Bank of Namibia

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Financial Stability Report
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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

"In support of economic growth and development our mandate is to promote price stability, efficient payment systems, effective banking supervision, reserves management and economic research in order to proactively offer relevant financial and fiscal advice to all our stakeholders"

VALUES

"We value high-performance impact in the context of teamwork.

We uphold open communication, diversity and integrity.

We care for each other's well-being and we value excellence."

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
GC15	Government Internal Registered Stock Maturing in 2015
GC18	Government Internal Registered Stock Maturing in 2018
GC21	Government Internal Registered Stock Maturing in 2021
GC24	Government Internal Registered Stock Maturing in 2024
HI	Herfindahl Index
IMF	International Monetary Fund
JSE	Johannesburg Stock Exchange
LHS	left-hand side (of graph)
NAD	Namibia dollar
NISS	Namibia Inter-bank Settlement System
NPL	Non-performing loan
NSX	Namibian Stock Exchange
RHS	right-hand side (of graph)
SA	South Africa
SACU	Southern African Customs Union
SARB	South African Reserve Bank
T Bill	Treasury bill
USA	United States (of America) Contents

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". 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[1] in Namibia during the first 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 March 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 promote understanding of, and contribute to informed debate on, financial stability issues.

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, centres on the banking industry's performance and ability of the industry to absorb unanticipated shocks.

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

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 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

The global economic recovery slowed in the second quarter of 2011, and downside risks to global economic outlook increased. In advanced economies, output growth weakened due to a combination of factors in particular the high rates of unemployment in many advanced economies. In emerging and developing economies, economic growth decelerated but was stronger than in advanced economies and served as a key driver for global economic growth. Although the downside risks to the recovery rose, the IMF in its World Economic Outlook Update for June 2011 expected the global economic slowdown to be temporary.

Global financial conditions became more volatile in the second quarter of 2011 and were expected to continue to be volatile. According to the IMF's June 2011 Global Financial Stability Report (GFSR) Update, deep-seated financial challenges remained, and concerns about debt sustainability and support for adjustment efforts in the Euro Area's periphery intensified. At the same time, financial risks rose and the outlook for sovereign debt in some larger economies worsened. In some emerging economies, inflationary pressures were emerging and signs of overheating from strong capital inflows were developing.

In the first half of 2011, domestic economic activity slowed together with the global economic slowdown. Performance was poorest in the primary industry, where mining and quarrying output was hampered by adverse weather conditions early in the period. In addition, mining exports was restrained by the strong Namibian currency during the period. Agriculture also recorded poor output due to floods that damaged crops. On the other hand, the tertiary industry improved, with wholesale and retail sectors improving and the tourism and water-transport sectors growing, while land transport moderated during the period. The construction sector also improved.

The real effective exchange rate (REER) of the Namibia Dollar (NAD) depreciated in the first half of 2011, resulting in gains of competitiveness for Namibian products on international markets, while the country's international reserves rose during the period and continued to be sufficient to sustain the currency peg. Furthermore, the level of reserves was also sufficient to support both the financial health of the domestic economy and financial stability. However, the county's reserves continued to be inhibited by recent declines in SACU receipts.

Overall inflation in Namibia rose in the first half of 2011, due to rising global commodity prices, especially food and oil prices. In the medium term, domestic inflation pressures would continue to be driven by food and transport prices and price adjustments for utilities.

Banking profitability deteriorated somewhat, but capital and liquidity were adequate and classified loans declined further, supportive of banking stability. The banking sector continued to be sufficiently liquid, well capitalised and non-performing loans fell during the first half of 2011. However, after-tax income declined slightly and overdue loans rose during the same period. Non-performing loans upheld the downward trend that began in the first half of 2010. Cost efficiency ratios deteriorated marginally, while improvement was noted in the second half of 2010. These setbacks notwithstanding, the banking sector continued to be sound and stable during the first half of 2011.

The assessment of the performance of the National Payment System found the system efficient, safe and compliant. During the review period, the Bank continued to perform its oversight function of the performance of the National Payment System (NPS). The main objective of these oversight activities was to safeguard the safety and efficiency of the NPS. The assessment did not reveal any major issues of the payment system that could pose systemic risk to the financial system.

The overall state of financial system stability is assessed to be stable and sound. The monitoring of the impacts of the current uncertainties in the global economic and financial conditions on the financial system, domestic inflation and banking sector stability will be ongoing.

2. EXTERNAL ENVIRONMENT

2.1 MACRO-ECONOMIC AND -FINANCIAL CONDITIONS

The global economic recovery slowed in the second quarter of 2011 and downside risks increased further, according to the IMF. A combination of supply disruptions due to the devastating earthquake in Japan, oil price increases, and the debt crises in the US as well as the Euro Area contributed to stifle the global economic recovery. In addition, the dampening effects of high commodity prices on income and spending, low private and public consumption, and high unemployment rate also contributed to slowing global economic activities. The global economic slowdown was particularly evident among advanced economies. On the other hand, growth in most emerging and developing economies continued to be strong and served as a key driver of global economic growth, despite recording slower growth during the second quarter of 2011.

The IMF, in its June 2011 Global Financial Stability Report (GFSR) Market Update, noted that global financial conditions became more volatile in the second quarter of 2011 and structural weaknesses and vulnerabilities remained in some important financial systems. At the same time, financial risks rose during the period. In addition, concerns persisted about debt sustainability and adequacy of support for debt adjustment efforts in the Euro Area's margin economies. These concerns led to market pressures and worries about potential contagion. There were also doubts about medium term fiscal adjustments in a few advanced countries, notably the US and Japan.

Furthermore, the IMF warned that the prolonged period of low interest rates might push investors into riskier assets in search of better yields. This phenomenon could lead to potential build up in financial imbalances for the future, particularly in some emerging markets. The IMF further noted that, given these risks, there was need to accelerate actions to address long-standing financial vulnerabilities. For example, emerging policy makers needed to guard against overheating and a build-up of financial imbalances amid strong credit growth and rising inflation, exacerbated by capital inflows in some countries.

According to the IMF's World Economic Outlook Update for June 2011, global economic activity slowed temporarily in the second quarter of 2011 and downside risks to global economic outlook increased again. At the same time, global expansion remained uneven among countries and regions. Growth in many advanced economies was still weak, given the depth of the recession experienced. In the US, real GDP slowed to 2.2 per cent and 1.5 per cent, respectively, in the first and second quarters of 2011. The slowdown in US economic activities was mainly due to weak domestic demand; higher commodity prices; bad weather; and supply chain disruptions from the Japanese earthquake on US manufacturing. At the same time, unemployment averaged about 9.1 per cent during the first half of 2011, the highest among advanced economies combined with the sovereign debt, housing market problems.

Similarly, in the UK, real GDP growth slowed to 0.7 per cent in the second quarter of 2011 compared with 1.6 per cent in the first quarter of 2011. Weak economic performance in the UK was chiefly a result of slow activities in manufacturing, mining and quarrying as well as electricity, gas and water supply sources.

In the Euro Area real GDP growth slowed to 1.7 per cent in the second quarter of 2011 from 2.5 per cent in the first quarter of 2011. Both France and Germany showed a considerable slow down in growth during the period, especially in their manufacturing sectors. There were concerns about the outlook for the Euro Area's economy and banks, but increased investments in both countries were expected to fuel growth in the Euro Area.

In Japan, real GDP growth contracted by 1.0 per cent during both the first and second quarters of 2011. The economic contraction could largely be ascribed to weak exports and declining private consumption. In addition, the manufacturing sector was severely affected by the devastating earthquake and tsunami that hit the country in mid-March 2011. However, unemployment in Japan fell from 4.7 per cent in the first quarter of 2011 to 4.6 per cent in the second quarter of 2011.

In emerging and developing economies, economic growth evolved as expected but with considerable variations across regions. Real GDP growth also slackened in some economies in the first half of 2011, although it remained relatively high than in advanced economies. In Asia, months of policy tightening contributed to slower growth in both China and India. The two economies also felt the pinch of key export markets in the US and Europe. China, however, continued to be the engine of global economic growth in the first half of 2011. Real GDP growth in China declined marginally to 9.5 per cent in the second quarter of 2011 from 9.7 per cent in the preceding quarter. In India, real GDP growth slowed to 7.7 per cent in the second quarter of 2011, from 7.8 per cent in the previous quarter. In addition to high interest rates, growth was also hampered by weaker manufacturing, mining finance and insurance sectors.

The IMF, in its World Economic Outlook for July 2011, expected the global economy to slow to 4.0 per cent during 2011, from 5.1 per cent in 2010. Furthermore, downside risk to the global economic recovery continued, with high and persistent unemployment, the sovereign debt crisis in the Euro Area and high federal government deficit in the US. In addition, global uncertainties, such as the turmoil in North Africa and the Middle East, remained. In advanced economies, GDP was expected to grow by about 1.6 per cent in 2011, while economic activities would continue to be subdued and unemployment high in some key economies, according to the IMF. On the other hand, GDP growth in 2011 was projected at about 6.4 per cent in emerging markets. Signs of a slowdown in economic activities in emerging markets appeared towards the latter part of the first half of 2011. Economic growth slowed in China and India and raised fears of a double-dip recession in these economies.

2.2 INFLATION RATES

The volatility in commodity prices and oil and energy, in particular, had a great impact on CPI inflation all over the world, in the first half of 2011. High commodity prices had a dampening effect on the income and spending in major economies that led to slowing economic activities. In the US and Euro Area the inflation rates rose from 1.3 per cent and 2.0 per cent, respectively, at the end of December 2010 to 3.5 per cent and 2.7 per cent at the end of June 2011. Japan had the lowest inflation rate during the period, which rose from 0.0 per cent to 0.2 per cent. At the same time, among the emerging economies, respective inflation rates Russia and China rose from 8.1 per cent and 4.7 per cent to 9.5 per cent to 5.7 per cent. India had one of the highest inflation rates among the emerging economies, at 8.9 per cent at the end of June 2011, although it fell from 9.2 per cent recorded in December 2010.

However, global inflationary pressures were expected to be lower in 2011-12 than a year ago, as crops were improving, but prices would still remain at robust historical levels, according to the United Nation’s Food and Agriculture Organisation (FAO). However, the organisation warned that given the tight nature of food stocks and reserves, volatility would not diminish. The FAO noted that world food prices rose by 1.0 per cent in June 2011 on account of higher sugar prices. A fall in prices of wheat, corn and soybeans as well as a broad retarding influence across a wide range of commodity markets in June 2011 were expected to drag on the world food price index and defuse food price inflation.

2.3 INTEREST RATES

Varying monetary policy stances characterised various policy priorities that existed in different countries during the first half of 2011. Most advanced countries and some emerging economies maintained their accommodative monetary stances in the face of sluggish economic recovery and uncertain outlook. However, some countries raised their rates during the period to restrain inflationary pressures.

The European Central Bank (ECB) raised its benchmark lending rate in April 2011, which prompted fears of emerging inflationary pressures and upward inflation expectations. The Euro Area inflation breached the ECB’s 2.0 per cent limit since December 2010. At the time of rate tightening on borrowing costs, ECB signalled its willingness to raise rates further if necessary. The ECB eventually adjusted its lending rate upwards by 25 basis points to 1.5 per cent in July 2011 (Table 1).

The US Federal Reserve (Fed) maintained its policy rate within the range of zero per cent to 0.25 per cent, as economic recovery continued to be fragile and inflation increased. However, the Fed expected the pace of economic recovery to increase. Inflation was also expected to subside as the impact of past energy and other commodity prices increases dissipated.

Table 1: Selected economies latest policy rates

Countries	Policy Rate	Current Rate (%)	Policy Rate%	Last Meeting	June Inflation	Real Interest
Advanced						
USA	Fed Fund rate	0-0.25	0.00	June	3.6	-1.0
Canada	**Overnight rate**	**1.00**	**0.00**	**July**	**3.1**	**-2.1**
Australia	Cash rate	4.75	0.00	July	3.6	1.2
Euro Area	**Refinance rate**	**1.50**	**0.00**	**July**	**2.7**	**-1.2**
UK	Base rate	0.50	0.00	August	4.2	-3.7
Japan	**Call rate**	**0-0.1**	**0.00**	**June**	**0.2**	**-0.2**
BRICS						
Brazil	**Short term interest rate**	**12.25**	**0.25**	**June**	**6.7**	**6.0**
Russia	Refinancing rate	8.25	0.00	August	9.4	-1.2
India	**Repo rate**	**8.00**	**0.50**	**July**	**8.6**	**-0.6**
China	Lending rate	6.56	0.25	July	6.4	0.2
South Africa	**Repo rate**	**5.50**	**0.00**	**July**	**5.0**	**0.5**

Sources: Bloomberg and Respective Central Banks

The Bank of Japan (BOJ) kept its policy rate unchanged at about 0.0/0.1 per cent during the first half of 2011. Real GDP in Japan fell in the first quarter of 2011, and domestic private demand was subdued. The country also faced severe supply-side constraints, especially after the March earthquake disaster.

Among emerging economies, Brazil, China and India raised their respective policy rates in the recent meetings. Brazil's central bank raised the benchmark lending rate for a fourth straight time and signalled that it was prepared to increase the borrowing costs further. The central bank lifted the Selic a quarter points to 12.25 per cent in early June 2011. The interest decision was taken to cool inflation that in April 2011 breached the 6.5 per cent upper limit of the bank's target range for the first time, since 2005.

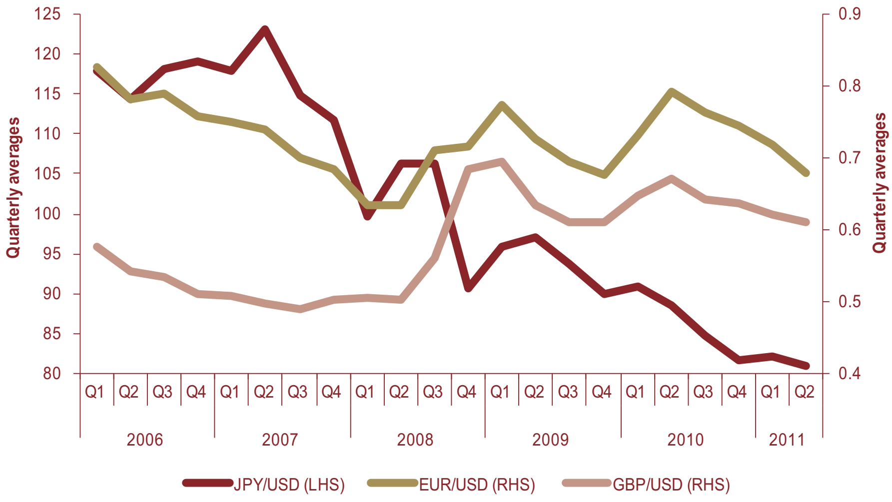
China's central bank increased interest rates for the third consecutive time in July 2011 to tame high inflation. Consequently, the lending rate was raised by 25 basis points to 6.5 per cent. China's inflation rate rose to 5.7 per cent in June 2011, above the government's annual inflation target of 4.0 per cent. Similarly, the Reserve Bank of India (RBI) tightened its policy rate by 50 basis points to 8.0 per cent at its June 2011 meeting to control high inflation.

South Africa was among the emerging economies that kept their policy rates unchanged during the first half of 2011. The South African Reserve Bank (SARB) left the repo rate steady at 5.50 per cent after reducing it by 650 basis points between December 2008 and December 2010. Although the SARB expected inflation to briefly peak at 6.2 per cent in the first quarter of 2012, it said that it would not raise rates solely because of cost-push pressures such as food prices.

2.4 EXCHANGE RATES

The growing downside risks to both the global economy and the fragile US economic recovery, high federal debt, and persistent worries over the European debt crisis, fuelled by sovereign credit risks, dominated the major international currency markets in the first half of 2011. The US dollar depreciated against the three major currencies in the first half of 2011 (Chart 1). The US Dollar fell by 7.6 per cent, 7.5 per cent and 8.9 per cent against Euro, Pound and Yen, respectively, to 0.7034 Euros, 0.6152 Pounds and 81.7048 Yen. The Dollar weakness continued to be negatively impacted by fragile US economic recovery, weak external account, high federal deficit, and loose monetary expansion relative to the rest of the world, leading to low interest rates.

Chart 1: Currency per US dollar



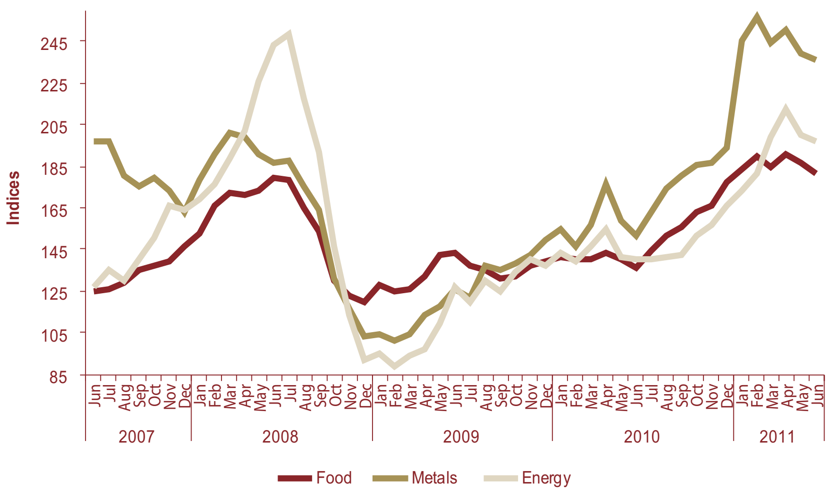
Source: Bloomberg

The currency also depreciated against the same three currencies on quarterly basis. The Dollar exchanged at 0.7198 Euro, 0.6205 Pound, and 82.2137 Yen at the end of June 2011. By contrast, the Dollar traded at 0.6864 Euro, 0.6098 Pound, and 81.0400 Yen at the end of March 2011. This represented a weakening of 4.6 per cent, 1.7 per cent, and 1.4 per cent, respectively, against the three currencies between the first and second quarters of 2011.

2.5 COMMODITY MARKETS

The commodity price indices for food, energy and metals trended downwards during the latter part of the first half of 2011 (Chart 2). The food price index rose by 4.1 per cent in the first quarter of 2011 before falling by 1.5 per cent between March and June 2011. The decline in the food price index was mainly due to improved supply prospects for key agriculture commodities such as wheat. The downward trend in energy price index was attributed to a reduction in crude oil prices, after the announcement of a release from the strategic stocks of the International Energy Agency (IEA) and the US Energy Department. The oil price index rose by 19.7 per cent in the first quarter of 2011, but fell by 1.2 per cent in the second quarter of 2011. Similarly, the reduction in the metals price index derived from renewed continued concerns about global commodities demand. The index rose by 25.9 per cent before falling by 3.5 per cent during the corresponding periods.

Chart 2: Selected commodity price indices



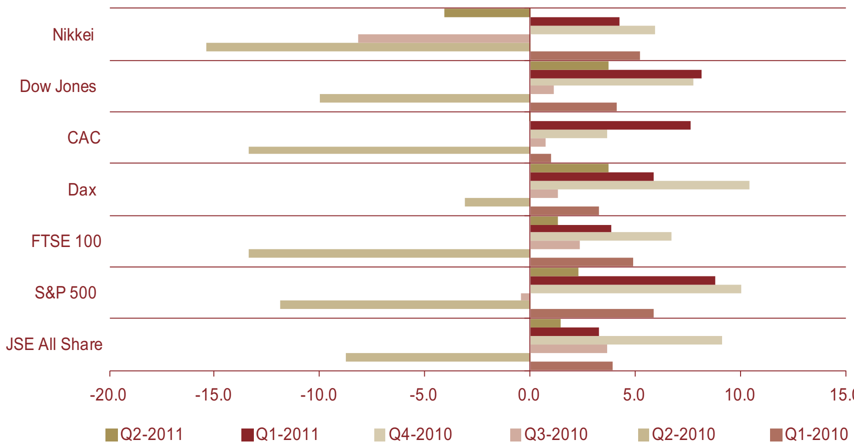
Source: IMF

The gold price started to rise since the Fed signalled in August 2010 that it would inject more stimuli into the US economy. Gold price rose from around US$1,430 an ounce at the end of December 2010 to US$1,529 at the end of June 2011. The precious metal's price reached a record high level of US$1 609.51 an ounce in early July 2011 as investors worried that the debt crisis that afflicted Greece could spread to Spain and Italy, and over negotiations to raise the US debt ceiling, failure of which could lead to default. By end-August 2011, gold price reached US$1,837 an ounce, as uncertainties over the global economy intensified.

2.6 EQUITY MARKETS

In the first half of 2011, most world stock markets sustained the recovery that began in the second half of 2010, pursuant to the continuing global economic recovery (Chart 3). However, midway through the period, worries over the faltering global economic recovery and outlook started to upset global stock markets. In the US, the S&P 500 and Dow Jones indices rose by 8.8 per cent and 8.1 per cent, respectively, in the first quarter of 2011, however declined by 2.3 per cent and 3.7 per cent, respectively, in the second quarter of 2011. European stock markets rose in the first quarter of 2011, encouraged by signs of continuing global economic recovery, but fell significantly in the second quarter of 2011. The indices were negatively affected by growing fears over the health of the global economy and the unrelenting European debt crisis.

Chart 3: Global stock exchanges quarterly growth rates (USD terms)



Source: Bloomberg

The global economic recovery slowed in the first half of 2011. The slowdown in economic activity was more evident among advanced economies, while economic growth was stronger in emerging and developing economies. Global economic activity is forecast to slow to 4.0 per cent in 2011, from 5.1 per cent in 2010. At the same time, global financial conditions became more volatile in the latter part of the first half of 2011. Deep-seated financial challenges remained, in addition to persisted concerns about debt sustainability and support for adjustment efforts in the Euro Area.

High and volatile prices of commodities, especially oil and energy, led to global inflation in the first half of 2011. However, global inflationary pressures were expected to be lower in 2011-12 than in 2010. During the period, some countries raised their policy rates in response to prevailing economic conditions, while others maintained their accommodative monetary policy stances.

The global foreign exchange markets were characterised by a weak US Dollar relative to the Euro, Pound and Yen in the first half of 2011. In equity markets, most world stocks continued to recover during the period in line with the continuing economic recovery. At the same time, in the commodity markets, prices trended downwards, but remained elevated.

3. DOMESTIC ENVIRONMENT

3.1 ECONOMIC CONDITIONS AND FINANCIAL MARKETS

3.1.1 Economic performance

The Namibian economy displayed a mixed performance in the latter part of the first half of 2011. Economic growth was mainly hurt by depressed global commodity demand, competitive imports, and adverse weather conditions. The weakest economic performance was recorded in the primary industry, while the secondary and tertiary industries posted positive performances. Within the primary industry, the mining sector performed poorly in the first half of 2011, in terms of output. The sector was negatively affected by adverse weather conditions in early 2011 that destroyed infrastructure and cut output in the mining sector, as well as by other operational challenges. The production of both diamond and gold fell during the first half of 2011, while the production of uranium improved in the second quarter of 2011 compared with the previous quarter. Output in the agricultural sector was also poor after floods damaged crop production, but the sector did better in the second quarter compared to the first quarter.

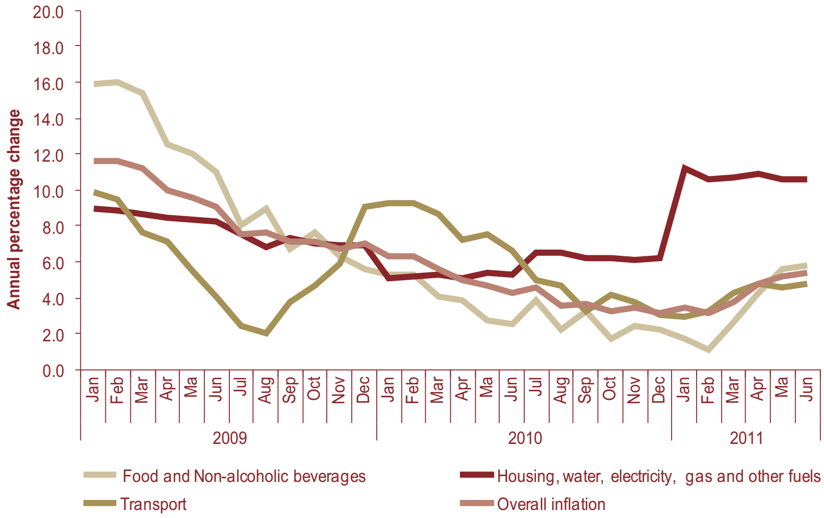
In the secondary industry, the manufacturing and construction sectors provided a boost to the industry. With regards to the manufacturing sector, blister copper, and cement production improved while the production of refined zinc and soft drinks declined. The construction sector, on the other hand, did relatively better in the second quarter compared with the first quarter, with public sector funded activities gaining the most momentum. Performance in the tertiary industry was slow in the first quarter, weighed down by poor turnout in the wholesale and retail sector, but improved in the second quarter. The tourism and water transport sectors recorded positive growths during the first half of 2011, while the transport sub-sector showed positive signs of improvement. However, land transportation was weak throughout the first half of 2011, mainly on account of heavy rainfall during the first quarter of the year.

In addition, domestic accommodative policies, both fiscal and monetary, would continue to provide support for the revival of the recovery momentum in the domestic sector. Furthermore, the weakening of the NAD is likely to improve export competitiveness and spur economic growth. However, downside risks to the domestic economy remained. Global uncertainties would continue to impact the global economy. In addition, the slow recovery of the global economy would have a negative impact on domestic economic growth. Furthermore, the rapidly rising global food and fuel prices could dampen growth by reducing purchasing power and tightening monetary policy. At the same time, unemployment was still a major challenge for the domestic economy, with a depressing effect on domestic demand.

3.1.2 Consumer prices

The overall annual inflation rate in Namibia reversed it's downwards trend in the first half of the year and accelerated from 3.1 per cent at the end of December 2010 to 5.4 per cent at the end of June 2011 (Chart 4). Responsible for the acceleration in consumer prices were food, transport and housing price inflation. The main driver of the escalation in the overall inflationary pressure was the food price inflation, which rose significantly during the period from 2.2 per cent at the end of 2010 to 5.8 per cent at the end of June 2011. The food price inflation category comprised 29.6 per cent of the total consumption basket. Within the food basket, *bread and cereals* and *meat* were mainly responsible for high and rising prices during the period. The annual inflation rate for bread and cereals rose from 2.2 per cent in December 2010 to 7.2 per cent at the end of June 2011. During the same period, the annual inflation rate for meat climbed from 4.5 per cent to 6.6 per cent. The sharp rise in bread and cereals inflation could be attributed to tight global demand and supply conditions of wheat and maize since the second half of 2010, which caused the international prices of these commodities to increase severely.

Chart 4: Contributions to CPI



Source: Central Bureau of Statistics

However, in the medium term, bread and cereal inflation might moderate, even diminish, if the supply of wheat improved and provided relief to existing price pressures. One of the largest international suppliers of wheat, Russia, indicated that it might lift its export ban on wheat from July 2011 if it received a favourable grain harvest.

The housing price inflation, a key driver of the upsurge in consumer inflation, rose from 6.2 per cent in December 2010 to 10.6 per cent in June 2011 per cent. The housing price category accounts for 20.6 per cent of the total consumption basket. Under the category, the most rise in inflation was in the component *renta payments* that rose from 3.8 per cent in December 2010 to 12.0 per cent in June 20111.

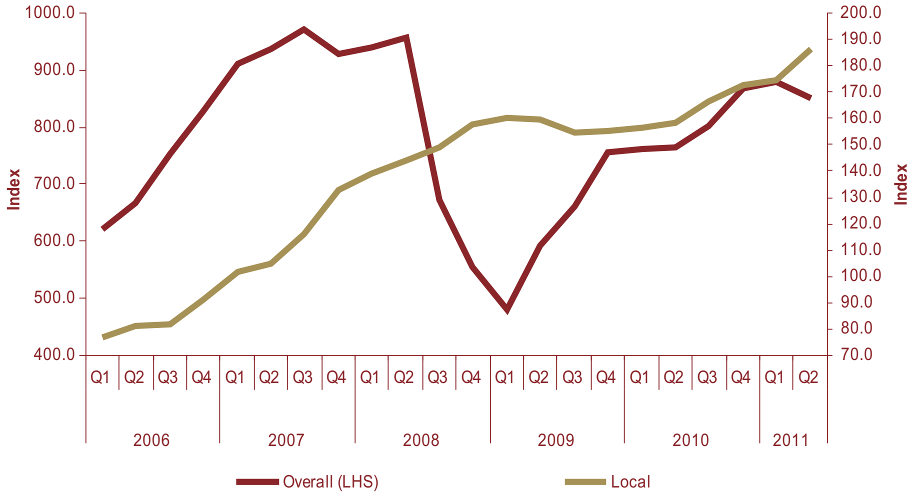
The transport price inflation, the other key driver of inflation, rose from 3.0 per cent at the end of 2010 to 4.8 per cent at the end of the second half of 2011. The transport price inflation category accounts for 14.8 per cent of the total consumption basket and is positively correlated with movements in crude oil prices. Under the sub-category, inflation in the component *operation of personal transport rose* from 5.8 in December 2010 to 16.9 per cent in June 2011. As a result of movements in its main components, annual inflation rate rose from 3.1 per cent in December 2010 to 5.4 per cent in June 2011.

In the medium term, as noted in our previous edition, the outlook for inflation in Namibia would continue to be driven by the prevailing global economic and inflation developments. According to the World Bank, rising food and fuel prices were negatively affecting global economic growth in 2011. At the same time, the United Nations' Food and Agriculture Organisation (FAO) expected inflationary pressures from world food prices to remain relatively lower in 2011-12 than in 2010, but world food prices would remain at high historical levels. In the longer term, however, high and rising global commodity prices, especially food and fuel prices, could mount inflation pressures. Furthermore, increasing domestic prices and accelerating inflation in South Africa would pose upside risks to the inflation outlook for Namibia. The South African Reserve Bank in June 2011 expected the CPI inflation to continue the upwards trajectory for the remainder of the year, reflective of steep price increases for food and administrative prices such as electricity, petrol, and rates and taxes, as well as sharp wage increases. Namibia's imports of goods from South Africa accounts for about 60.0 per cent of total imports.

3.1.3 Equity markets

The overall index of the Namibian Stock Exchange (NSX) comprises the performance of both local and dual-listed companies. The latter group of companies are listed on both the NSX and the Johannesburg Stock Exchange (JSE). The overall price index of the NSX declined to 849.8 points in June 2011 from 867.2 points in December 2010 (Chart 5). The fall in the price index transformed into a 2.0 per cent decline in the growth rate during the first half of 2011, which compared unfavourably with the 13.6 per cent growth in the second half of 2010. The dismal performance of the overall price index of the NSX reflected the JSE, which moderated to 2.4 per cent during the period from 22.3 per cent in the second half of 2010. The JSE, in turn, was in line with performance in global equities. The total overall market capitalisation of the NSX also decreased, by 1.5 per cent, from N$1,151.5 billion at the end of December 2010 to N$1,134.5 billion at the end of June 2011. The fall in market capitalisation tracked a weighty downswing in the share prices of a major company listed on the NSX during the review period.

Chart 5: Namibia stock exchange price indices



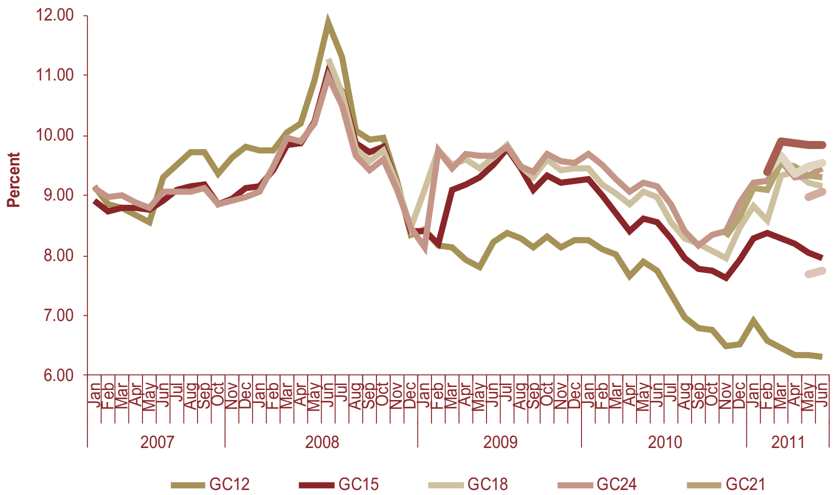
Source: Namibia Stock Exchange

The local index of the NSX, on the other hand, increased by 7.9 per cent from 172.72 points at the end of the second half of 2010 to 186.39 points at the end of June 2011. At the same time, the local market capitalisation rose by 2.2 per cent from N$7.8 billion in the second half of 2010 to N$7.9 billion at the end of the first half of 2011. The local index's positive performance and resilience is mainly derived from financial and industrial stocks that mirrored the optimistic outlook for the mining and financial sectors. The relative insulation of the local market from the global equity markets and the lack of trading of the listed shares continued to provide relative stability for the NSX.

3.1.4 Bond markets

The yields on most Namibian bonds through the yield curve rose in most of the first half of 2011 (Chart 6). The bond yields are benchmarked to South African bond yields. The latter were relatively high during the first half of 2011. International investors bought South African bonds, lured by a strong currency and higher yields relative yields in most advanced economies. However, the rise in yields on Namibian government bonds could also be attributed to the increase in the supply of government bonds during the period.

Chart 6: Government Bond yields

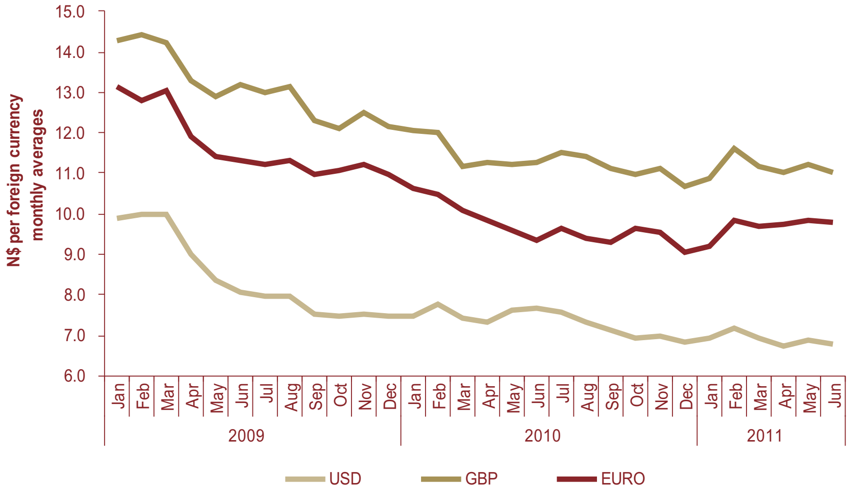


The yield on the GC12 fell from 6.53 per cent in December 2010 to 6.32 per cent in June 2011. On the other hand, the yields on maturities longer than 12 years increased during most during the period. The yields on the GC15 and GC18 rose from 7.93 per cent and 8.47 per cent in December 2010 to 7.97 per cent and 9.15 per cent in June 2011, respectively. At the time, the yields on GC21 and GC24 rose the most from 8.64 per cent and 8.87 per cent, respectively, in December 2010 to 9.31 per cent and 9.44 per cent in June 2011. Similarly, the yields on the GC27 and GC30, which were introduced in February 2010, increased from 9.38 per cent and 9.40 per cent, respectively, to 9.55 per cent and 9.85 per cent in June 2011.

3.1.5 Exchange rates

In the first half of 2011, the Namibia Dollar (NAD) sustained the appreciation against the US dollar that started mostly in the first half of 2009, but depreciated slightly against the Pound and Euro. During the period, the local currency exchanged at averages of N$6.9, N$11.2, and N$9.7 against the USD, Pound and Euro, respectively, (Chart 7). This compared with exchange rate averages of N$7.1, N$11.1 and N$9.4 against the USD, Pound and Euro, respectively, during the second half of 2010. Following the appreciation, the NAD gains against the US currency amounted to 2.8 per cent, compared with the gains of 5.3 per cent in the second half of 2010. On the other hand, the losses against the Pound and Euro during the first half of 2011 amounted to 0.9 per cent and 3.2 per cent, respectively, as compared with the gains of 10.5 per cent and 6.9 per cent during the second half of 2010.

Chart 7: Namibia dollar per foreign currency



Source: South African Reserve Bank

The strength of the ZAR was supported by continued global demand for South Africa's commodities exports and the country's relatively high interest rates that sustained inflows into South African bonds and equities. The inflows into the South African stock market rose as shares of mining companies surged along with metal prices during the global commodities boom. The NAD appreciation was also reinforced by the general weakness of the US Dollar stemming from the faltering US economy coupled with a high federal fiscal deficit.

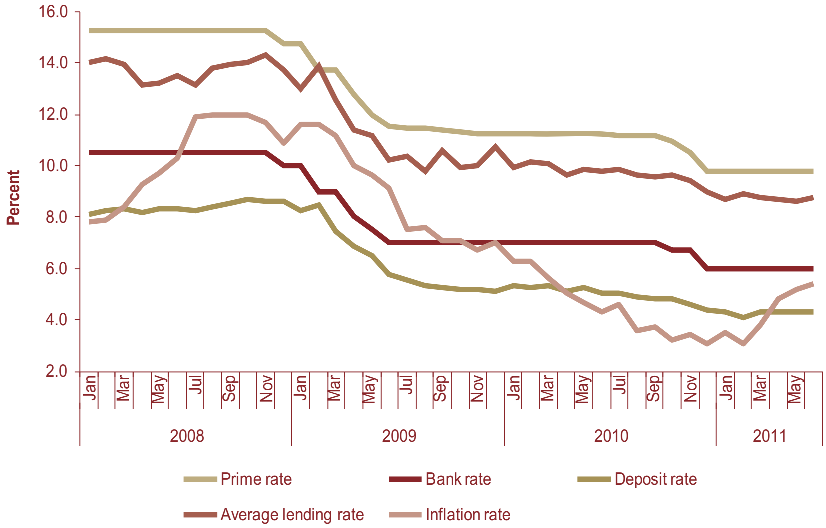
The real effective exchange rate (REER) index of the NAD fell slightly from 95.10 points in December 2010 to 94.70 points in June 2011. This denoted a real depreciation of 0.4 per cent during the period. The real depreciation meant that the country's export commodities became cheaper relative to those of the major trading economies during the first half of 2011. Hence, the real depreciation of the NAD caused a gain in export competitiveness due to a weaker NAD against the USD, GBP and EUR. On the other hand, a real depreciation could worsen the impact of higher international oil and food prices on domestic consumer inflation, by inducing higher import prices and costs.

3.1.6 Interest and inflation rates

The overall drift in the Namibian interest rates continued to trend downwards in the first half of 2010 (Chart 8). At the same time, the Bank of Namibia held its Repo rate at 6.0 per cent since December 2010 to instil confidence in the financial sector credit demand and sustain faltering economic growth.

Banking institutions kept their lending rates in tune with the policy stance adopted by the Bank of Namibia. The prime lending rate fell by 1.5 percentage points from 11.25 per cent in June 2010 to 9.75 per cent in December 2010 and remained constant in the first half of 2011. The average nominal lending rate and the average nominal deposit rate also declined. The former fell by 0.27 percentage points from 9.01 per cent at the end of the second half of 2010 to 8.74 per cent at the end of the first half of 2011. Similarly, the latter rate declined by 0.12 percentage points from 4.41per cent to 4.29 per cent. Following these movements in rates, the spread between the lending and deposit rates tightened albeit marginally to 4.5 percentage points in June 2011, from 4.6 percentage points in December 2010.

Chart 8: Interest and inflation rates



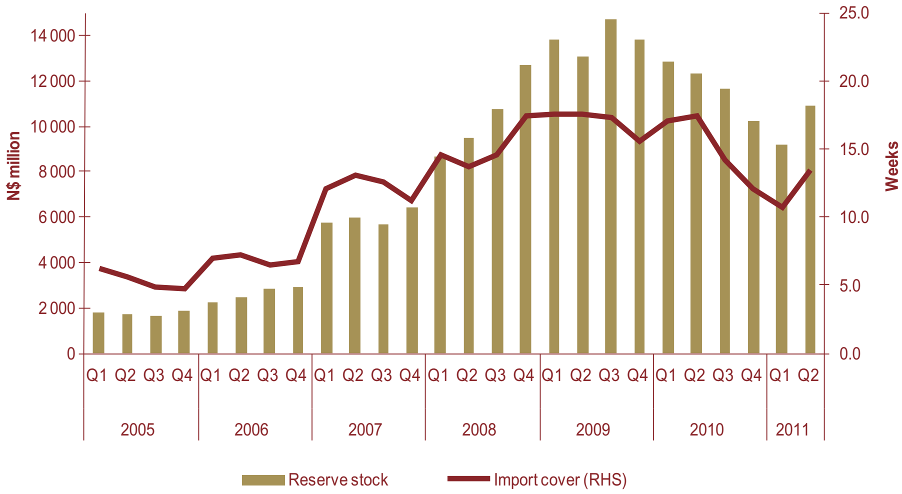
Source: Central Bureau of Statistics

3.1.7 Foreign exchange reserves adequacy

The accumulation of international reserves can help lessen the impact of a foreign currency-liquidity shortage or shock that might result when access to foreign borrowing and credit lines are restricted or withdrawn. Hence, adequate foreign-exchange reserves are critical to a country's ability to withstand external shocks and, therefore, to financial stability.

The level of international reserves in Namibia rose by 6.9 per cent from N$10.2 billion at the end of December 2010 to N$10.9 billion at the end of June 2011 (Chart 9). The international reserves rose largely as a consequence of interest income received; ZAR notes repatriated; Government and Bank of Namibia inflows; and Rand Seignorage income. However, reserve accumulation was moderated by purchases of ZAR by banking institutions from the Bank of Namibia; and Government and Bank of Namibia payments to foreign countries. In recent periods, the SACU receipts have been falling due to the global and regional economic slowdown. Nevertheless, the augmented level of country's international reserves continued to be adequate to support both the currency exchange peg and financial stability.

Chart 9: Quarterly international reserve stock and import cover



While foreign exchange reserves permit a country to pay for its imports and to discharge its other external obligations, import cover, on the other hand, measures the country's capacity to weather external shocks while at the same time meeting its external commitments. Namibia's import cover rose from 12.14 weeks of import cover in December 2010 to 13.46 weeks of import cover in June 2011. This took the measure to about one and half weeks of import cover above the international benchmark of 12 weeks. Therefore, the country could still continue to import goods and services for up to 13.5 weeks, if all other inflows of foreign earnings were unavailable. The rise in import cover was mostly attributable to an increase in foreign exchange reserves during the review period, while the import value declined.

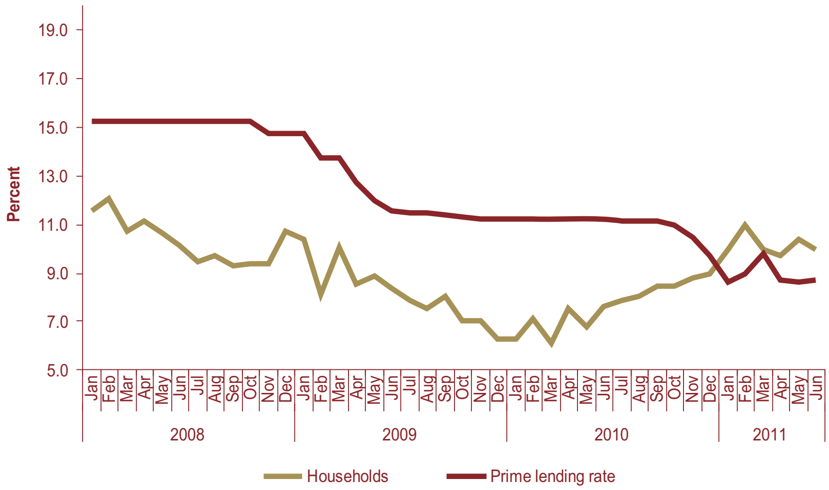
3.2 PRIVATE SECTOR CREDIT EXTENSION

Private sector credit extension (PSCE) rose in the first half of 2011, reaching the highest level since December 2010. Total credit to the private businesses and households rose to N$42.4 billion at the end of June 2011 from N$40.4 billion in December 2010. The improvement represented an annual growth rate of 12.9 per cent, or 7.5 per cent in real terms and compared with 10.8 per cent, or 7.8 per cent in real term, at the end December 2010. Being a key indicator of nominal demand, the expansion in PSCE was a positive response to the prevailing low interest rate environment.

3.2.1 Household sector borrowing

Total credit extension to the household sector expanded to N$26.5 billion, during the first half of 2011, from N$25.3 billion at the end of December 2010. This represented an expansion rate of 4.7 per cent at the end of June 2011 from 4.9 per cent at the end of December 2010 (Chart 10). However, the share of household debt in total credit extension to the private sector fell marginally to 62.5 per cent from 62.8 per cent during the period. Most of the growth in loans to households emanated from the mortgage loans sub-category, which advanced by 4.8 per cent at the end of June 2011 compared with 5.1 per cent at the end of December 2010.

Chart 10: Claims on households



3.2.2 Corporate sector borrowing

Aggregate lending to the business sector amounted to N$15.9 billion at the end of June 2011 compared with N$15 billion at the end of December 2010. Credit extension to the corporate sector accounted for 37.5 per cent of total private sector credit at the end of June 2011, slightly up from 37.2 per cent at the end of December 2010. Thus, corporate balance sheet performance continued to be vital for banking performance and financial stability.

Lending to the corporate sector accelerated by 4.1 per cent at the end of the second half of 2010 to 18.1 per cent at the end of the first half of 2011 (Chart 11). The lion share of the growth in credit extended to the corporate sector came from the mortgage loans sub-category, which surged 14.1 per cent to 17.1 per cent.

Chart 11: Claims on businesses

The expansion in credit extension to the corporate sector is expected to continue in the second half of 2011 if the domestic economy remained on the recovery path. However, increase in corporate indebtedness was not expected to cause a disproportionate increase in non-performing loans for the banking sector.

The domestic economic activity slowed in the first half of 2011 in line with the global economic slowdown. However, the latter was expected to be short-term and the domestic economy has shown improvements in the second quarter of 2011. Noticeable signs of improvements appeared in the secondary and tertiary sectors of the domestic economy. Domestic demand also improved. The favourable economic conditions would improve the financial positions of both households and corporates. This would further boost the performance of banking institutions and financial stability. In line with the previous reviews, the negative impact of the prevailing global economic and financial conditions on the domestic economy is expected to remain moderate.

3.3 BANKING SECTOR PERFORMANCE

3.3.1 Banking structure

The structure of the banking system, in terms of number and size of institutions, can have an impact on banking stability and access to credit. This is the case because of the implications for competition and market power that could result from the structure of the banking system. Since June 2010, five (5) banking institutions are licensed to do banking business in Namibia. However, the operations of the newly licensed micro-finance bank remained relatively slight. This left the banking sector controlled by four (4) banking institutions, owning virtually 100 per cent of total banking assets. Moreover, the primary indicators of banking sector concentration and market power deteriorated during the review period. Both the Gini and HHI indices rose from 11.1 points and 2,698 points at the end of December 2010 to 11.7 points and 2,833 points, respectively, at the end of June 2011. This compared with the universal thresholds for concentration of 10 points for the Gini index and 1,000 points for the HHI index. The rise in the indices came as one banking institution gained asset market shares at the expense of others during the period. Consequently, the banking sector continued to be characterised by high concentration levels, and, hence, considered less competitive. There is, therefore, a likelihood that the pre-eminent levels of concentration could lead to a constrained banking market, with costlier banking services and limited access to credit.

3.3.2 Balance sheet structure

The structure of the balance sheet of a banking sector is also of analytical interest because dramatic changes and huge fluctuations, such as unsustainable asset growth or decrease, could be an indication of the risks borne by the sector. The total assets of the banking sector grew by 2.5 per cent in the first six months of 2011(Chart 12). This growth rate, however, compared less favourably with the 7.9 per cent achieved in last six months of 2010. Banking assets grew by 1.8 per cent in the first quarter of 2011 and by a meagre 0.7 per cent in the second quarter of the year. Most of the growth in assets in the first half of the year was mainly attributed to the increase in *net loans and advances*, which rose by 5.3 per cent and made up 75.8 per cent of total banking assets during the period. Within the *loans and advances* category, *residential mortgages* and *instalments debtors*, which comprised 41.8 per cent and 16.0 per cent, respectively, rose by 4.6 per cent and 5.3 per cent. However, the increase in *loans and advances* was weighed down by a decrease in *cash and balances* with banks, leading to a slower asset growth rate during the period.

On the liabilities side of the balance sheet, funding-related liabilities, which rose by 2.2 per cent and comprised 96.2 per cent of total liabilities in the first half of 2011, was the main source of the increase. Within the category of funding, growth stemmed largely from non-bank funding that grew by 1.1 per cent and represented 94.1 per cent of total liabilities. Bank funding, on the other hand, remained largely unchanged during the same period.

Chart 12: Banking sector assets and growth rates

In a reversal of the practice of the second half of 2010, banking institutions in the first half of 2011 raised their utilisation of non-bank funding. The deposit category of the former grew by 56.7 per cent while that of bank funding rose by a mere 0.3 per cent during the period.

However, non-banking funding as a fraction of total funding-related liabilities continued to decline, falling from 95.9 per cent at the end of 2010 to 94.1 per cent at the end of first half of 2011. The funding category, nevertheless, remained the principal source of asset funding for the banking sector during the review period. At the same time, loans and advances remained the primary use of funds for the banking sector, rising to 89.4 per cent of total funding-related liabilities in the first six months of 2011 from 84.1 per cent at the end of 2010. There were, therefore, no significant changes in the balance sheet structure of the banking sector during the first half of 2011.Thus; the risk structure borne by the banking sector during the review period did not change substantially.

Consequently, the modest growth in assets and loans and advances of the banking sector of 2.5 per cent and 5.3 per cent, respectively, during the first half of represented no grounds for any supervisory concern.

3.3.3 Profitability, capitalisation and cost efficiency

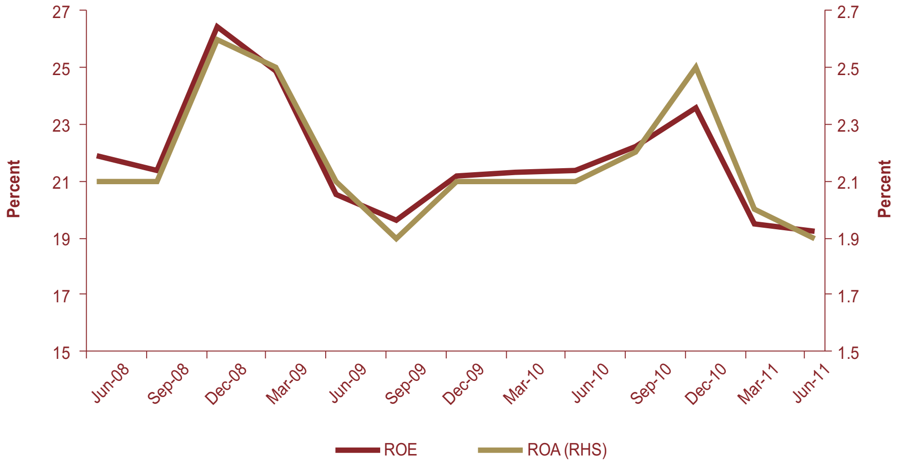
Profitability

Profitability allows banking institutions to be viable and solvent. In turn, solvency is critical for the soundness of the banking system and financial stability. At the same time, banking profitability is a function of income, provisions and write-downs, and operational expenses. The analysis bellow looked at the impact of the interaction among these variables.

The profitability of the banking sector deteriorated during the review period, with both interest income and non-interest income falling. After-tax income fell by 19.4 per cent, compared with a surge of 20.4 per cent in the second half of 2010. The fall in after-tax income was mainly due to a 4.5 per cent and 3.9 per cent decline in net interest income and non-interest income, respectively. At the same time, tanking profitability received mixed support from developments in expenses. Interest expense fell by 6.0 per cent while operating expense, non-interest expense, rose by 1.3 per cent during the period. The banking sector also experienced high provision charges.

The deterioration in the after-tax income of the banking sector was also reflected in the decline in both return on assets (ROA) and return on equity (ROE) in the last six months of 2011. The two ratios fell to 1.9 per cent and 19.2 per cent in June 2011, respectively (Chart 13). This compared less favourably with 2.0 per cent and 23.6 per cent in December 2010. The deterioration in the profitability, notwithstanding, the banking sector maintained efficient banking operations and kept adequate capital levels. The two are critical for the solvency of the banking sector and for the enhancement of banking stability.

Chart 13: Post-tax return on assets and return on equity



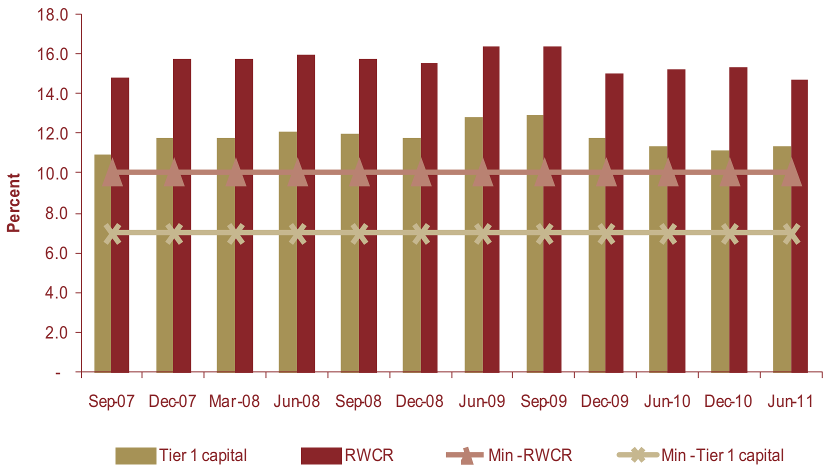
Capitalisation

Banking capital acts as a cushion against unexpected losses. Hence, capital ratios are utilised as core indicators of banking stability. Thus, adequate capital levels are necessary to enhance the banking system stability and support efficient financial market operations. Adequate capital is, therefore, indispensible for the maintenance of a sound and stable banking system.

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. The prevailing leading indicator of capital adequacy is the regulatory risk-weighted capital ratio (RWCR) of not less than 10 per cent. In addition, 7.0 per cent of that ratio should be Tier 1 or primary capital. The Tier 1 capital leverage ratio[2] of 6.0 per cent is a third capital-adequacy requirement.

Despite profitability setbacks, the banking sector continued to be sufficiently capitalised during the review period, with the sector capital ratio exceeding the minimum legal risk-weighted capital ratio (RWCR) of 10 per cent. The RWCR, however, fell significantly to an average of 14.7 per cent at the end of the first half of 2011, from 15.3 per cent at the end of December 2010 (Chart 14). The Tier 1 capital ratio, on the other hand, rose from 11.1 per cent to 11.4 per cent, during the same period.

Chart 14: Capital adequacy for banking institutions



The banking industry's total qualifying capital decreased whilst risk-weighted assets increased during the first half of 2011. Tier 2 capitals fell due to the decline in unaudited profits, as one of the drivers behind the lower qualifying capital. Dividends were also paid out from retained earnings, resulting in a drop in Tier 1 capital. The increase in the risk-weighted assets, on the other hand, was due to higher credit and operational risk exposures at some banks.

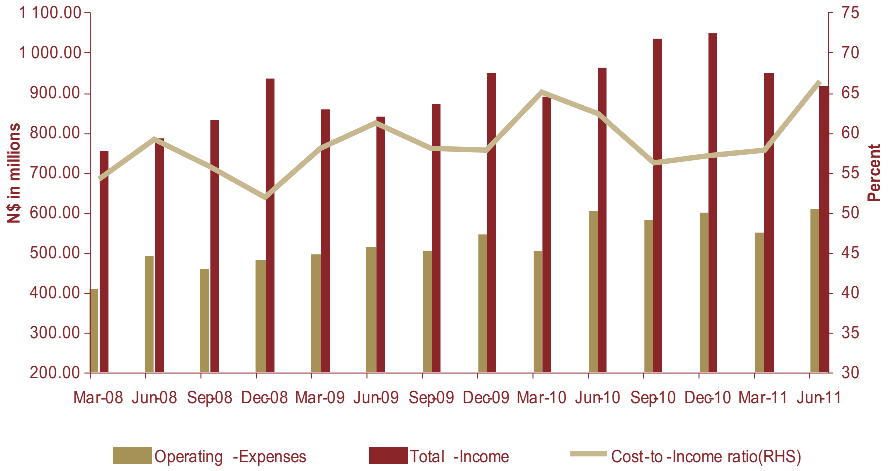
[2] Tier 1 capital leverage ratio is defined as Tier 1 capital over gross assets, where gross assets are defined as total assets plus general and specific provisions.

The banking industry's capital levels were sustained at levels surpassing supervisory minima in the first half of 2011, even though the profitability of the sector was dented and the RWCR capital ratio fell. Consequently, the banking sector continued to be well and adequately capitalised to cushion against unanticipated losses. In addition, the implementation of the Basel II capital accord, in 2010, further enhanced the banking sector's capital adequacy. By introducing market and operational risks in the determination of risk-weighted assets, the implementation of the accord resulted in additional risk coverage. As a result, the current level of capitalisation in the banking sector caused no financial stability concerns.

Cost efficiency

The cost-to-income (C/I) ratio is the conventional measure of efficiency in the management of operating costs, relative to income, in the banking sector. The measure rose from 57.3 per cent in the last six months of 2010 to 60.1percent in the first half of 2011 (Chart 15). The deterioration in the ratio came as a result of a 3.4 per cent decrease in total income, while other operating expenses rose by 1.3 per cent. Consequently, the cost efficiency ratio rose further above the international benchmark of 50.0 per cent.

Chart 15: 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 per cent during the review period. By contrast, the administration and other overheads costs, the second largest cost category of operating costs, fell by 19.2 per cent during the same period. In order to advance banking profitability and stability, the banking sector ability's to control operating expenses needs to be improved and sustained.

3.3.4 Liquidity risk

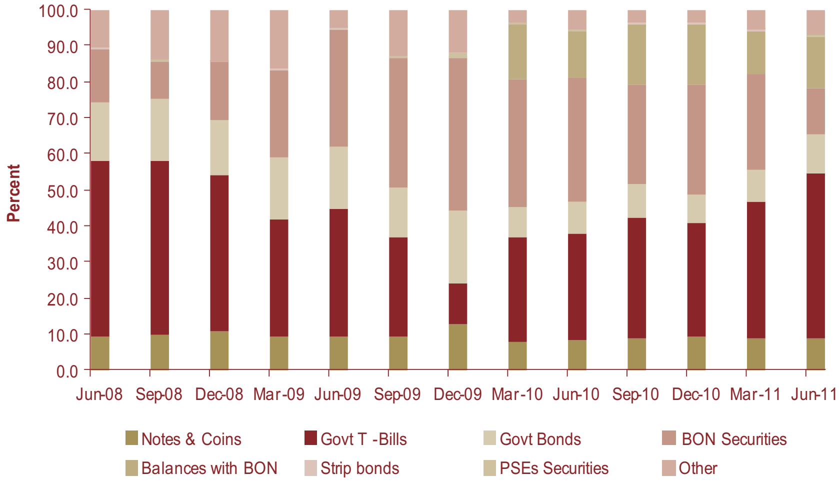
Liquidity risk refers to the danger of a banking institution being unable to finance its asset growth or to meet obligations as they fall due. Lack of liquidity is not only detrimental to the sustainability of the banking system's operations but liquidity shortfalls in banking institution can be transmitted to other banking institutions in one system with devastating effects to the system as a whole. This makes liquidity management critical to preventing liquidity problems from becoming systemic. Lack of liquidity was also cited as one of the factors that closely contributed to the 2008-2009 financial crises.

The most frequently used indicators, or factors, utilised to gauge banking liquidity are listed and analysed below. They are: the relationships between actual liquidity held and liquidity required; composition of liquid assets; loans-to-assets; loans-to-deposits; composition of funding-related liabilities; and liquidity conditions in the interbank market.

The banking sector's liquid asset fell albeit slightly by 0.2 per cent, from N$5.5 billion at the end of December 2010 June 2010 to N$5.4 billion at the end of June 2011. During the same period, the liquid assets prescribed by the minimum liquid asset requirement augmented by 3.9 per cent to N$4.8 billion from N$4.6 billion. Thus, the banking sector complied with the regulatory minimum liquid assets holding requirements with an average excess asset holding of N$0.6 billion during the first half of 2011, compared with N$0.9 billion at the end of December 2010. Nevertheless, the banking sector remained in compliance with statutory requirements.

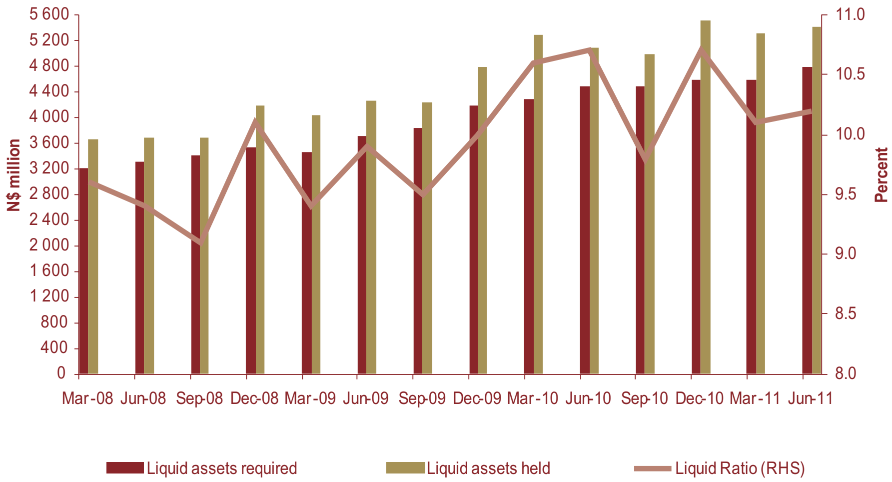
The Government T-bills improved its central position in the combination of liquid assets held by the banking sector, during the first half of 2011. Government T-Bills surged further to dominance from 31.5 per cent of liquid assets held to 45.8 per cent (Chart 16). Bank of Namibia Securities, on the other hand, fell dramatically to second position from 30.1 per cent of total liquid assets held to 13.1 per cent, after the supply of those securities was reduced. The sector's balances with the BON hopped into third largest liquid asset category position, despite having declined from 17.0 per cent at the end of the second half of 2010 to13.8 per cent in June 2011.

Chart 16: Structure/Composition of liquid assets



The liquid assets ratio or liquid ratio is traditionally used to measure the state of liquidity in the banking sector. It is expressed as total liquid assets held to total assets. The ratio fell slightly from 10.7 per cent at the end of December 2010 to 10.2 per cent at the end of June 2011 (Chart 17). The descent in the ratio was a result of the 2.5 per cent growth in total assets during the period that outdone the 0.2 per cent decline in the liquid assets held.

Chart 17: Liquid assets and liquidity ratio



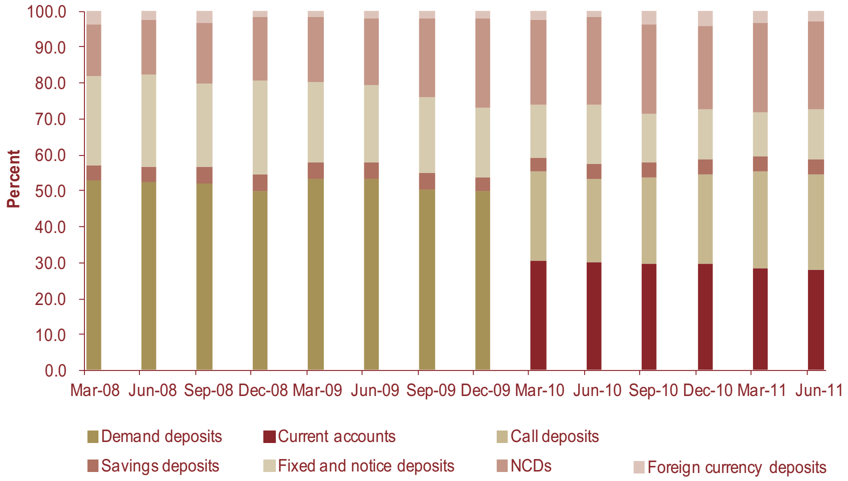
The share of loans to total banking assets rose from 74.1 per cent in December 2010 to 76.1 per cent in June 2011. The level of the ratio was testimony to the persistent prominence of the loan category in the banking industry's balance sheet. However, a ratio higher than the international standard of 75.0 per cent of assets might lead to liquidity concerns as loans are less liquid than other types of assets. Although the current level of the ratio is slightly above the threshold, there is no reason for stability concerns.

The ratio of total loans to total deposits (LTD ratio) rose from 86.6 per cent at the end of the second half of 2010 to 89.1 per cent at the end of June 2011. The LTD ratio is the traditional gauge of the degree to which the banking sector utilises core deposits to finance its loans. Core deposits are seen as comparatively more stable and inexpensive than borrowed funds. Furthermore, a ratio well below the 100 per cent threshold implies that the sector has adequate scope for asset growth before the need to resort to other more expensive funding sources. Consequently, the level of the LTD ratio posed no significant liquidity concerns.

The mixture of core or non-bank deposits employment by banking institutions has a defining effect on the liquidity risks encountered by those institutions. This is the case because the cost and volatility of funding sources is important. The banking sector's deposit application remained largely the same between December 2010 and June 2011. The less expensive and surer funding source, core deposits, upheld their leading position as the principal funding source of the banking institutions during the review period. As a share of total funding liabilities, core deposits averaged 94.4 per cent in the first half of 2011, compared with an average of 96.2 per cent in the second half of 2011. During the same period, the percentage of current account deposits in total core deposits fell from 29.9 per cent of total deposits to 27.9 per cent, while the share of call deposits rose from 24.5 per cent to 26.5 per cent (Chart 18). By contrasts, the share of NDCs increased from 23.5 per cent at the end of December 2010 to 24.1 per cent in June 2011.

Banking institutions are also vulnerable to liquidity risk emanating from the liquidity conditions in the interbank market, given that these conditions determine the easiness with which banking institutions can obtain funds on short notice through interbank borrowing. The Namibian banking institutions' interbank exposure remained small in relation to the banking industry's capital funds. At December 2010, inter-bank borrowings and deposits comprised 15.2 per cent of industry qualifying capital, or equivalently, 16.7 per cent of industry capital and reserves. This indicator showed moderate interdependence in the local inter-bank market. Consequently it is unlikely that a liquidity problem in one banking institution would develop into systemic contagion.

Chart 18: Composition of core/non-bank deposits



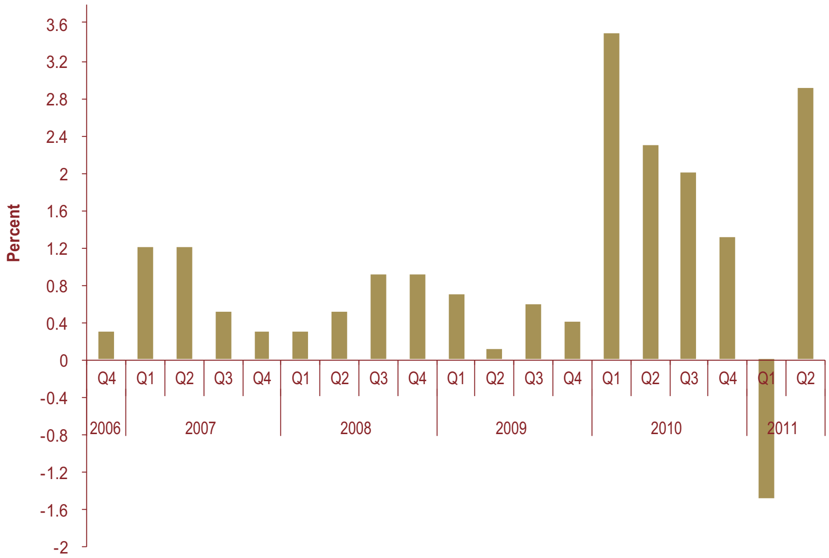
The key liquidity indicators of the banking sector's vulnerability to liquidity risk remained at suitable levels during the period under review. Hence, financial instability remained minimal in the first half of 2011.

3.3.5 Exchange rate risk

The measure of the extent of mismatches, or open positions, of foreign currency assets and liabilities is the net open position in foreign currency. It is expressed as a proportion of net foreign currency assets to the banking institutions' Tier-1 capital funds. The measure is generally used to assess the probable susceptibility or openness of banking capital to movements in exchange rates. Net open position in the banking sector rose to 2.9 per cent in June 2011 from 1.3 per cent in December 2010 (Chart 19). The ratio, however, turned to a negative 1.5 per cent in the first quarter of 2011.

The sharp rise in the ratio, during the first half of 2011, was a result of a 132.6 per cent increase in net open position, the numerator, which overtook a 3.5 per cent increase in Tier-1 capital funds, the denominator. A rise in the ratio implies an increase in the exchange rate risk of the banking sector during the period. However, the ratio remained well below the regulatory limit of 20 per cent. There were, therefore, no significant financial stability concerns originating from exchange rate risk during the review period.

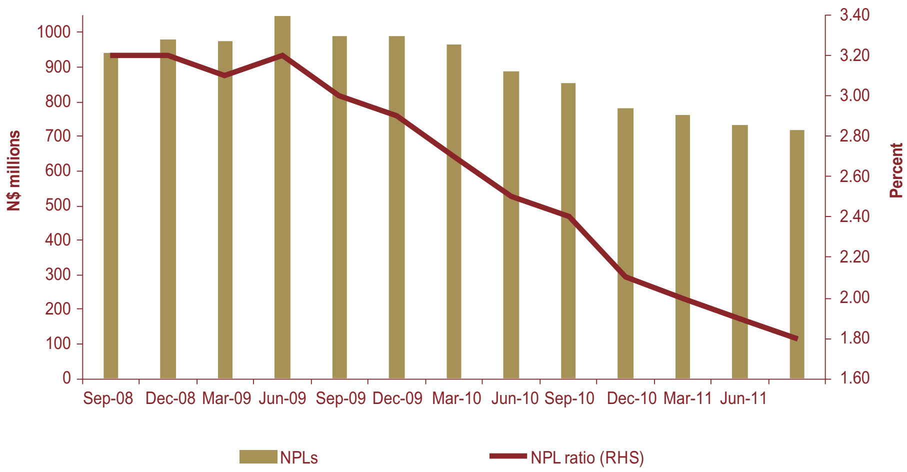
Chart 19: Net open position as per cent of tier-1 capital



3.3.6 Credit risk

The ratio of non-performing loans (NPLs) to total loans and advances, the NPL ratio, fell from 2.0 per cent at the end of December 2010 to 1.8 per cent at the end of June 2011(Chart 20). The fall in the ratio, which serves as an indicator of vulnerabilities emanating from the banking loan portfolios, represented a sustained improvement in the quality of the banking sector's loan portfolio that began in the second quarter of 2009. Furthermore, the decrease in the ratio implied an improvement in banking loan portfolio's credit risk over the period. Loans and advances rose by 5.2 per cent, while the NPLs fell by 5.7 per cent in the first half of 2011. Under the non-performing loans category, non-performing mortgage loans, accounting for 54.9 per cent, fell by 4.1 per cent 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. At the same time the NPL ratio continued to trend well within the acceptable range.

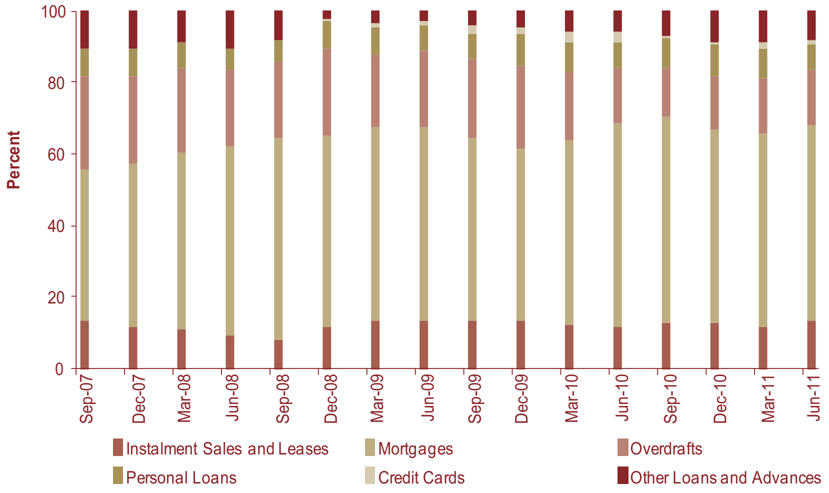
Chart 20: Banking asset quality



Overdue loans in the banking sector rose by 9.6 per cent to N$1.8 billion at the end of June 2011 from N$1.6 billion at the end of December 2010. The rise was largely driven by higher overdue mortgage loans because of payment problems during the same period. As a fraction of total loans, overdue loans rose from 4.3 to 4.5 per cent during the same period. At the same time, the proportion of NPLs to overdue loans fell from 46.0 per cent to 39.6 per cent, as NPLs fell by 5.7 per cent. The lower interest rate environment that prevailed since the first quarter of 2009 coupled with the improving domestic economic conditions continued to provide a conducive environment for overdue loans during the review period.

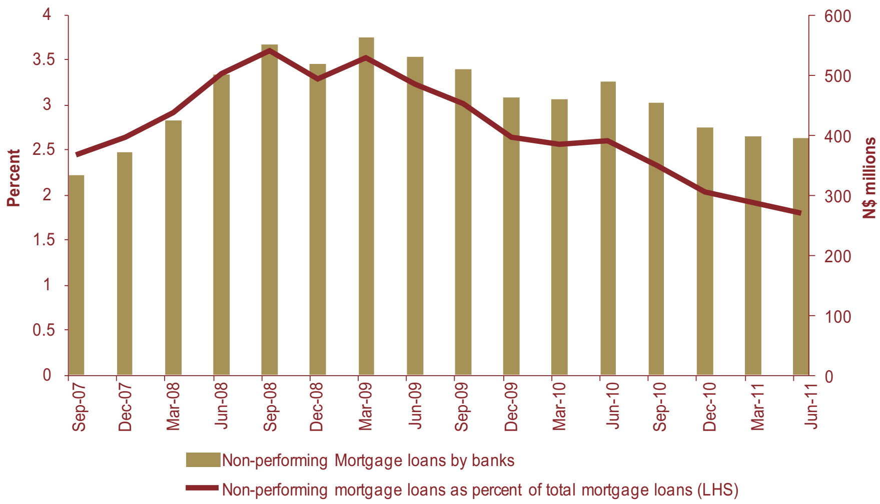
Non-performing mortgage loans as a share of total non-performing loans rose slightly to 54.9 per cent at the end of the first half of 2011 from 54.0 per cent at the end of December 2010 (Chart 21). However, non-performing mortgage loans as a proportion of total mortgage loans extended by banking institutions fell further to 1.8 per cent at the end of June 2011 from 2.0 per cent at the end of December 2010 (Chart 22). At the same time, the proportion of overdue mortgage loans in total mortgage loans rose from 4.1 per cent at the end of December 2010 to 4.9 per cent in June 2011. The largest increase, of 97.7 per cent, in overdue mortgage loans during the review period derived from the category "amount overdue for less than one month", which accounted for 51.9 per cent of total overdue loans.

Chart 21: Non-performing loans by category



The Determinations on Single Borrower Limit (BID-4) set 30 per cent and 800 per cent 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 per cent of industry qualifying capital, accounted for 20.0 per cent of the total loan portfolio of the banking sector, at the end of the first half of 2011, compared with 19.9 per cent six months previously. As a proportion of banking industry capital funds, aggregate large exposures rose from 130 per cent to 137.2 per cent, during the same period. The Determinations on Single Borrower Limit (BID 4) set 30 per cent and 800 per cent statutory limits for single borrowers and aggregate large exposures as a percentage of industry capital funds, respectively.

Chart 22: Non-performing mortgage loans



In the review period, the asset quality of the banking sector continued the improvements that initiated in the first half of 2009. In particular, the NPL ratio continued the decline during the period. Additionally, the structure of NPLs reflected the mixture of total loans and advances, although overdue loans rose. As a result, credit risk was assessed to be insignificant, necessitating merely low monitoring.

The banking sector continued to be liquid, adequately capitalised and solvent in the first half of 2011. Moreover, non-performing loans as a share of total loans have been falling since the first half of 2009. However, overdue mortgage loans rose, leading to an increase in total overdue loans as a proportion of total NPLs. At the same time, banking cost efficiency deteriorated during the period, with possible future implications for banking profitability, which also deteriorated.

The present global economic slowdown, despite current financial instability, was expected to be temporary. The improvement in the global economic conditions would help external demand for Namibian exports, with favourable consequences for the domestic real economy and the private sector. Furthermore, improvements in the financial position of banking borrowers would eventually have a positive effect on the banking sector.

Overall, therefore, the banking sector remained stable, adequately capitalised and solvent, as it was in the previews reviews. Consequently, the overall impact on the banking sector of the current financial instability from the sovereign debt crisis is assessed to be low.

Table 2: Banking sector indicators

	Jun-08	Dec-08	Jun-09	Dec-09	Jun-10	Dec-10	Jun-11
Structure							
Number of banks	**4**	**4**	**4**	**4**	**5**	**5**	**5**
Total assets of banks (N$'000)	39,398,740	41,562,708	43,275,865	47,669,192	47,698,656	51,501,023	52,781,969
Gini concentration index	12.2	11.3	10.8	11.45	12.0	11.07	11.70
Herfindahl index	2,705	2,689	2,677	2,690	2,692	2,680	2,833
Capital adequacy (%)							
Tier 1 leverage ratio	*7.9*	7.9	8.6	7.8	8.6	8.3	8.7
Tier 1 capital ratio	11.9	11.8	12.8	11.7	11.4	11.1	11.1
Total RBC (regulatory capital RWA's)	*15.8*	15.6	16.4	15.0	15.2	15.3	14.7
Asset quality (%)							
NPL's/Total gross loans	3.2	3.1	3.0	2.7	2.4	2.0	1.8
Gross overdue/Total loans and advances	3.9	5.7	6.5	8.0	4.7	4.3	4.5
Provisions/ Total loans	2.1	2.0	1.9	1.8	1.8	1.5	1.5
Provisions/NPL's	68.6	64.7	62.8	66.2	74.8	78.6	84.6
Specific provision/NPLs	33.8	29.2	27.2	28.7	30.5	30.3	31.3
Earnings and profitability (%)							
Return on assets	2.1	2.6	2.1	2.1	2.1	2.5	1.9
Return on equity	21.9	26.4	20.5	21.2	21.4	23.6	19.2
Net interest margin	4.6	4.7	4.3	4.5	4.9	5.2	4.9
Cost to income ratio	59.2	51.9	61.2	57.9	62.5	57.3	60.1
Liquidity (%)							
Liquid asset to total assets	9.3	10.1	9.9	11.6	12.1	12.4	10.2
Total loans/Total deposits	86.4	87.9	87.1	85.3	87.7	86.6	89.1
Total loans/Total assets	74.2	75.2	74.6	72.8	74.9	74.1	76.1

3.4 FINANCIAL SYSTEM INFRASTRUCTURE AND REGULATORY DEVELOPMENTS

3.4.1 Financial system infrastructure

In the first half of 2011, the Bank of Namibia performed its oversight assessment of the performance of the National Payment System (NPS) and related activities. The main focus of the assessment was on the payment business activities and inherent risk control. The findings were that the performance of payment system was satisfactory and inherent risks were soundly managed. At the same time, the National Interbank Settlement System (NISS) was available for 96.7 per cent of the time during the last six months of 2010. Furthermore, on-site inspection showed that payment service providers were fully compliant with the Bank's oversight policy and payment system regulations. In addition, the onsite visit to Smart Switch Namibia found the switching system to observe sound risk management practices and operational efficiency.

3.5 OVERALL ASSESSMENT AND OUTLOOK

The domestic economic activity slowed in the first half of 2011 in line with the global economic slowdown. However, the latter was expected to be short-term and the domestic economy has shown improvements in the second quarter of 2011. Noticeable signs of improvements appeared in the secondary and tertiary sectors of the domestic economy. Domestic demand also improved. The favourable economic conditions would improve the financial positions of both households and corporates. This would further boost the performance of banking institutions and financial stability. In line with the previous reviews, the negative impact of the prevailing global economic and financial conditions on the domestic economy is expected to remain moderate.

The banking sector continued to be liquid, adequately capitalised and solvent in the first half of 2011. Moreover, non-performing loans as a share of total loans have been falling since the first half of 2009. However, overdue mortgage loans rose, leading to an increase in total overdue loans as a proportion of total NPLs. At the same time, banking cost efficiency deteriorated during the period, with possible future implications for banking profitability, which also deteriorated.

The present global economic slowdown, despite current financial instability, was expected to be temporary. The improvement in the global economic conditions would help external demand for Namibian exports, with favourable consequences for the domestic real economy and the private sector. Furthermore, improvements in the financial position of banking borrowers would eventually have a positive effect on the banking sector.

During the review period, the Bank also continued to perform its oversight function of the performance of the National Payment System (NPS). The main objective of these oversight activities was to safeguard the safety and efficiency of the NPS. The assessment did not reveal any major issues of the payment system that could pose systemic risk to the financial system.

Overall, therefore, the banking sector remained stable, adequately capitalised and solvent, as it was in the previews reviews. Consequently, the overall impact on the banking sector of the current financial instability from the sovereign debt crisis is assessed to be low.

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