This issue of the Financial Stability Review focuses mainly on the six-month period ending December 2013. However, selected developments up to the date of publication were also reported on. Data may include own calculations made for purposes of this publication.
Purpose of the Financial Stability Review

The South African Reserve Bank’s (the Bank) primary objective is the achievement and maintenance of price stability in the interest of balanced and sustainable economic growth in South Africa.

In addition to this, the Bank’s role and mandate in overseeing and maintaining financial stability was reaffirmed by the Government. In pursuit of this objective and to promote a stable financial system, the Bank publishes a semi-annual Financial Stability Review. The publication aims to identify and analyse potential risks to financial system stability, communicate such assessments and stimulate debate on pertinent issues. The Bank recognises that it is not the sole custodian of financial system stability, but contributes significantly towards, and coordinates a larger effort involving the government, other regulators, self-regulatory agencies and financial market participants.

Defining financial stability

Financial stability is not an end in itself, but, like price stability, is generally regarded as an important precondition for sustainable economic growth and employment creation.

‘Financial stability’ is defined as the smooth operation of the system of financial intermediation between households, firms, and the government through a range of financial institutions. Stability in the financial system would be evidenced by, firstly, an effective regulatory infrastructure, secondly, effective and well-developed financial markets and, thirdly, effective and sound financial institutions. In its pursuit of financial stability, the Bank relies on market forces as far as possible and believes that any of its actions taken to contain systemic risk should be at the minimum level required to be effective.

Financial instability, conversely, could manifest through banking failures, intense asset-price volatility or a collapse of market liquidity and, ultimately, in a disruption in the payment and settlement system. Financial instability affects the real sector due to its links to the financial sector. It has the potential to cause significant macroeconomic costs, as it interferes with production, consumption and investment, and, therefore, undermines national goals of broader economic growth and development.
Contents

Overview .......................................................................................................................... 1
Introduction ....................................................................................................................... 3

Financial stability risk assessment .................................................................................. 4
  Financial stability risk review ...................................................................................... 4
  Macropurdenential regulation: Assessing the application of the countercyclical
capital buffer ................................................................................................................. 5

Financial stability developments and trends ................................................................. 7
  Economic growth and outlook ..................................................................................... 7
  Unemployment ........................................................................................................... 8
  Financial market developments and trends ............................................................... 9
    Volatility in global and domestic currencies .......................................................... 10
    Global and domestic bond and equity market volatility ......................................... 10
    Selected commodity price movements ................................................................ 13
  Banking and bank-lending conditions ..................................................................... 14
  Non-bank financial institutions .................................................................................. 18
  Confidence in the financial services sector .............................................................. 21
  Government finances and financial stability ............................................................ 21
  External sector ......................................................................................................... 23
  Corporate sector ...................................................................................................... 23
  Household sector ..................................................................................................... 25
  Residential real-estate sector .................................................................................... 27

The robustness of the domestic financial infrastructure ................................................. 29
  Regulatory and other developments affecting banks ................................................. 29
  Removal of adverse consumer credit information and paid-up judgments ............ 29
  Regulatory developments relating to the insurance sector ........................................ 29
  Update on the Financial Services Laws General Amendment Act ......................... 30
  Implementing a twin peaks financial regulation framework in South Africa ............ 30

Financial market infrastructure developments ............................................................ 31
  Implementing over-the-counter derivatives market reforms .................................... 31
  Principles for exchange-traded funds ........................................................................ 34
  Hedge funds regulation ............................................................................................. 35
  Retirement fund reforms .......................................................................................... 36

International regulatory developments which may affect domestic financial stability 37
  An update on the Global Legal Entity Identifier ..................................................... 37
  Other G-20-driven international financial regulatory developments ....................... 38

Financial Sector Contingency Forum simulation exercise .......................................... 39

Abbreviations and glossary ............................................................................................ 41

Boxes
1  Testing the resilience of banks against a possible increase in sovereign yields ......... 17
2  Issues requiring urgent attention in the over-the-counter reform process ................ 33

Figures
1  Private-sector credit-to-GDP gap ........................................................................... 5
2  Selected private-sector credit-to-GDP gaps according to asset class .................... 6
3  Purchasing managers’ indices ................................................................................ 7
4  Real GDP growth and average inflation in sub-Saharan Africa .............................. 7
5  Global unemployment ............................................................................................ 8
6  Global youth unemployment .................................................................................. 9
7  Size of selected central banks’ balance sheets ...................................................... 9
8  Fund flows in the first quarter of 2014 ..................................................................... 9
Overview

Global financial stability conditions continued to improve during the period under review as many of the risks identified in the September 2013 edition of the Financial Stability Review abated somewhat. The domestic financial system is, however, still exposed to some of the consequences of the global financial crisis, and to domestic financial, economic and social developments. Also, geopolitical risks have gained more prominence recently, including the intensified crisis in the Ukraine and upcoming elections in several emerging-market economies (EMEs), which could lead to renewed global financial market volatility.

The tapering of quantitative easing (QE) by the United States (US) Federal Reserve (the Fed) and the expectation of US interest-rate normalisation continued to impact on the pattern of global capital flows and the intensity of financial market volatility. Going forward, the extent of the impact on EMEs will be mainly determined by uncertainty about the manner in which policy normalisation is implemented by the Fed. Amplifying the impact of tapering and policy normalisation on South Africa is the prevalence of some fundamental domestic risks, which includes the prevailing tension in the domestic labour market, high unemployment, the a high current-account and budget deficits and a below-potential economic growth outlook. The higher cost of living for South Africans due to increasing electricity costs, higher fuel prices, and higher interest rates could impair consumers’ ability to service debt levels and impact households’ consumption expenditure.

Global economic growth improved in the second half of 2013, with further improvements anticipated in 2014/15 largely on account of a stronger recovery in advanced economies. This scenario continued to diverge from the subdued growth outlook for EMEs amid persistent concerns over country-specific structural and cyclical weaknesses. In line with other EMEs, the South African economy recorded below par real economic growth for 2013, contributing to a downward revision of the Bank’s economic growth forecast for 2014. While global unemployment levels remained high, general unemployment in most economies decreased slightly in the second half of 2013. Similarly, South Africa’s unemployment rate dropped marginally in the fourth quarter of 2013 compared to the third quarter. Youth unemployment remains a concern, globally and domestically, despite a slight decrease in the fourth quarter of 2013.

Although uncertainties around the timing and speed of tapering by the US Fed eased, the period under review witnessed a continued rotation of financial assets from emerging markets to advanced economies. The outflows from EMEs’ bond and equity markets raised financial stability concerns somewhat, particularly for countries with relatively large current-account deficits that are dependent on foreign-currency inflows. The magnitude of outflows from individual countries appeared to signal a growing influence of country-specific factors. Although the 2014 year-to-date outflow from South Africa is less than that experienced by other EMEs, the outflow is nonetheless double its cumulative total inflow for 2013. On balance, the South African rand has proven to be one of the emerging-market currencies most vulnerable to the change in investor sentiment. Actions towards policy normalisation by the US Fed have impacted negatively on financial stability in EMEs, including South Africa, and its impact is expected to continue in the short term.

The tightening of emerging-market lending conditions that started in the second quarter of 2013 moderated during the final quarter. In South Africa, credit extended by the banking sector continued to increase and impaired advances as a percentage of the total loan book continued to decrease. The profitability of the banking sector has generally declined since the onset of the financial crisis. The banking sector, however, remained adequately capitalised during the period under review.
An assessment of total credit extension, with the aim of considering the appropriateness of the current financial stability stance on the countercyclical capital buffer (CCB) for banks, showed that there is currently no reason to change the level of buffer capital that banks need to hold to influence the rate of credit extension. Some categories of credit, however, remained above their respective long-term trends, while others, such as mortgage lending, were well below.

Confidence in the domestic financial services sector in general improved in the fourth quarter of 2013, albeit marginally. In particular, confidence among life insurers rebounded despite the difficult underlying operating conditions, including relatively weak economic growth, a depreciating exchange rate and high unemployment.

The Financial Services Board is currently implementing an approach to market conduct regulation based on the concept of ‘treating customers fairly’. This approach seeks to ensure that fair treatment of customers is embedded within the culture of regulated entities. It should improve customers’ confidence in the sector.

Consumer confidence, conversely, remained near decade lows in the fourth quarter of 2013. Growth in households’ financial and total assets continued to moderate in the second half of 2013, and savings by households as a percentage of disposable income declined. Growth in total credit extended to the household sector also moderated. Although debt as a percentage of disposable income dropped during the period under review, the number of credit-active consumers in good standing decreased. Regulations relating to the removal of adverse consumer credit information, which came into effect on 1 April 2014 might make it more difficult for consumers to access credit in future.

To improve further the robustness of the domestic financial infrastructure, South Africa is in the process of implementing a twin peaks financial regulatory framework. The National Treasury (NT) released for public comment the cabinet-approved Financial Sector Regulation Bill to give effect to the establishment of the necessary regulators and clarify their powers and responsibilities. The Financial Sector Regulation Bill not only makes provision for the establishment of prudential and market conduct regulators, but also provides a mandate to the Bank for promoting financial stability.

South African authorities have adopted a three-phased approach to the implementation of the over-the-counter (OTC) derivatives regulatory reforms. This is a cautious approach, mindful of the need to minimise unintended consequences while the international cross-border OTC rules are being finalised. Details of the OTC derivatives regulatory reforms will be established in a regulatory framework provided for under the Financial Markets Act and will become operational once the relevant regulations are finalised.

Because of possible financial stability risks that could be brought about by exchange-traded funds, the Financial Stability Board’s (FSB) Standing Committee on the Assessment of Vulnerabilities in February 2014 examined the implications of exchange-traded funds and concluded that supervisors would need to improve their data gathering in a number of areas.

South Africa also embarked on a process to enhance and expand the scope of regulation and oversight of hedge funds, and to align itself with the new regulatory requirements on shadow-banking activities following the global financial crisis. This process culminated in the release of a proposed framework for regulating hedge funds in South Africa on 13 September 2013.
Introduction

This edition of the Financial Stability Review, which focuses mainly on the six-month period ended December 2013, comprises three main sections, namely (i) financial stability developments and trends, (ii) financial stability risk assessment, and (iii) the robustness of the domestic financial infrastructure.

The first section provides a summary of the prominent financial stability risks from the global and domestic environments that the Bank identified and rated according to the probability of their occurrence and their likely impact on the domestic financial system during 2014. This is followed by a discussion of the application of the CCB as a macroprudential instrument.

In the second section the main financial stability developments and trends over the period under review are analysed from both a global and a domestic perspective.

The final section provides a review of the developments in the domestic and international financial and regulatory environment. Although the focus is largely on domestic developments, the international context is also provided and considered where appropriate.
Financial stability risk assessment

Financial stability risk review

The Bank considers developments and trends in the global and domestic environments in an attempt to pre-emptively detect and mitigate possible risks to, and weaknesses in, the domestic financial system. All possible scenarios identified in this process are rated according to the probability of their occurrence and their likely impact on the domestic financial system.

One of the more prominent risks to domestic financial stability is the impact of QE tapering in the US and the effect that potentially higher interest rates in several advanced economies could have on EMEs in general and on South Africa in particular. The mere expectation of tapering by the US Fed since May 2013 and the actual tapering that started in January 2014 resulted in significant initial outflows from bond and equity markets in several EMEs, which have reversed somewhat in March 2014. The spillover of expected US monetary policy normalisation resulted in a further depreciation of emerging-market currencies and higher long-term bond yields. Amplifying the impact of QE tapering on South Africa, compared with a number of other EMEs, is the prevalence of some fundamental domestic risks.

The higher cost of living for South Africans, caused by increasing electricity costs, higher fuel prices and higher interest rates, could prompt some households to borrow more to meet their short-term spending needs. Against a backdrop of already relatively high household debt, this could ultimately weigh on consumers’ ability to service debt. The widespread granting of expensive unsecured lending facilities by both bank and non-bank financial institutions in the recent past could also contribute to future loan losses, lower profitability and eventually increased funding costs for these credit-granting institutions.

Unemployment in South Africa remains a concern. Labour disruptions in the mining sector, low corporate-sector investment, inadequate schooling and a gap in the required skills for specific jobs could exacerbate the situation. Higher levels of unemployment could not only fuel social unrest, specifically in light of the already high level of unemployment among South African youths, but also translate into increased defaults on loans at banks, with potential risks for the banking sector and eventually for the financial stability of the country.

The already high level of unemployment continues to weigh on economic growth prospects and, in line with the weaker growth outlook for EMEs, both the Bank and the International Monetary Fund (IMF) have revised downwards their forecasts for domestic economic growth for 2014. With labour disruptions and concerns over the possible effects that tighter monetary policy could have, the economic-growth outlook remains uncertain.

The prevailing tension in the domestic labour market, which started in the mining sector before spreading to other sectors of the economy, remains a

---

1 Almost 50 per cent of South Africans between the ages of 15 and 24 years are unemployed. Statistics South Africa, Quarterly Labour Force Survey, Q4 2013 (Pretoria: Statistics South Africa, December 2013).
concern. Strike action not only hampers productivity, but could also reduce the capacity of mining houses and workers to service their debt, with potential implications for the banking sector. The mining sector in particular plays a vital role in South Africa’s economy and is a significant earner of foreign exchange. The economy remains dependent on the export of minerals and metals for foreign earned revenue, which accounted for as much as 60 per cent of all export revenue in 2013. The sectors affected by strike action suffer significant production losses while workers forfeit wages, bonuses and other benefits.

Although narrowing most recently, the current-account deficit could pose a marked risk to the stability of the domestic financial system. The financing of the current-account deficit in South Africa relies heavily on foreign capital inflows, especially portfolio inflows considering the low domestic savings rate.

Regarding longer-term risks, income disparity ranks fourth in the top ten most likely global risks over the next ten years according to the World Economic Forum’s Global Risks 2014 report. South Africa’s Gini coefficient, which measures income disparity, is among the highest in the world. The significant gap between rich and poor threatens social and political stability as well as economic development and financial stability.

The above-mentioned risks could contribute to South Africa being more vulnerable to global developments, for example the uncertainty with regard to interest rate normalisation in the US. However, several factors such as a flexible exchange rate, robust financial infrastructure and open, deeply liquid markets should assist in mitigating the impact that these risks could have on South Africa.

Macroprudential regulation: Assessing the application of the countercyclical capital buffer

Following the summary provided in the September 2013 edition of the Financial Stability Review with regard to the application of the CCB, the updated private-sector credit-to-GDP (gross domestic product) gap is presented in Figure 1.

To comply with the Basel III framework, the CCB was designed to take into account the macrofinancial environment in which banks operate. The methodology suggests that the CCB should be considered for banks if the private-sector credit-to-GDP ratio is above its long-term trend.

The private-sector credit-to-GDP gap for South Africa reveals that credit extension relative to GDP continues to decrease and remains below its long-term average, suggesting that there is currently no need to consider a CCB add-on for banks.

However, credit extended in various loan categories can exhibit different and even diverging growth trends. The Bank therefore monitors the credit-to-GDP gaps of various categories of credit (Figure 2).

---

3 The application of instruments for macroprudential policy purposes should not be applied mechanistically, but subject to judgement.
Other loans and advances, and instalment sale credit categories had credit-to-GDP gaps that remained above zero during the period under review. However, these categories’ credit-to-GDP gaps have been relatively constant since the final quarter of 2012.

Mortgage advances and leasing finance credit categories had credit-to-GDP gaps that remained below their respective long-term trends. The credit-to-GDP gap for mortgage advances has been declining since 2008 and continued to decline throughout 2013, in line with a decline in the growth rate of mortgages extended. Given the large negative credit-to-GDP gap of mortgage advances, the implementation of other macroprudential instruments could be considered to promote the use of these types of credit, especially since a capital buffer was not initiated during the upswing.
Financial stability developments and trends

Economic growth and outlook

Global economic growth improved in the second half of 2013. Further improvement is anticipated in 2014/15, largely on account of a recovery in advanced economies following generally stimulating monetary policy. High levels of unemployment, however, remain a key challenge.

Nevertheless, the global economic recovery has been fragile and uneven. In 2013, the US recorded an average annual economic growth rate still lower than half of that experienced before the financial crisis. While aggressive policy stimulus in Japan also supported economic growth, the growth rate of one of the world’s largest economies could slow in 2014 if fiscal policy is tightened. Economic growth in the euro area has been positive since the second quarter of 2013, but the recovery remains slow and uneven.

Forward-looking indicators, including the manufacturing Purchasing Managers’ Index (PMI), supports a scenario of recovery in several advanced economies (Figure 3). The optimistic sentiment in advanced economies continued to diverge from the more subdued growth outlook for EMEs amid persistent concerns over country-specific weaknesses. These include weaker-than-expected domestic demand amid higher interest rates, a weaker currency and tighter fiscal policy. Ironically, many of the external difficulties now faced by EMEs were triggered in part by the US policy response to improved economic conditions. Nevertheless, stronger external demand from advanced economies could boost growth in EMEs and assist these countries in overcoming some of these challenges.

Global shocks have, however, weighed on economic growth in sub-Saharan Africa, causing it to moderate from 5.5 per cent in 2011 to 4.9 per cent in 2013 (Figure 4). Inflation in the region is also expected to decrease further from 9 per cent in 2012 to 6.3 per cent in 2013 before moderating to 6.1 per cent in 2014. While the IMF forecasts that economic growth will pick up in 2014 to around 5.4 per cent, global developments, including growth in imports by China, will continue to affect the performance of sub-Saharan African countries.

Similar to other EMEs, the South African economy recorded disappointing real economic growth in 2013 following erratic quarter-on-quarter growth. Real GDP grew at a quarter-on-quarter, annualised and seasonally adjusted rate of 3.8 per cent during the fourth quarter of 2013, following a very low 0.7 per cent in the third quarter. The main contributors to the improvement in economic activity in the fourth quarter of 2013 were the manufacturing, mining and quarrying, the wholesale, retail and motor trade, and the catering and accommodation sectors. Their collective contribution of 2.9 percentage points to GDP growth offset the decline in the real value added by the electricity, gas and water sector, which contracted by 5.6 per cent due to lower consumption of both water and electricity.

The Bank downwardly revised its economic growth forecast from 3.0 per cent to 2.8 per cent for 2014 and from 3.4 per cent to 3.3 per cent for 2015.

5 Note that the GDP rebasing exercise could lead to slower real GDP growth in Nigeria and ultimately could weigh on economic growth in sub-Saharan Africa.

6 International Monetary Fund, World Economic Outlook Update (Washington DC: International Monetary Fund, January 2014).
Also, the Kagiso PMI\footnote{KagisoTiso Holdings, Bureau for Economic Research and the Chartered Institute of Purchasing and Supply (CIPS) Africa, Kagiso Purchasing Managers’ Index (Pretoria: CIPS, April 2014).} fell to 50.3 index points in March 2014 after rising to 51.7 points in February 2014. In addition, the Bank’s leading business cycle indicator continued to trend broadly sideways in recent months, increasing marginally by 0.3 per cent in January 2014 compared with the preceding month.

Short-term indicators of future economic growth (Table 1) showed strong declines but were not representative enough to allow the drawing of meaningful conclusions. Data on approved building plans recorded mostly positive growth rates during the second half of 2013; while buildings completed recorded higher volatility but did not display a clear trend. Both retail and wholesale trade sales recorded positive growth rates during the second half of 2013 and ended the year fairly strongly. Growth in new vehicle sales and new passenger car sales remained negative in the last five months of 2013 and declined further in the first three months of 2014, reflecting somewhat weaker consumer demand. Electric current generated declined for most of the second part of 2013, although it increased modestly in January 2014.

### Table 1 Select indicators of real economic activity\footnote{At constant prices, seasonally adjusted by the South African Reserve Bank} \footnote{Quarterly indicator, ratio} \footnote{Denotes unavailability of data} 

<table>
<thead>
<tr>
<th>Activity indicators</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building plans passed</td>
<td>28.18</td>
<td>11.02</td>
</tr>
<tr>
<td>Buildings completed</td>
<td>25.22</td>
<td>17.46</td>
</tr>
<tr>
<td>Retail sales</td>
<td>2.24</td>
<td>2.03</td>
</tr>
<tr>
<td>Wholesale trade sales</td>
<td>7.20</td>
<td>6.92</td>
</tr>
<tr>
<td>New vehicle sales</td>
<td>6.11</td>
<td>-0.06</td>
</tr>
<tr>
<td>New passenger car sales</td>
<td>5.17</td>
<td>-3.27</td>
</tr>
<tr>
<td>Electric current generated</td>
<td>0.35</td>
<td>-1.13</td>
</tr>
<tr>
<td>Utilisation of production capacity\footnote{2}</td>
<td>...</td>
<td>...</td>
</tr>
</tbody>
</table>

Sources: Statistics South Africa. Data on new vehicle and new passenger car sales were obtained from the National Association of Automobile Manufacturers of South Africa.

### Unemployment

Even though unemployment in most economies decreased slightly in the second half of 2013, global unemployment levels remained high during the period under review. Similarly, South Africa’s unemployment rate remained at an elevated level during the period under review, although it decreased somewhat from 24.5 per cent in the third quarter of 2013 to 24.1 per cent in the fourth quarter. This brings the total number of unemployed South Africans to 4.83 million.

Youth unemployment remains a global concern even though the Organisation for Economic Co-operation and Development (OECD) area’s youth unemployment rate decreased to 15.7 per cent in the fourth quarter of 2013 from 16.1 per cent in the third quarter. Youth unemployment, however, remained high for euro area countries such as Greece, Spain, Italy and...
Portugal. While youth unemployment in Spain was on a downward trend in 2013, more than half of the population aged 15 to 24 remained unemployed during the period under review. The sustainability of the economic recovery hinges in part on a meaningful reduction in global unemployment.

The youth unemployment rate in South Africa also fell from the third to the fourth quarter of 2013, but at 48.9 per cent remains a concern given that almost half of South Africa’s youth are unemployed. This situation is exacerbated by continuing labour disruptions, especially in the mining sector, and a rather subdued economic growth outlook. Unemployment remains one of the major economic challenges in South Africa and has the potential to negatively affect financial stability.

Financial market developments and trends

Financial market developments were driven largely by a combination of improving macroeconomic conditions in advanced economies, divergent monetary policy action taken by major central banks, and heightened market turmoil and geopolitical tensions in emerging markets.

The European Central Bank’s (ECB) balance sheet shrunk in the period under review as many euro area banks made use of the early repayment option for their emergency ECB loans. Further, with improved economic prospects in the euro area, banks made less use of the ECB’s main refinancing operation, reducing the number of emergency loans from the ECB. The Bank of Japan (BoJ) and the Fed, conversely, continued to increase their respective balance sheets through further stimulus in 2013.

Indications of QE tapering by the Fed became the major driver of financial markets around mid-2013, and it was only once tapering had begun in earnest in 2014 that US interest rate expectations started showing a greater degree of stability. Although uncertainties around the timing and speed of QE tapering eased, the period under review witnessed a continued rotation from emerging markets to advanced economies as investors offloaded emerging markets’ financial assets, especially equities (Figure 8). The outflows from emerging markets’ bond and equity markets have raised some financial stability concerns, particularly for countries with relatively large current-account deficits, hence relying on capital inflows to finance these deficits.

The reversal of emerging-market capital flows due to the Fed QE tapering accelerated during 2013, resulting in a total outflow of US$15.6 billion and US$18.4 billion from emerging-market bond and equity funds respectively. While emerging markets’ bonds and equities were being sold off, their advanced economy counterparts continued to experience net equity inflows, even as bonds experienced some net sales. Within advanced economies, the preference for advanced economy equities changed, with European equity funds emerging as the most favoured investment vehicles. The attractiveness of European markets reflects optimism about the improving economic growth in Europe and perceptions of easing sovereign risk in the periphery. The latter is illustrated by the compression of spreads, with Italian and Spanish ten-year spreads over German bonds down to their lowest levels since early 2011.
The magnitude of outflows at an individual country level appeared to signal a growing influence of country-specific factors, with investors displaying a collective inclination to differentiate between economies. Among emerging markets, countries that appeared to be relatively more vulnerable, either because of weak or weakening macroeconomic fundamentals or because of amplified geopolitical risks, experienced larger outflows. In the Brazil, Russia, India, China and South Africa (BRICS) grouping, Brazil, Russia and China account for over a third of total equity and bond outflows from all emerging markets. The outflow from South Africa during the first quarter of 2014, a relatively small market, is fairly low compared to its BRICS peers. However, this outflow from South Africa during the first quarter is nonetheless double South Africa’s cumulative total for 2013 as a whole.

Non-resident investors in South Africa were net sellers of R69 billion worth of domestic bonds and equities between October 2013 and March 2014. Over this period, a large part of equity sales was concentrated in the mining and media sectors. Since the beginning of 2014, equity outflows from the banking sector have accounted for the largest proportion of equity outflows from South Africa and have since overtaken the mining sector on a month-to-month basis. In the first two months of 2014, equity outflows from the domestic banking sector accounted for approximately 40 per cent of the total equity sell-off in South Africa. It would appear, however, that not all sale proceeds from the sell-off were transferred abroad.

Volatility in global and domestic currencies

As mentioned above, while risk aversion and portfolio outflows affected emerging markets as a broad asset class, not all EME currencies reacted similarly and investor differentiation has had a noticeable influence. Initially, countries that experienced greater currency sell-offs were those that combined wide current-account deficits, slowing potential economic growth and, in some cases, deteriorating inflation fundamentals.

The South African rand has proved, on balance, to be one of the more vulnerable emerging-market currencies to the change in investor sentiment. Since the possibility of tapering was announced in May 2013, the rand depreciated by almost 17 per cent up to its late-January peak, but has posted a moderate recovery since then. Nonetheless, the marked depreciation seen in the three months to January 2014 has not been fully reversed (Figure 10).

Global and domestic bond and equity market volatility

The vulnerability of the South African rand to a mix of QE tapering by the US and investor concerns about emerging-market fundamentals extended to the domestic bond market. Yields on the benchmark South African ten-year government bond have backed up by at least 200 basis points since the May 2013 trough, while money-market rates also increased (although a substantial part of the rise in this regard followed the Bank’s increasing the repo rate in January 2014). Following the interest rate increase, however, the domestic yield curve pivoted around its eight- to nine-year maturities, with the short end of the curve increasing in line with expectations of further rate increases. The spread between the R157 bond and the R186 bond narrowed from 2.25 percentage points during August 2013 to around 1.5 per cent in March 2014.
A development noted in the previous issue of the Financial Stability Review was that a wide range of emerging-market government bond yields showed a close correlation with US Treasury yields, and thus looked likely to increase in line with the upward adjustment in Treasury yields inherent to QE tapering. As expected, emerging-market bond yields increased, with the JPMorgan EMBI+ yield increasing by up to 175 basis points between May 2013 and January 2014. Over the same period, the yield on the South African ten-year government bonds displayed a strong positive correlation of more than 0.9 with its US equivalent. However, since the beginning of 2014, this strong positive correlation between domestic bond yields and US Treasury yields turned negative, indicating a lesser influence of US monetary policy normalisation on domestic bond yields. Instead, it appears that yields could have rather become a function of risk sentiment as yields are moving in close correlation with the rand exchange rate and emerging-market sentiment.

Equity markets in advanced economies performed extremely well compared with their emerging-market counterparts during 2013. While rotation from emerging markets to advanced economies and increased discrimination by investors were common factors driving equity markets during the second half of 2013, other factors also explained the outperformance by advanced economy equities. In the US, lesser fiscal restraint, stronger economic activity and strengthened forward guidance by the Fed supported equity markets. In Europe, increased optimism about economic recovery prospects, both in the core and in the periphery, as well as stronger consumer and business confidence readings, contributed to the strong performance in equities. In Japan, the Nikkei 225 Stock Average benefited from a weaker yen amid increased policy divergence between the US and Japan.

Furthermore, weakening economic fundamentals across emerging markets, especially in China, are weighing on fixed-income markets, and geopolitical tensions in several countries caused emerging-market equities to underperform compared to their advanced-economy counterparts by approximately 30 percentage points during 2013. While emerging markets continued on a downward trend through 2013, frontier markets rallied despite fears over QE tapering. The resilience of frontier markets was partly due to the strong economic growth momentum in this group of economies.

South African equities, in line with other emerging markets, decreased by 9 per cent in US dollar terms during 2013. However, the JSE All-share Index (Alsi) delivered a performance more in line with that of advanced economy equities in local currency terms. While resulting in negative US dollar returns, the weaker exchange rate of the rand was arguably one of the largest contributing factors to the strong Alsi rally. The impact of the weaker rand was evident in the industrial sector through its support of earnings growth, particularly for rand-hedge stocks, exporters and other companies with large international diversification. The retail sector, the largest contributor to economic growth in 2012, underwent a reversal during 2013 amid constrained consumer spending. Additionally, the persistent impact

10 The JPMorgan EMBI+ is a dollar-denominated index of sovereign bonds issued by a selection of emerging-market countries. The index tracks total returns for traded foreign currency-denominated fixed-income instruments in emerging markets.
11 This does not necessarily imply that the strong positive correlation that was observed in the past will not resume in future.
12 Frontier markets are the smaller, less developed, less liquid countries that have less established investable stock markets than EMEs.
of wage-bargaining disputes in the domestic mining sector resulted in a weakening of mining shares.

So far in 2014, the impact of increased turmoil in emerging markets on the rand gold price has supported gold-mining shares (up 62 per cent since January 2014), and therefore the Alsi. The Alsi has also benefited from a strong rebound in banking shares, which increased due to positive earnings results for the fourth quarter of 2013. Despite some turmoil in emerging markets since the beginning of 2014, the Alsi has managed to reach record highs, and different measures of valuation suggest that the domestic equity market is becoming increasingly expensive by historical standards. The trailing and forward price-earnings (P/E) multiples for the Alsi have both increased to above their long-term averages, while the pace at which they increased between 2012 and 2013 was the fastest in recent history. The forward price-earnings multiple reached its highest level of 15 times the Alsi’s estimated earnings.

Since the price-earnings multiple began increasing during the second half of 2011, the Alsi’s market value relative to its book value also began to increase (also referred to as the price-book ratio or P/B ratio), albeit at a far slower pace than the Alsi’s value relative to its earnings. While the price-earnings multiples have increased far beyond their long-term averages, the market-to-book value has increased to only just above its average.

According to the two peak-valuation periods observed over the past ten years, it appears that generally when the Alsi valuation metrics increase above their long-term averages, they often start to decline. This was the case in 2006/08 and 2010/11. However, such an adjustment has not occurred yet in the current cycle.

Even though domestic factors such as consumer confidence affect economic growth, sub-Saharan African countries have become more vulnerable to global risks in recent years because of their increased reliance on foreign investment. Sub-Saharan African frontier markets received substantial amounts of capital inflows in 2013, totalling US$30 billion (Figure 14). Although this has contributed to economic growth in these countries, a large part of these flows are volatile and dependent on global developments.

The indication of possible tighter liquidity in global financial markets in May 2013 resulted in lower portfolio flows to many emerging markets, including those in sub-Saharan Africa. Ghana, Nigeria and Zambia suffered outflows worth US$442 million during the second half of 2013.

The JPMorgan Nexgem Africa Index shows that sovereign yields in African frontier markets have been decreasing since 2009, as depicted in Figure 15. This trend shows increased global demand for US dollar-denominated African bonds. The JPMorgan Nexgem Africa Index decreased in the period under review and if this trend continues, along with increased private capital flows, it should be conducive to economic growth in sub-Saharan Africa. The downside risk to sub-Saharan Africa’s growth is a possible deceleration in the economies of the emerging markets with which

13 The overall domestic equity market appears unusually expensive, but this is not necessarily the case across the various subsectors. A substantial amount of the high Alsi valuations is explained by the industrials sector.
14 The long-term averages are calculated over ten years for the trailing price-earnings ratio and the price-to-book ratio, but over nine years for the forward price-earnings ratio.
16 The JPMorgan Nexgem Africa Index tracks US dollar-denominated government bonds issued by frontier markets in a certain region.
these African countries are trading, particularly China given that China has been a major commodity importer over the past decade. This could pose some challenges for the region in its efforts to sustain economic growth.

**Selected commodity price movements**

Being a gold and platinum exporter and an oil importer, commodity prices play an important role in the economic growth prospects of South Africa. Oil prices have increased since July 2013 in line with increased global activity and trade. With global economic growth averaging 3 per cent in 2013,\(^\text{17}\) oil demand picked up in the latter part of 2013, driven mainly by higher demand from the US. Increasing unrest and geopolitical tensions in the Middle East and North Africa in the second half of 2013 led to frequent supply disruptions in countries such as Iran, Libya and Iraq and were the main contributors to the rally in oil prices. In August 2013, estimated unplanned disruptions among the Organization of the Petroleum Exporting Countries (OPEC) and non-OPEC producers reached 2.7 million barrels per day, the highest level since January 2011.\(^\text{18}\) Unrest in Libya during the second half of 2013, which caused a shutdown in many oil fields and a blockade of oil terminals in ports, affected the Brent crude oil price as these outages reinforced a tighter market in 2013. Between August and November 2013, Libya accounted for an average of 39 per cent of total global supply disruptions. While the risk of decreased supply remains significant, it is important to note that the US is currently experiencing a boom in energy production and is expected to become a net energy exporter by 2020; it could therefore play a significant role in capping oil prices in the future.

Conversely, international agricultural commodity prices decreased during the period under review due to increased global supplies in 2013. The export prices of wheat fell towards the end of 2013 as ample global supplies pushed prices down, more than offsetting the upward pressure from increased export demand and concerns over continued dry conditions and above-normal cold temperatures in the US. However, since the end of January 2014, agricultural prices have started to increase due to geopolitical tensions in the Ukraine, a major corn and wheat producer.

The gold price decreased by approximately 4.2 per cent in the period July 2013 to December 2013, and decreased by 28 per cent overall in 2013. The decline in the gold price in 2013 was due to slow net buying by central banks, weak investment demand and a generally stronger US dollar. The gold price also weakened in 2013 because of the new tariffs which the Indian government imposed on gold imports. Another significant factor driving the decline in gold prices was the suggestion of QE tapering by the Fed in May 2013. This decreased the demand for precious metals as alternative assets. Suggestions of QE tapering affected gold prices not only through decreased physical demand, but also through a stronger US dollar. The price of gold started to increase in 2014, recovering some of its losses as turmoil in many emerging markets increased its safe-haven appeal and net sales by gold-backed exchange-traded funds abated.

\(^\text{17}\) International Monetary Fund, World Economic Outlook Update (Washington DC: International Monetary Fund, January 2014).

Banking and bank-lending conditions

Bank-lending conditions in sub-Saharan Africa remained largely unchanged in the final quarter of 2013. Loan demand was particularly robust for consumer and business purposes while demand for and supply of trade finance showed a marked increase. Moreover, non-performing loans (NPLs) continued to fall during the final quarter of 2013, and banks expect NPLs to have declined further in the first quarter of 2014. Conversely, credit standards were tightened further across all loan categories while both domestic and international funding conditions continued to be tightened in the first quarter of 2014, albeit at a slower pace compared to the third quarter of 2013.

In South Africa, gross loans and advances extended by the banking sector increased by almost 8 per cent in the year to December 2013 (Table 2). The increase in total loans and advances was due to increases in the other loans to customers category, which includes specialised lending finance. Impaired advances, an indicator of the banking sector’s credit risk, declined to R106,9 billion in October 2013 but subsequently increased marginally to R108,3 billion in December 2013. The ratio of impaired advances as a percentage of total loans and advances has been decreasing since June 2013, largely due to the growth in gross loans and advances exceeding the increases in impaired advances during the same period. Specific credit impairments for the sector increased by 3,2 per cent for the six months to December 2013, suggesting that the sector increased its loan-loss provisioning in a period of decreasing impaired advances.

The four largest banks continued to hold over 80 per cent of the total banking sector’s assets during the second half of 2013. The Herfindahl-Hirschman Index (H-index) confirmed the continued high level of concentration in the domestic banking sector. The total capital-adequacy ratio (CAR) for the banking sector improved from 14,8 per cent in July 2013 to 15,6 per cent in December 2013. The improvement is reflected in increases in both the tier 1 and the common equity Tier 1 CARs, suggesting that the sector’s regulatory capital strengthened by means of a combination of share capital and reserve funds, the most loss-absorbent type of capital.

Return on equity (ROE) (smoothed) for the banking sector has decreased by over 200 basis points since June 2013. Year-on-year operating profit decreased due to the effect of a dividend that was received in December 2012 from a large bank’s subsidiary, and which was not repeated in 2013. The cost-to-income ratio (or efficiency ratio), an indication of the proportion of operating expenses used to generate operating income, increased marginally from 52,2 per cent in June 2013 to 52,6 per cent in December 2013.

### Table 2  Selected indicators of the South African banking sector

<table>
<thead>
<tr>
<th></th>
<th>Jul</th>
<th>Aug</th>
<th>Sep</th>
<th>Oct</th>
<th>Nov</th>
<th>Dec</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Market share (top four banks)</strong></td>
<td>83.35</td>
<td>83.22</td>
<td>83.39</td>
<td>83.40</td>
<td>83.55</td>
<td>83.40</td>
</tr>
<tr>
<td><strong>Gini concentration index</strong></td>
<td>83.26</td>
<td>83.17</td>
<td>83.23</td>
<td>83.18</td>
<td>83.17</td>
<td>83.09</td>
</tr>
<tr>
<td><strong>Herfindahl-Hirschman Index (H-index)</strong></td>
<td>0.183</td>
<td>0.183</td>
<td>0.184</td>
<td>0.183</td>
<td>0.184</td>
<td>0.183</td>
</tr>
<tr>
<td><strong>Banks’ share prices (year-on-year percentage change)</strong></td>
<td>1.38</td>
<td>2.14</td>
<td>13.34</td>
<td>19.54</td>
<td>12.02</td>
<td>5.39</td>
</tr>
<tr>
<td><strong>Capital adequacy</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total capital-adequacy ratio</strong></td>
<td>14.79</td>
<td>14.67</td>
<td>14.86</td>
<td>14.88</td>
<td>14.98</td>
<td>15.56</td>
</tr>
<tr>
<td><strong>Tier 1 capital-adequacy ratio</strong></td>
<td>11.75</td>
<td>11.65</td>
<td>11.77</td>
<td>11.76</td>
<td>11.79</td>
<td>12.40</td>
</tr>
<tr>
<td><strong>Common equity Tier 1 capital-adequacy ratio</strong></td>
<td>11.09</td>
<td>11.00</td>
<td>11.12</td>
<td>11.11</td>
<td>11.14</td>
<td>11.76</td>
</tr>
<tr>
<td><strong>Credit risk</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Gross loans and advances (R billions)</strong></td>
<td>2 867.8</td>
<td>2 926.7</td>
<td>2 914.3</td>
<td>2 896.6</td>
<td>2 958.1</td>
<td>2 970.3</td>
</tr>
<tr>
<td><strong>Impaired advances (R billions)</strong></td>
<td>113.3</td>
<td>112.1</td>
<td>108.1</td>
<td>106.9</td>
<td>107.9</td>
<td>108.3</td>
</tr>
<tr>
<td><strong>Impaired advances to gross loans and advances</strong></td>
<td>3.95</td>
<td>3.83</td>
<td>3.71</td>
<td>3.69</td>
<td>3.65</td>
<td>3.65</td>
</tr>
<tr>
<td><strong>Specific credit impairments (R billions)</strong></td>
<td>48.8</td>
<td>51.0</td>
<td>48.2</td>
<td>48.1</td>
<td>48.5</td>
<td>49.5</td>
</tr>
<tr>
<td><strong>Specific credit impairments to impaired advances</strong></td>
<td>43.08</td>
<td>45.48</td>
<td>44.58</td>
<td>44.99</td>
<td>44.92</td>
<td>45.74</td>
</tr>
<tr>
<td><strong>Specific credit impairments to gross loans and advances</strong></td>
<td>1.70</td>
<td>1.74</td>
<td>1.65</td>
<td>1.66</td>
<td>1.64</td>
<td>1.67</td>
</tr>
<tr>
<td><strong>Profitability</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Return on assets (smoothed)</strong></td>
<td>1.22</td>
<td>1.20</td>
<td>1.23</td>
<td>1.23</td>
<td>1.20</td>
<td>1.11</td>
</tr>
<tr>
<td><strong>Return on equity (smoothed)</strong></td>
<td>16.41</td>
<td>16.02</td>
<td>16.42</td>
<td>16.42</td>
<td>15.93</td>
<td>14.74</td>
</tr>
<tr>
<td><strong>Interest margin to gross income (smoothed)</strong></td>
<td>51.61</td>
<td>52.03</td>
<td>52.29</td>
<td>52.73</td>
<td>53.19</td>
<td>53.92</td>
</tr>
<tr>
<td><strong>Operating expenses to gross income (smoothed)</strong></td>
<td>52.22</td>
<td>52.29</td>
<td>52.25</td>
<td>52.38</td>
<td>52.60</td>
<td>52.64</td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Liquid assets to total assets (liquid-asset ratio)</strong></td>
<td>8.28</td>
<td>7.92</td>
<td>8.23</td>
<td>8.43</td>
<td>8.41</td>
<td>8.48</td>
</tr>
<tr>
<td><strong>Liquid assets to short-term liabilities</strong></td>
<td>16.47</td>
<td>15.75</td>
<td>16.49</td>
<td>16.80</td>
<td>17.14</td>
<td>16.74</td>
</tr>
<tr>
<td><strong>Effective net open foreign-currency position to qualifying capital and reserve funds</strong></td>
<td>-0.63</td>
<td>0.48</td>
<td>0.31</td>
<td>0.12</td>
<td>0.36</td>
<td>0.26</td>
</tr>
</tbody>
</table>

1 Data were updated on 25 March 2014
2 Impaired advances are advances in respect of which a bank has raised specific credit impairments

Sources: South African Reserve Bank. Data on share prices were obtained from the JSE Limited
Liquidity in the banking sector, as reflected by the liquid-asset ratio and the liquid-assets-to-short-term-liabilities ratio, remained stable over the six months to December 2013. Although there was significant volatility in the exchange rate of the rand towards the end of 2013, the sector’s aggregated effective net open foreign-currency position to qualifying capital and reserve funds remained well within the prudential 10 per cent limit.

An analysis of credit risk between the five largest banks in the banking sector and the other local banks (that is, banks other than the five largest banks and the branches of foreign banking institutions) continued to reveal diverging trends. Impaired advances reported by the five largest banks declined from a peak of R124 billion (or 5,9 per cent of total gross loans and advances) in October 2009 to R84 billion (or 3,1 per cent of total gross loans and advances) in December 2013 (Figure 17).

However, impaired advances of these other local banks increased from a low of R8 billion (or 15,6 per cent of total gross loans and advances) in January 2009 to a peak of R24 billion (or 17,4 per cent of total gross loans and advances) in July 2013 (Figure 18). Although the rand value of impaired advances has been increasing, the ratio of impaired advances to total gross loans and advances has been stable at between 16 and 18 per cent since September 2011, suggesting that the increase in impaired advances has been matched by similar increases in gross loans and advances.

Profitability in the banking sector has dropped since the onset of the global financial crisis, from ROE in excess of 20 per cent reported prior to February 2009 to 14,5 per cent in January 2014 (Figure 19). Since January 2013, decreases in ROE (smoothed) have been due to a combination of factors, including non-interest revenue, which declined due to trading losses reported from debt securities transactions, and a decline in dividends received from subsidiary companies. Also, expenses increased due to an increase in credit losses (12,5 per cent), increasing operating expenses (7,6 per cent – mainly due to increased staff expenses) and a significant increase in impairments on investments reported by a smaller local bank in August 2013.

Despite lower profitability, the net interest income ratio for the banking sector as a whole increased from 3,4 per cent in December 2009 to 3,9 per cent in January 2014 (Figure 20). Net interest income (12-month cumulative) increased by 15,8 per cent year on year to January 2014 while non-interest income decreased by almost 6 per cent during the same period.

The jaws ratio (the difference between growth in operating income and operating expenses) for the banking sector has been below zero from December 2013 due to the growth in operating expenses exceeding the growth in operating income (Figure 21). The sector’s recent deterioration in profitability is also reflected in the deterioration in the efficiency ratio from November 2013.
Box 1  Testing the resilience of banks against a possible increase in sovereign yields

Due to the economic volatility experienced by emerging markets following talk of QE tapering by the US Fed and the subsequent start of tapering in December 2013, the Bank deemed it prudent to conduct a survey on the impact that these events and an increase in sovereign yields could have on banks’ liquidity and capital levels and ratios. Prudential requirements that were tested included (i) the liquid asset requirement, which requires banks to hold 5 per cent of adjusted liabilities in level 1 high-quality liquid assets (HQLA) that are made up of government debt, Treasury bills (TBs), SARB debentures and cash, (ii) the liquidity coverage ratio (LCR), which requires banks to hold HQLA to cover the expected net cash outflows for a 30-day scenario, and (iii) the CAR, which requires banks to hold capital against a certain percentage of their assets.

The survey required banks to respond to a hypothetical sovereign downgrade of 100, 250, 350 and 500 basis points, based on the increase of yields on government bonds, and to indicate what effect each scenario would have on their liquid assets portfolio, LCR and CAR. Banks were also required to assume that for a move of 500 basis points, there had been a two-notch downgrade of the sovereign rating.

Important concepts that had a significant impact on the results of the scenario were the split between the holding of government bonds and TBs, and the accounting designation of the government bond portfolio. The split of government bonds and TBs was deemed relevant as they reflect different effects on banks’ income statements due to different accounting treatments applied. However, because TBs are short-dated and banks hold them to maturity, they are accounted for as ‘held-to-maturity’ instruments. Held-to-maturity investments are measured at amortised cost.1

Government bonds are longer-dated and are most commonly designated as ‘held for trading’. They are therefore accounted for at fair value. Marking the bonds to fair value incorporates all fluctuations in the price and leads to income statement volatility, if unhedged.

Having analysed banks’ responses, it was concluded that the various scenarios would not have a significant impact on the prudential requirements imposed on banks and would not cause banks to breach the minimum prudential requirements. The results confirmed the banking sector’s resilience to the impact of such a scenario, making it unlikely that banks would suddenly have to raise additional capital or increase liquidity buffers in adverse conditions.

1 Amortised cost is the amount at which a financial asset or financial liability is measured at initial recognition, less principal repayments, plus or minus any unamortised original premium or discount.

The total unsecured lending of six local banks to retail counterparties (total unsecured lending)20 increased to R481,8 billion in January 2014 from R466,1 billion in June 2013 (Figure 22). The six banks included in the survey21 constituted approximately 98,5 per cent of total unsecured lending of the banking sector as at 31 January 2014.

The year-on-year growth in total unsecured lending continued to slow in the second half of 2013, from 20,9 per cent in July 2013 to 7,9 per cent in January 2014 (Figure 23). Since July 2013, the rate of growth in all categories of unsecured lending decreased, with the ‘retail other’ category consisting of exposures greater than R30 000 per loan continuing to show the largest decrease. The ‘retail other’ category consisting of exposures less than or equal to R30 000 per loan contracted by 20,1 per cent in January 2014.

20 Unsecured lending to retail counterparties includes credit cards, overdrafts, personal loans and financing provided to small and medium enterprises (SMs) in the retail sector. The exposure includes both on- and off-balance-sheet exposures (on-balance-sheet exposure refers to credit extended, whereas off-balance-sheet exposure refers to potential credit risk in the form of facilities extended but not utilised at the time of reporting). The quantitative information is aggregated data based on surveys conducted and regulatory information reported by the six banks that are significant role players in the unsecured credit market.

21 All quantitative information is based on regulatory reporting from the six banks.
Total unsecured lending constituted 11.7 per cent of the total gross credit exposure of the banking sector as at 31 January 2014, a slight decrease from 11.9 per cent in July 2013 (Figure 24). More than a quarter of the sector’s retail credit exposure was to unsecured lending in January 2014 (27.5 per cent of total retail credit exposure). This increased slightly from July 2013 as a result of the growth rate in unsecured lending exceeding the growth rate of total retail exposure. The ratio of the ‘unsecured retail other’ category (which consists largely of personal term loans) to total gross credit exposure decreased from 4 per cent in July 2013 to 3.7 per cent in January 2014. As a percentage of total retail credit exposure, the ‘retail other’ category decreased from 9.1 per cent in July 2013 to 8.7 per cent in January 2014.

Other than the ‘retail other’ category consisting of exposures less than or equal to R30 000, the default ratios\(^{22}\) for all categories of total unsecured lending decreased from July 2013 to January 2014 (Figure 25). The coverage ratios\(^{23}\) for the ‘retail other’ category consisting of exposures greater than R30 000 and for the ‘SME retail’ category decreased from July 2013 to January 2014. Conversely, the coverage ratios for the ‘retail other’ category consisting of exposures less than or equal to R30 000 and the ‘retail revolving credit’ category have increased since July 2013.

**Non-bank financial institutions**

The share of banks’ total assets relative to all financial intermediaries has been declining since 2008 and reached 31 per cent in 2013.\(^{24}\) However, banks, insurers and pension funds still account for the largest share of total financial assets. Assets of other financial intermediaries, a proxy for the shadow-banking system,\(^{25}\) continued to increase and reached 24 per cent of total financial assets of financial intermediaries in 2013.

Non-bank financial institutions (NBFIs)\(^{26}\) play an important role in the financial system. They complement the commercial banking sector by addressing needs on which banks do not normally focus. Most NBFIs are actively involved in the securities markets and in the mobilisation and allocation of long-term financial resources. Examining the sources of credit extended, it would appear that credit extended by NBFIs remained relatively constant and small in size relative to total bank lending over the period under review (Figure 27).

Despite the difficult underlying operating conditions – including relatively weak economic growth, a depreciating exchange rate and high unemployment – confidence among life insurers rebounded during the fourth quarter of 2013. The EY Financial Services Index’s sub-index for the life insurance industry showed that confidence increased from 67 index points in the third quarter of 2013 to 80 index points in the fourth quarter of 2013. This increase in confidence was attributed mainly to new premium income trends, which rebounded in the fourth quarter of 2013. However, other measures

---

\(^{22}\) Default ratios are the aggregate of exposures greater than 90 days (for standardised approach portfolios) and defaulted exposures (for internal ratings-based portfolios) as a percentage of gross credit exposure.

\(^{23}\) Coverage ratios are specific credit impairments as a percentage of the aggregate of exposures greater than 90 days (for standardised approach portfolios) and defaulted exposures (for internal ratings-based portfolios).

\(^{24}\) See also the March 2013 and September 2013 editions of the Financial Stability Review which included summaries of South Africa’s response to the FSB’s annual shadow-banking exercise.

\(^{25}\) The category ‘other financial intermediaries’ is used to obtain a conservative proxy of the size of the shadow-banking system. The financial intermediaries included in this category are Money Market Funds, Hedge Funds, Other Investment Funds, Finance Companies, Participation Bond Schemes and Trust Companies.

\(^{26}\) In this discussion, NBFIs consist of long- and short-term insurers, private pension funds, participation bond schemes and finance companies.
of financial performance pointed to weak fundamentals as new business premium growth remained weak and lapses and surrenders increased.

During the second half of 2013, the life insurance industry experienced strong growth in share prices, recording an average annual growth of 31,2 per cent. The assets of the industry continued to increase throughout the review period and comprised about 63 per cent of GDP. The life insurance industry’s investment in the equity market continued to grow, increasing by 18,4 per cent in the year to December 2013, while its holdings of fixed-income securities increased by 11,7 per cent over the same period.

During the third quarter of 2013, the assets of pension and provident funds (including both official and private self-administered funds) grew at an annual rate of 13,8 per cent, up from 11,4 per cent in the previous quarter. Measured in relation to the size of the domestic economy, the assets of pension funds equaled about 67 per cent of GDP. Official pension funds continued to increase their holdings of fixed-interest securities to R96,7 billion during the fourth quarter of 2013, representing growth of 4,8 per cent in the year to December 2013. Because of the size of their bond holdings, pension funds could be subject to the same risks that banks face in the case of a sovereign downgrade. However, the large exposure to this asset class does not present a financial stability risk as bonds are usually held to maturity. Moreover, since the assets are marked to market, adjustments are also made to the liability side of the balance sheet. Pension funds’ investment in the domestic equity market increased by 18,7 per cent to R841,3 billion over the same period. During the third quarter of 2013, private self-administered pension funds also increased their investment in fixed-interest securities (R257,6 billion) and equities (R470,6 billion).

In December 2013, the 26 long-term typical insurers that represent about 75 per cent of the market share by premium recorded an overall increase of 14,6 per cent in gross premiums received when compared to the year before. This increase was achieved despite the weak economic growth in 2013 combined with frequent labour disruptions, a sharply depreciating currency and high unemployment, which collectively made the year difficult for the industry.

The industry’s use of reinsurance remained relatively unchanged, and the total risks retained on the balance sheets of primary long-term insurers ranged between 96,6 per cent and 97,0 per cent during the period under review. Recurring premium27 represents 52,7 per cent of total premium income in 2013 (2012: 53,4 per cent). In December 2013, the 26 long-term typical insurers were covered by a free assets-to-capital-adequacy requirement of more than one time, thus having adequate capital to cover more than the regulatory minimum requirement.

During 2013, the number of new policies written decreased by 5 per cent compared to the year before while the number of policy lapses as a percentage of the number of new policies issued increased to 61 per cent from 53 per cent in the previous year. Typical insurers collectively yielded an investment return of 16 per cent in 2013, which is slightly higher compared to the year before.

27 A ‘recurring premium’ refers to policies in terms of which the insurer receives a premium payment from a policyholder on a regularly basis, for example, monthly or annually.
Table 3  Free assets-to-capital-adequacy requirement of all primary long-term typical insurers

<table>
<thead>
<tr>
<th>Covered 0–1 time</th>
<th>March</th>
<th>June</th>
<th>September</th>
<th>December</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Covered 1–2 times</td>
<td>25</td>
<td>22</td>
<td>26</td>
<td>19</td>
</tr>
<tr>
<td>Covered 2–5 times</td>
<td>26</td>
<td>30</td>
<td>25</td>
<td>32</td>
</tr>
<tr>
<td>Covered 5–10 times</td>
<td>16</td>
<td>12</td>
<td>14</td>
<td>11</td>
</tr>
<tr>
<td>Covered 10+ times</td>
<td>2</td>
<td>4</td>
<td>3</td>
<td>3</td>
</tr>
</tbody>
</table>

1 The primary long-term insurance industry includes typical insurers, niche insurers, cell captive insurers, linked investment insurers and assistance insurers, but excludes reinsurers

Source: Financial Services Board

Table 4  Share of total financial assets in South Africa (excluding professional reinsurers and insurance companies in run-off)

<table>
<thead>
<tr>
<th>Kinds of assets</th>
<th>12 months ended Dec 2011</th>
<th>R millions</th>
<th>Per cent</th>
<th>12 months ended Dec 2012</th>
<th>R millions</th>
<th>Per cent</th>
<th>6 months ended Jun 2013</th>
<th>R millions</th>
<th>Per cent</th>
<th>12 months ended Dec 2013</th>
<th>R millions</th>
<th>Per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and deposits</td>
<td>205 790</td>
<td>12</td>
<td>221 377</td>
<td>11</td>
<td>215 621</td>
<td>10</td>
<td>193 901</td>
<td>9</td>
<td>193 901</td>
<td>9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Government and semi-government</td>
<td>191 549</td>
<td>11</td>
<td>173 874</td>
<td>9</td>
<td>185 071</td>
<td>9</td>
<td>178 194</td>
<td>8</td>
<td>178 194</td>
<td>8</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equities and collective investment schemes</td>
<td>852 648</td>
<td>50</td>
<td>1 221 629</td>
<td>61</td>
<td>1 308 365</td>
<td>62</td>
<td>1 470 533</td>
<td>65</td>
<td>1 470 533</td>
<td>65</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debentures and loan stock</td>
<td>128 379</td>
<td>7</td>
<td>176 585</td>
<td>9</td>
<td>183 034</td>
<td>9</td>
<td>215 743</td>
<td>9</td>
<td>215 743</td>
<td>9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Immovable properties</td>
<td>58 833</td>
<td>3</td>
<td>56 152</td>
<td>3</td>
<td>48 996</td>
<td>2</td>
<td>49 571</td>
<td>2</td>
<td>49 571</td>
<td>2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixed assets</td>
<td>181 838</td>
<td>11</td>
<td>2 112</td>
<td>0</td>
<td>2 209</td>
<td>0</td>
<td>2 367</td>
<td>0</td>
<td>2 367</td>
<td>0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debtors</td>
<td>94 965</td>
<td>6</td>
<td>118 589</td>
<td>6</td>
<td>118 326</td>
<td>6</td>
<td>133 930</td>
<td>6</td>
<td>133 930</td>
<td>6</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other assets</td>
<td>0</td>
<td>0</td>
<td>28 235</td>
<td>1</td>
<td>32 762</td>
<td>2</td>
<td>33 909</td>
<td>1</td>
<td>33 909</td>
<td>1</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Total 1 724 002 100 2 000 555 100 2 094 384 100 2 278 148 100

Source: Financial Services Board

The biggest risk currently facing the long-term insurance sector is market risk, since more than half of its assets are invested in equities. Although a significant percentage of its assets are invested in equities, a large portion of these equity investments relates to linked business where the policyholders carry the risk.

South African equities have been performing well and interest rates have been low in response to slower economic growth. The low interest rate environment has also been putting some strain on the balance sheets of the long-term insurance sector where guaranteed investment policies were issued. Although guarantees are low, the current low interest-rate environment raises concerns around the long-term insurance sector’s ability to meet these guarantees with matching investments.

In December 2013 gross premiums written by short-term typical insurers increased by 8,5 per cent, which is approximately the same increase as in 2012. Motor and property insurance combined makes up 86,7 per cent of total gross premium income in the short-term insurance sector.
## Underwriting results

Underwriting results (where underwriting profit is expressed as a percentage of net premiums) for the short-term typical insurance sector decreased by 4 per cent in 2013 (2012: 6 per cent). In December 2013, underwriting results continued to be under pressure due to the weaker rand and weather-related claims, with the net incurred loss ratio increasing slightly from 63,0 per cent in 2012 to 66,0 per cent in 2013.

### Table 5 Performance indicators of the short-term insurance sector

<table>
<thead>
<tr>
<th></th>
<th>12 months ended Dec 2011</th>
<th>12 months ended Dec 2012</th>
<th>6 months ended Jun 2013</th>
<th>12 months ended Dec 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net premium increase (year-on-year percentage change)</td>
<td>8</td>
<td>4</td>
<td>6</td>
<td>7</td>
</tr>
<tr>
<td>Loss ratio</td>
<td>58</td>
<td>63</td>
<td>66</td>
<td>66</td>
</tr>
<tr>
<td>Combined ratio</td>
<td>85</td>
<td>88</td>
<td>95</td>
<td>91</td>
</tr>
<tr>
<td>Management expenses</td>
<td>23</td>
<td>22</td>
<td>22</td>
<td>22</td>
</tr>
<tr>
<td>Commission</td>
<td>9</td>
<td>9</td>
<td>9</td>
<td>8</td>
</tr>
<tr>
<td>Underwriting profit/loss ratio</td>
<td>10</td>
<td>6</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Underwriting and investment income ratio</td>
<td>16</td>
<td>12</td>
<td>11</td>
<td>9</td>
</tr>
<tr>
<td>Surplus asset ratio (median)</td>
<td>43</td>
<td>55</td>
<td>55</td>
<td>55</td>
</tr>
<tr>
<td>CAR cover (median)</td>
<td>1,6</td>
<td>1,8</td>
<td>1,8</td>
<td>1,9</td>
</tr>
</tbody>
</table>

Source: Financial Services Board

## Confidence in the financial services sector

During the fourth quarter of 2013, the EY Financial Services Index recorded a marginal improvement to 72 index points as three of the four sub-indices recorded higher levels. However, the index remained below the long-term average of 77 index points.

A decrease in the investment banking and specialised finance sub-index, mainly as a result of a rapid increase in operating costs, was offset by increases in the retail banking, asset management and life insurance indices. The biggest increase was recorded in the life insurance confidence index due to cost cutting and the resultant improvement in profit.

## Government finances and financial stability

Effective government debt management is an important factor that underpins the credibility and reputation of a sovereign, and influences the stability of bond markets and the financial institutions that hold public debt. Prudent public-debt management supports financial stability which, in turn, can mitigate sovereign risk and thus enhance government’s ability to support financial stability.

Government’s borrowing requirement is reflected in the debt market. Government issuances accounted for 63 per cent of the listed securities in this market in 2013, with the nominal value of bonds in issue amounting to R1 096 billion as at 31 January 2014. National government’s gross borrowing obligation has steadily increased as a result of weak revenues since the start of the global financial crisis. Furthermore, the increase in government

---

28 The long-term average is calculated over the past 48 quarters, that is, since the inception of the EY Financial Services Index in 2002.
borrowing resulted from the implementation of countercyclical fiscal policy through accelerated public infrastructure investment. As such, national government gross loan debt increased from R1 366 billion at the end of March 2013 to R1 553 billion at the end of January 2014. The balance at the end of January 2014 surpassed the original budget projection marginally, but was still broadly in line with the revised R1 586 billion as per the Budget Review 2014.

In line with this increase, the government debt-to-GDP ratio also steadily increased to 46,1 per cent in the last quarter of 2013, up from 42,5 per cent in December 2012 (Figure 30). National government’s gross loan debt ratio is consistently higher than that of Russia and China, yet significantly lower than that of Brazil and India. As a member of the Southern African Development Community (SADC), South Africa adheres to the regional guideline of a public and publicly guaranteed debt-to-GDP ratio not exceeding 60 per cent.

Financial institutions holding excessive public debt can affect the stability of the financial sector as high levels of government debt can become unsustainable. Several domestic financial institutions gradually lowered their investment in government debt during the period under review, countering the upward trend witnessed during 2012, but pension and provident funds and official and self-administered private funds increased their holdings to R420,9 billion in the third quarter of 2013 (a year-on-year increase of 14 per cent), remaining the largest investors in government debt. The insurance industry also increased its government bond holdings over the same period by 10,4 per cent to R187,2 billion. Furthermore, in the year to September 2013, local banks decreased their holdings of government debt by 14,1 per cent to R148,7 billion. This decrease was on account of redemptions of bonds that banks held in their portfolios.

Sovereign debt ratings, which are credit-rating agencies’ opinions about the default risk of a government or company, have a significant impact on investor confidence because investor asset allocations are restricted by asset quality. A downgrade can therefore result in a sudden outflow of funds and directly affect the stability of a financial sector.

In January 2014, Fitch Ratings reaffirmed the South African government’s debt credit rating of BBB with a negative outlook. The motivation for the reaffirmation was government’s manageable debt position while the negative outlook was mainly attributed to heightened uncertainty over the outcome of the tension in the run-up to this year’s national elections.

In January 2014, Fitch Ratings reaffirmed the South African government’s debt credit rating of BBB with a negative outlook. The motivation for the reaffirmation was government’s manageable debt position while the negative outlook was mainly attributed to heightened uncertainty over the outcome of the tension in the run-up to this year’s national elections.

Recently, Standard & Poor’s issued a warning that South Africa’s sovereign credit ratings could be affected negatively if its economic situation did not improve. The agency cited worse-than-expected labour tensions, strike-related business losses (exacerbated by declining terms of trade) and less resilient household consumption, which all have a negative effect on the economy.

South Africa’s credit rating continues to be constrained by weak growth, high unemployment, wide income disparities, low national savings and infrastructure bottlenecks that limit economic growth potential. These bottlenecks are, however, being addressed in terms of the government’s National Development Plan.
External sector

In March 2014, the level of foreign-exchange reserves decreased slightly to US$49,5 billion from US$50,1 billion in February. At current levels, foreign-exchange reserves would cover about five months of imports. The Guidotti ratio deteriorated to 1,37 in the fourth quarter of 2013, from 1,46 in the third quarter, as short-term external debt increased and the level of foreign-exchange reserves decreased in December 2013. At this level the Guidotti ratio means that all short-term external debt due over a period of a year would be financed even if access to external capital markets was curtailed. The augmented Guidotti ratio (AGR) improved from 0,90 in the third quarter of 2013 to 0,93 in the fourth quarter; it was still below the adequacy threshold despite the recent improvement in the current-account deficit.

Corporate sector

The demand for credit by the corporate sector slowed down from a 12-month rate of increase of 9,3 per cent in the third quarter of 2013 to 7,6 per cent in the fourth quarter. The subdued level of demand for credit by corporates reflects a lack of confidence due to weak domestic economic growth and an uncertain labour environment. General expectations of higher interest rates in 2014 could add more pressure on the demand for credit.

Corporate profits increased in the period under review by 2,2 per cent in the fourth quarter of 2013 but corporate debt remained high (Table 6). As a percentage of annualised profits, corporate borrowing increased to 182,9 per cent in the final quarter of 2013 from 170,6 per cent in the third quarter.

Table 6 Selected indicators for the corporate sector

<table>
<thead>
<tr>
<th></th>
<th>Annual percentage change, unless indicated otherwise</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2012</td>
</tr>
<tr>
<td></td>
<td>4th qr</td>
</tr>
<tr>
<td>Bank credit granted</td>
<td>10,2</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>6,1</td>
</tr>
<tr>
<td>Credit as a percentage of GDP</td>
<td>50,8</td>
</tr>
<tr>
<td>Credit as a percentage of annualised profits</td>
<td>173,7</td>
</tr>
<tr>
<td>Net operating surplus</td>
<td>-3,9</td>
</tr>
</tbody>
</table>

1 Bank credit to the corporate sector in this case includes instalment sale and leasing finance, mortgage advances, overdrafts, credit card debtors, and other loans and advances
2 At current prices (seasonally adjusted)
3 Bank credit to the corporate sector and net operating surpluses of corporations were used as proxies for corporate debt and for corporate profits respectively
4 Gross operating surplus minus depreciation (seasonally adjusted rates)

Source: South African Reserve Bank

Corporate sector fixed investment remained high in the fourth quarter of 2013, possibly due to the replacement of existing capacity, according to the Bureau for Economic Research (BER).29 According to the survey, some of the increased fixed investment related to the purchase of labour-saving machinery and equipment. Manufacturers are, however, also expecting a continued increase in real fixed investment in 2014.

---

Growth over one year in non-financial corporate-sector deposits slowed from 10.0 per cent in July 2013 to 8.1 per cent in December 2013 to a level of R617.6 billion, before slowing further to 7.9 per cent in January 2014. An increase in fixed investments and slower growth in deposits could be indicative of business confidence improving. However, the overall business confidence index deteriorated during most of 2013, weakening to 41 index points in the first quarter of 2014.\(^{30}\) This suggests that slightly more than 40 per cent of respondents were positive about prevailing business conditions. Three of the five sub-indices recorded a fall, with new-vehicle dealers’ confidence dropping to a six-year low of 27 index points mainly as a result of weak consumer demand. Both retail and wholesale traders’ confidence fell as sales of consumer goods weakened. The building contractors’ and manufacturers’ confidence indices, however, improved marginally. Confidence among manufacturers strengthened due to a combination of improving global economic growth and a weaker domestic currency, which should support export earnings.

<table>
<thead>
<tr>
<th>Indices</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1st qr</td>
<td>2nd qr</td>
</tr>
<tr>
<td>Business confidence index</td>
<td>52</td>
<td>48</td>
</tr>
<tr>
<td>New vehicle dealers’ confidence</td>
<td>66</td>
<td>61</td>
</tr>
<tr>
<td>Retail traders’ confidence</td>
<td>50</td>
<td>41</td>
</tr>
<tr>
<td>Wholesale traders’ confidence</td>
<td>71</td>
<td>61</td>
</tr>
<tr>
<td>Building contractors’ confidence</td>
<td>30</td>
<td>45</td>
</tr>
<tr>
<td>Manufacturers’ confidence</td>
<td>42</td>
<td>34</td>
</tr>
</tbody>
</table>

The corporate sector’s ability to generate cash flows to finance its interest expenses is measured by the interest coverage ratio (ICR).\(^{31}\) The IMF recommends an ICR benchmark of at least one. The overall ICR for South African corporates remained higher than this benchmark in the third quarter of 2013, at four times. This indicates that non-financial corporates as a sector have enough cash to service commitments.

At an industry level, all ICRs – except for the mining and quarrying and the electricity-, gas- and water-supply industries – were above the benchmark of one. Corporates are therefore generally well positioned to cover interest expenses. The ICR for the mining and quarrying industry edged lower, mainly because of a contraction in profits as a result of the ongoing labour disputes.


\(^{31}\) The ICR is a ratio used to assess a company’s ability to meet its interest payments. It is calculated by aggregating enterprise information using the earnings or net profit before interest and taxes, and expressing it as a ratio of interest payments due.
Household sector

During the third and fourth quarters of 2013, households’ disposable income increased by 8.4 and 6.5 per cent respectively when compared to the corresponding period in 2012 (Table 8). This is in line with the BankservAfrica Disposable Salary Index (BDSI), which found that total wages paid out in the economy rose in real terms over the same period. This can, however, be attributed to the lower loss of working days due to strikes in the manufacturing sector. The annual increase of nominal wages was recorded at 8.2 per cent in September 2013 and at 6.4 per cent in February 2014.

Table 8  Selected indicators for the household sector

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>4th qr</td>
<td>1st qr</td>
</tr>
<tr>
<td>Disposable income</td>
<td>9.2</td>
<td>8.4</td>
</tr>
<tr>
<td>Financial assets</td>
<td>16.5</td>
<td>16.5</td>
</tr>
<tr>
<td>Total assets</td>
<td>13.5</td>
<td>14.3</td>
</tr>
<tr>
<td>Net wealth</td>
<td>14.5</td>
<td>15.5</td>
</tr>
<tr>
<td>Consumption expenditure</td>
<td>2.8</td>
<td>2.4</td>
</tr>
<tr>
<td>Consumer expenditure to GDP</td>
<td>61.4</td>
<td>60.7</td>
</tr>
<tr>
<td>Credit extension</td>
<td>9.9</td>
<td>9.6</td>
</tr>
<tr>
<td>Mortgages advances extended to the domestic private sector</td>
<td>1.9</td>
<td>1.6</td>
</tr>
<tr>
<td>Savings as a percentage of disposable income</td>
<td>0.02</td>
<td>0.00</td>
</tr>
<tr>
<td>Debt</td>
<td>9.6</td>
<td>9.2</td>
</tr>
<tr>
<td>Debt to disposable income</td>
<td>75.4</td>
<td>75.6</td>
</tr>
<tr>
<td>Debt to GDP</td>
<td>46.3</td>
<td>45.9</td>
</tr>
<tr>
<td>Mortgage debt as a percentage of household disposable income</td>
<td>40.9</td>
<td>40.8</td>
</tr>
<tr>
<td>Financing costs of household debt</td>
<td>1.7</td>
<td>6.1</td>
</tr>
<tr>
<td>Debt-service costs as a percentage of disposable income</td>
<td>7.6</td>
<td>7.7</td>
</tr>
<tr>
<td>Capital gearing (per cent) 3</td>
<td>19.3</td>
<td>19.0</td>
</tr>
<tr>
<td>Insolvencies 4</td>
<td>-14.9</td>
<td>-21.0</td>
</tr>
</tbody>
</table>

1 Household net wealth is defined as total assets of households less total financial liabilities
2 Interest payments on housing and personal debt
3 ‘Capital gearing’ refers to household debt as a percentage of total assets of households.
4 Data are preliminary
5 Monthly indicator, value of last month of respective quarter

Sources: South African Reserve Bank and Statistics South Africa

Consumption expenditure increased by 2 per cent year on year in the fourth quarter of 2013, the slowest growth since the recovery in 2009, while consumption expenditure as a percentage of GDP remained stable at around 61 per cent.

Growth in households’ financial and total assets remained steady in the second half of 2013. However, the fact that household savings, expressed as a percentage of disposable income, declined over the same period is cause for concern since savings play an important role in the future repayment ability of consumers.
Growth in total credit extended to the household sector and credit extended for domestic private-sector mortgages slowed during the period under review to 5.5 per cent and 1.9 per cent respectively following marked increases in the third quarter of 2013. Financing cost for household debt increased by 7.1 per cent in the fourth quarter of 2013 when compared to the previous year. It is expected that the cost of financing household debt will increase further since the Bank increased the repurchase rate in January 2014. Growth in capital gearing – the ratio of household debt to total assets – continued to moderate in the second half of 2013 due to the increase in household assets and the slower growth in household debt. Household debt as a percentage of disposable income also decreased during the period under review from 75.0 per cent in the third quarter of 2013 to 74.3 per cent in the fourth quarter, suggesting that households could be in a somewhat better position than before. This is also in line with the decline in insolvencies. In turn, the household debt-to-GDP ratio declined to 44.9 per cent over the period under review.

According to the National Credit Regulator (NCR), the number of credit-active consumers increased marginally between the third and fourth quarters of 2013, from 20.29 million to 20.64 million. The number of consumers with impaired records (9.9 million) remained relatively constant at 48.1 per cent of credit-active consumers over the same period (Figure 35). The proportion of consumers in good standing (10.7 million) was therefore recorded at 51.9 per cent of all credit-active consumers.

These figures indicate that even with steady growth in consumer credit and a relatively stable rate of impairments, the situation of credit-active consumers has not changed for the better in recent months.

The First National Bank (FNB)/BER Consumer Confidence Index (CCI) remained low during the period under review after falling to a decade-low of -8 index points in the third quarter of 2013. The FNB/BER CCI did, however, improved marginally in the fourth quarter of 2013 (-7 index points) and the first quarter of 2014 (-6 index points). Sub-indices indicated that consumer sentiment with respect to their own financial prospects improved slightly while the ratings of the appropriateness of the present time to buy durable goods and the consensus over the outlook for the national economy deteriorated further to the lowest levels since 1993. Overall, confidence levels were much lower for low-income earners than high-income earners according to the FNB/BER CCI.

In the first three quarters of 2013, consumers felt financially more vulnerable according to the Consumer Financial Vulnerability Index (CFVI) as a result of increased expenditure vulnerabilities. The CFVI decreased by 0.8 index points to 45.9 index points in the third quarter of 2013. The downward pressure was mostly due to slower domestic growth, declining access to credit, the increase in debt servicing costs, higher fuel costs, increases in transportation expenses, higher unemployment, labour strikes and the weak exchange rate of the rand. However, the fourth quarter of 2013 recorded an overall increase in the CFVI to 52 index points, moving consumers from the ‘financially very exposed’ to the ‘mildly exposed’ category, which is

---

Figure 35  Credit standing of consumers

Figure 36  Consumer Financial Vulnerability Index and the Consumer Confidence Index

---

1 CFVI: 0–20 implies ‘financially very vulnerable’; 20–39.9 implies ‘financially vulnerable’; 40–49.9 implies ‘financially very exposed’; 50–69.9 implies ‘financially exposed’; 70–99.9 implies ‘financially vulnerable’; 100–150 implies ‘financially very secure’

2 CCI: The CCI is expressed as a net balance between optimistic and pessimistic consumers, and vary between -100 for ‘extreme pessimism’ and 100 for ‘extreme optimism’, with 0 being ‘neutral’

Sources: MBD Credit Solutions; Bureau of Market Research, Unisa; and FNB/Bureau for Economic Research, Stellenbosch

---

32 National Credit Regulator, Credit Bureau Monitor (Midrand: National Credit Regulator, December 2013).
indicative of a possible recovery. The improvement can be attributed to a stabilisation in production output following the end of the strike season during the third quarter of 2013 as well as the ensuing wage increases that exceeded inflation for higher-salary earners. These findings concur with those of the BDSI, which indicated that consumers’ stress was relieved following the increase in real wages.

A continued improvement in consumer confidence would be essential for a sustained recovery in households’ financial position.

Residential real-estate sector

The residential real-estate sector seems to have improved during the second half of 2013.

Developments in the housing market can have both a direct and an indirect impact on households’ demand for credit and, in turn, their debt-servicing capacity. This is especially the case where rising house prices are not accompanied by more strenuous lending standards as it can ultimately result in excessive debt accumulation by households and housing developers. Conversely, in the event that house prices are sharply adjusted downwards, the impact on banking institutions’ balance sheets can be negative and can pose risks to financial stability. The price-to-rent (P/R) ratio is the expression of the residential real-estate value as a proportion of the annual income that it could earn over the period of one year (potential earnings for a given investment) and, similar to the P/E ratio for equities, gives an indication as to whether the market is fairly valued. Market prices can fluctuate, but when actual house prices deviate significantly from their potential earnings, the expectation is that the prices will move in such a way that the ratio will revert to the average. A high ratio (above its historical average) is therefore seen as an indication that the price will increase or decrease at a lower rate than where a P/R ratio is near the historical average at the time of purchase. In turn, where the P/R ratio is low, there is a greater probability that a purchase will be a good investment. Figure 37 is a representation of the indices created from P/R ratios as well as the actual house price and rental indices.

Considering the indices of house and rental prices, and the P/R ratios, Figure 38 illustrates that the P/R ratios were on a path of recovery (towards their respective long-run averages) during the last few months of 2013. This can be attributed to the coinciding steady growth in house and rental prices.

In December 2013, the P/R ratio calculated using the Absa House Price Index was 17.2 with a long-run average of 17.8; whereas the ratio calculated using house price data from FNB was 13.1 with a long-run average of 13.4. Both P/R ratios are below 20, indicating that these house prices are fairly valued.

The deceleration of growth (1.9 per cent year on year) in mortgage advances in the fourth quarter of 2013 confirmed continued restrained activity in the residential real-estate market during the period under review. Real interest

---

33 Data for the rental prices were obtained from PayProp, a company responsible for automated payments of rents in the rental portfolios of several leading property managers. For actual house prices, the average house price information from Absa Bank Limited and First National Bank (FNB) was employed. After the ratios were estimated, an index was created with December 2012 = 100.
rates on mortgage advances have been constant at approximately 8.5 per cent since the last two quarters of 2013. The ratio of mortgage debt to disposable income remained high at 39.3 per cent in the fourth quarter of 2013.

The FNB/BER Building Confidence Index (BCI)\(^{34}\) once again moved sideways within the broad band of 38 to 55 index points, with a two-point decrease to 41 index points in the first quarter of 2014. The BCI has historically been a good leading indicator for business cycle turning points as it employs survey results from the five most cyclical sectors in the South African economy. However, some signals indicate there may be a rebalancing of the sources of economic growth from consumption toward production. These signs include a general combination of an increase in confidence of building contractors and manufacturers as well as a deterioration of the business mood of trade sectors (service-oriented sectors).

---

\(^{34}\) FNB/BER Building Confidence Index (Johannesburg: FNB/BER, 18 June 2013).
The robustness of the domestic financial infrastructure

This section reviews developments in the domestic and international financial infrastructure and regulatory environment that relate to banking, insurance and other financial system infrastructures. Background information is provided on key domestic and international regulatory issues and risks. Although the focus is largely on domestic developments, the international context is provided by highlighting other reform initiatives being driven largely by the Group of Twenty (G-20) and the FSB. The section concludes with an update of a crisis simulation exercise conducted by the Financial Sector Contingency Forum (FSCF) during March 2014.

Regulatory and other developments affecting banks

To align South Africa’s banking legislation with recommendations that were made during the financial sector assessment programmes of the IMF and the World Bank, amended or new proposals, frameworks, requirements or standards issued by the Basel Committee on Banking Supervision (Basel Committee), international best practice and other domestic legislative developments, the President assented to the Banks Amendment Act, 2013 (Act No. 22 of 2013) (the Act) on 10 December 2013. The Act provides the necessary legislative framework to implement further changes to the standards issued by the Basel Committee as part of the global regulatory reform project to address the weaknesses in the global banking sector highlighted during the global financial crisis.

Removal of adverse consumer credit information and paid-up judgments

On 26 February 2014, regulations relating to the removal of adverse consumer credit information and information relating to paid-up judgments were published in terms of the National Credit Act, 2005 (Act No. 34 of 2005). These regulations, which came into effect on 1 April 2014, impose requirements on credit bureaus to remove certain credit information from their records pertaining to adverse consumer credit-information and paid-up judgments. This requirement is one of the most contentious aspects of these regulations in that the removal of the aforementioned information can weaken historical data needed for banks’ credit-scoring models. A possible unintended consequence of this requirement is the risk that it could make it more difficult for consumers to access credit since banks would not have a full credit history at their disposal. It could also render such credit more expensive.

Regulatory developments relating to the insurance sector

The Financial Services Board is currently developing legislation to propose a formal group-wide supervisory framework for insurance groups. The proposal is to undertake this project in two phases. Interim requirements will be implemented in a phased manner pending the final measures that will be
provided for in the same legislation that will give effect to the new Solvency Assessment and Management (SAM) regime. The Financial Services Board is also implementing an approach to market conduct regulation and supervision informed by the treating customers fairly (TCF) concept. The TCF approach seeks to ensure that the fair treatment of customers is embedded within the culture of regulated entities. It will use a combination of market conduct principles and explicit rules to drive the delivery of clear and measurable fairness outcomes so that customers are confident that they are dealing with firms where the fair treatment of customers is central to the firm’s culture. Delivery of these outcomes will be enforced through imposing a range of visible and credible deterrents to unfair treatment. The Financial Services Board has already begun embedding TCF into its regulatory and supervisory framework, with work under way to further entrench these principles in legislation.

Update on the Financial Services Laws General Amendment Act

The Minister of Finance confirmed 28 February 2014 as the commencement date for the updated Financial Services Laws General Amendment Act. This Act aims to ensure that even during the transition to the twin peaks financial regulatory framework, South Africa continues to have up-to-date financial sector legislation aimed at promoting financial stability and strengthening and enhancing the supervisory powers of regulators in the aftermath of the global financial crisis.


Implementing a twin peaks financial regulatory framework in South Africa

As reported in the 2012 and 2013 issues of the Financial Stability Review, South Africa is in the process of reforming its financial sector regulatory architecture by moving towards a twin peaks model of financial regulation. Under the planned twin peaks approach, supervisory roles will be streamlined between the Bank and the Financial Services Board. The Bank will oversee financial stability and take responsibility for prudential supervision in terms of the safety and soundness of banks, insurers, financial conglomerates and some financial market infrastructures (FMIs). The Financial Services Board will become the Market Conduct Authority and will be responsible for market conduct supervision across the financial system. In December 2013, the NT released for public comment the cabinet-approved Financial Sector Regulation Bill (the Bill) to give effect to the establishment of the necessary regulators, their powers and responsibilities. Public comments on the Bill closed on 7 March 2014.

The Bill not only addresses the establishment of the two regulators, but also covers broader matters, including the balancing of operational independence
and accountability of regulators, creating a Financial Services Tribunal, strengthening enforcement and the ombudsman schemes, enhancing co-ordination and co-operation between financial regulators, and establishing a crisis management and resolution framework.

On a crisis management and a resolution framework, the Bill gives the Bank primary responsibility to oversee financial stability and identifies the Bank as the resolution authority in South Africa. The Bill also creates a statutory, inter-agency Financial Stability Oversight Committee chaired by the Governor of the Bank, with appropriate financial stability powers.

In preparation for assuming its responsibilities as outlined in the Bill, the Bank set up working groups in 2013 to take the twin peaks process further. These working groups will address the details of implementation, including funding and resource requirements for the new prudential authority. In the interim, the Bank, together with the NT, will drive issues related to financial stability and its role as the prudential authority, including supervision of FMIs and resolution, while the Financial Services Board, also with the NT, will drive issues related to its role as the market conduct authority. It is envisaged that once the Bill is passed into law, the prudential authority and the other structures highlighted above will come into operation at both the Bank and the Market Conduct Authority relatively quickly.

Financial market infrastructure developments

Implementing over-the-counter derivatives market reforms

Following the recent global financial crisis, the G-20 agreed on a broad range of regulatory reforms to address the weaknesses revealed during the global financial crisis. One area identified as requiring attention was the opacity of OTC derivatives markets, transactions and products, as well as the systemic risks that they pose to financial stability. The Basel Committee, the FSB and the International Organization of Securities Commissions (IOSCO) have since developed a range of measures aimed at enhancing transparency in, and improving the regulation of, the OTC derivatives market. These new regulatory measures are meant to change the way in which OTC markets operate in terms of data accessibility, costs, supporting infrastructure, market functioning, transaction processing and related matters.

The sheer size of, and the risks associated with, OTC derivatives markets increase systemic risk. As at 30 June 2013, the global notional amount outstanding and the gross market value of OTC derivatives according to the latest available data from the Bank for International Settlements (BIS) were US$692 trillion and US$20 trillion respectively.\(^35\) The Basel Committee, the FSB and IOSCO have been driving progress with regard to OTC derivatives reform in order to achieve the G-20 nations’ 2009 commitment to implement the following three goals by the end of 2012:

- All standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties (CCPs).
- OTC derivative trades should be reported to trade repositories (TRs).
- Non-centrally cleared OTC derivatives should be subject to higher capital requirements.

\(^{35}\) Figures are rounded off, and the data are available on the BIS’s website at www.bis.org/statistics/dt1920a.pdf.
The use of central clearing and trading platforms is one way to reduce the systemic risk that is posed by bilateral OTC markets as CCPs reduce, among other things, bilateral counterparty risk and increase transparency. TRs collect and maintain the records of derivatives transactions and play a central role in enhancing the transparency of derivative markets. They also provide insight into the risks that OTC derivatives pose to financial stability. Regulatory reform initiatives are under way to implement the derivative reform measures in a number of jurisdictions. In its latest progress report on the implementation of OTC derivatives market reforms, the FSB advised that overall progress in this regard had been good but that significant and challenging work remained to be done.\[36]\n
Progress has, however, been uneven among jurisdictions in a number of derivatives-related areas. Despite these challenges, market participants’ use of CCPs and TRs is increasing, especially for interest rate and credit derivatives, with over 50 and 40 per cent respectively of these asset classes being centrally cleared through CCPs and an even higher percentage of these transactions being reported to TRs at the end of June 2013.\[37]\n
The OTC derivatives reforms involve international and national policy developments, the adoption of legislation and regulations, and the creation and expansion of market infrastructures. By the end of 2013, no jurisdiction had fully implemented all the reform requirements. Work in this regard is ongoing in the areas of trade reporting, central clearing, exchange and platform trading, and capital and margining requirements. According to the September 2013 FSB Chairperson’s report to the G-20 leaders, which includes a summary of progress in OTC derivatives reforms, by the start of 2014 three quarters of FSB member jurisdictions intended to adopt legislation and regulations which required transactions to be reported to TRs. Frameworks for central clearing requirements are in place in most of the largest derivatives markets, with concrete rules being implemented as evidenced above. It would appear that the jurisdictions with the larger derivatives markets – such as the US (with the Dodd-Frank Act), the European Union (with its Markets in Financial Instruments Directives, Markets in Financial Investments Regulation, and European Market Infrastructure Regulation) and Japan – have made the most progress with implementation.

As part of its G-20 commitments, South Africa enacted the Financial Markets Act, 2012 (Act No. 19 of 2012) (FMA) to put in place legislation to address, among other things, the reform of the domestic OTC derivatives market. The South African authorities have adopted a three-phased approach to the implementation of OTC derivative regulatory reforms. This is a cautious approach, mindful of the need to minimise unintended negative consequences. The stages are as follows:

- **Phase I:** A code of conduct for, and the registration and licensing of, market participants, and the implementation of central reporting on OTC derivative transactions;
- **Phase II:** Risk management, that is, margin and capital requirements for non-centrally cleared derivatives (where appropriate);
- **Phase III:** Standardisation, central clearing and trading (where appropriate).

---


The details of the reforms will be established in a regulatory framework provided for under FMA and will become operational once the regulations are finalised. In South Africa, like in many other jurisdictions with small OTC derivatives markets (where the size, volume of transactions and liquidity may be a restraining factor), there are a number of issues which constrain the effective implementation of the OTC derivatives reform and which need to be resolved (see box below for more details).

Box 2  Issues requiring urgent attention in the over-the-counter reform process

The matters that require resolution for the effective implementation of the OTC derivatives reform in the domestic context are all interlinked. Some of the key considerations in this regard are as follows:

- Proper implementation of the OTC derivatives reform requires exchanges or electronic trading platforms, CCPs and TRs. South Africa does not currently have fully fledged CCPs and TRs that can fulfil all of the required roles. Although there are domestic financial market institutions that could extend and enhance their functions to meet the requirements of a CCP, it is not yet clear if this would be the most efficient and effective way of providing the necessary FMIs. An important policy consideration is whether South Africa should have its own CCP and TR, or whether it should use a foreign-based CCP and TR.

- The reforms require mandatory clearing and reporting of all standardised OTC derivatives transactions. In South Africa, there is an absence of some of the required FMIs suited to mandatory clearing, uncertainty with regard to certain aspects of the international regulatory reforms (e.g., resolution, margining and access to data), concern about the unintended consequences of imposing mandatory clearing of standardised OTC derivatives transactions and unease about creating an uneven playing field for domestic banks. In this context, South Africa has sought to influence a shift to CCPs by incentivising banks to make use of standardised derivatives contracts and clearing them centrally.

- It has been estimated that around 61 per cent of domestic OTC trades are executed with international banks and cross-border transactions dominate derivatives markets of most FSB member jurisdictions. Cross-border concerns, such as how jurisdictions’ regulatory regimes abroad will apply to domestic participants involved in cross-border transactions, regulatory approval of domestic participants in other jurisdictions, cross-border resolution of FMIs and the regulatory uncertainty arising from inconsistencies and conflicts of different national regulations also need to be addressed. Given the international and interconnected nature of derivatives transactions, international co-operation and co-ordination are crucial for the effective implementation of OTC derivatives markets reform. The agreement reached by the European Commission, the US Commodity Futures Trading Commission and the OTC Derivatives Regulators Group on a set of measures for how to approach cross-border derivatives in July 2013 provides a framework for authorities to resolve this challenge, which South Africa will consider.

- The impact of the reforms on the functioning of the domestic derivatives market and on the broader economy also needs to be considered. The recent macroeconomic impact assessment of OTC derivative regulatory reforms conducted by the Macroeconomic Assessment Group on Derivatives of the BIS compares the economic benefits and costs of the planned OTC derivatives regulatory reforms with a focus on the consequences for output in the long term. Based on the underlying assumptions embedded in the study, the report’s primary result is that at the aggregate level the net benefit of reforms is roughly 0.12 per cent of GDP per year. However, a more detailed analysis suggests that the net benefit of the reforms found at a global level by this study may not map directly to a net benefit at the level of each individual jurisdiction.

- The risk of concentration occurring in the OTC derivatives space among a limited number of intermediaries providing centralised services is a potential concern going forward. The FSB has also cautioned against this risk, indicating that this appears to be growing at a number of levels, such as dealers, trade facilities and CCPs. The FSB has therefore requested focus on concentration and monitoring thereof by financial authorities. In the South African context, where there is a distinct possibility of limited clearing services emerging, the concentration of risk at a single CCP, whether domestic or abroad, is a real concern.

38 Argentina, Indonesia and Saudi Arabia are in a similar position according to the FSB’s report titled OTC Derivatives Market Reforms: Sixth Progress Report on Implementation.
There is still a significant amount of consultation with market participants required in South Africa to finalise the details of the regulations and rules that will apply to domestic OTC derivatives transactions. The Bank is actively assisting with the domestic development and implementation of these OTC derivatives principles and standards. It is expected that when these standards are finalised, the domestic regulatory authorities will again engage with market participants to ensure an effective way of implementing them in South Africa.39

Principles for exchange-traded funds

As outlined in the September 2011 edition of the *Financial Stability Review*, possible financial stability risks that could be brought about by exchange-traded funds (ETFs) include the potential increase in complexity and opacity of synthetic ETFs, the impact of this innovation on market liquidity, and the impact that ETFs could have on financial institutions during periods of market distress.40 Other channels through which risks to financial stability could materialise include:

- compromised risk management due to the lack of transparency regarding the replication of index returns by swap counterparties as there is no known mechanism for managing liquidity risk in synthetic replication schemes;
- collateral risk triggering a run on ETFs when market liquidity conditions have deteriorated;
- materialisation of funding liquidity risk when there are sudden and large investor withdrawals, which are invariably triggered by market events (the entire financial system can be adversely affected by the collapse of financial intermediaries); and
- increased product complexity and options on ETFs undermining risk-monitoring capacity.

Further to this, IOSCO engaged stakeholders in an effort to assist regulatory authorities with compiling a common set of principles for ETFs. IOSCO’s work culminated in the release of a report41 aimed at providing a common set of principles to guide regulators and industry participants when dealing with ETFs, particularly those that are organised as collective investment schemes.

The global ETF industry has grown considerably since its inception and as at 31 January 2014 had assets under management of US$2,177 trillion.42 The growth of the ETF industry and associated products, such as exchange-traded notes, has raised some concerns that as the ETF industry grows, so does the potential of the industry to pose a systemic risk to the financial system.

The nine principles presented in the FSB’s above-mentioned report cover a number of areas, including disclosure of classification, portfolios, costs and expenses, conflicts of interest and the management of counterparty risks.

40 This section is based on a note issued by the FSB, titled Potential Financial Stability Issues Arising from Recent Trends in Exchange-traded Funds and is available at http://www.financialstabilityboard.org/publications/r_110412b.pdf.  
41 This report is titled Principles for the Regulation of Exchange Traded Funds and is available at www.iosco.org/library/pdfopt/IOSCOPD414.pdf.  
42 These figures were sourced from www.etfgi.com/publications/reports/reportid/352.
In South Africa, ETFs are registered under the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002) (CISCA) and the Financial Services Board currently oversees these funds. The South African ETF market has grown steadily since its inception 14 years ago and had R58,2 billion under management as at 31 March 2014 across all asset classes. Although currently not as significant in size as the securities market, the domestic ETF market is growing as new and more complex products are being introduced. South Africa, as a member of IOSCO, will take these principles and other regulatory initiatives that relate to ETFs into consideration when developing its regulatory framework going forward.

In February 2014 the FSB’s Standing Committee on Assessment of Vulnerabilities examined the financial stability implications of ETFs and concluded that supervisors would need to improve their data gathering on a number of aspects of the ETF market. The JSE does not allow the use of derivatives and debt in either ETFs or synthetic ETFs. As such, issues related to liquidity risk are not yet a threat in the South African market.

Hedge funds regulation

On 10 February 2014 the NT released a summary of the public comments on the draft regulatory framework for hedge funds in South Africa. South Africa embarked on a process to enhance and expand the scope of regulation and oversight over hedge funds following the global financial crisis in 2008 and also to align with new regulatory requirements on shadow-banking activities. This process culminated in the release of a proposed framework for regulating hedge funds in South Africa on 13 September 2012. This was reported on in the September 2012 issue of the Financial Stability Review.

The proposals contained in the proposed framework are that the regulatory framework for hedge funds be effected through CISCA as a declared scheme by the Minister of Finance in terms of section 63 of CISCA. The NT and the Financial Services Board issued for public comment the proposed framework in November 2012 and received extensive and valuable comments from 21 industry bodies, regulatory bodies and other interested parties.

The public comments have laid a foundation for the drafting of the regulations to regulate hedge funds. A drafting panel constituted by the Financial Services Board, the NT, independent experts and relevant industry associations will prepare a draft of the regulations to be issued in the first half of 2014 for public comment. Some of the major issues highlighted by the public comment process include the distinction between retail and restricted hedge funds, the definition of a hedge fund and the allowable legal and operational structures for hedge funds.

In a related development, the Financial Services Board announced on 13 March 2014 that it had signed memoranda of understanding (MoUs) with 25 EU jurisdictions. The signing of the MoUs was preceded by extensive negotiations between the Financial Services Board and the relevant jurisdictions through the Office of the European Securities and Markets Authority. The MoUs are aimed at fostering cross-border consultation, co-operation and the exchange of information related to the supervision of Alternative Investment Management Fund Directive entities. This extends to mutual assistance in the supervision and oversight of managers.

of alternative funds, their delegates (to which functions are outsourced) and depositories operating on a cross-border basis in the jurisdictions of the signatories. The conclusion of the MoUs occurred at an opportune time as the Financial Services Board is in the process of developing South Africa’s regulatory framework for hedge funds.

It is envisaged that the MoUs will greatly assist regulatory authorities in achieving their regulatory objectives of investor protection, fostering market and financial integrity, and maintaining confidence and systemic stability. It is also in line with the G-20 recommendation and the IOSCO principles aimed at promoting cross-border co-operation, assistance and exchange of supervisory information between member jurisdictions. For the South African alternative fund management industry, the signing of the MoUs largely removes the obstacle that prevented marketing of their products in the EU. It is envisaged that a draft framework for regulating hedge funds will come into effect in the second half of 2014 upon completion of the public consultation process.

Retirement fund reforms

On 14 March 2014 the NT published two papers that elaborated on the proposed retirement fund reforms and tax free savings products announced in the 2014 Budget Speech by the Minister of Finance.

The first paper, titled 2014 Budget Update on Retirement Reforms, responds to public comments received in respect of the two papers on retirement reform which were released in 2013. The first paper also provides government’s response to comments received on findings of the paper, and proposes a range of measures to lower costs based on a mandatory contribution system, optimal preservation and consolidation. It further outlines short-, medium- and long-term reforms in the retirement industry. It also summarises the process of retirement reform from 2011 until the present, and provides direction for the implementation of reforms over the next few years.

The broad policy goals of the intended reforms are:

– implementing auto-enrolment or a mandatory contribution system;
– improving preservation;
– improving fund disclosure;
– getting defaults right;
– consolidating funds;
– simplifying retirement savings products and making them portable between providers;
– ensuring effective intermediation; and
– providing tougher market conduct regulation and more effective supervision.

The second paper, titled Non-Retirement Savings: Tax Free Savings Accounts, provides more details on the non-retirement savings reform announcements made by the Minister of Finance in his 2014 Budget Speech and lays the basis for the legislation that will be published for public comment by July 2014, and for tabling and enactment in Parliament before the end of 2014.

---

44 The two papers are titled 2013 Retirement Reform Proposals for Further Consultation (released on 27 February 2013) and Charges in South African Retirement Funds (released on 11 July 2013).
According to the second paper, individuals will be allowed to open one or two accounts where they may invest in interest-bearing or equity instruments (or both). However, total contributions for the tax year may not exceed the annual limit, initially to be set at R30 000. Unnecessary withdrawals will be discouraged by not permitting the replacement of withdrawn amounts. A lifetime limit of R500 000 will also apply.

Institutions that have a banking or a collective investment scheme licence and the government will automatically be eligible to offer products through the tax free savings accounts. Stockbrokers that are registered with the Financial Services Board and the JSE will also be eligible to provide investment products through a tax free savings account, provided that the products offered comply with the stated principles and characteristics. Further public comments on both documents were invited with a closing date set at 30 April 2014.

International regulatory developments which may affect domestic financial stability

An update on the Global Legal Entity Identifier

The March 2013 edition of the Financial Stability Review reported on the Global Legal Entity Identifier (GLEI) initiative. According to the FSB, the GLEI would assist regulators in identifying vulnerabilities in the financial system and facilitate financial stability objectives of improved risk management, assessment of macroprudential risks, containment of market abuse and the curbing of financial fraud.

Since then the FSB, in conjunction with the GLEI Regulatory Oversight Committee (ROC), has made some headway in establishing the Global Legal Entity Identifier Foundation (GLEIF), which will be the cornerstone of the GLEI system. Draft guidance and a request for nominations to the Board of Directors (Board) of the GLEIF were sent out in 2013. All the ROC regions were given until 12 September 2013 to nominate three candidates for endorsement. These nominees will be appointed as the directors of the Board of the GLEIF.

During the period under review, the ROC also agreed on the processes for endorsement of pre-local operating units (LOUs) and acceptance of pre-legal entity identifiers (LEIs) into an interim global LEI system. These principles were released in July 2013 and are aimed at creating an interim system for the LEI until the governance structures are established. This interim system provides for pre-LEIs to use the common identifier. To this end, the ROC received a number of applications for pre-LOUs. These applications were from, among other countries, Germany, France, the United Kingdom (UK), Turkey and Finland. As at the end of February 2014, the ROC had endorsed and allocated prefixes to 12 pre-LOUs. The majority of these pre-LOUs were already fully operational and issuing LEI numbers.

The ROC also issued principles that provide guidance on data issues in the context of business registries, legal obstacles related to business registry data, porting arrangements of pre-LEIs, funding of the GLEIF, recognition of certified codes and sponsoring arrangements for pre-LOUs.

The domestic LEI Steering Committee met to deliberate on possible Board nominees and the final list is still under deliberation at the ROC. It is expected that appointments will be made in due course.
The decision to establish a domestic LOU was also deliberated on and a number of possible options were explored. It was agreed that there is a need for a domestic LOU and applications will be assessed from all interested parties before being sent to the ROC. Currently there are two entities interested in applying to become pre-LOUs. One of the parties has expressed that it would be interested in partnering with an already established pre-LOU. According to the ROC, outsourcing of the LEI system is allowed provided the required service level agreements are in place and the domestic entity takes responsibility for all data. Possible partnerships will be with the US’s Depository Trust & Clearing Corporation or the UK’s London Stock Exchange as both have been approved as pre-LOUs.

In the meantime, the NT endorsed the Financial Services Board as the sponsoring authority for entities wishing to become LOUs. Strate (Pty) Limited (Strate), South Africa’s central securities depository, has been allocated a globally unique four-digit prefix to use in the issuance of LEIs to South African counterparties for reporting OTC derivative transactions. The allocation of the prefix is part of the process to become endorsed by the LEI ROC as a pre-LOU. Strate is in the process of finalising a solution for generating, recording and maintaining LEIs that will conform to the conditions and principles required for endorsement by the LEI ROC.

The domestic LEI Steering Committee will continue to focus on the establishment of the GLEI system in South Africa. The implementation of the GLEI will provide regulators with insight into counterparty risks and exposures of financial market participants. It will also assist regulators to measure and monitor systemic risk, which is essential for a stable financial system.

Other G-20 driven international financial regulatory developments

Since the onset of the global financial crisis, the G-20 proposed fundamental changes to be made to the global financial regulatory framework with the aim of making the global financial system more resilient. The FSB was mandated to assist in the fulfilment of these reforms and accordingly embarked on a number of regulatory reforms.

The FSB regularly releases a work plan of the regulatory reform programme and reports back on progress of each reform area. The work plan covers a number of key areas, including:

- building resilient financial institutions;
- addressing the too-big-to-fail problem;
- strengthening the oversight and regulation of shadow banking;
- increasing the transparency of OTC derivative trading;
- reducing reliance on credit ratings and improving oversight of credit rating agencies;
- enhancing compensation practices; and
- building and implementing macroprudential frameworks and tools.
South Africa, as a member of the G-20, fully supports the regulatory reform process. South Africa has made progress in adopting and implementing the new international standards and has been an active participant in the relevant forums in which the regulatory reform efforts are being addressed. However, conditions in the domestic financial market, as in many other emerging markets and developing economies, differ from those in advanced economies. Domestic regulators have therefore had to take cognisance of these circumstances when implementing new standards and principles of the regulatory reforms so as to avoid adverse unintended consequences.

South Africa has participated in many of the regulatory reform processes, including:

– complying with the Basel III framework, which is an important aspect of building resilient financial institutions;
– developing legislation that will align its resolution regime with the key attributes as proposed by the FSB;
– participating in the ongoing shadow-banking surveys;
– developing OTC derivatives markets;
– participating in the peer review on compensation practices;
– developing a macroprudential framework; and
– participating in the peer review of Financial Services Board on credit-rating agencies.

South Africa will continue to participate in international forums and adopt and implement the standards in order to enhance the robustness of the domestic financial system.

Financial Sector Contingency Forum simulation exercise

The financial impact of the 2008 financial crisis and an ever-increasing number of risks that the financial sector is exposed to have highlighted the critical need for effective business continuity management (BCM) and contingency measures to be in place for all financial industry participants, including regulators and government.

Given the nature and interlinkages in the financial sector, it is an inherent risk that a crisis in one participant’s business is likely to affect other institutions. This ever-present risk of contagion that could result in systemic distress makes it imperative that cross-sectoral contingency planning is maintained to align and co-ordinate individual BCM plans with each other.

Borne out of the need for effective co-ordination and synchronisation of responses in times of crises, the FSCF was established in 2001. The FSCF is a co-ordinating body which brings together the key financial sector decision makers from the various financial market infrastructures and participants, regulators, the NT and the Bank, and is chaired by the Deputy Governor.
of the Bank responsible for financial stability. As a non-statutory body, it has no legal authority and its functions and decisions are informed by its voluntary membership as per an MoU concluded between the members.

By creating a co-ordinated network of the key financial sector decision makers and the sharing of contingency plans across the financial services industry, the FSCF seeks to ensure that all the relevant parties are fully aware of their respective obligations and duties during periods of distress for the common good of the financial system.

Conducting periodic simulation exercises is an established way of assessing the effectiveness of contingency arrangements. A recent simulation exercise, held in March 2014, was designed to test the level of effectiveness of the FSCF’s escalation, co-ordination and communication strategies during a systemic financial crisis. Those members whose role would be critical in such a crisis were identified and invited to participate. The larger commercial banks were also invited to participate in the exercise to introduce a degree of realism during the simulation. They were required to react to decisions made by the FSCF participants as they would do in a real situation.

A pre-simulation workshop was held in February 2014 to enable participants to familiarise themselves with the respective escalation procedures for systemic crisis events. An external facilitator was appointed to assist with the planning, preparation, scenario development and facilitation of the simulation exercise. In preparation for the simulation exercise, the external facilitator conducted meetings and held discussions with the member bodies of the FSCF. The purpose of these meetings was to inform the external facilitator of each member organisation’s internal processes, escalation procedures, and disaster recovery and crisis management procedures as part of the planning.

The simulation exercise was designed to represent three working days condensed into approximately 1.5 hours each, with a 45-minute break between ‘days’ to allow the facilitators to assess the information produced by the participants and to calibrate the next day’s scenario based on the decisions taken.

The exercise emphasised the need for ongoing cross-sectoral contingency planning, and was hailed as a very informative and valuable exercise by the participants. In order to obtain the optimum benefit from the exercise, a post-test analysis was conducted. A comprehensive report was compiled which highlighted and identified shortcomings and gaps with appropriate recommendations on how to address them. The recommendations also included an action plan on how these shortcomings could be managed by the FSCF. These findings will be made available to the participants once they have been presented to the FSCF at its plenary meeting in April 2014.
Abbreviations

AGR  augmented Guidotti ratio
Alsi  All-share Index
BCI  Building Confidence Index
BCM  business continuity management
BDSI BankservAfrica Disposable Salary Index
BER Bureau for Economic Research
BITs Brazil, India, Indonesia, Turkey and South Africa
BIS Bank for International Settlements
BoJ Bank of Japan
BRICS Brazil, Russia, India, China and South Africa
CAR capital-adequacy ratio
CCB countercyclical capital buffer
CCI Consumer Confidence Index
CCP central counterparty
CFVI Consumer Financial Vulnerability Index
CIPS Chartered Institute of Purchasing and Supply
ECB European Central Bank
EME emerging-market economy
ETF exchange-traded fund
EU European Union
FMI financial market infrastructure
FNB First National Bank
FSB Financial Stability Board
FSCF Financial Sector Contingency Forum
G-20 Group of Twenty
GDP gross domestic product
GLEI Global Legal Entity Identifier
GLEIF Global Legal Entity Identifier Foundation
HQLA high-quality liquid assets
ICR interest coverage ratio
IIF Institute of International Finance
IMF International Monetary Fund
IOSCO International Organization of Securities Commissions
JSE JSE Limited
LCR liquidity coverage ratio
LEI legal entity identifier
LOU local operating unit
MoU memorandum of understanding
NBFI non-bank financial institutions
NCR National Credit Regulator
NPL non-performing loan
NT National Treasury
OECD Organisation for Economic Co-operation and Development
OPEC Organization of the Petroleum Exporting Countries
OTC over the counter
P/B  price-to-book
P/E  price-to-earnings
PMI  Purchasing Managers’ Index
P/R  price-to-rent
QE  quantitative easing
ROC  Regulatory Oversight Committee
ROE  return on equity
SADC  Southern African Development Community
SAM  Solvency Assessment and Management
TB  Treasury bill
TCF  treating customers fairly
TR  trade repository
UK  United Kingdom
US  United States

Glossary

Board  Board of Directors
CISCA  Collective Investment Schemes Control Act, No. 45 of 2002
EY  previously known as Ernst & Young
Strate  Strate (Pty) Limited
the Act  the Banks Amendment Act, No. 22 of 2013
the Bank  South African Reserve Bank
the Basel Committee  the Basel Committee on Banking Supervision
the Bill  Financial Sector Regulation Bill, 2013
the Fed  United States Federal Reserve
the FMA  Financial Markets Act, No. 19 of 2012