increase in the pace of government spending¹. As a result, banks maintained a healthy liquidity position, with an above-threshold average liquidity ratio of 17.6 percent in January 2024. Consequently, banks remained unconstrained in providing and increasing the range of financial services to support the economy.

¹ Average daily market liquidity refers to average daily excess liquidity over the duration of a month, where excess liquidity is the sum of commercial banks' overnight deposits at the central bank (current account), money absorbed through Bank of Botswana Certificates, outstanding reverse repos, and the Credit Facility.

- 1.6 **Strong macro-financial linkages pose a risk of contagion.** Notwithstanding the domestic financial system’s resilience and stability, strong and concentrated sectoral linkages pose a risk of intersectoral risk transmissions. However, this risk is mitigated by effective regulatory and supervisory measures, which continue to evolve as authorities strengthen the financial regulatory landscape with new standards and institutional arrangements, such as the widening of financial safety nets in alignment with international best practice, as well as proper governance and accountability structures. Related to macroprudential standards, First National Bank of Botswana Limited (FNBB) and ABSA Bank Botswana Limited (ABSA) were identified and designated as Domestic Systemically Important Banks (D-SIBs) for 2024, while Botswana Life Insurance Limited, The Hollard Insurance Company of Botswana and Continental Reinsurance Company were designated as Domestic Systemically Important Insurers (D-SIIs). On the basis of the D-SIBs and the D-SIIs frameworks, the institutions would significantly affect stability of the domestic financial system upon their failure but are nevertheless, currently adequately capitalised, liquid and solvent and do not pose a threat to domestic financial stability.
- 1.7 **Overall, vulnerabilities are generally contained in the financial and non-financial sectors.** The heat map (Appendix Chart A1), a vulnerability indicator, shows a moderately high level of contagion risk, low to moderate macroeconomic risks and low risk from the external sector, credit and liquidity markets. Vulnerabilities could be worsened by rising geopolitical and geoeconomic fragmentation risks, lower economic growth in advanced economies and continued exposure to cyber threats owing to increasing usage of technology, as well as climate-related financial risks.

2. GLOBAL FINANCIAL STABILITY

Risks to global financial stability have moderated

2.1 The April 2024 GFSR indicates that confidence on a soft landing for the global economy is growing against a backdrop of better-than-expected economic growth in many countries, leading to an easing of financial conditions. Stronger momentum on structural reforms is expected to bolster productivity, with positive cross-border spillovers. The positive expectations amid abating concerns on banking sector shocks are buttressed by the findings of the March 2024 Basel III monitoring exercise by the BIS. Using a sample of the largest global banks, the report shows that banks' leverage ratios were stable and above pre-pandemic leverage ratios in the first half of 2023. The liquidity and profitability of these institutions were adequate and strong.

2.2 The global optimism on the macroeconomic and financial stability outlook is, however, tampered by several potential near-term financial fragilities. These include weak fiscal sustainability, due to the build-up of public and private debt in both advanced and emerging economies; high refinancing costs resulting from high interest rates; fiscal deficits; and increasing interconnectedness of the financial sector with the fragile private credit markets. The IMF contends that private credit (lending by non-banks) market warrants closer monitoring and possible regulatory supervision given its growing interconnectedness with the financial sector. Although it is lowly leveraged, it is naturally highly exposed to fragile borrowers, has a growing share of semi-liquid investment vehicles and has stale and potentially subjective valuations.

US financial system sound and resilient

2.3 The April 2024 FSR of the United States (US) Federal Reserve Board (Fed) highlights several near-term risks for the US financial system that, if realised, could interact with existing vulnerabilities in the financial system and lead to financial instability. The Fed concluded that balance sheets of non financial corporations and households remained solid, and the banking sector remained sound and resilient, with most

banks reporting capital and liquidity levels that are well above regulatory requirements. There are, however, concerns around elevated corporate bonds markets and corporate credit spreads. Further, residential real estate valuations remained high, and commercial real estate (CRE) market conditions continued to deteriorate. Financial intermediaries and investors with a significant exposure to commercial real estate face heightened asset quality risks. There is, therefore, need for monitoring and management of risks related to the sector to mitigate potential risks to macro-financial stability.

2.4 Other salient financial stability risks in the US financial system include higher for longer interest rates in the US and other advanced economies, which could create strains in the global financial system; worsening global geopolitical tensions that could lead to broad adverse spillovers; and weakened economic activity leading to a reduction in investor risk appetite and additional strains in CRE.

Post-March 2023 collapse of US banks reforms contributed to the stability of the US banking system

2.5 The US banking system came under severe stress in March 2023 after experiencing deposit withdrawals at unprecedented speed coupled with insufficient liquidity, leading to the collapse of Silicon Valley Bank and Signature Bank on 10 March and 12 March, respectively. The two bank failures generated broader concerns about destabilising runs at other commercial banks with similar profiles. In response to the crisis, the Fed, the Federal Deposit Insurance Corporation and the US Department of the Treasury took actions to preserve financial stability by establishing a Bank Funding Term Program (BFTP). The BFTP provide deposit-taking institutions with an additional source of liquidity against high-quality securities for them to meet the needs of all their depositors, in the form of advances of up to one year against the par value of eligible collateral. The ability of depository institutions to access funding without selling securities at a loss during stress limited destabilising runs and the associated potential for further contagion throughout the banking system.

2.6 At the beginning of the banking crisis, deposit outflows amounted to USD472 billion in the first quarter of 2023 and moderated to USD99 billion in the second quarter and slowed further to USD90 billion in the third quarter, and the banking system experienced inflows of USD260 billion in the fourth quarter of 2023. The turnaround in flows reflect the positive and quick intervention by authorities to restore the stability of the financial system. The BFTP ceased extending new loans on 11 March 2024, as fears of another banking crises have receded.

UK financial system remains resilient

2.7 The Financial Policy Committee (FPC) of the Bank of England met on 27 March 2024 to deliberate on the stance of financial stability in the United Kingdom (UK). The responsibility of the Committee is to identify risks to financial stability and formulate and implement policy actions to safeguard the resilience of the UK financial system. FPC concluded that the UK economic outlook had improved since December 2023; however, risks to the stability of the UK financial system have increased. Major risks identified by FPC relate to geopolitical risks, including conflicts in Ukraine and the Middle East, which continue to increase vulnerability in some parts of the banking system and financial markets. UK households are still facing pressures from the increased cost of living and higher interest rates. The overall share of households that defaulted on their mortgages has risen slightly but remains low by historical standards. UK businesses are expected to continue to be resilient to higher interest rates and weak economic growth, while banks are judged to be generally well capitalised, liquid, profitable and resilient, hence strong enough to support households and businesses, even if economic and financial conditions become worse than expected.

Global output to remain moderate in 2024

2.8 The IMF in the World Economic Outlook (WEO) of April 2024 portends that the global economy has been remarkably resilient. World output grew by 3.2 percent in 2023 compared to the 2.2 percent in 2022 and it is forecast to remain steady at 3.2 percent in both 2024

and 2025. The projection for global growth in 2024 and 2025 is below the historical (2000 - 2019) annual average of 3.8 percent, because of restrictive monetary policies and withdrawal of fiscal support, as well as low underlying productivity growth. The World Economic Forum (WEF) 2024 Global Risks Report highlights global economic downturn as a prominent risk in the short-to-long term. The increase in the cost of living, persistent El Nino conditions, global geopolitical fragmentation, and the escalation of conflicts are expected to drag down future economic performance.

Financial technologies amplify cyber risks

2.9 Cyber vulnerabilities continue to increase as new financial technologies emerge and as artificial intelligence (AI) advances in global financial markets. The increase in the adoption of cloud computing and technologies, as well as integration of global payment systems and technologies, including the growing crypto asset market expose the global financial system to cyber attacks. These vulnerabilities are expected to increase amid growing global geoeconomic fragmentation, which undermines efforts to coordinate the mitigation of cyber-security risks.

2.10 Furthermore, the proliferation of AI presents challenges to global financial stability through increased susceptibility to cyber attacks and quicker transmission of system-wide risks. Fundamental vulnerabilities arising from the application of AI by both financial institutions and regulators include reaching biased and unfair decisions owing to historical consistencies, pricing out of customers from financial services because of inaccurate algorithms, financial losses caused by poor credit algorithms arising from applying AI, as well as concentrations created by the inherent optimisation by AI. Deployment of machine learning tools could also enhance methods of performing social engineering, email phishing, and smishing (text messaging) attacks, thus compromise data and operational resilience.

2.11 Developments in crypto activities continue to pose risks to the well-functioning of the traditional financial system and financial

stability at large. To address crypto assets related risks, the FSB published a global regulatory framework for crypto-asset activities in 2023, to promote the comprehensiveness and international consistency of regulatory and supervisory approaches. The framework recognises the evolving scale, existing structural vulnerabilities, and increasing interconnectedness that could disrupt financial stability. The IMF also released a synthesis paper² detailing a comprehensive approach to identifying and responding to macroeconomic and financial stability risks associated with crypto assets.

Climate risks are a threat to financial stability

2.12 Discussions on climate-related financial risks have featured prominently in recent years, in view of the potentially devastating impact of climate change on the global economy. For example, the 2024 WEF Global Risks Report ranks extreme weather as a top risk with high chances of presenting a substantial crisis. Climate change has material impact on food, water and health security and poses physical and transitional risks to the global financial system.

2.13 Extreme weather conditions have the potential to disrupt global value chains, leading to supply-driven increase in the cost of living thus decreasing the purchasing power of households and businesses and weakening their ability to service their loans. Physical risks would also escalate credit losses for the property market. Meanwhile, transition risks require financial institutions to develop new policies and products to mitigate and adapt to climate change, for example, environmentally sustainable products and services required by consumers and investors, thus affecting the value of financial assets and liabilities.

Continued regulatory supervision and coordination is key to circumventing financial stability risks

2.14 The IMF has called on authorities faced with overly optimistic expectations on the pace of disinflation and monetary policy

easing to act cautiously and take appropriate incremental monetary policy actions while also tempering markets expectations to be realistic. Financial regulatory authorities are to continue monitoring the financial sector and taking early corrective actions, including using stress tests and supervisory tools to identify and mitigate emerging risks. Agile, full and consistent implementation of internationally agreed prudential standards by regulators should enhance macroprudential policy effectiveness and ensure that banks and other institutions withstand defaults and other risks. Furthermore, to limit the contagion risk from weak institutions, authorities should ensure they have robust recovery and resolutions frameworks. To stem financial risk emanating from the fiscal budget and contain debt vulnerabilities, governments are urged to implement appropriate fiscal consolidation, as recommended by the April 2024 IMF Fiscal Monitor.

² IMF-FSB (2023) Synthesis Paper: Policies for Crypto-Assets. Available at <https://www.fsb.org/wp-content/uploads/R070923-1.pdf>

3. REGIONAL FINANCIAL STABILITY

Sub-Saharan Africa output projected to increase

- 3.1 For sub-Saharan Africa (SSA) growth in output is estimated at 3.4 percent in 2023 and it is expected to pick up to 3.8 percent in 2024 and 4 percent in 2025. The 2024 forecast is unchanged from the January 2024 WEO forecasts and partly reflects continued concerns about worsening climate shocks, uneven global economic growth, and regional supply challenges, including power supply shortages in South Africa.

Financial stability risks elevated in South Africa

- 3.2 The South African Reserve Bank (SARB)'s Financial Stability Review (2nd Edition 2023) indicates that systemic risks were elevated in 2023, emanating from increasing sovereign debt levels, debt-service costs and the impact of the country's grey listing by the Financial Action Task Force (FATF). Lingering fears of a global recession and geopolitical tensions, as well as domestic challenges such as repeated power outages also contributed to heightened systemic risk. Persistent underlying vulnerabilities in the financial system include a high level of government debt, highly indebted households, lower liquidity in bond markets, low borrowing, and high saving by corporates, which culminates into low investment and consequently restrained economic growth. In addition, the concentration of wholesale deposits exposes South African banks to potential funding shocks in the event there is an economy-wide funding squeeze. Despite these numerous challenges, the South African financial system remains resilient and stable, largely due to strong financial system buffers.

4. DOMESTIC FINANCIAL STABILITY

The domestic financial system remains resilient

4.1 The domestic financial system continues to be resilient to a wide range of shocks, including vulnerabilities emanating from credit, liquidity and funding concentrations, as well as interest rate risk, as evidenced by the stress-test results. Vulnerabilities in the financial and non-financial sectors are generally contained. The resilience and effectiveness of the financial system in providing financial services to the economy is anchored on strong capital and liquidity buffers, profitability, continuous innovation, and adaptability, as well as an enabling and robust regulatory environment.

Risks to domestic financial stability are moderate

4.2 Current risks to financial stability mainly relate to subdued global and regional economic performance, as well as economic and trade disruptions arising from geopolitical tensions and economic fragmentation. Therefore, close monitoring of risks and vulnerabilities is essential and, where necessary, appropriate macroprudential policies should be implemented to restore financial stability.

4.3 Other prevalent risks to domestic financial stability include climate-related risks. The occurrence of persistently dry conditions and a rise in global temperatures are threatening food security and have the potential to indirectly affect domestic financial stability. Severely dry weather conditions have the potential to drive food prices up, reduce household income and in some cases result in defaults on loans. Climate physical risks may amplify credit losses due to potential damage and/or loss of value to property and thus, deplete balance sheets of insurance companies which insure commercial real estate and mortgaged properties. The 2024 Budget Speech indicates that agriculture and tourism sectors are most vulnerable to climate change. As a result, the budget allocated P1.37 billion to fund climate mitigation activities, while legislation review and integration of climate change requirements into public finance management strategies are ongoing to foster sustainable and green development.

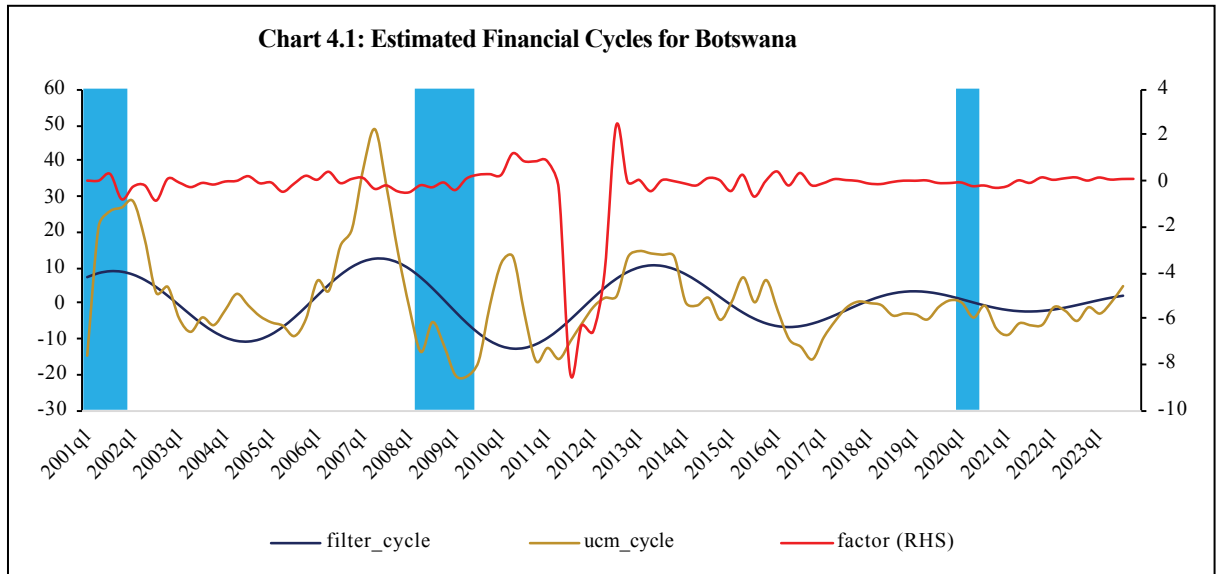
4.4 There is a notable increase in misconduct risks in the virtual asset market, where funds are solicited from the public by unlicensed entities and individuals, with a promise to invest in virtual assets. During the period October 2023 to March 2024, a total of 511 suspicious transactions were reported to the Financial Intelligence Agency (FIA). Most of these reports related to illegal deposit taking, followed by fraud cases. FIA was able to resolve these cases and avert loss of funds by members of the public. Misconduct issues in the banking sector are minimal and unlikely to pose significant risk to financial stability.

4.5 The domestic virtual assets market is however, still developing and relatively unsophisticated, thereby posing limited risks to financial stability. Cyber risks arising from financial technology (Fintech) are also considered minimal but as Botswana advances on innovation, this risk could magnify and pose a threat to the smooth functioning of the financial system. Cyber risks are among the top five national security risks that could emanate from the financial sector in Botswana (Box 4.1). For this reason, appropriate laws, regulations, frameworks, and surveillance are crucial to the early detection and prevention of such threats. Accordingly, the Cybercrime and Computer Related Crimes Act of 2018 and institution-based counter-cybercrime measures aim to curtail vulnerabilities in the technology landscape in support of financial stability. Relatedly, a National Fintech Working Group was launched on 30 January 2024, to provide strategic direction on Fintech matters. The working group was specifically established to develop an inclusive National Fintech Strategy and a Fintech Analytical Assessment Framework that facilitate development of the financial services sector consistent with national priorities on payment systems. The group comprises key national stakeholders including government, regulatory authorities, financial services infrastructure providers and other relevant stakeholders.

The domestic financial cycle is stable

4.6 There continues to be a need to enhance the country’s macroprudential toolkit to ensure effective and accurate assessment of risks to domestic financial stability. In that regard, a range of financial stability tools designed to act as early warning signals to a buildup of risk in the financial system include the heatmap (Chart A1), the risk assessment matrix (Table A1), financial sector interlinkage map (Chart 8.1), and the newly introduced financial cycle³.

The estimated financial cycle measures show that the financial cycle is generally stable for 2023, hovering around zero across all estimates (Chart 4.1). This implies that financial conditions are supportive of more lending and investment to drive economic activity. Further, the trajectory of the financial cycle measures shows that there is no buildup of systemic vulnerabilities, and there is room for deeper financial intermediation to support economic growth.



³ The Botswana financial cycle is estimated based on research work done by the Research and Financial Stability Department. See Setshegetso, L.N. and Mado, M. (2023) Approximating Botswana’s Financial Cycle:

Expanding the Macroprudential Toolkit. South African Journal of Economics, 1 – 16. Available at <https://doi.org/10.1111/saje.12359>.

Box 4.1: Top Five National Security Risks Emanating from the Financial Sector

Introduction

The financial sector plays a crucial role in economic development and the welfare of citizens by allocating funds for viable investments and providing payment services. However, the liberalisation of financial markets and greater connectivity between global financial markets, have increased financial system risks and crisis, and enabled the proliferation of criminal activities. Moreover, rapid technological advancement has facilitated adoption of borderless technology-based platforms in the financial system. These developments, could, if progressive and significant become an increasing concern to the health of the financial sector and the general economy. The aim of this article is to present the top five national security risks that could emanate from the financial sector in Botswana and their mitigation measures.

| RISK | MITIGATION MEASURES |
|---|--|
| <p>Money Laundering and Terrorism Financing: Evolution of digital platforms and digital payment instruments that promote anonymity of transactions present an opportunity for money laundering in the financial sector. With the complexity of recent financial technology developments, illicit funds can be transmitted globally with relatively low detection risks, particularly through intricate financial investment vehicles and other cyber-enabled crimes.</p> <p>According to the 2023 national risk assessment for money laundering and terrorist financing, the national vulnerability and threat to money laundering were rated medium and medium-high, respectively. This presents a likelihood for the country to be used as a conduit to move funds or be used to raise funds for terrorism activities. Therefore, money laundering remains a national security risk.</p> | <ul style="list-style-type: none"> • Ensuring that VASPs, such as cryptocurrency exchanges comply with Anti-Money Laundering/Counter Financing of Terrorism and Counter Proliferation Financing (AML/CFT/CPF) regulations is crucial to prevent the misuse of virtual assets for terrorist financing activities. This can be achieved through enhanced offsite monitoring and frequent engagements with the virtual assets sector (meetings/inspections). • Market surveillance and collaboration with other law enforcement agencies/authorities to detect illegal operators. • Strong AML/CFT/CPF legislation and supervisory capabilities. • Virtual Assets Act, 2022 |
| <p>Cybercrime and Financial Fraud: Cybercrime covers a wide range of criminal activities that are carried out using digital devices and/or networks. These crimes involve the use of technology to commit financial fraud, identity theft, data breaches, computer viruses and financial scams. With the increasing digitisation of financial services, including online banking, mobile payments and digital currencies, cybercrimes pose a significant threat to the financial sector and the economy.</p> <p>Malicious actors target institutions and individuals to steal sensitive information, conduct fraudulent transactions, and disrupt financial systems, leading to financial losses and undermining consumer confidence.</p> | <ul style="list-style-type: none"> • The Cybercrimes and Computer Related Crimes Act, 2018 by Botswana Communications Regulatory Authority • Enhanced oversight and frequent inspections of licenced entities. • Customer Due Diligence (CDD). • Public Awareness/notices. • Issuance of guidance notices. • Enforcement action for gross negligence and noncompliance. |

| RISK | MITIGATION MEASURES |
|--|--|
| <p>Physical Security Threats such as cash heists and Automated Teller Machine (ATM) bombings have increased in Botswana. Armed robbers organise cash-in-transit heists, overpowering security company guards and making off with large sums of money. In the past, these incidences have led to significant losses of central bank currency, as well as losses of lives. Financial institutions and businesses also incur costs to improve their security. Generally, these crimes do not only strip businesses off their hard-earned cash, but they also threaten confidence and security in the financial sector.</p> | <ul style="list-style-type: none"> • Enhanced stakeholder cooperation at all levels (regulatory, surveillance and law enforcement agencies). • Improved security measures by security companies. • Community responsibility initiatives. |
| <p>Asset Misappropriation in the NBFIs Sector: The complexity of retirement fund structures and investment vehicles, coupled with inadequate internal controls and oversight, can create opportunities for asset misappropriation to go undetected for extended periods. This lack of transparency and accountability increases the vulnerability of retirement funds to fraud. Asset misappropriation within retirement funds can have devastating consequences for members, jeopardising their financial security and retirement savings. It erodes trust in the retirement savings system and undermines the integrity of fund administrators, leading to reputational damage and legal repercussions.</p> | <ul style="list-style-type: none"> • Enhanced oversight and frequent inspections. • Public awareness and Issuance of guidance notices. • Enforcement action for gross negligence and non-compliance. • Enforcement of guidelines on corporate governance |
| <p>Illegal Deposit Taking/ Pyramid and Ponzi Schemes: Illegal deposit-taking refers to an act of receiving, taking, or accepting deposits from members of the public without a valid banking licence. There has been an increase in illegal deposit taking activities, where some companies solicit deposits from members of the public without a licence to do so, for example, by way of recruitment into investing in virtual assets and other digital investments for seemingly significant prospective returns.</p> <p>Meanwhile, pyramid schemes and other illegal deposit-taking activities such as Ponzi schemes or fraudulent investment vehicles are unlawful in Botswana, they are a criminal offence, punishable by law. Illegal deposit taking activities lead to loss of savings and pensions for those who participate in them, additionally they harm consumers' confidence in financial institutions and can potentially destabilise the financial system.</p> | <ul style="list-style-type: none"> • Capacity building and intensified public education by all stakeholders to capacitate consumers with undertaking due diligence at an individual level. • Cooperation and collaboration among regulators and law enforcement agencies. • Proper due diligence by financial institutions. |

5. SOVEREIGN RISKS

Positive domestic macroeconomic performance

5.1 The domestic macroeconomic environment remains conducive for financial stability despite sovereign vulnerabilities resulting from reduced fiscal and external buffers. Real GDP grew by 2.7 percent in 2023 and this is below the 5.5 percent recorded in 2022. The actual growth rate is 0.5 percentage points lower than the 3.2 percent projection made by MoF. Growth is forecast to rebound to 4.2 percent and 5.4 percent in 2024 and 2025, respectively. The rebound depends largely on the expected recovery of the world economy, which, in turn, is expected to support recovery in the mining sector. Furthermore, the performance of the economy will also depend on the extent of ramifications from ongoing geopolitical tensions, preparedness to tackle climate change effects, as well as traction and implementation capability for domestic development programmes and structural reforms.

5.2 The revised budget estimates for the 2023/24 fiscal year indicate a budget deficit of P7.1 billion compared with the earlier anticipated deficit of P7.6 billion. The slight improvement reflects better than expected mineral receipts due to exchange rate gains of the Pula against the US dollar. The 2023/24 total expenditure and net lending is projected to increase by P1.4 billion to P88.8 billion, driven by personal emoluments, grants and subventions, as well as other charges. The 2024/25 budget proposes total revenue and grants of P93.6 billion and total spending of P102.3 billion, with 70.1 percent allocated for recurrent expenditure. Thus, a 2024/25 budget deficit is estimated at P8.7 billion or 2.8 percent of GDP. The increase in the proposed budget is associated with the implementation of the Economic Recovery and Transformation Plan (ERTP) and overall improved delivery of government programmes and services, in part, due to the RESET Agenda⁴. The budget also reflects increased fiscal investment, marking the end of the two-year TNDP, which aims to support growth and promote export and revenue diversification.

Government borrowing rising but below the statutory limit

5.3 Government debt is projected to increase to P61.6 billion (22 percent of GDP) by the end of 2023/24 fiscal year, from P53.5 billion (20.6 percent of GDP) in the previous period. Government plans to further increase borrowing to P72.5 billion (24.2 percent of GDP) in the 2024/25 fiscal year. Some budget support loans were contracted externally, in addition to an increase in domestic issuance of government securities to finance structural deficits experienced over the years. Despite the increase in debt obligations, government debt remains within the statutory limit of 40 percent of GDP and therefore considered sustainable. The medium-term risk of debt distress remains low.

Public Finance Management reforms entrenched in the budgeting process

5.4 To enhance management of the country's resources and promote sustainable economic development, MoF's fiscal strategy entrenches public finance management reforms in its budgeting process. As a result, several initiatives, among which are measures to improve the efficiency gap by improving infrastructure governance to enhance the effectiveness of public investment are being implemented. Key reforms include the introduction of the Development Manager Model and strengthening of the Three-Stage Appraisal Process to ensure that planned projects are screened before inclusion in the forthcoming National Development Plan (NDP) 12. Further reforms include stepping up revenue maximisation, including review of tax laws to consolidate, simplify and modernise the existing Income Tax Act, harmonise the Value Added Tax Act concessions and enact a Tax Administration Act.

5.5 Other efforts entail diversifying and expanding the revenue base and addressing operational efficiencies, whereas a new three year Medium-Term Debt Management Strategy will be implemented in 2024/25 to align future borrowing choices with the government's preferred cost and risk levels. The proposed

⁴ The RESET agenda outlines five priorities intended to transform the economic landscape of Botswana amid challenges posed by the COVID-19 pandemic. The priorities are to save Botswana's population from COVID-19; reforming the public service; digitalisation; value-chain development; and mind-set change.

reforms seek to promote fiscal sustainability by rebuilding buffers, maintaining debt at sustainable levels, and achieving a budget balance. Ultimately sustainable budget must, within budget constraints, reprioritise spending to protect the most vulnerable populations, achieve green budget and spur economic growth to higher levels that transform Botswana from an upper middle income status to a high-income status while achieving prosperity for all Botswana by 2036. Sustainable government budget is critical for financial stability as a liquid government is able to support financial sector reforms including providing necessary guarantee to build financial buffers and support crises management and resolution endeavours.

Botswana susceptible to external sector shocks

- 5.6 The external sector presents the greatest potential for elevated financial stability risks to the domestic economy because of a narrow export base and significant dependence on trade revenues, that is, the Southern African Customs Union (SACU) receipts and mineral export revenue. Nevertheless, provisional balance of payments figures for 2023 indicate an overall surplus of P1.7 billion, compared with a surplus of P4.5 billion in 2022. The lower surplus in 2023 is mainly attributable to the poor performance in diamond trade, notably during the second half of the year. Weaker economic activity in major trading economies and tight global financial conditions could result in lower diamond sales and, in turn, negatively affect the current account position⁵. Similarly, the G7 countries' plan to verify the origin of non-Russian goods through diamond certification in Antwerp, Belgium, could affect revenues from diamonds, with implications for macroeconomic stability.

External buffers low but recovering

- 5.7 Foreign exchange reserves increased by 6.8 percent from P60.5 billion in January 2023 to P64.6 billion in January 2024, and translated to 8.7 months of import cover of goods

and services. In foreign currency terms, the reserves are estimated to have increased by 2.1 percent from USD4.7 billion to USD4.8 billion and by 2.9 percent from SDR3.5 billion to SDR3.6 billion. The external buffers are expected to continue a recovery path owing to fiscal consolidation efforts as government plans to compress the import bill and the anticipated recovery in market conditions. Sufficient external buffers reduce the country's susceptibility to external shocks, hence support financial stability.

NIIP remains positive

- 5.8 Preliminary figures for 2023 indicate that the country's net international investment position (NIIP) was P75.4 billion and this is a 9.3 percent increase from the revised position of P69 billion in 2022. Contributing to the positive net position were foreign assets, which increased by 11.1 percent to P187.1 billion from P168.4 billion in 2022, against an increase of 12.4 percent in foreign liabilities, which expanded to P111.7 billion from P99.4 billion in 2022. The country's foreign assets are significantly made up of portfolio assets by pension funds, followed by foreign exchange reserves. The effect of the revised pension funds domestic/offshore limits were insignificant during 2023, as the repatriation of pension funds is expected to take place gradually over a period of five years. The positive net investment position implies improved external sector resilience, which may culminate in stronger domestic financial stability safeguards. At the same time, significant exposure to external markets exposes Botswana assets to external shocks, although providing the needed diversification benefits.

5 Data for 2023 is not yet available.

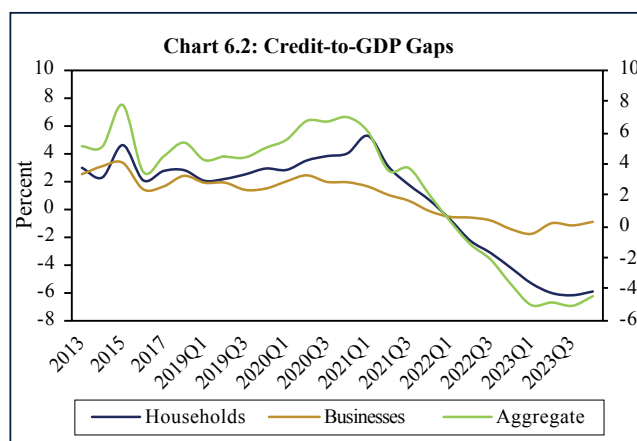
6. CREDIT AND LEVERAGE RISKS

(a) Commercial Bank Credit

Growth in overall commercial bank credit accelerates

- 6.1 Annual growth in commercial bank credit rose to 8 percent in February 2024 from the 6 percent growth in the corresponding period in 2023. The fast pace of credit growth was attributable to a higher utilisation of overdraft and revolving credit facilities by businesses, notably parastatals, as well as acquisition of new loans by households. Nevertheless, credit quality improved, with an overall non-performing loans (NPLs) ratio of 3.7 percent in February 2024, compared to 3.9 percent in February 2023. Meanwhile, household credit grew by 5.5 percent in February 2024, and was higher than the 3.6 percent growth in February 2023 (Chart 6.3a), against the backdrop of increased lending towards acquisition of property and motor vehicles during the review period.
- 6.2 That notwithstanding, the inherently expensive unsecured loans continue to dominate household credit, at 68 percent (Chart 6.3b), which presents potential debt distress to households, especially when financial and borrowing conditions could suddenly and sharply tighten. Overall, household credit dominated total credit at 64.5 percent against 35.5 percent for business credit (Chart 6.1b).
- 6.3 Using the credit-to-GDP gap (credit gap), credit growth is judged to be in line with its long-term trend and there is minimal risk of a credit boom. The credit-to-GDP gap is calculated by subtracting the credit-to-GDP ratio from its long-term average or trend. A gap of 10 percent is a reference threshold and any value above this threshold indicates excessive and rapid credit growth that could overheat the economy. The credit-to-GDP gap was negative at -4.5 percent, and below the 10 percent threshold in December 2023 (Chart 6.2), thus indicative

of room for sustained economic expansion supported by borrowing. In this context, there is scope for increased, disciplined, and prudent credit extension to support economic activity.



(b) Household Borrowing

Household borrowing poses minimal risk to financial stability

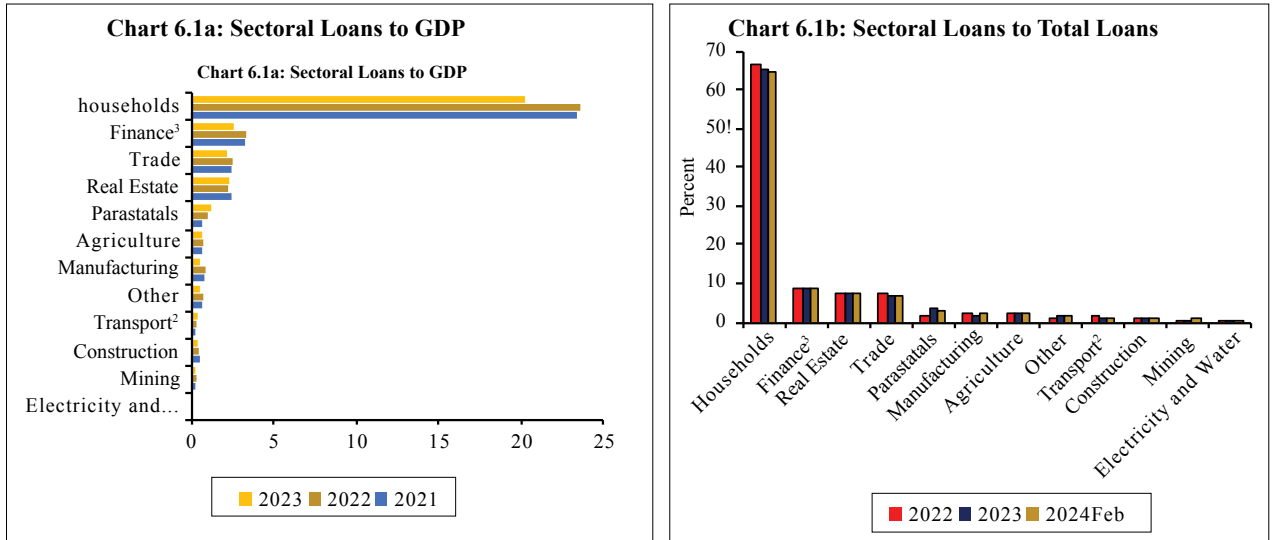
- 6.4 The 2022/23 Household Indebtedness Survey indicates that household debt posed minimal risks to financial stability in 2022. The quality of the household loan book for the largest credit provider (banks) was relatively satisfactory and credit extension remains positive for economic activity and wealth creation. The results of the survey show that households had debt-to-income (DTI) and debt-service-to-income ratios of 58 and 60 percent, respectively. Based on the two metrics, households in Botswana are less indebted compared to countries in the region, for example, South Africa and Namibia, which reported a DTI of 62.8 percent and 69.5 percent in 2022, respectively.
- 6.5 On the other hand, the household portfolio showed modest credit quality with an NPLs ratio of 3.2 percent in December 2023, which is slightly higher than the 3.1 percent in December 2022 but lower than the banking industry average of 3.7 percent (Chart 6.3c).
- 6.6 Moreover, households are net savers when considering their non-discretionary contractual pension savings and other assets (Chart 6.2a). Pension assets are important for mortgage

debt relief under the Retirement Funds Act of 2022, but also improve the long term financial welfare of households and in general, underpin wealth creation and financial security for retirees. Chart 6.2b indicates a positive net worth of households, which indicates a healthy

financial standing. The estimated net worth of households as a percentage of GDP increased to 51.3 percent in the fourth quarter of 2023 from 42.2 percent in the fourth quarter of 2022, reflecting a higher increase in net worth compared to the growth in GDP.

Composition of Banking Sector Loans¹

Household loans dominate commercial banks' loan portfolio



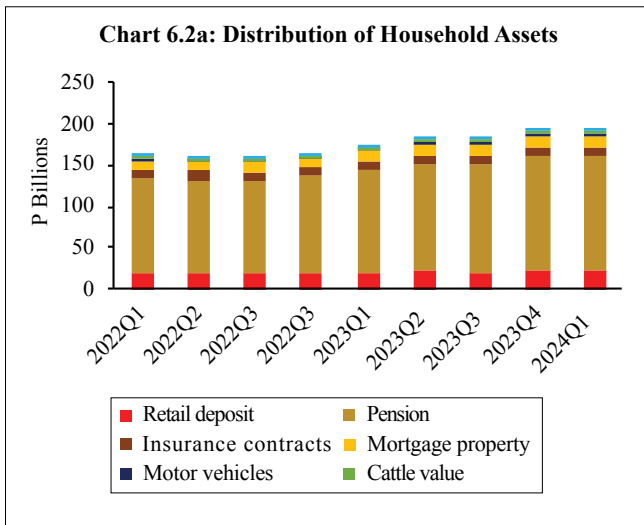
Notes:

- ¹ Sectoral contributions are calculated as a percentage of total commercial banks loans and subsector contributions are calculated as a percentage of sector loans.
- ² Transport and Communications.
- ³ Finance and Business Services.

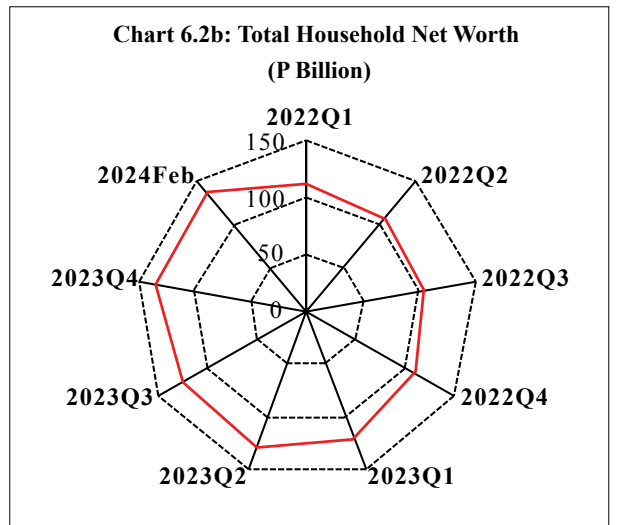
Source: Bank of Botswana

Household Net Worth Estimation

Pension savings dominate household assets



Households' net worth is increasing



Source: Bank of Botswana, Botswana Stock Exchange Limited and Statistics Botswana

Household Debt Analysis

Personal loans (other) are the major driver of household credit growth

Chart 6.3a: Growth in Household Debt

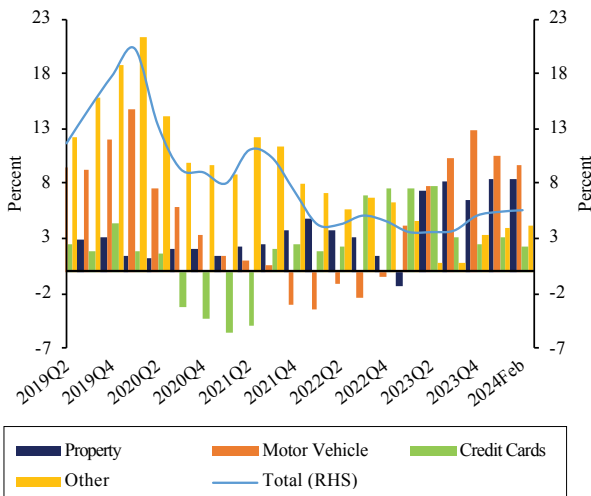
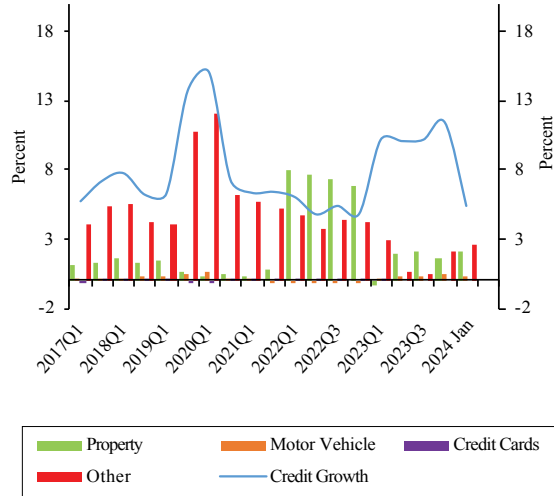
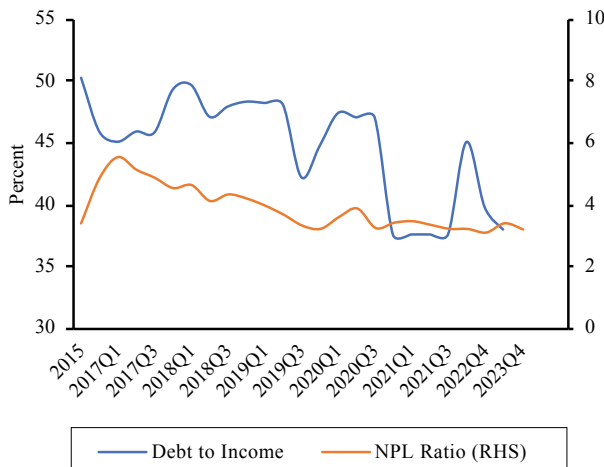


Chart 6.3b: Contribution to Credit Growth



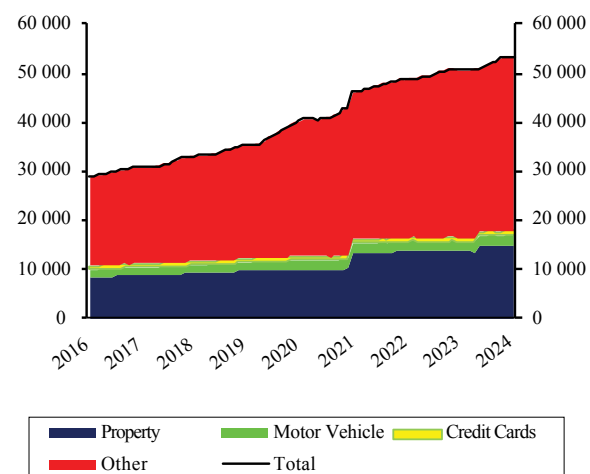
Both the debt burden and default rates are decreasing

Chart 6.3c: Debt to Income vs NPL Ratio



Personal loans dominate household debt

Chart 6.3d: Composition of Household Debt (P Million)



(c) Non-Financial Corporates Credit

Corporate sector exposures increase

6.7 Total commercial bank credit to the non financial corporate sector increased from P22.9 billion in February 2023 to P26.0 billion in February 2024. As a result, the proportion of corporate loans to total commercial banks' credit rose from 29.9 percent to 31.4 percent over the same period. Relative to GDP, bank credit to the corporate sector declined slightly to 10.8 percent in December 2023 from 10.2 percent in December 2022 and was significantly lower

than South Africa's 32 percent in December 2022⁶ and Namibia's 72 percent at the end of 2022⁷. This reflects room for prudent credit extension to support business activity and, in turn, domestic economic growth.

The corporate sector recovering but challenged by rising leverage

6.8 Selected financial soundness indicators of corporates listed on the Botswana Stock Exchange (BSE) indicate improved sector performance. Profit before and after tax increased, resulting in an increase in the return to equity.

⁶ SARB Financial Stability Review, Second Edition 2023.

⁷ Namibia Financial Stability Report, April 2023.

The cost-to-income ratio increased from 74.9 percent in 2021 to 81.7 percent in 2022 due to resumption in normal operation, which translated into increased production and, in turn, rising operating costs. Corporate leverage increased, with a debt-to-equity ratio of 102.6 percent in 2022 from 85.2 percent in 2021, suggesting that corporates have applied significant external funding in their operations. The increased leverage could cause corporate debt overhang and distress in the event financial conditions tighten suddenly. Meanwhile, the quality of corporate sector loans remained the same between December 2022 and December 2023, with an NPLs ratio of 5.7 percent.

Firms less optimistic about business conditions

- 6.9 The results of the March 2024 BES suggest that firms were less optimistic about business conditions in the first quarter of 2024, compared with the fourth quarter of 2023. The reduced level of optimism in the current quarter is reflected by the expected deceleration in exports and imports of goods and services; production; inventories; profitability; and investment in buildings, as well as plant and machinery, mainly owing to the weaker global demand and adverse impact of the Russia-Ukraine and Israel-Hamas wars. Firms expect GDP to expand by 3.2 percent and 3.4 percent in the first and second quarters of 2024.

(d) Property Market Credit

Limited risks from commercial real estate

- 6.10 Commercial real estate (CRE) credit increased to P6.2 billion in February 2024, from P5.6 billion in February 2023 and constituted 7.1 percent of total loans (Chart 6.4b). The CRE sector has maintained moderate NPLs ratio of 2.2 percent in December 2023, and coupled with the minimal exposure, poses limited risks to domestic financial stability. There are, however, outstanding concerns about concentration (location) risk, given that most loans finance properties in or around Gaborone⁸.

Mortgage lending short of development needs

- 6.11 Residential real estate loans increased slightly to P15.5 billion in February 2024 from the P14.4 billion in February 2023, constituting 27.6 percent and 10.8 percent of total household credit and total credit, respectively, (Chart 6.4a). These proportions compare unfavourably with South Africa and Namibia, where mortgage constituted 61 percent and 70 percent, respectively, of total household loans, thus suggesting that the level of domestic housing finance is not commensurate with the needed development and growth path to fill the apparent need for housing, as well as the financing gap⁹. At the same time, growth in incomes could be restrained relative to the increase in residential house prices over the years (possibly reflecting limited housing stock in various categories, or availability of land and prices of building materials).

Limited credit risk from mortgage lending

- 6.12 Credit risk in the mortgage sub-sector remains low, with commercial banks maintaining moderate loan-to-value (LTV) ratios, although the ratios have reached 105 percent in some isolated cases (Chart 6.5). The moderate LTV ratios, as well as security in the form of property financed limit the expected losses of banks from mortgage credit default. The proportion of impaired mortgage loans to total mortgage declined from 6.9 percent in December 2022 to 6.3 percent in December 2023, reflecting in part, the diminishing adverse effects of the COVID-19 pandemic on households. Overall, given the limited exposure as well as the self-secured nature of real estate facilities, vulnerabilities in the sector pose minimal risk to financial stability, but prospective developments require continuous close monitoring and assessment.

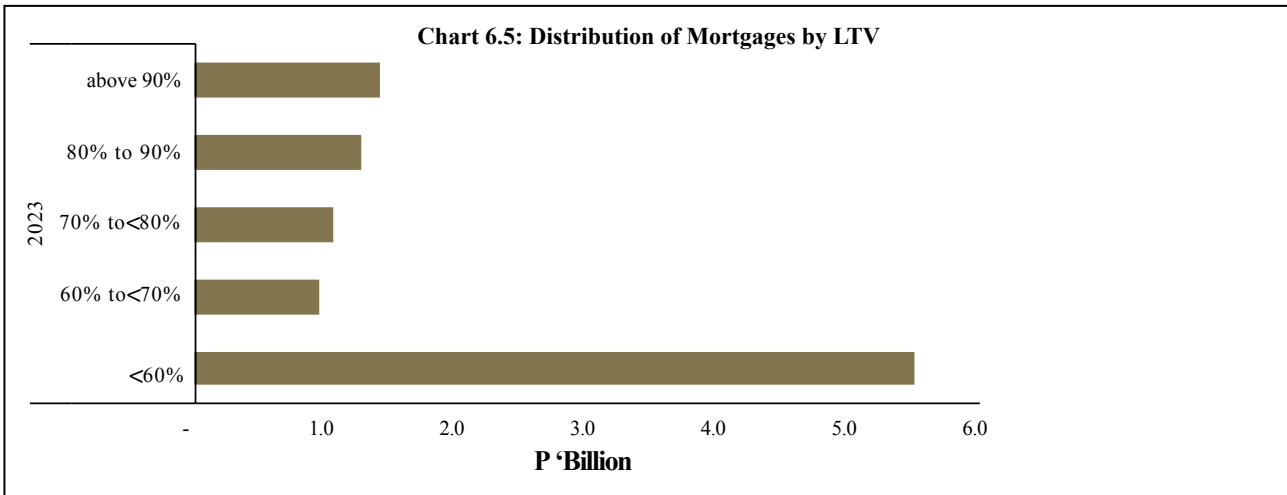
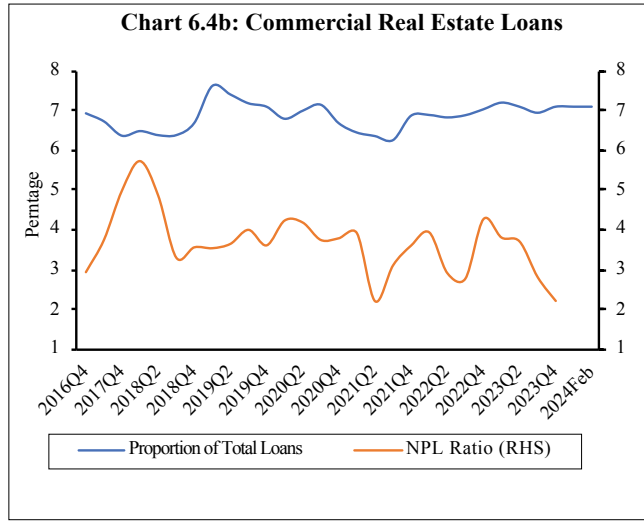
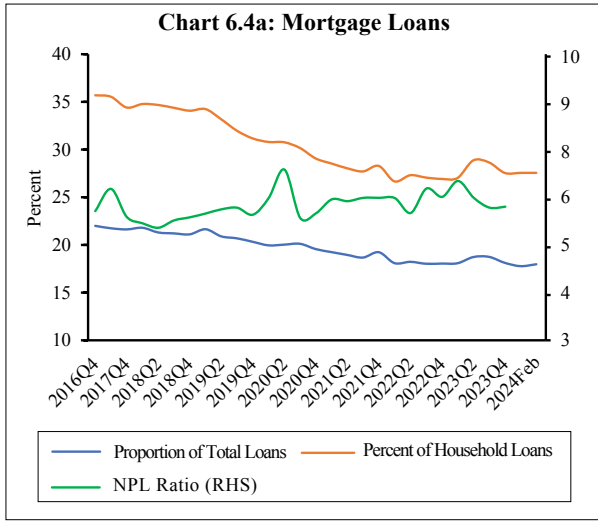
⁸ Bank of Botswana Residential Property Survey Report (Second quarter of 2022) and Riberry Property Market Report, June 2023.

⁹ Challenges in accessing mortgages viz., land tenure, relatively low average incomes and strict funding requirements have, however, shifted house financing to unsecured personal loans.

Property Market Developments

Mortgages as a percentage of both total loans and household loans and the NPL ratio are stable

The proportion of CRE loans to total loans is stable and the NPL ratio is volatile



7. LIQUIDITY AND FUNDING RISK

(a) Banking Sector Liquidity and Funding

Average market liquidity increased

- 7.1 Average daily market liquidity increased from P11 billion in January 2024 to P11.9 billion in February 2024, against the backdrop of high government spending. Banks continued to maintain adequate liquidity positions, with a liquid asset ratio (LAR) of 17.6 percent in February 2024.

Deposit concentration exposes banks to funding risks

- 7.2 The banking sector remains vulnerable to funding risk arising from a concentrated deposit base. Commercial banks' funding structure is concentrated on few wholesale deposits as reflected in the top 20 deposits to total deposits ratio of 44 percent in December 2023 and 42 percent in September 2023; highlighting the potential increase in funding costs due to the volatile and costly nature of wholesale deposits.
- 7.3 The banking industry continues to provide healthy levels of credit intermediation, with an intermediation ratio¹⁰ of 77.9 percent in January 2024, which is a slight decline from 81.7 percent in January 2023. This level of credit intermediation is within the 50 - 80 percent range and continues to support enduring economic growth.

(b) Interbank Funding

Non-D-SIBs dominate the interbank lending market

- 7.4 Interbank activity increased from P1.9 billion in January 2024 to P4.9 billion in February 2024, inconsistent with the overall increase in market liquidity. Non-D-SIBs contributed 55 percent to total interbank lending and took up 67.1 percent of total interbank borrowing.

(c) Foreign Currency Funding

US dollar funding risks remain limited

- 7.5 Domestic commercial banks' exposure to foreign exchange risks is highly limited and poses minimal threat to overall financial stability. That is reflected in both the overall net foreign exchange position and USD net open position of the banks. The overall net open position of banks increased from P102 million in December 2022 to P192 million in December 2023. The exposure represents 1 percent of unimpaired capital and remained significantly well within the prudential limit of 30 percent of unimpaired capital (Chart 7.1a). At the same time, the Pula equivalent overall net exposure of the domestic banking system to the US dollar increased to P335 million in December 2023 from P188 million in December 2022, translating into 2 percent of the industry's unimpaired capital and therefore showing limited risks from US dollar funding.

Limited exchange rate volatility

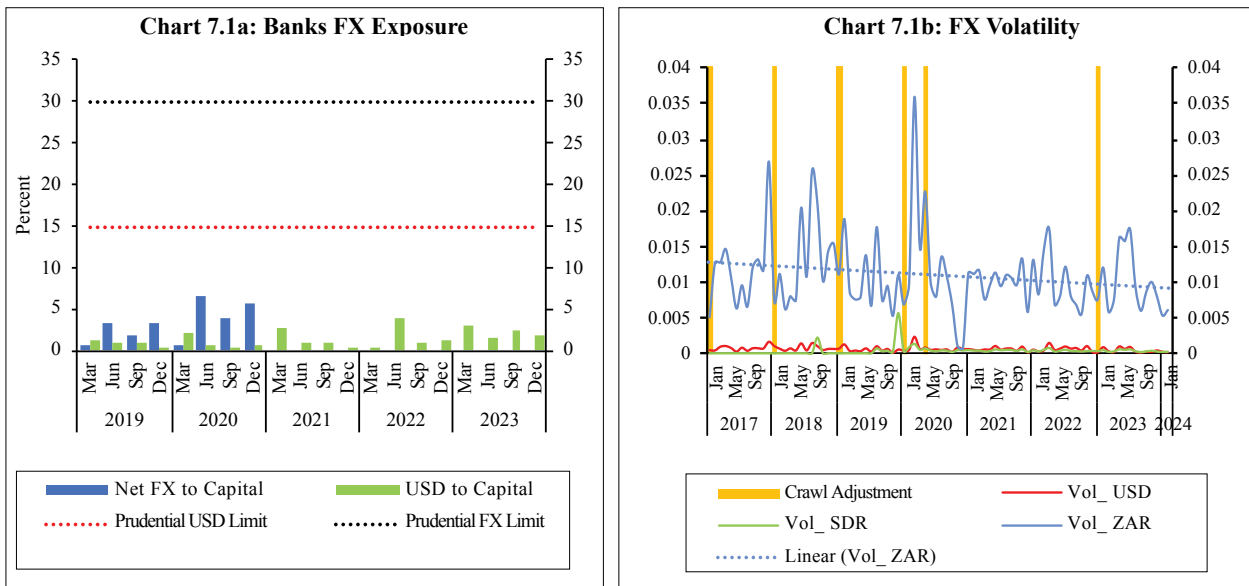
- 7.6 In the year to March 2024, the nominal Pula exchange rate appreciated by 0.8 percent against the South African rand but depreciated by 3.4 percent against the Special Drawing Rights (SDR). The movement of the Pula against the SDR constituent currencies largely reflected the performance of the South African rand against SDR constituent currencies. In that regard, the South African rand depreciated by 4.2 percent against the SDR. In general, volatility in the Pula exchange rate has been contained since May 2020 (Chart 7.1b), hence presenting limited risks to the domestic financial system and economy.

¹⁰ Measured as a ratio of loans to deposits, the financial intermediation ratio measures the extent to which funds (excess) are availed to those who need them.

Foreign Currency Funding and Exposure

Banks FX exposure is well below the prudential limits

Volatility of the BWP/ZAR nominal exchange rate has reverted to pre-COVID-19 levels



Source: Bank of Botswana

(d) Capital Markets – Equity Funding

Market capitalisation and liquidity improves

7.7 The total equity market value of domestic listed companies gained 15.9 percent, year on year, to P48.3 billion in February 2024 (February 2023: P41.7 billion). The gains reflect the overall recovery of the domestic market due to the opening of the economy and the resultant increase in economic activity. In general, the market is showing signs of resilience, with month on month increases in market capitalisation leading to a cumulative gain of P10.9 billion since January 2022. The increase in listed equity valuations is mainly due to the increase in share prices of some companies, with Chobe Holdings leading with gains of 86.6 percent in share prices, followed by Standard Chartered Bank at 76 percent. Other observed share price gains averaged above 10 percent for domestic listed companies.

7.8 Due to the revaluation of listed companies, turnover for traded equities increased significantly in 2023, and the momentum is expected to carry on in 2024, leading to an improvement in market liquidity (Chart 7.2c). This led to a surge in the liquidity ratio from

2.1 percent in December 2022 to 9.3 percent in December 2023 (February 2024: 9.3 percent). The development is indicative of both the BSE’s public awareness campaigns and recovery from the impact of the COVID-19 pandemic. During the pandemic, equity prices of listed companies fell significantly, and the prices have been trending upwards since the opening of the economy.

The domestic stock market is profitable but volatile

7.9 Profitability in the domestic market improved significantly as demonstrated by a 25.5 percent appreciation in the domestic company total return index (DCTRI) in December 2023 against a depreciation of 0.4 percent in the corresponding period in 2022¹¹. Furthermore, developments in market capitalisation in the twelve months to December 2023 translated into a stronger performance of the domestic company index (DCI), as it turned around from a gradual decline that started in 2015 (Chart 7.2d). The losses suffered by the local stock market since 2015 were precipitated by weak economic fundamentals, which partially translated into poor company performance. The DCI recovered to 7010 in 2021 from

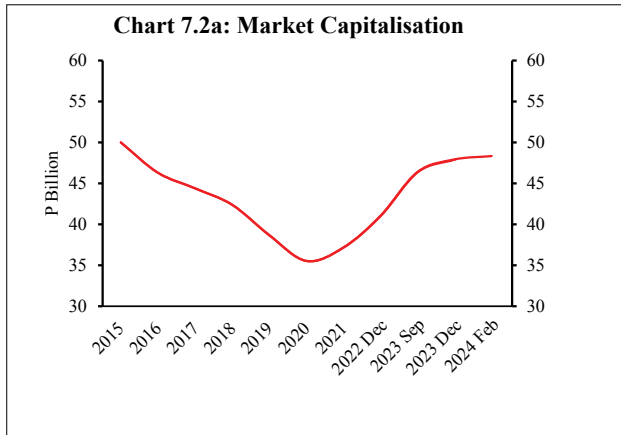
¹¹ The DCTRI shows gains (or losses) in equity positions due to market capitalisation appreciation (or depreciation) and dividend returns.

6865 in 2020, and further increased to 7726 in December 2022, and to 9001 in February 2024, albeit with rising volatility¹² that potentially reflects the inherently risky nature of equity markets (Chart 7.2f).

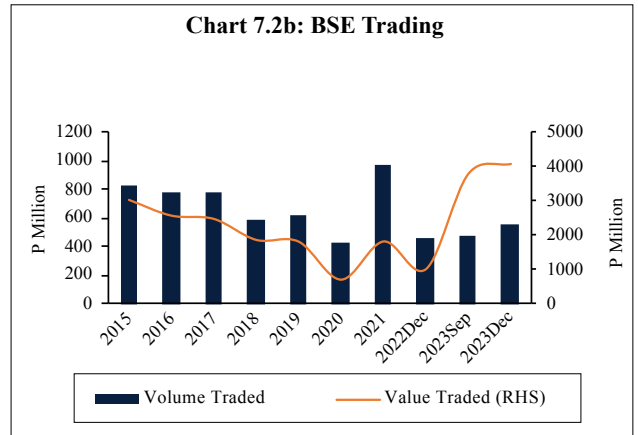
7.10 There is also a notable increase in the volatility of the foreign company index (FCI), owing to significant upward revaluations of equity prices for Anglo-American Company, CA Sales, and Investec over the twelve months to December 2023.

Stock Market Developments

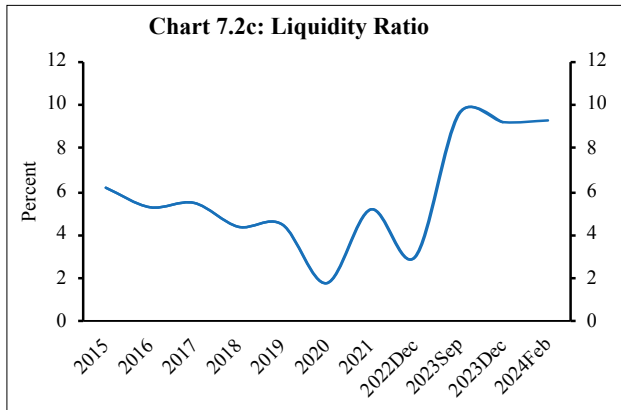
Banks FX exposure is well below the prudential limits



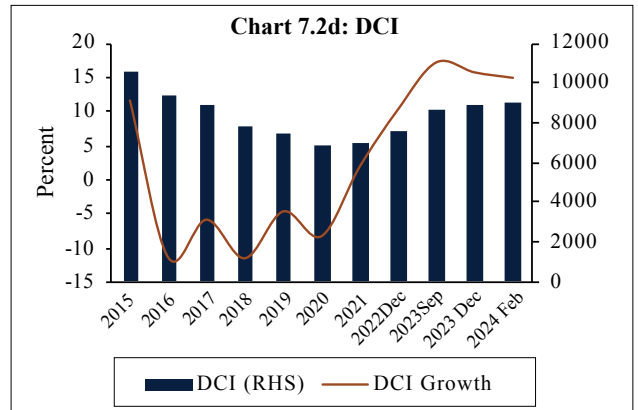
Volatility of the BWP/ZAR nominal exchange rate has reverted to pre-COVID-19 levels



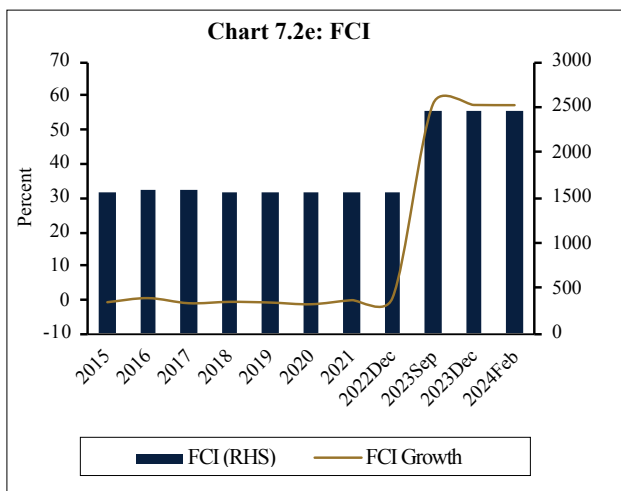
Liquidity in the BSE is increasing



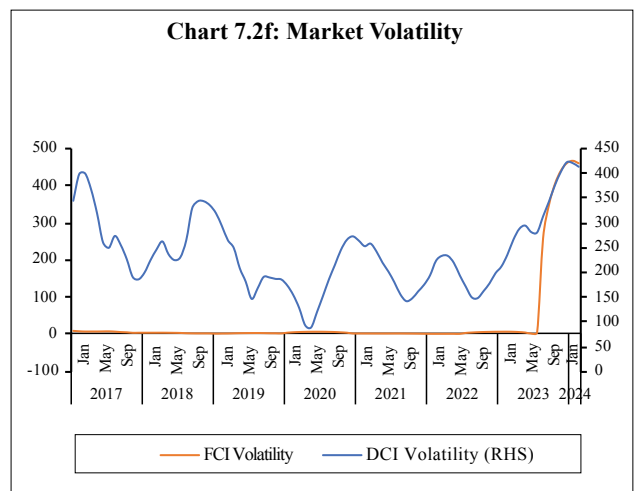
The DCI is improving



The Foreign Company Index is improving



Both DCI and FCI are highly volatile



Source: Botswana Stock Exchange and Bank of Botswana

12 Measured as the 12-month standard deviation of the DCI.

(e) Capital Markets – Bond Market Funding

Government bonds drive market capitalisation

7.11 Bond market capitalisation increased by 13.6 percent to P28.5 billion in the twelve months to February 2024 from P25.1 billion in February 2023, owing to the listing of new corporate bonds on the stock exchange and re opening of government bonds (Chart 7.3a). Since December 2021, the re-opening of government bonds has resulted in a cumulative increase of P5.5 billion in the value of government bonds¹³. Consequently, the nominal value of government bonds rose from P20.7 billion in December 2022 to P23.2 billion in December 2023, and to P24 billion in February 2024, while corporate bond valuations grew by 33 percent to P5.3 billion. It is also worth noting that redemption of a government bond in June 2023 led to the nominal value of listed bonds falling momentarily to P24.1 billion in June 2023 from P24.8 billion in June 2022.

7.12 The proportion of government bonds in the nominal value of the fixed income market was 81.4 percent in December 2023, and 84 percent in February 2024 and continues to demonstrate governments' ongoing commitment to deepen and develop the domestic capital markets. Nevertheless, a sustained dominance of government securities has the potential to crowd out capital funding from the private sector and may need to be scaled down as capital markets mature.

Bonds yield spread widening

7.13 The spread between average yields on corporate and government bonds increased from 0.54 percent in December 2023 to 1.53 percent in February 2024. The increase in the spread reflects falling yields on government bonds as financing conditions in the global markets improve and sovereign risks are abated. At the same time, yields on corporate bonds have significantly increased in the last quarter of 2023, but they are still significantly higher than the COVID-19 pandemic levels. This is indicative

of a growing risk premium placed on bond securities by investors. Meanwhile, uncertain global financing conditions, in conjunction with the effects of the Russia-Ukraine war and faltering economic recovery present significant uncertainty for the domestic capital market. Furthermore, tightening of monetary policy has the potential to increase interest rates on new bonds, which would depreciate the value of existing bonds as recently witnessed in the United States of America (USA).

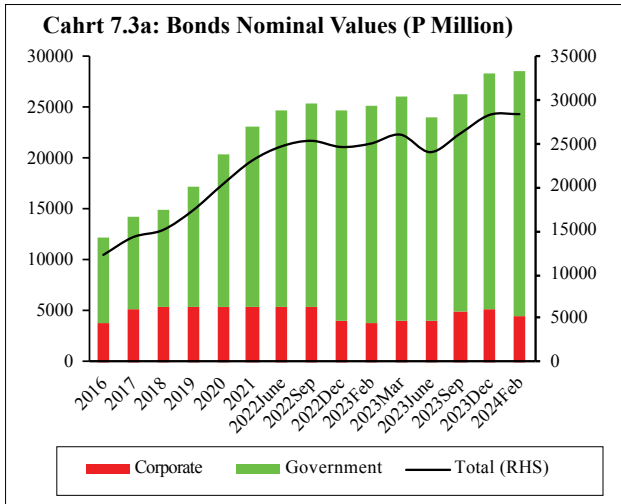
Bond market volatility increasing

7.14 The riskiness of all bonds is increasing as reflected in the increasing volatility of the bond indices (Chart 7.3f). The potential for tightening of funding in the bond market therefore remains. However, the generally accommodative financial conditions domestically, as judged from the real monetary conditions index (RMCI), present in the money markets funding opportunities that would augment any shortfall in capital market funding.

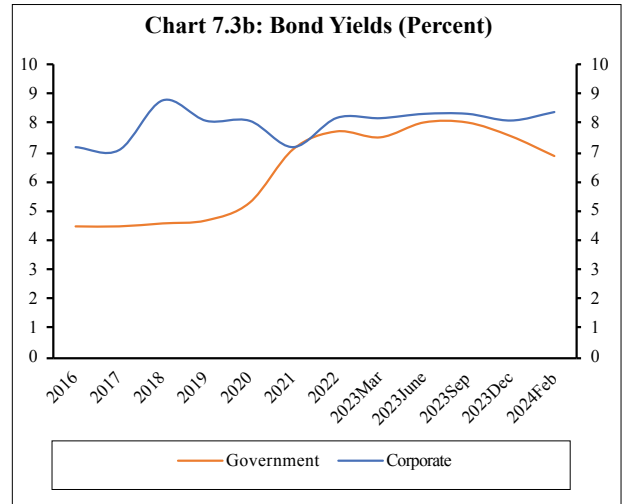
¹³ Reissuances were made on Government bonds BOTSGB0931 (P227 million), BOTSGB0640 (P225 million), BOTSGB0943 (P20 million) and BOTSGB0527 (P85 million).

Bond Market Developments

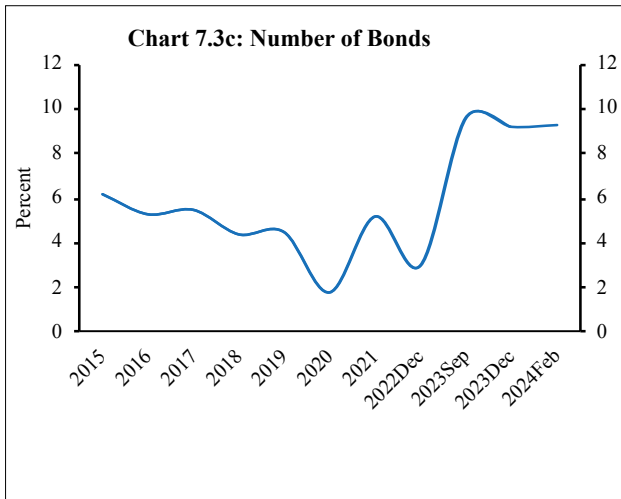
Government bonds dominate the bonds market



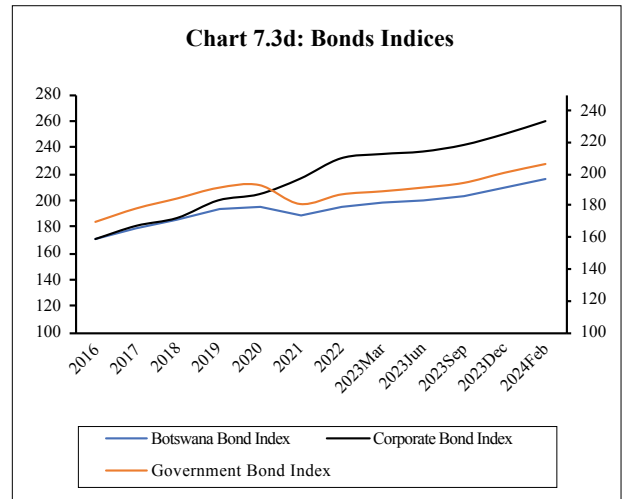
Bonds yields still above pre-COVID-19 levels, indicating higher uncertainty



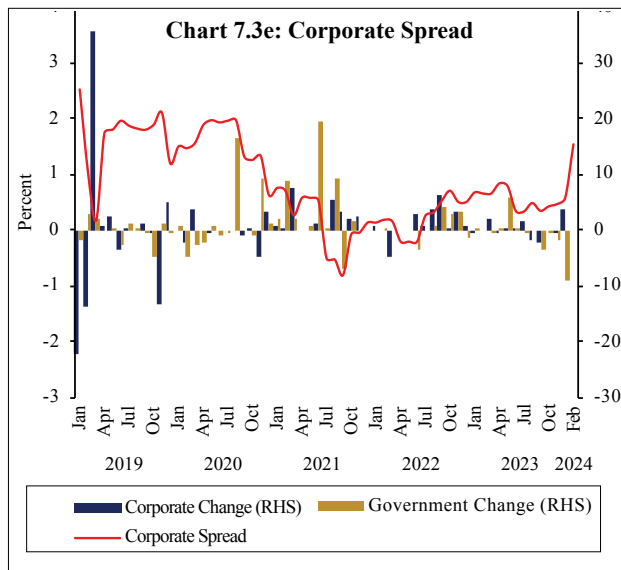
Corporates have many low-value bonds listed on the BSE



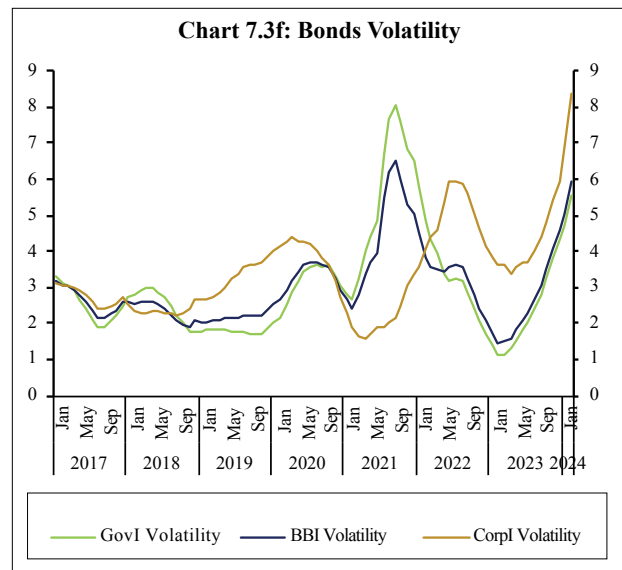
Bond indices are trending upwards



The corporate spread is widening



Bonds market volatility is increasing



Source: Botswana Stock Exchange and Bank of Botswana Calculations

8. CONTAGION RISK

D-SIBs and D-SIIs for 2024 identified and designated

8.1 The Bank developed a D-SIBs framework in 2021, with the first list of D-SIBs published in the May 2022 FSR. The D SIBs Framework is based on the assessment methodology of Basel Committee on Banking Supervision (BCBS) for G-SIBs. D-SIBs are banks which have the potential to significantly affect the stability of the domestic financial system should they become non-viable. Similarly, in 2023, NBFIRA developed a framework for identifying Domestic Systemically Important Insurers (D-SIIs) in Botswana, modelled on the International Association of Insurance Supervisors (IAIS) methodology. The Framework uses categories of size, cross-border activity, interconnectedness, substitutability and asset liquidation to identify the D-SIIs. The identification of systemically important institutions is part of the broader Macroprudential Policy Framework in which authorities wish to manage structural vulnerabilities within the financial system that arise through interlinkages, as well as direct and indirect exposure concentrations. The frameworks are thus, intended to strengthen the resilience of the domestic financial system through dedicated monitoring and supervision of D-SIBs and D-SIIs.

8.2 Using commercial banks data for December 2023, two D-SIBs for Botswana were identified, namely, FNBB and ABSA, which scored 206 points and 199 points, respectively. Domestic assets of the two banks constitute the largest share of total banking industry domestic assets. They represent 44.2 percent of the industry total assets and 53 percent of household deposits in Botswana. The combined number of bank branches for FNBB and ABSA is half of the total number of bank branches in Botswana. The D-SIIs for 2024 were identified and designated as Botswana Life Insurance Limited (life insurer), the Hollard Insurance Company of Botswana (general insurer) and Continental Reinsurance Company (reinsurer).

8.3 The identified D-SIBs and D-SIIs are adequately capitalised, liquid and solvent, hence pose no threat to domestic financial stability. The Bank and NBFIRA will continue to undertake assessment of the systemic importance of banks and insurers, respectively, in Botswana, annually to ensure that the results reflect the current state of economic and financial developments.

Significant interlinkages pose a risk of contagion

8.4 Significant interlinkages persist in the financial system, with the banking sector at the centre of the system. The banking sector is largely exposed to households (Figure 8.1) which, in turn, are highly exposed to NBFIs, with most of their assets, mainly pension assets, held by the sector. Moreover, a significant amount of NBFi assets (59.3 percent) are held abroad, exposing NBFIs to external financial and economic shocks, albeit providing the needed portfolio diversification benefits. NBFIs are also inter-linked with the rest of the financial system through multiple channels, such as deposits held with banks, funding avenues and capital market activities. In February 2024, NBFIs had a net lending position to commercial banks (deposits held with banks less loans from banks) of P22.5 billion. Similarly, NBFIs had bonds worth about P1.3 billion in the domestic market and a listed equity market capitalisation of P8.5 billion in the same period. Pension funds and asset management companies also hold equity positions in other sectors of the economy through their investment strategies. These interlinkages present a conduit through which contagion risk could be easily transmitted, hence present a potential source of systemic risk. Nevertheless, the risk is moderated by effective regulation and supervision of the domestic financial system.

8.5 Corporates were net lenders to banks in February 2024, with their deposits accounting for 35.6 percent of total commercial bank deposits, while their borrowing accounted for 28.0 percent of commercial bank credit. Meanwhile, deposits from NBFIs contributed a significant portion of bank funding, at 24.1 percent of total deposits, in February 2024.

The interlinkages also extend to state owned enterprises (SOEs), which accounted for 14.2 percent of bank deposits, while loans to the sector were 3.2 percent of total bank lending in February 2024. A sudden withdrawal of these funds would squeeze bank's funding and therefore warrant closer supervisory attention.

Insurance sector highly concentrated and interconnected

- 8.6 Insurance companies could affect financial stability and contribute to systemic risk through three potential transmission channels, namely, failure to provide critical services; inability to mitigate risk and compensate for loss with respect to systemically important counterparties; and risk to systemically important financial institutions. In a highly concentrated market, substitutability may be difficult upon failure of a dominant market player. Lack of alternative service providers could amplify the effect of an insurance company's distress on the real economy. This condition warranted development of a D-SIIs framework to support enhanced monitoring and supervision of such entities.
- 8.7 Life insurers continue to dominate the insurance industry, contributing the largest share of assets, at P20 billion in December 2023, while general insurers' assets were about P2 billion. Furthermore, the insurance industry in Botswana is interlinked with various market players and households, signifying a diversified portfolio and a potential contagion risk. A large concentration of the industry's assets (48 percent) is in the local collective investments units (CIUs), made up of both money market funds and non-money market funds (MMFs and NMMFs). Further, life insurers are more exposed to local CIUs (at 55 percent) than both general insurers and reinsurers. Local NMMFs hold 91 percent of the life insurance industry assets, hence pose a low risk of asset-liability mismatch since NMMFs invest in long-term assets. General insurance is equally exposed to Botswana residents (31 percent), commercial banks, statutory banks and the Savings and Credit Cooperative Society (31 percent). About 41 percent of reinsurance companies' assets are held by residents. Notwithstanding, the

risk-based supervision and regulatory approach currently applied by NBFIRA is effective in mitigating the risks identified in the NBFIs sectors.

Financial sector assets increase

- 8.8 The size of the financial system as reflected by total assets of banks and NBFIs increased by 12.7 percent to P320 billion in December 2023 from P284 billion in December 2022. NBFIs financial assets (mainly, pension funds) grew, reflecting improved performance in global financial markets. In December 2023, the NBFIs sector accounted for the largest share of financial system assets at 57 percent, compared with 43 percent of the banking sector. The size of the entire financial system represented approximately 121.4 percent of GDP in December 2023, compared to the 112.8 percent in December 2022, demonstrating the significant contribution of the financial sector to the economy.

Structure of the Financial System

The structure of the financial system has not changed much since 2016

Chart 8.1a: Structure of the Financial System in 2016

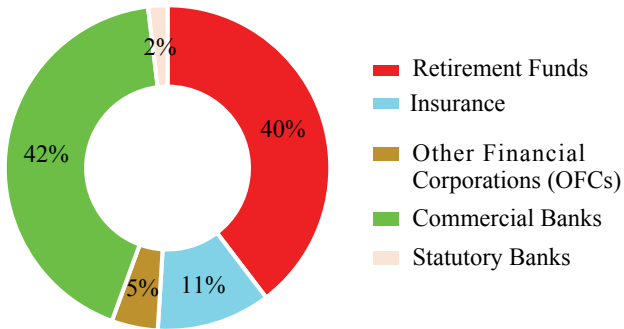
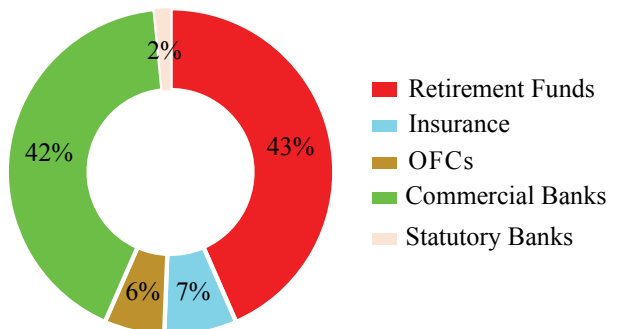
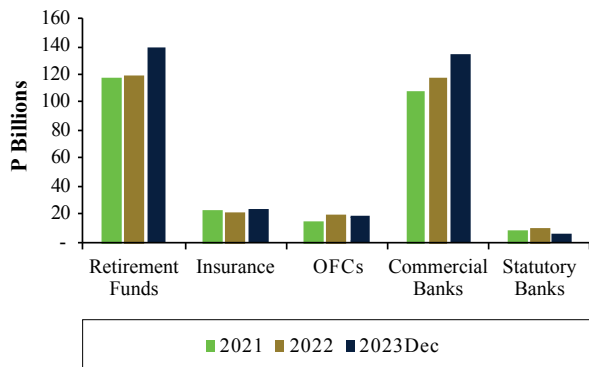


Chart 8.1b: Structure of the Financial System in December 2023



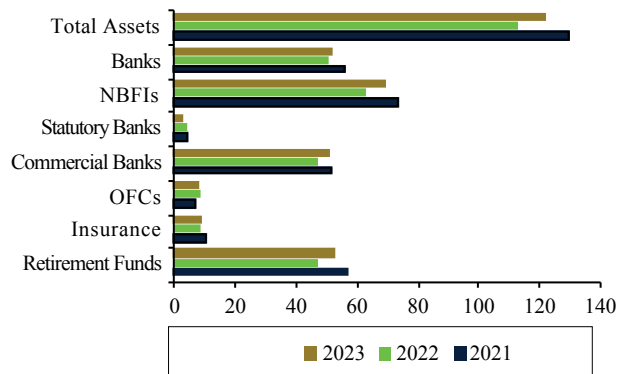
Retirement funds and commercial bank assets are relatively high

Chart 8.1c: Financial System Assets



NBFIs have the largest proportion to GDP owing to the relatively large retirement funds

Chart 8.1d: Financial Assets to GDP (Percent)



Financial Sector Inter-linkages

Banks are highly interconnected with the rest of the financial system

Figure 8.1: Macro-Financial Linkages (February 2024)



Notes:

1. A large node indicates a higher degree of interconnectedness across the financial system.
2. Thicker edges show a higher proportion of funds flowing out of the sector relative to the financial system.
3. Balances from the Bank to the external sector represent net foreign assets.
4. Balances from other financial corporations to the external sector are pension fund assets invested offshore.
5. Balances from commercial banks to the external sector are commercial banks' balances due from foreign banks.
6. See Table A5 in the Appendix for data on the flow of funds across the system and to the (or from) the external sector.
7. For Other Financial Corporations, 76 percent are retirement funds assets (December 2023).

Source: Bank of Botswana

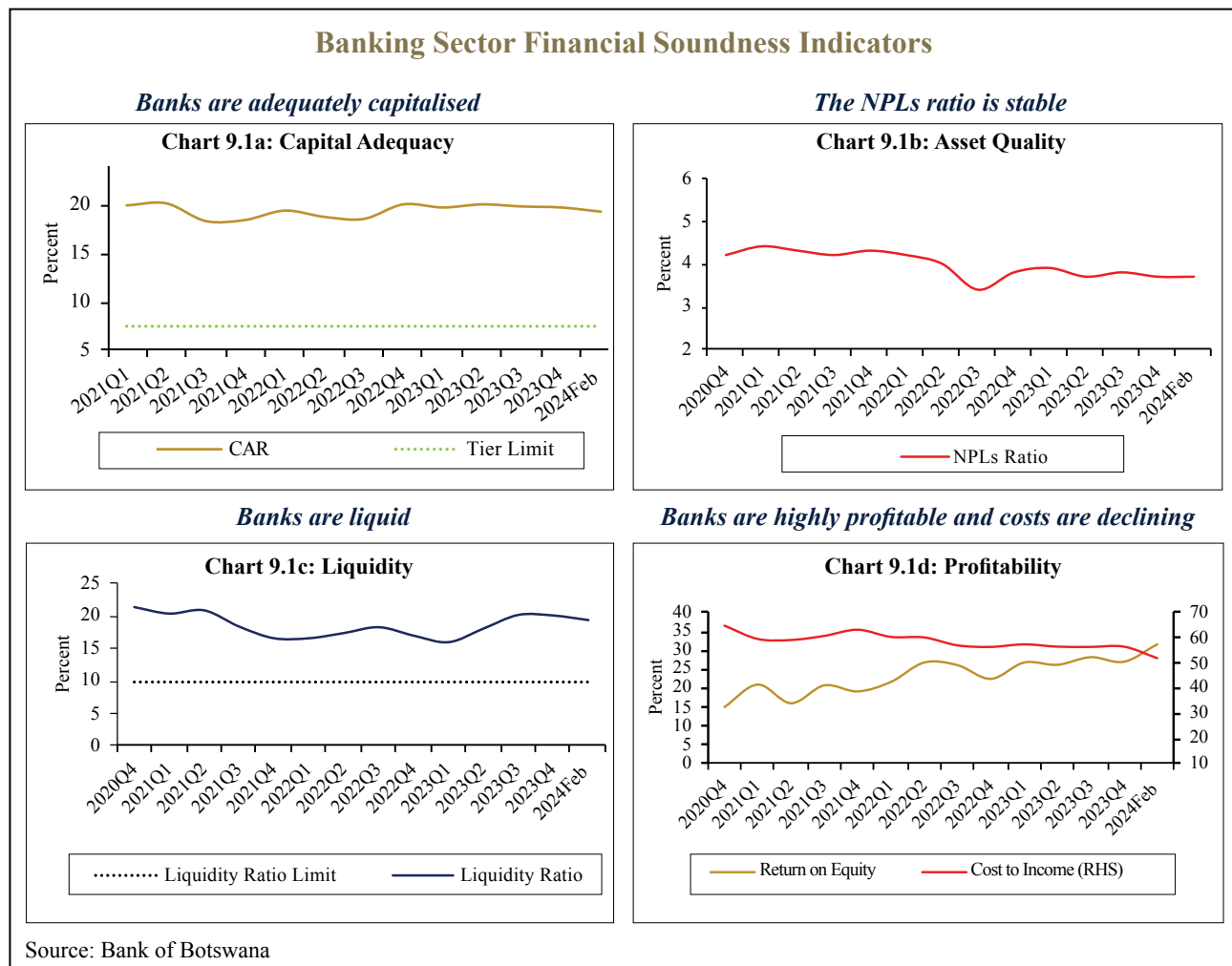
9. BANKING SECTOR RISK ANALYSIS

sector continues to be profitable, adequately capitalised and liquid, with stable credit quality (Charts 9.1a to 9.1d).

(a) Asset Quality and Performance

Banks are generally solvent, profitable, and well capitalised

9.1 Financial soundness indicators as at end of February 2024 indicate that the banking



(b) Stress Test Scenarios

9.2 The stress test assesses the resilience of the domestic banking sector to plausible moderate and adverse macro-financial shocks. The assumption for the tests is uncertain economic conditions, characterised by volatile nominal exchange rates, high global inflation rate, declining domestic market liquidity, stagnant household incomes, heightened climate risks, and geopolitical-induced vulnerabilities. The economic environment is assumed to present income challenges to businesses and corporates

alike, affecting their capacity to service their loans and support economic recovery, with a negative impact on the asset quality of banks.

9.3 In this context, the stress test exercise considered the impact of the economic uncertainty on the solvency of households and businesses and the potential impact of moderate and severe recessionary scenarios on the solvency or capitalisation of the banking sector, as well as the simulation of bank runs resulting from a decline in confidence of banking customers as the assumed risks materialise.

9.4 The tests, based on December 2023 data, involve simulation of credit losses due to an increase in NPLs for the credit risk, bank runs for the liquidity risk and a decrease in the policy rate affecting repricing gaps and the pricing of bonds for the interest rate risk. The policy decrease simulation considers a case where, the projected low inflation into the medium term leads to an easing of monetary policy to support economic activity.

Banks are subjected to credit shocks

9.5 Credit risk tests include the aggregate NPL shock, the concentration shock and sector specific credit-risk shocks. In the aggregate NPL shock it is assumed that 10 percent of performing loans are going to be non performing in the moderate scenario and 20 percent in the severe scenario. For the concentration shock, one largest exposure becomes non-performing in moderate scenario and two largest exposures become non performing in the severe scenario.

9.6 Sector specific tests were also conducted to capture the idiosyncratic impact of credit shocks across all sectors of the economy. With subdued global economic performance, potential sources of credit risks include possible second round effects of the pandemic on credit losses and structural vulnerabilities associated with overall dependence on the diamond sector, especially for government revenue, as well as the dominance of household unsecured lending in the credit books of banks. The dominance of household credit in total commercial bank credit can be a source of credit losses. Unsecured credit presents a significant underlying risk to the banking sector, especially in the event of a sudden erosion of the households' capacity to service their loans.

Banks are subjected to liquidity and interest rate shocks

9.7 The liquidity shock simulates stress on banks lasting 30 days, where banks' liabilities are demanded at specific rates for each liability category (run-off rates) and banks' assets are discounted at certain percentage rates (haircuts) when they go to the market to finance their

liquidity needs. The purpose of the liquidity stress is to test the ability of banks to meet near-term payment obligations when faced with loss of funding and counterparty cash drains. The test uses haircuts for asset holdings and run off rates for liabilities to estimate the number of days a bank is likely to survive a bank run without the assistance of the central bank or any other sources of financing.

9.8 The interest rate test considers the direct interest risk incurred by a financial institution when interest rate sensitivities of assets and liabilities of banks are mismatched. The test simulates changes in interest income and interest expenses resulting from the gap between the flow of interest on the holdings of assets and liabilities in each category. The gap in each time band or repricing category shows how net interest income will be affected by a given change in interest rates.

9.9 The moderate scenario assumes that the interest rate will decrease by 150 basis points and for the severe scenario, it would decrease by 225 basis points. Furthermore, the policy rate cut shocks assume that inflation will remain within the objective range in the short-to-medium term.

D-SIBs subjected to more severe stress conditions

9.10 For a subset of banks that are D-SIBs, a sensitivity scenario is assumed, whereby banks are simultaneously affected by a combination of shocks, including a general increase in NPLs and an upward adjustment in the policy rate, which leads to an increase in interest income. In addition, for the moderate scenario, the stress test exercise assumes credit losses for vulnerable sectors and the largest exposure. Under the severe scenario, credit losses are assumed for the total loan portfolio and two largest exposures. To capture liquidity risks associated with the potential insolvency of the D-SIBs in the stress scenario, the threshold for the capital adequacy ratio (CAR) is set such that the banks are closed out of funding markets if the post-shock CAR breaches set hurdle rates.

(c) Stress Test Results

Banks resilient but susceptible to severe credit shocks

- 9.11 The results of credit shocks indicate that commercial banks are generally resilient to stress, save for severe credit shocks that could result in significant prudential capital breaches. Under the system-wide moderate scenario, where an additional 10 percent of performing loans are assumed to become NPLs, bank capital adequacy levels decline to 10.9 percent, thus breaching the prudential capital adequacy requirement of 12.5 percent. The industry capital position worsens to 1.3 percent in the severe scenario, where 20 percent of performing loans are assumed to become NPLs. As a result, the asset quality declines, with the ratio of NPLs to total loans rising from a baseline of 3.7 percent to 13.2 percent and 22.8 percent under moderate and severe scenarios, respectively (Chart 9.2d).
- 9.12 For the sectoral shocks, under the moderate scenario, banks' CAR falls to 8.8 percent, while the NPLs ratio increases to 15.5 percent. The CAR falls further to 4.1 percent under the severe scenario, and credit quality deteriorates significantly with an NPL ratio of 20.2 percent. Regarding credit concentration shocks, banks breach the capital adequacy requirement at 9.9 percent under the assumption that the largest borrower defaults for each bank (moderate scenario). The CAR further falls to 5.1 percent under the severe scenario, which assumes that the largest two counterparties will default.
- 9.13 Under the moderate concentration and overall NPL scenarios, D-SIBs are resilient, with a CAR above the prudential limit at 15.9 percent for the concentration shock and 13.5 percent for the overall NPL shock. For the severe concentration and overall NPL shocks, CAR falls to 12.4 percent and 4.1 percent, respectively (Chart 9.2a).
- 9.14 In general, credit risk tests show that the overall NPLs shock has more prominence in the capital and asset quality position of banks than other shocks. Nevertheless, credit stress tests do not consider credit mitigation measures, such as underlying collateral.

Banks are resilient to liquidity shocks

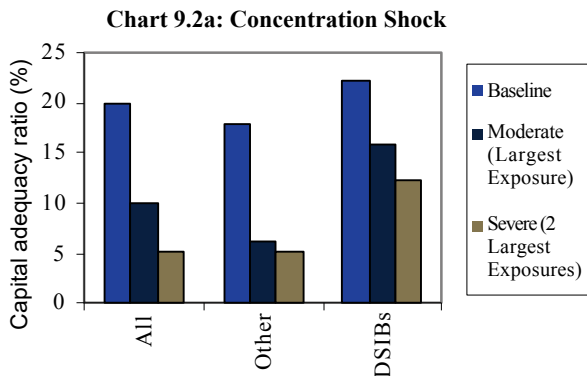
- 9.15 In the liquidity risk test, banks show resilience to a liability run in the moderate stress scenario, and all banks can withstand liability drawdowns for 17 days. Under the severe stress conditions, all banks would be able to withstand drawdowns for 6 days. The results show that dependence on wholesale deposits is prevalent in both bank categories, with a range of 26 to 67 percent of total customer deposits. Therefore, there is need for banks to continue diversifying their portfolios to mitigate liquidity risks.
- 9.16 However, the scenarios do not consider the availability of liquidity support provided by the Bank through the Credit Facility nor liquidity support available from related companies or holding banks. Accordingly, stress test results should not be interpreted to mean that banks would default under these conditions.

Bank profitability to increase with a policy rate decrease

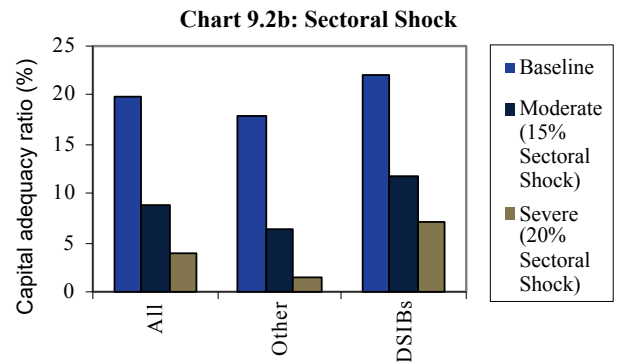
- 9.17 Results of the moderate interest rate shock indicate that a fall in the policy rate by 150 basis points would lead to an increase in interest income by P73.5 million, with an accompanying potential gain of P66.8 million from repricing of government bonds. Overall, banks' CAR would increase by 0.66 percentage points in the moderate interest rate shock scenario. For the severe scenario, banks would gain P110 million from interest earnings and P100 million from repricing of bonds, leading to an improvement of 0.75 percent for the CAR (Chart 9.2f).
- 9.18 The increase in profit generally reflects the banking industry's negative cumulative repricing gap over the next 12 months, where interest earning liabilities exceed interest earning assets in the stress horizon. Therefore, banks would gain from a fall in funding costs. Overall, domestic banks are highly liquid and can afford to hold bonds to maturity, therefore, there is limited risk stemming from the potential repricing of government bonds.

December 2023 Stress Test Results Credit Shocks

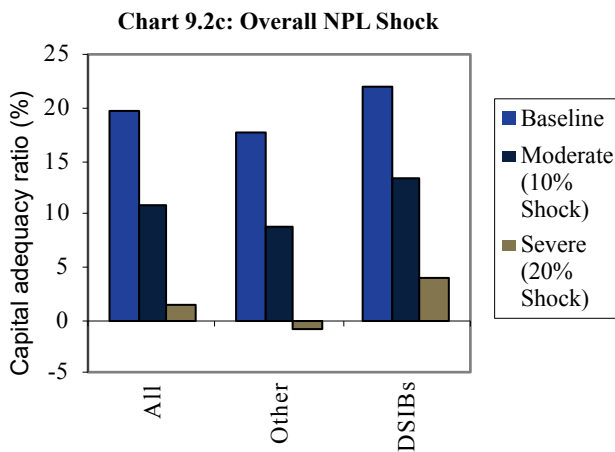
Banks are generally resilient to credit concentration shocks



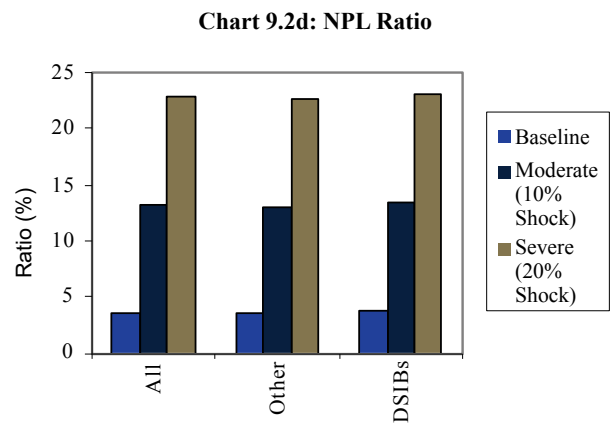
Severe sectoral shocks would lead to a significant breach in the capital adequacy ratio



A severe aggregate credit shock would deplete banks' capital

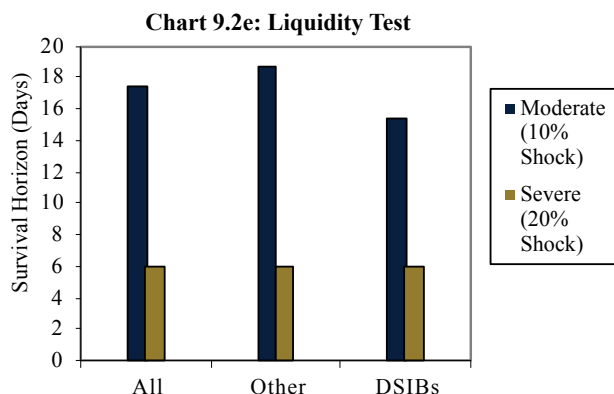


The NPL ratio for the aggregate credit shock increases significantly in the severe scenario

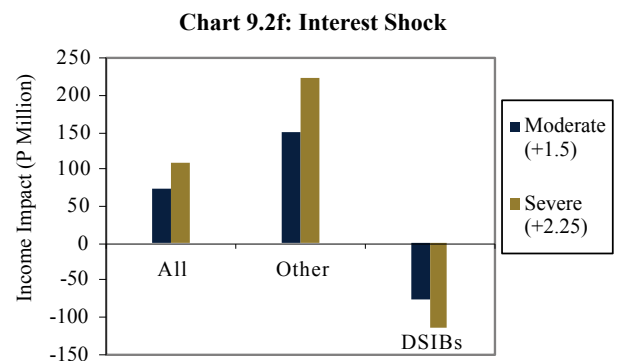


Liquidity and Interest Rate Shocks

Banks generally have low survival horizon under a severe liquidity shock



Bank profitability to increase with a policy rate decrease



D-SIBs are resilient to a combination of shocks

9.19 Considering a combination of shocks for scenario analysis, D-SIBs breach the prudential limit with a CAR of 8.5 percent in the moderate scenario and they are also insolvent in the severe scenario with a CAR of -8.5 percent (Chart 9.3a).

9.20 To capitalise D-SIBs, shareholders would have to inject capital amounting to P2.5 billion in the moderate scenario and P8.9 billion in the severe scenario. Given that credit mitigants are excluded from the stress test scenario, and the loss given default is assumed to be 100 percent, D-SIBs are adjudged to be resilient to

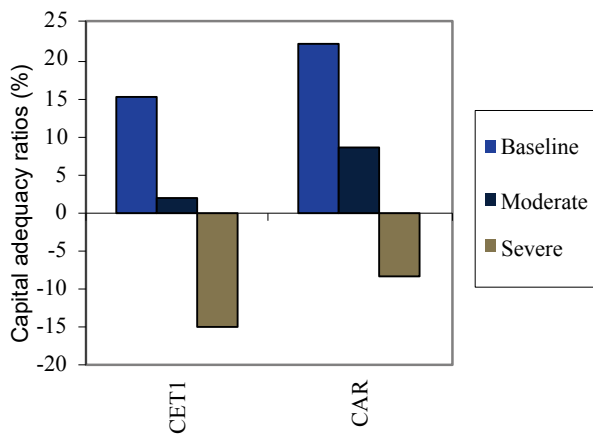
a combination of shocks, although susceptible to extreme shocks. To link liquidity risk and solvency of the D-SIBs, it is assumed that D-SIBs are closed out of funding markets if the CAR under stress scenario falls below set hurdle rates. Hurdle rates are set at 8 percent for customer deposits, 10 percent for short term funding and 4 percent for long-term funding. Under these assumptions, D-SIBs are closed out of short-term funding markets in the moderate

scenario and there is loss of short term funding amounting to P7.3 billion. Therefore, banks would not experience any liquidity shortfall. However, in the severe scenario, both D-SIBs are closed out of all funding markets, with an average CAR of -8.4 percent and total loss of funding of P13.2 billion. As a result, D-SIBs suffer a liquidity shortfall of P3.1 billion in the severe scenario.

D-SIBs Scenario Analysis

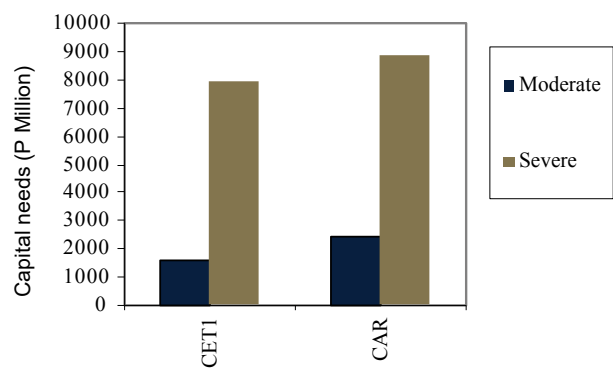
Severe stress scenario completely erodes D-SIBs' capital base

Chart 9.3a: D-SIBs Scenario



D-SIBs need significant capital injection to recapitalise under severe stress conditions

Chart 9.3b: Capital Needs



10. PAYMENTS AND SETTLEMENT RISKS

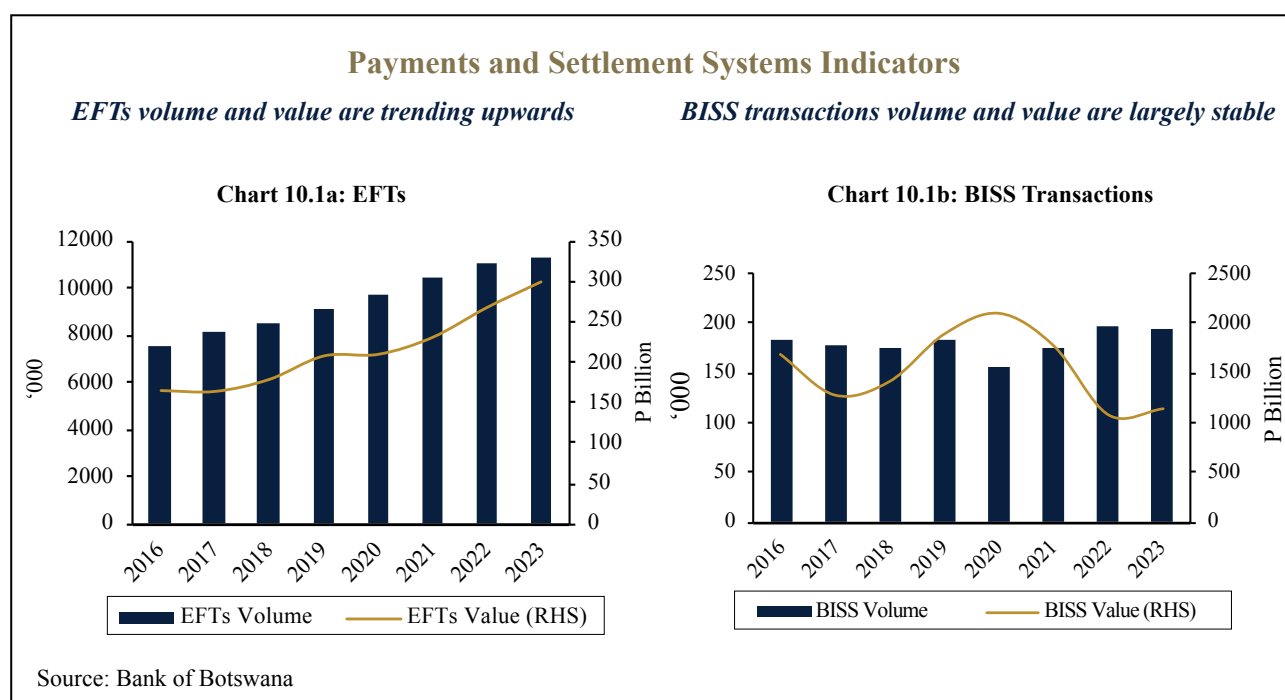
Increased digitalisation presents cyber risks

10.1 Clearing systems are largely resilient in handling large volumes of transactions without any major disruption. Meanwhile, the value and volume of electronic fund transfers (EFTs) continue to increase (Chart 10.1a).

10.2 The use of cheques as a payment instrument was discontinued on 31 December 2023 owing to challenges associated with their use and in recognition of availability of more cost efficient, safe, secure, and convenient digital/electronic payment instruments. As at 31 March 2024, the Bank had licensed twenty-five electronic

payment service (EPS) providers under the EPS Regulations of 2019. The emergence, growth and promotion of electronic payments is well aligned with, among others, digitalisation and financial inclusion initiatives, forming part of the economic transformation and policy reform programme for Botswana. It is, however, recognised that digital and electronic payments methods also entail risks that need to be identified, measured, mitigated and controlled.

10.3 Generally, FMIs consisting of payment systems, central securities depository, and securities settlement systems, remain stable and resilient, thus strengthening and preserving domestic financial stability.



11. REGULATORY DEVELOPMENTS

Regulatory and supervisory environment of the financial system conducive for financial stability

11.1 The regulatory and supervisory environment of the financial system remains robust and continues to be modernised and strengthened to elevate its effectiveness in controlling risk transmission and reducing vulnerabilities. Between 2022 and 2023, the financial sector conducted a holistic review of the regulatory and supervisory environment, resulting in amendments, enactments and re-enactments of several anchor laws. The list includes Bank of Botswana Act, amended and effected on 14 February 2023; Banking Act, re-enacted and published as an Act of Parliament on 26 May 2023; EPS (Amendment) Regulations, 2023; Financial Intelligence Act, 2022; and the Virtual Assets Act, 2022. As part of ongoing efforts to strengthen resolution and financial safety nets, the DISB was established in January 2023, and gained full legal authority after the coming into effect of the Bank of Botswana (Deposit Insurance Scheme) Regulations on 21 July 2023. The Deposit Insurance Committee (DIC), which is the governing body of DISB, is fully constituted following the appointment of independent members by the Minister of Finance on 1 April 2024. The DIC is responsible for providing oversight on the administration of the Fund and the management of the DISB (Box 11.1).

Credit bureaus to be regularised under the new Act

11.2 The Credit Information Act, 2021 came into operation in August 2022. The main objective of the Act is to provide for the regulation of the credit reporting system and licensing, as well as supervision of credit bureaus by the Bank. The three existing credit bureaus, namely, Credit Reference Bureau Africa (Pty) Ltd, Micro Finance Credit (Pty) Ltd and TransUnion (Pty) Ltd, as well as the fourth new potential entrant formally submitted their applications in 2023 to regularise their operations in accordance with the requirements of the Act. The Bank is reviewing the applications.

NBFIRA Act, 2023 effected

11.3 The NBFIRA Act, 2023 and the Securities (Amendment) Act, 2023, which have been aligned with international requirements and best practices, effected on 15 January 2024. The resultant changes enabled NBFIRA to be admitted as a member of the International Organisation of Securities Commissions (IOSCO), a global standard setter for the securities sector that brings together the world's securities regulators.

Income Tax (Amendment) Act, 2024 operational

11.4 Another important piece of legislation relates to the Income Tax (Amendment) Act, 2024, which came into effect on 15 January 2024. The Act aligns the Income Tax Act with the Retirement Funds Act, 2022. It increases the tax-free threshold applicable to pension fund commutable amounts, gratuity and severance pay from 33.33 percent to 50 percent. It also allows deferred pension members to access their pension funds to settle medical bills and use up to 50 percent of their deferred pension to settle loans. This development is expected to improve the soundness of retirees' financial standing and potentially reduce NPLs, provided the funds are properly used as intended.

National Financial Inclusion Roadmap and Strategy for 2024 - 2030 being developed

11.5 MoF is developing the new National Financial Inclusion Strategy and Roadmap, 2024–2030, in collaboration with the SADC Support Consortium comprising FinMark Trust, GFA Consulting Group and Southern Africa Trust. The new Strategy and Roadmap will be in line with the SADC Strategy on Financial Inclusion and Micro-Small and Medium Enterprises (MSMEs) access to finance and informed by the 2015–2021 National Financial Inclusion Strategy and Roadmap. The project is done under the Support for Improving the Business and Environment and will be launched in the first quarter of the 2024/25 financial year. Furthermore, MoF and SADC Support Consortium have commenced the 2024 FinScope Consumer Survey and the 2024 MSMEs Survey. Both projects are expected to be completed in the first quarter of the 2024/25 financial year.

Policy Protection Regulations being developed

- 11.6 To further enhance domestic financial safety nets, NBFIRA is developing legislation (Policy Protection Regulations, 2024) that would enable establishment of a fund to ensure protection of policyholders in the event of insolvency and failure of insurers to renew their licences, which may lead to non-honouring of claims. A technical working group has been set up and tasked with benchmarking the design of the fund, as well as engaging stakeholders for input in the development of the Regulations. The fund is expected to elevate investors' confidence in the insurance industry.

Botswana undergoing a mock ME in preparation for FATF's ME in 2027

- 11.7 According to the Eastern and Southern Africa Anti-Money Laundering Group Mutual Evaluation (ME) schedule, Botswana is expected to undergo an ME in January 2027. In preparation for the ME and to comply with AML/CFT/CPF international standards, Botswana completed a Money Laundering (ML) and Terrorist Financing (TF) National Risk Assessment in December 2023. The Assessment identified threats and vulnerabilities in some sectors and recommended counter measures to mitigate ML/TF risks. Additionally, the country is undergoing a mock ME with the technical support of the United Nations Office on Drugs and Crime. The mock ME started in February 2024, and is expected to be completed in August 2024. Further, Government is in the process of establishing a Centre for Combating Illicit Financial Flows in partnership with the University of Botswana to provide AML/CFT/CPF training and research. Establishment of the Institute is intended to contribute towards capacity building and the broader national security objectives of the country.

Box 11.1: Update on the Operations of the DISB

Introduction

This article outlines the performance of the DISB regarding achieving its mandate and fulfilling expectations of its stakeholders following its establishment in January 2023. The DISB has a *paybox plus* mandate, which allows for the payout of deposits in the rare event of failure of a member institution. This mandate also enables DISB to carry out additional functions, such as monitoring the performance of member institutions with a view to ensuring early detection of vulnerabilities that could lead to distress in some member institutions and to collaborate with the central bank to effectively respond to the risk of and actual failure of a member institution.

Governance

The Bank of Botswana (Deposit Insurance Scheme) Regulations, 2023 is the principal governing legislation of the DISB and it requires the Scheme, under regulation 16, to submit to the Minister of Finance, by 31st of March of each year, a report on its operations together with audited accounts. DISB has produced its inaugural Annual Report for submission to the Minister of Finance by the Chairperson of the Deposit Insurance Committee (DIC) following her appointment on 1 April 2024. The DIC is the governing body for DISB and is responsible for providing oversight on the administration of the Deposit Insurance Fund (DIF/Fund) and the management of DISB generally. The Committee established in terms of regulation 5 of the DISB Regulations, provides for constitution of its membership as follows:

- a) four members who are not public officers, one of whom is a representative of member institutions; a chairperson is appointed from amongst these members; and
- b) three ex-officio members:
 - i). Permanent Secretary in MoF,
 - ii). Governor, Bank of Botswana, and
 - iii). Director of the DISB.

The Minister of Finance has appointed the following non-public officers as members of the DIC with effect from 1 April 2024: Ms Clair Mathe-Lisenda (Chairperson); Ms Priscillah Ndadi (Member); Mr Oabile Mabusa (Member representing the Bankers' Association of Botswana) and Dr Jairos Josiah (Member). The three ex officio members are Ms Patrinah P. Masalela (Member representing the Permanent Secretary, MoF), the Governor, Bank of Botswana, Mr Cornelius K. Dekop and the Director of DISB, Mr Goememang Baatlhologeng.

DISB Membership

Membership of the DISB is mandatory for all commercial banks and deposit taking institutions licensed by the Bank. As of 31 December 2023, there were 10 member institutions, which included all commercial banks licensed by the Bank, as well as Botswana Savings Bank – a statutory bank.

Risk Analysis and Surveillance of Member Institutions

As of 31 December 2023, total insurable deposit liabilities amounted to P63.2 billion, constituting 59 percent of total deposit liabilities of member institutions. A review of member institutions' statutory returns data and on-site examination findings showed that during the review period, there were no member institutions that were considered distressed (i.e., a CAMELS composite

rating of 4 or 5) and most had satisfactory risk management practices for all major banking risks (i.e., credit, liquidity, market and operational risks). All member institutions were adequately capitalised and maintained satisfactory levels of liquidity. Even though some member institutions had challenges relating to asset quality and profitability, these did not warrant adverse ratings.

The DIF guarantees repayment of deposits up to a maximum of P250 000 per depositor per member institution in the event that a member institution fails. Coverage is extended to deposits held by member institutions of natural persons, as well as legal entities, regardless of origin of the deposit holder. Deposit balances over the coverage limit are uninsured and will therefore, be paid from the liquidation proceeds. The amount to be paid will depend on the recoveries made by the liquidator.

Performance of the DIF

The Fund balance was P25 million, made up of both refundable seed capital from government and membership registration fees, as of 31 December 2023. DISB was admitted as a participant in the Botswana Bond Auctions market in the last quarter of 2023 and participated in the government securities auction held on 29 December 2023 at which it was allotted a P7 million 3-month treasury bill.

Conclusion

The effectiveness of a deposit insurance system is built upon public confidence and credibility. Public awareness of the existence of a DISB is thus key in enhancing public confidence in the safety of deposits and stability of the domestic financial system. Consequently, during the second half of 2023, DISB conducted its inaugural public education initiative through the national radio station programme Masa-a-Sele, with the view to informing the public about the establishment and operations of DISB. This public education initiative was preceded by a series of bilateral engagements with the main stakeholders, member institutions, in a bid to sensitise the members about the benefits and limitations of DISB, its mandate and stakeholder obligations under the DISB Regulations.

12. CONCLUSION AND OUTLOOK

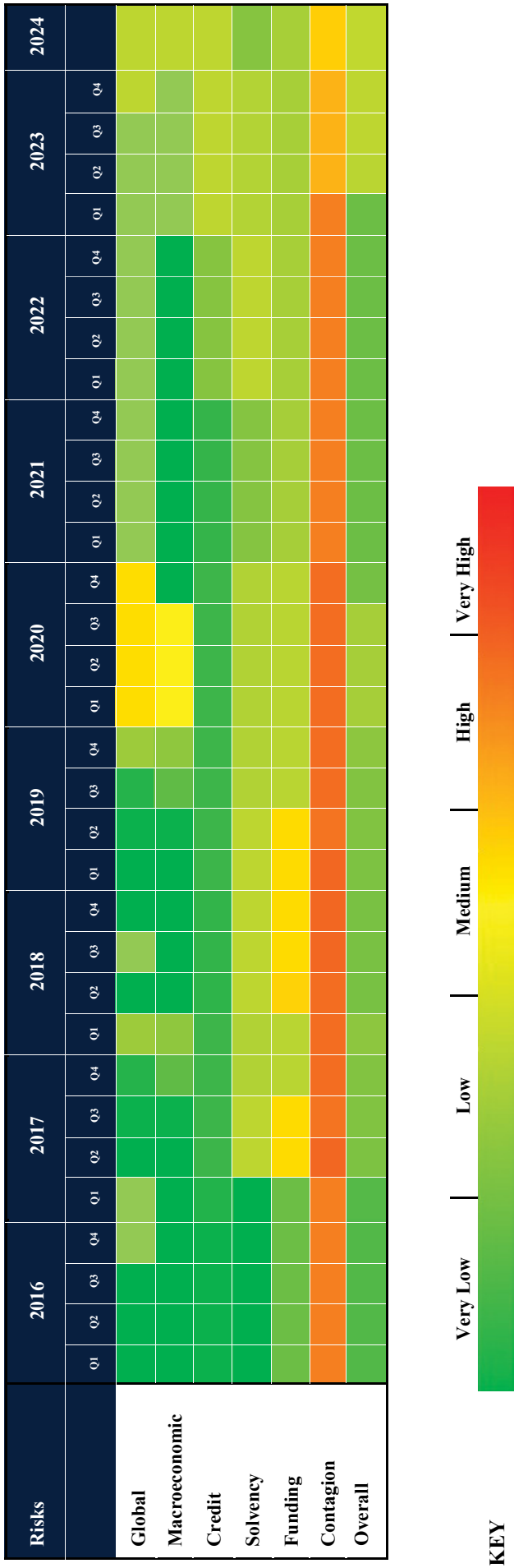
- 12.1 The domestic financial system remains resilient and robust, thus continues to be safe and sound as well as unconstrained in providing and growing the range of financial services to support the economy. The enduring stability of the financial system is supported by a conducive macroeconomic environment, characterised by the prevailing accommodative monetary conditions and positive economic growth prospects, despite sovereign vulnerabilities (i.e., reduced fiscal and external buffers) due to the current depressed global economic environment combined with long-term structural trends.
- 12.2 FMI's are adaptive to innovation and drive the digitalisation of the financial system and at the same time enable financial inclusion, thus supportive of financial stability. The regulatory environment has recently undergone significant legislation reviews, which contribute to the productive and smooth functioning of the financial system.
- 12.3 Emerging vulnerabilities from the global environment include challenges resulting from the subdued global growth, persistent geopolitical risks, as well as the high and rising sovereign debt burden. Further, the increasing interconnectedness of the volatile crypto assets market with the rest of the financial system presents a challenge of potential systemic risks. Therefore, regulators need to develop effective oversight frameworks for the sector. Climate-related financial risks are also on the rise owing to climate change and its potential to affect the safety and soundness of individual financial institutions and the broader financial systems. As a result, there is increased pressure on institutions and countries to green their financial systems. This may hamper growth of some economic activities considered harmful to the environment/climate, but open other opportunities from green solutions and climate change mitigation and adaptation measures. Similarly, improving data quality would greatly enhance identification and assessment of climate-related risks and the costs of greening the financial system.
- 12.4 Domestically, risks emanating from crypto assets are minimal but ongoing misconduct in the segment presents regulatory concerns. Domestic developments along with global dialogue on climate change will continue to drive efforts on developing, strengthening and implementing the domestic macroprudential policy framework.

APPENDIX

Table A1: Risk Assessment Matrix

| Risk Type and Underlying Vulnerabilities | Risk Mitigation Measures | Residual Risk |
|---|---|---------------|
| <p>Weak global economic growth Subdued prospects for global economic activity due to the adverse impact of climate change, geopolitical tensions, increased geo-economic fragmentation and rising public and corporate debts levels.</p> | <ul style="list-style-type: none"> Increased local production through import substitution (vegetable import ban), ERTIP, TNDP and other Government policies to boost economic growth. | Moderate |
| <p>Possible rise in inflation A possible rise in inflation that could lead to entrenched inflation expectations. Upward risks to inflation outlook include a possible rise in international commodity prices; persistent supply and logistical constraints; a rise in administered prices that is not factored in the projections; and any increase in domestic food prices due to the prevailing EL Nino induced drought conditions in Southern Africa.</p> | <ul style="list-style-type: none"> Inflation is forecast to remain within the objective range in the medium term. Central bank communication through MPC press briefings and statements and publication of the Monetary Policy Report (MPR) provides clarity on the drivers of inflation and expected outcomes, therefore, helps to stabilise expectations. | Low |
| <p>Tightening financial conditions Potential tightening of policy rates to control inflation expectations.</p> | <ul style="list-style-type: none"> The MPC, on 22 February 2024, maintained the MoPR at 2.4 percent as inflation is projected to remain within the objective range into the medium term. Central bank communication through MPC press briefings and statements and publication of the MPR provides clarity on the drivers of inflation and expected outcomes, therefore, helps to stabilise expectations. | Low |
| <p>Credit risk from households Dominance of total credit by households poses a risk of potential income loss to the financial sector in the event of a sudden erosion of the households' capacity to service loans and therefore, has a bearing on monetary policy and financial stability.</p> | <ul style="list-style-type: none"> The credit-to-GDP gap is negative, indicating low risks of overheating of the economy and that there is scope for further expansion of credit to support economic growth. Good lending standards, generally. Household credit is dominated by government employees (high job security), scheme loans and deduction from source hence, low NPLs. Households are net savers. | Low |
| <p>Climate risk Unfavourable climate conditions and global warming (i.e., droughts, cyclones, earthquakes etc.)</p> | <ul style="list-style-type: none"> Global (e.g., the Paris protocol on reducing carbon footprint) and domestic climate adaptation and mitigation have and continue to be developed. Promotion of greening of the economy. | Low |
| <p>Funding risk High dependence on retail deposits from NBFIs and NFCs Households' pensions placement with pension funds and asset management companies are the main source of deposits</p> | <ul style="list-style-type: none"> Well capitalised and highly liquid banking sector. Close monitoring of NBFIs. Strong accounting and audit standards. Regulatory checks and balances. The new 50/50 rule in pension investment abroad is likely to increase wholesale deposits. | Low |
| <p>Contagion risk The banking sector is highly integrated with NBFIs. NFCs and the real estate sector are integrated with the banking sector. NFCs and NBFIs are the main sources of bank deposits. Concentration risk: the insurance and pension sectors, and micro lenders are dominated by few companies.</p> | <ul style="list-style-type: none"> Well-regulated and supervised banking sector and NBFIs. Well-capitalised and liquid banks and NBFIs. The D-SIBs and D-SIFIs (for the insurance sector) frameworks ensure closer monitoring and supervision of systemically important entities. | Moderate |
| <p>Cybersecurity threat Rapid digitisation of payments and operations and processes (especially in the NBFIs sector).</p> | <ul style="list-style-type: none"> High ICT security implementation. High observance of CDD. Increased compliance to FATF protocols limits the potential negative impact on the financial system. | Low |
| <p>Risks from crypto assets Increased trade in crypto assets, predominantly in EMDEs.</p> | <ul style="list-style-type: none"> The crypto-asset market in Botswana is small. The Virtual Assets Act, 2022 provides for the regulation of the virtual assets market. | Low |

Chart A1: Financial System Vulnerabilities - Heat Map



Source: Bank of Botswana

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