SOUTHERN AFRICA GLOBAL COMPETITIVENESS HUB

Technical report:

Overview of the Botswana Banking Sector

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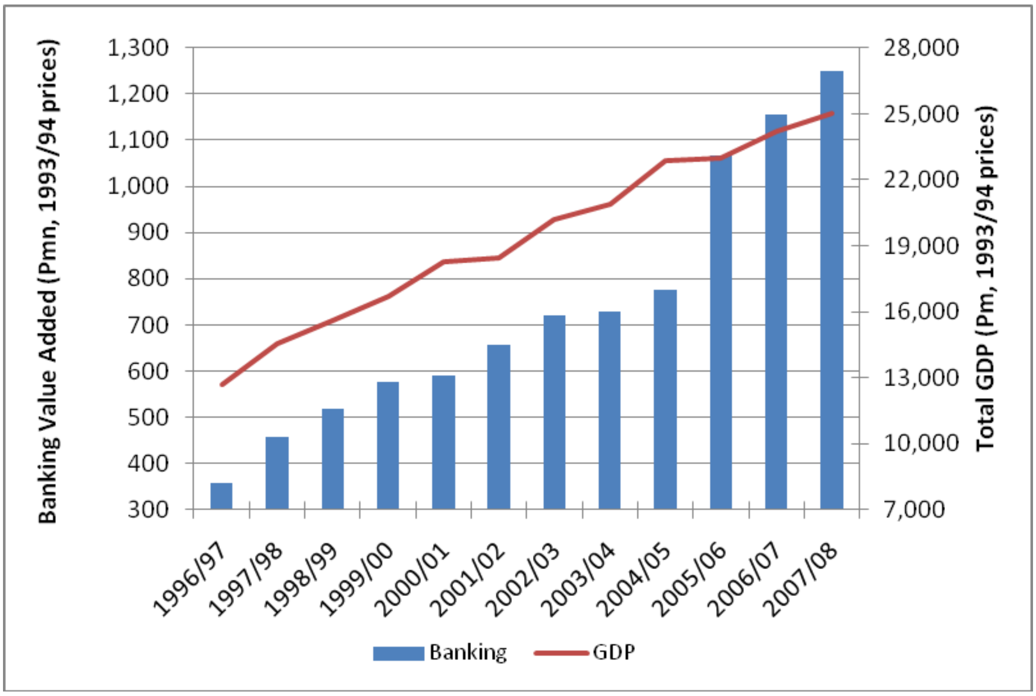
1. INTRODUCTION

The Botswana banking industry is an increasingly important sector of the economy, both in its own right and in terms of the supporting role it plays in the development of other sectors of the economy. The growth of the sector has been good – over the period from 1995/96 to 2007/08[1] it grew in real terms by 11.3% a year on average, while overall real economic growth averaged only 5.5% a year over this period (see Figure 1). Over that period of time, the banking sector's share of Gross Domestic Product (GDP) has doubled, from 4% to 8%.

Figure 1: Banking Sector & GDP



Source: Central Statistics Office

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

As the banking sector has grown in importance, scrutiny of the sector has become more intense. In the process, concerns have been raised regarding the activities of the banking sector and its wider economic role, with perceived shortcomings such as a focus on lending to households rather than businesses, high levels of bank charges and spreads between deposit and lending rates, reliance on Bank of Botswana Certificates (BoBCs) for assets and income, and reluctance to extend banking services to some areas of the country and the population. There are also

[1] The national accounts year runs from July to June.

perceptions of a lack of competition, poor service and a lack of innovation. While some of these concerns are real, others are misplaced, and there have been important positive developments in the banking sector in recent years, with enhanced competition, innovations in product and service delivery, and greater choices for customers, especially savers, both within and outside of the banking sector.

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

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

2.1 The Development of the Banking Sector

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

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

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

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

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

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

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

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

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

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

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

- The commercial banking system, while sound and profitable, is very conservative. With only three banks (and one of these very small) the degree of competitiveness is low. In the tradition of the last century of British commercial banking, these banks emphasize overdraft lending and do not offer much in the way of longer term resources to fund investment. The banks have not had to be particularly entrepreneurial

> to earn good profit . . . [and] . . . their capital bases are small in relation to the financing needs of some major clients (p.46).

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

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

Also consistent with the above policy reforms, but implemented slightly earlier, was the ending of formal controls on bank interest rates[2].

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

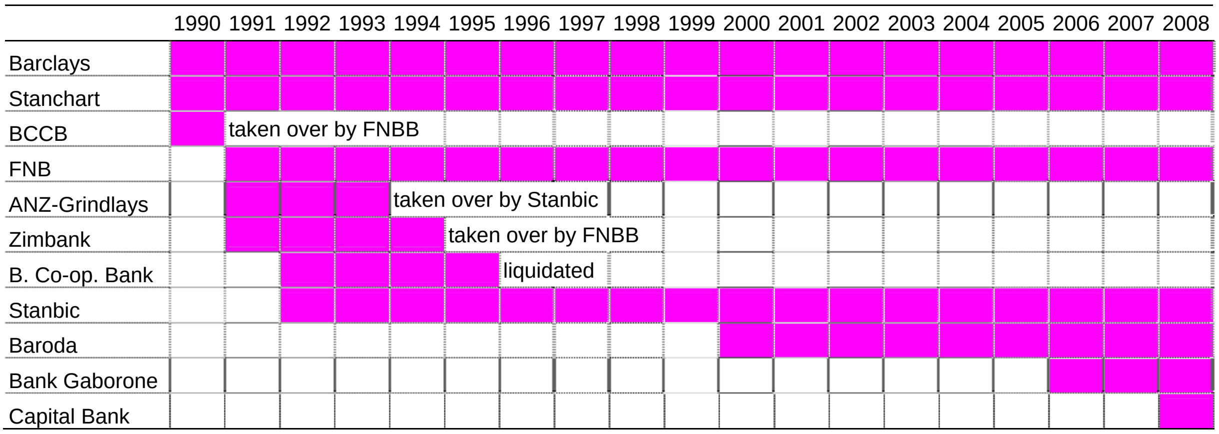
After this rapid expansion, a period of consolidation followed: ANZ-Grindlays was taken over by Union Bank, which was subsequently renamed Stanbic Bank, while Zimbank was taken over by FNBB, and hence the number of banks fell to four. Subsequently three more banks were established, the Bank of Baroda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

The Botswana Co-operative Bank (BCB) was established in 1974 to cater for the needs of the co-operative movement; the bank was formed out of the Bechuanaland Co-operative Development Trust, founded in 1962. Over the years, the BCB suffered from a range of problems – mistaken policies, inadequate management and poor

[2] Due to concerns about high and rising interest rate spreads, the Bank of Botswana has reintroduced controls on interest rates; as of March 2009, a maximum spread of 4% is permitted between the Bank Rate and a benchmark (91 day) deposit rate. At the end of 2008, the relevant spread was around 6.5%.

performance of its loan portfolio. After several bank examinations, audits and policy reviews, Government decided that the BCB could not be saved, and the bank was placed into liquidation in August 1995. The government, which had given the Botswana Cooperative Bank loans from the Public Debt Service Fund (PDSF), was the only creditor.

Figure 2: Commercial Banks Timeline



Source: Econsult

Investec Bank was licensed as a merchant bank in September 1998, and was taken over by Stanbic Bank in April 2004. African Banking Corporation (ABC) evolved from a credit institution, ulc, and was granted a merchant banking licence in December 2001. ABC plans to obtain a commercial banking licence and to roll out retail operations in 2009.

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

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

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

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

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

2.2 The Present Structure of the Financial Sector

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

Within the banking sector[3], there are:

- Seven commercial banks, of which three (Barclays Bank of Botswana, Standard Chartered Bank Botswana & First National Bank Botswana) are listed on the BSE, while the other four (Stanbic Bank, Bank Gaborone, Bank of Baroda and Capital Bank) are unlisted;
- One merchant bank (African Banking Corporation), whose parent company (African Banking Corporation Holdings) is listed on the BSE;
- One offshore bank, Kingdom Bank Africa Ltd (KBAL), and one offshore bank holding company (ABCH), which are registered in the IFSC; and,
- One statutory deposit-taking institution (BSB) and one building society (BBS).

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

- The Botswana Stock Exchange and stockbroking firms (registered in terms of the BSE Act);
- Insurers: short-term (casualty) insurance and long-term (life insurance) (registered in terms of the Insurance Industry Act, and supervised by NBFIRA));
- Pension funds (registered in terms of the Pension and Provident Funds Act, and supervised/regulated by NBFIRA);
- Asset managers (previously unregulated, but now regulated by NBFIRA);

[3] Defined as deposit-taking institutions, in line with Banking Act

- Credit institutions (non-bank lenders), which include “term” lenders such as Letshego (listed on the BSE), Penrich, Blue, Peo etc., which make medium-term loans against the security of payroll deductions, and short-term “cash loan” lenders (previously unregulated, but now regulated by NBFIRA);
- Deposit-taking microfinance institutions (e.g. Womens Finance House) (granted exemptions from the Banking Act by BoB);
- Collective Investment Undertakings (CIUs) (established under the CIU Act and regulated by the BoB – regulation to be moved to NBFIRA in due course);
- Three statutory development finance institutions (NDB[4], BDC and Citizen Entrepreneurial Development Agency (CEDA));
- Statutory funds (e.g. Motor Vehicle Accident Fund, National Petroleum Fund);
- The Public Debt Service Fund (PDSF)[5].

2.3 The Regulatory Structure of the Financial Sector

Banks are regulated by the BoB in terms of the Banking Act (Cap. 46:04)[6] and the associated Banking Regulations[7]. BoB issues banking licences and undertakes prudential supervision.

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

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

The BoB does not concern itself with market issues in considering licence applications (other than reviewing the viability of the prospective bank’s business

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

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

[6] Available at http://www.bankofbotswana.bw/files/attachments/an2077465886.html

[7] Available at http://www.bankofbotswana.bw/files/attachments/an31681338.html

plan), and is in general supportive of new banks from the perspective of enhancing competition.

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

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

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

- Reserve asset holdings;
- Minimum liquid asset holdings;
- Concentration of lending;
- Foreign currency exposure;
- Significant changes of shareholding;
- Appointments of Board members and Chief Executive Officer.

The system of prudential supervision has two main functions: (i) protection of depositors and (ii) systemic stability. It is less concerned with consumer protection, although BoB permission is required to open and close branches, and the BoB has taken up issues such as bank charges. A more recent third pillar of banking regulation relates to anti-money laundering and countering the financing of terrorism (AML/CFT).

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

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

- The BCCI crisis (1991): when the Bank of Credit and Commerce International was closed by the Bank of England, its Botswana subsidiary (Bank of Credit and Commerce Botswana) was taken over temporarily by the BoB, and was eventually sold as a going concern to the newly-licensed First National Bank of Botswana;
- Zimbank Botswana (1993): this subsidiary of a Zimbabwean bank was unprofitable, and with an eroding capital base, and the BoB co-ordinated a takeover by FNB in order to pre-empt the collapse of the bank.

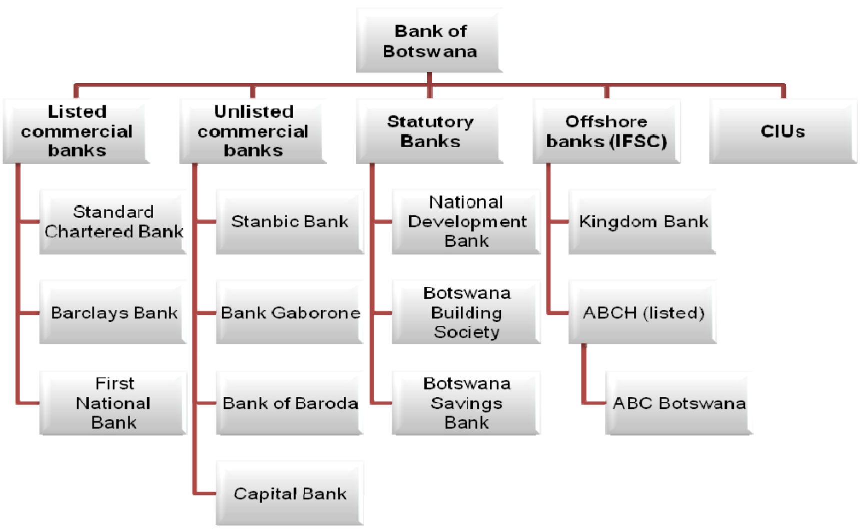
- Botswana Co-operative Bank (1995): originally established to serve the co-operative sector of the economy, it obtained a commercial banking licence but never operated profitably and was eventually closed by the BoB;
- Kingdom Bank Africa Limited (2005): the offshore bank's capital base was eroded due to unprofitable operations, and the bank was taken under temporary BoB management while it was restructured and recapitalised. This was achieved successfully, and the bank was returned to its management and owners within three months.

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

The International Financial Services Centre (IFSC). The BoB plays an important role in administering the IFSC regulations. All IFSC companies have to receive either a banking licence, a CIU licence or an exemption certificate from the BoB, or an insurance licence from NBFIRA. The first two categories (banks and CIUs) are subject to ongoing BoB supervision. The requirements for an IFSC (offshore) banking license are slightly less demanding than for a domestic banking licence. As offshore banks are restricted to non-pula business, there is no risk to the domestic financial system; the main risk is reputational risk.

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

Figure 3: Institutions Regulated by the Bank of Botswana



Source: Econsult

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

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

2.4 The Economic Importance of the Banking System

Financial intermediaries can be classified into four main groups depending primarily on the nature of their balance sheets: banks, statutory financial institutions, pension funds and non-bank lenders[8]. It is estimated that banks control almost half of total financial sector assets, while pension funds control another 43%. For much of the past decade, pension funds have been larger than the banks when measured by total assets, although the inflow of funds into the banks following changes to the BoBC regulations in early 2006 have enabled the banks collectively to overtake pension funds in terms of size of balance sheets.

The structure of the financial sector has changed considerably over the past decade (see Figures 4 and 5). The share of the banks in total assets has not changed a great deal, although it has grown slightly; the most striking changes have been the growth of the pension funds, and the relative decline in the importance of government-owned financial institutions, and of direct lending by government. In 1996, the Government’s Public Debt Service Fund (which used to make loans to parastatals) was by far the largest financial institution in Botswana, with a balance sheet exceeding that of any of the individual banks, and accounted for 29% of total financial sector assets. By 2008, the combined assets of the PDSF and DPCF[9] amounted to only 2% of total financial sector assets. Over the same period, the share of assets held by the pension funds rose from 11% to 31%, which was mainly driven by the establishment of a new pension scheme for government employees[10].

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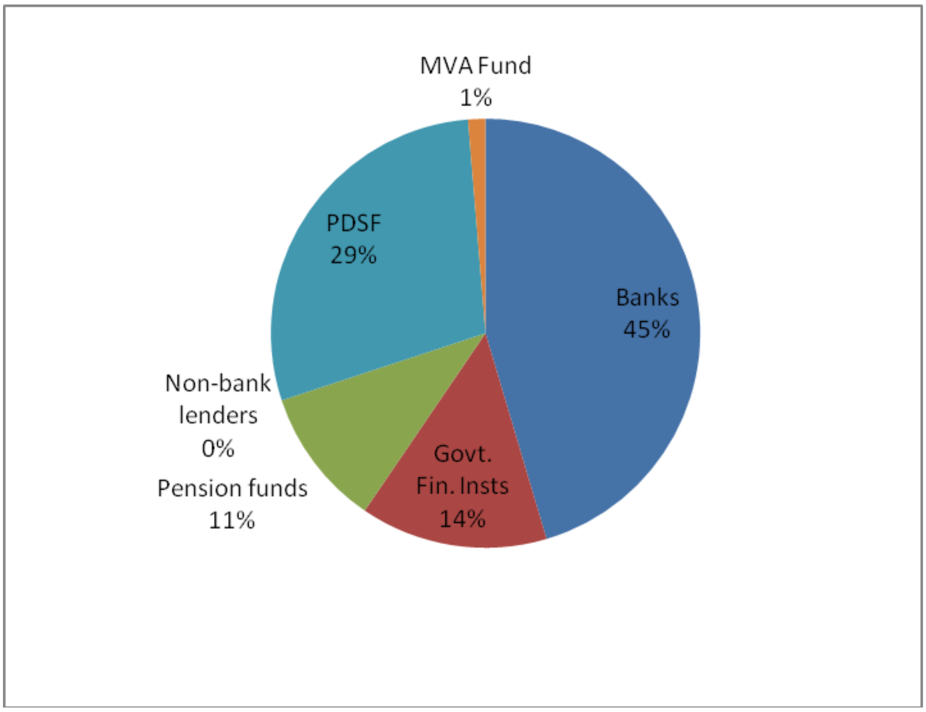
[8] Short-term insurers are excluded as they are not strictly financial intermediaries.

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

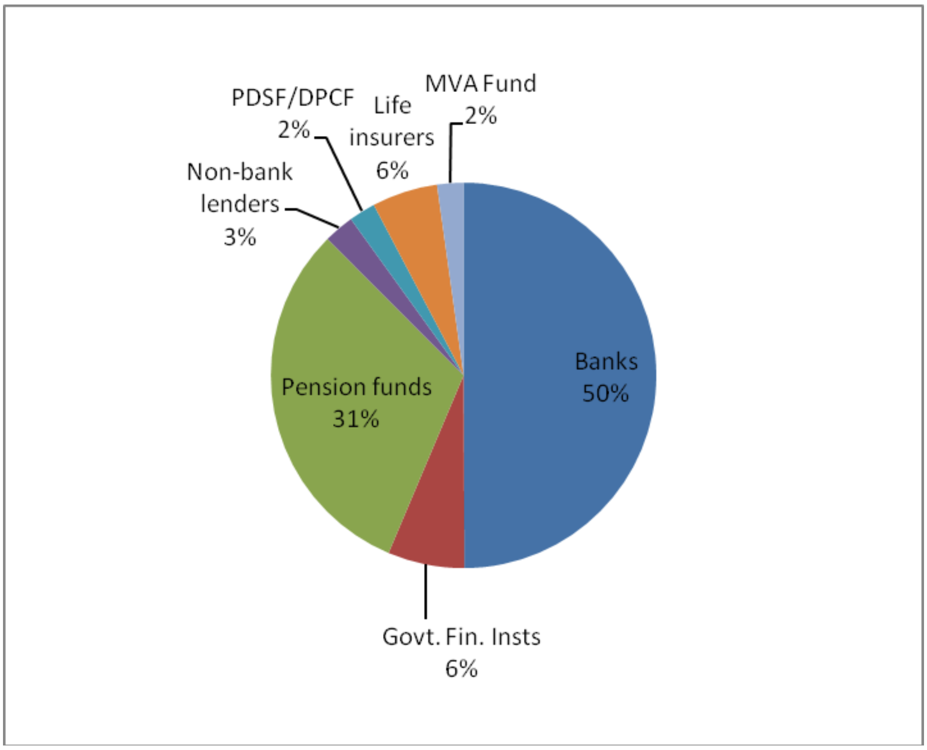
[10] The Botswana Public Officers Pension Fund (BPOPF) is a funded, defined contribution scheme, managed by private sector asset managers, and replaced the previous unfunded, defined benefit scheme.

Figure 4: Assets of the Financial System (1996)



Source: Bank of Botswana; Econsult

Figure 5: Assets of the Financial System (2008)



Source: Bank of Botswana; Econsult

Although the relative position of the banking sector in the broader financial sector has not changed much over the past decade, banks have nevertheless been growing rapidly, supported by the liberalisation measures undertaken during the 1990s. Over the decade from 1997 to 2007, the total assets of the banking system grew at an average annual rate of 21%, while (nominal) GDP grew on average by 14% a year over the same period. Relative to the size of the economy, therefore, the size of the banking sector – measured for instance by the ratio of banking assets to GDP – has been rising steadily.

3. KEY ISSUES FACING THE FINANCIAL SECTOR

There are a number of key issues facing the financial sector going forward, which we discuss in more detail below. These include issues of bank ownership (including those related to local and foreign ownership, and privatisation); competition and efficiency; and potential changes in the regulatory regime.

3.1 Bank Ownership and Privatisation of State-owned Financial Institutions

All seven commercial banks are either wholly or majority foreign owned[11]. This has had some advantages; most of the banks are part of large, well capitalised international banking groups, and this has provided stability, as well as access to capital, resources and management expertise (this is one reason why Botswana has no system of deposit insurance). There have also been gains with regard to access to technology and improved efficiency.

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

The only local financial or "quasi-banking" institutions are state-owned. In principle some of these are to be privatised, including BSB and NDB, along with the government's majority shareholding in BBS. How this is to be done is not yet resolved; consideration was given to merging NDB and BSB before privatisation, but the lack of synergies and high prospective merger costs seems to have put paid to the idea. Nevertheless, there is some potential for a state-owned financial institution to become a fully-fledged locally-owned bank through privatisation and restructuring, although they would still have to go through the process of obtaining a banking licence. The Public Enterprises Evaluation and Privatisation Agency (PEEPA) has commissioned a consultancy study to make recommendations on the privatisation of NDB, which may be the first state-owned financial institution to be privatised. It is also understood that the Government has agreed to as proposal for BBS to be

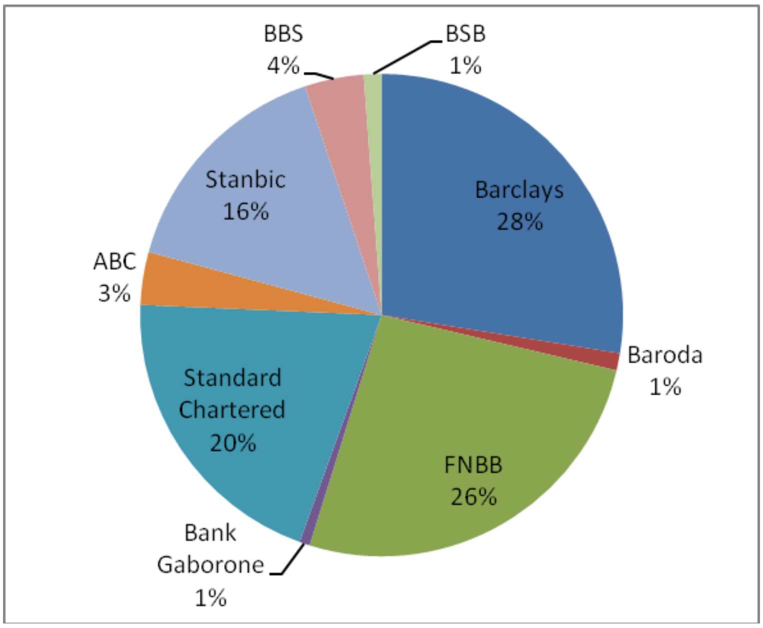
[11] Three have a portion of local shareholding through being quoted on the BSE, and two are joint ventures with minority local partners.

demutualised and apply for a banking licence, which may be followed by government selling down its shareholding. The privatisation process for NDB and BBS is likely to involve some preferences for citizens, perhaps at the stage of selling shares through an Initial Public Offering (IPO).

3.2 Trends in Banking Concentration and Competition

The reform and liberalisation measures adopted over the past two decades have had a positive impact on banking competition. As discussed above, several new banks have been established, and – notwithstanding the consolidation that followed the earlier round of new entry in the 1990s – the industry has become more competitive. FNBB has grown to a size that is comparable with that of Barclays and Standard Chartered, and whereas Stanbic was initially content to be a niche player, it has recently been taking on the three larger banks more directly. Over the past year, FNBB and Stanbic have been particularly successful in attracting new deposits as a result of the changed regulations regarding the holding of BoBCs. The net result is that the dominance of the industry by the two oldest banks, Barclays and Standard Chartered, has gradually been whittled away. For instance, while these two banks accounted for well over 95% of total banking assets in the late 1980s, by the end of 2007 they accounted for only around 50% of banking sector assets, loans and deposits. While Barclays remains Botswana's largest bank, FNBB has overtaken Standard Chartered as the second largest bank on all three measures.

Figure 6: Assets by Bank, December 2007

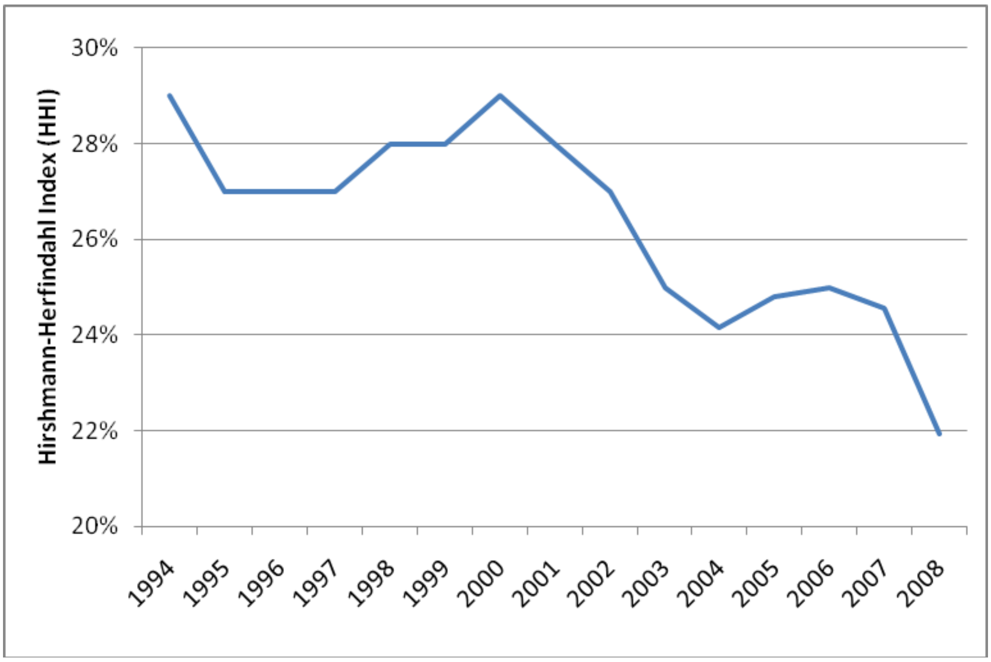


Source: Company reports; Econsult

Competition is a complex phenomenon which cannot be directly measured. However, the degree of concentration in an industry – the extent to which it is dominated by a small number of large firms – is often used as a proxy. Concentration measures for Botswana show that the level of concentration has been declining, as FNBB and Stanbic have grown relative to Barclays and Standard Chartered (see Figure 7).

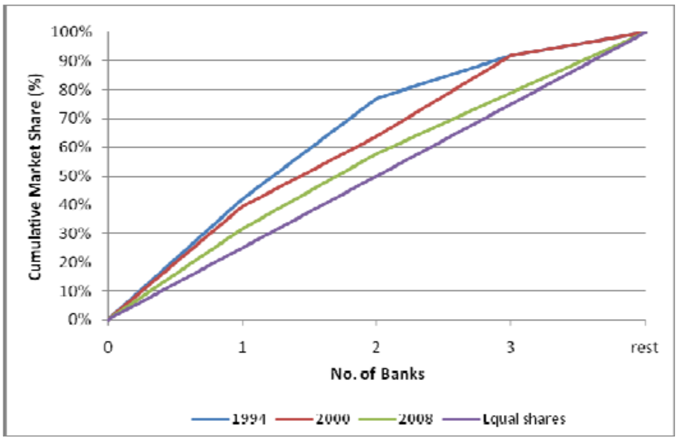
Figure 8 shows how market shares have become more equally distributed over time. These developments are supportive of rising competition amongst the banks. Nevertheless, despite new entrants to the banking sector, concentration remains high, although perhaps not excessively so by regional standards[12].

Figure 7: Banking Sector Concentration (1994-2007)



Source: Company reports; Econsult

Figure 8: Distribution of Banking Deposits – Shares of Largest Banks



Source: Company reports; Econsult

[12] In 2004, the two largest banks had a market share of 63%, and the next two a share of 32%. By comparison, in Mauritius the largest two banks had a market share of 90%, and in South Africa the top four banks had a market share of 85% (Soylemezoglu, A. *Botswana's Financial Sector: Issues and Prospects*, background paper prepared for World Bank/BIDPA Study on Export Diversification in Botswana, 2004).

Competition is likely to increase further, given that ABC is intending to convert to a commercial bank and roll out a retail network. There is also likely to be at least one specialised diamond-financing bank established to support the growth and diversification of the diamond sector.

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

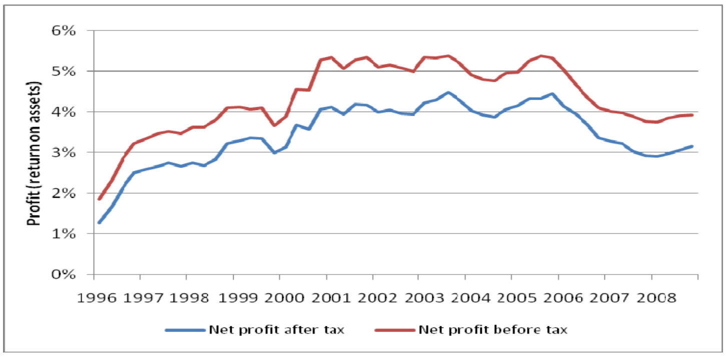
3.3 Competition, Profitability and Licensing Policy

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

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

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

Figure 9: Return on Assets



Source: BoB; Econsult

The fact that the licensing regulations permit new entrants, subject to modest capital requirements and prudential conditions, should provide an important check on profits. The small size of the market, however, may pose a limit on new entry, in that the Botswana banking market may not be big enough to accommodate very many full-service commercial banks.

Potential competition, however, may increasingly come from different types of banks, not necessarily offering a full range of commercial banking services. Technological developments (such as cell phone banking and e-money) also have implications for the traditional banking model, and enable some banking and money transmission services to be conducted by other entities. Whether alternatives to traditional banks will enter the market depends on, amongst other things, bank licensing policy. As a result, there may be arguments for making the bank licensing regulations more flexible, in order to accommodate the entry of new types of banking services into the market. One of the fastest growing segments of the financial services market in Africa is cell phone-based remittances. The Kenyan M-Pesa service is a pioneer in this field, and has grown rapidly partly because it was deemed by the Central Bank of Kenya to be a remittance service but not a banking service; as a result, the service operator did not need a banking licence, and M-Pesa is operated by a cell phone service provider. Other countries have taken different views – much depends on the interpretation of what is a “deposit” and thereby requiring a banking licence – in the context of banking legislation that was typically drawn up in a different era. Similar issues arise with “e-money”, or valued stored on a smartcard, which may or may not be interpreted as constituting a deposit. These issues have not yet been tested in Botswana, but undoubtedly will be in the not too far distant future.