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SARB Financial Stability Review

Introduction

The South African Reserve Bank (SARB) recently released its April 2018 Financial Stability Review (FSR). The SARB concluded that South Africa's (SA) financial sector is strong and stable and continues to feed off positive business and consumer sentiment, in spite of global uncertainties, monetary policy normalisation and protectionist measures. The local economic growth outlook is expected to improve, given positive confidence levels and ongoing household balance sheet recovery.

Global environment

- The potential global contagion effects of a prolonged equity bear market (given a deterioration in global risk aversion measures in the past few months) threaten benign market conditions.
- Some global stock market valuations (based on price-earnings and price-to-book ratios) suggest the global market could be overvalued and might be trading at levels that are not supported by economic fundamentals, while the one-year forward-earnings multiple indicates the rally is indeed underpinned by a solid global economic activity, which supports a bullish position on expected returns.
- In February 2018, there was a short global equity market correction with emerging markets (EMs) experiencing capital outflows (having appeared riskier).
- Continued firm growth expectations in advanced economies increase the risk of a faster-than-expected pace of interest rate tightening, which amplifies the risk of further capital outflows from EMs.
- The end of low global interest rates is signaled by higher global inflation (partly owing to an increase in oil prices).
- The increase in the Global Financial Stress Index (GFSI) in February 2018 captured concerns about expected volatility in the prices of global financial assets and reflected vulnerabilities of overvalued global financial assets to near-term price corrections.

Local environment

- Local improvements that aided in the aversion of a Moody's sovereign ratings downgrade include the market-favourable change in political administration, the positive austerity-themed 2018/19 budget and the general euphoria that spurred consumer and business confidence.
- Favourable interest rate differentials will continue to be advantageous for the currency at present foreign investment levels, barring a ratings downgrade in October 2018.
- Foreign currency-denominated debt securities issued by SA corporates could be a cause for concern for financial stability, given the elevated probability of further interest rate increases in advanced economies (and, hence, potential rand weakness, in Momentum Investments' view).

- The interest coverage ratio (ICR) is an estimation of a firm's ability to generate sufficient cash flows to finance its interest expenses on outstanding debt. The majority of industries have an ICR above two, indicating the sectors managed to generate enough cash in the previous year to service their debt. The electricity, gas and water supply industry, however, continued to record a low ICR.
- The expected default frequency (EDF) of a firm measures the probability that a firm's future market value could be insufficient to meet its future debt obligations. More than 70% of SA corporates recorded EDFs below 3% at the end of March 2018, implying there should be a less than 3% probability that these corporates would be unable to honour their debt obligations in the following year.
- Three (unspecified) non-financial corporates recorded EDFs of higher than 30%, which is a cause for concern. While the previous report (October 2017) rated non-financial corporates at an equivalent Standard and Poor's rating of Caa1, the current higher credit risk profile of non-financial corporates implies a lower debt rating for domestic non-financial corporates of Caa2.
- Banks' profitability continued to decline for the six months to January 2018, which could impair capital accumulation in the long run.
- US-dollar-denominated debt continues to be the largest portion of foreign currency-denominated debt by corporates, at 69.4%, followed by euro-denominated debt (15%).
- The 12-month risk assessment matrix (as viewed by the SARB) is briefly summarised in the table below. Other geopolitical risks at play are being closely monitored, but are not seen as posing a significant current risk to financial stability

Table 1

	Probability	Expected effect on financial stability in SA
Vulnerable local fiscal position	Medium: Rising contingent exposure of state-owned enterprises' (SoEs) financial impairments	High: Roll over of debt and SoE drawdown on guarantees pose risk to further credit rating downgrades. SoE guarantee utilisation increased from 54% FY 2016/17 to 64.5% FY2017/18.
Persistently low growth effects on bank asset quality	Medium: Prolonged downward business and financial cycles result in deep recession if incurred and expose banking sector to low asset quality	High: Unfavourable household and corporate conditions (high debt, low income and profitability) hurt bank asset quality
Abrupt repricing of risk premiums triggered by a policy expectation shock	Medium: Strong economic performance could spur policy shocks and a repricing of risk premiums, causing market corrections in overvalued markets	Medium: Financial system vulnerability to market corrections causes weak confidence and asset price losses
Trade protectionist measures	High: Trade protectionism and retaliatory measures	High: Lower global growth and global asset prices stemming from trade policy uncertainty

- Other significant, but low-risk, events monitored by the SARB include:
  - Steinhoff International Holdings is still under investigation for accounting irregularities that culminated in the company's share price dropping more than 80%. This does not pose an immediate risk to financial stability. The current risk includes default on its debt exposure.
  - Short-selling volumes have increased since December 2017, causing volatility by influencing markets through negative news flow with the risk of causing financial instability. This threatens investor confidence, more so for a deposit-accepting institution. Capitec Bank was targeted but the systemic event was negated by reassuring investors and depositors through swift communication refuting all allegations.
  - VBS Mutual Bank was placed under curatorship on 11 March 2018 for reasons including aiding the bank in maintaining its continued functioning and protecting the safety of depositors' money.
- The financial cycle is in a downward phase that started in the third quarter of 2016, with all its constituent price data (credit, house and equity) in downward phases.
- The private sector credit-to-GDP (gross domestic product) gap has been negative since 2011 and remains below its long-term average trend line.
  - The household credit-to-GDP gap has remained in negative territory for a significant period.

- The corporate credit-to-GDP gap is at negative 0.69. The Experian Business Debt Index (0 is the base, >0 shows improving business conditions with <0 indicating a deterioration in business conditions) recorded 0.443 index points in the fourth quarter of 2017, up from 0.059 index points in the third quarter of 2017, indicating that corporates' debt conditions have been improving
- Pension assets (relative to GDP) were at 73.7% in December 2017. From 2010, the lowest percentage relative to GDP was at 69.3% in 2010 and the highest at 80.4% in 2014. The exposure to the negative effect of a sovereign credit rating downgrade is similar to that of banks, as a direct result of the total holdings of bonds in pension portfolios. However, this does not pose a financial stability risk, as these bonds are generally held to maturity.
- The insurance sector faced continued policy lapses and surrenders, although assets of the long-term insurance industry continue to grow, comprising 61% of GDP.
- There has been a decline in the SA banking sector's share of financial assets in line with global outcomes, with other financial intermediaries' (OFIs) share having increased consistently since the global financial crisis amounting to 21% in September 2017.
- A large share of funding for the SA banking sector flows from OFIs compared to banking sectors in other countries.
- Household balance sheets appear to be out of the doldrums, as the short- to medium-term outlook keeps improving (see table 2). These include marginal improvements in disposable income, an 11.3% year-on-year net wealth increase and a meagre, but welcoming, reduction in debt (as a percentage of disposable income) from 72% to 71.5% between the third and fourth quarters of 2017. However, the VAT increase should have a negative effect on the purchasing power of households.

Table 2

Annual percentage change, unless indicated otherwise	2016	2017			
	Q4	Q1	Q2	Q3	Q4
Disposable income	8.5	7.8	7.3	7.2	7.3
Financial assets	4.5	3.7	2.8	7.1	12.3
Total assets	4.7	4.2	3.6	6.5	10.2
Net wealth	4.9	4.3	3.6	6.8	11.3
Consumption expenditure	0.9	1.6	2.3	2.3	2.7
Consumption expenditure to GDP	59.7	59.9	59.3	59.2	59.4
Capital gearing	16.6	16.4	16.4	16.2	15.8
Credit extension	0.7	0.6	2.9	3.3	3.8
Mortgage advances extended to households	2.9	2.9	3.0	2.9	3.4
Mortgage debt as a percentage of household disposable income	35.7	35.7	35.2	34.9	34.4
Savings as a percentage of household disposable income	0.1	0.2	0.3	0.4	0.2
Debt as a percentage of household disposable income	72.7	72.7	71.9	72.0	71.2
Debt to GDP	43.4	43.6	42.8	42.8	42.3
Debt-service cost of household debt	8.1	4.6	3.3	3.7	3.9
Debt-service cost as a percentage of disposable income	9.4	9.4	9.3	9.2	9.1
Debt	3.4	3.9	3.4	4.9	5.0
FNB Household Debt-Service Risk Index	5.1	5.2	5.3	5.4	n/a

Source: SARB