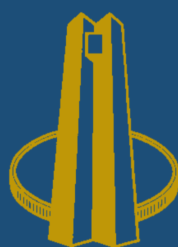
Financial Stability Review

March 2010



South African Reserve Bank

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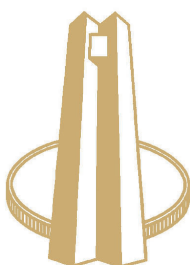

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This issue of the *Financial Stability Review* focuses mainly on the six-month period ending December 2009. However, selected developments up to 26 April 2010 were also reported on. Data may include own calculations made for purposes of this publication.

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Purpose of the *Financial Stability Review*

The South African Reserve Bank (the Bank) defines its primary objective as the achievement and maintenance of price stability. In addition to this, the Bank endeavours to contribute to a South African monetary, banking and financial system that as a whole is highly resilient. In pursuit of this objective and to promote a stable financial system, the Bank publishes a semi-annual *Financial Stability Review*. The publication aims to identify and analyse potential risks to financial system stability, communicate such assessments and stimulate debate regarding pertinent issues. The Bank recognises that it is not the sole custodian of financial system stability, but can contribute significantly towards a larger effort involving the government, other regulators, 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 and the government through a range of 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 relies on market forces to the fullest possible extent and believes that any of its actions taken to contain systemic risk should be at the minimum level required to be effective.

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

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Overview

Since the release of the September 2009 *Financial Stability Review*, the risks to global financial stability have eased and systemic risks have continued to subside as the global economic recovery has gained momentum. The recovery has been instrumental in moderating earlier high levels of uncertainty. Financial stability, nevertheless, remains to some extent fragile in many economies, including those emerging-market economies hardest hit by the crisis. Advanced economies, in particular, are still faced with the challenge of repairing damaged financial systems, on the one hand, and introducing regulatory reform, on the other.

Relatively conservative monetary and fiscal policies and structural reforms before the global financial crisis have helped many African countries to withstand the effects of the crisis better than during previous crises. The main risk facing Africa remains a stalling of the global economic recovery. This could place downward pressure on commodity prices, which could also undermine government revenues and raise public debt to unsustainable levels.

In South Africa, economic performance started improving in the third quarter of 2009 and continued at a markedly stronger pace in the fourth quarter, as the economy gradually emerged from the recession. Confidence in the financial services sector increased further in the fourth quarter of 2009, boosted mainly by higher levels of confidence among investment managers and life insurers.

The banking sector continued to maintain levels of capital well above the minimum prudential requirement. Despite the recovery in real economic activity, bank loans and advances contracted during the period under review. The contraction in credit extension had both demand- and supply-side elements. On the demand side, it would appear that households continued to be reluctant to incur more debt, while on the supply side lending standards have remained tight. Although the quality of loans and advances had been deteriorating consistently over the past two years, the pace of deterioration moderated during the second half of 2009. Banking profitability dropped somewhat during the second half of 2009, but efficiency has remained fairly stable.

The financial strength of long-term insurers in South Africa was assessed as being generally sound, based on the capital-adequacy levels. Other financial soundness indicators for typical long-term insurers, however, suggest that this sector continued to experience some strain. Financial conditions in the short-term insurance sector also deteriorated during the fourth quarter of 2009. In line with developments in international equity markets, the upward trend in the domestic equity market, which started in March 2009, continued in the second half of the year.

Business confidence increased in the fourth quarter of 2009, following persistent declines since the third quarter of 2006. The improvement in business confidence is consistent with some of the other leading indicators that generally precede a recovery in economic activity, and currently herald an improvement in economic conditions. Other indicators for the corporate sector, however, confirmed that the sector was still under pressure.

Confidence in the residential property market also showed some signs of recovery. In addition, the decelerating growth in mortgage advances, as reported by banks, bottomed out in December 2009 and started to show signs of an upward trend. The business operations of non-residential building contractors were, however, still constrained by a lack of demand for building work.

The household sector experienced some financial strain as job losses constrained disposable income. Although most indicators show that the decline in the real economy had bottomed out in the first half of 2009, consumers were, by the third quarter of 2009, still somewhat pessimistic about the prospects for future performance of the economy and its impact on their finances. The elevated rate of unemployment, continued tight lending conditions and a need to address weaker household balance sheets are expected to continue to impact consumption expenditure negatively. Also, on average, the credit standing of consumers has continued to deteriorate.

In these circumstances, the financial stability responsibilities of various central banks have become more explicit. The financial crisis has demonstrated, in general, that, although microprudential supervision makes a valuable and indispensable contribution to financial stability, it may be insufficient on its own to ensure systemic financial stability. For this reason, a macroprudential approach to policy formulation may be helpful in complementing microprudential supervision and monetary policy. The aim of such a policy would be to smooth out the impact of the economic cycle on the financial system and to contain the build-up of systemic risks in the financial system as a whole. The South African Reserve Bank is, therefore, currently in the process of developing an integrated framework for a macroprudential policy approach to achieve its financial stability objective.

The global financial crisis has also led to wide-ranging debate on the need to enhance the international regulatory framework in order to strengthen the global financial system and improve its resilience to shocks. The proposals for reform have gone beyond banking sectors and have been expanded to include insurance industries, rating agencies, hedge funds and accounting standards.

Introduction

This edition of the *Financial Stability Review*, which focuses mainly on the six-month period ending December 2009, comprises two main sections, namely (1) financial stability developments 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 section concludes with an analysis of the main developments in the South African financial system, focusing specifically on the sectors that have a significant bearing on the stability of the domestic financial system.

The second section focuses on the financial system infrastructure and regulation, and includes an update on policy, legislative and infrastructural developments affecting the South African financial system. It starts with a discussion on the Bank's financial stability role and the possible implementation of a macroprudential approach to policy formulation to complement microprudential and monetary policy. Also included in this section is an update of recent developments relating to co-operative banks and the various challenges faced by South African regulatory authorities with the debt counselling process.

Financial stability developments and trends

International macrofinancial developments

Global macroeconomic and financial developments during the second half of 2009 pointed to a recovery that was stronger than initially anticipated, following the deepest global downturn in recent history. Although the pace of recovery differed from region to region, positive economic growth returned to most advanced economies in the fourth quarter of 2009. As economic fundamentals improved and public support measures remained in place, systemic risks continued to subside. Conditions in the global financial system are, however, still influenced by above-normal levels of uncertainty and despite these improvements, financial stability remains fragile in a number of advanced economies and those emerging-market economies (EMEs) that had been hardest hit by the crisis.

Global financial and economic developments

Although systemic risks appear to have diminished during the period under review, there has been an increase in the inter-connectedness of risks following the global financial crisis.[1] This requires an integrated and more systemic approach to risk management and response by both public and private sectors. The World Economic Forum (WEF) expressed its concern about “slow failures” or “creeping risks” and identified them as the biggest threats facing the world today. These risks emerge over a long period, have a potentially large impact and their long-term implications are often underestimated. Global population growth, the resulting rise in consumption and the ageing of populations are cases in point and could, for example, have serious implications for the availability of resources.

1 World Economic Forum. 2010. *Global risks 2010: A global risk network report*, January.

Other important risks emanating from the global financial and economic environment are, firstly, that the global economic recovery could lose some momentum due to weak financial systems, negative developments in commercial real-estate markets and rising unemployment. Secondly, there are concerns about worsening fiscal positions in some countries causing volatility in financial markets and suppressing the global economic recovery by raising the cost of borrowing for households and businesses. Finally, continued credit supply constraints, further deleveraging, and a lack of progress in bank restructuring and recapitalisation could possibly undermine the global economic recovery.

The uncertainty characterising global economic and financial systems is not only a result of the ambiguity surrounding the shape and speed of economic recovery, but also of global regulatory reform proponents’ attempts to find a balance between re-regulation and over-regulation. The consensus view is that the financial-sector reform process needs to be co-ordinated as there appears to be a clear and strong asymmetry between exiting too early and exiting too late from stimulus packages. Exiting too early would be much more damaging and should be avoided at all cost. Other threats on the horizon are the return of a general sense of uncertainty and nervousness in some financial markets following rising sovereign risk in the euro area, asset-price inflation and commercial real-estate exposures. High levels of unemployment also remain a key concern and have become a structural imbalance in many countries despite the global economic recovery.

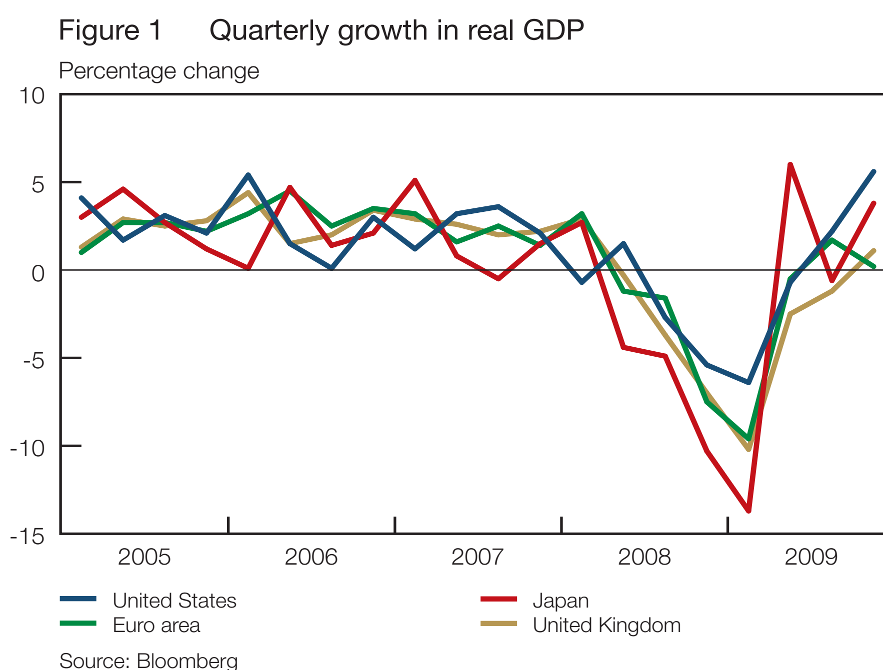
Financial and economic developments in advanced economies

Economic growth

The United States (US) and euro area recorded positive economic growth rates in the third quarter of 2009, but the economies of the United Kingdom (UK) and Japan still contracted. Gross domestic product (GDP) growth in the fourth quarter turned positive in most advanced economies and, in some cases, accelerated further. The US economy, for example, grew at an annualised rate of 5,6 per cent in the fourth quarter of 2009, compared with 2,2 per cent in the third quarter. Economic growth is, however, yet to affect private-sector behaviour sufficiently to generate the employment gains necessary for a self-sustaining expansion. The rebound in advanced economies was mainly driven by monetary and fiscal stimulus packages, which enabled a recovery in inventory cycles and consumption levels in the fourth quarter of 2009. Output in advanced economies is expected to expand by 2,3 per cent in 2010, following a contraction of 3,2 per cent in 2009.[2]

2 IMF. 2010. *World Economic Outlook*, April.

Figure 1 Quarterly growth in real GDP



Source: Bloomberg

Improving economic fundamentals and sustained policy support contributed to an overall reduction in systemic risks in advanced economies. Despite these positive developments, advanced economies are still faced with the challenge of repairing damaged financial systems, on the one hand, and introducing regulatory reform, on the other.

Banking sectors

The outlook for the banking sectors in advanced economies improved somewhat in the second half of 2009 as the pace of growth in global writedowns slowed and bank earnings recovered by more than was generally expected. Total bank losses accumulated since the start of the global financial crisis, as estimated by Bloomberg, were about US$1,7 trillion at the end of the fourth quarter of 2009, with banks having to

raise about US$1,5 trillion in new capital. Banks benefited somewhat from favourable conditions in fixed income, commodity and currency markets and, in some cases, results for 2009 showed improvements in capital, liquidity levels and profitability. The US banking sector benefited from the recovering economy and reported profits of US$0,9 billion in the fourth quarter of 2009, compared with total losses of US$37,8 billion in the same period a year earlier.[3] The Federal Reserve, in its *Quarterly Banking Profile*, indicated that this improvement was, however, concentrated in the larger banks. The number of smaller banks experiencing difficulties increased by 27 per cent during the fourth quarter of 2009, confirming that the industry's recovery remains uneven. Regulators have had to close 185 US banks since January 2008 and a further 20 since the beginning of 2010.

3 Federal Deposit Insurance Corporation. 2009. *Quarterly Banking Profile*, fourth quarter. Available online at: http://www2.fdic.gov/qbp/

The global financial crisis caused an unprecedented decline in credit extension by banks in advanced economies. The tightening of lending standards during the crisis was the most severe in the US and the euro area, where between 80 and 90 per cent of banks raised their lending standards in the fourth quarter of 2008.[4] The latest data reported in loan officer surveys indicate some stability in the supply of bank credit, with slightly more banks in advanced economies easing or leaving standards unchanged, compared with those that are tightening them. Although these surveys indicate that the demand for credit continues to fall, the stabilisation in banks' lending standards should provide some support for the economic recovery.

4 Board of Governors of the Federal Reserve System. 2009. Senior Loan Officer Opinion Survey on Bank Lending Practices, October.

Commercial real-estate markets

Since the second half of 2009, prices in most residential real-estate markets have started to recover, improving the outlook in this market significantly. Credit losses for banks arising from commercial real-estate exposures are, however, expected to increase. The request for a delay in payments on its debt by government-owned Dubai World was a manifestation of the severe downturn in commercial property markets. Prices of commercial property fell, on average, by between 30 and 40 per cent in the US, UK and Ireland in 2009. Commercial construction typically depends extensively on mortgage financing – either directly from banks or indirectly through commercial mortgage-backed securities or through private equity funds and life insurance companies. The commercial real-estate sector has traditionally relied more heavily on leverage compared with the rest of the corporate sector. Commercial real-estate leverage in the US, measured by the ratio of debt to equity, doubled from 1998 to 2008 as property prices rose and interest rates remained low. This could present a serious risk to financial stability, given the downturn in the commercial real-estate property cycle.

Net charge-offs[5] on commercial loans in the US are still increasing strongly, presenting a risk to providers of commercial real-estate finance. The banking sector holds about 50 per cent (US$1,7 trillion) of outstanding commercial real-estate (CRE) loans.[6] Community banks (banks with assets less than US$1 billion) have 30,7 per cent of their loans in CRE, compared with 12,1 per cent for larger banks (banks with assets greater than US$100 billion). Although distress in the commercial real-estate sector falls disproportionately on smaller community banks with higher concentrations of such loans, further CRE losses could weaken the fragile US banking system. It is estimated that CRE loans to the value of US$500 billion will mature over the next few years in the US.[7] Refinancing these loans could be challenging given the ongoing weakness in securitisation markets.

5 A charge-off occurs when a loan is written off as uncollectable bad debt. When full repayment is considered unlikely, loans are removed from the lender's balance sheet and charged against the loan-loss reserves account for bad debt.

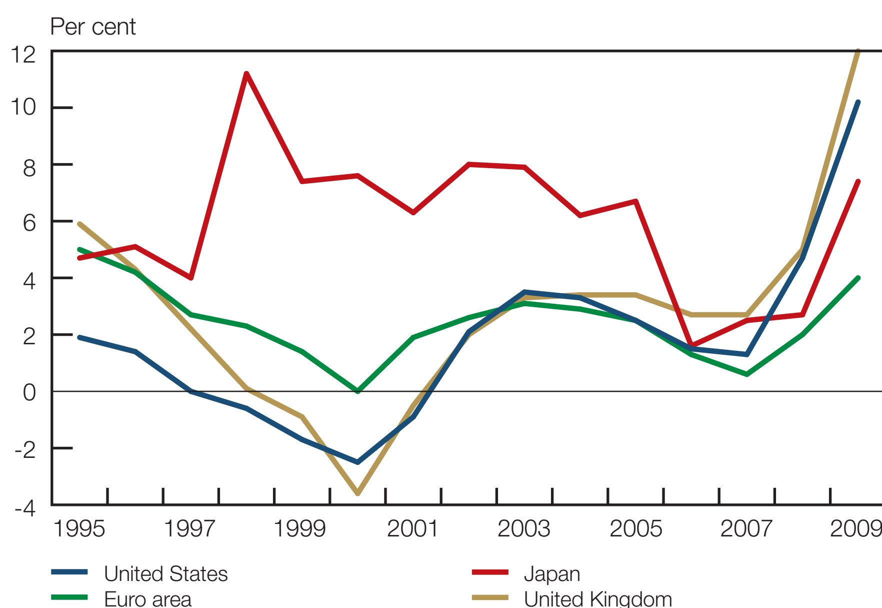
6 Bhaskar, R, Gopalan, Y and Kliesen, K. 2010. "Commercial real estate: a drag for some banks but maybe not for US economy", *The Regional Economist*. Federal Reserve Bank of St Louis, January.

7 Greenlee, J D. 2009. "Residential and commercial real estate". Testimony delivered before the Subcommittee on Domestic Policy, Committee on Oversight and Government Reform, US House of Representatives, November.

Fiscal positions

A number of advanced economies, especially the US, UK and Japan, are running exceptionally high fiscal deficits as a result of government spending programmes following the global financial crisis. In the US the federal budget deficit was at a post-war high of 10 per cent of GDP in the past fiscal year, while publicly held federal debt, which represented 41 per cent of GDP in 2008, is expected to double in the next decade. Following the debt crisis in Dubai and serious concerns over the fiscal health of debt-laden euro area economies such as Portugal, Ireland, Italy, Greece and Spain, sovereign default risk has become a substantial threat to the fragile global economic recovery.

Figure 2 Budget deficits as a percentage of nominal GDP



Source: Bloomberg

The likelihood and impact of an adverse scenario developing for countries with high fiscal deficits and high public debt could be significant. If credit ratings on sovereign bonds were to be downgraded, the resultant increase in the cost of funding and a steepening of the yield curve could negatively impact financial institutions and markets. Higher public debt issuance could also crowd out private-sector credit growth, gradually raising interest rates for private borrowers, thereby adding a drag on the economic recovery.

Credit default swap (CDS) spreads, which bear a positive correlation to the probability of default, have soared on Greek sovereign bonds since the extent of the country's debt troubles drew attention towards the end of 2009. The spread on five-year sovereign bonds peaked at 428 basis points in February 2010. Despite the announcement of austerity plans, analysts believe it is unlikely that Greece will be able to honour its commitment to reduce its budget deficit from 12 per cent to 8 per cent of GDP in 2010. The CDS spreads on Portuguese and Spanish sovereign bonds also increased sharply, and peaked in February, before declining somewhat since then.

Figure 3 Credit default swap spreads

Source: Bloomberg

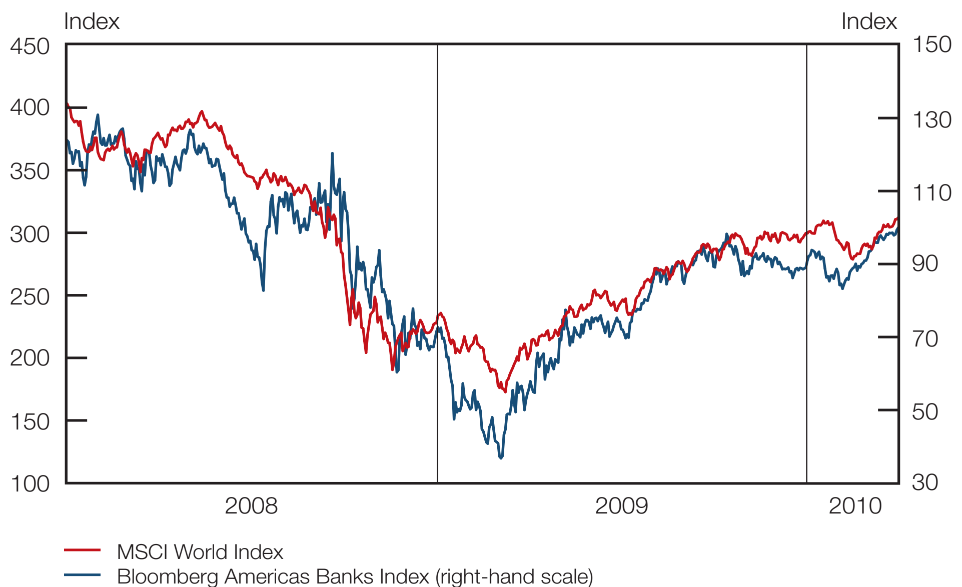
If the weaker fiscal positions of some advanced economies are not sufficiently addressed, higher real interest rates and the crowding out of private-sector credit could result. In a worst-case scenario, this could lead to serious concerns about possible sovereign default. Although it could be argued that the risk of a fiscal crisis in advanced economies is low, a sudden increase of capital flows from advanced economies into EMEs with better fundamentals is not inconceivable. Such an event, as well as shifts in investments between different advanced economies, could disrupt financial markets and add to instability in financial systems.

Financial markets

Financial markets recovered strongly in the second half of 2009, reflecting the general improvement in global economic prospects and a return of risk appetite. The Morgan Stanley Capital International (MSCI) World Index[8] rose by 32 per cent over this period

8 The MSCI World Index is a free float-adjusted market capitalisation-weighted index that is designed to measure the equity market performance of key developed economies.

Figure 4 MSCI World Index and Bloomberg Americas Banks Index



Source: Bloomberg

while the MSCI Emerging Markets Index[9] recorded even stronger gains of 75 per cent. In addition, the Bloomberg Americas Banks Index[10] rose strongly by 25 per cent during the same period.

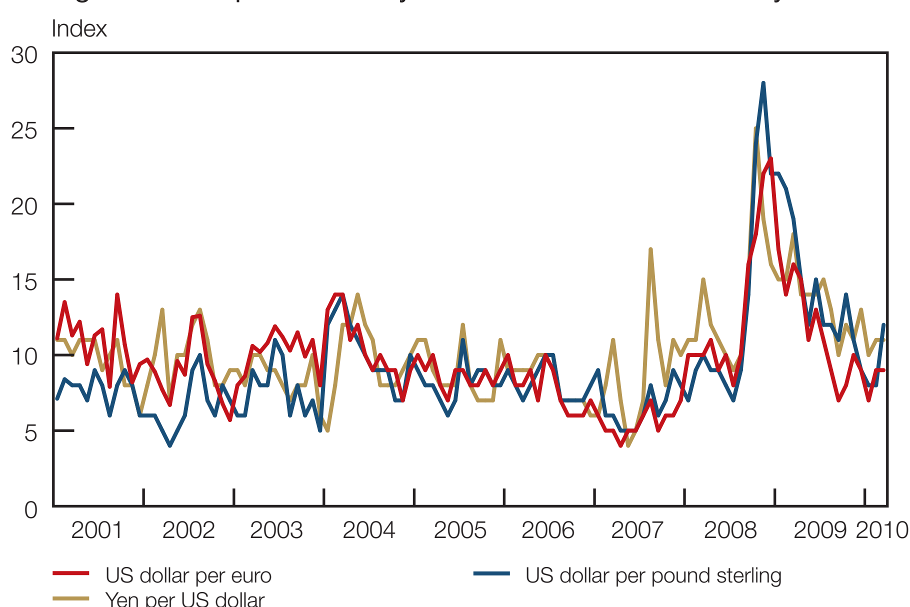
The rallies in equity markets appear to be partly based on renewed risk appetite among global investors, rather than being fully substantiated by the performance of the underlying real economies. As such, markets are susceptible to some correction and volatility, as seen from increased fiscal deficit concerns and possible credit-rating downgrades, especially in Europe and the US.

Volatility in currency markets eased to pre-crisis levels towards the end of 2009, contributing towards the improvement in global financial system stability. The US dollar depreciated by 3 per cent against the euro and the Japanese yen, and by 10 per cent against the pound sterling in 2009. Since November 2009, however, the US dollar has strengthened against most major currencies due to the persistence of global uncertainty created by fiscal debt concerns in Greece and other euro area economies. The resilience of the US dollar is, according to analysts, not primarily based on economic fundamentals, but also a result of the US dollar's safe-haven status.

9 The MSCI Emerging Markets Index is a free float-adjusted market capitalisation-weighted index that is designed to measure the equity market performance of key emerging-market economies.

10 The Bloomberg Americas Banks Index is a capitalisation-weighted index of leading bank stocks in the North, South and Central American region.

Figure 5 Implied volatility of the US dollar over 30 days[1]



1 Represents the consensus of option traders' forecasts for US dollar-volatility over the next 30 days

Source: Bloomberg

The strengthening of the US dollar since November 2009 has not deterred some analysts from predicting that it will weaken again in 2010. This view is based on the fact that, among other things, the credit quality of US government debt has deteriorated relative to that of other advanced economies and the large debt burden of the US is expected to prevail for some time. In addition, the so-called flight to quality is expected to continue to unwind as the Federal Reserve ends non-conventional measures designed to support the US economy. Conversely, when the Federal Reserve decides to increase interest rates, the US dollar could strengthen.

Financial and economic developments in emerging-market and developing economies

Emerging-market economies

GDP growth in most EMEs rebounded strongly in 2009. Countries such as China and India experienced significantly smaller declines in economic growth rates than advanced economies during the crisis, and recovered much quicker due to strong economic frameworks and swift policy responses in reaction to the crisis. Some Eastern European economies and the Commonwealth of Independent States (for example, Bulgaria, Croatia, Estonia, Hungary, Latvia, Lithuania, Romania and the Ukraine) were, however, hit particularly hard by the global crisis due to constrained cross-border funding. These economies also experienced sharp declines in GDP growth and capital inflows. The recovery in some of these economies is expected to be uneven and slower than in EMEs in other regions, given that cross-border capital flows will most likely remain lower for some time while unemployment levels will remain high. The International Monetary Fund (IMF) forecasts that real GDP in EMEs and developing economies will increase by 6,3 per cent in 2010 (from 2,4 per cent in 2009) and by 6,3 per cent in 2011.[11]

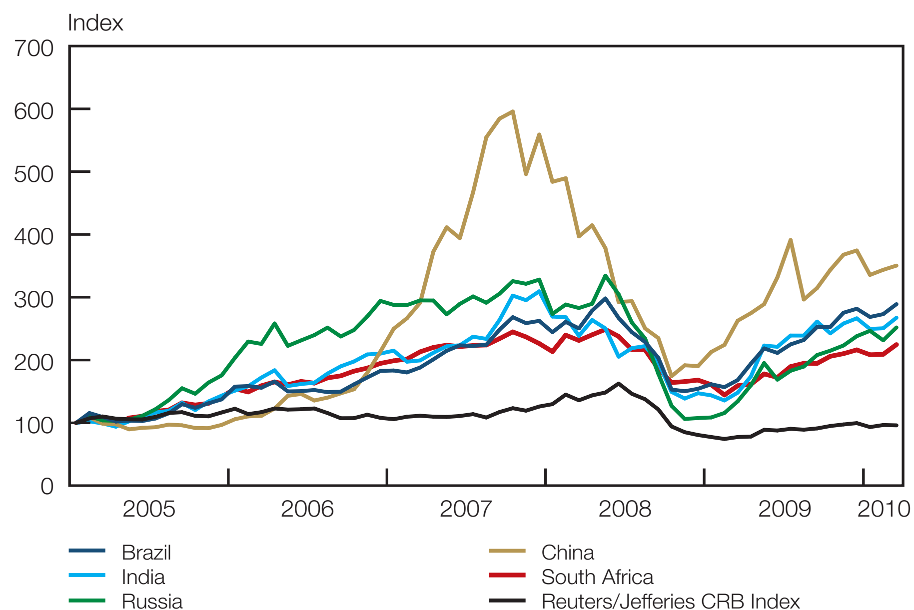
11 IMF. 2010. *World Economic Outlook*, April.

Commodity prices, especially those of oil and metals, have increased since the onset of the recovery, driven largely by buoyant growth in certain EMEs. The Reuters/Jefferies Commodity Research Bureau (CRB) Index[12] gained 23 per cent in 2009, with the prices of Brent crude oil rising by 85 per cent, that of gold by 26 per cent and platinum by 56 per cent. Although commodity markets have been fairly stable in 2010, prices are expected to rise further, mainly supported by the strength of global demand from EMEs and developing economies. Gains, however, are expected to be modest, given the above-average inventory levels and substantial spare capacity in many commodity sectors.[13]

12 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.

13 IMF. 2010. *World Economic Outlook Update*, January.

Figure 6 Reuters/Jefferies CRB Index and emerging-market equity indices



Source: Bloomberg

Capital flows to EMEs are expected to rise by 66 per cent to about US$720 billion in 2010.[14] Concerns have, however, been raised that excessive capital flows to EMEs could lead to asset price bubbles, overheating of economies, exchange rate volatility

14 Central Banking Newsdesk. 2010. "IIF sees sharp rise in emerging-market capital flows", January. Available online at: www.centralbanking.com.

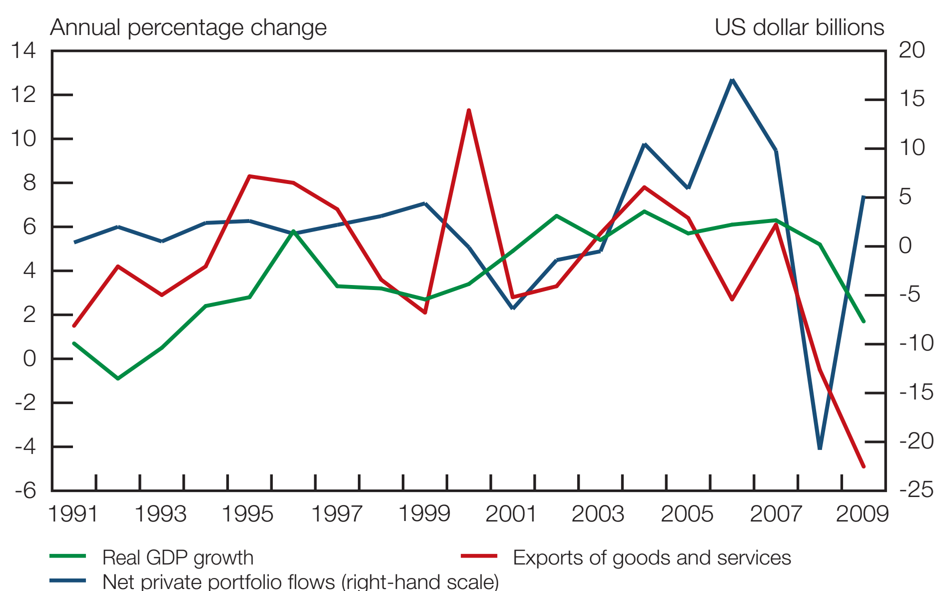
and financial system instability. This could constrain policy-making, and expose currency and maturity mismatches on the balance sheets of countries. The IMF, however, suggests that capital inflows are less problematic if exchange rates are flexible and capital outflows are liberalised.[15]

15 IMF. 2010. *Global Financial Stability Report*, April.

Africa, sub-Saharan Africa and the Southern African Development Community region

Relatively conservative monetary and fiscal policies and structural reforms before the global financial crisis have helped many African countries to withstand the effects of the global financial crisis better than during previous crises. The IMF forecasts that GDP growth in Africa will rise to 4,3 per cent in 2010 from an estimated 1,6 per cent in 2009.

Figure 7 Real GDP growth, exports and net private portfolio flows in Africa[1]



1 Data for 2009 are IMF estimtates

Source: International Monetary Fund

Recessions abroad have, however, weighed on Africa, resulting in reduced demand for its exports, increased portfolio outflows in 2008, and decreased workers' remittances. The main risk facing Africa remains a stalling of the global economic recovery. This could again place downward pressure on commodity prices, which could also undermine government revenues and raise public debt to unsustainable levels.

Given the important role that foreign direct investment plays in Africa, a reversal in flows would not only directly affect external financing needs, but could also have a severe impact on investment and growth. Furthermore, social safety nets in many countries in Africa are limited, which implies that the poor would not be effectively cushioned from such adverse developments. The crisis has clearly taken its toll on attempts to attain the 2015 Millennium Development Goals. Newly updated World Bank estimates suggest that the crisis could leave an additional 64 million people in extreme poverty globally in 2009 and some 50 million in 2010, relative to a no-crisis scenario.[16]

16 World Bank. 2010 "Prospects for the Global Economy". *Global Economic Prospects 2010: Crisis, Finance, and Growth*, January.

In sub-Saharan Africa (SSA), growth slowed to 2,1 per cent in 2009, after nearly a decade of strong economic performance. Growth is, however, expected to rise to 4,7 per cent in 2010 and 5,9 per cent in 2011.[17] Countries such as Angola, Nigeria,

17 IMF. 2010. *World Economic Outlook*, April.

Ghana and Uganda, which are heavily dependent on commodity exports, are expected to achieve GDP growth rates in excess of 5 per cent in 2010, as production of commodities is increased. A rise in foreign investment, supported by accommodative fiscal and monetary policies, could provide further impetus to growth in SSA.[18]

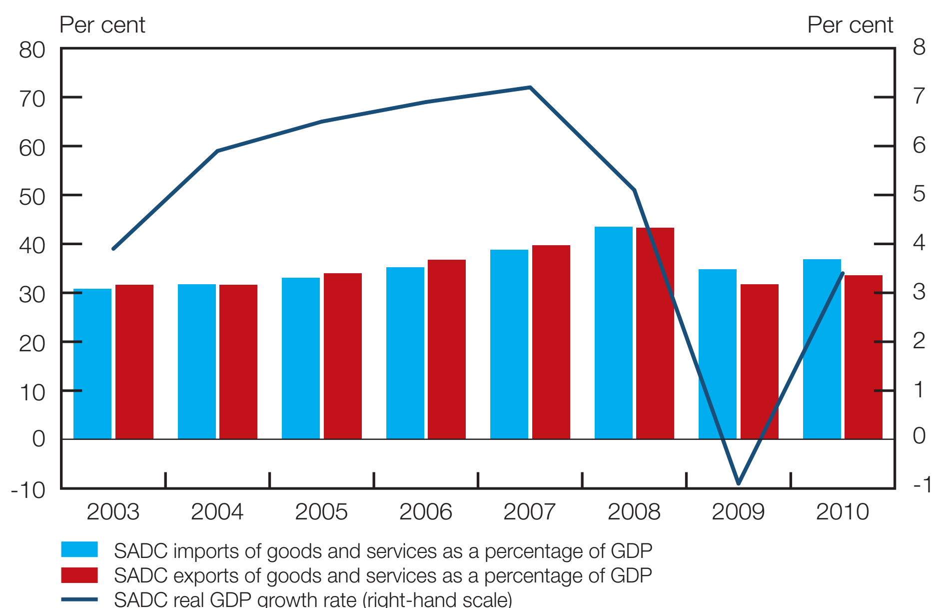
18 Business Monitor International. 2010. *South Africa Business Forecast Report,* Q2.

In the September 2009 edition of the *Financial Stability Review*, it was reported that the Central Bank of Nigeria had recapitalised five banks identified as possible sources of financial instability and had overseen a forensic audit of balance sheets. Confidence has since gradually returned to the market and plans are being put in place for a government-owned asset management company to be established that would enable banks to exchange their bad debts for government bonds and, subsequently, begin lending again. Foreign sentiment on the Nigerian financial sector appears to be improving with international financial institutions ready to inject new capital into Nigerian subsidiaries. Uncertainty over Nigeria's presidential succession, continued ethnic violence[19] and the risk of further unrest in the oil-producing Niger Delta could, however, cloud the country's investment outlook. Nigeria's financial markets have largely factored in these developments, but a delayed resolution on any of these issues could impact negatively on financial stability and the country's reputation as an investment destination.

19 Over the past few months more than 400 Nigerians were killed in ethnic violence between Muslims and Christians in the city of Jos for control of land and resources.

Real GDP in the Southern African Development Community (SADC) is estimated to contract by 0,9 per cent in 2009 (from a positive growth rate of 5,1 per cent in 2008), but rise by 3,4 per cent in 2010. The impact of the global crisis, initially only felt by countries with highly integrated financial markets, spread to oil exporters in the SADC region, such as Angola, and commodity exporters, such as Botswana and Zambia. The sharp decline in oil prices that accompanied the global recession has caused current-account balances in the region's oil-exporting countries to fall, on average, by more than 10 per cent of GDP. Lower tourism volumes, falling remittances and lower levels of official development assistance also affected the region adversely. Nevertheless, relatively prudent policies prior to the global financial crisis have provided room for domestic economies to absorb some of the shocks, supported on occasion by specific countercyclical policy measures.

Figure 8 SADC imports and exports and real GDP growth[1]



1 Data exclude Zimbabwe. Data for 2009 and 2010 are estimates

Source: IMF *Regional Economic Outlook: Sub-Saharan Africa*, October 2009

The establishment of a political power-sharing agreement in Zimbabwe in 2009 contributed towards stabilising its economy. The Zimbabwean government released a three-year Short-Term Emergency Recovery Programme, which outlines policies to restore economic growth and stability through the stabilisation of the macroeconomic environment, a democratisation agenda and the provision of a social safety net. The agricultural, mining, manufacturing, trade and tourism sectors recovered somewhat after the removal of price controls, easing of foreign currency surrender requirements, abandoning of a national currency and adoption of a multi-currency exchange rate regime. Inflation has fallen significantly[20] since the adoption of multiple currency transactions and is expected to remain under control as long as foreign currencies are allowed as official tender.[21] Nevertheless, the economic recovery remains fragile due to the build-up of some domestic and external imbalances.[22]

In early 2010 the IMF agreed to restore Zimbabwe's voting and related rights, including its eligibility to use IMF funds. This development is described by analysts as symbolic and a show of good faith that recognises efforts to rebuild the economy. The IMF, however, stipulated that Zimbabwe would not have access to IMF funds until it had fully settled its arrears to official creditors, including the IMF, the World Bank and the African Development Bank.[23] The IMF forecasts that GDP growth in Zimbabwe will rise to 6 per cent in 2010 from an estimated 3,7 per cent in 2009.

The outlook for Africa, SSA and SADC is generally positive. Excluding political risks, the major downside economic risk facing the continent remains a stalling of the global economic recovery. The vulnerability of economies in Africa stems mainly from a narrow export base dominated by commodities. Diversification of productive bases remains crucial to shield these economies from external shocks.

Domestic macroprudential analysis

This section provides an assessment of the stability of the South African financial system by analysing a set of financial soundness indicators for the financial sector, and its household and corporate-sector counterparts. Given the inter-linkages between the financial and real sectors of the economy, a set of selected real economic activity indicators is first reviewed as background.

Indicators of real economic activity

Overall economic performance started improving in the third quarter of 2009 as the South African economy gradually emerged from the recession. Real GDP increased at an annualised, seasonally adjusted rate of 0,9 per cent in the third quarter of 2009, followed by a markedly stronger rate of 3,2 per cent in the fourth quarter. After reaching a lower turning point in March 2009, the composite leading business cycle indicator increased further in December 2009, suggesting a continuation of the recovery in economic activity.

This trend can also be seen in the moderation in the pace of deterioration in the indicators of real economic activity summarised in Table 1. Whereas the negative growth rate of most indicators moderated in the month of December 2009 (compared to the year before), buildings completed increased markedly during this period. The utilisation of production capacity remained fairly stable throughout 2009 and improved somewhat in the fourth quarter. On a quarter-to-quarter basis, unemployment decreased in the fourth quarter, seeming to confirm the recovery in the domestic economy.

20 Zimbabwe's year-on-year inflation rate stood at -0,7 per cent in February 2010, measured in US dollar terms, after recording hyperinflation (measured in Zimbabwean dollar) for an extended period up to 2008.

21 Rand Merchant Bank. 2010. *Africa Quarterly*, February.

22 IMF. 2010. *Statement at the Conclusion of the 2010 Article IV Consultation Mission to Zimbabwe*. Press Release No. 10/107, 23 March.

23 Access to IMF funds is also subject to IMF policies on the use of such resources, including a track record of sound policies and the resolution of arrears to official creditors, which would require donor support.

Table 1 Selected indicators of real economic activity[1]

Annual percentage change in monthly indicators

Activity indicators	2008	2009			
	Dec	Mar	Jun	Sep	Dec
Building plans passed	-29,9	-37,2	-31,9	-13,9	-7,3
Buildings completed	10,5	-8,9	-6,4	-18,1	22,2
Retail sales	-0,1	-5,1	-5,9	-5,8	-3,8
Wholesale trade sales	4,7	-10,3	-12,5	-12,4	-6,7
New vehicle sales	-30,1	-37,8	-24,4	-21,3	-7,6
New passenger car sales	-26,7	-24,9	-17,6	-15,8	-8,8
Electric current generated	-11,6	-7,6	-4,1	-0,6	7,1
Utilisation of production capacity[2]	80,6	78,2	78,1	77,3	78,8

1 At constant prices, seasonally adjusted
2 Quarterly indicator, ratio

Sources: Statistics South Africa. Data on new vehicle and new passenger car sales were obtained from the National Association of Automobile Manufacturers of South Africa

Confidence in the financial sector

Confidence in the financial services sector, as measured by the Ernst & Young Financial Services Index,[24] increased further in the fourth quarter of 2009, boosted mainly by higher levels of confidence among investment managers and life insurers. The confidence level of investment managers increased, on the back of the recovery in equity markets, to levels last experienced before the global financial markets turmoil began to unfold. The increase in the confidence level of life insurers was boosted by higher investment income, even though net profits continued to contract. Retail banking confidence remained at a historically low level of 26 index points due to continued weakness in banks' income growth, with both interest and non-interest income falling sharply in the fourth quarter of 2009. The confidence level in the investment banking and specialised finance category fell sharply by 15 index points to 42 in the fourth quarter of 2009. This category saw disappointing business activity and contractions in income growth, despite previous expectations that business volumes would recover. Furthermore, weak credit demand, as corporate entities built reserves in an uncertain environment, adversely affected future business expectations.

24 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 confidence indices. The indices that make up this 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 2 Financial Services Index and its components

	2008		2009			
	3rd qr	4th qr	1st qr	2nd qr	3rd qr	4th qr
Financial Services Index	58	47	40	48	56	60
Retail banking confidence index	43	53	32	28	25	26
Investment banking and specialised finance confidence index	81	46	31	50	57	42
Investment management confidence index	57	42	45	60	83	99
Life insurance confidence index	51	48	50	53	58	71

Source: Ernst & Young

Banking sector

No significant changes were recorded in the market share of the top four banks or the level of concentration in the banking sector during the period under review (Table 3). Bank share prices recovered in the second half of 2009 after declining for the whole of 2008 and the first half of 2009. The recovery was in line with a general improvement in equity markets. The banking sector continued to maintain adequate levels of capital, improving the capital-adequacy ratio to 14,1 per cent in December 2009, which is well above the minimum prudential requirement. Tier 1 capital was also well above the regulatory requirement, indicating the high quality of capital in general.

Table 3 Selected indicators of the South African banking sector[1]

Per cent, unless indicated otherwise

	2009					
	Jul	Aug	Sep	Oct	Nov	Dec
Market share (top four banks)	85,00	84,59	84,90	84,65	84,86	84,59
Gini concentration index	84,25	83,69	83,84	83,70	83,78	83,65
Herfindahl–Hirschman index (H-index)	0,191	0,190	0,191	0,190	0,191	0,189
Banks' share prices (year-on-year percentage change)	13,01	6,32	7,90	29,20	25,56	19,76
Capital adequacy						
Capital-adequacy ratio	13,49	13,62	13,92	14,09	14,07	14,12
Regulatory Tier 1 capital to risk-weighted assets	10,47	10,62	10,88	11,01	10,95	10,97
Credit risk						
Gross loans and advances (R billions)	2 285	2 284	2 266	2 280	2 266	2 257
Impaired advances (R billions)	126,75	130,35	132,47	133,23	134,68	133,97
Impaired advances to gross loans and advances	5,55	5,71	5,85	5,84	5,94	5,94
Specific credit impairments (R billions)	37,42	38,61	39,58	40,32	39,90	39,61
Specific credit impairments to impaired advances	29,52	29,62	29,88	30,26	29,63	29,56
Specific credit impairments to gross loans and advances	1,64	1,69	1,75	1,77	1,76	1,75
Profitability						
Return on assets (smoothed)	0,98	0,98	0,95	0,94	0,94	0,94
Return on equity (smoothed)	17,29	17,26	16,57	16,24	15,98	15,84
Interest margin to gross income (smoothed)	50,47	50,24	50,12	49,95	49,89	49,48
Operating expenses to gross income (smoothed)	49,43	49,70	50,47	50,49	50,93	51,12
Liquidity						
Liquid assets to total assets (liquid-asset ratio)	5,55	5,62	5,80	6,14	6,14	6,35
Liquid assets to short-term liabilities	10,96	11,06	11,58	12,49	13,05	13,00
Effective net open foreign-currency position to qualifying capital and reserve funds	0,66	0,35	0,02	0,67	0,98	0,66

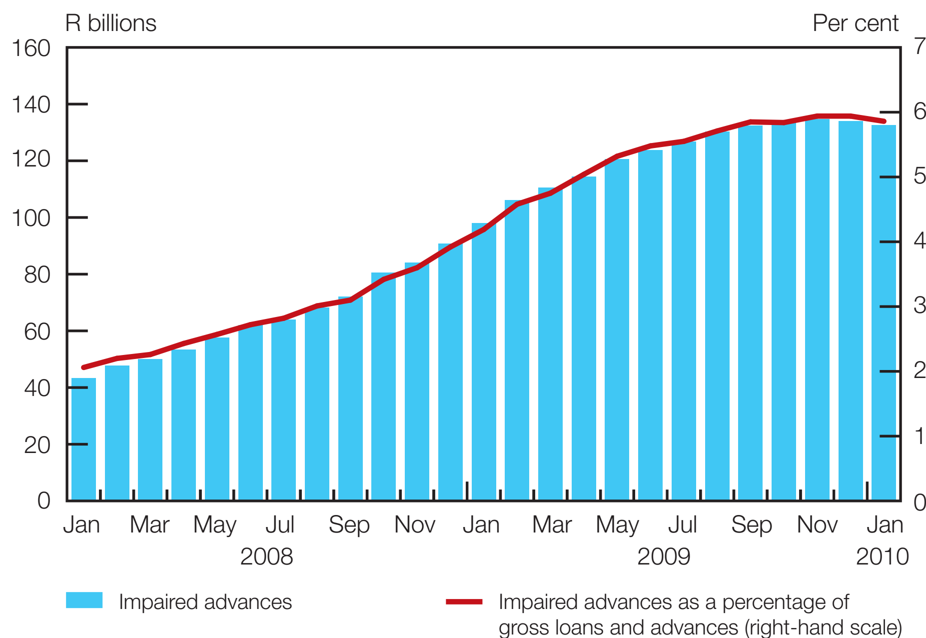
1 Data were updated on 13 March 2010

Sources: South African Reserve Bank. Data on share prices were obtained from the JSE Limited

Despite the recovery in real economic activity, bank credit continued to lag, recording an annual contraction of 2,6 per cent in December 2009. This contraction continued into 2010, with gross loans and advances declining by 3,2 per cent according to data released for January 2010. This trend has been particularly evident in credit card lending, which contracted by a cumulative 17,8 per cent between July 2009 and January 2010. The contraction in credit extension had both demand and supply-side elements. On the demand side, it would appear that households continued to be reluctant to incur more debt, while on the supply side lending standards remained tight.

Although the quality of loans and advances has been deteriorating consistently over the past two years, the pace of deterioration has been moderating somewhat during the second half of 2009 (Figure 9). In January 2010 the annual increase in impaired advances moderated to 35,4 per cent (to a level of R132,6 billion) from 47,5 per cent in December 2009. Profitability, however, dropped somewhat during the second half of 2009, but efficiency (as measured by the ratio of operating expenses to gross income) remained fairly stable over this period.

Figure 9 Impaired advances



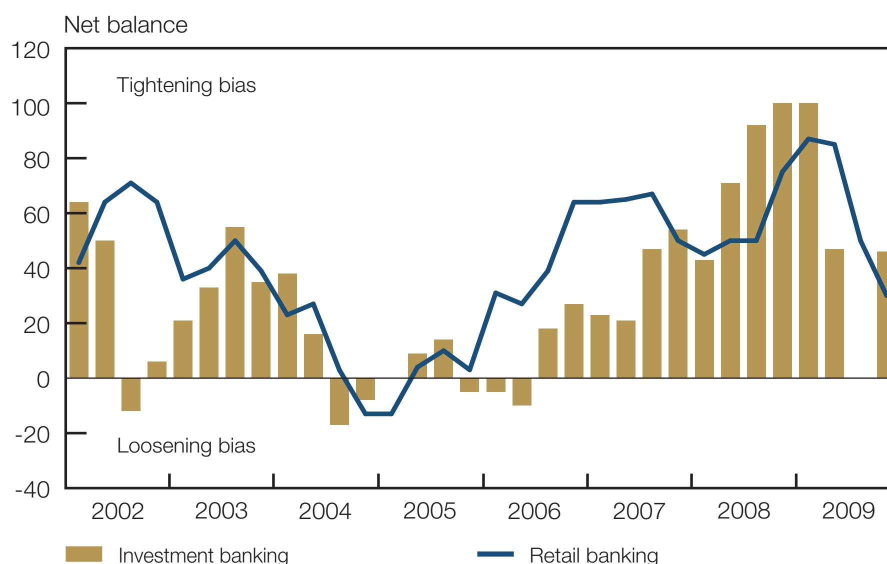
Source: South African Reserve Bank

25 'Retail banking' is defined for purposes of this survey as including business units of private banking, micro lending, retail banking, corporate banking and business banking for small- and medium-sized private enterprises.

26 'Investment banking' includes business units for corporate finance, private equity and direct investments, project finance, treasury and specialised finance and stock broking.

According to a survey conducted by Ernst & Young and the Bureau for Economic Research on the lending standards of banks, relatively fewer retail banks[25] tightened lending standards in the fourth quarter of 2009 compared with the third quarter (Figure 10). For investment banking-type activities,[26] some business units again tightened credit standards in the fourth quarter after keeping them, on average, unchanged in the third quarter.

Figure 10 Lending standards applied by banks for loan applications[1]



1 The net balance statistic is used to interpret the survey results. The net balance is the percentage of bank survey respondents whose banks tightened lending standards compared with the same quarter a year earlier minus those whose banks eased lending standards. The percentage that did not make changes (tightening or easing) is ignored

Source: Ernst & Young

At the end of the fourth quarter of 2009 banks' largest concentration of credit exposure was still to the private household sector, followed by the financial intermediation and insurance sector (Table 4). Overall, the distribution of private-sector credit across industries is fairly stable.

Table 4 Sectoral distribution[1] of credit to the private sector

Per cent

	2009		
	Jun	Sep	Dec
Agriculture, hunting, forestry and fishing	1,51	1,50	1,62
Mining and quarrying	3,05	3,15	3,21
Manufacturing	3,97	3,70	3,69
Electricity, gas and water supply	0,85	0,79	0,70
Construction	1,24	1,28	1,31
Wholesale and retail trade, hotels and restaurants	3,78	3,79	3,85
Transport, storage and communication	2,71	2,80	2,90
Financial intermediation and insurance	22,37	23,94	22,70
Real estate	5,08	5,21	5,49
Business services	5,82	4,62	4,68
Community, social and personal services	4,81	4,99	4,83
Private households	37,76	38,37	39,41
Other	7,06	5,86	5,62
Total[2]	100,00	100,00	100,00

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
2 Figures do not necessarily add up to 100 due to rounding

Source: South African Reserve Bank

Insurance sector

The financial strength of long-term insurers was assessed as generally sound, based on the capital-adequacy levels in the sector as measured by the ratio of free assets to required capital (Table 5). All long-term insurers were covered by more than the minimum requirement. Furthermore, in line with a general improvement in equity markets, share prices of long-term insurers recovered markedly in the fourth quarter of 2009.

Table 5 Free assets-to-capital-adequacy requirement[1]

Free assets-to-capital-adequacy requirement (typical long-term insurers)[2]	Number of insurers				
	2008	2009			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Covered 0–1 time	1	1	1	3	0
Covered 1–2 times	8	9	10	7	8
Covered 2–5 times	17	15	14	15	16
Covered 5–10 times	2	2	2	2	3
Covered 10+ times	1	1	1	1	1
Total	29	28	28	28	28

1 'Free assets' refers to the difference between total assets and the sum of total liabilities and required capital. The 'capital-adequacy requirement' is defined as the minimum capital required by the Financial Services Board for the registration of an insurance company and is equivalent to 13 weeks' worth of operating expenses
2 Typical insurers are those insurers 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

However, other financial soundness indicators for typical long-term insurers suggest that this sector continued to experience some strain. The annual growth rate of the number of new policies decelerated, individual lapses increased in the fourth quarter of 2009 compared with the same quarter in 2008 and there was a further weakening in underwriting profitability in the fourth quarter of 2009 (Table 6).

Table 6 Selected indicators for typical long-term insurers

	2008	2009			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Number of policies[1]	6	6	4	7	2
Share prices[1]	-43,4	-38,2	-16,5	8,6	42,0
Individual lapses[2]	59	66	67	62	63
Individual surrenders[2]	13	8	11	11	11
Claims[3]	99	101	88	91	93
Management expenses[3]	11	11	13	12	12
Commission[3]	6	6	6	6	6
Underwriting profitability[4]	-16	-18	-7	-9	-11
Conventional profitability[5]	23,3	15,3	25,2	12,3	...

… 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: Financial Services Board. Data on share prices were obtained from the JSE Limited

Financial conditions in the short-term insurance sector deteriorated somewhat during the fourth quarter of 2009. Underwriting profits dropped by 26 per cent compared with the year before, while underwriting and investment income decreased by 6,4 per cent. Management expenses and commission, as a percentage of net premiums, remained fairly stable throughout 2009 (Table 7).

Table 7 Selected indicators for typical short-term insurers

	2008	2009			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Net premiums[1]	9	6	6	7	5
Underwriting profit[1]	20,5	-25,1	3,6	-8,4	-26,0
Underwriting and investment income[1]	13,4	-1,5	21,5	11,8	-6,4
Claims[2]	66	69	68	67	67
Management expenses and commission[3]	27	28	28	27	28
Underwriting profit[3]	6	3	5	5	4
Underwriting and investment income[3]	13	13	14	13	12
Surplus asset ratio[4] (median)	40	39	46	47	43

1 Year-on-year percentage change
2 As a percentage of premiums earned
3 As a percentage of net written premiums
4 Surplus as a proportion of liabilities

Source: Financial Services Board

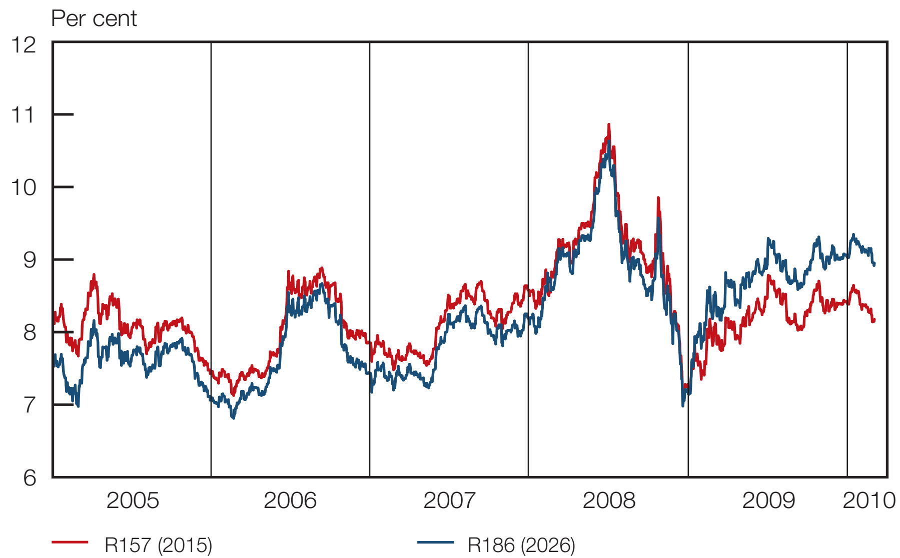
Short-term insurance companies are taking strain, not only because of the current challenging economic conditions, but also because households are still under financial pressure and not readily spending on insurance. There is pressure on insurance companies to ensure that premium rates are favourable in order to attract new clients and to retain existing ones. Insurance companies also have to deal with high losses experienced on corporate claims.

Bond and equity markets

Domestic government bond yields were more volatile in the second half of 2009 relative to the first quarter. Initially, yields trended higher due to the sharper-than-expected economic contraction, which resulted in lower-than-expected revenue collections and therefore an increase in the weekly government bond auction size on a number of occasions. At the same time, issuance by parastatals and corporates had also increased. However, the reduction in the repurchase rate in August 2009 was not expected by market participants and, together with the lower-than-expected inflation, overshadowed concerns regarding an increased supply of bonds. Furthermore, the rand appreciated to below R7,50 against the US dollar due to, among other things, better-than-expected second-quarter GDP data and the narrowing in the current-account deficit.

There was some upward pressure on bond yields ahead of the October 2009 *Medium Term Budget Policy Statement*, but the projected deficit of 7,6 per cent of GDP was in line with expectations. Non-resident investors were very active in the domestic bond market during 2009, purchasing a net R15,5 billion worth of bonds, which, together with the appreciation in the South African rand, helped to limit the upward pressure on yields during the year. Credit rating downgrades and capital controls in various other EMEs could have lured investors to South Africa. Furthermore, government finances domestically remained healthy compared to those of South Africa's peers and other developed economies.

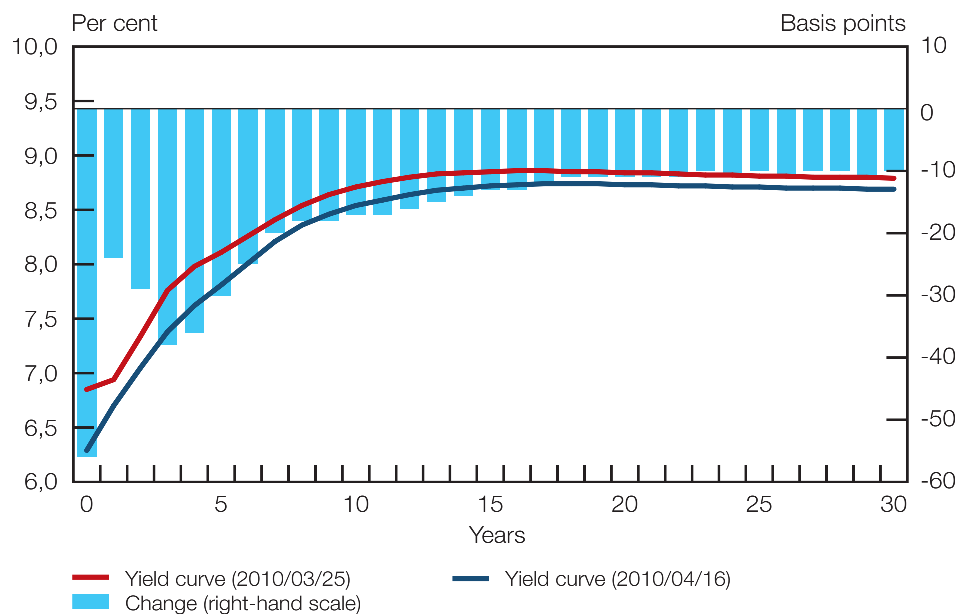
Figure 11 Selected domestic bond yields



Source: Bloomberg

Domestic bond yields have so far been declining in 2010, supported by the appreciation in the exchange rate, lower-than-feared tariff increases granted to Eskom and a lowering in the projected budget deficit and a further interest rate reduction. The February 2010 *Budget Review* also removed uncertainty as the Minister of Finance clarified the mandate of the Bank and kept the inflation target range at 3 to 6 per cent. Non-residents' appetite for domestic bonds remained healthy; they purchased bonds to a net amount of R13,1 billion in the year to 31 March 2010. The yield curve is positively sloped, reflecting optimism about economic growth prospects, but also expectations of increased inflationary risks.

Figure 12 Yield curve

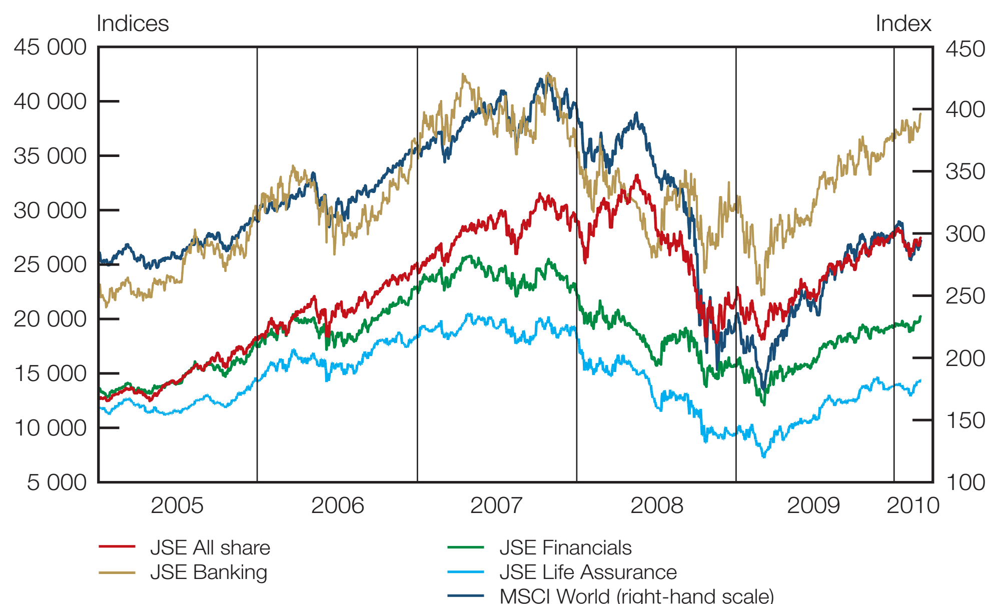


Source: Bloomberg

In line with the developments in the international equity markets, the upward trend in the domestic equity market, which started in March 2009, continued in the second half of the year. The equity market received support from lower domestic interest rates and a rise in commodity prices. Financial and banking shares, which bore the brunt of negative

developments in global banking stocks during 2008, gained support from the more accommodative monetary policy stance and an improvement in the financial sector globally. The platinum sector gained almost 55 per cent in 2009, supported by the improved outlook for the auto sector in the second half of 2009. Moody's upgrade of South Africa's foreign-currency rating and improved risk appetite of investors contributed to positive investor sentiment. Appetite for domestic equities remained robust as non-residents were net buyers to the extent of R75,3 billion in 2009.

Figure 13 Share price indices



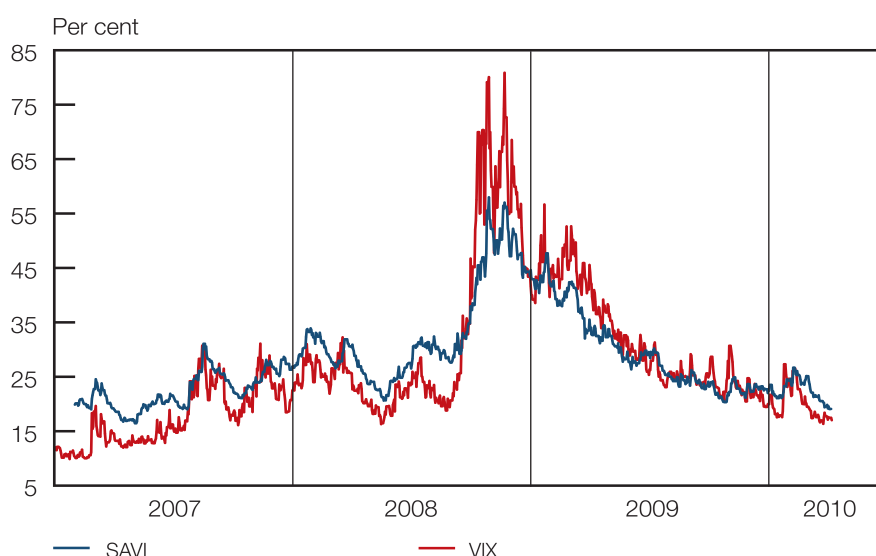
Source: Bloomberg

The South African Volatility Index (SAVI)[27] has been trailing the Chicago Board of Options Exchange (CBOE) Volatility Index (VIX).[28] In March 2010 the two indices were at almost the same level and trending downwards, intuitively implying less expected risk both in the global and domestic financial markets. Volatility in the South African market, therefore, still compares favourably with that in the developed markets.

27 The SAVI is calculated using implied volatilities from the Top 40 option prices and measures the expected level of volatility in the local equity market over an upcoming 90-day period.

28 The most referenced equity market volatility gauge in the world is the VIX, which is calculated using current Standard & Poor's (S&P) option-price data. It represents the consensus of option traders' forecasts for the S&P volatility over the next 30 days.

Figure 14 Volatility in equity markets



Sources: Data for the SAVI were obtained from the JSE Limited and data for the VIX were obtained from the Chicago Board of Options Exchange

External sector

29 The AGR is obtained by adding the annualised current-account deficit to short-term external debt to provide a measure of a country's total external financing requirements.

Foreign reserve-adequacy ratios continued to improve in the fourth quarter of 2009 (Table 8). The Guidotti ratio (GR), which is the ratio of foreign-exchange reserves to short-term external debt, improved to 1,59 implying that available foreign-exchange reserves were above the country's short-term foreign debt by about 59 percentage points. The improvement was due to a combination of an annual increase of 16,4 per cent in foreign-exchange reserves and a year-on-year decline of 13,9 per cent in the level of short-term debt. Over the same period, the augmented Guidotti ratio (AGR)[29] improved to 1,15 due to a further narrowing of the current-account deficit, indicating that existing foreign-exchange reserves were about 15 percentage points above the country's total short-term external financing requirements.

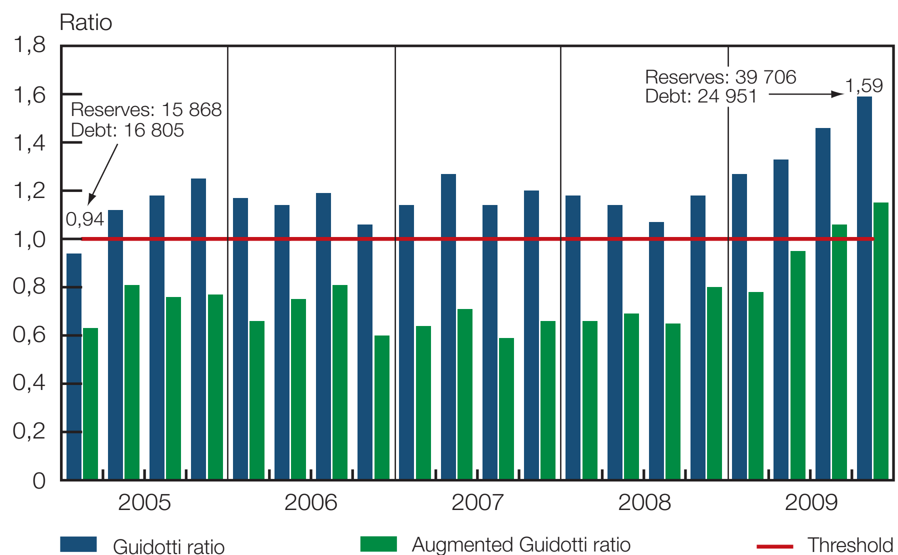
Table 8 Reserve-adequacy ratios

	US$ millions			Guidotti ratio	Augmented Guidotti ratio
	Gross foreign-exchange reserves[1]	Short-term foreign debt[2]	Current-account deficit		
2007: 2nd qr	28 279	22 319	-17 265,53	1,27	0,71
3rd qr	30 523	26 773	-24 834,64	1,14	0,59
4th qr	32 979	27 399	-22 526,87	1,20	0,66
2008: 1st qr	34 394	29 119	-23 117,78	1,18	0,66
2nd qr	34 854	30 507	-20 309,79	1,14	0,69
3rd qr	34 424	32 271	-21 035,79	1,07	0,65
4th qr	34 099	28 980	-13 622,68	1,18	0,80
2009: 1st qr	34 108	26 949	-16 595,58	1,27	0,78
2nd qr	35 760	26 961	-10 706,18	1,33	0,95
3rd qr	39 141	26 752	-10 090,59	1,46	1,06
4th qr	39 706	24 951	-9 670,19	1,59	1,15

1 Official foreign-exchange reserves comprise gross gold and other foreign-exchange reserves
2 Short-term debt (maturing within a year) includes all external debt of 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 15 Reserve-adequacy ratios[1]

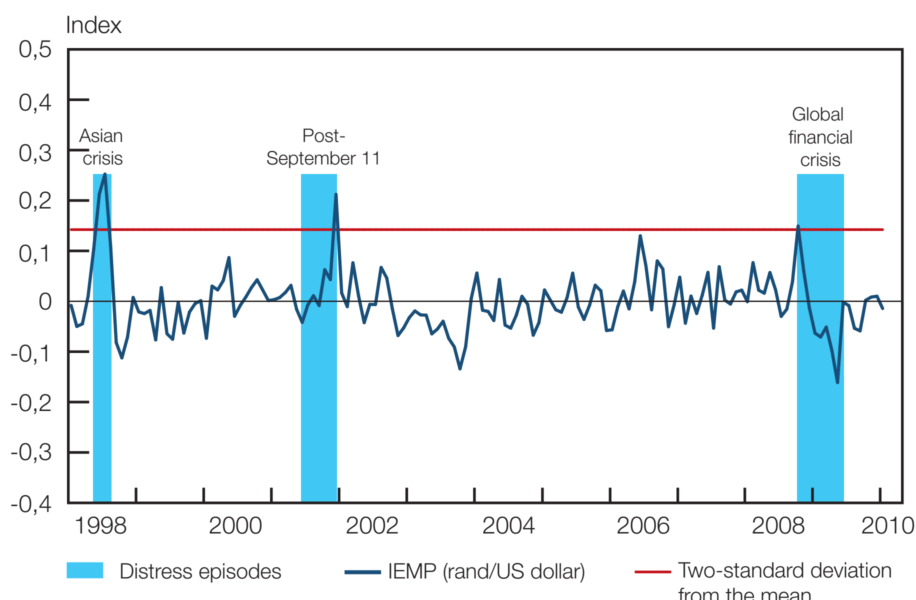


1 Figures for reserves and debt in US$ millions

Source: South African Reserve Bank

The index of exchange market pressure (IEMP) shows that the pressure experienced in the domestic foreign-exchange market during the final quarter of 2008, as a result of the global financial crisis, has since subsided. For the whole of 2009, the IEMP remained comfortably below the distress threshold. This should continue unless interest rates increase rapidly in the developed markets (especially in the US), which could result in capital outflows, thereby exerting pressure on the external value of the rand.

Figure 16 Index of exchange market pressure[1]



1 The IEMP 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 on the local currency and vice versa

Source: South African Reserve Bank

Corporate sector

Credit extended to the corporate sector continued to decrease, contracting by 4,7 per cent year on year in the fourth quarter of 2009. Business confidence increased to 28 index points in the fourth quarter of 2009, following persistent declines since the third quarter of 2006. The increase was mainly a result of increases in confidence of new vehicle dealers, and retail and wholesale traders. The improvement in business confidence is consistent with other leading indicators that generally precede a recovery in economic activity. Nevertheless, the index remained below 50, which implies that the majority of respondents to the survey were still rather pessimistic in their outlook.

Other indicators for the corporate sector confirmed that the sector was still under pressure. Following a marginal improvement in the third quarter, the net operating surplus contracted by 5,6 per cent in the fourth quarter. Furthermore, the corporate debt burden, as proxied by the ratio of credit to annualised profits, increased mainly as a result of declining profits.

Table 9 Selected indicators for the corporate sector

Annual percentage change, unless indicated otherwise

	2008	2009			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Bank credit granted[1]	12,3	8,6	-0,5	-3,9	-4,7
Gross fixed capital formation[2]	21,1	9,5	0,1	-9,3	-12,0
Credit as a percentage of GDP	37,1	36,9	35,4	34,2	33,1
Credit as a percentage of annualised profits[3]	182,8	205,7	167,9	170,5	184,4
Business confidence index[4]	33	27	26	23	28
Net operating surplus[5]	17,5	-4,0	-0,5	0,4	-5,6

1 Bank credit to the corporate sector in this case includes instalment sale and leasing finance, mortgage advances, overdrafts, credit card debtors, and other loans and advances
2 Gross fixed capital formation at current prices (seasonally adjusted rates) is used as a proxy for investment by private business enterprises
3 Bank credit to the corporate sector and net operating surpluses of corporations were used as proxies for corporate debt and for corporate profits respectively
4 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'
5 Gross operating surplus minus depreciation (seasonally adjusted rates)

Sources: South African Reserve Bank. Data on business confidence were obtained from Rand Merchant Bank/Bureau for Economic Research

The year 2009 was a challenging year for the corporate sector, among other things, because consumers avoided incurring expenses and banks maintained tight lending standards. Measured over a 12-month period, corporate liquidations increased by 10,1 per cent in December 2009. The highest number of liquidations for 2009 was recorded in the finance, insurance, real-estate and business services sector, followed by the wholesale and retail trade, catering and accommodation sector.

Table 10 Total number of liquidations by industry

Industry	2008	2009	
	Dec	Nov	Dec
Agriculture, hunting, forestry and fishing	1	1	7
Mining and quarrying	1	1	0
Manufacturing	13	15	13
Electricity, gas and water	2	1	3
Construction	12	19	18
Wholesale and retail trade, catering and accommodation	65	249	93
Transport, storage and communication	4	15	3
Finance, insurance, real-estate and business services	222	153	199
Community, social and personal services	27	33	46
Total number of liquidations	347	487	382

Source: Statistics South Africa

Household sector

The household sector experienced some financial strain as job losses constrained disposable income. Although most leading indicators show that the real economy may

have bottomed out in early 2009, consumers were, until the third quarter of 2009, still somewhat pessimistic about the future performance of the economy and its impact on their finances. In the fourth quarter of 2009 the level of consumer confidence increased by 5 index points to a level of 6 as consumers' perceptions about the future performance of the economy improved. However, the MasterCard Worldwide Index of Consumer Confidence,[30] which is also a forward-looking indicator, indicates that consumers in South Africa are less confident about the immediate future (59,3 points) than they were six months ago (67,3 points). According to this index, this trend was evident across four of the indicators, namely those measuring regular income, quality of life, the economy and employment.

30 The index determines the latest consumer confidence scores based on five economic indicators: the economy, unemployment, stock market, regular income and quality of life. The index score is calculated with 0 and under as the 'most pessimistic', 100 as 'most optimistic' and 50 being 'neutral', which indicates no change in confidence.

Table 11 Selected indicators for the household sector

Annual percentage change, unless indicated otherwise

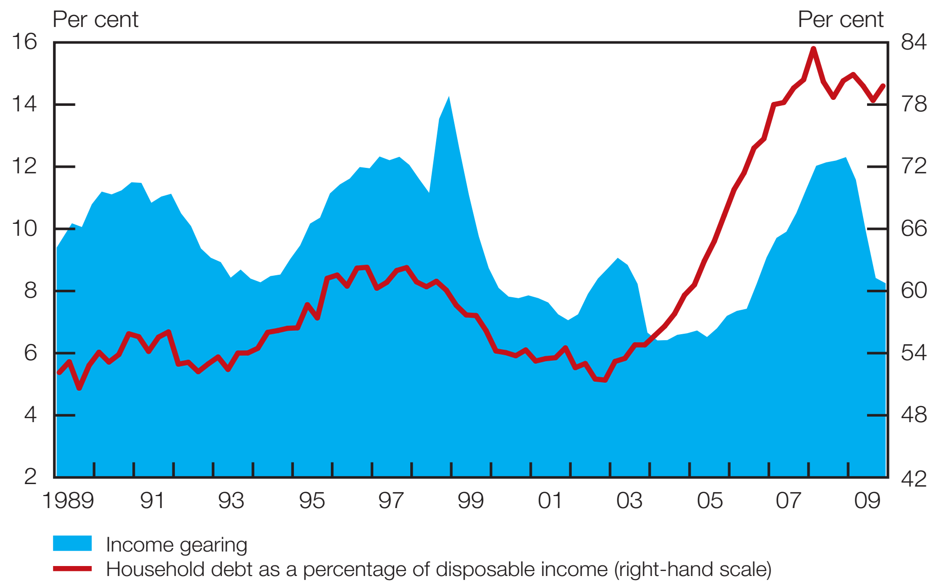
	2008	2009			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Nominal disposable income	9,3	7,5	4,6	2,7	2,7
Financial assets[1]	-7,7	-11,2	-12,5	0,9	9,0
Net wealth[2]	-7,0	-10,3	-12,0	1,5	9,7
Consumer confidence index[3]	-4	1	4	1	6
Consumption expenditure to GDP	61,4	61,6	61,6	61,1	58,9
Real consumption expenditure	-0,1	-2,2	-3,7	-3,8	-2,9
Credit extension	15,5	6,2	4,6	3,1	2,1
Savings as a percentage of disposable income	-0,4	-0,6	-0,6	-0,4	0,0
Debt	9,2	4,3	4,0	2,3	2,0
Debt to disposable income	80,3	80,9	79,8	78,4	79,8
Debt to GDP	49,1	49,5	48,8	47,7	47,0
Income gearing (per cent)[4]	12,3	11,6	9,9	8,4	8,2
Capital gearing (per cent)[5]	18,6	19,2	18,7	18,0	17,4

1 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 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 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 Bureau for Economic Research, the index can vary between -100 for extreme pessimism and +100 for extreme optimism, with 0 being neutral
4 'Income gearing' refers to financing costs of household debt as a percentage of disposable income. Data are preliminary
5 'Capital gearing' refers to household debt as a percentage of total assets of households. Data are preliminary

Sources: South African Reserve Bank. Data on consumer confidence were obtained from the Bureau for Economic Research, Stellenbosch University

Growth in credit extension to the household sector moderated throughout 2009, notwithstanding successive interest rate cuts during 2008 and 2009. The high rate of unemployment, still-tight lending conditions and a need to address the issue of weaker household balance sheets are expected to continue to impact consumption expenditure negatively. Household debt grew by a moderate 2,0 per cent year on year in the fourth quarter of 2009 as households attempted to contain their liabilities. As a percentage of disposable income, household debt increased marginally to 79,8 per cent in the fourth quarter from 78,4 per cent in the third quarter of 2009, after reaching a historical peak of 83,4 per cent during the first quarter of 2008.

Figure 17 Ratio of household debt to disposable income and income gearing



Source: South African Reserve Bank

31 The assessment of imbalances emerging is determined by comparing the actual values of the financial soundness indicators for the household sector to set thresholds, based on their mean and standard deviation over a specified period. If an indicator breaches the threshold, it issues a signal of a possible imbalance emerging.

As was already mentioned, job losses adversely affected the disposable income of households. The signal of imbalance[31] (Table 12) issued for growth in disposable income can also be ascribed, among other things, to job losses. Even though no signal of imbalance was issued for the annual growth rate of debt, it should be noted that signals of imbalances emerging were issued for the ratios of debt to GDP and debt to disposable income, suggesting that debt was generally growing at a disproportionate rate relative to GDP and income. A signal of imbalance was also issued for capital gearing, suggesting that debt is generally increasing at a disproportionate pace relative to the growth rate of total household assets.

Table 12 Financial soundness indicators for the household sector[1]

Annual percentage change, unless indicated otherwise

	Mean	Standard deviation	Threshold[2]	4th qr 2009	Signal issued
Disposable income	11,0	2,7	8,3	2,7	Yes
Financial assets[3]	13,1	11,3	1,8	9,0	No
Net wealth[3]	12,7	10,2	2,6	9,7	No
Debt	14,0	7,2	21,2	2,0	No
Debt to GDP (per cent)	39,2	5,5	44,7	47,0	Yes
Debt to disposable income (per cent)	62,0	9,6	71,7	79,8	Yes
Real consumption expenditure	3,7	2,6	1,1	-2,9	Yes
Consumption expenditure to GDP (per cent)	62,7	0,9	61,8	58,9	Yes
Credit extension	13,8	7,2	6,6	2,1	Yes
Income gearing (per cent)[3]	9,4	2,1	11,5	8,2	No
Capital gearing (per cent)[3]	15,6	1,2	16,8	17,4	Yes
Insolvencies	5,0	39,5	44,5	1,3	No
Summonses	1,9	12,4	14,3	3,2	No

1 Data start from the first quarter of 1993 and run to the fourth quarter of 2009, except for credit extension, which start from January 1995 and run to December 2009. The assessment of the vulnerability of the household sector to shocks involves the comparison of the threshold value to the actual value of each indicator
2 Threshold values have been set at one standard deviation from the mean. The standard deviation has been subtracted from the mean value for real consumption expenditure, consumption expenditure to GDP and credit extension in order to take the current phase of the economic cycle into account. The convention is to add standard deviation to the mean for these variables
3 Data are preliminary and based on work in progress at the Bank

Sources: South African Reserve Bank. Data on insolvencies and summonses were obtained from Statistics South Africa

The signals of imbalance issued for real consumption expenditure growth, the ratio of consumption expenditure to GDP and growth in credit extension are in line with the view that households seem to experience financial strain as a consequence of tough economic conditions following developments in the global economy. Even though no signal of imbalance was registered for insolvencies, it should be noted that this variable has a high volatility as reflected in the high standard deviation from the mean. The increase in the number of indicators issuing signals is an indication of the tough economic and financial conditions experienced by the household sector.

The financial vulnerability of consumers is also gauged by the Consumer Financial Vulnerability Index (CFVI), which is computed from the results of a survey (see Box 1 for more information on the CFVI). Even though the CFVI decreased from 5,48 in the third quarter of 2009 to 5,17 in the fourth quarter (Table 13) – suggesting improvement in the consumer financial vulnerability – the level of the CFVI indicated that the financial risk consumers were exposed to was still significant. Nevertheless, all components of the CFVI showed some improvement in the fourth quarter relative to the third quarter of 2009.

Table 13 Consumer Financial Vulnerability Index (CFVI)[32]

	2009		
	2nd qr	3rd qr	4th qr
Overall CFVI	5,17	5,48	5,17
Savings vulnerability index	5,74	5,90	5,40
Expenditure vulnerability index	5,54	5,45	5,26
Debt servicing vulnerability index	4,37	4,76	4,51
Income vulnerability index	5,64	6,03	5,81

Source: FinMark Trust

32 Vulnerability strata and score: 0,0–1,99 implies financially very secure; 2,0–3,99 implies financially secure; 4,0–5,99 implies financially somewhat vulnerable; 6,0–7,99 implies financially vulnerable; 8,0–10,0 implies financially very vulnerable.

Table 14 shows the percentage of consumers per income group that were, for the past three quarters, regarded as financially most vulnerable. It shows that the lowest income group has been the most vulnerable since the inception of the index. However, as job losses started increasing, the financial vulnerability of the groups earning more than R30 000 per year also increased. It is worth noting that the vulnerability of the top income group decreased somewhat in the fourth quarter of 2009.

Table 14 Percentage of consumers classified as most vulnerable according to income group

Income group	2009		
	2nd qr	3rd qr	4th qr
Earning below R30 000 per year	55,2	48,2	38,9
Earning between R30 000 and R100 000 per year	13,8	17,6	31,0
Earning above R100 000 per year	31,1	34,1	30,1

Source: FinMark Trust

According to the National Credit Regulator (NCR), the credit standing of consumers has continued to deteriorate somewhat (Table 15). Data show that the number of credit-active consumers increased to about 18 million in the third quarter of 2009 (from 17,8 million in the second quarter) and that the number of consumers with impaired credit records[33] increased to 8,1 million (representing 44,9 per cent of consumers) over this period.

33 An impaired credit record is a record on which any of the accounts are either classified as three or more payments in arrears, or has an adverse listing, or that reflects a judgement or administration order.

Table 15 Credit standing of consumers

In millions, unless indicated otherwise

	2008		2009		
	3rd qr	4th qr	1st qr	2nd qr	3rd qr
Credit-active consumers	17,5	17,6	17,6	17,8	18,0
Consumers in good standing	10,4	10,3	10,2	9,9	9,9
Consumers with impaired records	7,1	7,3	7,5	7,9	8,1
Percentage of consumers in good standing	59,5	58,4	57,6	55,9	55,1
Percentage of consumers with impaired records	40,5	41,6	42,4	44,1	44,9

Source: National Credit Regulator

Box 1 The Consumer Financial Vulnerability Index

The Consumer Financial Vulnerability Index (CFVI) was developed by the Bureau of Market Research (BMR) of the University of South Africa (Unisa) in collaboration with the FinMark Trust.[34] The first survey was conducted in the second quarter of 2009. Key informants were interviewed in order to understand the major areas of consumer vulnerability. The index is meant to explore vulnerability issues related to consumer income, expenditure, saving and debt-servicing obligations. In particular, its purpose is to measure and monitor consumer financial vulnerability, provide information on the financial vulnerability of consumers to stakeholders and policy-makers, and to send out early warning signals on financial stress of consumers.

The CFVI is composed of four sub-indices that are believed to be good indicators of consumer financial vulnerability. These indices are the following:

1. The income vulnerability index, which includes job security, income growth, social grants and the ability to access transfers from family and friends.
2. The savings vulnerability index, which is influenced by the savings and assets that a person can access during tough economic conditions.
3. The expenditure vulnerability index, which depends on various factors including whether a consumer is able to deal with rising costs of food and transport, or is living within its means.
4. The debt-service vulnerability index, which is driven by the cost of servicing debt and the level of debt consumers have.

34 Finmark Trust is an independent trust created with initial funding from the UK's Department for International Development, focusing on enhancing access to finance for the poor.

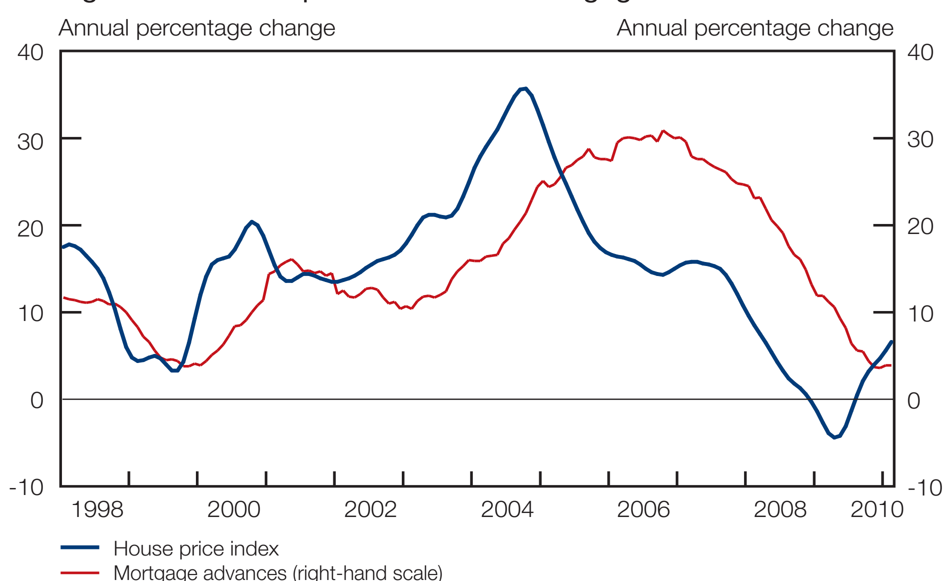
Residential real-estate sector

As the worst of the economic recession seems to be over, the residential property market is beginning to show some signs of recovery. According to the Absa House Price Index, annual growth in residential property prices turned positive in August 2009. According to the latest available data, this trend continued into 2010, increasing by 5,1 per cent in January and 6,6 per cent in February. Improved consumer confidence contributed to the recovery in the housing market. Despite this renewed upward trend in house prices, the moderate rate of increase in mortgage advances as reported by banks suggest that banks are still reluctant to extend credit.

Confidence in the residential property market improved more noticeably in the third quarter of 2009, following only mild improvements in the preceding three quarters. The Residential Property Confidence Indicator[35] (RPCI) recorded an increase from 4,8 in the second quarter to 5,7 in the third quarter of 2009, and remained on that level in the fourth quarter. Another sign of improved activity was the decrease in the average time that property remained in the market, which dropped further in the fourth quarter of 2009. The buy-to-let market also showed some improvement. However, the percentage of sellers willing to drop prices in order to sell properties increased in the fourth quarter of 2009. This could support the view that households may still be under financial strain.

35 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 house buyers visiting show houses.

Figure 18 House price index[1] and mortgage advances



1 The Absa House Price Index is based on the total purchase price of houses in the 80 m^2–400 m^2 size category valued at R3,1 million or less in 2008 (including improvements), in respect of which loan applications were approved by Absa. Prices are smoothed in an attempt to exclude the distorting effects of seasonal factors and outliers in the data

Sources: South African Reserve Bank. Absa Bank Limited supplied data for the house price index

Table 16 Activity level in the residential property market and the business confidence level of contractors

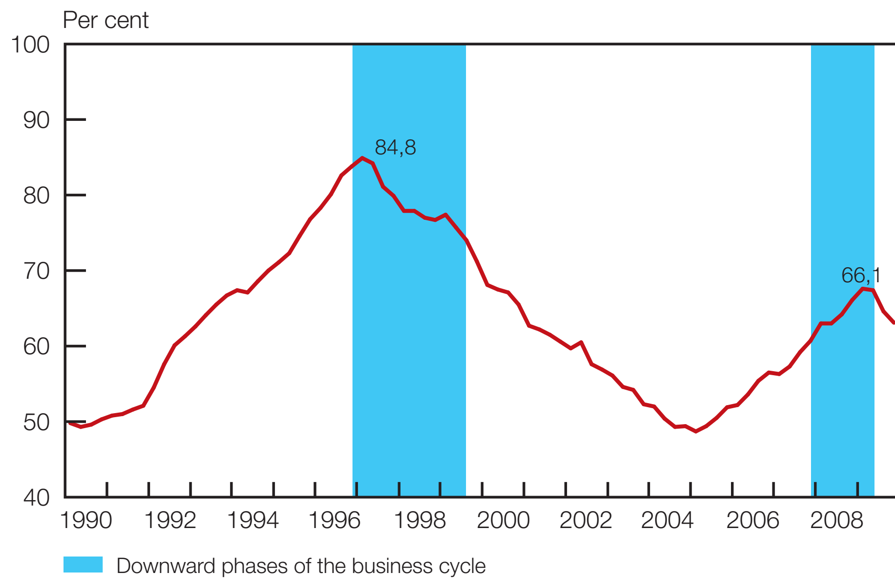
	2008	2009			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Residential property confidence indicator	4,6	4,8	4,8	5,7	5,7
Average time property remains in the market (days)	108	123	148	116	93
Percentage of sellers willing to drop prices	81	86	86	83	89
First-time buyers as a percentage of total buyers	17	15	14	15	19
Buy-to-let as a percentage of total buying	12	11	11	13	13
Business confidence indices					
Residential contractors index	34	26	17	19	21
Non-residential contractors index	59	51	36	33	30
Composite building confidence index[1]	40	28	30	32	28

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

Source: First National Bank. Data on business confidence were obtained from the Bureau for Economic Research

The confidence level of residential building contractors increased in the third and fourth quarters of 2009. Over the same period, the confidence level of the non-residential building contractors continued to deteriorate, weighing heavily on the composite building confidence index. The business operations of non-residential building contractors were still constrained by a lack of demand for building work.

Figure 19 Mortgage debt as a percentage of market value of housing



Source: South African Reserve Bank

The ratio of mortgage debt to the market value of housing remained high. The high ratio can be ascribed to a combination of a decline in house prices, coupled with a still-high level of mortgage debt following an extended period of favourable macroeconomic conditions and a fairly-low interest rate environment. However, at its peak in the current downward cycle (66,1 per cent in the first quarter of 2009), the ratio is still below the peak of 84,8 per cent recorded during the previous cyclical downturn (Figure 19). The ratio has been trending downwards in recent quarters, a combined result of the still-tight lending conditions of banks and the recovery in house prices.

Infrastructure and regulation

This section of the *Financial Stability Review* considers developments in the financial infrastructure and regulatory environment. It begins with an update on significant South African financial legislation and infrastructural developments that impact on the domestic financial sector, followed by a discussion of the challenges relating to the debt counselling process in South Africa.

Update on policy, and legislative and infrastructural developments affecting the South African financial system

The Bank's financial stability role

Following the international financial crisis, the financial stability responsibilities of various central banks have become more explicit. The financial crisis has demonstrated, in general, that although microprudential supervision makes a valuable and indispensable contribution to financial stability, it may be insufficient on its own to ensure systemic financial stability. For this reason, a macroprudential approach to policy formulation may be helpful in complementing microprudential supervision and monetary policy. The aim of such a policy would be to smooth out the impact of the economic cycle on the financial system and contain the build-up of systemic risks in the financial system as a whole. Macroprudential policy instruments need to be developed to reduce systemic risks or imbalances, while distinguishing them from conventional policy instruments. Macroprudential policy should nevertheless be harmonised with microprudential policy and monetary policy. (See Box 2 "Generic attributes of macroprudential policy instruments".)

The Bank's primary objective, as entrenched in the Constitution of South Africa, is to protect the value of the currency in the interest of balanced and sustainable growth. The Minister of Finance recently issued a statement regarding the Bank's mandate[36] stating, among other things, that balanced and sustainable growth should not give rise to an unsustainable balance-of-payments position or unsustainable debt burdens for the private and public sectors. The Minister emphasised the importance of a stable and well-regulated financial sector, and the need for central banks to have a deeper understanding of the banking sector and financial stability, which requires greater focus on macro- and microprudential analysis, regulation and supervision. The role of the Bank in overseeing and maintaining financial stability was thus clearly reaffirmed.

36 Letter from Minister Pravin Gordhan to Governor Gill Marcus, dated 16 February 2010, and titled "Clarification of the Reserve Bank's mandate". Available online at: www.treasury.gov.za.

As the monetary authority and the ultimate provider of liquidity to South Africa's financial system, the Bank has an interest in promoting the safety and efficiency of the financial system in order to withstand shocks. The regulation and supervision of banks, the oversight of the national payment system (NPS), the administration of exchange controls, the provision of emergency liquidity assistance and the daily management of liquidity conditions in the money market give the Bank considerable influence on macroprudential policy matters. The Bank is, therefore, in the process of developing an integrated framework for a macroprudential policy approach to achieve its financial stability objectives.

However, the achievement of financial stability, whether domestically or internationally, will always have to be a co-operative and joint effort by the various stakeholders, making it a shared responsibility.

Box 2 Generic attributes of macroprudential policy instruments

'Macroprudential policy instruments' can be defined as instruments capable of reducing systemic risks or imbalances before they reach their apex, at which point the financial system becomes excessively vulnerable to disruptions and/or crises, resulting in macroeconomic costs. Instruments used for macroprudential policy are generally characterised by a number of attributes, which distinguish them from conventional monetary policy instruments and microprudential policy instruments. These include the following attributes:

- Macroprudential policy instruments have a financial stability objective, which is much broader than the conventional price stability objective of monetary policy authorities or the institutional stability objectives of microprudential supervisors.
- These instruments are aimed at the financial system in aggregate and not its individual components. Just as systemic risk is not equal to the aggregate of individual risk exposures, macroprudential supervision is not equal to the aggregate result of microprudential supervisory measures. It also encompasses more than consolidated or cross-border supervision.
- Macroprudential policy instruments are designed to counter the inherently procyclical nature of banking and finance.
- These instruments are focused on limiting excess credit growth, which represents an endogenous source of self-feeding asset bubbles that are also associated with perceived lower risk at the level of the individual firm, thus disguising the build-up of systemic risk. In a macroprudential context, excess credit growth is a risk in itself. This is in contrast to monetary policy, which normally only considers the possible inflationary effects of credit growth.
- Macroprudential policy instruments are concerned with systemic inter-linkages, rapidly increasing large exposures and risk concentrations. This information should not only take into account the banking sector, but financial markets, financial market infrastructure and systems, and large non-bank financial institutions and other corporates that are systemically significant.

Rectification[37] of the Companies Act

The Department of Trade and Industry (dti) confirmed, through publication in *Government Gazette* No. 32832 dated 22 December 2009, that there are errors in the Companies Act, 2008 (Act No. 71 of 2008) (Companies Act) that require rectification. Although some commentators were expecting substantive amendments to what critics regarded as flaws in the Companies Act, the dti advised that the identified errors were confined to syntax and technical errors, incorrect reference and cross-referencing, omission of words and inconsistency of provisions. The affected sections were tabulated in the *Government Gazette*, and stakeholder comments were requested by 19 February 2010. The modernisation of company law in South Africa is long overdue and it is important that the rectification process does not delay implementation unduly.

37 The purpose of the rectification process is to correct mistakes that have occurred during the processing of the Companies Bill through Parliament.

Regulations to the Companies Act

Pursuant to the promulgation of the Companies Act, the dti published the draft regulations in *Government Gazette* No. 32832, with the deadline for public comments having been 1 March 2010. The regulations are intended to assist in the implementation of the provisions prescribed in certain key chapters of the Companies Act. These include regulations relating to business rescue, accountability and transparency, company accounting records and financial reporting standards.

Draft Tax Administration Bill

The Draft Tax Administration Bill was released for public comment, with a deadline of 26 February 2010.[38] The proposed Bill is envisaged as a consolidation of the existing tax Acts (excluding the Customs and Excise Act, 1964 (Act No. 91 of 1964) (as amended) into a single body of law in preparation for the further modernisation of the administration of existing tax legislation.

38 Further information on subsequent developments was unavailable at the time of going to print.

While the Bill introduces a number of changes, of particular relevance are the provisions relating to the powers of search and seizure without a warrant and the provisions to secure the collection of taxes from taxpayers who pose a default risk. The power to seize assets for up to 24 hours pending a court order preventing the sale of assets can influence an account holder's ability to transact, with the concomitant impact on counterparties. Presumably, these provisions will be invoked where large amounts are involved, which can adversely affect various interlinked financial transactions.

South African Postbank Bill

The Department of Communication has tabled the South African Postbank Bill, (B14 – 2009) (Postbank Bill) which is currently under consideration by the Portfolio Committee on Communication. The objective of the Postbank Bill is, among other things, to provide for the incorporation of the Postbank Division of the South African Post Office. In addition to its incorporation as a legal person, section 2 of the Postbank Bill provides for conducting the business of a bank to encourage and attract savings, render transactional services and lending. In this regard, section 4(2) makes provision for the Postbank to be registered as a bank after it has satisfied the requirements of the Banks Act, 1990 (Act No. 94 of 1990) (Banks Act). However, section 28(b) states that, until the Postbank is registered as a bank, it must be regarded as a legal person authorised to conduct the business of a bank. These provisions appear to vest the Postbank with the authority to act as a bank and conduct the business of a bank without it having as yet complied with the prescribed regulatory conditions usually required of banks and entities wishing to register as banks. Such a situation may present some practical and operational challenges in terms of the compatibility and integration of the above provisions with the existing bank regulatory regime and its application within the financial sector.

Draft proposed amended Regulations relating to Banks

In March 2010, the Bank Supervision Department of the Bank issued for public comment proposed amended Regulations relating to Banks (Proposed Regulations).[39] The amendments intend to capture, among other things, new capital enhancement measures as published by the Basel Committee on Banking Supervision (Basel Committee) on 13 July 2009, to strengthen, *inter alia*, the 1996 rules governing the trading-book capital of banks, and the Principles for Sound Compensation Practices and their related Implementation Standards issued by the Financial Stability Board (FSB) in April and September 2009 respectively.[40]

The Basel Committee's capital enhancement measures include the capturing of credit and market risk of complex trading activities, a stressed value-at-risk requirement to dampen the procyclicality of the minimum regulatory capital framework and the enhancement of the three pillars of the Basel II framework. The Proposed Regulations have been changed accordingly, and also include minimum corporate governance aspects on sound compensation policies, processes and practices. Among these are the deferral of variable compensation payments over longer periods to take into account the degree of risk assumed to generate the profit, and adequate disclosure to stakeholders.

Amendment of regulation 28 under the Pension Funds Act

On 17 February 2010 the National Treasury published proposed amendments to regulation 28 of the Pension Funds Act, 1956 (Act No. 24 of 1956) for public comment.

39 The proposed amended Regulations relating to Banks can be at accessed at www.reservebank.co.za. The closing date for comments is 30 April 2010.

40 Comprehensive details of the package of capital enhancement measures announced by the Basel Committee on 13 July 2009 can be accessed at www.bis.org. The documents issued by the FSB are available at www.financialstabilityboard.org.

Regulation 28 prescribes limits and the extent to which pension funds may invest in particular asset classes. One of the main objectives of the amendment is to bring the definitions contained in regulation 28 in line with definitions in the Security Services Act, 2004 (Act No. 36 of 2004), and the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002), and to provide for Islamic-compliant instruments.

The amendments are intended to allow for more efficient and effective portfolio management and proper disclosure of investment vehicles, and to guard against abusive practices. The closing date for submitting comments on the proposed amendments was 16 April 2010. See Box 3 for a summary of some of the key amendments to regulation 28.[41]

41 For more information, visit the National Treasury website at www.treasury.gov.za and the Financial Services Board website at www.fsb.co.za.

Box 3 Summary of some key amendments to regulation 28 under the Pension Funds Act

The following are some of the key amendments to regulation 28:

– *Derivatives*: At present regulation 28 does not accommodate modern investment products, such as derivatives, and does not take into account market developments over the past decade, particularly with respect to a significantly altered exchange control regime. 'Derivative instruments' have been defined in the proposed amendment, and investment in derivatives is permitted subject to provisions and conditions to be prescribed by the Registrar of Retirement Funds. It is intended that investment in derivative instruments should be permitted for purposes of efficient portfolio management and hedging of an investment held by the fund. Derivative investments will not be allowed for leverage purposes.
– *Foreign investments and exchange control*: This is to align regulation 28 with exchange control regulations that allow pension funds to invest up to 20 per cent of their assets in investments outside of South Africa.
– *Foreign investments in Africa*: This is to align regulation 28 with exchange control regulations that allow pension funds to invest an additional 5 per cent of their foreign exposure limit of 20 per cent for investment in African countries.
– *Securities lending*: To generate income for pension funds and promote capital market liquidity, pension funds are permitted to engage in securities lending, subject to limits and conditions to be prescribed by the Registrar of Retirement Funds. This is to protect the solvency and liquidity of pension funds and enhance members' retirement benefits.

Regulation of electronic money in the payment system environment

The utilisation of new types of payment technology such as mobile telephones[42] and chip cards is encouraged by the World Bank and other organisations as they, among other things, lower the cost of remittance payments around the world. Electronic money (e-money) is viewed as one such potential growth area in the payment system environment. 'E-money' is defined as "money stored electronically and issued on receipt of funds, is generally accepted as a means of payment by persons other than the issuer and is redeemable for physical cash or a deposit into a bank account on demand".[43] Since it is important that payment system regulators understand and anticipate developments to ensure the continued smooth functioning of payment systems, the Bank published a revised position paper[44] on e-money and related products in November 2009. The purpose of the paper was to outline the Bank's position with regard to all forms of e-money and to clarify the fundamental principles regarding e-money and its regulation.

42 The use of mobile person-to-person transfers is considered to be one of the best methods to achieve this objective in a cost-effective manner. Several schemes of this nature have already been launched around the world.

43 See Position Paper NPS 01/2009, p. 3.

44 Position Paper NPS 01/2009 is available at www.reservebank.co.za. The Bank first published a position paper on e-money in 1999 and revised it in April 2006. The 2006 position paper did not detract significantly from the 1999 paper, since e-money had not developed as was originally envisaged.

Overview of the main changes to the e-money position paper

Changes to the e-money position paper include the definition of e-money and clarification of the difference between the business of a bank (or deposit-taking institution) and auxiliary services that non-bank service providers may provide in terms of e-money. One of the main issues addressed in the e-money position paper is the

definition of a 'deposit', as contemplated for e-money purposes, relative to the definition in the Banks Act.[45] The e-money position paper describes a 'deposit' as an amount of money paid by one person to another person subject to an agreement in terms of which an equal amount or any part thereof will be repaid on demand, on a specified or unspecified date or in circumstances agreed upon. In terms of the position paper, e-money, when evaluated in terms of the Banks Act, is considered to be a deposit and only banks[46] are allowed to take deposits and therefore issue e-money.

45 The Banks Act, 1990 as amended, is available at www.reservebank.co.za.

46 'Banks' in this context means the South African Reserve Bank, a commercial bank, a mutual bank, a co-operative bank or branch of a foreign institution.

A number of non-bank institutions have approached the Bank with proposals to provide e-money services that would allow users of their prepaid issued payment instruments to purchase goods and services. In addition, many of these non-bank entities propose to provide an additional person-to-person transfer or remittance service wherein the beneficiary can redeem the value at a participating service provider. This would imply that the non-bank institution concerned would have control of the pool of funds that would accumulate between the time of deposit and the time of withdrawal.

The Bank is supportive of e-money developments, but it was deemed not appropriate and in contravention of banking legislation to allow non-bank institutions to issue and acquire e-money due to the deposit-taking nature of e-money. Non-banks have other opportunities to enter into agreements with banks to provide auxiliary payment-related services subject to regulatory approval by the Bank Supervision Department of the Bank.[47]

47 These auxiliary payment-related services typically refer to when a non-bank institution enters into a joint venture or partnership to provide services, such as the Shoprite money-market service with Capitec, FNB with Paypal and MTN with Standard Bank.

In line with its role and oversight responsibility, the Bank will continue to assess the benefits that new payment innovations could provide to South Africa, including the utilisation of such innovations and developments for enhancing efficiency and access to financial services into the payment system arena.

Dematerialisation of money-market instruments and securities

On 22 February 2010 South Africa's Central Securities Depository (CSD), Strate Limited, officially added the electronic settlement of money-market instruments to its portfolio of services, following a lengthy and complex process that started in 1999 to replace the manual paper-based system.[48] These services include same-day settlement (T+0), electronic recording of trades in money-market securities, and electronic clearing and settlement of money-market trades.[49] This is a significant milestone for the South African financial markets and its international status, as it leads to efficiencies and a reduction in risks through the dematerialisation of securities.

48 The South African financial markets experienced a dramatic rise in incidences of theft and fraud involving money-market instruments and, as such, a forum of industry representatives was formed with the goal of immobilising or dematerialising these instruments.

49 Further details can be found at Strate Limited's website at www.strate.co.za.

An electronic money-market environment can enhance the robustness of the settlement infrastructure in several dimensions as it provides a platform for consistent settlement processes (irrespective of the security or the issuer) and the settlement of transactions on a real-time, same-day (T+0) basis, thus providing synchronised delivery and payment. Such straight-through processing is achieved by means of an automated and streamlined end-to-end process, thereby enabling all eligible market participants to have timely and comprehensive information at their disposal.

Fundamental principles and strategies adopted

Some of the fundamental principles and strategies that were adopted in developing the electronic-settlement environment in South Africa include the following:

- All money-market securities are issued, traded and settled electronically.
- All money-market coupon and maturity payments are settled electronically.
- Money-market securities are standardised into four broad categories, namely

i discount-based, fixed-term securities;
ii yield-based, fixed coupon rate and fixed-term securities (interest only payable on maturity);
iii yield-based, variable coupon rate and fixed-term securities; and
iv yield-based, variable coupon rate and variable term securities.

- The Securities Ownership Register (SOR) held at the CSD (Strate) is regarded as the "definitive record of ownership".
- All money-market trades are settled on a gross "principal-to-principal" basis.

A number of preventative measures were implemented before switching over to the electronic settlement of money-market instruments in order to manage any potential liquidity problems. Since the implementation, the South African Multiple Option Settlement (SAMOS) operations team, together with participants in the money-market system, has monitored the availability of payment liquidity closely to ensure that participants meet their payment funding requirements. During this time no adverse liquidity experiences were observed.

Progress made on some key elements of the current international regulatory reform agenda

The global financial crisis has led to wide-ranging debate on the need to enhance the international regulatory framework in order to strengthen the global financial system and improve its resilience to shocks. The proposals for reform have gone beyond banking sectors and have been expanded to include insurance industries, ratings agencies, hedge funds and accounting standards. This section provides a brief account of selected regulatory reforms[50] that are being discussed internationally and the possible impact of such proposals on the financial sector in South Africa.

50 The higher-level principles of some of these regulatory reforms were covered in the March and September 2009 editions of the *Financial Stability Review*. This section addresses the substantive proposals issued to date by the Basel Committee and other standard-setting bodies.

Proposals for the banking sector relating to capital

In December 2009 the Basel Committee released its consultative document titled "Strengthening the resilience of the banking sector". This document covers a number of proposals with respect to the treatment of capital for regulatory purposes, which include:

- *Raising the quality, consistency and transparency of the capital base*: The proposal involves increasing substantially the common shares and retained earnings portion of capital so that it constitutes the bulk of Tier 1 capital, simplifying and harmonising Tier 2 capital, and eventually abolishing Tier 3 capital. The aim is to improve the quality of capital and to raise the importance of common equity in ensuring solvency. The quality of Tier 1 capital will also be strengthened by the exclusion from its scope of stock surpluses (share premiums), goodwill, deferred tax assets and other intangible items.
- *Enhancing the risk coverage of the capital framework*: The aim of this proposal is to better align the capital requirements arising from banks' derivatives, repurchase agreements ('repos') and securities financing activities with the risks associated with these assets. It presents measures to raise counterparty credit risk capital requirements and risk management standards, taking into account, among other things, stressed inputs, mark-to-market losses associated with a deterioration of the credit-worthiness of a counterparty, and collateral management. It also includes incentives to move over-the-counter (OTC) contracts to central counterparties.
- *Implementing a leverage ratio*: The use of a leverage ratio is intended to address the build-up of leverage and reduce the destabilising effects of deleveraging processes. The introduction of a measure such as a leverage ratio, which is not based on risk-weighted assets, will reinforce and supplement the risk-based measures of the Basel II framework. The leverage ratio will be harmonised internationally to ensure

cross-border comparability. It is proposed that the leverage ratio be based on defined capital and total exposure or assets measures and that off-balance sheet items be appropriately integrated.

- *Promoting countercyclical capital buffers*: The focus is on mitigating and reducing procyclical dynamics in the financial system and introducing measures that make the banking sector more resilient to, and less of an amplifier of, such dynamics. Proposed measures include the build-up of capital buffers, the promotion of forward-looking provisions by advocating a change in accounting standards towards an expected-loss approach and the favouring of capital conservation during periods of excessive credit growth.
- *Addressing systemic risk and interconnectedness*: Practical approaches to assist supervisors in measuring the importance of banks to the stability of the financial system and the real economy are being developed by the Basel Committee. Initiatives in this area will contribute to a broader effort by the FSB to address the risks of systemically important financial institutions.

Liquidity risk management

The Basel Committee also issued the “International framework for liquidity risk measurement, standards and monitoring” in December 2009, which is aimed at increasing the resilience of the banking sector to liquidity stress. This document proposes the introduction of two new international standards (metrics) to assist supervisors to assess both the adequacy of a bank's ability to survive a liquidity squeeze and the overall management of the liquidity profile of its balance sheet. (For further details on these two standards refer to Box 4.)

Box 4 New liquidity standards proposed by the Basel Committee on Banking Supervision[51]

The Basel Committee on Banking Supervision (Basel Committee) has developed two internationally consistent regulatory measures for liquidity-risk supervision, namely (i) the liquidity coverage ratio (LCR) and (ii) the net stable funding ratio (NSFR).

The LCR focuses on the short-term resiliency of the liquidity risk profile of financial institutions. The LCR identifies the amount of unencumbered, high-quality liquid assets an institution holds that can be used in a stress scenario to offset the net cash outflows it would encounter over a 30-day period. The LCR consists of two components, namely, (i) value of the stock of high-quality liquid assets and (ii) net cash outflows, both of which are calculated according to set parameters. The LCR is defined as:

$$\text{LCR} = \frac{\text{Stock of high-quality liquid assets}}{\text{Net cash outflows over a 30-day period}} \geq 100 \text{ per cent}$$

This standard would require that the value of the ratio be no lower than 100 per cent (i.e., the stock of liquid assets should at least equal the estimated net cash outflows). Current proposals are that banks might be expected to maintain a 30-day liquidity coverage ratio to strengthen their resilience to a liquidity crisis.

The NSFR aims to promote the resilience of financial institutions over the longer term, based on the liquidity characteristics of an institution’s assets and activities over a one-year horizon. The NSFR measures the amount of stable funding sources available to an institution relative to the liquidity profiles of the assets funded plus the potential liquidity demands arising from off-balance commitments. The NSFR is defined as:

$$\text{NSFR} = \frac{\text{Available amount of stable funds}}{\text{Required amount of stable funds}} > 100 \text{ per cent}$$

The current proposal would require that this ratio be above 100 per cent. These are minimum levels of liquidity for internationally active banks and national supervisors may increase and extend the scope thereof in their respective jurisdictions. The liquidity proposals also include a number of monitoring tools to assist supervisors in assessing and tracking liquidity stress in financial institutions.

51 BIS. Basel Committee on Banking Supervision. 2009. Consultative document: “International framework for liquidity risk measurement, standards and monitoring”, December.

The proposed time frame for the international implementation of the capital and liquidity reforms is between 2010 and 2012. An impact assessment, in which South Africa is also taking part, is being made in the first half of 2010. Based on this assessment and all the elements of the Basel Committee reform package, a fully calibrated set of standards is expected to be developed by the end of 2010 for implementation by the end of 2012.

Accounting standards

In November 2009, the International Accounting Standards Board (IASB) published a new International Financial Reporting Standard (IFRS) 9: *Financial instruments* on the classification and measurement of financial assets. Financial assets are classified in one of two measurement categories, namely (i) amortised cost or (ii) fair value. The classification is based on the way in which the instrument is managed in the entity's business model (e.g., as a loan) and its contractual cash-flow terms. The category into which the asset is classified determines whether it is measured on an ongoing basis at amortised cost or at fair value. IFRS 9 elaborates further on the conditions for amortised cost, the application of the fair value option, the accounting of hybrid contracts, the reclassification after initial recognition and related matters.

The IASB followed a phased-in approach to the adoption of the new requirements in the classification and measurement of assets. IFRS 9 was to be adopted on a voluntary basis for the 2009 financial year-end, but entities must apply the new requirements by no later than the financial years beginning on or after 1 January 2013. The publishing of IFRS 9 completed Phase 1 of a three-phase project to replace International Accounting Standard (IAS) 39: *Financial instruments: Recognition and measurement*. The second and third phases of the project concern the impairment of financial instruments, which is intended to address the move to an expected loan-loss-provisioning model from an incurred-loss model. The IASB also published an exposure draft *Financial instruments: Amortised cost and impairment* in November 2009 and it is expected that an exposure draft addressing hedge accounting will be published in early 2010.

Compensation practices

In January 2010 the Basel Committee issued the *Compensation principles and standards assessment methodology*, which provides supervisors with a guide to assess individual firms' compensation practices and compliance with the compensation principles outlined earlier by the FSB.[52] The FSB principles had defined three key areas that needed to be addressed. These are (i) effective governance of compensation by boards of directors, (ii) alignment of compensation and its various forms with prudent risk-taking measures and the time horizons of the related risks, and (iii) effective supervisory oversight and disclosure to facilitate engagement by stakeholders.

The assessment methodology contains sufficient flexibility for supervisors to implement the principles effectively as it makes allowances for national conditions and for the differences between individual firms. The principles were incorporated in July 2009 as supplementary guidance to Pillar 2 of the Basel II framework and the methodology is expected to serve as a tool to conduct the FSB peer review on compensation practices scheduled for the first part of 2010.[53] South Africa is participating in the peer-review exercise. Early efforts with regard to compensation had been undertaken by the South African banking supervisor in 2008, when aspects such as the governance of compensation practices and its alignment and management within an approved risk framework were discussed with banks.

52 Financial Stability Forum. 2009. *FSF Principles for Sound Compensation Practices*, April. (The Financial Stability Forum is the FSB's predecessor.) Available online at: www.financialstabilityboard.org.

53 BIS. Basel Committe on Banking Supervision. 2009. *Enhancements to the Basel II framework*, July. Available online at: www.bis.org/publ/bcbs157.htm.

Too-big-to-fail problems and systemically important financial institutions

Systemically important financial institutions (SIFIs) that fail have the potential to impose very significant socio-economic costs on society. Large-scale financial support for distressed SIFIs accentuates the moral-hazard problems associated with these "too-big-to-fail" (TBTF) institutions. The call by the Group of Twenty (G-20) leaders requiring the FSB to provide proposals by the end of 2010 has resulted in a number of policy proposals aimed at reducing the probability and impact of SIFI failures. These proposals range from strengthening the resilience of SIFIs by, for example, constraining their size or activities, to increasing their capital and increasing the intensity of their regulatory supervision.

To enable the financial system to deal with the failure of an SIFI more appropriately, these proposals focus on, for example, improving resolution capabilities of authorities and lessening contagion risks. While there will be a number of lessons for authorities in dealing with SIFIs, it is unlikely at this stage that a single approach will be appropriate for all countries and all SIFIs. The policy choices of authorities are most likely to be shaped by the size and nature of the financial system, the specific features of individual SIFIs (including their cross-border linkages), and the capacity of the national authorities to address the failure of these institutions. However, the availability of a broad range of tools and a consistent approach will assist authorities in dealing with the TBTF and SIFI challenges.

Possible implications of the proposed regulatory reforms for South Africa

The proposed regulatory changes currently on the international agenda are broad and potentially far-reaching for many countries and regulators. South Africa's commitments to the multilateral forums where these reforms are being discussed have resulted in a keen monitoring of the regulatory reform proposals and their possible impact (see Box 5 for recent announcements by South Africa's Minister of Finance in this regard). It should be clear that not all these reform proposals are equally appropriate for South Africa. Part of South Africa's focus of participation is to ensure that regulatory changes take into account South Africa's unique circumstances.

Should the current international proposals on capital adequacy, compensation and liquidity be formalised, it is likely to also be implemented in a South African context.[54] Fortunately, the efforts of the banking supervisor in encouraging the domestic banking sector to improve the level and quality of capital, and to implement prudent compensation practices in the domestic market, go back several years.

54 Refer also to the discussion under legislative developments for an update on the draft proposed amended Regulations relating to Banks, published to accommodate new BCBS capital measures.

South African banks, on an aggregated basis, at present comfortably exceed the current minimum liquid asset requirement. According to market researchers, the potential changes will have cost implications as banks are expected to increase their holdings of lower interest-earning liquid assets that may negatively affect banks' profitability. Changing the liquidity structure of banks' balance sheets, such as replacing short-term funding with increasing proportions of longer-term funding, will be one of the challenges. Effecting changes to the liquidity structure of banks' balance sheets presents policy-makers and regulators with difficult policy decisions that may require a phasing-in approach. The outcome of the quantitative impact studies should provide further clarity on this matter.

South African banks are not considered to be highly leveraged and leverage ratios, although monitored, are currently not formally part of the prudential regulations.[55] The implementation of a uniform leverage standard internationally will allow for cross-country comparison of banks' leverage ratios.

55 For further details on leverage, refer to the section on "Financial leverage and banks' financial position" on pages 45–46 in the March 2009 edition of the *Financial Stability Review*.

Box 5 Announcements by the Minister of Finance on the global regulatory reform agenda

South Africa's financial system has to date been fairly resilient to the global financial crisis and no financial institution has required assistance or a bail-out. South Africa is an active participant in the Basel Committee on Banking Supervision (Basel Committee), Financial Stability Board (FSB) and Group of Twenty (G-20) initiatives to strengthen the global financial regulatory framework and system. In October 2009 the Minister of Finance signalled his intention to continue aligning the domestic prudential regulations on financial institutions with developments taking place in international forums. He drew attention to progress being made in developing a systemic risk (macroprudential) approach to financial regulation, raising the quality and level of capital, making the regulatory framework less procyclical, expanding regulation to other risk areas, ensuring appropriate guidelines for compensation practices, and improving accounting standards.[56]

56 National Treasury. 2009. *Medium Term Budget Policy Statement*, October.

In the February 2010 *National Budget Speech*, the Minister cautioned against complacency and highlighted specific initiatives to improve South Africa's regulatory framework. These include the following:[57]

57 National Treasury. 2010. *National Budget Speech*, February.

– Strengthening the framework for accountability, co-ordination and performance of the financial regulators.
– Reviewing adherence to global regulatory standards in banking, insurance and securities markets.
– Various changes to the Basel II framework that will be implemented once the impact assessment is completed.
– Expanding the scope of regulation to include hedge funds, private equity and credit ratings agencies.
– Improving crisis contingency plans.

Recent developments relating to co-operative banks

Through the introduction of the Co-operative Banks Act, 2007 (Act No. 40 of 2007) (the Act), which was implemented in August 2009, member-based co-operative financial institutions (CFIs) are, for the first time in South Africa, acknowledged as part of the banking sector. In 2009 the Co-operative Banking Supervision Unit (CBSU) was established in the Bank and the Co-operative Banks Development Agency (the Agency) was formed under the auspices of National Treasury.[58] The CBSU and the Agency finalised the Regulations issued in terms of the Act, stipulating the prudential requirements to be adhered to. The Supervisors' Rules, containing the administrative requirements to be met, were issued in January 2010, thereby paving the way towards the registration of the first co-operative banks in South Africa. (See Box 6 for an explanation of the nature of co-operative banks.)

58 The CBSU is responsible for the registration and supervision of the larger primary co-operative banks (i.e., primary co-operative banks with at least 200 members and with deposits in excess of R20 million), all secondary co-operative banks and all tertiary co-operative banks. The Agency is responsible for registering primary co-operative banks with at least 200 members and with deposits between R1 million and R20 million.

Deposit-taking CFIs currently registered with the dti in terms of the Co-operatives Act, 2005 (Act No. 14 of 2005) (Co-operatives Act), meeting the criteria outlined in section 3 of the Act, are required to apply for registration as co-operative banks (qualifying CFIs).[59] Until registered as co-operative banks, qualifying and non-qualifying CFIs will continue to operate under the exemption notices issued in terms of the Banks Act, 1990 (Act No. 94 of 1990), and regulated by the self-regulatory bodies as designated in the exemption notices. As at 31 March 2010, there were 14 qualifying CFIs comprising, in aggregate, 18 000 members and R120 million held in deposits.

59 This is similar to a commercial bank that is registered as a company in terms of the Companies Act, 1973 (Act No. 61 of 1973), which is also registered as a bank in terms of the Banks Act, 1990 (Act No. 94 of 1990).

Box 6 The nature of co-operative banks

'Co-operative', in essence, means working together to reach a common objective. The definition given to 'co-operative' in the Co-operatives Act, 2005 (Act No. 14 of 2005) is based on an internationally accepted definition, that is "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly owned and democratically controlled enterprise organised and operated on co-operative principles". A co-operative, therefore, is a self-governing organisation, founded by a group of people that have common needs and goals, which is jointly owned by its members and in terms of which benefits are shared by its members. Each member has an equal vote in the organisation and, in general, decisions are based on the internationally accepted co-operative principles.[60] These principles relate to voluntary and open membership; equal voting rights; active member participation; the autonomy and independence of the organisation; education, training and information sharing; co-operation among co-operatives; and concern for the community.

Apart from the creation of limited liability structures, co-operative banks are fundamentally different from those types of financial institutions that are registered in accordance with the Companies Act, 1973 (Act No. 61 of 1973). A co-operative bank's primary duty is to its members, not to anyone else outside the co-operative bank. It is a voluntary organisation formed by a group of people who have common needs that they want to address, for example, access to basic financial services. Co-operative banks are also not formed by individuals or legal persons with the objective of maximising shareholders' wealth, where profits are shared pro rata according to shareholding and where strategic decisions can be controlled by majority shareholders. A co-operative bank is controlled democratically and in such a manner that each member has an equal vote in the strategic decisions taken by the co-operative bank, irrespective of the number of shares owned by the member in the co-operative bank. Economic benefits are distributed proportionally according to each member's level of participation in the co-operative, which is known as the 'patronage proportion'. For example, if the surplus is not retained by a co-operative bank, it is returned to its members based on the level of deposits or loans the members have with the co-operative bank, rather than according to the capital invested by members.

60 In terms of the Co-operatives Act, 'co-operative' principles mean "the internationally accepted principles of co-operation, exemplified by the principles adopted by the International Co-operative Alliance". Available online at: http://www.ica.coop/coop/principles.html.

At a workshop that was hosted by the CBSU and the Agency during December 2009, the application procedure and regulatory requirements were explained to the qualifying CFIs. It was agreed that applications to register as co-operative banks should reach the supervisor concerned by no later than the end of May 2010. This provided the qualifying CFIs with sufficient time to draft their constitutions to operate as proposed co-operative banks, to pass the necessary special resolutions to convert to co-operative banks and to apply to the supervisor concerned for registration as co-operative banks.

The status quo will prevail for those qualifying CFIs that do not meet the requirements to be registered as co-operative banks. For registration purposes, the supervisors may, in terms of section 8 of the Act, grant an application for registration subject to any condition that may be determined. The supervisors will therefore need to balance the development objectives of the Act with that of full compliance with the regulatory requirements of the Act, taking into account the nature, size and development potential of each applicant CFI.

Many community banks have failed in the past and public perception of these types of banks is currently negative. The failure of a co-operative bank in the early stages of launching will be damaging to public perceptions and will affect the growth of the sector negatively in the longer term. However, the timely establishment of an explicit deposit insurance scheme, as required in terms of the Act, should contribute significantly to confidence in the co-operative banking sector.

Challenges relating to the debt counselling process in South Africa[61]

The enactment of the National Credit Act, 2005 (Act No. 34 of 2005) (NCA),[62] paved the way for the establishment of the NCR with a view to regulating consumer credit. One of the key tenets of the NCA is the promotion of a fair and non-discriminatory marketplace for access to consumer credit. One of the remedies for a consumer that is over-indebted is to restructure debt obligations through a process of debt counselling. The NCR and some of the key role players in debt counselling, however, acknowledge that there are a number of challenges and obstacles going forward in terms of training, capacity and administrative bottlenecks encountered in processing applications for debt counselling.

The NCR announced in December 2009 that it had established a task team on debt counselling to provide solutions to the challenges and bottlenecks in the debt review process and to propose common standards and procedures for processing and finalising debt counselling applications. It is anticipated that the task team will operate for a period of about six months. This section of the *Financial Stability Review* briefly explains the current legislative process in respect of debt counselling[63] and the role players involved, and highlights some of the challenges that still require attention going forward.

61 Acknowledgement is given to the NCR, the Debt Counsellors Association of South Africa and the Banking Association of South Africa for their assistance in compiling this section.

62 The NCA came into effect on 1 June 2007.

63 Sections 78 to 88 of the NCA deal with over-indebtedness and reckless lending by means of the establishment of a debt counselling process. The process enables heavily indebted consumers to seek professional assistance in rearranging their debt obligations with credit providers so that they can continue to meet their financial obligations and avoid defaulting.

Debt review process

The application process for debt review is governed by section 86 of the NCA. A consumer may apply to a debt counsellor[64] to have the consumer declared over-indebted.[65] The application process broadly follows the following steps: firstly, a distressed consumer approaches a debt counsellor and provides details of income, monthly budget and debt commitments. Secondly, the debt counsellor completes an initial assessment to confirm over-indebtedness. This is followed by a consultation in which existing budget commitments are verified, credit bureau checks are conducted, and a possible payment plan is determined. Thirdly, the debt counsellor approaches all credit providers concerned to confirm the balances owed. The consumer's profile with the credit bureau is also updated to reflect that the applicant is undergoing debt counselling. The final step is for the debt counsellor to propose a payment plan to all credit providers. If there is agreement among all credit providers, a consent order is obtained from the courts. If there is no agreement, the matter is referred to court for a decision. The aforementioned steps have to be completed within 60 working days and during this time the credit provider may not institute any alternative means to recover the outstanding debt.

64 Section 44 of the NCA makes provision for the registration of natural persons as debt counsellors to assist over-indebted consumers.

65 Section 79 of the NCA states that a consumer is over-indebted if the preponderance of available information at the time a determination is made indicates that the particular consumer is or will be unable to satisfy, in a timely manner, all the obligations under all the credit agreements to which the consumer is a party.

Some statistics on debt counselling[66]

According to figures released by the NCR the consumer credit market in South Africa is worth about R1,1 trillion.[67] The main role players involved in the debt counselling process in South Africa are the NCR, the debt counsellors, the payment distribution agents[68] and the credit providers. The Debt Counsellors Association of South Africa (DCASA) represents about 300 debt counsellors. The National Debt Mediation Association (NDMA) was launched in May 2009 to resolve cases on a voluntary and consensual basis.

Impaired records, defined by the NCR as records that are three or more months in arrears, had, by September 2009, steadily increased to 44,9 per cent or about 8,1 million consumers out of a total credit-active population of about 18 million as estimated by the NCR. Approximately 160 000 consumers, representing about 1,98 per cent of impaired records, had applied for debt counselling, with the average applicant having between 13 and 17 credit agreements. The NCR estimates that the number of applicants for debt counselling could grow by approximately 7 500 per month. Of the total number of

66 For more information visit the NCR website, available at www.ncr.org.za.

67 NCR. 2009. *Consumer Credit Report*. Third quarter, September. Available online at: www.ncr.org.za.

68 A payment distribution agent is an entity that collects payments by way of debit order from the consumer's bank account and distributes payments to various credit providers.

applications for debt counselling, 60 per cent of cases still have to be referred to the courts and about a third could not be finalised. As at March 2010 there were 1 642 registered debt counsellors, five payment distribution agents and 4 120 registered credit providers which include the major banks, micro-lenders and retailers. Repayments to credit providers in terms of debt counsellors' agreements amounted to about R168 million from about 43 000 consumers. These repayments are increasing on a monthly basis and represent the amount that credit providers would not have been able to collect unless they had instituted other alternative collection means, which normally come at a cost.

Current challenges to the debt counselling process

The task team has, through its consultation with different stakeholders, identified a number of obstacles in the implementation of debt counselling. The task team has also identified a number of areas, as discussed below, where operational policies and practices of the different stakeholders are contributing to some of the challenges.

Training, capacity and administrative processes

While industry training is provided to debt counsellors, there is a view from the NCR, the debt counsellors and the credit providers that more can be done to enhance the efficient processing of debt counselling applications in order to reach the best repayment solution to both the over-indebted consumer and the credit provider. Over time, the reviewing of entrance requirements into the profession should also be addressed. The administrative impact of the debt-counselling process on the systems of credit providers has been underestimated. Banking information systems have not been designed, in general, to have a single view of a client as they are rather organised along product lines. Training of credit providers' staff has also been identified as an area that needs urgent attention.

Legislative processes

At present, there are huge backlogs of court cases awaiting either review or the granting of consent orders. The absence of definitive procedures to take matters to court, as well as a minimum standard for debt restructuring proposals in the NCA had impeded common interpretation and ruling by the courts in as far as consent orders are concerned. Legislative proposals are underway to improve the consent orders to be considered during the court processes, and the documentation required to declare a credit agreement as reckless credit and the re-arrangement of consumers' obligations.[69]

69 See *Government Gazette* No. 32869 of 14 January 2010 – Debt Counselling Regulations.

Credit providers may not terminate the debt counselling process once the debt review process is underway, especially not during the first 60 business days. This is particularly problematic in those cases where a debt counsellor and consumer are unco-operative, and delay legal action without any commitment to making any payments. As a result, debt counselling can reduce the realisable value of security and increase the eventual loss. This could lead to a growing pool of non-performing debtors who are protected from legal action. It is not the intention of the NCA, however, to protect such individuals and promote a culture of non-payment.

Concluding remarks on debt counselling

It is imperative that the debt counselling process functions in a smooth and stable manner. The effective recovery of outstanding debts owed to credit providers is central to this process in order to limit the number of impaired loans and to maintain the effectiveness and stability of the financial system and the economy as a whole.

The NCR's task team is committed to resolving most of the short-term problems and challenges to the debt counselling process. The NCR is also considering providing guidelines on affordability assessment and restructuring of credit rules, streamlining administrative processes and creating a special account for collecting debit orders.

For the longer term, amendments to the NCA might be necessary. These amendments might be needed to clarify, among other things, the process of court hearings, regulation of fees, rehabilitation of consumers and clarification of the powers of magistrates to adjust the interest and capital amounts outstanding on applications for debt restructuring.

Abbreviations

AGR	augmented Guidotti ratio
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
BMR	Bureau of Market Research
CBOE	Chicago Board of Options Exchange
CBSU	Co-operative Banking Supervision Unit
CDS	credit default swap
CFI	co-operative financial institutions
CFVI	Consumer Financial Vulnerability Index
CRB	Commodity Research Bureau
CRE	commercial real estate
CSD	Central Securities Depository
DCASA	Debt Counsellors Association of South Africa
dti	Department of Trade and Industry
EME	emerging-market economy
FNB	First National Bank
FSB	Financial Stability Board
FSF	Financial Stability Forum
G-20	Group of Twenty
GDP	gross domestic product
GR	Guidotti ratio
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IEMP	index of exchange market pressure
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
LCR	liquidity coverage ratio
MSCI	Morgan Stanley Capital International
NCA	National Credit Act
NCR	National Credit Regulator
NDMA	National Debt Mediation Association
NPS	national payment system
NSFR	net stable funding ratio
RPCI	Residential Property Confidence Indicator
SADC	Southern African Development Community
SAMOS	South African Multiple Option Settlement
SAVI	South African Volatility Index
SIFI	systemically important financial institutions
SOR	Securities Ownership Register
SSA	sub-Saharan Africa
TBTF	too big to fail
the Bank	South African Reserve Bank
Unisa	University of South Africa
US	United States
UK	United Kingdom
VIX	CBOE Volatility Index
WEF	World Economic Forum