

Financial Stability Review

September 2012



South African Reserve Bank

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This issue of the *Financial Stability Review* focuses mainly on the six-month period ending June 2012. However, selected developments up to 15 October 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.

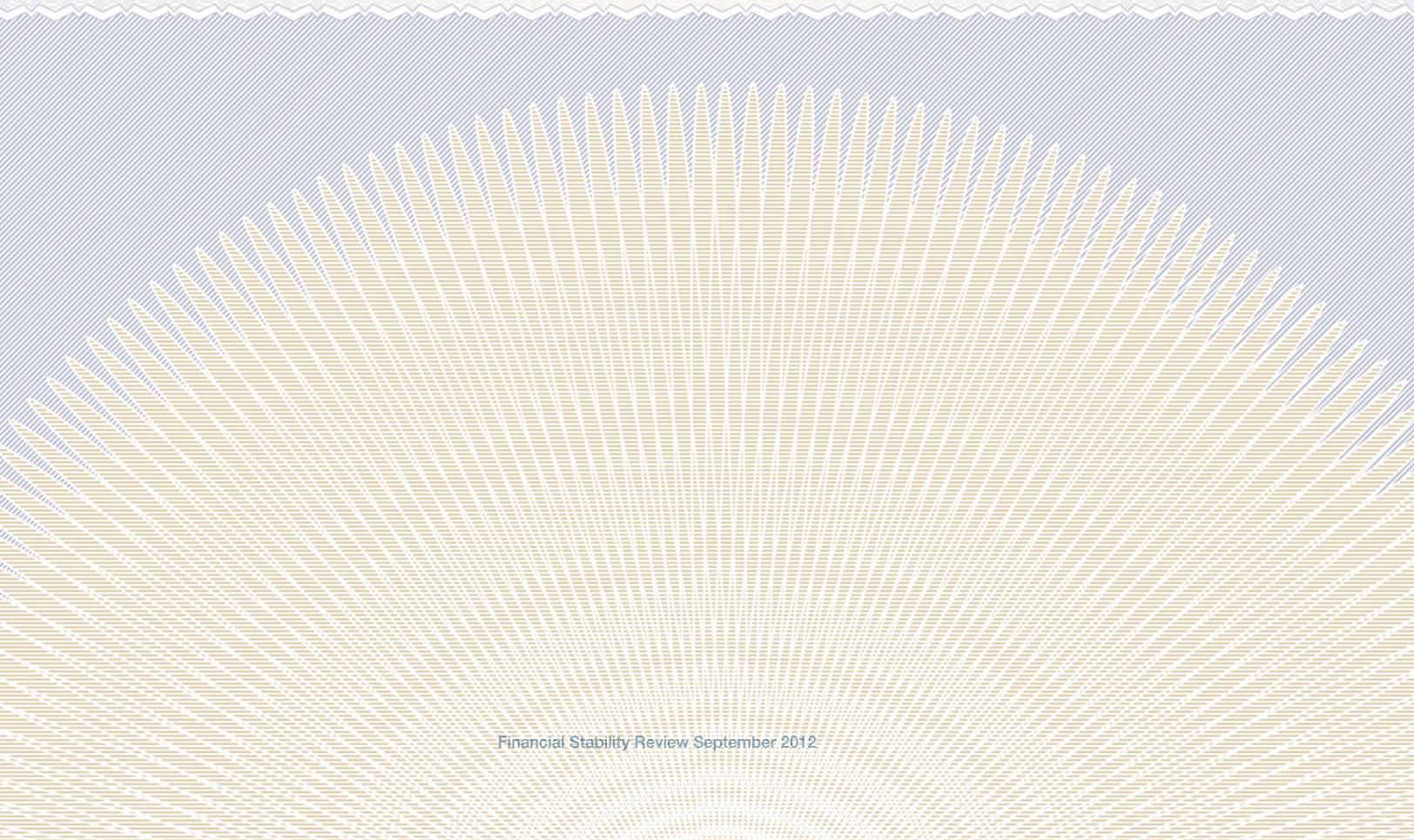
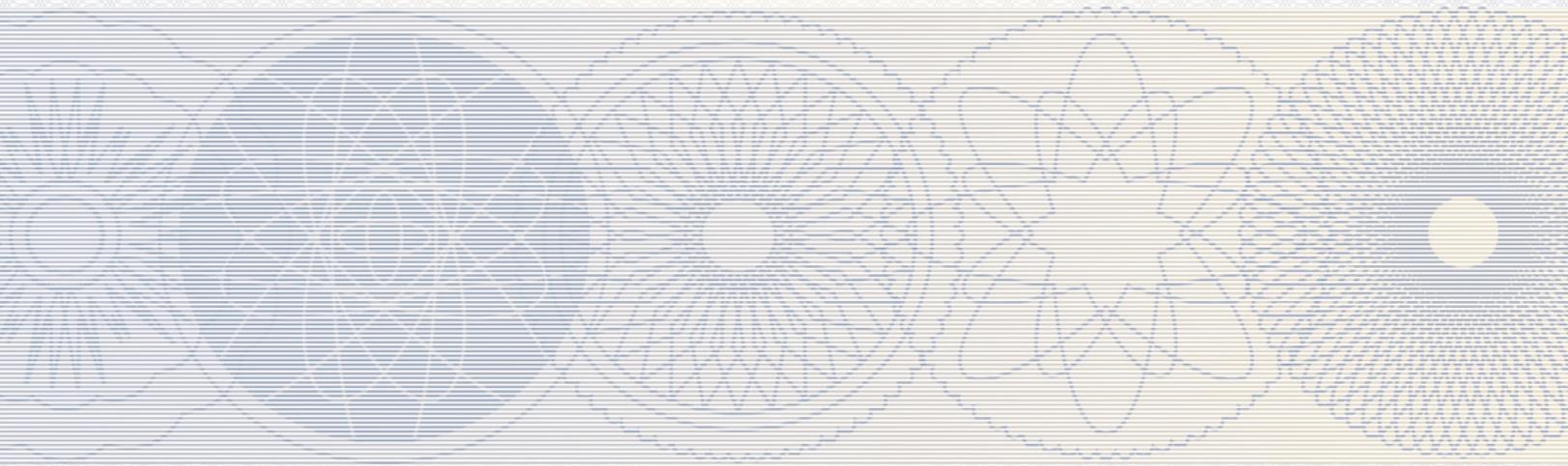
Defining financial stability

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, firstly, an effective regulatory infrastructure, secondly, effective and well-developed financial markets and, thirdly, effective and sound financial institutions. In its pursuit of financial stability, the Bank relies on market forces as far as possible and believes that any of its actions taken to contain systemic risk should be at the minimum level required to be effective.

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





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Overview

Global economic growth remained weak during the period under review with downside risks, which include the continued uncertainty regarding a lasting solution to the sovereign debt crisis in the euro area and the threatening ‘fiscal cliff’ in the United States (US). Negative prospects for economic growth in advanced economies pose a serious threat to global financial stability. However, the programmes of increased liquidity provisioning by the European Central Bank (ECB), the US Federal Reserve (the Fed), the Bank of Japan (BOJ) and the Bank of England (BoE) could mitigate this threat. While overall unemployment growth has been easing slightly in Japan, Germany, the US and the United Kingdom (UK), it continued to increase in the euro area.

Global financial markets remained volatile during the period under review, while at times also affecting emerging-market economies (EMEs). Against a backdrop of heightened financial market distress, global equity price indices have, on average, fallen since the beginning of the second quarter of 2012 but rebounded towards the latter part of the second quarter. Rising risk aversion towards EMEs caused developed-market equities to outperform emerging-market equities. Weighing further on the performance of EMEs were concerns about the sustainability of future economic growth in China. Concerns that the nature of the economic slowdown in China may in part be structural have led to fears that the slowdown may be protracted and may have significant economic and financial stability implications. Growth in other major EMEs is also projected to slow in 2012. Impediments to global economic growth are increasingly also challenging the resilience of economic growth in sub-Saharan Africa.

The uncertain and subdued global economic environment also negatively impacted real economic activity in South Africa. The Bank’s forecasts of growth in real gross domestic product (GDP) for 2012 and 2013 have also been revised down. Nevertheless, economic activity in the second quarter of 2012 expanded at a firmer pace compared to the first quarter, reflecting a strong contribution from the mining sector. Retail and wholesale trade sales increased consistently during the period under review, but other indicators of real economic activity were less positive. Confidence in the financial services sector remained high but has still not reached its pre-crisis levels. The South African banking sector continued to post healthy profitability numbers, supported by generally improved quality of assets. The sector also remained adequately capitalised in terms of the current minimum regulatory requirements. Although the banking sector’s total unsecured gross credit exposure increased further during the reporting period, it remained a relatively small portion of total gross credit exposure. The total credit exposure of the five largest domestic banks to counterparties with legal jurisdiction in Greece, Italy, Ireland, Portugal and Spain remained insignificant.

The life insurance industry continued to maintain adequate capital buffers. Healthy increases in income also contributed positively to its share prices, supporting the high level of confidence of life insurers. Short-term insurers, conversely, appeared to have experienced some financial strain during the period under review.

The domestic bond market generally performed strongly over the period under review, underpinned by lower inflation and an announcement that South Africa had become eligible for inclusion in Citigroup’s World Government Bond Index. Nevertheless, domestic financial markets remained vulnerable to global oil and food price shocks, as well as to domestic socioeconomic concerns following labour unrest at a local platinum mine in August which subsequently spread more widely. These events received broad media coverage locally and abroad, and impacted negatively on investor perceptions and are presenting risks to the stability of the domestic financial system. Despite the recent vulnerability of the resources sector, the JSE All-Share Index (Alsi) remained one of the top performers among the large emerging equity markets.

Much-needed corporate-sector investment to expand future capacity was lacking during the period under review. Business confidence decreased further in the second quarter of 2012 compared to the first quarter but more recent data suggest a slight but broad-based recovery in business confidence in the third quarter. Households debt as a percentage of their disposable



income increased marginally during the quarter ended June 2012 as households' appetite for debt increased but their savings portion of disposable income also increased, albeit only marginally. Consumer confidence, however, declined further during the period under review, borne out by a drop in the Consumer Financial Vulnerability Index. Residential real-estate market activity remained subdued as growth in mortgage advances slowed further, also negatively impacting profitability and confidence in the building and construction sector.

To enhance the soundness of domestic insurance companies and the protection of policyholders through a risk-based solvency regime, the Financial Services Board envisages implementation of the Solvency Assessment and Management (SAM) framework for the insurance sector in January 2015. Studies to determine the impact of the new proposed solvency rules on insurers were undertaken and some key areas were identified for further consideration. Renewed efforts globally to regulate private pools of capital also impacted on South Africa. The Financial Services Board has undertaken to regulate hedge funds and a draft legislative framework to this effect is currently under consideration.

Harmonisation of international standards and principles for payment, clearing and settlement systems that will be applied to all systemically important payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories (collectively known as 'financial market infrastructures' (FMIs)) is also being investigated. In South Africa, the National Payment System Department (NPSD) of the Bank has embarked on a process of mapping compliance of the domestic payment systems regime with the new principles.

Other regulatory reforms currently in the process of being implemented or investigated in the South African context include the Basel III changes, the development of legislation for the supervision of insurance groups, and strengthening resolution regimes and resolution planning for systemically important financial institutions.

Introduction

This issue of the *Financial Stability Review*, which focuses mainly on the six-month period ended June 2012, comprises two main sections, namely (i) financial stability developments and trends, and (ii) financial infrastructure and regulation.

The first section starts with an overview of current international macrofinancial conditions. It contains a discussion of the major developments in the international, emerging-market and regional environment that may influence financial stability in South Africa. This section concludes with an analysis of the main developments in the South African financial system, focusing specifically on the sectors that have a significant bearing on the stability of the domestic financial system.

The second section focuses on the financial system infrastructure and regulation, and starts with an update on financial policy, and legislative and infrastructural developments affecting the South African financial system. This is followed by consideration of principles underlying financial market infrastructure and an update of South Africa's progress with the implementation of international financial regulatory reforms.

Finally, this issue of the *Financial Stability Review* contains a note on the possible implications of the Basel III capital and liquidity framework for South Africa. It also includes a note on the calculation and publication of the Johannesburg Interbank Agreed Rate (Jibar) with a comparison drawn between the London Interbank Offered Rate (Libor) and the European Interbank Offered Rate (Euribor).



Financial stability developments and trends

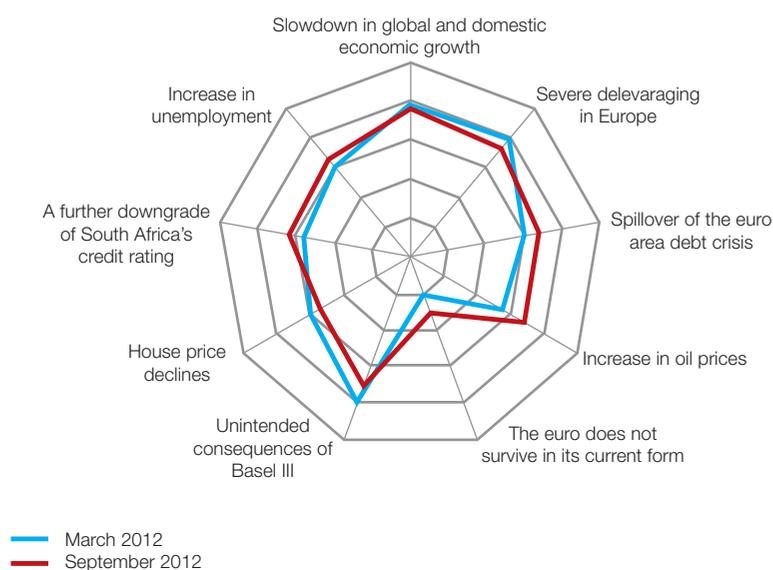
In the March 2012 *Financial Stability Review*, the global and domestic risks that were identified as of concern from a South African point of view were listed as the spillover effects of the euro area debt crisis to other parts of the world; the risk of disorderly deleveraging by European and other banks; changes in the direction of capital flows; a sharp increase in oil prices; and concerns that the euro area would not survive in its current form. In addition, risks specific to the South African economy and financial system were also noted, and included a possible slowdown in domestic economic growth as a result of slower global growth; sharp declines 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.

1. South African Reserve Bank, *Financial Stability Review*, March (2012): 5.

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

The initial selection of risks¹ included in the survey was 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. These risks are monitored continuously as they evolve. The extent to which these risks are expected either to worsen or abate during the remainder of 2012 is displayed in Figure 1.² Confirmed by analyses in this issue of the *Financial Stability Review*, continued increases in unemployment and oil prices, uncertainty in the euro area and some domestic sociopolitical issues that received widespread media coverage weighed heavily on future financial stability prospects. Concerns relating to the unintended consequences of Basel III seem to have abated somewhat, probably due to the fair amount of attention given to understanding and mitigating some of the consequences, both domestically and internationally.

Figure 1 Risks to financial stability¹



1 Closer to the centre signifies lower probability

Sources: South African Reserve Bank and financial stability analysts' expectations

International macrofinancial developments

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

Financial and economic developments in advanced economies

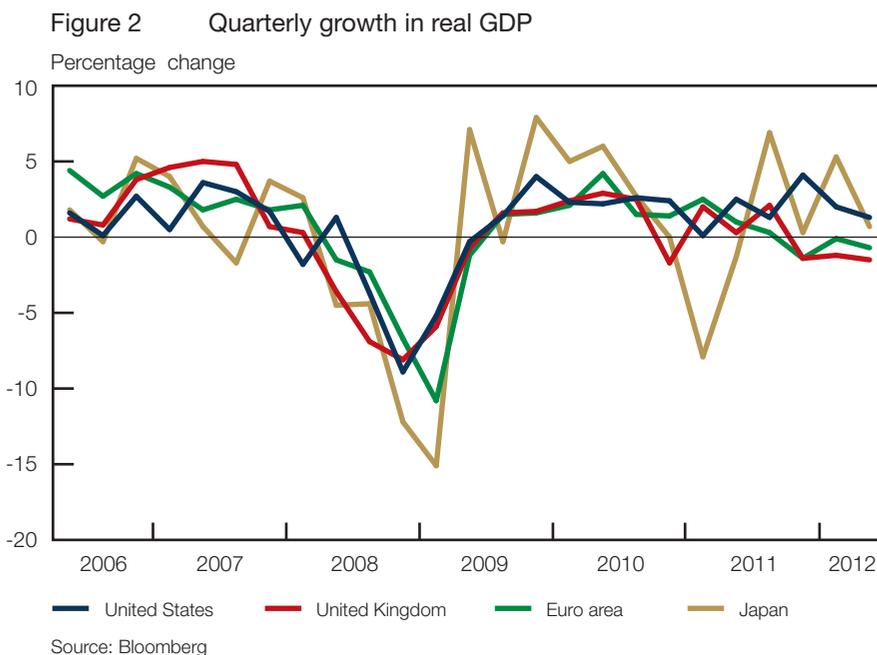
Uncertainty and low economic growth in advanced economies continues to affect emerging market and developing economies, through both trade and financial channels. The adverse feedback loop between financial markets and the real economy remains a concern.



Economic growth

In its assessment of the global economy, the International Monetary Fund (IMF) forecast the global economy to grow at 3,3 per cent in 2012 and 3,6 per cent in 2013.³ This forecast was predicated upon two important assumptions, namely (i) that there would be sufficient policy action to allow financial conditions in the euro area periphery to ease gradually, and (ii) that recent policy easing in EMEs would continue to exert more influence on global economic growth. However, the IMF has also highlighted its concern that downside risks continue to be prominent because of delayed or insufficient policy action in Europe and the US. According to the IMF, downside risks to a global recovery also include the threatening ‘fiscal cliff’ in the US and fears that authorities might delay raising the debt ceiling.

Global economic growth remained weak in the period under review (Figure 2). The weakness in global growth prompted monetary authorities in some of the advanced economies to support economic growth through additional asset purchase programmes while keeping policy rates at historic lows, or, in some cases, lowering them even further. Furthermore, there has been little evidence of an improvement in the transmission of liquidity from central banks to consumers or businesses since the March 2012 issue of the *Financial Stability Review*. The euro area sovereign debt crisis contributed to the withdrawal of deposits in some troubled countries in the euro area and has raised already-high borrowing costs even further. A combination of these factors made it challenging for countries at the centre of the sovereign debt crisis to finance their budget deficits and embark on expansionary government spending programmes. Instead, the sovereign debt crisis has forced these countries to implement further fiscal tightening measures even as their economies fall back into recession, further increasing the threat to a possible global economic recovery.



In line with these developments, the ECB has acknowledged that the transmission mechanism remained disrupted in some euro area countries, contributing to sluggish economic growth.⁴ Under normal financial market conditions the non-standard monetary policy measures undertaken by the ECB⁵ would enhance the banking sector’s access to liquidity, facilitate the functioning of the euro area money market, and support the provision of credit to households and non-financial corporations, thereby contributing to improved economic activity.

While economic growth in the US remained positive in the second quarter of 2012, its moderation indicated that the upward momentum in economic activity might be fading, posing a risk to the sustainability of the global economic recovery. Economic growth slowed from 2 per cent in the

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

4. European Central Bank, “Challenges to Monetary Policy in 2012” (Frankfurt: ECB, December 2011).

5. These measures include the unlimited provision of liquidity through fixed-rate tenders with full allotment; the provision of liquidity at lengthened maturities of up to one year; the provision of more liquidity in foreign currencies to euro area banks and of euro liquidity to other central banks for them to provide to their local banks; and a programme for purchasing covered bonds (i.e., debt securities backed by cash flows from mortgage or public-sector loans).

6. Bureau of Economic Analysis, "Gross Domestic Product: Second Quarter 2012; Third Estimate" (US Department of Commerce, 27 September 2012).

7. Moody's Investors Service, which has a negative outlook on the US credit rating, said in September 2012 that the US' Aaa credit rating might be downgraded to Aa1 if the 2013 budget talks did not produce policies that gradually decreased the country's debt (Reuters, "Update 2: US faces rating cut if 2013 budget talks fail – Moody's", 11 September 2012).

8. National Council of State Housing Agencies (18 April 2012).

9. Eurostat, "Second Estimates for the Second Quarter of 2012" (Luxembourg: Eurostat, 6 September 2012).

10. These EU member states include the Czech Republic, Greece, Italy, Cyprus, Hungary, the Netherlands, Portugal, Slovenia, Spain, and the UK.

11. Bank of England, "Minutes of the Monetary Policy Committee Meeting" (London: BoE, 19 September 2012).

12. Bank of Japan, "Enhancement of Monetary Easing" (Tokyo: BOJ, 19 September 2012).

quarter ended March 2012 to 1,3 per cent in the quarter ended June 2012.⁶ The slowdown in overall US GDP growth since December 2011 can be attributed to weak government spending and a sharp decline in real gross fixed private investment, which dropped from a high of 15,5 per cent annualised growth in the third quarter of 2011 to 9,8 per cent, and 4,5 per cent in the first and second quarters of 2012 respectively.

During the second half of September 2012, the Fed pledged to stimulate the US economy until there was a significant improvement in the labour market. The stimulus comes in the form of keeping interest rates near zero at least through mid-2015 and purchasing US\$40 billion in mortgage-backed securities per month for as long as it is necessary to spur economic activity onto a sustainable growth path.

Despite the tentative budget arrangement consented to on 31 July 2012 between the US House and Senate leaders, the risk that the fiscal cliff poses to US and global economic growth remains. The budget arrangement should keep the government's discretionary spending at its current level of US\$1,047 trillion for 2013, capped by the US Budget Control Act of 2011 (BCA). The BCA is an agreement reached towards the end of 2011 during the political brinkmanship that led Standard & Poor's (S&P) to strip the US of its AAA rating status towards the end of 2011.⁷ However, the agreement does not address the looming tax increases and mandatory spending cuts that are scheduled to take effect after 1 January 2013. Under the current BCA, tax increases and spending cuts will impact on defence and domestic programmes by an estimated 10 per cent and 8 per cent⁸ respectively in the next fiscal year if the US Congress fails to compromise. According to US Congressional Budget Office (CBO) forecasts, this could result in a contraction of about 1,3 per cent of the US' GDP in the first quarter of 2013. Another challenge to the US economy could be the expiry of former President George Bush's income tax cuts introduced in 2001 and 2003.

In the European Union (EU) continued weak economic activity in a significant number of EU countries also poses risks to global economic output. Real GDP growth in the broader 27-nation EU contracted by 0,7 per cent in the first quarter and by 0,1 per cent in the second quarter of 2012.⁹ The contraction reflects declines in household consumption expenditure, gross fixed capital formation and inventories. A number of EU member states recorded two or more consecutive quarters of negative GDP growth at the end of the second quarter of 2012.¹⁰ Negative contributions to overall GDP growth were partly offset by the slight improvement in export growth of some member countries, which was partially supported by a weak euro.

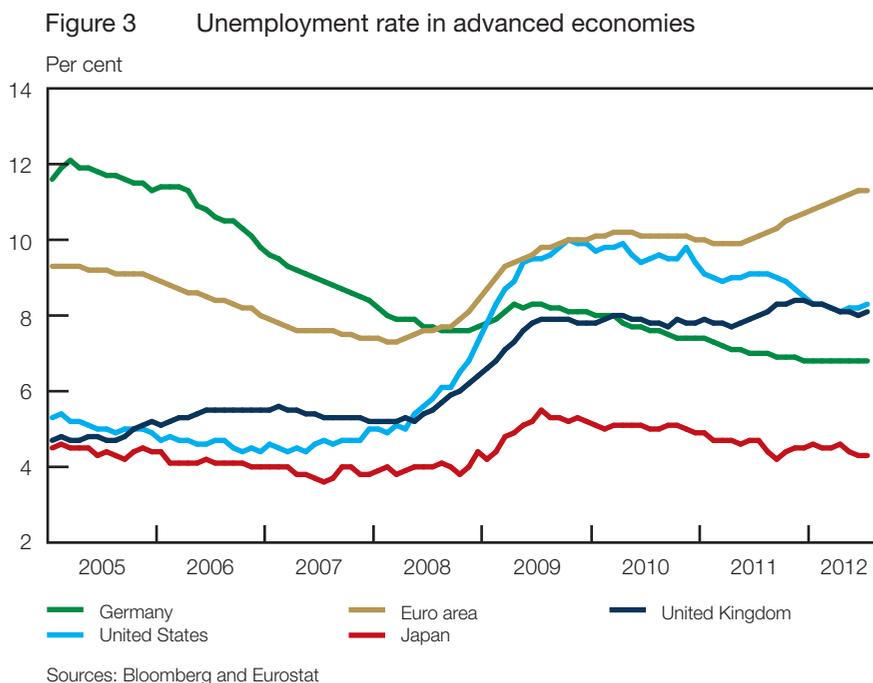
UK real GDP contracted by 1,2 per cent and 1,5 per cent (quarter-on-quarter annualised) in the quarters ended March 2012 and June 2012 respectively. The contraction in real output occurred despite efforts by the BoE to stimulate growth through its asset purchase programme and by keeping interest rates on hold. The BoE's Monetary Policy Committee nevertheless expects the UK's GDP to rise in the third quarter of 2012, alongside a possible boost from the 2012 London Olympics.¹¹ The BoE also reported that industrial production rebounded by 2,9 per cent in July 2012, following a sharp contraction in June 2012. However, the BoE believes that the sustained recovery in output will probably need to be accompanied by an upswing in consumption, since the outlook for spending in the UK economy is generally weaker.

In Japan second-quarter real GDP growth eased to 0,7 per cent after increasing at a rate of 5,3 per cent in the first quarter of 2012. In its monetary policy meeting held in September 2012, the BOJ stated that economic activity faced the critical challenge of overcoming deflation and returning to a sustainable growth path with price stability. This challenge would be met through a wide range of efforts to strengthen the Japanese economy's growth potential, which included increasing the amount of Japan's asset purchase programme.¹²

On the whole, continued weak economic growth in advanced economies poses a threat to global financial stability now that some countries in peripheral Europe slid back into recession in the second quarter of 2012. However, the programmes of increased liquidity provision by the ECB, the Fed, the BOJ and the BoE in September 2012 could mitigate this threat.

Risks emanating from high unemployment

While the overall unemployment rate has been easing slightly in Japan, Germany, the US and the UK, it continued to increase in the euro area (Figure 3). In the euro area about 10 per cent of people of working age are unemployed. The highest unemployment rate recorded is in Spain, where almost a quarter of the potential workforce is unemployed.



Youth unemployment, that is, unemployed people between the ages of 16 and 24 years, has become a global concern. These individuals are three times more likely to be unemployed than older people of a working age and over 75 million are seeking employment globally. A recent study¹³ conducted by the International Labour Organization (ILO) shows that the impact of the euro area crisis is spreading to East Asia and Latin America, worsening the situation for many young jobseekers. As a result of its continued recession, youth unemployment in Spain was estimated at 52,9 per cent in August 2012.¹⁴ This is much higher than the average youth unemployment rate for the euro area (22,8 per cent) and France (25,2 per cent). In Italy youth unemployment is estimated at 34,5 per cent. The rate at which youth unemployment continues to rise could result in more social unrest. The sustainability of any global recovery therefore also hinges on an improvement in global labour markets.

Banking-sector developments

European Central Bank support and banking-sector developments

Following the announcement by the ECB¹⁵ of its outright monetary policy transactions (OMT) programme, sovereign debt spreads between troubled nations at the centre of the euro area debt crisis and the German bund declined sharply along with credit default swap (CDS) spreads of the US and global banks (Figures 4 and 5). Market sentiment towards global banks also gleaned support from the announcement that the German Constitutional Court had recognised the legality of the European Stability Mechanism¹⁶ (ESM) in September 2012. This paved the way for the ESM, which became operational on 8 October 2012, to contribute to the sustainability of low credit-default risk spreads, especially for Spain, Italy and Greece.

13. International Labour Organization, "Global Employment Outlook: Bleak Labour Markets Prospects for Youth" (Genève: ILO, September 2012).

14. Eurostat news release: "Euro Area Unemployment Rate at 11,4%" (Luxembourg: Eurostat, 1 October 2012).

15. S Gibbs, H Q Tran, L Mitov, F Huefner, P Suttle, J Mazzacurati and K Morkunaite, "Euro Briefing: Whatever it Takes to Preserve the Euro" (Washington DC: Institute of International Finance, 21 September 2012).

16. The European Stability Mechanism is a permanent euro area debt crisis management structure approved in March 2011 with a lending capacity of €500 billion. Committed callable capital (guarantees) totals €620 billion and paid-in capital will reach €80 billion by 2014. Aimed at being operational by October 2012, the current European Financial Stability Facility will run in parallel until the end of 2013 to increase ESM lending capacity.

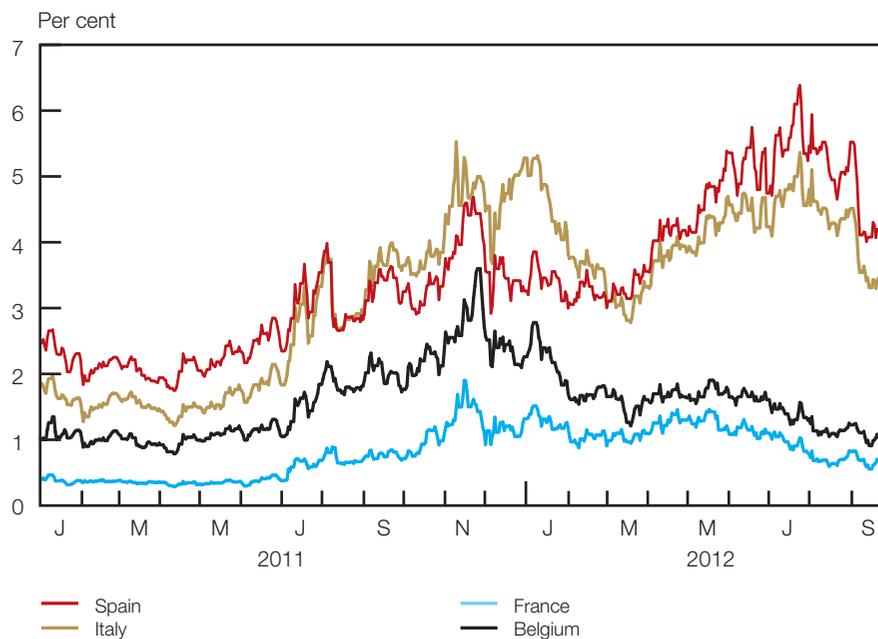
Figure 4 Global banks' five-year credit default swap spreads



Source: Bloomberg

Given that fear over Greece's exit from the euro area was one of the sources of increased risk aversion between March and July 2012, the decision of the Greek coalition government in September 2012 to proceed with the EU-IMF programme signalled a strong intention by the Greek government to remain in the euro area, improving market sentiment. However, a deep recession and surging unemployment rates could be stumbling blocks for Greece to meet the conditions for financial support as set by the IMF, the ECB and the European Commission (EC).

Figure 5 Ten-year sovereign bond spreads over German bunds for selected European countries

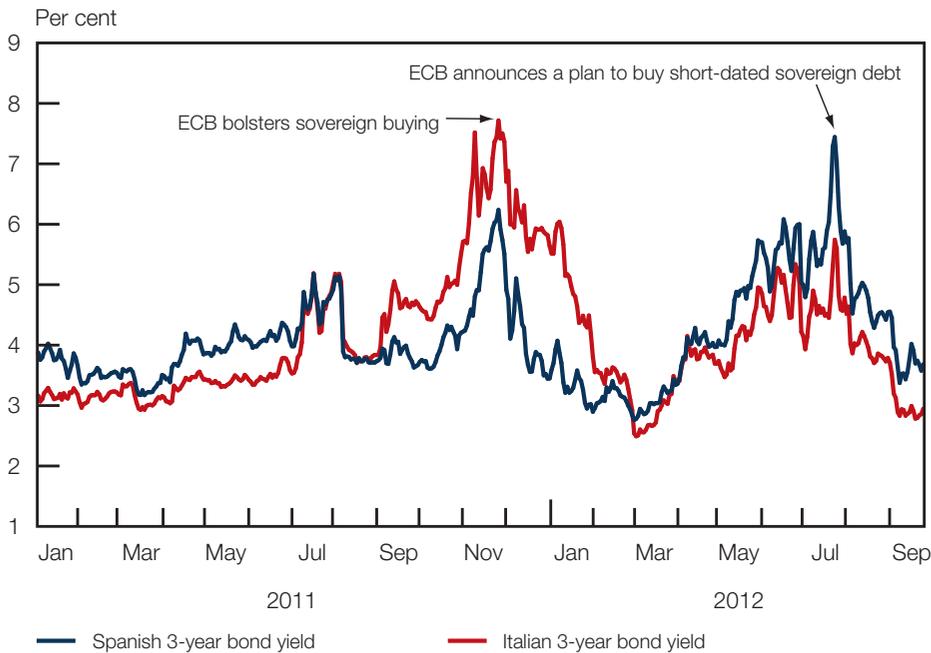


Source: Bloomberg

Also contributing to lower risk aversion since the second half of 2012 were the results of the EU summit held in June 2012, at which it was agreed that a single supervisory mechanism (SSM) would be established for the euro area. Following the EU summit held on 12 September 2012, the EC submitted a proposal to have the SSM in place by January 2013 with authority to exercise unprecedented supervisory tasks on all banks in the euro area. The establishment of the SSM is seen as the first step in creating a bank union, which is viewed as critical in addressing some of the structural limitations of the European currency union. However, there is a concern that the banking union could undermine the rights of EU countries outside the euro area and that the ECB might have excessive power compared to other national regulators when technical standards are set.

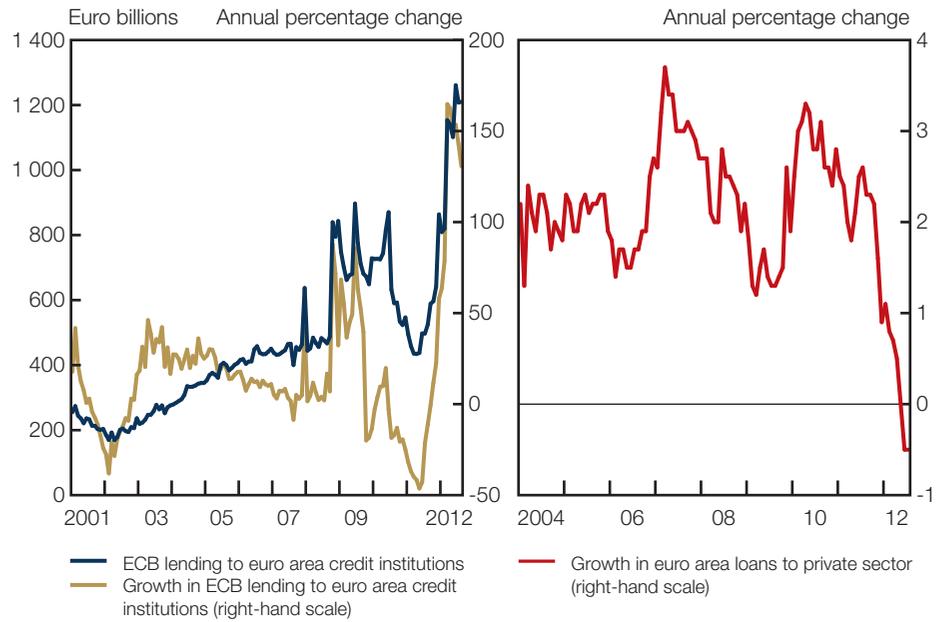
In addition to establishing the institutional infrastructure necessary to restore market confidence, the ECB also intervened to lower bond yields of countries that were at the centre of the sovereign debt crisis. Towards the end of 2011, the ECB managed to exert downward pressure on short-term rates in Spain and Italy after increasing its sovereign debt purchases. Furthermore, when the impact of its first intervention diminished and bond yields of the troubled European countries kept on rising, in September 2012 the ECB announced its plan to buy unlimited amounts of government bonds of those countries struggling to manage their debt. Following this announcement, Spain's and Italy's three-year bond yields fell sharply (Figure 6). However, should the economic fundamentals of the debt-laden countries not improve significantly, any positive impact of the ECB's announcement could be short-lived. In Spain, in particular, none of the 17 regions has been able to contain its rising government debt levels. Furthermore, countries in a recession have limited ability to raise capital on global bond markets. Given the social needs facing these EU countries, sustained support from the ECB is an integrated part of resolving the crisis.

Figure 6 ECB asset purchase programme and borrowing costs



In an attempt to encourage credit institutions to extend credit to businesses and consumers in order to revive the economy, the ECB's lending to European credit institutions breached €1,2 trillion in August 2012 (Figure 7). Nevertheless, loans granted to the private sector by banking institutions still contracted at an annual rate of 0,5 per cent in July 2012. It is against this backdrop that the ECB, in order to discourage commercial banks from hoarding excess liquidity at the ECB, also decided to lower its main refinancing rate from 1 per cent to 0,75 per cent and to lower its deposit facility rate to zero per cent from 0,25 per cent in July 2012.

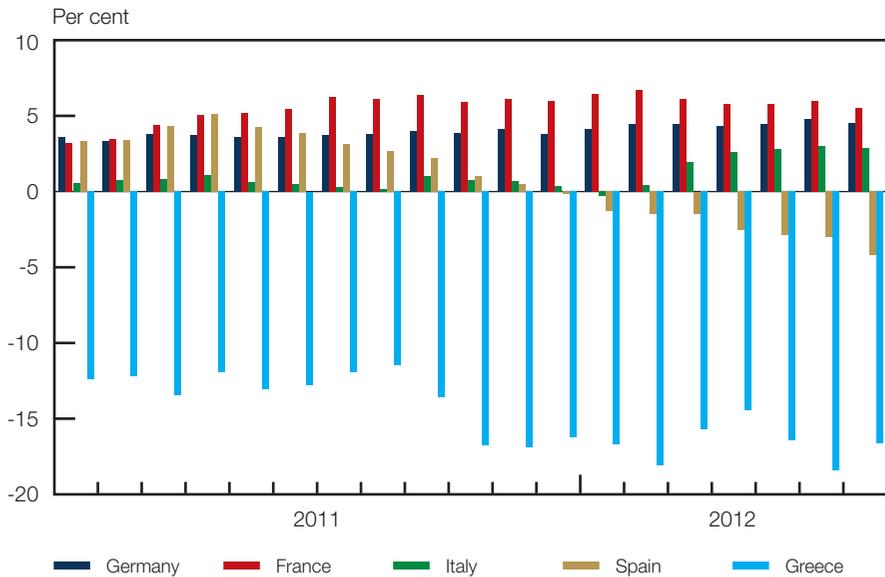
Figure 7 ECB lending to credit institutions and loans to private sector



Sources: Bloomberg and European Central Bank

Low levels of lending reported by EU banks remain a risk to Europe's recovery and, therefore, to Europe's contribution to any global economic recovery. Furthermore, households subject to continued employment uncertainty will also be reluctant to borrow, while businesses will not commit to investment plans. For the European banking system, the threat to financial stability not only stems from high borrowing costs for euro area government bonds, but also from deposit withdrawals, which are indicative of growing risk aversion (Figure 8). Banks faced with large-scale deposit withdrawals will be forced to borrow heavily from the ECB, thus creating additional exposure for the ECB and its sovereigns.

Figure 8 Annual percentage change in euro area retail deposits

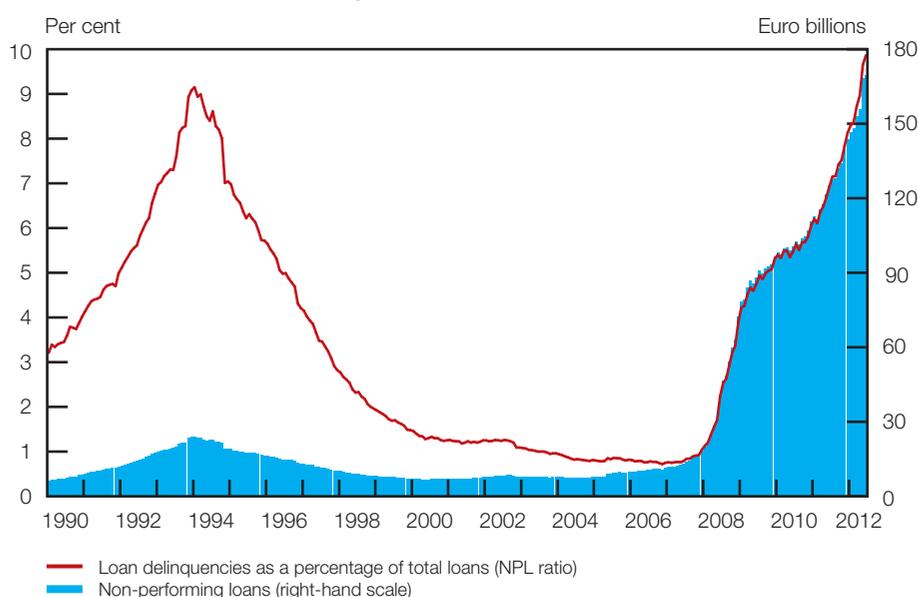


Sources: Bloomberg and European Central Bank

Developments in Spain's banking sector

Pressure on Spain's banking system also stems from bad debts. Non-performing loans reached a new high of €169 billion in July 2012 (see Figure 9). However, the EU has committed up to €100 billion for bank recapitalisation with limited conditions imposed.¹⁷ The results of a stress test conducted by Oliver Wyman (a global management consulting firm) with the close supervision from authorities, including the IMF and the ECB, failed to dispel doubts over the health of Spanish banks. It was reported that the banking sector would require as much as €59,3 billion of new capital to recapitalise it. In addition, a detailed examination of the loan books of 14 banks showed that 7 did not have enough capital.¹⁸ Despite the analysis, some market analysts criticised the narrow focus of the stress test, arguing that the test did not take into account provisions of the banks' equity portfolio, which is an important source of cash flow. The IMF indicated that the public funding for the banks' actual capital needs were expected to be lower than the amounts determined by the stress tests and that the needs could be comfortably financed under the recapitalisation programme supported by Spain's European partners.¹⁹

Figure 9 Spanish banks' non-performing loans and loan delinquencies as a percentage of total loans



Sources: Bloomberg and European Central Bank

Spanish banks, which have suffered rating downgrades and increased funding costs during 2012, may find it difficult to roll over maturing debt if bond yields were to rise in the near term. The total outstanding debt of the Spanish banking sector doubled from the end of the fourth quarter of 2008 to the first quarter of 2012, and now amounts to €145 billion. Spain has increasingly become dependent on the ECB, with its net borrowing rising to a record €375 billion in July 2012.

United States banking-sector developments

Uncertainty over growth prospects seems to be holding back private investment by corporates despite the existence of supportive lending conditions (Figure 10). Data from the Fed's Senior Loan Survey show that US banks in general subscribe to more accommodative lending standards.

The asset quality of the US banking industry has improved significantly, based on the net charge-offs²⁰ (NCOs) falling continuously since its peak in 2009 and a fall in the non-current loans (NCL)²¹ ratio (Figure 11). This bodes well for those US banks that were at the centre of the sub-prime banking crisis. Equity and regulatory capital held by US banks have also improved markedly since 2009.

17. Institute of International Finance, "Progress Made, Much Remains to be Done", (Washington DC: IIF, 13 July 2012).

18. Banco de España, "Bank Recapitalisation and Restructuring Process" (Madrid: Banco de España, 28 September 2012).

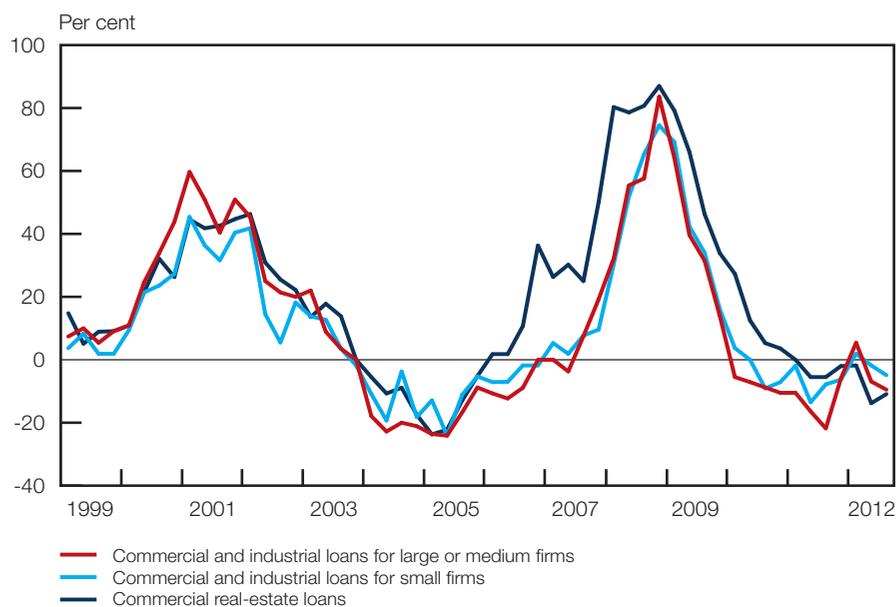
19. International Monetary Fund, "IMF Managing Director Christine Lagarde Welcomes the Completion of Spain's Banking Sector Valuation" (Washington DC: IMF, 28 September 2012).

20. Net charge-offs are losses realised on loans and leases currently in default minus any subsequent recoveries of delinquent debt.

21. A non-current loan is a loan in which a borrower is at least three months behind in payments and has stopped making payments altogether.



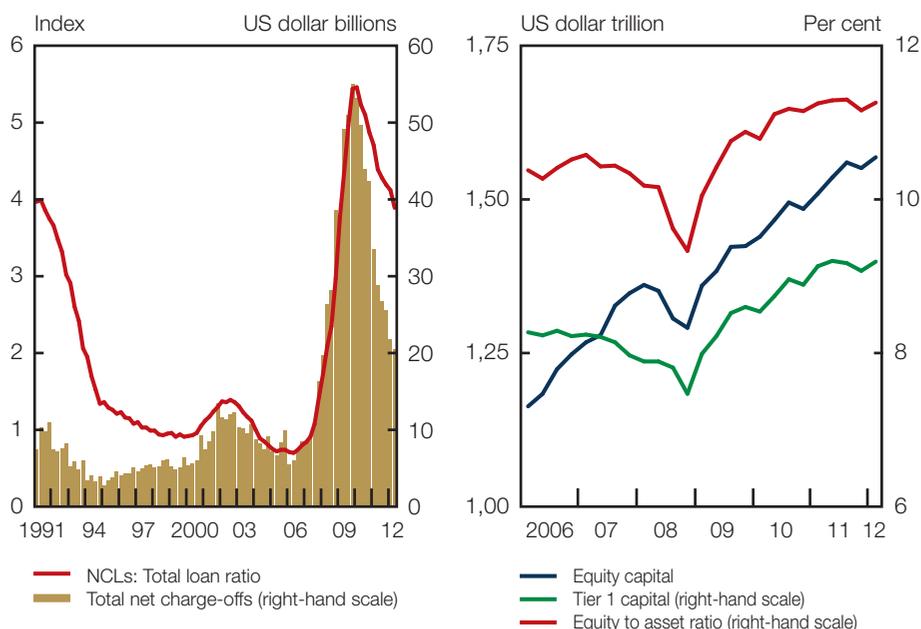
Figure 10 Percentage of banks tightening lending standards per loan category



Sources: Bloomberg and US Federal Reserve

The low interest rate environment in the US has, however, dampened growth in banks' profitability. With US Treasury bond yields falling on concerns of slowing economic growth and a general flight to quality, the decline in long rates, combined with stable short rates, has had a negative impact on interest margins. In addition, lower short rates limit deposit-pricing flexibility, leaving banks less able to offset any narrowing in interest rate spreads. This situation is expected to persist as the Fed is planning to keep short-term interest rates stable at low levels throughout 2015.

Figure 11 US banks' asset quality and bank regulatory capital



Sources: Bloomberg and US Federal Reserve

Financial market developments

Global financial markets remained volatile during the period under review, mainly due to continued uncertainty about the euro area sovereign debt crisis, deepening banking-sector fragilities and the subsequent downward revisions of the global economic outlook by the IMF in mid-July and October 2012. Adding further to the volatility prevalent in global financial markets were concerns about the looming US fiscal cliff, the political impasse between pro-austerity and anti-austerity groups in Greece and other European countries, and the ensuing doubt about the future of the euro area. EMEs have also been affected by volatile risk perceptions, prompting a sell-off of emerging-market assets during certain periods. Volatility has, however, recently abated and remains below its long-term trend as shown by the Chicago Board of Options Exchange (CBOE) Volatility Index (VIX[®]).²²

Despite this decline, financial market volatility could increase during the remainder of 2012, pending decisions regarding the payment of another bailout tranche for Greece and a possible bailout package for Spain. Uncertainty about the US fiscal position may further add to volatility.

Equity markets

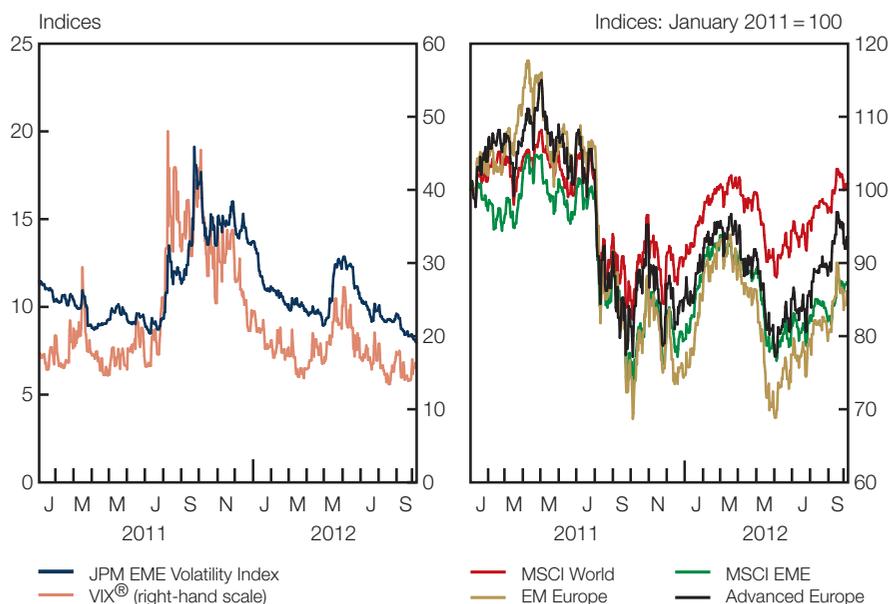
Against a backdrop of heightened financial market distress, global equity indices, on average, fell back early in the second quarter of 2012. Global equity markets, however, rebounded towards the latter part of the second quarter of 2012, mostly reflecting hopes of further unconventional policy easing by major central banks. The outperformance of emerging-market equities by equities of advanced economies continued as rising risk aversion towards EMEs resulted in an increased preference for equities in advanced economies. Weighing further on the performance of EMEs were concerns about economic growth in China and the resultant impact on commodity prices. During the second quarter of 2012, the Morgan Stanley Capital International (MSCI) Emerging Market Index²³ and the MSCI World Index²⁴ fell by about 7 per cent and 3 per cent respectively. Both indices have since recovered most of the losses recorded during that period. Equities in Europe (both emerging and advanced) underperformed compared to their international equivalents during this period.

22. VIX[®] is a symbol for the Chicago Board of Options Exchange (CBOE). It measures implied volatility of the S&P 500 Index for equities over the next 30-day period.

23. The Morgan Stanley Capital International (MSCI) Emerging Market Index is a free-floating adjusted market capitalisation-weighted index which is designed to measure the equity performance of key EMEs.

24. Similar to the MSCI Emerging Market Index, the MSCI World Index is a free-floating adjusted market capitalisation-weighted index, designed to measure the performance of equities in key developed economies.

Figure 12 Financial-market volatility and MSCI equity indices

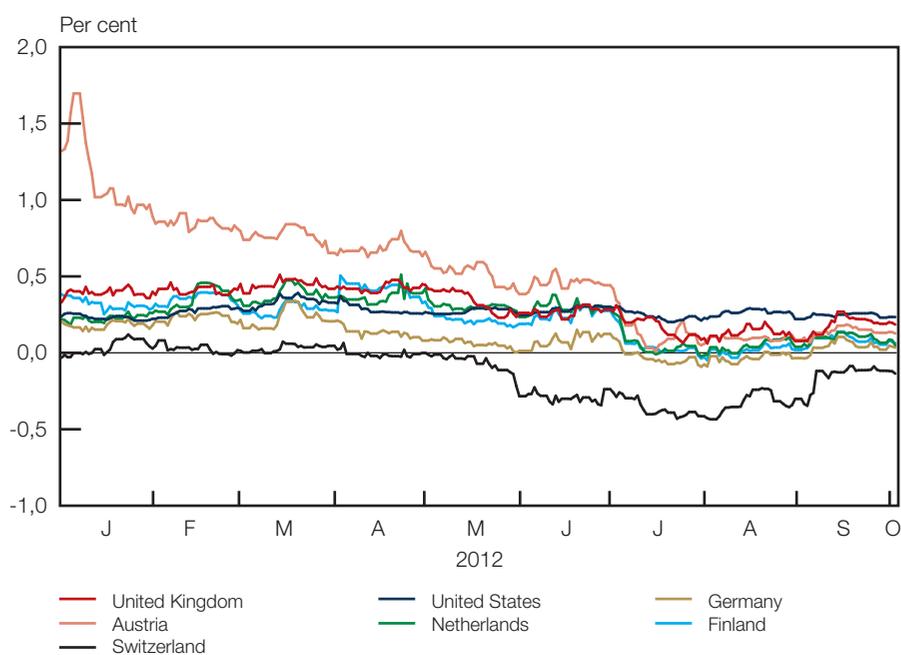


Source: Bloomberg

Bond markets

As strains in euro area debt markets continued to intensify, risk sentiment towards bond markets in EMEs and debt-laden euro area countries deteriorated. Bond markets also reacted to the possibility of a sovereign debt default and an eventual exit by Greece from the euro area. Fears of contagion to other fiscally vulnerable euro area countries also added to market unrest, leading to a widespread loss of confidence in non-core government bond markets in general. These developments led investors to search for safety in government bonds of countries such as the US, Germany and Switzerland, thereby causing short-term bonds of these countries to yield negative or near-negative returns (Figure 13). Conversely, caution towards bonds of emerging-market and peripheral euro area countries resulted in increased risk premia. This is shown by the JPMorgan Emerging Market Bond-plus Index (EMBI+) spread which has averaged 350 basis points in the six months ended June 2012, compared to an average of 267 basis points during the same period in 2011. Accordingly, emerging-market bond indices were outperformed by their international counterparts amid an increase in the preference for assets denominated in US dollar.

Figure 13 Selected two-year government bond yields



Source: Bloomberg

A further indication of the extent of stress in European bond markets was the general increase in the number of undersubscribed bond auctions, as investors believed that returns on certain bonds were not reflective of the true risk attached to those bonds.

However, indications of support by major world central banks, particularly the ECB, have helped to ease tensions and prompted a decline in some long-term government bond yields. For instance, in Spain yields on both short- and long-term Spanish government bonds have declined from record levels that were seen in July 2012 despite persistently declining output, rising unemployment, the ever-present doubts about the country's ability to meet its budget targets and failed attempts to rebuild confidence in its banking sector. These developments could, however, only be a temporary respite as concerns about the sustainability of the current measures taken to resolve the crisis engulfing the euro area are still present.

Currency markets

The flight-to-safety behaviour of investors was also evident in currency markets. The US dollar appreciated for the most part of the period under review, benefiting from its safe-haven status amid persistent downside risks relating to the European sovereign debt crisis. Economic growth concerns (particularly with regard to China) and fears of a protracted euro area recession also supported the US dollar.²⁵ Since mid-July 2012, the US dollar has, however, depreciated following expectations and the subsequent provision of further quantitative easing by the Fed to support the US economy.

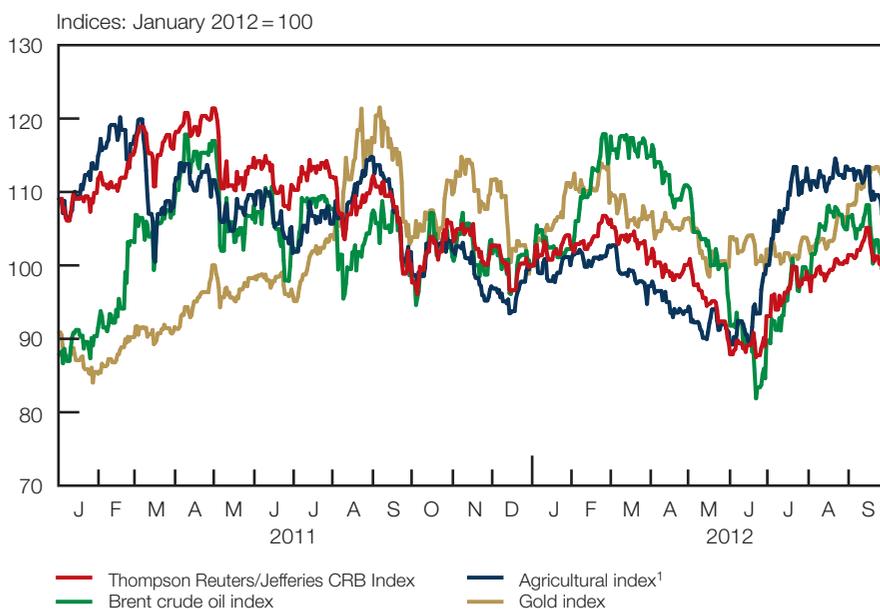
In the six-month period to June 2012, the euro depreciated against a larger number of currencies compared with the same period last year. Continued loss of confidence, deepening banking-sector vulnerabilities, poor economic data in some cases, and widespread sovereign and bank credit-rating downgrades were among the factors that weighed negatively on the euro. Commodity-linked and other high-yielding currencies also depreciated during the period under review. Since late July 2012, however, the euro has recovered most of its losses following pledges of support for peripheral bond markets and a commitment by the Fed to conduct further quantitative easing. The recovery of the euro may, to the extent that it affects the competitiveness of euro area exports, complicate the task of EU policymakers at a time when the weakening currency is helping the competitiveness of exports, thus providing a backstop against the recessionary consequences of fiscal austerity.

Commodities

Commodity prices fell sharply during the first half of 2012, with a more pronounced decline in growth-sensitive commodities such as oil. During this period, the Thompson Reuters/Jefferies Commodity Research Bureau (CRB) Index fell by over 9 per cent, while Brent crude oil fell by approximately 13 per cent. The interplay between demand- and supply-side factors underpinned most of the developments in the oil market. On the demand side, factors such as weak economic conditions in major oil-consuming countries and a strong US dollar exerted downward pressure on prices. On the supply side, this effect was reinforced by a general increase in crude oil inventories and expectations that some countries may release strategic oil reserves in order to limit the impact of higher oil prices on already weak economies.

25. This was also substantiated by the US dollar index (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) which showed a persistent appreciation of the US dollar that has remained above its long-term trend since the beginning of the year.

Figure 14 Thompson Reuters/Jefferies CRB Index and selected commodity price indices



¹ The agricultural index (formally the S&P GSCI Agricultural and Livestock 3-month forward capped component index spot) is designed to measure the performance of the agriculture and livestock market with periodic weight caps on constituents and calculated based on contract expirations that would be in the index 3 months ahead of the standard S&P GSCI index roll period

Source: Bloomberg



26. 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 to 2004.

Oil prices have rebounded since July 2012 despite weak economic conditions. The return of geopolitical tensions in Iran, increased seasonal demand and rising expectations of further quantitative easing have contributed to this rally in oil prices. The long-standing dispute over Iran's nuclear programme could result in an even higher risk premium on oil prices following calls in late September 2012 by some European countries to impose tougher sanctions on Iran. Agricultural commodity prices have also increased, elevating the potential threat of food security, although this is a phenomenon more common in developing countries (see Box 1). The rise in agricultural commodity prices can be attributed to severe drought conditions in the US, a weak monsoon season in Asia and poor wheat crops in the Black Sea region. After declining for three consecutive months, the United Nations' Food and Agriculture Organization's (FAO) Food Price Index²⁶ increased by 6 per cent in July 2012 — a gain that was sustained in August 2012. The Food Price Index has since stabilised, increasing by 1,4 per cent in September 2012.

In the period January to September 2012 the gold price increased by approximately 13 per cent, benefiting from its appeal as a "safe haven". For most of the period under review, gold prices exhibited similar trends in terms of trading to those of risky assets, partly due to the countering effect of a stronger US dollar on the metal's "safe-haven" status. As a balancing factor, however, the benefits of gold's "safe-haven" appeal appear to have outweighed those of a stronger US dollar. Furthermore, quantitative easing by major central banks also supported the gold price amid fears that such policy stances would result in increasing inflation.

Box 1: Food security

The threat of food security has, once again, appeared on the international agenda, mainly due to the significant increase in global food costs. The recent severe drought in the US and the Black Sea countries (i.e., Russia, Ukraine and Kazakhstan) has further exacerbated the potential threat of food insecurity. Although the potential impact of food insecurity is limited in most advanced countries, it is a common phenomenon in many African countries that have been dealing with food security issues for decades.

The recent rise in food costs can partly be attributed to the erratic weather conditions which have affected producers globally. The effect of the extreme drought experienced in the US is expected to impact markets globally since the country produces nearly half of the world's maize and a third of the world's soya beans. Similarly, continual rain is threatening wheat crops in some European countries. In India, which is the major producer of sugar and wheat, the monsoon rainfall for 2012 is expected to be below the long-term average, which will ultimately impact on the size of the harvest. Increased political unrest in North Africa and the Middle East is also expected to exacerbate the food security situation.

Although food prices declined marginally in late 2011 due to bumper harvests globally, prices remained close to some of the highest levels seen in decades. Food prices have also become more volatile in recent years and this phenomenon is expected to continue in the foreseeable future. Previous large increases in food prices (especially from 2007 to 2008) were predominantly due to factors associated with erratic weather conditions and low stocks, although these factors are still prevalent. The oil price and the use of food crops for biofuel have also become important factors contributing to recent food price increases.

The World Bank recently expressed its concern about the impact of international food price increases on the world's poor, who are most vulnerable to such increases. A recent report issued by the World Bank²⁷ highlighted the harsh realities of food price increases, indicating that the prices of staple foods had increased by 80 per cent since 2005. The World Bank's report also cautioned that higher-than-average grain prices could be expected until at least 2015. Higher global food prices are having a devastating impact on countries in sub-Saharan Africa, with maize prices having increased by 113 per cent in Mozambique. Moreover, the price of sorghum has increased by 180 per cent and 220 per cent in Sudan and South Sudan respectively.

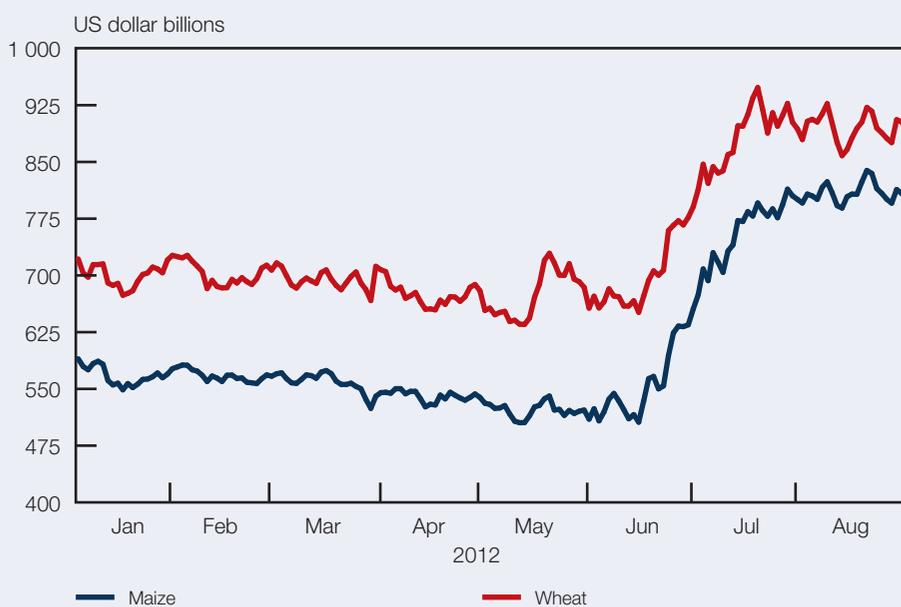
Figure A clearly illustrates the dramatic increase in the prices of both wheat and maize in the commodities futures markets for the period from January to August 2012. For the first half of 2012 wheat future prices were relatively stable at around US\$660 per ton, but the price sharply escalated to US\$934 per ton in July 2012. Similarly, the future prices of maize were also marginally stable at around US\$535 per ton for the first half of 2012 before spiking to US\$823 per ton in July 2012.

27. World Bank, "Food Price Volatility a Growing Concern, World Bank Stands Ready to Respond" (Washington DC: World Bank, 30 July 2012).



Food-to-ethanol conversion programmes, conducted by various developed economies, have also received widespread negative media coverage due to their impact on food security. The US is currently projected to divert about 40 per cent of its maize crop to the production of ethanol, and about 60 per cent of Europe's rapeseed crop goes to the production of biodiesel. In South America Brazilian ethanol production consumes half of the country's sugarcane crop. In 2008 the United Nations' report projected that biofuel production contributed 15 per cent to world food price inflation. However, since then the playing field has changed considerably. The United Nations will raise this issue and its impact on food security at various meetings.

Figure A Commodities futures market



Source: Bloomberg

The effects of increased food prices are not only problematic in terms of contributing to food risks for consumers, but also create unpredictability in the market. Food price inflation discourages much-needed investment in agriculture for development due to increased financial risks, and uncertainty for producers and traders. The cumulative effects inevitably involve widespread hunger and social unrest, as illustrated in the food crises of 2008 and 2011 which resulted in riots in some 30 mainly very poor countries. However, higher food prices do have some advantages in that they can bring desperately needed income to poor farmers, enabling them to invest, increase their production and thereby become part of the global food security solution.

Although agriculture in South Africa is regarded as highly developed in terms of international standards, South Africa remains in a precarious position in that, although it produces enough food to feed its entire population of about 50 million people and is able to export surpluses, external factors are adversely impacting on local food costs (especially staple food such as maize) and threatening food security. In South Africa the poorest segment of the population currently spends approximately 39 per cent of its income on food, up from 34 per cent in April 2011.²⁸

Various government and international bodies have acknowledged the damaging effects of price hikes and food insecurity, and have adopted various initiatives to mitigate their effects. Locally, several programmes are being implemented concurrently to ensure food security in South Africa. Besides contributing towards social assistance and nutritional programmes in the poorer areas, which are more severely impacted by higher food prices, the South African Government has also embarked on an integrated food security initiative, thereby hoping to eradicate malnutrition, food insecurity and hunger in South Africa by 2015.²⁹ Similarly, farmers in sub-Saharan Africa are initiating small-scale irrigation schemes in dry areas where the security of food supplies is being threatened. Since sub-Saharan Africa's agricultural productivity is regarded as the lowest in the world, mainly due to poor water availability, doubling the area under large-scale irrigation would raise the contribution of irrigated agriculture to food supply to 11 per cent by 2050 from the current 5 per cent.

28. T Randall, "Maize Crisis Looms in SA" (Mail & Guardian, 17 August 2012).

29. The Alliance for Commodity Trade in Eastern and Southern Africa, "Agriculture and Food Strategy in South Africa" (Lusaka: ACTESA COMESA).

30. B Witherhell, "2012: The Threat of a Global Food Crisis" (Baltimore, MA: Govtnslaves.info, 19 August 2012).

Internationally, the threat of food insecurity resulted in the Group of Twenty (G-20) convening in August 2012 to discuss ways to avoid policies that would exacerbate the situation, such as export restrictions and hoarding.³⁰ A rapid response forum has also been established, which could be convened at any point to deal with surging world food prices. The Global Food Price Crisis Response Program, which provides immediate relief to countries hard hit by high food prices, has made a significant difference by assisting 40 million people in 47 countries through a US\$1,6 billion emergency support programme. In an attempt to further mitigate the risk of food and energy shortages, and improve food security for the world's poor, the International Finance Corporation (IFC) is investing US\$1 billion in the Critical Commodities Finance Program, which is aimed at supporting trade in key agricultural and energy-related goods. The World Bank has also initiated a first-of-its-kind risk management product. It will be provided by the IFC, and will enable protection from volatile food prices for farmers, food producers and consumers in developing countries.

In conclusion, the issue of food security remains very complicated and therefore requires commitment and collaboration between all stakeholders, governments and global organisations if it is to be adequately addressed in the foreseeable future.

Financial and economic developments in emerging-market and developing economies

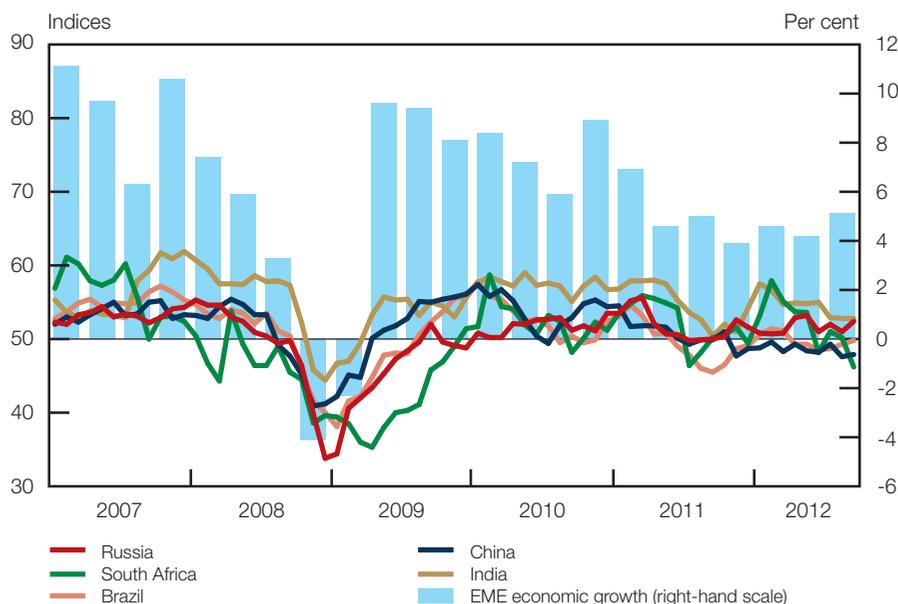
Emerging-market economies

The slowdown in advanced economies has also spread to EMEs during the period under review, resulting in declining emerging-market exports. Manufacturing purchasing managers' indices (PMIs)³¹ have for the most part been declining in some EMEs since the beginning of 2012, driven mostly by declining new orders for exports. Baseline projections for economic growth in emerging and developing economies, nevertheless, still remain in excess of 5 per cent although a moderation is expected in 2012.³²

31. JPMorgan manufacturing Purchasing Managers Indices.

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

Figure 15 Economic growth¹ and PMI manufacturing overall indices² 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

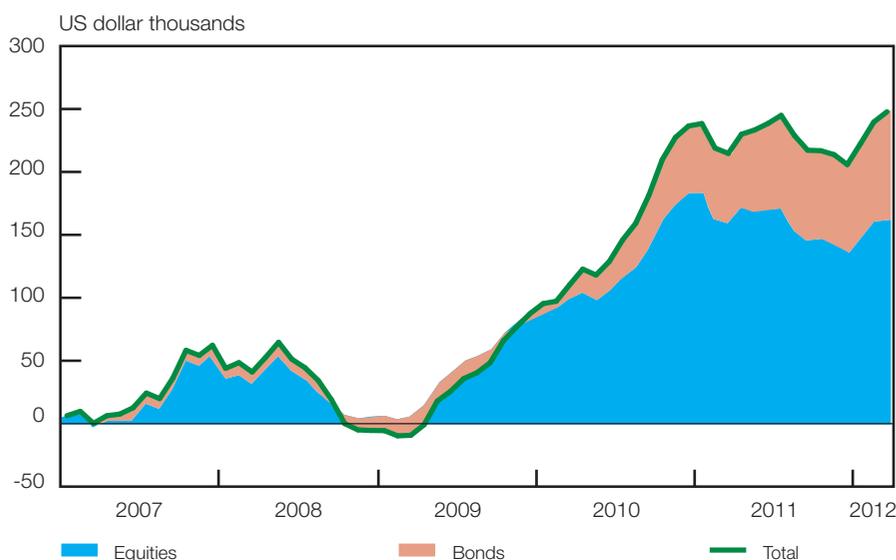
Growth in major EMEs (i.e., Brazil, Russia, India, China and South Africa) is also projected to slow in 2012. While still growing at a relatively faster pace than other EMEs, China's revision of its economic growth target and a further decline in its economic growth rate to 7,4 per cent in the third quarter of 2012 (from 7,6 per cent in the second quarter) have led to increased concerns about a possible 'hard-landing' in China. Furthermore, concerns that the nature of the economic slowdown in China may in part be structural have led to fears that the slowdown may be protracted, and may have significant economic and financial stability implications.

The adjustment of banks' balance sheets as part of their efforts to shore up their capital reserves is affecting their lending activity in EMEs. During the second quarter of 2012, emerging-market bank lending conditions deteriorated for the fourth consecutive quarter. According to the Institute of International Finance,³³ the deterioration in bank lending conditions was largely due to tightened cross-border funding. The tightening bank lending conditions in EMEs were also attributed to deteriorating bank asset quality due to subdued economic activity in the second quarter of 2012.

Despite volatile risk perceptions in global financial markets, the upswing in activity in EME capital markets persisted, supported by a search for yield and relatively better economic growth prospects. Data from the Emerging Portfolio Fund Research show that EMEs continued to record inflows to their local bond and equity markets, although more recently a reversal of equity investments due to rising global economic growth concerns can be noted. The latter could be caused by 'herd behaviour' among investors where, during periods of heightened risk aversion, preference for safety tends to dominate the search for yield.

33. Institute of International Finance, *Emerging Markets Bank Lending Conditions Survey – 2012Q2* (Washington DC: IIF, 20 July 2012).

Figure 16 Emerging-market capital flows



Source: Emerging Portfolio Fund Research

Emerging-market bond inflows are currently driven, among other things, by strong economic and debt fundamentals in EMEs. Against this backdrop, expectations of prolonged poor economic performance in EMEs could result in a reassessment of their risk and, consequently, prompt a reversal of capital inflows.

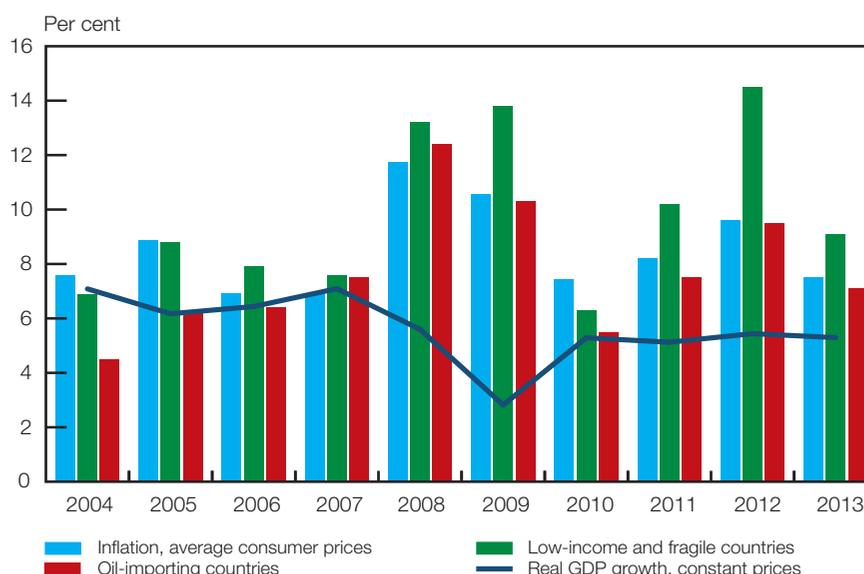
Africa, sub-Saharan Africa and the Southern African Development Community region

Impediments to global economic growth are increasingly challenging the resilience of economic growth in sub-Saharan Africa. Although the current downside risks to the global economic environment prompted only a marginal reduction of economic growth forecasts for the sub-Saharan Africa region, a further intensification of these downside risks could have profound effects on growth. According to IMF forecasts, economic growth in sub-Saharan Africa is expected to average 5,4 per cent in 2012 before easing to 5,3 per cent in 2013. These



growth levels may, however, be difficult to sustain as forward-looking indicators continue to point to suppressed economic conditions experienced by sub-Saharan Africa's main trading partners. Accordingly, trade activity in the region is expected to moderate, but the benefits of trade reorientation towards faster-growing EMEs, including destinations in Africa itself will limit the moderation. With the resurgence in oil and other commodity prices, there is a growing expectation that oil-exporting countries will grow faster than others in the sub-Saharan Africa region. Low-income and fragile countries in the region may conversely face an inflation risk. The risk of elevated inflation in these countries not only emanates from high oil prices, but also from the potential knock-on effects of increasing food prices.

Figure 17 Real GDP growth and average inflation in sub-Saharan Africa



Source: International Monetary Fund

34. Moody's Investors Service, "Sub-Saharan Africa Sovereign Outlook" (www.moody's.com).

In its latest review of the status of the sub-Saharan Africa region, Moody's Investors Service (Moody's) reaffirmed the region's credit dynamics as being broadly positive.³⁴ Relatively robust economic growth and reduced exposure to Europe were identified as positive factors contributing towards the region's creditworthiness. The credit risk profiles of the biggest countries in the region were also shown to be encouraging.

Table 1 Long-term foreign currency ratings of selected countries

Sovereign	Rating agency		
	Moody's	Standard & Poor's	Fitch
South Africa.....	Baa1	BBB	BBB+
Nigeria.....	NR	B+	BB-
Kenya.....	NR	B+	B+
Angola.....	Ba3	BB-	BB-
Ghana.....	NR	B	B+
Uganda.....	NR	B+	B

NR: not rated
Sources: Bloomberg and Moody's Investors Service

Concerns about political instability in the northern part of the region and the region's high reliance on foreign funding mostly from Europe were identified as potential factors that may weigh on the region's credit risk profile. However, funding for sub-Saharan Africa's banking system is mostly sourced locally. Only about 5 per cent of the region's banking-sector liabilities



are sourced from international banks.³⁵ Accordingly, the degree to which the regional banking sector is exposed directly to sudden changes in foreign funding is fairly limited. Furthermore, only a fractional part of this funding is sourced from peripheral countries, while most of it comes from the 'core' European countries.

35. Bank for International Settlements. *Preliminary Locational and Consolidated International Banking Statistics at End-March 2012* (Basel: BIS, July 2012).

Domestic macroprudential analysis

This section presents an analysis of developments in the South African financial system. The analysis includes the banking sector, bond and equity markets, and other non-bank financial institutions, which include the insurance, and the pension and provident fund industries. As shocks can also emanate from sources outside the financial system, developments in the external, household and corporate sectors, and the residential real-estate market are also covered. Given the interrelationship between the real and financial sectors of the domestic economy, the section begins with an overview of domestic real economic activity.

Real economic activity

In the second quarter of 2012 economic activity expanded at a firmer pace with real GDP rising by 3,2 per cent (seasonally adjusted and annualised), compared to 2,7 per cent in the first quarter. This improvement in economic activity in the second quarter of 2012 reflects a strong contribution from the mining sector, which recovered from a deep contraction in the first quarter. The output of the manufacturing sector, the second-largest economic sector in the South African economy, contracted by 1 per cent in the second quarter of 2012. A survey conducted by the Bureau for Economic Research (BER)³⁶ shows that sentiment among manufacturers remained negative in the third quarter of 2012 as manufacturing production slackened relative to the second quarter, due to weaker domestic sales and a drawdown on inventories that countered the growth in production.

36. Bureau for Economic Research, "FNB/BER Business Confidence Index, 3rd Quarter 2012" (Stellenbosch: Bureau for Economic Research).

The Bank's composite leading business cycle indicator has been declining since March 2012, which is indicative of the uncertain and subdued economic environment. The Bank's forecasts of real GDP growth for 2012 and 2013 have therefore also been revised down to 2,6 per cent and 3,4 per cent respectively. Furthermore, the Kagiso PMI has been moderating consistently since February 2012.

A selection of indicators of real economic activity (Table 2) reflects relatively subdued growth for the domestic economy. Buildings completed and electric current generated continued the declining trend in July 2012, while the value of buildings plans passed highlight the continued weak residential property market.

Table 2 Selected indicators of real economic activity¹

Annual percentage change in monthly indicators

Activity indicators	2012						
	Jan	Feb	Mar	Apr	May	Jun	Jul
Building plans passed	-10,04	6,22	-19,16	12,33	4,13	4,86	0,14
Buildings completed.....	5,15	6,05	-13,69	18,86	-1,08	-17,79	-6,48
Retail sales.....	4,75	5,46	4,82	3,27	4,89	6,89	5,87
Wholesale trade sales.....	10,42	12,88	9,55	10,13	8,35	6,47	6,84
New vehicle sales.....	10,27	11,89	6,17	10,11	20,08	16,53	17,38
New passenger car sales	13,06	6,78	10,80	12,11	20,84	14,23	18,16
Electric current generated.....	0,85	0,33	-3,35	-5,99	-5,49	-1,99	-1,14
Utilisation of production capacity ²	80,47	81,29	...

1 At constant prices, seasonally adjusted

2 Quarterly indicator, ratio

... Denotes unavailability of data

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



37. See the discussion of business confidence under the corporate sector on page 36.

38. Statistics South Africa, *Quarterly Labour Force Survey* (Pretoria: Statistics South Africa, Quarter 2, 2012).

39. 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'.

40. The long-term average is calculated over the past 42 quarters, since the inception of the Ernst & Young Financial Services Index.

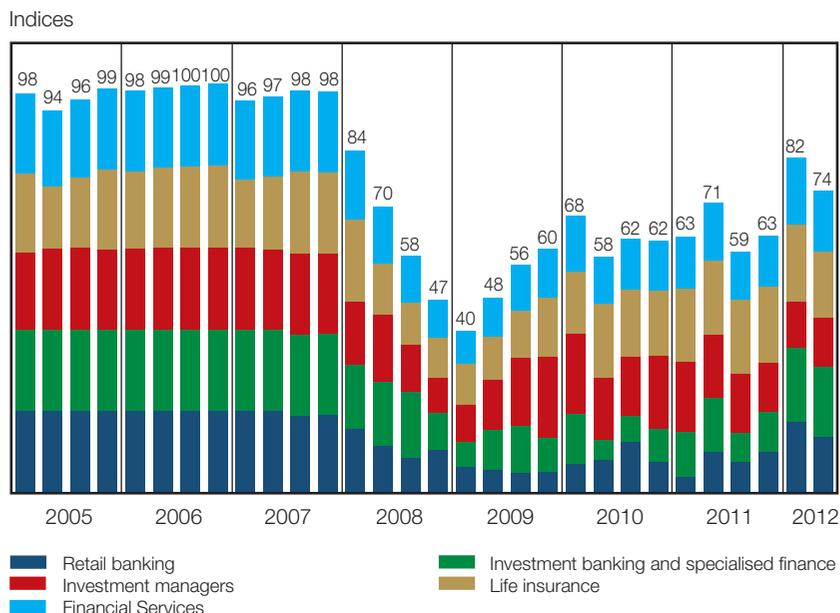
Retail and wholesale trade sales, however, increased consistently during the first seven months of 2012, with retail sales probably supported by improvements in the disposable income of households. Growth in wholesale trade sales increased at a slower pace in June than in May 2012, but recovered somewhat in July 2012. Confidence among new vehicle dealers improved markedly in the third quarter of 2012.³⁷ However, growth in the motor vehicle industry moderated in September 2012 following fairly robust increases up to August 2012. Annual growth rates of new vehicle and new passenger car sales slowed to 2,3 per cent and 4,4 per cent respectively in September 2012 from 9,2 per cent and 11,5 per cent in August.

The official unemployment rate in South Africa decreased marginally from 25,2 per cent in the first quarter, but still remained high at 24,9 per cent.³⁸ Despite the moderate improvement in employment in the second quarter of 2012, unemployment remains a concern and continues to weigh on economic growth prospects.

Confidence in the financial services sector

Confidence in the financial services industry remained relatively high in the first half of 2012 compared to 2011, although it still has not reached its pre-crisis levels. After surging from 63 index points at the end of 2011 to 82 index points in the first quarter of 2012, the index decreased to 74 index points during the second quarter of 2012.³⁹ The current level remains lower than the long-term average⁴⁰ of 77 index points. Decreases in the confidence levels of retail banking, investment management and specialised finance, and life insurance were partially offset by a moderate increase in the confidence of asset managers.

Figure 18 Financial Services Index and its components



Source: Ernst & Young

The decrease in confidence of retail banking occurred on the back of increases in credit losses for some product categories and a lack of clear direction for sustained growth in the banking sector during the second quarter of 2012. As banks in Europe came under continued pressure to ensure that they had sufficient capital to deal with sovereign debt defaults and given the continual changes in regulatory requirements, investment banking also faced subdued demand and increasing restrictions locally. This contributed to the deterioration in investment banking confidence. The confidence of life insurers decreased as growth in premium income slowed due to a significant decrease in investment product premiums.

The confidence of asset managers, conversely, increased despite the volatile environment in Europe and slower economic growth in key emerging markets. The increase could be a reflection of the higher income growth recorded in the financial services sector.

Developments in the domestic banking sector

Banking-sector overview

During the period under review, the four largest domestic banks⁴¹ continued to dominate market share (83,9 percent of the total banking sector in June 2012). The banking sector's total capital-adequacy ratio remained stable at approximately 14,7 per cent of risk-weighted assets on average during the first six months of 2012. The sector thus remained adequately capitalised in terms of the current minimum regulatory requirements.

41. Largest banks in terms of total assets.

Table 3 Selected indicators of the South African banking sector¹

Per cent, unless indicated otherwise

	2012					
	Jan	Feb	Mar	Apr	May	Jun
Market share (top four banks).....	84,28	84,20	84,27	84,46	84,04	83,93
Gini concentration index.....	82,73	82,66	82,75	82,76	82,67	82,62
Herfindahl-Hirschman Index (H-index).....	0,188	0,187	0,188	0,188	0,187	0,186
Banks' share prices (year-on-year percentage change).....	2,06	10,87	19,56	15,32	18,83	22,36
Capital adequacy						
Capital-adequacy ratio	14,75	14,66	14,70	14,71	14,68	14,80
Regulatory Tier 1 capital to risk-weighted assets.....	11,84	11,73	11,69	11,70	11,73	11,84
Credit risk						
Gross loans and advances (R billions).....	2 506	2 518	2 568	2 528	2 578	2 615
Impaired advances (R billions) ²	118,62	118,51	117,65	117,38	117,56	116,76
Impaired advances to gross loans and advances	4,73	4,71	4,58	4,64	4,56	4,46
Specific credit impairments (R billions).....	41,13	40,98	41,01	40,99	41,70	43,19
Specific credit impairments to impaired advances	34,67	34,58	34,86	34,92	35,48	36,99
Specific credit impairments to gross loans and advances.....	1,64	1,63	1,60	1,62	1,62	1,65
Profitability						
Return on assets (smoothed).....	1,20	1,20	1,22	1,21	1,19	1,19
Return on equity (smoothed)	17,10	17,11	17,41	17,22	16,87	16,96
Interest margin to gross income (smoothed)	50,17	50,45	50,69	50,96	50,79	50,56
Operating expenses to gross income (smoothed)	54,62	54,67	54,24	54,32	54,71	54,10
Liquidity						
Liquid assets to total assets (liquid-asset ratio)	8,39	8,52	8,32	8,50	8,51	8,52
Liquid assets to short-term liabilities.....	16,89	17,10	16,64	17,06	17,29	17,14
Effective net open foreign-currency position to qualifying capital and reserve funds.....	0,42	-0,86	-1,03	-1,87	-0,13	-0,27

¹ Data for revisions were updated on 2 October 2012

² 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



42. Impaired advances are advances in respect of which specific impairments have been raised.

43. Specific credit impairments or allowances are any impairment, allowance or provision raised against losses on a debt that has been specifically identified as bad or doubtful, and any impairment, allowance or provision made against groups of debt on the basis of their age.

44. G Kershoff and G Thompson, *The Financial Services Index, 2nd Quarter 2012* (Ernst & Young, BER).

Gross loans and advances, the largest asset on the banks' balance sheets, grew on average by 9,6 per cent year on year from January 2012, compared with an average annual growth rate of 5,1 per cent in the second half of 2011. All subcategories of gross loans and advances showed positive growth, contributing to a 10,9 per cent year-on-year increase in June 2012. Impaired advances⁴² continued their downward trend during the first half of 2012, indicating an improvement in the asset quality of banks in general. Specific credit impairments⁴³ as a percentage of impaired advances increased from 34,7 per cent in January 2012 to 37 per cent in June 2012, but this increase could be attributed to a change in reporting by one of the large banks.

Credit losses, however, continued to impact banking sector profitability negatively, especially in the second quarter of 2012, causing the return on equity to drop slightly. The cost-to-income or efficiency ratio was range-bound between 54 per cent and 55 per cent during the period under review, well within the international benchmark of 60 per cent. The sector's holdings of liquid assets continued to increase during the first half of 2012, while the aggregated effective net open foreign-currency position as a percentage of qualifying regulatory capital and reserve funds remained well within the 10 per cent regulatory limit.

There appears to have been a bias towards tightening lending standards by retail banks during the second quarter of 2012.⁴⁴ The portion of respondent retail banks that indicated that they had loosened lending criteria in the second quarter of 2012 was 17 per cent compared to about 25 per cent that indicated that they had tightened lending standards. For investment banking activities, all respondents indicated that no changes had been made to their lending standards during the second quarter of 2012.

The distribution of bank credit according to economic sectors remained largely unchanged. At the end of the second quarter of 2012, banks' largest concentration of credit exposure was still to the private household sector, followed by the financial intermediation and insurance sector which recorded a marginal increase.

Table 4 Sectoral distribution¹ of credit

Per cent

Sector	2011	2012	
	Dec	Mar	Jun
Agriculture, hunting, forestry and fishing	1,73	1,75	1,72
Mining and quarrying	3,68	3,67	3,73
Manufacturing	4,27	4,46	4,41
Electricity, gas and water supply	0,85	0,70	0,72
Construction.....	1,18	1,25	1,16
Wholesale and retail trade, hotels and restaurants.....	3,96	4,14	4,26
Transport, storage and communication	3,44	3,32	3,42
Financial intermediation and insurance	25,17	24,19	24,68
Real estate	6,34	5,19	5,12
Business services.....	3,71	3,78	3,68
Community, social and personal services.....	5,37	6,53	6,35
Private households	34,28	36,56	35,85
Other	6,02	4,45	4,91
Total².....	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

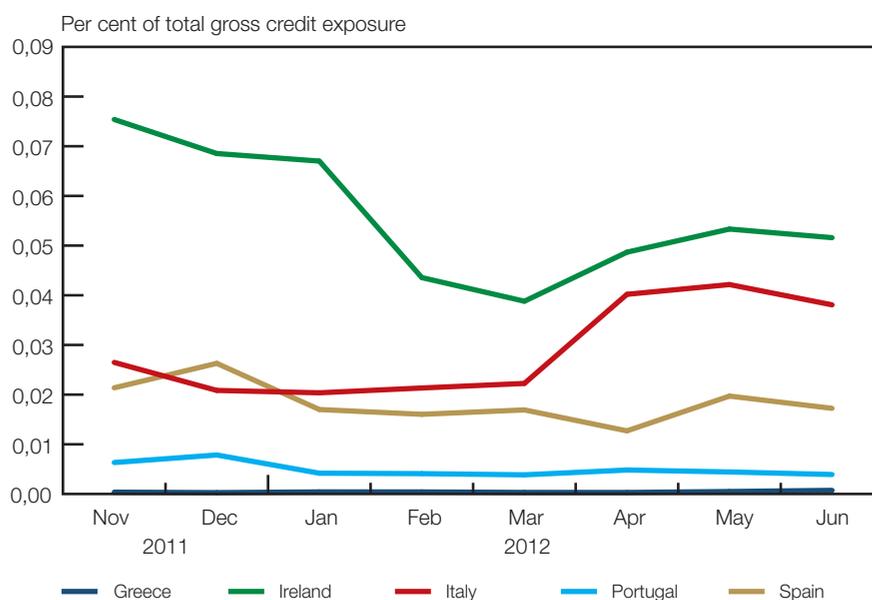
2 Figures do not necessarily add up to 100 due to rounding

Source: South African Reserve Bank

Banking-sector credit exposure to peripheral euro area countries

The credit exposure of the five largest domestic banks' (in terms of assets) to counterparties with legal jurisdiction in selected distressed European economies, namely Greece, Italy, Ireland, Portugal and Spain (GIIPS) is continually monitored by the Bank. The total gross exposure of the domestic banking sector to the GIIPS countries has remained range-bound between 0,08 per cent and 0,13 per cent of total credit exposure since October 2011. In June 2012, total gross exposure to the GIIPS countries as a percentage of the five largest banks' total credit exposure amounted to 0,11 per cent. In terms of instruments, the five largest banks' exposure was largely in derivatives (0,05 per cent of total gross exposure) and loans and advances (0,04 per cent of total gross exposure). The five largest banks' total gross exposure was largely to banks (0,07 per cent of total gross credit exposure) and private sector non-bank counterparties (0,03 per cent of total gross credit exposure). Direct exposures to sovereign counterparties were negligible.

Figure 19 Total gross credit exposure to selected European economies



Banking-sector exposure to unsecured lending

The South African banking sector's total unsecured gross credit exposure⁴⁵ increased to approximately R381 billion in June 2012 from R341 billion in December 2011 (Figure 20). The banks included in the survey⁴⁶ constituted approximately 98,2 per cent of total gross unsecured lending (all categories) of the banking sector as at June 2012. Measured over a period of 12 months, total unsecured gross credit exposure increased by 20,9 per cent in June 2012, mainly due to an increase of 51 per cent (R25,2 billion) in the 'retail other' (loans greater than R30 000) unsecured lending category. Banks' total unsecured credit exposure as a percentage of total gross credit exposure increased from 9,5 per cent in June 2011 to 10,5 per cent in June 2012.

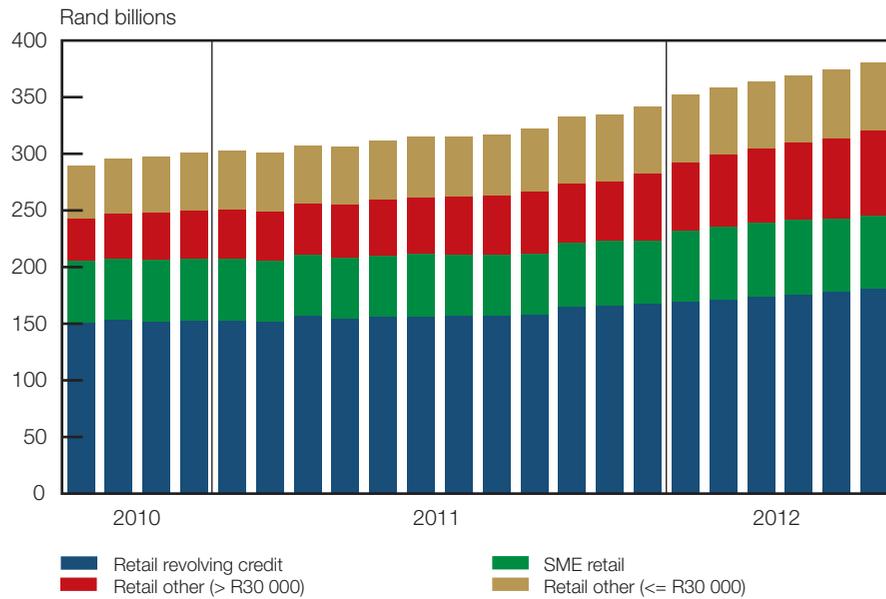
Taking into account other non-bank credit providers, data from the National Credit Regulator (NCR) showed that growth in unsecured credit increased in the second quarter of 2012 compared to the previous quarter.⁴⁷ Unsecured credit of R25,8 billion was granted in the second quarter of 2012 compared to R22 billion in the first quarter of 2012.

45. Unsecured lending includes credit cards, overdrafts, personal loans and financing provided to small and medium enterprises (SMEs) in the retail sector. The exposure includes both on- and off-balance-sheet exposures (on-balance-sheet exposure generally refers to credit extended, whereas off-balance-sheet exposures refer to potential credit risk in the form of facilities extended but not utilised at the time of reporting). The quantitative information is aggregated data based on surveys conducted and regulatory information reported by the six banks that are significant role players in the unsecured credit market.

46. All quantitative information is based on regulatory reporting from six banks.

47. Consumer Credit Market Report, June 2012.

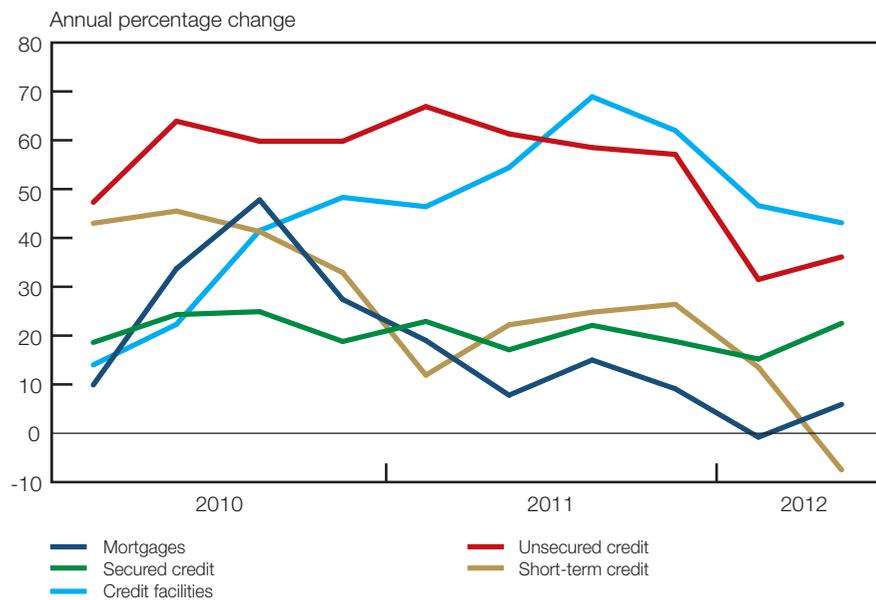
Figure 20 Total gross unsecured credit exposure



Source: South African Reserve Bank

Credit facilities continued to grow at a faster pace in the quarter ended June 2012 compared with the other components of credit (Figure 21). During the second quarter, credit facilities grew at an annual rate of 43,1 per cent, followed by unsecured credit, which grew at an annual rate of 36,1 per cent (up from 31,5 per cent in the first quarter of 2012), while short-term credit recorded an annual contraction of 7,5 per cent. Mortgages increased by 5,9 per cent in the second quarter compared to a contraction of 0,8 per cent in the first quarter.

Figure 21 Categories of credit granted by all credit providers



Source: National Credit Regulator

Non-bank financial institutions

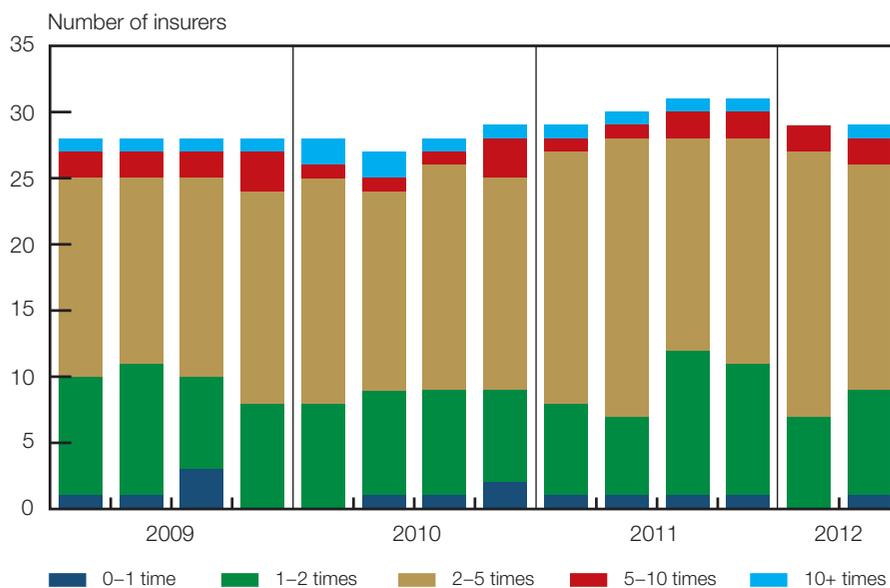
The discussion on non-bank financial institutions includes long-term insurers, short-term insurers and the pension and provident fund industry.

During the first quarter of 2012 the assets of the life insurance industry grew at 9,1 per cent year on year. In relation to the size of the domestic economy, the assets of life insurers remained fairly stable and in March 2012 amounted to 56,9 per cent of GDP, slightly up from the 56,2 per cent recorded in March 2011. Through investment in fixed-income securities (both public and private), the life insurance companies continued to play an important role in financial intermediation by contributing to liquidity in the financial system. In the year to March 2012 life insurance companies' investment in fixed-income securities increased by 7,5 per cent, up from an annual increase of 4,2 per cent a year earlier. Over the same period the life insurance industry's investment in equities increased by 10,1 per cent. The annual increase in net premiums received of 20 per cent in the six months ended June 2012 was one of the factors that contributed to the financial health of the life insurance industry. The share prices of long-term insurers continued along the positive growth path that began in November 2011, recording an increase of 30,8 per cent in the year to July 2012. Although the confidence level of life insurers (Figure 18) decreased in the second quarter of 2012, it remained high at 81 index points.⁴⁸

48. G Kershoff and G Thompson, *The Financial Services Index, 2nd Quarter 2012* (Ernst & Young, BER).

The life insurance industry continued to maintain adequate capital buffers during the period under review, with the majority of companies sustaining a free assets-to-capital-adequacy ratio of between two to five times. This means that these companies would have enough capital to cover operating expenses for a period of between 26 and 65 weeks even in the event of adverse financial conditions. Only one life insurer did not have capital that would cover the regulatory minimum requirement of 13 weeks of operating expenses under adverse financial conditions. Thus, the life insurance industry is regarded as resilient to adverse financial conditions.

Figure 22 Free assets-to-capital-adequacy requirement¹ of long-term typical insurers²

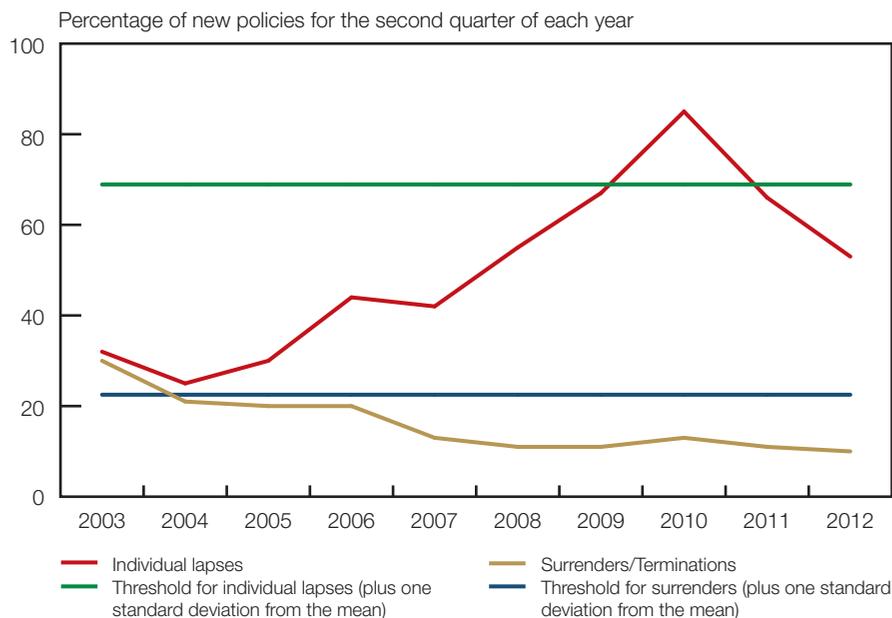


1 'Free assets' refers to the difference between total assets and the sum of total liabilities and required capital. The 'capital-adequacy requirement' is defined as the minimum capital required by the Financial Services Board for the registration of an insurance company and is equivalent to 13 weeks'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

The long-term typical insurance business improved somewhat in the first half of 2012. Individual lapses (expressed as a percentage of new policies) decreased from 66 per cent in the six months ended June 2011 to 53 per cent in the six months ended June 2012, while individual surrenders (expressed as a percentage of new policies) decreased from 11 per cent to 10 per cent over the same period (Figure 23).

Figure 23 Individual lapses and surrenders for long-term typical insurers¹



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

Conversely, the short-term insurance sector appeared to have experienced some financial strain during the period under review. Net premiums recorded an annual contraction of 0,3 per cent in the six months ended June 2012 compared with the same period a year earlier. Although underwriting profit rose by 6,1 per cent year on year during the review period, it was significantly less than the increase of 48,7 per cent recorded in the six months ended June 2011. The same trend can be noticed in respect of underwriting and investment income, which recorded an annual increase of 7,3 per cent in the current period compared to 30,9 per cent a year earlier.

Table 5 Selected indicators for short-term typical insurers¹

	2011			2012	
	6 months	9 months	12 months	3 months	6 months
Net premiums (after reinsurance) ²	14,0	12,9	8,2	3,3	-0,3
Underwriting profit ²	48,7	19,7	20,8	7,8	6,1
Underwriting and investment income ²	30,9	20,1	13,4	9,1	7,3
Claims ³	57	58	58	62	60
Management expenses and commission ⁴	34	33	32	31	31
Underwriting profit ⁴	10	9	10	8	10
Underwriting and investment income ⁴	16	15	16	16	17
Surplus asset ratio (median) ⁵	39	40	43	51	52

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

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

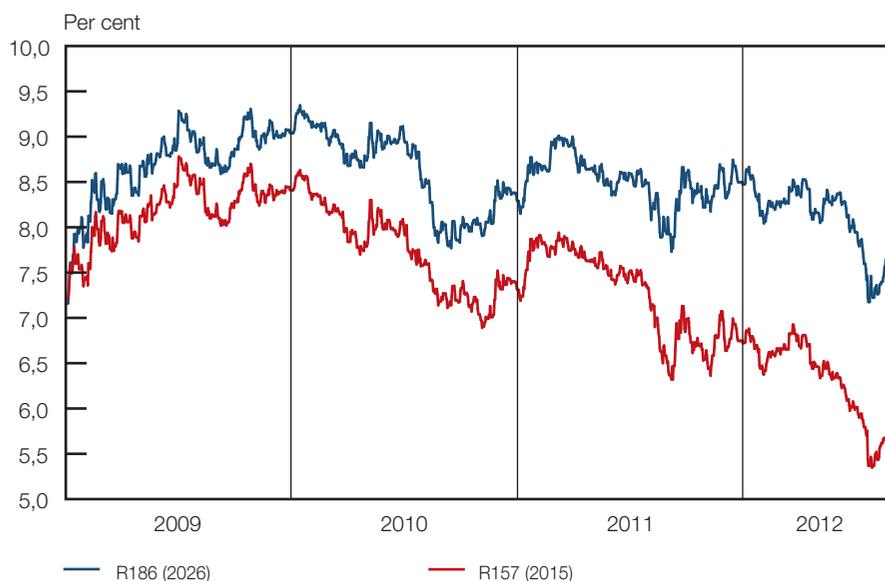
Pension and provident funds are important players in the financial system through, among other things, investments in bond and equity markets, thereby providing liquidity to the financial system. In terms of assets, the size of pension and provident funds (including both official and

private self-administered funds) amounted to 71,1 per cent of annual GDP in the first quarter of 2012, which is 2,5 percentage points higher compared to the fourth quarter of 2011. Equity investment of official pension and provident funds increased at an annual rate of 12,1 per cent during the second quarter of 2012, while holdings of fixed-income securities increased by 14,8 per cent compared to a year earlier, down from an annual increase of 33,8 per cent in June 2011. Over the same period, the year-on-year rate of increase in private self-administered pension and provident funds' holdings of bonds increased marginally to 6,3 per cent from 6 per cent, while their investment in equities slowed to 3,5 per cent year on year.

Bond, equity and currency markets

The domestic bond market generally performed strongly over the period under review, with longer-term yields testing levels that have not been seen since the end of the Bretton Woods system in the early 1970s. Both global and domestic factors contributed to this strong performance. The global environment, characterised by a continued ample supply of liquidity by the world's major central banks, an absence of structural inflation problems in advanced economies and an inability of the global economy to post a sustained recovery, has remained conducive to a "search for yield" and portfolio diversification into emerging debt markets. Until June 2012, such behaviour by international investors caused South African bond yields to post moderate declines even as global risk aversion increased, spurred by renewed concerns about the fiscal health of the euro area's periphery, the fading impact of large liquidity injections by the ECB and a loss of momentum in the US economy beyond the first quarter of 2012. From June 2012 onwards, however, the South African bond market was able to capitalise on a recovery in global risk appetite as the US Federal Reserve further extended the maturity of its bond portfolio, EU policymakers showed stronger commitment to safeguarding the integrity of the euro and many central banks (e.g., the ECB, the BoE, and monetary authorities in China, Brazil and Korea) resumed policy rate reductions.

Figure 24 Selected domestic bond yields



Source: Bloomberg

A recovery in risk appetite stimulated demand for South African bonds, although the major factor that provided impetus over the period June to July 2012 was probably the confirmation on 12 June 2012 that South Africa had become eligible for inclusion in the Citigroup's World Government Bond Index (WGBI) (see Box 2). After having sold a net R5,5 billion of South African bonds in May 2012, non-residents purchased bonds to the value of about R21,7 billion in June and R12,5 billion in July 2012, a cumulative amount of net purchases that had not been seen since the third quarter of 2010.

Box 2: South Africa's inclusion in the Citigroup World Government Bond Index

On 17 April 2012 Citigroup announced that South Africa had become eligible for possible inclusion in its World Government Bond Index (WGBI) and subsequently confirmed South Africa's inclusion on 12 June 2012. South Africa's inclusion in the WGBI accordingly became effective on 28 September 2012.

According to data from the JSE Limited, foreign investor demand for domestic bonds has increased notably since April 2012, amounting to around R55 billion. These strong bond inflows have been partly attributed to South Africa's WGBI inclusion, but also to generalised flows into emerging-market bonds as a result of higher interest rate differentials, healthier balance sheets and better growth prospects in emerging markets. The inclusion of South African government bonds (SAGBs) into the WGBI is a positive development and is expected to not only substantially increase offshore investment in South Africa, but also support SAGBs and the exchange rate of the rand in the coming months.

Figure B GOVI Index¹ and US dollar per rand



¹ The GOVI Index contains all bonds issued by the Republic of South Africa that fall into the top 10 positions of the All Bond Index according to the dual ranking scheme

Sources: I-Net Bridge and Bloomberg

1. Characteristics of the WGBI

Following the inclusion of South Africa, the WGBI has 23 member countries. Apart from South Africa, there are four EMEs that are represented on the WGBI (Mexico, Malaysia, Poland and Singapore) and 18 advanced economies (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, Spain, Sweden, Switzerland, the UK and the US).

The SAGB market is the first African sovereign to be included in the WGBI. According to Citigroup's calculations, 12 SAGBs⁴⁹ with a market value of US\$92 billion will be represented on the WGBI, with a pro-forma market weight of 0,44 per cent. This compares favourably with other emerging markets, with Singapore's WGBI weighting at 0,26 per cent, Malaysia's at 0,36 per cent, Poland's at 0,52 per cent and Mexico's at 0,66 per cent. Japan and the US have the largest weightings on the WGBI of 32,82 per cent and 28,55 per cent respectively.

2. WGBI requirements for entry and exit

To gain WGBI entry, three criteria need to be met by countries for three consecutive months:

- *Market size*: The outstanding amount of the applicant country's eligible bonds must total at least US\$50 billion, €40 billion or JPY5 trillion.

49. These bonds are the R157, R186, R201, R202, R203, R204, R206, R207, R208, R209, R213 and R214.

- *Credit*: The applicant country must have a minimum credit quality of A- or A3 by either S&P or Moody's for all issues.
- *Barriers to entry*: The applicant country must actively encourage foreign investor participation and show commitment and accountability for its own domestic policies.

Once a country is included in the WGBI, its performance is monitored and assessed on a regular basis. The following exit criteria are applicable:

- *Market size*: When the outstanding amount of a country's eligible issues falls below half of the entry-level market size criteria, namely below US\$25 billion, €20 billion or JPY2,5 trillion, for three consecutive months, the country will be removed from the next month's profile and moved to the Additional Market Indices.⁵⁰
- *Credit*: Any country whose rating falls below BBB-/Baa3 according to both S&P and Moody's will be removed from the next month's profile and moved to the Additional Market Indices.
- *Barriers to entry*: Owing to increased economic uncertainty, circumstances can change over time and a country might make adjustments or revisions to its domestic policies in the interests of national welfare. However, it is possible that new policies can have the effect of limiting investors' ability to replicate the returns of that country's portion of the index. In such a case, it may become necessary for the country to be removed from the WGBI and placed in the Additional Market Indices.

South Africa's eligible debt stock, currently at around US\$92 billion, is well above the US\$50 billion minimum threshold, its sovereign rating of A/A3 is above the A-/A3 minimum criterion, and it is fully liberalised for foreign investors. Moreover, SAGBs compare favourably relative to WGBI constituents, with a high nominal yield of 6,71 per cent (versus the WGBI average of 1,33 per cent) and below-index modified duration of 5,93 years (versus the WGBI average of 6,79 years) according to Citigroup's calculations.

3. Possible implications of South Africa's WGBI inclusion for domestic financial markets

Historically, foreign investment in SAGBs and equities has been largely held in real money accounts. The South African market has, however, attracted an increasingly diverse and mainstream global investor base in recent years, based on the country's wide interest rate differential. At present, between US\$1,5 and US\$2 trillion worth of funds track the WGBI. With South Africa's weight in the WGBI at around 0,44 per cent, it implies that SAGBs to the value of US\$10 billion could be bought by index tracker funds, which equates to about 8,9 per cent of South Africa's total outstanding debt. This is a substantial amount which could influence the bond and currency markets. Some market analysts estimate that this type of scenario could boost foreign holdings in SAGBs from the current levels of 30 per cent to around 37 per cent.

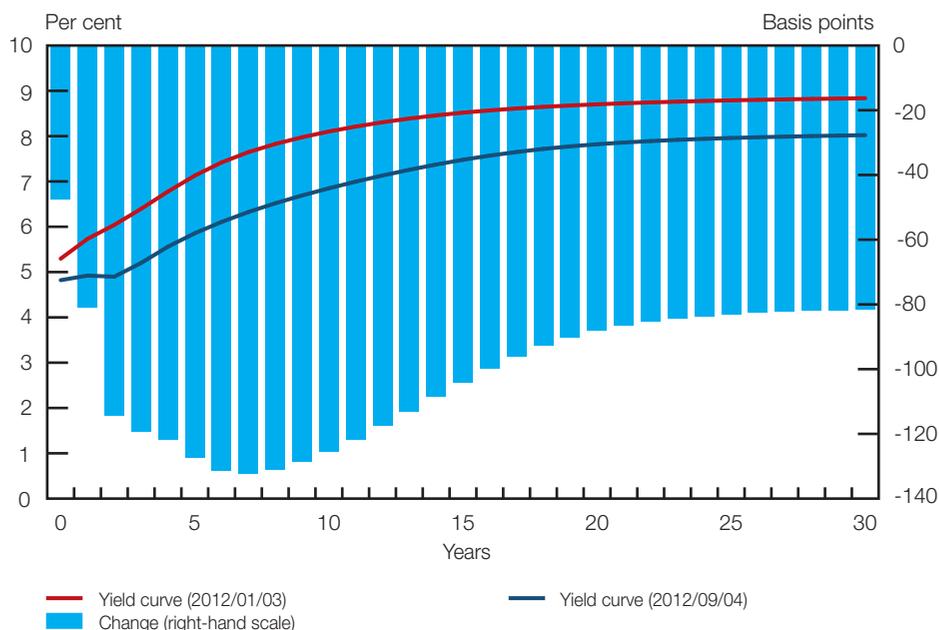
The domestic bond yield curve flattened over the period under review (Figure 25) despite additional policy easing in the form of a 50 basis-point repo rate cut on 19 July 2012, as offshore investors' flows, combined with a decline in inflation expectations embedded in bond yields, appeared mostly to impact longer maturities. Admittedly, the South African bond yield curve remains relatively steep both by historical and international standards.

Despite a favourable overall performance since March 2012, greater volatility and a mild correction in bond yields transpired in the months after June 2012, in an environment where non-residents sharply curtailed their purchases of local debt securities. Domestic financial markets remained vulnerable to global oil and food price shocks, and to domestic socio-economic concerns, which garnered renewed foreign investor concerns following labour unrest at a local platinum mine from mid-August 2012 which subsequently spread to other mines and industries.

50. The Additional Market Indices include bond markets tracked by Citigroup, but which do not, at that time, qualify for inclusion in the WGBI based on the criteria outlined.



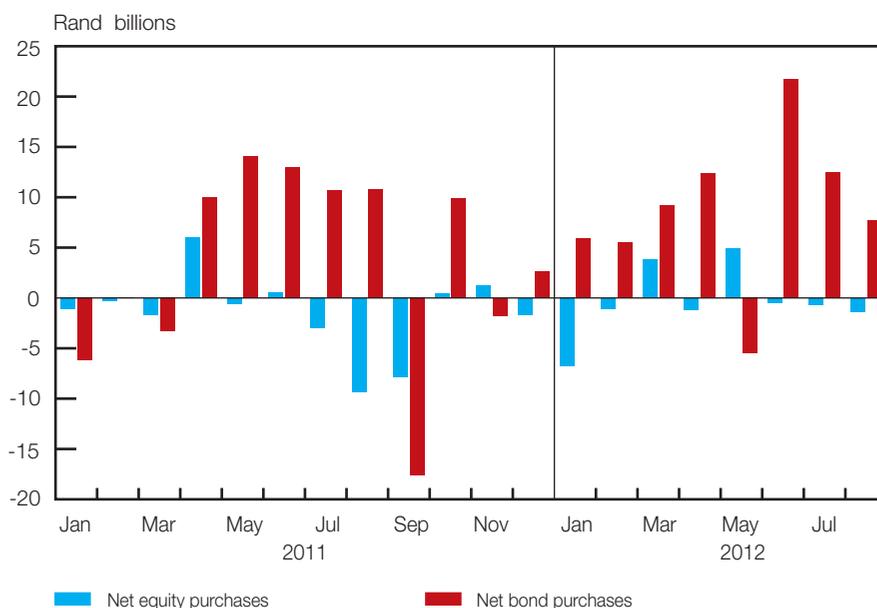
Figure 25 Bond yield curve



Source: I-Net Bridge

The South African equity market has enjoyed positive gains in the period under review, despite remaining highly dependent on international developments. As with the bond market, two different phases can be identified in the performance of local equities. From March to June 2012, the JSE Alsi largely traded sideways, maintaining the levels reached following the late 2011 and January 2012 upswing even as global equity markets came under pressure from the loss of momentum in the US economy, renewed sovereign debt concerns in the euro area's periphery and downward revisions to consensus growth forecasts for some EMEs, particularly China. The weakening of the exchange rate of the rand, both against the US dollar and on a trade-weighted basis, accounts for the stronger performance of the Alsi in local currency terms, as it weighed on offshore investors' returns in US dollar.

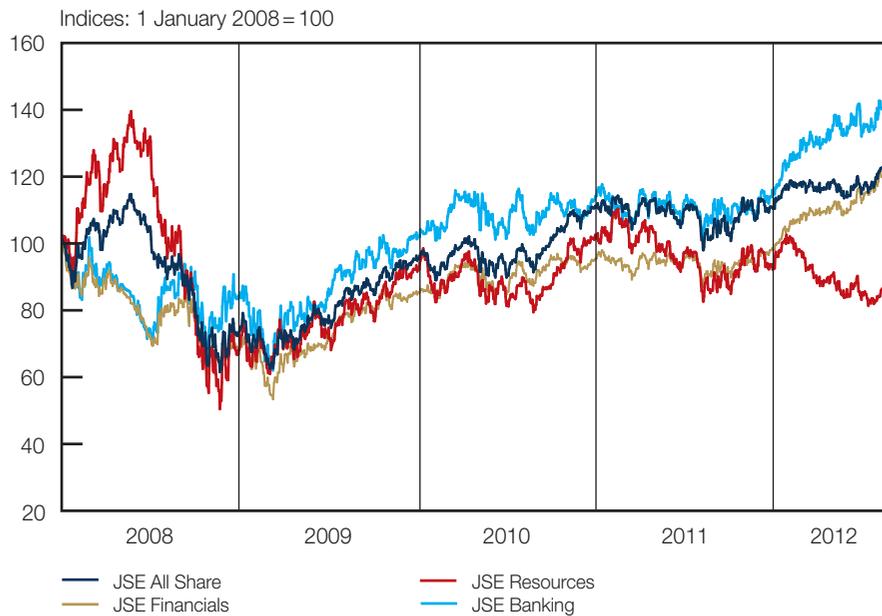
Figure 26 Non-resident purchases of domestic bonds and equities



Source: JSE Limited

June 2012 was a volatile month for domestic equities, which initially rallied amid higher prices of precious metals and an increase in foreign investors' net purchases. However, soon afterwards these gains were reversed as nervousness built up ahead of a crucial summit of EU leaders on 28 and 29 June 2012, and a policy conference of South Africa's ruling party, where the government's mineral resources policy was expected to come under discussion. Despite this nervousness, the early part of the third quarter of 2012 saw a marked recovery in equity prices, which tracked global developments as sovereign credit pressures in the euro area eased, central banks provided additional monetary stimulus and quarterly corporate earnings generally exceeded consensus forecasts.

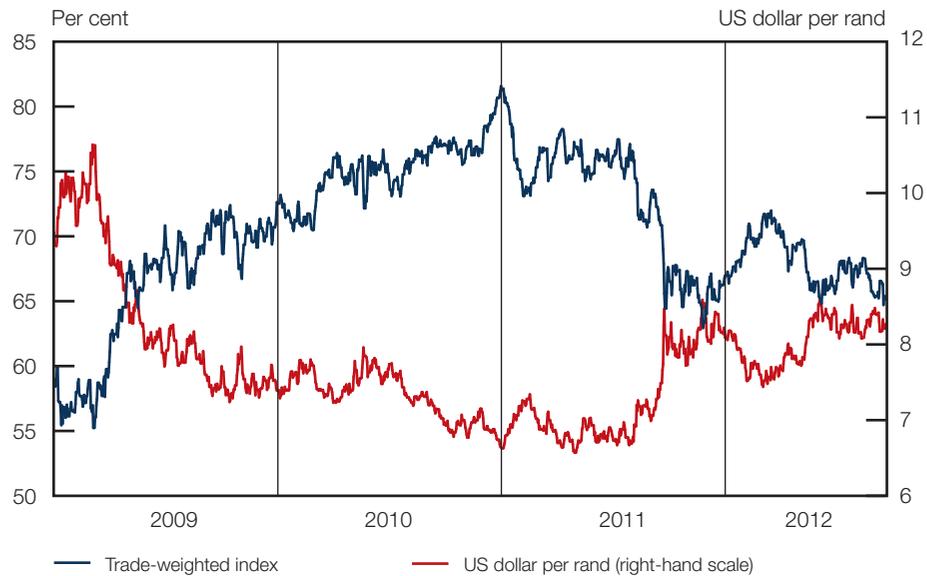
Figure 27 Equity indices



Although the Alsi reached a new record high on 27 August 2012, it was followed by a moderate retracing of earlier gains after the labour unrest at a local platinum mine on 16 August 2012. The spreading of the unrest to other mining operations in the platinum and gold sectors triggered a quick selloff in the JSE's Resources Index, which retraced all gains accumulated since mid-July 2012 and reached lows last seen in 2009. However, in the period under review and despite the recent vulnerability of the resources sector, the Alsi remained one of the top performers among the large emerging equity markets, outperforming the likes of China, India and South Korea.

The exchange rate of the rand has depreciated by around 2,8 per cent against the US dollar in the year to 30 September and has changed direction a few times. This was mainly as a result of changes in risk sentiment surrounding developments in the euro area sovereign debt crisis, and global growth concerns and volatile commodity prices. Therefore, similar to its emerging-market peers, the rand remained closely tied to the global economic and financial risk environment, and frequently tends to move in tandem with the exchange rate of the euro against the US dollar.

Figure 28 The exchange rate of the rand

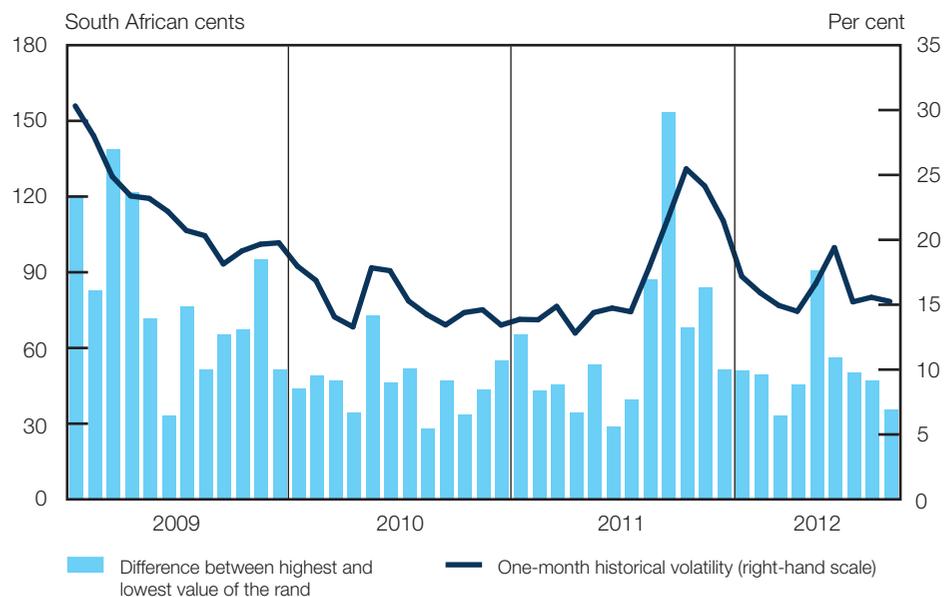


Source: Bloomberg

Domestic factors that negatively impacted the rand during the period under review were Fitch Ratings' and S&P's rating downgrades of South Africa's BBB+ foreign currency rating outlook from stable to negative in January and March 2012, tepid annualised GDP growth of 3,2 per cent in the second quarter of 2012 with signs of an underlying loss of momentum, a widening of the current-account deficit to 6,4 per cent of GDP, and labour unrest in the domestic mining sector since August 2012. Towards the end of September, the rand was further impacted when Moody's downgraded South Africa's government bond rating by one notch to Baa1 from A3.

Since June 2012, however, the rand has been supported by higher non-resident purchases of domestic bonds after Citigroup announced the inclusion of South African government bonds in the WGBI. These inflows into the domestic bond market are expected to support the relative performance of the rand in times of adverse risk conditions. Nonetheless, since the previous issue of the *Financial Stability Review* in March 2012, the rand has underperformed compared to currencies of most EMEs.

Figure 29 Volatility in the rand



Source: Bloomberg

Since the publication of the March 2012 *Financial Stability Review*, the volatility of the rand has eased somewhat as fears about the slowing global economy and domestic concerns were balanced by expectations of additional stimulus by global central banks and possible intervention by the ECB in euro area debt markets. However, as could be expected in times of high risk aversion, rand volatility rose in line with the currencies of other EMEs. Since the beginning of this year, the one-month historical volatility of the rand eased from 17,2 per cent in January 2012 to 15,3 per cent in September.

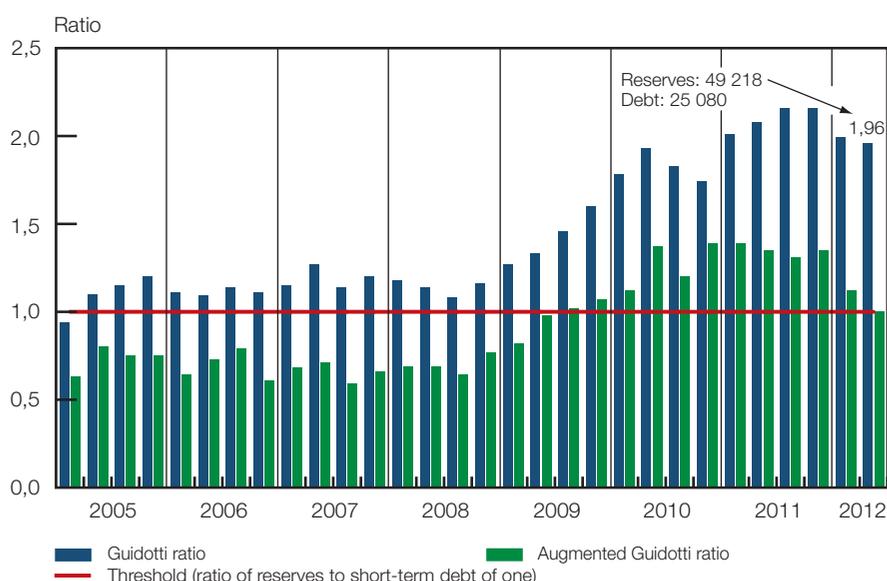
External sector

The level of a country's foreign-exchange reserves can help to mitigate its vulnerability to external shocks, and increase confidence in the domestic currency. In the year to June 2012, South Africa's gross gold and foreign-exchange reserves fluctuated around levels close to US\$50 billion, the fluctuations largely reflecting revaluation effects. With regard to trade financing in the unlikely event of a sudden reversal of capital inflows, available foreign-exchange reserves could cover roughly four-and-a-half months' imports in June 2012, which is more than the internationally accepted benchmark of three months. Foreign-exchange reserves can also be used to mitigate capital flight or the so-called internal drain by residents. As residents might convert domestic liquidity into foreign liquidity in times of low confidence in the domestic financial system, resulting in capital flight, a certain fraction of domestic money supply provides an indication of the potential for internal drain. The ratio of foreign-exchange reserves to broad money supply is used as a proxy for the cushion against domestic capital flight. It averaged 22 per cent in the first seven months of 2012, which can be regarded as sufficient for countries with a flexible exchange rate regime.⁵¹

The Guidotti ratio, which gauges a country's ability to finance its short-term external debt in the event of a sudden reversal in external capital inflows, deteriorated slightly to 1,96 during the second quarter of 2012. This was due to a contraction in the annual growth rate of foreign-exchange reserves and an increase in short-term debt. Despite the deterioration, available foreign-exchange reserves were still almost double South Africa's short-term external debt, which could be comfortably financed over a one-year time horizon even in the event of a reversal in foreign capital inflows. The augmented Guidotti ratio declined to 1,0 in the second quarter of 2012 from 1,12 in the first quarter as a result of the widening current-account deficit.

This indicated that the country's total external financing requirements (which include both short-term external debt and the current-account deficit) could be comfortably met.

Figure 30 Reserve-adequacy ratios¹



1 Figures for reserves and debt in US dollar millions

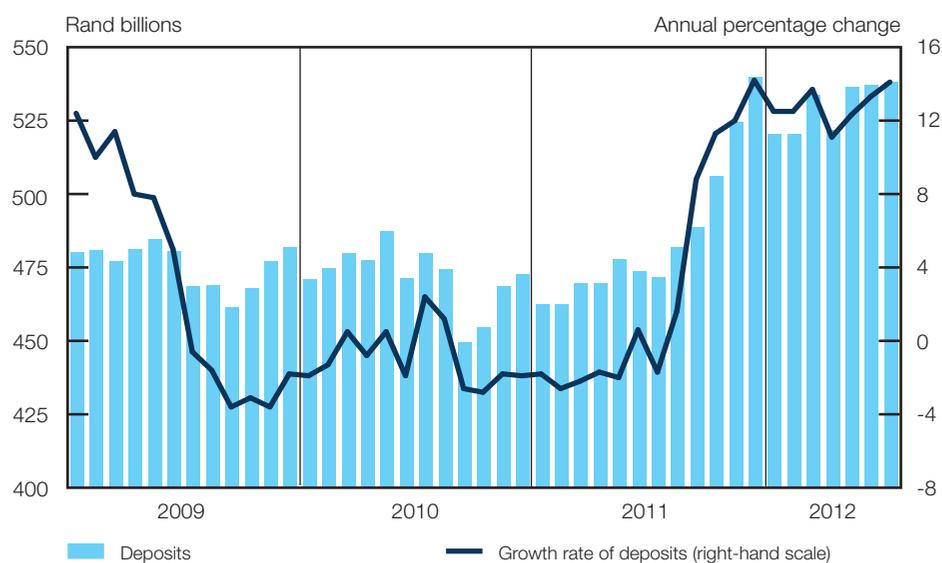
Source: South African Reserve Bank

51. J Onno de Beaufort Wijnholds and A Kapteyn, "Reserve Adequacy in Emerging Market Economies" (Washington DC: IMF, Working Paper WP/01/143, September 2001).

Corporate sector

After increasing by 12,2 per cent in the first quarter of 2012, growth in the demand for credit by the South African corporate sector slowed to 8,6 per cent year on year in the second quarter. This might be an indication of private companies waiting to see how the economic situation unfolds before embarking on new investments. In addition, deposits of private companies with banks increased by 13,3 per cent and 14,1 per cent in June and July 2012 respectively, raising non-financial corporate deposits to R538,2 billion.

Figure 31 Non-financial corporate-sector deposits



Source: South African Reserve Bank

Corporate-sector investment slowed in the first and second quarters of 2012. Higher levels of investment are needed to support an economic recovery and could result in positive externalities in the form of increased consumer spending through job creation. A survey conducted by the BER among manufacturers shows that there has been a consistent down scaling of fixed investment plans. The survey lists cost of credit, insufficient demand, tax structure and the political climate as factors that constrain investment.

Table 6 Selected indicators for the corporate sector

Annual percentage change, unless indicated otherwise

	2011			2012	
	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Bank credit granted ¹	3,6	5,4	8,6	12,2	8,6
Gross fixed capital formation ²	6,8	7,5	8,4	7,2	7,0
Credit as a percentage of GDP	45,2	46,9	47,4	49,4	47,8
Credit as a percentage of annualised profits ³	129,1	134,6	142,6	154,0	130,6
Net operating surplus ⁴	8,8	19,3	21,3	15,6	7,3

1 Bank credit to the corporate sector in this case includes instalment sale and leasing finance, mortgage advances, overdrafts, credit card debtors, and other loans and advances

2 At current prices (seasonally adjusted)

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)

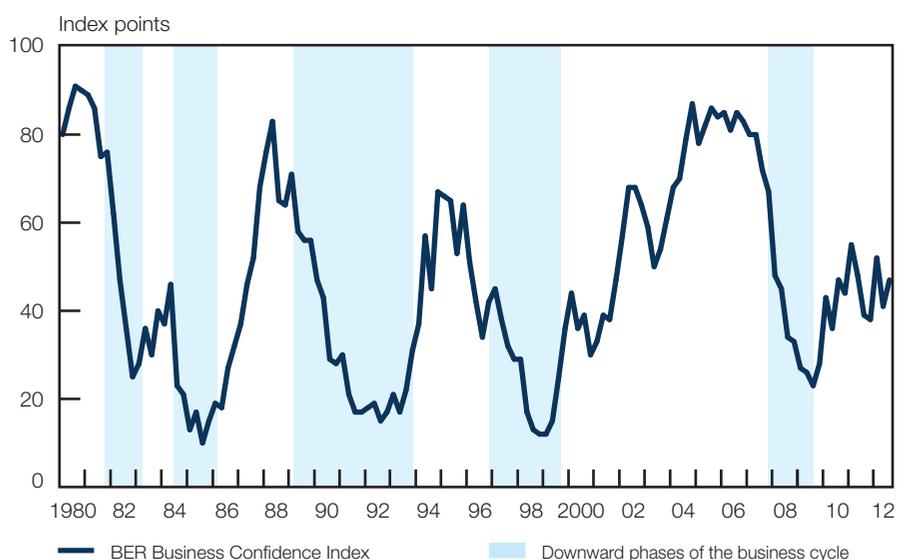
Source: South African Reserve Bank



However, the list of constraints does not provide insight into the reasons behind the corporate sector's reluctance to increase fixed investment. For instance, the deterioration in the overall outlook for business conditions among manufacturers was not accompanied by a rise in the percentage of respondents rating insufficient demand as a serious constraint on fixed investment. In the first two quarters of 2012 the annual growth rate of profits of the corporate sector (proxied by the net operating surplus) moderated noticeably.

In the second quarter of 2012, business confidence decreased to 41 index points from 52 index points in the first quarter (Figure 32). Retail confidence fell to its lowest level in two years, due to weaker growth in sales volumes. Manufacturing confidence dwindled as a growing number of manufacturers seemed to doubt the sustainability of the recent growth in turnover and production. The confidence of new vehicle dealers and building contractors diminished. A modest increase was recorded in wholesale business confidence, as sales of both non-consumer and consumer goods improved. Recent data, however, suggest a slight but broad-based recovery in business confidence in the third quarter of 2012.

Figure 32 Business confidence index¹



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'

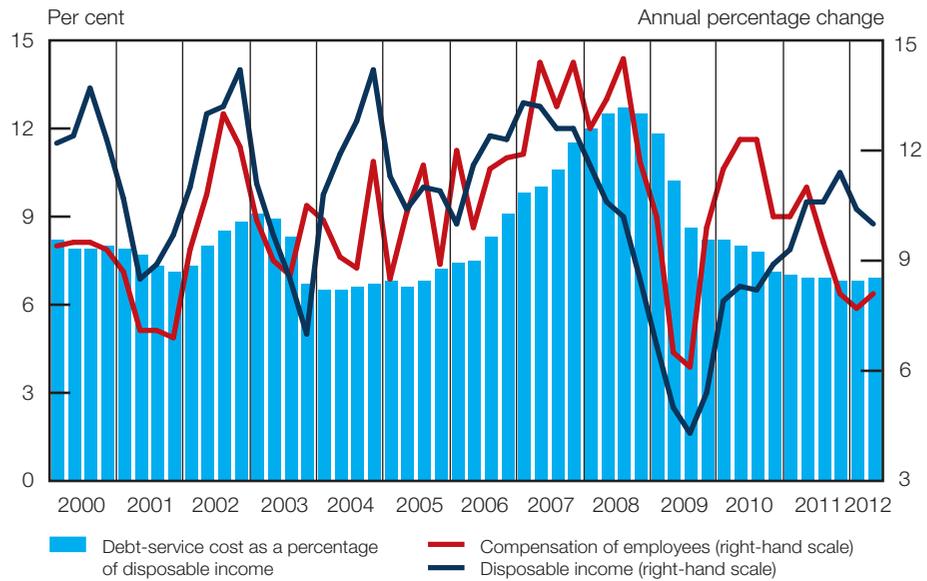
Sources: South African Reserve Bank and Bureau for Economic Research, Stellenbosch University

Household sector

During the second quarter of 2012, the total disposable income of households increased by 10 per cent compared to a year before (Figure 33). Increased credit uptake by the household sector that started in the fourth quarter of 2011 continued into the second quarter of 2012, with credit to the sector increasing by 7,7 per cent and 8,1 per cent in the year to June and July 2012 respectively. During the second quarter of 2012, total household debt increased by 10 per cent year on year, resulting in debt as a percentage of disposable income increasing marginally from 75,6 per cent in the quarter ended March 2012 to 76,3 per cent in the quarter ended June. However, household saving as a percentage of disposable income improved marginally in the second compared to the first quarter of 2012.

The increase in households' appetite for debt is corroborated by data from the NCR, which shows that the number of credit-active consumers increased from 18,8 million to 19,6 million in the year to June 2012, while the number of consumers with impaired records increased from 8,8 million to 9,2 million over the same period. Consumers in good standing increased from 10,0 million to 10,4 million, an indication that some households still exercise caution about managing their finances and repairing their balance sheets, although the balance was tilted towards the over-indebted households.

Figure 33 Household income growth and debt-service cost

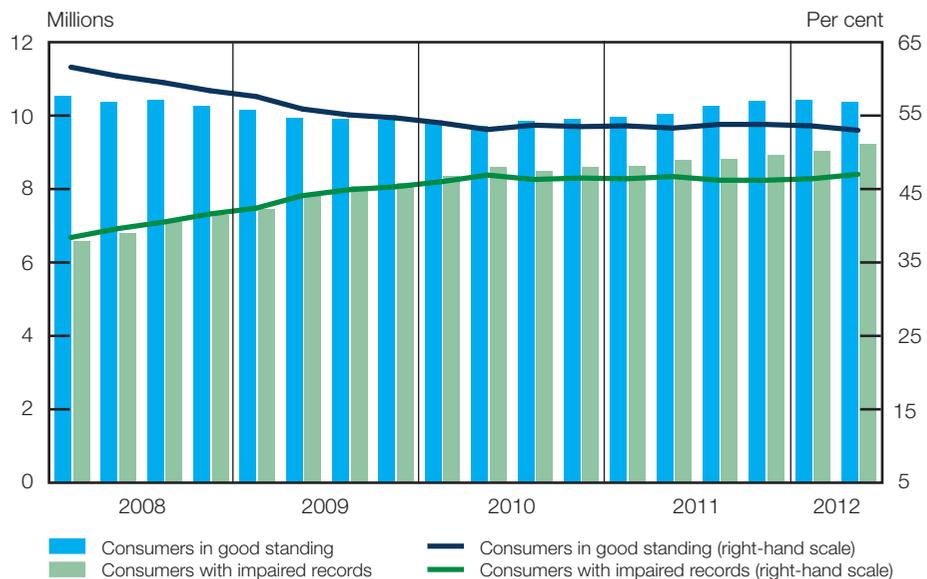


Source: South African Reserve Bank

During the second quarter of 2012 consumers with impaired records increased by 170 000 and consumers in good standing decreased by 60 000. Of the total credit-active consumers, 53 per cent were in good standing, while 47 per cent had impaired records in the second quarter of 2012. Of the consumers that have impaired records, 19,5 per cent were three months or more in arrears, 13,3 per cent were consumers with adverse listings and 14,2 per cent of consumers had judgments and administration orders. It would seem that most consumers have impaired records with non-bank credit providers as the banking sector's ratio of impaired advances to total gross loans and advances is very low.⁵²

52. Refer to Table 3 for more information in this regard.

Figure 34 Credit standing of consumers



Source: National Credit Regulator

Table 7 Selected indicators for the household sector

Annual percentage change, unless indicated otherwise

Indicator	2011			2012	
	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Financial assets	15,2	3,1	5,1	5,2	8,0
Net worth ¹	11,6	2,8	3,9	3,4	4,3
Total assets	10,8	3,7	4,8	4,1	5,4
Consumer confidence index ²	11	4	5	5	-3
Consumption expenditure to GDP (per cent)	59,0	58,6	58,8	59,3	59,8
Real consumption expenditure	5,4	4,7	4,5	3,7	3,6
Credit extension	7,5	5,5	6,8	6,8	7,7
Savings to disposable income (per cent)	-0,06	-0,04	-0,02	-0,01	0,02
Debt	7,4	7,4	8,6	7,3	10,0
Debt to disposable income (per cent)	76,3	76,2	75,4	75,6	76,3
Mortgage debt to disposable income (per cent)	46,0	45,1	43,7	43,4	42,9
Debt to GDP	45,0	44,6	44,3	44,9	45,7
Debt-service cost ³ to disposable income (per cent)...	6,9	6,9	6,8	6,8	6,9
Capital gearing (per cent) ⁴	19,4	20,2	19,9	20,1	20,2
Insolvencies ⁵	-10,3	-26,0	-17,2	-27,8	-24,8

1 Household net worth is defined as total assets of households less total financial liabilities

2 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'

3 Interest payments on housing and personal debt

4 'Capital gearing' refers to household debt as a percentage of total assets of households. Data are preliminary

5 Monthly indicator, value of last month of respective quarter

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

Data from the NCR further indicate that banks continued to dominate the consumer credit market. For the quarter ended June 2012, 83,1 per cent of all new credit was extended by banks. New credit granted by banks increased at an annual rate of 21,1 per cent. The number of applications for new credit during the second quarter increased by 47,2 per cent to R9,8 billion compared with a year earlier. Of all the applications for credit received by banks and other credit providers, 50,8 per cent were rejected.

Consumer confidence, as measured by the First National Bank (FNB)/Bureau for Economic Research (BER) Consumer Confidence Index, declined by 8 index points to minus 3 index points in the second quarter of 2012. The fall in consumer confidence was a result of substantial declines in all three areas surveyed, namely the expected performance of the economy, expectations about the financial position of households and the appropriateness of the present time to purchase durable goods.

The decline in the economic outlook coincided with decreases in other confidence indices such as the PMI, the building confidence index and the Rand Merchant Bank (RMB)/BER Business Confidence Index.

As elaborated on in the March 2010 *Financial Stability Review*, the Consumer Financial Vulnerability Index (CFVI) gauges the financial vulnerability of consumers through a survey. The overall CFVI decreased from 58,9 index points in the first quarter of 2012 to 48,6 index points in the second quarter of 2012, moving from 'financially mildly exposed' to 'financially very exposed'. Adverse international and domestic economic conditions led to a strain on the cash-flow position of South African consumers during the second quarter of 2012. This created a relatively high risk that consumers could become financially more vulnerable.

Table 8 Consumer Financial Vulnerability Index (CFVI)¹

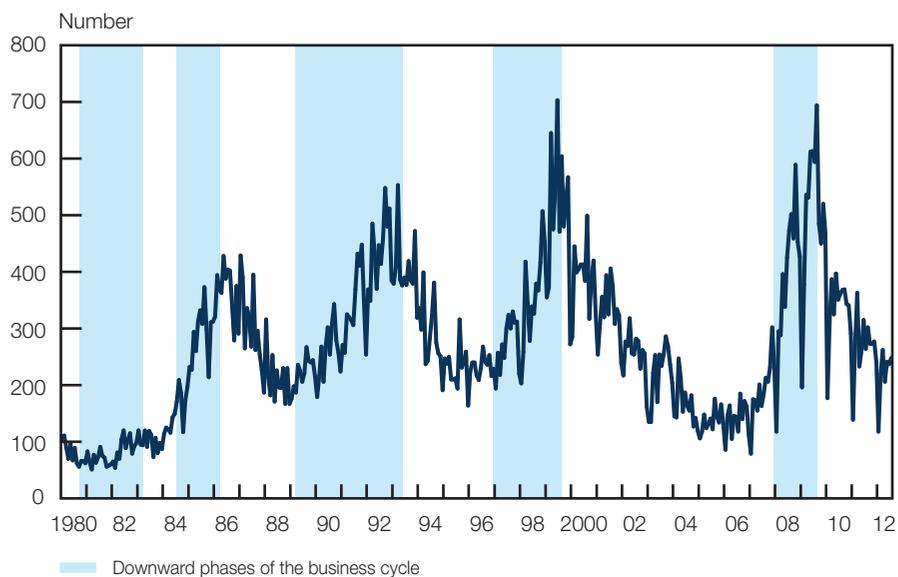
	2011			2012	
	2nd qr	3rd qr	4th qr	1st qr	2nd qr
Overall CFVI	55,4	55,8	56,7	58,9	48,6
Savings vulnerability index.....	46,7	47,7	51,1	58,8	47,5
Expenditure vulnerability index.....	54,2	55,6	57,3	60,1	53,8
Debt servicing vulnerability index.....	58,8	61,4	61,9	56,6	47,8
Income vulnerability index	54,8	52,4	52,8	57,6	44,8

1 The CFVI was changed from a 10-point index scale to a 100-point index scale in the second quarter of 2012, with the following vulnerability strata and scores: 0–20 implies ‘financially very vulnerable’; 20–39,9 implies ‘financially vulnerable’; 40–49,9 implies ‘financially very exposed’; 50–59,9 ‘financially mildly exposed’; 60–79,9 implies ‘financially secure’; 80–100 implies ‘financially very secure’

Source: Bureau of Market Research, Unisa

In the year to June 2012 the number of insolvencies contracted by 19,7 per cent. Low debt-servicing costs, as a result of relatively low interest rates and increases in disposable income, supported the declining trend in the number of insolvencies. The reduction in interest rates in July 2012 should afford households the opportunity to continue repairing their balance sheets. Households should, however, strive to attain a balance between repaying their debt and acquiring new debt as a result of the opportunities brought about by the reduction in interest rates. Banks are also expected to strike a balance between growing their loan books by extending credit to an already highly indebted household sector and reducing impaired advances.

Figure 35 Insolvencies



Source: Statistics South Africa

Residential real-estate sector

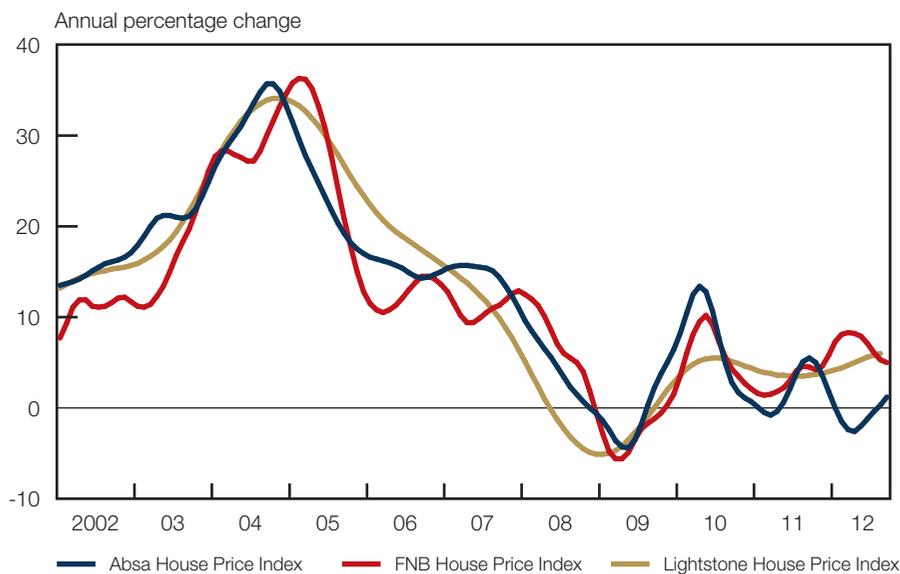
Residential real-estate market activity remained subdued during the period under review. Growth in mortgage advances (credit extended by all monetary institutions to the domestic private sector) slowed from 2,2 per cent in June 2012 to 1,9 per cent in July 2012, which is indicative of a continued sluggish domestic property sector. House price indices (Figure 36) continued to display mixed signals and recorded divergent trends in the first half of 2012. Historically, the different house price indices follow similar overall trends, but since October

2010 the Absa and FNB house price indices have started to diverge. The latest data for the Absa House Price Index, however, indicated a slight improvement in house prices as the index recorded an annual increase of 1,2 per cent in September 2012 following an increase of 0,3 per cent in August, the first consecutive positive growth recorded since the beginning of 2012. The FNB House Price Index increased by 5,0 per cent in September 2012, slightly down from 5,3 per cent recorded in August 2012. The Lightstone Extended House Price Inflation index,⁵³ which applies the 'repeat sales methodology',⁵⁴ has also increased, recording an annual rate of increase of 6,0 per cent in August 2012.

53. Lightstone, *Property Indices Report* (Johannesburg: Lightstone, 31 August 2012).

54. Repeat sales indices provide a measure of actual price inflation of houses that have transacted twice within a particular period of time, which means the index is less influenced by the mix of transacting properties. Both the Absa House Price Index and the FNB House Price index are calculated on an average basis.

Figure 36 House price indices¹



1 The Absa House Price Index is based on the total purchase price of houses in the 80 m²–400 m² 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. The Lightstone House Price Index applies the repeat sales methodology and uses data from the Deeds Office

Sources: Absa Bank Limited, First National Bank and Lightstone

According to the FNB/BER Building Confidence Index,⁵⁵ activity and profitability in the building and construction sector remained sluggish. The index fell to 29 index points in the second quarter of 2012, after increasing from 27 index points to 34 index points in the first quarter of 2012. All sub-indices fell, except for architects and sub-contractors. The biggest contraction in confidence in the second quarter was recorded in the building material and hardware retailers' sub-index which fell by 40 index points to 11 index points, followed by the building material manufacturers sub-index, which fell by 37 index points to 20 index points.

55. First National Bank, "FNB/BER Building Confidence Index" (Johannesburg, First National Bank, 12 June 2012).

The fall in the confidence level of hardware retailers followed on the back of a marked decrease in sales volumes combined with increased purchasing prices and unchanged selling prices. The confidence of building material manufacturers declined as a result of a significant increase in cost pressures throughout the second quarter of 2012.



Financial infrastructure and regulation

This section of the *Financial Stability Review* considers developments in the domestic and international financial infrastructure and regulatory environment. Firstly, an update is provided on a selection of the most recent significant financial, legislative and infrastructural developments that impact on the domestic financial sector. Secondly, international developments regarding the infrastructure of payment systems are discussed. Finally, an update of South Africa's progress in implementing key areas of the global financial regulatory reforms proposed by the Financial Stability Board (FSB) is provided.

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

The March 2012 *Financial Stability Review* reported on the Solvency Assessment and Management (SAM) framework for the insurance sector, and the release of both the Financial Markets Bill (FM Bill) and the Financial Services Laws General Amendment Bill, among other things. This section provides a brief update on the progress made since and the new proposals to reform the collective investment schemes regime and the retirement funds industry.

The Solvency Assessment and Management framework

The SAM framework is an initiative undertaken by the Financial Services Board to enhance the soundness of domestic insurance companies and the protection of policyholders through a risk-based solvency regime. SAM encompasses quantitative (Pillar 1), qualitative (Pillar 2), and enhanced reporting and public disclosure (Pillar 3) requirements. The SAM initiative will result in a revised solvency regime for both long- and short-term insurers, with the ultimate goal of aligning prudential requirements for the domestic insurance industry with the prescribed European standard commonly known as Solvency II.⁵⁶ As reported in the March 2012 *Financial Stability Review*, each jurisdiction is expected to adopt and customise Solvency II to suit its particular circumstances. South Africa is one of the jurisdictions currently being reviewed by the EC for deemed third-country equivalence to Solvency II once the SAM framework is implemented. The overarching principle of equivalence is to ensure that supervisory regimes of countries outside the EU enforce a similar level of policyholder and beneficiary protection as Solvency II. The Financial Services Board aims to ensure that the SAM framework meets the requirements of third-country equivalence under Solvency II, and that it is appropriately adapted for domestic circumstances.

The Financial Services Board conducted its first Quantitative Impact Study (QIS1) in December 2011 to determine the impact of the new proposed solvency rules on insurers. The results of QIS1 were taken into account for the second QIS (QIS2) data collection exercise, which was announced in July 2012. Results of QIS1 indicate that there are some key areas on which the Financial Services Board will need to focus on in QIS2, such as the ring-fencing of funds, boundaries of contracts, treatment of tax and calculation of solvency requirements for insurance groups. The data collection period for QIS2 commenced in July 2012 and will terminate in November 2012. QIS2 will also assist in the development of the final framework for the various working groups established as part of the SAM project.

The results of QIS1 and QIS2 will be incorporated into the economic impact study that is to be conducted under the auspices of National Treasury and the Financial Services Board. The economic impact study will focus on issues related to access to the insurance market, growth in the insurance industry, the impact on insurance policyholders and the stability of the financial system. The Financial Services Board envisages that the SAM framework will be implemented in South Africa in January 2015 and that it will not only enhance the insurance industry's financial soundness, but also contribute to a more stable financial system.

56. The Solvency II Directive was issued on 25 November 2009 by the EU and is a regulatory regime for the insurance sector that was first proposed by the European Commission in 2007. The rationale behind issuing Solvency II was to codify and harmonise the EU's insurance regulation. Under Solvency II, the EU's insurance law was revised in order to improve consumer protection and to modernise supervision.

Financial Markets Bill

The FM Bill, which was tabled for the first time in Parliament in April 2012, is the culmination of efforts to review and update the Securities Services Act, 2004 (Act No. 36 of 2004) due to developments in the financial markets in the aftermath of the global financial crisis. The FM Bill is intended to ensure that the objectives of financial regulation are still being met, relevant local and international developments and standards are aligned, and that legislation continues to be effective in mitigating risks facing the securities markets. Importantly, the FM Bill introduces new powers to regulate over-the-counter (OTC) derivative instruments, and establishes new infrastructure, including an independent clearing house and a trade repository, in response to the Group of Twenty (G-20) recommendation on the regulation of OTC derivatives.

The Standing Committee on Finance adopted the FM Bill in September 2012. The FM Bill is currently undergoing further parliamentary processes before the final version is sent to the President's office for assent. It is envisaged that the FM Bill will be adopted before the end of 2012.

Regulation of hedge funds

There have been renewed efforts internationally to regulate private pools of capital. To this end, the Financial Services Board has undertaken to regulate hedge funds through amending the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002) (CISCA). The Minister of Finance is empowered by section 63 of CISCA to declare any business other than a collective investment scheme in securities, property or participation bonds as a collective investment scheme. It is accordingly the intention of the Financial Services Board, prior to the amendment of CISCA, to request the Minister of Finance to declare hedge funds as such for the purposes of regulating them. At present, the conduct of hedge fund managers is regulated under the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002) (FAIS Act). The current value of hedge funds in South Africa is estimated at approximately R31 billion.

The Financial Services Board has proposed that under the new regulatory regime, hedge funds will be treated as either restricted or retail hedge funds. Restricted hedge funds are aimed at the sophisticated investor and will be subject to less rigorous regulation, while retail hedge funds will be regulated more closely as they will be open to more inexperienced retail investors. Hedge funds that are registered as restricted hedge funds will have to comply with disclosure requirements, including disclosing the number and names of clients, details of counterparties and submitting annual financial returns. Conversely, retail hedge funds will be subject to more intensive oversight, including restrictions on minimum investment amounts, asset portfolios and limits on leverage.

A draft legislative framework is currently under consideration and it is anticipated that a discussion document will be published for public comment by November 2012. It is envisaged that the new regulatory regime for hedge funds will lead to greater investor protection, prevent systemic risk and promote market integrity.

Principles for financial market infrastructures and a resolution regime

In April 2012 the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) released the final report on "Principles for Financial Market Infrastructure" (the Report).⁵⁷ The Report prescribes new international standards for payment, clearing and settlement systems, and contains a comprehensive set of 24 principles that will apply to all systemically important payment systems, central securities depositories (CSDs), securities settlement systems, central counterparties and trade repositories. These institutions are collectively referred to as FMI.⁵⁸

57. The Report is available online at <http://www.bis.org/publ/cpss101.htm>.

58. The Report defines an FMI as "a multilateral system among participating institutions . . . used for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions." Basel Committee, "Principles for Financial Market Infrastructures" (Basel: Basel Committee, April 2012), 7.



Previously, each of the above-mentioned FMI participants subscribed to different international standards and principles. The CPSS and IOSCO accordingly launched a review of these disparate standards and principles as part of efforts to strengthen the regulatory framework for payment and settlement systems. In view of the fact that robust and efficient FMIs help to ensure that markets continue to function effectively and are a prerequisite for financial stability, the new international standards and principles introduce more stringent requirements in many important areas, including credit, liquidity and settlement risk.

The standards proposed by the CPSS and IOSCO are principles-based in recognition of the fact that different FMIs may have different approaches to achieving a particular result. In some cases, the standards set out a specific minimum requirement to ensure a common minimum level of risk management across FMIs and countries. The Report is organised into various themes, including general organisation, credit and liquidity risk management, settlement, default management, efficiency and transparency (see Box 3).

Box 3: Financial Market Infrastructure Principles

The following is a summary of the key themes addressed in the “Principles for Financial Market Infrastructure”:

Legal basis: The principles in this theme establish a foundation for financial market infrastructure (FMI), and address the legal basis for including recommendations on the rules and procedures to which the FMI should subscribe. This theme also addresses FMI governance and provides a framework for risk management.

Credit and liquidity risk management: The principles in this theme address credit and liquidity risk management arising from payment, clearing, and settlement processes with which an FMI or its participants may be faced.

Settlement: A major risk in any payment system is settlement risk as a lack of settlement can affect an FMI or other participants. This set of principles deals with settlement finality, money settlements that involve central or commercial banks, and the physical delivery of the FMI's obligations.

CSDs and exchange-of-value settlement systems: CSDs and exchange-of-value settlement systems have their own set of distinctive risks due to the nature of the activities in which they engage. The principles in this theme deal with the risks posed by these settlement systems and depositories, and recommends that rules and procedures are put in place for CSDs to eliminate risks in transactions that involve the settlement of two obligations.

Default management: The set of principles in this theme deals with participant defaults as such defaults may hold implications for both the FMI and the financial system as a whole. The principles recommend that there should be rules and procedures in place for dealing with defaults, as well as rules for collateral arrangements relating to participants.

General business and operational risk management: An FMI also faces general business and operational risks similar to those faced by businesses in general. The failure of an FMI to continue as a going concern could have systemic risk implications for its participants and the broader financial markets. This theme's principles recommend that an FMI should have sufficient net assets to cover business losses and to safeguard the FMI's and participants' assets.

Access to FMIs: The principles in this regard recommend that an FMI adopts objective, risk-based, and publicly disclosed criteria for participation that allow for fair and open access. The principles also recommend that an FMI should manage the risks that arise from tiered participation arrangements and FMI link arrangements.

Efficiency: The principles in this theme provide guidance to an FMI on the efficiency and effectiveness of meeting its obligations, and on the adoption of internationally accepted communication procedures and standards.

Transparency: This theme's principles provide guidance on the disclosure of rules and procedures that must be provided to FMI participants to enhance their understanding of the risks and controls associated with the FMI, including fees and other costs related to participation. The principles also provide guidance on the type of data that trade repositories should provide to relevant authorities and the public in order to meet their information needs.

The Report also includes revised responsibilities of regulatory authorities when regulating and supervising an FMI. It is further recommended that regulatory authorities should clearly define and disclose regulatory and supervisory policies with respect to the FMI, and that they should adopt and consistently apply the CPSS–IOSCO principles. It is also recommended that central banks, market regulators, and other relevant authorities should have the powers and resources to effectively fulfil their responsibilities in supervising FMIs.

CPSS and IOSCO members are expected to adopt the new standards by the end of 2012 and implement them as soon as possible. An FMI is expected to comply with the standards as soon as it is practical to do so. Regulatory authorities are also expected to perform assessments of an FMI that operate in their jurisdictions and should ensure that this FMI that does not fully adhere to the principles is encouraged to do so.

In addition, CPSS and IOSCO published a report entitled *Recovery and Resolution of Financial Market Infrastructures: Consultative Report* in July 2012.⁵⁹ This report outlines the issues that should be taken into account for different types of FMIs when putting in place effective recovery plans and resolution regimes. It also recommends that relevant authorities should have powers to maintain an FMI's critical services as the disorderly failure of an FMI can lead to severe systemic disruptions if it causes markets to cease to operate effectively. Key areas in this regard include preventive measures, recovery planning, the necessary oversight and enforcement of such measures and plans by the regulator, and the regulator's ability to activate and enforce recovery plans. Moreover, co-operation and co-ordination with other authorities are also seen as important elements to promote effective and compatible plans, actions and outcomes in the face of potential combined stresses to FMI, their participants and the relevant markets.

In South Africa the NPSD of the Bank has initiated a process of mapping compliance of the domestic payment systems regime with the above-mentioned principles. It is envisaged that harmonising the different principles into one set of universally applicable principles will provide greater consistency in the supervision and regulation of FMIs worldwide.

Update on South Africa's progress in implementing international financial regulatory reforms

Since the onset of the global financial crisis, the G-20 has established core elements of a new global financial regulatory framework aimed at making the global financial system more resilient. International standard-setting bodies and national authorities, with the FSB fulfilling a central co-ordinating function in this regard, have further advanced this new global financial regulatory reform framework based on clear principles and timetables for implementation.

As part of its customary preparation for G-20 summits, in June 2012 the FSB released an update document for G-20 leaders regarding the progress made with the implementation of a variety of international financial reforms. The document focused on a number of key areas, including (i) building resilient financial institutions; (ii) addressing the "too-big-to-fail" problem; (iii) strengthening the oversight and regulation of shadow banking; (iv) increasing the transparency of OTC derivative trading; (v) reducing reliance on credit ratings and improving oversight of credit rating agencies; (vi) enhancing compensation practices; and (vii) building and implementing macroprudential frameworks and tools. South Africa's progress in addressing some of these reforms is reviewed in the following sections.

Participation in the Financial Stability Board peer reviews

South Africa is in the process of being evaluated by FSB member jurisdictions in respect of its commitment to (i) pursuing the maintenance of financial stability, (ii) maintaining the openness and transparency of the financial sector, and (iii) implementing international financial standards.⁶⁰ FSB member jurisdictions have committed themselves to undergoing periodic peer reviews focused on the implementation and effectiveness of international financial standards and policies agreed within the FSB. Peer reviews are an important assessment mechanism to promote complete and consistent implementation of agreed financial reforms. Member

59. Available at www.bis.org/publ/cpss103.htm.

60. The FSB aims to promote financial stability by developing strong regulatory, supervisory and other financial policies, and by promoting a level playing field through the coherent implementation of such policies across various sectors and jurisdictions.



jurisdictions are expected to undergo a peer review approximately two to three years after the completion of a Financial Sector Assessment Program (FSAP) or a Report on the Observance of Standards and Codes (ROSC) review.

There are two types of FSB peer reviews, namely (i) thematic reviews and (ii) country reviews. Thematic reviews focus on the implementation and effectiveness of international financial standards developed by standard-setting bodies and other areas important for global financial stability where international standards or policies do not exist or have not yet been finalised. In contrast, country reviews focus on the steps taken or planned by national authorities to address FSAP and ROSC recommendations on financial regulation and supervision, and institutional and market infrastructure. Country reviews can also focus on financial sector policy issues not covered in the FSAP that are timely and topical for both the jurisdiction itself and the broader FSB community. These two types of FSB peer reviews and their application to South Africa are discussed in greater detail below.

61. Available at http://www.financialstabilityboard.org/cos/cos_111001a.htm.

62. Refer to page 48 for a more detailed discussion on resolution regimes.

The 2012 thematic peer review focuses on the assessment of South Africa's implementation of the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions" (the Key Attributes) issued in October 2011.⁶¹ The Key Attributes set out the core elements of effective resolution regimes that should apply to any financial institution that could be systemically significant or critical if it fails. The objective of the peer review in this area is to evaluate FSB member jurisdictions' existing resolution regimes and any planned changes to those regimes using the Key Attributes as a benchmark.⁶²

The country peer reviews, by contrast, not only focus on the actions taken on the implementation of recent FSAP and ROSC recommendations, but also on the reforms aimed at moving the South African financial regulatory structure towards global best practice as advocated by the G-20 and global financial regulation standard setters. At present in South Africa, these reforms include the move towards a twin peaks model of financial regulation.

Once approved for publication by the FSB Plenary, the South African Country Peer Review will describe recent accomplishments and identify areas where implementation is lagging, with recommended actions to address any weaknesses identified. A press release summarising the main findings and recommendations will accompany the publication of the review, which is expected to be released early in 2013.

Implementation of Basel II, Basel 2.5 and Basel III

A major aspect of the international policy reforms is stronger minimum standards for bank capital and liquidity through the implementation of Basel II, Basel 2.5 and Basel III. In South Africa, Basel II and Basel 2.5 were adopted on 1 January 2008 and 1 January 2012 respectively. Draft 2 of the proposed amended Regulations relating to Banks (incorporating the Basel III changes) was published on 17 August 2012 in preparation for the adoption of Basel III in South Africa as from 1 January 2013. In South Africa the Bank has finalised proposals (refer to Box 4) in the form of a committed liquidity facility (CLF) available to banks in order to assist them to meet the requirements of the liquidity coverage ratio (LCR) component of the new liquidity standards.

In addition to monitoring the timely adoption of the Basel III rules, the Basel Committee on Banking Supervision (BCBS) has established a process to review the content of the new national rules for the implementation of Basel III. This review is meant to ensure that the national discretionary adaptations of Basel III are consistent with the minimum Basel III standards. The BCBS has initiated peer reviews of the domestic regulations of the EU, Japan and the US to assess their consistency with the globally agreed standards.

The BCBS will also review whether there are unjustifiable inconsistencies in risk measurement approaches across banks and jurisdictions, and what the implications of these inconsistencies might be for the calculation of regulatory capital. This review will initially focus on banks' risk-weighting practices in their banking and trading books, and will include the use of test portfolio exercises, horizontal reviews of practices across banks and jurisdictions, and joint on-site visits to large, internationally active banks.

Box 4: The committed liquidity facility available to banks

The Basel III liquidity framework⁶³ requires banks to adhere to a new liquidity coverage ratio (LCR) to ensure that they have sufficient high-quality liquid assets to survive a month-long period of significant stress. The LCR aims to ensure that banks have adequate assets available that can be readily converted into cash during a period of liquidity stress. The LCR will be phased in from 1 January 2013, and South African banks will have to comply with this standard by 1 January 2015 as prescribed internationally.

South Africa has a limited supply of high-quality liquid assets that meet the Basel III qualifying criteria as they are currently defined. Among other reasons, this is because of moderate government bond issuances due to prudent fiscal policy. One of the national discretion options available to authorities in jurisdictions with inadequate qualifying liquid assets is for the central bank to make available a committed liquidity facility (CLF) from which commercial banks can draw funds in times of liquidity stress. The South African Reserve Bank has decided to make available such a CLF to all South African banks to help them meet the required LCR. The CLF will be made available from 1 January 2013.⁶⁴

Banks will have to apply to secure access to the CLF at their own discretion, and each bank can determine the amount that it would need. However, the size of the facility afforded to banks will be restricted to a maximum of 40 per cent of each bank's required liquid assets to meet the LCR. Those banks that elect to secure access to the CLF will have to pay a commitment fee on a scaled basis, depending on the size of the facility requested, as well as a drawdown fee in the event that they do indeed draw down funds from the CLF. Banks will also have to pledge unencumbered collateral for the CLF in the form of high-quality marketable securities or loans. The particular composition of such collateral and the specific terms of the facility will be negotiated with each bank individually. The CLF will be negotiated on an annual basis for a calendar year, and the Bank reserves the right to adjust the amount of acceptable collateral required, the commitment fees or the draw-down rates when a facility is renewed.

The provision of a CLF will further strengthen South African banks' liquidity position in accordance with stricter international standards. The facility is an additional prudential instrument to safeguard deposits in the banking system. It should therefore not be regarded as an indication of any liquidity pressures experienced in the banking sector. Additional liquidity will only be provided by the Bank in the event of a drawdown or if banks experience severe liquidity pressure. Currently all South African banks comfortably meet the existing prudential liquidity requirements. No South African bank required liquidity support from the Bank during the global financial crisis and there are currently no reasonable indications that they might require such assistance in the foreseeable future.

Insurance-sector developments

In May 2012 the International Association of Insurance Supervisors (IAIS) released a public discussion document on global systemically important insurers (G-SIIs) which supports the development of indicators for G-SIIs. The IAIS assessment methodology is consistent with the BCBS methodology for designating global systemically important banks (G-SIBs). The IAIS proposes 18 indicators under the following categories and suggests different weights for each indicator:⁶⁵

- *Size*: Total assets and total revenues from all sources (weight 5 to 10 per cent).
- *Global activity*: Revenues derived outside of home country and number of countries where a group operates (weight 5 to 10 per cent).
- *Interconnectedness*: Intra-financial assets; intra-financial liabilities; reinsurance; derivatives; large exposures; turnover and level three assets⁶⁶ (weight 30 to 40 per cent).
- *Non-traditional and non-insurance activities*: Non-policy holder liabilities and non-insurance revenues; derivatives trading; short-term funding; financial guarantees; variable annuities and intra-group commitment (weight 40 to 50 per cent).
- *Substitutability*: Premiums for specific business lines (weight 5 to 10 per cent).

In addition to the earlier discussion on the SAM framework, a key priority for South Africa is the development of legislation for the supervision of insurance groups since a significant number of South African licensed insurers are operating within a group structure. At present the Financial Services Board supervises insurers on a solo basis but can, however, direct any insurer(s) to

63. Basel Committee, "Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring" (Basel: Basel Committee, December 2010).

64. Banks Act Guidance Note G5/2012, entitled "Provision of a Committed Liquidity Facility and Utilisation of Statutory Cash Reserves in Terms of the Basel III Liquidity Framework", was issued in this regard on 10 May 2012.

65. International Association of Insurance Supervisors, "Global Systemically Important Insurers: Proposed Assessment Methodology" (Basel: Basel Committee, July 2012).

66. For further details, see BCBS, "Globally Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement, Rules Text" (Basel: BCBS, November 2011) 9.



67. The Information Request (No. 5/2012 (LT&ST)) is available at <http://www.fsb.co.za>.

furnish any information relating to groups or group-related activity. As part of aligning South Africa's insurance regulatory and supervisory landscape with international standards, the Financial Services Board is currently forming its view on the legal and organisational structure of insurance groups and their risk exposure prior to proposing new legislation in this regard. The latest information request to the insurance industry was published on 24 August 2012.⁶⁷ The Financial Services Board's supervisory powers will be further enhanced by the legislative proposals aimed at establishing measures on governance, risk management, internal controls and group supervision.

Addressing the 'too-big-to-fail' issue of concern through resolution regimes

A central reform objective of the FSB is to strengthen resolution regimes and resolution planning for SIFIs. While some progress has already been made in establishing cross-border crisis management groups, much work is still required in terms of developing resolution strategies and plans, and establishing cross-border co-operation agreements to ensure the resolvability of SIFIs. As reported in the March 2012 *Financial Stability Review*, the Bank and the National Treasury conducted a joint project in 2011 under the auspices of the World Bank to assess South Africa's crisis management arrangements.

The FSB's Key Attributes set out the essential elements that all resolution regimes should possess to enable national authorities to resolve distressed financial institutions in a manner that does not expose taxpayers to losses related to such financial institutions' failure. FSB member jurisdictions have committed themselves to a schedule for aligning their resolution regimes with this new standard and for implementing a range of SIFI-specific requirements, which include (i) ensuring an appropriate legal framework and adequate crisis management tools; (ii) the establishment of crisis management groups (CMGs); (iii) the implementation of recovery and resolution plans; (iv) the conduct of resolvability assessments; (v) the adoption of institution-specific cross-border co-operation agreements; and (vi) the establishment of co-operation arrangements with the relevant jurisdictions that are hosts to operations of a G-SIFI but are not represented on the G-SIFI's CMG.

Recovery and resolution plans comprise two distinctly separate components, namely the recovery plan and the resolution plan. Both components form an integral part of banks' risk management programmes, albeit at various stages. Banks' normal risk management processes and the prudential supervision conducted by the BSD are aimed at crisis avoidance. However, banks may still at times experience severe stress due to risk management failures, exogenous shocks or contagion effects. Recovery plans therefore serve as a guide to a bank's management and board of directors on how its risk profile would be reduced in such circumstances to ensure its survival without being required to enter the resolution process. Banks are not obligated to follow their recovery plans closely in the event of stress: recovery plans should rather help to plan ahead and structure possible strategies for recovery by taking into account all relevant information.

However, should the recovery attempts fail and a distressed bank enter the resolution process, the resolution authority would need adequately detailed information on the bank to enable it to resolve the problem. The purpose of a resolution plan is to minimise not only the cost of failure of a bank, but also the actual use of public funds in its resolution, even in the case of a systemically significant bank.

The Bank Supervision Department (BSD) of the Bank has identified, *inter alia*, recovery and resolution plans as a key focus area for its supervisory programme for 2012. Banks have been requested to include a liquidity recovery plan, a capital recovery plan and a business continuity plan in their initial recovery and resolution plans for 2012.⁶⁸ The comprehensiveness and viability of these plans are assessed both from a microprudential and financial stability point of view. The development of resolution plans will primarily be the responsibility of the resolution authority, and banks will be required to provide any information that may assist the resolution authority in resolving either a bank failure or systemic crisis. South Africa follows a phased approach in the development of recovery and resolution plans.

68. This was done through the issuance of Banks Act Guidance Note 4/2012 on 8 May 2012.

Domestic systemically important banks and related matters

South Africa has a relatively diversified banking sector, consisting of 16 registered banks, 12 registered bank controlling companies, 2 mutual banks, 1 co-operative bank, 13 registered local branches of foreign banks and 43 foreign banks with approved local representative offices.⁶⁹ As in many other countries, a small number of very large banks dominate the South African banking sector. In June 2012 the five largest banks' assets constituted more than 90 per cent of the total banking sector. Although none of these banks would qualify to be G-SIBs, there is a strong possibility that some or even all of them could qualify as domestic systemically important banks (D-SIBs), whether nationally, regionally or on the continent, depending on the classification methodologies used in the respective jurisdictions.

Evidence of this is the fact that most of the big South African banks have earmarked Africa as an important part of their future growth strategies. Given the relative size of the South African economy and of these banks vis-à-vis their counterparts in other African countries, it is possible that some of these banks' subsidiaries would be identified as D-SIBs in the host countries. The proposed framework for D-SIBs will assist in reducing the impact of distress in systemically important banks on host countries and add to the stability of their financial systems.

In June 2012 the BCBS issued for comment the consultative document entitled "A Framework for Dealing with Domestic Systemically Important Banks" (the D-SIB consultative document).⁷⁰ This document follows the rules text on the assessment methodology for G-SIBs issued in November 2011⁷¹ and a request by the G-20 leaders to extend a similar framework to D-SIBs. The rationale for both documents was the impact of the negative externalities created by the failure of systemically important banks on domestic economies. The D-SIB framework will complement the G-SIB regime and its phase-in arrangements will be synchronous with the G-SIB regime from January 2016. The D-SIB consultative document contains principles both for a methodology to assess whether domestic banks are systemically important and for calibrating the level of higher loss absorbency in the form of capital that should apply to D-SIBs. Due to the unique characteristics of individual jurisdictions, the D-SIB consultative document allows for an appropriate level of national discretion in the application of the D-SIB policy tool.⁷²

An important aspect of a D-SIB framework relates to its compatibility with the G-SIB framework as it should ensure that adequate and consistent incentive structures are in place at both a domestic and an international level. The BCBS is accordingly developing a set of principles that will serve as a common framework for D-SIBs, including home-host co-ordination, and the instruments and composition of additional loss absorbency for D-SIBs. The principles being considered for D-SIBs seek to establish a minimum framework that would ensure compatibility with the G-SIB framework and preserve a level playing field within and across jurisdictions. The principles will also include guidelines for national authorities to assess the systemic importance of banks in a domestic context. The FSB and the BCBS will submit the proposed principles to the G-20 Finance Ministers and Central Bank Governors' meeting in November 2012.

The Bank is at a fairly advanced stage of preparing for the implementation of the Basel III framework in South Africa, reflecting the country's commitment to adopting new international standards for the banking sector.⁷³ Certain aspects of the proposed D-SIB framework are in the process of being clarified by the BCBS before its phased implementation starts in January 2016.

Strengthening the oversight and regulation of shadow banking

The FSB has set out recommendations for effective monitoring of shadow banking in its October 2011 report⁷⁴ and has committed to conducting annual monitoring exercises to assess global trends and risks in the shadow banking system.⁷⁵ The annual monitoring exercise is expected to facilitate the national authorities' assessment of shadow banking risks based on the FSB's recommendations, and the sharing of experiences among authorities in order to highlight trends in shadow banking that are relevant to the stability of the global financial system. The first global monitoring exercise conducted in 2011 covered 11 FSB member jurisdictions and the euro area, while the 2012 monitoring exercise has been extended to cover all the FSB member jurisdictions.

In June 2012 the FSB conducted a survey on shadow banking activities aimed at assessing credit extension by non-bank financial institutions in particular and the relationship between these institutions and the banking sector in general. Overall, the size and growth of shadow

69. South African Reserve Bank, *Bank Supervision Department Annual Report 2011* (Pretoria: South African Reserve Bank), 101–106.

70. The document is available on the BIS website (<http://www.bis.org/publ/bcbs224.htm>).

71. Basel Committee, "Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement" (Basel: Basel Committee, November 2011).

72. Basel Committee, "A Framework for Dealing with Domestic Systemically Important Banks" (Basel: Basel Committee, June 2012), 1–2.

73. On 17 August 2012, the BSD released draft 2 of the proposed amended Regulations relating to Banks for notification purposes. It covers all the material aspects of the Basel III reform proposals and is available on the Bank's website at www.resbank.co.za.

74. Financial Stability Board, "Shadow Banking: Strengthening Oversight and Regulation – Recommendations of the Financial Stability Board" (Basel: FSB, October 2011).

75. According to the FSB, the term 'shadow banking' is not intended to assign a pejorative tone to this system of credit intermediation. The FSB has chosen to use the term 'shadow banking' as this is most commonly employed and, in particular, has been used in the earlier G-20 communications. Alternative terms used by some authorities or market participants include 'market-based financing' or 'market-based credit intermediation'.



banking activities in South Africa are not necessarily viewed as a negative development given South Africa's need to broaden access to financial products for all South Africans under the overarching objective of financial inclusion. The FSB's final report on global trends and policy recommendations will be publicly released by early 2013.

Reducing reliance on credit ratings and improving oversight of credit rating agencies

76. Available at www.financialstabilityboard.org.

In February 2012 the FSB conducted a review of its members' compliance with the FSB's "Principles for Reducing Reliance on Credit Rating Agency Ratings".⁷⁶ The aim of these principles, issued in October 2010, is to reduce the mechanistic reliance on the ratings assigned by credit rating agencies (CRAs) as such ratings can amplify procyclicality, contribute to systemic disruption through herding behaviour and encourage the sell-off of securities when they are abruptly downgraded (the so-called cliff effect). In the period since these principles were issued, widespread rating downgrades of financial entities by CRAs have further underscored the importance of these issues.

The FSB's principles in this regard encourage banks, institutional investors and other market participants to develop their own internal risk management capabilities to avoid complete reliance on external credit ratings. CRA ratings should be treated as only one input to the risk assessment process. Creating the right incentives for market participants to develop their risk management capabilities includes reducing the use (or 'hard wiring') of CRA ratings in regulatory regimes. The incorporation of CRA ratings into regulatory risk assessment models has been wrongly interpreted as an official 'seal of approval' and has contributed to an undesirable reduction in firms' capacity for credit risk assessment and due diligence.

In the March 2012 issue of the *Financial Stability Review* it was reported that the Credit Rating Services Bill (CRS Bill), which provides for the regulation of CRAs and credit rating services in South Africa, had been tabled in Parliament. The legislation addresses CRA practices and procedures in respect of managing conflicts of interest, transparency and quality of rating processes. The legislation provides for CRAs that are fully compliant with foreign jurisdictions to operate in South Africa, subject to domestic registration. Regular reports on these CRAs' adherence to the rules in foreign jurisdictions will be required. The draft CRS Bill was subsequently referred back for further consideration on issues such as the high probability of litigation and possible unfair employment practices. It is anticipated that the CRS Bill would be promulgated by the end of 2012, in time to meet South Africa's G-20 commitments in this regard.

Enhancing consumer finance protection

The global financial crisis demonstrated the need to strengthen consumer protection policies and frameworks to ensure that the use (or misuse) of individual financial products does not become a source of financial instability. A significant contributor to the financial crisis was poorly underwritten residential mortgages, which often represent the largest component of household and consumer debt. In response, a number of FSB member jurisdictions have encouraged prudent underwriting practices to limit the risks that mortgage markets might pose to financial stability and to better safeguard consumers and investors. The FSB's "Principles for Sound Residential Mortgage Underwriting Practices", released in April 2012, provide a framework for jurisdictions to set acceptable minimum underwriting standards.

In South Africa, as reported in recent issues of the *Financial Stability Review*, the Financial Services Board in its role as market conduct regulator has already embarked on an outcomes-based market conduct and consumer protection regulatory initiative entitled "Treating Customers Fairly" (TCF). A multi-stakeholder steering committee is in the process of reviewing all current consumer protection-related legislation applicable to the financial services sector and formulating regulatory recommendations to close identified gaps or inconsistencies in the framework. As a follow-up to the pilot TCF self-assessment exercise conducted in 2011, the Financial Services Board has recently rolled out a new self-assessment tool to enable regulated financial firms, including financial service providers, to assess their TCF readiness.⁷⁷ The self-assessment tool is an indication of the types of action the Financial Services Board believes financial services firms and advisers should, where applicable, be taking to ensure fair treatment of their customers.

77. The TCF self-assessment tool is available at www.fsb.co.za.

Note on the possible implications of the Basel III Capital and Liquidity Framework for South Africa⁷⁸

Introduction

The global financial crisis has revealed significant weaknesses in not only the quantity and quality of banks' capital, but also in the management of liquidity risk. The Basel III capital and liquidity framework is a key component of regulatory reforms, and aims to improve the resilience of banks to better absorb losses and maintain liquidity during difficult periods. The Basel III framework complements other financial-sector reforms that are aimed at reducing systemic risk, containing excessive risk-taking by financial institutions, improving transparency, reducing moral hazard and preventing the build-up of unsustainable positions in the financial system. South Africa, as a member of the Bank for International Settlements (BIS), Basel Committee on Banking Supervision (BCBS), the Financial Stability Board (FSB) and the Group of Twenty (G-20), fully supports these initiatives.

However, while the Basel III framework is based on sound principles and provides a valuable basis for regulation, it also contains some elements that are not applicable to emerging markets and that are clearly intended to address issues peculiar to advanced economies. Regulation and supervision impose significant costs on the financial sector, and should be justified by a reduction in institutional and/or systemic risk. The purpose of this note is to point out specific areas in the Basel III framework that have potential negative consequences for the South African financial system and economy.

Issues relating to the Basel III liquidity framework

The definition of high-quality liquid assets for the liquidity coverage ratio

The Basel III liquidity framework is very specific and prescriptive about the characteristics of Level 1 and Level 2 high-quality liquid assets (HQLAs).⁷⁹ The intention is to ensure that the quality of these assets is good enough to be a reliable source of funding in a stressed situation. However, some of the definitions are inappropriate for emerging-market countries, as these countries have less developed and less liquid financial markets. The definitions in some instances also penalise countries with a limited supply of government securities (a consequence of maintaining prudent fiscal policies). It is accordingly the view of South Africa that the definitions of HQLA should rather be aligned with the characteristics of the domestic markets in which liquidity should be raised.

In order to achieve such alignment, the specific definition of HQLA within a specific jurisdiction should thus be left to the discretion of the relevant authorities and based on a set of generic, fundamental and market-related characteristics. The liquidity framework should not be too specific in defining a generic set of HQLA, but rather focus on defining the principles of good liquidity management.

Bond markets in emerging-market economies (EMEs) are typically not as deep and liquid as in advanced economies, and in many instances would not meet the minimum fundamental and market-related characteristics of HQLA if compared to advanced economies. South Africa's bond market is relatively well developed compared with those of other emerging markets, in particular with regard to the government bond market. However, the corporate bond market is still in an evolutionary phase in the sense that its market capitalisation is much smaller than that of the government bond market and turnover is relatively lower. The view of the South African regulatory authorities is that the fundamental and market characteristics specified in the Basel III framework should be determined in relative, rather than absolute, terms. They should be determined in relation to the market conditions in a specific jurisdiction, and not on a global scale.

78. This is a shortened version of a position paper that South Africa submitted to the G-20 early in 2012, and which was subsequently incorporated into the study by the FSB on the possible impact of regulatory changes on emerging-market economies. These views are also being discussed in the relevant standard-setting bodies.

79. Assets are considered to be high-quality liquid assets if they can be easily and immediately converted into cash at little or no loss in value. The Basel III liquidity framework sets out a number of fundamental and market-related characteristics to identify the two categories of HQLA (Levels 1 and 2) required to meet the liquidity coverage ratio. For more detail on these characteristics, refer to the document *Basel III: International Framework For Liquidity Risk Measurement, Standards and Monitoring*, issued by the Basel Committee on Banking Supervision in December 2010.



80. This standard aims to ensure that a bank maintains an adequate level of unencumbered, high-quality liquid assets that can be converted into cash to meet its liquidity needs for a 30 calendar day time horizon under a significantly severe liquidity stress scenario specified by supervisors.

There are also a few possible unintended consequences that South Africa foresees with regard to the implementation of the liquidity coverage ratio (LCR),⁸⁰ namely:

- i. The LCR seems to encourage the holding of government debt by banks, thereby increasing the interlinkages between governments and banks, and contributing to systemic risk. Holdings of international government bonds also increase cross-border interlinkages.
- ii. Obliging banks to hold large quantities of debt instruments that are in limited supply may reduce the turnover in the bond market – something that South Africa tries to promote, in particular with regard to the corporate bond market.
- iii. Linking HQLA to a specific credit rating seems to create an increased reliance on credit ratings in terms of regulation, which was one of the weaknesses in the Basel II framework. It also creates cliff effects when securities are downgraded in times of instability or uncertainty.
- iv. The national discretion option for banks to hold greater amounts of foreign currency liquid assets, which does not match the currency of the associated liquidity risk, could potentially introduce various other risks, such as foreign currency risk and counterparty credit risk, in an attempt to mitigate liquidity risk.
- v. The Basel III liquidity requirements may cause disintermediation from the banking sector which, in a concentrated financial system such as in South Africa, represents a shift in risk rather than a reduction of risk. Banks may appear safer, but systemic risk may not necessarily be lower.

In order to minimise the possible adverse effects of the LCR, South Africa has made proposals to the BCBS to review some of the definitions of HQLA and to allow regulators in different countries more discretion to determine which assets should qualify as HQLA within their jurisdiction. Urgent finality is also required on these issues, as banks are already adjusting their pricing structures and business models to accommodate the existing Basel III requirements.

Treatment of unsecured wholesale funding

In the Basel III liquidity framework, an underlying assumption is that wholesale funding is less stable than retail funding and more likely to be withdrawn if a bank is under pressure. This is generally true and has also been proven by events during the global financial crisis. It is therefore understandable that unsecured wholesale funding should be treated as more unstable. In the LCR calculation, it is assumed that all unsecured wholesale funding will be withdrawn from a bank during a time of distress, and in the net stable funding ratio (NSFR)⁸¹ none of this funding counts as “Available Stable Funding”.

South Africa is in a peculiar situation with regard to wholesale funding. As a country with one of the most skewed income distributions in the world, a large portion of the population is unable to make a significant contribution to typical retail savings in the economy. In the formal sector, savings originate mainly from contractual obligations, most notably employment-related contracts, and as a result savings are concentrated as wholesale savings in pension funds, life insurance products and relatively high-yielding collective investment schemes, including money-market funds. The relatively small percentage of South Africans who are wealthy are sophisticated investors and unlikely to keep their savings in a bank deposit account. Consequently, there is a structural constraint on the supply of retail deposits as a source of bank funding, and a relatively high reliance on wholesale funding, which increases both the LCR and NSFR requirements. This situation would probably also prevail in a number of other EMEs.

Faced with this structural constraint, there is a possibility that the Basel III liquidity requirements as they are currently defined could force banks in South Africa to reduce the size of their balance sheets, which would reduce the availability of bank credit to the real economy. If this should happen, it is expected to have negative consequences for economic growth and employment creation, in turn further reducing available savings.

81. The NSFR establishes a minimum acceptable amount of stable funding based on the liquidity characteristics of an institution's assets and activities over a one year horizon. For further details on the NSFR and the LCR see *Basel III: International framework for liquidity risk measurement, standards and monitoring* December 2010, BCBS.

Wholesale funding in South Africa is more stable than in other parts of the world, mostly due to various regulatory and economic barriers that prevent liquidity from flowing out of the domestic economy. South African banks have limited foreign exchange funding, and maintain small net open positions in foreign currency. The rand funding that the banks use is contained within the system: rand is therefore unlikely to flow out of the country in large amounts, even in a crisis, and the Bank has full control over rand liquidity. Therefore, even if funding is moved from one financial institution to another, or fund managers change their asset allocation, the rand liquidity remains captured within the domestic banking sector. It is South Africa's view that regulators should be allowed more discretion to assess the stability of banks' funding liabilities, and by implication, the run-off rates of liabilities within the context of their own jurisdictions.

Conclusion

Developing international standards for regulation inevitably poses a challenge between ensuring uniformity and being applicable and appropriate in different jurisdictions. This note highlights some of the challenges that EMEs face with regard to elements of the Basel III framework that differ from those in advanced economies. South Africa remains committed to adhering to international regulatory standards and is in the process of revising its Regulations relating to Banks to facilitate the phasing in of the Basel III requirements. South African representatives at the respective standard-setting bodies and international forums will continue to debate these issues in the interest of financial stability, a sound financial system and appropriate regulation.



Note on the Johannesburg Interbank Agreed Rate

The criminal investigation that has been launched into alleged rigging of the London Interbank Offered Rate (Libor) by key global banks has become the focal point of a fierce debate over ethics in the banking sector. Federal Reserve Board Chairperson, Ben Bernanke, in a testimony to Congress in July 2012, said that the Libor “weaken[ed] confidence” and was fundamentally “structurally flawed”. He added that additional reforms to the Libor process were needed and that an international effort would be needed to restore the Libor’s credibility as the benchmark for mortgages, derivatives and corporate lending around the world.

It has been widely argued that a stressful period of low policy rates and high interbank borrowing costs can create the temptation for bankers to report lower interest rates than they actually have to pay in order to boost profits, reflect confidence in the position of the bank and, hence, the interbank system, quell concerns about the health of the banking system and to ward off calls for additional regulation. The manipulation of the Libor has, therefore, led to global market participants questioning the credibility and proper regulation of money-market reference rates. Similar concerns have been raised domestically regarding the Johannesburg Interbank Agreed Rate (Jibar).

The South African Reserve Bank (the Bank) National Treasury (NT), Financial Services Board, the JSE Limited (JSE) and market participants have evaluated the situation with respect to reference rates in the domestic financial markets, with particular reference to Jibar. The daily calculation and publication of Jibar rates are overseen by the JSE. The JSE is a regulator in its capacity as a self-regulatory organisation for certain activities but, in turn, is also regulated by the Financial Services Board.

The daily calculation and release of Jibar are important for the efficient functioning of the South African money, capital and interest rate derivatives markets. While the process remained unchanged for a number of years, market participants supported the review to ensure the continued integrity of the Jibar. This rate is an important benchmark rate in South Africa and is used in determining the reset rate for over-the-counter swaps and forward rate agreements (FRAs) and its reliability is, therefore, a cornerstone for the efficient functioning of the domestic financial markets.

The Jibar is a key short-dated money-market reference interest rate in the domestic financial markets, and represents the interest rate at which banks in South Africa buy and sell their own negotiable certificates of deposit (NCDs) over specific maturities, and represent actual rates that can be traded in the money market. The 3-month Jibar⁸² rate in particular is the most widely used and accepted as a short-dated interest rate benchmark.

The analogous benchmarks in other currencies are the Libor and the European Interbank Offered Rate (Euribor), which are both calculated and published by Thompson Reuters. The Libor and Euribor represent an estimate by banks in the London and European markets of the rates at which they believe they could borrow funds from other banks.

The notable difference between the Jibar and Libor is that unlike Libor, the Jibar is based on interest rates at which domestic banks can buy and sell their NCDs. The Jibar represents actual rates that can be traded in the money market, depending on the prevailing liquidity in the market and the liquidity profile of the contributing bank.

The level quoted by the banks for the calculation of Jibar is public information – implying that if a bank submits a quote lower than the overall market level, the bank will be forced to buy back paper from the market at the “incorrect yield” that investors are offering. In addition, if Jibar quotes are not at levels where investors are actually trading with the bank, investors will pick this up and notify the JSE.

82. Although the 3-month Jibar is the most commonly used, Jibar reference rates for 1-, 3-, 6-, 9- and 12-month maturities are calculated and released on a daily basis.

Table A Comparison of the Libor, Euribor and Jibar

Activity	Libor	Euribor	Jibar
Calculation and publication of rates	Calculated and published by Thomson Reuters on behalf of the British Banking Association	Calculated and published by Thomson Reuters	Calculated by the Johannesburg Stock Exchange and published by Thomson Reuters
Number of rates published	150 Libor rates	15 Euribor rates	5 Jibar rates
Underlying information	Represents unsecured funding in the London interbank market, not based on actual transactions but quoted as annualised interest rates	Represents daily quotations of the rate that each panel bank believes one prime bank is quoting to another prime bank for interbank term deposits within the euro area	Represents interest rate at which banks in the South African interbank market buy and sell their NCDs, but can also be represented by rates achieved in the deposit and forward markets
Underpins financial transactions worth an estimated:	US\$300 trillion	Not available	Not available
Guiding principles	Contributor banks are selected in line with three guiding principles: i Scale of market activity ii Credit rating iii Perceived expertise in the currency concerned	Contributor banks can qualify for the panel if they are active players in the euro money markets in the euro area or worldwide and if they are able to handle good volumes in euro interest rate-related instruments, especially in the money market	There is no formal definition for the inclusion and/or exclusion of contributing banks
Calculation methods	Trimmed arithmetic. Contributions are ranked in descending order. The highest and lowest 25 per cent are excluded. Remaining contributions are then arithmetically averaged to create a Libor quote. Published daily at 11:00 by Reuters	The highest and lowest 15 per cent of all quotes collected is eliminated. The remaining rates will be averaged and rounded to three decimal places. Published daily at 11:00 by Reuters	A mid-rate is calculated as a halfway point between bid and offer rates provided by contributors. The two highest and two lowest mid-rates are discarded. The rest of the mid-rates are averaged to provide the fixing rate, published daily at 10:00 by Reuters
Panel of banks	15 (for each of the 10 currencies)	44	8

Sources: Bank of England, European Central Bank, European Banking Federation and the JSE Limited

In 2011 the South African Reserve Bank (the Bank) proactively initiated a review of the processes and procedures around the determination of domestic money-market reference rates, including the Jibar. The Jibar Review was done under the auspices of the Financial Markets Liaison Group⁸³ (FMLG) which is chaired by the Deputy Governor responsible for the Financial Markets Department of the Bank. This process was proactively initiated as part of the normal work programme of the FMLG and its subcommittees to ensure the continued integrity and reliability of money-market benchmark interest rates, and was not triggered by any particular event or development in the domestic financial markets or as a result of any problems encountered or suspected internationally.

The Jibar review project has resulted in the establishment of a Jibar Working Group with representatives of the current panel of contributing banks, the JSE and the Bank. The key objective of this working group was to formalise a code of conduct, governance process and operational rules for money-market reference rates in South Africa, which is expected to be completed in the near future.

South African regulators remain committed to ensuring sound and well-regulated processes to calculate, publish and monitor reference money-market rates in the domestic financial market. Although current legislation does not provide for the formal regulation of these processes as yet, the Bank will play a dominant part in overseeing these processes until the anticipated “Twin Peak” legislation has been formalised .

83. The FMLG is a consultative forum, and represents a joint initiative between the Bank and key participants in the financial markets. The FMLG comprises three subcommittees, namely the (i) Money Market, (ii) Fixed Income and Derivatives, and (iii) Foreign Exchange subcommittees.



Abbreviations

AGR	augmented Guidotti ratio
Alsi	All-Share Index
BCA	Budget Control Act
BCBS	Basel Committee on Banking Supervision
BER	Bureau for Economic Research
BIS	Bank for International Settlements
BoE	Bank of England
BOJ	Bank of Japan
BSD	Bank Supervision Department [of the South African Reserve Bank]
CBO	Congressional Budget Office
CBOE	Chicago Board of Options Exchange
CDS	credit defaults swap
CFVI	Consumer Financial Vulnerability Index
CISCA	Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002)
CLF	committed liquidity facility
CMG	crisis management group
CPSS	Committee on Payment and Settlement Systems
CRA	credit rating agency
CRB	Commodity Research Bureau
CSD	central securities depository
D-SIB	domestic systemically important bank
EC	European Commission
ECB	European Central Bank
EMBI+	JPMorgan Emerging Market Bond-plus Index
EME	emerging-market economy
ESM	European Stability Mechanism
EU	European Union
Euribor	European Interbank Offered Rate
FAO	Food and Agriculture Organization
FMI	financial market infrastructure
FMLG	Financial Markets Liaison Group
FNB	First National Bank
FRA	forward rate agreement
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
G-20	Group of Twenty
GDP	gross domestic product
GIIPS	Greece, Italy, Ireland, Portugal and Spain
G-SIB	global systemically important bank
G-SII	global systemically important insurer
H-index	Herfindahl-Hirschman Index
HQLA	high-quality liquid assets
IAIS	International Association of Insurance Supervisors
IFC	International Finance Corporation
ILO	International Labour Organization
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
Jibar	Johannesburg Interbank Agreed Rate
JSE	JSE Limited
LCR	liquidity coverage ratio
Libor	Interbank Offered Rate
MSCI	Morgan Stanley Capital International
NCD	negotiable certificate of deposit
NCL	non-current loan
NCO	net charge-off
NCR	National Credit Regulator
NPL	non-performing loan

NPSD	National Payment System Department [of the South African Reserve Bank]
NSFR	net stable funding ratio
NT	National Treasury
OMT	outright monetary policy transactions
OTC	over the counter
PMI	Purchasing Managers' Index
QIS	Quantitative Impact Study
RMB	Rand Merchant Bank
ROSC	Report on the Observance of Standards and Codes
S&P	Standard & Poor's
SAGB	South African government bonds
SAM	Solvency Assessment and Management
SIFI	systemically important financial institution
SME	small and medium enterprises
SSM	single supervisory mechanism
TCF	Treating Customers Fairly
UK	United Kingdom
US	United States
VIX®	Chicago Board of Options Exchange Volatility Index
WGBI	World Government Bond Index

Glossary

CRS Bill	Credit Rating Services Bill
FAIS Act	Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002)
FM Bill	Financial Markets Bill
Moody's	Moody's Investors Service
the Bank	South African Reserve Bank
the Fed	United States Federal Reserve
the Key Attributes	The FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions"
the Report	The IOSCO Report on "Principles for Financial Market Infrastructure"