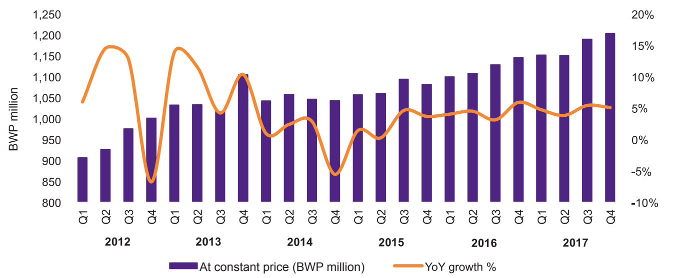
Banking and Financial Services

Botswana's Banking, Financial Services and Insurance (BFSI) industry at inflection point

Factors that detemine the outlook of the BFSI industry

The Banking Financial Services and Insurance industry in Botswana has experienced continued growth over the last 3 years, and its contribution to the country's Gross Domestic Product (GDP) stands at 5.1%. The size of the banking and insurance industry is currently BWP 4.7 billion in real terms (constant 2006 prices) and BWP 7.9 billion at current prices.

Contribution of the banking, insurance and business services sector to GDP: Year-on-Year (YOY) growth percentage



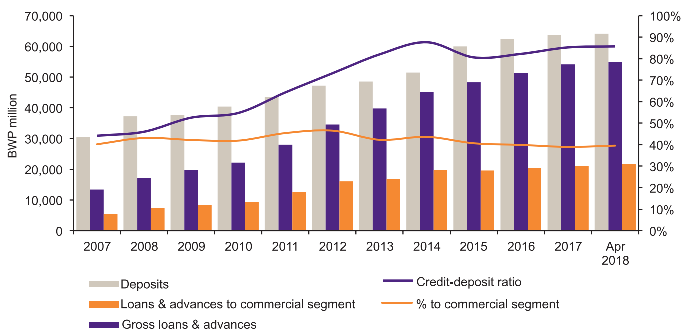
Source: Bank of Botswana financial statistics (May 2018)

As per 'The Africa Competitiveness Report 2017', all sub-Saharan African countries (excluding Angola, Nigeria, Democratic Republic of Congo, Malawi and Lesotho), faced a milder impact of commodity price decline over the last 2 years on their macroeconomic environment, than Botswana. Botswana is amongst the five countries which have lost most ground in terms of banking industry soundness as a result of commodity price adjustments (including Lesotho, Gabon, Nigeria and Chad).

Commercial banks operating in Botswana

Botswana's banking industry comprises of 10 commercial banks and 3 statutory banks. The banking sector is dominated by commercial banks that hold 91% of total loans and advances, and 93% of total assets. According to 'Banking Supervision Annual Report 2016' oligopolistic market conditions continue to be prevalent with the 5 large commercial banks, namely Banc ABC, Barclays Bank, First National Bank of Botswana (FNB), Stanbic Bank and Standard Chartered Bank which account for more than 90% of total banking loans, advances, assets and deposits.

Level of deposits, gross loans and advances



Source: Bank of Botswana financial statistics (May 2018)

The credit deposit ratio of local commercial banks has improved steadily from 64% in 2011 to 86% in April 2018, with banks having to move a significant portion of their risk free investments in Bank of Botswana Certificate (BOBC) into loans and advances to both commercial and household segments of the Botswana economy.

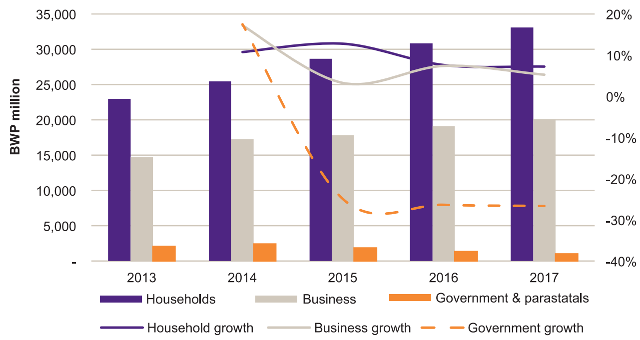
Gross loans and advances experienced a Compounded Annual Growth Rate (CAGR) of 9.4% from 2012 to 2017. As at Dec 2017, the figure stood at BWP 54.1 billion, which is 59% of real GDP versus 46% in 2012.

The decline in commodity prices over the past 2 years translating into lower export values and lower government revenues, affected all mineral exporting economies including Botswana. The collateral effects of the commodity price cycle are felt in the banking industry. Typically, the cycle results in shrinkage of country risk premiums and credit increases during commodity price booms. Consequently, with commodity price decline, the general economic conditions worsen, thus resulting in corporates finding it difficult to repay debts, and commercial banks suffer from higher Non-Performing Loans (NPLs) which affects their profitability.

Credit growth in the commercial segment has slowed down significantly in the last 3 years, with declining commodity prices impacting the segment as well as the overall economy. This is in sharp contrast to the previous years when credit growth grew in double digits (excluding 2013). There is a decline in credit growth within key sectors of the economy such as mining, manufacturing and agriculture. The mining sector's credit growth is negative due to low commodity prices – which has resulted in the closure of some big mines such as African Copper, Discovery Metals as well as BCL that has been placed in provisional liquidation.

Household segment credit growth rate expected to stabilize

Segment wise loans and YoY growth



Source: Bank of Botswana financial statistics (May 2018)

Loans and advances to the household segment has seen a CAGR 2012-17 of 12.3% as compared to only 5.6% for the commercial segment. Credit extension to the household segment accounts for 60% of gross loans and advances extended by local commercial banks. This poses a risk of households struggling to settle their debts, which will have a knock-on effect on the banking industry and overall economy if the interest rates starts to rise in the near future.

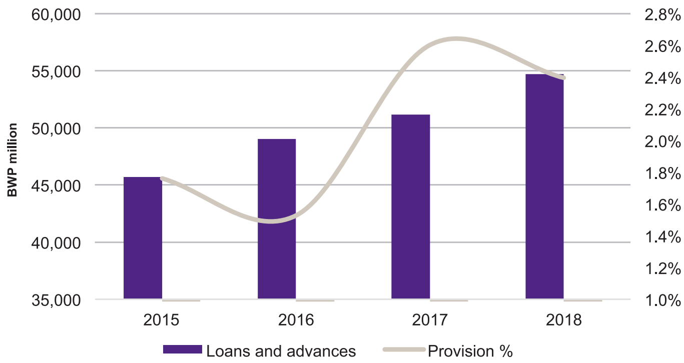
Credit growth declined from 6.2% in 2016 to 5.6% in 2017. Slower credit growth of the commercial segment is mainly on account of lower debt to parastatals, not the private sector. The decline in credit growth and rates over the years, as well as increased competition has seen the normalization of the banking industry's profitability.

Monetary policy has been accommodative over this period with the bank rate coming down from 9.5% in 2013 to 5% in 2017. Higher credit growth is expected in 2018 largely due to increased government spending which is also expected to boost business activity in the economy. This is reflected in the "Top 10 problematic factors for doing business in Botswana" by 'The Africa Competitiveness Report 2017', where the factor of access to financing is improving.

As per 'Grant Thornton's International Business Report (IBR) 2018 Q2', the economic outlook of businesses surveyed was 70% optimistic, while the global outlook of the financial services sector stood at 76% optimistic. Such high business optimism will require higher credit to fund expansion. Going forward, household credit growth is expected to be moderate, and business credit growth is expected to be more robust, given the higher levels of business confidence for the year as per Bank of Botswana's 'Business Expectations Survey March 2018'.

Provisions on loans and advances, and the impact of International Financial Reporting Standards IFRS 9 going forward

Provision for loans and advances



Source: Bank of Botswana financial statistics (May 2018)

With IFRS 9 effected on 1 Jan 2018, the adoption of expected credit loss model is expected to have a significant impact on the impairment, profitability and consequentially the capital of the banks. Many banks may adopt different pricing mechanism to factor for cost of capital. Many individual corporates with high credit ratings currently enjoy better pricing on their loans than other corporates, and it is probable that this gap may widen substantially.

Innovation to improve cost recovery

With Botswana's current low interest rate environment, a key factor driving profitability of local commercial banks is their ability to cover their non-interest expense with non-interest income. Based on the results published by the top 3 listed commercial banks in Botswana for 12 months ended December 2017, their recovery of non-interest expense through non-interest income is as shown below.

First National Bank
87.5%

Barclays Bank
63.6%

Standard Chartered Bank
42.5%

Major commercial banks are able to achieve this through a wider and larger customer base, by introducing mobile banking platforms, sophisticating their internet banking platforms, increasing the number of Point of Sale (POS) machines and Automatic Transaction Machines (ATM) as well as other new product offerings. The impact of such dynamic banking platforms is reflected in the comparative return on average assets with FNB and Barclays Bank reporting 0.9% and 2.9% respectively, and Standard Chartered Bank reporting a negative return of -1.3%.

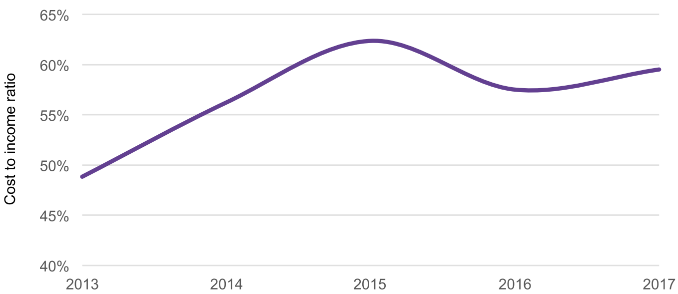
Key personnel costs are maintained by listed commercial banks between 29.6% (FNB) and 38.8% (Standard Chartered Bank) of net operating income (post impairment losses).

Net interest income and non-interest income

Year	Net interest income (BWP million)	Non-interest income (BWP million)	Non-interest income % of net interest income	Non-interest expense (BWP million)	Non-interest income % of non-interest expense
2013	3,510	1,926	55%	2,654	73%
2014	3,373	2,253	67%	3,164	71%
2015	3,143	2,280	73%	3,383	67%
2016	3,858	2,450	63%	3,628	68%
2017	3,991	2,524	63%	3,877	65%

Source: Bank of Botswana financial statistics (May 2018)

Cost to income ratio



Source: Bank of Botswana financial statistics (May 2018)

The cost to income ratio in local commercial banks has increased from 49% in 2013 to 60% in 2017. This is as a result of investments being made by major banks in improving operating systems such as POS machines, and deposit taking ATMs to maintain their competitive edge. However, the ratio is broadly stabilising at 60-65% levels as commercial banks also implement cost control programmes and rationalise activities.

Outlook for the local banking industry

As a result of the current state and outlook of Botswana's economy, the Bank of Botswana maintained its supportive monetary policy stance with reduction in prime rate by 50 bps to 6.5% in October 2017. Such low inflation and low interest rates that Botswana's environment maintains, are expected to result in investments into the country becoming attractive, eventually resulting in an increase in Foreign Direct Investment (FDI).

Given the low interest rate in Botswana's environment, and tight competition in the sector, banks are looking to increase the contribution of non-funded income to their revenue. There is an increased focus on digitisation through numerous initiatives including mobile technology, enhanced ATM functionalities, online banking, and partnerships with merchants through POS machines. Furthermore, banks are increasingly diversifying their services through offering insurance and wealth management services. There is potential for growth by leveraging these initiatives.

Major industry players are cautiously optimistic about Botswana's economy, with growth rates expected to be below historical trends based on the anticipated improvement in the mining sector, and slower but continued growth prospects for the non-mining sectors as these face the lagged impact of 2017's mining sector slowdown and slow pace of economic diversification. Within the non-mining sector, growth is expected to be driven by the construction, trade, hotels and restaurants, financial and business services sectors. The household segment is expected to be risky due to high levels of debt, subdued private sector employment and freeze on government headcount.

Key success factors for local commercial banks will be determined by their ability to:

- develop a healthy loan book with low impairments or NPLs,
- harness deposits, and
- introduce innovative products and services.

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