



Financial Stability Review: A more favourable domestic environment for the financial sector

Highlights

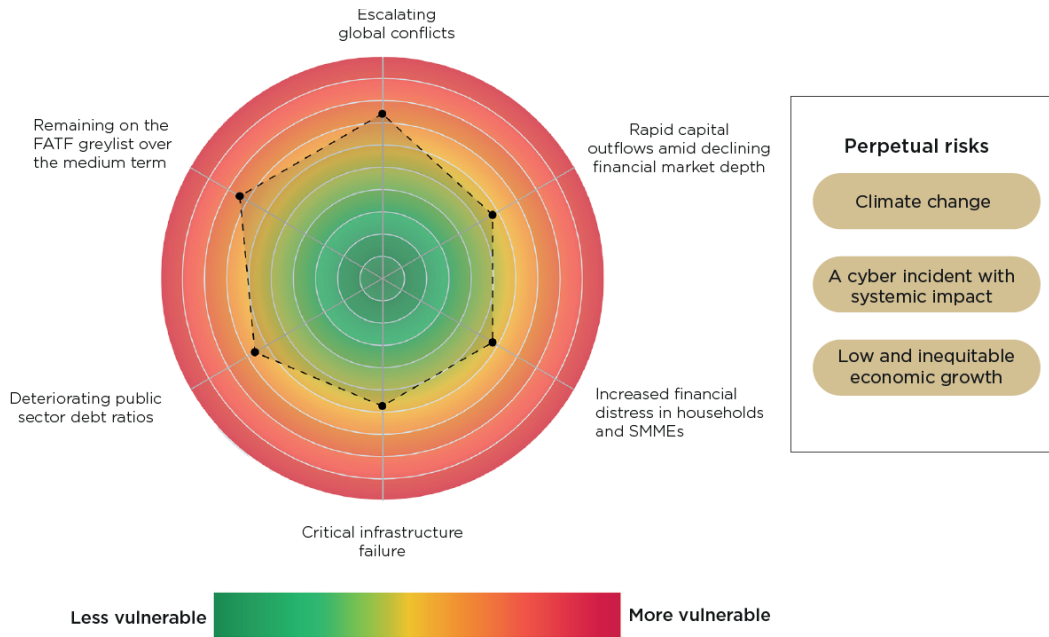
- The South African Reserve Bank's (SARB) assessment of the financial stability outlook has improved since the June 2024 Financial Stability Review (FSR), thanks to domestic factors including an improved fiscal outlook, a decrease in loadshedding, lower interest rates, and more positive sentiment among investors.
- The November FSR introduced a revised approach to illustrating the risks of the financial system in the new Residual Vulnerability Matrix (RVM), previously known as the Risks and Vulnerabilities Matrix (also RVM).
- The number of risks in the RVM was kept at six but with slight changes. Two risks (tight financial conditions for longer and insufficient and unreliable electricity supply) were removed and replaced with critical infrastructure failure (incorporating the deterioration in other network industries) and increased financial distress in households and small, medium, and micro enterprises (SMMEs).
- Risks that are deemed to pose the highest residual vulnerability to the financial system are escalating global conflicts and remaining on the Financial Action Task Force's (FATF) greylist over the medium term.
- While the fiscal outlook has improved since the June FSR, "several risks" to the fiscal outlook remain.
- A year ago, the SARB announced an increase to the counter-cyclical buffer (CCyB – a tool designed to enhance the resilience of the banking sector by adjusting capital requirements based on the macroeconomic environment) from 0% to 1% because having it at 0% was ineffective. The phase-in period for the positive cycle-neutral (PCN) CCyB will take 12 months from 1 January 2025 with minimal impact on lending and macroeconomic activity.
- Government debt still dominates banks' high-quality liquid assets (HQLA) holding which is a concern and contributes to financial stability vulnerabilities due to the low credit rating of SA's government debt. However, there is a positive shift to "more and better liquidity" with the increase in central bank reserves.
- The commercial real estate (CRE) sector continues to face vulnerabilities stemming from both the cost and income sides. Although investors could face significant financial losses during market shocks in the CRE sector, systemic risks to the financial sector are currently limited due to reduced direct bank exposure to the CRE sector.
- The November 2024 FSR highlights the resilience of SA's financial sector amid various global and domestic challenges. Despite facing risks such as escalating global conflicts, high public sector debt and vulnerabilities in the CRE sector, the financial system remained stable.
- The SARB notes that financial institutions are expected to continue providing financial services without interruptions over the forecast period to November 2025.

Evaluation of residual vulnerabilities somewhat more positive

According to the SARB, the financial stability outlook has improved since the June 2024 FSR, thanks to domestic factors including an improved fiscal outlook, a decrease in loadshedding, lower interest rates, and

more positive sentiment among investors since the formation of the government of national unity (GNU). Nevertheless, risks to financial stability remain and are illustrated in the revised RVM (see chart 1).

Chart 1: SARB's RVM



Source: SARB

Dots = assessment of the residual vulnerability of the financial system to each risk. Dots further away from the centre = higher residual vulnerability and vice versa

Residual vulnerability is based on the probability that the risk could materialise in 12 months and the likely impact should it materialise considering amplifying and mitigating factors

“Risks that are deemed to pose the highest residual vulnerability to the financial system are escalating global conflicts and remaining on the FATF greylist beyond June 2025.”

Heightened geopolitical tensions could affect the financial system through (1) increasing volatility and uncertainty in financial markets leading to a risk-off environment, (2) supply chain disruptions which introduce inflationary pressures and could derail the ongoing monetary policy easing cycle, (3) limiting access to a wider variety of markets which could lead to higher costs and reduced availability of funding, hedging and diversification options and (4) increased risk of cyber-attacks.

Regarding progress on being removed from the FATF's greylist, SA has progressed with addressing the outstanding action items with only six of the 22 items left to address by February 2025. Of the six items, three relate to prosecutions and the other three relate to access to beneficial ownership information for companies and trusts. If SA is not successful in being removed from the greylist in June 2025, the adverse impacts will escalate including (1) increased compliance costs, (2) restrictions to the global financial system, (3) higher funding costs, (4) less and more expensive hedging opportunities and (5) loss of regulatory equivalence status.

While the fiscal outlook has improved since the June FSR, “several risks” to the fiscal outlook remain. As usual, the biggest concern in this category is the financial sector's high exposure to sovereign debt which is reported to have increased since the June 2024 FSR.

The remaining three risks, critical infrastructure failure (new), increased financial distress in households and SMMEs (new) and rapid capital outflows amid declining financial market depth are deemed to pose similar residual vulnerabilities to the financial system.

The SARB had only featured the electricity crisis before. In the November FSR, they expanded their assessment to all the network industries (electricity, logistics and water). The deterioration in these industries could impact the financial system directly, by disrupting operations, and indirectly, by (1) adversely impacting the financial health of municipalities, making it challenging for them to meet their debt obligations to financial institutions, (2) deteriorating municipal service delivery which could spark social unrest with resulting losses absorbed by the financial system, and (3) high municipal rates threaten the viability and sustainability of commercial property. The SARB and the Financial Sector Contingency Forum are developing contingency plans to ensure the domestic financial system remains operationally resilient in the event of critical national infrastructure failures. "A current priority initiative is to establish direct connectivity among key nodes in the financial sector in a scenario where existing

telecommunication networks are unable to function so that a certain level of payment, clearing and settlement activity can continue".

Despite increasing financial distress in households and SMMEs, the aggregate banking sector appears resilient against credit risk. The SARB does, however, flag that individual banks may be more exposed and thus require close monitoring.

Lastly, the SARB reported that "the financial system's vulnerability to the risk of declining market depth has reduced somewhat since the release of the June 2024 FSR". This is supported by the increase in the allocation to domestic assets from 58.5% in the first quarter of 2024 to 62% in the third quarter according to J.P. Morgan's estimates. The higher domestic weighting (lower offshore weighting) may be attributed to investor optimism on the back of the formation of the GNU, a stronger rand against the United States (US) dollar and improving structural constraints.

The perpetual risks were unchanged (see chart 1).

Increasing the CCyB will have a short-term sacrifice for long-term stability

The move requiring banks to hold an additional 1% of their risk-weighted assets as capital (CCyB from 0% to 1%) as a measure to enhance the resilience of the banking system against sudden shocks will commence on 1 January 2025 and be effective from 1 January 2026.

“The SARB’s study indicates that implementing a 1% PCN CCyB would have a minimal and short-lived effect on lending and economic activity, insufficient to outweigh the long-term financial stability advantages of the policy tool.”

Supply of high-quality assets is gradually becoming more liquid

Banks are required to hold HQLA to comply with the liquidity coverage ratio to maintain sufficient liquidity to meet short-term obligations, particularly during times of financial stress. The composition of HQLA shows that banks are significantly reliant on government debt

(accounting for around 75% of HQLA holdings - see chart 2). This composition raises concern and contributes to financial stability vulnerabilities due to the low credit rating of SA's government debt (currently

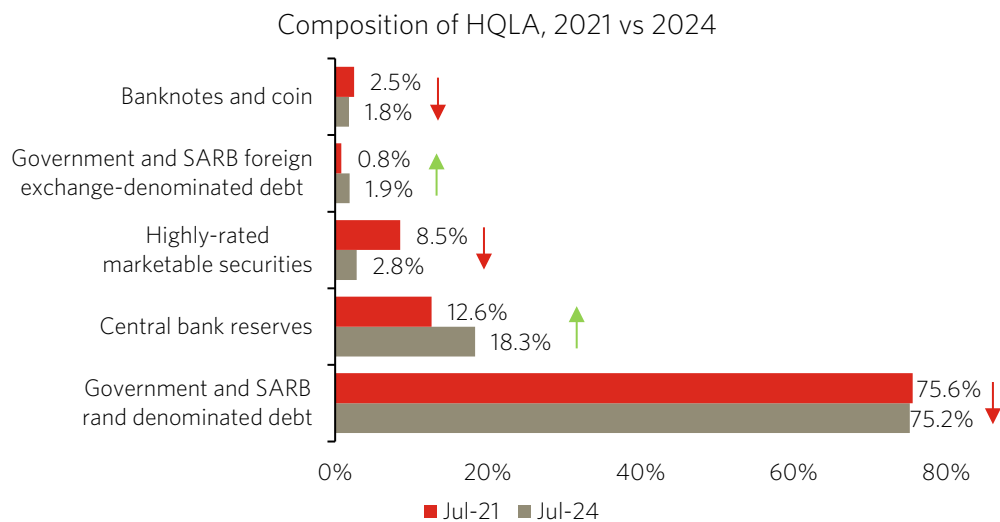
below investment grade) which could lose significant value in a crisis.

Nevertheless, the supply of HQLA is evolving towards “more and better liquidity”.

For instance, central bank reserves have increased from 12.6% in July 2021 to 18.3% in July 2024 (see chart 2)

on the back of regulatory changes (new monetary policy implementation framework in 2022) and the distribution of the Gold and Foreign Exchange Contingency Reserve Account (GFECRA) reserves. This shift enhances liquidity by providing stable, readily available assets that mitigate risks associated with reliance on government debt, thereby improving the overall quality of HQLA in the banking sector.

Chart 2: Shift to more liquid HQLA



Source: SARB, Momentum Investments

CRE sector vulnerable but systemic risks appear limited

The SARB has identified significant vulnerabilities in the CRE sector, intensified since the COVID-19 pandemic and exacerbated by climate change. Pressures on the CRE sector stem from a cost and income perspective.

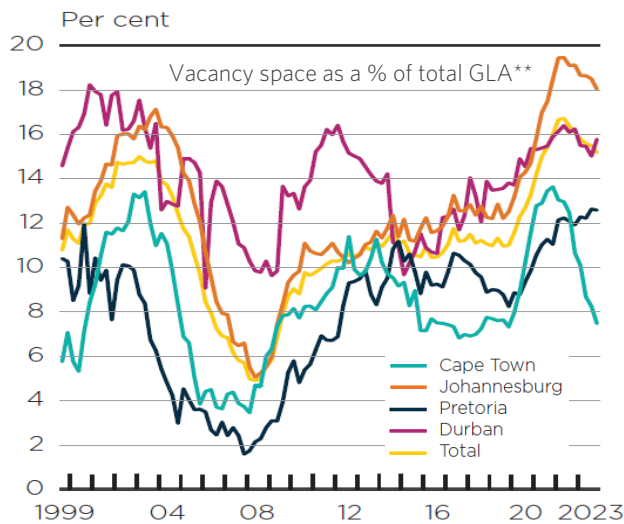
Pressure points on the cost side include investments in alternative energy sources, municipal tariff increases outpacing rental income, water shortages, and higher insurance costs due to climate change. On the income side, structural shifts towards e-commerce and remote work since the pandemic have resulted in higher vacancy rates which place downward pressure on rental prices but there is an improvement (see chart 3). Furthermore, tenant defaults can reduce rental income.

Lower interest rates in the coming months could provide some relief but high municipal tariff increases remain a risk.

Although investors could face significant financial losses during market shocks, systemic risks to the financial sector are currently limited due to reduced direct bank exposure to the CRE sector.

Lower bank exposure, reflecting tighter lending standards (see chart 4), benefits financial stability, but this has led to increased financing challenges for the CRE sector.

Chart 3: Office vacancy rates improve at varying rates*

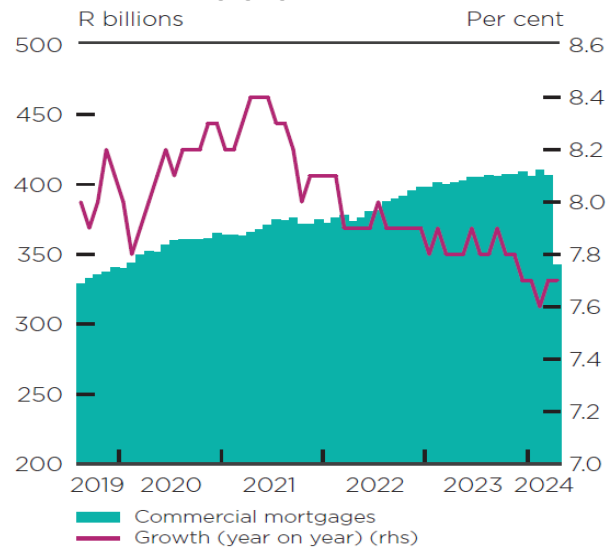


Source: SARB

* Cape Town vacancy rates helped by semigration

** GLA = Gross lettable area

Chart 4: CRE mortgage growth on a downward trend



Source: SARB

Financial stability expected to be maintained

The November 2024 FSR highlights the resilience of SA’s financial sector amid various global and domestic challenges. Despite facing risks such as escalating global conflicts, high public sector debt and vulnerabilities in the CRE sector, the financial system remained stable since the previous FSR. The SARB emphasises the importance of ongoing structural reforms and macroeconomic policies to support sustainable growth and enhance the financial sector’s resilience. Additionally, the introduction of a PCN CCyB is noted to have marginal impacts on lending but significant long-term benefits for financial stability.

“The SARB notes that financial institutions are expected to continue providing financial services without interruptions in the next 12 months.”

A resilient financial sector is important to support economic activity, particularly with increasing momentum on structural reforms and improving business and consumer sentiment.

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