Financial Stability Review

March 2013

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South African Reserve Bank

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

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Purpose of the *Financial Stability Review*

The South African Reserve Bank (the Bank) defines its primary objective as the achievement and maintenance of price stability in the interest of balanced and sustainable economic growth in South Africa. In addition to this, the Bank's role and 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 to the fullest possible extent and believes that any of its actions taken to contain systemic risk should be at the minimum level required to be effective.

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

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Overview

Global economic sentiment and the financial stability outlook improved notably towards the end of 2012 despite relatively weak financial conditions. There was a tentative improvement in global economic growth prospects amid accommodative monetary policy in most advanced economies during the period under review. Risks from the euro area remain present, even though the intensity of these risks varied. The outlook for Europe in 2013 remains bleak and concerns were recently reignited by developments in Cyprus. Another major concern is the United States' (US) fiscal debt ceiling.

A double-dip recession in several European economies has taken a heavy toll on labour markets. High and rising youth unemployment in particular remains a social threat across certain parts of Europe. Increasing resistance to austerity is equally concerning. In line with the trend that began in 2008, central banks generally remained willing to increase the size of their balance sheets by purchasing various debt market securities. This widespread accommodative monetary policy resulted in central banks' assets surging to record highs, while interest rates in advanced economies remained near historic lows.

The resolute macroeconomic policy action that lessened risks in the euro area and the US prompted a positive reaction from the global economy, leading to a general improvement in business and consumer confidence. Positive economic data and rising manufacturing and service-sector activity across emerging-market economies (EMEs) have added to signs that economic growth in EMEs may have reached an inflection point. Optimism regarding the success of measures taken to halt the economic growth slowdown in China has also added to the positive outlook for EMEs. A cautiously upbeat economic growth outlook for 2013 for the sub-Saharan African region is based on expectations that the two main sources of uncertainty and instability, namely (i) the euro area sovereign debt crisis and (ii) the US's fiscal problems, are being managed successfully and without severe repercussions for the global economy.

In South Africa real economic activity increased moderately in the fourth quarter of 2012. Output in the mining and quarrying sector shrank as production in this sector was adversely affected by work stoppages due to wage disputes. Nevertheless, albeit from a low base, the Bank's leading business cycle indicator has been increasing since September 2012, which supports expectations of a continued mild economic recovery into 2013. Confidence in the financial services industry continued to improve, though also from a low base, and remained at elevated levels during the second half of 2012 relative to 2011. The banking sector remained adequately capitalised during the period under review. Furthermore, the quality of the loan books of banks appeared to have improved slightly as the banking sector's impaired advances decreased further. Banks' profitability and efficiency improved moderately. All long-term typical insurers reported having adequate capital to cover more than the regulatory minimum requirement.

The South African bond market performed reasonably during the period under review, largely due to apparent improved investor appetite for risk as a result of improving economic growth prospects in the US and China, and steps taken by the European Central Bank (ECB) to stave off the risk of disorderly default in the euro area. While the domestic equity market managed to outperform most emerging markets in the period under review, its rally was kept in check in early 2013 by downward pressure on commodity prices, a downgrading in South Africa's sovereign credit rating by major rating agencies and sporadic, but persistent, wage disputes in the mining, transport and agriculture sectors. Expressed in US dollar terms, domestic equities underperformed those of their emerging-market counterparts.

The demand for credit by corporations accelerated in the fourth quarter of 2012, but total fixed investment by the corporate sector remained sluggish. The financial position of households remained relatively benign. Both disposable income of households and compensation of employees recorded positive growth rates. In addition, household saving remained marginally positive. Consumer confidence, however, dropped further. Households' appetite for debt seems to have increased somewhat during the period under review. However, residential real-estate market activity remained subdued, with the result that growth in mortgage advances slowed further. The various house price indices continued to display mixed signals in the second half of 2012.

On 1 February 2013, details on the implementation of the Twin Peaks Model of Financial Regulation in South Africa were published. The main themes that emerge from the implementation document include the structure and objectives of the prudential and market conduct regulator; the governance framework; financial stability oversight; crisis management; and enforcement of the regulatory requirements under the twin peaks model. This model will be implemented using a phased approach. The period of public consultations was concluded in March 2013. Furthermore, new amendments to the Regulations relating to Banks (the Regulations) were published and took effect on 1 January 2013. These amendments enabled the implementation of the provisions of the Basel III framework in South Africa.

As a member of the Financial Stability Board (FSB), South Africa has undergone a country peer review that covered interagency co-ordination and its regulatory structure, as well as the regulation of the over-the-counter derivatives markets. The Review Report noted the steps that the South African financial authorities had taken to address the enhancement of co-ordination and exchange of information, and the approach to the implementation of over-the counter derivative regulatory reform. South Africa will study the recommendations made in the Review Report and implement them in a manner that is appropriate to national circumstances and conducive to enhancing domestic financial stability.

Introduction

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

The first section provides an overview of current international macrofinancial conditions and 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 domestic financial system infrastructure and regulation, and provides an update on financial policy, and legislative and infrastructural developments affecting the South African financial system. The progress South Africa is making with the implementation of the twin peaks financial regulation framework is outlined and the review of the Johannesburg Interbank Average Rate (Jibar) is explained. Highlights of the FSB's recent peer review of South Africa's financial regulatory infrastructure are discussed, followed by an analysis of the FSB's global thematic review of risk governance across jurisdictions. The relevance of developments around the global legal entity identifier (LEI) for South Africa is also covered. The section concludes with an update on the implementation of the Basel III framework in South Africa.

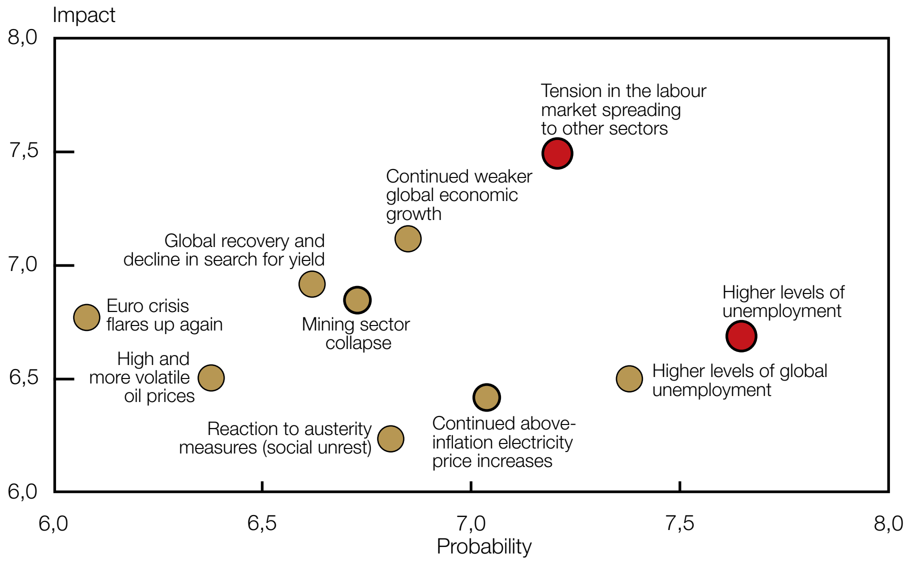
Financial stability developments and trends

The Bank's financial stability analysts consider developments and trends in the global and domestic financial systems in an attempt to pre-emptively detect and mitigate possible risks to, and weaknesses in, the domestic financial system. All possible scenarios identified in this process are then rated according to the probability of their occurrence and their likely impact on the domestic financial system, resulting in a risk intensity rating being assigned to each scenario. The risk intensity rating is used to guide research efforts for the year ahead and to inform policy-makers.[1] In order to determine the various risk intensities, a value between zero and ten is subjectively assigned to both the probability and likely impact of each risk. The rating scales are split into a low (between 0 and 3,5), medium (between 3,5 and 7) and high (between 7 and 10) range for both probability and impact. Figure 1 shows a list of selected risks that could potentially impact on the stability of the South African financial system during 2013. Different colours are used to indicate the relative intensity of the risks: gold represents moderate intensity and red represents high intensity. Domestic risks are circled with a solid line.

1 The selection of risks is revisited in the second half of each year to determine changes to the various risk intensities. The results are then published in the September issue of the *Financial Stability Review*.

According to the 2013 risk analysis, the most prominent risk to domestic financial system stability is the prevailing tension in the domestic labour market, which initially started in the domestic mining sector and then spread to other sectors of the domestic economy. Unemployment in South Africa also remains a concern and continues to weigh on economic growth prospects. The South African financial system is furthermore vulnerable to spillover effects from weaker global economic growth amid higher levels of global unemployment in addition to growing negative foreign investor perception against a backdrop of increased socioeconomic stress.

Figure 1 Risks to domestic financial stability



Sources: South African Reserve Bank and researchers' computations

In preparation for the implementation of a countercyclical capital buffer framework,[2] the most common indicator in this regard, namely the credit-to-gross domestic product (GDP) gap, is continually monitored. The countercyclical capital buffer methodology proposes that the buffer add-on should focus on the credit-to-GDP gap and that it would depend on deviations of the actual credit-to-GDP ratio from the long-term credit-to-GDP trend. As part of the research conducted for such a framework, the credit-to-GDP gap[3] was back-tested from 1965 and the results indicated that it could be a useful early-warning indicator of impending imbalances. However, it is by no means perfect as it also produces some misleading signals. While the countercyclical capital buffer framework is considered a useful tool in the selection of macroprudential instruments at the disposal of financial stability regulators, it is not advisable to apply it mechanically or uniformly.

2 See the September 2011 issue of the *Financial Stability Review*, p.43 (Pretoria: South African Reserve Bank) for a discussion of the countercyclical capital buffer framework.

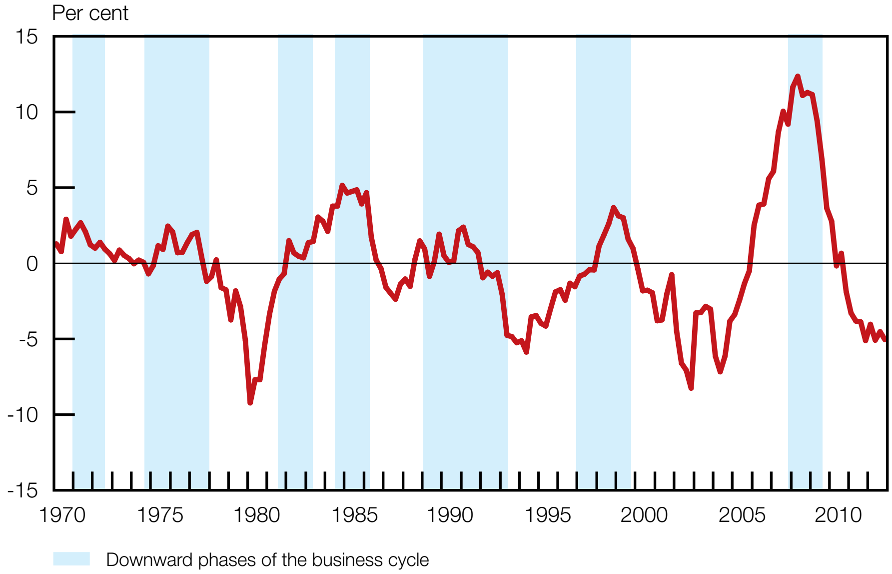
3 The credit-to-GDP gap is the gap between the aggregate private-sector credit-to-GDP ratio and its long-term trend.

Figure 2 displays the results of the calculation of the private-sector credit-to-GDP gap for South Africa over the past decades (since 1970), using the narrow definition of nominal credit and the recommended Hodrick–Prescott (HP) filter smoothing parameter of 400 000.[4] After the strong warning signal produced by the credit-to-GDP gap for a countercyclical capital buffer add-on for the 2006–2010 period,[5] the gap has been below zero since the final quarter of 2010. Given this countercyclical capital buffer methodology, the results displayed in Figure 2 suggest that there is no reason to consider the application of a countercyclical capital buffer for banks in South Africa at present.

4 In accordance with the Basel Committee on Banking Supervision (Basel Committee) proposal.

5 This could be interpreted as an indication of excessive credit growth on a system-wide basis in the domestic economy in the period leading up to the global financial crisis.

Figure 2 Private-sector credit-to-GDP gap and phases of the business cycle



Source: South African Reserve Bank

International macrofinancial developments

This section contains an overview of macroeconomic and financial developments in advanced economies, EMEs and Africa. Furthermore, the impact of these developments, or potential impact on, the financial system in South Africa is analysed.

Financial and economic developments in advanced economies

Global economic sentiment and the financial stability outlook improved markedly towards the end of 2012 despite relatively weak financial conditions. There was a general tentative improvement in global economic growth amid supportive monetary policy in most advanced economies during the period under review. Risks from the euro area crisis remain present and a major concern, even though the intensity of these risks varied during the period under review. Another major concern is the US fiscal debt ceiling. Financial markets started 2013 with a sense of euphoria following positive developments regarding the US fiscal cliff in December 2012. However, political and policy uncertainties in the US and in Europe intensified towards the end of February 2013, weighing on central banks' efforts to support an economic recovery. In Italy election results provided no clear winner, raising the prospect of a weak coalition government. Additionally, a default was avoided in Cyprus towards the end of the first quarter of 2013 when the Troika[6] agreed to provide up to €10 billion in loans on the condition that Cyprus will restructure its banking system and impose losses on uninsured depositors.

6 'Troika' is used to describe the EU, the ECB and IMF.

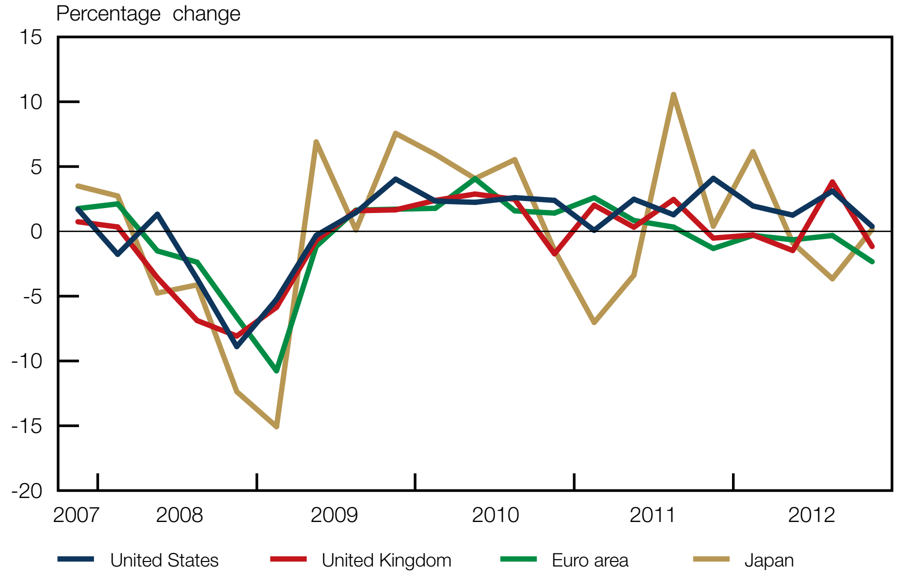
Economic growth

Global economic growth remained weak in 2012 and in its April 2013 *World Economic Outlook* (*WEO*),[7] the International Monetary Fund (IMF) revised its global economic growth forecast for

7 International Monetary Fund, *World Economic Outlook* (Washington DC: IMF, April 2013).

2013 downwards from previous estimates made in January 2013. Nevertheless, world output is expected to grow by 3,3 per cent in 2013 (up from 3,2 per cent in 2012), although this projection is subject to a successful resolution of financial and sovereign stresses in the euro area, and an end to fiscal uncertainty and instability in the US. In line with this view, the Organisation for Economic Co-operation and Development (OECD) expects that the global economy will make a hesitant and uneven recovery during 2013.

Figure 3 Quarterly growth in real GDP



Source: Bloomberg

In the US a gradual recovery in economic growth is expected in 2013 amid continued accommodative monetary policy.[8] The recovery is expected to be rooted in stronger domestic demand, coupled with signs of a tentative recovery in the construction sector and the housing market. However, lower labour force participation rates, continued relatively high levels of unemployment, weak income growth and continued deleveraging pressures associated with elevated household debt are still impediments to growth. Nevertheless, the US has the advantage of having progressed further in deleveraging its household and financial sectors than the euro area or the United Kingdom (UK). Policy uncertainty in the US and doubts about its fiscal position, however, remain a concern. Fiscal policy is expected to play a key role in shaping the US economic outlook and could possibly be the greatest drag on economic growth in 2013.

Persistent sovereign strains in the euro area resulted in a progressive weakening in the euro area's macrofinancial conditions and economic activity during the second half of 2012. The euro area's GDP contracted for the fifth successive quarter during the fourth quarter of 2012. The outlook for Europe in 2013 remains bleak, although slightly less so than was the case in 2012.[9] In recent months the ECB has reiterated its confidence in a gradual recovery of economic activity later in 2013, helped by its accommodative monetary stance and the improvements in regional financial markets since mid-2012. Nonetheless, in addition to deficiencies in the credit intermediation channels amid banking-sector fragility, fiscal constraints in several countries are hampering the process of reigniting economic growth. Economic growth is also hindered by the appreciation of the euro since mid-2012, which has weighed on the competitiveness of euro area countries, although the recent partial reversal of this appreciation since February 2013 should provide some relief.

8 To support a stronger US economic recovery, the United States Federal Open Market Committee (FOMC) indicated that it will continue purchasing additional agency mortgage-backed securities at a pace of US$40 billion per month and longer-term Treasury securities initially at a pace of US$45 billion per month, thereby increasing the FOMC's overall holdings of longer-term securities by about US$85 billion each month.

9 According to IMF baseline projections, euro area GDP is expected to contract by 0,3 per cent during 2013, less than the 0,6 per cent contraction observed in 2012.

In the UK, GDP contracted by 0,3 per cent in the fourth quarter of 2012 despite the measures taken by the Bank of England (BoE) to support economic growth. While the contraction was mostly due to a weakening in manufacturing activity, it was also a reflection of the waning effect of the Olympic Games that were held in London during the third quarter of 2012. Even though accommodative monetary policy is encouraging, the outlook for UK economic growth is expected to remain lacklustre due to fundamental economic weaknesses such as a large fiscal deficit and high inflation. Moreover, public- and private-sector deleveraging and fiscal austerity are additional downside risks to the UK economic outlook.

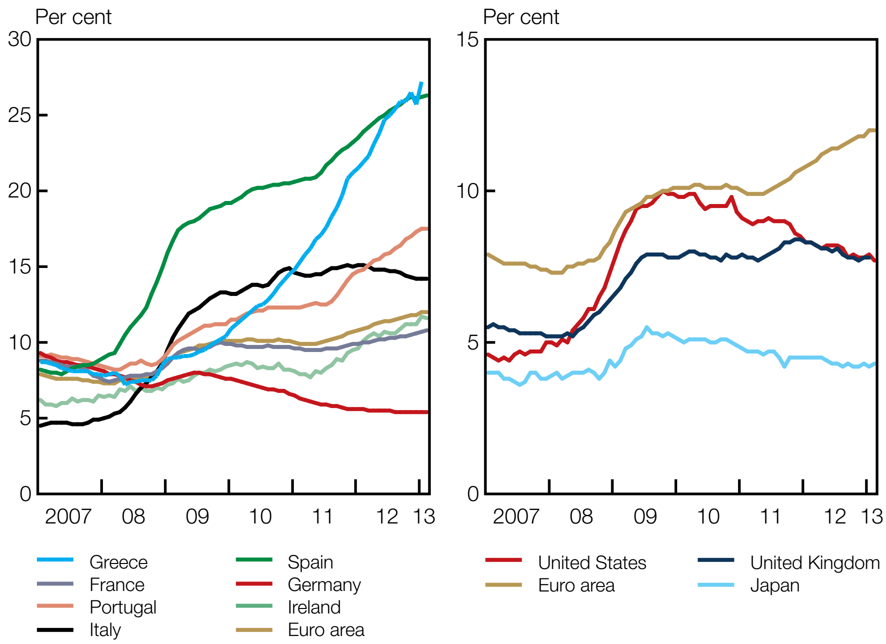
Japan's economy contracted in the second and third quarters of 2012 in line with a slowdown in global economic activity and weak domestic demand amid a strong yen weighing on exports. However, Japan's recession came to an end in the final quarter of 2012, with GDP growing at a revised 0,2 per cent on an annualised basis.

Weak economic conditions in advanced economies could spill over to South Africa through several channels, including lower levels of trade.

Unemployment

A double-dip recession in several European economies has taken a heavy toll on labour markets as the unemployment rate in the euro area continued to increase in 2012. High and rising youth unemployment in particular remains a social threat around much of the Mediterranean and across certain parts of Europe, increasing resistance to austerity. Furthermore, the pressure on governments to cut costs as part of the austerity measures could spread to other sectors where regulation has a strong influence on pricing. As a result, the consequent inability to counter cost pressures by increasing prices or relying on public support could force these sectors to look at other ways of reducing costs, such as reducing their staff complement.

Figure 4 Unemployment rate in selected countries



Source: Bloomberg

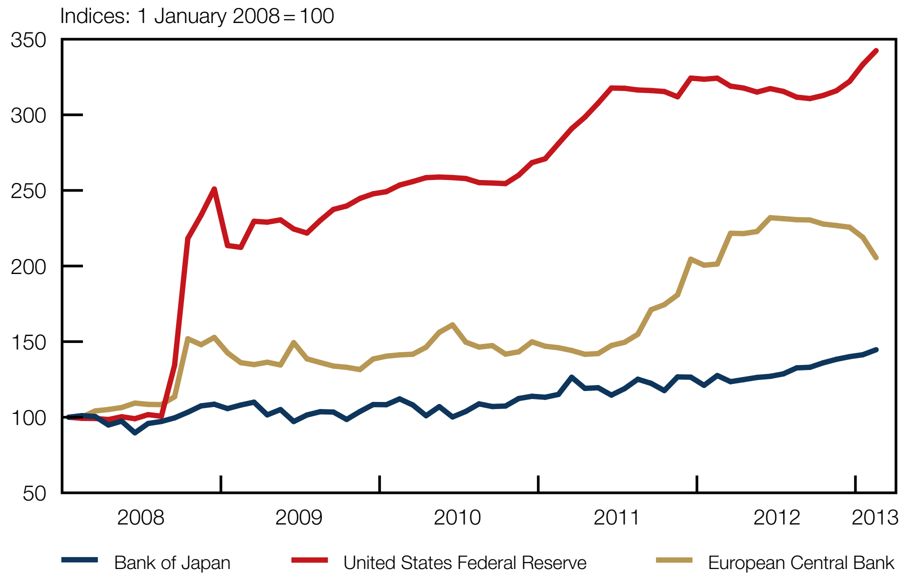
In the US, even though recent labour market reports surprised on the upside and unemployment reached its lowest level in four years in February 2013,[10] long-term unemployment remains high. Apart from the negative social consequences, this also raises economic concerns since it is likely that long-term unemployed workers will lose their skills and eventually permanently lower the level of potential output. This, in turn, would cause a rise in the natural rate of unemployment.

10 The 7,7 per cent attained in February 2013 is still some way from the 6,5 per cent marker that the FOMC indicated as a threshold for when it might increase interest rates.

Central bank stimulus

In line with the trend that began in 2008, central banks generally remained willing to increase the size of their balance sheets by purchasing various debt market securities. The US embarked on a third round of quantitative easing, while the ECB and the Bank of Japan (BOJ) were active participants in the open market. In the UK the BoE began its asset purchase programme in January 2009 and has so far committed a total of £375 billion to its quantitative easing programme. This widespread accommodative monetary policy resulted in central banks' assets surging to record highs, while interest rates in advanced economies remained near-historic lows. Even though the generally supportive monetary policy stance maintained by many of the advanced economies is still needed, the more reliance there is on central bank liquidity, the more excesses and distortions accumulate in the financial system and the more destabilising an eventual unwinding of these excesses could be. Relatively weak global economic growth implies that policy rates are likely to remain fairly low, which could result in further pressure on commercial bank interest rate margins and continued pressure on the long-run solvency of many insurance companies and pension funds.

Figure 5 Size of central banks' balance sheets



Source: Bloomberg

Concerns expressed by some US officials about the need to consider the implications of the asset purchase programmes have prompted speculation that the United States Federal Reserve (the Fed) may be considering an exit strategy, starting with a reduction in the pace of its asset purchases. These concerns have risen despite the Fed having stated explicitly that it would only consider moving away from its current extreme stance if the US unemployment rate fell to below 6,5 per cent and the projection for inflation levels of one and two years ahead remained lower than 2,5 per cent. Should the Fed move away from its current policy stance sooner than expected, the possibility of a significant increase in global interest rates and capital outflows from emerging economies could result. Such a drastic or sudden change in capital flows could have a marked impact on emerging-market currencies. The already-high level of foreign participation in emerging-market equity and bond markets, regularly testing new record highs, could cause a full-scale reversal of foreign capital inflows. In the past, South Africa has been vulnerable to capital flow volatility, which is expected to result in currency depreciation and high levels of exchange rate volatility, in addition to a possible decline in economic growth levels.

The BOJ committed itself to ending 15 years of deflation and announced an open-ended asset purchase programme in November 2012. Following this undertaking, market sentiment improved and the yen weakened while bond yields decreased. The depreciation of the yen inadvertently fuelled speculation of a 'currency war'. Even though the Group of Twenty (G-20) allayed such fears, concerns have been raised that deliberate depreciations of major economies' currencies could impact severely on EMEs.

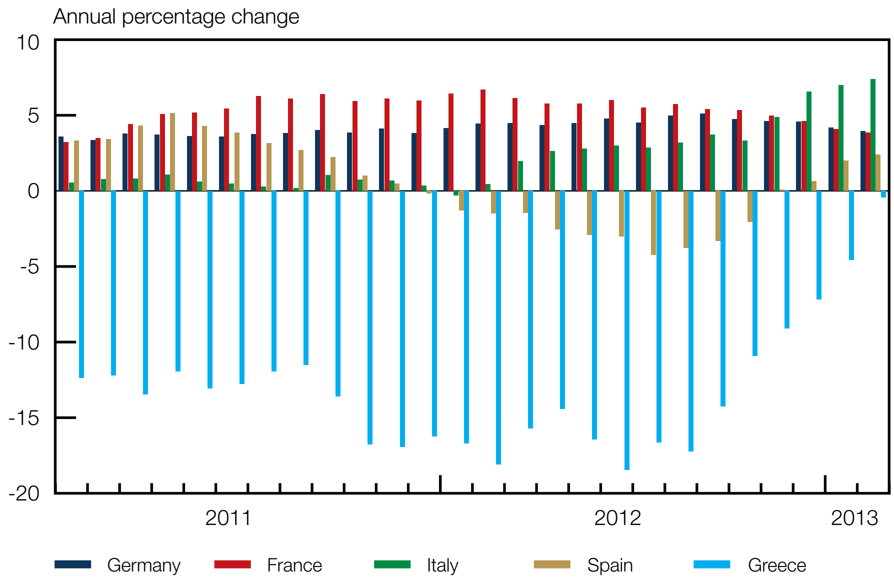
Banking-sector developments

Despite several positive developments in the European banking sector, the situation remains fragile as financial fragmentation remains a concern both at country and bank levels (see Box 1). Furthermore, even though there was a reduction in borrowing, banks in countries under distress still owe a net €844 billion to the euro system. Cross-border interbank funding in the euro area also continued to decline during the period under review. The progressive weakening in the euro area's macrofinancial environment also poses risks to banks' credit exposures, profitability and capital levels. This could result in a higher number of non-performing loans – a very concerning development for banks faced with already-low levels of profitability.

A decline in sovereign bond yields of the GIIPS (Greece, Italy, Ireland, Portugal and Spain) countries and renewed inflow of deposits into banks are yet to be translated into improved lending conditions and lower costs to businesses and households in the GIIPS countries. In fact, growth in bank lending to the non-financial sector has been negative on a year-on-year basis for several years in these countries.

Also of concern are losses of approximately €4,5 billion suffered by banks in Cyprus due to writedowns of Greek debt. At the beginning of March 2013, concerns over Cyprus flared up and after an initial proposal, including a one-off levy of up to 10 per cent on all bank accounts was rejected by the Cypriot parliament, banks were closed in order to avert a run on deposits.

Figure 6 Retail deposits in selected European countries



Source: Bloomberg

Subsequently, banks reopened in the last week of March after Cyprus agreed that in exchange for European Union (EU)/IMF support, it would restructure its banking sector and impose a levy on deposits over €100 000 (uninsured depositors). Even though the spillover effects have been more limited than in past episodes of turmoil in Europe, there is a risk that the precedents set by euro area policy-makers in addressing failing banks in Cyprus, notably the bailing in of bank depositors, could undermine confidence in vulnerable banking systems in other member states. This could exacerbate the current outflow of deposits from peripheral countries in the euro area if depositors fear that their deposits are no longer guaranteed. Developments in this regard should therefore be monitored closely in the future.

Box 1 Financial market fragmentation and deleveraging

In many advanced economies the need for structural deleveraging across both the financial and non-financial sectors, in conjunction with a high level of fragmentation in financial markets, has weighed further on economic growth prospects. In Europe, the stability and the integration of financial markets were challenged by events relating to the recent financial and sovereign debt crises, reversing the steady integration that has been occurring since the inception of the common currency in 1999.

One of the latest policy initiatives by the European Central Bank (ECB), namely the prospective Outright Monetary Transactions Programme, has reduced the immediate threat of countries being forced to exit the euro area. However, the fragmentation of euro area credit flows and economic headwinds have persisted. Furthermore, uncertainty remains about how the substantial imbalances within the euro area will be resolved in the medium term. High funding costs in stressed jurisdictions could serve to amplify pressure on banks to deleverage in a disorderly way, with the implied risk of asset fire sales, the loss of strategically important profitable assets and restricted lending to the real economy.

Thus far, persistent financial strain and heightened uncertainty in the euro area have resulted in bouts of financial market turbulence. The uncertain planning environment also dented macroeconomic growth prospects, not least by distorting economic resource allocation. Persistent uncertainty has fostered the home-country bias of investors, resulting in strong financial market fragmentation. This has exacerbated funding strains in some countries, while yielding the prospect of a new build-up of imbalances in others. Regarding European banks, a generalised trend towards home-country bias in interbank flows and collateral acceptance is expected to undermine an integrated market which resulted from a monetary union. More generally, any restrictions on the flow of liquidity could reduce market depth, with the prospect of large collective losses. Notwithstanding ECB action, the functioning of money and debt markets has remained under strain.

European banks began repaying the ECB's emergency three-year loans early in 2013 and the first repayment (€137 billion) was larger than expected. While repayments of the ECB's long-term refinancing operations (LTRO) were relatively high in January 2013, predominantly due to repayments by banks in the core countries, February's repayments were lower. Nonetheless, the early repayments of the LTRO, together with expectations of a further reduction in liquidity have, to some extent, reduced the excess liquidity[11] in the interbank markets. This could be an indication of improving funding conditions of banks or, alternatively, signal that euro area banks are in the process of repairing their balance sheets and therefore require less funding.

11 Excess liquidity is calculated as the difference between the amounts outstanding in the ECB's current-account and deposit facility, less the average reserve requirements and marginal lending facility.

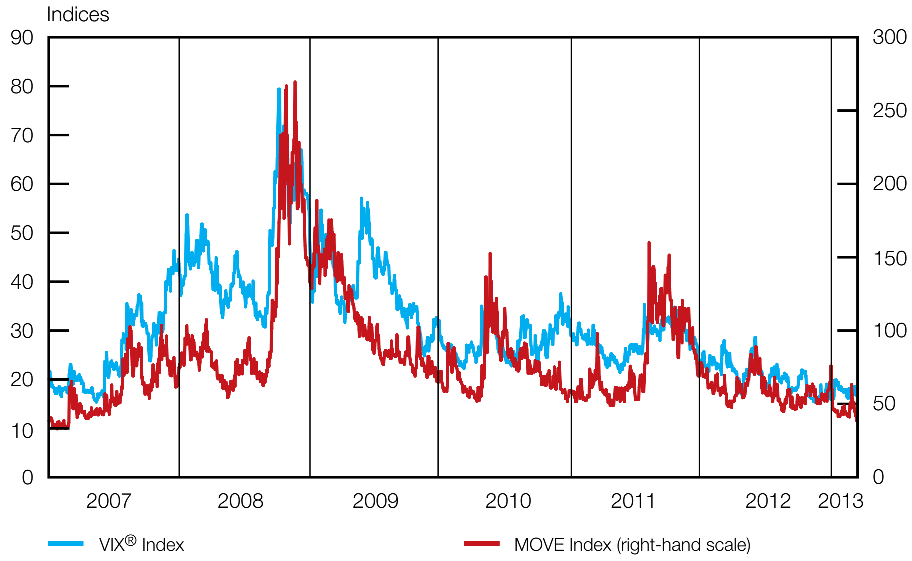
Financial market developments

Volatility in global financial markets eased somewhat during the period under review, except for mild upticks which coincided with the US presidential elections, the US fiscal cliff deadline and inconclusive election results in Italy. The relatively positive sentiment in global financial markets was underpinned mostly by policy actions taken in the euro area, which helped to ease concerns over the euro area's sovereign debt crisis, and positive economic data, particularly from the US and China. The easing in volatility has not been unique to equity markets. Bond markets have also exhibited a similar trend, with the Merrill Options Volatility Estimate (MOVE) Index[12] reaching a five-year low in March 2013. In the six-month period ended December 2012, the measures of volatility in bond and equity markets, namely the MOVE Index and the Chicago Board of Options Exchange (CBOE) Volatility Index (VIX®),[13] averaged lower compared with the preceding six months ended June 2012.

12 The MOVE Index is a yield curve-weighted index of the normalised implied volatility on one-month Treasury options.

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

Figure 7 Equity- and bond-market volatility



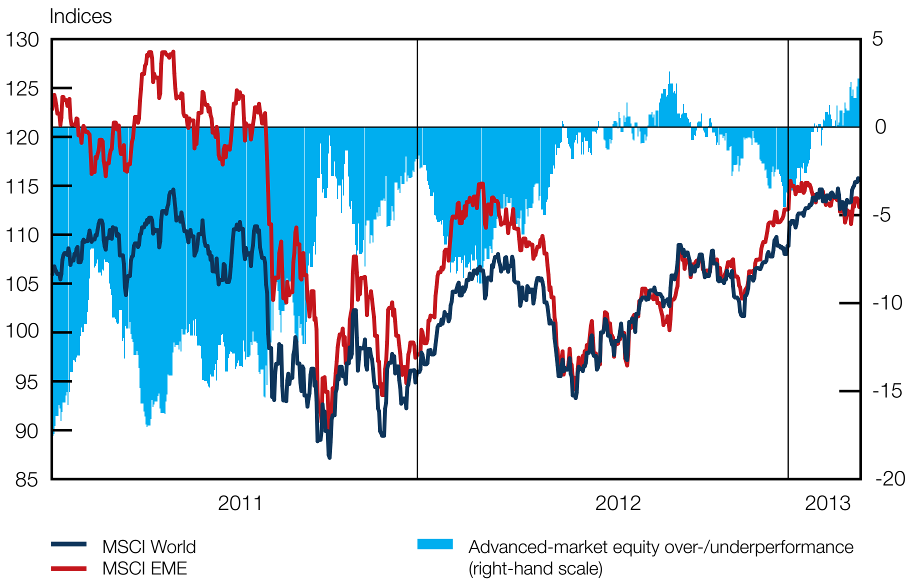
Source: Bloomberg

While the improvement in financial market volatility could be seen as a sign of optimism among investors against a backdrop of upbeat economic confidence and ample global liquidity, it could be equally indicative of the prevalence of excessive risk-taking behaviour among investors.

Equity markets

Global equity markets continued to rally during the fourth quarter of 2012. During this period, global equity market capitalisation increased to over US$52 trillion, but still remained below the pre-crisis level of US$63 trillion. Despite moves by major central banks to stimulate economic growth and diminishing concerns about disorderly adjustments in Europe, concerns relating to the US fiscal position and a weaker economic growth outlook for advanced economies led to an underperformance of equities in advanced economies. In contrast, the outperformance of advanced-economy equities by emerging-market equities was underpinned mostly by hopes that the economic downturn in China had ended given the recent positive economic trends. Since July 2012, the Morgan Stanley Capital International (MSCI) indices for advanced-economy and emerging-market equities rose by about 13 per cent and 9 per cent respectively.

Figure 8 MSCI equity indices

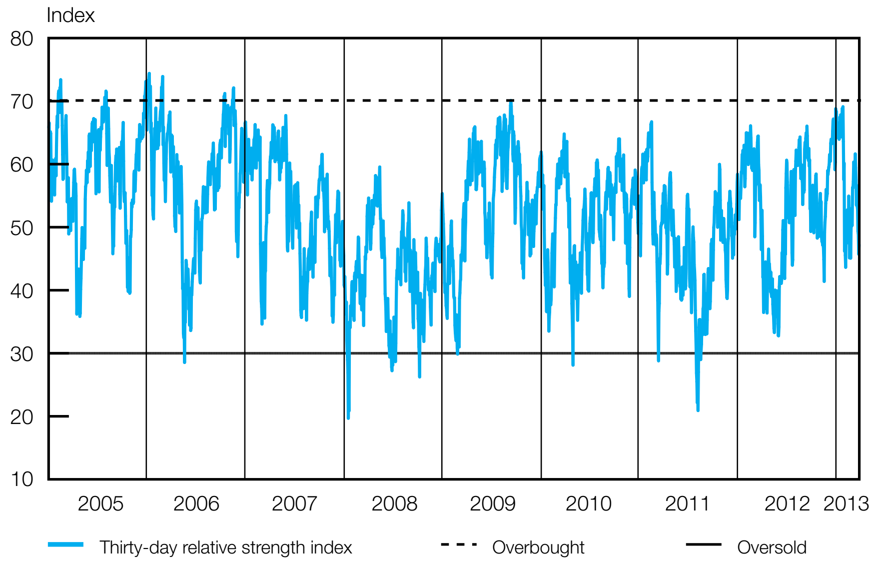


Source: Bloomberg

14 The MSCI Frontier Markets Index is a free float-weighed equity index of selected American, European, African, Middle East and Asian frontier markets.

Sub-Saharan African equity markets also performed relatively well during the period under review. The upbeat performance was in line with a generally higher appetite for riskier assets, although idiosyncratic determinants also played a role. On a year-to-date basis, the Nigerian and Kenyan equity markets grew by about 30 per cent and 17 per cent respectively. It is a concern, however, that the rate at which these markets grew in the course of 2012 could be a sign of impending risks that could lead to several vulnerabilities in the regional financial system. Owing to the fact that the growth in the regional equity markets is partly driven by a search for returns, there remains a risk of a sudden reversal should there be an adverse change in risk sentiment. Figure 9 shows a 30-day relative strength index (RSI) for the MSCI Frontier Markets Index.[14] According to the index, frontier-market equities traded mostly along the 70 index-points mark, indicating that these equities were regularly overbought. The strengthening momentum was, however, followed by a pull-back in early 2013 amid an increase in risk aversion that resulted from concerns about Italy and Cyprus. The RSIs of equity markets of other sub-Saharan African countries not included in the MSCI Frontier Markets Index, including South Africa, initially exhibited a similar bullish divergence that was followed by a reversal during the first quarter of 2013.

Figure 9 Thirty-day relative strength index[1]: MSCI Frontier Markets Index



1 A relative strength index (RSI) is a momentum indicator that compares the magnitude of recent gains to recent losses in an attempt to determine overbought and oversold conditions of an asset. The RSI scale ranges from 0 to 100. Equities are deemed to be overbought once the RSI approaches 70, meaning that it may be getting overvalued and is likely to pull back. Likewise, if the RSI approaches 30, it is an indication that the equity market is oversold and therefore likely to be undervalued

Sources: Bloomberg and researchers' computations

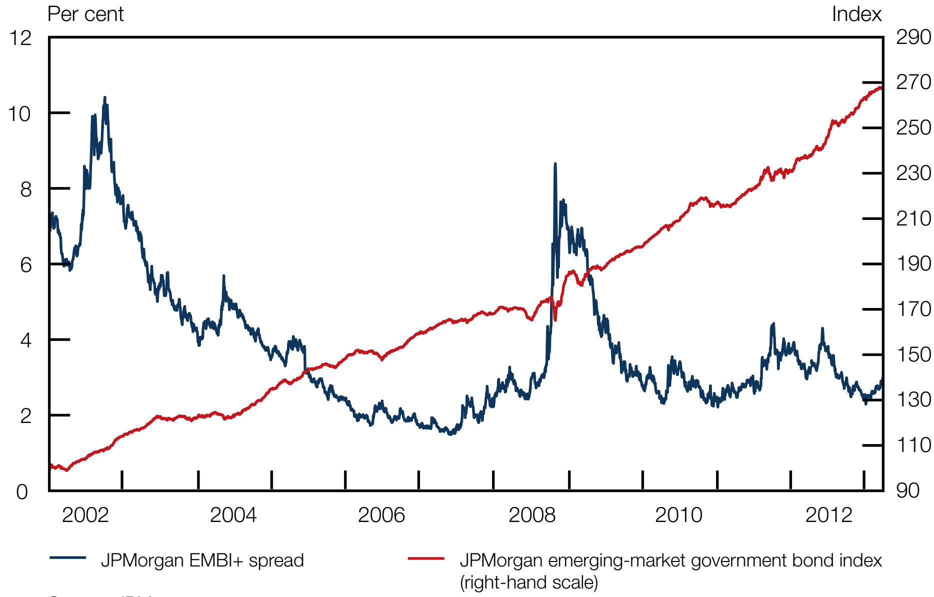
Bond markets

Emerging-market and euro area peripheral government bond yields declined during most of the period under review, reflecting a positive change in sentiment after the ECB indicated its readiness to implement its Outright Monetary Transactions Programme and committed itself to preserving the integrity of the euro area. In addition to these factors, a reprieve from the US fiscal cliff and the Fed's decision to continue purchasing additional agency mortgage-backed securities and longer-term Treasury securities provided additional support for developing-market bonds, leading to an increase in bond yields of advanced economies. Since July 2012, the JPMorgan measure of emerging-market government bonds[15] rose by approximately 7 per cent. European non-core government bond markets also gained marginally, supported by specific euro area developments. However, political risk, such as the February elections in Italy, capped the gains. Among other things, the maintenance of Spain's credit rating above investment grade reduced the risk of a sell-off that could have transpired if Spanish government bonds had lost their investment grade status. Furthermore, signs of intent to go ahead with further euro area integration, such as the Single Supervisory Mechanism[16] for banks, have helped reduce bond-market strains.

15 JPMorgan Government Bond Index Emerging Markets Global Core.

16 The Single Supervisory Mechanism is the tentative term for the mechanism through which the ECB will assume the ultimate responsibility for specific supervisory tasks related to the financial stability of all euro area banks.

Figure 10 Emerging-market government bond index and the JPMorgan EMBI+ spread



Source: JPMorgan

Since the beginning of 2013, US Treasury yields have increased due to waning demand for safe havens as a result of positive US economic data releases. Downside risks to the US economic outlook are expected to remain in focus due to uncertainty over whether the US government would overcome its fiscal challenges.

German bonds reversed earlier gains after the Italian election results and the ten-year Treasury-Bund spread widened to its highest level since 2010. The UK government yield curve has steepened as the unexpected contraction in UK GDP for the fourth quarter of 2012 fuelled expectations of further monetary policy easing by the BoE.

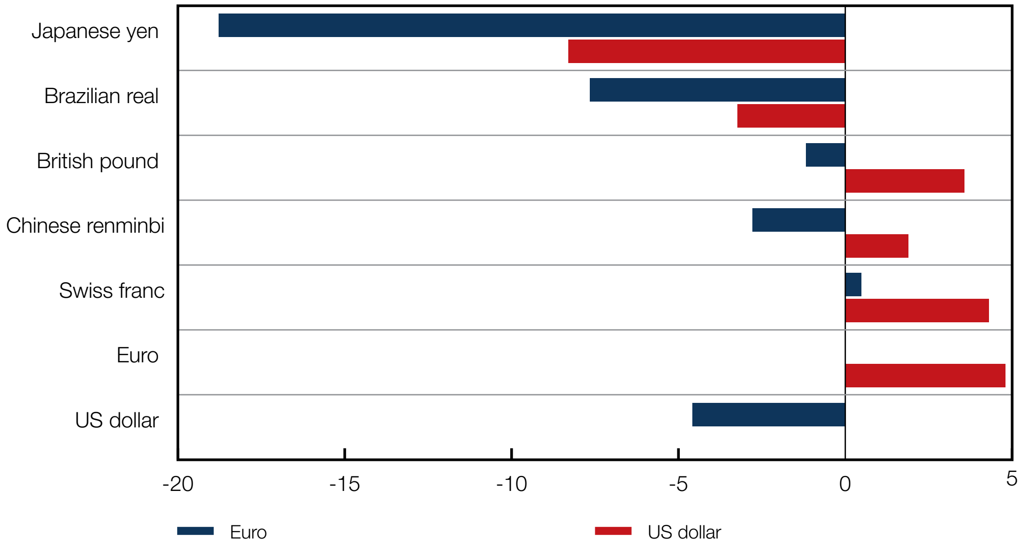
The outlook for global bond markets therefore depends on a number of short-term risks, including the large refinancing needs for some advanced economies and euro area countries, the risk of a sovereign default by Cyprus, and the risk of implementation challenges stemming from a failure by the euro area to carry out the reforms proposal for further euro area integration.

Currency markets

Recent policy actions taken by major central banks have resulted in an increase in the appetite for riskier and higher-yielding assets. Positive emerging-market interest rate differentials, positive developments in euro area bond markets and generally upbeat economic confidence provided further support to currency markets. These events, however, eroded the attractiveness of the US dollar as a safe haven, causing it to depreciate during the second half of 2012.[17] The depreciation of the US dollar can also be attributed to the quantitative easing programme of the Fed. Along with the excessive depreciation of the Japanese yen due to a widening trade deficit and an expansion of monetary stimulus by the BOJ, these changes raised concerns of widespread competitive currency devaluations. These concerns were, however, later addressed as the G-20 nations gave their assurances to the contrary.

17 The depreciation of the US dollar was confirmed by the US Dollar Index, which fell by about 2,3 per cent during the period under review. This index indicates the general value of the US dollar by averaging the exchange rates between the US dollar and six major world currencies, namely the euro, the Japanese yen, the British pound, the Canadian dollar, the Swedish krona and the Swiss franc.

Figure 11 Selected currencies' spot return against the euro and the US dollar[1]



1 The spot return measures the percentage change in the value of the selected currencies against the US dollar and the euro. Spot returns are calculated for the six-month period ending December 2012

Source: Bloomberg

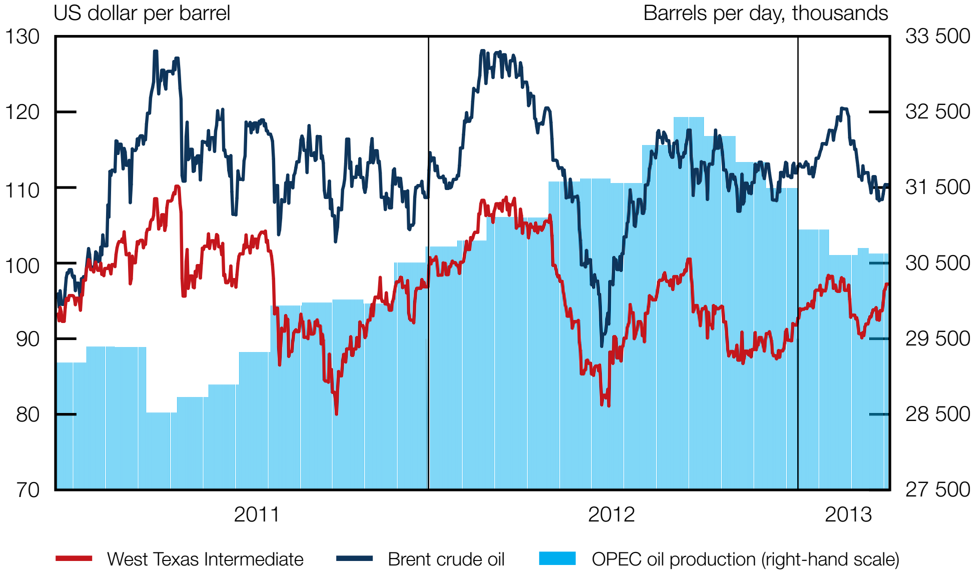
Over the six-month period to December 2012, the euro appreciated against a larger number of currencies compared with the preceding six months. The euro was mostly supported by resolute policy action in Europe aimed at stabilising global economic and financial conditions, and narrowing sovereign spreads in the euro area periphery. While the rally of the euro raised fears that the appreciation would undermine the competitiveness of the euro, it also raised concerns about the correctness of the euro exchange rate against other major currencies. Concerns about the value of the euro were also later dismissed by the ECB Governing Council, which signalled that despite the latest appreciation of the euro, the relevant indicators did not signal any serious overvaluation.

Commodities

Commodity trading volumes and prices fluctuated during the second half of 2012. The Thompson Reuters/Jefferies Commodity Research Bureau (CRB) Index rose by about 4 per cent after declining by 9 per cent in the first half of 2012. In line with expectations of liquidity injections which were later implemented by major world central banks, growth-sensitive commodities rose during the second half of 2012. Although some commodity prices eased off later in the year, Brent crude oil prices remained at elevated levels due to falling production, while geopolitical tensions added to the risk premium on oil prices. For most of the period under review, Brent crude oil traded in a narrow range of between US$110 and US$120 per barrel. For 2013, the Organization of the Petroleum Exporting Countries (OPEC) expects world oil demand growth to remain steady, although there are some downside risks. The largest portion of the anticipated oil demand growth in 2013 is expected to come from China, the Middle East and Latin America.

The gold price exhibited a similar trend to that of agricultural commodities, reaching a high of US$1 790 per ounce in early October 2012. The gold price increase was due to a rise in physical demand in Asia, a broadly weaker exchange rate of the US dollar, and rising demand for gold as a hedge against inflation amid increasing central bank liquidity. During the third quarter of 2012, gold demand increased by 10 per cent, with investments in exchange-traded funds being the single largest contributor to rising demand. Despite continued monetary easing, the gold price has since retreated to below US$1 600 per ounce in 2013. This decline can be partly attributed to the fact that inflation fears associated with the expansion of central bank balance sheets are now seen as excessive. While in the past, money creation often fed into higher prices, the current quantitative easing programmes have resulted in the money that was created remaining with the central banks. Credit extension to the real economy therefore remained subdued during the period under review. Furthermore, the velocity of money, in many instances, continues to slow. These factors, combined with continuing household debt deleveraging and corporate cash hoarding, have instead led to asset-price inflation and not 'real' inflation.

Figure 12 OPEC oil production and oil prices



Source: Bloomberg

Although the excessive levels of volatility in global financial markets have eased somewhat during the reporting period, it still added to the volatility in the South African bond, equity and currency markets.

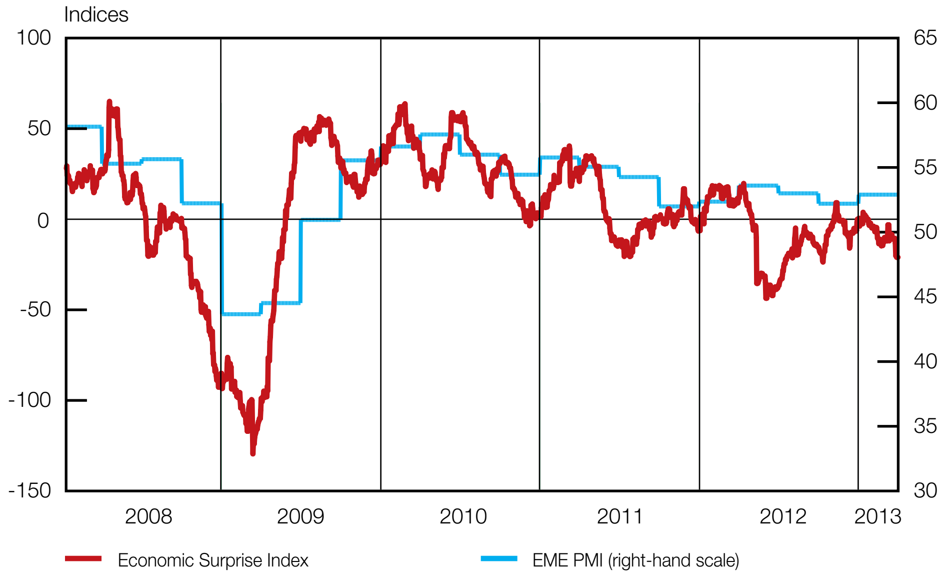
Financial and economic developments in emerging-market and developing economies

Emerging-market economies

The resolute macroeconomic policy action that lessened risks in the euro area and the US prompted a positive reaction from the global economy, leading to a general improvement in business and consumer confidence. Positive economic data surprises[18] and rising manufacturing and service-sector activity across EMEs (see Figure 13) have also added to signs that EMEs may have reached an inflection point. The combined manufacturing and service sectors of the major EMEs all registered an expansion during the fourth quarter of 2012. This growth in momentum was maintained in 2013, with the manufacturing Purchasing Managers' Indices (PMIs) of the BRICS (Brazil, Russia, India, China and South Africa) countries all rising to above 50 index points. The expansion in EME manufacturing activity during the fourth quarter of 2012 was led by an increase in new orders (the largest since the second quarter of 2011), although new export orders fell amid weak demand from advanced economies.

18 Positive economic surprises are measured using the Citigroup Economic Surprise Index, defined as weighted historical standard deviations of data surprises (actual releases versus Bloomberg survey median). A positive reading of the index suggests that economic data releases have, on balance, been beating consensus.

Figure 13 Emerging-market Economic Surprise Index and manufacturing PMI



Source: Bloomberg

Optimism regarding the success of measures taken to halt the economic growth slowdown in China has also added to the positive outlook for EMEs. China's GDP has grown at a slower pace for seven successive quarters, but re-accelerated to 7,9 per cent in the fourth quarter of 2012. Slightly stronger data during the second half of 2012 for industrial production, fixed investments, retail sales and exports, and a renewed rise in corporate leverage have led to hopes that China's economic growth moderation might be over.

Overall, the GDP growth rate for EMEs is estimated at 5,1 per cent for 2012, down from an average 6,4 per cent in 2011.[19] The baseline projection for 2013 is higher at 5,3 per cent. However, the short-term outlook for growth in EMEs depends on a number of downside risks, including inward spillover effects from a relapse in the euro area.

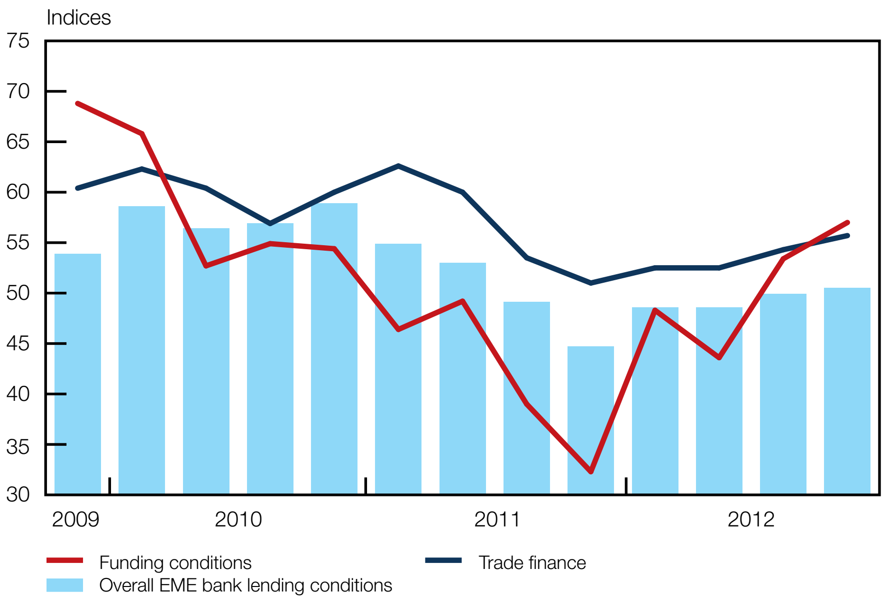
The drag from tighter bank lending conditions in EMEs also appears to be fading (Figure 14). According to the Emerging Markets Bank Lending Conditions Survey conducted by the Institute of International Finance,[20] emerging-market bank lending conditions improved in the fourth quarter of 2012 for the first time since mid-2011. The improvement in the overall bank lending conditions index was underpinned by a substantial easing of funding conditions (reflecting the easy monetary policy in advanced economies) and a sustained improvement in trade finance conditions.

The risk-friendly environment and the relatively positive macroeconomic conditions in EMEs continued to channel foreign investment flows towards EMEs. This flow of capital to EMEs is a result of both push factors, such as the search for yield, and pull factors, such as favourable interest rate and economic growth differentials, in EMEs. The search for yield is resulting from accommodative monetary policy in advanced economies and various rounds of quantitative easing to support these ailing economies. Conversely, the favourable interest rate and economic growth differentials, financial deepening and improving sovereign fundamentals in EMEs have provided an attractive base. It is clear, however, that EMEs, including South Africa, are among the countries that are exposed to a sudden reversal in capital inflows.

19 International Monetary Fund, *World Economic Outlook* (Washington DC: IMF, April 2013).

20 Institute of International Finance, *Emerging Market Bank Lending Conditions Survey, 2012 4Q* (Washington DC: IIF, 30 January 2013).

Figure 14 Emerging-market bank lending conditions



Source: Institute of International Finance

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

After having slowed in 2012, the sub-Saharan African economy is expected to grow by at least 5,6 per cent in 2013.[21] This cautiously upbeat economic growth outlook for the region is based on expectations that the two main sources of uncertainty and instability, namely (i) the euro area debt crisis and (ii) the US's fiscal problems, are managed successfully and without severe repercussions to the global economy. While finding a solution to the euro area crisis and the US's fiscal problems may lead to a normalisation of the global economic and financial landscape, failure to do so may have severe consequences. Coupled with private-sector deleveraging, these risks could be destabilising for Africa. Collectively, these downside risks are expected to have a differential impact on the individual countries in the region, depending on the nature and extent of interlinkages that each country has with the sources from which the vulnerabilities originate.

While there has been progress in improving capital levels and funding conditions in Europe, the dynamics of the European bank deleveraging process remain challenging. The potential for home bias during the deleveraging process adds more significance to this concern for non-EU countries. Furthermore, the nature and extent of the spillover effects to other countries will depend on the channel through which the deleveraging process takes place.[22] The vulnerabilities for sub-Saharan Africa originating from deleveraging in the euro area are discussed below with respect to banks and international trade linkages.

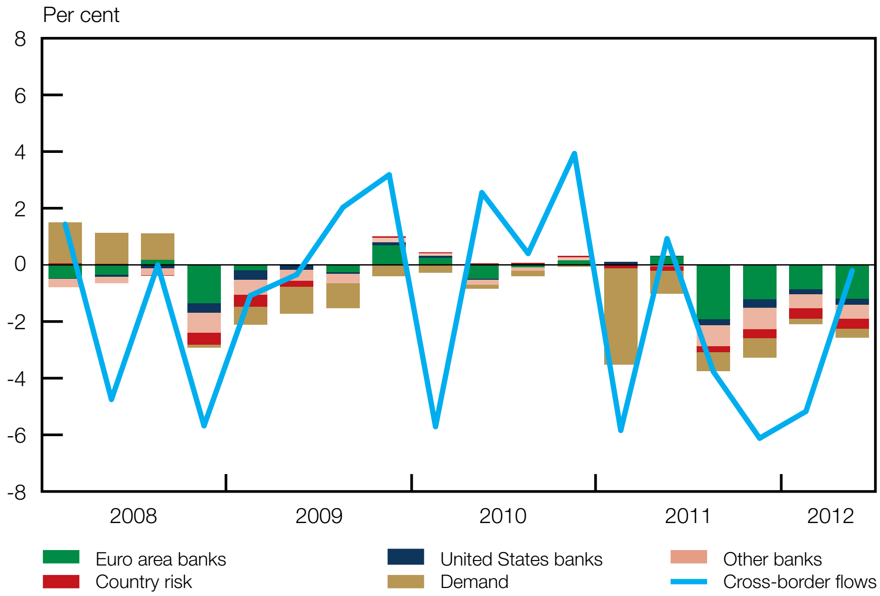
In line with other emerging and developing economies, cross-border lending to the region has been declining since the latter part of 2008. Similarly, lending from euro area banks to the region has also been declining. While a host of reasons, such as country risk and credit demand, have accounted for this decline, evidence seems to suggest that deleveraging by euro area banks has had a much bigger impact.[23] As far as banks are concerned, the vulnerability of sub-Saharan Africa to euro area bank deleveraging depends on a number of factors, including restrictions on credit, the presence and dominance of euro area banks in the region, and the reliance of local banks on funding from euro area banks. Figure 15 shows a decomposition of cross-border lending to the Emerging Middle East and Africa (EMEA) region.

21 International Monetary Fund, *World Economic Outlook* (Washington DC: IMF, April 2013).

22 The European deleveraging exercise could happen, among other things, through a sell-off of businesses, the disposal of liquid assets, the non-renewal of maturing loans and credit restrictions. The vulnerability of each country will depend on how dependent that particular country is on Europe through one or more of these channels.

23 Owing to the unavailability of data for sub-Saharan Africa as a whole, the country group Emerging Middle East and Africa (EMEA) is used as a proxy for sub-Saharan Africa to study the impact of euro area bank deleveraging on local banks.

Figure 15 Decomposition of cross-border lending to the EMEA region



Source: Bank for International Settlements

The data support the fears raised about the potentially destabilising impact that deleveraging by euro area banks may have on banks in other regions. This notwithstanding, the ECB noted that most deleveraging will be carried out through asset sales as corroborated by the restructuring plans of the individual euro area banks, as opposed to a withdrawal of lending facilities.

Another concern regarding deleveraging by euro area banks is that trade finance will be adversely affected, especially because loans for trade finance are mostly of a short-term nature, thereby making it easy for banks to reduce their exposure to such credit. Although a gradual retraction of trade finance, specifically by west-European banks, has been observed in certain parts of the world, other banks outside Europe have stepped in to fill the funding gap. This has helped to limit the impact on international trade activities. The policy decision taken by the oversight body of the Basel Committee to reduce the extent to which the liquid asset buffer is being driven by different trade finance operations[24] is also expected to curb the negative impact on trade finance.

Africa also faces the threat of intensifying geopolitical tensions that have the potential to derail it from its current economic growth trajectory, while also presenting threats to short-term stability. The spread of violence and instability, increasing terrorism across key growth economies, the heightened risk of social unrest driving regime change and resource nationalism are expected to be the drivers of risk for 2013.

24 The annexure to the press release by the Governors and Heads of Supervision endorsing the revised liquidity standard for banks stipulates that the Basel III regulations will include guidance to indicate that a low outflow rate (0–5 per cent) is expected to apply to trade finance operations.

Domestic macroprudential analysis

This section analyses the main developments in the domestic financial system. Risks to the stability of the financial system can originate from adverse developments in any of the economic sectors, such as the corporate and household sectors and the real-estate market. Given the interlinkages between the real and financial sectors of the economy, a set of selected indicators of real economic activity is first reviewed as background.

Real economic activity

Domestic real economic activity increased moderately in the fourth quarter of 2012. Real GDP increased by a quarter-on-quarter, annualised and seasonally adjusted rate of 2,1 per cent compared to 1,2 per cent in the third quarter of 2012. The main contributors to the moderate improvement in economic activity in the fourth quarter of 2012 were the manufacturing, finance, real-estate, business services and general government services sectors. Output in the mining and quarrying sector shrank at an annualised rate of 9,3 per cent in the fourth quarter of 2012 as production in this sector was adversely affected by work stoppages due to wage disputes.

The Bank's leading business cycle indicator has been increasing since September 2012, which supports expectations of a continuation of the mild economic recovery into 2013. The Kagiso PMI[25] also increased by 1,7 points to 49,1 index points in January 2013 before further increasing to 53,6 points in February 2013; the first time it had exceeded the 'neutral' 50-point mark since August 2012. The increase was a reflection of gains in the business activity, new sales orders and inventory subcomponents. The Bank has forecast real GDP growth of 2,7 per cent for 2013, marginally up from the previous forecast of 2,6 per cent, and 3,7 per cent in 2014, marginally down from the previous forecast of 3,8 per cent.

25 Kagiso Tiso Holdings, Bureau for Economic Research and CIPS Africa, *Kagiso Purchasing Managers' Index* (January 2013).

Short-term indicators of future economic growth (Table 1) do support a positive growth scenario to a certain extent, but more recent data would be needed to substantiate this view. Vehicle sales increased through the second half of 2012 and into January 2013, with both new vehicle and passenger cars sales recording strong growth rates in January 2013. However, in February and March 2013, annual growth in vehicle sales and new vehicle and passenger car sales slowed markedly. The slowdown in the growth rates of both retail and wholesale trade sales continued into January 2013, while electricity generation contracted.

Table 1 Selected indicators of real economic activity[1]

Annual percentage change in monthly indicators

Activity indicators	2012						2013
	Jul	Aug	Sep	Oct	Nov	Dec	Jan
Building plans passed	3,20	14,72	2,27	4,28	25,36	-4,86	21,97
Buildings completed	-5,71	23,13	16,69	-24,81	9,31	-8,82	6,66
Retail sales	5,03	6,77	5,12	1,98	3,06	2,82	1,14
Wholesale trade sales	7,20	7,68	3,77	7,02	8,84	5,36	4,13
New vehicle sales	16,93	9,80	3,91	7,48	7,60	1,83	13,89
New passenger car sales	18,16	11,57	4,39	13,02	10,92	4,70	12,36
Electric current generated	-0,72	1,76	-0,53	-2,05	-0,72	-2,86	-3,21
Utilisation of production capacity[2]	…	…	82,18	…	…	82,75	…

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

The official unemployment rate decreased marginally from 25,5 per cent in the third quarter of 2012 to 24,9 per cent in the fourth quarter.[26] Unemployment in South Africa remains a concern and continues to weigh on economic growth prospects. Expected low levels of economic growth in 2013 could contribute to even higher unemployment levels. Factors that could

26 Statistics South Africa, *Quarterly Labour Force Survey* (Pretoria: Statistics South Africa, Quarter 4, 2012).

further contribute to unemployment in 2013 include a lack of specifically required skills, labour demand-and-supply mismatches, and continued low levels of corporate-sector investment. Even in the current low interest rate environment, increasing unemployment levels will affect the affordability of debt repayments negatively. High unemployment levels could further give rise to more incidents of social unrest and increased crime levels that could weigh on the country's attractiveness to foreign investors and tourists.

The current labour disputes, which started in August 2012 in the mining sector and which have since spread to both the transport and agricultural sectors, are also not supporting a turnaround in unemployment trends.

Confidence in the financial services sector

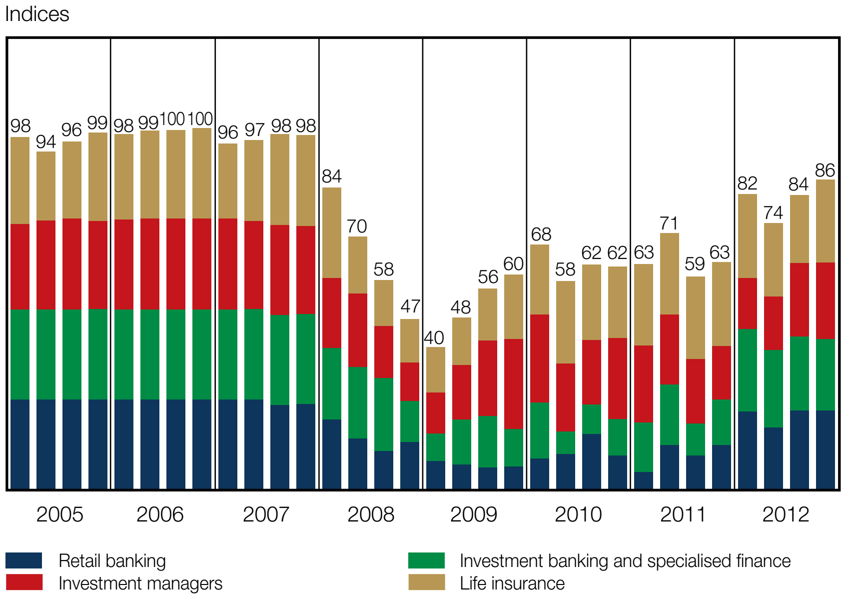
Confidence in the financial services industry continued to improve and remained at relatively elevated levels during the second half of 2012 compared to 2011, reaching its highest level since the onset of the global financial crisis. After increasing from 74 index points in the second quarter of 2012 to 84 index points in the third quarter, the Ernst & Young Financial Services Index recorded a further increase to 86 index points in the fourth quarter of 2012.[27] The level of the Ernst & Young Financial Services Index has been above the current long-term[28] average of 78 index points since the third quarter of 2012. Confidence in retail banking remained unchanged while investment management and specialised finance experienced a marginal decrease because of large cost increases. The increase in the confidence of asset managers from 81 index points in the third quarter of 2012 to 84 index points in the fourth quarter was supported by strong performances in the local equity market. The noteworthy increase in the confidence of the life insurance sector from 75 index points in the third quarter of 2012 to 92 index points in the fourth quarter occurred on the back of strong premium growth, and significant declines in the number of surrenders and lapses.

Compared to the third quarter of 2012, banks that are active in both retail- and investment-type banking activities tightened, on a net basis, lending standards in the fourth quarter. The percentage of retail banks that tightened lending standards during the fourth quarter of 2012 increased to 50 per cent (up from 31 per cent in September 2012).

27 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'.

28 The long-term average is calculated over the past 44 quarters, that is, since the inception of the Ernst & Young Financial Services Index.

Figure 16 Financial Services Index and its components



Source: Ernst & Young

None of the retail banks loosened their lending standards and 50 per cent kept their lending standards unchanged. The number of banks that tightened investment banking lending standards increased from zero to twenty-nine in the fourth quarter of 2012.

Developments in the domestic banking sector

Overview of the banking sector

The market share of the four largest banks remained unchanged at about 84 per cent of total banking-sector assets for the six months to December 2012. The concentration of the sector therefore remained fairly stable as evidenced by the Gini concentration index and the Herfindahl–Hirschman Index (H-index)[29] (Table 2). The annual increase in bank share prices averaged almost 23 per cent over the six months to December 2012 and was supported by ongoing improvement in profitability. The improvement in profitability was mainly due to an increase in non-interest income (9,4 per cent), largely because of increases in net trading income from debt securities and service charges; an increase in net interest income (6,0 per cent) due to increased interest received from term loans; and a decrease in interest expenses from current-account deposits. The banking sector's cost-to-income ratio (also known as the 'efficiency ratio') improved slightly from 53,9 per cent in July 2012 to 53,1 per cent in December 2012.

29 An H-index above 0,18 indicates a high level of concentration.

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

Per cent, unless indicated otherwise

Indicators	2012					
	Jul	Aug	Sep	Oct	Nov	Dec
Market share (top four banks)	83,56	83,64	83,69	83,86	83,93	83,75
Gini concentration index	82,57	82,52	82,27	82,38	82,57	82,49
Herfindahl–Hirschman Index (H-index)	0,185	0,185	0,185	0,186	0,186	0,186
Banks' share prices (year-on-year percentage change)	19,84	28,46	18,61	19,72	24,70	26,38
Capital adequacy						
Capital-adequacy ratio	14,81	14,96	14,97	14,99	15,12	15,84
Regulatory Tier 1 capital to risk-weighted assets	11,87	11,99	12,06	11,97	11,89	12,55
Credit risk						
Gross loans and advances (R billions)	2 638	2 647	2 680	2 685	2 770	2 751
Impaired advances (R billions)[2]	116,86	115,46	114,95	114,88	113,36	112,05
Impaired advances to gross loans and advances	4,43	4,36	4,29	4,28	4,09	4,07
Specific credit impairments (R billions)	43,20	42,64	44,00	44,18	45,95	44,80
Specific credit impairments to impaired advances	36,97	36,93	38,28	38,46	40,54	39,98
Specific credit impairments to gross loans and advances	1,64	1,61	1,64	1,65	1,66	1,63
Profitability						
Return on assets (smoothed)	1,20	1,19	1,17	1,14	1,16	1,26
Return on equity (smoothed)	17,14	16,96	16,52	16,13	16,32	17,54
Interest margin to gross income (smoothed)	50,31	50,40	50,59	50,74	50,84	49,62
Operating expenses to gross income (smoothed)	53,90	53,86	53,97	54,08	53,65	53,06
Liquidity						
Liquid assets to total assets (liquid-asset ratio)	8,50	8,47	8,46	8,59	8,38	8,57
Liquid assets to short-term liabilities	17,49	17,48	17,38	17,66	17,84	17,36
Effective net open foreign-currency position to qualifying capital and reserve funds	-0,01	0,78	1,14	0,62	0,71	0,52

1 Data for revisions were updated on 8 February 2013

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

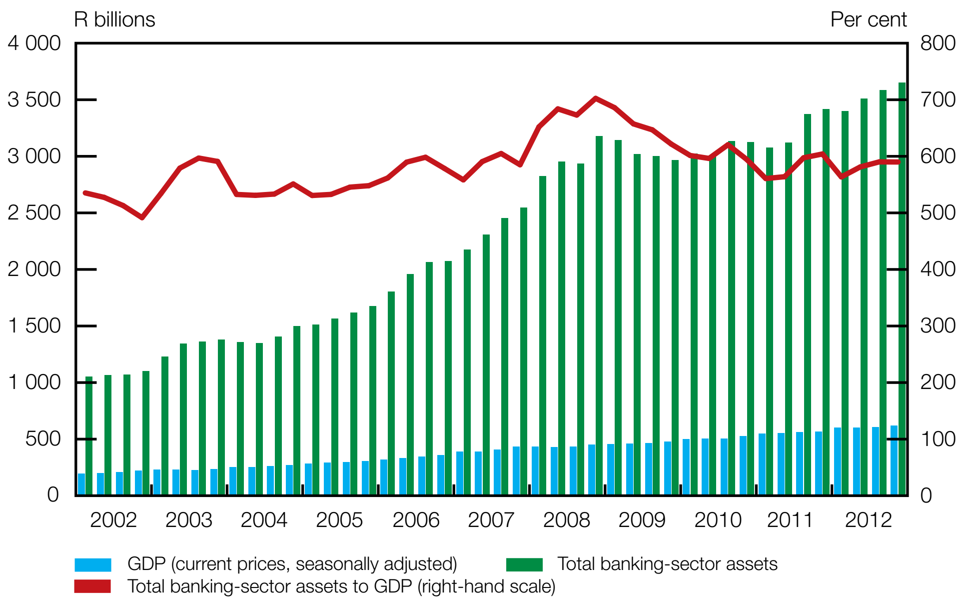
The banking sector remained adequately capitalised during the period under review. The capital-adequacy ratio as at 31 December 2012 was almost 16 per cent, which is well above the minimum regulatory requirement of 9,5 per cent. The majority of the South African banking sector's regulatory capital is comprised of Tier 1 capital, mainly in the form of ordinary shares and defined reserve funds. A marked increase in regulatory capital in December 2012 could be ascribed to appropriations of retained earnings by one of the large banks. Gross loans and advances – the largest asset on South African banks' balance sheets – increased by 5,3 per cent for the six months to December 2012. Most categories of gross loans and advances increased during the period under review, with the main growth being from "other" loans (10,3 per cent), term loans (10,1 per cent), and lease and instalment debtors (6,5 per cent). The quality of the loan books also appeared to have improved somewhat as the banking sector's impaired advances decreased to 4,1 per cent of the total loan book over the six months to December 2012, mainly due to continued write-offs. Specific impairments as a percentage of impaired advances increased to 40 per cent in December 2012 as the banking sector continued to raise specific impairments against the remaining impaired advances.

The ratio of liquid assets to total assets remained stable, averaging about 8,5 per cent during the period under review. There was no significant change in the ratio of liquid assets to short-term liabilities, which suggests that the banking sector's accumulation of liquid assets has slowed somewhat compared to 2011. The sector's effective net open foreign currency position in relation to qualifying capital and reserve funds remained within the limit of 10 per cent of net qualifying capital and reserve funds.

Total banking-sector assets increased by 6,9 per cent year on year to R3 652 billion in December 2012, while the contribution of the financial, real-estate, and insurance and business services industries to nominal GDP[30] increased to almost 10 per cent in the quarter ended December 2012. The ratio of total banking-sector assets to GDP (Figure 17) peaked in December 2009 at 702,4 per cent, following average year-on-year growth of 23 per cent in banking-sector assets from March 2006 to December 2008, well in excess of the 14,2 per cent average growth in nominal GDP during the same period. Since December 2008, growth in banking-sector assets has averaged about 5 per cent year on year, whereas GDP has grown, on average, by 8,5 per cent. As a result, the ratio of banking-sector assets to GDP was 589,9 per cent as at 31 December 2012.

30 'Nominal gross domestic product' refers to the gross value added of the finance, real-estate, insurance and business services industries at market prices, as published in the South African Reserve Bank *Quarterly Bulletin* (Pretoria: South African Reserve Bank, March 2013).

Figure 17 Total banking-sector assets in relation to GDP[1]



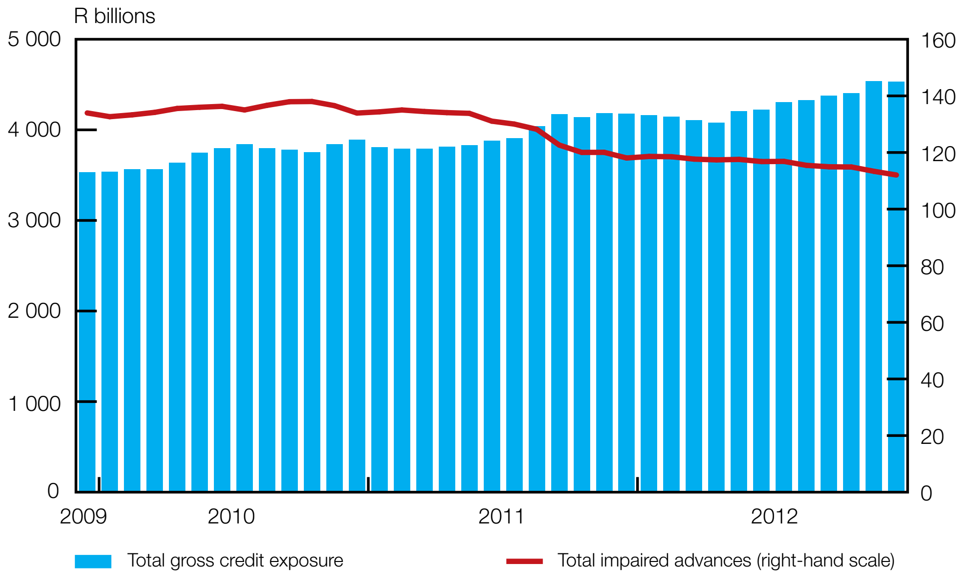
1 'Nominal GDP' refers to the gross value added of the finance, real-estate, insurance and business services industry at market prices

Source: South African Reserve Bank

Total gross credit exposure, that is, the banking sector's credit exposure for both on- and off-balance-sheet facilities, repurchase and resale agreements, and derivative financial instruments, grew by 8,5 per cent year on year in December 2012. The sector's total impaired advances decreased by 5,1 per cent over the same period (Figure 18), suggesting a general improvement in the quality of total credit exposures. However, an analysis of impaired advances of the branches of international banks and other local banks[31] reveals trends different from that of the five largest banks (Figure 19). Whereas the impaired advances of other local banks increased by 33,3 per cent year on year in December 2012, the impaired advances of the five largest banks decreased by 11 per cent. Local banks managed to match the growth rate of impaired advances to their gross credit exposure growth, which increased by 34,1 per cent year on year.

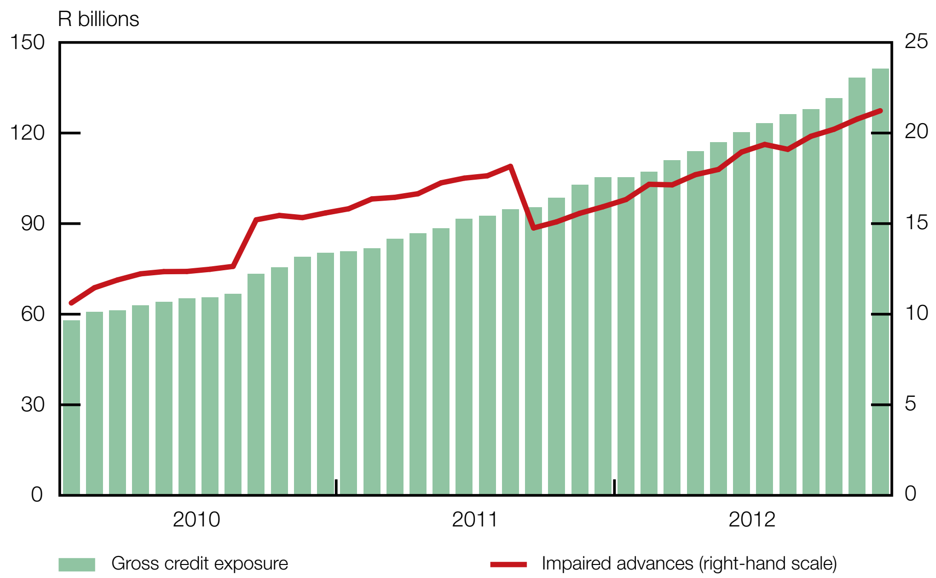
31 'Other local banks' are South African registered banks, excluding the five largest banks, domestic branches of international banks, mutual banks and co-operative banks.

Figure 18 Total gross credit exposure and total impaired advances for the total banking sector



Source: South African Reserve Bank

Figure 19 Gross credit exposure and impaired advances of 'other local banks'[1]



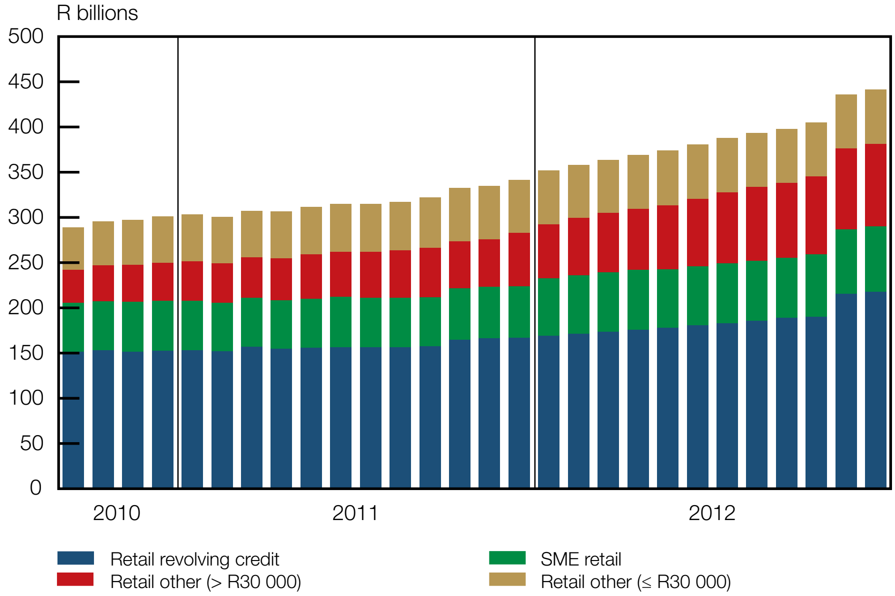
[1] Excluding the five largest banks and branches of international banks

Source: South African Reserve Bank

Banking sector's exposure to unsecured lending

The South African banking sector's total gross unsecured credit exposure[32] increased to approximately R441 billion in December 2012 from R381 billion in June 2012. Almost half of the banking sector's exposure to unsecured lending as at 31 December 2012 consisted of retail revolving credit, which mainly consists of exposure to credit cards. The marked increase in retail revolving credit in November 2012 (Figure 20) was mainly due to Absa Bank Limited's agreement to purchase the accounts and receivables relating to the private label store cards of Edcon (Pty) Limited.[33]

Figure 20 Total gross unsecured credit exposure



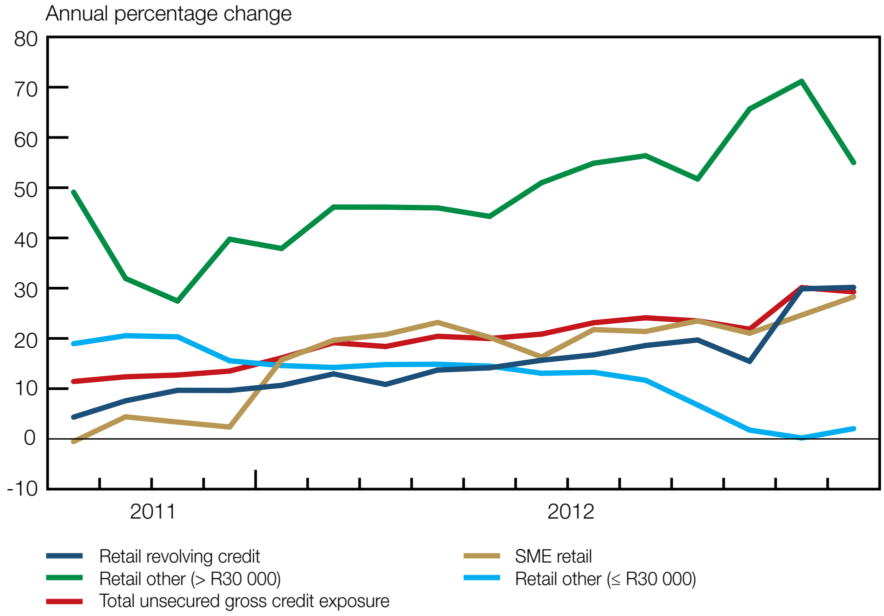
Source: South African Reserve Bank

Measured over a period of 12 months, total unsecured gross credit exposure increased from 20,9 per cent in June 2012 to 29,8 per cent in December 2012, mainly due to the aforementioned transaction. Banks' total unsecured credit exposure as a percentage of the sector's total gross credit exposure therefore increased from 10,2 per cent in June 2012 to 11,1 per cent in December 2012.

32 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 exposure' refers 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.

33 Refer to Absa Bank Limited's Stock Exchange News Service release entitled "Announcement Regarding the Acquisition of the Private Label Store Cards Portfolio of Edcon Proprietary Limited" (Pretoria: Absa, 2 November 2012), http://www.absa.co.za/Absacoza/About-Absa/Investor-Relations/SENS-Announcements.

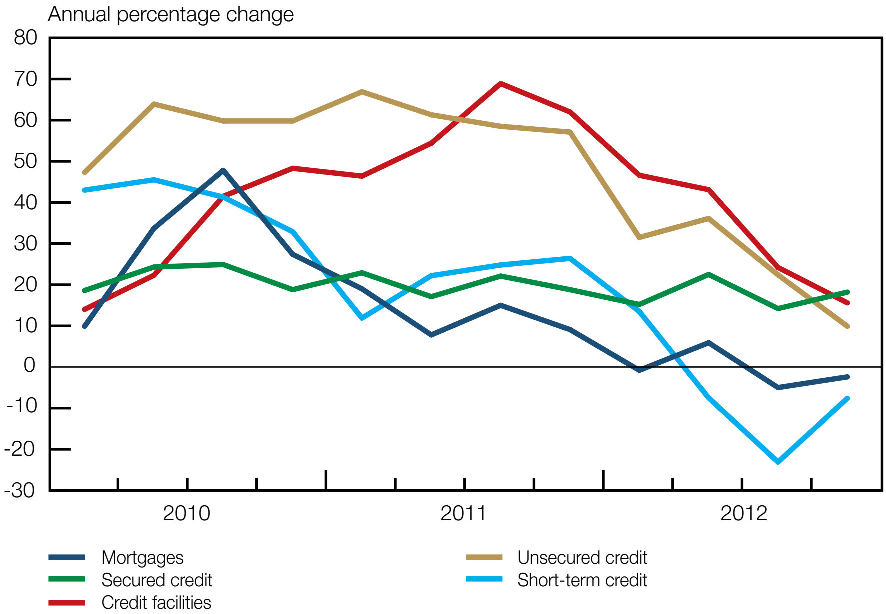
Figure 21 Growth in gross unsecured credit exposure



Source: South African Reserve Bank

Taking into account all credit providers (banks and non-banks), data from the National Credit Regulator (NCR) show that during the fourth quarter of 2012 the growth rates of unsecured credit and credit facilities continued to moderate, while mortgage advances and short-term credit contracted (Figure 22). Compared to other categories of credit, secured credit increased at the fastest pace, namely 18,2 per cent year on year. The annual growth rate of unsecured lending has, however, been moderating since peaking at 67 per cent in the first quarter of 2011.

Figure 22 Categories of credit granted by all credit providers

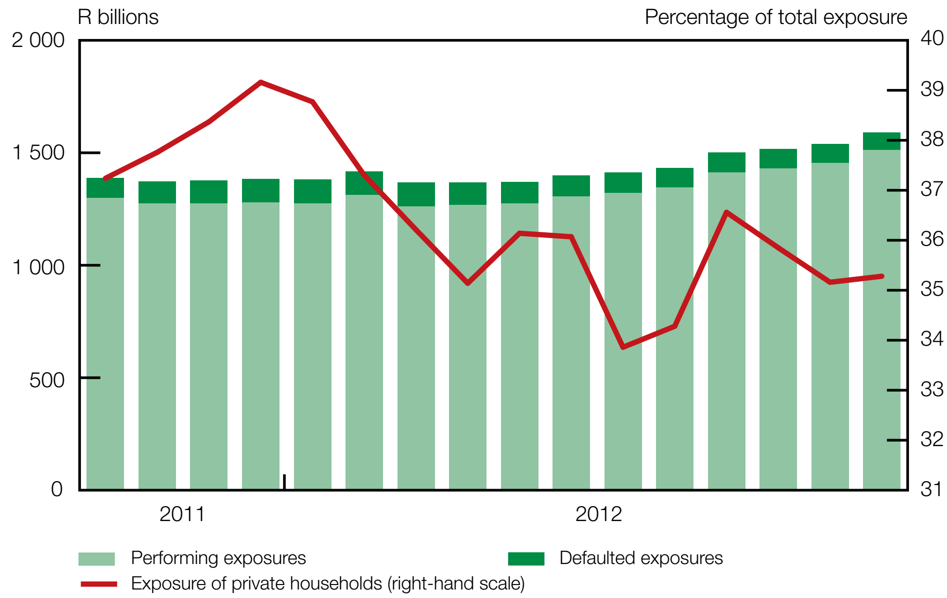


Source: National Credit Regulator

Sectoral and geographic distribution of credit

The distribution of banking-sector credit according to economic sectors remained largely unchanged during the period under review. The largest concentration of total credit exposure (approximately 35 per cent) was to the private household sector, followed by the financial intermediation and insurance sector (24,3 per cent). During the second half of 2012, the exposure of the banking sector to the mining and quarrying sector, and to the agriculture, hunting, forestry and fishing sector remained low and averaged 3,8 per cent and 1,7 per cent respectively of total banking-sector credit exposure. The exposure of the banking sector to private households amounted to R1,5 trillion in December 2012, of which 95 per cent was considered to be performing and only 5 per cent was in default.

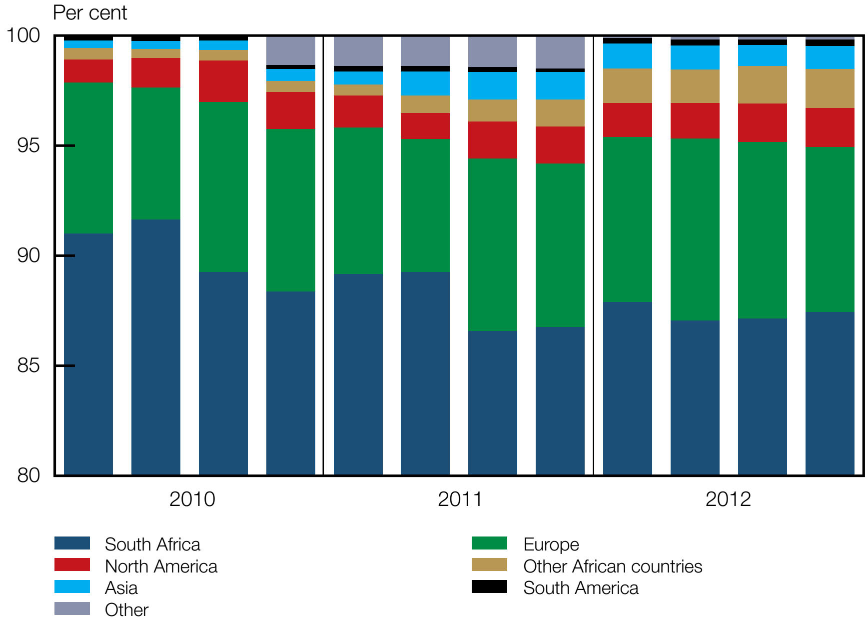
Figure 23 Banking-sector exposure to private households



Source: South African Reserve Bank

The geographic distribution of credit for South African banks has remained fairly unchanged since 2008 (Figure 24), with exposure to the South African economy remaining the most significant. Exposure to European counterparties averaged 7,8 per cent of total credit exposure over the same period. The exposure of domestic banks to the distressed European periphery economies, namely the GIIPS countries, has remained range-bound between 0,08 per cent and 0,13 per cent of total credit exposure since October 2011. Exposure to other African countries and to North America averaged 1,7 per cent during the period under review, although a marginal increase in exposure to other African countries is visible from 2010 onwards.

Figure 24 Geographic composition of the South African banking sector's gross credit exposure



Source: South African Reserve Bank

Non-bank financial institutions

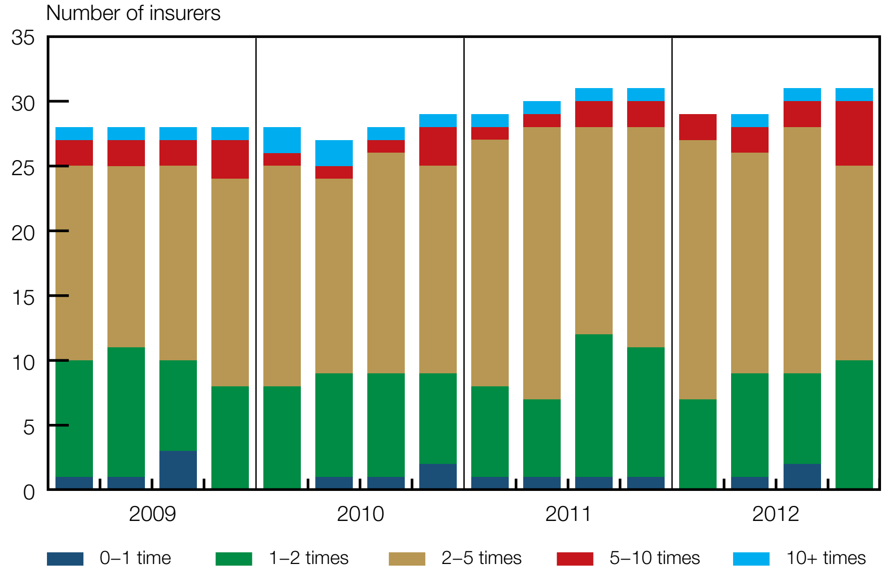
Non-bank financial institutions (NBFIs)[34] play an important role in the financial system by addressing needs not normally focused on by banks. Most NBFIs are actively involved in the securities markets, and in the mobilisation and allocation of long-term financial resources.

34 This discussion on NBFIs covers long-term insurers, short-term insurers, and the pension and provident fund industry.

During the third quarter of 2012 the size of the life insurance industry in terms of assets continued to grow and increased at an annual rate of 15,1 per cent; up from around 10 per cent during the previous quarter. Compared to the size of the domestic economy, the total assets of life insurers amounted to 59,7 per cent of South Africa's GDP. In line with the rally in the domestic equity market, the life insurance industry increased its investment in equities by an annual rate of 18,3 per cent in the third quarter of 2012; up from 10,7 per cent in the previous quarter. The life insurance industry's investment in fixed-income securities increased by 13,3 per cent year on year from 10 per cent over the same period. In the 12 months ended December 2012, the annual increase of 21 per cent in net premiums received suggests that the long-term typical insurers have sufficient funds to meet claims by policyholders.

The basic premise of insurance is the ability to forecast claims and set premiums accordingly to cover actual claims and other operating expenses. The sustainability of insurers would be threatened should that no longer be possible. It is therefore vital that the life insurance industry maintains adequate capital buffers. In December 2012, all 31 long-term typical insurers were covered by a free assets-to-capital-adequacy requirement of more than 1 time, thus having adequate capital to cover more than the regulatory minimum requirement of 13 weeks of operating expenses under adverse financial conditions. In the 12 months to December 2012 the number of new policies written increased by 19 per cent compared to a year before. The share prices of the life insurance industry continued to increase robustly, recording an average annual growth rate of 44,1 per cent during the second half of 2012. After declining to 75 index points during the third quarter of 2012 due, in part, to large annual increases in the number of surrenders (54,8 per cent) and lapses (48,3 per cent), confidence among life insurance companies rebounded in the fourth quarter, recording 92 index points. However, during the fourth quarter of 2012 lapses and surrenders registered annual contractions of 10,6 per cent and 51,4 per cent respectively.

Figure 25 Free assets-to-capital-adequacy requirement[1] of long-term typical insurers[2]



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

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

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

Box 2 Shadow banking monitoring exercise

'Shadow banking' is broadly described by the Financial Stability Board (FSB) as "credit intermediation involving entities and activities outside the regular banking system".[35] Even though credit intermediation through non-bank channels has several advantages, such channels "outside the regular banking system" can become a source of systemic risk and, as such, the appropriate monitoring and regulatory frameworks need to be in place to identify and mitigate the build-up of systemic risks. Initial recommendations to enhance the oversight and regulation of the shadow banking system were proposed by the FSB in October 2011.[36] The FSB also committed itself to conducting annual monitoring exercises to identify, and assess global trends and risks in the shadow banking system.

In 2012 South Africa, together with 25 jurisdictions including the euro area as a whole, participated in the second shadow banking monitoring exercise[37] conducted by the FSB's Analytical Group on Vulnerabilities.[38] The exercise involved an analysis of the national flow of funds and sector balance-sheet data, examining all non-bank financial intermediation[39] data in order to ensure that data gathering and surveillance cover the areas where shadow banking-related risks to the financial system might potentially arise. Following the exercise, a conservative estimate of the size of the global shadow banking system or non-bank financial intermediaries[40] was US$67 trillion in 2011, which is equivalent to 111 per cent of the aggregated gross domestic product (GDP) of the participating jurisdictions. The pace of growth between 2008 and 2011 was, however, slower than before the financial crisis in 2008. Of the participating jurisdictions, the US had the largest shadow banking system in terms of assets (i.e., US$23 trillion comprising 35 per cent of the total global shadow banking system in 2011), while the estimated size for South Africa is significantly smaller (roughly US$270 million in 2011, or less than 1 per cent of the total global shadow banking system).

In South Africa the banking sector, and the insurance and pension fund sector each represents roughly 38 per cent of the share of total financial assets (see Figure A). The share of other financial intermediaries (OFIs) (i.e., the conservative estimate for the shadow banking system) gradually increased from below 12 per cent in 2002 to about 20 per cent in 2012. On average, in the countries that participated in the exercise, the official banking sector comprised between 40 and 50 per cent of total financial assets, with OFIs making up about half of that.

35 Financial Stability Board. "Global Shadow Banking Monitoring Report 2012" (Basel, FSB, 18 November 2012).

36 Report available on www.financialstabilityboard.org/publications/r_111027a.pdf.

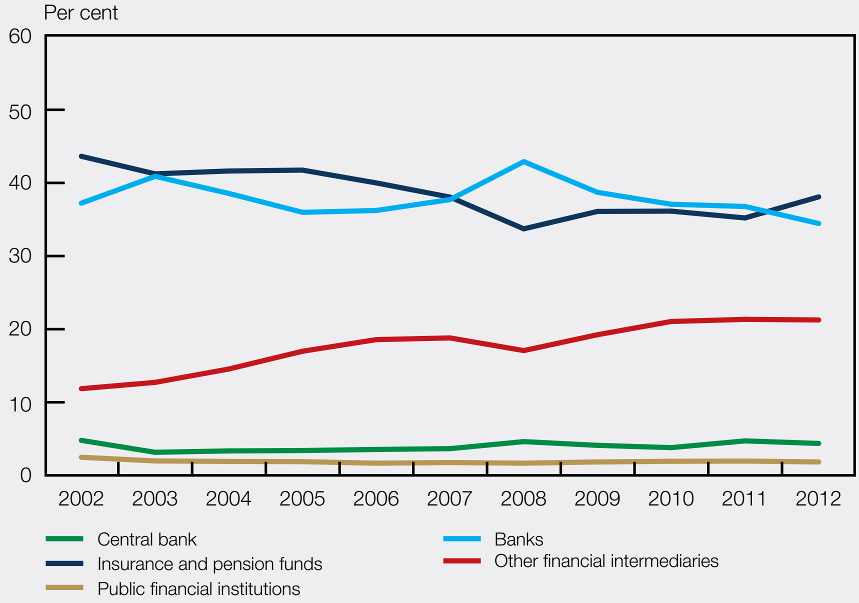
37 The coverage of this monitoring exercise was 86 per cent of global GDP and 90 per cent of global financial assets.

38 The report is available at http://www.financialstabilityboard.org/publications/r_121118c.pdf.

39 Non-bank financial intermediation excludes intermediation by insurance companies, pension funds and public financial institutions.

40 In this exercise the shadow banking system is conservatively proxied by other financial intermediaries (OFIs); a category indicative of flow of funds data comprising financial institutions that are not banks, central banks, public financial institutions, insurance companies or pension funds.

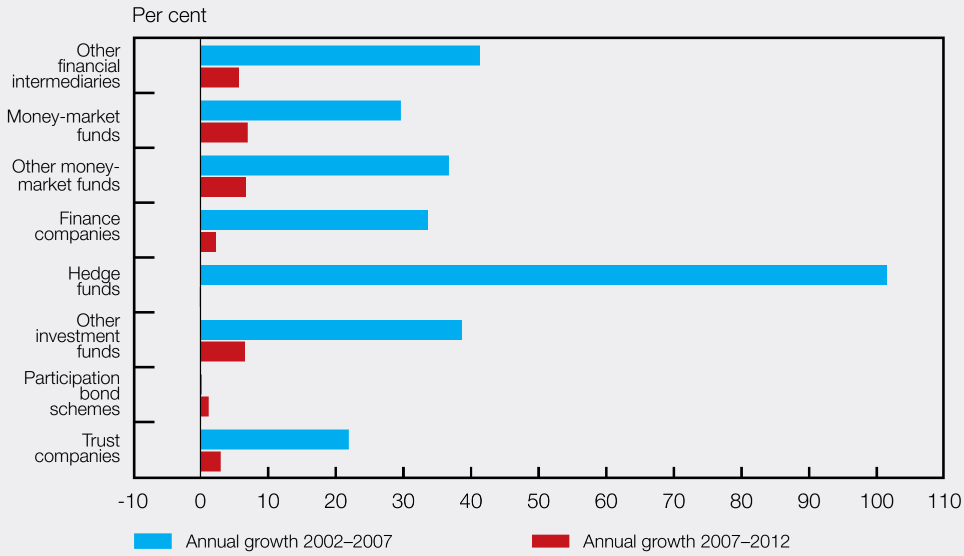
Figure A Share of total financial assets in South Africa



Sources: South African Reserve Bank and Financial Services Board

In line with developments in the global shadow banking system, this industry's assets in South Africa also grew rapidly between 2002 and 2007 (more than 40 per cent per annum) in all the categories. However, following the financial crisis, the annual growth rate fell significantly (approximately 6 per cent per annum between 2008 and 2012).

Figure B Growth rate in total other financial intermediaries and its components



Sources: South African Reserve Bank and Financial Services Board

In order to complement the analysis for the FSB's exercise, credit extension trends in South Africa by banks and NBFIs were compared, and it was concluded that even though credit extended by NBFIs had increased over the past decade, it remained more or less constant as a share of total credit extended at about 6 per cent.

Going forward, the monitoring exercise should benefit from ongoing enhancements. In South Africa and in some of the other jurisdictions, further improvements in data availability and granularity will be essential to capture the nature of the risks and the magnitude of the shadow banking system adequately.

The December 2012 *Special Report on the Results of the Short-term Insurance Industry* showed mixed results with regard to the performance of short-term typical insurers. Net premiums received increased at an annual rate of 4,2 per cent. However, year-on-year contractions of 35,4 per cent and 22 per cent were recorded for underwriting profit, and underwriting and investment income respectively. Over the same period, claims – expressed as a percentage of earned premiums – increased slightly, whereas management expenses and commission, and the median surplus ratio remained almost unchanged.

Table 3 Selected indicators for short-term typical insurers[1]

Indicators	2011	2012			
	12 months	3 months	6 months	9 months	12 months
Net premiums (after reinsurance)[2]	8,2	3,3	-0,3	1,9	4,2
Underwriting profit[2]	20,8	7,8	6,1	-0,8	-35,4
Underwriting and investment income[2]	13,4	9,1	7,3	2,2	-22,0
Claims[3]	58	62	60	60	63
Management expenses and commission[4]	32	31	31	30	31
Underwriting profit[4]	10	8	10	9	6
Underwriting and investment income[4]	16	16	17	15	12
Surplus asset ratio (median)[5]	43	51	52	54	55

1 Calculations based on 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

The assets of pension and provident funds (including both official and private self-administered funds) grew strongly in the first three quarters of 2012, recording an annual growth rate of 16,1 per cent during the third quarter of 2012. Over the same period, the importance of the pension fund industry in the domestic economy – as measured by the ratio of assets to GDP – increased to 75 per cent of GDP in the third quarter of 2012, up from 73,2 per cent during the previous quarter. The role played by pension funds in the financial system and the potential impact on the stability of the financial markets come through pension funds' investment behaviour. The investment of official pension and provident funds in fixed-income securities increased by an average annual rate of 17,8 per cent during the period under review, while investment in equities increased by an average annual rate of 25 per cent over the same period. During the third quarter of 2012 the year-on-year growth rate in private and self-administered pension and provident funds' holdings of bonds increased by 18,9 per cent and investment in equities increased by 13,3 per cent.

Bond, equity and currency markets

The South African bond market generally performed well during the period under review, largely due to improved investor appetite for risk as a result of improving growth prospects in the US and China, and steps taken by the ECB to stave off the risk of disorderly default in the euro area. The global economy remained characterised by ample liquidity provision by major central banks and low interest rates in advanced economies, supporting the search for yield. On the domestic front, the combination of slow economic growth and relatively stable inflation readings (both headline and core) supported market expectations of a prolonged period of low interest rates following the 50 basis-point cut in the repo rate in July 2012. In turn, this low rate outlook enhanced the attractiveness of South African bonds.

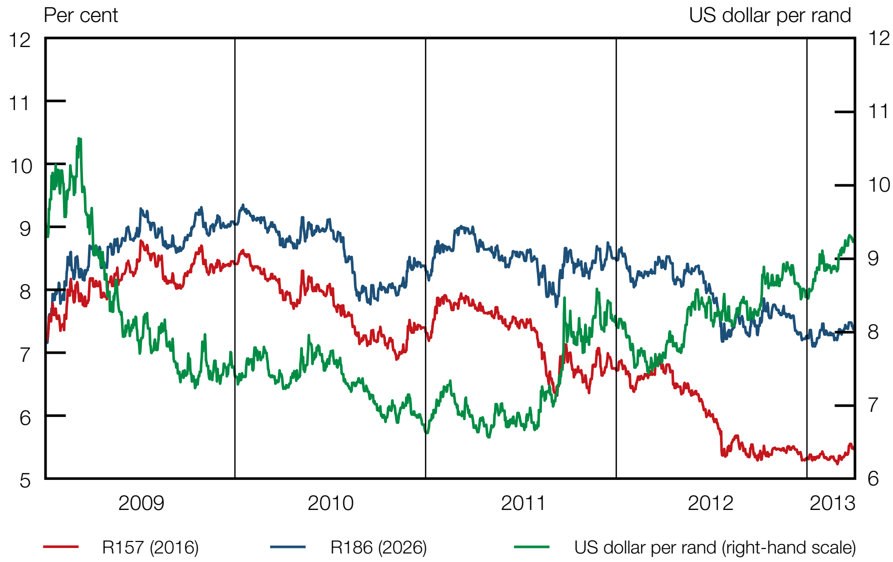
Non-resident purchases of South African government bonds contributed towards the domestic bond market rally in 2012, with the major downward shift in bond yields occurring from early June 2012 to mid-August 2012 as a result of the announcement of South Africa's inclusion in the Citi World Government Bond Index (WGBI) in June 2012. Following the announcement, non-residents purchased a record net R21,7 billion worth of domestic bonds in June 2012.

The pace of non-resident purchases of domestic bonds, however, has slowed since the third quarter of 2012 as in the aftermath of the actual WGBI inclusion on 28 September 2012, inflows by tracker funds[41] were neutralised by the negative impact on investor sentiment from domestic developments. These developments included growing labour unrest due to wage disputes in the domestic mining, agricultural and transport sectors; sovereign credit rating downgrades by the major rating agencies; a wider current-account deficit; a projected widening in the fiscal deficit (eventually confirmed in the February 2013 *Budget Review*); and a depreciating rand.

41 A tracker fund is an index fund that tracks a broad market index or a segment thereof.

Nevertheless, for 2012 as a whole, non-residents purchased a net R88,6 billion worth of domestic bonds, compared with R42 billion in the previous year. Furthermore, while the slower pace of non-resident purchases was confirmed in the early months of 2013, net purchases remained positive, recording a total of R9,4 billion in the first quarter of 2013.

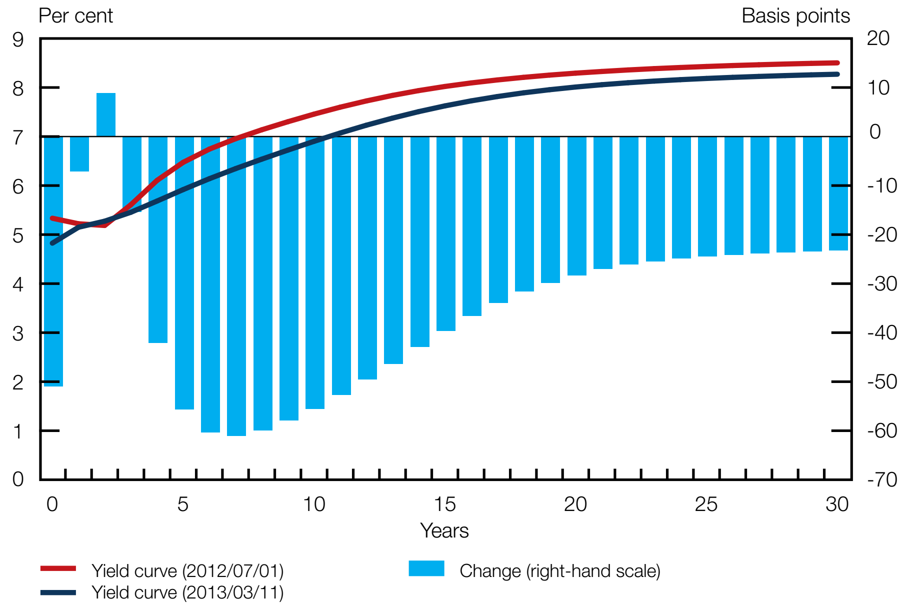
Figure 26 Selected domestic bond yields and the rand



Source: Bloomberg

Domestic bond yields continued to decline in early 2013 and gained support from the reweighting of the JPMorgan Global Bond Index, which resulted in a higher weighting for domestic nominal government bonds and the inclusion of R2023 (2023) and R2048 (2048) bonds in the index. In addition, auctions for nominal bonds in 2013 were well subscribed due to continued robust foreign demand. There were also indications of growing non-resident interest in inflation-linked bonds, which rallied strongly over the period under review and, in most cases, outperformed nominal bonds. As a result, breakeven inflation expectations generally drifted higher, especially for shorter maturities, although still remaining near the upper end of the Bank's 3 to 6 per cent target range.

Figure 27 Bond yield curve



Source: I-Net Bridge

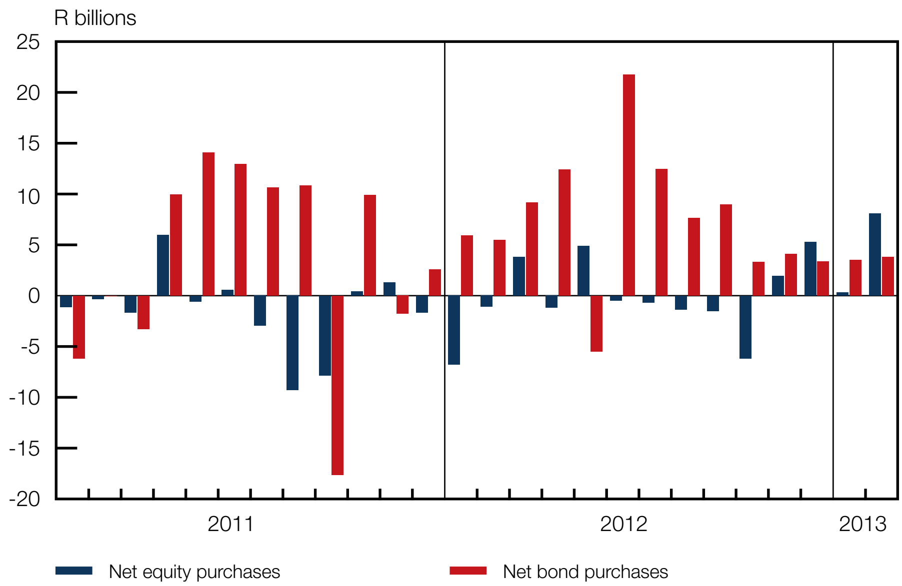
It was announced in the 2013 Budget Speech[42] that government would increase issuance at the longer end of the curve by introducing new nominal bonds maturing in 2030, 2032, 2037 and 2044 in the coming fiscal year, and an inflation-linked security maturing in 2046. While this announcement led to an underperformance of longer-term bonds, the rise in yields beyond the 15-year maturity nonetheless remained modest by historical standards. Government will also raise US$1,5 billion in international markets, including a debut Islamic bond.

42 National Treasury, "2013 Budget Speech" (Pretoria: National Treasury, 27 February 2013).

The South African bond yield curve shifted lower during the period under review due to generally better-than-expected domestic consumer price index data, continued non-resident purchases of domestic bonds and well-subscribed government bond auctions. The South African bond yield curve remains relatively steep both by historical and international standards, though this steepness can largely be explained by the unusually low levels of real short-term interest rates. It also contributes to rendering longer-dated bonds attractive to foreign investors.

Potential rising inflationary pressures stemming from the weaker rand, the wide current-account deficit and continued relatively high funding needs could, over time, weigh on domestic government bond yields, even if these factors have not had a negative impact on bonds so far. The long end of the curve is also at risk from weaker global investor appetite for emerging-market debt, for example, if improving global growth fundamentals entice a shift from bonds to equity investments.

Figure 28 Non-resident purchases of domestic bonds and equities

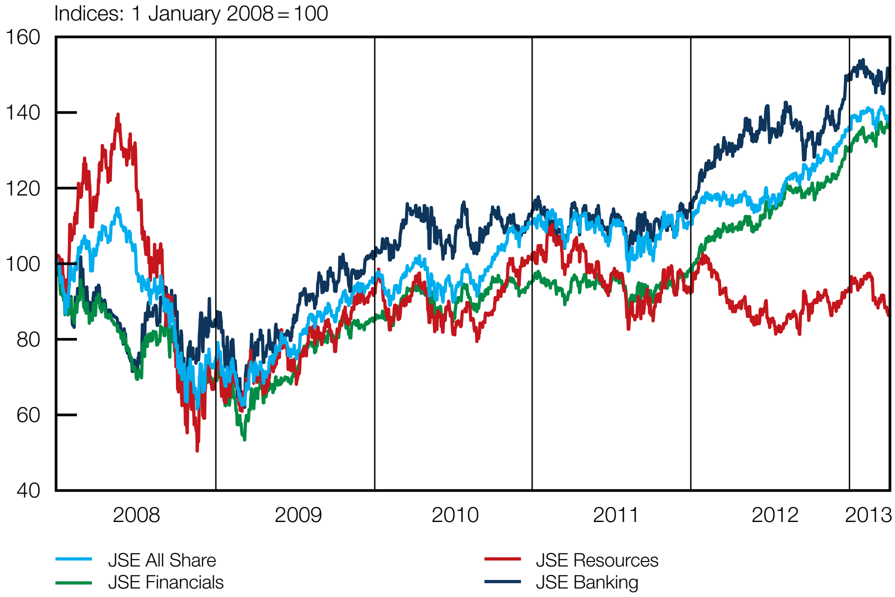


Source: JSE Limited

For most of 2012 non-residents sold domestic equities, largely due to persistent global growth concerns and investors' preference for South African bonds, given South Africa's wide interest rate differential and rising concerns about the medium-term growth potential of the economy. As a result, non-residents sold a net R3,4 billion worth of domestic equities in 2012, compared with net sales of R17,2 billion in 2011.

Since November 2012, however, foreigners began purchasing equities on improving growth prospects in the US and China, and as key global central banks continued to implement accommodative monetary policy. The resultant increased global liquidity was channelled towards global equities, including South Africa, while domestic bond purchases also continued. In the first quarter of 2013, non-residents purchased a net R3 billion worth of domestic equities.

Figure 29 Equity indices



Source: Bloomberg

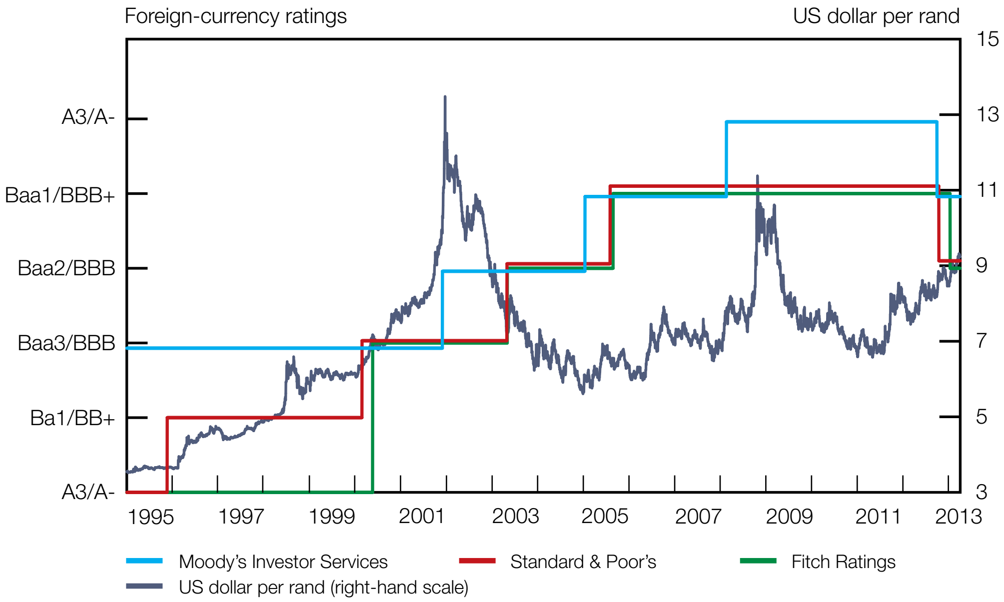
Despite the volatility in non-resident equity transactions, the South African equity market rallied during the period under review, benefiting from the strong performance of emerging equity markets in general due, in part, to increased hopes of further monetary policy stimulus from major central banks. The domestic equity market was also supported by the weaker rand, which boosted the earnings outlook for export-orientated and internationally diversified companies, and by positive earnings growth in a low interest rate environment. Financial and industrial stocks were the major beneficiaries. For most of the second half of 2012, the platinum sector gained on supply concerns, which boosted the international price of the metal after production losses were experienced at certain mines due to industrial action.

However, while the domestic equity market outperformed most emerging markets in the period under review, its rally was kept in check in early 2013; a consequence of downward pressure on commodity prices, a downgrading in South Africa's sovereign credit rating by major rating agencies, and sporadic but persistent wage disputes in the mining, transport and agriculture sectors.

In the first quarter of 2013, the JSE Limited (JSE) All-Share Index (Alsi) increased by about 1,6 per cent. However, when expressed in US dollar terms, domestic equities underperformed compared with most of their emerging-market counterparts. Share prices declined in the domestic gold and platinum sectors following the continued wage disputes, poor mining production, lower-than-expected earnings by the large mining companies and lower international commodity prices. At the same time, retail stocks, which were among the top performers in 2012, lost ground amid concerns over a slowdown in consumer spending, perceptions of shares being overvalued, and company reports reflecting lower sales and profit data.

The depreciating trend of the rand, which started in early March 2012, continued during the period under review. Unrest at Lonmin's Marikana mine in mid-August 2012 saw a sharp depreciation in the rand from R8,10 to R8,40 against the US dollar. The rand depreciated further to R8,93 towards the end of November 2012 as it also felt a negative impact from deteriorating current-account fundamentals and downgrades of the country's sovereign credit rating by the major rating agencies, who indicated that South Africa's fiscal and debt dynamics had deteriorated.

Figure 30 The rand versus foreign-currency ratings



Source: Bloomberg

In 2013 the depreciating trend of the rand continued, largely due to a wider trade deficit, and continued labour unrest in the mining and agricultural sectors. The *2013 Budget Review* had a moderately negative impact on the rand as it highlighted the deterioration in the country's current account, fiscal balance and economic growth outlook. Bond inflows related to the inclusion of domestic government bonds into the Citi WGBI and better-than-expected GDP growth of 2,1 per cent year on year in the fourth quarter of 2012 were not sufficient to prevent further rand weakness.

Therefore, the rand largely disconnected from global risk dynamics and has been mostly reacting to adverse domestic developments since mid-2012. The rand therefore did not benefit from improved global sentiment due to better growth prospects in the US and China, continued monetary policy accommodation by global central banks, favourable carry opportunities, and continued portfolio inflows into South Africa's capital markets. In March 2013 the rand breached R9,20 against the US dollar and had depreciated by about 8 per cent for the year to 31 March 2013.

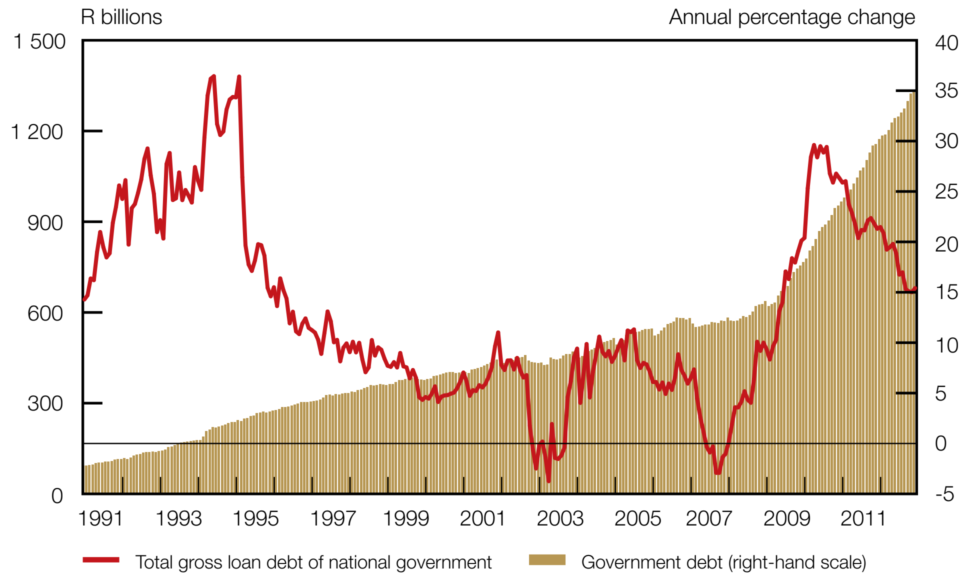
Government finances and financial stability

Prudent management of public finances and public debt is crucial for both macroeconomic and financial stability. The sovereign debt crisis in Europe has underscored the importance of policies that maintain public debt sustainability and the detrimental effects of high levels of public debt on financial system stability. More often than not, high levels of government debt result in ratings downgrades by rating agencies not only for the sovereign, but also for financial institutions as they hold substantial amounts of sovereign debt. Rating downgrades, in turn, have the potential to impact negatively on the attractiveness of a country's bond purchases by non-residents, thereby defeating the country's objective of accumulating foreign-exchange reserves. This weighs heavily on the external value of the domestic currency.

Since September 2008 there has been a marked and consistent increase in total loan debt of the South African government. Over a four-year period, total gross loan debt more than doubled between September 2008 and December 2012 from approximately R602 billion to just over R1,3 trillion. Growth estimates indicate that government debt had increased at an annual rate of 6,4 per cent in the third quarter of 2008, peaked in April 2010 at around 30 per cent per annum and systematically slowed down to 14,4 per cent in the fourth quarter of 2012 (Figure 31). Although the growth rate of government debt of 14,4 per cent is not a major cause for concern, the IMF[43] nevertheless warned that the systematic build-up of public debt levels in South Africa following the global crisis could place some constraint on the government's fiscal space, as a significant increase in debt accumulation could lead to increased funding costs.

43 International Monetary Fund, *Sub-Saharan Africa Regional Economic Outlook Report* (Washington DC: IMF, October 2012).

Figure 31 Gross loan debt of national government

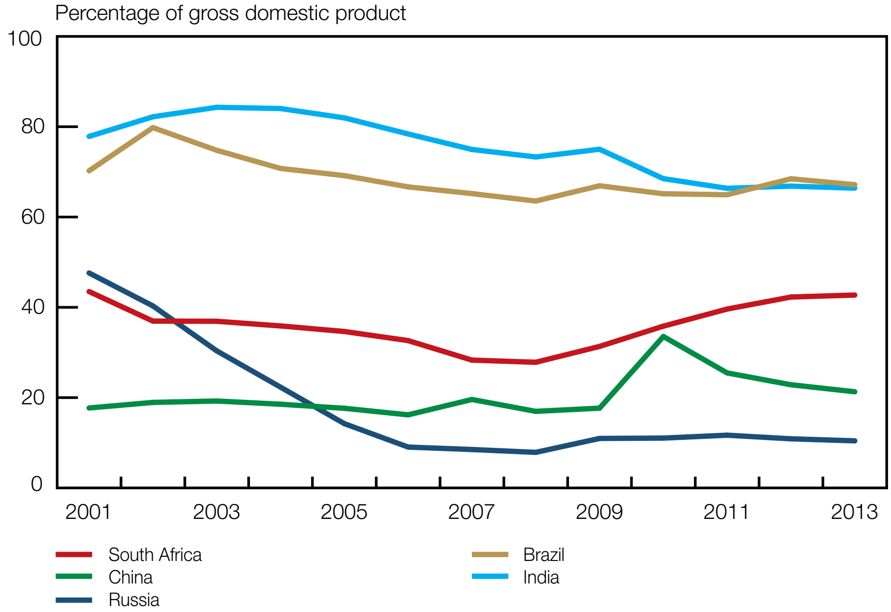


Source: South African Reserve Bank

44 International Monetary Fund, *World Economic Outlook* (Washington DC: IMF, April 2013) and IMF, *From Stimulus to Consolidation: Revenue and Expenditure Policies in Advanced and Emerging Economies* (Washington DC: IMF, 2010).

Since 2008, the growth-driven weakness in revenues and the simultaneous pick-up in the civil service wage bill had a significant impact on government deficits and, in turn, on the ratio of debt to GDP. Compared to the government debt-to-GDP ratios of other BRICS countries, the South African ratio has ranked below those of Brazil and India (consistently between 60 and 70 per cent of GDP), but has consistently been higher than that of China (on average 24 per cent) and Russia (11 per cent) since 2002. With a public debt-to-GDP ratio of 42,3 per cent in 2012, South Africa does not adhere to the proposed IMF benchmark of 40 per cent for emerging markets and developing economies. The IMF has recently projected that in 2013 the ratio would increase further to 42,7 per cent and reach 44,4 per cent during 2014.[44] The pace at which South Africa's debt to GDP ratio has consistently increased since 2008 is therefore a cause for concern considering the overall declining trend in the ratios of its BRICS country counterparts.

Figure 32 Government debt-to-GDP ratios of the BRICS countries[1]



[1] Data for 2013 are IMF estimates

Source: International Monetary Fund

The holding of public debt by financial institutions is yet another important factor that affects the stability of the financial system since elevated levels of government debt could become unsustainable, resulting in vulnerability of the financial sectors to which the government is mostly indebted. During the period under review, domestic financial institutions gradually increased their investment in government debt. Pension and provident funds (both official and self-administered) remained the largest investors in government debt, increasing their holdings to R369,2 billion in the third quarter of 2012, while the insurance industry increased its public debt holdings by 20,6 per cent to R161,9 billion over the same period. In the year to January 2013, local banks increased their holdings of government debt by 18,6 per cent to R185,4 billion.

During the period under review, the three ratings agencies, Moody's Investor Services, Standard & Poor's (S&P) and Fitch Ratings downgraded the South African sovereign credit ratings (long-term foreign currency debt).

Table 4 Sovereign debt ratings for South Africa

Agencies	2012		2013
	3rd qr	4th qr	1st qr
Moody's Investor Services	A3 Negative	Baa1 Negative	Baa1 Negative
Standard & Poor's	BBB+ Stable	BBB+ Stable	BBB Negative
Fitch Ratings	BBB+ Negative	BBB+ Negative	BBB Stable

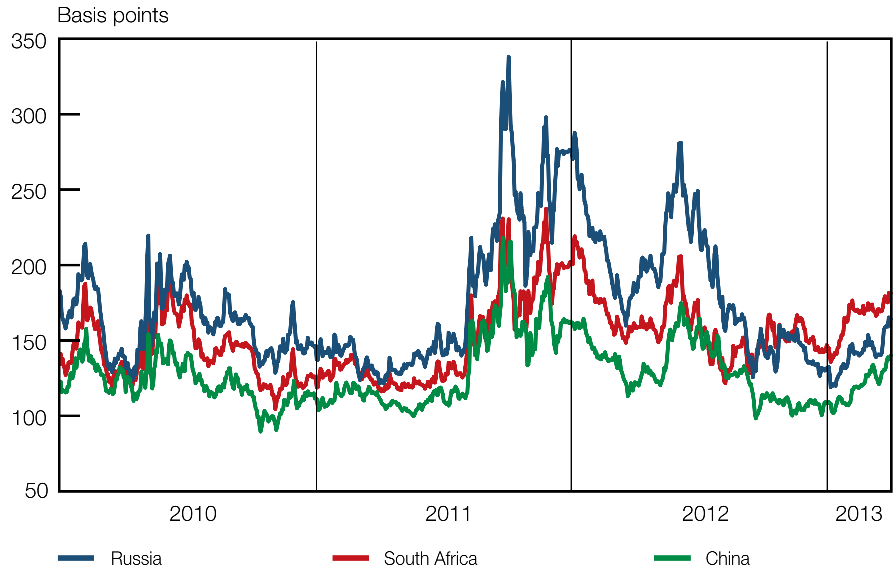
Sources: Moody's Investor Services, Standard & Poor's and Fitch Ratings

Emphasising the severity of these downgrades, the National Treasury (NT) noted in the *2013 Budget Review* that foreign ownership accounted for more than 35 per cent of local bonds, marking the first time that global investor holdings exceeded those of local pension funds. This distribution of ownership implies that if there were a reversal of foreign sentiment, the consequences for the South African bond market that would follow could be severe.

South Africa's budget deficit is also expected to increase in 2013. During the 2013 Budget Speech,[45] it was projected that the budget deficit for 2012/13 would amount to R16,3 billion, approximately 5,2 per cent of GDP, which was higher than the projection of 4,8 per cent of GDP contained in the October 2012 *Medium-Term Budget Policy Statement* (*MTBPS*). The budget deficit is projected to narrow to 3,1 per cent of GDP during the 2015/16 fiscal year, a level consistent with the stabilisation of debt. Should government's borrowing requirements increase, funding costs might increase, which would adversely affect South Africa's ability to raise funds in international capital markets. This is corroborated by the increase in the country's credit default swap (CDS) spreads. In terms of sovereign CDS spreads, South Africa's CDS spread widened notably compared to a selection of BRICS countries.

45 National Treasury, "2013 Budget Speech" (Pretoria: National Treasury, 27 February 2013).

Figure 33 Five-year credit default swap spreads of selected BRICS countries



Source: Bloomberg

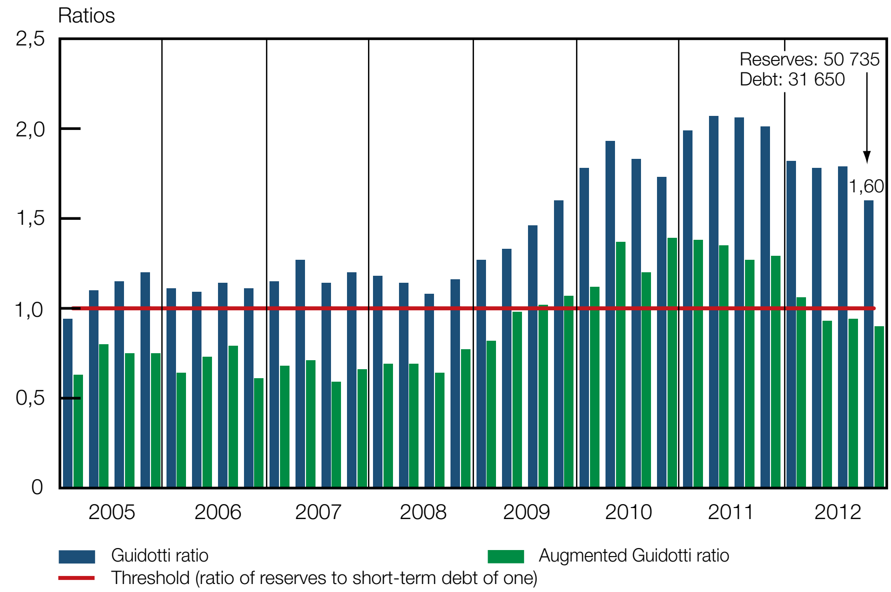
External sector

46 Short-term debt at original maturity.

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

The level of foreign-exchange reserves increased in January 2013 to US$51,2 billion from US$50,7 billion in the previous month. These gains were subsequently reversed, with the level of foreign-exchange reserves dropping to US$50 billion in March 2013. In December 2013 the Guidotti ratio, which measures South Africa's ability to finance its foreign short-term debt[46] in the event of a reversal of foreign capital inflows, declined to 1,6 due to the higher pace of growth of short-term debt (30,4 per cent) relative to the pace of accumulation of foreign-exchange reserves (3,8 per cent). Despite the sharp declining trend, the ratio was still well above the benchmark of one. Therefore, in the event of a sudden reversal of external capital inflows, all foreign short-term external debt due within one year could be financed comfortably. The augmented Guidotti ratio, which also takes into account the current-account deficit, was still below the benchmark of one due to the widening of the current-account deficit. A further widening of the current-account deficit could therefore increasingly deteriorate the ratio and negatively affect South Africa's ability to finance its total external financing requirements in the event of a reversal of foreign capital inflows. With regard to trade finance, foreign-exchange reserves could cover around five months of imports in December 2012. The ratio of foreign-exchange reserves to broad money supply, which measures the extent to which foreign-exchange reserves provide a cushion against domestic capital flight, amounted to 25 per cent in January 2013, which is generally regarded as sufficient for countries with a flexible exchange rate regime.[47]

Figure 34 Reserve-adequacy ratios[1]



1 Figures for reserves and debt in US dollar millions

Source: South African Reserve Bank

Corporate sector

The demand for credit by corporations accelerated in the fourth quarter of 2012. As a percentage of GDP, credit granted to the corporate sector remained at about 50 per cent on average for the second half of 2012. As a percentage of annualised profits, corporate debt remained high and increased to 174,1 per cent in the fourth quarter of 2012, mainly due to a contraction in profits (Table 5).

Table 5 Selected indicators for the corporate sector

Annual percentage change, unless indicated otherwise

Indicators	2011	2012			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Bank credit granted[1]	8,9	12,7	9,0	8,2	10,0
Gross fixed capital formation[2]	8,2	7,2	7,3	6,3	6,1
Credit as a percentage of GDP	47,3	49,3	47,7	49,4	50,8
Credit as a percentage of annualised profits[3]	156,5	162,6	136,1	156,0	174,1
Net operating surplus[4]	12,6	18,1	12,3	0,9	-1,0

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)

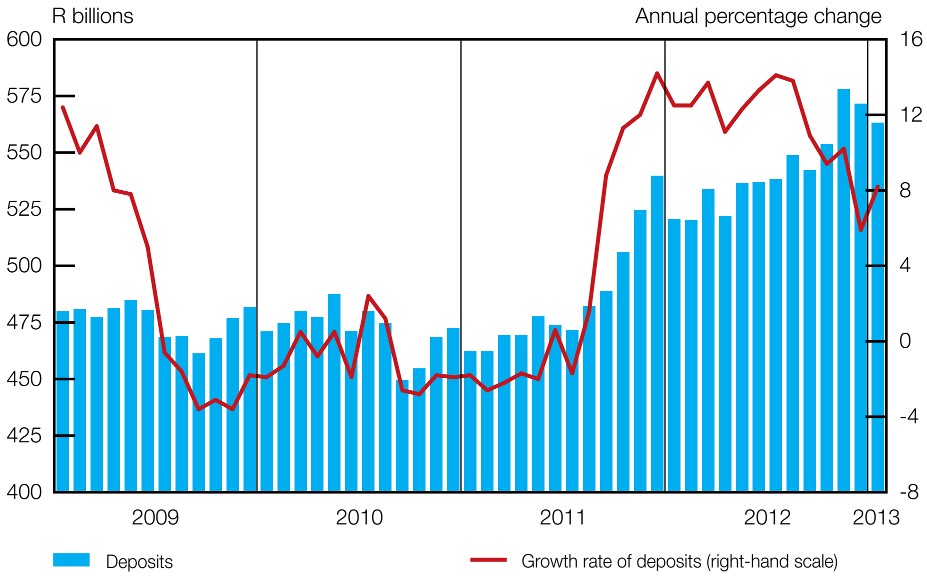
Source: South African Reserve Bank

Fixed investment by the corporate sector remained sluggish in the second half of 2012. A manufacturing survey conducted by the Bureau for Economic Research (BER)[48] indicated that most manufacturers also expected their fixed investment to weaken considerably during the first quarter of 2013 and remain weak for the rest of the year. Expectations were based on increased economic uncertainty in general and the domestic political climate in particular, with the percentage of manufacturers rating the political climate as a constraint increasing by 15 percentage points to 73 per cent according to the BER survey.

48 University of Stellenbosch, "BER Quarterly Analysis of Manufacturing Activity" (Stellenbosch: BER, 19 March 2013).

Moreover, private non-financial corporate-sector deposits with commercial banks remained high, albeit lower than the average rate for 2012, growing by 8,2 per cent year on year in January 2013 to R563,2 billion (Figure 35). Weak corporate-sector investment does not bode well for future employment creation.

Figure 35 Non-financial corporate-sector deposits



Source: South African Reserve Bank

During the first quarter of 2013, business confidence increased to 52 index points from a relatively stable 46 index points during the previous quarter (Table 6). This level implies that only slightly more than 50 per cent of the respondents were satisfied with prevailing business conditions. Four of the sub-indices recorded an improvement in confidence, with confidence of the retail trade sector marking the only decline (from 54 to 50 points) due to weaker sales of non-durable goods and semi-durable goods. Confidence among manufacturers increased by four index points to 42 as the weaker rand exchange rate supported export growth and the raising costs of imports shifted demand to locally produced goods. Overall, the competitiveness of domestic exporters has increased with the confidence of the wholesale and motor-trade sector increasing by 14 and 12 points respectively. Building contractors' confidence remained low. Overall, at 52 index points, business confidence is notably closer to the post-recession peak of 55 during 2011.

Table 6 Business confidence index[1]

Indices	2012				2013
	1st qr	2nd qr	3rd qr	4th qr	1st qr
Business confidence index	**52**	**41**	**47**	**46**	**52**
New vehicle dealers	73	65	79	54	66
Retail traders	61	39	46	54	50
Wholesale traders	48	50	53	57	71
Building contractors	31	24	26	28	30
Manufacturers	47	29	33	38	42

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

Source: Bureau for Economic Research, Stellenbosch University

Household sector

During the period under review, the financial position of households remained relatively healthy. Both disposable income of households and compensation of employees recorded positive growth rates. However, the growth rate of disposable income slowed during the third and fourth quarters of 2012. Households' net worth increased markedly, jumping from 4,8 per cent in the second quarter of 2012 to 12,3 per cent, and 12,9 per cent in the third and fourth quarters respectively. The increase in households' net worth could be attributed to a significant increase in total assets of households. In addition, household saving as a percentage of disposable income remained positive.

The consumer confidence index, as measured by First National Bank (FNB)/BER, dropped by 2 index points to minus 3 index points in the fourth quarter of 2012. The fall in consumer confidence was a result of notable declines in both the expected performance of the economy and the appropriateness of the present time to purchase durable goods. Latest data showed that consumer confidence decreased further during the first quarter of 2013. Expectations of improved financial positions of households increased marginally from 11 to 12 index points. As a result of weak confidence, the growth in real household consumption expenditure remained subdued at 3,1 per cent year on year during the fourth quarter of 2012. Growth in household consumption expenditure could be dampened further in 2013 by rising food, fuel and electricity prices.

Table 7 Selected indicators for the household sector

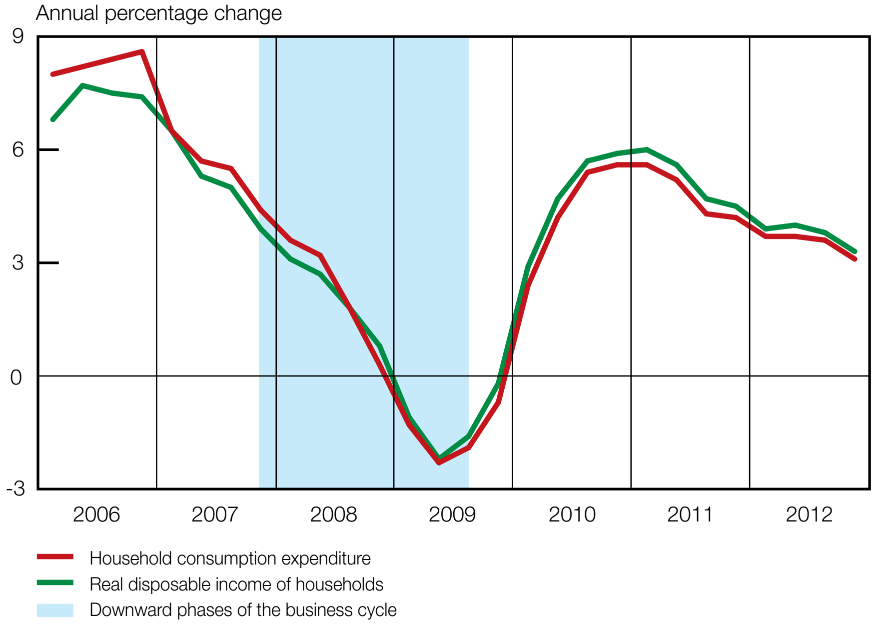
Annual percentage change, unless indicated otherwise

Indicators	2011	2012			
	4th qr	1st qr	2nd qr	3rd qr	4th qr
Financial assets	5,3	6,2	8,2	16,0	14,8
Net worth[1]	4,0	4,3	4,8	12,3	12,9
Total assets	4,7	4,7	5,6	11,7	12,4
Consumer confidence index[2]	5	5	-3	-1	-3
Consumption expenditure to GDP (per cent)	60,2	60,3	60,5	60,2	60,7
Real consumption expenditure	4,2	3,7	3,7	3,6	3,1
Credit extension	6,3	6,5	7,4	9,3	9,9
Savings to disposable income (per cent)	-0,11	-0,06	0,03	0,04	0,04
Debt	7,4	6,6	9,0	9,4	10,2
Debt to disposable income (per cent)	75,0	75,1	75,8	76,2	75,8
Mortgage debt to disposable income (per cent)	43,3	43,0	42,7	42,1	40,9
Debt to GDP (per cent)	45,1	45,3	45,9	45,9	46,1
Debt-service cost[3] to disposable income (per cent)	6,7	6,8	6,8	6,5	6,5
Capital gearing (per cent)[4]	19,9	19,9	20,1	19,7	19,5
Insolvencies[5]	-17,2	-20,8	-35,4	-23,9	-14,9

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

Figure 36 Real disposable income and consumption expenditure



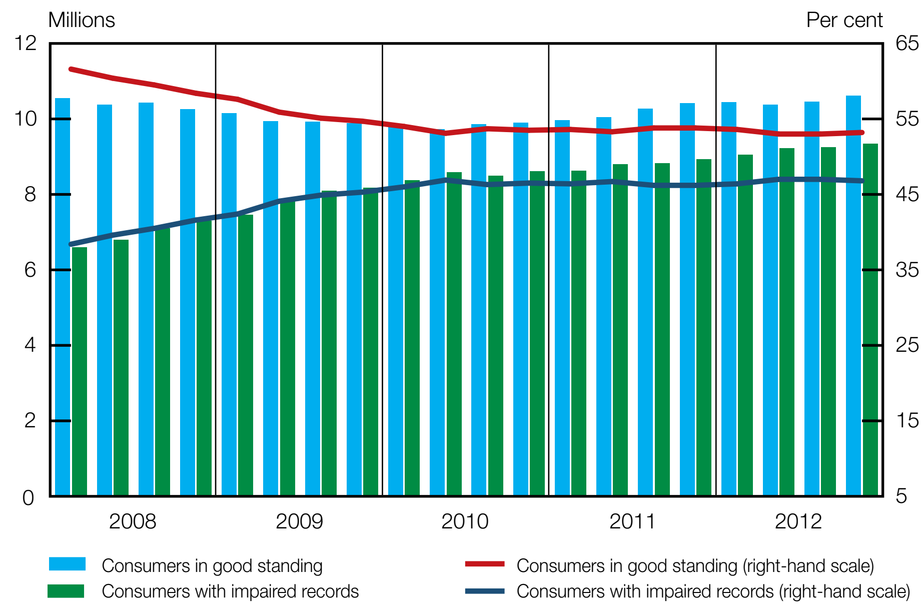
Source: South African Reserve Bank

Households' appetite for debt seems to have increased somewhat during the period under review. The annual growth rate of credit to the household sector increased by 9,3 per cent and 9,9 per cent during the third and fourth quarters of 2012. Total household debt increased by 10,2 per cent year on year. Household indebtedness measured as a percentage of disposable income has remained in a range of between 75 and 77 per cent since the second quarter of 2011. Debt-service costs remained low and constant at 6,5 per cent of disposable income during the review period, supported by the prevailing low interest rate environment.

The increase in the appetite for, and access to, debt by households was confirmed by data from the NCR, which showed that credit-active consumers increased from 19,7 million in the quarter ended September 2012 to 20 million in the quarter ended December. The increasing interest in debt was further confirmed by the number of enquiries at credit bureaux in respect of consumers seeking credit, which increased from 15,9 million to 17,2 million over the same period. Moreover, the number of applications for credit also increased, while the number of credit applications that were rejected decreased slightly, from 53,6 per cent to 53,3 per cent of total applications.

Of the total credit-active consumers, the number of consumers with impaired records increased to 46,8 per cent (9,3 million consumers) in the fourth quarter of 2012 and consumers in good standing increased to 53,2 per cent (10,62 million consumers). Of the consumers who had impaired records, 20,1 per cent were three months or more in arrears; 12,7 per cent were consumers with adverse listings; and 13,9 per cent of consumers had judgments and administration orders against them. It is therefore a concern worth highlighting that the proportion of impaired records has consistently increased by approximately 10 per cent since the start of 2007.

Figure 37 Credit standing of consumers

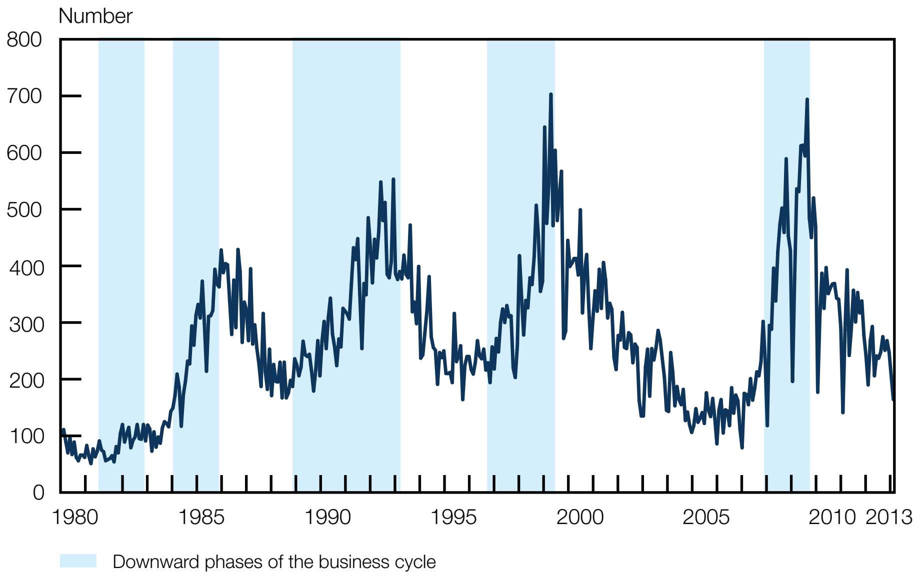


Source: National Credit Regulator

According to data from the NCR, banks continued to dominate the consumer credit market with a share of 80 per cent (R95,9 billion) of total credit granted for the quarter ending December 2012. This represents an annual increase in new credit granted by banks of 7,4 per cent.

Nevertheless, in the year to December 2012, the number of insolvencies contracted by 14,9 per cent, as the low interest rate environment further afford households the opportunity to continue repairing their balance sheets.

Figure 38 Insolvencies



Source: Statistics South Africa

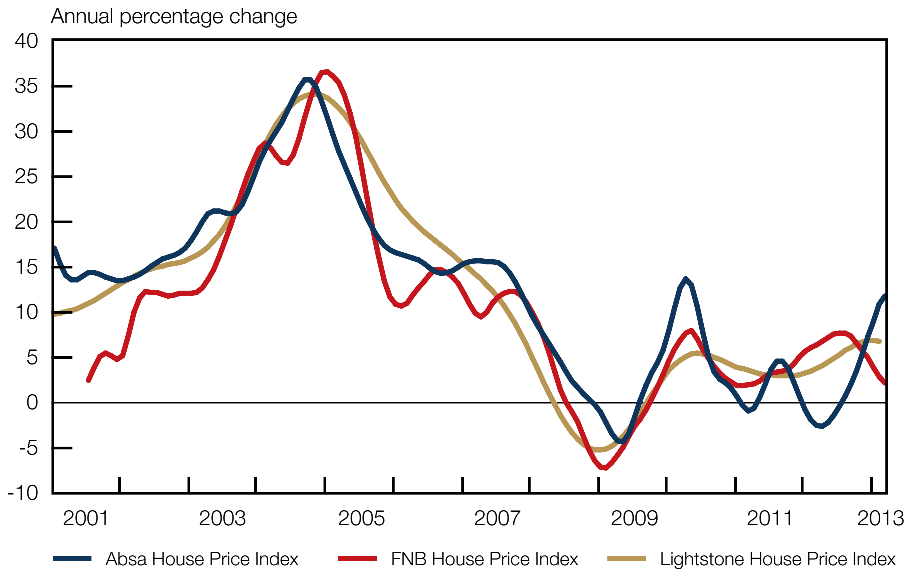
Residential real-estate sector

Residential real-estate market activity remained subdued during the period under review, with the result that mortgage advances also slowed down further from 2,0 per cent in November 2012 to 1,9 per cent in December 2012 and to 1,8 per cent in January 2013. Real interest rates on mortgage advances, which have been constant at about 8,5 per cent since March 2012, dropped to 7,1 per cent in January 2013. As a portion of household disposable income, mortgage debt decreased during the period under review but remained high at 40,9 per cent (Table 7).

The various house price indices continued to display mixed signals in the second half of 2012. The latest data for the Absa House Price Index reflected a strong annual increase of 10,2 per cent in February 2013, consistent with the upward trend in house prices since August 2012. The Lightstone Extended House Price Inflation index[49] also increased, recording an annual rate of increase of 6,9 per cent in December 2012. Conversely, the FNB House Price Index recorded a slowdown in growth to 2,6 per cent in February 2013, down from 3,9 per cent in January 2013.

49 Lightstone, *Property Indices Report* (Johannesburg: Lightstone, 6 March 2013).

Figure 39 House price indices[1]



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 R3,8 million or less in 2013 (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 an HP smoothing function. An index month begins seven days before the end of the previous month to seven days before 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

50 First National Bank, FNB/BER Building Confidence Index (Johannesburg: FNB, 6 March 2013).

According to the FNB/BER Building Confidence Index,[50] activity and profitability in the building and construction sector remained sluggish. The slow increase in confidence was ascribed to the fact that approximately 70 per cent of the survey respondents rated the prevailing business conditions as "unsatisfactory".

The most notable recoveries in confidence were made by retailers of building materials (34 index points), subcontractors (13 index points) and main contractors (2 index points), though it is important to note that the confidence among retail merchants possibly included a large seasonal component, since fourth-quarter confidence is typically expected to be much higher than the third quarter. The remaining indices fell, with architects losing 1 index point, manufacturers of building materials (minus 6 index points) and quantity surveyors (minus 10 index points). The non-residential sector outperformed the residential sector among main contractors and subcontractors, although the residential business recorded the biggest improvement among main contractors.

Financial infrastructure and regulation

This section considers developments in the domestic and international financial infrastructure and regulatory environment. Firstly, an update is provided of the progress South Africa has made with the implementation of the twin peaks financial regulation framework. Secondly, a brief overview is given on a selection of the most recent financial, legislative and infrastructural developments that might impact on the domestic financial sector. This is followed by an update on the review of the processes and procedures in determining the Jibar; highlights of the recent FSB peer review of South Africa's financial regulatory infrastructure; an analysis of the FSB's global thematic review of risk governance across jurisdictions; and the relevance of developments around the global legal entity identifier (LEI) for South Africa. In conclusion, South Africa's implementation of the Basel III framework is provided.

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

Implementation of a twin peaks model of financial regulation in South Africa

On 1 February 2013 the NT published a policy document entitled "Implementing a Twin Peaks Model of Financial Regulation in South Africa" (the implementation document).[51] The implementation document provides detailed information on the proposed twin peaks regulatory reform project and its implementation. The implementation document follows the publication of a policy document entitled "A Safer Financial Sector to Serve South Africa Better" in February 2011.[52] This document is aimed at maintaining and enhancing financial stability; improving consumer protection and market conduct; promoting financial inclusion; and combating financial crime.

51 (Pretoria: National Treasury, 1 February 2013). The twin peaks regulatory reform project stems from the Minister of Finance's February 2011 announcement of the proposed changes to the South African financial regulatory framework (http://www.treasury.gov.za/public%20comments/default.aspx).

52 The National Treasury, "A Safer Financial Sector to Serve South Africa Better" (Pretoria: National Treasury, February 2011).

Main proposals

The main themes that emerge from the implementation document include the structure and objectives of the prudential and market conduct regulator; the governance framework; financial stability oversight; crisis management; and enforcement of the regulatory requirements under the twin peaks model. According to the implementation document, it is envisaged that the Bank would take a leading role in promoting financial system stability and would therefore become the systemic regulator. The prudential regulator would be housed in the Bank, and be responsible for the prudential regulation and supervision of banks and insurers. The Financial Services Board would be responsible for market conduct regulation with the aim of protecting consumers and promoting confidence in the financial system.

The already-established Financial Stability Oversight Committee (FSOC) would play a pivotal role in co-ordinating efforts to maintain financial stability and mitigating and reducing the impact of systemic risk. The FSOC, which would be chaired by the Governor of the Bank, would be composed of the current members of the Financial Stability Committee (FSC), representatives of the prudential and market conduct regulators, and observers from the NT. Its roles would include:

- overseeing financial stability, identifying risks to the financial system and responding to them appropriately; and
- advising on crisis management and resolution, while taking into consideration the role of other stakeholders such as the Minister of Finance and the resolution authority.

Additional responsibilities

The implementation of the twin peaks regime will result in additional responsibilities for the Bank, one of which includes the mandate to regulate, supervise and oversee key financial market infrastructures (FMIs). The supervision of conglomerates would also be crucial for the twin peaks regulatory framework as some financial groups include banking, insurance and other business. The responsibility for co-ordinating conglomerate supervision would be developed as a financial stability function of the Bank in conjunction with the market conduct regulator.

Crisis management and resolution

Since the onset of the global financial crisis, the resolution of systemically important financial institutions has come under the spotlight. The Bank will be the resolution authority because of its financial stability mandate. The resolution framework will assist in reaching the Bank's financial stability objectives as opposed to focusing on individual institutions. This will entail applying the resolution framework to all elements of the financial system that are systemically significant, including banks, NBFIs and other significant participants in the financial system.

The way forward

The twin peaks model of regulation will be implemented using a phased approach. The first phase, scheduled to take place during 2013/14, will involve the legislative processes to support the implementation of the regulatory framework, including the transfer of resources to the prudential and market conduct regulators. The second phase is expected to take place over a longer period, and it involves harmonisation of the regulatory framework and the supervisory systems of the two peaks. The period of public consultations was concluded on 8 March 2013.

The Regulations relating to Banks

On 14 December 2012, the NT published new amendments to the Regulations, which took effect on 1 January 2013. The Regulations enabled the implementation of the provisions of the Basel III framework in South Africa.[53] This implementation will be phased in until 2018, in line with the timelines determined by the Basel Committee.

53 The Regulations relating to Banks are available at www.reservebank.co.za.

Financial Markets Act, 2012 (Act No. 19 of 2012)

The Financial Markets Act, 2012 (Act No. 19 of 2012) (the FM Act) was promulgated in the period under review. The FM Act replaces the Securities Services Act, 2004 (Act No. 36 of 2004) and aims to increase confidence in the South African financial markets by requiring that securities services be provided in a fair, efficient and transparent manner. It also aims to foster and contribute to the maintenance of a stable financial market environment; promote the protection of regulated persons and clients; reduce systemic risk; and to promote the international and domestic competitiveness of securities services in South Africa. Meanwhile, subordinate legislation in the form of board notices has been published for public comment by the Financial Services Board on 15 March 2013. The comment period closed on 15 April 2013.

Credit Rating Services Act, 2012 (Act No. 24 of 2012)

In its 27 October 2010 report entitled "Reducing Reliance on Credit Rating Agencies", the FSB encouraged national authorities and regulators to review references to credit rating agencies' ratings in national laws and regulations so as to reduce mechanical reliance on these ratings and, instead, to encourage market participants to form their own assessments as to the creditworthiness of counterparties.[54]

The September 2012 issue of the *Financial Stability Review*[55] reported on the progress made in reducing reliance on credit ratings and improving oversight of credit rating agencies in South Africa. The Credit Rating Services Act, 2012 (Act No. 24 of 2012) (the CRS Act) was promulgated in the period under review and its effective date was 15 April 2013. The CRS Act provides for the registration of credit rating agencies, the regulation of certain activities of credit rating agencies, conditions for the issuing of credit ratings, and rules on the organisation and conduct of credit rating agencies. The CRS Act also provides for the powers of the Registrar of Credit Rating Agencies, enforcement actions and the remedies available to the regulator. In addition, it deals with the endorsement of external credit rating agencies, and the liability and independence of registered credit rating agencies. The Financial Services Board published draft rules of the CRS Act for public comment on 15 March 2013. The rules clarify the requirements of the CRS Act and set out the process for the registration of credit rating agencies in South Africa.[56]

54 The FSB report entitled "Principles for Reducing Reliance on CRA Ratings" is available at http://www.financialstabilityboard.org/publications/r_101027.pdf.

55 Pretoria: South African Reserve Bank. September 2012.

56 The draft rules can be found at www.fsb.co.za.

Update on the Johannesburg Interbank Average Rate review

In 2011 a review of the processes and procedures on how to determine domestic money-market reference rates, including the Jibar, was initiated. This review happened to coincide with the criminal investigation that had been launched into alleged rigging of the London Interbank Offered Rate (Libor) by key global banks as highlighted in the September 2012 issue of the *Financial Stability Review*.[57]

The review process of the Jibar involved consultations with the commercial banks represented on the contributing panel, the JSE, Strate, ASISA, regulators and the NT. Once the review had been completed, the Bank published two documents on 16 November 2012. The first document, entitled "A Review of the Rate-setting Process of the Johannesburg Interbank Average Rate as an Interest Rate Benchmark",[58] presented the findings of the review. The review indicated that while there were no fundamental concerns around the Jibar determination process, certain aspects of the process could benefit from enhancements and formalisation, more specifically the governance process. Therefore, the review also contained recommendations that would contribute towards strengthening the governance process for determining Jibar rates, and maintaining their credibility.

The second document, entitled "The Jibar Code of Conduct, Governance Process and Operating Rules" (Jibar Code of Conduct),[59] was published for comment on 16 November 2012 and then, in its final form, on the implementation date of 1 March 2013. The final version serves to formalise the recommendations of the review project. The contributing panel for the Jibar consists of Absa Bank, FirstRand Bank, Investec, Nedbank and Standard Bank, who have formally agreed to be bound by the Jibar Code of Conduct.

The Bank will be responsible for supervising compliance with the terms and conditions of the Jibar Code of Conduct. This will be done through the Reference Rate Oversight Committee (RROC), chaired by a deputy governor of the Bank, and consists of representatives of various departments in the Bank and on the Financial Services Board. The respective roles of the JSE as the calculation agent and the Financial Markets Department of the Bank as the authority responsible for the post-publication surveillance of Jibar have also been formalised. The Jibar Code of Conduct became effective on 1 March 2013 and constitutes the final procedures for the Jibar rate-setting process. The Bank will continue to monitor evolving international best practice and align the Jibar Code of Conduct where appropriate.

The 2012 Financial Stability Board peer review of South Africa

As a member of the FSB, and as part of its commitment to the FSB's mandate of financial stability through promoting effective implementation of international financial standards, South Africa volunteered to undergo a country peer review. The review took place in the second half of 2012, during which time South Africa was contemplating a revision of its financial regulatory architecture. The results of the peer review were publicly released in February 2013.[60] These country peer reviews focus on the implementation and effectiveness of regulatory, supervisory and other financial-sector standards and policies agreed to by the members of the FSB. The review of South Africa covered two areas relevant to financial stability, namely (i) interagency co-ordination and the regulatory structure, and (ii) the regulation of over-the-counter (OTC) derivatives markets. Both topics currently subject to financial reform were initially identified in South Africa's 2008 Financial Sector Assessment Program (FSAP) and the 2010 Report on the Observance of Standards and Codes (ROSC) in banking, securities and insurance-sector standards.

South Africa's peer review was only the seventh country peer review conducted by the FSB and the first using the revised objectives and guidelines for the conduct of peer reviews set forth in the December 2011 *Handbook for FSB Peer Reviews*.[61] The Review Report (the Review) noted the steps that the South African financial authorities had taken in recent years to address the FSAP and ROSC recommendations regarding the enhancement of co-ordination and exchange of information between domestic regulatory agencies and the adoption of a three-phased approach to the implementation of OTC derivative regulatory reforms. The Review welcomed

57 Pretoria: South African Reserve Bank, September 2012.

58 http://www.resbank.co.za/Publications/Detail-Item-View/Pages/Publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist= 21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=5292.

59 http://www.resbank.co.za/Publications/Detail-Item-View/Pages/Publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=5291.

60 http://www.financialstabilityboard.org/list/fsb_publications/tid_141/index.htm.

61 http://www.financialstabilityboard.org/list/fsb_publications/tid_141/index.htm.

the move towards a twin peaks regulatory structure, and suggested that it could be an opportunity, among other things, to streamline supervisory responsibilities and elevate market conduct supervision. However, the Review also highlighted some of the practical challenges of integrating staff from different agencies.

The Review made several recommendations in relation to interagency co-ordination, the regulatory structure and OTC derivatives market reform. With regard to the first two matters, the Review proposed the following actions to be taken:

- Authorities are encouraged to establish clear implementation timelines for the twin peaks reform project.
- The Bank and the transformed Financial Services Board, as part of the twin peaks project, are advised to revise their memorandum of understanding to delineate clearly respective responsibilities, and outline mechanisms for information sharing, ensuring co-operation and resolving policy disagreements.
- The authorities are encouraged to incorporate the NCR into the Market Conduct Regulator. The aim is to ensure effective market conduct regulation and to avoid regulatory overlaps or gaps.
- The South African authorities are encouraged to move forward swiftly with the adoption of the final FSOC, and to clarify its mandate, powers and accountability arrangements. It was also suggested that these measures should help overcome any FSOC limitations.
- The authorities are encouraged to consider the establishment of a council of financial regulators with broad membership, including relevant agencies outside the NT's ambit, to share information and discuss financial-sector policy issues.

The body tasked with implementing the twin peaks system in South Africa, the Financial Regulatory Reform Steering Committee, had in its deliberations raised similar sentiments to most of the points highlighted in the Review. It is possible that the raising of these issues in the Review will give impetus to the process of implementing the twin peaks financial regulatory framework in South Africa.

With regard to OTC derivatives reforms, the Review made the following recommendations:[62]

- The authorities should publicly announce a date on which reliance on incentives to migrate contracts into central clearing arrangements would be reviewed. It is expected that such an announcement would signal to the market a clear intent on the part of the authorities to assess the effectiveness of incentives to encourage central clearing.
- The authorities, who would have access to data from trade repositories, should then be able to determine whether incentives are resulting in all standardised contracts being cleared centrally.
- The authorities should determine whether the trading of appropriate contracts on exchanges or through electronic trading platforms could be encouraged or mandated in a timely fashion.
- The Financial Services Board and the Bank should be given the ability to levy fines on licensed FMIs for failure to comply with substantive standards of the FM Act or their licence conditions.
- Licensed FMIs should be subject to adequate recovery and resolution requirements.[63]
- The Financial Services Board should be ready to supervise all facets of the OTC derivatives market in the event that the Bank lacks legal supervisory powers at the time when the market is brought within the regulatory ambit via the FM Act.

As with similar reviews in the recent past, the South African financial authorities will study both sets of recommendations carefully. It is expected that in terms of its commitment to international financial standards, South Africa will implement the recommendations in a manner and a timely fashion that are appropriate to national circumstances and conducive to enhancing domestic financial stability.

62 Pages 8 and 18–26 of the Review.

63 The report argued that while the FM Act bestowed adequate powers on the Financial Services Board, it did not impose these requirements clearly by its terms.

Global Financial Stability Board thematic peer review of risk governance

On 12 February 2013, the FSB published a report on the thematic peer review of risk governance across a number of jurisdictions.[64] The report takes stock of risk governance practices at both national authorities and firms; notes progress made since the financial crisis; identifies sound practices; and offers recommendations to support further improvements.

64 http://www.financialstabilityboard.org/list/fsb_publications/tid_141/index.htm.

The recent global financial crisis exposed a number of risk governance weaknesses in major financial institutions relating to the roles and responsibilities of their corporate board of directors (Board), the firm-wide risk management function, and the independent assessment of risk governance. According to the FSB, in the absence of appropriate checks and balances provided by boards, a culture of excessive risk-taking and leverage was allowed to gain a foothold in many of these firms.

The FSB found that since the onset of the global financial crisis, national authorities have taken several measures to improve regulatory and supervisory oversight of risk governance at financial institutions. These measures include developing or strengthening existing regulation or guidance; raising supervisory expectations for the risk management function; engaging more frequently with the board; and managing and assessing the accuracy and usefulness of the information provided to the board to enable the effective discharge of its members' responsibilities. Nonetheless, further measures are required in order to take these efforts forward. These measures include more specifically the national authorities' need to assess the effectiveness of a firm's risk governance framework better and in order to ensure the sound management of risk through the economic cycle. Supervisors will need to strengthen their assessment of risk governance frameworks to encompass an integrated view across all aspects of the framework.

Furthermore, the FSB found that most global firms had gone beyond meeting regulatory requirements and had made progress in various areas, including (i) assessing the collective skills and qualifications of board members and the board's effectiveness either through self-evaluations or through the use of third parties; (ii) instituting a stand-alone risk committee that is composed only of independent directors; (iii) establishing a group-wide chief risk officer and risk management function that are independent from revenue-generating responsibilities and have the stature, authority and independence to challenge decisions on risk made by management and business lines; and (iv) integrating the discussions among the risk and audit committees through joint meetings or cross-membership.

Finally, the FSB found that although many surveyed firms had made progress in the past few years, significant gaps remained relative to the criteria developed, particularly in risk management. There were also differences in the progress made across regions, with firms in advanced economies having adopted more of the desirable risk governance practices. Drawing from the findings of the review, the FSB identified a list of sound risk governance practices that would help firms continue to improve their risk governance, and assist national authorities in assessing their own effectiveness. The review set out several recommendations that targeted areas where more substantial work was needed, including recommending that (i) national authorities should strengthen their regulatory and supervisory guidance for financial institutions and devote adequate resources to assess the effectiveness of risk governance frameworks; (ii) standard-setting bodies should review their principles for governance, taking into consideration the sound risk governance practices set out in the report; (iii) the FSB should explore ways to assess the risk culture at financial institutions formally; and (iv) the FSB should provide general guidance on the key elements that should be included in risk appetite frameworks and establish a common template for terms used in risk appetite statements.

In South Africa risk governance is partly underpinned by the Companies Act, 2008 (Act No. 71 of 2008) and partly by the *King Code and the Report on Governance* (King III). King III was introduced in 2010 to entrench emerging corporate governance trends, with specific emphasis on the importance of integrated sustainability reporting and standards. As reported in the March 2010 issue of the *Financial Stability Review*,[65] other risk management principles introduced include alternative dispute resolution mechanisms, the concept of risk-based internal audits,

65 Pretoria: South African Reserve Bank, March 2010.

information technology governance, shareholders and remuneration, and the evaluation of boards and individual directors.

For the banking sector, Part III of the Regulations provides for the establishment of basic principles relating to the maintenance of effective risk management by banks and controlling companies, including the composition of the board and the conduct of its members. The adoption of these corporate governance best practices should lead to a more robust and transparent financial business environment. Similar safeguards are enshrined in insurance legislation and related regulations for the insurance industry.

Global legal entity identifier

Since the onset of the global financial crisis, international regulatory agencies have made recommendations to reform the financial system in order to improve its resilience and robustness. The establishment of the global LEI was supported by the G-20, the FSB, the Committee for Payment and Settlement Systems and the International Organization of Securities Commissions. Once established, the LEI will address the lack of a comprehensive identification system for parties to financial transactions, and will assist with the identification, aggregation and pooling of risk information arising from financial transactions.

The FSB has been tasked to take the lead in the preparation of recommendations for the appropriate governance framework, which will also encompass OTC derivatives data reporting. To this end, the FSB issued a report entitled "A Global Legal Entity Identifier for Financial Markets" in June 2012,[66] which sets out recommendations and proposals for the implementation of the global LEI. These recommendations and proposals include (i) a governance framework for a global LEI; (ii) an operational model; (iii) the scope of LEI reference data, access and confidentiality issues; funding model; and (iv) the implementation and phasing in of the global LEI.

66 http://www.financialstabilityboard.org/list/fsb_publications/tid_156/index.htm.

Defining a legal entity identifier and its purpose

An LEI is a unique reference code used to identify a legal entity that participates in financial transactions. A reference code will be allocated to each entity that takes part in financial transactions, in order for entities, risk managers and regulators to be able to identify parties to financial transactions. A unique reference code associated with a single legal entity will allow for the consistent identification of entities. It is proposed that the LEI will be an alphanumeric code and will comply with the specifications of the International Organization for Standardization (ISO), standard 17442:2012, which were proposed in May 2012.[67] The ISO standard proposes a 20-digit code that will be linked to an entity's business card information.

67 ISO 17442:2012 specifies the elements of an unambiguous LEI scheme to identify the legal entities relevant to any financial transaction.

According to the FSB, the use of an LEI will facilitate financial stability objectives, including improved risk management, assessment of macroprudential risks, facilitation of orderly resolution, containment of market abuse and curbing of financial fraud. The establishment of the global LEI will assist in identifying vulnerabilities in the financial system, and is expected to yield benefits to both firms and regulators.

There is currently no universal system for identifying entities that participate in the financial system. Regulators and financial firms have been exploring ways to create a common identifier for financial institutions. Therefore, a globally recognisable system for financial transactions will facilitate effective measurement and management of risk, improve operational efficiencies of entities, facilitate the measurement and monitoring of systemic risk, and enable organisations to measure and manage counterparty exposures effectively.

Implications for South Africa

As part of the efforts to align the domestic regulatory framework, standards and principles to those recommended by international regulatory agencies and to fulfil commitments made to the G-20, the Financial Services Board will take the lead in the discussions related to the LEI as it already has a seat on the Regulatory Oversight Committee (ROC). Once the necessary structures have been established, consultation on the proposed establishment of the LEI will take place.

The domestic establishment and adoption of the global LEI will ensure that regulators have a better insight into the interconnectedness of financial market participants, and more reliable information on counterparty risks and exposures. It will also promote better disclosure practices and enhance existing regulatory oversight practices.

Inaugural LEI meeting

The inaugural meeting of the global LEI initiative was held in January 2013 with the aim of establishing the ROC and the ROC Executive Committee, as well as to start discussions on a legal basis, governance framework, location, funding and other operational issues for the global LEI. The ROC will be the governing body of the LEI and it is proposed that the ROC will be domiciled in Switzerland. During this inaugural meeting, the ROC executive was appointed, as was a chairperson and deputy chairpersons from the regional groups. The FSB secretariat will be providing secretarial services until such time as permanent structures are in place. A South African representative has been appointed to the ROC Executive Committee. LEI discussions are still in their infancy but it is envisaged that 2013 will be a critical year for the establishment of the necessary framework for the LEI.

Proposals and recommendations from the FSB

The cornerstone of the global LEI is the establishment of the ROC for the proposed LEI. The FSB recommended a three-tier structure for the global LEI system to meet the broad objectives which will include the ROC, the Central Operating Unit (COU) and the Local Operating Unit (LOU). The functions of these structures are outlined below.

Regulatory Oversight Committee

The ROC has already been established and has the ultimate responsibility for governance of the global LEI system. It consists of authorities that support the establishment of the system. These authorities will promote the use of the global LEI in their jurisdictions. The governance principles and obligations will be set out in a global LEI ROC charter that is expected to be drawn up in the first half of 2013. The ROC Executive Committee was established in January 2013 and will steer the work on LEI using guidelines that will be set out in the above-mentioned LEI ROC charter.

Central Operating Unit

The COU will be responsible for effecting the operational part of the LEI system. According to the FSB, the COU will have the responsibility of ensuring the application of uniform global operational standards; seamless access to the global LEI and high-quality reference data for users; and methods for local systems connection to the COU, including providing support to the local systems. The COU will be registered as a legal entity and will rely on industry experts to identify and develop technologically and legally sound methods to implement the global LEI system in line with the standards and framework defined by the ROC.

Local Operating Units

The LOU will be the primary interface for entities to register for an LEI. The LOU will be the main implementer of the LEI and will be responsible for registration, validation, maintenance of reference data and the protection of information. LOUs would be required to compile a local business registry and allocate reference codes to the LEIs. Depending on the authority in that jurisdiction, there can be more than one LOU.

A number of jurisdictions have already made some progress with regard to the establishment and implementation of an LEI. Further explanation of these efforts and feedback from the inaugural LEI meeting are detailed in Box 3.

Box 3 Progress made with the legal entity identifier in other jurisdictions

United States

The US Commodity Futures Trading Commission (CFTC) is the first regulator to mandate the use of an LEI in regulatory reporting. In the US the LEI reference system was launched in August 2012 for financial markets participants such as swap dealers and swap participants executing OTC derivatives. The US LEI is called the 'CFTC Interim Compliant Identifier Utility' (CICI) and is jointly operated by the Depository Trust and Clearing Corporation and Society for Worldwide Interbank Financial Telecommunication (SWIFT). The CFTC mandated the use of LEI in regulatory reporting for dealers that execute OTC derivatives transactions before the establishment of the global LEI due to the need to identify counterparties to those transactions. The US LEI reference code is a 20-character, alphanumeric code associated with a single legal entity as per the prescribed ISO standard for LEI. The use of the LEI allows the CFTC to publish data on ownership, particularly each entity's immediate and ultimate parent. In future this will allow regulators and financial services firms to construct accurate group structures among firms and their counterparties for risk management purposes.

The CICI was created in collaboration with industry, and a phased-in approach was adopted. The first phase comprised mandating the use of the LEI to meet reporting requirements for OTC derivatives reporting. Entities that have registered for a CICI code include registered companies, their subsidiaries, municipal corporate entities, government departments, funds, partnerships, trusts and charities. Individuals, branch offices and operating divisions are excluded from the LEI as they utilise the CICI of the parent organisation.

Hong Kong

In 2011 the Hong Kong Monetary Authority (HKMA) published a consultation paper on "Logistical and Technical Arrangements for Reporting to the Hong Kong Trade Repository" (HKTR).[68] This consultation paper notes that the HKTR would work with the HKMA to consider how to incorporate the global LEI into its reporting. The HKMA is in the process of establishing a trade repository called 'HKMA-TR' for OTC derivatives transactions, while the Hong Kong Exchanges and Clearing Limited is in the process of establishing a new clearing house in Hong Kong that will serve as a central clearing party for the OTC derivatives market. It is envisaged that the HKMA and HKTR will implement a similar model than that of the US.

68 http://www.hkma.gov.hk/eng/key-functions/international-financial-centre/infrastructure/otc-derivatives-trade-repository.shtml.

Basel III implementation in South Africa

Following the introduction of Basel 2.5 on 1 January 2012, the Bank Supervision Department's (BSD) regulatory team focused on preparing for the Basel III framework and its timely implementation. Consultation with industry and other stakeholders on the Basel III framework was concluded towards the end of 2012. By 14 December 2012, South Africa had joined ten other Basel Committee member jurisdictions that had issued final regulations for the implementation of the Basel III framework.[69] A number of Basel Committee jurisdictions were not in a position to meet the Basel III agreed implementation date of 1 January 2013, but it is expected that some of these countries will implement the Basel III framework at some point in 2013 as they finalise their law-making processes.

69 These countries include Australia, Canada, China, Hong Kong SAR, India, Japan, Mexico, Saudi Arabia, Singapore and Switzerland. See the Basel Committee press release of 14 December 2012, entitled "Implementation of the Basel III Framework" (Basel: http://www.bis.org/list/press_releases/said_7/index.htm) for further information in this regard.

The implementation period for several of the Basel III requirements that were incorporated into the Regulations commenced on 1 January 2013. The globally agreed timeline has a number of milestones from 2013 to 2019, and includes transitional and monitoring arrangements until 1 January 2019. These arrangements are designed to provide for a gradual phasing in of the new Basel III requirements in order to give banks time to meet the higher capital and liquidity standards, while still supporting lending to the economy.

While the South African banking sector will have little difficulty in meeting many of the Basel III requirements, such as capital buffers, higher levels of capital, leverage ratios and risk coverage enhancements, the proposed new liquidity standards, the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) have been highlighted in the past as areas of potential difficulty. South Africa, like many EMEs, was challenged by the narrow, prescriptive requirements of high-quality liquid assets (HQLAs) and the withdrawal or run-off rates of wholesale funding, two of the key building blocks of the new liquidity standards contained in the Basel III framework.

With regard to HQLA, the limited supply thereof is often a function of bond markets in EMEs being typically not as deep and liquid as in advanced economies, and the lower levels of government securities are often a consequence of maintaining prudent fiscal policies. In order to address these challenges, the Bank used one of the national discretion options open to authorities with inadequate qualifying liquid assets by providing a committed liquidity facility (CLF) from which commercial banks can draw funds in times of liquidity stress.[70] In 2012 the Bank decided to make available such a CLF to all South African banks to help them meet the required LCR, effective from 1 January 2013.[71]

Prospects for the domestic banking sector of meeting the Basel III liquidity requirements have further improved with the Basel Committee's revision of the LCR standards in January 2013.[72] The key changes in the revised document include the following:

- The amendment of the definition of HQLA to expand the range of assets that qualifies as HQLA.
- Refinements to the assumed inflow and outflow rates to better reflect actual experience in times of stress.
- LCR requirements that will be subject to phase-in arrangements as of 1 January 2015. The minimum requirement will begin at 60 per cent, rising in equal annual steps of 10 percentage points to reach 100 per cent on 1 January 2019.

These changes will significantly reduce the pressure on the domestic banking sector to comply with the LCR requirements as they address some of the pertinent concerns raised by South Africa, among other countries, on the new liquidity standards. After the finalisation of the LCR, the Basel Committee is expected to press ahead with the review of the NSFR, the other component of the new global liquidity standards. In South Africa the NSFR will be subject to an observation period ahead of its implementation in 2018 and the outcomes of this observation period, and the review of the NSFR by the Basel Committee will give local regulators a clearer indication of what will be required of the domestic banking sector to comply with the NSFR. Nevertheless, the aim of the reforms is valid and needs the support of the global banking sector in order to enhance the resilience of the international financial system. Member countries' early implementation of Basel III will reduce the potential for regulatory arbitrage between member jurisdictions and provide momentum to the global financial regulatory reforms.

70 For more details on the CLF and further discussion of the implications of the Basel III capital and liquidity requirements for South Africa, refer to the September 2012 issue of the *Financial Stability Review* (Pretoria: South African Reserve Bank). pp. 47 and 51–53.

71 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.

72 The revised LCR standards are covered in the Basel Committee document entitled *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (Basel: BIS, 7 January 2013), www.bis.org.

Abbreviations

Alsi	All-Share Index
BER	Bureau for Economic Research at Stellenbosch University
BoE	Bank of England
BOJ	Bank of Japan
BRICS	Brazil, Russia, India, China and South Africa
BSD	Bank Supervision Department [of the South African Reserve Bank]
CBOE	Chicago Board of Options Exchange
CDS	credit default swap
CFTC	Commodity Futures Trading Commission
CICI	CFTC Interim Compliant Identifier Utility
CLF	committed liquidity facility
COU	Central Operating Unit
CRB	Commodity Research Bureau
ECB	European Central Bank
EMEA	Emerging Middle East and Africa
EME	emerging-market economy
EU	European Union
FMI	financial market infrastructure
FNB	First National Bank
FOMC	Federal Open Market Committee
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FSC	Financial Stability Committee
FSOC	Financial Stability Oversight Committee
G-20	Group of Twenty
GDP	gross domestic product
GIIPS	Greece, Italy, Ireland, Portugal and Spain
H-index	Herfindahl–Hirschman Index
HKMA	Hong Kong Monetary Authority
HKTR	Hong Kong Trade Repository
HQLA	high-quality liquid assets
IMF	International Monetary Fund
ISO	International Organization for Standardization
Jibar	Johannesburg Interbank Average Rate
JSE	JSE Limited
LCR	liquidity coverage ratio
LEI	legal entity identifier
Libor	London Interbank Offered Rate
LOU	Local Operating Unit
LTRO	long-term refinancing operations
MOVE	Merrill Options Volatility Estimate
MSCI	Morgan Stanley Capital International
MTBPS	Medium-Term Budget Policy Statement
NBFI	non-bank financial institutions
NCR	National Credit Regulator
NSFR	net stable funding ratio
NT	National Treasury
OECD	Organisation for Economic Co-operation and Development
OFI	other financial intermediary
OPEC	Organization of the Petroleum Exporting Countries
OTC	over-the-counter
PMI	Purchasing Managers' Index
ROC	Regulatory Oversight Committee
ROSC	Report on the Observance of Standards and Codes

RROC	Reference Rate Oversight Committee
RSI	relative strength index
S&P	Standard & Poor's
SWIFT	Society for Worldwide Interbank Financial Telecommunication
UK	United Kingdom
US	United States
VIX®	Chicago Board of Options Exchange Volatility Index
WEO	*World Economic Outlook*
WGBI	World Government Bond Index

Glossary

Basel Committee	Basel Committee on Banking Supervision
CRS Act	Credit Rating Services Act, 2012 (Act No. 24 of 2012)
FM Act	Financial Markets Act, 2012 (Act No. 19 of 2012)
Jibar Code of Conduct	"The Jibar Code of Conduct, Governance Process and Operating Rules"
the Bank	South African Reserve Bank
the Fed	United States Federal Reserve
the Regulations	Regulations Relating to Banks