Herman van Papendorp
Head of Investment Research & Asset Allocation

Sanisha Packirisamy
Economist

The Macro Research Desk

Financial Stability Review: South Africa's financial sector remains resilient

Highlights

- Global financial stability risks have intensified since April 2018.
- The downward phase in South Africa's (SA) business cycle is coinciding with a downward phase in the financial cycle, which exacerbates financial stability risks. However, the country's financial sector remains resilient and the banks have held up well in stress tests.
- The SA Reserve Bank (SARB) warned against four key risks, which include weaker global growth, low domestic growth, a faster-than-anticipated pace of policy tightening in developed markets (DM) and cybersecurity risks.
- A desynchronisation of global growth has been amplified by rising protectionism, weaker commodity prices and idiosyncratic emerging market (EM) vulnerabilities.
- Global liquidity conditions are tightening, leaving EMs with macroeconomic shortfalls in the spotlight.
- Although SA has a well-capitalised corporate sector and has limited foreign debt relative to its peers, deep and liquid financial markets make the country susceptible to negative spillover effects from EM pessimism.
- Contingent liabilities, which are greater than SA's foreign-currency-denominated debt holdings, pose a significant risk to SA's sovereign ratings.
- SA households have delevered significantly since 2008 and consumer vulnerability has dropped.
- The indebtedness of SA corporates in the lacklustre growth environment is concerning.
- The demand for insurance products has slowed against the backdrop of weaker growth and subdued confidence, as reflected in the decline in premium income growth in the past few years.

Global financial stability risks have intensified since April 2018

The SARB possesses the mandate to protect, support and enhance the banking sector and aims to maintain financial stability and identify vulnerabilities upfront.

In its October 2018 Financial Stability Review (FSR), the SARB pointed out four key risks that have intensified since the previous review in April 2018.

The desynchronisation in global growth has been amplified by rising protectionist measures, weaker commodity prices and idiosyncratic EM vulnerabilities. The drying up of global liquidity, due to a normalisation in monetary policy in a number of key DM economies, has contributed to global growth becoming more uneven. As such, the risk of abrupt asset repricing in the financial sector remains high.

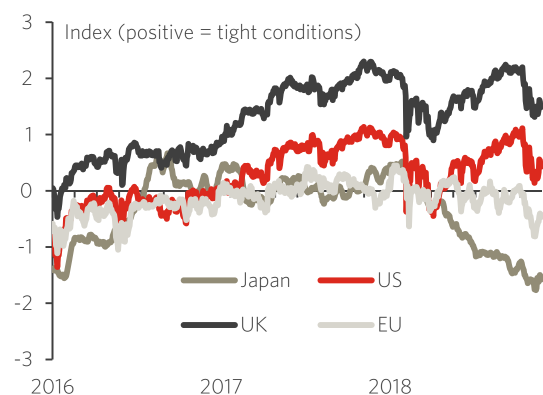
Uncertainty in the local economy has resulted in lacklustre growth, which has increased the risk of a negative spillover into the financial sector. Due to globalisation, cybersecurity has increased in importance and could further threaten financial stability in the local economy.

Financial stability risks have also increased in the local economy since the April 2018 FSR. The financial cycle, which is an estimated average of the medium-term cycles in credit, equity and house prices, has been in a downward phase since the fourth quarter of 2017. This downward phase is now coinciding with a downward phase in the business cycle, which exacerbates the risks to financial stability.

Global financial conditions expected to tighten

The United States (US) and United Kingdom (UK) have moved toward tighter monetary conditions (see chart 1), while the Euro area and a number of Asian economies have left monetary conditions reasonably accommodative.

Chart 1: Financial market conditions



Sources: Bloomberg, Momentum Investments

A gradual interest rate hiking cycle is expected to continue in the US, as the economy continues to grow above trend and employment gains remain strong. The US Federal Reserve (Fed) is expected to hike interest rates once more in 2018, followed by three hikes in 2019, before the anticipated downturn in 2020. Despite tepid growth in the UK, as a result of Brexit-related concerns, price pressures have built up on a weaker sterling. In response to stagflationary conditions, the Bank of England is expected to raise interest rates at a very gradual pace to stem inflation pressure, with one more hike projected for 2019. In the European Union, growth in 2018 has softened relative to 2017 and inflation has struggled to gain traction. The European Central Bank (ECB) should end its quantitative easing programme by the end of 2018 as indicated, but is expected to only raise interest rates for the first time in the final quarter of 2019, at the earliest. Momentum Investments expects monetary policy to remain ultra-accommodative in Japan, given a lack of inflation pressures and a modest growth outlook.

A tightening in global financial conditions and uncertainty around trade policy have culminated in weaker global risk appetite, which has led to an increased aversion to EMs, as observed through the recent sell-off in the EM equity, currency and fixed income markets. A faster-than-expected pace of interest rate tightening remains a risk for EMs because a repricing in assets could cause significant capital flight or sudden stops in capital flows, which are particularly threatening for economies with high external financing needs.

A more rapid rise in US interest rates would in addition exacerbate the dollar shortage in the global economy, which would result in a further tightening of financial conditions.

Idiosyncratic risks in Turkey and Argentina have made these markets more susceptible to sell-offs. US-dollar-denominated debt accounts for a whopping 66% and 52% of total sovereign debt, respectively, in Argentina and Turkey.

However, contagion risk spreads through a number of other EMs presenting macroeconomic shortfalls and high external financing needs. Currencies that experienced severe depreciation in the year to 13 November 2018 included the Argentine peso (negative 44.8%), the Turkish Lira (negative 31.4%), the SA rand (negative 17.8%) and the Russian rouble (negative 17%).

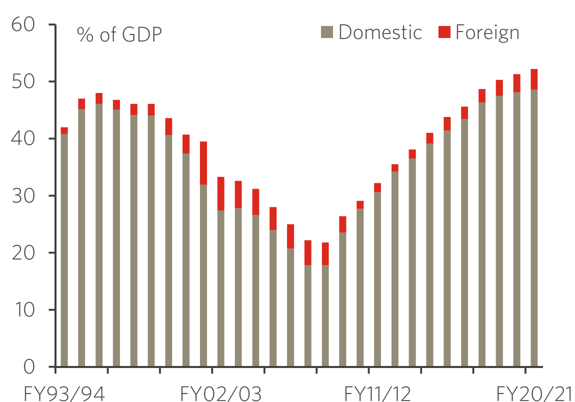
SA stands apart from its more vulnerable EM peers

The corporate and banking sectors in SA are highly capitalised because exposure to foreign currency debt is capped. The Financial Sector Laws Amendment bill, which aims to monitor and mitigate systemic risk in the market, the National Credit Act Amendment Bill (NCAAB), which will aid credit consumers in receiving debt relief from high unsecured loans, and the Insurance Act 18 of 2017 act as guidelines for the legal framework insurers are expected to perform within. These acts highlight the strong regulatory and financial systems in SA.

SA boasts foreign-currency-denominated debt of only 10%, while 90% of its debt is local-currency-denominated debt (see chart 2). Relative to its EM peers, this is a stable figure. China, India, Singapore and Thailand have very little to no foreign-denominated debt, while Argentina and Turkey are on the opposite side of the fence with exorbitant foreign-denominated debt, holding a shorter term to maturity.

SA's ever-growing twin deficits (current account and fiscal) have been marginally offset by the positive net international investment position the country has been running since 2015.

Chart 2: SA's share of foreign-currency-denominated debt



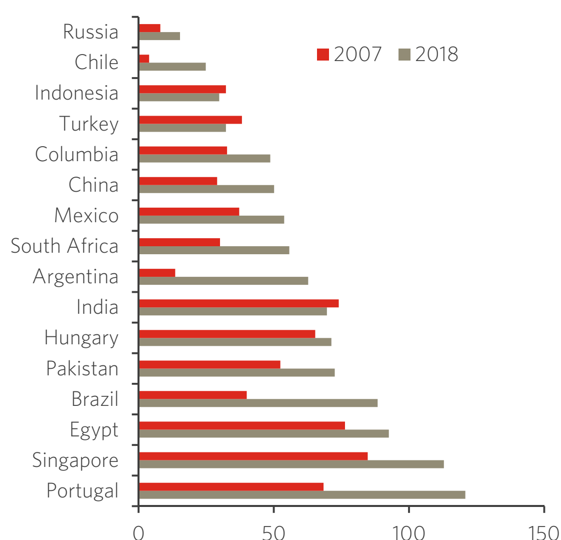
Sources: Treasury, Momentum Investments

External assets (amounting to 149% of gross domestic product (GDP)) continue to grow above the country's external liabilities (137% of GDP).

SA has been one of the most affected countries in the latest EM sell-off

Although SA has a well-capitalised corporate sector and limited foreign debt relative to its peers, deep and liquid financial markets in SA make the country susceptible to negative spillover effects from EM pessimism.

Chart 3: Comparative debt ratios



Sources: Bloomberg, Momentum Investments

Sovereign debt dynamics in SA have deteriorated in the last few years owing to below-trend growth, revenue shortfalls exacerbated by weak areas of governance, unsustainable growth in fiscal expenditure (including higher funding and guarantees to state-owned enterprises (SoEs)) and escalating debt-servicing costs.

Public debt has almost doubled since 2008, from 30% to 53% of GDP in fiscal year 2018/2019. High debt ratios have a negative effect on investor confidence, as sovereign creditworthiness becomes questionable and refinancing needs raise the risk of greater financial instability. A rise in the debt risk premium equates into higher interest rates, higher debt-servicing costs and increased rollover risk.
 Other financial assets could lose value through lower prices, thus affecting the soundness of financial balance sheets. Nevertheless, debt levels in SA remain below the average in EM at 53% (see chart 3). SA's public debt level (excluding contingent liabilities) is still below the 70% high-risk threshold set by the International Monetary Fund (IMF). However, after including SA's contingent liabilities and provisions, SA's total debt to GDP soars to 71%.

SA's contingent liabilities are a sizeable risk given they are greater than the country's foreign-currency-denominated debt holdings. Eskom's provision of guarantees alone exposes government to 6.5% of debt to GDP. A default by an SoE would result in government taking over the SoEs' debt obligations, exerting more pressure on the domestic fiscal framework, with the potential for a cycle of debt and defaults. The possibility of an SoE default could result in SA exiting the Citigroup World Government Bond Index (Citi WGBI) should Moody's decide to lower SA's sovereign rate into s ub-investment grade. This would in turn trigger an outflow of capital from SA's bond market, which is likely to be worse than the sell-off in 2017, when Fitch rating agency and Standard and Poor's Global Ratings downgraded the country's local currency rating to sub-investment grade.

The Common Scenario Stress test, aimed at evaluating the resilience of the SA banking sector, indicated the country's participating banks were adequately capitalised to withstand plausible and severe stress scenarios, designed to stimulate additional credit, market and liquidity risks within the banking sector. However, there is higher risk for sovereign distress

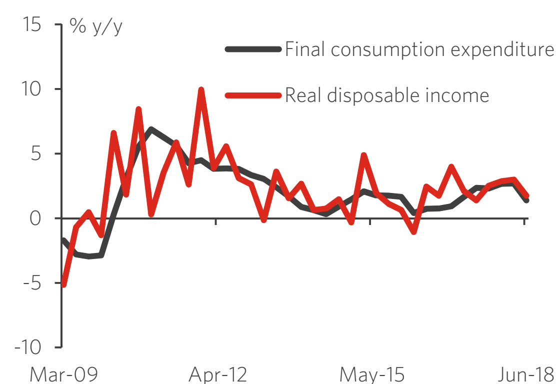
through the potential for large foreign capital outflows, which could intermittently cause a reduction in the value of the sector's government debt holdings. The banking sector presents risks in the next year that could emanate from the continued effect of International Financial Reporting Standards (IFRS) 9 on the sector's regulatory capital and reserves, increasing credit stress due to low loan portfolios and a repricing of government holdings that could be triggered by a sovereign crisis. The SARB noted medium-term risks depend on how the proposed policy for land reform without compensation is finally implemented.

SA's households may be past the peak point of vulnerability

A highly indebted household sector could be sensitive to shocks and spillovers into the financial sector. Decreases in household disposable income could impair consumers' ability to service their debt and inevitably default.

Growth in disposable income dipped from 7.2% in the first quarter of 2018 to 5.9% in the second quarter. Take-home pay declined by 2.4% in the second quarter in year-on-year terms, owing to higher inflation and a delay in annual salary adjustments for public sector servants. The SARB noted that, although the growth trend has declined, disposable income has grown faster than inflation since the start of 2017 (see chart 4) and is expected to continue this trend.

Chart 4: Real growth in household consumption closely tracks real growth in disposable income



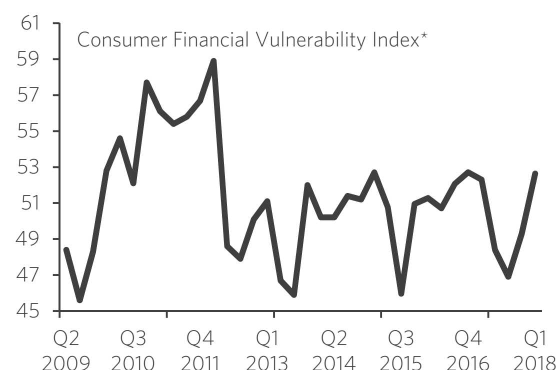
Sources: SARB, Momentum Investments

Despite a tepid rise in household credit, household debt, as a share of GDP, declined from 42.8% in the first quarter to 42% in the second quarter. Mortgage advances, instalment sale credit and credit card advances have been on the rise since the second quarter of 2017, contributing to the increase in credit extended to households.

Households have delevered significantly since the peak was reached in the household debt-to-disposable income ratio. This ratio dipped from a high of 85.7% in 2008 to 71.3% in the second quarter of 2018.

Household debt affordability has also improved, with the growth in debt-servicing costs falling from 3.7% in the first quarter of 2018 to 2.5% in the second quarter. The gap between the average interest rate paid by households and the prime lending rate narrowed between the first and second quarter of 2018. Meanwhile, the willingness to extend loans deteriorated in the same period, as shown by a rise in the rejection rate from 48.5% to 50.1% in the second quarter of 2018.

Chart 5: Consumer vulnerability has declined



Sources: Bureau of Market Research (UNISA), Momentum Investments
**10 to 20 = financially very vulnerable, 20 to 39.9 = financially vulnerable, 40 to 49.9 = financially very exposed, 50 to 59.9 = financially mildly exposed, 60 to 79.9 = financially secure, 80 to 100 = financially very secure*

The Consumer Financial Vulnerability Index (CFVI) compiled by MBD credit solutions/Bureau of Market Research (BMR) has improved from 49.5 index points in the last quarter of 2017 to 52.6 points in the first quarter of 2018 (see chart 5). This improvement relates to the increased relief on the sub-indices in income and expenditure, as sentiment regarding access to financial support improved.

The continual decline in the Household Economic Stress Index (HESI) since 2016 corroborates the decline in consumer vulnerability. The HESI for SA economy is a composite index including the average household interest rate (weighting = 28.7%), unemployment rate (28.1%), inflation rate (27.7%), annualised GDP (9.8%) and the change in

house prices (5.7%). Unemployment and inflation have a negative effect on the HESI, while the interest rate has a positive and negative effect, although the negative effect is more pronounced as it increases because of the high debt levels and low savings rate in SA. Income growth has a larger effect than house prices, while the unemployment rate is more important than inflation in the overall index. An increase in the HESI indicates a rise in stress in the household sector. The second quarter of 2018 reflected a marginal increase in the HESI to 12.3, just slightly above its ten-year average of 11.8 index points. Despite the recent increase, the two-year trend shows a marked improvement in household financial conditions.

The National Credit Regulator (NCR) provides debt review, which is considered a debt relief mechanism that restructures loans by lowering interest to predetermined levels and relinquishes fees for credit providers. The National Credit Act Amendment Bill (NCAAB) of 2017 makes explicit provision for a measure of debt relief. The NCAAB would allow debt relief and possibly debt written off to credit active consumers with an income of R7 500 and less who have unsecured credit of not more than R50 000.

The second quarter showed a 38.9% growth rate in consumer impairments, which equates to 9.57 million consumers from the total 24.59 million credit-active consumers, as recorded by NCR (see chart 6). At the second quarter of 2018, banks provided 77.2% of credit to consumers relative to 79.8% in the fourth quarter of 2012, followed by other credit providers (10.5% relative to 10.1%), vehicle financiers (7.9% relative to 5.2%) and retailers (4.4% relative to 4.8%). Banks are therefore still significantly more exposed to household indebtedness.

The distribution of credit granted is skewed towards income earners of R15 000 and higher. This category of income earners constitute 81.6% of total credit granted, as recorded in the second quarter of 2018 relative to 68.3% in the fourth quarter of 2012 when unsecured loans peaked. Only 6.1% of credit granted fell into the R7 500 or less income-earning group.

Chart 6: Growth in impairments is declining

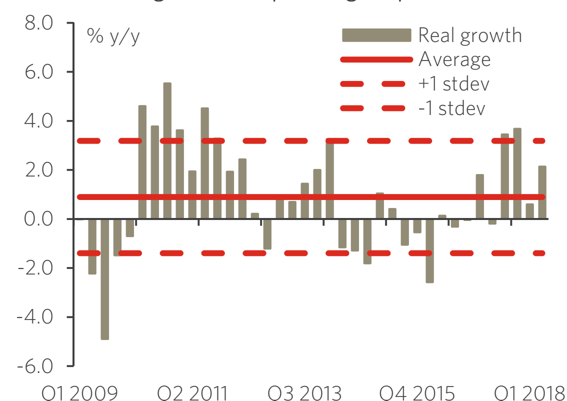
Sources: NCR, Momentum Investments

SA corporates remain under pressure

An environment of declining growth and subdued confidence has affected profitability growth for non-financial corporates. Real growth in operating surplus has averaged 1.2% in the past two years (see chart 7). Similarly, real growth in credit extension slowed from a recent peak of 9.6% in May 2015 to 0.2% in the first half of 2018. Fixed investment spend by corporates has remained weak, with real growth averaging negative 1.2% in the past three years.

Non-financial corporates' foreign-currency-denominated debt declined to US$8.6 billion from US$8.8 billion in the second quarter of 2018. These levels are still small relative to total debt securities and are generally used for offshore expansion. Therefore foreign debt is serviced using income generated abroad, creating a natural hedge against currency risk. SA corporates are therefore not as vulnerable as other EM corporates to the normalisation of DM monetary policy.

Chart 7: Real growth in operating surplus



Sources: NCR, Momentum Investments

The interest coverage ratio (ICR) is an estimation of a firm's ability to generate cash flows to finance its interest expenses on outstanding debt by dividing a firm's earnings before

interest and taxes (EBIT) with its annual interest expenses. An ICR below 2 is deemed weak according to the IMF. Corporates in SA had an ICR of 2 in the second quarter of 2018, having dropped from 2.4 in the first quarter because of a decline in EBIT. Electricity, gas and water supply providers have an ICR of less than 1, which has deteriorated since the previous review.

Debt-servicing costs have been low relative to EM peers, but increased since the second quarter of 2015. The indebtedness of corporates in the lacklustre growth environment is of concern. The distribution of the expected default frequency (EDF) has shifted to the right since the last FSR. There has been an increase in the number for corporates, which reported EDFs between 10% and 30% from 22 to 24 in September 2018, relative to a similar period a year ago. There were four corporates, which had an EDF of more than 30%. However, only 73% of corporates recorded EDFs of less than 3% in October 2018. This means there is a 3% probability that 73% of corporates could default in their debt obligations. Corporates had a one-year EDF of 3.9% in October 2018 relative to 3.1% since the previous review in April 2018. The unchanged debt rating for non-financial corporates of Caa2 is indicative of a still-elevated credit risk profile.

Likelihood and effect of risks facing SA's market

The SARB regularly assesses the risk to the country's financial stability in the next year, with a view to identifying and mitigating any risks and/or vulnerabilities in the domestic financial system.

Table 1: Identified risks to SA's financial stability

	Medium likelihood	High likelihood
Medium effect	(1) Weaker global growth	(2) Low domestic growth
High effect	(3) Faster developed market policy tightening (4) Cybersecurity risks	

Sources: SARB, Momentum Investments

(1) Weaker global economic growth

An uneven recovery in global growth could interrupt the recovery in the US and cause a slowdown in the Euro Area. Brexit issues could worsen and EMs could continue to face weaker growth, as commodity prices remain low and US dollar strength persists. US bond yields will soar in this scenario and trade tensions could escalate, while the turmoil in Turkey is expected to spread to other EMs. These events would cause lower external demand for SA exports. Lower local economic growth and weak fundamentals would negatively affect sovereign and corporate credit ratings. Unemployment rates would rise and hamper debt servicing, which would result in increasing funding costs. The financial and non-financial sector would experience an increase in credit risk.

(2) Lower domestic economic growth

Policy uncertainty about land expropriation in the local economy will raise confusion about the effect on property rights and intensify an already-pessimistic outlook from investors. The fiscal financial burden would worsen if SoEs failed to meet their debt obligations and further bailouts would be required from the state. Weak consumption expenditure would remain constrained by the VAT increase and the sharp rise in petrol prices in this scenario.
The combination of these negative variables would result in the economy remaining in a protracted low economic growth environment. The fiscal position would continue to deteriorate, while debt levels would edge higher, signalling ratings downgrades as the economy becomes more vulnerable. Capital would flow to economies with stronger balance sheets. Financial institutions would be exposed to collateral losses, while the quality of bank assets would deteriorate, spilling over into a reduction in private sector credit extension.

(3) Faster-than-expected tightening of global financial conditions

An unanticipated tightening in US monetary policy and an accelerated unwinding of its balance sheet with further US tax cuts would create a misalignment between US fiscal and monetary policies, creating further shortages in US dollar liquidity. Contagion effects to SA and other EMs from turmoil in Turkey would intensify in a stronger dollar environment. Risk repricing would lower domestic asset value and spur capital flight, while the rand could depreciate further. Lower investment and domestic growth would result in this scenario and companies would continue to shed jobs. Debt levels would soar and compromise the asset quality of banks.

(4) Cybersecurity risk

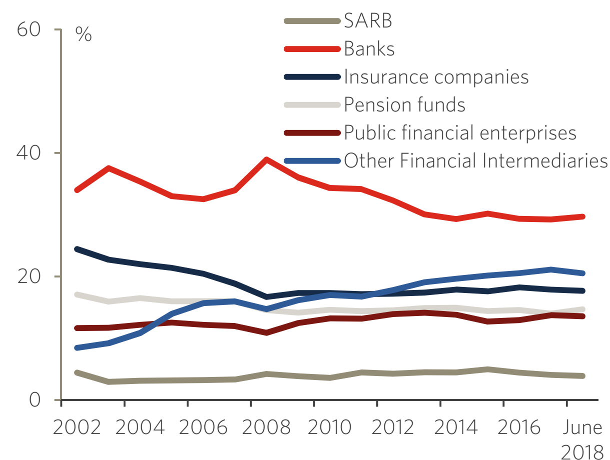
Breaches that relate to ransomware could target critical infrastructure and strategic industries through leaking confidential market-relevant information. Globalisation

elevates vulnerability to cyberattacks. Corporate breaches and financial losses at the helm of financial infrastructure crashes could weaken financial balance sheets.

Cyber risks continued to grow with gross losses up 7% in the first eight months of 2018, relative to the same period a year ago. A total of 13 438 online incidents were recorded in 2017, tallying up to R250 million in losses. The SARB has actively tried to create cybersecurity awareness in the banking sector through its Bank Security Department (BSD). In 2017, the BSD encouraged banks to test their cyber-resilience. The SARB also established the Financial Sector Contingency Forum (FSCF), in which all the major sector stakeholders are represented.

Shadow banking activities continue to be closely monitored, even though the Financial Stability Board (FSB) has seen a decline in these activities. The proportion of shadow banking activities has remained stable at 30% since 2015 (see chart 8). There has been an upward trend in the share of assets held by other financial intermediaries, but it has stabilised to 20.5% at the end of June 2018.
Pooled investment portfolios remained the largest contributor to shadow banking.

Chart 8: Distribution of financial assets between financial intermediaries in SA



Sources: SARB, Momentum Investments

SA continues to perform stress tests in the banking sector

The SARB conducted its common scenario stress test, which aims to assess the resilience of the SA banking sector with a set of hypothetical macroeconomic shock scenarios. Six major SA banks, that constitute 93% of the total assets in the banking sector, participated. The test was conducted for a three-year forward-looking horizon. Three scenarios were outlined, namely a baseline, a severe (yet short-lived) V-shaped recession and a more protracted L-shaped recession.

The V-shaped recession is assumed to be triggered by a sharp decline in global growth and is characterised by a significant decline in domestic growth. The scenario is accompanied by a rapid decline in commodity prices and lower oil prices resulting in lower global inflation. In this scenario, lower commodity prices and negative sentiment towards EMs should redirect capital towards safe-haven DMs. In this scenario, the repo rate is expected to rise initially, but decrease eventually to support the negative output gap.

In the L-shaped scenario, domestic growth is expected to decline due to idiosyncratic (rather than global-led) shocks and remains in negative territory, signifying a moderate but drawn-out recession. Lower confidence for consumers and producers should affect potential growth and shift it lower in the scenario. Continual job losses, lower investment and falling disposable income are likely to lead to a self-reinforcing cycle of weak sentiment and growth in the L-shaped scenario. Monetary policy is expected to tighten further until weaker activity results in a gradual easing of monetary policy.

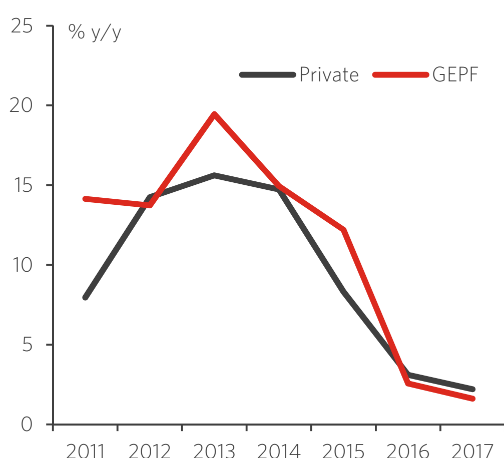
Credit losses are more pronounced in the V-shaped scenario. The L-shaped scenario leads to a reduction in bank income, as interest rates decline through the endowment effect. Reduced credit losses are experienced in this scenario.
A market-risk-sensitivity analysis showed the aggregated effect of a single factor sensitivity shock on the common equity tier 1 (CET 1) capital adequacy ratio (CAR) was negligible. Banks showed resilience in meeting minimum regulatory requirements even under disruptions.

The test concluded that the SA banking sector is resilient to the possible materialisation of what is considered to be the main financial stability risks. The banks proved to be solvent, with minimum required CARs above the average capital requirements under these considered adverse macroeconomic scenarios.

Update on SA's pension fund and insurance industries

Assets held in private self-administered pension funds have grown at a slower rate since 2013 (see chart 9). Insurance policies take up a significant share of these funds. Meanwhile, the growth in assets in the Government Employees Pension Fund (GEPF) has broadly mimicked that of private funds, but the GEPF has the majority of its funds allocated to listed equities and government bonds. The significant size of its bond holdings exposes GEPF holders to reduced asset values, if another sovereign credit ratings downgrade has to occur. The state would have to fund the shortfall, which adds to government's debt burden.

Chart 9: Growth in private pension funds and the GEPF



Sources: SARB, Momentum Investments

Pressure on EMs can translate into increased financial market volatility risk to assets and capital of insurers and can dampen income on investments. Demand for insurance products has slowed against the backdrop of weaker growth and confidence. This has been reflected in the decline in premium income growth in the past few years. Assets and liabilities in the long-term insurance industry have shown a similar trend. This is a reflection of a large portion of pure-linked business (where policy holders are exposed to investment risks) that is underwritten by long-term insurers.

There were 73 registered companies in the long-term insurance industry, with total assets increasing by 7.7%. The financial position remained favourable and the asset composition remains unchanged in the six months ended 30 June 2018. The industry has displayed financial stability and resilience despite the difficult business climate. The legal reserve buffer, also known as the CAR for the industry, is R42.0 billion, which is five times that which is required.

Growth in gross premiums for long-term insurers has been negative since 2016, while growth in premiums for short-term insurers has risen by 5.9% in the six months ending June 2018 relative to a similar period a year ago. The growth in premiums for short-term insurers was mainly driven by motor and property insurance, which constituted 74.8% of gross premiums. Adverse weather conditions have resulted in large payouts, specifically from the last three catastrophic events in the past 18 months. The Knysna fires in June 2017 resulted in payouts to the value of R3.5 billion, while the drought in the Western Cape and the storms in Gauteng and KwaZulu-Natal also amounted to significant payouts.

The insurance industry is highly concentrated. The largest-five long-term insurance firms constitute 73% of the market, while the largest-five short-term insurers represent 47% of the market. The performance of these firms has a significant effect on the system because of the high levels of interconnectedness in the financial sector.

Nevertheless, the sophistication of insurers' risk management is expected to improve because of the Solvency Assessment and Management (SAM) regime that took effect on 1 June 2018. This new regime will provide a more accurate reflection of risk for individual insurers and for the sector. Financial conglomerate supervision is expected to capture a more holistic view of the risks and concentration within diversified insurance and financial services groups.

Reasonable steps have been taken to ensure the validity and accuracy of the information in this document. However, Momentum Investments does not accept any responsibility for any claim, damages, loss or expense, howsoever arising out of or in connection with the information in this document, whether by a client, investor or intermediary. The content used in this document is sourced from various media publications, the Internet and Momentum Investments. For further information, please visit us at www.momentuminv.co.za.