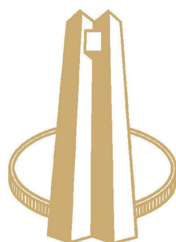
Financial Stability Review

September 2008

South African Reserve Bank

Financial Stability Review

September 2008



South African Reserve Bank

© South African Reserve Bank

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without fully acknowledging the *Financial Stability Review* of the South African Reserve Bank as the source. The contents of this publication are intended for general information only and are not intended to serve as financial or other advice. While every precaution is taken to ensure the accuracy of information, the South African Reserve Bank shall not be liable to any person for inaccurate information or opinions contained in this publication.

Data after 30 September 2008 were not considered for this publication, however, owing to the international financial market turmoil, global developments up to 15 October were also reported on.

Comments and enquiries relating to this Review are welcomed and should be addressed to:

Head: Financial Stability Department
South African Reserve Bank
P O Box 427
Pretoria 0001
Tel. +27 12 313 3911/0861 12 7272

E-mail: sarbfsr@resbank.co.za

http://www.reservebank.co.za

ISSN 1811-2226

Produced by Publishing Section

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 by, firstly, an effective regulatory infrastructure, secondly, effective and well-developed financial markets and, thirdly, effective and sound financial institutions. In its pursuit of financial stability, the Bank prefers to rely on market forces and to only intervene if required to contain systemic risk.

Financial instability, conversely, could manifest through banking failures, intense asset-price volatility or a collapse in market liquidity, and ultimately in a disruption in payments and settlements. 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. Thus a consistent monitoring of the linkages between the financial and real sectors, and expected consequences of spillovers from one sector to the other remains critical to the *Financial Stability Review's* endeavours.

Contents

Introduction 1

Overview 2

Financial stability developments and trends 4
- International macrofinancial developments 4
  - Economic growth and output in industrialised countries 4
  - Global imbalances 6
  - United States housing market and the sub-prime crisis 7
  - Emerging markets 10
  - Commodity prices 11
  - Regional developments 13
- Domestic macroprudential analysis 16
  - Real-sector activity 17
  - Financial-sector development 17
  - Level of confidence in the financial sector 18
  - Banking sector 19
  - Bond, equity and currency markets 21
  - Insurance sector 23
  - External sector 24
  - Corporate sector 25
  - Household sector 26
  - Real-estate sector 30

Infrastructure and regulation 33
- Update on legislative developments in the financial sector 33
  - Companies Bill 33
  - Financial Intelligence Centre Amendment Act 34
  - Insurance Laws Amendment Bill 35
  - Financial Services Laws General Amendment Act 35
  - Developments in co-operative banking 36

- Financial-sector developments 37
  - The South African mortgage-originating industry 37
  - The micro-insurance sector 38

- Overview of the South African national payment system 39
  - Background 39
  - The payment system networks 40

Abbreviations 44

Boxes

1 International Monetary Fund guidelines on currency surveillance 7
2 Estimates relating to losses emanating from the United States sub-prime crisis 9
3 Food security 13
4 A second generation of emerging market countries in Africa 14
5 Comparative analysis of household-sector vulnerability: 1998 and 2008 29
6 Update on the results of the consumer credit insurance enquiry 39

Figures

1 Quarterly growth in GDP 4
2 Global manufacturing PMI and its components 5
3 Exchange rates of the US dollar 6
4 Current-account balances as a percentage of GDP 7
5 Annual house price and GDP growth in the US 8
6 MSCI EME Index and JPMorgan EMBI global spreads 10
7 Reuters/Jefferies CRB Index 11
8 UN FAO World Food Price Index and Brent crude oil 12
9 Ease-of-doing-business ranking: SADC 16
10 New passenger car sales and prime lending rate 17
11 Sectoral distribution of credit to the private sector 20
12 Selected domestic bond yields 21
13 Share price indices 22
14 Index of exchange market pressure 22
15 Conventional and underwriting profitability for typical long-term insurers 23
16 The Guidotti and augmented Guidotti ratios 25
17 Household debt and household disposable income 27
18 Ratio of household debt to disposable income and income gearing 28
19 House price index 31
20 Mortgage debt as a percentage of the market value of housing 31
21 South African payment system networks 41

Tables

1 Selected indicators of real-economic activity 17
2 Selected indicators of financial-sector development 18
3 Financial Services Index and its components 18
4 Selected indicators of the South African banking sector 19
5 Free assets-to-capital-adequacy requirement 23
6 Selected indicators for typical long-term insurers 24
7 Guidotti and augmented Guidotti ratios 24
8 Selected indicators for the corporate sector 25
9 Total number of liquidations by industry 26
10 Selected indicators for the household sector 27
11 Financial soundness indicators for the household sector 29
12 Activity level in the residential property market and the business confidence level of contractors 32
13 List of settlement participants 43

Introduction

This edition of the *Financial Stability Review*, which focuses mainly on the six-month period ending June 2008, comprises two main sections, namely (1) the latest financial stability developments, implications and trends, and (2) 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 that 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 significant legislative developments in the financial sector and an overview of selected developments in the South African financial system environment. In addition, an overview of the South African national payment system (NPS), a core component of the broader financial system, is provided in this section.

Overview

Over the past half year global financial market turmoil has continued to shake consumer and investor confidence worldwide. This, combined with rising inflationary pressures, weak consumer demand, low business sentiment, a deterioration in global manufacturing activity and tight funding conditions in financial markets, points to further moderation in world economic growth and increasing risks for global financial stability.

Recent events in financial markets in the United States (US) and other developed economies have left little doubt that the world is in the midst of the most extraordinary and difficult global financial market circumstances. With each new financial institution coming into difficulties as a result of funding problems and asset repricing, the potential for the effects of the crisis to spread more widely is rising as it becomes more broad-based and the turmoil more protracted. Fortunately, the key international regulatory authorities have demonstrated their willingness to consider global systemic issues seriously and have implemented unprecedented resolution actions, in concert with one another when appropriate, to help limit the fallout.

The contribution of emerging-market economies (EMEs) to global growth continued to increase in 2008 and the slowdown in economic growth of EMEs as a group is expected to be less marked than in the developed economies. Largely driven by China, global oil demand is expected to remain high, with the price outlook still uncertain given expectations of slowing global economic growth. Global food prices have been rising rapidly since 2004, and although they may moderate, they are likely to remain high due to poor harvests, robust demand from most EMEs, rising biofuel production, rising input costs related to high oil prices and export restrictions on food.

Sub-Saharan Africa recorded its highest gross domestic product (GDP) growth in decades as a result of growing oil exports, rising domestic investment and higher productivity throughout the region. The sub-Saharan African region has not been severely impacted by the global financial market turmoil. Nevertheless, countries in the region with more globally integrated financial markets, such as South Africa, faced increased sovereign spreads and rising volatility in foreign-exchange markets. Economic growth in the Southern African Development Community (SADC), excluding Zimbabwe, is healthy and expected to remain fairly buoyant, partly as a result of continuing efforts to enhance regional integration, such as the recently launched free trade area.

In South Africa higher lending rates, and increases in food and fuel prices contributed to increased risks to financial stability as corporate and household budgets became more strained. Although nominal disposable income continued to grow at around its medium-term average rate, real disposable income growth slowed considerably in recent quarters. The annual growth rate of credit to the corporate sector decelerated further and business confidence declined significantly. However, the annual growth rate of credit to the household sector remained relatively high. The ratio of household debt to disposable income seems to have peaked, however, and as a percentage of financial assets, household debt has decreased. The annual growth rate of nominal house prices decelerated further to reach the lowest rate recorded since January 1993.

The South African financial system has been largely protected against the global financial market turmoil. The South African regulatory and credit environment is viewed as very conservative, and the “originate and distribute” model has not really taken off. There is also no separate “investment bank” regulatory format as in the US, with its particular incentives and risk appetite. As a result, South African financial institutions

have very little direct exposure to sub-prime-related assets and their balance sheets are likely to remain healthy. The Basel II implementation process was completed seamlessly and banks remain well capitalised. To date there has been no indication that South African financial institutions would require any capital injection or government assistance as has been applied in the US and elsewhere in recent weeks.

This does not mean that the South African economy cannot be affected by the prolonged global financial turmoil. The financial markets are highly integrated and contagion risks are clearly more of a reality now than before the US financial crisis. Increasing volatility in markets, further repricing of risks and financial assets, increasing cost of funding and possibly reduced flows to emerging markets are clear threats to the local economy and financial system. This notwithstanding, and barring a spate of additional adverse events or more political uncertainty, there is a strong consensus that the South African financial system will weather the storm quite well and there is certainly no immediate threat of a crisis of the proportion of that being managed in the US for instance. Financial system authorities and participants would, nevertheless, do well to stay vigilant and enhance efforts to improve resilience and refine contingency measures to manage any plausible stress events.

Ongoing developments in the financial infrastructure and regulatory environment that are likely to contribute to further strengthening of the financial system include the release of new legislation to address outdated company and financial laws, and the provision of more enforcement powers for regulators. A significant event in this period was the Financial Sector Assessment Program (FSAP) update process. Although the final report has yet to be approved, exit discussions with the joint International Monetary Fund (IMF) and World Bank mission team indicated broad satisfaction with the financial system's inherent design and adherence to current international best practice standards.

The NPS is central to stability in the financial system, but its complex role is not always well understood. A brief conceptual description of the payment system networks is included in this *Financial Stability Review* and should help to reinforce the prevailing confidence in the system brought about by the fact that it has repeatedly been assessed as highly compliant with internationally accepted core principles for systemically important payment systems.

Financial stability developments and trends

International macrofinancial developments

Global financial market turbulence has shaken consumer and investor confidence worldwide. More than a year after the start of the turmoil, difficult conditions persist and the resultant financial disruptions are weighing heavily on real economic activity in industrialised economies. As these real effects are becoming more broad-based and the turmoil more protracted, the potential for its effects to spread more widely is rising. The IMF, however, is of the opinion that a global economic recession could be avoided, provided that coherent and effective policy responses are implemented by regulatory authorities worldwide.

Economic growth and output in industrialised countries

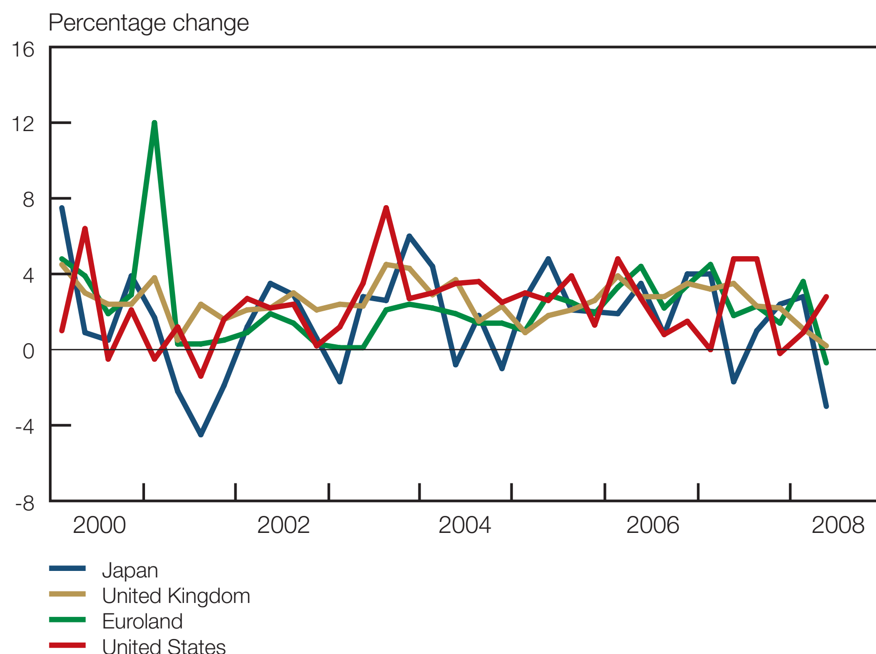
World economic growth is expected to moderate to 3,9 per cent in 2008 (from 5 per cent in 2007) and 3,0 per cent in 2009.[1] The slowdown in global economic growth was expected, given rising inflationary pressures, weak consumer demand, and low economic and business sentiment, following the global financial market turmoil. According to the latest World Economic Climate Survey,[2] economic sentiment fell to 73,4 index points in the third quarter of 2008 (its lowest level in seven years), from 81,4 in the second quarter. The survey has shown that economic conditions deteriorated in the US, Western Europe and Asia.

1 IMF. 2008. *World Economic Outlook*. October.

2 CES ifo. 2008. "Ifo World economic climate index declines again" (http://www.ifo.de/portal).

GDP growth in the US increased to an annual rate of 2,8 per cent in the second quarter of 2008 from 0,9 per cent in the first quarter. The increase in US GDP growth primarily reflected increases in exports, personal consumption expenditure, non-residential construction and government spending. There are expectations that the US government's financial rescue plans could support US economic growth in 2008 and

Figure 1 Quarterly growth in GDP



Source: Thomson Financial Ltd (DataStream)

2009. The IMF, nevertheless, expects US GDP growth to slow to an annual rate of 1,6 per cent in 2008 (from 2,0 per cent in 2007) and 0,1 per cent in 2009, due to the continuing housing market correction, rising inflation, slowing consumer demand and tight credit conditions.

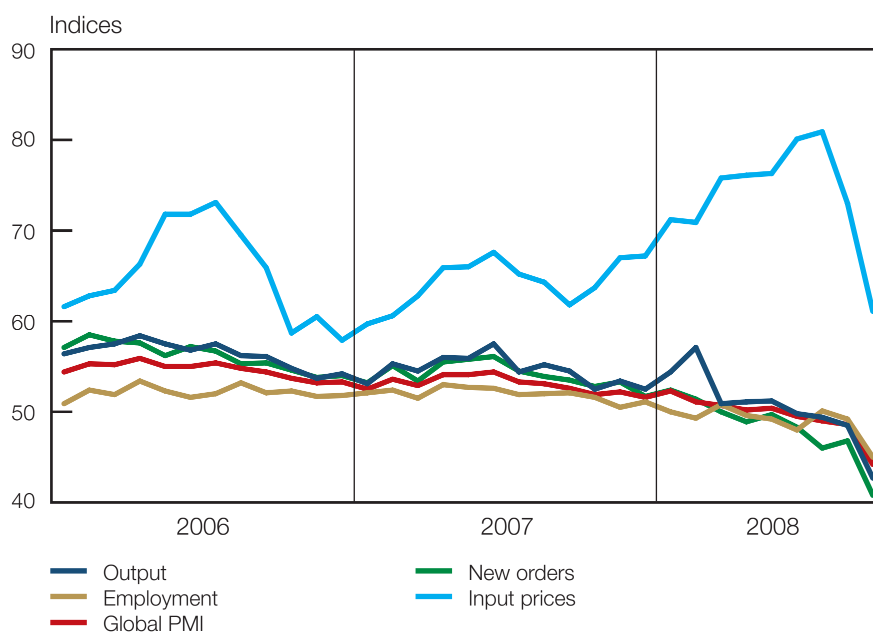
In Euroland, GDP contracted at an annual rate of 0,7 per cent in the second quarter of 2008, from an increase of 3,6 per cent in the first quarter, mainly as a result of a decrease in consumer spending and a drop in business investment. The IMF expects this downward trend to continue, with GDP growth in Euroland expected to slow to 1,7 per cent in 2008 (from 2,6 per cent in 2007) and to 1,2 per cent in 2009. GDP growth in the United Kingdom (UK) slowed to an annual rate of 0,2 per cent in the second quarter of 2008, from 1,1 per cent in the first quarter, due to a decrease in business investment, manufacturing, construction and consumer spending. GDP growth in the UK is expected to slow to 1,0 per cent in 2008, from 3,0 per cent in 2007. In 2009 GDP in the UK is expected to contract at an annual rate of 0,1 per cent. In Japan GDP contracted by an annual rate of 3 per cent in the second quarter of 2008 after growing by 2,8 per cent in the first quarter, mainly due to a decrease in exports and consumer spending. GDP growth in Japan is expected to be 0,7 per cent in 2008 (from 2,1 per cent in 2007) and 0,5 per cent in 2009.

For the first time in five years, the global manufacturing Purchasing Managers Index[3] (PMI) fell below the neutral level[4] of 50 in June 2008. The index has subsequently continued its downward trend, signalling further deterioration in global manufacturing output. In September 2008 the global PMI recorded its lowest reading of 44,2 since late 2001. Weak performances by the US, Euroland, UK and Japan weighed heavily on the global PMI. The contraction of the manufacturing sector reflected a marked deterioration in the trends for production, new orders and employment. Conversely, input prices dropped sharply in September 2008 and are expected to ease inflationary concerns as commodity prices recede from historical peaks.

3 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.

4 A reading below the 50 level indicates a contraction.

Figure 2 Global manufacturing PMI and its components



Source: JPMorgan

The expected moderation in global economic growth and the deterioration recorded in global manufacturing output point to further weakening. Future growth prospects remain fragile as the global financial turbulence also poses a significant downside risk. According to the IMF, industrialised economies could be in, or close to, recession in the second half of 2008 and early 2009.

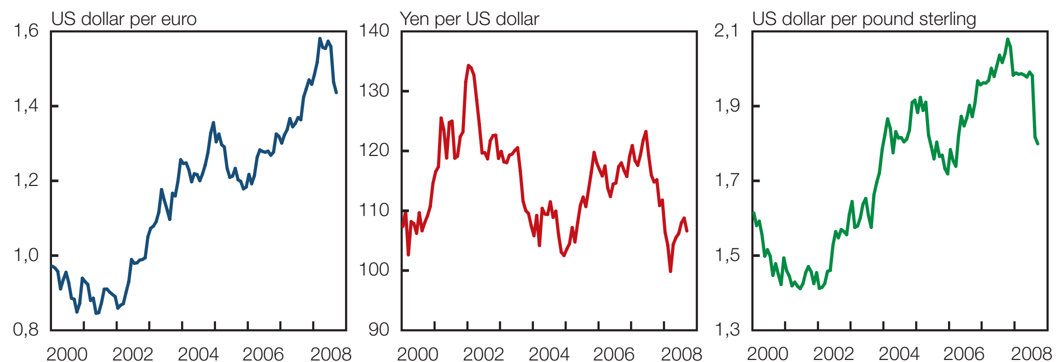
Global imbalances

5 BIS. 2008. *78th Annual Report*, June.

6 From July to September 2008, the US dollar recovered, appreciating by about 6 per cent and 10 per cent against the euro and pound sterling respectively.

Increased risk aversion caused by the US sub-prime crisis led to a renewed focus on global imbalances. Recent movements in the exchange rates of major currencies, and changes in global growth and demand patterns, were consistent with a narrowing of global imbalances. According to the Bank for International Settlements (BIS),[5] the real effective value of the US dollar in April 2008 was about 25 per cent below its peak in February 2002. The weakening trend in the exchange rate of the US dollar persisted in the first half of 2008, depreciating by 8 per cent against the euro and 5 per cent against the pound sterling during this period.[6] Furthermore, economic growth slowed in industrialised countries, while the contribution of EMEs to global growth continued to increase in 2008. These changes to growth and demand patterns, in addition to the weakening of exchange rates in the US and the UK, could possibly further reduce their current-account deficits. The US current-account deficit, for instance, fell from US$811 billion in 2006 (6,2 per cent of GDP) to US$692 billion in 2007 (4,9 per cent of GDP), and remained fairly stable on an annualised basis in the first half of 2008.

Figure 3 Exchange rates of the US dollar



Source: Bloomberg

7 IMF. 2008. "Global imbalances to stay high despite weak dollar", 22 July.

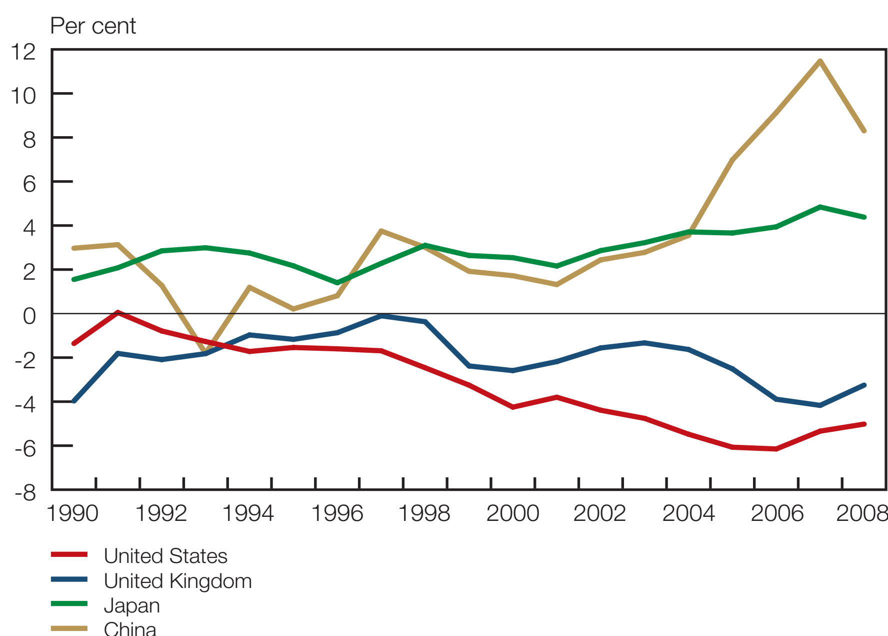
8 World Bank. 2008. *Global Economic Prospects*.

9 Policy plans include currency revaluation plans, adjusting interest rates, intervention in foreign-exchange markets, changing capital account regulations, adjusting fiscal policy and tightening prudential regulations.

10 BIS. 2008. *78th Annual Report*, June.

US dollar and pound sterling weakness, combined with expected slower GDP growth in the UK and the US in 2008, might not be sufficient to alleviate global imbalances significantly and new misalignments may still emerge.[7] The mirror image of the US and UK current-account deficits may be found in EMEs, developing countries and a few Organisation for Economic Co-operation and Development (OECD) countries where the magnitude of current-account surpluses suggests that imbalances are still deeply entrenched. Expectations of a decline in GDP growth as a result of slowing import demand from industrialised nations,[8] high oil prices and progress made in implementing policy plans[9] to reduce imbalances, nevertheless, resulted in surpluses diminishing in the second quarter of 2008 in the main surplus economies of China and Japan.[10] The IMF issued new guidelines on the implementation of rules on currency surveillance in an effort to correct misaligned exchange rates causing external instability (see Box 1 for guidelines on currency surveillance).

Figure 4 Current-account balances as a percentage of GDP



Source: Thomson Financial Ltd (DataStream)

Box 1 International Monetary Fund guidelines on currency surveillance

In 2007 the Executive Board of the International Monetary Fund (IMF) adopted a decision to strengthen its surveillance of the economic policies of member countries, placing external stability at the centre of its surveillance. New procedures on how it will monitor member countries' economic policies, particularly their exchange rate policies and impact on the global economy, were adopted to ensure that the policy dialogue between the IMF and its member countries is more focused and effective. The IMF now provides a consistent conceptual framework to assess how members' economic policies impact on the stability of their economies and that of the global monetary system. In addition, the IMF sets out four principles to guide members in the management of their exchange rates:[11]

1. Avoid manipulating exchange rates or the international monetary system in order to prevent effective balance-of-payments adjustment or to gain an unfair competitive advantage over other members.
2. Intervene in the foreign-exchange market if necessary to counter disorderly conditions, which may be characterised by, among other things, disruptive short-term movements in the exchange rate of the currency.
3. Take into account the interest of other members in policies of intervention.
4. Avoid exchange-rate policies that result in external instability.

The framework lists indicators that would require review by the IMF. These indicators include a fundamentally misaligned exchange rate, that is, when the underlying current account is in disequilibrium due to exchange rate policies, unsustainable domestic policies or market imperfections. Procedures to formalise dialogue with member countries, also as a complement to regular Article IV consultations, are spelt out.

11 Dauphin, J. F. 2008. "IMF clarifies how it will monitor economic policies". *IMF Survey Magazine*, 12 August.

United States housing market and the sub-prime crisis

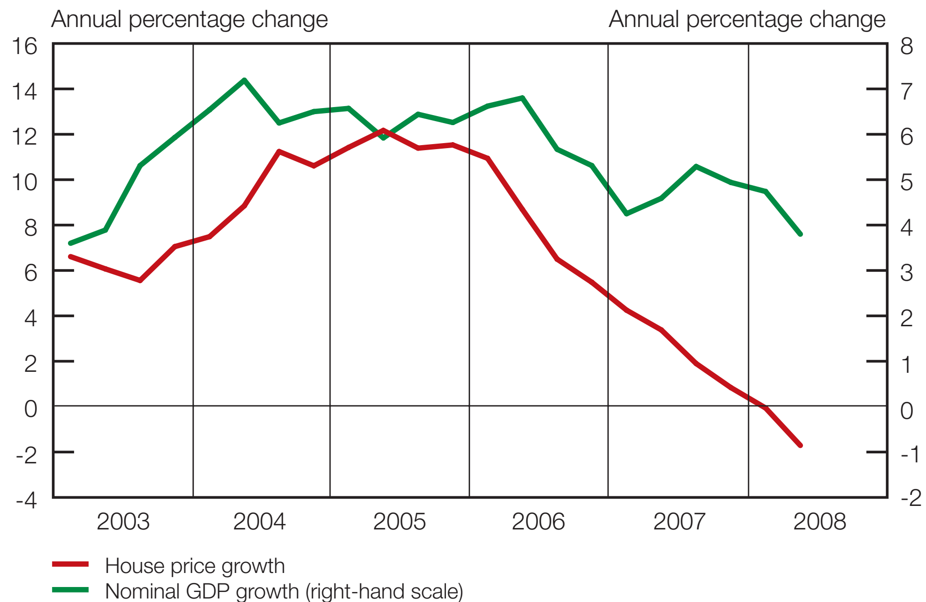
US house prices continued to decline during the first half of 2008. Measured over a period of 12 months, house prices[12] declined by 1,7 per cent in the second quarter of 2008, from a decline of 0,1 per cent in the first quarter (its first negative growth rate in four decades). Prices in some regions of the US fell by between 24 and 28 per cent[13] year on year as US banks put more foreclosed homes on the market. Despite properties now generally being regarded as "cheap", mounting losses on sub-prime mortgages forced banks to withhold

12 As measured by the Office of Federal Housing Enterprise Oversight.

13 As measured by the Standard & Poor's Case-Shiller Index.

credit and, combined with increased borrowing costs, caused a decline in home sales. The number of unsold properties in the US increased to record levels and sales of new homes dropped by 33,2 per cent in June 2008 (compared with June 2007). Some market analysts expect the slump in the housing market to continue into 2009, which makes the outlook for the US economy even more uncertain.

Figure 5 Annual house price and GDP growth in the US



Source: Thomson Financial Ltd (DataStream)

Stemming this decline in the US housing market is regarded as necessary for market stabilisation, and the IMF is of the opinion that the US housing market could bottom out in the coming months.[14] Furthermore, it would appear that the deterioration in loan quality has become more widespread as delinquencies for Alt-A,[15] and even prime mortgage loans, have increased. The number of foreclosures increased to 2,75 per cent of the total inventory of homes during the second quarter of 2008, while the total number of delinquencies increased from 6,35 per cent in the first quarter of 2008 to 6,41 per cent in the second quarter.[16] Credit losses associated with the sub-prime mortgage crisis continue to mount and estimates of bank losses are currently about US$600 billion (see Box 2 for the latest available loss estimates).

14 IMF. 2008. "IMF head urges greater regulation of financial sector, September. (http://www.imf.org).

15 An Alt-A mortgage is considered riskier than 'prime' and less risky than 'sub-prime', the riskiest category.

16 Mortgage Bankers Association. 2008.

A further spurt of turbulence hit the global financial system, and US financial markets in particular, in September 2008. The US government took control of two of its government-sponsored housing enterprises in an attempt to support the distressed US housing market and economy. Any positive impact of placing the companies into conservatorship[17] was, however, of a short-term nature, as the markets again came under pressure when one of the top investment banks in the US filed for bankruptcy, a large investment brokerage was bought by a bank to save it from financial ruin and the Federal Reserve provided emergency funding to the world's largest insurance group in an effort to prevent its disorderly failure. The nervousness in global financial markets continued as a number of other US and European financial institutions were nationalised, filed for bankruptcy or were bought by other institutions.

17 A conservator is similar to a curator in the sense that it entails the appointment of an official with appropriate powers to protect the assets of a troubled bank or savings institution while a permanent solution to its financial problems is found.

Box 2 Estimates relating to losses emanating from the United States sub-prime crisis

The disarray in global credit markets caused by the United States (US) sub-prime mortgage crisis quickly spread across borders because the loans were packaged into complex financial securities, and resold to both domestic and international investors. Increased lending rates in the US caused house prices to fall, adding to a variety of problems, including rising foreclosure rates and outstanding mortgages exceeding the market value of property. Repeated large-scale writedowns of exposures to the US mortgage market and continuing deterioration of the US housing sector have given rise to a strong interest in estimates of overall sub-prime-related losses.

Estimates at the end of 2007 suggested that potential losses in the distressed mortgage sector of the US could reach US$300 billion.[18] These loss estimates were based on a 14 per cent default rate (based on weighing up the ABX[19] indices across vintages and tranches) on sub-prime and Alt-A mortgages (amounting to about US$2,3 trillion at that stage), a rate that was regarded as plausible by economists. By January 2008 the chairperson of the US Federal Reserve said losses could climb to US$500 billion as total outstanding sub-prime (adjustable-rate) mortgages were about US$1 trillion and losses "must be less than half of that".[20] At that stage, about 20 per cent of sub-prime mortgages were already delinquent. However, banks worldwide have subsequently announced US$591 billion in writedowns and credit losses related to the sub-prime crisis and had to raise about US$434 billion in capital.[21] According to the International Monetary Fund (IMF),[22] however, broader credit deterioration, a weakening economy and falling credit prices combine into a substantial impact on the capital of systemically important financial institutions. The IMF estimates aggregate potential writedowns and losses (relating to loans and securities) to be approximately US$1,4 trillion[23] as at September 2008. Furthermore, about US$29 billion of adjustable, rate mortgage loans are due for resetting to higher monthly payments by the end of 2009 and an additional US$67 billion in 2010.[24]

Some critics are of the opinion that the methodology used by the IMF should produce far higher loss estimates. Others, while not commenting directly on the IMF's estimate, are of the opinion that any method relying on market prices is unreliable and misleading, because "price discovery for structured products has been problematic with bouts of panic and extreme liquidity problems".[25] According to Blundell-Wignall, price discovery is problematic and mark-to-market price calculations are unlikely to be valid, because central banks have at times been the only market makers in residential mortgage-backed securities and the Federal Reserve has increased its liquidity operations and accepted asset-backed securities as collateral.

In addition, the IMF indicated that the potential credit losses would lower the aggregate capital-adequacy ratios of US banks by about 250 basis points and of European banks by about 150 basis points.[26] Banks are likely to carry about half of the aggregate potential losses, with insurance companies, pension funds, money-market funds, hedge funds and other institutional investors accounting for the balance. According to Bloomberg, more than US$25 trillion in total stock market value worldwide was wiped out in 2008 alone because of the sub-prime crisis,[27] while data records on sub-prime mortgage-related job losses show that about 121 000 jobs were cut by the world's biggest banks and securities firms since July 2007.

With mortgage delinquencies and foreclosures in the US still rising and mortgage market deterioration still deepening, uncertainty about future losses and banks' ability to raise sufficient new capital remain. Furthermore, loss estimates could be substantially higher following the failing, take-over and bail-out of financial institutions that took place in September 2008.

18 Blundell-Wignall, A. 2007. "Structured products: Implications for financial markets". OECD. *Financial Market Trends*, 2(93).

19 ABX is an asset-backed securities index.

20 Statement of the Chairperson of the Board of Governors of the Federal Reserve System before the Committee on the Budget. January 2008. (http://budget.house.gov/hearings/2008/01.17bernanke.pdf).

21 Bloomberg. 2008. "Banks sub-prime related losses surge to $591 billion", September. (http://www.bloomberg.com).

22 IMF. 2008. *Global Financial Stability Report*, April.

23 IMF. 2008. *Global Financial Stability Report*, October.

24 Fitch Ratings. 2008 *Special Report*. 2 September. (http://www.fitchratings.com).

25 Blundell-Wignall, A. "The subprime crisis: Size, deleveraging and some policy options". *OECD*. *Financial Markets Trends*. 2008.

26 IMF. 2008. *Global Financial Stability Report*, April .

27 Bloomberg. 2008. "European leaders vow bank guarantees, bid to stop financial rot", October. (http://www.bloomberg.com).

The US Congress also approved a US$700 billion financial market rescue plan that authorised the US government to buy troubled assets from financial institutions impacted by record-high home foreclosures. The rescue plan was linked to a temporary increase in the limit on federal deposit insurance and, in addition, tied to a two-year extension of tax breaks and credits for the development of renewable energy. Central banks continued to reassure financial markets by providing additional liquidity and extending some of the existing liquidity arrangements in a co-ordinated manner. The consensus view is that although the rescue plan will not solve the global credit crisis in the short term, it represents a critical step towards stabilising global financial markets and resuming the flow of credit to major economies.

It would seem that the full extent of the market fallout from the collapse of the US sub-prime mortgage market has not been seen. The financial turmoil has been marked by ongoing credit market strains (mostly in industrialised economies), a significant repricing of credit risk and severe distress in some financial institutions. Globally, markets have been reminded that benign conditions cannot continue indefinitely. The dangers of contagion and systemic risk to financial-system stability were illustrated clearly, and the need for transparency and adequate disclosure of the risks attached to innovative financial products has been emphasised. Many countries have experienced the effects that such negative events in global financial markets have on economic and financial stability. Regulatory authorities in key countries are, however, considering global systemic issues and demonstrated a determination to implement resolution action to help limit the fallout.

Emerging markets

EMEs achieved strong economic growth, recorded impressive gains in equity markets and experienced significant narrowing in sovereign debt spreads over the past number of years (Figure 6). These positive developments appear to have been more a result of improved macroeconomic fundamentals and structural reforms in EMEs than of favourable global financial conditions.[28] In the second half of 2007 uncertainties in global credit markets and the possibility of a US recession created a less benign economic and financial environment for EMEs. Nevertheless, it would seem that most EMEs thus far managed to resist the direct spillovers of the credit crisis and have shown some resilience to the slowdown in economic growth recorded by major industrialised countries.

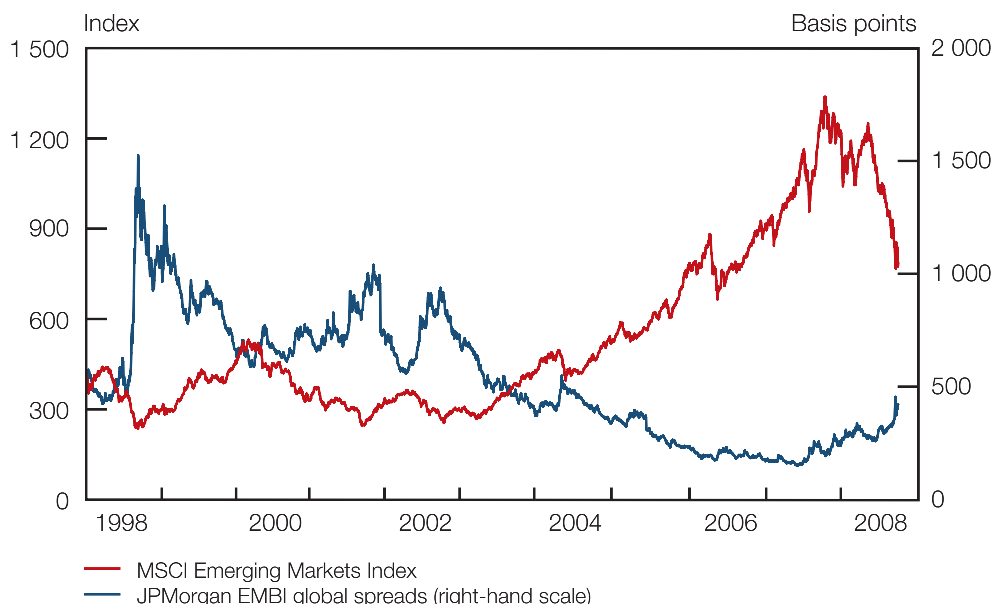
EMEs remain vulnerable to the indirect effects of the global credit crisis.[29] Since the beginning of 2008 the Morgan Stanley Capital International (MSCI) Emerging Markets Index[30] has fallen by 37 per cent (Figure 6), reflecting weaker equity and bond markets in many EMEs. The Emerging Markets Bond Index (EMBI) global spread also widened somewhat during this period. The potential knock-on effects of financial market spillovers

28 Maier, P. and Vasishtha G. 2008. "Good policies or good fortune: What drives the compression in emerging market spreads?" *Bank of Canada Working Paper 2008-25*.

29 According to the G-20, the four main spillovers from the credit crisis that are evident across most EME financial markets are (1) a rise in the price of risk, (2) a reduction in international bond issuance, (3) a sell-off in equity markets and (4) an unwinding of carry trade positions.

30 The MSCI Emerging Markets Index is designed to measure the performance of the core capital market asset classes comprising EME equities and bonds.

Figure 6 MSCI EME Index and JPMorgan EMBI global spreads



Sources: Bloomberg and JPMorgan

are increasing the risk of a slowdown in EMEs. EMEs as a whole recorded economic growth of 8 per cent in 2007, which is expected to slow to 6,9 per cent in 2008 and to 6,1 per cent in 2009. Despite this expected moderation, economic growth in EMEs remained firm in the second quarter of 2008 as it continued to be underpinned by the strong performance of China.

Although many EMEs are not as dependent on exports to the US as before, the BIS[31] is of the opinion that a pronounced global economic slowdown could make EMEs vulnerable as they remain, to a certain extent, dependent on the US and other industrialised countries for external demand. Several EMEs have also been pressured by inflation concerns as robust demand growth and slow supply responses by commodity producers put upward pressure on food and energy prices. As with many industrialised economies, the conflicting forces of slower growth and rising inflation are creating a dilemma for policy-makers in EMEs. Because of the prolonged nature of the global credit crisis, external funding conditions in EMEs are tightening, which increases pressure to adopt policy measures to address slowing economic growth and rising inflation.

31 BIS. 2008. *78th Annual Report*, June.

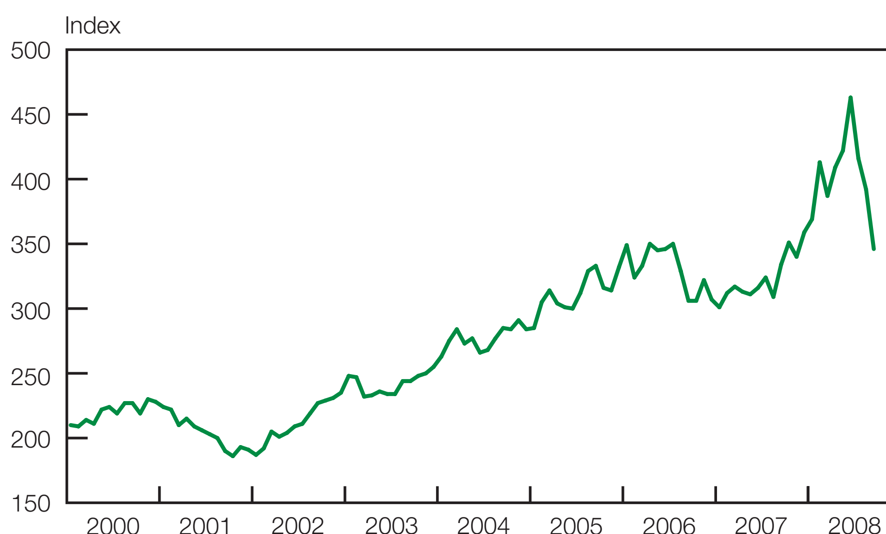
Although the outlook for financial stability in EMEs is generally favourable, the longer the turmoil lasts, the more EMEs are likely to be negatively impacted. Firstly, tighter conditions in global financial markets could further constrain EMEs with large current-account deficits and high short-term debt; particularly those that are heavily reliant on portfolio inflows to finance deficits. Secondly, EME exports might decline by more than expected, causing a sharp decline in EME economic growth. Thirdly, EMEs might not have the ability to boost domestic demand to compensate for a weakening in exports.

Commodity prices

Commodity prices, particularly those of oil and food, continued their rapid rise in 2008, having had a major impact on global economic and financial conditions as inflationary pressures intensified. Recently, however, many commodity prices have started declining in response to renewed fears of a global economic recession, as reflected in the Reuters/Jefferies Commodity Research Bureau (CRB) Index[32] (Figure 7).

32 The CRB Index serves as a measure of 19 global commodity futures prices, which include soft commodities, energy, grains and oil seeds, precious metals, livestock, industrial metals and base metals.

Figure 7 Reuters/Jefferies CRB Index

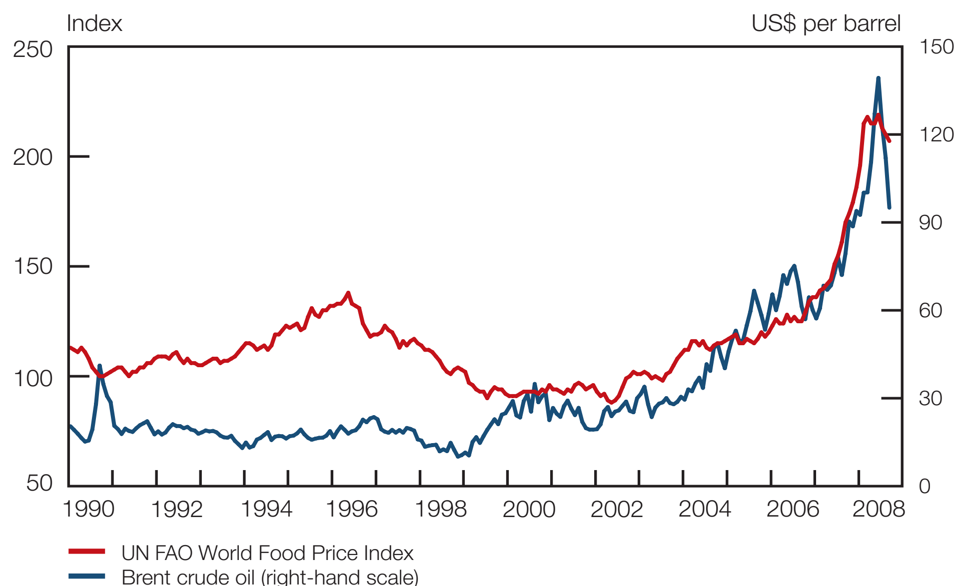


Source: Bloomberg

The price of Brent crude oil reached record-high levels in July 2008, driven by strong global oil demand, a weaker US dollar, rising geopolitical tensions,[33] low stockpiles and speculative demand.[34] In addition, the demand for oil in EMEs has been supported by government subsidies for energy consumption at the retail level.[35] Prices subsequently declined to less than US$100 per barrel in September (see Figure 8), following general concerns of slowing global economic growth. According to the International Energy Agency (IEA), oil demand is, however, expected to remain high, particularly from China. Global oil demand is expected to increase by 1,1 per cent in 2009 from 0,9 per cent in 2008 and China's oil demand is expected to increase by 5,7 per cent in 2009. On the supply side, the IEA expects oil production from non-Organization of the Petroleum Exporting Countries (OPEC) nations to increase due to an improved outlook for North Sea and US oil projects.

During the past two decades food supply has been unable to keep up with the rapid pace of demand (see Box 3 on food security). As a result, global food prices have been rising rapidly since 2004. The rise in global food prices was exacerbated by bad harvests, robust demand from especially EMEs, rising biofuel production, rising input costs related to high oil prices and export restrictions on food. This was reflected in the United Nations (UN) Food and Agriculture Organization[36] (FAO) World Food Price Index (Figure 8) which rose by 56 per cent year on year in March 2008. Subsequently, food prices came down and this index recorded lower year-on-year growth of 25 per cent in August. According to the IMF, global food prices are expected to moderate in 2008, but will remain at high levels and continue to be negatively affected by rising biofuel production, and strong demand from EMEs and developing countries. The frequently observed relationship between high food prices and political instability represents serious risks to the global environment and, ultimately, the stability of the financial system.

Figure 8 UN FAO World Food Price Index and Brent crude oil



Source: Bloomberg

Precious metals, as an asset class, tend to do well in periods of a depreciating US dollar, rising inflation and geopolitical uncertainty; events that tend to depress other asset classes. Precious metals benefited from the global financial market turmoil during the first half of 2008, before being impacted negatively by the recovery of the US dollar. Since July 2008 US dollar prices of gold and platinum have declined by 11 per cent and 40 per cent respectively.

33 Geopolitical tensions include nuclear disagreements between US and Iran, military action by Russia against Georgia and political instability in Nigeria.

34 The IMF concluded that it found very little hard evidence of speculation being a systematic driving factor of recent high oil prices, although it is possible that shifting investor sentiment has amplified short-term oil price fluctuations ("The global economy and financial crisis", speech by John Lipsky, September 2008 (http://www.imf.org)).

35 BIS. 2008. *78th Annual Report*, June.

36 The UN FAO World Price Food Index is a constant trade-weighted average of over 60 agricultural commodity prices quoted internationally.

Box 3 Food security

The United Nations (UN) Food and Agriculture Organization (FAO) states that food security is achieved when all people, at all times, have physical and economic access to sufficient, safe and nutritious food to meet their dietary needs and food preferences for an active and healthy life. Food security is therefore not only about having sufficient food supply, but also about securing food supply at a reasonable price.

Food security has emerged as a major risk and there is uncertainty as to whether it is as a result of short-term conditions that have existed at various times throughout history or whether a more fundamental change is taking place.[37] Global food reserves are currently at a 25-year low and food price increases have not been uniform throughout the world. Southern Africa, Asia, the former Soviet Union and parts of Latin America have been particularly hard hit as poor people in these countries spend relatively more of their disposable income on food. Concerns about food security have also spread to industrialised countries. The United Kingdom (UK) and United States (US) have, historically, depended on international markets to supply food at reasonable prices and are now experiencing additional pressure due to the surge in food prices.

37 World Economic Forum. 2008. *Global Risk Report*.

Food security has resulted in political instability in countries such as Mexico, Italy and India where riots have erupted over food rationing. In other countries such as Russia and China where governments have administrative control of basic supplies, governments have intervened by deploying measures to minimise the political consequences of rising food prices. Measures include controlling the price of staple foods, increasing subsidies to farmers to boost agricultural production, reducing import duties and providing financial support for low-income earners. From a macroeconomic perspective, higher oil and food prices have led to higher inflation, higher import bills and deteriorating balance-of-payments positions, especially in emerging-market economies and developing nations, which have strained government budgets. The relationship between high food prices and political instability could present serious risks to financial stability, as institutions sometimes become the targets of disruptive actions by groups threatened by food insecurity.

Growth in the global population and changes in lifestyle, increased biofuel production, and climate change are expected to drive food prices higher. The UN predicted that the global population could rise above 9 billion by 2050 and threaten global food supply, water supply and the availability of agricultural land. The use of crops to produce biofuel is expected to increase due to more policy support from the US and the European Union in the form of biofuel subsidies. This could cause price increases in agricultural crops such as maize, soya beans, flaxseed and sugar cane, and agricultural inputs such as fertilisers and transport. The IMF expects that diverting crops towards biofuel production could continue for at least another five years until new technology is introduced in the form of second-generation biofuel feedstocks.

Climate changes and volatile weather conditions are also expected to affect global agricultural production adversely and increase the number of undernourished people. Rain-dependent regions such as south Asia and Africa are expected to be the hardest hit and produce half their current agricultural yield. Owing to the unpredictable nature of a global food crisis, policy-makers globally are faced with the dilemma of modifying food policies to offset inflationary pressures and still promote economic growth.

According to the BIS, slower global economic growth could result in volatility and a decline in commodity prices in the short term. In the long term, however, high commodity prices are likely to persist due to low inventory levels, and as the world population grows and China and India continue their economic transformation.

Regional developments

Africa

Many countries in Africa have been experiencing rapid economic expansion driven by a surge in commodity prices, greater inflows of capital, and increased economic relations with China and India. Africa's economy grew by 6,3 per cent in 2007 and is expected to moderate to 5,9 per cent in 2008.[38] Improved macroeconomic management and growth performance, the commodity price boom, and lower debt levels following debt relief,[39] have resulted in more investor interest in some African countries.

38 IMF. 2008. *World Economic Outlook*, October.

39 Brazil, China, India, and Saudi Arabia have emerged as a new group of aid donors.

Although several African countries have performed well in recent years, some downside risks remain for the continent. Firstly, African countries may be negatively impacted as the

global slowdown causes a reduction in foreign direct investment (FDI) and a possible reversal of capital flows. The IMF indicated that a one-percentage-point decline in global growth may lead to a 0,5-percentage-point decline in growth rates of African countries in the year thereafter.[40] Secondly, high food and fuel prices pose important economic and social challenges to African countries, especially those that are net importers of food and oil. Many African governments have recently suspended import duties on staple foods and reduced taxes for citizens in an effort to absorb the sharp rises in the prices of oil and food. In addition, the collapse of the World Trade Organisation (WTO) talks in Geneva in July 2008 may result in more protectionist measures in industrialised countries, posing further challenges for African countries that face high inflation, deteriorating current-account balances, and a decrease in international reserves and agricultural production. Thirdly, some African economies still lack financial depth, while the political and armed conflicts in parts of the continent may also result in declining confidence and deteriorating risk ratings. These downside risks may pose some challenges to the stability of financial systems in Africa.

40 IMF. 2008. *Regional Economic Outlook*, April.

Sub-Saharan Africa

Sub-Saharan Africa recorded its highest GDP growth in decades at 6,9 per cent in 2007, driven by growing oil exports, rising domestic investment and higher productivity throughout the region. The IMF, however, expects GDP growth in sub-Saharan Africa to moderate to 6,1 per cent in 2008, mainly because of a less favourable external environment.

Personal and institutional remittances are growing sources of external financing for the sub-Saharan African region. In a recent report by the World Bank it was estimated that personal remittance inflows to the region increased from US$9,3 billion in 2005 to US$10,3 billion in 2006.[41] Unrecorded flows through informal channels are believed to be even higher as sub-Saharan Africa is said to have the highest share of remittances flowing through unofficial channels among all regions, partly due to the high cost of sending remittances through official channels to the region. FDI to the region, excluding South Africa, rose from US$5,8 billion in 2000 to an estimated US$13,3 billion in 2006. The IMF[42] expects sub-Saharan Africa's net FDI inflows to increase to US$18 billion in 2008. FDI is the second-largest source of external funding for this region, with official aid continuing to be the dominant source. According to the IMF, private capital flows to the region increased from US$11 billion in 2000 to about US$53 billion in 2007. Most capital flows were directed towards South Africa and Nigeria, but other sub-Saharan African countries also attracted FDI as a result of improved country risk ratings and higher yields (see Box 4 on "A second generation of emerging market countries in Africa").

41 World Bank. 2008. "Beyond aid: New sources and innovative mechanisms for financing development in sub-Saharan Africa", January.

42 IMF. 2007. *Regional Economic Outlook*, October.

Box 4 A second generation of emerging market countries in Africa[43]

The nature and level of sophistication of a country's stock market in relation to the degree of development of the economy are often used to decide whether a country should be classified as an emerging-market. South Africa has thus far been seen as the only emerging-market economy (EME) in Africa, but several other African countries may in future become part of a second generation of emerging markets. Financial markets in these new potential EMEs are developing fast and are already attracting institutional financial investment.

Three criteria that countries should meet in order to qualify for second-generation emerging-market status were identified:

1. A take-off in economic growth: Resource-rich countries should ensure that they have sound economic institutions in place to avoid a boom–bust cycle, while resource-scarce countries should have the ability to record solid growth even in times when their terms of trade turn negative. Many countries in Africa experienced rapid economic expansion in the past number of years.
2. Private-sector-led growth: In the past Africa has generally fared poorly in terms of the attractiveness of the business environment and this makes the continent a less attractive destination for investors. Recently, many African countries have, however, been successful in promoting the role of the private sector in their economies.

43 This box is based on an IMF article written by Nellor, D. C. L., 2008. "The rise of Africa's 'frontier' markets". *Finance and Development*, 45(3), September: 30–33.

3. **The presence of financial markets**: First-generation emerging markets welcomed institutional investors to their equity markets and used policy actions to establish themselves as emerging markets. African countries have also made progress in this regard. Equity market capitalisation surged to over 60 per cent of gross domestic product (GDP) in 2007 and trading in debt markets has more than tripled since 2005, reaching about US$12 billion. Africa's domestic bond markets are attracting interest in a way not seen in many first-generation emerging markets.

Eight sub-Saharan African countries[44] met the three criteria identified and this places them in a position to be considered for emerging-market status. These countries compare well with the Association of Southeast Asian Nations (ASEAN) countries of 1980.[45]

44 Botswana, Ghana, Kenya, Mozambique, Nigeria, Tanzania, Uganda and Zambia.

45 ASEAN countries were considered for reclassification (from 'developing' to 'emerging market') in 1980.

Table A Selected economic indicators: ASEAN countries versus the sub-Saharan African countries considered for reclassification

	ASEAN[1]	Selected sub-Saharan African countries[2]
	1980	2007
GDP (annual growth, per cent)	7,5	6,9
Inflation (annual CPI, per cent)	16,5	7,3
Financial depth[3]	28,9	29,1
Size of government[4]	11,0	22,1
International reserves[5]	3,1	9,4
Debt (percentage of GDP)	27,0	12,0
Foreign direct investment (percentage of GDP)	1,3	4,8
Portfolio inflows (percentage of GDP)	0,1	0,3

1 Indonesia, Malaysia, the Philippines, Thailand and Singapore
2 Botswana, Ghana, Kenya, Mozambique, Nigeria, Tanzania, Uganda and Zambia
3 Money supply as a percentage of GDP
4 Government expenditure as a percentage of GDP
5 As a percentage of imports

Source: Nellor, D. C. L. 2008. "The rise of Africa's 'frontier' markets". *Finance and Development.* 45(3), September: 30–33

The current economic growth figures of sub-Saharan African countries compare well with those of ASEAN countries in 1980. The sub-Saharan African countries have lower inflation, higher international reserves and lower debt-to-GDP ratios relative to those of ASEAN countries (mainly due to debt relief initiatives). Government comprises a larger share of sub-Saharan African economies than it did in the case of ASEAN countries.

Reclassification is an opportunity for African countries to rise to emerging-market status, gain access to capital markets and move towards private-sector-led growth. Institutional investors enter sub-Saharan Africa's financial markets through complex financial instruments, providing an opportunity for further financial system development. However, the central banks of sub-Saharan African countries will have to strengthen supervision to promote financial-sector stability and effective intermediation in order to manage the new sophisticated financial activities of the current complex and integrated global environment.

The sub-Saharan African region continued its strong economic performance as it remained fairly unaffected by the recent global financial market turmoil. However, countries in the region with more globally integrated financial markets faced increased sovereign spreads, higher interbank rates and rising volatility in foreign-exchange markets.

Southern African Development Community

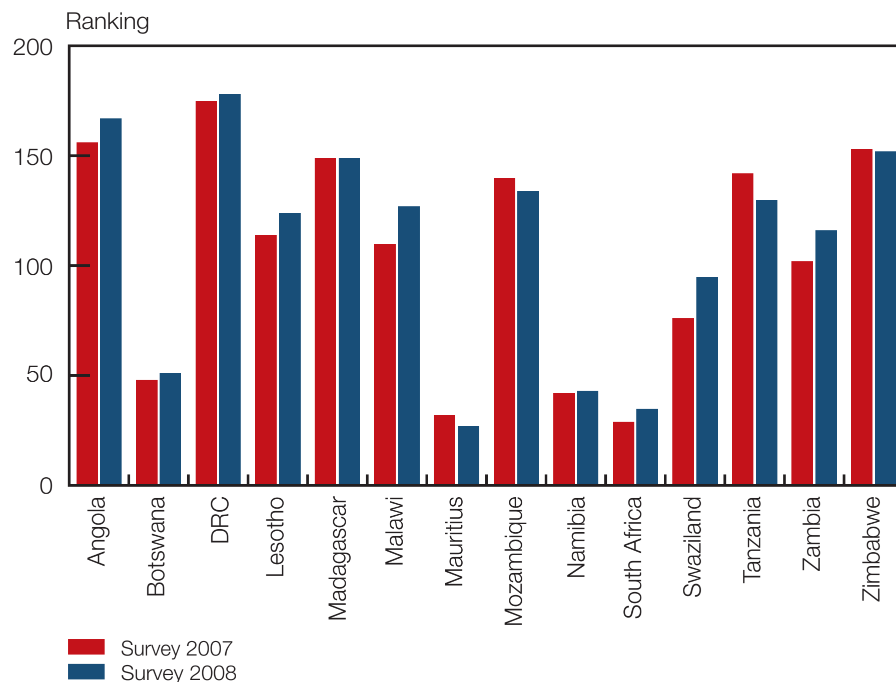
The economies of the SADC countries also performed well during recent years. Economic growth (excluding Zimbabwe) reached 7,4 per cent in 2007 and is expected to amount to 7,9 per cent for 2008. The SADC has recently launched a free trade zone that aims to eliminate import tariffs and enhance regional integration. Angola, the Democratic Republic of Congo (DRC) and Malawi are countries in the SADC that plan to join the free trade area at a later stage. The free trade area is paving the way for a customs union by 2010, a common market by 2015, monetary union by 2016 and a single currency by 2018.[46]

46 Fin24. 2008. "SADC launches free trade zone", 17 August. (http:\\www.fin24.com).

47 SADC, World Bank and International Finance Corporation. 2008. *Doing business 2008*. April.

Mauritius, followed by South Africa and Namibia, were ranked the three SADC countries with the best ease-of-doing-business ranking.[47] The ranking of most of the SADC countries, however, worsened in 2008 when compared with 2007 (Figure 9). Poor infrastructure, particularly energy and transportation, restrains the interest of doing business in the region. SADC countries can attract more capital and promote private-sector-led growth if they introduce measures to reduce the regulatory impediments to private activity, thereby enhancing the depth of financial markets.

Figure 9 Ease-of-doing-business ranking: SADC[1]



1 The lower the ranking, the greater the ease of doing business

Sources: World Bank and International Finance Corporation

48 Figure quoted from the Zimbabwe Central Statistical Office.

Zimbabwe is in the midst of a major political and economic crisis, and still presents risks to the stability of the region. With an inflation rate of about 231 million per cent,[48] it is facing a socio-economic emergency. The Zimbabwean election process featured high on the agenda of the African Union summit, and some African leaders and states threatened to distance themselves from Zimbabwe, expressing concerns that the reputation of the African region could be tainted by developments in the country. Zimbabwe's two main political parties reached a power-sharing deal in September 2008 which enabled the establishment of a government of national unity. A UN Development Report has stated that about US$5 billion in foreign aid over five years is needed to rebuild the Zimbabwean economy. Many private investors and governments have indicated that they may return to Zimbabwe as soon as political stability is restored in the country.

Domestic macroprudential analysis

This section presents the main developments in the South African domestic financial sector and its counterparts, the corporate and household sectors. It also analyses developments in other sectors relevant to the stability of the financial system, namely the external sector and the real-estate market. Trends in key financial soundness indicators in these sectors are analysed with the objective of assessing the soundness of the domestic financial system and its resilience to shocks. Given the interrelationships between the real and the financial sectors of the economy, the section starts off by providing an overview of real economic activity, using a selected set of indicators.

Real-sector activity

Based on a set of selected indicators of real economic activity, overall activity in the real economy declined in the six months to June 2008 (Table 1). Out of six selected indicators of real economic activity monitored, only the wholesale trade sales category registered positive growth rates during the period under review. Relatively higher lending rates, among other things, may have contributed to the decline in real economic activity, especially for new passenger car sales, which have maintained a long-run inverse relationship with the prime lending rate (Figure 10).

Table 1 Selected indicators of real-economic activity[1]

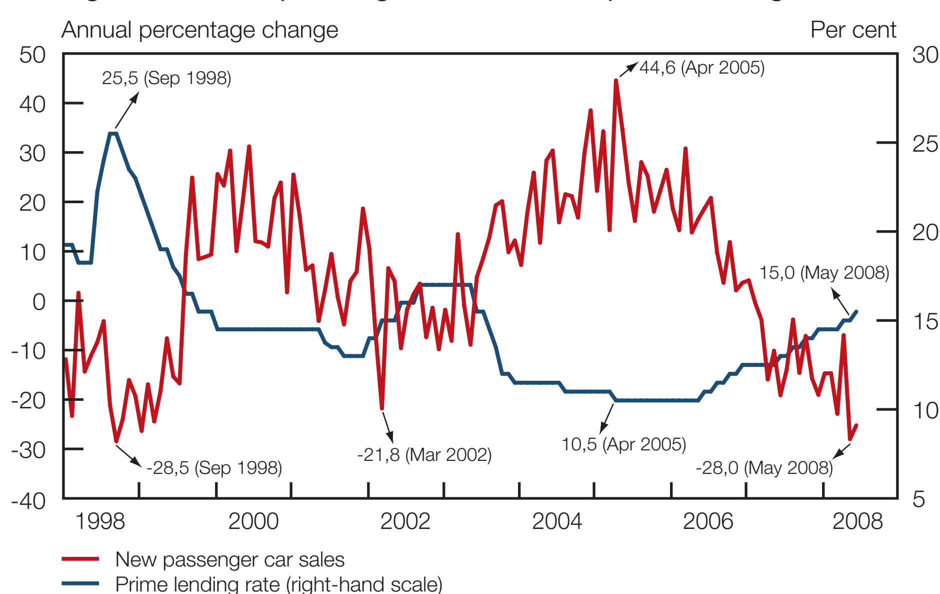
Annual growth rates

	2007			2008	
	Jun	Sep	Dec	Mar	Jun
Building plans passed	-2,6	-7,4	-15,8	-6,5	-23,5
Buildings completed	-0,7	0,8	-14,3	5,9	-7,0
Retail sales	6,2	2,2	0,1	-1,1	-1,0
Wholesale trade sales	6,3	4,1	3,7	12,1	8,6
New vehicle sales	-9,8	-9,6	-11,2	-11,7	-27,4
Electric current generated	5,0	4,2	4,7	1,6	-0,1

1 Indicators measured in volume terms or at constant prices

Source: South African Reserve Bank

Figure 10 New passenger car sales and prime lending rate



Sources: South African Reserve Bank and National Association of Automobile Manufacturers of South Africa

Financial-sector development

The above-mentioned decline in real economic activity was observed despite a high level of activity in the financial sector. Two of three indicators relating to the equity market improved in June 2008 compared with December 2007 (Table 2). However, they all dropped compared with their levels in the first quarter of 2008. The degree of monetisation in the system, as measured by the ratio of broad money supply (M3) to GDP, was relatively high, and the degree of bank intermediation, as measured by the ratio of private-sector credit to GDP, also remained high during the same period.

Table 2 Selected indicators of financial-sector development

	2007			2008	
	Jun	Sep	Dec	Mar	Jun
Equity-market size					
Market capitalisation to GDP	288,3	291,5	271,3	264,7	262,6
Turnover ratio/liquidity (per cent)	46,0	43,2	35,8	48,3	46,4
Equity traded to GDP	13,1	12,0	9,7	12,8	12,1
Monetisation					
Bank assets to GDP	118,0	122,4	121,3	129,2	130,3
Central bank assets to GDP	11,6	11,7	11,8	13,7	12,8
Deposits to GDP	87,0	89,2	88,4	88,4	88,7
M3 to GDP	77,8	79,9	80,1	79,5	80,7
Bank intermediation					
Private-sector credit to GDP	81,7	83,2	82,1	84,3	84,6
Private-sector credit to total credit	102,3	101,0	100,7	99,7	99,9
Private-sector credit to deposits	93,9	93,3	92,9	95,4	95,4

Sources: South African Reserve Bank and JSE Limited

Level of confidence in the financial sector

In the second quarter of 2008 all of the components of the Financial Services Index[49] dropped compared with their levels in December 2007. The sharp decline in the retail banking confidence level in the second quarter of 2008 (compared with the first quarter) was attributed to high and rising inflation and higher interest rates that reduced the demand for credit, while causing increases in bad debts and loan-loss provisions. The life insurance confidence level dropped to 63 index points in the same quarter, mainly as a result of falling growth in premium income and rising growth in benefit pay-outs, which resulted in weaker growth in profits. The drop in the level of confidence was also in response to the slower growth in investment income and the deteriorating financial position of consumers due to higher lending rates, and increases in food and fuel prices.

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

Table 3 Financial Services Index and its components

	2007		2008	
	3rd qr	4th qr	1st qr	2nd qr
Financial Services Index	98	98	84	70
Retail banking confidence index	94	95	78	57
Investment banking and specialised finance confidence index	100	100	79	79
Investment management confidence index	99	97	77	81
Life insurance confidence index	100	100	100	63

Sources: Bureau for Economic Research and Ernst & Young

In the second quarter of 2008 the overall Financial Services Index dropped to 70 index points, which is well below the average of 88 index points since the inception of the survey in 2002, and the lowest level of overall confidence since the fourth quarter of 2002. Possible reasons for the decline include the indirect impact of the turmoil in the global financial markets and deteriorating domestic business fundamentals.

Banking sector

The market share of the top four banks (based on total assets) has remained fairly high, averaging 84,1 per cent from January to June 2008. The level of concentration in the banking sector, using both the Gini concentration index and the Herfindahl index[50] (H-index) as measures of concentration, remained high. The marked decline in share prices of banks during the review period could be a reflection of the global credit crunch, and the current cycle of rising lending rates and their effect on the asset quality of South African banks. In the year to 30 September, however, the share prices of banks had declined by only 8,4 per cent and the banking sector was still the best-performing sector on the JSE Limited (JSE). This was an indication of the inherent soundness of the South African banking sector during a period of global financial turmoil.

50 The H-index is computed as a sum of squares of the market share of all banks. Values less than 0,10 indicate 'no concentration', values greater than 0,18 indicate 'high concentration' and values between 0,10 and 0,18 indicate 'moderate concentration'.

Table 4 Selected indicators of the South African banking sector[1]

Per cent, unless indicated otherwise

	2008					
	Jan	Feb	Mar	Apr	May	Jun
Market share (top four banks)	84,65	84,20	83,77	84,35	83,57	83,85
Gini concentration index	83,90	83,80	83,60	83,70	83,20	83,60
H-index	0,188	0,187	0,185	0,186	0,183	0,185
Banks' share prices (year-on-year percentage change)	-14,22	-18,18	-19,14	-25,74	-29,31	-33,54
Capital-adequacy						
Capital-adequacy ratio	11,67	11,88	12,17	12,37	12,39	12,54
Regulatory Tier 1 capital to risk-weighted assets	8,78	8,97	9,28	9,40	9,41	9,56
Credit risk						
Total advances (R billion)	2 103	2 175	2 210	2 195	2 242	2 281
Impaired advances (R billion)	44,39	46,18	47,85	49,54	55,66	58,74
Impaired advances to total advances	1,99	2,00	2,17	2,27	2,49	2,59
Specific credit impairments (R billion)	17,60	18,70	19,50	20,00	20,70	22,20
Specific credit impairments to impaired advances	39,72	40,56	40,68	40,30	37,28	37,82
Specific credit impairments to gross loans and advances	0,79	0,81	0,89	0,91	0,93	0,98
Profitability						
Return on assets (risk-weighted assets)	2,44	1,84	3,42	1,96	2,15	1,76
Return on assets (interest-earning assets)	1,71	1,24	2,30	1,32	1,43	1,20
Return on equity	24,12	18,00	33,56	19,20	20,95	17,48
Interest margin to gross income (unsmoothed)	62,15	62,29	44,96	54,89	54,32	42,65
Operating expenses to gross income	46,98	54,25	45,78	48,12	50,60	53,78
Liquidity						
Liquid assets to total assets (liquid-asset ratio)	4,67	4,50	4,48	4,75	4,69	4,50
Liquid assets to short-term liabilities	8,30	8,13	8,15	8,71	8,28	8,15
Effective net open position in foreign exchange to capital	0,36	1,19	1,67	1,73	1,22	0,43

1 Data updated on 2 September 2008. Data collection forms were changed with the implementation of Basel II in January 2008 and the term 'non-performing loans' was replaced with the term 'impaired advances', which has a more stringent definition and results in a technical increase from non-performing loans to impaired advances. Impaired advances are advances in respect of which the bank has raised specific credit impairment

Source: South African Reserve Bank

51 Impaired advances are explained in Table 4.

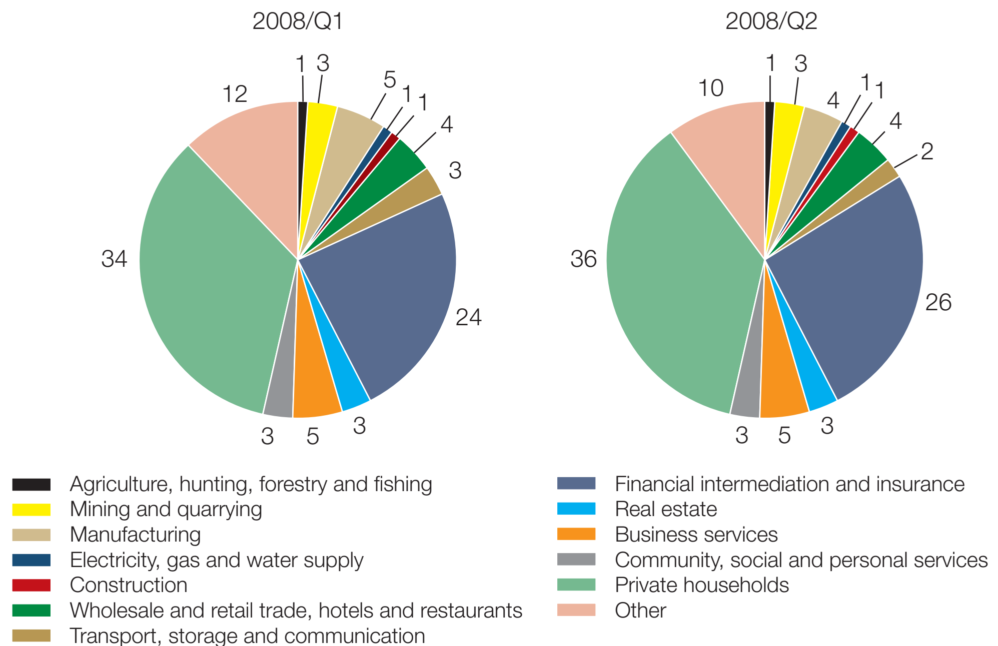
Indicators of credit risk show that risk was on the rise in the first six months of 2008 (Table 4). While total advances had generally been trending upwards between January and June 2008, impaired advances had been increasing at a faster rate during the same period.[51] As a result of the monthly increases in impaired advances, impaired advances as a ratio of total advances have been showing an upward trend. The ratio of specific credit impairments to total gross loans and advances has also demonstrated an upward trend since January 2008. These developments are believed to be an expected consequence of the prolonged period of very low lending rates, rapid lending growth and excessive leverage by borrowers.

There was also some deterioration in the profitability of the banking sector in June 2008 compared with January 2008. Both measures of profitability (return on assets and return on equity) were lower in June 2008 compared with their levels in January 2008. Consequently, there was also an increase in the ratio of operating expenses to gross income. However, the banking sector was still well capitalised with a capital-adequacy ratio well above the minimum regulatory requirement.

Sectoral distribution of credit

At the end of the second quarter of 2008, of the total credit extended to the private sector, 36 per cent was granted to private households, and 26 per cent to the financial intermediation and insurance sector. The banking sector therefore continues to be relatively highly exposed to these sectors. However, interbank exposures are included in the financial intermediation and insurance sector.

Figure 11 Sectoral distribution[1] of credit to the private sector (per cent)



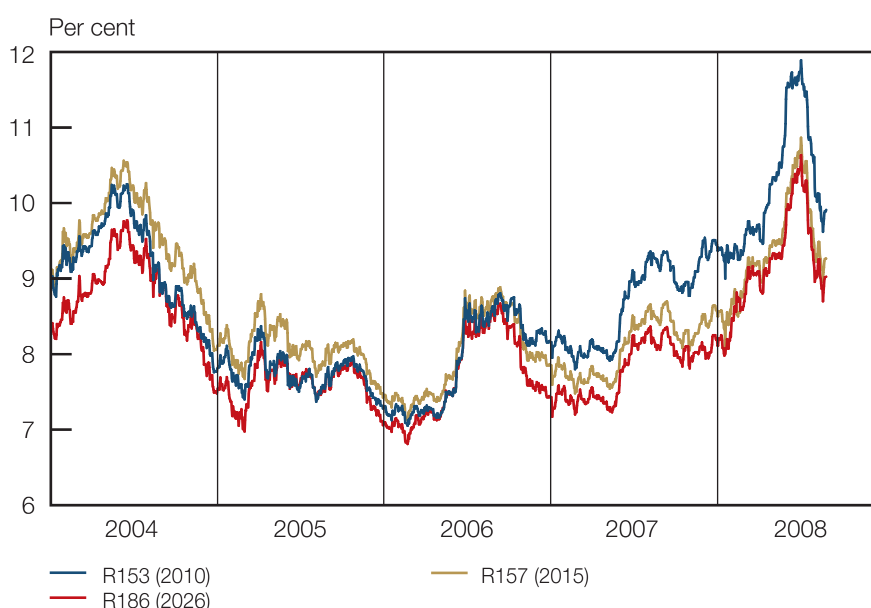
1 The classification of credit exposure according to the sectors or industries is based on the directives and industries specified in the Standard Industrial Classification of all economic activities

Source: South African Reserve Bank

Bond, equity and currency markets

In the first six months of 2008 domestic government bond yields increased as monetary policy was tightened further. The repurchase (repo) rate was increased by a further 100 basis points from 11,00 per cent in December 2007 to 12,00 per cent in June 2008. Consistently high readings on the inflation front, together with concerns surrounding the financing of the current-account deficit and depreciation in the exchange rate of the rand, also lent support to the increase in government bond yields. However, the upward trend in bond yields has reversed since July 2008 as a result of anticipated lower inflation in 2009, partly due to the possible dampening effects of the reweighting and rebasing of the consumer price index (CPI) basket in January 2009, and therefore expectations that the monetary policy tightening cycle had come to an end. At this time food prices also started to moderate, while oil prices declined from their record-high levels.

Figure 12 Selected domestic bond yields

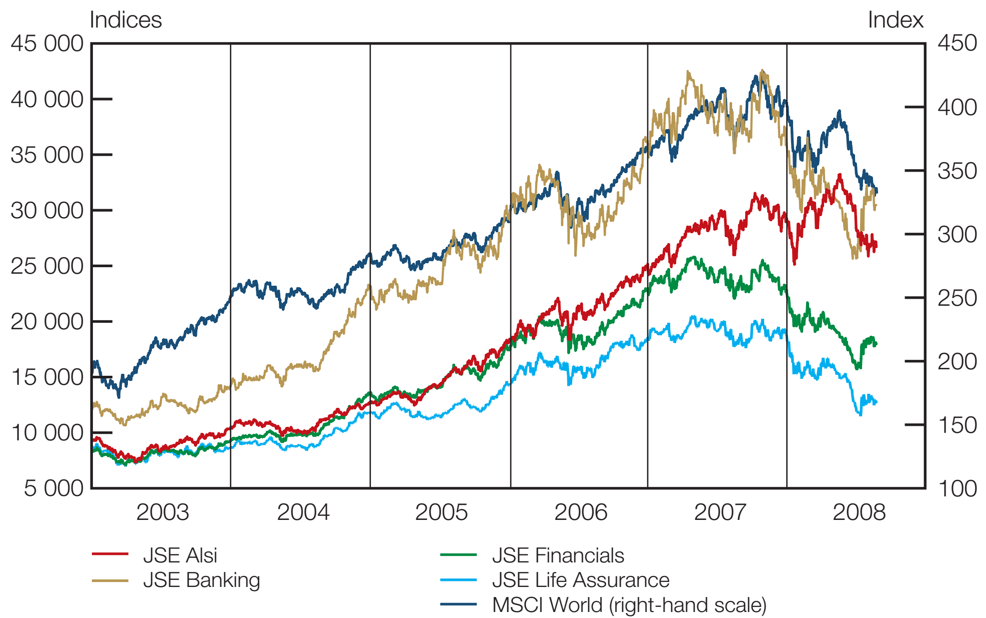


Source: I-Net Bridge

In January 2008 the equity market was pulled down by the pessimistic outlook for the domestic and international economic environment, the disruption of production in the mining sector due to domestic power outages and the decline in global banking shares as sub-prime-related losses were being factored in. The equity market managed to recover as production resumed at various mines and commodity prices rose further; gold and platinum specifically reached record highs. The recovery occurred despite weak sentiment in local markets due to high inflation and other downside risks to growth prospects. Until May 2008, the All-share Index (Alsi) was supported by the resources sector compensating for the pressures on financial shares due to inflationary concerns, weak earnings and expectations of higher interest rates.

After reaching peaks of over 33 000 index points towards the end of May, the equity market subsequently declined in line with international markets. This was mainly due to poorer earning prospects, declining gold-mining production and expectations of further interest rate increases, which impacted negatively on the banking and financial sectors. In July and August the equity market recouped some lost ground, supported mainly by the industrial, banking and financial sectors, as expectations firmed that interest rates would start to decline in 2009.

Figure 13 Share price indices

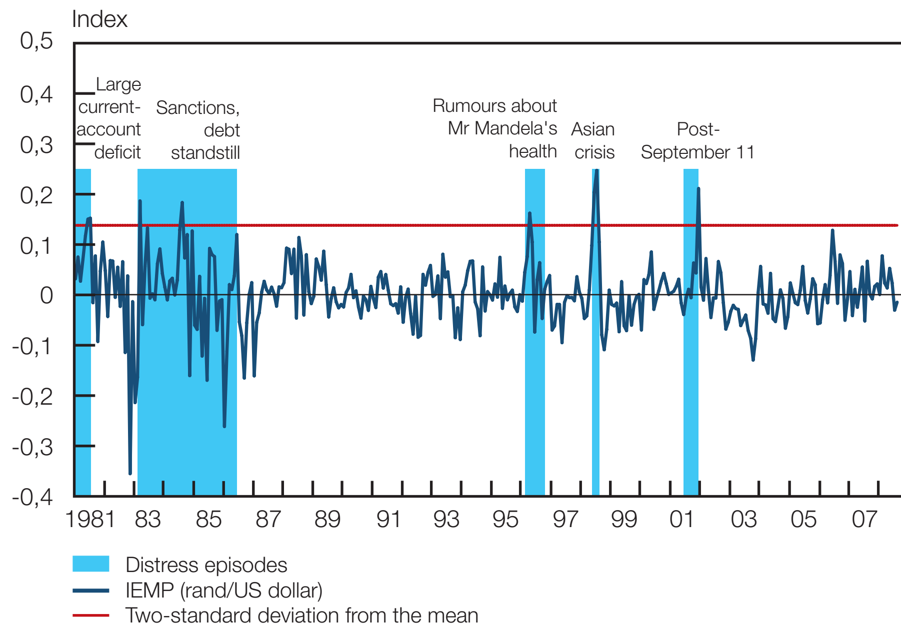


Source: Bloomberg

Assessing pressure build-up in the foreign-exchange market

During the first eight months of 2008 the index of exchange market pressure (IEMP) was not pointing to undue pressure in the foreign-exchange market that could impact on the stability of the financial system. The IEMP was still below the two-standard deviation threshold.

Figure 14 Index of exchange market pressure[1]



1 The index of exchange market pressure is usually defined as a weighted average of the depreciation of the local currency, the percentage change in international reserves and the change in the domestic interest rates. A rise in the value of the index indicates increasing pressure in the local currency and vice versa

Source: South African Reserve Bank

Insurance sector

The financial strength of long-term insurers, as measured by the ratio of the free assets-to-capital-adequacy requirement, remained sound in the first six months of 2008. About 69 per cent of long-term insurers were covered by the free assets-to-capital-adequacy requirement of two or more times, which is considered to be well above the minimum requirement.

Table 5 Free assets-to-capital-adequacy requirement

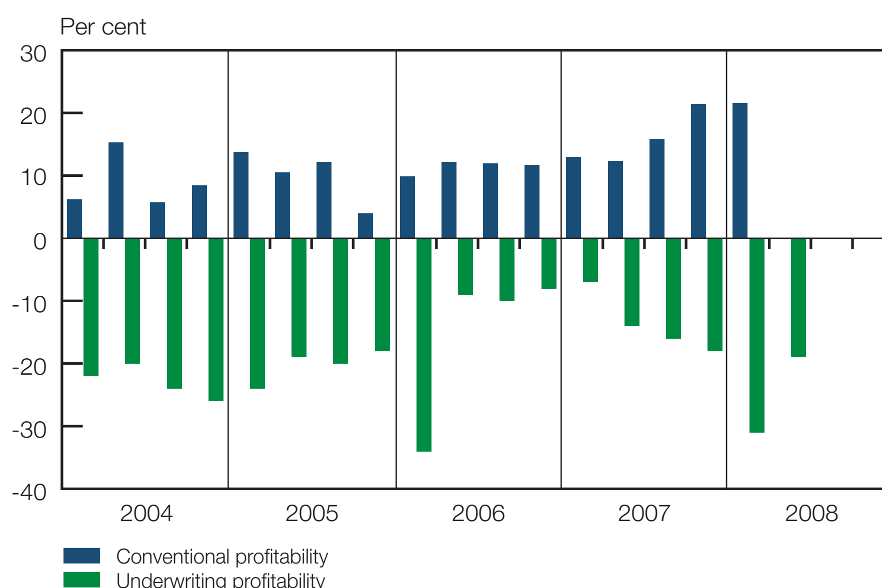
Free assets-to-capital-adequacy requirement (long-term typical insurers)[1]	Number of insurers		
	2007	2008	
	4th qr	1st qr	2nd qr
Covered 0–1 time	0	0	0
Covered 1–2 times	7	7	8
Covered 2–5 times	14	13	14
Covered 5–10 times	4	5	3
Covered 10+ times	1	1	1
Total	**26**	**26**	**26**

1 Typical long-term insurers are those that offer most of the six classes of business as defined in the Long Term Insurance Act, 1998 (Act No. 52 of 1998) in the primary market. The figures were not audited

Source: Financial Services Board

A selected set of other financial soundness indicators for typical long-term insurers showed some deterioration in the performance of the sector from the fourth quarter of 2007 to the second quarter of 2008. The annual growth rate of the number of policies issued dropped marginally and that of share prices declined further. Individual lapses increased substantially and claims also increased, albeit marginally. Underwriting profitability continued to be negative. On the positive side, individual surrenders dropped.

Figure 15 Conventional and underwriting profitability for typical long-term insurers



Sources: South African Reserve Bank and Financial Services Board

Table 6 Selected indicators for typical long-term insurers

	2007	2008	
	4th qr	1st qr	2nd qr
Number of policies[1]	7	6	6
Share prices[1]	7,7	-16,6	-27,9
Individual lapses[2]	44	59	55
Individual surrenders[2]	16	15	11
Claims[3]	101	114	102
Management expenses[3]	11	11	11
Commission[3]	6	6	6
Underwriting profitability[4]	-18	-31	-19
Conventional profitability[5]	21,4	21,5	...

... Denotes unavailability of data
1 Year-on-year percentage change
2 Expressed as a percentage of the number of new policies issued during the period using statistics that were not audited
3 Expressed as a percentage of net premiums
4 Net premium income less net premium expenditure all divided by net premium income. Profit used when calculating profitability refers to underwriting profit, which is money earned by insurers in their underwriting operations excluding money earned in the investment of assets and other sources
5 Profit over total revenue. Profit used when calculating conventional profitability is the excess of revenue over expenditure

Sources: South African Reserve Bank and Financial Services Board

External sector

In the second quarter of 2008 the ratio of foreign-exchange reserves to short-term external debt (the Guidotti ratio (GR)) stood at 1,14. That suggested that available foreign-exchange reserves were above the country's short-term foreign debt by about 14 percentage points compared with 18 percentage points in the first quarter. The augmented Guidotti ratio (AGR) – the ratio of foreign-exchange reserves to annualised current-account deficit and short-term external debt (the country's total external financing requirements) – improved slightly to 0,68 in the second quarter of 2008.[52] The improvement was attributed to the relatively lower current-account deficit compared with the first quarter.

52 The Guidotti ratio (GR) or augmented Guidotti ratio (AGR) gives a summary measure of the extent of a country's foreign currency liquidity risk and is a rough stress test of a country's foreign currency liquidity position. As a rule of thumb, a GR or AGR of unity indicates that a country has sufficient foreign-exchange reserves to cover its external short-term debt or its total external financing requirements, respectively, for up to one year, should access to foreign capital markets be withdrawn.

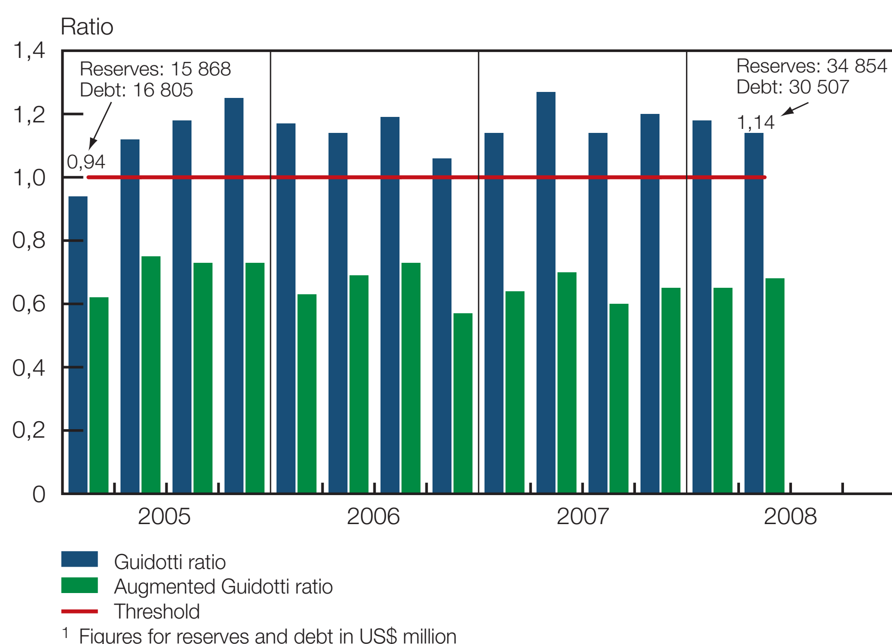
Table 7 Guidotti and augmented Guidotti ratios

	US$ millions			Guidotti ratio	Augmented Guidotti ratio
	Gross foreign-exchange reserves[1]	Short-term foreign debt[2]	Current-account deficit		
2005: 4th qr	20 650	16 457	-11 639,05	1,25	0,73
2006: 1st qr	22 969	19 661	-17 032,72	1,17	0,63
2nd qr	23 950	21 031	-13 905,72	1,14	0,69
3rd qr	24 650	20 738	-12 961,24	1,19	0,73
4th qr	25 613	24 171	-20 566,43	1,06	0,57
2007: 1st qr	26 518	23 315	-18 281,51	1,14	0,64
2nd qr	28 279	22 319	-17 848,41	1,27	0,70
3rd qr	30 523	26 773	-23 771,32	1,14	0,60
4th qr	32 979	27 399	-23 150,95	1,20	0,65
2008: 1st qr	34 394	29 119	-24 034,20	1,18	0,65
2nd qr	34 854	30 507	-21 040,18	1,14	0,68

1 Official reserves (measured by the gross gold and other foreign-exchange reserves)
2 Short-term debt (maturing within a year) includes all external debt by the public authorities, public corporations, monetary authorities, banking and other sectors, and the short-term component of foreign direct investment

Source: South African Reserve Bank

Figure 16 The Guidotti and augmented Guidotti ratios[1]



1 Figures for reserves and debt in US$ million

Source: South African Reserve Bank

Corporate sector

The annual growth rate of bank credit to the corporate sector decelerated again in the second quarter of 2008 compared with both the fourth quarter of 2007 and the first quarter of 2008. As a percentage of GDP, credit to corporations increased marginally compared with the same quarters. A positive development was a decline in the corporate debt burden (credit to corporations as a percentage of annualised profits) in the second quarter of 2008. Corporate debt was therefore increasing at a lower rate relative to corporate profits.

Table 8 Selected indicators for the corporate sector

Annual growth rates, unless indicated otherwise

	2007		2008	
	3rd qr	4th qr	1st qr	2nd qr
Bank credit granted[1]	31,3	25,3	22,7	21,5
Gross fixed capital formation	25,4	23,2	22,8	25,3
Credit as a percentage of GDP	36,9	36,9	36,9	37,4
Credit as a percentage of annualised profits	166,7	187,4	184,8	161,5
Business confidence index[2]	72,0	67,0	48,0	45,0
Net operating surplus[3]	22,7	17,6	15,1	22,5

1 Bank credit to the corporate sector in this case includes instalment sales, leasing finance, mortgage advances, overdrafts, credit card debtors, and other loans and advances
2 The business confidence level is measured on a scale of 0 to 100, where 0 indicates an extreme lack of confidence, 50 neutral and 100 extreme confidence
3 Gross operating surplus minus depreciation

Sources: South African Reserve Bank and Rand Merchant Bank/Bureau for Economic Research

The Rand Merchant Bank/Bureau for Economic Research (RMB/BER) Business Confidence Index declined to 48 index points in the first quarter of 2008. Factors that weighed on business confidence included the deepening slowdown in business volumes, pressure on profitability, and increased economic and political uncertainty. Subsequently,

the confidence level dropped to 45 index points in the second quarter of 2008. The drop was attributed to further interest rate increases, and large increases in food and fuel prices. There was a further decline in the third quarter of 11 index points to 34 index points (not shown in the table). This latest decline was due to, among other things, the fact that most businesses were caught between rapidly rising costs, weaker domestic and foreign demand, and the deterioration of the global economic environment.

The total number of liquidations increased by 29 per cent in June 2008 compared with the year before. The increase confirms that the favourable financial conditions of recent years are probably at an end. Although most liquidations were recorded in the finance, insurance, real-estate and business services industry, liquidations in this industry dropped by 12 per cent in the same period. The biggest increases were in the construction; community, social and personal services; and agriculture, hunting, forestry and fishing industries.

Table 9 Total number of liquidations by industry[1]

	2007	2008	
	Jun	May	Jun
Agriculture, hunting, forestry and fishing	0	2	8
Mining and quarrying	1	24	0
Manufacturing	12	9	19
Electricity, gas and water	1	2	0
Construction	4	20	13
Wholesale and retail trade, catering and accommodation	55	80	75
Transport, storage and communication	7	13	9
Finance, insurance, real-estate and business services	90	93	79
Community, social and personal services	11	22	30
Total number of liquidations	181	265	233

1 Information on liquidations is obtained from the Registrar of Companies and Close Corporations, and the Department of Trade and Industry

Source: Statistics South Africa

Household sector

Financial position, consumer confidence, consumption expenditure and credit extension

Despite the deceleration in the annual growth rates of financial assets and net wealth to single-digit levels, the financial position of households remained strong in the second quarter of 2008. Disposable income registered a year-on-year growth rate of 14,1 per cent, which was comparable with the long-term annual average growth rate of 14,5 per cent (first quarter of 1980 to second quarter of 2008).

The level of consumer confidence dropped significantly in the first half of 2008. The 10 index-point decline in the first quarter of 2008 was attributed to further increases in lending rates in December 2007, higher food and fuel prices and power outages in January 2008. The further 18 index-point drop during the second quarter of 2008 brought consumer confidence to -6 index points; the same level that prevailed during the first quarter of 2004. Apart from the reasons already mentioned, this latest decrease in consumer confidence was attributed to, among other things, falling house prices and perceived deteriorating employment prospects.

Rising food and fuel prices had a dampening effect on household consumption expenditure in the first half of 2008 compared with the second half of 2007. The annual growth rate of real household consumption expenditure decelerated to 4,1 per cent in the first quarter of

2008, followed by a further deceleration to 3,2 per cent in the second quarter. However, as a percentage of GDP, household consumption expenditure remained almost unchanged at about 61 per cent for each of the first two quarters of 2008. Over the same period, the annual growth rate of credit to the household sector remained high despite the deceleration in the second quarter of 2008 compared with the first quarter.

Table 10 Selected indicators for the household sector

Annual growth rates, unless indicated otherwise

	2007		2008	
	3rd qr	4th qr	1st qr	2nd qr
Nominal disposable income	12,6	12,5	13,1	14,1
Financial assets[1]	28,8	14,7	9,1	9,5
Net wealth[2]	26,4	13,8	8,3	8,2
Consumer confidence index[3]	18,0	22,0	12,0	-6,0
Consumption expenditure to GDP	62,2	61,3	61,1	61,3
Real consumption expenditure	6,5	5,1	4,1	3,2
Credit extension	20,2	19,5	24,4	21,0
Saving as a percentage of disposable income	-0,5	-0,6	-0,7	-0,5
Debt to GDP	48,0	47,3	47,4	46,8
Debt to financial assets	27,1	28,5	28,6	27,6
Capital-gearing ratio[4]	18,5	19,2	19,5	19,0
Income-gearing ratio[5]	10,2	10,9	11,3	11,6

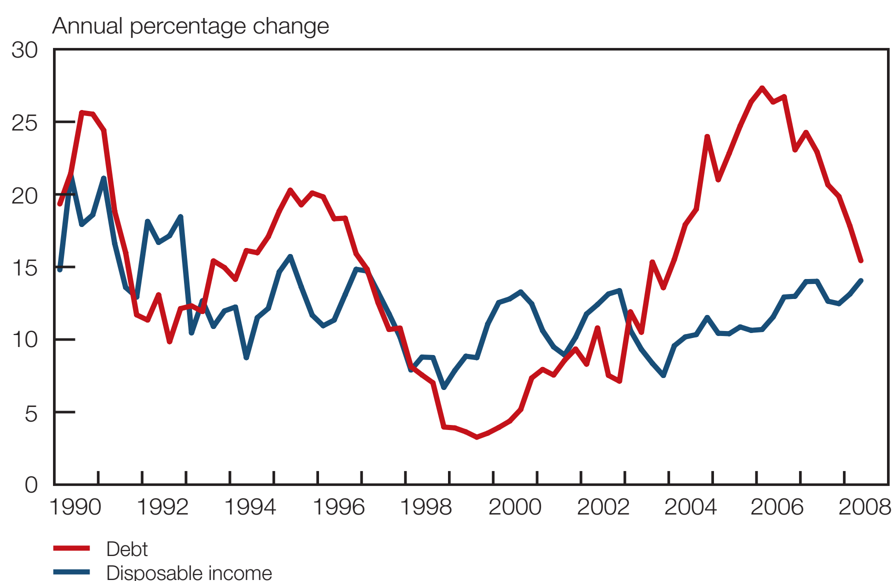
1 Household financial assets include households' deposits with financial institutions, their share in pension funds and a proxy for their holdings of shares. Data on financial assets are preliminary and are based on work in progress at the Bank
2 Household net wealth comprises household total assets, that is, total fixed assets plus financial assets less liabilities. Data on net wealth are preliminary and are based on work in progress at the Bank
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 'Capital gearing' refers to household debt as a percentage of total assets of households
5 'Income gearing' refers to financing costs of household debt as a percentage of disposable income

Sources: South African Reserve Bank and Bureau for Economic Research

Household indebtedness

In the second quarter of 2008 the ratio of household debt to disposable income started to decline. After peaking at 78,2 per cent in the first quarter of 2008, the ratio of

Figure 17 Household debt and household disposable income

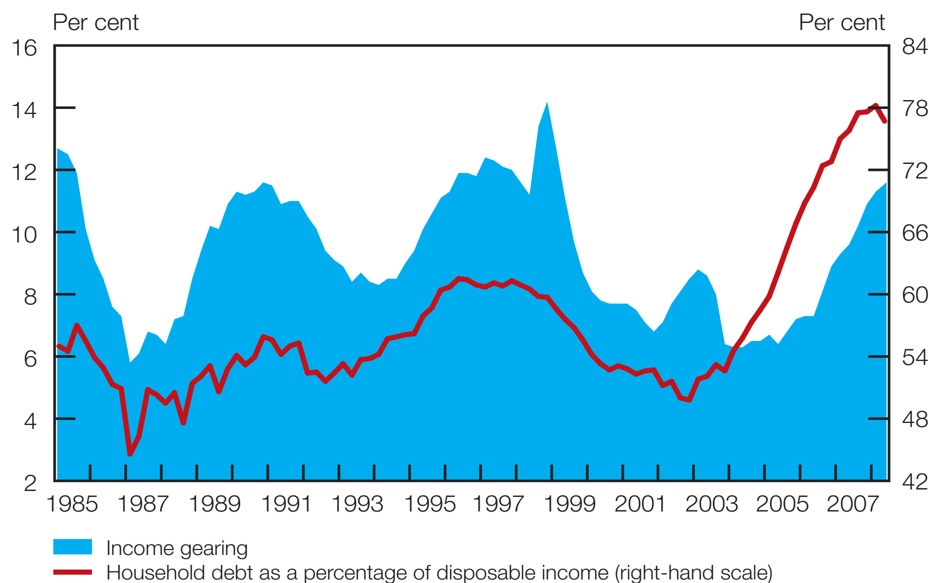


Source: South African Reserve Bank

household debt to disposable income dropped to 76,7 per cent in the second quarter (Figure 18). The decrease in the ratio may be attributed to factors such as stricter credit-granting requirements following the implementation of the National Credit Act, No. 34 of 2005 (NCA), coupled with rising lending rates and debt-servicing costs. As a ratio of GDP, household debt declined slightly in the second quarter.

The high level of household indebtedness continues to be a source of vulnerability to the financial system in the event of an adverse shock to the repayment capacity of households. As a percentage of financial assets, household debt decreased from 28,6 per cent in the first quarter of 2008 to 27,6 per cent in the second quarter. Debt-servicing costs continued to increase in the first half of 2008, resulting in income gearing (interest costs as a ratio of disposable income) increasing from 11,3 per cent in the first quarter of 2008 to 11,6 per cent in the second quarter. Over the same period, capital gearing (household debt as a ratio of total assets of households) decreased slightly from 19,5 per cent to 19 per cent.

Figure 18 Ratio of household debt to disposable income and income gearing



Source: South African Reserve Bank

In June 2008 summonses for civil debt grew by 7 per cent compared to the year before and the number of insolvencies also grew markedly by 31,8 per cent (Table 11). Households clearly started to feel the impact of higher lending rates, which can negatively affect their ability to service debt obligations.

Assessing the financial soundness of the household sector

When assessing the vulnerability of the household sector to shocks by comparing the threshold value to the actual value of each indicator (Table 11), four indicators issued warning signals at the end of the second quarter of 2008. The indicators were (1) the ratios of household debt to GDP, (2) debt to disposable income, (3) income gearing and (4) insolvencies. The fact that all the indicators that issued warning signals are debt-related can be an indication that the high level of household debt can make the financial sector vulnerable to unexpected shocks and should therefore be monitored closely. Box 5 compares the vulnerability of households to shocks between two periods, namely 1998 and 2008.

Table 11 Financial soundness indicators for the household sector[1]

Annual growth rates, unless indicated otherwise

	Mean	Standard deviation	Threshold	2nd qr 2008	Signal
Nominal disposable income	11,4	2,0	9,3	14,1	No
Financial assets[2]	14,8	7,9	6,9	9,5	No
Net wealth[2]	14,2	6,7	7,5	8,2	No
Debt	14,4	6,9	21,3	15,4	No
Debt to GDP	37,6	4,5	42,0	46,8	Yes
Debt to disposable income	59,2	7,5	66,7	76,7	Yes
Real consumption expenditure	4,4	2,1	6,5	3,2	No
Consumption expenditure to GDP	62,5	0,7	63,2	61,3	No
Credit extension	14,4	7,1	21,4	21,0	No
Income-gearing ratio	9,2	2,1	11,2	11,6	Yes
Capital-gearing ratio	19,1	1,1	20,2	19,0	No
Insolvencies	-0,5	31,3	30,9	31,8	Yes
Summonses	1,2	12,3	13,5	7,0	No

1 First quarter of 1993 to the second quarter of 2008. For credit extension, insolvencies and summonses the mean is for the period January 1995 to June 2008
2 Data on financial assets and net wealth are preliminary and are based on work in progress at the Bank

Sources: South African Reserve Bank and Statistics South Africa

Box 5 Comparative analysis of household-sector vulnerability: 1998 and 2008

Financial crises are often accompanied by heightened household-sector vulnerability that spills over into the financial system. The recent upturn in the interest rate cycle, and rising food and fuel prices have put pressure on the finances of the household sector. The increased strain in the finances of the household sector is, among other things, reflected in the increasing number of house and motor vehicle repossessions,[53] the decrease in the number of motor vehicles sold, increasing insolvencies and the deteriorating asset quality of banks. This box compares household-sector indicators during the current cycle of rising interest rates with those of 1998, when households were under severe strain following interest rate increases in the wake of the Asian crisis.

Table A compares selected macroprudential indicators for the household sector. The consumer confidence level is currently at a level that was recorded in the fourth quarter of 1998. Although the overall sentiment of consumers shifted from positive to negative in the second quarter of 2008, the current level (-6 index points) is not low by historical standards.[54] Growth rates of household financial assets and net wealth are currently at much higher levels compared with 1998. This notwithstanding, there were marked declines in these growth rates between the fourth quarter of 2007 and the first quarter of 2008.

Table A Selected indicators for the household sector[1]

Annual growth rates, unless indicated otherwise

	1998	2008
Consumer confidence index	-6 (Q4)	-6 (Q2)
Nominal disposable income	6,7 (Q4)	14,1 (Q2)
Financial assets[2]	0,3 (Q3)	9,5 (Q2)
Net wealth[2]	3,0 (Q3)	8,2 (Q2)
Prime lending rate	25,5 (Aug)	15,5 (Jun)
Debt	7,6 (Q2)	15,4 (Q2)
Debt to disposable income	60,5 (Q2)	78,2 (Q1)
Debt to GDP	39,0 (Q3)	46,8 (Q2)
Income-gearing ratio	14,2 (Q4)	11,6 (Q2)
Capital-gearing ratio	21,4 (Q3)	19,0 (Q2)
Insolvencies	105,9 (Dec)	31,87 (Jun)

1 Figures represent extreme values for each period
2 Data on financial assets and net wealth are preliminary and are based on work in progress at the Bank

Sources: South African Reserve Bank, Bureau for Economic Research and Statistics South Africa

53 As suggested by anecdotal evidence.

54 Historically, the lowest level of consumer confidence was -33 index points recorded in the second quarter of 1985.

At present the household debt ratios are at much higher levels compared with 1998 levels. This situation was brought about by favourable financial conditions, in particular the prolonged period of low interest rates and strong economic fundamentals that households enjoyed between 2003 and June 2006, which paved the way for the accumulation of more debt by households. The debt-service ratios are, however, currently lower than those in 1998.

Lending rates are currently lower compared with 1998 levels. The high lending rates of 1998 had a lagged impact on insolvencies, which increased at a 12-month rate of about 106 per cent in December 1998. At present the impact of the increase in interest rates since June 2006 is partly reflected in the growth rate of insolvencies. However, insolvencies are currently growing at a level well below that of 1998. This may partly be attributed to the debt-counselling provisions introduced with the National Credit Act (NCA), which limit or avoid the use of courts as first recourse in dealing with defaulting consumers.

During episodes of unfavourable financial conditions the financial system, especially banks, may be exposed to the household sector via the real-estate sector. The historically high interest rates of 1998 had dampened the growth rate of nominal house prices. Having peaked at 17,6 per cent in March 1998 (not shown in the table), the 12-month growth rate of nominal house prices deteriorated drastically and was 3,3 per cent by September of the same year. At present the annual growth rate of nominal house prices is lower than the 1998 level.

The residential property market slowdown of 1998/99 adversely affected the business confidence of residential building contractors, with the building confidence level dropping to 9 index points in the fourth quarter of 1998. Although the business confidence level of residential contractors is currently relatively high (32 index points as at the second quarter of 2008), it had dropped substantially since the fourth quarter of 2006. The increase in non-performing mortgage loans was higher at the end of 2007 compared with 1998.

Table B Selected real-estate sector indicators

Annual growth rates, unless indicated otherwise

	1998	2008
Nominal house prices	3,3 (Sep)	1,7 (Aug)
Residential contractors' confidence index (level)[1]	9 (Q4)	32 (Q2)
Non-performing mortgage loans[2]	59,0 (Q4)	84,3 (07 Q4)

1 Index, 50 = neutral
2 Comparable figures for 2008 not available. Now defined as impaired advances under Basel II

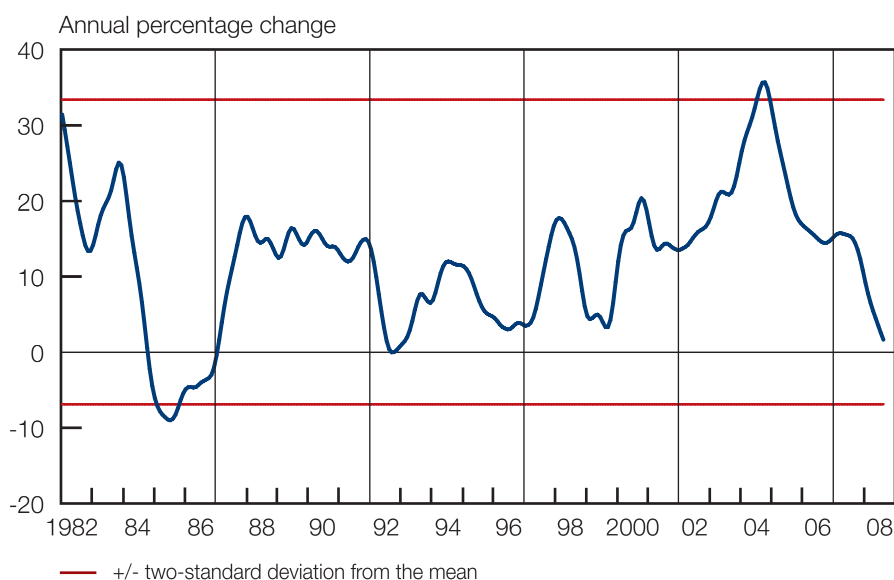
Sources: South African Reserve Bank, Absa Bank and Bureau for Economic Research

Although the current and longest upturn in the country's economic cycle may be of assistance in protecting households against a 1998 type of problem with household finances, financial institutions are currently more exposed since households are more vulnerable to shocks. The vulnerability of the household sector to shocks has increased because of a higher level of indebtedness and the exposure of the financial institutions to the household sector has subsequently increased. It can therefore be concluded that even though the balance sheets of households seem to be strong, the risk to financial institutions is that should there be unexpected large shocks to households (as was the case in 1998 when the prime lending rate jumped 5,25 percentage points to 25,5 per cent within one quarter), financial institutions will be affected more adversely, given their increased exposure to the household sector.

Real-estate sector

The annual growth rate of residential property prices slowed for each of the first eight months of 2008. According to the Absa House Price Index, the 12-month growth rate of nominal house prices decelerated to 1,7 per cent in August 2008; the lowest growth rate recorded since January 1993. The slowdown in the growth rate of residential property prices can be attributed to higher borrowing costs and tighter credit-granting requirements, which have tended to stifle the demand for houses. Using the two-standard deviation as a benchmark, the house price index was still within the acceptable range during the period under review although moving towards the lower threshold.

Figure 19 House price index[1]

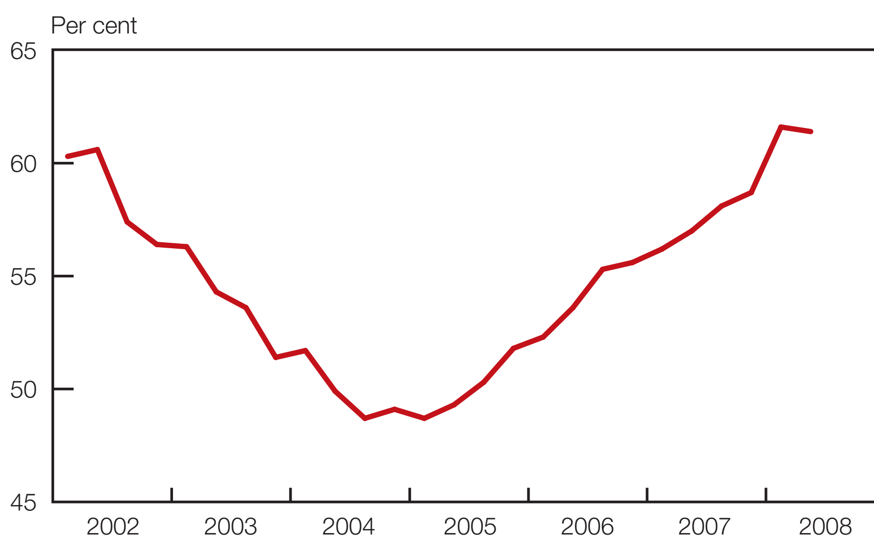


[1] The Absa House Price Index is based on the total purchase price of houses in the 80–400 m^2 size category valued at R2,9 million or less in 2007 in respect of which loan applications were approved by Absa. Prices are smoothed in an attempt to exclude the distorting seasonal factors and outliers in the data

Source: Absa Bank Limited

The ratio of mortgage debt to the market value of housing, which had been rising since the second quarter of 2005, decreased slightly in the second quarter of 2008. Again, this could largely be attributed to the tightening of credit standards and higher interest rates, although the slower growth rate of house prices partly offset these effects.

Figure 20 Mortgage debt as a percentage of the market value of housing



Source: South African Reserve Bank

55 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 home-buyers visiting show houses.

Activity in the residential property market deteriorated further in the second quarter of 2008. The Residential Property Confidence Indicator (RPCI)[55] dropped to 4,4 (the lowest level recorded since the survey commenced in 2003), from 5,1 recorded in the fourth quarter of 2007. The residential building contractors' confidence index also dropped sharply in the second quarter of 2008 compared with both the first quarter of 2008 and the fourth quarter of 2007.

Confirmation of slowing residential property market activity came from the fact that the market continues to be a buyers' market. The number of properties sold below asking price increased to 85 per cent in the second quarter of 2008 (from 82 per cent in the previous quarter) and 82 per cent of properties remained in the market for 3 months or longer. The average time that property remained in the market also increased to 15 weeks in the second quarter of 2008, from 12 weeks and 4 days in the previous quarter, according to First National Bank.

Factors stated as having influenced the residential property market negatively include rising costs of borrowing, slowing economic growth, emigration, an increase in the number of sellers selling property in order to downscale due to financial pressure, rising building costs and the lagged impact of the NCA.

Table 12 Activity level in the residential property market and the business confidence level of contractors

	2007		2008	
	3rd qr	4th qr	1st qr	2nd qr
Residential property confidence indicator	5,3	5,1	5,0	4,4
Business confidence indices				
Residential building contractors	76	76	60	32
Non-residential building contractors	91	92	78	70
Composite building confidence index[1]	85	86	66	50

1 The First National Bank Building Confidence Index measures the business confidence of all the major role players and suppliers involved in the building industry, such as architects, quantity surveyors, contractors, sub-contractors, wholesale and retail merchants, and manufacturers of building materials

Sources: First National Bank and Bureau for Economic Research

A possible impact of these developments on financial stability could be through negative equity, as some sellers are selling their properties at prices equal to or below their earlier purchase prices. Since properties are usually used as collateral when acquiring credit from financial institutions, negative equity erodes the value of that collateral and therefore, if widespread, can be detrimental to the stability of the financial system.

Infrastructure and regulation

This section of the *Financial Stability Review* considers a number of issues in the financial infrastructure and regulatory environment. An update is provided on ongoing significant legislative developments in the financial sector, focusing, in particular, on new legislation that addresses the modernisation of outdated company and financial laws, and the provision of more enforcement powers for regulators. Financial-sector developments include an overview of the current state of the South African mortgage-originating industry and developments in the micro-insurance sector.

The South African NPS is regarded as a core component of the broader financial system, since it provides the necessary infrastructure for processing payments resulting from various economic activities, nationally and internationally. An overview of the NPS is provided which explains the different networks, the system and the linkages in the NPS, and the relationship between the domestic and international payment systems.

Update on legislative developments in the financial sector

The achievement of financial stability is dependent on a legal infrastructure that provides a framework within which financial institutions operate. Steps introduced to make financial systems less crisis-prone often entail changes to regulatory measures and legislation. A high-level overview is provided of relevant issues relating to several Acts and Bills that Parliament has recently considered, and recent developments in co-operative banking.

Companies Bill

The Department of Trade and Industry began the company law reform process in 2004. In February 2007 Cabinet approved the publication of a draft Companies Bill, No. 61 of 2008 (the Companies Bill) for public comment. Since then, numerous revisions had been published before it was tabled in Parliament in June 2008.

While the Companies Bill represents a rewrite and modernisation of the existing Companies Act, No. 61 of 1973 (the Companies Act), it retains appropriate provisions of the Companies Act, incorporates the principles of the latest amendments[56] to this Act and introduces the necessary provisions to align it with current related legislation. The Companies Bill aims, among other things, to promote the development of the South African economy by creating flexibility and simplicity in the formation of companies, and to encourage entrepreneurship, efficiency, transparency and high standards of corporate governance.

56 In terms of the Corporate Laws Amendment Act, No. 24 of 2006.

Significant changes proposed to the Companies Act include the creation of a capital maintenance regime based on solvency and liquidity, as well as the abolition of the concepts of ‘par value’ and ‘nominal value’ shares. Furthermore, the rights and obligations of stakeholders and directors in companies are more balanced, which include increased shareholder activism and the introduction of the concept of ‘company rescue’. To reduce formality and increase shareholder activism, provision is made for the increased use of electronic means for shareholder meetings and administration of documentation in general. Whistle-blowers and minority shareholders are given increased protection, and standards for directors’ conduct are introduced. New categories of companies are introduced and appropriate structures are created for enhanced enforcement.

Two newly defined categories of companies are introduced, namely 'not for profit companies', currently known as 'section 21 companies', and 'for profit companies'. While the first is largely unchanged, the 'for profit companies' category comprises private companies, personal liability companies, public companies and state-owned enterprises. The Companies Bill provides for the continued existence of the Close Corporations Act, No. 69 of 1984, but this Act will no longer be an avenue for the incorporation of close corporations, or for the conversion of companies into close corporations from the effective date of the Companies Bill. Consequently, close corporations existing at that time may continue to operate in their current form or, alternatively, convert to a company.

To assist the general public, shareholders and potential investors with decisions relating to the financial information disclosed by companies, provision is made for companies to produce financial statements in a manner and form that satisfy prescribed financial reporting standards. The reporting standards may vary between the different categories of companies, but must be consistent with International Financial Reporting Standards (IFRSs) of the International Accounting Standards Board. To protect public interest, public companies and state-owned enterprises are subject to more onerous governance requirements, since their financial statements are required to be audited, while the financial statements of other categories of companies are only subject to independent reviews. If, however, the operations of these other categories of companies have a significant social or economic impact, audited financial statements may still be required. It is also the responsibility of a person specifically designated in every company to ensure that annual accountability and transparency reports are lodged. The proposed changes to financial information disclosure are generally regarded as a positive move towards compliance with international best practice in governance, since they address the need to communicate financial as well as non-financial information to all stakeholders.

The Companies Bill envisages appropriate structures with improved oversight and enforcement capabilities. In this regard, the Companies and Intellectual Property Registration Office (CIPRO) is to be subsumed under a new organ of state with expanded functions and powers, known as the Companies and Intellectual Property Commission, while the existing Securities Regulation Panel (SRP) will be transformed into the Takeover Regulation Panel, an independent organ of state with powers similar to those currently vested in the SRP. The Financial Reporting Standards Council (FRSC) is to be re-established as an advisory committee to the Minister of Finance. The High Court will remain the principal forum for remedies, but a newly established body, the Companies Ombud, will serve as a forum for alternative dispute resolution.

Financial Intelligence Centre Amendment Act

The Financial Intelligence Centre Amendment Act, No. 11 of 2008 (FIC Amendment Act) aims to give appropriate and adequate responsibilities and powers to supervisory bodies[57] and the Financial Intelligence Centre (FIC) to enforce the provisions of the principal Act, that is, the Financial Intelligence Centre Act, No. 38 of 2001 (FICA). This is done by explicitly providing for the establishment of administrative enforcement structures and by granting powers to the respective supervisory bodies that would enhance South Africa's ability to combat money laundering and the financing of terrorism effectively.

To improve oversight, all accountable institutions,[58] including banks and long-term insurance companies, are required to register with the FIC. These financial institutions

57 Supervisory bodies include the Bank, the Financial Services Board (FSB), Registrar of Companies, the Estate Agents Board, Independent Regulatory Board for Auditors (previously the Public Accountants and Auditors Board), the National Gambling Board, the JSE Limited (JSE) and the Law Society of South Africa.

58 There are 19 categories of accountable institutions listed in Schedule 1 of the FICA.

are also subject to enhanced supervision, as the amendments empower their respective supervisory bodies and the FIC to undertake inspections, issue directives, request information and impose administrative sanctions, where applicable. A mechanism is also created for the accountable institutions to appeal against the decisions taken by the FIC and the supervisory bodies. It is important to note that the current provisions for enforcement through criminal sanctions remain in place, in addition to the administrative sanctions envisaged in the FIC Amendment Act. Sanctions through the administrative enforcement process should provide a flexible and efficient alternative to address regulatory contraventions of FICA.

Implementation of the aforementioned provisions is only expected to take place in early 2009, that is, after the current joint Financial Action Task Force (FATF) and the Eastern and Southern Africa Anti-Money Laundering Group (ESAAMLG) assessment[59] of South Africa's ability to combat money laundering and the financing of terrorism. While the assessors might have noted the proposed amendments, it is likely that the final report would only reflect the actual measures and processes in place at the time. The outcome of the assessment, expected in 2009, will be an important source of information for independent rating agencies, since it will be reflective of South Africa's ongoing ability to combat money laundering and the financing of terrorism.

59 During the evaluation, assessors benchmark South Africa's regime against the international standards of the 40 + 9 FATF Recommendations.

Insurance Laws Amendment Bill

The primary objective of the Insurance Laws Amendment Bill, No. 26 of 2008 (Insurance Amendment Bill) is to "strengthen the legislative framework for a sound and well-regulated insurance services industry and to provide financial market stability to industry players as well as consumers".[60] Urgent technical and regulatory issues relating to insurance legislation are addressed, legal uncertainty across the different insurance laws is removed and insurance legislation is aligned with the recent amendments made to the Companies Act.[61]

60 According to the Memorandum of the Insurance Amendment Bill.

61 In terms of the Companies Law Amendment Act, No. 24 of 2006.

To enhance transparency and corporate governance of client funds, thus also strengthening supervision and consumer protection, the reporting obligations of auditors and actuaries are expanded. Consumers are further protected by regulating and clarifying the principal and agent relationship of insurers and outsourced persons who provide services to clients.

General supervision and oversight should also be enhanced as the Insurance Amendment Bill enables the Registrar of Insurance to issue directives to regulated institutions. To provide clarity on the regulatory demarcation of products between health and financial services, the Registrar of Insurance will also be enabled to demarcate a policy as either a health policy or financial policy. In addition, insurance companies' investments in derivatives will be more closely regulated and improved risk management rules for insurers will be introduced in a move towards risk-based supervision.

Financial Services Laws General Amendment Act

The Financial Services Laws General Amendment Act, No. 22 of 2008 (FSL General Amendment Act) is the outcome of collective efforts by the National Treasury, the South African Reserve Bank (the Bank) and the Financial Services Board (FSB) to identify weaknesses in the financial regulatory system and methods by which they can be addressed. While the FSL General Amendment Act amends a wide range of financial-sector laws, this section focuses primarily on significant amendments to the Financial Services Board Act, No. 97 of 1990 (the FSB Act), the National Payment System Act,

No. 78 of 1998 (the NPS Act) and the Financial Advisory and Intermediary Services Act, No. 37 of 2002 (the FAIS Act).

The FSL General Amendment Act amends the FSB Act to establish an enforcement committee that has the capacity to impose administrative sanctions. The powers of the FSB will therefore be enhanced with the ability to levy considerably increased fines and penalties. The FSB will be enabled to appoint an acting executive officer under certain circumstances, which should prevent situations where the absence of the executive officer may restrict the general effectiveness of the FSB.

Although participation in the NPS has traditionally been the domain of commercial banks, there has been increased participation of non-banks in the clearing environment. It has therefore become necessary to create an enabling environment that regulates the participation of such entities in the payment system, and to bring non-bank and designated clearing system participants under the oversight of the Bank and the payment system management body. The NPS Act is thus amended accordingly. The amendment will allow the Bank to approve participants, provided that they meet the specified criteria, to operate within the clearing environment.

To improve supervision, oversight and consumer protection, various amendments have been made to the FAIS Act. These include provisioning for compliance visits and inspection of financial services providers; the ability of the FSB to use the media to inform the public of service providers that contravened the FAIS Act (the principle of 'naming and shaming'); improved financial reporting; and the introduction of requirements for persons who act as compliance officers to have the necessary experience and qualifications.

Developments in co-operative banking

Since the promulgation of the Co-operative Banks Act, No. 40 of 2007 (Co-operative Banks Act) in February 2008, the focus shifted towards the development of subordinate legislation and the establishment of the Co-operative Banks Development Agency (the Agency). The National Treasury released the draft regulations for public comment in August 2008. Depending on the comments received from the public on this draft, it is likely that a simple overarching regulatory approach will be followed, especially during the start-up and early development stages of co-operative banking.

A single set of prudential requirements applicable to all types of co-operative banks is proposed, that is, primary, secondary and tertiary co-operative banks, whether supervised by the Agency or the Bank.[62] Primary co-operative banks that hold deposits between R1 million and R20 million are to be supervised by the Agency (smaller co-operative banks), while those that hold deposits of more than R20 million are to be supervised by the Bank. Secondary and tertiary co-operative banks will also be supervised by the Bank.

62 This does not imply that the prudential requirements and the rules will be the same for all types of co-operative banks.

The development of the smaller co-operative banks will be the main task of the Agency, which will be under the auspices of the National Treasury. The mandate of the Agency is to administer the registration of smaller co-operative banks, and to develop, regulate and supervise such co-operative banks. The Agency will support, promote and develop smaller co-operative banks by facilitating training and providing financial support through loans or grants. Furthermore, the Agency will be responsible for registering and regulating representative bodies and support organisations, as well as managing the yet-to-be-established deposit insurance fund for co-operative banks.

The Minister of Finance appointed the members of the Agency's board.[63] The board will be responsible for, among other things, good governance, strategic direction, risk management, performance and service delivery. The board will also be responsible for appointing the managing director of the Agency, whereafter the introduction of co-operative banking in the financial sector is expected to gain further momentum.

63 The Minister of Finance, acting in terms of section 58 of the Co-operative Banks Act, No. 40 of 2007, has appointed 11 persons as the Board members of the Agency. *Government Gazette* No. 31336 of 15 August 2008.

Once the Agency has been established and is fully operational, it would be crucial to monitor early developments in the co-operative banking sector, both locally and internationally. More specifically, the possibility of regulatory arbitrage, the level of consumer confidence in co-operative banking and its impact on the formal banking sector need to be monitored. In addition, the extent to which the objectives of the Co-operative Banks Act are met, which includes increased access to banking services and the development of sustainable and responsible co-operative banks, needs to be assessed on an ongoing basis.

Financial-sector developments

The South African mortgage-originating industry

The past ten years have seen significant growth in the South African mortgage-originating industry. Mortgage originators have become an integral part of the South African home loan market, since they source mortgage finance on behalf of borrowers from commercial banks. The banks, using mortgage originators, perform the credit risk assessment function and take the ultimate decision on whether to extend credit or not, and the terms applicable. As a relatively new industry, some business and regulatory issues are highlighted in order to facilitate discussions on the role of this industry in the development and soundness of the local financial system.

The end of the local industry's first decade of operations has coincided with closer attention being paid to the role of mortgage brokers in the home loan markets of other countries. For example, in the US, the sub-prime mortgage crisis has led some critics to argue that weak regulation, hidden fees and other dubious practices by some mortgage brokers contributed to the surge in delinquencies and defaults on sub-prime home loans in the US. As part of a package to address this ongoing financial turmoil, reforms have been proposed to key parts of the mortgage-origination process in the US by, among others, the implementation of higher standards and conditions for the licensing of mortgage brokers.[64] In other countries, such as Australia, a tightening of regulations pertaining to mortgage brokers has also been proposed.[65]

64 For more information on US developments, refer to the US Senate Report on "The sub-prime lending crisis" (http://jec.senate.gov) and the "Policy statement in financial market developments" (http://www.ustreas.gov) of the President's Working Group on Financial Markets.

65 Refer to the Green Paper entitled *Financial services and credit reform* issued by the Australian Government in June 2008 (http://www.treasury.gov.au).

The South African mortgage-originating business started off with mortgage originators acting as agents who sourced loans on behalf of individuals and businesses. Technological developments, entrepreneurial initiative and the drive among mortgage lenders to cut costs were factors that contributed to the growth of the local mortgage-originating industry. Generally, mortgage originators in South Africa liaise between the borrower and the lender, and deal mostly with the four big local banks that dominate the mortgage-finance market.[66] In contrast to the US and Australia where mortgage brokers charge fees to borrowers, the vast majority of South African mortgage originators provide a free service to borrowers. In South Africa the banks pay a fee to mortgage originators on successful registration of a mortgage loan sourced and mortgage originators do not have a direct stake in subsequent loan performance.

66 There are three tiers of mortgage originators in the local mortgage-originating industry, discernible in terms of (1) size, (2) whether they have a direct or indirect business relationship with the banks or (3) whether they have national or regional coverage.

There are no legal or specific regulatory requirements for establishing a mortgage-originating business in South Africa. However, mortgage-origination disclosure standards, application processes and marketing practices are subject to the NCA requirements. In addition, mortgage originators that wish to provide additional financial service products, such as credit insurance, must obtain the required licence from the regulator of the non-bank

financial services sector, the FSB, in terms of the FAIS Act. There are also no significant barriers to entry in the South African mortgage-originating industry.

Most of the big mortgage-lending banks have encouraged mortgage originators to be registered with the National Association of Mortgage Originators (NAMO). NAMO is responsible for setting standards and prescribes a code of conduct for its members. To provide for the sustainability of the industry, key players have commissioned a report on the industry, which will consider issues of enhanced regulation and consumer protection. There are various types of models by which the industry could be regulated, of which self-regulation seems the most likely option. The mortgage-originating industry and other stakeholders should continue to consider the level of risk this industry poses to the financial system and the appropriate level of consumer protection required.

The micro-insurance sector

The National Treasury, in conjunction with various stakeholders, released a discussion paper in April 2008 titled "The Future of Micro-insurance Regulation in South Africa".[67] This discussion paper was issued in order to address the deficiencies and access imbalances that exist in the low-income insurance sector and to develop a framework to curb the current consumer abuse practices that are generally prevalent in the micro-insurance funeral sector. The advent of the Zimele insurance product, together with the requirements of the Financial Sector Charter,[68] has created an opportunity for the short-term insurance sector to address access imbalances of the low-income sector. The main aim of the regulatory framework proposed in the discussion paper is to create good-value insurance policy products[69] that can easily be accessed by low-income consumers, with the ability to renew the policy every 12 months.[70]

The formal micro-insurance funeral sector in South Africa is relatively small and makes up less than 2 per cent of the total insurance market. Entities that have previously been hindered from participating in the insurance sector due to stringent capital and onerous operational requirements will in future be able to participate. The removal of barriers to entry and the creation of the necessary regulatory space should allow product innovation and stimulate competition within the sector. It is proposed that the micro-insurance sector be regulated in a manner similar to the formal insurance sector. The discussion paper recommends that a separate micro-insurance licence be introduced, since it would minimise the effect on other legislative processes as opposed to incorporating micro-insurance products into the existing insurance framework. In addition, careful consideration is also required of the possible impact of the pending social security reform[71] process and the consistent tax treatment between the proposed micro-insurance entities and those already operating under current insurance legislation.

Micro-insurers will need to adhere to minimum operational requirements, corporate governance principles, and capital and investment restrictions. Those micro-insurers who intend to underwrite will still have to demonstrate their ability to handle administrative functions. Entities planning entry into this sector will be afforded several avenues, even if the minimum capital requirement is not met.[72] The four entry options are: (1) allowing the smaller insurers to underwrite until such time as they have the capacity to manage the resultant risks; (2) buying into a cell captive;[73] (3) operating as a friendly society; and (4) registering as a short- or long-term insurer that can then operate with a micro-insurance licence. Although the micro-insurance regulatory regime makes provision for a simplified framework, it will still be comprehensive.

The proposed enhancement of the FSB's enforcement and administrative powers through the FSL General Amendment Act would further assist the process of establishing a robust

67 'Micro-insurance' refers to insurance that is accessible to the low-income stratum of the population. The discussion paper is available online at http://www.treasury.gov.za. The rest of the text is based on this paper.

68 Discussions on aligning the Financial Sector Charter closely with all the stakeholders' expectations are still continuing.

69 All classes of insurance will be covered, including funeral insurance, life cover and property insurance.

70 A product-based definition of 'micro-insurance' is that the term of the contract must not exceed 12 months. The terms of the product must be easy to understand and cover must be capped at R50 000 per policy per individual life insured with no savings component.

71 As reported in the March 2008 edition of the *Financial Stability Review*, the third discussion paper is to be issued by the National Treasury in due course.

72 Currently R3 million for short-term insurance companies.

73 A 'cell captive' is a special purpose insurance company vehicle that allows entry into the insurance industry. The shareholder is issued with shares that allow access to conventional insurance capabilities.

micro-insurance regulatory regime to act against unlicensed entities. In addition, inter-agency co-operation among the South African Revenue Services (SARS), the Department of Health, Department of Trade and Industry and National Treasury will need to be strengthened for the proposed regulatory regime to be successful. It is envisaged that participation by the low-income consumers, as well as small and medium enterprises should foster confidence in the micro-insurance sector. Draft legislation is expected to be released in 2009.

Further progress has also been made in respect of enhancing consumer confidence in the insurance market, with the release of the findings of the enquiry into consumer credit insurance (see Box 6 for more information).

Box 6 Update on the results of the consumer credit insurance inquiry

The inquiry into consumer credit insurance, which was commissioned by the Life Offices' Association of South Africa (LOA) and the South African Insurance Association (SAIA) in 2007 was completed in April 2008. The inquiry was prompted by consumers' complaints about the unscrupulous use of insurance products by some credit providers.

The panel[74] was guided by terms of reference, which included the investigation of improper and inappropriate marketing and distribution practices, pre- and post-sale disclosures provided to consumers, improper fees and excessive commissions, and the fairness or otherwise of standard terms and conditions of the contracts. The inquiry found that excessive payments for intermediary services arose from the misinterpretation of section 48(2) of the Short-term Insurance Act, No. 53 of 1998. The panel concluded that the Financial Services Board (FSB) should issue guidance notes on the legal basis for intermediary service payments and that, until such time as the guidance notes are in place, insurers should consult the FSB in dealing with these issues.

Recommendations made relating to the lack of pre- and post-sale disclosures include that the LOA and SAIA consider standardising the wording used in the contracts with emphasis on exclusions and limitations of a policy. The practice of collecting single premiums from consumers in this industry has already been eliminated by the advent of the National Credit Act, No. 34 of 2005 (NCA)[75] as premiums are now payable monthly over the term of the credit agreement.

Misconduct by some insurance companies was also raised in the recommendations. The main issue in this regard was the lack of proper disclosure, which is the crux of consumer protection. Credit providers sometimes engage in unscrupulous behaviour when concluding credit transactions linked to credit insurance, because the insurance part of the agreement is not disclosed upfront. As a result of this distinction between regular insurance[76] and consumer credit insurance, the panel recommended that the NCA and both the Short- and Long-term Insurance Acts be amended so that the National Credit Regulator (NCR) can assume all responsibility for consumer credit insurance. This function would include regulation of conduct and the function of intermediary services, which currently lies with the FSB.

Consumer education initiatives that aim to educate the consumers on fair practices in the financial services industry have been undertaken by SAIA and its partners, including the FSB and the LOA. However, the panel suggested that more needs to be done. The panel suggested that a separate budget be provided by the LOA and SAIA for consumer education. Consumers are being exposed to more complex financial products and the only way to enforce their rights would be for them to gain a better understanding through these initiatives.

It is envisaged that the recommendations made by the panel to eradicate some of these undesirable practices and consumer abuse will improve confidence in the consumer credit insurance sector.

74 A panel was appointed to investigate these allegations and it consisted of representatives of the LOA, SAIA, the legal firm Webber Wentzel, FSB and the Ombudsman for Short-term and Long-term Insurance.

75 Consumer credit insurance forms part of a credit agreement and therefore should be distinguished from regular insurance. As a result, this type of insurance falls within the ambit of the NCA and has been catered for in the Act.

76 Insurance is a system of insuring property, life or one's person against loss or harm.

Overview of the South African national payment system

Background

A national payment system (NPS) does not only entail payments made between banks, but encompasses the total payment process. This includes all the systems, mechanisms, institutions, agreements, procedures, rules and laws that come into play from the moment

an end-user, using a payment instrument, issues an instruction to pay another person or a business, through to the final interbank settlement of the transaction in the books of the central bank. The NPS therefore enables transacting parties to exchange value to conduct business efficiently.

The stability of the financial sector is intricately linked to the payment and settlement system. While financial instability may be characterised by banking failures, intense asset-price volatility, interest and exchange rate volatility, liquidity problems and systemic risk, it would often manifest in the disruption of the payment and settlement system. Therefore, a robust payment and settlement system is crucial for financial stability, since the default by one participant can easily have knock-on effects and, under certain circumstances, may cause the failure of other participants in the system.

In South Africa the responsibility for the NPS and its oversight are entrenched in law. The South African Reserve Bank Act, No. 90 of 1989 (SARB Act) was amended in 1996 to clarify the role and responsibility of the Bank in the domestic payment system. Section 10(1)(c)(i) of the SARB Act empowers the Bank to "perform such functions, implement such rules and procedures and, in general take such steps as may be necessary to establish, conduct, monitor, regulate and supervise the payment, clearing and/or settlement systems".

The Bank has been given the power to govern the entire process, from the moment that a payment is initiated until such time as the beneficiary receives the money. The NPS Act enables the Bank to perform the functions as provided for in the SARB Act. The authority to perform these functions is vested in the Bank's National Payment System Department. The NPS Act also provides for the regulatory and supervisory powers of the Bank to manage and control all payment-related risks.

The payment system networks

Over the past few decades the South African NPS has developed steadily into an efficient, sophisticated and complex environment. The environment may, for clarification, be broken down into various interlinking networks that enable and facilitate the generation, transfer, verification and processing of a payment instruction. A high-level view of the South African payment system and the various networks is depicted in Figure 21.

The customer network

Bank customers use various payment instruments issued by banks to do transactions. These transactions include, among other things, financial market transactions, and the ordinary purchase of goods and services. The banks' business customers do not have direct access to the settlement network and therefore have to utilise the payment networks of participating banks in order to access the clearing and settlement networks. Customer networks include the networks that have been put in place by the business customers of the various commercial banks. Examples of these business customers are public utilities and some of the major supermarkets. The customer networks enable business customers to participate in the payment system and provide payment services to their clients.

Participants in the customer networks often provide additional value-added services to their customers. For this reason, as explained in more detail in the *Financial Stability Review* of September 2007, system operators[77] and third-person payment service providers[78] were formalised into a new category of participants in the NPS. As at the end of July 2008, 22 third-person payment service providers and 39 system operators had already registered with the Payments Association of South Africa (PASA). These non-bank participants form an important link between the payment and customer networks, and enhance the efficiency and footprint of the payment system.

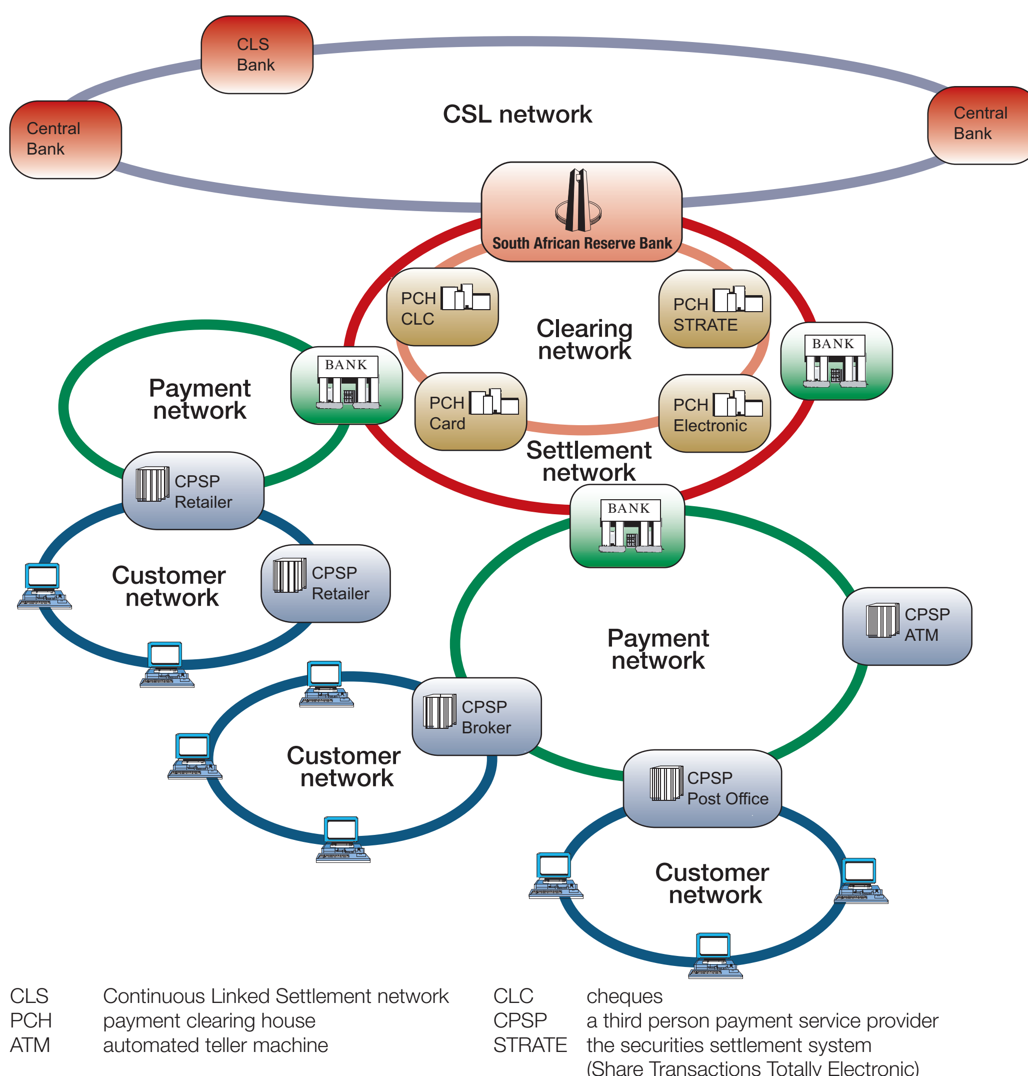
77 'System operators' are defined in the NPS Act as "any person who provides payment services to two or more persons in respect of payment instructions". Payment instructions are typically from large retailers and banks.

78 The NPS Act defines 'payments to third persons' as "a person who may as a regular feature of its business accept money or payment instructions from any other person for purposes of making payment on behalf of the other person to a third person to whom the payment is due", such as the payment of utility bills.

The payment network

The payment network can be described as the systems and communications mechanisms put in place by commercial banks to provide their customers with the facilities and channels to effect payment. These networks include the bank-owned automated teller machines (ATMs), Internet banking facilities, branch networks and payment instruments. The banking industry has been encouraged to develop payment instruments and systems. These include a variety of payment instruments such as electronic funds transfer (EFT) mechanisms, debit orders, debit cards and credit cards.

Figure 21 South African payment system networks



Innovation, access, security and safety are important features of which commercial banks need to take cognisance when developing payment instruments. Commercial banks should also take note of the banking requirements of their customers and provide robust, fit-for-purpose payment instruments that adhere to international best practice.

The clearing network

'Clearing' is defined in the NPS Act as the exchange of payment instructions. The *South African National Payment System Framework and Strategy document – 1995*[79] defined

79 The document is available online at http://www.reservebank.co.za. All the strategies identified in this document were implemented by 2004 and in 2006, the Bank released a new document entitled *The National Payment System Framework and Strategy – Vision 2010*.

80 Also refer to the earlier discussion on legislative developments.

'clearing' "as the physical exchange of payment instructions between the payer's bank and the payee's bank (or their agents)". Traditionally, only banks were allowed in the clearing network. As the payment system evolved and became more sophisticated, more non-banks began to participate in the payment system and the Bank decided to re-evaluate participation criteria in the clearing environment. Changes proposed to the NPS Act would allow the Bank to designate non-bank participants to clear in their own name in the clearing network.[80] Settlement, however, will continue to be the exclusive domain of the settlement system participant banks.

Also participating in the clearing domain is the payment clearing house (PCH) system operators, also known as 'clearing houses'. A 'PCH system operator' is defined in the NPS Act as a person that clears on behalf of two or more settlement system participants. The BIS defines a 'clearing house' as a central location or processing mechanism through which financial institutions agree to exchange payment instructions or financial obligations such as securities. The institutions settle for items exchanged at a designated time based on the rules and procedures of the clearing house.

81 Bankserv was founded in 1972 as the Automated Clearing Bureau (Pty) Limited. More information is available online at http://www.bankserv.co.za.

82 The SAMOS system provides a facility for banks to settle their obligations on a real-time basis, providing final and irrevocable settlement.

The PCH system operator responsible for clearing and determining interbank obligations stemming from the retail payments environment is known as Bankserv.[81] Bankserv is owned by the South African clearing and settlement banks. The transactions in the retail payments environment include cheques, credit and debit card transactions, and Internet and ATM transactions. In terms of the settlement value in the overall settlement system, the value of retail transactions on average amount to 8 per cent of transactions settled in the South African Multiple Option Settlement (SAMOS)[82] system. High-value payments represent on average 92 per cent of the value of the transactions settled in SAMOS. However, the volumes of transactions in the clearing network far outnumber the volume of transactions in the high-value settlement system.

Payment instructions are sent to Bankserv through the various payment networks. It is at Bankserv that the actual clearing takes place. The clearing process includes sorting the instructions and determining the settlement obligations of the participants. These obligations are then submitted to the Bank for settlement.

83 The South African securities settlement operator is known as STRATE (Share Transactions Totally Electronic) and is owned by the JSE Limited (JSE) and the South African registered banks. More information is available online at http://www.strate.co.za.

The PCH system operator responsible for the settlement of securities in South Africa is STRATE Limited[83] (STRATE). STRATE determines the interbank payment obligations arising in the equity and bond markets, which are then settled at the Bank. STRATE is not only the PCH system operator for the clearing of securities transactions, but also performs the role of the self-regulatory body for securities settlement in South Africa. Other PCH system operators active in South Africa are the card associations such as Visa and MasterCard.

The settlement network

The core of the South African settlement system is the SAMOS system, which is owned and operated by the Bank. The SAMOS system was introduced on 9 March 1998. SAMOS brought domestic interbank settlement practices in line with international best practice and signalled the start of a new era for payment practices in South Africa. At the end of July 2008, 22 settlement participants were active in the SAMOS system. See Table 13 for a list of settlement participants.

84 More information is available online at http://www.cls-services.com.

To become a settlement system participant, an institution must be either the South African Reserve Bank; a commercial bank registered in terms of the Banks Act, No. 94 of 1990; a mutual bank registered in terms of the Mutual Banks Act, No. 124 of 1993; a branch of a foreign institution or a designated settlement system operator such as the Continuous Linked Settlement (CLS) system.[84] Once the Co-operative Banks Act has

been implemented, a co-operative bank that meets the necessary requirements may also become a settlement system participant.

A settlement system participant has an account at the Bank from which interbank settlement obligations are settled. Furthermore, the settlement system participants need to lodge collateral at the Bank, as prescribed by the Bank.[85] These requirements are necessary to provide sufficient liquidity and to ensure the smooth functioning of the settlement system.

85 Refer to the NPS Position Paper No. 02/2006 for collateral arrangements, available online at http://www.reservebank.co.za.

Table 13 List of settlement participants

ABN AMRO Bank NV	Mercantile Bank Limited
Absa Bank Limited	Investec Bank Limited
African Bank Limited	Nedbank Limited
Bidvest Bank Limited	Société Générale
Calyon Corporate and Investment Bank	Standard Chartered Bank (Johannesburg Branch)
Capitec Bank Limited	State Bank of India
Citibank NA	TEBA Bank Limited
FirstRand Bank Limited	The South African Bank of Athens Limited
Grindrod Bank Limited	The Standard Bank of South Africa Limited
Habib Overseas Bank Limited	CLS Bank International
HBZ Bank Limited	South African Reserve Bank

Source: South African Reserve Bank

The settlement network provides for settlement participants to settle their interbank obligations finally and irrevocably.[86] For example, bank A owes bank B an amount of R500 million. Bank A would initiate the transaction and send a settlement instruction, via the messaging network[87] available to the settlement banks, to the SAMOS system. Once the instruction is received by the Bank and available funds permit, a transfer will take place from the account of bank A to the account of bank B within the books of the Bank. The SAMOS system will send a message to bank A confirming that the transfer was successful. The SAMOS system will also send a message to bank B notifying the bank that a payment has been made. The SAMOS system only has information relating to the interbank settlement of the funds. No information regarding the underlying payment enters the SAMOS system. The total value settled through the SAMOS system in July 2008 amounted to a record high of R6,8 trillion and the total number of transactions for the same period was 246 060.

86 Section 5(2) of the NPS Act embodies the principle of 'final and irrevocable'.

87 Refer to the *National Payment System in South Africa 1995 to 2005*, page 8, for a diagram of the messaging network.

The Continuous Linked Settlement network

On the highest level of the networks depicted in Figure 21, the link between the domestic and international payment system networks is shown. This is the link between the CLS system and the SAMOS system, and it was implemented to reduce the settlement risk associated with foreign-exchange transactions. The settlement of foreign-exchange transactions between South African rand and that of other foreign currencies settled in the CLS system takes place within this environment. CLS settles both legs of a foreign-exchange transaction simultaneously.

At present there are 17 currencies participating in the CLS settlement system. The South African rand was included as a CLS[88] settlement currency in 2004. The Standard Bank of South Africa Limited is the only South African-registered bank that is a direct CLS member. Furthermore, there are three settlement banks in South African that provide liquidity for the South African rand settlement in CLS, namely Absa Bank Limited, FirstRand Bank Limited and The Standard Bank of South Africa Limited. In July 2008 the total value of transactions settled by the CLS participant banks in the SAMOS system amounted to approximately R144 billion.

88 For additional information on participation in the CLS system refer to T*he National Payment System in South Africa 1995 to 2005* section 5.2, page 17.

Abbreviations

ABX	asset-backed securities index
AGR	augmented Guidotti ratio
Alsi	All-share Index
ASEAN	Association of Southeast Asian Nations
ATM	automated teller machine
BER	Bureau for Economic Research
BESA	Bond Exchange of South Africa
BIS	Bank for International Settlements
CIPRO	Companies and Intellectual Property Registration Office
CLC	cheques
CLS	Continuous Linked Settlement
CPI	consumer price index
CRB	Commodity Research Bureau
DRC	Democratic Republic of Congo
EFT	electronic funds transfer
EMBI	Emerging Markets Bond Index
EME	emerging-market economy
ESAAMLG	Eastern and Southern Africa Anti-Money Laundering Group
FAIS	Financial Advisory and Intermediary Services
FAO	Food and Agriculture Organization
FATF	Financial Action Task Force
FDI	foreign direct investment
FIC	Financial Intelligence Centre
FICA	Financial Intelligence Centre Act
FNB	First National Bank
FRSC	Financial Reporting Standards Council
FSAP	Financial Sector Assessment Program
FSB	Financial Services Board
FSL	Financial Services Laws
GDP	gross domestic product
GR	Guidotti ratio
H-index	Herfindahl index
IEA	International Energy Agency
IEMP	index of exchange market pressure
IFRSs	International Financial Reporting Standards
IMF	International Monetary Fund
JSE	JSE Limited
LOA	Life Offices' Association of South Africa
MSCI	Morgan Stanley Capital International
NAMO	National Association of Mortgage Originators
NCA	National Credit Act
NCR	National Credit Regulator
NPS	national payment system
OECD	Organisation for Economic Co-operation and Development
OPEC	Organization of the Petroleum Exporting Countries
PASA	Payments Association of South Africa
PCH	payment clearing house
PMI	Purchasing Managers Index
qr	quarter
repo	repurchase
RMB	Rand Merchant Bank

RPCI	Residential Property Confidence Indicator
SADC	Southern African Development Community
SAIA	South African Insurance Association
SAMOS	South African Multiple Option Settlement
SARS	South African Revenue Services
STRIPS	Separate Trading of Registered Interest and Principal Securities
SRP	Securities Regulation Panel
STRATE	Share Transactions Totally Electronic
UK	United Kingdom
UN	United Nations
US	United States
WTO	World Trade Organisation