Introduction

The South African Reserve Bank (the Bank) defines its primary objective as the achievement and maintenance of price stability. In support of this objective, the Bank endeavours to ensure that the South African monetary, banking and financial system is sound. To promote awareness and stimulate debate on financial stability, the Bank publishes this semi-annual *Financial Stability Review*. Furthermore, the publication aims to identify and analyse potential risks to financial system stability and communicate such assessments regarding pertinent issues. The Bank recognises that it is not the sole custodian of financial system stability, and that it can only contribute towards a larger effort involving the government, other regulators and self-regulatory agencies.

This edition of the *Financial Stability Review* comprises three main sections, namely international macrofinancial developments and trends, domestic macroprudential analysis, and an overview of the Southern African Development Community activities towards regional harmonisation.

The first section presents an overview of the current state of international 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. Issues that are discussed include international capital flows and foreign direct investment, hedge funds and financial stability as well as emerging-market sovereign debt issuance.

The second section covers an assessment of the domestic environment, based on selected macroprudential indicators for the banking, insurance, corporate and household sectors, paying due attention to the main financial markets and the real-estate market. Issues that are discussed in this section include initiatives to broaden access to finance and extend economic empowerment, developments in the South African retirement fund and insurance industries, and the new policy framework for the consumer credit industry.

As usual, the third section focuses on infrastructure and regulation, and this time provides a qualitative overview of the Southern African Development Community's activities regarding regional harmonisation of financial systems and markets. Other issues discussed include a brief history of the development of the Southern African Development Community, terrorism and financial stability, major steps towards full compliance with the 40 plus 9 recommendations of the Financial Action Task Force, and legislative reforms to combat and prevent corruption.

Overview

Despite a pick-up in the first quarter of 2005, global economic growth moderated in the second quarter, in part reflecting the impact of higher oil prices. Global growth remained unbalanced and still unduly dependent on the United States and China. Other uncertainties, challenges and risks in the global macroeconomic and financial environment that have occupied policy-makers include the continuing global imbalances, excessive exchange-rate volatility, and the possibility of faster-than-expected interest rate rises that could lead to a correction in overvalued real-estate markets.

In emerging-market countries, macroeconomic and financial conditions in the first half of 2005 remained generally positive, as was reflected in relatively favourable access to financial markets. In sub-Saharan Africa, growth was supported by the strength of the global economy, improved domestic macroeconomic policies and progress with structural reforms. The debt relief for some African countries, announced at the Gleneagles G-8 summit, was a further positive development. Although the political and economic difficulties in Zimbabwe seem to be deepening, they do not pose a threat to the financial system of South Africa.

Based on the analysis of various indicators, the South African financial system is assessed as sound during the period under review. The asset quality and profitability of banks continued to improve, and banks remained well capitalised. The assessment of risks facing both the household and non-financial corporate sectors, as well as the capacity of the banking sector to absorb shocks, showed that it was unlikely that the current robust health of the South African banking sector would be compromised over the medium term.

With regard to the residential property market, the risk of stagnation or even a significant decline in residential property prices cannot be ruled out. The possibility of an increase in the default rate among mortgage holders, who may have been too willing to take on higher levels of indebtedness in a low interest-rate environment, can also pose a threat to the health of the banking sector. Overall confidence in the financial services sector still remained high during the period under review despite confidence in life insurers declining somewhat.

South Africa's continued good economic performance and financial stability are also dependent on the relative prosperity of the Southern African region. The international community expects national economies to broadly follow similar financial policy rules and good practices. Much value is therefore attached to the adoption and implementation of internationally accepted financial policies and best practices. Despite many challenges, good progress has been made by the South African Development Community towards the harmonisation of financial systems and markets in order to develop more robust and efficient financial systems in the region.

Financial stability developments and trends

International macrofinancial developments

While the rate of expansion in global economic growth in 2004 was the highest in nearly 30 years, it slowed down somewhat in mid-2004. Despite a pick-up in the first quarter of 2005, it again slowed down in the second quarter, in part reflecting the impact of higher oil prices. Global growth also remained unbalanced and was still unduly dependent on the United States (US) and China.

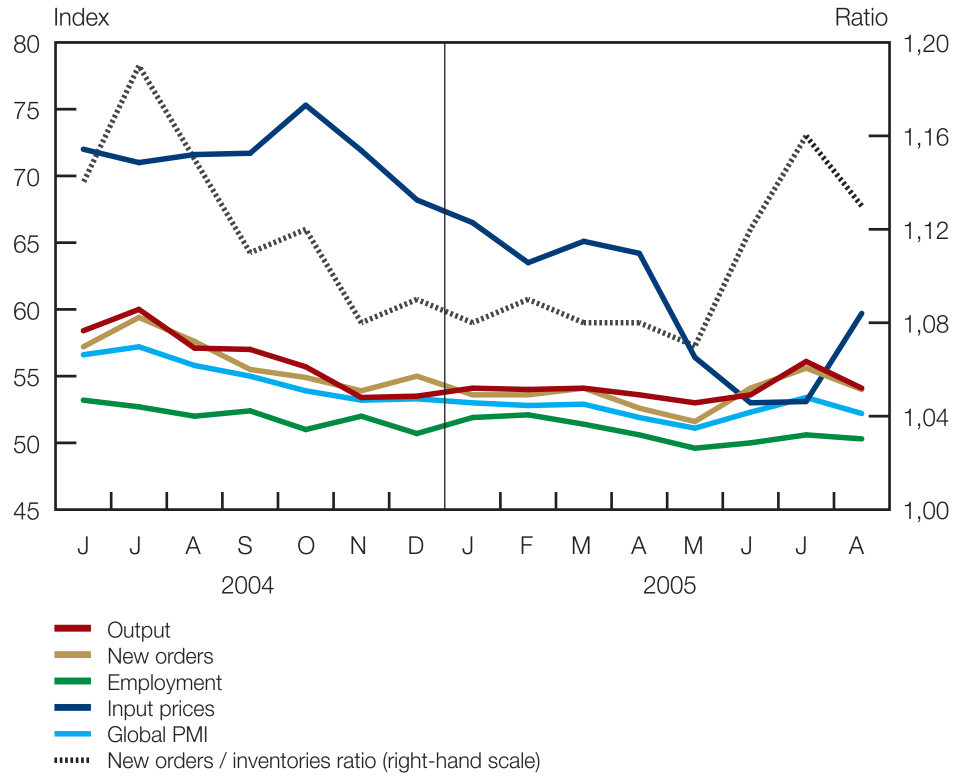
Global growth

An acceptable and sustainable level of growth in real gross domestic product (GDP) tends to support financial stability by reducing uncertainty and promoting confidence in financial markets and institutions. Although global growth was threatened by higher oil prices which rose sharply in the first half of 2005, this did not seem to impact negatively on the stability of financial systems.

In June 2005, the global manufacturing Purchasing Managers Index[1] (PMI) recorded its first increase since July 2004, sending a strong signal that a pick-up in manufacturing growth is in sight. Up until May 2005, the PMI still confirmed a deepening in the slowdown in world economic growth. The improvement in June 2005 was broadly based, with all countries forming part of the PMI survey reporting gains. The PMI for July 2005 confirmed

1 The global PMI is a survey of manufacturing output as measured by a global indicator, compiled by JPMorgan from selected developed countries and is viewed here as a general indicator of world growth trends.

Figure 1: Global manufacturing PMI and its components



Source: JPMorgan

that the upward momentum was carried over into the third quarter, but a slight slowdown in August 2005 raised questions about the strength and duration of the global upswing.

According to JPMorgan, turning points in global industrial production have in the past been marked by simultaneous upturns in PMI new orders, output and the ratio of new orders to inventories. In June 2005, all three indicators recorded increases. New orders jumped almost 3 percentage points in July 2005, propelling the cyclically-sensitive orders to inventories ratio to the highest level since August 2004. In June and July 2005 input prices, conversely, dropped to the lowest level since September 2003. Surging energy prices, however, are set to inhibit future growth in manufacturing output.

Oil prices

Stable oil prices are important for continued global economic and financial stability. Brent crude has risen from an average of US$25 per barrel in 2003, through US$45 per barrel in the second quarter of 2005, to US$68 per barrel at the beginning of the third quarter of 2005. Towards the end of August oil prices soared over concerns about possible production shutdowns and damage to platforms and refineries in the Gulf of Mexico following hurricane Katrina. Prices eased amid news of the US government's readiness to intervene by releasing oil from the Strategic Petroleum Reserve and Saudi Arabia's pledge to raise production to make up for any supply losses caused by hurricane Katrina.

At the core of the rising oil prices lies the alleged imbalance between demand and supply. The global economic recovery, continued strong demand for oil (especially from China, India and the US) and a series of supply disruptions that eroded spare capacity, kept oil prices high and volatile. The surge in demand for oil comes against the backdrop of mounting supply-side concerns due to an apparent lack of production and refining capacity. These have been exacerbated by production setbacks due to industrial actions, geopolitical risks and possible confrontation between the US and Iran over the latter's nuclear programme. Also, speculative activity could still play a role in driving oil prices higher, possibly beyond levels explainable by supply and demand factors alone.

The rise in oil prices is expected to have a significant effect on global GDP growth this year. If sustained, this rally in oil prices and the prospect of continuing interest rate increases in the US could dampen consumer confidence, prompting consumers and businesses to reduce spending. Historically, most US and global recessions have been associated with steep rises in oil prices. For instance, the 1974-75 recession followed the threefold increase in oil prices after the war between Israel and Arab states, the 1980-81 recession was due to an increase in oil prices following the 1979 Iranian revolution and the 1990-91 recession followed a rise in oil prices after the Iraqi invasion of Kuwait.

In real terms, oil prices are still below the levels reached in 1979, and many analysts believe it would need to surpass US$90 per barrel to exceed the peak set in 1980. However, many production processes are nowadays less energy intensive. Threats of a global recession arising therefrom may, therefore, still be distant.

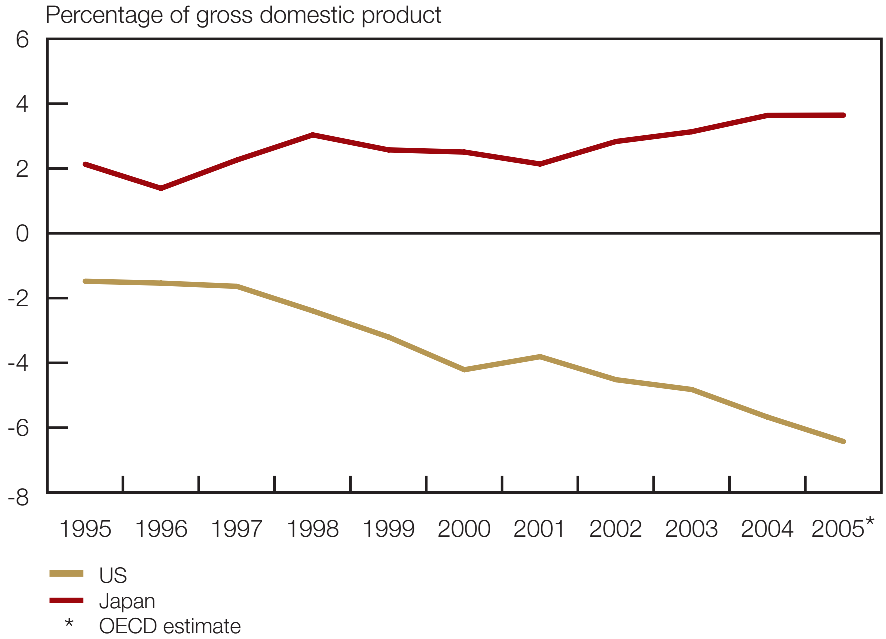
Global imbalances

Global imbalances (in the form of a large current-account deficit in the US, and the matching surpluses in Japan, emerging Asia, some oil-exporting countries and other industrialised countries such as Canada) continued in the second quarter of 2005. The US current-account deficit, however, narrowed slightly to US$195,7 billion in the second quarter of 2005 (from a revised record high of US$198,7 in the first quarter) and measured 6,3 per cent of GDP. Net inflows of capital into the US rose to US$87,4 billion in July 2005, from US$71,2 billion in June[2]. This was more than the amount needed to cover the monthly trade deficit of US$57,9 billion in July 2005. The concern that investor appetite for US assets might not continue to grow indefinitely, however, remains.

2 *US Treasury Department. 18 September 2005.* International Capital Data.

Although total net foreign purchases of US Treasury bonds and notes increased to US$28,52 billion in July 2005 from a revised US$15,79 billion in June, net purchases by foreign official institutions declined sharply to US$3,62 billion from US$16,67 billion in June. This confirms the concern about reduced foreign official funding of the US current-account deficit.

Figure 2: Current-account balances



Source: Thompson Financial Ltd (Datastream)

Global imbalances are a problem for the global economy and require a collaborative international effort to address the underlying causes. If investors drastically reduce the flow of capital into the US, it could lead to a rapid depreciation of the US dollar and excessive volatility in currency and capital markets. US interest rates may even rise sharply as a result, posing a threat to global financial stability. The unbalanced pattern of global growth, the large US fiscal deficit, the low rate of savings in the US and the undervalued and relatively inflexible exchange rates of China[3] and some emerging Asian countries are major contributing factors to the widening global imbalances.

3 *In July China moved toward currency flexibility by abandoning the fixed peg to the US dollar and revaluing its currency by 2,1 per cent, to 8,11 yuan per US dollar. Though allowed to deviate by ±0,3 per cent around the central parity, no significant strengthening of the yuan has been recorded since the adoption of the crawling peg.*

It is therefore important that policy-makers attend to the gradual reduction of the US fiscal deficit (this would go some way towards improving the attitude of foreign investors towards US assets and maintaining investor confidence in the US dollar), stepping up structural reform in Euroland and Japan to increase economic growth, and greater exchange rate flexibility in China and emerging Asia.

These measures should not only be taken in the interest of global financial stability, but also in the interest of each country's own economic and financial health in the long term. While an orderly adjustment process involving a co-operative effort would be growth-enhancing, a disorderly adjustment (through a rapid depreciation of the US dollar, for example) could have serious consequences for the stability of the global financial system (see box "International capital flows and foreign direct investment").

International capital flows and foreign direct investment

Foreign direct investment (FDI) is preferred to portfolio investment as it is a more permanent type of investment and acts as a seal of approval of the political and economic performance of a country. FDI, which includes mergers and acquisitions as well as where companies acquire a significant stake in a foreign company, deepens the integration of global markets and increases economic growth. Analyses suggest that a one-percentage-point rise in the ratio between the stock of FDI and the gross domestic product (GDP) in developing countries raises output by about 0,4 percentage points[4]. FDI inflows, however, could potentially have some negative effects as they expose the domestic economy to external volatility. In addition, such flows might cause volatility in the exchange value of the domestic currency and impact negatively on the balance-of-payments position, as the initial inflow will be followed by regular dividend outflows.

4 OECD Working Paper *no 19, Trade Policy: Promoting Investment for Development, June 2005.*

Developed countries are currently the biggest source of FDI. FDI by developed countries grew strongly in the late 1990s, driven mainly by stock-market booms leading to cross-border mergers. After peaking in 2000 at more than six times its 1991 level, FDI inflows dropped dramatically. A three-year slump followed, but the strong economic recovery in the US since 2004 has boosted investor confidence and FDI flows started to increase again. According to the Organisation for Economic Co-operation and Development (OECD), total FDI outflows from OECD countries were US$668 billion in 2004, still well below the peak of more than US$1 200 billion in 2000. Inflows to OECD countries were just over US$400 billion in 2004. The US is the largest provider of FDI funds (with outflows of US$252 billion), and also regained its status as the largest recipient. The recovery in US FDI inflows was, however, not enough to counter a general decline in FDI flows into OECD countries, given the weak economic performance in Euroland, particularly in Germany and France.

The most important development, however, is that, in addition to large portfolio flows, FDI is increasingly flowing to emerging-market countries. According to the International Monetary Fund (IMF), there has been a significant recovery in FDI flows into emerging-market countries recently, with Asia receiving the largest share[5]. After dipping into negative territory in 2000, net outflows from OECD countries subsequently increased, reaching their highest level in a decade in 2004. With FDI inflows reaching a record high of US$55 billion in 2004, China was a major beneficiary in this regard. Inflows into other emerging-market countries like Argentina and India, also grew rapidly. FDI flows into South Africa peaked in 2001 at US$6,79 billion (mainly due to the De Beers restructuring deal), before declining to levels of US$756 million in 2002, US$719 million in 2003 and US$584 million in 2004. In the first quarter of 2005, US$225 million of FDI flowed into South Africa.

5 *International Monetary Fund. April 2005.* World Economic Outlook.

The flow of funds to the developing world should, through increased economic activity, help to counter the growing levels of global imbalances. FDI flows from developed countries to developing countries are therefore an encouraging development that should support global financial system stability.

International developments in banking, insurance and pension funds

In Japan, all major banks met the Japanese Financial Services Agency's March 2005 target of halving non-performing loan (NPL) ratios from their earlier peaks. The systemic risk posed by poor loan quality seems to have been greatly reduced.

According to the International Monetary Fund's (IMF) *Global Financial Stability Report* (April 2005), banking systems in emerging markets generally show improving capital positions, asset quality and earnings. Regulatory attention in many emerging markets is focused on improving institutions and their risk-management capacity in general. Residual immediate concerns are the risks posed by rapid credit growth and the potential effects of higher interest rates. Banking systems in a number of African countries continue to be burdened by serious weaknesses, and implementation of reform measures remains slow.

In its update on the global insurance industry, the IMF noted that insurance firms in a number of mature markets have increasingly taken on credit risks that were formerly borne by banks and other market participants. At the same time, regulatory authorities in several countries have moved to implement more market-sensitive and risk-based capital adequacy standards for insurers. In response, insurers have generally improved their own risk-management systems.

Numerous challenges remain, however. Issues that insurance companies have to address include the restoration of confidence (especially in the US following numerous allegations of misconduct), adherence to regulatory requirements (including tougher corporate governance standards), financial stress imposed on the industry by an ageing population, and complying with international accounting standards, to name but a few.

In 2004, global funding levels of pension funds recovered marginally[6], with increased contributions primarily helping to improve the funding gap. Awareness of the economic and financial implications of an ageing population continues to grow. Also, the development of markets for long-dated and index-linked bonds, which can contribute significantly to risk management in the pension fund industry, is progressing.

6 *International Monetary Fund. April 2005* Global Financial Stability Report.

Real-estate markets

Since the mid-1990s house prices have risen sharply in most industrialised economies and some emerging markets (see Table 4 on page 29). This global boom has been driven by low interest rates, as well as a general aversion to investing in the stock markets in reaction to, among other reasons, the equity boom-bust cycle.

In the US, for example, house prices have been rising at the fastest pace since the late 1970s, heightening concerns that the housing market is overheating. This was encouraged by the persistence of low mortgage rates and robust consumer sentiment. House prices soared by 14,7 per cent over the twelve months to June 2005, the biggest increase in almost 25 years.

In the euro area, residential property prices remained very strong in a number of member states where favourable financing conditions and expected capital gains seem to have supported strong demand[7]. In China, the People's Bank of China has warned that the country faces a potential property bubble which could leave banks with huge losses should it burst.

7 *European Central Bank.* Financial Stability Review. *June 2005.*

In the United Kingdom (UK), the recent high pace of increase in average house prices has eased, and the housing market is expected to remain fairly subdued[8].

8 *Bank of England.* Financial Stability Review. *June 2005.*

Hedge funds

Financial regulators around the world are stepping up their scrutiny of hedge funds amid rising concerns that the industry's recent dramatic growth and lack of disclosure could pose a risk to financial stability. The European Commission, which is responsible for drafting pan-European financial legislation, plans a review of the hedge fund industry to determine whether a new regulatory framework is needed. Currently, the Financial Services Authority (FSA), however, does not perceive significant risks to UK retail consumers arising from the hedge funds sector because of the extremely low levels of direct retail investor participation.

Hedge funds and financial stability

There is no universally accepted definition of hedge funds. The term hedge fund comes from the phrase "to hedge one's bets" and refers to the practice of structuring transactions to ensure that no matter which way the market turns, a profit can still be made. Hedge funds use unconventional methods of investing in almost any opportunity in any market where "impressive gains" at reduced risk are foreseen.

Internationally, hedge funds are continuing to play an increasingly important role in financial markets and the financial system as a whole. This can mainly be attributed to the size of, and dramatic growth in the hedge fund industry. Initially, investors in hedge funds were high net worth individuals, but there has since been a major increase in the number of institutional investors, especially pension and retirement funds. Hedge funds play a significant role in the financial system by providing risk-management diversification tools and reducing arbitrage opportunities.

Recently, concerns over the systemic nature of hedge funds have increased due to the extensive use of leverage combined with their rapid growth in a time of ultra-liquid markets and the quest for yield in a low interest-rate environment. A rapid turnaround could place much pressure on these funds, with possible systemic consequences.

Assets under management internationally by hedge fund managers are estimated at US$1 trillion. South Africa's hedge fund industry is estimated at R8,5 billion (assets under management) and is therefore relatively small compared to total banking-sector assets and the traditional asset management industry.

Hedge funds, in general, are only "lightly" regulated. Concerns have been expressed worldwide regarding the regulation and management of hedge funds. Some of these concerns relate to the general lack of transparency among hedge fund managers, which hampers market discipline. Also, in the event of disappointing returns, there is a potential for rapid outflows from sectors in which there is a high concentration of hedge fund activity.

As a result, financial regulators around the world are paying closer attention to this industry. In South Africa, the Financial Services Board (FSB), the Association of Collective Investments and the Alternative Investment Management Association have released a joint discussion paper on the regulation of the hedge fund industry [9]. Through the process initiated with this discussion paper, the FSB aims to ensure that the activities of the hedge fund managers are appropriately regulated to obtain a better understanding of the demand for creating a regulated product structure or structures aimed at accommodating hedge funds, and to clarify the rules governing the marketing and selling of hedge fund investment products. According to the joint discussion paper, the regulation of hedge funds can be achieved by declaring regulations in terms of the Collective Investment Schemes Control Act, 2002.

From a stability point of view, however, it is not expected that the regulation of hedge funds will be the full answer to perceived concerns. The local hedge fund industry is not likely to pose a threat to financial stability in the near future, provided banks manage their credit and other risks prudently and effectively when dealing with hedge funds.

9 *Financial Services Board,* Hedge Funds Discussion Paper. *Online http://www.fsb.co.za*

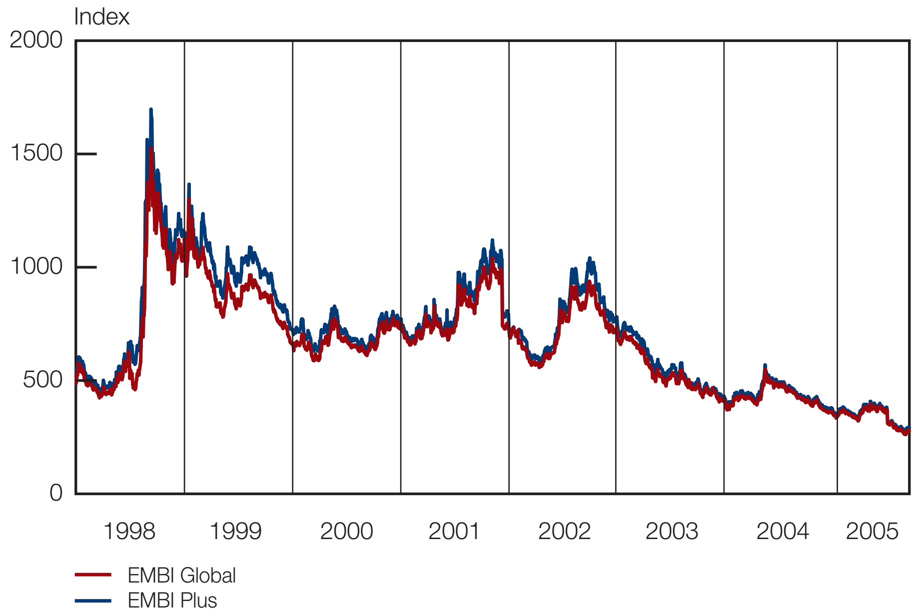
Emerging markets

Macroeconomic conditions remain generally positive in emerging-market economies, which mostly continue to enjoy relatively favourable access to financial markets, as reflected in the narrow margin between yields on emerging-market bonds and those of highly-developed countries. Since 2000, emerging-market bonds have been among the best-performing assets, and emerging-market equities have generated higher risk-adjusted returns than mature equity markets. Credit-rating upgrades have widened the pool of potential investors in emerging-market bonds (also see box "Emerging market sovereign debt issuance"). Although the measured tightening of monetary policy as currently applied by the Federal Reserve did not impact significantly on emerging-market bond spreads, an abrupt increase in interest rates could lead to a rapid widening of credit spreads and a less hospitable external financing environment. It therefore remains a risk facing those countries, including South Africa.

While fiscal indicators have generally improved, many countries still have to bring public debt-to-GDP ratios down to sustainable levels. According to the IMF[10], emerging-market economies need to intensify their recent fiscal consolidation efforts seeing that the average public debt ratio of 60 per cent of GDP is still too high. A combination of shocks – such as lower global growth, higher interest rates, and rising oil prices – may create significant difficulties for many emerging-market and developing countries.

10 *International Monetary Fund. September 2005,* World Economic Outlook*: 17.*

Figure 3: Emerging-market bond indices[11]



Source: JPMorgan

11 *The Emerging Market Bond Index spread represents the spread between the average yield on selected US dollar-denominated sovereign bonds issued by emerging-market economies and the US Treasury rate.*

Emerging-market sovereign debt issuance

Sovereign debt issuance in the international market by emerging-market countries increased by 32,7 per cent in the first quarter of 2005 from the end of 2004[12]. Given that emerging-market countries set a record for borrowing on the international market in 2004, the strong growth is particularly striking. Investors continue to have a strong appetite for emerging-market debt, even though credit markets globally are losing momentum. A combination of improved macroeconomic fundamentals in emerging-market countries, low risk aversion and a search for yield amongst investors remain the main drivers in this market. The spread on JPMorgan Chase's Emerging Market Bond Index (EMBI) reached a historical low in the second quarter of 2005 and remains around the pre-Asian crisis levels.

12 *Bank for International Settlements. June 2005.* Quarterly Review.

According to the Bank for International Settlements (BIS), the largest issuer from Asia on the international market in 2005 was Korea, while Mexico and Brazil were the largest from Latin America. The governments of Poland, Turkey and Hungary were the largest issuers from emerging Europe. Argentina, Chile, India, Indonesia, Russia, South Africa, Turkey and Venezuela received rating upgrades by at least one major rating agency in 2005.

South Africa's prudent macroeconomic policies and the social, political and financial stability prevailing enhanced its credit history. The substantial strengthening in the country's foreign reserves position (the gross gold and other foreign reserves position stood at US$18,7 billion at the end of June 2005 compared to US$11,2 billion in June 2004) and improved economic stability, earned the rating upgrades in January and August 2005.

Regional developments

According to the IMF's *World Economic Outlook* (September 2005), real GDP growth in sub-Saharan Africa accelerated to 5,4 per cent in 2004, the highest in almost a decade. Growth has been underpinned by the strength of the global economy and the associated high commodity prices, improved domestic macroeconomic policies and progress with structural reforms, and the ending of several protracted armed conflicts.

Growth was particularly strong in countries where oil production increased and where agriculture recovered after droughts. Conflicts, political instability and poor governance, however, continued to affect some countries. The IMF projects growth of 4,8 per cent in 2005 and 5,9 per cent in 2006 for sub-Saharan Africa. Oil-exporting countries are expected to enjoy the strongest growth, while in non oil-producing countries growth is expected to be negatively affected by the moderation in non-oil commodity prices.

While debt relief alone is inadequate to place the continent on the road to sustainable development, the debt write-off by the G-8 countries is a positive development. Fourteen of the 18 poor countries that benefited are in sub-Saharan Africa, of which three (Mozambique, Tanzania, and Zambia) are in the Southern African Development Community (SADC) region. The debt deal is set to save sub-Saharan African nations about US$1 billion a year. If oil prices were to remain at current levels, however, this relief may be more than offset by higher production costs. The International Energy Agency estimates that the oil-import bill of sub-Saharan Africa will double to about US$20 billion on the back of crude prices of more than US$55 a barrel – amounting to far more than the debt relief.

The Gleneagles G-8 summit also resolved to increase aid to Africa by US$25 billion per year by 2010. If the measures are fully implemented, the G-8 members estimate that Africa's economy and trade could double by 2015. Issues around the removal of global trade barriers, however, remain unresolved.

Though only 24 countries have as yet signed up to the New Partnership for Africa's Development's (NEPAD) African Peer Review Mechanism (APRM), the third summit of the APRM in June 2005, at which the Country Review Reports of Ghana and Rwanda were presented, is an important milestone, demonstrating the continent's commitment to strive for good governance. While significant strides towards peace and stability have been made, some pockets of tension remain, particularly in the Democratic Republic of Congo and Côte d'Ivoire.

The economic and political difficulties in Zimbabwe seem to be deepening. A recent IMF Article IV Mission has indicated that real production is likely to decline by a further 7 per cent this year. Foreign currency reserves are down to three days' worth of imports[13]. Foreign exchange shortages have restricted essential imports needed for industrial and agricultural production, fuel, energy and basic commodities, further exacerbating the decline of the formal economy and the government's revenue base. The headline inflation rate increased to 265,1 per cent year on year in August 2005 from 254,8 per cent in July.

13 *United Nations Special Envoy on Human Settlement Issues in Zimbabwe. 18 July 2005.* Report of the fact-finding mission to Zimbabwe to assess the Scope and Impact of Operation Murambatsvina.

The budget deficit is estimated to exceed 14 per cent of GDP. Unemployment is currently estimated at 75 per cent, with over 70 per cent of the population living under the poverty line. Food shortages, exacerbated by drought affecting the entire sub-region, have been an additional challenge, particularly in the rural areas.

According to a United Nations' *Report of the Fact-Finding Mission to Zimbabwe to assess the Scope and Impact of Operation Murambatsvina*, the widely-condemned government initiative "Operation Restore Order" has led to an estimated 700 000 people in cities across the country either losing their homes or their livelihoods or both. The operation has had a major economic, social, political and institutional impact on Zimbabwean society and its effects will be felt for many years to come.

Though not posing a threat to South Africa's financial system stability, a total collapse in Zimbabwe could have wider political, economic and social consequences for the region.

Domestic macroprudential analysis

Macroprudential analysis involves regular monitoring and analysis of risks and threats to the stability of the financial system. The main purpose of the analysis is to detect, at an early stage, any trends or vulnerabilities that may lead to a crisis in the financial system. The assessment in this section is based on selected macroprudential indicators covering the banking, financial markets, insurance, corporate, household and real-estate sectors. It analyses the main developments in, and risks to, the financial system and is an attempt at a systematic analysis of the soundness of the financial system. The analysis largely covers the period ending June 2005. In some cases, however, the analysis goes beyond this period.

Banking sector

Banks are central within a financial system, as they are a source of liquid funds for the rest of the economy and also provide payment services that are relied upon by all entities conducting business. Banks are also systemic in nature, in part due to maturity mismatching between their assets and liabilities. Therefore, a failure of a bank 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 soundness of the banking sector central to any assessment of financial system stability.

In June 2005 the South African banking sector comprised 14 locally-controlled banks, 6 foreign-controlled banks, 2 mutual banks and 15 branches of foreign banks. The banking sector remained concentrated. The Gini concentration coefficient increased from 82,6 per cent in June 2004 to 83,7 per cent in June 2005 and, over the same period, the market share (in terms of assets) of the four big banks also increased from

82,2 per cent to 83,8 per cent. The relationship between concentration in the banking sector and financial stability was discussed extensively in the September 2004 edition of the *Financial Stability Review*. The domination of four large banks in South Africa may reduce the likelihood of banking problems but, at the same time, may also increase the complexity of resolving systemic problems.

Table 1 gives a summary of key financial soundness indicators for the South African banking sector.

Table 1: Key financial soundness indicators for the South African banking sector
Per cent, unless indicated otherwise

	2003 Dec	2004 June	2004 Dec	2005 June
Structure				
Number of banks (excluding mutual banks)	37	35	35	35
Total assets of banks (excluding mutual banks, R'billion)	1 379,8	1 350,5	1 498,4	1 564,1
Gini concentration index*	82,9	82,6	83,2	83,7
Market share (top 4 banks)**	80,8	82,2	83,6	83,8
Capital adequacy				
Regulatory capital to risk-weighted assets	12,2	13,2	13,3	2,8
Regulatory Tier 1 capital to risk-weighted assets	7,9	8,8	9,3	9,0
Asset quality				
Gross overdues to total loans and advances	2,4	2,0	1,8	1,6
Specific provisions to total loans and advances	1,9	1,6	1,5	1,4
Share of mortgage advances in private credit	39,6	42,8	43,3	45,0
Earnings and profitability				
Return on assets***	0,8	1,0	1,2	1,1
Return on equity***	11,6	12,6	14,7	14,1
Interest margin to gross income	38,3	34,8	42,3	52,0
Non-interest expenses to gross income	74,8	61,8	68,6	74,7
Liquidity				
Liquid assets to total assets (liquid asset ratio)	4,7	5,0	4,7	4,8
Liquid assets to short-term liabilities	9,2	9,4	9,4	9,5
Sensitivity to market risk				
Net open position in foreign exchange to capital	0,9	2,5	0,9	0,7

* The Gini Index is used to estimate the degree of inequality among banks in terms of market share. The index is scaled between zero (which implies perfect equality or no concentration) and 100 (which implies perfect inequality or complete concentration).
** Based on assets
*** Smoothed over a period of 12 months

Asset quality

The total assets of the banking sector grew by 15,8 per cent (measured over a 12-month period) in June 2005, apparently without a deterioration in asset quality. For instance, by the end of June 2005, gross overdues constituted 1,6 per cent of total loans and advances, compared to 2 per cent in June 2004[14]. Total provisioning (that is the market value of security, specific and general provisioning) against overdue accounts was considered adequate. This improvement in asset quality was further borne out by a decrease in specific provisions (measured as a percentage of total loans and advances), from 1,6 per cent in June 2004 to 1,4 per cent in June 2005. Further comfort regarding asset quality of banks is found in the low level of mortgage debt as a percentage of the market value of housing (see Figure 24 on page 32).

14 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.

Profitability and capital adequacy

Profits and capital, respectively, provide the first and second lines of defence against losses that banks incur. Generally, profits generated from a range of activities can cushion losses in a specific area. The more credit and market risk banks take, the higher the banks' expected profits need to be for actual profits to absorb those risks should they materialise. If losses cannot be absorbed by profits, capital provides an essential second line of defence. The widely used measures of profitability are the return on equity (ROE) and the return on assets (ROA), while the capital adequacy ratio is a measure of the robustness of banks to withstand shocks to their balance sheets.

The ROE, i.e. the ratio of net profit to average equity, reflects the banks' efficiency in using equity and, over time, provides information on the sustainability of banks' capital positions. The ROA, i.e. the ratio of net profits to total assets, gives an indication of how efficiently banks' assets are employed. Smoothed over a period of 12 months, ROA increased from 1 per cent in June 2004 to 1,1 per cent in June 2005, whilst ROE increased from 12,6 per cent to 14,1 per cent over the same period.

Banks also remained well capitalised. Against a minimum regulatory capital adequacy requirement of 10 per cent, the banking sector's capital adequacy ratio stood at 12,8 per cent in June 2005, compared to 13,2 per cent in June 2004.

The annual growth rate in bank share prices was 55 per cent in July 2005, up from 17,8 per cent in July 2004. Speculation about foreign take-overs of domestic banks, among other factors, contributed to the rise in bank share prices.

Liquidity

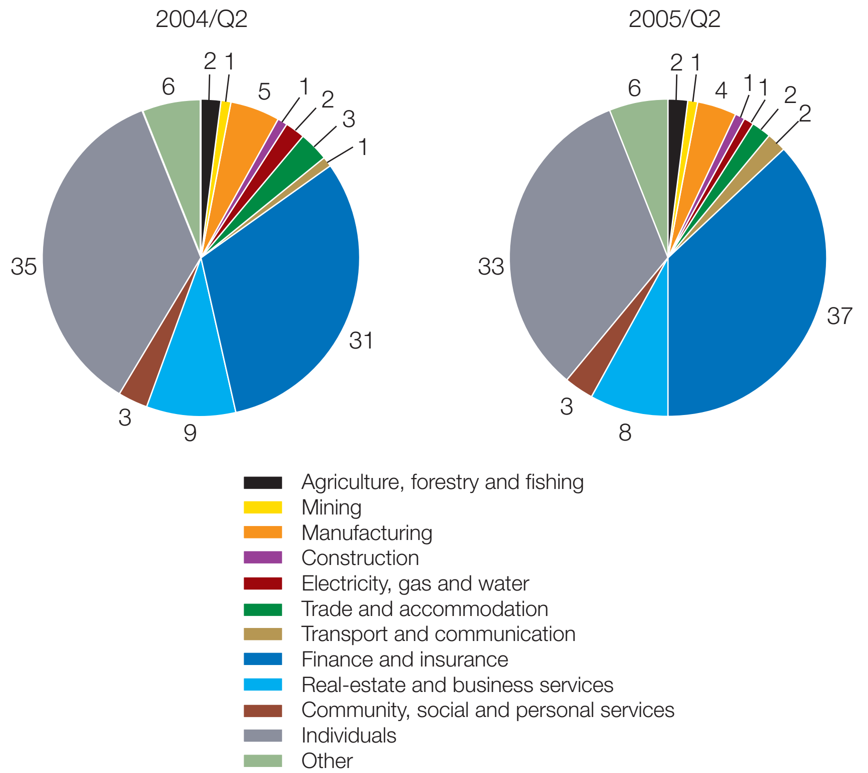
The level of liquidity influences the ability of the banking sector to withstand shocks. Indicators used mostly to measure liquidity include liquid assets to total assets (liquid asset ratio) and liquid assets to short-term liabilities. These ratios reflect the maturity structure of an asset portfolio and can highlight excessive maturity mismatches and a need for more careful liquidity management. The liquid asset ratio stood at 4,8 per cent in June 2005, up from 4 per cent in June 2004.

The ratio of liquid assets to short-term liabilities for the South African banking sector increased from 7,7 per cent in June 2004 to 9,5 per cent in June 2005. Both these measures were in line with historic levels, and were considered adequate as part of a sophisticated liquidity risk management system.

Exposure to various sectors of the economy

Macroprudential analysis of the banking sector also requires an analysis of the sectoral distribution of loans, which allows for the monitoring of risks arising from the exposure of the banking sector to certain sectors, or a group of sectors. A large concentration of credit in a specific economic sector or activity (measured as a share of total loans) may signal vulnerability of the banking sector to negative developments in that sector or activity. In the past, financial crises have been caused or amplified by downturns in particular sectors of the economy spilling over into the financial system.

Figure 4: 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.

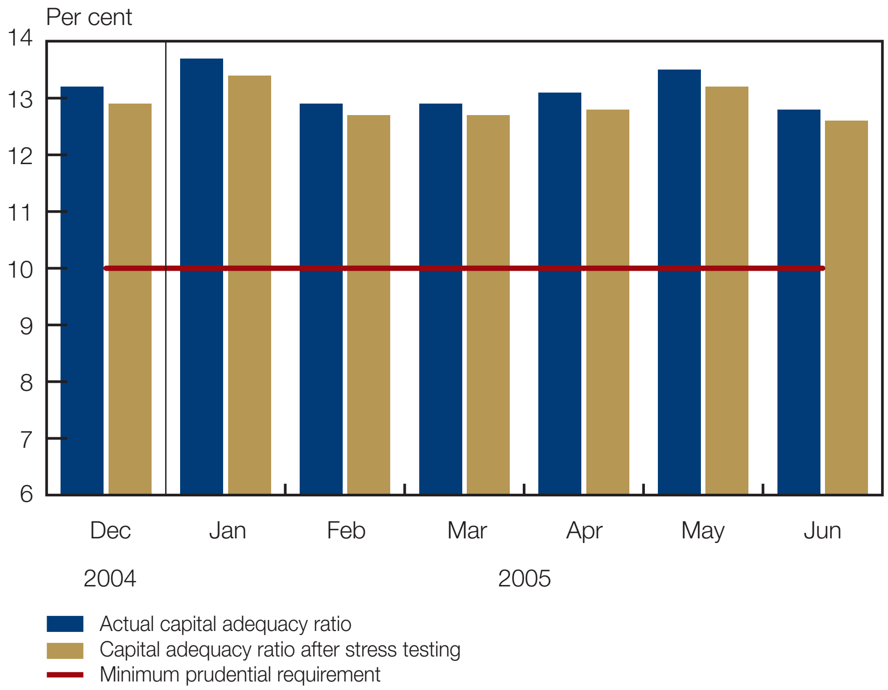
At the end of the second quarter of 2005, the shares of the household sector and the finance and insurance sector in total credit extension to the private sector were 33 and 37 per cent, respectively. The finance and insurance sector, however, includes inter-bank lending, and its large share is therefore not considered to be a cause for concern. Credit extension to the household sector is discussed in detail under the household sector.

Stress testing the banking sector

Stress testing the vulnerability of the financial system to adverse macroeconomic events is an important tool in assessing financial stability. Stress tests are 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 (through credit risk manifestation) if the historical worst-case scenarios were to occur to the variables in question.

By applying such a test, the banking sector was deemed resilient to a range of specific plausible adverse events on loan assets at the end of June 2005. The capital-adequacy ratio (after stress testing) remained at 2,6 percentage points above the minimum prudential requirement of 10 per cent (taking into account the average of the historical worst-case scenarios of all variables found to influence the capital-adequacy ratio). The second-round effects of such scenarios, however, were not estimated in the model.

Figure 5: Stress testing the resilience of the banking sector



Even though the banking sector is regarded as sound, some challenges nevertheless remain, which include the broadening of access to finance and the extension of economic empowerment to the previously disadvantaged groups.

Initiatives to broaden access to finance and extend economic empowerment

The socioeconomic imperative of broadening access to finance and black economic empowerment presents an important financial stability challenge. On the one hand, the exclusion of large sections of the population from mainstream economic and financial activities is unsustainable and can create systemic imbalances. On the other hand, inappropriately conceived mechanisms to provide redress may compromise the integrity of the financial system.

In response to the challenge, the Financial Sector Charter provides for broad commitments to redressing financial sector imbalances. An example is the Mzansi bank account[15], the first in a range of solutions proposed by the banking sector to extend access to financial services. Launched in 2004, one million Mzansi accounts had been opened by May 2005.

Another example is the low-cost housing initiative. In keeping with the provisions of the Financial Sector Charter, the banking sector has committed to a minimum of R42 billion in targeted investment for new housing finance in the income range of R1 500 to R7 500 per month. The proposal extends access to mortgage finance for low-income earners, and stems from commitments made in a Memorandum of Understanding (MoU) between the banking sector and the Department of Housing. The MoU was based on the realisation that neither government nor the banking sector could individually address the challenge of broadening access to mortgage finance and low-cost housing. Central to this partnership between government and the banking sector is

15 *South African Reserve Bank. March 2005.* Financial Stability Review*: 37*

delivery in terms of access, affordability and realisable property value in the housing market. The successful implementation of the housing initiative hinges on the following being in place: Firstly, a housing subsidy scheme to increase affordability in the low-income market. Secondly, a centralised conduit to facilitate access to low-cost capital market funding and to facilitate hedging of fixed interest rate risk, and thirdly, a centralised loss insurer for collateral deficiency and for the protection of banks from factors outside their control.

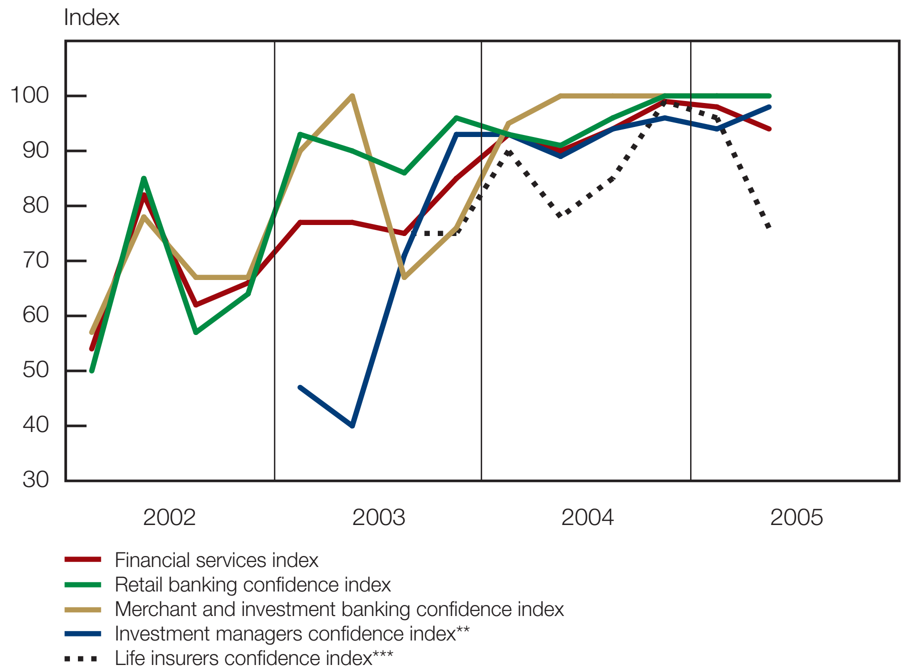
Another opportunity for the banking sector in extending access to financial services lies in the provision of mobile banking services. Thirty-four per cent of the unbanked market has a mobile phone and mobile transactions are currently conducted in the form of recharge transactions and airtime management. Mobile banking satisfies established sectoral trends of being technology driven, lowering cost, increasing customisation around consumer needs and decreasing dependence on cash. In August 2005, a transactional account was launched in a joint venture between a cellular network and one of the big four banks. This should further innovation in mobile banking and the use of mobile technology to service the unbanked market. Careful regulation of the mobile network and supervision of the funding float under banking prudential standards will ensure continued confidence in the system once this product achieves large-scale market penetration.

Confidence in the financial sector

Confidence in the financial sector, as measured by Ernst & Young's financial services index[16], decreased from 98 index points in the first quarter to 94 index points in the second quarter of 2005. The decline was driven mainly by a deterioration in confidence

16 The index is based on the results of a survey, and 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.

Figure 6: Financial services index and its components*



* 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.*

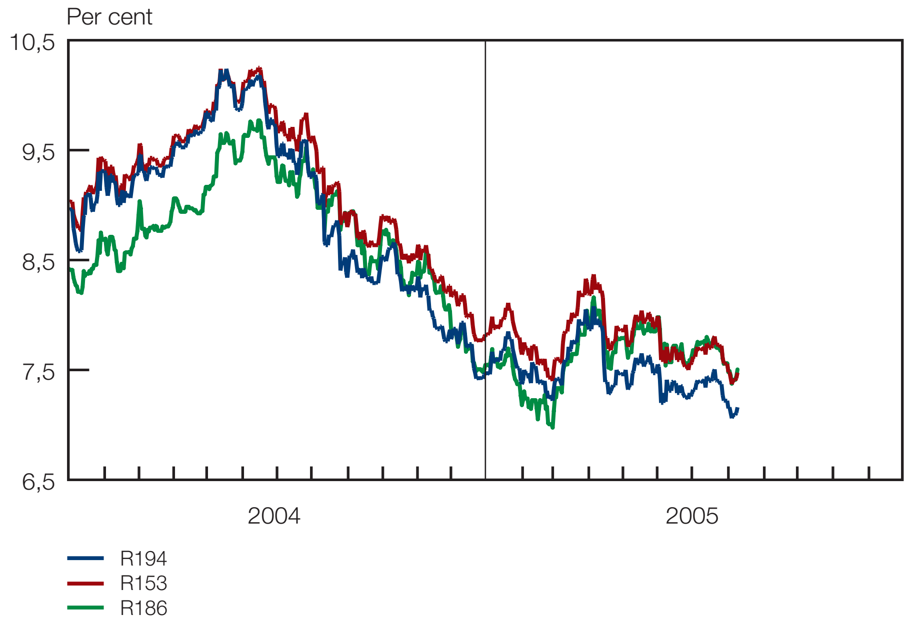
in the life insurance industry from 96 to 76 index points in the second quarter of 2005. Rising surrenders and lapses and the drop in net profit after tax brought confidence in the life insurance industry down. This was exacerbated by the extensive media coverage of a number of rulings of the pension funds adjudicator against pension funds and life insurers managing such pension funds, and the growing realisation that life insurers urgently need to modify their business models. Other components of the overall financial services index either remained unchanged or increased in the second quarter of 2005. Overall, confidence in the financial sector remained high.

Bond, equity and currency markets

Macroprudential analysis requires an analysis of developments in the equity, bond and currency markets that may point to increased and extreme market-price volatility following a shift in expectations. Ideally, such an analysis is focussed mainly on the consequences for financial institutions of sharp price changes resulting from institutional herding, as groups of such institutions imitate each other's strategies. Volatility in these markets, by itself, may pose little threat to the stability of the financial system. It is rather the combination of events in the financial and real sectors that exposes the financial system to a higher level of risk. Volatility in these markets may threaten the financial system if it is coupled with the unwinding of financial imbalances built up in previous periods.

In the eight months to August 2005 domestic bond yields remained relatively low compared to the same period a year earlier. Bond yields were supported by a relatively strong and stable currency, the upgrades of South Africa's credit rating and the lack of supply of bonds caused by a lower-than-expected budget deficit. This resulted in higher prices of bonds. The low yields in the market seem to broadly reflect economic growth and inflation expectations. Presently, there are no indications of a breakdown in market consensus that may result in increased volatility. However, the possibility of oil-price upswings spilling over to financial assets cannot be ruled out.

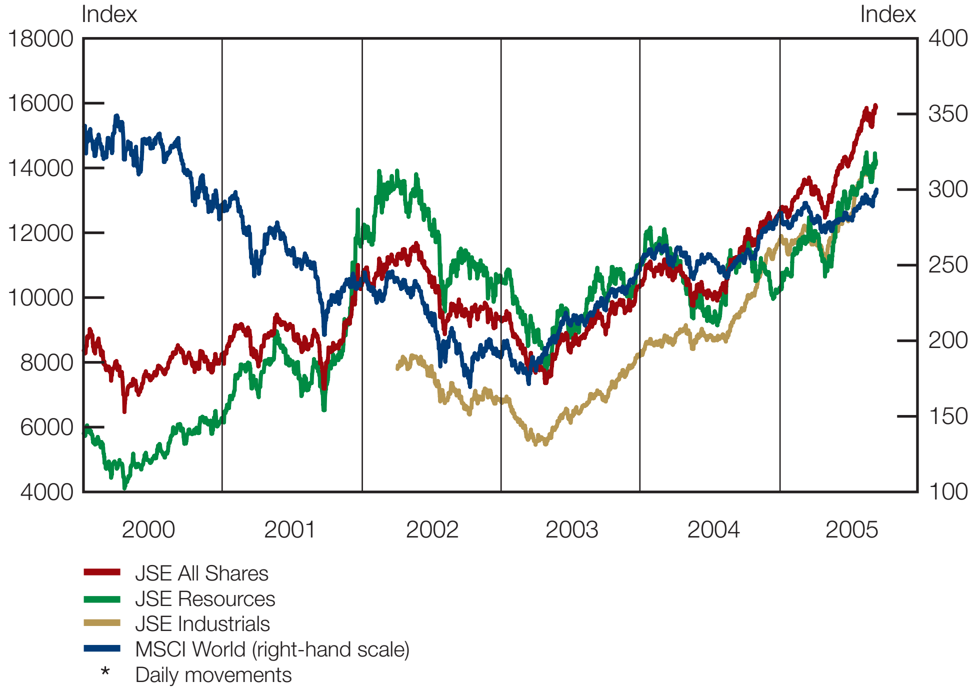
Figure 7: Selected bond yields



Source: Bloomberg

The domestic equity market experienced strong positive growth in the eight months ending August 2005. The JSE All-Share Index (Alsi) rose from lows of 12 511 index points in January 2005 to a record high of 15 414 index points by the end of August 2005. Apart from a slight correction in the Alsi between March and April 2005, there was limited volatility in equity values in the period under review. Among other factors, ratings upgrades by Standard and Poor's (S&P) and Fitch boosted confidence in domestic equities, while positive growth data and high consumer spending promised good returns. These developments bode well for the health of the financial system as they reduce uncertainty about equity market conditions.

Figure 8: Share price indices*

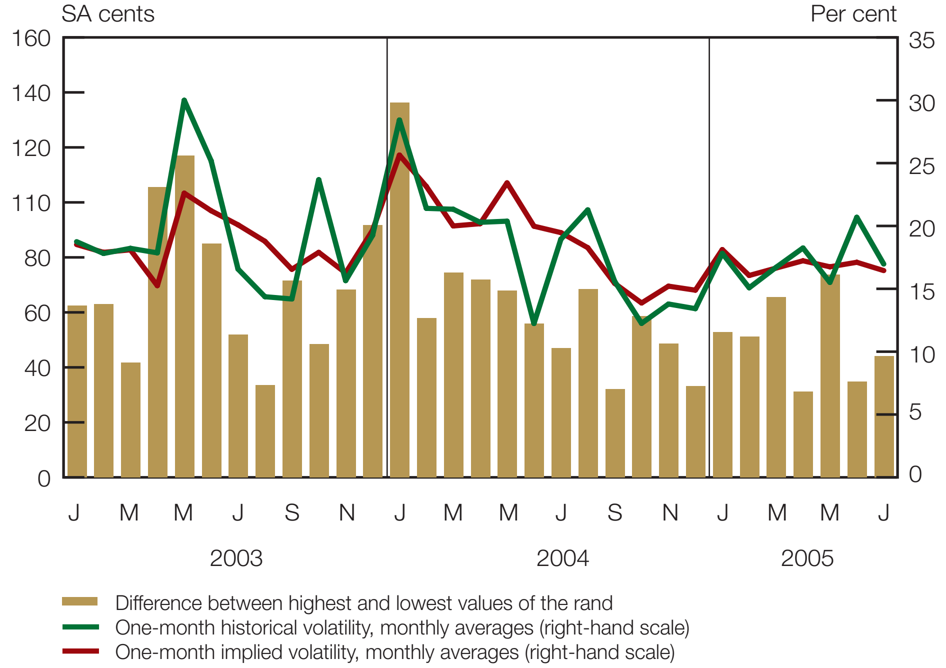


Source: Bloomberg

The volatility of the exchange rate of the rand, as measured by the one-month historical volatility and the difference between the highest and lowest monthly values of the rand, increased marginally in the first half of 2005. This was of little concern, however, when compared to the relatively high levels of volatility recorded in the second and fourth quarters of 2003, and in 2001 and 2002.

The actual intra-day volatility of the rand, as measured by the one-month historical volatility, increased to levels of 18,3 per cent in April and 20,7 per cent in June 2005. The volatility of the rand based on option pricing, as measured by the one-month implied volatility, was more stable and increased only marginally. However, the difference between the highest and lowest monthly values of the rand showed more volatility. The trading range of the rand was 65 cents in March, 31 cents in April, 73 cents in May and 34 cents in June 2005. These ranges are narrower compared to the 117 cents and 136 cents recorded in May 2003 and January 2004 respectively and partly reflect sizeable fluctuations in major international currencies. Expectations of foreign direct investment inflows and actual portfolio flows also added to volatility. Overall, however, the recent volatility of the exchange rate of the rand is well contained and is not in itself a source of concern for the financial system.

Figure 9: Volatility indicators of the rand/US dollar exchange rate



Insurance sector

The ratio of free assets to capital adequacy requirement[17] gives an indication of the financial strength of a long-term insurer, i.e. the number of times the capital adequacy requirement is covered by free assets is used as a measure of the solvency of long-term insurers (see Table 2 for a comparison of the six months ending June 2004 and June 2005). All the long-term typical insurers now have free assets that at least cover the requirement, and the bulk of them cover it multiple times.

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

Table 2: Free assets and capital adequacy requirement

Free assets to capital adequacy requirement (long-term typical insurers)*	Number of insurers	
	2004 June	2005 June
Covered 0 – 1 time	2	0
Covered 1 – 2 times	6	8
Covered 2 – 5 times	18	16
Covered 5 – 10 times	4	3
Covered 10 + times	1	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

The growth in the number of new policies for long-term insurers increased by 14 percentage points between the six months ending June 2004 and the six months ending June 2005. Over the same period, individual lapses of policies for long-term typical insurers (as a percentage of the number of new policies issued during the period) increased from 25 per cent to 30 per cent, while individual surrenders (as a percentage of the number of new policies issued during the period) decreased marginally from 21 per cent to 20 per cent. The annual increase in share prices of insurers (see Table 3) remained almost unchanged at 34,2 per cent in July 2005 from 34,5 per cent in July 2004 (see box "Developments in the South African retirement fund and insurance industries" for more information on the insurance sector).

Table 3: Selected indicators for long-term typical insurers

	Six months ending June	
	2004	2005
Individual lapses*	25	30
Individual surrenders*	21	20
Number of policies (year on year)	4	18
Insurance share prices (year on year)**	34,5	34,2

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

Source: Financial Services Board

Developments in the South African retirement fund and insurance industries

The South African retirement fund and long-term insurance industries currently have to deal with a number of challenges in order to maintain public confidence and trust. These include the negative publicity arising from the growing number of Pension Funds Adjudicator (PFA) determinations, changing consumer needs, the reform of the retirement fund industry initiated by the National Treasury and the low inflation and interest rates impacting on investment returns.

The financial soundness and stability of the retirement fund and long-term insurance industries are critical since they represent a large section of the financial services industry and play an important role as vehicles for saving and investment in the economy. There is also significant cross-shareholding between the South African banking and insurance sectors. In the light of this, the PFA determinations made against funds administered by long-term insurers, as well as against the long-term insurers themselves, could have a significant impact on the profitability, reserves and future business models of the retirement fund industry. Some retirement annuity funds concerned have appealed to the High Court.

The issues covered by the determinations include, among other things, complaints about "early termination values", final maturity value of savings or investment products compared to illustrative values, transfer of members' interest between retirement annuity funds and/or funds invested in inflation-related increments for retirees and the interpretation of South Africa's tax laws by the administrators of the funds[18]. It has been estimated that the financial fallout from these determinations could cost the industry billions of rands to provide for additional payments to be made to policy holders.

18 More information on the PFA determinations can be obtained from the Life Offices' Association of South Africa. Online http://www.loa.co.za

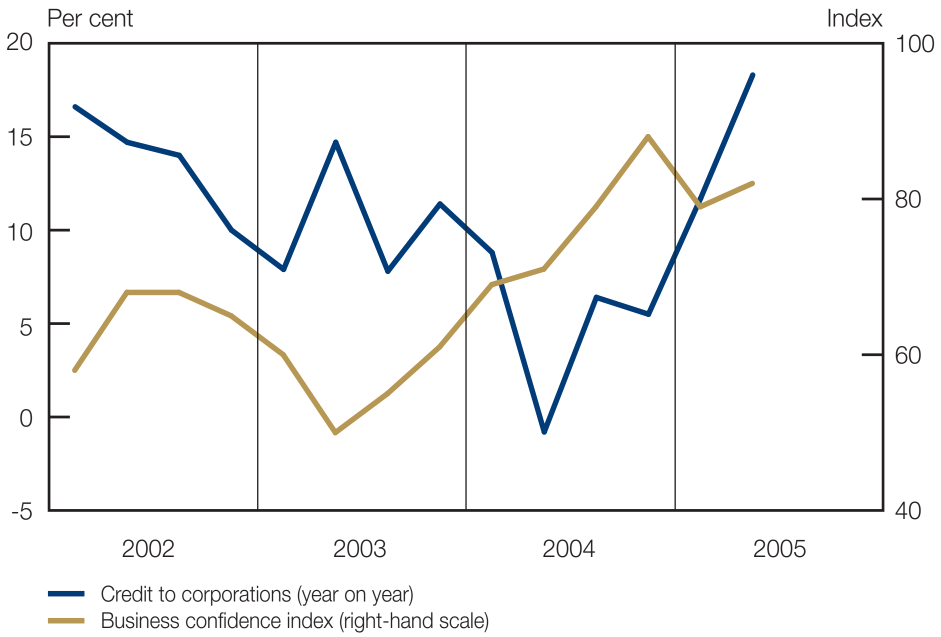
Although potentially very harmful to the individual firms, it is unlikely to turn into a systemic problem as most firms have considerable reserves, and any increase in claims and liabilities would probably occur gradually over the life of the product. The industry has already taken steps to find a sustainable solution to the problems and is in the process of reviewing its business practices, with the intention of limiting the potential damage to brand names and of ensuring the long-term sustainability of its business models. Plans underway include spreading costs and commissions over the term of the products, which will result in improved early termination values, bringing in new-generation products to the market and changing the benefit illustration models traditionally relied upon by life insurance companies. These initiatives should contribute to enhancing the transparency, disclosure and fairness practices of the industry, leading to greater public confidence and certainty.

Corporate sector

Business confidence and corporate borrowing

The Rand Merchant Bank/Bureau for Economic Research (RMB/BER) business confidence index recovered to 82 index points in the second quarter of 2005 following a 9-index-points decline during the first quarter. According to the (RMB/BER), developments that impacted positively on the index included an interest rate cut in April 2005, the weakening of the rand, which lifted the confidence of exporters and companies competing against imports, a cut in the petrol price in early June and regulatory approval of the Absa/Barclays deal. The increase in business confidence was reflected in the annual growth rate of bank loans and advances to corporations, which increased from 11,7 per cent in the first quarter of 2005 to 18,3 per cent in the second quarter of 2005. This increase in credit was high by historical standards and needs to be monitored closely as it could be detrimental to financial stability.

Figure 10: Business confidence index and credit to the corporate sector*

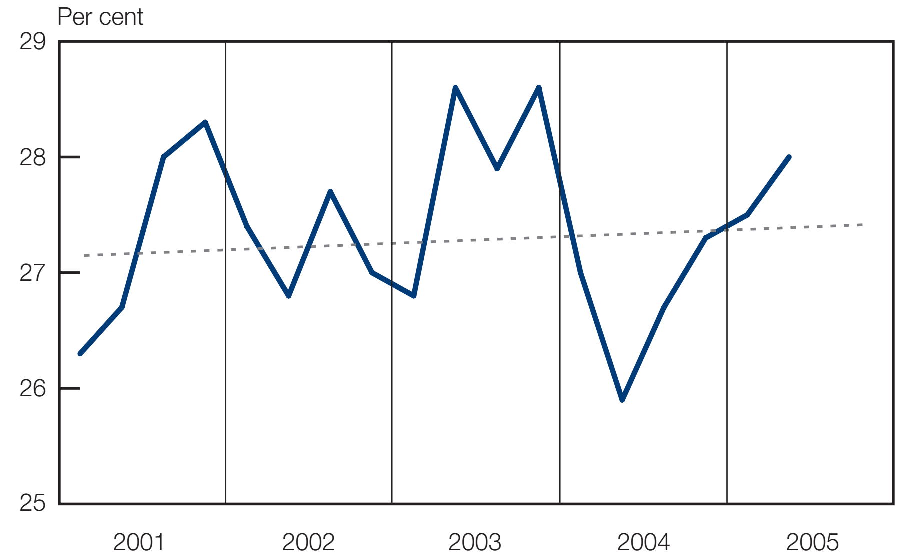


* Credit to the corporate sector includes instalment sale and leasing finance, mortgage advances, overdrafts, credit card debtors and other loans and advances.

Sources: Rand Merchant Bank and South African Reserve Bank

Another indication of a lending boom is a rapid growth in the ratio of private-sector credit to GDP. Such lending booms need to be monitored closely in an analysis of the financial system, as they have preceded financial crises in the past. Credit to corporations, as a percentage of GDP, increased marginally from 27,5 per cent in the first quarter of 2005 to 28 per cent in the second quarter. Though low compared to historical peaks, the increase was once again above the long-term trend line (see Figure 11).

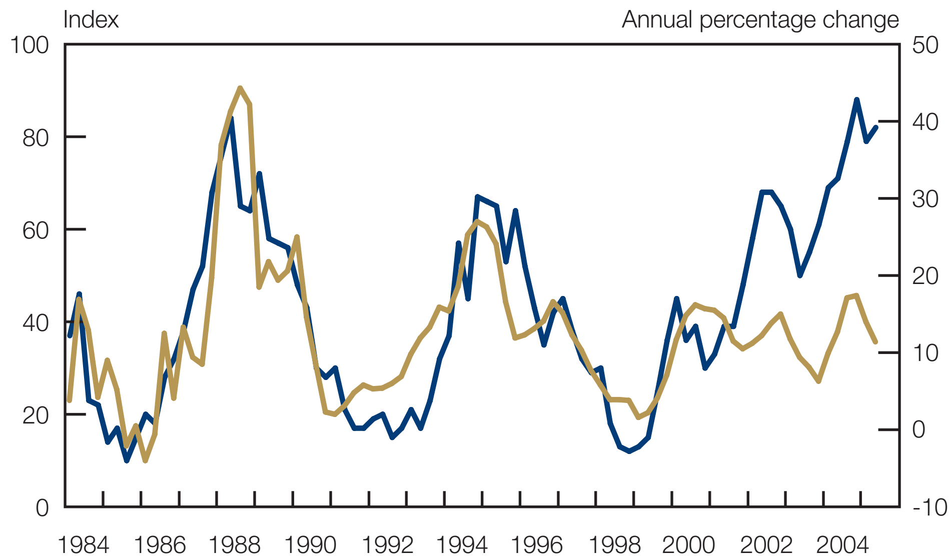
Figure 11: Credit to the corporate sector* as percentage of gross domestic product



- - - Trendline

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

Figure 12: Annual growth in real 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.

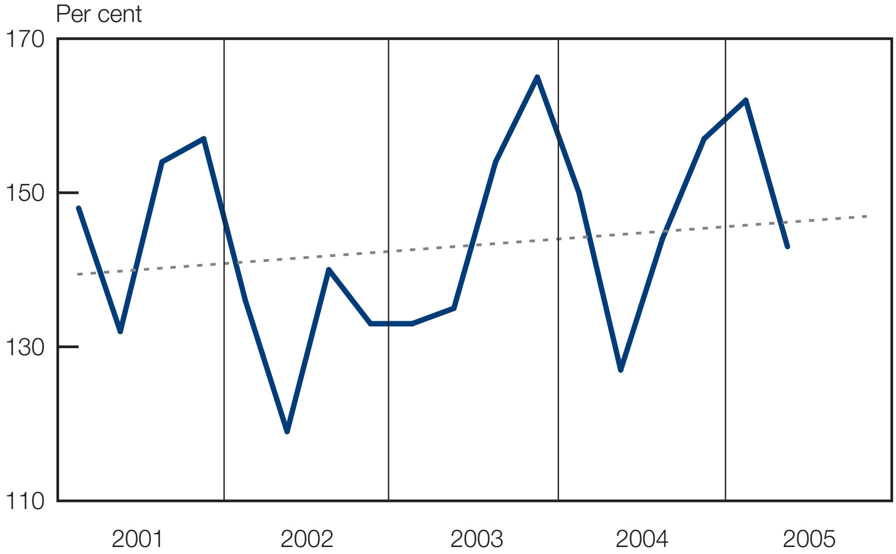
Sources: Rand Merchant Bank and South African Reserve Bank

Corporate investment, indebtedness and the business confidence index

Despite the historical correlation between business confidence and real gross fixed capital formation, the rate of increase of the latter moderated to an annual growth rate of 11,4 per cent in the second quarter of 2005 from 14 per cent in the first quarter of 2005. The increase in business confidence bodes well for investment, which, in turn, is favourable for financial stability.

The ratio of corporate debt to profits measures the debt-servicing capacity of businesses and is an important financial system stability indicator. The ratio decreased from 162 per cent in the first quarter of 2005 to 143 per cent in the second quarter of 2005, and was well below the trend line. The decrease in the ratio can be attributed to an increase in company profits, as many companies reported improved returns for their respective financial years ending in 2004/05.

Figure 13: Credit to the corporate sector* as percentage of annualised profits



- - - Trendline

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

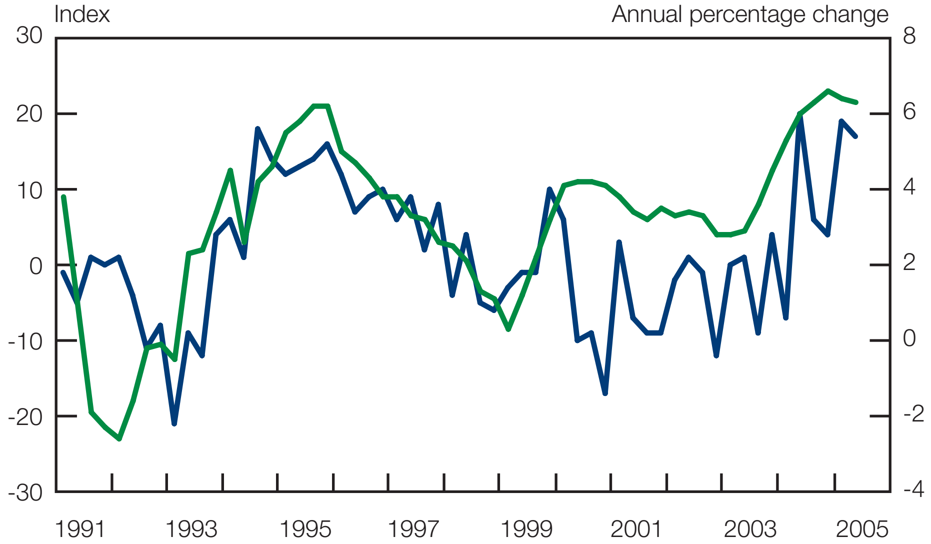
Household sector

Consumer confidence, consumption expenditure and credit extension

The reduction in interest rates since mid-2003 has boosted consumer confidence and household consumption expenditure. In spite of its volatility, consumer confidence has been on an upward trend since the first quarter of 2003 (see Figure 14). According to the BER, consumer confidence decreased marginally by 2 index points to 17 index points between the first and second quarters of 2005. At that level, consumer confidence was still high and slightly below the historical high of 20 index points recorded a year before. Household consumption expenditure also declined only marginally from 6,4 per cent in the first quarter of 2005 to 6,3 per cent in the second quarter.

Consumption expenditure was supported by an increased use of credit facilities provided by both the banking and the micro-finance sectors. As a percentage of GDP, household consumption expenditure increased slightly from 63,5 per cent in the first quarter of 2005 to 64,2 per cent in the second quarter (see Figure 15).

Figure 14: Annual growth in real household consumption expenditure and consumer confidence index*

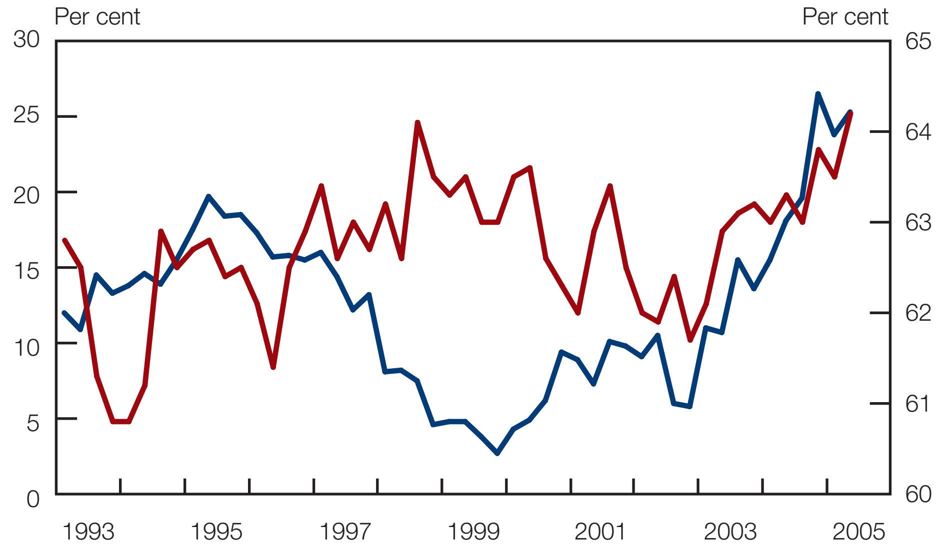


Consumer confidence index
Household consumption expenditure (right-hand scale)

* 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.

Sources: Bureau for Economic Research and South African Reserve Bank

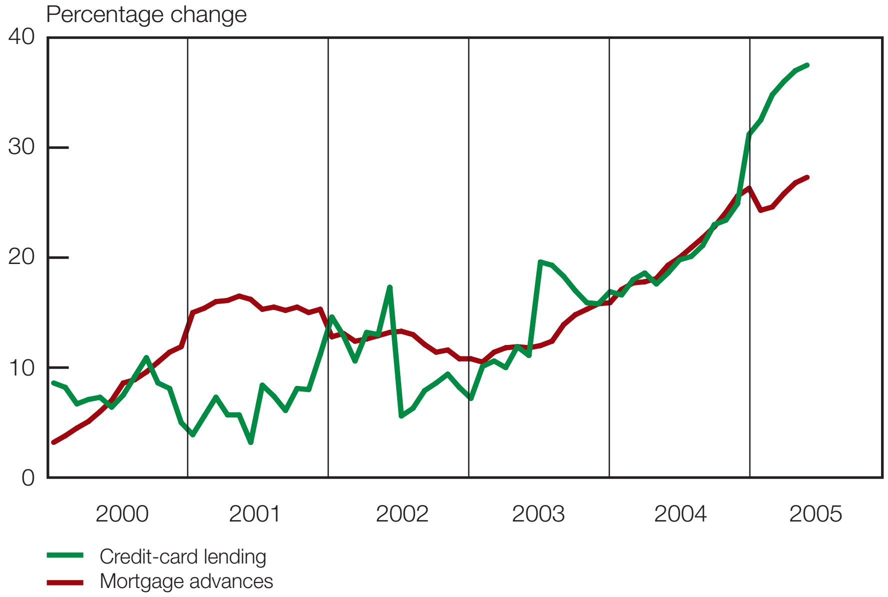
Figure 15: Ratio of household consumption expenditure to gross domestic product and annual growth in credit to the household sector



Credit to households
Household consumption as percentage of gross domestic product (right-hand scale)

Categories of consumer credit that have led to a surge in credit to the household sector are credit-card and mortgage advances. Credit-card lending has been increasing since the beginning of 2004, with an annual growth rate of 37,5 per cent in June 2005, up from 18,6 per cent a year before. However, credit cards form only a small proportion of consumer credit. Mortgage advances have been increasing since 2003 and recorded an annual growth rate of 27,3 per cent in June 2005.

Figure 16: Annual growth in credit-card lending and mortgage advances*

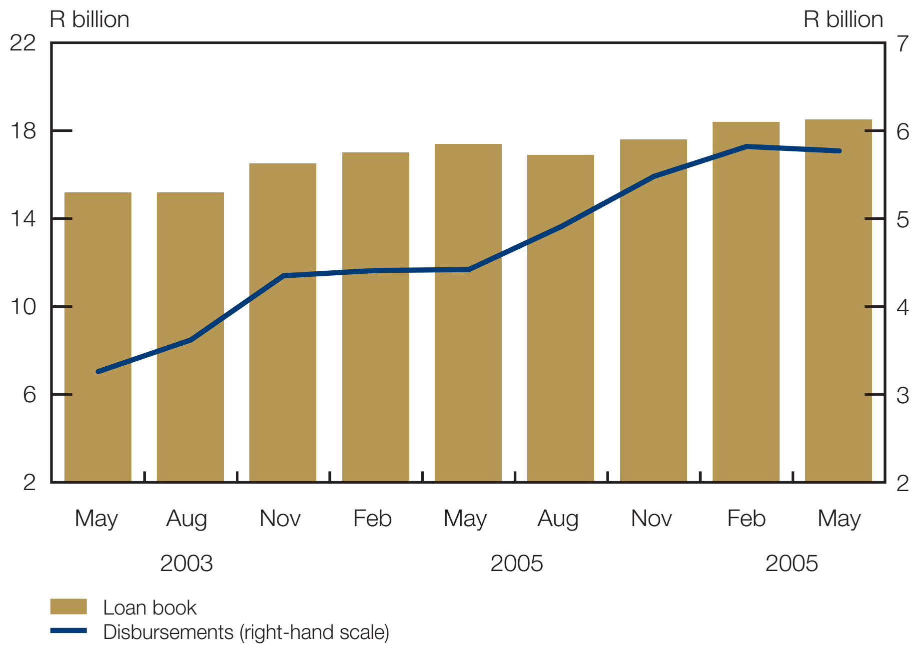


* Cedit-card lending includes lending to both the corporate and household sectors.

Micro-finance indicators also show that lending to the household sector remained high for the quarter ending May 2005[19]. The total loan book increased slightly from R18,4 billion at the end of February 2005 to R18,5 billion in May 2005. Over the same period,

19 The Micro Finance Regulatory Council quarters run from March to May, June to August, September to November and December to February.

Figure 17: Micro-finance loan book and disbursements as at the end of each quarter



Source: Micro Finance Regulatory Council the recorded value of disbursements remained unchanged at R5,8 billion. However, the micro-lending loan book is very small compared to the loan book of banks (see box "The new policy framework for the consumer credit industry" for developments in the consumer credit industry).

The new policy framework for the consumer credit industry

The South African consumer credit market is worth approximately R360 billion and provides credit to about 15 million people. The government aims to create a more efficient market in which consumers will be able to access credit at affordable rates and to combat over-indebtedness by consumers. To achieve these objectives, the Department of Trade and Industry (DTI) appointed a Technical Committee in May 2002 to conduct an extensive review of the consumer credit market. Following the report handed to the DTI in October 2003, the National Credit Bill[20] (the Bill) was introduced to Parliament in May 2005 and is expected to be promulgated in 2006.

With certain exceptions[21], the Bill applies to every credit agreement made between parties dealing at arm's length[22]. The Bill proposes the establishment of a National Credit Regulator and National Consumer Tribunal, tasked with the registration of credit providers, credit bureaus, debt counsellors and the adjudication of consumer complaints. The Bill deals extensively with the rights of consumers and steps to be taken to curb reckless credit extension and allows for the designated minister to prescribe an interest cap and cost controls.

The Bill proposes a number of significant and far-reaching changes to South Africa's consumer credit laws. For some credit providers it might become uneconomical to stay in business unless they adjust their business models accordingly.

The reforms will probably only impact on small, non-systemic banks involved in micro lending, and should not negatively impact on the safety and soundness of the banking system as a whole. With increased disclosure and sharing of information, it is possible that the expected increase in competition could lead to somewhat lower profit margins. At the same time, information sharing could lead to better credit-risk management practices by loan providers.

20 The Bill proposes to repeal the Usury Act, 73 of 1968, the Credit Agreements Act, 75 of 1980 and the Exemption Notice to the Usury Act, 1999.

21 Exemptions include credit agreements concluded by a juristic person as the consumer, where such entity's asset value or annual turnover at the relevant time equals or exceeds a prescribed threshold.

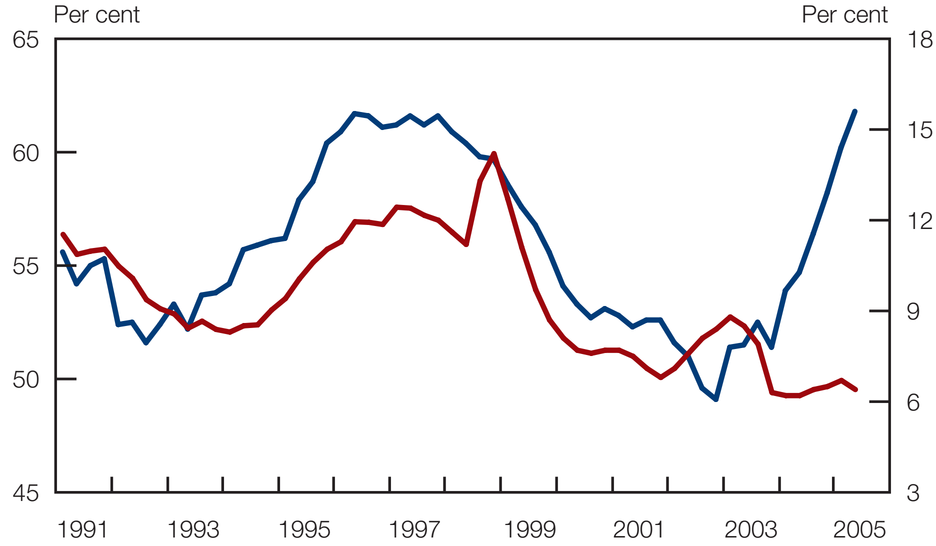
22 Loans between family members, partners and friends on an informal basis will not be regulated.

Household indebtedness

A rapid increase in households' indebtedness could entail risks should interest costs rise. An analysis of households' total indebtedness and the affordability of their total debt burden give, among other factors, an indication of the sustainability of household consumption expenditure and consumers' ability to honour their debt obligations. Household debt has been trending upward since the beginning of 2003. The ratio of household debt to disposable income increased from 60,2 per cent in the first quarter to 61,8 per cent in the second quarter of 2005, and is now close to the peak of 62 per cent recorded in the fourth quarter of 1997.

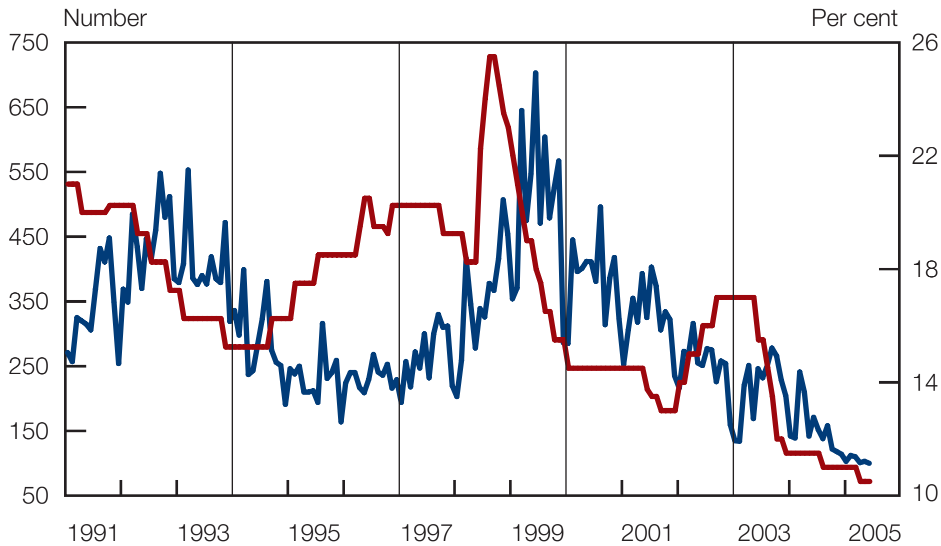
The reduction in interest rates resulted in an initial decline in income gearing (financing costs of household debt to income), from 8,5 per cent in the second quarter of 2003 to 6,5 per cent in the fourth quarter of 2004. Since then, income gearing has only varied marginally and amounted to 6,4 per cent in the second quarter of 2005. The ratio shows that households use a small fraction of their disposable income to finance debt given the current lower interest rate environment, which could imply a low probability of default on debt. The number of insolvencies, which is related to the extent of unpaid debt by households and close corporations, declined by 41,5 per cent in the year to June 2005, probably due to the current relatively low interest rates, among other factors. However, the picture could change, should interest costs rise. Therefore, the increase in household debt as a percentage of disposable income needs to be monitored closely to ensure that it does not become a threat to the stability of the financial system.

Figure 18: Household debt as percentage of disposable income and income gearing*



Household debt as percentage of disposable income
Income gearing (right-hand scale)
* Income gearing refers to the financing cost of household debt as percentage of disposable income.

Figure 19: Number of insolvencies* and prime lending rate

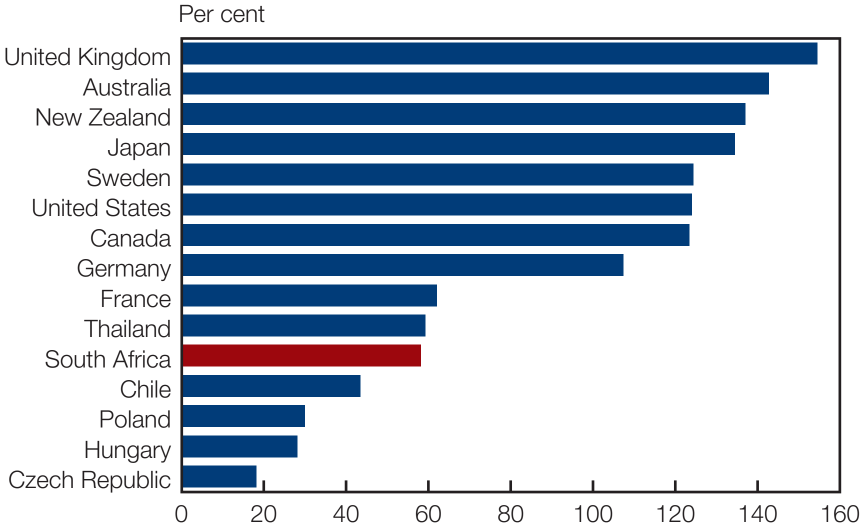


Number of insolvencies
Prime lending rate (right-hand scale)
* Information on insolvencies is based on Notices of the Master of the Supreme Court.

Sources: Statistics South Africa and South African Reserve Bank

As shown in Figure 20, the vulnerability of the South African household sector to high debt levels compares favourably to that of other countries, with the UK, New Zealand, Japan, Sweden, the US, Canada and Australia having household debt levels in excess of 120 per cent of disposable income. The Central European economies (Poland, Hungary and Czech Republic) have the lowest household debt to income ratios of below 30 per cent. South Africa's household debt to disposable income ratio was 58,2 per cent, which was slightly below Thailand's (59,3 per cent) and above Chile's (43,5 per cent).

Figure 20: Household debt as percentage of disposable income – country comparisons*



* For the Czech Republic, Hungary and Poland, data are as at end of 2003. Chile and Thailand's data are as at end of third quarter of 2004 and the first half of 2004, respectively. The rest of the data are as at end 2004.

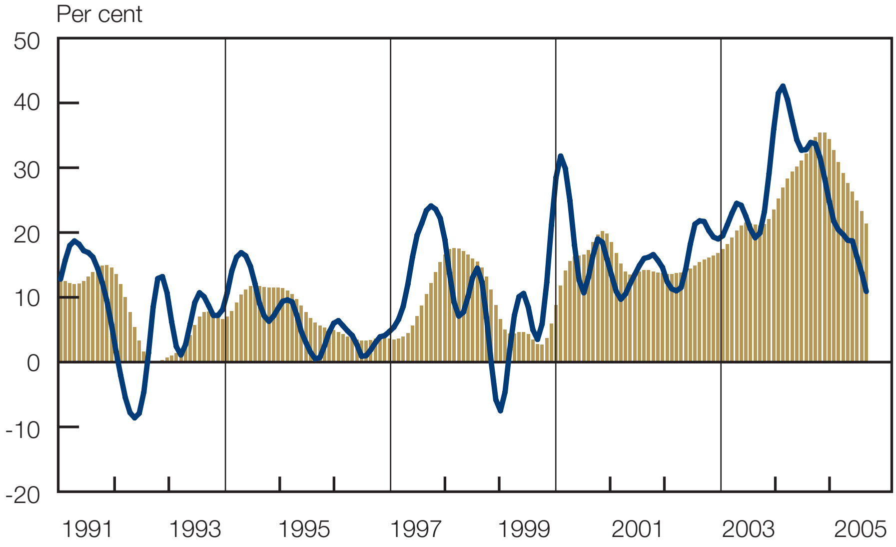
Sources: OECD, Central Banks and BIS

Residential property market activity

The annual growth in house prices began to moderate in the last quarter of 2004, and continued along this trend until July 2005. According to the Absa house price index, house price growth slowed for the ninth consecutive month in July 2005 to an annual growth rate of 21,4 per cent, down from 23,3 per cent in June 2005. For the six months to June 2005, prices rose at an average of 27 per cent, compared to an average growth rate of 30 per cent for the first six months of 2004. Although the growth in house prices remains strong, the major factor causing the downward trend in house price growth is that residential houses have become less affordable.

A comparison of house price growth rates in selected countries (Table 4) shows that house prices in most countries grew at double-digit rates in 2004, especially in developed economies. However, signs of cooling off are evident in several countries, including the UK, Ireland and Australia. In 2003 and 2004 house price growth rates in the local market topped the list. However, a differentiating factor of the local property market was that the growth was supported by strong economic fundamentals and some country-specific factors, which included the emergence of the new middle class, the participation of foreign buyers as well as the fact that house prices were catching up after years of limited activity.

Figure 21: House price index*



* The house price index is based on the total purchase price of houses in the $80m^2$-$400m^2$ size category, valued at R2,2 million or less in 2004, in respect of which loan applications were approved by Absa. Prices are smoothed in an attempt to exclude the distorting seasonal factors and outliers in the data.

Source: Absa Bank

Table 4: Annual house price growth rates – selected countries

Country	2003 +	2004 +	Latest
South Africa	21,4	32,1	21,4*
United Kingdom	19,4	18,8	2,2**
New Zealand	19,2	18,5	12,2***
Australia	18,2	10,4	2,3***
United States	7,0	10,9	12,5***
Sweden	6,7	9,3	8,0***
Ireland	14,3	11,6	6,6****
Norway	1,7	10,2	7,9***
Denmark	5,0	10,0	8,0***

\+ Average growth rate for the year
* July 2005 data
** June 2005 data
*** First quarter 2005 data
**** May 2005 data

Sources: Central banks, National Statistics Offices, Halifax and Office of Federal Housing Enterprise Oversight

It is expected that the demand for housing will continue to be supported by strong consumer demand, which is underpinned by increases in disposable income, favourable financial conditions and structural changes in the economy.

First National Bank (FNB) also computes other measures of residential property market activity. The primary measure is the Residential Property Confidence Indicator (RPCI)[23]. The RPCI shows that there has been a drop in market activity from 7,4 in the first quarter to 6,8 in the second quarter of 2005. According to FNB, the major driving force behind the decline in property market activity was seasonality, as the survey was conducted in the run-up to the winter months.

23 The RPCI measures activity on a scale of 1 to 10, where 1 to 3 indicates “Not Very Active”, 4 to 6 indicates “Stable”, 7 to 8 is “Active” and 9 to 10 indicates a “Very Active” market. Activity is defined as “feet through doors”, which translates into the number of potential homebuyers visiting show houses.

Table 5: Residential Property Confidence Indicator

Period	2003 Q4	2004 Q1	2004 Q2	2004 Q3	2004 Q4	2005 Q1	2005 Q2
Level of activity	7,6	7,7	7,5	6,7	7,3	7,4	6,8

Source: First National Bank

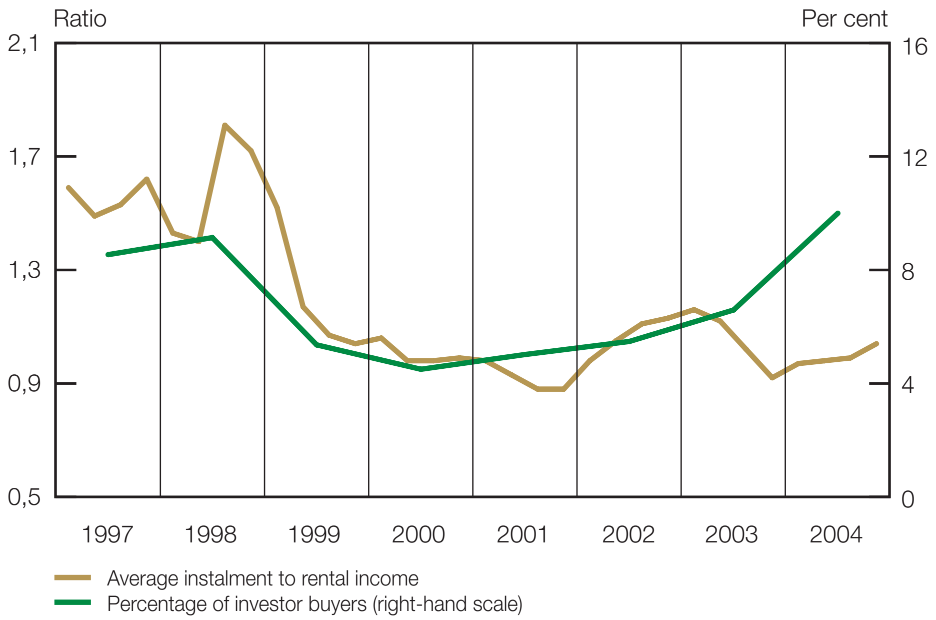
Other signs that the residential property market was cooling off included the fact that the percentage of properties sold below asking price increased from 29 per cent in the first quarter to 44 per cent in the second quarter of 2005, according to FNB. Over the same period, the average length of time properties stayed in the market increased from 5 to 7 weeks. Furthermore, the percentage of properties bought for letting remained constant at 25 per cent. Despite the signs of cooling off, the market was driven mainly by first-time buyers, who increased to 32 per cent in the second quarter of 2005, compared to 26 per cent in the fourth quarter of 2004.

The buy-to-let market and investor activity[24]

24 Investors are distinguished from homeowner-occupants by the fact that they own more than one property.

The participation of investors in the residential property market provides the market with momentum and can fuel the trend in house price growth. Investors are more likely than homeowner-occupants to sell their property when they expect or see a fall in house prices. A simultaneous selling-off by investors to avoid or limit capital losses can exacerbate a decline in house prices. Over the past four years the percentage of home buyers that are investors has been rising steadily, from 5 per cent in 2001 to 6,6 per cent in 2003 and 10 per cent in 2004.

Figure 22: Mortgage instalment to rental income and percentage of investors in the residential property market



Source: Standard Bank

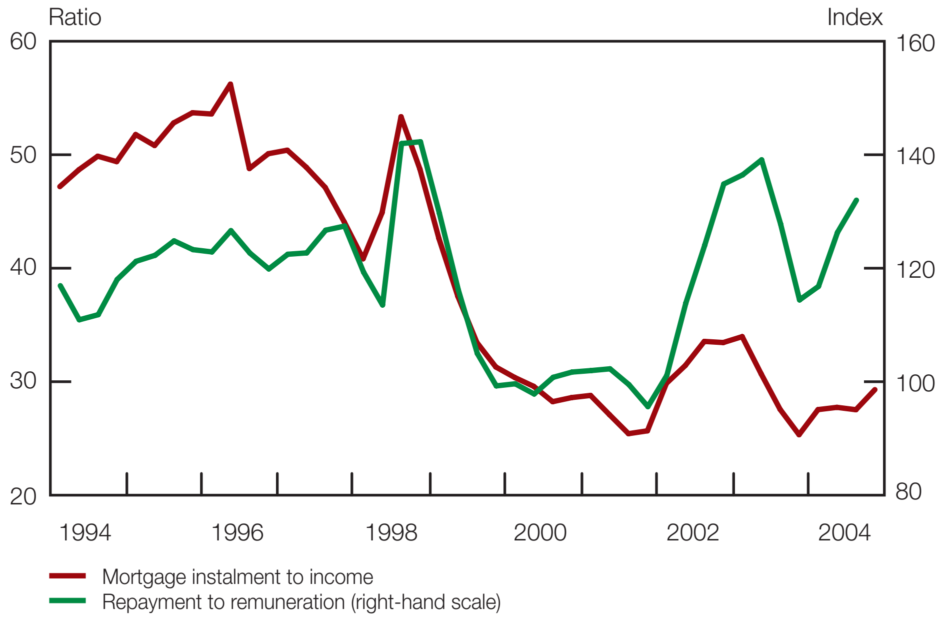
One major factor that investors consider is the gap between rental income and mortgage instalments, or the ratio thereof. A decrease in the ratio of mortgage instalments (on a newly-acquired dwelling) to rental income means that rental income is growing at a faster pace than mortgage instalments and that the return on investment will be enhanced. This ratio decreased considerably from 1998 to 2001, signifying improved returns. It then started to rise on account of rising house prices, but this increase was interrupted in 2003 as declining interest rates caused mortgage instalments to decrease. The ratio again rose steadily in 2004, an indication that rental yields are slowly being eroded by the sharp and high growth rate of house prices since the second half of 2003.

Affordability of housing

One widely used measure of the cost of housing is the affordability index. Absa computes this measure by taking the index of the ratio of mortgage repayments to remuneration/income. A similar measure from Standard Bank is the un-indexed ratio of mortgage instalments to household income. An increase in these measures of affordability indicates that the mortgage instalments/repayments to income ratio is rising and, hence, households are using a larger fraction of their income on property.

Measures of affordability declined between the second and fourth quarters of 2003 in response to the reduction in interest rates from mid-2003, indicating that housing became relatively more affordable than in the earlier period. In 2004 the affordability ratio and index have been rising (worsening) despite low interest rates, an indication that houses were becoming less affordable, essentially because of escalating house prices.

Figure 23: Housing affordability

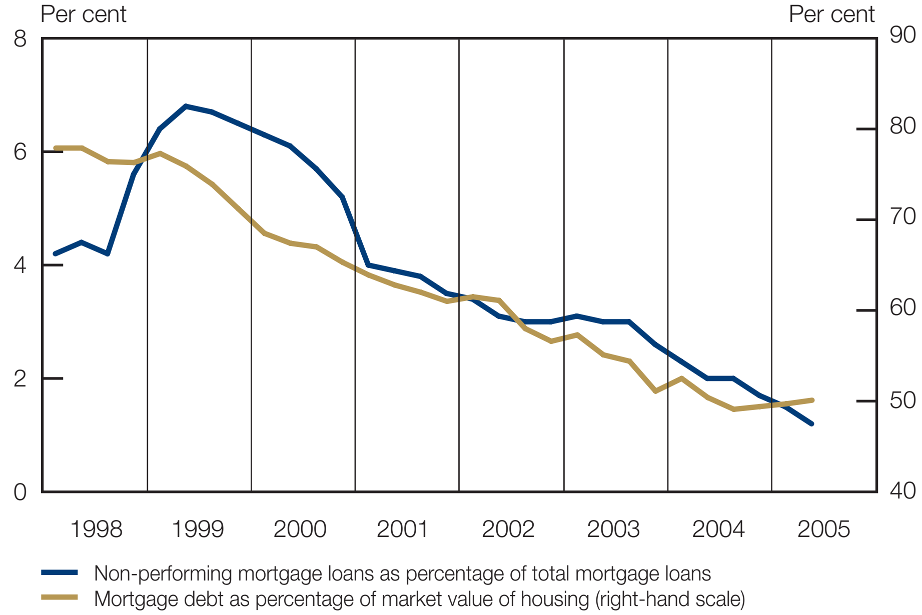


Sources: Absa and Standard Bank

Overdue mortgage loans

The ratio of non-performing mortgage loans to total mortgage advances declined further to 1,2 per cent in the second quarter of 2005, from 1,5 per cent in the first quarter. Despite the marginal increase in the ratio of mortgage debt to market value of housing in the second quarter of 2005 to 50,1 per cent (from 49,7 per cent in the first quarter of 2005), the historical trend in the ratio is still declining, which is a positive development for financial stability.

Figure 24: Non-performing mortgage loans and mortgage debt



In summary, available measures of residential market activity pointed to a cooling-off phase following above average trend growth in house prices. This phase also indicated that the impact of previous interest rate cuts is gradually fading away and households are getting accustomed to the low interest rate environment. Developments in the residential property market did not pose a risk to the banking sector and overall financial stability as there were no indications of rising defaults in mortgage repayments. However, the possibility of an increase in the default rate among mortgage holders, who may have been too willing to take on higher levels of indebtedness at low interest rates, could pose a threat to the health of the banking sector.

Infrastructure and regulation

Episodes of financial instability can be caused or triggered by a whole range of global or domestic macroeconomic or financial market developments. In addition to the probability of a shock, the system's ability to withstand shocks is surely as important. For this reason a substantial part of the work of the Bank is more qualitative in nature, and focuses on systematically evaluating the laws, regulations, standards and practices that constitute the financial regulatory environment.

In the March 2005 edition of the *Financial Stability Review*, it was explained that in order to enhance global and national financial system stability, the adoption and implementation of sound economic and internationally-accepted financial standards and codes are crucial. The said edition gave an overview of South Africa's status regarding the adoption and implementation of the Financial Stability Forum's 12 key internationally-accepted standards and codes for sound financial systems, and concluded that South Africa has a robust financial system infrastructure that generally complies with international standards and sound practices.

Overview of SADC's activities regarding regional harmonisation of financial systems and markets

South Africa's continued economic prosperity and financial stability also depends on the relative prosperity of the Southern African region. In this regard, South Africa contributes towards the positive development of the African continent through NEPAD and is closely involved in the activities of the Southern African Development Community (SADC)[25]. One of SADC's long-term objectives is to introduce a common currency in the region by 2016 and to establish a Common Monetary Union by 2018. Macroeconomic convergence, and the harmonisation of the region's financial systems and markets are, however, prerequisites for future monetary union in the region.

25 The SADC consists of 14 member countries: Angola, Botswana, Democratic Republic of Congo, Lesotho, Madagascar (as from 1 August 2005), Malawi, Mauritius, Mozambique, Namibia, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe.

A brief history of the development of SADC

On 1 April 1980, the governments of nine Southern African countries decided to enhance co-operation and work towards the harmonisation of their respective countries' macroeconomic policies in order to build a stronger and integrated economy in the region. This was endeavoured through the formation of the Southern African Development Coordination Conference (SADCC), the forerunner of SADC[26]. The SADCC was transformed into SADC in 1992, and adopted a new framework for a higher level of regional co-operation.

Following a restructuring of SADC in 2001, the activities of the regional integration programme were centralised into four directorates, namely the Trade, Industry, Finance and Investment Directorate, the Food, Agriculture and Natural Resources Directorate, the Infrastructure and Services Directorate and the Social and Human Development and Special Programmes Directorate.

In 2004 SADC adopted a development framework, the "Regional Indicative Strategic Development Plan", which sets out the strategic priorities of the SADC and provides a framework for the integration of the economies, with the ultimate objective of fostering sustainable development.

26 The complete history of the SADC and all of its activities can be viewed at: http://www.sadc.int

27 The Committee's activities can be viewed at http://www.sadcbankers.org

The responsibility for co-ordinating and facilitating harmonisation of the financial systems and markets rests with the Trade, Industry, Finance and Investment Directorate, which is one of the four directorates that have been established by the SADC (see box "A brief history of the development of SADC"). Within this directorate, two independent but interrelated committees have been actively involved since 1995 in developing and implementing strategies for the harmonisation of financial standards and norms in the region. The Committee of Senior Treasury Officials attends to fiscal issues, while the Committee of Central Bank Governors[27] attends to monetary policy issues. These two committees have embodied their policy objectives in the still-to-be-approved Finance and Investment Protocol. The policy objectives for this particular protocol include regional macroeconomic stability and convergence, the deepening of financial and capital markets and stimulating investment flows in the region. These objectives require co-operation on fiscal policies, monetary policies, financial systems, markets and regulatory frameworks.

28 More information on the goals and objectives of SADC can be obtained from: http://www.sadc.int

This section gives a high-level overview of SADC's activities regarding regional harmonisation in respect of financial markets, systems and regulatory frameworks. These harmonisation activities and efforts would contribute in the long term to a financially stable Southern African region. It should be noted that SADC has a multitude of other programmes and activities, with policy objectives, strategies and projects designed to realise the overall goals and objectives of SADC[28].

The 14 member countries comprising SADC are at various stages of economic development and financial reform. In recent years a number of the member countries have already subjected themselves to the joint external assessment mechanisms of the IMF and the World Bank, namely the Financial Sector Assessment Programme (FSAP) and Reports on the Observance of Standards and Codes. Some of the main concerns that emanated from these assessments relate to, among other things, financial sector regulation and supervision, independence of central banks in some cases, corruption and poor governance, concentrated domestic banking systems and outdated financial and other legislation. Initiatives are underway to address these concerns.

The speed at which progress can be made and objectives can be achieved is, however, determined by the availability of human and financial resources. Training and information sharing will be crucial to the ongoing efforts to establish effective regulatory frameworks and financial markets in the SADC countries. In this regard, a number of bilateral and multilateral Memoranda of Understanding have been signed among the member countries in support of the Finance and Investment Protocol development process.

Financial regulation and supervision

Banking

29 See SADC Banking Association website at http://www.banking.org.za/sadc/

The SADC Banking Association was created in 1998 and provides a platform for private banks to interact with one another and their respective authorities on issues such as good banking practices, uniform legislation, money laundering, training, robberies, fraud and fraud prevention[29]. The association is currently pursuing projects relating to public/private partnerships for infrastructure development, combating bank-related crime, and the formulation and implementation of uniform norms for good banking practice across the region.

In furtherance of regional integration objectives, the Committee of Central Bank Governors has established its own sub-committee to deal with bank supervision processes, known as the SADC Sub-committee of Bank Supervisors. This function was previously performed by the East and Southern Africa Banking Supervisors Group (ESAF). ESAF was established in 1993 and was responsible for implementing and maintaining internationally-acceptable standards of banking supervision and legislation across the sub-region. Successes of ESAF include the endorsement of the 25 Core Principles for Effective Banking Supervision as a basis for harmonisation of standards and supervisory practices in the region and the formulation of several annual training programmes. ESAF was formally dissolved towards the end of 2004.

The SADC Sub-committee of Bank Supervisors will continue the activities of ESAF and its objectives include the promotion and enhancement of bank supervision through adherence to and the promotion of international supervisory standards, the harmonisation of banking legislation, supervision systems and practices, the implementation of the Core Principles for Effective Banking Supervision, anti-money laundering compliance, combating of terrorist financing and formulation of training programmes in conjunction with regional and international bodies (see box "Terrorism and financial stability").

Terrorism and financial stability

Acts of terror can permeate society in a variety of ways. From a financial stability point of view, key concerns associated with terrorism relate to the disruption of the financial markets and its adverse effects on confidence in the economy and in the financial system.

Associated with both the 11 September 2001 attacks in the United States and the recent 7 July 2005 terror bombings in London were economic effects such as diminished confidence in industrialised countries, a flight to quality away from emerging markets and the impact of movements in commodity markets on other developing countries. The influence of the London bombings on world markets was markedly muted when compared with the 11 September terror attacks largely due to the smaller scale of the event, greater market resilience and preparedness in respect of terror threats, a more rapid recovery from the shock impact of the event and market focus on the minimal long-term economic impact of the event.

While the direct costs of terror (destruction of property and the loss of life) are of greatest concern, it is the indirect costs of terror that often have the strongest impact on financial stability, i.e. the potential of acts of terror to impact the economy by undermining investor and consumer confidence. These indirect costs may quantifiably manifest in the form of reduced consumer spending and a decline in asset prices as investors diversify to "safe" jurisdictions. The actual stability impact is determined by, among other factors, the nature of the attack, the nature of the response to the attack and the resilience of the markets. The resilience of financial markets is reflected in their ability to recognise the occurrence of the event, recover from the shock of the event and behave in accordance with their long-term economic goals rather than the short-term financial impact of the event[30].

The London bombing of 7 July 2005 was a low-impact event largely due to the global experience of the 11 September 2001 terror attacks, and the contingency planning and preparedness that have evolved since. International markets responded to the event with remarkable resilience. There were no incidents of widespread disruption or loss of confidence. Rather, open communication and an orderly and logical approach to the event contained its systemic potential.

The financial stability objective of central banks provides for the central bank to have numerous and wide-ranging roles in a crisis. The South African Reserve Bank's efforts begin with financial-sector threat assessment and mitigation, include co-ordinating contingency planning and responses to financial crises, and extend to maintaining the ongoing operation of the national payments system, ensuring that there is sufficient liquidity in the market and to keeping markets open.

30 Based on Johnston R B and Nedelscu O M. 2005. The Impact of Terrorism on Financial Markets. IMF Working Paper *WP/05/60. Washington: IMF.*

31 Information on the BSA solution can be viewed on http://www.reservebank.co.za/esaf/esafv2.nsf

A key initiative of the SADC Sub-committee of Bank Supervisors, and previously of ESAF, has been the Bank Supervision Application solution, an information and technology system which was developed with the purpose of enabling and supporting harmonised bank supervision processes in SADC central banks[31]. The Bank Supervision Application solution, which was initiated in 1997, has been deployed in all the 11 countries that participated in the initiative, which was the first of its kind in the world. The solution contains, *inter alia*, a risk analysis tool, a research information system, a bank profile system, a data collection mechanism, a statutory data return administration system, scheduling and project planning tools, an on-site examination support system and a document-handling system. The Bank Supervision Application has contributed substantially to the strengthening and harmonisation of bank supervision standards and procedures in the region.

Non-bank financial institutions and securities firms

CISNA, the Committee of Insurance, Securities and Non-Banking Financial Authorities, was established in June 1998. Effectively a subcommittee of the Committee of Senior Treasury Officials, CISNA consists of the regulatory authorities of capital markets, retirement funds, collective investment schemes, insurance companies and providers of intermediary services. The secretariat for CISNA is located at the Financial Services Board in South Africa.

In 2002 CISNA developed a strategy (revised in April 2005) to give direction to its activities and to contribute to the sound regulation, effective supervision and rapid development of the financial services industries. CISNA aims to establish a sound regulatory framework that would allow for a free flow of capital in a comprehensive and harmonised regional market where adherence to the principles of corporate governance is effectively monitored. Further objectives include effective co-operation between regulators, informed investors and the promotion of investment and economic growth.

Continuous efforts are being made through contact with organisations such as the Financial Sector Reforms and Strengthening Initiative, World Bank, IMF and the International Association of Insurance Supervisors to secure sponsorships for training and other CISNA projects. The South African Financial Services Board hosts annual training sessions and familiarisation programmes for CISNA members.

Market infrastructure

Stock exchanges

32 More information on the activities of the Cmmittee of SADC Stock Exchanges is available at http://www.jse.co.za

33 The NEPAD Business Foundation aligns itself with the ideals of NEPAD and undertakes to support these ideals through the delivery of sustainable projects for the benefit of African people and the prosperity of the African continent. More information on the activities of NBF is available at http://www.nepadbusiness foundation.org

The Committee of SADC Stock Exchanges was established in 1997 and its vision is to establish an integrated real-time network of national securities markets within SADC to pave the way for cross-border listings, trade and investment among the different member exchanges[32]. The NEPAD Business Foundation[33] has also identified a need to create an investment channel to generate foreign capital flows into Africa and thus established the Stock Exchange Sector Committee. This sectoral committee acts as a point of contact for business and other interested parties within the industry to identify and pursue multiple opportunities in Africa and also works closely with this committee.

Since its establishment, a number of stock exchanges in the region have harmonised their listing requirements based on 13 principles extracted from the listing requirements of the JSE Limited (JSE). This was done on the premise that common listing requirements could lead to cross-border investments and dual listings.

The JSE has offered the possibility to other stock exchanges in the region to make use of the electronic trading system currently used by the JSE at marginal cost. The use of a common electronic trading platform would be the first step in facilitating the movement of capital within the region and giving access to investors to all stocks listed in the region.

The Committee of SADC Stock Exchanges has also reached an advanced stage in preparing recommendations for a central depository system for the region, under its electronic clearing and settlement project. The model for the development of a shared clearing and settlement infrastructure for member exchanges by Central Depository & Settlement Company Limited, Mauritius, was found to be suitable. The SADC exchanges have also successfully completed the harmonisation of entry-level examinations for stockbrokers, aimed at improving the level of expertise in the region's financial markets.

Anti-money laundering

The Eastern and Southern African Anti-Money Laundering Group (ESAAMLG), a regional body of fourteen countries[34] similar to the Financial Action Task Force (FATF)[35], was established towards the end of 1999. ESAAMLG has acknowledged that regional and international co-operation is critical in the fight against money laundering and the financing of terrorism and reaffirmed its commitment to adopt and implement the 40 plus 9 recommendations of the FATF. ESAAMLG has launched a mutual evaluation programme of the anti-money laundering systems of its members. A number of member countries have already been assessed in terms of the mutual evaluation programme.

The FATF works closely with regional organisations concerned with combating money laundering, and representatives of such bodies participate in the work of the FATF. The FATF will hold a joint plenary session with ESAAMLG in February 2006.

34 Botswana, Kenya, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe.

35 The FATF is an inter-governmental body whose purpose is the development and promotion of national and international policies to combat money laundering and terrorist financing. The FATF is a policy-making body created in 1989 that works to generate the necessary political will to bring about legislative and regulatory reforms in these areas. The FATF has published 40 plus 9 recommendations in order to meet this objective.

Major step towards full compliance with the 40 plus 9 recommendations of the Financial Action Task Force

In 2003, South Africa became a member of the Financial Action Task Force (FATF), an inter-governmental body whose purpose is to develop and promote policies at national and international levels to combat money laundering and terrorist financing. South Africa assumed presidency of FATF as from July 2005 and will host a joint plenary meeting with the Eastern and Southern African Anti-Money Laundering Group, scheduled to take place early next year. This meeting will discuss issues of common interest with the intention of putting into place measures to fight money laundering and the financing of terrorism.

As part of South Africa's efforts to be fully compliant with FATF'S 40 plus 9 recommendations, the Protection of Constitutional Democracy against Terrorism and Related Activities Act, 2004, came into effect in May 2005. This Act enables South African law enforcement agencies to effectively deal with international and domestic terrorist activities and brings South Africa in conformity with the United Nations' Counter Terrorism Conventions and Protocols[36] and with the African Union Convention on the Prevention and Combating of Terrorism[37].

36 Online:http://www.unodc.org/pdf/crime/terrorism/explanatory_english2.pdf

37 Online: http://www.africa-union.org/home/Welcome.htm

Accounting and auditing standards

The Eastern, Central and Southern African Federation of Accountants (ECSAFA), which was established in 1989, is the regional body that co-ordinates the development of the accounting profession and promotes internationally-recognised standards of

38 More information on the activities of ECSAFA are available on http://www.ecsafa.org

professional competence and conduct within the region[38]. ECSAFA is recognised by the International Federation of Accountants as a regional organisation.

The NEPAD Business Foundation has also established the NEPAD Accounting and Auditing Sector Committee with the key objective of enhancing financial reporting in Africa. This does not only refer to applying high-quality accounting standards, but also high-quality auditing standards and corporate governance principles. Since ECSAFA has well-established infrastructures supporting accountants and auditors and can contribute towards NEPAD objectives, an ECSAFA NEPAD Committee was established towards mid-2004 to further pursue the enhancement of financial reporting at individual country and regional levels.

In order to enhance accountability, transparency and honesty in government operations, as well as the proper use and management of public resources, the SADC Organisation of Supreme Audit Institutions and the Organisation of English-speaking Supreme Audit Institutions in Africa (AFROSAI-E) officially merged their two organisations in April 2005 under the aforementioned name. Supreme audit institutions are usually the highest external auditors of the public sector of a country. They make a vital contribution to good governance and the fight against corruption by promoting accountability and transparency in the public sector, and by highlighting poor management and inappropriate use of public money. AFROSAI-E and ECSAFA work together to discuss matters relating to the accounting and auditing profession in the private and public sector and the harmonisation of accounting standards in the broader sub-region.

Legislative reforms to combat and prevent corruption

39 Southern African Development Community Protocol against Corruption. Online: http://www1.oecd.org

40 African Union Convention. Online: http://www.africa-union.org

41 United Nations Convention. Online: http://www.unodc.org/unodc/index.html

It is generally accepted that high levels of corruption or perceptions of corruption could negatively affect financial and political stability. High levels of corruption harm market integrity and good governance. In recognition that significant and lasting progress to combat and prevent corruption can only be achieved through international co-operation, South Africa adopted the Southern African Development Community Protocol[39] against corruption, the African Union Convention[40] on preventing and combating corruption and the United Nations Convention[41] against corruption. These programmes complement each other and share similar objectives as they promote, strengthen and develop mechanisms that aim to prevent, detect, punish and eradicate corruption. These programmes also aim to promote, facilitate and regulate co-operation among countries and to develop and harmonise policies and domestic legislation.

42 A comparative study was conducted by the Public Service and Administration Department. Online: http://www.pmg.org.za/docs/2004.

South Africa now has a comprehensive legislative framework in place to combat and prevent corruption, which is in line with the aforementioned programmes[42]. Effective enforcement of the legislative framework, however, remains crucial. The President of South Africa reconfirmed the government's commitment to act against corruption in his State of the Nation Address in February 2005.

Payment and settlement systems

43 More detail information on the SADC Payment System project can be viewed at http://www.sadcbankers.org

The SADC Payment System Project[43] has as its objectives that each member country has an efficient and effective national payment system based on internationally acceptable standards and that these systems in the region are inter-linked to support cross-border flows within the region with the ultimate objective of supporting the SADC objective of free trade.

A number of SADC central banks have in the meantime implemented automated clearing systems and Real Time Gross Settlement systems in their respective countries. Another major development in this area has been the drafting of the Model National Payment System Act by a team of legal experts from SADC central banks. This draft Model Act has been forwarded to each country's legal team for use as a framework in the development of their payment system regulation.

Ongoing activities include addressing cross-border payment issues and developing a unique cross-border payment model for SADC, capacity building, training on oversight of payment systems to improve risk-management capabilities, and a peer-review/self-assessment mechanism based on the IMF's FSAP methodology.

Other related projects and activities

The Committee for Central Bank Governors and the Committee of Senior Treasury Officials have a host of other related projects that all contribute towards the process of the harmonisation and standardisation of the region's financial markets and systems. Some of those projects and research studies in the SADC region are the introduction of an automated monetary and financial statistics database, the establishment of an information database on central banks and financial markets, compilation of annual country specific reports regarding the progress made with liberalisation of exchange controls, the role of central banks to enhance money-market operations, analysis of currency flows and microfinance and the establishment of guidelines for reforming central bank legislation.

Concluding remarks on SADC activities

As countries become more integrated into the global economy, the international community wants assurance that national economies are broadly following the same financial policy rules and recognised good practices. The international community therefore attaches much value to the adoption and implementation of internationally-accepted financial policies and best practices as this can help to increase the overall robustness of national and international financial systems. Implementation of such policies and best practices should be adapted to a country's overall strategy for its economic and financial-sector development, taking into account its stage of development, level of institutional capacity and other domestic factors.

The process of strengthening the region's financial systems and markets is an important part of the overall process to contribute to SADC's vision, namely the fostering of sustainable development for the region. In 2005, SADC celebrated its 25th anniversary as an organisation. The SADC Directorate for Trade, Industry, Finance and Investment has taken the responsibility to co-ordinate and facilitate the achievement of macroeconomic convergence, the deepening of financial and capital markets and increased investments to support economic growth. Challenges such as a lack of capacity, know-how, training and funding are some of the issues that limit the ability of the SADC region to rapidly harmonise the region's financial systems and markets.

Despite these challenges, good progress has already been made by the SADC region with the harmonisation of financial systems and markets in order to enhance the robustness and efficiency of the financial system in the region.