Purpose of the Financial Stability Review

The primary objective of the South African Reserve Bank (the Bank) is to protect the value of the currency in the interest of balanced and sustainable economic growth in South Africa.

In addition to this, the Bank’s role and mandate in overseeing and maintaining financial stability was reaffirmed by government in a letter from the Minister of Finance addressed to the Governor dated 16 February 2010. In pursuit of this objective and to promote a stable financial system, the Bank publishes a semi-annual Financial Stability Review. The publication aims to identify and analyse potential risks to financial system stability, communicate such assessments and stimulate debate on pertinent issues. The Bank recognises that it is not the sole custodian of financial system stability, but that it contributes significantly towards and co-ordinates a larger effort involving government, other regulators, self-regulatory agencies and financial market participants.

Defining financial stability

Financial stability is not an end in itself but, like price stability, is generally regarded as an important precondition for sustainable economic growth, development and employment creation.

Financial stability refers to a financial system that is resilient to systemic shocks, facilitates efficient financial intermediation and minimises the macroeconomic costs of disruptions in such a way that confidence in the system is maintained.
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Foreword by the Deputy Governor responsible for financial stability

The South African Reserve Bank (the Bank) has been publishing a semi-annual Financial Stability Review since 2004 with the aim of promoting a better understanding and awareness of financial stability issues in South Africa. This year is the tenth anniversary of the first publication of the Financial Stability Review.

In addition to its primary objective of price stability, the Bank also oversees and maintains financial stability. In pursuit of the broader mandate of the Bank and in an effort to contain systemic risk, the Bank continually assesses the stability and efficiency of the key components of the financial system and formulates policies to contribute toward financial stability and crisis resolution. Through the publication of its Financial Stability Review, the Bank endeavours to communicate its assessment of potential risks to financial system stability and the mitigation thereof. The Bank also hopes to enhance the understanding of, and encourage informed debate on, these complex and challenging matters related to financial stability.

South Africa is in the process of reforming its financial sector regulatory architecture by implementing a twin peaks model of financial regulation. Under this approach, supervisory roles will be divided between the Bank and the Market Conduct Authority. The Financial Sector Regulation Bill of 2013 gives primary responsibility to the Bank for promoting financial stability. The Bank will be responsible for the prudential supervision of banks, insurers, financial conglomerates and financial market infrastructures (FMIs) through a Prudential Authority. The Financial Services Board will become the Market Conduct Authority and will be responsible for consumer protection through its market-conduct supervision.

The Bank transformed its Financial Stability Unit into a fully fledged Financial Stability Department with effect from 1 April 2014, and elevated the status of the Financial Stability Committee which has been in existence since 2000. The Financial Stability Review is currently being revamped in line with the expanded mandate of the Bank and best practice globally. The revamped publication will report in more detail on various issues including financial stability policy decisions once the new architecture is in place. The Financial Stability Department is in the process of developing a toolkit of macroprudential policy instruments in addition to further refining its monitoring framework for financial stability, developing a top-down stress-testing framework and preparing policy proposals for the development of a resolution framework for the systemically important financial institutions and markets in South Africa. The definition of financial stability has also been refined and is included in this edition of the Financial Stability Review.

This edition of the Financial Stability Review covers the six-month period ending June 2014, but also takes into account some events up to the point of publication. It consists of three main sections. The first section provides a reassessment of financial stability risks that were identified as potential risks in the March 2014 edition of the Financial Stability Review. In the second section, the main financial stability developments and trends over the period under review are analysed from a global and domestic perspective. The final section provides a review of the developments in the domestic and international financial and regulatory environment.

The South African financial system continues to be resilient in the wake of a volatile and uncertain global environment and some domestic socioeconomic concerns. Although the current conjuncture is uncertain and several challenges remain, the financial system is sound.
I trust that you will find this publication interesting, stimulating and relevant to the current environment, and I invite you to provide comments as part of the important process of ongoing debate on financial stability.

Francois Groepe  
Deputy Governor  
South African Reserve Bank  
September 2014
Executive summary

The South African banking sector remained sound with adequate levels of capital well above the minimum regulatory requirement, increased levels of high-quality liquid assets, good asset quality and profitability that compares favourably with other jurisdictions. This was despite a deteriorating domestic economic growth outlook and the first significant bank resolution in almost a decade when African Bank Limited was placed under curatorship in August 2014. The Bank managed the resolution of African Bank Limited in a speedily and decisive manner, limiting any potential contagion to the rest of the banking sector. As part of this process the Bank put in place a package of measures based on the Key attributes of effective resolution regimes of the Financial Stability Board (FSB), enabling the institution to continue operating. Although some spillovers did occur to bond markets, money-market funds and pension funds, the proposed resolution ensured that potential systemic risk was contained. Contagion to other less regulated parts of the financial system occurred mainly as a result of the wholesale nature of African Bank Limited’s funding model. Co-ordinated interventions by the authorities, regulators and the private sector contained these spillovers and ensured the continued stability of the financial system and the banking sector in particular.

The banking sector is exposed to the household sector directly through households’ capacity to repay consumer and mortgage loans, and indirectly through the effect that household consumption decisions have on the financial strength of the corporate sector. Although household debt, measured as a percentage of disposable income, has been improving consistently since reaching a peak in the first quarter of 2009 and the ability of households to service their debt has remained strong given an extended period of low interest rates, the household sector is now facing a rising interest rate cycle and higher cost of living. Despite the fact that household wealth has increased strongly, mainly as a result of a significant increase in the valuations of financial assets, the financial vulnerability of consumers remains significant.

Asset prices are important elements to consider in the assessment of possible vulnerabilities in the financial system. A sudden fall in asset prices could expose vulnerabilities, especially where asset markets are supported by high leverage and assets are widely held. According to analyses, on the one hand house prices in South Africa are fairly valued at present and do not present any risks to financial stability. Equity market valuations in South Africa, on the other hand, are currently at fairly elevated levels although this is not attributable to leverage. A sudden and sharp correction in equity markets could expose vulnerabilities that could have certain significant indirect effects on the financial system.

Globally, non-bank financial intermediation, or shadow banking, has become an important part of financial systems as it provides an alternative way for borrowers to gain access to credit and other financial services in support of economic activity. However, a large and growing non-bank financial sector could also pose potential systemic risks to the financial system as it might not be regulated as prudently as the banking sector and may incentivise regulatory arbitrage. Shadow banking, broadly defined as credit intermediation outside the conventional banking system, constitutes about one quarter of total financial intermediation worldwide. Since 2011, the official financial sector (through the FSB) has been engaged in a global project to monitor and measure shadow banking, and to adapt the regulatory framework to better address shadow-banking risks. South Africa has been participating in the FSB’s monitoring exercise since 2012, improving on the estimates of the size of ‘other financial intermediaries’ (OFIs), a proxy for shadow banking. Results show that OFIs’ share of financial assets of all financial intermediaries increased to 18 per cent in 2013, from 13 per cent in 2008. Non-bank financial intermediaries currently provide about 11 per cent of total credit extension in the South African financial system.
Although global economic activity rebounded in the second quarter of 2014, the recovery remained fragile and uneven, with stronger growth in the United States (US) and the United Kingdom (UK) contrasting with continuing weakness in the euro area and a further loss of momentum in some major emerging-market economies (EMEs). While leading indicators are pointing to the global recovery gaining strength in the second half of 2014, some constraints from both the fiscal and the monetary sides, as well as slow progress with structural reforms in some instances remain a risk to a sustainable global recovery. A prominent exogenous risk to domestic financial stability is the effect that monetary policy normalisation in advanced economies and the US in particular could have on EMEs, including South Africa. It is evident from the reaction in financial markets following the announcement by the US Federal Reserve (Fed) in May 2013 of its intention to start tapering asset purchases, that changing the expectations of an upward adjustment of the Fed policy rate could unsettle markets globally, and South Africa remains vulnerable to such a tightening in external financial conditions. Although normalisation has been discounted to an extent and forward guidance allows markets to anticipate policy moves better, the timing and magnitude of interest rate increases and their effects on capital flows and financial markets remain uncertain.

Global geopolitical risks have multiplied during 2014 and although financial markets have not been severely impacted by the events in Ukraine, the Middle East or Hong Kong, the combined effect of turmoil in these regions and the potential for spillovers to other regions remains a concern. Although the currency, equity and bond markets in countries such as Russia, Iraq and, more recently, China, specifically Hong Kong, have been negatively affected, more generalised contagion to global financial markets has been contained. The risk, however, remains that the developments in Russia, Hong Kong and the Middle East, together with news of weakening economic activity in the euro area and China, could trigger turmoil in financial markets.
Financial stability risk assessment

Financial stability risk review

In the March 2014 Financial Stability Review, global and domestic risks to the South African financial system that constituted possible causes for concern in 2014 were identified. As noted at the time, the Bank’s initial selection of risks was determined by estimating both the probability of a particular risk materialising during 2014 and the impact that it might have on the domestic financial system. The risks are continually monitored as they evolve, and this edition of the Financial Stability Review provides an update of the status of these risks.

Each risk identified was reassessed to determine whether the threat it poses to domestic financial stability has increased or decreased since March 2014. The reassessment of the risks resulted in a new set of ratings, shown in Figure 1.

During the period under review, focus shifted from the impact of quantitative easing (QE) tapering in the US to the effect that potentially higher interest rates in both the US and other advanced economies could have on EMEs in general and on South Africa in particular. It is evident from the reaction in financial markets following the announcement by the Fed in May 2013 of its intention to start tapering asset purchases, that expectations of an upward adjustment of the Fed policy rate could unsettle markets globally and influence global capital flows to the extent that such an adjustment has not already been fully discounted. The repricing is expected to be less abrupt than what was experienced with the announcement of QE tapering in May 2013 and with the implementation thereof in January 2014. Better communication by the Fed and the success of the forward-guidance approach allow markets to anticipate policy moves better.

The risks posed by an increase in the cost of living for South Africans, as measured by the headline consumer price index (CPI), brought about by higher fuel prices, increased electricity costs and higher interest rates, has increased somewhat recently and remained substantial. The full decrease in international oil prices did not translate into significantly lower domestic fuel prices due to the depreciation in the rand exchange rate. Coupled with higher interest rates, increased unemployment and already high debt levels, households’ financial positions have deteriorated further since March 2014. Despite a slight improvement in consumer confidence, it would appear that consumers’ incomes have moved close to the ‘very exposed’ category (see page 28).

The risks associated with the widespread granting of relatively expensive unsecured lending facilities by both bank and non-bank financial institutions remained present. While unsecured lending is an important source of funding for many households and companies, it remains a risk to lenders and needs proper management. The Bank is of the view that this risk has diminished somewhat with the continued moderation in the growth rate of unsecured lending against a backdrop of generally tighter lending standards.
Unemployment in South Africa remains a concern. Since the previous assessment in March 2014, the unemployment rate increased further to 25.5 per cent in the second quarter of 2014 while youth unemployment remains high at 51.8 per cent (discussed on page 11). High unemployment could fuel further social unrest and spill over into the banking sector through higher defaults on loans.

The current-account deficit poses a marked risk to the stability of the domestic financial system as its financing is heavily reliant on foreign capital inflows. The deficit widened even further in the second quarter as the effects of the prolonged strikes were felt. Declining commodity prices (discussed on page 15) also severely dented South Africa’s export earnings. Even though South Africa’s available reserves to cover imports remained adequate (discussed on page 32), the potential risk associated with financing the current-account deficit has intensified since March 2014. Furthermore, the moderation in portfolio flows to emerging markets in general could make the financing of the current-account deficit more expensive.1

Projected weaker economic growth, coupled with vulnerabilities related to South Africa’s current-account and fiscal deficits have increased the risk of the country’s sovereign credit rating being downgraded. A downgrade of South Africa’s sovereign credit rating is likely to constrain access to funding and raise the cost of borrowing. The specific rating of a sovereign also influences the ratings of corporates and therefore their cost of funding.

The Bank revised downwards the domestic economic growth outlook for 2014, 2015 and 2016 again at its most recent Monetary Policy Committee (MPC) meeting in September 2014. Various structural issues, including electricity-supply constraints and unemployment conditions, weigh on economic growth prospects. Continued weak growth in the euro area, China and other trading partners of South Africa also impacts negatively on domestic growth prospects.

Labour disputes seem to have diminished somewhat following the end of the strike in the platinum-mining industry, one of the longest strikes in South Africa’s history. This was followed by a metalworkers strike. The devastating impact of these strikes will probably be felt for some time to come, both by the affected households and by the economy at large.

As a result of these strikes, real output of the mining sector shrank in both the first and the second quarters of 2014.2 Accordingly, due to the forward and backward linkages of the mining sector, real value added by, and utilisation of capacity in, the manufacturing sector also declined in the second quarter of the year. Continued poor performance by the mining sector could exacerbate the already high unemployment rate in South Africa.

Apart from the aforementioned risks, there are a number of additional domestic and global risks that could have an impact on the stability of both the South African and global financial systems:

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1 See the September 2014 Quarterly Bulletin of the South African Reserve Bank, p. 34.
2 See the September 2014 Quarterly Bulletin of the South African Reserve Bank.
– The generally low levels of interest rates and low volatility have resulted in an increased risk appetite and a search for yield, which has gathered pace as observed in the narrowing of credit spreads. Investors have invested in high-risk, high-yield instruments despite a lacklustre macroeconomic backdrop. Accordingly, there is a concern that risks in financial markets might be underpriced. If investors change their perception, this could lead to a significant correction in asset prices.

– There were several geopolitical developments in countries like Libya, Iraq, Nigeria and Ukraine during the period under review. Tensions and violence are also continuing between Russia and Ukraine. Additional sanctions have been placed on Russia by the West, including the US, the European Union (EU) and Australia, for supporting pro-Russian separatists in eastern Ukraine. These sanctions were the first to target Russia’s economic sectors, and include Russia’s energy, banking and defence sectors. If these sanctions continue for an extended period of time or expand further, it could impact on the uneven global economic recovery. Geopolitical events could have devastating effects on global financial markets through increased uncertainty and excessive volatility.

– The outbreak of the Ebola virus in West Africa is a serious concern as, according to the World Health Organization, over 9,000 confirmed, probable, and suspected cases and over 4,500 deaths have been reported in the year to 14 October 2014. Since Ebola has no known treatment that has been proven to control or cure it, governments are forced to rely on a traditional public health method, namely the isolation of cases. Several governments have declared states of emergency in order to restrict people’s movements from affected areas and limit new infections. This has included the closing of borders as well as bans on large gatherings such as markets and schools. The outbreak of this virus is already having a negative impact on the economies of Guinea, Liberia and Sierra Leone through higher food prices, increased food shortages (as a result of decreased agricultural production) and decreased tourism. South Africa may also be affected by the decline in tourism as roughly 72 per cent of non-residents who visited the country between 2010 and 2013 originated from Africa.

**Macroprudential regulation: Assessing the application of the countercyclical capital buffer**

To comply with the Basel III framework, the countercyclical capital buffer (CCB) was designed to take into account the macrofinancial environment in which banks operate. The methodology suggests that imposing the CCB should be considered for banks if the private-sector credit-to-GDP ratio is above its long-term trend. The private-sector credit-to-GDP gap is presented in Figure 2.

After generally decreasing since the onset of the recent global financial crisis, a tentative increase in the private-sector credit-to-GDP gap was recorded in the first half of 2014 due to lower economic growth. However, the credit-

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4 Calculations were done using data from 1965 onwards.
to-GDP gap remains well below its long-term average, suggesting that there is currently no need to consider a CCB add-on for South African banks.5

During the period under review, credit extended in the various loan categories continued to exhibit different and even diverging trends (see Figure 3). Other loans and advances as well as the instalment sale credit categories had positive credit-to-GDP gaps. After remaining relatively constant for most of 2013, the credit-to-GDP gap of other loans and advances increased during the first half of 2014, mainly as a result of increases in the revolving credit category.

The credit-to-GDP gaps of mortgage advances, investments and leasing finance remained below their respective long-term trends. The credit-to-GDP gap for mortgage advances has been declining since 2008 and levelled off somewhat in early 2014, while the credit-to-GDP gaps of investments and leasing finance remained relatively constant during the period under review.

The Bank has not yet considered the application of the CCB on specific loan categories.

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5 Instruments for macroprudential policy purposes should not be applied mechanistically, but should be subject to judgement.
Financial stability developments and trends

Economic growth and outlook

Global economic growth moderated more than expected in the first quarter of 2014, mainly due to disappointing growth rates in the US and several EMEs, especially China. Even though global activity rebounded in the second quarter of 2014, the recovery remained fragile and uneven, with stronger growth in the US and the UK contrasting with continuing weakness in the euro area, a sharp slowdown in Japan and a further loss of momentum in some major EMEs. Subsequently, in October 2014, the International Monetary Fund (IMF) revised its global economic growth forecast for 2014 downwards to 3.3 per cent.

The optimistic outlook of several advanced economies continues to diverge from the more subdued growth outlook for EMEs amid persistent concerns over country-specific weaknesses. The US economy rebounded strongly in the second quarter of 2014 from its weak performance in the first quarter, growing at a rate of 4.2 per cent, while the UK economy expanded by 3.3 per cent over the same period. Business activity in the euro area as a whole slowed, with the euro area Purchasing Managers’ Index (PMI) falling to a one-year low in August 2014. Similarly, the PMIs of China and India fell in August 2014, with the PMI of Brazil hovering around the 50-point level for the past 12 months.

Leading indicators point to the global recovery regaining moderate strength in the second half of 2014, with the global composite indicator remaining above 50 points throughout the period under review (see Figure 4). Expectations of accelerated global economic growth in the second half of 2014 are underpinned by policy support and the lagged impact of easier financial conditions.

However, some policy constraints from both the fiscal and the monetary sides remain a risk to a sustainable global recovery, and with several governments’ debt-to-GDP ratios having risen further since the global financial crisis (see Figure 5), there are concerns that they might have reached unsustainably high levels. The high debt-to-GDP ratios of most of the countries that were at the centre of the global financial crisis and the subsequent euro area sovereign debt crisis is an area of vulnerability, given the strain on fiscal policy. Without effective fiscal and monetary policy support and in the absence of structural reforms, low levels of global economic growth could be prolonged even further. Lower economic growth in the euro area, a trading partner of South Africa, could have a negative impact on South Africa.

According to the IMF, growth in sub-Saharan Africa is projected to remain strong at 5.1 per cent in 2014, largely due to strong growth in both public and private investment and strong private consumption expenditure,

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6 See International Monetary Fund, World Economic Outlook, Washington DC: International Monetary Fund, October 2014.

7 According to the Bank for International Settlements’ (BIS) 84th Annual Report released in August 2014, the combined public-sector debt of G-7 economies has ballooned by close to 40 percentage points to 120 per cent of GDP in the post-crisis period. The report is available at: http://www.bis.org/publ/arpdf/ar2014e.pdf.
particularly from low-income countries. Economic growth in the region is underpinned by infrastructure, energy and mining investments.

Given the increased number of countries in sub-Saharan Africa issuing Eurobonds (which are mostly used to fund investment activities), future economic growth in the region could be driven by large investments in infrastructure. Countries such as Ghana, Zambia, Nigeria, Kenya, Senegal and Rwanda have issued Eurobonds (see Figure 6), with Kenya’s recent bond issue being the largest debut for an African country in the sovereign bond market. While increased access to international financial markets allows many of these countries to access larger sums of money than could be attained through aid or domestic savings, it also exposes these countries to additional risks. Eurobonds have increased the debt levels of many sub-Saharan Africa countries while simultaneously integrating them into the global financial system, making them more vulnerable to external shocks. If the projected economic growth for many of these countries is not realised, it could make debt servicing more challenging. An alternative source of funding for these countries could be the newly created New Development Bank (NDB) established by Brazil, Russia, India, China and South Africa (the BRICS countries). The NDB could contribute towards improved access to funding for infrastructure investment and could potentially address some development challenges faced by many of these countries.

Economic growth in sub-Saharan Africa is, however, subject to downside risks, with a significant risk coming from the outbreak and spread of the Ebola virus which may negatively impact the economies of the countries affected if not contained. The virus has caused more than 4 500 deaths up to 14 October 2014 and has started to affect tourism and air travel in the region. While the outbreak of the virus is currently largely confined to West Africa, sub-Saharan Africa, including South Africa, has already been affected as many tourists have cancelled or delayed their trips to the region. Other risks to economic growth in sub-Saharan Africa include tighter global financial conditions, lower commodity prices, weakening fiscal positions and increased geopolitical tensions in some regions.

Similar to several other EMEs, South Africa experienced disappointing GDP growth in the first quarter of 2014 and recorded only slightly improved growth of 0,6 per cent, quarter-on-quarter annualised and seasonally adjusted, in the second quarter. The main drivers of economic activity in the second quarter were general government services and the transport, storage and communication industries. Due to an increase in banking activities during the second quarter of 2014, the finance, real-estate and business services industries also made a noteworthy positive contribution to South Africa’s economic growth. The collective contribution of 1,0 percentage point to GDP from these three sectors outweighed the negative contribution by the mining and quarrying as well as manufacturing industries.

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8 International Monetary Fund, World Economic Outlook, Washington DC: International Monetary Fund, October 2014.
9 Note that funding will initially only be available to BRICS countries, but in the long term it is envisaged that funding could be made available to other member countries that have a shareholding in the NDB.
The Bank has revised downwards the domestic growth outlook for 2014, from 2.8 per cent in January 2014 to 1.5 per cent in September 2014. The most recent BankservAfrica Economic Transaction Index (BETI),\textsuperscript{11} which correlates with the Bank’s coincident business cycle indicator, recorded a 1.4 per cent year-on-year decline in July 2014. This is the largest decline since February 2010 and suggests weak economic growth for the third quarter of 2014. The Bank’s growth forecasts for 2015 and 2016 were also revised downwards in September 2014, to 2.8 per cent and 3.1 per cent respectively.

Short-term indicators of future economic growth paint a rather bleak picture, with mostly negative growth recorded during the first half of 2014 (see Table 1). Building plans passed recorded mixed results, ending with relatively high growth in June 2014, while buildings completed recorded mostly negative annual growth rates and indicated a significant decline for the same month. Retail and wholesale trade sales were the only activities that recorded positive growth for the whole period under review, although a weakening trend can be observed. Growth in new vehicle sales and new passenger car sales remained negative throughout the period, with both recording their biggest decline in May 2014. Electric current generated also declined for most of the first two quarters, with the biggest decline observed in June 2014.

Table 1  

Selected indicators of real economic activity\textsuperscript{1}

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<tr>
<td>Building plans passed</td>
<td>2.99</td>
<td>1.33</td>
<td>-4.05</td>
<td>6.57</td>
<td>-3.78</td>
<td>-1.95</td>
<td>15.48</td>
</tr>
<tr>
<td>Retail sales</td>
<td>4.06</td>
<td>5.51</td>
<td>2.34</td>
<td>1.47</td>
<td>1.96</td>
<td>1.45</td>
<td>1.26</td>
</tr>
<tr>
<td>Wholesale trade sales</td>
<td>5.86</td>
<td>7.87</td>
<td>6.51</td>
<td>3.26</td>
<td>3.96</td>
<td>0.47</td>
<td>2.26</td>
</tr>
<tr>
<td>New vehicle sales</td>
<td>-2.10</td>
<td>-4.66</td>
<td>-3.54</td>
<td>-7.66</td>
<td>-2.90</td>
<td>-9.57</td>
<td>-2.95</td>
</tr>
<tr>
<td>New passenger car sales</td>
<td>-2.95</td>
<td>-5.68</td>
<td>-5.92</td>
<td>-9.57</td>
<td>-2.82</td>
<td>-11.24</td>
<td>-6.08</td>
</tr>
<tr>
<td>Electric current generated</td>
<td>-1.71</td>
<td>1.23</td>
<td>-0.51</td>
<td>-0.30</td>
<td>-1.60</td>
<td>-1.01</td>
<td>-3.12</td>
</tr>
<tr>
<td>Utilisation of production capacity\textsuperscript{2}</td>
<td>82.50</td>
<td>...</td>
<td>...</td>
<td>82.10</td>
<td>...</td>
<td>...</td>
<td>80.60</td>
</tr>
</tbody>
</table>

\textsuperscript{1} At constant prices, seasonally adjusted  
\textsuperscript{2} Quarterly indicator, per cent  
\textsuperscript{3} Denotes unavailability of data  
Sources: Statistics South Africa. Data on new vehicle and new passenger car sales were obtained from the National Association of Automobile Manufacturers of South Africa

Unemployment

Even though unemployment continued to decrease in most major economies in the first half of 2014, the unemployment rate in South Africa increased and remained a prominent concern (see Figure 7). The unemployment rate increased to 25.5 per cent (5.15 million people) in the second quarter of 2014, up from 25.2 per cent in the first quarter. Youth unemployment remained high at 51.8 per cent even though it fell somewhat from the first to the second

\textsuperscript{11} BankservAfrica, BETI, Johannesburg: BankServAfrica, 13 August 2014. The BETI is designed as an early economic scorecard which will give an overall trend in economic activity in the near term.
quarter. This means that more than half of the South African labour force aged between 18 and 24 remained unemployed in the second quarter of 2014.

For South Africa, the weak economic growth outlook does not bode well for the state of unemployment in the country and it remains a rather significant economic challenge that could adversely affect financial stability.

Financial market developments and trends

Price movements in global financial markets during the period under review were largely a function of central bank policy actions and geopolitical risks. Demand for risky assets increased and volatility declined to record-low levels across the different markets (see Figure 9) as market participants took comfort in central bank forward guidance.

Since the onset of the global financial crisis, central banks’ balance sheets (especially in the major advanced economies) have expanded significantly in an attempt to support economic growth (see Figure 8). In combination with the expansion in balance sheets, policy rates have also been lowered and kept at near-zero levels. Much of the buoyancy in the financial markets and the search for yield during this time can be attributed to excess liquidity being available as a result of the accommodative monetary policy actions of central banks in advanced economies.

Continued accommodative monetary policy during the period under review sustained the bullish momentum in equities and high-yield bonds, pushing valuations in these markets either close to or into overvalued territory. The low-volatility conditions, usually indicative of low perceived price risk, persisted despite intermittent periods of heightened geopolitical risks and other macroeconomic financial developments that presented downside risks to financial asset prices. With the most recent rise in geopolitical risks, volatility increased but was still low by historical standards.

The low levels of volatility, if sustained over protracted periods, may incentivise the mispricing of risk and possibly result in disorderly price corrections, thus increasing risks to financial stability. For example, bond market volatility remains low even with declining secondary market liquidity and increasing valuations. A combination of these conditions and an unexpected adjustment in US monetary policy could result in a sell-off in bond markets, especially in light of the sharp increase in bond yields in 2013 which indicated how uncertainty about, and misinterpretation of, the future course of monetary policy can destabilise markets. A similar condition can be observed in equity markets and a correction in equity prices in August 2014 is an indication of what could transpire if market sentiment changes quickly and adversely.

There is arguably already evidence of a build-up of such imbalances in the domestic equity market (see Figure 10). A comparison of domestic equity price valuations and equity market volatility already points to potentially complacent behaviour among investors.
Extreme valuations could lead to wealth increases, and given the exposure of domestic pension funds to equities, a disorderly or sharp increase in volatility could be potentially disruptive and cause a significant decrease in valuations. Table 2 shows how the JSE All-share Index (Alsi), domestic bond yields and the South African rand have, in the past, coincided with sharp increases in volatility.

Table 2 Reaction to changes in volatility

<table>
<thead>
<tr>
<th>Indicators</th>
<th>∆ volatility = 1-2 standard deviations</th>
<th>∆ volatility &gt; 2 standard deviations</th>
<th>Largest ∆ volatility; largest ∆ asset price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ten-year yield</td>
<td>18 bps</td>
<td>43 bps</td>
<td>10%; 33bps</td>
</tr>
<tr>
<td>South African rand</td>
<td>3%</td>
<td>9%</td>
<td>16%; 9%</td>
</tr>
<tr>
<td>Alsi</td>
<td>5%</td>
<td>7%</td>
<td>10%; 6%</td>
</tr>
</tbody>
</table>

Note: Asset price changes are given in absolute value terms and are based on daily changes in volatility. Price reaction to volatility does not take into account the prevailing macroeconomic or financial backdrop and may therefore under- or overstate the outcome.

Sources: Bloomberg Finance LP and South African Reserve Bank computations

Using data on implied and historical volatility of up to ten years, exaggerated movements in bond-market, foreign exchange market and equity-market volatility have been accompanied and driven by changes of up to 43 basis points in the domestic ten-year bond yield, 9 per cent in the rand and 7 per cent in the Alsi respectively.

Bond markets

Another important trend characterising developments in global financial markets during the period under review was the divergence in monetary policy among the major markets. While the Fed and the Bank of England (BoE) are set to tighten monetary policy, the Bank of Japan (BoJ) and the European Central Bank (ECB) are expected to maintain their accommodative monetary policy stance or even loosen the monetary policy stance further in the case of the ECB. As a consequence, short-dated US and UK government bonds (which tend to be more sensitive to changes in central bank policy rates) have underperformed compared to their European and Japanese counterparts. In fact, yields on two-year German government bonds declined to below zero while yields on similar-maturity US and UK government bonds have increased by at least 20 basis points since January 2014. In line with expectations of aggressive ECB easing, bond spreads on peripheral government bonds in Europe have declined to pre-euro area debt-crisis levels, raising fears that the compression is exaggerated, especially given that the sustainability of public finances is still questionable.

Changes in interest rate expectations in the advanced economies have filtered through to bond markets of emerging markets, causing a widespread increase in yields on short-dated emerging-market government bonds. Furthermore, recent concerns about intensifying geopolitical risks and position adjustments ahead of the expected tightening of US monetary policy have caused a widening of emerging-market bond spreads. While in some instances the increase in emerging-market bond yields and spreads was due to country-specific factors, the bond market reaction in August and September 2014
indicates that emerging markets are particularly vulnerable to international risk perceptions as there were no fundamental changes in emerging-market macrofinancial conditions that justified those specific movements.

In South Africa, yields on short-dated government bonds have increased by up to 80 basis points while yields on longer-dated bonds have declined. This movement is attributable to the short-term rates being more sensitive to policy changes while long-term rates are more sensitive to structural factors. Consistent with this movement, the domestic yield curve pivoted around the five-year maturities as the short-end yield increased in line with increasing domestic interest rates and interest rate expectations (see Figure 12).

There are, however, risks that may reverse the relatively lower yields at the longer end of the curve, with US policy normalisation probably constituting the single most important factor. Furthermore, and notwithstanding that South Africa is not mainly trading on its own fundamentals, there are domestic factors that may add to the reversal. These include the risks presented by low trading volumes and low volatility, possible switch auctions in light of the R32.1 billion government debt maturing between September and December 2014, and further selling of local bonds by non-resident investors which has concentrated on medium- to long-term debt.

In line with the low-volatility environment and the associated search for yield, domestic corporate bond spreads initially tightened during the period under review. Corporate credit spreads tightened more among banks, in particular bank-subordinated debt, while state-owned enterprises remained under pressure. Corporate bond spreads, however, widened following concerns about the domestic banking sector after African Bank Limited was placed under curatorship on 10 August 2014 (see Box 1). While the sell-off in corporate bonds focused mainly on African Bank Limited, there were visible spillover effects to the wider corporate bond market.

**Currency movements**

The March 2014 issue of the *Financial Stability Review* noted that the South African rand is vulnerable to concerns about US monetary policy normalisation and weakening EME fundamentals. While this was also evident during the current review period, the rand exhibited a large degree of responsiveness to domestic factors. The rand initially depreciated during the opening weeks of 2014, but later appreciated in line with improved market sentiment and further benefited from increased carry trade activity as the low-volatility environment improved the attractiveness of EMEs’ carry trade returns. Gains were, however, limited as new disputes in the domestic labour market surfaced, geopolitical risks intensified, domestic real economic data showed little improvement, and the current-account deficit remained high.

A number of domestic financial assets (including bonds, forward rate agreements, forward swaps and break-even inflation rates) have begun tracking the rand exchange rate more closely in expectation of the pass-through to inflation.
Capital flows

The long-term interest rates in advanced economies remained low and even declined further during the period under review. Furthermore, indicators of expected price volatility also declined while equity prices rose. Against this backdrop, capital flows to EMEs recovered during the period under review despite generally weaker economic activity, benefiting from strong risk appetite (see Figure 13). However, following several months of buoyant inflows, portfolio investments in emerging markets slowed sharply in August but edged up again in September 2014. Going forward, monetary policy decisions in the main advanced economies, including more easing by the ECB and potentially Japan, will remain a key driver of capital flows to EMEs. However, capital flows to EMEs remain vulnerable to a possible escalation of the Ukraine crisis and surprises in the timing, pace and/or magnitude of eventual Fed monetary policy tightening.

Selected commodity price movements

Being a gold and platinum exporter and an oil importer, commodity prices play an important role in South Africa’s economic growth prospects. Following the sharp decline in the prices of precious metals in 2013, prices stabilised in the first half of 2014. The gold price increased by approximately 6.8 per cent in the period January to July 2014. The moderate increase in the gold price in the first quarter of 2014 was due to rising geopolitical tensions in the Middle East and Ukraine. However, this trend has reversed since April 2014 due to a strengthening US dollar and the general slowdown in economic growth of commodity-purchasing EMEs, most notably China. China’s efforts to regulate its shadow-banking system may place further downward pressure on gold prices, given that gold is used as collateral in financing deals. Furthermore, the persistence of more restrictions on gold imports by the Indian government could negatively affect gold prices. China and India together account for more than 70 per cent of the global demand for gold. Similarly, the prices of platinum and iron ore declined in the third quarter of 2014.

Fluctuations in oil prices have been driven mainly by geopolitical concerns and output disruptions in Ukraine, Libya and Iraq on the supply side, and changing developing-country growth prospects on the demand side. Geopolitical risks have re-emerged as a driver of oil prices in the second quarter of 2014, with events in Iraq and Ukraine playing a significant part in the price increases. However, after peaking at US$111 per barrel in late June 2014, prices reversed course and continued to decrease\(^\text{12}\) as production in Iraq was not disrupted as expected. Among other factors, Libya’s announcement of the reopening of its export ports that had been shut for nearly a year, further alleviated price increases.\(^\text{13}\)

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\(^{12}\) The Brent crude oil price dropped to US$97.34 per barrel as at 16 September 2014.

Financial services

Banks and bank-lending conditions

Bank-lending conditions in sub-Saharan Africa eased further in the second quarter of 2014. The demand for consumer and business loans was particularly robust while the demand for, and supply of, trade finance also increased. Moreover, non-performing loans (NPLs) continued to decline during the second quarter of 2014, albeit at a slower pace. According to the Institute of International Finance (IIF), banks in sub-Saharan Africa expect NPLs to continue declining in the third quarter of 2014. Lending conditions in the South African banking system remained relatively tight as South African banks continued to either tighten credit standards or kept standards at prevailing levels. During the second quarter of 2014, 8 per cent of domestic retail banks tightened lending standards and 92 per cent remained unchanged. The tightening bias also continued for investment banking, with 38 per cent of investment banks tightening and 62 per cent keeping credit standards unchanged. In addition, demand conditions also tightened given employment prospects, the relatively high levels of indebtedness and the interest rate cycle.

The South African banking sector remained sound, adequately capitalised and profitable, despite African Bank Limited being placed under curatorship in August 2014. The sector faced a number of real-economy headwinds during 2014, emanating mainly from the increase in unemployment, ongoing labour disputes and relatively high inflation. The banking sector’s total capital-adequacy ratio (CAR) remained well above the regulatory requirement of 10 per cent, although it decreased from 15,6 per cent in December 2013 to 14,6 per cent in June 2014 (see Table 3). This was mainly the result of the gradual phasing out of non-Basel III compliant capital instruments, and partly the result of the losses incurred by African Bank Limited, which was placed under curatorship on 10 August 2014 (see Box 1). The declines in the common equity tier 1 CAR and the tier 1 CAR were for the same reasons. The sector’s profitability decreased marginally over this period, mainly as a result of increases in operating expenses and credit losses. Overall, the sector’s exposure to credit risk, as shown by the ratio of impaired advances to gross loans and advances, decreased. Furthermore, the sector is increasing its holdings of high-quality liquid assets (HQLAs) in anticipation of the phasing in of the liquidity coverage ratio (LCR) from 1 January 2015.

Box 1 The curatorship and resolution of African Bank Limited

In a press release on 10 August 2014, Governor Gill Marcus announced that African Bank Limited had been placed under curatorship with immediate effect. The Minister of Finance, in consultation with the Registrar of Banks, appointed Mr T Winterboer from PricewaterhouseCoopers (PwC) as curator of African Bank Limited in terms of section 69 of the Banks Act 94 of 1990 (the Banks Act). At the time of the curatorship, African Bank Limited’s total assets amounted to R58 billion, which constituted 1,44 per cent of the total assets of the banking sector.

Curatorship became necessary after shareholders and funders lost confidence in African Bank Limited and to prevent contagion to the rest of the system. The curator was tasked with ensuring the successful execution of the resolution plan announced as part of the curatorship. The resolution package essentially entails the separation of

15 Bureau for Economic Research and EY.
16 Refer to the March 2013 and March 2014 editions of the Financial Stability Review for further information on the LCR in South Africa.
the performing assets from the non-performing assets, in other words, a good assets and bad assets split. This means that the performing loans and other assets of African Bank Limited will be transferred to a new entity, the so-called ‘good bank’. It is important to note that the non-performing loans will not be transferred to the new ‘good bank’ but will remain in African Bank Limited, with the South African Reserve Bank (the Bank) assuming responsibility for the ‘bad book’. In addition, a new bank holding company will be established as a parent to the ‘good bank’, which will be capitalised with share capital of R10 billion underwritten by a consortium of banks and the Public Investment Corporation (PIC). Current shareholders will be offered the opportunity to participate in the new ‘good bank’ in due course, following the completion of regulatory processes and consultation with stakeholders.

The problems at African Bank Limited arose due to a significant deterioration of the confidence of shareholders and wholesale funders in the bank’s ability to generate earnings that could sustain future business growth and provide the necessary return on investments. At three consecutive reporting periods, African Bank Limited surprised the market by posting significant losses as a result of raising provisions against non-performing loans. The most significant were the credit losses reported for the September 2013 year-end, amounting to approximately R9 billion, inclusive of prior-year adjustments. The aforementioned losses resulted in African Bank Investments Limited (ABIL), the holding company of African Bank Limited, having to raise capital through a rights issue amounting to R5,5 billion in December 2013. Confidence in the bank and in the group was temporarily restored by the rights issues which culminated in the capital adequacy ratio, after the rights issue, exceeding the required level.

However, the market was surprised again when ABIL announced that its interim results for March 2014 would record losses of R3,1 billion due mainly to an increase in general provisions of R2,5 billion. The losses reported had a negative impact on its share price, reflecting the negative investor and funder sentiment that severely affected the confidence of the market in both ABIL and African Bank Limited and their ability to raise funding through the capital markets, both domestically and internationally. The situation was aggravated by Moody’s Investors Service announcing in May 2014 that African Bank Limited’s national and international credit-rating scale was being downgraded by one notch. More losses followed, and on 6 August 2014 African Bank Limited and ABIL released their third-quarter results, reporting additional and projected losses, most notably R3 billion related to additional credit impairments as a result of a special review performed by PwC on the bank’s provisioning policy. This was found to be less conservative compared to other banks’ unsecured lending portfolios. It was reported in the third-quarter results that the expected headline loss for September 2014 would be R6,4 billion.

As indicated in the curatorship announcement by Governor Marcus, African Bank Limited continues to be open for business. The bank still advances loans, although now based on a reduced risk appetite and stricter lending criteria. Collections of outstanding debt have continued as expected, with no significant deviations from expectations. An unequivocal guarantee was provided to retail depositors, and no ‘run’ on retail deposits after the curatorship announcement was observed. The 5 000 employees at African Bank Limited remain at the bank, with no immediate plans of retrenchments. In addition, the Bank Supervision Department (BSD) of the Bank has not seen any sign of contagion on the funding markets, for either retail or wholesale deposits, to other individual banks or to the banking system as a whole. Since the curatorship announcement, the curator has been providing the Registrar of Banks and the Minister of Finance with weekly reports in respect of the progress being made in the execution of the resolution plan for African Bank Limited.

The Bank has instituted a formal independent investigation into the circumstances that gave rise to African Bank Limited being placed under curatorship. The Registrar of Banks has, pursuant to this decision, appointed Advocate J F Myburgh as Commissioner to investigate the business, trade, dealings, affairs and liabilities of African Bank Limited and submit a report within a period of five months.

The Bank managed the resolution of African Bank Limited by putting in place a package of measures in line with the Key attributes of effective resolution regimes of the FSB. These measures were aimed at enabling the institution to continue operating and to deal with any contagion effects to the rest of the banking sector and the financial system in general. Although the intervention of the Bank managed to avoid systemic risk materialising
and there were no significant adverse effects on the rest of the banking sector (despite a downgrade by one of the rating agencies), the broader financial markets or the economy, some spillovers did occur, especially to bond markets, money-market funds and pension funds.

African Bank Limited is primarily funded by wholesale creditors. As part of the resolution process, senior debt instrument holders and wholesale depositors were given the option to be transferred to the new so-called ‘good bank’ at 90 per cent of face value, while ordinary shareholders and subordinated debt holders were afforded the opportunity to participate in the capital raising of the ‘good bank’. Contagion of distress from African Bank Limited to other parts of the financial system (such as institutional investors) was always a possibility given its funding model. Concerns were expressed following the curatorship regarding the exposure of money-market funds and pension funds to African Bank Limited debt instruments. The Registrar of Collective Investment Schemes confirmed that the assets of 43 money-market funds active in South Africa were valued at R270 billion, of which 1.3 per cent was exposed to African Bank Limited.

Money-market fund managers offset the write-downs on African Bank Investments Limited (ABIL), the holding company of African Bank Limited, debt securities against the interest payments to investors. Generally, money-market fund managers indicated that they had sufficient interest to offset the 10 per cent depreciation and did not ‘break the buck’. It was found that although the extent of write-downs was fairly small, money-market funds experienced some outflows during the week following the announcement. Some of the money-market funds with larger exposures to ABIL bonds were downgraded by rating agencies. In a subsequent announcement, the Registrar of Collective Investment Schemes allowed money-market funds to isolate debt in ABIL from their other investments (so-called ‘side-pocketing’), thereby separating illiquid assets from more tradable investments.

The African Bank Limited event has brought to the fore the degree to which the financial sector, and the banking system in particular, is interconnected. From a financial system perspective, interconnectedness increases risk. Part of the Bank’s mandate and responsibility is to protect the financial system against systemic risk. The Bank will continue to strike a suitable balance between protecting the financial system against excessive risk-taking or unhealthy lending practices and promoting financial deepening, integration and inclusion.

The gross loans and advances of the South African banking sector increased by 6.5 per cent for the six months to June 2014, largely due to increases in loans denominated in foreign currency (22.8 per cent), overnight loans (83.5 per cent) and term loans (11.3 per cent). The sector’s credit risk-weighted exposure (RWE) has increased by about 4 per cent since December 2013, mainly due to increases in credit exposure to corporates (6.1 per cent) and, to a lesser extent, small and medium enterprise (SME) corporates (2.8 per cent). Retail RWE increased marginally (1 per cent) during the six months to June 2014, mainly due to a 4 per cent increase in revolving credit exposures (which include credit card facilities). The five largest banks increased their average growth rate of loans and advances from slightly more than 1 per cent in 2010 to 8.6 per cent in the first half of 2014.

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17 The Government Employees Pension Fund held about 186 million shares in African Bank Limited.

18 To ‘break the buck’ is when unit prices in a money-market fund decline to below R1 per unit. The resulting loss of confidence can cause a run on the money-market fund.
Table 3  Selected indicators of the South African banking sector

<table>
<thead>
<tr>
<th>Performance indicators</th>
<th>2014</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Jan</td>
<td>Feb</td>
<td>Mar</td>
<td>Apr</td>
<td>May</td>
<td>Jun</td>
</tr>
<tr>
<td>Market share (top four banks)</td>
<td>83,02</td>
<td>82,97</td>
<td>82,67</td>
<td>82,83</td>
<td>82,16</td>
<td>83,10</td>
</tr>
<tr>
<td>Gini concentration index</td>
<td>83,06</td>
<td>83,01</td>
<td>82,82</td>
<td>82,71</td>
<td>82,80</td>
<td>82,81</td>
</tr>
<tr>
<td>Herfindahl–Hirschman Index (H-index)</td>
<td>0,182</td>
<td>0,182</td>
<td>0,180</td>
<td>0,181</td>
<td>0,182</td>
<td>0,182</td>
</tr>
<tr>
<td>Banks’ share prices (year-on-year percentage change)</td>
<td>-1,63</td>
<td>-2,31</td>
<td>6,58</td>
<td>16,45</td>
<td>22,44</td>
<td>33,56</td>
</tr>
<tr>
<td>Capital adequacy</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total capital-adequacy ratio</td>
<td>14,85</td>
<td>14,97</td>
<td>14,84</td>
<td>15,07</td>
<td>14,87</td>
<td>14,60</td>
</tr>
<tr>
<td>Tier 1 capital-adequacy ratio</td>
<td>12,02</td>
<td>12,19</td>
<td>12,08</td>
<td>12,12</td>
<td>12,05</td>
<td>11,76</td>
</tr>
<tr>
<td>Common equity Tier 1 capital-adequacy ratio</td>
<td>11,45</td>
<td>11,62</td>
<td>11,51</td>
<td>11,55</td>
<td>11,49</td>
<td>11,21</td>
</tr>
<tr>
<td>Credit risk</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross loans and advances (R billions)</td>
<td>3 015,3</td>
<td>3 030,4</td>
<td>3 084,2</td>
<td>3 078,0</td>
<td>3 088,3</td>
<td>3 147,5</td>
</tr>
<tr>
<td>Impaired advances (R billions)</td>
<td>108,3</td>
<td>108,2</td>
<td>108,4</td>
<td>108,9</td>
<td>110,6</td>
<td>108,6</td>
</tr>
<tr>
<td>Impaired advances to gross loans and advances</td>
<td>3,59</td>
<td>3,57</td>
<td>3,51</td>
<td>3,54</td>
<td>3,58</td>
<td>3,45</td>
</tr>
<tr>
<td>Specific credit impairments (R billions)</td>
<td>49,2</td>
<td>49,8</td>
<td>50,2</td>
<td>51,1</td>
<td>52,2</td>
<td>50,2</td>
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<tr>
<td>Specific credit impairments to impaired advances</td>
<td>45,45</td>
<td>46,06</td>
<td>46,30</td>
<td>46,88</td>
<td>47,18</td>
<td>46,20</td>
</tr>
<tr>
<td>Specific credit impairments to gross loans and advances</td>
<td>1,63</td>
<td>1,64</td>
<td>1,63</td>
<td>1,66</td>
<td>1,69</td>
<td>1,59</td>
</tr>
<tr>
<td>Profitability</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Return on assets (smoothed)</td>
<td>1,08</td>
<td>1,06</td>
<td>1,03</td>
<td>1,03</td>
<td>1,06</td>
<td>1,03</td>
</tr>
<tr>
<td>Return on equity (smoothed)</td>
<td>14,45</td>
<td>14,10</td>
<td>13,87</td>
<td>13,87</td>
<td>14,26</td>
<td>13,94</td>
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<tr>
<td>Interest margin to gross income (smoothed)</td>
<td>54,73</td>
<td>55,04</td>
<td>54,84</td>
<td>55,01</td>
<td>55,41</td>
<td>55,79</td>
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<tr>
<td>Operating expenses to gross income (smoothed)</td>
<td>53,88</td>
<td>54,43</td>
<td>54,11</td>
<td>54,35</td>
<td>54,22</td>
<td>54,74</td>
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<tr>
<td>Liquidity</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Liquid assets to total assets (liquid-asset ratio)</td>
<td>7,94</td>
<td>8,13</td>
<td>7,96</td>
<td>8,40</td>
<td>8,68</td>
<td>8,49</td>
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<tr>
<td>Liquid assets to short-term liabilities</td>
<td>15,91</td>
<td>15,94</td>
<td>15,08</td>
<td>16,13</td>
<td>17,11</td>
<td>16,39</td>
</tr>
<tr>
<td>Effective net open foreign-currency position to qualifying capital and reserve funds</td>
<td>1,01</td>
<td>0,99</td>
<td>0,81</td>
<td>0,68</td>
<td>0,39</td>
<td>0,91</td>
</tr>
</tbody>
</table>

1 Data were updated on 28 August 2014
2 Impaired advances are advances in respect of which the bank has raised specific credit impairments

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

Average impaired advances for the six months to June 2014 decreased by 0,1 per cent from the second half of 2013. The ratio of impaired advances to gross loans and advances dropped from 3,6 per cent in December 2013 to 3,5 per cent in June 2014, mainly as a result of the growth in gross loans and advances and, to a lesser extent, the decline in impaired advances. Defaulted
exposures declined by 0,7 per cent during the six months to June 2014, mainly due to declines in corporate and SME corporate defaulted exposures. This suggests a general improvement in loan-book quality. However, there are indications of increasing credit stress in retail exposures, with credit card default exposures increasing by 11,0 per cent and vehicle and asset finance default exposures increasing by 14,8 per cent in the first half of 2014. The ratio of specific impairments to impaired advances continued to increase during the period from slightly less than 45 cents per rand of impaired advances in December 2013 to over 47 cents per rand in June 2014, suggesting that the banking sector is providing adequately for future losses.

For the five largest banks, impaired advances declined from a peak of R123,6 billion in November 2009 to R81,8 billion in June 2014 (see Figure 15). The ratio of impaired advances to gross loans and advances also reflects this declining trend. In the second half of 2013, the impaired advances of the five largest banks declined by 7,3 per cent, with a further decline of 2,1 per cent observed in the first half of 2014.

In contrast to the declining trend in impaired advances reported by the five largest banks, the impaired advances for other banks increased by 3,7 per cent for the second half of 2013, with a further increase of 4,7 per cent in the first half of 2014 (see Figure 16). The year-on-year growth in gross loans and advances slowed markedly during most of 2013 and the first half of 2014. The gradual increase in the ratio of impaired advances to gross loans from 16,3 per cent in December 2013 to 17,1 per cent in June 2014 suggests that these banks’ loan portfolios are experiencing increased credit stress. Although the assets of other local banks represent less than 10 per cent of the South African banking sector’s assets, this development needs to be closely monitored, especially in view of the possible interconnectedness with the rest of the financial sector.

Three key ratios of the sector’s profitability, namely the return on equity (ROE), the return on assets (ROA) and the cost-to-income (CTI) ratios, indicate lower profitability in the six months to June 2014. The decrease in ROE and ROA was due to the growth, over the same period, in credit losses (7,1 per cent) and operating expenses (5,7 per cent) exceeding the growth in operating income (3,6 per cent). Although gross operating income improved compared to the second half of 2013, this was offset by increased credit losses as well as expenses related to occupation, accommodation, fees and insurances, office equipment and consumables.

The ratio of liquid assets to total assets for June 2014 remained unchanged from December 2013 at 8,5 per cent, mainly because the growth in total assets (4,7 per cent) was largely matched by the growth in liquid assets held (4,83 per cent) for the first half of 2014. However, there was a slight deterioration in the ratio of liquid assets held in relation to short-term liabilities, largely as a result of increases in short-term liabilities as cash holdings were moved to instruments with shorter tenures in anticipation of further interest rate increases. The banking sector is currently preparing for the phasing in of the LCR, one of the Basel III liquidity requirements to be implemented from January 2015. This is reflected in the continued increases in HQLA holdings reported by the sector in the second half of 2013 and the first half of 2014.

19 Defaulted exposures include exposures reported as overdue for more than 90 days for standardised approach portfolios and exposures reported as being ‘in default’ for advanced approach portfolios.

20 Other banks include all banks other than the five largest banks and the domestic branches of foreign banks.
The ratio of aggregate effective net open foreign-currency position (NOP) to qualifying capital and reserve funds remained within the prudential limit of 10 per cent during the period under review. The average NOP reported in the first half of 2014 (0.8 per cent) was higher than that reported during the second half of 2013 (0.4 per cent), largely a reflection of the depreciation of the rand/US dollar exchange rate in the first half of 2014 when compared to the second half of 2013.

The banking sector’s exposure to unsecured lending

The total gross unsecured credit exposure\(^{21}\) of the six local banks that provide this type of loans to retail counterparties (total unsecured lending) increased to almost R490 billion in June 2014 from R479.2 billion in December 2013 (see Figure 17). However, the year-on-year growth in total unsecured lending has been moderating since its peak of 30 per cent in November 2012. This moderating trend is reflected in all categories of unsecured lending. Total unsecured lending increased by 2.3 per cent during the first half of 2014, mainly due to increases in the retail revolving credit category (which includes credit cards and other unsecured revolving facilities). The ‘retail other’ category (which includes personal term loans) contracted by 0.8 per cent during the same period.

Non-bank financial institutions

The activities of non-bank financial institutions (NBFIs)\(^{22}\) are important to the process of financial intermediation. However, NBFIs could add to the build-up and transmission of risks, with the potential to contribute to systemic risk. Due to their high interconnectedness with banks and other NBFIs, financial distress at the level of an individual NBFI can transmit to other financial institutions (banks and non-banks), for example via counter-party risk, generating distress for the whole financial system.

The assets of the life insurance industry increased by 14.3 per cent year on year in the second quarter of 2014, up from 10.5 per cent during the first quarter. In relation to the size of the local economy, the assets of the life insurance industry represented 65.4 per cent of GDP in the second quarter of 2014. The value of the industry’s investment in the domestic equity market continued to grow, increasing by 23.3 per cent in the second quarter of 2014, while the value of its holdings of fixed-income securities increased by 11.5 per cent over the same period. Share prices in the life insurance industry experienced strong growth during the review period, increasing by an average annual rate of 18.6 per cent in the first seven months of 2014.

Growth over one year in the assets of pension and provident funds (including both official and private self-administered funds) remained strong and constant at 10.8 per cent in both the fourth quarter of 2013 and the first quarter of 2014. Over the same period, the importance of the pension fund industry in the domestic economy, as measured by the ratio of assets to GDP, increased to 79.6 per cent, marginally up from 79.2 per cent during the previous quarter. The value of investments of official pension and provident

\(^{21}\) Unsecured lending to retail counterparties includes credit cards, overdrafts, personal loans and financing provided to SMEs in the retail sector. The exposure includes both on- and off-balance-sheet exposures (on-balance-sheet exposure generally refers to credit extended, whereas off-balance-sheet exposures refer to potential credit risk in the form of facilities extended but not utilised at the time of reporting). The quantitative information is aggregated data based on surveys conducted and regulatory information reported by the six banks that are the most active in the unsecured credit market.

\(^{22}\) This discussion on NBFIs covers long-term insurers, short-term insurers, and the pension and provident fund industry.
funds in fixed-income securities increased at an annual rate of 12.7 per cent during the second quarter of 2014, while the value of their investment in equities increased by 28.3 per cent (year on year). During the first quarter of 2014, the year-on-year growth rate in private and self-administered pension and provident funds’ holdings of bonds was 14.1 per cent and investment in equities increased by 14.6 per cent. The investment behaviour of pension and provident funds appears to have positively contributed to the continued stability of the South African financial market.

In the six months ended June 2014, there were 68 companies registered in the long-term insurance industry. The financial position of the overall long-term insurance industry continued to be favourable, with its total assets increasing by 6.7 per cent in the six months to June 2014.

The number of times that the capital-adequacy requirement is covered by excess assets (i.e. assets in excess of liabilities, determined on a statutory basis) – also referred to as a CAR cover – gives an indication of the financial strength of a long-term insurer. Any insurer with a CAR cover below one is investigated and corrective measures are taken by the Registrar of Long-term Insurance.

Table 4  Excess assets to capital-adequacy requirement of primary long-term insurers

<table>
<thead>
<tr>
<th>Number of insurers</th>
<th>As at Dec 2012</th>
<th>As at Jun 2013</th>
<th>As at Dec 2013</th>
<th>As at Jun 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Covered 0–1 time</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Covered 1–2 times</td>
<td>26</td>
<td>22</td>
<td>19</td>
<td>16</td>
</tr>
<tr>
<td>Covered 2–5 times</td>
<td>27</td>
<td>30</td>
<td>32</td>
<td>38</td>
</tr>
<tr>
<td>Covered 5–10 times</td>
<td>15</td>
<td>12</td>
<td>11</td>
<td>9</td>
</tr>
<tr>
<td>Covered 10+ times</td>
<td>2</td>
<td>4</td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

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

Source: Financial Services Board

Table 5  Spread and categorisation of assets of primary long-term insurers (excluding professional reinsurers and insurance companies in run-off)

<table>
<thead>
<tr>
<th>Kinds of assets</th>
<th>12 months ended Dec 2012</th>
<th>12 months ended Dec 2013</th>
<th>6 months ended Jun 2013</th>
<th>6 months ended Jun 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>R millions</td>
<td>Per cent</td>
<td>R millions</td>
<td>Per cent</td>
<td>R millions</td>
</tr>
<tr>
<td>Cash and deposits</td>
<td>221 377</td>
<td>11.1</td>
<td>193 901</td>
<td>8.5</td>
</tr>
<tr>
<td>Government and semi-government</td>
<td>173 874</td>
<td>8.7</td>
<td>178 194</td>
<td>7.8</td>
</tr>
<tr>
<td>Equities and collective investment schemes</td>
<td>1 221 629</td>
<td>61.1</td>
<td>1 470 533</td>
<td>64.5</td>
</tr>
<tr>
<td>Debentures and loan stock</td>
<td>176 585</td>
<td>8.8</td>
<td>215 743</td>
<td>9.5</td>
</tr>
<tr>
<td>Immovable properties</td>
<td>56 132</td>
<td>2.8</td>
<td>49 571</td>
<td>2.2</td>
</tr>
<tr>
<td>Fixed assets</td>
<td>2 112</td>
<td>0.1</td>
<td>2 367</td>
<td>0.1</td>
</tr>
<tr>
<td>Debtors</td>
<td>118 589</td>
<td>5.9</td>
<td>133 930</td>
<td>5.9</td>
</tr>
<tr>
<td>Other assets</td>
<td>28 235</td>
<td>1.4</td>
<td>33 909</td>
<td>1.5</td>
</tr>
<tr>
<td>Total</td>
<td>2 000 555</td>
<td>100</td>
<td>2 278 148</td>
<td>100</td>
</tr>
</tbody>
</table>

Percentages may not add up to 100 due to the rounding off of input figures

Source: Financial Services Board
In June 2014, the 30 long-term typical insurers (which represent about 63 per cent of the market share according to gross premiums collected) recorded an overall increase of 3.5 per cent in gross premium income when compared to the year before. This low growth in premium income was the result of the weak growth of the South African economy, labour unrest and rising unemployment.

In the six months to June 2014, the individual lapse ratio, expressed as a percentage of the number of new policies issued during the period, increased to 69 per cent compared to 46 per cent in the six months to June 2013. This is a reflection of the current difficult market conditions and macroeconomic environment.

The biggest risk facing the long-term insurance sector is market risk, since more than half of its assets is invested in equities. However, approximately 27 per cent of these equity investments relate to linked business where the policyholders carry the risk. While life insurers have benefited from strong investment gains on their underlying share portfolios, premium growth is essential for longer-term sustainability.

In the six months to June 2014, the gross premiums written by short-term typical insurers increased by 8.2 per cent when compared to the six months ending June 2013. At the end of June 2014, motor and property insurance combined made up 77.4 per cent of total gross premiums written in the short-term insurance sector.

Underwriting profit (expressed as a percentage of net written premiums) for the short-term typical insurance sector increased to 8 per cent in June 2014 (June 2013: 6 per cent). In June 2014, underwriting results improved, with the net incurred loss ratio decreasing slightly from 66.0 per cent in 2013 to 63.0 per cent in 2014 as a result of an improvement in the claims ratio.

Table 6  Performance indicators for typical short-term insurers

<table>
<thead>
<tr>
<th>Performance indicators</th>
<th>12 months ended Dec 2012</th>
<th>12 months ended Dec 2013</th>
<th>6 months ended Jun 2013</th>
<th>6 months ended Jun 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net premium increase (year-on-year percentage)</td>
<td>4</td>
<td>7</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>Loss ratio*</td>
<td>63</td>
<td>66</td>
<td>66</td>
<td>63</td>
</tr>
<tr>
<td>Combined ratio*#</td>
<td>88</td>
<td>91</td>
<td>95</td>
<td>87</td>
</tr>
<tr>
<td>Management expenses**</td>
<td>22</td>
<td>22</td>
<td>22</td>
<td>22</td>
</tr>
<tr>
<td>Commission**</td>
<td>9</td>
<td>8</td>
<td>9</td>
<td>8</td>
</tr>
<tr>
<td>Underwriting profit/loss ratio**</td>
<td>6</td>
<td>4</td>
<td>6</td>
<td>8</td>
</tr>
<tr>
<td>Underwriting and investment ratio**</td>
<td>12</td>
<td>9</td>
<td>11</td>
<td>13</td>
</tr>
<tr>
<td>Capital-adequacy ratio cover (median)</td>
<td>1,6</td>
<td>1,9</td>
<td>1,8</td>
<td>1,8</td>
</tr>
</tbody>
</table>

* Expressed as a percentage of net earned premium during the period
** Expressed as a percentage of net written premium during the period
# Claims plus commission plus expenses less total investment income as a percentage of net earned premium

Source: Financial Services Board

Confidence in the financial services sector

The second quarter of 2014 saw the domestic Ernst & Young (EY) Financial Services Index decreasing to 61 index points, its lowest level since the third
quarter of 2011 and well below the long-term average\textsuperscript{24} of 77 index points. This was down from 67 index points in the first quarter of 2014.

Of the three subindices that caused the overall decline, the biggest contributor was the life insurance industry, with its index falling by 15 index points to 64 index points. Only the retail banking sector confidence index increased, but remained fairly low.

The life insurance industry started to show signs of being affected by the slower economic growth of the country. After staying almost unchanged at 80 index points in the fourth quarter of 2013 and the first quarter of 2014, the EY Financial Services Index’s subindex for the life insurance industry declined sharply to 64 index points in the second quarter of 2014, marking the lowest level of confidence in almost five years. The sharp fall in confidence was caused by an unexpected decrease in the growth of premium income (as referred to in the previous section), increasing costs and a slowdown in risk-based premium growth.

Table 7  EY Financial Services Index and its components

<table>
<thead>
<tr>
<th>Indices</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1st qr</td>
<td>2nd qr</td>
</tr>
<tr>
<td>EY Financial Services Index ........</td>
<td>85</td>
<td>73</td>
</tr>
<tr>
<td>Retail banking ........................</td>
<td>80</td>
<td>46</td>
</tr>
<tr>
<td>Investment banking and specialised finance</td>
<td>83</td>
<td>78</td>
</tr>
<tr>
<td>Asset management ........................</td>
<td>83</td>
<td>85</td>
</tr>
<tr>
<td>Life insurance ........................</td>
<td>95</td>
<td>83</td>
</tr>
</tbody>
</table>

Source: EY

Box 2  Shadow banking in South Africa

In an ongoing effort to improve the measurement and understanding of non-bank financial intermediaries, South Africa has been participating in the FSB’s annual shadow-banking monitoring exercises since 2012. This time around, South Africa focused on improving the estimates of the size of other financial intermediaries (OFIs), a proxy for the size of shadow banking in South Africa.

Both broad and narrow measures of shadow banking were estimated using balance-sheet data from national financial accounts. The broad measure includes all non-bank financial intermediaries apart from insurance companies, pension funds and public financial institutions. This conservative estimate ensures that most areas where shadow banking-related risks to the financial system might potentially originate are monitored. The shadow-banking measure is then refined by using the narrow measure, which excludes OFIs that have no direct relation to credit intermediation. In line with this refinement, banks’ securitisation issuances were included in the narrowly defined estimate while several OFIs that are included in the broad measure were excluded from the narrow measure. This resulted in a drop in the estimation of the size of OFIs’ assets as a percentage of assets of all the financial intermediaries in South Africa.

Results show that OFIs’ share of financial assets of all the financial intermediaries continued to increase during 2013 and reached 18 per cent in the fourth quarter (from 13 per cent in 2008), while the assets of banks, as a share of total financial intermediaries, decreased to 33 per cent in the fourth quarter of 2013 (from 43 per cent in 2008). The financial assets of pension funds, insurance companies, public financial institutions and the South African Reserve Bank as a share of total financial intermediaries remained relatively constant during the same period (see Figure A).

It is important to note that even though the level of the OFI estimate has decreased, trends have broadly remained unchanged. The narrow measure is helpful in avoiding inappropriate regulatory regimes advertently being imposed on those entities that play an important role in the mobilisation of savings and finances in emerging markets but do not have a direct relation to credit intermediation.

Further improvements to the availability and granularity of data are essential for monitoring the shadow-banking system in addition to identifying risks in this sector. For example, the nature of the relationship between OFIs and banks remains opaque, and the link between banks’ off-balance-sheet activities and the shadow-banking system remains unclear.

\textsuperscript{24} The long-term average is calculated over the past 50 quarters.
Non-financial corporates

Growth in gross fixed investment by the corporate sector moderated in the second quarter of 2014. A survey conducted by the Bureau for Economic Research (BER) among manufacturers showed that fixed investment fell mostly due to production falling below full capacity, with the continued risk of uncertain electricity supply listed as a factor that could further constrain fixed investment. The profitability of the corporate sector, as measured by the net operating surplus, also fell from 7,2 per cent in the first quarter of 2014 to 2,6 per cent in the second quarter as industrial action weighed on production. The demand for credit by the corporate sector, concentrated in a few large corporate firms, accelerated and recorded a 12-month growth rate of 13,8 per cent in the second quarter of 2014. Expressed as a percentage of GDP, credit to non-financial corporate-sector firms remained at an elevated level and reached 58,3 per cent in the second quarter of 2014.

Table 8 Selected indicators of the corporate sector

<table>
<thead>
<tr>
<th>Performance indicators</th>
<th>2013</th>
<th>2014</th>
<th>2014</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bank credit granted(^1)</td>
<td>10,6</td>
<td>9,3</td>
<td>7,4</td>
<td>12,5</td>
</tr>
<tr>
<td>Gross fixed capital formation(^2)</td>
<td>10,3</td>
<td>13,4</td>
<td>12,7</td>
<td>12,6</td>
</tr>
<tr>
<td>Credit as a percentage of GDP(^3)</td>
<td>51,8</td>
<td>53,1</td>
<td>53,5</td>
<td>56,9</td>
</tr>
<tr>
<td>Credit as a percentage of annualised profits(^3)</td>
<td>157,2</td>
<td>170,9</td>
<td>182,9</td>
<td>194,1</td>
</tr>
<tr>
<td>Net operating surplus(^4)</td>
<td>-2,5</td>
<td>2,0</td>
<td>2,2</td>
<td>7,2</td>
</tr>
</tbody>
</table>

1 Bank credit to the corporate sector in this case includes instalment sale and leasing finance, mortgage advances, overdrafts, credit card debtors, and other loans and advances
2 At current prices (seasonally adjusted)
3 Bank credit to the corporate sector and net operating surpluses of corporations were used as proxies for corporate debt and for corporate profits respectively
4 Gross operating surplus minus depreciation (seasonally adjusted rates)

Source: South African Reserve Bank

The overall business confidence index, a subjective forward-looking measure of confidence in the economy, improved in the third quarter of 2014, increasing by five index points to 46 index points. This is an indication that almost 50 per cent of the respondents rated business conditions as currently being ‘satisfactory’.

The wholesalers’ confidence index recorded the largest increase of all the subcomponents. Although the index benefited mainly from the end of the mining and manufacturing strikes, production is yet to return to full capacity.

---

Table 9  Business confidence index

<table>
<thead>
<tr>
<th>Indices</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3rd qr</td>
<td>4th qr</td>
</tr>
<tr>
<td>Business confidence index</td>
<td>42</td>
<td>43</td>
</tr>
<tr>
<td>New vehicle dealers’ confidence</td>
<td>39</td>
<td>41</td>
</tr>
<tr>
<td>Retail traders’ confidence</td>
<td>49</td>
<td>40</td>
</tr>
<tr>
<td>Wholesale traders’ confidence</td>
<td>43</td>
<td>51</td>
</tr>
<tr>
<td>Building contractors’ confidence</td>
<td>43</td>
<td>47</td>
</tr>
<tr>
<td>Manufacturers’ confidence</td>
<td>37</td>
<td>37</td>
</tr>
</tbody>
</table>

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

Source: Bureau for Economic Research, Stellenbosch University

Non-financial corporate bond issuance has moderated since 2013 (see Figure 18). South African companies began issuing corporate bonds at an unprecedented rate during 2009, taking advantage of the record-low interest rates, favourable global liquidity conditions and the search for higher yields by investors in developed economies. Strong capital inflows, coupled with lowered risk premiums and cost of funding, supported a surge in bond issuances by non-financial corporates. The proceeds of these issuances were used to increase capacity and to refinance previous issuances. However, should investor appetite for these products diminish, firms may face difficulty in rolling over the bonds at similar prices.

An important factor for investors would be corporates’ ability to manage their debt levels. Weak earnings growth amid a downbeat South African business outlook (as suggested by the weak business confidence index) could further constrain the ability of corporates to manage and service their debt. The Experian Business Debt Index (see Figure 19) is a measure of the debt stress experienced by domestic corporates.26 According to this index, the debt stress of corporates increased markedly from 2009 following the increased issuance of bonds.

In order to determine a firm’s ability to generate sufficient cash flows to finance its interest expenses on debt levels, the interest coverage ratio (ICR) is used. This measure divides a firm’s earnings before interest and taxes by its annual interest expenses. The IMF identifies weak firms as those with an ICR value below two. The results of this measure for South African corporates are shown in Figure 20; for the first half of 2014, the ICR remained well above the IMF benchmark of two. Therefore, the South African non-financial corporate sector is considered to have more than enough cash to service commitments over the next year.

At economic industry level (see Figure 21), electricity, gas and water supply was the only industry with cash flows below the IMF benchmark for the first quarter of 2014, and it could be argued that this poses a risk when considering the sector’s total debt obligations. This particular industry, however, consists mostly of South African parastatals that are supported by government guarantees. The volatile levels of the sector’s ICR can be explained by several infrastructure spending and development programmes employed throughout South Africa.

26 The Experian Business Debt Index is an indicator of the overall health of domestic corporates. It measures the relative ability of businesses to pay outstanding debts on time and tracks macroeconomic indicators that can impact on the ability of corporates to pay their creditors. The index is made up of business debtors’ and macroeconomic data which include the debtor day ratio (measuring how quickly cash is being collected from debtors), consumer and producer inflation spreads, interest rate spreads and real GDP data.
With the noticeable increase in corporate debt and the increasing repayment burden of the corporate sector, an analysis of the expected default of corporate debt is also needed in addition to corporates’ ability to service the interest on this debt. In short, a firm’s expected default frequency (EDF) represents the probability that the firm’s future market value will be insufficient to meet its future debt obligations within a specified time horizon. Higher market values serve as an incentive and generate the ability for equity holders to pay the debt obligations of a particular firm by selling its assets to raise cash or by issuing additional debt and/or equity. In essence, it is asset volatility – a measure of the variability in a firm’s future market value of assets and its market leverage – that critically drives a firm’s EDF.

The majority of South African non-financial corporate-sector firms has an EDF distribution below 3 per cent (Figure 22), which indicates that there is a less than 3 per cent chance that these firms will not be able to honour their debt obligations in the following year. Of the remainder of the sample, approximately 8,3 per cent of non-financial corporate-sector firms have an EDF between 3,01 and 10 per cent, while 8,7 per cent have an EDF above 10 per cent. Overall, the non-financial corporate sector has an average one-year EDF of 2,8 per cent for enterprises incorporated in South Africa.

Households

Households’ financial and total assets increased markedly by 21,2 per cent and 17,6 per cent respectively during the second quarter of 2014. Consequently, the net wealth of households increased by 20,6 per cent (year on year). This finding is corroborated by the Momentum/University of South Africa (Unisa) Household Wealth Index, which attributes the increase in household wealth to the significant increase in the JSE Limited (JSE) Alsi (which is, however, subject to market volatility). The growth in household disposable income did not match that of net wealth, resulting in the ratio of households’ net wealth to disposable income rising to 357,9 per cent in the second quarter of 2014, a level achieved on only one other occasion since 1990, that being in February 2007. Gains due to increases in the value of financial assets are, as already stated, subject to the market volatility associated with these assets.

Table 10 Selected indicators of the household sector

<table>
<thead>
<tr>
<th>Indicators</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2nd qr</td>
<td>3rd qr</td>
</tr>
<tr>
<td>Disposable income</td>
<td>8,1</td>
<td>8,4</td>
</tr>
<tr>
<td>Financial assets</td>
<td>13,8</td>
<td>15,2</td>
</tr>
<tr>
<td>Total assets</td>
<td>13,4</td>
<td>13,6</td>
</tr>
<tr>
<td>Net wealth1</td>
<td>14,7</td>
<td>15,1</td>
</tr>
<tr>
<td>Real consumption expenditure</td>
<td>2,6</td>
<td>2,5</td>
</tr>
<tr>
<td>Consumption expenditure to GDP</td>
<td>60,8</td>
<td>61,2</td>
</tr>
<tr>
<td>Capital gearing (per cent)2</td>
<td>19,1</td>
<td>18,6</td>
</tr>
<tr>
<td>Credit extension</td>
<td>8,7</td>
<td>7,5</td>
</tr>
<tr>
<td>Mortgage advances extended</td>
<td>1,6</td>
<td>2,4</td>
</tr>
<tr>
<td>Mortgage debt to disposable income</td>
<td>40,2</td>
<td>39,8</td>
</tr>
<tr>
<td>Net wealth to disposable income</td>
<td>319,9</td>
<td>329,0</td>
</tr>
</tbody>
</table>

1 Household net worth is defined as total assets of households less total financial liabilities
2 Capital gearing refers to household debt as a percentage of total assets of households. Data are preliminary

Sources: South African Reserve Bank and Statistics South Africa

Figure 21 Non-financial corporate sector: Industry interest coverage ratios

Figure 22 Non-financial corporate sector: EDF distribution of South African incorporated firms

Source: Moody’s Analytics – CreditEdge

27 Momentum and Unisa, Summary South African Household Wealth Index, Q4 2014.
Capital gearing continued to moderate in the first half of 2014 due to an increase in household assets and slower growth in household debt (see tables 10 and 11). Slower household debt growth also supported household wealth. Household debt growth moderated to an annual rate of 4.3 per cent in the second quarter of 2014 – a notable slowdown compared to the growth of 8.7 per cent in the second quarter of 2013. Mortgage advances to the domestic sector grew by 3.4 per cent (year on year) in the second quarter compared to 2.9 per cent in the first quarter of 2014.

The credit standing of consumers in general appears to have improved in early 2014. According to the National Credit Regulator (NCR), the number of consumers with impaired records decreased by 329,000 while consumers in good standing increased by 1.4 million to 12.11 million. Of all the credit-active consumers, 55.8 per cent were in good standing and 44.2 per cent had impaired records in the first quarter of 2014.

Sentiment and the subjective opinions of consumers often play a principal role in the sustainable recovery of their financial positions and consumer spending. The latest consumer confidence index (CCI) indicated that confidence rebounded in the second quarter of 2014, increasing by 10 index points. The improvement was mainly driven by the forward-looking sub-components of the CCI that reconcile consumers’ expectations of future economic growth with the anticipated improvement in their finances over the next 12 months. It is, however, important to note that these improvements are compared to previously depressed levels and might reflect a temporary overstatement of confidence.

Conversely, consumer confidence represented by subcomponents driven by present conditions – which essentially gives an indication of whether consumers think it is an appropriate time to buy durable goods – remained negative, signifying that households remain under strain but expect their situation to improve over the next year. In relation to its long-run average, the CCI appeared to be improving. Overall, however, confidence levels remained lower for low- and middle-income households compared with high-income earners, which can be attributed to higher unemployment in this category of consumers, increased food and fuel inflation, and income losses incurred during the longest industrial impasse in South Africa’s history.

The MBD Credit Solutions/Bureau of Market Research (MBD/BMR) Consumer Financial Vulnerability Index (CFVI), which measures the financial vulnerability of consumers, confirmed that consumers’ finances have been under pressure, with the index remaining below its long-run average of 51.7 index points over the past two years (see Figure 23). The index value of 50.2 points in the second quarter of 2014 indicates a mildly exposed situation and is on the border (50.0 index points) of being ‘financially very exposed’. Of the four components of the index, consumer income moved from a mildly exposed to a very exposed point, debt servicing remained at a very exposed level, savings remained mildly exposed, and consumer expenditure remained mildly exposed in line with the marginal increase in retail expenditure during the second quarter of 2014. An important finding of the MBD/BMR CFVI is that consumers seem to be adjusting their spending habits. The exposed position of households is further confirmed by continued dissaving.

28 According to the NCR, the decrease in consumers with impaired records in the first quarter of the year was a result of the “removal of adverse information and paid-up judgments project”. Even though the regulations came into effect on 1 April 2014, the submission date for the first quarter was 15 May 2014, and the impact is therefore reflected in the data.

29 Compiled by MBD Credit Solutions and the Bureau of Market Research, University of South Africa.
Table 11  Selected indicators of household savings and debt
Annual percentage change, unless indicated otherwise

<table>
<thead>
<tr>
<th>Indicators</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
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<tr>
<td></td>
<td>2nd qr</td>
<td>3rd qr</td>
</tr>
<tr>
<td>Savings as a percentage of disposable income</td>
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<td>-0.04</td>
</tr>
<tr>
<td>Debt</td>
<td>8.1</td>
<td>7.0</td>
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<tr>
<td>Debt service cost1 to disposable income</td>
<td>7.7</td>
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<tr>
<td>Debt to disposable income</td>
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<tr>
<td>Debt to GDP</td>
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<td>45.9</td>
</tr>
<tr>
<td>Financing costs of household debt</td>
<td>6.1</td>
<td>7.5</td>
</tr>
</tbody>
</table>

1  Interest payments on housing and personal debt

Source:  South African Reserve Bank

Residential real-estate sector

Fluctuations in house prices have an impact on economic activity since housing is typically the most important component of household wealth, with the ability to affect future expenditure. The valuation of properties is an important element to consider in the assessment of fundamental vulnerabilities in the financial system since a sudden fall in asset prices could have a destabilising effect on the economy. This phenomenon occurs especially where assets are widely held and the value of these assets is supported by high leverage, as is often the case in the real-estate sector.

In theory, rising interest rates lead to an upward movement in the price-to-rent (P/R) ratio through higher repayment instalments over time. However, the higher the property repayments relative to rental payments, the lower the demand to buy. Therefore, a decline in real house prices (a situation where inflation outstrips nominal house-price growth) is represented by a decrease in the P/R ratio, indicating a sensible move to buy rather than rent a property. From Figure 24 it is clear that between 2008 and 2013 there were extended periods when house-price growth did not keep up with inflation, indicated by the negative percentage changes. The price recovery in 2014 has been marginal, with real house-price growth of 2.2 per cent recorded in the second quarter, down from 2.7 per cent in quarter one.

In line with these trends, the Bank for International Settlements (BIS) reported a 7 per cent decline in real house prices in South Africa from 2007 leading up to the end of 2013, with data for the first quarter of 2014 indicating a marginal uptick. Statistics South Africa reported a marginal annual increase in the CPI component measuring actual rentals of 5.2 per cent, up from 5.0 per cent between January and July 2014. Although very small, this could be an early indication of an upward movement in property prices.

To measure the current affordability of property and its possible impact on financial stability, a monthly mortgage payment series was created by employing predominant interest rates over time and the long-run Absa House Price Index (HPI). The series is compared to the average P/R ratio index in Figure 25. With the slower growth in rental inflation relative to real house prices, it can be expected that the P/R ratio will increase slightly,

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30  This ratio determines the expected value of benefits derived from home ownership received in the form of rent by owners or savings by owner-occupiers.

which is seen in Figure 25. The ratio indicates that house prices are fairly valued at present. There is, however, a notable uptick in the ratio of mortgage instalments to average rent, indicating an increase in the cost of home ownership and the repayment burden that accompanies such asset purchases. The phenomenon can be ascribed to the increase in interest rates in recent months, which could place additional stress on already highly leveraged investors in buy-to-rent properties. In support of these findings, the household demand, represented by mortgage advances extended to the domestic private sector, remained low during the second quarter of 2014, with a reported annual increase of 3.4 per cent.

The First National Bank (FNB)/BER Building Confidence Index, which has been increasing steadily since September 2012, fell by 11 index points to 41 index points in the second quarter of 2014. This was due to the lower confidence in all subsectors, with the largest fall reported by building material manufacturers, though this could be due to the strike action in this sector during the period under review. The building activity of both local and international contractors decreased. Overall results showed that approximately 60 per cent of respondents were dissatisfied with the prevailing business conditions.

Government finances and financial stability

Effective government-debt management is an important factor that underpins the credibility and reputation of a sovereign and influences the stability of bond markets and the financial institutions that hold public debt. Prudent public-debt management supports financial stability which, in turn, can mitigate sovereign risk and thus enhance government’s ability to support financial stability.

In the first eight months of 2014, government issuances accounted for an average of 62 per cent of listed securities, with the total nominal value of government bonds in issue amounting to R1 210 billion as at 31 August 2014. National government’s gross borrowing needs have been increasing in line with the countercyclical fiscal policy pursued by government through accelerated investment in public infrastructure. As such, national government’s gross loan debt increased from R1 585 billion at the end of March 2014 to R1 687 billion at the end of July 2014 (see Figure 26). The Budget Review 2014 projected that total gross loan debt would amount to R1 778 billion at the end of the 2014/15 fiscal year. In line with higher debt levels, gross loan debt of national government as a ratio of GDP increased significantly to 46.1 per cent in the last quarter of 2013, up from 42.5 per cent in December 2012. Compared to the other BRICS countries, the South African national government’s gross-loan-debt-to-GDP ratio exceeds that of Russia and China, but is significantly lower than Brazil’s and India’s (see Figure 27). South Africa still meets the Southern African Development Community (SADC) guideline of a public and publicly guaranteed debt-to-GDP ratio not exceeding 60 per cent in line with a memorandum of understanding on macroeconomic convergence.

The FNB/BER Building Confidence Index measures the business confidence of all the major role players and suppliers involved in the building industry such as architects, quantity surveyors, contractors, subcontractors, retail merchants and manufacturers of building materials. The index is compiled quarterly from the building, manufacturing, retail and wholesale opinion surveys undertaken by the BER at Stellenbosch University. See the FNB/BER Building Confidence Index, Johannesburg: FNB/BER, 17 September 2014.
The holding of excessive public debt by financial institutions can affect the stability of the financial sector as high levels of government debt can ultimately become unsustainable. There is thus a need to continuously monitor the changes in the holders of government debt.

Non-resident investors’ holdings of government debt instruments declined as net sales of R20 billion were recorded in the seven months to July 2014. However, several domestic financial institutions increased their exposure to government debt during the period under review alongside increased regulatory requirements. In the second quarter of 2014, pension and provident funds as well as official and self-administered private funds increased their collective holdings to R469,5 billion, registering a year-on-year increase of 18 per cent. Local banks increased their holdings of government debt as well by 6 per cent year on year in the second quarter of 2014 to reach R165,7 billion.

The holdings of government debt securities by financial institutions represent the second-largest asset class after equities. The ratio of general government debt to GDP has increased significantly since 2008, and is projected to reach 49,6 per cent at the end of the 2014/15 fiscal year. Although this level is well above the historical average of 35,8 per cent recorded for the period 2001 to 2013, it is believed to be sustainable given the generally long-dated maturity structure of government debt and the relatively low level of foreign-currency liabilities. Furthermore, the ratio is still below the identified threshold for debt sustainability for South Africa.33

### Box 3  Debt ratings

Debt ratings reflect credit-rating agencies’ views on the likelihood of default on contractually promised payments of a government, corporates and banks, and the expected financial losses suffered in the event of a default. The ratings have a significant impact on investor confidence because investor asset allocations are largely determined by asset quality. In the case of banks, a downgrade can raise borrowing costs and result in more stringent lending criteria, thus lifting the financing costs for companies and consumers which directly affect the stability of the financial sector.

Moody’s Investors Service downgraded the long-term local currency deposit ratings of the four largest South African banks by one notch and placed them on review for further downgrade in August 2014. The downgrade was mostly motivated by the rating agency’s concern over the lesser likelihood that authorities fully protect creditors should a bank fail, coupled with the agency’s uneasiness about pressure on consumers’ finances and high indebtedness which might lead to higher credit losses for banks.

In contrast, the other two rating agencies use a different measure to Moody’s Investors Service and did not downgrade the largest five banks. Standard & Poor’s have not placed government support into the ratings of South African banks for some time, given the banks’ sound position compared to the sovereign. Fitch Ratings stated that the resolution of African Bank Limited did not change its view of the credit profiles of the largest five banks or its approach to factoring in government support for the systemically important banks.

South Africa’s credit rating continues to be affected by domestic factors such as subdued economic growth, relatively high inflation, labour disputes, highly indebted consumers and, more recently, the increasing interest rate cycle that will put pressure on borrowers’ repayment abilities.

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Adequacy of foreign-exchange reserves

Foreign-exchange reserves provide a buffer for the financing of short-term external debt and the current-account deficit in the event that access to foreign-exchange markets is curtailed.

In August 2014, South Africa’s foreign-exchange reserves grew at an annual rate of 5.4 per cent to US$44.6 billion. During the first and second quarters of 2014, the Guidotti ratio\(^\text{34}\) remained constant at 1.31, down from 1.37 in the fourth quarter of 2013, as short-term external debt grew at a faster pace than growth in foreign-exchange reserves. A ratio above one indicates that short-term external debt due over a one-year period could be financed even if access to foreign-currency markets were curtailed. The augmented Guidotti ratio\(^\text{35}\) declined to 0.84 in the second quarter of 2014 from 0.93 in the previous quarter as the current-account deficit continued to widen. However, apart from foreign-exchange reserves, the flexible exchange-rate regime in South Africa also acts as a shock absorber.

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\(^{34}\) The Guidotti–Greenspan rule states that a country’s reserves should equal short-term external debt (maturity of one year or less), implying a ratio of reserves to short-term debt of one.

\(^{35}\) The augmented Guidotti ratio is obtained by adding the annualised current-account deficit to short-term external debt to provide a measure of a country’s total external financing requirements.
The robustness of the domestic financial infrastructure

This section reviews developments in the domestic and international financial infrastructure and regulatory environment that relate to banking, insurance and other industries in the financial system. The review provides an update on the latest developments in the implementation of a twin peaks financial regulatory architecture in South Africa. This is followed by legislative and regulatory developments in the banking and insurance industries, as well as in financial markets. Finally, a review of recent payment system developments is presented.

Twin peaks financial regulatory framework developments

As reported in the March 2014 edition of the Financial Stability Review, the Prudential Authority Implementation Working Group (PAIWG) was established to facilitate a smooth transition to the twin peaks model of financial regulation. The output of the PAIWG is partially dependent on the Financial Sector Regulation Bill, for which the comment period ended on 7 March 2014. The National Treasury will be releasing a revised draft of the Financial Sector Regulation Bill in due course, taking these comments into consideration. The revised draft of the Financial Sector Regulation Bill will then be tabled in Parliament. The proposed Financial Sector Regulation Bill should streamline the prudential oversight of the financial system and also improve consumer protection from a market conduct perspective.

Regulatory developments impacting the domestic banking sector

This section focuses on developments regarding the regulation of credit-rating agencies in South Africa, amendments to the National Credit Act 34 of 2005 (the National Credit Act), bank recovery plans and the impact of the FSB-led banking structural reforms.

Credit-rating agencies

The September 2012 and March 2013 editions of the Financial Stability Review reported on the regulatory initiatives to reduce reliance on credit-rating agencies and covered the enactment of the Credit Rating Services Act 24 of 2012 (the Credit Rating Services Act). The Financial Services Board has since registered four credit-rating agencies and has established the Credit Rating Services Unit, responsible for supervising these agencies and for all the supervisory and regulatory functions related to them, including:

- undertaking an annual assessment and review of the registered credit-rating agencies;
- conducting on-site reviews at selected credit-rating agencies;
- monitoring market developments to ensure that local markets remain safe, sound, fair and efficient, and that best practice and standards are adopted in the management of risks;
- assessing South African legislation in terms of the International Organization of Securities Commissions (IOSCO) Principles, with the aim of complying with international best practice and standards;
– monitoring compliance with legislation and subordinate regulations and board notices;
– undertaking other functions relating to the administration of the Credit Rating Services Act; and
– handling and responding to complaints and queries from investors and consumers.

The first on-site visit to one of the four registered credit-rating agencies was completed on 30 June 2014, and three more reviews are scheduled for completion by year-end. The Credit Rating Services Unit plans to conduct risk assessments on all registered contingent reserve arrangements (CRAs). The supervision and regulation of CRAs will ensure that these agencies comply with best practice and bolster investor confidence in the ratings given by these agencies.

National Credit Amendment Act and regulations

The National Credit Act continues to be refined to address pertinent matters emerging in the South African credit market. The principal Act was strengthened further by amendments contained in the National Credit Amendment Act 19 of 2014 (NCAA).

The amendments resulted from authorities’ concerns over certain objectionable practices prevalent in certain areas of the South African credit industry and provide, among other things, for:

– the alteration of the governance structure of the NCR;
– the registration of payment distribution agents;
– tightening measures relating to debt counsellors;
– the removal of adverse consumer credit information;
– the National Consumer Tribunal to declare a credit agreement as ‘reckless’; and
– the Minister of Trade and Industry to prescribe affordability assessment regulations.

It is envisaged that the NCAA amendments will address the gaps identified to achieve a sustainable credit provision regime in the domestic economy.

Subsequent to the promulgation of the NCAA on 5 August 2014, the Minister of Trade and Industry published the draft National Credit Regulations for Affordability Assessment in terms of the NCAA. In the past, it was found that affordability assessment models were inconsistently developed and applied. The draft regulations now set out criteria for conducting affordability assessments and make them legally binding, thereby ensuring that the application of affordability assessments is compulsory before credit can be granted. The proposed regulations are not limited to affordability assessments, but include regulations dealing with the registration and the fees applicable to the payment of distribution agents, retention periods for credit bureau information and the listing of adverse information by

36 Available on the website of the National Credit Regulator (NCR) (http://www.ncr.org.za/).
credit bureaus. Consumers are also obligated to fully disclose their financial obligations to the credit provider for accurate affordability assessments. It is expected that the NCAAs amendments and the proposed regulations should address many of the reckless lending practices still prevailing in some areas.

Bank recovery plans

In terms of the FSB’s Key attributes of effective resolution regimes38 issued in October 2011, member countries are required to have in place recovery and resolution plans (RRPs) for all systemically important financial institutions in order to improve the resolvability of an institution during distress. South Africa’s approach to recovery plans will be discussed by giving a high-level overview of the required elements of a recovery plan as well as the Bank’s involvement in the review of RRPs thus far.

The document titled Key attributes of effective resolution regimes contains details of the core elements of what the FSB considers necessary for an effective resolution regime. The implementation of these elements is considered essential to resolve financial institutions in an orderly manner with minimal use of taxpayer funds, while maintaining the continuity of critical economic functions. One of the core elements of an effective resolution regime that was identified by the FSB is an ongoing process for recovery and resolution planning. At a minimum, recovery and resolution planning should be done for institutions that could be systemically significant.

The development of recovery plans was identified by the Bank Supervision Department (BSD) of the Bank as a ‘flavour-of-the-year’ topic for discussion at the bilateral meeting held between the BSD and the board of directors of each bank39 during 2012 and 2013. These recovery plans should ideally contain details of how a bank’s management and board of directors would execute the identified recovery options in order to recover from a severe financial crisis. The recovery plans should also identify trigger points at which they would be invoked, clear escalation procedures and interventions required in various stress scenarios. The treatment of branches and subsidiaries of banking groups in these stress scenarios should also be addressed.

In 2013, the BSD started conducting workshops with the largest banks in South Africa to discuss the development of their recovery plans and to provide guidance on gaps identified. Such workshops will in future become part of the normal supervisory process followed by the BSD. Additional guidance on the key elements of a recovery plan will be issued towards the end of 2014.

The Bank, having been identified as the resolution authority in the twin peaks architectural proposals, will have the responsibility of developing resolution plans for domestic systemically important banks (D-SIBs) as soon as the relevant legislative framework is in place. Resolution plans will need to be developed in close co-operation with BSD, and should contain details on how banks would be resolved if the recovery actions identified by the banks failed. The purpose of a resolution plan is to minimise the cost of a bank’s failure and the use of public funds in resolution.

39 Local branches of foreign banks were not required to develop recovery plans in terms of Banks Act Guidance Notes 4/2012, 5/2012 and 10/2012.
Impact of Financial Stability Board-led banking structural reforms

In the wake of the recent global financial crisis, a number of key offshore jurisdictions – including the UK, the US and the EU – embarked on a process of structural reform proposals of their respective banking industries. The intended goal of this process is to enhance regulatory oversight of the banking sector, and a common feature of these proposals is some form of preventative risk measures associated with investment banking. These structural reforms are aimed mainly at large, complex and integrated banking entities such as global systemically important banks (G-SIBs). In 2013, the Group of Twenty Finance Ministers and Central Bank Governors (G-20) called on the FSB and others to assess cross-border consistencies and global financial stability implications of structural banking reforms, taking into account country-specific circumstances, and to report relevant findings to the 2014 G-20 Leaders’ Summit in Australia.

Jurisdictions at the forefront of such initiatives have highlighted the benefits of the structural banking reforms. Potential advantages include the:

- alignment of businesses and capital where the risks are located in separate legal structures;
- preservation of continuity in the provision of core financial services such as credit extension (should the investment banking part run into difficulties);
- improvement of financial authorities’ capacity to resolve banking institutions in distress; and
- overall positive contribution that structural banking reforms could make to financial stability.

In contrast, structural banking reforms have also raised concerns revolving around the potential negative effects that they could have, particularly from an EME perspective. Some of the issues raised in this regard include the potential for fragmentation in the industry, the curtailment of the benefits of economies of scale, the impediments to cross-border capital flows, the decrease of liquidity in some financial markets, and competitiveness and efficiency issues in developing economies.

At the current stage of development of the domestic banking industry, the profile of investment banking and its associated risks are in many ways different to its counterparts in the developed world where these structural reforms have been proposed. While the risks originating from investment activities can theoretically affect the retail deposit-taking side of banks, the more immediate risks to the safety and soundness of domestic banks appear to be rather on the application of sound lending standards, the quality of the various loans books, the use of collateral for loans, the indebtedness of consumers, and broader economic issues related to growth and unemployment.

However, some matters that might directly relate to structural banking reforms require further consideration. Firstly, because of the relative size of the four big South African banks and the extent of their activity in the SADC region and the African continent, the local regulatory authorities have correctly sought to apply many of the G-SIB proposals, such as additional
capital requirements, to these D-SIBs. However, enforcing the separation of the investment banking operations from the retail side of business on the four big South African banks is unlikely as investment banking has not yet presented the kind of risks to local banks as has been the case globally.

Secondly, while South Africa may not be a home authority of any G-SIB, it plays host to some G-SIBs that are active in the domestic market. It has been suggested that the enforced unbundling of their investment banking and retail banking divisions will most likely reduce the number and quality of the stand-alone banks, and therefore affect their competitiveness in the domestic banking industry.

South African financial authorities will consider the potential impact and effects on the domestic banking sector of these proposed reforms, and could try to influence the global decision-making process to be more relevant to EMEs’ circumstances.

Regulatory developments relating to the insurance sector

This section focuses on developments in the domestic insurance sector, highlighting amendments to the Insurance Binder Regulations and the National Treasury’s proposals on consumer credit insurance.

Amendments to the Insurance Binder Regulations

The National Treasury and the Financial Services Board are seeking public comments on the proposed amendments to the Insurance Binder Regulations which were published in the *Government Gazette*. These amendments are aimed at addressing undesirable practices and regulatory gaps identified after the implementation of the initial regulations in 2012. The regulations focus on outsourcing, which can bring significant benefits to an organisation making use of expertise that is not available within a particular institution. However, failure to manage the risks associated with outsourcing negates many, if not all, such benefits and synergies.

The proposed regulations also govern the manner in which insurers outsource binder functions. The regulations seek to ensure greater accountability of insurers through responsible outsourcing to protect policyholders and avoid conflicts of interest.

The National Treasury’s consumer credit insurance report

On 3 July 2014, the National Treasury and the Financial Services Board issued a document titled *Technical report on the consumer credit insurance market in South Africa* for public comment. The report identifies some of the abuses in market conduct or business practices in the consumer credit insurance industry. It also outlines a set of policy responses to strengthen the existing regulatory framework and to improve the value of consumer credit insurance to consumers. The key issues in the report include a lack of transparency in the total cost of credit, high premiums and different pricing, product differentiation which limits comparison, and the extent to which consumer credit insurance cover meets, or does not meet, the needs of the target market.

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40 Binder functions refer to the authority granted to an underwriting manager or intermediary to enter into, vary or renew a policy on behalf of an insurer, or to settle claims on behalf of an insurer.

Financial market infrastructure developments

This section reviews recent financial market infrastructure developments in South Africa. These include the proposed regulations for over-the-counter (OTC) derivatives, the regulation of platforms for trading unlisted securities, and recent global legal entity identifier (LEI) developments. The section concludes with an overview of national payment system developments.

Proposed regulations for over-the-counter derivatives

On 4 July 2014, the National Treasury published for public comment a policy document and proposed regulations on OTC derivatives. These regulations form part of a broader package of global regulatory reforms aimed at making derivatives markets safer and strengthening the overall financial system. These draft regulations will ensure that South Africa meets its G-20 obligations by bringing its OTC derivatives regulatory framework in line with changes in other G-20 jurisdictions. The proposed regulations represent the final phase of a multi-year effort to provide more appropriate and improved regulation of derivatives in the domestic market.

The following five principles guided the development of the OTC regulatory framework for the domestic environment:

1. adopting appropriate international standards;
2. developing harmonised and equivalent regulatory frameworks;
3. aligning the framework with existing legislation;
4. implementing a twin peaks model of financial regulation; and
5. minimising market disruptions.

The draft OTC regulations were issued in terms of the Financial Markets Act 19 of 2012 (the FMA), and were aligned with the FMA’s objectives. The FMA, as the enabling legislation, provides for the regulation and supervision of the OTC derivatives market and related FMIs, such as clearing houses and trade repositories, necessary for the implementation of the G-20 requirements. The FMA, which was also reported on in the March 2013 edition of the Financial Stability Review, aims to reduce systemic risk; protect regulated persons, clients and investors; and promote fair, efficient and transparent financial markets.

The proposed regulations go beyond the licensing requirements, duties and functions of FMIs, and address in detail issues pertaining to access, auditing, business continuity, capital and liquidity requirements, governance, margin requirements, risk management and compliance, and other related FMI matters.

Platform for trading unlisted shares

On 11 July 2014, the Financial Services Board issued a directive and guidelines regarding infrastructures provided by companies facilitating trading in their own shares. This is intended to regularise the affairs of all unlicensed exchanges that facilitate trade in their own shares only. A number of issuers currently provide infrastructures conforming to the definition of

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42 Both the policy document titled Regulating over-the-counter derivatives markets in South Africa and the draft Financial Markets Act Regulations are available on the National Treasury’s website (www.treasury.gov.za).
43 See Regulating over-the-counter derivatives markets in South Africa.
an exchange under the FMA in terms of which they facilitate trade in their own shares through an exchange platform. These entities have the options to, inter alia, cease the unlicensed exchange activities or get licensed under the FMA.

The licensing requirements of the FMA are intended to ensure that certain basic safeguards for investors who trade on an exchange are in place. According to section 7 of the FMA, exchanges must have arrangements in place for the effective and efficient surveillance of all transactions effected through an exchange. Moreover, exchanges must be responsible for supervising authorised users in order to identify possible market abuse and to ensure compliance with exchange rules and regulations. Market abuse provisions such as insider trading, market manipulation and false reporting only apply to regulated markets.

Global legal entity identifier update

The March 2014 edition of the Financial Stability Review reported on developments related to the global LEI. Since then, Strate (Pty) Limited (Strate) has been allocated a unique four-digit prefix for utilisation in the issuance of LEIs. Strate has also subsequently submitted an application to the international Regulatory Oversight Committee to become a local operating unit. As a member of the Regulatory Oversight Committee, the Financial Services Board will be the sponsoring authority for Strate.

Globally, authorities are also extending the reporting requirements of the LEI beyond derivatives reporting. Some of the sectors that may be mandated to use the LEI include banks, securities issuance firms, and investment holders for insurance and funds. As the adoption and implementation of LEI continues, South African regulatory authorities and the local LEI Steering Committee will continue to monitor developments in this area. The LEI will be instrumental in supporting financial stability analysis and systemic risk management; facilitating orderly resolution and providing better-quality data.

National payment system developments

Adoption of the CPSS–IOSCO Principles for Financial Market Infrastructures

With the envisaged move to a twin peaks model of financial regulation, the Bank’s mandate will be expanded to include the responsibility for the systemic and prudential oversight and supervision of FMIs. Where applicable, the responsibility will be shared with the market conduct regulator.

To illustrate its continued commitment to complying with international best practice and standards, the Bank published a position paper and a supporting information paper in September 2013, embracing the Principles for Financial Market Infrastructures (PFMI) and committing to implementing them. Furthermore, the Bank has delegated to its National Payment System Department (NPSD) the mandate to implement and oversee the PFMI for payment systems. To that end, the NPSD has requested all FMIs in the payment system to conduct a self-assessment exercise on their compliance with the PFMI. A process is currently under way to review the FMIs’ self-assessments.
Continuous Linked Settlement Bank and the impact of the downgrading of South Africa’s country rating by Standard & Poor’s

The downgrading of South Africa’s credit rating to BBB- by Standard & Poor’s in June 2014 had a consequential impact on the country’s participation in the Continuous Linked Settlement (CLS) Bank for the settlement of foreign-exchange obligations. According to the CLS Bank Rules and Member Handbook, the minimum rating of a country whose currency is used for settlement in the CLS system within normal payment grids should be BBB. The normal payment grids require banks to fund settlements in grids at every hour from 08:00 to 12:00 Central European Time (CET) within the short-position limit (SPL) as set for the currency. According to the CLS Bank Rules and Member Handbook, a downgrade by Standard & Poor’s to BBB- requires the CLS Bank to reduce the currency SPL to zero, and to change the currency haircuts for the rand to 99,99 per cent. These changes have to be implemented within five days of a downgrade.

Essentially this meant that the full rand funding in the CLS system needed to be accelerated to be completed by 09:00 instead of being staggered in the normal payment grids that could be funded as late as 12:00. In addition, long balances held by any CLS member in rand do not have any impact on the settlement completion calculations undertaken by the CLS system at 09:30. South African banks participating in the CLS settlement process (as settlement members or as nostro agents) always managed their CLS pay-ins in a very conservative manner. Most South African banks normally completed their full rand CLS pay-in obligations by 08:00 CET. The change in the payment grid was implemented from the value date of 23 June 2014. Since the implementation of the changed payment grid, no major liquidity issues have arisen and all South African banks have met the accelerated payment grid deadline of 09:00.

Digital currencies

Digital currencies refer to decentralised cryptocurrencies that interact with the real economy (in other words, they are exchangeable for legal tender and may be used to purchase real-world goods and services). Digital currencies are a subset of virtual currencies and are distinct from electronic money (e-money), defined in the Position Paper NPS 1 of 2009 (the Electronic Money Position Paper) as electronically stored monetary value issued on receipt of funds and represented by a claim on the issuer. E-money is generally accepted as a means of payment by persons other than the issuer and is redeemable for physical cash or a deposit into a bank account on demand.

Digital currencies reduce the costs associated with the conventional banking system and facilitate faster payments. However, they are susceptible to misuse, introduce a new set of risks to consumers and, at the very worst, have the ability to disrupt the financial system. The domestic digital currency landscape, systems and intermediaries are currently not supervised, overseen or regulated. Consequently, any and all activities related to the acquisition, trading and use of digital currencies are performed at the end user’s own risk.

44 A nostro agent is a financial institution that acts as an agent for a settlement member to facilitate payments from or to the member’s account in an eligible currency.
45 This is a digital currency that relies on cryptography for security.
South Africa is home to a digital currency exchange platform known as ‘BitX’ and a cryptocurrency exchange known as ‘MadibaCoin’. South Africans have shown interest in digital currencies but should at all times be mindful of the potential dangers associated with such unregulated undertakings.

The National Treasury, the Financial Intelligence Centre (FIC), the Financial Services Board, the South African Revenue Service (SARS) and the Bank together issued an investor and consumer alert notice highlighting the risks associated with virtual currencies. As a subset of virtual currencies, digital currencies are also covered by the notice.

The main sources of financial instability in the context of digital currencies would be the link between digital currencies and the real economy, and where digital currencies jeopardise the smooth functioning of payment systems.

In early 2014 the market value of Bitcoin, the leading digital currency, was slightly above US$6 billion based on an exchange rate of US$500 and the number of daily transactions then averaged 60,000, which is insignificant when compared to the national or other major global currencies. Digital currencies are also not considered legal tender in most jurisdictions. A multitude of independent variants of digital currencies exist and are being developed, all aimed at the same niche market. Based on the aforementioned data, digital currencies, at this stage of their development, are neither broad nor pervasive enough to be classified as systemic or a systemic risk. However, constant monitoring thereof is necessary and the Bank is continually monitoring and analysing market and other financial and economic factors to identify and mitigate systemic risks by implementing appropriate policies, and assessing the potential impact of these policies on the broader financial system.

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47 A digital currency exchange is an online marketplace where buyers and sellers stipulate their respective bids for various digital currencies. The exchange matches buyers with sellers, and charges a broker fee for a successful trade or ‘match’.

48 The notice is available on the National Treasury’s website at www.treasury.gov.za/communicationandmedia/press/2014.

Abbreviations

ABIL  African Bank Investments Limited
Alsi  All-share Index
BER  Bureau for Economic Research
BETI  BankservAfrica Economic Transaction Index
BIS  Bank for International Settlements
BMR  Bureau of Market Research
BoE  Bank of England
BoJ  Bank of Japan
BRICS  Brazil, Russia, India, China and South Africa
BSD  Bank Supervision Department
CAR  capital-adequacy ratio
CCB  countercyclical capital buffer
CCI  Consumer Confidence Index
CET  Central European Time
CET1  common equity tier 1
CFVI  Consumer Financial Vulnerability Index
CLS  Continuous Linked Settlement
CPI  consumer price index
CPSS  Committee on Payment and Settlement Systems
CRA  contingent reserve arrangement
CTI  cost to income
D-SIB  domestic systemically important bank
ECB  European Central Bank
EDF  expected default frequency
EME  emerging-market economy
EU  European Union
EY  Ernst & Young
FIC  Financial Intelligence Centre
FMI  financial market infrastructure
FNB  First National Bank
FSB  Financial Stability Board
GDP  gross domestic product
G-SIB  global systemically important bank
H-index  Herfindahl-Hirschman Index
HP  Hodrick–Prescott
HPI  house price index
HQLA  high-quality liquid assets
ICR  interest coverage ratio
IIF  Institute of International Finance
IMF  International Monetary Fund
IOSCO  International Organization of Securities Commissions
Jibar  Johannesburg Interbank Agreed Rate
JSE  JSE Limited
LCR  liquidity coverage ratio
LEI  legal entity identifier
MPC  Monetary Policy Committee
NBI  non-bank financial institution
NCAA  the National Credit Amendment Act 19 of 2014
NCR  National Credit Regulator
NDB  [BRICS] New Development Bank
NOP  net open foreign-currency position
NPL  non-performing loan
NPSD  National Payment System Department
NSFR  net stable funding ratio
OFI  other financial intermediary
OTC  over the counter
P/R  price to rent
PAIWG  Prudential Authority Implementation Working Group
PFMIs  Principles for Financial Market Infrastructures
PIC  Public Investment Corporation
PMI  Purchasing Managers’ Index
PwC  PricewaterhouseCoopers
QE  quantitative easing
ROA  return on assets
ROE  return on equity
RRP  recovery and resolution plan
RWE  risk-weighted exposure
SADC  Southern African Development Community
SARS  South African Revenue Service
SME  small and medium enterprise
SPL  short-position limit
UK  United Kingdom
Unisa  University of South Africa
US  United States

Glossary

e-money  electronic money
Strate  Strate (Pty) Limited
the Bank  the South African Reserve Bank
the Banks Act  the Banks Act 94 of 1990
the Credit Rating Services Act  the Credit Rating Services Act 24 of 2012
the Fed  United States Federal Reserve
the FMA  Financial Markets Act 19 of 2012
the National Credit Act  the National Credit Act 34 of 2005