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Financial stability review: SA's financial sector remains resilient

Highlights

- Global growth is projected to slow to 3.3% in 2019 from 3.6% in 2018 and is expected to recover to 3.6% in 2020. The growth outlook in South Africa (SA) remains constrained by electricity supply shortages, high unemployment, low business confidence and a lack of fiscal consolidation.
- Global risk sentiment has rebounded, as a result of anticipated easier monetary conditions, following the dovish turn the Federal Reserve (Fed) and other key developed market (DM) central banks took since the last financial stability review in November 2018.
- The International Monetary Fund (IMF) estimates outflows worth 0.5% of gross domestic product (GDP) would occur if Moody's downgraded SA. This is based on the rating agency's assessment of the R186 and R2023 bonds, but could be higher if total foreign investment in SA's government bonds was taken into account.
- There has been an increase in credit risk in the banking sector in the past few months.
- Retail and corporate default ratios ticked higher in recent months.
- Retirement funds remain vulnerable to a sovereign credit rating downgrade (attributable to the high bond allocation).
- Profitability in non-financial corporates has been constrained and has tracked below its 18-year average since the last quarter of 2008, underpinned by weak growth.
- Non-financial corporate debt as a share of GDP grew to 32% in the last quarter of 2018 from 28.7% in the last quarter of 2005. While this signals a weaker debt-service capacity, this ratio is still lower than that of emerging market (EM) peers.
- The share of foreign-currency-denominated debt has increased to 42% of total non-financial corporate debt.
- Households have become more vulnerable, given the increase in household debt measures in a slowing growth environment and a weakening of household balance sheets.
- Government finances remain a risk to stability of the local financial system and are key in determining the potential for further sovereign credit rating downgrades.
- Despite these challenges, the financial sector remains resilient and is supported by a robust financial infrastructure and strong regulatory and supervisory frameworks.
- Should some of the risks to SA's financial stability materialise, Momentum Investments' clients should take comfort from the company's outcome-based investing philosophy, which incorporates a risk-adjusted investment approach through diversified exposure to a variety of asset classes, as this should shield retirement goals from the risk effect on any specific asset class.

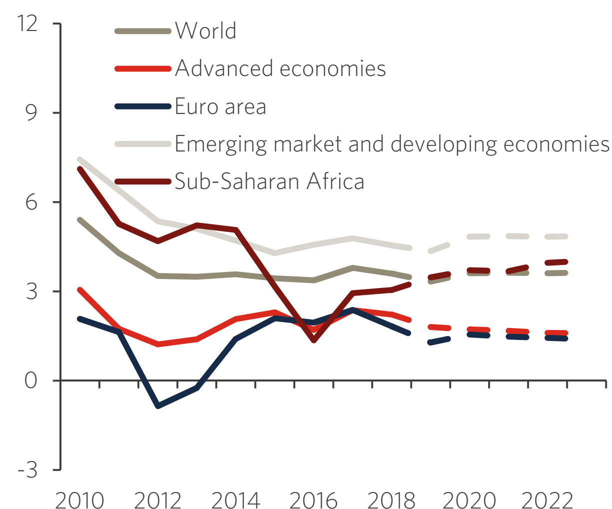
Deteriorated growth outlook across the globe

Financial stability and economic growth are co-dependent. Hence, low economic growth through high unemployment could result in the inability to service debt held by households and corporates. This could, in turn, result in lower profitability and a reduction in the quality of banks and insurers. Global growth is projected to slow to 3.3% in 2019 from 3.6% in 2018 and is expected to recover to 3.6% in 2020 (see chart 1). Anti-globalisation, slower investment growth, rising monetary policy rates in EMs and a hard Brexit are all threats to the global growth projection.

European country-specific weaknesses in Germany, Italy and France are expected to have a negative effect on growth in the European Union. Meanwhile, a weaker growth outcome in advanced economies would likely be driven by the slowdown in growth in the United States (US), as fiscal stimulus dwindles and the government shutdown effects manifest.

Growth in EMs is forecasted to deteriorate in 2019 and can be attributable to economic recessions in Argentina and Turkey. Growth in China is likely to disappoint and dip by more than expected due to deleveraging and de-risking activities. Nevertheless, stimulus is likely to arrest a faster slowdown. Growth in India and Indonesia is expected to support the EM composite, with stronger domestic demand and investment, alongside improving income growth and past reforms. Growth in Sub-Saharan Africa is expected to recover in 2019, driven by higher exports and consumption. However, a moderation in commodity prices is expected for large oil producers. The growth outlook in SA remains constrained by electricity supply shortages, high unemployment, low business confidence and a lack of fiscal consolidation.

Chart 1: Global and regional growth outlook



Source: IMF, Momentum Investments

Financial markets rebounded temporarily in early 2019

Global risk sentiment has rebounded, as a result of the dovish turn the Fed and other central banks took since the last financial stability review in November 2018. The global financial stress index (GFSI) declined below zero, which is indicative of less financial stress for markets alongside volatility indicators (those measuring DM bond volatility – MOVE index – and the VIX – a proxy for DM equity volatility) having eased. Credit default swap spreads have also narrowed for EMs during this dovish shift in the Fed's stance. EM asset prices increased in this period, but were limited by idiosyncratic factors.

Moody's Investor Services, which is the only ratings agency that has not downgraded SA into sub-investment grade, did not give its twice-yearly sovereign review for SA soon after this rebound in financial conditions and sentiment towards EMs, which saw the rand, bonds and equities record strong returns in line with other EMs. This rebound did not last long, however, attributable to weak domestic fundamentals (Eskom's weak financial balance sheet and an underperformance in government tax revenue), which increase the risk of a sovereign credit rating downgrade to sub-investment grade. Historically, countries

that have been downgraded (such as Russia, Brazil or Turkey) have seen less-than-anticipated portfolio outflows because a large percentage of bondholders sell before the downgrade occurs and investors with sub-investment grade mandates buy these bonds, which offset the loss.

Investment-grade-sensitive debt holders of SA's local government bonds declined from 20% in 2016 to 2%. The IMF estimates net foreign portfolio outflows worth 0.5% of GDP would occur if Moody's downgraded SA based on its assessment of the R186 and R2023 bonds. Therefore, the effect could be larger if total investment is considered.

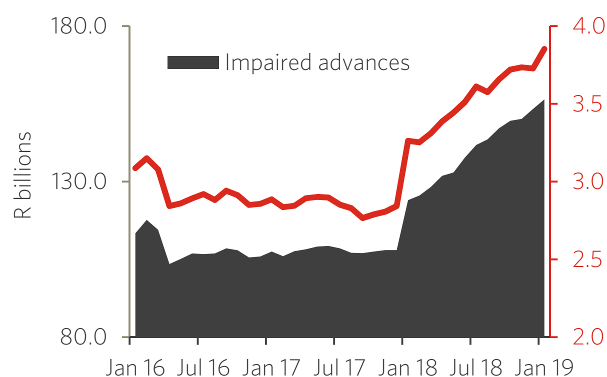
The SA Reserve Bank (Sarb) does not view the SA equity market as overvalued and sees financial stability risks as contained.

Risks to the global financial system are still rife. If US growth and inflation remained robust for longer, it would prompt monetary policy normalisation, which could result in tighter financial conditions and are negative for EMs. Moreover, a re-escalation in trade tensions between the US and China could spill over into European countries and the global slowdown could be deeper and more protracted, which would also be negative for EMs, including SA.

Financial institutions have seen a rise in default ratios, but not at an alarming rate

Impaired advances in the banking sector have increased since January 2018, which is representative of the implementation of the International Financial Reporting Standards (IFRS) 9 and a rise in risk of the sector's credit portfolios (see chart 3). The 90-days overdue ratio (an indicator of credit risk) for the sector increased by 48 basis points from a trough of 1.94% to 2.42% between November 2017 and January 2019. The total default ratio rose to 3.03% from 2.49% between September 2017 and January 2019.

Chart 3: Impaired advances in the SA banking sector



Source: SARB, Momentum Investments

Of the total R26.5 billion default exposure, retail default exposure represented R16.2 billion, while corporate exposure accounted for nearly R10 billion.
In January 2019, unsecured loans represented 13.1% of default ratios, followed by revolving credit facilities (6.7%) and vehicle and asset finances (6.1%).
This represents increasing credit risk in the banking sector's loan portfolio.

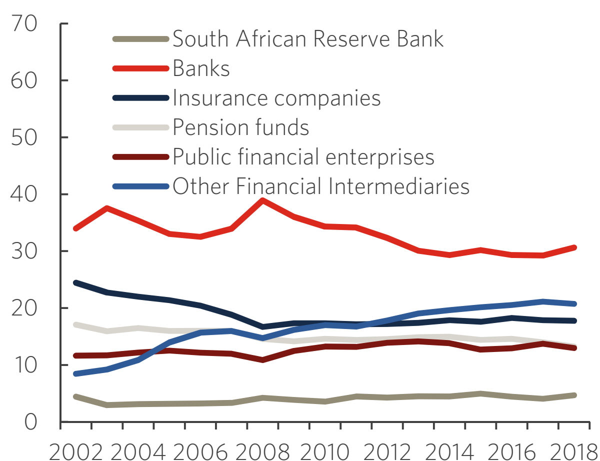
The private household sector's default exposures represented the largest share of total default exposures at December 2018 at almost 73%. This was followed by wholesale and retail trade (5%), real estate (5%) and the manufacturing sector (4%). A significant ratings migration of the on-balance sheet loans from investment grade to sub-investment grade of 30% was noted between December 2016 and December 2017 (and by another 19% between December 2017 and December 2018). Credit risk is exacerbated in a low growth environment, driven by financial stress in corporates, alongside job losses and deteriorating growth in incomes among households.

The five-largest banks traditionally reflect the return on equity (RoE) and return on assets (RoA) for the sector, while the profitability of the smaller banks is not reflective of the sector. The largest banks show resilience in profitability during times of economic stress, which can be attributed to diversified income streams, while the smaller banks are more vulnerable. RoE and RoA for smaller banks have been deteriorating since May 2018, while those for the larger banks have shown resilience. A number of larger banks in the sector have implemented changes to their organisational

structure and do not pose adverse effects on the financial system or on economic activity.

The share of financial assets held by SA banks has declined since the financial crisis at around 30%. In contrast, the share of financial assets held by other financial intermediaries has grown to 21%. Retirement funds and insurance companies hold a significant share of total financial assets, combined amounting to 31% (see chart 4). The rise in the share of other financial intermediaries has been driven by the increase in multi-asset-class portfolios (attributable to changes in regulation requirements).

Chart 4: Distribution of financial assets between financial intermediaries (%)

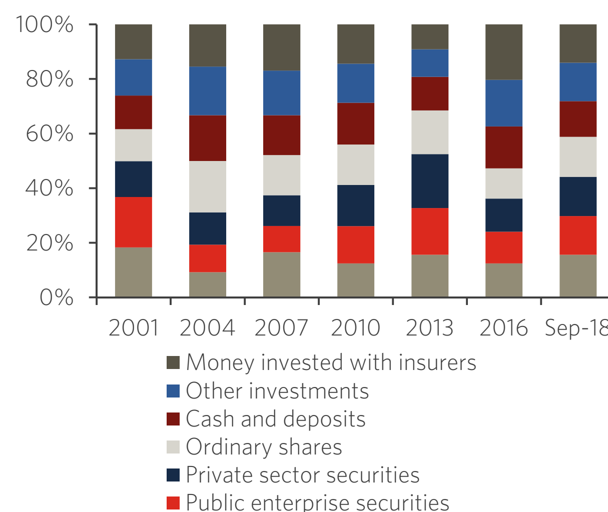


Source: SARB, Momentum Investments

In aggregate terms, the investment allocation of retirement funds remained mostly unchanged. Ordinary shares and government bonds accounted for the biggest share (45% and 17% respectively) in the portfolio investment allocation of retirement funds (see chart 5). Retirement funds remain vulnerable to a sovereign credit-rating downgrade of SA. This, however, does not present a financial stability risk, as bonds are usually held to maturity.

Macro-prudential insurance risk indicators (insurance penetration, density, reinsurance retention rate and insurer concentration) established by the Financial Sector Conduct Authority (FSCA) aid as a risk assessment of the industry. The SA insurance sector continues to outperform most regions in the world and is not signalling any evidence of systemic risk in the sector.

Chart 5: Investor allocation of retirement funds



Source: FSCA, Momentum Investments

The insurance density indicator shows that SA has scope for further growth and the retention ratio for the non-life insurance is not indicating risks to financial stability. The life insurance industry is significantly concentrated at 73% for the five-largest life insurers and 57% for the largest non-life insurers in SA. High concentration levels remain a concern and are continually being monitored. The Solvency Assessment Management (SAM) framework is based on the economic balance sheet of an insurer and is in place to align the SA insurance industry with international standards. The SA insurance industry remains financially sound with adequate capital.

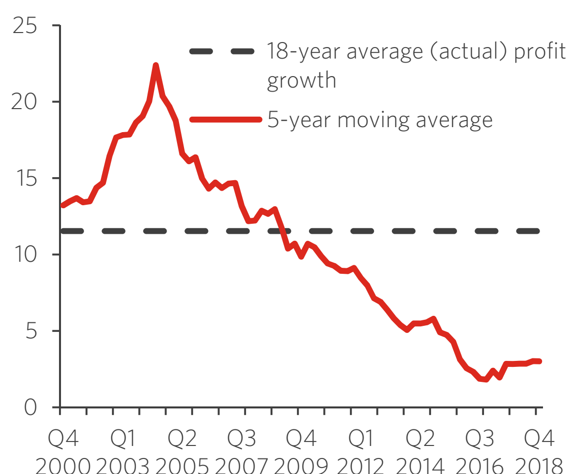
Non-financial institutions are experiencing weak domestic demand

Downbeat business confidence persisted in the first quarter of 2019, attributable to declining profit margins, load shedding since the end of 2018 and political instability (corruption and no clear way forward on land reform). Sub-indices that constitute business confidence, like the building contractors' confidence, deteriorated further, driven by rising defaults in the construction sector, alongside a sharp decline in

retailers' confidence underpinned by underperformance in the sale of non-durable (food) goods. Continued low levels of confidence crowds out corporate spend and investment, leading to lower growth and, ultimately, higher financial instability.

Profitability in non-financial corporates has been constrained and has tracked below its 18-year average since the last quarter of 2008, undermined by weak growth (see chart 6). Credit extension to non-financial corporates remained constrained by weak growth in the local economy, but it has grown faster than economic growth since the last quarter of 2017, which is a signal of the sector overextending in a slow growth environment.

Chart 6: Year-on-year growth in corporate sector profitability



Source: SARB, Momentum Investments

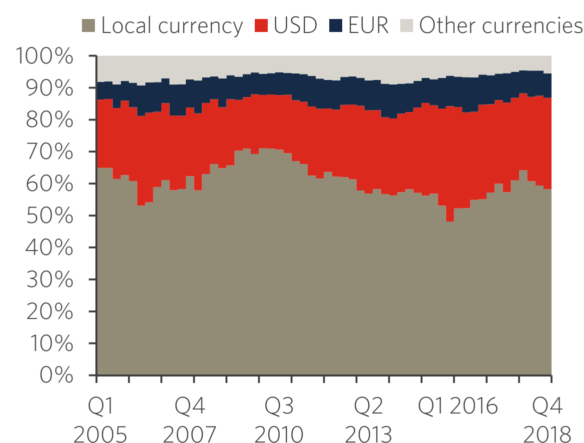
Non-financial corporate debt, as a share of GDP, grew to 32% in the last quarter of 2018 from 28.7% in the last quarter of 2005. However, it remains lower than that of EM peers. Reduced inability to service debt in a low growth and highly leveraged environment remains a concern.

The share of foreign-currency-denominated debt has increased to 42% of total non-financial corporate debt. US-denominated debt represents 69% of the total, euro-denominated debt is 18% of the share and the remaining 13% is representative of other foreign-currency-denominated debt (see chart 7).

This increases the sector's exposure to refinancing risk. However, this is limited by the accommodative monetary policy stance in DMs. Currency risk exposure from high foreign-currency-denominated debt levels nevertheless remains a concern to the Sarb.

The interest coverage ratio (ICR) is an estimation of a firm's ability to finance interest expenses on outstanding debt and an ICR of below two classifies the firm as weak. SA's corporate sector has an ICR of 2.4 at the end of 2018 and deteriorated from 2.8 at the start of 2018, indicating a deterioration in the sector's ability to service its debt. The electricity, gas and water supply had the lowest ICR of negative 1.09 at the end of 2018, relative to a host of other sectors also recording weak ICRs.

Chart 7: Foreign currency composition of SA non-financial corporate debt



Source: IIF, Momentum Investments

The expected default frequency (EDF) of a firm measures the probability the future market value of the firm would be insufficient to meet its future debt obligations. This ratio is below 3% for 72% of non-financial firms in SA, implying that below 3% of firms in that sector are likely to default on their debt obligations in the next year. Non-financial corporates have a debt rating of Caa2, translating into a high credit risk profile, which is concerning in a low growth environment.

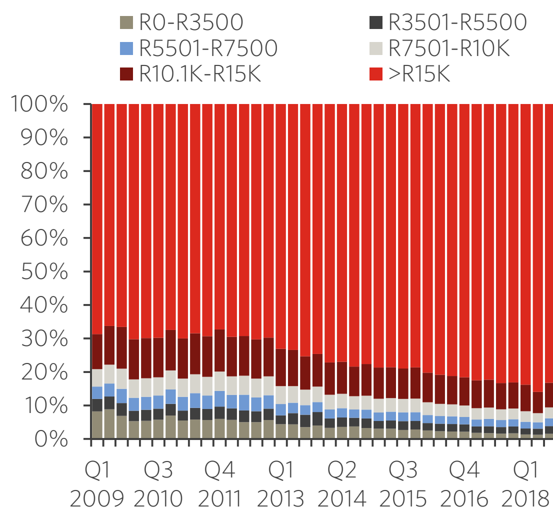
Weakening household balance sheets

Household balance sheets have weakened amid a worsening financial position. Salary growth has declined, as a result of high transport inflation in the second half of 2018 and the contraction in household net wealth was driven by a decline in the growth of the

Value of household financial assets. Increased liabilities from the growth in credit extension have also negatively affected disposable income. Household credit growth has been on an upward trend since the second quarter of 2017.

Households have become more vulnerable, indicated by the increase in household debt measures in a slowing growth environment and a weakening of household balance sheets. The distribution of credit, however, remains skewed towards high income earners (above R15 000 a month) accounting for 83% of total credit granted in the form of mortgages and secured loans (see chart 8). Although consumers are highly sensitive to interest rate hikes when owing this kind of debt, the debt servicing costs are generally lower for this category of debt. This could be a cause for financial stability concern given the weight households add to the banking sector loan book.

Chart 8: Distribution of household debt

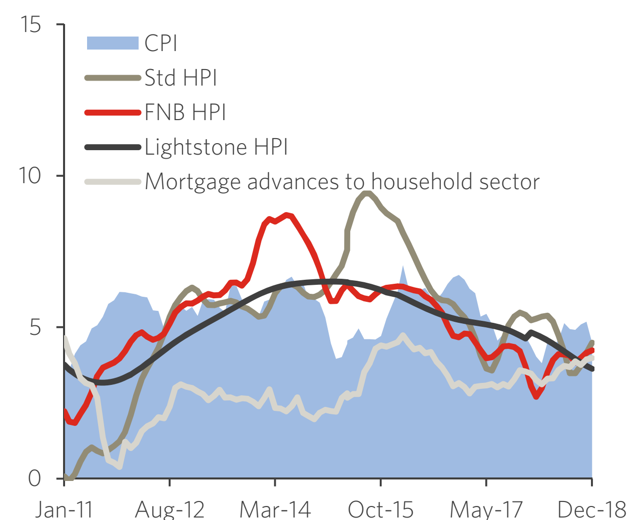


Source: NCR, SARB, Momentum Investments

Household debt affordability deteriorated marginally, as credit spreads increased. The debt-servicing cost to disposable income ratio is still lower than that of the levels during the 2008 crisis, but is on an upward trend. The introduction of the Affordability Assessment Regulations under the National Credit Act of 2005 and a relatively stable interest rate profile have supported subdued debt financing costs since 2016. Credit lending conditions from financial institutions have also tightened, as a rise in rejection rates has been identified. Consumer confidence has contracted, as consumers do not see the outlook for growth and finances improving significantly in the next year.

Housing market trends reflect the health of the financial system and the confidence in the economy. Growth in house prices remained negative since 2016 (see chart 9). The building confidence index declined to 25 index points in the first quarter of 2019 from 32 index points in the last quarter of 2018. Growth in activity for architects and quantity surveyors deteriorated sharply, underpinned by lower confidence.

Chart 9: House price indices, mortgages and inflation (%)



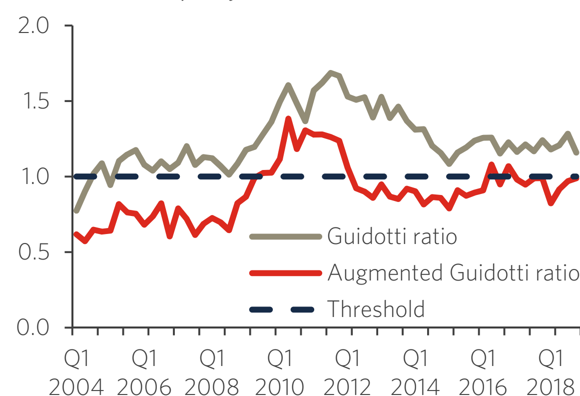
Source: Standard Bank Limited, First National Bank, Lightstone Property, Sarb, Momentum Investments

Deteriorating government finances supported by adequate reserves

One of the main potential determinants of further sovereign credit rating downgrades is government finances, which remain a risk to the stability of the local financial system. A downgrade could result in refinancing difficulties and possibly trigger wider financial system instability. A decline in the perception of public finance stability would increase the debt risk premium, which, in turn, would propel interest rates, higher debt-servicing costs, increased rollover risk and increase the probability that other financial asset prices could decrease. This could affect the soundness of financial sector balance sheets. The estimate for SA's government expenditure has been revised upwards since the Medium-term Budget Policy Statement. This is underpinned by financially deteriorating state-owned enterprises (SoEs) and the rise in the public sector wage bill. Domestic government debt has risen and the higher borrowing requirement stems from underperforming tax revenue collection.
Fiscal consolidation activities should include a decline in the public sector wage bill and an improvement in infrastructure spend.

Foreign reserve holdings are important to maintain liquidity and investor confidence. The Guidotti ratio suggests sufficient money is available to service the country's short-term external debt due within the next year (see chart 10). The financial cycle started trending downwards since the last quarter of 2016. Although all the sub-cycles are in a downward phase, the asset price cycle appears to be bottoming out, which implies the rate of decline in that specific cycle may have reached its trough.

Chart 10: Adequacy of nominal reserves



Source: IMF, Momentum Investments

Financial stability risk assessment for SA

Table1: Risks to SA's financial stability

Likelihood	Effect
High likelihood	• Deteriorating fiscal position
Medium likelihood	• Weaker global growth • Tightening of global financial conditions • Rising cybersecurity risks

Source: SARB, Momentum Investments

Deteriorating fiscal position

A continued deterioration in debt dynamics is not sustainable because of the limited room for fiscal intervention. If the state continues to aid SoEs financially and run a high wage bill, debt levels will continue rising. Moreover, tax rates will continue soaring. This could prompt a sovereign rating downgrade, which would result in capital outflows and tighter financial conditions against the backdrop of tanking sentiment.

Weaker global growth

In the event that DMs continue to see a decline in their growth trajectory, the temporary deterioration in EM growth will continue. This scenario assumes Brexit

remains in an uncertain state and the US government shutdown effects start manifesting. Trade tensions would escalate and SA would be adversely affected. SA would see a decline in demand for its exports, which would lower growth momentum further and unemployment levels would surpass the already high 27%. This would weaken confidence and crowd out investment and prompt a sovereign ratings downgrade.

Tightening of global financial conditions

An unanticipated divergence of the Fed from its recent dovish stance back to monetary policy normalisation would result in a repricing of EM risk assets, which is negative for EM capital flows. This would lead to a rise in DM capital inflows. EM central banks would likely resume their monetary policy hiking cycles and crowd out credit growth, ultimately weakening the asset quality of banks.

Rising cybersecurity risks

Ransomware attacks could result in corporate security breaches, including, but not limited to, production stoppages, leaking of confidential information and even the crash of crucial financial infrastructure.

The Sarb, however, maintains SA's financial stability continues to facilitate financial intermediation and mitigate negative spillovers and disruptions. The financial sector remains resilient and is characterised by well-regulated, highly capitalised, liquid and profitable financial institutions supported by a robust financial infrastructure and strong regulatory and supervisory frameworks.

Outcome-based investing philosophy ideally suited for potential risks to SA's financial stability

Should some of the risks to SA's financial stability materialise, Momentum Investments' clients should take comfort from the company's outcome-based investing philosophy, which incorporates a risk-adjusted investment approach through diversified exposure to a variety of asset classes, as this should shield retirement goals from the risk effect on any specific asset class.

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