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South African Reserve Bank

Editorial committee

Data and events after 30 March 2007 were not considered for this publication.

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Purpose of the *Financial Stability Review*

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 contribute to a South African monetary, banking and financial system that as a whole is as robust as possible. In pursuit of this objective and to promote a stable financial system, the Bank publishes this semi-annual *Financial Stability Review*. This 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 and financial market participants.

Defining financial stability

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

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

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

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Introduction

This edition of the *Financial Stability Review*, focusing mainly on the six-month period ending December 2006, comprises two main sections, namely financial stability developments and trends, and infrastructure and regulation.

The first section starts with an overview of current 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. This is followed by an analysis of 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.

The second section focuses on the financial system infrastructure and regulation, and includes an update on important developments in the financial system.

Overview

Global economic growth from 2004 to 2006 was the strongest recorded since the early 1970s. Expectations of a global slowdown in economic growth in 2007 were supported by gross domestic product figures for the third quarter of 2006 but fourth-quarter growth figures for the major economies came out much stronger than expected. The global manufacturing Purchasing Managers Index, however, dropped slightly in January 2007, suggesting that global manufacturing output growth might be sluggish in 2007.

In recent years, emerging-market economies have shown a consistent ability to grow more strongly than developed economies. Since the brief investor sell-off experienced in May – June 2006, increased investor confidence, continuing investment fund inflows and sound macroeconomic fundamentals contributed to strong performances in the financial markets of emerging-market economies.

African economies are experiencing a major turnaround following decades of sluggish progress. Growth is, however, uneven across countries and sub-regions, with oil-exporting countries growing much faster than oil-importing countries. The outlook for sub-Saharan Africa is generally positive. Excluding political risks, the major downside economic risk is a hard landing in the global economy that may result in a turnaround of the commodity boom.

During the period under review, the South African financial system remained sound, based on the analysis of various indicators. Overall confidence in the financial services sector remained high. Stress-testing results showed that the banking sector should remain resilient to a range of plausible adverse developments. The capital-adequacy ratio exceeded the regulatory requirements even after factoring in the impact of stress scenarios, and there were signs of an overall improvement in the asset quality of banks. The life insurance sector was considered to be generally healthy. The annual growth rate of share prices of life insurance companies remained high, although it dropped when compared to the previous quarter. There were, however, concerns about the high lapses and surrenders and the low number of new policies issued.

The growth rate of credit to the corporate sector continued to accelerate, which may partly be attributed to increased investment in infrastructure. Business confidence levels also remained relatively high.

The level of household indebtedness, already high by historical standards, edged higher. Mortgage advances, which form a dominant portion of credit to the household sector, continued to grow at a high rate. Existing fundamentals do not point to overall fragility in household-sector balance sheets, as debt-servicing costs are still low and household wealth and financial assets are growing. Growth of household debt nevertheless needs to be monitored, taking into account the increases in interest rates during 2006.

Available measures of residential property market activity point to some cooling off although house price increases continue to exceed consumer price inflation. Overdue mortgage loans as a percentage of total mortgage loans are fairly low and there are no indications of large-scale default in mortgage repayments, despite an apparent increase in the annual growth rate of mortgage overdues.

The ongoing resilience of the South African financial system is also dependent on the proactive efforts of financial authorities and policy-makers to enhance the functioning of the financial system and reduce the risk of financial distress and contagion. In this regard, a number of significant regulatory development milestones were reached in the period under review. These include regulatory amendments introduced in the insurance and retirement industries to give effect to certain undertakings of the Statement of Intent, and the release of the draft Companies Bill, 2007 for public comment.

Financial stability developments and trends[1]

International macrofinancial developments

According to the International Monetary Fund (IMF), the world economy is changing to a slower pace of expansion after three years of uninterrupted robust growth. It is generally expected that this adjustment will occur smoothly. However, changes in the United States (US) housing market, disorderly resolution of global imbalances and a significant and widespread reduction in risk appetite carry the threat of a sharper-than-expected slowdown in the world economy (see Box 1: "Summary of selected risks in the global environment"). Such a correction could result in a broad-based adjustment in asset prices, leading to distress in global financial markets.

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

Box 1: Summary of selected risks in the global environment

The threat posed by global warming, attempts to revive the Middle Eastern peace process and fresh talks on a new world trade deal were the issues that dominated the 2007 World Economic Forum (WEF). Discussants at the WEF annual meeting, held in Davos, Switzerland in February 2007, highlighted a number of economic, financial and social risks in the global environment. Some of the main risks identified can be summarised as follows:

Threat posed by large, persistent economic imbalances to world financial stability. The US dollar remains susceptible to depreciation due to the large US current-account deficit. A sharp decline in the US dollar would impact negatively on global economic growth and increase volatility in financial markets.

Hidden risks in global finance. These particularly relate to the widespread use of derivatives. New derivative instruments are often not well understood and risks may spread to others in the system who may not price the risks appropriately.

Private equity and hedge funds. These have been expanding rapidly in size, coming increasingly under public and regulatory scrutiny. However, some analysts are of the opinion that increased transparency will not reduce or eliminate systemic risk, but will only make it more difficult for hedge funds to operate.

Geopolitical risks. Issues identified as among the most pressing include the instability in the Middle East, particularly Iraq, communal strife in Africa, notably Darfur, the threat of terrorism and a proliferation of materials and weapons of mass destruction.

Climate change. Changes in climate are on the increase worldwide and can derail economic growth, with negative consequences for financial markets through, for instance, commodity price volatility.

Multilateral trade talks. The future of multilateral trade negotiations remains uncertain. There is currently no agreement on the negotiating process since the multilateral trade talks in the Doha Round were suspended in July 2006.

Demographics and implications for global stability. Native populations in most developed and some emerging economies are declining and ageing as birth rates fail to keep up with the death rate. This might negatively impact on financial stability through its influence on future economic growth and the financing of pension funds. Yet, numbers are growing in poorer nations, where scores of young people find themselves with few job opportunities. These nations and other developing countries will make up the overwhelming majority of the world's population by 2050.

Managing access to oil. This was dubbed "the risk of the 21st century". Questions were raised on the future of the oil industry, whether new conflicts would arise, what the roles of both oil producers and oil consumers are, and what impact this might have on the environment.

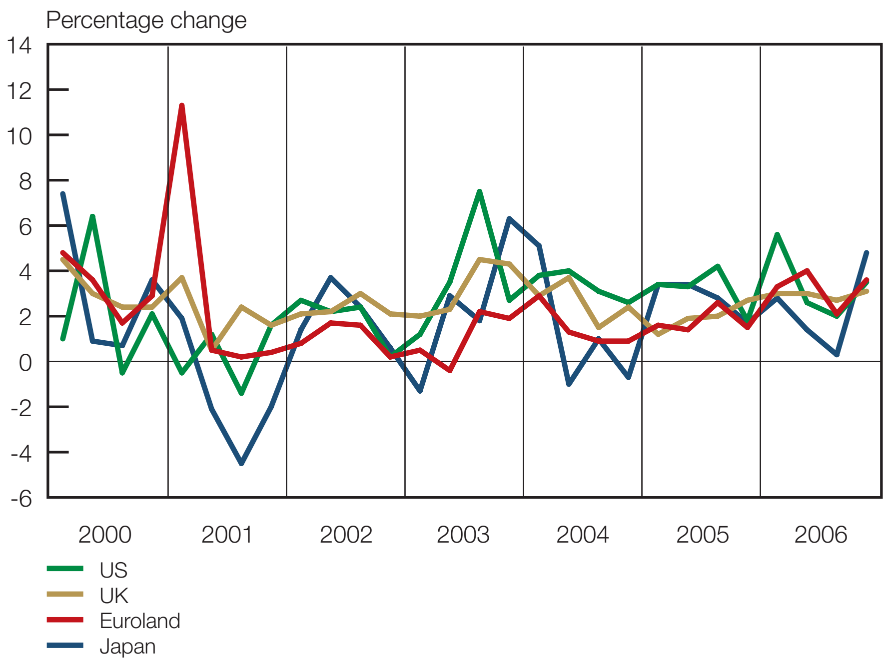
House price deflation. After years of strong demand and soaring prices, the housing boom in the developed world appears to have reached its peak, raising the question whether the ensuing correction will be slow or fast, economically benign or financially destabilising.

Current global economic conditions

While global economic growth from 2004 to 2006 was the strongest recorded since the early 1970s, the IMF expects it to slow from an estimated 5,1 per cent in 2006 to 4,9 per cent in 2007. This view was supported by growth figures recorded in the third quarter of 2006 as quarterly real gross domestic product (GDP) data for the US, United Kingdom (UK), Euroland and Japan reflected a slowdown.

However, GDP data for the fourth quarter of 2006 came out much stronger compared to the third quarter. In Japan, GDP growth accelerated from 0,3 per cent in the third quarter to 4,8 per cent in the fourth, while in the UK it increased from 2,1 per cent to 3,6 per cent over the same period. In the US, GDP growth also increased, albeit only moderately, from 2 per cent in the third quarter to 2,2 per cent in the fourth quarter as weaker developments in the housing market, among other factors, impacted negatively on growth. In the euro area, growth for 2006 was still strong, but slower growth in exports to the US, a less expansionary monetary policy and reduced fiscal stimulus are likely to curb growth in 2007.

Figure 1 Quarterly growth in gross domestic product



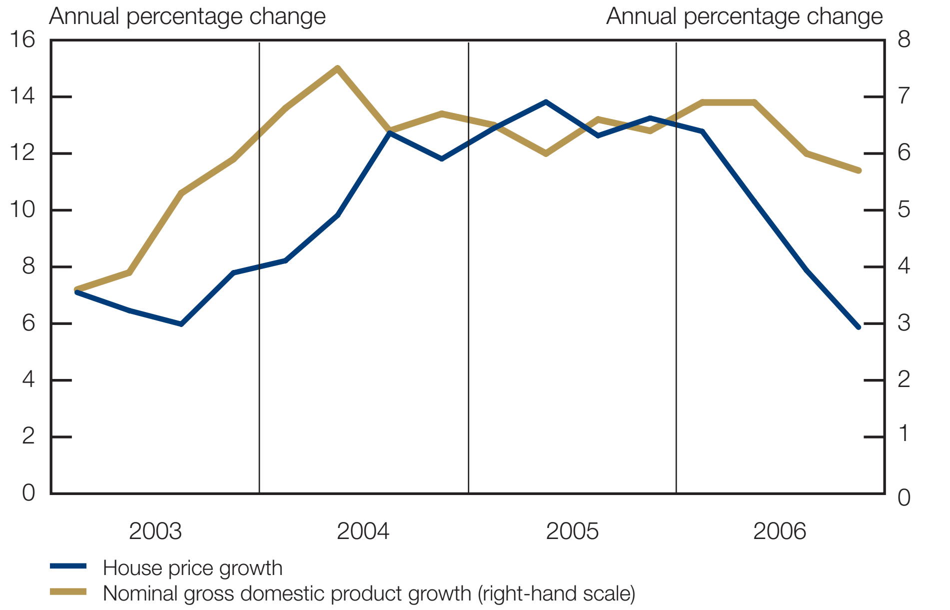
Source: Thomson Financial Ltd (DataStream)

House prices in the US have been slowing markedly from the beginning of 2006. Historically, developments in the US housing market have been closely related to the general pace of economic growth. By some accounts, the US housing crunch has already cut GDP growth by one percentage point in the second half of 2006. Analysts believe that the wealth effects of the downturn in housing, amplified by weaknesses in other sectors, e.g. the automotive sector, could conceivably push the US economy towards a recession.

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

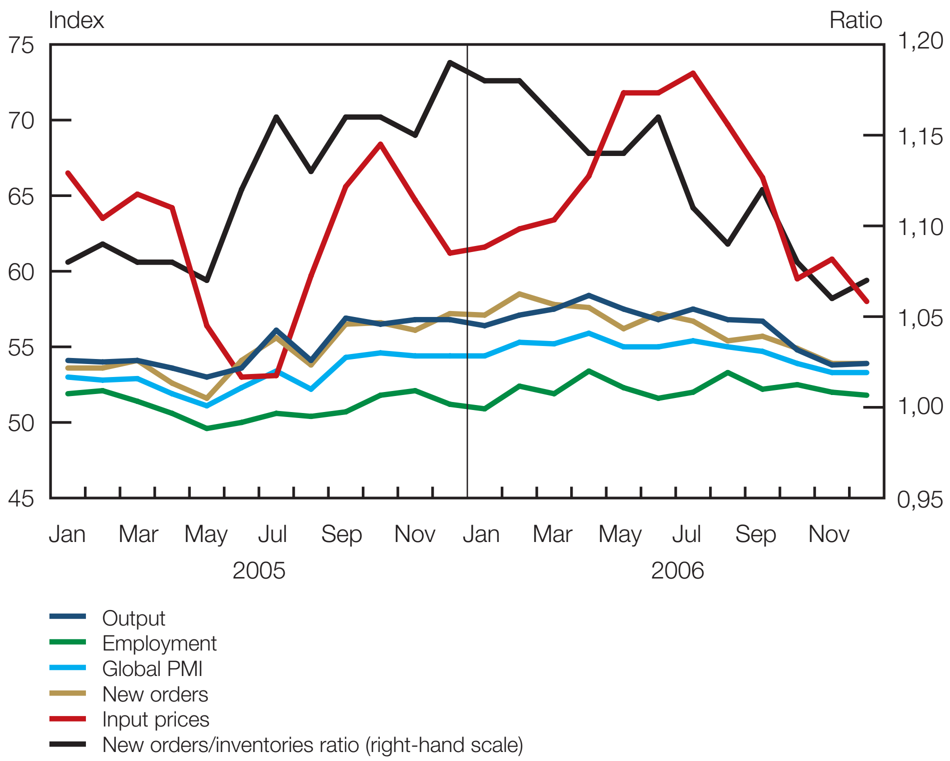
After recording a slight improvement in December 2006 following decreases since July 2006, the global manufacturing Purchasing Managers Index[2] (PMI) dropped a further one percentage point in January 2007. Because both the output and new orders components fell in January, it can be expected that global manufacturing output growth might be sluggish in 2007.

Figure 2 Annual house price and economic growth in the US



Source: Thomson Financial Ltd (DataStream)

Figure 3 Global manufacturing PMI and its components



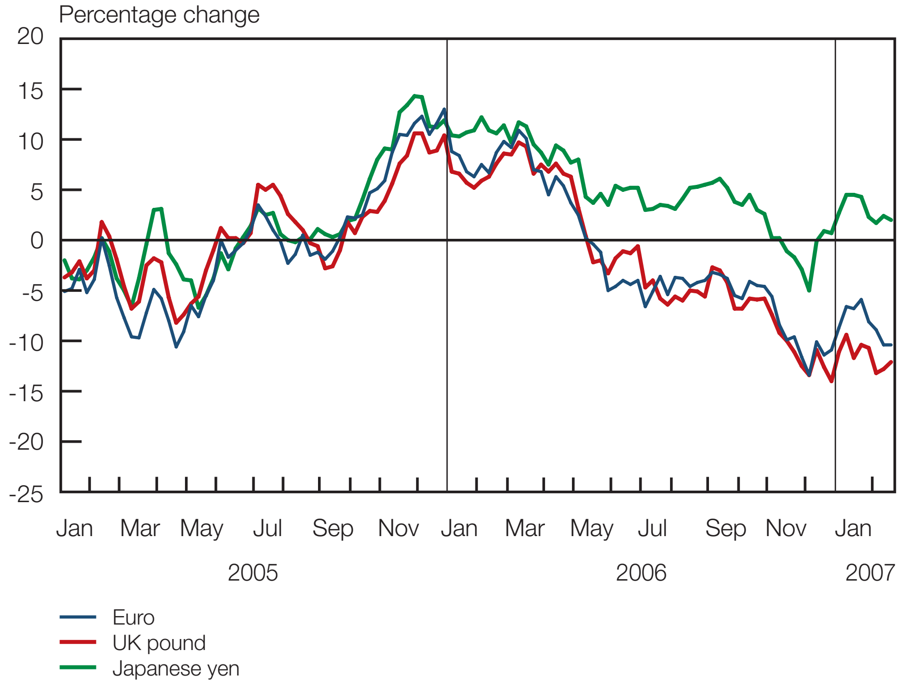
Source: JPMorgan

Value of the US dollar and global imbalances

The US dollar has been weakening markedly against the euro (10 per cent), UK pound (12 per cent) and, to a lesser extent, the yen (4 per cent) since March 2006. The US dollar strengthened for a brief period in early 2007, drawing support from expectations that the Federal Reserve would not cut interest rates at the time, lower oil prices, a government report that showed US jobless claims falling to their lowest level since July 2006, and an improvement in non-farm payrolls data. Subsequently, the US dollar again resumed its weakening trend as interest-rate expectations became biased towards a possible cut in interest rates.

The apparent end of the tightening interest-rate cycle in the US, high levels of fiscal and current-account deficits, further interest-rate increases in Japan, Euroland and the UK, as well as reports of further diversification of foreign-exchange reserves by some central banks indicate that the US dollar could weaken further and cause volatility in global financial markets. Countries with large holdings of US dollars in their foreign-exchange reserves are showing a new tendency to diversify their reserve holdings. In December 2006, the United Arab Emirates, Russia, Switzerland and Venezuela transferred some of their foreign-exchange reserves into euros. There have also been signals from China and Iran of diversifying their foreign-exchange reserves to other currencies. In January 2007, the Malaysian Prime Minister announced that some of its US$82 billion currency reserves had been moved out of the US dollar.

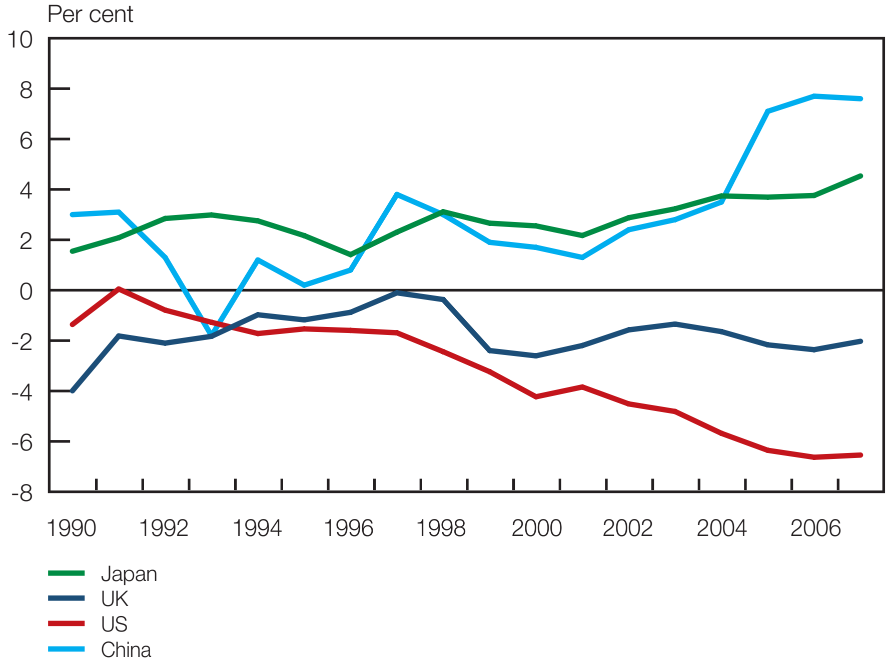
Figure 4 Weekly exchange rate of the US dollar to euro, UK pound and Japanese yen



Source: Thomson Financial Ltd (DataStream)

Global imbalances remain one of the key global economic risks. The concern remains that the adjustment arising from large current-account deficits (the most visible aspect of global imbalances) could involve a depreciation of currencies 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 ever-widening divergence between current-account deficits (predominantly in the US) and surpluses in Asia (especially in China and Japan), puts renewed pressure on these countries to make a concerted effort towards reducing global imbalances.

Figure 5 Current-account balances as percentage of GDP



Source: Thomson Financial Ltd (DataStream)

Global equity and bond markets

Global equity markets recovered from the brief investor sell-off experienced in May – June 2006 due to increased merger-and-acquisition activities, strong corporate profitability, lower oil prices and expectations of stable growth in the US economy. Bond markets performed well on expectations of benign inflation and a slowdown in the US housing market. As a result, the Morgan Stanley Global Capital International (MSCI) Global Markets Index[3] rose by 15 per cent in 2006.

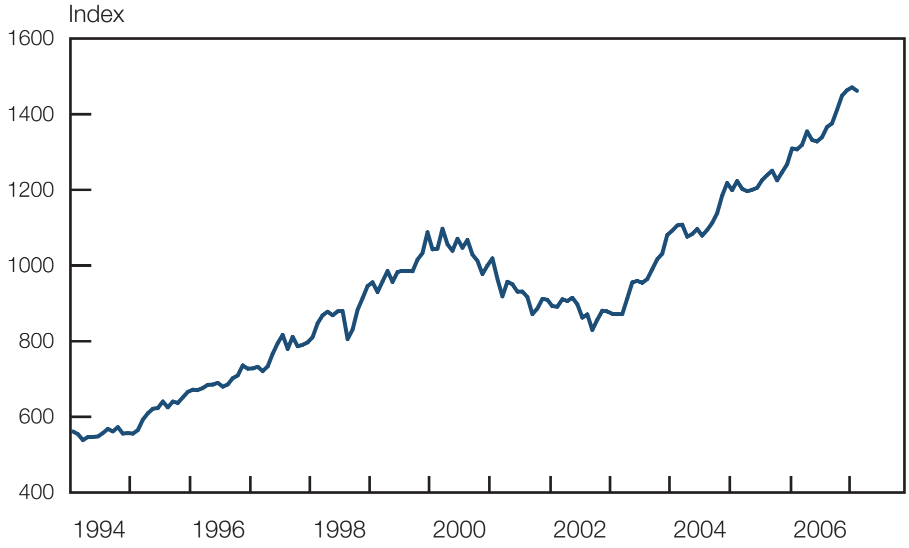
The more recent brief global market sell-off in February 2007 has resulted in volatility in global equity and bond markets. This sell-off was triggered by fears of a slowdown in China[4], defaults in the United States subprime mortgage market (see Box 2: "A note on the US subprime lending market"), the threat of an unwinding of yen carry trades (see Box 3: "Carry trade") and geopolitical concerns surrounding the nuclear power tensions between Iran and the United States. Although markets have recovered somewhat, increased levels of volatility have forced investors to re-assess their pricing of risk. Since the sell-off in February 2007, the MSCI Global Markets Index has fallen by 2 per cent[5].

3 The MSCI Global Markets Index is designed to measure the performance of the core capital market 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.

4 China's equity markets declined by about 9 per cent on 26 February 2007 due to the imposition of capital-gains tax on equities as well as expectations of higher inflation and higher interest rates.

5 As at 20 March 2007.

Figure 6 MSCI Global Markets Index



Source: Bloomberg

Box 2: A note on the US subprime lending market

The US subprime mortgage lending market has received a lot of attention lately, with a number of lenders reporting larger-than-expected losses from subprime loans and Freddie Mac[6] announcing tougher subprime lending standards. This has been particularly significant for financial markets, so much so that in February 2007, part of the gains in US government bond prices was attributed to a flight to quality as the perceived risk of low-rated mortgage bonds increased.

6 A government-sponsored housing enterprise holding mortgage-related asset portfolios.

Subprime lending refers to high-interest loans to consumers with impaired or non-existing credit histories. Typically, subprime customers are those who do not qualify for prime market rates because of blemished or limited credit histories. Companies offering such products often look for added security in the form of collateral. According to market reports, subprime mortgage activity grew by an average of 25 per cent per annum from 1994 to 2003, outpacing the rate of growth for prime mortgages. This was a result of the house price boom and expectations of further increases in house prices. The industry accounted for US$330 billion, or 9 per cent of US mortgages in 2003, up from US$35 billion a decade earlier.

Recently, a number of companies providing these loans reported losses. HSBC Finance reported that it was setting aside 20 per cent more than analysts had estimated for bad loans in 2006 because of a weakening in the US mortgage business. New Century Financial, the second-largest subprime mortgage originator in the US, announced that it would restate results for the first three quarters of 2006 to correct accounting errors related to loan repurchase losses. The company was then suspended from the New York Stock Exchange, while four states barred it from issuing more mortgages or taking new applications. Shares of other big mortgage players, Countrywide Financial and Washington Mutual, declined and smaller subprime lenders were hit even harder.

The recent turbulence in the subprime market was in large part due to the fact that a substantial share of subprime loans consists of adjustable rate mortgages (ARMs), a number of which have already reset to higher rates and more of which will reset in 2007 and 2008. ARMs became increasingly popular in 2003 and 2004, as the US Federal Reserve left interest rates at a four-decade low for about a year and then raised rates slowly. However, in spite of the surge in ARMs, fixed rate mortgages still account for approximately 85 per cent, with the ARMs making up the remainder. Thus, while subprime mortgage origination has risen in the past few years, it still constitutes a limited share of the mortgage market. Of approximately US$10 trillion currently outstanding in the entire mortgage market, about US$1,2 trillion are subprime loans. Although still early, indications are that the macroeconomic impact of ARM resets and subprime strain could be small.

However, more recently, fears have intensified that a crisis in the subprime lending market could spread to the mainstream lenders, raising the cost of borrowing for all borrowers. This could impact on the already fragile US housing market and cause further volatility in financial markets.

Box 3: Carry trade

The carry trade mechanism became popular a decade ago in the form of the yen carry trade. Investors borrowed at zero interest rates in Japanese yen and used the loans to buy high-yielding assets in countries with higher interest rates such as the United States, United Kingdom, Australia, New Zealand and emerging-market economies (e.g. South Africa, Hungary, Brazil, Russia and Turkey).

Carry trades usually yield profits if the investor correctly assumes that the currency in which funds are borrowed will remain weak. Increases in interest rates and the appreciation of a currency cause an increase in the repayment cost of borrowing. This offsets the interest-rate differential and often triggers the unwinding of carry trades. In 1998 the yen unexpectedly strengthened by 20 per cent in less than two months and caused massive market sell-offs worldwide. This was also a direct cause of the collapse of Long-Term Capital Management (LTCM) and Russia's debt default. As Japan slid back into recession and deflation, the yen carry trade returned to favour.

A very similar dilemma is faced currently. A 3-per-cent strengthening of the yen against the dollar since February 2007, prompted by gradual interest-rate increases to 0,5 per cent from zero per cent, has sparked the unwinding of yen carry trades. This unwinding of yen carry trades is possibly one of the reasons behind the February 2007 global sell-off in bond and equity markets of high-yielding currencies.

There is uncertainty regarding the total magnitude of the global yen carry trade, but the Chicago Mercantile Exchange estimates the yen carry trade to be worth US$1 trillion, scattered among hedge funds, insurance companies and mutual funds. A rapid and massive unwinding of yen carry trades could result in increased risk aversion and volatile global financial markets.

It is possible that the South African rand, like other high-yielding emerging-market currencies, could have been a beneficiary of the yen carry trade. A rapid and massive unwinding of yen carry trades could therefore cause some volatility in South Africa's equity, bond and commodity markets.

It is still too early to tell whether the unwinding of yen carry trades is a long-term phenomenon. South Africa's financial system and the global financial system are, however, in a better economic position to withstand such shocks than they were in 1998. The economies of the United States, Europe and Japan are growing in tandem and there is the added benefit of strong growth in China, India and most of East Asia.

Emerging markets

Following the brief investor sell-off experienced in May – June 2006, increased investor confidence, renewed risk appetite, continuing investment fund inflows and sound macroeconomic fundamentals contributed to strong performances in the financial markets of emerging-market economies (EMEs). In recent years EMEs have shown a consistent ability to grow by between 3 and 4 per cent per annum more than developed economies. The Morgan Stanley Capital International (MSCI) Emerging Markets Index[7] rose by 29 per cent in 2006. China and India continued to experience buoyant domestic conditions and strong export growth and this was reflected by strong real GDP growth rates of 10,7 per cent and 8,6 per cent, respectively, in 2006. Both countries are expected to continue to post strong economic growth in 2007.

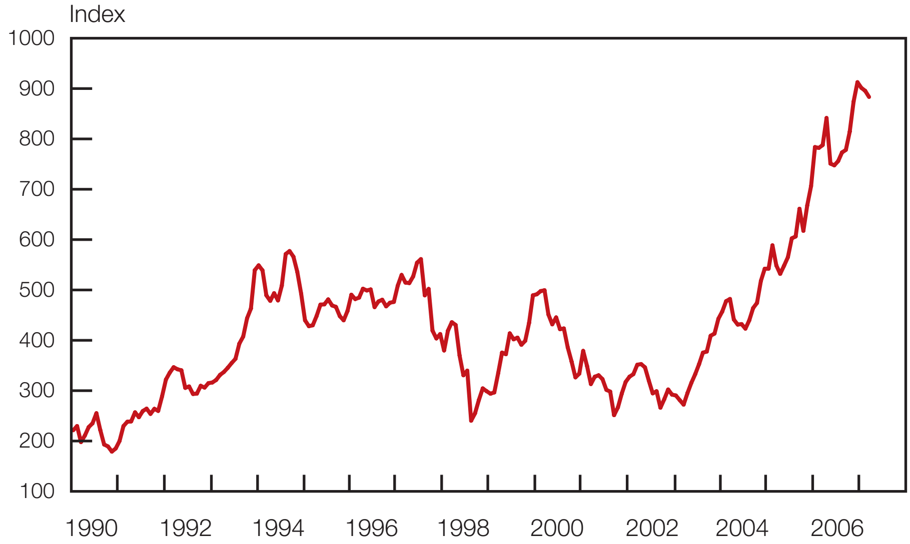
7 The MSCI Emerging Markets Index measures the performance of the core capital markets asset classes comprising global equities and bonds.

In 2006, emerging-market bond spreads remained at record-tight levels, supported by stronger equity markets and expectations that the US Federal Reserve Board would keep interest rates on hold, thereby resulting in a search for higher yields in EMEs. The tightening in debt spreads was further supported by a limited supply of emerging-market debt, a low default rate and continued improvement in fiscal conditions.

The resilience of EMEs was again tested on 18 December 2006, when Thailand's equity market declined by 15 per cent after Thailand's central bank announced capital controls to stem the rapid appreciation of the baht. Global markets recovered quickly as

Thailand's central bank retracted some of the restrictions. Overall, the effect of the turbulence in Thailand on markets in Asia and elsewhere was limited and temporary.

Figure 7 MSCI Emerging Markets Index



Source: Bloomberg

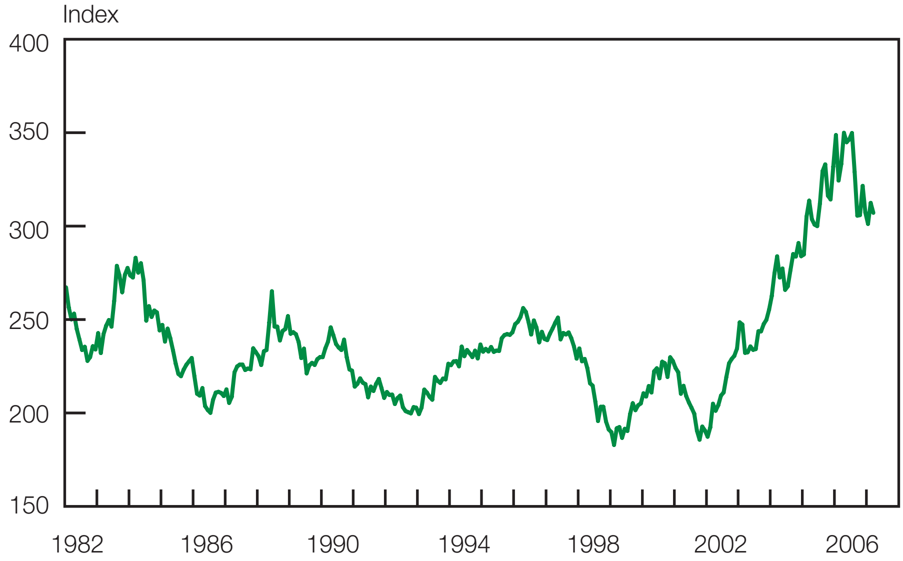
The global market sell-off in late February 2007 (see the previous section: "Global equity and bond markets") resulted in an increase in uncertainty and a depreciation of EME currencies, especially those with liquid markets and large current-account deficits. Although most markets have recovered and it appears that the sell-off in global financial markets was only a modest correction, such events could become more frequent in future. It has, nevertheless, forced market players to take stock of liquidity in the market and the pricing of risk.

Although EMEs have been in a better position to withstand volatility in financial markets in recent years due to improved fundamentals and structural reforms, certain weaknesses remain. Concerns of a sharp slowdown in global economic growth, lower commodity prices, a rise in geopolitical tensions, tighter global liquidity, a rapid unwinding of carry trades and higher interest rates in developed countries (Europe and Japan) could therefore make investments in EMEs less attractive and result in risk aversion and increased volatility in EME financial markets.

Commodity prices

After a strong performance in the first half of 2006, commodity prices slowed in the second half. For the year as a whole, the Reuters/Jefferies Commodity Research Bureau (CRB) Index fell by 7 per cent, mainly due to expectations of a slowdown in global economic growth. Gold and platinum prices, however, remain high when compared to historical levels, having increased by 36 per cent and 28 per cent, respectively, in 2006.

Figure 8 Reuters/Jefferies CRB Index*



* The Reuters/Jefferies CRB 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.

Source: Bloomberg

The global market sell-off in late February 2007 caused commodity prices to decline. The gold price has lost 5 per cent and the platinum price has fallen by 1 per cent since the sell-off. Should the sell-off be a short-term correction, commodity prices should continue to be supported by a weakening dollar, strong speculative and investment demand for commodities, stable economic growth, low inventory levels and strong sustained demand from China.

After sharp increases in recent years (see Box 4: "The dynamics of rising oil prices"), the inflation in the price of Brent crude oil slowed to 20 per cent in 2006. The price, however, decreased from US$78 per barrel in August 2006 to US$52 per barrel in mid-January 2007 due to fewer hurricanes, receding geopolitical tensions, an increase in oil inventories and warmer-than-expected weather in the US.

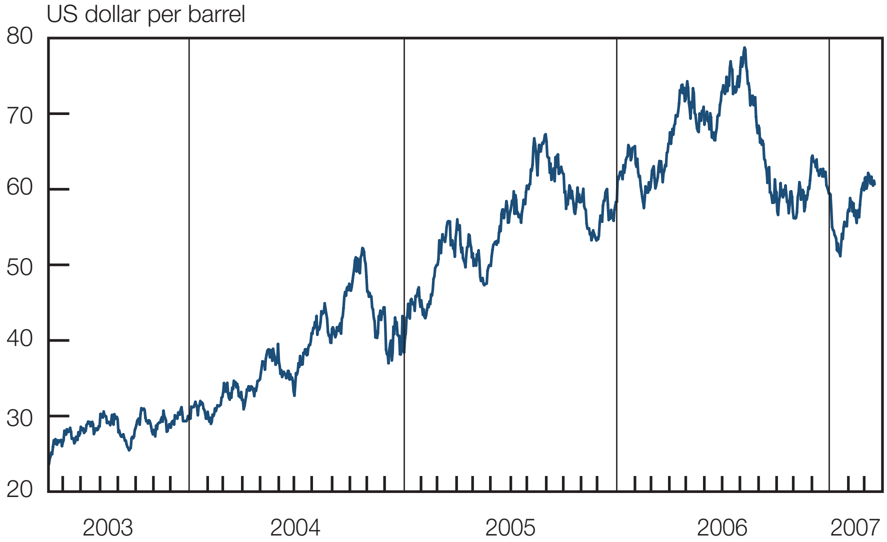
Since then, oil prices have risen again to US$61 per barrel and are up by two per cent in 2007[8] as a result of colder weather in the US, expectations of higher global demand and tighter supply by the Organisation of Petroleum Exporting Countries (OPEC). The International Energy Agency (IEA) expects global oil demand in 2007 to increase by 1,8 per cent, more than the previous forecast of 1,6 per cent[9]. China's growth in demand for oil was revised upwards to 6,1 per cent. The IEA also expects oil production from non-OPEC countries to be lower in 2007 than the previous forecast.

8 As at 20 March 2007 (year to date).

9 International Energy Agency Oil Market Report. February 13, 2007.

New geopolitical events or a turnaround in current geopolitical issues could conceivably cause a large supply disruption that could damage investor confidence. High and volatile oil prices remain a key risk to global financial stability due to their strong potential impact.

Figure 9 Brent crude oil



Source: Thomson Financial Ltd (DataStream)

Box 4: The dynamics of rising oil prices

Crude oil prices rose from US$21 per barrel in January 2002 to US$78 per barrel in August 2006. According to market analysts, the high prices were primarily a result of fears of a possible decline in oil production.

Krichene studied the dynamics of oil markets during the four-and-a-half-year period of rising prices and reported his results in an *IMF Working Paper*[10]. Krichene modelled oil prices as a jump-diffusion process[11] as well as a Levy process[12]. Both models produced similar results, and a number of conclusions regarding oil markets and the increase in oil prices can be drawn from this paper. Firstly, world oil demand pressure kept increasing during this period, causing prices to increase rapidly. Secondly, oil markets seemed to be consistently out of equilibrium as price movements were dominated by sudden increases, often to new record highs, before retreating temporarily, and then resuming the increase to new highs once again. Thirdly, the volatilities of oil prices were very high. Volatility levels were in the range of 30 per cent, as measured by implied volatility. This suggested that oil markets were sensitive to shocks and news, and there was major uncertainty regarding future price developments. Fourthly, markets had stronger expectations for further price increases than for decreases in oil prices. This was indicated by crude oil call and put option prices that were right-skewed. The price and volume of options at strike prices in the range of US$75 to US$85 per barrel indicated that market participants held higher probabilities for oil prices to rise, rather than fall.

Although oil prices came down significantly from the record-high levels reached in August 2006, forecasts of oil supply and demand remain tight and daily oil prices might continue to be driven by these factors. Analysts believe that while oil prices are unlikely to exceed the levels reached in 2006, a sudden and extended decline is equally improbable.

10 Krichene, N. 2006. Recent Dynamics of Crude Oil Prices. IMF Working Paper, WP/06/299.

11 Based on empirical findings, a jump-diffusion model, which recognises the presence of jumps in asset prices and produces more accurate option pricing, is seen as an adequate model for oil prices.

12 A Levy process is characterised by independent and stationary increments where discontinuity occurs at random times. Levy processes are successful for modelling small and frequent jumps in asset prices.

Regional developments

African economies are experiencing a major turnaround from the previous decades of economic stagnation. According to the United Nations' *World Economic Situation and Prospects 2007*, Africa's GDP has expanded by 5,6 per cent in 2006, continuing the momentum of strong growth that has been achieved since 2003. GDP growth rates in most countries, however, still fall short of the 7 per cent required for Africa to achieve the Millennium Development Goal of halving poverty by 2015. From 1998 to 2006, only seven of the 52 countries monitored by the Economic Commission for Africa (ECA) achieved an average real GDP growth rate of more than 7 per cent. Africa is expected to grow at a rate of 5,6 per cent in 2007. Growth, while generally stronger, is uneven across countries and sub-regions, with oil-exporting countries growing faster than oil-importing countries.

Economic growth in sub-Saharan Africa (excluding Nigeria and South Africa) reached 5,9 per cent in 2006. Growth of the majority of the economies in the region has clustered in the range of 3 to 7 per cent. A smaller number of sub-Saharan countries expanded by more than 7 per cent in 2006, and these are expected to maintain very similar growth levels in 2007. In the Southern African Development Community (SADC) region, oil-exporting Angola recorded a GDP growth rate of more than 10 per cent, reflecting the continued strength in oil-export revenues, while strong metal prices and post-conflict reconstruction activities lent strong support to GDP expansion in Mozambique and the Democratic Republic of the Congo.

Political uncertainty and deteriorating macroeconomic conditions continue to cause economic and financial instability in Zimbabwe. Fuelled principally by rising food prices, continued accelerating money supply growth, and a severe weakening of the currency, headline inflation reached a new record high of almost 1 600 per cent in January 2007, up from approximately 1 300 per cent in December 2006. The Zimbabwean economy at the same time has been contracting since 1999.

Despite this, the outlook for sub-Saharan Africa is generally positive. Excluding political risks, the major downside economic risk is a hard landing in the global economy that may result in a turnaround of the commodity boom. The vulnerability of the economies of the region stems from their narrow export base dominated by commodities. Diversification of productive bases remains crucial to shield these economies from external shocks.

Domestic macroprudential analysis

Macroprudential analysis involves the assessment of the soundness of the financial system and its resilience to endogenous and exogenous shocks and its ability to absorb such shocks should they materialise. The assessment is done to detect potential vulnerabilities and risks that could pose a threat to the stability of the financial system, with a view to minimising their impact to the extent possible.

This section, therefore, gives an analysis of developments within the domestic financial system and its counterparts. The financial sectors and markets included in the analysis are the banking sector, the Johannesburg Securities Exchange Limited (JSE), the Bond Exchange of South Africa (BESA), the insurance and the micro-lending industries. As shocks can emanate from sources external to the financial system, the assessment includes the analysis of developments in other areas of the economy, namely the household and corporate sectors, the real-estate market and the external sector. The assessment covers the period ending the fourth quarter of 2006. However, where appropriate and where data permit, it extends beyond this period.

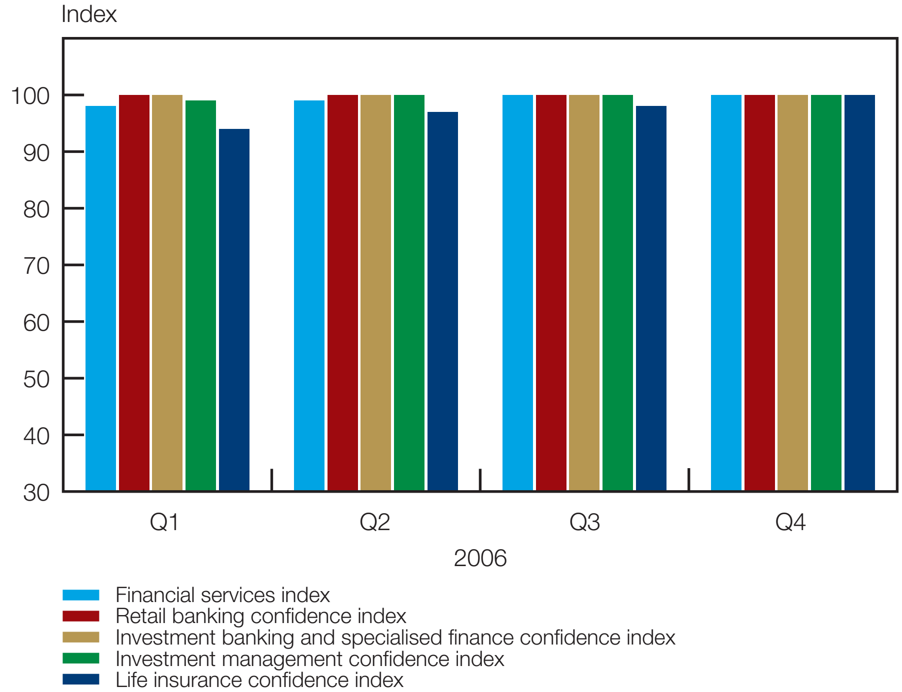
Confidence in the financial sector

A high level of confidence in the financial system is essential for a strong and stable financial sector. The level of confidence in the financial sector, as measured by the Ernst & Young Financial Services Index, remained high in the fourth quarter of 2006, with

13 *The Ernst & Young financial services index is calculated as the unweighted average of retail banking, investment banking and specialised finance, investment management and the life insurance's confidence indices. The indices that make up the financial services index are based on the results of surveys and range from a scale of 0 to 100, where 0 shows extreme lack of confidence, 50 is neutral and 100 shows extreme confidence.*

all the components of the financial services index reaching 100 index points[13], indicating extreme optimism.

Figure 10 Financial services index and its components



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

Banking sector

The role of banks is central to the financial system due to the importance of effective intermediation in the economy. Instability in the banking system can, therefore, have a significant impact on the activities of other financial and non-financial entities and on the confidence in, and the functioning of, the whole financial system. An assessment of the financial health of the banking sector and its resilience to shocks involves the analysis of financial soundness indicators such as capital adequacy, asset quality, earnings, liquidity and sensitivity to market risk. Table 1 gives a summary of key financial soundness indicators for the banking sector. The importance of these indicators is emphasised in the Coordinated Compilation Exercise (CCE) of the IMF. Box 5 provides an update of the CCE and South Africa's participation in it.

There were no major changes to the structure of the banking sector in the last six months of 2006. The sector remained highly concentrated, with the Gini concentration index, which estimates the numeric value of concentration, increasing slightly from 82,9 index points in June 2006 to 83,1 index points in December 2006. Over the same period, the market share of the four big banks (based on total assets), which gives an indication of the extent of their domination in the sector, was 84,1 per cent compared with 82,2 per cent in June.

Table 1: Key financial soundness indicators for the South African banking sector[1]

Per cent, unless indicated otherwise

	2005		2006	
	June	Dec	June	Dec
Structure				
Number of banks (excluding mutual banks)	34	34	34	34
Total assets of banks (excluding mutual banks, R billion)	1 564,1	1 677,5	1 960,2	2 075,1
Gini concentration index[2]	83,0	83,1	82,9	83,1
Market share (top four banks)[3]	83,8	83,8	82,2	84,1
Capital adequacy (based on the banking book)				
Regulatory capital to risk-weighted assets	12,8	12,3	12,4	12,1
Regulatory Tier 1 capital to risk-weighted assets	9,0	8,9	8,4	8,5
Asset quality				
Gross overdues to total loans and advances	1,6	1,5	1,2	1,1
Specific provisions to total loans and advances	1,4	1,2	1,0	0,8
Share of mortgage advances in private-sector credit	45,0	46,0	47,4	47,7
Earnings and profitability				
Return on assets[4]	1,2	1,2	1,2	1,4
Return on equity[4]	14,7	15,2	16,0	18,3
Interest margin to gross income[5]	52,0	38,2	45,1	44,0
Non-interest expenses to gross income	74,7	61,6	59,9	49,8
Liquidity				
Liquid assets to total assets (liquid asset ratio)	4,8	4,8	4,5	4,6
Liquid assets to short-term liabilities	9,5	9,3	9,0	8,7
Sensitivity to market risk				
Aggregate net open position in foreign exchange to regulatory capital	0,7	1,1	1,9	1,5

1 Data as at 1 March 2007
2 The Gini concentration 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)
3 Based on total assets
4 Smoothed over a period of 12 months
5 Not smoothed, hence the volatility

Source: South African Reserve Bank

Banks continued to be well capitalised during the same period. Against the minimum regulatory capital-adequacy requirement of 10 per cent, the capital-adequacy ratio for all banks was 12,1 per cent in December 2006, a marginal decrease from the 12,4 per cent recorded in June 2006. It decreased further to 11,9 per cent in January 2007.

The asset quality of banks showed a slight improvement between June 2006 and December 2006. When measured as a percentage of total loans and advances, gross overdues[14] decreased from 1,2 per cent in June 2006 to 1,1 per cent for both December 2006 and January 2007. This could partly be due to the favourable macroeconomic environment and the relatively low – albeit rising – cost of debt.

14 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.

Box 5: South Africa's participation in the Coordinated Compilation Exercise of the International Monetary Fund[15]

15 *The financial soundness indicators and the Coordinated Compilation Exercise were discussed for the first time in the March 2005 Financial Stability Review.*

The Coordinated Compilation Exercise (CCE) of the International Monetary Fund (IMF) was established in 2003 following endorsement by the IMF Executive Board. The overall aim of the exercise is to develop country capacity to compile financial soundness indicators (FSIs) for the surveillance of financial systems and to promote international comparability of FSIs. The objectives of the exercise are, therefore, to compile cross-country comparable FSIs in line with the *Compilation Guide on Financial Soundness Indicators* (the Guide), for use in assessing the strengths or vulnerabilities of financial systems and to disseminate the FSI data along with the metadata to increase transparency and strengthen market discipline.

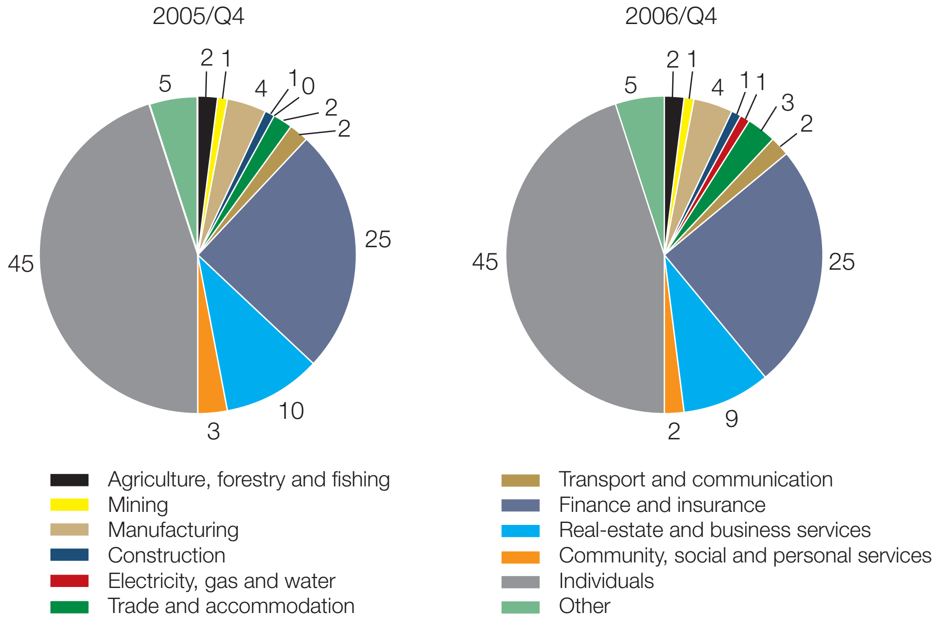
Sixty-two countries are participating in the CCE pilot project and have agreed to compile and submit at least 12 core FSIs to the IMF by the end of 2006 for the end-2005 reference date. South Africa is one of the 62 countries participating in the project. In compiling the data, participating countries are encouraged to follow the recommendations of the Guide to the extent possible in order to promote comparability of data across countries and to use the standard report forms for the FSI data and the underlying data series, along with detailed metadata to explain any deviation of the data from the Guide. Countries are also encouraged to compile and submit data and metadata to the IMF for any of the 28 encouraged FSIs for the same reference date.

The FSI data and the metadata of 52 participating countries, including those of South Africa, have now been submitted to the IMF and can be viewed on the IMF website. The IMF is planning to arrange a post-exercise meeting of participating countries to take stock of the CCE, share views on the lessons learnt from the exercise and to decide on the way forward with FSIs in the financial stability work of member countries and the IMF.

Given that a large concentration of aggregate credit in a specific economic sector or activity makes banks vulnerable to adverse developments in that sector or activity, an analysis of the sectoral distribution of credit forms part of the assessment of the soundness of the financial system. Such analysis indicates that the banking sector continues to be mostly exposed to the household, and finance and insurance sectors. The shares of the household, and finance and insurance sectors were 45 and 25 per cent, respectively, at the end of December 2006. The latter is of less concern as credit to this sector includes inter-bank lending. In assessing the substantial share of the household sector, the divergence within the sector – for instance, the differences in income levels between individuals – should be kept in mind.

Stress testing is a collective name for methods of measuring the size of losses that would arise if an improbable but conceivable event occurs. The role of stress-testing techniques is to help assess the resilience of the banking sector to adverse developments in the macroeconomic environment. Based on an econometric framework, stress-testing results, notwithstanding some caveats, suggest that at the end of December 2006, the shock absorption capacity of the banking sector remained strong and resilient to a range of plausible adverse impacts on loan assets. The capital-adequacy ratio after stress testing the banking sector was 0,7 percentage points above the benchmark of 10 per cent in December 2006 and improved slightly to 0,8 percentage points in January 2007. This level is considered adequate as an initial cushion against most adverse conditions.

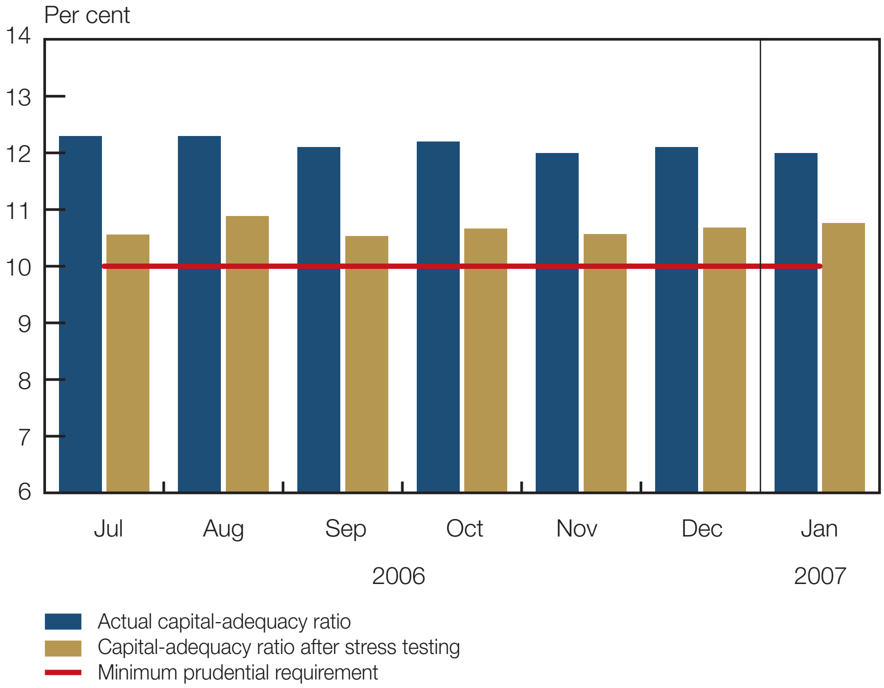
Figure 11 Sectoral distribution* of credit (per cent)



* 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 do not necessarily add up to 100 due to rounding.

Source: South African Reserve Bank

Figure 12 Stress testing the resilience of the banking sector



Source: South African Reserve Bank

The profitability of the banking sector improved during the review period and in the first month of 2007. The return on equity (ROE), i.e. the ratio of net income to total equity, smoothed over a period of 12 months, increased from 16 per cent in June 2006 to 18,3 per cent in December 2006 after which it improved further to 18,6 per cent in January 2007. The return on assets (ROA), i.e. the ratio of net income to total assets also increased and stood at 1,4 per cent in both December 2006 and January 2007, up from 1,2 per cent in June 2006. Good banking-sector earnings are important for financial stability as they enable banks to use current income to cover losses without reducing their buffer capital.

The level of liquidity in the banking sector enhances the sector's ability to withstand shocks. Indicators mostly used to measure liquidity include liquid assets to total assets (liquid-asset ratio) and liquid assets to short-term liabilities. These ratios are usually rather low due to normal maturity mismatches in banks' processes of maturity transformation. Fortunately, banks have advanced liquidity risk-management operations. The liquid-asset ratio improved slightly from 4,5 per cent in June to 4,6 per in December 2006, followed by a marginal 0,1-percentage-point improvement in January 2007. The ratio of liquid assets to short-term liabilities dropped to 8,7 per cent in December 2006, but this is unlikely to be of concern. In fact, it recovered to 8,9 per cent in January 2007.

Banks are always involved in diversified operations, which involve one or more aspects of market risk. Generally, the most relevant components of market risk are interest rate and exchange rate risks. The net open position in foreign currency as a percentage of net qualifying capital and reserves is a measure of banks' foreign-exchange exposure. After an initial decline from 1,9 per cent in June 2006 to 1,5 per cent in December 2006, this ratio increased to 2,5 per cent in January 2007. This is still very low; in fact the exposure of banks to foreign-exchange risk has been fairly limited since the mid-1980s, and is unlikely to be a source of stability problems.

Bond, equity and foreign-exchange markets

The assessment of financial stability involves monitoring developments in the bond, equity and foreign-exchange markets, among other things. Extreme volatility in these markets could have an impact on financial stability.

Bond market

Bond markets are relevant when assessing financial stability as they provide an alternative funding source than banks for government and corporations. In particular, the risk of corporate-sector vulnerabilities associated with balance-sheet mismatches calls for a greater diversity of funding sources for corporations. Corporate bond markets can also add stability to the financial system, since bond yields increase in times of crises as bond prices fall, making bonds more attractive to investors in a downturn. However, there is a need to monitor corporate bond markets that are growing too quickly to guard against the risk of accumulating bad credits that can harm financial system stability.

South Africa has a very well-developed bond market. Tables 2 and 3 give outstanding debt of various issuers at BESA as a percentage of total debt and the annual growth rate of debt listed on BESA, respectively. Although government remains the main issuer of debt (above 60 per cent of total debt listed on BESA), the contribution of the private sector is also increasing steadily (see Table 2). In terms of growth, private-sector debt is outpacing government debt. Private-sector debt grew at an annual rate of 51,3 per cent in December 2006 and the growth rate decelerated to 49 per cent in February 2007. It is expected that the debt of parastatals and municipalities will increase in the next few years due to planned infrastructure spending in alignment with AsgiSA and partly in preparation for the 2010 Soccer World Cup.

Table 2: Composition of outstanding debt listed on BESA
Per cent of total

	2005				2006			
	March	June	Sep	Dec	March	June	Sep	Dec
Government	69,3	68,8	67,7	66,8	65,3	63,4	61,3	60,3
Municipalities	0,4	0,5	0,4	0,4	0,4	0,6	0,6	0,5
Parastatals	13,0	12,9	12,3	11,3	11,5	11,2	10,9	10,7
Companies	14,2	14,4	15,8	17,3	18,5	20,3	22,2	22,9
Commercial paper*	3,1	3,4	3,8	4,2	4,3	4,5	5,0	5,6
Total	100,0	100,0	100,0	100,0	100,0	100,0	100,0	100,0

* Commercial paper was first listed on BESA in December 2002 and inward listings first occurred in April 2003

Source: South African Reserve Bank

Table 3: Annual growth in outstanding debt listed on BESA
Per cent

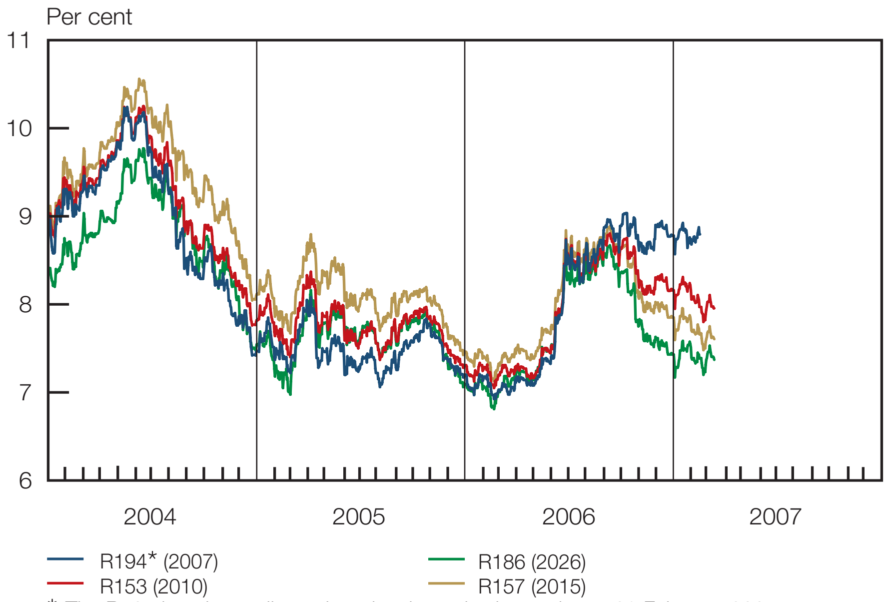
	2005				2006			
	March	June	Sep	Dec	March	June	Sep	Dec
Government	8,3	8,2	7,1	5,9	5,7	3,5	3,5	2,7
Municipalities	2 192,2	29,2	29,1	29,1	29,1	44,4	44,4	44,4
Parastatals	9,9	17,6	11,3	-0,6	-0,6	-2,5	0,9	8,4
Companies	25,5	24,6	35,8	40,5	45,7	58,4	60,6	51,3
Commercial paper	66,3	78,8	62,0	68,4	54,8	48,0	47,2	53,7

Source: South African Reserve Bank

During the second half of 2006 domestic bond yields were characterised by mixed movements, initially on an upward trend from June to about mid-September (see Figure 13). The upward trend was attributed to a depreciation of the rand, expectations of further interest rate increases in August, concerns over domestic inflation and the current-account outlook. This was followed by a downward trend until the end of December 2006, which was fuelled by a reduced supply of government bonds, lower international oil prices, a stronger currency and thin liquidity conditions.

During February 2007 bond yields declined by between 22 and 34 basis points due to, among other things, the budget surplus reported in the 2007 Budget.

Figure 13 Selected domestic bond yields



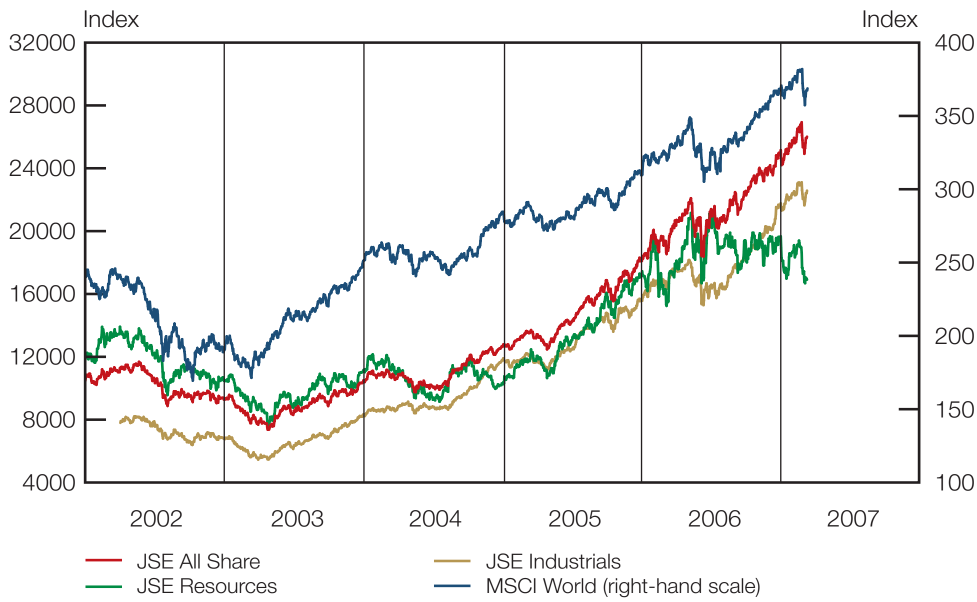
* The R194 bond was discontinued as it reached maturity on 28 February 2007

Source: I-Net Bridge

Equity market

During the second half of 2006, the JSE All Share Index (Alsi) continued its upward momentum, registering successive highs, despite its short-lived declines at times. In September 2006 the Alsi declined slightly due to concerns regarding inflation, a drop in metal prices, and the announcement of import quotas on Chinese textile imports. However, it managed to recover the losses as the implementation date of the quotas was pushed forward to January 2007 from September 2006. During December 2006, buoyant activity in equities was positively influenced by, among other things, the performance of global equity markets and higher commodity prices in the second half of 2006. The Alsi ended the year at new record highs.

Figure 14 Share price indices*



* Daily movements

Source: Bloomberg

During the first two months of 2007, the Alsi continued to register record highs, boosted by, among other things, a generally well-received 2007 Budget, declining oil prices and increased demand for equities by non-residents. Factors that led to a decline in equities (mostly the resources and financial indices) during the last few days of February 2007 included developments in China that led to a global sell-off in equities (see also "Global equity and bond markets" and "Emerging markets"), the possibility of a gains tax on mining houses and the announcement in the 2007 Budget of a possible synthetic fuel tax.

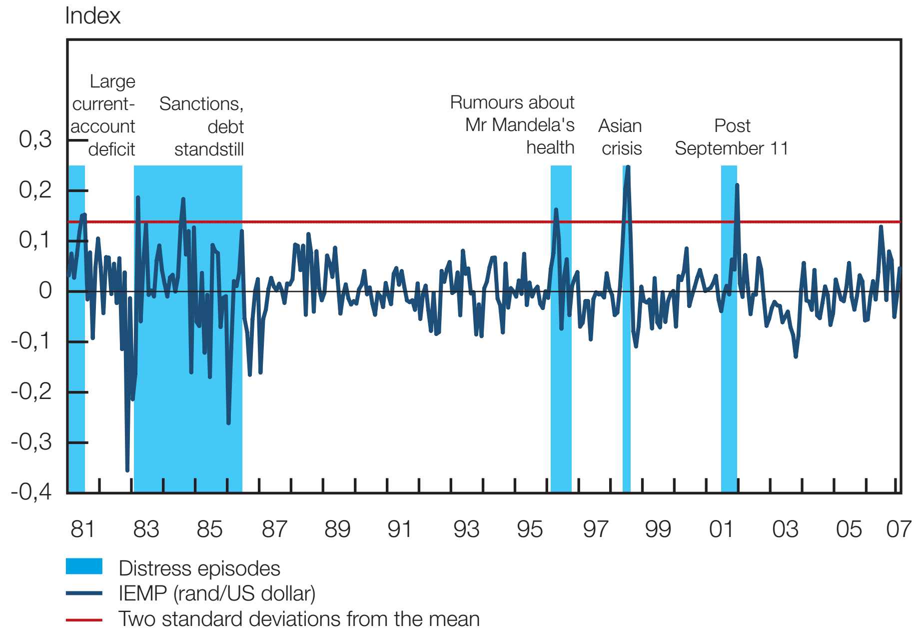
Assessing pressure build-up in the foreign-exchange market

The index of exchange market pressure (IEMP) is a tool used in the analysis of the vulnerability of the financial system to currency crises (which could lead to financial instability) in conjunction with other traditional surveillance methods and other indicators[16]. This index is usually defined as a weighted average of the depreciation of the local currency, the percentage change in international reserves, and the change in domestic interest rates. A rise in the value of the index indicates increasing pressure in the local currency and *vice versa*.

16 It should be noted that monitoring the IEMP does not in any way imply that the Bank will intervene in the foreign-exchange market should the index show increasing pressure on the rand, as the Bank does not target the exchange rate.

Towards the end of the second quarter of 2006 there was mounting pressure in the foreign-exchange market, as evidenced by the index of exchange market pressure approaching the two standard deviations threshold in June 2006. For the second half of 2006 that pressure subsided with the index of exchange market pressure hovering well below the two standard deviations threshold. At this stage the index is not pointing to pressure in the foreign-exchange market.

Figure 15 Index of exchange market pressure



Source: South African Reserve Bank

External sector

17 Foreign-exchange reserves are measured by the gross gold and other foreign-exchange reserves.

18 Short-term debt includes all external debt by public authorities, public corporations, monetary authorities, the banking sector and other sectors maturing within one year.

The ratio of a country's foreign-exchange reserves[17] to its short-term external debt, the Guidotti ratio (GR), provides an estimate of a country's resilience to foreign-currency liquidity problems. The augmented Guidotti ratio (AGR) is obtained by adding the annualised current-account deficit to short-term external debt to provide a measure of a country's total external financing requirements[18]. As a rule of thumb, a GR or an AGR of unity indicates that a country has foreign-exchange reserves sufficient to cover its short-term debt and its total external financing requirements, respectively, should access to foreign capital markets be withdrawn for up to one year. A country that does not hold sufficient foreign-exchange reserves can be vulnerable to external shocks and, therefore, to financial crises.

Table 4: Guidotti and augmented Guidotti ratios

	GR	AGR
2005 1st quarter	0,94	0,61
2005 2nd quarter	1,11	0,77
2005 3rd quarter	1,18	0,76
2005 4th quarter	1,26	0,77
2006 1st quarter	1,17	0,64
2006 2nd quarter	1,28	0,73
2006 3rd quarter	1,35	0,79
2006 4th quarter	1,13	0,59

Source: South African Reserve Bank

There was a deterioration in the GR in the fourth quarter of 2006, as a result of a decrease of about 6,7 per cent in foreign-exchange reserves and an increase of approximately 11,3 per cent in short-term debt. However, this ratio showed that foreign-exchange reserves were still 13 percentage points above the country's short-term debt. The widening current-account deficit adversely affected the AGR, which showed that foreign-exchange reserves were still short (41 percentage points) of the country's total external financing requirements in the fourth quarter of 2006.

Insurance sector

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

Risks within the insurance industry and the links that this industry has with the rest of the financial system make it necessary to assess the industry's financial soundness. Among other measures, the ratio of free assets to capital-adequacy requirement gives an indication of the financial strength of a long-term insurer[19]. That is, the number of times the capital-adequacy requirement is covered by free assets is generally used as a measure of the solvency of long-term insurers.

Table 5: Free assets and capital-adequacy requirement

Free assets to capital-adequacy requirement (long-term typical insurers)*	Number of insurers	
	December 2005	December 2006
Covered 0 – 1 time	0	0
Covered 1 – 2 times	5	6
Covered 2 – 5 times	17	16
Covered 5 – 10 times	5	7
Covered 10 + times	2	2
Total	**29**	**31**

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

Source: Financial Services Board

The total number of long-term typical insurers increased from 29 in December 2005 to 31 in December 2006. Most of the long-term typical insurers had free assets covering their capital-adequacy requirement 2 to 5 times. This is considered sufficient cover and therefore bodes well for financial stability. Another positive development was the increase in the number of insurers covered 5 to 10 times. This number rose from 5 to 7 over the same period. Using this measure, it can be concluded that the balance sheets of typical insurers have strengthened.

At the end of December 2006, individual lapses, expressed as a percentage of new policies issued during the period, increased. The individual surrenders (also expressed as a percentage of new policies issued during the period) also increased. The annual growth rate of the number of new policies for long-term typical insurers was 4 per cent in the twelve months ending December 2006.

Table 6: Selected indicators for long-term typical insurers

	2003[1]	2004[1]	2005[1]	2006[1]
Individual lapses[2]	31	24	27	38
Individual surrenders[2]	25	20	18	22
Number of policies (year-on-year percentage change)	1	19	7	4
Share prices (year-on-year percentage change)[3]	(5,3)	36,5	15,2	26,1

1 Twelve months ending December
2 Expressed as percentage of the number of new policies issued during the period using statistics that were not audited
3 Share price index

Sources: South African Reserve Bank and Financial Services Board

Insurance share prices increased at an annual rate of 26,1 per cent in December 2006, up from 15,2 per cent in December 2005. The increase in share prices is, among other things, a reflection of continued confidence in the insurance industry coupled with the good performance of the equity market in general. Increased confidence in the industry was also confirmed by the high level of the life insurance confidence index (see Figure 10), despite the challenges following determinations made by the Pension Funds Adjudicator, which are set to raise payouts to policy-holders.

Corporate sector

The analysis of corporate-sector balance sheets has become an integral part of financial stability monitoring, given the close relationship between corporate-sector vulnerabilities and the occurrence of banking and financial crises in many countries. Moreover, corporate-sector conditions are fundamental to equity and capital market performance. Table 7 gives a summary of selected indicators for the corporate sector.

Business confidence and corporate borrowing

The business confidence level, as measured by the Rand Merchant Bank/Bureau for Economic Research (RMB/BER) business confidence index, remained strong in the fourth quarter of 2006 although it had dropped from 85 to 83 index points. According to RMB/BER, a factor which may have played a role in the drop in the overall business confidence level was a slowdown in the pace of growth in vehicle trade. During the first quarter of 2007, business confidence was still high despite the drop to 81 index points, marking the first time since 2003 for confidence to have eased for two consecutive quarters. Factors believed to have supported the still relatively high level of business confidence include the government's infrastructure plans, its decision to make the fight against crime a priority and announcements in the 2007 Budget that business would benefit directly from the phasing out of secondary tax on companies (STC) and the relaxation of exchange controls on investments outside Africa.

Table 7: Selected indicators for the corporate sector

(Annual growth unless otherwise indicated)	2005		2006			
	3rd qr	4th qr	1st qr	2nd qr	3rd qr	4th qr
Business confidence index[1]	86	85	86	82	85	83
Credit to the corporate sector as percentage of GDP	28,8	28,9	30,8	30,7	31,9	33,8
Real gross fixed capital formation	15,4	16,9	19,6	20,5	21,1	22,9
Credit to the corporate sector	20,0	19,7	20,1	17,5	25,5	31,8
Credit to the corporate sector as percentage of annualised profits	144,2	156,3	158,8	140,7	156,0	175,1
Net operating surplus[2]	13,9	12,0	15,8	16,0	15,9	17,7

1 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
2 Gross operating surplus minus depreciation

Sources: South African Reserve Bank and Bureau for Economic Research

The growth rate of credit to the corporate sector continued to accelerate. On an annual basis, it grew at a historical high rate of 31,8 per cent in the fourth quarter of 2006. The high growth may be attributed to increased investments in infrastructure. This is confirmed by the increase in real gross fixed capital formation, which grew at an annual rate of 22,9 per cent during the same period. As a percentage of GDP, credit to corporations amounted to 33,8 per cent during the same period. The increase in credit to corporations was also reflected in the rise in corporate debt burden, which is calculated as the ratio of credit to the corporate sector to annualised profits. The ratio increased to 175,1 per cent in the fourth quarter of 2006 from 156,0 per cent in the third quarter.

Table 8: Total number of liquidations by industry

Industry	Number			
	2006 Jan	2006 June	2006 Dec	2007 Jan
Agriculture, hunting, forestry and fishing	2	0	1	1
Mining and quarrying	0	3	0	0
Manufacturing	15	21	23	5
Electricity, gas and water	0	2	2	0
Construction	11	24	16	15
Wholesale and retail trade, catering and accommodation	47	74	61	61
Transport, storage and communication	7	6	15	2
Financing, insurance, real-estate and business services	68	105	100	67
Community, social and personal services	21	27	48	25
Total number of liquidations	171	262	266	176

Source: Statistics South Africa

Among other things, the stability of the financial sector depends on the financial position and overall performance of companies and in particular their ability to meet payment obligations as they become due. This is because companies are key customers of financial institutions, and banks in particular. Table 8 gives the total number of liquidations by industry. As shown in the table, while the total number of liquidations increased from June to December 2006, it dropped substantially in January 2007, which is positive for financial stability. Most liquidations were in the finance, insurance, real-estate and business services, and wholesale and retail trade, catering and accommodation industries (see Table 8).

Household sector

Balance sheets of the household sector are an integral part of the assessment of financial stability, especially given the considerable credit risk banks incur through lending to the household sector. Table 9 shows selected indicators for the household sector.

Table 9: Selected indicators for the household sector
Per cent

(Annual growth unless otherwise indicated)	2005		2006			
	3rd qr	4th qr	1st qr	2nd qr	3rd qr	4th qr
Household disposable income	10,6	10,2	10,1	11,0	12,0	12,3
Household financial assets[1]	21,9	20,5	26,6	26,9	17,8	18,8
Household net wealth[2]	21,2	18,9	22,7	22,6	14,9	16,3
Consumer confidence index[3]	17	20	21	20	17	18
Household consumption expenditure to gross domestic product	62,4	62,0	62,5	63,4	62,2	62,2
Real household consumption expenditure	6,4	6,0	6,5	7,1	7,5	8,0
Credit to households	22,8	22,3	27,5	27,2	26,7	24,3
Household debt to household disposable income	64,6	67,0	69,4	70,8	73,0	73,8
Income gearing[4]	6,8	7,2	7,3	7,4	8,2	9,0
Capital gearing[5]	18,6	19,2	18,9	19,2	20,1	20,1

1 Household financial assets include households' deposits with financial institutions, their share in pension funds and a proxy for their holdings of shares
2 Household net wealth comprises household total assets, that is total fixed assets plus financial assets less liabilities
3 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
4 Income gearing refers to financing costs of household debt as percentage of disposable income
5 Capital gearing refers to household debt as percentage of total assets of households

Sources: South African Reserve Bank and Bureau for Economic Research

Households' financial position

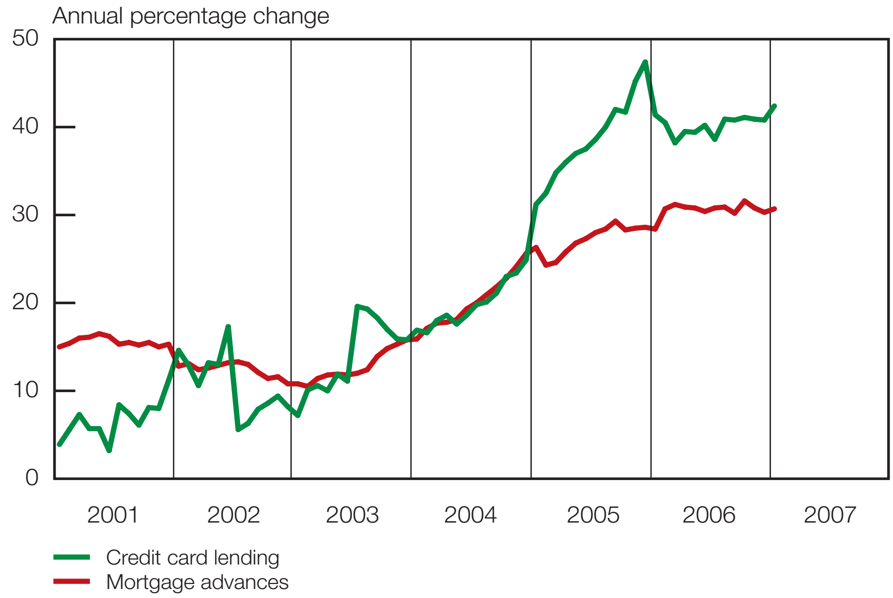
With the relatively low interest rates and increases in disposable income, the financial position of households remains strong. Household disposable income grew at an annualised rate of 12,3 per cent by the fourth quarter of 2006, up from 11 per cent during the second quarter of 2006. These developments have been accompanied by a continuous rise in household net wealth and household financial assets. The annual growth rate of household net wealth was 16,3 per cent in the fourth quarter of 2006, while over the same period household financial assets recorded a year-on-year growth rate of 18,8 per cent.

Consumer confidence, consumption expenditure and credit extension

During the fourth quarter of 2006, the consumer confidence index increased by one index point to 18, following a decline from 20 index points in the second quarter to 17 index points in the third quarter of 2006. The increased level of consumer confidence can be attributed to, among other things, a rise in real household income. Debt servicing costs also remained contained despite a measured tightening of monetary policy from June 2006. The rise in consumer confidence could be an indication of consumers' willingness to spend additional income and to incur more debt. Real household consumption expenditure increased at a rate of 8 per cent per annum in the fourth quarter of 2006, probably reflecting the increased level of consumer confidence. As a percentage of GDP, household consumption expenditure was 62,2 per cent in the second half of 2006.

After peaking at an annual growth rate of 27,2 per cent in the second quarter of 2006, growth in aggregate credit to the household sector decelerated to 26,7 per cent and 24,3 per cent during the third and fourth quarters of 2006, respectively. This could be a manifestation of the effect of the interest rate increases which started in June 2006. In the twelve months to January 2007, credit card lending grew by 42,4 per cent from 40,8 per cent in the year to December 2006. Over the same period, the rate of growth in mortgage advances also accelerated marginally from 30,3 per cent to 30,7 per cent. Although credit card lending constitutes a small fraction of credit extension to the household sector, it nevertheless needs close monitoring as it may point to reckless lending practices. It is envisaged that the implementation of the National Credit Act in June 2007 will, among other things, help address any problems of reckless lending.

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



* Credit card lending includes lending to both the corporate and household sectors

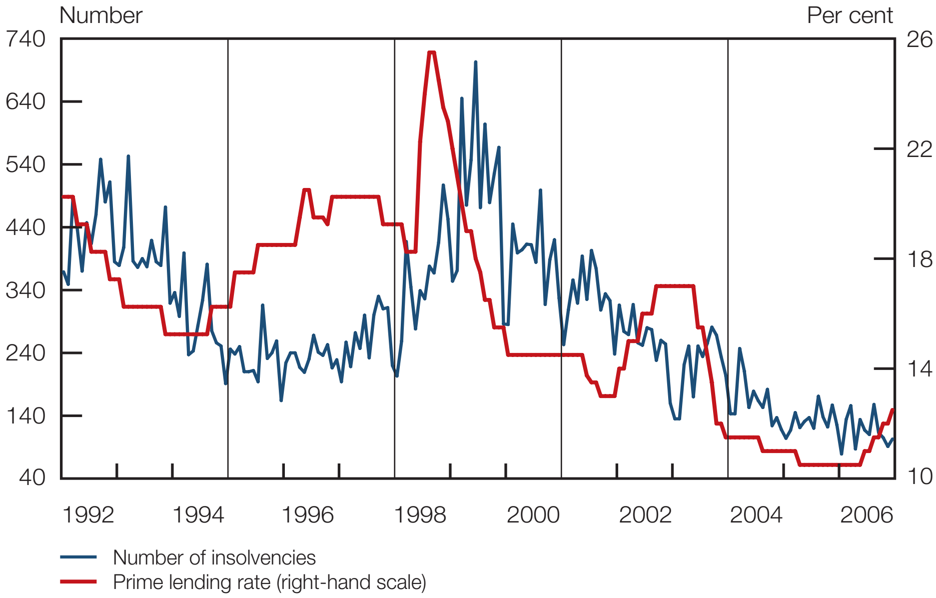
Source: South African Reserve Bank

Household indebtedness

The relatively low interest rate environment could have created an environment conducive to high household indebtedness. The ratio of household debt to household disposable income increased from 73 per cent in the third quarter to 73,8 per cent in the fourth quarter of 2006. The increase in household debt must be assessed in the context of the low interest rate environment and increasing house prices in recent years. In this prolonged upturn in the business cycle, it is crucial for financial institutions to remain vigilant and provide or reserve enough capital as buffer for weaker cyclical conditions in the long run. The ratio of household debt to disposable income has to be analysed in tandem with other measures of the sustainability of household debt, such as the income and capital-gearing ratios.

The increase in interest rates during the second half of 2006 was reflected in an increase in the proportion of household disposable income used to finance household debt. Income gearing increased from 8,2 per cent in the third quarter of 2006 to 9 per cent in the fourth quarter. The ratio shows that households still use a relatively small portion of their disposable income to finance debt, which could suggest a fairly low probability of debt default. Capital gearing, which refers to household debt as a percentage of total assets of households, remained constant at 20,1 per cent in the third and fourth quarters of 2006.

Figure 17 Number of insolvencies and prime lending rate



Sources: South African Reserve Bank and Statistics South Africa

Although lending rates increased during the second half of 2006, the number of insolvencies declined. On an annual basis, the number of insolvencies declined by 17,6 per cent in December 2006. Banks are therefore unlikely to experience loan defaults that are widespread enough to cause systemic concerns.

Micro-finance sector

Credit extension by the micro-finance sector remained high in the quarter to November 2006[20]. Disbursements increased by 11,1 per cent from R7,7 billion to R8,5 billion in the quarter to November 2006. The increase in disbursements can be partly explained by seasonal factors and, although still strong, it is lower than the quarter-on-quarter increase of 20 per cent reported in the same period in 2005. Micro-lending by banks accounted for a significant portion of total disbursements in the industry (see Table 11). On a quarter-on-quarter basis, the average size of loans disbursed increased by 9 per cent. The value of the gross loan book stood at R27,3 billion at the end of the November 2006 quarter.

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

Table 10: Micro-finance sector
R billions

	Nov 2005	Feb 2006	May 2006	Aug 2006	Nov 2006
Loan book	21,1	22,9	23,8	25,0	27,3
Disbursements	7,5	7,6	7,2	7,7	8,5

Source: National Credit Regulator

The banking sector remained exposed to the micro-finance industry during the period under review. Although disturbances in the micro-finance industry can impact on the banking sector, this is not a major concern as bank lending to micro-lenders comprises a small proportion of total bank lending.

Table 11: Disbursements by type of micro-lender: November 2006 quarter
Per cent of industry by value

Banks	Public companies	Private companies	Close corporations	Trusts	Co-operatives	Section 21 companies
41,0	0,3	42,0	14,0	0,9	0,8	0,8

Source: National Credit Regulator

Property market

Developments in the residential and commercial property markets have significant bearing on financial stability, as a sudden fall in property prices may adversely affect companies and households, and thereby the banking sector. This is because real-estate assets form a major element of the wealth of the private sector.

Residential property market activity

Activity in the residential property market continued to stabilise during the period under review. According to the Absa House Price Index, the annual growth rate in house prices remained unchanged at 15,4 per cent in the year to February 2007. It is expected that the interest rate increases in 2006 can dampen house price increases further. The nominal growth rate of house prices was well within the two standard deviations range, which is regarded as an acceptable region, and therefore, did not point to any imminent danger.

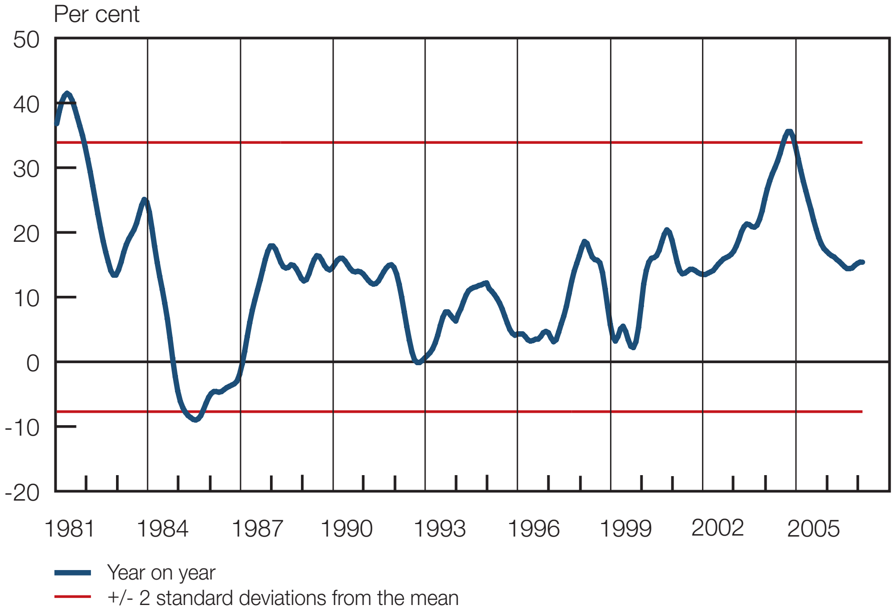
Confidence in the residential property market

The FNB Residential Property Barometer (RPB)[21] revealed a moderate improvement in the views of property professionals in the South African property market during the third quarter of 2006. Using the Residential Property Confidence Indicator (RPCI)[22] to measure the level of activity in the residential property market, the overall activity level registered 6 points in the fourth quarter compared to 5,5 recorded in the third quarter of 2006. Factors responsible for the improvement included seasonality, more realistic prices and affordability. Other positive developments in the third quarter included a decrease in the length of time property remains in the market, a decline in the number of cases where sellers realise prices below asking prices and the fact that the buy-to-let market was stabilising. In particular, the property market in the previously disadvantaged areas continued to show signs of good growth potential.

21 The FNB RPB began measuring property professionals' sentiments in the fourth quarter of 2003. It determines, on a quarterly basis, the market sentiment of 150 real-estate professionals employed by the top estate agents who are active in major metropolitan areas. It measures existing market perceptions and expectations and, as such, provides both a current and forward-looking short-term assessment of the market at a particular point in time – effectively a measure of market confidence.

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.

Figure 18 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 R2,7 million or less in 2006 in respect of which loan applications were approved by Absa. Prices are smoothed in an attempt to exclude the distorting seasonal factors and outliers in the data.

Source: Absa Bank Limited

Another positive development was the increase in the business confidence of the residential contractors. According to the BER, the business confidence level of residential contractors increased by 8 index points in the fourth quarter of 2006 to 89 index points. The rise in the confidence level was, among other things, brought about by the booming medium-priced housing segment where demand conditions are more favourable than in the upper end of the market.

Table 12: Residential property confidence indicator and business confidence indices of residential and non-residential contractors

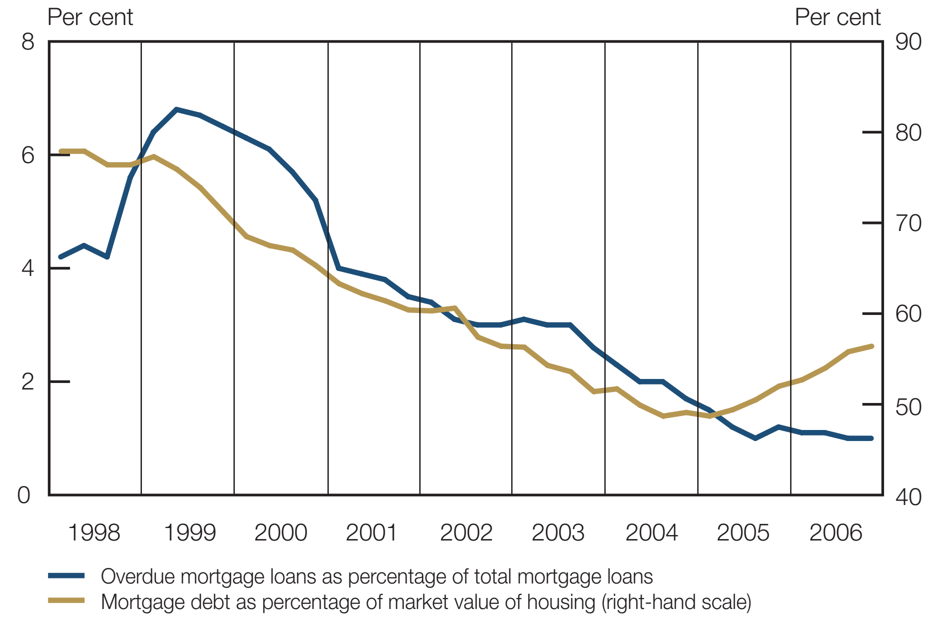
	2005				2006			
Period	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Activity level	7,4	6,8	6,1	5,8	6,3	6,3	5,5	6,0
Residential	94	91	93	90	94	85	81	89
Non-residential	90	89	94	93	95	89	95	93

Sources: First National Bank and Bureau for Economic Research

Mortgage debt

As mortgage loans continued to increase more strongly than house prices, the ratio of mortgage debt as a percentage of the market value of housing continued to increase. It registered 56,4 per cent in the fourth quarter of 2006 and has been on an upward trend since the second quarter of 2005. However, the ratio of overdue mortgage loans as a percentage of total mortgage loans remained unchanged at 1 per cent in the fourth quarter of 2006. The relatively low debt-servicing costs can, among other things, explain the rise in mortgage debt. While not posing an immediate threat to financial stability, it could adversely affect highly indebted individuals should interest rates increase.

Figure 19 Overdue mortgage loans and mortgage debt

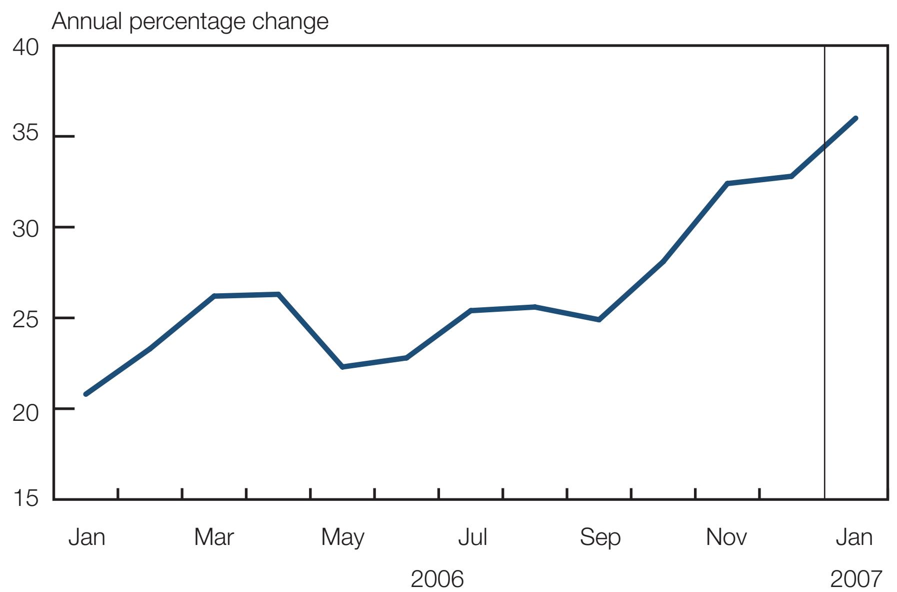


Source: South African Reserve Bank

Commercial property market activity

While activity in the residential property market was stabilising, activity in the non-residential commercial market continued to accelerate. Advances to the commercial property sector rose by 36 per cent in the year to January 2007, up from a 32,8-per-cent annual growth rate in December 2006. According to the BER, building activity in the commercial property market expanded above expectations, with the business confidence of the non-residential contractors registering a confidence level of 93 index points in the fourth quarter of 2006 (see Table 12). At such a high level, the outlook for 2007 remains positive.

Figure 20 Commercial and other mortgage advances*



* Includes non-incorporated farming, companies and close corporations, public enterprises and individuals, and other

Source: South African Reserve Bank

Infrastructure and regulation

Financial authorities, agencies and policy-makers continuously have to review the financial system environment in an effort to ensure that the financial system, including key financial markets and financial institutions, is capable of functioning efficiently under all types of economic conditions. A robust financial system that generally complies with international standards and best practice improves, *inter alia*, market integrity and reduces the risks of financial distress and contagion. In this regard, South African financial system authorities and agencies are proactively pursuing a number of regulatory initiatives to maintain, among other objectives, the integrity of financial institutions, markets and infrastructure.

This section consists of an update on ongoing regulatory work to enhance the robustness of the financial system.

Insurance and retirement sector

As explained in previous editions of the *Financial Stability Review*, a Statement of Intent was agreed to in 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)[23]. Since then, the LOA, the National Treasury (NT) and the FSB have worked closely on regulatory amendments aimed at providing greater regulatory certainty going forward. In this regard, regulations were issued on 1 December 2006 (*Government Gazette* No 29446) and 1 March 2007 (*Government Notice*, R186 of 2007), which introduced regulations regarding commission reforms and a number of other changes to give effect to some of the undertakings of the Statement of Intent.

The regulations of 1 December 2006 introduced limitations and requirements for minimum values that will apply to certain policies where contractual changes are made. These requirements apply to in-force policies and, in certain instances, to policies that had been on the books of the insurer since 1 January 2001, but have since been discontinued. These measures ensure an improved remedy in cases where the policy-holder reduces or discontinues contributions to a contractual savings policy. In particular, they harmonise the burden of cost between the policy-holder, insurer and the intermediary in the event of early termination of contractual saving policies[24].

Corporate Law Reform

As explained in the September 2006 issue of the *Financial Stability Review*, the Department of Trade and Industry (the dti) published a policy document titled *Company law for the 21st century* in June 2004. The dti envisaged the development of a "clear, facilitating, predictable and consistently enforced law" that provides for "a protective and fertile environment for economic activity".

The Corporate Laws Amendment Bill (generally regarded as the first phase of the Company Law Reform) was tabled in Parliament in May 2006 and is now awaiting the President's assent. It introduced a number of necessary and urgent amendments to the Companies Act and the Close Corporations Act.

The Companies Bill, 2007 (the Bill) was released for public comment early in February 2007 as phase two of the Company Law Reform process[25]. According to the dti, the strategy envisioned in the draft Bill represents a significant departure from the existing

23 The insurance and retirement industries face a number of challenges following negative publicity surrounding determinations made by the Pension Funds Adjudicator. As part of finding a sustainable solution, a Statement of Intent was reached. A key element was the agreement to meet minimum fund values of 65 per cent backdated to January 2001 for certain retirement annuity fund member policies.

24 Information letter 3/2006 as published by the FSB on 21 December 2006.

25 More information on the draft Companies Bill can be obtained online at www.dti.gov.za The closing date for public comments was Monday, 19 March 2007.

statute and sets out to modernise and repeal the Companies Act, 1973, aligning it with international best practice and post-1994 South Africa. The Bill also seeks to reduce the cost of registering and maintaining a company and the regulatory burden and compliance costs for small and medium-sized companies. In this regard, the Bill provides for the possible eventual repeal of the Close Corporations Act, following a 10-year experimental period, during which both laws would be in force concurrently. In addition, the dti indicated that it intends to enhance corporate governance, transparency and accountability of large institutions.

It also aims for improved regulatory oversight and better remedy for shareholders. Significantly, the Bill introduces a new business rescue scheme to facilitate the turnaround of struggling companies. In respect of dealing with and winding up insolvent companies, the dti indicated that it would retain the current regime on an interim basis until such time as the new unified insolvency law is brought into operation[26].

26 Information obtained from the public statement by the dti is obtainable online at www.dti.gov.za It is the intention that the Bill would be debated in Parliament from November 2007.

Explicit deposit insurance scheme

The introduction of an explicit deposit insurance scheme in South Africa has been under debate for a number of years. The general objective of an explicit deposit insurance scheme is to provide protection for insured depositors against consequences of a bank failure, and to promote confidence and stability in the financial system.

Some progress has been made in developing a deposit insurance scheme according to the specific needs and requirements of South Africa, taking into account international best practice and principles. A number of policy decisions on issues such as the funding structure and basis of membership are being refined and finalised. The NT is in the process of finalising draft legislation for the introduction of an explicit deposit insurance scheme. The NT also intends to consult with the Bank and other affected parties prior to publishing the draft legislation for public comment.

Insolvency reform

In recent years the South African Law Commission has been engaged in the reform of the country's insolvency laws. Government intends to unify fragmented insolvency legislation and improve the effectiveness of the insolvency industry. In addition, a new business rescue system is envisaged whereby, *inter alia*, a company can be ring-fenced while it addresses its financial problems rather than being placed in liquidation. South Africa has had limited success with business rescue to date partly because company legislation is regarded as pro-creditor. The concept of a business rescue regime now forms part of the proposed Companies Bill recently released for public comment.

While progress has been made in drafting insolvency legislation, the industry faces challenges such as slow progress on transformation and the absence of a regulatory structure. A World Bank "Report on the Observance of Standards and Codes on Insolvency and Creditor Rights for South Africa" is in the pipeline to assess the effectiveness of the insolvency regime. Revised insolvency laws are close to being completed by the Department of Justice and Constitutional Development.

Regulation of hedge funds

The hedge fund industry is evolving and is characterised by rapid growth, increased usage of new and complex investment instruments, and high levels of leverage. Challenges faced by the industry and regulators alike include lack of transparency and uniform disclosure requirements. In an unregulated environment, this raises possible systemic concerns as the exposures and risks are generally unknown and unquantified.

Similar to other international initiatives, South African regulators intend to bring the hedge fund sector within the scope of current legislation in order to create a more transparent environment to enhance investor protection. In this regard, the FSB in 2004 initiated a formal process with the assistance of the Alternative Investment Management Association – SA Chapter. The FSB is consulting with various stakeholders to determine an appropriate regulatory framework for the sector. Issues under discussion include an appropriate tax regime for the hedge fund industry as well as enhanced “fit and proper” requirements for hedge fund managers.

Financial Action Task Force evaluation

South Africa’s membership of the Financial Action Task Force (FATF) is due to be reviewed during the latter part of 2007. The review will be based on the progress made with implementation and enforcement of legislation relating to anti-money laundering measures and to counter the financing of terrorism. Notwithstanding the costs associated with FATF membership, failure to remain a member of FATF could impact negatively on the perception of the integrity of the South African financial system, which may result in negative investor sentiment and a general lack of confidence in the financial sector.

In August 2006 a workshop was held that marked the commencement of ongoing preparations for FATF membership re-evaluation, focusing on actual implementation and enforcement of legislation relating to anti-money laundering and the countering of the financing of terrorism as well as to address previous shortcomings.

Enquiry into competition in banking

The ongoing safety and robustness of the banking sector and the national payment system (NPS) are essential for financial system stability. The Competition Commission commenced in the latter part of 2006 with its enquiry into particular aspects of bank charges and participation in the NPS and intends to make recommendations to improve competition in banking and increase participation in and access to the NPS. A report on the enquiry’s findings is expected during the latter part of 2007.

The Competition Commission is aware that undue negative publicity surrounding the banking sector could lead to a loss of confidence in this sector with direct economic implications. In this regard, the commission is consulting extensively with all the relevant and affected parties, including the regulatory authorities and the public.

Adoption of a new capital framework (Basel II)

Basel II seeks to improve on the existing rules for capital adequacy in banks by aligning regulatory capital requirements more closely with the underlying risks that banks may face. Implementation of Basel II presents a significant challenge for supervisors and banks, as failure to implement Basel II successfully could lead to, *inter alia*, reputational risk, mispricing of risk and a lack of confidence in the banking sector.

In line with other international jurisdictions, the South African Bank Regulator anticipates adopting Basel II on 1 January 2008. The Minister of Finance intends tabling the Banks Amendment Bill, 2007 in Parliament during the current parliamentary term. The revised legislation aims to create a sufficiently robust regulatory environment as envisaged in the revised capital framework. The Basel II Accord Implementation Forum proactively monitors the Basel II implementation process through various subcommittees.

Retirement Fund reform

In 2004, the NT issued a "Discussion Paper on Retirement Fund Reform". As a follow-up to this, the NT issued a second discussion paper titled "Social Security and Retirement Reform" in February 2007. The primary objective of this reform is to provide basic income protection for all South Africans through a combination of social assistance and contributory savings and insurance arrangements.

Similar to some Organisation of Economic Co-operation and Development (OECD) countries' initiatives, there is a need for such reform as it would encourage household savings by both the formal and informal sectors of the economy. In addition, it would complement existing social assistance programmes, and help ensure adequate income replacement for all retired citizens. This, in turn, should increase the robustness of the pensions sector to adequately absorb trends such as shifts in demographics.

The proposals outlined in the discussion paper will form the basis for consultation with the organised business sector, trade unions and other stakeholders during 2007. It is anticipated that this process will take place over the medium to long term.

Concluding remarks

Considerable progress has been made over the past few years in addressing regulatory developments that are both challenging in nature and on the international agenda. Significant milestones reached in the period under review include the regulatory amendments introduced in the insurance and retirement industries to give effect to certain undertakings of the Statement of Intent and the release of the draft Companies Bill, 2007 for public comment. The respective authorities are addressing the regulatory developments adequately and there is no reason to believe that the international community would have serious concerns regarding the robustness of the South African financial system in general.