Financial Stability Review

March 2005

South African Reserve Bank

Financial Stability Review

March 2005

South African Reserve Bank

Editorial committee

Comments and enquiries relating to this Review are encouraged and should be addressed to:
Head: Financial Stability Department
S A Reserve Bank
P O Box 427
Pretoria 0001
Tel. +27 12 313 3401

E-mail: sarbfsr@resbank.co.za

http://www.reservebank.co.za

ISSN 1811-2226

Contents

Introduction

The South African Reserve Bank (the Bank) defines its primary goal as the achievement and maintenance of price stability. In addition to this the Bank is responsible for ensuring that the South African monetary, banking and financial system as a whole is sound. In pursuit of this objective and to promote and maintain a stable financial system, the Bank publishes this semi-annual *Financial Stability Review*. The publication aims to identify and analyse potential risks to financial system stability, communicate such assessments and stimulate debate regarding pertinent issues. The Bank recognises that it is not the sole custodian of financial system stability. It must, however, contribute towards a larger effort involving the government, other regulators and self-regulatory agencies.

This edition of the *Financial Stability Review* comprises two main sections, viz:
- financial stability developments and trends, and
- infrastructure and regulation.

The first section presents an overview and assessment of the current state of macroeconomic and macrofinancial conditions. It contains a discussion of the major developments in the international, emerging market and regional environment, which may influence financial stability in South Africa. The domestic assessment is based on selected macroprudential indicators for banks, financial markets, and insurance, corporate, household and, among other things, the real-estate sectors. Issues that are discussed include:
- China and its role in the global economy;
- financial contagion; and
- financial soundness indicators and the co-ordinated compilation exercise.

The second section that focuses on infrastructure and regulation includes a qualitative assessment of the domestic financial system environment. This assessment aims to detect potential vulnerabilities by systematically evaluating laws, regulations, standards and practices and to benchmark these according to the Financial Stability Forum's 12 internationally accepted standards and codes. Other issues discussed include:
- the gradual phasing out of exchange controls;
- the Continuous Linked Settlement system; and
- anti-money laundering measures in South Africa.

Overview

Global economic recovery continued during the second half of 2004. Early estimates suggest overall world growth to be the strongest since 1998. Employment levels, however, were disappointing despite global manufacturing output performing reasonably well. Although global economic growth was threatened by the higher oil price, financial system stability was not negatively affected. Concerns regarding the global imbalances remain as they continued to intensify during the second half of 2004. Although terrorist attacks have become more isolated, geopolitical issues remain risk factors to global financial stability.

The global economic recovery and a surge in commodity prices have boosted growth prospects in emerging-market economies. Renewed borrowing by these economies partly reflects an improvement in fundamentals and low borrowing costs in some of the main capital markets. Better fundamentals have also resulted in a number of emerging-market economies achieving investment-grade ratings.

The South African financial system was assessed as sound during the period under review, based on an analysis of various indicators. Increased confidence in the financial system was evidenced by a rise in the financial services index in the fourth quarter of 2004 and an increase in bank share prices. Stress testing results showed that the South African banking sector would still remain resilient to specific plausible macroeconomic shocks and would remain well capitalised after any losses resulting therefrom have been realised. The insurance sector also remained healthy.

A rise in business confidence was another positive development for financial stability, as confidence indicators tend to lead real macroeconomic developments which, in turn, are related to financial stability. While there was a drop in consumer confidence, the number of insolvencies continued to recede in December 2004. Since the household sector and small businesses on average utilise a major part of banks' credit extension, low levels of insolvency bode well for debt repayment and hence, for financial stability. However, house price developments and growing household debt still need to be monitored closely.

An appraisal of the South African financial regulatory environment has shown that South Africa generally complies with international standards and best practice, which also serve as a guide to reform policies and a benchmark for policy-makers to assist with the identification of vulnerabilities. The continuous commitment to establishing a stronger and more stable financial system environment makes South Africa less vulnerable to financial crises and the effects of contagion, and at the same time allows the country to reap the benefits of continuous integration into world markets.

In December 2004, the South African Reserve Bank announced the successful implementation of the rand as a settlement currency in the Continuous Linked Settlement (CLS) system. The inclusion of the rand in the Continuous Linked Settlement system will not only reduce the foreign exchange settlement risk, but will also provide valuable real-time settlement information and improve the robustness of the national payment system.

Overall, the global environment did not present any serious risks to the stability of the domestic financial system, and the South African financial environment appears to be sound. No evidence could be found that suggests any threat to domestic financial stability.

Financial stability developments and trends

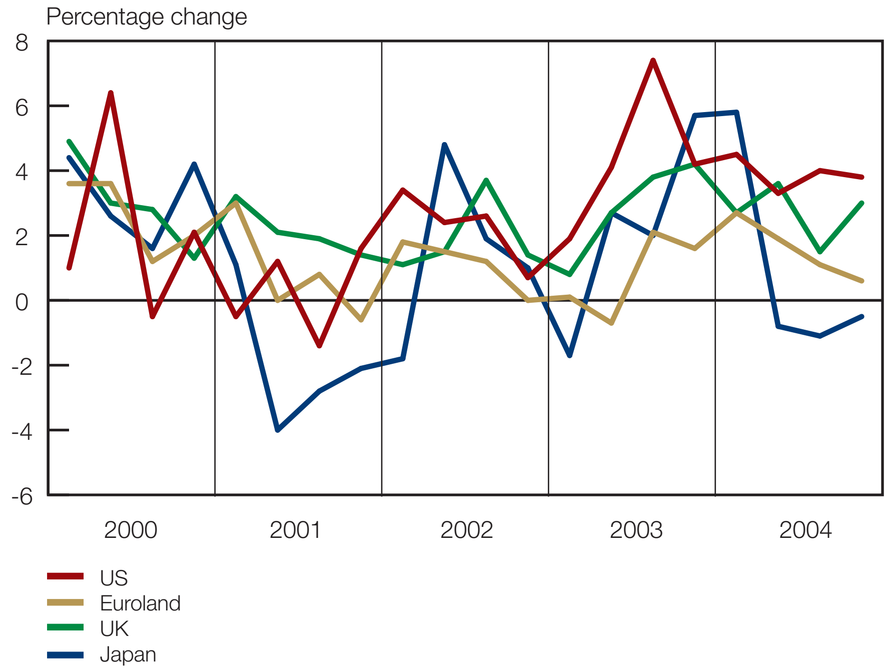
International macrofinancial developments

The global economic recovery continued during the second half of 2004, but at a more measured pace. Although global manufacturing output performed reasonably well, employment levels disappointed. Inflationary pressures did not materialise to the extent initially expected while interest rates, although increasing, remained low. Property prices increased strongly, leaving many economies vulnerable to interest rate increases. Other risks identified that could impact on the stability of the financial system are the growing levels of disparity in global trade and current-account imbalances, high oil prices, the ever-present threat of terrorism and political tensions in Iraq and the Middle East, a destabilising reversal of investment flows into emerging markets and the impact of under-funding and ageing populations on pension funds.

Global growth and output

Global gross domestic product (GDP) increased by 4,1 per cent in 2004, the strongest economic growth since 1998. The recovery in economic growth during most of 2004 was mainly driven by United States of America (US) consumers and by China (see box "China and its role in the global economy"). The pace and nature of economic growth in industrial countries continued to vary considerably with the US economy growing at an annualised rate of 3,8 per cent during the fourth quarter of 2004 (compared to 4 per cent during the third quarter), Euroland at 0,6 per cent (compared to 1,1 per cent during the third quarter), the UK at 3 per cent (1,8 per cent in the third quarter) and Japan at -0,5 per cent (-1,1 per cent in the third quarter). The Organisation for Economic Co-operation and Development (OECD) expects the global economic recovery to gather momentum despite the low levels of economic growth in Japan and Euroland.

Figure 1: Growth in gross domestic product: US, Euroland, UK and Japan



Although global economic growth was threatened by the higher oil price, which rose sharply in the third quarter of 2004, financial system stability was not negatively affected. Oil prices declined to more acceptable levels during the fourth quarter of 2004, but have since reached new record high levels. The volatility in oil prices has become a financial stability concern.

The global manufacturing Purchasing Managers Index[1] (PMI) recorded a modest gain in December 2004, following a decline for four consecutive months. The global PMI output index improved slightly, while the employment and new order indices fell marginally[2]. Input prices fell noticeably in the manufacturing sector as energy prices continued their downward trend during the fourth quarter of 2004. Global production trends did not suggest any risks to financial system stability.

1 *The global PMI is a survey of manufacturing output as measured by a global indicator, compiled by JPMorgan from selected developed countries.*

2 JPMorgan, *Global Manufacturing PMI, December 2004.*

China and its role in the global economy

China is becoming one of the world's largest economies and has been growing consistently at more than 8,5 per cent a year since the early 1990s[3]. As China continues to grow strongly, so does its fundamental role in international trade. China's share of global trade has grown rapidly, representing 6 per cent of total world exports and 5,7 per cent of total world imports in 2004[4]. As this level of economic growth is probably not sustainable, and given the significant role that China plays in the world economy, there are two possible economic growth scenarios with different implications for the global economy: a "soft-landing" scenario with sustained economic growth that may gradually moderate over the medium to long term, and a "hard-landing" scenario implying a sudden loss of economic momentum.

If the current pace of China's economic growth is sustainable or if a soft-landing scenario materialises, the challenge for China's economic policy-makers would be to ensure sustainable economic growth over the medium term without substantially increasing inflation. In 2004, authorities implemented a number of measures to moderate the pace of economic growth, including a moderate increase in interest rates. The recent interest rate increase was also an attempt by the authorities to restrain inflationary pressures.

Using monetary policy as a counter-inflationary tool is complicated by China's current fixed exchange rate regime. The fixed exchange rate can only be maintained by actively purchasing foreign currency reserves. Such a policy, however, causes an increase in the money supply and could contribute to inflation. The authorities also used foreign reserves to recapitalise the big state-owned banks in an attempt to manage the high levels of non-performing loans (NPLs) and prepare these banks for listing overseas.

Although China's economic growth can be seen as contributing to opportunities for emerging markets, its low-priced exports also threaten to displace production in countries that produce competing products. South Africa could find it particularly difficult to compete in the more labour-intensive manufacturing subsectors.

China's growth has contributed to its increasing demand for oil, making China the world's second largest oil-importing country. Among other things, the increase in China's demand for oil products has put upward pressure on oil prices in the third quarter of 2004, threatening global economic growth. Oil-importing emerging economies, such as that of South Africa, will be negatively affected by high oil prices, increasing the risk to financial system stability.

A hard-landing scenario in China would probably be a consequence of a failure in efforts to control excessive economic growth and curb inflation. It is also argued that the development of China's property market is a stronger determining factor for a hard landing than government policies. Due to excessive investment in this sector, the property sector is at the root of the risk of China's economy overheating. A hard landing for China's economy will not only increase the fragility of its banking system (NPLs are estimated at 14 per cent of gross domestic product), but will also impact on the global economy through lower commodity prices, declines in international levels of trade and lower levels of global economic growth.

3 China Daily. *2004. Second interest rate rise possible. Online: http://www.chinadaily.com Accessed on 9 November 2004.*

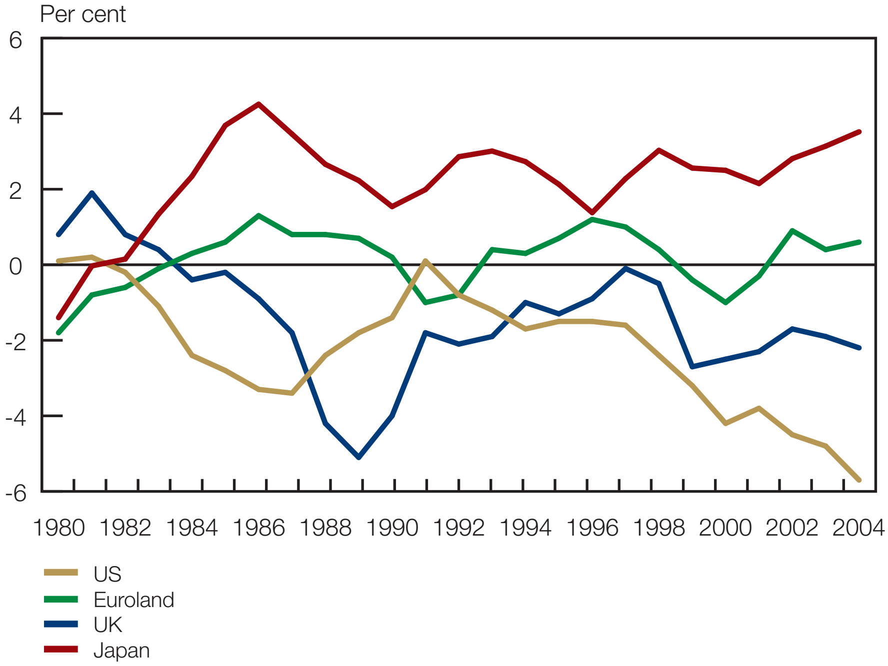
4 American Enterprise Institute for Public Policy Research. *2005. China and the global economic recovery. Online: http://www.aei.org Accessed on 16 February 2005.*

Global imbalances

Concerns regarding global imbalances remain prevalent as they continued to intensify during the second half of 2004. A dominant characteristic of these imbalances is the ever-widening divergence between current-account deficits (predominantly in the US) and surpluses in Asia, especially in China and Japan. According to Morgan Stanley's Global Economic Forum in 2004, the spread between these surpluses and deficits reached a record of more than 3 per cent of world GDP in 2004. Trade gaps, which also deteriorated in several G-7 countries during the second and third quarters of 2004 mainly as a result of higher oil prices, improved slightly in the fourth quarter.

Further depreciation of the US dollar remains a risk to international financial stability as it could lead to heightened volatility across foreign exchange, bond, credit and equity markets.

Figure 2: Current-account balances (as percentage of GDP)



Source: Thompson Financial Ltd (Datastream)

High consumer demand and the low gross national saving rate in the US are additional factors that impact on the current-account deficit in the US. As mentioned before, global growth differentials remain large (see Figure 1), mostly because of strong US consumer demand and differences in macroeconomic policies. At the same time, the US gross national saving rate averaged 16 per cent, compared to 23 per cent for other developed countries, and 46 per cent for China. Lower consumer demand, more exports and higher savings are needed to correct the current-account deficit in the US and imbalances globally. These global imbalances are, however, not only caused by conditions in the US. Stronger consumer spending, lower savings and appreciating currencies are most likely needed in the rest of the world to address global imbalances.

Although foreign investment flows into the US were healthy enough to cover the current-account deficit (the US needs to attract about US$2 billion in foreign finance daily), some concerns remain as there are signs of decreasing appetites for US dollar assets. If this imbalance should continue to grow it would increase the danger of sudden disorderly adjustments being needed instead of orderly corrective measures and adjustments. The possibility of spill-over effects of such disorderly adjustments into other financial markets poses a risk to sustainable growth in the world economy.

Recent reports by central bank reserves managers have indicated that central banks appear to be increasing their exposure in favour of the euro. Data from the Bank for International Settlements also revealed that the share of US dollars in deposits of the Organization of the Petroleum Exporting Countries (OPEC) members fell from 75 per cent in 2001 to 61,5 per cent in the second quarter of 2004. Such reluctance to increase exposure to dollar assets could complicate the US's ability to finance the current-account deficit, exerting further downward pressure on the US dollar.

Geopolitical issues

The security situation in Iraq remains a grave concern. The run-up to the elections of 30 January 2005 was marred by increasingly sophisticated attacks against anything deemed pro-American. The elections were held under war conditions and the boycott by the Sunni community has cast doubts on any post-election security improvement. Despite the recent tit-for-tat attacks between the Israelis and Palestinians, reciprocal measures from both sides have given prospects for peace in the Middle East a boost. Terrorist attacks were isolated but the ever-present threat of terrorism and the potential impact on global financial stability remain.

Banking sector developments

Globally, large financial institutions remain strong. In general, it would appear that there has been a moderate easing in concern over both asset quality and profitability. According to the December 2004 *Financial Stability Review* of the Bank of England, credit losses suffered by UK-owned banks remain subdued. Also, non-performing loans (NPLs) of Japan's major banks continued to fall. With the Japanese Financial Services Agency's looming target of halving NPL ratios from their peaks by March 2005, several banks reported higher-than-expected write-offs and provisioning for loans to troubled borrowers in the six months to September. This inevitably led to lower operating profitability at major banks.

The profitability of large European banks continued to recover because of further reductions in costs, while some large German banks have sold NPLs to third parties. Such measures might boost net interest income in future. The US banking sector remains strong. Capital ratios and profitability are high, and credit quality has improved.

In China, the annual growth in bank lending has been decelerating steadily from 20 per cent in March to 13 per cent in October 2004. There are reports of a severe shortage of credit in some sectors. It appears that some companies are, to some extent, probably financing spending from outside the official banking system[5]. In response to renewed risks of China's economy overheating, the authorities increased interest rates at the end of October, the first rise in nine years. A rapid increase in interest rates would increase the fragility of the banking system where NPLs (equal to about US$200 billion), estimated at 14 per cent of GDP, represent a large contingent claim on the government.

5 China Daily. *2004. Running money out of banks arouses concern, 27 July.*

Property market

Globally, economies are more vulnerable to interest rate increases as a result of the recent property boom. This is especially evident in the UK, US and Euroland. High levels of exposure to mortgage lending by banks could increase the vulnerability of the banking sector and lead to financial system instability should interest rates increase and/or property prices drop dramatically.

After four months of slower mortgage lending growth, mortgage lending in the UK for December 2004 saw an underlying monthly rise similar to the first half of last year. It is likely, however, that this partly reflected a catch-up following the advent of mortgage regulation and the competitive attractiveness of specific products[6]. Lending to buy-to-let investors was 18 per cent lower in the second half of 2004 than in the first half, the first decrease since 1999. In the same period, mortgage lending for general home purchases fell by 3 per cent. At the end of 2004 the value of buy-to-let mortgages was 34 per cent higher than at the end of the previous year. New lending in the second half of 2004 was 18 per cent lower than in the first half of 2004. However, total residential investment lending for 2004 was still 14 per cent higher than in 2003[7].

6 British Bankers' Association. *Mortgage lending strengthened in December. Online: http://www.bba.org.uk Accessed on 14 January 2005.*

7 Financial Times. *2005. UK buy-to-let mortgage lending cools down, by Friederike Tiesenhausen Cave, Economics Reporter, 15 February.*

In 2004, property transactions in Europe increased by 7 per cent from 2003, and 50 per cent from 2000[8]. In the US, lending to commercial real-estate buyers has continued to grow rapidly. It now accounts for almost one-eighth of commercial banks' outstanding loans and over a quarter of total loans at small banks.

8 Capital Markets Bulletin. *2005. Jones Lang LaSalle, February.*

Commodity prices

By mid-November 2004, oil prices in real US dollar terms reached levels similar to those preceding the recessions in the early 1970s and 1990s, although still well below the levels of the oil price shock of 1981. Increased global demand – primarily led by the strength of Chinese and US demand after the second half of 2003 – was an important factor in driving oil prices upwards. Political tensions in some of the major oil-producing countries affected oil supply and added to the higher oil prices. According to the European Central Bank (ECB) *Financial Stability Review*[9], speculative activity also appears to have played a role in driving oil prices higher, possibly beyond levels explainable by underlying supply and demand alone.

9 *First edition of the* Financial Stability Review *of the European Central Bank published in December 2004.*

Over the past two years, gold and other precious metal prices have surged in US-dollar terms and were driven, in part, by the weakening US dollar, geopolitical uncertainties and the low interest rate environment.

Emerging markets

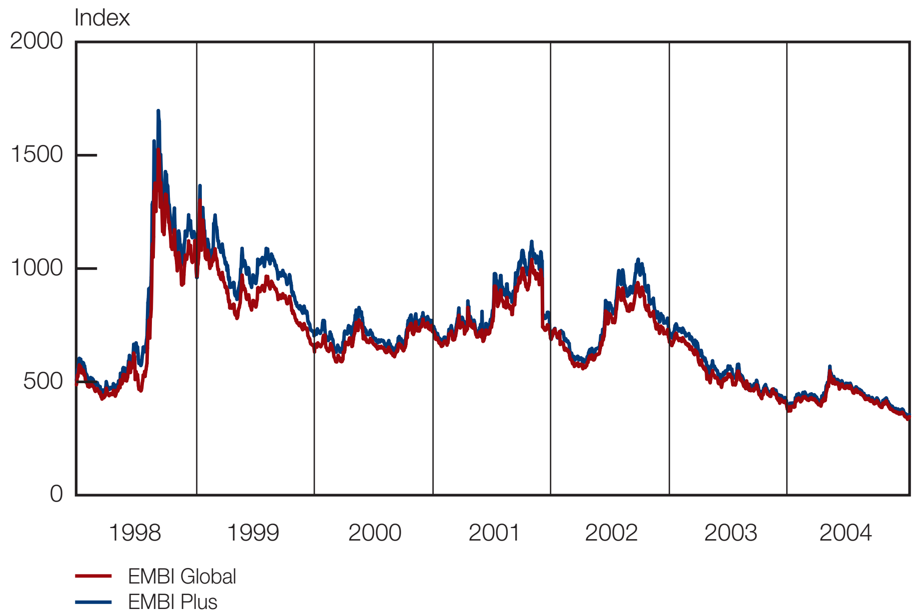
The world economic recovery and the surge in commodity prices have boosted growth prospects in emerging-market economies (EMEs). Led by Asia, Russia and Eastern Europe, many EMEs are still growing faster than their advanced economy counterparts. Net private capital flows to EMEs increased by 32 per cent to US$279 billion in 2004, with the Asian region remaining the principal destination for capital. According to the Institute of International Finance (IIF), the gross issuance of emerging-market bonds totalled US$100 billion in 2004. This renewed borrowing by EMEs partly reflects an improvement in EME fundamentals and low borrowing costs in the main capital markets. Moreover, longer-term structural inflows from pension funds in developed economies seeking to diversify their portfolios, have increased capital flows to EMEs.

As was reported in the September 2004 *Financial Stability Review*, emerging markets have accumulated sizeable foreign exchange reserves, which is a direct reflection of the strength of the balance of payments positions and current-account surpluses generated in most emerging Asian economies. A number of EMEs are delinking from the dollar (e.g. Brazil) and diversifying the range of currencies in which they hold reserves.

The spread of the JPMorgan emerging markets bond indices (EMBIs) continued its narrowing trend during the second half of 2004. Better fundamentals have resulted in a number of EMEs achieving investment-grade ratings. Furthermore, with US interest rates still at fairly low levels, investors opted to increase their exposure to EMEs in search of higher yields. Although investors perceive these markets as less risky, there is a possibility that if interest rates remain low, some emerging-market governments or companies may borrow in excess of their capacity to repay. In addition, many investors are becoming involved in emerging-market debt for the first time, which increases the risk of a destabilising market reversal. It is therefore important that strong capital inflows must not detract from the need for EMEs to pursue prudent policies.

Subsequent to the reporting period, yields on emerging-market debt started to increase. After the Federal Reserve Bank increased its benchmark interest rate on 22 March 2005, the EMBI spreads widened significantly. This development was strengthened by profit taking and a correction of what analysts believed to be irrationally-low bond spread levels.

Figure 3: Emerging-market bond indices



Source: JPMorgan

10 World Markets Research Centre. *Tsunami: Impact and Analysis. Online: http://www.worldmarketsanalysis.com Accessed on 20 January 2005.*

The tsunami that caused destruction across a 4 500-kilometre span of the Indian Ocean during December 2004 affected several EMEs. The total cost of damage to infrastructure and property is estimated at US$20 billion[10]. The economic impact, however, is expected to be limited and will depend on the macroeconomic, structural and institutional strength of the affected countries. The typical pattern for economies hit by such disasters is a brief deceleration in growth, followed by a rebound as the stimulatory impact of reconstruction takes effect.

According to the December 2004 edition of the Bank of England's *Financial Stability Review*, there are a number of other downside risks to EMEs. These include a combination of sustained high oil prices, a sharp rise in world interest rates and significantly lower world growth and non-oil commodity prices.

Regional developments

According to the International Monetary Fund's (IMF's) *World Economic Outlook* (September 2004), real GDP growth in sub-Saharan Africa is projected to rise to 4,75 per cent in 2004 and 5,75 per cent in 2005. Underlying the pick-up in growth are improving macroeconomic stability and global expansion – notably through higher demand for commodities at higher prices, easing of external debt burdens through the Heavily Indebted Poor Country (HIPC) initiative, and improved access to industrialised country markets.

Table 1 Real GDP, consumer prices and current-account balances of selected countries

	Real GDP (annual percentage change)				Consumer prices (annual percentage change)				Current-account balance (percentage of GDP)			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
Tanzania	7,2	7,1	6,3	6,5	4,6	4,5	4,3	4,0	-3,8	-2,4	-5,2	-6,2
Angola	14,4	3,4	11,2	15,5	108,9	98,3	56,1	16,5	-1,4	-4,9	9,2	14,5
Zimbabwe	-11,1	-9,3	-5,2	1,8	140,0	431,7	350,0	450,0	-2,6	-4,4	-7,1	-10,9
DRC	3,5	5,6	6,3	7,0	25,3	12,8	5,0	5,0	-2,8	0,6	-3,0	-5,9
Botswana	3,9	5,4	4,5	3,7	5,5	4,7	4,5	4,5	11,6	11,0	6,4	5,7
Mauritius	4,3	2,7	4,4	4,8	6,4	5,0	3,9	4,0	5,4	2,6	2,6	0,5
South Africa	**3,6**	**1,9**	**2,6**	**3,3**	**9,2**	**5,8**	**2,6**	**5,7**	**0,6**	**-0,8**	**-2,0**	**-2,1**

Source: IMF *World Economic Outlook*, September 2004. 2004 and 2005 figures are IMF staff projections.

The renewal of tensions in the eastern part of the Democratic Republic of the Congo (DRC) and between the DRC and Rwanda, the political crisis in Côte d'Ivoire and the humanitarian catastrophe in Sudan's western province of Darfur remain cause for concern. However, 2004 ended with the signing of peace agreements in Sudan, bringing to an end the continent's longest raging civil war. Peace processes are also gathering pace in Uganda and Senegal.

Zimbabwe's banking sector has been in a crisis for over a year. By the end of 2004, eight financial institutions were under curatorship and two were under provisional liquidation. A plan to merge and recapitalise most of the failed institutions into a new state-owned bank is still contending with legal, regulatory and operational issues, as well as funding problems.

The banking crisis in Zimbabwe is a reflection of the deteriorating macroeconomic environment: Hyper-inflation, negative real interest rates, high and rising unemployment, lack of foreign currency and overvalued exchange rates. Although authorities project positive growth rates in 2005, the economy has been in recession over the past five years and the cumulative decline in real GDP is estimated at 40 per cent. In such an environment the banking sector seems overtraded. Currently the country still has 40 banks. The Reserve Bank of Zimbabwe has introduced some measures to restore stability in the financial sector. These address licensing, capital adequacy, independence of management and credit ratings by reputable agencies. However, the direct exposure of the South African financial sector to Zimbabwean banks remains fairly low and conservatively managed, thus posing no immediate threat.

The continued economic meltdown in Zimbabwe may have wider economic implications. Although constituting a modest 2,4 per cent of South Africa's exports, Zimbabwe remains South Africa's largest trading partner on the continent. South African exports to Zimbabwe declined by 5,6 per cent in 2004.

Financial contagion

Financial contagion refers to the spreading of market disturbances from one country (usually an emerging market) to another, through co-movements in asset prices, exchange rates, sovereign spreads and capital flows. There are mainly two reasons why financial contagion occurs. Firstly, the interdependence between economies causes shocks (whether global or local) to be transmitted through their real and financial linkages. Secondly, a financial crisis that is not linked to observed macroeconomic changes can occur as a result of the behaviour of investors or other financial agents.

Mechanisms through which shocks can be transmitted internationally are explained by the following three main theories:
- The multiple equilibrium theory.
- The endogenous liquidity shocks theory.
- The political economy theory.

The multiple equilibrium theory assumes that a crisis in one country can be a signal for crises in other countries. A crisis in one country could co-ordinate investors' expectations, shifting them from a good to a bad equilibrium for another economy, thereby causing a crash in the second economy[11]. The transmission of the shock is therefore not driven by real linkages, but by investor expectations and beliefs.

The theory of endogenous liquidity shocks assumes that a crisis in one country can reduce the liquidity of market participants, forcing them to recompose their portfolios and sell assets in other countries in order to continue operating in the market, satisfy margin calls, or meet regulatory requirements[12]. The perception is that investors require capital to operate in the market and a crisis in one country generates a capital loss that requires portfolio recomposition.

The theory of political economy assumes that central bank governors are under political pressure to maintain a fixed exchange rate regime[13]. When one country decides to abandon its regime, the political cost of abandoning respective regimes by other countries is reduced. This could increase the likelihood of those countries switching exchange rate regimes, resulting in currency crises being bunched together.

Emerging markets are more affected by contagion as a result of asymmetric information. In the absence of better information about these markets, investors may conclude that a financial crisis in one market could lead to a crisis in other emerging markets as well. Improved economic fundamentals and standards for data disclosure, regulation and supervision, and corporate governance could prevent the build-up of vulnerabilities in emerging markets.

11 Masson, P. 1998. *Contagion: Monsoonal Effects, Spillovers, and Jumps between Multiple Equilibria,* IMF Working Paper 98/142.

12 Valdes, R. 1996. *Emerging Market Contagion: Evidence and Theory,* Central Bank of Chile Working Paper 007.

13 Drazen, A. 1998. *Political Contagion in Currency Crises,* NBER Working Paper W7211.

Domestic macroprudential analysis[14]

The assessment in this section is based on selected macroprudential indicators, which cover most of the relevant sectors, being the banking, financial markets, insurance, corporate, household, real-estate, and micro-lending sectors. It analyses the main developments in and risks to the financial system and is an attempt at a more systemic analysis of the health of the financial system. The analysis largely covers the six-month period ending December 2004. Where data permit, however, the analysis goes beyond this period.

14 *Some of the data used in this section may differ from that of the previous* Financial Stability Review *due to revised national accounts estimates and to the re-basing of prices from 1995 to 2000.*

Banking sector

Within a financial system, the role of banks is central as banks are a source of liquid assets and funds to the rest of the economy and also provide payment services that are relied upon by all other entities in conducting business. Banks are also systemic in nature due to maturity mismatching between their assets and liabilities. Therefore the failure of banks can have a significant impact on the activities of all other financial and non-financial entities and on the confidence in, and the functioning of the financial system as a whole. This makes the analysis of the health and soundness of the banking sector central to any assessment of financial system stability.

The South African banking sector comprised 15 locally controlled banks, 6 foreign controlled banks, 2 mutual banks and 15 branches of foreign banks in December 2004. The banks remained well capitalised. Against a minimum regulatory capital adequacy requirement of 10 per cent, the banking sector's capital adequacy ratio stood at 13,5 per cent in December 2004 compared to 12,2 per cent in December 2003. The market share of the four big banks (based on total assets), which gives an indication of the extent of their domination, increased from 80,9 per cent in December 2003 to 83,7 per cent in December 2004. The banking sector remained concentrated. The Gini concentration coefficient, which estimates the numeric value of concentration (taking into account the difference between actual concentration and the hypothetical state in which no concentration exists) increased slightly from 82,9 per cent in December 2003 to 83,1 per cent in December 2004.

Total assets of the banking sector grew by 8,6 per cent (measured over a 12-month period) in December 2004 to R1 498 billion. The asset quality of banks also improved. By the end of December 2004, gross overdues amounted to R20,4 billion and constituted 1,8 per cent of total loans and advances compared to R23,8 billion in December 2003 (2,4 per cent of total loans and advances)[15]. Total provisioning (that is market value of security, specific and general provisioning) against overdue accounts was more than adequate. The improvement in asset quality was borne out by a decrease in specific provisions (measured as a percentage of total loans and advances), from 1,9 per cent in December 2003 to 1,5 per cent in December 2004.

15 The Bank Supervision Department regards loans classified as being "doubtful" or "loss" as falling within the definition of "overdue" or "non-performing". "Doubtful" loans are loans that are more than 180 days overdue and are not adequately secured, whereas loans classified as "loss" are not only more than 180 days overdue, but are also considered to be uncollectable.

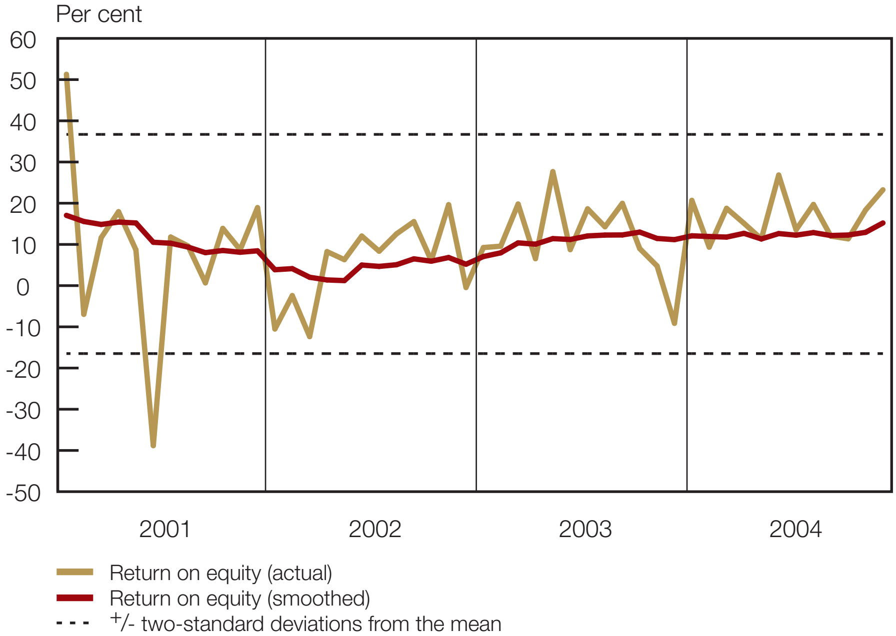
Return on equity (ROE), i.e. the ratio of net profit to average capital, reflects the banking institutions' efficiency in using capital and, over time, provides information on the sustainability of banks' capital positions. A high ratio may indicate either high profitability or low capitalisation, while a low ratio may indicate either low profitability or high capitalisation.

ROE improved from -9,1 per cent in December 2003 to 23,3 per cent in December 2004. ROE tends to be highly volatile (see Figure 4), which is exacerbated by the introduction of fair value accounting in 2003. By using a twelve-month moving average, a more subdued measure of underlying ROE is obtained. Calculated on this basis, the ROE improved from 11,2 per cent to 15,2 per cent in December 2004. The increase in ROE could be ascribed mainly to an improvement in net income and was therefore a result of increased profits and not lower capitalisation. In fact, net qualifying capital and reserves of the banking sector increased by 20 per cent (measured over a 12-month period) in December 2004.

A two-standard deviation (either above or below the mean) is often used as a warning signal of emerging problems or of a need for further investigation[16]. The actual ROE remained well within the threshold of two-standard deviations from the indicator's mean during the review period.

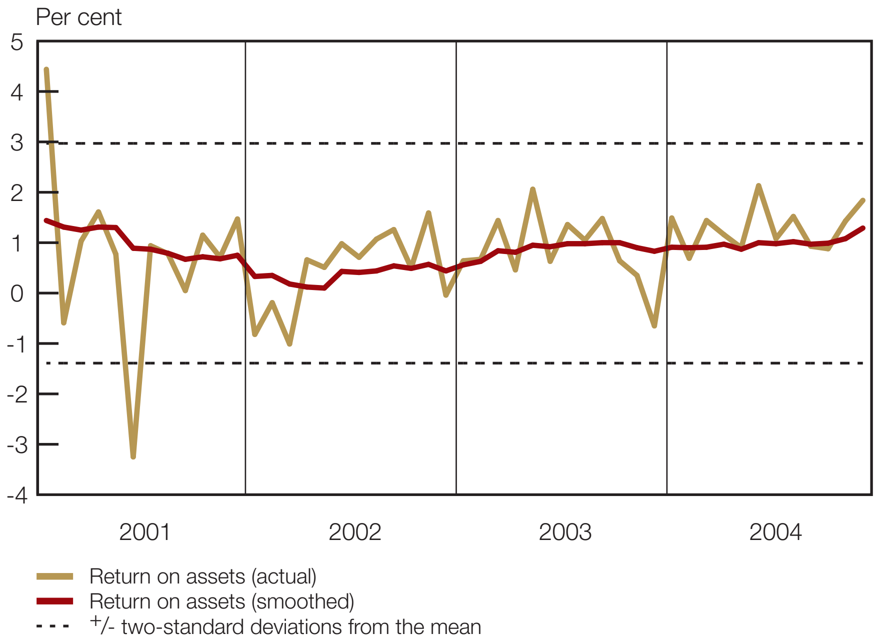
16 See the box "Early warning system models" on page 15 of the September 2004 Financial Stability Review *for a discussion of the relevance of the two-standard deviation technique.*

Figure 4: Return on equity



The return on assets (ROA), i.e. the ratio of net profits to total assets, is another measure of banking institutions' profitability and indicates how efficiently financial institutions' assets are employed. ROA increased from -0,65 per cent in December 2003 to 1,8 per cent in December 2004, supported by the strong improvement in net profits. ROA also remained within the threshold of two-standard deviations during the review period, suggesting that the volatility was within the acceptable range.

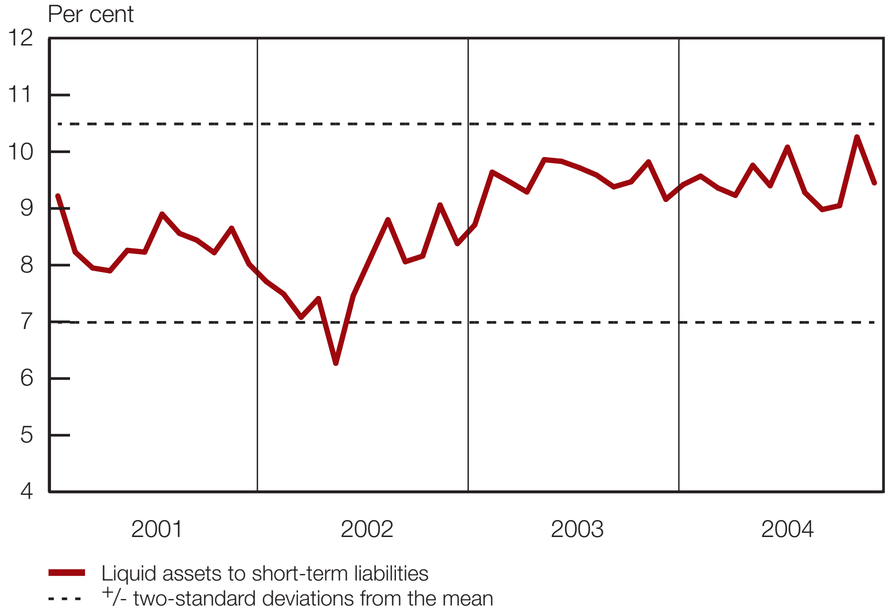
Figure 5: Return on assets



The improved profitability of banks translated into higher share prices, which increased by 55,4 per cent in the year to December 2004 from 8,3 per cent in the year to December 2003. Speculation of foreign take-overs of domestic banks also contributed to this trend.

As mentioned in the IMF's *Compilation Guide on Financial Soundness Indicators* (see box "Financial Soundness Indicators and the Coordinated Compilation Exercise" for more information), the level of liquidity influences the ability of the banking sector to withstand shocks. The indicators mostly used to measure liquidity include liquid assets to total assets (liquid assets ratio) and liquid assets to short-term liabilities, or short-term loans to assets as a crude measure. These ratios reflect the maturity structure of the asset portfolio and can highlight excessive maturity mismatches and a need for more careful liquidity management.

Figure 6: Liquid assets as percentage of short-term liabilities



The ratio of liquid assets to short-term liabilities is intended to capture the liquidity mismatch of assets and liabilities, and provides an indication of the extent to which banks could meet short-term withdrawals of funds without facing liquidity problems. The ratio of liquid assets to short-term liabilities for the South African banking sector increased slightly from 9,2 per cent in December 2003 to 9,5 per cent in December 2004. The ratio also remained within the two-standard deviations benchmark from the indicator's mean during the period under review.

Financial Soundness Indicators and the Coordinated Compilation Exercise

The increasing focus on financial stability has led the International Monetary Fund (IMF), in collaboration with other international and regional agencies, to undertake a work programme to promote the compilation and analysis of Financial Soundness Indicators (FSIs) as a key tool that can be used for strengthening macroprudential surveillance of financial systems – the assessment and surveillance of the strengths and vulnerabilities of financial systems – with the ultimate objective of enhancing financial stability and, in particular, limiting the likelihood of a failure of the financial system. The compilation and dissemination of FSIs also support the important goals of increasing transparency in the financial system and of strengthening market discipline. FSIs are, therefore, indicators of the current financial health and soundness of financial institutions, their corporate and household counterparts in a country and the markets in which financial institutions operate. It is a new body of economic statistics that can be used, along with other economic and financial indicators, by national authorities and the IMF to assess the financial strength and vulnerabilities of a country's financial sector.

In order to support the efforts of countries in the compilation of the FSIs, the IMF published a *Compilation Guide on Financial Soundness Indicators* (Guide). The primary purpose of the Guide is to provide comprehensive guidance on the concepts and definitions of indicators, sources and techniques of computing, as well as enhancing cross-country comparability of the FSIs. The ultimate goal is to construct aggregated statistics suitable for the assessment of current vulnerabilities and strengths of the financial sector as a whole. Use of aggregated statistics also allows for the analysis of the interaction of the financial system with other sectors of the economy.

Subsequent to the publication of the Guide, the IMF embarked on a voluntary Coordinated Compilation Exercise (CCE). The objectives of the exercise are to co-ordinate efforts by national authorities to compile cross-country comparable FSIs, in line with the Guide, for use in assessing the strengths and vulnerabilities of financial systems and to disseminate the FSI data along with the metadata. Participating countries (of which South Africa is one) are expected to provide the IMF with data and metadata by the due date. Table A gives an overview of the progress made and the way forward. The South African Reserve Bank, through the Financial Stability Department, has been actively involved with the project since its inception.

Table A: The Coordinated Compilation Exercise: Main activities

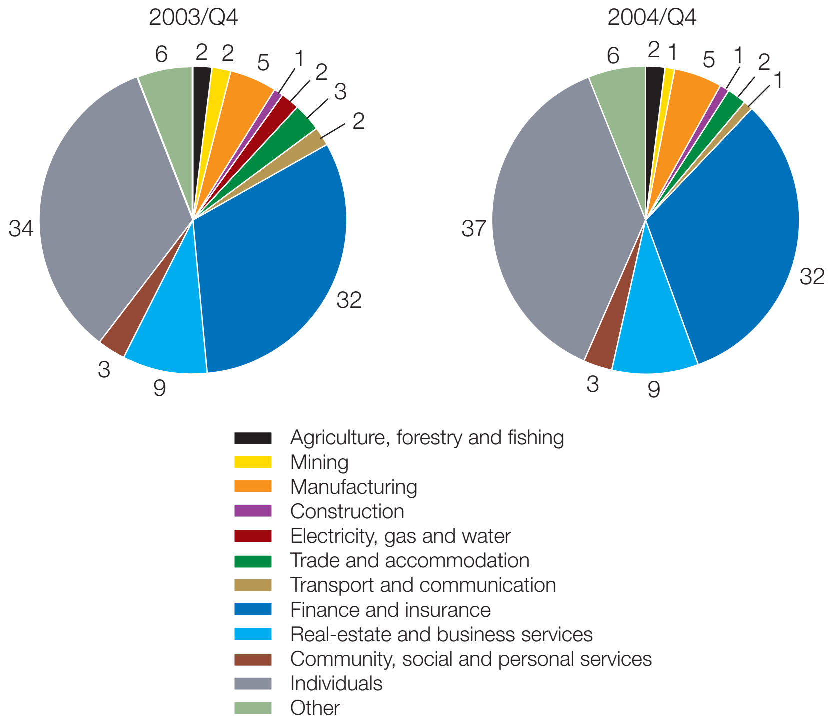
Period	Event
April 2004	Participating countries nominated country co-ordinators
September 2004....	Countries submitted initial inventories of data available for compiling the FSIs
November 2004	Country co-ordinators and compilers met at the IMF Headquarters in Washington, D.C.
Mid 2005	First round of regional consultations
Spring 2006	Second round of regional consultations
July 2006	Submission of data and metadata to the IMF
End 2006	Publication of data and metadata
Spring 2007	Post-exercise meeting of country co-ordinators and compilers

Macroprudential analysis of the banking sector also requires the analysis of sectoral (see Figure 7) and geographical (see Figure 8) distribution of loans, which allows for the monitoring of risks arising from exposure to certain sectors or countries, or a group of sectors or countries. A large concentration of aggregate credit in a specific economic sector or activity (measured as a share of total loans) makes banks vulnerable to adverse developments in that sector or activity.

The banking sector continued to be exposed to the household and the finance and insurance sectors. At the end of the fourth quarter of 2004, the shares of the two sectors in total credit extension were 37 per cent and 32 per cent, respectively. Further concentration of exposures to these two sectors will have to be carefully monitored and managed.

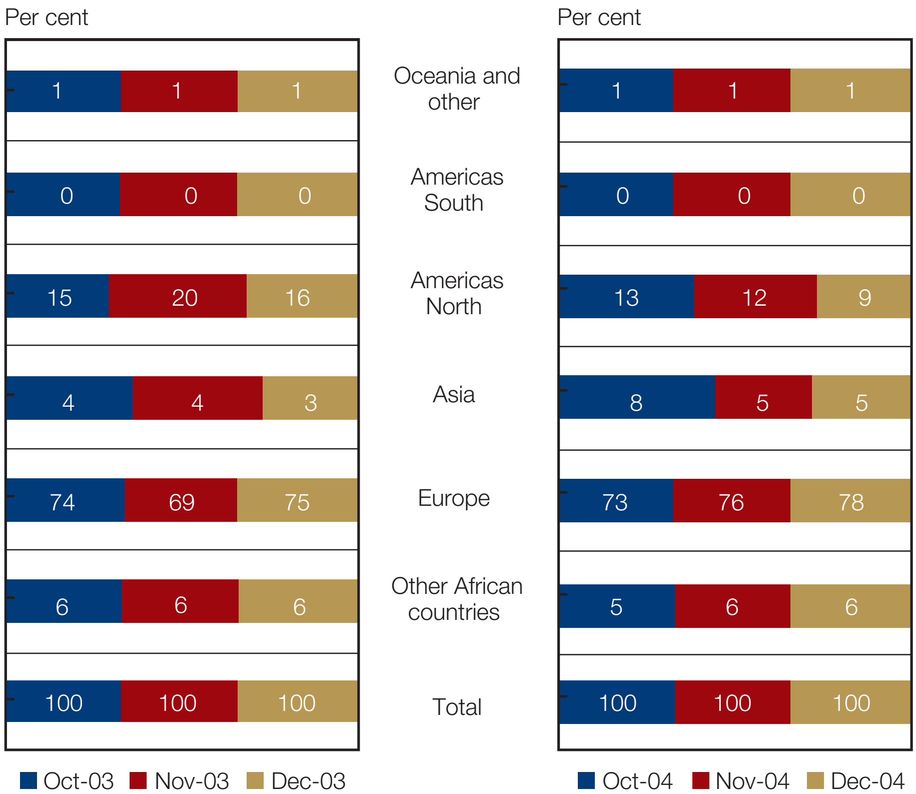
An analysis of the geographical distribution of loans by region allows for the monitoring of credit risk arising from exposure to particular countries or group of countries, and an assessment of the impact of adverse developments in those countries on the domestic financial system through contagion. At the end of December 2004, South Africa's total loans and advances to other parts of the world constituted 10,3 per cent of total banking sector loans and advances. As Figure 8 shows, 78 per cent of that had gone to Europe, 9 per cent to North America and 6 per cent to other African countries. The concentration of loans in Europe is not considered a cause for concern as the loans are dispersed across Europe.

Figure 7: Sectoral distribution* of credit (per cent)



* Classified according to the Standard Industrial Classification (SIC) of all economic activities. Advances to individuals who are owners of one-person businesses or partnerships are included under the relevant industry. Advances to individuals who are employees are included under "individuals" irrespective of the industry in which the individual is employed. Figures may not necessarily add up to 100 due to rounding off.

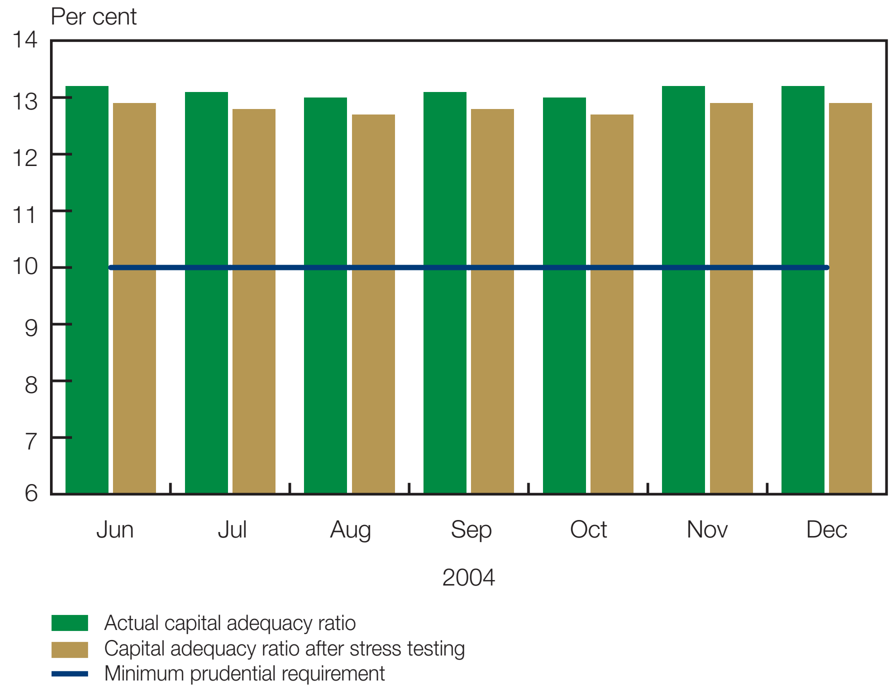
Figure 8: Geographical distribution of foreign loans and advances*



* Total discounts, loans and advances excluding South Africa.
Figures may not necessarily add up to 100 due to rounding off.

Stress testing the vulnerability of the financial system to adverse macroeconomic events is an important tool in assessing financial stability. Stress tests are also designed to assess the ability of banks to absorb potential losses due to adverse economic shocks. The basic method to assess the impact of each variable is to estimate the change in the capital adequacy ratio if the worst-case scenario were to occur to each statistically significant variable. By applying such a test, the banking sector was deemed to be resilient to a range of specific plausible adverse events on loan assets at the end of December 2004. The capital adequacy ratio (after stress testing) remained at 2,9 percentage points above the minimum prudential requirement of 10 per cent (taking the average of the worst-case scenarios of all significant variables into account). It should be noted, however, that second-round effects of such scenarios were not estimated in the model that was used.

Figure 9: Stress testing the resilience of the banking sector

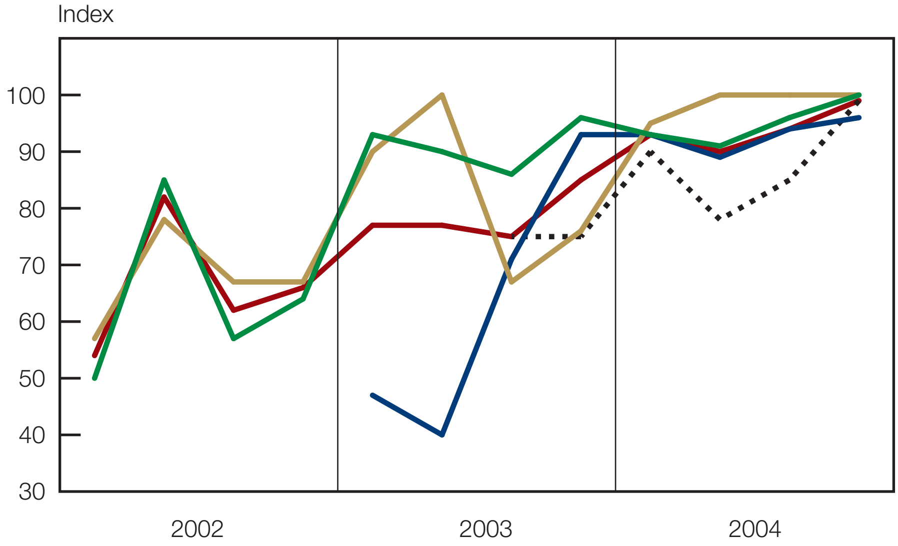


17 The index is based on the results of a survey, which is designed to assist in analysing trends in the banking sector over the short term. The results of the survey reveal current and expected changes in banks' income, expenses, profitability, competitive position, credit standards and investment. The survey also covers life insurers and investment managers.

The Ernst & Young financial services index increased further from 94 index points in the third quarter to 99 index points in the fourth quarter of 2004, reflecting that respondents were highly satisfied with prevailing business conditions[17]. According to Ernst & Young, the factors that contributed to the booming financial sector included low nominal interest rates and low inflation, an appreciating exchange rate, rising share and property prices, strong domestic demand, and a stable political and macroeconomic policy environment. Of the components of the financial services index, the retail banking confidence index increased to 100 index points in the fourth quarter of 2004, mainly reflecting declining NPLs, rising investment values and increasing household demand for loans. The investment managers' confidence index increased slightly to 96 index points while the life insurers' confidence index increased to 99 index points in the fourth quarter of 2004.

Based on the above indicators, the South African banking sector appeared healthy during the period under review. There were no signs of fragility as the trends for all the indicators were within acceptable ranges.

Figure 10: Financial services index and its components*



Financial services index
Retail banking confidence index
Merchant and investment banking confidence index
Investment managers confidence index**
Life insurers confidence index***

* The retail banking, merchant and investment banking, the investment managers and the life insurers' confidence indices are based on the results of surveys and range from a scale of 0 to 100, where 0 shows extreme lack of confidence, 50 is neutral and 100 shows extreme confidence. The financial services index is calculated as the unweighted average of the retail banking, the merchant and investment banking, the investment managers and the life insurers' confidence indices.

** Data are only available from the first quarter of 2003.

*** Data are only available from the third quarter of 2003.

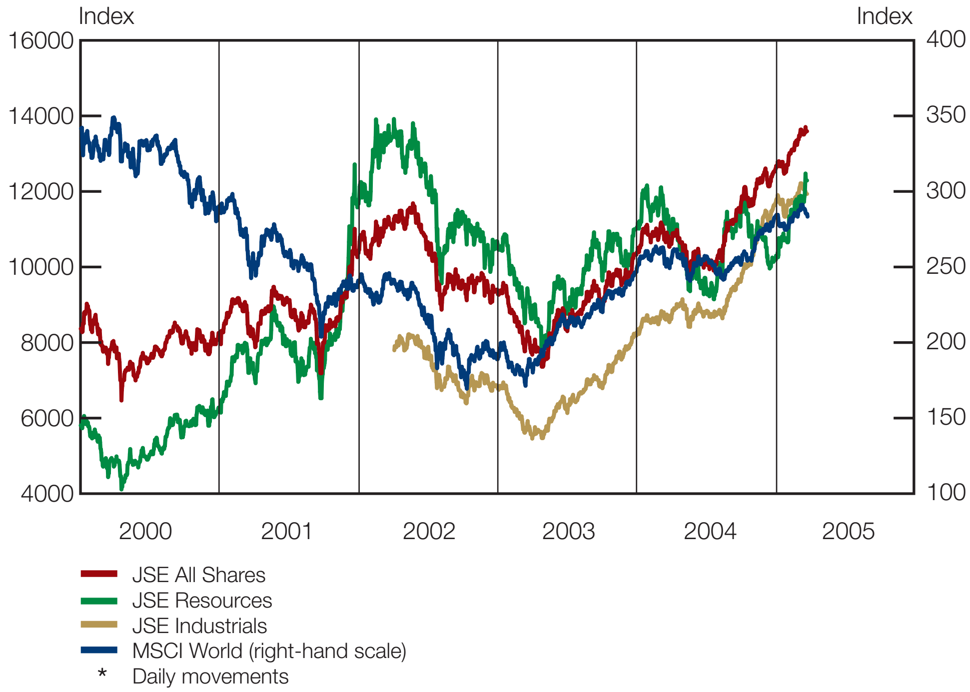
Source: Ernst & Young. *Financial Services Banking Survey.*

Financial markets

Financial markets play an important role in channelling savings to investment projects and in diversifying risk. Developments in financial markets have a direct impact on banking institutions via their portfolio holdings. Wide fluctuations in these markets can threaten financial stability and spread financial instability from one country to another. Developments in domestic and international securities markets are therefore monitored in order to identify potential risks to financial stability.

Movements in share prices reflected a sanguine outlook during the review period. The domestic equity market has been increasing in line with global equity markets. After decreasing for five months ending July 2004, the JSE All-Share Index (ALSI) increased by approximately 29 per cent between August 2004 and February 2005. Factors behind the strong growth included the buoyant economic outlook, low interest rates and market expectations of even lower interest rates that were prevailing at the time, the country's improved ratings outlook and upgrade, and expectations of continued higher corporate profits. After declining for about five months to mid-December 2004 due to the appreciation of the rand, the resources index has been increasing probably due to the stronger global markets and the subsequent good performance of dual-listed companies. Growth in the industrials index has been supported by robust domestic economic conditions. This favourable outlook in the domestic stock market bodes well for financial stability.

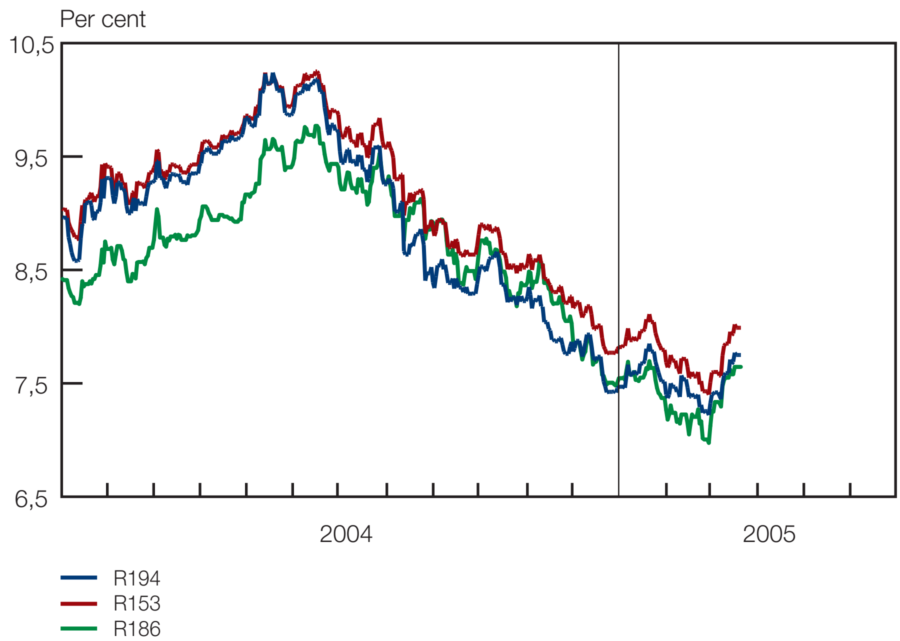
Figure 11: Share price indices*



Source: Bloomberg

Domestic bond yields declined consistently across the board (on average by about 200 basis points) during the reporting period and reached new record low levels in December 2004. Factors which contributed to this downward trend were the persistent appreciation of the rand and the positive outlook for inflation. At these levels, bond yields were vulnerable to a retracement, and should this move have been sudden and

Figure 12: Selected bond yields



Source: Bloomberg

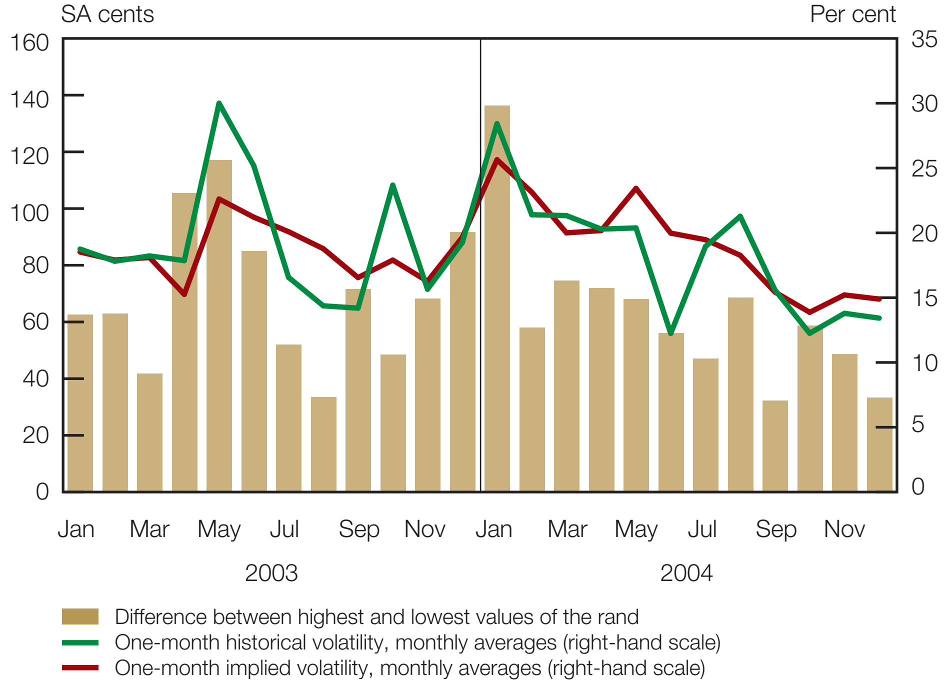
extended it could have caused volatility in financial markets. However, in February 2005 bond yields started to increase and it would appear that the increase is a gradual and controlled correction and therefore does not raise any concerns for financial system stability.

In the *Financial Stability Review* of September 2004 it was reported that the volatility in the exchange rate of the rand against the US dollar diminished markedly during the first half of 2004. This trend continued during the second half of 2004 (Figure 13), partly the result of a policy of building up foreign exchange reserves. The volatility indicators of the rand, especially the one-month historical volatility[18] and the one-month implied volatility[19], remained fairly stable and even moderated slightly as the rand approached the important R6,00 technical level against the US dollar. Since August 2004, the difference between the highest and lowest values of the rand has been fluctuating by between 30 cents and 60 cents, while the one-month implied volatility and one-month historical volatility have been declining fairly consistently over this period. The lower levels of volatility experienced during this time are conducive to long-term economic growth, due to the more certain operating environment for importers, exporters, borrowers and lenders, and hence to long-term financial stability.

18 Historical volatility is the actual intra-day volatility of the rand averaged for the month.

19 Implied volatility is the volatility of the rand based on option pricing.

Figure 13: Volatility indicators of the rand/US dollar exchange rate



Insurance sector

Insurers and banks often have ownership and investment linkages that make each subsector vulnerable to adverse developments in the other. The size and growth in the operations of insurance companies raise a number of issues relating to the overall structure and functioning of the financial system, and thus have implications for financial stability. The ratio of "free assets"[20] to capital adequacy requirement, i.e. the number of times the capital adequacy ratio is covered by free assets, gives an indication of the financial strength of a long-term insurer. Table 2 shows a slight deterioration in solvency

20 Free assets refer to the difference between total assets on the one hand, and the sum of total liabilities and required capital on the other hand. Capital adequacy requirement is defined as the minimum capital required by the Financial Services Board for registration of an insurance company and is equivalent to 13 weeks' worth of operating expenses.

across the various strata compared to December 2003. That did not constitute a serious cause for concern, however, as the category that was covered by free assets of 2 to 5 times, which is generally considered sufficient coverage and which also included the five big insurers, improved compared to the previous year.

Table 2 Free assets and capital adequacy requirement

Free assets to capital adequacy requirement (long-term typical insurers*)	Number of insurers	
	December 2003	December 2004
Covered 0 – 1 time	2	1
Covered 1 – 2 times	5	4
Covered 2 – 5 times	17	20
Covered 5 – 10 times	3	2
Covered 10 + times	3	2
Total	**30**	**29**

* *Typical insurers are those that offer most of the six classes of business as defined in the Long Term Insurance Act, No 52 of 1998. The figures are not audited.*

Source: Financial Services Board

Compared to the year before, the number of new policies for long-term insurers increased by 19 per cent in 2004. Individual lapses and surrenders of policies for long-term typical insurers decreased from 31 to 24 per cent and from 25 to 20 per cent, respectively. The decrease in lapses and surrenders, coupled with an increase in the number of new policies, bodes well for the health of the insurance sector.

Table 3 Surrenders and lapses of policies for long-term typical insurers

	2001	2002	2003	2004
Individual lapses*	31	26	31	24
Individual surrenders*	27	23	25	20
Annual percentage change in the number of new policies	14	(14)	1	19

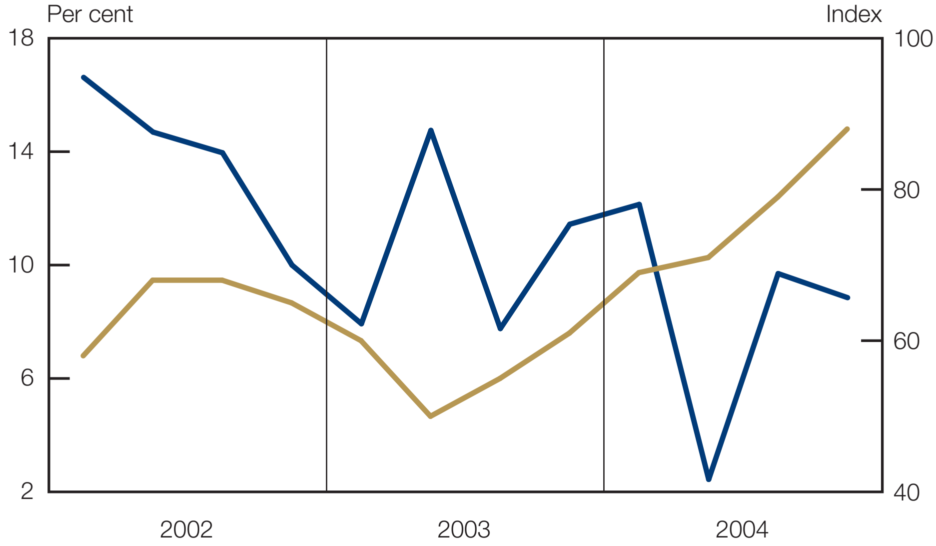
* *Expressed as a percentage of the number of new policies issued during the period using unaudited statistics.*

Source: Financial Services Board

Corporate sector

The Rand Merchant Bank/Bureau for Economic Research (RMB/BER) business confidence index jumped by 9 index points in the fourth quarter of 2004 to 88 index points, and was three index points short of the historical high of 91 index points recorded in the third quarter of 1980. Confidence rose in four of the nine economic sectors, but the main improvement occurred among building contractors, with the manufacturing sector lagging due to the impact of the rand’s strength on the manufacturers’ ability to compete. The annual growth rate of credit to corporations decreased from 9,7 per cent in the third quarter to 8,9 per cent in the fourth quarter of 2004.

Figure 14: Business confidence index and credit to the corporate sector*

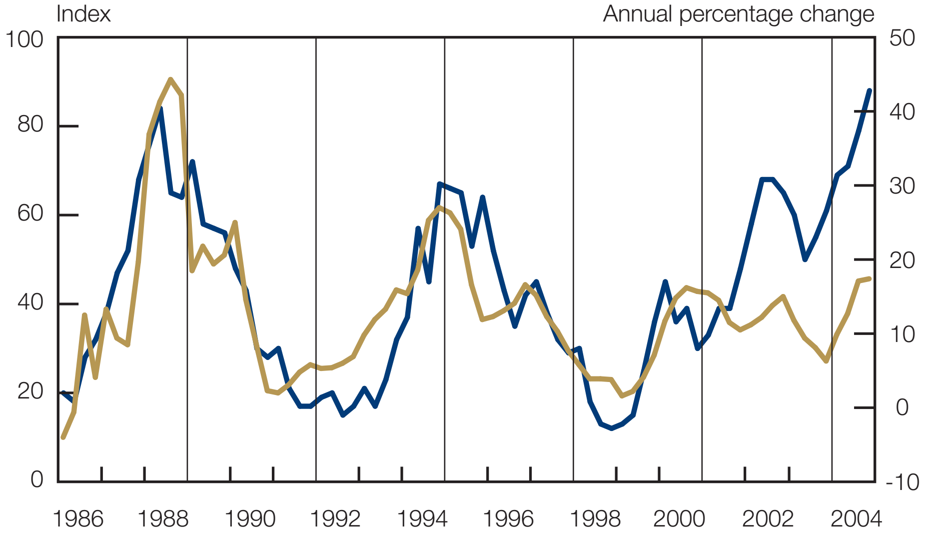


Credit to corporations (year-on-year)
Business confidence index (right-hand scale)
* Credit to the corporate sector includes instalment sales transactions, leasing transactions, mortgage advances, overdrafts, credit card debtors and other loans and advances.

Source: Rand Merchant Bank and South African Reserve Bank

There is a high correlation between business confidence and gross fixed capital formation (see Figure 15). Gross fixed capital formation increased at an annual rate of 17,4 per cent in the fourth quarter of 2004 from 17,1 per cent in the third quarter. The increase in business confidence therefore bodes well for investment, which, in turn, is favourable to financial system stability.

Figure 15: Annual growth in gross fixed capital formation and business confidence index*

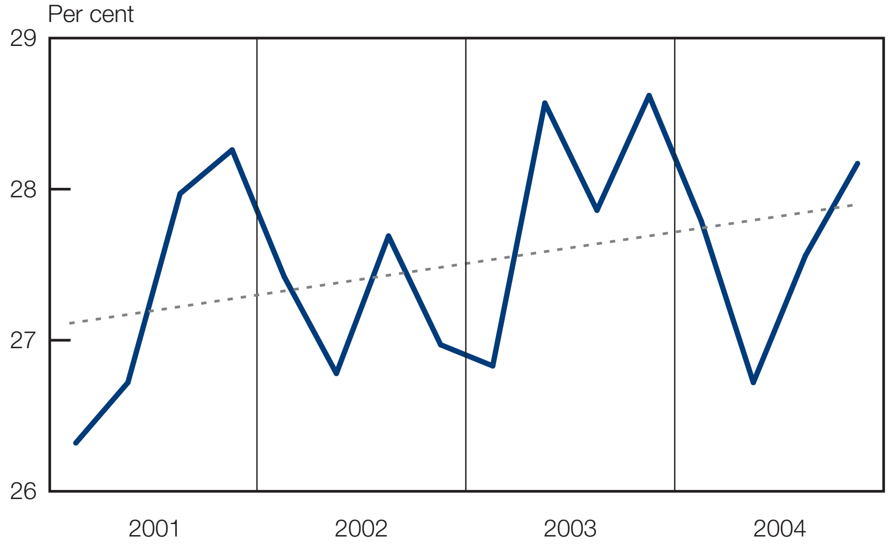


Business confidence index
Gross fixed capital fomation (right-hand scale)
* Business confidence is measured on a scale of 0 to 100, where 0 indicates an extreme lack of confidence, 50 neutrality and 100 extreme confidence. Gross fixed capital formation is used as a proxy for investment by private business enterprises.

Source: Rand Merchant Bank and South African Reserve Bank

Rapid growth in the ratio of private sector credit to GDP could be an indication of a lending boom. Such booms need to be monitored closely as they have preceded financial crises in the past. Credit to corporations as a percentage of GDP increased from 27,6 per cent in the third quarter of 2004 to 28,2 per cent in the fourth quarter. Growth in corporate sector credit was still lower than the nominal growth rate of the economy. In the fourth quarter of 2004, credit to the corporate sector increased at an annual rate of 8,9 per cent, while the nominal annual growth rate of the economy was 10,6 per cent.

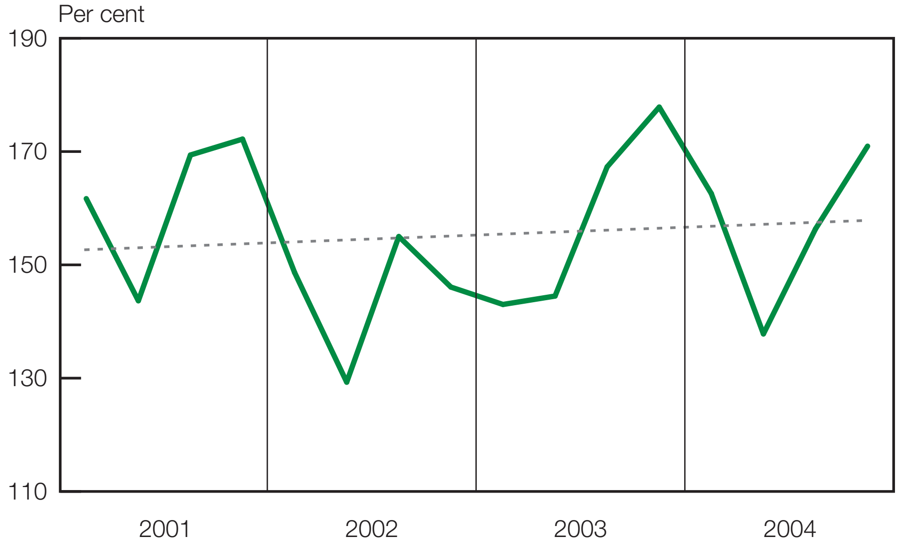
Figure 16: Credit to the corporate sector* as percentage of gross domestic product



--- Trendline

* Credit to the corporate sector includes instalment sales transactions, leasing transactions, mortgage advances, overdrafts, credit card debtors and other loans and advances.

Figure 17: Credit to the corporate sector as percentage of annualised profits*



--- Trendline

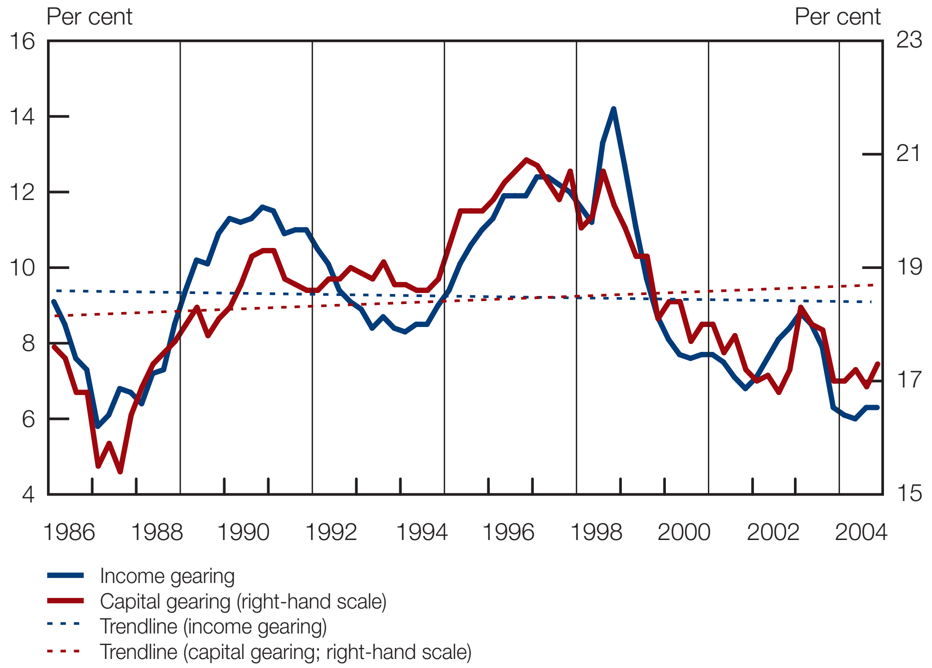
* Credit to the corporate sector and net operating surplus of corporations were used as proxies for corporate debt and corporate profits, respectively.

The ratio of corporate debt to profits measures the debt-servicing capacity of businesses and is therefore directly related to financial system stability. This ratio increased from 156,3 per cent in the third quarter to 171 per cent in the fourth quarter of 2004.

Household sector

Income and capital gearing ratios are useful financial stability indicators for the household sector. Respectively, they show the extent to which disposable income covers the financial costs of household debt and total assets cover household debt. Compared to the third quarter of 2004, income gearing remained unchanged at 6,3 per cent in the fourth quarter. Capital gearing increased marginally from 17 per cent in the third quarter to 17,3 per cent in the fourth quarter of 2004. These gearing ratios indicate that household debt is not growing too rapidly, which is a positive development for financial stability.

Figure 18: Household sector income and capital-gearing ratios*

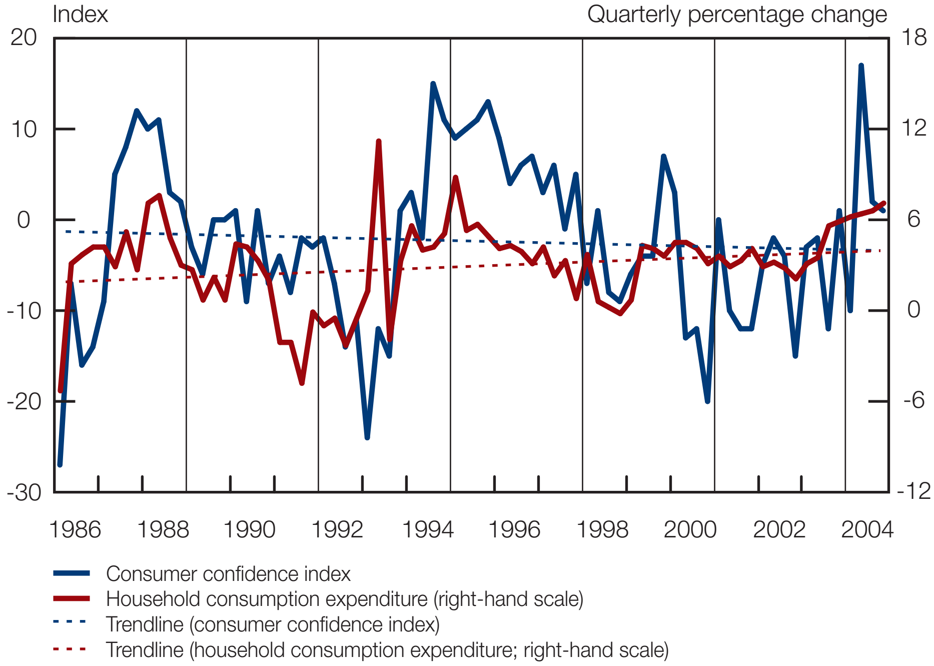


* Income gearing refers to financing costs of household debt as percentage of disposable income and capital gearing refers to household debt as a percentage of total assets of households.

The First National Bank/Bureau for Economic Research (FNB/BER) consumer confidence index dropped from 2 index points in the third quarter to 1 index point in the fourth quarter of 2004. The consumer confidence index was, however, still considered to be relatively high, as it was above the long-term average of -4 index points. Household consumption expenditure nevertheless increased slightly from 6,6 per cent in the third quarter to 7,1 per cent in the fourth quarter of 2004, further confirming that consumer confidence is not a cause for concern for financial stability.

The number of insolvencies is a useful indicator of the extent of unpaid debt by the household sector and close corporations (see Figure 20). The number of insolvencies decreased by 42,4 per cent from December 2003 to December 2004. The decline could be ascribed to a relaxation of monetary policy since 2003. The decline in the number of insolvencies bodes well for banking sector stability as the household sector and small businesses are among the major clients of banks.

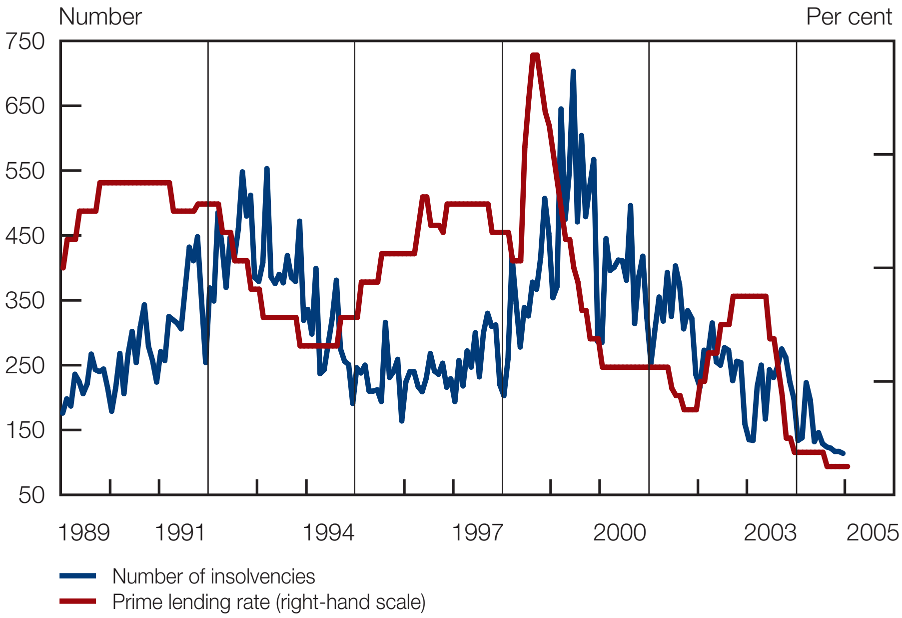
Figure 19: Quarterly growth in household consumption expenditure and consumer confidence index*



* The consumer confidence index is expressed as a net balance between optimistic and pessimistic consumers. According to the BER, the index can vary between –100 for extreme pessimism and +100 for extreme optimism.

Source: Bureau for Economic Research and South African Reserve Bank

Figure 20: Number of insolvencies* and prime lending rate

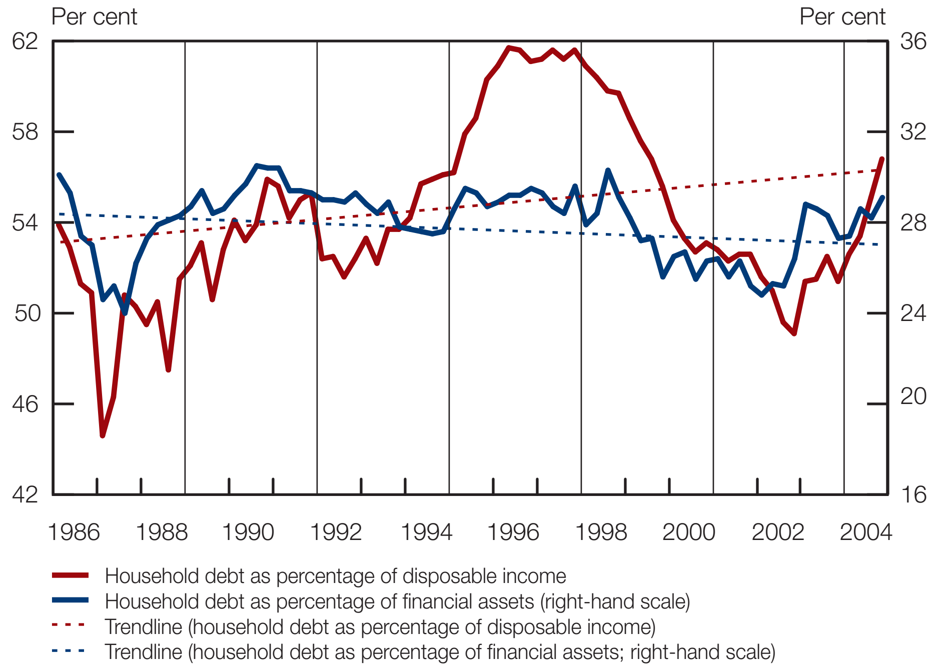


* Information on insolvencies is based on Notices of the Master of the Supreme Court. It is a useful indicator of the scope of unpaid debt by the household sector and close corporations.

Source: Statistics South Africa and South African Reserve Bank

Loans to the household sector constitute a significant part of banks' portfolios. Banks are exposed to households directly through their repayment capacity on consumer and mortgage loans, as well as indirectly through the effect that household consumption decisions have on the financial strength of the corporate sector. The debt servicing capacity of households therefore has a major impact on the health of the banking sector and financial stability. The ratio of household debt to disposable income increased from 55,1 per cent in the third quarter of 2004 to 56,8 per cent in the fourth quarter, the highest level recorded since the fourth quarter of 1999. The ratio has been increasing for four consecutive quarters but was still below the peak of over 60 per cent recorded between 1996 and 1998, and was therefore not considered out of line with the current business cycle. Measured as a percentage of household financial assets, household debt increased from 28,2 per cent in the third quarter of 2004 to 29,1 per cent in the fourth quarter.

Figure 21: Household debt as percentage of disposable income and financial assets* respectively



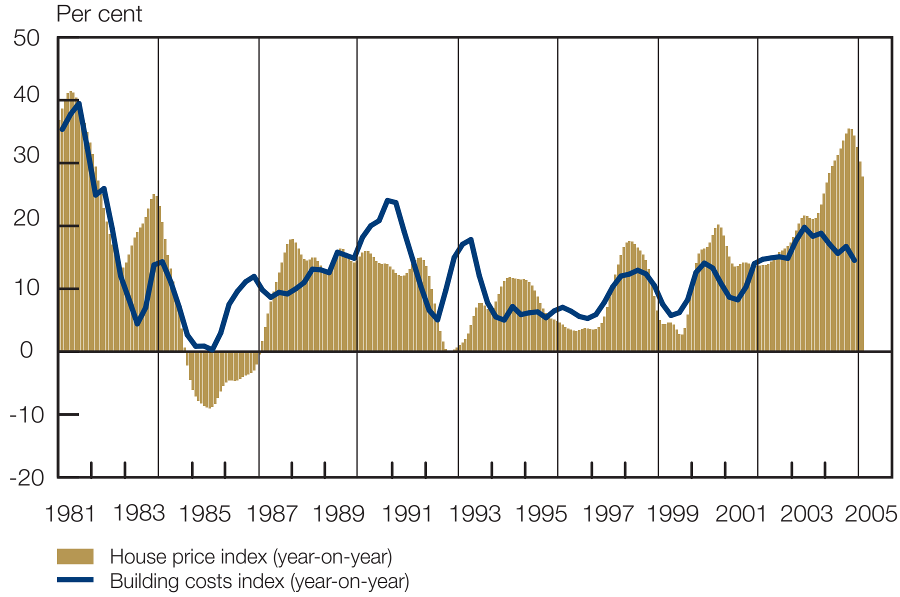
* Financial assets include household deposits with financial institutions, their share in pension funds and a proxy for their holdings of shares.

Real-estate sector

According to the Absa house price index, growth in house prices reached a peak in September 2004 at an annual rate of 35,5 per cent, slowing down subsequently to 27,8 per cent in February 2005. House price growth appears to be tracking the trend in building costs. The building costs index peaked at an annual growth rate of 19,8 per cent during the second quarter of 2003 and has since been decreasing, recording a year-on-year growth rate of 14,5 per cent by the fourth quarter of 2004. In contrast to the early 1980s when prices fell from a peak of 41,5 per cent in May 1981 to -9 per cent in July 1985, the current downward adjustment takes place against the backdrop of a strong economy, a low inflation and interest rate environment and a housing market expansion due to the emergence of a black middle class.

According to Absa, the month-on-month annualised growth rate in house prices has continued its downward trend, decreasing from 41,4 per cent in February 2004 to 12,6 per cent in February 2005, suggesting a further gradual moderation in the rate of house price increases in 2005, reducing the probability of a sudden harmful over-correction in house prices (bursting of a bubble).

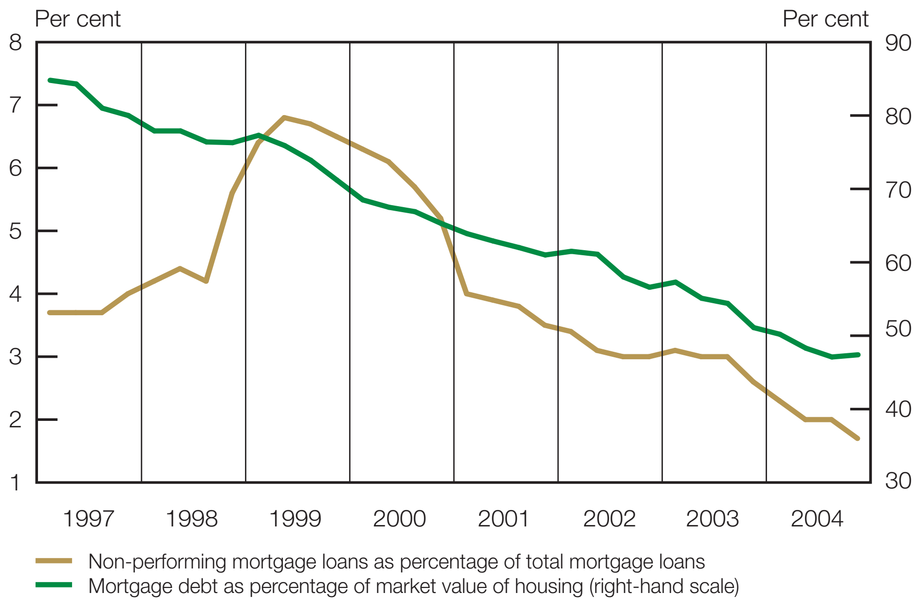
Figure 22: House price index* and building costs



* The house price index is based on the total purchase price of houses in the $80m^2 – 400m^2$ size category valued at R1,5 million or less in respect of which loan applications were approved by Absa.

Source: Absa Bank and South African Reserve Bank

Figure 23: Non-performing mortgage loans and mortgage debt



The low inflation and interest rate environment as well as the strong performance of real-estate prices have led to an increase in the growth rate of mortgage advances. Mortgage advances to the domestic private sector have been increasing since June

2003 in line with increased demand for housing, thereby supporting the current house price surge that began in September 2003. The annual growth rate of mortgage loans increased from 16 per cent in December 2003 to 24,1 per cent in December 2004.

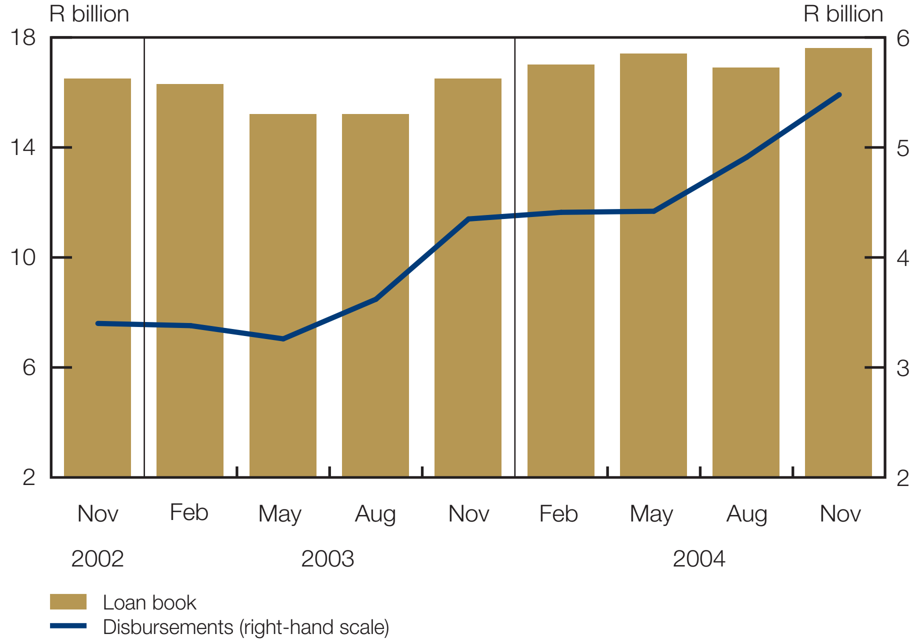
NPLs give an indication of potential losses from credit extended. Non-performing mortgage loans as a percentage of total mortgage loans have been decreasing since the third quarter of 1999 and stood at 1,7 per cent by the end of the fourth quarter of 2004. A decline in the ratio of NPLs as a percentage of total mortgage loans reflects the increased ability of customers to service mortgage debt obligations. A downward trend in the ratio of mortgage debt to market value of housing also implies that mortgage debt is growing at a slower rate compared with growth in prices. The percentage of mortgage debt to market value of housing remained almost unchanged at 47,4 per cent in the fourth quarter of 2004, compared to 47,1 per cent in the third quarter.

Micro-finance sector

Non-bank micro-finance institutions and banks often have ownership and investment linkages that make each subsector vulnerable to adverse developments in the other. Moreover, micro-lenders are major clients of banks. Their vulnerability can, therefore, have spill-over effects on the banking sector. Statistics from the Micro Finance Regulatory Council (MFRC) indicate robust micro-lending activity for the quarter ending November 2004[21]. The total loan book was estimated at R17,6 billion at the end of November 2004, slightly up from R16,9 billion at the end of August 2004. The recorded value of loan disbursements was estimated at R5,5 billion at the end of November 2004, up from R4,9 billion at the end of August 2004. Growth in disbursements over the past year was largely driven by increases in lending by existing banks and private micro-finance companies, while the slow growth in the loan book was driven by write-offs totalling more than R150 million. These write-offs, however, constituted a small percentage of total loans and did not pose a threat to the micro-finance sector. According to the MFRC, those write-offs reflected old lending and did not indicate problems with new lending.

21 The MFRC quarters run from March to May, June to August, September to November and December to February.

Figure 24: Micro-finance loan book and disbursements as at the end of each quarter



Source: Micro Finance Regulatory Council

Infrastructure and regulation

Appraisal of the South African financial system

The Bank broadened its focus on the promotion of overall financial system soundness a number of years ago by, *inter alia*, conducting qualitative appraisals of the domestic financial system environment in order to detect potential vulnerabilities, mitigating the risks where possible and monitoring progress on reforms. The approach followed in these appraisals is to systematically evaluate laws, regulations, standards and practices, which underline the financial system environment, against the Financial Stability Forum's (FSF's) 12 internationally accepted standards and codes[22]. In addition, useful information is obtained from findings by independent bodies such as the IMF and the World Bank e.g. reports completed as part of the joint World Bank-IMF programme styled Reports on the Observance of Standards and Codes (ROSCs), Article IV Consultations with the IMF and findings of the South African Financial System Stability Assessment (FSSA) that forms part of the joint IMF-World Bank Financial Sector Assessment Program (FSAP)[23].

The implementation of standards in itself is, however, not sufficient to ensure financial stability. Standards are not an end in themselves but a means for promoting sound financial systems and sustainable economic growth.

This section is about the FSF's 12 key economic and financial standards and codes (12 standards), their financial stability significance and a brief overview of some of the key developments in South Africa pertaining to the 12 standards.

As explained in the March 2004 *Financial Stability Review*, the international financial community considers the adoption and implementation of sound standards and codes as crucial because they enhance global and national financial system stability. High priority should therefore be given to the continuous implementation of the 12 standards identified by the FSF as important for sound, stable and well-functioning financial systems. Regulatory authorities alone cannot achieve this important objective. Market participants also need to share the responsibility by acting in a manner that enhances the robustness of the financial system.

Furthermore, the adoption and successful implementation of the 12 key standards promote international financial stability by facilitating better-informed lending and investment decisions, improving market integrity, and reducing the risks of financial distress and contagion.

The 12 key standards are grouped according to 3 broad areas, namely:
- transparency standards and codes (monetary and financial policies transparency, fiscal transparency and data quality);
- market integrity standards (accounting, auditing, corporate governance, insolvency, anti-money laundering and payment systems); and
- financial regulation and supervision standards (banking, insurance and securities).

Transparency standards and codes

Code of Good Practices on Transparency in Monetary and Financial Policies

Transparency (or disclosure) refers to an environment in which the objectives of government policy, its legal, institutional and economic framework and the terms of

22 The FSF was established by the Group-of-seven (G7) in April 1999 to promote international financial stability, improve the functioning of markets and reduce systemic risk through information exchange and international co-operation in financial supervision and surveillance. The FSF promotes the adoption of the 12 globally accepted key standards, set by various international bodies, for sound financial systems.

23 There are two types of external assessment mechanisms for international standards, namely the Financial Sector Assessment Program (FSAP) and Reports on the Observance of Standards and Codes (ROSCs). The comprehensive nature of these assessments requires a wide range of analytical tools and techniques, including macroprudential analysis, stress testing and scenario analysis, and assessments of observance and implementation of relevant international financial sector standards, codes and good practice.

financial agencies' accountability are provided to the public in an understandable, accessible and timely basis. Improved transparency should lead to better-informed public debate about the design and results of economic policy and make governments more accountable for the implementation of policy, thus strengthening credibility and public understanding. The Code of Good Practices on Transparency in Monetary and Financial Policies is based on two broad principles. *Firstly*, the public must be informed of the goals and the instruments of policy and the authorities must make a credible commitment to meeting them. *Secondly*, central banks and financial agencies[24] should be held accountable for their actions.

Policy influences on the financial environment

The focus of the Financial Stability Forum[25] is on the 12 key economic and financial standards which are generally accepted by the international community as being objective and relatively free of national biases. There is, however, a broad range of political, social, legal and institutional factors that could also influence financial stability. Some of these developments that are influencing the South African financial system as a whole include the following:

Reforming crucial financial legislation: The first democratic election in April 1994 set the scene to reintegrate the South African financial sector into the global environment. Far-reaching financial reforms took place as the country adapted to the new socio-political structure and international demands for South Africa to adhere to the disciplines of the global market economy. While there is a lag in reforming outdated legislation, there is also a flow of new and proposed financial legislation that significantly affects the way financial institutions and advisers conduct business. The emphasis increasingly shifted towards consumer protection, black economic empowerment, regional co-operation and the adherence to international standards.

Broadening access to financial services: It is of crucial importance to reduce the economic inequalities in society by improving basic access to financial services. The removal of discriminatory practices on non-commercial bases and the limited financial and broader infrastructural support available to small, medium and micro enterprises, receive ongoing attention from regulatory authorities and social partners. Initiatives include a commitment to expand access to financial services in terms of the Financial Sector Charter, increased disclosure on lending practices for addressing the inefficiencies in the consumer credit market, and the development of a multi-tiered banking sector.

Increased competition: It is generally accepted that increased competition improves efficiency in the economy and lowers costs to the consumer. A financial environment with a competitive infrastructure therefore needs to be promoted. The financial markets are increasingly opening up to foreign competition, which is generally regarded as a valuable source of innovation, new technology and management skills. The removal of unnecessary barriers is reviewed on a continuous basis by policy-makers and regulatory authorities to ensure a level playing field for all market participants.

Enhancements to the financial safety net: The design of financial safety nets for the handling of banking crises is of particular importance to protect the public against the consequences of financial disruption and to limit the risk of contagion and systemic instability[26]. In this regard, the introduction of a deposit insurance scheme is currently under consideration by the financial sector regulatory authorities. A high degree of care in its development is required to ensure that the level of coverage is not too high that it increases moral hazard or too low that it fails to promote confidence in the financial system. The key challenge remains co-ordination and co-operation between the various financial safety net players. To this end, cross-sectoral regulatory committees have been established to co-ordinate financial sector crisis responses and to facilitate business and economic continuity.

Review of the regulatory architecture: The blurring of boundaries between different financial institutions and products as well as financial institutions merging into ever more complex financial conglomerates have led to a need for more consolidated supervision, consumer education and co-operation between different regulators. It seems likely that changes will have to be made to the current regulatory architecture to address this issue. The challenge is to ensure that such changes will be appropriate to local conditions.

Significant progress has been made in South Africa to enhance transparency and public understanding of monetary policy, especially since the formal adoption and implementation of inflation targeting as its monetary policy framework. The Bank has a

24 The term "financial agencies" in the Monetary and Financial Policies Transparency (MFPT) Code is defined as the agency/institution which carries exclusive or primary responsibility for the regulation, supervision, and oversight of the financial and payment systems, including markets and institutions. The term "financial policies" in the MFPT Code refers to the policies related to the regulation, supervision, and oversight of the financial and payment systems, including markets and institutions, with the view to promoting financial stability, market efficiency, and client-asset and consumer protection.

25 The Financial Stability Forum, housed at the Bank for International Settlements in Basel, Switzerland, promotes the adoption of 12 globally accepted key standards set by various international bodies, for sound financial systems. Details of the standards can be viewed on the website of the Financial Stability Forum available at: http://www.fsforum.org

26 The financial safety net typically comprises three broad components. Firstly, *the liquidity support facility of the central bank for illiquid, but solvent banks,* secondly, *a deposit insurance scheme to compensate retail depositors in case of bank failure and* thirdly, *support for systemically significant banks in distress.*

27 *The* Monetary Policy Review *can be accessed online at: http://www.resbank.co.za*

policy of publicly reporting on and explaining its monetary policy stance and direction, its financial policy decisions, the inflation targets it pursues and the instruments it uses in order to make monetary and financial policies effective. In this regard, the Bank has been publishing its *Monetary Policy Review*[27] on a semi-annual basis since 2001. The composition of the decision-making bodies is made known while the independence of the Bank and the requirement to consult on a regular basis with government is enshrined in legislation in order to address the requirements of accountability.

Code of Good Practices on Fiscal Transparency

Good governance is critical to the achievement of macroeconomic stability and sustainable economic growth. Fiscal transparency is a key aspect of good governance. It strengthens accountability of government and decreases the risk of unsustainable policies. The benefits include enhanced credibility, lower borrowing costs, stronger support for sound economic policies by a well-informed public, and stable economic growth. The Code of Good Practices on Fiscal Transparency contains transparency requirements to provide assurances to the public and capital markets that sufficient information about the fiscal structure (government revenues, expenditures, borrowing and financing) and functions of government, its fiscal policy intentions, public-sector accounts and fiscal projections are available.

South Africa has made rapid advances in the area of fiscal transparency during the past few years by making available routinely a wide range of data. The IMF has conducted a ROSC on Fiscal Transparency and concluded in the 2002 Article IV Consultation report that the quality of fiscal management and transparency in South Africa is high by international standards. The Constitution of the Republic of South Africa, Act No 108 of 1996, sets out the responsibilities of and roles across the different levels of government. The passing of legislation, such as the Public Finance Management Act, No 1 of 1999, provided a legal framework for fiscal management. The *Budget Review*, *Medium Term Budget Policy Statement* and the Bank's *Quarterly Bulletin* are some of the communication tools used to ensure that fiscal data are readily available. The South African government was recently commended by the IMF for its strong record of fiscal discipline in the face of budgetary pressures, which has helped keep long-term interest rates low, maintained a competitive exchange rate and revived confidence in the economy. The IMF also expressed its strong support for the policy of the gradual phasing out of the remaining exchange controls (see box "The gradual phasing out of exchange controls" for more information).

The gradual phasing out of exchange controls

The responsibility for exchange control policy is vested with the Minister of Finance, who has delegated the powers outlined in the Exchange Control Regulations to the Exchange Control Department of the South African Reserve Bank (the Bank). The Bank implements and administers exchange control and acts as an adviser to the Minister of Finance in respect of exchange control policy.

After the first democratic elections in April 1994 it was accepted as a policy objective of the newly elected government to abolish the remaining exchange controls. The government is committed to a gradual process of exchange control liberalisation that takes into account critical sequencing considerations. Progress that has been made since 1994 includes:

- The removal of exchange controls applicable to non-residents.
- The removal of exchange controls on current-account transactions.
- The termination in 1995 of the two-tier exchange rate system ("financial-rand system").
- South African corporates are allowed to effect significant direct foreign investments, subject to certain conditions.

- South African resident private individuals are allowed to transfer limited amounts of capital from South Africa for foreign investment purposes.
- The debt standstill arrangements, which placed a restriction on the repayment of a part of South Africa's foreign debt, expired on 15 August 2001.
- Funds belonging to former residents (emigrants' blocked funds) may be transferred abroad, subject to an exiting schedule and an exit charge of 10 per cent of the relevant amount.
- To assist individuals with funds illegally held offshore and who wish to bring those funds back to South Africa without the risk of prosecution, Government announced a joint amnesty with respect to foreign assets in terms of both the Exchange Control Regulations and the Income Tax Act.

The gradual phasing out of the remaining exchange controls allows Government more time to implement other policy changes in order to achieve the preconditions necessary for a successful abolition of exchange controls.

Special Data Dissemination Standard

Availability of information allows market participants to compare economic, financial and socio-demographic information to agreed-upon and internationally accepted benchmarks, leading to a better appreciation of policy actions as well as informed lending and investment decisions. Countries subscribing to the Special Data Dissemination Standard (SDDS) issued by the IMF undertake to follow good statistical practices in four dimensions, namely timeliness of data, accessibility by the public, integrity and quality of the disseminated data.

South Africa has met the SDDS specifications since 2000 and posts data on the IMF's Dissemination Standards Bulletin Board on the real, fiscal, financial and external sectors, as well as on the population. The IMF's 2004 Article IV consultation with South Africa concluded that the economic data are generally of high quality and fully adequate for surveillance purposes. The South African authorities were encouraged to address remaining weaknesses in employment and other labour market data as labour market statistics are published with lags of about six months, and unemployment data are available only half-yearly. Efforts are underway to implement the recommendations of the IMF's 2003 and 2004 monetary and financial statistics missions towards full implementation of the methodology recommended in the IMF's *Monetary and Financial Statistics Manual*.

Market integrity standards

International Accounting Standards and International Standards on Auditing

With greater cross-border capital movements, the need for increased consistency, transparency and comparability of financial information has become more acute. The reliability of financial information is critical to informed decision-making in the financial sector. The practical effectiveness of many of the 12 key standards relies heavily on the quality of the underlying data and associated accounting and auditing practices. A single set of high-quality, understandable and comparable global accounting and auditing standards (the International Accounting Standards and International Standards on Auditing issued by the International Accounting Standards Board and the International Federation of Accountants) has been developed to allow for transparent and comparable information[28].

28 The accounting and auditing standards were combined for pragmatic reasons.

South Africa has already completed its harmonisation process of local accounting standards with international standards some years ago. Companies listed on the JSE

Securities Exchange SA (JSE) are required to comply with international financial reporting standards for financial periods beginning on or after 1 January 2005. Local auditing standards are reaching the point of full harmonisation with international auditing standards. Some other key developments underway include the Draft Auditing Profession Bill that will regulate the auditing profession and provide for professional development of its members, the drafting of appropriate legislation that will give legal backing to accounting standards and proposed amendments to the Companies Act, No 61 of 1973, to take into account new developments in corporate financial reporting.

Principles of Corporate Governance

Good corporate governance is essential for companies that require access to international capital and for countries that want to stimulate private-sector investment. The integrity of corporations, financial institutions and markets is particularly central to the health of economies, their stability and the welfare of individuals. Poor corporate governance can lead to the abuse of power that could cause corporate failure. The Principles of Corporate Governance issued by the Organisation for Economic Cooperation and Development, were devised with four fundamental concepts in mind, namely responsibility, accountability, fairness and transparency. The principles in the standard are aimed at improving the legal, institutional and regulatory framework for corporate governance.

Significant progress on applying principles of good corporate governance has been achieved in South Africa since 1994. A committee, led by businessman and ex-judge Mervyn King, compiled a Code of Corporate Practices and Conduct (King I) in 1994, which was revised in 2002 (King II). The King reports helped to establish South Africa as a country that embraces good corporate governance principles. There were also other significant legislative developments[29] since the publication of the King reports. However, South Africa's corporate law does not currently fully embrace the principles of good governance, but this is being addressed by the Department of Trade and Industry's Corporate Law Review initiative.

29 Developments include the introduction of the Insider Trading Act (Act No 135 of 1998, providing for the monitoring of insider trading), amendments to the Banks Act (Act No 94 of 1990, enforcing higher levels of corporate governance compliance and risk reporting in the banking sector) and the Public Finance Management Act (Act No 1 of 1999, bringing into force more stringent provisions for reporting and accountability in the public sector).

Core Principles for Systemically Important Payment Systems and Recommendations for Securities Settlement Systems

Disruption to a systemically important payment system could threaten the stability of markets both domestically and internationally. Default by one participant can easily cause the failure of other participants in the system. A major payment system failure would bring countless commercial transactions to a halt, impede the operation of business in virtually all parts of the economy and fundamentally undermine investor and business confidence. The Core Principles issued by the Committee on Payment and Settlement Systems identify the minimum requirements that should be met for securities settlement, risk management, access, governance, efficiency, transparency, oversight and the best practices that regulators and systems should strive for.

Reduction of foreign exchange settlement risk

Following the direct participation by members of the local banking industry, the South African rand was only the fifteenth currency added to the Continuous Linked Settlement (CLS) system which is likely to enhance the attractiveness of South Africa as an investment destination. CLS is a concept pioneered by the major international players in the foreign exchange market to reduce settlement risk (often referred to as Herstatt risk[30]) arising from the gross settlement of foreign exchange trades by settling foreign exchange transactions finally and irrevocably. CLS settles both currency legs of a foreign

30 On 26 June 1974, Herstatt Bank had taken in all its foreign currency receipts in Europe, but had not made any of its US-dollar payments when German banking regulators closed the bank. At the end of the particular business day, counterparties were therefore left with unsecured claims against an insolvent bank's assets.

exchange trade transaction simultaneously, irrespective of time zones. The Bank worked closely with the major role-players to prepare for the implementation of the inclusion of the South African rand as a currency in the CLS system. With reference to the article that appeared in the previous issue of the *Financial Stability Review*[31], the required amendments to the National Payment System Act, No 78 of 1998, have been made with the assistance of the National Treasury. In December 2004, the Bank announced the successful implementation of the rand as a settlement currency in the CLS system. The inclusion of the rand in the CLS will not only reduce the foreign exchange settlement risk, but will also provide valuable real-time settlement information to the Bank that could further improve the management of settlements.

31 Financial Stability Review. *September 2004. Oversight of the national payment system in South Africa, p.33.*

The Bank oversees the safety and soundness of the national payment system and implements risk-reduction measures in the payment system to reduce systemic risk[32]. The South African Multiple Option Settlement system became operational in 1998. Furthermore, the South African rand was included in the Continuous Linked Settlement (CLS) system in December 2004 to mitigate foreign exchange settlement risk (see box “Reduction of foreign exchange settlement risk” for more information). The National Payment System Act, No 78 of 1998, was amended in 2004 to provide the Bank with increased regulatory power to oversee the national payment system and to cater for broader access to and participation in the payment system. In addition, the Bank is continuously evaluating its position in respect of the use of electronic money in the payment system.

32 *See the September 2004 issue of the* Financial Stability Review *for an article on the oversight of the national payment system in South Africa.*

The 40 Recommendations of the Financial Action Task Force on Money Laundering and 9 Special Recommendations on Terrorist Financing

In response to mounting international concern over money laundering, and in recognition of the threat posed to the global banking system and to financial institutions, the Financial Action Task Force (FATF) has developed 40 principles to combat money laundering. The FATF has subsequently added an additional 9 Special Recommendations, which set out the basic framework to detect, prevent and suppress the financing of acts of terrorism. Non-compliance with these principles, commonly referred to as the “40 plus 9 Recommendations”, is likely to undermine investor and business confidence in an economy, would affect sentiment towards the country and may result in a possible country down-grading by the rating agencies. The recommendations are aimed at improving the criminal justice system and law enforcement procedures, establishing the role of the financial system and regulation and strengthening of international co-operation.

South Africa is the only country in Africa that is a member[33] of the FATF, following the FATF evaluation that took place in 2003. The second round of evaluation is likely to take place in 2006. To be fully compliant with the 40 plus 9 Recommendations, South Africa still faces some challenges, especially with regard to the successful implementation of all the statutory requirements of the Financial Intelligence Centre Act[34] and the legislation governing the financing of terrorism[35].

33 *List of FATF members can be viewed on the following web-site: http://www.fatf-gafi.org*

34 *Act No 38 of 2001, which came into operation in February 2003.*

35 *Protection of Constitutional Democracy against Terrorist and Related Activities* Act, No 33 of 2004.

Principles and Guidelines on Insolvency Systems

The need for appropriate insolvency systems became most apparent with the financial crises that hit emerging markets especially in Asia in the mid-1990s. The banking community responded with a series of initiatives to encourage and assist emerging-market economies to build effective insolvency systems. Where there is clarity as to the rights attaching to financial assets pre- and post insolvency, financial institutions can leverage their lending capacity by securitising financial assets. The principles and guidelines set by the World Bank cover creditor rights, the legal framework, the regulatory framework and the enabling framework for credit risk management and business rescues.

The South African insolvency system is generally regarded as pro-creditor with effective enforcement of secured and unsecured creditor rights. The general legal framework for the insolvency system is well established, albeit fragmented in a number of legislative pieces. The Cross-Border Insolvency Act, No 42 of 2000, was promulgated to govern the mechanisms for dealing with cases of cross-border insolvency. Further recent improvements include the proposed unification of insolvency laws and increased usage of corporate rescues as opposed to liquidation. The administration process at the Master's Office is being enhanced while statutory regulation of the insolvency industry is receiving attention.

Anti-money laundering measures in South Africa

Money laundering is the process whereby criminals attempt to change the nature of their crime proceeds to create the impression of wealth obtained by legitimate means. This enables them to enjoy the proceeds of their crime without interference from the authorities. Throughout the world anti-money laundering legislation and regulations are being developed as part of a strategy to take the profit out of crime by confiscating the proceeds thereof. The acceptance of South Africa in 2003 as a full member of the Financial Action Task Force (FATF) is a significant milestone in the fight against money laundering. As part of compliance with the 40 plus 9 Recommendations of the FATF, South Africa developed a comprehensive legal structure to combat money laundering.

To comply with the South African Financial Intelligence Centre Act (Act No 38 of 2001), banks had to verify the identities of some 17 million existing clients. The initial deadline of 30 June 2004 was extended by the Minister of Finance to 31 October 2004 for high-risk clients and 30 September 2006 for the lowest-risk clients. In order to give practical effect to their legal obligations, banks froze the accounts of non-cooperative clients after the deadline for high-risk clients was reached. These clients would not be able to withdraw money until they provided the required documentation to re-identify themselves in terms of the Act. It is expected that all the major role-players will continue to fully embrace the enforcement of anti-money laundering measures as part of South Africa's efforts to ensure that the integrity of the global financial system is not impaired through its participation therein.

Financial regulation and supervision

Core Principles for Effective Banking Supervision

Weaknesses in the banking system of a country can threaten financial stability both within that country and internationally. The need to improve the strength of banking systems has therefore become an international concern. The Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision encompass applicable laws, prudential regulation, supervisory guidelines, on-site examinations and off-site analysis, supervisory reporting and public disclosures, and evidence of enforcement or non-enforcement.

South Africa participated in the pilot FSAP of the IMF and the World Bank as well as the follow-up FSAP, which took place in late 2000. The banking supervision and regulation function was evaluated as broadly compliant and as being pro-active in addressing areas in which it did not fully comply with the Basel Core Principles. Most of these issues have been addressed by legislative amendments, conducting of consolidated supervision and the implementation of anti-money laundering measures by banks. Other developments include the proposal for the establishment of a South African Deposit Insurance Scheme and broadening access to basic banking services through a multi-tiered banking sector. Another development in this regard includes the Mzansi account (see box "Mzansi account" for more information). The implementation of the New Basel Capital Accord (Basel II) will be one of the high-priority strategic focus areas. Basel II will be implemented in the South African banking sector on 1 January 2008, while parallel runs will take place during 2007.

Mzansi account

The Financial Sector Charter commits the South African banking sector to providing "effective access" to financial services to 80 per cent of the people in the Living Standards Measures (LSM) 1–5 categories[36]. "Effective access" to financial services is defined as having access to full banking services within 20 kilometres of the customers' location and automated teller machine (ATM) services within 10 kilometres of the customers' location. Towards this end, the major banks have developed a type of "national bank account" known as the Mzansi Account (Mzansi).

Mzansi was launched on 25 October 2004 and by early February 2005 it had attracted more than 550 000 customers; 90,3 per cent of the customers were new account holders and only 9,7 per cent were previously banked[37]. Mzansi is relatively affordable, easily accessible and tailored to meet the needs of the LSM 1–5 market segments. There are no monthly management fees and low bank charges. Mzansi is both a competitive initiative as well as a co-operative initiative. Banks compete on pricing, sales and distribution, but co-operate in defining standards, branding and network access.

Although Mzansi targets basic savings and transmission needs, it does provide a portal for access to the banking system and could facilitate access to credit and other banking services. Greater additions to banks' customer databases through Mzansi would contribute to a better understanding of the previously unbanked and facilitate the introduction of further products to better target the needs of this market.

36 The different LSM 1-5 categories can be obtained from the South African Institute of Race Relations. 2000. Structure of the workplace, living standards and personal income. *Online: http://www.sairr.org.za Accessed on 21 February 2005.*

37 The Banking Association South Africa.

Objectives and Principles of Securities Regulation

The securities sector is sensitive to macroeconomic factors as there typically is a predictable correlation between these factors and market sentiment. Extreme macro-economic conditions can lead to rapid changes in investor confidence. A systematic loss of confidence, for whatever reason, on the part of the markets can lead to massive and rapid withdrawal of short-term funds, producing a collapse in asset prices. The objectives of securities regulation are to protect investors, ensure that the markets are fair, efficient and transparent, and to reduce systemic risk.

As part of the FSAP mission an assessment of South Africa's financial system was made by the World Bank and the IMF on the regulation and supervision of non-banking financial services. On the whole the findings in the draft FSAP report were favourable. Using a high-level questionnaire designed by the International Organization of Securities Commissions (IOSCO), the Financial Services Board[38] (FSB) subsequently also conducted annual self-assessments which indicated a substantial level of compliance. The FSB has drafted several pieces of legislation and subordinate regulations, e.g. the Securities Services Act, No 36 of 2004, and the Financial Services Ombud Schemes Act, No 37 of 2004, to enhance compliance with international standards and to address certain deficiencies in the regulatory framework. The JSE upgraded its listing requirements to include, among other things, principles of corporate governance and to comply with international financial reporting standards.

38 The Financial Services Board is an independent institution established by statute to oversee the South African Non-banking Financial Services Industry in the public interest. The FSB's mission is to promote sound and efficient financial institutions and services together with mechanisms for investor protection in the markets it supervises.

Insurance Core Principles

The insurance industry is of fundamental economic and social importance, both nationally and internationally. Most domestic insurance markets are increasingly being integrated into a global financial market. In the interest of policy-holders it is necessary to maintain efficient, fair, safe and stable insurance markets. The Insurance Core

Principles issued by the International Association of Insurance Supervisors comprise essential elements that need to be in place for an insurance supervisory system to be effective. The principles set out the framework for insurance supervision and identify subject areas that should be addressed in legislation or regulation.

The FSB is operationally independent and accountable in the exercising of its functions and powers in respect of insurance supervision. It has developed many new supervisory guidelines and revisited existing ones to improve its efficiency in supervising insurance institutions. Numerous new pieces of legislation were passed to enhance consumer protection, the most notable one being the Financial Advisory and Intermediary Services Act, No 37 of 2002. Prudential regulation of capital adequacy of insurance institutions has yet to undergo the kind of redesign that new risk-management practices in banks and the new capital adequacy framework (Basel II) brought about in banking supervision. Significant progress was made with the amendment of the Long-Term Insurance Act, No 52 of 1998, which regulates the method of calculating the value of the long-term insurers' assets and liabilities for the purpose of remaining financially sound. Capacity building and enforcement are continuing to receive attention in order to measure up to the international standards set by the International Association of Insurance Supervisors (IAIS). A broad self-assessment of the insurance supervisory principles of IAIS also demonstrated a high level of compliance and highlighted the importance of corporate governance, similar to the findings of the FSAP mission.

Conclusion

The South African financial system, with its real potential to stimulate economic growth and improve living standards, operates in a complex and ever-changing political, social, legal and institutional environment. A well-designed underlying legal, regulatory and institutional infrastructure can contribute substantially to the mitigation of effects of shocks to the financial system. South Africa is fortunate to have a financial system infrastructure which generally complies with international standards and best practice, making the South African environment more robust in withstanding financial shocks.