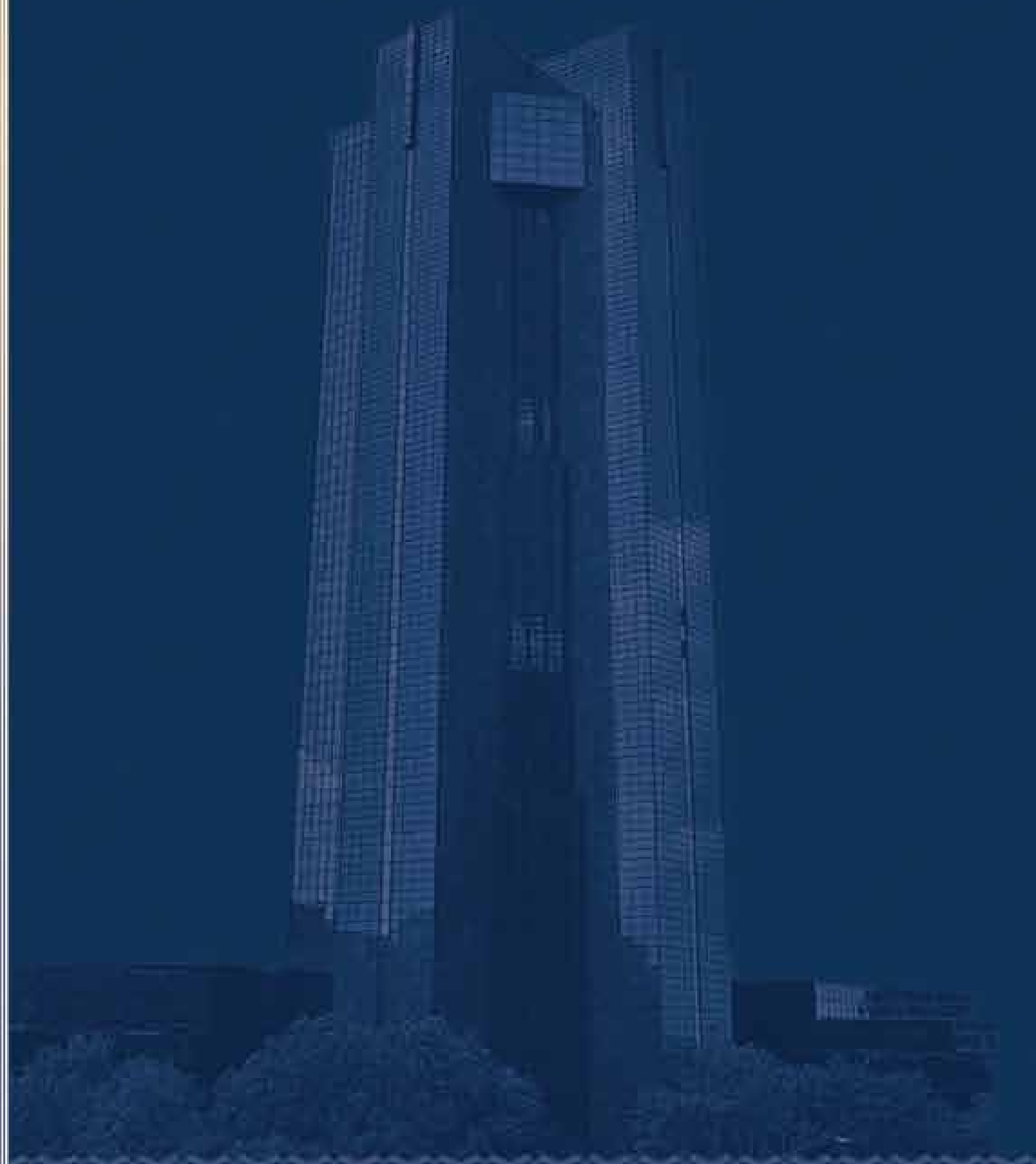

Financial Stability Review

March 2012

South African Reserve Bank

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This issue of the *Financial Stability Review* focuses mainly on the six-month period ending December 2011. However, selected developments up to 31 March 2012 are also reported on. Data may include own calculations made for purposes of this publication.

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Purpose of the *Financial Stability Review*

The South African Reserve Bank (the Bank) defines its primary objective as the achievement and maintenance of price stability in the interest of balanced and sustainable economic growth in South Africa. In addition to this, the Bank's mandate in overseeing and maintaining financial stability was reaffirmed by the Government. 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 contributes significantly towards and co-ordinates 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, first, an efficient regulatory infrastructure, second, efficient and well-developed financial markets and, third, efficient 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 measures 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

This issue of the *Financial Stability Review* focuses on the six-month period ending December 2011, and selected developments up to 31 March 2012 are also reported on. Since the release of the September 2011 *Financial Stability Review*, the global macrofinancial environment initially became more challenging before showing signs of improvement in early 2012. However, the environment continues to be characterised by fragility, with significant downside risks remaining. Global output remains subdued given the impact of the euro area's sovereign debt crisis, deleveraging by global banks and a slowdown in trade activity. This could dampen future investment, output and consumer spending, which might have a negative impact on global financial stability. Unemployment rates have also increased further in a number of advanced economies and, as a result, are weighing on private consumption expenditure and affecting social cohesion.

Central banks in several advanced economies have responded to the subdued economic and financial conditions by maintaining an accommodative monetary policy stance during the period under review. Actions to stimulate economic activity through asset purchases, low interest rates and injections of liquidity into the financial system not only improved market sentiment, but also acted as a catalyst for a switch in risk appetite. However, these actions have thus far not led to an increase in lending by banks. Many banks are still in the process of mending their balance sheets and are facing tighter regulatory requirements. The combination of deleveraging and stricter capital and liquidity requirements is likely to impact negatively on the global business cycle over the implementation period. The possibility of an adverse feedback loop between financial markets and the real economy remains a threat.

Global economic growth concerns, coupled with anxiety over the euro area sovereign debt crisis, led to a general increase in risk aversion, depressed financial markets and high levels of volatility in financial markets in the second half of 2011. During the first quarter of 2012 financial market stress decreased as concerns over the global economic outlook and the euro area sovereign debt crisis eased amid substantial provision of central bank liquidity.

During the period under review oil prices increased and exhibited a high degree of volatility. The global economic recovery could be derailed if the current high level of oil prices persists for an extended period. Initially, oil prices were weighed down by demand concerns amid a subdued global economic outlook, but towards the end of 2011 concerns about geopolitical tensions drove oil prices higher. Volatility in oil prices is expected to continue as the interplay of risks from the slowdown in global economic growth and tensions in some oil-producing countries persist.

Emerging-market economies (EMEs) continue to be the main drivers of global economic growth despite a slowdown in 2011 when export growth decreased significantly. Weaker demand from advanced economies (notably Europe) and high energy prices also pose downside risks to EME growth. In the second half of 2011 funding difficulties for a number of euro area banks intensified and the consequential deleveraging by these banks in an attempt to shore up capital has resulted in a decline in cross-border bank lending. Subsequently, European banks reduced their international lending in general and their claims on EMEs in particular. Contagion fears and increased uncertainty associated with the turbulence in euro area debt markets resulted in higher levels of risk aversion and lower levels of private capital flows to emerging and developing economies. During the first quarter of 2012, however, capital inflows to EMEs resumed. Volatility of flows to EMEs has increased and the direction has become highly uncertain. Economic uncertainty and the associated risk aversion also weighed on economic growth in the sub-Saharan Africa (SSA) region. Other risks to which this region is exposed include possible disruptions to trade finance as European banks sell assets and reduce lending; a reversal of portfolio capital; less foreign direct investment inflows; and a slowdown in export demand.

In South Africa output growth was also impacted negatively by the economic slowdown in advanced economies, but edged higher in the third quarter and recovered in the fourth quarter. For 2011 as a whole, real gross domestic product (GDP) increased by 3,1 per cent mainly, due to a steady expansion in the services sector throughout the year. The Bank revised its GDP growth forecast upwards to 3,0 per cent in 2012 and 3,9 per cent in 2013. Confidence in the financial services sector recovered strongly, but the Financial Services Index has not returned to its pre-crisis levels.

Conditions in the South African banking sector, which plays a key role in the stability of the financial system, remained stable with banks well capitalised and on track to meet the Basel III[1] capital requirements that will be phased in over a ten-year period from 2013. Profitability increased gradually throughout the second half of 2011, which could mainly be attributed to higher fee income and a decrease in credit losses. Liquidity in the sector also exceeded the current regulatory requirements. Banks will, however, face challenges in meeting the anticipated stricter liquidity requirements resulting from the implementation of Basel III if relevant adjustments are not made during the transition period to the new framework. Although a rating agency recently downgraded the senior debt and deposit ratings of the five largest South African banks, the downgrade was motivated by the view that the authorities would face challenging policy decisions if multiple financial institutions were to need financial support simultaneously.

1 Two documents published by the Basel Committee on Banking Supervision in December 2010 (revised in June 2011) are commonly collectively referred to as 'Basel III', namely: *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* and *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring*.

The Bank continues to monitor the credit exposure of the five largest South African banks to Greece, Italy, Ireland, Portugal and Spain (GIIPS). These banks' combined gross credit exposure to the GIIPS countries as a percentage of total gross credit exposure amounted to less than 1 per cent in the fourth quarter of 2011, with negligible direct sovereign exposure. The five largest banks mainly held derivatives with banks and private-sector non-bank counterparties with legal jurisdiction in the GIIPS countries.

According to information provided by selected banks, their total exposure to unsecured lending (including credit cards, overdrafts, personal loans and financing provided to small and medium enterprises (SMEs)) increased moderately in 2011, but still amounted to only 8 per cent of the total gross credit exposure in December. The highest growth in unsecured lending was in the 'retail other' unsecured lending category consisting of loans greater than R30 000. At current levels unsecured lending does not constitute a bubble and the Bank is monitoring developments closely. Unsecured lending does not currently present any systemic risk to the financial system.

The life insurance industry continued to play an important role in financial intermediation and participation in the financial system, particularly through investments in fixed-income securities and equity. Although investments by life insurance companies in fixed-interest securities contracted in the third quarter of 2011, the life insurance sector maintained positive premium growth. The industry remained well capitalised and adequately equipped to absorb unforeseen shocks in the financial system. Other positive developments include a decrease in surrenders and individual lapses, an increase in underwriting profits and net premiums, and a decrease in management expenses and commissions (as a percentage of net written premiums).

The domestic bond and equity markets were fairly volatile during the period under review amid heightened risk aversion towards emerging markets. The domestic bond market was further negatively impacted by uncertainty surrounding the domestic interest rate outlook and the potential impact of global developments on domestic economic growth. The JSE All-Share Index (Alsi) continued to track international developments and was pressured by higher risk aversion due to fears that the sovereign debt crisis in peripheral Europe could spread to the core countries, concerns of a slowdown in global economic growth, and lower-than-expected domestic GDP growth in the third quarter of 2011. Equity market losses, however, were limited by positive domestic sentiment surrounding proposals relating to the reclassification of inward-listed shares announced in the *Medium Term Budget Policy Statement* (*MTBPS*) in October 2011. The JSE Alsi was further supported by better-than-expected domestic economic data and the return of positive sentiment to global equity markets from December 2011. Although volatility in domestic bond and equity markets increased, it still compared favourably with that observed in many advanced economies. Developments in domestic financial markets did not present any systemic risks to the financial system.

Corporates and households are important customers of banks and adverse developments in these sectors could increase the vulnerability of banks and the financial system. Credit extended to the corporate sector continued to improve steadily and the annual growth rate of profits of the sector remained positive in the fourth quarter of 2011. A review of the corporate sector by a rating agency, following the change in the outlook for South Africa's sovereign rating, concluded that the corporate sector remained stable, mainly on account of its solid liquidity profile. During the period under review, the financial position of the household sector continued to improve, supported by increases in total assets and income growth. With disposable income growing faster than household debt, the debt burden of households decreased slightly. Although still high, the ratio of household debt to disposable income declined. The relatively low household interest burden, coupled with the growth in disposable income, should contribute to enhanced short-term debt-servicing capacity. However, the household sector continued to be impacted by the high rate of unemployment and the savings rate of the sector remained stagnant at low levels. Given the fairly low level of consumer confidence and the burden of high levels of household debt, the growth rate of household demand remains at moderate levels.

The South African banking sector has significant exposure to the real-estate sector. The resurgence in activity in the residential real-estate market that started in early 2009 turned out to be short-lived and the growth rate of house prices moderated from the middle of 2010. Towards the end of 2011 house price indices started showing diverging trends. The residential property market is still influenced by economic and confidence factors affecting the household sector. Consequently, as long as the confidence levels of households remain low, activity in the property market is likely to remain at moderate levels.

Recent developments that have enhanced the robustness of the financial regulatory environment in South Africa include the public release of the Credit Rating Services Bill (CRS Bill), the Financial Markets Bill (FM Bill) and the Financial Services Laws General Amendment Bill (FSLGA Bill); the progress made towards improving the solvency standards of the insurance industry; and the establishment of the Financial Regulatory Reform Steering Committee (FRRSC).

The CRS Bill will improve accountability on the part of credit rating agencies, enhance transparency and reliability of the credit rating process and credit ratings, protect investors and reduce systemic risk. The FM Bill, once enacted, will ensure that the legislative framework for financial markets is aligned with relevant local and international developments and standards, and continues to be effective in mitigating the impact of the global financial crisis. Furthermore, the National Treasury (NT) has published the first draft of the FSLGA Bill, which proposes amendments to domestic financial services laws. The objective of the FSLGA Bill is to address gaps and strengthen the financial sector regulatory framework, notwithstanding the legislative process under way as part of the move towards a twin peaks model of financial regulation.

Significant progress has been made both internationally and domestically to improve solvency standards for the insurance industry. Jurisdictions need to ensure that they follow the basic principles and objectives of Solvency II[2] and modify it according to their own particular environment. The Financial Services Board (FSB) issued a number of Solvency Assessment and Management (SAM) discussion documents in the latter part of 2011 covering reporting and disclosure, capital requirements, and governance issues. These documents are aimed at obtaining the input of stakeholders and to contribute to the drafting of secondary legislation. Finally, the FRRSC, which consists of senior members of the Bank, the FSB and the NT, was established in 2011 to drive the reform of financial regulation in South Africa and implement a twin peaks financial regulatory model.

2 Refer to the 'Infrastructure and Regulation' section for more details in this regard.

The overall assessment made from the analyses in the *Financial Stability Review* is that the South African financial system has proved to be relatively resilient in the wake of a volatile and uncertain global environment. Financial institutions and markets in South Africa have limited exposure to financial institutions and products in countries that are a source of high levels of risk. Although the recent conjuncture is uncertain and several challenges remain, the South African financial system is generally sound.

Introduction

This issue of the *Financial Stability Review* focuses on the six-month period ended December 2011, but is updated with more recent information where available, and comprises two main sections, namely (i) financial stability developments and trends, and (ii) 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 environments 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 starts with an update on financial policy, followed by an overview of legislative and infrastructural developments affecting the South African financial system. This is followed by an update on South Africa's implementation of the SAM project for the insurance sector and an update regarding the progress made in implementing the Treating Customers Fairly (TCF) initiative. An assessment of the progress made in implementing the proposed twin peaks model of financial regulation for South Africa is also provided. This section concludes with a discussion of issues pertaining to strengthening South Africa's financial-sector crisis resolution framework.

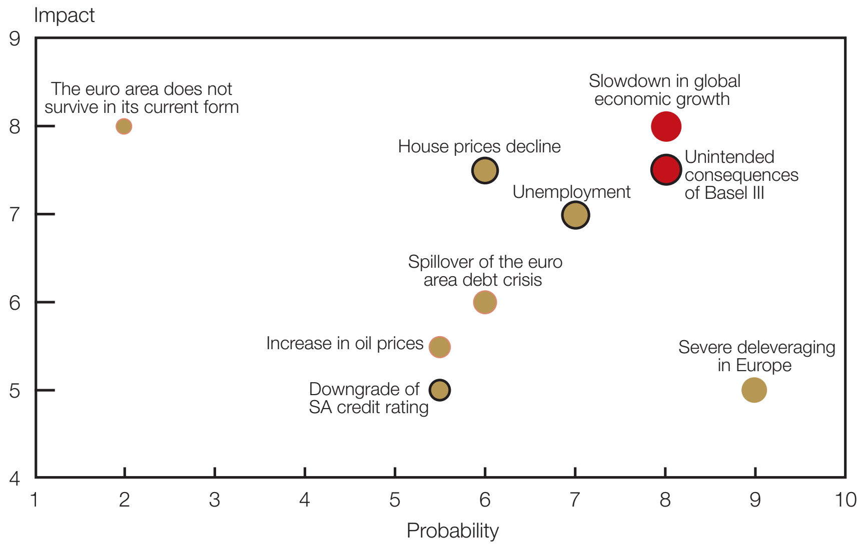
Financial stability developments and trends

The global financial system is currently facing a multitude of risks, including spillover effects of the euro area debt crisis to other parts of the world; the risk of disorderly deleveraging by European and other banks; changes in the direction of capital flows; a sharp increase in oil prices; and concerns that the euro area will not survive in its current form. Prospects of higher global economic growth rates have also been dampened by the ever-present risk of negative feedback loops from the financial sector to the real economy. In addition, there are also risks specific to the South African economy and financial system. These risks include a possible slowdown in domestic economic growth as a result of slower global growth; a decline in house prices and higher unemployment; the unintended impact of the Basel III framework on banks and lending; and the risk of a downgrade of South Africa's credit rating.

Figure 1 shows selected exogenous and endogenous risks that could potentially impact on the South African financial system during 2012. The relative importance of each risk is measured, first, by the probability of that particular risk materialising during 2012 and, second, by the likely impact that it would have on the domestic financial system. In order to obtain the various risk intensities, a value between zero and ten was assigned[3] to both the probability and impact of each risk. The rating scales were split into a low (between 0 and 3,5), medium (between 3,5 and 7) and high (between 7 and 10) range for both probability and impact. The risk intensity was subsequently calculated as the product of the probability and impact of each risk. In Figure 1 different colours are used to indicate the relative intensity of the risks: gold represents moderate intensity and red represents high intensity. Domestic risks are circled with a solid line.

3 Values were assigned by a group of financial stability analysts in the Bank.

Figure 1 Risks to financial stability



Sources: South African Reserve Bank and researchers' computations

The most prominent risk to domestic financial system stability, as shown in Figure 1, is a possible slowdown in global economic growth. The potential unintended negative consequences of complying with the Basel III liquidity requirements were also identified as a concern as it could result in an increase in the cost of funding for banks and reduced availability of long-term credit.

International macrofinancial developments

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

Financial and economic developments in advanced economies

Economic growth

Despite concerted efforts by central banks in advanced economies to encourage economic activity, growth remained weak in the second half of 2011. The pace of economic growth remains uneven across advanced economies, partly due to different policy approaches. Global economic growth is likely to continue facing challenges in view of persistent concerns about the euro area's sovereign debt crisis, deleveraging by global banks and a possible slowdown in trade activity. Moreover, the transmission mechanism for the provision of liquidity from central banks to commercial banks and, ultimately, to consumers and businesses is not functioning optimally. This could dampen future investment, production and consumer spending, which might have a negative impact on global financial stability.

The United States (US) seems to have weathered the global financial crisis much better than Europe and embarked on aggressive fiscal spending in addition to adopting a resolute accommodative monetary stance. In the latter part of 2011 economic activity started to show signs of gaining momentum, and US consumption expenditure and GDP growth data improved. On an annualised basis, GDP growth in the US was recorded at 3,0 per cent in the fourth quarter of 2011, which is significantly higher than the 1,8 per cent reported in the third quarter.[4] This brought the annual growth rate for the US in 2011 to 1,7 per cent, which is much lower than the 3,0 per cent attained in 2010. A recovery in the US housing market has been cited by the US Federal Reserve as an important prerequisite for a sustainable recovery in US economic activity (see Box 1).

4 Bureau of Economic Analysis, "Gross Domestic Product: Fourth Quarter and Annual 2011 (Third Estimate)" (Washington DC: US Department of Commerce, 29 March 2012), 1.

In contrast to the approach adopted by the US, some countries in the euro area reduced government spending through austerity measures in order to support economic growth in the long term. However, the sovereign debt crisis led to higher borrowing costs for several European countries, which must first normalise before domestic demand and business activity are likely to return to normal.

In both the euro area and the much broader 27-nation European Union (EU), the seasonally adjusted quarter-on-quarter GDP contracted by 0,3 per cent in the fourth quarter of 2011.[5] Six euro area member states (i.e., Greece, Portugal, Belgium, the Netherlands, Slovenia and Italy) slipped into a recession in the fourth quarter, with the largest contraction recorded in Greece (7 per cent year on year) following contractions in the first three quarters of 2011. The economies of the United Kingdom (UK) and Germany contracted in the fourth quarter of 2011, while France maintained a positive economic growth rate over the same period.

5 Eurostat, "Second Estimates for the Fourth Quarter of 2011" (Luxembourg: Eurostat, 6 March 2012), 3.

After a tentative recovery in the third quarter of 2011, economic activity in Japan declined by an annualised seasonally adjusted rate of 0,7 per cent in the final quarter, largely driven by a decrease in exports.

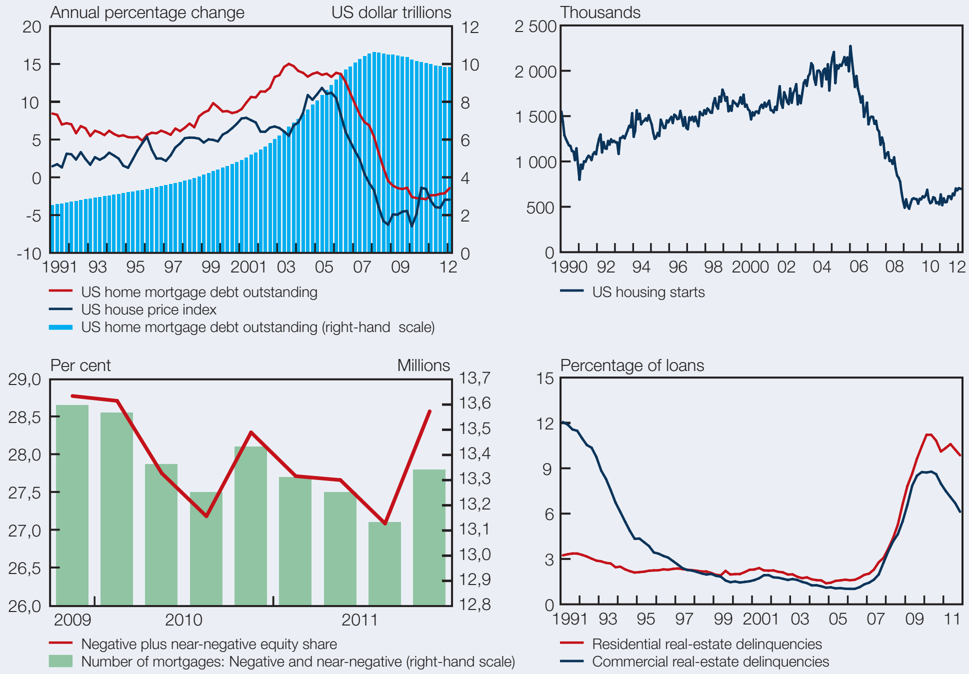
Box 1 United States real-estate market

The depressed real-estate market continues to expose the United States (US) financial system to a fair degree of instability and is an important factor weighing on the US economic recovery. Although recent developments are pointing towards a tentative improvement in the market, concerns about potential foreclosures and an uptick in the number of mortgages in negative and near-negative equity may be indicative of continued weakness.

According to RealtyTrac,[6] despite the fact that US foreclosure activity fell by 8 per cent nationally in February 2012, there were cities that showed year-on-year increases during this period due to the bureaucratic nature of the judicial foreclosure process, which had resulted in a larger build-up of foreclosures in the preceding year in these cities.

6 RealtyTrac, "Foreclosure Tide Rising in Half of Largest Metro Areas", February 2012 *U.S. Foreclosure Market Report* (Irvine: Renwood RealtyTrac LLC, 13 March 2012).

Figure A1 Developments in the US real-estate market



Sources: Bloomberg and United States Federal Reserve

Furthermore, there is concern that US house price stabilisation may take longer as household deleveraging continues. The US house price index fell by almost 3 per cent during the fourth quarter of 2011, although this was a moderation from the 4 per cent contraction seen during the third quarter.

There are, however, signs that a recovery in the US real-estate market is gaining momentum. The ratio of delinquent loans to total loans for commercial and residential real estate continued to fall in 2011, except for a mild uptick in delinquency rates for residential real-estate loans during the third quarter. The downward trend in the amount of outstanding mortgage debt also continued. US housing inventories showed signs of improvement as the number of months of existing home supply fell from 9,1 months in June 2011 to 6,1 months in January 2012. Furthermore, in the second half of 2011, average housing starts increased to 643 000 from 577 000 in the first half of 2011.

Despite these developments, and against the backdrop of continued challenges in the US labour market, it appears that the US housing market will continue to pose downside risks to a sustainable US economic recovery.

Risks emanating from high unemployment rates

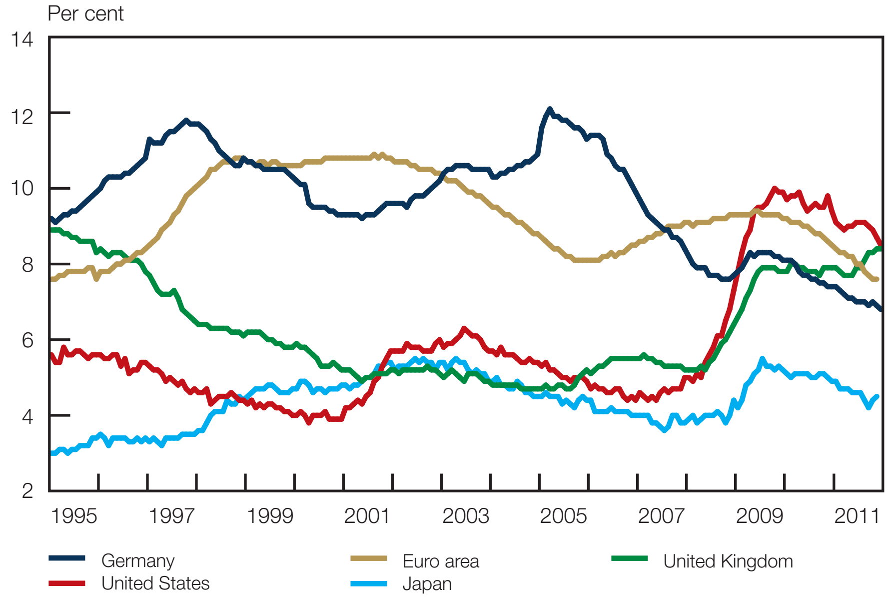
Unemployment rates in advanced economies have started to diverge, with unemployment increasing in a number of countries in the euro area and in the UK, while there has been a tentative decrease in unemployment levels in the US.

Some countries in the euro area face the difficult task of reducing unemployment while implementing austerity measures. The overall seasonally adjusted euro area unemployment rate[7] increased throughout the period under review and reached a record high of 10,8 per cent in February 2012, with the unemployment rate in Spain particularly concerning at 23,6 per cent. Furthermore, the youth unemployment rate[8] in Spain increased to 50,5 per cent in February 2012, and reached 50,4 per cent in Greece as at the end of December 2011. In sharp contrast, the German unemployment rate fell to 5,7 per cent in October 2011 and remained at this level in February 2012. High unemployment rates, which are usually associated with a slowdown in global economic activity, have resulted in isolated instances of social unrest and political instability in the euro area. These developments, should they remain unresolved, could translate into increased volatility in the European financial markets which, in turn, could spill over to financial markets in EMEs. Moreover, deteriorating labour market conditions are likely to continue weighing on private consumption in the euro area.

7 Eurostat, *Euro Area Unemployment Rate at 10.8%* (Luxembourg: Eurostat, 2 April 2012).

8 'Youths' are defined as people between the ages of 16 and 24.

Figure 2 Unemployment in advanced economies



Source: Bloomberg

9 The underemployment rate is defined as the number of unemployed people plus those who want a full-time position, but who can only find part-time work.

Despite the decline from 9 per cent in September 2011 to 8,3 per cent in February 2012, the US unemployment rate remains high. A bleaker picture is sketched by the underemployment rate,[9] which increased to 19,1 per cent in February 2012, from 18,7 per cent in January. Unless there is a significant decrease in the underemployment rate, US household earnings and the housing market can be expected to remain relatively weak, casting doubt over the depth and sustainability of the US economic recovery.

Banking-sector developments and central bank support

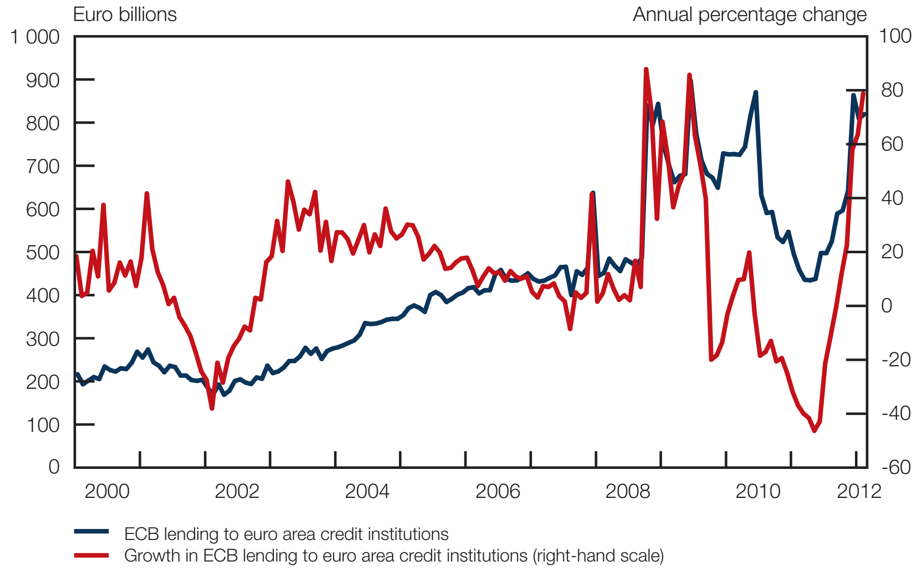
In response to global economic growth and bank-funding concerns in Europe, central banks in several advanced economies, including those of the US, the UK, Europe and Japan, maintained an accommodative monetary policy stance during the period under review.

In the US the Federal Reserve declared its intention to maintain an accommodative monetary policy stance until 2014 in an effort to stimulate economic activity. This was motivated by its assessment that the recovery in the US economy is weak and still in need of support.

In February 2012 the Bank of Japan announced an increase of 10 trillion yen (US$128 billion) in its asset-purchase programme. Similarly, in the UK a slowdown in economic activity prompted the Monetary Policy Committee of the Bank of England (BoE) to raise its asset purchase target by £50 billion to £325 billion in order to support the uncertain recovery.

Vulnerabilities in the European banking sector associated with the sovereign debt crisis prompted the European Central Bank (ECB) to announce a three-year bank-funding facility, known as the Long-Term Refinancing Operation (LTRO). This was intended to support European banks and ease the impact of the euro area crisis by increasing liquidity in the market, revive the interbank market and enable banks to meet their repayment schedules more easily. In turn, this would avoid a potential credit crunch and address the systemic implications of the risk of a possible collapse of one or more major banks. The first round of the LTRO was carried out in December 2011 when banks borrowed €489 billion from the ECB with a maturity of three years at a rate of 1 per cent per annum. A second round of the LTRO was carried out in February 2012 with banks borrowing €530 billion on the same terms.

Figure 3 ECB lending

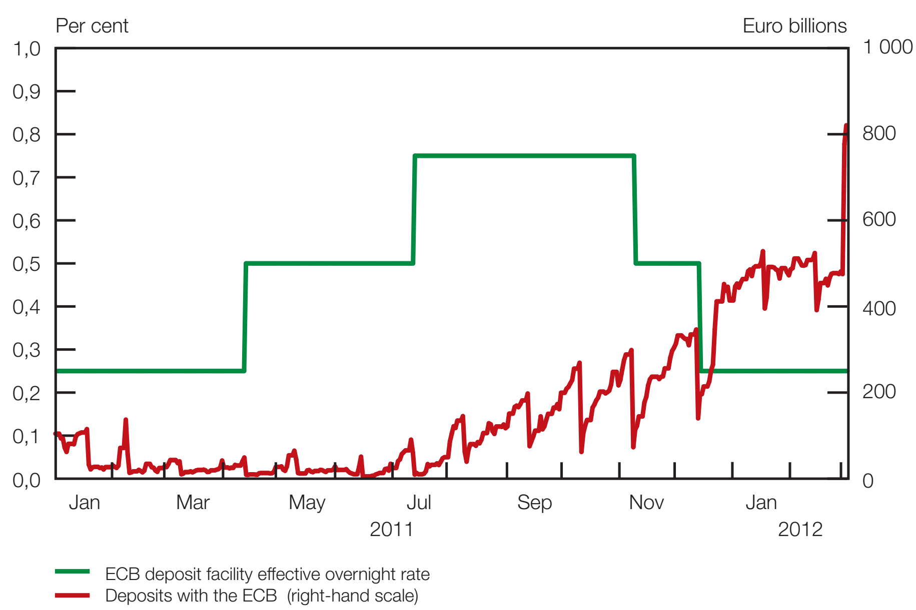


Source: Bloomberg

Actions of the ECB to stimulate economic activity through asset purchases, lower interest rates and injections of liquidity into the financial system have been watered down by banks' subdued lending to consumers and businesses. This reluctance to lend, as banks continue to mend their balance sheets and face tighter regulatory requirements, is likely to impact negatively on the global business cycle. The threat of an adverse feedback loop between credit markets and the real economy remains, as deleveraging could still be substantial despite the LTROs.

Even though some pressure on European banks was alleviated and market sentiment improved following the ECB's refinancing operations, borrowing costs remain high and bank lending remains subdued throughout Europe, particularly in the countries with higher levels of bank debt. Data from the ECB show that banks' deposits with the ECB increased by about €300 billion following the second LTRO of the ECB (see Figure 4). Nevertheless, interbank market tensions

Figure 4 ECB deposit facility overnight rate and deposits with the ECB



Source: Bloomberg

eased substantially in the first quarter of 2012 as indicated by the difference between the three-month euro interbank offered rate (Euribor) and overnight indexed swaps (OISs). The Euribor–OIS spread narrowed in the first three months of 2012 to levels last recorded in August 2011. Credit provision to households and businesses in Europe is yet to increase, but has shown signs of stabilising in January 2012. In the UK bank lending also remains constrained. By contrast, in the US bank lending to the corporate sector increased throughout 2011, albeit from very low levels.

Euro area developments

Tension in the euro area intensified in the second half of 2011 with much of the focus centring on Greece (see Box 2). Sovereign bond spreads widened amid concerns over fiscal sustainability and banks' exposure to stressed European sovereign debt. Negative outlooks and rating downgrades of several European countries in the third quarter of 2011 contributed to the rise in yields. With a view to mitigating these tensions and moving towards a long-term solution, significant measures have been undertaken by various role-players in the euro area. These measures include the initial decision to strengthen the European Financial Stability Facility (EFSF) and accelerate its transition to the European Stability Mechanism (ESM), a permanent fund with paid-in capital with a greater lending capacity (€500 billion) than the EFSF. In March 2012 it was decided that the EFSF would continue to run for an additional year, in parallel with the ESM, which is due to start operating in July 2012. While the ESM is focused on the financing of debt, the 'fiscal compact' announced at the EU summit in December 2011 aims largely to eliminate government deficits by establishing a constitutional limit for the structural budget deficit of governments at 0,5 per cent of their respective GDPs. These actions, in addition to actions from the ECB, reduced sovereign and bank debt yields, and lessened funding pressures in the latter part of 2011.

Box 2 Debt restructuring and the second bail-out package for Greece

Greece's first bail-out package was agreed to in May 2010 and amounted to €110 billion. However, in 2011 Greece's Prime Minister announced that in order to avoid a default on its debt, Greece needed a second bail-out package.

Following an extensive period of negotiations between Greek lawmakers and private holders of Greek debt, a debt-swap agreement was reached in March 2012, averting the immediate threat of an uncontrolled default by Greece. Private-sector creditors agreed to take a 75 per cent haircut from the face value of their Greek bond holdings. This reduced Greece's debt obligations by roughly €100 billion and hence significantly reduced the country's financing needs. The swap enabled it to receive a second bail-out package, funded mostly by other euro area countries and the International Monetary Fund (IMF). The IMF's €28 billion contribution was formally approved on 15 March 2012 as part of the overall financing package of €130 billion agreed to by the euro area partners. Following the debt-swap agreement and a new European Union/IMF rescue plan, Greece's debt is expected to decrease to below 120 per cent of GDP in 2020, from the current level of 160 per cent.

Near-term uncertainty was substantially reduced by these developments, although several long-term structural problems remain. First, Greece's primary budget deficit remains large, implying that it still needs to raise capital in the debt market, most likely at relatively high borrowing rates. Second, Greece's pension and public-sector obligations also remain large amid weak economic growth due to a series of austerity measures that the country has adopted as part of its undertakings in its bailout programmes. Finally, there is little support from Greek citizens for what is perceived as harsh austerity measures falling on the Greek citizenry. A combination of these factors could still result in Greece defaulting on its debt obligations in future.

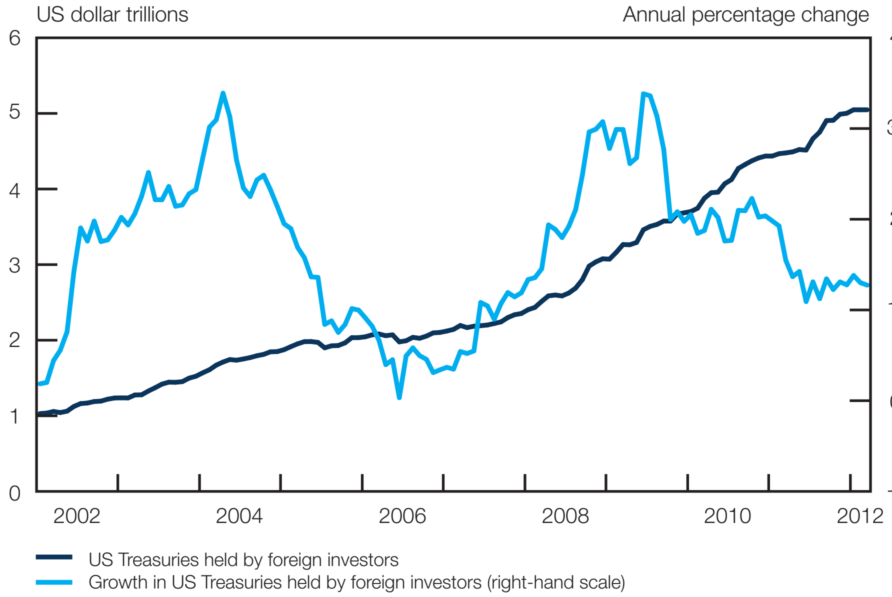
Towards the end of the first quarter of 2012, concerns about the euro area sovereign debt crisis were reignited. In Spain lacklustre economic growth, together with high unemployment, especially among the youth, underpinned concerns regarding Spain's ability to meet its 2012 budget deficit target. This prompted caution among investors and resulted in an increase in Spanish government bond yields. The austere 2012 budget could result in weaker economic growth and hence undermine Spain's ability to reduce its debt levels, locking Spain into a worsening debt trap.

Financing of the United States twin deficits

Global imbalances between current-account deficit nations and current-account surplus nations could pose a risk to global financial stability, especially if those positions were to unwind in a disorderly manner.

Although many believe that the US financial system remains vulnerable to a possible reversal in high levels of demand for US Treasuries, the US continued to benefit from its 'safe-haven' status despite a downgrade of its AAA-rating in August 2011. Surplus funds from the Organization of the Petroleum Exporting Countries, China, Japan and other global investors seeking to hold US Treasuries and other securities have enabled the US Federal Reserve to keep the cost of borrowing very low.

Figure 5 Foreign holding of US Treasuries



Source: Bloomberg

International holdings of US Treasuries increased by 13 per cent to a record high of US$5 trillion in 2011, with China still holding the largest proportion thereof. Japan increased its holdings of US Treasuries by 20 per cent year on year to just over US$1 trillion at the end of 2011, compared with US$882 billion at the end of 2010. US Treasuries continued to benefit from their status as the ultimate safe haven as investors became more concerned about the developments in Europe than the problems experienced by the US. The continuation of large global imbalances continues to pose a risk to global financial stability.

Financial market developments

Equity markets

Global economic growth concerns, coupled with anxiety over the European sovereign debt crisis, led to a general increase in risk aversion and depressed financial markets in the second half of 2011. Financial market volatility increased sharply in the third quarter of 2011 as shown by the Chicago Board of Options Exchange (CBOE) Volatility Index (VIX®),[10] while equity prices fell globally, particularly in the euro area and EMEs. After a short-lived recovery, equity prices weakened again towards the end of 2011 as sovereign debt concerns resurfaced. Equity indices in advanced economies declined by less than equities in EMEs during 2011, with the Morgan Stanley Capital International (MSCI) World Index[11] decreasing by about 9,4 per cent and the MSCI Emerging Market Index[12] falling by more than 20 per cent.

10 VIX® is a symbol for the Chicago Board of Options Exchange Volatility Index. It measures implied volatility of the S&P 500 Index for equities over the next 30-day period.

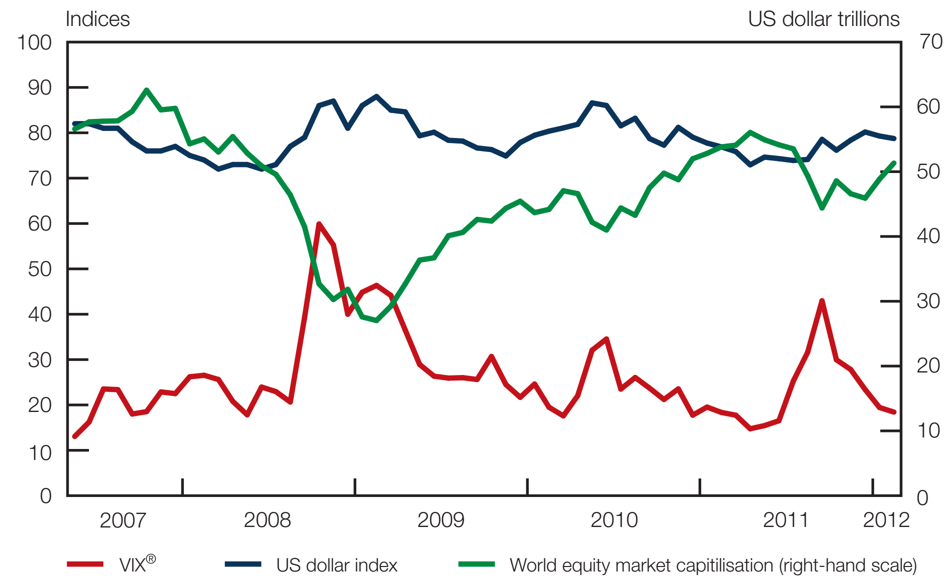
11 The MSCI World Index is a free float-adjusted market capitalisation-weighted index which is designed to measure the performance of equities in key developed economies.

12 The MSCI Emerging Market Index is a free float-adjusted market capitalisation-weighted index which is designed to measure the equity market performance of key EMEs.

Financial market stress, however, decreased in the first quarter of 2012 as concerns over the global economic outlook eased following substantial provision of central bank liquidity. Furthermore, investors became more confident that Greece would secure a rescue package. During the first three months of 2012, world equity market capitalisation increased by US$5,6 trillion, almost reversing the US$6 trillion decline seen during 2011. At the end of March 2012, in line with improved market sentiment, emerging-market equities were outperforming equities in advanced economies.

The strengthening trend of the US dollar that commenced in the second quarter of 2011 generally continued throughout the rest of the year due to the perceived 'safe-haven' status of the dollar amid intensified sovereign bond market tensions and increased volatility in financial markets. The flight to familiarity due to deteriorated market sentiment led to the depreciation of several emerging-market currencies. However, following the turnaround in risk sentiment in December 2011, the US dollar depreciated slightly, but remained relatively strong.

Figure 6 VIX®, US dollar index[1] and world equity market capitalisation



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

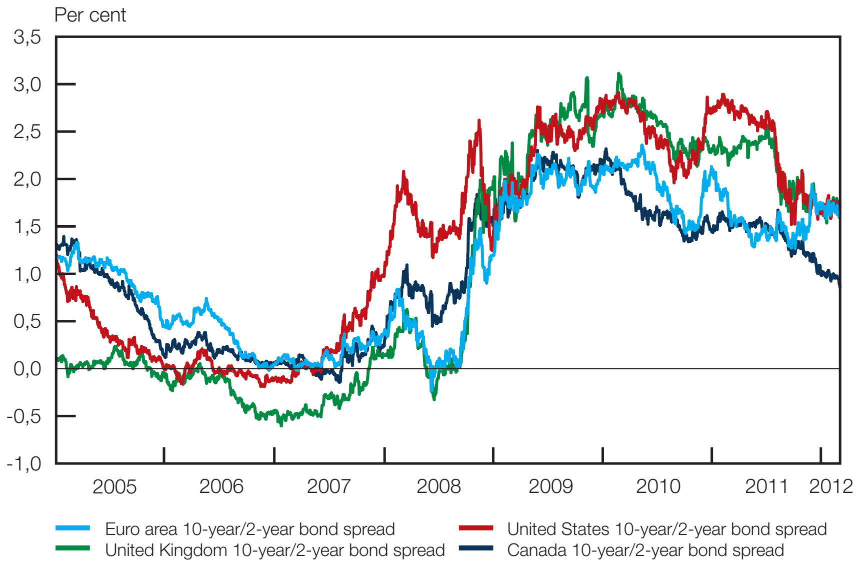
Source: Bloomberg

Bond markets

Globally, central banks have maintained an accommodative monetary policy stance, causing short-term rates to fall well below long-term rates. However, since the second half of 2011, the effect of lower economic growth expectations has also weighed on the longer bond yields. This is because long-term rates are driven mainly by economic and inflation expectations, while short-term rates are more related to central bank interest rate policy. Furthermore, the US Federal Reserve introduced 'Operation Twist'[13] in September 2011, in an attempt to drive down long-term interest rates and reinvigorate the faltering economy.

13 The US Federal Reserve announced that it would purchase US$400 billion worth of long-dated US Treasuries, financed by the sale of an equal amount of bonds with three years or less to maturity.

Figure 7 Bond spreads in selected advanced economies



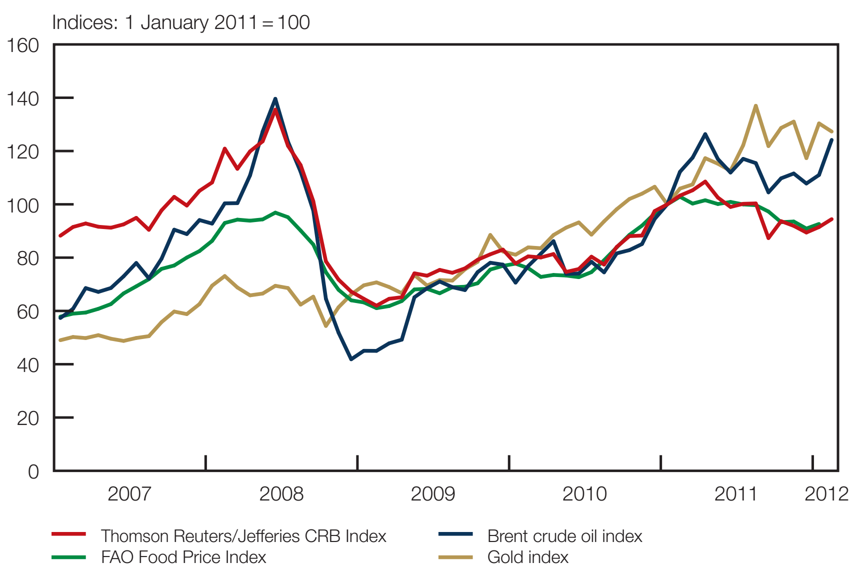
Source: Bloomberg

Commodity prices

The increases in commodity prices during the first four months of 2011 were mostly reversed in the remainder of the year amid global economic growth concerns and a relatively strong US dollar. This pattern can be observed in the Thomson Reuters/Jefferies Commodity Research Bureau (CRB) Index[14] that had reached its highest level since 2008 in April 2011, and subsequently declined by 17,6 per cent in the remainder of 2011. Commodity prices have increased since the beginning of 2012, in line with an increase in risk appetite and improved liquidity conditions.

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

Figure 8 Thomson Reuters/Jefferies CRB Index and selected commodity price indices[1]



1 The FAO Food Price Index is a measure of the monthly change in international prices of a basket of food commodities. It consists of the average of five commodity group price indices (representing 55 quotations), weighted with the average export shares of each of the groups for 2002–2004

Source: Bloomberg

Oil prices exhibited a high degree of volatility during the period under review and were weighed down in the third quarter of 2011 by demand concerns amid a subdued global economic outlook. However, towards the end of 2011 rising tensions between Iran and certain Western nations, and unrest in Egypt and Syria caused concern about supply from the Middle East and North Africa region. These concerns drove oil prices higher due to an increase in precautionary inventories. Supply concerns, unusually cold weather in Northern Europe and an improvement in market sentiment led to higher oil prices in the first quarter of 2012, with prices increasing by about 16 per cent. Volatility in oil prices is expected to continue due to the interplay of risks from the slowdown in global economic growth (demand side) and tensions in some oil-producing countries (supply side).

After increasing sharply in the third quarter of 2011 the gold price was volatile, but in contrast to most other commodities it remained at relatively high levels in the following six months. The gold price was supported by safe-haven flows as financial market tensions persisted. Search-for-yield pressures amid ample liquidity conditions and a low real interest rate environment in advanced economies further supported the gold price. Towards the end of the first quarter of 2012, however, the gold price was weighed down by a stronger US dollar.

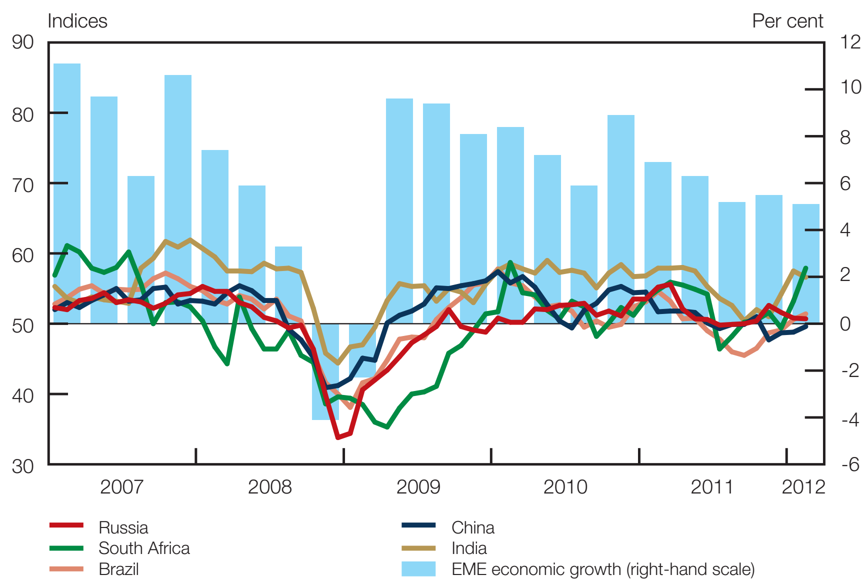
Financial and economic developments in emerging-market and developing economies

Emerging-market economies

15 Institute of International Finance, *Global Economic Monitor* (IIF Research Note, Washington DC: IIF, March 2012).

EMEs were not immune to the slowdown in economic growth experienced in advanced economies, with year-on-year growth slowing down from 7,2 per cent in 2010 to 6 per cent in 2011[15] as export growth in EMEs decreased significantly in the second half of 2011. Economic growth in EMEs is forecast to moderate even further to 5,5 per cent in 2012 due to a deterioration in the external environment and a slowdown in domestic demand in key EMEs.

Figure 9 Economic growth[1] and PMI manufacturing overall indices[2] for selected EMEs



1 Seasonally adjusted
2 Index values above 50 index points indicate expansion, while index values below 50 index points indicate contraction

Sources: JPMorgan and Institute of International Finance

Despite the moderation in economic growth, EMEs continue to be the main drivers of global economic growth. However, weaker demand from advanced economies (notably Europe) and high energy prices pose downside risks to EME growth.

Inflation levels in EMEs generally eased in the latter part of 2011 in line with previously tightened monetary policy conditions, lower commodity prices and weak consumer spending. Declining food prices, which commonly have a large weight in consumer price baskets in EMEs, played an important role in decreasing inflation levels. Amid lower inflation levels, several EMEs eased monetary policy in the latter part of 2011 and at the start of 2012[16] with a view of supporting economic growth.

Forward-looking indicators such as the manufacturing Purchasing Managers' Indices (PMIs) show an improved growth outlook for certain key EMEs, including India, Brazil and Russia, recording values above 50 index points in February 2012. However, in China – a significant contributor to global growth – the PMI remained below 50 points[17] for the fifth consecutive month in March 2012 and the Chinese government adjusted its economic growth target for 2012 downwards to 7,5 per cent. Downside risks to economic growth include the unwinding of the property boom, a worsening of the euro area debt crisis and higher commodity prices. Despite the challenging external environment, the Chinese economy has proven to be fairly resilient, supported by robust corporate profitability and rising household incomes.

Funding difficulties for a number of euro area banks intensified and the consequent external deleveraging by these banks in an attempt to shore up capital has resulted in a decline in cross-border bank lending. This deleveraging increased further after the announcement in October 2011 by the European Banking Authority (EBA) that European banks were required to achieve a 9 per cent Tier 1 capital ratio by mid-2012. Subsequently, European banks reduced their international lending in general and their claims on EMEs in particular. Furthermore, contagion fears and increased uncertainty associated with the turbulence in euro area debt markets resulted in higher levels of risk aversion towards EMEs. Net private capital flows to EMEs accordingly declined significantly in the second half of 2011 and are estimated to have declined by over 10 per cent from 2010 to 2011.[18] Recently, capital flows have largely been driven by risk perceptions and even though they stabilised and resumed to certain EMEs at the beginning of 2012, capital flows are likely to continue to be volatile in 2012.

16 For example, in January 2012 Brazil cut its policy rate by 50 basis points; India decreased the cash reserve ratio by 50 basis points; and Thailand and the Philippines cut rates by 25 basis points. In April 2012 Brazil cut its policy rate by an additional 75 basis points and India reduced its policy rate by 50 basis points.

17 HSBC Holdings, "HSBC China Manufacturing PMI™ Press Release" (Beijing: HSBC, 1 April 2012). In contrast, the official sector manufacturing PMI rose from 51 points in February 2012 to 53,1 points in March 2012.

18 Institute of International Finance, "Capital Flows to Emerging Market Economies" (Washington DC: IIF, 24 January 2012).

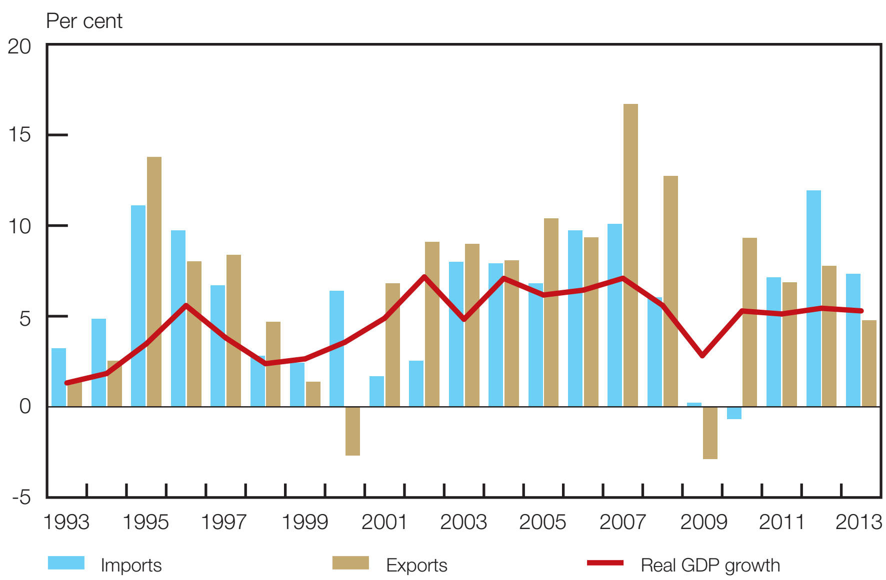
Africa, sub-Saharan Africa and the Southern African Development Community region

Real economic developments

Actual economic growth levels in the SSA region are estimated to have been lower than the levels that were initially forecast in 2011 and reflect the effects of heightened economic uncertainty during most of the year. Economic uncertainty and the associated risk aversion did not only weigh on the region's economic growth, but also resulted in a deterioration in funding conditions, while simultaneously steering lending practices towards a tightening bias in some economies during the fourth quarter of 2011.[19] However, a rebound in export demand, higher commodity prices and resilient domestic demand negated the worst of these effects.

19 Institute of International Finance, "Emerging Markets Bank Lending Conditions Survey: Sub-Saharan Africa" (Washington DC: IIF, January 2012).

Figure 10 Real GDP growth and trade developments in sub-Saharan Africa



Source: International Monetary Fund

20 International Monetary Fund, *World Economic Outlook* (Washington DC: IMF, April 2012).

21 International Monetary Fund, *Regional Economic Outlook* (Washington DC: IMF, October 2011).

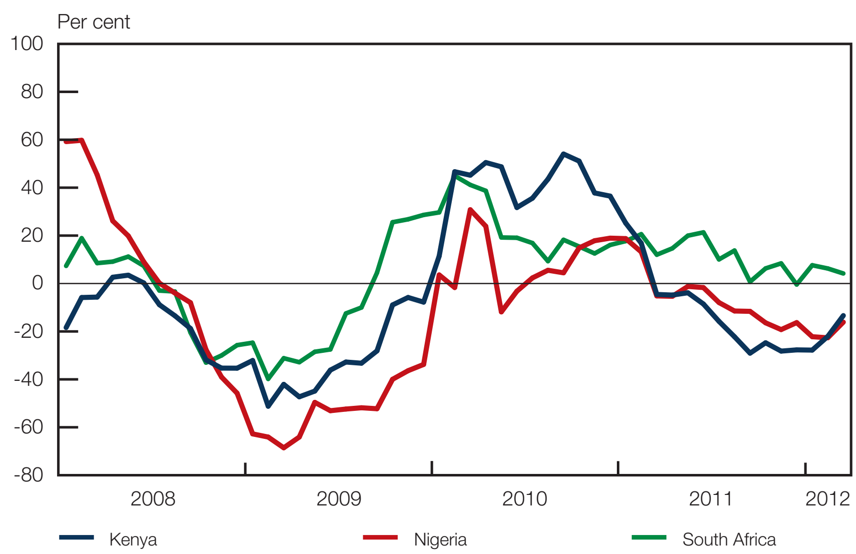
Exports grew by approximately 7 per cent in 2011 after having contracted by about 1 per cent in the previous year, while imports moderated. It is estimated that real GDP in the SSA region grew by 5,1 per cent in 2011, down from 5,3 per cent in 2010.[20] Economic growth in the Southern African Development Community (SADC) region did, however, manage to exceed initial projections. The average economic growth rate for the SADC region is estimated to have been 3,9 per cent in 2011, up from 3,6 per cent in 2010.[21]

Against the backdrop of an increasing risk of negative feedback loops to the real economies of Europe and beyond, SSA economic growth projections for 2012 have been revised downwards. Nonetheless, forecasts still remain relatively buoyant. Other risks to which SSA is exposed include possible disruptions to trade finance as European banks sell assets and reduce lending; a reversal of portfolio capital; less foreign direct investment inflows; and a slowdown in export demand. Trade finance concerns could be compounded by challenges to find new sources of trade finance with the ability to fill funding gaps. Although exposures to the risk of capital flight may be somewhat limited, there could be serious ramifications for current-account balances and currencies if the risk was to materialise. Furthermore, the projected slowdown in the economic growth rate in China, a prominent investor in Africa, and the possibility of disorderly deleveraging in Europe also present downside risks to the region's economic growth prospects. According to IMF forecasts, SSA is expected to grow by 5,4 per cent and 5,3 per cent in 2012 and 2013 respectively, while the SADC region is expected to grow by 5,0 per cent in 2012.

Financial market developments

Apart from risks that emanated from within the SSA region, uncertainty about, and fears of, financial contagion from the European sovereign debt crisis dominated developments in the SSA financial sectors. Along with the widespread sell-off of risky assets in other emerging and developing countries, regional equity markets declined during 2011. Equity indices in Kenya and Nigeria – two of the largest economies in the region – fell by approximately 24 per cent and 16 per cent respectively during 2011. However, equity markets have recovered since then, supported by a broad-based upsurge in commodity prices.

Figure 11 Year-on-year growth in selected sub-Saharan African equity indices



Source: Bloomberg

22 In a basket of 15 selected major African currencies, 12 out of the 15 depreciated against the US dollar, while only 9 depreciated against the euro.

Similarly, the subdued mood in advanced economies and elevated risk aversion weighed on the performance of most high-risk and commodity-linked currencies. In line with this trend, the spot return on the US dollar of currencies of most middle-income countries in the region was negative in the year to December 2011. The position was, however, slightly different against the euro, with fewer currencies depreciating against it.[22]

Domestic macroprudential analysis

This section contains an appraisal of the general health, soundness and robustness of the South African financial system. It starts with an analysis of selected indicators of real economic activity to provide a broad overview of macroeconomic conditions. While analysis of the financial strength of the banking sector reveals the resilience of domestic banks and the possible build-up of systemic imbalances, the stability of the financial system also depends on the soundness of other financial institutions, such as insurance companies and pension funds, due to their financial connectedness with banks. Developments in financial markets and financial positions of the corporate and household sectors are analysed as these sectors have strong macrofinancial linkages with the financial system. This section concludes with an overview of developments in the domestic real-estate market.

Indicators of real economic activity

During the fourth quarter of 2011, South Africa's real GDP grew at a quarter-on-quarter, annualised and seasonally adjusted rate of 3,2 per cent compared to a revised increase of 1,7 per cent in the third quarter. The wholesale, retail and motor trade; catering and accommodation industry; the manufacturing industry; general government services; and the finance, real estate and business services were the main contributors to the overall acceleration in real GDP growth in the fourth quarter of 2011. For 2011 as a whole, real GDP increased by 3,1 per cent mainly due to the sustained steady expansion in activity in the services sector throughout the year. The Bank's GDP growth forecast has been revised upwards to 3,0 per cent in 2012 and 3,9 per cent in 2013, while the IMF forecast marginally lower growth of 2,7 per cent in 2012 and 3,4 per cent in 2013.[23]

Underlying factors, however, remain negative and the growth rate is still well below the targeted economic growth rate of 7 per cent that is required to achieve the government's target of reducing the unemployment rate to 14 per cent by 2020.[24] During the fourth quarter of 2011, the official unemployment rate decreased to 23,9 per cent from 25,0 per cent in the third quarter, while the broad unemployment rate, which includes discouraged work seekers, also decreased from 36,9 per cent to 36,0 per cent.[25] Although this decrease reflects a positive change, unemployment remains at an elevated level.

The picture painted by a selected set of indicators of real economic activity remained fairly positive for overall activity in the real economy during the second half of 2011. The number of building plans passed contracted in the third quarter, but the trend was reversed and the number increased sharply during the fourth quarter. During the review period the composite leading business cycle indicator broadly followed a sideways trend.

The annual growth rates of both retail and wholesale trade sales increased during the third and fourth quarters of 2011, with retail sales most likely supported by a low interest rate environment. Growth in wholesale trade sales was also in line with the acceleration in domestic aggregate consumption.

The motor vehicle industry continued its robust performance through the six months up to the end of December 2011, recording positive annual growth in both total new vehicle and new passenger car sales. Growth in motor vehicle sales continued in early 2012, with annual growth rates of 5,4 per cent and 10,8 per cent recorded for total new vehicle and new passenger car sales respectively in March 2012. It should be noted, however, that it seems as if the pace of growth in vehicle sales, which peaked in September 2011, has moderated.

The overall picture of the real economy seemed positive during the second half of 2011 as most indicators reflected positive trends.

23 International Monetary Fund, *World Economic Outlook* (Washington DC: IMF, April 2012).

24 National Planning Commission, *National Development Plan* (Pretoria: National Planning Commission, 11 November 2011).

25 Statistics South Africa, *Quarterly Labour Force Survey* (Pretoria: Statistics South Africa, quarter 4, 2011).

Table 1 Selected indicators of real economic activity[1]

Annual percentage change in monthly indicators

Activity indicators	2010	2011			
	Dec	Mar	Jun	Sep	Dec
Building plans passed	-4,60	-0,16	-2,57	-14,16	16,23
Buildings completed	-38,45	14,08	17,63	18,31	-1,57
Retail sales	6,82	5,39	2,30	7,79	7,63
Wholesale trade sales	5,90	5,70	7,88	9,18	5,72
New vehicle sales	29,27	17,64	11,92	30,25	19,04
New passenger car sales	38,85	23,55	17,33	26,18	19,33
Electric current generated	1,25	1,26	0,98	2,00	1,00
Utilisation of production capacity[2]	80,74	80,49	80,94	79,61	80,10

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

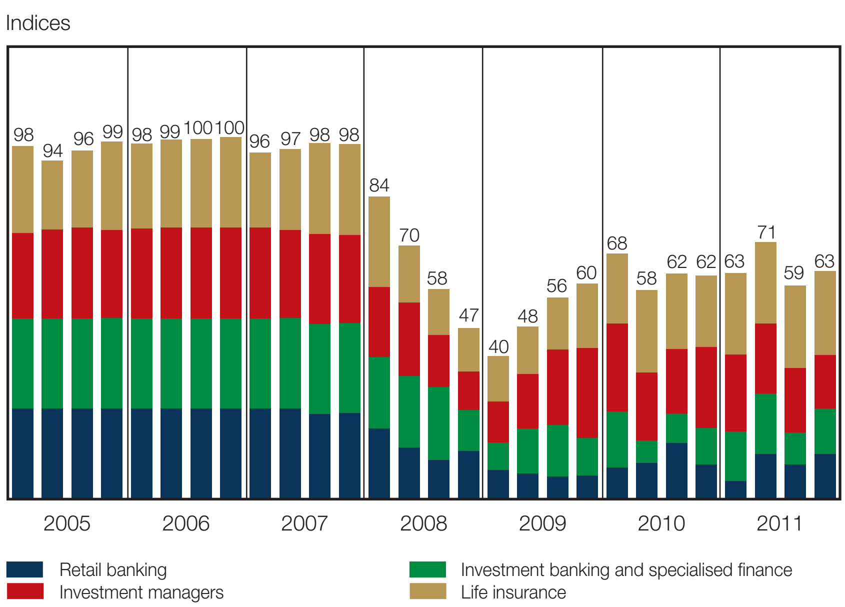
Sources: Statistics South Africa. Data on new vehicle and new passenger car sales were obtained from the National Association of Automobile Manufacturers of South Africa

Confidence in the financial services sector

Confidence in the financial services sector recovered strongly during 2009, following a sharp decline in confidence during 2008. The Ernst & Young Financial Services Index[26] has, however, not returned to its pre-crisis levels and has been fairly volatile since the crisis. After decreasing to a revised 59 index points in the third quarter, the Ernst & Young Financial Services Index increased to 63 index points in the fourth quarter of 2011. Significant increases in the level of confidence of both retail and investment bankers, coupled with a marginal increase in the level of confidence of life insurers, offset the lower confidence levels of investment managers.

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

Figure 12 Financial Services Index and its components



Source: Ernst & Young

The main driver behind the increase in the confidence level of retail banking was higher income growth, which resulted in stronger net profits. Investment banking confidence surged during the same period due to increased trading volumes. Taking a longer-term view, the continued uncertainty in the euro area is expected to have a negative impact on deal flow, the availability of funds for financing, and general business uncertainty as companies hold back on anything considered to be non-essential expenditure.

The confidence of both small and large investment managers[27] continued to decline during the fourth quarter of 2011, reflecting an uncertain investment climate and the withdrawal of funds from EMEs, as investors sought out safer havens for their investments. The life insurance sector maintained its high level of confidence and seemed to be less affected by the crisis in the euro area, despite its strong reliance on capital markets as a key earnings driver.

27 As at 2007, large investment managers had assets under management in excess of R20 billion, while small investment managers had assets under management of less than R20 billion.

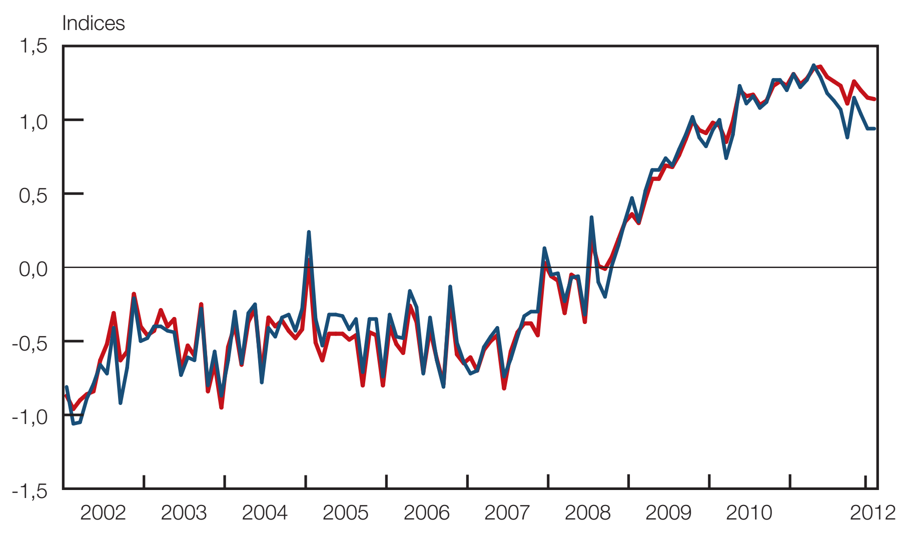
Banking sector

During the second half of 2011, conditions in the banking sector were fairly stable and banks remained on track to meet the Basel III capital requirements that will be phased in from 2013 to 2018. Banks will, however, face challenges in meeting the Basel III liquidity requirements. Table 2 reports on key financial soundness indicators for the banking sector and provides a broad overview of developments in the sector. The capital-adequacy ratio remained well above the minimum prudential requirement of 9,5 per cent. The return-on-assets and return-on-equity ratios increased gradually throughout the second half of 2011, which could be attributed to higher fee income, the decrease in credit losses and the write-back of provisions during the same period. Measured under the current regulatory framework, liquidity in the sector also remained at relatively high levels. This high level of liquidity is expected to be maintained given the low credit demand environment, and should help to meet the anticipated stricter regulations resulting from the implementation of Basel III.

The banking stability index[28] depicted in Figure 13 assesses stability in the banking sector. The index was computed from a core set of financial soundness indicators that cover capital adequacy, asset quality, profitability, liquidity and foreign exposure. Values above zero show periods of above-average stability in the banking sector and values below zero show below-average stability. Although the banking stability index has show some volatility with a downward bias recently, it still suggests above-average stability in the banking sector, mainly driven by the gradual accumulation of capital and liquid assets held by banks.

28 The methodology followed to compute the banking stability index is explained in the September 2011 issue of the *Financial Stability Review*.

Figure 13 Banking stability index



Sources: South African Reserve Bank and researchers' computations

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

Per cent, unless indicated otherwise

	2011					
	Jul	Aug	Sep	Oct	Nov	Dec
Market share (top four banks)	84,75	84,35	83,96	84,06	83,84	84,07
Gini concentration index	82,74	82,62	82,56	82,56	82,52	82,57
Herfindahl–Hirschman index (H-index)	0,189	0,187	0,186	0,187	0,186	0,187
Banks' share prices (year-on-year percentage change)	-3,48	-4,09	-4,42	-6,66	-6,19	0,10
Capital adequacy						
Capital-adequacy ratio	14,92	15,06	14,84	14,89	14,94	15,09
Regulatory Tier 1 capital to risk-weighted assets	11,97	12,13	11,96	12,03	12,20	12,22
Credit risk						
Gross loans and advances (R billions)	2 368	2 424	2 428	2 448	2 499	2 516
Impaired advances (R billions)	130,04	128,20	122,62	120,07	120,10	118,06
Impaired advances to gross loans and advances	5,49	5,29	5,05	4,90	4,81	4,69
Specific credit impairments (R billions)	42,58	42,24	42,23	41,40	40,99	41,17
Specific credit impairments to impaired advances	32,74	32,95	34,44	34,48	34,13	34,87
Specific credit impairments to gross loans and advances	1,80	1,74	1,74	1,69	1,64	1,64
Profitability						
Return on assets (smoothed)	1,05	1,07	1,12	1,13	1,13	1,15
Return on equity (smoothed)	15,06	15,30	15,92	16,16	16,03	16,38
Interest margin to gross income (smoothed)	48,86	48,81	49,04	49,08	49,70	50,34
Operating expenses to gross income (smoothed)	56,82	56,68	55,90	55,67	56,02	55,20
Liquidity						
Liquid assets to total assets (liquid-asset ratio)	8,25	8,18	8,20	8,39	8,33	8,31
Liquid assets to short-term liabilities	16,89	16,88	16,97	17,42	17,18	16,58
Effective net open foreign-currency position to qualifying capital and reserve funds	-0,06	0,30	0,78	-0,43	0,14	0,78

1 Data for revisions were updated on 4 April 2012. 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

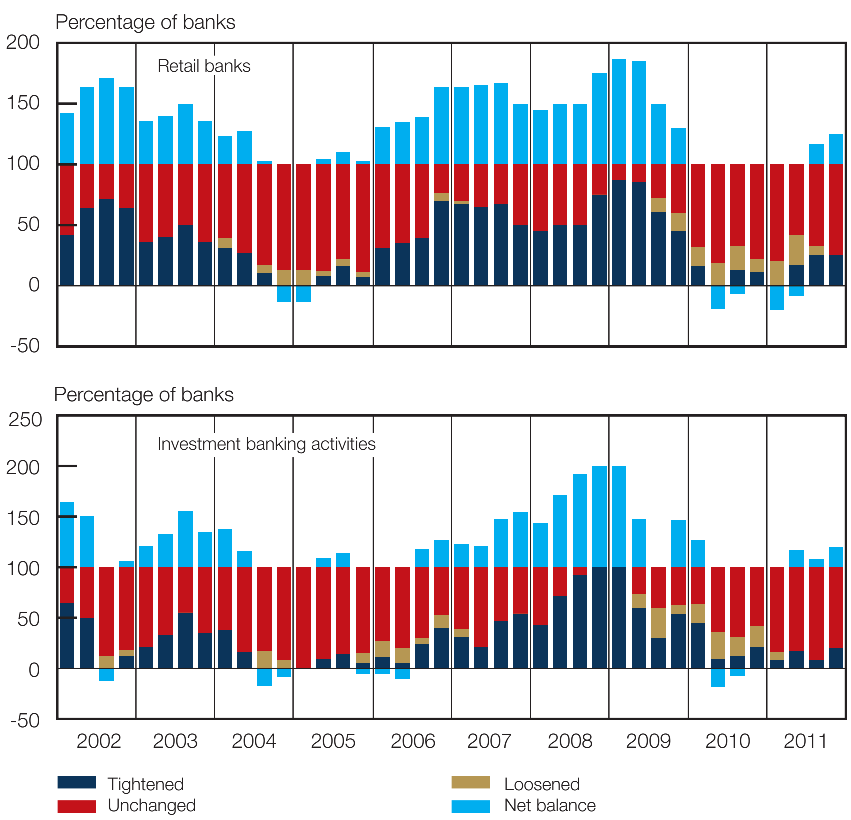
Following the change in the outlook of South Africa's sovereign debt rating to negative in November 2011, the banking sector was placed under review by Moody's Investors Service (Moody's). The review concluded that the domestic banking system remained stable on the back of a continuation of favourable macroeconomic conditions, solid capital buffers, stabilisation in non-performing loans and sustainable profitability. These supportive features were balanced against funding and liquidity challenges due to the reliance on short-term wholesale deposits, elevated but improving credit risk from the retail segment, and subdued loan growth. In February 2012 Moody's downgraded the senior debt and deposit ratings of the five largest South African banks by one notch.[29] The downgrade was driven by constrained public finances and the view held by Moody's that authorities would face challenging policy decisions if multiple financial institutions were to need financial support simultaneously. The five downgraded banks are, however, well capitalised, provide investors with acceptable returns, have weathered the global financial crisis well and have limited exposure to the sovereign debt crisis troubling numerous European countries.

29 Moody's, "Moody's Downgrades South African Banks: Concluding Review Focusing on Systemic Support Assumptions" (Limassol: Moody's, 28 February 2012), 1.

The Bank continues to monitor the credit exposure of the five largest banks in the domestic banking sector to counterparties with legal jurisdiction in the GIIPS countries. The monitoring process includes all counterparties that are banks, investment banks, insurance firms, property companies, hedge funds, private equity firms and any other major counterparty or listed stock, bonds, indices or derivatives of these that are registered in the selected European countries, or traded on any securities exchange. The five largest South African banks' combined gross credit exposure to the GIIPS countries as a percentage of total gross credit exposure amounted to only 0,13 per cent between October and December 2011. The five largest banks mainly held derivatives with banks and private-sector non-bank counterparties with legal jurisdiction in the GIIPS countries. Direct sovereign exposure was negligible.

Based on the results of a survey conducted by the Bureau for Economic Research (BER), the lending standards of banks remained fairly tight in the third and fourth quarters of 2011. None of the retail banks surveyed had loosened lending standards in the fourth quarter and none of the investment banks had done so in the last three quarters of 2011 (Figure 14). These results could be an indication that banks still remain risk-averse. Most of the participants in both retail and investment banks left lending standards unchanged from the third to the fourth quarter.

Figure 14 Lending standards of retail banks and investment banking activities



Sources: Bureau for Economic Research and Ernst & Young

As has been the case historically, the sectoral distribution of bank credit (depicted in Table 3) remained fairly constant. At the end of the fourth quarter of 2011, banks' largest concentration of credit exposure was still to the private household sector, followed by the financial intermediation and insurance sectors.

Table 3 Sectoral distribution[1] of credit

Per cent

Sector	2011 Jun	2011 Sep	2011 Dec
Agriculture, hunting, forestry and fishing	1,77	1,66	1,73
Mining and quarrying	3,41	3,70	3,69
Manufacturing	4,25	4,14	4,25
Electricity, gas and water supply	0,87	0,78	0,85
Construction	1,30	1,21	1,18
Wholesale and retail trade, hotels and restaurants	3,97	3,69	3,92
Transport, storage and communication	3,36	3,29	3,40
Financial intermediation and insurance	22,83	26,36	25,20
Real estate	6,52	6,34	6,35
Business services	3,61	3,40	3,69
Community, social and personal services	5,60	5,46	5,38
Private households	36,07	33,86	34,35
Other	6,44	6,10	6,01
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

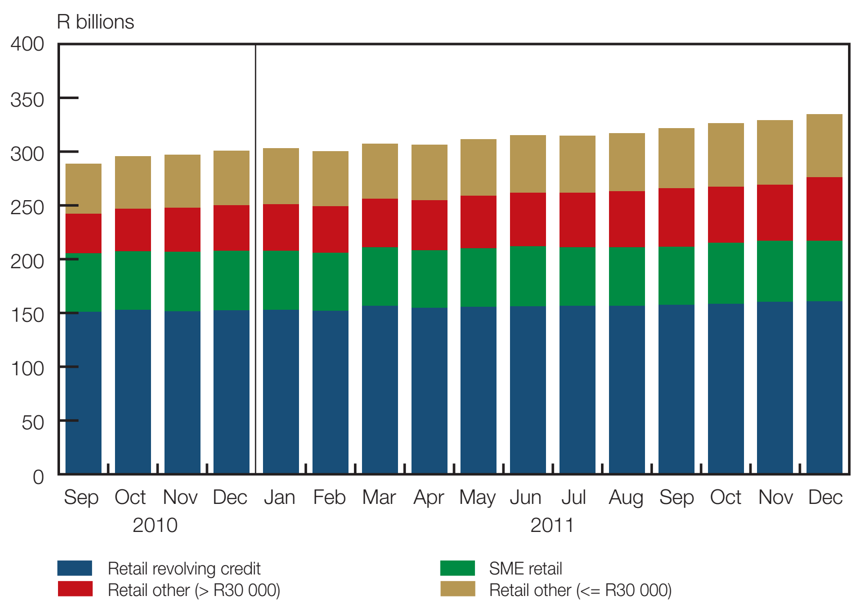
Source: South African Reserve Bank

Unsecured lending exposure

In terms of the information provided by banks, exposure to unsecured lending includes credit card lending, overdrafts, personal loans and financing provided to SMEs. The exposure is both on- and off-balance sheet.[30] Total gross unsecured credit exposure by selected banks amounted to R334,9 billion in December 2011 (Figure 15). Over the same period, total gross

30 'On-balance-sheet exposure' generally refers to loans extended, whereas 'off-balance-sheet exposure' refers to potential credit risk in the form of facilities extended but not utilised at the time of reporting.

Figure 15 Total gross credit exposure to unsecured lending



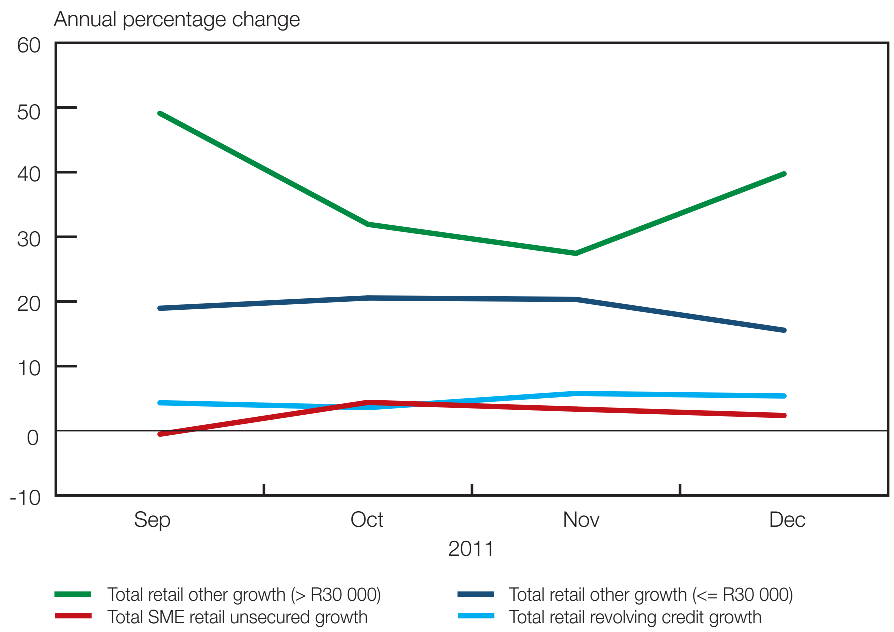
Source: South African Reserve Bank

unsecured credit exposure as a percentage of total gross credit exposure amounted to 8 per cent. The two 'retail other' and 'SME retail' categories depicted in Figure 15 were based on a survey of six banks that are significant role-players in the unsecured credit market. The 'retail revolving credit' category is based on the exposure measured using the advanced credit risk-based approaches of the four largest banks in the sector.

The major part of unsecured lending exposure was to the 'retail revolving credit' category. The major part of this category consists of exposure to credit card lending and overdrafts. Year-on-year growth in the six selected banks' credit risk exposure to unsecured lending was 11,3 per cent in December 2011. The highest growth in gross credit exposure to unsecured lending was in the two 'retail other' categories, namely exposures greater than R30 000, which grew at 39,8 per cent (R16,7 billion), and exposures less than or equal to R30 000, which grew at 15,6 per cent (R7,9 billion) year on year in December 2011. Annual growth in the 'retail revolving credit' category amounted to 5,4 per cent (R8,2 billion).

Although certain categories of unsecured lending are showing high growth rates, the total unsecured credit exposure of banks remains at less than 10 per cent of banks' total gross credit exposure. At these levels unsecured lending does not constitute a bubble and the Bank will continue to monitor developments closely. This should also be seen against the background of a banking sector that is managing its exposure to unsecured lending prudently and according to well-established models. Therefore, unsecured lending does not currently present any systemic risk to the financial system.

Figure 16 Growth in selected categories of unsecured lending



Source: South African Reserve Bank

Sectoral preference for financial intermediation instruments: A flow of funds perspective

The stability of the financial system depends on the soundness of various financial institutions, markets and processes comprising the financial system. One such process is financial intermediation. From a financial stability point of view, changes in the choice of intermediation instruments provide an indication of the shifting risk across institutions in the financial system. Thus, beyond arguments for intermediation presented in conventional financial intermediation theories,[31] financial intermediation is also about risk and the management thereof to create value. The manner in which this risk is managed could potentially lead to actions inducing financial instability, for example, the rationing of credit, adverse selection and moral hazard. The vulnerability of the financial system can therefore be expected to change in line with the risks associated with the use of financial intermediation instruments.

31 Such arguments include the reduction of asymmetric information and transaction costs.

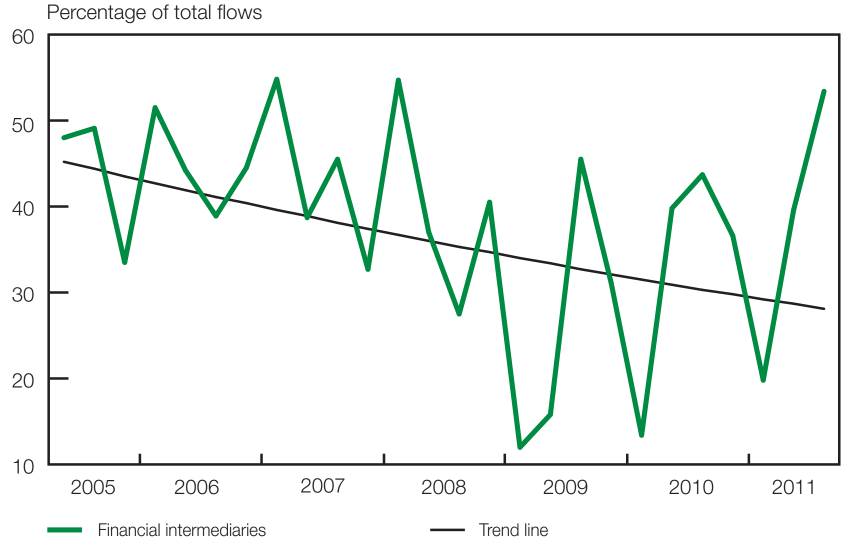
32 The South African bond market comprises approximately 61 per cent of government bonds on issue.

33 Financial intermediaries included in the flow-of-funds framework are the monetary authority (i.e., the Bank), commercial banks, collective investment schemes, insurers, the Public Investment Corporation, pension funds and finance companies. Both private and public institutions are covered in the framework.

34 'Flow' and 'flow of funds' are henceforth used interchangeably.

The main intermediation instruments in the South African financial system, ranked in descending order according to the level of associated risk, are shares, loans (including other advances), bonds[32] and cash (including deposits). On a long-term average basis, financial intermediaries[33] account for approximately 39 per cent of the total flow of funds[34] in the domestic economy. Their contribution has been trending downwards for the past few years, with a notable rebound in recent quarters (Figure 17).

Figure 17 Flows of financial intermediaries[1]



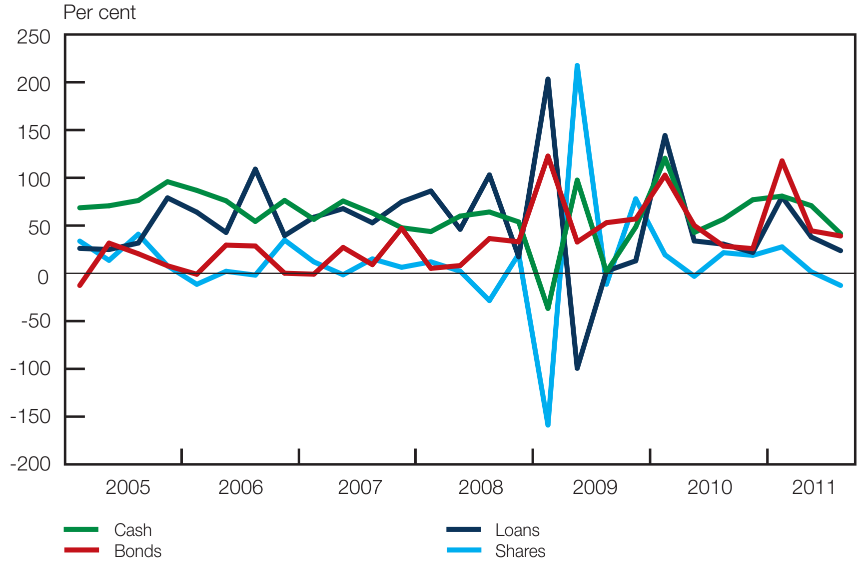
1 'Total flows' refers to the sum of all flow of funds across all sectors and all financial instruments per quarter

Source: South African Reserve Bank

35 'Preferred' means the top two most frequently used financial instruments for purposes of intermediation. This analysis is concerned with the financial system and therefore looks at the instrument usage from the financial intermediaries' point of view.

Before the global financial crisis, financial intermediaries preferred[35] cash and loans as intermediation instruments. Following the crisis, however, cash and bonds have been preferred as cautious risk tolerance levels have been maintained. Accordingly, for example, the recent rally in share prices (see section on "Bond and equity markets" on page 28) can therefore not only be explained in terms of flow of funds, but also in terms of valuation effects. However, even after adjusting for valuation effects on the share prices, the flow values remain high. Given the recent preference of financial intermediation instruments, namely cash and bonds, the level of financial instability risk is low.

Figure 18 Preference for financial intermediation instruments



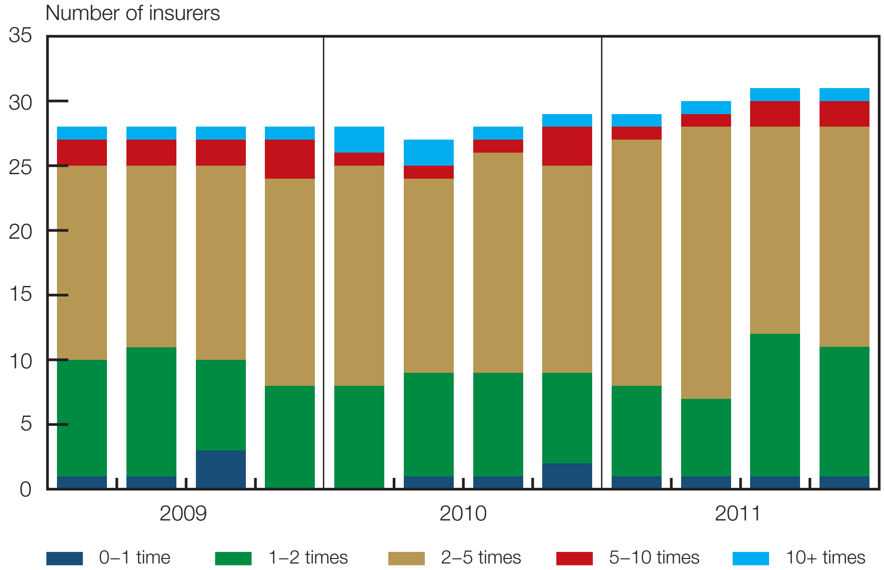
Source: South African Reserve Bank

Insurance sector

The life insurance industry continued to play an important role in financial intermediation by not only providing an avenue for contractual saving and personal risk management, but also adding liquidity in the financial system, particularly through investments in fixed-income securities and equity. The third quarter of 2011 saw the total investment of life insurance companies in fixed-interest securities contracting at an annual rate of 2 per cent, down from an expansion of 2,7 per cent in the year to June 2011. Over the same period the rate of increase in equity investments by life insurance companies decelerated from 15,1 per cent to 4,7 per cent. Nevertheless, the life insurance sector still maintained positive premium growth. In the year to December 2011, net premiums grew at an annual rate of 8,8 per cent. Although the South African economy was affected by the global economic crisis, the insurance industry remained sound during the period under review. The continued high level of confidence in the life insurance industry (see section on confidence in the financial services sector) is an encouraging sign for the sector going into 2012.

In part, the buoyancy of the long-term insurance industry is attributable to a well-capitalised sector as the industry's free assets-to-capital-adequacy requirement exceeds the regulatory minimum. Of the 30 life insurers, only one had a free assets-to-capital-adequacy requirement of 0 to 1 time. With the larger systemically significant life insurers in the higher categories, the life insurance sector is adequately equipped to absorb unforeseen shocks in the financial system and does not currently present any systemic risks.

Figure 19 Free assets-to-capital-adequacy requirement[1] of long-term typical insurers[2]

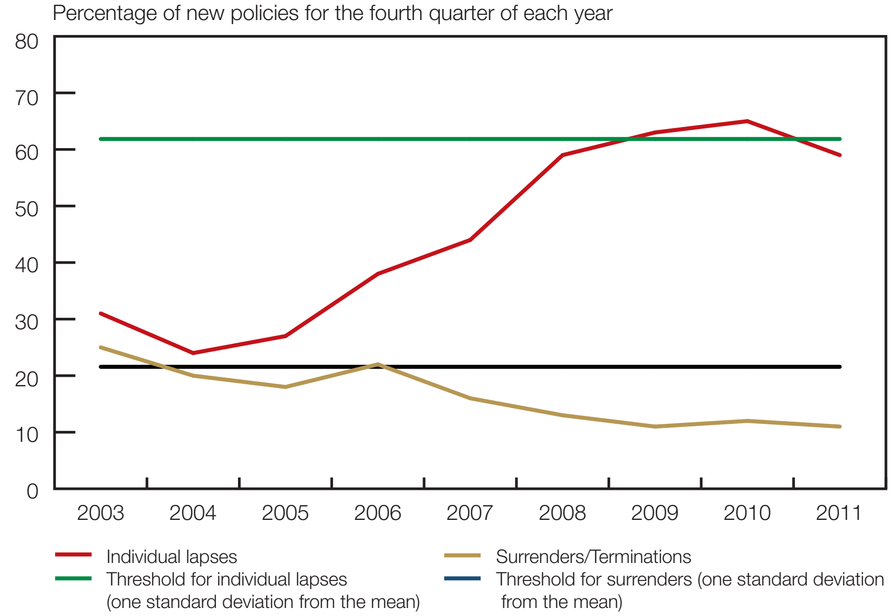


1 'Free assets' refers to the difference between total assets and the sum of total liabilities and required capital. The 'capital-adequacy requirement' is defined as the minimum capital required by the Financial Services Board for the registration of an insurance company and is equivalent to 13 weeks' worth of operating expenses
2 Long-term typical insurers are those insurers that offer most of the six classes of business as defined in the Long-term Insurance Act, 1998 (Act No. 52 of 1998), in the primary market. The figures were not audited

Source: Financial Services Board, *Special Report on the Results of the Long-term Insurance Industry,* various reports

Another positive observation in the life insurance industry was the downward trend of surrenders and individual lapses, expressed as a percentage of the number of new policies issued during the period under review (Figure 20). Surrenders decreased from 12 per cent in the last quarter of 2010 to 11 per cent in the same quarter of 2011, while individual lapses decreased from 65 per cent to 59 per cent during the same period. The decrease in surrenders and lapses can be ascribed to the fact that many life insurance companies intensified their focus on writing quality business and business retention in the aftermath of the global financial crisis.

Figure 20 Individual lapses and surrenders for long-term typical insurers[1]



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, *Special Report on the Results of the Long-term Insurance Industry,* various reports

Financial conditions also improved in the short-term insurance sector. Although underwriting profit increased by 20,8 per cent in the year to December 2011, it is still well below the annual increase of 114,6 per cent attained in the year to December 2010. Net premiums also increased in the fourth quarter, albeit at a slower pace compared to the previous quarter, while claims as a percentage of premiums earned remained unchanged. Management expenses and commission (as a percentage of net written premiums) declined moderately in the fourth quarter compared to the third quarter of 2011.

Table 4 Selected indicators for short-term typical insurers

	2010	2011			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Net premiums (after reinsurance)[1]	7	11	14	13	8
Underwriting profit[1]	114,6	74,9	48,7	19,7	20,8
Underwriting and investment income[1]	33,5	62,3	30,9	20,1	13,4
Claims[2]	61	62	57	58	58
Management expenses and commission[3]	31	31	34	33	32
Underwriting profit[3]	9	8	10	9	10
Underwriting and investment income[3]	15	15	16	15	16
Surplus asset ratio (median)[4]	38	40	39	40	43

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

Source: Financial Services Board, *Special Report on the Results of the Short-term Insurance Industry*, various reports

Pension and provident funds

Pension and provident funds play a crucial role in the process of financial intermediation. For example, their holdings of fixed-interest securities and ordinary shares represent an important part of their connectedness with the rest of the financial system and, as such, represent some of the channels through which risks may spread in the financial system. In terms of assets, the size of the pension and provident funds industry (including both official and private self-administered funds) has been around 70 per cent of annual GDP in 2011, a decrease of 2 percentage points compared to 2010.

During the second half of 2011, official pension and provident funds[36] substantially increased their holdings of local government (albeit from a low base) and private-sector fixed-interest securities. Over the same period, their holdings of government bonds moderated, while their investment in other public enterprise securities increased. Official pension and provident funds' participation in the equity market declined. Compared with a year ago, the current income surplus available for further investment grew by 8,9 per cent to approximately R13,5 billion in the fourth quarter of 2011.

36 Official pension and provident funds are administered by the Department of Finance, Transnet, Telkom and the South African Post Office.

Table 5 Official pension and provident funds

Annual percentage change, unless indicated otherwise

	2010	2011			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Government bonds	9,5	16,6	17,6	14,9	12,8
Local government securities	21,8	156,5	169,3	119,2	132,1
Public enterprise securities	27,5	18,3	16,0	5,7	10,2
Private-sector securities	-16,9	54,5	108,0	72,3	76,9
Ordinary shares	23,3	6,3	9,7	-2,4	-3,3
Investable funds (R millions)	12 346	12 004	9 444	14 024	13 491

Source: South African Reserve Bank

Private self-administered pension and provident funds drastically reduced their holdings of government bonds and other public enterprise securities during the period under review. After increasing their holdings of private-sector securities by 79,9 per cent in the second quarter of 2011 compared to a year earlier, the growth rate of private self-administered pension and provident funds' investment in these financial instruments increased by only 2 per cent in the third quarter, mainly as a result of base effects. Private self-administered pension and provident funds' participation in the equity market diminished in the third quarter of 2011 compared to a year earlier. Over the same period, investable funds grew by 10,3 per cent.

Table 6 Private self-administered pension and provident funds

Annual percentage change, unless indicated otherwise

	2010		2011		
	3rd qr	4th qr	1st qr	2nd qr	3rd qr
Government bonds	1,0	-15,3	-19,5	-13,1	-12,1
Local government securities	419,4	293,2	104,8	40,4	-14,1
Public enterprise securities	7,1	-16,9	-21,2	-10,1	-10,1
Private-sector securities[1]	79,0	72,3	90,1	79,9	2,0
Ordinary shares	21,1	21,7	8,2	11,7	-0,9
Investable funds (R millions)	1 677	140	2 837	2 696	1 849

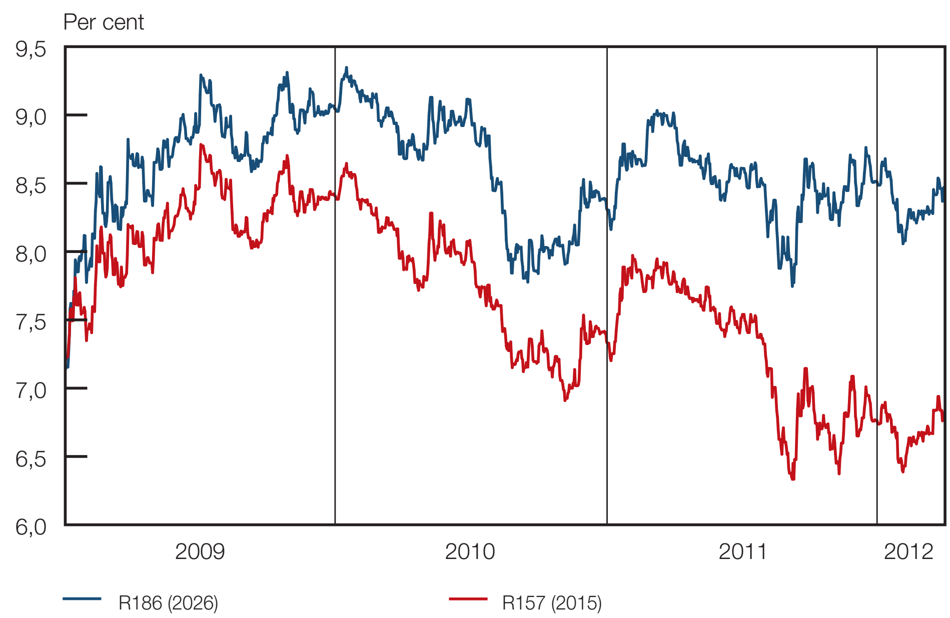
1 Include company stock, loan securities, preference shares and foreign securities

Source: South African Reserve Bank

Bond and equity markets

The domestic bond market was fairly volatile during the period under review amid heightened risk aversion towards emerging markets. The volatility was partly due to deteriorating sovereign debt conditions in the euro area and global economic growth concerns. The domestic bond market was further negatively impacted by uncertainty surrounding the domestic interest rate outlook due to rising domestic inflation and an expected slowdown in economic growth. The strong bond inflows from previous months reversed in September 2011, with non-residents selling a net R17,6 billion worth of domestic bonds. As a result, yields on government bonds increased towards the end of 2011, and were further exacerbated by a depreciation of the rand; concerns of a possible increase in weekly bond issuance ahead of the *MTBPS* in October 2011; Fitch Ratings' downward revision of South Africa's credit rating outlook; and thin liquidity conditions in December 2011. The *MTBPS* offered some support to the bond markets after net domestic long-term bond issuance increased by less than expected.

Figure 21 Selected domestic bond yields



Source: Bloomberg

The 2012 National Budget, released in February 2012, caused a temporary decline in bond yields after the government had announced plans for faster budget deficit reductions for the 2011/12 and 2012/13 fiscal years to 4,8 per cent and 4,6 per cent of GDP respectively. As a way of extending the average maturity of government debt, switches of the R206 (maturing in December 2014) and R201 (maturing in January 2014) bonds will commence in the 2012/13 financial year to reduce refinancing risk.

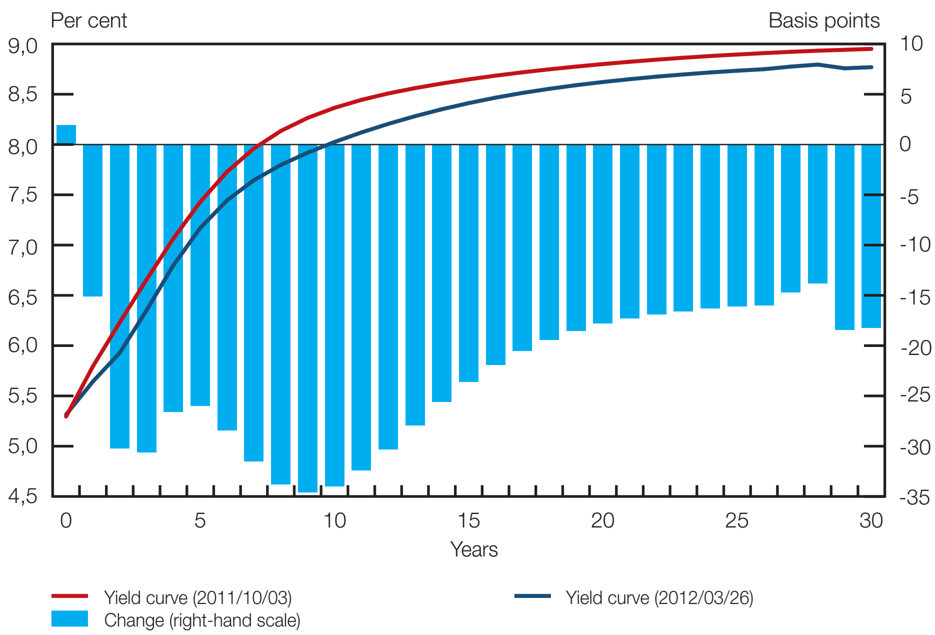
However, bond yields rose again amid scepticism regarding the attainability of the government's narrower budget deficit targets. Furthermore, a sell-off was seen in the longer end after the announcement of a new longer-dated bond maturing in 2048. Yields increased further in line with US Treasury yields, due to a stronger US dollar and a resulting weaker rand after Federal Reserve Chair Ben Bernanke had given a positive assessment of US economic growth prospects and bond markets began pricing out expectations of quantitative easing 3. After declining to a low of 6,38 per cent on 2 February 2012, the yield on the R157 government bond increased to a three-month high of 6,93 per cent on 20 March 2012.

The domestic bond yield curve moved marginally higher in the second half of 2011, with a steepening bias, possibly due to the NT's plans to increase bond issuance at the longer end. The short end of the yield curve was impacted by a deteriorating inflation outlook (given the recent spike in the oil price and emerging demand-side pressures); non-residents' preference to hold short-dated bonds; and an appreciation of the rand. Looking ahead, however, market analysts see the steepness in the yield curve as reflecting the following:

- Markets are more positive about the domestic economic growth outlook, given generally better-than-expected economic data releases from the US and Europe, and expectations of a soft landing in China. This positive outlook was confirmed by better-than-expected domestic GDP growth of 3,2 per cent in the fourth quarter of 2011, while the most recent Kagiso PMI and manufacturing production readings surpassed market expectations.
- Markets are unconvinced that the government's narrower budget deficit targets are achievable.
- There are expectations that corporate bond issuance will increase sharply in 2012.

In the first quarter of 2012 the yield curve moved lower as market sentiment improved given a more positive global outlook and better-than-expected domestic economic data.

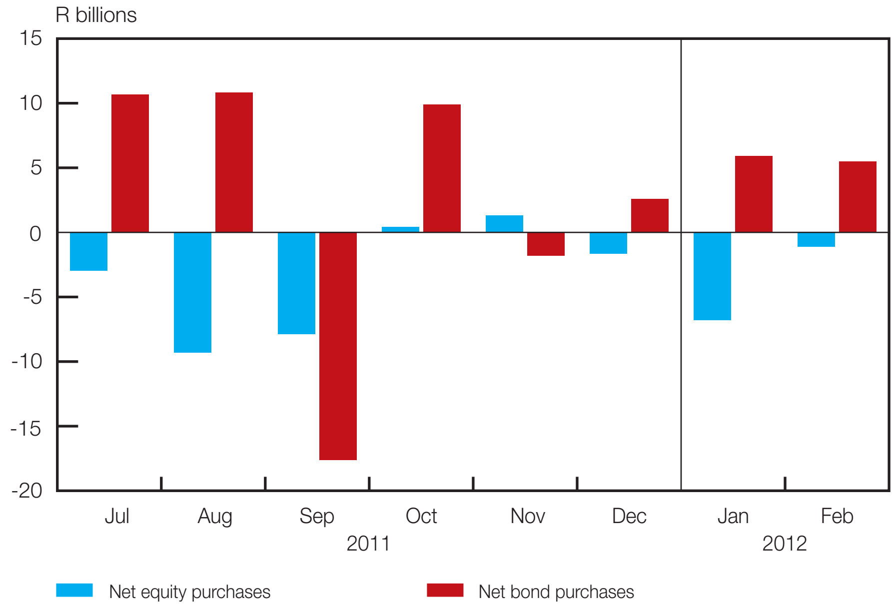
Figure 22 Bond yield curve



Source: Bloomberg

During the period under review, the JSE Alsi continued to track international developments. The index was pressured by higher risk aversion towards emerging-market assets due to fears that the sovereign debt crisis in peripheral Europe could spread to the core countries, concerns of a slowdown in global economic growth and lower-than-expected domestic GDP growth in the third quarter of 2011. For 2011 as a whole, non-residents sold a net R17,2 billion worth of domestic equities.

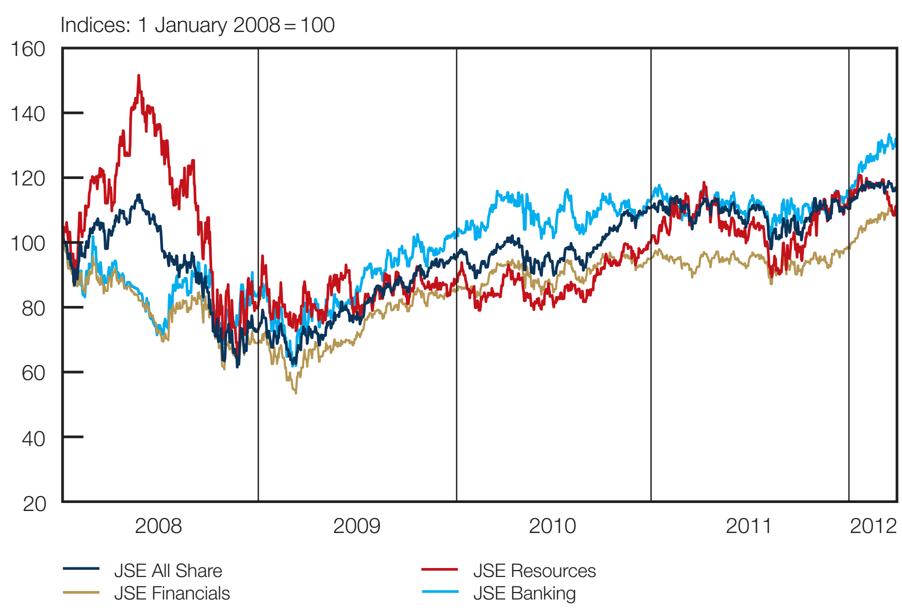
Figure 23 Non-resident purchases of domestic bonds and equities



Source: JSE Limited

Equity market losses, however, were limited by positive domestic sentiment surrounding proposals announced in the *MTBPS* in October 2011 relating to the reclassification of all inward-listed shares as 'domestic' due to reforms in the prudential and investment regulatory policies to boost investment and reduce the cost of doing business. Bank share prices increased after Moody's had affirmed the stability of the domestic banking sector due to a stabilisation in non-performing loans, solid capital buffers and sustainable profitability.

Figure 24 Equity indices



Source: Bloomberg

Positive sentiment returned to global equity markets in December 2011 after the release of better-than-expected economic data from the US in particular and after central banks globally announced co-ordinated measures to improve US dollar liquidity conditions. The ECB also announced further liquidity measures in an attempt to stabilise financial markets. Nevertheless, for 2011 as a whole, the JSE Alsi declined marginally by 0,4 per cent.

This positive sentiment continued in 2012 due to an agreement reached on Greece's debt restructuring, another successful liquidity injection by the ECB, generally positive economic data releases, moves by China to ease monetary policy further and higher commodity prices. The JSE Alsi was further supported by better-than-expected domestic economic data (particularly in terms of GDP growth in the fourth quarter of 2011; the latest readings for the Kagiso PMI; and manufacturing production) and better-than-expected earnings reported by some large companies. On 2 March 2012, the JSE Alsi reached an all-time record high of 34 387 index points. Gains, however, were capped by a stronger rand; bouts of profit-taking; elevated concerns over the sharp rise in oil prices (and possible negative implications for domestic and global economic growth); and China's decision to lower its growth target for GDP growth in 2012 to 7,5 per cent.

The JSE Alsi rose by about 5 per cent in local currency terms in the first quarter of 2012, underperforming in comparison to equities in other EMEs such as Turkey, Brazil and India. The underperformance may be largely attributed to a stronger rand, which has negatively impacted the heavily weighted resources index, and a decline in the gold price, which negatively influenced the gold index. In addition, there was non-resident selling of domestic equities amounting to R7,3 billion as of 19 March 2012.

Global developments are generally transmitted through the domestic bond, equity and foreign-exchange markets. During the period under review elevated levels of volatility were experienced in domestic financial markets as risk aversion towards EMEs increased. Nevertheless, volatility in domestic financial markets still compared favourably with that observed in many advanced economies. Therefore, developments in domestic financial markets did not present any systemic risks to the financial system.

External sector

In view of the fact that South Africa is an EME that is vulnerable to volatile capital flows, an assessment of the adequacy of the country's official foreign-exchange reserves is crucial for financial stability assessment. This is due to the fact that a sudden reversal of capital inflows could cause excessive volatility in the exchange rate of the rate and domestic financial markets in general. It may also have negative implications for the country's macroeconomic performance and for the strength of the domestic financial system. The level of the country's official foreign-exchange reserves provides a potential buffer against the reversal of capital flows and sudden stops of capital inflows. Foreign-exchange reserves also provide the country with the ability to finance its foreign requirements in terms of import coverage, short-term foreign debt and the current-account deficit. In December 2011, available foreign-exchange reserves could cover about 19,8 weeks of imports and had increased at an annual rate of 11,5 per cent. The latest data for March 2012 showed that foreign-exchange reserves had increased at a 12-month rate of 2,9 per cent.

The Guidotti ratio (GR),[37] which gauges a country's ability to finance its short-term external debt in the event of a sudden reversal in external capital inflows, remained unchanged at 2,16 in the fourth quarter of 2011. At this level, official foreign-exchange reserves were more than double South Africa's short-term external debt, meaning that it could be comfortably financed over a one-year timeline, even in the event of a reversal in foreign capital inflows. The augmented Guidotti ratio (AGR)[38] improved somewhat in the fourth quarter of 2011 to 1,35 mainly due to a lower current-account deficit compared to the previous quarter. At its current level, the AGR shows that the country's total external financing requirements, which include both short-term external debt and the current-account deficit, would be comfortably covered by official reserves. In summary, the level of the country's foreign-exchange reserves still provides a buffer against financial system vulnerabilities emanating from the external environment.

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

38 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.

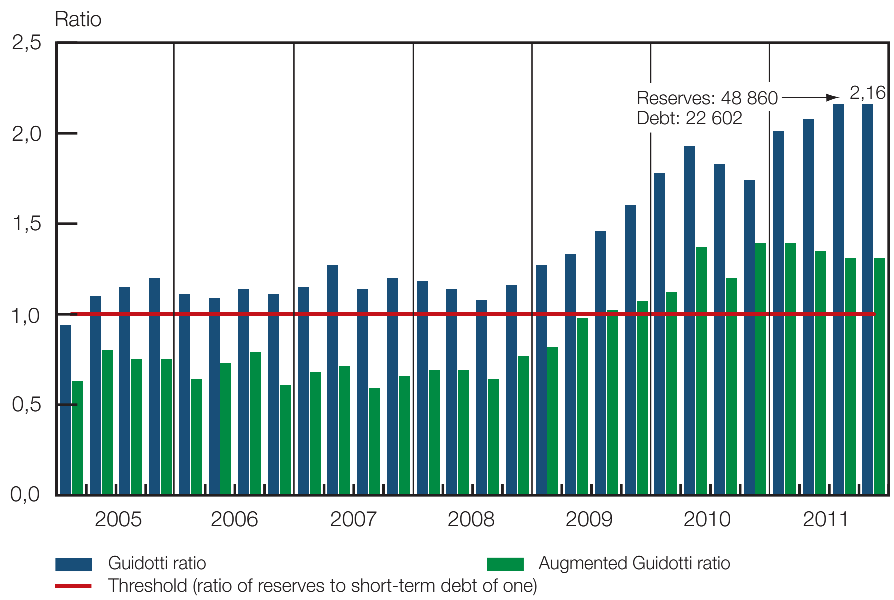
Table 7 Reserve-adequacy ratios

	US$ millions			Guidotti ratio	Augmented Guidotti ratio
	Gross foreign-exchange reserves[1]	Short-term foreign debt[2]	Current-account balance		
2009: 1st qr	34 108	26 949	-14 591,15	1,27	0,82
2nd qr	35 760	26 961	-9 639,82	1,33	0,98
3rd qr	39 141	26 776	-11 448,52	1,46	1,02
4th qr	39 706	24 852	-12 255,56	1,60	1,07
2010: 1st qr	42 007	23 647	-13 801,91	1,78	1,12
2nd qr	42 203	21 878	-8 953,14	1,93	1,37
3rd qr	44 069	24 031	-12 723,64	1,83	1,20
4th qr	43 834	25 198	-6 240,12	1,74	1,39
2011: 1st qr	49 266	24 541	-11 016,94	2,01	1,39
2nd qr	50 041	24 040	-12 990,09	2,08	1,35
3rd qr	49 725	22 980	-15 036,74	2,16	1,31
4th qr	48 860	22 602	-13 536,21	2,16	1,35

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 25 Reserve-adequacy ratios[1]



1 Figures for reserves and debt in US dollar millions

Source: South African Reserve Bank

Corporate sector

During the second half of 2011, credit extended to the corporate sector continued to reflect a steady improvement, with a further annual increase of 8,1 per cent. Credit granted by banks to the corporate sector has been increasing since the beginning of 2010. Investment by private business enterprises showed a modest increase in the fourth quarter of 2011. The annual growth rate of profits of the corporate sector (proxied by the net operating surplus) slowed in the fourth quarter of 2011, but was still positive.

Table 8 Selected indicators for the corporate sector

Annual percentage change, unless indicated otherwise

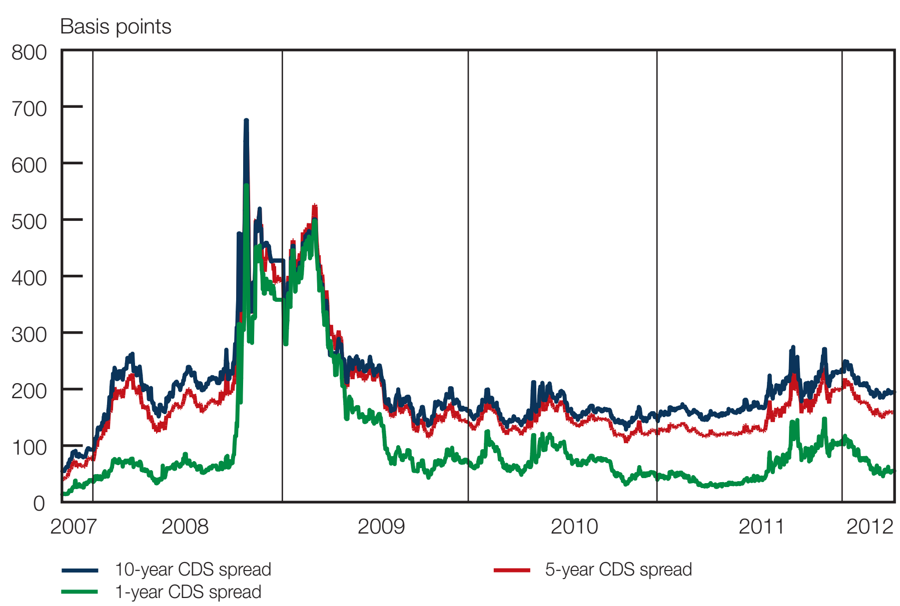
	2010	2011			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Bank credit granted[1]	1,0	2,6	3,2	5,0	8,1
Gross fixed capital formation[2]	6,6	7,6	6,8	7,5	8,4
Credit as a percentage of GDP	45,0	44,9	45,2	46,9	47,9
Credit as a percentage of annualised profits[3]	160,0	156,1	130,7	131,6	151,0
Net operating surplus[4]	18,8	17,3	7,4	21,9	14,6

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

Source: South African Reserve Bank

Credit default swap (CDS) spreads of the debt of the South African corporate sector confirm the results of the review of the corporate sector by Moody's following the change in the outlook for the country's sovereign rating. Continued stability of the corporate sector was supported by the sector's display of a solid liquidity profile even during the recent financial crisis. Moody's was of the view that the domestic corporate sector could be at risk should the sovereign debt crisis in Europe have a global spillover effect, as this would lead to the curtailment of corporate lending by domestic banks. It further emphasised the need for South African corporates, especially those with speculative grade profiles, to proactively address their significant debt maturities falling due in the next few years, as failure to do so will lead to liquidity concerns that could result in negative rating actions during the current year. Despite this view, the corporate sector remains sound with CDS spreads declining and with high levels of liquidity (see Figures 26 and 27).

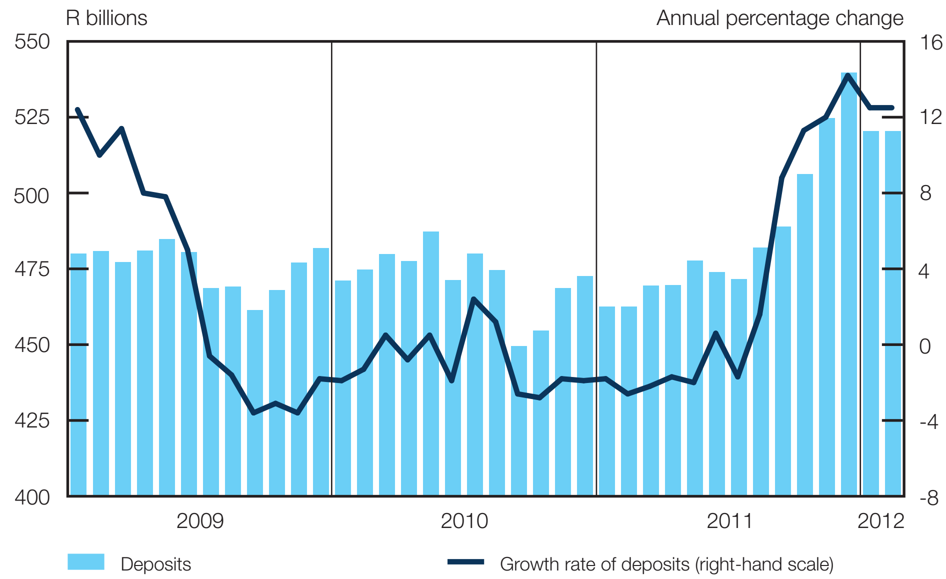
Figure 26 South African corporate sector credit default swap spreads



Source: Bloomberg

The global economic uncertainty, together with a low (albeit improving) business confidence level, resulted in the corporate sector increasing its deposits with financial institutions and delaying investment in new projects. Corporate sector deposits with banking institutions peaked at nearly R540 billion (14,2 per cent year-on-year) in December 2011 before decreasing slightly to approximately R520,5 billion in February 2012. Some analysts are of the view that companies would rather hold cash that currently earns low yields than invest in the domestic economy.

Figure 27 Non-financial corporate-sector deposits



Source: South African Reserve Bank

The Rand Merchant Bank/BER Business Confidence Index declined steadily throughout 2011. Business confidence, however, remained almost unchanged in the fourth quarter of 2011, dropping by only one index point to 38 points. The confidence levels of retail and wholesale traders improved notably in the fourth quarter of 2011, mainly as a result of the growth in sales volumes and increases in prices. Despite the relatively strong growth recorded in new vehicle sales in the last quarter of 2011, new vehicle dealers' sentiment continued to fall and deteriorated by a further 14 index points in the same period.

Table 9 Business confidence index[1]

Indices	2010	2011			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Business confidence index	44	55	48	39	38
New vehicle dealers confidence	51	84	76	58	44
Retail traders confidence	63	58	47	48	56
Wholesale traders confidence	47	65	47	31	38
Building contractors confidence	20	18	21	20	19
Manufacturers confidence	41	51	51	36	35

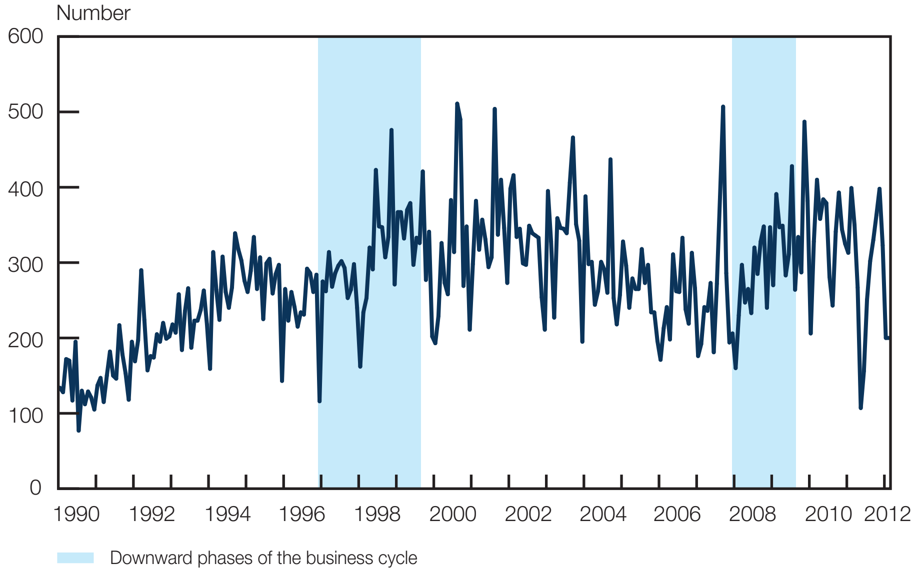
1 The business confidence level is measured on a scale of 0 to 100, where 0 indicates 'an extreme lack of confidence', 50 'neutral' and 100 'extreme confidence'

Source: Rand Merchant Bank/Bureau for Economic Research

After falling to 36 index points in the third quarter from 51 index points in the second quarter of 2011, the confidence level of manufacturers remained almost unchanged in the fourth quarter. The drop in confidence levels recorded in the third quarter of 2011 can be attributed to weak output in the corporate sector due to industrial action, increased rand volatility and weak global demand. The confidence level of building contractors edged lower in the fourth quarter of 2011, dropping by only one index point. The latest data from the BER show that business confidence increased by 14 index points to 52 index points in the first quarter of 2012. The business mood increased in all five of the sub-indices during the same period. The revival of business confidence is a welcome reversal of the declining trend seen throughout the whole of 2011.

The number of liquidations recorded decreased by 0,6 per cent year on year in December 2011, and this trend continued into the first two months of 2012. During 2011, the number of voluntary liquidations decreased by 14,3 per cent, while the number of compulsory liquidations increased by 34,2 per cent. Although trends are far more informative than single-month statistics, and despite the fact that this indicator is extremely volatile, the long-term trends for both liquidations and insolvencies were fairly flat. However, challenging business conditions and the expectation that the economic growth rate is likely to remain sluggish in 2012 could erode any gains achieved.

Figure 28 Liquidations



Source: Statistics South Africa

Household sector

During the period under review, the financial position of the household sector continued to improve, supported by increases in total assets and income growth. The total assets of the household sector grew at an annual rate of 4,1 per cent in the fourth quarter of 2011. Nominal disposable income and compensation of employees continued their positive growth momentum, increasing at 12-month rates of 11,4 per cent and 8,1 per cent respectively in the fourth quarter of 2011. However, the household sector continued to be impacted by the high rate of unemployment and the savings rate of the sector remained stagnant at low levels. With disposable income growing faster than household debt, the debt burden of households decreased slightly. Although still high, the ratio of household debt to disposable income declined to 74,6 per cent in the fourth quarter of 2011, from 77,3 per cent a year earlier. The fact that mortgage debt constitutes approximately 60 per cent of total household debt reveals the extent of financial institutions' exposure to the residential real-estate sector. Relative to GDP, household debt also moderated marginally from 44,3 per cent in the third quarter of 2011 to 43,9 per cent in the fourth quarter.

Table 10 Selected indicators for the household sector

Annual percentage change, unless indicated otherwise

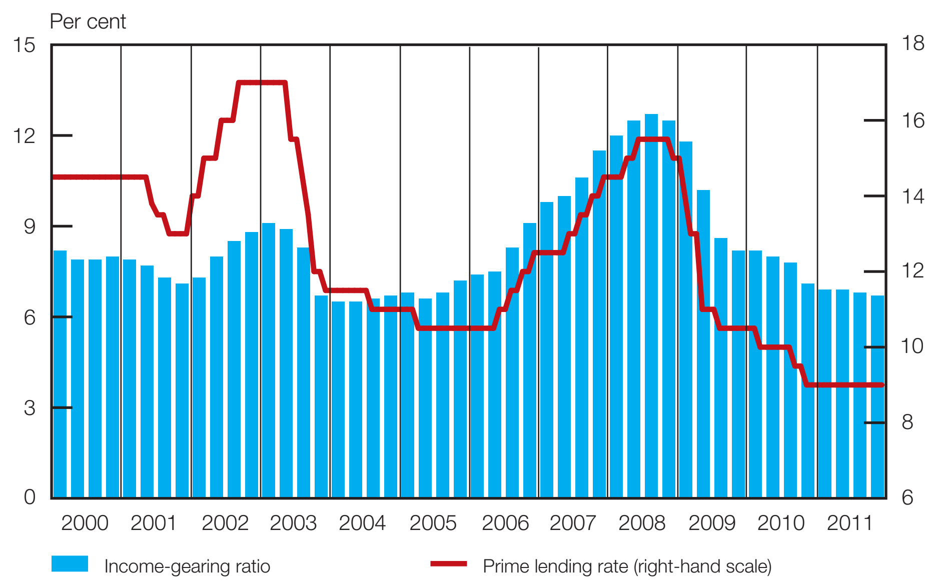
Indicator	2010	2011			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Nominal disposable income	8,9	9,2	10,5	10,6	11,4
Compensation of employees	10,2	10,2	11,0	9,5	8,1
Total assets	9,6	7,2	10,8	3,9	4,1
Consumer confidence index[1]	14	9	11	4	5
Consumption expenditure to GDP	58,3	58,0	59,0	58,6	58,8
Real consumption expenditure	5,2	5,3	5,4	4,7	4,5
Credit extension	6,9	7,4	7,5	5,5	6,8
Savings as a percentage of disposable income	-0,2	-0,2	-0,1	-0,1	0,0
Debt	6,0	7,2	7,0	6,5	7,5
Debt to disposable income	77,3	77,1	76,0	75,6	74,6
Outstanding household mortgage debt as a percentage of total household debt	63,1	62,3	61,8	60,8	59,9
Debt to GDP	45,0	44,7	44,8	44,3	43,9
Income-gearing ratio (per cent)[2]	7,1	6,9	6,9	6,8	6,7
Capital gearing (per cent)[3]	19,2	19,4	19,3	20,0	19,8
Insolvencies	-38,0	-22,7	-31,9	-33,9	-17,2

1 The consumer confidence index is expressed as a net balance between optimistic and pessimistic consumers. According to the Bureau for Economic Research, Stellenbosch University, the index can vary between -100 for 'extreme pessimism' and +100 for 'extreme optimism', with 0 being 'neutral'
2 'Income gearing ratio' refers to financing costs of household debt as a percentage of disposable income. Data are preliminary
3 '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

In the current low interest rate environment, the household interest burden remained low. Interest payments on debt, as measured by the income-gearing ratio, dropped marginally from 6,8 per cent in the third quarter of 2011 to 6,7 per cent in the fourth quarter. The relatively low household interest burden, coupled with the growth in disposable income, should contribute to enhanced short-term debt-servicing capacity.

Figure 29 Income-gearing ratio and prime lending rate



Source: South African Reserve Bank

The current low levels of interest rates could, however, be disguising vulnerability in the household sector given the continuing high levels of debt. In the longer term, the debt-servicing capacity of households will depend on the monetary policy response to the inflation outlook, income growth and the extent to which the household sector takes on additional debt. The interest burden of households has historically followed interest rates fairly closely.

After declining by 7 index points to 4 points in the third quarter of 2011, the level of consumer confidence remained almost unchanged at 5 index points in the fourth quarter of 2011 and the first quarter of 2012. The slight gain in consumer confidence was due to an increase in the percentage of consumers who were optimistic about improvements in their finances over the next 12 months and a rise in those who rated the time as appropriate to buy durable goods. These improvements were offset by increased pessimism about the performance of the economy.

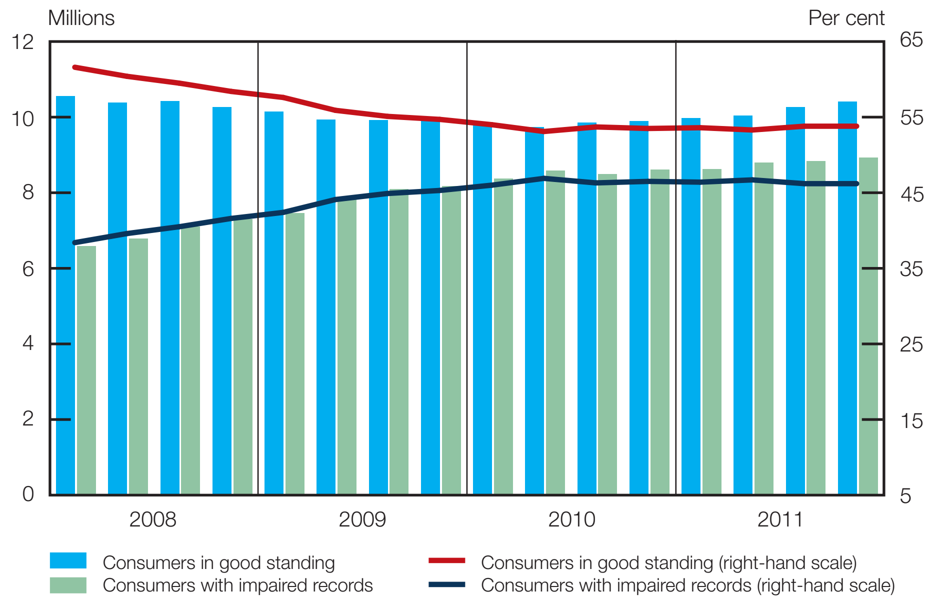
Household-sector demand is mainly credit-driven. Given the fairly low level of consumer confidence and the burden of high levels of household debt, the growth rate of household demand remains at moderate levels. Real household consumption expenditure growth declined from 4,7 per cent in the third quarter of 2011 to 4,5 per cent in the fourth quarter. In the short to medium term, household demand is likely to be dampened by the implementation of the Gauteng tolling system, and increases in petrol and electricity prices, which will pose downside risks to the debt-repayment capacity of households. Lower household demand will likely have a negative impact on corporate sector earnings. During the second half of 2011, the growth rate of credit extended to the household sector improved, but remained restrained by the low levels of consumer confidence, high household indebtedness and the pursuit of balance-sheet consolidation by households. After declining to 5,5 per cent in the third quarter of 2011, credit extended to households gained momentum and registered an annual growth rate of 6,8 per cent in the fourth quarter.

Although household debt increased marginally, households continued to consolidate their balance sheets and exercise caution about their finances. The number of credit-active consumers increased by 4,3 per cent year on year in December 2011 from 18,5 million to 19,3 million consumers. After decreasing to 46,2 per cent of total credit-active consumers in the year to September 2011, the number of consumers with impaired records remained unchanged in December 2011. Over the same period, the proportion of accounts in good standing also remained constant at 75 per cent of all accounts on record at the credit bureaus. In the year to December 2011, the number of consumers in good standing, which is calculated by simply inverting the number of consumers with impaired records, remained unchanged from the 12 months to September 2011 at 53,8 per cent of total credit-active consumers.

Data from the National Credit Regulator (NCR) indicated that banks continued to dominate the consumer credit market. As at the end of December 2011 banks extended credit to 87,9 per cent of consumers with credit records, followed by other credit providers.[39] The number of applications for credit facilities increased by 44,6 per cent year on year in the fourth quarter of 2011, mainly as a result of the inclusion of additional credit providers in the NCR database during the previous quarter. The total value of new credit granted over the quarter ended December 2011 increased to R107,6 billion, representing an annual increase of approximately 28,8 per cent. Of this amount, credit by banks accounted for approximately 83 per cent. The high rejection rate of applications for new credit in the fourth quarter of 2011 (45,7 per cent) could be further evidence of tight credit conditions on the supply side of the consumer credit market.

39 'Other credit providers' consist primarily of pension-backed lenders, developmental lenders, micro-lenders, agricultural lenders, insurers, non-bank mortgage lenders and securitised debt.

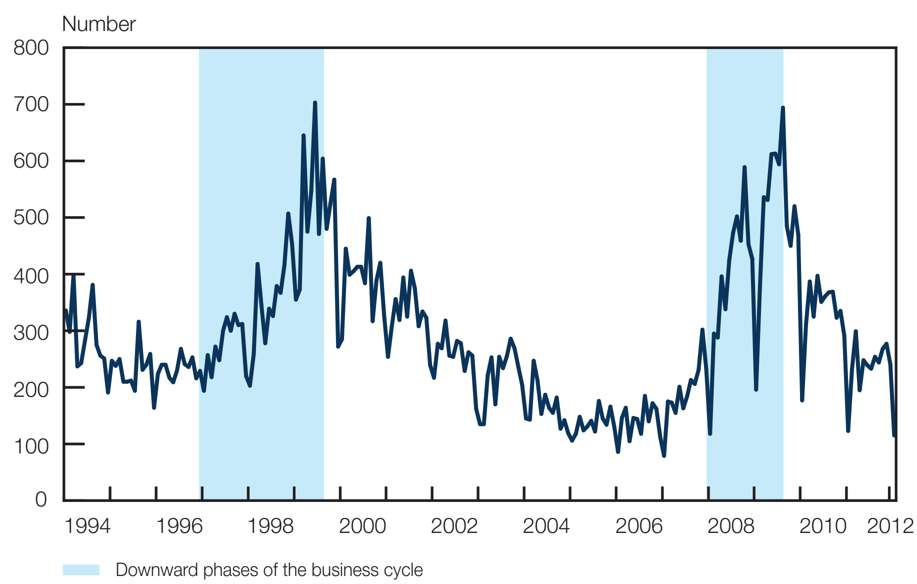
Figure 30 Credit standing of consumers



Source: National Credit Regulator

The declining trend in the annual growth rate of the number of insolvencies continued during the second half of 2011 and into January 2012. The decline in insolvencies of individuals and partnerships was aided by relatively low debt-service cost and rising disposable income of households, both of which afford households the opportunity to repay their debt quicker. However, downside risks to the inflation outlook may erode the purchasing power of households and adversely affect their debt-financing capacity, leading to a possible reversal of the declining trend in insolvencies.

Figure 31 Insolvencies

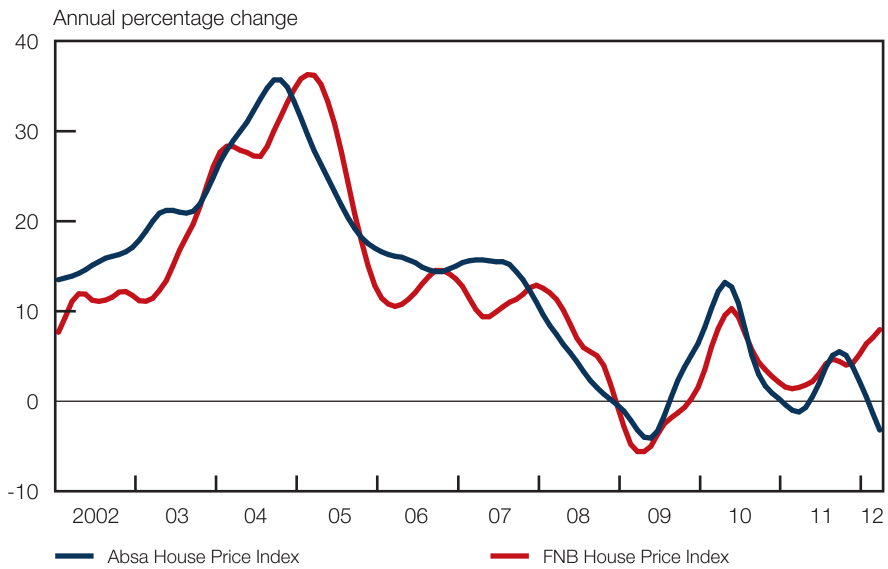


Source: Statistics South Africa

Residential real-estate sector

The resurgence in activity in the residential real-estate market that started in early 2009 turned out to be short-lived and the growth rate of house prices moderated from mid-2010. Towards the end of 2011 house price indices started showing diverging trends. The latest data for the Absa House Price Index indicated that house prices had fallen by 3,2 per cent year on year in March 2012, whereas the First National Bank (FNB) House Price Index increased by about 8 per cent over the same period.

Figure 32 House price indices[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 R3,6 million or less in 2012 (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. The FNB House Price Index is a fixed-weighted average of its sub-indices, which are split by room number and by sectional title versus freehold properties. The index is lightly smoothed using a Hodrick-Prescott smoothing function. An index month commences 7 days prior to the end of the previous month to 7 days prior to the said calendar month

Sources: Absa Bank Limited and First National Bank

According to the FNB Property Barometer,[40] 2011 as a whole saw first-time buyers become a more significant source of residential demand, increasing to 23 per cent of total home buyers from an estimated 15 per cent in 2008. This is the highest percentage of first-time buying since 2005. FNB observed that one of the most positive aspects seen during 2011 was the increasing ability of first-time buyers to produce the required deposit and transfer fees.

40 First National Bank, *Property Barometer* (Johannesburg, First National Bank, 11 January 2012).

Throughout 2011 the buy-to-let segment of the market remained fairly weak. During the fourth quarter, it was estimated that around 8 per cent of total buyers were buying to let, virtually unchanged from the first three quarters of 2011 and well below the close to 25 per cent recorded in early 2004. The participation of foreign buyers in the local residential real-estate market remained low, although there were signs of a gradual rise in their contribution. For the first quarter of 2012, it was estimated that foreign buyers comprised approximately 4 per cent of total buyers.

The residential property market is still influenced by economic and confidence factors affecting the household sector. As stated above, the confidence level of households remains low. Rising inflation, a relatively high debt-to-income ratio, damaged credit records and tight credit conditions are some of the factors influencing home owners and prospective homeowners.

Infrastructure and regulation

This section of the *Financial Stability Review* considers developments in the domestic and international financial infrastructure, and in the regulatory environments. It provides an update on recent financial, legislative and infrastructural developments that could potentially impact on the domestic financial sector. This is followed by an update on South Africa's implementation of the SAM project for the insurance sector and the progress made in implementing the TCF initiative. The remainder of this section is devoted to an assessment of the progress made in implementing the proposed twin peaks model of financial regulation for South Africa, before finally highlighting issues pertaining to the strengthening of South Africa's financial sector crisis resolution framework.

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

The September 2011 *Financial Stability Review* reported on, among other things, the release of the microinsurance policy document, the CRS Bill and the FM Bill. This section provides a brief update on the progress made with the legislative processes since then.

Credit Rating Services Bill

The period allowed for the public to comment on the CRS Bill closed on 16 September 2011, after which the intention to table the CRS Bill in Parliament was announced in the *Government Gazette* (Gazette No. 35022, Notice 109) in February 2012. The CRS Bill gives effect to the Group of Twenty (G-20) recommendations on the regulation of credit rating agencies (CRAs), which include mandatory registration. The objectives of the CRS Bill are to improve accountability of CRAs; enhance transparency and reliability of the credit rating process and credit ratings; protect investors; and reduce systemic risk. Once the CRS Bill has been enacted, it is expected that it will not only improve transparency in the credit rating services industry, but also increase confidence in the domestic financial sector as a whole.

The FSB will be responsible for monitoring and enforcing compliance with the CRS Bill, once enacted. Over and above the minimum criteria set in the CRS Bill, regulators that place reliance on credit assessments as part of the regulatory framework, such as the Bank Supervision Department of the Bank, may impose additional requirements and conditions on external credit assessment institutions (ECAIs) or export credit agencies. As such, when calculating its minimum capital requirement and reserve funds, no bank or bank controlling company is allowed to take into account credit assessments of any ECAI or export credit agency unless the ECAI or export credit agency concerned obtained the prior written approval of the Registrar of Banks to act as an 'eligible institution'.

Financial Markets Bill

The FM Bill was tabled in Parliament on 3 April 2012 and is the culmination of efforts by the relevant authorities to replace the Securities Services Act, 2004 (Act No. 36 of 2004). The FM Bill primarily focuses on the regulation of securities exchanges, central securities depositories, clearing houses and their respective members. Of particular importance is the proposal that over-the-counter derivatives regulation will be implemented in a balanced and consultative way, and that standardisation, central clearing and central trading will only be required where appropriate and feasible. The FM Bill, once enacted, will ensure that the legislative framework is aligned with relevant local and international developments and standards, and that it continues to be effective in mitigating the impact of the global financial crisis.

Financial Services Laws General Amendment Bill

On 9 March 2012 the NT published the first draft of the FSLGA Bill, which proposes amendments to 11 domestic financial services laws. The objective of the FSLGA Bill is to address gaps and strengthen the financial-sector regulatory framework as recommended by the IMF/World Bank Financial Sector Assessment Program (FSAP) evaluation of South Africa's adherence to international financial regulatory principles in respect of insurance, banking and securities regulation. In addition, the amendments are aimed at aligning South Africa's financial laws with the provisions of the Companies Act, 2008 (Act No. 71 of 2008) and addressing some of the shortcomings in South Africa's financial regulatory architecture following the global financial crisis. Some of the proposals also intend to address the regulatory gaps identified in the February 2011 policy document of the NT entitled "A Safer Financial Sector to Serve South Africa Better".[41] Some of the intended amendments will:

- make the FSB the lead regulator where there is concurrent jurisdiction in respect of the same entities, except for banks and mutual banks;
- give the Minister of Finance appropriate emergency powers to deal with potential and actual systemic risks to the financial system;
- necessitate the amendment of the South African Reserve Bank Act, 1989 (Act No. 90 of 1989) to strengthen the Bank's powers to intervene in the event of a banking crisis. It will allow the Bank to lend or advance money on security of a mortgage of immovable property or of a notarial or other bond or a cession, or to acquire immovable property;
- require the amendment of the Co-operatives Banks Act, 2007 (Act No. 40 of 2007) to transfer the supervisory function of the Co-operatives Banks Development Agency to the Bank; and
- lead to an amendment to the definition of "business of a medical scheme" in the Medical Schemes Act, 1998 (Act No. 131 of 1998), which Act is required to support the Demarcation Regulations released during March 2012 by the NT and the Department of Health.

The NT will be embarking on a public consultation process leading to the expected tabling of the FSLGA Bill in Parliament in the second half of 2012.

41 Available at http://www.treasury.gov.za.

Update on the Solvency Assessment and Management framework project and related developments

The March 2011 *Financial Stability Review* reported on the SAM framework which the FSB has embarked on with the aim of enhancing the prudential capital-adequacy soundness of insurance companies, which contributes to the protection of policyholders. Significant progress has been made both internationally and domestically to improve solvency standards (Solvency II)[42] for the insurance industry. Internationally, the Committee for European Insurance and Occupational Pensions Supervisors (CEIOPS) released the first equivalence assessments of Solvency II regimes in selected jurisdictions. The equivalence assessments were conducted according to the document entitled "Consultation Paper No. 82: The Methodology for Equivalence Assessments by CEIOPS under Solvency II".[43] In the consultation paper, the CEIOPS confirms that insurance regimes adopted by jurisdictions need not be identical to Solvency II, as jurisdictions do not necessarily operate in similar financial and economic environments. Jurisdictions do, however, need to ensure that they at least follow the basic principles and objectives of Solvency II. Each country therefore needs to modify Solvency II according to its own particular environment. These measures will greatly assist South African insurers to comply with Solvency II, while taking into consideration the specific market risks that insurers are exposed to.

Domestically, the FSB issued a number of SAM discussion documents in the latter part of 2011 covering reporting, disclosure, capital requirements and governance issues. These documents are aimed at obtaining the input of stakeholders and to contribute to the drafting of secondary legislation. The FSB has also indicated that it intends to align certain regulatory requirements for short-term and long-term insurers with the revised standards set by the International Association of Insurance Supervisors (IAIS). The IAIS revised the Insurance Core Principles[44] in October 2011 to take into account developments that had taken place since the last revision in 2003 and to include guidelines on macroprudential surveillance.

42 Solvency II is a regime that was proposed by the European Commission in 2007 with the intention of codifying and harmonising the EU's insurance regulation. The proposed Solvency II regime primarily concerns the amount of capital that EU insurance companies must hold to reduce the risk of insolvency, improve consumer protection and modernise supervision.

43 Available at https://eiopa.europa.eu.

44 Available at http://www.iaisweb.org/index.cfm?pageID=795.

The IAIS standards will be introduced by way of amendments to the Insurance Laws Amendment Bill, 2012. The amendments will address, among other matters, the SAM solvency regime, the revised Insurance Core Principles, and the alignment of insurance laws to any changes that have taken place in the wider legislative framework. It is envisaged that the adoption of the SAM framework and the proposed amended insurance laws will enhance the soundness of insurance companies and promote policyholder protection.

Treating Customers Fairly update

45 The TCF feedback report on the self-assessment exercise can be accessed at http://www.fsb.co.za/.

As highlighted in previous editions of the *Financial Stability Review*, the TCF project will complement sector-specific conduct regulation of all affected entities (including banks) and will form part of the market conduct 'peak' of the twin peaks model of financial regulation. In March 2011, the FSB developed a TCF self-assessment tool which firms can use to gauge their success levels in achieving the TCF fairness outcomes and culture framework requirements.[45] A self-assessment tool was piloted with a sample of financial services firms between July and November 2011.

The purpose of developing and piloting a self-assessment tool is to:

– provide firms with insight as to how ready they are to demonstrate to the FSB and other stakeholders, through behaviour of management and monitoring processes, that they are consistently treating customers fairly;
– provide firms with an indication of the kinds of factors that the FSB may take into account in monitoring and assessing TCF delivery in future;
– use the self-assessment tool (or an appropriate variation of the tool) to conduct a TCF baseline exercise against which the financial services industry's future progress in delivering TCF outcomes can be measured; and
– use the insights obtained from the pilot self-assessment process and baseline exercises to inform the development of the TCF regulatory, supervisory and enforcement frameworks.

According to the FSB, the participating firms found the pilot self-assessment process useful, and there was general consensus that the assessment was of value in helping some of the participating firms to identify opportunities for improving their interactions with the public. Participating firms were also of the view that the in-depth follow-up interviews had helped executive and senior management gain better insight into the strategic and cultural implications of TCF and the role that firms' boards of directors should play.

The FSB plans further implementation of the TCF road map during 2012, which includes the publication of the final version of the TCF self-assessment tool; conducting a baseline exercise on TCF readiness; and implementing a TCF regulatory and supervisory framework and a regulatory guidance document.

Update on the implementation of a twin peaks model of financial regulation in South Africa

In the previous two issues of the *Financial Stability Review*, the announcement and the broad policy objectives of establishing a twin peaks model of financial regulation in South Africa were highlighted and explained. Without reiterating the more detailed explanations provided in previous issues of the *Financial Stability Review*, in summary under the planned twin peaks approach, prudential regulation of the financial system will be the responsibility of the Bank, while market conduct regulation will fall under the FSB. The regulatory reform project emanated from a number of factors, including South Africa's commitment, as a member country, to its G-20 and Financial Stability Board undertakings; the lessons learnt from the ongoing global financial crisis; and the unique conditions prevalent in the South African financial system.

Although the Bank views financial stability as a shared responsibility, the Bank will take a leading role in overseeing and maintaining financial stability, while the Financial Stability Oversight Committee will fulfil a co-ordinating and information-sharing role between all the relevant authorities who have a responsibility to contribute towards financial stability. This implies that the Bank would also become the macroprudential or systemic regulator and supervisor to ensure that it is in a position to fulfil its financial stability mandate. The responsibility of a systemic regulator is an onerous and complex task wherein the operational powers, functions and tools of the systemic regulator are not as clearly defined as those, for example, of the microprudential or market conduct regulator.

The Financial Regulatory Reform Steering Committee (FRRSC), which consists of senior members from the Bank, the FSB and the NT, was established in June 2011. The FRRSC, supported by various working groups, aims to co-ordinate the implementation of the twin peaks regulatory reform proposals. The FRRSC has consulted with various international and domestic experts on issues such as the role of central banks in financial stability and macroprudential supervision and related legislative frameworks, challenges relating to the introduction of proactive market conduct regulation and consumer protection, crisis management and failure resolution, co-ordination mechanisms between regulators and other authorities, governance arrangements and funding models under a twin peaks approach.

The twin peaks approach has the potential to become an effective model of regulation since it permits regulators to each focus on a primary objective. However, effective regulation is not solely a function of regulatory architecture and should be complemented by effective supervisory processes and the effects of exceptional people. The reforms currently under way represent an ideal opportunity to enhance and build on existing sound supervisory processes.

Strengthening South Africa's financial-sector crisis resolution framework

The legislative and infrastructural reforms outlined above aim to strengthen the South African financial system's ability to withstand future crises in the interest of overall financial stability. However, it has been demonstrated during the recent global financial crisis that risks can originate both from within and from outside a specific jurisdiction's borders. As such, regulators and national authorities have to be prepared to respond to any eventualities at any given time. A credible resolution framework has to be in place to ensure that risks that may apply to specific institutions do not become systemic by spreading to other financial institutions, markets and ultimately the whole financial system.

The main purpose of having an effective resolution framework in place is to ensure the feasibility of the resolution of financial institutions without severe systemic disruption and without unduly exposing taxpayers to loss, while still protecting vital economic functions. An effective resolution framework aims to:

– restore financial stability in a crisis with the least possible loss of value and public cost;
– maintain and restore confidence in the financial system;
– ensure that key functions in the financial system continue (payment systems, securities settlement, financial intermediation, etc.);
– prevent a loss of value through prompt and appropriate intervention; and
– let losses, where they do occur, be absorbed by appropriate buffers and shareholders rather than by taxpayers.

In 2011 the Bank and the NT jointly conducted a project under the auspices of the World Bank to assess South Africa's crisis management arrangements. Subsequently, the Financial Stability Board released its "Key Attributes of Effective Resolution Regimes for Financial Institutions" (Financial Stability Board key attributes) in November 2011. These attributes were endorsed by the G-20 at its summit in Cannes in November 2011 and, as such, represent the international standard to which G-20 member countries have to adhere. The implementation of the Financial Stability Board key attributes will require legislative and administrative changes in many jurisdictions. The Financial Stability Board will monitor the implementation of the key attributes in the national resolution regimes of member countries. It has already commenced with this monitoring process by formally requesting countries to report the gaps in their own regimes and the nature and extent of legislative and regulatory changes needed to address those gaps. The process of monitoring is expected to gain momentum during 2012.

A self-assessment conducted against the key Financial Stability Board attributes revealed a number of gaps in South Africa's current crisis management arrangements. Such shortcomings include inadequate formalised co-ordination arrangements among regulators; fragmented powers in various pieces of legislation to deal with a crisis; inadequate crisis management tools; too narrow a scope of crisis management; and the absence of a privately-financed resolution fund and/or deposit insurance fund. The Bank, the NT and the FSB are currently in the process of strengthening South Africa's resolution framework, in line with international standards.

Concluding remarks

The South African authorities, cognisant of the need to ensure that the South African financial system is adequately prepared for any future crises, are committed to introducing various reforms and measures. Authorities will, first, seek to influence emerging global standards as they apply to EMEs such as South Africa. Second, the authorities will endeavour to align South Africa's financial regulatory environment with regulatory developments internationally. Finally, the current reform process will be used as an opportunity to identify and address any gaps in the regulatory sphere that have become apparent over time, and will be strengthened through both internal self-assessments and external assessments such as FSAPs. The next few years promise a continuance of these initiatives across the financial sector.

Abbreviations

AGR	augmented Guidotti ratio
Alsi	All-Share Index
BER	Bureau for Economic Research
BoE	Bank of England
CBOE	Chicago Board of Options Exchange
CDS	credit default swap
CEIOPS	Committee for European Insurance and Occupational Pensions Supervisors
CRA	credit rating agency
CRB	Commodity Research Bureau
EBA	European Banking Authority
ECAI	external credit assessment institution
ECB	European Central Bank
EFSF	European Financial Stability Facility
EME	emerging-market economy
ESM	European Stability Mechanism
EU	European Union
Euribor	euro interbank offered rate
FAO	Food and Agriculture Organization
FNB	First National Bank
FRRSC	Financial Regulatory Reform Steering Committee
FSAP	Financial Sector Assessment Program
FSB	Financial Services Board
G-20	Group of Twenty
GDP	gross domestic product
GIIPS	Greece, Italy, Ireland, Portugal and Spain
GR	Guidotti ratio
IAIS	International Association of Insurance Supervisors
JSE	JSE Limited
IMF	International Monetary Fund
LTRO	Long-Term Refinancing Operation
MSCI	Morgan Stanley Capital International
MTBPS	*Medium Term Budget Policy Statement*
NCR	National Credit Regulator
NT	National Treasury
OIS	overnight indexed swap
PMI	Purchasing Managers' Index
SADC	Southern African Development Community
SAM	Solvency Assessment and Management
SME	small and medium enterprise
SSA	sub-Saharan Africa
TCF	Treating Customers Fairly
UK	United Kingdom
US	United States
VIX®	Chicago Board of Options Exchange Volatility Index

Glossary

Basel III	"Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" and "Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring" issued in December 2010
CRS Bill	Credit Rating Services Bill, 2012
FM Bill	Financial Markets Bill, 2012
FSLGA Bill	Financial Services Laws General Amendment Bill, 2012
the Bank	South African Reserve Bank