

Financial Stability Review

September 2013



Financial Stability Review

September 2013



South African Reserve Bank

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This issue of the *Financial Stability Review* focuses mainly on the six-month period ending June 2013. However, selected developments up to the date of publication were also reported on. Data may include own calculations made for purposes of this publication.

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ISSN: 1811-2226

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 were 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 and domestic financial stability risks that were identified in the March 2013 *Financial Stability Review* as a cause for concern included risks related to developments in the euro area, continued weaker global economic growth and higher global unemployment levels. These risks, however, seem to have abated somewhat during the period under review. Risks that were identified in the previous publication that appear to have intensified further are mostly domestic risks and include risks related to protracted labour disputes during the period of wage negotiations as well as the risk of higher levels of unemployment. In a global context, the risk to the domestic financial system of a global recovery, the unwinding of unconventional policy actions in advanced economies and the resulting decline in the search for yield, intensified. In addition, other risks that emerged during the assessment period of the current edition of the *Financial Stability Review* include (i) domestic households' vulnerability to any future interest rate increases given the relatively high debt levels, (ii) disintermediation due to tighter regulation of banks (domestically but also globally), (iii) consequences of possible downgrades of South Africa's sovereign credit rating and (iv) implications of a slowdown in China's economy.

An assessment of total credit extension, with the aim of considering the appropriateness of the current policy stance on the countercyclical capital buffer (CCB) for South African banks, showed that there is no reason, given the methodology used in the assessment, to change the level of buffer capital that banks need to hold for this purpose. Total credit extension remained well below its long-term average. Although some individual categories of credit do display trends that may warrant the application of such a capital buffer add-on, the Bank has not yet considered the possibility or feasibility of using the buffer on any other basis than that of total credit extension.

Assessing financial stability risks for the period under review showed that amid an uneven global economic recovery, South Africa recorded an increase in the growth rate of real gross domestic product (GDP) in the second quarter of 2013. The higher economic growth rate can be partly ascribed to base effects. There was, however, a decline in production by the mining and quarrying sector, which contracted mainly as a result of labour disputes. Even though the Bank's leading business cycle indicator increased in July and August, optimism over the economic growth outlook remains tentative as recent developments have not yet reflected stronger underlying momentum in economic activity.

The possible unwinding of the United States' (US) quantitative easing (QE) programme dominated global and domestic financial market trends. Its negative impact on capital flows and bond, equity and foreign-exchange markets of emerging-market economies (EMEs), including South Africa, was fairly dramatic. Nevertheless, external flows into the domestic bond and equity market remained positive during the period under review.

The South African banking sector remained well capitalised and profitable despite a tightening bias in lending standards. Loans and advances increased further and the quality of assets generally improved. South African banks' credit exposure to distressed European peripheral economies is also continually monitored and remains a small portion of the banking sector's loan book. Direct exposures to sovereign investment and trading securities also remained low. Because banks' statutory capital ratios are influenced by the way in which they apply risk weights to their assets, the Basel Committee on Banking Supervision (Basel Committee) proposed the adoption of a minimum leverage ratio as a non-risk-based capital measure to serve as a 'backstop' to the risk-based capital requirements of the Basel III framework. The implementation of leverage ratios is regarded as a necessary addition to the other risk-based measures to reduce banking-sector risks.

The Financial Stability Board released a framework for addressing the moral hazard risks posed by systemically important financial institutions (SIFIs). This framework introduces measures aimed at reducing the probability and the broader negative externalities associated with the failure of SIFIs. It consists of an assessment and designation methodology, additional loss-absorbency requirements, more intensive supervision, more effective resolution mechanisms, and a stronger financial market infrastructure. The framework could be applied to global systemically important banks (G-SIBs) and domestic systemically important banks (D-SIBs). In South Africa, the Bank has developed an indicator-based methodology to identify D-SIBs. Although the South African D-SIB approach is broadly based on the Basel Committee's G-SIB approach, a number of the indicators and weightings were adjusted to be aligned to the characteristics of the domestic financial sector. Additional capital requirements applicable to these banks are expected to be met stepwise over a period of four years starting 1 January 2016.

An assessment of the non-bank financial sector of South Africa showed that long-term typical insurers and short-term insurers all maintained adequate capital buffers during the period under review. The premium income of short-term insurers derived from vehicle and property insurance contributed the majority of total premium income. Confidence in the financial sector, however, dropped in the second quarter of 2013, in line with a view that general economic conditions remain tough given weak employment growth and a challenging labour environment. Overall business confidence, which also deteriorated in the second quarter, weakened even further in the third quarter of 2013, with participants in the survey citing similar reasons. Consumer confidence dropped sharply in the third quarter and fell to its lowest level in over a decade. Furthermore, activity in the residential real-estate market remained subdued despite low interest rates. Factors such as elevated household indebtedness, low economic growth, higher unemployment and weak growth in disposable income remain key obstacles to higher levels of house price increases.

Globally non-bank financial intermediation has become a vital part of the financial system as it provides an alternative to customers for gaining access to credit and other financial services in support of economic activity. However, a large non-bank financial sector also poses potential systemic risks to the financial system. To this end, the Financial Stability Board created a monitoring framework to enhance national authorities' ability to track developments in the non-bank financial sector. South Africa is participating in the shadow-banking project of the Financial Stability Board within the annual monitoring exercise. From a systemic risk perspective, it is important that bank-like activities outside the banking sector are regulated commensurate with the risk that they introduce into the financial system and to promote a level playing field. The Bank is in the process of investigating the refinement of the instrument revaluation methodology and to collect more granular data on the domestic shadow-banking system.

Introduction

This edition of the *Financial Stability Review*, which focuses mainly on the six-month period ended June 2013, comprises three main sections, namely (i) financial stability developments and trends, (ii) financial stability risk assessment and (iii) the robustness of the domestic financial infrastructure.

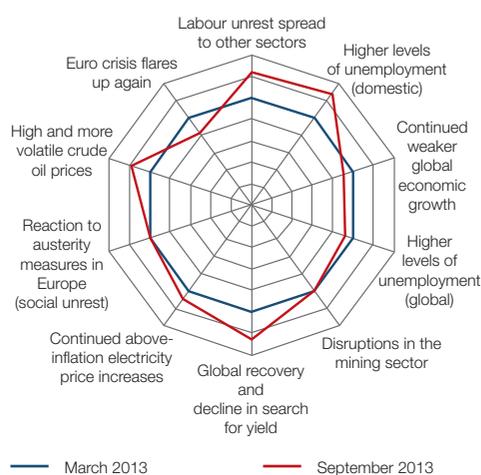
The first section provides an update on global and domestic risks that were discussed in the March 2013 edition of the *Financial Stability Review* as well as additional risks that have been identified since then. This is followed by a discussion regarding the application of the CCB as a macroprudential instrument.

In the second section an analysis is made 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. An overview of current international macrofinancial conditions that could influence the stability of the domestic financial system is also included.

The final section provides an update on financial policy, and legislative and infrastructural developments affecting the South African financial system. Regulatory developments that impact the domestic banking sector, including a leverage ratio for banks, are discussed in addition to the methodology to identify systemically important banks and the latest developments relating to shadow banking in South Africa. This section concludes with an update on developments that impact the domestic insurance sector.

Financial stability developments and trends

Figure 1 Review of risks reported in the March 2013 *Financial Stability Review*



Note: An increase in risk since March 2013 is depicted as a movement away from the centre, while an easing in the intensity of the particular risk is depicted as a movement towards the centre

Sources: South African Reserve Bank and researchers' computations

Figure 2 Possible risks to financial stability

| Risk | Average probability | Average impact |
|---|---------------------|----------------|
| Increased household vulnerability due to high debt levels | Medium | High |
| Disintermediation due to tighter regulation of banks | Medium | Low |
| Further downgrade of South Africa's credit rating | Medium | Medium |
| Slowdown in China's economic growth and rebalancing | Medium | Medium |

Key to risk analysis



Sources: South African Reserve Bank and researchers' computations

Financial stability risk review

In the March 2013 *Financial Stability Review*, global and domestic risks to the South African financial system that constituted possible causes for concern in 2013 were identified. As further mentioned in the previous edition of the *Financial Stability Review*, the Bank's initial selection of risks was determined by estimating both the probability of that particular risk materialising during 2013 and the likely impact that it might have on the domestic financial system. The risks are continually monitored as they evolve, and this edition of the *Financial Stability Review* provides an update.

Each risk identified was reassessed to determine whether the threat it poses has increased or decreased since March 2013. A uniform rating of 5 was assigned to all risks that had been identified previously. The reassessment of risks resulted in a new set of ratings, shown in Figure 1.

Domestic labour unrest during the period of wage negotiations and the high level of unemployment remained two key risks for financial stability, increasing further in intensity compared to March this year. The risk related to the decline in the search for yield also increased, mainly as a result of indications from the US regarding the possible slowdown in quantitative easing, which caused strong capital flow reversals in many emerging markets. The risks of higher and more volatile international crude oil prices also increased during the period under review and were exacerbated by geopolitical risks, especially in Syria.

Apart from the aforementioned risks, other domestic and global risks that could have a direct impact on the South African financial system have also been highlighted, following a review of the current conjuncture. In this case, a 'heat map' was used to plot the probability and impact of these risks as low, medium or high. The net results are shown in Figure 2.

Increased household vulnerability due to high debt levels

South Africa's ratio of household debt to disposable income has been increasing steadily over time and peaked at 83 per cent in the first quarter of 2009. Since then the ratio has decreased steadily, but remains at an elevated level despite decreases in the prime interest rate since a peak of 15,5 per cent in the second quarter of 2008. Should the interest rate cycle turn, at the current elevated debt levels, the household sector and related credit providers exposed to this sector could be very vulnerable (also see page 26 of this publication for a discussion of the financial health of the domestic household sector).

Disintermediation due to tighter regulation of banks

Globally and domestically, the resurgence of non-bank financial institutions performing bank-like activities has again brought to the fore matters relating to the monitoring and regulation of these so-called 'shadow banks'.

Non-bank lending has a legitimate role to play in increasing the access to finance of borrowers that are experiencing funding shortages, especially as the maturity of their liabilities often constitutes a better match for the borrower's maturity needs than banks' liabilities. Nearly all the services that banks provide can also be provided by shadow banks, with the main exception being, specifically in the case of South Africa, taking deposits from the public. Non-bank financial intermediaries, however, are not subject to the same strict regulatory criteria that apply to banks, even though they can pose systemic risks to the financial system, and therefore there is a need for closer monitoring of non-bank lending. The supervision of these entities needs to be adapted to reflect liquidity risk and credit risk, and to avoid unintended regulatory arbitrage. Systematic information on these activities needs to be collected regularly to monitor their size, growth and characteristics, and to detect the build-up of risk.

Until stricter regulation is introduced, the shifting of credit demand of borrowers from banks to non-banks is expected to continue, even though this is still small in size in South Africa compared with total bank lending (also see page 34 of this publication for a discussion of shadow banking).

Further downgrade of South Africa's credit rating

The weak economic performance and recurring labour market tensions in South Africa continue to threaten the outlook for South Africa's sovereign credit rating. The performance of the South African economy in the near future, the speed of the intended fiscal consolidation in the next fiscal year, and the occurrence and impact of labour disputes would be critical factors in determining South Africa's credit rating. Further downgrades could trigger a negative reaction from investors, especially since it might bring South Africa's credit rating closer to the benchmark that Citibank uses to exclude countries from its World Government Bond Index (WGBI). Once a country is included in the WGBI, its performance is monitored and any country whose rating falls below BBB-/Baa3 according to both Standard & Poor's and Moody's Investors Service (Moody's) could be removed from the next month's profile and moved to the Additional Market Indices.¹ Given the extent of non-resident investors' holdings of South Africa's sovereign debt (about 37 per cent) and the estimated amount of capital inflows to South Africa attributable to its inclusion in the WGBI (about R60 billion),² further credit-rating downgrades could have far-reaching implications for South Africa. Whereas some passive investors are likely to maintain their exposure to South Africa, more active investors may reconsider their portfolio exposures.

Slowdown in China's economic growth and rebalancing

Economic growth in China has continued to moderate. The process of slowing growth is also associated with rebalancing away from exports and investment towards local consumption demand. These are appropriate and welcome steps as the risks to a growth model premised on low private consumption levels, current-account surpluses and debt-driven economic growth were growing more acute.

¹ Information related to South Africa's inclusion in the Citigroup's WGBI is contained in the September 2012 edition of the *Financial Stability Review*.

² These strong bond inflows can also be attributed to generalised flows into emerging-market bonds as a result of higher interest rate differentials, healthier balance sheets and better economic growth prospects in emerging markets.

China's changing growth dynamic poses some financial stability risks to South Africa. The central concern is that China's slowing growth and rebalancing will drive down commodity prices. Reduced levels of investment might mark a turning point in the 'supercycle' for industrial metals, such as iron ore, which are important South African exports. It is also a threat to thermal coal prices. This has the potential to weigh on economic growth which, in turn, could result in pressure on the financial system via risks to the banking sector and a further widening of South Africa's current-account deficit.

Macroprudential regulation: Assessing the application of the countercyclical capital buffer

One of the instruments that have already been agreed upon for application in terms of Basel III compliance is the CCB for banks.³ The CCB is designed to protect the banking sector from the build-up of system-wide risks associated with periods of excessive credit growth, by ensuring that there is a capital buffer that takes into account the macrofinancial environment in which banks operate. The methodology proposed for the CCB add-on, which was discussed in more detail in the September 2011 *Financial Stability Review*, suggests that the buffer be considered for banks whenever the credit-to-GDP ratio is above its long-term trend (Figure 3). The results of the exercise conducted by the Bank in this regard show that there is currently no need to consider a CCB add-on for banks as total credit extension relative to GDP remains well below its long-term average. It should, however, be noted that the application of instruments for macroprudential policy purposes would also be subject to judgement and not be applied mechanically.

Taking into account that credit extended in the various loan categories can experience different and even diverging growth trends, there is merit in the analysis of credit-to-GDP gaps for the various categories of credit. Even though the Bank has not yet considered the possibility or feasibility of using the CCB on any other basis than for that of total credit extension, the CCB methodology can be applied to specific asset classes should the development of credit extension in certain asset classes be cause for concern.⁴ In Figure 4, the credit-to-GDP gaps for different subcategories of credit extended in South Africa are shown in order to identify where credit growth is currently above or below its long-term trend.

Two categories of credit for which the gaps were larger than zero were identified, namely other loans and advances, and instalment sale credit. The positive gaps indicate that the ratios of these categories of credit extension to GDP were above their respective long-term trends. Should these trends continue, it could be seen as signals to consider a CCB for some of these asset classes.

Figure 3 Private-sector credit-to-GDP gap

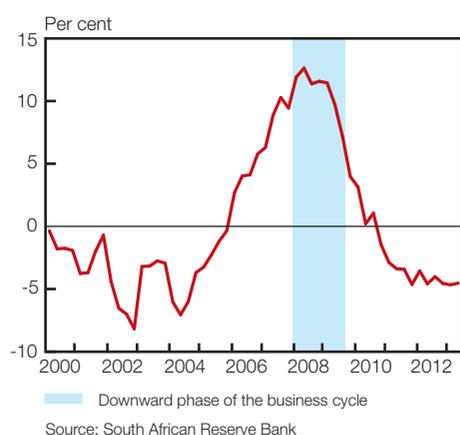
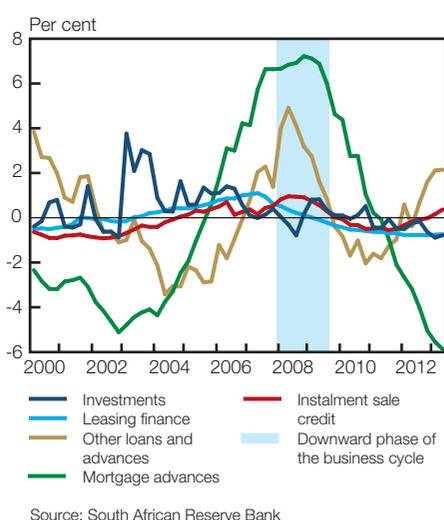


Figure 4 Selected private-sector credit-to-GDP gaps according to asset class



³ See p43 of the September 2011 *Financial Stability Review* for a discussion of the application of the CCB in South Africa.

⁴ For example, in February 2013 a sector-specific CCB was activated on loans secured against residential properties in Switzerland due to concerns about the development of cyclical imbalances in the Swiss mortgage and real-estate market.

Conversely, mortgage advances, investments and leasing finance are the three remaining categories of credit where the credit-to-GDP gaps were below zero, indicating that the ratio of these categories of credit extension to GDP remains below their respective long-term trends. From a macroprudential perspective, it can also be argued that the large negative credit-to-GDP gap provides a signal to consider utilising other potential macroprudential instruments to promote use of these types of credit.

The long-term trends should be interpreted with caution as they could be misleading, particularly where structural change is taking place. Furthermore, some trends observed recently could be partly attributed to financial deepening.

Financial stability risk assessment

This section of the *Financial Stability Review* addresses the main risks posed by the global environment to domestic financial stability in terms of economic growth and financial market developments. It also provides an overview and analysis of the health of the domestic banking and non-banking financial sectors, the household sector, and the corporate and real-estate sectors.

Economic growth developments and outlook

Despite an improvement in global economic growth in the second quarter of 2013, in October 2013 the International Monetary Fund (IMF)⁵ revised downwards economic growth forecasts for 2013 and 2014 mainly due to lower economic growth and significantly weaker domestic demand in key EMEs. The projection for economic growth in emerging and developing economies was revised downwards from 5,3 per cent in 2013 to 4,3 per cent, with growth expected to be underpinned by economic growth in the developing Asia and sub-Saharan Africa regions. The growth outlook for 2013 in sub-Saharan African economies was also revised downwards from an initial projection of 5,5 per cent to 5,0 per cent. The key factors underlying the weaker economic outlook for emerging and developing countries not only included the effects of a possible unwinding of US monetary stimulus and its impact on the direction of capital flows, but also the risk of a possible protracted weakening in China. Countries with a high share of non-oil commodity exports in overall exports seem most vulnerable to a slowdown in China's economic growth.

Conversely, economic growth in advanced economies generally improved in the first half of 2013 amid continued accommodative monetary policy, especially in the US and Japan. The US recorded modest economic growth as higher private consumption expenditure and exports offset the negative effects of declines in government spending. Furthermore, unemployment levels in the US decreased slightly but remained relatively high.⁶ The low level of global inflation, especially in advanced economies, also remains supportive of economic growth since it supports consumption growth and enables central banks to maintain an accommodative monetary policy stance.

Major challenges remain in the euro area countries' public finances and banking sectors against a backdrop of weak economic growth. Even though concerns in the euro area financial sector appear to have eased somewhat, financial stability conditions remain fragile. Without stronger growth prospects, the problem of high public debt levels remains and a further rise in bond yields could make it increasingly challenging for European policymakers to stabilise public-sector debt burdens. However, there have been some positive indications that the recession in the euro area might have bottomed out with economic activity rebounding in the second quarter of 2013 and purchasing managers' indices (PMIs) trending upwards.

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

6 United States Department of Labor, *Employment Situation Summary* (Washington DC: IMF, Bureau of Labor Statistics, 6 September 2013).

Nevertheless, economic growth in the region continues to be underpinned by certain core economies such as France and Germany, while several peripheral countries remain in recession, including Greece, Cyprus, Spain and Italy.

Despite the weaknesses in emerging and developing economies, the rate of economic growth is still higher (and is expected to remain at elevated levels) than that of its advanced counterparts. However, the gap is narrowing. Since the beginning of 2013, forward-looking indicators of economic activity in EMEs exhibited a slower pace of growth than in most advanced economies – where the message from PMIs with readings above 50 is for further improvement (Figure 5).⁷ There are also divergences across EMEs, for example there are clear indications that EMEs with large current-account deficits would be more impacted by US Federal Reserve (Fed) tapering.⁸

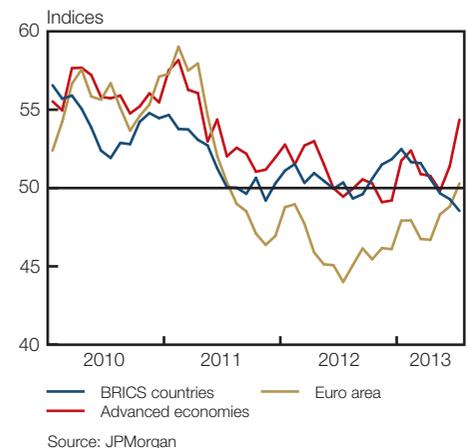
The uneven global recovery, in addition to concerns related to the euro area, is still clouding the outlook for global financial stability. Furthermore, the unemployment rate remains high in several countries, and runs the risk of becoming structural.

In South Africa, real economic activity picked up in the second quarter of 2013. Real GDP grew at a quarter-on-quarter, annualised and seasonally adjusted rate of 3,0 per cent following disappointing growth of 0,9 per cent in the first quarter of 2013. The enhanced performance could in part be contributed to base effects, but also to improved economic activity in sectors such as the manufacturing, finance, real-estate and business services, the wholesale, retail and motor trade, and the catering and accommodation. Their collective contribution of 2,9 percentage points to GDP growth was significant enough to offset the decline in the output of the mining and quarrying sector, which contracted by 5,6 per cent due to lower production volumes as a result of labour disputes. The expansion in manufacturing output partly reflected the normalisation of output in the second quarter of 2013, following setbacks in the first quarter, and was also in line with an increase in real gross domestic final demand.

Even though the Bank's leading business cycle indicator increased in July and August 2013, optimism over the economic growth outlook remains tentative as recent developments have not yet reflected stronger underlying momentum in economic activity. The Bank's economic growth forecast has been revised downwards from 2,4 per cent to 2,0 per cent for 2013 and from 3,5 per cent to 3,3 per cent for 2014. Furthermore, the Kagiso PMI⁹ fell below the 'neutral' 50 index point threshold (to 49,1) in September 2013, reversing the gains that were made since April 2013. The decline in the headline PMI in September can be attributed to a deterioration in business activity and new sales orders.

Short-term indicators of future economic growth (Table 1), however, seem to support a positive growth scenario, but more recent data would be needed to substantiate this view. Both building plans passed and buildings completed experienced positive growth for the most of the first seven months of 2013.

Figure 5 Purchasing managers' indices



7 JPMorgan manufacturing PMIs.

8 See discussion of "Government finances and financial stability" on p22.

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

Vehicle sales increased through the first eight months of 2013. After growth in retail sales peaked in February 2013, it slowed until July, while wholesale trade sales peaked in March and then slowed for the remainder of the first half of the year. Electric current generated declined for the first two months of the year, whereafter it recorded marginal growth up to July.

Table 1 Selected indicators of real economic activity¹

Annual percentage change in monthly indicators

| Activity indicators | 2013 | | | | | | |
|---|-------|-------|-------|-------|-------|-------|-------|
| | Jan | Feb | Mar | Apr | May | Jun | Jul |
| Building plans passed | 22,39 | 17,81 | 38,00 | 17,56 | 11,31 | -6,42 | 35,70 |
| Buildings completed..... | 6,13 | 26,37 | 8,90 | 2,40 | 3,82 | 11,21 | 26,06 |
| Retail sales | 1,44 | 7,50 | 3,38 | 1,84 | 5,27 | 2,57 | 2,05 |
| Wholesale trade sales..... | 3,79 | 5,96 | 6,40 | 1,85 | 7,61 | 8,71 | ... |
| New vehicle sales..... | 13,89 | 1,63 | 6,30 | 8,60 | 7,95 | 4,41 | 7,85 |
| New passenger car sales | 12,36 | 0,83 | -3,60 | 16,36 | 6,31 | 3,40 | 6,42 |
| Electric current generated..... | -3,17 | -3,61 | 1,75 | 2,67 | 1,03 | 0,09 | 0,85 |
| Utilisation of production capacity ² | ... | ... | 80,90 | ... | ... | 81,34 | ... |

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

South Africa's unemployment rate increased further during the period under review and reached 25,6 per cent in the second quarter of 2013, bringing the total number of unemployed to 4,72 million. Of particular concern is the increase in the youth unemployment rate, which amounted to 52,8 per cent in the second quarter of 2013. Current labour disputes, coupled with the sluggish economic growth outlook, could further dampen employment creation.

Although economic activity is expected to remain subdued and possibly moderate further, it is not expected to cause substantial negative spillovers to the financial system in the immediate future.

Financial market developments and trends

Unwinding of the US's quantitative easing programme

Low yields in the bond markets of advanced economies have over recent years contributed to investors searching for yield and subsequently seeking to reallocate portfolios towards riskier assets. These included lower-rated European bonds, corporate debt and emerging-market local currency paper. This caused spreads to decline even further while the issuance in riskier credit market segments strengthened. Risk taking and carry-trade activity were common in an environment of abundant liquidity and low volatility. If underlying risks have been underestimated or mispriced during this search for yield, it could become a potential source of financial instability.

Following continued positive economic data, the US Federal Open Market Committee (FOMC) announced its intention to commence the unwinding of the QE programme under certain circumstances through asset purchase tapering. The extent to which market sentiment is influenced by US monetary policy was illustrated by the increased volatility following public statements by the US Fed officials regarding the timing of a phase-out of securities purchases. Also, the announcement triggered a significant outflow of capital from EME bonds. The capital outflow from Brazil, Russia, India, China and South Africa (the BRICS countries) since the initial FOMC announcement in May 2013 is estimated at US\$2,3 billion, with Brazil recording the single largest outflow of US\$1,8 billion (Figure 6). The magnitude of the reversal and the speed with which it occurred have sparked serious concerns, especially among those countries that rely on foreign funding for the financing of the current account and budget deficits.

Furthermore, the impact that the reversal of capital flows has had on emerging-market currencies (Figure 7) and the risk that this poses to the inflation outlook are cause for concern. However, whether these risks materialise will depend on whether the reversal of capital inflows to EMEs continues and the extent of the reversal. This, in turn, is dependent on the timing and magnitude of Fed QE tapering, which is based on the performance of the US economy, as the FOMC has reiterated that its policy stance is data-dependent and embodies flexibility to react to incoming data.

With US government bond yields still some 150 basis points below pre-QE levels, there remains a risk that as US yields increase, a wide range of interest rates in EMEs that have a close correlation with US yields will also correct or normalise to historic levels. Figure 8 shows the correlation between ten-year government bond yields of a selected number of EMEs and the US. The figure shows a clear shift from a relatively low correlation to a higher correlation since the Fed announced its intention to reduce its bond purchases. Bond markets experienced a broad-based sell-off because of their direct correlation with US Treasuries, but also because of EMEs' vulnerability created by increased liquidity flowing into bond markets. In this regard, the most severe sell-offs were seen in countries with the largest current-account deficits including South Africa, Turkey, Indonesia and India.

The discussions by the Fed regarding the unwinding of the asset purchase programme therefore resulted in upward pressure on both US and other yields around the world. However, there are concerns that the United Kingdom (UK) and Europe are less well-placed than the US to cope with higher interest rates. The Bank of England (BoE) and the European Central Bank (ECB), in response, have introduced forward guidance, a communication instrument to convey likely future monetary policy orientation.¹⁰

Rising volatility and risk premiums in a broad range of financial assets were also witnessed during the period under review. The latter in part follows erosion in the 'comparative advantages' that EMEs previously enjoyed over advanced economies. In the past EMEs benefited from robust portfolio inflows, strong GDP growth, healthy current-account balances and relatively low private-sector leveraging. However, the landscape for EMEs

Figure 6 Emerging-market capital flows, cumulative

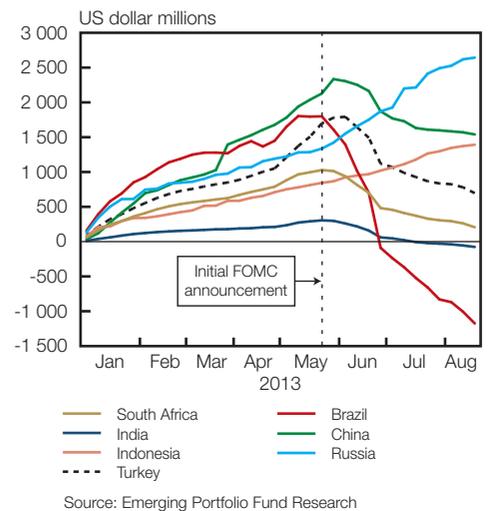


Figure 7 Emerging-market currencies

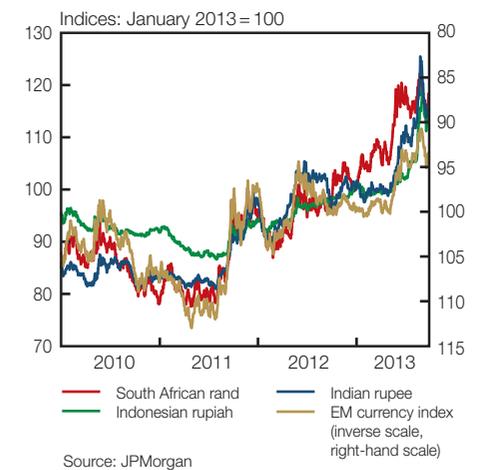
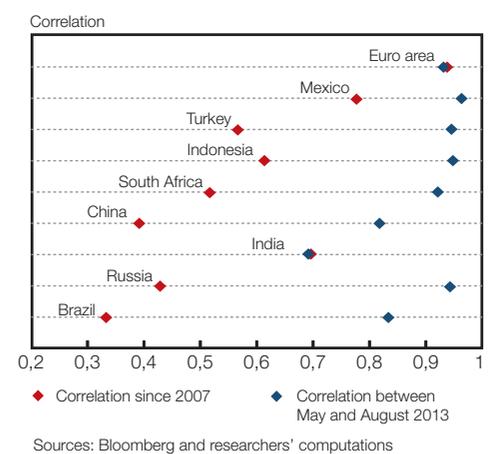


Figure 8 Correlation between selected emerging markets and US government bond yields



10 See for example <http://www.bankofengland.co.uk/monetarypolicy/Pages/forwardguidance.aspx>.

has changed and EMEs have begun adjusting to a new era of potentially less liquidity and rising interest rates from record-low levels. Since 22 May 2013, financial markets started pricing in the starting point of Fed policy normalisation, resulting in many EME currencies, bonds and equities experiencing large losses.

South Africa has not been immune to such global market turmoil and witnessed continued rand depreciation and volatility, as well as a sharp rise in government bond yields.

Volatility in global and domestic currencies

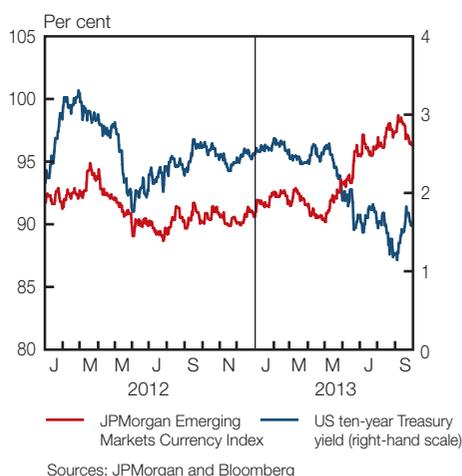
A significant consequence of the narrowing gap between the economic performance of advanced economies and EMEs in the review period has been the performance of advanced economies' currencies in 2013. So far in 2013 there has been a general appreciation of the US dollar. Whereas the Fed's QE programme had previously promoted the US dollar as a funding currency for carry trades, prospects for the winding down of QE as per the timetable laid out by Fed Chairman Ben Bernanke in July 2013 could result in a reversal of carry trades and thus support a stronger US dollar. The larger rise in US Treasury yields relative to other major government bond markets, multi-year high US share prices, and the improving US current-account balance are all factors that appear supportive of US dollar appreciation, although the unresolved US debt ceiling remains a challenge for the US currency.

Since the beginning of 2013, the euro has held up well against the US dollar and appreciated against most currencies, supported by improved liquidity conditions and renewed calm in euro area peripheral government debt markets. Other European currencies equally benefited from an improved economic outlook in 2013. However, the Japanese yen depreciated against its peers following the start of the Bank of Japan's asset-buying programme, increasing public debt and plans for a sales-tax hike, which may impede the Japanese economic recovery and prompt further monetary stimulus.

By contrast, commodity-linked and emerging-market currencies have depreciated across the board and were particularly vulnerable to investor deleveraging amid growing expectations that the world's major central banks will eventually normalise policy from the current highly accommodative stance which was largely responsible for large capital inflows into high-yielding assets. The diverging trend between the JPMorgan Emerging Markets Currency Index and US Treasury yields since 22 May 2013, when the Fed first unveiled a roadmap for QE tapering, illustrates the key role now played by expectations of reduced monetary policy accommodation (see Figure 9).

The recent sell-off in emerging-market currencies has highlighted an increasingly selective approach to emerging-market assets by global investors. This has resulted in the underperformance of those markets seen as most vulnerable because of widening current-account deficits, higher external financing needs, deteriorating private-sector balance sheets, elevated inflation and lower potential GDP growth. If recent patterns in global portfolio flows were to continue, some EMEs could find it difficult to attract external funding on the same terms available in recent years. Furthermore, the recent moderation in China's GDP growth as it strives to

Figure 9 JPMorgan Emerging Markets Currency Index versus US ten-year Treasury yield



rebalance its economy towards a more consumer-driven model continues to present downside risks to emerging-market currencies.

Growing turmoil in emerging-market currency markets has not left the South African rand unscathed and its nominal effective exchange rate depreciated by 15 per cent from the beginning of 2013 up to the end of September 2013. In addition to the aforementioned global developments, the rand was also pressured by: (a) protracted industrial protests which negatively impacted on the country's productivity and exports; (b) lower commodity prices that continued to reverse the terms-of-trade gains of earlier years; (c) concerns about the financing of the country's budget and current-account deficits; (d) lingering market fears that South Africa may suffer another credit-rating downgrade; and (e) the delay in electricity generation at Eskom's Medupi power plant and fears that it may result in electricity supply constraints.

South Africa's ability to resolve domestic issues may continue to hold significant implications for the future of the rand's exchange value. Admittedly, currencies rarely move in a straight line and several market participants believe that the rand is currently oversold, based on purchasing power parity methodology. Consensus forecasts project a moderate recovery in the rand's exchange value versus the US dollar over the coming quarters. Furthermore, the rand may find support from positive economic data indicating that China's economy has bottomed out, an economic recovery in Europe, higher commodity prices, and expectations that the US economy is firm enough to resist the potentially negative consequences of QE withdrawal, in particular a stronger US dollar exchange rate and rising US Treasury yields.

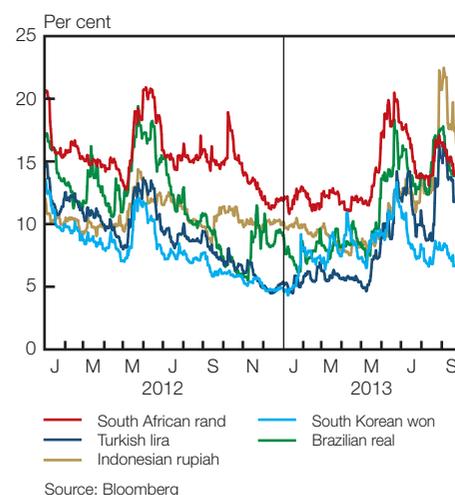
In the past few years, one-month implied volatility of the rand-US dollar exchange rate has been high relative to that of its emerging-market peers. Even though the volatility is currently much lower in absolute terms than at the time of the global financial crisis, it may nevertheless compound South Africa's challenge to attract significant portfolio inflows.

Global and domestic bond and equity market volatility

Another major consequence of the change in the international economic and monetary policy backdrop has been a reversal in the performances of global bond markets. While yields on government bonds of advanced economies have risen on expectations of reduced asset purchases by major central banks, the upward move in EME government bond yields has been compounded by currency weakness and, in some cases, rising concerns about the issuers' creditworthiness. A situation where QE tapering in the US proceeds according to the Fed's baseline scenario, and improving growth in advanced economies raises real fixed-income yields from unusually low levels may present continued downside risks to emerging-market bonds.

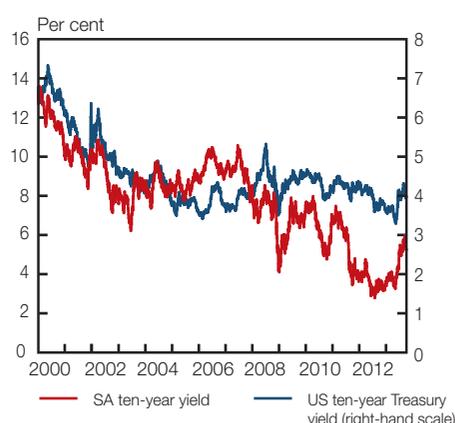
The divergent performance so far in 2013 between advanced and emerging economies' equity markets also illustrates the recent changes in investor sentiment. While US, Japanese and UK equities have benefited from an improved outlook for GDP growth and corporate profitability, their European counterparts have lagged. Most major EME equity markets are also down on a year-to-date basis not only in US dollar terms, but also in local currency terms. In the prevailing economic environment global investors may be expected to remain selective in their equity allocations.

Figure 10 One-month implied volatility of the rand and selected emerging-market currencies



The South African bond market fluctuated considerably during the review period, rallying initially to record low yield levels in April 2013 before reversing these gains between May and July 2013, amid a sell-off in EME assets, particularly local currency bonds. The domestic bond market rally in April 2013, which was triggered by the announcement of the Bank of Japan's aggressive monetary stimulus programme, pushed yields on the benchmark R186 bond to a record low of 6,59 per cent on 9 May 2013. However, local yields reversed quickly, owing to concerns about possible reductions in asset purchases by the Fed, reduced expectations of strong portfolio inflows from Japan, deteriorating domestic economic fundamentals and concerns about the domestic fiscal outlook.

Figure 11 South Africa ten-year and US ten-year Treasury yields



Source: Bloomberg

Domestic bond yields also closely tracked the direction of US Treasuries during the period under review. For the year to 30 September 2013 the local ten-year bond yield tracked the ten-year US Treasury yield 85 per cent of the time. The rise in both domestic bond yields and US Treasuries is part of a general move that has seen investors requiring higher yields on most global bond markets. In light of global investors' focus on the speed of QE tapering in the US, this strong correlation with US Treasuries continues to present downside risks to the domestic government bond market.

Net foreign purchases of domestic bonds nevertheless remained positive during the first three quarters of 2013. During this period non-residents were net buyers of R17,3 billion of domestic bonds, compared with R84,5 billion worth of cumulative bond inflows during the same period in 2012. The strong bond inflows during 2012 are partly attributable to South Africa's inclusion in the WGBI, but are also the result of interest rate differentials and generally improved economic growth prospects for EMEs at the time.

The South African yield curve shifted upwards and steepened during the period under review, owing to deteriorating domestic economic fundamentals, increased government bond issuance and rising market expectations of an increase in the repo rate over the next 12 to 18 months. The R186/R157 bond spread widened to 2,25 per cent in early August 2013 after narrowing considerably in April. 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.

While the relative steepness of the yield curve maintains some attractiveness of 'carry trade' investments in the longer end of the bond market, a slowing or reversal of capital flows to EMEs remains a risk to emerging-market assets. Non-resident holdings of South African bonds have risen to about 37,0 per cent as of end-August 2013, contributing to the lower bond yields, particularly since 2010.

Therefore, amid persistent concerns about the financing of the current-account deficit and the large percentage of domestic bonds held by foreign investors, South African debt instruments will not be immune to these risks. However, there is scope for some recovery in the domestic bond market by year-end as the wage-settlement season draws to an end.

In contrast to the losses observed in most EME equity markets, the JSE Limited (JSE) All-Share Index (Alsi) has increased by roughly 12 per cent in the 9 months ended September 2013. However, the JSE Alsi was somewhat

volatile during the period under review in line with global equity markets. The JSE Alsi initially rose on a better outlook for the global economy, reaching its highest close on record on 11 March 2013. These gains were, however, wiped out in April 2013 as concerns over the European debt crisis were reignited, US economic data disappointed and commodity prices declined. Continued support from major central banks and hopes of further monetary policy easing, fuelled by softer economic data in the US, China and the euro area, subsequently led the JSE Alsi to recover and reach a new record high on 31 May 2013, before a negative shift in global sentiment and concerns about the economic slowdown in China led to a renewed sell-off in June. However, signs of stabilisation both in China's economic growth and commodity prices have since prompted a renewed rally by the JSE Alsi.

Despite a rebound in the third quarter of 2013, gold shares are down by more than 40 per cent so far this year,¹¹ amid continued labour unrest and wage disputes in the gold sector. More generally, poor mining production has undermined earnings of the large mining companies.

At the same time, retail stocks, which were among the top performers in 2012, lost ground due to concerns over a slowdown in consumer spending, worries about shares being overvalued and company reports of lower sales and profit data. A slowdown in total unsecured lending, which had helped to support consumer spending in the past few years, compounded the uncertainty facing retail stocks. However, positive earnings reports from some of the major retail companies helped retailers to recoup some of the earlier losses towards the end of the third quarter of 2013.

More generally, notwithstanding the recent attractiveness of South African equities as an alternative investment to bonds, the mix of relatively high price-earnings ratios, rising cost pressures and sluggish growth in sales volumes continues to present a challenging environment for the domestic equity market.

Despite the above-mentioned challenges facing domestic equities, encouraging patterns have emerged over the past year, which can be attributed to the outperformance of the JSE Alsi relative to emerging-market equities. A weaker currency has lifted the rand value of repatriated earnings of a large number of JSE-listed firms with key external operations. This 'rand hedge' quality of particularly the platinum, resources and industrial sectors has offset other underlying fragilities. Between June and September 2013 the platinum sector gained almost 20 per cent while the industrial sector rose by 7 per cent. These positive performances, coupled with higher commodity prices, supported the JSE Alsi, which reached another record high in August 2013, at a time when most emerging-market equities suffered large losses and equity outflows amid Fed QE tapering concerns.

The nature of the relationship between emerging and US bond markets presents various concerns for global and domestic financial stability, including losses for banks with relatively large exposures to bond markets, a possible tightening of bank funding and stricter lending conditions.

Figure 12 JSE equity indices

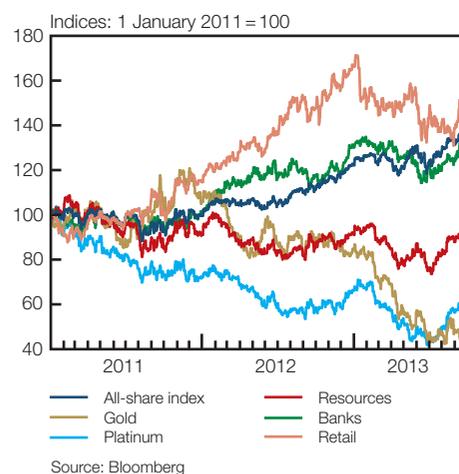
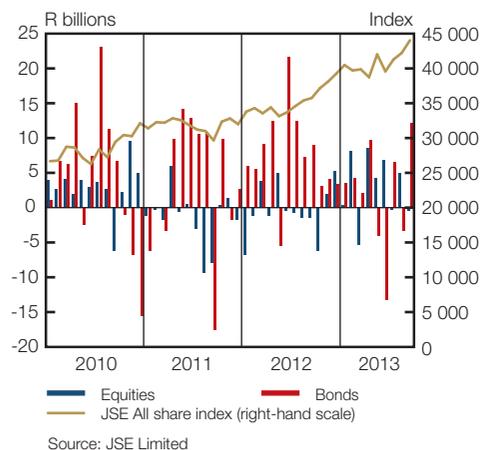


Figure 13 Non-resident purchases of domestic bonds and equities



11 In the year to 30 September 2013.

The pass-through effect of higher benchmark interest rates to other bank borrowing and lending rates could have far-reaching implications for the real economy. Risks to EMEs posed by the possible unwinding of US monetary stimulus go beyond just the impact on the direction of capital flows and the resultant influence on currencies – such risks also encompass potentially destabilising effects for banks and sovereigns through various channels.

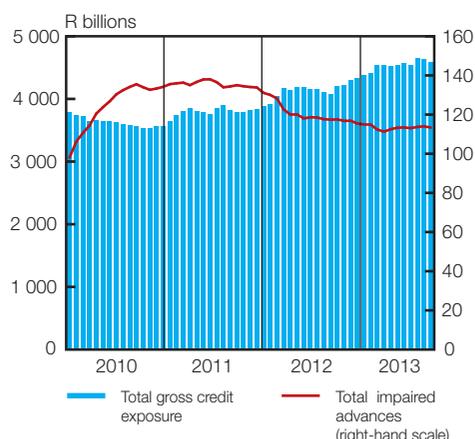
The South African banking sector

Credit lending conditions for South African banks were tighter in the first half of 2013 compared to the same period a year earlier. This was in line with other EMEs¹² where banks in general also reported a tightening in bank funding conditions during the second quarter of 2013, compared to the same period in 2012. Survey results¹³ showed that, on average, 50 per cent of respondent retail banks had tightened lending standards during the second quarter of 2013 compared to 25 per cent a year earlier. Over the same period the level of tightening in investment banking increased to 20 per cent.

Regardless of the somewhat tighter lending conditions, the South African banking sector remained profitable and well capitalised during the period under review (Table 2). The ratio of regulatory capital to risk-weighted assets (also known as the capital-adequacy ratio or CAR) for the banking sector remained above the minimum required CAR of 9,5 per cent for the first half of 2013,¹⁴ although the sector's CAR dropped slightly compared to the second half of 2012. The return-on-equity and return-on-asset ratios indicate that the banking sector remained profitable during the first half of 2013, although there was a marginal decline in return on equity from February to May 2013, mainly due to a decrease in net foreign-exchange trading income and an increase in credit losses. The liquid asset ratios also remained adequate. The ratio of the effective aggregate net open foreign-currency position to regulatory capital and reserve funds remained within the prudential limit of 10 per cent of regulatory capital and reserve funds.¹⁵

Credit risk indicators showed mixed signals, with the banking sector's gross loans and advances increasing by about 5 per cent in the first half of 2013 to R2,9 trillion, largely due to increases in 'other' loans and advances,¹⁶ term loans and bank intragroup balances. The banking sector's impaired advances declined to R112,0 billion in December 2012, before increasing by 1,3 per cent during the first half of 2013, suggesting some increased stress in the sector's loan portfolios in comparison to the second half of 2012. Impaired advances as a percentage of gross loans declined to just below 4 per cent at the end of June 2013. Against the backdrop of increasing impaired

Figure 14 Total gross credit exposure and total impaired advances of the banking sector



Source: South African Reserve Bank

12 Institute of International Finance, *Emerging Market Bank Lending Conditions Survey, 2013 Q2* (Washington DC: IIF, 24 July 2013).

13 Bureau for Economic Research and EY, (Stellenbosch: Stellenbosch University).

14 The Basel III framework provides for transitional phase-in arrangements for minimum capital levels and buffers beginning in 2013, with the final ratios being implemented from 2019. For more details on South Africa's implementation of the Basel III framework, refer to the September 2012 and March 2013 editions of the *Financial Stability Review*. Amended banking regulations incorporating the respective requirements of the Basel III framework were implemented from 1 January 2013.

15 Refer to Banks Act Directive 10/2013, available at <http://www.resbank.co.za/Publications/Pages/Bank-Act-directives.aspx>.

16 'Other' loans and advances include call loans, foreign currency loans, specialised lending, collateral and other loans.

Table 2 Selected indicators of the South African banking sector¹

Per cent, unless indicated otherwise

| | 2013 | | | | | |
|---|---------|---------|---------|---------|---------|---------|
| | Jan | Feb | Mar | Apr | May | Jun |
| Market share (top four banks)..... | 83,82 | 83,70 | 83,55 | 83,52 | 83,45 | 83,52 |
| Gini concentration index..... | 83,6 | 83,5 | 83,5 | 83,4 | 83,4 | 83,4 |
| Herfindahl–Hirschman Index (H-index)..... | 0,186 | 0,186 | 0,185 | 0,185 | 0,184 | 0,185 |
| Banks' share prices (year-on-year percentage change)..... | 25,8 | 18,2 | 13,6 | 10,4 | 6,0 | -2,0 |
| Capital adequacy | | | | | | |
| Total capital-adequacy ratio..... | 15,21 | 15,12 | 15,03 | 15,22 | 14,81 | 14,92 |
| Tier 1 capital-adequacy ratio..... | 12,12 | 12,06 | 11,99 | 12,18 | 11,84 | 11,99 |
| Common equity Tier 1 capital-adequacy ratio..... | 11,44 | 11,39 | 11,33 | 11,51 | 11,18 | 11,33 |
| Credit risk | | | | | | |
| Gross loans and advances (R billions)..... | 2 754,0 | 2 791,8 | 2 831,4 | 2 818,7 | 2 839,9 | 2 890,5 |
| Impaired advances (R billions) ² | 112,5 | 113,3 | 113,4 | 113,1 | 113,7 | 114,0 |
| Impaired advances to gross loans and advances..... | 4,09 | 4,06 | 4,01 | 4,01 | 4,00 | 3,94 |
| Specific credit impairments (R billions)..... | 45,1 | 45,9 | 46,1 | 46,7 | 47,7 | 48,0 |
| Specific credit impairments to impaired advances..... | 40,09 | 40,48 | 40,67 | 41,29 | 41,92 | 42,10 |
| Specific credit impairments to gross loans and advances..... | 1,64 | 1,64 | 1,63 | 1,66 | 1,68 | 1,66 |
| Profitability | | | | | | |
| Return on assets (smoothed)..... | 1,27 | 1,29 | 1,23 | 1,23 | 1,21 | 1,23 |
| Return on equity (smoothed)..... | 17,63 | 17,71 | 16,87 | 16,74 | 16,44 | 16,61 |
| Interest margin to gross income (smoothed)..... | 49,71 | 49,88 | 50,54 | 50,67 | 50,83 | 51,02 |
| Operating expenses to gross income (smoothed)..... | 52,61 | 52,16 | 52,77 | 52,46 | 52,19 | 52,30 |
| Liquidity | | | | | | |
| Liquid assets to total assets (liquid-asset ratio)..... | 8,93 | 8,91 | 8,11 | 8,40 | 8,22 | 8,22 |
| Liquid assets to short-term liabilities..... | 18,61 | 18,39 | 16,60 | 17,20 | 17,03 | 16,31 |
| Effective net open foreign-currency position to qualifying capital and reserve funds..... | -2,38 | -1,67 | -2,38 | -2,69 | -2,66 | -3,28 |

1 Data were updated on 4 September 2013

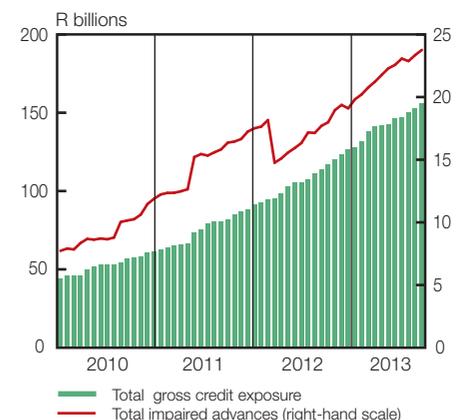
2 Impaired advances are advances in respect of which the bank has raised specific credit impairments

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

advances, the banking sector also increased its specific credit impairments¹⁷ to R48 billion in June 2013, increasing the ratio of specific impairments to impaired advances by almost 200 basis points in the first half of 2013.

17 Regulation 67 of the Regulations relating to Banks defines 'specific impairment or allowance for doubtful debt' as "an impairment, allowance or provision made against losses on a debt that has been specifically identified as bad or doubtful, and any impairment, allowance or provision made against groups of debt on the basis of their age".

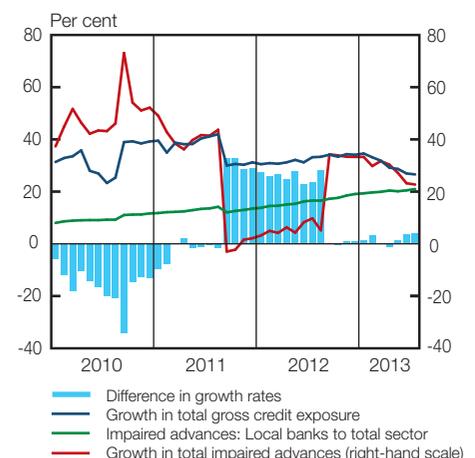
Figure 15 Total gross credit exposure and impaired advances of 'other local banks'¹



¹ Excluding the five largest banks and branches of international banks

Source: South African Reserve Bank

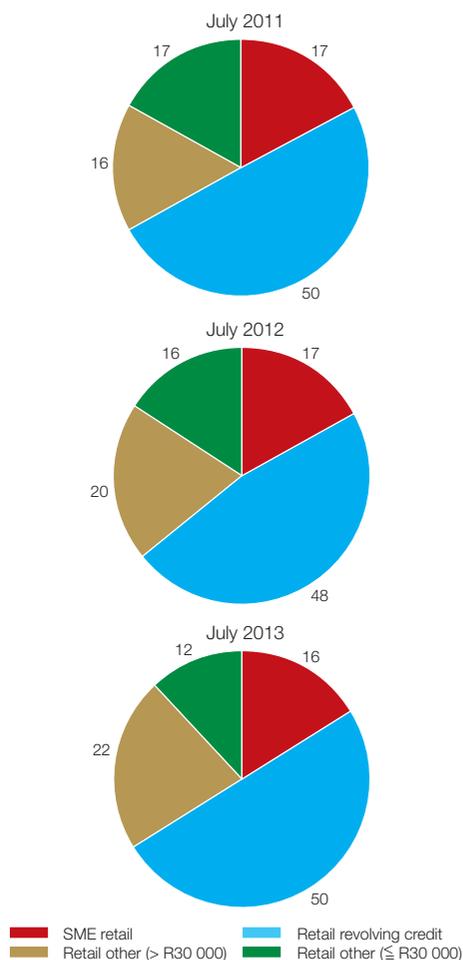
Figure 16 Growth in gross credit exposure and impaired advances of 'other local banks'¹



¹ Excluding the five largest banks and branches of international banks

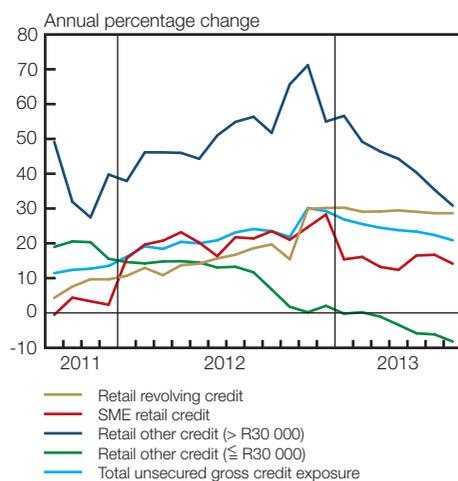
Source: South African Reserve Bank

Figure 17 Composition of total unsecured lending to retail counterparties



Source: South African Reserve Bank

Figure 18 Growth in gross unsecured credit exposure



Source: South African Reserve Bank

The banking sector's total gross credit exposure¹⁸ grew by 9,8 per cent year on year in June 2013, which was slightly higher than in June 2012 (8,9 per cent). The growth was mainly due to increases in loans to retail and corporate counterparties. Impaired advances contracted by 2,3 per cent year on year in June 2013, a slower contraction than in June 2012 (-10,9 per cent). As reported in the March 2013 *Financial Stability Review*, impaired advances of the five largest banks continued to mirror the decreasing trend of the total banking sector. However, impaired advances reported by the remainder of the local banks¹⁹ (Figure 15) continued to grow and increased from R21,2 billion in December 2012 to R23,4 billion, constituting just over 20 per cent of total impaired advances in June 2013. However, since the growth in impaired advances continued to be matched or exceeded by the growth in gross loans and advances during the first half of 2013, it resulted in a net improvement in the quality of the loan book of this grouping (Figure 16).

The total gross unsecured credit exposure (total unsecured lending)²⁰ of the six local banks providing such products to retail counterparties increased to R468,7 billion in July 2013 from R441 billion in December 2012. The unsecured loans provided by these six banks accounted for approximately 98,5 per cent of total gross unsecured lending (all categories) of the banking sector as at 31 July 2013.

Approximately half of total unsecured lending in the period between July 2011 and July 2013 was in the form of retail revolving credit exposures (consisting largely of credit card products and overdraft facilities) (Figure 17). In July 2013 credit exposure to small- and medium-sized entities comprised about 16 per cent of total unsecured lending while the unsecured 'retail other' category, which consists mainly of personal term loans represents about 34 per cent. The retail other category consisting of exposures greater than R30 000 increased to about 22 per cent of total unsecured lending. Industry participants are of the opinion that the increase in this category of unsecured lending is a result of both improved income levels and increased debt consolidation.

Since December 2012 growth in total unsecured lending has been moderating consistently (Figure 18). The annual growth in all categories of unsecured lending slowed, with the retail other category consisting of exposures greater than R30 000 showing the largest decrease (from 55,0 per cent in December 2012 to 30,8 per cent in July 2013). The retail other category consisting of exposures less than or equal to R30 000 contracted by 8,2 per cent year on year in July 2013.

By July 2013, total unsecured lending of banks constituted 11,9 per cent of total gross credit exposure and 27,1 per cent of total retail credit exposure. Despite the slowdown in the growth of total unsecured lending in 2013, unsecured loans make up an increasing, but still small portion, of banks' total loan book.

18 Total gross credit exposure is the banking sector's credit exposure to both on- and off-balance-sheet facilities, repurchase and resale agreements and derivative financial instruments.

19 Excluding the five largest banks and branches of international banks.

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

The default exposures and specific credit impairments of different categories of unsecured lending are shown in Figure 20. The 'retail other' category of less than or equal to R30 000 had the highest default exposure ratio,²¹ while the 'retail other' category consisting of exposures greater than R30 000 had the highest coverage ratio²² compared to other categories of unsecured lending and, by implication, carries a lower risk than other categories of unsecured lending.

The two economic sectors to which the banking sector had the largest credit exposure during the period under review remained the financial intermediation and insurance sectors and the household sector, amounting to 24,2 per cent and 35,3 per cent respectively of total gross credit exposure as at 28 June 2013 (Figures 21 and 22). The defaulted exposures of the private household sector as a percentage of total credit exposures (default ratio) decreased from 6,1 per cent in December 2012 to 4,7 per cent in June 2013, despite an increase in credit exposure to this sector.²³ In June 2013 the default ratio of the financial intermediation and insurance sector was negligible (about 0,2 per cent). The annual growth rate of the financial intermediation and insurance sectors increased from 5,4 per cent in December 2012 to 7,2 per cent in June 2013.

In June 2013 the banking sector's gross credit exposure was mainly to South African counterparties (see Figure 23). The highest year-on-year growth rate of gross credit exposure was to other African countries, in line with the strategy of some of the large banks to increase their operations in Africa. The five largest banks' gross credit exposure to selected distressed European peripheral economies is also continually monitored. As a percentage of the banks' gross credit exposure it remained less than 1 per cent as at 28 June 2013. The majority of the five largest banks' gross credit exposure to selected European countries²⁴ was in the form of interbank derivative financial instrument exposures (refer to Figure 24). Direct exposures to sovereign investment and trading securities also remained low, at less than 1 per cent, therefore not presenting any significant risks to the domestic banking sector.

Non-bank financial institutions

Non-bank financial institutions (NBFIs)²⁵ play an important role in the financial system. They complement commercial banks 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. NBFIs also extend credit, especially where the maturities of their liabilities constitute a better match for the borrower's maturity needs than banks' liabilities.

In the six months ended June 2013 there were 68 companies in the long-term insurance industry. All companies had more than the minimum regulatory capital, with the majority having a ratio of free assets to

Figure 19 Ratio of unsecured lending to total lending

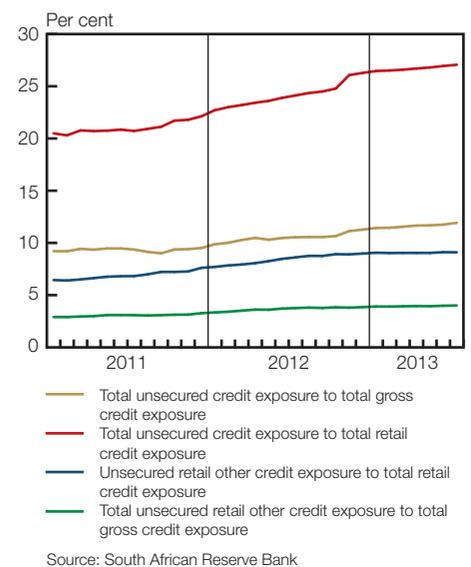


Figure 20 Default exposures and specific credit impairments of total unsecured lending as at 31 July 2013

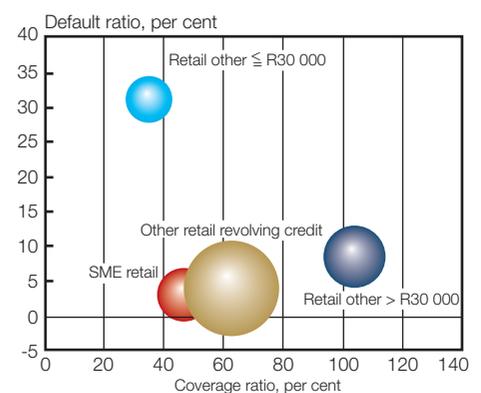
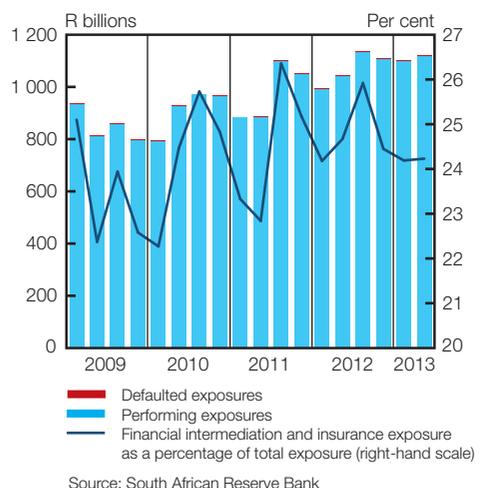


Figure 21 Banking-sector exposure to financial intermediation and insurance sectors



21 The default exposure ratio consists of exposures greater than 90 days reported for standardised approach portfolios and defaulted exposures reported for internal ratings-based (IRB) portfolios as a percentage of gross credit exposure.

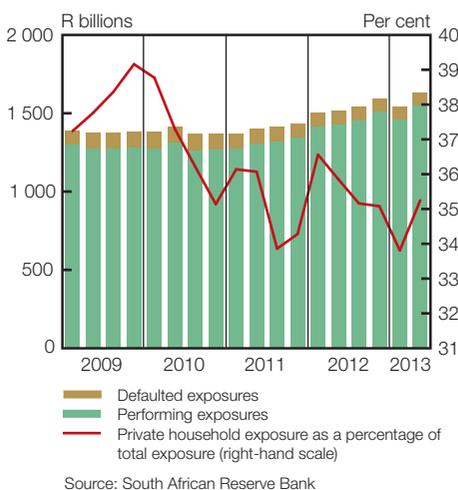
22 The coverage ratio is specific credit impairments as a percentage of the total of 90 days overdue exposures reported for standardised approach portfolios and defaulted exposures reported for IRB portfolios.

23 Also see the section on the household sector on p26.

24 Selected European countries included in the survey to the five largest banks include France, Germany, Greece, Ireland, Italy, Portugal, Spain and the UK.

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

Figure 22 Banking-sector exposure to the private household sector



capital-adequacy requirement of two to five times (Table 3). The financial position of the overall long-term insurance industry continued to be favourable, with the total assets increasing by 4,7 per cent in the six months to June 2013 and net premiums increasing by 26 per cent year on year. However, individual lapses and surrenders (both expressed as a percentage of new policies issued over the period) increased by 46 per cent and 14 per cent respectively.

The results of the EY Financial Services Index's sub-index regarding life insurers were, however, less positive in the second quarter of 2013 compared to the preceding quarters. Confidence among life insurers decreased by 12 index points, but remained at an elevated level of 83 index points during the second quarter of 2013. Although life insurers reported stronger fundamentals in terms of robust total income growth (driven by higher premium and investment income) and strong new business premiums, this was not sufficient to support confidence at the former higher levels.

Figure 23 Geographic exposure of the banking sector as at 30 June 2013

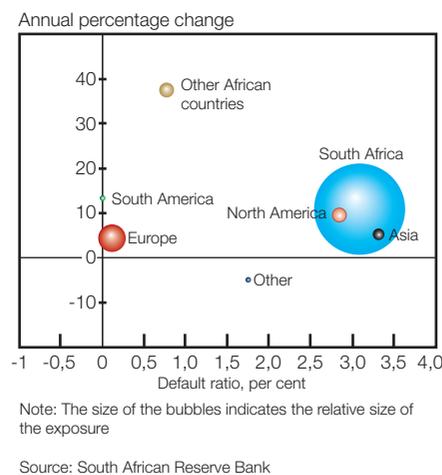


Table 3 Free assets-to-capital-adequacy requirement of the primary long-term insurance industry¹

| | Number of insurers | | | |
|--------------------------|--------------------------|--------------------------|-------------------------|-------------------------|
| | 12 months ended Dec 2011 | 12 months ended Dec 2012 | 3 months ended Mar 2013 | 6 months ended Jun 2013 |
| Covered 0–1 time | 2 | 0 | 0 | 0 |
| Covered 1–2 times | 27 | 26 | 25 | 22 |
| Covered 2–5 times | 29 | 27 | 26 | 30 |
| Covered 5–10 times | 12 | 15 | 16 | 12 |
| Covered 10+ times | 2 | 2 | 2 | 4 |

¹ The primary long-term insurance industry includes typical insurers, niche insurers, cell captive insurers, linked investment insurers and assistance insurers, but excludes reinsurers

Source: Financial Services Board

Long-term typical insurers²⁶ maintained adequate capital buffers. In the six months to June 2013, all long-term typical insurers were covered by a free assets-to-capital-adequacy requirement of more than one time, thus having adequate capital to cover more than the regulatory minimum requirement of 13 weeks of operating expenses under adverse financial conditions. Most long-term typical insurance companies (17) were covered by a free assets-to-capital-adequacy requirement of two to five times (Figure 25). During the same period, the number of new policies written increased by 12 per cent compared to a year before.

Based on annualised figures, about 1,6 million lapses for long-term typical insurance companies were recorded in the three months to June 2013 (Table 4). Over the same period, 252 842 surrenders were recorded. As a percentage of new policies issued over the period, lapses stayed relatively constant at around 50 per cent and surrenders at approximately 10 per cent. The trends evident in lapses and surrenders do not present an undue prudential risk to the insurance industry or the financial system in South Africa.

²⁶ Long-term typical insurers are those who offer most types of policies mostly to the general public.

Table 4 Lapses and surrenders of long-term insurers

| | Lapses | | | Surrenders | | |
|--------------------|-----------|---------------------|---------------------------------|------------|---------------------|---------------------------------|
| | Number | Year-on-year growth | Per cent of new policies issued | Number | Year-on-year growth | Per cent of new policies issued |
| 2011: 1st qr | 1 425 833 | -15,9 | 66 | 187 382 | 12,9 | 9 |
| 2nd qr | 1 599 133 | -14,7 | 66 | 326 683 | -16,9 | 11 |
| 3rd qr | 1 468 382 | 115,1 | 63 | 192 913 | -15,0 | 10 |
| 4th qr | 1 416 791 | 18,7 | 59 | 369 400 | 64,6 | 10 |
| 2012: 1st qr | 1 505 664 | 5,6 | 53 | 343 223 | 83,2 | 12 |
| 2nd qr | 1 373 902 | -14,1 | 53 | 192 334 | -41,1 | 10 |
| 3rd qr | 2 177 226 | 48,3 | 52 | 298 643 | 54,8 | 9 |
| 4th qr | 1 266 873 | -10,0 | 53 | 179 642 | -51,4 | 9 |
| 2013: 1st qr | 1 331 516 | -11,6 | 50 | 256 271 | -25,3 | 9 |
| 2nd qr | 1 598 712 | 16,4 | 57 | 252 842 | 31,5 | 10 |

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

The 82 short-term insurers maintained adequate capital buffers with total assets increasing by 4,3 per cent in the six months ended June 2013 (Table 5). The biggest contribution to total net premiums of the short-term insurance industry came from motor vehicle insurance (45,1 per cent) followed by property insurance (32,4 per cent). Underwriting and investment income of around R6 billion was recorded and underwriting profits of R3,7 billion were registered.

Table 5 Free assets-to-capital-adequacy requirement of the primary short-term insurance industry¹

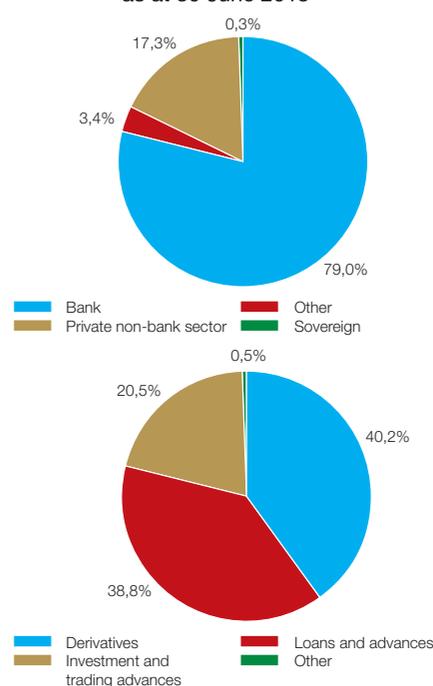
| | Number of insurers | | | |
|--------------------------|--------------------|----------|----------|----------|
| | Sep 2012 | Dec 2012 | Mar 2013 | Jun 2013 |
| Covered 0–1 time | 0 | 1 | 0 | 0 |
| Covered 1–2 times | 36 | 39 | 38 | 34 |
| Covered 2–5 times | 24 | 23 | 27 | 30 |
| Covered 5–10 times | 11 | 10 | 11 | 13 |
| Covered 10+ times | 9 | 10 | 6 | 5 |

¹ The primary short-term insurance industry includes typical insurers, niche insurers, cell captive insurers and captive insurers, but excludes reinsurers

Source: Financial Services Board

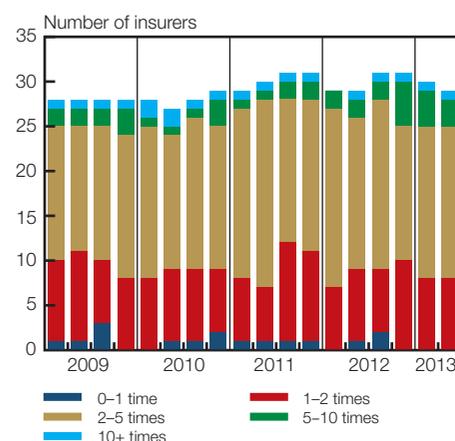
Growth in the assets of pension and provident funds, both official and self-administered private funds, remained strong in the first quarter of 2013, recording an annual growth rate of 15,7 per cent, which is only slightly down from the growth rate of 17,8 per cent recorded in the last quarter of 2012. 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 77,6 per cent, up from 76,4 per cent in the fourth quarter of 2012. The investment of official pension and provident funds in

Figure 24 Banking-sector exposure to selected European countries as at 30 June 2013



Source: South African Reserve Bank

Figure 25 Free assets-to-capital-adequacy requirement¹ of long-term typical insurers²



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

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

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

fixed-income securities increased by an average annual rate of 14,3 per cent during the first half of 2013, while investment in equities increased by an average annual rate of 18,1 per cent over the same period. During the first and second quarters of 2013, the year-on-year growth rate in private and self-administered pension and provident fund holdings of bonds increased by 22,6 per cent on average, while investment in equities increased by 15,3 per cent. The investment behaviour of pension and provident funds positively contributed to the continued stability of the South African financial market.

Confidence in the financial services sector

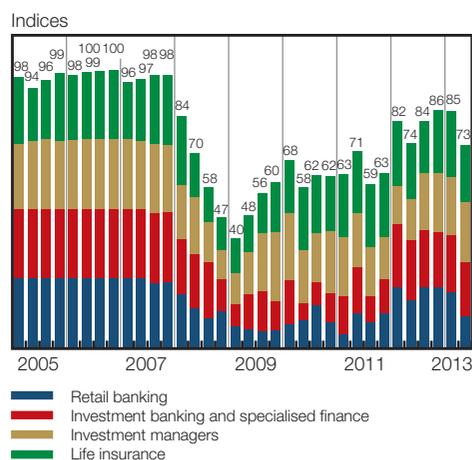
In line with weaker economic growth and the uncertainty surrounding emerging markets, confidence levels in the financial sector weakened during the first half of 2013. The EY Financial Services Index declined from 85 index points in the first quarter of 2013 to 73 index points in the second quarter, after reaching a high of 86 index points in the fourth quarter of 2012.²⁷ This is the first time since the third quarter of 2010 that the EY Financial Services Index was below the long-term average²⁸ of 78 index points. In the second quarter of 2013, the index recorded declines in retail banking-sector confidence, which fell sharply to its lowest level in over a year, from 80 index points in the first quarter of 2013 to 46 index points in the second quarter. This is an indication that the majority of retail banks are not satisfied with the prevailing business conditions. By contrast, confidence levels in investment banking declined only moderately in the second quarter of 2013. The decline in the confidence of investment banking was due to depreciating currencies and weaker demand for commodities in emerging markets in general, despite signs of improved economic growth in major global economies.

This considerably lower level of confidence in the second quarter of 2013 is in line with the view that general economic conditions remain tough, given weak employment growth and a challenging labour environment, which is exacerbated by the simmering tensions in the mining, motor manufacturing, agricultural and textile sectors.

Government finances and financial stability

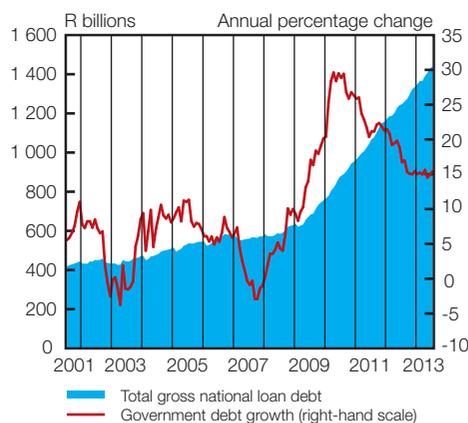
Government finances, economic performance and financial stability are all interdependent. Government debt management is an important factor that underpins the credibility and reputation of a sovereign, and influences the stability of bond markets and the financial institutions that hold public debt. The interlinkages between financial stability and sovereign risk operate through a feedback loop: prudent public debt management supports financial stability, which, in turn, can mitigate sovereign risk, thus enhancing the government's ability to support financial stability. However, downgrades in sovereign debt could adversely impact on a financial sector through its holding of public debt.

Figure 26 Financial Services Index and its components



Source: EY

Figure 27 Gross loan debt of national government



Source: South African Reserve Bank

27 The EY 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'. The Bureau for Economic Research at Stellenbosch University conducted the survey and processed the results on behalf of EY.

28 The long-term average is calculated over the past 46 quarters, that is, since the inception of the EY Financial Services Index.

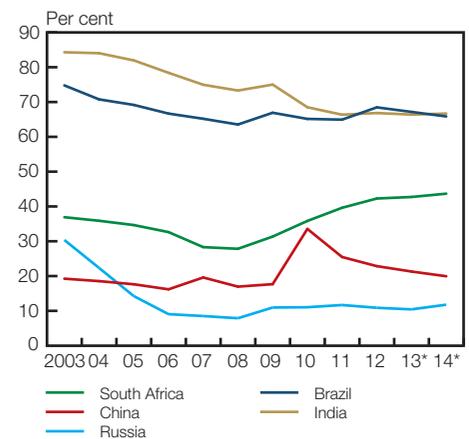
There has been a consistent increase in the total loan debt of the South African national government mainly as a result of countercyclical fiscal policy responses during the time of the global financial crisis. The gross loan debt of national government increased to R1 440 billion in July 2013 from R1 350 billion in January 2013, in line with the initial budgetary projection of R1 522 billion for the 2013/14 fiscal year. Government debt also increased during this period as a result of weak revenues due to the recession of 2008/09.

South Africa's debt-to-GDP ratio was estimated by the IMF at 42,3 per cent in 2012 and forecast to remain around these levels in the foreseeable future.²⁹ When compared to its BRICS counterparts, South Africa's debt-to-GDP ratio has consistently ranked below that of Brazil and India,³⁰ but has been increasing at a higher pace since 2008 (Figure 28). South Africa is a signatory to the Southern African Development Community (SADC) memorandum of understanding on macroeconomic convergence, according to which the benchmark for the government debt-to-GDP ratio is set at 60 per cent.

The stability of the financial sector could be affected through the holding of excessive public debt by financial institutions as elevated government debt levels could become unsustainable, which, in turn, could result in vulnerability of the financial sector to which government is mostly indebted. During the period under review, however, domestic financial institutions gradually tapered their investment in government debt, countering the upward trends witnessed during 2012. Pension and provident funds, both official and self-administered private funds, remained the largest investors in government debt, increasing their holdings to R404,2 billion in the first quarter of 2013 (constituting a year-on-year increase of 18 per cent), while the insurance industry increased its public debt holdings by 8,8 per cent to R155,5 billion over the same period. In the year to June 2013, local banks decreased their holdings of government debt by 11,8 per cent to R150,7 billion.

Sovereign debt ratings have a significant impact on investor confidence as a downgrade could result in a sudden outflow of funds, and hence directly impact the stability of a financial sector. During the period under review Moody's, Standard & Poor's and Fitch Ratings (Fitch) reaffirmed South Africa's investment-grade credit rating. Moody's and Standard & Poor's maintained a negative outlook citing concerns regarding the mining industry, the lacklustre economic performance and recurring labour tensions, while Fitch revised the economic outlook for South Africa from 'negative' to 'stable'.

Figure 28 Government debt-to-GDP ratios of the BRICS countries



* Data for 2013 and 2014 are IMF estimates
Source: International Monetary Fund

29 International Monetary Fund, 2013 Article IV Consultation, South Africa (Washington DC: IMF, October 2013).

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

Table 6 Sovereign debt ratings for South Africa

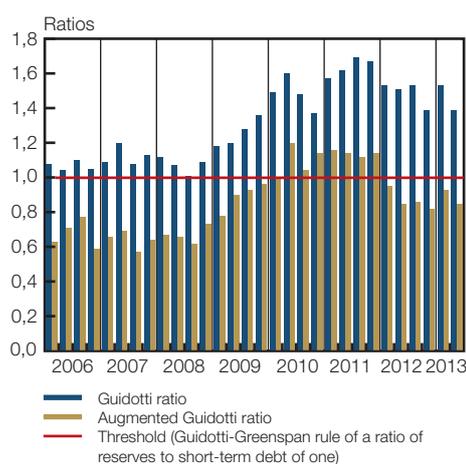
| Agencies | 2012 | 2013 | |
|---------------------------------|------------------|------------------|------------------|
| | 4th qr | 1st qr | 2nd qr |
| Moody's Investors Service | A3 Negative | Baa1 Negative | Baa1 Negative |
| Standard & Poor's | BBB+ Stable | BBB Negative | BBB Negative |
| Fitch Ratings | BBB+ Negative | BBB Negative | BBB Stable |

Sources: Moody's Investors Service, Standard & Poor's and Fitch Ratings

External sector

During the period under review the level of foreign-exchange reserves decreased from US\$51,2 billion in January 2013 to around US\$48 billion in August 2013, after which they increased to US\$50 billion in September. At current levels, foreign-exchange reserves would cover about five months' imports. The Guidotti ratio (GR), which gauges a country's ability to finance its short-term external debt in the event of a sudden reversal of foreign capital inflows and which also includes the possible inaccessibility to external capital markets for a period of one year, decreased to 1,39 in the second quarter of 2013 from 1,53 in the first quarter of 2013. The deterioration can be attributed to a decrease in the level of foreign-exchange reserves³¹ and an increase in short-term external debt. Nevertheless, all short-term external debt³² could be comfortably financed under stressful conditions in external capital markets. Early indications point to a rebound in the level of reserves in the third quarter of 2013. The augmented Guidotti ratio (AGR), which takes into account the current-account deficit in addition to short-term debt, also decreased to 0,85 in the second quarter of 2013 from 0,93 in the first quarter. The decrease in the AGR was due to the widening of the current-account deficit. At the current level, the AGR indicates that available foreign-exchange reserves could fall short of financing the country's total external financing requirements over a period of one year. Despite the decrease in the level of foreign-exchange reserves and the deterioration in the GR and AGR, there was still a net inflow of bonds and equities which amounted to R11,6 billion in September 2013.

Figure 29 Reserve-adequacy ratios¹



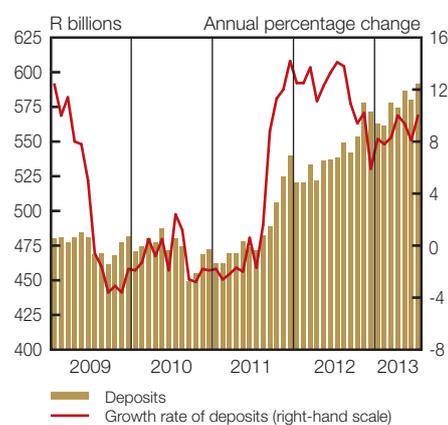
¹ Figures for reserves and debt in US\$ millions

Source: South African Reserve Bank

Corporate sector

During the period under review credit extended to the corporate sector increased, recording a 12-month growth rate of 10,5 per cent in the second quarter of 2013 (Table 7). Expressed as a percentage of GDP, credit to corporations remained at elevated levels of around 52 per cent compared to the long-term average (1975-2013) of roughly 36 per cent. Fixed investment by the corporate sector picked up somewhat in the second quarter of 2013, but deposits with commercial banks remained high during the first seven months of 2013, growing by 10 per cent in the year to July to R592 billion (Figure 30). Elevated levels and high growth rates in non-financial corporate sector deposits could be an indication of a lack of

Figure 30 Non-financial corporate-sector deposits



Source: South African Reserve Bank

31 The reduction in reserves was due to a temporary drawdown to repay a maturing foreign loan. However, reserves have subsequently been replenished with a US\$2 billion issue.

32 Short-term debt at original maturity.

confidence which could be negative for future job creation. Profitability of the corporate sector, as measured by the net operating surplus, remained under strain with profit growth contracting by 1 per cent in the second quarter of 2013.

Table 7 Selected indicators for the corporate sector

Annual percentage change, unless indicated otherwise

| | 2012 | | | 2013 | |
|---|--------|--------|--------|--------|--------|
| | 2nd qr | 3rd qr | 4th qr | 1st qr | 2nd qr |
| Bank credit granted ¹ | 9,0 | 8,2 | 10,2 | 6,3 | 10,5 |
| Gross fixed capital formation ² | 7,3 | 6,3 | 6,1 | 7,4 | 8,3 |
| Credit as a percentage of GDP..... | 47,7 | 49,4 | 50,9 | 51,4 | 51,7 |
| Credit as a percentage of annualised profits ³ | 136,1 | 156,0 | 174,3 | 171,4 | 152,0 |
| Net operating surplus ⁴ | 12,3 | 0,9 | -1,0 | 0,9 | -1,1 |

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 rates)

Source: South African Reserve Bank

Overall business confidence also weakened further during the third quarter of 2013, decreasing to 42 index points from 48 index points in the second quarter (Table 8). Three of the sub-indices recorded lower confidence levels, with new vehicle dealers and wholesale traders' confidence dropping sharply. The growth in confidence levels of new vehicle dealers earlier in the year was sustained by a move to smaller, lower-priced vehicles combined with significant wage increases and easier access to credit for people with secure employment. As these factors subsided a concomitant slowdown in sales in the third quarter of 2013 was recorded. Pre-emptive buying in anticipation of price increases due to a depreciating domestic currency could also contribute to higher confidence levels for new vehicle dealers. The drop in wholesale traders' confidence was mainly due to slower profit growth as sales volumes decreased. The retail trade and manufacturing sectors were the only indices that improved due to stronger growth in domestic sales. The decline in the overall business confidence index highlights subdued conditions in South Africa. Widespread domestic labour unrest, rising inflation and a weakening currency are factors that are likely to further impact negatively on the business environment.

Table 8 Business confidence index¹

| Indices | 2012 | | 2013 | | |
|--|--------|--------|--------|--------|--------|
| | 3rd qr | 4th qr | 1st qr | 2nd qr | 3rd qr |
| Business confidence index | 47 | 46 | 52 | 48 | 42 |
| New vehicle dealers' confidence | 79 | 54 | 66 | 61 | 39 |
| Retail traders' confidence..... | 46 | 54 | 50 | 41 | 49 |
| Wholesale traders' confidence..... | 53 | 57 | 71 | 61 | 43 |
| Building contractors' confidence | 26 | 28 | 30 | 45 | 43 |
| Manufacturers' confidence | 38 | 38 | 42 | 34 | 37 |

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

Source: Bureau for Economic Research, Stellenbosch University

Figure 31 Non-financial corporate sector: Aggregate interest coverage ratio

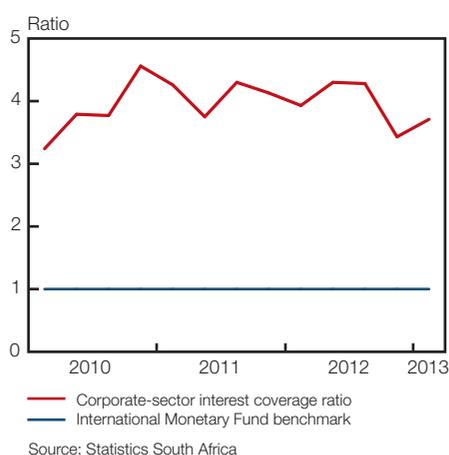
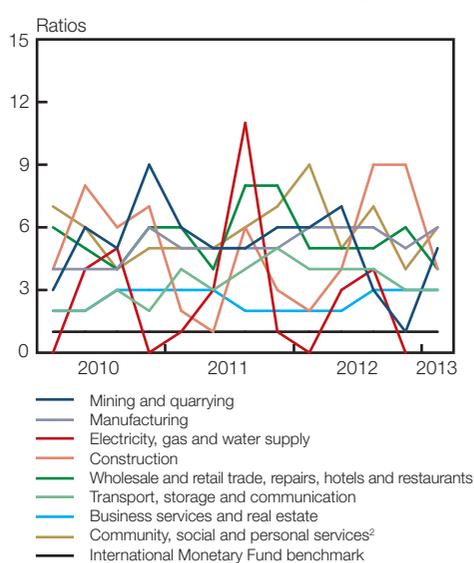


Figure 32 Non-financial corporate sector: Industry interest coverage ratios¹



¹ Figures for the first quarter of 2013 are preliminary

² Excluding public administration and defence activities, and education

Source: Statistics South Africa

The interest coverage ratio³³ (ICR) is used to gauge the ability of the corporate sector to generate cash flows to finance its interest expenses. In order to measure the vulnerability of corporates, the IMF determined that the corporate sector's ICR should have a benchmark of 1. The aggregated ICR remained high for the South African corporate sector in the first quarter of 2013 at between three and four times (Figure 31). This indicates that non-financial corporates as a sector generate enough cash flow to pay their interest expenses while interest rates are being kept at low levels. Should interest rates start increasing, however, it could have a marked financial impact on the industry, with a higher possibility of defaults.

At an industry level all ICRs were above the benchmark of 1, except for the mining and quarrying; electricity, gas and water supply; and construction industries. Since only a few enterprises supply the majority of the output of the electricity, gas and water industry, the ratio tends to be quite volatile as reflected in this particular curve fluctuating markedly around the benchmark of 1 (Figure 32).

Household sector

Even though households' financial assets, total assets and net worth continued on the strong growth path that began in the third quarter of 2012, vulnerabilities remain. During the period under review disposable income of households grew in line with growth in compensation of employees, albeit at a lower rate compared to previous quarters.

After recording a positive ranking in the second quarter of 2013 for the first time in over a year, the consumer confidence index as measured by First National Bank (FNB)/Bureau for Economic Research (BER) fell to its lowest level in over a decade to negative 8 index points (Figure 33). Consumers' ratings of both the prospects for their household finances and the appropriateness of the present time to buy durable goods declined by nine index points, and the economic outlook sub-index deteriorated to a five-year low of negative 14 index points.

³³ The ratio is calculated by aggregating enterprise information by using the earnings/net profits before interest and taxes and expressing it as a ratio of its interest payments due.

The consumer confidence index remained well below the average of 4 index points calculated from 1994. This implies that consumer confidence is still low and not supportive of a recovery in consumer spending, which could further dampen economic growth. Weak consumer confidence coupled with rising food, fuel and electricity prices had a dampening impact on household consumption expenditure. Growth in real household consumption expenditure has decelerated since the second quarter of 2011 and remained subdued at 2,5 per cent during the second quarter of 2013. Consumption expenditure as a percentage of GDP remained stable at around 61 per cent.

Table 9 Selected indicators for the household sector

Annual percentage change, unless indicated otherwise

| | 2012 | | | 2013 | |
|--|--------|--------|--------|--------|--------|
| | 2nd qr | 3rd qr | 4th qr | 1st qr | 2nd qr |
| Disposable income..... | 9,7 | 9,2 | 9,0 | 8,6 | 7,8 |
| Financial assets..... | 8,2 | 16,5 | 17,0 | 16,2 | 15,7 |
| Total assets..... | 5,6 | 11,9 | 13,7 | 14,2 | 15,0 |
| Net wealth ¹ | 4,7 | 12,6 | 14,7 | 15,4 | 16,8 |
| Consumption expenditure..... | 3,7 | 3,6 | 3,1 | 2,7 | 2,5 |
| Consumption expenditure to GDP..... | 60,5 | 60,2 | 60,7 | 60,9 | 61,0 |
| Credit extension..... | 7,4 | 9,3 | 9,9 | 9,6 | 8,8 |
| Unsecured credit..... | 24,0 | 23,7 | 22,7 | 21,3 | 18,0 |
| Savings as a percentage of disposable income.... | 0,03 | 0,04 | 0,04 | 0,01 | -0,02 |
| Debt..... | 9,0 | 9,3 | 9,6 | 9,2 | 7,9 |
| Debt to disposable income..... | 75,7 | 76,1 | 75,4 | 75,4 | 75,8 |
| Debt to GDP..... | 45,8 | 45,9 | 45,8 | 50,0 | 46,3 |
| Financing costs of household debt..... | 5,2 | 2,2 | 1,7 | 6,1 | 5,9 |
| Debt-service cost ² as a percentage of disposable income..... | 7,8 | 7,7 | 7,6 | 7,7 | 7,7 |
| Capital gearing (per cent) ³ | 20,1 | 19,7 | 19,4 | 19,1 | 18,9 |
| Insolvencies ⁴ | -27,0 | -29,3 | -14,9 | -8,6 | 5,4 |

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

2 Interest payments on housing and personal debt

3 'Capital gearing' refers to household debt as a percentage of total assets of households.

Data are preliminary

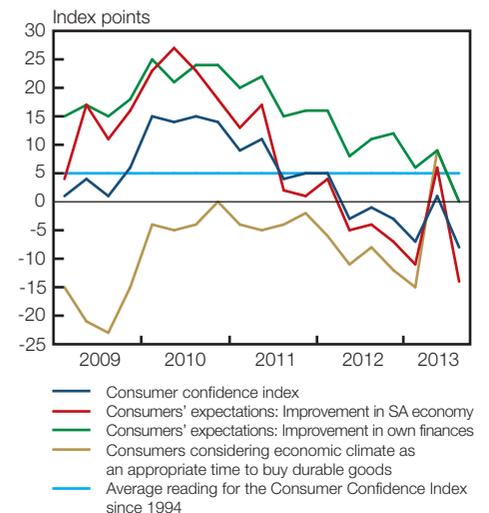
4 Monthly indicator, value of last month of respective quarter

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

During the first half of 2013, the household sector's appetite for debt seemed to have moderated somewhat. Credit to the sector moderated to an annual rate of 8,8 per cent in the second quarter of 2013. The slowdown in the growth rate of unsecured lending to the household sector that started in the third quarter of 2012 continued into the second quarter of 2013, with unsecured lending to the sector moderating to 18 per cent year on year.

Historically, household debt expressed as a percentage of both household disposable income and GDP has been high. After increasing to 6,1 per cent year on year in the first quarter of 2013, up from 1,7 per cent in the fourth quarter of 2012, the cost of financing household debt decreased marginally to an annual growth rate of 5,9 per cent in the second quarter of 2013. Because of the low interest rate environment, the debt-servicing cost of households, as measured by the debt-service ratio, remained low and stable at 7,7 per cent during the first half of 2013. However, in the second quarter of 2013 the

Figure 33 Consumer confidence index¹



¹ The consumer confidence index is expressed as a net balance between optimistic and pessimistic consumers. According to the Bureau for Economic Research, the index can vary between -100 for 'extreme pessimism' and 100 for 'extreme optimism', with 0 being 'neutral'

Source: First National Bank/Bureau for Economic Research, Stellenbosch University



growth rate of insolvencies gathered momentum, recording a year-on-year increase of 5,4 per cent, although it remains a relatively volatile indicator.

Residential real-estate sector

In the real-estate market, the price-to-rent ratio is used to gauge the fundamental value of housing, the sustainability of house price levels and, in turn, the impact of these levels on financial stability. This ratio determines the expected value of benefits derived from home ownership received in the form of rent by owners or savings by owner-occupiers. The measure is related to the price-to-earnings ratio, typically used to determine the present value of future earnings of equity returns, since a decomposition of the movements in the price-to-rent ratio for housing mirrors that of the price-to-earnings ratio.³⁴

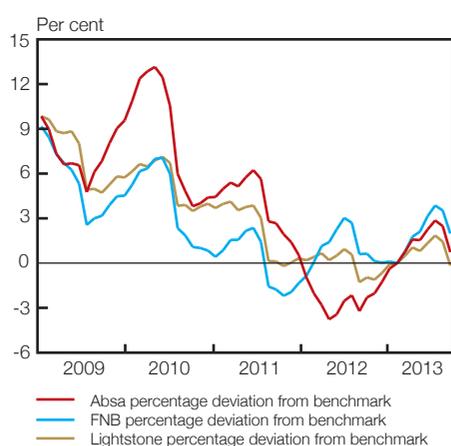
Figure 34 illustrates the percentage deviations of the price-to-rent ratios from the IMF benchmark rate of 100 for Absa, FNB and Lightstone.³⁵ It is evident that the respective ratios broadly follow very similar trends, with the exception of a few short periods, and have neither over- nor undervalued house prices in relation to their rental proxies by more than 5 per cent since June 2011. Therefore, according to the estimated price-to-rent ratios, houses in the real-estate sector have been fairly valued during the period under review.

Activity in the residential real-estate market remained subdued during the period under review. Growth in mortgage advances fluctuated between 1,6 per cent and 1,8 per cent year on year between January and July 2013, down from an average of 2,1 per cent year on year during 2012. Real interest rates on mortgage advances have been constant at approximately 8,5 per cent since the fourth quarter of 2012 – the lowest rate in several years. The ratio of mortgage debt to disposable income remained high at 40,4 per cent in the second quarter of 2013. However, despite favourable interest rates, factors such as elevated household indebtedness, low economic growth, higher unemployment and weak growth in disposable income remain key obstacles to double-digit growth in house prices.

A general improvement in the building sector was suggested with the FNB/BER Building Confidence Index³⁶ increasing to a four-year high of 41 index points during the second quarter of 2013. This was also the third consecutive quarterly increase for the first time since 2005. An improvement was experienced in both the residential and non-residential sectors.

Building activity and confidence in the residential sector are picking up despite the drop in confidence of building material retailers as retail sales in this sector decreased. Although it seems as if there are signs of recovery in the residential building sector, it should be kept in mind that the increase in confidence and activity emanates from a very low base.

Figure 34 Price-to-rent ratios¹



¹ Preliminary estimations

Sources: Absa Bank Limited, First National Bank, Lightstone and Statistics South Africa

34 For South Africa these ratios were estimated by using the actual average house prices, and the housing and utilities component of the consumer price index (data were obtained from Statistics South Africa, COICOP data series) as a proxy for rental income. All indices were rebased to have December 2012 as the base year in order to have a common reference point. The ratio therefore indicates the extent to which property prices have increased or decreased in relation to the rental prices in the same market.

35 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. The FNB House Price Index is the national market average of all house prices in its sample. The Lightstone House Price Index applies the repeat sales methodology and uses data from the Deeds Office.

36 First National Bank/Bureau for Economic Research Building Confidence Index (Johannesburg: FNB/BER, 18 June 2013).

The robustness of the domestic financial infrastructure

This section reviews developments in the domestic and international financial infrastructure and regulatory environment that relate to banking, insurance and other financial system infrastructures. Furthermore, background information is provided on key domestic and international regulatory issues and risks.

As reported in detail in the March 2013 *Financial Stability Review*, South Africa is in the process of reforming its financial sector regulatory framework by moving towards a twin peaks model of financial regulation. Following the publication by the National Treasury (NT) in February 2013 of the twin peaks regulatory framework implementation document,³⁷ additional working groups have been established under the Financial Regulatory Reform Steering Committee (FRRSC). These additional working groups will consider aspects specifically related to the reform and funding of the prudential regulator and the resolution framework of systemically important financial institutions and markets.

Regulatory developments impacting the domestic banking sector

This section focuses on the infrastructural and regulatory developments in the domestic banking sector. Developments relating to banks and related financial institutions are discussed, focusing on the introduction of a leverage ratio for banks, shadow banking and measures to address the too-big-to-fail problem.

Progress towards an enhanced, binding limit on banks' leverage

Banks' statutory capital ratios are influenced by the way in which they apply risk weights to their assets. In order to overcome possible inconsistencies in risk weightings between banks and to impose a uniform and binding limit on banks' ability to leverage their balance sheets excessively, the Basel Committee proposed the adoption of a minimum leverage ratio of 3 per cent as a non-risk-based capital measure towards the end of 2010 to serve as a 'backstop' to the risk-based capital requirements of the Basel III framework.³⁸ In June 2013, the Basel Committee issued a consultative document entitled *Revised Basel III Leverage Ratio Framework and Disclosure Requirement* (Revised Leverage Framework), which refines the original 2010 leverage ratio proposals. While the implementation of the leverage ratio requirement began with banks reporting their leverage ratios and their components to supervisors from 1 January 2013, the public disclosure of leverage ratios

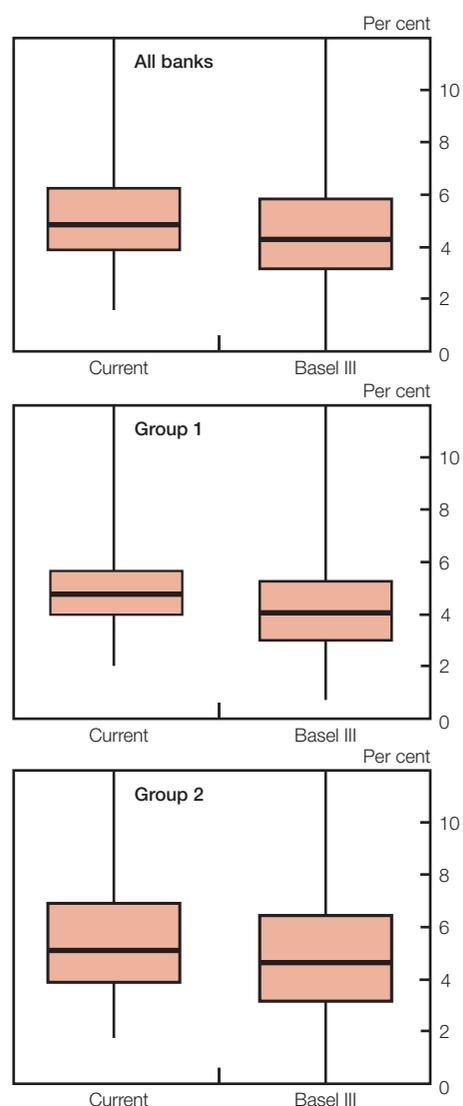
³⁷ The twin peaks regulatory reform stems from the Minister of Finance's February 2011 announcement of the proposed changes to the regulatory framework. The roadmap document entitled *Implementing a Twin Peaks Model of Financial Regulation in South Africa* is available at <http://www.treasury.gov.za>.

³⁸ The initial details of the leverage ratio were discussed and released in the rules texts published by the Basel Committee in December 2010 entitled *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*. This document was revised in June 2011.

will only start on 1 January 2015. Final adjustments to the definition and calibration of the leverage ratio will be made by 2017, with a view of migrating it to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration.

In the banking regulatory environment a leverage ratio is generally based on a ratio of capital in relation to an aggregated measure of risk-bearing assets, expressed as a percentage. Conversely, the leverage multiple, which is often referred to in discussions on leverage, is the inverse of the leverage ratio.³⁹ There is broad consensus that one of the major risks associated with unsustainably high leverage is that while it can lead to higher profits, it concomitantly magnifies losses that can deplete a bank's capital during unfavourable conditions. The Basel Committee's leverage ratio proposal is relatively less complex than the other risk-based capital requirements of the Basel III framework, such as those covering credit, market and operational risk, and the new liquidity standards. The leverage ratio is intended to be a simple and transparent measure to complement the other risk-based measures of the Basel III framework. It will operate alongside the capital, liquidity and other requirements of the Basel III framework to assist supervisors to evaluate and mitigate risks with the ultimate aim of reducing the risk of excessive leverage building up in the banking sector.

Figure 35 Banks' Basel III Tier 1 and current leverage ratios



Note: The median value is represented by the thick and horizontal line, with 50 per cent of the values falling in the range shown by the box. The upper and lower end points of the vertical lines generally show the range of the entire sample. Group 2 banks with leverage ratios above 12 per cent or with negative leverage ratios are included in the calculation but are not shown in the graph

Source: Basel Committee on Banking Supervision

Global and domestic banking-sector leverage trends

Over the past decade, average leverage in the banking sector has followed some distinct trends in many countries. In the period leading up to the global financial crisis, the average leverage ratio for banks trended downwards in many European countries and in the US. At their peak during the period preceding the global financial crisis, banks in these jurisdictions had leverage ratios of between 2,6 and 5 per cent.⁴⁰ The results of the first Basel Committee quantitative impact study (QIS) on leverage ratios, which was based on data of a broader spectrum of banks as at 31 December 2009, categorised the results of participating banks into two groups, namely Group 1 and Group 2 banks.⁴¹ It found that the average leverage ratio for Group 1 banks was 2,8 per cent and 3,8 per cent for Group 2 banks, but the QIS did not provide an average for both groups.⁴² These low leverage ratios bottomed out in 2008 before starting an upward trend.

The results of the second QIS conducted by the Basel Committee, released in March 2013 and based on data as at 30 June 2012, confirmed this upward movement. The average Basel III Tier 1 leverage ratio for all banks participating in the Basel Committee's second QIS was 3,8 per cent – a marked improvement on the 2009 QIS where the average for the bigger banks was below the proposed minimum ratio of 3 per cent. Figure 35 depicts the leverage ratios of all 210 participating banks, including South Africa. The banks were again divided into Group 1 and Group 2 banks, and two alternative measures of Tier 1 capital were used as the numerator, namely the fully phased-in Basel III definition of Tier 1 capital,

39 The leverage multiple is the aggregated measure of risk divided by capital. Therefore, the lower a bank's leverage ratio, the higher its leverage multiple will be. For example, if a bank's leverage ratio is below 3 per cent, its leverage multiple will necessarily be more than 33,3 times.

40 Refer to the March 2011 *Financial Stability Review* for further details on these global and domestic leverage trends. The average leverage multiple for these banks was between 20 and 35 times.

41 Group 1 banks are those that have Tier 1 capital in excess of €3 billion and are internationally active. All other banks are considered Group 2 banks. Basel Committee of Banking Supervision, *Results of the Comprehensive Quantitative Impact Study* (Basel: BIS, December 2010).

42 This approximates to capital being leveraged between a range of 26 and 37 times.

and the current Tier 1 capital of the participating banks. Noteworthy was that the smaller banks in Group 2, with an average Basel III Tier 1 leverage ratio of 4,4 per cent, were less leveraged than the bigger banks in Group 1, with a ratio of 3,7 per cent. A total of 49 banks did not meet the 3 per cent minimum leverage ratio.⁴³

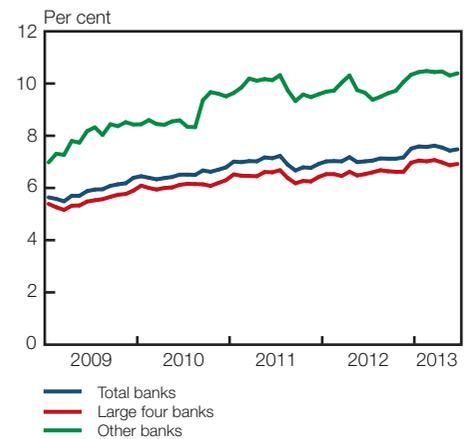
In South Africa, leverage ratios over the past decade followed a similar pattern, albeit at relatively higher levels and with some timing differences. The average leverage ratio of the four largest banks, which account for over 80 per cent of domestic banking-sector assets, started decreasing from around 2000 and reached its lowest levels of just below 5 per cent in 2003.⁴⁴ Since then, the average leverage ratio of these banks has been increasing steadily to its current level of around 7 per cent. Figure 36 depicts this increasing trend in the average leverage ratio of the four largest South African banks, the total banking sector and the other banks (which are mostly the smaller banks) since 2008. Similar to the results of the Basel Committee’s second QIS, the smaller banks in South Africa are also less leveraged than their larger counterparts. The data used to calculate the leverage ratios in the graph were not entirely based on the latest proposals in the Revised Leverage Framework. Nevertheless, the South African banking sector in aggregate is unlikely to have any difficulty in meeting the Basel minimum leverage ratio of 3 per cent.

Going forward in containing leverage

Leverage ratios may not be a perfect supervisory tool, but the enhanced proposals of the Basel Committee will make them robust measures for the stated aim of restricting the “build-up of leverage in the banking sector to avoid destabilising deleveraging processes that can damage the broader financial system and the economy”.⁴⁵ Implementing the leverage ratio in different jurisdictions will not be without its challenges. At a standard level, differences remain in the accounting treatment of certain items used in the calculation of leverage ratios, such as derivatives. These differences will have to be harmonised between the US’s Generally Accepted Accounting Practices and International Financial Reporting Standards. At a banking-sector level, it can be anticipated that there might be consideration for shifting assets to subsidiaries in order to meet the minimum leverage ratio. The procyclical nature of leverage, which typically builds up in boom periods and declines in bust periods, and the potential negative impact of deleveraging in reducing the supply of credit to the market are some of the macroeconomic factors that have to be taken into account by financial authorities.

The benefits of standardising the disclosure of leverage ratios as outlined in the Basel Committee’s disclosure framework are convincing as the diligent application of these standards will allow supervisory authorities and other market participants to conduct direct comparisons on an intra- and cross-jurisdictional basis. The implementation of leverage ratios is regarded as a necessary addition to the other risk-based measures to reduce banking-sector risks.

Figure 36 Domestic banking-sector leverage ratios



Note: The calculation of these leverage ratios is not entirely based on the Basel Committee’s proposals. The capital measure used closely matches the leverage proposal, but the exposure measure is based on an alternative, more conservative measure. However, the trends are indicative of leverage ratios among domestic banks

Source: South African Reserve Bank

43 Basel Committee, The Results of the Basel III Monitoring Exercise as of June 2012 (Basel: BIS, March 2013).

44 Refer to the March 2011 *Financial Stability Review*.

45 Basel Committee on Banking Supervision, Revised Basel III Leverage Ratio Framework and Disclosure Requirements (Basel: BIS, June 2013) p4.

Identifying domestic systemically important banks: Overview of the South African methodology

In November 2010 the Financial Stability Board released a framework for addressing the moral hazard risks posed by too-big-to-fail (TBTF) financial institutions, also referred to as SIFIs.⁴⁶ This SIFI framework addresses the TBTF issue by introducing measures aimed at reducing the probability and the broader negative externalities associated with the failure of SIFIs. This framework consists of an assessment and designation methodology, additional loss-absorbency requirements, more intensive supervision, more effective resolution mechanisms, and a stronger financial market infrastructure. The Basel Committee further developed the SIFI framework so that it could be applied to G-SIBs.⁴⁷ South Africa, like some other Financial Stability Board jurisdictions, does not have G-SIBs, but does have D-SIBs which pose similar systemic risks to the domestic and regional markets.

In order to address the systemic risks presented by D-SIBs, the Basel Committee issued the final version of its recommended methodology to identify D-SIBs in October 2012.⁴⁸ The D-SIB framework is an extension of the Basel Committee's framework for identifying G-SIBs and was developed at the request of the G-20 leaders to help financial authorities reduce the impact of the negative externalities created by the failure of systemically important banks both on global and domestic economies.

The Basel Committee's D-SIB framework contains guidelines for a methodology to identify D-SIBs and to impose an additional higher loss-absorbency (HLA) capital requirement on the identified D-SIBs. The D-SIB and G-SIB frameworks will be phased in concurrently from 1 January 2016. Whereas the G-SIB methodology is an indicator-based approach consisting of selected indicators with equal weights (size, interconnectedness, substitutability, global activity and complexity), the D-SIB methodology is a principles-based approach allowing for a degree of national discretion in the choice of indicators. It is intended that the D-SIB methodology's weightings should also reflect the characteristics of the domestic financial system.

The indicators proposed by the Basel Committee in the D-SIB framework include size, interconnectedness, complexity and substitutability. Global activity was considered to be less relevant for the D-SIB methodology than for the G-SIB methodology since domestic banks may have limited cross-jurisdictional activities. National authorities are expected to develop a D-SIB methodology and assess the systemic importance of the banks in their jurisdictions regularly. This assessment should reflect the potential impact of a bank's distress or failure on the domestic financial sector. Supervisory judgement of the outcome of the assessment methodology is allowed to ensure that it reflects the current financial conditions in the domestic economy. This judgement is time dependent and will be influenced by the general state of the economy.

⁴⁶ The Financial Stability Board released its *Report on Reducing the Moral Hazard Posed by Systemically Important Financial Institutions* and two related documents in November 2010. The documents are available on the Financial Stability Board's website (www.financialstabilityboard.org).

⁴⁷ See the Basel Committee document entitled *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement*, available at <http://www.bis.org/publ/bcbs207.htm>.

⁴⁸ *A Framework for Dealing with Domestic Systemically Important Banks*, available at <http://www.bis.org/publ/bcbs233.pdf>.

In South Africa, the Bank has developed an indicator-based methodology to identify D-SIBs. Although the South African D-SIB approach is broadly based on the Basel Committee's G-SIB approach, a number of the indicators and weightings were adjusted to be aligned to the characteristics of the domestic financial sector.⁴⁹ Table 10 shows the indicators used to determine the systemic importance of South African banks, with each indicator being based on a number of sub-variables.

Table 10 South Africa's D-SIB and the Basel Committee's G-SIB methodology indicators

| Indicator | South Africa's D-SIB methodology indicators | Basel Committee's G-SIB methodology indicators |
|---|---|--|
| | Weighting (Per cent) | Weighting (Per cent) |
| Size | 20 | 20 |
| Global activity | 10 | 20 |
| Interconnectedness | 20 | 20 |
| Substitutability | 20 | 20 |
| Complexity | 10 | 20 |
| Impact on confidence within the financial sector/social impact..... | 20 | Not applicable |

Sources: South African Reserve Bank and Bank for International Settlements

The indicators that have been included in the South African D-SIB methodology are as follows:

- *Size*: The total assets and off-balance-sheet exposures.
- *Global activity*: Even though global activity is considered less relevant in the Basel Committee's D-SIB methodology, it is deemed relevant for South African banks due to their cross-border activities and the potential spillovers relating to these activities, especially within the African continent. Most of the large South African banks are already active in many parts of Africa and all have earmarked growth in Africa in their expansion strategies. Cross-border externalities have therefore been included in the South African D-SIB assessment methodology, albeit at a lower weighting than in the Basel Committee's G-SIB framework.
- *Interconnectedness*: Interconnectedness in the South African banking sector is high due to the high level of concentration in the sector. Interconnectedness takes into account exposures to and from other financial institutions and activity in the financial markets.
- *Substitutability*: Substitutability largely reflects participation in financial market infrastructure.
- *Complexity*: The weighting assigned to the complexity indicator has been reduced to reflect the fact that South African banks' involvement in complex activities is limited.
- *Impact on confidence within the financial sector/social impact*: This indicator is currently unique to the South African D-SIB methodology and consists of sub-indicators that reflect the potential impact a bank's

⁴⁹ The application of this methodology will also be subject to judgement in order to ensure that all aspects relating to the systemic significance of institutions are taken into account.

failure would have on confidence in the South African financial sector in the form of financial inclusion and social considerations. Should a bank fail and its customers suffer hardship in the process, it is likely to harm their confidence in the formal banking system and to have broader social consequences, especially if there are spillover effects to other banks in the sector.

Some South African banks have been classified as D-SIBs using the above methodology. Based on a bank's (or controlling company's) score, it will be allocated to a 'bucket'. Each bucket will represent an increasing level of domestic systemic importance with a corresponding increase in HLA requirements. This requirement shall be met by a combination of common equity Tier 1 capital, Tier 1 capital and total capital. The HLA requirement will be phased in over a period of four years starting on 1 January 2016.

Shadow-banking developments

Globally non-bank financial intermediation has become a vital part of the financial system as it provides an alternative to customers for gaining access to credit and other financial services in support of economic activity. However, a large non-bank financial sector also poses potential systemic risks to the financial system. To this end, at its Cannes Summit in November 2011, the G-20 requested the Financial Stability Board to develop policy measures to assess the extent of these risks and to address them appropriately. The Financial Stability Board followed a two-phase approach, firstly creating a monitoring framework to enhance national authorities' ability to track developments in the non-bank financial sector, and secondly coordinating the development of policies in five areas in order to consider whether oversight and regulation need to be strengthened to reduce systemic risks.

In November 2012, the Financial Stability Board published its consultative documents on strengthening oversight and regulation of shadow banking. These documents provided an initial integrated set of policy recommendations to strengthen oversight and regulation of shadow banking. The five policy areas identified by the Financial Stability Board for further strengthening include:

- mitigating risks in banks' interactions with shadow-banking entities. Work in this area covers the scope of consolidation for prudential purposes; introducing a revised large exposures regime for banks to limit interconnectedness with shadow-banking entities; and developing a more risk-sensitive capital treatment for banks' equity investments in managed funds;⁵⁰
- reducing the susceptibility of runs on money-market funds (MMFs) by introducing common standards for the regulation of MMFs;⁵¹
- improving transparency and aligning incentives in securitisation by introducing risk-retention and enhanced disclosure requirements for securitisation products;

⁵⁰ Work in this area is spearheaded by the Basel Committee and includes developing better guidance with respect to these issues.

⁵¹ Work in this area is led by the International Organization of Securities Commissions, who released a document entitled *Policy Recommendations for Money Market Funds* in October 2012. The document makes final recommendations on regulating MMFs.

- dampening procyclicality and other financial stability risks in securities financing transactions such as repurchase agreements and securities lending; and
- assessing and mitigating financial stability risks posed by other shadow-banking entities and activities.

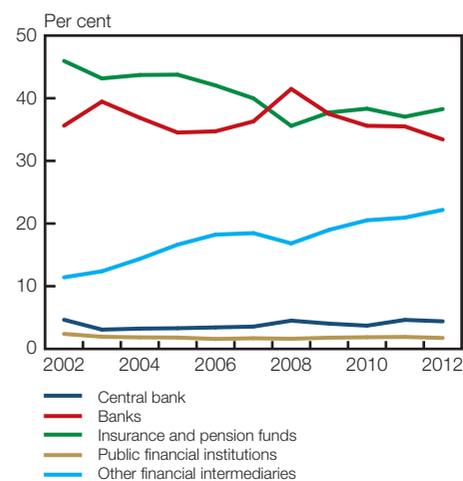
The Financial Stability Board emphasises economic functions and activities rather than the legal forms of entities conducting such functions and activities. This is aimed at ensuring that the recommendations remain robust.

South Africa is participating in the shadow-banking project of the Financial Stability Board within the annual monitoring exercise. From a systemic risk perspective, it is important that bank-like activities outside the banking sector are regulated commensurate with the risk that they introduce into the financial system and to promote a level playing field. In order to achieve this, it is essential that a commonly agreed definition of shadow banking be formulated. Such a definition could be based on measures of credit provision and maturity transformation outside the banking sector with reference to the resultant risk exposures.

The March 2013 edition of the *Financial Stability Review* gave a summary of South Africa’s response to the Financial Stability Board’s 2012 shadow-banking monitoring exercise. In South Africa, the share of banks’ total assets relative to financial intermediaries has been declining since 2008, and reached 33 per cent in 2012. However, banks, insurance corporations and pension funds, which are well regulated, still account for the largest share of total financial assets, as depicted in Figure 37. It seems that the asset share lost by banks since 2008 has largely been gained by other financial intermediaries (OFIs), a conservative proxy for the shadow-banking system,⁵² whose assets have consistently increased as a share of total assets of financial intermediaries since 2002, reaching 22 per cent of the total financial system in 2012. These OFIs have been active in extending credit and should accordingly be the focus of shadow-banking monitoring in South Africa. This ties in with work of the Financial Stability Board aimed at enhancing disclosure by other shadow-banking entities, such as OFIs, in order to understand the extent of shadow-banking risks posed by such entities. This could include information on overall firm-risk exposures, interconnectedness, funding concentration and aggregated maturity profiles of assets and liabilities.

With regard to the identification of shadow-banking entities, data collection may prove to be a challenge in South Africa and in other EMEs. There is a concern that many entities would not be able to afford the risk management infrastructure or levels of capital required by regulators. There is also a danger that entities conducting sound and well-regulated operations may be affected detrimentally. The Bank is in the process of investigating the refinement of the instrument revaluation methodology and compiling stock values for flows in order to collect more granular data on the domestic shadow-banking system.

Figure 37 Distribution of total assets between financial intermediaries in South Africa



Sources: South African Reserve Bank and Financial Services Board

52 'Other financial intermediaries' is used to obtain a conservative proxy of the size of the shadow-banking system and typically includes NBFIs that cannot be categorised as pension funds, insurance corporations or public-sector financial entities.

Another concern is that the intended scope of shadow banking is far-reaching and may have other unintended consequences. This is especially true for lending and credit provision activities that fall outside of the banking system and are funded by short-term liabilities. There may be significant challenges in being able to identify all types of entities that provide such credit. Additionally, access to the funding profiles of these entities may prove challenging, especially if they have not been regulated to date or are not listed.

Regulatory developments relating to the insurance sector

The insurance industry is a major part of the financial system and the global financial crisis highlighted a need for the financial and systemic stability risks of the industry and its interaction with other parts of the financial system to be taken into account. This section focuses on the global regulatory reform developments that are aimed at addressing such risks by enhancing the stability of the insurance industry, with emphasis on the revised Insurance Core Principles, the Insurance Laws Amendment Bill, 2013 (ILAB) and the Solvency Assessment and Management (SAM) Project.

Insurance Core Principles, Standards, Guidance and Assessment Methodology

Updated Insurance Core Principles

In October 2011,⁵³ the International Association of Insurance Supervisors (IAIS) issued the updated Insurance Core Principles, Standards, Guidance and Assessment Methodology, which included a number of new core principles. The Insurance Core Principles (ICPs) provide a universally recognised framework for the supervision of the insurance sector. The ICPs recommend the components that need to be present in the supervisory regime in order to promote a financially sound insurance sector and safeguard policyholders. The ICPs apply to insurance supervision in all jurisdictions, irrespective of the level of sophistication of the insurance markets and insurance products or services that are supervised in that particular jurisdiction. The ICPs are also applicable to the supervision of all insurers whether private or government controlled.

The areas that IAIS has strengthened in the new ICPs include corporate governance, risk management, group-wide supervision, cross-border co-operation and macroprudential surveillance. The ICPs can enhance a jurisdiction's supervisory system and can be used as an assessment tool to identify weaknesses in the financial system. Insurance supervisors will therefore need to give due consideration to financial market efficiency when implementing the new ICPs.

Impact on the South African regulatory environment

The March 2011 edition of the *Financial Stability Review* reported on outcomes of the insurance supervision Report on the Observance of Standards and Codes (ROSC) that was conducted by the IMF in 2010. The assessment of South Africa's compliance with the insurance ICPs of IAIS

53 The Insurance Core Principles are available at <http://www.iaisweb.org/Insurance-Core-Principles--795>.

was based on the 2003 version of IAIS's methodology and ICPs. The findings of the insurance ROSC were generally positive, but highlighted certain areas of South Africa's regulatory and supervisory framework in need of further development. South Africa was measured against the 28 ICPs and was found to be 'observing' 15 ICPs, 'largely observing' 10 ICPs and 'partially observing' 3 ICPs.

Some of the areas that the Financial Services Board were working on at the time of the ROSC included consolidated supervision of groups, the modernisation of solvency requirements through the SAM project and the introduction of guidelines on market conduct through the 'treating customers fairly' (TCF) initiative. These issues are still work-in-progress, but since the ROSC was conducted in 2010, the ICPs have been updated and there are new principles that the regulatory authorities need to take into consideration when improving their regulatory regimes.

Insurance Laws Amendment Bill

As part of the regulatory enhancements to the insurance regulatory framework and the renewed focus on consumer protection, the Financial Services Board has embarked on a comprehensive review of all insurance-related laws. The proposed Insurance Bill, 2014 will introduce the solvency regime and focus on prudential changes related to the twin peaks regulatory regime. The Insurance Bill, 2014 will evolve over time to include SAM project outcomes, reviews of the ICPs and the existing insurance legislative framework.

NT published the ILAB in June 2013 and requested public comments to be submitted by the end of July 2013.⁵⁴ The ILAB proposes amendments to the Long-term Insurance Act, 1998 (Act No. 52 of 1998) and the Short-term Insurance Act, 1998 (Act No. 53 of 1998) to address shortcomings and regulatory gaps identified by the IMF/World Bank Financial Sector Assessment Program evaluation of South Africa's adherence to international financial regulatory principles in respect of insurance. The ILAB contains a set of interim measures relating to the governance, risk management, internal controls of insurers and insurance group supervision, pending the finalisation of the broader review of the existing insurance legislative framework and the SAM project.⁵⁵

The global financial crisis, sophisticated financial products and technological advances have led to a change in the way in which financial markets operate and have accordingly necessitated regulatory changes to contribute to improved supervision of the domestic insurance industry. Enhancing the robustness of the insurance sector will ultimately promote the development of a well-regulated market, protect policyholders and contribute to financial stability.

Solvency Assessment and Management project's third quantitative impact study

Financial weaknesses in the insurance industry can cause uncertainty among policyholders and a loss of confidence and stability in the sector. In an effort to improve supervisory oversight and monitor the solvency of insurance companies, the Financial Services Board embarked on the SAM project in 2010.

⁵⁴ The Insurance Laws Amendment Bill 2013 and its annexures are available at www.treasury.gov.za.

⁵⁵ Further information on the SAM project can be found in the Financial Services Board SAM 2013 update on the Financial Services Board's website (www.fsb.co.za).

The September 2012 issue of the *Financial Stability Review* reported on the SAM initiative, a project which is aimed at aligning the South African insurance industry with Solvency II developments in Europe. In order to understand the potential impact of SAM on the insurance industry, three quantitative impact studies have been scheduled for the duration of the SAM project, which is expected to be implemented from 2016. The first two quantitative impact studies were conducted in 2011 and 2012 and results from these were used to inform the development of the SAM framework. The third and final quantitative impact study in South Africa (QIS3) will be conducted ahead of the parallel run which is scheduled to start in the second half of 2014.

What will QIS3 entail?

QIS3 will require all insurers to use the SAM specifications to determine their solvency position. This will entail the calculation of capital resources, which requires the market-consistent valuation of assets and liabilities of the insurers, as well as adjustments made to reflect the quality of their capital resources. In the solvency position, these capital resources are measured against the risk-based capital requirement, which is based on a value-at-risk approach to measure market, credit, underwriting and operational risks to which the insurer is exposed. In addition to the calculation of the solo insurance solvency positions, insurance groups (i.e., where there is more than one insurer) and financial conglomerates will be required to determine their group solvency position.

Expected outcomes of QIS3

QIS3 will be a key tool in assisting both the insurance industry and the regulator with the implementation of the quantitative components of SAM. The information produced by the QIS3 exercise will provide an indication to the Financial Services Board on the type of data that will be needed on an ongoing basis, especially as some of the returns for QIS3 will be based on the quantitative reporting templates that are being developed for the SAM project. This will facilitate the development of the target operating model for insurance supervision when SAM goes live in 2016. It will also facilitate the development of supervisory tools that can be used when SAM is implemented.

It is expected that SAM will improve the quality of insurers' capital as the new framework is likely to have more appropriate capital requirements with the ultimate aim of reducing systemic risk. The adoption of SAM will strengthen supervisory oversight of insurers, improve transparency and foster confidence in the insurance industry, while keeping up to date with regulatory reforms such as the updated ICPs.

Financial market infrastructure developments

According to the Bank for International Settlements (BIS), a financial market infrastructure (FMI) can be "defined as a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives,

or other financial transactions”.⁵⁶ In order to maintain the stability of the financial system and promote economic growth, FMIs and the regulatory environment in which they operate can play a crucial role in mitigating systemic risks. In South Africa, there has always been a concerted effort to keep the regulatory environment relevant and aligned with global financial regulatory standards. To this end, and especially since the onset of the global financial crisis, various initiatives have been undertaken to position South Africa’s key FMIs and regulatory environment appropriately to deal with potential future crises. In the next section the implementation of the SADC regional payment and settlement system is discussed.

Implementation of the SADC Integrated Regional Electronic Settlement System in the Common Monetary Area countries

In an effort to support the harmonisation of financial and payment systems within the SADC region, the SADC Committee of Central Bank Governors (CCBG) approved the vision and strategy document for the SADC Payment Integration Project on 22 July 2013. This document aims to provide a single payment platform among participating countries for the settlement of cross-border transactions within the SADC region. This is in support of the SADC regional strategic development plan.

Based on the South African real-time gross settlement system SAMOS, a proof-of-concept system, namely the SADC Integrated Electronic Settlement System (SIRESS), was adapted for the SADC region and launched on 22 July 2013. The system will be hosted by the Bank’s infrastructure. Although 53 banks from 10 SADC countries participated in the market testing of SIRESS, it was initially implemented only in the Common Monetary Area (CMA) countries. The benefits of this approach include testing the SIRESS concepts of regional clearing and settlement, creating confidence in the regional settlement environment, identifying legal issues, breaking down barriers and misconceptions, and considering the cost and processing efficiencies that SIRESS will provide.

The South African rand is used as the settlement currency to prove the concept of a regional settlement system. Participants (i.e., central banks and commercial banks) have their own settlement accounts in SIRESS and transact in their own name. Settlement takes place on the pre-funded principle, meaning that settlement instructions are only processed if a participant has sufficient funds in its account and no loan facilities are provided for. SIRESS only settles cross-border transactions among the countries, whereas domestic transactions are settled in each country’s domestic real-time gross settlement system.

At the launch of SIRESS on 22 July 2013 there were 21 participants (4 central banks and 17 commercial banks). SIRESS processed 1 780 settlement instructions to the value of R15 billion in August 2013, the first full month of operation. At its September 2013 meeting, the CCBG approved that up to four non-CMA SADC countries may join the live system in the first quarter of 2014.

⁵⁶ Bank for International Settlements, *Principles for Financial Market Infrastructures* (Basel: BIS, April 2012), <http://www.bis.org/publ/cpss101.htm>.

Abbreviations

| | |
|--------|--|
| AGR | augmented Guidotti ratio |
| Alsi | All-Share Index |
| BER | Bureau for Economic Research |
| BIS | Bank for International Settlements |
| BoE | Bank of England |
| BRICS | Brazil, Russia, India, China and South Africa |
| CAR | capital-adequacy ratio |
| CCB | countercyclical capital buffer |
| CCBG | [SADC] Committee of Central Bank Governors |
| CCF | credit conversion factor |
| CCP | central counterparty |
| CMA | Common Monetary Area |
| D-SIB | domestic systemically important bank |
| ECB | European Central Bank |
| EME | emerging-market economy |
| ETF | exchange-traded fund |
| FMI | financial market infrastructure |
| FNB | First National Bank |
| FOMC | Federal Open Market Committee |
| FRRSC | Financial Regulatory Reform Steering Committee |
| GDP | gross domestic product |
| GR | Guidotti ratio |
| G-SIB | global systemically important bank |
| HLA | higher loss absorbency |
| IAIS | International Association of Insurance Supervisors |
| ICPs | Insurance Core Principles |
| ICR | interest coverage ratio |
| IIF | Institute of International Finance |
| IMF | International Monetary Fund |
| IRB | internal ratings-based |
| JSE | JSE Limited |
| MMF | money-market fund |
| NBFI | non-bank financial institution |
| NT | National Treasury |
| OFI | other financial intermediary |
| PMI | Purchasing Managers' Index |
| QE | quantitative easing |
| QIS | [Basel Committee] quantitative impact study |
| QIS3 | quantitative impact study 3 |
| ROSC | Report on the Observance of Standards and Codes |
| SADC | Southern African Development Community |
| SAM | Solvency Assessment and Management |
| SAMOS | South African Multiple Option Settlement |
| SIFI | systemically important financial institution |
| SIRESS | SADC Integrated Electronic Settlement System |
| SME | small and medium enterprise |

| | |
|------|-----------------------------|
| TBTF | too big to fail |
| TCF | treating customers fairly |
| UK | United Kingdom |
| US | United States |
| WGBI | World Government Bond Index |

Glossary

| | |
|----------------------------|--|
| Basel III framework | <i>Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems</i> |
| Basel Committee | Basel Committee on Banking Supervision |
| EY | previously known as Ernst & Young |
| Fitch | Fitch Ratings |
| FMA | Financial Markets Act, 2012 (Act No. 19 of 2012) |
| ILAB | Insurance Laws Amendment Bill |
| Moody's | Moody's Investors Service |
| the Fed | United States Federal Reserve |
| Revised Leverage Framework | <i>Revised Basel III Leverage Ratio Framework and Disclosure Requirement</i> |