KPMG

Financial Stability Review: Second Edition, 2017

Summary

November 2017

Objective of the Review:

In order to promote a stable financial system, the SARB publishes a biannual 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.

Financial Stability: Key Indices, Development and Trends impacting the financial stability of the country

Economic growth

Sub-saharan Region: The economic growth outlook of the region improved, in the backdrop of a global economic recovery in H1, 2017. However growth rates are expected to lag behind global trends for the next couple of years.

South Africa: For the South African economy, the SARB's projection of economic growth remained subdued. However, at the 2017 Monetary Policy Committee meeting held in September, the forecast was revised upwards marginally to 0.6% from 0.5%, while the forecasts for 2018 and 2019 remained unchanged at 1.2% and 1.5%.

Financial markets

In South Africa, the JSE Limited (JSE) All Share Index (ALSI) price-earnings ratio remained below 18 times earnings since 2011. Its growth rate in 2016 was equivalent to markets in UK, US and Germany, despite low domestic economic growth. However, a spillover effect of a sudden normalisation of interest rates and improved prospect of growth in advanced economies may negatively impact the South African equity market. Such a situation is unlikely with most of the key central banks governors suggesting a gradual reduction of balance sheets and normalisation of policy rates.

Financial institutions

Banking: South African banks remained healthy and well capitalised during the period under review. However, credit defaults continued to increase in H1, 2017. There is an increased credit stress in retail loan categories of the smaller banks, however profitability in the banking sector remained strong, decreasing slightly in the H1, 2017.

Pension Fund: Total assets of the pension and provident funds industry continued to increase, but at a slower pace.

Insurance: The long-term insurance industry remained adequately capitalised but its profitability has been negatively impacted by the subdued performance of the South African equity market.

Non-financial institutions

The share of financial assets held by other financial intermediaries (OFI's) in South Africa has increased consistently since the global financial crisis, and has continued to increase during the period under review. Interconnectedness among OFIs and banks is also relatively high in South Africa. This entails banks in South Africa receiving a relatively larger portion of their funding from OFIs than banks in other countries that participated in the international annual shadow-banking monitoring exercise. While this is not a risk in itself, it could contribute to systemic risks.

Households

- Households' balance sheets continued to deteriorate in Q2, 2017;
- Growth in disposable income of households moderated further and households remained financially vulnerable;
- Growth in savings by households remained positive in 2017.

Government finances

South African SOEs' debt is about 700 billion ZAR. Although government financial guarantees to SOEs remain around 10% of gross domestic product, the financial condition of most of South African SOEs deteriorated markedly in recent years. This could potentially lead to SOEs defaulting on their debt obligations and adversely affecting both government finances as well as other financial institutions exposed to these enterprises. Government debt also continued to trend upward, and is expected to increase to almost 60% of GDP in 2020/21. The containment of public debt and the narrowing of the budget deficit remains a focus area of the government.

Financial stability risks and outlook

Financial stability risks identified and rated as 'high' by the SARB include:

- Deteriorating domestic fiscal position resulting from lower-than-expected revenue collection;
- Rising contingent liabilities of State Owned Enterprises (SOEs); and
- Changing geopolitical events (North Korea, the Gulf state and Brexit), which could have considerable implications for financial stability.

Both the South African financial cycle and the business cycle continued their downward phases in the period under review, implying that the economy could go into a long and deep recession. Business confidence in South Africa dropped markedly in Q2, 2017 as policy and political uncertainty continued to depress business sentiment.

Securities outstanding in Q1, 2017 increased. Although the portion of domestic currency denominated securities have been increasing relative to foreign denominated securities since Q4, 2015, South African non-financial corporates remained exposed to external shocks emanating from foreign currency movements.

Robustness of the domestic financial infrastructure

Following are some of the key initiatives and update on regulatory developments undertaken by the government in 2017 to enhance financial stability.

Financial Sector Regulation Bill 2015

On August 21, 2017 the President of the Republic of South Africa signed the Financial Sector Regulation Bill into law. The effective date of implementation of the Financial Sector Regulation Act (FSRA) still has to be gazetted by the Minister of Finance. The FSRA authorises the SARB to establish a Financial Stability Oversight Committee (FSOC) to assist the SARB with the execution of its financial stability mandate. The FSRA also enables the establishment of a Prudential Authority (PA) which would be situated within the SARB, and a Financial Sector Conduct Authority (FSCA), a successor to the Financial Services Board (FSB). The move towards the Twin Peaks regulatory architecture will be introduced in a phased approach:

With Phase 1 being the establishment of the PA and the FSCA;

During Phase 2, the legal frameworks for prudential and market conduct regulation will be further developed, harmonised and strengthened by repealing the industry-specific legislation and introducing new legislation such as the Insurance Bill, the Special Resolution Bill and the Conduct of Financial Institutions Bill (Cofi Bill).

Regulatory developments affecting the domestic banking sector

The Financial Intelligence Centre Amendment Act

The Financial Intelligence Centre (FIC) Amendment Act was first passed by Parliament in May 2016. The Minister of Finance signed and gazetted the operationalisation of various provisions of the FIC Amendment Act 2017 on June 13, 2017 together with a roadmap, draft regulations, draft withdrawal of exemptions and draft guidance notices. The implementation of the FIC Amendment Act demonstrates South Africa's commitment to combating corruption, money laundering and illicit financial flows. It also brings South Africa's regulatory regime for AML/CFT in line with other members of the Group of Twenty (G20), thereby ensuring the safety and soundness of the financial system.

Proposals to establish a deposit

The SARB and National Treasury are currently developing new legislation that will facilitate the resolution of failing financial institutions in an orderly and transparent way, and thus minimising the use of government funding to bail out such institutions. This new resolution framework is an important pillar of the SARB's expanded and explicit financial stability mandate, as contained in the FSRA. A key component of such a resolution framework is the establishment of an explicit deposit insurance scheme to ensure that depositors who are most exposed to an asymmetry of information and thus least able to hedge or mitigate against financial loss in the event of a bank failure, are protected against losses and hardship that may stem from a bank failure. The implementation of an explicit deposit insurance scheme will bring about increased adherence to the Key Attributes of Effective Resolution Regimes and the Core Principles of Effective Deposit Insurance Systems issued by the Financial Stability Board and the International Association of Deposit Insurers respectively.

Regulatory developments affecting the insurance sector

Draft Insurance Bill of 2016

The Insurance Bill is being enacted as part of the broader Twin Peaks model of financial regulation. The Insurance Bill will introduce the Solvency Assessment and Management (SAM) regime and will also promote financial inclusion and transformation in the insurance sector. At the time of the first edition of the 2017 Financial Stability Review, the Standing Committee on Finance (SCOF) had called for public hearings on the Insurance Bill. On May 10, 2017 the National Treasury presented its response to public comments received on the Insurance Bill to the SCOF. The envisaged commencement date for the Insurance Bill is July 2018. Once enacted, the Insurance Bill will contribute to maintaining financial stability through an enhanced supervisory framework.

Finalisation of the International Financial Reporting Standard 17 on Insurance Contracts

On May 18, 2017 the International Accounting Standards Board (IASB) published the International Financial Reporting Standard (IFRS) 17: Insurance Contracts replacing IFRS 4: Insurance Contracts. IFRS 17 is intended to improve transparency and consistency in reporting by entities on insurance contracts by introducing consistent accounting for all insurance contracts based on a current measurement mode.

Regulatory developments affecting the domestic financial markets

Retirement fund default regulations

On 25 August 2017, the Minister of Finance issued the final regulations for implementation regarding retirement default fund regulations. The aim of default strategies is to reduce complexity by requiring retirement funds to develop cost-effective, relatively simple, and standardised products during the accumulation phase, when members withdraw from funds before they retire, and when members convert their retirement savings into an income upon retirement.

SADC Integrated Regional Electronic Settlement System (SIRESS)

The September 2013 and March 2015 editions of the Financial Stability Review reported on the plans to establish the Southern African Development Community (SADC) Integrated Electronic Settlement System (SIRESS). The SIRESS system is one of the building blocks that contribute to greater regional financial integration. Over the last two and a half years, participation in SIRESS has grown from nine to 14 countries, with at least one bank in each country being active on the SIRESS platform. The overall number of participants has also increased to 83 banks of which seven are central banks and 76 are commercial banks.

Exemption of retirement funds from certain prudential investment limits

On July 21, 2017, the FSB proposed to exempt retirement funds from certain prudential investment limits. These limits determine that funds may invest in debt instruments issued or guaranteed by a listed South African bank against its balance sheet, subject to limits being based on the market capitalisation of the South African bank. Enabling retirement funds to access safe local assets to invest in could lead to an increase in aggregate domestic savings which could potentially reduce reliance on volatile foreign capital inflows.

Financial technology innovation and SARB's regulatory approach

The SARB started monitoring FinTech innovation in 2013 when it joined an informal, domestic intergovernmental working group (IWG) consisting of National Treasury, FIC, and the South African Revenue Services. The SARB has recently made three proposals to strengthen the regulatory approaches to FinTech. These proposals, aligned to the Financial Stability Board's FinTech report, are as follows:

- Focusing analysis on activities involving financial services rather than on firms or technologies;
- Continuing collaboration between local and global regulatory authorities; and
- Investigating and deciding on the most appropriate structures, such as sandboxes, to keep abreast of FinTech developments and to allow for demonstration of the technology and experimentation with user cases.

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