Risk Management

Regulatory environment

The Banking Supervision Department of the Bank of Botswana strives to promote the soundness of banks through effective supervision. In doing so, it contributes towards a stable and efficient payments and banking system. The supervisory environment promotes sound risk management in banks, together with sound corporate governance, transparency and full disclosure.

Group risk management

One of the biggest challenges facing bank supervisors worldwide is the growing internationalization of banking groups. The structure of financial groups should be transparent and conducive to risk management and supervision from a group perspective. The Board of Directors and bank management team have the key responsibility for the management of this risk.

The minimum standards set by the Basel Committee on Banking Supervision are that:

- all international banking groups should be supervised by a home-country authority that capably performs consolidated supervision; and

- bank supervision authorities are expected to give assurance to host country supervisors through their supervision of group risk of international banks.

The purpose of risk management is to identify the risk factors, which could adversely affect the desired outcomes of the bank's activities. Risk management also seeks to manage these risks so as to reduce and control these risk factors and thereby minimize the incidence and impact of adverse outcomes.

Operational risk

Operational risk arises from the potential for loss through fraud, error, systems failure or other similar occurrences. The bank guards against these risks through the following measures:

- good systems and strong internal control;
- disaster and business recovery procedures;
- regular internal and independent audits;
- risk management programmes; and
- external insurance policies.

The primary objective of the management of operational risk is to identify possible weak links and to strengthen these links. The bank has in place a comprehensive policy, standards and a business recovery plan designed to ensure that its key business functions can continue under disaster conditions.

Solvency risk

Insolvency is the chronic condition of being unable to pay one's debts in full. An insolvent bank cannot discharge its debts and must be either liquidated or rescued, usually with public money. Bank failures cause a contraction in the economy.

A bank's solvency may be threatened if its other risks have been mismanaged. Capital adequacy is an exclusive concept which bankers, analysts and regulators measure by a variety of methods. The numerator of the calculation is always the capital base (equity capital, plus reserves, plus subordinated types of debts, plus revaluations and general bad debt provision), and the denominator is the value of the total risk-weighted assets, including off-balance sheet risks.

Credit risk

Credit risk can be defined as the risk that a debtor will default on servicing and repaying a borrowing and also includes the possible shortfall in recovering a debt after realising security. In banking terms this is associated with the principal business of a bank, being that of lending money.
The credit department manages the bank's credit risk centrally. The department's primary functions are to formulate credit policies on a macro-level, independently review the Group's largest credit exposures and manage the portfolio of risk concentrations. Efficiency of the credit process is also continuously reviewed, as is the efficiency of credit approval processes and the effectiveness of ongoing management of the portfolio. Portfolio credit risk is managed via a categorisation system that identifies and monitors deteriorating credit risks at an early stage.

An established credit process is in place. This process involves delegated approval authorities and credit procedures. The objective of this process is to build and maintain high quality assets. The approval delegation includes the use of credit committees. These committees have been formed to effectively and objectively review proposed limits of varying amounts. The most senior of these committees includes members of the Board of Directors.

It is necessary for the credit department to continually assess, investigate and adopt best practices applied by banks world-wide, including technological advances, management tools, enhancement of procedures, support and reporting

Credit risk (continued)

systems. Many developments, especially processes coupled with technology development, are being planned, investigated and rolled-out on an ongoing basis.

Special attention is continually paid to the management of problematic credit. Where appropriate, this is managed to provide intensive control to maximise recoveries. In line with international practice, the bank has recognised the need to move towards integrating credit and market risk management. The credit department oversees concepts and activities that cover any key aspects of risk within the bank.

Market risk

The bank operates within the Market Risk Management Framework of the FirstRand Banking Group, within which the risks associated with trading positions are managed.

Market risk arises from the negative impact on the current and future earnings potential of the bank as a result of the movement and volatility of exchange rates or interest rates.

The trading portfolio

The risk of adverse movements in the comparative rates of exchange between currencies is managed in the Dealing Room where operations occur within limits assigned to each dealer based on individual knowledge, expertise and experience. The Treasurer and an independent Risk Manager monitor the trading portfolio on a daily basis reporting weekly to a higher authority.

Operational risk with regard to market operations

All activities are authorised and conducted using operational systems that are adequate for the recording, valuation and settlement of all transactions. Adequate security measures are in place to prevent the access of unauthorised persons to the trading and settlement premises and systems. There is adequate segregation of duties in respect of dealing, settlement confirmation and risk exposure measurement.

The non-trading portfolio

The bank's balance sheet is managed by the ALCO (Asset and Liability Committee), which consists of the bank's executive management representing key business areas. The committee meets on a monthly basis or on a more frequent basis should circumstances require them to do so. The sensitivity to moves in interest rates is measured, using a standard set of rate shocks. The impact of this on the net interest income of the bank is reviewed monthly.

Counterparty risk

This risk arises from a counterparty to a transaction failing to meet punctually a financial commitment. This risk is managed in the bank's dealing room by allotting counterparty trading limits on foreign exchange and money market transactions. The risk manager monitors these limits daily and deviations are reported to a higher authority.

Liquidity risk management

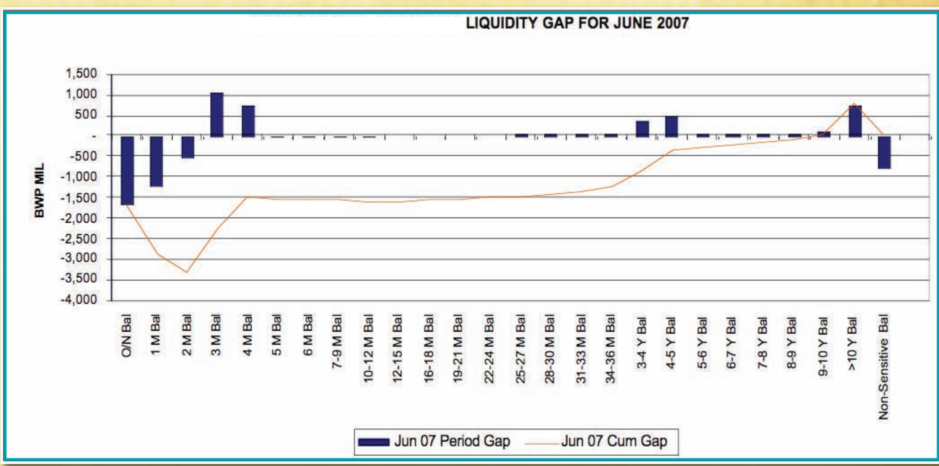
Liquidity risk describes the risk of not being able to generate sufficient cash to meet financial commitments to extend credit, meet deposit maturities and fund other transactions in the ordinary course

Risk Management

Liquidity risk management (continued)

of our business, the aim being to remain prudently and economically liquid.

with the responsibility of managing the structure of the balance sheet and administering the key risks that arise during the ordinary course of banking.



Maturing assets and liabilities imply an inflow and outflow of funds respectively. The mix and maturity of the balance sheet therefore impact on liquidity.

The graph below represents the liquidity gap as per the ALCO model at 30 June 2007. Both the period and cumulative gaps are shown.

Interest rate risk management

Interest rate risk is the possibility of incurring losses as a result of changes in interest rates. The ALCO is charged

This risk is quantified by calculating the impact of a one per cent increase and decrease in interest rates on net interest and is reported to the Board and Group ALCO.

By managing these risks, ALCO ensures that all future cash flow commitments and capital adequacy are met and that net interest income is maximised.

The graph below represents the interest rate gap as per the ALCO model at 30 June 2007. Both the period and cumulative gaps are shown.