RESERVE BANK OF ZIMBABWE

BANK LICENSING, SUPERVISION & SURVEILLANCE

ANNUAL REPORT

2007

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PURPOSE OF THIS REPORT

The purpose of this Annual Report is to provide an analysis of the condition and performance of the banking sector in Zimbabwe for the year ended 31 December 2007. The report also provides an overview of the supervisory operations and activities during the period under review. Readers should note that this report is not a statutory requirement, and that it has been prepared solely for information purposes for the benefit of the Bank's various stakeholders.

GOVERNOR'S FOREWORD

1.1 Stability of the financial sector remained prominent in the year 2007 as financial institutions spruced up their risk management and corporate governance structures in line with supervisory expectations. The banking system remained largely in conformity with international best practices of prudence, alert risk management, as well as sound corporate governance norms, among many other virtuous standards. The Reserve Bank on the other hand continued to closely and rigorously monitor developments of supervisory concern and implemented swift corrective measures where necessary.

1.2 Inflationary pressures coupled with indiscipline and imprudent behaviour in the balance sheet structures of financial institutions resulted in cash shortages in the last quarter of the year as some errant financial institutions invested depositors' funds in the less liquid assets in the stock market resulting in liquidity mismatches. Where some institutions had acquired such shares in underwriting arrangements, it was established that the concerned institutions were holding onto these shares for a period longer than required. As Monetary authorities corrective remedies were taken and I am pleased to report that the response by concerned institutions was excellent.

1.3 Faced with these cash shortages in the market, the Reserve Bank responded by introducing higher denominations bearer cheques in December 2007 in order to assist the transacting public access their account balances. On the other hand, the Reserve Bank raised the bar of its supervisory activities on banking institutions resulting in revelations of some individuals and companies abusing multiple bank accounts to withdraw more cash than the stipulated amounts.

1.4 Pursuant to our objective of ensuring financial stability, and in order to support the realignments of asset portfolios of banks, the Reserve Bank reduced the statutory reserve thresholds across various deposit classes. In addition, the tenor on excess liquidity management, zero coupon bonds was reduced from 270 days to 7 days. The Reserve Bank has continued to closely monitor developments in the banks' balance sheets and liquidity profiles with a view to stem out any non-compliant behaviour.

1.5 Various memoranda of understanding with countries where Zimbabwe banking institutions are represented by way of subsidiaries, joint interests, associates or branches were signed in the spirit of consolidated supervision and management of contagion risks at a macro level. Home-host information exchanges continue to take place with bilateral and multilateral institutions as far as supervisory issues are concerned.

1.6 Internationally, implementation of the Basel II Framework continues to move forward. A significant number of countries and banks have already implemented the standardised and foundation approaches as of the beginning of 2008. In many other jurisdictions, the necessary infrastructure (legislation, regulation, supervisory guidance, etc) to implement the Framework is either in place or in process, which will allow a growing number of countries to proceed with implementation of Basel II's advanced approaches in 2008 and 2009. This progress is taking place in both Basel Committee member and non-member countries. The Basel Committee on Banking Supervision's Accord Implementation Group (AIG) and its working groups on validation, operational risk and trading book issues continue to actively share supervisory experiences in Basel II implementation, thereby promoting consistency across jurisdictions.

1.7 As highlighted before, the Reserve Bank has taken a gradual approach in implementing Basel II in order to ensure a smooth transition and to date significant progress has been made towards laying groundwork for Basel II implementation. With effect from the second half of 2007 and in line with the market discipline requirements of Basel II, banking institutions and asset management companies are required to make additional discloses relating to the results of their latest on-site ratings as part of their published financial statements.

1.8 The ongoing global subprime crisis has brought startling revelations of excessive risk taking by banking institutions and failure of banks' risk management systems to appreciate that the new "structured finance vehicles" that they used to offload their risky sub prime investments were not really viable. While credit rating agencies have been targeted as carrying significant responsibility for the crisis, concerns have been raised on the responsiveness of financial sector supervision and regulation to the rapid innovation and shift in business models, leaving scope for excessive risk-taking by banking institutions.

1.9 Many global regulators have been grappling with ways of containing the financial scourge to prevent financial system collapse. Many central banks including the Federal Reserve of the USA the same route that we did in 2003/4 in order to bail out financial institutions. Having drawn lessons from the corporate collapses during 2003/4 and the current subprime crisis involving the abuse of special purpose vehicles (SPVs) to achieve regulatory arbitrage by some banks, the Reserve Bank issued a guideline covering the operations of SPVs.

1.10 In addition the Reserve bank issued a guideline on consolidated supervision. It was noted that some banks were tempted to abuse holding companies as a way of circumventing the law and achieve regulatory arbitrage. Armed with the supervisory techniques such as group wide risk assessment and consolidated supervision; such institutions may face the undesirable consequences of uncompromising corrective measures which may result in closure without period of nursing and incubation as provided for by the curatorships of the 2003/4 period. This is in line with the prompt corrective action strategies adopted by the Reserve Bank in 2006.

1.11 Lastly, I would like to express my appreciation for the cooperation of the banking sector and other stakeholders to ensure success of the economic capital aspirations of the Reserve Bank.

………………………..
Dr. G. Gono
Governor

DEPUTY GOVERNOR'S REMARKS

1.1 The financial sector remained generally stable during the year. However, the industry has been showing signs of relapsing into imprudent behaviours as seen in 2003/ 2004. The Reserve Bank continues to take swift action in dealing with imprudent practices which have the potential of exposing the entire financial sector to systemic risk.

1.2 The Asset Management sub sector has remained overtraded. It has been noted that some institutions are now relying on income from non core activities as income and investments under management have not been sufficient to sustain operations. To date only a few asset management companies have heeded the call to consolidate their businesses. In this regard, the moratorium on the licensing of asset management companies remains in force.

1.3 As part of the groundwork towards Basel II implementation, the Reserve Bank issued guidelines on Special Purpose Vehicles, Securitisation & Structured Finance and Consolidated Supervision Framework. In view of the rapid growth in structured finance and growing sophistication in synthetic forms of asset securitization, the guideline provides a common regulatory policy on the treatment of SPVs and securitization activities in which banking institutions have a role to play. On the other hand, the primary objective of Consolidated Supervision is not to supervise each and every entity in the group but to supervise the regulated entity as part of the group so as to take into account the potential impact of the various group entities on the banking institution.

1.4 Following the successful implementation of consolidated supervision of bank holding companies in Zimbabwe, the Reserve Bank is working on the modalities of incorporating all subsidiaries and branches of Zimbabwean banks operating in other regional countries to On-site Consolidated Supervision. Such on-site consolidated supervision will provide a practical opportunity for regional harmonisation of prudential benchmarks.

1.5 The Reserve Bank, in collaboration with the Bankers Association of Zimbabwe (BAZ) and Building Societies Association is setting up a Credit Reference Bureau. The Credit Reference Bureau will warehouse valuable credit information on individual and corporate entity borrowers. The Bureau will foster the enhancement of credit risk assessment and management by banking institutions by providing better and more accurate knowledge of every borrower's credit quality and by facilitating appropriate analysis of their credit worthiness.

1.6 In January 2007, the Reserve Bank unveiled the Financial Inclusion Framework whose main objective was to increase access to financial services to the previously unbanked or underbanked communities. Pursuant to the efforts, the financial sector has made notable efforts towards extending their services to previously unbanked or underbanked communities.

1.7 Finally, on behalf of the Reserve Bank, I wish to convey my sincere gratitude to all our stakeholders who continue to play a pivotal role in maintaining the safety and soundness of the financial system in Zimbabwe.

………………………..
Dr. C. L. Dhiwayo
Deputy Governor

SENIOR DIVISION CHIEF'S PREVIEW

1.1 In line with our mission "of promoting and maintaining the safety and soundness of the financial system through proactive and rigorous regulation and supervision in line with international best practice", the Reserve Bank's Bank Licensing, Supervision & Surveillance Division has consolidated the gains made in the previous years by working towards continuous improvement of bank supervision systems and processes.

1.2 During the year, the Reserve Bank issued a Risk-Based Supervision Policy Framework. The framework explains and provides guidance on the risk-based supervisory methodologies, policies, procedures and practices adopted by BLSS. It is envisaged that the framework will provide a dynamic, efficient, structured and risk-oriented prudential supervision.

1.3 BLSS conducted a risk management survey between August 2005 and April 2006 to establish the risk management practices and processes in the banking sector. The survey revealed that there were deficiencies in the risk management systems of some financial institutions. Subsequently, a Risk Management Guideline on minimum requirements on sound risk management practices for specific risks was issued in July 2006.

1.4 The Division will continue to assist financial institutions in the implementation of sound risk management policies and practices, in order to build on the gains achieved in maintaining a sound financial system.

1.5 During the year, earnings performance, asset quality and liquidity management of banking institutions improved as most banking institutions recovered from the challenges encountered in the preceding years.

1.6 Two banking licences were cancelled in 2006 while one asset management licence was cancelled at the beginning of the year. Curatorship for three banks was extended into 2007 to enable the finalisation of pending litigation.

1.7 The year also saw some financial institutions consolidating their operations by merging some of their subsidiaries in response to the upward review of minimum capital requirements which were announced in January 2006.

1.8 A capital verification exercise was carried out in the fourth quarter to assess for compliance with the minimum capital levels, and all financial institutions were found to be in compliance with the increased capital requirements.

1.9 Capacity building has been a key element in the bid to align the Division's operations to international best practices. The Division will continue to invest in staff training and development programs in order to equip them with the requisite skills to enhance their efficiency and effectiveness.

1.10 The Reserve Bank has been participating in and monitoring regional and international activities relating to the implementation of Basel II. Considerable effort has been made in laying the groundwork for the successful implementation of the New Accord. BLSS will engage banking institutions in order to facilitate the drafting of an implementation plan.

1.11 Finally, I recognize and convey my appreciation for the support and the contributions that our key stakeholders have continued to give to the Division in our quest to maintain the safety and soundness of the financial system in Zimbabwe.

……………………….
N. Mataruka
Senior Division Chief

CHAPTER 1: ECONOMIC AND FINANCIAL DEVELOPMENTS

1.1 OVERVIEW

1.1.1 The macroeconomic environment remained largely unfavourable during 2007. The economy was characterised by rising inflation, high unemployment, persistent foreign currency shortages and frequent power outages. Against this background, the economy registered further decline in real Gross Domestic Product (GDP).

1.1.2 In spite of the aforementioned challenges, the financial sector remained largely stable and sound.

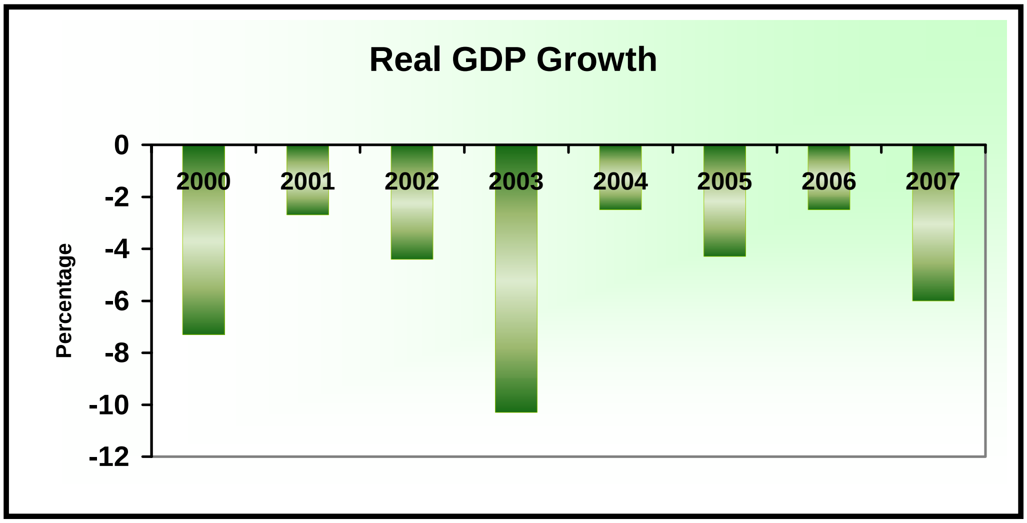
DOMESTIC MACROECONOMIC DEVELOPMENTS

1.2 Gross Domestic Product

1.2.1 The economy is estimated to have decline by 6% in 2007 compared to a decline of 2.5% in 2006.[1]

1.2.2 The graph below shows real GDP growth for the past eight years.

[1] Economist Intelligence Unit, Country Report December 2OO7



(Source: RBZ, Economic Research and Policy Enhancement Division)

1.2.3 The economy has been experiencing negative real GDP since 2000. This has been attributed to low industrial productivity and agricultural output as well as subdued Foreign Direct Investment (FDI).

SECTORAL ANALYSIS

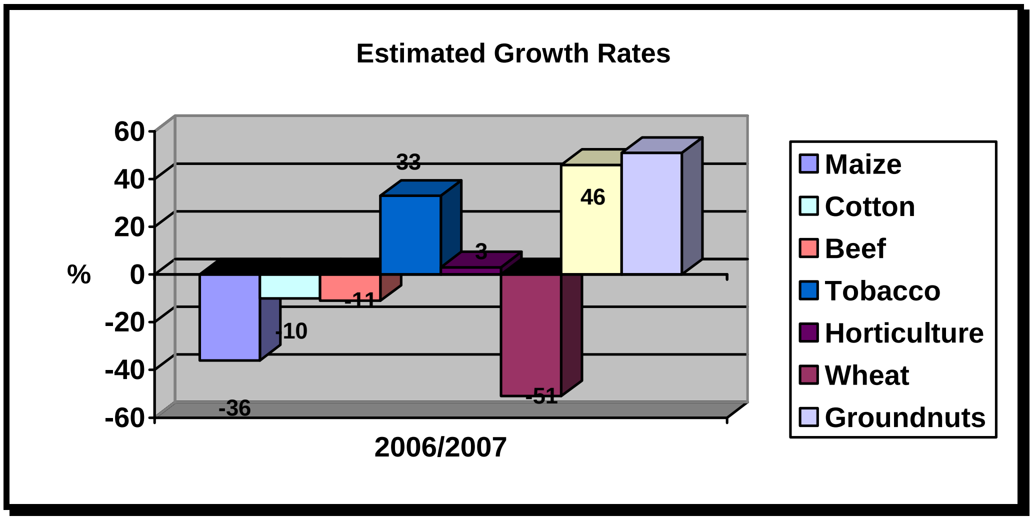
Agriculture…

1.2.4 The 2006/2007 rainy season was largely characterised by drought conditions. Despite the drought conditions the sector was expected to register growth of 1.4%.

1.2.5 Agriculture contributed 16.1% to the country's GDP and 22% of foreign exchange earnings.

1.2.6 Groundnuts, soya beans and Tobacco, were among the major contributors to 2007's overall positive agricultural performance.

The following graph shows estimated growth rates for major agricultural produce.



(Source: RBZ, Economic Research and Policy Enhancement Division)

Mining…

1.2.7 The mining sector which accounted for 3.8% of GDP declined by 18.5% in 2007 compared to a decline of 17.6% in 2006.[2] The continued decline is due to inadequate investment in the mining sector, persistent power outages, rising mining production costs, brain drain of skilled labour and continued leakages in mineral exports, especially gold.

1.2.8 Gold production declined by 16.7% from 10.96 tonnes in 2006 to 6.8 tonnes in 2007.

[2] The 2OO7 National Budget Statement

1.2.9 Nickel production declined from 8 825 tonnes in 2006 to 8 582 tonnes in 2007, while platinum production increased from 4.50 tonnes in 2006 to 5.09 tonnes in 2007.

Manufacturing…

1.2.10 The sector is estimated to have declined by 16.3% in 2007 as compared to a decline of 7% in 2006. The decline is mainly attributed to the continued shortages of foreign currency for the importation of critical raw materials, power outages, fuel shortages, and rising cost of production.

1.2.11 As a result, most companies were operating at capacity levels below 30% up to October 2007. The introduction of the Basic Commodity Supply Side Intervention (BACOSSI) facility by in October 2007 improved capacity levels to about 50%.

1.3 Inflation

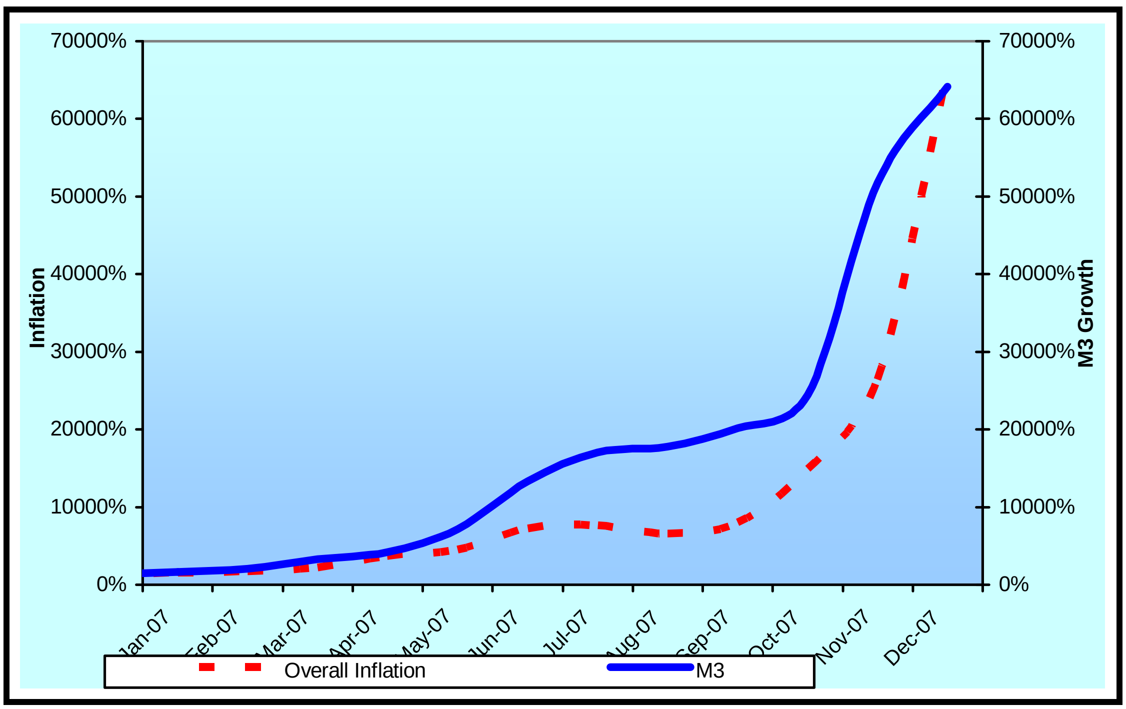
1.3.1 The annual inflation rate was on an upward trend during 2007, increasing from 1 593.6% in January 2007 to 66 212.3% in December 2007.

1.3.2 This increase was largely driven by high broad money supply (M3) growth, which continued on an upward trend in 2007, increasing from 1 577% in January 2007 to 64 113 % in December 2007, and supply bottlenecks emanating from capacity underutilization in manufacturing companies and decreased agricultural.

1.3.3 The increase in oil prices, coupled with the accelerated depreciation of the Zimbabwean dollar on the parallel market, impacted negatively on inflation as fuel constitutes 15% of the total costs of production.

1.3.4 Increased government borrowings to finance the widening budget deficit also contributed to increased inflation.

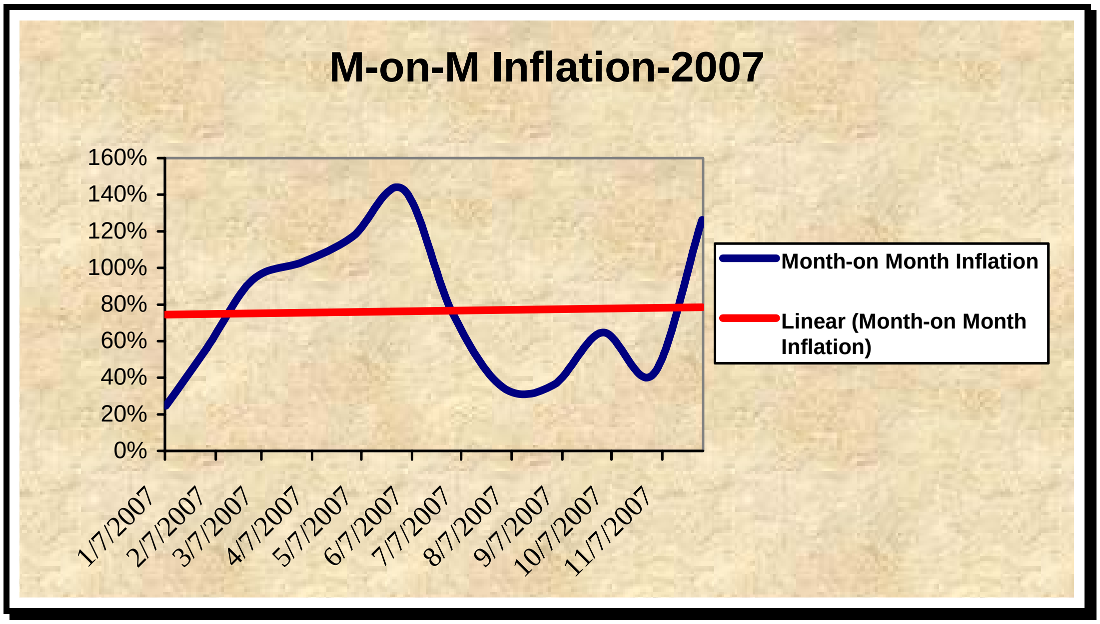
1.3.5 The graph below shows the annual inflation profile from January 2007 to December 2007.



(Source: RBZ Monetary Developments & Analysis Report, December 2007)

1.3.6 Month on month inflation rose from 24.7% in January 2007 to close peak of 143.1% in June 2007 before closing the year at 126.2% in December 2007.

1.3.7 The following graph shows the month-on-month inflation profile from January 2007 to December 2007.



(Source: RBZ Monetary Developments & Analysis Report, December 2007)

1.4 Employment

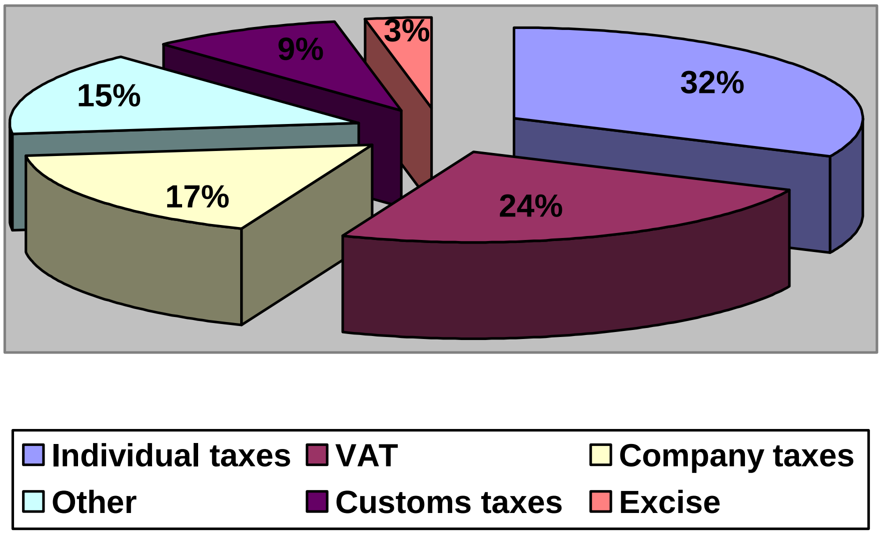
1.4.1 Employment levels have continued to decrease due to the prevailing harsh macro-economic environment. The challenges facing the agricultural and manufacturing sector have resulted in companies scaling down their operations.

1.4.2 The unemployment rate was estimated at over 70% in 2007.

1.5 Fiscal Developments

1.5.1 Total government revenue for 2007 was projected at $43.3 trillion against projected expenditure of $29.4 trillion resulting in a projected budget deficit of $13.9 trillion.

1.5.2 As at 31 December 2007, total revenue amounted to $89 trillion. The pie chart below shows contributions of the revenue heads in 2007:



(Source: ZIMRA)

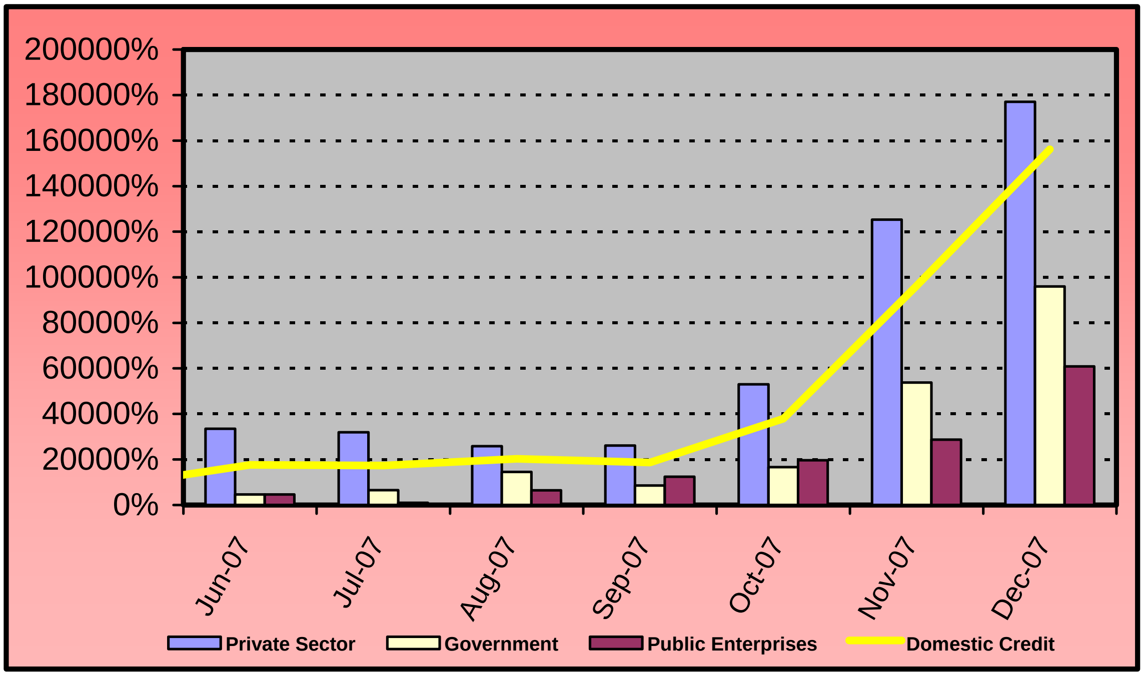
1.5.3 The budget deficit was largely financed from domestic sources in the form of debt instruments such as treasury bills and government bonds. As a result of this funding structure, banking institutions' balance sheets are now skewed towards money market instruments in place of loans and advances.

Domestic Debt…

1.5.4 Rising domestic debt has adverse consequences on economic stability. The stock of outstanding Government debt grew from $175.70 billion in January 2007 to $21.17 trillion as at 31 December 2007. The rolling over of government debt and recourse to the domestic market for deficit financing has led to a further increase of domestic debt.

1.5.5 The graph below shows domestic credit annual growth rates for the second half of 2007:

Domestic Credit Growth Rates for the second half of 2007



(Source: RBZ, Economic Research and Policy Enhancement Division)

1.5.6 The rapid growth in domestic debt is largely attributed to expansion in credit to the private sector, claims on Government and credit to public enterprises.

1.5.7 Domestic credit expansion has also been aided by cumulative productive sector disbursements by the Central Bank amounting to **$114.5 trillion** as at 31 December 2007, of which **$27.6 trillion** was under Basic Commodities Supply Side Interventions (BACOSSI).

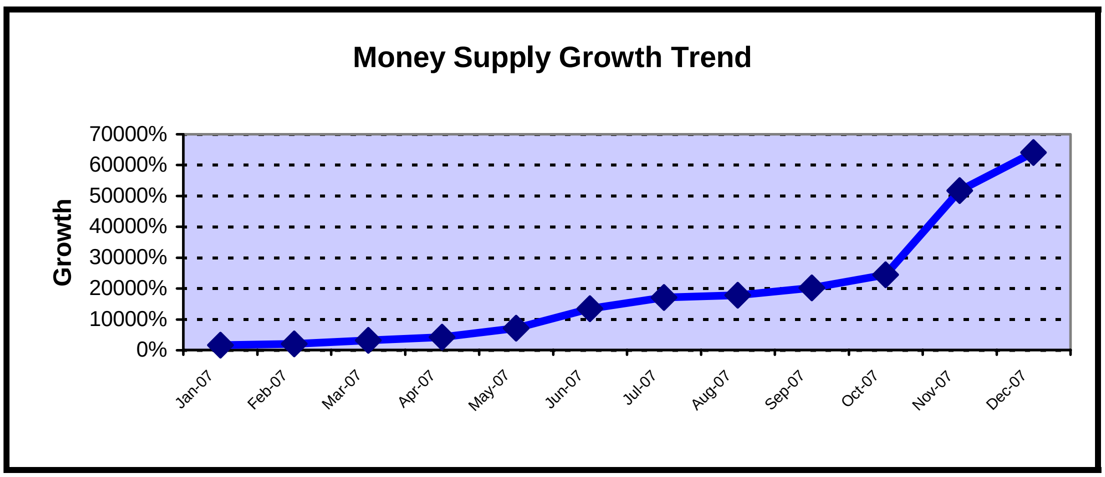
1.5.8 BACOSSI facility was meant to restore production capacity of manufacturing firms whose operations have been severely affected by the current economic problems.

Money Supply…

1.5.9 Annual money supply (M3) growth increased from 1 638.4% in January 2007 to 64 113% by December 2007.

1.5.10 This growth was due to domestic credit growth, largely reflecting both increased Government borrowing and liquidity injections.

1.5.11 The graph below shows the money supply growth trend up to December 2007.



(Source: RBZ, Weekly Economic Highlights, January 2007, Volume 9, No. 3)

Reserve Money…

1.5.12 Reserve money continued to go up rising from $373.72 billion in January 2007 to $206.77 trillion in December 2007.

1.5.13 The growth is attributed to increases in excess reserves, new currency issued and growth in bank deposits. The surge in inflation, currency hoarding by cash barons and inherent adverse inflation expectations continued to give impetus to growth in currency in circulation.

EXTERNAL SECTOR DEVELOPMENTS

1.6 Exchange Rate Developments

1.6.1 The exchange rate remained largely fixed in 2007 having been pegged at 250.00 against the United States Dollar until August 2007. The dollar was devalued to 30 000.00 against the US Dollar in September 2007 and remained pegged at the same rate until December 2007.

1.7 Balance of Payments Developments

1.7.1 The country's balance of payments position (BOP) improved from a deficit of US$191.3 million in 2006 to a deficit of US$33 million in 2007, against the backdrop of improved export performance.

1.7.2 Despite the improvement in the BOP in 2007, the overall balance remained in deficit position as a result of subdued export performance and low foreign direct investment.

1.7.3 The table below shows the balance of payments position in 2006 and the estimated position in 2007.

Balance of Payments (US$M)

	2006	2007 (Estimated)
Current Account	**(366.7)**	**(231.6)**
Exports	1721.4	1795.1
Imports	(1965.7)	(1899.0)
Non-factor Services (net)	(28.3)	(77.6)
Income (net)	(208.7)	(204.3)
Private Transfers	114.6	154.2
Capital Account	**87.5**	**312.9**
Grants	56.8	42.3
Direct Investment	40.0	149.6
Portfolio Investment	(34.0)	53.8
Long Term Capital	(120.7)	12.1
Short Term Capital	145.4	55.1
Errors And Omissions	87.9	(114.3)
Overall Balance	**(191.3)**	**(33.0)**
Financing	**191.3**	**33.0**
Change in Other Liabilities	(201.6)	(268.7)
Change in RBZ Usable Reserves	(12.0)	(29.3)
Extra Ordinary Financing	404.9	331
Financing Gap	0	0

(Source: RBZ, Economic Research and Policy Enhancement Division)

1.7.4 Total exports increased by 4.28% from US$1 721.4 million in 2006 to an estimated US$1 795.1 in 2007 mainly as a result of growth in agricultural and mining exports.

1.7.5 Agricultural exports were expected to grow by 4.92% from US$370.1 million in 2006 to US$388.3 million projected for 2007. The growth in agricultural exports was mainly a result of increased output due to less severe drought in 2007as compared to the 2006 farming season.

1.7.6 Mining exports were expected to increase by 4.47% from US$770.6 million in 2006 to $US805.1 million in 2007. The growth in mining exports was mainly driven by increases in prices of minerals on the international markets.

1.7.7 The manufacturing sector continued to face challenges such as inadequate foreign currency to procure raw materials and power outages. As a result, exports from manufacturing were expected to decline by 6.75% from US$526.3 million in 2006 to a projected US$490.8 million in 2007.

1.7.8 Total imports were expected to decline by 3.39% from US$1965.7 million in 2006 to an estimated US$1899.0 million in 2007. The decline in imports was mainly a result of the critical foreign currency shortages, which constrained the capacity of key productive sectors of the economy to import.

1.8 External Debt

1.8.1 Zimbabwe's total external debt stock increased by 4.1% from US$4 246 million in December 2006 to US$4 419 million in December 2007. The increase in the debt stock was due to new debt contracted by the country's public enterprises in 2007.

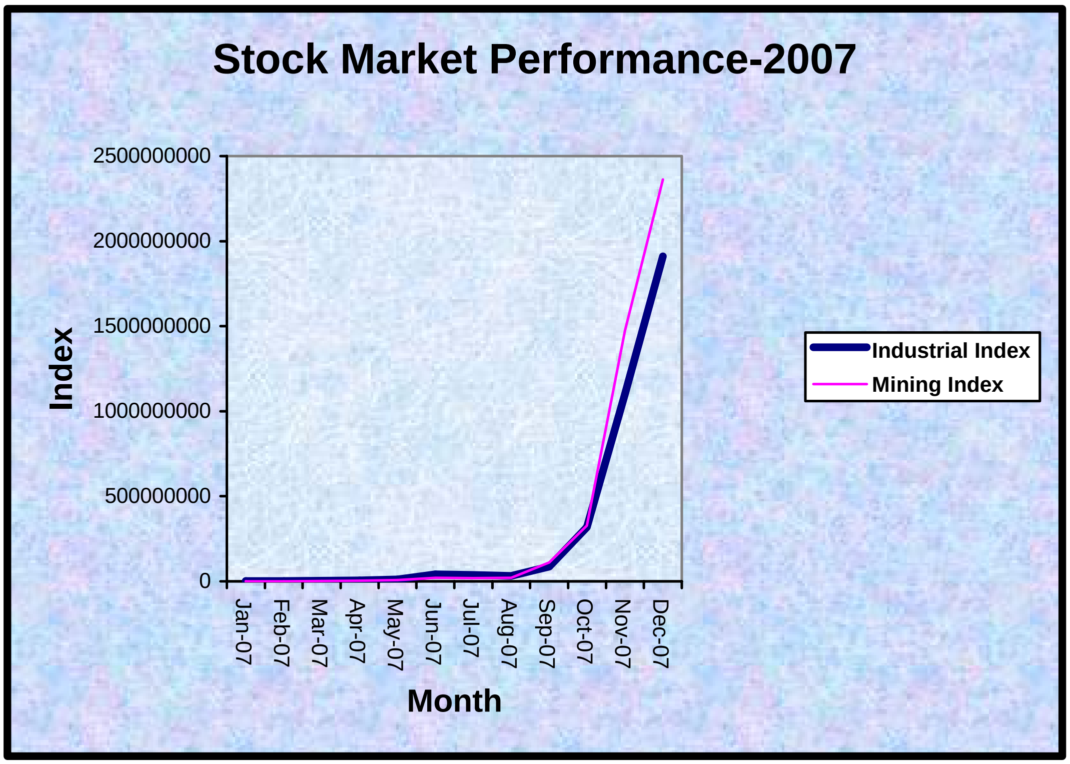
1.8.2 The public sector contracted debt amounting to US$240 million in 2007 for financing procurement of the agro-inputs and the refurbishment of the Hwange Power Station.

CAPITAL MARKET

1.9 Stock Market

1.9.1 The industrial index opened the year at 569 864.08 points and increased by 3 353.38 times to 1 911 538 281.84 points at the end of the year. The mining index which opened the year at 409

303.21 points increased by 5 772.86 times to 2 363 257 849.25 as at 31 December 2007. Returns at the stock market as reflected by growth of both indices was well above the average annual inflation for 2007 which stood at 66 212.3%. The graph below shows the performance of the stock market in 2007.



(Souce: Zimbabwe Stock Exchange)

1.9.2 The performance of the stock market was buoyed by investors seeking to hedge against high inflation given negative real returns on money market investments.

CHAPTER 2: MAJOR DEVELOPMENTS IN THE BANKING SECTOR

2.1 INTRODUCTION

2.1.1 During 2007, the Reserve Bank, consistent with its mandate, continued to focus its regulatory and supervisory initiatives on promoting a stable and competitive financial sector.

2.1.2 Particular attention was given to issues arising out of the increasing complexity of the financial system, the impending implementation of the New Capital Adequacy Framework (Basel II) in Zimbabwe, consolidated supervision, risk management and corporate governance. In this regard, the Reserve Bank provided guidance on several regulatory and supervisory policy decisions.

2.1.3 In view of the fast pace of deregulation, liberalisation and the emergence of financial conglomerates, the supervisory process is being constantly fine-tuned to ensure that adequate attention is given to the complexities of organisational structures, business processes and risk-positions of the banks.

2.2 BANKING SECTOR CONSOLIDATION

2.2.1 Driven by the need to increase capital, enhance competitiveness, position strategically and achieve synergies and economies of scale, the scope of consolidations through mergers and acquisitions transcended across the banking sector and included non banking group subsidiaries. Resultantly, capital inflows were evidenced by increased foreign participation in some cases.

2.2.2 The Reserve Bank views consolidations as a strategic step towards strengthening capital position and development of a healthy competitive environment among bigger and stronger financial institutions. To this end, the Reserve Bank is supportive of the consolidation processes.

2.2.3 During the year, Loita Financial Holdings Limited acquired 60% shareholding in Metropolitan Bank Limited whilst Kingdom Financial Holdings Limited, Meikles Africa Limited, Cotton Printers and Tanganda Tea Company successfully reorganised their shareholding structure to create one group under a single holding company, Kingdom Meikles Africa Limited.

2.2.4 Going forward, with more consolidations, the economy expects development of a more stable and resilient banking sector.

2.3 MAJOR ON-SITE EXAMINATION FINDINGS

2.3.1 The Reserve Bank continues to utilise the risk-based supervision methodology in conducting on-site examinations. On-site supervision helps to develop and maintain a thorough understanding of the operations and risk profiles of banking institutions.

2.3.2 The knowledge gained through risk based on-site supervision enables supervisors to effectively monitor and evaluate changes in the financial condition of financial institutions and take appropriate corrective action where necessary.

2.3.3 The risk-based examinations were carried out to review the performance of banks in terms of the CAMELS (for banking institutions) and CEFM (for asset management companies) rating models, the Risk Assessment System (RAS).

2.3.4 Targeted examinations were conducted mainly to determine compliance with the applicable rules and regulations such as compliance statutory reserve requirements, establish the extent of liquidity challenges experienced by some banking institutions, determine the causes of cash shortages experienced during the last quarter of 2007 as well as to verify injection of new capital.

2.3.5 The major findings of the risk-based on-site examinations and targeted examinations conducted in 2007 were as discussed hereunder.

Capital Adequacy…

2.3.6 It was determined that although most banking institutions met the prudential capital requirements, some had capital bases below the USD-linked expected minimum capital requirements.

2.3.7 Further, some institutions were not providing sufficient capital to support proposed diversification strategies as envisaged by their strategic plans.

2.3.8 Two institutions had their capital bases severely eroded by the existence of non-performing insider loans and the fraudulent externalisation of foreign currency, respectively.

2.3.9 During the year under review, retained earnings were the key source of capital growth for most banking institutions.

Asset Quality…

2.3.10 The proportion of non-performing loans to banking institutions' total assets was noted to have generally decreased in 2007, due to increased money market activities and subdued lending.

2.3.11 However, a few institutions exhibited high exposure to credit risk as reflected by high levels of non-performing loans (NPLs), high concentration risk and excesses to prudential lending limits.

2.3.12 One institution imprudently granted a loan to its holding company to finance the purchase of shares on the Zimbabwe Stock Exchange. The insider loan became non-performing, resulting in the institution in question facing liquidity and solvency challenges.

Management…

2.3.13 The corporate governance arrangement of most banking institutions continued to improve in 2007.

2.3.14 There were however, a few institutions which were noted to be operating without comprehensive corporate strategic plans, with the institutions' strategies and vision being driven by a few dominant executives. Such institutions were directed to restructure their boards and management committees.

2.3.15 Weak internal control systems were prevalent in some institutions, with some dominant senior managers noted to be overriding internal controls and regulatory requiremenst.

2.3.16 The examinations established that management of some institutions were wilfully violating prudential requirements and regulatory requirements, including, exchange control violations, understatement of deposit levels for purposes of computing statutory reserves, concealment of related party facilities, and engagement in non-permissible activities notably active trading in equities.

2.3.17 Weak risk management and internal control systems resulted in the fraudulent externalisation of foreign currency and creation of solvency challenges for one banking institution.

Earnings…

2.3.18 The intermediation role of banking institutions continued to be subdued in 2007 as most banking institutions' balance sheets were skewed towards money market instruments, while loans and advances constitute negligible proportions of assets and earnings. Consequently most of the earnings emanated from money market investments and continuous revaluation of the same.

2.3.19 The sector's earnings were also driven by unrealised revaluation gains on commercial and residential properties.

2.3.20 Further, a sizable proportion of earnings fro some institutions emanated from non-permissible activities such as trading in shares.

2.3.21 It was, however, noted that some banking institution's profitability levels could not sufficiently support capital growth.

Liquidity…

2.3.22 Some banking institutions experienced liquidity challenges during the year under review, resulting in inability to fund their statutory reserve obligations, liabilities to counterparties as well as outstanding RTGS payments.

2.3.23 These challenges emanated from poor liquidity risk management, inadequate contingency planning and poor cash management by banking institutions.

2.3.24 In addition, some banking institutions had tied up a sizeable portion of their balance sheets in illiquid assets such as shares, properties and foreign currency.

Sensitivity to Market Risk…

2.3.25 In 2007, the balance sheets of most banking institutions continued to be skewed towards money market investments, in response to the macroeconomic environment which is not conducive for lending business.

2.3.26 Exposure to high repricing risk was noted at most institutions as reflected by a significant net liability-sensitive book.

2.3.27 It was however, noted that most banking institutions are yet to develop advanced methods of managing market risk as shown by lack of benchmarks and non-adoption of stress testing methodologies. Further, despite the apparent shift in significance of exposures from credit risk to market risk on the balance sheets of most institutions, there has not been a similar shift in deployment of appropriately skilled personnel in risk management.

2.4 SUPERVISORY RESPONSES

Corrective Orders…

2.4.1 Five (5) banking institutions were operating under Corrective Orders in 2007. These orders required the institutions to address the following, among, other issues:

a) review of group corporate structures to ensure that these are conducive to adoption of sound corporate governance and risk management practices;

b) computation of statutory reserves in terms of Statutory Regulations and Guidelines issued by the Reserve Bank;

c) compilation of all financial records in compliance with the Banking Act, Companies' Act as well as International Accounting and Reporting Standards;

d) regularisation of exchange control transactions and comply with the Exchange Control Act and Exchange Control Regulations;

e) injection of additional capital by shareholders;

f) cease and desist from trading in equities; and

g) ensure that all intra-group exposures and insider loans are settled.

Other Enforcement Actions…

2.4.2 The Reserve Bank directed some banking institutions to remove some of their directors and senior managers from office for various corporate governance malpractices including, undue negative dominance over their boards, siphoning of depositors funds, understatement of statutory reserves, ineffective internal controls and risk management systems.

2.4.3 Further, the institutions were directed to reorganize their board and senior management in order to strengthen and improve risk management and oversight capabilities.

2.4.4 One banking institution's authorised dealership licence, was revoked after the unearthing of serious risk management deficiencies in its international banking division.

2.5 ISSUANCE OF PRUDENTIAL GUIDELINES

2.5.1 As part of the ongoing efforts to strengthen the banking system through the adoption of policies aimed at both improving the financial strength of banks as well as bringing about greater transparency, several guidelines were issued during 2007.

2.5.2 The Reserve Bank will continue with various regulatory and supervisory initiatives to strengthen the financial sector in order to maintain financial stability.

Consolidated Supervision Framework…

2.5.3 Consolidated Supervision's main thrust lies in the realisation that banking activities are not limited to balance sheets of the registered banking institutions.

2.5.4 As financial markets continue to develop new instruments and techniques, it is likely that banking institutions will increasingly conduct part of their business off balance sheet through subsidiary companies and participations. To date, various bank holding companies have mushroomed in Zimbabwe's banking industry, propelled by the aforementioned.

2.5.5 It is against this backdrop that BLSS has embraced consolidated supervision as an essential tool for effective and sound supervision. Consolidated Supervision signifies a comprehensive approach to banking supervision which seeks to establish the soundness of financial conglomerates, by incorporating all the risks which may affect a bank, regardless of whether these risks are emanating from the bank itself or its related parties.

Special Purpose Vehicles, Securitisation & Structured Finance…

2.5.6 The guideline outlines the regulatory framework for banking institutions involved in securitisation and SPV activities.

2.5.7 In addition, the guideline prescribes minimum regulatory requirements to ensure that banking institutions appropriately manage the risks arising out of their involvement with SPVs and that appropriate capital is held against the risks involved.

2.5.8 Any banking institution proposing to undertake or participate, either solely or jointly with other parties, in new schemes involving SPVs in securitization or structured finance transactions must seek prior approval of the Reserve Bank. Where a banking institution seeks to undertake a securitization transaction using a structure which it had previously received approval from the Reserve Bank, only notification is required.

2.5.9 Further, any banking institution proposing to participate in any securitization transaction that raise issues not covered in this Guideline should consult the Reserve Bank well in advance.

Additional Disclosure Requirements…

2.5.10 During the quarter ended 31 December 2007, the Reserve Bank prescribed additional disclosure requirements as part of its on going efforts to enhance market discipline in the financial sector.

2.5.11 All banking institutions and asset management companies are now required to disclose the most recent on-site CAMELS and Risk Assessment System (RAS), ratings, as well as ratings assigned by accredited Credit Rating Agencies, in their published annual financial statements.

2.6 OTHER DEVELOPMENTS

2.6.1 In view of the important role played by the non-banking financial institutions in broadening access to financial services, enhancing competition and diversification of the financial sector, the Reserve Bank in pursuit of its mandate to maintain financial stability. continued to work closely with regulators of these institutions.

Supervisory Cooperation …

2.6.2 The local Memorandum of Understanding (MoU) between the Reserve Bank of Zimbabwe, Insurance & Pension Commission and the Zimbabwe Stock Exchange was finalized during the year 2007.

2.6.3 The MoU once signed, is expected to enhance financial stability through effective co-operation among the regulators of the financial sector, in addition to facilitating consolidated supervision of financial groups.

2.6.4 During the year 2007, significant progress was achieved with regards improved collaboration with other supervisory authorities in the region. This gave effect to the signing of MoU governing the sharing of information among regional regulators and conduct of joint examinations. To date, the Reserve Bank signed an MoU with Bank of Zambia, Bank of Botwsana.

2.6.5 The MoU are critical in the implementation of consolidated supervision as information sharing reduces regulatory gaps.

Financial Inclusion…

2.6.6 During the year 2007, the Reserve Bank continued to persevere with its efforts towards greater financial inclusion and improvement in customer service provided by the banking sector.

2.6.7 In the January 2007 Monetary Policy Statement, the Central Bank unveiled the Financial Inclusion Framework whose main objective was to facilitate eradication of financial exclusion and increase access to financial services by all Zimbabweans, particularly the rural marginalised populace.

2.6.8 The Bankers Association of Zimbabwe (BAZ) responded positively to this call and nominated a Financial Inclusion Committee which is working closely with Reserve Bank in implementing the framework.

2.6.9 In this regard, a National Microfinance Policy, which articulates at the National level, the Reserve Bank's vision and strategy for the development of the microfinance industry in Zimbabwe, will be issued.

2.6.10 To date, six banking institutions have opened a total of thirty-seven (37) branches, twenty-two (22) agents and five (5) mobile units countrywide, pursuant to the provisions of the financial inclusion framework.

Establishment of a Credit Reference Bureau…

2.6.11 The Reserve Bank considers the Credit Reference Bureau as critical in the promotion of financial discipline and better credit risk management at banks. In its efforts to promote prudent lending decisions, the Reserve Bank, in collaboration with the Bankers Association of Zimbabwe (BAZ) and Building Societies Association, is setting up a Credit Reference Bureau.

2.6.12 The Credit Reference Bureau will warehouse valuable credit information on individual and corporate entities' borrowing history and their repayment patterns to facilitate ease access of information for the enhancement of credit risk assessment and management by banking institutions.

2.6.13 By providing a better and more accurate knowledge of every borrower's credit quality and by facilitating appropriate analysis of their creditworthiness, the Bureau will foster greater transparency and easier access to the credit market on better terms.

2.6.14 This contributes to raising the stability of the financial system as a whole. The information contained in the Bureau shall constitute one of the most important available mechanisms to address some of the validation, benchmarking and modeling issues that Basel II requires.

2.6.15 Thus, through the Bureau, the Reserve Bank can help the banking institutions in the progressive adoption of the advanced credit risk measurement approaches advocated under Basel II.

2.6.16 From a broader perspective, the collection of credit information and the access to it plays an important role in supporting the mechanics of finance, banking and business, and the stability of the economy.

Progress on Basel II Implementation…

2.6.17 The Reserve Bank has adopted the revised framework of the International Convergence of Capital Measurement and Capital Standards (also known as Basel II framework).

2.6.18 The Basel II capital accord provides a comprehensive and more risk-sensitive capital allocation methodology.

2.6.19 Implementation of Basel ll prescribes significant up-gradation of risk management standards and technological advancement in banks. As a result, the Reserve Bank has taken a number of initiatives and had has come up with a roadmap for implementation of Basel ll, to ensure a smooth transition to the new methodology.

2.6.20 To date and in line with Basel II requirements, banking institutions are required to allocate capital for market and operational risk.

2.6.21 As part of the Basel II implementation process, the Reserve Bank has issued out the following guidelines: Special Purpose Vehicles, Securitisation & Structured Finance and the Consolidated Supervision Framework.

CHAPTER 3: CONDITION AND PERFORMANCE OF THE BANKING SECTOR

3.1 OVERVIEW

3.1.1 As at 31 December 2007, there were twenty eighty (28) banking institutions operating in the country, comprising fourteen (14) commercial banks, five (5) merchant banks, four (4) discount houses, one (1) finance house and four (4) building societies.

3.1.2 The Minister of Finance approved the application by Infrastructure Development Bank of Zimbabwe (IDBZ), the holding company of ZDB Financial Services (ZDBFS), to merge the operations of the finance house with those of IDBZ, in April 2007.

3.1.3 Towards the end of 2007, the banking sector faced challenges including cash shortages, liquidity and failure of Information Technology (IT) systems to cope with many digits resulting from rising inflation.

Cash Shortages…

3.1.4 Most financial institutions experienced cash shortages during the fourth quarter of 2007, as result of high inflation, cash hoarding and cash selling involving bank tellers and large movers of cash. This resulted in long queues in banking halls and at ATMs, negatively affecting confidence in the banking sector.

Liquidity Challenges…

3.1.5 Several banking institutions experienced liquidity challenges during the fourth quarter of 2007 through to January 2008 resulting in inability to fund their statutory reserve obligations, liabilities to counterparties as well as outstanding RTGS payments.

3.1.6 These challenges emanated from, among other factors, weaknesses in the liquidity risk management processes in the institutions which included poor liquidity contingency planning, gross asset - liability mismatches and absence of liquidity stress tests. In addition, some banking institutions had tied up a sizeable portion of their balance sheets in illiquid assets such as shares, properties and foreign currency.

3.1.7 The liquidity challenges were exacerbated by the increase in daily cash withdrawal limits to $500 million for both corporates and individuals on 18 January 2008.

3.1.8 The Reserve Bank directed the affected institutions to dispose of their equities portfolios and strengthen their risk management processes.

3.1.9 Further, through the Monetary Policy announced on 31 January 2008, the Reserve Bank introduced measures to smoothen the adjustment process following the introduction of higher denomination bearer cheques. These measures included reduction of statutory reserve thresholds and tenure of zero coupon bonds.

3.1.10 By the end of February 2008, all banks had traded out of their cash and liquidity challenges.

Truncations…

3.1.11 Most banking institutions' IT systems are no longer coping with the number of digits arising from trillion-dollar values emanating from the hyperinflationary environment.

3.1.12 This challenge has resulted in manual intervention in data processing which makes the institutions susceptible to high operational risk.

Capitalisation…

3.1.13 All the banking institutions had capital ratios above the regulatory minima as at 31 December 2007.

3.1.14 Twelve out of the 28 banking institutions however, had capital bases below the expected minimum capital as at 31 December 2007, as shown in the table below:

Capital Bases below Expected Minimum Capital Requirements

Institution Category	Expected minimum capital requirement	Name of Institution	Capital Base as at 31/12/07
Commercial Banks	$5 trillion	NMB Bank	$3.82 trillion
		Metropolitan Bank	$3.72 trillion
		Agribank	$2.03 trillion
		CFX Bank Limited	$0.54 trillion
Merchant Banks	$4 trillion	Renaissance	$3.63 trillion
		Genesis	$1.94 trillion
		Interfin	$1.15 trillion
Finance Houses	$4 trillion	Trustfin	$0.32 trillion
Discount Houses	$3 trillion	Discount Company of Zimbabwe	$1.14 trillion
		Highveld Discount House	$0.05 trillion
		National Discount House Limited	$0.19 trillion
		Tetrad Securities Limited	$0.50 trillion

Outlook…

3.1.15 The general outlook for the sector is positive based on the ability of most banking institutions to organically generate capital and willingness of shareholders to recapitalise the institutions in need.

3.1.16 Further, the Reserve Bank continues with efforts to enhance market discipline in the financial sector as shown by the additional disclosure requirements on banking institutions to publish on-site examination ratings and ratings assigned by accredited Credit Rating Agencies, in their annual financial statements.

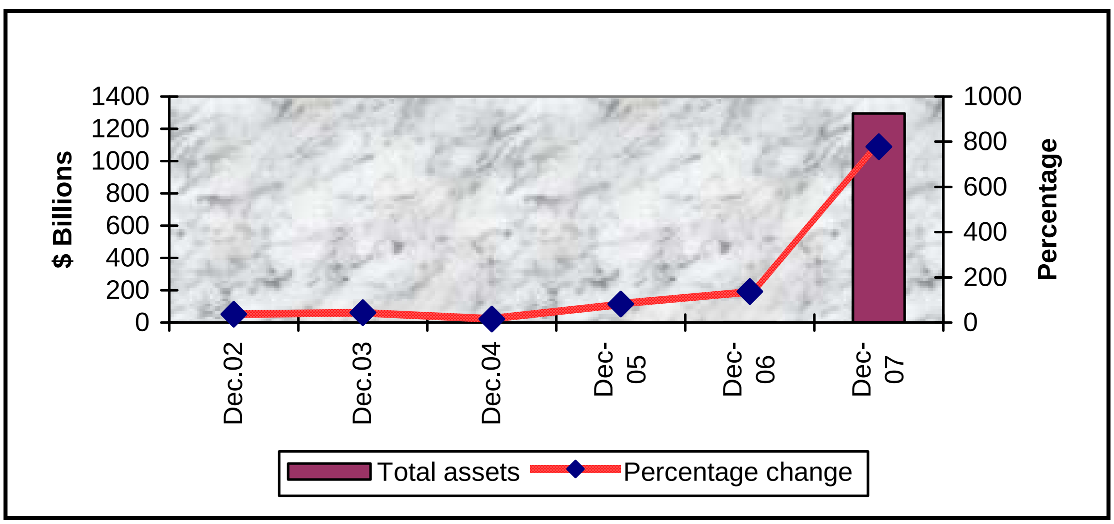
3.2 CONSOLIDATED BALANCE SHEET STRUCTURE

Composition of Assets…

3.2.1 The banking sector's total assets increased significantly from \$1.66 trillion as at 31 December 2006 to \$1,294.09 trillion as at 31 December 2007. This was attributable to high inflation levels and availability of concessionary funds for lending such as Agricultural Sector Productivity Enhancement Facility (ASPEF) and Basic Commodities Supply Side Intervention Facility (BACOSSI).

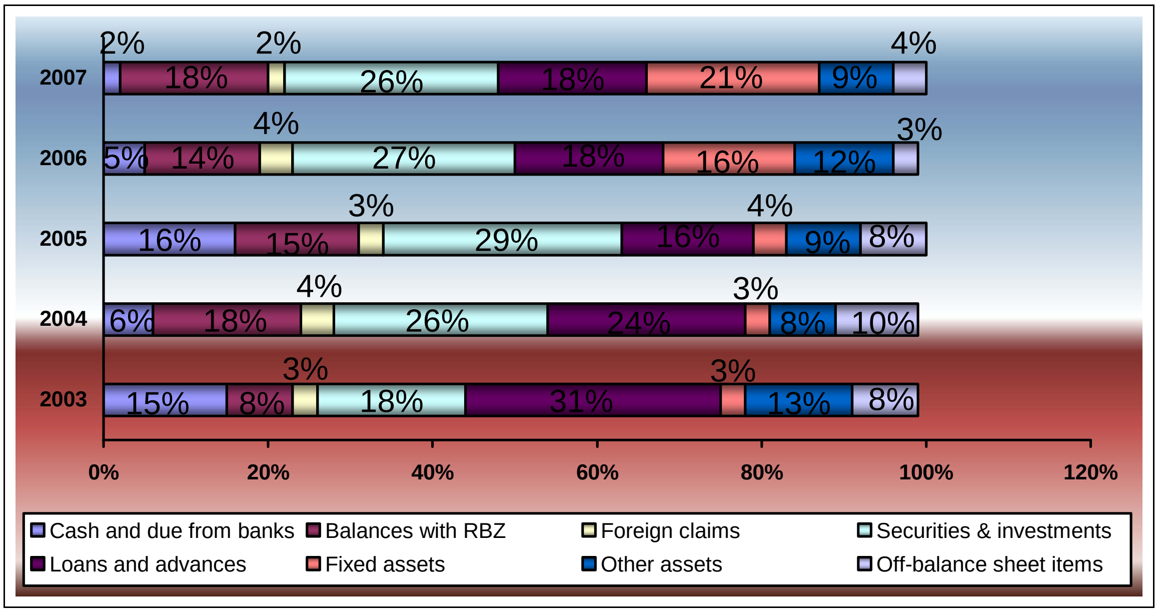
3.2.2 An annual trend analysis of total assets of the banking sector from December 2002 to December 2007 is shown in Figure 3.1.

Figure 3.1: Total Banking Sector Assets



3.2.3 As was the case in 2006, most banking institutions' balance sheets as at 31 December 2007 remained skewed towards investments in money market instruments (26.34%), indicating a shift from the traditional business of lending. A trend analysis of the composition of total assets from 2003 to 2007 is shown in Figure 3.2 below.

Figure 3.2: Composition of Assets

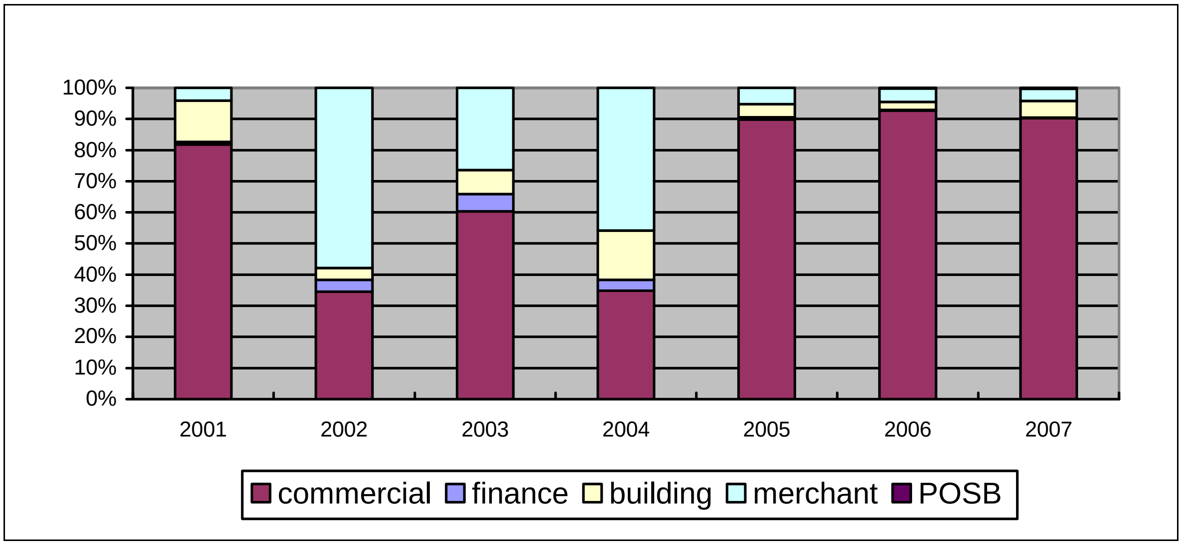


Loans and Advances

3.2.4 Total loans and advances increased from $339.16 billion as at 31 December 2006 to 251.95 trillion as at 31 December 2007, with commercial banks constituting 90.22%, merchant banks 3.92%, building societies 5.29%, finance houses 0.28% and POSB 0.30%. Growth in total loans and advances from 2004 on-ward has been hampered by limited borrowing in the face of high interest rates and the general conservative attitude towards lending by banking institutions.

3.2.5 The proportion of loans and advances per banking category between December 2001 and December 2007 is shown in Figure 3.3 below.

Figure 3.3: Distribution of Loans



Composition of liabilities…

3.2.6 As at 31 December 2007, total deposits amounted to $590.62 trillion and constituted 41.82% of total liabilities. Deposits remained the main source of funding for the banking sector. A year-on-year comparison of the composition of liabilities is reflected in figure 3.4.

Figure 3.4: Composition of liabilities: 2006 & 2007

	Dec-2006	Dec-2007
Total Deposits	45.73%	41.82%
Due to RBZ	5.82%	6.76%
Due to Financial Institutions	4.41%	5.91%
Foreign Liabilities	0.73%	1.13%
Capital and Reserves	23.81%	29.00%
Other Liabilities	16.82%	11.52%
Off-balance sheet liabilities	**3.17%**	**3.86%**
Total Liabilities	**100.00%**	**100.00%**

3.2.7 Commercial banks continued to command a lion's share of deposits with a market share of 84.10% as at 31 December 2007, as shown in figure 3.5.

Figure 3.5: Sectoral Distribution of Deposits

Banking Category	**Deposit Market Share (%)**
Commercial banks	84.10
Merchant banks	7.42
Building societies	6.76
Finance houses	0.19
Discount houses	0.77
Savings Bank (POSB)	0.76
Total	**100**

3.2.8 As at 31 December 2007, demand deposits, (both domestic and foreign), constituted the greatest part of total deposits at 63.72%, while savings deposits contributed 23.03%.

3.2.9 Although the scarcity of long term deposits persisted during 2007 as a result of the hyperinflationary macroeconomic environment, the proportion of savings deposits to total deposits increased from 15.96% as at 31 December 2006 to 23.03% as at 31 December 2007. This was a result of the impact of Sunrise II, wherein the $200,000.00 bearer cheques, were to cease to be legal tender on 31 December 2007.

3.3 PERFORMANCE OF BANKING SECTOR

Capital Adequacy…

3.3.1 The banking sector's capital base increased from $395.68 billion as at 31 December 2006 to $302.03 trillion as at 31 December 2007, buoyed by retained earnings of $130.32 trillion recorded during the year under review as well as inflation induced asset revaluations.

3.3.2 The sector remained well capitalised with average capital adequacy and tier 1 ratios of 33.39% and 24.18% respectively. All banking institutions had capital adequacy ratios above the regulatory minimum of 10% as at 31 December 2007.

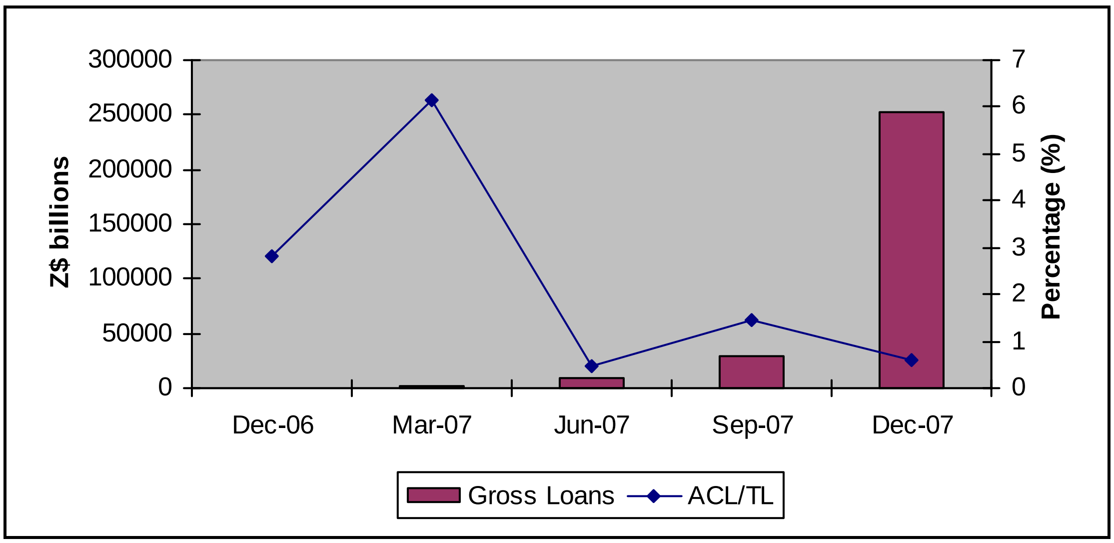
Asset Quality…

3.3.3 Loans and advances increased 756 fold from $333.95 billion as at 31 December 2006 to $251.95 trillion as at 31 December 2007. The level of financial intermediation marginally improved as loans and advances constituted 23.37% of total assets as at 31 December 2007, up from 18.27% as at 31 December 2006.

3.3.4 The asset quality of the banking sector continued to improve as reflected by the decrease in the ratio of adversely classified loans to total loans, from 2.81% as at 31 December 2006 to 0.60% as at 31 December 2007.

3.3.5 Figure 3.6 below depicts quarterly asset quality trend for year 2007.

Figure 3.6: Banking sector – Asset Quality Indicators



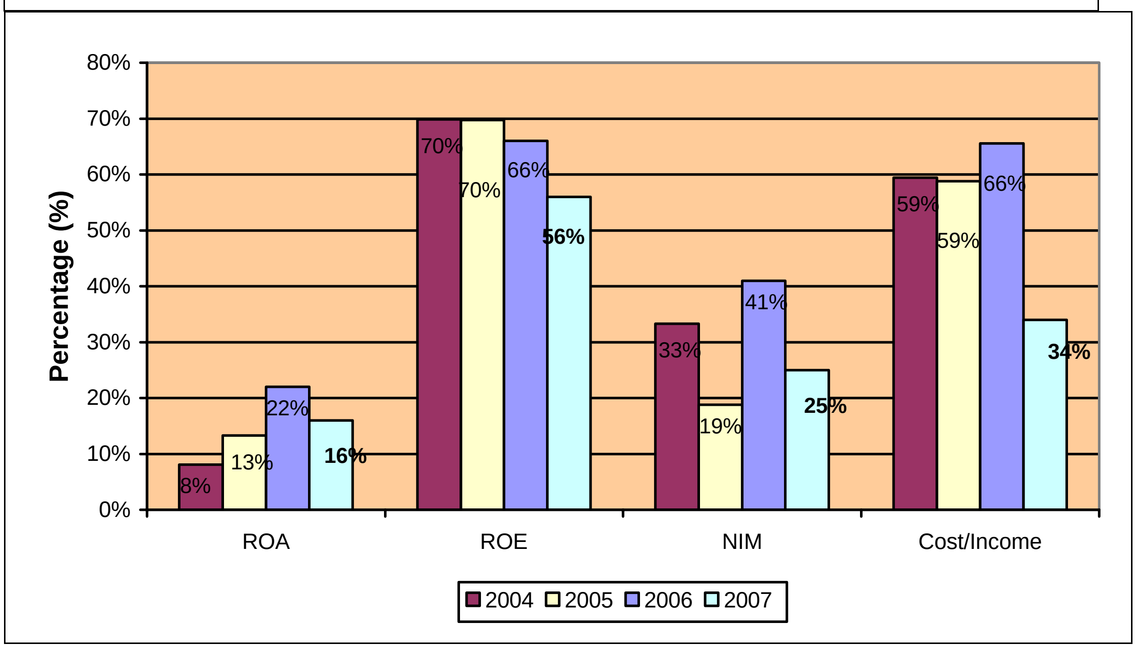
3.3.6 The decrease in the ratio was attributable to reduced lending as banks invested more in money market instruments.

Profitability…

3.3.7 The sector remained profitable as total income increased from $278.12 billion for the year ended 31 December 2006 to $130.42 trillion for the year ended 31 December 2007. Return on assets, however, declined from 21.92% as at 31 December 2006 to 25.22% as at 31 December 2007. The decline was mainly due to the growth in the sector's non-interest bearing assets resulting from inflation-induced revaluations.

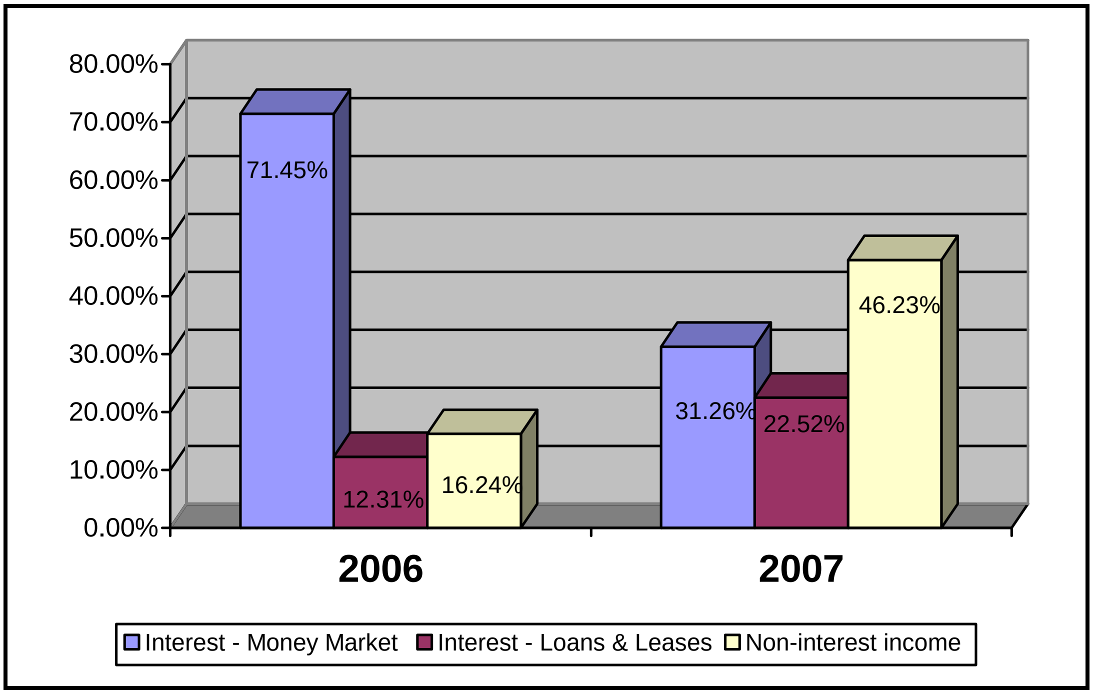
3.3.8 Figure 3.7 below depicts profitability indicators from December 2004 to December 2007.

Figure 3.7: Profitability Indicators of the Banking Sector



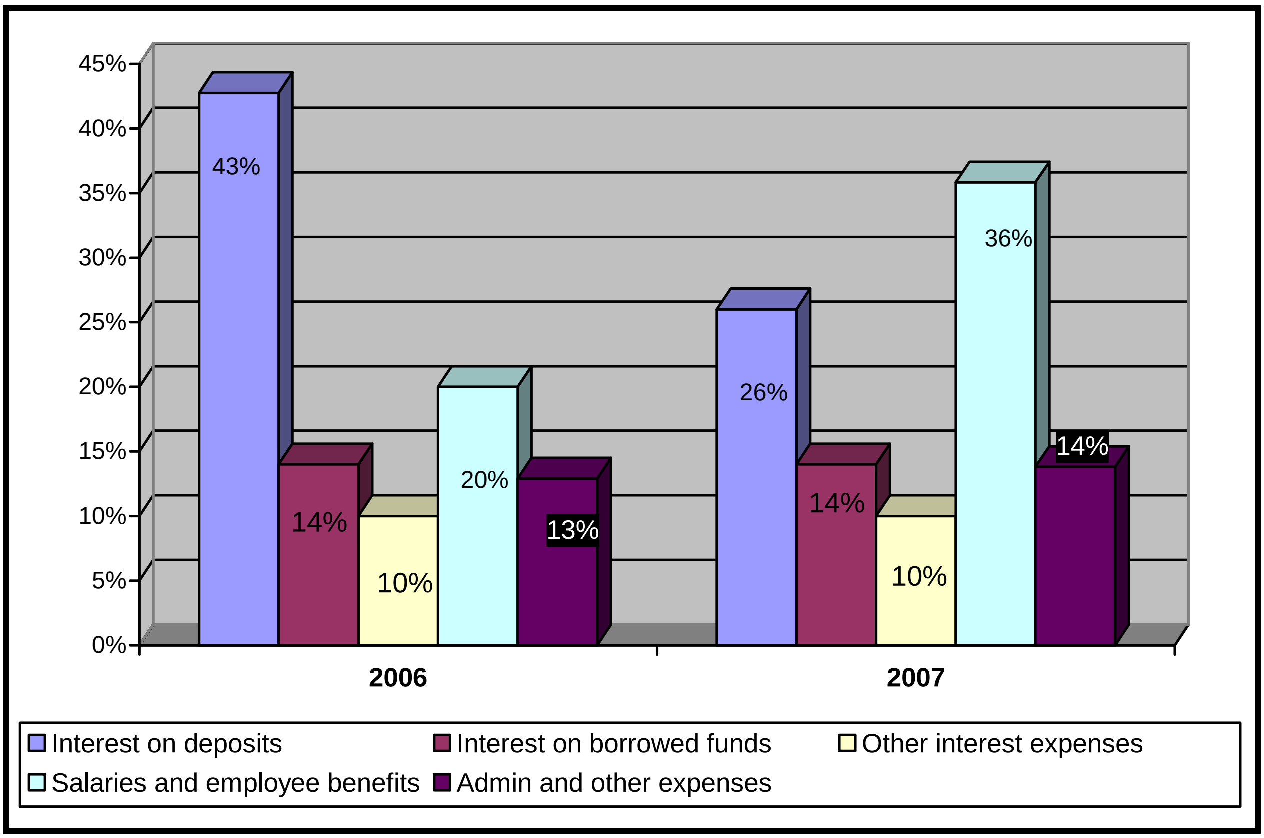
3.3.9 The banking sector's income mix was skewed towards non-interest income which accounted for 46.23% of total income while income from securities and investments accounted for 31.26%, with the balance of 22.52% being interest income from loans and advances. The changes in the sector's income mix is shown in the table below:

Figure 3.8: Composition of Total Income



3.3.10 Total expenses increased from $359.18 billion in 2006 to $108.33 trillion in 2007, largely due to inflationary pressures. The changes in the composition of total expenses for the banking sector during the period under review are shown below:

Figure 3.9: Banking Sector Expense Mix



Liquidity and Funds Management…

3.3.11 Total deposits for the sector amounted to $554.60 trillion as at 31 December 2007. Demand deposits accounted for 61.30% of total deposits, while savings deposits accounted for 23.03% with the balance of 15.66% being wholesale deposits.

3.3.12 The sector experienced liquidity challenges during the period December 2007 to February 2008, signified by failure to pay statutory reserves, repay Reserve Bank overnight borrowings, inability to fund cash requisitions and failure to effect customer RTGS payments. The liquidity challenges largely emanated from some banks who invested in illiquid assets such as properties and equities.

Commercial Banks

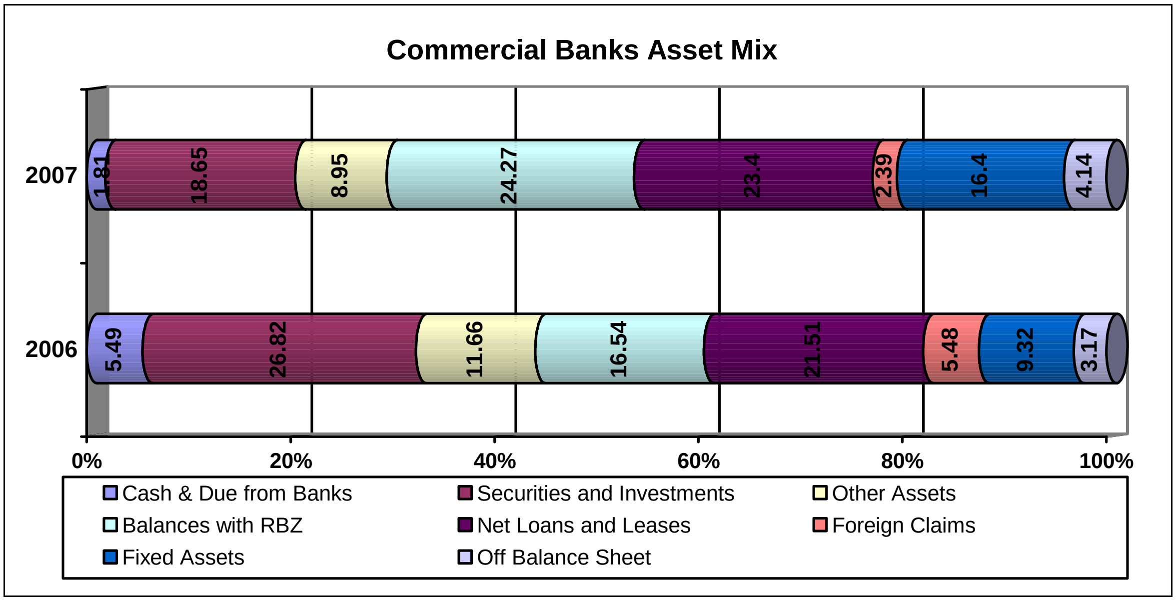
3.3.13 There were fourteen (14) commercial banks operating in the sub-sector as at 31 December 2007, the same number that was in operation as at 31 December 2006. The commercial banking sector generally remained safe and sound.

Total Assets…

3.3.14 Total assets in the sub-sector increased 695 times from $1.30 trillion as at 31 December 2006 to $904.51 trillion as at 31 December 2007. The significant growth was largely attributable to inflationary pressures.

3.3.15 Figure 3.10 below shows a comparative asset mix for commercial banks as at 31 December 2006 and 2007.

Figure 3.10: Commercial Banks- Composition of Assets



3.3.16 Commercial banks' assets as at 31 December 2007 mainly comprised of balances with the Reserve Bank which constituted 24.27% of total assets. This is attributed to the increase in statutory reserve ratios by the Central Bank in the third quarter of 2007.

3.3.17 Money market investments constituted 18.65% of total assets as at 31 December 2007 down from 26.82% as at 31 December 2006. Financial intermediation in the commercial banking sector marginally increased with loans and advances increasing from 21.51% of total assets as at 31 December 2006 to 23.40% as at 31 December 2007. The sub-sector has maintained a conservative lending approach due to the prevailing macro-economic environment, which is characterized by high interest rates and probability of default.

Total Liabilities…

3.3.18 Total deposits grew 696 times from $713.08 billion in 2006 to $496.71 trillion at the end of 2007. The restrictive cash withdrawal limits resulted in the retention of more deposits in the formal banking system.

3.3.19 Commercial banks continued to fund their operations mainly through demand and savings deposits, which constituted 88.66% of total deposits as at 31 December 2007, an increase from 68.83% recorded as at the end of 2006.

3.3.20 Central bank borrowings increased marginally from 6.14% of total assets as at 31 December 2006 to 9.10% of total assets as at 31 December 2007. This was a result of the liquidity challenges faced by banks in the last quarter of 2007 which resulted in them accessing lender of last resort facility to fund cash requirements.

3.3.21 Foreign currency liabilities grew 203 times from $72.69 billion as at 31 December 2006 to $14.85 trillion as at 31 December 2007. The increase was largely due to the devaluation of the local currency during the course of the year.

Capital Adequacy…

3.3.22 The net capital base for the sub-sector increased from $221.60 billion as at 31 December 2006 to $103.49 trillion as at 31 December 2007, mainly due to retained earnings.

3.3.23 The sub-sector remained adequately capitalised with an average capital adequacy ratio of 19.09% as at 31 December 2007. All banks in the sub-sector had capital adequacy ratios above the regulatory minimum requirement of 10%.

3.3.24 However, six banks had net capital bases below the expected minimum capital of $5 trillion for commercial banks as at 31 December 2007.

Asset Quality…

3.3.25 The sub-sector recorded total loans and advances of $227.30 trillion as at 31 December 2007, from $310.35 billion as at 31 December 2006. The growth in loans was mainly attributable to inflationary pressure and concessionary loans issued during the year such as ASPEF, BACOSSI and SME facilities.

3.3.26 The proportion of sub-sector loans to total banking sector loans marginally decreased to 90.58% as at 31 December 2007, from 92.74% as at 31 December 2006.

3.3.27 The sub-sector's proportion of adversely classified loans to total loans decreased from 2.93% as at 31 December 2006 to 0.60% as at 31 December 2007. Banks have resorted to conservative lending towards borrowers with high repayment capacity. Further, most of the loans were granted under cheap concessionary facilities, which have low rates of default.

Earnings…

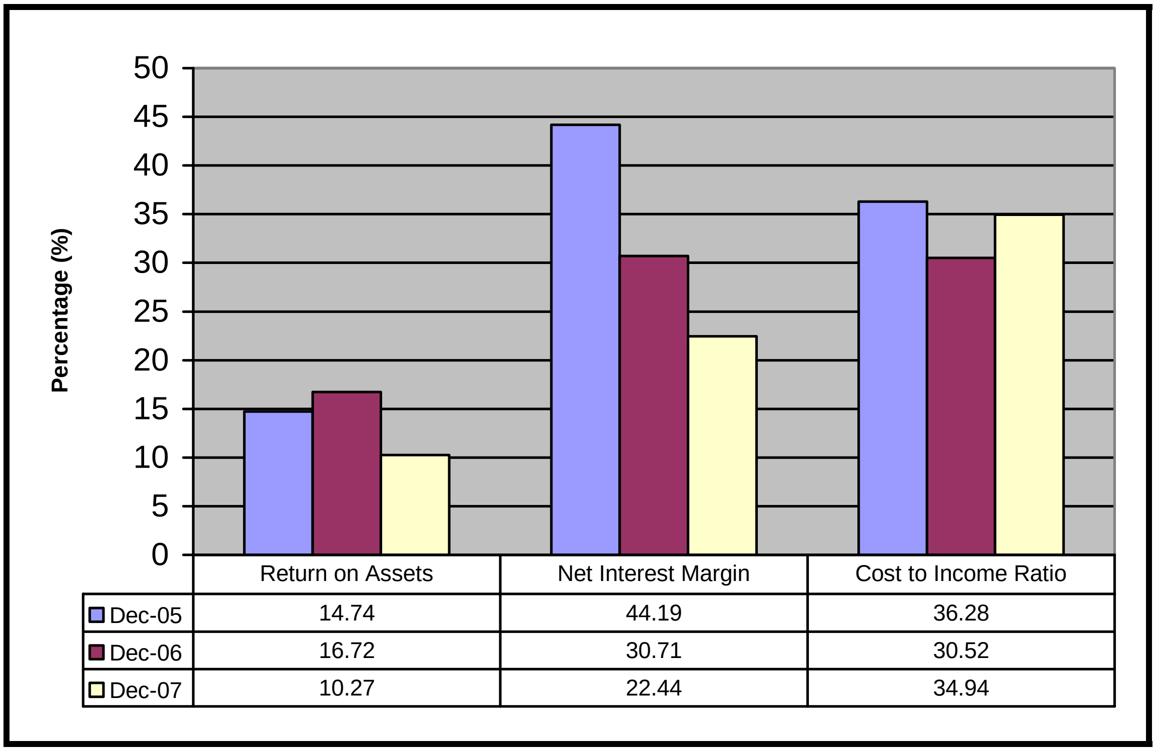
3.3.28 Although the commercial banking sector's net income increased by 421 times from $144.31 billion in 2006 to $60.87 trillion in 2007, the increase in earnings was below inflation which rose by 66 216% over the same period.

3.3.29 Earnings for the sub-sector were driven by interest income from money market investments as well as loans and advances, constituting 27.34% and 37.65% of total income, respectively.

3.3.30 The sub-sector's return on assets decreased from 16.72% to 10.27% over the period under review, mainly due to the rapid increase in asset values due to inflation. The fall in the sector's profitability is also attributable to the fall in net interest margins from 30.71% to 22.44% during the year.

3.3.31 Figure 3.11 below shows the comparative key earnings indicators for commercial banks as at 31 December 2005, 2006 and 2007.

Fig 3.11: Commercial Banks - Key Earnings Indicators



3.3.32 Although the cost to income ratio increased from 30.52% in 2006 to 34.94% in December 2007 mainly due to an increase in operating expenses as a result of high levels of inflation, the subdued growth in the ratio shows that the sub-sector managed to contain its operating costs.

Liquidity and Funds Management…

3.3.33 Total deposits for the sub-sector increased from $713.08 billion as at 31 December 2006 to $496.71 trillion as at 31 December 2007, due to bottlenecks on withdrawal limits which made it difficult to withdraw funds from the banking sector as well as the high inflationary levels.

3.3.34 The sub-sector's liquidity condition deteriorated with the ratio of liquid assets to total assets falling from 35.92% as at 31 December 2006 to 21.06% as at 31 December 2007.

3.3.35 Liquidity risk for the sub-sector was however mitigated by the funding structure that was skewed towards relatively cheap and stable retail deposits, which constituted 88.66% of total deposits as at 31 December 2007.

Merchant Banks

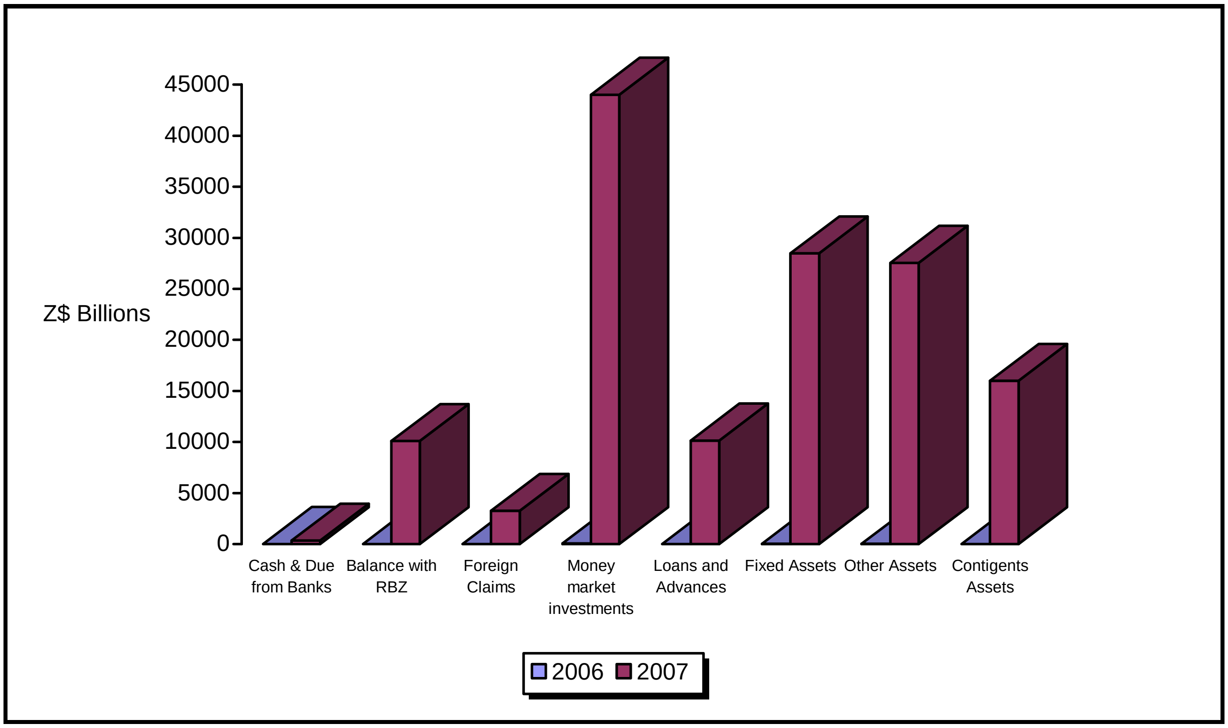
3.3.36 There were five (5) merchant banks operating in the sub-sector as at 31 December 2007, with a market share of 11.85% of the total banking sector assets.

Total Assets…

3.3.37 As at 31 December 2007, total assets for the sub-sector amounted to $139.86 trillion representing an 885 fold increase from $157.90 billion as at 31 December 2006. The growth is largely attributed to high inflation and an increase in securities and investments.

3.3.38 Figure 3.12 shows the comparative asset mix for merchant banks as at 31 December 2006 and 2007.

Fig 3.12: Merchant Banks - Composition of Assets



3.3.39 The proportion of securities and investments to total assets remained dominant at 31.47% as at 31 December 2007.

3.3.40 Loans and advances remained relatively low at 7.25% of total assets as at 31 December 2007, compared to 9.35% as at 31 December 2006, due to the conservative lending adopted by all merchant banks.

3.3.41 Fixed assets which accounted for 20.36% of total assets as at 31 December 2007, increased from $39.06 billion as at 31 December 2006 to $28.48 trillion. The increase is largely due to fixed asset revaluations necessitated by inflationary pressures.

Capital Adequacy…

3.3.42 The sub-sector was adequately capitalised with average capital adequacy and tier 1 ratios of 54.33% and 35.14%, respectively, as at 31 December 2007.

3.3.43 As at 31 December 2007, two (2) merchant banks namely African Banking Corporation Zimbabwe Limited ($37.12 trillion) and Premier Banking Corporation ($5.04 trillion) had capital levels above the expected minimum capital of $4 trillion for merchant banks whilst the other three institutions, Interfin ($1.15 trillion), Genesis Investment Bank ($1.94 trillion) and Renaissance Merchant Bank ($3.663 trillion) were below the expected minimum.

3.3.44 Retained earnings continued to be the major source of capital growth for the sub-sector.

Asset Quality…

3.3.45 The sub-sector recorded a significant increase in loans and advances from $14.76 billion as at 31 December 2006 to $10. 14 trillion as at 31 December 2007. Loans and advances however, constituted 7.255 of total assets.

3.3.46 Credit risk for the sub-sector remained relatively low as reflected by the ratio of adversely classified loans of 1.34% as at 31 December 2007, compared to 0.22% recorded as at 31 December 2006. The low levels of adversely classified loans are a result of a conservative approach to lending adopted by the institutions and effective debt collection efforts.

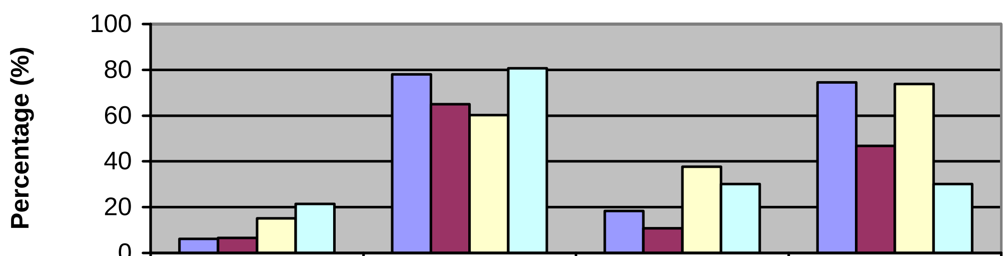
Earnings…

3.3.47 Total earnings for the sub-sector amounted to $66.75 trillion in 2007, up from $93.01 billion in 2006.

3.3.48 Return on assets for the sub-sector increased from 15.16% as at 31 December 2006 to 21.43% as at 31 December 2007. The improvement was attributed to increased interest earnings on money market investments and profit from revaluation of investments and securities.

3.3.49 Figure 3.13 below shows the sub-sector's key earnings indicators:

Figure 3.13: Merchant Banks-Key Earnings Indicators



	Return on Assets	Return on Equity	Net Interest Margin	Cost to Income Ratio
Dec-04	6.18	77.96	18.31	74.55
Dec-05	6.56	64.93	10.78	46.77
Dec-06	15.16	60.16	37.71	73.79
Dec-07	21.43	80.64	30.16	30.06

3.3.50 The sub-sector's cost to income ratio improved from 73.79% as at 31 December 2006 to 30.06% as at 31 December 2007. This was due to the significant earnings growth recorded during the year.

3.3.51 Non-interest income mainly from revaluation of investments and securities constituted 53.48% of total income whilst the balance was from interest income.

Liquidity and Funds Management…

3.3.52 The merchant banks' deposit base increased 16 times from $60.08 billion as at 31 December 2006 to $43.84 trillion as at 31 December 2007.

3.3.53 The sector's deposit mix was inclined towards time deposits ($28.35 trillion) which constituted 64.67% of the total merchant bank deposits.

Discount Houses

3.3.54 There were four (4) operating discount houses as at 31 December 2007, with a market share of 0.69% of banking sector total assets.

3.3.55 NDH and Highveld Discount House have applied for conversion to a merchant bank and commercial bank respectively.

Total Assets…

3.3.56 The sub-sector had total assets of $8.17 trillion as at 31 December 2007, up from $15.59 billion as at 31 December 2006.

3.3.57 Securities and investments continued to dominate the balance sheets of discount houses, constituting 39.48% of the total assets in line with the traditional business of discount houses. Fixed assets, balances with other banking institutions and balance with Reserve Bank constituted 35.61%, 7.63% and 6.31% respectively.

Capital Adequacy…

3.3.58 The sub-sector recorded a net capital base of $1.89 trillion as at 31 December 2007, up from $6.88 billion as at 31 December 2006.

3.3.59 The average capital adequacy ratio for the sub-sector declined from 45.89% as at 31 December 2006 to 42.89% as at 31 December 2007. All discount houses recorded capital adequacy ratios well above the prescribed minimum of 10%. This was a result of the decline in DCZ's capital adequacy ratio from 62.36% as at 31 December 2006 to 50.26% as at 31 December 2007.

Asset Quality…

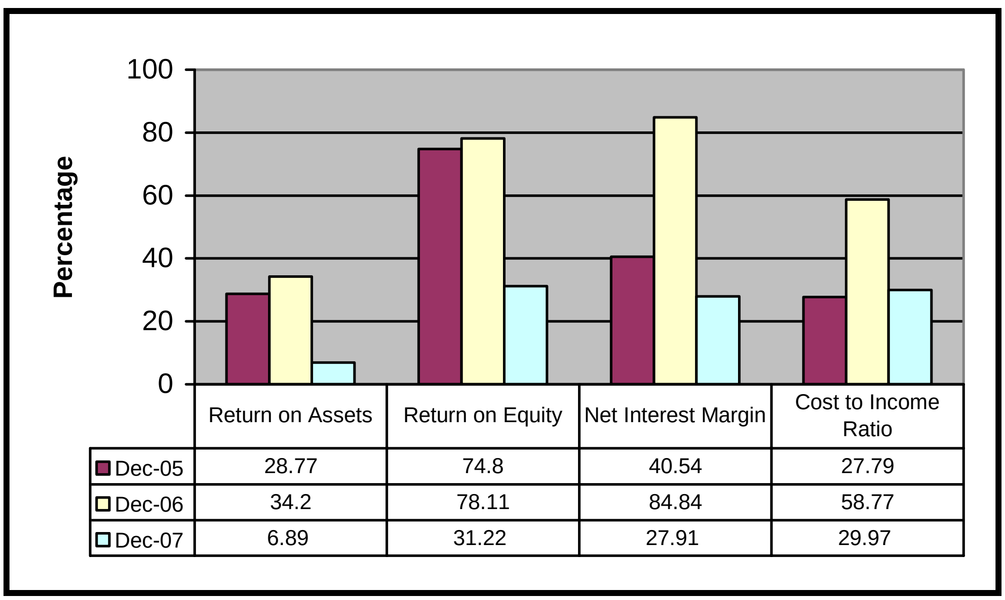
3.1.1 Credit risk for the sub-sector remained low. Typical of discount houses, the balance sheets were skewed towards liquid investments assets particularly treasury bills, which constituted 39.48% of the total assets as at 31 December 2007.

Earnings…

3.3.60 The sub-sector's net profit after tax increased by 156.22 times from $2.72 billion for the year ended 31 December 2006 to $427.63 billion for the year ended 31 December 2007. Investments and securities contributed 60.59% of the total income of $2.25 trillion for the year ended 31 December 2007.

3.3.61 Figure 3.14 shows the sub-sector's key earnings indicators:

Figure 3.14: Discount Houses- Key Earnings Indicators



3.3.62 The return on assets ratio decreased from 34.20% as at 31 December 2006 to 6.89% as at 31 December 2007, primarily due to inflation driven revaluation of non interest earning assets.

Liquidity and Funds Management…

3.3.63 Total deposits for the sub-sector increased from $4.42 billion as at 31 December 2006 to $4.53 trillion billion as at 31 December 2007. The growth was largely driven by inflation.

3.3.64 Total deposits for the sub-sector constituted 0.77% of the total banking sector deposits.

Finance Houses

3.3.65 Trustfin is the only remaining stand-alone finance house.

3.3.66 Other previously stand alone finance houses are now operating as divisions of banking institutions.

3.3.67 Trustfin's parent company, TN Financial Holdings Limited (TNFH), submitted an application to the Reserve Bank to convert the finance house to a commercial bank.

3.3.68 Trustfin's net capital base of $320.75 billion as at 31 December 2007 was way below the expected minimum capital base of $4 trillion for finance houses and does not adequately support the institution's strategic thrust to convert to a commercial bank.

3.3.69 The finance house's low capitalisation adversely impacted on the institution's level of business undertaking and profitability, as reflected by a loan book of $695.07 billion and profit after tax of $255.48 billion as at 31 December 2007.

Building Societies

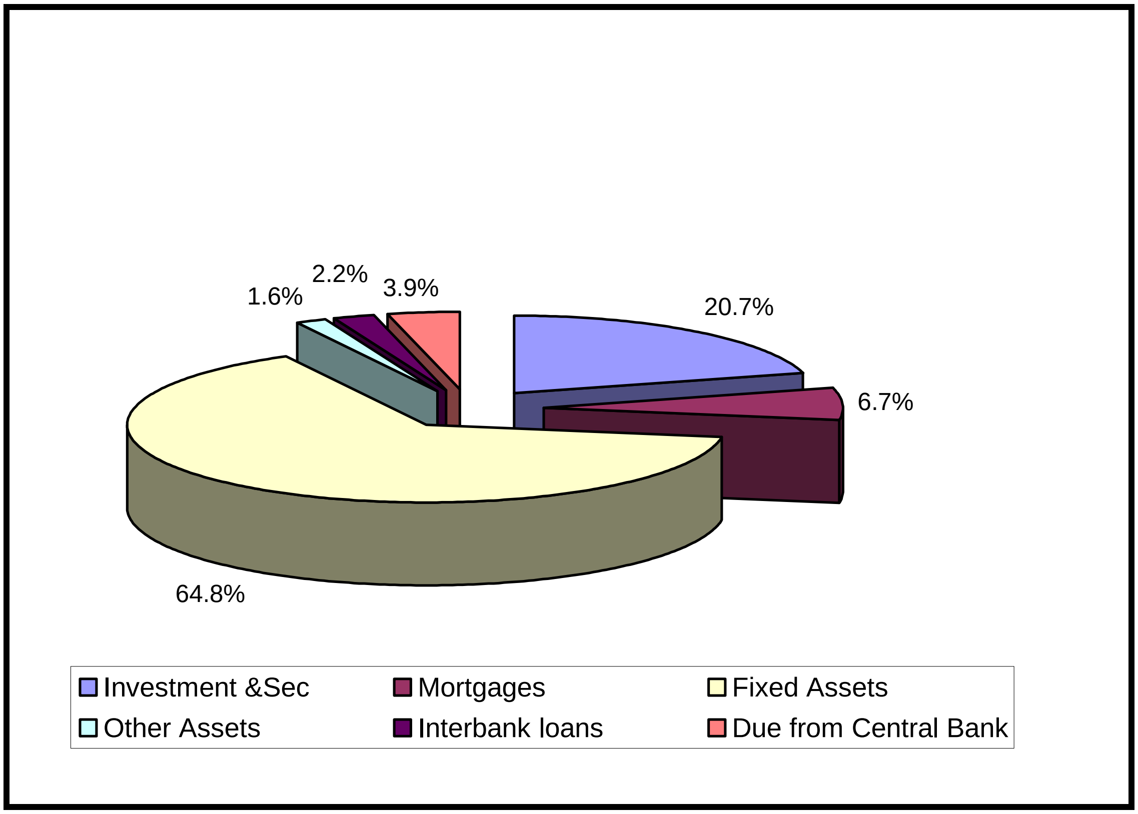
3.3.70 There were four (4) building societies as at 31 December 2007 with a market share of 9.80% of the total banking sector assets.

Total assets…

3.3.71 The sub-sector's total assets increased by 684.33 times from $184.91 billion as 31 December 2006 to $126.72 trillion as at 31 December 2007. The growth was mainly attributed to revaluation of fixed assets.

3.3.72 Figure 3.15 shows the asset mix for the sub-sector as at 31 December 2007.

Figure 3.15: Building Societies-Asset Mix



3.3.73 The sub-sector's asset mix, however, reflects a conservative approach to lending as loans and leases constituted only 3.90% of total assets, as at 31 December 2007, a decline from 4.33% as 31 December 2006, whilst investments and securities accounted for 64.80% of total assets as 31 December 2007, an increase from 22.25% as at 31 December 2006.

3.3.74 Despite the utilization of funds under Low Cost Housing Development Scheme, which emanates from some exemptions on statutory reserves for building societies, the level of mortgage lending remained low.

Capital adequacy…

3.3.75 The building societies had average capital adequacy and tier 1 ratios of 72.01% and 55.28% respectively as at 31 December 2007.

3.3.76 The sub-sector's net capital base amounted to $59.11 trillion as at 31 December 2007, up from $101.91 billion as at 31 December 2007. The growth is largely attributed to retained earnings recorded during the year.

3.3.77 The building societies' capital bases were above the expected minimum capital of $4 trillion.

Asset quality …

3.3.78 The building societies' mortgage advances amounted to $13.32 trillion as at 31 December 2007, an increase from $8.61 billion as at 31 December 2006, mainly due to disbursements made under the Low Cost Housing Development Scheme. The Low-Cost Housing Development Fund utilization amounted to $5.17 trillion as at 31 December 2007.

3.3.79 Credit risk in the building societies remained low over the year under review as evidenced by the average adversely classified loans to total loans ratio of 0.04% as at 31 December 2007.

Earnings…

3.3.80 The sub-sector recorded retained earnings of $30.69 trillion for the year ended 31 December 2007, up from $48.46 billion in 2006. Improved profitability resulted in return on assets improving from 25.57% as at 31 December 2006 to 28.71% as at 31 December 2007.

3.3.81 Interest income from securities and investments accounted for 35.37% of total income while mortgages contributed 11.06%, with the balance of 53.57% being non-interest income.

Liquidity and funds Management …

3.3.82 Total deposits in the sub-sector amounted to $39.94 trillion as at 31 December 2007, up from $50.25 billion as at 31 December 2006.

3.3.83 The building societies' funding source is dominated by savings deposits which constituted 94.50% of total deposits while time and demand deposits accounted for 2.55% and 0.34% respectively.

3.3.84 The sub-sector had an average liquidity ratio of 68.05% as at 31 December 2007, a decline from 129.62% as at 31 December 2006, reflecting the tight liquidity condition in the banking sector at the end of 2007.

3.3.85 This could translate to failure by the building societies to meet the short-term obligations as they fall due.

3.4 ASSET MANAGEMENT COMPANIES SECTOR

Overview…

3.4.1 The asset management sector comprised 17 operating companies as at 31 December 2007, the same number of institutions as at 31 December 2006. The moratorium on the licensing of asset management companies remained in effect in 2007.

3.4.2 The institutions had total proprietary assets of $22.05 trillion and client funds under management of $7.52 quadrillion as at 31 December 2007. This is contrast as at 31 December 2006, where total proprietary assets amounted to $20.81 billion and managed assets to $2.18 trillion.

3.4.3 In 2007, two asset management companies, namely, Legend Asset Management (Private) Limited and Premier Asset Management (Private) Limited were issued with corrective orders, following a determination by the Reserve Bank that the institutions were:

a. engaging in non-permissible activities of margin trading by accepting deposits and quoting interest rates upfront and then investing the funds at higher rates; and
b. to address certain corporate governance deficiencies noted during the conduct of on-site examinations.

Capital Adequacy…

3.4.4 The asset management sector had an average capital base of $1.19 trillion as at 31 December 2007, representing a significant increase from $725.11 million as at 31 December 2006. The growth in the capital levels was largely attributed to retained earnings.

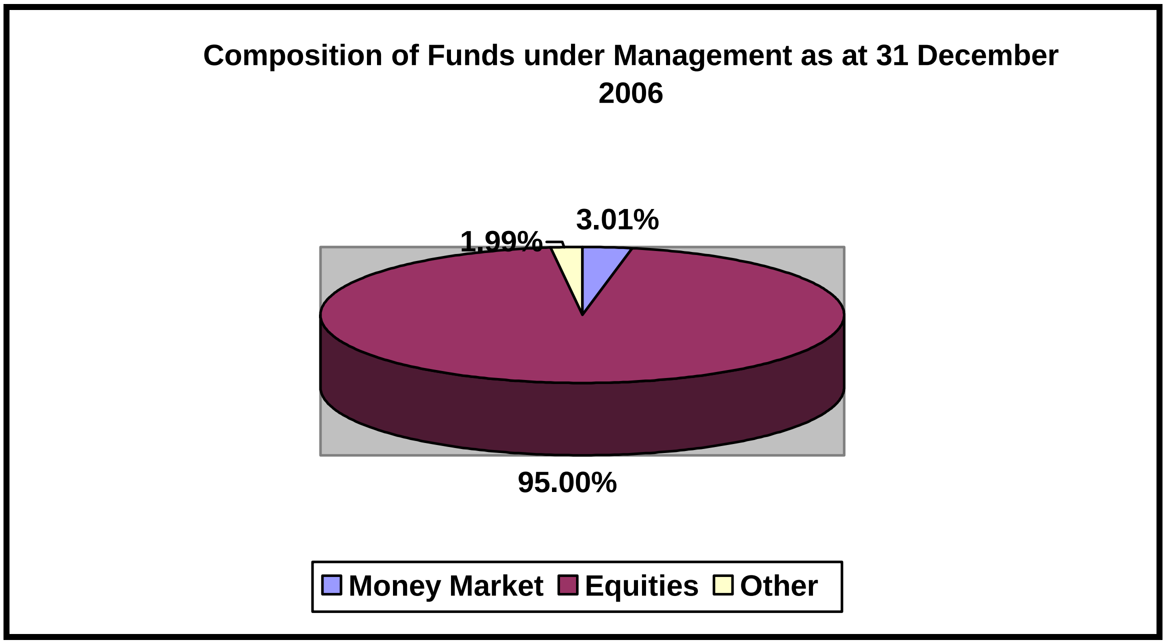
3.4.5 As at 31 December 2007, ten (10) asset managers recorded net capital bases which were below the expected minimum capital requirement of $500 billion for asset management companies.

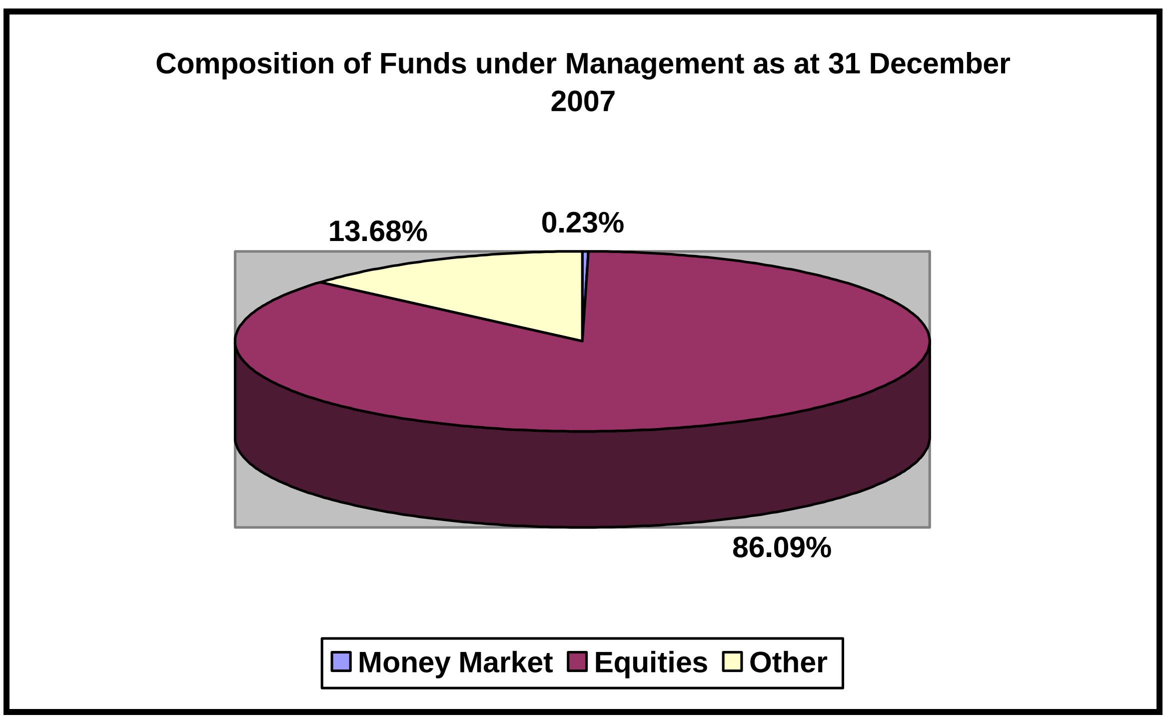
Funds under Management…

3.4.6 The sector experienced an exponential increase in total funds under management from $2.18 trillion as at 31 December 2006 to $7 519.48 trillion ($7.52 quadrillion) as at 31 December 2007. The increase in funds under management was largely attributed to strong performance on the equities market, particularly, during the last quarter of 2007.

3.4.7 The trend in the composition of funds under management for the sector are illustrated in the charts below.

Figure 3.16: Composition of Funds under Management December 2006 to December 2007


Composition of Funds under Management as at 31 December 2006
3.01%
1.99%
95.00%
Money Market
Equities
Other


Composition of Funds under Management as at 31 December 2007
13.68%
0.23%
86.09%
Money Market
Equities
Other

3.4.8 Total funds under management were skewed towards equity investments which comprised 86.09% of total managed assets, a decline from 95% as at 31 December 2006. The proportion of money market investments in total funds under management also declined from 3.01% as at 31 December 2006 to 0.23% as at 31 December 2007.

3.4.9 Conversely, the proportion of other investments in total managed funds increased from 1.99% as at 31 December 2006 to 13.68% as at 31 December 2007. Property investments comprise 97.30% of other investments as at 31 December 2007.

3.4.10 The sector's average portfolio performance improved as evidenced by the growth in managed funds of 363 745% for the year ended 31 December 2007. The sectoral portfolio growth was marginally above the growth in the industrial index of 322 495% during the course of the year.

Sectoral Concentration …

3.4.11 One asset manager, namely, Old Mutual Asset Management dominated the sector as it had a market share in terms of funds under management of 59.70% as at 31 December 2007, a decline from 64.69% as at 31 December 2006.

3.4.12 The top four asset managers had a combined market share of 87.47% as at 31 December 2007, while the remaining 14 institutions accounted for 12.53% as at 31 December 2007. This is in comparison with an aggregated market share of 90.50% for the top four institutions and 9.50% for the remaining 14 asset management companies as at 31 December 2006.

Earnings and profitability…

3.4.13 The sector's aggregate net profit after tax for the year ended 31 December 2007 was $22.49 trillion, an increase from $10.94 billion recorded as at 31 December 2006. The increase in net profit after tax is largely due to gains on revaluation of proprietary equity investments.

3.4.14 The sector mainly relies on income from investments and securities which constituted 62.94% of total income, as opposed to core fee income (management fees) which comprised 28.70% of total income.

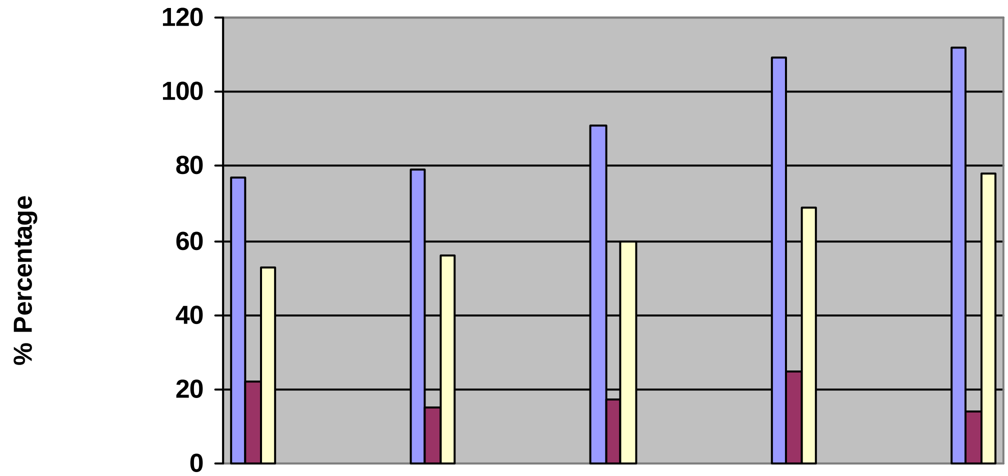
3.4.15 Despite, the foregoing, management fees were generally sufficient to cover operational costs as indicated by an average operational cost to management fees ratio of 49.91% for the sector as at 31 December 2007.

3.4.16 The exception was four asset management companies which failed to cover operational expenses from core income streams during the year ended 31 December 2007. The institutions, thus, largely relied on income from proprietary investments as opposed to management fees.

3.4.17 The return on assets and return on equity ratios improved from 52.58% and 76.50% in December 2006 to 77.57% and 111.63% in December 2007, respectively.

3.4.18 The profitability indicators for asset management companies are highlighted in the graph below:

Figure 3.17: Key Earnings Indicators December 2006 to December 2007



	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07
ROE	77	79	91	109	112
Cost/Income	22	15	17	25	14
ROA	53	56	60	69	78

3.4.19 The sectoral cost to income ratio improved from 22.05% in December 2006 to 14.32% in December 2007. The improvement in the cost to income ratio was attributable to an increase in earnings from $21.61 billion in December 2006 to $32.34 trillion in December 2007.

CHAPTER 4: TROUBLED BANK RESOLUTION

4.1 INTRODUCTION

4.1.1 During the course of 2007, Zimbabwe's banking sector remained relatively stable and is expected to remain so in the forthcoming year. No banking institution was placed under curatorship or liquidation during the course of the year.

4.1.2 However, alert needs to be maintained particularly on some pertinent issues including the re-emergence and increase in incestuous relationships between certain banking institutions, their holding companies and other related parties that are reminiscent of the pre-2003 era.

4.1.3 Some unprincipled shareholders and unscrupulous executives continue to use convoluted group structures as conduits for abuse of depositors' funds and engagement into non-permissible activities such as the purchase of stocks on the equity market.

4.1.4 Investigations conducted by the Reserve Bank have revealed a number of irregularities at some banking institutions and as part of the corrective process, the Reserve Bank has directed three banking institutions, in terms of the Banking Act, to relieve the culpable executives of their duties.

4.2 PENDING LITIGATION ON TROUBLED BANKS

Overview…

4.2.1 A number of legal issues pertaining to troubled banking institutions that have been under curatorship/liquidation since 2004 remain outstanding.

4.2.2 Finalisation of these pending litigations is crucial in reaching final resolution of the troubled banks. It is envisaged that once these cases are finalized the Reserve Bank would be able to bring to finality resolution of these troubled banks.

4.2.3 It is on this basis that the Reserve Bank would like to see finalisation of the pending cases and close liaison with the relevant stakeholders is being maintained.

Status of Appeals to the Administrative Court…

4.2.4 The appeals lodged by the shareholders of Trust Bank Corporation Limited and Royal Bank Zimbabwe Limited *(both under curatorship)* with the Administrative Court are still pending.

4.2.5 The shareholders of the two institutions appealed to the Administrative Court following the dismissal of their claim against the curator's decision to sell their institutions' assets to ZABG. The claim had been dismissed by the Reserve Bank following the deliberations of the Justice Smith Panel of Experts and was also dismissed by the Minister of Finance on appeal.

4.2.6 The Administrative Court has not yet set down the matters for hearing. The Reserve Bank of Zimbabwe is advised that the Administrative Court is still in the process of identifying suitable Court Assessors to assist in the hearing of the appeals.

4.2.7 Consequently the institutions' curatorships have been extended to 30 June 2008 pending the finalisation of the appeals.

4.2.8 Meanwhile, on 18 January 2008, Trust Holdings Limited, the shareholders of Trust Bank Limited filed a claim in the High Court for damages amounting to **$70.50 trillion** (excluding interest) at the High Court against the Curator, the RBZ and ZABG Bank.

4.2.9 The respondents have each filed separate opposing papers and Reserve Bank awaits the setting down of the matter.

Time Bank (former Time Bank of Zimbabwe Limited)…

4.2.10 The institution's licence as a banking institution was cancelled on 19 May 2006. The shareholders of Time Bank appealed in the Administrative Court against the Registrar of Banking Institutions' decision to cancel the institution's licence.

4.2.11 Following the cancellation of the institution's banking licence, and concurrent termination of curatorship, the former directors were invited by the Reserve Bank to a formal hand-over take-over of the affairs of the institution.

4.2.12 The former directors of Time Bank refused to attend the meeting, preferring instead to have a hand-over take-over initiated by the former curator.

4.2.13 In an urgent chamber application brought before Justice Ndou in the High Court of Bulawayo on 18 October 2007 by Time Bank seeking a Court Order compelling the former Curator to hand-over all the affairs of the troubled institution, the High Court upheld the former Curator's argument and dismissed the Urgent Chamber Application.

4.2.14 This means that Time Bank can only approach RBZ for the hand-over. Reserve Bank awaits further developments.

4.2.15 Meanwhile the High Court matter in which Time Bank is seeking reversal of the Reserve Bank decision to place the institution under liquidation which had been set for 10 March 2008 could not take off as Time Bank's lawyers sought more time to consider the matter as they had been recently engaged.

First National Building Society [in liquidation]…

4.2.16 Following the failure of the recapitalisation initiatives by the former shareholders of FNBS, and the subsequent cancellation of its licence on 25 October 2006, the institution was placed under liquidation.

4.2.17 The unilateral appointment of Mr. W. Sibanda, of AMG Global Chartered Accountants as the Liquidator of FNBS by the Master of High Court appointed of at the instance of the former shareholders of FNBS, was reversed by the Supreme Court following an appeal by the Reserve Bank and Mr. Scott of PriceWaterhouseCoopers was reappointed.

4.2.18 The appeal was based on the argument that the appointment was in contravention of the Banking Act which required a nominee of the RBZ and that the appointee was not independent, being biased in favour of the former shareholders. Before his appointment, he had worked in concert with the former shareholders purporting to pay creditors without due regard to the liquidation process.

4.2.19 On commencement of the liquidation of the institution, the shareholders issued summons in the High Court seeking, among other things, an order that the RBZ be paid the sum of $4 million ($2 million principal debt plus 100% interest as per induplum rule) in full and final settlement of its claim against FNBS instead of $257,583,861.00 lodged with the Master.

4.2.20 They also filed an urgent chamber application on 7 November 2007 interdicting the liquidator from disposing any assets belonging to FNBS. The chamber application was dismissed.

4.2.21 The liquidation process has however, been stalled once again following an appeal filed in the Supreme Court by FNBS's shareholders. This Supreme Court matter is yet to be set down for hearing.

4.3 ENHANCEMENTS OF THE TROUBLED BANK RESOLUTION FRAMEWORK

4.3.1 Faced with new challenges in the banking sector, the Reserve Bank is in the process of refining its policy for dealing with problem/troubled banks.

4.3.2 The policy builds on existing supervisory enforcement actions specified under various sections of the Banking Act (Chapter 24:20) and gives guidance on how the Reserve Bank will use various supervisory assessment systems in identifying the main features of problem banks, enforcing corrective actions and implementing resolution techniques for failed banks.

4.3.3 Further, the policy has been enhanced to provide for the employment of early warning systems (EWS) to identify problem banks for early intervention. The EWS enable the Reserve Bank to detect financial weaknesses and vulnerabilities and to take preemptive steps to reduce the risk of bank failures and financial crisis.

CHAPTER 5: OUTLOOK

5.1 Overview

5.1.1 The banking industry is expected to sustain the strong performance into 2008, benefiting from expanding business opportunities and a safe and sound financial sector. Institutions are expected to continue rolling out new products as they expand the branch and ATM networks as part of increasing their outreach to the previously unbanked or under banked communities in the forth coming year.

5.1.2 Competition in the year 2008 is likely to increase with the planned conversion of banking licenses by some banking institutions. During the year, two discount houses sought approval to convert to a merchant bank while two other banking institutions have also applied to convert to a commercial bank.

5.2 Additional Disclosure Requirements

5.2.1 The Reserve Bank prescribed additional disclosure requirements as part of its on going efforts to enhance market discipline in the financial sector. All banking institutions and asset management companies are now required to disclose the most recent on-site **CAMELS and Risk Assessment System (RAS), ratings,** as well as **ratings assigned by accredited Credit Rating Agencies**, in their published annual financial statements.

5.2.2 These additional disclosure requirements are expected, going forward, to promote adequate transparency in financial institutions. Transparency strengthens confidence in the banking system by reducing information asymmetry between banks and their clients.

5.3 Capital Preservation…

5.3.1 Banking institutions are encouraged to always build adequate capital buffers on their own initiative, which are commensurate with their risk profiles and prudential requirements of the operating environment.

5.3.2 It is imperative that banking institutions take note that optimal capital levels are dynamic and are subject to changes as would be dictated by such fundamentals as the exchange rate among other key indicators.

5.3.3 Going forward banking institutions are expected to come up with capital preservation strategies in light of the hyperinflationary environment which will continue eroding the value of the capital amount.

5.3.4 The Reserve Bank will continue to review the minimum capital requirements for banking institutions from time to time, in line with developments in the domestic market, as well as regional and international capital standards.

5.4 Asset Management Companies…

5.4.1 Over the past two years, the Central Bank has been calling for asset management companies to consolidate their businesses but only a few institutions have heeded the call. The call was based on the inability of some institutions' incomes and investments under management to sustain operations and the continued reliance on income from non core sources by some asset management companies.

5.4.2 It is anticipated that consolidations will take place in the industry through mergers and acquisitions as institutions seek to achieve economies of scale required to effectively compete and expand levels of funds under management and sustain operations.

5.5 Credit Reference Bureau…

5.5.1 The Reserve Bank, in collaboration with the Bankers Association of Zimbabwe (BAZ) and Building Societies Association, is setting up a Credit Reference Bureau.

5.5.2 The Credit Reference Bureau will provide a central database for credit information sharing which will, among other things, aid lenders in the evaluation of the creditworthiness of borrowing clients.

5.5.3 Credit information sharing is critical to addressing the challenge of non-performing loans in the banking sector and enhancing access to banking products and services particularly for small and medium size enterprises and individuals engaged in the informal sector. By providing a better and more accurate knowledge of every borrower's credit quality and by facilitating appropriate analysis of their creditworthiness, the Bureau will foster greater transparency and easier access to the credit market on better terms.