



Strengthening Financial Sectors

FINAL REPORT

Botswana: Non-Bank Financial Institutions – Supervision and Strategy*

21 November 2005

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1. This Report is presented in compliance with the terms of reference for project No. CNTR IDA.F.03 R249 as detailed in the contract between Carmichael Consulting Pty Ltd and the FIRST Management Unit dated 17 March 2004 and amended 17 June 2004.
2. This Report completes the project to assess the state of non-bank regulation in Botswana and to recommend a capacity building strategy and action plan.
3. The Report is in three parts. The first is an Executive Summary of the findings and recommendations of the project. The second is the Main Report. The third part, in an attachment, contains a draft Bill for establishing an independent non-bank regulatory agency, as well as amendments to existing industry laws needed to establish consistency with the draft Bill.
4. The Report meets the Terms of Reference for the project. It updates and extends the Interim Report dated 30 December 2004.
5. We wish to thank the officials of the Ministry of Finance who gave freely of their time and views.



Dr Jeffrey Carmichael
Chairman and CEO
Carmichael Consulting Pty Ltd

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EXECUTIVE SUMMARY OF THE KEY FINDINGS AND RECOMMENDATIONS

Botswana: Non-Bank Financial Institutions – Supervision and Strategy

The non-bank financial sector in Botswana has been evolving quickly and now rivals or even surpasses the banking system in terms of assets under management. On any objective measure the NBFi sector is well developed and therefore a significant risk to the stability of the Botswana economy. The Ministry of Finance has done a creditable job in supervising this industry in the face of limited resources and limited regulatory powers. However, in view of the growing size and sophistication of the NBFi sector, the need for more effective non-bank financial regulation and supervision is likely to increasingly pressing over the next decade or so.

The case to establish a single, independent NBFi regulatory agency is quite compelling on grounds of both effectiveness and efficient use of scarce regulatory resources. In view of the need to provide adequate staffing levels and quality, and to provide flexibility in establishing regulatory independence and powers we strongly favour the parastatal model over the department model.

Recommendation 1

There should be a single NBFi regulator for Botswana (called for the purposes of this Report the Botswana Financial Institutions Commission – BFIC) established as a parastatal authority.

In terms of regulatory coverage we suggest dividing responsibilities between the Bank of Botswana and BFIC largely the along the lines of whether or not a financial institutions accepts deposits from the public. On this basis, BFIC would have the following regulatory responsibilities:

Recommendation 2

BFIC should have regulatory and supervisory responsibility for: insurance companies, agents and brokers; pension funds and pension fund administrators; asset managers; organized exchanges; securities brokers and dealers; investment advisors; specialized finance companies; medical aid funds, microlenders; and any other NBFIs deemed by the Minister of Finance to warrant regulatory oversight. BFIC's responsibility should extend to these institutions regardless of whether they operate in the domestic market or the IFSC.

The design features of BFIC can be separated into external (primarily those characteristics that will be encoded into law) and internal features (those that will be decisions of the BFIC Board).

External Design Features

Regulatory powers establish how, and how effectively, the regulatory agency is able to monitor and enforce the regulatory requirements set by primary and subsidiary financial laws.

Modern financial regulatory agencies have powers that cover: licensing and delicensing; the making of legally binding rules and standards of prudence/conduct; routine information gathering; monitoring and surveillance; the issuing of directions; investigations; enforcement; prosecution; statutory

management; transfers of business; winding up; conglomerate supervision; and supervision of self-regulatory organizations.

Recommendation 3

BFIC should have the full range of policy and enforcement powers needed for modern and effective regulation and supervision.

There are several alternative legislative approaches to establishing the powers of a regulatory agency such as BFIC. By far the most effective of these involves establishing a single, harmonized set of powers in the BFIC Bill.

Recommendation 4

The legislative drafting should be approached in such a way that all regulatory and supervisory powers, including licensing, monitoring and enforcement powers are consolidated under the BFIC Bill, with appropriate amendments to existing industry laws to bring them into consistency with the BFIC Bill by removing any conflicting or duplicative powers.

A regulator's capacity to meet its legislated objectives is dependent first and foremost on the skills and experience of its staff which, in turn, is dependent on having a sound funding base that is independent in the sense that the resources available to the regulator are free from influence by individuals or groups within the industry or government. While financial independence is fundamental to regulatory independence, full operational independence encompasses other elements that are equally important, including legal protections and adequate powers to meet the regulator's statutory objectives.

Legal independence derives from legal provisions that both require the regulator to act independently and provide legal support for regulators who exercise that independence. A legally independent regulator can form regulatory judgements and decisions without fear of retribution from individuals or groups within the industry or government.

Recommendation 5

BFIC should be given appropriate operational independence from the Government of Botswana in formulating, implementing and enforcing regulation and supervision of NBFIs. The BFIC Bill should provide explicit guidance as to the appointment and dismissal of BFIC officials, legal protection against attempts to exercise improper influence over the agency, a legal indemnity for staff and officials who act in good faith, and a mechanism for dealing with potential conflict between BFIC and the Government of Botswana.

Governance refers to the systems and procedures adopted by an entity to manage its business and resolve conflicts among its various stakeholders. Central to good governance is the independence of the Board as a governing body. It is important to recognize that governance is more than just a set of rules and structures. Not only must the board ensure that the agency has in place the necessary controls over its activities, of equal importance it must ensure that the controls are working. This requires a level of "buy-in" and commitment by board members of regulatory agencies at least as great as that expected of public company boards.

Recommendation 6

BFIC should be governed by a board consisting of a non-executive chair, the CEO, other non-executive members and, ex officio, the Governor of the Bank of Botswana and the Permanent Secretary of the Ministry of Finance, or their nominees. The members of the board should be

appointed by the Minister of Finance and Development Planning for their skills and expertise, and the CEO should be appointed by the Minister on the recommendation of the board.

Strong independence should be balanced by equally strong accountability requirements. Accountability refers to the ways in which the entity reports its decisions and is held responsible for its actions. Strong accountability starts with clear responsibilities in the law, supported by requirements to account to the government, the public, and the industry that it regulates. Strong accountability requirements are designed to ensure that the agency acts independently and transparently in meeting its legislated responsibilities

Recommendation 7

The BFIC Bill should include extensive accountability requirements to the Minister, the industry and the public. These should include reporting requirements, the requirement to consult with government, industry and the public in formulating prudential rules, strong transparency provisions around regulatory decisions, and appropriate appeal mechanisms.

Adequate funding is a key feature of good regulation.

A regulator's capacity to meet its legislated objectives is fundamentally dependent on the skills and experience of its staff which, in turn, require a sound funding base that is independent in the sense that the resources available to the regulator are free from influence by individuals or groups within the industry or government. Over the past decade or so there has been a marked trend towards industry funding of financial regulatory agencies. This trend has been particularly evident among developed Western economies. It is our assessment that the NBFi industry in Botswana can afford to support BFIC at an appropriate funding level without imposing unduly on the industry's resources.

Recommendation 8

BFIC should be funded primarily by levies and licence fees paid by industry. BFIC's budget should be subject to industry consultation and determination by the Minister for Finance and Development Planning. The BFIC Bill should provide appropriate flexibility for the way in which industry funding may need to evolve as the industry grows.

Internal Design Features

Internal design features include considerations such as staff numbers, organizational structure, skill needs, remuneration, and an approximate budget.

It is our assessment that the existing staff capacity devoted to NBFi regulation and supervision is too small and too dispersed to provide an effective foundation for regulating and supervising NBFIs. Even within the Ministry, the focus is largely on licensing and de-licensing, with little time or capacity for on-going off-site and on-site supervision. In contrast with the current level of around 17 staff members devoted to NBFi regulation and supervision, based on international comparisons, we estimate that a staff complement of closer to 50 will be needed in BFIC. These staff should be organised in a way that makes most efficient use of scarce regulatory resources.

Recommendation 9

BFIC should adopt a target internal structure that strikes a balance between the desire to extract synergies from an integrated approach to regulation and the need to manage change at a pace that can be absorbed by both regulatory staff and the industry. The transition to this structure should evolve over a period of up to 5 years.

The skill demands of a regulatory agency such BFIC extend to the fields of finance, accounting, law, actuarial analysis, market analysis, and general administration, and extend beyond the existing capacity of the regulatory staff in the Ministry. In part, the necessary skills for regulation and supervision can be recruited, but much of the skills need to be built up internally through training programs.

Recommendation 10

BFIC should allocate a significant amount of its resources over the first 5 or so years to training new and existing staff in regulatory philosophy and practice, through a combination of systematic training through regional providers, once-off training programs offered by the FSB in South Africa, international organizations, and the Toronto Centre, secondments of outstanding staff to other regulatory agencies, and both short and long term resident regulatory advisors. Where needed, BFIC should seek donor support.

The most critical ingredient in providing effective regulation is the quality, skills, and experience of the regulatory staff. This, in turn, requires that the regulatory agency is able to pay competitive salaries in the market for those skills and to be able to retain experienced staff by offering a sufficiently attractive overall remuneration package.

It is our assessment that, if BFIC is to recruit and retain the skills and expertise that it will need to provide effective regulation of the NBF sector in Botswana, it is likely to need to pay competitive salaries with both the Bank of Botswana and the private finance sector.

Recommendation 11

BFIC should employ staff on total remuneration terms comparable with those of the Bank of Botswana and should retain sufficient flexibility in its remuneration structure to enable it to pay a premium, if needed, for specialist skills.

Finally, there is a need to adopt a staged approach to the establishment and implementation of BFIC. The Report offers a realistic action plan for implementation and development of the skills and resources needed for effective non-bank regulation and supervision. The plan has two party-overlapping stages broken into: legal stages and establishment stages.

The action plan is summarised in the following tables.

Action Plan for Creating the BFIC

Activity	Time required to complete task	Starting date from start of 3 rd Quarter 2005	TA Support Required
Legal Stage 1			
Finalize design details for BFIC	2-3 weeks	0	N
BFIC Bill to be reviewed by Attorney General's Department	1-2 month	1 month	N
Legal Stage 2			
Prepare policy paper on issued to be resolved in updating industry laws and creating new laws	3 weeks	1 month	Y
Consult with officials and industry to agree policy issues	2 weeks	2 months	Y
Draft new laws and amendments to industry laws	7 weeks	3 months	Y
Expose drafts and consult with stakeholders	2 weeks	5 months	Y
Refinement and finalization of Bills	2 weeks	6 months	Y
Legal Stage 3			
Draft, expose and consult on Insurance rules and regulations	2 months	3-4 months	Y
Draft, expose and consult on rules and regulations for previously unregulated institutions	3 months	6-9 months	Y
Draft, expose and consult on Pension Fund rules and regulations	2 months	9-12 months	Y
Draft, expose and consult on Securities rules and regulations	2 months	12-18 months	Y
Draft, expose and consult on Collective Investment Undertakings rules and regulations	2 months	18-24 months	Y
Establishment Stage 1			
BFIC Act to be proclaimed	1 day	6-9 months	N
Minister to appoint Board	1 month	7-10 months	N
Board to find suitable CEO	2-6 months	9-15 months	N
Board to set delegations	1-2 month	7-12 months	N
Board and/or senior management to set employment conditions and HR policies	1-2 months	8-12 months	N
CEO and/or senior management to find suitable premises for BFIC	1-3 months	7-12 months	N
Premises to be fitted out	3-4 months	9-12 months	N
Initial IT systems to be installed	3-9 months	10-16 months	N
Staff to be transferred to new agency	1 month	6-9 months	N
Recruitment of new staff	6-12 months	9-18 months	N
Establishment Stage 2			
Ongoing recruiting, training, development of policies and procedures, etc	48-60 months	18-24 months	Y

Action Plan for Creating the BFIC

Projects	Quarters from Q3 2005																			
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Legal Projects																				
1. Stage 1 – Finalize BFIC Law	█																			
2. Stage 2 – Rebuild Industry Laws		█	█																	
3. Stage 3 – Rules and Regulations			█	█	█	█	█													
Implementation Projects																				
1. Establishing the BFIC				█	█	█	█													
2. Upgrading Policies & Practices								█	█	█	█	█	█	█	█	█	█	█	█	█

Recommendation 12

To carry the proposed action plan forward we recommend establishing a Steering Committee including senior representatives from the Ministry of Finance, the Bank of Botswana, and industry.

FINAL REPORT

Botswana: Non-Bank Financial Institutions – Supervision and Strategy

1. Introduction

The Terms of Reference for this project are set out in Consulting Services Request Number: CNTR IDA.F.03 R249 and include the following:

The project provides an assessment and strategy for strengthening the supervision of non-bank financial intermediaries (NBFIs) in Botswana. The project is designed to assist the authorities in determining what supervision is needed, supervision priorities, and how supervision should be organized in terms of agencies. A central question is whether or not a new non-bank supervisory body should be created and, if so, what its coverage, responsibilities, and funding arrangements should be.

Key project outputs include:

- An assessment of the existing operations of principal industry participants and recommendations as to which NBFIs should be supervised.
- A detailed action plan, agreed with the authorities, on the steps needed to strengthen the system for the supervision of NBFIs and, possibly, including the creation of a new body to supervise some or all of the NBFIs in the country.
- Detailed proposals regarding new legislation, and amendments to existing legislation, needed to create the new supervisory authority if deemed appropriate.

Project Goal and Purpose

“The goal of the project is the strengthening of the Botswanan financial sector.

The purpose of this project is to strengthen the regulatory and supervisory regime of the non-bank financial sector in Botswana.”

Terms of reference

- *“identify gaps in the current regulatory/supervisory framework.*
- *conduct an analysis of the cost of supervision and whether any government funding is needed to establish the new agency*
- *consider other non-bank institutions and issues such as burial schemes, Medical Aid Funds, Microlending and Accounting and Auditing standards.*
- *consider whether it is appropriate for the MOF to act both as regulator and ombudsman*
- *examine the involvement of public servants in the supervision of the non-bank financial institution sector.*

- *review the legal processes linked to resolution of financial disputes (At present Botswana does not have a commercial court to expedite resolution of complex financial issues)."*

The project consisted of two phases with the following requirements.

Phase 1

- *"conduct a full diagnostic of current regulatory and supervisory practices including supervisory capacity and enforcement practice and capability.*
- *gain a full understanding of the NBFi sector, its prospects and risks associated with the current regulatory and supervisory regime.*
- *conduct a high level review of current primary and secondary legislation.*
- *develop a set of preliminary options and recommendations regarding the regulatory and supervisory structure for Botswana.*
- *facilitate a workshop to discuss these options and to build consensus behind a preferred structure and institutional design."*

Phase 2

- *"review existing regulation and develop proposals on drafting new legislation,*
- *amending existing legislation in order to lay the legal basis for the creation of the new supervisory regime, and*
- *produce an explanatory memorandum to outline the changes to legislation required and the implications that these changes will have on the current system.*
- *develop an action plan using information gathered from the earlier assessment and any feedback from the Interim Report. The action plan will include recommendations as to capacity building, agency design and transition processes.*
- *facilitate a workshop to build consensus behind the action plan.*
- *refine the action plan based on feedback from the workshop participants. The action plan will focus on the practical steps that need to be taken to establish a sustainable regulator/supervisor. As part of this, recommendations will be made as to the legal structure of the regulator (will it be independent of government, who it will report to, whether it will control its own budget etc)."*

In carrying out the work the consultants were directed to take into account key lessons learnt from the FIRST Swaziland NBFi project, including:

- Creation of a stakeholder steering committee to ensure early consultation with all stakeholders, including key NBFi management
- Liaison and consultation with IMF representatives
- Involvement of a legal expert in reviewing existing legislation and drafting legislation for the creation of the new supervisory authority

- Provision of a detailed and practical business plan for the development of the new regulator/supervisor. This will include a focus on the human resource requirements, analysis of training needs and sustainability considerations

Key Deliverables

- *“An Interim Report reviewing the financial industry, the existing regulatory and supervisory frameworks, and the options for regulatory structure.”*
- *Legal review and recommendations/drafting of new legislation*
- *Final action plan. This will include an analysis of further TA requirements, an outline of practical steps required and recommendations on possible donors for future funding of the set up of the regulatory body.”*

Consultations

During the course of the project we met with relevant representatives of the Ministry of Finance. We also met with representatives of the following industry sectors and regulators:

- Insurance;
- Pension funds;
- Unit trusts;
- Asset managers;
- Stock brokers;
- The Bank of Botswana;
- The Botswana Securities Exchange;
- The Commissioner of Co-operatives;
- The Registrar of Societies; and
- The Ministry of Trade and Industry (Office of Consumer Protection).

In addition to the one-on-one meetings we held two briefing sessions for the public sector stakeholders and two meetings for industry and regulators.

Sequencing

The first stage of the project, completed during November/December 2004, focused on developing a solid understanding of the status quo, including the structure of the financial system, the structure and capacity of the existing regulators, and the legal framework under which NBFIs are supervised.

Meetings were held with industry participants and regulators, followed by a round-table meeting of public sector stakeholders on 13 December 2004 to discuss the structural options and to find a consensus among the officials present as to the direction to be followed in the second stage of the project.

Following the Interim Report a submission was made by the Minister to Cabinet to proceed with drafting of a new law to create a non-bank regulatory agency as an independent parastatal authority. The second stage of the project followed acceptance of that proposal by Cabinet.

Structure of the Report

Section 2 provides an overview of the Botswana financial system, including the participants, the current regulatory structure and an assessment of likely future developments and directions. It considers the regulatory issues and challenges that arise from the characteristics of the financial system and it considers the appropriate role for non-bank regulation and supervision against this backdrop.

Section 3 provides an assessment of the regulatory framework for NBFIs in Botswana. It reviews the role and contribution of NBFIs to the economy and also the need for strong regulation. It considers the alternatives architectures for the regulatory structure and recommends creating an independent parastatal non-bank regulatory authority (called for convenience the Botswana Financial Institutions Commission – BFIC¹). It also provides a summary assessment of the existing non-bank industry laws in Botswana.

Section 4 assesses the key design features of the BFIC. These include its regulatory powers, its independence, governance framework and accountability mechanisms. The report recommends that BFIC be given powers consistent with its responsibilities, a governance structure to support its independence and rigorous accountability requirements to ensure that it uses its powers wisely and transparently in the pursuit of its legislated objectives. This section also considers the critical question of funding arrangements and levels.

Section 5 considers the capacity needs for BFIC. Comparisons are made with other regulatory agencies both in Botswana and elsewhere. By international standards there is a clear need to increase significantly the resources and skills involved in regulating and supervising NBFIs in Botswana. This section proposes an internal structure for BFIC that cuts a middle path between the desire to take advantage of the synergies offered by integrated regulation and the need to move forward a pace that can be absorbed by both the agency and the industry. This section also considers remuneration structures, training options and a likely budget level for BFIC in its early years.

Section 6 puts forward a proposed action plan for establishing BFIC. This plan prioritizes among the various legal and establishment aspects that will be required over coming years. Section 7 offers some concluding thoughts.

A Caveat

There are many views and opinions expressed in this Report. They are the result of our experience as regulators and of our observations about Botswana. While we were exposed to a wealth of information and views while in Botswana, our time there was extremely short. Off the back of such a steep learning curve we cannot profess to be experts on Botswana. The assessments and recommendations below should be read with that caveat in mind.

¹ The title of the agency is, of course, a matter of choice for the authorities in Botswana.

2. The Botswana Financial System

2.1 Participants in the Botswana Financial Sector

The financial system in Botswana consists of the following main institutional groups and markets:

- Institutional financiers including banks (commercial banks, merchant banks and Government-owned quasi-banks), building societies, insurance companies (both life and general, as well as medical aid funds), and pension funds;
- Asset management companies that operate collective investment schemes as well as managing funds under individual investment mandates;
- Capital markets and institutions, including the Botswana Stock Exchange and securities dealers;
- Supporting market professionals such as insurance agents and brokers;
- Other specialised finance and leasing companies;
- Microfinanciers including savings and credit co-operatives (SACCOs), microlenders, burial societies, and bureaux de change; and
- Institutions registered under the International Financial Centre (IFSC) to provide offshore financial services to non-residents of Botswana.

Table 1 provides a snapshot of the numbers of institutions and assets under management by each group although, in some cases, a figure for assets under management is not available or has been estimated based on interviews with a sample of market participants. A simple summation of the assets of the various groups in Table 1 would give a biased measure of total industry assets given that a number of institutional groups provide finance to others, thereby creating a degree of double-counting. Given the dominance of the pension fund industry as a supplier of funds to the asset management industry, the most accurate measure of total financial sector assets is provided by excluding the asset managers and unit trusts from the total. This is the figure used as the total in Table 1.

The role and character of each of these market participants is summarised below.

2.1.1 Institutional Financiers

Commercial Banks - the commercial banking system in Botswana comprises five full service banks: Standard Chartered Botswana, Stanbic of Botswana, Barclays of Botswana, First National Bank of Botswana, and Bank of Baroda Botswana. As at December 2003, assets of the five commercial banks were close to P13 billion (see Table 1 below), which is around 36% of GDP (which was approximately P36 billion in 2003). All five commercial banks are either wholly or majority owned by foreign banks. First National Bank and Stanbic Bank are wholly-owned subsidiaries of South African banks, while Bank of Baroda is a wholly owned subsidiary of an Indian bank. Both Standard Chartered and Barclays are subsidiaries of British banks that have floated around a quarter of their shares on the Botswana Stock Exchange.

Table 1: Financial Institutions and Markets in Botswana (P million)²³:

Financial Institutions	No. 2003	Assets Dec.	Assets Dec.	2-yr GAGR*
		2003	2001	
Commercial Banks	5	12,963	11,001	8.5%
Merchant Banks	1	1,066	651	28.0%
Botswana Savings Bank	1	224	181	11.2%
Botswana Building Society	1	569	464	10.8%
National Development Bank	1	535	401	15.5%
Savings and Credit Co-operatives	21	133	106	12.0%
Life Insurance Companies	5	5,648	2,542	49.0%
General Insurance Companies	8	482	341	18.9%
Medical Aid Funds**	6	500	-	NA
Pension Funds	139	14,512	4,463	80.3%
Funeral Funds	1,057			NA
Botswana Development Corporation	1	1,163	785	15.5%
Finance and Leasing Companies	0	0	182	NA
Microlenders Long term**	4	440		NA
Microlenders Short term**	75	40		NA
Approximate Financial Sector Assets		38,275	21,117	
Pension Fund Administrators	4			
Pensions Fund Advisors	2			
Life & General Insurance Brokers	25			
Life Insurance Agents	86			
General Insurance Agents	32			
Stock Brokers	3			
Asset Managers**	8	16,000		
Unit Trusts	5	2,314		
Financial Markets	No. 2003	Assets Dec. 2003	Assets Dec. 2001	2-yr GAGR
Total Stock Market Capitalisation	25	151,923	182,127	-8.7%
(Local Market Capitalisation)	19	9,438	8,909	2.9%
Bonds on Issue***	14	375	250	22.5%
Total Securities on Issue	39	152,298	182,377	-8.6%

* CAGR is the compound annualized rate of growth over the 2-year period.

** Rough estimates only.

*** Bonds on issue increased sharply in 2004 to 21 issues with a combined face value of P2.1 billion.

Merchant Banks – there is currently only one merchant bank in Botswana: African Banking Corporation Botswana (ABC) Ltd. A second merchant bank, Investec Bank (Botswana), was taken

² At the time of writing, the Botswana Pula/US dollar exchange rate was approximately 5/1.

³ Figures for end 2003 were the most up to date available figures for the industry as a whole. Since end 2003 a number of sectors have grown significantly in terms of assets, especially the pensions fund industry.

over by Stanbic Bank. While ABC operates as a merchant bank (for example, underwriting share issues and advising in mergers and acquisitions) it is licenced by the Bank of Botswana as a commercial bank. As at December 2003, assets of merchant banks in Botswana were a little over P1 billion, about 8% of commercial banking assets and around 3% of GDP.

Government-owned Quasi-banks – the Botswana Government owns two financial institutions that provide some banking services: the Botswana Savings Bank; and the Botswana Development Bank⁴.

The Botswana Savings Bank, established under the Botswana Savings Bank Act (1992), provides banking services, including taking deposits and extending loans and advances to retail customers, small businesses, and parastatals. Its banking services are provided predominantly through the Botswana Postal Services. The National Development Bank, established under the National Development Bank Act (1964), provides development loans to industry in Botswana.

As at December 2003, the assets of these two Government-owned quasi-banks were P759 million, of which the National Development Bank accounted for P535 million and the Botswana Savings Bank P224 million. Consideration is being given to combining these two institutions to create a full service bank as a first step towards possible privatization.

Long-term (Life) Insurance Companies – there are 5 companies operating in the long-term insurance market (Botswana Life, Regent Life (Botswana), Metropolitan Life, First Life, and BIFIM Life) the majority of which are either wholly or partly-owned subsidiaries of non-Botswana insurance companies. In 2003, total assets for the industry were P5.6 billion (approximately 16% of GDP). Long-term insurers underwrite death, disability, and funeral risks, as well as offering long-term savings through endowment policies and income provision through annuities. As shown in Table 1, life insurance has been one of the most rapidly growing areas of the financial system over the past two years, with an annualized growth rate of almost 50% per annum. This strong growth reflects the general growth in the funds management industry and a growing awareness in the community about the need for insurance products.

Gross premiums written by life insurers in 2003 were just under P950 million, an increase of around 160% from the level of 2001.

General Insurance Companies – there are 8 registered general insurers in Botswana (Botswana Eagle, Botswana Insurance, Export Credit Insurance and Guarantee, Mutual and Federal, Prefsure (Botswana), Regent Insurance (Botswana), Skerry and General Insurance Botswana) with total assets of just under P500 million as of December 2003 (a little over 1% of GDP). As with most other institutional groups, ownership of the larger general insurers is dominated by foreign parent companies (most are more than 50% owned by foreign companies, mostly from South Africa). Insurers underwrite most forms of general insurance risks, although the majority of business written relates to short-tailed business such as motor vehicle and accident insurance. Reinsurance is provided from major international reinsurers either directly or via parent companies.

Gross premiums written by general insurers in 2003 were a little over P420 million, an increase of 50% from the level of 2001.

⁴ A third government-owned financial institution, the Botswana Development Corporation, which is registered as a corporation, provides development loans. However, it accesses funds only through the wholesale market and the Government and is therefore not included in this analysis of financial intermediaries.

In addition to the private general insurers, the Government of Botswana provides insurance through the Motor Vehicle Accident Fund which handles third party bodily injury liability. This insurance is funded from levies on the price of petrol. The Government also provides insurance to its employees for loans taken out against motor vehicles and real property; and it also provides export credit insurance.

Pension Funds – the pension fund industry is one of the largest institutional sectors in the Botswana financial system. In 2003, there were 139 registered pension funds accounting for over P14.5 billion of assets (roughly 40% of GDP), and over 71,000 members. The industry is dominated by the Botswana Public Officers' Pension Fund, which accounts for approximately 82% of industry assets. The second largest fund, the Debswana Pension Fund, has approximately P1 billion of assets, and there are another five funds with assets between P100 million and P250 million.

The decision to fully fund the Public Officers' Fund accounts for the spectacular growth of private pension fund assets over the past two years or so. Prior to 2001 the public sector's defined benefit pension obligations were funded on a pay-as-you-go basis from the Government's budget. In 2001 a decision was taken to convert the Government's obligations to a defined contribution scheme and to fully fund it over a period of several years. By December 2003 the level of funding had increased to P10.9 billion, and by mid-2004 had reached P12.7 billion, within P1 billion of full funding. Management of the fund is divided between four private sector asset managers (BIFIM, Investec, African Alliance and Fleming). While the industry is arguably exposed by the dominance of the Public Officers' Fund, the fact that it is fully funded by the Government reduces this risk relative to the situation in many other countries.

Pensions in Botswana are dominated by defined contribution funds (approximately 85% by number of funds and higher by total assets - given the nature of the Public Officers' Fund as a defined contribution fund). The pension fund industry is a major investor in the domestic capital market, holding around 65% of the free float of equities listed on the Botswana Stock Exchange.

Six pension fund administrators (Alexander Forbes Financial Services Botswana, Metropolitan Life of Botswana, Glenrand MIB, Jacques Mallan Associates, Marsh, and AON Botswana) provide administrative services to the vast majority of the market (some of the larger funds do their own administration in house). Pension fund services are provided to small firms via five umbrella funds offered mostly in conjunction with the pension fund administrators by Alexander Forbes Retirement Fund (Alexander Forbes), BIFM Umbrella Fund (Glenrand), Ntlo Pension Fund (Metropolitan Life), Sentlhaga Pension Fund (AON), and Deferred Pensioners Pension Fund); umbrella funds provide their own trustees and effectively enable small firms to outsource their pension fund responsibilities. Alexander Forbes, Jacques Mallan and NARCO Solutions provide consulting services to the industry, although it appears that other smaller advisors may also have entered the field in recent years.

Medical Aid Funds – the medical aid industry is dominated by three large providers (the Government Medical Aid Fund, Pula Medical Aid Fund, and BOMAID) that account for over 90% of the market. There are also three smaller providers that have entered the market in recent years. The industry provides conventional health insurance to members. The principal members of the funds are firms wishing to offer medical cover to their employees. Coverage is estimated to be a little over one third of the formal workforce in Botswana. While no official statistics are available on the medical aid industry, as at December 2003, assets of the industry were estimated informally at around P500 million.

2.1.2 Asset Management and Collective Investments

Unit Trusts – the unit trust industry is one of the faster growing institutional sectors in Botswana. Unit trusts cater primarily to the retail end of the collective investment schemes market, providing flexible investment products for individuals and pension funds. There are currently two domestic unit trust management companies (African Alliance Botswana Management Company, and Stanbic Investment Management Services (SIMS)). Given that SIMS was only licenced during 2004 figures are not yet available on the number of funds they intend to operate or the volume of funds already under management. As at December 2003 African Alliance was operating four 4 funds with a total of P2.3 billion in funds under management. While pension funds are the dominant investors in unit trusts, other investors account for substantial holdings (up to 30%) in some unit trusts.

Asset Management Companies – The growth in asset management services has mirrored the growth in pension funds in Botswana. There are currently 8 asset managers in Botswana (BIFIM, Investec Asset Management Botswana, African Alliance Botswana, Allan Gray Botswana, Fleming Asset Management, Imara Asset Management, Metropolitan Botswana, and Stanbic Investment Management Services) that manage assets for the pension fund industry and for wealthy individuals or companies. The asset managers are all independent of the pension fund administrators.

Total assets of asset management companies at December 2003 were estimated to be around P16 billion. Asset managers cover the professional end of the managed funds market, with the majority of their business coming from pension funds under direct mandates. There are two types of asset managers: multi-managers and single-managers. Single-managers make investment decisions and actively manage funds. Multi-managers choose a portfolio of single managers to manage their funds, thereby acting as a fund of funds. The growth of the asset management industry has been tied largely to the growth of the pension fund industry.

2.1.3 Capital Markets

Botswana Stock Exchange – The Botswana Stock Exchange (BSE) was established in 1995. As at December 2003 there were 25 listed companies in the stock exchange, with 20 on the main board and 5 on the venture capital board; 18 are primary listings (domestic companies), while the rest are dual listed companies from South Africa and Australia. Total market capitalization as at December 2003 was just over P150 billion, of which only P9.4 billion (approximately 26% of GDP) was accounted for by primary listings. The market advanced by a further 22% in the first 3 quarters of 2004.

The exchange operates as a call auction market with auctions held twice each working day. Clearing and settlement of trades is done manually, with settlement time operating at T+5, although there are plans within the next year or so to create an electronic registry and central depository, with electronic trading to follow after that. Market turnover is currently running at around 3% per annum but has been as high as 9% in the past. The free float is relatively low although listing rules require a minimum of 20% on main board listings and 10% on the venture capital board.

The exchange also lists corporate and quasi-government bonds. Bond issues have grown more rapidly than equity listing, especially during the past year during which the number of bond issues has increased from 14 to 21 (including one short-term commercial paper issue) and the face value of debt on issue has increased by over 450%, from P375 million to P2.1 billion. The Botswana Government has issued a number of government-guaranteed, quasi-government bonds through a special-purpose vehicle. These bonds have been used to fund the operations of parastatal organisations.

During 2003 the Government has also issued three long-term Pula-denominated bonds in its own name, with a total face value of around P2.5 billion. To date, these are traded by the banks and have not been listed on the BSE.

Securities Dealers – Botswana has three brokerage firms: Botswana Stockbrokers, Motswedi Securities, and Investec. These brokers support trading of equities and bonds on the BSE.

2.1.4 Supporting Market Professionals

Insurance Agents and Brokers – The Insurance Act in Botswana covers insurance brokers, agents and agents for brokers. Whereas brokers are permitted to place business with any licenced insurer, agents are linked to one company only. There are currently 25 insurance brokers in Botswana who are licenced to place both life and general insurance business. There are also 86 life insurance agents and 32 general insurance brokers.

2.1.5 Other Specialised Finance and Leasing Companies

Botswana Development Corporation – The Botswana Development Corporation (BDC) was created around 30 years ago to help finance investment in infrastructure and business in Botswana. The BDC makes loans to industry as well as taking equity positions and providing guarantees. Unlike most other parastatals in Botswana the BDC is registered under the Companies Act rather than being established under its own law. The Botswana Government funded the BDC initially through both equity and debt although, in more recent years, BDC has raised its own funding from internally generated funds and bond issues into the local and overseas markets.

Finance and Leasing Companies – Since 2003 there have been no specialised finance or leasing companies in Botswana other than the BDC.

2.1.6 Microfinance Providers

Savings and Credit Co-operatives – the SACCO industry in Botswana is still relatively small. Savings and credit schemes can be operated by specialised SACCOs or by multipurpose co-operatives that also carry out traditional agricultural co-operative functions. SACCOs raise savings deposits from members with the objective of encouraging long-term thrift. Under the rules of SACCOs members may borrow a multiple of their accumulated savings. As at end 2003 there were 21 registered SACCOs providing savings and finance services to their members. Total assets were in the order of P61 million. The largest of these has a savings book of around P28 million.

Microlenders – The microlending industry in Botswana is segregated into large long-term lenders and small short-term lenders. Long-term microlenders are run as corporate businesses and extend unsecured loans for up to 3 years. Short-term lenders typically make unsecured loans of a month at a time.

As at end 2003, there were 4 long-term microlenders (Letshego Micro Provident Fund, First Funding, Penrich, and Blue). Letshego, the largest of these is listed on the Botswana Stock Exchange, with a market capitalisation of around P255 million. First Funding is a subsidiary of First National Bank of Botswana. Blue is considerably smaller than the other three. The long-term microlenders service different markets with some making loans of less than P20,000 while others make loans of up to P60,000. Some of the long-term lenders have access to repayments through automatic salary deductions via the payroll systems of the Government and some corporations.

There were also 65 short-term microlenders registered with the Micro Lenders Association of Botswana. The total loan book of the largest of these short-term lenders is reported to be unlikely to exceed P2 million. The Association is aware of at least another 10 short-term lenders and there are possibly others, given that membership of the Association is voluntary. While reliable statistics are not available on total credit extended by microlenders, it is estimated that total lending by long-term lenders is currently around P440 million, and by short-term lenders is around P40 million.

Burial Societies – there are currently 1,057 burial societies in Botswana. Burial societies are mutual associations that provide benefits to members to help defray funeral costs. The societies are not for profit and are not permitted to employ full-time employees. Societies are typically formed by groups of individuals in Government or private offices, or villages (minimum 10 persons), who then register with the Registrar of Societies. Members contribute a minimum amount each week to a common bank account. Withdrawals are made in the event that funeral services are needed. While the societies are typically very small in size, the number of such societies has been growing rapidly, driven at least partly by the HIV problem in the region. Statistics about assets of societies are not available but are suspected to be relatively small.

Bureaux de Change – Bureaux de change provide retail foreign currency changing services throughout Botswana.

2.1.7 The Botswana International Financial Services Centre

The Botswana International Financial Services Centre (IFSC) is provided for under s137-142 of the Income Tax Act (1995). The IFSC is an offshore financial centre through which financial services can be provided to non-residents of Botswana with the benefit of lower taxation. Under the Act, a company issued with a tax certificate under s138(2) is able to carry out financial activities specified under s137(7), which include: banking, securities dealing, insurance, providing financial advice, and other financial activities approved by the Minister.

There are presently 24 companies licenced to operate under the IFSC, including banks, insurance companies, hedge funds, asset managers, and a number of non-financial companies including call centres and telecommunications companies. African Alliance International, the largest asset manager in the IFSC, has close to P1 billion under management.

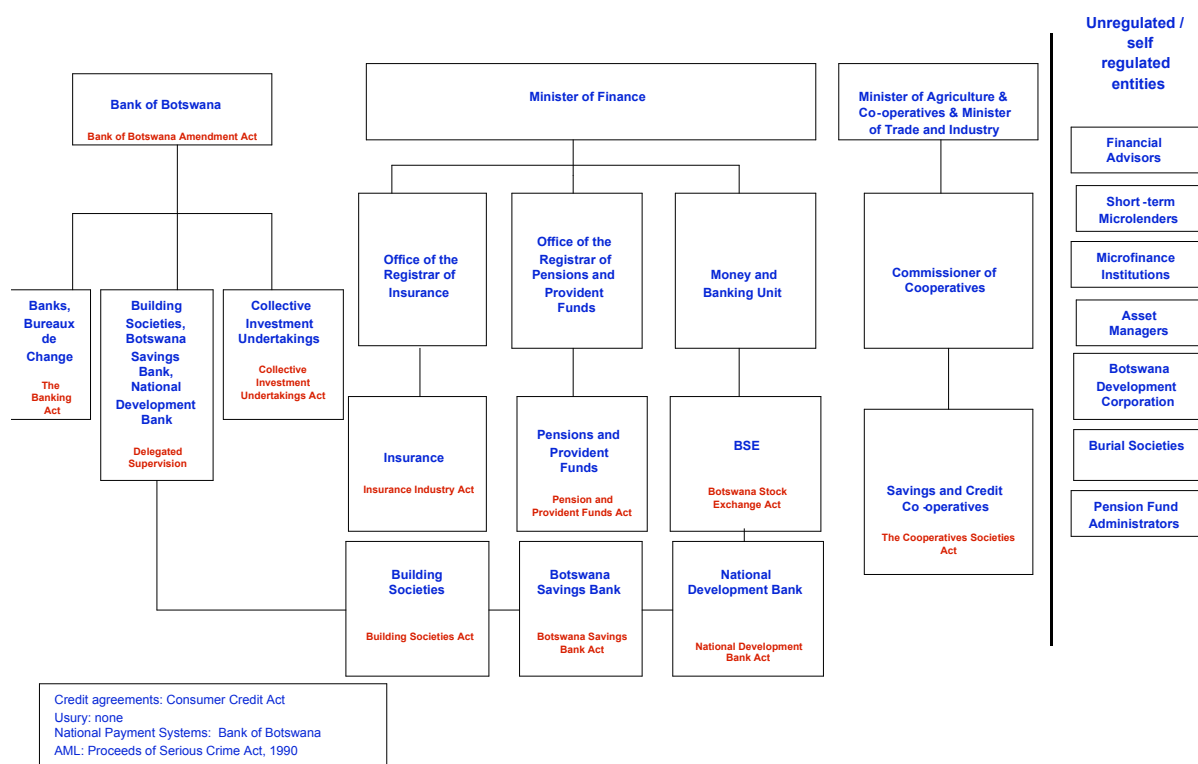
2.2 Regulatory and Supervisory Responsibilities

2.2.1 The Existing Structure of Regulation and Supervision

In what follows we will draw the usual distinction between regulation and supervision whereby the former will refer to the establishment of the rules and requirements by which regulated institutions must abide (these are usually set in primary Acts and their regulations), whereas the latter will refer to the process of monitoring and enforcing those rules. Despite drawing this distinction it will often be convenient to use the term “regulation” to cover all aspects of the regulatory process including both regulation and supervision.

Botswana has two front-line regulatory agencies with responsibility for financial sector regulation: the Bank of Botswana; and the Ministry of Finance and Development Planning (henceforth either the “Ministry of Finance” or, where there is no ambiguity, the “Ministry”). Other regulatory responsibilities are shared among the Ministry of Trade and Industry and the Ministry of Agriculture. Regulatory demarcation lines are nevertheless quite blurred, as summarised in Chart 1 and detailed in Table 2 below.

Chart 1: The Existing Regulatory and Supervisory Structure in Botswana⁵



Under law, regulatory responsibilities in Botswana are allocated as shown in the second column of Table 2. However, as shown in the third column of Table 2, a number of regulatory responsibilities are delegated either formally or informally to other agencies:

- The Botswana Savings Bank, building societies, and the National Development Bank are formally registered and regulated by the Ministry of Finance. However, due to capacity problems at the Ministry, ongoing supervision of these institutions has been delegated by the Ministry to the Bank of Botswana.
- The Ministry of Finance has formal regulatory and supervisory responsibility for stock brokers, but has delegated this informally to the Botswana Stock Exchange as a self-regulatory organisation for the securities market.

Other aspects of the existing regulatory structure in Botswana that are worthy of note include the following:

- Insurance companies are regulated by the Ministry of Finance under the Insurance Industry Act (1987).

⁵ This chart updates an earlier chart presented by Karin Rathbone of Deloitte Touche to a workshop on Tiered banking held in Pretoria, South Africa, on 22-23 November 2004.

- SACCOs are registered by the Commissioner of Co-operatives. While the Commissioner is legally attached to the Ministry of Agriculture, responsibility has shifted informally (presumably in anticipation of proposed legal amendment to the Co-operative Societies Act) to the Ministry of Trade and Industry. There is currently no prudential regulation or supervision of SACCOs along the lines usually applied to deposit-taking institutions.
- While, technically, there is no direct provision for merchant banks in the Botswana Banking Act, the law does allow the Bank of Botswana to establish different levels of regulation and supervision for different classes of banks and to control the use of the term “bank”. In practice, the Bank of Botswana has licenced merchant banks as banks and has regulated and supervised them as banks. Thus, in practice, there is no regulatory distinction between the two.

Table 2: Regulatory Structure

Institutional Group	Legally Designated Regulator	Regulator/Supervisor in Practice
Commercial Banks	Bank of Botswana	Bank of Botswana
Botswana Savings Bank	Ministry of Finance	Bank of Botswana
Building Societies	Ministry of Finance	Bank of Botswana
Botswana Development Bank	Ministry of Finance	Bank of Botswana
Merchant Banks		Bank of Botswana
Bureaux de Change	Bank of Botswana	Bank of Botswana
Botswana Development Corporation		
Savings and Credit Co-operatives	Ministry of Agriculture	Commissioner of Co-operatives (Ministry of Trade and Industry)
Insurance Companies	Ministry of Finance	Ministry of Finance
Pension Funds	Ministry of Finance	Ministry of Finance
Pension Fund Administrators		
Pension Fund Investment Advisors		
Exchanges	Ministry of Finance	Ministry of Finance
Stock Brokers	Ministry of Finance	Botswana Stock Exchange
Asset Managers		Bank of Botswana (for collective investments only)
Microlenders		
Funeral Funds		
Medical Aid Funds		
IFSC	Bank of Botswana and Ministry of Finance	Bank of Botswana and Ministry of Finance

- Burial societies are registered by the Registrar of Societies (in the Ministry of Home Affairs) but are not regulated or supervised in the normal sense of these terms.
- Medical aid funds are not regulated, although they have some ongoing contact with the Ministry of Health and there have been ongoing discussions about legislation to bring them formally under the regulatory jurisdiction of the Ministry of Health.
- Market misconduct provisions in the Consumer Protection Act (1998) are administered by the Office of Consumer Protection, which resides in the Department of Trade and Consumer Affairs which, in turn, resides in the Ministry of Trade and Industry. While the Act does not address consumer credit directly, abuses relating to credit, including complaints against microlenders are investigated by the Office of Consumer Protection.

- Under an amendment to the Bank of Botswana Act (s42A) the Bank of Botswana has been given regulatory responsibility for all financial institutions in the IFSC with the exception of insurance companies, which are regulated by the Ministry of Finance. In principle, this gives the Bank of Botswana jurisdiction over asset managers, hedge funds and even non-financial companies such as telecommunications companies.

As illustrated in Chart 1 and Table 2, the existing regulatory and supervisory structure in Botswana is fragmented and confusing. The structure has:

- gaps – for example, while the Ministry of Finance regulates pension funds (under the Pensions and Provident Funds Act (1987)) it has no legal jurisdiction over pension fund administrators or asset managers, both of which create significant exposures for pension fund members;
- overlaps – for example, the Bank of Botswana regulates some NBFIs in the domestic market and an even wider set of NBFIs in the IFSC; and
- some supervisors that operate without formal legal powers - for example, the supervision of securities dealers by the BSE and the supervision of building societies, the Savings Bank of Botswana, and the National Development Bank by the Bank of Botswana, are all carried out without formal legal backing.

2.2.2 The Approach to Regulation and Supervision

It is not within our terms of reference to carry out a comprehensive review and assessment of the various regulatory and supervisory approaches currently in practice in Botswana. The following are nevertheless some summary observations:

- The Bank of Botswana appears to have adopted the general approach to banking supervision recommended by the Basel Committee under what is known as the Basel I framework. There are nevertheless some areas in which the regulatory and supervisory framework for banking supervision could be strengthened or extended. These include in the areas of supervisory independence, supervising banking conglomerates, creating a tiered regulatory framework for lower tier deposit-taking institutions, and information exchanges with other regulatory bodies. The Bank of Botswana is currently considering possible amendments to the Banking Act to address some of these issues. We suggest that these amendments be co-ordinated with the legislative work that will be carried out for the non-bank regulatory framework and that the amendments be submitted as a package of reforms.
- The Ministry of Finance currently faces some difficulties in meeting its regulatory responsibilities. Not the least of these is a serious understaffing problem. Data systems are operated manually, there is an absence of computerised analytic tools for supervisors, and there is insufficiency of solid and timely industry information. In the face of these handicaps the supervisory staff have focused primarily on the licensing and delicensing processes. In this they have done a creditable job, but there is much more that needs to be done to raise the effectiveness of non-bank regulation in Botswana (see following sections). To the Ministry's credit, recognition of these shortcomings and needs prompted this project.
- As noted above, pension fund administrators, asset managers, SACCOs, custodians, microlenders, and specialised financiers are not currently subject to any regulation or supervision.

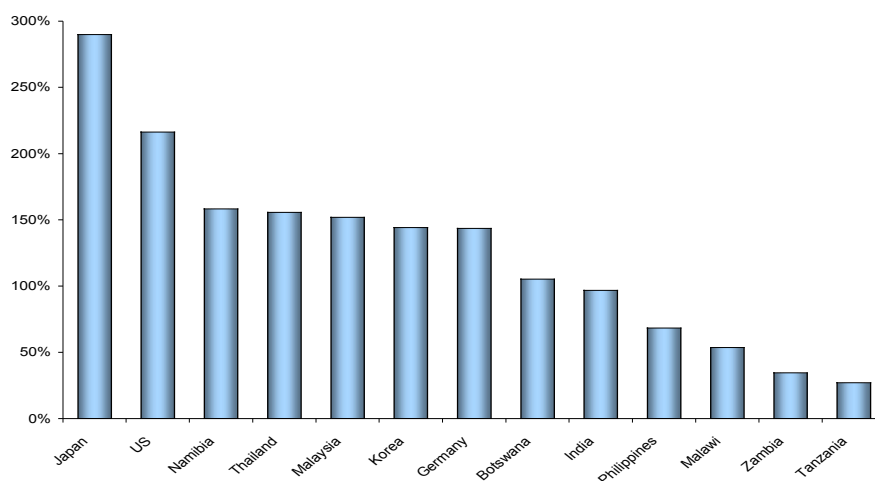
2.3 Financial Sector Assessment and Trends

2.3.1 The Botswana Financial System is Relatively well Developed

On the surface, given the small size of Botswana (population 1.8 million), the Botswana financial sector is surprisingly mature in terms of the extent of finance provided. That maturity is less surprising when viewed against its status as a middle income country and its close proximity to South Africa and the prevalence of South African owned financial institutions.

One measure of financial sector development is the ratio of total financial sector assets to GDP (see Chart 2 below). In developed countries this ratio is usually well in excess of 100%, with countries like Japan, the USA and the United Kingdom having ratios in excess of 200%. The more financially advanced emerging market countries, such as Thailand, Malaysia, Korea and Namibia have financial sector assets of around one and a half times GDP. While this is only a rough benchmark, a measure of financial immaturity is when this ratio falls significantly below 100%. Financial sector assets relative to GDP in Botswana were just over 100% at end 2003⁶.

Chart 2: Financial Sector Assets to GDP – % Selected Countries⁷



2.3.2 NBFIs in Botswana are Well Developed

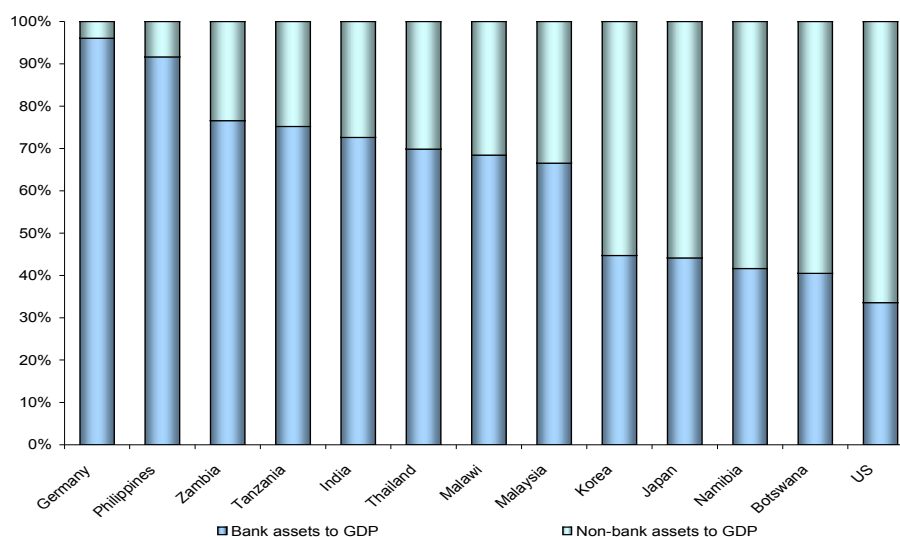
A second measure of financial maturity is the extent of balance between banks and NBFIs in the financial system. As shown in Chart 3, NBFIs play a significant role in the Botswana financial system, with pension funds alone controlling more assets than the commercial banking system, and insurance companies having assets close to half those of the commercial banking system.

⁶ The figure used for total financial sector assets in this calculation is only a rough approximation in that it excludes from the total of all financial institutions the assets of unit trusts and asset managers under the assumption that they are largely already included in the assets of insurance companies and pension funds. This estimate, however, is likely to be around the correct order of magnitude.

⁷ All data used in the comparative graphs in this Report are from World Bank *Financial Structure and Economic Development Database*, created by Beck, Demirguc-Kunt, and Levine, and are for 2002 data.

The extent of NBF development is often taken as an indicator of financial sector depth. In well-developed market systems such as the USA, where banks account for as little as 25% of financial sector assets, the depth of non-bank finance provides an additional degree of resilience to the financial system. In contrast to Botswana (and a number of other countries in the SADC region) many of the emerging market economies in Asia are heavily bank dependent.

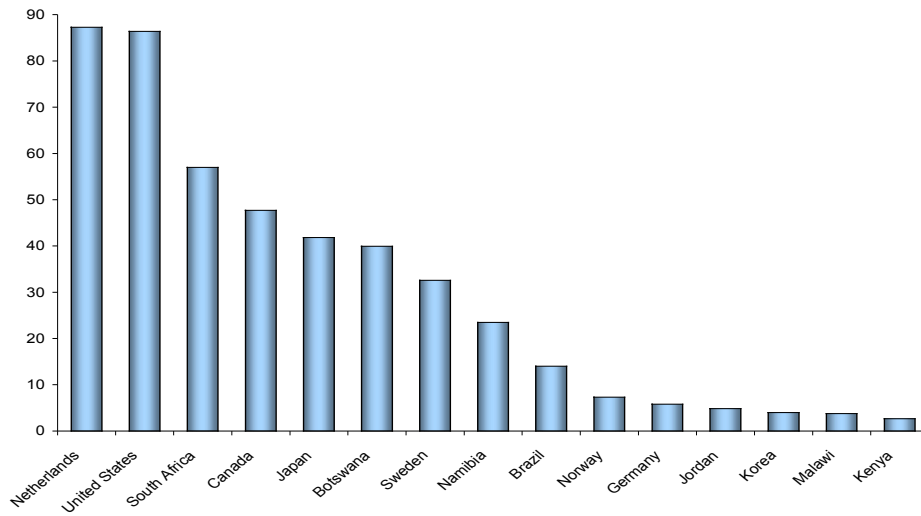
Chart 3: Bank and Non-bank Financial Assets (% of GDP) - Selected Countries



The banking system in Botswana is relatively well developed with assets of around one third of GDP. They are not, however, the dominant institutional group in the Botswana financial system. NBFIs collectively have roughly double the assets of the banking system.

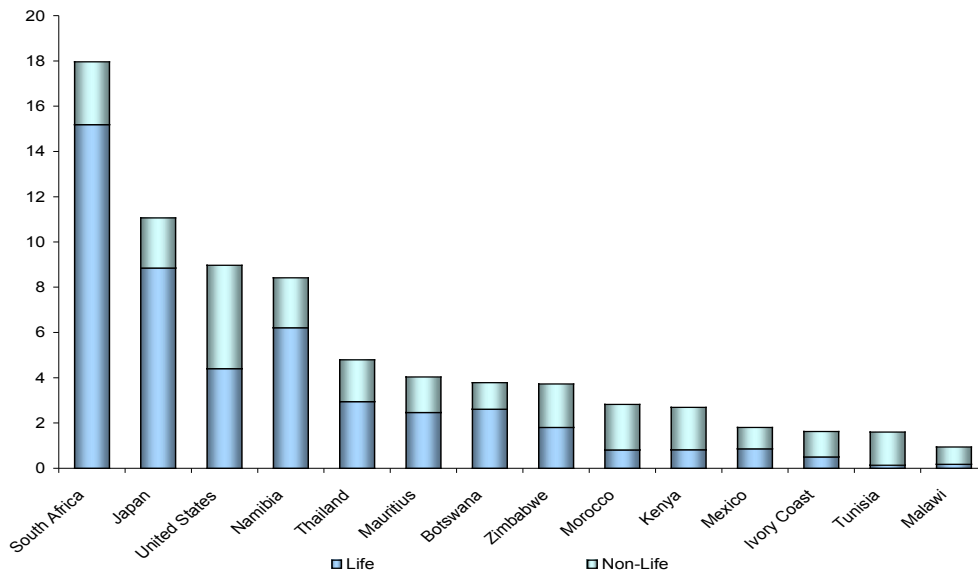
In terms of international comparisons, insurance products have an average level of penetration for emerging market financial systems, while pensions have an exceptionally high level of penetration. For example, on the most commonly used measure of penetration, insurance premiums as a percentage of GDP in Botswana are 2.6% for long-term insurance and 1.3% for short-term insurance. These penetration ratios are low compared with developed financial systems, but not out of line with experience in the region (see Chart 4 below).

Chart 4: Insurance Penetration – Premiums/GDP – % Selected Countries⁸



Private pension penetration in Botswana, as measured by pension fund assets as a percentage of GDP, is exceptionally high. As note earlier, however, a large part of the penetration in this sector is the result of the Government’s decision to fully-fund and “privatise” the management of the Public Officers’ Pension Fund. The overall level of pension penetration in Botswana is comparable with some of the most developed pension markets in the world (see Chart 5).

Chart 5: Private Pension Penetration – Assets/GDP – % Selected Countries



⁸ The picture for Zimbabwe has changed significantly for the worse since the figures in these charts.

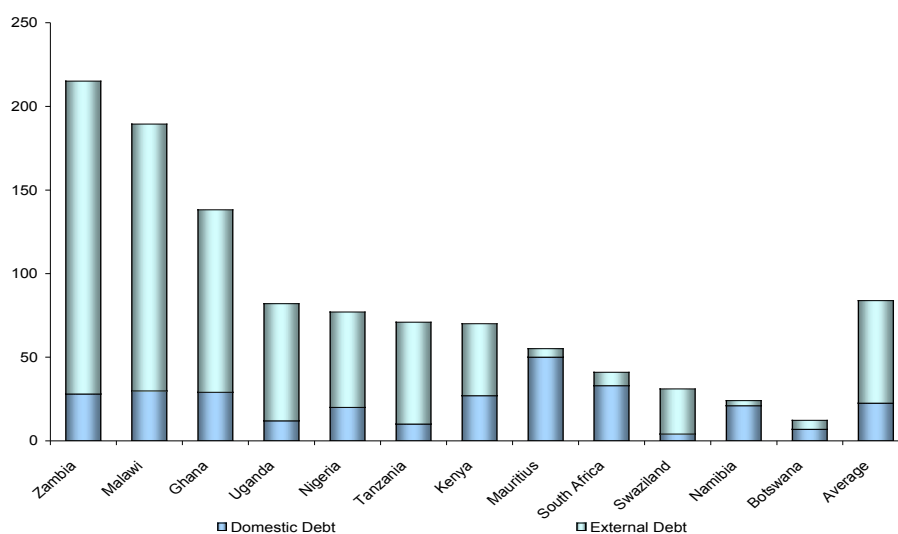
The apparent high level of financial sophistication among the institutional financiers, however, masks the fact that financial services are not provided to large sections of the lower-income community. Where the lower-income community has access to financial services they are more likely to be provided through high-cost providers.

2.3.3 Government Involvement in the Botswana Financial System is Relatively Minor

A third general feature of the Botswana financial system is the relatively low level of Government involvement. Overall Government ownership of financial institutions is well below emerging market norms and has been restricted to the two specialized quasi-banks, the Botswana Development Corporation and some publicly-operated insurance funds. The Government has also made relatively modest demands on finance, thereby allowing the private sector ready access to development funding (see Chart 6 below).

The Botswana Government has issued two types of domestic debt. The first, which was used to fund parastatal agencies, was privatized through the creation of a special purpose vehicle. The second, conventional longer-term bonds issued directly in the Government's name, were first issued in 2003 to primarily to provide a Government yield curve to help underpin the corporate and parastatal market.

Chart 6: Government Debt to GDP – % Selected African Countries



2.3.4 Foreign Involvement in the Botswana Financial System and Industry Concentration are both High

As a fourth general observation, while the level of Government involvement in the financial system is low, the reverse is the case for foreign involvement. All of the banks in Botswana are either wholly or majority owned by foreign parent banks. Similarly, most of the insurance companies have foreign parents with major shareholdings, as do the firms operating as pension fund administrators and asset managers. It is only at the microfinance level that wholly local firms begin to play a significant role in the financial sector.

The final general feature of the Botswana financial system is the high level of industry concentration. There are only 5 banks, 5 life insurers and 8 general insurers. The largest pension fund (of 139) accounts for 82% of industry assets. The largest 3 medical aid funds accounts for around 90% of the business. The largest four microlenders account for 90% of the business. Of over 80 microlenders the largest 3 account for around 90% of the business. While this level of concentration is neither unusual nor inappropriate for a small economy, it does expose the system to a significant concentration of risk in a small number of institutions.

2.3.5 Growth Prospects for the Botswana Financial System are Relatively Subdued

Given the high level of development of the Botswana financial system and the high growth experienced in recent years, the industry - especially the non-bank sector - is likely to experience a period of relative stability in terms of overall activity in coming years. Growth of the underlying economy will underpin some business expansion, but there is unlikely to be rapid growth beyond that.

Areas in which growth prospects are strongest are those where the markets are relatively under-tapped, such as microfinance. These are not, however, likely to add significantly to overall financial intermediation. Until the poorer sectors of the community reach income levels at which conventional financial services become viable they are unlikely to add much to the total demand for financial services.

3. Regulation of NBFIs in Botswana

3.1 Introduction

As outlined in Section 2, NBFIs in Botswana have grown rapidly in recent years and now dominate the financial sector. A large NBFIs sector brings with it both advantages and risks. This section reviews those advantages and risks and the need for a strong regulatory framework to mitigate those risks. It considers the appropriate regulatory coverage of NBFIs in Botswana, the optimal architecture of regulatory agencies and an appropriate division of responsibilities among these agencies. The main recommendation of the section is the establishment of a single independent parastatal agency to regulate and supervise all non-deposit taking NBFIs in Botswana.

3.2 The Role of NBFIs and their Attendant Risks

There has been a growing recognition in the past decade or more of the importance of non-bank financial institutions. That importance arises from their contribution to both financial and economic development.

3.2.1 Benefits Associated with NBFIs

The contribution of NBFIs to financial development is reasonably well understood:

- They deepen financial markets by providing services that banks cannot provide efficiently because of their involvement in the payments system – services such as risk pooling and provision of long-term savings instruments;
- By specializing in particular areas of finance services such as leasing and mortgage finance they lower the cost of those financial services to consumers; and
- They add resilience to the financial system in times of crisis – what US Federal Reserve Chairman Greenspan has referred to as adding a “spare tyre” to the financial system.

The contribution of NBFIs to economic development is not nearly as well understood or appreciated. There is now a growing body of evidence supporting two propositions:

- First, that development of financial institutions generally adds significantly to economic growth; and
- Second, that the contribution is greater where there is a balance between banks and NBFIs in the financial system.

The reasons behind this second observation lie partly in the efficiency that NBFIs add to the financial system, but the contribution goes further than that. For example:

- insurance underpins commerce – particularly international trade - by enabling those who could not otherwise bear the risks involved to shift them to those who are more willing and able to do so;

- some countries have found that micro-finance institutions and credit co-operatives are the only means of providing financial services into remote rural regions and to the poorer elements of the community; and
- pension funds, particularly compulsory national pension schemes, have been found to increase national savings and long-term capital formation - for example, studies in Chile, Switzerland, Mexico and Australia have found that the introduction of compulsory national pensions increased national savings by between 40% and 70%, and GDP by up to 2%⁹.

3.2.2 *Risks Associated with NBFIs*

These benefits from the NBFi sector are significant. But they come with significant risks as well. NBFIs have sometimes been used to avoid regulations imposed on banks. For example:

- In Thailand, finance companies issued high-yielding promissory notes and borrowed offshore, then loaned the funds in local currency to high-risk borrowers who could not meet banking standards – when the crisis hit, in mid 1997, the Government was forced to close 69 insolvent finance companies.
- Malaysia experienced similar problems with finance companies that had extended hire-purchase loans.
- In Korea, NBFIs grew very strongly in the pre-97 period precisely because they competed directly with banks, but with a regulatory advantage. This included merchant banks in the pre-97 period, which borrowed offshore and helped leverage the Chaebol. The problem re-emerged in a different guise between 1997 and 1999 when poorly regulated Investment Trust Companies replaced merchant banks as the primary source of corporate finance.

A second risk arises where NBFi subsidiaries of banks are used to take on high-risk business activities that are not permitted within banks. This factor was also a contributor to the Asian crisis in the late 1990s, most particularly in Korea and Indonesia. But the problem is by no means confined to emerging markets. While Australia has lost only two banks through outright failure in the past century, both failed because of high-risk activities carried out through their unregulated and very large subsidiaries.

There is a common theme in most of the problems arising in the NBFi sectors of different countries – either inadequate or, in some cases, non-existent regulation.

The lesson from these experiences is very clear. Competition between NBFIs and banks in providing financial services is healthy. But competition based on poor regulation is unhealthy - and can have costly consequences that may affect economic growth and financial stability for years.

The clearest way to resolve the unquestionable benefits of having NBFIs with the risks that they bring is to have a sound system of effective regulation. That regulatory system should balance the need for these institutions to grow and prosper against the need to ensure that growth is based on sound fundamentals and not just on regulatory arbitrage.

⁹ See, for example, the evidence cited in Carmichael J. and M. Pomerleano (2002), *The Development and Regulation of Non-Bank Financial Institutions*, The World Bank, Washington DC.

One of the biggest changes in world thinking in the past decade or so has been the recognition that non-bank regulation is as important as banking regulation, and also that it is every bit as challenging to do it well. While regulation involves many elements, its effectiveness ultimately comes down to the quality of regulatory staff. Effective regulation requires that each regulatory agency charged with overseeing NBFIs has staff with the skills and experience to formulate and enforce regulatory policy. That, in turn, requires that each agency has sufficient funds and sufficient independence of funding to ensure its ability to recruit and retain suitable staff.

3.2.3 Costs Associated with NBF1 Regulation

Recognition of the importance of non-bank regulation has also focused attention on both the direct costs and indirect costs associated with regulation.

The direct costs of regulation are the costs of funding the agency (or agencies) that carry out the legislated regulatory responsibilities of the country. While the actual cost of funding regulatory agencies around the world varies enormously, when measured against industry assets the cost is mostly no more than .001 to .0012 (i.e. 10 to 12 basis points or .1 to .12 percent).

This direct cost is usually dominated by staff remuneration and technological support. The reason for this is straightforward. The finance industry is extremely complex. A regulator capable of meeting the legislated objectives and expectations of the community must have staff with the expertise and experience capable of dealing with the industry on its own terms. Not only does the safety of the consumers of financial services depend on this expertise, but so too does the reputation of the well-run institutions in the market.

This latter point is not always well understood – good regulation is in the interests of the industry. This works in several ways:

- First, an inexperienced regulator that lacks the expertise to properly evaluate a complex new product is more likely to put off making a decision to approve its use than one who has confidence in his/her own knowledge and judgment;
- Second, there has been a world-wide shift in the style of regulation from compliance-based regulation to risk-based regulation. Risk-based regulation requires judgment from regulators as to the assessment of risks, rather than whether or not the industry simply complies with the law. In this way it is much more focused on the intent of the law than on the letter of the law. Risk-based regulation is much more supportive of industry – but it is also much more demanding on the skills and judgment of regulators.
- Third, good regulation facilitates long-term industry growth by ensuring that the growth is soundly based on good business principles. Poor regulation is often associated with periodic collapses of the industry. A failure or scandal associated with a weak financial institution can cause as much difficulty for other institutions in the same sector as it can for consumers. Ukrainian experience with trusts (where the industry has not yet recovered from the crisis of confidence of a decade ago) is a good example of this effect.

In summary, not only consumers but also industry participants benefit in the long term from having a strong and effective regulator.

The indirect costs of regulation relate to the costs that can be imposed on the whole community when regulation fails to meet its objectives. These costs are much more difficult to measure, which explains why they are rarely taken fully into account in the decision to fund a new regulatory agency.

The evidence of these costs can best be drawn from the impact of failed financial systems and sectors. While these failures often reflect a combination of factors, regulatory failure is often a critical element either as a trigger in the failure or in the scale of the costs associated with the failure. To put these cost into perspective:

- The rescue of the Savings and Loan industry in the United States in the 1980s cost US taxpayers over \$US130 billion;
- The recapitalization of the financial system in Indonesia in the late 1990s could cost industry and taxpayers up to 25% of a full year's GDP by the time it is finished;
- The collapse of the Farrow Building Society Group in Australia cost less than \$A1 billion, but almost bankrupted the State of Victoria which had regulated and subsequently guaranteed its liabilities.

In many cases, the cost imposed on surviving institutions following a crisis is many times the cost that would have been born by adequately funding the regulator before the crisis.

3.3 Balancing the Approach to Regulation Against the Potential Costs

In view of the potentially significant direct costs of regulation it is important to balance that cost against the benefits. This requires understanding of the rationale for regulation and tailoring of the regulatory approach to the particular groups of financial institutions that are brought within the regulatory net.

The approach to regulating different groups of NBFIs around the world varies widely. There are nonetheless certain key requirements that have emerged in recent years to form the core of regulation in most countries. Many of these are picked up by the international regulatory bodies such as the Basel Committee, IOSCO and IAIS in their core principles and regulatory guidelines.

Identifying the appropriate level and form of regulatory requirements for each institutional group demands an understanding of the market failures that give rise to the need for regulation. There are three main types of market failure that justify regulatory intervention¹⁰:

- Market misconduct;
- Information asymmetry; and
- Systemic instability¹¹.

There are two common forms of market misconduct that cause damage to the financial system: unfair or fraudulent conduct by market participants; and inadequate disclosure of information on which to base investment decisions. Market conduct regulation, which focuses on disclosure, licensing and good governance, is largely about protecting market participants from fraud or unfair market

¹⁰ A fourth market failure often addressed by regulation, namely anti-competitive behaviour, is less relevant in the Botswana context.

¹¹ This terminology and the concepts outlined in this section are based on the analysis in Carmichael and Pomerleano (2002), and the Wallis Report (1997).

practices. By protecting markets in this way, market conduct regulation seeks to promote confidence in the efficiency and fairness of markets.

Information asymmetry arises where products or services are sufficiently complex that disclosure, by itself, is insufficient to enable consumers to make informed choices. This form of market failure should be distinguished from market misconduct associated with inadequate disclosure. Information asymmetry arises where disclosure by itself is insufficient to resolve the market failure. Information asymmetry arises in situations where buyers and sellers of particular products or services will never be equally well informed - regardless of how much information is disclosed. Regulation to deal with information asymmetry is usually referred to as prudential regulation.

Prudential regulation involves a higher level of intervention than market conduct regulation. Prudential regulation overcomes the asymmetric information market failure in part by substituting the judgement of a regulator for that of regulated financial institutions and their customers. Consequently, prudential regulation is typically more intrusive than conduct regulation. Whereas conduct regulation is primarily about producing market efficiency and fairness, prudential regulation is primarily about increasing safety for consumers who are unskilled in assessing complex financial promises. A by-product of the intrusive nature of prudential regulation is that it should reduce the rate of failure among key financial institutions, thereby increasing systemic stability.

However, while prudential regulation supports financial sector stability, there are other factors that affect systemic stability that lie outside the purview of (most) prudential regulators. It is a fundamental characteristic of parts of the financial system that they operate efficiently only to the extent that market participants have confidence in their ability to perform the roles for which they were designed. The more sophisticated the economy, the greater its dependence on financial promises and the greater its vulnerability to failure of the financial system to deliver against its promises. Systemic instability arises where failure of one institution to honour its promises can lead to a general panic as individuals fear that similar promises made by other institutions may also be dishonoured. A crisis occurs when contagion of this type leads to the distress or failure of otherwise sound institutions. While the potential for systemic instability is usually associated with payments services and deposit taking, equally disruptive consequences can also flow from other types of market disturbances such as stock price collapses and even the failure of a single large institution where that institution is involved in a complex network of transactions. Responsibility for overall financial system stability is usually assigned to monetary policy and to regulation of critical components of the financial infrastructure such as the payments system.

In every country there is a need to identify which financial institutions could potentially give rise to each particular market failure. There is no unique classification that fits every country. At the most basic level it is widely accepted that all financial institutions and market participants require some form of conduct regulation. This may be as trivial as requiring a licence to operate (for example, where an institution or individual provides financial advice), or it may extend to relatively rigorous disclosure and governance requirements (for example, where an institution seeks to raise funds from the public). Whether or not any particular institution or institutional group involves sufficient information asymmetry to warrant the additional oversight of prudential regulation is usually a matter of weighing the costs and benefits of providing the additional oversight.

A useful rule of thumb in classifying institutions for different levels of regulation is to consider the nature of the “promises” they make. Not all financial promises are equally demanding of the promisor and the promisee. Financial promises can be distinguished according to the following three main characteristics:

- the inherent difficulty of honouring the promise (i.e. how difficult it is for the promisor to keep its promises);

- the difficulty faced by the consumer in assessing the creditworthiness of the promisor (i.e. how difficult it is for the promisee to understand and assess what is being promised); and
- the adversity caused by promissory breach.

Each of these characteristics involves risk. The more difficult a promise is to keep, the greater the risk to the consumer and the greater the impact of information asymmetry. The more complex the institution making the promise, the more difficult it is for the promisee to assess its creditworthiness and therefore the greater the risk. Finally, the greater the consequences of promissory failure, the greater the risk, not only to the individual, but also to the community.

A useful guiding principle is that institutions making financial promises warrant prudential regulation only where their promises are judged to have a sufficiently high intensity in some or all three of the characteristics outlined above. Only in these cases will the potential cost of the market failure dominate the potential efficiency costs of prudential regulation. This is the same principle that is usually applied to regulation in other situations characterized by asymmetric information failure, such as air safety, drugs, and medical services. Applying the same principle, it is reasonable to assume that the intensity of prudential regulation should also increase as the intensity of the promises involved increases¹².

In a theoretical context, based on the scale of promissory intensity, most observers would rank institutions in the following broad order (of decreasing promissory intensity): banks, insurance companies, defined-benefit pension funds, other demand-deposit takers, organized exchanges, defined-contribution pension funds, pension fund administrators and asset managers, securities dealers, microfinanciers, other financiers such as leasing financiers, finance companies, market professionals, and so on. While it is useful to note that these rankings may vary from country to country, it is even more important to note that many countries do not necessarily reflect their ranking of promissory intensity in their regulatory framework. Anomalies can arise from historical accident, from industry lobbying, and from the differential pace of reform in different sectors.

That said most countries include banking within the prudential regulatory net. Many also include both short-term and long-term insurance and pensions. Some have added to this set of core institutions various combinations of other non-bank deposit takers, securities dealers and organised markets. No simple formula exists for defining the best boundaries for prudential regulation.

Finally, the boundaries of regulation for systemic stability are somewhat vague. Indeed the concept of systemic stability regulation (as distinct from prudential regulation) is a relatively new idea and many central banks are grappling with the best way in which to approach this. Most would accept that, apart from monetary policy, the payments system is the key area of regulatory focus for systemic stability. Some extend this to include other settlement systems. Similarly, provision of the lender of last resort facility is a matter of judgement for the central bank but is often restricted to large banks, although smaller banks and other deposit-takers may be included.

This classification of regulators suggests a pyramidal structure in which the lower levels are less intrusive and broader in their coverage. It also suggests that the lower levels are supportive of the

¹² There is no unique cut-off point for prudential regulation. The suggestion above, that some institutions are singled out for prudential regulation because they rate highly on the “promises scale”, is largely a reflection of how regulatory agencies are established in practice. It is equally plausible to argue, however, that the “promises scale” is a continuum with low intervention regulation at one end of the scale and highly-interventionist regulation at the other.

higher levels. Thus conduct regulation, which is directed primarily at improving efficiency and fairness (by correcting market failures that arise from misconduct), supports safety and stability, while prudential regulation, which is directed primarily at creating safety (by correcting market failures that arise from information asymmetry), supports systemic stability¹³.

3.4 Optimal Regulatory Architecture for NBFIs Regulation in Botswana

The Terms of Reference for this project include developing options and recommendations regarding the regulatory and supervisory structure for Botswana. Taking account of the historical evolution of financial regulation in Botswana the structural issues come down to two main issues:

- First, whether there should be a single or multiple NBFIs regulatory agencies for non-bank financial institutions; and
- Second, whether this agency (or agencies) should be located within the Public sector or established as a parastatal agency (or agencies).

The Interim Report discussed these options and length. Rather than repeat the arguments in full in this Report, the following offers a brief summary of the issues and conclusions.

3.4.1 The Optimal Number of Non-bank Regulatory Agencies

At present, regulatory and supervisory responsibilities for NBFIs are spread across multiple agencies. In some cases, different agencies are responsible for supervision as distinct from regulation (see Table 2). Not only has this resulted in gaps in regulatory coverage, it has resulted in confused lines of responsibility and uneven powers of enforcement.

The case for concentrating all responsibility for non-bank regulation and supervision into a single agency is compelling. Internationally there has been a trend towards regulatory amalgamation for a combination of reasons including:

- To eliminate or reduce regulatory arbitrage;
- To better cope with the regulation of financial conglomerates; and
- To make more efficient use of scarce regulatory resources.

While in many developed countries the focus has been primarily on the first and second issues, in emerging market countries the focus has been more on the second and third issues. In a country such as Botswana, with a relatively small financial sector in absolute terms, and where there is a shortage of skilled regulators, the case for regulatory amalgamation is difficult to ignore.

Compared with the alternative of multiple agencies a single NBFIs regulatory agency would:

- Provide economies of scale in regulation and supervision;
- Provide better career opportunities for regulatory/supervisory staff;

¹³ Somewhat perversely, prudential regulation may work against market efficiency by restricting entry and competition into sensitive areas of the financial system.

- Provide cost efficiencies in the operations of the agency;
- Facilitate a more consistent approach to regulating institutions that offer similar types of promises;
- Minimise regulatory gaps and overlaps; and
- Be broadly consistent with emerging non-bank regulatory structures in the region.

3.4.2 Location of the Non-bank Regulatory Agency

At present, non-bank financial regulation is located entirely within the public sector. The options on creating a consolidated single NBF regulator are to either:

- Locate the function within the Ministry of Finance; or
- Create a new agency as a parastatal authority drawing its legal form, responsibilities, and powers from its own law.

There are three key considerations to be addressed in choosing between these options; namely, staffing, independence and funding arrangements. Each of these issues is critical to the ability of the agency to provide effective supervision.

As detailed in the Interim Report, the following are the main features of the two models in terms of their ability to address these three issues.

Features of the parastatal model:

- Since the staff of a parastatal authority would not be public servants, staffing levels and remuneration conditions would not be limited by the restrictions imposed by the Botswana public service, thereby providing greater flexibility to recruit and maintain the necessary supervisory skills for effective supervision.
- Since a parastatal authority would be established under its own Act, there would be flexibility to legislate the desired level of agency independence.
- Establishment as a parastatal authority would also provide full flexibility to introduce industry funding in line with international trends (see Section 4.2 below).
- Another significant advantage of this model is that this it would be consistent with international best practice and also with emerging regulatory structures in other SADC countries (for example, the South African FSB, NAMFISA in Namibia, and the proposed FSRA in Swaziland).
- The legislation would need to be drafted carefully to ensure adequate accountability in the agency's exercise of its independence in setting and implementing financial supervision and too prevent over-budgeting.

Features of the Ministry model:

- Staff employed within a Department of the Ministry are automatically public servants, which can create difficulties in remunerating staff adequately for specialist skills. In some countries the challenge of providing adequate remuneration for financial regulators has been met by

establishing a special grade or classification of employees within the public service structure. Other countries have introduced special salary loadings for particular skill types, such as financial, legal and actuarial skills.

- Given that establishing the single regulator as a Department within the Ministry would not involve a special Act of the Parliament, the legal basis for regulatory independence would need to be established through the underlying industry laws. While some of the key aspects of regulatory independence can be legislated in industry laws, ultimately, regulatory independence is problematic since a Government Department is always subject to direction by the Minister.
- Establishing the NBF1 regulator as a Department within the Ministry would not necessarily rule out industry funding for the agency. To achieve this, the revenue collected from industry would need to be hypothecated for the sole purpose of financial regulation.
- Perhaps the greatest challenge of the Ministry model in the Botswana context would be achieving the necessary staffing flexibility within the constraints of the Botswana Public Service both in terms of expanding the number of regulatory staff and paying the remuneration levels needed to attract and retain the skills appropriate for financial supervision.

Based on these considerations and extensive discussions with stakeholders we made the following recommendation in the Interim Report¹⁴.

Recommendation 1

There should be a single NBF1 regulator for Botswana (called for the purposes of this Report the Botswana Financial Institutions Commission – BFIC) established as a parastatal authority.

This recommendation was made to the Cabinet of Botswana in a Cabinet submission subsequent to the Interim Report. It is our understanding that this proposal has the support of the Minister and the Cabinet and that formal approval has been given to draft legislation consistent with this model. This understanding forms the basis for the rest of this Report.

3.5 Appropriate Coverage of NBF1 Regulation in Botswana

3.5.1 A Proposed Allocation of Regulatory Responsibilities Among Regulatory Agencies in Botswana

Given Recommendation 1 it is our assessment that the financial regulatory responsibilities in Botswana should be allocated as follows:

Bank of Botswana:

- Commercial banks;
- Botswana Savings Bank;

¹⁴ This recommendation is, in fact, an amalgamation of Recommendations 1 and 2 in the Interim Report.

- Botswana Building Society;
- National Development Bank;
- Merchant banks;
- SACCOs*; and
- Bureaux de change.

BFIC:

- Insurance companies;
- Pension Funds;
- Pension fund administrators;
- Custodians;
- Organised exchanges and depositories;
- Securities dealers;
- Collective investment undertakings and trustees;
- Asset managers (mandate and CIU);
- Insurance brokers and agents;
- Medical aid funds;
- Investment advisors;
- Specialised finance companies; and
- Microlenders*.

* subject to some qualifications – see below.

3.5.2 Justification for the Proposed Allocation of Responsibilities

The primary basis for the division of financial institutions between the Bank of Botswana and BFIC is whether or not the institutions in question take retail deposits. Thus, we suggest allocating SACCOs and building societies to the Bank of Botswana for regulatory oversight. Correspondingly, responsibility for administration of the Collective Investment Undertaking Act (1999) would move to BFIC. The one minor exception to this rule is that bureaux de change would stay with the Bank of Botswana because of the Bank's responsibility for currency.

Some comments on specific aspects and institutions in the proposed allocation follow.

Merchant Banks

Merchant banks are unusual in that, while they take deposits and use the term “bank” in their description, they normally take deposits only from the wholesale market and engage in activities outside banking business. Thus they do not assume the same risk profile that banks do. While this might otherwise lead to their being allocated to BFIC rather than to the Bank of Botswana, the situation in Botswana is a little unusual.

First, there is no formal legislation or regulatory framework for merchant banks as such in Botswana. Second, there is only one merchant bank still licenced in Botswana. Third, the one merchant bank that remains is licensed by the Bank of Botswana as a bank and could, if it wished, undertake the full range of banking business. Fourth, commercial banks in Botswana undertake merchant banking activities (such as underwriting share floats) on their balance sheets. In view of these factors it appears to be more practical to allocate formal regulatory responsibility for merchant banks to the Bank of Botswana and to leave it to the Bank to determine whether or not it should create a lighter regulatory and supervisory framework for them or to continue to licence them as full service banks.

SACCOs

The SACCO industry in Botswana is very small. As such the risks are relatively minor and are unlikely to justify the costs of significant regulatory intervention. The reason for suggesting bringing them under the Bank of Botswana’s jurisdiction is because they take retail deposits and because of their potential to grow both in size and in the range of financial services that they offer. It is not uncommon in Africa and elsewhere to find that some of these institutions, while unregulated, grow very quickly and then collapse, thereby putting at risk the life savings of many of the poorer elements of the community. We understand that a decision to bring SACCOs under the Bank of Botswana lies outside the terms of reference of this report, and can do little more than encourage the Bank and the Government of Botswana most strongly to consider this step.

If it takes on responsibility for supervising SACCOs the Bank of Botswana would need to establish a framework for regulating them that is appropriate to the size and risks involved. At this stage of their development we would see merit in an approach based around encouraging the establishment of a “SACCO central” that could play an extensive self-regulatory role, and also in establishing a “solvency support fund” into which SACCOs would contribute. This fund would be tapped in the event of a failure to help preserve the value of depositors’ funds. Subject to the solvency fund and adequate self-regulatory oversight by a SACCO central, the Bank of Botswana could largely exempt SACCOs from the other provisions of the Banking Act. Their growth and performance would nevertheless need to be closely monitored with a view to bringing either larger or problem SACCOs under a closer form of supervision if needed.

Medical Aid Funds

We understand that the appropriate regulator for medical aid funds has been a much-debated issue in Botswana and that a decision has been taken recently to bring them under the Ministry of Health. However, bringing them under the purview of the Ministry of Health should not preclude a role for BFIC.

Medical aid funds have two distinctly separate aspects to their operations. One involves a purely medical aspect including their assessment of and selection of medical providers. The other aspect is the product they sell to consumers of medical aid. This product is by its very nature an insurance product. Medical aid funds offer what is best described as a mutual insurance product limited to medical services. While they do not undertake risk assessment in the conventional sense, medical

coverage still amounts to taking regular premiums in return for payments conditioned on the occurrence of certain events. In many countries, medical aid funds compete directly with medical insurance products issued by general insurance companies. Despite their restriction to medical services, their primary business is clearly insurance business and should be regulated as such. Importantly, if a medical aid fund fails, its policy holders can face significant financial losses.

In our view, given the small number of institutions involved, and the current trend towards expansion due to absence of regulatory requirements, it would be advisable to include these institutions under the regulatory umbrella sooner rather than later.

We have included medical aid funds in our analysis of the BFIC, although we recognize that in this (as in other areas) the final decision rests with the Government of Botswana.

Micro lenders

Micro lenders have been included in the class of institutions to be ultimately regulated by BFIC although, in our view there is no great urgency in bringing this about. The type of regulatory intervention would be very minor and based largely on ensuring good conduct. As mentioned above for SACCOs, the regulatory needs of microlenders are well-suited to a self regulatory organisation, with powers delegated by the non-bank regulator for establishing an industry Code of Conduct and for disciplining members. The self-regulatory route is likely to be the most constructive and cost-effective way of regulating this industry. In view of the disparity in size and type of business between the long-term lenders and the short-term lenders there will need to be some differentiation in the type of regulation for the two groups.

Specialized Financiers and Advisors

Specialized financiers (such as finance and leasing companies) and financial advisors have been included within the suggested regulatory net of BFIC. We should emphasise, however, that the form of regulation applied to these groups should be strictly conduct regulation. That is, BFIC would be responsible for licensing and collecting annual returns and statistics on these groups and for setting standards of conduct. There would be minimal regulatory interaction with these groups other than in response to complaints about their conduct. In the case of specialised financiers this is likely to relate largely to their fund-raising activities.

Burial Societies

Burial societies have been excluded from the recommended jurisdiction of BFIC. While technically burial societies can be considered to be in the category of micro-insurance providers, the fact that they operate solely as small, non-profit associations with no full-time staff means that the risks they pose are very small. They are more akin to a club than a financial institution. At the same time, their small size and large numbers means that they would be a major distraction for the non-bank regulator, while adding very little in terms of regulatory value to the members of the societies. We recommend, however, that the BFIC law be written in such a way that there is flexibility to add any non-bank financial institution, including individual burial societies, in the event that they outgrow their current limited scope and nature of activities.

International Financial Services Centre

We have not included the IFSC under the regulatory jurisdiction of BFIC directly. The development of policy for the IFSC should remain within the Ministry of Finance. Regulation of the institutions that operate in the IFSC, however, is a different matter.

It is international best practice to draw no distinction between financial institutions that operate on-shore and off-shore in terms of their regulation and supervision. Thus, banks that operate in the IFSC should be required to obtain a banking licence from the Bank of Botswana and should be regulated and supervised the same as Botswana banks. Similarly, any non-bank financial institution operating in the IFSC that would be required to obtain a licence from BFIC if it were operating in the domestic market, should be required to obtain the same licence to operate in the IFSC as an NBFi.

Those institutions that are neither deposit-takers nor NBFIs should not be required to be regulated or supervised by either the Bank of Botswana or BFIC.

Recommendation 2

BFIC should have regulatory and supervisory responsibility for: insurance companies, agents and brokers; pension funds and pension fund administrators; asset managers; organized exchanges; securities brokers and dealers; investment advisors; specialized finance companies; medical aid funds, microlenders; and any other NBFIs deemed by the Minister of Finance to warrant regulatory oversight. BFIC's responsibility should extend to these institutions regardless of whether they operate in the domestic market or the IFSC.

3.6 Review of Existing Regulatory Framework in Botswana

The existing regulatory framework for NBFIs in Botswana consists of four main Acts and their regulations: the Insurance Industry Act (1987); the Pensions and Provident Funds Act (1987); the Botswana Stock Exchange Act (1994); and the Collective Investments Undertakings Act (1999). The changes to these law recommended in the draft legislation attached to this Report are designed merely to ensure that the administrative and regulatory structure is amended to accommodate BFIC as the regulator, and to remove obvious overlap between the proposed BFIC Act and the existing legislation. They are not designed to establish a new or more appropriate prudential framework for regulating and supervising the relevant NBFIs.

Establishing a more appropriate prudential framework will require a more comprehensive overhaul of the existing industry laws and associated regulations. The following is a brief review of the four main industry laws, with suggestions as to areas that are in need of strengthening in an overhaul of the laws. In a number of cases our assessment of the weaknesses of these laws draws on and reinforces weaknesses previously identified by the Ministry. These reviews take as given that the changes recommended in the draft legislation attached to this Report will be implemented and therefore do not repeat any weaknesses that would be addressed by the draft legislation.

3.6.1 The Insurance Industry Act (1987) and Regulations

This legislation and associated regulations have a number of deficiencies and adopt a number of policy positions that may not be appropriate, in particular, in relation to the restrictions on the structure and investment capabilities of insurers. Among the deficiencies and policies that should be reviewed are:

- The position of foreign insurers is unclear.
- There is inadequate prudential regulation of the controllers of insurers. Although "controller" is defined in a relatively expansive way, the definition has gaps and shortcomings. Moreover, no adequate "fit and proper person" test is applied to controllers (the only test applied relates

to their knowledge of insurance) while a test approximating a "fit and proper person" test is only applied to controllers employed by the insurer.

- The prohibitions on cross-ownership of insurers and brokers appear to be ineffective in that they could be avoided by relatively simple structuring of the relevant transactions.
- The Minister has a detailed and extensive level of control over the investments that an insurer can make. This has the potential to divert the application of policyholders' funds to investments that do not produce optimal returns, which could have a potentially deleterious effect on the financial stability of the insurer as well as on the returns to policy holders.
- There are few explicit consumer protection provisions in the Act. In particular, there is a need to prescribe appropriate levels of disclosure to policyholders, detailing the terms of the policies and the risks and benefits associated with them. This is particularly important where policies have an investment as distinct from an indemnity component. In all cases, the risks covered, as well as the pricing of the policy, should be required to be clearly and explicitly identified for consumers.
- It is not clear whether or not the insurer carries the risk of a broker failing to pass through premiums collected by the broker (in these cases, the insured should still be covered even if the broker defaults).

3.6.2 *The Pension Funds and Provident Funds Act (1987) and Regulations*

The Pensions and Provident Funds Act and Regulations have a number of shortcomings, including in the areas of coverage of industry participants, powers of the Registrar, administrative arrangements and dispute resolution mechanisms. In many cases the Act suffers from a lack of clarity in definitions and requirements.

- Coverage of participants in the industry – the Act provides no framework to licence many of the key service providers in the pension fund industry including pension fund administrators, custodians, asset managers, or advisors.
- Deficiencies in the powers of the Registrar – the Registrar has no power to require routine reporting by pension funds or to conduct routine, on-site inspections. The Registrar has limited powers of direction (see s22). The Registrar does not have an explicit power to replace fund trustees or force the transfer of a fund to another administrator other than in a case where the fund is financially unsound (s19 - see also below). Many of the features of a prudential regime, including good governance, accountability and investment policies are set in the Act, rather than left to the Registrar. Consequently, many of these aspects are below international best practice. For example, there is no requirement for pension funds to have an investment policy, that it be explicitly managed in the interests of the members and that it be available to all members. Of even more concern, the investment rules as set out in the Act are either determined by the Minister or set down in law and are, in many cases, either unclear or inappropriate. For example, the Act allows lending to members for housing, which is not generally regarded as best practice. The prohibition on investment in liquor licences may be difficult to enforce where the investment is in a company whose activities may peripherally include a liquor licence (eg through the ownership of hotels). It is also unclear whether or not the investment in Botswana requirements include or exclude a fund registered in Botswana that invests fully or partially in investments outside Botswana. This list of deficiencies in the powers and appointment of the Registrar are representative rather than exhaustive; a more comprehensive treatment is offered in Section 4 dealing with the design of BFIC.

- Administrative arrangements – the Act and Regulations should establish the necessary administrative framework within which funds and members operate. It should provide clear guidance for establishing, operating and dissolving funds, the rights and responsibilities of all parties involved, rules for vesting and transferring pension rights, and so on. The Act and Regulations have some significant deficiencies in these areas, many of them due to lack of clarity in the original drafting. For example:
 - The definitions of employees, pensions, provident fund, and other key concepts are unclear (eg the definition of employee refers to the inclusion of directors, but does not define employee explicitly, similarly the definition of a pension is completely unclear, while the definition of a provident fund is any fund “which is not a pension fund”).
 - It is not clear what role provisional registration plays in the regulatory regime or what happens if a fund is not approved for full registration within the designated period.
 - There is some ambiguity about the validity of funds registered in other jurisdictions.
 - There is a need for greater clarity about the distinction between registration of a pension fund for the purpose of providing pensions, as distinct from the tax status of funds – which is a matter for tax law rather than the Pensions and Provident Funds Act.
 - The role of trustees in pension fund management is unclear, as are their legal responsibilities and potential liabilities.
 - There guidelines for the dissolution of funds are inadequate, nor is there clarity about who has entitlement to any surplus on dissolution.
 - There are references to the Financial Institutions Act – which has been repealed.
 - There are no vesting provisions.
 - There are few, if any, provisions dealing with the collection of contributions and payment of benefits (e.g. it is unclear who has responsibility for collections and whether or not interest should be paid on late payment of benefits).
 - In addition to the issues raised above, there are many other provisions that could be reworded to improve clarity.
- Dispute resolution – the Act provides that a person aggrieved by a decision of the Registrar may appeal to the Minister and, if still aggrieved, to the courts (s30). There is no provision covering the resolution of disputes between the industry and its members (although the Registrar has been called on under the Arbitration Act to act as an unofficial ombudsman for such disputes. While appeal to the courts is always the last resort, an efficient regulatory regime should provide for reasonable dispute resolution mechanisms that allow problems to be resolved with the need for expensive legal action. Such mechanisms should be impartial and appropriate to the complexities of the situations that may arise. The formal and informal mechanisms currently in place fall short of these ideals. First, there is a basic conflict between the Registrar’s role as industry regulator and unofficial ombudsman for disputes between the industry and its members. Second, the Minister is unlikely to have the independence or access to the specific expertise required for resolving disputes between the industry and the Registrar.

3.6.3 The Botswana Stock Exchange Act (1994) and Regulations

The Botswana Stock Exchange Act establishes and regulates the operations of the Botswana Stock Exchange (BSE). At present work is being undertaken to prepare a general law regulating dealings in securities. It is anticipated that, as a more modern basis for regulating securities transactions is enacted, there will need to be significant amendments to the Botswana Stock Exchange Act. Difficulties with the present Act include:

- an unduly restrictive definition of securities (for example, limiting securities to fully paid up securities and options);
- a high level of Ministerial involvement in the governance of the BSE, including by appointing and removing members to the Committee of the BSE, rather than leaving the BSE to have the responsibility of electing or appointing Committee members subject only to a "fit and proper person" test;
- certain financial criteria are "hardwired" into the Act (for example, the minimum asset level for stockbrokers), so that legislative change is needed to amend the amounts for inflation;
- responsibilities in relation to registration and removal of stockbrokers are split between the Committee and the Registrar;
- there are limited "investor protection" provisions included in the Act; for example:
 - there is no requirement that a broker hold client funds in a trust account to provide insolvency protection for the client; and
 - the broker's responsibility for acts of his or her employees and associates is limited to contraventions of section 33 rather than, as in other jurisdictions, imposing liability on the broker for any default or breach of trust by the employee or associate;
- the abolition under section 59 of rights to sue other brokers may lead to injustices where, for example, a broker not retained by the client published misleading or deceptive inducements to acquire particular securities - this restriction leaves only section 68 (administrative action) available to deal with misleading or deceptive conduct by brokers and only criminal sanctions (available to deal with market manipulation and the like).

3.6.4 The Collective Investments Undertakings Act (1999) and Regulations

The Collective *Investment Undertakings Act* regulates collective investment undertakings in the form of unit trusts and investment companies with variable capital. Among the shortcomings of the present Act are:

- the limitation of the Act's coverage to unit trusts and investment companies with variable capital means that some forms of collective investment, not structured as companies or unit trusts, may escape regulatory and prudential oversight;
- section 6 restricts the Act's application to investment vehicles that operate with the aim of "spreading investment risk". Investment vehicles that are in all other respects the same as those defined in section 6, but whose investment object is a single asset, would arguably not be caught (this appears to be so despite the provision made for closed-end funds and property funds in the Regulations.) Examples may include investments in, for example, a shopping

centre, or an industrial estate, where investors' funds are pooled to acquire and operate the shopping centre or estate;

- the general obligation to buy back units on demand (subject to regulatory permission not to) may unduly restrict collective investment vehicles' investment activities;
- the treatment of trustee and manager fees in the legislation is problematic: the language of the provisions relating to unit trusts (for example, section 6(4)), may mean that the trustee is not entitled to deduct ongoing fees from the fund assets (as all funds are held for the benefit of unit-holders); the provisions concerning issue price for units do not appear to contemplate application or similar fees;
- the provisions in regard to prospectuses for collective investment undertakings may not be enough to ensure that the prospectus sets out, in a way that can easily be understood by the ordinary investor, the risks and benefits of the proposed investment so to enable him or her to make an informed judgment whether to invest in, or retain an investment in, the fund. In particular, the civil consequences (liability to pay damages to investors who suffer loss) of defective, or misleading or deceptive, prospectuses, and the civil liability of the issuer of, and others involved in the preparation of, the prospectus are not addressed.
- Although there is a facility for the regulator to issue a "stop order" (prohibiting temporarily the issue of units), there is no facility for the regulator to suspend the licence of a collective investment undertaking, or a trustee, manager or custodian.

3.6.5 Strategy for Revising and Upgrading the Regulatory Framework for NBFIs in Botswana

With respect to the overall regulatory framework in Botswana the Terms of Reference for this project include:

- conducting a high level review of current primary and secondary legislation;
- identifying gaps in the current regulatory/supervisory framework;
- reviewing existing regulation and developing proposals on drafting new legislation; and
- amending existing legislation in order to lay the legal basis for the creation of the new supervisory regime.

The high level review of current primary and secondary legislation is covered in the preceding sub-sections. The amendments to existing legislation to lay the basis for creating the BFIC are discussed in Section 4 following and presented in draft form in the Attachment to the Report. The following sub-sections summarise the gaps in the current framework and a proposal for drafting further legislative amendments.

Gaps in the Current Regulatory and Supervisory Framework

As suggested by the preceding analysis of existing laws and regulations, there are several critical gaps in the current framework:

- As pointed out earlier, there is currently no regulatory or supervisory framework covering a number of key institutional groups, including pension fund administrators, custodians, asset managers, and microlenders.

- There is no mechanism, other than through the courts, for dealing with disputes between the industry and its customers.
- There is no mechanism, other than through the courts, for dealing with disputes between the industry and financial regulators.

Both of the latter two shortcomings apply to both the banking and non-banking sectors. While there is an ombudsman for the banking industry, this role is funded and controlled by the banking industry itself and therefore does not have the independence required of such a mechanism. Similarly, some disputes between NBFIs and their customers are handled by the Ministry, an equally unsatisfactory arrangement. In both industries, disputes between the industry and the regulator are referred to the Minister.

Approach to Drafting Further Legislative

We propose that the legislative drafting process be carried out in three (possibly overlapping) stages:

- Stage 1: (the current project) – draft a Bill for the establishment of BFIC along with the amendments to existing industry laws necessary to enable the BFIC to be created and to operate. The amendments to existing laws will be primarily by way of ensuring consistency between the BFIC and industry laws. They will not address the shortcomings of the existing industry laws. When passed by the Parliament, this package of laws will enable BFIC to operate under essentially the same structure of laws and regulations that are in place currently. They will, however, endow BFIC with the powers to extend its regulatory coverage to currently unregulated NBFIs (see Section 4).
- Stage 2: (the industry laws) – draft amendments to the existing industry laws and draft new bills. This stage will address the shortcomings of the existing industry laws. It will also involve drafting of laws, where necessary, to close gaps in the existing legislative framework. As noted above there is a need for both an ombudsman and a tribunal to handle disputes within the NBF industry. While each of these could be established under the BFIC Bill, there is a need for these roles to cover not only the NBF sector but also the deposit-taking sector. Given this need for industry-based dispute resolution mechanisms it is both more appropriate and more efficient to create these through separate pieces of legislation. Addressing the gaps in regulatory coverage is less demanding. In many cases the legal framework for regulating currently unregulated NBFIs will be able to be addressed through regulations issued under the BFIC Act (see Section 4). In the case of microlenders however, the regulatory framework would be better addressed through a separate primary Usury law.
- Stage 3: (the regulations) – draft new and amended regulations and prudential rules (see Section 4) under the BFIC and amended industry laws. This will be the most demanding stage of the legal reforms and will involve a systematic upgrading of the regulatory requirements and framework for regulated NBFIs.

Stage 1 of this process is addressed in this Report as required by the terms of reference. The second and third stages go beyond the current terms of reference. A proposed timetable for the second and third stages is proposed in Section 6.

4. Design Features of BFIC

4.1 Introduction

The key design features of any regulatory agency include both external design issues (such as regulatory powers, independence, governance, accountability, funding, and legal framework), as well as internal design issues (such as staffing and organisational structure). This section addresses external design issues while the next section addresses internal design issues.

4.2 Regulatory Powers

Regulatory powers establish how, and how effectively, the regulatory agency is able to monitor and enforce the regulatory requirements set by primary and subsidiary financial laws. One advantage of establishing a new agency such as BFIC is that it provides an opportunity to strengthen regulatory powers in a comprehensive way. While some of the powers outlined below may not be needed in the near term, providing BFIC with the full range of regulatory powers will ensure that it is able to deal with difficult situations should they arise in the future.

4.2.1 *Appropriate Regulatory Powers for BFIC*

An agency with responsibilities such as BFIC's should have the following powers:

Licensing and delicensing - the power to license or register NBFIs under financial sector laws, and to administer licensing requirements under those laws. This includes the power to impose relevant conditions, and the power to vary and revoke licences/registrations in appropriate circumstances.

Making of legally binding regulations/rules and (less formal) guidance notes - the power to formulate and promulgate rules and regulations for all licenced NBFIs and the power to vary and revoke them. While regulations are usually executed formally by the Minister, the regulatory agency should have primary responsibility for their development. Rules, which set prudential and market conduct standards, and guidance notes, on the other hand, are usually issued by the agency. These subordinate legislative instruments should cover at least the following:

- standards of corporate governance for licenced entities, including codes of conduct, roles of boards and management, and methods for resolving conflicts;
- standards governing the ownership and control of NBFIs, including fit and proper conditions and minimum qualification requirements;
- standards of business conduct, including resolving conflicts between NBFIs and their clients, prohibition of certain abuses and insider trading;
- standards governing the prevention of financial crime;

- standards defining capital adequacy/solvency and the measurement of capital, including excluded assets and liabilities;
- standards defining valuation methods where relevant for both assets and liabilities, including choice of discount rates and levels of sufficiency in provisioning;
- standards concerning the management of risks by NBFIs; and
- standards of disclosure for securities and retail investment products, including insurance policies and pension products.

Reporting obligations and information gathering - the power to require all NBFIs to provide whatever information the regulator requires in whatever form it judges to be appropriate. This should include both regular reporting and specific reporting in non-routine situations.

Monitoring and surveillance - clear monitoring and surveillance powers are an integral part of the supervisory and market conduct functions. These include powers:

- to enter an NBFIs premises for the purpose of routine on-site inspection;
- to require the production of documents and the giving of information;
- to inspect and copy documents; and
- to test an institution's compliance with prudential regulations/standards including appointing, at the institution's expense, an appropriate expert to report on any aspect of the institution's business, or the business of a group of which it may be a part, for the purpose of establishing compliance with regulatory requirements.

These powers should be able to be exercised without having to demonstrate that there is any suspicion of wrongdoing; they are purely routine information gathering powers.

Directions – the power to direct any licenced NBFIs to do something specific (such as to remove an officer from a particular position or from the institution, to not pay a dividend, etc) or to cease doing something specific (such as promoting a product in a certain way, investing in certain assets, doing certain types of business, etc) for the purposes of ensuring compliance with a financial sector law or regulation/rule. Direction powers are ideally parameterized in the law, both to provide legal certainty and to reduce the possibility of their being misused. A typical parameterization (subject in certain cases to conditions precedent) would include the power to issue directions:

- to comply with the whole or a specified part of a financial services law, regulation or rule;
- to appoint an auditor to audit the records of a licensed NBFIs;
- to appoint an actuary to prepare a report on the affairs of a licensed insurer, agent or broker;
- to prevent a specified director or employee of a licensed NBFIs from taking part in the management or conduct of the business of the entity;
- to appoint a specified person or persons to a specified office of a licensed NBFIs;

- to remove an actuary or auditor of a licensed NBFi;
- not to incur further debt;
- not to pay a dividend;
- not to pay or transfer any amount to any person, or create an obligation (contingent or otherwise) to do so;
- not to undertake a financial obligation (contingent or otherwise) on behalf of another person or to transfer funds to another person;
- to take any other action that the regulator considers necessary or desirable in the interests of the licensed NBFi, its creditors, or the financial system.

Investigating breaches - where the regulator has reason to suspect a breach of a financial sector law it should have comprehensive powers to investigate the suspected breach.

Responding to breaches – effective responses to breaches of financial sector laws require a combination of the powers to:

- revoke licences;
- suspend the operations of a licenced institution;
- remove directors of a licenced institution;
- require a licenced institution to appoint new auditors and/or actuaries;
- levy administrative fines – the regulator should be able to penalise non-criminal breaches appropriately with administrative penalties. Ideally, the regulator should have the power and discretion to negotiate administrative penalties and remedial action without the need to rely on court proceedings. Where such remedies cannot be negotiated, prosecution should result.
- freeze assets of or under the control of a licenced institution where the regulator suspects that the interests of the customers of the institution may be at risk;
- require a licenced institution to publish corrective material;
- require a licenced institution to terminate or unwind specific transactions; and
- accept enforceable undertakings from licenced institutions and their officers who are in breach of financial sector laws or regulations/standards. These written undertakings can cover any aspect of an activity that is required to be licenced under a financial sector law. An enforceable undertaking should be published and, in the event of a breach of the undertaking, the regulator should be able to apply to the court for an order directing compliance with the undertaking.

Prosecuting breaches - In many countries the prosecution of criminal breaches of financial sector laws are shared between the regulatory agency and the Department of Public Prosecutions (or its equivalent – the Attorney General’s Department in Botswana). The case for the regulator to prosecute at least some breaches rests on both the support it adds to the agency’s credibility as

an effective regulator and to the particular expertise that it brings to the area. Prosecution can nevertheless be expensive and demanding on staff resources¹⁵.

Imposing statutory management – Where the regulator is concerned that a licenced prudentially-supervised institution (an insurance company or pension fund) may be insolvent, behaving imprudently in a manner that is putting clients' interests at risk, or is violating financial sector laws, it should have the power to appoint a statutory manager. The statutory manager should take directions from the regulator. A statutory manager should not be able to be appointed to a prudentially-regulated NBFIs without the regulator's consent.

Transfers of business – the power to approve mergers and acquisitions of licenced NBFIs.

Winding up a licenced institution – standing to apply to the Courts for the winding up of licenced NBFIs. No application to the Court to wind up a licenced prudentially-regulated NBFIs should be able to be made without the regulator's prior approval.

Authorising self-regulatory organisations - the power to authorise and make appropriate arrangements with industry self-regulatory organisations and other agencies with regulatory roles as the regulator sees fit.

Conglomerate supervision – the power to supervise a financial group including a licenced NBFIs on a consolidated as well as a stand-alone basis.

Information sharing powers - the power to share information with other regulatory agencies (some of which may not yet be established), including the central bank, other relevant domestic agencies, and overseas financial regulators, as well as the Police. In all cases, the nature and extent of the information sharing arrangements should be detailed in a Memorandum of Understanding between the agencies.

While the vast majority of these powers should apply to all major NBFIs groups, some will not. For example, the more intrusive powers of statutory management, and transfers of business are appropriate to insurers and pension funds but not to broker-dealers in securities markets, insurance brokers and agents, asset managers and investment advisers. Thus there is a need in the law to distinguish which powers apply to which groups of institutions.

Recommendation 3

BFIC should have the full range of policy and enforcement powers needed for modern and effective regulation and supervision.

4.2.2 Alternative Approaches to Legislating Regulatory Powers in Botswana

At present, some regulatory powers are contained in the existing industry Acts. For example, some surveillance and enforcement powers are contained in the Insurance Industry Act (1987) and the Pensions and Provident Funds Act (1987). Other institutions, such as microlenders and pension fund administrators operate without and industry-specific law (although, arguably, some of these, such as

¹⁵ In a small country such as Botswana it makes sense for most prosecutions to be referred to the Attorney General's Department. BFIC should nevertheless have standing to bring legal action against NBFIs and others who breach financial sector laws.

pension fund administrators should be brought under existing industry Acts). Achieving a harmonized set of regulatory powers can be approached in different ways:

- Industry specific Acts could be drafted to cover those sectors not currently covered by industry laws. In this case, regulatory powers would be included in each of the industry specific laws, as is the case at present.
- New Acts could be drafted that provide the regulator with powers that cut across industries – these might deal with common powers such as directions, making of standards, administrative penalties, and so on;
- Create a new omnibus Act (as has been done in the UK) that brings together the Act establishing the regulator with all subsidiary industry Acts into a single law, with comprehensive amendments to create the desired framework; and
- Draft the BFIC Act in a way that it creates and consolidates within that Act the necessary powers and regulatory requirements to supervise effectively and flexibly over time. This would leave the industry Acts essentially as administrative Acts.

The first of these approaches involves a significant volume of new legislation. It also involves constant monitoring and amendment of each of the industry Acts if the regulatory powers are to be kept in harmony over time. The second approach also involves the creation of multiple new Acts, both to cover the newly regulated industry groups as well as each of the areas of regulatory powers. The third is attractive in some respects in that it ensures a harmonized approach to all sectors. It does, however, involve very complex legislation and, based on the experience in the UK, may be difficult to pass through Parliament. Of these four approaches, the last is by far the most flexible and involves few new laws and the least on-going legislative change – thereby being generally more acceptable to both the Parliament and industry. It is an approach that is being implemented in a number of countries in the Southern African region.

Under the fourth approach, BFIC's regulatory powers would be consolidated under the BFIC Act. The existing powers under the Insurance Industry and Pensions and Provident Funds Acts would be removed by amendment. Previously unregulated NBFIs could be licensed and regulated through regulations issued under the BFIC Act, rather than through new primary laws. It would enable BFIC to issue standardized rules (eg dealing with governance) across the entire NBFi sector, by issuing them under the BFIC Act. The new BFIC Act should provide sufficient powers for BFIC's right to make and enforce regulatory policy to be beyond legal challenge, while retaining sufficient flexibility for BFIC to adapt to changes in international best practice in regulatory requirements without the need to return to the Parliament for legislative amendment other than in the most extreme circumstances.

Recommendation 4

The legislative drafting should be approached in such a way that all regulatory and supervisory powers, including licensing, monitoring and enforcement powers are consolidated under the BFIC Bill, with appropriate amendments to existing industry laws to bring them into consistency with the BFIC Bill by removing any conflicting or duplicative powers.

4.3 Independence

The Core Principles of each of the international regulatory groups¹⁶ emphasize the need for regulatory independence. A regulator's capacity to meet its legislated objectives is dependent first and foremost on the skills and experience of its staff which, in turn, is dependent on having a sound funding base that is independent in the sense that the resources available to the regulator are free from influence by individuals or groups within the industry or government. Only a financially independent regulator can form regulatory judgments and decisions without fear that its resources will be reduced in retaliation.

While financial independence is fundamental to regulatory independence, full operational independence encompasses other elements that are equally important, including legal protections and adequate powers to meet the regulator's statutory objectives.

Legal independence derives from legal provisions that both require the regulator to act independently and provide legal support for regulators who exercise that independence. A legally independent regulator can form regulatory judgements and decisions without fear of retribution from individuals or groups within the industry or government.

In practice, legal independence is determined by a wide range of factors including:

- the processes under which regulatory policies are formulated;
- the terms under which regulators are appointed and dismissed;
- legal protections from interference;
- legal indemnities for regulatory staff who carry out their regulatory duties in good faith; and
- the way in which potential conflicts between the regulator and the government are resolved.

The following is a summary of international best practice in these areas.

4.3.1 *Formulating and Implementing Regulatory Policy*

The statement that an independent regulator should be able to develop regulatory policy refers to the detail of policy, not to the broad policy framework – which is rightly the province of government. The detail, however, is an art rather than a science and can evolve quickly as markets, institutions and products evolve. A good regulator has constant contact with the industry and should have the expertise to assess developments within the industry and to adapt regulations accordingly and quickly – whether to facilitate a new innovation or to head off a potentially dangerous development. Operational independence requires that the agency is able to issue legally binding directives within the parameters set down in the law, without first having to seek the approval of other departments in the bureaucracy, the Minister, or the Parliament. It is good practice to ensure that such policies are nevertheless subject to adequate consultation (see section below on accountability), but the right to issue the policies should rest unambiguously with the agency that will be held accountable for their effectiveness.

¹⁶ Namely, the Basel Committee for banking regulation, IOSCO for securities regulation and the IAIS for insurance regulation.

Similarly, operational independence requires that the agency is able to exercise its powers under the law (including the power to issue and revoke licenses, to issue directions, and to take enforcement actions) without first having to seek the approval of other departments, the Minister, or the Parliament. Natural justice, of course, demands that these regulatory decisions should be subject to appeal to an appropriate body (such as an appeals tribunal or the courts), but the regulator must be able to act quickly and without interference to protect the interests of those for whom it has a statutory responsibility.

4.3.2 Mechanisms for Appointing and Dismissing Board Members

A major factor in the legal independence of a regulatory agency is the process by which board members (or commission members where the agency is established as a commission) are appointed and dismissed (for the role of the board see the section below on governance). The greater the protection afforded against capricious dismissal, the greater the likelihood that individual board members will act in accordance with the requirements of the legislation, free from coercive pressure from outsiders. At the same time, board members should not be so confident of their tenure that they regard themselves as unaccountable for their performance and for the performance of their agency. There is a balance to be struck; that balance is most likely to be achieved where the appointment of board members is seen to be open, accountable and fair.

Best practice is to include in the law a statutory list of qualifications to ensure that board members are appropriately qualified for the challenges of financial regulation and to minimize the appointment of “political friends” who lack the competence to lead a regulatory agency. Another protection against inappropriate appointments is to require board appointments by the President (or the Minister in countries where the agency is directly responsible to a Minister) to be ratified by the Parliament. Finally, to enhance independence, board appointments should be for a term longer than the electoral cycle.

The dismissal process should also be transparent to avoid unfair dismissal or dismissal for political or personal reasons. Board members are best protected from capricious dismissal by including a statutory list of conditions for dismissal in the law establishing the agency. The most common grounds for dismissal are bankruptcy, criminal conviction and mental incapacity. As with appointments, dismissals should be subject to ratification by the Parliament.

While many countries extend the appointment process to include senior executives, this creates a potential conflict for the head of the agency. Unless the head is able to appoint executives in whom he/she has confidence, it is difficult for the head to be held accountable for his/her performance. Where the appointment process does extend to executives, best practice is for the appointment to be on the recommendation of the head of the agency.

4.3.3 Legal protection from Interference

International best practice is for it to be an offense to improperly influence, or to attempt to improperly influence, the regulator. To the extent that existing anti-corruption laws do not create this offense, the agency law should contain such a provision.

4.3.4 Legal Indemnities for Staff and Officials of the Regulator

One design aspect that has diminished regulatory independence in a number of countries has been the absence of an adequate legal indemnity for staff members and officials who carry out their duties in good faith (in legal terms the protection is considerably stronger if the requirement is for the accuser to have to establish that the staff member acted in bad faith).

It is unavoidable that regulatory decisions affect the capacity of firms and individuals to earn income. Most regulatory decisions favour the rights of one group at the expense of others. It is implicit in the objectives of any regulatory agency that it will, from time to time, be required to uphold the rights of individual depositors, policyholders, or investors relative to those of financial institutions and licensed individuals. It is an inevitable consequence of this requirement that aggrieved parties may seek legal redress where they believe the decisions of the agency have unjustly deprived them of their rights.

For regulators to act in the national interest in carrying out their regulatory responsibilities it is fundamental that they have legal protection against damages generated by their actions, provided those actions are taken in good faith and in pursuit of the objectives set down in the legislation. Without such protection it is difficult for regulators to make decisions; it can also be difficult to recruit good quality staff, given the knowledge that they are taking on substantial personal risk through their work. Most countries have such legal protections in their legislation.

The potential for capricious legal action in some countries has also led to the extension of the indemnity to the agency itself, provided that its office bearers do not act in bad faith and act within the legal powers provided by the law.

4.3.5 Resolution of Potential Conflicts with the Government

While best practice is for the regulatory agency to have the power to formulate, implement and enforce regulations and regulatory policy, as noted above, it is impossible to rule out that circumstances may arise in which the national interest may dominate the legislated objectives of the agency. In such circumstances, the government should have the right to overrule the agency, subject to this being done in an open and transparent manner.

The ideal way to implement such a provision is for the law to specify that:

- Presidential directions (or Ministerial directions in countries where the agency is directly responsible to a Minister) may be made to the agency only where they are in the national interest or where there is a conflict with established government policy;
- These directions should be on broad policy matters and should not relate to individual institutions; and
- Any such directions should be tabled in the Parliament.

Recommendation 5

BFIC should be given appropriate operational independence from the Government of Botswana in formulating, implementing and enforcing regulation and supervision of NBFIs. The BFIC Bill should provide explicit guidance as to the appointment and dismissal of BFIC officials, legal protection against attempts to exercise improper influence over the agency, a legal indemnity for staff and officials who act in good faith, and a mechanism for dealing with potential conflict between BFIC and the Government of Botswana.

4.4 Governance

Governance refers to the systems and procedures adopted by an entity to manage its business and resolve conflicts among its various stakeholders. In essence governance is about the way in which an entity proposes to reconcile the conflicting interests of its various stakeholders and the structures it puts in place to ensure that these objectives are met; that is, it encompasses both policy and practice.

Among regulatory agencies established as parastatal bodies, some are established as corporations sole (where the head of the agency effectively “is” the agency) while others vest authority in boards of directors or commissioners more along corporate lines¹⁷. Boards play two main roles in regulatory authorities: they enhance independence and accountability.

Boards enhance independence by vesting responsibility for high-level decisions in a group of board members rather than in a single CEO or Departmental Head. The existence of the board should reduce the likelihood of inappropriate interference in regulatory policies and decisions. To the extent that the staff of the agency are accountable to the board, it also provides a measure of protection for staff against pressure that might otherwise be brought to bear on them as individuals. Additionally, the involvement of a group of experts in the high-level decision making process should provide a measure of reassurance for the government and other stakeholders that decisions will be made in a manner that is consistent with the legislated objectives of the agency.

Boards also provide an important accountability mechanism for the staff of the agency. Since decisions by the CEO and senior staff of the regulatory agency are typically taken with the express delegation of powers from the board, there is a need for them to be accountable to the board for those decisions.

As noted above, the governing body of a regulatory agency should be, to the greatest extent possible, independent from the government that sets the broad policy framework within which the board operates. Good governance more generally requires that the board should be as free as possible from any conflicts of interest that could impair its ability to meet its statutory objectives. Ideally:

- The board should include a majority of non-executives, including a non-executive Chair, drawn from the community to provide the necessary skills and experience for the direction of the agency.
- The board should be as free as possible from conflicts of interest. Industry experience is essential but, to avoid conflicts of interest, it is equally essential that board members do not include current market practitioners.
- While it is virtually unavoidable that the board will be appointed by the government of the day, it is best practice for either the board to appoint the CEO (as well as having the power to dismiss him/her), or for the President or Minister to appoint the CEO on the recommendation of the board.
- The roles and responsibilities of the board and the agency should be spelled out clearly and unambiguously in the law (and the powers of the agency should be sufficient for it to meet its responsibilities).
- Where cooperation and coordination is required between agencies, this should be provided for in the law and, where appropriate (i.e. subject to relevance and conflicts of interest), the heads of other regulatory agencies should be *ex officio* members of the agency board.

In addition to avoiding conflicts of interest in the structure of the governing body of the agency, good governance requires that the agency has a strong internal governance structure and internal controls.

¹⁷ While the terminology is not universal, the commissioner model usually refers to an executive board, whereas the director model is usually taken to refer to a board comprised of non-executives.

These are more matters for the board to establish than for the law, although the following may provide some guidance:

- The board should conduct its own review of its roles, responsibilities and objectives, should document these clearly, and review them periodically.
- The board should conduct a thorough assessment of those functions that it is able to perform directly and those that it will delegate to management. While a board cannot retain hands-on management of day-to-day operations it should retain the right to make decisions on a broad range of issues that are critical to the business of the agency (e.g. strategic direction, policy matters, decisions to delicense institutions, etc).
- The board should establish sub-committees as needed to assist it in meeting its obligations:
 - In a regulatory agency there should, at a minimum, be a sub-committee for risk management and audit.
 - Sub-committees should support the board but should not usurp the powers or responsibilities of the board.
 - Each sub-committee should have a clear charter that defines its roles and responsibilities.
 - Sub-committees should be established so as to avoid conflicts of interest (e.g. neither the Chair, CEO, nor senior management should be members of sub-committees, although they may be invited to attend from time to time; the audit sub-committees should have direct reporting lines that avoid conflicts, etc).
- The board should document all delegations to management along with a clear statement about how it expects its delegations to be exercised, how it will monitor that exercise, and how it will require management to account for its exercise of the delegations.
- Management should be required to carry out a parallel exercise of determining its delegations to staff, documenting the delegations, giving clear directions on how the delegations are to be exercised, and specifying how the delegations are to be monitored and accounted for.
- There should be a regular review by an independent party of the governance framework, including a test of whether or not the delegation process is operating at all levels within the agency (i.e. whether they are being executed, monitored and accounted for in the way intended by the board). The process of reviewing the governance framework should involve constant referral back to the roles and responsibilities defined in the Law and the underlying principles established in the agency's Vision and Mission Statements.
- The board should review from time to time its own performance and the extent to which it is meeting its obligations.
- The board should establish a Code of Conduct for staff and should review it at regular intervals.

It is important to recognize that governance is more than just a set of rules and structures. Not only must the board ensure that the agency has in place the necessary controls over its activities, of equal importance it must ensure that the controls are working. This requires a level of "buy-in" and

commitment by board members of regulatory agencies at least as great as that expected of public company boards.

Recommendation 6

BFIC should be governed by a board consisting of a non-executive chair, the CEO, other non-executive members and, ex officio, the Governor of the Bank of Botswana and the Permanent Secretary of the Ministry of Finance, or their nominees. The members of the board should be appointed by the Minister of Finance and Development Planning for their skills and expertise, and the CEO should be appointed by the Minister on the recommendation of the board.

4.5 Accountability

Strong independence should be balanced by equally strong accountability requirements. Accountability refers to the ways in which the entity reports its decisions and is held responsible for its actions. A pre-condition for a good accountability framework is that the law should specify clearly the objectives of the agency. Without such a statement it is unclear precisely against which standards the agency is to account. While objectives vary from agency to agency according to the range of responsibilities involved, a typical set of objectives for an agency with regulatory responsibility for the non-bank financial sector would include the promotion of:

- The stability of the financial system.
- The safety and soundness of financial institutions.
- The highest standards of conduct of business by financial institutions.
- The fairness, efficiency and orderliness of the financial sector.
- The protection of consumers of financial services and products.
- The reduction and deterrence of financial crime.

In establishing objectives it is important to recognize that there are certain trade-offs to be made in good regulation. In particular, it should be recognized that over-regulation can be as destructive as under-regulation. Some countries acknowledge this by requiring the regulator to take account of these trade-offs in pursuing its objectives. For example, the objectives may be qualified by a clause such as the following:

- In pursuing these objects the regulator must take into account:
 - the impact of the costs of regulation and supervision on the ability of the community to gain access to financial services; and
 - the need to balance the effectiveness of regulation and the efficiency of the financial system.

These latter clauses are appropriately included as qualifications. In contrast, they can create contradictory obligations when they are elevated to the same status as objectives such as safety, soundness and fairness of markets.

Accountability of a regulatory agency should extend to the government, the public, and the industry that it regulates. The governing principle of accountability should be that the greater the degree of independence of the agency, and the greater its powers, the greater should be its accountability.

The first line of accountability of any regulatory agency should be to the individual responsible for appointing and dismissing the leaders of the agency. In most countries this will be the President or Minister of Finance.

The primary mechanism for acquitting that accountability is through statutory reporting requirements. Full accountability requires the highest levels of transparency and disclosure. Ideally, a regulatory agency such as BFIC should be subject to the following accountability requirements:

- The agency should be required to report to the Minister annually and more frequently if either the Minister requires or the agency sees fit.
- Annual reports should outline the agency's policies and cover its operations as well as matters affecting the achievement of its statutory objectives.
- Annual reports should include the agency's audited accounts, prepared in accordance with international accounting and reporting standards. The audit responsibilities should include effectiveness audits of the agency's performance, operational efficiency, and its regulatory effectiveness.
- All routine reports from the agency to the Minister (annual and otherwise) should be required under law to be tabled in Parliament and/or published.
- In addition to its accountability to the Minister, the agency should appear regularly before the Parliament or an appropriate Parliamentary Committee to provide information and explanations concerning its policies and operations, subject to appropriate safeguards to avoid infringing the rights of persons under investigation, or prejudicing ongoing operations.
- With respect to the formulation of regulatory policy the law should require the agency to consult with the industry and the public before major policy changes; all proposed regulations and directives should be exposed to the public for comment for a minimum period before being passed into law.
- The agency should have a legislated responsibility to keep the Minister regularly apprised of any licensed financial institution which the agency has reason to believe is experiencing financial difficulty and is at risk of failing.

Regulatory agencies should also be accountable to the community at large. Much of this accountability is provided for in the annual reporting process and also through the consultation provisions mentioned above. Beyond these processes regulatory agencies should have a legislated responsibility to educate the public about the financial system in general (including the risks involved), the roles and responsibilities of the regulatory agency, and their rights and responsibilities as consumers of financial products. Regulatory agencies should be required to establish user-friendly complaints handling mechanisms for the public and should be seen to be responsive to the public's concerns.

Finally, regulatory agencies should be accountable to the industries that they regulate. Again, some of this accountability is provided for in the annual reporting process and consultation provisions mentioned earlier. Accountability to the industry should, however, go beyond these basic disclosure and consultation processes. There is a case for establishing industry advisory panels to ensure that the

agency has the benefit of industry expertise in its formulation of policy. As suggested earlier, regulatory staff should be protected against legal action for decisions taken in good faith in carrying out their duties under the law. Such an indemnity, however, should be balanced by adequate provisions to protect industry participants against capricious decisions by the agency. Also as noted earlier, natural justice requires both that the agency's decisions, and the basis of those decisions, be available to affected parties, and that there is an adequate process for appealing decisions.

A best practice accountability structure to industry should include some or all of the following:

- The law should provide for the establishment of specialist industry advisory panels – it is good practice for these panels to include representatives of consumers of financial services.
- The agency should conduct regular meetings (e.g. annually) with financial services sector participants to review progress towards achieving its statutory objectives and to allow participants to raise and discuss with the agency any matters of general concern.
- In addition to the exposure period for proposed new regulations, all policy statements and regulations should be available to the industry and the public at all times (e.g. through the agency's website).
- The law should require the agency to give reasons when it makes decisions adverse to the interests of particular financial institutions or individuals.
- With respect to the enforcement of regulations the law should generally give affected parties an opportunity to make representations before the decisions (for example, revocation of a licence) become effective.
- Regulatory decisions should be subject to review by an internal panel of agency staff not involved with the original decision. The law should spell out the circumstances and mechanisms under which such opportunities will be given.
- Affected parties should also have access to external review of agency decisions in an appeals tribunal and/or the courts.

Recommendation 7

The BFIC Bill should include extensive accountability requirements to the Minister, the industry and the public. These should include reporting requirements, the requirement to consult with government, industry and the public in formulating prudential rules, strong transparency provisions around regulatory decisions, and appropriate appeal mechanisms.

4.6 Funding Arrangements

A regulator's capacity to meet its legislated objectives is fundamentally dependent on the skills and experience of its staff which, in turn, are dependent on having a sound funding base that is independent in the sense that the resources available to the regulator are free from influence by individuals or groups within the industry or government. Only a financially independent regulator can form regulatory judgments and decisions without fear that its resources will be reduced in retaliation.

Internationally, there are three main models of funding financial regulation:

- Budgetary funding;

- Industry funding; and
- A mixture of industry and budgetary funding.

4.6.1 The International Trend in Regulatory Funding – Adequacy and Independence

Over the past decade or so there has been a marked trend towards industry funding of financial regulatory agencies. This trend has been particularly evident among the developed Western economies. It has reflected both the decision to increase regulatory funding and the trend towards regulatory consolidation (or integration), whereby the functions of two or more regulators are combined under the same roof.

For example, a survey carried out at the first meeting of the International Group of Integrated Regulators in Australia in 1999 found that all but one (namely Japan) of the nine foundation members were either partly or fully industry funded. Of these, all but one (Korea) were fully industry funded; the fully industry funded countries included the UK, Canada, Australia, Denmark, Sweden, Norway, and Singapore.

Other amalgamated regulators that have followed, including Germany, the Netherlands, Hungary, Estonia, Latvia, Namibia, South Africa and others, have all adopted either full or partial industry funding. For example, Hungary, Estonia and Latvia have all adopted a mixed State/industry funding approach.

At the latest count there are 45 countries in the world with regulatory agencies that have consolidated either banking and insurance, insurance and securities, or all three. The vast majority of these are industry funded.

The main logic behind the shift to a greater reliance on industry funding is that the beneficiaries of good regulation should pay for it. Since financial institutions are usually able to shift at least part of the cost of regulation on to their customers the cost is ultimately born by both consumers and the industry, both of whom are beneficiaries of regulation. In a sense the cost of regulation can be considered like an insurance premium for a safer, fairer and more stable financial system.

While there is an underlying logic in the shift to industry funding, the main reason behind the shift is more pragmatic than principle based and derives from the need to adequately fund regulation. The difference between the adequacy of regulatory funding under the two models could not be more pronounced. Regulatory agencies that are funded on-budget are almost universally under-resourced. The reasons for this are hardly surprising:

- There are always more demands on the government's resources than it can possibly meet. Since the potential costs of poor regulation are unlikely to show up for some years, there is a natural temptation to shift funds away from regulation to finance more immediate and politically expedient demands such as public housing, welfare, health, and education.
- It is also the case that agencies that are funded through the government's budget are unable to make reliable long-term plans - given that their funding has to be re-negotiated every year in competition with many worthy causes.
- Finally, the needs of financial regulators are largely counter-cyclical - it is the very time at which regulatory resources are most needed to deal with financial problems that the access to budgetary funds is likely to be at its most restrictive.

International experience suggests that, in most countries, full industry funding is the only reliable way to secure an adequate long-term funding base for regulation and to pay remuneration sufficient to recruit and retain the expertise needed for effective regulation.

4.6.2 Risks in Industry Funding of Regulation

While reliance on industry funding is clearly advantageous for both the government and the regulatory agency, it carries some risks.

First, while industry funding largely removes the regulator's dependence on Government, it potentially creates a dependence on the industry. Whenever the providers of the funds have the ability to withhold funds they have leverage to influence regulatory policy and its enforcement.

The obvious counter to this conflict is to structure the funding in such a way that the providers have no say in the size or timing of contributions. This is best achieved by adopting a simple and transparent formula that is neutral in its impact on industry participants and open for all to see.

Second, an agency that can set its own budget with absolute freedom has a temptation to over-budget and also to over-regulate. International best practice in terms of accountability and control involves the following checks and balances:

- The agency's budget should be circulated to industry before the start of the financial year for consultation and comment, and be subject to approval by the Minister.
- The budget, in turn, should determine the levy structure according to a neutral and transparent formula. While the proposed levy structure should be disclosed along with the budget in consultations with the industry, the focus of discussion should be on the budget, not on the levies *per se*.
- Funds raised from industry should be used exclusively for the agency's regulatory activities and related fixed costs.
- The agency should be allowed to build up a reserve over a period of say 5 years, after which any funding shortfalls should draw on the reserve in the short term, which should then be replenished in the subsequent year, while revenues raised in excess of budgeted needs should be returned to the industry in the subsequent year.
- The accounts of the agency should be prepared in accordance with International Accounting Standards, audited by an appropriate auditing body and published for all stakeholders to see.
- Any excess cash reserves accumulated as a result of the accrual basis of accounting or as a result of timing effects should be invested only in commercial bank deposits or Government securities.
- The agency's annual report should include not only the financial statements but also an account of the agency's activities and the extent to which it has met its statutory objectives. Audits should include periodic performance audits.
- The agency should appear annually before the Parliament or an appropriate Parliamentary Committee to account for its use of funds, its performance, and its plans for the period ahead.
- The agency should meet with industry at least once a year to discuss its use of industry funds, its approach to regulation and its plans for the period ahead.

4.6.3 *Methods of Raising Industry Funds*

While the trend towards reliance on industry funds is clear, the method of calculating the funds to be raised from individual institutions is much less so.

Regulatory funds are mostly raised from industry using some combination of:

- A base fee calculated on some measure of institution size;
- Licensing fees;
- Fees for specific services; and
- Fines and penalties for breaches of the law¹⁸.

The trend among developed financial systems is to put a greater emphasis on fees for services.

For example, the UK Financial Services Authority (FSA) charges:

- Annual fees that cover the bulk of the FSA's statutory functions;
- Application fees which are designed to recover most of the FSA's costs in processing applications such as licences; and
- Special project fees where the FSA carries out a specific activity for an institution and where the benefit accrues predominantly to the institution.

In many countries the levies charged to different industry groups are tailored to reflect the different demands on regulatory resources of the different groups. For example, in Australia, the regulatory charge levied by the Australian Prudential Regulation Authority (APRA) on pension funds is considerably lower than the charge on insurance companies, reflecting the greater time spent by regulatory staff in supervising the latter.

The UK FSA similarly allocates regulated institutions to "fee blocks" depending on the regulatory activities required to meet the legislated objectives for that group of institutions or activities.

Most industry-funded regulators set the base levy on some broad measure of institution size. Total assets under management is the most commonly-used measure of size, although some regulators have used flow measures such as premiums written for industries such as insurance. Total levies paid by any one licence holder are sometimes subject to absolute maxima or minima.

While much science appears to be used in allocating costs to industry groups, the reality is that the allocations are often driven largely by pragmatic considerations.

For example, in Australia, the levy rate on insurance companies and pension funds was, at least in the initial stages following APRA's creation, considerably lower than the equivalent rate for banks. The differential rates in practice were driven largely by the reality that banks had a long history of being taxed by the previous regulator (the central bank) whereas insurance companies and pensions funds

¹⁸ Retention of fines by regulatory agencies is not widespread as it can create a perverse incentive to over-penalise licensed institutions.

had no such experience and were initially much more resistant to the idea of paying for their regulation. Over time those differences have been reduced as APRA has pursued its objective of establishing a common levy rate.

4.6.4 Industry Capacity to Fund Regulation in Botswana

Ultimately, the size of industry levies should be determined by BFIC's budget. The agency's proposed budget and proposed levy structure should be open to industry consultation and should be approved by the Minister after the consultation process. Since the industry has an incentive to minimize the cost to itself, it should have a voice in the process but, consistent with international best practice, it should not have a right of veto.

The critical issue is the size of the levies and the impact that they could have on the industry. For a new agency such as BFIC it is critical that the law provides for industry funding without limiting flexibility as to how the funding may be charged or how it may evolve over time to changes in the industry.

Some principles for industry funding:

- Funding for ongoing operations should be provided completely from industry;
- Funding for the establishment of the agency may be provided by Government, either as a grant or as a loan to be repaid by industry over a period of years; and
- Levies should be imposed in a manner that is as neutral as possible in its impact on industry, so that the cost can, to the greatest extent possible, be passed on to consumers of financial services (the ultimate beneficiaries of regulation).

These principles suggest that, at least for the foreseeable future in Botswana, levies should be charged on a measure of assets under management for institutional financiers (insurance companies and pension funds), supplemented in the case of non-institutional financiers by licence fees (securities dealers, pension fund administrators, asset managers, microlenders, securities exchanges, insurance agents and brokers, specialized finance companies, and investment advisors). The relevant asset bases for the institutional financiers are:

- Insurance companies – P6.1 billion; and
- Pension funds – P14.5 billion.

Using the longer-term full operating budget proposed in Section 5.6 of around P19 million, the financing could be raised, for example, by a levy rate of .001 (.10 percent) on insurance company assets, and .00085 on pension fund assets (.085 percent), supplemented by relatively low licensing fees on all other NBFIs. The cost should be considerably lower during the years taken by BFIC to reach full strength.

The actual budget for the Commission, the pre-determined State budget allocation, and the levy rates are all matters for consultation and negotiation. These calculations, however, suggest that the impact on industry of a financing structure such as that illustrated should be relatively minor.

Recommendation 8

BFIC should be funded primarily by levies and licence fees paid by industry. BFIC's budget should be subject to industry consultation and determination by the Minister for Finance and Development Planning. The BFIC Bill should provide appropriate flexibility for the way in which industry funding may need to evolve as the industry grows.

5. Capacity Needs of BFIC

5.1 Introduction

Section 4 addressed the external design considerations for BFIC. This section addresses internal design considerations such as staff numbers, organizational structure, skill needs, remuneration, and an approximate budget.

5.2 Staffing Levels for BFIC

The Ministry currently employs 15 staff members who are employed full time in financial regulation and supervision. In addition, two senior members of the Ministry are allocated part time to the area. This group covers insurance companies, pension funds, the Botswana Stock Exchange, and insurance companies operating in the IFSC. While the Ministry has formal regulatory authority over the Botswana Savings Bank, the Botswana Development Bank and the Botswana Building Society, supervision of these deposit-taking institutions has been delegated to the Bank of Botswana due to lack of capacity at the Ministry. Similarly, the Botswana Stock Exchange plays an extensive but informal self-regulatory role. Outside the Ministry, the Department of Trade and Consumer Affairs allocates several people part time to handling complaints about microlenders arising from breaches of the Consumer Protection Law (1998)¹⁹. These staff members have responsibilities that extend to other areas of consumer protection.

The existing capacity is too small and too disperse to provide an effective foundation for regulating and supervising NBFIs. Even within the Ministry, the focus is largely on licensing and de-licensing, with little time or capacity for on-going off-site and on-site supervision.

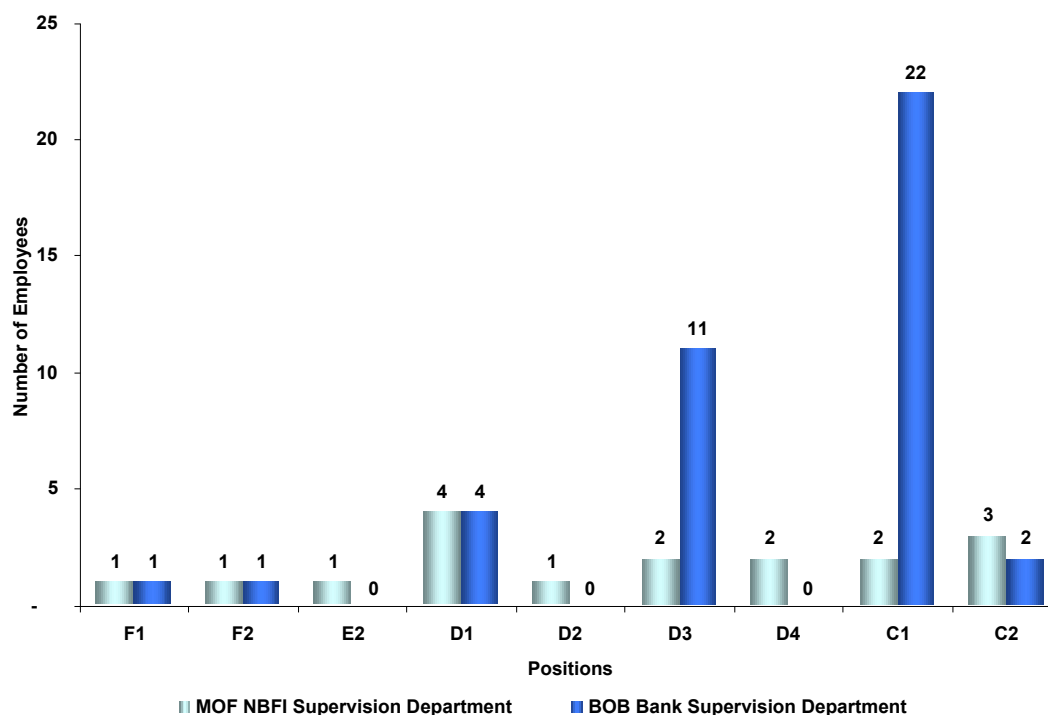
There is no universally accepted formula for evaluating staffing needs for regulatory agencies around the world. For example, regulators in developed financial systems such as Canada, the United States, and the United Kingdom typically allocate between 2 and 5 full-time staff member equivalent units to each institution (higher numbers are allocated where the institution involves a conglomerate group – for example, in the US, between 20 and 25 staff members would normally be allocated to a large banking conglomerate)²⁰. In comparison, the Bank of Botswana has a professional staff complement of 41, of which, about 27 are allocated to bank supervision (including commercial banks, the Botswana Building Society and the Botswana Savings Bank), which implies an allocation of around 4 staff members per institution, spread across off-site and on-site supervision.

¹⁹ The Ministry of Agriculture, through the Commissioner for Co-operatives (currently housed in the Ministry of Trade and Industry), has a staff of 228 to attend to the registration and general development of all co-operatives (including SACCOs). In allocating staff to these tasks, the Commissioner makes no distinction between types of co-operatives and carries out no prudential regulation or supervision as such and, for the purposes of assessing the financial regulatory capacity of the existing structure these staff can effectively be discounted.

²⁰ These figures are averages across different types of institutions including banks as well as non-banks and conglomerate groups.

Chart 7 provides a comparison of Ministry staff resources allocated to financial regulation compared with the regulatory staff at the Bank of Botswana.

Chart 7: Staff Resources in Financial Regulation in the MOF and BOB



The staff numbers in Chart 7 are not directly comparable given that, internationally, the numbers allocated to insurance supervision are usually lower than those allocated to banks, notwithstanding that the supervisory needs are often as demanding. A typical insurance regulator, for example, allocates around 1 staff member to each large insurer and between .5 and .2 staff members to each small and medium sized insurer.

Pension funds require less supervisory attention than insurers and regulators usually allocate between 5 and 50 funds to each staff member, depending on the size and complexity of the funds. In the case of the Public Officers Pension Fund at least one-half a full-time staff member should be allocated to supervision. In the case of public offer funds (such as umbrella funds) the allocation should be around 2 funds per staff member.

In the Botswana context pension fund administrators should be allocated on the basis of roughly 4 funds per staff member, as should securities dealers and merchant banks. Insurance brokers and agents can be allocated much more thinly at around 25 to 50 per staff member. Finally, the allocation of front-line supervisors to microfinanciers such as microlenders could be spread as thinly as one staff member for every 500 or so funds.

The allocation of staff suggested by these rough rules of thumb should not be considered rigid. One of the advantages of having a larger organisation with a broad range of responsibilities is the flexibility that it offers in terms of redeploying resources where they are most needed at any point in time.

In addition to the front-line supervisors, BFIC will require staff for common activities such as enforcement, complaints handling, policy and research, corporate services (such as human resources, finance and information technology), secretarial and other support and senior management.

Table 3 provides an estimate of overall staffing needs based on the allocations suggested above²¹.

Table 3: Projected Staff Needs for Effective NBFi Regulation and Supervision in Botswana

Financial Institution Group	No. Institutions	Institutions per staff member	Staff needs
Life Insurance Companies	5	5	1.00
General Insurance Companies	8	5	1.60
Life & General Brokers	25	25	1.00
Life Insurance Agents	86	50	1.72
General Insurance Agents	32	50	0.64
Private Pensions (excluding POPF)	138	50	2.76
(Public Officers' Pension Fund)	1	1	1.00
Umbrella funds	4	2	2.00
Pension Fund Administrators	4	4	1.00
Pensions Fund Advisors	2	25	0.08
Medical Aid Funds	6	6	1.00
Stock Exchange	1	0.50	2.00
Stock Brokers	3	3	1.00
Asset Managers and Collective Investments	10	5	2.00
Other Financiers	2	20	0.10
Micro lenders	1000	500	2.00
Disclosure and Market Conduct			2.00
Licensing			4.00
Enforcement & Complaints			4.00
Policy & Research			4.00
Corporate Services			6.00
Internal Audit			2.00
Support staff			8.00
CEO			1.00
Total			52

5.3 Internal Structure

Internationally, there are almost as many internal structures for integrated regulatory agencies such as BFIC as there are agencies. Notwithstanding the many subtle differences in structure, most fall into one or the other of two main types:

- Those that attempt to extract synergies from the consolidation of regulatory functions; and
- Those that keep the industry regulators largely separate, sharing only common infrastructure such as computer resources and administration.

Those countries that have taken the former route have generally been countries in which conglomerates are common and in which there is a high level of financial sophistication. Thus, for example in Australia, APRA - which is responsible for regulating banks, insurance companies and pension funds - has an internal structure based primarily on whether or not institutions pose a

²¹ It should be noted that Table 3 and Figure 8 revise and update the preliminary estimates of staff numbers an internal structure presented in the Interim Report.

systemic threat. Regulatory departments are divided into those dealing with complex, systemically-important institutions and those dealing with smaller, stand-alone institutions; in neither case are there dividing lines based on industry affiliation. The philosophy behind this integration of staff is that it better reflects the integrated structure of the industry and offers greater synergies among the supervisors (where the approach to supervision can be targeted on types of risk rather than on types of institution). While the benefits of a fully-integrated approach to financial regulation/supervision may be tempting, they have yet to be proved. Further, attempting this level of integration, involves some risks. Staff in fully-integrated agencies have found it difficult to acquire the level of cross-skilling required and, in some cases, the regulator can move ahead of the industry in terms of its perception of business integration.

At this stage of the development of the Botswana financial system there is a strong case to proceed conservatively and to start with a much more conventional, industry-based structure:

- There are currently very few conglomerates in the Botswana financial system (although many of the industry participants have conglomerate connections through foreign parent entities);
- The focus in the early years for staff will need to be predominantly on building basic regulatory skills - this is likely to occur more quickly in groups specialising in particular industries than in a structure focused on cross-industry skilling;
- Regulation will be new to some parts of the non-bank financial system and they must be given time to “acclimatise” to the new regime – attempting to push the industry beyond the basics of industry-based supervision could reduce industry support for the reforms.

Therefore, a relatively simple, industry-based structure is likely to be most appropriate for BFIC and is likely to involve the lowest risk. This structure could include at least two separate supervisory groups, one covering insurance and pensions, and the other capital markets and investment managers. Each of these groups would develop its own framework for supervision including, where appropriate, on-site and off-site monitoring.

While such a structure would limit the higher-level regulatory synergies from integration in the short-term, there would still be considerable scope to extract both lower-level regulatory and financial synergies. Some of these could be extracted by creating shared groups to handle activities such as:

- Licensing;
- Policy and research;
- Enforcement and complaints handling; and
- Corporate services.

A suggested internal structure for BFIC, showing the recommended internal divisions and their responsibilities is shown in Chart 8 below. The assumptions underlying the estimates of staff numbers are based on the calculations in Table 3.

Chart 8 – Suggested Internal Organizational Structure for BFIC



Chart 8 also gives an approximate break-down of staff numbers in each department²².

Under the proposed structure, BFIC would have two front-line supervision departments plus two departments providing services common to all financial institutions. A brief outline of the roles and responsibilities of the suggested departments is as follows.

5.3.1 The Pensions and Insurance, and Capital Markets Departments

These are the two front-line supervision departments with responsibility for the supervision of financial institutions. Each department should conduct relationship management of each supervised entity as well as off-site surveillance and analysis. Each department should also be responsible for on-site examination programs to ensure sound risk management and operating practices by institutions as well as compliance with regulations and standards. Within the Pensions and Insurance Department there may be some advantage – especially in the short term while capacity is being built up - for on-site supervision of both insurance and pensions to be conducted by the same group, with inspections supplemented by inclusion of staff from the off-site institutional groups.

²² Note that all support staff, including secretarial staff, are allocated for the purposes of Chat 8 to the Corporate Services Department.

The nature of capital markets surveillance is sufficiently different to that in the other two areas that the internal structure of the department is likely to be quite different. The Capital Markets Department could be sub-divided into institutional groups covering respectively, the Botswana Stock Exchange plus securities dealers, collective investment schemes plus asset managers, microlenders and other groups including specialist financiers plus investment advisers, and a fourth section dealing with market conduct and disclosure. Again there could be merit in having a separate on-site team that could be supplemented on visits by staff from the institutional groups.

In terms of disclosure, the Department should oversee and regulate the fund raising activities of corporations, including securities dealers, insurance companies and pension fund managers. The Department's staff should routinely review the disclosure documents filed by companies including: registration statements for newly-offered securities; annual and quarterly filings; reports to shareholders; and filings related to mergers and acquisitions.

The Capital Markets Department should oversee corporate disclosure of important information to the investing public from all regulated institutions, as well as the conduct of all financial institutions and market participants. While this would create some overlap between the two Departments in terms of institutions supervised it would help ensure a consistent framework for disclosure and conduct across all non-bank financial institutions. The policy framework for disclosure and conduct should be developed by the Policy, Licensing and Enforcement Department and should be consistent across sectors.

5.3.2 Policy, Licensing and Enforcement Department (PLE)

The primary responsibility of the Policy Section within the PLE Department should be for the development of regulations and supervisory practices across the full range of licensed entities. This section should be responsible for monitoring domestic and international developments in regulatory and academic thinking in the area. The section should have the prime responsibility for co-ordination and co-operation with international and regional agencies and groups including IAIS, IOSCO, the World Bank, IMF and regulators in the various SADC countries and sub-groups.

To broaden the specialized skills in this section and to provide staff with a practical orientation, staff should be required to spend at least part of their time in on-site examinations, either in specialist visits (for example, a targeted visit to an insurance company to examine internal control systems) or as members of a more general supervision team.

The Policy Section should also be also responsible for BFIC's objective of promoting a confident and informed consumer and investing public. BFIC has an important task in educating the industry and the public about the financial system, the role played by the regulator, and the limitations of regulation and supervision. It also needs to ensure that public expectations are consistent with BFIC's objectives and its capacity to deliver against those objectives. This activity must be well resourced and targeted appropriately at different stakeholder groups.

While the Licensing Section should be responsible for managing the process of licensing and re-licensing all financial institutions and financial market participants, in more complex cases (e.g. those involving insurance companies or umbrella pension funds) the decision-making process should rest with a team drawn from senior staff in the appropriate departments having responsibility for reviewing applications and conducting further investigations and interviews necessary to make a determination to grant the licence.

The Legal and Enforcement Section should extend and enhance the enforcement role in the capital markets currently carried out by the Ministry. This section should be responsible for investigating possible violations of financial sector laws, recommending action when appropriate, and negotiating

settlements on behalf of BFIC. The Legal and Enforcement Section should work closely with criminal law enforcement agencies in Botswana and internationally to develop and bring criminal cases to court when the misconduct warrants more severe action.

The Legal and Enforcement Section should also be responsible for the management and work out of any distressed financial institutions, such as insurance companies, pension funds, securities exchanges, clearing and settlement companies, custodians and asset managers. Supervision of distressed institutions is specialized and resource intensive. Therefore, where remedial action includes statutory management, administration, removal of boards or management or liquidation, responsibility for the distressed institution should be transferred from the front line supervision departments to Policy, Licensing and Enforcement Department, until the institution is either wound up or returned to sound financial operations through work out, merger or recapitalization. Where detailed knowledge of a particular institution is considered to be particularly important, staff from the front line Supervision Departments could be transferred temporarily to Enforcement and Complaints section to assist with remedial action.

The Enforcement and Complaints section should also handle routine consumer complaints. The complaints handling unit should provide the filtering needed on complaints. This unit should handle routine complaints (e.g. where the UFSA is able to act as a “referee” between the consumer and the financial institution) or where the problem can be resolved by ensuring that the consumer is made aware of his/her rights under financial sector laws. Where complaints involve issues of conduct or concern about an institution’s prudential health they should be referred to the relevant front-line supervision divisions for action. To ensure that the front-line supervisors are aware of all complaints as part of their information support system, all complaints should be logged into a complaints database and cross referenced to the supervisory database. A monthly summary of all complaints should be circulated to the supervisory departments.

In its consumer protection role, the Legal and Enforcement Section should serve the interests of individual investors, policyholders and pension fund members. The section should oversee industry Codes of Conduct and approve industry-based dispute resolution schemes. It should deal with self-regulatory organizations. Finally, the Legal and Enforcement Section should be responsible for drafting new laws, regulations and prudential standards in conjunction with the Policy Section.

5.3.3 Corporate Services Department

The Corporate Services Department should be responsible for human resources, finance, information technology, communications and administration.

Corporate Services should implement and evaluate BFIC’s programs for human resource and personnel management, such as position management and pay administration; recruitment; secondments; staffing; payroll; performance management and awards; employee training and career development; employee relations; personnel management evaluation; employee benefits and counselling; the processing and maintenance of employee records; and ethics and financial disclosure.

Corporate Services should also be responsible for finance and administration for the agency, including assisting the CEO with budget preparation and financial monitoring; collection of levies; accounts payable; collection and remittance of fines and fees; and preparation of annual financial reports and statutory disclosure requirements.

Corporate Services should be responsible for communications with industry and for coordinating high-level communications with government and media, under the direction of the CEO.

Corporate Services should develop and execute programs for office services, such as IT services; telecommunications; procurement and contracting; property management; contract and lease administration; space acquisition and management; management of official vehicles; general affairs, travel services, safety programs; emergency preparedness programs; physical security; mail receipt and distribution; and publications, printing and desktop publishing.

Internal Audit

For governance purposes Internal Audit should report directly to the Board (usually to the Risk Management and Audit sub-Committee of the board). However, for “pay and rations” Internal Audit would be nominally located in the Corporate Service Department. Internal Audit should conduct internal audits and investigations of BFIC programs and operations. Through these audits and investigations, Internal Audit should seek to identify and mitigate operational risks, enhance governance and integrity and improve the efficiency and effectiveness of BFIC programs.

5.3.4 Transition to the Target Structure

The staff numbers and internal structure outlined in Table 3 and Figure 8 should be regarded as targets to be achieved over a period of time. Depending on the availability of suitably qualified staff both from within and outside Botswana filling a staff structure such as that outlined in Figure 8 could take several years. We estimate the period needed to achieve the staffing levels to fill such a structure could be 5 years or more. In the interim, the internal structure should evolve in line with the availability of staff resources.

Recommendation 9

BFIC should adopt a target internal structure that strikes a balance between the desire to extract synergies from an integrated approach to regulation and the need to manage change at a pace that can be absorbed by both regulatory staff and the industry. The transition to this structure should evolve over a period of up to 5 years.

5.4 Skill Needs for BFIC

Chart 9 shows the highest qualification levels of existing regulatory staff within the Ministry. The overall qualification level is high, with all professional staff having at least a bachelor’s degree and more than half having either a Masters degree or MBA. The fields of undergraduate expertise are evenly divided between economics and statistics, science and accounting, with one staff member holding a qualification in actuarial science. The graduate level fields of expertise are similarly divided between economics, finance, administration and accounting.

Chart 9 – Qualifications of the Regulatory Staff in MOF

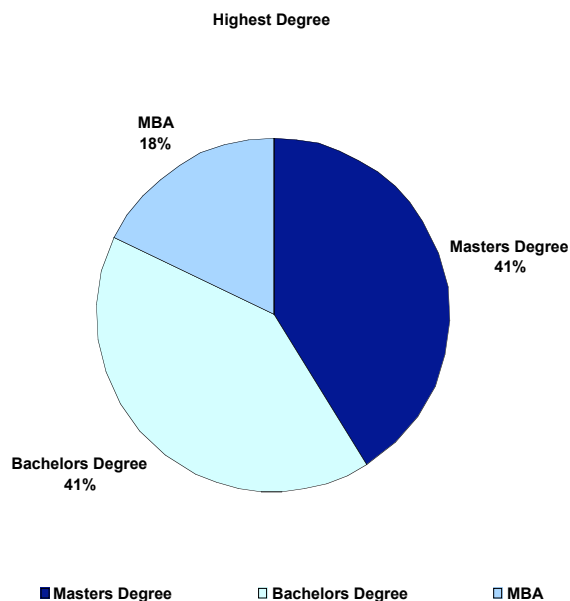
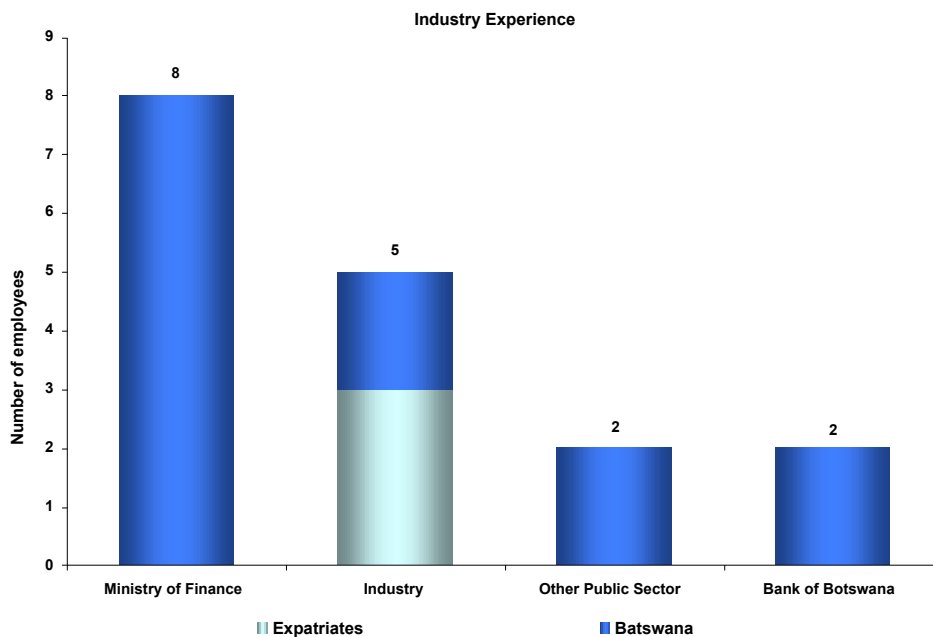


Chart 10 shows that the majority of regulatory staff in the Ministry have either worked their whole careers in the Ministry or elsewhere in the Botswana public service or Bank of Botswana. Only five staff members (including three expatriates) have had experience in industry prior to joining the regulatory staff.

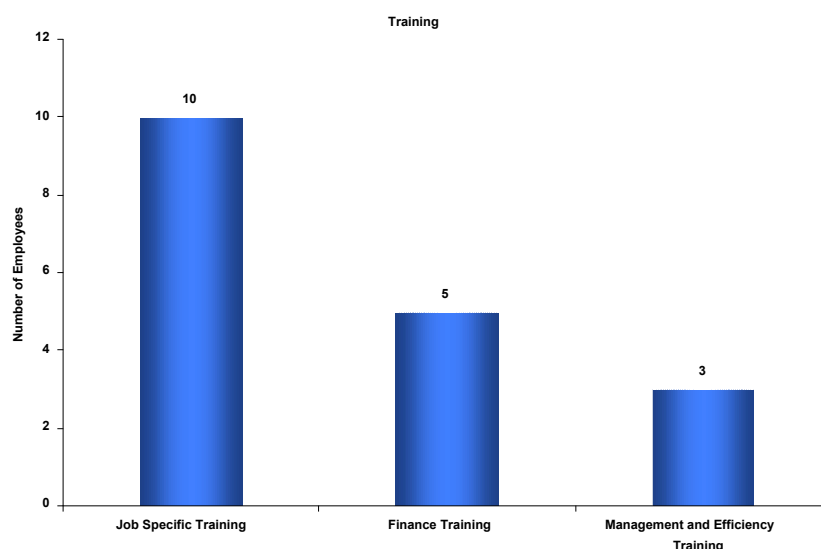
Chart 10 – Experience of Regulatory Staff in the MOF



The skill demands of a regulatory agency such as BFIC extend to the fields of finance, accounting, law, actuarial analysis, market analysis, and general administration, and extend beyond the existing capacity of the regulatory staff in the Ministry.

In part, the necessary skills for regulation and supervision can be built up through training programs. The training experience of MOF staff is summarised in Chart 11. As can be seen from Chart 11, two-thirds of the MOF regulatory staff have been provided with some regulation-specific training. Another five have been provided with specific training in finance.

Chart 11 – Training Experience of Regulatory Staff in the MOF



The recommended structure illustrated in Table 3 and Chart 8 will require a significant upgrade in the skills currently available in the MOF. The recommended Enforcement and Complaints Handling Section will require specialist legal skills to support both enforcement actions and legal drafting for the Policy and Research Section. At least two experienced lawyers and possibly a junior qualified lawyer would normally be needed to meet the enforcement demands of an agency such as BFIC. There will be a need to develop expertise within this group for dealing with financial crime in general and, more specifically, in the areas of anti-money laundering and anti-terrorist financing. While good lawyers are usually flexible in moving across different areas of law, it would be helpful if the individuals recruited had qualifications in commercial law, financial crime, and/or regulation.

The recommended Policy Section will require specialist skills in the finance industry. The skills needed to develop regulatory policy include an understanding of regulation and supervision, specialist skills in finance, and an understanding of the workings of each of the industries being supervised. The academic qualifications for this division should cover primarily finance (preferably at the Masters level or higher) and, to a lesser extent, law. Experience with the industry would also be very helpful, not only in terms of understanding how the industry works, but also from the perspective of consulting with the industry over proposed prudential and market conduct requirements.

The supervisory demands of the front-line supervision divisions will require expertise primarily in finance and accounting. While it is not uncommon for regulatory agencies to be staffed predominantly by ex-public servants, the public service is not generally an ideal background for developing the skills needed by good supervisors. There will be a need to upgrade the overall skill base of existing supervisory staff through a combination of training and recruitment of new staff with industry backgrounds.

Particular areas of expertise to be developed within the regulator include:

- corporate governance;
- operational risk;
- insurance provisioning;
- international core principles and practices; and
- market conduct.

Not only will the additional demands of the broader regulatory role envisaged for BFIC require recruitment of additional skills, it will require a concerted training program to extend the capabilities of both existing staff and additional recruits. BFIC will need a dedicated and focused training program to meet these needs.

5.5 Training Needs and Options

Good regulators and supervisors are not created overnight. In many cases, it is only after being exposed to fraud, misrepresentation and failure that a regulator can truly consider himself/herself experienced. It is essential, in our view, that as much as possible of the regulatory expertise currently residing in the Ministry be transferred to BFIC on its establishment. Not only will this ensure continuity of supervisory approach, it will ensure that the experience that has been built up in the Ministry is not lost. These staff will need to be supplemented by a judicious recruiting and training program.

Notwithstanding the recommendation to increase the staff complement at BFIC relative to staff numbers currently in the Ministry, overall staff numbers will remain well below the level needed to justify an ongoing in-house training program other than a general induction program designed to introduce new staff to the culture and supervisory approach of the agency. This leaves three main avenues for training: external training programs; technical assistance from experienced regulators; and secondments of BFIC staff to other regulatory agencies;

5.5.1 External Training Programs

Internationally there is still a dearth of adequate training programs available for regulatory staff. The Bank for International Settlements has developed an electronic self-teach program for banking regulators. The IAIS, in conjunction with the World Bank, has been developing a more conventional program for insurance regulators. IOSCO has similarly developed some training programs for securities regulators. While these programs are helpful, they fall short of offering a coherent and comprehensive training program for start-up operations such as BFIC. These programs are also relatively generic and not always appropriate to the African situation. While the South African Financial Services Board provides occasional training programs for its staff, to which other countries in the region have been welcome to participate, these have been largely once-off courses on specific topics.

It has been our observation that the need for a more comprehensive, locally-based training structure is common to most countries in the SADC region. Importantly, such a structure should offer different points of entry to cater for staff with different levels of training and experience. The need for such a structure is becoming sufficiently compelling that the FIRST Initiative is exploring ways in which such a structure, drawing on regional training providers, might be put in place. It is critical that such a

structure be self-sustaining and able to continue training new staff, even after experienced staff have left the regulatory agency.

Subject areas that need to be addressed in such a structure include at least the following (not all topics would be relevant to every regulator):

- Basic financial analysis
- Principles of regulation and supervision
- Financial institutions, markets and instruments
- Risk management methodologies
- Financial statement analysis
- Statistical analysis
- Governance
- Provisioning
- Understanding regulatory law
- Surveillance techniques
- Market conduct
- Risk rating of financial institutions and risk-based supervision
- On-site supervision methodologies
- Consolidated supervision of financial conglomerates
- Collective investments
- Understanding the core principles of international associations of supervisors
- Introduction to actuarial concepts and techniques

These subject areas need to be explored from the most basic level (for new staff) through to the advanced level (for experienced regulators) through a combination of lectures, workshops, hands-on case studies and assignments. Importantly, there is a need to provide a process of follow-through to ensure that regulators have guidance in applying the techniques they learn in their day-to-day activities as regulators. It is also important that the techniques learned are applicable in the local context. The ideal training structure for the region would draw on the training modules prepared by the international associations of supervisors, but would tailor them for the region and extend them to make them more applicable.

Creating such a training structure is a large task. It is unlikely to be available in the near term. There is nevertheless a reasonable prospect that such a program may start to emerge by the time BFIC is ready to start training its new staff.

Short of the creation of a comprehensive structure such as this, the most obvious alternative sources of training are: in-house programs offered by other regulatory agencies (such as the FSB); programs offered by international agencies; and programs offered by training groups such as the Toronto Centre and the Financial Stability Institute at the Bank for International Settlements. The latter courses are relatively expensive and are typically targeted at experienced regulators. They nevertheless have a useful role to play in developing staff skills and exposure to experienced regulators in other countries.

5.5.2 Technical Assistance from Experienced Regulators

The second source of training and experience comes from having technical assistance in the form of experienced regulators who would spend time in BFIC.

Technical assistance from overseas regulators can be a useful source of expertise during the establishment stages but cannot replace expertise within the agency on a long-term basis. The main areas in which overseas consultants may be of assistance are in the development of the approaches to regulation and supervision and in the drafting of regulations and prudential standards. Experience shows that regulatory and supervisory processes can be designed by overseas consultants. However, there must be a significant involvement of local staff if these are to be effective over time. Processes that are designed without sufficient “ownership” by the local regulatory agency are prone to break down once the consultants leave for home.

This can nevertheless be a particularly useful way of transferring regulatory experience and expertise to BFIC staff. The advantage of having an experienced regulator within the agency for a reasonable period of time is maximised if the visitor takes an active role in the supervisory process and assists in the development of supervisory practices. Visits by experienced regulators could vary from a month to six months, depending on the availability of suitable individuals and their willingness to spend time on site.

The case for using short-term technical assistance in this way is strengthened by the need to establish and document supervisory policies and practices. The optimal approach to achieving the desired objective would be to have an experienced regulator or two from outside Botswana working in conjunction with BFIC staff to develop the practices and to assist with the documentation. As noted above, it is essential that BFIC staff are committed to and involved with the process, even if it is driven by a consultant.

The key areas in which technical assistance is likely to be most helpful over the next few years are:

- insurance regulation/supervision;
- market surveillance;
- market conduct; and
- development of regulatory approaches and policies and documentation of policies and procedures.

5.5.3 Secondments to Other Regulatory Agencies

Notwithstanding the value and importance of classroom-type training, the best experience is usually gained in the field, and efforts should be made to second some of the more promising staff to other regulators to spend between 3 and 6 months developing their expertise. While shorter visits are also used by some regulators it is difficult for the host regulatory agency to gain much benefit from the

seconded in a short visit. Visits of between 3 and 6 months enable the host agency to place the seconded into a line position with responsibilities and therefore tend to be more mutually beneficial.

Secondments can be relatively expensive in that they usually involve transport, accommodation and living expenses for a relatively long period. They also tend to “capitalize” a significant amount of expertise into a single individual. It is also the case that the demand for secondments of this nature has been growing rapidly in recent years, thereby putting a strain on host agencies. Consequently, they need to be used strategically. Ideally they should be used for a small number of the agency’s most promising staff. There should also be a requirement for the seconded to document the lessons and experiences of the secondment and to devote time after returning to transferring the benefits of the experience to other staff members (e.g. through a seminar or series of seminars to staff). Given the time involved, the loss of key staff members for the period of the secondment, and the using up of goodwill with host agencies, secondments should be limited to one or two each year.

There are several agencies that would be useful to target in this respect. The most obvious agency is the South African FSB. It is likely that secondments could be set up with the FSB without the need for outside assistance. Other target agencies should include the FSA in the UK, OSFI in Canada (for insurance and pensions), the various Scandinavian agencies and both APRA and ASIC in Australia. Assistance may be needed in establishing the necessary contacts with these agencies when a program for secondments has been set up. In addition to the FIRST Initiative, assistance could be pursued for both contacts and financial support from DFID (in relation to the FSA in the UK), CEDA (in relation to OSFI in Canada), AusAID (in relation to APRA and ASIC in Australia) and the various Scandinavian aid agencies (in relation to the Danish, Swedish and Norwegian agencies).

Recommendation 10

BFIC should allocate a significant amount of its resources over the first 5 or so years to training new and existing staff in regulatory philosophy and practice, through a combination of systematic training through regional providers, once-off training programs offered by the FSB in South Africa, international organizations, and the Toronto Centre, secondments of outstanding staff to other regulatory agencies, and both short and long term resident regulatory advisors. Where needed, BFIC should seek donor support.

5.6 Remuneration

As noted earlier, the most critical ingredient in providing effective regulation is the quality, skills, and experience of the regulatory staff. This, in turn, requires that the regulatory agency is able to pay competitive salaries in the market for those skills and to be able to retain experienced staff by offering a sufficiently attractive overall remuneration package.

It is generally accepted that regulators are unlikely ever to be able to compete with industry for the top paid financial experts, but there are many talented individuals in the next bracket who would willingly work in a regulatory agency provided the remuneration is adequate.

It is not possible, without a more in-depth analysis of human resource markets in Botswana to assess exactly how high BFIC salaries should be. Some international comparisons may nevertheless be helpful as a guide to the experience of other similar agencies:

- In Colombia, results of a recent salary review of the finance industry suggested that the median monthly salary for a middle manager in the private finance sector was between 1.2 and 1.6 times that of salaries for equivalent positions in the non-bank regulator. That put

regulatory salaries in the lower 25th percentile of salaries in the financial sector overall. The Colombians were finding it difficult to retain skilled regulatory staff and were reviewing the need to increase regulatory salaries to closer to the 75th percentile of financial sector salaries.

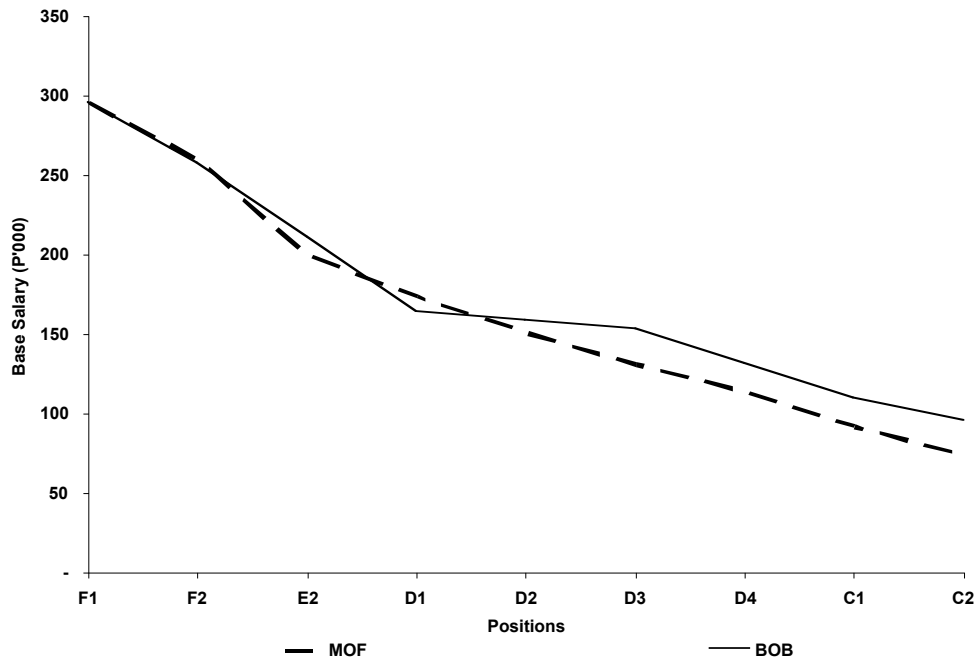
- At OSFI in Canada, the compensation strategy developed in 1998 targeted the average of the financial sector market, roughly equivalent to the 50th percentile, for total compensation excluding stock options. Implementing this strategy, which gave rise to a material increase in OSFI's payroll at the time, proved helpful in reducing the turnover which OSFI had been experiencing. However, senior managers in OSFI's Toronto-based supervision divisions still found that they could not recruit working level examiners with sufficient industry experience to make the judgments required by OSFI's supervisory framework. Also, as OSFI sought to build its specialist groups, it found that the general financial market compensation data was irrelevant. Many of the specialists received non-standard compensation packages and targeted survey data were needed. As a result of these experiences and an updated financial sector compensation survey including specialist data, OSFI's compensation strategy was revised in 2001 to target the 75th percentile of the financial sector market for total compensation, taking into account the actuarial value of long-term incentive compensation including stock-options. In addition, a second compensation band was established for specialists.
- APRA's experience in Australia's was similar. The compensation strategy implemented in 1998 targeted the bottom 25th percentile of market remuneration. This proved totally inadequate in attracting the specialist skills needed for effective supervision. In 2003 the target was raised to the 50th percentile, with loadings for specialist positions. The structure is again under review with the possibility of raising the target percentile further.

These experiences reflect a general trend for regulatory agencies to benchmark their remuneration scales against the private financial sector and to align their structures somewhere around the median of the market or a little higher, where possible.

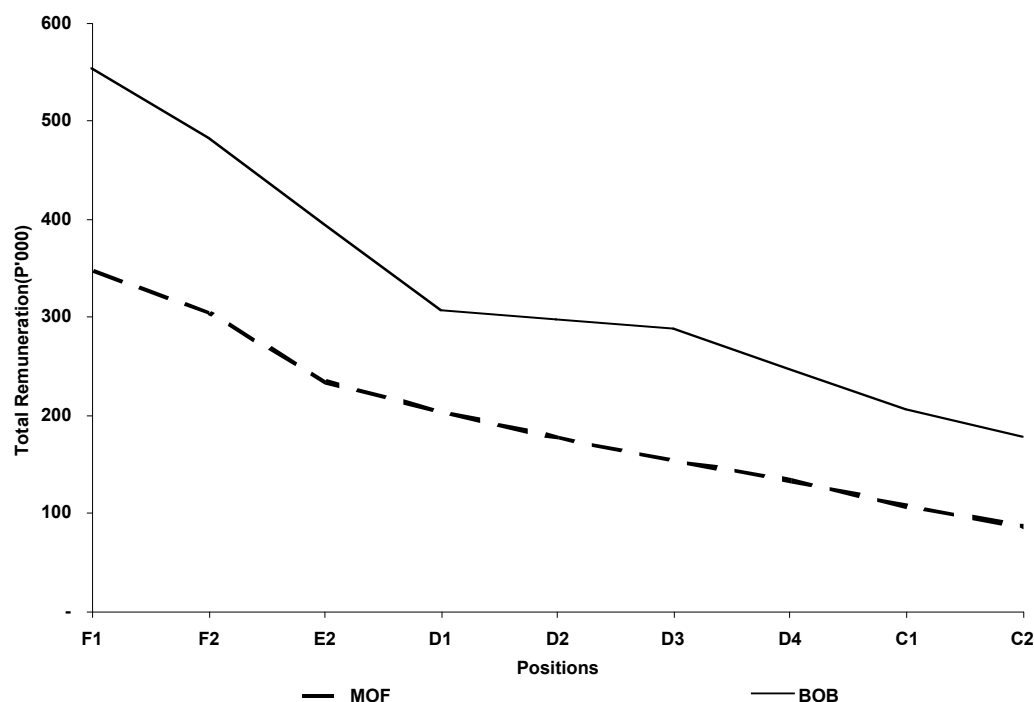
The other relevant benchmark for remuneration is the Bank of Botswana. In Botswana, as in most countries, the central bank has a degree of independence (though not total independence) in setting remuneration levels for its staff. Chart 12 below shows public sector base salaries as paid to existing financial regulators in the Ministry against equivalent seniority levels in the Bank of Botswana. The figures for the Bank of Botswana are the middle of the range of base salaries paid at each level. As shown by the chart, the base salary levels at the Ministry and the Bank are roughly comparable²³.

²³ If the upper limit of the Bank salary ranges were used, rather than the mid point, the salaries paid by the Bank at the junior levels would increase by up to 50% above those at the MOF.

Chart 12 – Base Salary: Financial Regulators in the MOF and BOB



The comparison in Chart 12, however, fails to take into account the differential in staff benefits between the two agencies. Benefits in the Ministry are limited to a contribution to the officer’s pension scheme (17.5% of salary for full-time staff and 30% for contract workers in lieu of pension) and a modest entertainment allowance for senior staff, whereas the Bank of Botswana pays a pension contribution, a transportation allowance, a housing allowance, a utility allowance, an entertainment allowance, the combination of which increases the base salary significantly. Chart 13 below shows the same comparison between the Ministry and the Bank of Botswana based on total remuneration.

Chart 13 – Total Remuneration: Financial Regulators in the MOF and BOB

As shown in Chart 13 the Bank of Botswana total remuneration levels for financial regulators exceed their Ministry equivalents by almost 100% at the most junior levels and by around 50% at the most senior levels.

Surveys of private sector remuneration in Botswana are carried out by Tsa Badiri Consultants. At the time of the project we were not privy to the survey data as such although, from discussions with Tsa Badiri, we learned that Bank of Botswana remuneration, and that of the better remunerated Botswana parastatals, are generally competitive with the median level of remuneration packages in the private financial sector. Discussions with the Bank of Botswana confirmed that staff turnover is relatively low and that their recruiting capacity is strong, which suggests that Bank remuneration is broadly competitive with the market.

The main message from these comparisons is that, if BFIC is to recruit and retain the skills and expertise that it will need to provide effective regulation of the NBF sector in Botswana, it is likely to need to pay competitive salaries with both the Bank of Botswana and the private finance sector. Further, it is likely to require flexibility in the remuneration structure to enable BFIC to pay salary premiums where needed to acquire specialist skills.

Recommendation 11

BFIC should employ staff on total remuneration terms comparable with those of the Bank of Botswana and should retain sufficient flexibility in its remuneration structure to enable it to pay a premium, if needed, for specialist skills.

5.7 Approximate Budget for BFIC

The approximate budget presented in this section is indicative only and is presented for the purpose of providing some guidance as to the likely overall cost of BFIC and thereby to give an indication of the cost that may need to be born by industry or the Botswana taxpayers. A firmer budget should be drawn up as the details of the agency are finalized, after the BFIC legislation has been passed by the Parliament. It should be emphasised that the operating budget in Table 5 is for a full year based on the full staffing complement outlined in Table 3 and Figure 8. It is unlikely that BFIC will reach this full staffing complement for a number of years. Thus, actual budgets will need to drawn up to take account of the transition to the structure and budget in this Report.

In broad terms, the salary scale used for costing purposes is based on the Bank of Botswana scale as shown in Table 4 below. It is difficult on the basis of such short experience in Botswana for us to assess whether or not a suitable local candidate can be found for the role of CEO. In many similar situations it has been necessary to search outside the country to find someone with the regulatory and institution building experience needed to establish an agency of the size and complexity of BFIC. In the rough budget below we have assumed that a local can be recruited to this position. If that is not the case the budget would be increased by the cost of recruiting such a person from a regulatory agency overseas²⁴.

Table 4: Approximate Staff Salaries by Broad Seniority Band²⁵

	No.	Ave. Salary p.a.	
		P'000	Total Cost p.a. P'000
CEO	1	540	540
Division Heads	4	350	1,400
Chief Inspectors	15	300	4,500
Senior Analysts	6	220	1,320
Analysts	18	170	3,060
Support Staff	8	40	320
Totals	51		11,140

5.7.1 Assumptions Underlying BFIC's Approximate Operating Budget

- The full staffing complement of BFIC should be in the order of 43 professionals and 8 support staff (see Table 3 above).
- Premises are leased rather than purchased outright.
- Computer hardware and software are purchased outright (see below).
- Total remuneration is broadly in line with Bank of Botswana remuneration.

²⁴ The salary necessary to attract someone of the experience and calibre required is difficult to determine with any accuracy. In some recent cases, agencies have paid salaries in the order of \$US300,000 to \$US500,000 to attract very senior regulators.

²⁵ Since these figures were put together the Pula has depreciated by a little over 10%. To the extent that currency movements feed through into general wages and salaries these estimates may need to be increased accordingly.

- On-costs include health benefits and long service leave (on an accrual basis), but exclude pensions since they are already implicitly captured in the package value used for staff remuneration.
- Training costs are higher than might otherwise be the case in the establishment years in order to accelerate capacity building.

Staff on-costs, including health insurance and long service leave accruals are assumed to cost approximately 5% of direct salary costs. Other staff costs, including travel, recruiting etc. are assumed to cost 8% of direct salary costs. Training in an agency such as BFIC would normally run at around 10% of direct salary costs once the agency has reached maturity. During the establishment stage, however, given the need to accelerate the development of regulatory and supervisory skills, these are assumed to run at around 20% of salary costs for the first few years at least.

In general, it is simpler and more efficient to maintain premises on a leased basis rather than to purchase a building outright. Leasing not only avoids the uneven impact of major capital expenditure on the budget, and thereby on industry levies, it provides greater flexibility in asset management.

The cost of leasing office space in Gaborone in the order of P55 per square metre per month. The leasing cost estimate in the budget is based on the following assumptions about space needs:

- Senior Executives 10 sq M;
- Professional and management staff an average of 7 sq M; and
- Support staff 5 sq M.

This gives a total space requirement of around 360 square metres and an overall office rental of P237,600 per annum. This estimate of space would be on the low side if extensive use is made of closed offices, as appears to be the norm in Botswana. The trend in regulatory agencies around the world, however, is to use open plan offices, which are both more cost effective and considerably better for productivity. Following the international trend could reduce the office rental figure by up to 10 percent.

At the time this budget was put together no information was available about office fit-out costs in Botswana. Based on figures from other countries, roughly \$US1,600 per head of staff, or \$250 per square metre, is normal for an agency such as an NBFBI regulator. These estimates suggest an estimated total fit-out cost of between P400,000 and P450,000 for BFIC if international costs are the appropriate benchmark (which they probably are, given that many of the items in the fit-out would need to be imported). Assuming straight-line depreciation over 5 years, this provides a contribution to operating costs of P86,000 per annum.

One of the largest and most variable cost elements in establishing a regulatory agency such as BFIC is that of creating a suitable information technology architecture. Data systems range greatly in cost and effectiveness. At a minimum, BFIC would need basic computers, networking and internet services. The effectiveness of financial supervision is, however, greatly enhanced by support from a solid suite of database and analytic tools. These can be expensive and time consuming to develop. The return can nevertheless be significant. The following sub-section outlines an information technology architecture based on a system somewhere between the most basic and the most sophisticated. A decision will be needed in coming months as to how far BFIC should go down this track in its early years. It may make sense to install a more basic system initially to ensure that data are captured for future analysis, and to leave the development of sophisticated analytic tools for a later stage as staff

skills and experience are developed. The cost of a mid-range system is nevertheless included here for reference purposes.

In principle the same argument made above with respect to leasing premises also applies capital equipment such as IT hardware and software. However, in emerging market economies the leasing market can be quite thin, especially for specialized equipment as is often needed for financial regulation. Thus, the following budget is based on the assumption that IT hardware and software are purchased outright. The cost of set-up forms a part of the establishment budget, while depreciation on the hardware and software are a part of the operating budget.

A very rough estimate of the likely set-up cost for a mid-range system of IT hardware and software in the order of P6 million (see Table 6 in the next sub-section). The figure in the operating budget reflects depreciation on that total cost over a 3-year period of P2 million per annum plus depreciation on the office fit-out of P86,000. The cost of leasing, if it is available, is unlikely to be significantly different from the estimate for depreciation. As already noted, this estimate could be reduced significantly by starting BFIC with a very basic IT system (PCs, printers, a mail server and a small number of peripherals) and adding more sophisticated hardware and software as the agency develops its expertise.

Table 5: Approximate Operating Budget – Full Year (Pula) – Accrual Basis

Expenses	Full Year
Employment costs	11,140,000
On costs (excl. pensions)	557,000
Other staff costs	891,200
Training	2,288,000
Printing and Publishing	150,000
Maintenance of Regulatory Software	350,000
Rental of Premises	237,600
Depreciation of IT and premises fit-out	2,086,000
Consultancies and Other Costs	2,000,000
Total Expenditure/Funds Required (rounded)	19,640,800

5.7.2 Establishment Costs

Establishment costs are those costs that are incurred during the start-up period of the new agency. These cost include recruiting costs, the cost of establishing fixed equipment and systems (which may be phased in over the period as staff are recruited), and the cost of finding and fitting-out suitable premises. These costs are additional to normal operating costs include the cost of assistance with establishing regulations and supervisory practices and are usually budgeted separately from operating costs. Including the fixed capital costs involved it is normal for the establishment costs to be in the order of one full year's operating costs. The start-up period is likely to take 6 to 12 months.

As a very rough benchmark, the staffing and recruiting costs during the start-up period typically run to about 50% of the expected full-year costs. Other costs are adjusted in similar fashion.

The cost of hardware and software for the mid-range IT system are summarised in the table below. This estimate does not include the cost of developing any specialised supervisory software in-house. It is assumed that BFIC will be able to obtain some appropriate software from another country. For example, some countries in the region are using and modifying a supervisory software program developed by the South African Reserve Bank for banking supervision. As noted above, the total IT

budget for even a mid-range system is still very high and could be reduced significantly in the short-term by starting BFIC with a more basic IT architecture.

Table 6: Estimated IT Set-up Budget (Pula)

Item	No.	Cost (Pula)	Total
Enterprise File Servers	1	265,500	265,500
Enterprise Mail Servers	1	175,600	175,600
Enterprise Storage	1	290,000	290,000
Enterprise Backup	1	135,000	135,000
Print Server, DNS Server, Mail Sweep Server, WWW Server, Middleware Servers	2	25,500	51,000
HRIS, FMIS Servers	1	43,500	43,500
Database Servers	1	175,600	175,600
Racks for Servers	1	101,750	101,750
Server Room Switches	1	215,000	215,000
Floor Switches	2	30,500	61,000
Firewall	1	55,000	55,000
Standard Desktop	8	4,350	34,800
PA Desktop	44	5,250	231,000
Laserprinters	2	11,200	22,400
Copier/Printer/Fax	3	70,000	210,000
Electronic Whiteboards	1	8,500	8,500
Data Projectors	3	9,995	29,985
Conference Phones	3	2,495	7,485
Laptops	10	9,600	96,000
Microsoft Select - Office, operating systems etc.	50	6,000	306,000
HRIS	1	850,000	850,000
E-mail Gateway	1	95,000	95,000
Network Monitoring and Database Monitoring Tools	1	600,000	600,000
PABX	1	1,350,000	1,350,000
Handsets	50	1,550	77,500
Handphones	10	650	6,500
Contingency			500,000
Total			5,990,000

Based on these estimates a rough establishment budget for BFIC is likely to be in the order of P16 million, as shown in Table 7 below.

Table 7: Estimated Establishment Budget (Pula) – Cash Flow Basis

Expenses	Full Year
Employment costs	5,570,000
On costs (pension etc)	278,500
Other staff costs	445,600
Training	1,114,000
Printing and Publishing	75,000
Maintenance of Regulatory Software	175,000
Rental of Premises	118,800
Consultancies and Other Costs	2,000,000
Office fit-out	433,000
IT Set-up Cost	5,990,000
Total Expenditure/Funds Required	16,199,900

6. Proposed Action Plan for Establishing BFIC

6.1 Introduction

This Report has recommended establishing a single integrated non-bank regulator for Botswana (called for convenience the BFIC). The Report has also recommended a target staffing level for BFIC, an appropriate internal structure, a likely budget, and an industry-based funding mechanism. When fully operational, in combination with the Bank of Botswana, BFIC should provide a sound prudential and conduct framework for regulating and supervising the entire Botswana financial system. Reaching this level of effectiveness will, however, take many years. Good regulations and good regulators are not created overnight. In particular, good regulators require experience that can only be built up over time and through exposure to actual situations. This section offers a realistic action plan for implementation and development of the skills and resources needed for effective non-bank regulation and supervision.

6.2 Elements in the Implementation Process

The implementation of effective non-bank regulation and supervision in Botswana will involve the following distinct elements or projects:

Legal Stages

6.2.1 Legal Stage 1 - Finalisation of the Design Elements of BFIC, fine-tuning the draft BFIC Bill and Associated Amendments to Existing Laws, and passage of the Legislative Package

Project Description

- The Attachment to this Report contains a draft BFIC Bill and amendments to the existing industry laws to bring them into alignment with the BFIC Bill. The draft is based on the design features recommended in the Report as they relate to legislated provisions. This includes the roles and powers of BFIC, as well as its independence, governance arrangements, accountability provisions, and funding arrangements. While these design features have been discussed with the key stakeholders within the Botswana bureaucracy and also with industry, they have yet to be endorsed by the Government. Any changes in the underlying design features will require fine-tuning of the draft BFIC Bill. A Steering Committee has been formed between senior members of the Ministry and Bank of Botswana to take these matters forward.
- It is our understanding that, once presented to the Botswana Parliament, this package of laws should be passed and proclaimed relatively quickly, such that the establishment of BFIC could be possible in the early months of 2006. This may require establishment funding from consolidated revenue – either as a grant or as a loan to be repaid from industry levies over a specified period of years.
- When passed and proclaimed, the BFIC Bill and associated amendments will provide the basis for establishing BFIC as an independent non-bank regulatory agency. BFIC will be

able to start operating under essentially the same regulatory environment as exists at present. All licensing and relicencing of existing NBFIs, for example, will be able to continue under regulations included in the package of laws. While this may not greatly change the existing regulatory landscape, it will create the foundations for more significant changes as BFIC moves forward. For example, BFIC will be able to issue new regulations under the BFIC Act to set prudential rules, to licence institutions not currently licensed, and to address shortcomings in the existing regulatory framework. These advances are part of the subsequent stages outlined below.

Need for Technical Assistance

- The work involved is unlikely to require more than a few days of input from external technical experts. Input should be largely in the area of fine tuning the draft BFIC Bill contained in this Report and possibly commenting on amendments to the Bill made by Ministry lawyers. The remaining budget from the current project should be adequate for this purpose.

Completion of Stage 1 of the Legal Stage will mark the end of the current project.

6.2.2 Legal Stage 2 - Review of and Draft Amendments to Strengthen Existing Industry Laws

Project Description

- As outlined in Section 3, the existing laws covering NBFIs in Botswana have a number of shortcomings. As a consequence, the existing regulatory framework falls well short of international best practice for middle income countries.
- This project will involve amending the existing laws to address the shortcomings identified and drafting new laws in three areas: a usury law, a law to create a financial sector ombudsman to handle disputes between the industry and its customers, and a law to create a financial sector tribunal to deal with disputes between the regulated industry and BFIC.
- Amending these laws and preparing the new laws will require preparation of initial policy papers to identify the policy issues involved, (this could be done off-site) consultation with the industry and officials to resolve policy options, drafting of the laws and amendments (again, much of this could be done offsite), presentation and discussion of the draft Bills, and fine-tuning of the agreed drafts to meet with local requirements and customs.

Need for Technical Assistance

- This project will require considerable technical assistance from both a policy perspective and in terms of legal drafting. Experts will need to engage with industry extensively during the design and drafting of the amendments.
- In view of the number of laws involved and the nature of the amendments the estimated time required from technical assistants is likely to be in the order of 3-4 months of a legal expert's time and around 1 month of a policy expert's time.

6.2.3 Legal Stage 3 – Rebuild Regulations and Prudential Rules to Establish a Modern Regulatory Environment

Project Description

- There will be two main exercises in this stage. First, existing regulations under the industry laws will need to be updated to take account of international developments in regulatory practice. Under the structure of the BFIC Bill, these regulations will need to be separated into those elements that of a legalistic or administrative nature (eg, licencing requirements, operational requirements of pension funds etc) and those that are of a prudential nature (eg, solvency requirements for insurers, governance standards, etc). The former will be reviewed where appropriate and reissued as regulations. The latter will be restructured as prudential rules to be issued by BFIC under the BFIC Act.
- The second exercise involves writing new regulations and prudential rules (where appropriate) for those institutions not previously regulated and for those activities and practices not previously subject to regulation or prudential guidance.
- Consistent with the provisions of the BFIC Bill, these regulations and prudential rules will require development, drafting and consultation with industry. Based on experience from other countries, development of a suitable prudential framework through rules is a time-consuming process and can take several years.
- Two of the highest priorities in this stage should be the drafting of rules and regulations for institutions not previously regulated and also the drafting of rules and revised regulations for the International Insurance Act (2005). The former should be a priority in order to establish the supervisory framework for these institutions, while the latter is driven by the desire of the IFSC to establish its credibility in international eyes in order to develop as an offshore centre.

Need for Technical Assistance

- This project will require considerable technical assistance from both a policy perspective and in terms of drafting. Experts will need to engage with industry extensively during the design and drafting of the rules and regulations.
- In view of the number of laws involved and the nature of the amendments the estimated time required from technical assistants is likely to be in the order of 5-6 months of a legal expert's time and 5-6 months of a policy expert. The work is likely to be spread over two or more years and should be developed progressively.

Institutional Establishment Stages

6.2.4 Establishment Stage 1 – Start-up

Project Description

- As implied by the discussion of the establishment budget in Section 5, the establishment of a new agency involves a substantial logistical exercise. After the Act is proclaimed, the Minister will need to appoint a suitable Chair and suitable non-executive Board members. This is one of the most critical steps in the establishment of BFIC and will need to be considered very carefully. The Chair, in addition to being a person of integrity, and good

judgement, must have the energy and commitment to creating BFIC as a first class regulatory agency.

- The Board, once appointed, will need to begin a search for a suitable CEO. Ideally, such a search should be an international search. If an international regulator is appointed, it should be on the understanding that he/she would groom a local to take over at a later date.
- The initial establishment stage also involves locating and leasing suitable premises, fitting the new premises out with furniture, phones, and IT equipment, and creating the basic IT infrastructure needed to operate. It is common during this stage for an agency such as BFIC to continue operating out of the Ministry for a period of up to 6-12 months while the necessary appointments and logistical arrangements are put in place.
- This stage usually involves establishing formal delegations, Board procedures, staff employment conditions, the Code of Conduct, human resources policies, finance policies, and basic operating procedures for the agency.
- This stage is also likely to involve some minimal recruiting of new staff, although recruiting is more a feature of the operational stage that follows.
- This stage is likely to last anything up to 12 months from the date of proclaiming the Act.

Need for Technical Assistance

- Technical assistance required during this stage is likely to be minimal.

6.2.5 Establishment Stage 2 – Operations and Development

Project Description

- Once the Board and key staff have been appointed and the distractions of initial establishment have been attended to, the BFIC will commence its operational stage. This stage will initially involve a continuation of the current operating methodology of the Ministry, though it should quickly evolve beyond that to take advantage of the broader, roles, responsibilities and powers granted to it under the BFIC Act.
- This stage will involve establishing new policies and procedures consistent with the development of new regulations and prudential rules under the third legal stage.
- This stage will require continued recruitment and training of new and existing staff in the methodologies and practices that evolve.

Need for Technical Assistance

- Technical assistance during this stage is likely to be extensive and on-going. Assistance will be needed to establish new policies and procedures, as well as appropriate techniques for on-site inspection and data analysis.
- Ideally, assistance will be provided through a resident advisor, supplemented by short-term visits by area experts.

- The extent of assistance is difficult to estimate at this stage and will be dependent partly on the availability of suitable experts willing to spend sufficient time with BFIC. It will nevertheless be extensive.

6.3 Action Plan

The stages outlined above are described as relatively distinct projects. In practice there will be scope for some of these stages to overlap. A detailed action plan for the legal and implementation stages is outlined in Table 8 below. Table 9 indicates how the stages could be overlapped.

Table 8: Action Plan for Creating the BFIC

Activity	Time required to complete task	Starting date from start of 3rd Quarter 2005	TA Support Required
Legal Stage 1			
Finalize design details for BFIC	2-3 weeks	0	N
BFIC Bill to be reviewed by Attorney General's Department	1-2 month	1 month	N
Legal Stage 2			
Prepare policy paper on issued to be resolved in updating industry laws and creating new laws	3 weeks	1 month	Y
Consult with officials and industry to agree policy issues	2 weeks	2 months	Y
Draft new laws and amendments to industry laws	7 weeks	3 months	Y
Expose drafts and consult with stakeholders	2 weeks	5 months	Y
Refinement and finalization of Bills	2 weeks	6 months	Y
Legal Stage 3			
Draft, expose and consult on Insurance rules and regulations	2 months	3-4 months	Y
Draft, expose and consult on rules and regulations for previously unregulated institutions	3 months	6-9 months	Y
Draft, expose and consult on Pension Fund rules and regulations	2 months	9-12 months	Y
Draft, expose and consult on Securities rules and regulations	2 months	12-18 months	Y
Draft, expose and consult on Collective Investment Undertakings rules and regulations	2 months	18-24 months	Y
Establishment Stage 1			
BFIC Act to be proclaimed	1 day	6-9 months	N
Minister to appoint Board	1 month	7-10 months	N
Board to find suitable CEO	2-6 months	9-15 months	N
Board to set delegations	1-2 month	7-12 months	N
Board and/or senior management to set employment conditions and HR policies	1-2 months	8-12 months	N
CEO and/or senior management to find suitable premises for BFIC	1-3 months	7-12 months	N
Premises to be fitted out	3-4 months	9-12 months	N
Initial IT systems to be installed	3-9 months	10-16 months	N
Staff to be transferred to new agency	1 month	6-9 months	N
Recruitment of new staff	6-12 months	9-18 months	N
Establishment Stage 2			
Ongoing recruiting, training, development of policies and procedures, etc	48-60 months	18-24 months	Y

Table 9: Action Plan for Creating the BFIC

Projects	Quarters from Q3 2005																			
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Legal Projects																				
1. Stage 1 – Finalize BFIC Law	■																			
2. Stage 2 – Rebuild Industry Laws		■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
3. Stage 3 – Rules and Regulations			■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
Implementation Projects																				
1. Establishing the BFIC				■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■	■
2. Upgrading Policies & Practices									■	■	■	■	■	■	■	■	■	■	■	■

6.3.1 Approximate Budgetary Implications of the Action Plan

The following estimates are approximate only and relate only to the likely cost of technical assistance for the legal and implementation stages. The final cost will depend on the quality of assistance provided and on the actual time taken. Subject to those caveats, we offer the following as guidance.

Legal Stage 2

Legal Expert – draft new laws to cover:

- Industry Ombudsman
- Disputes Tribunal
- Usury

Plus draft amendments to existing industry laws, including:

- Insurance Act
- International Insurance Act
- Pensions and Provident Funds Act
- Stock Exchange Act
- Collective Investments Undertakings Act

Approximate time involved:

- | | |
|---|---------|
| • Off-site preparation of issues | 16 days |
| • On-site consultation on the basis of the new laws | 20 days |
| • Off-site drafting | 34 days |
| • Off-site refinement of drafts | 10 days |

Policy Expert – policy framework for the new laws. Approximate time involved:

- | | |
|---|---------|
| • Off-site preparation of issues | 5 days |
| • On-site consultation on the basis of the new laws | 15 days |

Total Budget, including travel, accommodation and per diem for two on-site visits \$US260,000

Legal Stage 3

Legal Expert – draft new regulations to cover:

- Microlenders
- Pension Fund Administrators

- Custodians
- Asset managers

Draft revised regulations to cover:

- Insurance Act
- International Insurance Act
- Pensions and Provident Funds Act
- Stock Exchange Act
- Collective Investments Undertakings Act

Approximate times involved:

- | | |
|---|---------|
| • Off-site preparation of issues | 15 days |
| • On-site consultation on the new regulations | 30 days |
| • Off-site drafting | 30 days |
| • Off-site refinement of drafts | 15 days |

Policy Expert – policy framework for the new laws and regulations. Approximate time involved:

- | | |
|---|---------|
| • Off-site preparation of issues | 20 days |
| • On-site consultation on the new regulations | 30 days |
| • Preparation of policy papers and reports | 20 days |

Total Budget, including travel, accommodation and per diem for three on-site visits \$US440,000

Establishment Stage 1

Nil

Establishment Stage 2

Resident Expert – assist with development of policies and procedures and methodologies:

Approximate times involved (over a period of say 3 years):

- | | |
|----------------------|----------|
| • On-site assistance | 300 days |
| • Off-site advice | 30 days |

Visiting Area Experts – assist with issues related to specific areas (such as insurance, pensions etc):

Approximate times involved (over a period of say 3 years):

- | | |
|----------------------|----------|
| • On-site assistance | 200 days |
| • Off-site advice | 60 days |

Total Budget, including travel, accommodation and per diem \$US500,000 to \$US750,000

6.3.2 Possible Sources of Funding for Implementation

Whereas at the start of this project it was anticipated that the FIRST Initiative would be a source of some on-going funding towards the implementation of the BFIC, circumstances have changed such that, in the future, FIRST will be able to provide only limited support for middle income countries such as Botswana. The sooner the law is finalized and passed by the Botswana Parliament and the

sooner the action plan is agreed by the stakeholders, the greater the prospect of obtaining at least some further support from the FIRST Initiative.

We suggest that the FIRST Initiative be approached as a matter of priority to ascertain the extent of possible future financial support for the implementation stage of the BFIC.

Other possible sources of donor funding include:

- The UK – through DFID
- Canada – through CIDA
- The World Bank – through its technical assistance programs and access to Japanese trust funds for financial sector reforms

The British aid agency has a particular interest in the economic prosperity and political stability of the SADC region and may have an interest in assisting with the establishment of a sound non-bank financial regulator. The Scandinavian countries have a commitment to integrated financial regulation and have provided some limited aid funding to the SADC region. Donor agencies in those countries should also be considered.

In all cases, these agencies are likely to look to the Government of Botswana to show its commitment to strengthening financial regulation by committing some of the funds for these reforms from its own resources.

Recommendation 12

To carry the proposed action plan forward we recommend establishing a Steering Committee including senior representatives from the Ministry of Finance, the Bank of Botswana, and industry.

7. Concluding Comments

In this final section we attempt briefly to put the suggestions and recommendations of the Report into perspective.

The non-bank financial system in Botswana has been evolving quickly and now rivals or even surpasses the banking system in terms of dominance. The need for more effective non-bank financial regulation and supervision is likely to become increasingly pressing over the next decade or so. The case to establish an independent NBF regulatory agency is quite compelling on grounds of both effectiveness and efficiency of using scarce regulatory resources.

In this Report we recommend establishing such an agency, BFIC, with the following key design characteristics:

- It should be a parastatal authority drawing its roles, responsibilities, and powers from its own Act of Parliament;
- It should have the full range of regulatory and supervisory powers needed to meet its legislated objectives;
- It should be given operational independence from both the Botswana Government and industry;
- It should be governed by a largely non-executive Board with a non-executive chair;
- It should face rigorous accountability requirements to ensure that it acts independently and transparently in meeting its legislated responsibilities;
- It should be funded by a structure of levies on industry;
- It should have a target internal structure that is largely industry based, but which extracts some synergies from its scale through the amalgamation of common functions such as enforcement, policy, and licensing;
- Staff remuneration should be set by the Board at a level competitive with the bank of Botswana and the finance industry to ensure that it is able to recruit and retain the necessary staff skills and resources to meet its legislated objectives;
- It should be adequately resourced to meet its staff and technology needs;
- It should adopt a business plan that devoted adequate resources to staff recruitment and training.
- It should adopt a staged approach to creating the agency and implementing the recommendations of this Report.

To carry this plan forward we recommend establishing a Steering Committee consisting of senior representatives from the Ministry of Finance, the Bank of Botswana and industry.