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MESSAGE FROM THE GOVERNOR

I am delighted to present the 2005 Annual Report which has been prepared in compliance with Section 54 of the Banking Act, 1989. In this publication, the Reserve Bank of Malawi seeks to highlight developments that have taken place in the financial sector during 2005, performance of the sector, and activities of the banking supervision function in pursuance of the mandate of Reserve Bank of Malawi. It also includes issues that the banking supervision function is yet to *address* in the future.

Over the past decade, the Malawi financial sector has seen new entrants on the market resulting in increased growth in size, product range, and competition. Unlike in the past when the market was dominated by two banks, the coming in of other market players on the financial industry has significantly changed the operating environment. It is critical that as the supervisory authority, the Reserve Bank should quickly respond to these new challenges by mastering the innovations introduced by the market players and where necessary to take proactive efforts to prepare the supervisors for discernible future challenges. Training in both short-term and long-term basis is therefore important.

The financial sector continued to play a vital role in the economic development of the nation. The Reserve Bank of Malawi will therefore endeavour to perform the supervisory function with professionalism, integrity, and impartiality that will enable the financial sector to realise its full potential. As the sector evolves to meet the needs of increasingly sophisticated customers, the Reserve Bank will enhance surveillance of the industry to ensure that emerging weaknesses are timely addressed. The Bank will also strive to establish a firm, timely and effective supervisory machinery. This entails reinforcement of supporting infrastructures such as review of laws regulating activities and operations in the market in order to ensure that the Bank has autonomy and is accountable for the system's operations; continuous improvement in supervisory and regulatory skills; and adoption of international best practices and standards relating to prudential supervision.

In order to strengthen the supervisory process, the Bank undertook some projects in the ensuing year. These include amendment of laws for the financial services industry, review and introduction of new directives and guidelines, full implementation of automation of the bank supervision processes in order to effectively manage the supervisory function and conducting premises inspection of all the banking organisations. The Bank is also considering introduction of a framework for risk-based supervision and risk management guidelines for the financial industry.

All in all, this report gives an insight of the supervisory function and how the country is coping with international trends and the status of the banking system during the year under review. Finally, let me take this opportunity to express my appreciation for the satisfying relationship that exists between the financial institutions and the Reserve Bank of Malawi.

Victor Mbewe
GOVERNOR

AN OVERVIEW OF THE REPORT

This report is produced annually in compliance with the requirements of Section 54 of the Banking Act, 1989. It is largely a joint effort of staff from Bank Supervision Department under the guidance of the Senior Management of the Reserve Bank of Malawi.

In the first chapter, the Annual Report presents a general description of the environment in which the financial industry has been operating. The macro-economic variables have shown depressing trends during the year mainly because of the dry spell that the country experienced during the year, and high global oil prices that affected prices of essential commodities. Real economic growth was stunted with acceleration in inflation rates and poor performance of the domestic currency. This is evidenced by declined growth of GDP which was at 2.1 percent as compared to 5.1 percent growth in 2004.

The operating environment for the financial sector has been a challenging one due to the less than satisfactory performance of the economy. Based on the level and trends in capital adequacy, asset quality, and liquidity, the performance of the banking sector registered slow growth as compared to the previous year. Aggregate asset growth was at 14.1 percent lower than 20.2 percent of 2005. In the ensuing year, loans and leases made up the largest composition of total assets substituting securities and investments which have been the dominant assets for some time. This is as a result of reduction in Government treasury bills yield. Deposits remained the major source of funding and constituted 75 percent of total liabilities and registered an annual growth rate of 17.6 percent. Despite the unfavourable economic conditions, levels of non performing assets remained relatively low due to prudent loan administration by the banks. As a result of growth in loans and other assets, risk weighted assets increased by 48 percent from K32.5 billion. Hence the banking sector, registered declined ratios of core capital and total capital to risk weighted assets of 17.8 percent and 22.3 percent from 23.0 percent and 28.5 percent respectively. The liquidity ratio has been declining for the past two years as banks have concentrated more on lending than investment in treasury bills.

Pursuant with its mandate drawn from the Reserve Bank of Malawi Act and the Banking Act, the Department continued to ensure that banks and other financial institutions are being operated in a sound and viable manner so as to develop and maintain public confidence in the financial sector. This was achieved through controlling entry into the market; carrying out on-going surveillance of market players; and continuous review of laws, regulations, guidelines and overall regulatory environment to ensure that they are in line with international standards and practices.

During the year 2005, Bank Supervision conducted on-site examinations of three banks, all of which were rated fair. One of the banks examined was characterized by weak credit underwriting practices, while one had flaws relating to management information system and the other had weaknesses at both, Management and Board levels. Profitability wise, two of the examined banks posted losses during the year ended December 2005.

With the advent of globalization of financial services, new challenges are emerging. Therefore new ways of doing banking business emerge that have resulted in new risks requiring attention of both bank management and supervisory authorities. As in the previous years, two issues topped high on the supervision agenda: the New Capital Accord (Basle II) and the fight against money laundering. It is worth mentioning that the Reserve Bank of Malawi took a bold decision to adopt the New Capital Accord. Following this decision, Bank Supervision Department formed a Basel II Preparedness Committee to spearhead preparations for Basel II implementation. The committee is charged with the responsibility of looking into practical considerations, national priorities, and banks' preparedness in liaison with the banks, and then make recommendations to senior management for policy formulation.

The Reserve Bank of Malawi has also made significant strides with regard to the anti-money laundering. In recognition of the fact that money laundering threatens the stability of the financial sector and the economy as a whole, the Bank maintained its instrumental role in the preparation of the Money Laundering and the Proceeds of Serious Crime Bill, 2004 by engaging all stakeholders.

The year 2005 was another challenging one such that some of the issues were not tackled or finalised. Most of the directives and guidelines were drafted, reviewed and finalised but have been carried forward for implementation to 2006. The department also revised internal guidelines that will be adopted in 2006.

From the above, it is evident that the work to be accomplished is challenging and requires commitment from Supervision staff and a collective effort of all stakeholders.

Finally, I am very grateful to senior management for the support and guidance given during the preparation and eventual publication of this report. I would like to appreciate the tireless efforts of every member of the Supervision function in making this publication a success and the continued harmonious relationship between the Chief Executives of supervised financial institutions and the Reserve Bank of Malawi that has operated in partnership to maintain financial sector soundness and stability. It is our desire to improve this publication from time to time and we would appreciate views, suggestions and comments.

Tobias S Chinkhwangwa

CHAPTER 1

MALAWI FINANCIAL LANDSCAPE IN 2005

1.1 Introduction

This chapter provides a description of the economic environment, legal framework and structure of the banking industry that characterized the market in 2005.

1.2 Recent Economic Developments

1.2.1 Gross Domestic Product (GDP)

Real gross domestic product (GDP) grew by 2.1 per cent in 2005 compared to 5.1 per cent in 2004. The decline in economic activity in 2005 was influenced by the dry spell that hit the country during the growing season. In addition, the slackening activity in the agricultural sector[1] and high global oil prices also affected national output. However, construction, transport and distribution sectors grew by 52.1 per cent, 9.4 per cent and 12.8 per cent, respectively.

1.2.2 Inflation and Money Supply

Money supply expanded by 14.3 per cent to K52.2 billion in 2005 compared to an increase of 29.8 per cent in 2004. The expansion in money supply mainly resulted from liquidity injections emanating from the banking system's extension of credit to the private sector. Also contributing to monetary pressure was the resumption of the Poverty Reduction Growth Facility (PRGF) by the International Monetary Fund (IMF) as it contributed to an increase in net foreign assets.

Annual inflation for 2005 was 15.4 per cent, acceleration from 11.5 per cent in 2004. This was largely attributed to high food prices arising from the shortfall in maize production and other cereals following the erratic rainfall during the 2004/2005 growing season.

[1] The agriculture sector's share to GDP averaged 34.7 per cent from 38.9 per cent in 2004, the lowest in the past seven years.

1.2.3 Public Finance

Central Government operations during the year 2005 improved somewhat from the preceding year as evidenced by the narrowing of the budget deficit including grants to K8.3 billion from K9.0 billion in 2004. The improved budgetary position was largely attributed to a marked increase in foreign grants earmarked for budgetary support due to the resumption of the PRGF program with the IMF within the year arising from satisfactory performance against benchmarks set by the IMF. This in turn resulted in other donors resuming aid to Malawi. The deficit was mainly financed through domestic resources.

1.2.4 Balance of Payment (BoP) and Exchange Rate

Malawi's balance of payments difficulties continued in 2005 with current account balance estimated to reach K65.9 billion from K55.5 billion in 2004. Pressures on the kwacha in 2005, as a result of lower earnings from tobacco and higher demand for exports caused by the drought was partly off-set by the upturn in donor inflows following the resumption of IMF funding. Consequently, the exchange rate depreciated marginally from an average of K108.8967/USD in 2004 to K118.4171/USD in 2005.

1.2.5 Interest Rates

The economic environment was still characterised by high interest rates. The Bank rate stood at 25.0 per cent throughout the year. Consequently, commercial bank's lending rates also remained unchanged at 27.0 per cent except for the months of January and February in which the lending rate averaged 27.50 per cent. Yields on Treasury Bills eased during the year as liquidity in the domestic market increased due to lack of alternative avenues for lending. As such all-type Treasury bill yield dropped year-on-year by 37 basis points to 24.41 per cent as at end December 2005. Individually, the 91-day, 182-day and 273-day tenors lost 7, 40 and 64 basis points to 24.44, 24.49 and 24.30 per cent, respectively. The table below depicts the trend in major interest rates during the year.

Table 1.1 Principal Interest Rates in 2005

1	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**
Bank Rate	25	25	25	25	25	25	25	25	25	25	25	25
T/B 182 days	23.57	23.41	24.52	24.41	24.52	24.53	24.48	24.45	24.30	24.48	24.49	24.49
3 Months deposit	10.50	10.50	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0	11.0
Base Lending Rate	27.50	27.50	27.50	27.50	27.50	27.50	27.50	27.50	27.50	27.50	27.50	27.50

1.3 Legal and Regulatory Environment

The mandate to supervise banks and financial institutions is drawn from the Reserve Bank of Malawi Act (1989) and the Banking Act (1989). In addition, the Reserve Bank of Malawi issues directives from time to time to provide guidance to banks and other financial institutions on various prudential issues to ensure proper functioning of the system. With support from the IMF technical assistance, most directives were reviewed and some new ones drafted during the year 2005. These were expected to be issued to the market in the first quarter of 2006. A list of such directives is provided in **Appendix 1.**

The Reserve Bank of Malawi uses the CAMEL (Capital adequacy, Asset quality, Management, Earnings and Liquidity) system of examination. Each component is rated on a scale of 1 (strong) to 5 (unsatisfactory). Plans are however, underway to adopt Risk Based Supervision (RBS) system of examination.

1.4 Ownership and Market Structure

As at end December 2005, the financial sector consisted of 11 banking institutions. One bank went into voluntary liquidation during the year after the Minister revoked its banking license. Compared to other countries in the region, Malawi's financial sector is small and relatively underdeveloped. The banking sector remains highly concentrated as it is dominated by two largest commercial banks whose assets and total capital represented 63.8 per cent and 65.9 per cent, respectively, of the total banking sector as at end 2005.

Two commercial banks operate as holding companies for leasing institutions.[2] Over the years, direct Government control and ownership has significantly reduced.[3] As at end December 2005, foreign investors had controlling stake in 4 commercial banks which constituted 29.0 per cent and 28.8 per cent of total assets and total deposits, respectively (see Table below).

Table 1.2 Ownership Structure

	Total	100% State Owned	Locally Controlled	Foreign Controlled
No of banking institutions	11	1	6	4
As a % of total assets	100	3.1	67.9	29.0
As a % of total deposits	100	3.6	67.6	28.8
As a % of total capital	100	2.1	73.7	24.2

[2] Towards the end of the year, one bank had applied to the RBM for approval to assimilate its leasing subsidiary into a functional division within the bank itself effective 01 January 2006.
[3] Only one bank is 100.0 per cent owned by government. However, government indirectly through some of its parastatals/entities still has shares in some of the banks.

CHAPTER 2

THE BANKING AND FINANCIAL SYSTEM IN 2005

2.1 Introduction

This Chapter analyses the balance sheet structure and performance of major components of the aggregate balance sheet for the industry during the year 2005. The balance sheet is analysed to determine the source and application of funds, as well as to consider the impact of any changes thereto on the risk profile of the banking sector.

The number of banking institutions declined to eleven (11) as at end December 2005 from twelve (12) in December 2004 following the liquidation of Finance Bank Malawi. These comprised 9 commercial banks and two leasing institutions.

2.2 Balance Sheet Structure of the Banking System

Generally, the year 2005 has been characterised by poor macro-economic performance. This impinged on the activities of the financial sector as evident from the slow growth of the aggregate balance sheet of the banking system in comparison to the previous year. Asset growth rate stood at 14.1 percent, which is comparatively lower than the growth rate of 20.2 percent registered in 2004.

Fig 2.1: BALANCE SHEET GROWTH

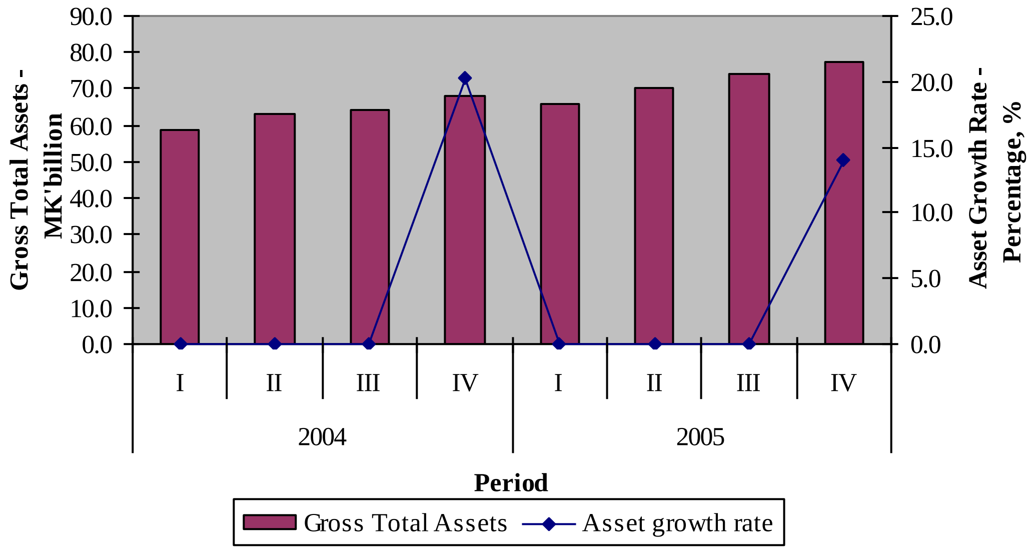


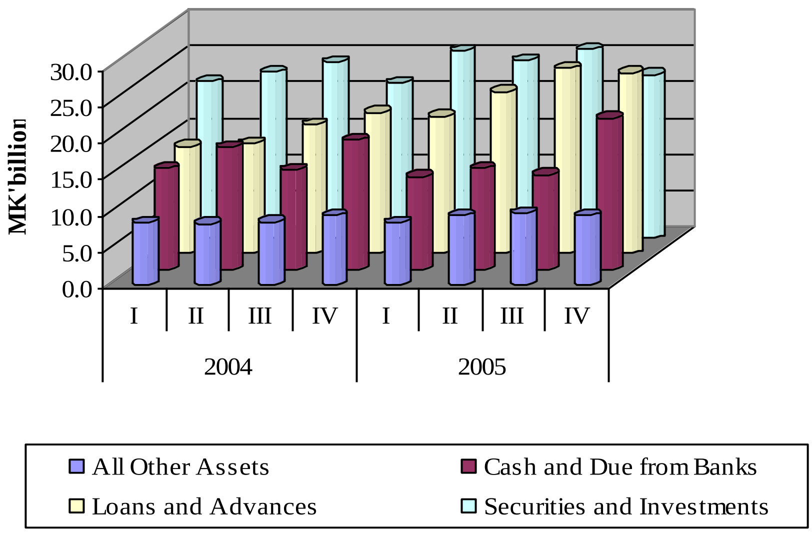
Figure 2.1 illustrates the Balance Sheet position and growth rate of the Banking Sector on a quarterly basis between the years 2004 and 2005. Aggregate Balance Sheet figure stood at K77.5 billion in December 2005 from K67.9 billion in December 2004. Balance sheet growth was mainly funded by Deposits, Capital and Reserves. The last three quarters of 2005 depict a declining balance sheet growth trend which is mainly reflective of the unfriendly economic environment the banks were operating in.

2.2.1 Asset Structure of the Banking Sector

Figure 2.2 graphically illustrates the composition of assets on a quarter-end basis from March 2004 to December 2005.

- Cash and balances with other banks and the Reserve Bank of Malawi increased by 16.9 percent from K17.7 billion in December 2004 to K20.7 billion in December 2005;
- Loans and advances at K24.8 billion in December 2005 were up from K19.4 billion in the preceding year representing a growth rate of 27.8 percent.
- Securities and investments recorded a modest growth rate of 5.2 percent, moving from K21.4 billion in December 2004 to K22.5 billion in December 2005. The dawdling growth is due to declining returns on Government Treasury Bills which comprise the largest part of Securities and investments.
- All Other Assets at K9.4 billion remained static.

Fig 2.2 ASSET STRUCTURE



In contrast with the previous year 2004, loans and leases made up the largest portion of total assets in 2005 substituting securities and investments which have been the dominant assets for some time. The reduction in Government treasury bill yield has served as a catalyst for enhanced financial intermediation.

2.2.2 Liability Structure of the Banking Sector

Figure 2.3 depicts the main components of liabilities of the banking sector during the year under review. Deposits remained the major source of funding and constituted 75 percent of total liabilities including capital and reserves as at December 2005. In absolute terms, deposits increased to K58.0 billion from K49.3 billion in December 2004 translating into an annual growth rate of 17.6 percent.

Capital and reserves recorded a 13.4 percent increase from K9.7 billion in December 2004 to K11.0 billion in the current period. The increase is attributed to a rise in reserves and retained profits. Other liabilities declined by 28.6 percent from K7.2 billion in December 2004 to K5.6 billion in December 2005.

Fig 2.3: Liability Structure

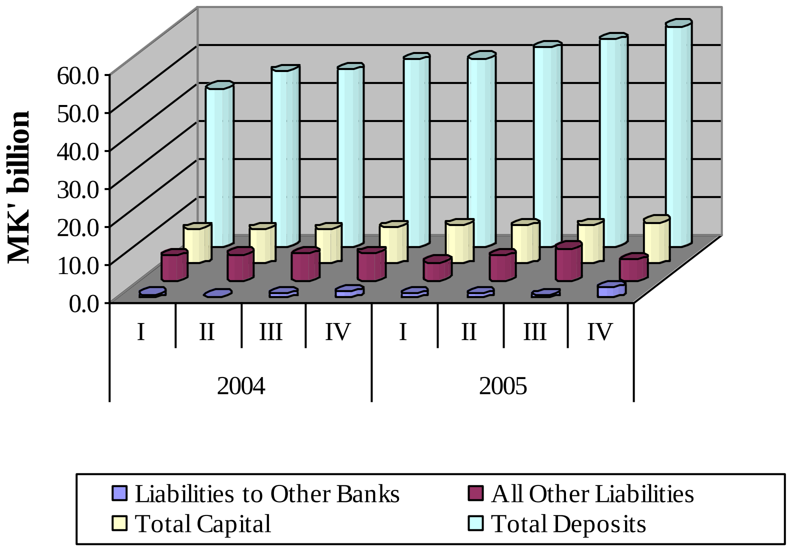
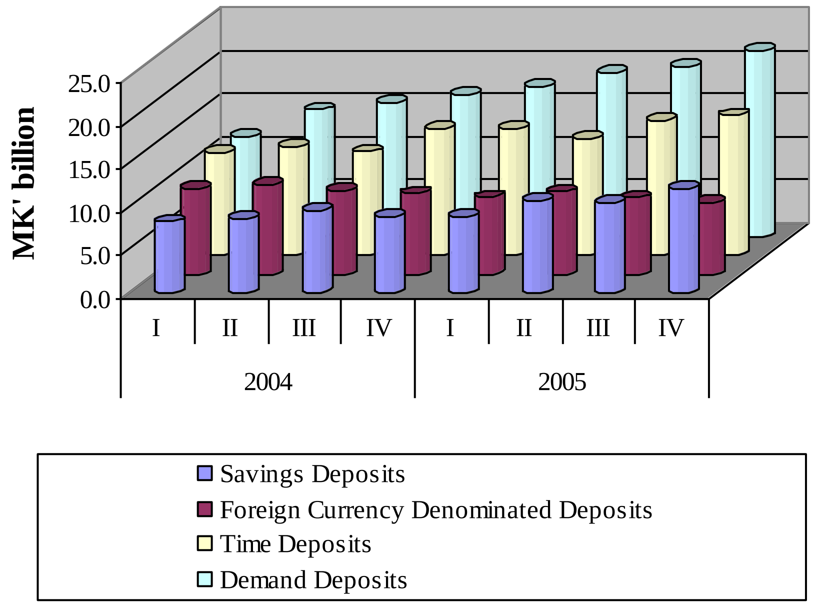


Figure 2.4 illustrates the composition of deposits on a quarterly comparative basis over the past two years. The structure of deposits in terms of type remained unaffected. Demand deposits at K21.4 billion continued to be the dominating source of deposits, growing by 30.4 percent between the two years and constituting 36.9 percent of total deposits as at December 2005. Time deposits increased by 10.9 percent to K16.2 billion from K14.6 billion. The 10.9 percent growth rate is a decline from a growth rate of 25.5 percent registered in December 2004, reflecting investors' preference for short term investments to long term. Foreign currency deposits declined to K8.2 billion from K9.3 billion as a consequence of foreign exchange shortages that characterised the economy during the year. Savings deposits registered a 35.9 percent rise to K12.1 billion.

Fig 2.4 Structure of Deposits



A detailed review of the performance of the banking sector over the year 2005 with respect to capital adequacy, asset quality, earnings and liquidity is provided below.

2.3 Performance and Condition of the Banking Sector

The condition and performance of the banking sector remained sound throughout the year. Most of the banks were generally adequately capitalised with strong financial returns and healthy liquidity positions. Despite the unfavourable economic conditions, levels of non performing assets still remained relatively low due to prudent loan administration by the banks. In assessing the financial system's performance, data provided from the banks' audited accounts was used.

2.3.1 Capital Adequacy

Capital plays a very crucial role in the banking industry as it serves as a cushion to absorb losses either emanating internally or external shocks. For this reason, capital is regarded as one of the key factors in the assessment of the soundness of a bank. The banking system is required to have adequate and strong capital position at all times. In assessing banks' capital, Reserve Bank of Malawi follows international requirement on banks' capital which prescribe minimum capital requirement for banking institutions. Capital is categorised into Core Capital comprising:- paid up capital, retained profits, current year profits and share premiums, and Total Capital which includes core capital plus revaluation and other statutory reserves. The minimum ratio of core capital to risk based assets which banks in Malawi are required to maintain at any time is 6.0 per cent. Banks are encouraged to maintain a higher ratio and failure to achieve this is considered to be weak. Where the ratios are below desired levels, banks are directed to increase their capital. As at the end of the year, all banks met the minimum capital requirements.

An analysis of capital adequacy as at end December 2005 portrays total shareholders' funds at K11.0 billion, up by 13.4 percent from K9.7 billion recorded in December, 2004. Retained earnings made up 58 percent (64 % in 2004) of total shareholders funds, paid up capital 15 percent (2004:17%), Share premium 5 percent (2004:4%) and reserves 22 percent (2004:15%) respectively. Figures 2.5 and 2.6 below depict the composition of shareholders' funds for the years ending December 2005 and 2004, respectively.

Fig 2.5 Composition of Shareholders' Funds, 2005

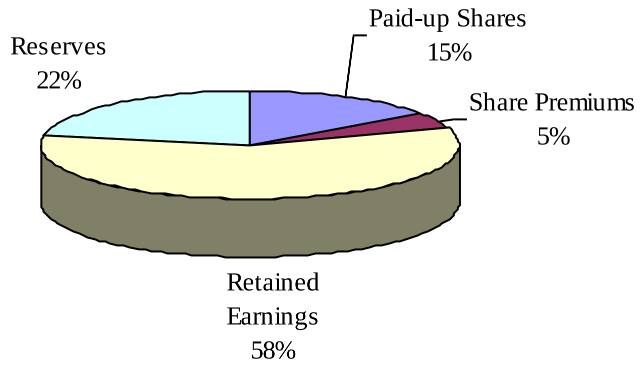


Fig 2.6: Composition of Shareholders' Funds, 2004

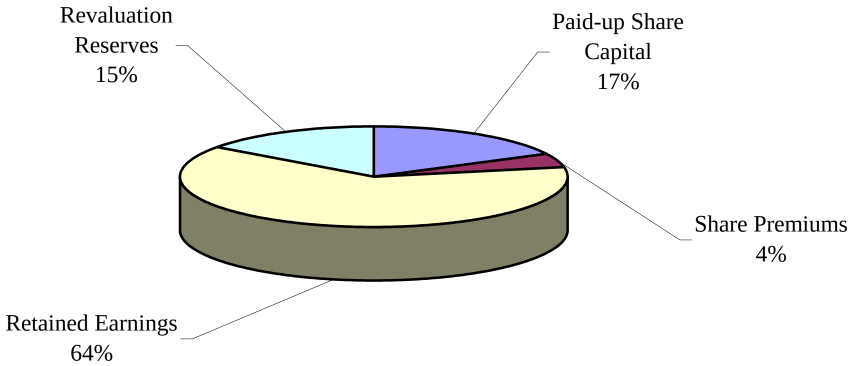
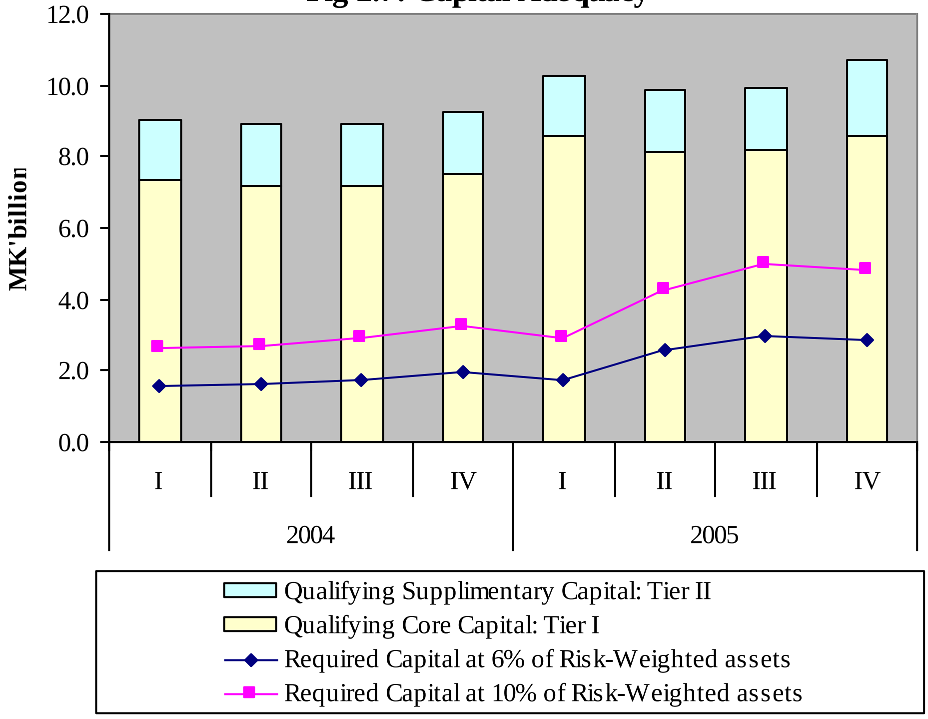


Figure 2.7 reflects in absolute values the position of core capital and total capital and capital adequacy ratios. As at December 2005, Core capital stood at K8.5 billion from K7.5 billion in December 2004. This represents a growth of 15 percent which is largely on account of growth in retained earnings. Likewise, total capital increased by 16 percent from K9.2 billion to K10.7 billion in the year under review. On the other hand, risk weighted assets at K48.1 billion in December 2005 have grown by 48 percent from K32.5 billion. The growth in risk weighted assets is attributed to growth in loans and other assets. In response to the huge growth in risk weighted assets, the ratios of core capital and total capital to risk weighted assets declined to 17.8 percent and 22.3 percent from 23.0 percent and 28.5 percent, respectively. Eight (9) out of the eleven (11) operating banking institutions recorded satisfactory capital rating as at December 2005, while one bank had a fair rating and the remaining bank had a marginal rating.

Fig 2.7: Capital Adequacy



2.3.2 Earnings and Profitability of the Industry

Earnings capacity of any banking industry plays a very crucial role in sustaining a bank's capacity to expand its operations, strengthen its capital position and remain competitive in the industry. It is very important that banks at all times generate adequate earnings if they are to remain viable. In addition, earnings act as a cushion to capital depletion.

The analysis of earnings and profitability focuses on the following aspects:

- The quality and sources of earnings,
- The level of earnings, including trends and stability
- The earnings exposure to market risks such as interest rate risks and foreign exchange risks
- The level of expenses in relation to operations and
- The ability to provide for adequate capital through retained earnings

The banking system collectively recorded gross income of K15.2 billion from K14.2 billion recorded in December 2004, representing an increase of 7 percent. Total interest income accounted for 66.3 percent of gross income down from 70 percent recorded last year. Intermediation income at K5.2 billion made up 34.6 percent of gross income, while investments income constituted 26.2 percent of gross income. Non interest income rose to K5.1 billion representing 33.7 percent of gross income in contrast to 29 percent recorded in 2004. The increase in non interest income is a reflection of efforts by banking institutions to open up more avenues of income. Figures 2.8 and 2.9 demonstrate the main sources of income for the past two years.

Fig 2.8 Composition of Gross Income in 2005

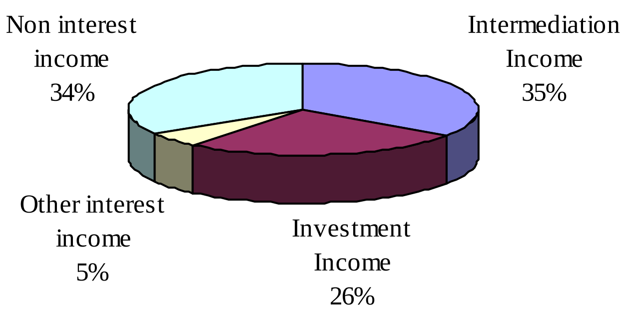


Fig 2.9 Composition of Gross Income in 2004

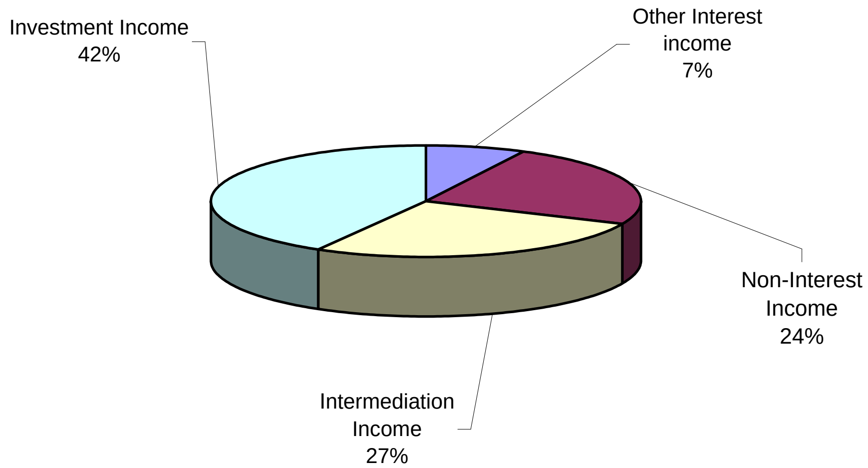


Figure 2.10 presents a composition of the income statement for the previous two years. Net interest income closed at K7.1 billion from K6.5 billion in December 2004, representing a modest increase of 9 percent. Operating expenses at K8.3 billion were up from K7.1 billion registered the previous year.

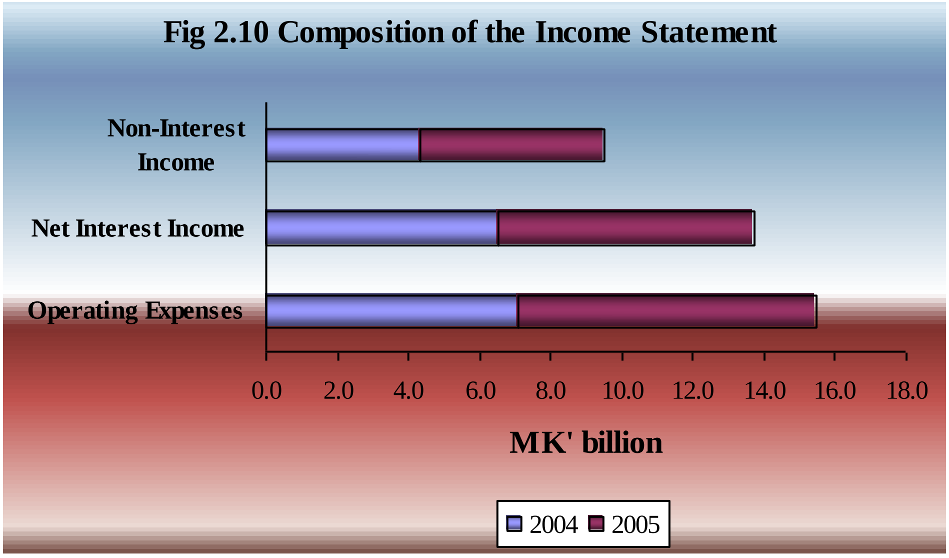
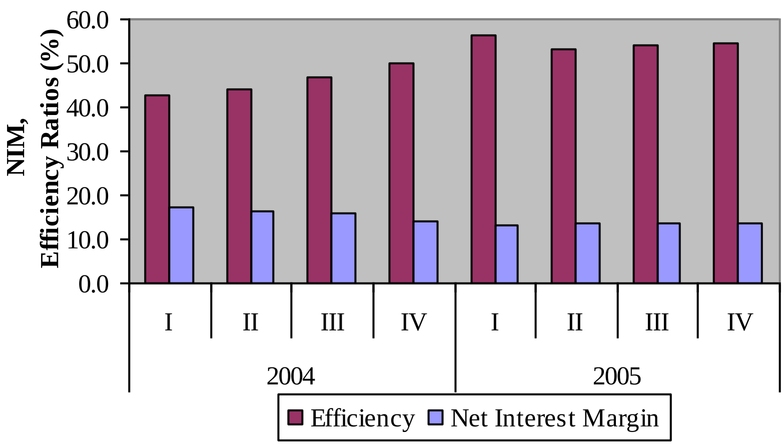


Figure 2.11 graphically illustrates quarterly interest margins and efficiency ratios of the banking sector in 2004 and 2005.

Fig. 2.11 Net Interest Margin, Efficiency Ratio



Lower interest margins were recorded in 2005 compared to 2004 interest margins. Interest margin as at end of December 2005 stood at 13.6 percent as compared to 14.0 percent recorded in the previous year. Among other factors, this slight drop is attributed to the relatively higher growth of earning assets as compared to the growth of net interest income and, a decline in interest income earned on investments especially treasury bills.

Efficiency of the banking sector is measured by using various methods. One of the common methods is by expressing operating expenses as a percentage of total income. Using this method, some pieces of literature suggest that international benchmark for efficiency is 60.0 percent. In this case, banks that have an efficiency ratio above 60.0 percent are considered as inefficient.

At the close of 2005, the banking sector achieved an efficiency ratio of 54.7 percent, increasing from 50.0 percent in the preceding year. It is evident that the efficiency of the banking sector is steadily declining. This is mainly because of relatively low growth in gross income in comparison to the growth in operating expenses as discussed above. High staff costs and other administrative expenses associated with inflationary environment contributed significantly to the growth in operating expenses. Nonetheless, the banking sector still remained efficient within the international benchmark of 60 percent.

Earnings can further be analysed by looking at the trends in the return on assets (ROA) and return on equity (ROE) during the year under review. For the two consecutive years, these ratios have revealed a downward trend.

Fig 2.12 Return on Assets, Return on Equity

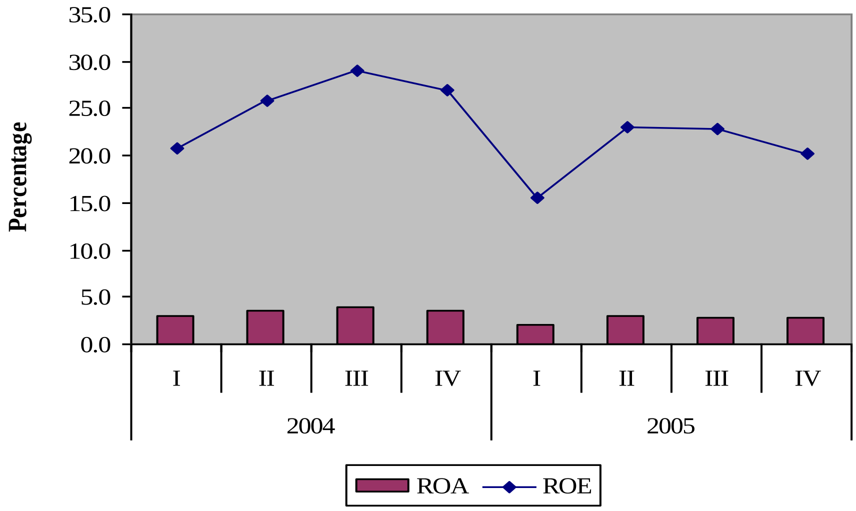
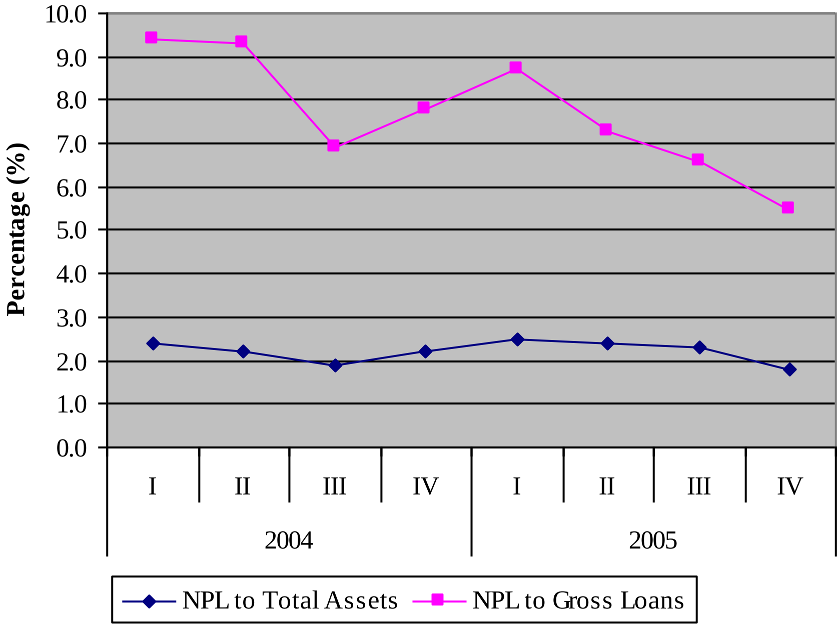


Figure 2.12 depicts trends in ROE and ROA for the years 2004 and 2005 on a quarterly basis. As can be seen from the graphs both ratios registered a remarkable decline in 2005 from the 2004 position. ROE declined to 20.2 percent in December 2005 from 26.9 percent in December 2004 while ROA dropped to 2.9 percent from 3.5 percent. The decline resulted from a drop in net income after tax to K2.2 billion from K2.4 billion in December 2004 following an increase in operating expenses. At the same time, both equity and total assets registered notable growths as mentioned above which further affected the ratios.

2.3.3 Asset Quality

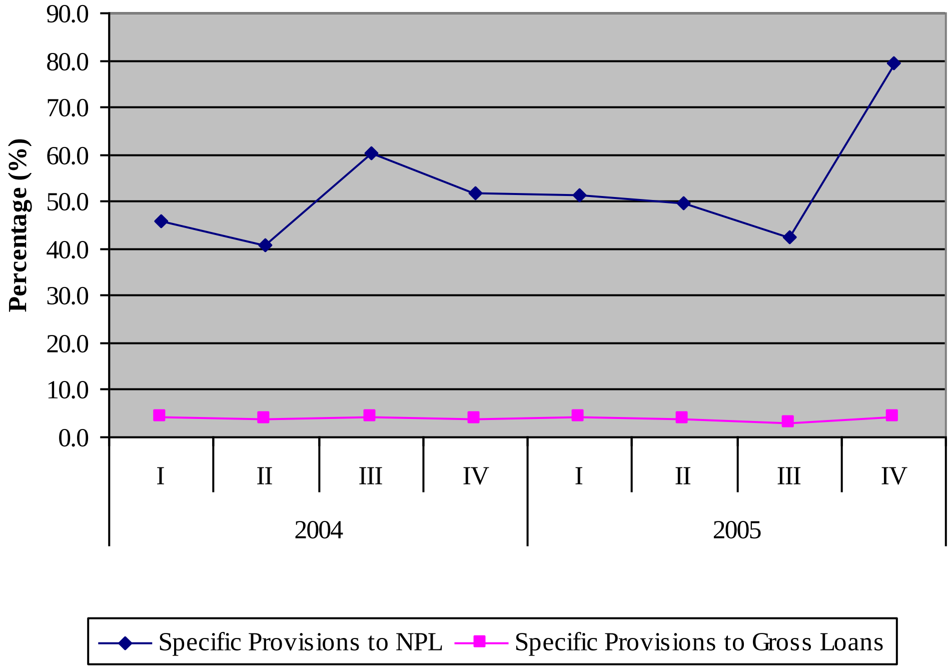
Asset quality of a financial institution is measured by the quality of loan portfolio and the level of non- performing advances. In assessing asset quality, the Reserve Bank uses the Directive on Asset Quality as a guiding tool. In addition, Directives on Credit Concentration and Foreign Currency Lending Ratio are also used in the assessment. Loans and advances form a major portion of the asset structure and also present the greatest credit risk and therefore a potential loss exposure to banks.

FIG 2.13: Non-Performing Loans (as Percentage of Total Loans and Total Assets)



The quality of the loan portfolio as measured by the levels of non-performing loans (NPL) and provisions on impaired loans is considered fair. Total non-performing loans reported by the banking sector improved by 10 percent from K1.5 billion at end December 2004 to K1.36 billion in December 2005. NPL constituted 5.5 percent of total loans and advances and 1.8 percent of total assets at December 2005 compared to 7.8 percent and 2.2 percent in December 2004, respectively.

Fig 2.14: Specific Provisions to NPL, Gross Loans



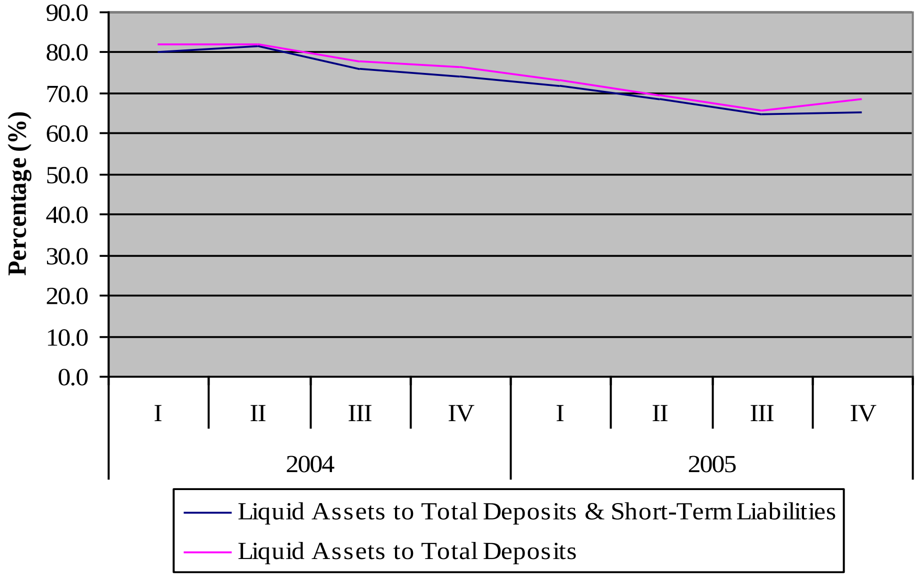
Specific provisions for impaired loans stood at K1.08 billion or 79.3 percent of non-performing loans compared to 51.9 percent registered in December 2004.

As required under Credit Concentration Directive, banks are prohibited from extending and or maintaining credit facilities to a single customer or a group of related borrowers, when such facility is 25.0 percent or more of the bank's core capital unless prior Reserve Bank approval is granted. In some few cases, the Reserve Bank of Malawi has permitted banks to lend their customers in excess of the prescribed limit provided that the facilities are export-related or the purpose of the facility is considered to be of strategic importance to the economy. Except for such cases, most banks operated within the lending limits.

2.3.4 Liquidity and Funds Management

Liquidity and funds management is the process of ensuring that a licensed institution is able to meet all of its funding obligations. When a bank has adequate liquidity it will be able to fund its obligations such as deposit withdrawals and liabilities maturing in the normal course of business at reasonable cost. Inadequate liquidity may lead to failure by a bank to settle its maturing obligations leading to loss of public confidence. Illiquidity can also affect profitability, capital and may lead to insolvency. For these reasons, banks are required to maintain adequate liquidity at all times.

FIG 2.15: Liquid Assets to Deposits and Short-Term Liabilities



Liquidity performance of the banking sector measured by the level and stability of liquid assets remained satisfactory. As at December 2005 total liquid assets held by the banks amounted to K39.7 billion from K37.8 billion registered in the previous year. Liquid assets constituted 65.4 percent of total deposits and short term liabilities down from 74.1 percent in December 2004. The ratio of liquid assets to total deposits and short term liabilities is one of the ratios that are used to measure a bank's ability to fund maturing obligations as they fall due. The regulatory minimum for this ratio in Malawi is 30 percent. Liquidity ratio has been declining for the past two years as banks have leaned towards more financial intermediation in light of falling yields on treasury bills which constitute a high percentage of total liquid assets. Fig. 2.15 presents the ratio of liquid assets to total deposits and short term liabilities.

CHAPTER 3

ACTIVITIES OF BANK SUPERVISION DEPARTMENT IN 2005

3.1 Introduction

The activities of Bank Supervision Department are based on the mandate of the Reserve Bank of Malawi under the Reserve Bank of Malawi Act 1989 and Banking Act 1989 to supervise banks and other financial institutions. This Chapter looks at the objectives of supervision, the legal and regulatory framework and the activities of the Department.

3.2 Principal Objectives

The financial sector plays a pivotal role in the economic development of any country and the continued strength and stability of a financial system is a matter of public interest. The main purpose for supervising financial services is to ensure that banks and other financial institutions are being operated in a sound and viable manner so as to develop and maintain public confidence in the financial sector. Protection of depositors and other creditors' interest through the existence of a sound financial system is critical, as the failure of one institution may create a systemic risk. Being vehicles for implementation of monetary policy, it is imperative that banks and other financial institutions are financially sound and stable at all times.

3.3 The Legal and Regulatory Framework

The Reserve Bank of Malawi draws its mandate to supervise banks and financial institutions from the Reserve Bank of Malawi Act, 1989. In particular, Section 4 (h) of the Act provides that one of the principal objectives of the Bank is to supervise banks and financial institutions. Alongside the Reserve Bank of Malawi Act, there is a Banking Act, 1989 which addresses licensing, prudential requirements and enforcement matters. In terms of this Act, the Ministry of Finance is the licensing authority while the Reserve Bank is the supervisory authority. To complement these legal instruments, the Reserve Bank issues directives from time to time to provide guidance to the banks and financial institutions on various prudential issues to ensure proper functioning of the system.

3.4 The Department's Functions and Structure

The Department's functions can be categorized into two critical areas of activities. The first relates to the Department's role in controlling entry into and exit from the industry. This responsibility aims at ensuring that only fit and proper players enter the banking market and that exit from the market is done in an orderly manner. The other major responsibility vested with the Department relates to its on-going supervision and regulation of banks and other financial institutions.

The primary justification for supervising financial institutions is to limit the risk of loss to depositors in order to maintain public confidence in these institutions and the industry as a whole. Furthermore, a country is dependent on financial institutions for economic and financial life in payments, acceptance of deposits and mobilization and allocation of financial resources.

Operationally the department is divided into two main divisions: Off-Site Surveillance Division and On-Site Examinations Division. Below these Divisions, there are sections namely; Banks I, Banks II, and Policies & Regulatory Administration. The current structure enables the department to cover all critical sectors of the financial market requiring prudential supervision (*see Appendix 2 for the actual organizational chart for the Department*).

3.4.1 On-going Supervision and Regulation

Once an institution meets the entry requirements and commences operations it becomes subject of different risks i.e. credit, solvency, foreign exchange, market counter party, and operational risks. These, if not well managed, can lead to an institution's financial distress and eventual failure. On-going supervision aims at the early identification and correction of such risks to minimise, but of course not to prevent, the occurrence of bank failures. This is achieved through the conduct of both off-site and on-site examinations. Off-site examinations entail the analysis of weekly, monthly, quarterly and annual prudential returns or call reports. Focus is on key parameters such as capital adequacy, liquidity, asset quality, management, profitability, and foreign exchange exposure. The findings from this exercise constitute an input to on-site examinations. This involves physical calls to the institutions on an ad-hoc or programme basis. Evaluation of the financial institutions' compliance with the various directives and regulations is also a critical aspect of on-going supervision and regulation. The findings in these areas serve as an input to the other key result areas of policy development and maintenance of the regulatory framework as well as exit administration.

3.4.2 Examinations and Work Conducted in 2005

During the year 2005, Bank Supervision conducted on-site examinations of three banks, all of which were rated fair. One of the banks examined was characterized by weak credit underwriting practices, while one had flaws relating to management information system and the other had weaknesses at both, Management and Board levels. Profitability wise, two of the examined banks posted losses during the year ended December 2005.

On the basis of findings and where necessary, corrective measures and supervisory action plans are made. The Division is also responsible for conducting premises inspection for banks and other financial institutions. This is aimed at ascertaining existence of adequate security equipment and operational infrastructure suitable for banking business.

In 2005, the Department boasts of a number of achievements such as: the putting in place of various directives and guidelines that were formally issued to the market in 2006, preparatory activities for Basle II implementation in the country, a successful reopening and curatorship of Finance Bank Malawi Limited, and countrywide premises inspections of two institutions that have recently converted to fully fledged banks.

However, there are a number of activities that were planned for implementation in 2005 but have not been implemented due to various bottlenecks. These include tripartite meetings, risk based supervision, deposit insurance scheme, credit reference bureau, and legislation for bank holding companies (BHCs), just to mention a few. Other outstanding issues include:

- Broaden disclosure requirements for the banking system to comply with Basel II requirements and in accordance with the International Accounting Standards;
- Introduce a formal relationship with auditors and discuss minimum expectations of the RBM from external audit work;
- Initiate the drafting of legislation for bank holding companies;
- Implement the BSA system along with a review of related returns;

- Guidelines on minimum requirements for banking premises; and
- Formulation of Exit Policy.

In addition, the Department only visited and examined three (3) institutions from the eight (8) that were planned. This was mainly so due to disturbances emanating from the closure of Finance Bank Malawi by the Reserve Bank of Malawi, and the splitting of the original Bank Supervision department into two, which resulted in reduction of the Department's staff by half. These two developments contributed significantly to the Department's failure to fulfil all its planned activities. Nevertheless, almost all the tasks outstanding from 2005 have been carried forward for implementation in 2006.

3.4.3 Staff Compliment and Human Resource Development

The year 2005 saw a creation of a new function called Supervision of Financial Institution within the Bank, separate from the Economic Services function. This therefore, led to a split of the original Bank Supervision Department into two: Bank Supervision and Supervision of Non-Bank Financial Institutions Departments with a Deputy General Manager as its head.

The establishment of the two departments led to a reduction of members of staff within Bank Supervision Department. In this regard, there is need for the department to be strengthened in view of the reduced staff numbers vis-à-vis the work load. During the year, the staff compliment was at 16. This includes one member who was on attachment to International Operations and Accounting departments and another who was doing postgraduate studies.

3.5 Licensing, Compliance Review and Corporate Governance

A strong banking system helps monetary authorities carry out their objectives, reduces the possibility and cost of bank failure to society and serves as a link between surplus and deficit customers. It is therefore fundamental for the Reserve Bank of Malawi to ensure the existence at all times of a market environment that is considered safe and secure by all stakeholders e.g. banks and customers.

3.5.1 Licensing

The Reserve Bank of Malawi continues to view the licensing process as a key success factor to the efficiency, stability and soundness of the banking system as well as to develop the confidence needed by depositors. To this end, supervisory efforts of the Reserve Bank of Malawi were aimed at ensuring that only properly qualified applicants enter the banking industry and that those already in the industry continue to comply with the governing statutes.

Further, the Reserve Bank of Malawi continues to enhance the licensing process in order to align with international best practice and to accommodate changes occurring in the banking sector. This is done through broadening the knowledge pool by way of attending regional and international supervisory seminars, courses and forums where regulatory issues and current developments are discussed. Various staff members attended several of such courses in 2005.

To this end, the licensing process requires that new applicants for banking licences have integrity and proper standing, financial stability to provide further financial support if called to do so and that their source of capital can easily be determined. In addition, the proposed business area should not be a captive or ring-fenced source of finance for its owners; rather it should serve the interests of all its depositors and the general public. No new applications for banking licences were received in 2005.

3.5.2 Compliance Review

This involves an examination of the operations of each licensed commercial bank and financial institution to determine level of compliance with the guiding laws, policies, directives and regulations as set by the Reserve Bank of Malawi from time to time. Corrective action is then administered on banks showing material non-compliance. Penalties range from simple caution for small cases to financial penalties for serious deviations.

A review of off-site analysis reports and other submissions showed that most of the banks were compliant with supervisory requirements. For instance, most of the institutions were submitting statutory returns within the stipulated time period and had adequate liquidity throughout the year. However, occasional monetary penalties were administered on several banks for non-compliance with foreign currency exposure limits.

3.5.3 Closure of Banks

Under section 31 of the Banking Act, the Reserve Bank of Malawi is empowered to recommend to the Minister of Finance sanctions to banks that conduct their business in an unlawful manner. In this regard, the Minister temporarily withdrew a banking licence from one commercial bank for serious breach of Exchange Control regulations. After discussions with shareholders, the bank reopened for normal business. The trading licence for foreign exchange business was however permanently withdrawn. Meanwhile, depositors continued to withdraw their deposits en mass. Eventually, the shareholders opted for a voluntary liquidation of their bank.

3.5.4 Corporate Governance

Presently, the country does not have a widely accepted set of standards to be used as a benchmark for assessing institutional compliance with corporate governance issues. In this regards, institutions use best practice as a proxy for the standards.

Notwithstanding, there is a growing trend for regulators to place much responsibility for running banks and financial institutions on the board and executive management. Emphasis is thus made on compliance with the fit and proper tests by board members and senior management by requiring that their credentials should be vetted by the Reserve Bank prior to being engaged in the running of banks. Except for two rejections on grounds of inadequate qualifications and banking experience, all applications submitted in 2005 were approved. Also, members are not allowed to hold positions on more than one institution at a time.

In order to secure approvals, commercial banks have identified individuals with requisite knowledge and skills for board and senior management positions and this has effectively helped them manage their risks better than before.

3.5.5 Challenges of the Compliance Process

The following constitute the major challenges of the compliance process:

- **Restructuring and Resource Allocation**
  Due to the restructuring that was carried out in 2005, the department was split into two new units - Bank Supervision to look after commercial banks and Supervision of Non-Bank Financial Institutions to look after all other financial institutions, both of which are under the Deputy General Manager, Supervision of Financial Institutions. As a result, the staff complement and all applicable resources were also split between the two departments; however, the two continue to be perceived as one and the same old Bank Supervision Department. The major challenge is therefore to secure adequate resources – both human and financial for the department to operate at optimal capacity.

- **Legal Framework for Supervising Discount Houses**
  Currently, discount houses are registered under the Banking Act but there are gaps in our laws and practices that provide opportunities for discount houses to enjoy regulatory arbitrage. There is therefore need to establish an appropriate and enabling legal framework and strategy for supervising such institutions. In the present setup, discount houses operate more or less like commercial banks but are not subjected to liquidity reserve requirements, much to the dismay of commercial banks.

- **Banking Act Review**
  Compliance is also hindered by lack of adequate legal mandate under the existing Banking Act for the Reserve Bank to take certain corrective action on problem banks. After all the gaps have been identified, technical expertise will be sought to address the need.

3.6 Regulatory Review

The Reserve Bank of Malawi draws its mandate to supervise banks and financial institutions from the Reserve Bank of Malawi Act (1989) and the Banking Act (1989). The latter addresses issues of licensing, prudential requirements and enforcement matters. Specifically, the Banking Act confers licensing powers on the Ministry of Finance while the Reserve Bank is the supervisory authority. Alongside these legal instruments, the Reserve Bank issues directives from time to time to provide guidance to banks and financial institutions on a range of prudential issues to ensure proper operation of the system. Most of the directives in force during the year were developed in 1993, however these are being updated and new ones will be introduced on entirely new areas.

Financial sector commentators observe that the past twenty-five years have probably seen greater changes in the banking and broader financial services industry than any comparable period in history. During the last quarter century, the financial services industry around the globe has become more concentrated, diversified and interconnected. Accompanying these developments have been technological changes that have increased the speed and volume of transactions enormously and fostered widespread innovation in markets, organizational structures, services and instruments. While this period has seen greater growth and profitability in the financial services, it has also been accompanied by wider risk assumption and repeated banking crises in many countries.

The fast changing dynamics of the global financial arena underline the importance of evolution of the current supervisory and regulatory approaches in order to narrow down mismatches and keep it relevant. Some of the key issues that have dominated the minds of regulators include the most appropriate way of regulating the diverse participants in the financial system, the future role of deposit insurance scheme, risk management and the impact of cross-border insolvencies in a highly integrated financial system. In recognition of this fact, the Reserve Bank of Malawi has initiated radical reforms to the governing laws and also solicited technical assistance from the International Monetary Fund (IMF) to revamp the directives and introduce new ones so that the legal and regulatory framework in Malawi is consistent with the changing financial landscape and also in line with international supervisory standards. Significant progress has been made in this area such that the first sets of directives are due for issuance during the first quarter of 2006. A list of these directives and other tools is provided in Appendix 1.

Performance and condition of banks and financial institutions are evaluated using the CAMEL (**C**apital adequacy, **A**sset quality, **M**anagement capabilities, **E**arnings and **L**iquidity and funds management) rating system. This is a uniform method where each of the five components is put on a scale of 1 to 5. A rating of **1** is the highest rating and indicates the strongest performance and risk management, and the least degree of supervisory concern. A rating of **5** is the lowest rating and indicates the weakest performance and critically deficient risk management and therefore, the highest degree of supervisory concern. The overall rating is derived after evaluating each of the five components.

3.7 Finance Bank Malawi Limited (In Receivership)

In May 2005, the Minister of Finance revoked the banking licence of Finance Bank Malawi Limited (FBM) under section 10 of the Banking Act, 1989 for malpractices relating to foreign exchange operations and opening of accounts. At the time of revoking the licence, FBM ranked fifth in the market in terms of asset size with assets in excess of MK2.8 billion. The shareholders requested to voluntarily liquidate the bank after failing to identify an acceptable buyer. The Reserve Bank allowed the shareholders to appoint a Liquidator to manage the liquidation process. This has been the first bank closure in the history of the country.

3.8 Regional Supervisory Activities

During the year, Malawi participated in a number of supervisory activities including SSBS meetings, meetings of the SADC legal steering Committee, and the Heads of supervision training that took place in Lesotho. The department also participated in a three-day in-house training facilitated by the FSI in Maputo at the bank of Mozambique Training Centre on the subject of "Problem Bank Resolution". All these activities were beneficial in enhancing supervision both in the country and the region.

In addition, the BSA project was successfully launched in Malawi complete with new returns. There remain however, a few generic problems which are being addressed by the respective IT teams.

CHAPTER 4

CURRENT ISSUES IN BANK SUPERVISION

4.1 Introduction

The New Capital Accord (Basle II) and anti-money laundering and the combating of the financing of terrorism (AML/CFT) have been topical issues in the corridors of supervisory authorities worldwide. At the national level, a number of activities have been conducted in line with regional and international initiatives. This Chapter highlights some of these critical steps. Overall, Basel II and AML/CFT issues appear to be *new breeds of animals* to be tamed by supervisory authorities. As such, there is need for thorough sensitization and awareness campaigns to enhance the level of understanding among all stakeholders.

4.2 Progress Report Towards Implementing Basel II

The Reserve Bank of Malawi took a policy decision for Malawi to adopt Basel II following resolutions that were made at the MEFMI Workshop which the Bank hosted in Lilongwe in October 2004. It was agreed that implementation date would vary from country to country taking into account the different economic challenges facing each jurisdiction. Each regulatory authority was therefore to decide when to implement Basel II based on its state of preparedness. The Reserve Bank of Malawi tentatively set 2010 as the earliest possible date for implementation.

4.2.1 Approach

Basel II consists of mainly three Pillars: Pillar I, Pillar II and Pillar III. It is not a must for a country to implement all the pillars at one time. Depending on its state of preparedness, a country can implement either one or two pillar(s) first, and then the other(s) at a later stage.

In view of the complexity and costs involved under Pillar I, the Reserve Bank of Malawi strategy is to implement Basel II in a staggered/phased manner; preferably starting with pillar III (Disclosure regime) and Pillar II (Risk Management), and ending with Pillar I (Capital allocation). In opting for such an approach, the Reserve Bank of Malawi recognizes the fact that Basel II is not just a capital regulating tool, but rather an attempt to bring into the banking business a risk management culture. Such an approach, therefore, will allow us to embrace elements of Basel II, while we are still operating under Basel I.

Considering the costs, supervisory expertise and level of financial sophistication in our market, the Reserve Bank of Malawi will encourage banks to adopt the standardized approach under Pillar I, for calculating both, credit and operational risk[4]. However, for those banks that are subsidiaries of foreign banks, they may, in liaison with their parent banks, and subject to supervisory discretion, be allowed to adopt the advanced approaches, such as Internal Ratings Based (IRB) approach.

4.2.2 Progress to Date

From October 2004 when a policy decision was taken to adopt Basel II, the Reserve Bank of Malawi has taken a number of steps as part of its preparedness towards Basel II implementation. Notable ones include the following:

1. A Basel II Preparedness Committee was set up within the Bank to spearhead Basel II preparations and map the way forward. Four key areas were identified as prerequisites for Basel II implementation, namely: review of the regulatory framework, adoption of Risk Based Supervision, establishment of a credit information bureau, training and capacity building of Supervisors.

2. A sensitization workshop for banks in conjunction with MEFMI was conducted mid 2005.

3. Review of the existing Directives was done to make them Basel II compliant. New Directives were also issued to the market, all of which are fully operational at the moment.

4. Training of staff in Basel II has commenced and is on-going.

5. Self assessment to ensure full compliance to the Basel Core Principles (BCPs) was done in July 2004, and revealed that the country is largely compliant, except for a few principles.

4.2.3 Challenges

[4] SADC does not mind countries adopting Simplified Standardized Approach (SSA) which is less advanced than Advanced Measurement Approaches (AMA) and very close to Basel I.

There are currently three major issues that need to be addressed, some of which will require support and commitment from other stakeholders to ensure that preparations are adequate for implementation of Basel II. These are:

1. There is need to ensure that the Banking Act, and other related laws/regulations are amended to make them Basel II complaint. The Reserve Bank of Malawi is banking on the support from the IMF Technical Assistance Team on this matter. Success in this area however, will largely depend on how quickly the draft legislation is enacted in Parliament. Government support is therefore, key in this aspect.

2. Basel II requires that each borrower be rated to ensure that the capital charge allocated reflects his/her riskness. However, there are no credit rating agencies in Malawi at the moment and chances are very slim that agencies such as Moody's, J.P. Morgan and others would extend their services to Malawi. However, the Reserve Bank of Malawi will explore other options such as sharing services with one or two other SADC countries, or any other feasible options. The Reserve Bank of Malawi, therefore, welcomes the idea from the Banker's Association of Malawi to establish a credit reference bureau in Malawi. This will provide valuable information resources for the work of the credit rating agency. As regulators, we are committed to work with the market on this aspect.

3. Basel II is relatively complex and requires well trained expertise and up-to-date information technology systems. These require significant financial resources. Every effort is being made to ensure that the Supervisors are equipped in this regard.

4.2.3 Way Forward

Currently, there are a number of tasks that the Reserve Bank intends to undertake as part of its continued preparedness on Basel II. These will include:

1. Liaising with other stakeholders on the possibility of forming a Basel II National Steering Committee (composition of this committee to be agreed with banks). The

Reserve Bank of Malawi strongly encourages banks to form individual or inter-bank technical committees to oversee Basel II preparedness.

2. Training of Bank Supervision staff in Risk Based Supervision (RBS), and consider fully implementing RBS system of examination. This is a prerequisite for successful Basel II implementation.

3. Training of Bank Supervision staff in Credit and Operational Risk measurement under Basel II.

4. Ensuring that the country is fully compliant to the BCPs, especially those relating to cross boarder supervision, consolidated supervision and corporate governance.

5. Conducting sensitization workshops to all relevant stakeholders for them to appreciate Basel II and what it will entail in practice.

4.3 Preventing Money Laundering and Terrorist Financing in Malawi

Money laundering is variously defined in literature but the most common definition states that money laundering is the process undertaken to cover up the source of money especially if it has been derived from criminal activity, usually from criminal offences connected with organised crime and other capital- intensive felonies related to drug trafficking, corruption tax evasion, etc. The purpose of laundering the money is to sever the link between the money and the criminal activity, so that it can be used legally while the criminal escapes detection and prosecution.

The literature on money laundering lists three main stages by which money is laundered: 1) *placement*, i.e. changing the location or the form of ill-gotten assets, for example by converting or depositing cash into a financial institution; 2) *layering* i.e. performing numerous transactions with the property to obscure or hide its origin, for example making international transfers; and 3) *integration,* i.e. converting the property into a source of finance for legitimate activities. These stages may be performed either concurrently or separately, and in different geographical locations.

There is no single uniform method for laundering money. It can be carried out via a variety of activities, for instance, dividing a large amount of cash among many people who are paid a commission to deposit it in banks; using legitimate cash-based businesses (shops, garages, etc) to mix clean money with dirty money; setting up fictitious businesses to channel money gained from criminal activity (front businesses; and physically smuggling cash into countries which do not have systems of supervision or regulation). Money laundering is mainly identified with banking transactions such as making deposits, international transfers, credit and guarantees, but there are other financial channels which can be used for this purpose such as investment houses, accountants, lawyers, car dealers, etc.

During the year, the global fight against money laundering continued to be at the centre stage worldwide. The Financial Task Force, the global authority on anti-money laundering and combating terrorist financing, added a key element to the world's counter-terrorist financing defences. The new measure, Special Recommendation IX, calls on countries to stop cross-border movements of currency and monetary instruments related to terrorist financing and money laundering and confiscate such funds. It also calls for enhanced information-sharing between countries on the movement of illicit cash related to terrorist financing or money laundering.

At national level, the Reserve Bank of Malawi took a leading role in a number of AML/CFT related activities, some of which are highlighted below:

4.3.1 Money Laundering and Proceeds of Serious Crime Bill

After failing to have the Money Laundering and Proceeds of Crime Bill, 2002 passed in Parliament in several previous occasions, Government re-gazetted the Bill in September 2004. The Bill, which seeks to plot the path for the anti-money laundering, will be administered by the Minister of Finance. The main elements of the law are that it:

- criminalises money laundering;
- imposes obligations on all financial institutions and cash dealers to identify customers, report suspicious transactions to appropriate law enforcement authorities, Directorate of Public Prosecutions and equivalent authorities abroad;
- sets monetary fines and custodial sentences on anyone who fails to perform any of the obligations stipulated in the Bill.

- imposes an obligation to retain the identification documents and records of every transaction for at least seven years from the date the relevant business or transaction was completed.

As at the close of the year, the Bill was still in the corridors of Parliament. Through its Legal Affairs Committee, Parliament was engaging various stakeholders for expert advice on the contents of the Bill.

CHAPTER 5
BEYOND THE HORIZON

Introduction

The foregoing chapters have given account of the past and present condition of the financial system and the task of supervision in Malawi. This final chapter provides an overview of what the department anticipates to carry out in the year 2006.

Amendment of Laws

The task of amending the Banking Act and the Reserve Bank of Malawi Act was not completed in 2005. This will therefore continue in 2006 with the assistance of the IMF. FIRST Initiative are continuing to assist the Reserve Bank in amending a number of laws for the financial services and making sure that there is consistency among the financial services laws of the country. The intention is to bring all financial remedial measures and supervisory powers under the proposed Financial Services Act with the Reserve Bank of Malawi as the supervisory authority, while the rest of the operational rules remain in the respective industry laws. Consistency with the SADC Model Central bank law will also be pursued in the amendment process.

In 2006, the Reserve Bank of Malawi will also continue to make follow up on the enactment of the Anti-Money Laundering and Combating the Financing of Terrorism (AML\CFT) legislation which has been a Parliamentary Bill since 2002. The bill was discussed in Parliament but was not passed as a number of issues needed to be addressed. It is expected that these will be addressed to the satisfaction of the House while remaining consistent with international standards. In addition, it is expected that drafting of legislation for bank holding companies will be initiated in 2006 to be completed in 2007 all things being equal.

Review and Introduction of Directives

Due to preoccupation with the Finance Bank saga and the moving of some members of staff from Bank Supervision Department to the newly created Supervision of Non-Bank Financial Institutions Department, review of many directives that had been planned for

2005 was not completed. However, substantial progress in this respect has been achieved and all the directives are expected to be adopted and issued to the market during 2006.

Review and Introduction of Internal Guidelines

Developments in the bank supervision function worldwide make capacity building among supervisory staff a priority. One way of achieving this is through training. Since formal training usually has resource implications, on-the-job training is viewed as an important part of the process. A number of guidelines were therefore identified for review and introduction in the department. However, for reasons similar to those under Review and Introduction of Directives above, review of the guidelines was not completed. Nevertheless, most of these are expected to be completed in 2006.

Other Activities

In the year under review, the department managed to conduct premises inspections of all business premises of the two banks that had just newly converted into full commercial banks. As expected, most of the premises were not up to the required standard. It was pleasing however, to note that both banks had embarked on face lifting exercises to ensure the premises were of the appropriate standard. Since such exercise had resource implications, the banks were given a grace period in which to ensure that all their premises are compliant with the standards for banking premises. At the appropriate time, follow-up inspections will be conducted to verify compliance.

The activities on the agenda earmarked for implementation in 2006 include:-

- Reinforcement of supporting structures (e.g. establishment of a credit information bureau, deposit insurance scheme, and continuing to liaise with relevant authorities on the establishment of commercial courts. A lot of progress has been made by the authorities in this respect and it is expected that the commercial courts may begin to sit in October 2006. Sensitisation efforts for the deposit insurance scheme will continue in 2006).
- Formulation of an exit policy and formal written operating guidelines for administering an orderly exit.
- On-going tripartite meetings for banks as necessary.

Appendix 1

DIRECTIVES AND GUIDELINES IN FORCE DURING 2005

DO1- 93	Prudential Guidelines on Asset Quality for Banks
DO1A-93	Prudential Guidelines on Asset Quality for Financial Institutions
DO2-93	Minimum Capital Ratios for Banks
DO2A-93	Minimum Capital Ratios for Financial Institutions
DO3-93	Credit Concentrations for Banks
DO3A-93	Credit Concentrations for Financial Institutions
DO1- 96	Liquidity Reserve Requirement
DO1-97	Foreign Currency Exposure Limits
DO2-97	Foreign Currency Lending Ratio
DO1-04	Submission of Call Reports by Banks and other Financial Institutions
DO1-05	Customer Due Diligence for Banks and Financial Institutions

Policy Statement on the Prudential Aspects of Bank Liquidity

DRAFT DIRECTIVES EXPECTED TO BE ISSUED IN 2006

Directive on Capital Adequacy (Revised)

Directive on Large Exposures

Directive on Asset Classification and Provisioning

Directive on Audit Committee and Annual Audits

Directive on Transactions with Related Persons

Directive on New Directors and Senior Management Officials

REVISED INTERNAL GUIDELINES TO BE ADOPTED IN 2006

Credit Quality, Advanced Procedures for On-site Examination Manual

Guidelines for Processing Applications for New Directors and Senior Management Officials

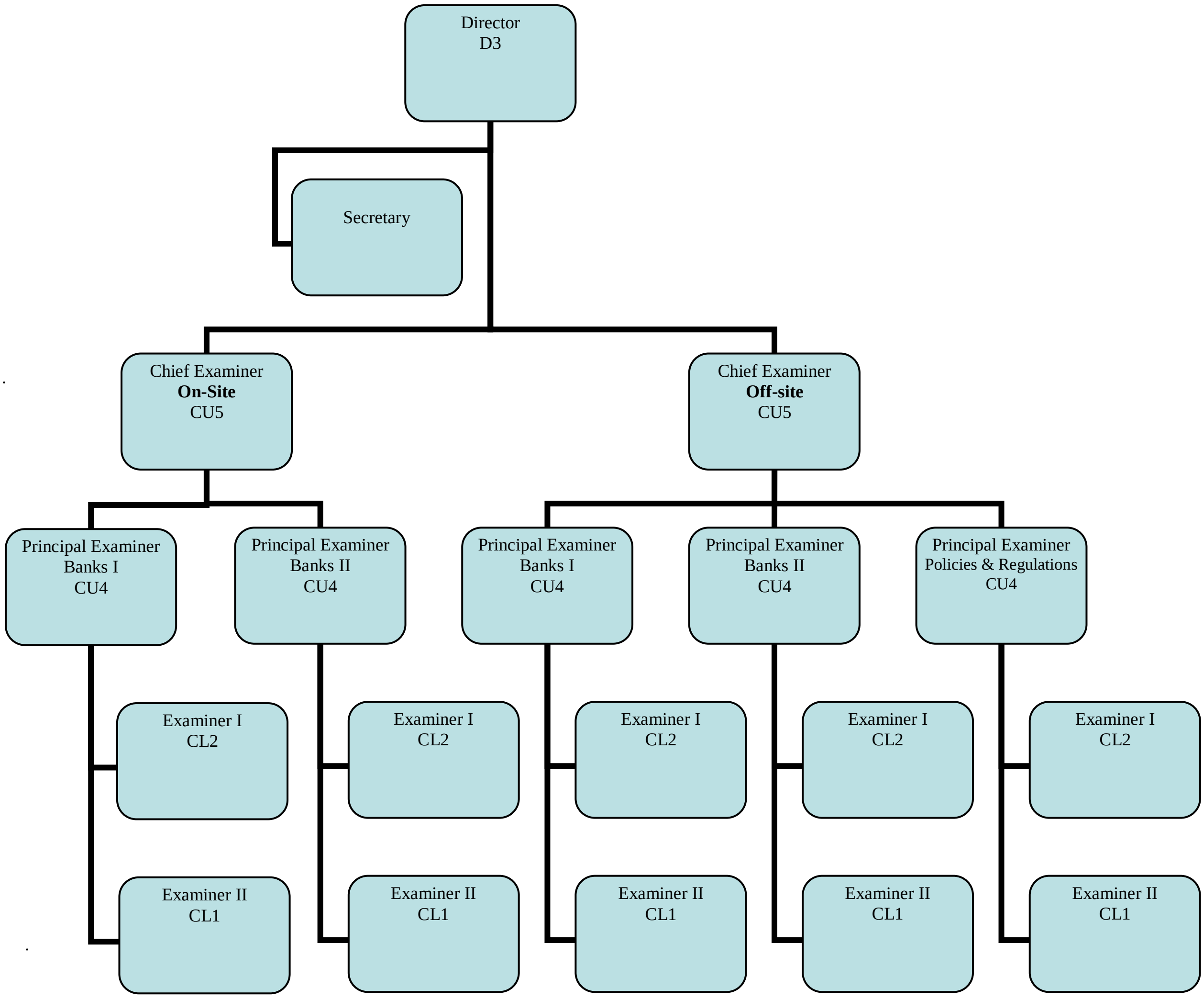
Management, Advanced Procedures for On-site Examination Manual

Bank Licensing Guidelines; Application for Bank Licensing

CAMELS Bank Rating System

Appendix 2

ORGANISATION STRUCRURE OF BANK SUPERVISION



Appendix 3

REGISTER OF COMMERCIAL BANKS AND OTHER FINANCIAL INSTITUTIONS AS AT 31 DECEMBER 2005

Name of Institution	Title & Name of Top Officer	Postal Address	Phone and Fax Numbers	Location of Head Office
National Bank of Malawi	Chief Executive Mr. I Nsamala	Box 945, Blantyre	01 820622 01 820321	Victoria Avenue, Blantyre
Stanbic Bank Malawi Ltd	Managing Director Mr. P Odera	Box 1111, Blantyre	01 820144 01 820360	Glyn Jones Road, Blantyre
Nedbank Malawi Ltd	Managing Director Mr. R Pedder	Box 750, Blantyre	01 820477 01 820102	Victoria Avenue, Blantyre
INDEbank Malawi Ltd	Acting Chief Executive Mr. K Stewart	Box 358, Blantyre	01 820055 01 835703	Top Mandala, Blantyre
First Merchant Bank	Managing Director Mr. K Chaturvedi	P/Bag 122, Blantyre	01 821942 01 821978	Glyn Jones Road, Blantyre
Finance Bank Malawi Ltd	Managing Director Mr. A. Pillai	Box 421 Blantyre	01624232 01622957	Victoria Avenue Blantyre
Loita Investment Bank	Managing Director Mr. G Duff	P/Bag 389, Blantyre 3	01 822681 01 822683	Victoria Avenue, Blantyre
NBS Bank Ltd	Chief Executive Officer Mr. J Biziwick	Box 32251, Blantyre 3	01 876222 01 875485	Ginnery Corner, Blantyre
Opportunity International Bank Malawi Ltd	Chief Executive Mr. R Voorhies	P/Bag A71, Lilongwe	01 758403 01 758400	Old Town, Lilongwe
Malawi Savings Bank	General Manager Mr. I Bonongwe	Box 521, Blantyre	01 825111 01 821089	Victoria Avenue, Blantyre
National Finance Company	General Manager Mr. M Bamford	Box 821, Blantyre	01 823670 01 820549	Victoria Avenue, Blantyre
Leasing and Finance Company	General Manager Mr. M Lungu	Box 1963, Blantyre	01 820233 01 820275	Glyn Jones Road Blantyre

Appendix 4

BRANCH NETWORK ETC FOR BANKS IN 2005

Name of Institution	Branch Network	No of ATMs	No of Employees	No of Accounts
National Bank of Malawi	13	27	924	130,692
Stanbic Bank Malawi Ltd	9	26	588	161,892
Nedbank Malawi Ltd	2	2	88	3,702
INDEbank Malawi Ltd	4	0	105	11,893
First Merchant Bank	7	7	347	12,691
Loita Investment Bank	2	N/A	36	N/A
NBS Bank Ltd	12	28	366	191,349
Opportunity International Bank Malawi Ltd	1	6	94	38,407
Malawi Savings Bank	3	5	182	151,622
Leasing and Finance Co Ltd	2	0	15	1476
National Finance Co Ltd	N/A	N/A	N/A	N/A
First Discount House Ltd	0	0	16	N/A
Continental Discount House Ltd	0	0	20	0

N/A: Information not available

Appendix 5

OVERALL BANKS CAMEL RATING

NO. OF INSTITUTIONS	COMPOSITE RATING	CAPITAL	ASSET QUALITY	MANAGEMENT	EARNINGS	LIQUIDITY
Strong	0	0	0	0	0	0
Satisfactory (2)	4	7	7	5	3	8
Fair (3)	3	1	0	2	2	1
Marginal (4)	2	1	0	2	1	0
Unsatisfactory (5)	0	0	2	0	3	0

TABLE 1

COMPOSITION OF BALANCE SHEET: LIABILITIES

	Deposits	Due to Other Banks	Interest Payable	Other Liabilities	Capital and Reserves	Total Capital and Laibilities
			K, millions			
Average End of Quarter						
2004: 01	41,629	965	434	6,276	9,191	58,495
2004: 02	46,247	462	477	6,574	9,227	62,988
2004: 03	46,618	1,131	600	6,575	9,232	64,155
2004: 04	49,294	1,659	577	6,675	9,696	67,901
2005: 01	48,515	775	351	5,930	9,945	65,516
2005: 02	52,444	1,083	456	6,176	10,136	70,295
2005: 03	54,594	794	555	7,978	10,200	74,121
2005: 04	58,029	2,748	391	5,249	11,034	77,451
Month-end balance for year						
Dec 2003	39,332	2,094	523	6,061	8,495	56,505
Dec 2004	49,294	1,659	577	6,675	9,696	67,901
Dec 2005	58,029	2,748	391	5,249	11,034	77,451

TABLE 2

COMPOSITION OF BALANCE SHEET:ASSETS

	Cash and Due from Other Banks	Loans and Advances	Securities and Investments	Other Assets	Total Assets
			K, millions		
Average End of Quarter					
2004: 01	13,781	14,702	21,506	8,506	58,495
2004: 02	16,786	15,134	22,777	8,291	62,987
2004: 03	13,633	17,718	24,225	8,579	64,156
2004: 04	17,732	19,375	21,348	9,446	67,901
2005: 01	12,670	18,833	25,571	8,443	65,516
2005: 02	13,855	22,208	24,470	9,491	70,024
2005: 03	12,923	25,463	25,948	9,769	74,103
2005: 04	20,749	24,819	22,456	9,432	77,456
Month-end balance for year					
Dec 2003	14,855	13,715	21,413	6,523	56,505
Dec 2004	17,732	19,375	21,348	9,446	67,900
Dec 2005	20,749	24,819	22,456	9,432	77,456

TABLE 3

COMPOSITION OF BALANCE SHEET: DEPOSITS

	Demand Deposits	Savings Deposits	Time Deposits	FCDAs	Total Deposits
			K, million		
Average End of Quarter					
2004: 01	11,437	8,265	11,952	9,974	41,629
2004: 02	14,637	8,685	12,547	10,378	46,247
2004: 03	15,393	9,564	11,957	9,703	46,618
2004: 04	16,377	8,936	14,655	9,327	49,294
2005: 01	17,232	8,781	13,640	8,862	48,514
2005: 02	18,843	10,619	13,445	9,537	52,444
2005: 03	19,701	10,439	15,610	8,843	54,593
2005: 04	21,434	12,148	16,163	8,284	58,029
Month-end balance for year					
Dec 2003	11,747	8,452	11,666	7,466	39,331
Dec 2004	16,377	8,936	14,655	9,327	49,294
Dec 2005	21,434	12,148	16,163	8,284	58,029

TABLE 4

TRENDS IN CAPITAL ADEQUACY

	Tier 1 Capital	Total Capital	Risk Weighted Assets	Tier 1 Capital Ratio
		K, million		%
Average End of Quarter				
2004: 01	7,343	9,048	26,478	27.7
2004: 02	7,187	8,897	26,820	26.8
2004: 03	7,179	8,904	29,230	24.6
2004: 04	7,496	9,255	32,530	23.0
2005: 01	8,232	9,957	27,397	30.0
2005: 02	8,131	9,871	42,854	19.0
2005: 03	8,164	9,941	49,947	16.3
2005: 04	8,586	10,736	48,123	17.8
Month-end balance for year				
Dec 2003	5,999	7,336	22,472	26.7
Dec 2004	7,496	9,255	32,530	23.0
Dec 2005	8,586	10,736	48,123	17.8

TABLE 5

COMPOSITION OF INCOME STATEMENT: SELECTED ITEMS

	Total Gross Income	Gross Interest Income	Non-Interest Income	Interest Expenses	Operating Expenses
	K, million				
Average End of Quarter					
2004: 01	3,604	2,705	899	1,029	1,535
2004: 02	7,349	5,436	1,913	2,002	3,246
2004: 03	10,922	7,789	3,133	2,691	5,091
2004: 04	14,238	9,879	4,359	3,329	7,107
2005: 01	3,192	2,299	892	731	1,799
2005: 02	7,168	4,774	2,394	1,472	3,798
2005: 03	11,053	7,453	3,600	2,219	5,987
2005: 04	15,250	10,097	5,153	2,916	8,336
Month-end balance for year					
Dec 2003	14,296	10,715	3,581	4,158	5,714
Dec 2004	14,238	9,879	4,359	3,329	7,107
Dec 2005	15,250	10,097	5,153	2,916	8,336

TABLE 6

PROFITABILITY: SELECTED RATIOS

	Interest Margin	Efficiency	ROE	ROA
	%			
Average End of Quarter				
2004: 01	17.3	42.6	20.7	3.0
2004: 02	16.3	44.2	25.9	3.5
2004: 03	16.0	46.6	29.0	3.9
2004: 04	14.0	49.9	26.9	3.5
2005: 01	13.4	56.4	15.5	2.1
2005: 02	13.5	53.0	23.0	3.0
2005: 03	13.7	54.2	22.8	2.9
2005: 04	13.6	54.7	20.2	2.9
Month-end balance for year				
Dec 2003	17.6	40.0	38.0	5.0
Dec 2004	14.0	49.9	26.9	3.5
Dec 2005	13.6	54.7	20.2	2.9

TABLE 7

ASSET QUALITY

	Loans and Advances K, million	Non-Performing Assets to Gross Loans %	Non-Performing Assets to Total Assets %	Specific Provisions to Gross Loans %	Specific Provisions to Non-Performing Assets %
Average End of Quarter					
2004: 01	14,702	9.4	2.4	4.3	45.8
2004: 02	15,134	9.3	2.2	3.8	40.8
2004: 03	17,718	6.9	1.9	4.1	60.3
2004: 04	19,375	7.8	2.2	4.0	51.9
2005: 01	18,833	8.7	2.5	4.4	51.3
2005: 02	23,386	7.3	2.4	3.7	49.7
2005: 03	26,557	6.6	2.3	2.8	42.4
2005: 04	24,819	5.5	1.8	4.4	79.3
Month-end balance for year					
Dec 2003	13,715	12.2	2.5	6.5	80.2
Dec 2004	19,375	7.8	2.2	4.0	51.9
Dec 2005	24,819	5.5	1.8	4.4	79.3

TABLE 8

LIQUIDITY

	Liquid Assets to Total Deposits & Short Term Liabilities %	Liquid Assets to Total Deposits %	Rate Sensitive Assets/ Rate Sensitive Liabilities %
Average End of Quarter			
2004: 01	80.1	81.9	124.6
2004: 02	81.5	82.3	123.7
2004: 03	76.1	78.0	130.5
2004: 04	74.1	76.6	120.5
2005: 01	71.7	73.4	128.2
2005: 02	68.7	69.7	148.7
2005: 03	64.8	65.7	152.3
2005: 04	65.4	68.4	147.8
Month-end balance for year			
Dec 2003	85.5	90.5	124.8
Dec 2004	74.1	76.6	120.5
Dec 2005	65.4	68.4	147.8