2016 SUPERVISION ANNUAL REPORT

CENTRAL BANK OF LESOTHO

BANKA E KHOLO EA LESOTHO

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GOVERNANCE, MISSION & OBJECTIVES

Ownership and Governance

The Central Bank of Lesotho is a statutory organisation fully owned by the Government of Lesotho.

The Central Bank enjoys a fair amount of independence in formulating and implementing monetary policy. The Governor, who is also the chairman of the Board of Directors, together with the two Deputy Governors, are appointed by His Majesty The King on the advice of the Prime Minister. The Minister of Finance appoints the other Board Members.

Mission Statement

The Mission of the Central Bank of Lesotho is to achieve and maintain monetary and financial system stability to support balanced macroeconomic development of Lesotho.

Objectives

The principal objective of the Central Bank of Lesotho, as stipulated in the Central Bank of Lesotho Act of 2000, is to achieve and maintain price stability. Other related objectives which are supportive to this mission are:

- To foster the liquidity, solvency and proper functioning of a stable market-based financial systems;
- To formulate, adopt and execute the monetary policy of Lesotho;
- To issue, manage and redeem the currency of Lesotho;
- To formulate, adopt and execute the foreign exchange policy of Lesotho;
- To license, register and supervise institutions pursuant to the Financial Institutions;
- To own, hold and manage its official international reserves;
- To act as a banker and advisor to, and as fiscal agent of the Government of Lesotho;
- To promote the efficient operations of the payments system;
- To promote the safe and sound development of the financial system; and
- To monitor and regulate the capital market.

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During the year 2016, the Commissioner continued to implement reforms aimed at developing the financial sector assisted by the development partners.

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FOREWORD BY THE GOVERNOR

During the year 2016, the Commissioner continued to implement reforms aimed at developing the financial sector assisted by the development partners, namely; the International Monetary Fund and the World Bank Group.

In the insurance sector, the exercise culminated into the publication of six (6) sets of insurance regulations which among others included regulations on capital requirements and financial reporting by key players, including, insurance companies and insurance intermediaries. The regulations closed the gaps that were created by the repeal of the Insurance Act of 1976, following the enactment of the Insurance Act of 2014. The reform agenda is expected to continue into the year 2017 with the drafting of the micro-insurance regulations and the review of the Insurance Act of 2014. The proposed review is evidence rapid evolution of the both the global and domestic financial services sectors. The proposed review is expected to address new challenges by enhancing monitoring and supervision by the Insurance Commissioner.

Notwithstanding, using multiple financial soundness indicators, the insurance sector continued to be resilient, financially sound and highly liquid during the year under review. The insurance business remained highly profitable, although its contribution to the overall economy still needs to improve relative to regional peers. There is a huge gap in terms of insurable economic activities in the country where the insurance industry could play a crucial role through more competition and appropriate innovation. The insurance industry continued to offer traditional insurance products, with limited innovation.

In the banking sector, sixteen (16) sets of regulations were published. The changes to the regulatory framework were substantial, and were necessitated by the enactment of the Financial Institutions Act (FIA) 2012, which mandated the development of a large new body of regulations, and necessitated revisions to the existing bank supervisory regulatory framework. Nine regulations were reviewed and amended, while seven new regulations were developed in line with emerging developments in the revised Basel Core Principles and international best practice. The new regulations included Risk Management, Agent Banking, Consolidated Supervision, Disclosure of Bank Charges and Interest Rates, Disclosure of Financial Information, Permissible Activities and Prompt Corrective Action.

The banking sector remained sound and stable as reflected by satisfactory performance in profitability and capital position. The liquidity funding structure, which is dominated by wholesale funding, remained a challenge, making banks vulnerable to huge withdrawals by top depositors. A notable increase in the credit intermediation was also observed in 2016. However, the implementation of Financial Institutions (Asset classification) Regulations 2016 necessitated banks to increase provisions for loans; by the end of the year. In terms of market outreach in 2016, two new bank branches were opened while payment channels in respect of ATMs and POS terminals across the country increased.

In spite of the positive growth in the financial sector, challenges were still prevalent in 2016. The financial sector was clouded by a number of pyramid schemes which emerged in the form of stokvels and/or illegal investment schemes. The Bank undertook public financial education campaigns to ensure that people are empowered to be able to make the right investment choices.

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FOREWORD BY THE GOVERNOR

The Bank continues to advance its efforts to promote a stable financial system by enhancing its Financial Stability function[1]. To this effect, the Bank continues to promote macro-prudential indicators (including financial soundness indicators (FSIs)) as well as increase the coverage to include the non-bank sector. This has facilitated regular reporting on financial system stability, in the form of a Financial Stability Watch report, which analyses international and domestic developments and trends of the FSIs, and distil germane financial stability implications arising therefrom. In addition, in enhancing its early warning system, the Bank conducts Banking Sector Stress Testing semi-annually to assess resilience of the sector to both external and internal shocks ❑

A. R. Matlanyane (PhD)
Governor • Mookameli oa Banka

[1] The function includes establishment of Financial Stability Division in 2014 and a Financial Stability Committee (not yet operational).

2

The Banking Supervision Division carried out on-site examinations of three commercial banks in 2016 in line with the annual plan.

BANKING SECTOR REVIEW

2.1 ON-SITE EXAMINATION

The Banking Supervision Division carried out on-site examinations of three commercial banks in 2016 in line with the annual plan. This followed an assessment which was undertaken by the off-site monitoring section which exhibited serious weaknesses from reports submitted as well as other data sources including but not limited to internal and external audit reports. The examinations focused on the financial condition and performance of the three banks placing more emphasis on assessment of adequacy of Board and Senior Management Oversight, adequacy of policies and procedures, effectiveness of the internal controls and the appropriateness of the Management Information Systems. In all banks, Board and Senior Management oversight was generally acceptable with minor concerns. The Board and Senior Managements were in possession of appropriate qualifications and experience; they had also been exposed to relevant training that enabled them to execute their oversight effectively. There were however, notable incidents in which some banks failed to review policies on annual basis as most of them had passed their review date.

The banks had developed and adopted appropriate policies and procedures to ensure compliance with applicable laws and to manage various risks exposures. However, incidents of non-adherence to policies and procedures by banks' staff were still observed. In some cases, staff was not even aware of certain policies and procedures due to poor distribution of the same by Senior Management and training on the same. Further observations included certain capacity constraints within the Compliance Departments which obstructed compliance with laws, regulations, policies and procedures. Consequently, compliance risk was rated high due to several incidents of non-compliance with the Financial Institutions Act (FIA) 2012 and its implementing Regulations.

During this period, two banks were in the process of updating their core banking systems due to the challenges that were prevalent in the previous examinations. It was hoped therefore, that system issues would be minimised even though some level of operational risk may increase. The quality of audit and internal control systems were found satisfactory as they provided adequate checks and balances across the banks.

2.2 OFF-SITE SURVEILLANCE

2.2.1 Compliance Issues

In 2016, about sixteen (16) sets of regulations were gazetted; some were entirely new while some repealed some of the old regulations pursuant to certain developments in the banking industry.

a) Minimum Local Assets Requirement

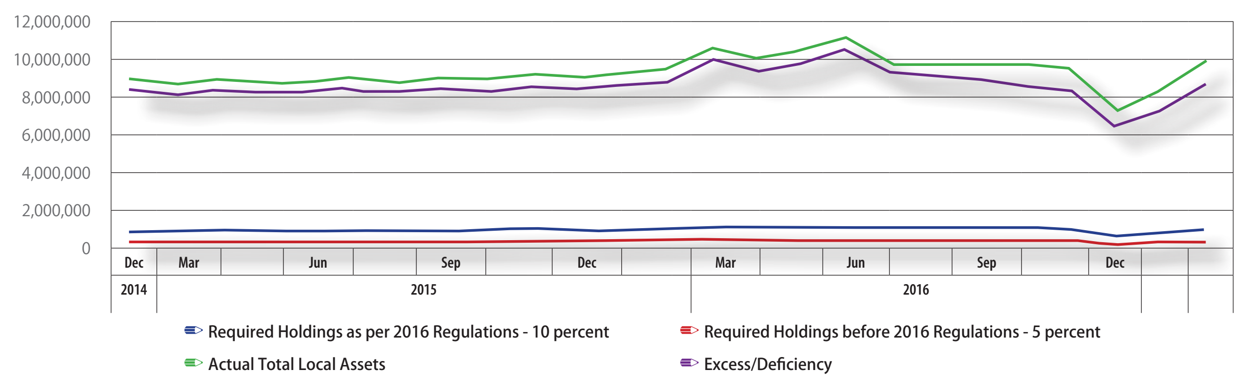
The Financial Institutions (Minimum Local Assets[2] Requirements) regulations, 2016 require a bank to maintain local assets at an amount not less than 10 percent of the aggregate value of its liabilities to the public in Lesotho and its

[2] The regulations define local assets as advances and credit facilities to persons doing business or resident in Lesotho, properties and other assets situated in Lesotho.

The Banking Supervision Division carried out on-site examinations of three commercial banks in 2016 in line with the annual plan.

required paid up or assigned capital, even in the case of a branch of a foreign bank and statutory reserve account. The objective of the minimum local assets requirement is to encourage banks to engage in financial intermediation in Lesotho and ensure that funds raised locally grow the local economy. Figure 1 depicts the banking industry's compliance with the regulations, prior to and after the gazettment of the 2016 regulations. The required local assets ratio of banks in 2016 was well above the 10 percent regulatory (the gazettment of the) requirement; a slight dip was noted in October 2016 but no supervisory action was necessary.

Figure 1 Minimum Local Assets Requirement



Source: Central Bank of Lesotho

b) Liquidity

Commercial bank's liquidity requirements are stipulated in Financial Institutions (Liquidity Requirements), Regulations 2016. The regulations are intended to ensure that a bank maintains adequate liquidity and require frequent reporting and monitoring of liquidity positions not only for prudential reasons but also for purposes of implementing macro-economic policies and fostering public confidence in banks in Lesotho. Liquidity ratios measure the institution's ability to pay off its short-term debts[3] (fostering). The regulations require banks to maintain a reserve ratio of 3 per cent and a liquidity ratio of 25 per cent of the aggregate of deposit liabilities balances due to banks abroad and other liabilities for reserve ratio of borrowed money excluding CBL and government borrowings as reserve requirement or liquid assets requirements respectively. Figure 2 shows the industry's compliance with the liquidity requirements regulations. During the period under review, the reserve ratio was slightly above the regulatory requirement averaging 3.2 per cent while the liquid asset ratio averaged 32.2 per cent which were both in excess of the minimum requirements.

[3] The more liquid assets a bank has compared to short term liabilities, the greater the ability to pay its debts when they fall due and still fund its on-going operations.

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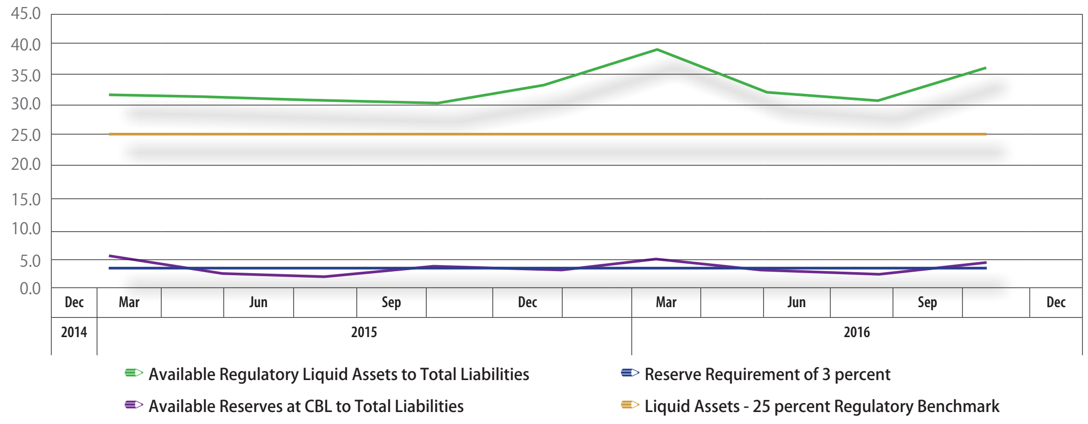
Figure 2 Liquidity Requirements (%)



Source: Central Bank of Lesotho

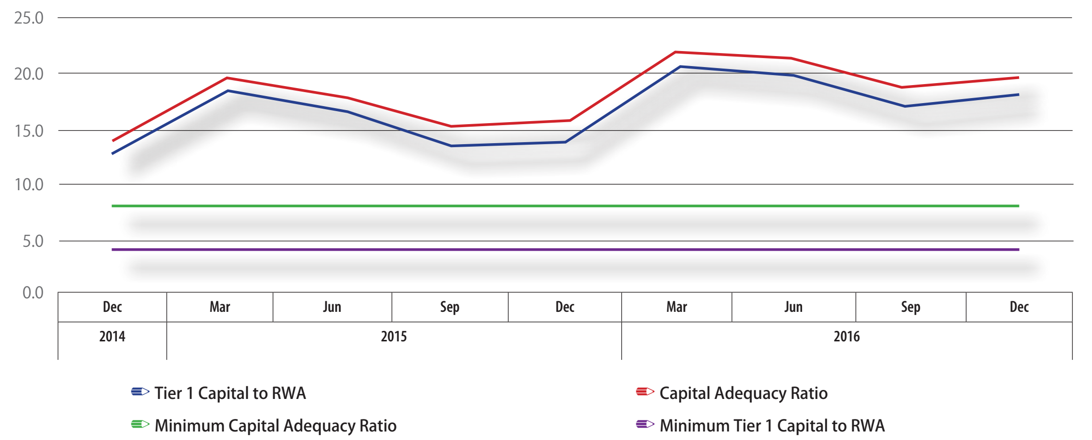
c) Capital Adequacy

Minimum capital adequacy ratios serve to protect depositors and promote the stability and efficiency of the financial system[4]. The ratio provides some assurance that banks can absorb a reasonable level of losses before becoming insolvent and before depositors. The ratios funds are lost. The higher the capital adequacy ratio, the greater the ability of a bank to absorb probable losses. The banking sector in Lesotho remained adequately capitalised for the period ending December 2016. The ratio of total regulatory capital to risk-weighted assets stood at 18.0 percent. Depicted in Figure 3, the ratio was higher than the one recorded in December 2015 by 0.03 percentage points. Similarly, the ratio of tier-1 capital to risk-weighted assets increased from 13.8 percent in December 2015 to 17.1 percent in December 2016, showing that the banking industry continued to maintain sufficient levels of core capital to absorb adverse shocks.

[4] http://www.rbnz.govt.nz/finstab/banking/regulation/0091769.html.

The banking sector in Lesotho remained adequately capitalised for the period ending December 2016.

Figure 3 Capital Adequacy ratios (%)

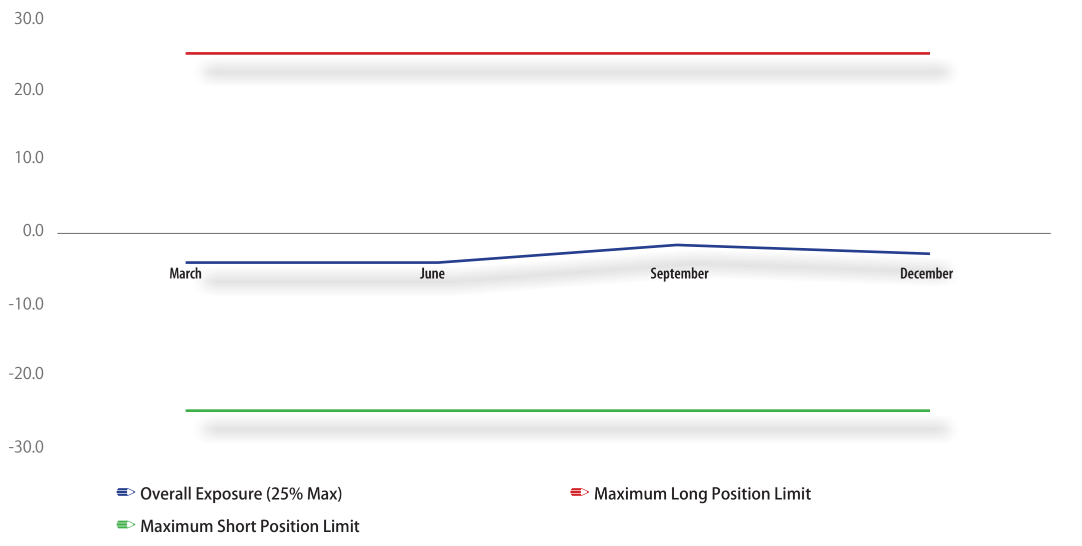


Source: Central Bank of Lesotho

d) Foreign Currency Exposure

The Financial Institutions (Foreign Currency Exposure Limits) Regulations, 2016 require banks to maintain, as at the close of any business day, its foreign exchange exposures, irrespective of short or long positions, at not more than 15 percent of the total qualifying capital for any single foreign currency exposure and 25 percent of the total qualifying capital for the overall foreign exchange exposure. The banks are also required to monitor and maintain, within prudential limits established by the board of directors, intra-day foreign exchange exposures both in single currency and overall position. The ratios are computed daily, but reported weekly. The regulations intend to encourage banks to adopt sound and prudential foreign exchange risk management policies, practices and systems in accordance with the relevant laws on risk management. Both the industry's single currency exposure and the overall foreign currency exposure requirements were within the regulatory requirements for the entire period, albeit within short positions.

Figure 4 Foreign Currency Exposure (%)



Source: Central Bank of Lesotho

2.2.2 Banking Sector Performance

a) Main Balance Sheet Items

i) Total Assets

The banking sector balance sheet size reflected a lacklustre performance and declined by 5.3 percent, from M13.9 billion in 2015 to M13.2 billion in 2016 (see Table 2). A decline was explained by subdued performance of balances due from local banks and banks abroad. Balances with banks abroad declined by 15.4 percent, from M3.5 billion in 2015 to M3.0 billion in 2016. In addition, balances with local banks recorded a significant decline of 7.3 percent, from M2.3 billion in 2015 to M2.1 billion in 2016. However, the loan book picked-up though at a slower and fragile pace and observed a growth of 2.9 percent, from M5.3 billion in 2015 to M5.4 billion in 2016. A slower growth in credit portfolio could be attributed to a decrease in demand for credit and challenges that faced the domestic economy such as heightened political uncertainty which sent a country to elections in June 2017.

Balances with banks abroad declined by 14.3 percent, from M3.5 billion in 2015 to M3.0 billion in 2016

Table 1 The Growth Rates of Total Assets (%)

	2012	2013	2014	2014	2015
TOTAL ASSETS	1.2	35.0	7.5	13.3	-5.3
Cash and Cash Items	34.1	21.5	-9.2	45.6	8.7
Balances with CBL	7.6	157.0	22.7	-31.9	19.0
Balances with local banks	-6.4	97.0	21.5	6.7	-7.3
Balances with banks abroad	-21.9	27.4	11.0	36.2	-15.4
Marketable securities	16.7	-20.6	-8.1	22.5	7.7
Other investments	-52.2	99.8	-41.0	4.3	-70.8
Loans and advances	40.2	21.9	12.2	7.3	2.5
Fixed Assets	-1.2	21.3	20.5	25.7	22.3
Other Assets	4.0	59.5	42.1	-12.1	34.9

Figure 5 depicts the distribution of loans. Business loans declined by 6.5 percent, from M2.1 billion in 2015 to M2.0 billion in 2016 (See Figure 1). Mortgages improved by 18.3 percent, from M712.7 million in 2015 to M842.8 million in 2016, while personal loans increased by 6.1 percent, from M2.6 billion in 2015 to M2.8 billion in 2016.

Figure 5 Distribution of Loans by Type (%)

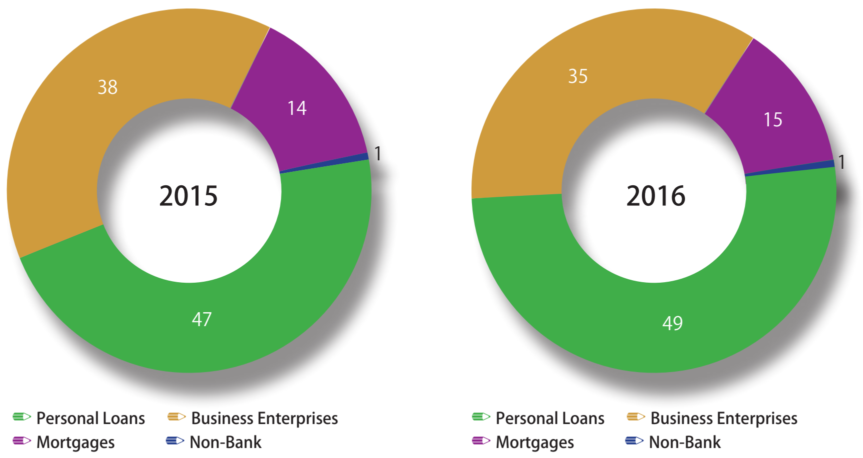


Figure 6 depicts the trend performance of business loans. The business loan portfolio was dominated by mining, manufacturing and real states sub-sectors. It was, however, threatened by a gradual decline in the country's competitiveness in the US market, uncertainty around AGOA and risks facing the domestic economy.

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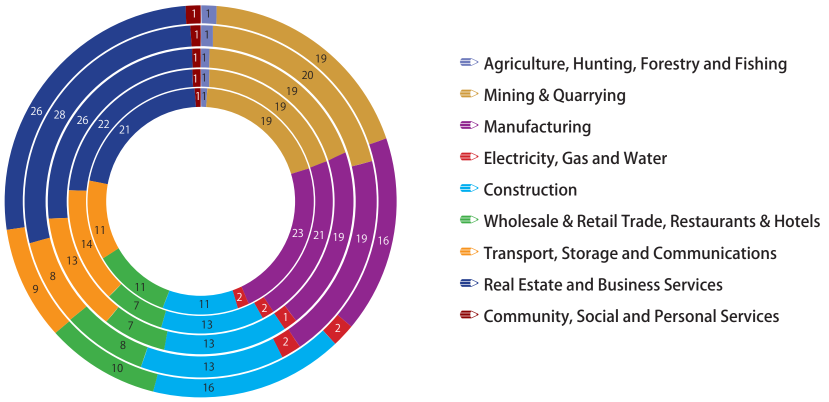
BANKING SECTOR REVIEW

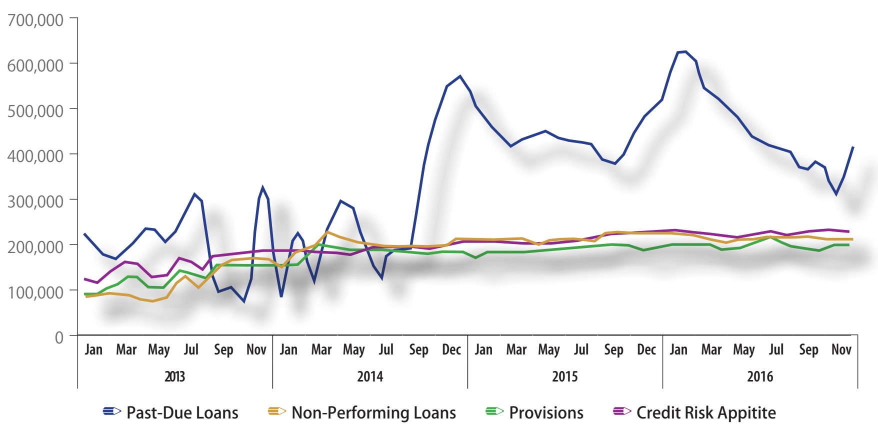
Figure 6 Distribution of Business Loans: Dec 2015 – Dec 2016 (%)



**The innermost doughnut corresponds with Dec 2015*

Figure 7 depicts a decrease of 5.9 percent in NPLs, from M220.5 million in 2015 to M207.4 million in 2016. The industry continued to make efforts to contain credit risk as seen by increasing provisioning and declining past-due loans. Provisions increased slightly by 3.8 percent, from M190.2 million in 2015 to M197.4 million, largely influenced by implementation of Financial Institutions (Asset Classification) Regulations 2016 which improved provisions. A trend on past-due loans suggested improved projections on NPLs due to a sharp contraction of 16.9 percent, from M498.3 million in 2015 to M413.9 million in 2016. A decline in this component is mainly explained by repayments in loans and overdrafts.

Figure 7 Credit Risk (M`000)



Source: Central Bank of Lesotho

The industry continued to make efforts to contain credit risk as seen by increasing provisioning and declining past-due loans.

The outlook on credit growth specifically for the manufacturing sub-sector may be clouded by a gradual decline of the country's competitiveness in the US market, high lending rates and surrounding AGOA. However, the impact was expected to be offset by the envisaged positive outlook in the construction and mining sub-sectors.

ii) Total Liabilities

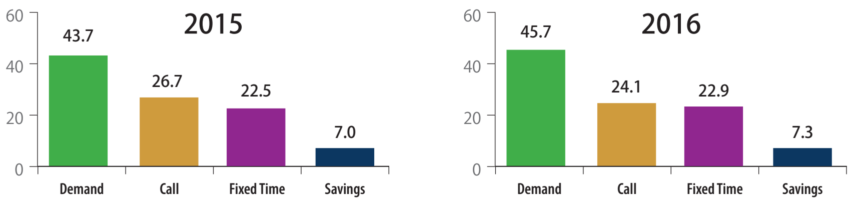
Total liabilities declined sharply by 7.7 percent, from M12.5 billion in 2015 to M11.5 billion in 2016, due to a decrease in total deposits from M9.4 billion in 2015 to M8.8 billion, which is generally attributable to a decline in wholesale deposits. In addition, balances due to local banks recorded a decline of 13.8 percent, from M2.3 billion in 2015 to M2.0 billion in 2016. Balances due to foreign banks also declined by 9.7 percent, from M249.4 million in 2015 to M225.1 million in 2016.

Table 2 The Growth Rates of Total Liabilities (%)

	2012	2013	2014	2015	2016
TOTAL LIABILITIES	-0.4	37.3	6.2	13.4	-7.7
Deposits	5.4	28.5	5.0	13.9	-5.9
Due to Local Banks	-9.6	87.9	15.6	7.8	-13.8
Due to Foreign Banks	-72.1	530.8	-36.9	26.1	-9.7
Other Borrowings					1.1
Other Liabilities	-20.7	-14.7	20.6	16.1	-11.9

Figure 8 depicts the structure of the total deposits, which continued to be dominated by short-term deposits indicating that the financial intermediation is mostly financed by short-term deposits. Therefore, the asset and liabilities mismatch remained on upward trajectory and was also expected to gain some momentum as a result of increasing mortgages.

Figure 8 The Structure of Deposits (%)



Source: Central Bank of Lesotho

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iii) Shareholders` Equity

Total capital increased by 15.1 percent, from M1.5 billion in 2015 to M1.7 billion in 2016, underpinned by increase in retained earnings and profits. Paid-up capital increased significantly by 2.0 percent, from M123.4 million in 2015 to M125.9 million by 2016. The statutory reserve account increased significantly by 50.0 percent, from M120.8 million in 2015 to M181.2 million in 2016. Retained earnings increased significantly by 10.0 percent, from M727.3 million in 2015 to M884.2 million in 2016. There were no dividends pay-outs made in 2016; all profits were re-invested to support deployment of new core banking systems and/or upgrades of core banking systems, and preparation for adoption of Basel II.5.

With the expected implementation of Basel II.5 in 2018, growth in capital base and resilience of the banking system were expected to strengthen further. Therefore, in 2017 a built-up in the capital base is expected.

Table 3 Growth Rates in Total Capital (%)

	2012	2013	2014	2015	2016
					-7.7
TOTAL CAPITAL	16.0	16.8	19.7	11.9	15.1
Paid-up capital	11.3	10.1	0.0	13.3	2.0
Statutory reserve	-4.2	3.6	-0.7	-2.7	50.0
Revaluation reserves	0.0	0.0	16.4	52.1	-21.6
Other reserves	128.6	-54.9	64.9	-39.3	299.7
Retained earnings	19.9	21.1	25.8	14.3	10.0
Profit/ loss	12.1	31.0	9.3	5.0	12.1

b) Main Income Statement Items

i) Total Income

Total income increased by 10.9 percent, from M1.4 billion in 2015 to M1.6 billion in 2016, supported by interest income and, commission income. Interest income on loans grew by 28.7 percent, from M711.9 million in 2015 to M916.4 million in 2016, primarily driven by increasing lending rates. The maximum lending rate increased by 10.4 percentage points from 20.6 percent in 2015 to 30.8 percent in 2016 (see Figure 9). The commission income rose by 11.0 percent, from M520.4 million in 2015 to M577.4 million, while income from domestic placements observed a growth of 27.4 percent, from M185.6 million in 2015 to M236.5 million in 2016. Income from foreign placements observed a growth of 17.1 percent, from M212.3 million in 2015 to M248.6 million in 2016.

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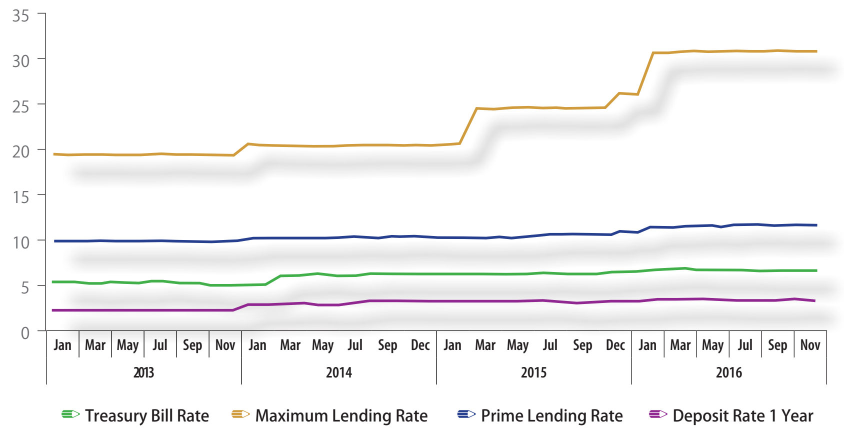
Total capital increased by 15.1 percent, from M1.5 billion in 2015 to M1.7 billion in 2016, underpinned an increase in retained earnings and profits.

Table 4 Growth Rates in Total Income (%)

	2012	2013	2014	2015	2016
TOTAL INCOME	20.4	27.5	8.7	10.7	10.9
Interest Income-Loans	64.2	46.3	8.0	27.1	28.7
Interest Income-Placements	-19.5	3.2	55.8	10.9	4.7
Foreign Payments	19.8	-15.0	46.2	5.0	17.1
Domestic Payments	-43.7	-24.3	80.1	19.3	27.4
Interest Income-Securities	0.0	10.2	28.6	-63.1	-45.9
Total Interest Income	14.0	26.5	23.5	8.5	16.8
Net Interest Income	22.7	28.3	12.3	10.2	13.3
Fees and Commission Income	20.0	30.5	5.4	9.4	11.0
Forex Gains/Losses	17.1	-2.6	11.3	21.0	-23.6
Other Income	-34.0	101.3	1.0	51.2	80.8
Grants	-8.9	30.8	-70.0	-14.6	-100.0
Non-interest Income	17.6	26.6	4.3	11.4	7.7

Figure 9 Interest Rates (%)



Source: Central Bank of Lesotho

ii) Total Expenses

Total expenses increased by 11.5 percent, from M859.0 million in 2015 to M957.6 million in 2016. Interest expenses, operating expenses and staff salaries accounted for the lion's share of total expenses. Interest expenses on domestic liabilities rose by 25.3 percent, from M346.2 million in 2015 to M434.0 million in 2016. Interest expenses on foreign liabilities increased by 25.3 percent, from M246.2 million in 2015 to M346.2 million while provisions for bad debts decreased by 2.1 percent, from M97.9 million in 2015 to M95.9 million in 2016. Bad Debts Write-offs stood at M9.9 million in 2016. Operating expenses increased by 12.1 percent, from M251.4 million in 2015 to M281.8 million in 2016.

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Table 5 The Growth Rates in Total Expenses (%)	2012	2013	2014	2015	2016
TOTAL EXPENSES	26.1	24.0	7.9	13.5	11.5
Interest Expense	-6.1	21.0	59.4	4.6	25.3
Staff Salaries and Benefits	1.5	23.9	11.3	14.3	13.9
Management/Directors Fees	141.8	-26.1	9.1	17.0	4.2
Auditors/Consultants Fees	8.2	33.3	11.2	12.4	7.3
Provision for Bad Debts	188.8	31.3	24.5	19.7	-2.1
Depreciation	7.4	28.7	1.0	0.3	15.7
Other Operating Expenses	6.8	62.8	-0.5	11.1	12.1
Operating Income/Loss	12.5	33.0	9.9	6.8	10.0
Income/Loss Before Taxation	12.5	33.0	9.9	6.8	10.0
Taxation	13.9	38.4	5.9	7.4	11.8
Net Income	12.1	31.0	11.5	6.6	9.4
Retained Income	83.0	18.6	-15.3	14.8	194.8

Net income increased by 9.4 percent, from M423.9 million in 2015 to M463.6 million in 2016. However, the performance was challenged by a built-up in distressed credit portfolio, as seen by increased write-offs and a slowdown in credit growth. Expenses grew at a faster pace than income as seen by increased cost to income ratio, from 59.7 percent in 2015 to 60.0 percent in 2016.

2.2.3 Market Share Analysis

The summary of market shares and measures of concentration which are used to assess the level of banking sector competitiveness are shown in Table 1. Table 2 depicts additional information on market outreach and total number of employees in categories of both the Top 2 banks and other banks.

The market shares of foreign banks in 2016 reflect a virtually identical picture compared to the previous year and remained at 97.2 percent. The HHI[5] remained elevated and increased by 3.4 percentage points from the 76.4 percent in 2015 to 79.8 percent in 2016. HH Index suggests high market concentration in a category of top-2 banks and thus reflecting an oligopolistic nature of the banking system.

[5] Herfindahl–Hirschman Index: is a measure of market concentration-The closer a market is to being a monopoly, the higher the market's concentration (closer to 100 percent) and the lower the level of competition reflecting in the market.

The market shares of foreign banks in 2016 reflect virtually identical picture compared to previous year and remained at 97.2 percent.

Table 6	Market Shares (%)				
	2012	2013	2014	2015	2016
Market Share of the top 2 Banks	85.9	87.6	86.4	86.4	80.5
Share of Revenue of the Top 2 Banks	89.9	78.0	81.9	82.0	81.4
Market Share of foreign Banks	96.7	97.3	97.2	97.2	78.0
HHI	75.8	78.3	76.6	76.4	79.8
Source:	Central Bank of Lesotho				

Table 7 indicates that employment level in the banking sector increased by 22.2 percent from 1,409 in 2015 to 1,722 in 2016, largely due to opening of new branches. ATMs increased by 13.3 percent, from 180 in 2015 to 204 in 2016 while POS devices increased significantly by 17.6 percent from 1,168 in 2015 to 1,374 in 2016.

Table 7	Market Outreach for 2016		
	2015	2016	Growth Rates (%)
Branches	47	49	4.3
ATMs	180	204	13.3
POS	1,168	1,374	17.6
Employees	1,409	1,722	22.2

2016 marked an era of technological developments in the banking sector as some banks implemented new core banking systems while some upgraded core banking systems, to strengthen security measures and take advantage of opportunities through introduction of new products. It was therefore, noted that banks would need to strengthen efforts to contain operational risk which remained elevated. On global front, risks associated with cybercrime remained escalated. These may have adverse implications on financial stability. Hence there is a need to invest more in cyber-security, including development of relevant laws.

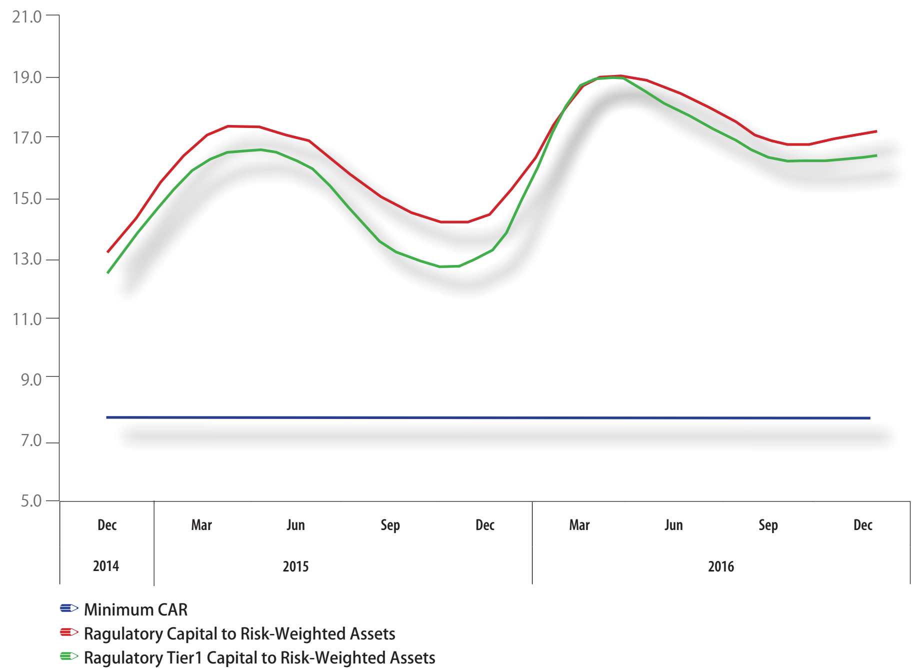
2.2.4 Financial Soundness Indicators

Financial Soundness Indicators (FSIs) are statistical measures designed to monitor the financial health and soundness of a country's financial sector, and its corporate and household counterparts. Analysis of FSIs covered in this report only focused on the banking sector and were compiled according to the IMF Financial Soundness Indicators Compilation Guide of 2006.

a) Capital Adequacy

Capital adequacy ratios measure the amount of a bank's capital buffers. These ratios are expressed as a percentage of risk weighted exposures. The purpose of having minimum capital adequacy ratios is to ensure that banks can absorb a reasonable level of losses before becoming insolvent and before depositors funds are lost. The higher the capital adequacy ratios a bank has, the greater the level of unexpected losses it can absorb before it becomes insolvent. Bank insolvency often lead to loss of confidence in the financial system, and may trigger contagion effect to other banks and above all, threaten the general financial sector stability.

Figure 10 (a) Capital Adequacy Ratios (%)



Source: Central Bank of Lesotho

The banking sector in Lesotho remained well capitalised for the period ending in December 2016 with capital levels above the minimum regulatory capital requirements[6]. The ratio of total regulatory capital to risk-weighted assets stood at 18.0 percent. On a year-on-year basis, this ratio increased by 2.8 percentage points. Tier-1 capital (core capital) to risk-weighted assets ratio increased by 3.3 percentage points to 17.1 percent in December 2016, showing that the banking industry continued to maintain higher levels of core capital.

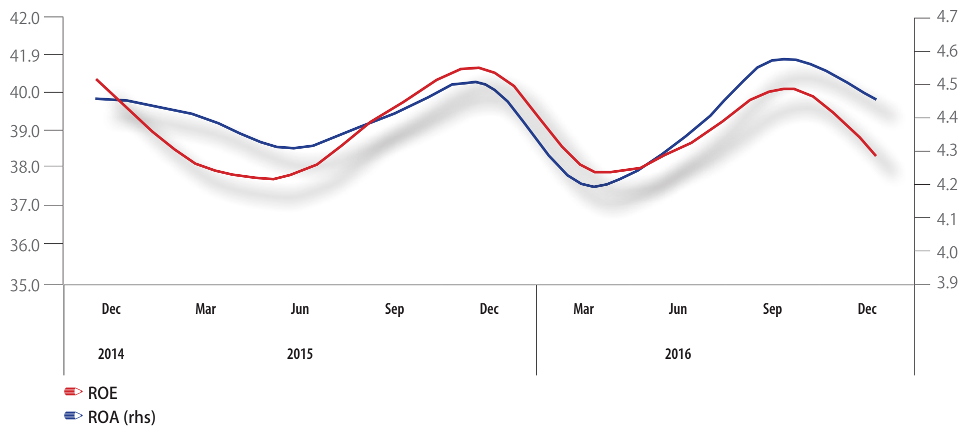
b) Earnings and Profitability

The industry remained profitable during 2016, which shows that the banks were efficient in utilising their resources (assets and capital) to generate income. The return on assets (ROA) was 4.6 percent as at December 2016 and was relatively unchanged compared to December 2015. Return on equity (ROE) decreased slightly during the review period. The decline was brought about by growth in retained earnings component of revenue in 2016 while equity remained relatively the same. The ratio decreased by 2.9 percentage points on an annual basis to 38.0 percent in December 2016.

[6] Regulatory minimum CARs are 8 percent for total regulatory capital to risk weighted assets(RWA) and 4 percent for tier-1 to RWA.

The ratio of net interest margin to gross income was 58.0 percent for the period ending December 2016.

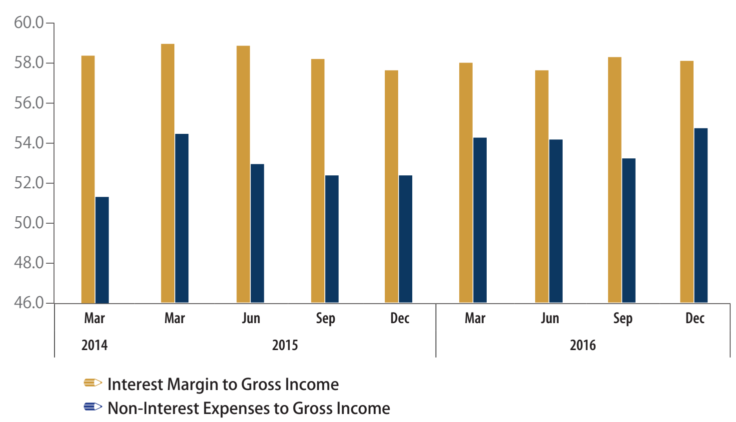
Figure 10 (b) Capital Adequacy Ratios (%)



Source: Central Bank of Lesotho

The ratio of net-interest margin to gross income stood at 58.0 percent in December 2016. This was less than the ratio observed in December 2015 by 0.4 percentage points. In contrast, the ratio of non-interest expenses to gross income, which measures the proportion of administration expenses to total income or the efficiency of a bank in using its resources to generate income, increased from 52.2 percent in 2015 to 54.7 percent in 2016. The increase was caused by a rise in non-interest expenses such as personal costs and other expenses during the period under review[7].

Figure 11 Earnings and Profitability Ratios (%)



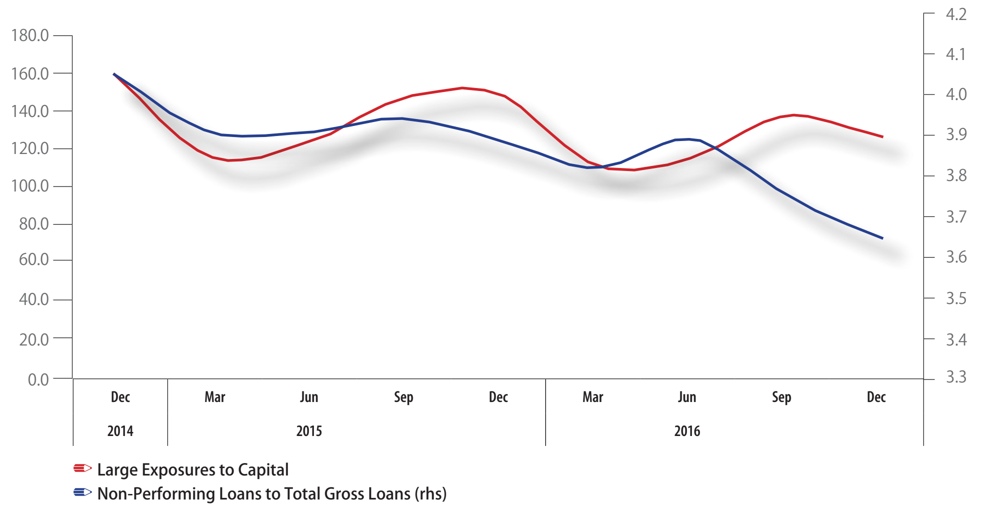
Source: Central Bank of Lesotho

[7] Since this is the end of the year, most banks do provide bonus to their staff, that is why the value of NIE will increase.

c) Asset Quality

Asset quality is one of the critical areas in determining the overall soundness of the financial institutions. The primary factor affecting overall asset quality is the constitution of the loan portfolio and the credit administration programmes. Loans typically comprise a majority of a bank's assets and carry the greatest amount of risk to capital[8]. Hence non-performing loans (NPLs) have to be managed carefully. The ratio of NPLs to total loans decreased from 4.0 percent in 2015 to 3.6 percent in 2016. This ratio was within the industry's threshold of 4.0 percent in the period ending in December 2016, indicating bank's successful efforts in managing credit risk effectively.

Figure 12 Asset Quality Ratios (%)



Source: Central Bank of Lesotho

One of the key lessons from the financial crisis is that banks did not always consistently measure, and control aggregate exposures to single counterparties across their books and operations. It is therefore important that banks manage large exposures carefully to minimise concentration risk. The ratio declined from 150.9 percent in December 2015 to 124.5 percent in December 2016. The large exposures declined by 26.6 percentage points on an annual basis due to a decline in the value of large exposures and an increase in capital. This ratio is intended to identify vulnerabilities arising from the concentration of credit risk. The industry threshold of this ratio is 800 percent and as at December 2016, the banking industry was below the set threshold.

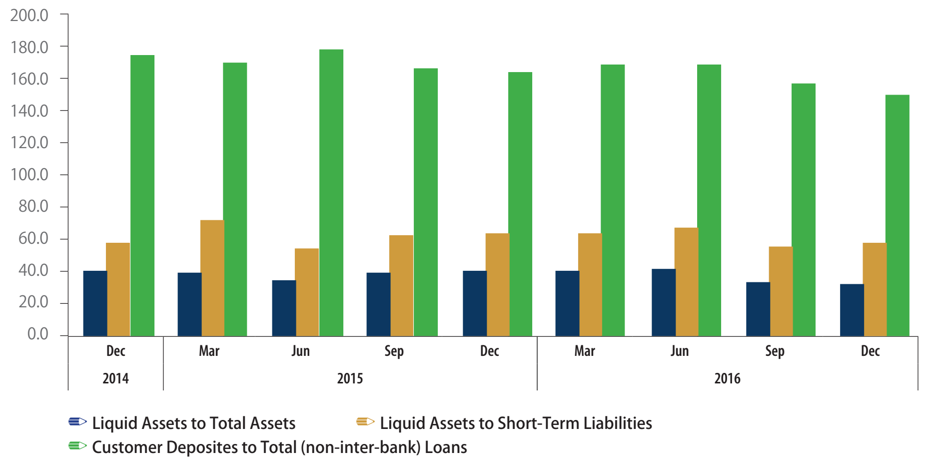
d) Liquidity

Liquidity is a measure of the ability and ease with which assets can be converted to cash. Liquid assets are those that can be converted to cash quickly if needed to meet financial obligations. Examples of liquid assets generally include cash, central bank reserves, and government debt[9]. To remain viable, financial institutions must have enough liquid assets to meet their near-term obligations, such as withdrawals by depositors. Generally, the higher the liquidity ratio, the larger the margin of safety that the bank possesses to cover short-term debts.

[8] http://www.fdic.gov/regulations/safety/manual/section3-1.pdf
[9] http://www.federalreserve.gov/faqs/cat_21427.htm

Asset quality is one of the critical areas in determining the overall condition of the financial sector.

Figure 13 Liquidity Ratios (%)



Source: Central Bank of Lesotho

The ratio of liquid assets to total assets is a liquidity management tool used to assess on an on-going basis the extent to which liquid assets can support the asset base. As at December 2016, the ratio was 31.4 percent which was lower than 40.3 percent observed in December 2015. The decline in the ratio was as a result of a decrease in currency and other cash items as well as in transferable deposits.

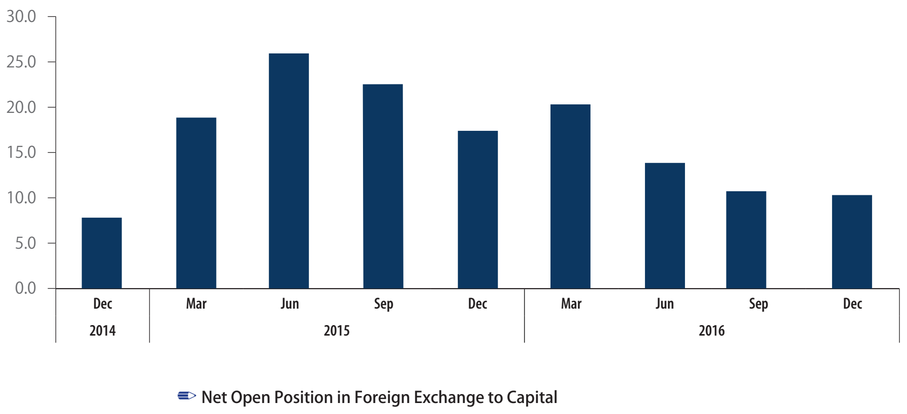
The ratio of liquid assets to short-term liabilities is a liquidity and efficiency ratio that measures an institution's ability to pay off short-term liabilities with its liquid assets. The ratio of liquid assets to short-term liabilities decreased from 63.3 percent in 2015 to 52.4 percent in 2016. The decline was due to the contraction of liquid assets (currency and other cash items and transferable deposits).

The ratio of customer deposits to total (non-interbank) loans is used to detect liquidity problems, whereby a low ratio might indicate potential liquidity stress in the banking sector and hence loss of depositors and investor's confidence in the banking sector. As at December 2016, the ratio was 149.4 percent which was lower than 163.1 percent that was observed in December 2015. The ratio declined because of an increase in total gross loans.

e) Sensitivity to Market Risk

Sensitivity to market risk is generally described as the degree to which changes in interest rates, foreign exchange rates, commodity prices or equity prices can adversely affect earnings and/or capital. However, in this report, only the ratio of net open position in foreign-exchange to capital is used to assess sensitivity to market risk. The ratio of net open position in foreign-exchange to capital remained positive, even though it decreased at the end of December 2016. The ratio decreased to 10.5 percent from 17.5 percent that was observed in December 2015. The ratio declined due to a decrease in assets denominated in foreign currencies while liabilities on the other hand increased.

Figure 14 Market Sensitivity Ratio (%)



Source: Central Bank of Lesotho

The Financial Soundness Indicators discussed above attributes a sound and healthy banking sector in 2016. The indicators revealed that the banking sector maintained high levels of capital and a good asset quality in the review period. Furthermore, the level of liquidity within banking sector remained adequate to withstand shocks to bank's balance sheet and the banking industry was satisfactorily profitable as at December 2016. In relation to sensitivity to market risk, the bank's exposure to foreign exchange risk remained low, signifying less sensitivity to market risk.

2.3 EXCHANGE CONTROL AND ANTI-MONEY LAUNDERING

2.3.1 Exchange Control Issues

a) New Exchange Control Circular

The CBL issued new circulars in line with developments in the CMA. The Exchange Control Rulings were also revised accordingly. During the review period, eleven (11) circulars were issued by the Central Bank of Lesotho for implementation by the authorised dealers (ADs) as follows:

- Duties and responsibilities of Authorised Dealers; Section A.3(D)
- Advance Payments, Capital Goods and Imports Undertaking Dispensation; Section B.1(E) and (F)
- Foreign Investments; Section B.2(B)
- Income Transfers; Section B.3(A)
- Single Discretionary Allowance, Donation to Missionaries, Gifts, Travel Allowance and Foreign Capital Allowance; Section B.4(A), (B), (D), (E) and (L)

The Central Bank of Lesotho issued new circulars in line with developments in the CMA.

- Bulk Transfers by shipping and Airline Companies; Section B.8(D)
- Miscellaneous payments for imports, services or subscriptions by means of credit and/or credit cards; Section B.16(E)
- Customer Foreign Currency Account; Section E.(B)
- Offshore Secondary Listings and Depository receipt programmes; Section G.(K)
- Measures applicable to inward listed debt instruments Derivative Instruments and equity issues on the JSE Limited; Section H.(A) and (C).
- Trade Finance, Long-term loans and working capital loans extended by ADs; Section I.3(B)

b) Compliance with Exchange Control Rulings

During the review period, ADs continued to attest for their clients despite the outstanding proceeds which have exceeded the 180 days repatriation requirement. This shows non-adherence to provisions 7,11 and 12 of the Exchange Control Regulations, 1989 and section B.18(B) of the Exchange Control Rulings, 2013. Nonetheless, there was a noticeable improvement in outstanding proceeds during the review period. This resulted from issuance of two directives to ADs to stop attesting for clients on CMT/P basis, as well as clients for which there were still outstanding proceeds due for over 180 days.

On the Balance of Payments (BOP) categories, some improvements have been realised following the onsite examinations on the ADs. Some of the BOP categories are now being classified appropriately. There is, however, still a need for refresher trainings for ADs to enhance compliance.

c) Analysis of Export Proceeds

The share of repatriation of export proceeds for the whole banking industry in 2015 and 2016 is depicted in Figure 17. Export proceeds received declined by 5.1% from a revised figure of 95.8% in 2015 to 90.7 in 2016. In 2016, outstanding proceeds were 9.3 percent of total proceeds. The grave improvement in the overall received proceeds for the two years being reviewed resulted from repatriation by exporting companies following the directive from the Regulator that ADs should stop attesting for companies with outstanding export proceeds beyond the required 180 days.

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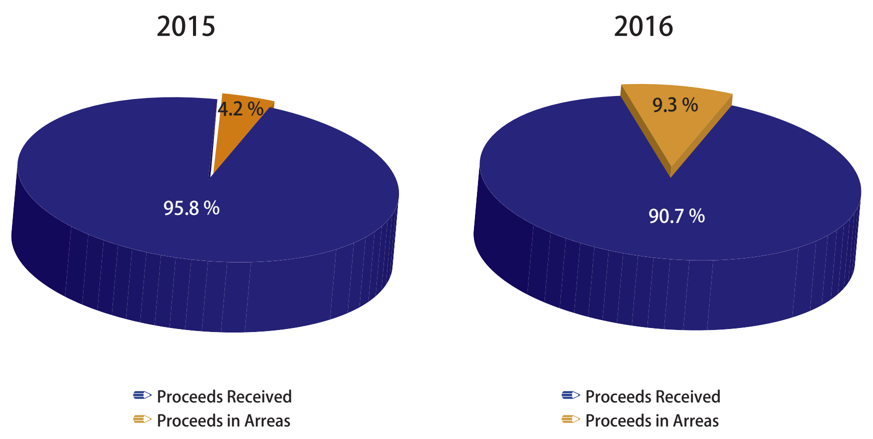
Figure 15 Share of Repatriation of Export Proceeds in 2015 and 2016



Source: Central Bank of Lesotho

d) Applications to Sell Foreign Currencies

In 2016, 200 applications were submitted by the ADs to Financial Surveillance Division for approval and were all approved. This figure is less by 38 applications that were submitted in the previous year. In value terms, approved applications stood at M0.9 billion in 2016, a decline of M1.4 million from the value appeared in 2015. Approved applications were mainly for payment of dividends, professional services, royalties, management fees, the value approved in loans and premiums. The recorded change was attributable to low activity mainly in the mining and quarrying sectors.

Table 8 Application by Type of Service in 2016

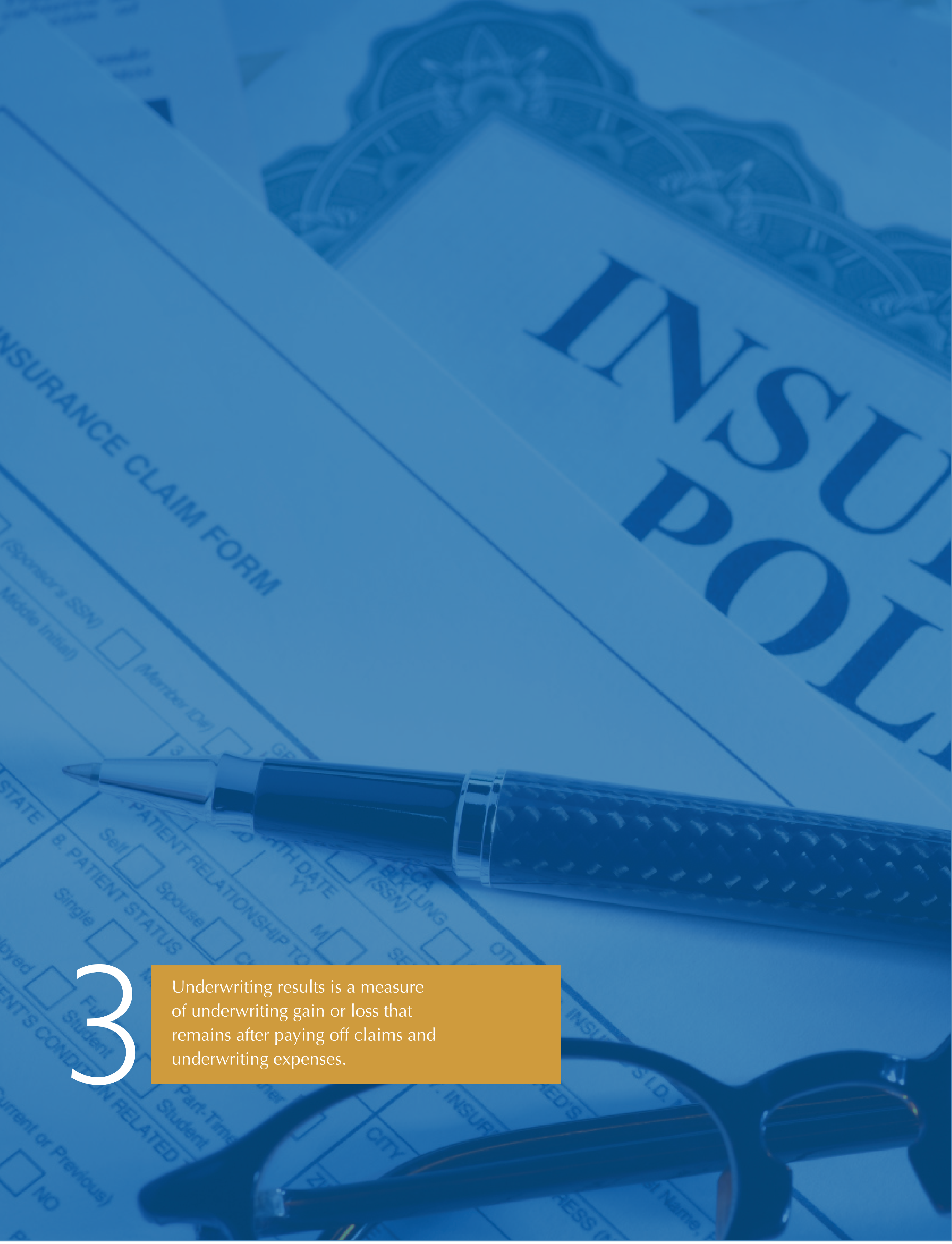
Item	No. of applications	Value	%share
Dividends	10	757529774.8	81.8
Professional Services	69	49089991.69	5.3
Royalties	8	30059224.51	3.2
Management Fees	18	29159178.77	3.1
Loans	10	23000085.48	2.5
Premium	32	19296919.7	2.1
Franchise Fees	23	1443142.27	0.2
Miscellaneous	30	17007550.31	1.8
Total	200	926585867.5	100

The Financial Soundness Indicators discussed above attributes a sound and healthy banking sector in 2016

2.3.2 AML/CFT Regulatory Framework

In 2016, the Central Bank of Lesotho continued to participate in regional forums including the Eastern and Southern African Anti-Money Laundering Group to ensure that issues of money- laundering and terrorist financing were addressed in all entities that are licensed and regulated. In its efforts to strengthen its legislative framework, the Central Bank organised a workshop in which the banking industry was made aware of their obligations under the Financial Institutions (Anti-Money laundering and Combatting of Financing of Terrorism) Regulations 2015. The regulations prescribe safeguards against the abuse of financial services.

The year 2016 was also marred with a number of mushrooming entities in the form of stokvel and pyramid schemes which to some extent threatened financial stability in Lesotho. The entities were alleged to have taken deposits from a number of people and had promised them huge profits. The Bank collaborated with other institutions including the Financial Intelligence Unit (FIU) and the Lesotho Mounted Police Service (LMPS) to ensure that the situation is contained and the public is alerted about the dangers of investing in pyramid schemes. Efforts also included directives to banks to report suspicious activities that could erode the soundness and stability of the banks and the economy ❑



3

Underwriting results is a measure of underwriting gain or loss that remains after paying off claims and underwriting expenses.

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INSURANCE SECTOR REVIEW

3.1 SHORT-TERM INSURANCE BUSINESS REVIEW

According to Section 5 (2)b of the Insurance Act 2014, short-term insurance business is general insurance business and includes property, accident and health, motor, transportation, engineering, liability and guarantee as specified in Part B of Schedule 1.

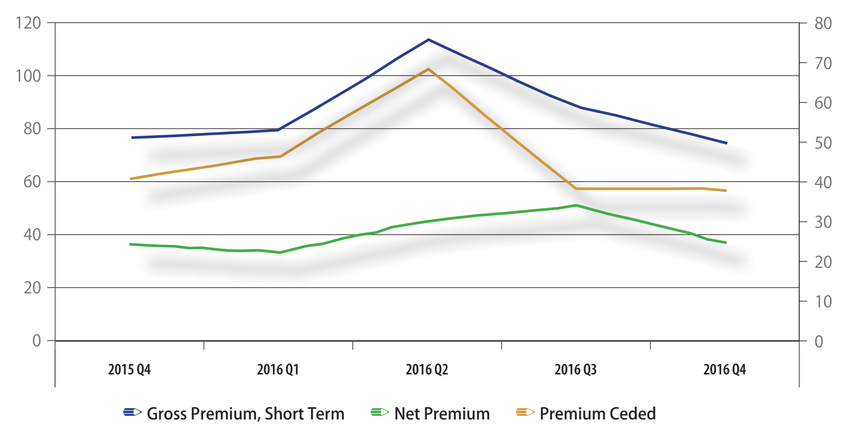
3.1.1 Underwriting Results

Underwriting results is a product of underwriting activity and could be a gain or a loss following claims and underwriting expenses.

Gross premium collected by the short term insurance industry increased by 8 percent to M354.2 million in 2016, from M329.2 million in 2015. Of the total gross premium collected for that year, the top 3 insurers contributed 89 per cent, while the remaining 3 insurers contributed 11 percent. This is an indication that this sector continues to be dominated by a few players, and as such there are opportunities by new entrants.

Premium ceded to reinsurers increased by 18 percent to M189.6 million in 2016, from 161.2 million in 2015. This is indicative of the short term insurance industry's unwillingness to shoulder more risk. The level of risk retained by the industry thus decreased to 46.5 per cent compared to 51.0 percent retained in 2015. This risk aversion by the sector is evident during the peak seasons as depicted by Figure 1 below, which indicate a widening gap between the gross premium collections and the net premium. This implies that more of the premium is being ceded to reinsurers as new business is been acquired, or put in other words, as insurers take on more risk.

Figure 16 Underwriting Results (Short-term Insurance)



Source: Central Bank of Lesotho

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From this reinsurance arrangement, the industry short-term insurance sector realized a 38 percent rise in commission income, which totalled M53.0 million in 2016 compared to M38.5 million received in 2015. Commission income is revenue the industry receives from reinsurers for premium ceded to them. The rise in commission income is in line with the increase in premium ceded to reinsures.

Total underwriting expenses rose by 17 percent to M191.1 million from M163.5 million incurred in the 2015, mainly due to increases in management expenses and net claims incurred, which rose by 27.0percent and 14 per cent respectively. This indicates a need for the industry to control management expense and to improve on efficiencies so that more of the policy holders' funds are channeled to productive use.

Following the increase in the total underwriting expenses and an increase of 92 percent in other expenses , the industry recorded a 61 percent decline in profit before tax to 20.2 percent.

3.1.2 Assets

The industry registered an improvement of 14.3 percent of total assets to M404.3 million in the reporting year from M353.8 million in the preceding year. This was attributable to a significant increase in long-term investments by 455.7 per cent. Long-term investments form 41.4 per cent of total assets. The remaining 58.6 per cent is shared between short term investments, amounts due from reinsurers, outstanding premiums and loans to related parties.

3.1.3 Equity and Liabilities

Shareholders' funds (capital and reserves) reported a gain of 7.9 percent to M116.9 million in 2016, from M108.3 million in 2015, driven by accumulated profits.

The short-term insurance industry reported a rise of 21.0 percent in technical provisions to M249.9 million in the reporting period thus showing increased ability of the sector to meet its policy obligations as they fall due. This increase in provisioning is most desired given that the claims experience. In addition to this, the sector remained highly liquid with the liquidity ration 623.6 percent, supplementing the provisioned capital and adding on the solvency position of the sector..

3.1.4 Financial Soundness Indicators

Financial soundness indicators (FSIs) provide an insight into the financial health of insurance companies. Below are FSIs for the short term industry.

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Premium ceded to reinsurers increased by 18 percent to M189.6 million in 2016, from 161.2 million in 2015.

Table 9	Financial Soundness Indicators (Short-term Insurance)		
Category	**Indicator**	**Level (%)**	
Capital Adequacy	Capital to Liabilities	40.7	↓
	Capital to Assets	28.9	↓
Asset Quality	Premium Receivable to Gross Premium	10.6	↑
	Investment to total Assets	64.9.	↓
Reinsurance	Retention ratio	46.5	↓
Actuarial Liabilities	Claims incurred to outstanding claims Prov.	71.2	↓
	Unearned premium provision to gross premium	26.3	↓
Management Soundness	Operating expenses to gross premium	37.6	↑
Earnings	Loss ratio	40.0	↑
	Expense ratio	48.8	↑
	Investment Income to net premium	8.6	↓
	Return on Equity	17.3	↓
Liquidity	Liquid Assets to Current Liabilities	623.6	↓

The Financial Soundness indicators show the possibility of credit risk as indicated by the increase of the ratio of premium receivable to gross premium. This is substantiated by increase in outstanding premiums by 18.1 percent to M37.6 million. This implies need for more effective collection strategies within the industry. In addition to this, the industry does not manage its expenses well. Both underwriting and operating expenses have an increase of 11 and 18 per cent respectively. This in turn is reflected in the decline in profitability of the sector as shown by the by 64 percent decline in Return on Equity. On the positive side, the sector is liquid enough to cover its short term obligations as they fall due as seen by the liquidity ratio which is greater than 500 per cent.

3.2 LONG-TERM INSURANCE BUSINESS

In terms of 5 (2) (a) of the Insurance Act 2014, long-term insurance business means "life insurance business comprising all types of life policies of a class specified in Part A of Schedule 1". Life, health, assistance, disability, fund and sinking fund are listed as classes of long term insurance business in that Schedule.

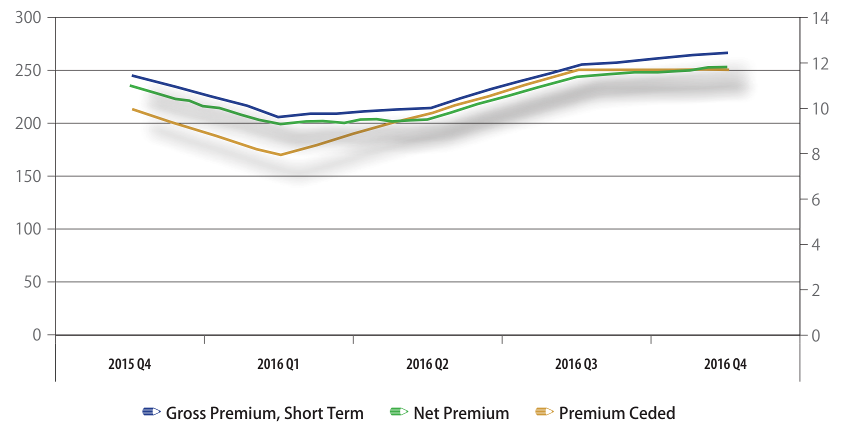
3.2.1 Underwriting Results

Gross premium collected by the long term insurance industry increased by 6.0 percent to M971.7 million in 2016 from M916.7 million in 2015. 98 per cent of gross premium is contributed by top 3 insurers in the long term industry while 2 percent is contributed by the remaining 3 insurers.

INSURANCE SECTOR REVIEW

Premium ceded increased by 25.4 percent to M41.0 million in 2016 from M32.7 million in 2015. Despite the increase in premium ceded to reinsurers, the industry's net premium rose by 5.3 percent to M930.7 million in 2016, from M884.0 million in 2015 following the aforesaid rise in gross premium collected. Over time the same pattern is observed. Figure 2 below shows that as gross premium increases net premium also increases in line with that increase. This implies that the amount of premium ceded does not change significantly as new business is acquired meaning that more risk is retained within the industry.

Figure 17 Underwriting Results (Long-term Insurance)



Source: Central Bank of Lesotho

Claims incurred increased by 12.9 percent to M501.2 million in 2016 from M443.9 million in 2015. The insurers do not have any control on the occurrence of claims incurred, but they are expected to act prudently by holding adequate funds to absorb policyholders' liabilities. This is apparent from the high ratio of claims incurred to outstanding claims provision of 865.3 percent.

Commission expenses on the other hand decreased by 3.4 percent to M132.2 million in 2016 from M136.8 million recorded in 2015. Management expenses increased by 36.3 percent to M194.5 million in 2016, from M142.7 million incurred in 2015, signaling the need to contain expenses by management. The increase in management expense led to a 37.6 decrease in underwriting profit to M103.1 million in 2016 compared to M165.1 million in 2015.

Similarly, investment income registered a decline of 20.6 percent to M194.4 million in 2016, from 244.8 million in 2015 while other expenses increased to M212.2 million from M55.6 million in the preceding year. The in investment income and other expenses changes led to a 65.2 percent decrease in profit before tax to M132.7 million in 2016

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Claims incurred increased by 12.9 percent to M501.2 million in 2016 from M443.9 million in 2015.

3.2.2 Assets

Total assets of life insurance business rose by 8.3 percent to M4.9 billion in 2016, from M4.5 billion in the prior year. The long-term insurance sector, by its nature, requires higher long-term investments than short-term investments to match the long-term policyholders' obligations and promised return. The industry, therefore, acted prudently by increasing long-term investments by 13.1 percent to M3.4 billion in order to secure high investment returns.

Bank and cash balances declined to M66.1 million at the end of 2016, from M222.6 million in the previous year, as funds were invested in longer term investments.

3.2.3 Equity and Liabilities

Shareholders' wealth improved by 9.3 percent to M1010 million in 2016 from M924.1 million in 2015. This was due to a rise in accumulated funds and share capital by 17.2 and 11.8 per cent, respectively.

The sector is very liquid as evidenced by the ratio of current assets to current liabilities which exceeds 700 per cent. This indicates that the sector will not have any problem in settling short term policyholder's obligations should they fall due.

3.2.4 Financial Soundness Indicators

Below is an analysis of Financial Soundness Indicators for the Long-term sector.

Table 10 Financial Soundness Indicators (Long-term Insurance)

Category	Indicator	Level (%)	
Capital Adequacy	Capital to Liabilities	25.8	↑
	Capital to Technical Provisions	808.4	↑
Asset Quality	Premium Receivable to Gross Premium	34.9	↑
	Investments to total Assets	83.4	↓
Reinsurance	Retention ratio	95.8	↓
Actuarial Liabilities	Claims incurred to outstanding claims Prov.	865.3	↑
Management Soundness	Operating expenses to gross premium	107.0	↑
Earnings	Loss ratio	100.0	↓
	Expense ratio	68.1	↑
	Investment Income to net premium	20.9	↓
	Return on Equity	13.1	↓
Liquidity	Current Assets to Current Liabilities	782.6	↓

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The Financial Soundness Indicators depict a significant increase in premium receivable to gross premium. This implies a possibility of credit risk and a need for better collection strategies by the sector. Reduced profitability is also seen within the sector as shown by the negative Return on Equity which is driven by high operating expenses and low investment income as seen by the operating expense to gross premium ratio and the investment income to net premium ratio respectively. The industry therefore needs to manage its expenditures while investing in lucrative securities/markets to increase the investment income. On the upside the sector has capacity to cover both its long and short term obligations should they fall due. This is depicted by the high and increasing capital adequacy ratios as well as the positive liquidity ratio.

3.3 COLLECTIVE INVESTMENT SCHEMES, PENSIONS AND SECURITIES

3.3.1 Licensing

The number of formally registered asset managers remained the same at four at the end of 2016. While only two of the four licenced asset managers had locally registered collective investment schemes, there were no new applications for registration of collective investment schemes from the two asset managers licenced in 2015. The number of active and registered collective investment schemes therefore remained at five, four managed by STANLIB Lesotho (Pty) Ltd and one by African Alliance Lesotho Management Company (Pty) Ltd. African Alliance Lesotho Management Company (Pty) Ltd, however, indicated its intention to wind up the only collective investment scheme it managed in the next review period due to stagnant business.

It will be observed that the fund management industry is still monopolistic and dominated by one big player. The industry is expected to develop with the mobilisation long term savings brought about by the envisaged Pensions Law.

Oversight and regulation of collective investment schemes in Lesotho is guided by the Central Bank of Lesotho (Collective Investment Schemes) Regulations 2001. The review of these regulations to ensure that they conform to relevant and current international best practices, continued during the review period, and was expected to be completed in 2017.

Capital markets are regulated in terms of Central Bank (Capital Markets) Regulations, 2014. During the review period, a number of licence applications were received in the various categories of market players on the Maseru Securities Market, resulting in one broker-dealer and one investment advisor satisfying the requirements and subsequently being licenced. Efforts were being made to sensitise and encourage entities that were identified as eligible to list their stocks on the market.

During the review period, the Central Bank together with relevant stakeholders completed the process of drafting the Pensions Bill together with implementing regulations for oversight and regulation of pension funds in Lesotho. The Pensions Bill is at advanced stage and the expectation is that it will be enacted by the Parliament soon enough for this important sector to be regulated.

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The Financial Soundness Indicators depict a significant increase in premium receivable to gross premium

3.3.2 Market Share

STANLIB Lesotho (Pty) Ltd controlled a larger market share in terms of total assets under management and a number of funds being managed. These funds were placed in various types of investment categories including call deposits, fixed deposits, negotiable certificates of deposits, Bonds and other collective investment schemes. At end of last quarter of 2016, STANLIB Lesotho held 97 per cent (or M1.801 billion) of the market while African Alliance held the remaining 3 per cent at M0.052 billion. The level of market share gave STANLIB Lesotho (Pty) Ltd a considerable degree of systemic significance.

3.3.3 Compliance

A non-compliance issue recorded during the review period involved failure to appoint a principal officer by one of the asset managers in contravention of Regulation 35 (2) of the Central Bank of Lesotho (Collective Investment Schemes) Regulations 2001. All these hampered monitoring and timely analysis of the health of the industry. Remedial actions were however taken to ensure compliance.

3.3.4 Sector Performance

The overall performance of the collective investment schemes industry has shown a stable and sound financial position. The combined assets under management grew from M1.544 billion as at the end of 2015 to M1.853 at the end of 2016.

The funds consolidated operating profits totalled M 35.100 million at the end of the review period with the combined income. The combined income comprised interest received and dividends ❑

4

The legal and regulatory environment in Lesotho provide for both deposit taking MFIs as well as the credit-only MFIs.

NON-BANKS FINANCIAL INSTITUTIONS REVIEW

4.1 OVERVIEW OF THE NON-BANK FINANCIAL INSTITUTIONS

The Non-Banks Financial Institutions comprise of a diverse set of financial institutions as per the following categories and their relevant pieces of legislations:

- Micro-Finance Institutions (MFIs) under the Financial Institutions (Credit Only and Deposit Taking Micro-Finance) Regulations of 2014.
- Money Transfer under the Financial Institutions (Money Transfer) Regulations of 2014
- Credit Bureau under the Credit Reporting Act 2011 and Credit Reporting Regulations 2013.
- Financial Leasing Under the Financial Institutions (Financial Leasing) Regulations of 2013.
- Money Lenders Amendment Act of 1993.

This set of financial institutions are supervised by the Non-Banks Supervision Division which is also tasked with several projects aimed at building requisite financial infrastructure and fostering financial inclusion and access to finance.

4.2 MICROFINANCE SUB-SECTOR IN LESOTHO

4.2.1 Introduction

Microfinance Institutions (MFIs) in Lesotho are supervised and regulated by the Central Bank of Lesotho under the Financial Institutions Act 2012 and the Financial Institutions (Credit only and Deposit Taking Microfinance Institutions) Regulations 2014. These Regulations are currently under amendment as part of the World Bank Technical Assistance under the First Initiative. The amendments, amongst others, seek to create a more conducive environment for MFIs to operate effectively and efficiently by creating a more accommodative regulatory environment.

4.2.2 Overview of MFIs

The legal and regulatory environment in Lesotho provide for both deposit taking MFIs as well as the credit-only MFIs. In the year under review two new credit-only MFIs were licensed and as at 31st December 2016, there were nine licensed Credit-Only MFIs and no licensed deposit taking MFIs operating in Lesotho. The MFIs subsector is predominantly foreign owned and the market share is highly concentrated towards two largest credit-only MFIs.

Credit only MFIs operating in Lesotho predominantly serve the salaried government and private employees with personal loans of up to M250,000.00 and mitigate the risk of non- payment by deducting from source. However, it is worth noting that these personal loans are both for consumption and investment. The market being served by MFIs is already being served by the formal banking sector and therefore MFIs are making little impact to the unbanked, under banked population and MSMEs in terms of credit extension.

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NON-BANKS FINANCIAL INSTITUTIONS REVIEW

Non-compliance in general, financial education and literacy remained a challenge for MFIs in 2016. As part of its effort to address these challenges, the Bank intensified compliance seminars for MFIs and awareness campaigns for consumers and the general public. The asset base of the subsector grew by 32 per cent per cent year-on-year from M528 million in December 2015 to M698 million by December 2016. Non-current assets grew by 35 per cent year-on-year while non-current liabilities grew by 36 per cent year-on-year in the year under review.

Long term loans extended to the public grew 37 per cent while provisioning for doubtful debts had fallen by 48 per cent by end of the year. Accounts receivable saw a 36 per cent decline in the year under review. Total liabilities excluding equity grew by 24 per cent from M467 million in 2015 to M580 million in the year under review.

Credit–Only MFIs do not take deposits and are currently not able to raise funds from the banking sector. To finance their credit operations, these are primarily funded through loans and equity from their owners. The Credit–Only MFIs consolidated balance sheet is therefore dominated by loans and advances extended to the general public on the assets side and on the other side liabilities are primarily dominated by loans from creditors and shareholders funds. Shareholder's equity for MFIs grew by 11 per cent from M4.7 million to M5.2 million by end of 2016. While this is a massive investment, it is worth noting that most of these institutions are capitalized through funds raised internationally, implying a heavy capital outflow in the name of interest expense and management fees, leaving lower tax revenue for the country.

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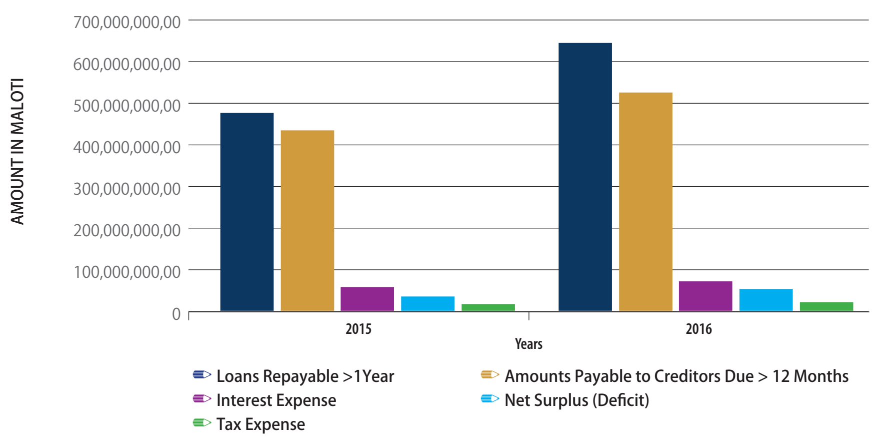
Non-compliance in general, financial education and literacy remained a challenge for MFIs in 2016.

Figure 18 Micro-Finance Size and Performance



Source: Central Bank of Lesotho

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The MFIs subsector financial performance showed strong growth and remained profitable in the year under review. It realized profits of M49 million in the year under review amounting to 62 per cent increase year-on-year compared to 2015. Total income for the sub-sector increased 42 per cent from M137 million in 2015 to M195 million in 2016. Interest income constituted 77 per cent of the entire earnings while fees and other income contributed 23 per cent of the earnings in 2016.

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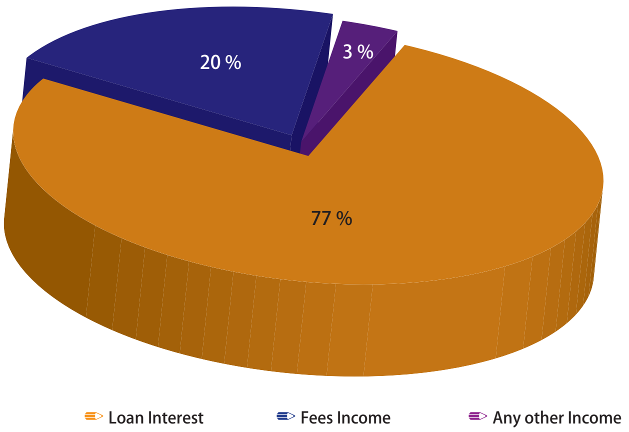
Figure 19 Share of Microfinance Earnings 2016



Source: Central Bank of Lesotho

Return on assets in the microfinance sub-sector for the year ended December 2016 was 10 per cent, a 2 percent increase from 8 percent in December 2015. Shareholders' funds returned 41 per cent in surplus, 9 per cent less than the return realized in 2015.

Non-performing loans for the credit-only MFIs as at 31st December, 2016 increased to 6.1 per cent from 5.1 per cent of total assets in the previous period. This increase provides an early warning sign of over-indebtedness currently prevailing in the market. Despite this increase, the Credit-only MFIs sector is seen to have maintained a good quality of its credit portfolio since the percentage is still below the international standards. This is aided by the efficiency of borrowers' screening as a result of improved credit information reporting by the microfinance institutions.

4.2.3 Conclusion

Overall, the microfinance sub-sector showed strong growth both in assets and performance in the year under review. This is attributed to an increase in the number of licensed microfinance institutions, increase in investment in this industry and improved credit underwriting due to the use of the credit information bureau amongst others. The subsector is expected to show strong growth going forward as more MFIs are expected to come on board and venture into the MSMEs space and also lend to the unbanked.

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4.3 MONEY TRANSFER INSTITUTIONS

4.3.1 Introduction

In 2014 the Government of Lesotho published Financial Institutions (Money Transfer) Regulation 2014 under which Money Transfer institutions are now licensed, regulated and supervised. According to these Regulations, money transfer business refers to the business of transferring money from one person to another or the equivalent amount in the local currency to another person against a fee or commission.

The rational of bringing Money Transfer under a regulatory framework arose over concerns of increasing remittances made through unsecure informal channels and emerging global challenges of money laundering and terrorism financing. In addition, flow of remittances has been increasing over time thus contributing significantly to the country's foreign exchange flow.

Money Transfer Institutions provide a formal and critical conduit through which payments are made and remittances are transferred for households and business purpose in a safe manner. These institutions play a critical role in fostering financial inclusion and access to finance which is one of the main objectives of the FSDS.

4.3.2 Financial Performance in 2016

The Central Bank of Lesotho, up to this end, has licensed two stand-alone money transfer institutions, namely: Interchange Lesotho and Inter Africa Bureau de Change. Their main service is transfer of funds from Lesotho to the rest of the world and vice versa. These companies are also licensed to operate as exchange bureaus.

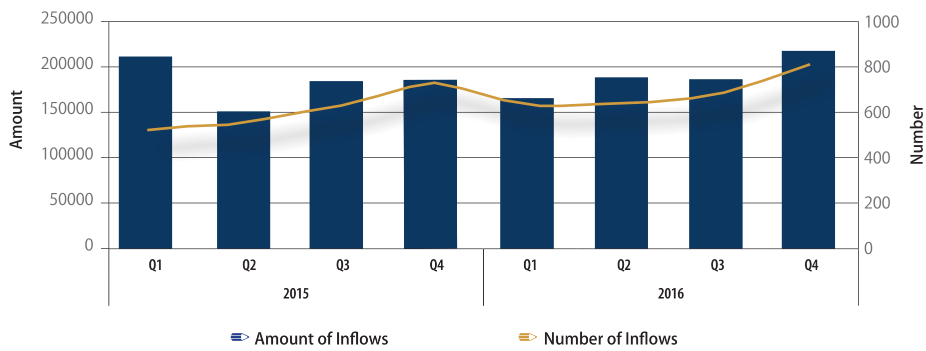
The entire money transfer sector has increased significantly in the year under review as compared to previous year. The total assets of the sub-sector have increased by 35% from last quarter of 2015 to the last quarter of 2016 as a result of coming into operation of one more money transfer and the expansion of branch network by the other money transfer company. Nonetheless, the profitability of the sub-sector in the year under review has contracted as compared to performance in the year 2015. Return on assets in 2016 was 12 per cent compared to 27 per cent declared in 2015 and return on equity in 2016 was 20 per cent as compared to 28 per cent reported in 2015.

The main factor that has contributed to this contraction in profitability is the 24 per cent increase in expense contrary to 4 per cent increase in income. The higher increase in expense versus a lower increase in income reflects the lower returns in the short-run from the new investments being made in the sub-sector. The main contributor to this sub-sector's total income is money transfer which accounts for 83 per cent of the income while foreign exchange activities account for only 17 per cent of the business.

4.3.3 Inflow Transactions

The inflow transactions for the year 2016 can be divided into two groups: Inflows denominated in US Dollars from the rest of the world and inflows denominated in Rand from South Africa only. In volumes, there were 2749 inflow transaction in US Dollar denomination amounting to US$ 764,454.92 while there were 4855 inflow transactions denominated in South African Rand amounting to R2,626,470.00. In the year under review, the amount of inflow transactions in US dollar increased by 10 per cent quarterly and 4 per cent annually. The aggregate inflow transactions in 2016 amounted to US$ 957,105.40.

Figure 20 Amount and Number of Inflows of Transactions in US$

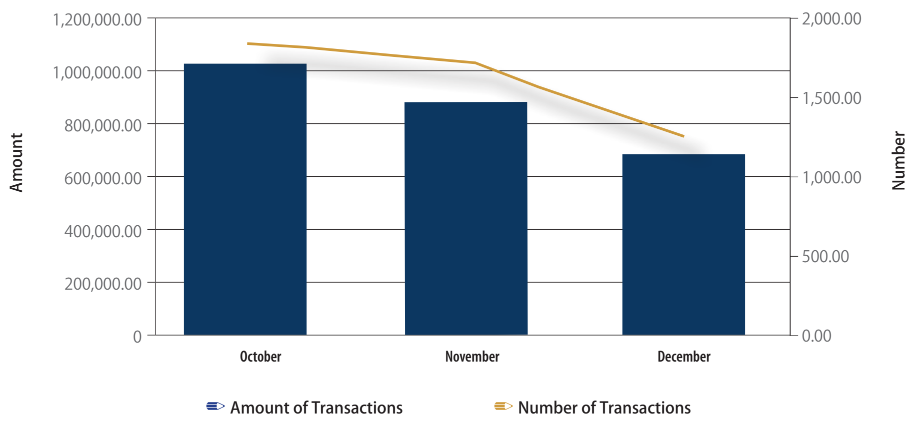


Source: Central Bank of Lesotho

This sub-sector has for a long while not operated the South African corridor but during the last quarter of the year under review, the South African corridor was opened only on an inbound basis. The figure below depicts inflows from South Africa and portrays a declining trend both in number and amount of transactions from October to December 2016. This fall is attributable to the flow of migrant workers towards the festive season. During the festive season, migrant workers come home and physical bring money and hence why they remit less through money transfer platforms.

The aggregate inflow transactions in 2016 amounted to US$ 957,105.40.

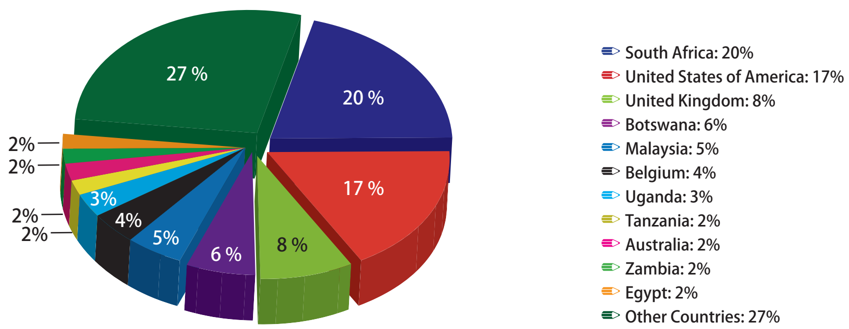
Figure 21 Amount and Number of Inflows of Transactions in Rand from South Africa



Source: Central Bank of Lesotho

Money transfer platforms in Lesotho are able to receive funds from many countries in the world across all the continents. The figure below shows the 2016 percentage share of inflow transactions amount by country of origin. The depiction shows that the highest percentage share, 20 per cent of inflow transactions came from South Africa, followed by United States of America which accounted for 17 per cent, next was United Kingdom with 8 per cent and Botswana accounted for 6per cent. This picture may relatively be associated with statistics of Lesotho migrant workers living abroad. The highest recipients of Lesotho immigrants are South Africa, United State of America, United Kingdom and Botswana.

Figure 22 Inflows by Countries of Origin in 2016



Source: Central Bank of Lesotho

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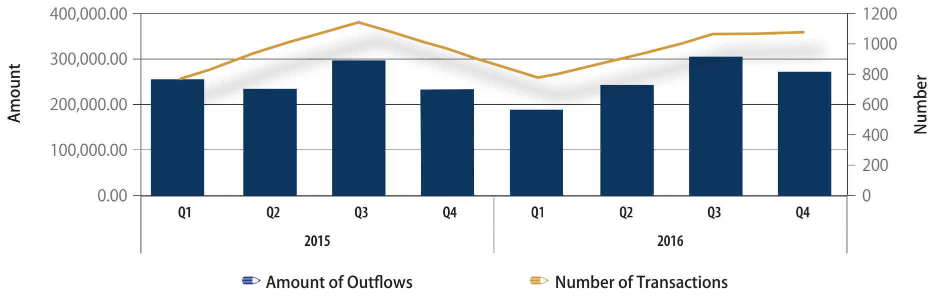
4.3.4 Outflow Transactions

In 2016, the number of outflows remitted through the money transfer platform has been on the increase during the year recovering from fall in the first quarter. It registered an average increase of 12 per cent on a quarterly basis but declined by 1 per cent from 2015 to 2016. The amount of outflows remitted through the money transfer platform has also been on the rise except for the decline in the 4th quarter of 2016. It registered an average increase of 14 per cent on a quarterly basis but fell by 1 per cent on an annual basis. As the end of December 2016, the number and amount of transfers aboard excluding South Africa stood at 3824 and US$ 1,014,333,23 respectively.

Figure 23 Number and Amount of Outflow Transactions in US$

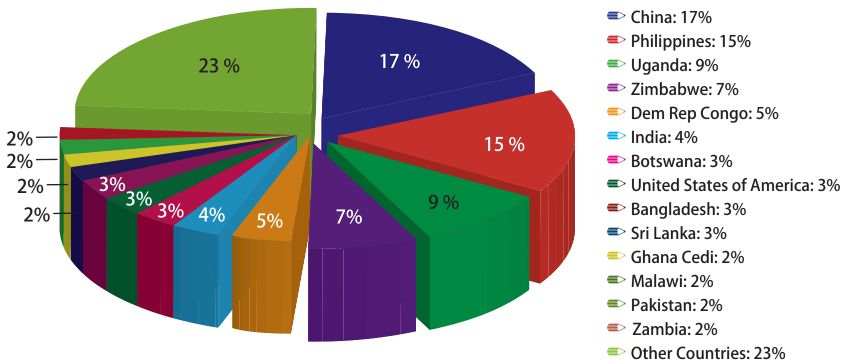


Source: Central Bank of Lesotho

The money transfer sub-sector in Lesotho is also able to remit funds to many countries globally. In the year 2016, outflow transactions by country of destination mostly went to China with 17 per cent; followed by Philippines with 15 per cent; Uganda with 9 per cent; and Zimbabwe with 7 per cent. This is in line with the number of migrant workers of these countries in Lesotho. South Africa is a special case, where the transfer of funds is largely made through the banking sector and other channels given the level of integration and the linkage between Lesotho and South African banking system.

Money transfer platforms in Lesotho are able to receive funds from many countries in the world across all the continents.

Figure 24 Outflow by Country of Destination in 2016



Source: Central Bank of Lesotho

The outflow transactions are mostly destined to Asian and African countries while inflow transactions are mainly from South Africa, Europe and North America. Money transfer sector is mainly utilised by migrant workers to send money home for households' consumption and to a lesser extent for business or productive purposes. Therefore the picture above portrays the dynamics of immigrants in and out of Lesotho. Large proportions of Migrants from Lesotho, excluding South Africa, settle in the United Kingdom and North America while many immigrants in Lesotho are of Asian and African descent.

4.3.5 Net Flows

Given the skewed-to-right distribution of immigrants in Lesotho, in aggregate money transfer platform outflow transactions in amount exceed inflow transactions significantly by 6 per cent. Net flow has been negative until last quarter of 2016 when inflows from South Africa came through money transfer conduit. As per money transfer subsector, Lesotho was running a deficit net flow in this subsector. This is in line with the greater number of migrants from abroad than migrants from Lesotho to the rest of the world. However, this deficit does not hold across all countries. Asian and some African countries reflect greatest deficit but South Africa, North American and European countries shows greatest surplus.

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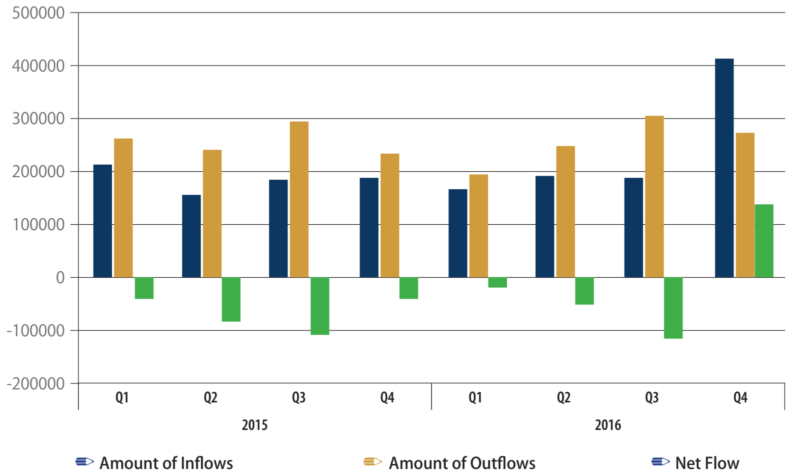
Figure 25 Transactions Net flow in US$ (2015/2016)



Source: Central Bank of Lesotho

4.4 CREDIT INFORMATION SHARING IN LESOTHO, 2016

4.4.1 Overview

Credit information reporting and sharing system in Lesotho comprises the private credit providers, credit information bureau, the Central Bank of Lesotho and Government. This system is established to create a sound financial infrastructure that facilitates access to credit for consumers and businesses in Lesotho while at the same time improving lending practices by credit providers, thereby curbing credit risk and facilitating extension of credit in the country. The Central Bank of Lesotho (CBL) supervises both the financial institutions and the credit information bureau in the country to ensure that all credit providers share their debtors' credit information with the credit bureau timeously.

During the year ended December 2016, the following developments are highlighted:

- The number of persons recorded in the credit information bureau rose to 100,000;
- There were over 130,000 accounts recorded in the bureau; and
- The number of accounts with adverse status fell 12 per cent by end of the year.

Credit information reporting and sharing system in Lesotho comprises the private credit providers, credit information bureau, the Central Bank of Lesotho and Government.

4.4.2 Credit Information Analytics

During the year under review, the number of total loans recorded at the bureau amounted to M9.4 billion, 13 per cent of which were on mortgage accounts, 8 per cent were vehicle and asset finance, while unsecured credit transactions weighed at 79 per cent of total credit.

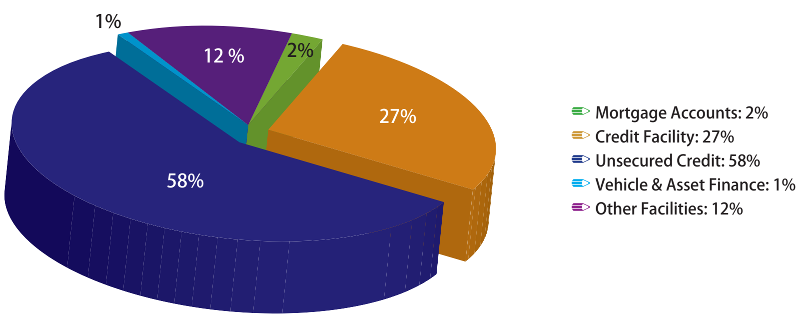
Consumers of age groups 30-49 were the most active in the credit market in the year under review. Unsecured loans and other credit facility accounts are the most credit products which the majority of consumers took in the year under review. The number of accounts for Mortgages, credit facilities, unsecured loans, other credit facilities and vehicle and asset finance accounts have all grown in the year under review.

Even though the number of persons who were 3 months in arrears slightly declined by 2.11 per cent year-on-year, the number of up-to-date accounts recorded in the bureau had declined by 34 per cent year-on-year compared to last quarter of 2015.

4.4.3 Annual Credit Activity Growth by Product Type

There were over 130,000 credit accounts recorded in the credit bureau system by the end of 2016.

Figure 26 Share of Volumes of Credit Activity by Product Type



Source: Central Bank of Lesotho

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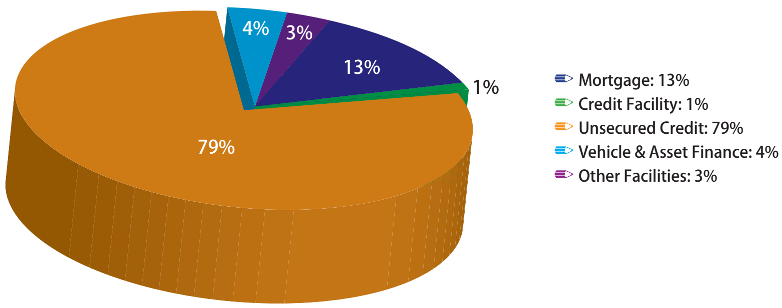
In volumes, unsecured credit accounts dominated the credit market at 58 per cent in the year under review reflecting 11.1 per cent growth year-on-year. The second highest product type was credit facilities at 27 per cent, highlighting a 10 per cent growth on year-on-year. Vehicle and asset finance accounts recorded in the credit bureau were only 1 per cent of total consumer accounts in 2016, despite 8.65 per cent growth year-on-year.

Figure 27 Share of Values of Credit Activity by Product Type



Source: Central Bank of Lesotho

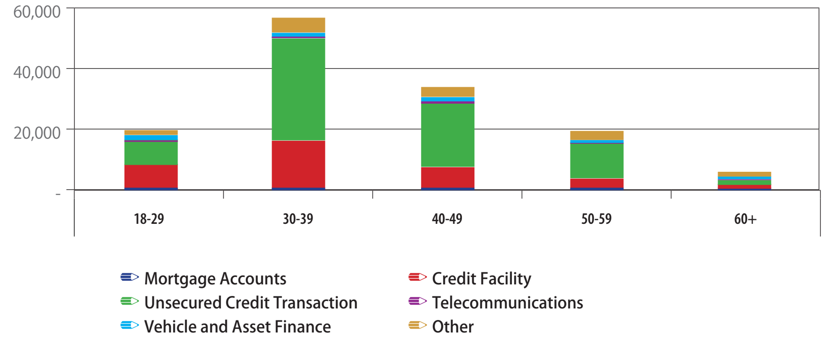
In values, the picture generally portrays a similar picture albeit with varying magnitudes. Unsecured credit accounts still dominated the credit market at 79 per cent, however, followed by Mortgage with 13 per cent and vehicle and asset finance with 4 per cent. Although credit facilities are many in volumes they are very low in volumes accounting for only 1 per cent of the total credit extended.

4.4.4 Credit Activity by Consumer Age

Credit consumers in the age groups 30-39 and 40-49 are the most active in the credit market in line with the fact that these are the most economical active age groups. As far as the variations in terms of the type of credit across all age groups, the picture remains more or less the same with unsecured credit and other credit facilities dominating.

In volumes, unsecured credit accounts dominated the credit market at 58 per cent in the year under review reflecting 11.1 percent growth year-on-year.

Figure 28 Underwriting Results (Short-term Insurance)



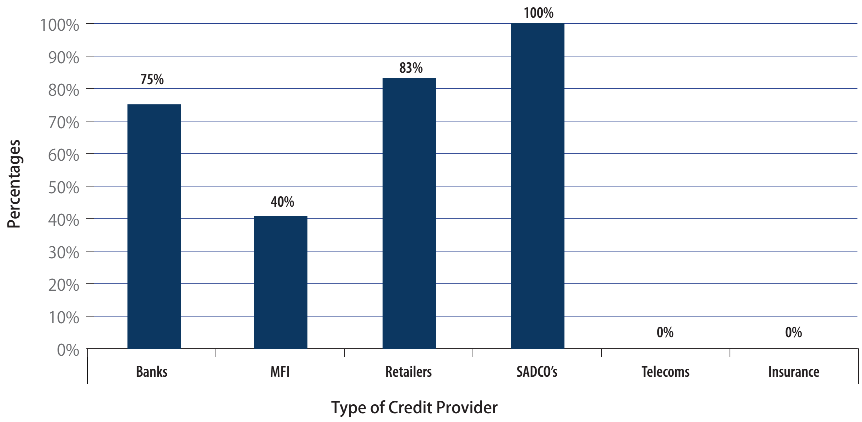
Source: Central Bank of Lesotho

Consumers in the age group of 40-49 are most active in the mortgage loans while those in the age group of 30-39 are reported to be dominating the vehicle and asset finance loans as portrayed in graph 1. It is observed that more consumers have mortgage accounts than vehicle and asset finance accounts. Consumers in the age group of 30-39 dominated the unsecured loans and credit facilities in the year under review. This is followed by a group of 40-49 where 21 thousand consumers had unsecured loan accounts.

4.4.5 Credit Reporting Status by Type of Credit Provider

There were 27 credit providers registered with the credit bureau as data providers as at 31 December 2016. 14 credit providers were reported as successfully uploading data in the credit information bureau system. These comprised of microfinance institutions, banks, retailers and savings and credit cooperatives. Money lenders, insurance companies and telecommunications companies were not successful in their efforts to share credit information of their clients with the credit information bureau.

Figure 29 Status of Credit Information Reporting by Credit Providers



Source: Central Bank of Lesotho

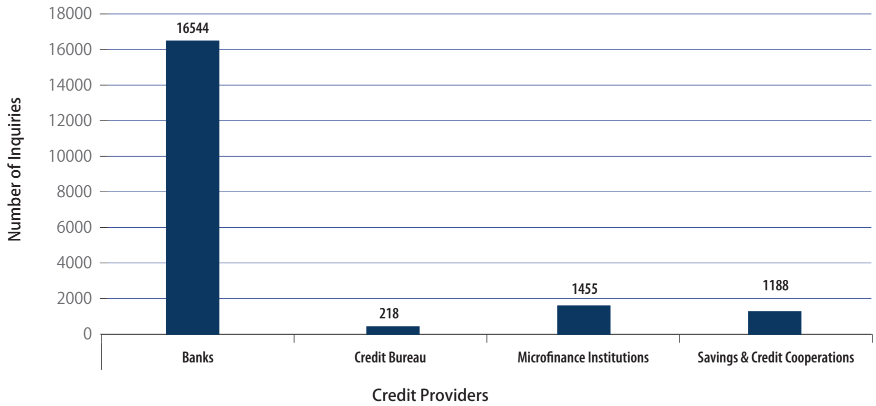
The participation rate of credit providers to the credit information bureau as at December 2016 depicts that data for only 3 Banks was live on the bureau while that of MFIs recorded only 40 per cent. Credit data for 83 per cent and 100 per cent of retailers and SACCOs respectively were live while telecommunications, insurance and money lenders data was not yet live or being tested.

4.4.6 Credit Providers Inquiries

Credit providers are required by law to make proper risk and affordability tests of their prospective clients prior to granting credit. The credit information bureau system provides comprehensive credit history of consumers to aid credit underwriting. To view consumer history, credit providers undertake credit checks of consumers in the credit bureau system. The credit information bureau then reports on the number of these hits per sub-sector.

There were 27 credit providers registered with the credit bureau as at 31 December 2016.

Figure 30 Credit Providers Inquiry Hits



Source: Central Bank of Lesotho

In the year under review, a total of 19 thousand hits were reported. Microfinance institutions made 1.4 thousand hits while banks were reported to have made 16.5 thousand hits. Retailers, telecommunication companies and other credit providers were reported to have not made any inquiries in this year since their data was still not yet live on the bureau.

4.5 CONSUMER ACCOUNTS STANDINGS

Consumer accounts standings showed an overall decline year-on-year by the end of 2016. While the number of persons with credit records grew 9.38 per cent year-on-year, persons whose accounts are up-to-date have declined by 56.63 per cent year-on-year, this is a negative indicator for risk and affordability of consumers in the credit market in Lesotho. The number of persons whose worst position is an adverse enforcement has also risen 55.39 per cent year-on-year. These indicators point to the fact that many consumers may be under financial stress in the year under review.

Table 11 Consumer Standings as at 31 December 2016

Description	Q4 2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016	Y/Y
Total number of natural persons recorded in the bureau system	91,190	90,757	95,064	97,592	99,742	9.38%
Total number of natural persons with a credit record	90,479	89,923	94,159	96,550	98,685	9.07%
Persons with up-to-date accounts	51,641	51,065	49,544	24,346	22,396	-56.63%
Up-to-date accounts %	57.08%	56.79%	52.62%	25.22%	22.69%	-34.38%
Persons with worst position 1-2 months in arrears	7,823	7,939	7,858	7,000	6,446	-17.60%
Persons with 1-2 months arrears %	9%	9%	8%	7%	7%	-2.11%
Persons with worst position 3+ months in arrears	8,563	8,337	9,831	8,360	7,470	-12.76%
3+ months in arrears %	9.46%	9.27%	10.44%	8.66%	7.57%	-1.89%
Persons whose worst position is an adverse enforcement status code	10,705	10,731	12,703	14,816	16,635	55.39%
Adverse position %	11.83%	11.93%	13.49%	15.35%	16.86%	5.03%

Source: Central Bank of Lesotho

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5

Since its launch in 2006, Lesotho Wire (LSW) has been the backbone of the payment and settlement system in Lesotho.

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DEVELOPMENTS RELATED TO SUPERVISION

5.1 LESOTHO WIRE PERFORMANCE IN 2016

Since its launch in 2006, Lesotho Wire (LSW) has been the backbone of the payment and settlement system in Lesotho. In 2016, this system continued to process and settle significant interbank transactions in the country. In 2016, the system processed and settled a total of 23,917 transactions valued at approximately M34.26 billion compared to 27,683 transactions to the tune of M28.06 billion processed and settled in 2015. On the one hand, this represents approximately 7% decline in terms of transaction volumes from 2015. On the other hand, it represents 22% growth in terms of transaction values from the same year. On average, this system processed and settled a total of 26,816 interbank transactions valued at approximately M27.92 billion per year between 2013 and 2016. The magnitude of these transactions indicates the significance of this system to the economy of Lesotho.

5.2 MOBILE MONEY PERFORMANCE IN 2016

Development of the financial leasing market is identified by the FSDS as an integral reform in addressing financial inclusion Mobile money continued with its phenomenal growth in 2016. Mobile network operators registered a total of 6,479 agents throughout the country in 2016, which was a 77% growth compared to the number of agents in 2015. Despite the growth in agents the number of active agents as a proportion of total agents remained at the low ebb at 32%. This was due to amongst others lack of agents and customer education relating to mobile money in some areas. Regarding the number of transactions both MNO's processed a combined total of 29.69 million transactions, valued at around M4.21 billion, representing a 77% and 116% growth in volumes and values respectively from the 16.76 million transactions valued at around M1.95 billion in 2015. The foregoing notwithstanding, there were some teething problems that continued to plaque the mobile money service provision during the period under review, specifically these challenges are first; the agents' distribution is skewed towards urban areas. Second; the lack of liquidity by agent networks continued to dissuade an increased usage of the service.

5.3 LESOTHO SCALING INCLUSION THROUGH MOBILE MONEY (SIMM) PROJECT

In 2016, the CBL as one of the main stakeholders participated in the planning phase of the Lesotho Scaling Inclusion through Mobile Money (Lesotho SIMM) project. Lesotho SIMM is a project conceptualised by the United Nations Development Programme (UNDP) to foster the development of an inclusive business ecosystem in Lesotho. Specifically, the project intends to improve access to financial services for the poor through the development of an inclusive ecosystem for mobile financial services. To achieve its objectives the project has brought together the CBL, local MNO's, Ministry of Finance, UNDP, Finmark Trust, commercial banks and other relevant stakeholders in the country. Moreover, the project objectives have been broken down further into four key pillars for ease of implementation, these pillars are first; policies and incentives; this involves the development of a financial inclusion policy framework. Second, product development;

concentration in this stream is on fostering financial inclusion through innovation of inclusive and sustainable solutions. Third is financial literacy that focuses mainly on supporting the implementation of financial education for existing and potential mobile money users. Fourth, capacity of agents; this entails identifying agents' capacity needs so as to develop their training programs. This project was officially launched in May 2017 and is expected to be completed in 2019.

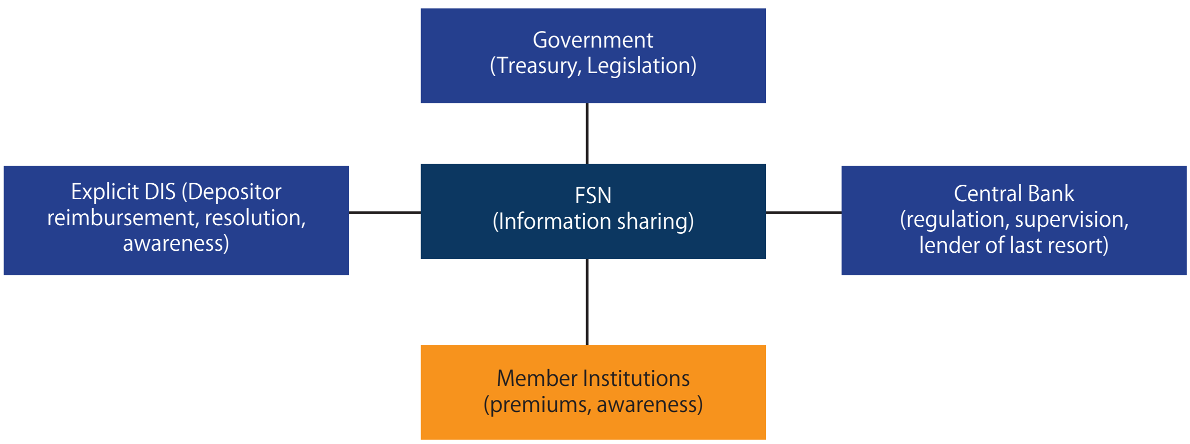
5.4 DEPOSIT PROTECTION

Efforts for the establishment of a Deposit Insurance System (DIS) that is intended to protect small unsophisticated depositors from loss of their deposits due to failure of banks and non-bank deposit-taking institutions continued in 2016. As a starting point, CBL intends to establish a minimally staffed pay-box with a narrow mandate confined to among others, collection of premiums from member institutions, building and managing of a deposit protection fund. The system will be part of the financial safety-net (FSN) aimed at promoting confidence in the financial sector.

During the year under review, the bank focused mainly on the development of a proper framework for the FSN following lessons learned from the recent global financial crisis. The main concern was to know from the outset what organisations, institutions or departments will be included as part of the FSN. The core stakeholders of the FSN will therefore become major role players that will each take their respective parts in crisis management and resolution of failing member banks and non-bank financial institutions through effective co-ordination and co-operation among role players.

Traditionally FSNs included only a few role players such as the central bank, government departments, explicit DISs and member institutions as illustrated in figure 31 below.

Figure 31 Traditional FSN Model



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Dealing with failing financial institutions is a complex matter that requires numerous players.

However, a recent global crisis that started in 2008 has revealed that dealing with a failing financial institution or a crisis is a complex matter and can involve numerous FSN players and stakeholders resulting in a broader structure that brings in additional members into the system. Figure 32 illustrates various role players and the roles that each one of them has to play.

Figure 32 FSN Role Players Post Recent Crisis

This type of a structure is more inclusive and hence ensures that the FSN is able to respond proactively rather than reactively in order to improve confidence in the financial sector to a higher degree since improved techniques within the system minimise the effects of catastrophic events. The structure describes the mandates, roles and responsibilities of the agencies and how they have to act prior to and during the course of a crisis.

As indicated in the structure, the DIS will form a major part of the FSN. What was evident from the recent financial crisis is that a poorly designed DIS can escalate a bank failure into a crisis. The design for the DIS in Lesotho will take cognisance of this fact. Therefore, in line with the international best practices, it is meditated that the system will be an independent unit with its own board of directors and independent law. This ensures full accountability and operational efficiency.

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Based on the level of development of the financial sector in Lesotho, the system will start small and gradually grow in line with the level of growth in the financial sector. During this period, the system will be under CBL incubation.

The division assigned to look into the modalities of establishing the system will complete the draft legal framework in 2017. The legal framework will require the system to cover all types of deposits but subject to a set maximum. A fund that will be used to compensate depositors in the event of a bank failure will be established and such a fund will be build overtime through member premiums. Membership will be compulsory to all banks and non-banks deposit-taking institutions licensed by CBL.

Box 1 MIGRATION FROM BASEL I TO BASEL II

During the year under review, the CBL's efforts of migrating from the Basel I regulatory framework to Basel II gained further traction. The ground work was done, and it was necessary to solicit participation of the commercial banks on the migration path and outline the role that the banks had to play in the process.

To that end, the CBL held a seminar with commercial banks to officially create awareness on the migration plan to Basel II. The seminar provided participants with the rationale for the migration process, outlined implementation plan for the project as well as identified selected elements of Basel II and III. The selected elements were contrasted with the likely impact on the current situation under Basel I. Following this seminar, implementation of the plan continued in earnest. The Bank conducted the quantitative impact studies (QISs), QIS-0 and QIS-1 which took the form of gap analyses. The first aspect of QIS-0 was a self-assessment of compliance with the Basel Core Principles (BCP's). The objective of the self-assessment was to establish and identify regulatory and supervisory gaps and make recommendations based on the gaps identified. It was undertaken in accordance with the guidelines set out in Core Principles for Effective Banking Supervision. The second aspect covered the gap analysis of the regulatory and legal framework in Lesotho in the context of risk-based supervision which served as a launch-pad for Basel II implementation. These marked completion of the first section of the implementation plan.

Pillar 2-*Supervisory Review*, was selected for adoption to encourage banks to develop and use better risk management techniques in monitoring and managing their risks. This pillar comprises of internal capital adequacy assessment process (ICAAP) coupled with Supervisory Review and Evaluation Process (SREP). The Bank came up with clear guidelines on how ICAAP and stress testing should be conducted in Lesotho. Moreover, comparison with other countries was done to draw lessons from other jurisdictions. The objective of the ICAAP is to ensure that a bank understands its risk profile and has systems in place to assess, quantify and monitor the management of risk in the bank as well as assessing its overall capital adequacy in relation to its risk profile and developing a strategy for maintaining its capital levels. Under this pillar, a bank will be required to demonstrate that its chosen internal capital target is well-founded and also that the target is consistent with its overall risk profile and its current operating environment.

Following the completion of the activities slated for 2016, the CBL continued with other aspects of the implementation plan. In this regard, the Bank commenced preparatory work on volume II of QIS-1, as well as some of the remaining work on the risk weights for credit, operational and market risks. The first part of volume II focused on basic disclosure requirements and, the second discusses guidelines on corporate governance. While the CBL muted the exclusion of pillar III from the proposed regulatory basket, its usefulness as a conduit of market discipline necessitated re-consideration of the initial stance. The basic disclosure requirements build on *Financial Institutions (Disclosure of Financial Information) Regulations, 2016* and were necessitated by revisions to Pillar III standards. In particular, the requirements sought to beef up effective disclosure in capital adequacy ratio and its components as well as in the areas of credit risk, market risk & securitization activities. The inclusion of Corporate Governance framework to the arsenal of guidelines at the disposal of CBL sought to assess the adequacy of a bank's management oversight and internal controls.

It is envisaged that once the CBL has completed all the outstanding components of the implementation plan, a parallel run will commence in 2018. During this time, banks will be required to demonstrate movement to compliance with Basel II but will still legally be compliant under Basel I. This will be preparatory stage for full compliance in 2019, when all banks will be required to switch to Basel II altogether.

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Appendices

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Appendix I	Audited Industry Balance Sheet (M`000)					
BALANCE SHEET	2011	2012	2013	2014	2015	2016
TOTAL ASSETS	**8,373,136**	**8,472,376**	**11,441,254**	**12,295,054**	**13,926,566**	**13,194,771**
Cash and Cash Items	261,996	351,431	426,976	387,871	564,886	613,960
Balances with CBL	162,043	174,311	447,963	549,673	374,398	445,400
Balances with local banks	965,562	903,599	1,780,323	2,163,450	2,307,861	2,138,905
Balances with banks abroad	2,342,103	1,830,326	2,332,483	2,590,189	3,528,206	2,985,556
Marketable securities	718,913	839,216	666,030	612,183	750,200	807,664
Other investments	1,112,531	532,188	1,063,519	627,325	654,354	190,991
Loans and advances	2,559,526	3,588,483	4,375,961	4,907,856	5,265,522	5,396,675
Fixed Assets	146,361	144,577	175,394	211,284	265,665	324,867
Other Assets	104,101	108,245	172,605	245,223	215,474	290,753
Goodwill	0	0	0	0	0	0
TOTAL LIABILITIES	**7,565,468**	**7,535,848**	**10,347,048**	**10,985,499**	**12,461,502**	**11,508,065**
Deposits	5,777,309	6,087,825	7,822,771	8,213,781	9,352,181	8,796,049
Due to Local Banks	1,097,954	992,324	1,864,779	2,156,610	2,325,171	2,009,065
Due to Foreign Banks	178,138	49,674	313,361	197,786	249,352	225,095
Other Borrowings	0	0	0	0	50,417	50,981
Other Liabilities	512,067	406,025	346,137	417,322	484,381	426,876
TOTAL CAPITAL	**807,671**	**936,527**	**1,094,205**	**1,309,555**	**1,465,063**	**1,686,708**
Paid-up Capital	88,858	98,858	108,858	108,858	123,358	125,858
Statutory Reserve	125,909	120,625	124,919	124,059	131,777	211,975
Revaluation Reserves	13,975	13,975	13,975	16,261	24,740	23,211
Other Reserves	11,711	26,775	12,070	19,903	12,074	13,628
Retained Earnings	558,649	669,740	810,813	1,019,916	1,155,039	1,282,576
Profit/ loss for the year to date	243,054	272,382	356,919	397,870	423,949	463,600

APPENDICES

Appendix II	Audited Industry Income Statements (M`000)					
	2011	2012	2013	2014	2015	2016
TOTAL INCOME	**779,079**	**937,818**	**1,196,139**	**1,300,320**	**1,439,500**	**1,596,248**
Interest Income - Loans	216,056	354,706	519,024	560,308	711,899	817,655
Interest Income - Placements	277,283	223,323	230,404	358,880	397,896	485,133
Foreign Payments	**142,323**	**169,348**	**144,646**	**207,677**	**212,271**	**248,609**
Domestic Payments	**196,741**	**112,410**	**85,759**	**151,203**	**185,626**	**236,524**
Interest Income - Securities	110,940	110,905	122,176	157,164	57,934	61,674
Total Interest Income	604,279	688,934	871,604	1,076,352	1,167,729	1,364,462
Interest Expense	182,689	171,576	207,659	330,943	346,249	433,950
Net Interest Income	421,590	517,358	663,945	745,409	821,480	930,512
Fees and Commission Income	288,043	345,598	451,125	475,642	520,386	577,370
Forex Gains/Losses	51,810	60,655	59,049	65,699	79,523	60,753
Income on Equity Investment	0	0	0	0	0	510
Other Income	7,394	4,879	9,822	9,916	14,992	27,103
Grants	10,242	9,328	12,198	3,654	3,119	0
Non-interest Income	357,489	420,460	532,194	554,911	618,020	665,736
TOTAL EXPENSES	**448,684**	**565,995**	**701,571**	**756,673**	**858,974**	**957,596**
Staff Salaries and Benefits	218,733	222,110	275,201	306,336	350,179	398,896
Management/Directors Fees	49,294	119,209	88,122	96,164	112,558	117,250
Auditors/Consultants Fees	3,105	3,359	4,478	4,979	5,596	6,006
Provision for Bad Debts	17,318	50,011	65,685	81,805	97,947	95,919
Bad-Debts Write-offs/Irrecoverable losses	0	0	0	0	0	9,917
Depreciation	29,514	31,693	40,787	41,200	41,307	47,795
Other Operating Expenses	130,720	139,613	227,298	226,189	251,387	281,813
Operating Income/Loss	330,395	371,823	494,568	543,647	580,526	638,652
Share Of Profits Of Associates	0	0	0	0	0	0
Income/Loss Before Taxation	330,395	371,823	494,568	543,647	580,526	638,652
Taxation	87,341	99,441	137,649	145,777	156,578	175,051
Net Income Before Appropriation	243,054	272,382	356,919	397,870	423,948	463,601
Dividend	169,245	137,286	196,659	266,363	265,754	0
Retained Income	73,811	135,097	160,260	135,686	155,833	459,327

Appendix III	Short-Term Insurance Business Underwriting and Revenue Accounts (Million Maloti)				
Particulars	2016	%	2015	%	%
	M'000	Comp	M'000	Comp	Variance
	M'000	Comp	M'000	Comp	Variance
Gross Premium	354.2	100.0%	329.2	100.0%	8%
Reinsurance Premium	189.6	53.5%	161.2	49.0%	18%
Net Premium	**164.7**	46.5%	**168.0**	51.0%	-2%
Commission Income	53.0	15.0%	38.5	11.7%	38%
Net Earned Income	**217.6**	61.4%	**206.5**	62.7%	5%
Claims Incurred	87.0	24.6%	73.1	22.2%	19%
Less Reinsurance share	3.8	1.1%	0.0	0.0%	
Net claims incurred	**83.2**	23.5%	**73.1**	22.2%	14%
Commissions Expenses	49.7	14.0%	45.9	13.9%	8%
Management Expenses	56.5	15.9%	44.5	13.5%	27%
Change in IBNR	0.3	0.1%		0.0%	
Change in unearned premiums	1.5	0.4%		0.0%	
Underwriting Expenses	**191.1**	53.9%	**163.5**	49.7%	17%
Underwritiing Gains/Loss	**26.5**	7.5%	**43.0**	13.1%	-38%
Investment Income	18.7	5.3%	18.7	5.7%	0%
Other income	1.8	0.5%	4.0	1.2%	-55%
Operating Profit	**47.0**	13.3%	**65.7**	20.0%	-28%
Other Expenses	26.8	7.6%	14.0	4.3%	92%
Profit Before Taxation	**20.2**	5.7%	**51.7**	15.7%	-61%

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Appendix IV	Short-Term Insurance Industry Balance Sheet as at Indicated Dates (Million Maloti)				
	2016	%	2015	%	
	M'000	Comp	M'000	Comp	Change %
ASSETS					
Fixed Assets	4.6	1.1%	2.3	0.7%	95.6%
Long-Term Investments	167.5	41.4%	30.1	8.5%	455.7%
Loans to related parties	19.8	4.9%	18.7	5.3%	6.0%
Deffered tax	0.5	0.1%	0.8	0.2%	-30.6%
Deffered finance charges	0.2	0.1%		0.0%	
Goodwill	5.1	1.3%		0.0%	
Total Non-Current Assets	**197.7**	48.9%	**51.9**	14.7%	280.8%
Current Assets		0.0%		0.0%	
Bank and Cash	6.4	1.6%	12.2	3.4%	-47.1%
Short-term investments	94.9	23.5%	222.3	62.8%	-57.3%
Debtors	1.5	0.4%	5.0	1.4%	-69.1%
Outstanding premiums	37.6	9.3%	31.8	9.0%	18.1%
Inter-Divisional current Account	0.0	0.0%	0.3	0.1%	-100.0%
Inter-company borrowings	0.2	0.1%	0.0	0.0%	
Provision for tax	0.0	0.0%	0.0	0.0%	
Amounts due from Reinsurers	54.7	13.5%	30.4	8.6%	80.1%
Reinsurers' share of unearned premium	10.4	2.6%		0.0%	
Reinsurance claims O/S-Fac	0.1	0.0%		0.0%	
Reinsurance Claims O/S-QS	0.7	0.2%		0.0%	
Prepaid Expenses	0.0	0.0%		0.0%	
Total Current Assets	**206.7**	51.1%	**301.9**	85.3%	-31.5%
Total Assets	**404.3**	100.0%	**353.8**	100.0%	14.3%
EQUITY AND LIABILITIES					
Share Capital	14.3	3.5%	14.3	4.0%	0.5%
Share Premium	19.5	4.8%	11.0	3.1%	76.9%
Accumulated Profit	83.1	20.6%	70.8	20.0%	17.4%
Other reserves	0.0	0.0%	12.3	3.5%	-100.0%
Total Shareholders Funds	**116.9**	28.9%	**108.3**	30.6%	7.9%
Non-current Liabilities		0.0%		0.0%	
Borrowings	1.1	0.3%		0.0%	
Amounts due to related parties	3.3	0.8%		0.0%	
Total non-Current Liabilities	**4.4**	1.1%	**0**	0.0%	
Technical Provisions		0.0%		0.0%	
Insurance Fund	5.1	1.3%	3.6	1.0%	41.5%
Outstanding claims Provision	116.9	28.9%	87.2	24.7%	34.0%
Unearned Premium Provision	93.2	23.0%	95.1	26.9%	-2.1%
Other underwriting Provisions	20.3	5.0%	20.5	5.8%	-1.1%
IBNR	0.4	0.1%		0.0%	

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Appendix IV	Short-Term Insurance Industry Balance Sheet as at Indicated Dates (Million Maloti) continued				
	2016	%	2015	%	
	M'000	Comp	M'000	Comp	Change %
Unexpired risk reserve	0.1	0.0%		0.0%	
Reinsurance Premium	0.0	0.0%	0.0	0.0%	
Treaty Control Motor QST	5.2	1.3%		0.0%	
Treaty Control Non-Motor QST	3.3	0.8%		0.0%	
Treaty Control-Surplus	3.2	0.8%		0.0%	
Facultative Proportional Control	1.9	0.5%		0.0%	
Cash Collaterals on Bonds	0.3	0.1%		0.0%	
Total Technical Provisions	**249.9**	61.8%	**206.5**	58.4%	21.0%
Provisions for Taxation	5.6	1.4%	5.6	1.6%	-0.9%
Creditors	19.7	4.9%	29.3	8.3%	-32.9%
Government Stamp duty	0.0	0.0%		0.0%	
Provision for Doubtful Debts	3.1	0.8%	4.1	1.2%	-23.5%
Employees Tax & Salaries Control	1.1	0.3%		0.0%	
Inter-Divisional Current Account	3.5	0.9%		0.0%	
Contingent liabilities	0.2	0.0%		0.0%	
Total Current Liabilities	**33.1**	8.2%	**39.0**	11.0%	-15.0%
Total Capital, Reserves and Liabilities	**404.3**	100.0%	**353.8**	100.0%	14.3%

Appendix V	Financial Soundness Indicators: Short-Term			
		2016	2015	
Categories	Indicator	(% Change)	(% Change)	Variance
Capital Adequacy	**Capital (shareholder funds)/(total liabilities-shareholder funds)**	40.7%	44.1%	-8%
	Capital/total assets	28.9%	30.6%	-6%
	capital/technical provisions	46.8%	52.4%	-11%
Asset quality	**Total receivables/total assets**	9.7%	10.5%	-8%
	Premium Receivables (outstanding premium)/gross premium	10.6%	9.7%	10%
	investments (both long & short)/total assets	64.9%	71.3%	-9%
	equity (shares/stocks)/total assets	28.9%	30.6%	-6%
Reinsurance	Risk retention ratio (net premium/gross premium)	46.5%	51.0%	-9%
Actuarial liability	Claims incurred/Outstanding claims provision	71.2%	83.8%	-15%
	unearned premium provision/gross premium	26.3%	28.9%	-9%
Management Soundness	Operating expenses (commision+mgt+ other operating xpen/gross premium)	37.6%	31.7%	18%
Earnings and Profitability	Expense Ratio (expenses (mgt+ commision)/net premium)	48.8%	43.8%	11%
	Loss Ratio (net claims/net premiums)	40.0%	35.4%	13%
	Combined ratio (Expense + claims ratio)	88.7%	79.2%	12%
	Return on equity (ROE)=net income (Profit before tax)/shareholders' equity	17.3%	47.7%	-64%
	investment income/investment assets	7.1%	7.4%	-4%
	investment income/net premium	8.6%	9.1%	-5%
Liquidity	current assets/current liabilities	623.6%	774.4%	-19%

Appendix VI	Long-Term Underwriting Results and Revenue Account as At Dates Indicated (Million Maloti)				
	2016		2015		Variance
	M'000	Comp %	M'000	Comp %	%
Gross Premium	971.7	100.0%	916.7	100.0%	6.0%
Premium Ceded	41.0	4.2%	32.7	3.6%	25.4%
Net Premium Income	**930.7**	95.8%	**884.0**	96.4%	5.3%
Commission Income	0.3	0.0%	0.3	0.0%	0.0%
Reinsurance recoveries	-	0.0%	**4.2**	0.5%	-100.0%
Net Earned Income	931.0	95.8%	888.5	96.9%	4.8%
Claims Incurred	501.2	51.6%	443.9	48.4%	12.9%
Commission Expenses	132.2	13.6%	136.8	14.9%	-3.4%
Management Expenses	194.5	20.0%	142.7	15.6%	36.3%
Underwriting Expenses	**827.9**	85.2%	**723.4**	78.9%	14.4%
Underwriting Profit /(Loss)	**103.1**	10.6%	**165.1**	18.0%	-37.6%
Investment Income	194.4	20.0%	244.8	26.7%	-20.6%
Other Income	47.4	4.9%	26.6	2.9%	78.2%
Operating Profit	**344.9**	35.5%	**436.5**	47.6%	-21.0%
Other Expenses	212.2	21.8%	55.6	6.1%	281.7%
Profit Before Taxation	**132.7**	13.7%	**380.9**	41.6%	-65.2%

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Appendix VII	Long-Term Balance Sheet as at Dates Indicated (Million Maloti)				
	2016		2015		Variance
Non-Current Assets	M'000	Comp %	M'000	Comp %	%
Fixed assets	31.9	0.6%	26.9	0.6%	18.5%
Long Term Investments	3,376.8	68.7%	2,984.4	65.7%	13.1%
Loans to policy holders	167.8	3.4%	143.0	3.1%	17.4%
Investment in subsidiaries	100.5	2.0%		0.0%	
Loans to subsidiary companies	56.4	1.1%	137.8	3.0%	-59.1%
Investment properties	86.2	1.8%		0.0%	
Other assets	3.7	0.1%		0.0%	
Total Non-Current Assets	**3,823.3**	77.7%	**3,292.1**	72.5%	16.1%
Current Assets					
Bank and Cash	66.1	1.3%	222.6	4.9%	-70.3%
Short Term Investments	657.1	13.4%	791.3	17.4%	-17.0%
Amounts due from reinsurers	5.2	0.1%	3.0	0.1%	72.4%
Outstanding Premium	163.6	3.3%	175.7	3.9%	-6.9%
Intercompany accounts	24.5	0.5%		0.0%	
Amounts due from related parties	23.3	0.5%	1.7	0.0%	1286.9%
Prepaid tax	4.0	0.1%		0.0%	
Debtors	150.6	3.1%	56.4	1.2%	167.0%
Total Current Assets	**1,094.4**	22.3%	**1,250.7**	27.5%	-12.5%
Total Assets	**4,917.8**	100.0%	**4,542.8**	100.0%	8.3%
Equity, Reserves and Liabilities					
Share Capital	143.9	2.9%	128.7	2.8%	11.8%
Share Premium	11.0	0.2%		0.0%	
Accumulated Profit	810.2	16.5%	691.5	15.2%	17.2%
Retained Income	37.3	0.8%		0.0%	
Other reserves	7.8	0.2%	103.9	2.3%	-92.5%
Total Shareholders Funds	**1,010.1**	20.5%	**924.1**	20.3%	9.3%
Non-Current Liabilities					
Borrowings	0.1	0.0%		0.0%	
Total Non-Current Liabilities	**0.1**	0.0%	**0.0**	0.0%	
Policy holders funds					
Long-term insurance contracts	1,965.0	40.0%	2,048.3	45.1%	-4.1%
Financial instrument-Discr participation	1,080.3	22.0%	1,199.5	26.4%	-9.9%
Designated at fair value through income	67.8	1.4%	74.1	1.6%	-8.5%
Employee benefits (provident fund)	314.6	6.4%	8.7	0.2%	3520.5%
Assurance Fund	215.2	4.4%		0.0%	
Total policy holders funds	**3,642.8**	74.1%	**3,330.6**	73.3%	9.4%
Technical Provisions					
Outstanding Claims provision	107.6	2.2%	121.7	2.7%	-11.6%
Unearned Premium provision	15.2	0.3%	16.0	0.4%	-4.7%

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Appendix VII	Long-Term Balance Sheet as at Dates Indicated (Million Maloti) continued				
	2016		2015		Variance
Non-Current Assets	M'000	Comp %	M'000	Comp %	%
Other Underwriting and Premium provision	2.1	0.0%		0.0%	
Total Technical Provisions	**125.0**	2.5%	**137.6**	3.0%	-9.2%
Amount due to related Parties	10.2	0.2%	22.7	0.5%	-55.1%
Overdrafts	0.4	0.0%		0.0%	
Contigent liabilities	8.7	0.2%		0.0%	
Creditors	120.6	2.5%	127.6	2.8%	-5.5%
Total Current Liabilities	**139.9**	2.8%	**150.3**	3.3%	-7.0%
Total Equity, Reserves and Liabilities	**4,917.8**	100.0%	**4,542.7**	100.0%	8.3%

Appendix VIII	Long-Term Financial Soundness Indicators			
		2016	2015	
Categories	Indicator	%	%	%
		Change	Change	Change
Capital Adequacy	Capital(share holder funds)/(total liabilities-shareholder funds)	**25.8%**	**25.5%**	1.2%
	Capital/total assets	**20.5%**	**20.3%**	1.0%
	capital/technical provisions	**808.4%**	**671.4%**	20.4%
Asset quality	Receivables/total assets	**6.9%**	**5.1%**	34.8%
	Receivables/gross premiums	**34.9%**	**25.3%**	37.7%
	Investments(both long & short+cash&cash equiva)/total assets	**83.4%**	**88.0%**	-5.3%
	Equity(shares/stocks)/total assets	**48.9%**	**45.7%**	7.0%
Reinsurance	Risk retention ratio (net premium/gross premium)	**95.8%**	**96.4%**	-0.7%
Acturial liability	Claims incurred/Outstanding claims provision	**865.3%**	**730.2%**	18.5%
Management Soundness	Operating expenses(commision+mgt+ other operating xpen/gross premium	**107.0%**	**85.0%**	26.0%
Earnings and Profitability	Expense Ratio (expenses(mgt+ commision)/net premium)	**68.1%**	**65.7%**	3.6%
	Loss Ratio (net claims/net premiums)	**100.0%**	**100.5%**	-0.5%
	Combined ratio(Expense + claims ratio)	**168.1%**	**166.2%**	1.1%
	Return on equity (ROE)=net income(Profit before tax)/shareholders' equity	**13.1%**	**41.2%**	-68.1%
	investment income/investment assets	**4.8%**	**6.5%**	-25.7%
	investment income/net premium	**20.9%**	**27.7%**	-24.6%
Liquidity	Liquid assets (current assets/current liabilities)	**782.6%**	**832.1%**	-5.9%
Subsidiaries	Loans to related parties(subsidiaries)/total assets	0.0%	0.0%	0.0%

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APPENDICES

Appendix IX	List of Licensed Banks	
Bank	**Managing Director**	**Contact Details**
Lesotho Post Bank	Managing Director: **Mr. Molefi Leqhaoe**	**Mafike House** Kingsway, Maseru Tel. 22317832 mleqhaoe@lpb.co.ls
Standard Lesotho Bank	Chief Executive Officer: **Mr. Mpho Vumbukani**	**1st Floor Tower Bank Building** Kingsway, Maseru Tel. 22315737 vumbukanim@stanbic.com
First National Bank Lesotho	Chief Executive Officer: **Mr. Warren Adams**	**Star Lion Group Building** Corner Kingsway and Parliament Road, Maseru Tel. 22241000 Warren.adams@fnb.co.za
Nedbank Lesotho	Managing Director: **Mr. Petrus Jurgens Bouwer**	**Nedbank Building** Kingsway, Maseru Tel. 22282100 pjbouwer@nedbank.co.ls

Appendix X	List of Licensed Insurance Companies	
No.	**Institution**	**Class**
1.	Lesotho National Life Assurance Company (LNLAC)	Long-term Insurance (All categories of life insurance products)
2.	Metropolitan Lesotho Limited	Long-term Insurance (All categories of life insurance products)
3.	Alliance Insurance Company	Long term Insurance (All categories of life insurance products)
		Short-term Insurance (All Categories of general insurance products)
4.	NBC Insurance Lesotho Limited (New)	Long-term Insurance (Pension and retirement administration, consulting)
5.	Liberty Life Lesotho Limited	Long-term Insurance (All categories of life insurance products)
6.	Lesotho National General Insurance (LNGIC)	Short-term Insurance (All categories of general insurance products)
7.	The Legal Voice Limited	Short-term Insurance (Legal insurance products only)
8.	Zenith Horizon Insurance Company	Short-term Insurance (All Categories of general insurance products)
9.	Law Protection Clinic	Short-term Insurance (Legal insurance products only)
10.	Specialised Insurance Company	Short-term Insurance (All Categories of general insurance products)

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