Bank of Namibia

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THE BANK'S CORPORATE CHARTER

VISION

Our vision is to be a centre of excellence – a professional and credible institution – working in the public interest and supporting the achievement of the national economic development goals

MISSION

To support economic growth and development in Namibia, we

- act as fiscal advisor and banker to the Government
- promote price stability
- manage reserves and currency
- ensure sound financial systems and conduct economic research

VALUES

- We value high-performance impact and excellence.
- We uphold open communication, diversity, integrity and teamwork.
- We care for each other's well-being.

LIST OF ABBREVIATIONS

List of abbreviations

AML/CFT	Anti-money Laundering and Combating of Financing of Terrorism
BoN	Bank of Namibia
CBS	Central Bureau of Statistics
CMA	Common Monetary Area
EMEs	Emerging Market Economies
FIA	Financial Intelligence Act
FIC	Financial Intelligence Centre
FNB	First National Bank
FSR	Financial Sector Review
GC12	Government Internal Registered Stock Maturing in 2012
GC14	Government Internal Registered Stock Maturing in 2014
GC15	Government Internal Registered Stock Maturing in 2015
GC17	Government Internal Registered Stock Maturing in 2017
GC18	Government Internal Registered Stock Maturing in 2018
GC21	Government Internal Registered Stock Maturing in 2021
GC24	Government Internal Registered Stock Maturing in 2024
GC27	Government Internal Registered Stock Maturing in 2027
GC30	Government Internal Registered Stock Maturing in 2030
HI	Herfindahl Index
IMF	International Monetary Fund
JSE	Johannesburg Stock Exchange
LHS	Left-hand Side
NAD	Namibia Dollar
NISS	Namibia Inter-bank Settlement System
NPL	Non-performing loan
NSX	Namibian Stock Exchange
RHS	Right-hand Side
SA	South Africa
SACU	Southern African Customs Union
SARB	South African Reserve Bank
T Bill	Treasury Bill
TIPEEG	Targeted Intervention Programme for Employment and Economic Growth
USA	United States of America

CONTENTS

PREFACE

In terms of Section 3(a) of the Bank of Namibia Act, 1997 (No. 15 of 1997, as amended), one of the objectives of the Bank is "to promote and maintain a sound monetary, credit and financial system in Namibia and sustain the liquidity, solvency and functioning of that system". Financial system stability refers to the Bank's efforts aimed at promoting the development of sound and well-managed banking and other financial institutions as well as encouraging the development of efficient and well-functioning financial markets. For that purpose, the Bank compiles and publishes its financial stability review (FSR) on a half-yearly basis. The Bank of Namibia has finalised its regular assessment of the state of financial system stability in Namibia during the second half of 2011. The FSR highlights the Bank's assessment of key risks and vulnerabilities to financial stability emanating from developments in the national and international environment, since the last publication in September 2011. The Bank of Namibia, accordingly, takes appropriate actions where there are financial instability concerns. By publishing the Report, the Bank of Namibia aims to inform the public on the state of financial stability in Namibia.

The review examines external factors affecting the agents in the financial system and focuses on key sectors, infrastructures and institutions that are critical to financial system stability in Namibia. Banking institutions play a key role in the financial system, and shocks to the banking sector can be transmitted to the rest of the financial sector and real economy with harmful effects. Much of the assessment of financial stability, therefore, focuses on the banking industry's performance and ability of the industry to absorb unanticipated shocks. The Bank of Namibia is in the process of taking steps for the financial stability report to cover the whole financial system.

The review starts with a short overview of the latest developments in the real economy, financial markets, and regulatory issues that have implications on financial stability. It then concludes with a summary of risks, anticipated global and domestic developments, and the overall assessment.

Each main section of the FSR concludes with a relative ranking of the degree of apparent impact of developments and factors on financial system stability. The rankings, in ascending order of the degree of probable impact, are: low; moderate; and high impact.

1 The Bank defines financial system stability to refer to the efforts of the Bank at promoting the development of sound and well-managed banking and other financial institutions as well as encouraging the development of efficient and well-functioning financial markets.

1. EXECUTIVE SUMMARY

Global financial conditions deteriorated and financial risks sharply escalated in the second half of 2011 and were expected to continue to be volatile. Challenges and downside risks to the global financial stability intensified. In the Euro Area, the most immediate policy challenges were sovereign financing; restoration of confidence; containing deleveraging; and providing more liquidity and monetary accommodation to banks. For other advanced economies, the challenges were to address medium-term fiscal imbalances, repair and rehabilitate the financial systems. Additional hostile factors for the advanced economies included sovereign debt; the effects of the Japanese earthquake and tsunami; banking sector problems; and sluggish domestic demand.

In emerging economies, policymakers needed to employ countercyclical measures to limit the impact of external liquidity shocks. Downside risks for advanced economies emanated from low underlying growth, increased fiscal and financial uncertainty, and high unemployment. The above factors of the risks entailed the possibilities of suffering more adverse export conditions and more volatile capital flows.

In the emerging and developing economies, economic growth was also slow but relatively healthier than in the advanced economies during the period. Some of the emerging and developing economies were negatively affected by political unrests; reduced export demand; monetary-policy tightening; and a less favourable external financing environment. Given the upswing in the downside risks to the global economic recovery, the slowdown is expected to continue in 2012.

Domestic economic activity improved in the second half of 2011, despite the slowdown in the global economy, compared with the first half of 2011. However, growth is forecast to decline to 3.8 percent in 2011 from 6.6 percent in 2010. Output expansion was recorded in secondary and tertiary industries of the economy.

The real effective exchange rate (REER) index of the Namibia Dollar (NAD) depreciated in the second half of 2011, resulting in competitiveness gains for Namibian exports in international markets, whereas the country's international reserves accumulated significantly during the period and remained adequate to maintain the currency peg. In addition, the level of reserves was also sufficient to support both the financial strength of the domestic economy and financial stability, and import cover rose to 14.20 weeks. SACU revenues were expected to continue to improve.

In Namibia, the banking sector remained sound and stable during the second half of 2011. The banking sector continued to be sufficiently liquid, well capitalised and solvent during the second half of 2011. Non-performing loans upheld the downward trend that began in the first half of 2010 and remained below the 4.0 percent benchmark. At the same time, after-tax income rose and overdue loans declined. Cost efficiency ratios improved due to effective cost management. All these developments enhanced banking stability.

Overall inflation in Namibia rose in the second half of 2011, mainly owing to high global commodity prices, especially food and oil prices. The domestic inflation pressures would continue to be a function of food and transport prices in 2012.

The assessment of the performance of the National Payment System (NPS) found the systematically important Namibia Interbank Settlement System to be safe and compliant. During the second half of 2011, the Bank continued to oversee the performance of National Payment System. The main objective of these oversight activities was to protect the safety and efficiency of the NPS. The assessment did not find any issues in the payment system that could pose systemic risk to the financial system.

In the housing market, risks to financial stability were assessed to be low, although it was too early to tell whether price moderation during the second half of 2011 was indicative of price correction. However, the vast housing backlog was expected to absorb supply pressures from the TIPEEG and prevent a sharp price slump. The share of private sector credit to GDP, 49.6 percent, and the growth rate in private sector credit extension, 4.5 percent, were moderate enough not to pose any risks to financial stability. In the banking sector, possible risks relate to the reliance of liquidity funding from South African parent companies and the use of short-term wholesale deposits that are inherently volatile.

Notwithstanding the concerns highlighted, the overall conclusion of the review was that the impact of the prevailing global economic and financial situations remained minimal, and the financial system continued to be stable.

2. EXTERNAL ENVIRONMENT

2.1 MACRO-ECONOMIC CONDITIONS

The risks to global financial stability have risen sharply since the third quarter of 2011, according to the IMF's January 2012 Global Financial Stability Report (GFSR) Market Update. Furthermore, the Euro Area debt crisis intensified further and required urgent action. In addition, deleveraging by Euro Area banks might worsen financial stability risks in the Euro Area and beyond. At the same time, the IMF noted, emerging markets beyond Central and Eastern Europe could face spill-overs from the Euro Area debt crisis through credit channels, and local asset markets could suffer renewed capital outflows and deteriorating liquidity.

Consequently, the IMF warned that further policy actions were needed to restore financial market confidence going forward. This would include, *inter alia*, for advanced economies building larger emergency precautions for sovereign financing; assuring adequate bank funding and capital; and maintaining sufficient flow of credit to the real economy. For policymakers in emerging market economies, the IMF advised that they should stand ready to counter funding and credit pressures. At the same time, they should implement a combination of macro-economic and financial policy measures to help limit the impact of external shocks.

The global economy continued to slow in the second half of 2011 and the IMF and World Bank projected it to remain weak in 2012. A combination of dynamics was responsible for the poor performance in the global economy. These included the impacts of the Japanese earthquake and tsunami; the sovereign debt crisis; and banking sector problems in the Euro Area. In addition, sluggish demand in the US and political unrests in the Middle East, which fuelled oil prices, also contributed to the dampened global economic growth. At the same time, high unemployment and weak consumer and business confidence affected global aggregate demand, further weakening the global economic recovery. Growth also slowed in some key emerging and developing economies, although performance remained stronger than in advanced economies.

Growth in many advanced economies continued to be slower and weaker than anticipated in the second half of 2011. Economic recovery in the US was mediocre, while Europe was on the verge of a recession. In the US, growth remained subdued by weak investment and consumption demand. GDP grew by 1.5 percent and 1.6 percent, respectively, in the third and fourth quarters of 2011. In the Euro Area, growth remained poor, at 1.4 percent and 0.9 percent, respectively, in the third and fourth quarters of 2011. The main constraints on performance were weak export demand, and the dampening effect of the debt crisis on domestic consumption and investment. Growth in the UK remained subdued at 0.4 percent and 0.7 percent in the third and fourth quarters of 2011, respectively, mainly owing to adverse internal conditions and the impact of the Euro Area debt crisis. In Japan, real GDP grew by 0.4 percent in the third quarter of 2011 and declined by 0.2 percent in the fourth quarter of 2011, due to loss of export competitiveness and the destructive effects of natural disasters.

In many emerging and developing economies, economic growth slowed more than forecasted in the second half of 2011, although growth remained higher than in advanced economies. The slowdown was ascribed to reduced export demand; an unfavourable external financing environment; and high interest rates. In China, real GDP growth has slowed from 9.5 percent in the second quarter of 2011 to 9.1 percent in the third quarter and to 8.9 percent in the fourth quarter of 2011. In India, growth fell from 7.0 percent during the second quarter of 2011 to 6.5 percent during the following quarter and was expected to slow further. Growth in South Africa accelerated to 3.2 percent in the fourth quarter of 2011, driven by consumer demand, and was estimated to expand to 3.1 percent in 2011 from 2.9 percent in 2010, due largely to improvements in domestic expenditure.

According to the IMF's World Economic Outlook (WEO) Update for January 2012, the global economy was expected to slow to 3.3 percent in 2012, from an estimated 3.8 percent in 2011. At the same time, downside risks to the global economic recovery remain elevated and could even intensify. The risks included the possible escalation of the debt crisis; a high US federal deficit; a weak US housing market; and high unemployment. In advanced economies, growth was estimated to grow by about 1.2 percent in 2012, and would continue to be subdued and unemployment will remain high. GDP growth in emerging market economies in 2012 was projected at about 5.7 percent, due to a worsening external environment and weakening internal demand.

2.2 INFLATION RATES

Global commodity prices declined on average in 2011 in response to weaker global demand, but prices remained high. In advanced economies, consumer inflation receded in the US as price inflation fell from 3.6 percent in June 2011 to 3.0 percent in December 2011. However, inflation remained unchanged in the Euro Area, UK and Japan during the period, at 2.7 percent, 4.2 percent and 0.2 percent, respectively.

In emerging economies, consumer inflation fell in India and China from 8.6 percent and 6.4 percent in June 2011, respectively, to 6.5 percent and 4.1 percent at the end of December 2011. In South Africa, nevertheless, consumer price inflation rose to 6.1 percent in December 2011 from 5.0 percent in June 2011.

The IMF, in its WEO Update for January 2012, projected global consumer price inflation to ease as demand softened and non-oil commodity prices stabilise or recede. In advanced economies, inflation pressures were expected to remain subdued, due to ample economic slack and well-anchored inflation expectations. Accordingly, the institution projected inflation in these economies to about 1.5 percent in 2012, down from a peak of about 2.7 percent in 2011. The IMF also expected the inflation pressure in emerging and developing countries to fall, as a result of slowing growth and food price inflation. Hence, the overall consumer prices in these economies are projected to decelerate and inflation to fall to around 6.3 percent during 2012 from above 7.3 percent in 2011. However, the latest developments linked to the sanctions against Iran, led to rising oil prices that are expected to feed into higher global inflation.

2.3 INTEREST RATES

The sluggish global economic environment resulted in a host of monetary policy stances in the second half of 2011. In this connection, key central banks in advanced economies broadly maintained an accommodative monetary-policy stance. The central banks in the US, UK, and Japan kept their policy rates unchanged, at 0.00-0.25 percent, 0.50 percent, and 0.00 percent, respectively (Table 1). In addition, the three central banks in November 2011 announced coordinated measures to increase their capacity to provide liquidity support to the global financial system. The interventions were meant to ease liquidity pressures in financial markets and mitigate the pressures on credit supply to households and businesses, as well as to help support economic activities. On the other hand, the European Central Bank reduced its refinancing rate to 1.00 percent to support sluggish economic activities in the Euro Area.

Among emerging market economies, some central banks eased, while others tightened, their monetary policy stances during second half of 2011. The central banks of Brazil, Russia and India cut their policy rates by 75 basis points, 25 basis points, and 50 basis points, respectively, to 11.0 percent, 8.0 percent and 7.5 percent, to promote economic activities. The latter were adversely affected by the deterioration in the international economic climate, particularly in Brazil and India. In contrast, the People's Bank of China raised its policy rate to 6.56 percent in July 2011 in view of rising inflation, while the South African Reserve Bank (SARB) retained its repo rate at 5.5 percent during the second half of 2011, to underpin economic growth.

Table 1: Selected economies' latest policy rates

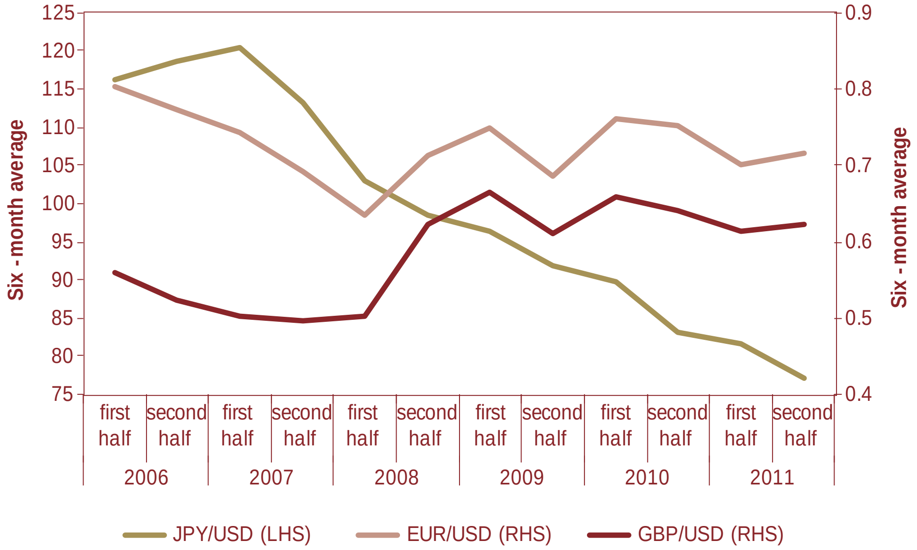
Countries	Policy rate	Current	Policy[1]	Latest	February	Real
	Rate	Rate (%)	Rate % Δ	Meeting	Inflation	Interest
Advanced						
USA	Fed funds rate	0.00-0.25	0.00	January	2.9	-2.7
Canada	Overnight rate	1.00	0.00	January	2.5	-1.5
Australia	Cash rate	4.25	0.00	January	3.1	1.2
Euro Area	Refinance rate	1.00	0.00	February	2.6	-1.6
UK	Base rate	0.50	0.00	February	3.6	-3.13
Japan	Call rate	0.00	0.00	January	0.1	-0.1
BRICS						
Brazil	Short-term interest rate	10.50	-0.50	January	6.2	4.3
Russia	Refinancing rate	8.00	0.00	December	4.2	3.8
India	Repo rate	7.50	-1.00	December	5.3	2.2
China	Lending rate	6.56	+0.50	July	3.2	3.4
South Africa	Repo rate	5.50	0.00	September	6.3	-0.8

Sources: Bloomberg and Respective Central Banks

2.4 EXCHANGE RATES

The sluggish global economic growth, the Euro Area sovereign debt crisis, and the increasing risks to the global financial stability, particularly in the advanced economies, impacted the major international currency markets in the second half of 2011. Under those circumstances, the US Dollar appreciated against the Euro and Pound, but depreciated against the Japanese Yen (Chart 1) during the period. The US currency strengthened by 2.3 percent and 1.4 percent against Euro and Pound, respectively. However, the Dollar fell by 5.6 percent against the Yen during the same period. The strength of Dollar against the two currencies was mainly driven by relatively better US economic performance. The Dollar's weakness against the Yen, on the other hand, was based on the expectations for better growth prospects in Japan following the natural disaster early in 2011.

Chart 1: Currency per US Dollar



Source: Bloomberg

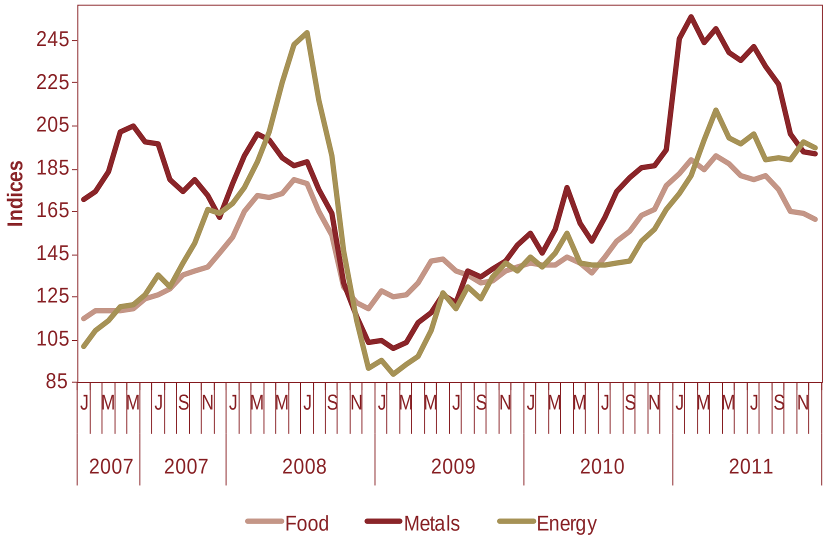
[1] The changes presented here are cumulative percentage point changes in policy rates for the whole year (i.e. 2011).

2.5 COMMODITY MARKETS

Weaker global demand resulted in relatively lower commodity prices in 2011. During the second half of 2011, the price indices for food and metals continued to decline, while the energy price index rose because of the combination of adverse supply developments and strong demand (Chart 2). The food price index fell by 10.8 percent in the second half of 2011. The fall was mainly attributable to favourable supply and stock outlook for food, and the dampening effect of concerns about the world economy on food demand. These conditions were expected to cause further price declines in non-oil commodities in 2012. However, global food prices were anticipated to remain high and volatile in 2012.

Similarly, the metals price index declined by 14.3 percent during the period. The weakening in the metals price index was largely driven by a substantial slowdown in the demand for copper.

Chart 2: Selected commodity price indices



Source: IMF

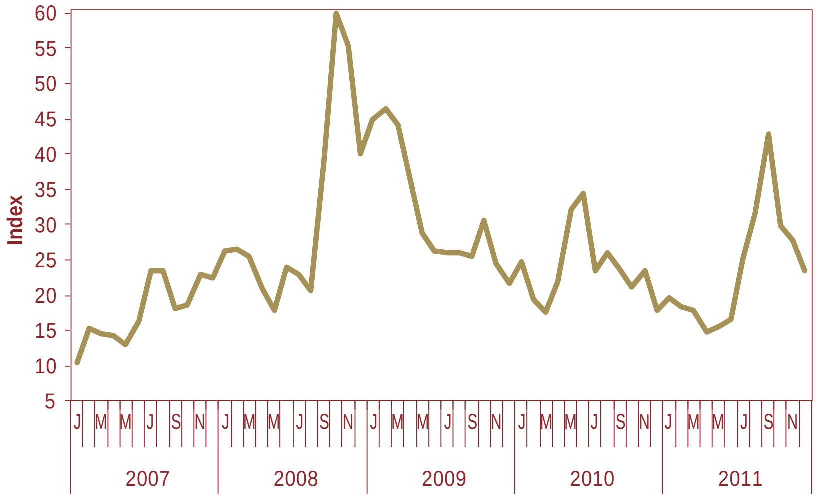
The price of gold reached a record high level of US$1 609.51 an ounce in early July 2011 as investors worried about the impact of the Euro Area debt crisis and the possible US government default. However, the metal price started to recede, reaching US$1,531 an ounce at the end of December 2011. The other factors that drove the precious metal price during the second half of 2011 included the strong US Dollar; inflation fears; the Euro Area sovereign debt crisis; the threat of a slowdown in Asia; and increased gold supply.

On the other hand, the energy price index increased by 16.2 percent in the second half of 2011. The rise was fuelled by political instabilities in the Middle East and North Africa, coupled with significant energy demand from emerging market countries. Looking ahead, concerns about geopolitical oil supply risks have increased again in 2012, given the possible market impact of an Iran-related oil supply disruption. According to the IMF, this supply shock could be exacerbated by limited inventory and spare capacity buffers.

2.6 EQUITY MARKETS

Uncertainties about the possible spread of the Euro Area sovereign debt crisis, coupled with fears about the efficacy of monetary and fiscal policies in advance economies, and the debt ceiling debate in the USA, overshadowed the global economic recovery in the second half of 2011. Most major global equity markets were negatively affected by these developments. Investors sought safe-haven assets, as uncertainty rose, particularly in September 2011, on expectations of an imminent Greek default (Chart 3).

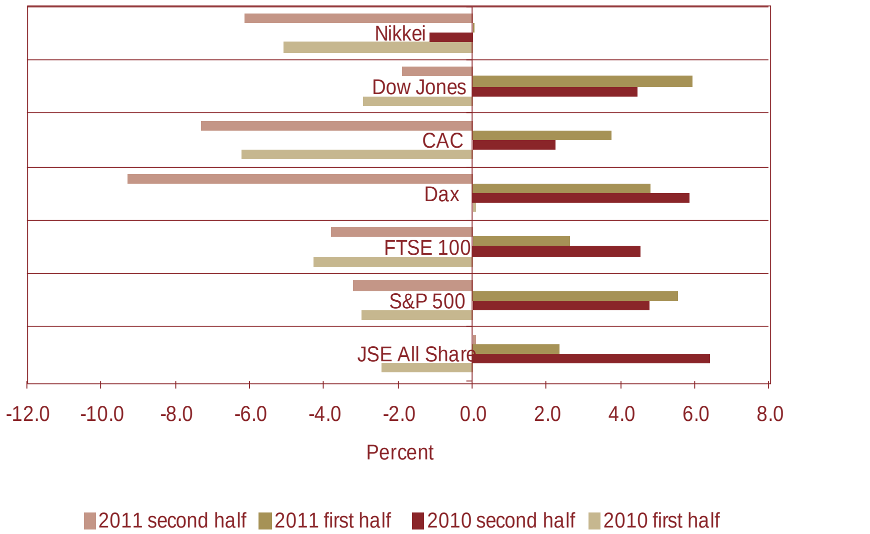
Chart 3: The VIX Index[2]



Source: Bloomberg

Consequently, most major international equity markets fell in the second half of 2011. The DAX, CAC and Nikkei declined the most, by 9.3 percent, 7.3 percent and 6.2 percent, respectively, (Chart 4). The Dow Jones, FTSE 100, and the S&P 500 also experienced significant declines. By contrast, the JSE All Share index registered some gains, rising by 0.1 percent during the period.

Chart 4: Global stock exchanges quarterly growth rates (USD terms)



Source: Bloomberg

The global economy slowed and the risks to the global financial stability rose sharply in the second half of 2011. The global economy was expected to continue to slow in 2012, as downside risks to the recovery remained elevated and could even intensify. At the same time, the Euro Area debt crisis intensified further and shocks from the crisis could worsen financial stability risks in other areas of the globe. Global commodity prices generally declined in response to weaker global demand. Global inflation pressure was expected to fall due to slowing global economic growth and as food prices stabilise or fall. However, global inflation pressure could increase, given the latest oil supply developments related to the sanctions against Iran that lead to rising oil prices. During the period, some countries raised their policy rates, while others maintained their easy monetary policy stances. The US Dollar was strong against the Euro and Pound, but was weak against the Yen.

[2] The VIX Index is a key market measure of investor market sentiment and expectations of near term volatility or uncertainty. The higher the index, the higher the expected price volatility and vice-versa.

3. DOMESTIC ENVIRONMENT

3.1 ECONOMIC CONDITIONS AND FINANCIAL MARKETS

3.1.1 Economic performance

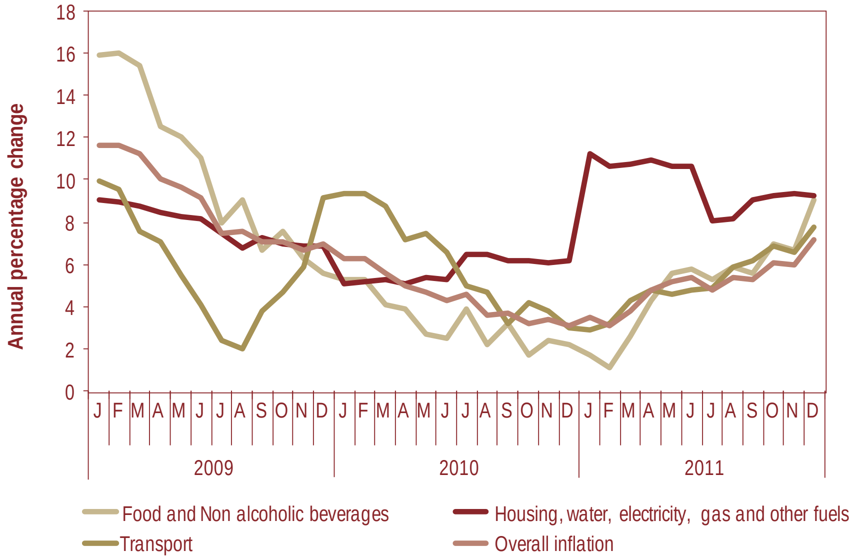
The domestic economic performance improved in the second half of 2011, compared with that of the first half of the year. However, growth was estimated to have slackened from 6.6 percent in 2010 to about 3.8 percent in 2011. The slowdown was mainly due to a fall in mining activities in the primary industries and a slowing in the secondary industries. On the other hand, the tertiary industry registered strong performance, supported by continued improvements in most sectors. The economy is projected to grow by 4.2 percent in 2012, with growth expected in uranium output and investment in the construction, mining, and manufacturing sectors.

However, downside risks to the domestic economy have increased, mainly due to the uncertain outlook resulting from the Euro Area debt crisis. Both the continuing global financial market uncertainties and the anticipated slowing of the global economy could weaken global demand for Namibian exports and negatively impact domestic economic growth in 2012. In addition, a sustained strengthening of the NAD would likely reduce export competitiveness and further suffocate economic growth. At the same time, prevailing high levels of unemployment could exacerbate the economic fragility by depressing domestic demand.

3.1.2 Consumer prices

Namibia's annual inflation for all-items steepened its increasing trend in the second half of 2011, rising from 5.4 percent at the end of June 2011 to 7.2 percent at the end of December 2011 (Chart 5). The upsurge in the overall inflation was driven by the acceleration in inflation rates for food, and non-alcoholic beverages and transport. Developments in the global markets for food commodities and crude oil were largely responsible for increased domestic inflation rates for food and transport.

Chart 5: Contributions to CPI



Source: Central Bureau of Statistics

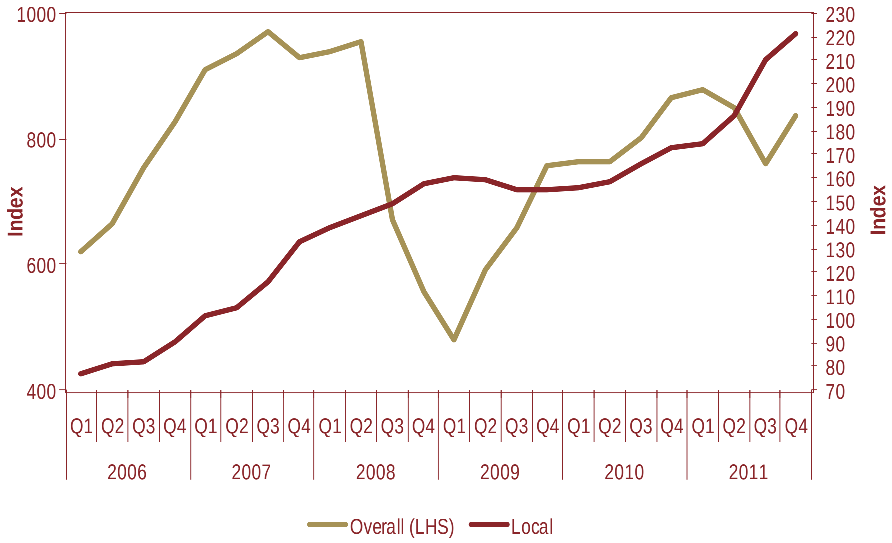
The outlook for inflation in Namibia, in 2012, will continue to be a function of global developments in commodity prices, especially food and energy. According to the World Bank, global food prices are expected to fall in 2012 as a weaker world economy dampens consumer demand while food supplies increase. However, rising oil prices could reverse the downward trend in world food prices and keep inflation high.

3.1.3 Equity markets

The developments in the Namibian Stock Exchange (NSX) indices in the second half of 2011 continued to be affected by developments in the global financial markets during the period. These markets were mostly influenced by the implementation of monetary policies in the major advanced economies in response to shocks to the global economy. The overall index of the NSX comprises the performance of companies listed on both the NSX and the Johannesburg Stock Exchange (JSE). The NSX Overall Index declined further to 838.2 points in December 2011 from 849.8 points in June 2011 (Chart 6). The decline in the index amounted to a 1.4 percent decline in the growth rate during the second half of 2011, compared with the 2.0 percent decline in the first half of 2011.

The performance of the NSX Overall Index reflected the performance of the JSE. The latter, however, slowed to 1.7 percent during the period from 2.4 percent in the first half of 2011. The JSE's performance was in tandem with performance in most global equities that were impacted by weaknesses in the global economy and volatility in equity markets. On a quarterly basis, however, the NSX Overall Index was more in line with the JSE, which also fell in the third quarter of 2011 but recovered in the fourth quarter of the year. The total market capitalisation of the NSX also decreased, by 10.6 percent, from N$1,134.5 billion at the end of June 2011to N$1,122.5 billion at the end of December 2011. The weak performance is reflective of the decline in the number of deals concluded at the NSX during the period under review.

Chart 6: Namibia stock exchange price indices



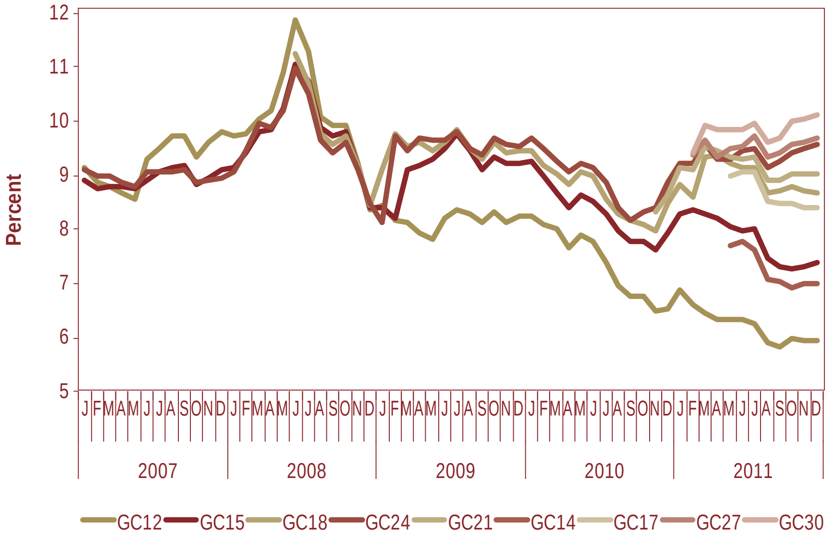
Source: Namibia Stock Exchange

In contrast with the Overall Index, the Local Index of the NSX maintained its upward trend. The Local Index rose by 5.0 percent from 210.6 points at the end of the first half of 2011 to 221.2 points at the end of December 2011. During that period, the local market capitalisation rose by 17.7 percent from N$7.9 billion in the first half of 2011 to N$9.3 billion at the end of the second half of 2011. The rise was influenced by corresponding performances in the financial and industrial stocks that echoed the optimistic outlook for the mining and financial sectors during the period. Despite, the negative impact of the global market on local market through the JSE, the local market continued to be relatively insulated from the global equity markets. This, together with the limited trading of the listed shares continued to provide comparative stability to the NSX during the review period.

3.1.4 Bond markets

The Namibian Government bond yields across the yield curve were lower for most bonds during the second half of 2011 (Chart 7). The bond yields moved in tandem with South African bond yields to which they are benchmarked. The South African bond yields have been relatively high since the first half of 2011 due to strong demand from international investors who sought them mainly because of their higher yields relative to those in most advanced economies. In addition, the rise in yields on Namibian government bonds is also a function of supply and demand in the domestic bond market. For instance, the yields on the bonds with longer maturities were relatively high mainly because their supply exceeded the demand.

Chart 7: Government Bond yields[3]

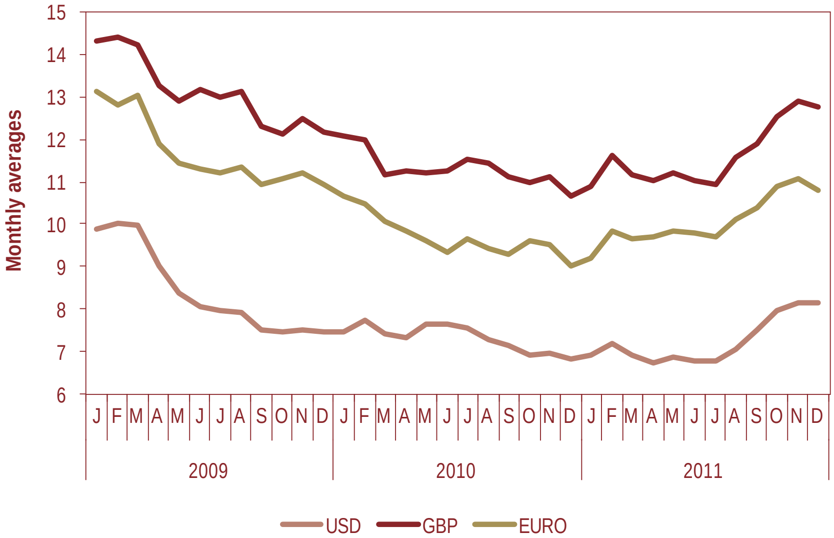


The yields on bonds with shorter maturities were much lower and declined more during the second half of 2011 compared with the previous six months of the year. The yields on the GC12 and GC14 fell from 6.32 percent and 7.76 percent, respectively, in June 2011 to 5.95 percent and 7.01 percent in December 2011. This means that the GC12 bond lost 0.366 percentage point, while the GC14 lost 0.740 percentage point during the period. By contrast, the yields on bonds with longer maturities were either higher, fell the least, or even rose in some cases during the period. The yields on the GC17 and GC18 fell from 9.06 percent and 9.15 percent in June 2011 to 8.40 percent and 8.67 percent, respectively, in December 2011. At the time, the yields on GC27 and GC30, which were introduced in February 2010, increased from 9.55 percent and 9.85 percent, respectively, in June 2011 to 9.69 percent and 10.11 percent in December 2011.

3.1.5 Exchange rates

In the second half of 2011, the NAD weakened against the USD, Pound and Euro. During the period, the NAD exchanged at averages of N$8.2, N$12.8, and N$10.8 against the three currencies, respectively (Chart 8). The depreciation brought the losses against the USD, Pound and Euro to 20.5 percent, 16.4 percent and 10.2 percent, respectively. By contrast, the gains against the USD during the first half of 2011 amounted to 2.8 percent, while the losses against the Pound and Euro amounted to 0.9 percent and 3.2 percent, respectively.

Chart 8: Namibia dollar per foreign currency



Source: South African Reserve Bank

[3] The GC21 was introduced in November 2010. The GC27 and GC30 were issued in February 2011, while the GC14 and GC17 came on the market in May 2011.

The weakness of the ZAR[4] against the USD during the second half of 2011 was driven by, *inter alia*, panic buying of dollars by importers, a general negative sentiment about the Euro Area, and growing concerns of recession in the Euro Area.

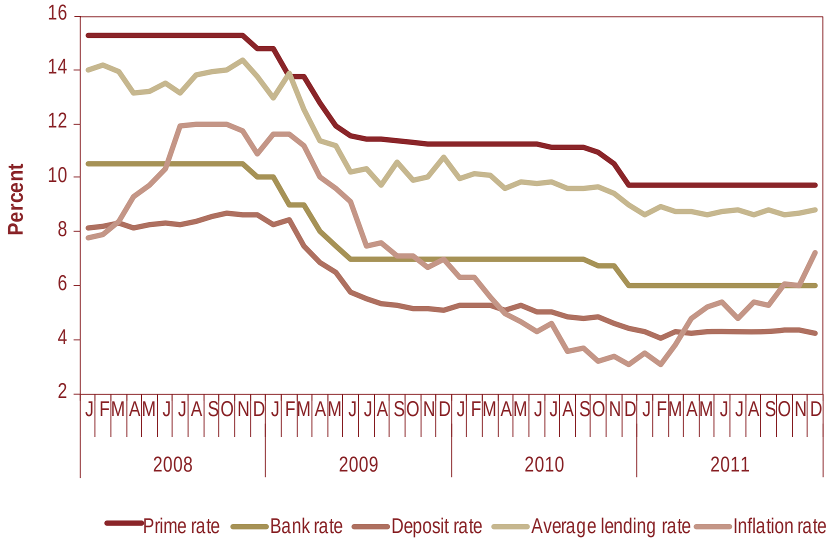
The real effective exchange rate (REER) index of the NAD declined to 90.70 points in December 2011 from 94.70 points in June 2011, representing a real depreciation of 4.2 percent during the period. The real depreciation is a favourable development for the country's trade, because it implies that export commodities became cheaper relative to those of the major trading economies during the second half of 2011. Hence, the real depreciation of the NAD implied that Namibian export products remained competitive due to a weaker NAD against the USD, GBP and EUR during the second half of 2011. At the same time, through higher import costs and prices, a real depreciation of the NAD could worsen the impact of higher international oil and food prices on Namibia's domestic consumer inflation.

3.1.6 Interest rates

The general level of the Namibian interest rates remained largely flat in the second half of 2011 (Chart 9), as the Bank of Namibia kept its policy rate, the Repo rate, unchanged at 6.0 percent. The rate was last lowered in December 2010 to encourage private sector credit demand and stimulate economic growth.

Notwithstanding the unchanged policy rate, the banking institutions adjusted their deposit and lending rates during the period. The average nominal deposit rate fell by 0.07 percentage points, from 4.29 percent to 4.22 percent. On the other hand, the average nominal lending rate rose by 0.06 percentage points, from 8.74 percent at the end of the first half of 2011 to 8.8 percent at the end of the second half of 2011. Accordingly, the spread between the lending and deposit rates rose to 4.6 percentage points at the end of December 2011, from 4.5 percentage points at the end of June 2011.

Chart 9: Interest and inflation rates



Source: Central Bureau of Statistics

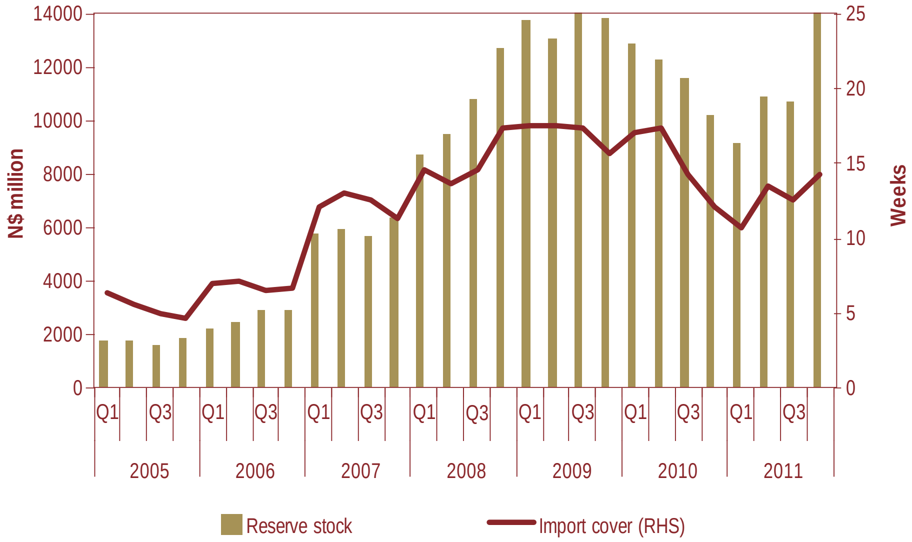
3.1.7 Foreign exchange reserves adequacy

When access to foreign borrowing and credit lines are restricted or withdrawn, a foreign currency-liquidity shortage or shock might result. Under those circumstances, sufficient international reserves can help cushion the impact of the occurrence. Hence, adequate foreign-exchange reserves are critical to a country's ability to withstand external shocks and, therefore, to financial stability. Foreign exchange reserves also allow a country to pay for its imports and to honour its other external obligations.

The level of international reserves in Namibia surged considerably, by 32.2 percent, from N$10.9 billion at the end of June 2011 to N$14.4billion at the end of December 2011 (Chart 10). The rise in the reserves holdings was mainly a result of the Eurobond proceeds; SACU revenue; ZAR notes repatriated; and interest income received. However, reserve accumulation was moderated by purchases of ZAR by banking institutions from the Bank of Namibia; and Government foreign payments. In recent periods, the SACU receipts fluctuated due to the global and regional economic slowdown, but more receipts were expected. Overall, the enlarged level of country's international reserves continued to be regarded as adequate to support both the currency exchange peg and financial stability.

[4] The Namibia Dollar trades one-to-one against the South African Rand (ZAR) and is, therefore, referred to interchangeably against international currencies. The rates referred to are monthly averages, per currency.

Chart 10: Quarterly international reserve stock and import cover



Closely related to foreign exchange reserves is the import cover that measures a country's capability to withstand external shocks while still able to deal with or honour its external obligations. Namibia's import cover rose from 13.46 weeks in June 2011 to 14.20 weeks of import cover in December 2011. This compared with the international benchmark of 12 weeks of import cover. The rise in import cover was mostly attributable to the 32.2 percent increase in foreign exchange reserves during the review period that outperformed the 30.3 percent growth in the import value, from N$9.2 billion to N$11.9 billion.

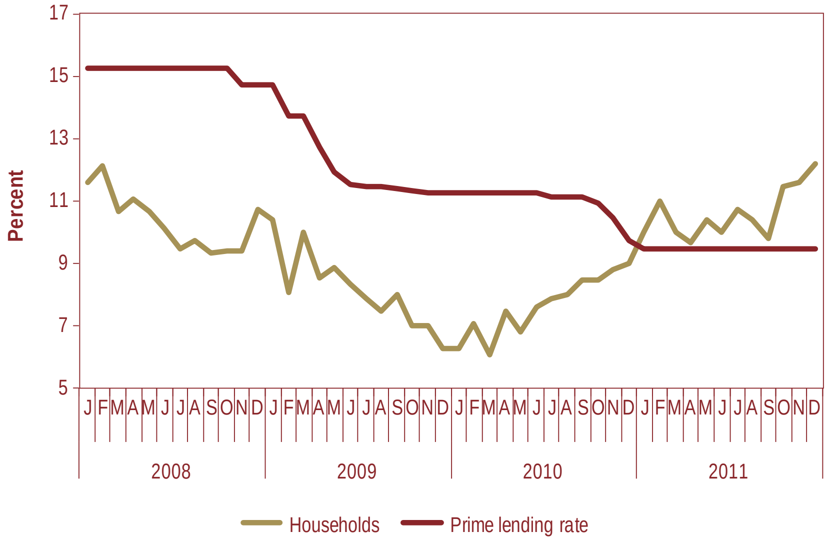
3.2 PRIVATE SECTOR CREDIT EXTENSION

Private sector credit extension (PSCE) continued to grow in the second half of 2011, although it showed moderation compared with the first half of 2011. Total credit to the private sector rose to N$44.3 billon, or 49.6 percent of GDP, at the end December 2011 from N$42.4 billion, or 47.2 percent of GDP, at the end of June 2011. The increase amounted to a growth rate of 4.5 percent, compared with a 12.9 percent at the end of June 2011. The subdued growth in the PSCE was mainly a consequence of a contraction in credit extended to the business sector during the period. Despite the slowdown in the PSCE, credit extension to the private sector remains an important component of the banking balance sheet and could, therefore, have an impact on banking stability.

3.2.1 Household sector borrowing

Aggregate lending to the household sector rose at the end of the second half of 2011. Credit advanced to individuals expanded to N$28.5 billion, or 31.9 percent of GDP, at the end of December 2011 from N$26.5 billion, or 29.7 percent of GDP, at the end of the first half of 2011. This represented a growth rate of 7.5 percent at the end of December 2011 compared with that of 4.7 percent at the end of June 2011 (Chart 11). The credit expansion lifted the share of household debt in total credit extension to the private sector to 64.3 percent in December 2011 from 62.5 percent at the end of June 2011. The mortgage loans sub-category, constituting 81.4 percent of total loans extended to individuals during the period, grew by 6.8 percent at the end of December 2011 compared with 4.8 percent at the end of June 2011.

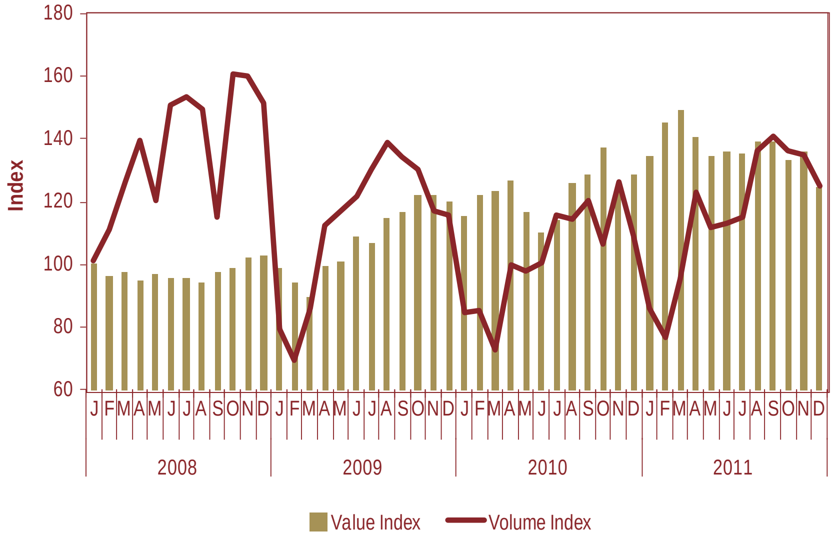
Chart 11: Claims on households



The high concentration of credit extension by the banking sector in mortgage loans warrants further analysis into developments in the housing market. Taking into account the significant increases in house prices over the past few years, the concern for financial stability stemmed from the worry that a sudden reversal of that trend might affect the financial sector negatively. However, the house prices receded during the second half of 2011, with the FNB house value index falling from 135.6 points during June 2011 to 124.4 points during December (Chart 12). This was a positive development and well in line with the volume index, which edged up from 113.2 points to 124.8 points over the same period.

FNB attributed the moderation in the value index to the buyers' inability to pay the required prices coupled with the downward pressure exerted by NHE housing in the lower income segment. It was, however; too early to tell whether this decline would be sustained through 2012. Nonetheless, the momentum contained in the volume index showed that housing demand remained strong enough to cushion the market from a steep slump in prices. Although further supply pressure was expected to stem from the implementation of TIPEEG that will result in more housing supply, the threat to financial stability was gauged to remain mild considering the high volume of the housing backlog.

Chart 12: House Price Index



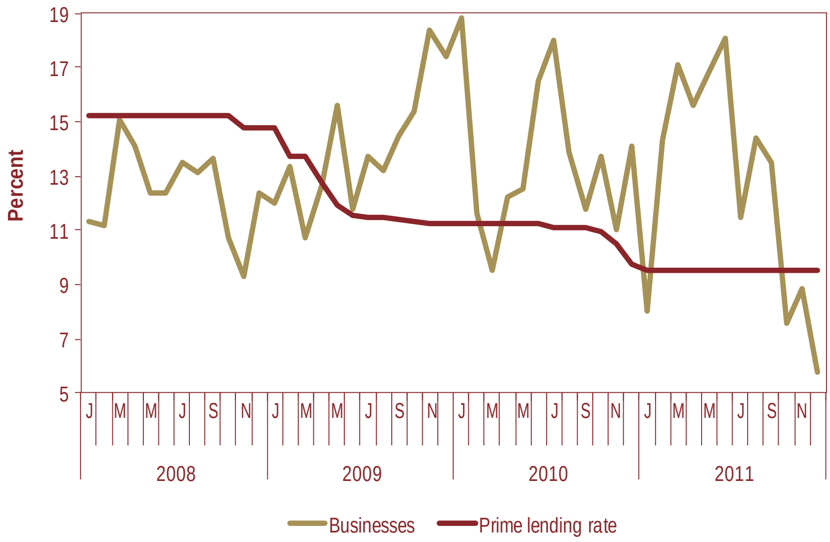
Source: FNB Namibia

3.2.2 Corporate sector borrowing

Total credit extension to the corporate sector declined slightly to N$15.8 billion, or 17.6 percent of GDP, at the end of December 2011, from N$15.9 billion, or 17.8 percent of GDP, at the end of June 2011. The slowdown brought the share of credit extension to the corporate sector to 35.7 percent of total private sector credit at the end of December 2011, slightly down from 37.5 percent at the end of June 2011. Despite the decline in the share, corporate balance sheet performance retains the potential to influence banking performance and financial stability.

Credit extension to the business sector slowed to 5.8 percent at the end of the second half of 2011 from 18.1 percent at the end of the first half of 2011 (Chart 13). Most of the slowdown in credit to the sector came from the *overdrafts* sub-category of loans and advances that declined by 17.9 percent during the second half of 2011. The decision by corporates to repay some of their debts, especially overdrafts, was mainly responsible for the slowdown in corporates borrowing during the period under review.

Chart 13: Claims on businesses



Despite a slow start in the first half of 2011, domestic economic growth improved in the second half. Overall, the economy is forecasted to expand by 4.2 percent in 2012, on account of increased uranium output, investments in construction, as well as mining and manufacturing sectors. Furthermore, favourable economic conditions will lift domestic consumer and business confidence and will lead to more consumer demand and business investment expenditure. At the same time, the financial conditions of household and corporates will improve. This would further boost the performance of banking institutions and financial stability. However, downside risks to the domestic economic outlook related to the prospects of the global economic recovery and the possible negative impact on exports. The downside risks notwithstanding, as noted in our past financial stability reviews, the adverse impacts of the current global economy and financial uncertainties on the Namibian economy and financial stability are anticipated to be minimal.

3.3 BANKING SECTOR PERFORMANCE

3.3.1 Banking structure

As of December 2011, five (5) banking institutions are licensed to carry out business in Namibia. Though, the operations of the recently licensed micro-finance bank continued to be relatively minor. The four (4) institutions, possessing practically 100 percent of total banking assets, therefore, continued to dominate the banking sector. This domination was also supported by the deterioration in the two main measures of sector concentration and market power during the review period. Both the Gini and HHI indices[5] rose from 11.7 points and 2,698 points at the end of June 2011 to 13.2 points and 2,734 points, respectively, at the end of December 2011. The universal thresholds for concentration are 10 points for the Gini index and 1,000 points for the HHI index. The gains in asset market shares of one bank at the expense of others during the period were responsible for the increase in the indices. Consequently, the high concentration levels implied that the banking sector continued to be less competitive, with a high probability of pricier and restricted banking services and credit.

[5] The two indices are the traditional measures of concentration in a banking sector. Values below 10 points and 1,000 points for the Gini and HHI indices, respectively, correspond to equality among banks and, therefore, more competition.

In theory, a banking sector where banking business is controlled by a few institutions is considered to be less competitive and the institutions in such a sector are perceived to possess market power. The latter can lead to institutions charging higher interest rates for their loans. This can result in an increase in non-performing loans. In addition, higher rates might attract riskier borrowers through adverse selection effect. Market power can also result in institutions becoming "too big to fail" and high risk-taking incentives, and, hence, increased banking system fragility. Consequently, a combination of the dearth of competition and market power could lead to restricted access to services, high costs, banking fragility. In other words, the structure of the system, in terms of the number and size of institutions, can have an impact on banking stability, costs, and access to credit.

The banking sector's non-performing loans have been declining since the second half of 2009. However, the Finscope survey of 2007 concluded that the sector in Namibia was profitable and highly concentrated. In addition, banking institutions were likely to be oligopolistic and did not consider transaction costs in their setting of fees. At the same time, very little reference was made to unit costs, while certain pricing appeared to disadvantage the poor. Consequently, the behaviour suggested that institutions were sheltered from effective competition.

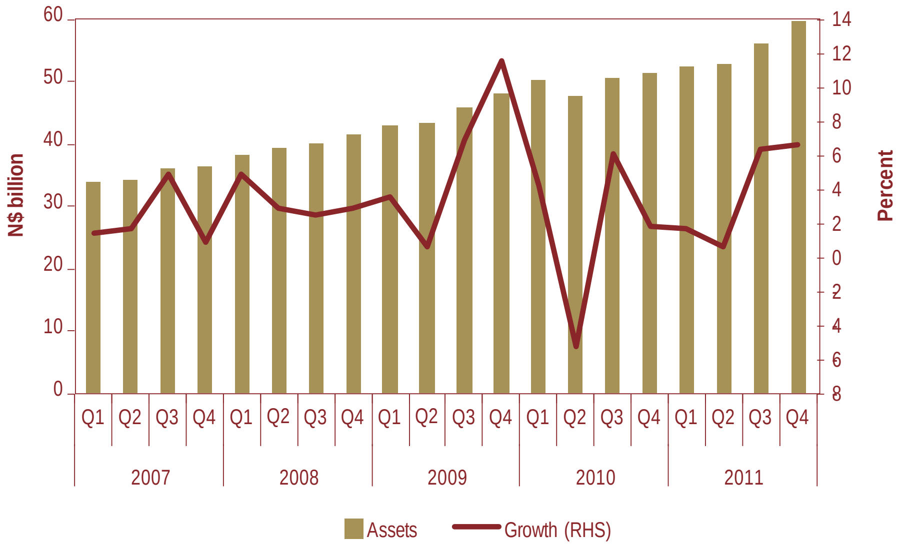
3.3.2 Balance sheet structure

The structure of the balance sheet of a banking sector is of interest to the stability of the banking sector because large and fast variations, such as rapid asset growth or decrease, could be unsustainable and, therefore, destabilising. The banking balance sheet expanded by 13.6 percent during the second half of 2011(Chart 14). This expansion dwarfed the 2.5 percent achieved in first six months of 2011, but was fairly evenly distributed over the period, 6.3 percent in the third quarter and 6.8 percent in the fourth quarter.

The bulk of the growth in banking assets came from a 5.9 percent increase in net loans and *advances*, which constituted 70.8 percent of total banking assets during the period. This growth rate was not far from the 5.3 percent reached during the previous six months. The other major sub-categories, the *cash and balances with banks* and *short-term negotiable securities*, rose by 124.8 percent and 95.7 percent, respectively, in the last six months of 2011. The former category comprised 13.0 percent of total assets, while the latter category made up 10.4 percent of the same. Within the *loans and advances* category, *residential mortgages* and *instalments debtors*, which comprised 42.0 percent and 16.7 percent, respectively, rose by 7.1 percent and 10.8 percent.

On the liabilities side of the banking balance sheet, growth was mainly driven by the increase in *non-bank funding*, which rose by 16.2 percent and comprised 95.6 percent of total liabilities in the second half of 2011. *Bank funding*, on the other hand, fell by 44.3 percent during the same period, due to decreases in *interbank borrowings* and *balance due to Bank of Namibia* of 89.9 percent and 97.4 percent, respectively.

Chart 14: Banking sector assets and growth rates



The non-banking funding as a fraction of total funding-related liabilities rose to 98.9 percent at the end of December 2011 from 97.8 percent at the end of first half of 2011. At the same time, net loans and advances remained the primary use of funds for the banking sector, even after falling to 73.7 percent of total funding-related liabilities at the end of December 2011 from 87.9 percent at the end of first six months of 2011.

Overall, the banking sector experienced a high asset growth of 13.6 percent during the review period. However, this is moderated by the relatively modest 5.9 percent expansion in loans and advances, which are considered riskier assets. At the same time, the asset quality has continued to improve. Moreover, non-performing mortgage loans as a fraction of total loans extended fell from 0.9 percent at the end of June 2011 to 0.8 percent at the end of December 2011. Thus, the asset growth rate during the review period poses no supervisory concerns and only calls for minimal monitoring.

3.3.3 Profitability, capitalisation and cost efficiency

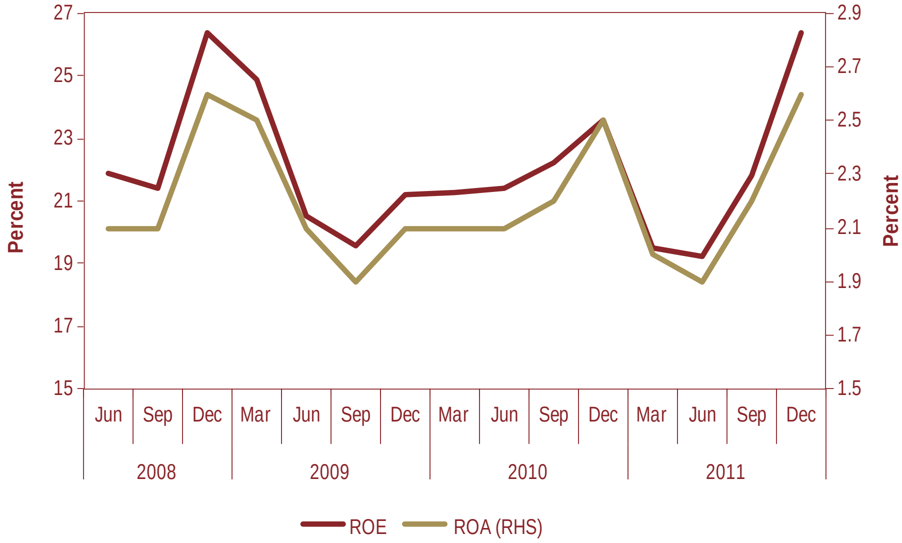
Profitability

Banking profitability is a major determinant of banking solvency and capital adequacy. Thus, banking profitability is critical for the soundness of the banking system and financial stability. At the same time, banking profitability is a function of; *inter alia*, income, provisions and write-downs, and operational expenses.

The profitability of the banking sector improved during the review period. After-tax income increased by 4.7 percent, as opposed to a 19.4 percent decline in the first half of 2011. Both net interest income and non-interest income, which rose by 17.5 percent and 4.2 percent, respectively, were mainly responsible for the increase in after-tax income during the period. The banking sector's profitability was also lifted by the reversal in provisions charged during the review period. At the same time, banking profitability was moderated by an 8.9 percent increase in interest expenses, although non-interest expense fell by 6.7 percent during the period.

The improvement in the after-tax income of the banking sector was also replicated in the increase in both returns on assets (ROA) and return on equity (ROE) in the last six months of 2011. The two ratios rose to 2.6 percent and 26.4 percent, respectively, in December 2011 (Chart 15). This contrasted with the levels of 1.9 percent and 19.3 percent in June 2011, respectively. Consequent to the improvement in the profitability, the banking sector was able to preserve efficient banking operations and keep adequate capital levels.

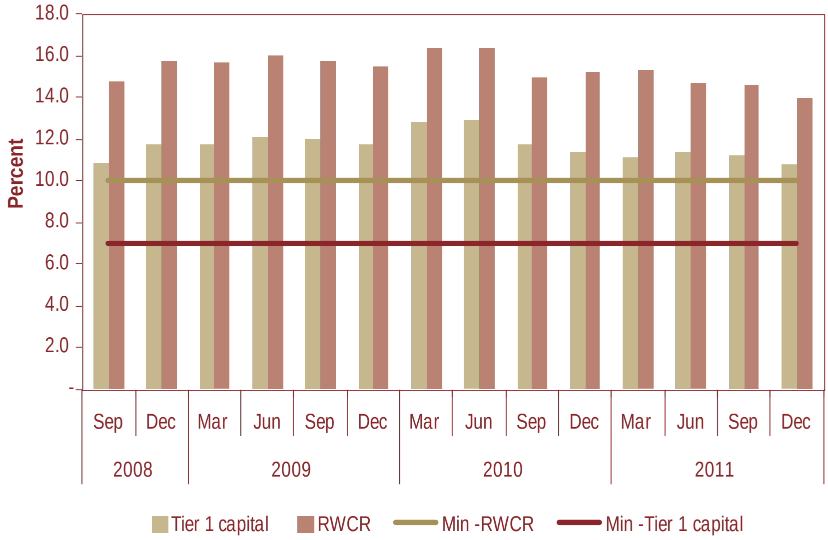
Chart 15: Post-tax return on assets and return on equity



Capitalisation

The banking sector sustained adequate capital levels during the review period, as the sector's capital ratios remained significantly above the minimum regulatory risk-weighted capital ratio (RWCR) of 10 percent. Nevertheless, the RWCR declined to an average of 14.0 percent at the end of the second half of 2011, from 14.7 percent at the end of June 2011 (Chart 16). The Tier 1 capital ratio, also, fell from 11.4 percent to 10.8 percent, during the same period.

Chart 16: Capital adequacy for banking institutions



The total qualifying capital and risk-weighted assets of the banking sector increased by 3.4 percent and 7.4 percent, respectively, during the second half of 2011. The rise in qualifying capital, Tier 2 capital, was a result of increases in general provisions and unaudited profits. Tier 1 capital fell as a result of dividends that were paid out of retained earnings. The increase in the risk-weighted assets, on the other hand, was due mainly to increases in credit and operational risk exposures.

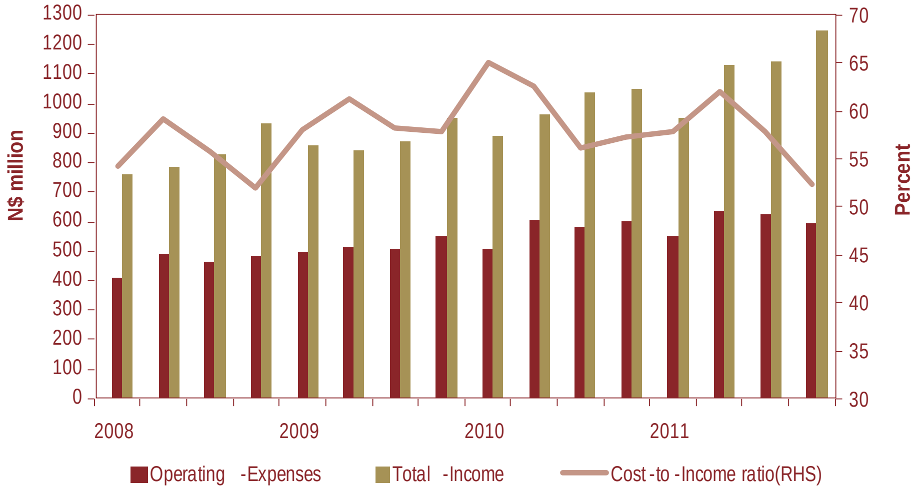
The Determinations on Measurement and Calculation of Capital Charges for Credit Risk, Operational Risk and Market Risk (BID-5) requires all banking institutions authorised to conduct banking business in Namibia to maintain prescribed capital minima, adhering to three requirements, namely: (i) the prevailing leading indicator of capital adequacy is the regulatory risk-weighted capital ratio (RWCR) of not less than 10 percent, of which (ii) 7.0 percent should be Tier 1 or primary capital and (iii) the Tier 1 capital leverage ratio of 6.0 percent should be maintained.

Improvements in the profitability allowed the banking industry to preserve capital levels above supervisory minima in the second half of 2011, although the RWCR slackened slightly. The banking sector, therefore, remained sound and sufficiently capitalised and in a safe position to cushion itself against unforeseen losses. Furthermore, the implementation of the Basel II capital accord, in 2010, improved the determination of the banking sector's capital adequacy. This was achieved through the introduction of market and operational risks in the calculation of risk-weighted assets and resulted in additional risk coverage. As a result, the present level of banking sector capitalisation is no source for financial stability concerns.

Cost efficiency

The conventional quantitative measure of efficiency in the controlling of operating costs, relative to income, in the banking sector is the cost-to-income (C/I) ratio. The efficiency measure improved from 62.0 percent in the first six months of 2011 to 52.3 percent in the last half of 2011 (Chart 17). The improvement in the C/I ratio was a direct result of a 10.4 percent increase in total income and a 6.7 percent decrease in (other) operating expenses during the same period. Consequent to the favourable movements in total income and operating expenses, the cost efficiency ratio edged closer to the international benchmark of 50.0 percent.

Chart 17: Banking costs, income and cost-to-income ratio



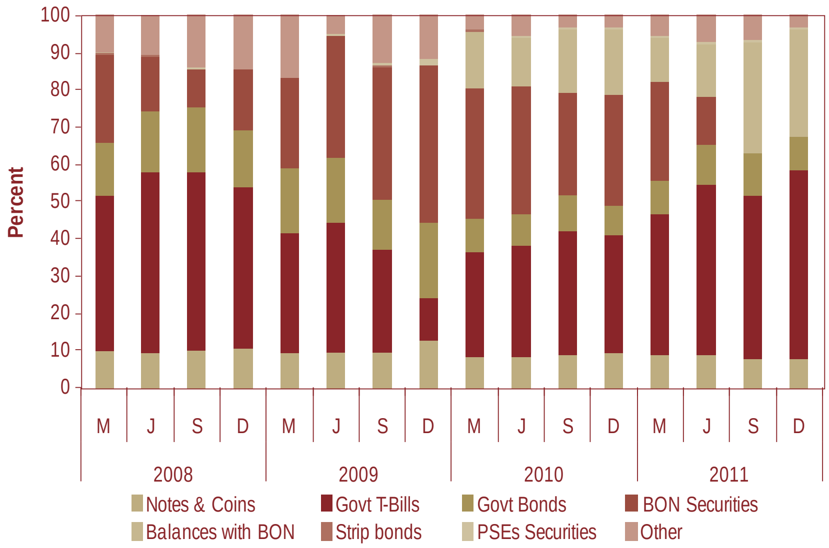
The major increase in operating expenses came from staff costs, its largest cost category, which rose by 4.6 percent during the review period. By contrast, the administration and other overheads costs, the second largest cost category of operating costs, fell by 19.2 percent during the same period. The banking sector's ability to boost banking profitability and, consequently, banking stability, therefore, hinged on the success of improving and sustaining the efficient management of operating expenses.

3.3.4 Liquidity risk

The banking sector's liquid assets grew by 37.0 percent, from N$5.4 billion at the end of June 2011 to N$7.4 billion at the end of December 2011. The industry also remained compliant with the statutory requirement of 10 percent of average total liabilities. However, the average excess asset holding fell slightly from N$0.6 billion during the first half of 2011 to N$2.3 billion at the end of December 2011.

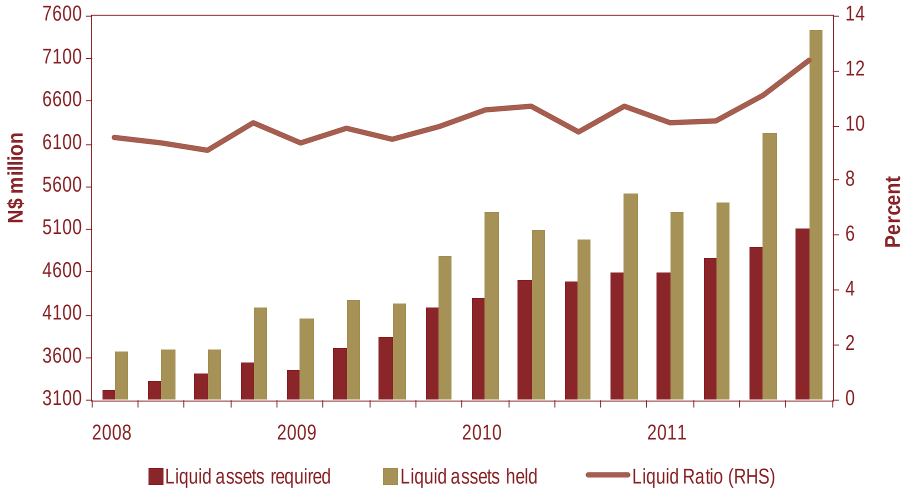
The increase in liquid assets mainly stemmed from a rise in Government T-bills, which improved its share of liquid assets held by the banking sector from 45 percent in June 2011 to 50.6 percent in December 2011(Chart 18). During the same period, the sector's settlement account balances with the BON became the second largest liquid asset category, climbing from 13.8 percent to 28.8 percent. The share of Government bonds in total liquid assets fell to third spot from 10.6 percent to 9.5 percent, during the same period. Bank of Namibia Securities, which previously formed part of the banks liquid assets, on the other hand, were discontinued to allow more room for increased Government borrowing.

Chart 18: Structure/Composition of liquid assets



The traditional measure of the state of liquidity in the banking sector is the liquid assets ratio or liquid ratio. The ratio, expressed as total liquid assets held to total assets, rose from 10.2 percent at the end of June 2011 to 12.4 percent at the end of December 2011 (Chart 19). The upswing in the ratio was mainly attributed to a 37.0 percent upsurge in the liquid assets held that prevail over the 13.6 percent growth in total assets during the period.

Chart 19: Liquid assets and liquidity ratio



Following the disproportionate growth in assets compared with loans, the share of loans to total banking assets fell from 76.1 percent in June 2011 to 71.0 percent in December 2011. At the same time, the ratio slipped below the international standard of 75.0 percent of assets, and thus implied an improvement in the general liquidity of the banking industry's asset base. Despite the fall, the loans ratio remained the most significant loan category in the banking industry's balance sheet. This development augurs well as it alleviates pressures on the banking sector.

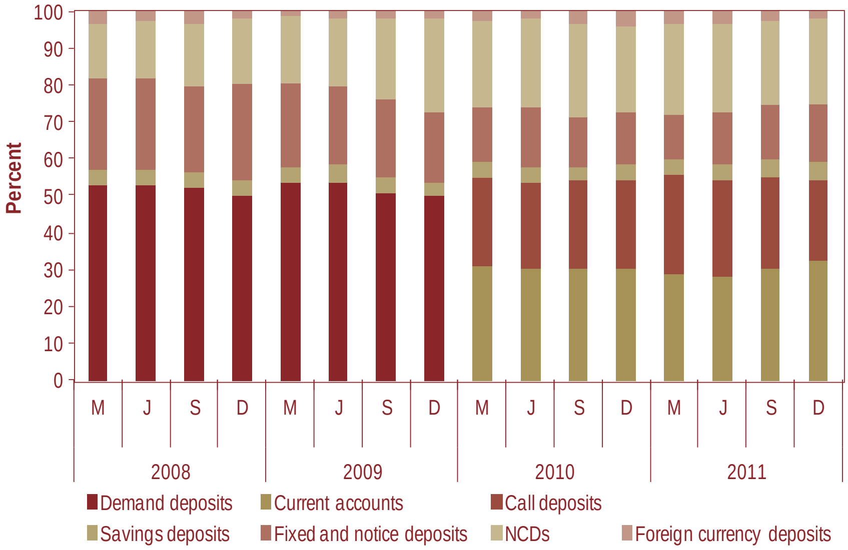
Meanwhile, the ratio of total loans to total deposits (LTD ratio) is the traditional measure of the degree to which the banking sector utilises core deposits to fund the growth in loans. The LTD ratio fell from 89.1 percent at the end of the first half of 2011 to 82.2 percent at the end of December 2011. A ratio lower than the 100 percent funding threshold implies that the banking sector has sufficient margin of safety for asset growth before it becomes imperative to utilise other more costly sources of funding, such as borrowed funds. As a result, the state of loan financing with core deposits in the banking sector posed no substantial liquidity alarms.

The cost of funds and instability of funding sources are critical to the lending operations of the banking sector. Hence, the combination of core or non-bank deposits employment by banking institutions can impact the liquidity risks faced by those institutions. This impact was also reflected in the fact that the banking sector's deposit utilisation mixture stayed basically unchanged between June 2011 and December 2011. The core deposits, which are safer and less expensive, were the most used. Their share of total funding liabilities rose from an average of 96.2 percent in the first half of 2011 to an average of 96.5 percent in the second half of 2011. Similarly, the share of current account deposits in total core deposits increased from 27.9 percent to 32.1 percent (Chart 20). On the other hand, the share of call deposits fell from 26.5 percent to 22.4 percent, while that of NCDs also dropped from 24.1 percent at the end of June 2011 to 23.4 percent at the end of December 2011.

Liquidity conditions in the interbank market define the easiness with which banking institutions can attain funds on short notice through interbank borrowing. Banking institutions can, therefore, be susceptible to liquidity risk emanating from the liquidity conditions in the interbank market. However, this susceptibility is moderated by the fact that the Namibian banking institutions' interbank exposure remained relatively small. For instance, at the end of December 2011, the inter-bank borrowings and deposits comprised only 3.4 percent of the banking industry's total qualifying capital, or equivalently, 3.5 percent of industry capital and reserves.

Risk in the inter-bank market might arise from the fact that not all funding lines between the South African parent banks and their Namibian banking subsidiaries are formalised. So, in a liquidity crisis, banking institutions might not have access to adequate liquidity from their parent banks. Another possible risk for the banking sector emanates from the fact that the banking sector relies on volatile wholesale deposits, from the ten largest depositors. Wholesale deposits make up 36.6 percent of the sector's total funding liabilities and 14.2 percent of the fraction is in the 1-7 days maturity time band.

Chart 20: Composition of core/non-bank deposits



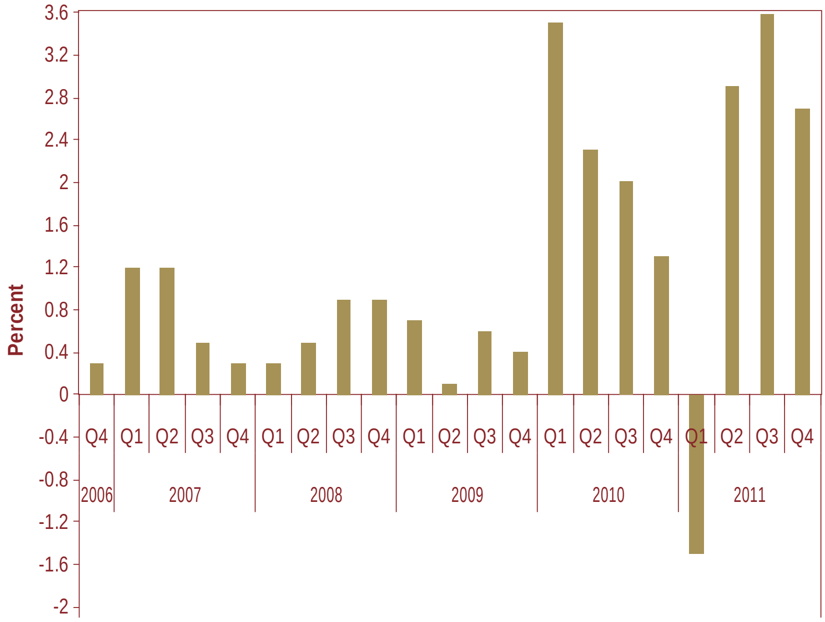
The above analyses of the key indicators of liquidity in the banking sector have revealed that the liquidity condition remained satisfactory during the period under review. Consequently, the risks of liquidity vulnerability and financial instability remained negligible in the second half of 2011.

3.3.5 Exchange rate risk

The banking sector is generally exposed to foreign exchange risks emanating from movements in exchange rates because of their holdings of foreign currency assets and liabilities. This predisposition is measured as the extent of mismatches, or open positions, of foreign currency assets and liabilities. It is calculated as a ratio of net foreign currency assets to the banking institutions' Tier-1 capital funds. The ratio is used as an indication of the likely vulnerability or openness of the banking sector's capital to movements in exchange rates. Net open position in the banking sector fell slightly from 2.9 percent in June 2011 to 2.7 percent in December 2011, after rising to 4.2 percent in September 2011 (Chart 21). The variation in the ratio during the period is testimony to the uncertainties the banking sector faced in its operations in the foreign exchange markets in the second half of 2011.

The fall in the ratio, during the second half of 2011, was attributable to a 22.6 percent decrease in net open position, which was offset by the Tier-1 capital funds that rose by 13.8 percent. A decrease in the ratio signified a decline in the exchange rate risk to which the banking sector was exposed during the period. At the same time, the ratio continued to be minute relative to banking capital and to trend comfortably below the regulatory limit of 20 percent. Hence, foreign exchange rate risk in the banking sector posed no substantial financial stability concerns during the review period.

Chart 21: Net open position as percent of tier-1 capital



3.3.6 Credit risk

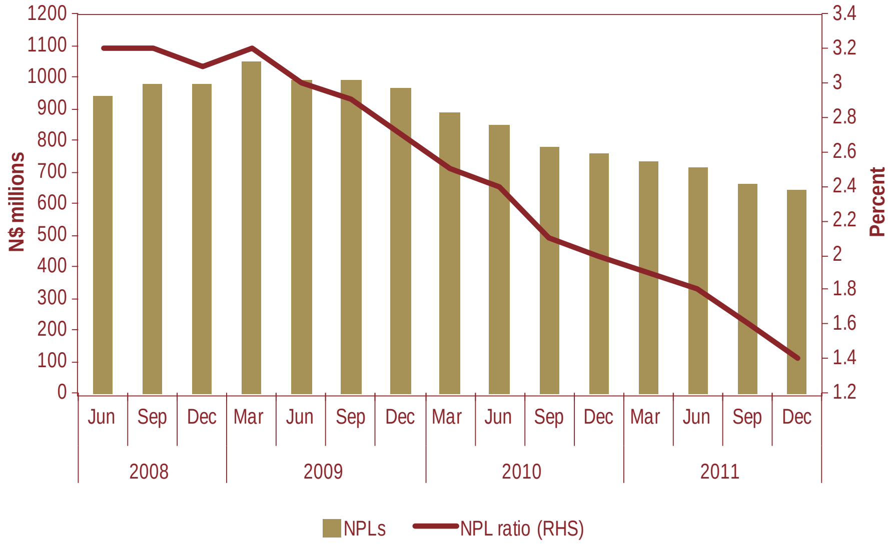
In the context of the banking sector, credit risk refers the possibility of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Given that loans constitute the lion's share of banking sector assets, credit risk is, therefore, the major risk faced by the sector.

The ratio of non-performing loans (NPLs)[6] to total loans and advances, the NPL ratio, serves as an indicator of vulnerabilities emanating from the banking loan portfolios. The NPL ratio of the banking sector fell further from 1.8 percent at the end of June 2011 to 1.5 percent at the end of December 2011 (Chart 22). The declining trend in the ratio, which started in the second quarter of 2009, represented a sustained improvement in the banking loan portfolio's credit risk over the period. The decrease in NPLs during the period was mainly due to improvements in non-performing mortgage loans, in arrears for more that 12 months.

These improvements included payments received or recoveries on bad loans and debt write-offs. For instance, bad debts amounting to about 5.0 percent of NPLs were written off during the second quarter of 2011. Under the non-performing loans category, non-performing mortgage loans, accounting for 59.5 percent, fell by 3.2 percent during the period. The downward trend in the NPL ratio was also aided by lower interest rates which alleviated the debt burden of banking borrowers, especially, households faced by high debt levels, and by the then favourable economic environment. The NPL ratio also remained well below the Bank's early warning system (EWS) threshold of 4.0 percent.

[6] NPLs refer to loans that have been overdue for a period of 90 days and longer.

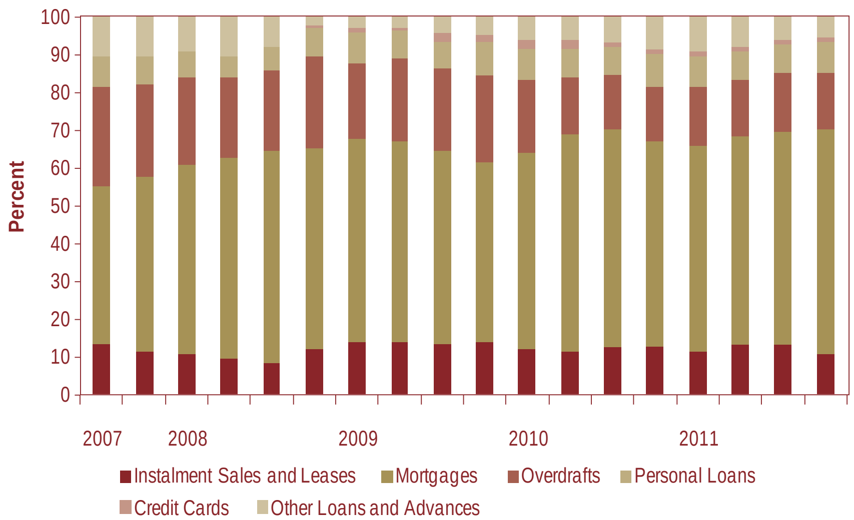
Chart 22: Banking asset quality



Overdue loans in the banking sector fell by 15.4 percent to N$1.5 billion at the end of December 2011 from N$1.8 billion at the end of June 2011. The fall was partly a result of lower overdue mortgage loans due to payment received or recoveries, during the same period. The fraction of total loans that was overdue loans fell from 4.5 percent to 3.5 percent during the same period. At the same time, the proportion of NPLs to overdue loans rose from 39.6 percent to 41.9 cent, as overdue loans declined by 15.4 percent while the NPLs fell by 10.6 percent. The lower interest rate environment, since the first quarter of 2009, coupled with favourable domestic economic conditions, sustained the beneficial environment for overdue loans during the review period.

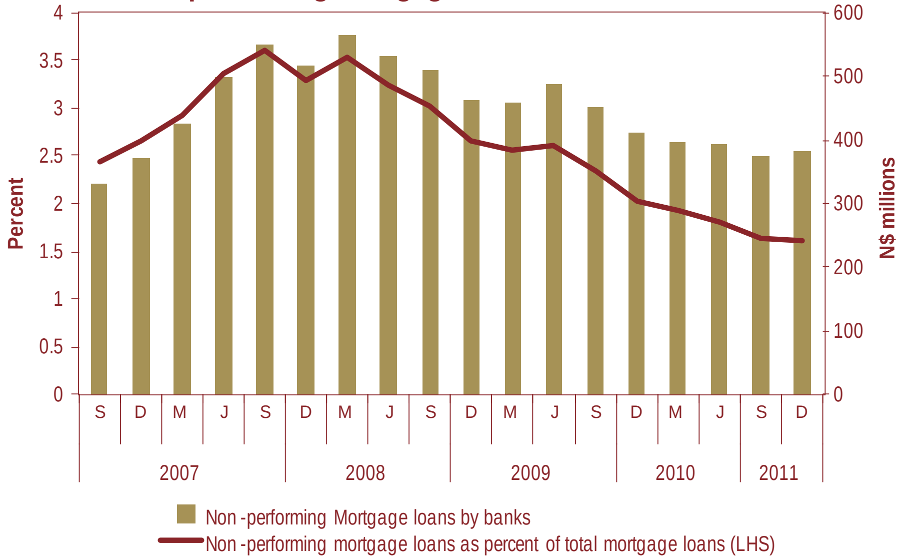
As a share of total non-performing loans, non-performing mortgage loans increased to 59.5 percent at the end of the second half of 2011 from 54.9 percent at the end of June 2011 (Chart 23). However, non-performing mortgage loans as a proportion of total mortgage loans extended by banking institutions fell further to 1.6 percent at the end of December 2011 from 1.8 percent at the end of June 2011 (Chart 24). At the same time, the proportion of overdue mortgage loans in total mortgage loans fell from 4.9 percent at the end of June 2011 to 4.1 percent at the end of December 2011. The largest decreases in overdue mortgage loans during the review period came from the categories “amount overdue for less than one month” and “amount overdue for 12 months to less than 18 months”, which accounted for 6.1percent and 1.2 percent, respectively, of total overdue loans.

Chart 23: Non-performing loans by category



The Determinations on Single Borrower Limit (BID-4) set 30 percent and 800 percent statutory limits for single borrowers and aggregate large exposures as a percentage of industry capital, respectively. The statutory large exposures of the banking sector, exposures that are at least 10 percent of industry qualifying capital, accounted for 20.8 percent of the total loan portfolio of the banking sector, at the end of the second half of 2011, compared with 20.0 percent six months previously. During the same period and as a fraction of banking industry capital funds, aggregate large exposures rose from 137.2 percent to 147.7 percent.

Chart 24: Non-performing mortgage loans



The banking sector's asset quality continued to improve during the review period and it was considered satisfactory. The NPL ratio has been falling since March 2009, mainly due to recoveries on mortgage loans in arrears for more than 12 months, as well as payment received on other bad loans and debts written-offs. Consequently, credit risk was assessed to be minimal.

Table 2: Banking sector indicators

Structure	Dec 08	Jun 09	Dec 09	Jun 10	Dec 10	Jun 11	Dec 11
Number of banks	**4**	**4**	**4**	**5**	**5**	**5**	**5**
Total assets of banks (N$ '000 000)	41,563	43,276	47,669	47,699	51,501	52,782	59,971
Gini concentration index	11.3	10.8	11.45	12	11.07	11.7	13.2
Herfindahl index	2,689	2,677	2,690	2,692	2,680	2,833	2,734
Capital Adequecy (%)							
Tier 1 leverage ratio	7.9	8.6	7.8	8.6	8.3	8.7	7.8
Tier 1 capital ratio	11.8	12.8	11.7	11.4	11.1	11.1	10.8
Total RWCR	15.6	16.4	15	15.2	15.3	14.7	14
Asset Quality							
NPL/Total gross loans	3.1	3	2.7	2.4	2	1.8	1.5
Gross overdue/ Total loans and advances	5.7	6.5	8	4.7	4.3	4.5	3.5
Provisions/Total loans	2	1.9	1.8	1.8	1.5	1.5	1.4
Provisions/NPLs	64.7	62.8	66.2	74.8	78.6	84.6	94
Specific provision/NPLs	29.2	27.2	28.7	30.5	30.3	31.3	33.3
Earnings and Profitability							
Return on assets	2.6	2.1	2.1	2.1	2.5	1.9	2.6
Return on equity	26.4	20.5	21.2	21.4	23.6	19.2	26.4
Net interest margin	4.7	4.3	4.5	4.9	5.2	4.9	5.7
Cost to income ratio	51.9	61.2	57.9	62.5	57.3	60.1	52.3
Liquidity (%)							
Liquid assets to total assets	10.1	9.9	10.0	10.5	10.7	10.2	12.4
Total loans/Total deposits	87.9	87.1	85.3	87.7	86.6	89.1	82.2
Total loans/Total assets	75.2	74.6	72.8	74.9	74.1	76.1	71

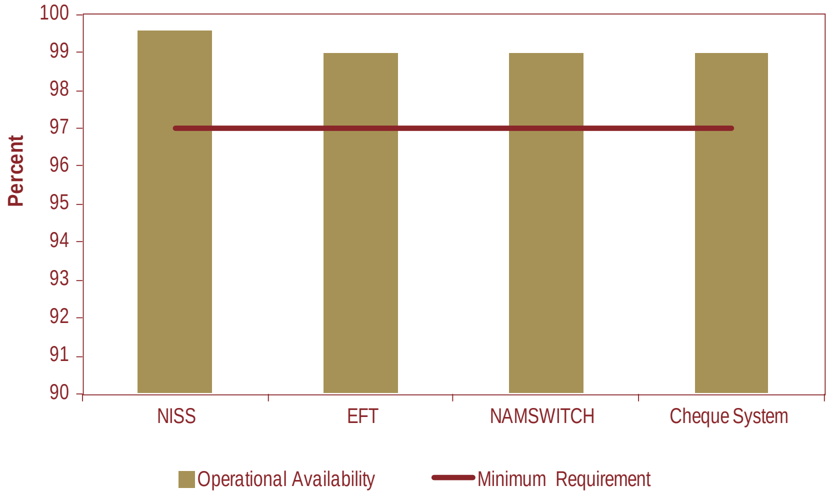
3.4 FINANCIAL SYSTEM INFRASTRUCTURE AND REGULATORY DEVELOPMENTS

3.4.1 Financial system infrastructure

During the second half of 2011, The Bank of Namibia conducted various payment system oversight activities for the purposes of promoting the maintenance of a sound and efficient financial system. Operational vulnerabilities contribute to various risks in payment systems, which may lead to disruptions that affect the stability of financial markets, and undermine public confidence. The Bank, as part of its oversight activities, continues to place emphasis on the operational robustness, security, timeliness and contingency planning for systemically important payment systems.

Consistent with its core role, the Namibian Real-Time Gross Settlement System (NISS) showed resilience and robustness and enabled wholesale high value payments to be processed without major disruptions. Operational availability of Namibian retail payments systems, namely Electronic Funds Transfer System (EFT), Cheque Processing System (CPS), and NAMSWITCH also remained high for the second half of 2011 which is broadly in line with those reported for retail payment systems in other countries.

Chart 25: NPS Operational Availability



Over the fourth quarter of 2011, NISS availability ratio was 99.55 percent. The system experienced 3 operational failures, the longest lasting 6 hours and 15 minutes. Consequently, NISS was not available for 10 hours and 55 minutes. The EFT availability ratio stood at 99 percent, with 27 operational disruptions or settlement delays recognised in the 4th quarter of 2011. The CPS availability ratio stood at 99 percent. Generally, 68 operational disruptions or settlement delays were identified in the system in the 4th quarter of 2011. NAMSWITCH availability ratio stood at 99 percent. Only one operational disruption or settlement delay was recorded in the 4th quarter. The overall assessment, therefore, is that the high value payment and retail payment systems performed satisfactorily during the second half of 2011.

3.5 OVERALL ASSESSMENT AND OUTLOOK

The domestic economy improved in the second half of 2011, the slowdown in the global economy notwithstanding. The secondary and tertiary industries contributed to most of the growth. During the second half of 2011, the banking sector continued to be liquid, well capitalised and solvent: non-performing loans maintained its downward trend since the first half of 2009, while both total overdue loans and overdue mortgage loans fell. In addition, cost efficiency in the utilisation of assets improved significantly. This could have positive spin-offs for future banking profitability, which also improved during the review period. However, there are risks in the banking sector resulting from the sector's reliance on potentially volatile wholesale deposits and non-formalised liquidity support from parent companies.

The National Payment System has performed satisfactorily in the second half of 2011. The system remained functionally available most of the time and no systemic risks were experienced.

The prevailing global economic slump was expected to continue in 2012. The deterioration in the global economic conditions could hurt external demand for Namibian exports. This could also have negative implications for the domestic economy and the private sector, with possible negative consequences for the banking sector and financial stability. However, the domestic economy is projected to grow in 2012, with all three industries contributing to the growth. The positive economic state of affairs would also benefit banking borrowers and further enhance the performance of the banking sector and financial stability. Consequently, in line with previous financial stability reviews, the risk on financial stability emanating from the current global situation is expected to remain minimal in 2012.

NOTES

Bank of Namibia