



Financial Stability Review: Idiosyncratic factors amplify risks

Highlights

- According to the South African Reserve Bank (SARB), systemic risk has increased in both domestic and global financial markets.
- The collapse of international regional banks, due to funding and liquidity pressures, has heightened vulnerabilities in the global setting.
- Fortunately, global banking sector turmoil has caused little to no interruptions in the domestic financial system so far. Idiosyncratic factors, such as the energy crisis, worsening performance of the logistics network and the high government debt burden are driving local financial stability risks.
- The domestic financial cycle remained in an upward phase on the back of a continued recovery in private sector credit extension, equity prices and house prices in the fourth quarter of 2022.
- A rise in non-payments has accompanied the increase in private sector credit extension in light of deteriorating economic conditions which is a risk for the banking sector.
- The SARB will be revising the countercyclical capital buffer (CCyB) requirement because keeping it at 0% deems it ineffective as a countercyclical tool.
- The insurance sector was assessed to be in a relatively good condition but there is a rise in uninsurable risks.
- Since November 2022, the SA government bond (SAGB) yield steepened significantly on the back of domestic concerns. This increases the risk of a sharp repricing in government debt.
- Greylisting is assessed to have longer-term implications if SA remains on the list for longer than 24 months.
- Insufficient and unreliable electricity supply is assessed to be the most severe (high likelihood) over the near term while the level of the financial sector's preparedness for climate change risk is on the other end of the spectrum (low likelihood and a medium- to longer-term risk).
- Two new risks have been added to the Risk and Vulnerability Matrix (RVM), namely 'capital outflows and declining market depth and liquidity' and 'secondary sanctions amid heightened geopolitical fragmentation'.
- Higher financial stability risks can reduce business and consumer confidence, which can translate into lower investment and spending, and ultimately dampen economic growth prospects. Heightened financial stability risks can also raise risk aversion among investors and discourage capital flows. In addition, financial stability risks can cause lenders to become more cautious about extending loans which will make accessing credit by businesses and consumers more challenging. This will limit their ability to invest, expand or make large purchases. Ultimately, higher financial stability risks complicate monetary policy decision-making as authorities are forced to balance the potential for market disruptions with having to encourage investment and stimulate spending.

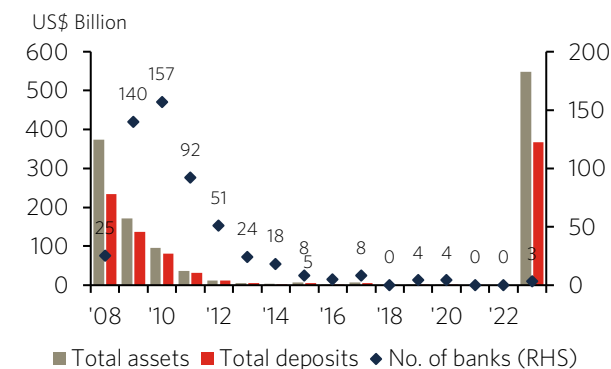
- Given the expectation of rates remaining higher for longer, the persistent loadshedding (possibility of stage eight in winter), logistics inefficiencies and deteriorating government finances, the current pressures on financial stability are unlikely to dissipate over the near term.

International regional bank failures tested global financial stability

According to the SARB, systemic risk in the global environment increased since the November 2022 Financial Stability Review (FSR) mainly due to higher policy rates, persistently high inflation, weaker growth projections, volatile financial markets and concerns about the resilience of the banking system.

In March 2023, three banks in the United States (US) and one in Europe collapsed. Silvergate Bank (a crypto-focused bank) was the first to fail this year. A few days later, Silicon Valley Bank (SVB) which specialises in lending to technology start-up companies collapsed. In the same week, Signature Bank was closed due to a bank run as fears from the collapse of SVB spread. This was followed by the collapse of the second largest bank in Switzerland (Credit Suisse) which, according to the April 2023 International Monetary Fund (IMF) Global Financial Stability Report (GFSR), was the first bank that was systematically important to fail since the global financial crisis (GFC). The April World Economic Outlook (WEO) indicates that the collapse of these regional banks was triggered by severe monetary policy tightening, but central banks acted swiftly to prevent further financial instability. In May 2023, First Republic Bank failed, marking the fourth US bank failure as at May 2023.

Chart 1: US bank failures since GFC



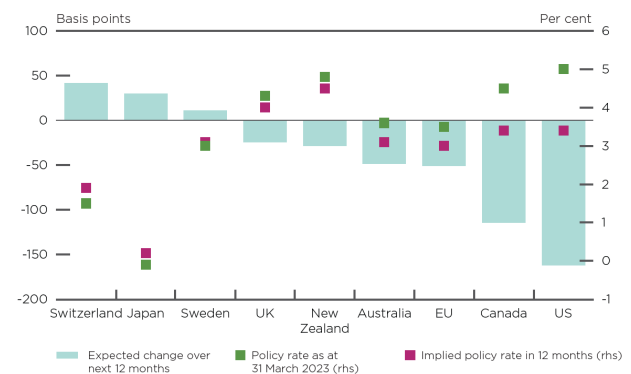
Source: Federal Deposit Insurance Corporation (FDIC), S&P Global, Momentum Investments
Data until 2023 year-to-date (January 2023 to May 2023)

The failure of First Republic Bank pushed total assets and total deposits (year-to-date) of failed banks to levels higher than during the GFC, but this time with a fraction of the total number of banks (see chart 1). This is largely due to a high level of consolidation in the regional banking space.

The IMF GFSR identifies three differences between 2008 and 2023. The collapse in 2008 was due to credit losses from the housing market crash while the current bank failures are due to unrealised losses from the decreasing market value of bank capital reserves. Furthermore, during 2008, the fallout spread quickly from banks to non-banks while the current turmoil has been contained within the banking sector.

Nevertheless, the April WEO notes that there are still bank and non-bank financial institutions that remain vulnerable, such as those that have excess leverage, high credit risk or interest exposure, high dependence on short-term funding and those located in jurisdictions with tight fiscal space. This signals more potential stress in the financial system which may be intensified by global policy rates remaining elevated for longer (see chart 2) to address sticky core inflation.

Chart 2: Expected change in policy rates over the next 12 months



Source: SARB, Bloomberg

According to the IMF, the likelihood of the banking crisis spreading to major emerging markets (EM) is currently contained because EM banks do not have as much exposure to interest rate risks. In SA for instance, the high exposure of banks to SA government bonds (SAGB) is largely in non-systemic banks. However,

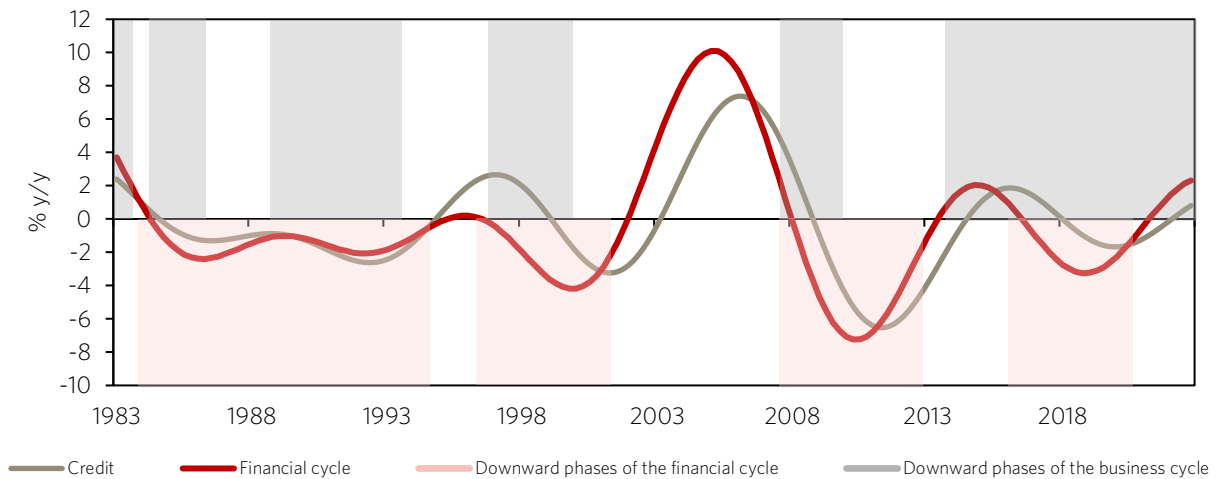
some EM banks are more vulnerable than others and the IMF notes that the consequences of banking sector stress in EM could be more severe because EM banks have a more substantial role in their respective financial systems compared to those in advanced economies.

Resilient financial cycle despite tighter financial conditions

While the business cycle remains in a prolonged downward phase as depicted in chart 3, activity in the financial cycle during the fourth points of 2022 points

to the financial cycle being in an upward phase for the seventh consecutive quarter.

Chart 3: Financial cycle in an upward phase

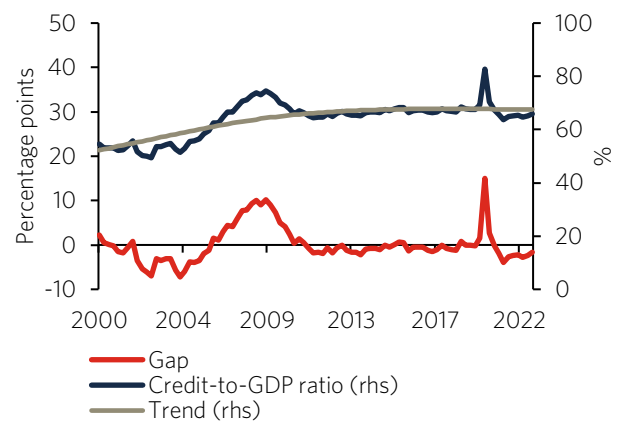


Source: SARB, Momentum Investments

The recovery of credit extension is driven by consumers' increased appetite for unsecured credit to supplement their deteriorating disposable income. Corporates are also seeking more credit to address the higher input costs incurred to reduce the impact of loadshedding.

The improvement in credit extension is reflected in the credit-to-gross domestic product (GDP) gap. The fourth quarter credit-to-GDP gap narrowed slightly as seen in chart 4 but remained in negative territory which indicates that credit growth is still below pre-pandemic levels. We may see a further improvement in corporate and household credit as the need for investing in alternative sources of energy increases.

Chart 4: Narrower credit-to-GDP gap

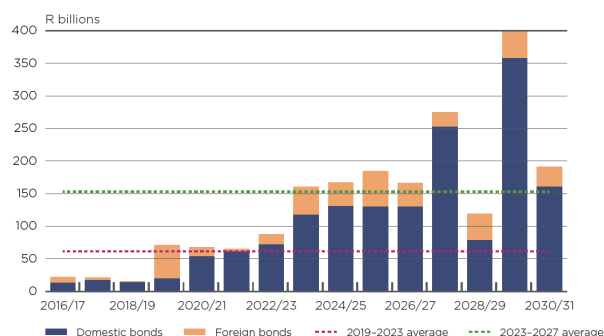


Source: SARB, Momentum Investments

Assessment of the various domestic sectors

Financial market conditions deteriorated over the past six months. The rand depreciated by 8% against the US dollar making it the third-worst performing currency in a sample of 24 EM currencies. Moreover, the SAGB yield steepened significantly on the back of domestic concerns and spreads have widened. Developments in the currency and bond markets place upward pressure on the risk of a sharp repricing in government debt.

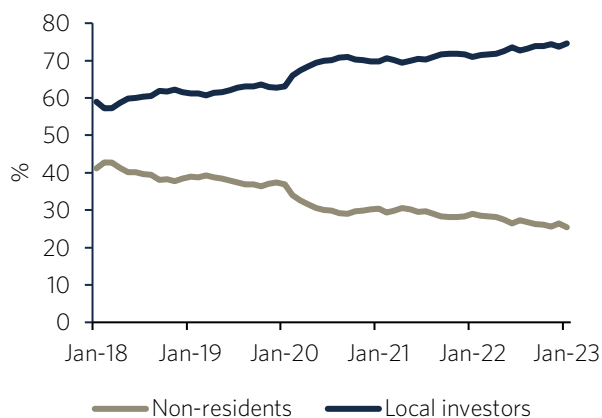
Chart 5: Maturity profile of marketable SA long-term debt



Source: SARB, Bloomberg

The FSR further notes the risk of government needing to refinance maturing government debt at higher interest rates. Net redemptions of marketable government debt are estimated to be around R1.7 trillion over the next seven years with the bulk falling due in 2027/28 and 2029/30 as seen in chart 5.

Chart 6: Local investors increase holdings of SAGBs



Source: SARB, Momentum Investments

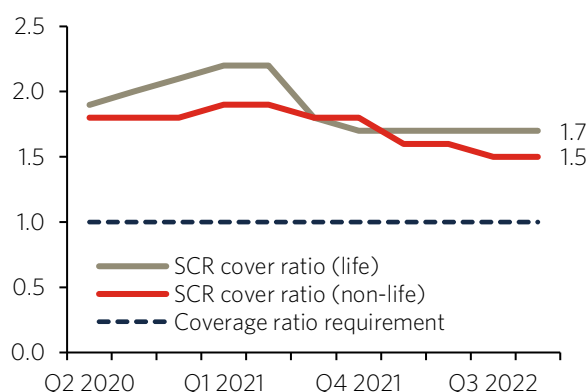
A higher holding of SAGBs by non-residents previously raised risks in the banking sector. Over the years, there has been a steady decline in the holdings of SAGB by non-residents (see chart 6). On the other hand, local investors increased their holdings from 58% in 2018 to 75% in February 2023.

While the improvement in credit extension is beneficial for the credit-to-GDP gap, banks are lending at rates higher than GDP which increases the occurrence of non-payment and reduces capital buffers. According to Fitch Ratings, prolonged bouts of loadshedding could also lead to an increase in the banking sector's non-performing loan ratio from 4.7% (at year end 2022) to highs of 5.2% reached during the pandemic. The consequence of this would be tighter lending standards which could decelerate the recovery of the financial cycle.

An instrument available to mitigate the risk of declining capital buffers is the CCyB. The Bank for International Settlements (BIS) defines the CCyB as 'a countercyclical capital buffer which aims to ensure that banking sector capital requirements take account of the macro-financial environment in which banks operate. Its primary objective is to use a buffer of capital to achieve the broader macroprudential goal of protecting the banking sector from periods of excess aggregate credit growth that have often been associated with the build-up of system-wide risk'. However, the SARB has the rate set at 0% which makes it ineffective as a countercyclical tool. They are therefore reviewing the neutral level which will likely be set between 0% and 2.5%. Over the past 12 months, cracks in the system were evidenced by two banks being placed under curatorship (Ubank and Habib) but they are not big enough to cause systemic risk.

The insurance sector has been resilient. Gross written premiums of life and non-life insurers increased, but high inflation may erode demand for these products. Moreover, the sector's total assets increased to levels above pre-pandemic (slightly above R4 trillion) in the fourth quarter of 2022 and adequate solvency capital requirements (SCR) were maintained (see chart 7).

Chart 7: Life and non-life cover ratios above the requirement



Source: SARB, Momentum Investments

The insurance sector faces the risk of more frequent uninsurable risks, such as damage due to riots and loadshedding. Since these events are occurring more often, they are being excluded from the category of high impact/low probability risk events. Moreover, covering these risks is becoming more expensive for the insurer and consumers.

Heightened concerns around the impact of idiosyncratic factors

Domestically, the strain on the resilience of the financial sector has stemmed from idiosyncratic factors such as the energy crisis, deteriorating performance of the logistics network and government's debt burden. Fortunately, turmoil in the global banking sector has caused little to no interruptions in the domestic financial system.

Loadshedding has intensified in duration and severity. The SARB indicates that the number of days of loadshedding in 2023 (year to date until 21 May 2023) is 136 days (13 000 GWh). The number of days of loadshedding in 2023 will surpass 157 days recorded in 2022 and the energy shed of 11 697 GWh in 2022 has already been surpassed. Furthermore, Clyde Mallinson (energy expert) has warned of higher stages of loadshedding (possibly stage eight or above) during the winter months which could result in a worse outcome for GDP than the SARB's current estimate of loadshedding detracting 2% from growth in 2023 (0.7% in 2022). During the period under review, most companies have incurred higher operating costs (diesel) which have squeezed profit margins and the operations of manufacturers, retailers, telecommunication companies and banks have been affected.

The impact of loadshedding on financial stability can occur through the inefficient functioning of automated teller machines (ATMs), disruptions to the

telecommunication network and higher insurance claims.

The probability of a grid failure remains low, however, key industries are devising and investing in measures to reduce the impact of a blackout:

- The SARB's Financial Sector Contingency Forum (FSCF, established to identify risks that could lead to a systemic event) has been looking into details around an orderly closing and reopening of markets.
- The SARB, BankServ, Johannesburg Stock Exchange (JSE) and banks have increased their diesel storage plans.
- Companies are investing in generators, solar panels and battery storage.
- Insurance companies are considering not paying for claims related to a grid collapse as a contingency plan. Sasria (SA Special Risk Insurance Association) announced the non-payment of grid collapse claims but later withdrew the announcement.

The SARB is also increasingly concerned about the financial sector's exposure to government debt particularly given the risks around the fiscal outlook. The November 2022 FSR noted an improving fiscal outlook on the back of higher revenue collections as a mitigating factor for the repricing in government debt. However, commodity prices have been softening which will lower

revenue, expenditure pressures are building from the ballooning wage bill and the results of the elections in 2024 may have a negative impact on fiscal consolidation and investor sentiment leading to a higher risk premium. Fortunately, S&P kept SA's sovereign credit rating unchanged in May 2023 following a downgrade from positive to stable in March 2023. A further downgrade would've placed upward pressure on debt-service costs in the midst of deteriorating fiscal balances and SA being on the greylist.

The SARB notes that risks from being greylisted are tilted toward the medium- to long-term because the initial impact was already priced into financial markets.

Financial stability risks can dampen growth and complicate monetary policy decision-making

Insufficient and unreliable supply of electricity is assessed to be the most severe (high likelihood) and short-term risk while the level of the financial sectors' preparedness for climate change risk is on the other end of the spectrum (low likelihood and a medium- to longer-term risk)

The April 2023 FSR added two new risks to the financial stability outlook (see chart 8). The first risk relates to capital outflows and declining market depth and liquidity. The addition of this risk was prompted by a decrease in the demand of SAGBs by non-residents which would be supplemented by residents who adopt buy and hold strategies. This may increase the concentration in the financial sector through direct investing and the system's interconnectedness. The SARB notes that while this risk is not unique to SA, the domestic challenges increase the risk.

The second risk added is around secondary sanctions given growing concerns about SA's stance on Russia. There is an overlap between these two risks because if sanctions are imposed and international payments can't be made in US dollars, capital inflows could come to a halt and the risk of capital outflows would be increased. Another systemically important consequence of secondary sanctions would be the exclusion from the Society for Worldwide Interbank Financial

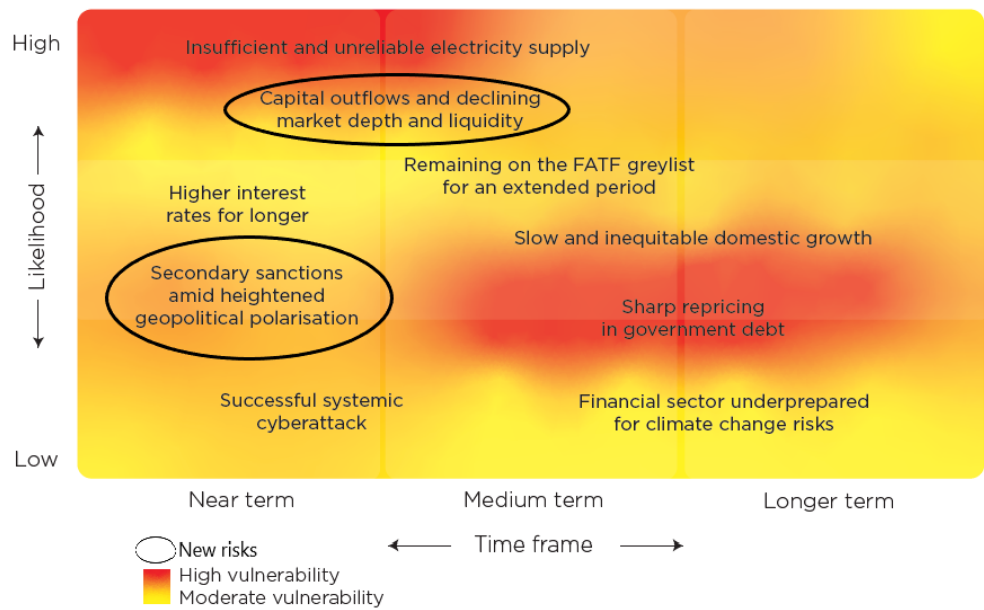
Another risk that materialised during the period under review is higher policy rate increases. The EU has increased rates more aggressively by 200- basis points (bps) since November 2022 compared to US (175-bps) and UK (150-bps). Higher policy rates have led to tighter financial conditions, increased the risk of a recession and amplified the risk of capital outflows from EMs.

Telecommunication (SWIFT) which would make it virtually impossible to make international payments because 90% of SA's international payments are processed through SWIFT.

While systemic risk has increased over the past six months and new risks have been identified, the SARB notes that capital and liquidity requirements make SA's financial system more resilient to absorb shocks. Nevertheless, given the nature of the ongoing concerns about financial stability, the current pressures are unlikely to dissipate over the near term.

The implication of higher financial stability risks include reduced business and consumer confidence, which can translate into lower investment and spending, and ultimately dampen economic growth prospects. Heightened financial stability risks can also raise risk aversion among investors and discourage capital flows. In addition, financial stability risks can cause lenders to become more cautious about extending loans which will make accessing credit by businesses and consumers more challenging. This will limit their ability to invest, expand or make large purchases. Ultimately, higher financial stability risks complicate monetary policy decision-making as authorities are forced to balance the potential for market disruptions with having to encourage investment and stimulate spending.

Chart 8: Modified SARB RVM*



SARB, Momentum Investments
*Two new risks have been added and the placement of risks now overlap across the time frame and likelihood

The information used to prepare this document includes information from third-party sources and is for information purposes only. Although reasonable steps have been taken to ensure the validity and accuracy of the information contained herein, Momentum Metropolitan Life Limited does not guarantee the accuracy, content, completeness, legality or reliability of the information contained herein and no warranties and/or representations of any kind, expressed or implied, are given to the nature, standard, accuracy or otherwise of the information provided.

Neither Momentum Metropolitan Life Limited, its affiliates, directors, officers, employees, representatives or agents (the Momentum Parties) have any liability to any persons or entities receiving the information made available herein for any claim, damages, loss or expense, including, without limitation, any direct, indirect, special, incidental, punitive or consequential cost, loss or damages, whether in contract or in delict, arising out of or in connection with information made available herein and you agree to indemnify the Momentum Parties accordingly. For further information, please visit us at momentum.co.za. Momentum Investments is part of Momentum Metropolitan Life Limited, an authorised financial services and registered credit provider, and rated B-BBEE level 1.