Financial Stability Review

September 2010

South African Reserve Bank

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This issue of the *Financial Stability Review* focuses mainly on the six-month period ending June 2010. However, selected developments up to 20 September were also reported on. Data may include own calculations made for purposes of this publication.

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ISSN 1811-2226

Produced by the Publishing Section

Purpose of the *Financial Stability Review*

The South African Reserve Bank (the Bank) defines its primary objective as the achievement and maintenance of price stability. In addition to this, the Bank endeavours to contribute to a South African monetary, banking and financial system that as a whole is 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 on 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

The improving macrofinancial conditions that prevailed at the time of the previous *Financial Stability Review* were interrupted in the first half of 2010 when concerns about the fiscal health of certain debt-laden euro area economies caused uncertainty in global financial markets. The announcement of a €750 billion aid package by the joint European authorities and International Monetary Fund (IMF) helped to lessen the extent to which sovereign risk concerns spilled over into banking sectors. Subsequently, the European supervisory authorities conducted a European Union- (EU) wide stress-testing exercise, the results of which brought welcome transparency regarding sovereign exposures and settled uncertainty somewhat.

Despite initial expectations of a steady economic recovery, downside risks to this scenario have risen sharply in advanced economies. Economic growth in advanced economies was still mainly driven by monetary and fiscal stimulus packages. The weaker economic outlook and financial risks in advanced economies, and fears of another technical recession in the United States (US), have raised the likelihood of negative feedback loops between the real economy and financial systems. A modest recovery in consumption levels contributed somewhat to output growth in the first half of 2010, and prospects are still positive for a modest but steady economic recovery in advanced economies in 2010 and 2011.

Global banking sectors remain vulnerable as deleveraging continues and uncertainty remains about possible levies, taxes and the tightening of bank regulation. Bank funding pressures remain as several banks are still dependent on special support measures and central bank liquidity and, in general, bank lending growth remains elusive.

The modest recovery in 2009 in global housing markets is proving hard to sustain as some uncertainty about the underlying strength of the global economic recovery continues to linger. High unemployment rates, coupled with high levels of negative home equity, fuel the risk of another sharp decline in house prices. In commercial real-estate markets credit losses increased further as delinquencies rose. Many loans that originated during the peak of the cycle will soon mature, causing refinancing challenges.

Gross domestic product (GDP) growth in emerging-market economies (EMEs) was more robust than in advanced economies in the first half of 2010, but is uneven between regions and still very much dependent on growth in advanced economies. Better growth prospects in many EMEs and sustained low interest rates in advanced economies continue to raise the risk of excessive capital inflows that could lead to asset-price bubbles, overheating of economies, exchange rate volatility and financial system instability. African countries proved to be fairly resilient to the economic crisis, although growth remains largely dependent on the recovery of the global economy and a revival in global trade. The sub-Saharan African region was largely affected by the global financial crisis through the trade channel, which remains the conduit through which adverse developments in the euro area may be transmitted into the region.

In South Africa, despite positive signs of economic recovery, jobs continued to decline, which places a significant damper on the domestic financial system. Confidence in the financial services sector declined somewhat as a result of renewed uncertainty in global markets, coupled with lower growth in profits. Nevertheless, the banking and insurance sectors maintained high-quality capital buffers well above the minimum prudential requirements, and remained profitable. Growth in bank credit granted has begun to increase, the growth rate in impaired advances is decelerating and banks' lending standards are showing signs of loosening.

The South African bond market remained attractive as a result of increased risk appetite among foreign investors, combined with strong domestic demand for bonds. Equity markets continued to follow international equity markets upwards, with gains across most sectors, except for a temporary dip in May as a result of the sovereign debt crisis in the euro area. Capital inflows into domestic bonds and equities have increased significantly, providing finance for the current-account deficit. Such inflows can, however, create significant volatility and instability in the event of a sudden stop or outflow of such funds.

Business confidence eased in the second quarter, after having increased in the first quarter of 2010, indicating that initial expectations of a vigorous recovery in real economic activity were too optimistic. Credit to the corporate sector moved sideways, and the number of liquidations, though volatile, seems to be declining. Consumer confidence remained almost unchanged in the second quarter of 2010, and there were improvements in household disposable income, financial assets and net wealth in the first two quarters of 2010. Insolvencies, civil summonses and judgments for debt also declined, as did the rejection rate of applications for credit. These and other developments seem to indicate that household balance sheets are on the mend and consumer financial vulnerability is improving in general.

Current developments in enhancing the strength of the financial regulatory environment include the publication of the Companies Amendment Bill, 2010 with the purpose of improving the administration and effectiveness of the Companies Act, 2008; the South African Reserve Bank Amendment Act, 2010 to enhance the Bank’s governance framework and to uphold its public interest role; and the proposed draft Banks Amendment Bill, 2010 to align the provisions of the existing Banks Act with the new Companies Act.

The global financial crisis has affected the financial systems of countries in different ways. In addition to international efforts to strengthen the overall robustness of the regulatory environment, some countries have responded by reforming national regulatory systems. Some common themes that have emerged from countries that have already announced regulatory reforms include the extension of central banks’ powers related to supervision, market conduct and consumer protection; the provision of more appropriate structures and policy instruments to assess and mitigate “systemic risks”; the need to address the “too-big-to-fail” moral hazard problems associated with systemically important financial institutions (SIFIs); and the need to close the regulatory gaps that were prevalent in the build-up to the financial crisis. Many other issues remain to be addressed, and although some countries are proceeding with changes, it is thought that a degree of international convergence around a common international framework is needed. Some of the proposed reforms will only be fully operational over the next few years, and therefore the implications of these developments for regulation and supervision will only become more apparent some time in the future.

Introduction

This issue of the *Financial Stability Review*, which focuses mainly on the six-month period ending June 2010, 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, and legislative and infrastructural developments affecting the South African financial system. It starts with a discussion of the Companies Amendment Bill, 2010 and the South African Reserve Bank Amendment Act, 2010. Also included in this section is a discussion of regulatory responses that have emerged from countries in reaction to the global financial crisis.

Financial stability developments and trends

International macrofinancial developments

This section provides an overview of macroeconomic and financial developments in advanced economies, EMEs and Africa, and how these developments have impacted, and could potentially impact, on the financial system in South Africa.

Although global economic conditions had generally improved since the peak of the crisis in September 2008, the stability of the global financial system experienced a setback in the first half of 2010. Concerns about the fiscal positions of a number of euro area countries developed into a sovereign debt crisis. It then spread to the banking system in the region, as uncertainty about bank exposures to sovereign debt led to some interbank funding strains. Financial asset-price volatility increased globally and investor risk appetite declined. Rising sovereign debt spreads, continuing deleveraging in credit markets, uncertainty about possible levies and taxes on banks, and the tightening of bank regulation also caused concerns that the financial system was still more fragile than previously thought. Following the announcement of a comprehensive rescue package in the euro area, a temporary reprieve set in, although it did not allay all fears of lower levels of economic activity and global financial instability.

The weaker economic outlook and financial risks have raised the likelihood of negative feedback loops between the real economy and the financial system. Although the current unconventional expansionary policy measures in advanced economies seem to be unsustainable, recent evidence points towards fragile financial systems and a possible stalling of the global economic recovery, which have generated a need for continued stimulus.

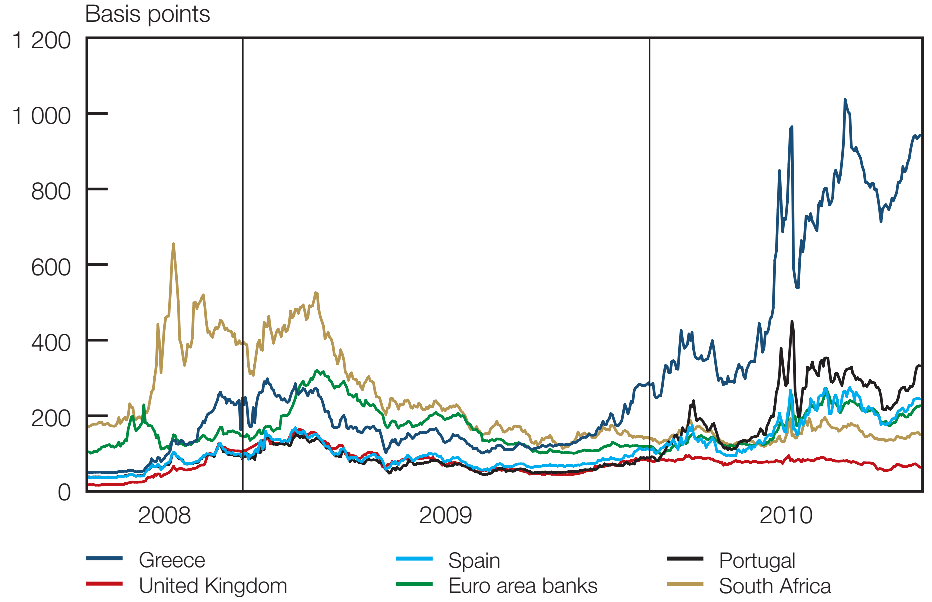
In EMEs, not only has GDP growth been more robust, but growth prospects have also remained stronger than in advanced economies. This, together with market expectations that official interest rates in advanced economies will remain at low levels for some time, provides strong incentives for capital flows into EMEs. Apart from the risks of asset-price bubbles and exchange rate volatility, the potential rapid reversal of these positions adds to the uncertainty and fragility of financial systems in EMEs. Conditions in the global financial system are therefore still influenced by above-normal levels of uncertainty, highlighting the fact that the process of repairing impaired financial systems is far from complete.

Financial and economic developments in advanced economies

Sovereign debt concerns

The improving trend in macrofinancial conditions in the second half of 2009 was interrupted in early 2010 by concerns about the fiscal health of certain debt-laden euro area economies, including Portugal, Spain and, particularly, Greece. Sovereign risk in the euro area was reassessed and investors repriced risk across the region, exacerbating Greece's fiscal distress. As concerns about the sustainability of Greece's high fiscal deficit and high public debt mounted, uncertainty spilled over into global financial markets in early May 2010. Credit default swap (CDS) spreads, which bear a positive correlation to the probability of default, increased sharply on Greek sovereign bonds. CDS spreads on sovereign bonds in Portugal and Spain also increased, although not as severely. The sharp increase in CDS spreads receded somewhat following the announcement of a €750 billion aid package by the European Central Bank (ECB), the IMF and the EU. Investors were, however, not convinced about the ability of governments to implement fiscal austerity plans successfully in the region, and CDS spreads on sovereign bonds widened again.

Figure 1 Credit default swap spreads



Sources: IMF and Bloomberg

Sovereign risk concerns soon spilled over into the banking sector in the euro area, confirming the financial stability implications of rising sovereign debt. The co-movement of European bank CDS spreads with sovereign CDS spreads reflects concern about the substantial sovereign debt holdings of European banks.[1] It also reflects the increasing risk of negative feedback between the sovereign and financial sectors, and the potential negative impact on the balance sheets of governments in cases where weak banks need support. According to the IMF, uncertainty about the health of some banks was exacerbated by the slow process of strengthening the balance sheets of banks in the euro area following the global financial crisis.

1 IMF, *Global Financial Stability Report Market Update*, July 2010.

Banking sectors

Uncertainty about bank exposures to sovereign debt has led to interbank funding strains as banks again became less willing to lend to one another, except at very short maturities. This was especially true of banks in euro area countries perceived to be facing serious debt challenges. Banks are also confronted with funding pressures, given their refinancing needs as a result of maturing bonds. The recent turbulence in the sovereign debt market is expected to dampen the primary market for bond issuance by banks temporarily.

The Committee of European Banking Supervisors (CEBS) was mandated to conduct an EU-wide stress-testing exercise in co-operation with the ECB, the European Commission (EC) and the national supervisory authorities in the EU. The objective of the stress-testing exercise was to provide policy information for assessing the resilience of the EU's banking system to possible adverse economic situations, and to assess the ability of participating banks to absorb possible shocks on credit and market risks, including sovereign risks (see Box 1).

2 The results of the stress-testing exercise were released in July 2010.

3 The scenario does not assume any default on a government's bonds as this was felt to be a "highly implausible" event. As a result, the "haircuts" only apply to bonds held in the trading book, although the sovereign stresses do feed into credit losses in the trading book.

4 A Tier 1 capital ratio was used as opposed to core Tier 1 since there is, as yet, no harmonised definition of core Tier 1 across the EU, and thus the use of core Tier 1 would not have facilitated a direct comparison of results across countries. However, there is a harmonised and precise legal definition of the components of Tier 1 capital.

5 The threshold of 6 per cent is used as a benchmark solely for the purpose of this stress-testing exercise and should not be interpreted as a regulatory minimum.

Box 1 European Union stress-testing exercise[2]

A sample of 91 banks in the euro area, which hold 65 per cent of the European Union's (EU) total assets, participated in the stress-testing exercise. The scope included the major EU cross-border trading groups and a group of mostly large credit institutions in Europe. In each EU member state, the sample was built by including banks in descending order of size, so as to cover at least 50 per cent of the national banking sector, expressed in terms of total assets. The Committee of European Banking Supervisors (CEBS) examined the banks in terms of three scenarios, based on estimates from the European Central Bank (ECB) and the European Commission (EC). The test focused mainly on capital adequacy, while liquidity risks were not directly tested. The banks were tested on a consolidated basis and their subsidiaries elsewhere were included. The three shock scenarios were

1 a benchmark scenario serving as a basis for comparing the other two scenarios;
2 an adverse scenario intended to show the effects of a double-dip recession; and
3 an adverse scenario with a sovereign debt shock,[3] added after concerns over bank exposures to the falling value of sovereign debt of peripheral euro area countries such as Greece, Spain and Portugal.

The base for the stress test was a bank's position at the end of 2009, and the scenarios covered 2010 and 2011. A threshold value for the Tier 1 capital ratio[4] of 6 per cent[5] was used as a benchmark to determine the potential need for recapitalisation. Those banks that were unable to maintain a Tier 1 capital ratio of at least 6 per cent by the end of 2011 under the most adverse scenario used in the test failed the test. The ECB provided guidelines for the probability that certain classes of loans would default and the likely loss they would suffer. Big banks were allowed to use their own models to estimate losses, though under supervision of local regulators.

The main difference between the European stress test and the stress test conducted in the United States (US) in 2009 is that the European stress tests were done at a much later stage of the credit cycle. Furthermore, the main objective of the US stress test was to determine the individual capital needs of banks, while the European stress tests were, in addition to this, done to provide policy information on the buoyancy of the EU banking system.

Of the 91 banks 7 (5 small Spanish regional saving banks, 1 German bank and 1 Greek bank) failed the test and it was found that €3,5 billion would be needed to increase Tier 1 capital to 6 per cent in these banks. More than a dozen banks barely passed the test under the most stressful scenario. Spain tested a large part of its banking system and disclosed more data than any other country, hoping to dispel lingering suspicion about its smaller banks' solvency. The combined results suggest a rather strong resilience for the EU banking system as a whole and may appear reassuring for the banks in the exercise, but it should be highlighted that this outcome is partly due to the continued reliance on government support for a number of institutions.

There were mixed reactions to the results of the stress tests carried out in Europe. Although the tests were described as too lenient, a more severe, implausible scenario would not have served a purpose either. The capital ratio used and the threshold value were also criticised, although the granularity of the disclosures makes it possible for the market to conduct its own tests. The stress test was also attacked for only examining bonds held in banks' trading books and not those in their banking books. This, however, was a deliberate decision as haircuts of bonds in banking books would imply a sovereign default of one of the EU members, something of which the ECB could not be part. Considerable value was gained by the increased transparency concerning disclosure of sovereign bond holdings, which was achieved with these tests. Therefore, even though the methodology was questioned by some commentators, others believe that valuable information was gained from the exercise.

Banking sectors remain vulnerable globally as deleveraging continues and uncertainty about possible levies, taxes and the tightening of bank regulation mounts. In the United Kingdom (UK) a new annual levy was imposed on banks, building societies and on UK operations of foreign banks that will come into effect in January 2011. The levy is expected to raise about £1,2 billion in 2011 which will be used to fund future bail-outs of banks. France and Germany had also pledged to introduce a similar bank levy. Levies and taxes on banks could, however, impact negatively on financial intermediation and add to negative feedback effects to real economies.

Real-estate markets

The importance of a well-functioning housing market to a healthy economy has been emphasised by the global financial crisis. Housing market activity serves as a broad indicator of financial system health, and shows the availability of credit and the level of consumer confidence in the economy. Global housing markets broadly staged a modest recovery in 2009 following the house price crash of 2007 and 2008. Gains in property markets, however, are proving hard to sustain as the global economic recovery remains fragile and the improvement in many countries is showing signs of slowing down. In the US and the UK, lower levels of economic growth emphasise concerns about declines in property prices.

In the commercial real-estate market, credit losses arising from exposures of US and European banks increased further as delinquencies rose. Many loans that originated during the peak of the cycle will soon mature, causing refinancing challenges. Further refinancing difficulties could emerge following sharp falls in US commercial property values,[6] since the value of collateral may no longer be sufficient to cover outstanding loan amounts. Depressed property prices may lead to further defaults and additional foreclosures on commercial properties, adding to the supply of properties on the market and exerting further downward pressure on property values. In the US the high unemployment rate, coupled with a large backlog of residential foreclosures and high levels of negative home equity, poses a risk of another sharp decline in house prices. Although house prices have rebounded somewhat from crisis lows, other recent housing indicators point to more ominous signals as tax incentives have ended and foreclosures continue.

6 The Moody's Commercial Property Price Index fell by more than 40 per cent from its peak in October 2007.

In England and Wales the Royal Institute of Chartered Surveyors (RICS) Housing Market Survey[7] shows more surveyors are seeing falling rather than rising prices. The RICS headline house price index is now declining and recorded a negative reading of -32 in August 2010 from -8 in July, the sharpest one-month fall since June 2004. In Germany the residential property market was quite resilient to the global financial crisis and robust growth is expected in 2010.

7 RICS, *Housing Market Survey*, August 2010.

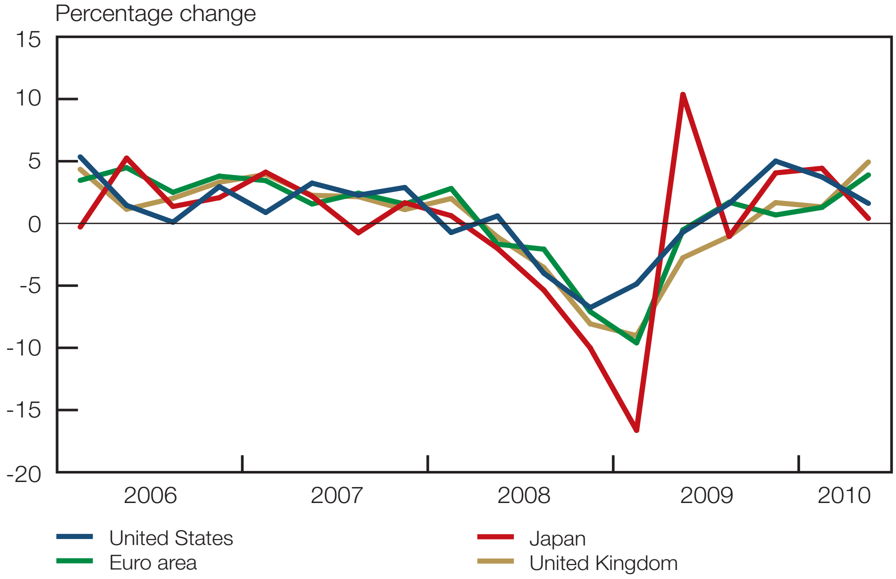
Economic growth

The recovery in economic activity gained momentum in the US and Japan in the fourth quarter of 2009, before moderating somewhat in the first half of 2010. In contrast, economic growth in the euro area and in the UK remained subdued in the first quarter of 2010 before accelerating strongly in the second quarter. Global growth is projected at about 4,6 per cent in 2010 and 4,1 per cent in 2011, while output in advanced economies is expected to expand by 2,6 per cent in 2010, following a contraction of 3,2 per cent in 2009.[8]

8 IMF, *World Economic Outlook Update*, July 2010.

Figure 2 Quarterly growth in real GDP

Percentage change



Source: Bloomberg

Although economic growth in advanced economies was still mainly driven by monetary and fiscal stimulus packages, a modest recovery in consumption levels contributed somewhat to output growth in the first quarter of 2010. Prospects are still positive for a modest but steady economic recovery in advanced economies in 2010 and 2011.

The weaker economic outlook and financial risks in advanced economies have raised the likelihood of negative feedback loops between the real economy and financial systems significantly. Despite initial expectations of a steady economic recovery, the IMF emphasised the fact that downside risks to the economic recovery in advanced economies have risen sharply. The pace of recovery in output and employment in the US slowed significantly in the second quarter of 2010 and fears that the country could fall into another recession resurfaced. This was confirmed when the United States Federal Reserve (the Fed) downgraded its view of the economic outlook in the US and decided to start reinvesting proceeds from expiring mortgage-backed securities in long-term US Treasury bills. Some analysts even fear a period of falling prices and economic stagnation, or so-called Japanese-style deflation.

9 IMF, *Global Financial Stability Report Market Update*, July 2010.

In the euro area, a pertinent risk seems to be that bank funding pressures may accelerate the ongoing deleveraging process as bank lending growth declines. The supply of credit could also be curtailed as there are indications that lending standards of euro area banks are reversing their downward trend and are tightening again.[9] Lower consumer and business confidence could follow and suppress private consumption and investment at a time when the sustainability of the economic recovery is becoming more dependent on improvements in private consumption and investment expenditure. At this stage the potential dampening effect of the recent euro area financial distress on global economic growth remains uncertain.

Financial markets

10 The ECB suspended its collateral requirements on Greek sovereign debt and reactivated some of its long-term operations, while the Fed reinstated its foreign-exchange swap lines and also announced measures to reinvest payments from mortgage debt into government debt.

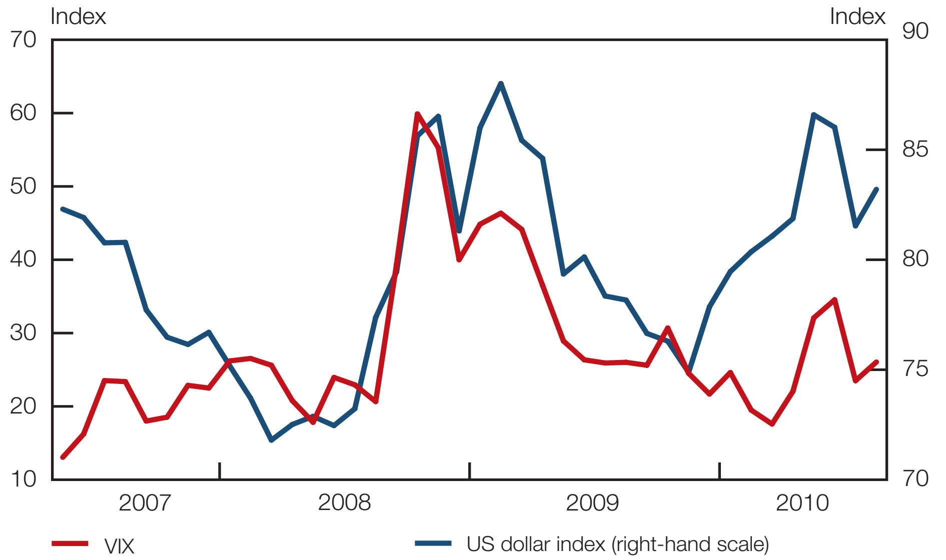
Although equity markets have made tentative recoveries from time to time, they remain at fairly subdued levels and are generally volatile. Markets were mainly supported by a rise in economic confidence following the announcement of the €750 billion aid package in Europe in May 2010, the publishing of the European banks' stress test results in July 2010 and well-received government bond auctions in the euro area. In addition, interbank funding rates for the US dollar, euro and pound sterling have fallen to relatively low levels, as lending standards for euro area banks remained tight and central banks reintroduced some flexibility into their liquidity operations to alleviate funding strains.[10]

11 VIX is a symbol for the Chicago Board Options Exchange Volatility Index and measures implied equity-market volatility of the Standard & Poor's 500 Index over the next 30-day period.

After easing to pre-crisis levels in early 2010, financial-market volatility returned in the second quarter, as reflected in the Chicago Board Options Exchange Volatility Index (VIX).[11] Turbulence in financial markets reflecting lower confidence in fiscal sustainability, policy responses and future growth prospects has cast a cloud over the global outlook. Equity markets in advanced economies reversed most of the gains achieved in early 2010 as a result of renewed global risk aversion, following credit-rating downgrades, fears of debt contagion in the euro area, and concerns about austerity plans to reduce fiscal deficits.

In the foreign-exchange market the US dollar has recently weakened against a basket of currencies, after experiencing high levels of volatility and strong appreciation in the first half of 2010. According to market analysts, this weakening is expected to continue as the focus shifts from the tentative recovery in European sovereign debt markets to the weak housing and labour markets in the US. Global bond yields declined to even lower levels in the first half of 2010, supported by flight-to-safety considerations and expectations that interest rates in advanced economies would remain low for the remainder of the year amid subdued inflationary pressures.

Figure 3 VIX and US dollar index[1]



1 The US dollar index indicates the general international value of the US dollar by averaging the exchange rates between the US dollar and six major world currencies, namely the euro, Japanese yen, British pound, Canadian dollar, Swedish krona and Swiss franc

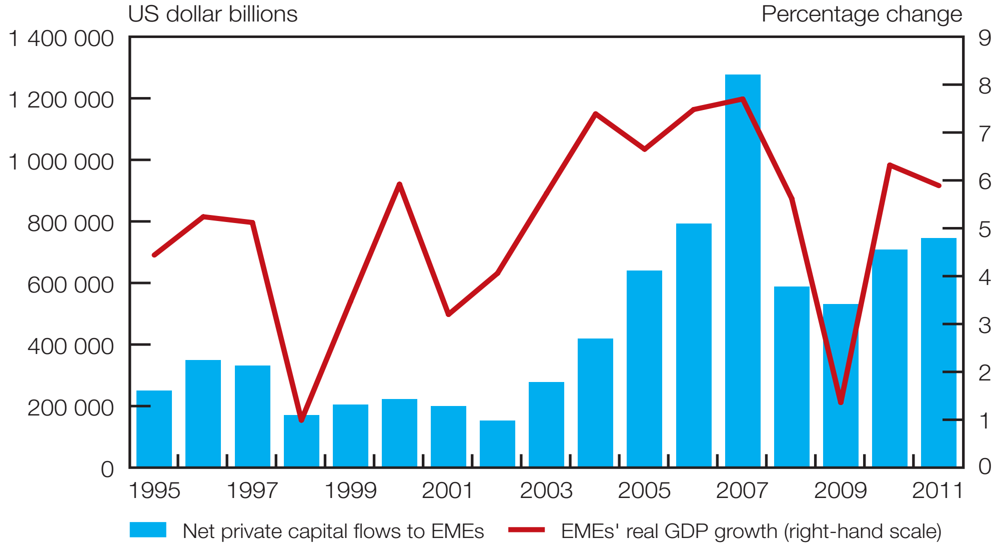
Source: Bloomberg

Financial and economic developments in emerging-market and developing economies

Emerging-market economies

GDP growth in EMEs was more robust than in advanced economies in the first half of 2010, but proceeded fairly unevenly between regions. Economic activity in Asian and Latin American EMEs continues to accelerate, while in some Eastern European countries, activity is expected to be subdued for the remainder of the year, mainly as a result of constrained cross-border credit flows. The Institute of International Finance (IIF) forecasts that real GDP in EMEs will increase by 6,3 per cent in 2010 (from 1,4 per cent in 2009) and by 5,9 per cent in 2011.

Figure 4 Emerging markets' net private capital flows and real GDP growth[1]



1 Data for 2010 and 2011 are The Institute of International Finance estimates

Source: The Institute of International Finance

The downside risks to the EME outlook remain the possibility of a sharp slowdown in GDP growth in advanced economies (and the resulting negative impact on the demand for EMEs' exports). Another factor is whether China will be able to sustain its high economic growth rate given further liquidity-tightening measures to contain rising inflation and to prevent the formation of asset-price bubbles in the real-estate sector.

12 The Institute of International Finance, *Capital Flows to Emerging Market Economies*, April 2010.

Better growth prospects in many EMEs and low interest rates in advanced economies triggered a return of net private capital flows to EMEs in early 2010. As a result, EMEs were cautioned by the IMF against excessive capital inflows that could lead to asset-price bubbles, overheating of economies, exchange rate volatility and financial system instability. Since the second quarter of 2010, however, capital flows to EMEs subsided due to the reduction in risk appetite and declines in asset prices. These flows are expected to remain constrained by tighter regulations and increased demand for funding. Estimates of net private capital flows to EMEs for 2010 and 2011 have been revised downwards, but are expected to recover to US$709 billion in 2010 from US$454 billion in 2009.[12] In the longer term, however, EMEs are still faced with the possibility of a sharp upward trend in capital inflows, and will therefore need to enhance their macroeconomic and prudential policies to reduce their vulnerability to excessive levels of volatility in capital inflows (see Box 2).

Box 2 Foreign portfolio investment flows, risk tolerance and policy reactions

Investors are inherently risk-averse, and their strategic investment allocations are based on their willingness to take on a perceived or estimated degree of risk (i.e., their degree of risk tolerance) in exchange for an expected rate of return. Investors' degree of risk tolerance reflects their entrenched preferences with regard to the risk/return trade-off, and takes account of the fundamental characteristics of different asset classes and investment destinations. The improved economic fundamentals of many emerging-market economies (EMEs) and subsequent ratings upgrades to investment grade and higher during the boom period since 2004 have increasingly convinced risk-averse investors to include emerging-market assets in their investment policies. The fact that EMEs as a group survived the financial crisis in better shape than most developed markets has also increased their fundamental attractiveness as investment destinations.

However, investors are subject to a great extent of uncertainty about the fundamental risks to which they are exposed. Investors react to new economic data releases, comments by policy-makers and other financial market developments. They adjust their positions and risk exposures in reaction to these uncertainties which, in turn, contribute to sudden changes in risk premiums, fluctuations in market liquidity and volatile asset prices. Following the financial crisis, fundamental characteristics of various assets and countries have deteriorated, investors have generally become more risk-averse and their state of uncertainty has increased. All these factors make them even more sensitive to daily news and events and, consequently, more prone to contagion and potentially destabilising behaviour.

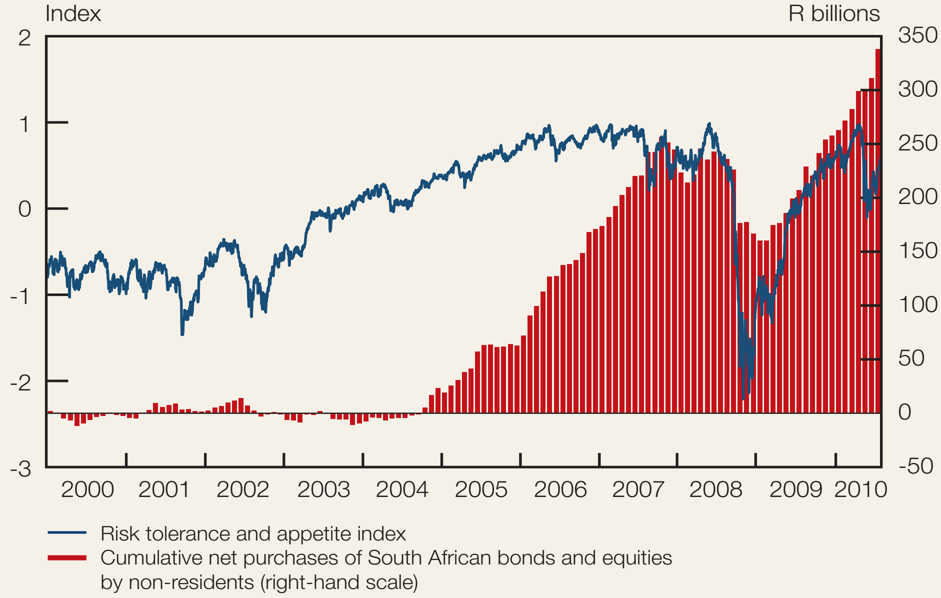
13 An inventory of both types of measures is provided by the ECB in its *Financial Stability Review* of June 2007.

Foreign investment flows present a potential transmission channel of financial crises. Therefore, it is important for emerging markets, in particular, to monitor developments that determine global capital flows. Investor demand for riskier investments is one such driver. There are basically two approaches that can be followed to gauge investors' demand for riskier investments, namely (1) measures that are based on a financial or economic model that is applied to a particular market, or (2) market-based measures that are constructed by using simple statistical methods to aggregate information from market prices. These methods can include information about more fundamental changes in risk aversion and short-term fluctuations in risk appetite.[13]

In order to gauge the investor demand for risky assets, particularly as it applies to South Africa, a market-based index has been compiled to estimate trends in global investors' risk tolerance and appetite, which tend to correlate with the demand for South African financial assets. The index was compiled as an equally weighted average of the standardised values of the Chicago Board Options Exchange Volatility Index (VIX), the Morgan Stanley Capital International Emerging Market (MSCI EM) Index, the Emerging Market Bond Index (EMBI) spread, the Commodity Research Bureau (CRB) Index and the two-year US swap spread, the latter serving as an indicator of global liquidity conditions. By standardising the values, the index averages at zero and each particular level equals its standard deviation at that point. This index is shown in Figure A, combined with the cumulative net purchases of bonds and equities by non-residents since 2000, as reported in the trading statistics of the JSE Limited.

Before 2004, when the index was below average, foreigners' net purchases, and sales of South African bonds and equities were small and fairly balanced, and their cumulative holdings fluctuated around zero. However, a steady increase in the index since 2004 has coincided with a build-up of cumulative bond and equity holdings. This was suddenly reversed between October and December 2008 when investor uncertainty surged, risk appetite dissipated and foreign investors liquidated some of their holdings of EME assets. There was a steady recovery in the index in the course of 2009, and by April 2010 the index was again at its pre-crisis level. Despite concerns about peripheral Europe's fiscal sustainability, the index remained positive in the first half of 2010, coinciding with a renewed build-up of holdings of South African financial assets.

Figure A Global risk tolerance and appetite index



Sources: South African Reserve Bank, JSE Limited, Bloomberg and I-Net Bridge

The IMF in its *Global Financial Stability Report* of April 2010 noted that the increased investment flows to emerging markets were partly caused by liquidity expansion and very low interest rates in the US, Europe and Japan. The IMF also discussed a number of policy options available to emerging markets in response to a surge in global liquidity and capital inflows, namely

– adopting flexible exchange rate policies, which would cause the domestic currency to appreciate in the event of large inflows, thus reducing the attractiveness of the investment destination;
– absorbing some of the inflows by increasing official reserves, thus limiting their impact on domestic asset prices;
– reducing interest rate differentials to discourage carry transactions;
– tightening fiscal policy if the overall macroeconomic policy stance is too loose, thus reducing aggregate domestic demand and preventing an overheating of the economy; and
– implementing and reinforcing prudential regulations, for example, by increasing cash reserve ratios, introducing or tightening capital controls and taxes on financial inflows and liberalising capital outflows.

Not all these or any alternative policy responses would be equally appropriate in all countries. The choice of policy reaction would depend on factors such as the inflation outlook, macroeconomic policy stance, exchange rate regime, regulatory regime, legislative environment and the expected duration of the flows (i.e., whether they are expected to be temporary or more permanent in nature). It should also be kept in mind that markets tend to be self-correcting over the longer term, and that policy reactions may have unforeseen adverse effects for the domestic economy and for other emerging-market countries. Nevertheless, in the light of the financial stability risks associated with large capital flows, there is a definite place for some of these policy options to be considered and many emerging-market countries, including South Africa, have adopted some of them to various degrees.

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Institute of International Finance. 2010. *Capital Markets Monitor*, July/August.

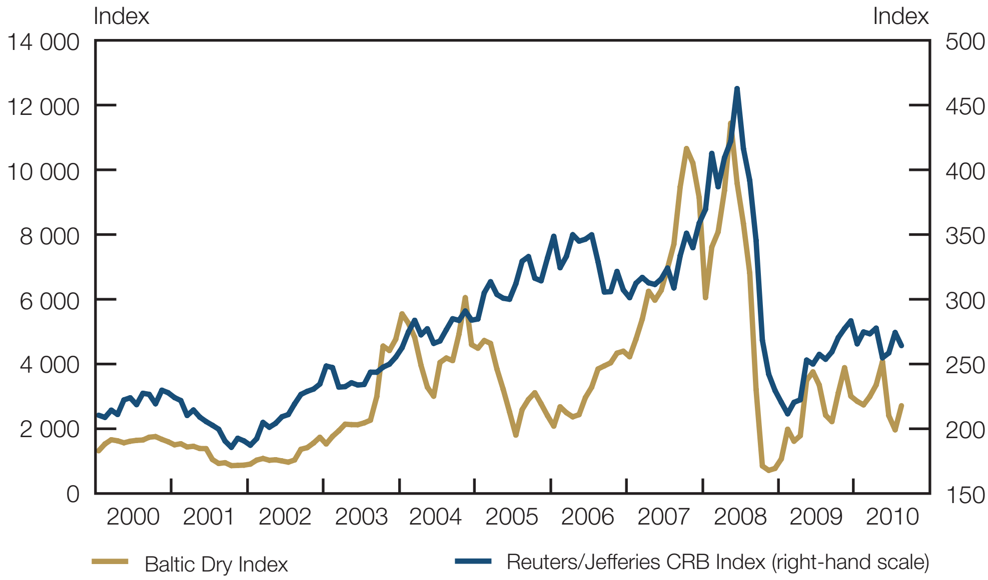
14 The Reuters/Jefferies CRB Index serves as a measure of 19 global commodity futures prices.

After rising in the first quarter of 2010, commodity prices, especially oil and metals, experienced high levels of volatility and recorded declines in the second quarter of 2010, as reflected in the Reuters/Jefferies Commodity Research Bureau (CRB) Index,[14] which decreased by about 7 per cent. This was mainly due to expectations of slower global GDP growth and lower demand for commodities. The price of copper declined by 16 per cent and was further impacted by the weak US housing market, while the spot price of Brent crude oil declined by 9 per cent. The gold price was the exception, being a traditional safe-haven asset, and rose by 11 per cent in the second quarter of 2010.

15 The Baltic Dry Index is issued daily by the London-based Baltic Exchange and tracks worldwide international shipping prices of various dry bulk cargoes. It measures the demand for shipping capacity versus the supply of dry bulk carriers. Investors look to the Baltic Dry Index as one possible gauge of future global growth.

Since July 2010, however, a weakening US dollar and positive investor sentiment have resulted in a rise in most commodity prices. The outlook for commodity markets, however, still remains cautious and prices are expected to rise modestly due to conservative demand estimates arising from expectations of slower global GDP growth. In addition, the Baltic Dry Index[15] has declined by 34 per cent since May 2010, reflecting a rise in concerns about global growth and trade flows in the remainder of 2010.

Figure 5 Baltic Dry Index and Reuters/Jefferies CRB Index



Source: Bloomberg

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

16 McKinsey Global Institute. *Lions on the move: the progress and potential of African economies*, June 2010.

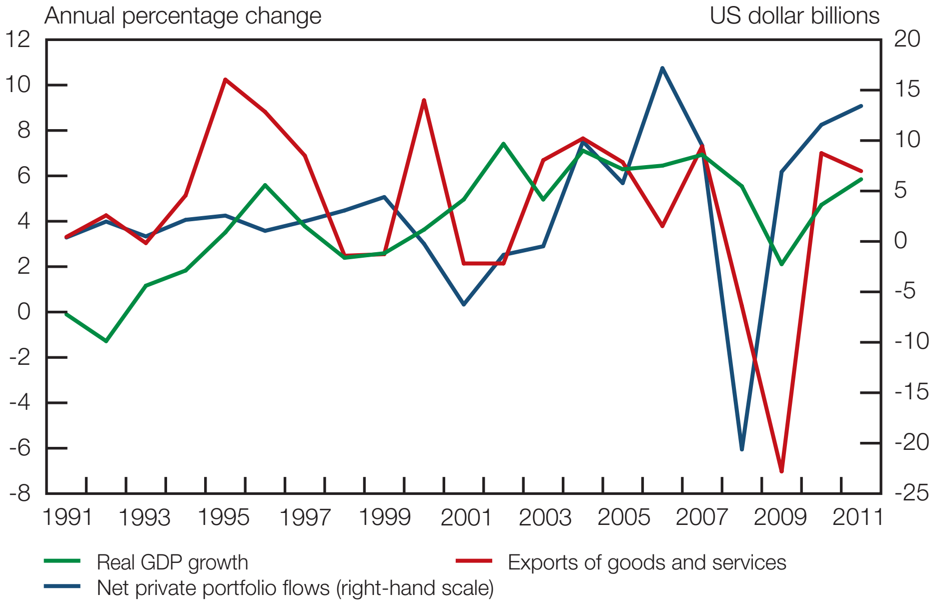
17 IMF, *World Economic Outlook Update*, July 2010.

Africa's real GDP, on average, grew by 4,9 per cent per annum between 2000 and 2008, making it the third fastest growing region in the world.[16] Growth has been attributed to, among other things, increased risk appetite, a sustained recovery in commodity prices and an improved business climate. Following the global financial crisis, however, growth slowed to 1,9 per cent in 2009 with much effect being felt by Southern African Development Community (SADC) countries, while East and North African countries proved to be the most resilient. Overall growth in the region is estimated at 4,3 per cent in 2010 and 5,3 per cent in 2011. In sub-Saharan Africa, growth slowed to 2,2 per cent in 2009, and is estimated to be 5 per cent in 2010 and 5,9 per cent in 2011.[17]

The growth forecasts, however, remain largely dependent on the recovery of the global economy and a revival in global trade. In addition, growth in the sub-Saharan African region is also expected to be enhanced by an increase in capital inflows. Net private portfolio flows are estimated to increase to about US$11,56 billion in 2010 and US$13,43 billion in 2011, while net direct investments are also expected to follow an increasing trend. Exports of goods and services in sub-Saharan Africa are also estimated to increase at an annual rate of 7 per cent in 2010 and 6,2 per cent in 2011.

The sub-Saharan African region was largely affected by the global financial crisis through the trade channel and trade remains the conduit through which adverse developments in the euro area may be transmitted into the region. After increasing by an annual rate of 7,3 per cent in 2007, exports of goods and services in sub-Saharan Africa contracted by 7 per cent in 2009.

Figure 6 Real GDP growth, exports and net private portfolio flows in sub-Saharan Africa[1]



1 Data for 2010 and 2011 are IMF estimates

Source: IMF

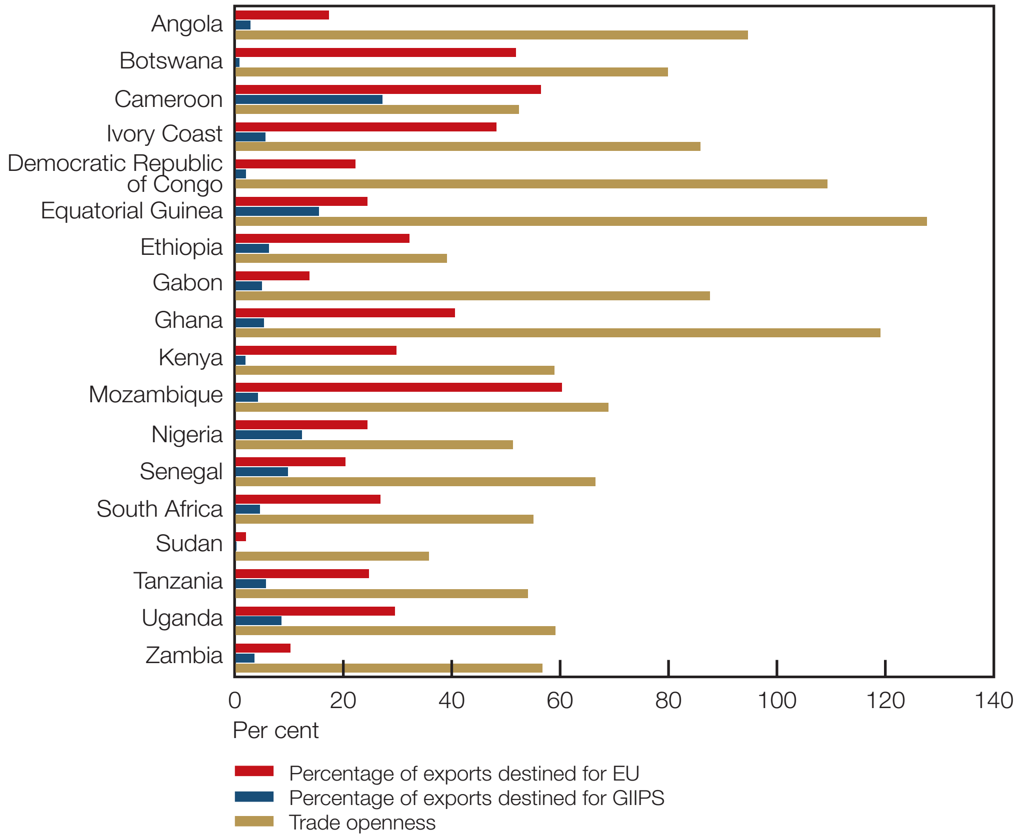
Although the IMF and the EU made significant efforts to contain the effects of the sovereign debt crisis in Europe, the crisis is nevertheless expected to pose some risks to sub-Saharan Africa. Figure 7 shows countries that are most vulnerable to the EU debt crisis through the trade channel.[18] As such, countries that could potentially be disadvantaged the most by impediments to growth from the euro area, that is, those that are most vulnerable, include Cameroon and Mozambique as large percentages of their exports are destined for the Greece, Italy, Ireland, Portugal and Spain (GIIPS) countries and the EU respectively. Equatorial Guinea has also been identified as vulnerable to the developments in the euro area, given the country's high level of trade openness.

Along with Nigeria, Angola and Sudan, South Africa appears to be better positioned in terms of its exposure to the EU. Although South Africa has a diversified export market, about 30 per cent of its exports are destined for the EU, exposing it to a reasonable extent to the region. Its vulnerability is, however, limited as far as its exposure to the GIIPS countries is concerned. As at the end of 2009, about 62 per cent of South Africa's exports comprised manufactured goods, 30 per cent mining products and 8 per cent were agricultural products.[19] It can therefore be presumed that manufactured goods exports could be most significantly impacted by the sovereign debt crisis in the euro area.

18 Vulnerability is measured in terms of trade openness (ratio of exports and imports to GDP), percentage of exports destined for GIIPS countries and the percentage of exports destined for the EU.

19 Department of Trade and Industry, *South African Trade Statistics*, available at www.dti.gov.za.

Figure 7 Vulnerability of sub-Saharan African countries through trade with the EU



Source: Standard Bank

Domestic macroprudential analysis

In this section the stability of the South African financial system is assessed by analysing a set of macroprudential indicators for the financial sector, and its household and corporate-sector counterparts, together with selected indicators for the real-estate market and the external sector. Given the inter-linkages between the financial and real sectors of the economy, a set of real economic activity indicators is first reviewed as background.

Indicators of real economic activity

Overall economic performance accelerated markedly in the first quarter of 2010 with real GDP growth increasing by an annualised and seasonally adjusted rate of 4,6 per cent. The growth momentum, however, slowed to an annualised and seasonally adjusted rate of 3,2 per cent in the second quarter. Despite the positive signs of economic recovery, the economy continued to shed jobs in the first quarter of 2010 with 171 000 jobs lost. In the second quarter 61 000 jobs were lost and the unemployment rate increased marginally to 25,3 per cent.[20]

20 Statistics South Africa, *Quarterly Labour Force Survey*, Quarters 1 and 2, 2010.

Revival of activity in the motor industry was evidenced by positive annual growth in new vehicle and new passenger car sales. Although these developments could be indicating a recovery in the sector, they might be a reflection of a low base in 2009. They could also be reflecting the effects of the 2010 FIFA World Cup™ tournament as many car rental companies had invested in new vehicles in the run-up to the event. Total new vehicle sales and passenger car sales have been recording positive annual growth rates since January 2010. In August they increased by annual rates of 33,5 and 49,7 per cent respectively. The increases in August were in line with expectations that sales would be boosted by pre-emptive buying to avoid the new vehicle CO^2 emission tax to be implemented in September 2010. It is envisaged that the growth rates of new vehicle and passenger car sales could moderate for the remainder of the year following the introduction of this tax.

The annual growth rates of retail and wholesale trade sales and building plans passed also increased in June 2010. The increases in retail and wholesale trade could also be attributed to the 2010 FIFA World Cup™ which is believed to have fuelled spending on clothing, food and sportswear. The annual growth rate of the number of buildings completed decreased, which could be a lagged effect of the downturn in the building industry since 2008.

Table 1 Selected indicators of real economic activity[1]

Annual percentage change in monthly indicators

Activity indicators	2009			2010	
	Jun	Sep	Dec	Mar	Jun
Building plans passed	-27,84	-14,63	-7,91	6,73	12,35
Buildings completed	8,21	-25,53	22,39	-27,27	-39,54
Retail sales	-5,80	-3,33	-1,93	2,03	6,74
Wholesale trade sales	-11,64	-11,04	-5,94	1,75	2,96
New vehicle sales	-24,37	-21,29	-7,60	22,71	18,83
New passenger car sales	-17,58	-15,80	-8,81	21,89	25,74
Electric current generated	-4,13	-0,55	7,08	8,19	4,71
Utilisation of production capacity[2]	78,11	77,27	78,57	79,61	80,59

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

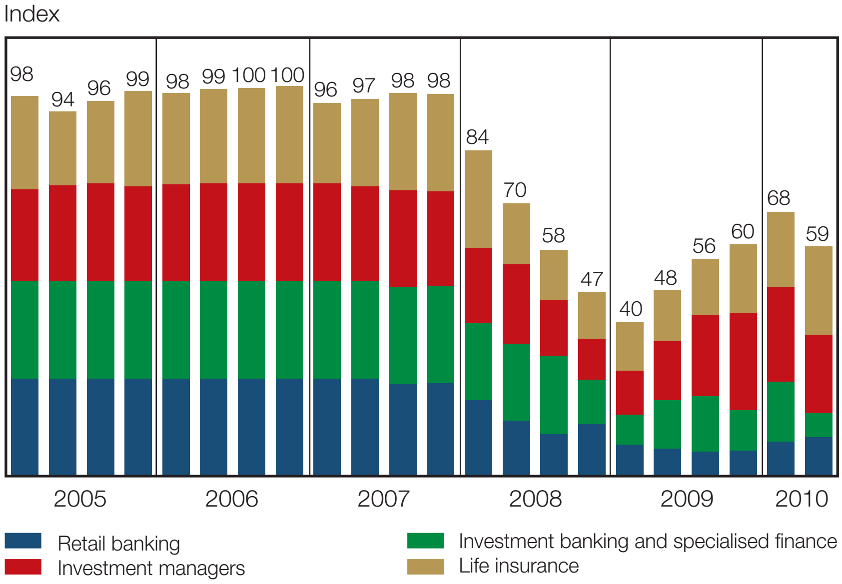
Sources: Statistics South Africa. Data on new vehicle and new passenger car sales were obtained from the National Association of Automobile Manufacturers of South Africa

Confidence in the financial services sector

The level of confidence in the financial services sector, as measured by the Ernst & Young Financial Services Index,[21] dropped to 59 index points in the second quarter of 2010, from a revised figure of 68 index points in the first quarter (Figure 8). The drop resulted from substantial declines in the investment banking and specialised finance, and investment managers sub-indices, which dropped by 37 and 17 index points respectively. According to Ernst & Young, the declines in both sub-indices were attributed to renewed uncertainty in global equity markets resulting from problems in the euro area, coupled with reduced net inflows and lower growth in profits.

21 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 from 0 to 100, where 0 shows 'extreme lack of confidence', 50 is 'neutral' and 100 shows 'extreme confidence'.

Figure 8 Financial Services Index and its components



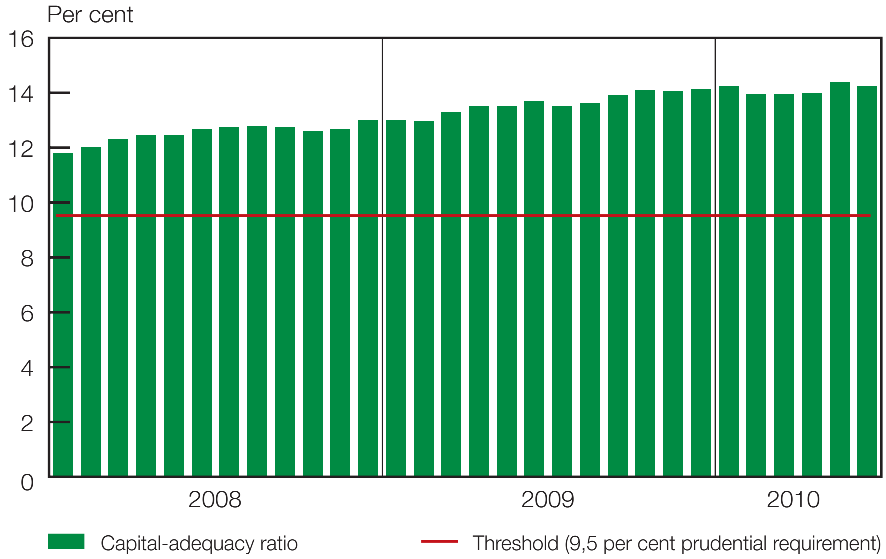
Source: Ernst & Young

Banking sector

22 See *Financial Stability Review*, September 2006 for a discussion on considerations of concentration on financial stability.

The market share of the four big South African banks and the level of concentration in the banking sector remained high in the first half of 2010. While the domination of the four largest banks may reduce the likelihood of banking-sector problems, it increases the complexity of resolving any systemic problem should it arise.[22] Over the same period, the recovery of bank share prices that began in the second half of 2009 continued. The banking sector maintained adequate capital buffers, with the capital-adequacy ratio well above the minimum prudential requirement of 9,5 per cent and recording 14,3 per cent in June 2010 (Figure 9). Tier 1 capital also remained well above the regulatory requirement, indicating a high quality of capital in general.

Figure 9 Capital-adequacy ratio of banks



Source: South African Reserve Bank

Gross loans and advances contracted from September 2009 to April 2010 before turning around to grow at an annual rate of 1,5 per cent in May 2010. This was followed by an annual growth rate of 2,2 per cent in June 2010. Despite these and other signs of imminent recovery of the economy, overdraft lending still contracted by 16,3 per cent year on year in June 2010, possibly indicating consumers' reluctance to acquire more debt in the aftermath of the recession in the real economy.

The growth rate of impaired advances moderated further in June and July 2010, to annual rates of 10,1 and 7 per cent respectively, significantly down from a year earlier. As a percentage of total loans and advances, impaired advances increased to 5,9 per cent in June 2010 compared with 5,5 per cent in June 2009. This increase reflected a combination of the slower pace of growth in gross loans and advances, and an increase in the amount of impaired advances from R133 billion in January 2010 to R136 billion in June. Profitability of banks remained fairly stable in the first half of 2010.

Table 2 Selected indicators of the South African banking sector[1]

Per cent, unless indicated otherwise

	2010					
	Jan	Feb	Mar	Apr	May	Jun
Market share (top four banks)	84,50	84,89	84,26	83,98	83,98	84,07
Gini concentration index	83,57	83,64	83,54	83,29	83,30	83,29
Herfindahl–Hirschman index (H-index)	0,189	0,190	0,188	0,185	0,185	0,185
Banks' share prices (year-on-year percentage change)	30,06	45,55	65,13	46,88	39,51	31,02
Capital adequacy						
Capital-adequacy ratio	14,24	13,97	13,95	14,02	14,40	14,34
Regulatory Tier 1 capital to risk-weighted assets	11,05	10,82	10,91	10,98	11,24	11,26
Credit risk						
Gross loans and advances (R billions)	2 263	2 289	2 282	2 279	2 300	2 307
Impaired advances (R billions)	132,65	133,30	134,17	135,55	135,98	136,31
Impaired advances to gross loans and advances	5,86	5,82	5,88	5,95	5,91	5,91
Specific credit impairments (R billions)	39,98	41,28	41,18	41,75	42,15	42,76
Specific credit impairments to impaired advances	30,14	30,97	30,69	30,80	31,00	31,37
Specific credit impairments to gross loans and advances	1,77	1,80	1,80	1,83	1,83	1,85
Profitability						
Return on assets (smoothed)	0,92	0,95	0,97	0,97	0,97	0,97
Return on equity (smoothed)	15,28	15,55	15,82	15,63	15,40	15,33
Interest margin to gross income (smoothed)	50,17	49,89	49,20	49,10	49,10	49,10
Operating expenses to gross income (smoothed)	51,84	51,97	52,08	52,46	53,02	53,39
Liquidity						
Liquid assets to total assets (liquid-asset ratio)	6,33	6,28	6,48	6,98	7,34	7,48
Liquid assets to short-term liabilities	12,84	12,68	13,19	14,13	14,38	14,92
Effective net open foreign-currency position to qualifying capital and reserve funds	-0,18	0,93	0,34	-0,70	0,00	-0,32

1 Data were updated on 20 September 2010. Impaired advances are advances in respect of which the bank has raised specific credit impairments

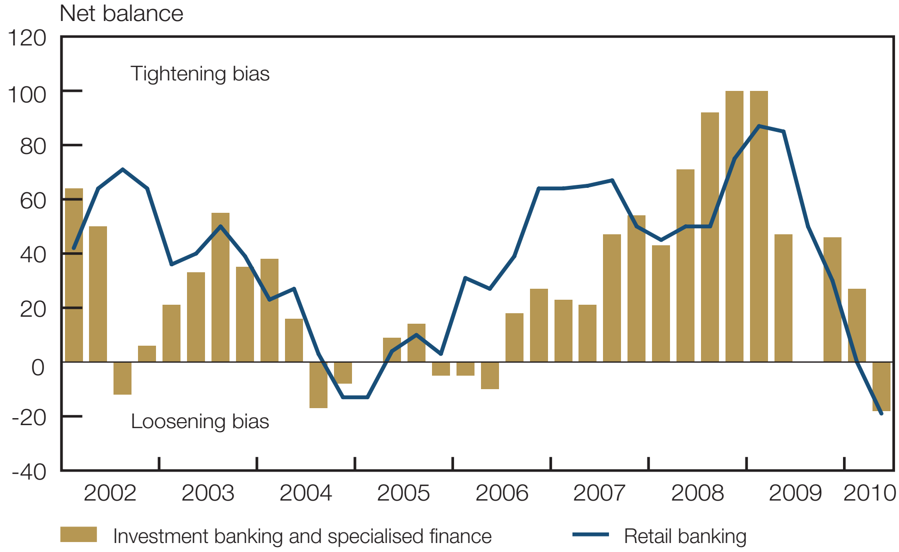
Sources: South African Reserve Bank. Data on share prices were obtained from the JSE Limited

23 '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.

24 Investment banking and specialised finance consists of corporate finance, private equity, project finance, treasury and specialised finance.

According to a survey conducted by Ernst & Young and the Bureau for Economic Research on the lending standards of banks, both retail banks[23] and investment banking-type activities[24] eased lending standards in the second quarter of 2010. For retail banks, 19 per cent loosened their lending standards, none tightened them, while 81 per cent left their lending standards unchanged (a net loosening balance of -19). For investment banking-type activities, 27 per cent of banks loosened their lending standards, 9 per cent tightened them, while 64 per cent left their lending standards unchanged (a net loosening balance of -18).

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



1 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. The net balance statistic is used to interpret the survey results

Sources: Bureau for Economic Research and Ernst & Young

The easing of lending standards was in line with improving economic conditions. Lending standards of retail banks last recorded a loosening bias (below zero) during the first quarter of 2005 and those of investment banking-type activities during the second quarter of 2006. The demand for credit is also expected to increase further in the remainder of the year as a result of lower lending rates and the generally expected recovery of the economy.

The sectoral distribution of credit exposure has historically been fairly consistent. At the end of the second quarter of 2010, banks' largest concentration of credit exposure was still to the private household sector, followed by the financial intermediation and insurance sector.

Table 3 Sectoral distribution[1] of credit to the private sector

Per cent

	2009	2010	
	Dec	Mar	Jun
Agriculture, hunting, forestry and fishing	1,61	1,61	1,59
Mining and quarrying	3,19	3,08	3,03
Manufacturing	3,67	3,55	3,91
Electricity, gas and water supply	0,69	0,93	1,16
Construction	1,30	1,47	1,22
Wholesale and retail trade, hotels and restaurants	3,83	3,72	3,67
Transport, storage and communication	2,88	2,75	2,57
Financial intermediation and insurance	22,58	22,27	23,59
Real estate	5,46	5,45	5,28
Business services	4,65	4,58	5,32
Community, social and personal services	4,80	4,84	5,39
Private households	39,16	38,77	37,55
Other	6,17	6,97	5,72
Total[2]	100,00	100,00	100,00

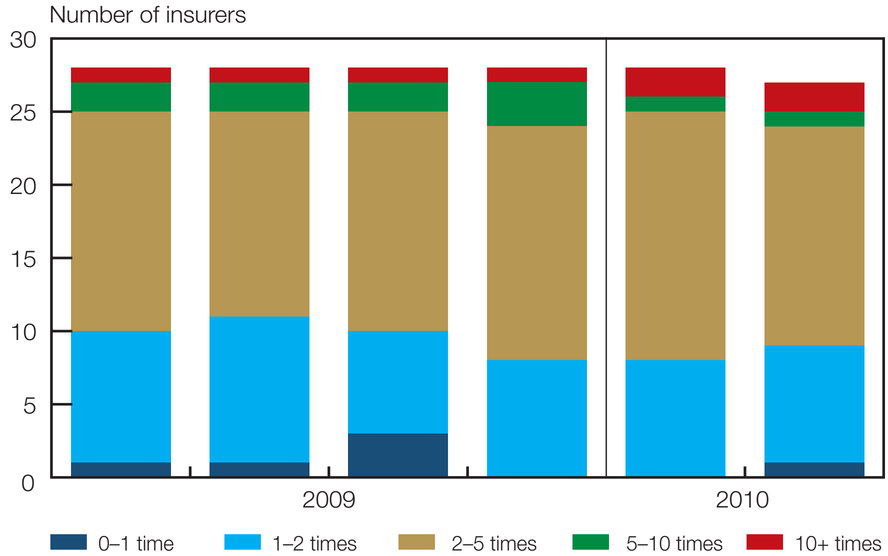
1 The classification of credit exposure according to the sectors or industries is based on the directives and industries specified in the Standard Industrial Classification of all Economic Activities
2 Figures do not necessarily add up to 100 due to rounding

Source: South African Reserve Bank

Insurance sector

Life insurance confidence continued to rise from its weakest level recorded at the end of 2008 as a result of returning investor sentiment and stronger equity markets in the second quarter of 2010. The increase in the confidence level also reflected a sustained low level of surrenders (expressed as a percentage of new policies issued during the

Figure 11 Free assets-to-capital-adequacy requirement[1] of typical long-term insurers[2]



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 long-term 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

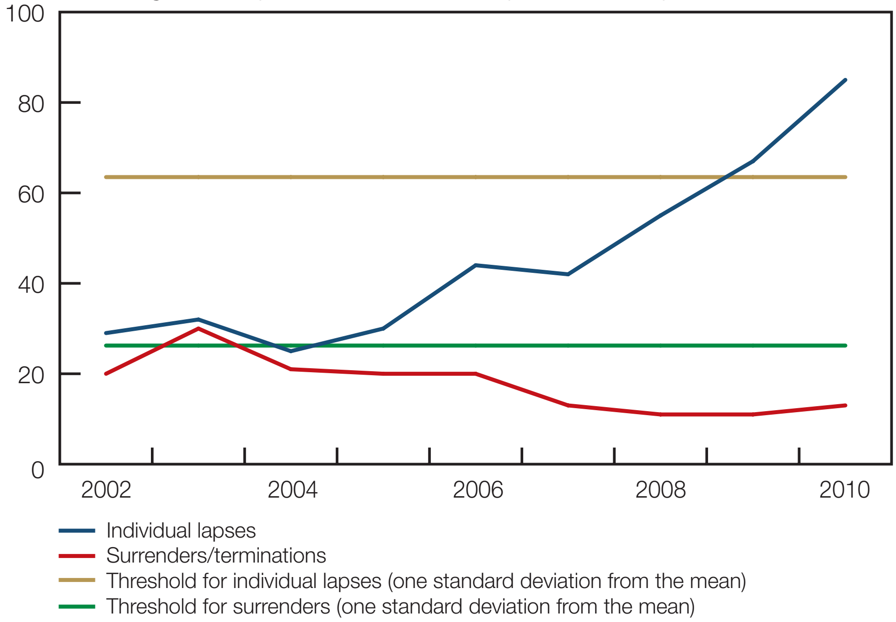
Source: Financial Services Board

period). Furthermore, in line with the general strengthening of equity markets, share prices of long-term insurers continued to grow at a brisk rate. The long-term insurance industry remained well capitalised (Figure 11). This is positive for the stability of the sector in terms of the absorption of unexpected shocks.

However, individual lapses (expressed as a percentage of the number of new policies issued during the period) increased and surpassed the calculated reasonable threshold of one standard deviation from the mean (Figure 12). The increase was, however, largely a reflection of the low growth in the number of new policies.

Figure 12 Individual lapses and surrenders for long-term typical insurers[1]

Percentage of new policies for the second quarter of each year



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

Source: Financial Services Board

For the short-term insurance sector, a positive development was an increase of 60,8 per cent in underwriting profits in the year to June 2010 compared with an annual increase of 46,7 per cent in the first quarter of 2010. Furthermore, the annual growth rate of net premiums accelerated, and that of underwriting and investment income was positive for the first time after two consecutive quarters of negative annual growth rates. Underwriting and investment income (as a percentage of net written premiums), as well as surplus assets (as a proportion of liabilities), also increased. However, management expenses and commission (as a percentage of net written premiums) increased slightly.

Table 4 Selected indicators for typical short-term insurers

	2009			2010	
	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Net premium (after re-insurance)[1]	6	7	5	3	5
Underwriting profit[1]	3,6	-8,4	-26,0	46,7	60,8
Underwriting and investment income[1]	21,5	11,8	-6,4	-21,7	1,7
Claims[2]	68	67	67	66	63
Management expenses and commission[3]	28	27	28	30	31
Underwriting profit[3]	5	5	4	5	7
Underwriting and investment income[3]	14	13	12	10	14
Surplus asset ratio (median)[4]	46	47	43	42	39

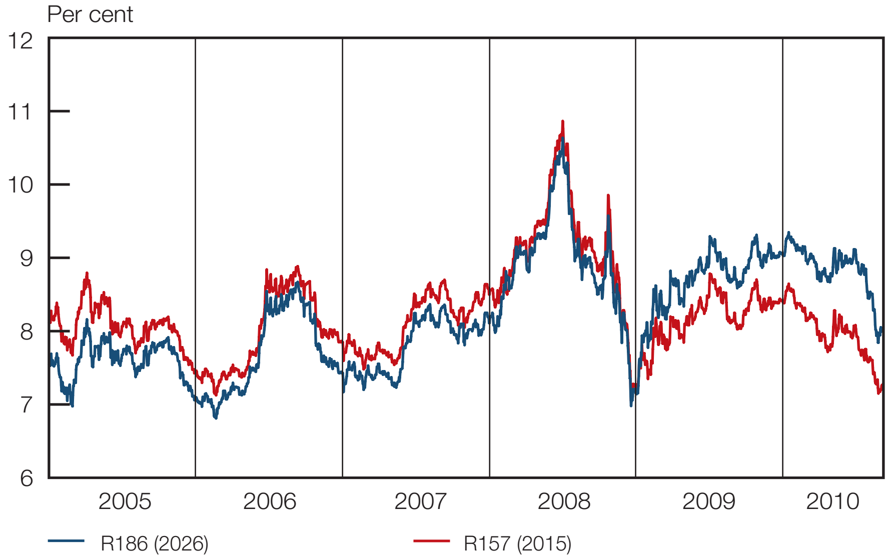
1 Year-on-year percentage change
2 As a percentage of premiums earned
3 As a percentage of net written premiums
4 Surplus as a proportion of liabilities

Source: Financial Services Board

Bond and equity markets

Domestic government bond yields have been declining since the beginning of 2010. Initial concerns surrounding the possible impact of the budget deficit and the National Energy Regulator of South Africa's (Nersa) electricity tariff increase on inflation, and ultimately interest rates, proved to have been overestimated. The budget deficit was revised lower, and Nersa's tariff increases were more or less in line with the Bank's projections. Bond yields increased temporarily during May 2010 due to the sovereign debt crisis in Greece, and the subsequent increase in risk aversion and flight to safety.

Figure 13 Selected domestic bond yields

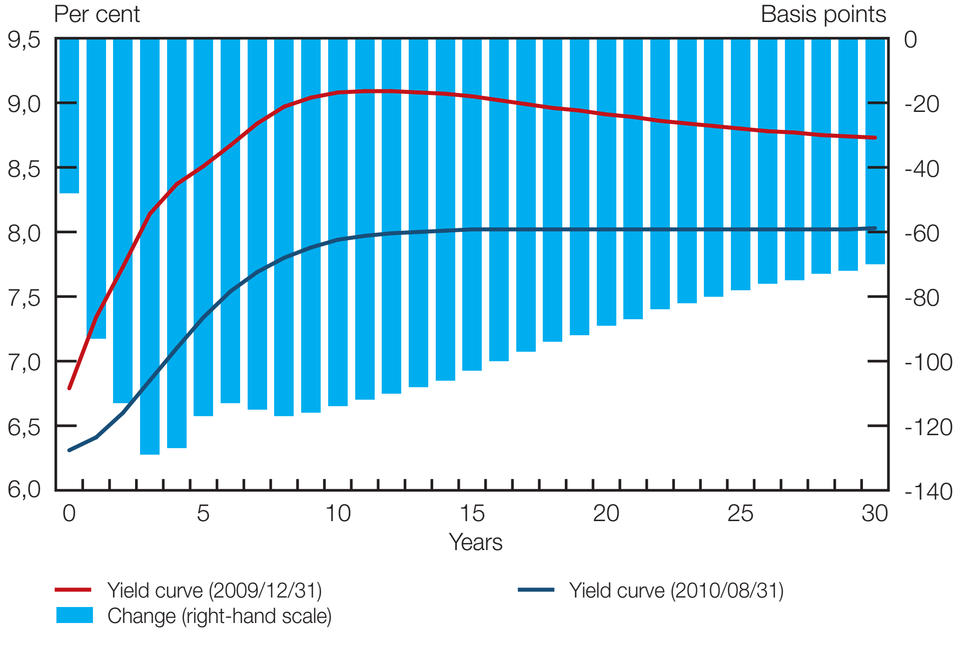


Source: Bloomberg

This was also the only month during the year, thus far, when non-residents were net sellers of domestic bonds. Despite substantial increases in CDS spreads of some southern European countries in early May (in Greece's case in excess of 700 basis points since the beginning of the year), South Africa's CDS spread increased by only 60 basis points before returning to lower levels.

The domestic bond market was supported by a disinflationary trend, the appreciation in the exchange rate of the rand, persistently weak credit growth, the interest rate reduction in March 2010, expectations of possible further monetary easing and strong demand for local currency bonds by non-residents. Non-residents purchased a net R76,0 billion worth of domestic bonds in the year to 20 September 2010. Despite record-low domestic interest rates, South Africa's interest rate differential with most other countries remained positive. US, UK and European policy rates have been kept at close to zero, and the possibility of renewed quantitative easing increased. The South African bond market remained attractive also as a result of increased risk appetite, deep and liquid markets, and modest public and foreign debt ratios when compared to other emerging markets and developed countries. The yield curve remained positively sloped, reflecting the longer-term inflation expectations associated with accommodating monetary policy and the improved economic growth outlook.

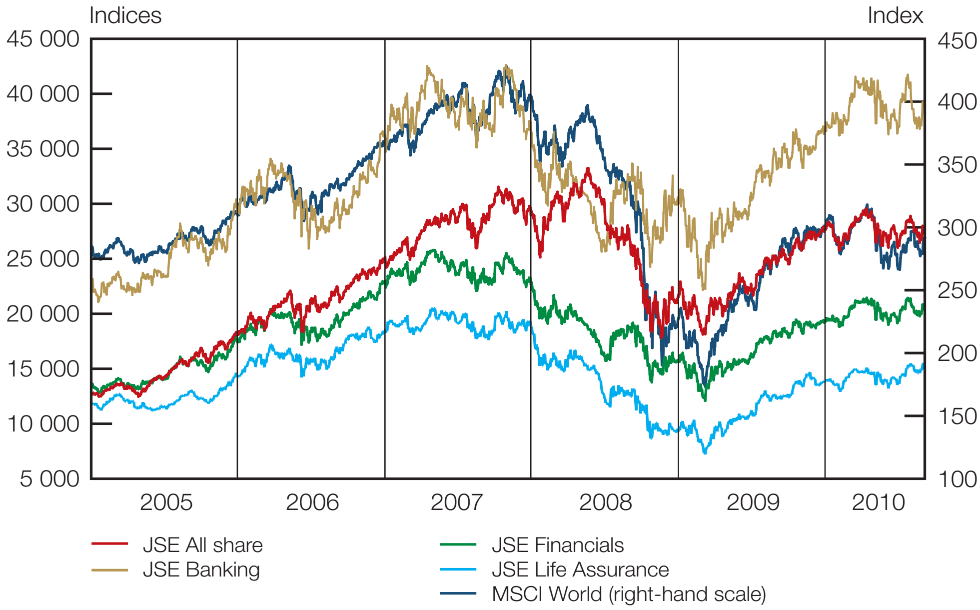
Figure 14 Yield curve



Source: Bloomberg

From the low levels reached in March 2009, the All-Share Index (Alsi) increased by more than 50,0 per cent in the year to 31 August 2010. During the first half of the year, gains were broad based across all sectors, supported by an improvement in commodity prices, healthier economic growth prospects domestically and abroad, and positive trends in international equity markets.

Figure 15 Share price indices



Source: Bloomberg

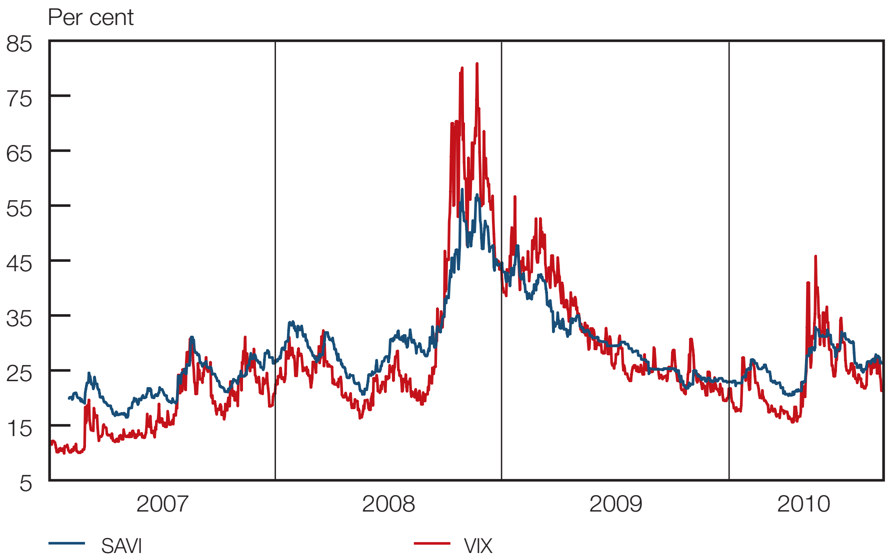
Uncertainty about the sustainability of the global recovery, low policy rates in advanced countries and South Africa's positive interest rate differentials have resulted in increased capital inflows. For the year to 20 September 2010, non-residents have purchased a net R98,5 billion worth of domestic bonds and equities. These inflows are significant when compared with previous years and have assisted in providing the needed finance for the current account deficit. Such inflows can, however, create significant volatility and instability in the event of a sudden stop of inflows or outflow of such funds.

The South African Volatility Index (SAVI)[25] has been trailing the Chicago Board of Options Exchange VIX.[26] In July 2010 the two indices were at almost the same level, intuitively implying the same level of perceived risk in both the domestic and global financial markets. Volatility in the South African equity market, therefore, still compares favourably with that in the advanced economy equity markets.

25 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.

26 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 16 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

27 The GR is the ratio of foreign-exchange reserves to short-term external debt.

28 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.

During the first quarter of 2010, the annual increase of 23,2 per cent in foreign-exchange reserves, combined with a year-on-year decline of 12,3 per cent in short-term debt, contributed to a significant improvement in the Guidotti ratio (GR).[27] The ratio improved to 1,78 in the first quarter, implying that available foreign-exchange reserves were above the country's short-term foreign debt by about 78 percentage points. Over the same period, the augmented Guidotti ratio (AGR)[28] dropped from 1,15 in the fourth quarter of 2009 to 1,06, but was still above the logical threshold of 1. The latest reading meant that existing foreign-exchange reserves were about 6 percentage points above the country's total short-term external financing requirements (Table 5 and Figure 17).

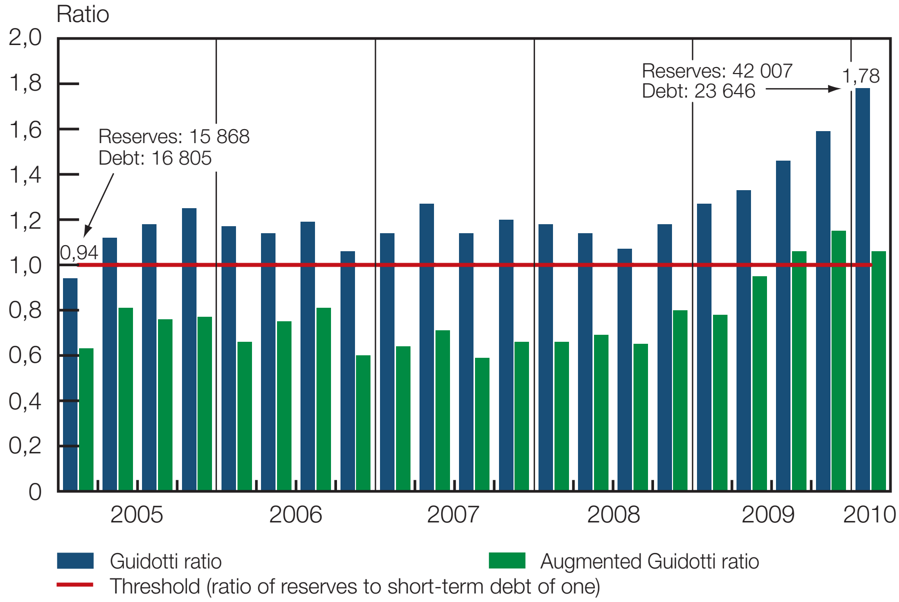
Table 5 Reserve-adequacy ratios

	US$ millions			Guidotti ratio	Augmented Guidotti ratio
	Gross foreign-exchange reserves[1]	Short-term foreign debt[2]	Current-account deficit		
2007: 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
2010: 1st qr	42 007	23 646	-15 832,58	1,78	1,06

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 by the public authorities, public corporations, monetary authorities, banking and other sectors, and the short-term component of foreign direct investment

Source: South African Reserve Bank

Figure 17 Reserve-adequacy ratios[1]

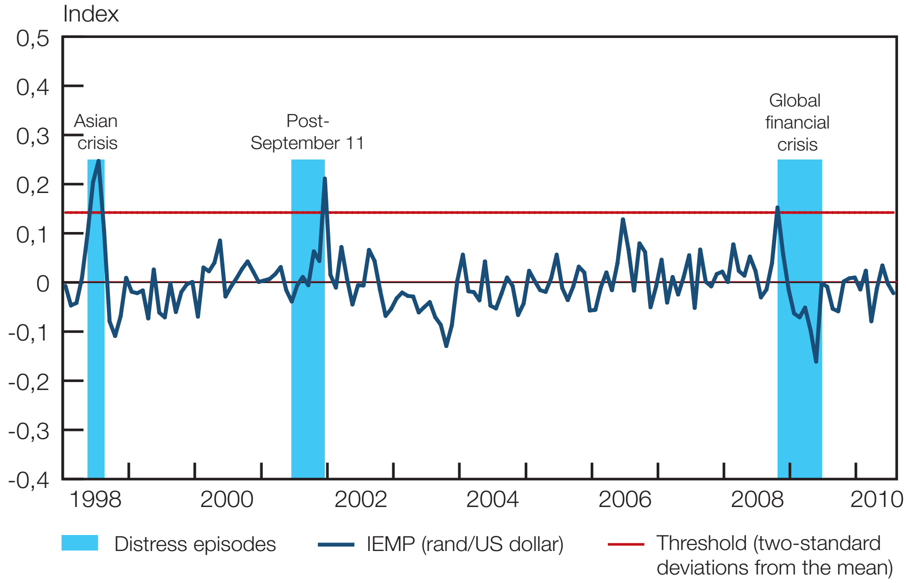


1 Figures for reserves and debt in US$ millions

Source: South African Reserve Bank

The index of exchange market pressure (IEMP) is used as a measure of pressure build-up in the foreign-exchange market. According to this measure, pressure in the domestic foreign-exchange market can be due to a depreciation of the currency and a fall in foreign-exchange reserves. For the whole of 2009 and the first seven months of 2010, the IEMP remained comfortably below the implied threshold of two standard deviations from the mean, suggesting that the exchange rate of the rand was not under considerable pressure. The resilience of the local currency to pressure was mainly attributed to the increase in foreign-exchange reserves.

Figure 18 Index of exchange market pressure[1]



1 The IEMP is usually defined as a weighted average of the change in the external value 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

The Rand Merchant Bank/Bureau for Economic Research (RMB/BER) Business Confidence Index eased by seven points to 36 index points in the second quarter of 2010 before rebounding to 47 index points in the third quarter. This was the highest level in two-and-a-half years and was a reflection of the continued recovery in economic activity. The business confidence level of the South African Chamber of Commerce and Industry (SACCI) also increased to 87,6 per cent in August 2010 with all its sub-indices recording increases.

Interest rate cuts since 2008 do not seem to have spurred corporate credit extension. It is possible that the growth of credit to the corporate sector has been restrained by weak household demand, as reflected in low real household consumption expenditure.

Table 6 Selected indicators for the corporate sector

Annual percentage change, unless indicated otherwise

	2009			2010	
	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Bank credit granted[1]	-0,5	-4,0	-4,6	-4,9	-2,4
Gross fixed capital formation[2]	0,1	-9,3	-12,0	-6,3	-2,7
Credit as a percentage of GDP	47,8	47,0	46,3	45,5	45,3
Credit as a percentage of annualised profits[3]	179,0	168,5	180,1	169,7	144,0
Business confidence index[4]	26	23	28	43	36
Net operating surplus[5]	-6,7	1,5	-3,1	14,2	21,3

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

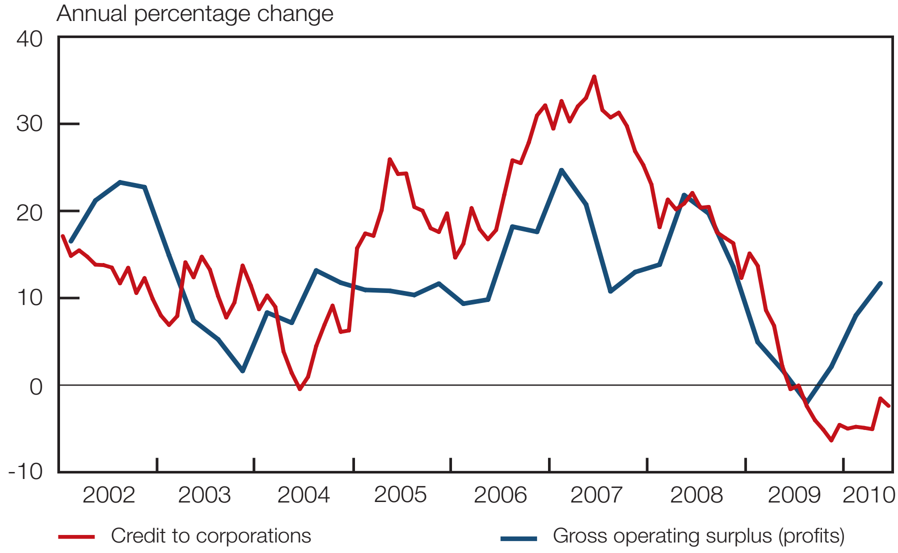
Signs of financial strain in the corporate sector were deduced from a further increase in the number of liquidations. Measured over a 12-month period, the total number of liquidations increased by 21,9 per cent in June 2010 (Table 7). The highest number of liquidations was recorded in the finance, insurance, real-estate and business services sector, followed by the wholesale and retail trade, catering and accommodation sector. However, the situation was reversed in July 2010 when liquidations recorded an annual decline of 34,3 per cent. This indicator should, however, be interpreted with caution as it is very volatile.

Table 7 Total number of liquidations by industry

Industry	2009	2010	
	Jun	May	Jun
Agriculture, hunting, forestry and fishing	2	5	2
Mining and quarrying	0	0	0
Manufacturing	22	24	26
Electricity, gas and water	1	1	0
Construction	20	12	25
Wholesale and retail trade, catering and accommodation	79	98	101
Transport, storage and communication	10	12	19
Finance, insurance, real-estate and business services	148	206	185
Community, social and personal services	29	26	21
Total number of liquidations	311	384	379

Source: Statistics South Africa

Figure 19 Credit to corporations and corporate profit



Source: South African Reserve Bank

Household sector

Despite the negative sentiment brought about by rising unemployment, the level of consumer confidence remained almost unchanged in the second and third quarters of 2010, following a strong recovery in the first quarter. Consumers also remained optimistic about the 12-month prospects for the economy as a whole and about their finances, although they were still somewhat reluctant to commit to the purchase of durable goods.

Table 8 Selected indicators for the household sector

Annual percentage change, unless indicated otherwise

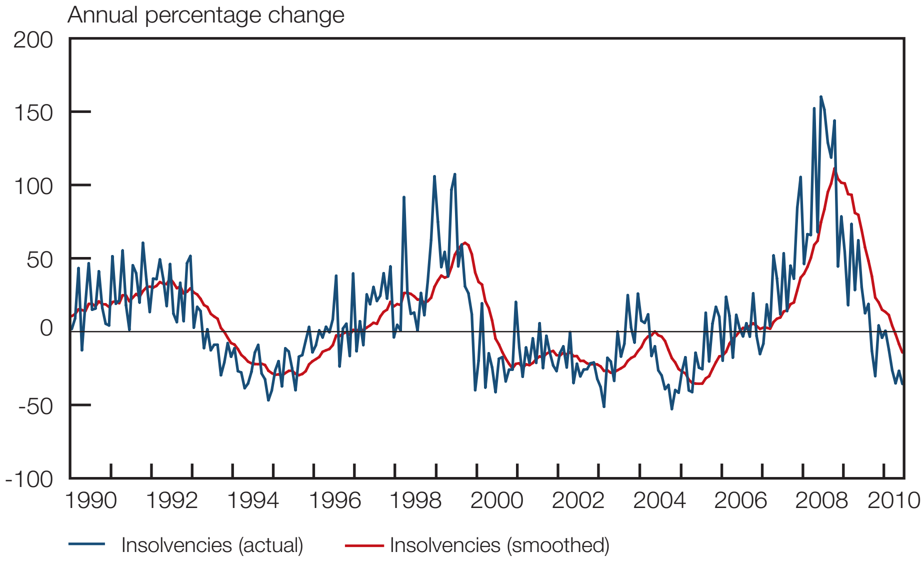
	2009			2010	
	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Nominal disposable income	4,5	2,5	3,2	6,0	7,0
Financial assets[1]	-12,5	3,0	11,8	17,9	11,0
Net wealth[2]	-12,1	3,2	12,0	19,0	13,3
Consumer confidence index[3]	4	1	6	15	14
Consumption expenditure to GDP	62,0	61,6	59,5	60,4	59,6
Real consumption expenditure	-3,7	-3,8	-2,8	0,0	2,5
Credit extension	5,2	3,9	2,9	3,6	4,3
Savings as a percentage of disposable income	-0,4	-0,2	0,0	-0,2	-0,2
Debt	3,8	2,7	2,5	3,1	4,8
Debt to disposable income	79,7	78,8	79,9	78,4	78,2
Debt to GDP	49,2	48,4	47,5	47,2	46,5
Income gearing (per cent)[4]	10,0	8,5	8,3	8,2	8,0
Capital gearing (per cent)[5]	18,8	17,8	17,2	17,0	17,6
Insolvencies	33,7	-8,0	-5,1	-27,7	-37,3
Summonses	11,3	7,0	2,4	-6,1	-11,0

1 Financial assets include households' deposits with financial institutions, shares in pension funds and a proxy for shareholding. 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 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, Statistics South Africa and Bureau for Economic Research, Stellenbosch University

Another positive development in this sector was an accelerated decline in the number of insolvencies throughout the first half of 2010. Insolvencies declined by 27,7 per cent and 37,3 per cent on an annual basis in the first and second quarters of 2010 respectively. The year-on-year percentage change in the total number of civil summonses issued for debt and civil judgments recorded for debt, and the total value of civil judgments recorded for debt also declined in the second quarter of 2010. These developments, coupled with the increase in credit granted, relatively low costs of financing debt and a downward trend in the rejection rate of applications for credit (up to March 2010) may suggest that the balance sheets of households are improving. These developments could also be reflecting the effects of debt restructuring efforts which limit or avoid the use of courts as first recourse in dealing with defaulting consumers.

Figure 20 Insolvencies

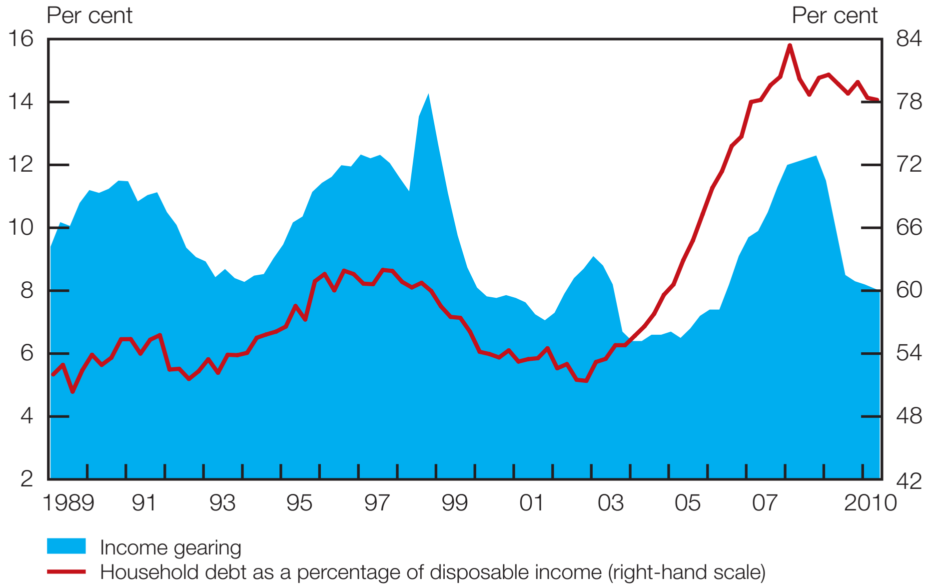


Source: Statistics South Africa

Annual growth in credit to the household sector increased slightly in the first quarter of 2010, followed by a further increase in the second quarter. It did, however, remain well below the historical average. A slow recovery in credit demand, among other factors, moderated the rate of growth in household consumption expenditure, with real household consumption expenditure nevertheless recording an increase in the second quarter of 2010. As a ratio of GDP, household consumption expenditure decreased marginally.

The ratio of household debt to disposable income decreased further, albeit marginally, in the second quarter of 2010. Falling debt-servicing costs, resulting from the downward interest rate cycle that commenced in June 2008, have eased the burden of households in debt. Overall, growing household net wealth and falling debt servicing costs paint a slightly more positive picture about the household sector’s resilience to adverse financial shocks.

Figure 21 Ratio of household debt to disposable income and income gearing

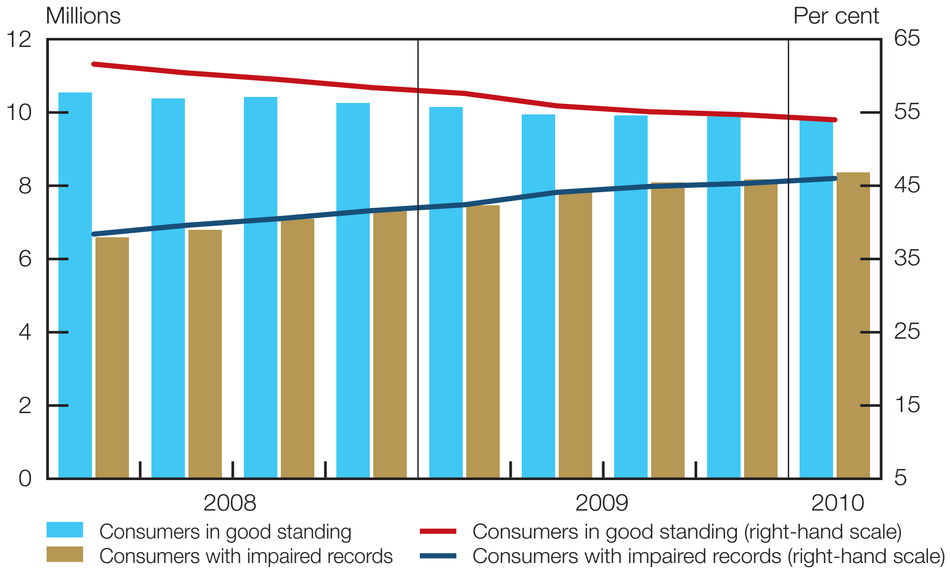


Source: South African Reserve Bank

However, data for the first quarter of 2010 from the National Credit Regulator (NCR) suggest that the household sector may still be experiencing some financial stress. This is reflected in the decline in the number of credit-active consumers in good standing and a rise in the number of consumers with impaired credit records.[29] The situation is, however, expected to improve in the remainder of the year, given relatively low lending rates, which result in declining debt-servicing costs and gradually improving household balance sheets.

29 Consumers have "impaired records" when any of their accounts are either classified as three or more payments or months in arrears, or have an adverse listing (such as "handed over" and/or "written-off"), or that reflect a judgment or administration order. All other consumers are considered to be "in good standing".

Figure 22 Credit standing of consumers



Source: National Credit Regulator

The University of South Africa (Unisa) Bureau of Market Research and FinMark Trust gauge financial vulnerability of consumers using the Consumer Financial Vulnerability Index (CFVI), which is computed from the results of a survey. The level of consumer financial vulnerability improved from 5,17 in the fourth quarter of 2009 to 4,66 in the first quarter of 2010. Despite the improvement, it is evident that consumers remain vulnerable, although less so compared with the last quarter of 2009, as the economy continues to recover, incomes increase and consumers are better able to service their debts. The improvement in savings vulnerability could be attributed to consumers adapting their lifestyles in the aftermath of the recession and coping better with savings at their disposal. The improvement in the debt-servicing vulnerability sub-index can also be attributed to relatively lower lending rates and debt restructuring efforts.

Table 9 Consumer Financial Vulnerability Index (CFVI)[1]

	2009			2010
	2nd qr	3rd qr	4th qr	1st qr
Overall CFVI	5,17	5,49	5,17	4,66
Savings vulnerability index	5,74	5,90	5,40	4,60
Expenditure vulnerability index	5,54	5,45	5,26	5,33
Debt servicing vulnerability index	4,37	4,76	4,51	4,32
Income vulnerability index	5,64	6,03	5,81	4,88

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

Sources: FinMark Trust and Unisa Bureau of Market Research

Up to the fourth quarter of 2009, the lowest income group had been financially most vulnerable. The situation changed in the first quarter of 2010, with 46,4 per cent of consumers earning between R30 000 and R100 000 per annum being financially most vulnerable. Most consumers who lost their jobs in 2009 and the first quarter of 2010 belonged to this income bracket.

Table 10 Percentage of consumers classified as financially most vulnerable according to income group

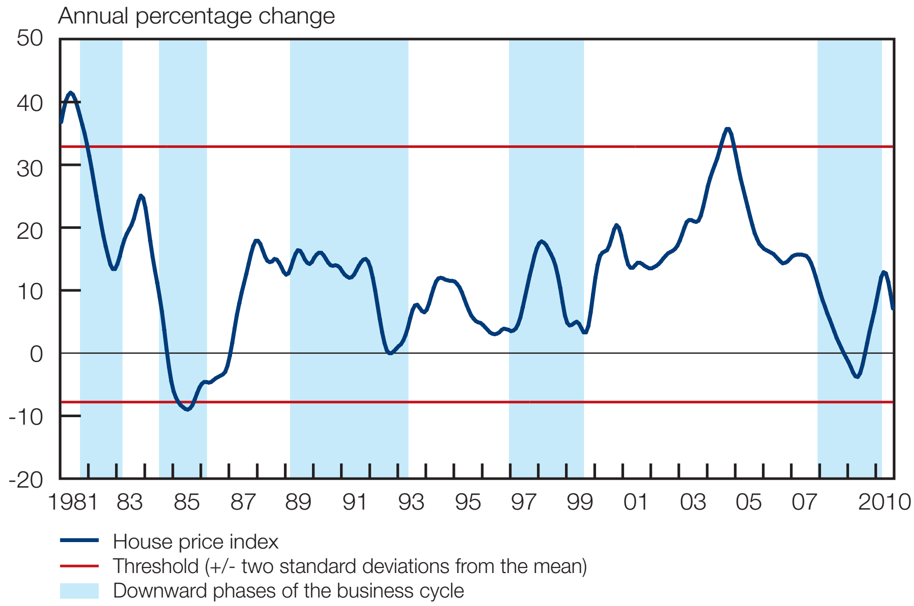
Income group	2009			2010
	2nd qr	3rd qr	4th qr	1st qr
Earning below R30 000 per annum	55,2	48,2	38,9	34,0
Earning between R30 000 and R100 000 per annum	13,7	17,6	31,0	46,4
Earning above R100 000 per annum	31,1	34,2	30,1	19,6

Sources: FinMark Trust and Unisa Bureau of Market Research

Residential real-estate sector

The nominal year-on-year annual growth rate of house prices had been accelerating from October 2009 until April 2010. After reaching a peak of 12,9 per cent in April, it began to decelerate and reached an annual growth rate of 7,1 per cent in August 2010. Affordability is expected to improve as a result of relatively low lending rates and improving household balance sheets.

Figure 23 House price index[1]



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

Source: Absa Bank Limited

According to the Residential Property Confidence Indicator[30] (RPCI), the level of activity in the residential property market improved markedly in the first quarter of 2010. This indicator increased to 6,4 index points; the highest level reached since the first quarter of 2007. Another sign of improved activity was the decrease in the average time that property remained in the market.

However, the confidence levels of both residential and non-residential building contractors decreased in the second quarter of 2010, pulling down the composite building confidence index. According to the First National Bank Building Confidence Index, the construction industry remained in a recessionary mode due to caution on the side of consumers who preferred buying existing homes to building new ones, and were mindful of still-high debt levels. In the case of non-residential building contractors, it would seem that the investment boom ended in mid-2009.

30 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.

Table 11 Activity level in the residential property market and the business confidence level of contractors

	2009			2010	
	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Residential property confidence indicator	4,8	5,7	5,7	6,4	...
Average time property remains in the market (days)	148	116	93	88	...
Buy-to-let as a percentage of total buying	11	13	13	9	...
Composite building confidence index[1]	30	32	28	30	24
Residential contractors index	17	19	21	26	21
Non-residential contractors index	36	33	30	26	18

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

Sources: First National Bank. Data on business confidence were obtained from the Bureau for Economic Research, Stellenbosch University

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 common themes emerging from regulatory reforms undertaken by a number of countries.

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

Companies Amendment Bill, 2010

During the consultation process by the Department of Trade and Industry (dti) on the regulations relating to the new Companies Act, 2008 (Act No. 71 of 2008) (Companies Act, 2008), it was found that amendments were required to rectify some of the provisions in the Companies Act, 2008 and to ensure its improved administration. This resulted in the dti publishing the Companies Amendment Bill, 2010 (the Bill) on 19 July 2010. The Bill seeks to

– amend the Companies Act, 2008 to make better provision for its administration and, in particular, establish a proper foundation for certain necessary regulations;
– continue the mechanisms established under the Companies Act, 1973 (Act No. 61 of 1973), which allow for the transfer or registration of foreign companies to the jurisdiction of South Africa; and
– correct certain errors that resulted in inconsistency, disharmony and ambiguity in the Companies Act, 2008 that could result in the misapplication of the Companies Act, 2008 in a manner contrary to its objective.

It is anticipated that the proposed amendments, to be referred to as the Companies Amendment Act, 2010 will come into operation on the same date as the Companies Act, 2008, which is expected to be in 2011 .

South African Reserve Bank Amendment Act, 2010

The South African Reserve Bank Amendment Act, 2010 became law on 13 September 2010 and the regulations have been amended accordingly. The Act makes amendments to the South African Reserve Bank Act, 1989 (Act No. 90 of 1989), among other things to

– prevent shareholders of the Bank from circumventing the existing Act's current limitation of a maximum of 10 000 shares per shareholder;
– allow for the nomination of directors by a broader base of the South African public and to broaden representation on the Bank's Board of Directors (the Board);
– provide for the confirmation of the Board nominees against "fit and proper" and fiduciary criteria;
– clarify the powers and functions of the Board, which will primarily be focused on governance, with all remaining powers and duties being vested in the Governor and deputy governors; and
– provide an option to re-appoint the Governor and deputy governors for terms of less than five years.

Draft Banks Amendment Bill, 2010

In July 2010 the Bank Supervision Department of the Bank released the proposed draft Banks Amendment Bill. The purpose of the proposed Bill is to align the provisions of the existing Banks Act, 1990 (Act No. 94 of 1990) with the Companies Act, 2008 as well as to ensure that the legal framework for the regulation and supervision of banks and bank controlling companies is based on international standards and best practice.[31] The amendments also take cognisance of the developments in the banking industry and financial markets, and new or amended legislation that might have an impact on banks and/or banking regulation or supervision. The second Bill was open for public comment until 31 August 2010.[32]

31 This would include accommodating the July 2009 proposals of the Basel Committee on Banking Supervision (BCBS) relating to strengthening the 1996 rules governing trading book capital in respect of complex trading activities, as well as the December 2009 and subsequent BCBS proposals regarding capital, liquidity, leverage, etc.

32 A high-level summary of the proposed amendments can be found at http://www.reservebank.co.za.

Treating Customers Fairly Discussion Paper

The Financial Services Board (FSB) is developing a new framework for market conduct regulation, known as 'Treating Customers Fairly' (TCF) and issued a discussion paper in this regard for public comment.[33] The proposed TCF programme is similar to the TCF framework used in the UK. The Financial Services Authority in the UK has been applying the framework since 2001.

33 The 'Treating Customers Fairly' Discussion Paper is available at http://www.fsb.co.za.

TCF is an outcomes-focused approach to improving the fair treatment of customers. It seeks to improve behavioural change in the way financial institutions conduct business to ensure fair treatment of customers throughout the "product life cycle" and in their daily business practices. By encouraging financial firms to re-evaluate their company culture and to inculcate an attitude of treating customers fairly, this initiative is likely to result in a more optimal outcome from the perspective of the regulators, consumers and financial firms.

The FSB would like to see that the desired outcomes include
- an environment being created in which consumers can be confident that they are dealing with financial firms for which the fair treatment of consumers is central to the corporate culture;
- retail financial products and services that are designed to meet the needs of identified consumer groups and are targeted accordingly;
- consumers being provided with clear information and kept appropriately informed before, during and after the point of sale;
- consumers being provided with financial products that perform according to specifications and service that is of an acceptable standard and consistent with the expectations raised by the firm; and
- consumers not being faced with unreasonable post-sale barriers to changing a financial product, switching between providers, submitting a claim or making a complaint.

The FSB will further enhance its current supervisory approach to include TCF principles based on an evaluation of the comments received on the discussion paper. Financial institutions will be required to conduct a self-assessment of compliance with TCF principles in the near future.

Progress made on addressing challenges relating to the debt counselling process

As explained in the March 2010 *Financial Stability Review*,[34] the NCR established a task team in December 2009 to investigate problems around the debt counselling process. The task team had comprehensive engagements with various stakeholders and affected parties, including credit providers, debt counsellors, retailers and court magistrates. The NCR provided feedback to stakeholders on the findings and recommendations of the task team's deliberations at the end of July 2010.

34 For further details on the debt counselling process in South Africa, refer to the March 2010 issue of the *Financial Stability Review*.

In its recommendations, the task team proposed that voluntary, non-statutory measures be put in place to resolve identified problems and challenges. The view of the task team is that the backlogs in the debt review process are caused by a variety of factors related to severe capacity constraints in the judicial system; process weaknesses; inadequate operational compliance by credit providers and debt counsellors, including a lack of co-operation between them; and possible abuse of the debt counselling process by some consumers and other parties.

The key recommendation of the task team is to establish a National Debt Review Committee consisting of representatives of credit providers, debt counsellors and payment distribution agents, and chaired by an independent chairperson. This entity would be mandated to develop, implement and monitor working arrangements for the debt review process on an ongoing basis, subject to the supervision of the NCR. It was also proposed that codes of conduct be developed and implemented, and that guidelines be drafted on various areas for credit providers, debt counsellors and payment distribution agents. It is anticipated that these proposed codes and guidelines will be finalised by the end of 2010.

Common themes emerging from global regulatory reforms

The global financial crisis has affected the financial systems of countries in different ways. In addition to international efforts to strengthen the overall robustness of the regulatory environment, some countries have also responded in the meantime by reforming national regulatory systems. Some themes that have emerged from countries that have already announced regulatory reforms are discussed below.

Expanded role of central banks

The importance and the responsibility of central banks in the regulatory and supervisory framework is a key feature of the reform proposals that are under way. Some central banks' powers with regard to supervision, market conduct and consumer protection have been extended. In the US, the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) has, among other things, extended the Fed's oversight from bank holding companies to include all systemically important financial institutions.[35] The enhanced role of the Fed with regard to supervision has, among other things, been supported by the creation of a new position of Vice Chairman for Supervision.

35 See "Summary of Dodd–Frank Act as prepared by the House Financial Services Committee" available at http://www.lexology.com.

Similarly in Ireland, the Central Bank Reform Bill gives new and extended powers to the central bank. The supervisory powers of the Irish Financial Services Regulatory Authority were transferred to the Central Bank of Ireland, which will be the single regulator of all financial institutions in Ireland. In the UK the Financial Services Authority (FSA) will be dissolved and its powers transferred mainly to the Bank of England (BoE). A new prudential regulator, the Prudential Regulation Authority (PRA), will be established as a subsidiary of the BoE with its board chaired by the Governor, and with a chief executive who will also occupy the newly created post of Deputy Governor for Prudential Regulation.

Other aspects of the regulatory reforms currently under way are proposals regarding the consumer protection function and the role of central banks in this regard. Although a separate and dedicated Consumer Protection and Markets Authority (CPMA)[36] will be created in the UK, the BoE, through its Financial Policy Committee (FPC), will have some macroprudential control over the actions of the CPMA. In the US, a Consumer Financial Protection Bureau is to be established within the remit of the Fed. These steps reflect the expanding influence of the central bank in a range of regulatory and supervisory matters, including consumer protection.

36 The CPMA will regulate the conduct of all firms, both retail and wholesale, including those regulated by the PRA.

The growing importance of the systemic regulator

The significant costs of the global financial crisis to both the financial system and the real economy required financial authorities to address the regulatory implications of what has commonly been called 'systemic risks' or vulnerabilities faced by the financial system as a whole. There is an ongoing debate on the range of policy instruments that should be used to assess and mitigate systemic risks and the appropriate institutional infrastructure that should be adopted to achieve this. A number of authorities and countries have introduced changes in this regard. The EU was one of the first authorities to announce definite proposals in this regard by calling for the establishment of the European Systemic Risk Board (ESRB) in 2009. The ESRB is expected to start operating in 2011 and will be responsible for macroprudential oversight at the EU level.

In the US a Financial Stability Oversight Council (FSOC) will be established and chaired by the Treasury Secretary. The FSOC will be responsible for monitoring and assessing systemic risks and making policy recommendations. The UK's response to dealing with systemic risks is the proposal that the BoE be put in charge of macroprudential regulation by establishing the FPC within the BoE. It is intended that the FPC will be responsible for overseeing the financial system at the macroeconomic level and identifying financial issues that may threaten financial stability. It will be given tools to address the risks and the power to require that the new PRA implements its macroprudential decisions. In February 2010 India also announced the establishment of a high-level Financial Stability and Development Council that will be tasked with responsibility for macroprudential supervision with a view to strengthening and institutionalising the mechanism for maintaining financial stability.

Addressing moral hazard risks associated with systemically important financial institutions

Addressing the "too-big-to-fail" moral hazard problems associated with SIFIs has been a major project of various groupings of financial authorities, including the Group of Twenty (G-20) and the Financial Stability Board.[37] The Financial Stability Board has committed itself to working on this matter and has developed the following principles[38]:

– All jurisdictions should have a policy framework in place to reduce the moral hazard risks associated with SIFIs in their jurisdictions.
– All jurisdictions should have effective resolution tools that enable the authorities to resolve financial firms without systemic disruptions and without taxpayer losses.
– All jurisdictions should have the capacity to impose prudential requirements on firms that are commensurate with their systemic importance.
– All national supervisory authorities should have the powers to apply differentiated supervision requirements for institutions based on the risk they pose to the financial system.
– All jurisdictions should put in place or strengthen core financial market infrastructure to reduce contagion risk upon a firm's failure and encourage their use.
– Financial Stability Board members will establish an ongoing peer-review process to promote national policies to address the risks associated with SIFIs.

Countries that have SIFIs are expected to heed the principles of the Financial Stability Board and seek ways of incorporating these principles into financial regulatory reforms. This would form a basis for achieving consistency and co-ordination across different jurisdictions when dealing with SIFIs.

37 South Africa is a member of the G-20 and the Financial Stability Board.

38 See the Financial Stability Board interim report to the G-20 leaders titled *Reducing the moral hazard posed by systemically important financial institutions*, issued on 18 June 2010.

The US has addressed this issue in the Dodd–Frank Act by proposing what it deems a safe way to liquidate failed financial firms, and impose tough new capital and leverage requirements that make it undesirable for financial firms to get too big. The Fed has been provided with the authority to provide system-wide support, but no longer to support individual firms, while also establishing rigorous standards and supervision processes to protect the economy and US consumers, investors and businesses.

The closing of regulatory gaps

The regulatory gaps that were prevalent in the build-up to the financial crisis have been addressed in some jurisdictions. The US has addressed a number of these gaps, for example, by extending the regulatory powers of the Securities and Exchange Commission to include hedge funds, private equity funds and ratings agencies. More transparency and accountability in the derivatives market are envisaged as most derivative transactions will be directed through channels such as regulated exchanges and central clearing houses. It is expected that these initiatives will reduce arbitrage opportunities to financial institutions and contribute to financial stability.

The EU issued a directive on Alternative Investment Fund Managers (AIFM) in April 2009.[39] The objective of the directive, which is currently being considered by the EU legislative structures, is to close regulatory gaps by creating a comprehensive and effective regulatory and supervisory framework for AIFMs such as hedge funds and private equity funds at the EU level. Similarly, Australia and New Zealand are in the process of creating new, or extending existing, hedge fund regulation.

39 The EU's AIFM directive can be accessed at http://ec.europa.eu.

Political and government involvement in regulatory reforms globally

The key regulatory structures proposed to address systemic or macroprudential oversight concerns have in some cases been structured to accommodate government involvement and/or political representatives.[40] The involvement of political and/or government representatives in macroprudential policy matters may require some forethought to ensure the operational independence of the micro supervisory decision-making process. While it is understandable and necessary that there should be accountability and transparency when using tax-payer funds for financial stability purposes, the possibility that sound supervisory decisions could be influenced by political agendas must also be considered.

40 Both the UK and the US, the FPC and FSOC, respectively, allow for government involvement. In the UK, the membership of the FPC will include a non-voting Treasury representative, while the Chancellor will be entitled to appoint four external members of the FPC. In the US, the FSOC will be chaired by the Treasury Secretary.

In conclusion, some countries are proceeding with national regulatory proposals before a common international framework has emerged and/or international recommendations are agreed to. A lack of international convergence with regard to overall robust regulatory frameworks may ensue and could impede the harmonisation of supervisory standards and practices globally. Fragmented regulatory structures and unco-ordinated regulatory proposals from individual countries may challenge the attainment of equitable outcomes in, and across, different jurisdictions. Some of the proposed reforms discussed above will only be fully operational over the next few years,[41] and therefore the implications of these developments for regulation and supervision will only become more apparent some time in the future.

41 Some of the aspects of the US regulatory proposal are subject to further statutory reports and studies, and in the UK detailed legislation will only be introduced in 2011.

Abbreviations

AGR	augmented Guidotti ratio
AIFM	Alternative Investment Fund Managers
Alsi	All-Share Index
BCBS	Basel Committee on Banking Supervision
BER	Bureau for Economic Research
BoE	Bank of England
CDS	credit default swap
CEBS	Committee of European Banking Supervisors
CFVI	Consumer Financial Vulnerability Index
CPMA	Consumer Protection and Markets Authority
CRB	Commodity Research Bureau
dti	Department of Trade and Industry
EC	European Commission
ECB	European Central Bank
EMBI	Emerging Market Bond Index
EME	emerging-market economy
ESRB	European Systemic Risk Board
EU	European Union
FPC	Financial Policy Committee
FSA	Financial Services Authority
FSB	Financial Services Board
FSOC	Financial Stability Oversight Council
G-20	Group of Twenty
GDP	gross domestic product
GIIPS	Greece, Italy, Ireland, Portugal and Spain
GR	Guidotti ratio
IEMP	index of exchange market pressure
IIF	Institute of International Finance
IMF	International Monetary Fund
MSCI	Morgan Stanley Capital International
NCR	National Credit Regulator
Nersa	National Energy Regulator of South Africa
PRA	Prudential Regulation Authority
RICS	Royal Institute of Chartered Surveyors
RMB	Rand Merchant Bank
RPCI	Residential Property Confidence Indicator
SACCI	South African Chamber of Commerce and Industry
SADC	Southern African Development Community
SAVI	South African Volatility Index
SIFI	systemically important financial institutions
TCF	Treating Customers Fairly
the Bank	South African Reserve Bank
the Board	Board of Directors of the South African Reserve Bank
the Fed	United States Federal Reserve
Unisa	University of South Africa
US	United States
UK	United Kingdom
VIX	CBOE Volatility Index