FINANCIAL STABILITY REVIEW

First edition

2022

South African Reserve Bank

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Legal basis and purpose of the *Financial Stability Review*

Section 12 of the Financial Sector Regulation Act 9 of 2017 (FSR Act) requires the SARB to:

- monitor and review any risks to financial stability, including the nature and extent of those risks, as well as the strengths and weaknesses of the financial system; and
- take steps to mitigate risks to financial stability, including advising the financial sector regulators and any other organ of state, of the steps to take to mitigate those risks.

Section 13 of the FSR Act requires the SARB to assess the stability of the South African financial system at least every six months, and to communicate its assessment in the *Financial Stability Review* (*FSR*). Among other things, the SARB is required to include the following in the *FSR*:

- its assessment of the stability of the financial system during the six-month review period;
- its identification and assessment of the risks to financial stability in at least the next 12 months;
- an overview of steps taken by the SARB and the financial sector regulators to identify and manage identified risks and vulnerabilities in the financial system; and
- an overview of recommendations made by the SARB and the Financial Stability Oversight Committee (FSOC) during the period under review, and progress made in implementing those recommendations.

Against this background, the *FSR* provides readers with the SARB's assessment of the stability of the South African financial system. The period under review for each edition is the six months following the publication of the previous edition until at least the next twelve months. For this edition, the period under review is from November 2021 to May 2022, while the forecast period is until at least May 2023.

The intended readers of the *FSR* are principally the Members of Parliament of South Africa, and specifically the Standing Committee on Finance, through which the SARB is accountable to the people of South Africa. The report is also relevant to a broader readership interested in how the SARB implements its mandate, including but not limited to international central bank peers, ratings agencies, international financial institutions, standard-setting bodies and academia. The *FSR* also aims to stimulate debate on pertinent issues of relevance to financial stability in South Africa.

Key terms used in the *FSR*

Drawing on the definitions used by the Financial Stability Board (2021), the frequently used terms in the *FSR* are defined as follows:

Shock: An event that may cause disruption to, or the partial failure of, the financial system.

Vulnerability: A property of the financial system that (i) reflects the existence or accumulation of imbalances, (ii) may increase the likelihood of a shock, and (iii) when impacted by a shock, may lead to systemic disruption.

Residual vulnerability: The remaining or net vulnerability after considering the identified mitigating factors and actions.

Transmission channels or mechanisms: Also referred to as 'propagation mechanisms', these are the channels through which vulnerabilities may lead to actual disruption of the financial system, should a shock occur.

Resilience: This refers to the ability of a financial system to deal with shocks and prevent financial instability.

Executive summary

The SARB's assessment of the stability of the financial system during the period under review is as follows:

- The South African financial system continues to be resilient under heightened volatility and challenging global and domestic conditions, and this resilience is expected to be sustained over the forecast period.
- There are persistent underlying vulnerabilities in some areas of the financial sector, which weigh on overall resilience.
- In aggregate, prudentially regulated domestic financial institutions remain resilient, partly owing to their ability to maintain adequate capital buffers to absorb the impact of shocks.

The SARB undertook the following initiatives and policy actions to enhance financial stability:

- The SARB and the Prudential Authority (PA), through the SARB's Financial Stability Committee (FSC), continued to assess various policy options to address the bank-sovereign nexus.
- The SARB collaborated with FSOC members to address some of the key risks to financial stability, as summarised in this edition of the *FSR*.
- The SARB continued with work to implement the new resolution and deposit insurance framework that was enacted in the Financial Sector Laws Amendment Act 23 of 2021 (FSLAA).
- The FSC maintained the countercyclical capital buffer (CCyB) at 0%.

The largest shock to the global financial system during the period under review was caused by Russia's invasion of Ukraine on 24 February 2022, with the ensuing Russia-Ukraine war resulting in numerous disruptions across the global economy. The war resulted in heightened volatility in global financial markets, disruption of global supply chains, an imposition of sanctions on Russia and higher inflation outcomes and inflation expectations, driven primarily by rising oil, gas, wheat and other grains prices.

The pre-existing risks to global financial stability resulting from another wave of the coronavirus disease 2019 (COVID-19) infections and virus strains, as covered in the previous edition of the *FSR*, remain pertinent. What has, however, changed from the previous *FSR* are increasing global concerns about rising inflation and slowing economic growth, together with concerns about faster monetary policy normalisation as recently signalled by major central banks. This combination of rising policy rates and slowing growth is stoking global stagflation fears.

Domestically, South Africa remains vulnerable to spillover effects of global events, particularly the Russia-Ukraine war and global stagflation concerns. The most likely channels through which South African financial stability could be impacted are the macroeconomic impact of global stagflation, which could contribute to continuing slow and inequitable domestic growth and rising inflation, putting pressure on some sectors of the financial system. In addition, rising oil and food prices could have negative implications for social stability. Heightened volatility in global and domestic financial markets could also weigh on investor sentiment.

The South African financial cycle continues to recover, primarily due to rising house and equity prices, but remains in a downward phase. Although the National State of Disaster was lifted in April 2022, South Africa remains vulnerable to the risk of further COVID-19 flare-ups impacting negatively on economic activity.

An emerging risk to domestic financial stability is the impact of a potential unfavourable outcome of the Financial Action Task Force's (FATF) Mutual Evaluation (ME) of South Africa. Should South Africa fail to demonstrate sufficient progress in remediating the deficiencies identified in the FATF ME report by October 2022, it will likely result in South Africa being publicly identified as a jurisdiction that is subjected to increased monitoring by the FATF. This could have wide-reaching consequences for the South African financial system, particularly from a reputational risk perspective.

The localised flooding in KwaZulu-Natal during April 2022 caused significant damage to infrastructure. The KwaZulu-Natal provincial government estimates the cost of repairing damaged infrastructure to be in the region of R17 billion, and the flooding is another shock to the domestic insurance industry that is still recovering from the lingering impact of COVID-19-related claims and the July 2021 unrest.

This edition of the *FSR* includes a pertinent focus on the potential financial stability impact of the unprecedentedly low levels of liquidity in the South African government bond (SAGB) market since the start of the COVID-19 pandemic. Although the SARB has taken various steps to restore and maintain smooth market functioning since the onset of the COVID-19-induced shock, the decline in SAGB market liquidity has prevailed beyond the initial shock. Should such illiquidity persist, it could make the domestic financial system vulnerable to high volatility, sharp price adjustments and an increased cost of funding. When considered alongside the bank-sovereign nexus, as discussed in detail in the first edition of the 2021 *FSR*, liquidity in the SAGB market will be the subject of closer monitoring from a financial stability perspective going forward.

Chapter 1: Assessment of financial stability risks and system resilience

Global financial stability risks

This section identifies and assesses the risks to global financial stability through the ongoing monitoring of macroeconomic and external vulnerabilities, and considers the potential implications thereof for financial stability in South Africa.

The most notable global development since the release of the previous *FSR* was Russia's invasion of Ukraine on 24 February 2022. The uncertainty emanating from the ensuing war caused significant volatility in global financial markets. This, coupled with resultant global supply chain disruptions and far-reaching sanctions imposed on Russia by most advanced economies, is likely to add to pre-existing global inflationary pressures through higher global energy and food prices against a backdrop of growing concerns over slowing economic growth and an expected continuation of interest rate increases and monetary tightening. The sanctions imposed on Russia could have spillover effects to emerging markets more broadly. Over the medium term, developments may lead to a tightening of financial conditions[1] overall, which could threaten domestic financial stability through a variety of transmission channels. This edition of the *FSR* identifies and considers the potential impact of such scenarios.

Spillovers from the Russia-Ukraine war hold negative implications for global financial stability, primarily by exacerbating financial market uncertainty and volatility against the macroeconomic backdrop of (i) the slowing of an already tentative global economic recovery from the COVID-19 pandemic; and (ii) sustaining elevated inflation and inflation expectations over a longer time frame.

Since the release of the previous *FSR*, risks to global financial stability resulting from further COVID-19 flare-ups and mutations of the virus have not dissipated and continue to weigh on global economic activity and investor sentiment. In particular, a sharper-than-anticipated deceleration of economic growth in China as a result of its strict zero COVID-19 strategy has slowed down the tentative global recovery. China's growth prospects are further hampered by continued cutbacks in the real estate sector and weaker-than-expected

1 In its simplest form, the term 'financial conditions' refers to the ease with which finance can be obtained (IMF, 2017). Financial conditions indices measure how easily money and credit move through the economy via financial markets, and use indicators such as asset price volatility, borrowing costs, exchange rates, inflation rates and commodity prices (Adrian, Duarte, Grinberg and Mancini-Griffoli, 2018).

private consumption. The long-anticipated increase in the United States (US) policy rate materialised during the period under review,[2] as did policy rate hikes by several other major central banks. While global financial conditions remain relatively benign, recent increases in policy rates have already started to result in the gradual tightening of global credit conditions. Overall, global growth is seen to be weaker than initially expected for 2022, and forecasted growth for both the US and China has been adjusted downwards since the previous *FSR*.

As depicted in Figure 1, global financial conditions have tightened over the period under review. In the US specifically, financial conditions have tightened to levels last seen towards the end of 2020.

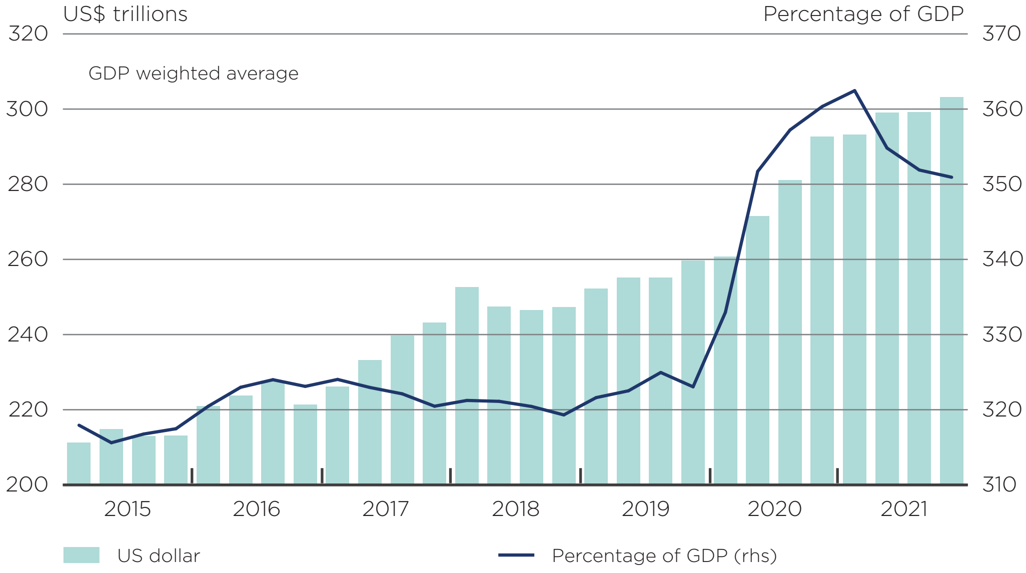
Figure 1: Global financial conditions index

Source: Bloomberg

As financial conditions tighten, rising debt levels emerge as a vulnerability in the global financial system. As shown in Figure 2, total public and private sector debt grew sharply since the onset of the COVID-19 pandemic, by US$33 trillion trillion in 2020 and US$10 trillion in 2021, reaching a new record high of US$303 trillion trillion at the end of last year. Over 80% of the increase came from emerging markets, largely driven by China. As depicted by the right-hand scale of Figure 2, the global debt-to-gross domestic product (GDP) ratio moderated modestly from an all-time high of 360% in 2020 to 351% in 2021, but remains some 28 percentage points above pre-pandemic levels.

2 The US Federal Reserve's Open Market Committee (FOMC) increased its policy rate by 25 basis points in March 2022 – the first increase since 2018. This was followed by a 50-basis-point increase in May 2022 – the largest rate hike since 2000.

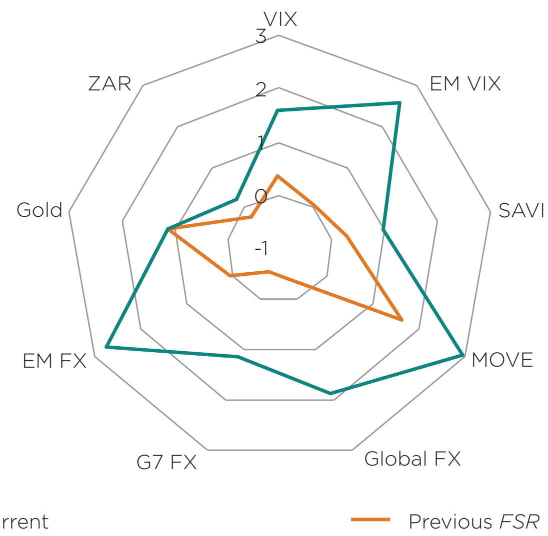
Figure 2: Global debt levels



Source: IIF

The ongoing Russia-Ukraine war has already had a notable impact on global financial market volatility, of which a few indicators are depicted in Figure 3. Volatility was particularly high in emerging market currency and equity markets, as well as in the US fixed-income market. Such heightened volatility is expected to continue over the short to medium term.

Figure 3: Selected volatility indices

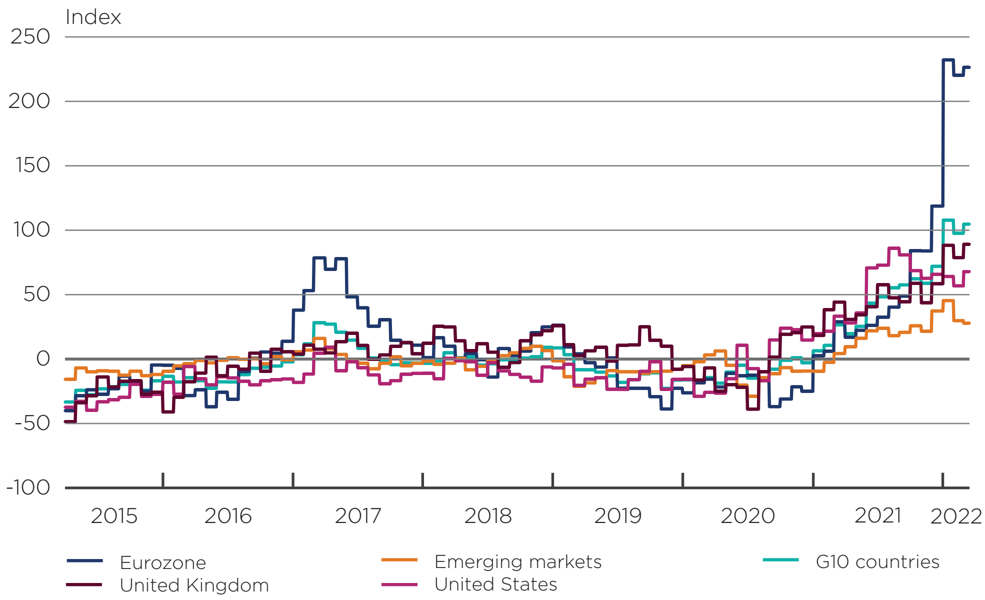


VIX = Chicago Board Options Exchange (CBOE) Volatility Index
EM VIX = Emerging Market Volatility Index
SAVI = South African Volatility Index
MOVE = Merrill Lynch Option Volatility Estimate
Global FX = Global Foreign Currency Volatility Index
G7 FX = G7 Foreign Currency Volatility Index
EM FX = Emerging Market Foreign Currency Volatility Index
Gold = Gold Volatility Index

Source: Bloomberg

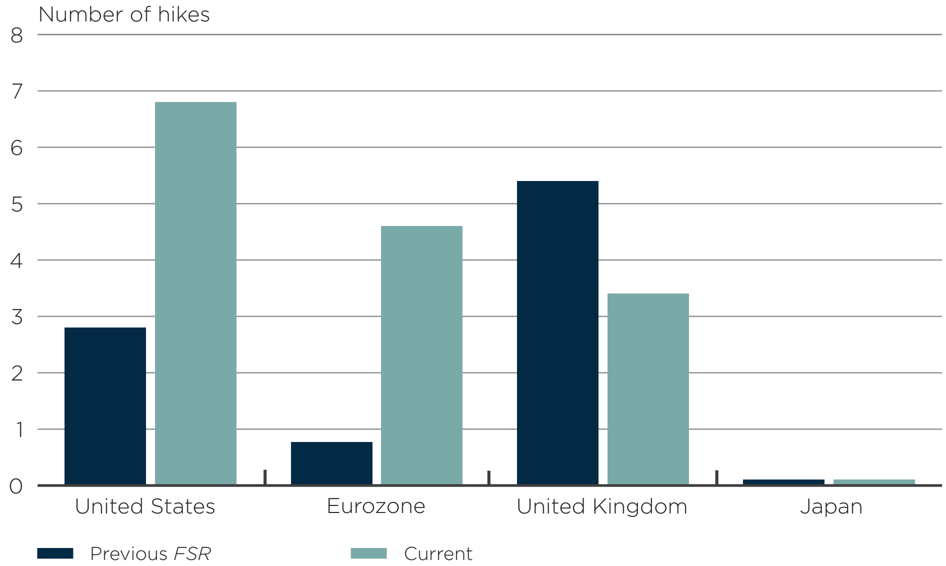
While policy rates in advanced economies remain largely accommodative, growing concerns over higher global inflation (Figure 4) are likely to accelerate interest rate increases (Figure 5), a tapering of asset purchases by major central banks and, in some instances, a reduction of central bank balance sheets to normalise liquidity conditions. Thus far, several emerging market central banks have increased their policy rates in response to elevated inflationary pressures from global supply chain disruptions, combined with elevated energy and food prices.

Figure 4: Global inflation surprises



Source: Bloomberg

Figure 5: Changing global interest rate expectations in 2022



Source: Bloomberg

Emerging market currencies maintained a modestly firmer bias for most of the period under review, although some have depreciated since the start of the Russia-Ukraine war. The currencies of commodity-exporting emerging markets appreciated somewhat on the back of higher commodity prices. Nevertheless, heightened uncertainty raised the cost of US dollar funding for emerging markets in general. A growing concern for emerging markets is the bank-sovereign nexus, with domestic banks in emerging markets continuing to be encouraged – whether directly or indirectly – to take on ever-increasing amounts of government debt.

South Africa's current financial stability conjuncture

This section describes recent developments in the state of financial stability, as assessed by the SARB through its ongoing monitoring of macrofinancial vulnerabilities in the South African financial system.

The impact of COVID-19 and the measures taken to contain it continue to exacerbate pre-existing economic and financial vulnerabilities in South Africa. Although the domestic economy continued to rebound from the impact of the COVID-19 pandemic during the period under review, there are significant downside risks to the growth outlook. These include high levels of unemployment, rising fuel and food prices, electricity supply constraints, physical infrastructure deficiencies and low vaccination rates, combined with tightening financial conditions globally as well as in South Africa. The continuation of slow and inequitable economic growth, coupled with the disproportionately larger impact of increasing food and transport costs on lower-income earners who typically spend between 40% and 45% of their income on these items, increases the likelihood of further episodes of social unrest. This creates a challenging operating environment for financial institutions, which could affect their profitability and viability.

South African financial institutions have limited direct exposure to Russia and Ukraine. However, the transmission channels through which the Russia-Ukraine war could impact South African financial stability include the impact on growth and inflation, as well as the broader uncertainty weighing on global and domestic investor sentiment. Concerns over spillover effects remain pertinent at the current conjuncture, although the potential impact is ameliorated to some degree due to the combination of (i) inflation and inflation expectations that are still moderate compared to other emerging markets and advanced economies; (ii) a relatively strong and stable currency (up until mid-April 2022[3]), supported by strong exports and high commodity prices; and (iii) an improved fiscal outlook as reflected in the 2022 Budget Speech. Moody's Investors Service upgraded its outlook for South Africa's credit rating on 1 April 2022 as higher commodity prices support the government's efforts to reign in debt and reduce budget deficits.

Contrary to the material depreciation experienced by most emerging market currencies, the exchange value of the rand initially appreciated during the period under review on the back of favourable terms of trade

3 The rand was one of best-performing emerging market currencies in 2022 until mid-April, when it suffered significant losses amid growing expectations of a faster-than-anticipated tightening of US monetary policy and the concomitant sharp sell-off in emerging market assets, as well as the impact of China's zero-COVID-19 policy on growth. Domestic factors such as Eskom's electricity supply challenges and the effects of the floods in KwaZulu-Natal also weighed on the rand's performance.

and high commodity prices before weakening in recent weeks. A sustained weakening in the exchange value of the rand could put additional pressure on import costs and domestic inflation. Of particular concern, however, is the fact that fixed investment in South Africa as a percentage of GDP has decreased steadily over the last decade, from more than 18% in 2013 to an 18-year low of around 13% currently. The sustained decrease in fixed investment constrains the growth potential of the domestic economy over the longer term, which presents a more challenging environment for the financial system in which to flourish. Elevated domestic inflation and rising interest rates may exacerbate existing social inequalities and create vulnerabilities in the South African financial system over the medium term, for example, through banks' exposure to unsecured credit to households with high debt levels, or through episodes of civil unrest that cause repeated high claims on insurance companies.

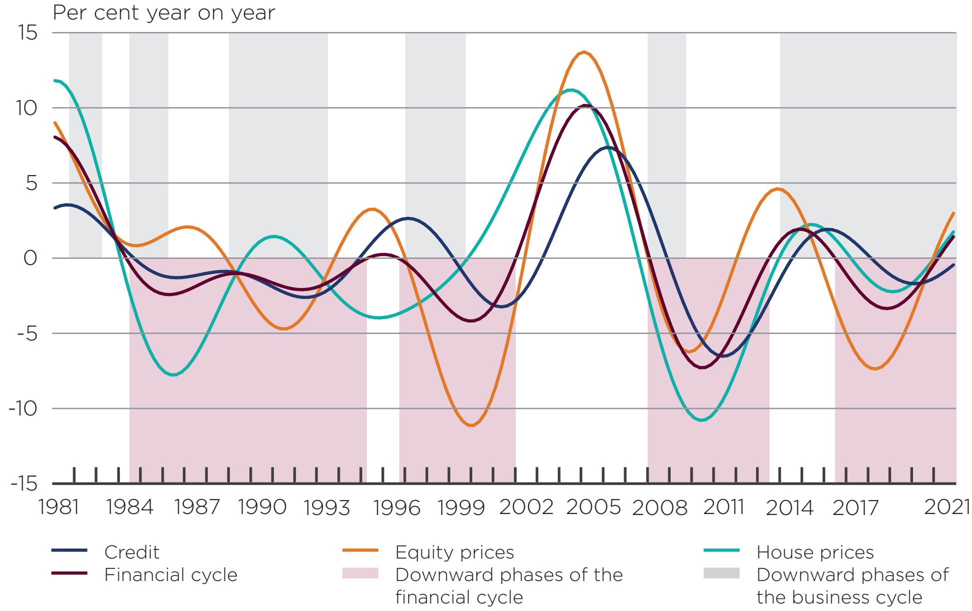
The emerging threat of an unfavourable outcome of the FATF ME of South Africa[4] could materialise should the country not make satisfactory progress in remediating the deficiencies identified in the October 2021 FATF Mutual Evaluation Report by October 2022. Following the adoption of the FATF ME report at the FATF Plenary in June 2021, South Africa met the criteria for a FATF International Co-operation Review Group (ICRG) review and entered a one-year observation period, which will end in October 2022. The ICRG's Africa/Middle East Joint Group will assess the degree of progress made by South Africa based on relevant information submitted to the Joint Group. The post observation period report will be developed after the end of the observation period and the FATF Plenary meeting in October 2022. The ICRG meeting will take place in February 2023 and if the Joint Group is satisfied that South Africa has made sufficient progress in addressing the identified deficiencies, it will recommend to the ICRG that South Africa be removed from the ICRG process and that further monitoring by the FATF through the enhanced follow-up process will be sufficient. Conversely, failure to demonstrate sufficient progress in remediating the deficiencies identified in the FATF ME report will result in a recommendation to the FATF Plenary that South Africa be publicly identified in the list of *Jurisdictions under Increased Monitoring* by the FATF. This could have wide-reaching consequences for the South African financial system from a broader reputational risk perspective, and for the banking sector in particular in terms of funding costs and the ability to maintain correspondent banking relationships (CBRs).

As depicted in Figure 6, the domestic financial cycle continues to recover from its downward phase amid rising house and equity prices. Equity prices were supported by higher-than-expected corporate earnings, optimism surrounding the waning impact of the COVID-19 pandemic and high commodity prices,

4 The FATF ME report on South Africa is available at https://www.fatf-gafi.org/publications/mutualevaluations/documents/mer-south-africa-2021.html#:~:text=The%20Financial%20Action%20Task%20Force,compliance%20with%20the%20FATF%20Recommendations.

while low real interest rates supported increases in house prices. By contrast, the credit cycle remains in a contractionary phase, with credit growth remaining below its long-term trend during the period under review.

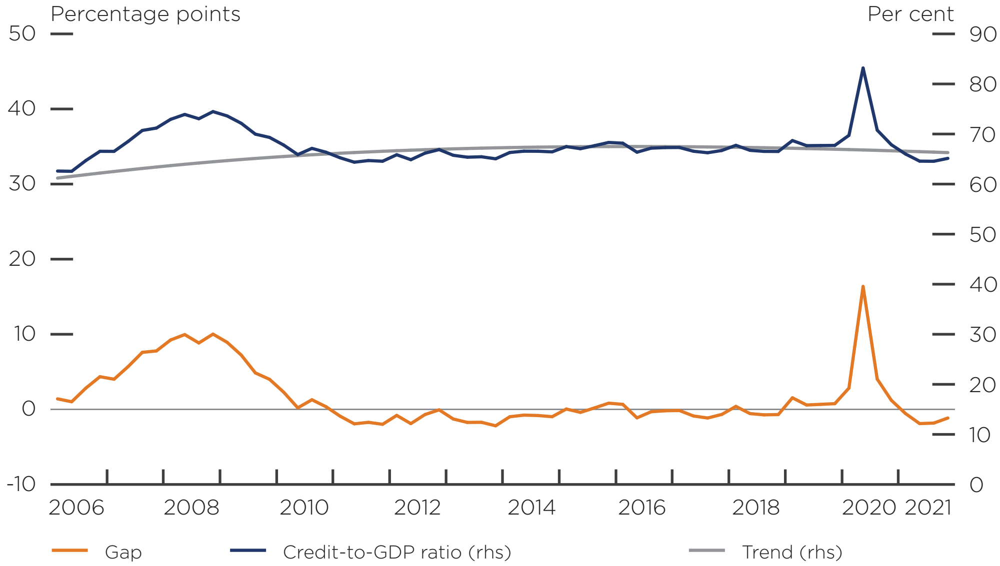
Figure 6: The South African financial cycle



Source: SARB

The gap between South Africa's credit-to-GDP ratio and its long-term trend narrowed slightly during the review period, but remained negative amid slower credit growth compared to pre-pandemic levels (Figure 7).

Figure 7: South Africa's credit-to-GDP gap



Source: SARB

South Africa remains highly vulnerable to a material deterioration in government finances. The national government debt-to-GDP ratio increased from an average of 52% in 2019 to an average of 65% in 2021. However, some improvement was observed during the period under review: South Africa's gross national government debt is now expected to stabilise at 75.1% of GDP in 2024/25, lower than the 2021 Budget's projected estimate of 80.5%. Although this was partly attributable to the benchmarking and rebasing of GDP, the fiscal position was also supported by increased tax revenue as a result of the economic recovery and high commodity prices. However, government debt servicing costs continue to grow at 10.7% per year over the medium term, at the expense of growth-supporting spending priorities.

Despite the improved fiscal outlook, the high level of government debt and committed expenditure items still pose a risk to domestic debt sustainability. A slowdown in global economic growth and geopolitical tensions could negatively affect commodity prices and result in lower domestic tax revenue collections. Despite growth forecasts having been revised upwards, the slow and inequitable recovery from the pandemic also puts pressure on government to continue its social spending. In addition, the public wage bill remains a risk to government's fiscal consolidation efforts. South Africa continues to hold most of its government debt in rand, which limits the impact of a depreciation in the exchange value of the rand, and South African government debt also has a longer-dated maturity profile than emerging markets in general. However, the reliance on government funding in rand makes the existence of a deep and liquid domestic bond market essential. Recently, there has been a decline in the liquidity of the SAGB market which, if it persists, could make the financial system vulnerable to high volatility, sharp price adjustments and an increased cost of funding for both government and private sector companies. Box 2 in Chapter 3 provides a detailed discussion of liquidity in the SAGB market.

Financial management at several state-owned enterprises (SOEs) has been weakened by corruption and state capture over several years, and the already weak state of SOEs' finances was further exacerbated by the impact of COVID-19-related lockdowns. As a result, investors are increasingly reluctant to fund SOEs without government guarantees. As at March 2021, Eskom had utilised about 80% of its R350 billion guarantee. At the time of the 2022 Budget Speech, the South African Special Risks Insurance Association (Sasria), which provides short-term insurance cover for risks such as public disorder, strikes, riots and terrorism, had already received balance-sheet support of R32 billion from the government as claims following the July 2021 social unrest far exceeded its available cash reserves, investments and reinsurance coverage.[5] The potential for further financial support to SOEs with weak balance sheets, and the possibility that contingent claims on the government may materialise, cannot be precluded at this stage.

5 http://www.treasury.gov.za/documents/national%20budget/2022/review/FullBR.pdf.

The second edition of the 2020 *FSR* provided a comprehensive discussion of the potential financial stability risks to the domestic financial system resulting from a successful cyberattack on key financial infrastructure, as well as from the effects of climate change on the financial sector. Cyber-threats and associated attacks remain a key threat to financial institutions domestically and abroad, and the heightened cyber-activity and increased attacks reported globally in recent months have largely been attributed to the Russia-Ukraine war. The fact that the large South African financial institutions are users of major international financial market infrastructures and transact with global counterparts indirectly exposes the domestic financial system to global cyberattacks.

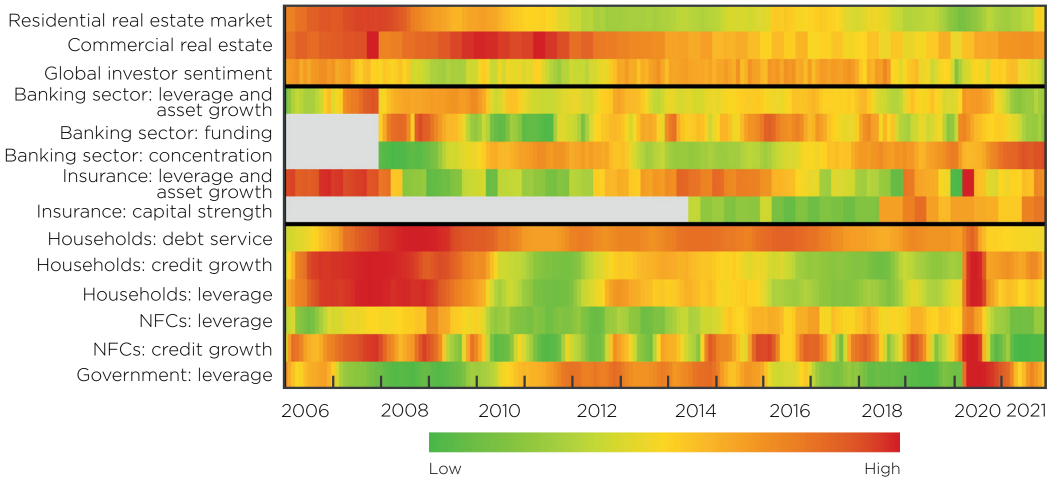
Regarding climate-related risks, South Africa experienced widespread and severe flooding during the period under review, and the resultant increase in claims had detrimental effects on the non-life insurance sector. Going forward, climate change will likely increase the frequency and severity of physical climate-related risks. This increase, coupled with possible geographical concentration risk, could translate into increased claims particularly in the non-life insurance sector. In the long term, it is possible that insurance and reinsurance could become more expensive, and product offerings could be limited in areas that are more exposed to the effects of climate change. Increased investment and credit risk for banks could occur through counterparties that are exposed to varying degrees to physical risk, depending on their combination of exposure, susceptibility and adaptive capacity.

Against the broader overview of risks to, and indicators of, domestic financial stability, the South African financial stability heatmap (the heatmap) provides a consolidated view of the state of financial stability vulnerabilities across various components of the financial and non-financial sectors. The heatmap is a snapshot of domestic financial stability conditions against historic averages, and is used as a basis from which to conduct more qualitative and forward-looking assessments.[6]

As depicted in Figure 8, the heatmap indicates some improvement in financial stability conditions in a number of sectors since the height of the COVID-19 shock in 2020, largely due to the gradual resumption of economic activity as government eased lockdown restrictions. The most pertinent developments in relation to selected heatmap elements are summarised below.

6 Refer to Annexure A for an overview of how the South African financial stability heatmap is composed, including the elements comprising the heatmap and the indicators underlying the colour weightings assigned to the heatmap elements. In an effort to continually improve the reliability of the indicators used in the heatmap and to keep them relevant, they are reviewed and updated from time to time.

Figure 8: The financial stability heatmap



Source: SARB

- **Asset valuations:** Since the beginning of 2022, positive investor sentiment has been maintained in the domestic bond market. Non-resident investors were net purchasers of SAGBs as risk-return dynamics remained attractive relative to emerging market peers. The FTSE/JSE All-Share Index continued to outperform its peers, mainly led by a strong performance from the resources sector, which is dominated by the precious metals and mining companies that benefited from a rally in commodity prices during the period under review. House prices increased, but commercial property prices are showing the impact of a prevalence of work-from-home arrangements that are likely to continue after the pandemic.
- **Banking sector:** Growth in bank credit extended continued to recover during the period under review, while the level of non-performing loans (NPLs) moderated and banking sector profitability increased. The banking sector's return-on-equity ratio also increased during the period under review. The deterioration in concentration measured on the heatmap is due to the two indicators used to measure concentration in the banking sector, namely (i) exposure to the housing market (home loans/gross loans and advances); and (ii) exposure to the sovereign. Both indicators are currently showing 'red', meaning that relative to historical data for that indicator, the indicator is high. The deeper red is the sovereign indicator, which affirms that relative to history, the banking sector has a high exposure to the sovereign. South African banks' holdings of government debt remains a vulnerability that is subject to ongoing monitoring.[7]
- **Insurance:** The aftermath of the social unrest observed in July 2021 and the resultant damage to property continue to weigh on the performance of the domestic non-life insurance sector, and makes it vulnerable to repeated episodes of unrest, which would likely lead to Sasria requiring additional

7 The bank-sovereign nexus was discussed at length in the first edition of the 2021 *FSR*.

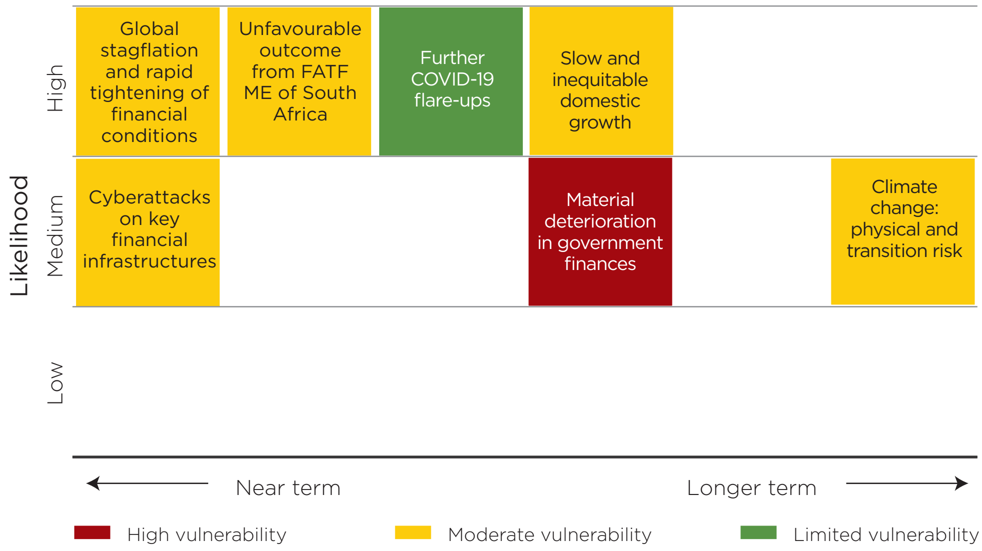
funding. Combined with an increase in COVID-19-related insurance claims in the life segment, there was pressure on insurers' retained earnings during the period under review, resulting in relatively lower solvency capital requirement (SCR) ratios. However, the ratios remain above the regulatory requirement. Despite the effects of these recent shocks, South Africa's insurance sector remains relatively resilient and adequately capitalised. The recent flooding in KwaZulu-Natal is yet another shock to the domestic insurance industry that is still recovering from the lingering impact of COVID-19-related claims and the July 2021 unrest.

- **Households:** Household indebtedness remains high despite some moderation. The household debt-to-GDP ratio has slowed slightly due to moderation in household credit extension and the benchmarking and rebasing of GDP. Secured credit was the key driver of the moderate credit growth recorded, accounting for 79% of total household credit. Debt servicing costs remain favourable compared to pre-pandemic levels. Rising interest rates are expected to result in higher debt servicing costs, placing pressure on household finances, particularly low-income earners who tend to hold higher levels of debt compared to income.

The outlook for financial stability

The SARB Risk and Vulnerability Matrix (RVM) provides a forward-looking assessment of the key risks to financial stability in South Africa over the short, medium and longer term (Figure 9). The key risks are identified based on the current conjuncture, but also takes into account possible future developments and the vulnerability of the financial system to such developments, after considering existing mitigating factors and policy actions. The colour of the block represents the residual vulnerability of the financial system to each risk. Risks with a lower residual vulnerability are the ones where the financial system is relatively well-placed to absorb a shock without a broader spillover of distress across the system. Risks with a higher residual vulnerability are the ones that are more likely to lead to financial instability if no further mitigating actions are taken.

Figure 9: SARB RVM



Source: SARB

The RVM is supported by Table 1, which (i) identifies the risks to South African financial stability; (ii) highlights the associated domestic vulnerabilities through which the risk could manifest in a shock to the South African financial system; (iii) identifies the mitigating factors and actions that would alleviate the impact of the potential shock to domestic financial stability; and (iv) describes the likely residual impact on financial stability in South Africa (i.e. the potential net impact the risk would have should it materialise as a shock after the identified mitigating factors and actions have been accounted for). The RVM and accompanying Table 1 represent the SARB's overall assessment of the residual vulnerability of the domestic financial system to the identified risks once mitigating factors and actions have been accounted for.

From a macrofinancial perspective, the most pertinent residual financial stability vulnerabilities identified in the RVM are the high level of government debt and the financial sector's elevated exposure thereto, against a backdrop of slow and inequitable domestic growth, global stagflation risks and tightening financial conditions globally. In addition, there are increased operational risks in the form of potentially disruptive cyberattacks on financial institutions and market infrastructures globally, as well as the lingering risk of further waves and new variants of the COVID-19 pandemic. Over the short to medium term, the financial sector is vulnerable to steps that may be taken if the deficiencies identified in the FATF ME report are not addressed in a timely manner. Over the longer term, financial institutions remain vulnerable to the physical and transition effects of climate change, such as reduced competitiveness of the South African financial sector as the world moves towards carbon neutrality, the increasing cost of short-term insurance and the potential unwillingness by insurers and reinsurers to provide cover against climate-related risks.

Table 1: Residual financial stability vulnerability (high, moderate or limited vulnerability)

Risk	Associated domestic vulnerabilities	Mitigating factors/actions	Residual financial stability vulnerability (high, moderate or limited vulnerability)	Change since previous *FSR*	Time frame
Material deterioration in government finances	• Despite an improvement in recent months, vulnerabilities remain due to the high level of debt, committed spending items and structural constraints in the economy. • Banks have high exposures to government debt, making them vulnerable to sharp spikes in yields, particularly if combined with lower liquidity in the SAGB market. • Crowding out of private investment and savings by high public borrowing affects the growth potential of the economy. • Orderly functioning of the government bond market can be disrupted, potentially requiring repeated episodes of support by authorities.	• Government debt is largely domestic currency denominated with long maturities. • Fiscal consolidation is supported by an economic recovery and higher commodity prices. • Relaxation of lockdown measures and the removal of the National State of Disaster in April 2022. • Large, diversified banks are less exposed to government debt and better hedged against adverse events.	• Financial sector exposures to the sovereign remain elevated, in particular among smaller banks, and not all institutions may be sufficiently capitalised against a severe sovereign debt shock event. • The risk of dysfunction in the SAGB market is exacerbated by high exposure, concentration and lower liquidity. • Failure in fiscal consolidation can lead to unsustainable government debt levels.	→	Medium to longer term
Slow and inequitable domestic growth	• Weak economic growth affects the operating environment and long-term prospects of financial institutions through various channels. • Unemployment and low income dampen demand for financial services, credit and access to finance. • Tighter financial conditions increase debt servicing costs and credit risk. • Inequitable growth raises the risk of social unrest, which in turn may negatively impact on investor confidence, funding costs, insurance claims and operational costs.	• Extension of COVID-19 social grants. • Relatively high capital/solvency buffers. • Comprehensive supervisory oversight of lending standards and provisioning. • Increasing profitability of the banking sector.	• Limited progress on implementing structural reforms leaves the economy vulnerable to an extended period of weak, inequitable growth. • Muted new business growth may lead to increased risk-taking to increase profits. • A sudden and sharp correction in commodity prices would undermine economic growth, unwind the current account surplus and weaken the fiscal position. • Sasria reserves depleted; possibility that unrest-related risks may not be covered by insurance.	↑	Medium term
Further COVID-19 flare-ups	• Exacerbating pre-existing economic and financial vulnerabilities in South Africa. • Limited fiscal space to respond to the economic and health impacts of COVID-19. • COVID-19 has affected lower-income individuals more acutely. • Measures to contain the spread of COVID-19 exacerbate financial strain among households and corporates.	• Lockdown measures have been largely removed and are likely to be more targeted in future. • The move towards mandatory vaccination by many companies. • Decrease in vaccine apathy as vaccination rate increases. • Corporates and households have adapted to lockdown measures.	• Potential for further waves and new variants of COVID-19 could require repeated containment measures, with effects on the economy. • South Africa lagging behind peers in vaccinations.	↓	Short term

Table 1: Residual financial stability vulnerability (high, moderate or limited vulnerability)

Risk	Associated domestic vulnerabilities	Mitigating factors/actions	Residual financial stability vulnerability (high, moderate or limited vulnerability)	Change since previous *FSR*	Time frame
Global stagflation and rapid tightening of financial conditions	• Higher global and domestic interest rates due to inflation pressures will increase funding and debt servicing costs. • Lower global growth will affect domestic economic activity and weaken the financial position of financial institution customers. • High levels of risk-taking to boost profit may result in overvaluation and excessive leverage. • Rising interest rates in advanced economies could trigger capital outflows and currency depreciation for emerging markets.	• Flexible exchange rate and foreign exchange (FX) reserves. • Low FX mismatches on bank and sovereign balance sheets. • Foreign exposure limits on financial institutions encourage the repatriation of FX during periods of balance of payment (BoP) stress. • Favourable net international investment position (NIIP). • SARB balance sheet policies to address market dysfunction. • Domestic inflation expectations still anchored.	• Limited regulation of certain investment fund activities means they remain vulnerable to risks. • The high level of interconnectedness in the South African financial sector means that risks in investment funds could spill over to other areas of the financial system. • Tighter financial conditions could interact with low growth to weaken balance sheets. • Increased capital outflows and a decrease in the exchange value of the rand if foreign investor appetite wanes and commodity prices decline.	↑	Medium term
Climate change: physical and transition risks	• High concentration of carbon-intensive activities in South Africa may potentially lead to large exposures of the financial system with the possibility of stranded assets in the future. • Relatively high risk of climate-related damage to property and infrastructure, which would negatively impact non-life insurers. • Lack of clarity around financial sector exposures to unsustainable assets limits the scope for supervisory oversight. • Changing policies, technologies and preferences could increase financing costs and leave financial institutions with stranded assets. • Lack of comparable, granular climate-related data on financial exposures and voluntary reporting limit supervisory and regulatory analysis.	• Voluntary disclosures by some financial institutions give some insight to supervisors. • Introduction of climate stress testing by the SARB promotes industry efforts to define and quantify risks. • Establishment of the Presidential Climate Financial Task Team should contribute to policy certainty. • Annual repricing of non-life insurance premiums to reflect higher risk. • South African carbon tax implemented in June 2019 to increase to at least USD30 per tonne by 2030.	• Loss of competitiveness in the South African economy as the world shifts toward carbon neutrality. • Higher funding costs and other barriers for financial institutions that fund unsustainable assets. • Worsening physical impact of climate change. • Increasing cost of short-term insurance and unwillingness to provide cover against climate-related risks.	→	Medium to longer term
Cyber-attacks on key financial infrastructures	• Growing dependency on information technology (IT) for transactions and communication. • Financial services firms among the most attractive targets. • Work-from-home arrangements increased staff interactions with IT systems and interfaces. • Growing reliance on third party IT service providers and increased centralisation of IT infrastructure globally. • Increased risks of disruptive attacks on major global financial market infrastructures that are also used by South African financial institutions, as retaliation for Western sanctions against Russia.	• Large IT security spending and focus in the financial sector. • Enhanced structures to ensure prevention, timely detection, response and recovery by the SARB and the financial sector. • Promulgation of the Cybercrimes Act 19 of 2020.	• Large tail risks associated with even a single successful cyberattack. • Smaller financial institutions and third-party service providers appear to be most vulnerable given limited skills and resources to address cyber-risk. • Exposure to global market infrastructure at risk of attack introduces risk into the domestic financial system, with limited mitigation possibilities.	↑	Short to medium term
Unfavourable outcome from FATF ME of South Africa	• Higher transactional, administrative and funding costs for domestic banks. • Restricted cross-border transactional ability impacting on imports and exports, including hedging opportunities, leading to a corresponding decline in GDP. • Reputational damage to South Africa's financial system could have negative capital and currency implications. • A potential decline in correspondent banking relationships for South African banks, with regional spillover effects.	• Coordinated response to address the deficiencies identified through a government-led interdepartmental committee on anti-money laundering, counter financing of terrorism and counter financing of proliferation to coordinate South Africa's response.	• Mitigating actions from the remedial recommendations of FATF may not be implemented timeously.	New risk	Short term

The SARB's risk assessment

On the basis of the risks, vulnerabilities, and mitigating factors and actions identified and discussed in Chapter 1, the SARB's assessment of the stability of the financial system is as follows:

- The South African financial system continues to be resilient under heightened volatility and challenging global and domestic conditions, and this resilience is expected to be sustained over the forecast period.
- There are persistent underlying vulnerabilities in some areas of the financial sector, which weigh on overall resilience.
- In aggregate, prudentially regulated domestic financial institutions remain resilient, partly owing to their ability to maintain adequate capital buffers to absorb the impact of shocks.

Policy actions undertaken to enhance domestic financial stability

The FSC continues to assess various policy options to address the bank-sovereign nexus. As discussed in the risk assessment section and in the second edition of the 2021 *FSR*, the bank-sovereign nexus is regarded as a potential threat to financial stability. The FSC is monitoring developments in this area and the PA is undertaking an impact assessment of possible mitigating actions. The sustained illiquidity in the SAGB market forms part of this ongoing monitoring and analysis.

The SARB continued to collaborate with FSOC members to address some of the key risks to financial stability, as summarised in this edition of the *FSR*.

Work continued on the implementation of the new resolution and deposit insurance framework enacted by the FSLAA. In preparation for the issuing of secondary legislation and regulations, the SARB published, for public comment, a series of policy papers on the technical elements of deposit insurance and resolution.

The SARB's FSC maintained the CCyB[8] at 0% at its April 2022 meeting. The financial cycle has only recently shifted into an upward phase, and credit growth remained mild relative to growth in the real economy. In the absence of any need to dampen credit growth, the FSC has kept the CCyB at 0%.

8 The CCyB can be adjusted to increase the level of capital in the banking sector during upswings in the financial cycle (at times when credit growth and risk-taking are outpacing underlying economic conditions). This helps to ensure that banks build additional buffers during an upswing period to absorb losses during a subsequent downswing period. The CCyB also assists in containing excessive growth in broader credit extension.

Chapter 2: A new resolution and deposit insurance framework

Overview

An important element of the SARB's mandate to maintain financial stability is the ability to manage the failure of systemically important financial institutions (SIFIs) in a way that contains the impact on the financial system and the real economy, and that protects the interests of customers. On 28 January 2022, the President enacted the FSLAA, which designates the SARB as Resolution Authority (RA) for all designated financial institutions,[9] provides the SARB with resolution powers, and establishes the Corporation for Deposit Insurance (CODI) as a subsidiary of the SARB. The FSLAA did not, however, become effective in its entirety on the date of enactment, but the various provisions will become effective in a logical sequence as explained later in this chapter. This chapter sets out the reasons for, and implications of, the new resolution framework in terms of the FSLAA.

The FSLAA brings South Africa's resolution framework in line with international standards. Following the global financial crisis of 2008, addressing the too-big-to-fail (TBTF) problem became one of the Group of Twenty's (G20) key priorities. The Financial Stability Board (FSB) accordingly developed the Key Attributes for Effective Resolution Regimes for Financial Institutions (Key Attributes). The Key Attributes were formally adopted by the G20 in 2011 (revised in 2014). The FSB has subsequently also published detailed standards and guidance on the implementation of the Key Attributes. Collectively, these publications form the international standards that G20 members have agreed to implement in their jurisdictions.

The Key Attributes require jurisdictions to enhance their resolution frameworks by having available the necessary legal powers to deal with the failure of a SIFI, and to improve coordination and cooperation among jurisdictions in cases where SIFIs operate in more than one country. Because of the complexity of resolving a failing SIFI, and the time constraints within which an orderly resolution has to be conducted, the Key Attributes require resolution authorities to develop resolution plans and conduct resolvability assessments as part of the ongoing regulation of SIFIs.

To combine the protection of overall financial stability with depositor protection, the Key Attributes require jurisdictions to have deposit insurance arrangements in place. The role of a deposit insurance scheme (DIS) is to ensure that the cost of a bank failure does not fall disproportionately on the most vulnerable consumers or those that are least able to protect

9 Designated institutions refer to the institutions that fall within the scope of the resolution framework as provided for in the FSLAA. These institutions include banks, non-bank SIFIs and the holding companies of these institutions.

themselves through diversification, hedging, financial structuring or other sophisticated risk management measures. A DIS refers to the complete set of legal, operational and financial arrangements that should be in place to facilitate efficient, transparent and fast protection and/or compensation of covered deposits in the event of a bank failure.

The International Association of Deposit Insurers (IADI) issued guidance on the various design features to be considered in the development of a DIS by publishing the Core Principles for Effective Deposit Insurance Systems (Core Principles) in 2014, including the deposit insurance lessons learned from the global financial crisis.

The development of the resolution and deposit insurance frameworks, as contained in the FSLAA, took several years of extensive collaboration and consultation. Table 2 contains a summary of the most important milestones and consultation papers published during this process.

Table 2: Key milestones in the development of South Africa's resolution and deposit insurance framework

Year	Milestone	Key provisions and implications
2011	A Safer Financial Sector to Serve South Africa Better[1]	Outlines the underlying approach to be taken for a series of legislative and regulatory changes to be introduced to shift South Africa towards a twin peak model for financial regulation.
2012	Financial Stability Board Key Attributes of Effective Resolutions Regime for Financial Institutions. Revised in 2014[2]	Sets out 12 essential features that should be part of the resolution regimes of all jurisdictions, including scope, powers, safeguards, funding and resolvability assessments.
2015	Strengthening South Africa's Resolution Framework for Financial Institutions[3]	The position paper sets out the motivation, principles and policy proposals for a strengthened framework for the resolution of designated financial institutions in South Africa.
2017	Designing a deposit insurance scheme for South Africa[4]	This position paper set out the initial design features of the envisaged DIS and formed the basis for subsequent consultations and refinements.
2017	Financial Sector Regulation Act 9 of 2017[5]	Establishes a system of financial sector regulation by establishing the Prudential Authority and the Financial Sector Conduct Authority, and conferring powers on these entities, in addition to the SARB, to preserve and enhance financial stability in the Republic.
2018	Financial Sector Laws Amendment Bill[6]	Amends various financial sector laws including the FSR Act to provide for the establishment of a framework for the resolution of designated institutions, to designate the SARB as the resolution authority and to establish a deposit insurance scheme, including CODI and a Deposit Insurance Fund.
2019	Ending too big to fail framework: South Africa's intended approach to bank resolution[7]	Provides an overview of how the SARB intends to perform its functions as the resolution authority, as well as some of the requirements that may be imposed on designated institutions after the promulgation of the Financial Sector Laws Amendment Bill.
2022	FSLAA promulgation	

1 http://www.treasury.gov.za/documents/national%20budget/2011/A%20safer%20financial%20sector%20to%20serve%20South%20Africa%20better.pdf

2 https://www.fsb.org/2014/10/key-attributes-of-effective-resolution-regimes-for-financial-institutions-2/

3 http://www.treasury.gov.za/twinpeaks/Strengthening%20South%20Africa%E2%80%99s%20Resolution%20Framework%20for%20Financial%20Institutions.pdf

4 http://www.treasury.gov.za/twinpeaks/Designing%20a%20deposit%20insurance%20scheme%20for%20South%20Africa.pdf

5 http://www.treasury.gov.za/legislation/acts/2017/Act%209%20of%202017%20FinanSectorRegulation.pdf

6 http://www.treasury.gov.za/twinpeaks/Financial%20Sector%20Laws%20Amendment%20Bill.pdf

7 https://www.resbank.co.za/content/dam/sarb/what-we-do/financial-stability/resolution-planning/South%20Africa%27s%20intended%20approach%20to%20bank%20resolution%20-%202019.pdf

The need for a strengthened resolution framework

Financial institutions play a critical role in any economy and affect the daily lives of all citizens. They make it possible to make payments, to save and invest funds, to borrow and lend, and to protect against various types of risk. In providing these services, financial institutions must transact with one another. For example, a loan from one bank becomes a deposit at another bank, a payment from an account at one bank becomes a deposit into an account at another bank, or a large claim from one insurance company results in a withdrawal of funds from another part of the financial system, to be paid into the bank account of the claimant. Because financial institutions are highly interconnected and rely on each other to perform their functions, the failure of one institution can disrupt the whole network of transactions. Also, when a non-financial corporate fails, the losses fall mostly on its owners and creditors. When an interconnected financial institution fails, the losses also fall on its customers, including ordinary depositors.

The failure of banks and non-bank SIFIs can have a significant adverse impact on the financial system and real economy, thereby potentially resulting in the:

- interruption of critical functions, such as deposit-taking, provision of credit and payment, clearing and settlement functions;
- loss of value and access to funds for depositors and other creditors of a financial institution, with consequences for the welfare of affected parties;
- adverse impact on consumer and investor confidence, with knock-on effects for economic activity and investment;
- adverse impact on asset prices; and
- weakening of international confidence in the South African financial system and economy, with a potential consequence that foreign investment into South Africa declines.

When a SIFI fails in a disorderly way, it can trigger a financial crisis with long-lasting effects. The larger, more complex and more interconnected a financial institution is (i.e. the higher its systemic importance), the more severe the systemic disruption when it fails, unless the failure can be managed in an orderly way through the application of special resolution powers. In the absence of an adequate resolution framework and DIS, governments are often forced to inject funds into failing financial institutions to protect their customers against losses and to avoid a severe disruption in the financial system or extreme hardship. Such support is referred to as bail-out. The use of taxpayer funds to bail out failing financial institutions reduces the government's ability to fund other priority areas and increases the social impact of a failure. When taxpayer funds are insufficient, a government must increase its borrowing, thus increasing the public debt burden and effectively laying a claim on future tax collections.

Other costs of financial crises include reduced economic activity, higher unemployment and subdued investment that can last for several years. The loss of retail deposits has a severe welfare impact, particularly on low- to middle-income households where the loss of access to funds severely constrains their ability to meet obligations and pay for necessities.

The adverse impact resulting from the failure of financial institutions, particularly where these failures result in a financial crisis, have been experienced by many countries in the past, with the 2007/2008 global financial crisis being the most recent notable example. Research on financial crisis outcomes by Laeven and Valencia (2013) suggests that global output loss (measured as a percentage of pre-crisis GDP) could be as high as 23%, while global debt levels (measured as a percentage of GDP) could increase by as much as 12.1% as a result of a crisis.

The framework provided by the FSLAA will empower the SARB to conduct an orderly resolution to mitigate the impact of the failure of a designated institution, thereby reducing the probability of a costly financial crisis. The objectives of the FSLAA are to:

- ensure the continuity of critical functions and services to mitigate the impact on the financial sector and the real economy;
- protect covered depositors from loss and provide them with prompt access to their protected funds which will enhance confidence in the financial system and limit contagion; and
- minimise the risk of public funds being used to bail out financial institutions or to guarantee financial institution liabilities by assigning losses to shareholders and creditors.

Key provisions of the FSLAA[10]

An orderly resolution refers to the process in terms of which the RA manages the affairs of a designated institution that is failing or likely to fail, by using resolution tools that are designed to ensure the continuity of critical functions, mitigate the risk of contagion, avoid an excessive destruction of value and protect public interest.

According to the FSLAA, the resolution process will take place under the management and control of the SARB as the RA. The FSLAA makes consequential amendments to several existing financial sector laws to provide the SARB with new and additional powers to manage the failure of a designated institution. The most substantial amendment is contained in section 51 of the FSLAA, which is the insertion of a new Chapter 12A ‘Resolution of Designated Institutions’ in the FSR Act that deals with resolution and depositor protection. In addition to the new chapter in the FSR Act, the resolution framework also required amendments to various other laws and sections of the FSR Act. These amendments are summarised in Box 1 and Annexure B.

10 The key sections of Chapter 12A of the FSLAA are summarised in Annexure B.

Box 1: Amendments by the FSLAA to existing legislation

- Amendments to the Insolvency Act 24 of 1936 to (i) change the creditor hierarchy; (ii) clarify that the provisions of the FSR Act apply to the liquidation or sequestration of the estate of a designated institution; and (iii) state that actions taken by the RA in performing its resolution functions may not be set aside by a trustee (or liquidator).
- The main amendment made to the SARB Act 90 of 1989 relates to the powers and duties of the SARB to acquire the shares of an institution to fulfil its objectives. The amendments will enable the SARB to establish bridge institutions, should it be necessary to do so to conduct an orderly resolution.
- The Banks Act 94 of 1990 confers powers on the Prudential Authority (PA) to institute actions against directors, chief executive officers or executives of a bank who contravene section 77 or 424 of the Companies Act 71 of 2008 (Companies Act).
- The Mutual Banks Act 124 of 1993 makes provisions for the issuing of guidance notes and directives by the PA and an offense in the case of non-compliance with a directive.
- The amendments to the Competition Act 89 of 1998 exclude transactions in relation to resolution from the application of certain provisions. Provision is also made for consultation with the Competition Commission in relation to certain transactions.
- The Financial Institutions Act 28 of 2001 amendment excludes designated institutions in resolution from the application of certain provisions.
- The amendments to the Co-operative Banks Act 40 of 2007 repeal certain provisions and exclude the application of certain provisions to co-operative banks as designated institutions.
- The amendments to the Companies Act provide for the winding up of a designated institution in resolution.
- The amendment to the Financial Markets Act 19 of 2012 excludes designated institutions from the application of certain provisions.
- The amendment to the Insurance Act 18 of 2017 is to exclude certain insurers from the application of Chapter 12A of the FSLAA and make provisions for matters connected therewith.

New resolution powers

Dealing with the failure of a SIFI requires additional powers introduced by the FSLAA. The most prominent of the new powers are the power to conduct bail-in; the power to restructure failing institutions; and the power to transfer assets and liabilities. In addition, the FSLAA contains several general powers to help facilitate an orderly resolution.

Bail-in

Bail-in is a legal mechanism through which a financial institution's solvency is restored from its own balance sheet, rather than by using government or taxpayer funds. Bail-in involves the forced reduction or conversion to equity of earmarked liabilities to recapitalise a failing financial institution. Bail-in is based on the principle that a failed or failing designated institution should not be bailed out by using public funding. Instead, the losses of the designated institution should be absorbed by the shareholders and creditors of the institution. Normally, equity holders bear the losses of a failure, but if these losses exceed equity, specified categories of liabilities may also be converted into equity or written down.

The FSLAA empowers the RA to take actions aimed at conducting the bail-in of a designated institution in resolution. These powers will enable the authority to recapitalise the institution by writing down the claims of shareholders and writing down or converting (to equity) the claims of certain unsecured creditors. This recapitalisation will provide the failing designated institution with sufficient levels of capital that will allow it to return to viability and instill market confidence. To ensure that bail-in occurs in a fair and transparent way, the FSLAA makes provision for a special category of liabilities that SIFIs will have to hold, which should be sufficient to enable their recapitalisation even if all regulatory capital is depleted. To make this process fair and transparent, and to ensure that investors in these instruments receive an appropriate risk premium on their investments, the RA must follow the creditor hierarchy in its bail-in actions and adhere to the no-creditor-worse-off than in liquidation (NCWOL)[11] safeguard.

Transfer and bridge institutions

The FSLAA empowers the RA to restructure a failing financial institution to restore its viability. These powers are set out in section 166R, which states that the RA can transfer the assets and/or liabilities of the designated institution to another institution. This power enables the RA to conduct a sale of assets and liabilities and to facilitate a merger or a similar arrangement. The combination of the powers in section 166R also enables the RA to establish a bridge entity and transfer assets and liabilities to this entity. The RA could, for example, transfer the low-quality assets, together with earmarked liabilities, to such a bridge entity, thereby restoring the feasibility of the operating financial institution itself. Because such an action will incur losses on certain creditors, it is also subject to the safeguards described above.

General powers

The FSLAA contains a broad range of general powers, such as the ability to apply stays on early termination rights, issue moratoria, take over control and management in resolution, and apply for liquidation. The powers regarding stays are found in section 166L, which states that placing a designated institution in resolution and taking a resolution action may not give rise to contractual early termination rights. This provision prevents a resolution action from triggering a mass of contractual early termination rights that would put the failing institution under even more strain. Termination rights can only be triggered if the institution defaults on its obligations – something that the resolution process is designed to avoid.

11 The NCWOL principle is a safeguard provided for in the FSLAA and adopted from the principle set out in the Key Attributes. In terms of the NCWOL safeguard, the SARB must ensure that a resolution action does not result in a creditor suffering loss that exceeds the losses it would have suffered in liquidation.

The RA may also issue moratoria, including for the suspension of the designated institution's obligations in terms of the agreements it entered into before resolution. These moratoria will be for a specified limited period, in line with internationally accepted practices, and will only be used in exceptional circumstances to mitigate the impact on financial stability. The use of moratoria by the RA will be detailed in a regulatory standard to provide legal certainty to contractual counterparties. Section 166M states that the RA will manage and control the affairs of the designated institution in resolution. This means that the RA will be responsible for the day-to-day management of the designated institution and the exercise of any of the powers of the governing body. The RA may also apply to court to place a designated institution in liquidation. It may only make such an application after it has determined that the designated institution is insolvent.

Resolution planning and resolvability assessments

Section 166E places a requirement on the RA to develop resolution plans for designated institutions and provides the RA with powers to assess their resolvability and take action to remove barriers to resolvability. The purpose of resolution plans is to assist the RA in obtaining a comprehensive understanding of designated institutions and their critical functions, and to ensure preparedness in the case of resolution. Resolution planning is also a process that the RA will use to facilitate the effective use of its resolution powers to conduct an orderly resolution. Resolution plans will be institution-specific, analysing specific group and funding structures, identifying critical functions and linkages with the rest of the financial sector, and considering appropriate resolution strategies. Furthermore, the resolution planning process should include an assessment of the extent to which designated institutions are resolvable and ready to execute the chosen resolution strategy.

The purpose of resolvability assessments is to evaluate the feasibility of resolution strategies and their credibility in light of the likely impact of the firm's failure on the financial system and overall economy. Included in the assessments is the identification of potential impediments to the resolvability of the designated institutions and plans to address those impediments. Designated institutions are expected to provide the necessary information to the RA for the purposes of resolution planning and resolvability assessments.

The establishment of a deposit insurance scheme

South Africa is currently the only G20 country without an explicit DIS. The absence of an explicit and privately funded DIS in South Africa represents a gap in the design of the financial safety net. This gap is filled by the FSLAA, which provides the over-arching framework for the establishment of CODI as a wholly owned subsidiary of the SARB, and for a Deposit Insurance Fund (DIF) to be maintained and administered by CODI.

CODI's main objectives will be to protect covered depositors' access to their funds in the event of a bank failure. For SIFI banks, access to funds will be preserved through an open-bank resolution strategy, during which customers will have normal access to their deposits. For smaller banks that run the risk of being closed in resolution, certainty about deposit insurance can help to contain large-scale panic withdrawals of deposits that may precipitate a bank's failure. Efficient pay-outs also prevent the hardship suffered by ordinary depositors that can accompany a bank failure.

In terms of the guidance provided by IADI, deposit insurance coverage should be limited, credible and cover the large majority of depositors, but leave a substantial amount of deposits exposed to market discipline. Blanket coverage or too high a limit will increase the cost of deposit insurance for all depositors, introduce moral hazard and encourage higher risk taking, adding to financial instability. In South Africa, the deposits of more than 90% of depositors will be fully covered at the proposed coverage level of R100 000, thereby providing protection for the majority of depositors. Depositors who are not fully covered comprise corporates and wealthy individuals, who are better equipped to assess the riskiness of individual banks and hedge themselves against such risks.

For a DIS to successfully promote financial stability, there should be a high degree of public awareness about its existence and the protection it provides. CODI and the DIF will serve as pillars of the financial safety net. By protecting the covered deposits in all banks, the DIS can also contribute to the development of a less concentrated banking sector and support financial inclusion and transformation of the sector.

Implications of a DIS for the banking sector

It will be compulsory for all banks (including local branches of foreign banks), cooperative banks and mutual banks to be members of CODI and to make financial contributions to CODI. These banks' covered depositors[12] will be protected by CODI in the unlikely event of a bank failure. Initially, cooperative financial institutions will not be members of CODI, but will be considered for inclusion at a later stage.

The FSLAA requires member banks to provide CODI with the information it needs to fulfil its functions. Members will submit depositors' information, accounts and balances to CODI on a monthly basis. CODI will use this information to calculate the covered deposit balances per depositor and per bank. The covered deposits will be used to calculate the bank's financial contributions to CODI. CODI will also provide guidance to its member banks on their public awareness responsibilities (i.e. to inform their depositors about the benefits and limitations of the protection offered by CODI).

12 Covered deposits mean qualifying deposits held by individuals and non-financial corporate depositors up to the maximum proposed coverage level of R100 000 per qualifying depositor per bank.

CODI's funding model

CODI will be funded on a tiered basis that allows it to build the DIF and fulfil its pay-out obligations in a cost-effective way. In addition to levying premiums, the DIF will be funded by a liquidity tier that banks will place with CODI and on which they will earn interest. Both the premium and the size of each bank's contribution to the liquidity tier will be a function of a bank's covered deposits balance. The target DIF size is 4% of covered deposits (3% liquidity tier + 1% premiums) and will be built up over five years. An annual levy of 0.015% of covered deposits will be paid by banks to cover CODI's operational cost. Surplus levies, after provisions, will be allocated to the DIF.

Figure 10: CODI's tiered funding model

As needed	Emergency tier (SARB emergency funding) • Only needed in exceptional cases • First to be repaid by CODI from proceeds of liquidation • If shortfall, repaid through premiums by banks

DIF

3% of covered deposits	Liquidity tier (funds placed by banks with CODI) • Interest-earning asset for banks • Adjusted monthly in line with covered deposit balance • Used for liquidity during payout as an advance against liquidation preceeds • High degree of certainty of recovery from liquidation proceeds due to position in amended creditor hierarchy
0.2% of covered deposits per year (0.2%/12 per month)	Equity tier (premiums by banks) • Funded through premiums (expensed) • Flat premiums of 20 bps per year (paid monthly) • Possible increase in premiums if there is shortfall in liquidation proceeds

Annual levy to cover operational costs: 0.015% of covered deposits

CODI will have a 'paybox-plus' mandate, meaning that it can use the DIF to either reimburse covered depositors when a failing bank is closed, or to support other forms of resolution to avoid a closure, subject to conditions. When a bank is liquidated, CODI will use the DIF to pay out the failed bank's covered depositors by using electronic funds transfers or through a pay-out agent bank. The proposed protection afforded to qualifying depositors will be up to the coverage limit of R100 000 per depositor per bank.

After a depositor pay out, CODI will recover funds from the estate of the bank in liquidation, with a preferred claim on liquidation proceeds. CODI also has the legal right to increase the funding contributions from remaining banks to rebuild the DIF if there is a shortfall in the recoveries from the estate of the failed bank. The SARB will provide CODI with emergency funding in the form of a committed funding line, in cases where the DIF is not sufficient for a pay out. Future refinements of the funding model may include the gradual reduction in the size of the liquidity tier, adjusting premiums and levies as CODI's funding requirements change, aligning to new guidelines issued by IADI or developing differentiated funding obligations for banks. In terms of the FSLAA, CODI's Board of Directors (Board) must establish an investment committee to develop the necessary investment mandate for the DIF and oversee the performance of CODI's investments.

Future implementation milestones

Publication of a commencement schedule

Because of the interdependencies of various clauses in the FSLAA and the preparations required for implementation, both by the SARB and by financial institutions, the FSLAA does not become effective in its entirety on the date of enactment. The SARB and National Treasury are currently compiling a schedule according to which the different clauses in the FSLAA will become effective. The Minister of Finance will publish commencement schedules that will specify when various provisions of the FSLAA will become effective in a logical sequence.

Establishment of CODI as a company

CODI will be established as statutory legal entity according to the commencement schedule. However, in anticipation of its legal establishment, the SARB has appointed a dedicated project team to prepare for its implementation and operationalisation. The SARB carries the start-up costs for CODI, and CODI will use some of the SARB's support functions to minimise its own operational cost. The project team is currently documenting a targeted operating model to define how CODI will operate within the SARB environment. This will inform the management agreement with the different support departments within the SARB.

CODI will have its own Board and Chief Executive Officer (CEO). The FSLAA specifies the composition of the Board as having eight members. The members include:

- a representative from National Treasury, appointed by the Director-General;
- a SARB Deputy Governor, appointed by the SARB Governor;
- the CEO of the PA;
- the Commissioner of the Financial Sector Conduct Authority (FSCA);
- the CEO of CODI;
- the SARB's Chief Financial Officer; and
- two persons appointed by the SARB Governor with concurrence of the Minister of Finance.

Development of secondary legislation

The FSLAA is the enabling primary legislation for the SARB and CODI, but has to be supplemented by more detailed secondary legislation. In anticipation of the enactment of the FSLAA, the SARB has published a series of discussion papers on the envisaged resolution and deposit insurance framework and consulted extensively with domestic and international stakeholders. Since 2019, the SARB published discussion papers on the following topics:

- Group structure reporting requirements for resolution planning[13]
- Proposed requirements and principles for first-loss-after-capital (Flac) instruments[14]
- Proposed requirements for funding in resolution[15]
- Operational Continuity in Resolution[16]
- Proposed valuation requirements for resolution-planning purposes[17]
- Resolution stays and moratoria[18]
- Coverage and reporting rules discussion paper[19]
- The deposit insurance funding model and the implications for banks[20]
- Data definition and reporting requirements discussion paper[21]
- The use of the deposit insurance fund to reimburse covered depositors[22]

The contents of the discussion papers and the comments received will form the basis from which secondary legislation will be drafted. After commencement of the provisions of the FSLAA, the SARB and CODI will direct the PA to issue standards on various aspects of the resolution and deposit insurance frameworks, according to the process set out in the FSR Act. The provisions for the deposit insurance levies and premiums have been included into the Financial Sector Levies Bill and the Financial Sector Levies and Deposit Insurance Premium (Administration) Bill respectively, which will amend the FSR Act. These bills are expected to be promulgated during 2022.

13 https://www.resbank.co.za/en/home/publications/publication-detail-pages/media-releases/2020/10278

14 https://www.resbank.co.za/en/home/publications/publication-detail-pages/media/media-releases/2021/Flacdiscussionpaperforpublication

15 https://www.resbank.co.za/content/dam/sarb/publications/media-releases/2021/invitation-to-comment-on-a-discussion-document-on-the-proposed-requirements-for-funding-in-resolution/Discussion%20Document.pdf

16 https://www.resbank.co.za/content/dam/sarb/what-we-do/financial-stability/resolution-planning/OCIR%20Discussion%20Paper%20-%20Operational%20Continuity%20In%20Resolution.pdf

17 https://www.resbank.co.za/content/dam/sarb/what-we-do/financial-stability/resolution-planning/Discussion%20Paper%20-%20Proposed%20valuation%20requirements%20for%20resolution-planning%20purposes.pdf

18 https://www.resbank.co.za/en/home/what-we-do/financial-stability/revised-discussion-paper---resolution-stays-and-moratoria

19 https://www.resbank.co.za/en/home/publications/publication-detail-pages/media-releases/ad-hoc-news/2020/9849

20 https://www.resbank.co.za/en/home/publications/publication-detail-pages/media-releases/2020/10208

21 https://www.resbank.co.za/en/home/publications/publication-detail-pages/media/media-releases/2021/SARB-CoDI-data-and-reporting-discussion-paper

22 https://www.resbank.co.za/en/home/publications/publication-detail-pages/media-releases/Consultation-papers-/2021/CoDI/Discussion-document-on-deposit-insurance-fund-to-reimburse-covered-depositors

Chapter 3: Sectoral overview

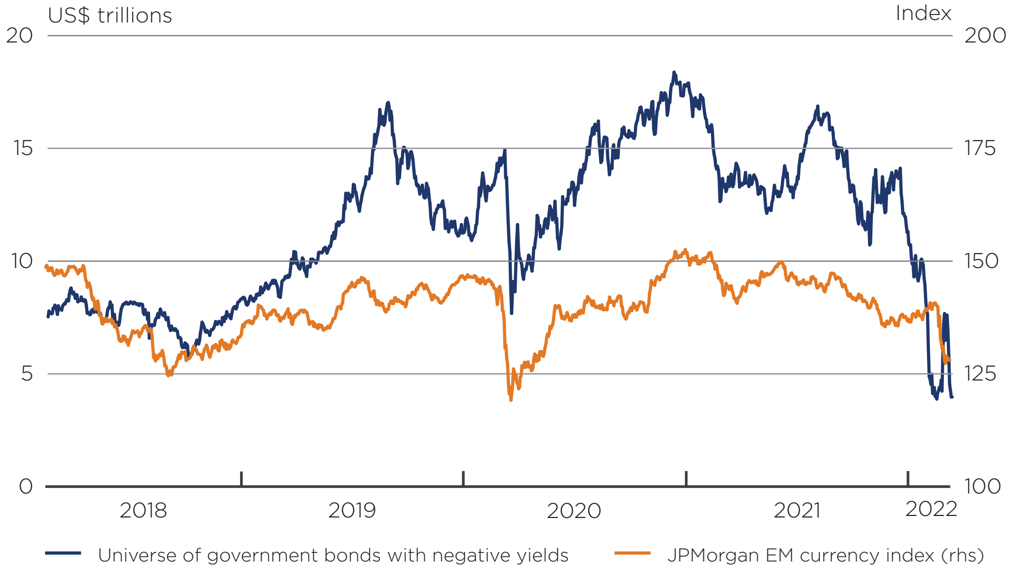
Overview

This section provides a more detailed discussion of the main elements of the heatmap presented in Chapter 1 and focuses on selected indicators of domestic financial stability of greatest relevance at the current conjuncture. The sectoral overview covers relevant developments in areas such as financial markets, banking, insurance, collective investment schemes (CISs), pension funds, non-financial corporates, households, residential and commercial real estate, and government over the period under review. Of particular focus in this edition of the *FSR* is liquidity in the SAGB market, and Box 2 is dedicated to a comprehensive discussion thereof.

Financial markets

Expectations of monetary policy tightening in advanced economies triggered a widespread rise in bond yields. The universe of government bonds with negative yields shrank from US$12 trillion in November 2021 to just under US$3 trillion at the end of March 2022 (Figure 11).

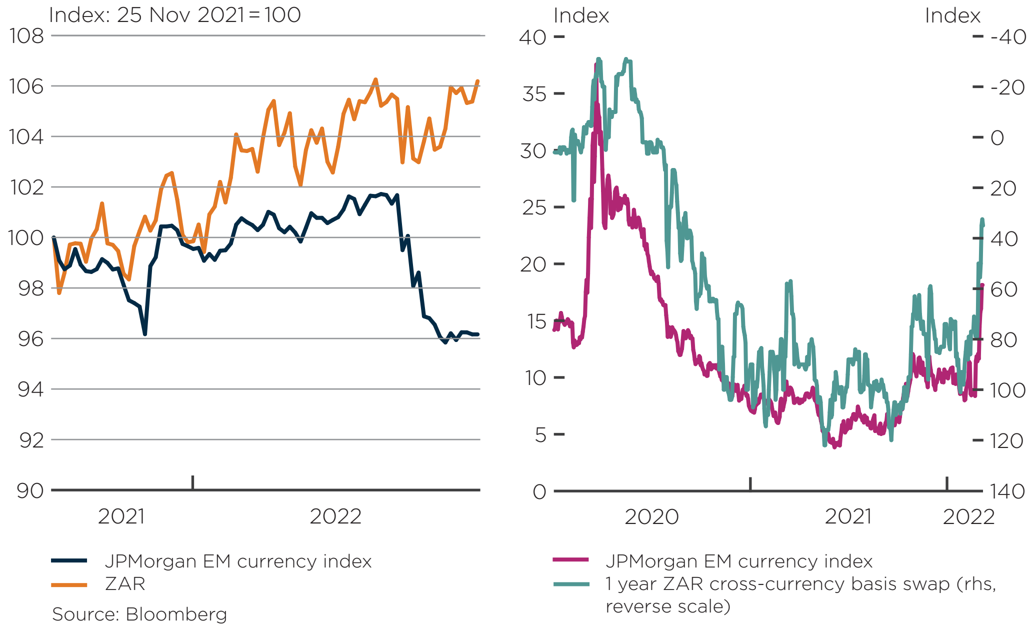
Figure 11: Universe of government bonds with negative yields



Source: Bloomberg

Emerging market currencies maintained a modestly firmer bias for the earlier part of the period under review. While some emerging market currencies depreciated from the start of the Russia-Ukraine war, growing expectations of a faster-than-anticipated tightening of US monetary policy and the concomitant sharp sell-off in emerging market assets caused the exchange value of most emerging market currencies to decline sharply since mid-April 2022. The currencies of commodity-exporting emerging markets appreciated somewhat on the back of higher commodity prices, although heightened uncertainty raised the cost of US dollar funding for emerging markets in general (Figure 12).

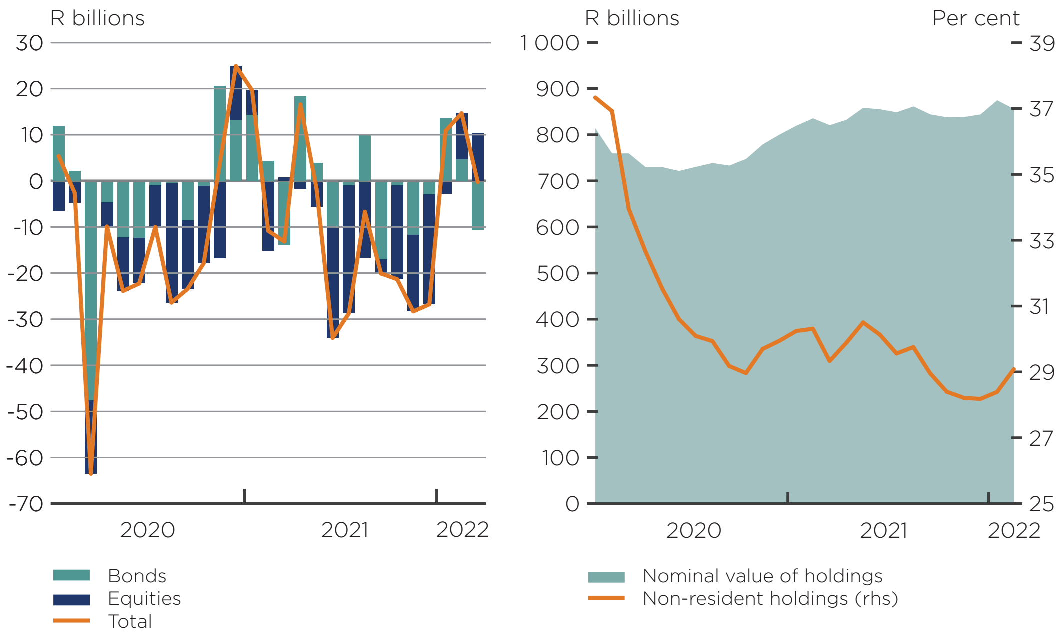
Figure 12: EM currencies (left) and USD funding conditions (right)



Source: Bloomberg

The net selling of SAGBs by non-resident investors in the first quarter of 2022 was countered by net purchases of equities as South Africa's commodity-based equities became particularly attractive to foreign investors (Figure 13). Data from the JSE Limited (JSE) showed that foreign investors sold R15 billion and R61 billion worth of domestic bonds and equities respectively during the fourth quarter of 2021. However, in the first quarter of 2022 South Africa attracted an estimated net R26 billion into bond and equity investments.

Figure 13: Non-resident transactions in SA bonds and equities (left) and non-resident holdings of SAGBs (right)



Sources: Strate and National Treasury

Notwithstanding the relative resilience of the rand, there are signs that South African financial and non-financial corporates are experiencing elevated costs when raising US dollars in offshore markets.

Liquidity in the South African government bond market

Liquidity in the secondary market for SAGBs has declined since the outbreak of COVID-19, introducing some vulnerability to shocks for both the issuer of, and investors in, domestic bonds. The issuer may face higher volatility and funding costs, while investors may find it expensive to liquidate their holdings in large amounts when they have a need for cash.

The decline in liquidity is partly attributable to lower participation by foreign investors in domestic financial markets. In February 2022, non-resident investors held 29% of SAGBs, down from approximately 37% before the COVID-19 shock (Figure 15). As non-resident investors reduced their holdings of SAGBs, domestic banks and other financial institutions increased their holdings. However, local investors' capacity to absorb SAGBs may become constrained and, as significant holders of SAGBs, they are vulnerable to material price fluctuations or illiquidity constraints in times of stress. The effects of illiquidity could be exacerbated by rising global and domestic interest rates, increased geopolitical risks and prospects for further increases in SAGB issuance.

Besides the stress experienced in US dollar funding markets and the lower liquidity in the SAGB market, there is no evidence that risks prevalent in global financial markets have triggered widespread funding liquidity pressures in other segments of the domestic money and capital markets.

Box 2: Liquidity in the South African government bond market

Market liquidity is important for the stability of the financial system as it is the foundation for efficient and effective market functioning and pricing of assets. The lack of market liquidity can give rise to disorderly market conditions and magnify shocks. A liquid market is generally defined as a market where participants can rapidly execute large transactions at low costs with a minimal impact on price. Liquidity in the SAGB market is particularly relevant as SAGB yields serve as benchmark for a range of market rates, making effective price discovery essential. Illiquidity in the SAGB market was particularly evident during the COVID-19-induced financial market shock starting in March 2020, which for the first time in its history required unprecedented central bank support in order to restore market functioning.

The decline in bond market liquidity has prevailed beyond the COVID-19 shock. A study by Gubareva (2021)[1] shows that this is a phenomenon that is not unique to South Africa, as liquidity conditions for high-yield emerging market bond markets have deteriorated after the COVID-19 shock – both in corporate and sovereign bond markets. Even the largest bond market in the world, the US bond market, has experienced a decline in liquidity.

Several cyclical and structural factors have contributed to illiquidity in the domestic bond market. The exclusion of SAGBs from the FTSE World Government Bond Index (WGBI) and other indices after South Africa's sovereign credit rating downgrades to sub-investment grade has resulted in lower participation by non-resident investors. Non-resident participation was further reduced by cyclical factors such as the ongoing monetary policy normalisation in advanced economies and heightened geopolitical risk, which has proved to be generally negative for emerging markets. Domestic investors took up a greater portion of outstanding SAGBs, but their buy-and-hold strategies did little to alleviate market illiquidity.

In addition, increased government bond issuance has made liquidity conditions more challenging. Structurally weak domestic economic growth has resulted in a higher fiscal deficit, which has been funded through increased government borrowing. A study by the Bank of Canada[2] showed that increasing the issuance of debt instruments that are already in circulation beyond a certain threshold could hinder rather than aid the instruments' liquidity.

The remainder of this box considers the evolution of several indicators of liquidity in the SAGB market.

Speed of execution[3]

While turnover days in SAGBs ranged between 16 and 18 days between 2013 and 2019, it increased to 25 days in 2021 (Figure B2.1). This was the consequence of a sharp increase in SAGB issuance in 2020 against average turnover that tapered off (Figure B2.2).

1 Available at https://doi.org/10.1057/s41283-021-00074-7.

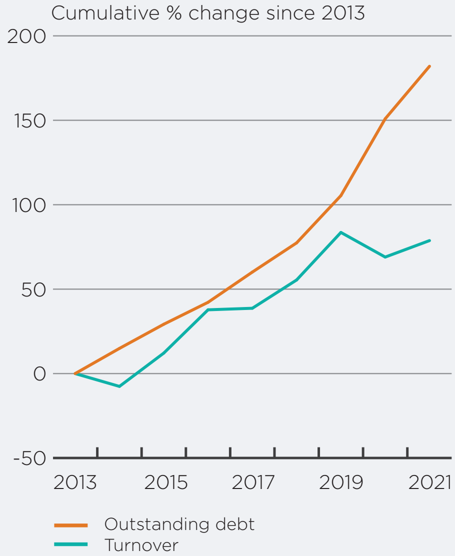
2 Bank of Canada Staff Working Paper, No. 2018-35.

3 Speed of execution is measured by an index of turnover days, which is derived from total outstanding government bonds adjusted by average daily turnover. The index measures the number of days it takes to trade the total amount of outstanding SAGBs.

Figure B2.1: Turnover days ratio

Sources: SARB and JSE

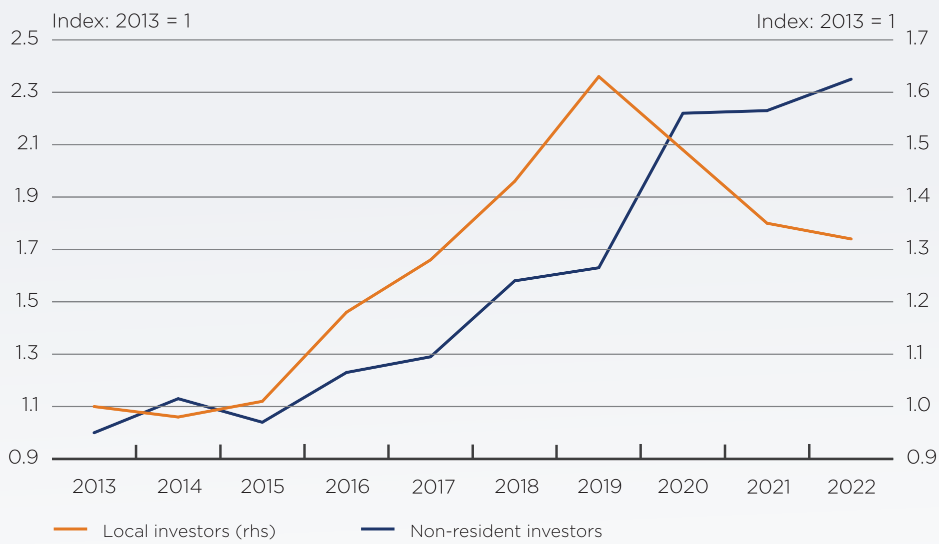
Figure B2.2: Growth in SAGB turnover



Transaction volumes[4]

Figure B2.3 shows that transaction volumes for both local and non-resident investors increased between 2013 and 2019. However, since the COVID-19 crisis, local investors' transaction volumes declined, reflecting a sensitivity to price changes caused by large trading volumes. Non-residents' transaction volumes continued to increase, but the decline in the share of non-resident holdings of SAGBs since the COVID-19 crisis put further strain on liquidity conditions in the SAGB market.

Figure B2.3: Transaction volumes for both local and non-resident investors



Sources: JSE and SARB

Transaction costs

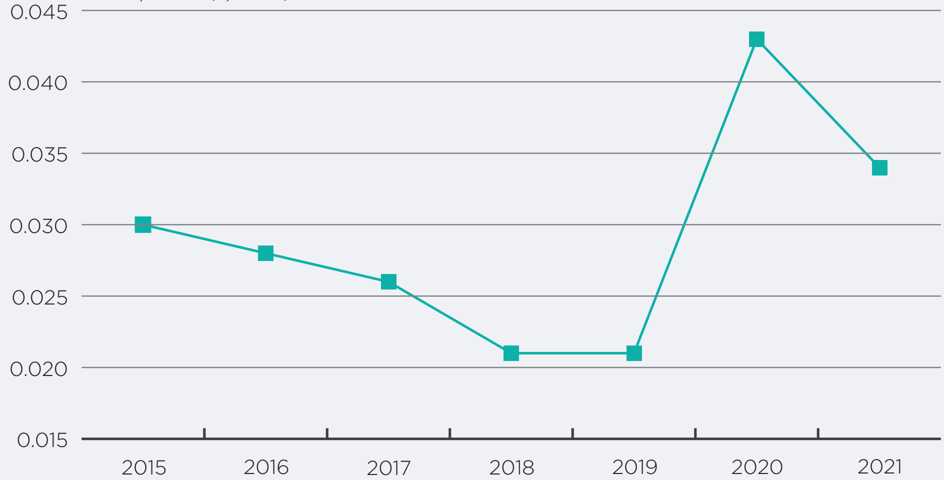
A working paper published by the International Monetary Fund (IMF)[5] argues that the bid-offer spread captures most of the transaction costs incurred in a trade. According to the paper, higher transaction costs reflected in a wider bid-offer spread reduce demand for

4 Transaction volumes are calculated by dividing total SAGB turnover by the number of deals in each period.

5 IMF Working Paper WP/02/232, Measuring Liquidity in Financial Markets.

trades and therefore the number of potentially active participants in a market. In South Africa, the average bid-offer spread in SAGBs narrowed notably between 2015 and 2019, but widened sharply during the COVID-19 crisis. Bid-offer spreads in SAGBs have since moderated but remain much wider than before the outbreak of COVID-19.

Figure B2.4: Annual average bid-offer spread on R2048

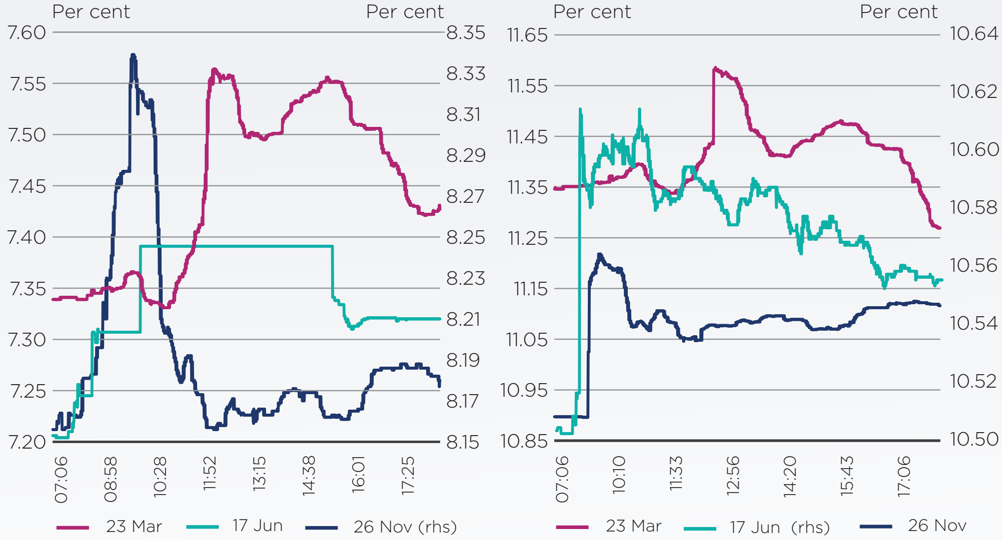


Source: Bloomberg

Market gapping[6]

The SAGB market experienced several episodes of market gapping since the COVID-19 crisis. When there are market gaps, there is an increased risk that the actual price may differ from the expected price, which disincentivises active trading. The higher occurrence of price gaps indicates a higher level of bond market illiquidity.

Figure B2.5: Selected intraday pricing in R186 (left) and R2044 bonds in 2021 (right)



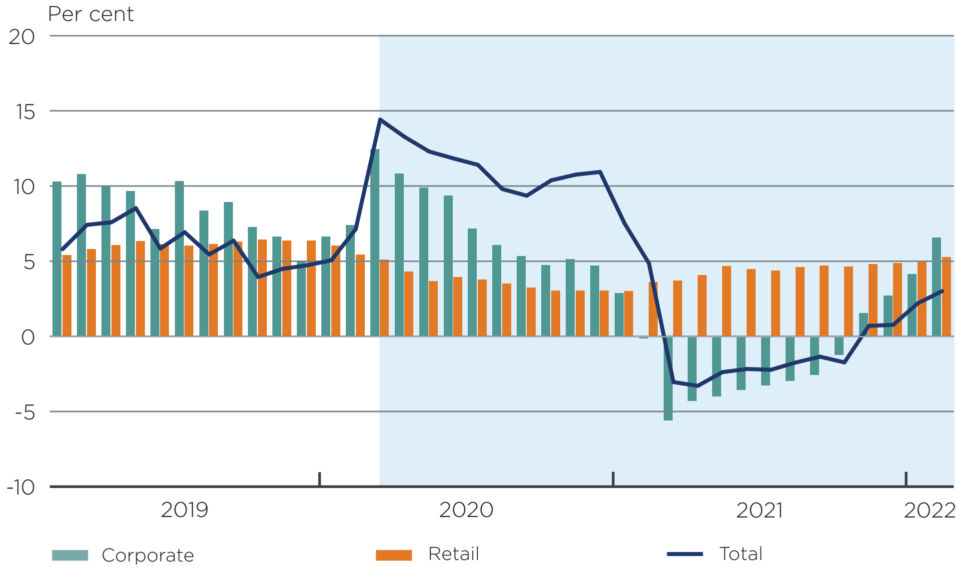
The above non-exhaustive list of indicators is used to monitor liquidity conditions in the SAGB market, which collectively point to fragile liquidity conditions in the SAGB market. In addition to these price- and volume-based indicators, the SARB also relies on market intelligence as an important source of information, particularly for segments of the market where liquidity conditions are not directly observable from price and/or volume trends. This qualitative feedback provides a more nuanced view from market participants on both the buy-side and sell-side of the market, as well as those with distinct operating models.

6 A market gap exists when there are sharp price adjustments with small or no trades.

Banking sector

Growth in bank credit is recovering from its significant slowdown since the onset of COVID-19 in March 2020. Between June 2021 and the end of January 2022, retail credit increased by approximately 3%, while corporate credit increased by almost 4% over the same period (Figure 14). By value, most retail lending was secured credit, such as residential mortgages, and vehicle and asset finance. Most of the corporate credit growth was to the community, social and personal services, mining and quarrying, and manufacturing sectors.

Figure 14: Growth in banking sector credit exposures



Blue shading: COVID-19 period – starts in March 2020

Source: SARB

As economic growth recovered during 2021, the level of NPLs[23] moderated. Following the onset of COVID-19 in March 2020, the sector's credit risk (as indicated by its NPL ratio[24]) increased substantially, but steadily declined during 2021 (Figure 15). Although non-performance in unsecured retail small and medium enterprise (SME) loans as well as in unsecured term loans (which have a revolving credit component) increased, these loan categories constitute less than 2% of total loans and advances. The sector's probability of default (PD) ratios, which provide forward looking expectations of defaults over the next 12 months, is trending downwards, suggesting that the sector expects credit risk to continue to moderate through 2022 (Figure 16).

23 NPLs in this context refer to the ratio of unpaid loans greater than 90 days to total loans for the respective asset category or impaired advances as a percentage of on-balance sheet loans and advances.

24 The NPL ratio is defined as (i) default ratios for internal-ratings based portfolios, (ii) the ratio of impaired advances to gross loans and advances for the total sector, or (iii) the ratio of loans overdue for more than 90 days as a percentage of on-balance sheet loans and advances for the total banking sector.

Figure 15: NPLs for the banking sector and selected portfolios

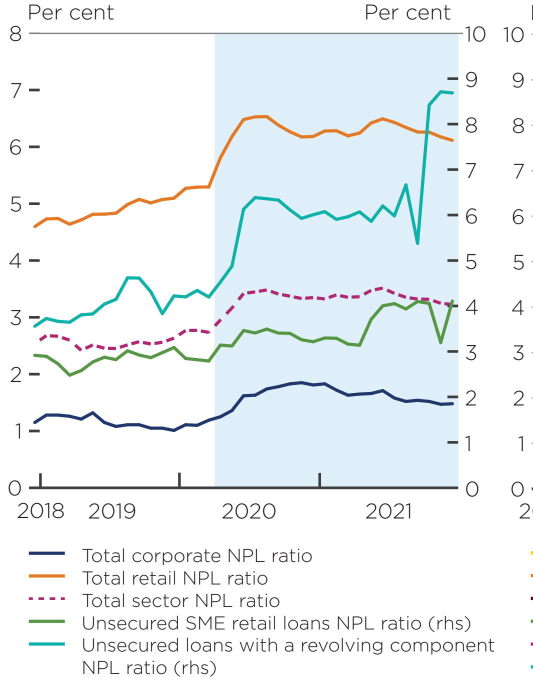
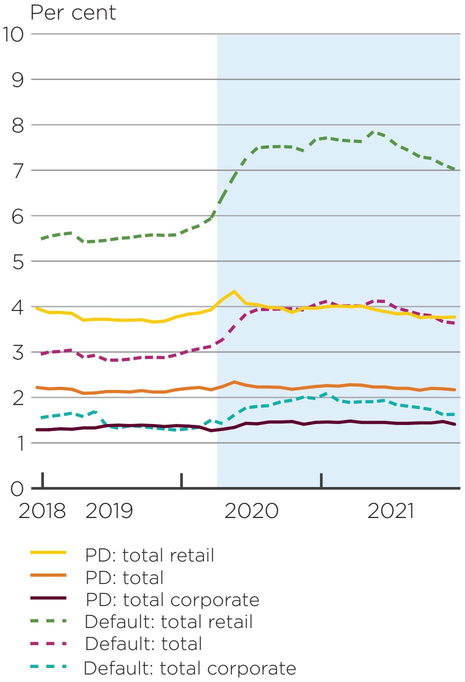


Figure 16: Banking sector NPLs and PD ratios



Blue shading: COVID-19 period – starts in March 2020

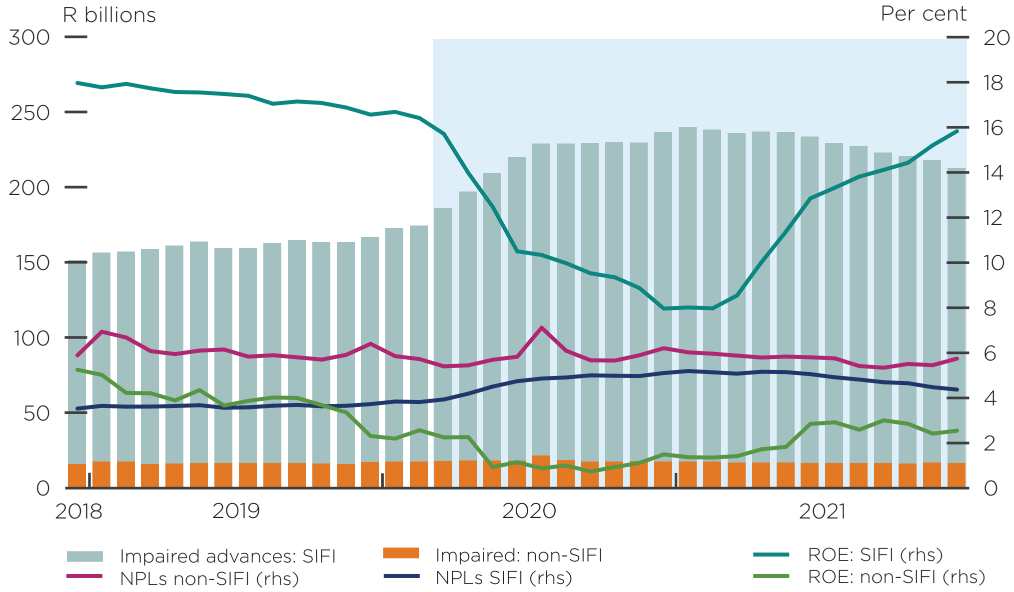
Sources: PA and SARB

Banking sector profitability also increased during the period under review. The return-on-equity ratios of both the SIFIs[25] and non-SIFIs started to recover from the COVID-19 shock in 2021, although the recovery was more pronounced for SIFIs. Non-SIFI profitability was burdened by continuing increases in credit losses, as reflected by the rise in the ratio of NPLs to total loans (Figure 17). While SIFIs have a diversified asset base, non-SIFIs are often monoline banks operating in niche segments of the economy such as retail unsecured lending and lending to SMEs. These sectors were particularly hard hit by the COVID-19 lockdowns.

A continuation of the divergence in profitability between SIFIs and non-SIFIs could point to an emerging vulnerability in the banking sector. Although none of the non-SIFIs are considered to be systemically important on an individual basis, simultaneous and interrelated stress in a number of non-SIFIs can pose systemic risk.

25 Financial institutions can be designated by the Governor of the SARB as SIFIs, in terms of the FSR Act. SIFIs are typically the larger, more complex and more interconnected institutions whose operations have a greater impact on the rest of the financial system. Refer to the second edition of the 2019 *FSR* for more information on the six designated SIFIs.

Figure 17: Impaired advances, NPLs and return on equity for SIFIs and non-SIFIs



Status: Data is not publically available
Blue shading: COVID-19 period – starts in March 2020

Sources: PA and SARB

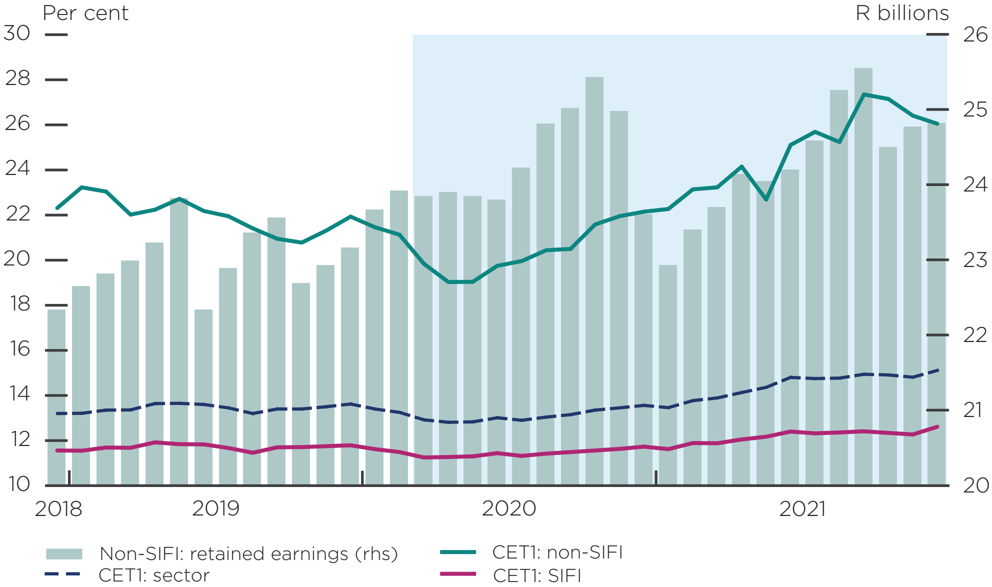
Overall, the banking sector's regulatory capital (as indicated by the common equity tier 1 ratio (CET1 ratio[26])) increased steadily throughout 2021 to levels higher than those of the pre-COVID-19 period (Figure 18). In general, the non-SIFI banks hold significantly higher ratios of loss-absorbing capital (as reflected by the higher CET1 ratios), which helped to absorb the rising credit losses, as reflected by the decline in their CET1 ratio since the fourth quarter of 2021. The increasing trend in non-SIFI credit losses requires further monitoring, but does not present any systemic risk.

The important role of sufficient levels of regulatory capital in guarding against periods of distress is highlighted by the case of Ubank. On 16 May 2022, the Minister of Finance placed Ubank under curatorship due to the bank's deteriorating capital position. In terms of the SARB's assessment and monitoring of SIFIs, Ubank is not systemically significant and its curatorship does not pose any systemic risk to the rest of the financial sector. The criteria used when considering systemic significance is set out in a discussion paper published by the SARB in 2019.[27]

26 The CET1 ratio is an indication of the highest loss-absorbing capital that the sector holds in the event of unexpected losses. CET1 regulatory capital consists mostly of paid-in capital and retained earnings.

27 Available at https://www.resbank.co.za/content/dam/sarb/what-we-do/financial-stability/resolution-planning/A-methodology-to-determine-which-banks-are-systemically-important-within-the-South African-context%20(2).pdf.

Figure 18: CET1 regulatory capital ratios for the total sector, SIFIs and non-SIFIs



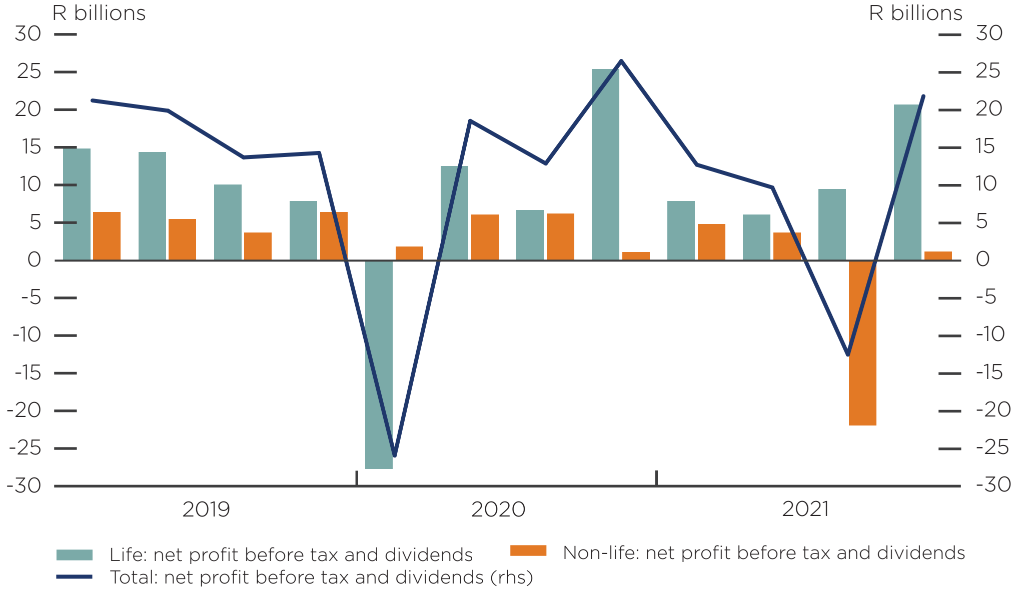
Blue shading: COVID-19 period – starts in March 2020

Sources: PA and SARB

Insurance sector

Profitability in the insurance sector recovered in the fourth quarter of 2021. After recording a net loss in the third quarter of 2021, the sector posted a net profit before tax and dividends of R21 billion in the fourth quarter (Figure 19). This recovery in profitability was concentrated in the life insurance segment, which benefited from higher investment income and asset valuation, as well as lower COVID-19-related claims as vaccination rates increased. Profitability in the non-life segment remained under pressure due to a combination of continuing claims arising from the social unrest experienced during the latter part of 2021 and flood damage caused by heavy rainfalls. However, non-life insurance claims also decreased as claims from the social unrest moderated.

Figure 19: Insurance sector net profit before tax and dividends



Source: PA

Insurance sector gross written premiums (GWPs) declined for the first time since the third quarter of 2020. Total GWPs decreased by 3.8% in the fourth quarter of 2021. Life insurance GWPs decreased by 5% to R151 billion and non-life GWPs decreased by 1.3% to R39 billion. Slow economic growth remains a key concern for the sector as it has the potential to negatively impact future demand for insurance products.

Table 3: Selected domestic insurance sector indicators

	2020Q4	2021Q1	2021Q2	2021Q3	2021Q4
Total net profit before tax and dividends (R millions)	26 509	14 850	10 731	(12 484)	20 681
Total insurance sector net claims (R billions)	176	162	173	184	154
Life: net claims	156	146	156	141	133
Non-life: net claims	19	15	17	42	21
Total gross written premiums (R millions)	204 987	198 380	227 321	196 458	190 933
Life: gross written premiums (R millions)	162 556	155 068	178 875	148 460	151 372
Non-life: gross written premiums (R millions)	42 431	43 311	48 446	47 997	39 560

Sources: PA and NT

Between the start of the social unrest in July 2021 and the start of April 2022, Sasria received claims to the value of R32.8 billion, of which R20.8 billion had been paid out by the beginning of April 2022. Before the unrest, Sasria's financial position was sound, but subsequent claims depleted its reserves and required an initial cash injection of R3.9 billion from National Treasury. In January 2022, additional funds were allocated to Sasria as part of its approved larger capital injection programme. The cost of Sasria cover also increased: from 1 February 2022, insurers subscribing to the Sasria insurance option were required to pay up to 1 700% more for premiums related to unrest insurance. The possibility of additional cash injections required by Sasria and the potential of further social unrest incidents owing to low economic growth and rising inequality pose a vulnerability to the insurance sector and the fiscus.

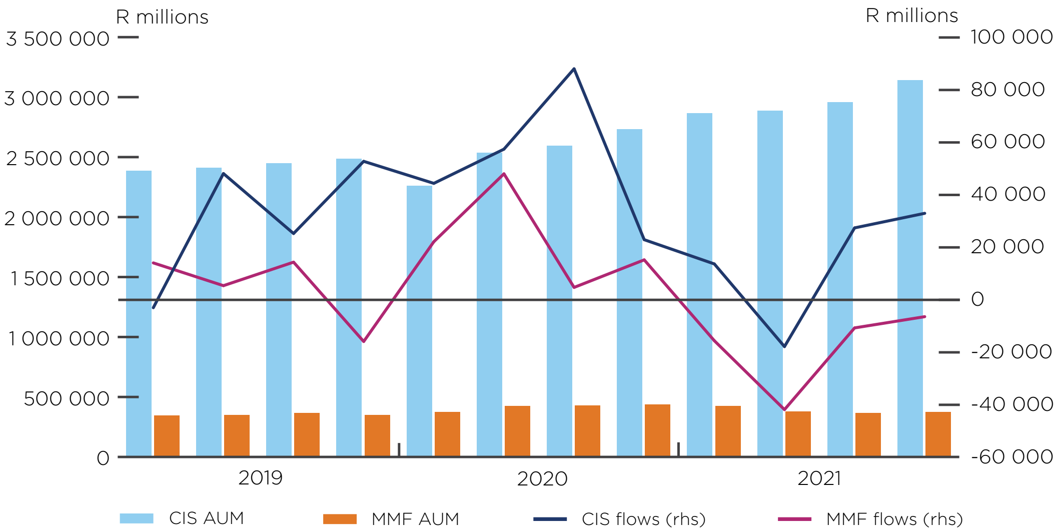
The insurance sector remained adequately capitalised during the period under review. Both the life and non-life insurance segments maintained average SCR coverage ratios well above the minimum requirement of one during the period under review. Sasria had an SCR cover of less than one (-2.26) at the end of December 2021, but is in discussions with National Treasury for the final tranche of a R7.1 billion capital injection, which would restore its SCR cover to around 1.8 times.

Collective investment schemes

CISs' assets under management (AUM) continue to grow steadily. CISs' AUM rose to R3.1 trillion in December 2021, with net inflows picking up again after the outflows in the second quarter of 2021 that had been caused by the closure of the Absa Money Market Fund (Figure 20).

Although relatively small as a portion of overall CIS, trends in money market funds (MMFs) receive particular interest in financial stability assessments because of their potential impact on liquidity in the banking sector. MMF assets decreased to R373 billion between the third and fourth quarters of 2021, from a peak of R438 billion in the fourth quarter of 2020.

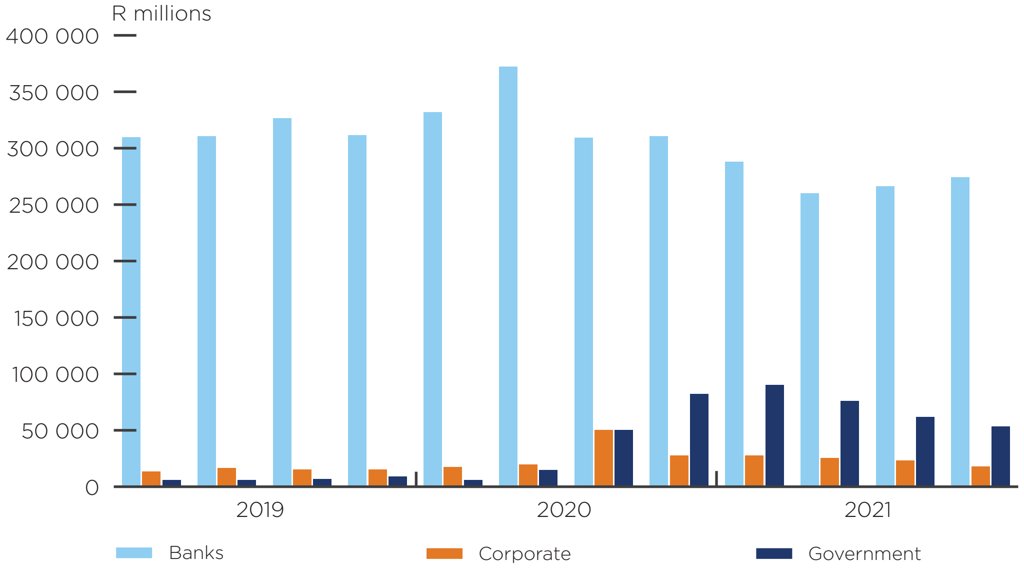
Figure 20: Assets under management and net flows of CISs and MMFs



Source: ASISA

There is potential risk associated with MMFs' increased exposure to Treasury bills (T-bills) (Figure 21). The shift in holdings of T-bills by MMFs reflects more attractive returns on T-bills relative to negotiable certificates of deposit (NCDs). However, the secondary market for T-bills is illiquid, which may impair MMFs' access to cash in times of liquidity strain, for example, when there is an unexpected and large increase in redemptions. This may require MMFs to make large withdrawals from their bank deposits, which can translate into liquidity pressure in individual banks. Although MMF exposure to banks is decreasing (Figure 21), it remains above pre-COVID-19 levels.

Figure 21: MMFs' exposure

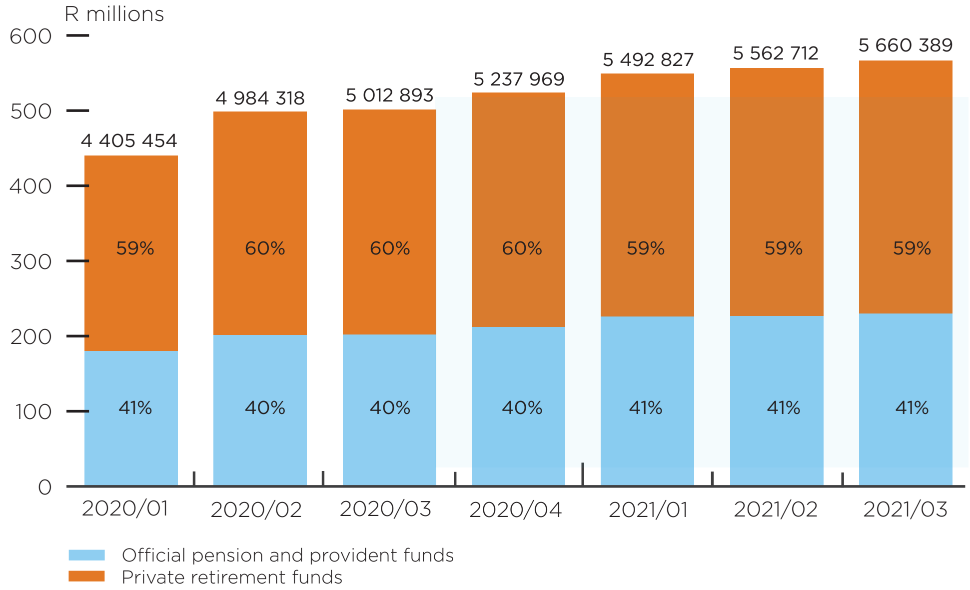


Sources: ASISA and SARB

Pension funds

Pension funds recorded a modest increase in the total fair value of assets held. Following a strong increase of 6.21% in the first quarter of 2021, subsequent growth was more subdued due to the July 2021 unrest as well as the lingering effects of the COVID-19 pandemic, but the annual growth rate of asset values was a healthy 8.42% (Figure 22).

Figure 22: Total assets of pension funds



Source: SARB

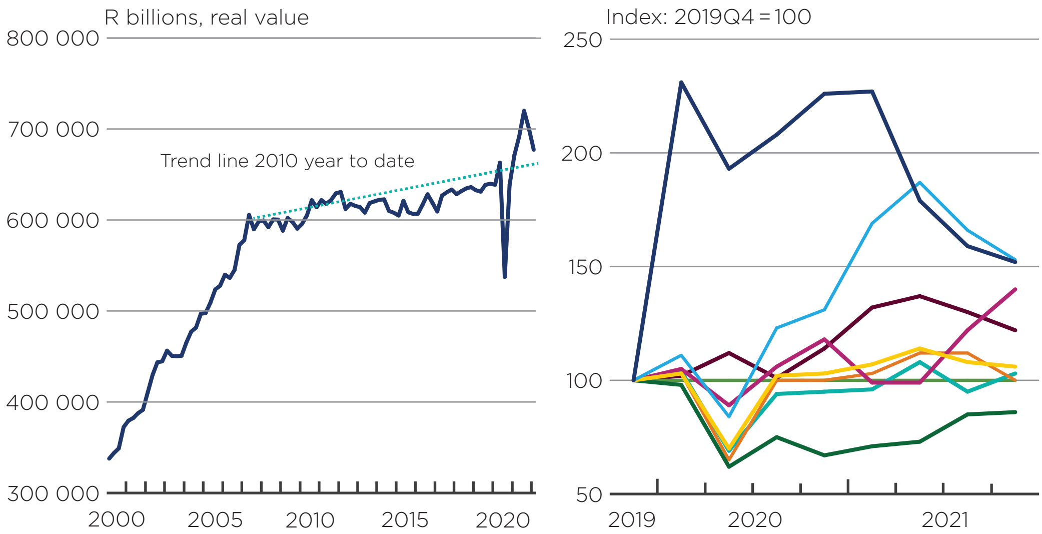
The investment allocation of pension funds remained fairly constant and balanced among a range of asset classes. The restrictions imposed by Regulation 28 of the Pension Funds Act 24 of 1956 limits the effects of shocks on a single asset class of pension funds. This, combined with a long-term investment horizon, mitigates both the contribution and exposure of pension funds to systemic risk. The well-balanced portfolios of both government and private pension funds have shown resilience despite the effects of the COVID-19 pandemic and social unrest.

Non-financial corporates

The rebound in economic activity has been beneficial for the performance of non-financial corporates (NFCs), although the recovery remains uneven across industries. Operating surplus[28] in the sector has recovered since its 2020 lows, rising by 4.5% above its pre-COVID-19 pandemic trend. There was a marginal deterioration in the last two quarters of 2021 as surpluses declined by an average of 3.0% from the previous quarter, mostly due to renewed COVID-19-related restrictions and the July 2021 social unrest. The end of the National State of Disaster is, however, expected to allay concerns over renewed lockdowns. While considerable profit gains are primarily from the mining and quarrying sector that benefited from the commodity price surge, the recovery was also driven by agriculture, forestry and fishing, electricity, gas and water, personal services and manufacturing, which contributed nearly a third of the corporate sector's surpluses. However, profits in the construction and transport sectors remain below their pre-COVID-19 pandemic levels. Moreover, profitability is lagging in those sectors where activity continues to be suppressed by the pandemic and government restrictions, such as the transport industry.

28 The simple definition of operating surpluses is sales less cost. The surplus/deficit is calculated before interest income and tax.

Figure 23: Non-financial corporate surpluses* (left) and operating surpluses by sector (right)



* Excludes real estate

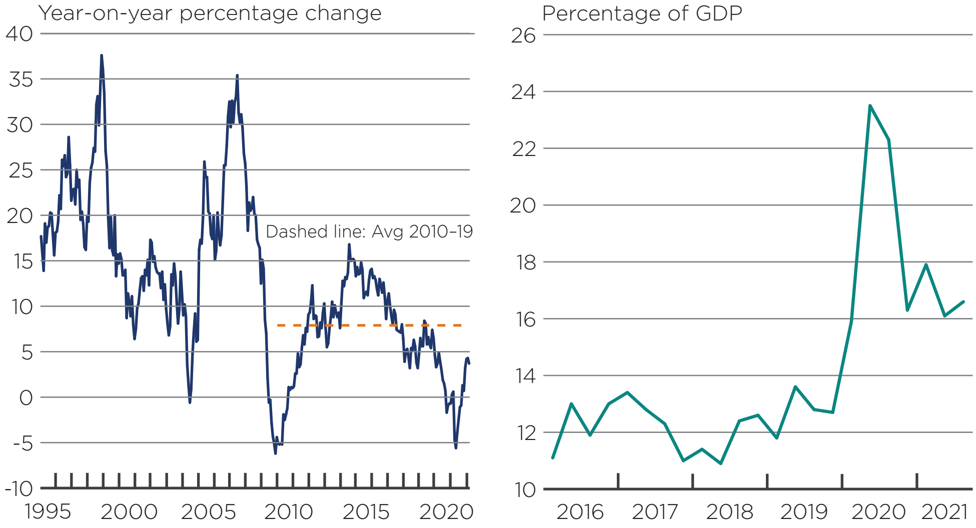
Agriculture, forestry and fisheries (2%)*
Mining and quarrying (12%)*
Personal services (9)*
Electricity, gas and water (3%)*
Manufacturing (14%)*
Wholesale and retail trade (15%)*
Finance, real estate and business
Transport and communication (8%)*
Construction (2%)*

Sources: SARB and Haver

* Share of total corporate operating surpluses

Higher revenue and profitability have improved NFC solvency ratios. Since the end of 2020, declining revenue and profit margins have led to a contraction in corporate credit. However, this trend has reversed from October 2021, with a rise in bank credit funding to corporates. These developments reflect an improvement in the sector's operations, higher financing needs for inventory and banks' easing of lending conditions (Figure 24). Corporates have also increased their savings buffer at a savings rate of 16.6% of GDP – higher than the pre-COVID-19 rate of 12.3% of GDP. The higher savings buffer primarily reflects the improved financial positions of large, listed firms. SMEs have lower cash buffers, reflecting limited access to funding and the withdrawal of government support.

Figure 24: Credit extension to NFCs (left) and corporate savings rate (right)



Sources: BIS and Stats SA

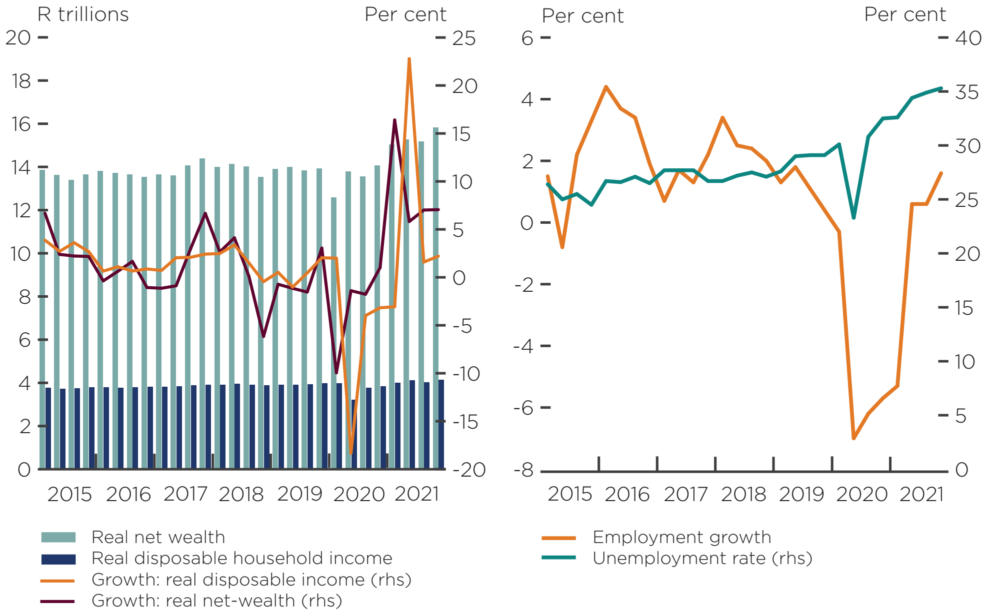
Liquidations have increased since 2020 and remained at high levels in some sectors. Banks' NPLs originating from the NFC sector decreased to 1.0% of total non-financial corporate loans in default status in November 2021, from 1.5% in November 2020. Additionally, the interest coverage ratios (ICRs)[29] of all industries recorded levels above the IMF's benchmark of 2 in the third quarter of 2021, implying that NFCs are managing to pay off debt. Sectors that were more severely affected by the COVID-19 restrictions (electricity, services, transport and construction) also showed improvement in their ICRs.

Households

Household finances continued to recover but vulnerabilities remain. Real disposable income increased by 2.2% year on year in the fourth quarter of 2021 as employment growth increased marginally (Figure 25). However, the record-high official unemployment rate of 35.3% in the fourth quarter of 2021 is a key risk to growth in disposable income. Despite the high unemployment rate, households' balance sheets are in a stronger position, with real net wealth increasing in the fourth quarter of 2021 to R15.8 trillion, supported by strong growth in financial assets. The recovery in employment and wealth is uneven between income groups, with lower-income households expected to take longer to recover as they tend to hold fewer financial assets and are affected more by the COVID-19 pandemic. Households remain vulnerable to rising interest rates, increasing fuel and food prices, further variants of COVID-19, a slow rate of vaccinations, as well as weak and inequitable economic growth. Furthermore, they are vulnerable to inflationary pressures resulting from increases in food and fuel prices caused by the Russia-Ukraine war. Rising interest rates to contain inflation would put severe pressure on highly indebted households as servicing debt becomes more costly.

29 The ICR is an estimation of a firm's ability to generate enough cash flow to finance its interest expenses on outstanding debt by dividing a firm's earnings before interest and taxes by its annual interest expenses.

Figure 25: Growth in real disposable income and wealth (left) and unemployment rate and employment growth (right)



Sources: SARB and Stats SA

Household indebtedness remains high despite some moderation. The household debt-to-GDP ratio has slowed slightly due to moderation in household credit extension and rebasing of GDP. Secured credit was the key driver of the moderate credit growth recorded, accounting for 79% of total household credit. There has been a slowdown in unsecured credit extension since 2019, in line with slower household consumption expenditure. High levels of indebtedness leave households vulnerable to shocks and exposes the banking sector to higher credit risk. This is because highly indebted households are more likely to default on their loans, especially in a stressed environment. Retail NPL ratios[30] declined in the fourth quarter of 2021 because of a reduction in the amount of NPLs, but are still elevated, particularly for unsecured credit.

Debt servicing costs are still moderate compared to pre-pandemic levels, but are expected to increase. Rising interest rates are expected to result in higher debt servicing costs, placing pressure on household finances, particularly low-income earners who tend to hold higher levels of debt compared to income. The debt-servicing cost to disposable income ratio declined marginally in the fourth quarter of 2021 as a result of lower financing costs (Table 4). A positive factor is that households have entered the interest rate hiking cycle with a higher level of savings that could be utilised to service debt. Looking ahead, credit extension to households is expected to increase. However, stringent bank credit approvals (reflected by a higher application rejection rate), and an expected rise in debt servicing costs could mitigate a significant rise in debt.

30 The NPL ratio is calculated as the ratio of the amount of total NPLs to total outstanding loans.

Table 4: Selected household indicators

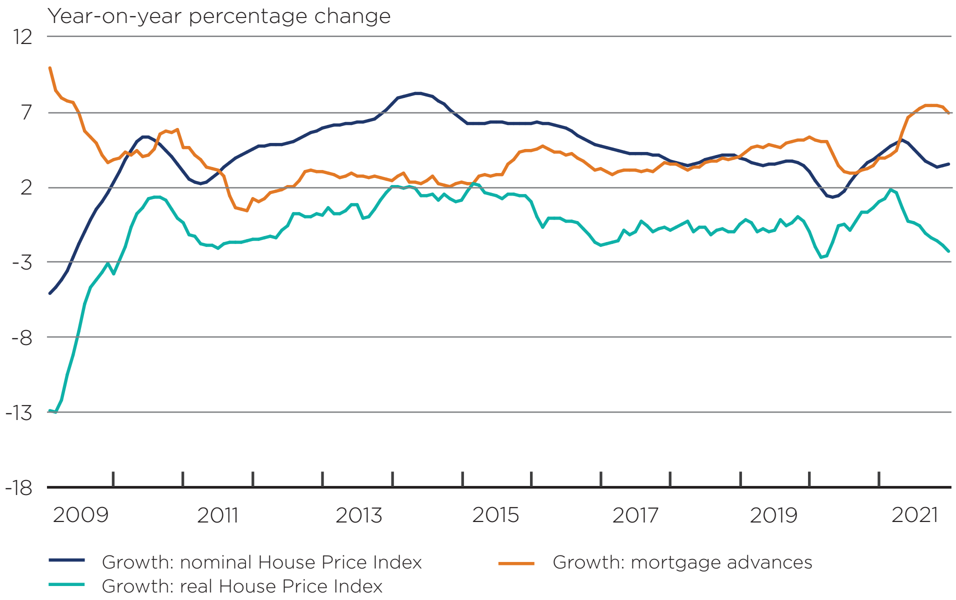
	2019	2020	2021Q2	2021Q3	2021Q4
Household debt (R trillions)	2.33	2.43	2.53	2.56	2.59
Household debt Growth (%)	4.7	4.3	8.1	8.2	6.3
Household debt-to-GDP ratio (%)	35.1	36.2	35.4	34.9	34.7
Debt-service cost (%)	9	8.5	7.5	7.5	7.3
Secured credit extension growth (%)	5.2	3.6	6.8	7.0	6.5
Unsecured credit extensiongrowth (%)	10.2	0.7	1.7	0.6	0.6
Net savings as % of disposable income	-0.4	0.7	0.6	1.2	0.7
Credit application rejection rate (%)	58.9	62.9	63.6	66.6	66.0

Sources: National Credit Regulator and SARB

Residential real estate

Residential house price growth moderated amid rising inflationary pressures. Growth in nominal house prices moderated to 3.4% year on year in the fourth quarter of 2021 and, in real terms, prices declined as a result of higher inflation. While house prices have been supported by low interest rates, weak domestic economic growth prospects, a stagnant labour market and rising interest rates could limit future price increases.

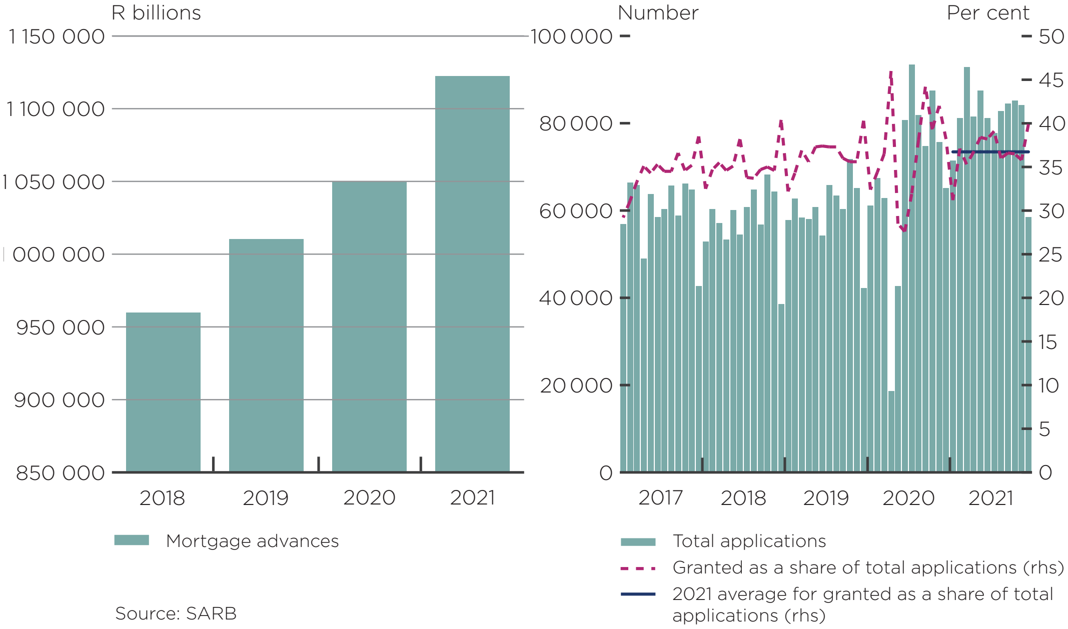
Figure 26: Residential nominal and real house price indices



Sources: BIS, Stats SA and SARB

The value of residential mortgage advances increased and continued to trend above pre-COVID-19 levels. Growth in mortgage advances has increased since the third quarter of 2020 in response to a low interest rate environment, but has since reversed as demand slowed in the last quarter of 2021 as reflected in the number of approved applications (Figure 27). The value of mortgage advances increased between December 2019 and December 2021 even though credit granted for all mortgage applications had been stable at an average of 36% in 2021. This suggests that banks are possibly lending more to affluent households.

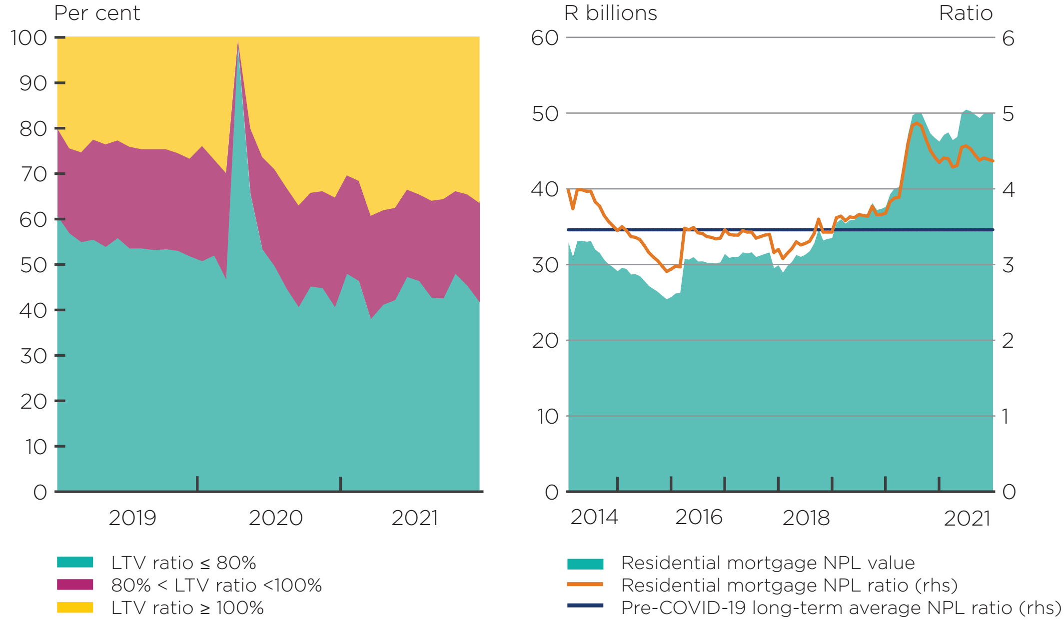
Figure 27: Mortgage advances (left) and credit applications (right)



Source: SARB

New residential mortgages granted with loan-to-value (LTV) ratios of less than or equal to 80% have decreased from an average of 53% in 2019 to 44% in 2021 (Figure 28), suggesting that banks have eased requirements for significant deposits when purchasing property. However, this also increases the credit risk of the bank. This indicates that banks are still adopting a cautious stance when extending credit.

Figure 28: Loan-to-value ratios (left) and residential mortgage non-performing loans ratio (right)



Source: SARB

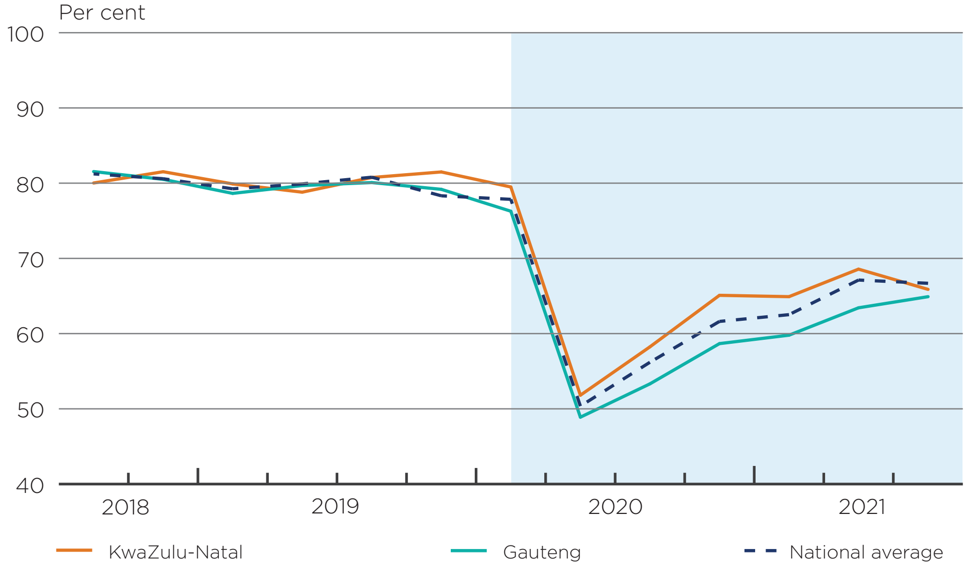
Rising residential mortgage defaults pose higher credit risk to the banking sector as the ratio remains above its pre-COVID-19 levels. Residential mortgage defaults increased substantially in the second half of 2020 but have since stabilised because of a slight recovery in households' financial positions. Looking ahead, higher interest rates and the lingering effects of COVID-19 could potentially weaken mortgage affordability and dampen demand for residential houses.

Commercial real estate

Commercial real estate (CRE) has the potential to negatively impact the financial system as a result of a substantial, abrupt decline in valuations. Such a decline in real estate valuations introduces credit risk if values become less than the corresponding loans made against those properties. Declining valuations could also weaken the ability of property owners and developers to access credit, and weaken the ability of asset managers to meet demand for redemptions. These effects are particularly evident in times of stress in the financial system. Although there are vulnerabilities in certain subsectors, the CRE sector continues to recover as economic growth increases. The CRE sector has been resilient during the COVID-19 period but the retail and office subsectors of the CRE sector were particularly affected by continued lockdowns as well as the large-scale move to remote working arrangements. Current vulnerabilities in the CRE sector are likely to be mitigated by continued economic recovery, as consumer spending gradually increases and domestic tourism improves. The industrial and storage subsectors have been the most resilient during the COVID-19 period and are close to reaching pre-COVID-19 rental levels in the near term.

Rental occupation has not yet recovered to pre-COVID-19 levels. The lockdown restrictions implemented during the multiple waves of the COVID-19 pandemic since March 2020 reduced economic activity. As a result, the tenants of CRE were unable to always pay their rental obligations, which had an immediate and direct impact on valuations. The average percentage of tenants in good standing[31] for all subsectors[32] for the COVID-19 period[33] has yet to reach the pre-COVID-19 average, with tenants in the storage subsector being the most resilient and those in the retail subsector being the most vulnerable. Although retail CRE in both Gauteng and KwaZulu-Natal provinces was impacted by the civil unrest during July 2021, the percentage of retail tenants in good standing declined only in the KwaZulu-Natal Province (Figure 29).

Figure 29: Rental in good standing by provinces mainly affected by July 2021 civil unrest



Blue shading: COVID-19 period – starts in March 2020

Source: TPN

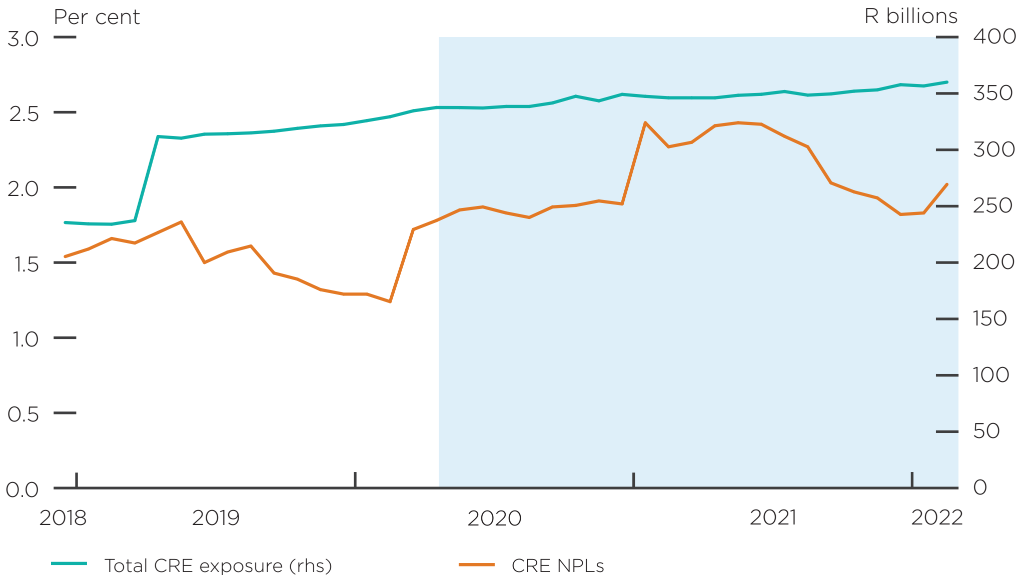
31 Tenants in good standing include tenants that have paid their rental obligations on time, within a grace period or have paid late.

32 Tenant Profile Network (TPN) credit bureau data include subsectors for industrial, office, retail and storage.

33 The COVID-19 period is referred to as the 16 months following the onset of the COVID-19 pandemic in March 2020. The pre-COVID-19 period is measured as the period from January 2019 to February 2020.

The banking sector is a significant lender to the CRE sector and the related CRE NPLs are low. Although the banking sector's credit exposure[34] to CRE has continued to increase following the onset of COVID-19 in March 2020, it remains a minor part of the banking sector's total lending (CRE comprised less than 6% of total banking sector credit exposure in December 2021, with less than 2% of this exposure to the high-risk property development category) (Figure 30). The peak NPL ratio reported in January 2021 during COVID-19 was almost double the NPL ratio reported in February 2020. The ratio has, however, trended downwards since then and the total CRE NPL ratio remains well below that of the average total sector NPL ratio during the COVID-19 period of 3.85%.

Figure 30: Banking sector credit exposure to CRE and related NPL ratio



Blue shaded area: period following the onset of the COVID-19 pandemic

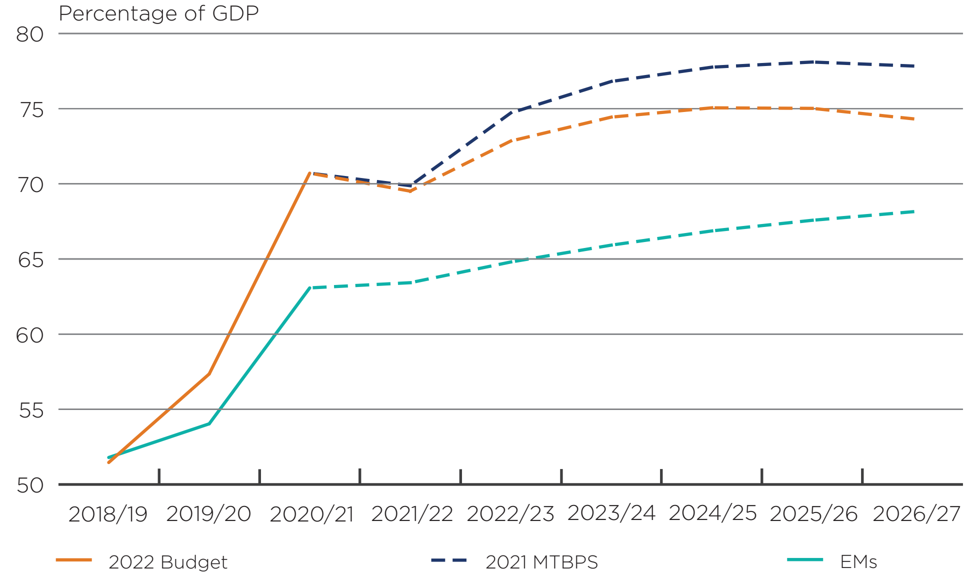
Source: PA

Government

Despite the improved outlook, the high level of South African government debt (Figure 31) and committed expenditure items still pose a risk to domestic debt sustainability. A slowdown in global economic growth and geopolitical tensions could negatively affect commodity prices and result in lower domestic tax revenue collections (Figure 32).

34 CRE exposures are on- and off-balance sheet credit exposures for high volatility and income-producing commercial real estate portfolios reported by banks that have approval to use the internal ratings-based (IRB) approach.

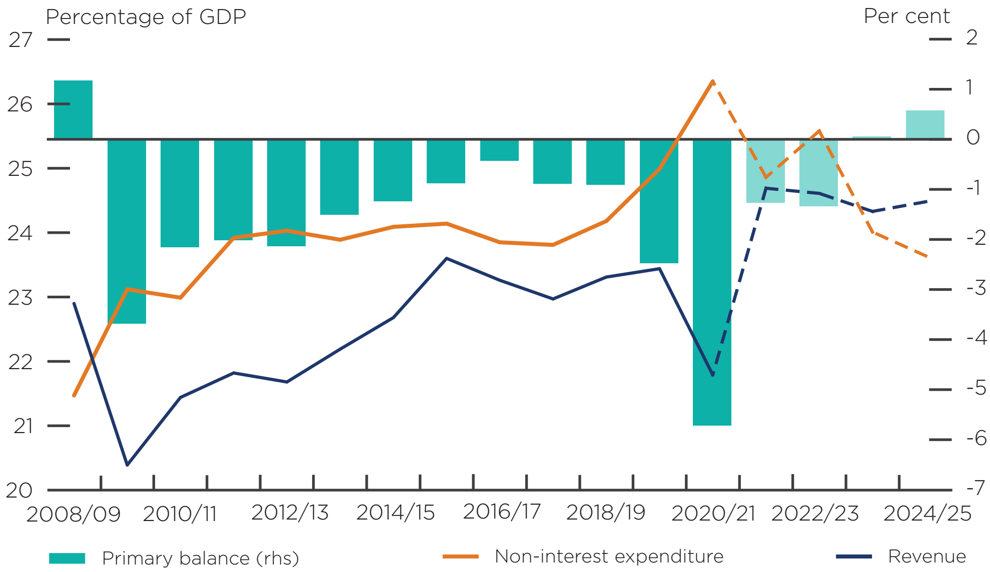
Figure 31: South African government debt outlook



Sources: IMF and National Treasury

The slow and inequitable recovery from the pandemic lockdowns puts pressure on government to continue its social spending. National government expenditure is expected to grow by 3.2% over the medium term, largely due to an expanded social spending which constitutes about 59.4% of non-interest expenditure. The *2022 Budget* provides for a 12-month extension of the R350 per month special COVID-19 social relief of distress grant. Social tensions may heighten from further widening of inequality caused by the pandemic.

Figure 32: Government revenue, expenditure and primary balance



Sources: National Treasury and SARB

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Abbreviations

ASISA	Association for Savings and Investment South Africa
AUM	assets under management
BIS	Bank for International Settlements
BoP	balance of payments
bps	basis point
CAR	capital adequacy ratio
CBR	correspondent banking relationship
CCyB	countercyclical capital buffer
CEO	Chief Executive Officer
CET1	common equity tier 1
CIS	collective investment scheme
CODI	Corporation for Deposit Insurance
COVID-19	coronavirus disease 2019
CRE	commercial real estate
DIF	Deposit Insurance Fund
DIS	deposit insurance scheme
EL	expected losses
EM	emerging market
EU	European Union
FATF	Financial Action Task Force
Flac	first loss after capital
FMIs	financial market infrastructures
FOMC	Federal Open Market Committee
FSB	Financial Stability Board
FSC	Financial Stability Committee
FSCA	Financial Sector Conduct Authority
FSOC	Financial Sector Oversight Committee
FSR	*Financial Stability Review*
FSR Act	Financial Sector Regulation Act 9 of 2017
FSLAA	Financial Sector Laws Amendment Act 23 of 2021
FX	foreign exchange
GDP	gross domestic product
GWP	gross written premium
G20	Group of Twenty
IADI	International Association of Deposit Insurers
ICR	interest coverage ratio
ICRG	International Co-operation Review Group
IFRS	International Financial Reporting Standard
IIF	Institute of International Finance
IMF	International Monetary Fund
JSE	JSE Limited
LCR	liquidity coverage ratio
LGD	loss given default
lhs	left-hand side
LTV	loan to value
ME	Mutual Evaluation
MCR	minimum capital requirement
MMF	money market fund
NCD	negotiable certificate of deposit
NCWOL	no-creditor-worse-off than in liquidation

NFC	non-financial corporate
NIIP	net international investment position
NPL	non-performing loan
NT	National Treasury
PA	Prudential Authority
PD	probability of default
RA	Resolution Authority
rhs	right-hand side
RVM	Risk and Vulnerability Matrix
SAGB	South African government bond
SAMOS	South African Multiple Options Settlement System
SARB	South African Reserve Bank
Sasria	South African Special Risk Insurance Association
SCR	solvency capital requirement
SIFI	systemically important financial institution
SMEs	small and medium enterprises
SOE	state-owned enterprise
Stats SA	Statistics South Africa
TPN	Tenant Profile Network
US	United States
WGBI	World Government Bond Index

Annexure A: South African financial stability heatmap elements and indicators

The financial stability heatmap is composed by (i) identifying various financial stability elements; and (ii) assigning a weighted colour rating to the identified elements by using predefined indicators. The elements comprising the financial stability heatmap and the corresponding financial stability indicators underlying the colours on the heatmap are presented in Table A.1 below.

Table A.1: South African financial stability heatmap elements and indicators

Heatmap element	Indicator(s)
Residential real estate market	• Annual growth rate of the Standard Bank House Price Index • Mortgage loans as a share of total loans
Commercial real estate market	• Commercial real estate loans divided by gross loans and advances
Global investor sentiment	• Chicago Board Options Volatility Index (VIX)
Banking sector	• Averages for the sector-wide value of assets to equity • Impaired advances to gross loans and advances • Liquidity coverage ratio (LCR) • Assets-to-GDP gap • Credit-to-GDP gap
Insurance sector	• Assets-to-GDP gap • Combined ratio, that is, underwriting profit calculated as net claims and expenses incurred, divided by net premiums written (non-life) • Growth in gross written premiums (life and non-life) • Individual lapse ratio (life) • Solvency capital requirement (SCR) (life and non-life)
Households	• Debt-service-cost-to-disposable-income ratio • Debt-to-disposable-income ratio • Debt-to-GDP ratio
Non-financial corporates	• Debt-to-GDP ratio • Debt-to-net-operating-profit ratio • Interest coverage ratio
Government	• Gross government debt-to-GDP ratio

Annexure B: Summary of the sections of Chapter 12A of the Financial Sector Laws Amendment Act 23 of 2021

The FSLAA has 63 clauses which, except for clause 51, are all relatively short. Clause 51 is an insertion of Chapter 12A into the Financial Sector Regulation Act 9 of 2017. Chapter 12A deals with the resolution objectives, powers and functions of the SARB, and makes provision for the Deposit Insurance Fund and the establishment of a Corporation for Deposit Insurance to administer the Fund. Chapter 12A contains eight parts, as indicated in Table B.1 below.

Table B.1: Summary of sections of Chapter 12A of the FSLAA

CHAPTER 12A	
Section	**Summary**
Part 1: General provisions with respect to designated institutions	
166A	**Exercise of Reserve Bank's powers** The section provides for the designation of the Reserve Bank as the resolution authority and confers on it the resolution functions in the Financial Sector Regulation Act. These functions are performed by the Governor of the Reserve Bank.
166B	**Reserve Bank's resolution objectives** The section sets out the objectives for the Reserve Bank when performing its resolution functions, which includes assisting in the maintenance of financial stability and protecting the interests of depositors by effecting the orderly resolution of designated institutions that are in resolution.
166C	**Reserve Bank's resolution functions** The section deals with performance of the resolution functions and stipulates that the Reserve Bank, when performing its resolution functions in relation to a designated institution: – must have regard to and seek to minimise any adverse impact on the interests of shareholders and creditors of the members in the group of companies of which the designated institution forms part; – must comply with applicable labour laws; and – may consider the possible impact that this action may have on a foreign jurisdiction.
166D	**Winding up and similar steps in respect of designated institutions** The section replaces the provisions contained in the repealed section 31 of the Financial Sector Regulation Act (see clause 45) and extends the ambit of the section to designated institutions. The concurrence of the Reserve Bank is required before a number of actions may be taken in respect of designated institutions. These actions include, but are not limited to, cancellation of a licence, winding up, appointing a curator, commencing business rescue operations, entering into an amalgamation or merger agreement, concluding a compromise arrangement with creditors, or any action by a financial sector regulator to reduce the value of an outstanding claim against the designated institution or to convert an instrument issued by the designated institution to another instrument.
166E	**Resolution planning** The section places a requirement on the Reserve Bank to develop resolution plans for designated institutions.
166F	**Bridge companies** The section provides for the creation of bridge companies that maybe used should a designated entity fail. The powers and duties of the Reserve Bank in the creation and management of these companies are specified.
166G	**Act of, and evidence of, insolvency** The section prevents the action of a designated institution entering resolution from being considered as an act of insolvency.

Table B.1: Summary of sections of Chapter 12A of the FSLAA (continued)

CHAPTER 12A	
Section	**Summary**
166H	**Liquidation** The section provides special provisions for the liquidation of a designated institution where there are no reasonable prospects that the institution will cease to be in resolution.
166I	**Delegation of Reserve Bank's resolution functions** The section deals with the delegation of some of the Reserve Bank's resolution functions provided for in Chapter 12A.
Part 2: Placing designated institutions in resolution	
166J	**Determination by Minister to place designated institution in resolution** The section sets out the process for placing a designated institution in resolution. The Minister will have the authority to place a designated institution in resolution upon receiving a recommendation from the Reserve Bank.
166K	**When designated institution ceases to be in resolution** The section deals with when a designated institution ceases to be in resolution.
166L	**Placing designated institution in resolution not termination or acceleration event** The section excludes the action of being placed in resolution from being considered a termination or acceleration event as may be provided for in agreements entered into with the designated institution.
166M	**Reserve Bank to manage and control affairs of designated institution** The section provides for the management and control by the Reserve Bank of a designated institution which has been placed in resolution by the Minister.
166N	**Reserve Bank not holding company** The section confirms that the Reserve Bank is not the holding company of the designated institution in resolution.
166O	**Resolution practitioners** The section allows for the appointment of a resolution practitioner by the Reserve Bank to assist with the execution of an orderly resolution.
166P	**Transfer of shares in designated institution in resolution** The section suspends the trading of a designated institution's shares while in resolution.
Part 3: Resolution measures	
166Q	**Valuation** The section requires the Reserve Bank to conduct a valuation of the assets and liabilities concerned before taking a resolution action, in order to establish, amongst other matters, the liquidation value and to allow for compliance with the safeguards provided in the Financial Sector Regulation Act.
166R	**Powers** The section provides for moratoria to suspend obligations of agreements entered into by the designated institution in resolution and for the cancellation of certain agreements for, amongst other reasons, reasons similar to those provided for in liquidation.
166S	**Resolution action, including restructuring and bail in** The section provides for the management and control by the Reserve Bank of a designated institution which has been placed in resolution by the Minister.
166T	**Outcome of resolution actions** The section confirms that the liabilities of a designated institution in resolution may be converted to a shareholding in a designated institution or a bridge company.
166U	**Creditor hierarchy and equality of claims** The section requires that resolution action must be taken in line with the creditor hierarchy as provided for in the proposed amendments to the Insolvency Act and that creditors of the same class must be treated equally.
166V	**'No creditor worse off' rule** The section creates the safeguard that resolution actions may not result in a creditor or shareholder bearing losses greater than they would have borne should the designated institution have been placed in liquidation.

Table B.1: Summary of sections of Chapter 12A of the FSLAA (continued)

CHAPTER 12A	
Section	**Summary**
166W	**Ranking of claims** The section specifies a ranking of claims against the designated institution in resolution.
166X	**Registration of transactions** The section places the obligation on relevant parties to record a transaction which results from an action taken by the Reserve Bank in terms of these proposed provisions.
166Y	**Costs of resolution** The section provides for resolution costs to be recovered by the Reserve Bank from a designated institution in resolution.
Part 4: Protections	
166Z	**Administrative process for actions taken by Reserve Bank in terms of Chapter** The section provides for the administrative process to be followed by the Reserve Bank when taking resolution actions.
Part 5: Banks in resolution	
166AA	**Corporation to ensure bank depositors have reasonable access to their covered deposits** The section deals with how the Corporation may apply the Deposit Insurance Fund to ensure that depositors of a bank may have reasonable access to their covered deposits.
166AB	**Limit of cover for covered deposits** The section deals with the limit of coverage for covered deposits.
166AC	**Payments made in error or as result of fraud** The section deals with the recovery of payments made in error or as a result of fraud.
166AD	**Corporation substituted for depositor in respect of claims** The section deals with the substitution of a covered depositor's claim against the designated institution in resolution in favour of the Corporation.
Part 6: Corporation for Deposit Insurance – establishment, function and governance	
166AE	**Establishment** The section provides for the establishment of the Corporation.
166AF	**Objective and functions** The section deals with the objective of the Corporation, and the functions of the Corporation in relation to the Deposit Insurance Fund (Fund).
166AG	**Membership** The section determines that all banks must be members of the Corporation.
166AH	**Governance of Corporation** The section places responsibility for efficient corporate governance on the Corporation.
166AI	**Board** The section provides for a board of directors (Board) to manage and control the affairs of the Corporation and specifies the composition of the Board.
166AJ	**Function of Board** The section deals with the functions of the Board, regarding general management and applying amounts from the Fund.
166AK	**Meetings of Board and decisions** The section provides for the different forms of meetings and decision-making by the Board.
166AL	**Appointment of Chief Executive Officer of Corporation** The section deals with the appointment, performance, responsibilities and functions of the Chief Executive Officer of the Corporation.
166AM	**Term of office of Chief Executive Officer of Corporation** The section deals with the term of office of the Chief Executive Officer of the Corporation and provides that the Chief Executive Officer is eligible for re-appointment for one further term at the end of the aforesaid term.

Table B.1: Summary of sections of Chapter 12A of the FSLAA (continued)

CHAPTER 12A	
Section	**Summary**
166AN	**Removal of Chief Executive Officer of Corporation** The section deals with the removal from office of the Chief Executive Officer of the Corporation in certain instances.
166AO	**Committees** The section provides for the establishment of committees by the Board to perform functions as determined by the Board.
166AP	**Duties of directors of Board and members of committees** The section provides for the duties of directors and members of committees.
166AQ	**Disclosure of interests** The section sets out the requirements regarding the disclosure of interest by directors, committee members and staff members of the Corporation.
166AR	**Share capital** The section deals with the share capital of the Corporation.
166AS	**Financial year of Corporation** The section sets the financial year end of the Corporation at 31 March.
166AT	**Surplus funds** The section provides for surplus funds of the Corporation to be credited to the Fund.
166AU	**Bookkeeping and auditing** The section sets out the auditing and bookkeeping requirements of the Corporation.
166AV	**Annual report** The section deals with the annual report of the Corporation, including submission to the Minister and tabling in Parliament.
166AW	**Winding up of Corporation** The section provides that the Corporation may only be wound up by an Act of Parliament.
166AX	**Staff and resources** The section provides for the staff and resources necessary for the effective functioning of the Corporation.
166AY	**Resources provided by Reserve Bank** The section provides that the Reserve Bank must provide necessary resources to the Corporation.
166AZ	**Duties of directors, committee members and staff members** The section sets limits on the behaviour of present or past directors, committee members and staff members of the Corporation.
166BA	**Cooperation and collaboration with financial sector regulators and Reserve Bank** The section creates a requirement for the Corporation, the Reserve Bank and the financial sector regulators to cooperate and collaborate in order to assist the Corporation in the exercise of its powers and the performance of its functions.
166BB	**Memoranda of understanding** The section provides for the Corporation to enter into memoranda of understanding with the Reserve Bank, a financial sector regulator or a similar body in a foreign jurisdiction.
166BC	**Deposit insurance levy** The section empowers the potential imposition of a deposit insurance levy to be paid by members to the Corporation in order to fund the operations of the Corporation and the administration of the Fund.
Part 7: Deposit Insurance Fund	
166BD	**Deposit Insurance Fund** The section provides for the establishment of the Fund and specifies the amounts to be credited to the Fund and how the Fund may be applied.
166BE	**Investment** The section sets out requirements for investments of the Fund.

Table B.1: Summary of sections of Chapter 12A of the FSLAA (continued)

CHAPTER 12A	
Section	**Summary**
166BF	**Information** The section provides that the Prudential Authority and Financial Sector Conduct Authority must provide the Corporation with information that is relevant to the performance of the Corporation's functions.
Part 8: Contributions to Fund	
166BG	**Deposit insurance premiums** The section provides for the collection of a deposit insurance premium to be paid by members as contributions to the Fund and also provides for exemptions from this premium in certain circumstances.
166BH	**Fund liquidity** The section would require member institutions that hold covered deposits to maintain a minimum amount in the account of the Fund as specified by the Corporation in a standard. The Corporation would pay interest on those amounts in the Fund, as specified in the standard, to the member institutions.

Annexure C: Banking and insurance sector indicators

Banking sector indicators

	2018	2019	2020	2021	January 2022
Market share in terms of assets (five largest banks)	90.24	90.37	89.99	89.84	89.53
Gini concentration index	83.40	83.21	83.11	82.68	82.51
Herfindahl-Hirschman Index (H-index)	0.18	0.18	0.18	0.18	0.18
Banks' share prices (year-on-year percentage change)	22.18	-1.82	-36.17	55.10	125.72
Total assets (R billions)	5 311.43	5 769.31	6 457.27	6 562.62	6 629.30
- Year-on-year percentage change	6.09	8.63	11.93	1.74	1.40
Total loans and advances (R billions)	3 944.68	4 249.48	4 542.46	4 643.10	4 755.88
- Year-on-year percentage change	4.05	7.75	6.90	2.24	4.03
Total capital adequacy ratio	16.39	16.53	16.21	17.49	18.07
Tier 1 capital adequacy ratio	13.32	13.45	13.14	14.47	15.22
Common equity tier 1 capital adequacy ratio	12.79	12.69	12.33	13.30	13.89
Impaired advances (R billions)*	137.05	161.72	211.91	229.24	212.66
Impaired advances to gross loans and advances	3.47	3.81	4.66	4.94	4.47
Specific credit impairments (R billions)	60.75	73.58	92.25	105.45	104.86
Specific credit impairments to impaired advances	44.27	45.51	43.56	46.07	49.31
Specific credit impairments to gross loans and advances	1.54	1.73	2.03	2.27	2.20
Return on assets (smoothed)	1.31	1.24	0.79	0.81	1.10
Return on equity (smoothed)	15.84	15.31	10.22	10.62	13.89
Interest margin to gross income (smoothed)	56.74	56.80	58.17	58.65	58.43
Operating expenses to gross income (smoothed)	57.19	58.22	58.26	58.73	58.27
Liquid assets to total assets (liquid asset ratio)	10.23	11.05	12.18	13.33	13.86
Liquid assets to short-term liabilities	20.49	22.43	24.05	24.10	24.87
Liquidity coverage ratio	125.13	146.92	142.21	144.09	144.84

* All data are averaged for the year shown and reported in percentages, unless stated otherwise. Data were updated on 7 March 2022.

** Impaired advances are advances in respect of which a bank has raised a specific impairment, and include any advance or restructured credit exposure subject to amended terms, conditions and/or concessions that are not formalised in writing.

*** 2022 Data only include one period (January 2022)

Source: SARB

Table C.2: Insurance sector indicators

	2016	2017	2018	2019	2020	2021
Market share in terms of assets (five largest life insurers)	74	73	73	74	73	72
Market share in terms of GWPs (five largest non-life insurers)	48	47	46	48	47	47
Balance sheet						
Total assets: life insurers (R billions)	2 671 813	2 928 973	3 011 459	3 143 872	3 254 815	3 724 365
Total assets: non-life insurers (R billions)	149 371	160 976	196 726	206 831	239 132	255 345
Total liabilities: life insurers (R billions)	2 514 463	2 769 335	2 638 347	2 760 773	2 909 562	3 359 563
Total liabilities: non-life insurers (R billions)	91 349	98 152	114 828	117 377	141 422	178 488
Profitability						
GWPs: life insurers (R billions)	498 688	485 507	529 741	551 175	564 327	620 821
Net profit before tax and dividends: life insurers (R billions)*			45 067	45 373	11 766	48 731
Individual lapse ratio: life insurers	56	63	61	91.1	66	77
GWPs: non-life insurers (R billions)	127 036	136 774	144 265	159 548	158 632	169 846
Combined ratio: non-life insurers	87	77	97	97	113	119
Operating profit ratio: non-life insurers	21	22	15	23	16	-10.8
Solvency and capital*						
Solvency capital requirement cover ratio (median): life insurers			1.9	2.0	1.9	1.7
Minimum capital requirement cover ratio (median): life insurers			4.3	4.2	4.4	4.2
Solvency capital requirement cover ratio (median): non-life insurers			1.8	1.8	1.8	1.8
Minimum capital requirement cover ratio (median): non-life insurers			3.9	4.0	4.2	3.8

* These returns are only available from 2018 due to changes in reporting requirements.

Source: SARB