FINANCIAL STABILITY REVIEW

Second edition
2024

SOUTH AFRICAN RESERVE BANK

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Background to the *Financial Stability Review*

The primary mandate of the South African Reserve Bank (SARB), as stated in the Constitution of the Republic of South Africa, is to achieve and maintain price stability in the interest of balanced and sustainable economic growth in South Africa. The Financial Sector Regulation Act 9 of 2017 (FSR Act) assigns a statutory mandate to the SARB to protect and enhance financial stability in South Africa.

The SARB follows a structured framework designed to gather information and monitor developments, assess financial stability, and communicate its assessment through the *Financial Stability Review (FSR)*. Among other things, the FSR Act requires the SARB to (i) 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 (ii) 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 in order to mitigate those risks.

The FSR Act also 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 *FSR*. The *FSR* provides readers with the SARB's assessment of the stability of the South African financial system. The SARB assesses financial stability as part of its ongoing operations and its Financial Stability Committee (FSC) reviews the financial stability outlook and assessment at four meetings per year. The period under review for this edition of the *FSR* is the six months from June to November 2024, while the forecast period is until November 2025.

The *FSR* is tabled in Parliament and is targeted at the Members of Parliament, participants in the financial sector, international central bank peers, ratings agencies, international financial institutions, standard-setting bodies and academia. The *FSR* aims to stimulate debate on pertinent issues related to financial stability in South Africa.

Executive summary

The South African financial system has demonstrated notable resilience over the past several years, despite various global and idiosyncratic shocks. Following the start of the COVID-19 pandemic in 2020, several other global shocks materialised, such as Russia's invasion of Ukraine, disruptions to supply chains and transportation routes, sharp increases in inflation and interest rates and, more recently, escalating conflicts in the Middle East.

Domestic developments have further tested the resilience of the South African financial system in recent years. These include South Africa's sovereign credit rating downgrade, the subsequent exclusion from the World Government Bond Index (WGBI), greylisting by the Financial Action Task Force (FATF), unprecedented levels of load-shedding, extreme weather events such as floods, and violent incidents of social unrest.

Since the release of the June 2024 *FSR*, however, the outlook for financial stability has improved. This is largely attributable to an orderly election and the formation of the Government of National Unity (GNU), which contributed notably to stabilising the political landscape. Other factors, such as an improvement in the availability and supply of electricity, evidence of fiscal consolidation and an improved sovereign credit rating outlook, also supported positive investor sentiment towards South Africa.

Despite the improved financial stability outlook, a number of key risks to domestic financial stability remain. These include the risk of:

1. escalating global conflicts;
2. deteriorating public sector debt ratios;
3. rapid capital outflows amid declining financial market depth;
4. increased financial distress in households and small, medium and micro enterprises (SMMEs);
5. critical infrastructure failure; and
6. remaining on the FATF greylist over the medium term.

These risks are assessed against the backdrop of perpetual or structural risks, such as South Africa's low and inequitable economic growth, the implications of climate change for the financial sector and the ever-present vulnerabilities associated with cyber incidents with systemic impact.

This edition of the *FSR* also includes a summary of the impact studies the SARB conducted on the potential economic impact of implementing a 1% positive cycle-neutral (PCN) countercyclical capital buffer (CCyB). The results confirm that the introduction of a 1% PCN CCyB would have a marginal and temporary impact on

lending supply and broader macroeconomic activity, and underscore the longer-term financial stability benefits of such a countercyclical policy tool.

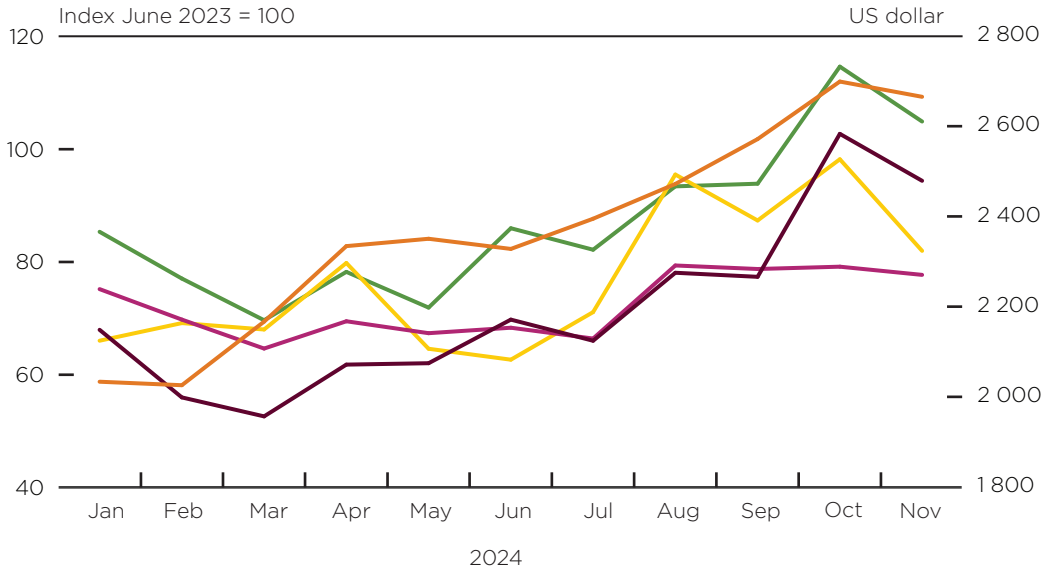
The changing composition of high-quality liquid assets (HQLA) in South Africa and an assessment of vulnerabilities in the South African commercial real estate sector are also topical focus areas covered in this edition of the *FSR*.

Financial stability developments and outlook

Global developments and risks

Since the release of the June 2024 *FSR*, selected measures of volatility have increased (Figure 1). The elevated level of global uncertainty has seen gold – the historical safe-haven asset – benefit significantly. The gold price increased from around US$2 000 per ounce at the start of 2024 to almost US$2 700 per ounce at the end of October 2024 – an increase of 35%. However, volatility reduced following the conclusion of the United States (US) elections as uncertainty over the outcome ended.

Figure 1: Selected volatility measures



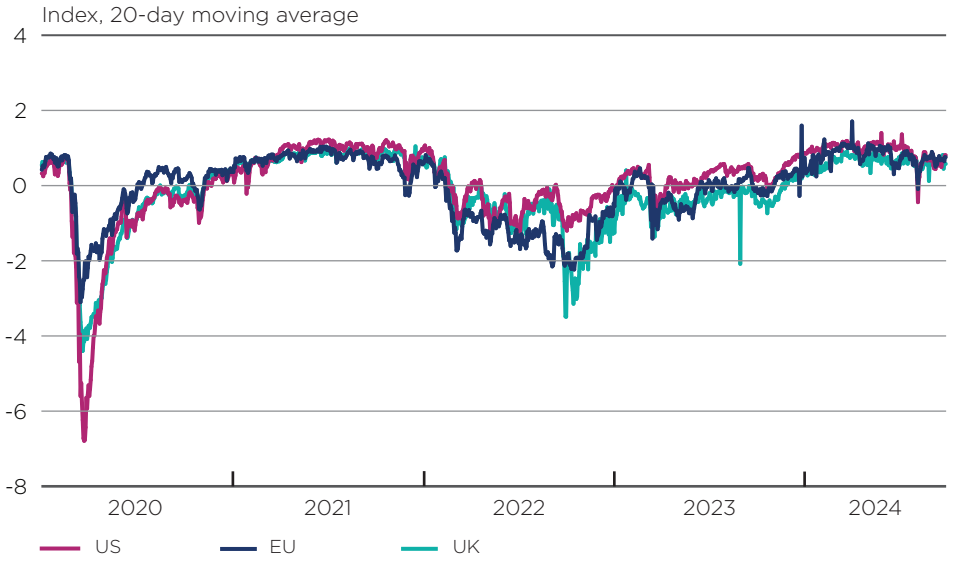
Source: Bloomberg

Recent episodes of heightened volatility, such as the one observed in early August 2024,[1] demonstrated that markets have become increasingly sensitive to economic news, especially where valuations are high. In addition, markets across jurisdictions have become increasingly correlated when reacting to negative news as demonstrated by the August 2024 market turbulence.

Financial conditions in selected advanced economies have eased somewhat since the release of the previous edition of the *FSR* (Figure 2), largely supported by policy rate cuts and expectations of further cuts in 2025 (Figure 3).

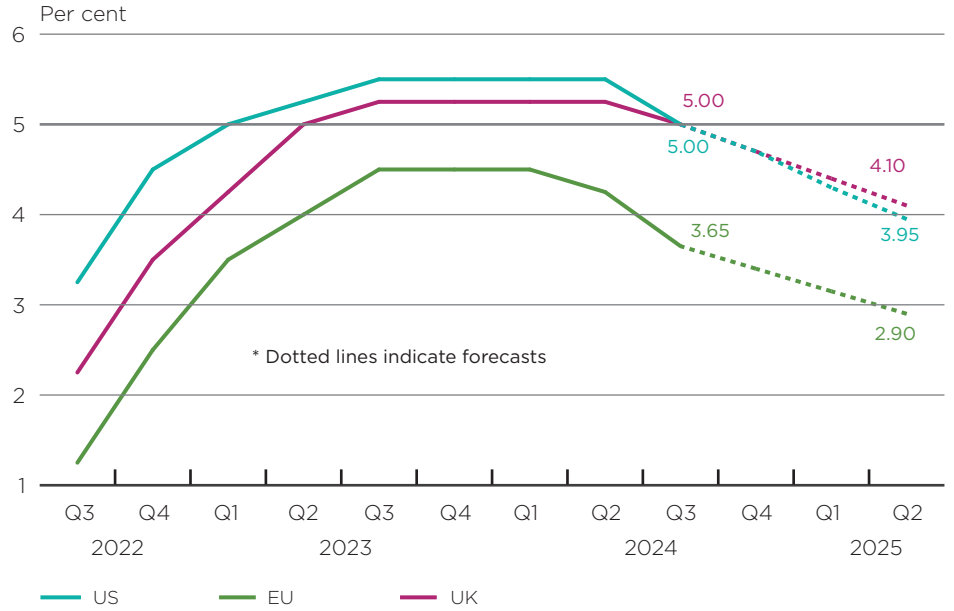
1 Disappointing US labour market data released on 2 August 2024 reignited investor concerns over a US recession. Japanese markets subsequently bore the brunt of the fallout, with the Tokyo Stock Price Index declining by 12% on 5 August 2024. For a more detailed discussion, see the Bank for International Settlements' note on the topic: https://www.bis.org/publ/bisbull90.htm.

Figure 2: Financial conditions in selected advanced economies



Source: Bloomberg

Figure 3: Policy rate expectations in selected advanced economies*



Source: Bloomberg

One of the key global financial stability risks highlighted by the International Monetary Fund (IMF) in its latest *Global Financial Stability Report* is rapidly rising sovereign debt levels.[2] The IMF's latest *Fiscal Monitor* predicts that global public debt will exceed US$100 trillion – or 94% of global gross domestic product (GDP) – in 2024 and increase to around 100% of GDP by 2030.[3] The IMF anticipates that public debt will either stabilise or decline in approximately two-thirds of countries. Concerningly, countries where debt is not projected to stabilise account for around two-thirds of global GDP and more than half of global debt.

2 See the IMF's *Global Financial Stability Report*, October 2024. https://www.imf.org/en/Publications/GFSR/Issues/2024/10/22/global-financial-stability-report-october-2024.

3 See the IMF's *Fiscal Monitor*, October 2024. https://www.imf.org/en/Publications/FM/Issues/2024/10/23/fiscal-monitor-october-2024.

Other developments that weigh on the global financial stability outlook include escalating geopolitical tensions and conflicts, high levels of private debt and concerns about the ability of households and businesses to service their debt. Fragilities in commercial real estate markets remain, while the economic slowdown in China continues to be closely monitored after the announcement of several government stimulus measures.

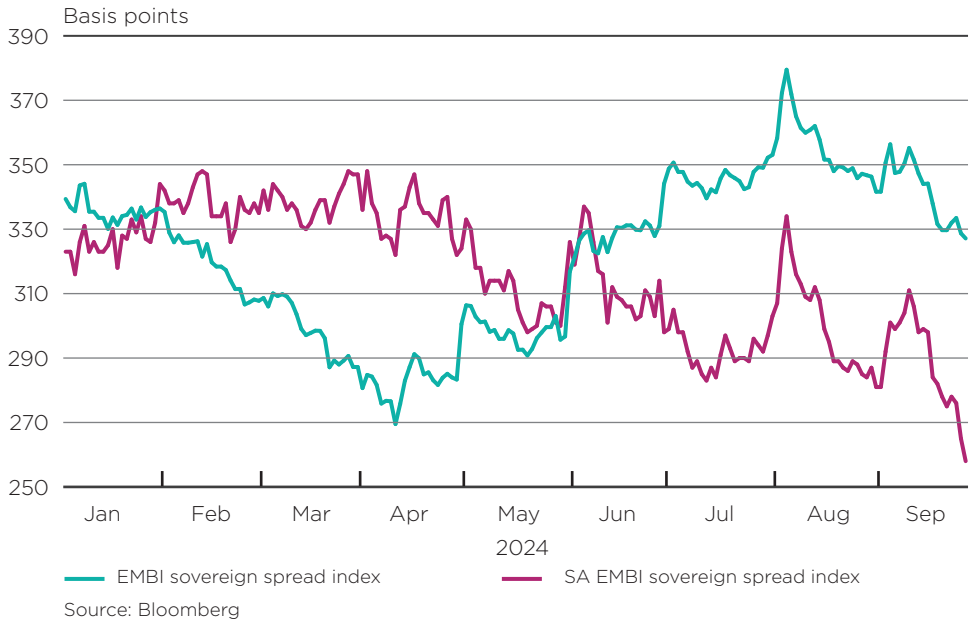
Domestic developments

In addition to the above-mentioned global risks and vulnerabilities, South Africa has faced various idiosyncratic domestic risks and challenges in recent years. These include the country's sovereign credit rating downgrade to sub-investment grade, the resultant exclusion from the WGBI, greylisting by the FATF, unprecedented levels of load-shedding, natural disasters such as floods and violent incidents of social unrest.

Since the release of the June 2024 *FSR*, which broadly coincided with South Africa's general elections and the formation of the coalition government, investor sentiment towards South Africa has improved. This was supported by other factors such as improved availability and supply of electricity, an improved sovereign credit rating outlook and demonstrable efforts in pursuit of fiscal consolidation.

Government debt increased marginally from 74.1% of GDP in the first quarter of 2024 to 74.6% of GDP in the second quarter. The Gold and Foreign Exchange Contingency Reserve Account (GFECRA) distribution should reduce government's funding needs and support fiscal consolidation in the near term. Against this backdrop, South Africa's country risk – as measured by the sovereign bond spread – improved to its lowest level of 2024, some 69 basis points lower than its peers as at the end of September (Figure 4).

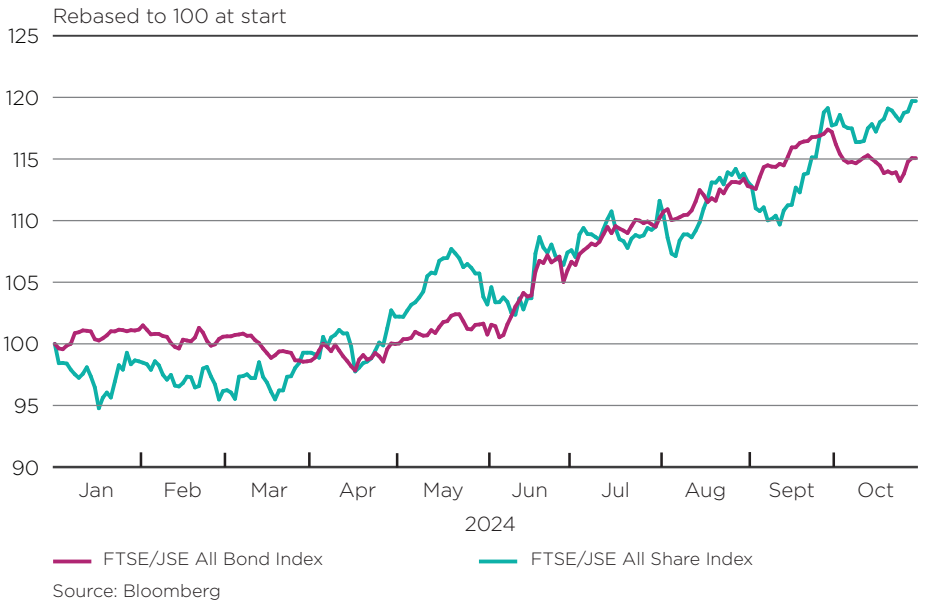
Figure 4: South African versus emerging market sovereign bond spreads in 2024



Source: Bloomberg

As a result of the improved investor sentiment following the formation of the GNU, South African financial assets have performed well in the second half of 2024 (Figure 5), reversing some of the underperformance observed in previous periods.

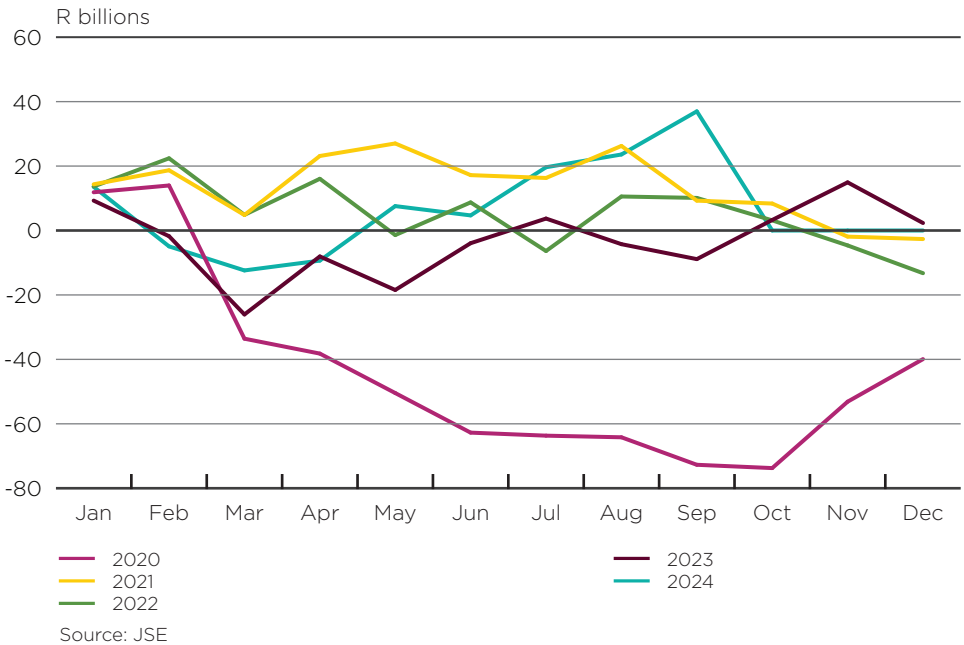
Figure 5: FTSE/JSE All Share versus FTSE/JSE All Bond total return indices



Source: Bloomberg

Non-residents have been net buyers of South African government bonds (SAGBs) since May this year (Figure 6). This is a notable reversal of the trend in 2022 and 2023.

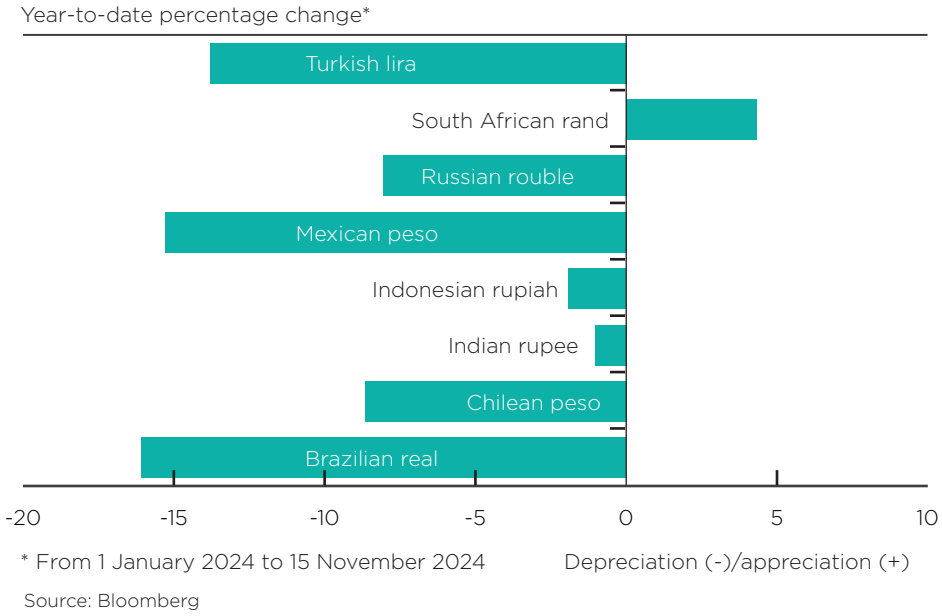
Figure 6: Non-resident SAGB inflows



Source: JSE

Since the beginning of 2024, several emerging market (EM) currencies have depreciated against the US dollar (Figure 7). However, the rand strengthened by almost 6% against the US dollar in the year to October 2024 as investor sentiment towards South Africa improved. Despite weakening in the aftermath of the US elections, the rand has still strengthened by 4.3% against the US dollar in the year to date.

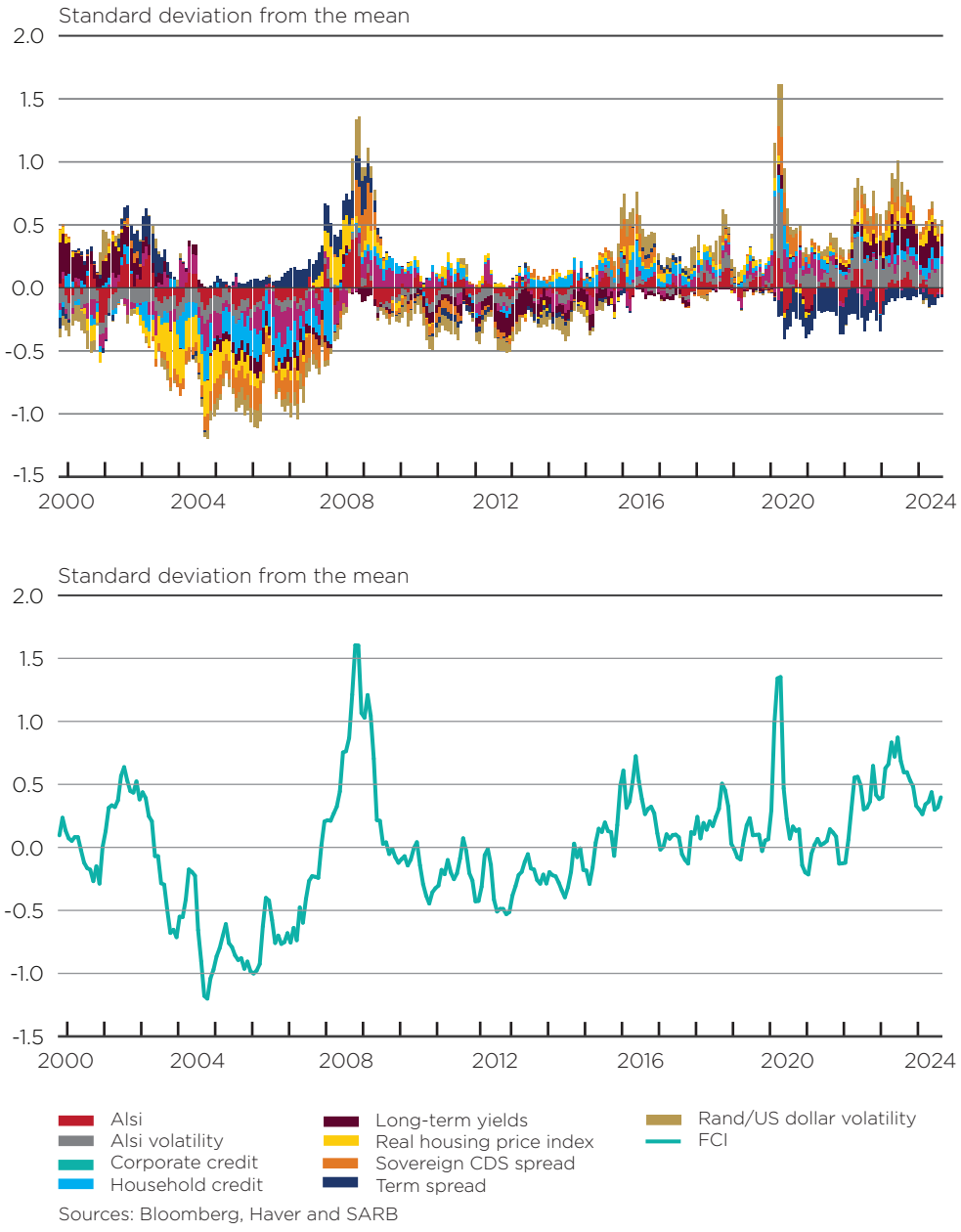
Figure 7: Performance of selected EM currencies against the US dollar in 2024



Source: Bloomberg

The SARB compiles a financial conditions index (FCI), which gives an overall view of the ease with which firms, households and government can access finance. The FCI – summarised in Box 1 – shows that domestic financial conditions remain relatively tight (Figure 8). Volatility in the equity market subsided somewhat at the start of 2024 but resumed in the build-up to South Africa's 29 May general elections and has remained high since. Other factors that contributed to tight financial conditions are a decline in household credit, elevated long-term government bond yields and high exchange rate volatility. Real property prices have continued to fall, declining by 4.4% year on year in the second quarter of 2024. However, since South Africa's elections, financial conditions have shown signs of easing, in part due to higher equity prices and an uptick in investor sentiment. Real disposable income growth, debt-service costs and the debt-to-disposable-income ratio for the household sector improved marginally in the second quarter of 2024.

Figure 8: SARB FCI composition (top) and index (bottom)



Sources: Bloomberg, Haver and SARB

Box 1: The SARB FCI for South Africa[1]

Financial conditions can be broadly defined as the ease with which firms, households and government can access finance. When financial conditions are tighter, it is more difficult to access finance, while looser financial conditions mean easier access to finance. The main purpose of the SARB FCI is to assess and summarise prevailing financial conditions within the domestic financial system.

There are several methods to construct FCIs, but the process entails identifying the objectives to be achieved through the FCI, selecting the variables required and calculating the weights associated with the variables to form the index. The SARB previously utilised a more complex method to construct the FCI, comprising more than 30 variables with time-varying weights assigned to them. This made it more challenging to communicate the drivers behind changes in financial conditions, as well as changes in the FCI, which sometimes appeared counterintuitive. The revised SARB FCI reflects a simpler and more intuitive FCI.

FCIs typically use variables that provide insights into interest rates, asset prices, credit extension and external conditions. The SARB FCI employs the nine key variables listed in Table B1.1, all of which are available at a monthly frequency from the year 2000. Each variable contributes equally to the FCI, thereby ensuring a balanced representation across different financial indicators. Despite the uniform weighting, specific signs[2] are assigned to the variables as they enter the system as shown in Table B1.1.

Table B1.1: Variables and signs for the SARB FCI

Variable	Sign
10-year government bond yield	+
Sovereign credit default swap spread	+
Term spread	+
Rand/US dollar exchange rate volatility	+
Equity volatility	+
Equity prices, month-on-month (m-o-m) growth rate	-
Real household price index, m-o-m growth rate	-
Credit to households, m-o-m growth rate	-
Credit to corporates, m-o-m growth rate	-

This approach provides a simplified, yet effective, means of interpreting shifts in financial conditions, where every variable holds equivalent influence in the overall assessment.

1 The revised SARB FCI is supported by a research paper on the underlying methodology, which is available at https://www.resbank.co.za/en/home/what-we-do/financial-stability.

2 A positive sign reflects a tightening of financial conditions and vice versa.

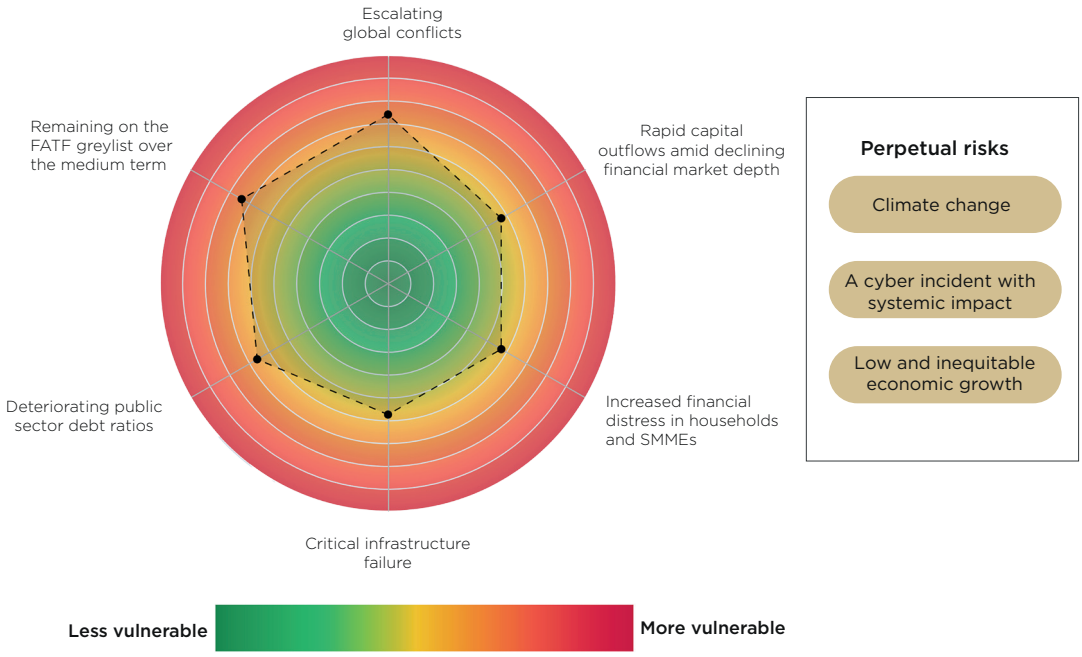
Key financial stability risks and assessment

In this edition of the *FSR*, the following key risks to domestic financial stability are included in the SARB's Residual Vulnerability Matrix (RVM):[4]

1. escalating global conflicts;
2. deteriorating public sector debt ratios;
3. rapid capital outflows amid declining financial market depth;
4. increased financial distress in households and SMMEs;
5. critical infrastructure failure; and
6. remaining on the FATF greylist over the medium term.

The perpetual risks to financial stability include (i) persistently low and inequitable domestic economic growth; (ii) the impact of climate change on the financial sector; and (iii) the ever-present threat of a cyber incident with systemic impact. These risks are reflected on the SARB's RVM, which reflects the SARB's assessment of the residual vulnerability of the South African financial system to the identified risks. The closer to the outer edge of the circle, the higher the residual vulnerability and vice versa. Each of these key risks is discussed below.

Figure 9: SARB RVM



Escalating global conflicts

As a small, open economy, South Africa remains vulnerable to the broader effects of geopolitical shocks. Escalating conflicts, such as those in the Middle East and between Russia and Ukraine, and the geopolitical tensions that build up between economic blocs, threaten financial stability through two main channels.

4 This edition of the *FSR* introduces a revised RVM that shows the residual vulnerability of the financial system to key financial stability risks. Residual vulnerability takes into account both the probability of a risk materialising within the forecast period (i.e. the next 12 months), and the effect of mitigating (or amplifying) factors that reduce (or increase) the financial system's vulnerability to these risks. The revised RVM aligns the SARB's financial stability monitoring and assessment framework with the approach of the Financial Stability Board, which focuses on the vulnerabilities and resilience of the global financial system, after considering mitigating factors and actions.

First, they contribute to heightened financial market volatility and uncertainty, which commonly shift investor sentiment away from riskier financial assets and lead to a flight to safe-haven assets. This generally means that EMs in particular could see large capital outflows and currency depreciation triggered by unexpected exogenous factors over which they have little or no control.

Second, the conflict in the Middle East has disrupted shipping supply channels, delaying the transportation of goods as alternative routes have had to be used at higher costs. Combined with associated higher oil and commodity prices, these costs could reignite upward inflationary pressures, which could slow – or even reverse – the decline in global interest rates. As a net importer of oil, and coupled with possible currency depreciation in EMs that would likely accompany rising global conflicts, South Africa could experience sharp increases in transportation and production costs. This, in turn, could contribute to higher inflation, which would require an appropriate monetary policy response.

The IMF has warned that escalating global conflicts are eroding the benefits of the global integration that occurred in recent decades.[5] The surge in the number of trade restrictions that were introduced after the global financial crisis (GFC), the COVID-19 pandemic, the Russia–Ukraine war and the conflict in the Middle East have exacerbated divisions between trading blocs. From a financial stability perspective, growing preferences for 'friendshoring' or 'nearshoring' may reduce access to a more diverse range of markets, in turn potentially also increasing the cost and availability of funding, hedging and diversification options. This could contribute to financial markets globally becoming shallower and less liquid, which could amplify the impact of a shock.

An increase in geopolitical conflicts generally leads to a higher number of cyberattacks globally, particularly against the countries involved.[6] Such attacks may extend to countries not directly involved in conflicts, but which may be seen as being aligned with or sympathetic to a particular country or group involved in a conflict.

Deteriorating public sector debt ratios

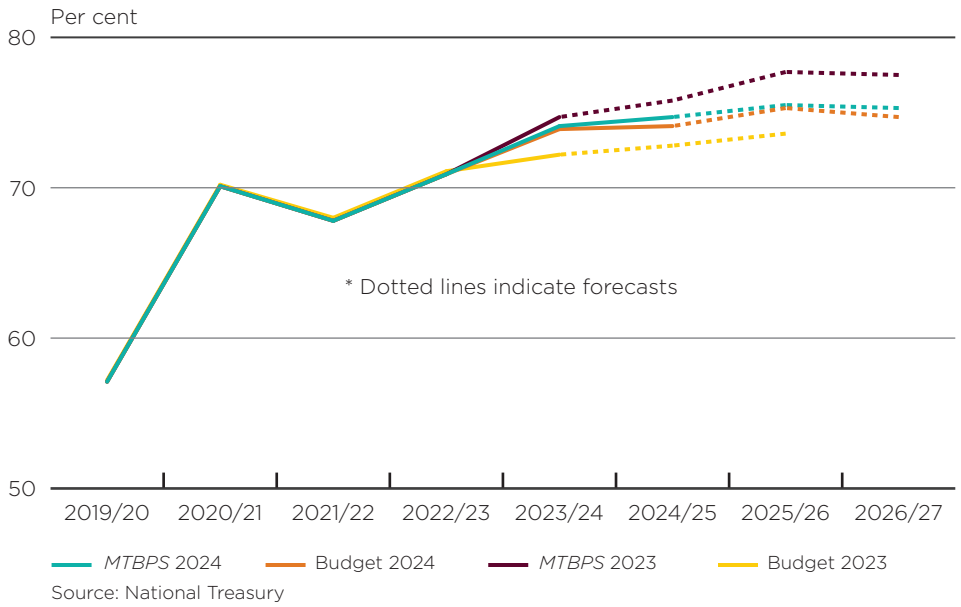
Since the release of the June 2024 *FSR*, the fiscal outlook has improved somewhat. An improved domestic growth outlook, combined with the transfer of GFECRA balances of R100 billion from the SARB to National Treasury in the current fiscal year, has reduced government's funding needs and supported an improved fiscal outlook. After persistently recording primary deficits between 2009 and 2023, South Africa recorded its first primary surplus in the 2023/24 fiscal year. Primary surpluses are also expected for the next three fiscal years.

A general improvement in market sentiment toward South African sovereign debt after the formation of the GNU helped to suppress borrowing costs. The implementation of the two-pot retirement system in September 2024 should also support fiscal revenues. Government debt as a share of GDP is projected to peak at 75.5% in the 2026/27 fiscal year, marginally higher and a year later than the projected peak of 75.3% in the 2025/26 fiscal year announced in the 2024 *Budget Review* (Figure 10). Debt-service costs are also expected to stabilise at a modestly higher level than previously projected (Figure 11).

5 See the IMF's *Global Financial Stability Report*, October 2024. https://www.imf.org/en/Publications/GFSR/Issues/2024/10/22/global-financial-stability-report-october-2024.

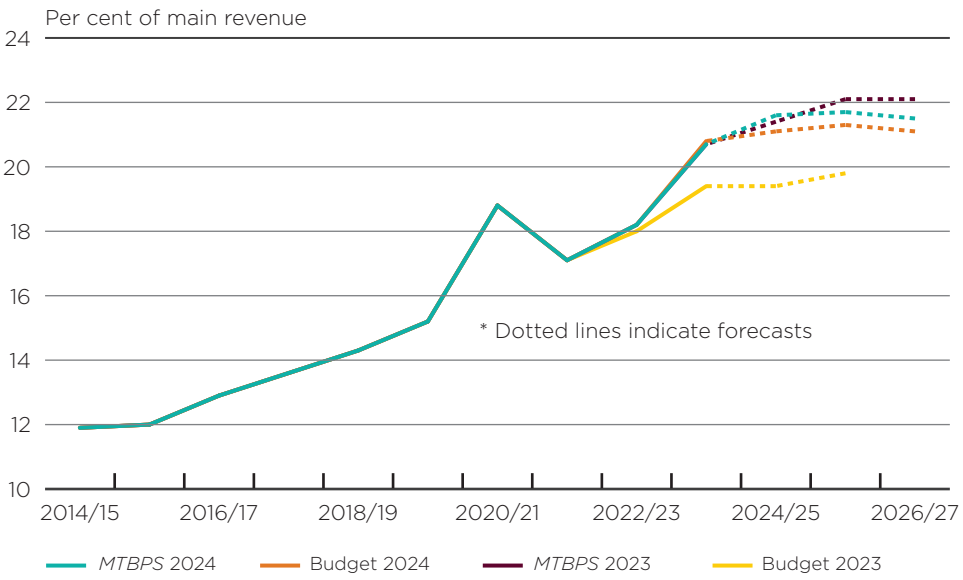
6 See Chapter 3 of the IMF's *Global Financial Stability Report*, April 2024. https://www.imf.org/en/Publications/GFSR/Issues/2024/04/16/global-financial-stability-report-april-2024.

Figure 10: Government debt-to-GDP ratio*



Source: National Treasury

Figure 11: Government debt-service costs*



Source: National Treasury

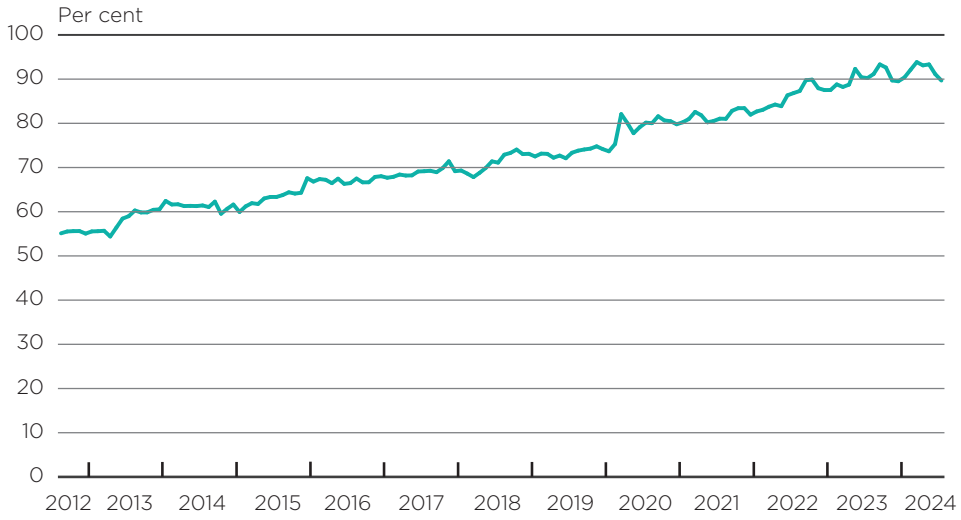
Several risks, however, remain to the fiscal outlook. Despite the GFECRA transfers and the boost to fiscal revenue from the introduction of the two-pot pension system, the fiscal position remains vulnerable to shocks. Consistent with recent years, the 2024 *Medium Term Budget Policy Statement (MTBPS)* included an upward revision to the main budget deficit over the forecast horizon due to revenue underperformance, increased expenditure and higher debt-service costs. Debt-service costs increased relative to the 2024 *Budget Review* projections, despite the notable decrease in sovereign borrowing costs this year. These developments suggest that debt sustainability will remain a challenge going forward.[7]

7 See page 27 of the *MTBPS*, 30 October 2024, https://www.treasury.gov.za/documents/mtbps/2024/mtbps/FullMTBPS.pdf for a full list of risks to the fiscal outlook.

The increase in non-interest expenditure may be attributed to above-inflation increases in public sector wages, disaster relief and expenditure on state-owned enterprise (SOE) obligations. All three of these factors are likely to constrain the fiscal outlook over the medium term. Indeed, several SOEs have in recent years required bail-outs, or had been supported by explicit or implicit government guarantees for their debt. Moreover, there are increasing demands on the fiscus to address the deteriorating critical infrastructure in South Africa, exacerbated by the weak financial positions of large SOEs such as Transnet and Eskom.

The South African financial system's exposure to government debt has increased further since the release of the June 2024 *FSR*, as government bond issuance has remained elevated relative to its historical average.[8] SAGBs continued to dominate the local bond market, peaking at almost 94% of all listed bonds at the end of March 2024 in the build-up to the general elections before moderating to 89.7% at the end of July (Figure 12).

Figure 12: SAGBs as share of total domestic listed bonds



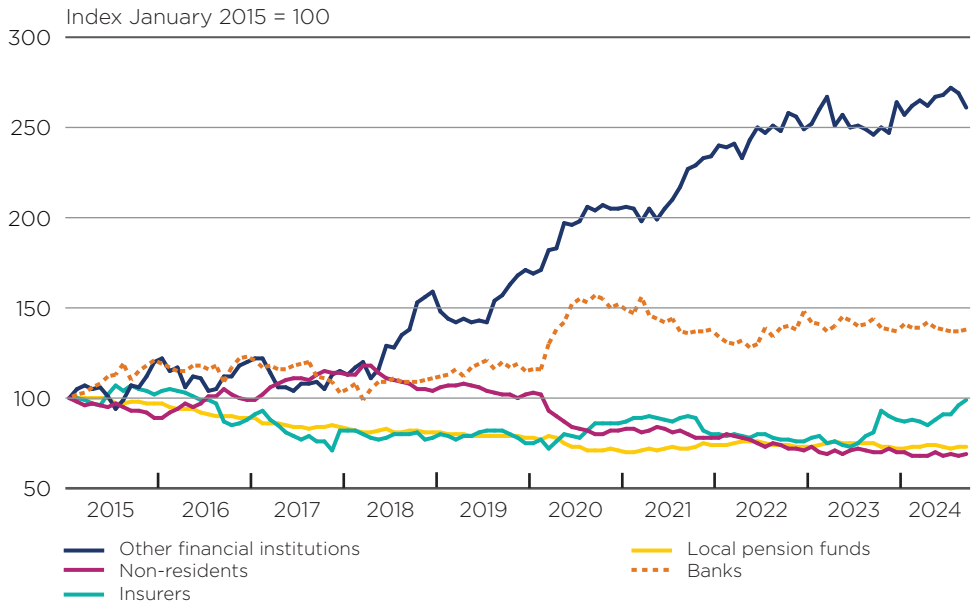
Source: SARB

There has been a modest increase in non-resident investor demand for SAGBs since the release of the June 2024 *FSR*. However, because of sustained SAGB issuance, non-resident investors' share of SAGB holdings has not increased and the domestic financial sector continued to absorb most of the new bond issuance (Figure 13). Faced with limited investment opportunities amid weak economic growth and a shrinking equity market due to net JSE Limited (JSE) delistings in recent years, the asset management industry has absorbed the largest proportion of new government debt issuance since 2020. The exposure of banks to government debt decreased to 20% at the end of August 2024, down from 20.7% in April.

South Africa's structural challenge of low economic growth, high unemployment and high interest rates have reduced the overall creditworthiness of borrowers and made banks more sensitive to credit risk. The reduced creditworthiness of borrowers has constrained private sector credit extension by banks, incentivising banks to rather invest in government debt with high yields. Although this trend seems to have been arrested, banks' holdings of SAGBs remains well above pre-pandemic levels (Figure 13).

8 The growing collective exposure of the South African financial system to a single issuer (i.e. the government) is referred to as the sovereign-financial sector nexus. The associated financial stability implications have been covered extensively in recent editions of the *FSR*.

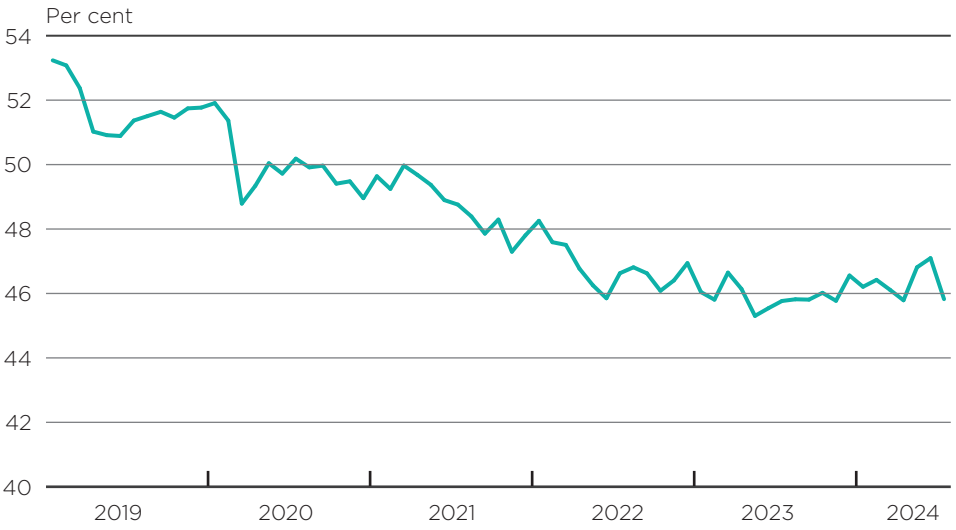
Figure 13: Holdings of SAGBs



Source: National Treasury

Banks' investment in government debt is further driven by the zero-risk weighting applied to bonds under the standardised approach to credit risk, which is mostly followed by non-systemic banks. A low- or zero-risk weighting means that banks hold little or no regulatory capital against these assets, which may have contributed to the decline in banks' risk-weighted assets over the past few years (Figure 14).

Figure 14: Banks' risk-weighted assets as a percentage of total assets



Source: SARB

As government borrowing is projected to remain elevated, the risk of further increases in the financial sector's exposure to the sovereign is high. However, there are also potential mitigating factors that could help to shift domestic savings to the private sector rather than to government. Should the recent improvement in foreign investor sentiment towards South Africa prevail, the reliance on the domestic financial system to fund the fiscal deficit may reduce. Also, a reduction in credit risk as interest rates decline and the growth outlook improves may incentivise banks to increase credit extension to the private sector instead of buying government bonds. The improvement in the growth outlook may also result in more investment opportunities for non-banks.

Increased financial distress in households and SMMEs

During the lockdown imposed in response to the COVID-19 pandemic, households' gross savings as a share of GDP increased significantly. At the same time, regulatory relief provided by the Prudential Authority (PA) to the banking sector at the onset of COVID-19 in 2020 allowed banks to restructure a significant amount of loans.[9] As COVID-19-related restrictions eased and the economy started to open up, corporates and households had some savings to fall back on to help finance their consumption. These savings buffers also shielded them from the initial effects of rising interest rates.

As borrowers' ability to repay credit improved, the regulatory relief was withdrawn in October 2021.[10] While the current volume of restructured loans does not pose an immediate threat to financial stability, an increasing dependence on restructuring could conceal underlying credit weaknesses and introduce systemic risks if not managed properly.

Following the onset of interest rate increases in November 2021, borrowers started showing signs of financial stress towards mid-2022, with an increasing proportion of borrowers encountering difficulties in meeting their loan obligations. Non-performing loans (NPLs),[11] an indicator of credit risk, are recognised as one of the primary factors that historically contributed to bank failures and subsequent banking crises. From March 2023 to July 2024, NPLs rose significantly from R257 billion to R304 billion, with the NPL ratio[12] increasing from 4.7% to 5.7% (Figure 15).

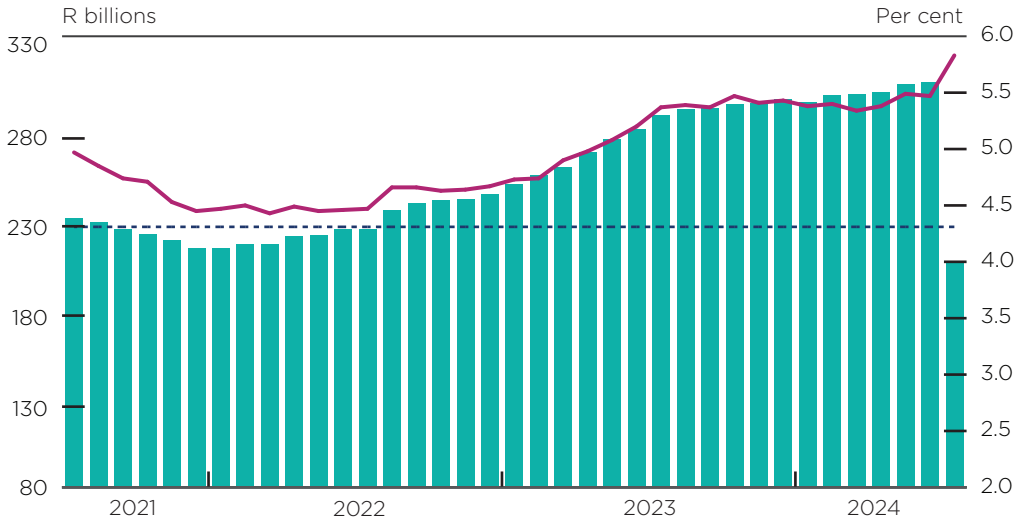
9 To manage risk effectively, many banks employ loan restructuring strategies to aid borrowers in managing their debt. This approach not only reduces default rates but also enhances the financial stability of the institution. Loan restructuring presents a cost-effective credit risk mitigation strategy compared to, for example, repossession. While repossession involves substantial expenses, including legal fees and potential asset depreciation, restructuring primarily requires administrative adjustments at a lower cost. Banks can support their borrowers while safeguarding their investments and avoiding the significant costs and losses associated with repossession through restructuring. Refer to Banks Act Directive 3 of 2020 for more information.

10 Refer to Banks Act Directive 7 of 2021.

11 NPLs are proxied by impaired advances or accounts overdue by more than 90 days (i.e. loans or advances that have been identified as impaired), with objective evidence that these borrowers are experiencing significant financial difficulty that will likely result in a loss incurred by the bank.

12 The NPL ratio is the ratio of impaired advances to loans and advances.

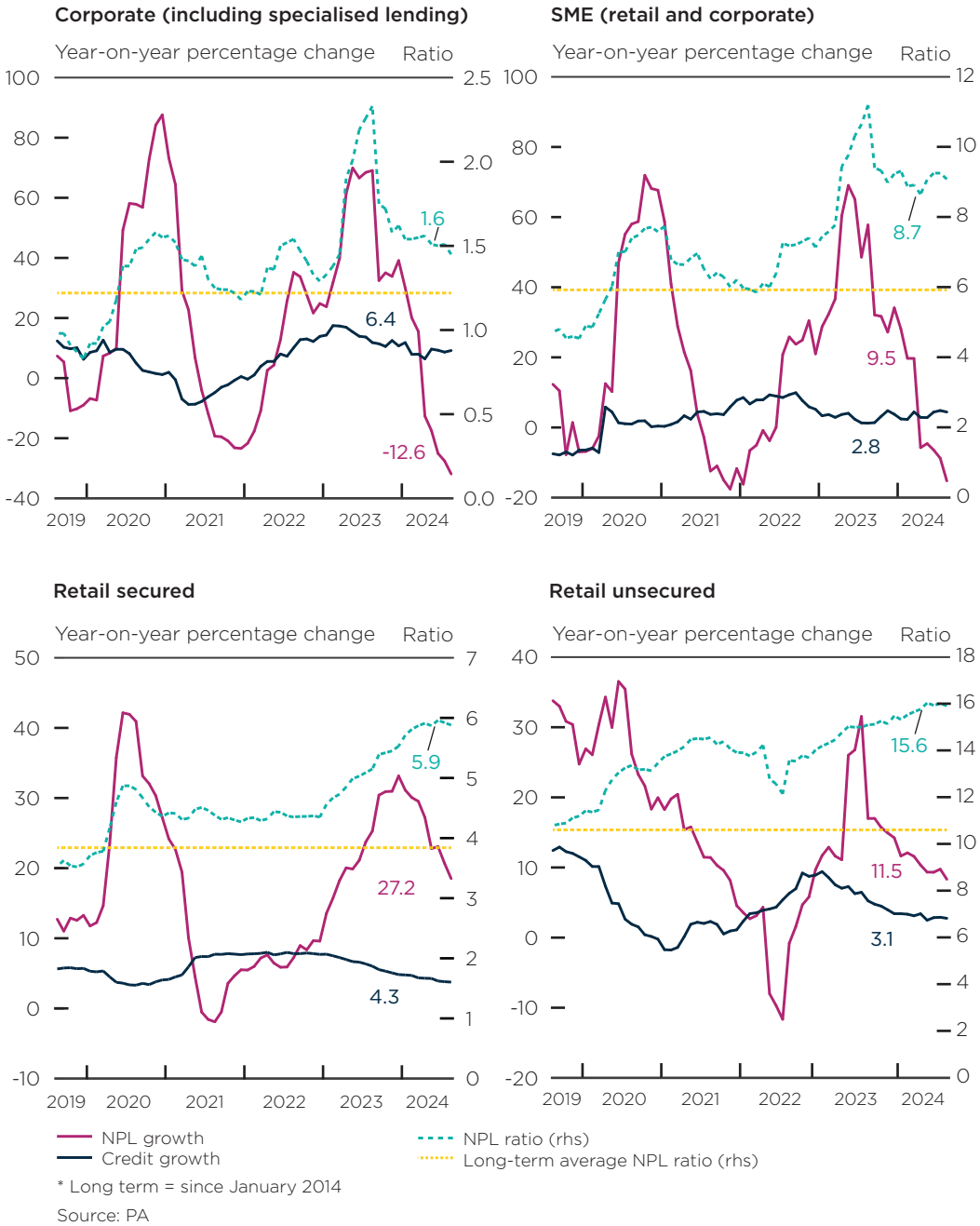
Figure 15: Banks' NPLs and the ratio of NPLs



* Long term = since January 2009
Source: PA

Figure 16 shows that NPLs for all credit classes have been above their long-term averages since the onset of COVID-19. However, the increases in NPLs since 2023 have been the most pronounced in the retail and SMME sectors.

Figure 16: NPLs per asset class

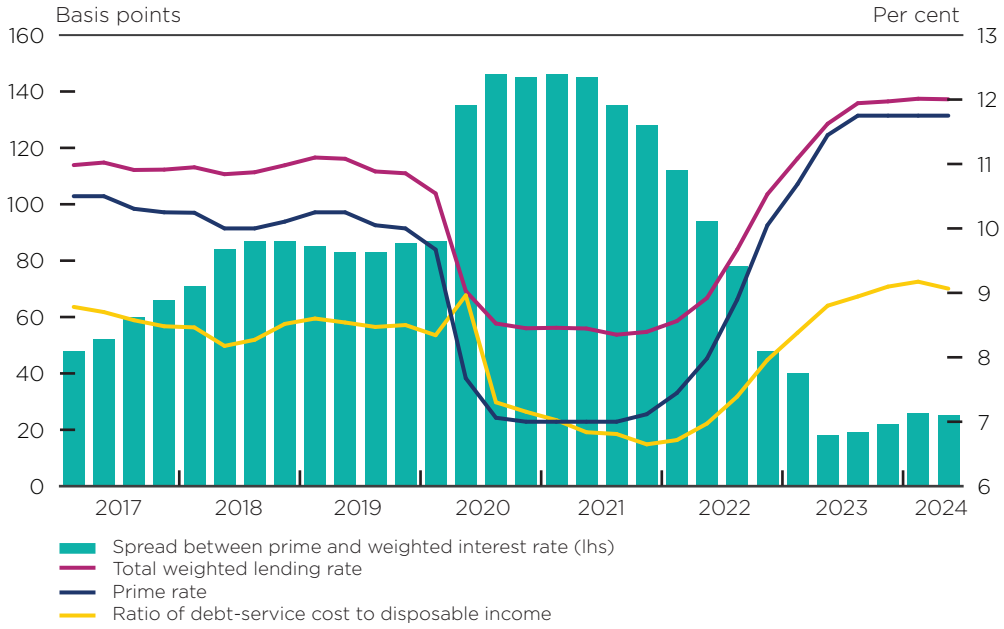


* Long term = since January 2014

Source: PA

The ratio of households' debt-service cost to disposable income seems to have peaked at 9.2% in the first quarter of 2024, declining slightly to 9% in the second quarter (Figure 17). The growth in household debt also slowed over the same period, which may act as a mitigant going forward.

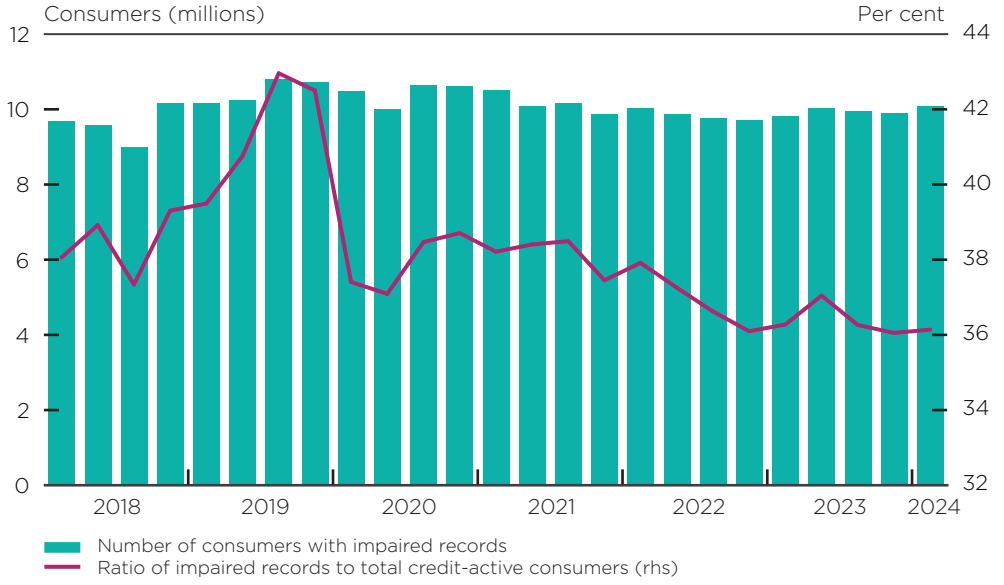
Figure 17: Household debt-service costs and affordability



Sources: SARB and NCR

Financial distress among households is also evident in data collected by the National Credit Regulator (NCR). There were close to 28 million credit-active consumers in the first quarter of 2024, of which just over 10 million had impaired records (Figure 18). Despite the declining trend since the end of 2019, impaired records as a percentage of total active consumers remained high at about 36% in the first quarter of 2024.

Figure 18: Consumers with impaired credit records

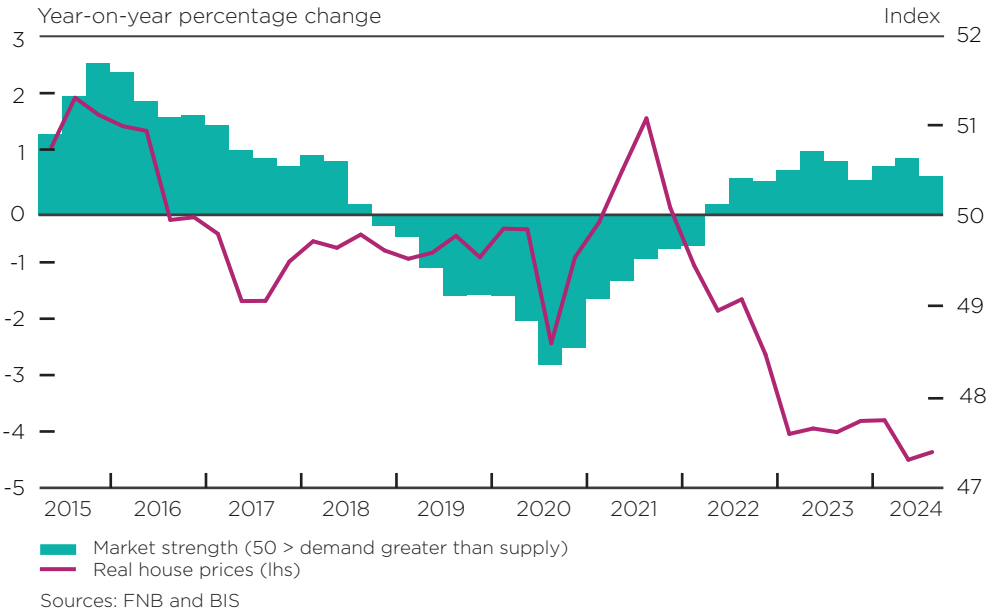


Sources: SARB and NCR

Other indicators of household financial distress include trends in house prices and borrowers becoming overdue or defaulting on their mortgages. Despite the residential market strength indicator remaining above the 50 index point level, indicating that the

demand for property exceeds the supply, real house prices have declined since 2022 (Figure 19). This may point to affordability constraints faced by prospective buyers, which seems to be confirmed by the increase in residential mortgage payments that are more than 90 days overdue (Figure 20).

Figure 19: Housing market strength and real prices



Sources: FNB and BIS

Figure 20: Residential mortgage defaults

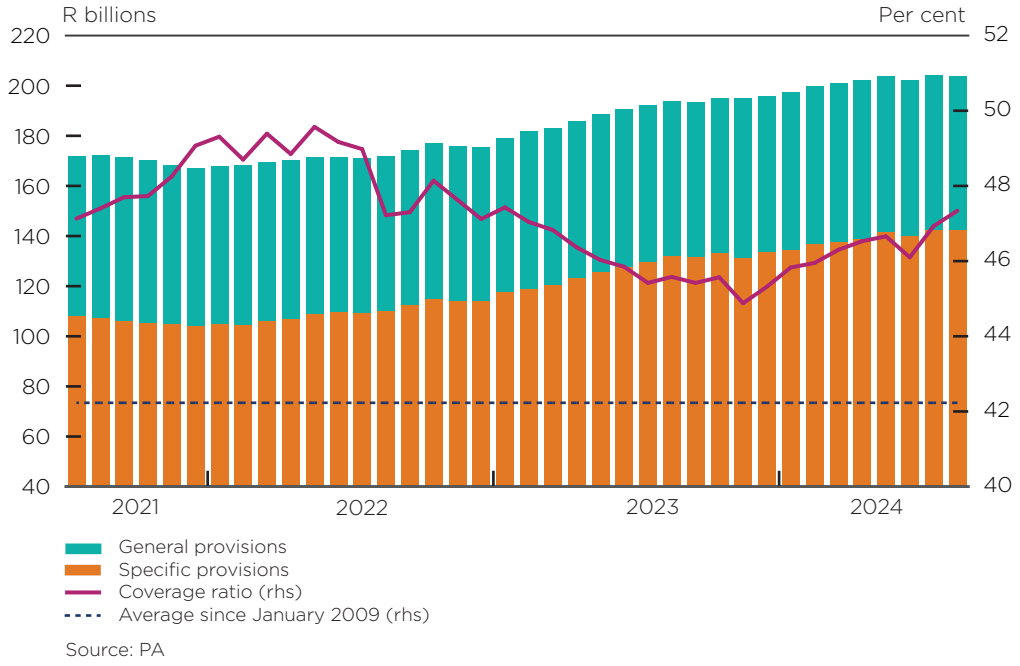
Source: PA

In response to rising NPLs, banks have increased their general and specific provisions against doubtful exposures since February 2023. These provisions peaked in April and June 2024 respectively (Figure 21). The overall coverage ratio has also increased since the start of 2024, which suggests that banks are increasingly capable of covering outstanding exposure amounts, thereby enhancing the sector's resilience in the face of potential economic headwinds.[13] An improvement in the ratio signifies a proactive

13 The coverage ratio is calculated as the ratio of specific provisions to total NPLs and illustrates the alignment of these provisions relative to the volume of NPLs.

approach to risk management and an enhanced capacity to absorb losses associated with NPLs, ultimately reinforcing the overall stability of the sector.

Figure 21: Bank provisions and coverage ratio

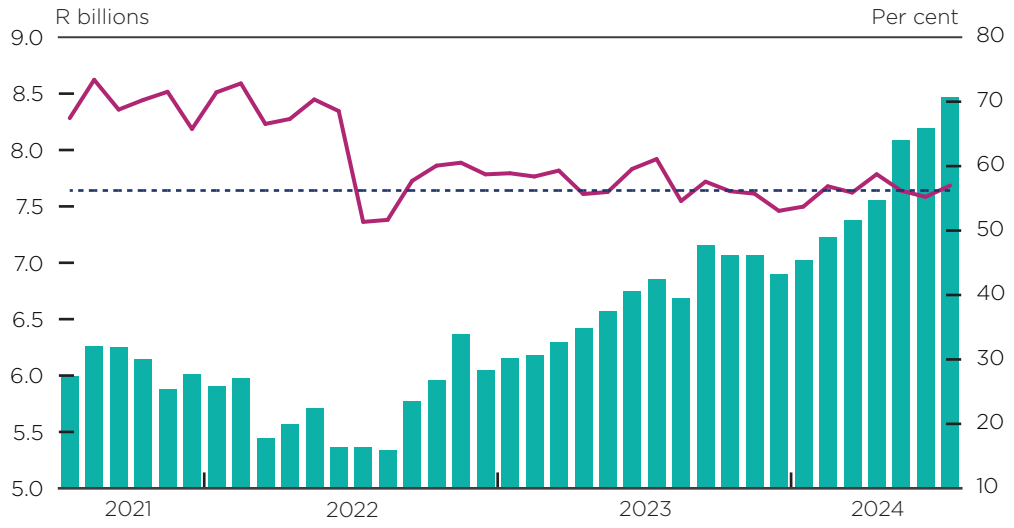


Source: PA

Although the overall coverage ratio shows improvement, there are signs of financial distress in the small and medium-sized enterprise (SME) corporate sector (Figure 22). The growth in NPLs in the SME corporate sector has outpaced the rise in overall NPLs since mid-2022, leading to a decline in banks' SME corporate coverage ratio to around, and occasionally below, its long-term average. Small businesses generally have less room than large corporates to protect themselves against shocks such as the COVID-19 lockdowns and high degrees of load-shedding, or against the effects of rising interest rates.

The continued increase in provisions against SME corporate loans and the relatively small proportion of SME loans in banks' total loan portfolios (5.7% at the end of July 2024), provide comfort about the resilience of the aggregate banking sector against credit risk in SME corporate loan portfolios. However, individual banks may be more exposed, requiring close monitoring of the declining coverage ratio and possibly a re-evaluation of risk management strategies within the sector.

Figure 22: Provisions and coverage ratio for SME corporates



Source: PA

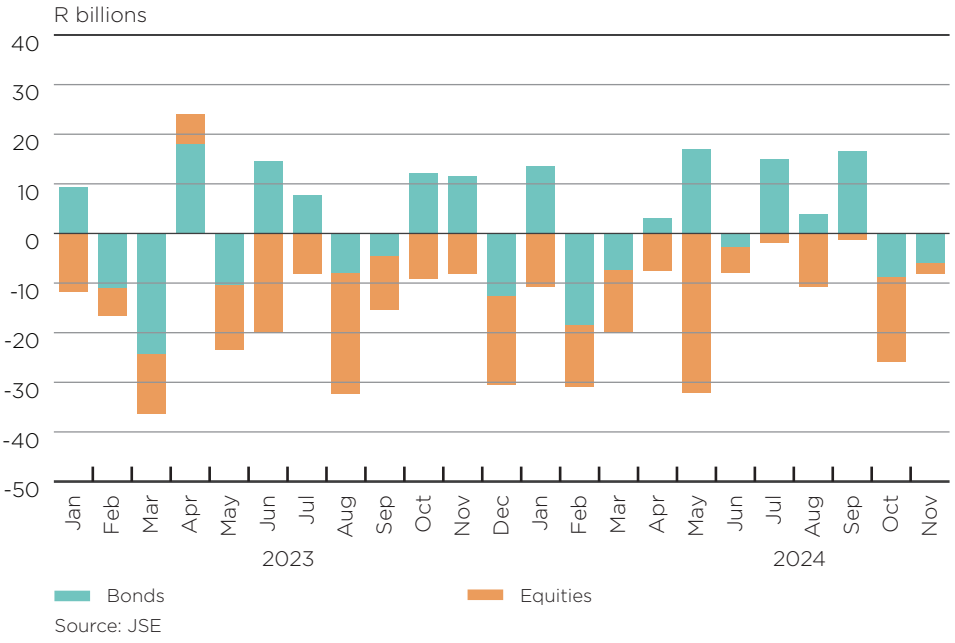
Rapid capital outflows amid declining financial market depth[14]

From a financial stability perspective, the more liquid, deeper and diversified financial markets are, the larger the shock that they can absorb without becoming dysfunctional. In financial markets that are shallower and less liquid, smaller shocks may be amplified and have a disproportionate disruptive effect. The June 2024 edition of the *FSR* noted a significant decline in market depth and liquidity, which was caused by capital outflows, the dominance of government bonds in the domestic debt market and the buy-and-hold strategies favoured by investors, among other factors.

The financial system's vulnerability to the risk of declining market depth has reduced somewhat since the release of the June 2024 *FSR*. The post-election optimism towards the current political environment, coupled with a stronger rand-US dollar exchange rate, has supported demand for domestic assets, especially SAGBs. By contrast, equity flows continued to decline despite the positive sentiment, with foreign investors looking for more sustained economic reforms. Non-residents were net sellers of JSE-listed shares worth R113.3 billion and net buyers of R25.3 billion in bonds in the year to mid-November 2024 (Figure 23).

14 Market depth in this context refers to the combination of market depth (i.e. high market capitalisation), market liquidity (i.e. material amounts can be traded without a disproportionate impact on price) and market diversification (i.e. there is a wide variety of borrowers and lenders active in the market).

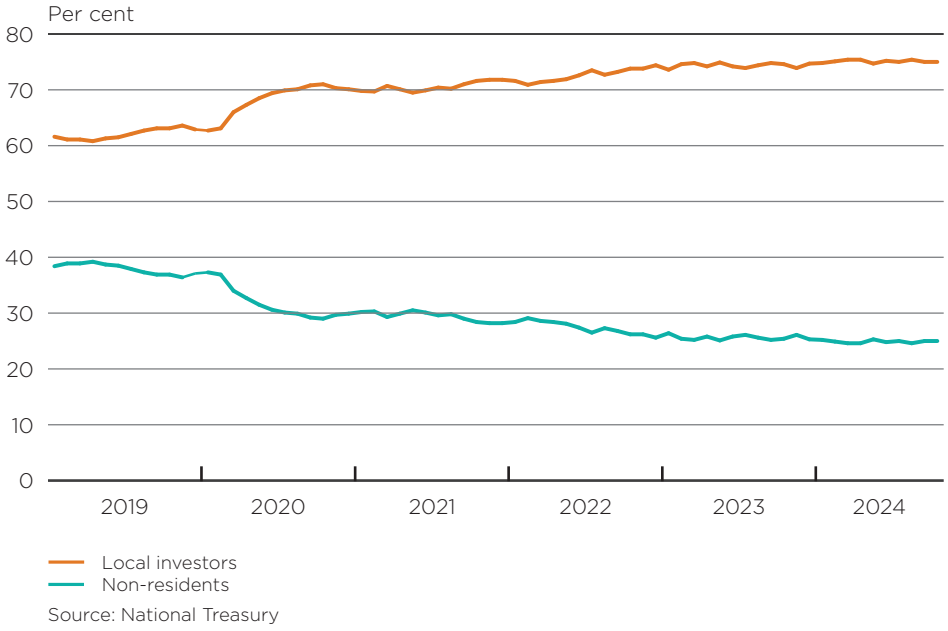
Figure 23: Non-resident bond and equity flows



Source: JSE

Non-resident holdings of SAGBs increased marginally to 25% at the end of October 2024, up from 24.6% in April (Figure 24). While non-residents have been net buyers of government bonds this year, their demand has lagged the pace of new debt issuance. The structural decline in foreign participation in the government bond market is consistent with South Africa's steadily declining share in major EM bond indices, such as the JPMorgan Government Bond Index for Emerging Markets, following the introduction of other countries such as India. South Africa has also been excluded from other major indices, including the WGBI in 2017.[15]

Figure 24: Local versus non-resident holdings of SAGBs



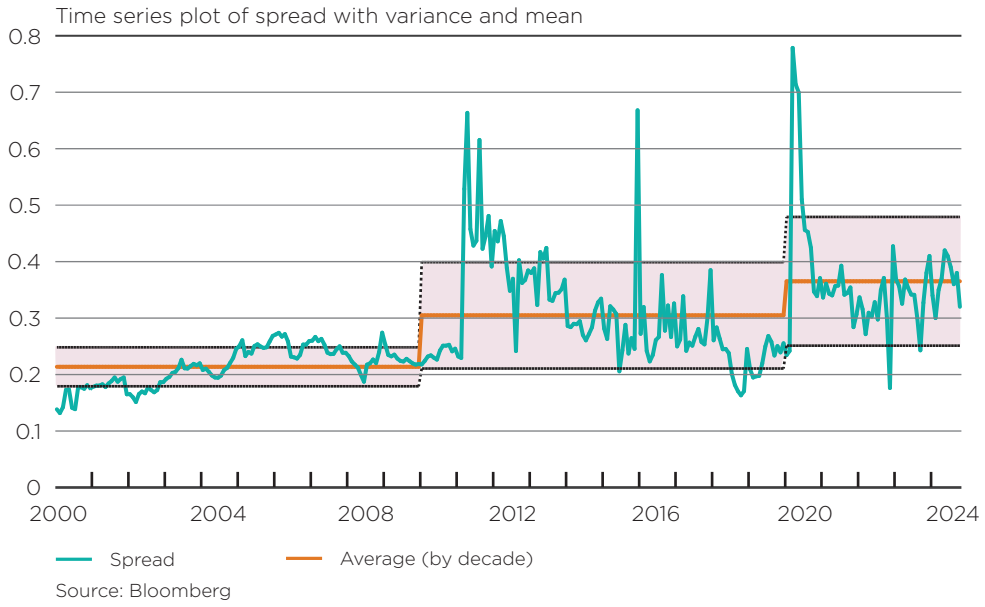
Source: National Treasury

15 There is significant empirical evidence that benchmark inclusion in bond indices has a significant impact on foreign participation in EM bond markets. See, for example, S Arslanalp et al., 'Benchmark-driven investments in emerging market bond markets: taking stock', 25 September 2020, https://www.imf.org/en/Publications/WP/Issues/2020/09/25/Benchmark-Driven-Investments-in-Emerging-Market-Bond-Markets-Taking-Stock-49740.

The collective exposure of the South African financial system to a single issuer (i.e. the government) has contributed to a decline in government bond market liquidity in recent years. Liquidity and depth in domestic bond and equity markets, measured as bond and equity turnover as a percentage of total market capitalisation, have been declining broadly in parallel.[16]

Bid-ask spreads in the SAGB market have widened and become more volatile (Figure 25). The notable spikes in the bid-ask spread have coincided with several unexpected global and domestic events over the past few decades, including the Asian crisis (1997), the Taper Tantrum (2013), South Africa's downgrade by credit rating agencies (2017) and COVID-19 (2020). High and volatile spreads are one of the symptoms of low market depth and liquidity.

Figure 25: Bid-ask spreads in the SAGB market



Source: Bloomberg

Although there has been a decline in foreign participation in domestic bond and equity markets over the past five years, the trend is not unique to South Africa. With the exception of Peru and the Czech Republic, all EMs have a lower non-resident participation rate compared to a decade ago. In particular, EMs that experienced large bond market inflows in the aftermath of the 2008 GFC have experienced similar declines in foreign participation in recent years. The drivers of this decline are standard capital market and real economy features, such as the increase in advanced economy yields following the recent interest rate hiking cycle and low real growth rates. Declining participation by non-residents contributes to lower market depth and liquidity. However, lower holdings by non-residents mitigate the impact of rapid capital outflows as the bulk of assets are held by local investors.

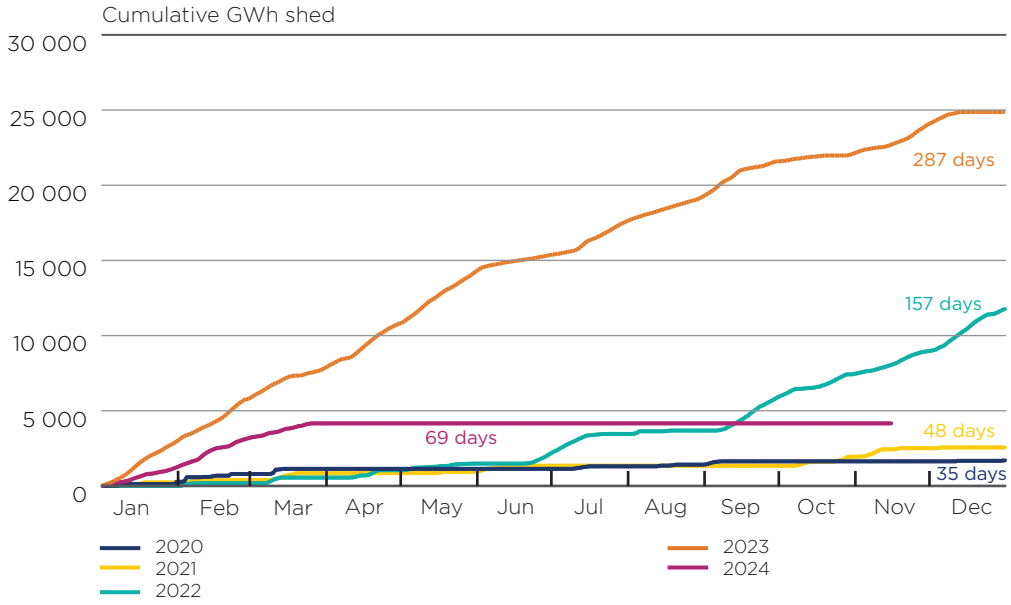
Critical infrastructure failure

The deterioration in critical national infrastructure such as roads, railways, water and electricity has contributed to South Africa's structural challenge of low and inequitable economic growth. As covered in detail in recent editions of the *FSR*, South Africa experienced record levels of load-shedding in 2023, with almost 25 000 gigawatt hours (GWh) shed over a total of 287 days (Figure 26). This has improved significantly in 2024; in the first 10 months of the year South Africa

16 See pages 9–14 of the June 2024 *FSR* for a more detailed discussion.

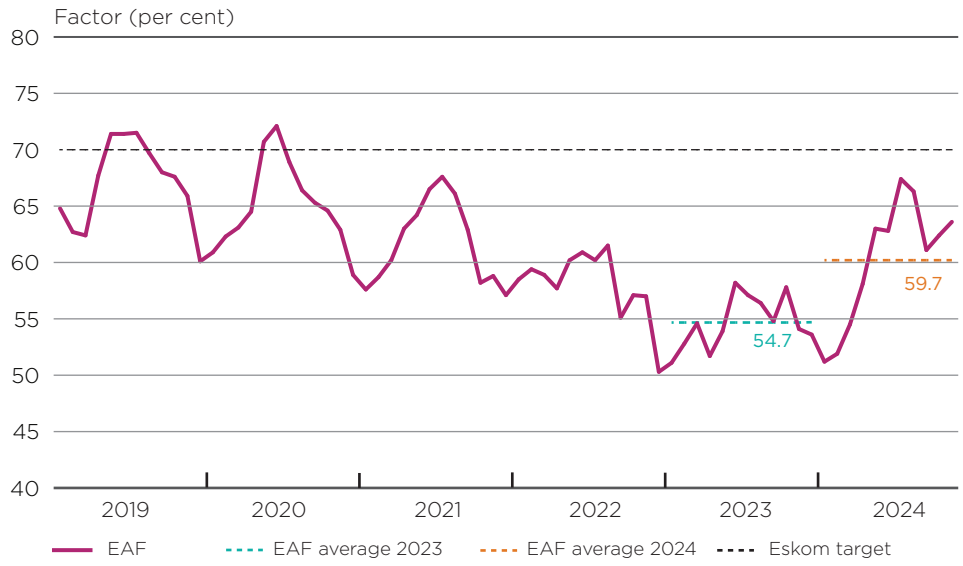
experienced 69 days of load-shedding, with just over 4 100 GWh shed. One of the main reasons for the improvement is the higher electricity availability factor (EAF), which rose from just over 51% in January 2024 to over 63.6% in November 2024 (Figure 27). A key contributing factor to the increase in the EAF is a reduction in the demand for Eskom-supplied electricity as alternative energy sources increase.

Figure 26: Cumulative load-shedding, 2020–2024



Source: Eskom and SARB

Figure 27: Eskom EAF, 2019–2024



Sources: Eskom and SARB

The sustained deterioration in critical infrastructure poses direct operational risks that could disrupt the functioning of the financial system. While electricity availability appears to be gradually returning to historical trends, other critical infrastructure such as the supply and quality of water as well as transport infrastructure – especially rail, port and road networks – continues to degrade.

There are also indirect, non-operational transmission channels through which deteriorating infrastructure could affect financial stability. First, numerous municipalities are in a precarious financial position. For some municipalities, the bulk of their revenue is generated by on-selling critical services such as electricity and water. The failure of critical infrastructure could therefore threaten the financial viability of various municipalities, in turn affecting their ability to service their debt in the financial sector, and potentially placing further strain on the fiscus should government support be provided.

Second, deteriorating critical national infrastructure negatively affects municipalities' ability to deliver key services. To help compensate for these declining revenue streams, many municipalities have implemented above-inflation increases in their rates and taxes. This adds to general social discontent, which could make societies more prone to events such as the June 2021 riots, with subsequent losses having to be absorbed by the financial system.

Third, high municipal rates and taxes increase the hurdle rates at which new commercial property developments become viable and can threaten the sustainability of existing commercial property. This contributes to a cycle of low investment in new commercial developments, low maintenance and financial defaults in certain areas.

To increase the operational resilience of the domestic financial system against the failure of critical national infrastructure, in 2023 the SARB, together with the Financial Sector Contingency Forum (FSCF), announced the development of various contingency plans. The initiative was initially motivated by the risk of an electricity grid collapse and the first phases of the project focused predominantly on how financial markets would be closed and reopened in an orderly manner.[17] In 2024, the focus was broadened to increase the operational resilience of the financial sector more generally to ensure business continuity under different disruption scenarios. A current priority initiative is to establish direct connectivity among key nodes in the financial sector in a scenario where existing telecommunication networks are unable to function so that a certain level of payment, clearing and settlement activity can continue.

Financial institutions acknowledge the importance of business continuity and the need to strengthen the sector's operational resilience as a collective. There are certain extreme – possibly systemic – events that could threaten the interoperable and interconnected financial sector value chain, impairing the continuation of core processes across the ecosystem. As such, appropriate measures need to be put in place to limit the ultimate impact of such events and ease the resumption process once possible.

Remaining on the FATF greylist over the medium term[18]

As noted in recent editions of the *FSR*, remaining on the FATF greylist beyond June 2025 – the first opportunity for South Africa to be removed from the list – exposes the financial system to various vulnerabilities. On 25 October 2024, the FATF Plenary announced upgrades to nine action items on South Africa's 22-item Action Plan, including eight to 'largely addressed' and one to 'partly addressed'. As stated in National Treasury's media statement on the same date, South Africa is now deemed to have largely or fully addressed 16 of the 22 action items in its Action Plan, leaving the country with six outstanding action items to be addressed in the last scheduled reporting cycle concluding in February 2025.[19]

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17 See 'SARB statement on the role of the Financial Sector Contingency Forum', 21 February 2023.

18 This risk has been rephrased from 'Remaining on the FATF greylist beyond June 2025' to 'Remaining on the FATF greylist over the medium term' to reflect that vulnerabilities associated with being on the greylist will increase the longer South Africa remains on it.

19 See 'FATF greylisting: South Africa's positive progress as at October 2024', 25 October 2024. https://www.gov.za/news/media-statements/national-treasury-fatf-greylisting-progress-25-oct-2024.

Three of the six outstanding action items relate to South Africa's ability to demonstrate a sustained increase in the investigation and prosecution of complex money laundering, terrorist financing and unlicensed cross-border money or value transfer services cases. The remaining three relate to the timely access of beneficial ownership information in respect of companies and trusts, and the imposition of remedial action and dissuasive sanctions by designated anti-money laundering and combating the financing of terrorism supervisors.

According to National Treasury, if South Africa satisfactorily addresses all six remaining action items in the next reporting cycle (i.e. by January 2025), the FATF Africa Joint Group will conduct an on-site visit during mid-2025 to confirm this assessment.[20] If the on-site assessment confirms that South Africa has successfully addressed all six remaining action items, the FATF Africa Joint Group will recommend to the June 2025 FATF Plenary that South Africa be removed from the FATF greylist. However, if any of the remaining action items have not been addressed by February 2025, South Africa will be required to continue reporting back to the FATF Africa Joint Group every four months until all the action items have been addressed. Should South Africa therefore not exit the greylist in June 2025, the next opportunity to do so will be four months later (i.e. in October 2025).

Should South Africa fail to demonstrate sufficient progress to be removed from the greylist, domestic financial institutions' access to the global financial system could become increasingly restricted the longer it remains on the greylist. The longer South Africa remains on the FATF greylist, the less reliance can be placed on existing correspondent banking relationships to mitigate the impact, and the more restrictions will start to be imposed by foreign authorities. As international scrutiny intensifies, financial institutions and market infrastructure providers in developed markets may enhance their risk assessments, leading to enhanced due diligence requirements for South African counterparts. As a result, existing facilities may not be renewed, or the costs associated with them could increase, making these services economically unviable. Such a situation would not only hinder the ability of South African banks to secure new facilities, but could also result in foreign financial institutions curtailing or even terminating their services in South Africa.

Remaining on the greylist could also compromise the capacity of South African financial institutions to manage interest rate and foreign exchange risks as only a small number of banks operating in South Africa have the ability to take on significant interest rate and foreign exchange risk on their balance sheets. These capabilities primarily rest with major global banks that can manage their risk appropriately through global diversification. Financial contracts of this nature typically require clearing through central clearing counterparties domiciled in major financial centres such as London. Prolonged greylisting may impose additional costs and impair banks' ability to hedge risks effectively through offshore markets, impacting their capital requirements. This could affect the willingness and ability of banks to provide hedging opportunities to domestic clients, ultimately jeopardising risk management processes and overall financial stability.

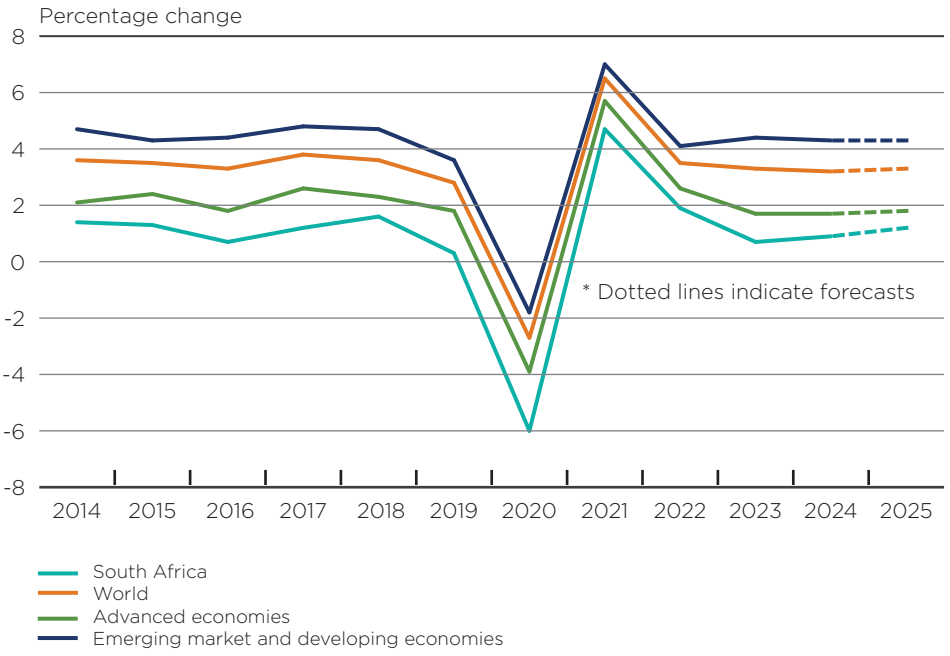
20 See 'FATF greylisting: South Africa's positive progress as at October 2024', 25 October 2024. https://www.gov.za/news/media-statements/national-treasury-fatf-greylisting-progress-25-oct-2024.

Perpetual risks

Low and inequitable economic growth

As highlighted and discussed in detail in the June 2024 *FSR*, South African GDP growth has averaged only 1.3% per year since 2010, exacerbating already high levels of inequality and unemployment. Over the next three years, South Africa's economy is forecast to grow by 1.1% in the 2024/25 fiscal year, 1.7% in 2025/26 and 1.8% in 2026/27,[21] which is insufficient to bring down unemployment. South Africa's economic performance continues to lag that of EMs (Figure 28). Without a sustained improvement in economic growth, many of South Africa's structural challenges will likely remain.

Figure 28: South Africa's relative economic performance since 2014*



Source: IMF *World Economic Outlook*

Climate change

The common financial stability challenges associated with the transition to a net-zero economy are relevant to South Africa as detailed in a recent SARB Working Paper titled 'Transition and systemic risk in the South African banking sector: assessment and macroprudential options'.[22] The study notes that South Africa's reliance on coal is central to many of the risks it faces in moving to a green economy, finding that the banking system's exposure to transition risks in the corporate sector is both material and widespread. While the global transition requires a drastic reduction in coal production and utilisation, the South African economy relies heavily on coal, both for energy generation and for trade, given that the country is the fifth-largest coal exporter globally. In addition, tax revenue from coal exports, coal products and

21 See the 2024 *MTBPS*, 30 October 2024. https://www.treasury.gov.za/documents/mtbps/2024/mtbps/FullMTBPS.pdf.

22 South African Reserve Bank, 'Transition and systemic risk in the South African banking sector: assessment and macroprudential options', *South African Reserve Bank Working Paper Series WP/24/12*, 22 July 2024. https://www.resbank.co.za/content/dam/sarb/publications/working-papers/2024/transition-and-systemic-risk-in-the-south-african-banking-sector-assessment-and-macroprudential-options.pdf.

the mining and quarrying sectors comprises approximately 30% of total company tax. However, as global preferences migrate towards greener energy sources, the global coal sector will become increasingly irrelevant. If not managed appropriately, the transition from fossil fuels to greener energy sources is likely to have structural implications for the South African financial sector and for banks in particular.

A cyber incident with systemic impact

The FSR Act definition of financial stability primarily concerns the ongoing ability of financial institutions to deliver financial products and services, even under adverse conditions. Although the financial system is bombarded by cyberattacks on a daily basis, most of which are warded off or have a limited effect on the system, a cyber incident with systemic impact would impede the ability of financial institutions to continue operating. The risk of a cyber incident with systemic impact occurring is a perpetual one and will become even more relevant as the digital economy grows. Potential risk amplifiers would likely result from advances in technology such as artificial intelligence, quantum computing, growing market concentration and reliance on third-party technology service providers, interconnectivity and geopolitical fragmentation.

One of the ways in which resilience to cyber incidents can be increased is through the establishment and operationalisation of cybersecurity incident response teams (CSIRTs). To this end, the FSCF's Cyber Resilience Subcommittee (CRS) has been working on establishing and embedding financial sector incident oversight and cyber response structures, including the Financial Sector CSIRT (to share threat intelligence and collectively respond to cyber incidents in the financial sector) and the Financial Sector Overseers CSIRT (to coordinate the efforts of regulators and oversight bodies during a cyber incident). Other mitigants include the South African Banking Risk Information Centre Banking CSIRT and the Payments Association of South Africa incident management process.

Financial stability assessment

The South African financial system has demonstrated remarkable resilience over the past several years in the face of global and idiosyncratic factors that threatened the domestic financial stability outlook. The outlook for financial stability has improved since the release of the June 2024 *FSR*, largely on the back of positive sentiment following the formation of the GNU, the suspension of load-shedding, the expected positive impact of the GFECRA distributions in moderating government borrowing, and expectations of lower interest rates globally and in South Africa. Steady progress continues to be made in increasing the domestic financial system's resilience against the key risks highlighted, most notably by strengthening the domestic financial safety net and mitigating the impact of a potential systemic event. Prudentially regulated domestic financial institutions, in aggregate, remained resilient, as measured by their ability to maintain adequate capital and liquidity buffers to absorb the impact of shocks. Financial institutions have been able to provide financial services without interruption and are expected to continue doing so over the forecast period to November 2025.

Policy actions and initiatives undertaken to enhance domestic financial stability

- **Introducing a PCN CCyB:** The SARB continued to prepare for the increase in the CCyB from 0% to 1% on 1 January 2025. The PA will issue a final directive to give effect to the phasing in of the 1% CCyB from 1 January 2025.
- **Mitigating the sovereign-financial sector nexus:** The SARB continued to closely monitor developments around the sovereign-financial sector nexus in particular given the high levels of government debt and the domestic financial sector's exposure thereto.
- **Increasing the financial sector's resilience to deal with an operational disruption with a systemic impact:** The SARB, through the FSCF, continued to plan for the highly unlikely but not impossible scenario of a national electricity grid shutdown and other operational disruptions with a potential systemic impact.
- **Collaborating with Financial Stability Oversight Committee (FSOC) members:** The SARB collaborated with FSOC members to discuss some of the key risks to financial stability, particularly on the financial stability implications of the weak fiscal position and the sovereign-financial sector nexus, the issue of reduced market depth and liquidity, and progress made in addressing the deficiencies that resulted in South Africa being placed on the FATF greylist.
- **Enhancing cyber-resilience in the financial sector:** The FSCF, through the CRS, continued to make progress in establishing various CSIRTs for the financial sector.

Briefings on selected topics

The economic impact of a 1% positive cycle-neutral countercyclical capital buffer

In November 2023, the SARB announced its decision to introduce a 1% PCN CCyB as a macroprudential instrument. To this end, the PA subsequently published a proposed directive giving effect to this decision for comment.[23] The PCN CCyB differs from other layers in the capital stack in the sense that it can be increased in times when credit growth in the banking sector outpaces general economic activity, but also reduced to zero in the event of a shock that constrains bank lending. As a macroprudential instrument, the decision to increase or decrease the CCyB is made by the SARB's FSC, without affecting any of the other layers in the capital stack. The CCyB has been 0% since its introduction in 2016, nullifying the SARB's ability to use it in a countercyclical manner as intended by releasing it during times of stress.

Over the past several years, the SARB has conducted various studies on the potential economic impact of implementing a 1% PCN CCyB.[24] The studies consider how an increase in bank capital requirements affects lending supply and macroeconomic activity more broadly. While the key focus of these studies is on the bank lending channel, they also capture the impact that the proposed capital requirement change will have on the real economy. Overall, the results suggest that the introduction of a 1% PCN CCyB would have a marginal and temporary impact, and not severe enough to outweigh the long-term financial stability benefits that a countercyclical policy tool brings.

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23 The proposed directive is available at https://www.resbank.co.za/content/dam/sarb/publications/prudential-authority/pa-documents-issued-for-consultation/2023/proposed-directive---pcn-ccyb/Proposed%20Directive%20PCN%20CCyB.pdf.

24 The methodological approaches followed and the detailed results of the studies are in the process of being finalised for publication.

More and better liquidity: the changing composition of high-quality liquid assets in South Africa

Through the liquidity coverage ratio (LCR) rules set by the Basel Committee on Banking Supervision (BCBS), banks are required to hold HQLA. HQLA can be easily and immediately converted into cash at little or no loss of value. An asset's liquidity depends on the underlying stress scenario, the value to be monetised and the time frame over which it is to be realised. In South Africa, the set of HQLA-eligible assets currently comprises (i) banknotes and coin; (ii) highly-rated non-government debt; (iii) central bank reserves; (iv) government and SARB rand-denominated debt; and (v) government and SARB foreign exchange-denominated debt (for specific exposures). To satisfy the LCR, banks must hold sufficient unencumbered HQLA to meet all outflow demands, for a period of 30 calendar days, during episodes of stress.[25]

In South Africa, approximately 75% of HQLA is government bonds and Treasury bills. The fact that the bulk of HQLA is government debt instruments raises some concerns. South African government debt is no longer rated investment grade by global measures and may lose notable value in a crisis. This vulnerability would be exacerbated if debt owners engaged in fire sales to raise liquidity, further reducing its value. Heavy reliance by banks on government debt for HQLA is therefore a contributor to the financial stability vulnerabilities associated with the sovereign-financial sector nexus, an issue discussed in previous editions of the *FSR*.[26]

Banks' growing exposure to the sovereign attracted attention when the PA ended banks' exemption to hold foreign-currency assets against rand-based liquidity needs from 2024 (as specified in Banks Act Directive 11 of 2022). This change achieved compliance with the BCBS rules, but may have contributed to encouraging banks to increase their South African sovereign exposure in pursuit of increasing their HQLA holdings.

Nonetheless, as Table 1 shows, the share of government debt in Level 1 HQLA decreased by nearly 0.5% between 2021 and 2024. This occurred despite a significant – and expected – fall in non-government debt in Level 1 HQLA (down nearly 6% between 2021 and 2024). Over the same period, the contribution of banknotes and coin to Level 1 HQLA also moderated by nearly 1%, which is consistent with the declining cash intensity of the South African economy.

Table 1: Changes in the composition of HQLA, 2021–2024

Components of Level 1 HQLA	July 2021	July 2024	Change
Banknotes and coin	2.5%	1.8%	-0.7%
Highly-rated marketable securities	8.5%	2.8%	-5.7%
Central bank reserves	12.6%	18.3%	5.6%
Government and SARB rand-denominated debt	75.6%	75.2%	-0.4%
Government and SARB foreign exchange-denominated debt	0.8%	1.9%	1.1%

25 For more information, see https://www.bis.org/basel_framework/chapter/LCR/30.htm.

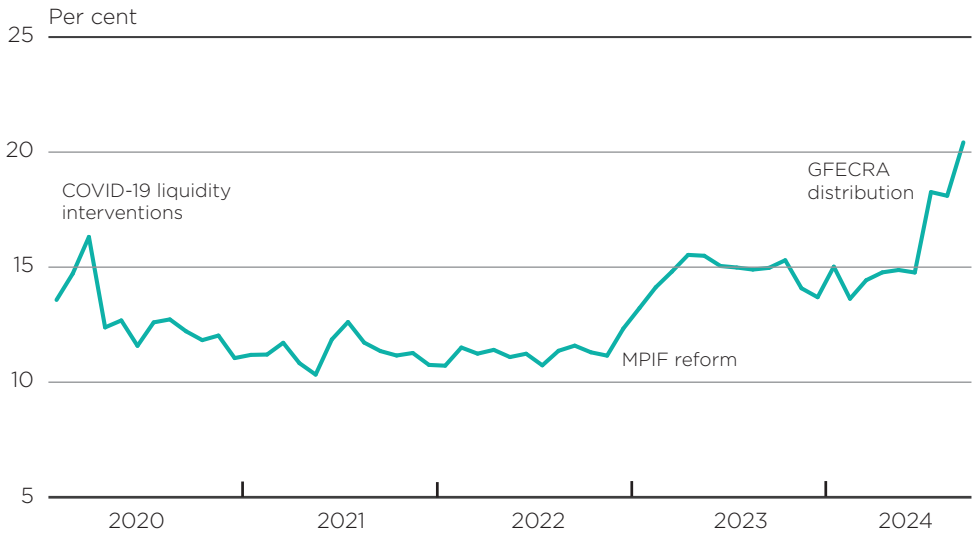
26 Previous editions of the *FSR* are available at https://www.resbank.co.za/en/home/publications/review/financial-stability-review.

The main offsetting factor has been growth in central bank reserves, which increased by almost 6% between 2021 and 2024. While these balances have long featured in banks' HQLA given the cash reserve requirement, they have become a more important source of HQLA since the introduction of the SARB's new monetary policy implementation framework (MPIF) in 2022.[27]

From 1998 to 2022, the SARB implemented monetary policy through a scarcity system, that is, by draining enough liquidity from the market to force banks to borrow at weekly repurchase (repo) auctions to satisfy their cash reserve requirements. The liabilities issued by the SARB to drain this liquidity mostly did not qualify as HQLA. The 2022 MPIF reform, however, established a surplus system. The SARB expanded the supply of liquidity and provided banks with a deposit facility that paid the repo rate (i.e. the policy rate). This allowed banks to maintain larger cash deposits at the SARB without incurring a penalty. The liquidity surplus grew further with the drawdown of the National Treasury Sterilisation Deposit Account in early 2023 and the distribution of GFECRA funds in mid-2024. The supply of excess GFECRA reserves has now risen to around R160 billion, from roughly R45 billion in late 2022.

Before the MPIF reform, banks' cash reserves with the SARB were around 12% of total Level 1 HQLA held by banks. Following the GFECRA distribution, they are now over 20% (Figure 29). This has contributed to the banking sector holding historically high levels of HQLA (Figure 30).

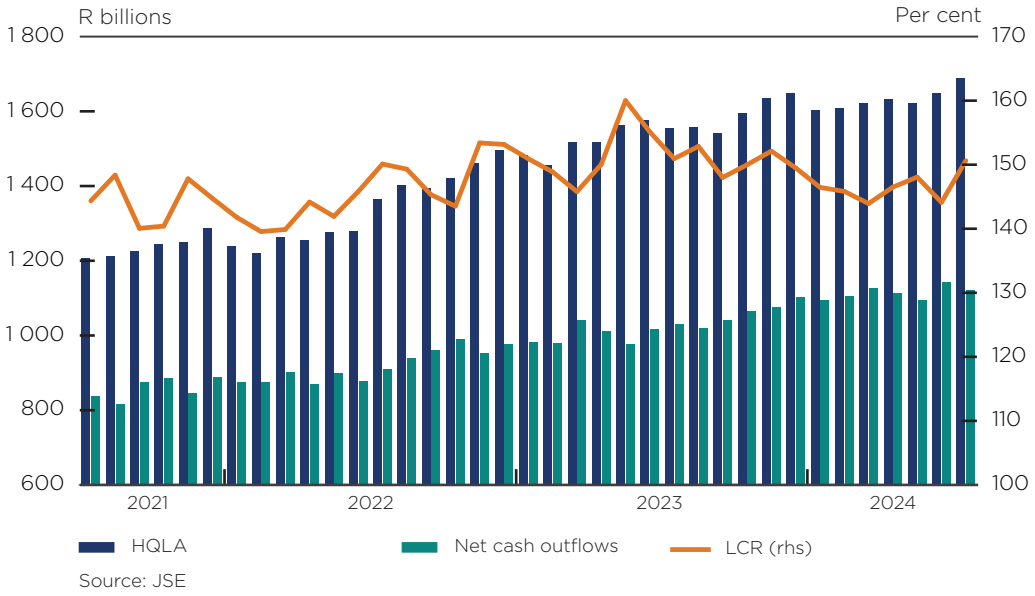
Figure 29: Central bank reserves as share of total Level 1 HQLA



Source: PA

27 For more information on the evolution of the MPIF, see https://www.resbank.co.za/en/home/what-we-do/financial-markets/monetary-policy-implementation-framework.

Figure 30: HQLA held by the banking sector



Source: JSE

Central bank reserves have several advantages as HQLA. They always trade at face value, with no credit or interest rate risk, and do not experience fire sales. Unlike other HQLA instruments, there are also no logistical frictions in monetising them – they are already cash balances held within the payment system. While this is no silver bullet, a larger supply of this asset helps mitigate the sovereign-financial sector nexus in South Africa by improving the supply and quality of HQLA.

An assessment of vulnerabilities in the South African commercial real estate sector and the financial stability implications[28]

The SARB assessed vulnerabilities in the South African commercial real estate (CRE) sector and its implications for financial stability. The assessment found that financial imbalances within the South African CRE sector have significantly increased since the COVID-19 pandemic, with vulnerabilities exacerbated by climate change. Meanwhile the banking sector's exposure to CRE has also declined, indicating tighter lending standards. Although this is positive for financial stability from a bank credit risk perspective, it has contributed to growing financing challenges for the sector. The findings indicate a decline in capital growth and transaction activity due to higher borrowing costs. Higher interest rates have also led to a deterioration in banks' CRE asset quality. While investors may incur large financial losses in the event of market shocks, systemic risks appear limited due to the relatively low direct exposure of the financial system to the CRE sector.

The South African CRE sector is under pressure, both from a cost and income perspective. From a cost perspective, significant investments in alternative electricity supply are required, and municipal rates and taxes have increased at a much faster pace than rental income. Water supply is also a concern in some areas. Moreover, physical risks stemming from climate change present a significant challenge for the CRE sector, impacting property values and increasing insurance costs.[29] Construction activity is at an all-time low, as depressed asset values and rising construction costs have made new developments financially unfeasible.

Various factors contribute to lower rental income, which in turn affect property valuations and the ability of owners to cover operational, maintenance and debt-service costs. The shift to e-commerce and work-from-home models caused a structural decline in demand for retail and office space resulting in higher vacancy rates. Although this shift was triggered by the COVID-19 lockdowns, and despite the fact that most organisations have reverted to a hybrid working model, rental demand remains subdued. While Figure 31A shows a sharp increase in vacancies due to COVID-19-related factors, it is noteworthy that vacancy rates had already been gradually rising since 2009, as new developments outpaced the demand for new property.

A high vacancy rate above the pre-COVID-19 level exerts pressure on office rental prices. Although there are signs of recovery in vacancy rates, they have yet to return to pre-pandemic levels, and this continues to exert pressure on real rental prices (Figure 31D). However, there are notable differences in trends among provinces. The trend of semigration[30] to Cape Town has resulted in a stronger recovery in vacancy rates (Figure 31A) and real rentals (Figures 31B and 31C) for Grade A offices in the Western Cape region.

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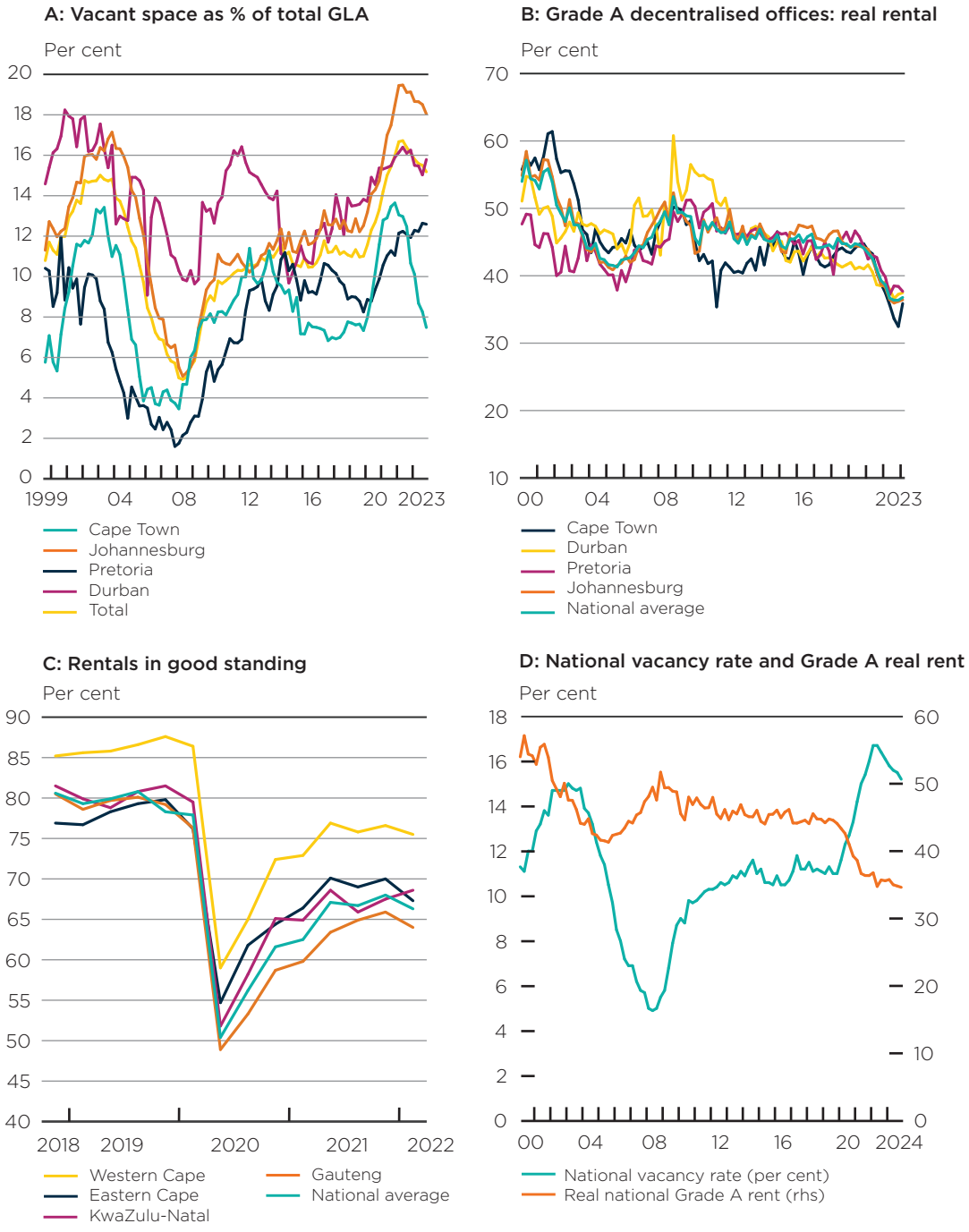
28 This write-up is based on a comprehensive research paper on the topic, which is available at https://www.resbank.co.za/en/home/what-we-do/financial-stability.

29 J Clayton, S Devaney, S Sayce and J van de Wetering, 'Climate risk and real estate prices: what do we know?', Journal of Portfolio Management 47, 2021. ('Climate risk and real estate prices: what do we know?') https://www.pm-research.com/content/iijpormgmt/47/10/75

30 Market sentiment indicates that businesses and individuals are relocating to the Western Cape, attracted by lower property rate increases and better-managed municipalities.

Figure 31: Vacancy rates and rentals



Note: Decentralised means all nodes in a metropolitan lumped together, excluding the central business district, while GLAdenotes gross lettable area.

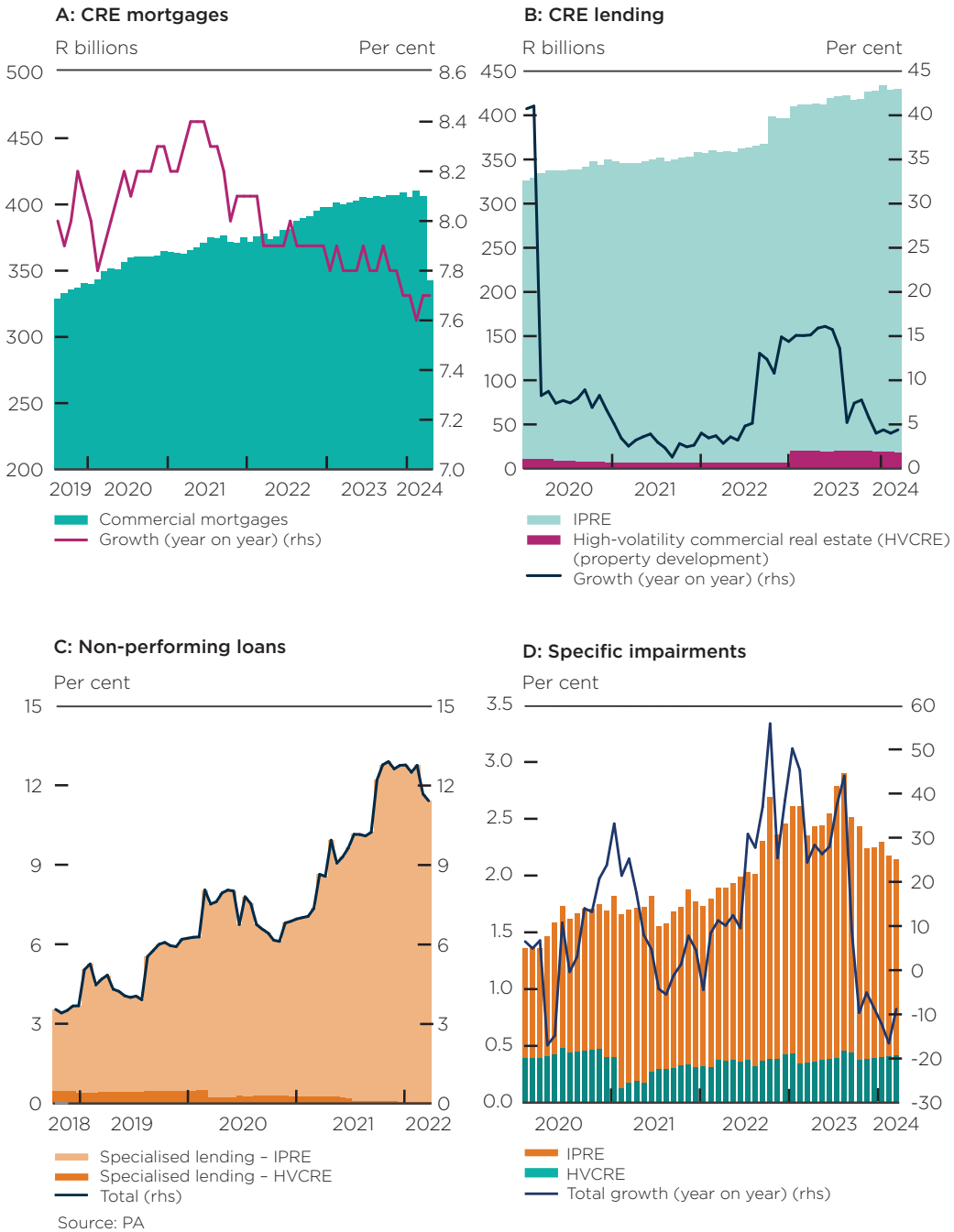
Sources: SAPOA, MSCI, Rode and Associates and TPN

In addition to vacancy rates, tenant payment behaviour exacerbates the decline in rental income. The variability in tenant payment patterns is influenced by factors such as property rates and taxes, which vary across different geographical areas. While some recent recovery is noted, tenants in good standing (tenants who consistently meet their lease obligations) remain well below the pre-COVID-19 level (Figure 31C). Defaults by tenants can reduce rental income and induce a cycle of debt defaults.

The slowing growth in credit extension to the CRE sector could suggest potential challenges in securing financing for new building projects or growing refinancing

risks. Commercial mortgages as a share of total lending continued on a downward trend in the post-pandemic period (Figure 32A). The bulk of CRE specialised lending was to income-producing real estate (IPRE), which relies on income from underlying properties or businesses to repay loans, increasing the risk of default in a downturn (Figure 32B). Year-on-year growth in credit extended in the CRE sector plummeted drastically in the first three quarters of 2020 due to the financial fallout from the effects of the COVID-19 pandemic. The downward trend moderated somewhat until the third quarter of 2021. As restrictions to economic activity were gradually relaxed, credit extension to the CRE sector regained momentum, growing at around 15% year on year at the end of 2023. The credit quality of CRE assets continues to deteriorate (Figure 32C) – albeit more moderately in recent months, as seen by a moderation in the specific impairments (Figure 32D) – due to the COVID-19-induced structural changes in the sector coupled with persistently weak economic growth.

Figure 32: Banking sector exposure to the CRE sector



Source: PA

Global and domestic conditions in the CRE markets are currently in a downward phase, which poses several financial stability concerns. The structural growth constraints interacting with higher interest rates have skewed the supply and demand dynamics in the CRE sector, negatively impacting cash flows and property values. In response to this and potential future stress, investment and lending activities are deteriorating. Since the COVID-19 impact, financial imbalances in the domestic CRE sector have grown but are differentiated across segments, with the office segment being the worst affected. Rising incidences of extreme weather have further negatively impacted all channels of transmission of CRE vulnerabilities. Domestically, financial and non-financial institutions face potential credit losses from the exposure to the CRE sector. While investors could face large losses, systemic risks currently appear limited.

Abbreviations

ABIL	African Bank Investments Limited
Alsi	JSE All-Share Index
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CBOE	Chicago Board Options Exchange
CCyB	countercyclical capital buffer
CDS	credit default swap
COVID-19	coronavirus disease 2019
CRE	commercial real estate
CRS	Cyber Resilience Subcommittee
CSIRT	cybersecurity incident response teams
EAF	energy availability factor
EMBI	Emerging Market Bond Index
EM	emerging market
EU	European Union
FATF	Financial Action Task Force
FCI	financial conditions index
FMI	financial market infrastructures
FNB	First National Bank
FSC	Financial Stability Committee
FSCF	Financial Sector Contingency Forum
FSOC	Financial Stability Oversight Committee
FSR	*Financial Stability Review*
FSR Act	Financial Sector Regulation Act 9 of 2017
FTSE	Financial Times Stock Exchange
GDP	gross domestic product
GFC	global financial crisis
GFECRA	Gold and Foreign Exchange Contingency Reserve Account
GLA	gross loans and advances
GNU	Government of National Unity
GWh	gigawatt hours
HQLA	high-quality liquid assets
HVCRE	high-volatility commercial real estate
IMF	International Monetary Fund
IPRE	income-producing real estate
JSE	JSE Limited
LCR	liquidity coverage ratio
lhs	left-hand scale
MCR	median cover ratio
MOVE	Merrill Lynch Option Volatility Estimate
MPIF	monetary policy implementation framework
MTBPS	*Medium Term Budget Policy Statement*
NCR	National Credit Regulator
NPL	non-performing loan
PA	Prudential Authority

PCN	positive cycle-neutral
R	rand
repo	repurchase
rhs	right-hand scale
RVM	Residual Vulnerability Matrix
SAGB	South African government bond
SARB	South African Reserve Bank
SCR	solvency capital requirement
SME	small and medium-sized enterprise
SMME	small, medium and micro enterprise
SOE	state-owned enterprise
SRISK	systemic risk
UK	United Kingdom
US	United States
VIX	Volatility Index
VIX EM	Volatility Index Emerging Market
WGBI	World Government Bond Index

Glossary

- **Financial stability risk:** A risk is any adverse development that could prevent financial institutions from providing financial products and financial services, and financial market infrastructures (FMIs) from performing their functions and duties in terms of financial sector laws, without interruption despite changes in economic circumstances, and without a loss of general confidence in the ability of financial institutions and financial market infrastructures to do so.
- **Vulnerability:** A characteristic of the financial system that increases the likelihood and/or impact of a financial stability risk realising.
- **Shock:** An event that may trigger the realisation of financial stability risk.
- **Amplifier:** A property, factor or action that increases the vulnerability.
- **Mitigant:** A property, factor or action that reduces the vulnerability.
- **Transmission channels or mechanisms:** The channels through which the materialisation of a financial stability risk could cause financial instability.
- **Residual vulnerability:** The assessed vulnerability after considering mitigants.
- **Resilience:** A characteristic of the financial system that decreases the likelihood and/or impact of a financial stability risk realising.
- **FMIs:** FMIs include payment market infrastructures and market infrastructures (i.e. exchanges, central securities depositories, central counterparties, clearing houses and trade repositories).

Annexure A: Financial stability heatmap

The SARB uses a wide range of financial stability indicators that are designed to act as early warning signals of a potential build-up of cyclical changes in the financial system that could lead to vulnerabilities if left unattended. A 'snapshot' of all material developments is communicated through the financial stability heatmap. The heatmap visually depicts the statistical transformation of a wide range of financial stability indicators against their historical averages. It is data driven and based on historical information, and does not contain any evaluation of financial stability risks. It serves as a communication tool to flag areas for deeper analyses.[31]

Not every indicator used in the construction of the heatmap is discussed in the *FSR*. Rather, the focus is on key global and domestic factors that may be relevant to financial stability risks and vulnerabilities in South Africa. The potential build-up of imbalances as reflected in the heatmap is discussed in detail in the write-up of the key risks identified as per the SARB RVM.

31 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 A.1: Financial stability heatmap

Methodology: The heatmap is based on a z-score transformation of the underlying indicators. The transformed indicators are thereafter mapped onto an empirical cumulative distribution function (ECDF). Low values from the ECDF are mapped to green while higher values are mapped to shades of red.

*Other financial intermediaries: these include unit trusts and finance companies.

Source: SARB

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

Component	Indicator	Measure
Risk appetite and asset valuation partition		
Residential real estate	Real house price growth	BIS real residential property prices year on year
Equity market	JSE: price-earnings ratio	JSE All Share price-earnings ratio
	Chicago Board Options Exchange (CBOE) Volatility Index (VIX)	Logarithm of CBOE VIX
Government bond market	South African credit default swap (CDS) spread	CDS spread on South African five-year government bond
	Merrill Lynch Option Volatility Estimate (MOVE)	Logarithm of MOVE
Corporate bond market	Corporate spreads	JPMorgan Corporate Emerging Market Bond Index
Banking sector: risk appetite	Bank lending margin	Weighted average lending rate *minus* weighted average deposit rate
Financial sector partition		
Banking sector	Capital adequacy ratio	Capital divided by risk-weighted exposure
	Real credit growth	Real growth in gross loans and advances
	Loan-to-deposit ratio	Gross loans and advances divided by deposits *plus* current accounts *plus* other creditors
	Liquidity coverage ratio	High-quality liquid assets divided by net cash outflows
	Maturity mismatches	Cumulative on-balance sheet contractual mismatch divided by contractual maturity of assets
	Sovereign exposure	Treasury bills *plus* government bonds divided by total assets
	Housing market exposure	Residential mortgages divided by total loans and advances
Insurance: life	Liquidity transformation	Illiquid financial assets divided by total assets
	Leverage	Total financial assets divided by equity
	Solvency capital requirement (SCR)	SCR median
Insurance: non-life	Liquidity transformation	Illiquid financial assets divided by total financial assets
	Leverage	Total financial assets divided by equity
	SCR	SCR median

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

Component	Indicator	Measure
Other financial institutions (these include unit trusts and finance companies)	Credit intermediation	Loans divided by total financial assets
	Liquidity transformation	Illiquid financial assets divided by total financial assets
	Leverage	Total financial assets divided by equity
Sector-wide	SRISK	NYU Stern
Non-financial sector partition		
Households	Debt-to-disposable income	Household debt to disposable income of households
	Debt-service ratio	Ratio of debt-service cost to disposable income
	Net saving	Net saving by households
Non-financial corporates (NFCs)	NFC debt-to-net-operating income ratio	Debt divided operating income
	Interest coverage ratio	Earnings before interest and taxes divided by interest expense
Government	Debt-to-GDP ratio	Total gross loan debt as a percentage of GDP
	Interest-to-revenue ratio	Interest expenditure divided by total revenue
	Primary budget balance	Primary balance as a percentage of GDP
External vulnerabilities partition		
Global financial cycle	US financial conditions index	Federal Reserve Board and/or Chicago Fed indices
Real effective exchange rate (REER)	REER	Real effective exchange rate of the rand: average for the period against 20 trading partners (trade in manufactured goods)
Capital flows	Net portfolio purchases by non-resident investors	Total net purchases of shares and bonds (repo and outright) by non-residents on the JSE

Annexure B: Banking and insurance sector indicators

Table B.1: Banking sector indicators*

	2020	2021	2022	2023	2024***
Market share in terms of assets (five largest banks)	89.99	89.85	89.55	89.69	89.55
Gini concentration index	83.11	82.50	81.88	80.89	79.65
Herfindahl-Hirschman Index (H-index)	0.176	0.178	0.179	0.179	0.180
Total assets (R billions)	6 457.3	6 562.3	7 019.7	7 488.7	7 762.8
- Year-on-year percentage change	11.93	1.74	6.96	6.75	4.24
Total loans and advances (R billions)	4 542.5	4 643.1	4 984.0	5 348.9	5 562.7
- Year-on-year percentage change	6.90	2.20	7.30	7.40	4.50
Total capital adequacy ratio	16.21	17.49	17.68	17.36	17.21
Tier 1 capital adequacy ratio	13.14	14.47	14.96	15.01	14.99
Common equity tier 1 capital adequacy ratio	12.33	13.30	13.63	13.43	13.31
Impaired advances (R billions)**	211.9	229.2	226.7	276.8	300.0
Impaired advances to gross loans and advances	4.7 0	4.9 0	4.5 0	5.20	5.40
Specific credit impairments (R billions)	92.2	105.5	109.7	127.2	139.4
Specific credit impairments to impaired advances	43.56	46.07	48.45	45.97	46.46
Specific credit impairments to gross loans and advances	2.03	2.27	2.20	2.38	2.51
Return on assets (smoothed)	0.79	0.81	1.12	1.11	1.11
Return on equity (smoothed)	10.22	10.62	14.26	14.84	14.94
Interest margin to gross income (smoothed)	58.17	58.65	58.77	60.08	60.67
Operating expenses to gross income (smoothed)	58.26	58.73	58.08	56.59	56.97
Liquid assets to total assets (liquid asset ratio)	12.2	13.3	14.0	15.0	14.9
Liquid assets to short-term liabilities	24.1	24.1	25.2	27.4	27.3
Liquidity coverage ratio	142.2	144.1	145.4	150.6	147.0

* Updated as at 29 October 2024. All data are averaged for the year shown. Data are in percentages unless stated otherwise.
** 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.

*** 2024 is year to date (to August 2024).

Source: PA

Table B.2: Insurance sector indicators

	2020	2021	2022	2023	2024 Q2
Market share in terms of assets (five largest life insurers)	73	73	74	72	72
Market share in terms of gross written premiums (five largest non-life insurers)	47	50	49	48	49
Balance sheet					
Total assets: life insurers (R millions)	3 254 815	3 724 257	3 705 455	4 115 321	4 297 942
Total assets: non-life insurers (R millions)	239 132	260 616	290 127	308 317	319 668
Total liabilities: life insurers (R millions)	2 909 562	3 343 586	3 353 525	3 734 322	3 913 375
Total liabilities: non-life insurers (R millions)	141 422	178 516	170 057	172 212	178 045
Profitability					
Gross written premiums: life insurers (R millions)	564 327	620 821	631 629	673 360	179 250
Net profit before tax and dividends: life insurers (R millions)	11 766	48 731	19 848	25 488	17 425
Individual lapse ratio: life insurers	66.0	77.0	76.2	63.9	62.5
Gross written premiums: non-life insurers (R millions)	158 632	169 846	181 916	209 132	165 559
Combined ratio: non-life insurers (%)	113.0	119.0	98.0	100.6	98.5
Operating profit ratio: non-life insurers (%)	16.0	-14.4	14.0	27.0	21.0
Solvency and capital*					
Solvency capital requirement cover ratio (median): life insurers	1.9	1.7	1.7	1.9	1.8
Minimum capital requirement cover ratio (median): life insurers	4.3	4.2	4.7	4.9	5.0
Solvency capital requirement cover ratio (median): non-life insurers	1.9	1.8	1.5	1.7	1.7
Minimum capital requirement cover ratio (median): non-life insurers	4.4	3.8	3.7	4.3	3.9

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

Source: PA

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