Financial Stability Review

March 2006

South African Reserve Bank

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Introduction

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

This edition of the *Financial Stability Review,* focusing mainly on the six-month period ending December 2005, comprises four main sections, namely international macrofinancial developments and trends, domestic macroprudential analysis, an overview of important developments in the financial system environment and financial sector continuity planning in South Africa.

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 growth, savings and investment imbalances and the Guidotti ratio as a measure of external vulnerability.

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.

The third section focuses on infrastructure and regulation, and includes an overview of important developments in the financial system environment, including institutional and market infrastructure developments, financial regulation and supervision developments, and macroeconomic policy and data transparency developments.

The fourth section gives an update on financial sector continuity planning in South Africa and examines the financial system stability impact of emerging and potential physical threats. Financial sector continuity arrangements in selected international jurisdictions are also discussed.

Overview

Underpinned by favourable macroeconomic conditions and accommodative macroeconomic policies, the global economy continued to expand strongly during the period under review, albeit at a slightly more moderate and possibly more sustainable pace. This supported stable macrofinancial conditions by reducing uncertainty and promoting confidence in financial markets and institutions.

Notwithstanding these favourable outcomes, a number of key risks to the global economic and financial stability outlook remain. These include high and volatile energy prices, global imbalances and abnormally high residential real-estate prices in certain areas. In addition, the abundance of global saving and the associated search-for-yield, as well as the possible mispricing of risk as a result of an extended period of favourable economic conditions and relatively low levels of volatility in financial markets, are causes for concern. This is particularly true for investment in emerging-market economies where credit spreads narrowed further. Although concerns regarding a possible reversal of capital flows and a damaging correction in financial asset prices (especially following interest rate increases by the US Federal Reserve) did not materialise, a sudden change of sentiment of investors towards emerging markets remains a risk.

The outlook for the Southern African Development Community countries broadly continues to improve, benefiting from general macroeconomic stability, stronger fundamentals, more stabilising policies in most countries, and improved prospects for the global economy. The HIV/Aids pandemic, high unemployment, poverty, conflict and civil strife remain risks for the region, as does imprudent economic policies in some instances.

The domestic financial system continued to be characterised by robust financial institutions, stable financial markets and a resilient market infrastructure. The banking sector continues to be profitable, well-capitalised and able to withstand considerable adverse shocks. The favourable macroeconomic environment contributed towards improved asset quality, and provisioning against overdue accounts was considered adequate in aggregate. The life insurance sector was generally healthy and earlier concerns over the sustainability of the business model of insurers are in the process of being resolved.

Business confidence and confidence in the financial services sector remained high and liquidations and insolvencies continued to show a downward trend. The ratio of household debt to disposable income was at a historical high in December 2005. Although households are able to service outstanding debt quite comfortably, borrowers need to be aware that the benign environment may not continue indefinitely. The Bank continues to monitor the high level of household indebtedness.

Measures of residential property market activity stabilised at high levels and point to a cooling-off phase following above-trend growth rates in house prices. Mortgage debt (representing about 50 per cent of total loans and advances) continued to increase strongly. Although overdue mortgage loans still declined in December 2005 (compared to December 2004), this trend appears to have subsequently reversed. Although not posing a threat to financial stability currently, lenders would be well advised to guard against complacency as experience has shown that the worst loans are made near the top end of the business cycle.

Domestic financial system stability is also dependent on the pro-active efforts of policy-makers to continuously review and improve the financial, regulatory and legal infrastructure. As a result, the financial system should improve its resilience and maintain its international acceptance and recognition. Given the ongoing financial legislative and regulatory reforms, South Africa has recently introduced, and is expected to introduce, some important changes that have the potential to contribute to the promotion of financial stability, market efficiency and consumer protection.

In addition to the efforts to detect and prevent financial instability, the Bank helps to co-ordinate financial sector contingency planning for systemic crisis resolution. Given the prevalence of natural disasters and terror risks globally, domestic financial institutions and regulatory authorities have co-operated well to manage risks that threaten continuity. Financial institutions nevertheless need to pay closer attention to broader continuity management disciplines. This requires a heightened awareness and improved monitoring of emerging threats and continuous testing and improvement of business continuity strategies.

Financial stability developments and trends[1]

International macrofinancial developments

1. Unless otherwise indicated, data were supplied by the Bank Supervision, Research, Financial Markets and Financial Stability Departments of the South African Reserve Bank.

Global financial conditions remained fairly benign during the second half of 2005 despite widening global imbalances, rising oil prices and the occurrence of natural disasters. Solid output growth, accommodative macroeconomic policies, strong equity markets and improved fundamentals, and narrowing credit spreads in emerging economies, bolstered financial stability globally.

Oil prices remained volatile and generally high during the second half of 2005 as a result of continued fears of oil supply disruptions. With world oil demand expected to increase in 2006, the price of oil is expected to continue to impact negatively on global growth. Despite strong supply, buoyant demand conditions propelled other commodity prices during 2005, and commodity prices are expected to remain high in 2006.

Global growth

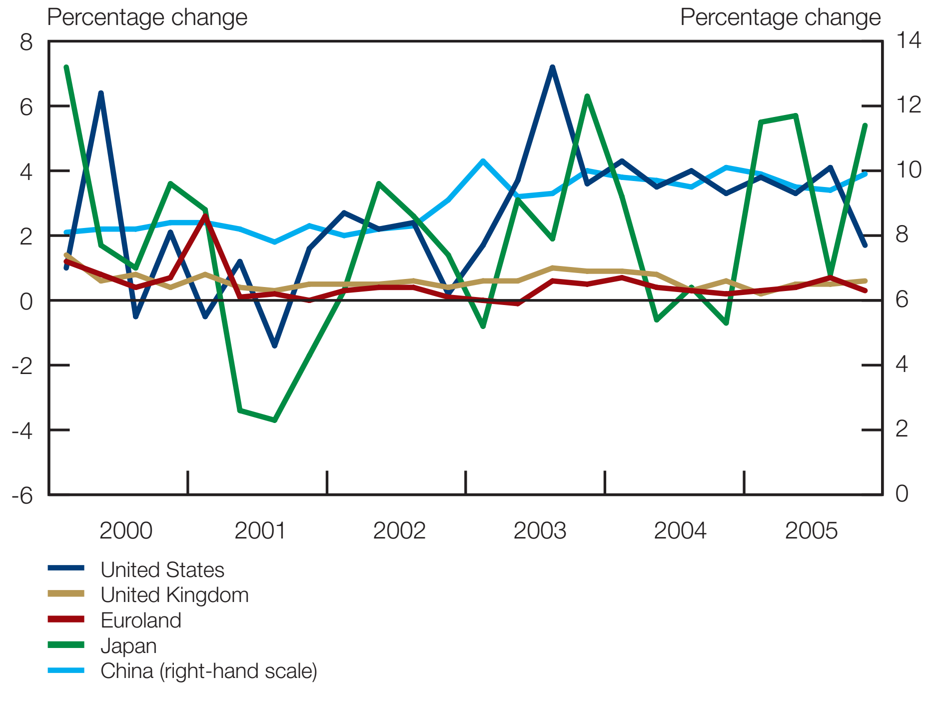
A sustainable level of growth in real gross domestic product (GDP) tends to support financial stability by reducing uncertainty and promoting confidence in financial markets and institutions. Economic growth helps the financial system to absorb shocks and presents more policy options than during periods of contraction. A sudden slowdown in economic growth among the major global role players, especially in combination with other adverse market developments, could have a direct and dramatic impact on global financial system stability.

2. Thompson Financial Ltd. DataStream.

3. World Bank. 16 November 2005. Prospects for the Global Economy.

World growth is estimated to have amounted to 3,4 per cent in 2005, down from 4 per cent in 2004[2]. The slowdown that began in the second half of 2004 was experienced throughout the industrialised world. It was precipitated by higher oil prices, capacity constraints in the resources sector, tightening monetary policy in the United States (US) and, in some countries, the maturation of the investment cycle following a year of very fast growth[3].

Figure 1 Growth in gross domestic product of selected countries



Source: Thompson Financial Ltd (DataStream)

Growth among industrialised countries in 2005 is estimated at about 2,5 per cent, compared with 3,1 per cent the year before. In the US, GDP growth slowed down from 4,1 per cent in the third quarter of 2005 to a revised 1,7 per cent in the fourth quarter, its slowest pace since the first quarter of 2003.

Apart from adverse US circumstances and an oil price spike, another down-side risk to the global economy and that of Japan in particular, is a slowdown in economic activity in China. China's strong economic performance (GDP growth of 9,9 per cent was recorded for 2005) has to a large extent been dependent on its export performance. China would probably wish to stimulate domestic demand by redirecting its growth model to private consumption. Rising domestic demand and household incomes in Japan compensated for much slower import demand from China, allowing GDP growth in Japan to improve from 0,8 per cent in the third quarter to 5,4 per cent in the fourth quarter of 2005.

Among other large developing economies, GDP continued to expand rapidly. India, for example reported GDP growth of 6,9 per cent in 2005. However, high oil prices, combined with domestic capacity constraints and slower import demand from high-income countries, are estimated to have reduced growth among oil-importing developing countries in 2005 from 6,9 per cent to 6,1 per cent.

The global manufacturing Purchasing Managers Index[4] (PMI) has, up until January 2006, been more than two percentage points above the series average for five months in a row. The PMI points to a strong, steady advance in the manufacturing sector extending into 2006. On balance, global production trends do not point to any specific financial system risks arising.

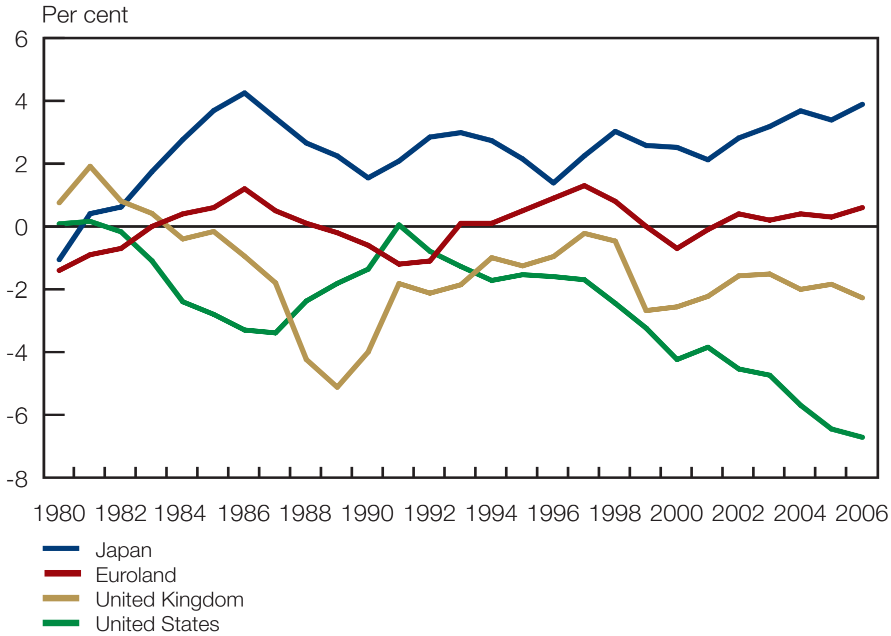
4. The global PMI is a survey of manufacturing output as measured by a global indicator, compiled by JPMorgan from selected developed countries.

Global imbalances

Global imbalances remain one of the key global economic risks. While global current-account imbalances[5] have been widening (see Figure 2), the fact that they have been financed quite comfortably could induce a sense of complacency among policy-makers (also see box "Growth, savings and investment imbalances"). Generally, the adjustment arising from large current-account deficits is associated with a depreciation of currencies

5. 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.

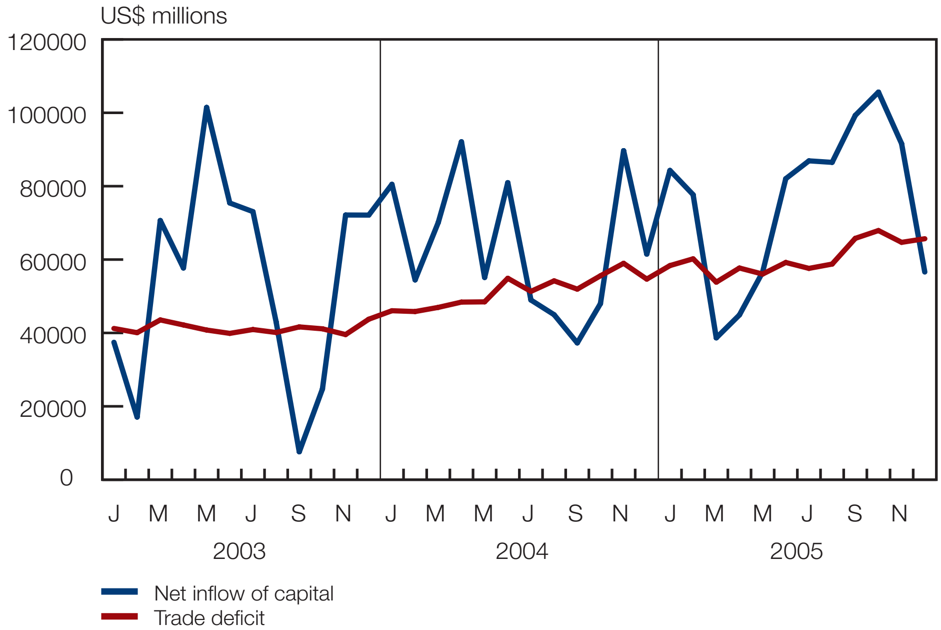
Figure 2 Current-account balances (as percentage of gross domestic product)



Source: *OECD Economic Outlook*, 2005 – includes estimates for 2006 and a marked slowdown in economic growth. If such an adjustment takes place in a disorderly manner, it could be very costly and disruptive to the global financial system.

The US current-account deficit, the most visible aspect of the global imbalances problem, widened to a record US$224,9 billion in the fourth quarter of 2005, from a revised US$185,4 billion in the third quarter. The US trade deficit increased from US$182,1 billion to US$198,3 billion over the same period. Net inflows of capital into US assets, which fell to US$38,6 billion in March, had been increasing steadily to US$105,6 billion in October, before dropping to US$91,6 billion in November and US$56,6 billion in December 2005 (Figure 3). The inflows in December 2005 were therefore inadequate to cover the trade deficit of US$65,7 billion.

Figure 3 Monthly US capital inflows



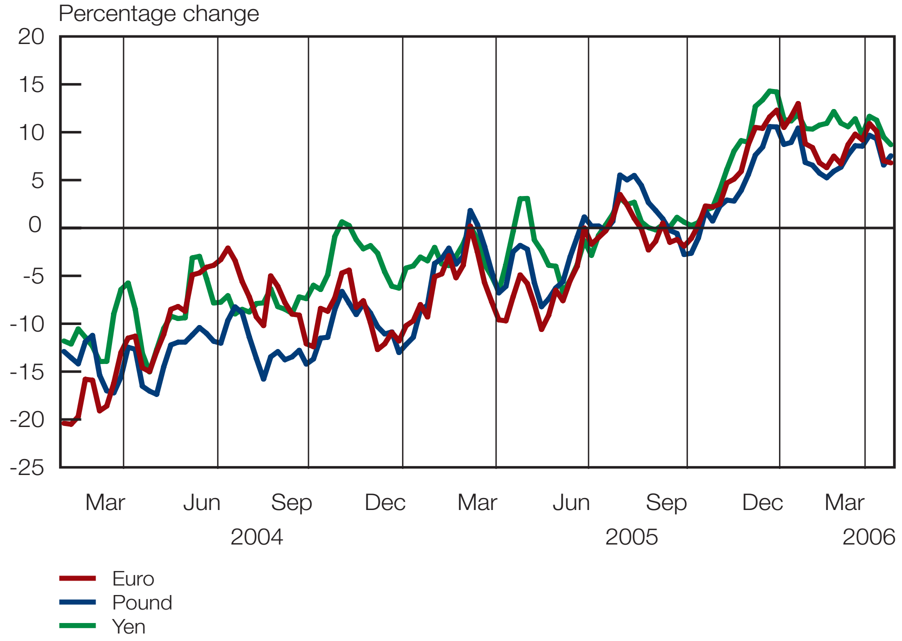
Source: Thompson Financial Ltd (DataStream) and AmericanEconomicAlert.org

Wide swings in currency values tend to increase instability in the world economy by inhibiting international trade and investment because of rising uncertainty. Although the US dollar appreciated against the euro, the British pound and the Japanese yen during 2005, it weakened somewhat towards the end of 2005 and early 2006. The US dollar was quite volatile during the reporting period (six months ending December 2005), causing some uncertainty (Figure 4). An abrupt and less orderly depreciation of the dollar remains a concern as it could destabilise financial markets globally.

In recent times, based on a number of central banks indicating that they are reconsidering the composition of their foreign exchange reserve holdings, there has been growing speculation that there could be a shift away from the US dollar, especially by Asian central banks. China's foreign exchange reserves, one of the largest in the world, rose to US$818,9 billion in December 2005. With most of their reserves denominated in dollars, China and its Asian neighbours now hold the greatest sway over the value of the US dollar. The sustainability of the value of the US dollar is, therefore, of great importance to these countries.

Although concerns are increasingly being raised about the growing size of the US current-account deficit, it seems that the only consolation is that as long as it is comfortably financed, the threat to global stability is not high. The US current-account deficit may have become a structural part of the world economy, and more sustainable than previously assumed. The fact remains, however, that it is not possible for any country to indefinitely increase debt at such a pace, and still remain attractive to investors.

Figure 4 Weekly US dollar to euro, pound and yen exchange rate (percentage change over 52 weeks)



Source: Thompson Financial Ltd (DataStream)

Growth, savings and investment imbalances

The current-account deficit in the US and financial imbalances globally are, among other things, the result of certain underlying problems. These are, firstly, divergent trends of growth between countries as a result of unsynchronised policies, and secondly, different patterns of saving and investment.

The increasing output gaps and divergent trends in GDP growth across the world could be seen as the result of a combination of high consumption expenditure in the US and low domestic demand in Japan and the Euro zone. In addition, growth is mainly domestic-led in the US, while it is export-led in the rest of the world. In China, for example, the sharp increase in exports has helped to build up a large surplus on the current account, in addition to the already significant surplus on the capital account due to high foreign investment. The People's Bank of China buys up huge quantities of foreign exchange, mainly US Treasury bills, to keep the yuan at what it believes is an appropriate level (see accompanying table). The resulting level of the yuan supports the export-based Chinese economy and exacerbates the imbalance. To a lesser degree this situation is true also of Japan, and other emerging Asian countries such as India.

Major foreign holders of US Treasury Securities (Treasury bills, notes and bonds)

Holder	Total (Dec 2005) US$ billion	Percentage of total US Treasury Securities
Japan	685,0	31,47
China	256,7	11,79
United Kingdom	234,4	10,77
Caribbean Banking Centre	111,2	5,11
Taiwan	71,1	3,27
Germany	67,0	3,08
OPEC	66,7	3,06
Korea	66,5	3,05
Canada	53,2	2,44

Source: Compiled from US Treasury Department data.

In the US, savings are low and have been on a downward trend for the past decade mirroring the trend in the current-account deficit. The downward trend has accelerated in recent years owing mainly to the effects of the housing boom in the US. In Japan and emerging Asia, savings are relatively high, but they suffer from a lack of domestic investment. In emerging Asia, for example, investment has averaged about 25 per cent of GDP, about seven percentage points below its average in the five years prior to the East-Asian crisis. This is significant because a striking feature of the global economy has been the extent to which net savings from relatively poor emerging-market countries have been flowing to capital-rich industrial countries, mainly in the form of buying US Treasury bills. The long-term impact of this abnormal direction of the capital flow is that developing countries cannot develop as they should as a result of a shortage of capital.

This "imbalance" could go on for some time because it is in the interest of both parties (US growth financed by Asian inflows and Asian buying of US Treasury bills leading to competitive exports). It cannot, however, represent a sustainable global equilibrium and needs to be corrected in the long term.

Real-estate prices

The cost of homes in relation to average income is at a record high in the US, Australia, the United Kingdom (UK), France, Ireland, the Netherlands, New Zealand and Spain[6]. Whilst house price growth has been slowing down in Australia and the UK, house prices are still growing strongly in the US and France. It is estimated that the US housing boom has accounted for about one-third of economic growth over the past two years[7]. While analysts feel that there is no national housing bubble in the US, a few regions show residential values that are much higher than market fundamentals would suggest. According to Global Insight[8], a fall in national house prices of 10 per cent in the US could reduce GDP growth by between one and two percentage points.

6. *World Economic Forum. Global Risk Inventory. Online at http://www.weforum.org. Accessed on 19 January 2006.*

7. *American Express Bank Ltd. February 2006.* Economics for Investment.

8. *Global Insight.* Outlook and Risks for the Global Economy. *February 2006.*

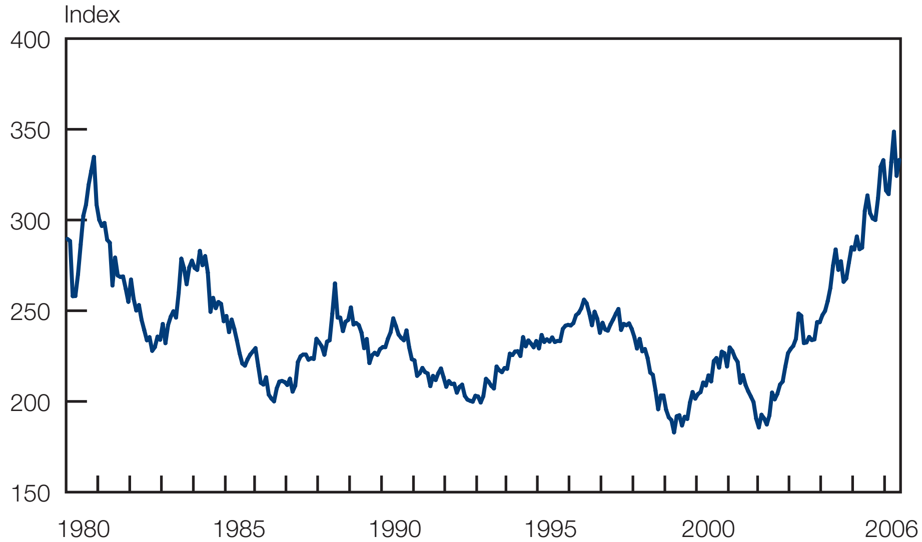
Commodities

After a strong performance in 2004, commodity prices continued to surge ahead in 2005 as reflected in the Reuters/Jefferies Commodity Research Bureau (CRB) index[9] (Figure 5).

Brent crude oil prices rose by 45 per cent in 2005. In January 2006, fears of oil supply disruptions emerged from Nigeria, Iran and the Middle East, which, along with continued supply-side management by the Organization of the Petroleum Exporting Countries

9. *The Reuters/Jefferies CRB commodity index serves as a measure of global commodity prices. As a benchmark, it is designed to provide timely and accurate representation of a broadly diversified investment in commodities through a transparent and disciplined calculation methodology. It represents a collaborative effort of Reuters, the global information company, and Jefferies Financial Products LLC. It now comprises nineteen commodity futures markets.*

Figure 5 Reuters/Jefferies CRB commodity index



Source: Thompson Financial Ltd (DataStream)

(OPEC), are expected to keep oil prices high in 2006. According to the International Energy Agency, world oil demand is expected to accelerate in 2006 based on strong Chinese and US consumption. Oil consumption is expected to grow by 1,8 per cent in 2006, after gaining 1,3 per cent in 2005.

The gold price rose by 9 per cent in 2005. This was due to strong jewellery demand, investment demand, stagnating mine output, inflationary concerns in the US, geopolitical risks and speculative demand. Gold's strong performance is expected to continue to benefit from its role in asset diversification as a hedge against economic uncertainty.

Resurgent speculative demand and increased demand from China (being a net importer of platinum) propelled the platinum price to rise by 6 per cent on an annual basis. The slight revaluation of the yuan contributed to the increased demand for platinum from Chinese merchants who replenished their stocks. Surging oil prices and inflationary pressures in the US also supported the platinum price.

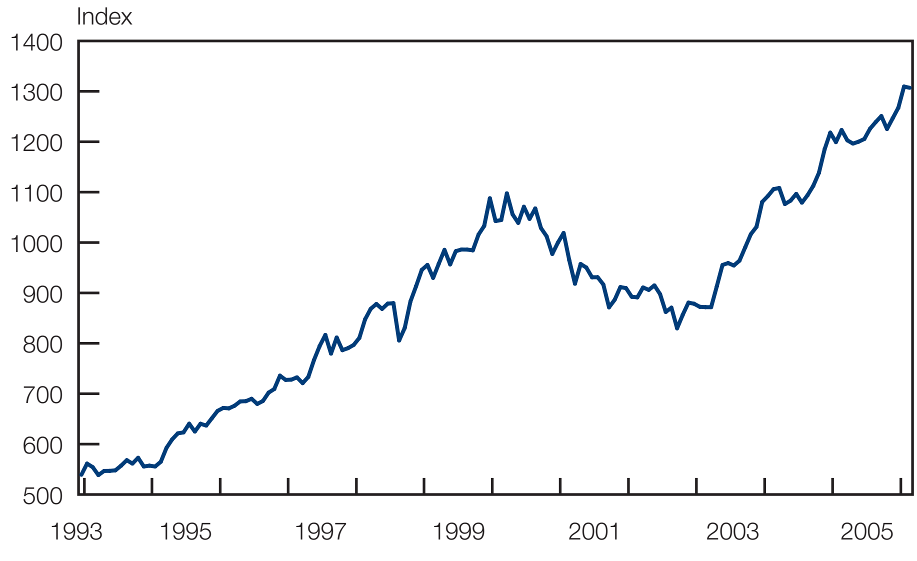
Commodity prices are expected to remain strong in 2006. A slowdown in global economic growth and a moderate further tightening of monetary policy in the US and Euro zone may, however, moderate commodity prices.

Global equity and bond markets

An improved economic outlook underpinned strong equity and bond markets in 2005, as reflected in the Morgan Stanley Capital International (MSCI) Global Capital Markets Index[10]. This strong performance raised expectations for another strong run in 2006. A series of shocks (London bombings, Hurricane Katrina and record high oil prices) did little to disrupt the momentum in markets. Concerns about further oil price increases and tighter monetary policy, however, erased some of the gains in equity and bond markets.

10. The MSCI Global Capital Markets Index is designed to measure the performance of the core capital markets asset classes comprising global equities and bonds. It is a market capitalisation weighted composite of the MSCI All Country World Index and the MSCI Global Total Bond Index.

Figure 6 MSCI Global Capital Markets Index



Source: Bloomberg

According to the Mercer Survey[11], global equity markets are expected to lag 2005's strong returns due to expectations of slower economic growth in the US. The performance of US equities is, however, expected to improve in 2006 and move in line with the performance of developed markets of Europe, Australia, Asia and the Far East.

11. The Mercer Survey is a global investment manager's survey in Europe, North America and Asia Pacific, on global and regional views on economies and capital markets. Online available at http://www.merceris.com.

The survey shows that investment managers expect more volatility in equity markets in 2006 compared with 2005. Extreme volatility in equity markets could negatively affect sustained global financial stability.

Global bond markets showed some volatility during 2005, becoming more stable by the end of the year. The continuing low levels of long-bond yields in the US present potential risks to financial stability. Should central banks drastically reduce or discontinue their buying of US Treasury bills in particular, a resultant sudden correction in bond yields could cause instability in financial markets and the global financial system. According to the Mercer Survey, investment managers expect the global bond index to increase by 4 per cent in 2006. The best performing bond markets are expected to be Australia, the US, the UK and New Zealand. Global bond markets are expected to display low levels of volatility in 2006, adding to stable market conditions. It should, however, be noted that extended periods of favourable economic conditions and low levels of volatility in financial markets could lead to the mispricing of risk.

Emerging markets

12. The IFC is a private-sector arm of the World Bank.

The International Finance Corporation (IFC)[12] cited a convergence of a number of trends that contributed to the strong performance of emerging markets in 2005. These include macroeconomic growth rates that continued to be roughly double those of developed nations and cross-border capital flows into emerging markets (foreign direct investment, equity flows, and commercial bank lending) approaching record levels last witnessed a decade ago. Also, emerging-market equity funds have reported record flows. The growing interest of institutional investors is likely to lift the capitalisation of emerging stock markets above US$5 trillion for the first time in history. Emerging-market mutual funds (measured by assets or as a percentage of GDP), are now at levels more than double those seen in 1997.

13. International Monetary Fund. September 2005. Global Financial Stability Report.

Emerging-market economies were generally also able to build up high levels of dollar reserves, maintain improved balance-of-payments positions and demonstrate fiscal and monetary responsibility. As a result, emerging markets have become more resilient to market disturbances. According to the International Monetary Fund (IMF), emerging markets will continue to build up cushions against adverse developments by accumulating additional reserves and by early refinancing of external borrowing requirements[13].

Credit spreads in emerging-market economies narrowed further in 2005 (Table 1). These economies benefited from high commodity and oil prices, low interest rates, solid growth in the US and continued investor appetite for risk. The outlook for emerging-market economies in 2006 is, on balance, favourable. China, India and Latin America (specifically Brazil) look set to provide the impetus for solid economic growth.

Table 1: Emerging-market bond index spreads*

Year	EMBI Global			EMBI Plus		
	Average	Maximum	Minimum	Average	Maximum	Minimum
2000............	677	777	588	716	828	631
2001............	799	1 040	657	841	1 098	674
2002............	730	938	563	776	1 041	588
2003............	535	725	405	563	751	420
2004............	423	549	335	436	569	346
2005............	306	395	230	316	408	238

* The emerging-market bond index spreads represent the spread between the average yield on selected US dollar-denominated sovereign bonds issued by emerging-market economies and the US Treasury rate.

Source: JPMorgan

Short-term risks to financial stability raised in previous editions of the *Financial Stability Review* are declining as credit quality improves and commodity producers in emerging markets shift to higher international credit status. The IMF, however, warns that, while growth prospects in emerging Europe remain positive, there are a number of risks that could threaten this outlook. These include the global structural imbalances, high oil prices and sudden shifts in global financial markets that could reverse the flow of funds to emerging markets. Performances of emerging markets are expected to remain positive, building on the strong economic fundamentals of 2005. However, should any of the above risks materialise, they could threaten the favourable outlook for emerging-market economies.

External vulnerability in emerging markets

From a financial stability perspective, it is important to assess a country's ability to discharge external obligations and absorb external shocks. Foreign exchange reserves play an important role as an indicator of a country's liquidity position since they assist with the absorption of shocks where access to foreign borrowing and/or credit lines is withdrawn. The Guidotti ratio (the ratio of reserves to foreign short-term debt) provides a summary measure of the extent of a country's foreign currency liquidity risk and a rough stress-test of a country's foreign currency liquidity position[14]. As a rule of thumb, countries should hold reserves such that their Guidotti ratios are greater than unity (see box "The Guidotti ratio as a measure of external vulnerability" for more information). Table 2 provides Guidotti ratios for South Africa together with other selected emerging-market economies.

14. Short-term external debt refers to both private and public debt that mature within one year and includes loans, debt securities (bonds and notes and money-market instruments), currency and deposits and trade credits. Reserves refer to official reserves as defined in the Balance of Payments Manual, *5th edition.*

Table 2: Guidotti ratios of selected emerging-market economies

	Argentina	Brazil	Indonesia	Korea	Mexico	South Africa	Thailand
1996	0,84	1,66	0,60	0,51	0,65	0,20	0,81
1997	0,70	1,48	0,53	0,38	1,03	0,54	0,71
1998	0,80	1,47	1,17	1,85	1,21	0,47	1,00
1999	0,90	1,22	1,36	2,13	1,32	0,68	1,49
2000	0,89	1,07	1,29	2,38	1,88	0,79	2,19
2001	0,73	1,27	1,28	2,93	2,49	0,89	2,50
2002	0,70	1,62	1,41	2,59	5,11	1,03	3,26
2003	0,62	2,52	1,58	2,75	6,42	1,08	3,87
2004	0,35	1,33	2,19	3,53	2,62	1,42	4,49
2005*	0,39	1,45	2,09	3,06	2,92	1,51	5,38

* Ratios for 2005 are based on the data for the first quarter of 2005.

Source: Computed using data from the IMF, the World Bank and the OECD

Since 1999 (aftermath of the Asian crisis) the improvement in most of the countries' reserves situation has mitigated their external vulnerability outlook, with most countries having Guidotti ratios above unity. Based on the latest data for the first quarter of 2005, only Argentina is still indicated as vulnerable. Argentina's Guidotti ratio shows that available reserves would cover only 39 per cent of its total short-term debt, should access to foreign borrowing be withdrawn.

The Guidotti ratio as a measure of external vulnerability

The failure of earlier models in explaining the Asian crisis in 1997-98 encouraged a shift towards comparing reserves to some measure of short-term debt, thus gauging the risks associated with adverse developments in international capital markets or risks associated with external vulnerability. In the aftermath of the Asian crisis, major shortcomings were revealed in the management of foreign debt and international liquidity in emerging economies.

A country's external vulnerability to financial crises stems from the financial relations a country has with the rest of the world. Sound policies for debt and liquidity management are increasingly seen as crucial elements for the assessment of an economy's external sector soundness. These policies help to identify the extent of an economy's external vulnerability and are important for financial crisis prevention. Debt and reserves are important in assessing a country's ability to honour external obligations in the event that capital markets are closed to a borrower for a period of time. The Guidotti ratio provides a measure of vulnerability to external shocks emanating from the international capital markets. According to this measure, countries that do not hold a sufficient amount of reserves will be more vulnerable to external shocks, and therefore to financial crises.

Greenspan (1999) and Guidotti (1999), among others, proposed a rule of thumb which states that "…countries should manage their external assets and liabilities in such a way that they are always able to live without new foreign borrowing for up to one year."[15] To obtain a more complete measure of a country's external financing requirements, short-term debt has often been augmented by the current-account deficit (augmented Guidotti ratio). This means that other borrowing needs – in particular the current-account deficit – would be included alongside short-term debt. Researchers have noted the remarkable ability of the Guidotti ratio in explaining the Asian crisis.

15. See Greenspan, A. 1999. Currency Markets and Debt. Remarks at the World Bank Conference on Recent Trends in Reserve Management, Washington DC, 29 April and Guidotti, P. 1999. Remarks at G33 seminar in Bonn, April.

Regional developments

Sub-Saharan Africa continued to experience positive economic growth, driven by global growth, high commodity prices and improved policies. According to the World Bank's Global Economic Prospects 2006 (GEP), real GDP growth reached 4,6 per cent in 2005, marking the sixth consecutive year of growth above 3 per cent. This aggregate performance in 2005 represents the combination of a significant slowing among oil-exporting countries from 6,1 per cent to 5,5 per cent, and an acceleration among oil importers from 4 per cent growth in 2004 to an estimated 4,3 per cent in 2005.

The GEP projects further growth in 2006 (5,3 per cent), moderating to a still fairly robust rate of 4,5 per cent in 2007. Overall, GDP growth among oil producers is projected to accelerate to about 6,5 per cent in 2006, but to ease to about 5,7 per cent in 2007. For oil-importing economies, the combination of high oil prices and easing non-oil commodity prices is projected to contribute to a deceleration in growth to about 4,1 per cent by 2007.

In the Southern African Development Community (SADC) countries, the IMF projects 4,7 per cent GDP growth in 2005, up from 4,2 per cent in 2004 (Table 3). GDP growth of least 7 per cent is projected for Malawi, Mozambique and Madagascar for 2006. Output growth below 2 per cent is projected in only three SADC countries – Lesotho, Swaziland and Zimbabwe. In general, however, this favourable outlook for the region stems from general macroeconomic stability, stronger fundamentals, a stabilising policy environment in most countries, and improved prospects for the global economy.

Though still mostly hypothetical, there is growing international alarm over the threat posed by bird influenza, should it transform and become infectious among humans. The outbreak of H5N1 – the bird influenza strain that can kill people – among poultry in Nigeria could lead to substantial social, economic and financial disruption if it spreads to other parts of the continent. According to the United Nations Food and Agriculture Organisation (FAO), few

African countries have systems to test for H5N1. Also, efforts to control outbreaks would be hampered by difficult terrain and low levels of education.

Table 3: Real gross domestic product growth – SADC

Country	1997 – 2001	2002	2003	2004	2005*
Angola	4,8	14,4	3,4	11,1	14,7
Botswana	6,2	5,0	6,6	4,9	3,8
DRC	-4,1	3,5	5,7	6,8	6,6
Lesotho	1,4	3,7	3,2	3,0	0,8
Madagascar	4,6	-12,7	9,8	5,3	6,3
Malawi	1,6	2,1	3,9	4,6	2,1
Mauritius	6,3	3,5	3,2	4,3	3,6
Mozambique	9,3	8,2	7,8	7,2	7,7
Namibia	3,4	2,5	3,7	4,2	3,6
South Africa	2,5	3,6	2,8	3,7	4,3
Swaziland	2,8	2,9	2,7	2,1	2,0
Tanzania	4,4	7,2	7,1	6,7	6,9
Zambia	2,4	3,3	5,1	5,0	5,0
Zimbabwe	-2,4	-4,4	-10,4	-4,2	-7,1
SADC	**2,3**	**3,9**	**2,9**	**4,2**	**4,7**

* Figures for 2005 are IMF staff estimates.

Source: IMF – World Economic and Financial Surveys, October 2005.

Impediments to economic growth include the HIV/Aids pandemic, high unemployment, poverty, conflict and civil strife. Other risks to the region's favourable growth outlook are exogenous factors like weather, natural calamities, and commodity price developments. Most of the economies in the region are relatively undiversified and heavily resource-dependent, rendering them more vulnerable to global economic volatility. This heavy dependence of some countries on only one or a few commodity exports could point to future economic disruptions if the commodity cycle turns. Structural reforms, primarily economic diversification, remain crucial.

Domestic macroprudential analysis

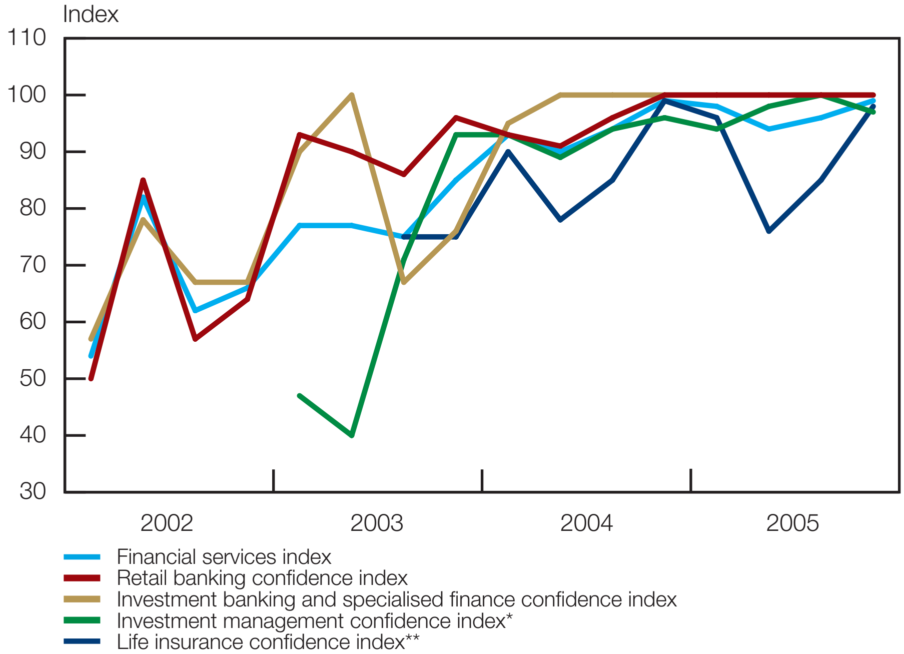
This section analyses the main developments in the domestic financial system and in some of the sectors that have a significant bearing on the overall stability of the financial system. Experience has shown that risks to financial system stability can derive from developments in other sectors of the economy such as the corporate and the household sectors and the real-estate markets. The section therefore gives an assessment of the likely impact of such developments.

Confidence in the financial sector

The Ernst & Young financial services index remained high in the fourth quarter of 2005, largely reflecting increased confidence in most of its components (Figure 7). Two of the index's components (the retail banking and the investment banking and specialised finance) recorded 100 index points[16]. The life insurance confidence level increased by 13 index points to 98, mainly due to improvement in new business premium income and slow growth of surrenders. High levels of confidence in the financial sector normally bode well for financial stability. However, overconfidence can trigger or worsen instability later on.

16. The Ernst & Young Financial Services Index is calculated as the unweighted average of the retail banking, the investment banking and specialised finance, the investment management and the life insurance's confidence indices. These indices are based on the results of surveys and range from 0 to 100, where 0 shows extreme lack of confidence, 50 is neutral and 100 shows extreme confidence.

Figure 7 Financial services index and its components



* 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*

Banking sector

The role of banks is central within any financial system as they are a source of liquid funds to 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. Failure of banks can, therefore, have a significant impact on the activities of all other financial and non-financial entities and on the confidence in, and the functioning of the financial system as a whole. This makes the analysis of the health and soundness of the banking sector central to any assessment of financial system stability. Based on a set of financial soundness indicators (see Table 4) for the period under review, the South African banking sector continued to appear robust and able to withstand considerable adverse shocks.

Structure

The banking sector remains highly concentrated, with the Gini concentration coefficient, which estimates the numeric value of concentration, recording 83,8 index points in December 2005. The market share of the top four banks (based on total assets) continued to be high. While the domination of four large banks may reduce the likelihood of banking sector problems, it increases the complexity of resolving any systemic problems should they arise[17].

17. The relationship between concentration in the banking sector and financial stability was discussed extensively in the September 2004 edition of the Financial Stability Review.

Capital adequacy

Banks continued to be well capitalised. The capital adequacy ratio is a measure of the robustness of banks to withstand shocks to their balance sheets. As at the end of December 2005, the aggregate capital adequacy ratio for all banks was 12,3 per cent, compared with a minimum regulatory capital adequacy requirement of 10 per cent.

Table 4: Key financial soundness indicators for the South African banking sector*

Per cent, unless indicated otherwise

	2004 June	2004 Dec	2005 June	2005 Dec
Structure				
Number of banks (excluding mutual banks)	35	35	35	35
Total assets of banks (excluding mutual banks, R billion)	1 350,5	1 498,4	1 564,1	1 677,5
Gini concentration index**	82,6	83,2	83,7	83,8
Market share (top four banks)***	82,2	83,6	83,8	83,8
Capital adequacy				
Regulatory capital to risk-weighted assets	13,2	13,3	12,8	12,3
Regulatory Tier 1 capital to risk-weighted assets	8,8	9,3	9,0	8,9
Asset quality				
Gross overdues to total loans and advances	2,0	1,8	1,6	1,5
Specific provisions to total loans and advances	1,6	1,5	1,4	1,2
Share of mortgage advances in private-sector credit	42,8	43,3	45,0	46,0
Earnings and profitability				
Return on assets****	1,0	1,2	1,1	1,1
Return on equity****	12,6	14,7	14,1	14,7
Interest margin to gross income	34,8	42,3	52,0	42,2
Non-interest expenses to gross income	61,8	68,6	74,4	61,0
Liquidity				
Liquid assets to total assets (liquid asset ratio)	5,0	4,7	4,8	4,8
Liquid assets to short-term liabilities	9,4	9,4	9,5	9,2
Sensitivity to market risk				
Aggregate net open position in foreign exchange to capital	2,5	0,9	0,7	1,1

* Data as at 18 April 2006

** 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 total assets

**** Smoothed over a period of 12 months

Asset quality

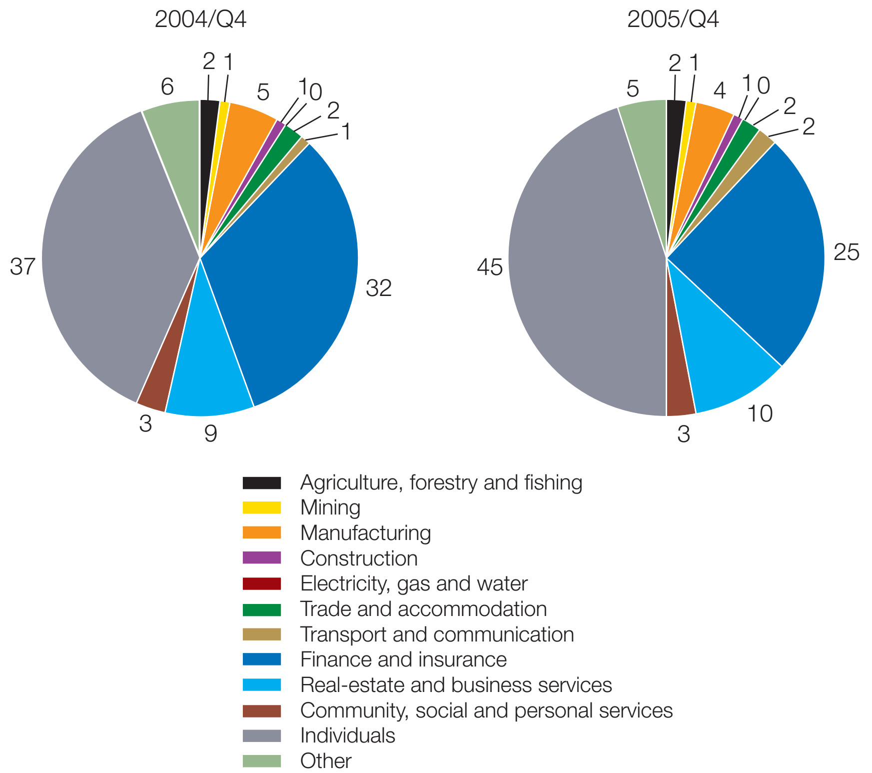
The asset quality of banks improved in December 2005, with gross overdues constituting 1,5 per cent of total loans and advances, compared with 1,8 per cent in December 2004[18]. This improvement in asset quality was partly due to a favourable macroeconomic environment and was further borne out by a decrease in specific provisions (measured as a percentage of total loans and advances), from 1,5 per cent in December 2004 to 1,2 per cent in December 2005. Total provisioning (that is the market value of security, specific and general provisioning) against overdue accounts was considered adequate in aggregate. Further comfort regarding the asset quality of banks can be found in the low level of mortgage debt as a percentage of the market value of housing (Figure 15 on page 25). However, banks need to guard against complacency as it is well known that the worst loans are usually made near the top end of the business cycle.

18. The Bank Supervision Department regards loans classified as being "doubtful" or "loss" as falling within the definition of "overdue". "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.

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 8 compares the sectoral distribution of credit for the quarters ended December 2004 and December 2005, respectively.

The sectoral breakdown of bank credit shows that the funds extended to the household sector continued to grow. At 45 per cent, total credit extension to individuals increased by 8 percentage points compared with the previous year. Although further concentration of exposure to this sector will have to be carefully monitored and managed, it is not considered a cause for concern at present as it is in line with current macroeconomic developments.

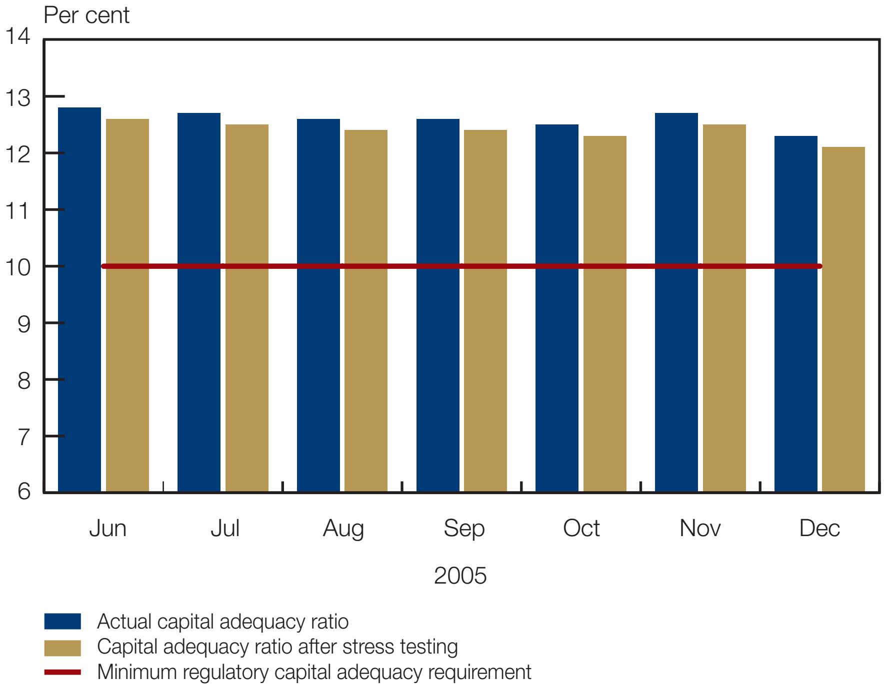
Figure 8 Sectoral distribution* of credit (per cent)



* 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.

To assess the resilience of the banking sector to credit risk, a stress test was conducted based on the average of multiple scenarios which include, among others, a sharp depreciation in the exchange rate of the rand and a marked increase in the prime lending rate. The risk bearing capacity of banks was measured through the net effect of the shocks on the capital adequacy ratio. Under the stress scenarios, the capital adequacy ratio remained at 2,1 percentage points above the minimum regulatory requirement of 10 per cent at the end of December 2005. The part of banking sector capital that exceeds the minimum capital requirement would help to ensure that operations can continue even if the stress scenarios were to materialise.

Figure 9 Stress testing the resilience of the banking sector



Earnings and profitability

Profits usually provide the first line of defence against losses that banks incur. 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), i.e. the ratio of net profit to average equity, and the return on assets (ROA), i.e. the ratio of net profits to total assets.

The ROE reflects the banks' efficiency in using equity and, over time, provides information on the sustainability of banks' capital positions. The ROA gives an indication of how efficiently banks' assets are employed. Smoothed over a period of 12 months, aggregate ROE remained at 14,7 per cent in December 2005 (compared with December 2004), while aggregate ROA decreased slightly from 1,2 per cent to 1,1 per cent over the same period.

Liquidity

The level of liquidity also influences the ability of the banking sector to withstand shocks. A large shock, for instance, which could contribute to credit or market losses, could cause some loss of confidence in the banking sector and lead to withdrawals by market participants or depositors. Indicators mostly used to measure liquidity include liquid assets to total assets (liquid asset ratio) and liquid assets to short-term liabilities. These ratios give some indication of 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 increased marginally from 4,7 per cent in December 2004 to 4,8 per cent in December 2005, while the ratio of liquid assets to short-term liabilities decreased from 9,4 per cent to 9,2 per cent. However, both measures were in line with their historical levels, and were considered adequate in light of the South African money-market's inherent structure and the relatively sophisticated liquidity risk management systems of the banks.

Sensitivity to market risk

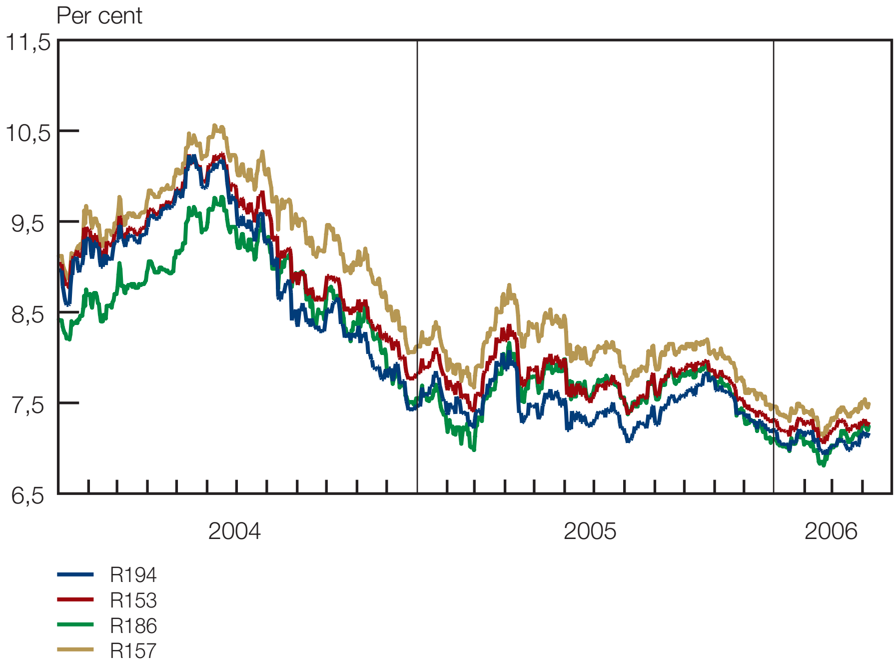
As banks become increasingly involved in diversified operations and take positions in financial instruments, they become more exposed to market risk, i.e. the risk of losses arising from changes in market prices. One of the components of market risk is exchange rate risk, with the net open position in foreign currency being the common measure. The net open position in foreign currency as a percentage of capital increased from 0,9 per cent in December 2004 to 1,1 per cent in December 2005.

Bond, equity and currency markets

Financial markets are important in the assessment of the soundness of a financial system because they often display considerable volatility. Extreme volatility may undermine the financial viability of market players and hamper new investment in the economy due to the uncertainty that it creates. Such volatility could be detrimental to financial system stability especially when coupled with some other adverse developments in the real sector of the economy.

Contrary to the increasing yields in the major international bond markets in the second half of 2005, South African bond yields continued to decline during most of 2005. These declines could be ascribed to factors such as the announcement of a downward revised budget deficit (1 per cent of GDP) in the Medium-Term Budget Policy Statement (MTBPS), an appreciation in the exchange rate of the rand and lower than expected inflation figures. Yields on domestic government bonds reached record lows in February 2006 following the National Budget Speech.

Figure 10 Selected domestic bond yields



Source: I-Net Bridge

In addition, the domestic bond market was supported by supply and demand imbalances, in particular with regard to government bonds. Growth in banks' balance sheets created an increasing demand for statutory liquid assets, which outpaced the increase in issuances of government bonds in recent years. Banks generally prefer to keep shorter-dated bonds as liquid assets. However, the maturing of the R152 bonds at the end of February further reduced the supply of short-term statutory liquid assets available, to some extent forcing banks to lengthen the duration of their liquid asset portfolios.

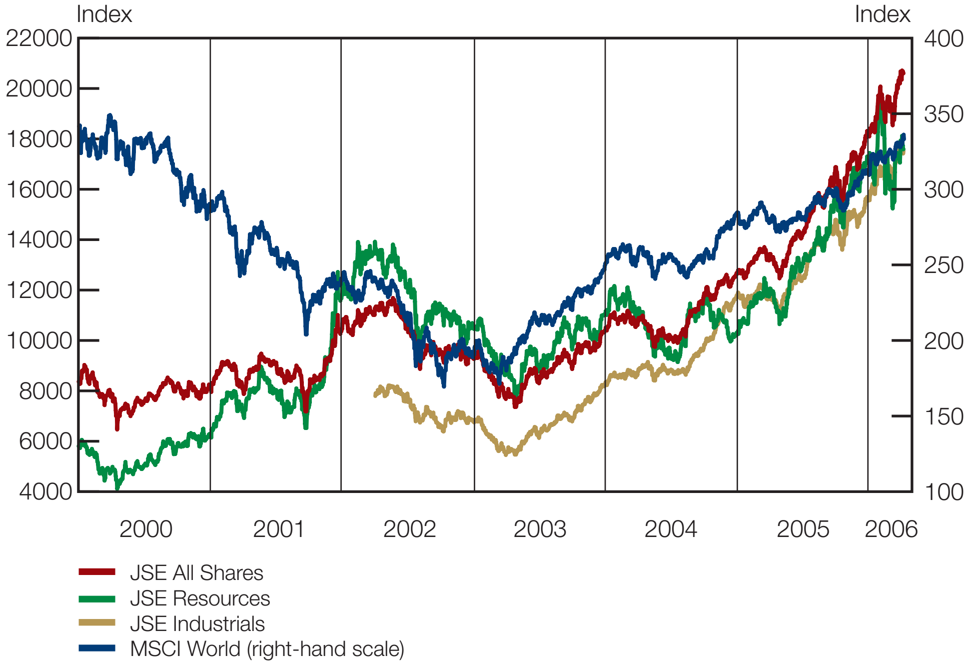
The equity market continued its rally from August 2005 through December 2005 and January 2006, reaching successive new highs. During this period the market was driven by generally strong economic fundamentals, increasing commodity prices, expectations of steady interest rates, projections of future economic growth announced in the MTBPS, and a strong interest by non-residents in the domestic equity market. A new record high in excess of 20 000 index points in the JSE All-Share Index (Alsi) was recorded at the beginning of February 2006, after which the market retraced somewhat. The downward trend was, however, capped by mergers and acquisitions, and good results and trading statements of some of the banks.

Volatile conditions in the domestic foreign exchange market improved markedly during the second half of 2005. The actual intra-day volatility of the rand, as measured by the one-month historical volatility[19], declined from more than 20 per cent in June to below 10 per cent in December 2005. The one-month implied volatility[20], based on option pricing, also declined consistently over the six-month period to reach a level of 10,9 per cent in December 2005. The more stable exchange rate of the rand was also reflected in the difference between the highest and lowest trading levels recorded during a month. These differences fluctuated between 24 and 42 cents during the six-month period to December 2005, well below the levels reported in previous months. Overall, the low levels of volatility in the exchange rate of the rand added to the stability of the financial system.

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

20. Implied volatility is the expected volatility of the rand based on option pricing.

Figure 11 Share price indices*



* Daily movements

Source: Bloomberg

Insurance sector

From December 2004 to December 2005, the total number of long-term typical insurers remained unchanged at 29. Using the ratio of free assets to the capital adequacy requirement as a measure of the solvency of long-term insurers, most of the insurers were covered by free assets to capital adequacy requirement of 2 to 5 times, which is considered sufficient (Table 5). Since the majority of the large insurers fell within this category, it can be concluded that the sector was generally solvent.

Table 5: Free assets and capital adequacy requirement

Free assets to capital adequacy requirement (long-term typical insurers)*	Number of insurers	
	2004 December	2005 December
Covered 0 – 1 time	1	0
Covered 1 – 2 times	4	5
Covered 2 – 5 times	20	17
Covered 5 – 10 times	2	5
Covered 10 + times	2	2
Total	**29**	**29**

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

Source: Financial Services Board

The number of new policies of long-term typical insurers increased at an annual rate of 7 per cent in 2005 compared with 19 per cent in 2004. Individual surrenders, expressed as a percentage of new policies issued during the period, decreased while individual lapses increased. Earlier concerns over the sustainability of the basic business model of insurers, as highlighted by the adjudicator's rulings (see box "Update on developments in the South African retirement and insurance industries" for more information), are in the process of being resolved.

Table 6: Selected indicators for long-term typical insurers

	2002	2003	2004	2005
Individual lapses*	26	31	24	27
Individual surrenders*	23	25	20	18
Number of policies (year-on-year percentage change)	(14)	1	19	7
Share prices (year-on-year percentage change)	(11,9)	(5,3)	36,5	15,0

* Expressed as a percentage of the number of new policies issued during the period using statistics that were not audited.

Source: Financial Services Board and South African Reserve Bank

The share prices of long-term insurers registered an annual increase of 15 per cent in December 2005, down from a twelve-month increase of 36,5 per cent in December 2004. Insurance share prices rose further (by 17,3 per cent) from December 2005 to March 2006.

Corporate sector

An assessment of the strength of corporate sector balance sheets is important, as it pertains to the credit risk posed by firms to banks. Also, corporate sector balance sheet conditions are fundamental in understanding equity and capital market performance. Table 7 gives summary statistics of the corporate sector.

Table 7: Corporate sector

	2005			
	Q1	Q2	Q3	Q4
Business confidence index*	79,0	82,0	86,0	85,0
Credit to the corporate sector as percentage of gross domestic product	27,6	28,3	27,8	28,0
Real gross fixed capital formation (year-on-year percentage change)	12,6	13,8	12,2	14,4
Credit to the corporate sector (year-on-year percentage change)	12,5	19,2	14,8	14,6
Credit to the corporate sector as percentage of annualised profits	149,7	137,7	148,0	151,6

* 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.

Source: Bureau for Economic Research and South African Reserve Bank

Business confidence and corporate borrowing

The Rand Merchant Bank/Bureau for Economic Research (RMB/BER) business confidence index remained high during the fourth quarter of 2005 and stood at 85 index points. The latest information shows that the confidence level increased to 86 index points in the first quarter of 2006. The historically high level of business confidence suggests strong expected economic activity.

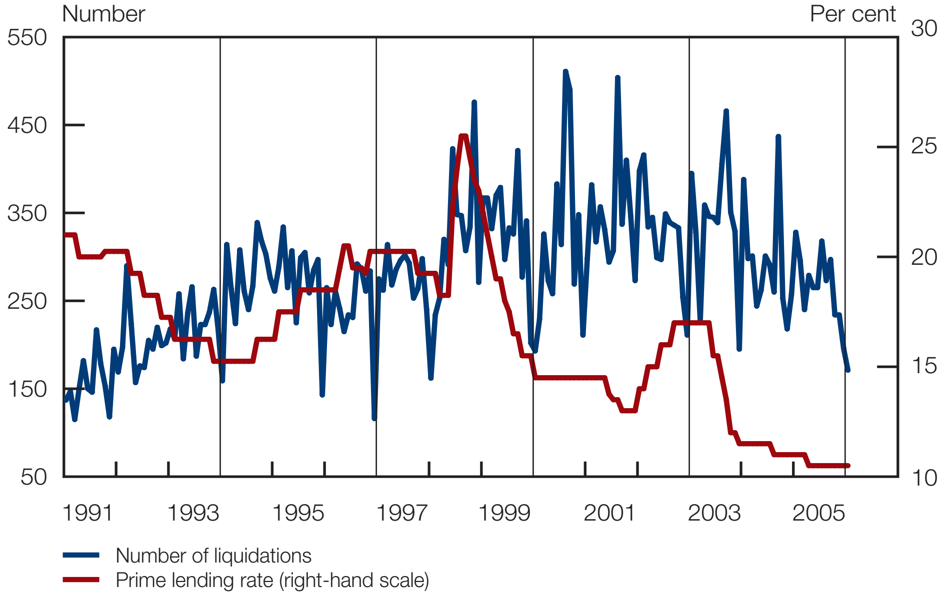
There was a slowdown in the annual growth rate of credit to corporations from the third to the fourth quarter of 2005. The increase in credit is nevertheless still high by historical standards and needs to be monitored closely. Credit to corporations as a percentage of GDP increased marginally from 27,8 per cent in the third quarter of 2005 to 28 per cent in the fourth quarter.

The ratio of corporate debt to profits measures the debt-servicing capacity of businesses. The ratio increased from 148 per cent in the third quarter of 2005 to 151,6 per cent in the fourth quarter.

Liquidations are a further indicator of the possible scope of doubtful debt of corporations. In the year to December 2005, liquidations decreased by 23,7 per cent. The latest information shows that liquidations declined by 28 per cent, from 296 in February 2005 to 213 in February 2006.

There is, therefore, currently no evidence suggesting imminent disturbances arising from excessive lending to the corporate sector.

Figure 12 Number of liquidations and the prime lending rate



Sources: Statistics South Africa and South African Reserve Bank

Household sector

As is mentioned in the discussion on banks, banks incur considerable credit risk through lending to the household sector. Therefore, the balance sheets of households are relevant to financial stability. The financial health of households continued to improve on the back of strong economic growth in the second half of 2005. Table 8 gives summary statistics of the household sector.

Table 8: Household sector

	2005			
	Q1	Q2	Q3	Q4
Consumer confidence index*	19,0	17,0	17,0	20,0
Household consumption expenditure to gross domestic product	63,3	64,6	63,3	63,0
Real household consumption expenditure (annual growth)	7,1	7,0	6,7	6,5
Credit to households (annual growth)	23,8	25,4	27,1	26,7
Household debt to disposable income	59,4	60,9	63,5	65,6
Income gearing**	6,6	6,3	6,7	7,0
Capital gearing***	19,4	19,8	19,5	20,1

* 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, with 0 as neutral.
** Income gearing refers to financing costs of household debt as percentage of disposable income.
*** Capital gearing refers to household debt as percentage of total assets of households.

Source: Bureau for Economic Research and South African Reserve Bank

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, and gained 3 index points during the fourth quarter of 2005 (see Table 8). High consumer confidence has supported strong growth in retail sales, new vehicle sales and activity in the building industry from the third quarter of 2005. Based on the latest figures, the level of consumer confidence increased further (by one index point) in the first quarter of 2006.

Household indebtedness

The level of households' indebtedness could entail risks should the current benign environment change. An analysis of households' total indebtedness and the affordability of their total debt burden give, among other things, an indication of the sustainability of household consumption expenditure and consumers' ability to honour debt obligations. Household debt has been trending upwards since the beginning of 2003. The ratio of household debt to disposable income increased from 63,5 per cent in the third quarter of 2005 to 65,6 per cent in the fourth quarter. At these levels, the ratio is above the peak of 62 per cent recorded in the fourth quarter of 1997.

From a financial stability perspective, it is not only the level of household debt that matters, but its sustainability as well. The sustainability depends on the ability of households to service outstanding debt out of income and, possibly, out of assets in the event of adverse shocks to income. Income gearing, which shows the extent to which disposable income covers financing costs of household debt, increased marginally from 6,7 per cent to 7 per cent in the fourth quarter of 2005. The ratio shows that households nevertheless use a relatively small fraction of their disposable income to service the financing costs of debt. Capital gearing, which refers to household debt as a percentage of total assets of households, increased from 19,5 per cent to 20,1 per cent during the same period.

The number of insolvencies also declined by 12,3 per cent in the year to December 2005. It can therefore be concluded that there is no clear threat to financial stability arising from any inability of households to service debt obligations.

Micro-finance sector

Credit extension by the micro-finance sector continued to grow in the quarter to November 2005[21]. Compared with the quarter ending August 2005, disbursements increased by 19,7 per cent to R7,52 billion, the highest level recorded since the Micro Finance Regulatory Council started compiling statistics in August 2000. The increase in disbursements was driven by new products from two large players and an increase in the average size of loans. The value of the gross loan book was R21,1 billion at the end of November 2005.

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

Table 9: Micro-finance sector
R billion

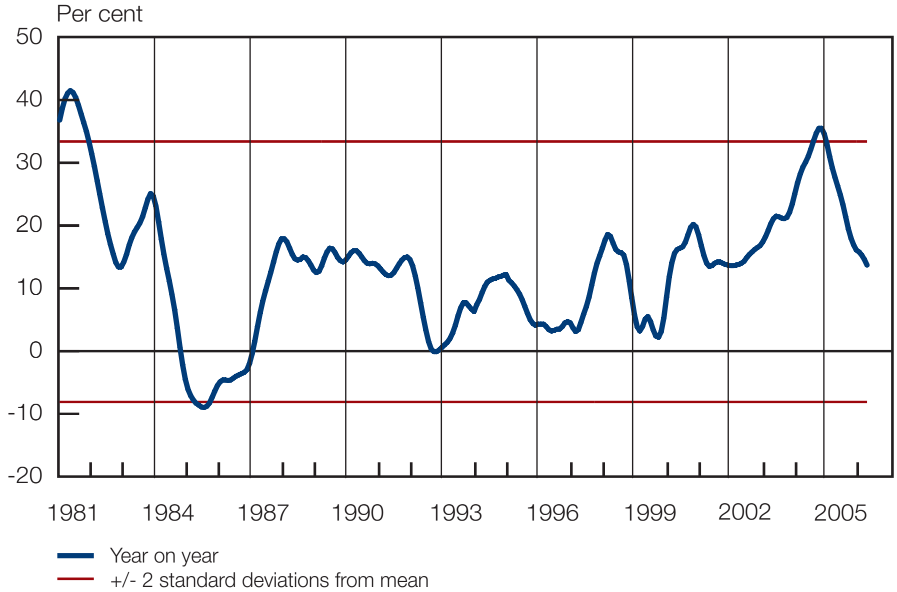
	2005			
	Feb	May	Aug	Nov
Loan book	18,4	18,5	19,4	21,1
Disbursements	5,82	5,77	6,29	7,52

Source: Micro Finance Regulatory Council

Residential property market activity

The annual growth rate of house prices moderated further to 13,7 per cent in the year to March 2006, down from a revised 14,6 per cent in the year to February 2006. The nominal growth rate of house prices is well within the two standard deviation range.

Figure 13 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 distortions and outliers in the data.

Source: Absa Bank Ltd

22. 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.

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

Given the reading of 5,8 (Table 10) the residential property confidence indicator (RPCI)[22] showed stable overall activity levels. Property markets in some previously disadvantaged areas are showing signs of good growth potential. The average length of time that property remains in the market also decreased from 8 weeks in the third quarter of 2005 to 7 weeks in the fourth quarter. However, activity in the buy-to-let market dropped with the percentage of home buyers that are investors[23] decreasing from 10 per cent in 2004 to 4,7 per cent in 2005 (Figure 14), probably reflecting less attractive returns during the cooling-off phase in the residential property market.

Table 10: Residential property confidence indicator

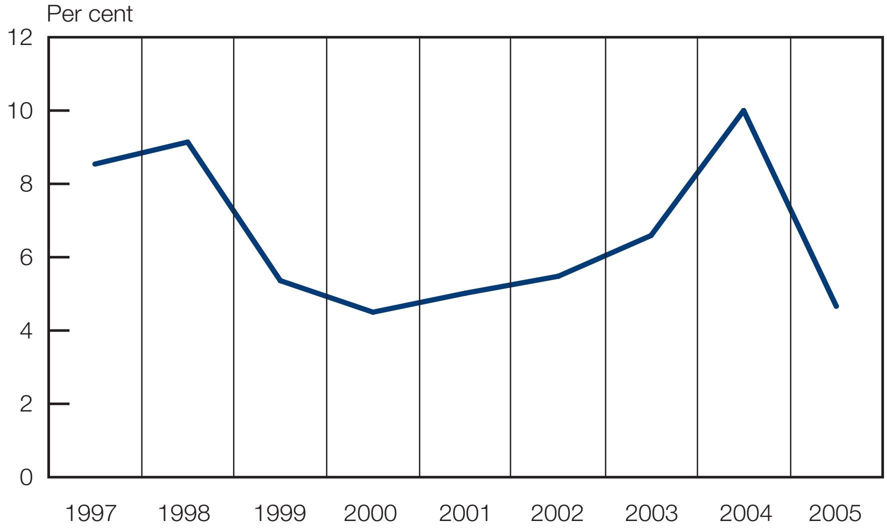
Period	2003	2004				2005			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Level of activity.....	7,6	7,7	7,5	6,7	7,3	7,4	6,8	6,1	5,8

Source: First National Bank (FNB)

Growth in mortgage loans and the market value of housing

Although mortgage debt continued to increase in December 2005 (compared with December 2004), mortgage loans overdue continued to decline over this period. This trend appears to have subsequently changed as mortgage loans overdue increased by 5,5 per cent (measured over a 12-month period) in February 2006. The ratio of overdue mortgage loans to total mortgage advances increased slightly from 1 per cent in the third quarter of 2005 to 1,2 per cent in the fourth quarter. Mortgage debt of households continued to increase at a faster pace than the market value of housing. The ratio of mortgage debt to market value of housing increased from 51,7 per cent in the third quarter of 2005 to 53,4 per cent in the fourth quarter. The low interest rate environment contributed to the rise in mortgage debt. While not posing a threat to financial stability now, it could adversely affect the stability of the system should the environment change.

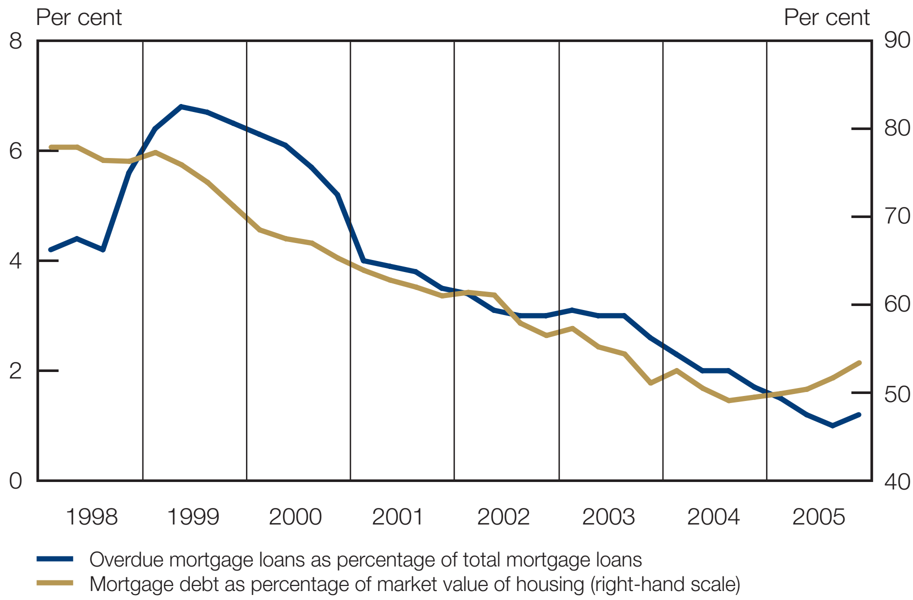
Figure 14 Percentage of investors in the residential property market



Source: The Standard Bank of South Africa Ltd

It is expected that the demand for housing will continue to be supported by rises in disposable income, favourable financial conditions and structural changes in the economy. However, it should be noted that a sudden increase in the cost of credit could cause problems for overly indebted households in servicing debt obligations.

Figure 15 Overdue mortgage loans and the market value of housing



Infrastructure and regulation

Important developments in the financial system environment

Like many other countries, South Africa's financial system operates in a complex and ever-changing political, social, legal and institutional environment. The emphasis has increasingly shifted towards consumer protection, broader transformation, regional co-ordination, adherence to international standards and codes and the enforcement thereof. South Africa is experiencing a period of increasing and far-reaching financial legislative and regulatory reform in order to adapt to the new socio-political landscape and to meet international demands to comply with recognised best practices.

Policy-makers continuously review the financial, regulatory and legal infrastructure in an effort to ensure that the financial system maintains international acceptance and is capable of withstanding shocks under all types of economic conditions.

This section highlights some of the more important developments recently introduced or expected to be introduced by the respective financial authorities. If implemented correctly, these developments have the potential to contribute to the promotion of financial stability, market efficiency and consumer protection.

Institutional and market infrastructure developments

Combating money laundering and the financing of terrorism

South Africa actively pursues the reduction of the vulnerability of the South African financial system to criminal activities. Legislation to combat the financing of terrorism[24] came into effect in May 2005. This brings South Africa in line with internationally accepted standards and enables law enforcement agencies to effectively deal with terrorist-related activities.

24. The Protection of Constitutional Democracy Against Terrorism and Related Activities Act, No 33 of 2004.

Apart from ongoing efforts to comply fully with the requirements of the Financial Action Task Force (FATF), South Africa accepted the FATF presidency for the period July 2005 to June 2006 and hosted the joint FATF/ESAAMLG[25] plenary meeting in February 2006. During the latter part of 2007, South Africa's membership of FATF is due to be reviewed, based on the actual implementation and enforcement of anti-money laundering measures and legislation.

25. Eastern and Southern African Anti-Money Laundering Group, a FATF-styled regional body.

The prevailing level of public awareness regarding money laundering is in general higher since all banks' customer due diligence measures, commonly known as 'Know Your Client' procedures, must be finalised during 2006.

Insolvency regime

It is generally accepted that an effective insolvency regime contributes directly to financial stability by spreading risk among debtors and creditors in a predictable and equitable manner, which improves the ex ante functioning of financial markets.

There are ongoing discussions between the Government and the private sector regarding the overhaul and unification of the insolvency legislative framework and industry within the broader context of the Company Law Reform process[26]. It is expected that the insolvency regime would in future lean more favourably to the increased usage of corporate rescue as opposed to liquidation. This is considered more appropriate to the needs of the South African economy.

26. Company law provides the legal basis for corporate business entities. The current framework for South African company law is built on principles dating from 19th century English law. Government, through the Department of Trade and Industry, has embarked on a comprehensive, consultative company law reform initiative to review and modernise company law in South Africa.

Furthermore, the World Bank is in the process of assessing South Africa's insolvency creditor rights system against the *World Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems.* The final report is expected during 2006 from which further refinement to South Africa's insolvency framework will most probably be made.

Corporate governance principles

Good corporate governance principles are essential for countries and companies that require access to international capital and want to attract foreign direct investment.

Increased awareness and implementation of principles of corporate governance among companies listed on the JSE Ltd (the JSE) is evident from the number of companies included in the Socially Responsible Investment Index, despite having to meet even more stringent requirements[27].

In a study finalised during 2005, the Bank Supervision Department of the Bank concluded that the smaller South African registered banks are in general committed to adherence to, and application of high standards of corporate governance[28]. In 2003, a similar conclusion on the status of the five largest banking groups' compliance with sound corporate governance principles was reached following an independent review.

The Companies Amendment Bill[29], likely to be promulgated in 2006, introduces a number of urgent amendments required prior to the completion of the Company Law Reform process. These amendments include legal backing for accounting standards, promoting and maintaining auditor independence and adherence to International Financial Reporting Standards (IFRS). Sections in this Bill, dealing with the definition of independent non-executive directors and the composition of an audit committee, give long awaited legal backing to some of the corporate governance standards as set out in the King II Report on Corporate Governance[30].

27. A committee led by Adv Mervyn King compiled a Code of Corporate Practices and Conduct (King I) in 1994, which was revised in 2002 (King II). The Socially Responsible Investment Index is an index on the JSE Ltd reflecting companies that support the triple bottom line approach of King II. The triple bottom line concept recognises that a "bottom line" should not solely reflect the economic return on investment of a business, but also include other issues such as environmental and social aspects.

28. General Report on the Standard of Corporate Governance in South African Registered Banks and Mutual Banks, May 2005.

29. As published in Government Gazette No 27784 dated 13 July 2005.

30. See footnote 27 for more information.

Accounting and auditing standards

In the global market economy, there is clearly a need for increased consistency, transparency and comparability of financial information.

Since the beginning of 2005, the new IFRS have applied to all companies listed on the JSE (see box "Impact of IFRS conversion on the banking sector"). The Companies Amendment Bill proposes such compliance by all public interest companies, whether listed or not.

The Auditing Profession Act, No 26 of 2005, created a legislative framework for regulating registered auditors in order to address earlier concerns regarding their independence and conduct. This Act came into effect on 1 April 2006 and is likely to enhance, *inter alia*, the independence, effectiveness and powers of the re-constituted regulatory board, namely the Independent Regulatory Board for Auditors.

Impact of IFRS conversion on the banking sector[31]

In terms of the JSE Ltd's revised listing requirements, all listed entities were required to convert to International Financial Reporting Standards (IFRS) beginning 1 January 2005. Although SA Generally Accepted Accounting Practice (GAAP) was already harmonised with IFRS, the International Accounting Standards Board (IASB) which is responsible for issuing IFRS statements had in fact recently amended fifteen of the standards and had introduced six new

31. This box is based on an as yet unpublished working paper by Donné Sephton, Senior IFRS Manager in the FS Banking Practice at Pricewaterhouse-Coopers Inc., South Africa.

standards. Most notably for the banking industry were the amendments made to IAS 32(Financial Instruments: Presentation and Disclosure) and IAS 39 (Financial Instruments: Recognition and Measurement). Using international standards also means that the standards need to be interpreted and applied in the same manner across the globe. Therefore, preparers have had to come to grips with not only the new requirements, but have also had to revisit South African interpretations of the accounting standards to ensure that there is consistency both locally and internationally.

While IFRS has clarified the recognition of expenses and income, assets and liabilities, it does not provide regimented measurement criteria. Rather, IFRS makes it clear that judgement and estimates are required to be made by an IFRS reporter to get to their IFRS published information. IFRS in fact requires forty-five instances where management must use judgement and estimates to measure items that are recognised in the accounts. In the banking sector, the most significant judgements and estimates required to be applied to determine the measurement of an item under IFRS lies in the instances summarised below.

To measure the effective interest rate on an advance, a bank has to determine the expected life of the advance by taking into account historical data as well as forward–looking data such as any potential change in the behaviour[32] of the customer. The effective interest rate that is established in this way is thus very sensitive to any changes in the estimated life of an advance.

32. For example, in the mortgage industry, home loans have traditionally had a very stable expected life. However, as mortgagers are churning their properties more quickly due to the significant growth in the property market, this assumption needs to be reassessed.

In measuring any impairment of advances, banks are required to determine the recoverable amount of the advances by estimating the expected timing and amount of future cash flows attributable to the advances. A bank would consider historical data supporting its estimate, but is also required to take into account any potential change in the behaviour of the customer due to current macroeconomic circumstances. Similarly, to provide for latent losses in a portfolio of loans, the historical data regarding the loss emergence period must be modified to provide a more meaningful representation of the current circumstances. This requires a significant amount of data to be retained by the banks to justify the estimates made under IFRS. As this information is not always available, it is necessary for management to make estimates and apply its judgement.

In light of the amount of estimates and judgements that IFRS requires, in a highly regulated industry such as banking, the introduction of IFRS does little to quell the fears of regulators who are concerned with the soundness of individual banks as well as the overall reduction of systemic risk. The requirement to use estimates and judgements to appropriately measure particular items should not overshadow the value that IFRS brings to the reporting environment of banks. Following the implementation of IFRS, a significant increase in consistency in the recognition and measurement of items presented in financial reports has been noted in the market.

Disclosure is one way of dealing with uncertainty, ambiguity and lack of comparability that arise from the use of estimates and judgements. Currently, the sensitivity attributable to assumptions which can have a significant impact on the IFRS numbers presented by the banks is not required disclosure. Unlike IFRS 4 (Insurance Contracts), which requires extensive and prescriptive disclosure of estimates for insurance contracts, banks are not required currently to provide detailed disclosure relating to the estimates they have made for items which they do not believe have a significant risk of causing a material adjustment to the carrying amount of assets and liabilities within the next financial year.

There is little doubt that, as a comprehensive and cohesive financial reporting framework, IFRS is still in its infancy and a body of good quality, globally acceptable disclosures and interpretations still need to be developed. However, if the users of the IFRS published information, such as regulators, were to encourage banks to make the necessary additional disclosure, so that the users can better understand whether the estimates and judgements made are sound, the objective of meaningful disclosure could be achieved.

National payment and settlement systems

Robust payment, settlement and custody arrangements are crucial for financial stability since default by one participant can easily have knock-on effects and under certain circumstances even cause the failure of other participants in the system.

A self-assessment exercise was conducted to benchmark compliance of, and to enhance where necessary, South Africa's national payment system against the principles issued by the Committee on Payment and Settlement Systems[33].

The continued successful settlement of the rand leg of foreign exchange transactions on the Continuous Linked Settlement (CLS) system[34] since its inclusion, demonstrates South Africa's credibility as an international settlement participant. Other developments include the phasing-out of preferential treatment of certain payment instructions above others[35] and enhancing competition between payment system participants following a study into competitive issues around the payment system. Recently introduced legislative amendments enabled the Bank to issue directives that have legal standing, thereby enhancing the general oversight abilities of the Bank.

33. The Committee on Payment and Settlement Systems is a sub-committee of the Bank for International Settlements.

34. CLS is a concept pioneered by major international players in the foreign exchange market to reduce settlement risk arising from the gross settlement of foreign exchange trades by settling foreign exchange transactions finally and irrevocably.

35. For more information on the phasing-out of preferential payments, refer to General Notice 231 of 2006: Directive for Conduct within the National Payment System, No 1 of 2006 (Government Gazette number 28546)

Financial regulation and supervision developments

Financial markets supervision

The securities sector is sensitive to, inter alia, macroeconomic factors and market sentiment. A sudden loss of confidence, for whatever reason, on the part of the markets can lead to rapid and massive withdrawal of short-term funds, resulting in the collapse of equity prices.

The Securities Services Act, No 36 of 2004 (the SSA), which unified various pieces of legislation[36], came into effect in 2005 and added a number of new regulatory provisions such as the reporting of off-market transactions, the buying and selling of unlisted securities of public companies, and the establishment of a Directorate of Market Abuse. The SSA aligns South African securities services law with internationally accepted principles. This was confirmed by a recent self-assessment exercise undertaken by the Financial Services Board (FSB).

36. The Securities Services Act, No 36 of 2004, consolidates the Stock Exchanges Control Act, No 1 of 1985, the Financial Markets Control Act, No 55 of 1989, the Custody and Administration of Securities Act, No 85 of 1992, and the Insider Trading Act, No 135 of 1998.

The JSE demutualised in July 2005, allowing it to operate as a company with share capital. This has put the JSE on par with its international competitors, the majority of which have already demutualised and converted to companies. Furthermore, the JSE is set to be listed on the JSE Ltd in 2006.

Against the background of an increased focus by financial regulators around the world to increase their understanding of the hedge fund industry, the FSB is currently in the process of drafting legislation to regulate hedge fund products.

Insurance supervision

The insurance industry is of fundamental economic and social importance and it is therefore in the interest of policy-holders that efficient, fair, safe and stable insurance markets are maintained.

In 2005, the FSB adopted a risk-based approach to supervision of industries under its jurisdiction, which is consistent with international best practice. This approach now also includes the regulation of financial service providers that give advice and provide intermediary services to their clients. Over time, the approach is expected to promote market integrity, contribute to the management of systemic risk and protect consumers of financial products and services.

Steps were taken to mitigate potential systemic risk that could have arisen from loss of confidence in the insurance sector and retirement industry following the negative publicity arising from the determinations made against the industries by the Pension Funds Adjudicator. The Life Offices' Association of South Africa (LOA), representing the long-term insurance sector and the five major life insurance companies, signed a "Statement of Intent" with the Minister of Finance to resolve consumer protection issues and transparency problems regarding retirement products and other savings policies (see box "Update on developments in the South African retirement and insurance industries"). In this regard, revised regulations relating to commissions on retirement annuity fund member policies and other savings policies are expected.

The FSB, in consultation with the National Treasury (NT), is also in the process of overhauling outdated legislation pertaining to pension funds in an effort to attain a more consistent and coherent structure and regulation of the broader social security system.

Update on developments in the South African retirement and insurance industries

As reported in the September 2005 *Financial Stability Review,* the South African retirement fund and long-term insurance industries have been faced with, inter alia, the challenge of maintaining public confidence and trust, following the negative publicity arising from the determinations made against the industries by the Pension Funds Adjudicator. Some of the determinations made were precedent-setting and posed the possibility of having a significant impact on the short-term financial viability and the future business models of the retirement fund industry. Worst-case scenario analysis under a number of permutations of likely outcomes broadly suggested the risk of systemic instability in the life insurance sector.

As part of finding a sustainable solution to the problems and stemming concerns about the possibility of systemic instability, a "Statement of Intent" was reached on 12 December 2005 between the Minister of Finance, the five major life insurance companies and their representative body, the Life Offices' Association of South Africa (LOA). The key elements include an agreement to meet minimum fund values of 65 per cent backdated to 1 January 2001, for cases of early premium termination and premium reductions with respect to retirement annuity fund member policies and other savings products, such as endowment policies. It is envisaged that the minimum standards will be increased to 70 per cent of the member's fund value. Regulatory and legislative amendments have to be enacted to make the agreement legally binding.

The cost of complying with the agreed minimum standards is estimated at around R3 billion, which will be borne by the life insurance companies from shareholders' funds and reserves. Since most of the affected life insurance companies have sufficient reserves, their statutory capital adequacy requirements should not fall below the regulatory requirement.

The agreement reached by the various stakeholders helped to boost investor sentiment and raise public confidence towards the insurance and retirement industry and gave policy-holders, life insurers and regulators more certainty. An improved regulatory framework will exist in future as a result of the government, various regulators and industry bodies co-operating in facilitating solutions to tackle the challenges facing this particular industry.

Furthermore, the LOA, the Minister of Finance and the FSB are jointly devising ways to make the life insurance industry more consumer-friendly and equitable. The LOA is in the process of co-ordinating and rolling out a consumer awareness campaign to explain the minimum standards to policy-holders. It also initiated a drive by the life insurance companies to offer insurance products to low-income earners that are affordable, sustainable, and easy to access and understand.

Banking supervision

Weaknesses in the banking system of a country can threaten financial stability both within that country and internationally.

As from 1 January 2008, South African registered banks will be required to comply with the new Capital Accord (Basel II). The Accord Implementation Forum (AIF)[37] is leading the Basel II initiative in South Africa. A report on the economic impact of Basel II is due to be disseminated to the AIF Steering Committee. Draft legislation to comply with the requirements of Basel II will be tabled in Parliament during 2006. The process would also enable banks to conduct field-testing of the new capital adequacy requirements and to cater for the necessary infrastructure.

37. The main sub-committees of the Accord Implementation Forum Steering Committee are the Disclosure Sub-committee, the Economic Impact Sub-committee, the Regulatory Framework Sub-committee and the Risk Sub-committee. Various stakeholders, including NT, banks, Bank Supervision Department of the Bank and the South African Institute of Chartered Accountants, are represented on the Steering Committee.

The establishment of an explicit deposit insurance scheme for South Africa is under consideration. The proposed scheme will primarily protect small depositors from the risk of bank failures. It is also envisaged that such a scheme would enhance confidence in the South African banking system and improve competition by supporting the development of new banking institutions.

A further financial sector challenge is to facilitate broader access to financial services for a major part of the population. The Dedicated Banks Bill and Co-operative Banks Bill, aiming to broaden access to banking services, closed for public comments early in 2005 and are now in the process of being redrafted, taking into account the comments that were received[38]. The National Credit Act, No 34 of 2005, due to be enacted in 2006, also aims, among other objectives, at promoting a fair and non-discriminatory marketplace for access to consumer credit.

38. The Dedicated Banks Bill aims to increase competition with regard to the offering of savings and loan accounts through two types of dedicated banks. The Co-operative Banks Bill aims for the registering of co-operative banks in alignment with the provisions of the Co-operatives Act, No 14 of 2005, enabling those banks to take deposits and provide financial services only to their members, as defined in the co-operative's constitution.

Macroeconomic policy and data transparency developments

Fiscal policy transparency

Fiscal policy transparency is a key aspect of good governance and is critical to the achievement of macroeconomic stability and sustainable growth.

The 2004/2005 *Annual Report* of the Financial and Fiscal Commission of South Africa (FFC) highlighted that the persistent trend by government to overspend or underspend – provincial governments in particular – poses risks to the efficiency and credibility of the intergovernmental fiscal relations system[39]. In this regard, the FFC undertook a programme to restructure its operations and expand its skill and human resources base to enable it to do in-depth and extensive research on trends in government spending in order to provide recommendations and proposals to Parliament.

39. FFC Annual Report *2004 – 2005. The FFC is an advisory body and has the mandate to make recommendations on financial and fiscal matters to Parliament, the provincial legislatures, and any other institutions of government when necessary. The FFC is separate from government and therefore able to perform impartial checks and balances between the three levels of government. It facilitates co-operative government on intergovernmental fiscal matters.*

The Intergovernmental Relations Framework Act, No 13 of 2005, establishes a framework to promote and facilitate inter-governmental relations that should enhance effective implementation of fiscal policy and legislation.

Monetary policy transparency

Increased monetary policy transparency (or disclosure) should lead to better-informed public debate about the design and implementation of monetary policy, thus strengthening credibility and public understanding.

In addition to publishing the inflation forecast twice a year in the *Monetary Policy Review*, the Bank has also become more explicit in the periodic Statement of the Monetary

Policy Committee on its outlook for inflation. To further enhance monetary policy transparency, the Bank started with a peer review process in 2005 by exposing its macroeconomic forecasting model to international and local academics.

Data dissemination

Availability of information allows market participants to compare economic, financial and socio-demographic information to agreed-upon and internationally accepted benchmarks, leading to better understanding of policy actions as well as informed lending and investment decisions.

40. This method entails enumerators visiting outlets to collect price and product information on typical items purchased by consumers.

The reliability of statistics as collated by Statistics South Africa improved with the finalisation of the new register of businesses. The drawing of new samples on an annual basis has improved the sampling methodology and, consequently, the coverage of businesses for statistical purposes improved. Further developments include the direct price collection method for the consumer price index that was implemented from early 2006, which is in line with international best practice[40].

The increased focus on financial stability has led the IMF to publish a *Compilation Guide on Financial Soundness Indicators.* It includes economic and financial indicators that can be used by national authorities and the IMF to assess the financial strength and vulnerability of a country's financial sector. The IMF has also embarked on a voluntary Coordinated Compilation Exercise to co-ordinate the efforts of national authorities to compile cross-country comparable Financial Soundness Indicators. South Africa, being one of the participating countries, will provide the IMF with the required data for subsequent publication by the IMF.

Concluding remarks on developments in the financial system environment

In recent years, South Africa experienced increased integration with the world economy. This necessitated the ongoing process of reforming critical financial and regulatory legislation and implementing international standards and best practices. Today, South Africa has a robust financial infrastructure that generally complies with international standards and best practices and is recognised for the role it can play in the region and internationally.

Given the complex and ever-changing financial system environment, it is necessary that new and appropriate measures are implemented on an ongoing basis as part of the role-players' combined efforts to mitigate shocks to the South African financial system in the common interest of financial system stability.

Financial sector continuity planning in South Africa

41. http://www.voanews.com/english/2006-01-30-voa29.cfm

There are indications of an increasing prevalence of physical or non-economic threats to financial system stability. A recent United Nations report shows that the number of natural disasters around the world rose by 18 per cent last year, resulting in nearly 92 000 fatalities, affecting the lives of 157 million people, and causing hundreds of billions of dollars in economic damage[41]. In many instances, the impact of physical threats is not limited to the financial sector but extends to the broader economy as well.

This section examines the financial system stability impact of emerging and potential physical threats. It discusses some physical threats currently on the radar screens of financial sector authorities. A framework for financial sector contingency or continuity planning is presented and some elements of the South African approach to financial sector contingency planning are described.

Physical threats and continuity planning

Physical threats or risks are non-economic and non-financial in nature but could, if not managed properly, present a risk to financial sector continuity. While any event that has the potential to impact the stability of the financial system is considered a systemic risk, physical threats form one class of systemic risks[42]. The range of physical threats spans from natural disasters and breakdowns in the provision of utilities and basic services, to terror attacks and sabotage.

42. The concept of systemic risk was discussed in the March 2004 edition of the Financial Stability Review.

Natural disasters

A disaster resulting from a seismic event, hurricane, flood, or other severe weather condition typically would have its probability of occurrence defined by geographic location. In instances where early warning of pending disasters is possible, managements of financial firms need to concentrate on advance preparations to minimise losses.

The growing prevalence of seismic activity in Johannesburg and surrounding areas raises concerns in respect of their impact on banking activities and key financial sector infrastructural institutions. The increasing occurrence of tremors has been ascribed by many to the intense mining activities in the greater Johannesburg area. A panel has been appointed to investigate the role that mining activities have played in contributing to seismic events with particular emphasis on the events of 9 March 2005, the so-called "Stilfontein incident"[43].

43. http://www.dme.gov.za/newscentre/media_rel/Media_Rel_Expert_panel.pdf

In terms of financial sector continuity, physical risks in South Africa are exacerbated by weaknesses in the physical infrastructure, including geographic concentration of primary and back-up facilities, single points of communication failure[44] and interruptions in the provision of certain utility services.

44. Single points of failure (SPF) have to do with what can go wrong in the environment and what impact a failure would have on an institution or system. SPF analysis details the interdependencies and relationships among the major components in the environment with a view to identifying vulnerabilities with potential adverse consequences.

Disruptions in the supply of electricity and other utilities

Some parts of South Africa have been increasingly experiencing electricity supply disruptions with power failures affecting residential as well as commercial and industrial areas. These power outages have been ascribed to weaknesses in electricity infrastructure as well as to overloading of the electricity network. These outages have noticeably been concentrated in the country's economic hub. The Johannesburg city centre presents the greatest challenge in terms of demand increasing at between four and five per cent per year, a situation aggravated by the recent housing boom.

Since the beginning of 2006, water supply disruptions have on occasion been experienced in various parts of the Eastern Cape, Limpopo, Free State and the Northwest. These disruptions are thought to have resulted from a combination of improper management and drought conditions and have affected many small businesses.

Due to the monopolies of regional utilities providers, contingency planning for disruptions in utility provision is challenging. It does, however, remain a priority in financial sector continuity. The emphasis is primarily on sustained and uninterrupted supplies of energy and telecommunications services and other essential utilities.

Terror, war and other security threats

Many of the lessons learned from the 11 September 2001 terror attack form the basis of modern contingency planning. A key lesson, observed from the World Trade Centre attack, was that it is crucial to maintain confidence in the financial system. While South Africa has not experienced a significant act of terror, the risk of terrorism cannot be ignored in business continuity planning. Expectations of the magnitude of potential disruption and destruction that could be caused by terror attacks continue to increase. Some forms of terrorism (e.g. chemical or biological contamination) may leave facilities intact but inaccessible for extended periods of time. The earlier an imminent attack is detected, the better the opportunity for successful response and recovery.

Financial sector contingency planning

The varying and evolving nature of threats to the financial environment poses a challenge to those who plan responses to these threats. A comprehensive contingency plan describes and prioritises as many scenarios of distress as possible. The plan contemplates responses to these distress situations developed around a combination of technology, manpower, critical documents and alternative sites. Effective contingency plans ensure that roles are clarified, responsibilities are determined, teams are trained to work well together, and that innovation, improvisation and implementation of solutions are possible under severe pressure. Contingency plans should strive to be flexible, adaptable and comprehensive enough to provide for a range of risks as opposed to being specifically developed to manage specific crises.

The philosophy underlying contingency planning approaches

There are two broad approaches to contingency planning: The specific and the generic. The specific approach is premised on the development of crisis management plans for specific contingencies. Under this approach there is a plan to deal with specific crises and less discretion is left to the crisis management authorities than under the generic approach.

The generic approach is premised on the assumption that authorities will not be able to anticipate all possible threats and specifically plan for them. A broad, comprehensive crisis management strategy is developed to deal with all possible contingencies. A further assumption underlying this approach is that if one is prepared for the worst case scenarios, then lesser crises are manageable under the same strategies. The generic approach presupposes that risks have similar or the same fundamental impacts: The destruction of physical infrastructure and facilities, the loss or inaccessibility of personnel and restricted access to the affected area. It is around these impacts that the contingency plans are developed. The generic approach is preferred in South Africa.

The elements of cross-sectoral contingency planning

Business continuity planning (BCP) is the responsibility of the managements of individual financial firms. Although regulators require and inspect adherence to best practice for continuity, they do not manage regulated institutions and therefore take no responsibility for business continuity management. Due to the interdependencies between financial institutions, some sector-wide co-operation is necessary, and to this end regulators sometimes play a facilitating role.

Contingency planning to address distress in individual financial institutions may provide a useful basis for sector-wide contingency planning, but would generally not be sufficient to handle a sector-wide crisis and adequately subdue the adverse impacts of contagion. Cross-sectoral continuity planning, although interwoven with institutional contingency plans, is a unique process in itself. The success of sectoral contingency planning requires co-operation, co-ordination and involvement across multiple authorities and decision-makers.

As with organisational BCP, sectoral continuity planning comprises four fundamental elements:

Risk identification

Ongoing identification and assessment of threats are critical to the success of continuity planning. Planning should include guidelines for the determination of risks that can be dealt with at an organisational level and those that need to be escalated to the sectoral level. Risk assessments should include a frank consideration of mitigating controls already in place and the extent of response required in respect of residual risks.

Continuity strategy

The three keys to business continuity strategy are co-ordination, consistency and efficiency. As discussed above, it must be determined whether a generic or a specific approach is to be followed. At the sectoral level, if a generic approach is chosen, co-ordination would be easier if component institutions followed suit as opposed to there being inconsistency in the choice of generic versus specific approaches across the sector. Efficiency is important both in terms of the speed of crisis responses and managing efficiency of spending. The former is self explanatory, while the latter refers to the limited enthusiasm and funding generally given to contingency planning in normal times.

Clarification of roles, responsibilities and decision-making authorities

This element is as important to the success of crisis handling as is the continuity strategy. In particular, issues such as who has the responsibility for identifying crisis situations that require a response, who has the authority to call for a response and who has the authority to co-ordinate/steer the response must be addressed. From the point of view of sectoral continuity planning, the responsibility for organisational BCP remains with the individual institutions.

Documentation, testing and maintenance

In documenting continuity strategies, a balance must be achieved between being sufficiently comprehensive in covering all relevant issues and ease and speed of reference in a crisis. Crisis-handlers may also benefit from making note of key events, communications exchanges and decisions taken along the way to facilitate the post-crisis review and any other investigations that may be held in respect of the crisis-handling. Documentation should also be one of the aspects assessed in testing. The format of a test could be determined by accessing the database of existing and likely threats, reviewing the recent experiences of other jurisdictions or by testing only worst-case scenarios. Learning from testing experiences, identifying gaps and building these lessons into contingency plans are as important, if not more so, than the successful completion of a test.

For financial sector continuity planning to be successful, individual firms need to acknowledge the broader sectoral role in their own continuity plans. Firms would be unwilling to take on additional costs in their continuity planning to benefit the broader sector (although this is probably less so for providers of infrastructural services). However, they can often yield huge benefits to sectoral continuity merely by taking cognisance of their broader role in the sector and remaining considerate of such a role in their planning processes.

Co-ordination and co-operation in contingency planning in South Africa

South Africa has established a co-ordinating forum for financial sector contingency planning. This forum creates a co-ordinated network of contingency planning contacts throughout the financial services industry and supports contingency planning at both the level of physical threats and financial system risks. The primary objective of this forum is to facilitate cross-sectoral co-operation in identifying threats to the stability of the financial sector and propose plans, mechanisms and structures to mitigate such threats.

This forum also creates a medium for open discussion of contingency planning topics, allowing information and insight to be shared, thereby providing a framework to leverage ideas and experience. It allows regulators and other official bodies to keep the forum updated and provide guidance on contingency planning requirements and issues. Lastly, the forum provides a mechanism for working with both local and international organisations pursuing similar objectives, exchanging agendas, ideas, experiences, etc., thereby creating a substantial repository of contingency planning information.

Comparable approaches to financial sector contingency planning are evident in other jurisdictions as described in the box on "Financial sector continuity arrangements in selected jurisdictions".

Financial sector continuity arrangements in selected jurisdictions

The United Kingdom

Although the main responsibility for financial sector resilience lies with the sector itself, the UK Tripartite Standing Committee provides an established mechanism for the co-ordinated response of Her Majesty's Treasury, the Bank of England and the Financial Services Authority (FSA) to financial contingencies. This committee liaises with the markets, key infrastructure providers, government departments, and the police and emergency services in responding to threats to financial sector continuity.

The United States of America

The federal system in the US has the effect that continuity efforts are somewhat fragmented. Financial sector self-regulatory institutions have promulgated business continuity requirements for their members in their rules. In addition, two cross-sectoral committees have co-ordination of financial sector continuity as their key objective: The Financial and Banking Information Infrastructure Committee (FBIIC) and the Financial Services Sector Coordinating Council for Critical Infrastructure Protection and Homeland Security (FSSCC). The FBIIC is charged with improving co-ordination and communication among financial regulators, enhancing the resilience of the financial sector and promoting the public/private partnership. The FSSCC was established to facilitate the co-ordination of cross-sectoral financial services activities and initiatives designed to improve critical infrastructure protection and homeland security. The FSSCC and the FBIIC conduct joint meetings to share information about infrastructure protection activities and to co-ordinate their respective activities.

Canada

The Financial Institutions Supervisory Committee (FISC) was established in 1987 pursuant to the Office of the Superintendent of Financial Institutions (OSFI) Act. The functions of the FISC include exchanging information with regard to the health of financial institutions, assessing the impact of unexpected developments in financial markets on the financial conditions of financial institutions and discussing strategies to deal with financial institutions facing serious difficulties.

Development areas identified through cross-sectoral co-operation in South Africa

In line with efforts to improve cross-sectoral co-operation and institutional effectiveness in contingency planning, a range of issues have been identified.

Firstly, although South Africa's financial system is generally considered to have a resilient information technology (IT) infrastructure, there are several areas that need improvement, e.g. single points of failure, and the reliability of the electricity infrastructure. Secondly, financial institutions need to move towards more comprehensive business continuity principles which are flexible and constantly reviewed against threats as they develop. In addition, issues such as the geographical concentration of critical business functions must be addressed through dispersing back-up sites while taking cognisance of the feasibility of getting staff to back-up sites and other staffing issues. Thirdly, greater attention must be paid to security as a holistic concept, including background checks of workers, IT security and cash-in-transit security. Fourthly, the resilience of communication plans, both intra-sectorally and with the public, needs to be constantly reviewed and tested. Lastly, greater attention needs to be paid to, and resources devoted to, testing and simulated disaster recovery exercises to test readiness for terrorist attacks, natural disasters or major damage to the infrastructure.

Concluding remarks on financial sector continuity

Physical threats are currently the focus of BCPs and of regional and national governments' emergency plans. While the economic outlook for 2006 remains positive, contingency planning readiness in terms of non-economic or physical threats needs to be reviewed. Physical threats should not only play a key role in inspiring contingency and BCP efforts but should also receive attention in continuity testing. Effective testing of contingency plans is likely but not guaranteed to increase the efficiency of response when an actual crisis occurs. Whether the lessons learned from testing and crisis experiences were well assimilated and accommodated would only be revealed over time.