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
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

BoN	Bank of Namibia
CMA	Common Monetary Area
EMEs	Emerging Market Economies
FNB	First National Bank
FSR	Financial Stability Report
HI	Herfindahl Index
IMF	International Monetary Fund
JSE	Johannesburg Stock Exchange
LHS	Left-hand Side
NAD	Namibia Dollar
NAMFISA	Namibia Financial Institutions Supervisory Authority
NISS	Namibia Inter-bank Settlement System
NPL	Non-performing loan
NSX	Namibian Stock Exchange
PSCE	Private Sector Credit Extension
RHS	Right-hand Side
SA	South Africa
SACU	Southern African Customs Union
SARB	South African Reserve Bank
USA	United States of America
VIX	Volatility Index

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PURPOSE

The purpose of the Financial Stability Report is to assess developments in the financial system of Namibia, in the context of the global and regional financial systems, and identify risks to the system. The aim of the assessment is to encourage debate in the public and private sectors on the vulnerabilities identified, as well as serve as an early warning system to possible risks. The report presents action recommendations to identified risks. Lastly, the report is published to educate the reader on the resilience of the system, and what the regulators and government are doing in order to mitigate risks to the Namibian financial system.

PREFACE

Financial Stability and the approach of the Bank of Namibia

The Bank of Namibia defines financial system stability as the resilience of the domestic financial system to internal and external shocks, be they economic, financial, political or otherwise. It can also be described as the absence of macroeconomic costs of disturbances in the system of financial exchanges between households, corporates, and financial institutions.

The financial system in Namibia consists of financial markets, instruments, institutions and infrastructure. The regulatory structure, while not strictly a part of the financial system, plays an important role in regulating and monitoring the system.

Under the mandate of Section 3(a) of the Bank of Namibia Act, 1997 (No 15 of 1997, as amended) the Bank of Namibia has an objective "to promote and maintain a sound monetary, credit and financial system in Namibia and sustain the liquidity, solvency and functioning of that system". The stability of the financial system is critical as the system provides important services to households, corporates, and the real economy.

As such, the Bank of Namibia engages in active, on-going and formalised engagements with the Namibia Financial Institutions Supervisory Authority (NAMFISA) and the Government of Namibia, through the Ministry of Finance, to ensure a comprehensive assessment of systemic financial risks and of policy actions to ensure lasting financial system stability.

I. INTRODUCTION AND SUMMARY

1. The *Financial Stability Report (FSR)* is a bi-annual publication of the Bank of Namibia (BoN), which assesses the recent performance of important institutions and infrastructure with a bearing on financial system stability. The assessments, which hitherto mainly focused on the banking institutions and payment system infrastructure, now also include an appraisal of the performance of the non-banking financial sector. Results from a stress testing model of domestic commercial banking institutions are also included, on an aggregate level, as part of the banking sector performance assessment.

2. The present *Report* uses economic and financial data available through December 2012 – unless otherwise stated – to assess the stability and resilience of the Namibian financial sector to internal and external shocks. Following the introduction and summary section, the report discusses the main risks to the Namibian financial sector. The risk assessment is founded on analyses presented in subsequent sections, including, Section III: main economic and financial developments in global, regional, and the domestic economies; Sections IV: analysis of domestic households and corporate debt indicators; Sections V and VI: analyses of the performance of the banking institutions and non-bank financial institutions; and Section VII: an examination of the payments system infrastructure. Concluding remarks and policy recommendations to enhance financial stability are discussed in Section VII.

3. Since the last issuance of the *FSR* in October 2012, the risks to the global economic recovery remain, with conceivable potential effects to the real economy and financial sector in Namibia. Weakness in the global economy affects the Namibia economy mainly through trade and foreign direct investment channels, and foreign exchange markets. Unfavourable international terms of trade have also reduced export receipts and increased the import bill for food and energy. The developments in the global economy could potentially weaken the balance sheets and ability of local companies to meet their debt obligations.

4. On the regional front, the second half of 2012 witnessed the downgrading of South Africa's sovereign credit rating and banking institutions. The downgrade had implications for the South African economy, especially as reflected in the observed depreciation of the South African Rand. Yet, despite the depreciation of the Rand, inflation remained marginally below the upper-bound of the SARB's inflation target band, averaging 5.6 percent for 2012, while the external current account deficit remained significant.

5. On the domestic front, the output and inflation mix in Namibia remained broadly favourable during 2012. Preliminary real GDP growth for 2012 registered 5.0 percent on the back of a recovery in diamond export volumes. Headline inflation, at 6.5 percent, was higher than in 2011, although it mainly reflected supply shocks from elevated international commodity prices. The external current account deficit has remained relatively small, as sizeable trade imbalances were financed by a surge in SACU receipts. International reserves stood at about 3.4 months of imports of goods and services by end-December 2012.

6. Also, Namibia's long-term foreign sovereign credit rating remained unchanged. In December 2012, Fitch Rating Agency affirmed Namibia's long-term foreign currency credit rating at 'BBB-' but revised the outlook for Namibia from positive to stable. Moody's Ratings Agency also reaffirmed Namibia's overall outlook as stable, thereby assigning the country a sovereign rating of Baa3, with a country ceiling at A3.

7. Domestic commercial banking institutions remain sound, profitable and adequately capitalised, with the Bank of Namibia remaining well-positioned to address potential risks to the financial system. The assets for commercial banking institutions remain concentrated in mortgage loans, which represent around 55 percent of their consolidated balance sheet. There are however mitigating measures to counter this risk. For residential mortgages, a risk weight of 50 percent is applied, whereas for commercial real estate, a risk weight of 100 percent is applied. Although these measures are generally adequate, they are not forward looking and in the near future the Bank will be exploring the usage of macro prudential tools, such as requesting customers to put up a deposit for second housing loans (prescribing the so-called maximum Loan-to-value ratios), to further boost the risk management practises by commercial banking institutions.

8. **The levels of households and corporations debt have recently registered some welcome developments, although indebtedness levels warrant continuous monitoring by the Regulator and commercial banking institutions**. The level of households' indebtedness remain high, although it reduced slightly by 1 percentage point, while the household debt servicing ratio remained unchanged at 21 percent, despite a cut in the Bank of Namibia's repo rate in August 2012. Overall debt for corporates declined with a shift from external to domestic debt. The majority of external corporate debt is owed to parent companies of multinationals operating in Namibia, which debt appears to have been repaid to a large extent over the past year. On the other hand, predominantly domestic debt is taken out by local corporations, which debt has increased notably over the past year.

9. Despite higher household indebtedness the results of the stress testing conducted by BoN staff confirms that domestic commercial banking institutions are adequately capitalised, even in the event of an increase in credit risk in the form of an upsurge in loans default. Additionally, the quality of the banking assets improved and credit risk declined as the proportion of NPLs to total loans fell from 1.4 percent at the end of June 2012 to 1.3 percent at the end of December 2012. Credit risk is at its lowest level since 2008, when the ratio of NPL to total loans stood at 3.1 percent.

10. Non-bank financial institutions, through their asset managers, manage a relatively large share of total private sector savings in the economy thus warranting strong supervision by the Regulator. While their balance sheets appear to be robust and growing, these financial intermediaries are net creditors vis-à-vis the rest of the world and, therefore, are exposed to the headwinds of international finance. Little can be done to eliminate the contagion risk from global financial markets domestically, and, as such, the local priority should be to mitigate and manage the risk through the existing prudential regulation framework.

11. The national payment systems infrastructure continues to operate efficiently and safely. The current analysis reveals that the risk to the effective functioning of the payment system in the near to medium term could be considered insignificant.

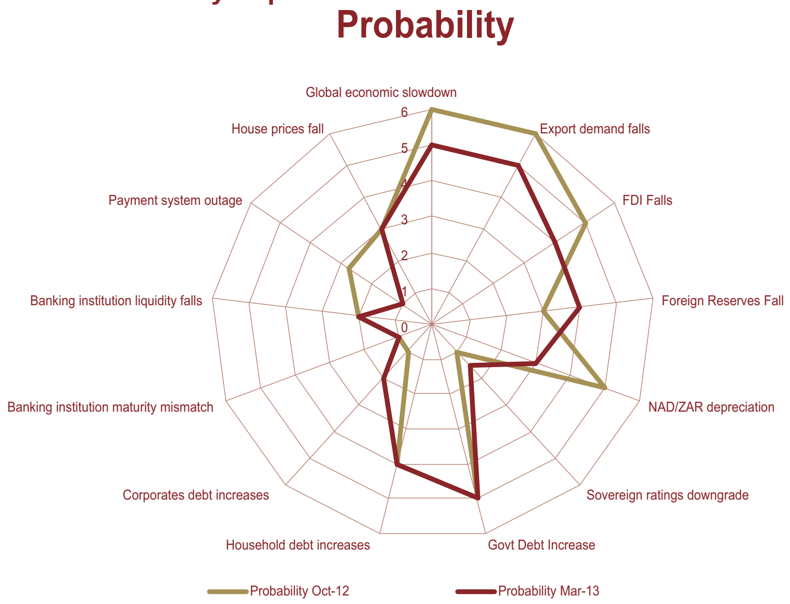
II. RISK ANALYSIS

This section presents the Bank's analysis of the main risks to the stability of the domestic financial system. Consistent with sections III-VII in this Report, the analysis identifies risks arising from: (i) the external macroeconomic environment, (ii) trends in household and corporate debt, and (iii) trends in the domestic banking and non-banking institutions' financial soundness indicators. The risks are analysed and rated from one (low risk) to six (high risk) based on their probability of occurring, and the potential impact on financial stability in Namibia should the risk develop and be realised.

Review of Risks reported in October 2012 edition

Since the last FSR, the stated possibility of a change in credit rating has already occurred and the likelihood of other identified risks to the financial system stability occurring were reassessed on the back of updated information (Figure 1). Fitch Ratings Agency downgraded the outlook for Namibia from 'positive' to 'stable', but confirmed the country's long-term foreign credit rating at BBB-. Due to greater regulatory oversight and concrete steps towards gaining more information on the sector, the probability of a payment systems outage was downgraded by two notches when compared to the last FSR. Similarly, the likelihood of a dramatic fall in FDI has been downgraded by one notch, mainly due to a clearer picture of developments in the mining sector. Since the October 2012 FSR, the likelihood of a fall in international reserves has increased due to Namibia Dollar and Rand depreciation, which occured due to a likely sluggish supply response of mineral exports. A rising food and energy import bill has also contributed to falling international reserves. The risk of further local currency depreciation is seen to have abated somewhat as a result of the depreciation already seen and analysts' expected marginal buy back of Rand assets over coming months, meaning that further significant Rand depreciation is seen as unlikely.

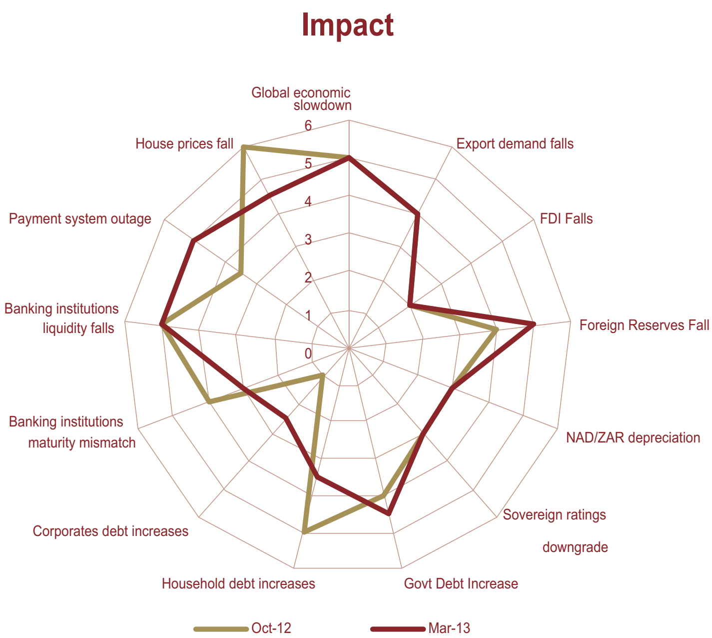
Figure 1: Comparison of Risk Probability between previous and current Financial Stability Report



Source: Bank of Namibia and researchers' computations

The calculated impact of a risk to financial system stability remained largely unchanged since the last issuance of the FSR in October 2012 (Figure 2). The impact of a fall in reserves, a payment systems' outage, and a government debt increase have been revised upwards, albeit in the margin. The impact of a fall in reserves is expected to increase slightly in line with the foreseen increase in probability of such. Due to efforts to include more operators into the payment system, the impact of an outage could impact a wider range of institutions, resulting in an upward revision of the potential impact of such an event. Also, the impact of a government debt increase has been revised upwards along a recently-released medium-term public expenditure framework targeting a less ambitious fiscal consolidation than before. Otherwise, the potential impacts of a fall in house prices (please refer to Box Article I for further information) and an increase in household debt levels have been revised down slightly, as latest available data suggest that they may have been marginally overstated in the previous FSR.

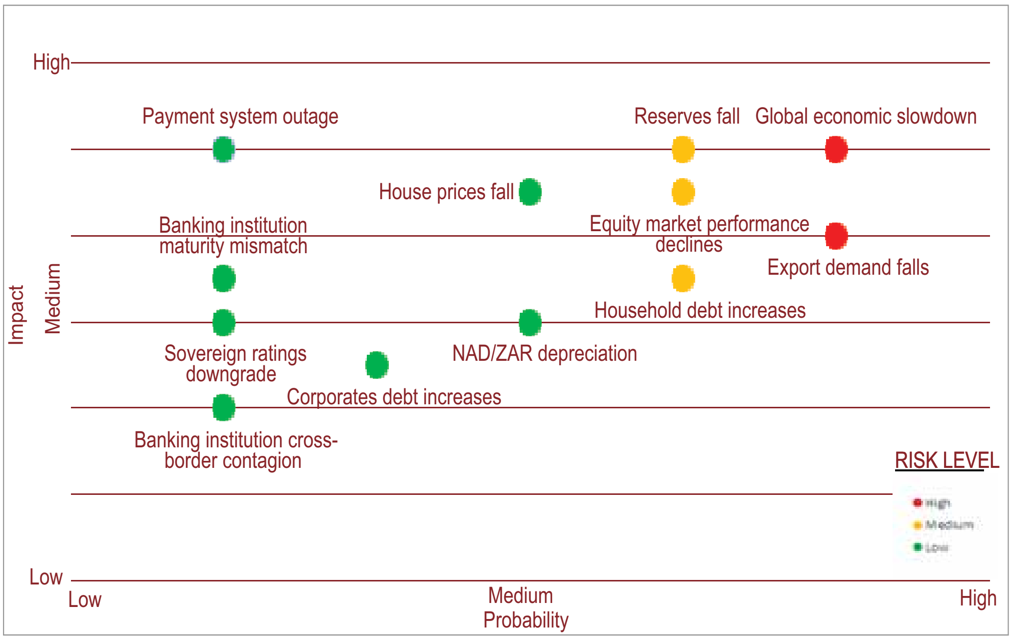
Figure 2: Comparison of Risk Impact between previous and current Financial Stability Report



Source: Bank of Namibia and researchers' computations

Analysis of Risks Identified in the Current edition

Figure 3: Risks to Financial Stability



Source: Bank of Namibia and researchers' computations

While the majority of the risks identified in the FSR October 2012 persist, new risks to the stability of the financial system were identified with the additional analysis of the non-banking financial system (Figure 3). A 'heat chart' (Table 1) of the risks as identified for the first 6 months of 2013 is presented below:

Table 1: Risks to financial stability

	Risk		Change	
	Probability	Impact	Probability	Impact
Global economic slowdown			Down	Unchanged
Export demand falls			Down	Unchanged
FDI falls			Down	Unchanged
International Reserves fall			Up	Up
NAD/ZAR depreciation			Down	Unchanged
Sovereign ratings downgrade			Unchanged	Unchanged
Govt debt increase			Unchanged	Up
Household debt increases			Unchanged	Down
Corporates debt increases			Up	Up
Banking institution maturity mismatch			Unchanged	Down
Banking institution liquidity falls			Unchanged	Unchanged
Payment system outage			Down	Up
House prices fall			Unchanged	Down
Banking institution cross-border contagion			New	New
Equity market performance declines			New	New

Source: Bank of Namibia and researchers' computations

Risk Analysis Key

High		Medium		Low	
6	5	4	3	2	1

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A. Risks stemming from the External Environment

Since the last issuance of the FSR, the risks to global economic recovery remain. Should these risks be realised, they will negatively affect the country's external (and fiscal) position, the expansion plans of some of the domestic companies, as well as the companies' abilities to service their loans. Namibia is an exporter of minerals and demand is dependent on global growth dynamics. A slowdown in global growth could translate into a depressed demand for export products, most notably in the mining sector, and this could negatively affect the expansion plans of domestic institutions, as well as their abilities to service loans taken out in line with their expansion plans. The country's external position would also be affected through reduced export earnings, which are also important source of government revenue (i.e. royalties and corporate profit taxes).

The downgrading of the South African sovereign and banking institutions poses some direct macroeconomic and some indirect risks to Namibia that warrant monitoring. The risks associated with South Africa's sovereign debt downgrade could lead to increased volatility and the depreciation of the Rand. The latter could result in foreign debt servicing becoming more costly for local companies, depending on companies' currency denomination of revenues and costs, and, as such, result in risk to Namibia's external position. Also, the depreciation of the Rand would increase input costs for Namibian businesses and increases of the overall import bill, particularly food and energy, which could prove detrimental to the current account of the country. The indirect risk related to the foreign costs of borrowing by commercial banking institutions is remote. Namibian commercial banking institutions, though subsidiaries of South African banking institutions rely on their own balance sheet to raise funds. Further, the loan to deposit ratio for Namibian commercial banking institutions remains below 100 percent.

B. Risks Stemming from Domestic Households and Corporate Debt

Household Sector

Since the last issuance of the FSR, the stock of household debt to disposable income has decreased somewhat but remains elevated, suggesting that future increases in the interest rate may place repayment burdens on Namibian households. The debt servicing cost remained unchanged in 2012, remaining high by international standards. A reason for this is that many of the countries that collect household debt figures are high income, or advanced country economies, which generally have significantly lower interest rates than those of emerging markets. As such, the debt servicing cost for Namibians is relatively high when compared to other states with similar levels of household debt to disposable income. Furthermore, the high debt serving ratio persisted despite the reduction in interest rates, suggesting that the current uptake of credit is substantial. In this context, a future increase in the interest rate from its current record-low level may place an additional repayment burden on Namibian households.

Corporate Sector

The decline in overall debt stocks of corporations suggests that corporates' balance sheets are strengthening, and that less debt financing is being sought for businesses' expansion. While the movement away from foreign debt (mostly sourced from foreign parent companies of resident firms) has reduced currency valuation risks to local corporates, a noticeable recent increase in local corporates' domestic debt, if sustained, may hold a potential risk to local lenders. Yet, the overall effect of a change in the composition of corporates' debt (foreign versus domestic debt) has been a decline in overall debt stocks of local corporations.

Given that the overall size of total large exposures at the end of 2012 were substantially lower than at the end of 2011, some risk can be said to have abated, though some level of monitoring is still required. The significant concentration in the manufacturing and food categories is an issue that warrants oversight, so as to ensure that concentration risk in an individual sector does not become a risk going forward. Furthermore, individual large exposures will pose some risk to the balance sheets of banking institutions, should these loans prove to be non-performing. However, given that the large exposure to total private sector credit extension (PSCE) ratio is at approximately 7 percent, this risk is not deemed to be systemic at the current point in time.

C. Risks Stemming from the Performance of the Banking Sector

Financial soundness indicators for the banking sector remain at comfortable levels by international standards; some structural patterns of the balance sheets however require monitoring. The banking institutions assets are highly concentrated in long term mortgage loans, and as such the situation needs continuous monitoring in light of the high level of household indebtedness.

Stress testing, conducted as part of the surveillance work of the Bank of Namibia, found the commercial banking institutions to be robust. As of December 2012, the commercial banking institutions were found to carry enough capital to sustain an increase in default rates.

D. Risks Stemming from the Performance of the Non-Banking Financial Sector

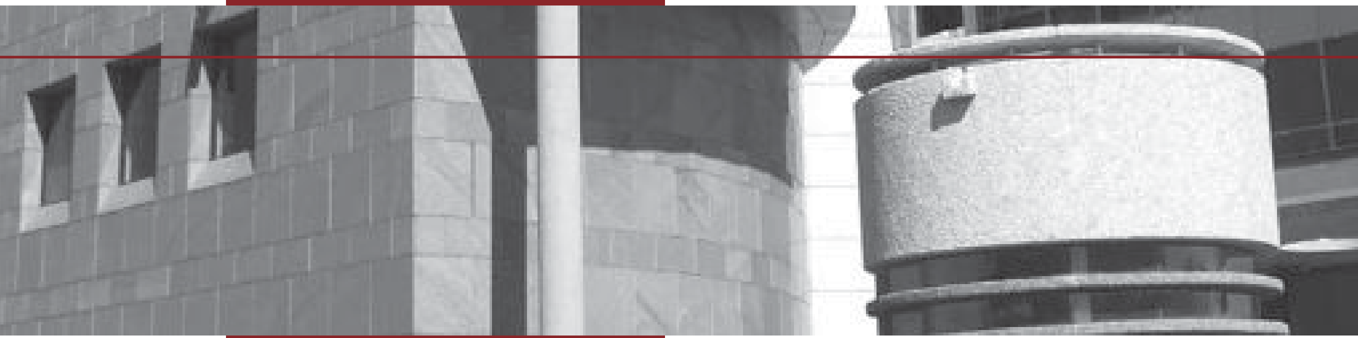
The sheer magnitude of the resources managed by the non-bank financial intermediaries (NBFIs) warrants monitoring. These financial institutions administer private sector savings of an amount larger than nominal GDP and about 1.5 times the money supply. The non-bank financial sector's assets are significantly allocated in equity and bonds investments on the NSX, JSE, and offshore. While this in itself is not a risk per se, it is a situation that warrants monitoring. Should there be a plunge in the performance of equity markets and consequently the JSE and NSX, this might adversely affect the solvency of most non-bank financial institutions, with investors (e.g. pensioners and others) being adversely affected.

The major contagion risk between NBFIs and banking institutions exists due to NBFIs' deposit/cash holdings with local banking institutions. These cash allocations are an important source of liquidity for banking institutions and, as such, a draw down of these cash holdings could cause a liquidity challenge for banking institutions. As of December 2012, 6.3 percent of total banking institutions' deposits belonged to unit trusts and totalled over N$4.3 billion, while as of September 2012, the insurance sector held approximately N$ 5 billion with local commercial banking institutions. Pension funds have similarly large cash holdings with the commercial banking institutions, contributing to the liquidity of such, and presenting a similar risk should sizable withdrawals occur.

Some potential risks exist for long-term pension funds with defined-benefit payment systems in place. The realisation of this risk would materialise if outgoing payments to pensioners exceed incoming payments from contributors. However, this issue is only applicable for defined-benefit funds, of which the Government Investment Pension Fund (GIPF) is one of few. If shortfalls were to materialize, the government may need to fund the financing gap.

E. Risks Stemming from the Payment and Settlements System

The current analysis reveals an insignificant risk to the efficient functioning of the payment system in the near- to medium-term. That said, the payment and settlement system is vulnerable to system outages and insufficient regulatory information. The local institutions are required to conduct payments using the NISS and an outage to the system would lead to payments not being undertaken in a timely manner.



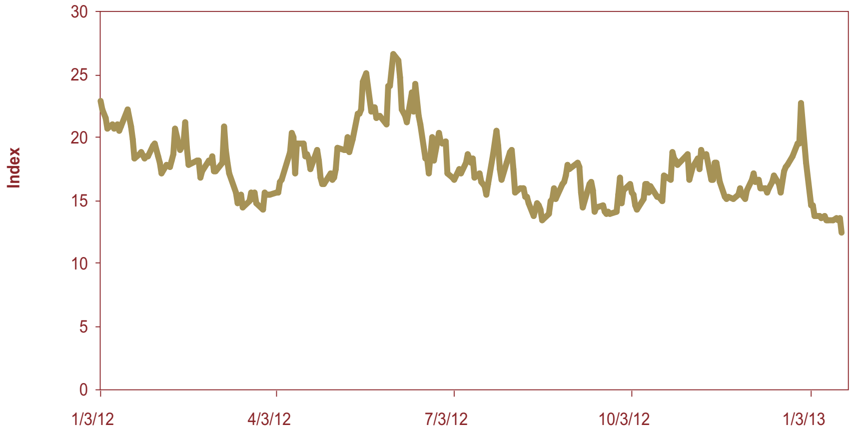
III. MACROECONOMIC ENVIRONMENT

Advanced Economies

Since the last publication of the FSR in October 2012, global economic conditions have remained volatile, and sentiments in global market performance continued uncertain, though less so than in the first half of 2012, as is indicated by the VIX[1] (Figure 4). The US fiscal cliff[2] dominated the news towards the end of 2012, and uncertainty on whether a deal would be reached by 31 December 2012 led to a temporary increase in the index's volatility. Similarly, depreciation of the US dollar against major currencies was experienced due to the uncertainties created by the last minute resolution. A compromised deal was reached on the 3rd January 2013 and this led to a correction in the observed increased volatility. The US has largely avoided a tax revenue increase, with spending cuts and the debt ceiling the only unresolved issues remaining in early 2013.

The risks in the Euro Zone related to sovereign debt remain. Financial strains in the Euro Area have somewhat lessened as a result of commitments by the European Central Bank (ECB), such as the launching of the Outright Monetary Transactions (OMT) program and the introduction of the European Stability Mechanism (ESM), although output remains depressed across the monetary area.

Figure 4: The last half of 2012 saw the Volatility Index edge down from the peak in May 2012.



Source: Bloomberg

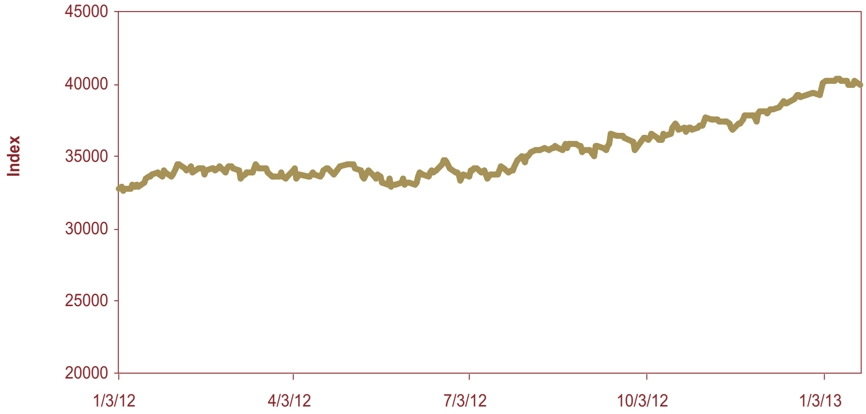
[1] The Chicago Board Options Exchange Volatility Index ('VIX') shows the market's expectation for 30-day volatility. The index is constructed using the implied volatilities of a wide range of S&P 500 index options. The VIX is a widely used measure of market risk and is often referred to as the "investor fear gauge." (Investopedia, 2012)

[2] The term is used to describe the situation that the U.S. government faced at the end of 2012, when the terms of the Budget Control Act of 2011 were scheduled to go into effect. Among the changes that were set to take place at midnight on 31 December 2012 were: (1) the end of temporary payroll tax cuts, (2) the end of certain tax breaks for businesses, (3) shifts in the alternative minimum tax that would take a larger bite, (4) a rollback of the "Bush tax cuts" from 2001-2003, and (5) the beginning of taxes related to the health care law. At the same time, the spending cuts agreed upon as part of the debt ceiling deal of 2011 - a total of $1.2 trillion over ten years - were scheduled to go into effect. It was feared that the cliff would push the US into economic deterioration.

Emerging Economies

Confidence in emerging market economies continued to increase during the second half of 2012, mainly in response to developments in the BRICS economies. The confidence was, for instance, evident in the rise of the JSE Africa All Share Index (Figure 5). That is despite the increased risks emanating from within South Africa's economic performance, especially towards the end of 2012.

Figure 5: Towards the end of Q2 2012 the JSE Africa All Share Index continued with the trend of a steady incline on the back of confidence in emerging markets.



Source: Bloomberg

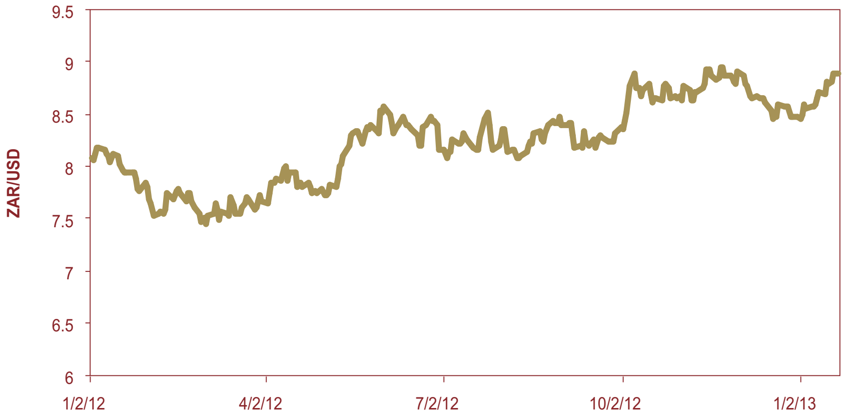
Regional Highlights

The second half of 2012 witnessed the downgrading of the credit rating of South Africa by two major rating agencies. In September 2012, Moody's credit rating agency downgraded the South African government's bond rating from A3 to Baa1. Similarly, in October 2012 Standard and Poor's (S&P) downgraded the long term foreign currency sovereign credit rating of South Africa from BBB+ to BBB. The ratings agencies' cited reasons were, amongst others, the negative developments (wildcat strikes) in the country's labour market.

Following the downgrading of the sovereign rating, Moody's lowered its outlook for South African banking institutions from 'stable' to 'negative', citing their overexposure to government debt, the deteriorating economic outlook, and liquidity challenges. In October 2012, Moody's downgraded the foreign-currency deposit ratings of the five largest South African banking institutions, namely: Standard Bank of South Africa, Absa Bank Limited, FirstRand Bank Limited, Nedbank Limited, and Investec Bank Limited. All five banking institutions, in addition to African Bank Limited, were considered to carry negative outlooks regarding their local asset portfolios and debt ratings and their positions vis-à-vis the government. Moody's cited the weakening of the South African government's credit profile and the high sovereign exposure of the five largest South African banking institutions, comprising on average more than 150% of their Tier 1 capital, as one of the main reasons for the downgrade. The overall financial strength of each of the leading South African commercial banking institutions was, however, rated as 'stable' (see Table 1 in the Appendix for more detail).

The sovereign debt downgrade and labour unrest had implications for the South African economy, especially regarding the observed depreciation of the Rand that developed as a result of such. Compared to the first half of 2012, the Rand depreciated in the second half of 2012, settling at an average level of just above R8.46 for the third and fourth quarters against the US dollar, compared to an average of R7.85 during the first two quarters of 2012 (Figure 6).

Figure 6: Currency movements of the Rand against the US dollar



Source: Bloomberg

Despite the depreciation of the South African Rand, inflation remained below the upper-bound of the SARB's inflation target band, averaging 5.6 percent for 2012. Inflation in South Africa averaged an annual rate of 5.38 percent during the last half of the year, compared to an annual rate average of 5.95 percent over the first six months of 2012 (Table 2).

Table 2: Annual inflation

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Index	120.6	121.3	122.6	123.1	123.2	123.5	123.9	124.2	125.3	126.1	126.4	126.7
Rate (%)	6.3	6.1	6.0	6.1	5.7	5.5	4.9	5.0	5.5	5.6	5.6	5.7

Source: Statistics South Africa

Domestic Economy

Output and Inflation

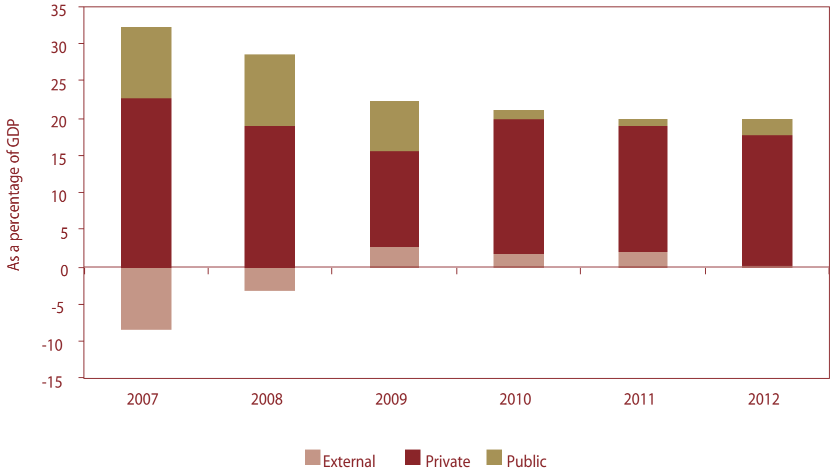
Preliminary real GDP growth figures for 2012 show an annual growth of 5.0 percent, compared to 4.8 percent in 2011. The estimated growth is accredited to a recovery in mining activities, mainly diamonds and uranium, and some sustained growth of construction on the back of increased public infrastructure and property developments. The Namibian economy is further projected to grow at 4.4 percent in 2013, as a result of resilient growth in mineral and construction activities, as well as increased manufacturing and wholesale and retail value added.

Namibia's average consumer price inflation rate increased from an average of 5.0 percent in 2011 to an average of 6.5 percent in 2012, mainly due to rising inflation of food and transport during the second half 2012. The inflation rate declined during the first half of 2012 from 7.4 percent in February to 5.6 percent in June. However, that trend reversed during the second half of the year as inflation rate rose to 7.6 percent in November before moderating to 6.3 percent in December 2012. Inflation is expected to level off at 6.4 percent in 2013 and beyond.

Savings and Investment

A negative savings-investment gap was observed in 2012, and is expected to continue in 2013, as public sector and private sector savings decline. The savings-investment gap as a ratio of GDP was negative in 2012, signifying that Namibia experienced a net draw down of foreign savings to finance its investment needs (see Bank of Namibia's Economic Outlook, December 2012). The expectation for 2013 is that Namibia will remain a net user of external savings, and public and private sector savings will continue to weaken. Public sector savings are expected to fall on account of a sizeable recurrent expenditure. Similarly, private sector savings are expected to decline alongside sustained buoyant import growth and rapidly rising consumer bank credit.

Figure 7: Savings



Sources: Namibia Statistics Agency, National Accounts, 2008–2011; Bank of Namibia Annual Report 2012 for 2012 estimates.

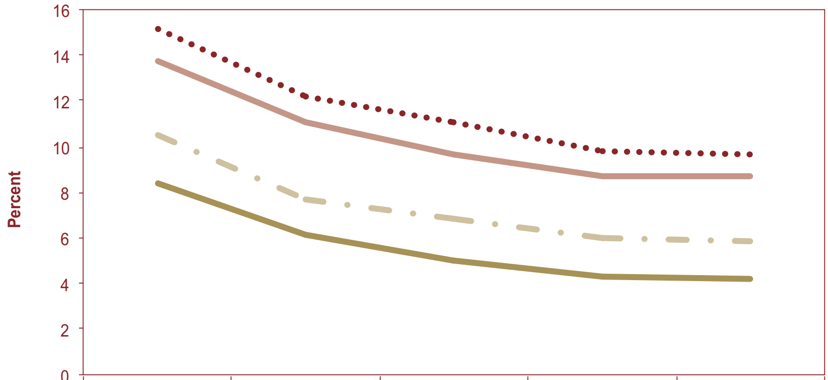
Fiscal Policy

During 2012, the stance of fiscal policy was generally tight, as the overall fiscal deficit declined from about 7 percent of GDP in 2011/12 to an estimated 2.9 percent of GDP in 2012/13. The decline in the overall fiscal deficit resulted from a moderation in public spending growth, while total revenue increased significantly due to elevated SACU revenue and a spike in income tax collection. The deficit was financed by drawdowns in government deposits with the Central Bank and the issuance of debt in the domestic market and the international government debt markets through the issuance of Rand denominated bonds (totalling R850 million) on the JSE.

Interest Rate Policy

Interest rates in Namibia are at historically low levels, following substantial policy rate cuts during the last four years to support the domestic economy in an environment of weak global growth (Figure 8). For the first half of 2012 the Bank of Namibia's Repo rate was kept unchanged at 6.0 percent. In August 2012 however, the Repo rate was reduced to 5.5 percent against the background of uncertain developments for leading exports and policymakers' desire to enhance domestic demand. The extended period of low Repo rates-which broadly translated to low prime and bank deposit rates-has meant that the cost of borrowing is relatively low and the return on bank deposits is very low, thus increasing demand for credit and putting pressure on the country's net external position.

Figure 8: Selected Interest Rates 2008-2012



	2008	2009	2010	2011	2012
Repo rate	10.5	7.7	6.9	6	5.8
Prime rate	15.2	12.2	11	9.8	9.6
Deposit rate	8.4	6.2	5	4.3	4.2
Lending rate	13.7	11.1	9.7	8.7	8.7

Repo rate • • • • Prime rate Deposit rate Lending rate

Source: Bank of Namibia

Exports

During 2012, Namibia's export earnings rose significantly, owing mainly to the recovery of the mineral sector, especially *diamonds, uranium* and *gold*, coupled with the depreciation of the local currency. The strong performance of the diamond sector surprised analysts, who had initially foreseen a weaker performance of this leading export for the country. Mineral exports remained the single highest contributor to the total export earnings. The share of mineral exports to total exports rose by 4.2 percentage points in 2012, from 41.1 percent in 2011 (Table 3). Other exports, such as food products and light manufacturing, registered less buoyant growth rates, related to low dynamism in traditional markets, such as South Africa, for example. Trade with Angola has remained important, but volatile, and below the peaks of activity registered before the global financial crisis.

Table 3: Major Export Receipts as Percentage of Total Exports

Export receipts	2008	2009	2010	2011*	2012
Minerals	54.3	56.7	44.0	41.1	45.3
Diamonds	24.8	17.3	20.6	20.0	24.4
Uranium	19.6	17.8	17.2	15.6	13.9
Other minerals	9.8	5.6	6.2	5.5	7.2
Food and live animals	11.4	12.0	12.3	12.7	11.4
Manufactured products	27.1	23.7	22.2	22.3	19.7
Other commodities	7.2	23.6	21.4	23.9	23.3

Source: Bank of Namibia Annual Report 2012. The figures for 2011 were revised.

Imports and Import Reserve Coverage

The rapid growth of commodity imports registered in the last few years persisted in 2012. Despite the reported recovery in export growth, Namibia's trade balance deteriorated sharply as a share of GDP. An elevated import bill for oil, food, and transportation equipment explains these developments. The buoyancy of imports has coincided with a period of broadly accommodative monetary policy and appreciation of the real effective exchange rate, particularly through mid-2011.

The stock of official international reserves rose by 2.1 percent to N$14.7 billion in 2012, but declined in terms of imports of goods and services. The increase in reserves emanated from almost doubling SACU receipts in 2012 relative to 2011, the issuance of the ZAR bond on the JSE, the repatriation of ZAR banknotes to South Africa, and valuation gains due to the depreciation of the national currency. In line with a significant increase in imports, the months of import cover fell from 3.8 months in 2011 to 3.4 months in 2012, but remained slightly above the international benchmark of 3.0 months.

Credit Rating of the Sovereign and Local Financial Institutions

In December 2012, Fitch Rating Agency affirmed Namibia's long-term Foreign Currency Issuer Default Rating at 'BBB-', Long-Term Local Currency Rating a notch above at 'BBB' and with a Country Ceiling of 'A'. The outlook was revised to stable from positive. Fitch Ratings also assigned the Republic of Namibia an 'AA-' (zaf) South African national scale rating during in 2012 (Table 4). A *strong balance sheet* of the Namibian Government supported the good rating. In particular, the Namibian Government's debt level, as a percentage of GDP, has remained relatively low (at about 26 percent of GDP) compared to debt levels of rating peers. Also, the budget deficit was significantly reduced from about 7 percent of GDP in 2011/12 to about 3 percent of GDP in 2012/13. Fitch's assessment also factored in the expected fiscal consolidation targeted in the government's medium term expenditure framework (however the budget tabled in February 2013 no longer projects such a contraction). The strong real GDP growth forecast for 2013 and the country's political stability were two other important factors that contributed to the rating assigned.

Moody's Ratings Agency also reaffirmed Namibia's overall outlook as stable, thereby keeping the country's rating of 'Baa3' with the Country Ceiling at 'A3'. According to the rating agency, the rating largely reflected the government's track record of responsible budget management, as well as the country's investor-friendly policy framework. These elements are reflected in a healthy government balance sheet, which enabled expansionary fiscal policies in the aftermath of the global financial crisis.

Table 4: Rating Scores

Foreign Currency	
Long-Term IDR	BBB-
Short-Term IDR	F3
Local Currency	
Long-Term IDR	BBB
Country Ceiling	A
Outlooks	
Long-Term Foreign-Currency Rating	Stable
Long-Term Local-Currency IDR	Stable

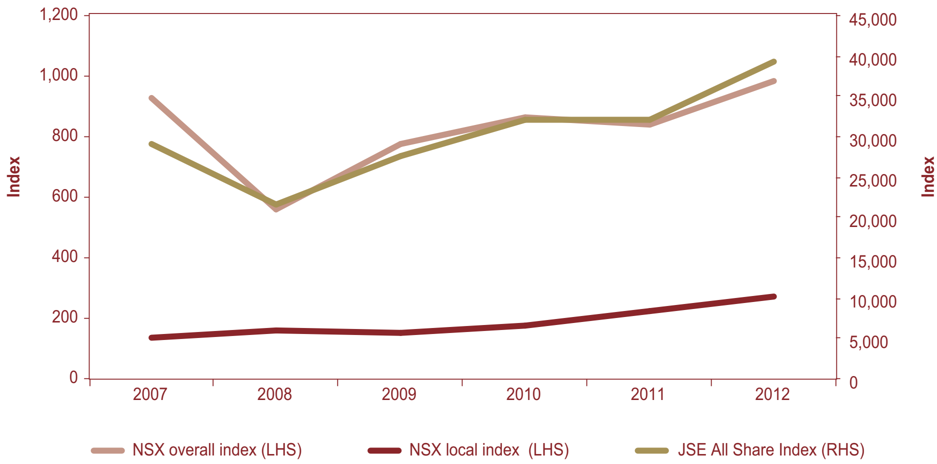
Source: Fitch Rating Agency

Subsidiaries of the South African commercial banking institutions continued to dominate the domestic banking system, while maintaining strong balance sheets. Standard financial soundness indicators remain strong and at the level of international benchmarks. Moreover, following the downgrade of the commercial banking institutions in South Africa in October 2012, the Bank of Namibia[3] informed the public that the local subsidiaries of the South African commercial banking institutions would not be negatively affected, as the local banking institutions rely mainly on their own balance sheet (i.e., deposits and capital) for funding. The impact of the South African banking institutions' rating downgrade on income or cost of borrowing of Namibian banking institutions was, therefore, presumed to be negligible.

Capital Markets

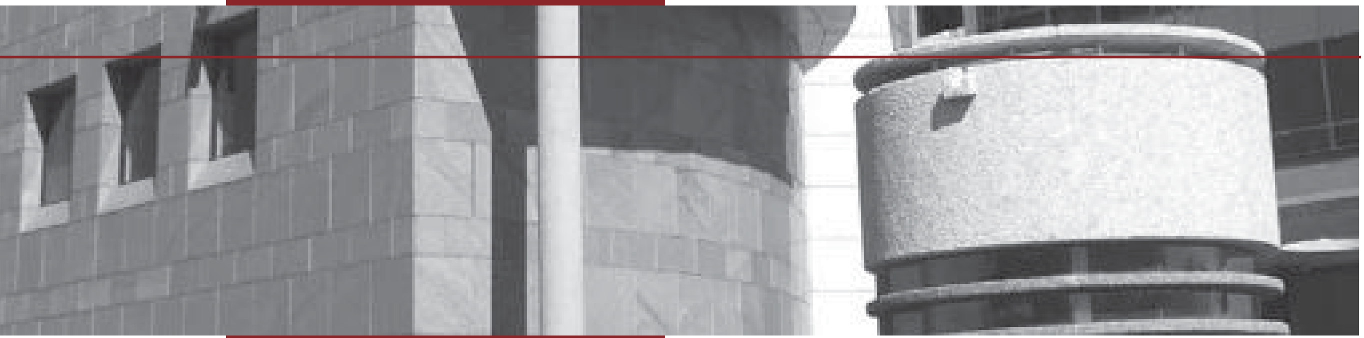
The Namibia Stock Exchange (NSX) overall index performed well in 2012. The NSX overall Index reached 984 in 2012, compared to 838 in 2011 (Figure 9). This implies that the share prices of listed companies went up overall, as investors were, in general, willing to pay more for company shares based on financial health of the listed companies. Economic trends and industry perception were also important factors considered.

Figure 9: NSX and JSE Indices



Source: NAMFISA

3 See The Namibian newspaper of 08 October 2012, interview with Director of Strategic Communication and Financial Sector Development.



IV. DOMESTIC HOUSEHOLDS AND CORPORATE DEBT INDICATORS

Household Debt

An analysis of household debt was introduced in the FSR of October 2012, covering household debt levels from 2003 to the end of 2011, and data permitting, the first quarter of 2012. The October 2012 report discussed methodological issues covering the calculations of debt indicators used in the report. The finding of the report was that the (adjusted) household debt to disposable income ratio was approximately 89.6 percent, while the adjusted debt servicing to gross income ratio was 21 percent.[4]

The current issue of the Financial Stability Report has reviewed and revised the estimates included in the FSR of October 2012, including updated figures up to the end of 2012. Data updates are as a result of updated central government budget figures, final GDP figures for 2011, and preliminary official national accounts for 2012.

Household Debt to Disposable Income

The ratio of household debt to disposable income identifies the extent to which households leverage their financial positions, relative to their income after tax[5] (i.e. disposable income). The indicator (Table 5) is calculated based on income and tax data extracted from the national budget documents, and national accounts, as well as data on household debt, collected by the Bank of Namibia from deposit-taking institutions in Namibia[6].

Table 5: Household Debt to Disposable Income*

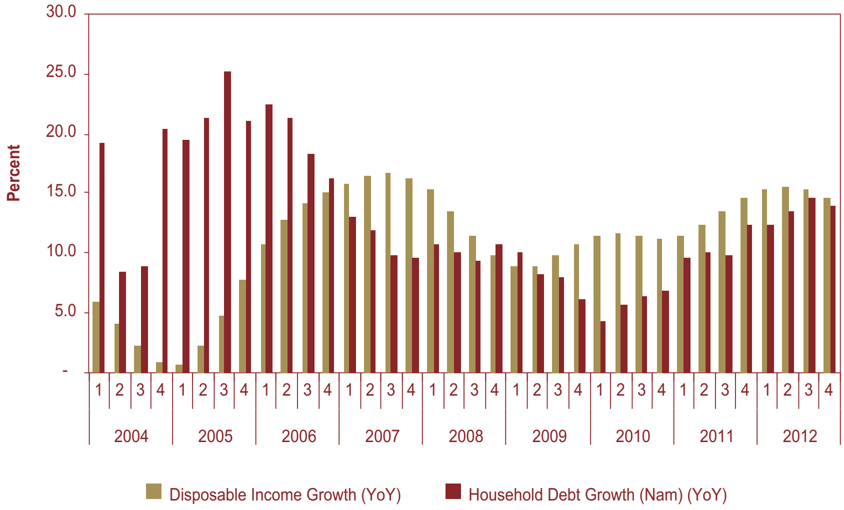
	2006	2007	2008	2009	2010	2011	2012
Total (Disposable Income) (N$ million)	20 304	23 525	27 109	29 515	32 901	36 659	42 303
Credit To Individuals/Households (N$ million)	18 044	19 770	21 899	23 256	24 856	27 917	31 795
Household Debt to Disposable Income (%)	89	84	81	79	76	76	75
Adjusted Credit To Households (N$ million)	20 119	22 043	24 417	25 930	27 714	31 127	35 452
Adjusted Credit to Disposable Income (%)	99	94	90	88	84	85	84

Source: Bank of Namibia, * data as of year-end

4 The adjustment accounts for the skewed distribution of income and debt in Namibia, as well as informal sector debt that is not reflected in official figures.
5 Given the 2013/14 National Budget's proposed reduction in the income tax rate in Namibia, disposable incomes can be expected to increase somewhat in 2013, which will, ceteris paribus, reduce the household debt to disposable income ratio.
6 First National Bank of Namibia, Standard Bank of Namibia, Nedbank Namibia, Bank Windhoek, Agribank of Namibia, National Housing Enterprise, and the Namibia Post Office Savings Bank.

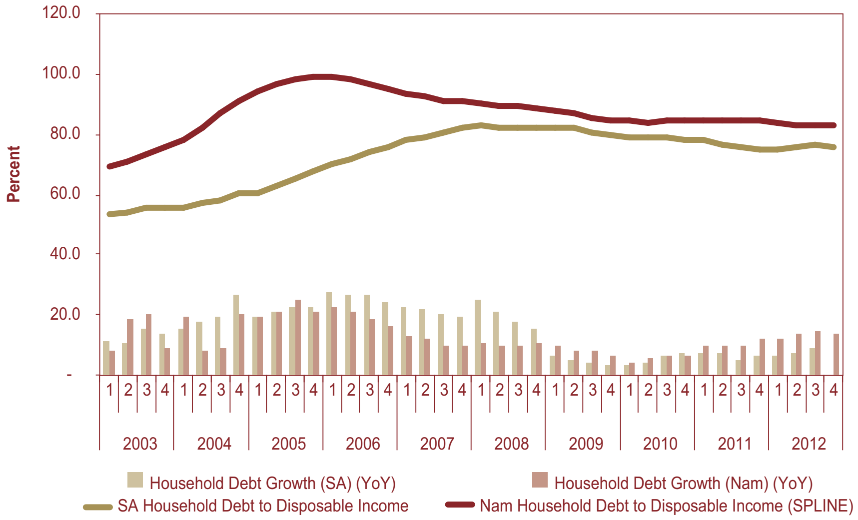
Since the last FSR, household indebtedness[7] decreased to 84 percent, from the previous (revised) level of 85 percent[8]. This decrease was driven, predominantly, by a strong growth in gross household income in 2012, which grew by 14.8 percent year on year, up from the 5 year-average of 12.2 percent growth per annum (Table 5). Over the same period, average growth in household debt was 13.6 percent. At 84 percent of disposable income, current levels of household indebtedness are below the maximum seen over the past decade. In 2005 and 2006, the household debt to disposable income ratio approached 100 percent, before registering a gradual decline through early-2010 (Figures 13 and 14).

Figure 10: Household Debt and Disposable Income growth



Source: Bank of Namibia

Figure 11: Household Debt to Disposable Income: Namibia and South Africa



Source: Bank of Namibia, South African Reserve Bank

Namibia's household indebtedness level remains above that of South Africa. Currently, South Africa has a household debt to disposable income ratio of approximately 76 percent; a level that has remained largely unchanged for the past 18 months. Namibia, in turn, has a debt-to-disposable income ratio of approximately 84 percent, which has decreased marginally over the past 18 months, bringing Namibia's household debt levels closer to that of South Africa (Figure 11). The differing trends between the two economies in terms of household indebtedness are likely to reflect differences in demand for, and supply of credit from commercial institutions, as well as the relatively stronger growth seen in Namibia over South Africa over the past few years. Indeed, despite South Africa currently having a lower interest rate than Namibia, demand for credit is thought to be fairly depressed possibly due to greater market saturation and reduced income prospects, as well as the impact of credit ceilings. On the supply side, having experienced a price correction in the property market over the past half decade, mortgage lending institutions have apparently become risk averse, and broadly unwilling to lend in South Africa. Given the restrained demand for and supply of credit in South Africa, the general credit uptake has been relatively low when compared to that of Namibia.

[7] The ratio of credit to disposable income
[8] figures have been adjusted for informal sector debt.

Debt Servicing Ratio

The debt servicing ratio is a measure of the percent of individual's gross income that is spent on servicing and repaying their debt. It is calculated based on individuals' gross income (Table 6) and an estimated debt servicing cost based on normal amortization calculations of (estimated) loan duration, average interest rate and outstanding debt.

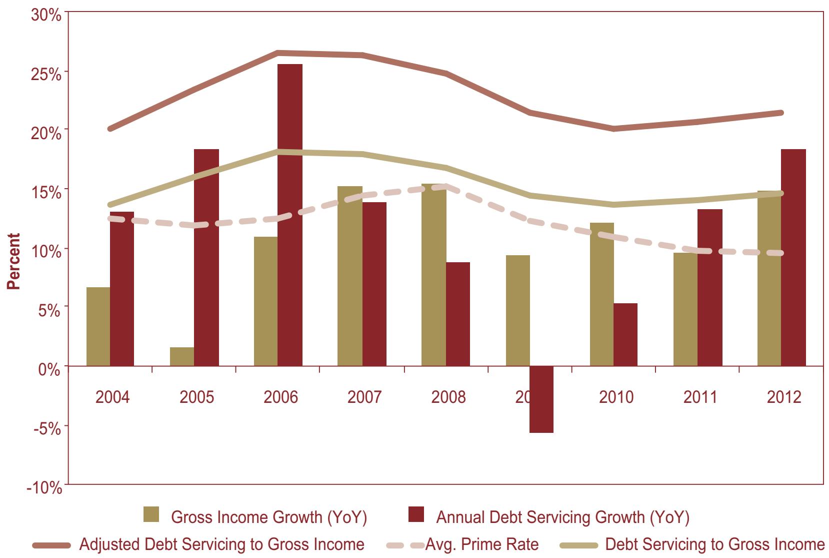
Table 6: Debt and Income Levels

	Gross Income	Disposable Income	Annual Debt Servicing	Debt Servicing to Gross Income	Debt Servicing to Disposable Income	Adjusted Debt Servicing to Gross Income
2003	19 004	17 190	2 456	13%	14%	19%
2004	20 270	18 205	2 778	14%	15%	20%
2005	20 585	18 339	3 287	16%	18%	23%
2006	22 818	20 304	4 125	18%	20%	27%
2007	26 284	23 525	4 698	18%	20%	26%
2008	30 350	27 109	5 107	17%	19%	25%
2009	33 177	29 515	4 817	15%	16%	21%
2010	37 181	32 901	5 075	14%	15%	20%
2011	40 741	35 419	5 749	14%	16%	21%
2012	46 751	39 003	6 804	15%	17%	21%

Source: Bank of Namibia

Over the past year, the debt servicing to gross income ratio has increased by one percentage point, while the adjusted ratio, which takes into account the unequal distribution of debt, has remained unchanged at 21 percent. As with the household debt to disposable income ratio, the cost of household debt servicing is influenced by both household income growth, and the growth in total credit extension to households. However, unlike the household debt to disposable income ratio, the debt servicing ratio also takes into account the effective interest rate for debt in Namibia. In 2009, debt servicing costs contracted, both as a result of falling interest rates, and as a result of a net repayment of instalments sales and overdrafts. Subsequently, the uptake of credit has increased faster than the interest rate has fallen, resulting in a once again increasing debt servicing cost to the nation. In 2012 however, incomes increased by 14.8 percent, relative to a debt increase of 13.2 percent, which coupled with an interest rate cut of 50 basis points towards the end of the year, halted the increase in debt servicing costs (Figure 12).

Figure 12: Debt Servicing Costs



Source: Bank of Namibia

Corporate Debt

During 2012, the stock of debt held by Namibian corporations declined in nominal terms by 2 percent when compared to 2011, with the share of domestically-sourced corporate in total debt increasing (Table 7). The reduction in the stock of total corporate debt was predominantly due to a decline in foreign debt, or money owed by resident companies to foreign companies. However, the 19 percent decline in foreign debt was largely offset by a substantial uptake of credit issued locally, amounting to a 26 percent increase on the 2011 end-of-period figure. These developments appear to suggest that current credit conditions are favourable in Namibia, despite the interest rate being above that of South Africa, and higher than in advanced economies. Concurrently, the reduction in foreign debt is likely to display the repayment of debt to parent companies by local subsidiaries of multinationals.

Table 7: Domestic and External Corporate Debt

N$ Millions	2006	2007	2008	2009	2010	2011	2012*
Domestic	42%	49%	46%	52%	47%	39%	50%
Foreign	58%	51%	54%	48%	53%	61%	50%
Total Debt	19 436	20 905	25 679	26 230	32 472	41 867	41 180
YoY Change (Total)	27%	8%	23%	2%	24%	29%	-2%
GDP (Nominal)	54 028	62 081	72 946	75 070	81 120	90 835	103 158
Debt to GDP Ratio	33%	32%	32%	32%	38%	44%	38%

*Estimate

Source: Bank of Namibia

Corporate debt also declined as a share of GDP between 2011 and 2012. Nominal GDP is estimated to have grown by 13.6 percent[9], which, when coupled with a decline in nominal corporate debt, has substantially reduced the corporate debt to GDP ratio of the country. The ratio, which stood at 44 percent in 2011, is estimated to have fallen to 38 percent in 2012 (Table 7).

Table 8: Domestic and External Corporate Debt Breakdown

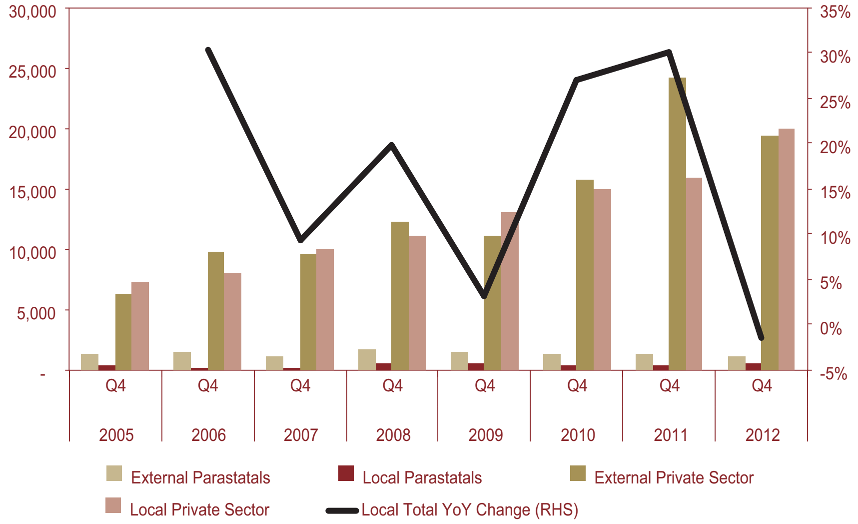
N$ Millions	2006	2007	2008	2009	2010	2011	2012
Private Sector (Foreign)	9 729	9 596	12 251	11 065	15 742	24 149	19 390
Private Sector (Local)	8 148	9 976	11 210	13 155	15 013	15 876	20 049
Total	**17 878**	**19 572**	**23 461**	**24 221**	**30 754**	**40 025**	**39 439**
Foreign (% Total)	54%	49%	52%	46%	51%	60%	49%
Local (% Total)	46%	51%	48%	54%	49%	40%	51%

Source: Bank of Namibia

The debt uptake by local corporations is sourced from domestic and external sources, and has remained volatile. In 2012, approximately 49 percent of total corporate debt was sourced from local lenders, while around 47 percent was sourced from foreign lenders (Figure 13). The remaining four percent of total corporate debt was to parastatals, with 67 percent of parastatals debt being sourced from outside of the country, with the remainder (33 percent) being sourced from local lenders. After experiencing growth of 30 percent in 2011, total corporate debt has contracted by 1 percent in 2012.

[9] Bank of Namibia, Economic Outlook: December 2012.

Figure 13: Credit to Corporations, 2005 - 2012



Source: Bank of Namibia

As private sector foreign corporate debt is approximately 47 percent of overall debt, the debt servicing cost of such makes up a sizable portion of overall debt servicing. During 2012, the overall cost of foreign debt servicing fell by 13.8 percent, notwithstanding the nominal depreciation of the national currency and the South African Rand (Table 9).

Table 9: Foreign Private Sector Debt and Debt Servicing

N$ Million	2005	2006	2007	2008	2009	2010	2011	2012
	Q4	Q4	Q4	Q4	Q4	Q4	Q4	Q4
Total Foreign Private Sector Debt	6 412	9 729	9 596	12 251	11 065	15 742	24 149	19 390
Total Foreign Private Sector Debt Servicing	522	740	441	698	1 402	304	473	407

Source: Bank of Namibia

Large Exposures[10]

Commercial banking institutions in Namibia lend a large portion of total corporate loans to individual companies, or groups of companies, in a single sector. As such, these loans have the potential to become a systemic risk to overall financial stability, through the possibility of excess concentration risk to individual companies or sectors.

The year 2012 saw a substantial decline in large exposures to individual companies from commercial banking institutions, with total large exposures shrinking by 15 percent from the 2011 level. Overall declines in single large exposures were seen in the fishing (-21 percent), property and construction (-21 percent), tourism (-49 percent) and other (-72 percent) sectors. On the other hand, growth was experienced in large exposure debt to the manufacturing and food (12 percent), mining and minerals (52 percent) and transport and logistics (27 percent) sectors (Table 10).

[10] Large exposures are classified as the 25 largest corporate exposures to the commercial banking institutions of Namibia at a given point in time. For the most part, for an exposure to be classified as a "large exposure" it has to be over N$2 million in value.

Table 10: Large Exposures by Sector

N$ millions	2006	2007	2008	2009	2010	2011	2012
Fishing (5)	194	479	286	385	238	228	180
Manufacturing and Food (4)	607	134	160	167	1 024	1 264	1 413
Mining and minerals (8)	94	252	457	283	550	188	285
Property/Construction (10)	279	468	474	329	277	757	597
Tourism (2)	66	-	170	-	-	74	38
Transport and Logistics (7)	665	953	1 429	1 521	785	718	913
Other (16)	522	377	423	316	1 390	1 212	340
Total (52)	**2 427**	**2 665**	**3 400**	**3 001**	**4 263**	**4 440**	**3 765**
% Change Y-o-Y							
Fishing (5)		147%	-40%	35%	-38%	-4%	-21%
Manufacturing and Food (4)		-78%	19%	4%	513%	23%	12%
Mining and minerals (8)		168%	81%	-38%	94%	-66%	52%
Property/Construction (10)		68%	1%	-31%	-16%	174%	-21%
Tourism (2)		-100%	0	-100%	0	0	-49%
Transport and Logistics (7)		43%	50%	6%	-48%	-9%	27%
Other (16)		-28%	12%	-25%	339%	-13%	-72%
Total (52)		**10%**	**28%**	**-12%**	**42%**	**4%**	**-15%**

Source: Bank of Namibia

At the end of 2012, large exposures (over N$2 billion in 2012) to private sector corporations made up 7 percent of overall private sector credit and 19 percent of private sector credit to businesses (Table 11). At the same point in 2011, the ratios were 10 percent and 27 percent respectively. This change illustrates that while overall private sector credit to corporations has grown, loans have become less concentrated to individual companies.

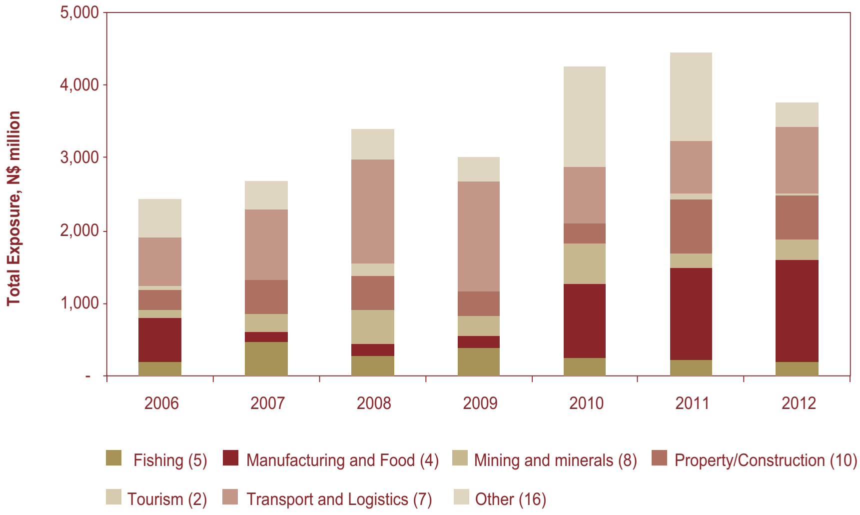
Table 11: Large Exposures

	2006	2007	2008	2009	2010	2011	2012
Total Largest Exposures	2 427	2 665	3 400	3 001	4 263	4 440	3 765
Total Private Sector Credit (PSC)	26 538	30 100	34 241	37 751	41 838	44 575	52 030
PSC to Businesses	8 148	9 976	11 210	13 155	15 013	16 411	20 049
Large Exposures to PSC	9%	9%	10%	8%	10%	10%	7%
Large Exposures to Business PSC	30%	27%	30%	23%	28%	27%	19%

Source: Bank of Namibia

Significant concentration remains in loans to the manufacturing and food sector, which make up approximately 37.5 percent of total large loans by the commercial banking institutions, despite the overall fall in total large exposures (Figure 14). Similarly, the total exposure to the transport and logistics sector was sizable, at 24.2 percent of the total large exposure to commercial banking institutions. The manufacturing and food and transport and logistics sectors have increased in overall share of total large exposures over the past year, increasing from 28.5 and 16.2 percent of the total, respectively. On the other hand, the third largest category, that of property and construction, has shrunk somewhat in terms of total share of large exposures, from 17.1 to 15.8 percent.

Figure 14: Large Exposures by Category



Source: Bank of Namibia

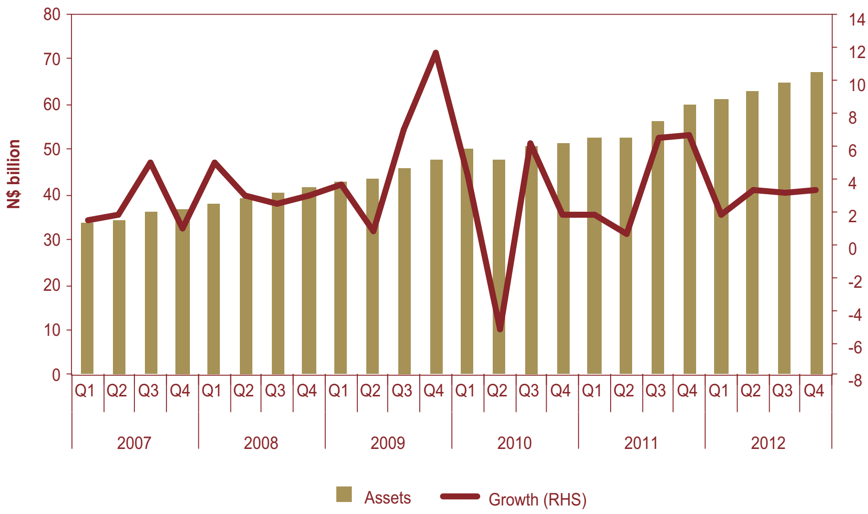
V. PERFORMANCE OF THE BANKING SECTOR

The Namibian banking sector is dominated by four major banking institutions, three of which are locally authorised subsidiaries of South African holding companies. Together, the four banking institutions account for almost 100 percent of banking assets and deposits. This makes the sector highly concentrated with a HHI concentration index of 2 705 points in December 2012, albeit down from 2727 points in June 2012, whereas 1 000 points is considered as competitive.

Balance Sheet Structure

Both the upward trend in the total assets of the banking sector and the concentration in the residential mortgage asset class continued in the second half of 2012 (Figure 15). The total assets of the banking sector grew by 6.6 percent during the second half of 2012, as compared to 4.9 percent during the first half of the year. The major contributor to the growth resulted from an 8.9 percent increase in net loans and advances. Of the lending categories, residential mortgages and instalments debt, comprising 41.0 percent and 15.8 percent of total loans and advances, respectively, grew by 7.8 percent and 5.8 percent. The lending to residential mortgages increased faster than the total advances of the banking institutions, while instalments debt rose more slowly.

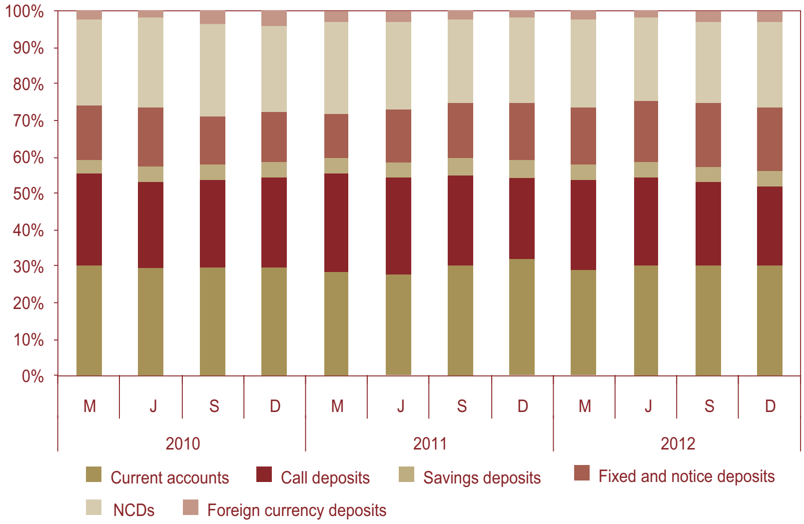
Figure 15: Banking Sector Assets and Growth Rate



Source: Bank of Namibia

Non-bank funding (i.e., deposits) drove growth on the liability side. Deposits grew by 5.1 percent and represented 93.9 percent of total funding-related liabilities during the period. Most of the growth emanated from the current accounts and negotiable certificates of deposit, which, respectively, rose by 5.1 percent and 8.4 percent, and accounted for 30.0 percent and 23.3 percent of total deposits, respectively (Figure 16). Call accounts, comprising 21.7 percent of total deposits, declined by 6.3 percent.

Figure 16: Composition of Banking Institution Deposits

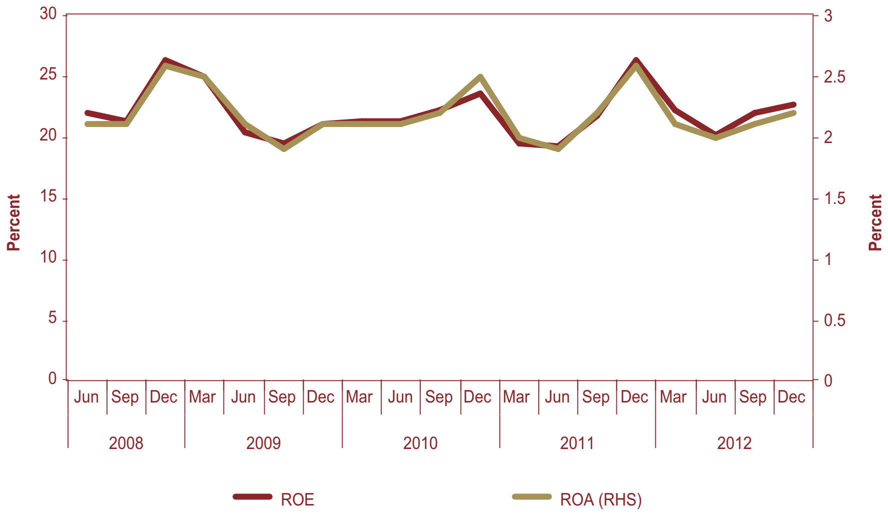


Source: Bank of Namibia

Earnings and Profitability

In contrast to the first half of 2012, the earnings of the banking sector rose in the second half of 2012 and profitability indicators remained relatively high by international standards. During the period, net interest income to gross income (total income) fell from 55.7 percent to 55.5 percent, while non-interest (other operating) expenses to gross income fell more from 61.4 percent to 56.6 percent. Consequently, total income rose by 12.4 percent during the period. This positive performance compares with an income decline of 0.5 percent registered between December 2011 and June 2012. As a result of the increase in income, the sector's profitability as measured by ROA and ROE rose from 2.0 and 20.2 percent at the end of June 2012, respectively, to 2.2 percent and 22.7 percent at the end of December 2012 (Figure 17). Accordingly, the ROA and ROE remained high by international standards.

Figure 17: Post-tax Return on Assets and Return on Equity



Source: Bank of Namibia

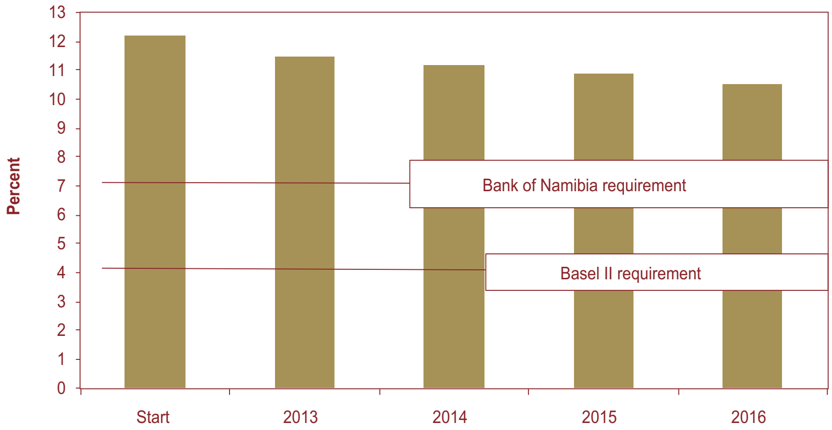
Capitalisation

During the second half of 2012, the banking sector improved its capital adequacy, supported by retained earnings, although this performance was restrained by an increase in risk-weighted assets. The risk-weighted capital ratio (RWCR) rose slightly from 14.5 percent at the end of June 2012 to 14.6 percent at the end of December 2012, while Tier 1 risk-based capital ratio fell marginally from 11.5 percent to 11.2 percent during the same period. The ruling supervisory minima for the RWCR and Tier 1 capital remained at 10.0 percent and 7.0 percent, respectively.

Stress Testing for Capital Adequacy

Stress test scenarios were conducted to examine the extent to which the 'first' capital buffer (Core Tier 1 capital) would be able to withstand an increase in credit risk in the form of an increase in default rates. The tests were conducted on the four main commercial banking institutions in the economy (see Appendix for methodology). The result is presented in Figures 18 below.

Figure 18: Results of Core Tier 1 Ratio after shock administered, on an aggregate level



Source: Bank of Namibia

For financial data as at December 2012, the stress test exercise indicates that banking institutions are adequately capitalised in the event of an upsurge in the default rate of sectors to which they are exposed. The model links credit risk to the expected losses by trends in Probability of Default (PD) and Loss Given Default (LGD) for various sectors of the economy. Thus, given a commercial banking institution's exposures, the model shocks default rates originating from each sector to which it is exposed. These rates are combined with balance sheet data, income statements and capital returns in order to get an estimate of the institutions regulatory capital level. The data used for the exercise is confidential; the results do not identify a specific banking institution. The Bank of Namibia requires the banking institutions to carry higher capital buffers than expected by the Basel II qualifications. As such, it is foreseen that they are better prepared to absorb shocks to their balance sheets.

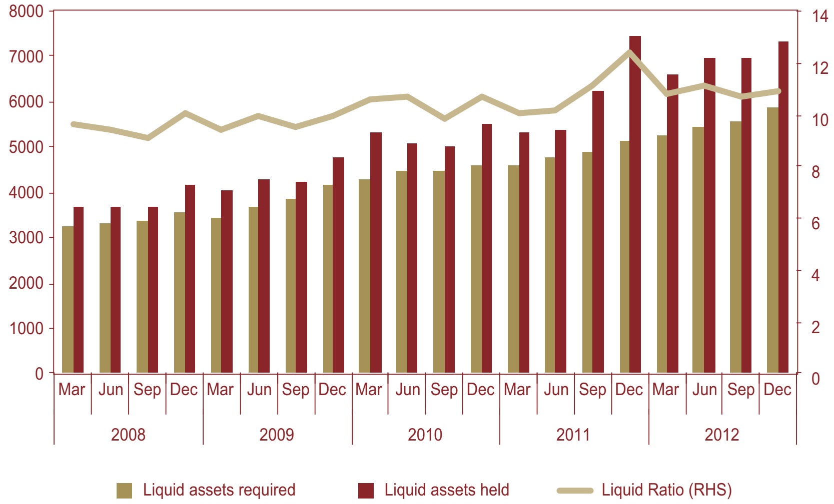
Liquidity

The banking sector continued to meet regulatory liquidity requirements, while the composition of liquid assets remained broadly unchanged during the second half of 2012. The ratio of liquid assets to average total liabilities to the public, one of the two core indicators of financial soundness, declined marginally from 11.1 percent at the end of the first half of 2012 to 10.9 percent at the end of the second half of 2012, but remained above the 10.0 percent requirement level (Figure 19).

In addition, the banking sector comfortably met the regulatory minimum asset holding requirements[11] with an average excess stock of N$1.5 billion (or 21.1 percent) during the second half of 2012. The structure of liquid assets remained almost unchanged between June 2012 and December 2012 (Figure 20). The highest liquid asset class remained the Government Treasury Bills, at 53.9 percent of total liquid assets as at end-December 2012, compared to a level of 53.4 percent at end- June 2012.

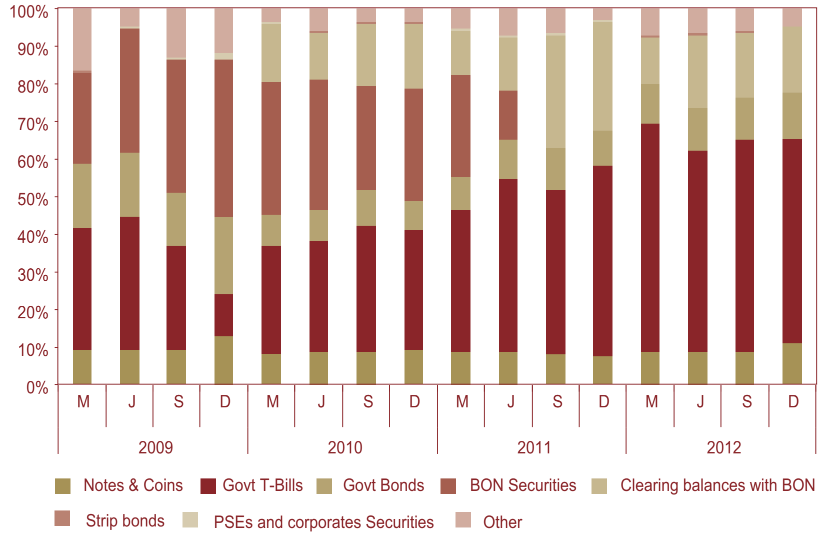
[11] The minimum asset holding requirement is 10 percent of average total liabilities

Figure 19: Liquid Assets and Liquidity Ratio



Source: Bank of Namibia

Figure 20: Structure/Composition of Liquid Assets

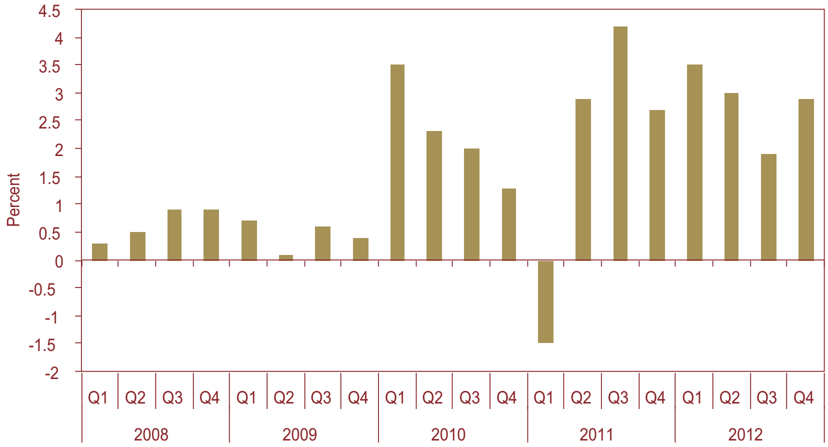


Source: Bank of Namibia

Foreign Exchange Risk

The net open position was sufficient to shield the banking sector against adverse movements in foreign exchange rates in the second half of 2012. The ratio of mismatches, or net open position, of foreign currency assets and liabilities to capital in the banking sector rose marginally from 2.7 percent at the end of June 2012 to 2.9 percent at the end of December 2012 (Figure 21). Tier 1 capital improved by 0.4 percent and net open position rose by 6.5 percent, resulting in a rise of the ratio. Despite the increase, the ratio still remained significantly below the regulatory limit of 20 percent.

Figure 21: Net Open Position as percent of Tier-1 capital



Source: Bank of Namibia

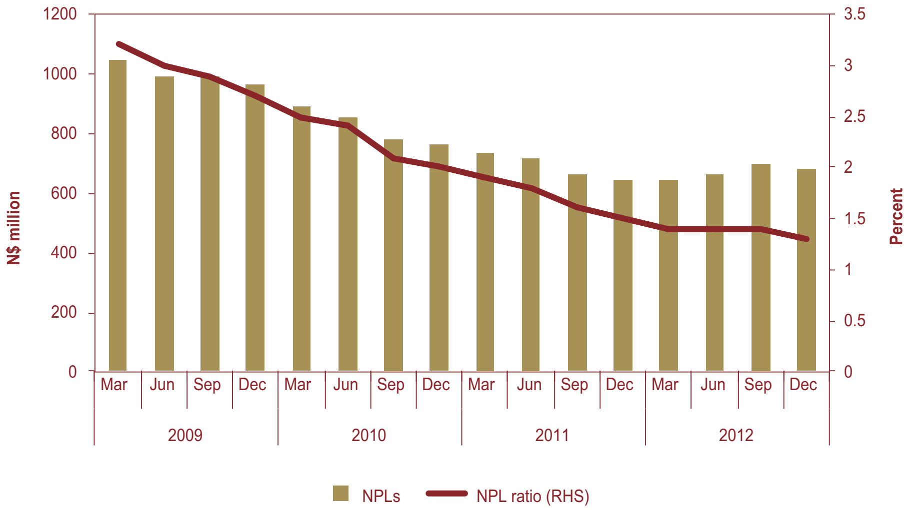
Interest Rate Risk[12]

The banking sector continued to face limited danger of a loss in interest income or qualifying capital funds that could result from adverse movements in interest rates, as per the assessments by the Bank of Namibia. As of end-December 2012, simulation results showed that if interest rates were to decline by 200 basis points, the cumulative impact on banking institutions' net interest income over the following 12 months would be a decline of about N$262.5 million, as at end December 2012. This would translate into a decline of N$56.5 million in the economic value of the equity of the banking industry or, equivalently, 0.8 percent of the industry's capital funds. Conversely, a rise in interest rate of a similar magnitude would lead to an N$262.5 million and N$56.5 million increase in net interest income and equity, respectively. The impact of interest rate movements on banking institutions' balance sheets and profit and loss statements are thus relatively limited.

Credit Risk

Notwithstanding a high loan concentration in mortgages, the quality of the banking assets improved, as credit risk continued to decline. Credit risk remained the greatest risk on the asset side of the banking balance sheet, with lending to the private sector averaging 77.4 percent of banking assets during the second half of 2012. However, the proportion of non-performing loans (NPLs) to total loans continued to trend downwards, falling, albeit slightly, from 1.4 percent at the end of June 2012 to 1.3 percent at the end of December 2012 (Figure 22).

Figure 22: Banking Asset Quality

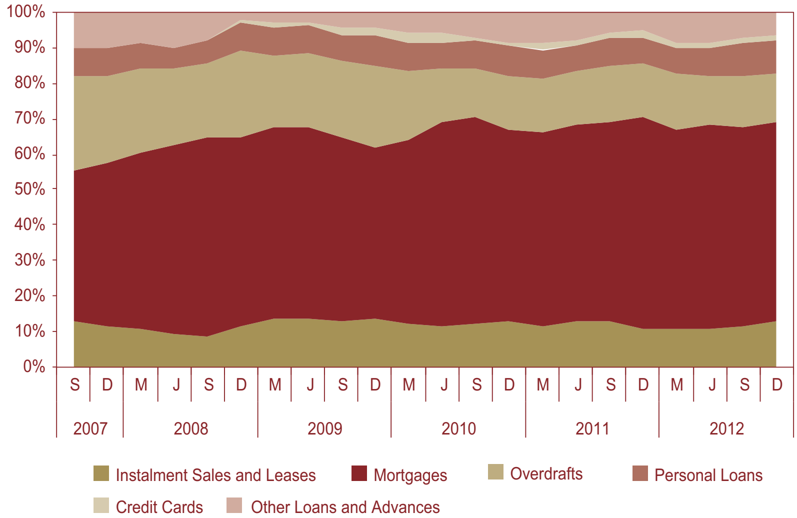


Source: Bank of Namibia

[12] Interest rate risk measures the interest-sensitivity of assets and liabilities to changes in interest rates.

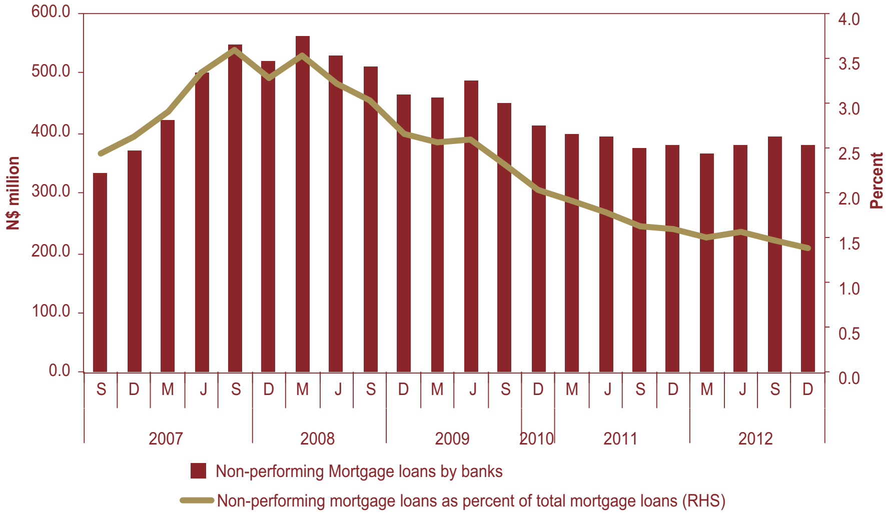
A reduction in non-performing mortgage loans, which made up 56.2 percent of total NPLs during the period, was the major cause of a fall in the NPL ratio (Figure 23 and Figure 24). The low interest rate environment, prevailing since January 2009, presumably improved the ability of bank borrowers' to meet interest and amortisation payment obligations on their loans. Although the proportion of non-performing loans, net of provisions, to total qualifying capital ticked up slightly from 0.7 percent at the end of the first half of 2012 to 0.8 percent at the end of the second half of 2012, it continued to be very low by international standards.

Figure 23: Non-Performing Loans by Category



Source: Bank of Namibia

Figure 24: Non-performing Mortgage Loans



Source: Bank of Namibia

Box Article I: The Namibian Housing Market

Introduction

The box article provides a synopsis of the main findings of two studies which were carried out by the Bank of Namibia (2011) and IMF (2012) to assess the existence and ascertain the extent of house price misalignment in the Namibian property market, so as to establish whether house prices are rooted, or not, in fundamentals. Rising property prices is a concern for policy makers given that high residential property prices not aligned to fundamentals could pose risks to financial stability and the economy at large. In Namibia, this becomes critical given that the banking industry is highly exposed to mortgage loans, which constitute almost half of the total loans extended.

Property Price Developments

Since the turn of the millennium, house prices grew rapidly in Namibia. The average price of residential properties financed by First National Bank (FNB) increased from N$199,670 in 2000 to N$782,122 during 2010, translating into an average growth rate of 14.7 percent per annum, outpacing the inflation rate which averaged 4.5 percent over the same period. The growth in residential property prices has not only resulted in housing unaffordability challenges for the majority of the Namibian people, but also is a potential risk to financial stability. For instance, with an average house price of N$720 000, at a mortgage rate of 10.25 percent and a repayment period of 20 years, the monthly repayment is N$7068. When the 1/3 principle[13] is applied, an individual would have to earn a monthly gross income of N$21 204 to be able to afford such a property (Table 1). The above case raises three main questions: (a) are residential property prices in Namibia overvalued? (b) What are the main causes of such steep price increases? (c) What tools are available to policy makers to not only arrest the steep increases, but to also ensure that the risks to price stability are minimised without a sharp correction?

Table 1: Mortgage instalments

Mortgage rate	Bond value		
	N$500,000	N$750,000	N$1,500,000
7.5	4,028	6,042	12,084
9.5	4,661	6,991	13,982
11.5	5,332	7,998	15,996
13.5	6,037	9,055	18,111
15.5	6,770	10,154	20,308

Are residential property prices overvalued/is there a price misalignment?

Studies conducted by the Bank of Namibia and the IMF revealed that the escalation in property prices could mainly be explained by fundamentals, although there have been signs of overvaluation since 2010. The studies arrived at this conclusion by using regression analysis, which included variables such as real GDP per capita, real mortgage interest rates, and real mortgage credit extension as proxies for economic fundaments. The IMF study showed that from October 2010 onwards, there was evidence which suggests that *"residential property prices were higher than fundamental-based prices"*. That is, residential property prices showed signs of overvaluation during recent years. The BoN study, on the other hand, could not, with the evidence presented, confidently reject the null hypothesis that residential property prices were not explained by fundamentals. Nonetheless, the BoN study cautioned that such a conclusion should be treated with care given data limitation and the difficulty in identifying a price bubble *a priori* as shown by literature.

From a financial stability point, the balance of evidence suggests that banking institutions' exposure to the real estate market does not, in and of itself, pose a significant threat to financial stability. Nonetheless, close monitoring is required for the following reasons: Firstly, the extent of the banking institutions exposure to the housing market is significant, with mortgages

[13] As a rule of thumb, banking institutions will issue mortgage loans for which the repayment cost is not greater than 1/3rd of the client's gross monthly income.

representing some 55 percent of total loans to the private sector in the banking institutions' balance sheets. Secondly, a reversal in the levels of mortgage rates from the existing historical low rates could adversely affect people's ability to pay. At the same time, the banking sector can suffer considerable losses in the form of declines in collateral values, if house prices decline significantly. However, the capital adequacy of the local banking sector remains sound considering the 50 percent risk weight assigned to mortgage loans. The risk-weighted capital adequacy ratio for the Namibian banking sector stood at 14.6 percent, higher than the Basel II requirements of 10 percent.

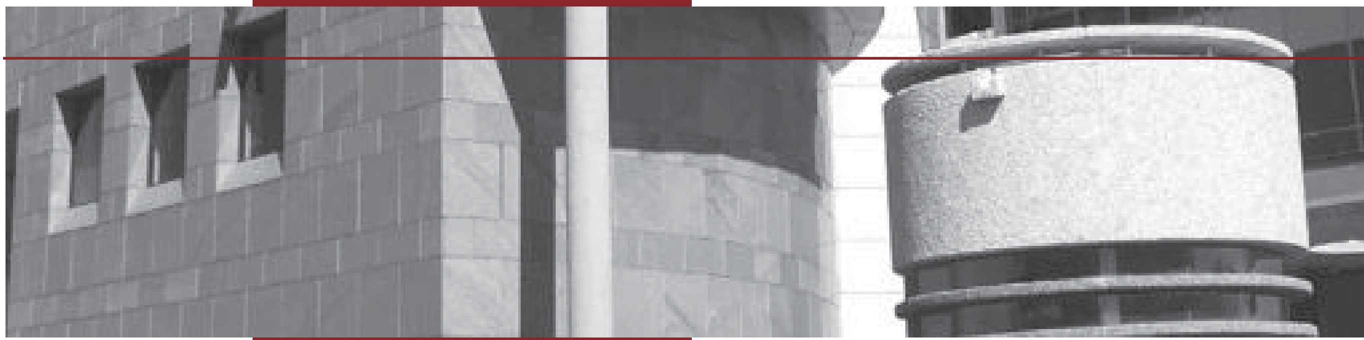
Determinants of Residential Property Prices

The steep escalation in residential property prices can be attributed to both demand and supply factors. On the demand side, important factors include the increasing urbanisation trends and the impact of high income earners. Supply side factors include unavailability/shortage of serviced land; increases in the costs of building materials; the use of auctions by local authorities to distribute land and the historically low interest rates. All these factors have and could still further support further escalation in residential prices.

Conclusion and Policy Recommendations

The studies reached a number of conclusions regarding the potential impact of the current trend of residential property prices on financial stability. The BoN study concluded that the empirical results provided little evidence for concern at this point. Also, whilst the risk of default could not be ruled out, the risk of major financial losses to banking institutions from a series of extended interest rate hikes appears minimal, given the existing capital buffers of the local financial intermediaries. The IMF study identified some level of overvaluation in the prices and made the following policy recommendations:

- Close monitoring of the financial system's exposure to mortgage loans and loan guarantees through periodic stress testing,
- Continued encouragement of banking institutions to augment their capital buffers, and
- Identify measures aimed at increasing the availability of serviced land.



VI. PERFORMANCE OF THE NON-BANKING FINANCIAL SECTOR

Non-bank financial institutions (NBFI) play an important role in the intermediation of savings of individuals and corporations. Their stock of assets--most of which are administered by assets managers--is marginally higher than the country's annual nominal GDP, or about 1.5 times the size of the money supply in Namibia (Table 11 and Figure 25). NBFIs, through their asset managers, allocate most of their financial resources in domestic and other CMA financial markets; only a small share of total resources is invested beyond the CMA's boundaries (Table 12). Data indicate that NBFIs' investment managers hold the bulk of their assets in short-term (money market) and listed equity holdings (Table 13). Unlisted debt, equity, and other investment vehicles held by asset managers have been on the rise in recent years—albeit from a low base—reflecting incoming regulatory requirement of investing 5 percent of the required locally invested funds (35 percent of total funds) in unlisted securities[14]. Notably, the increase in money market and listed NBIs' asset holdings has been a function of strong growth in unit trust schemes, while the asset value growth of pension funds and long-term insurance companies has been due to solid performances in stock exchanges and fixed income markets and not because of rising investment flows.

Table 11: Sources of Funds by Type of Institution 1/ 2/

	Dec. 2010 (N$ millions)	Dec. 2011	Sept. 2011	Sept. 2012
Pension Funds	47 574	50 977	47 184	57 433
Short-term insurance companies	686	783	750	787
Long-term insurance companies	12 822	13 757	13 081	15 344
Medical aid funds	288	321	311	339
Unit trust schemes	22 333	22 878	21 650	25 736
Mgt. Companies	406	532	403	493
Natural persons	5	9	8	23
Other	1 941	2 408	2 192	2 555
Total Funds	**86 055**	**91 665**	**85 579**	**102 709**
(In percent of total funds)				
Pension Funds	55.3	55.6	55.1	55.9
Short-term insurance companies	0.8	0.9	0.9	0.8
Long-term insurance companies	14.9	15.0	15.3	14.9
Medical aid funds	0.3	0.4	0.4	0.3
Unit trust schemes	26.0	25.0	25.3	25.1
Mgt. Companies	0.5	0.6	0.5	0.5
Natural persons	0.0	0.0	0.0	0.0
Other	2.3	2.6	2.6	2.5
Total Funds	**100.0**	**100.0**	**100.0**	**100.0**
Memo item:				
Nominal GDP (end-year; N$ billions)	81 136	90 842		
Total Funds/GDP (percent)	106	101		

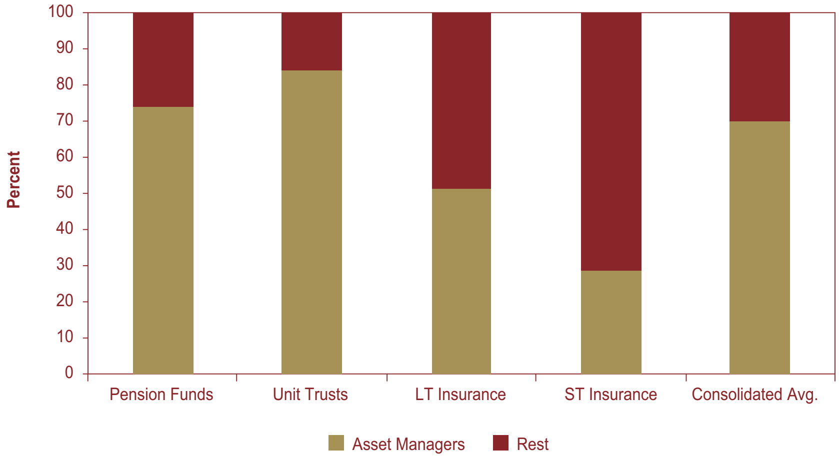
1/ Refers to total funds under investment management

2/ Data exclude asset management being done by management companies in terms of the Unit Trust Control Act.

Source: NAMFISA

[14] This implies that 1.75 percent of total funds under management must be invested in unlisted assets.

Figure 25: Asset Allocation between Asset Managers and Other (% of Total)



Source: NAMFISA

Table 12: Asset Allocation per Region 1/

	Dec. 2010 (N$ millions)	Dec. 2011 (percent)	Sept. 2012	Avg. share
Namibia	45 509	46 386	52 495	51.5
CMA	32 145	35 061	38 432	37.7
Offshore	8 400	10 218	11 783	10.8
Total Assets	**86 054**	**91 665**	**102 709**	**100.0**

1/ Refers to total funds under investment management

Source: NAMFISA

Table 13: Asset Allocation by Instrument 1/

	Dec. 2010	Dec. 2011	Sept. 2012
(N$ billion)			
Money Market	28.1	30.2	33.3
Listed Equity	38.7	42.6	48.0
Listed Debt	11.0	13.3	15.2
Unlisted Equity	0.6	1.0	1.1
Unlisted Debt	0.4	0.2	0.2
Unlisted Investment	0.3	0.0	0.4
Other Assets	4.7	4.4	4.5
Total Assets	**83.8**	**91.7**	**102.7**
(In percent of total assets)			
Money Market	33.5	32.9	32.5
Listed Equity	46.2	46.5	46.7
Listed Debt	13.1	14.5	14.8
Unlisted Equity	0.7	1.1	1.1
Unlisted Debt	0.5	0.2	0.2
Unlisted Investment	0.4	0.0	0.4
Other Assets	5.6	4.8	4.3
Total Assets	**100.0**	**100.0**	**100.0**

1/Refers to total funds under investment management

Source: NAMFISA

Available information suggests a number of economic and financial challenges confronting the non-banks in an environment of low external and domestic interest rates. Namibia's NBFIs are net creditors vis-à-vis the rest of the world (i.e., have positive net foreign asset positions) and, therefore, face significant exposed to financial stress in regional (CMA) and global financial markets. On the domestic front, the requirement for Pension Funds (and insurance companies) to invest up to 35 percent of their funds in local assets may have also become more challenging in the current environment of significantly reduced interest rates and shallow capital markets (Table 13).[15] Also, in the case of the GIPF, pension funds' contributions received are only marginally higher than net transfers and defined-benefits paid, possibly heightening a structural problem in terms of available institutional savings, as the domestic labor force ages over the coming decades (Table 14).

[15] The 35 percent local investment requirement for Pension Funds, as stipulated in Regulation 28, also takes into account for dual listed stocks (i.e. those that are dual listed on the JSE & NSX), thus it gives indirect access to the South African Capital Market .

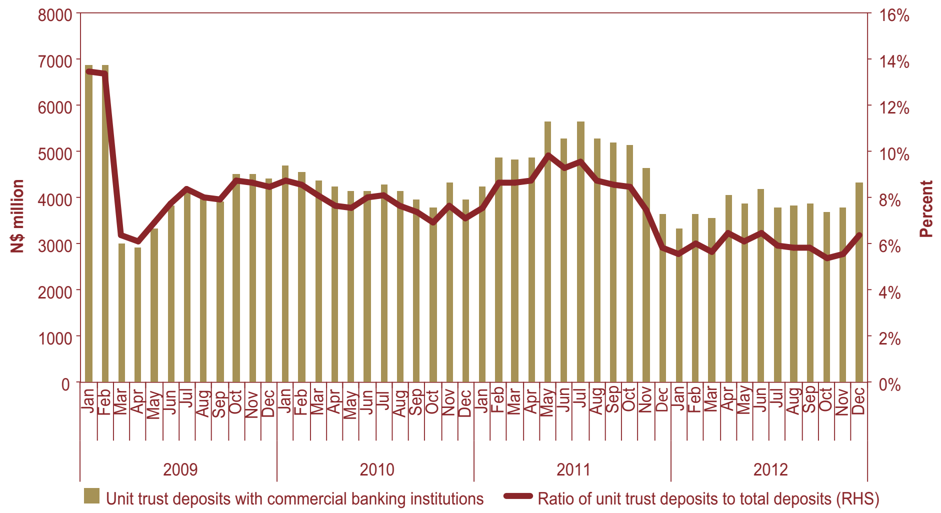
Table 14: Pension Funds Income Statement 2009 – 2011 (N$ billion)

	2009	2010	2011
Total Income	10.4	8.5	8.7
o/w: Net investment income	7.0	4.6	4.9
Contributions received	…	2.9	3.1
Total Adm. Expenses	0.5	0.6	0.6
Net Income	**9.9**	**7.9**	**8.1**
Net transfers and benefits paid	2.1	2.6	2.3
Net Income (after transfers & benefits)	**7.8**	**5.3**	**5.8**

Source: NAMFISA Annual Report 2011

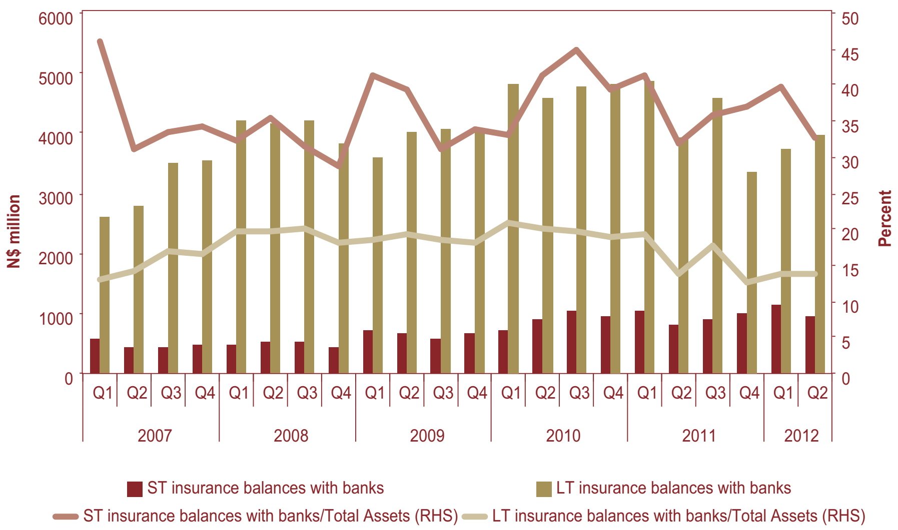
From the point of view of systemic risk, there is limited contagion risk from NBFI's to commercial banking institutions, however what risk exists is as a result of investments by NBFI's held in cash with commercial banking institutions. Cash from NBFI investments held by commercial banking institutions are an important source of liquidity for these institutions, without which liquidity challenges would exists. As of end-December 2012, unit trust deposits with commercial banking institutions made up approximately 6.3 percent of total deposits, totaling over N$4.3 billion (Figure 26) while deposits from the insurance sector amounted to approximately N$ 5 billion as of end- September 2012 (Figure 27).

Figure 26: Unit trust deposits with banking institutions

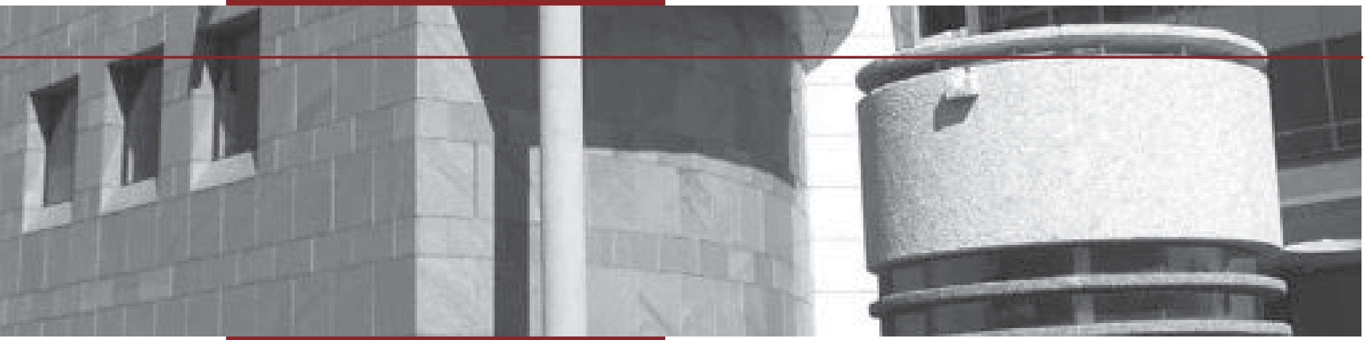


Source: NAMFISA

Figure 27: Insurance sector deposits with commercial banking institutions



Source: NAMFISA



VII. PAYMENTS INFRASTRUCTURE AND REGULATORY DEVELOPMENTS

Introduction

A disturbance to the smooth function of the payment system could trigger financial and economic disturbances, thus warranting an assessment of risks to the system. The payment and settlement systems facilitate trade in goods and services and transactions in financial assets. Hence, disruptions to the payment systems have the capacity to transmit shocks and trigger widespread financial and economic disturbances. Therefore, an assessment of the safety and soundness of payment and settlement systems is important for the evaluation of risks to financial stability.

Key Trends in Payment and Settlement Systems

The current payments and settlement infrastructure in Namibia comprises of four main components: 1) the Namibia Interbank Settlement System (NISS), 2) the Electronic Funds Transfer (EFT) System, 3) Cheque Processing System (CPS), and 4) NamSwitch System (Table 15). This section describes recent trends in the NISS, EFT, CPS and NamSwitch components.

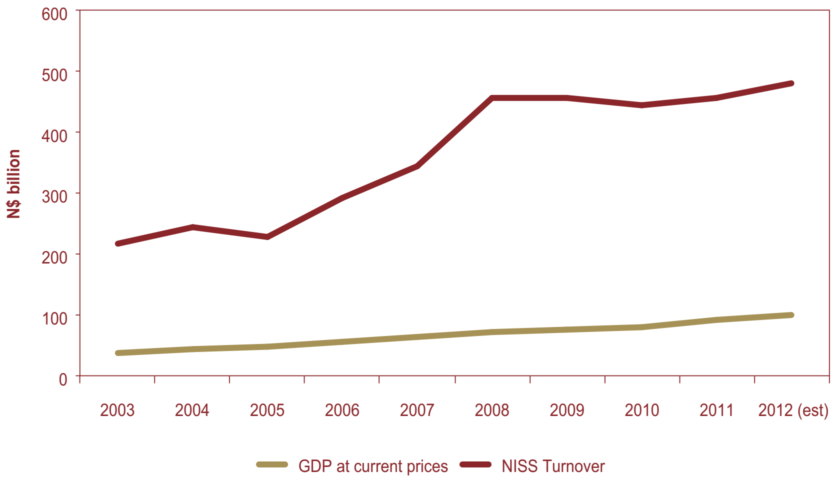
Table 15: Payment and Settlement Systems

System		Description	Owner/Operator
High Value	Namibia Interbank Settlement System (NISS)	Primarily used to ensure real-time gross settlement in Namibia dollar for the Bank of Namibia monetary policy operations, large-value interbank payments, final settlement or netting of other payment systems operating in Namibia and urgent customer payments.	Bank of Namibia
Retail	Electronic Funds Transfer (EFT) System	Supports low-value (EFT Debit maximum value of N$ 500 000 and EFT Credit maximum value of N$ 5 million) interbank electronic payments.	The three retail systems are owned by four commercial banks, which established a company, NamClear, to manage its operations.
	Code Line Clearing (CLC) System	Supports interbank cheque payments (maximum value of N$ 500 000).	
	NamSwitch System	Supports domestic interbank card payments.	

Source: Bank of Namibia

An indicator of the importance of the settlement systems for the national economy is the value of payments settled through these systems. The NISS turnover to GDP ratio is relatively large in Namibia compared to other countries, which could be attributed to the relatively high level of financial deepening (Figure 28).

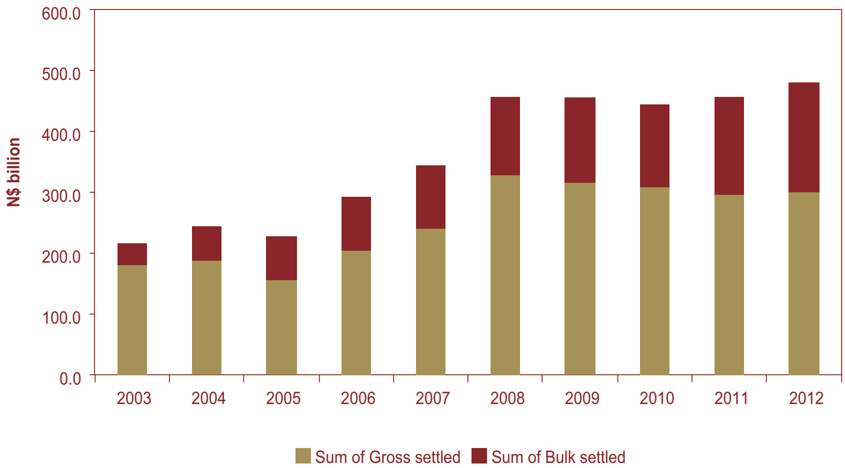
Figure 28: GDP and NISS turnover



Source: Bank of Namibia

NISS payments during the last half of 2012 increased compared to the previous period. NISS payments during the second half of 2012 averaged 4 298 payments per month settled, at a total value of N$256 billion. The value of payments settled in NISS increased by 7% in the second half of 2012 compared to the same period in 2011 and the number of payments decreased by 1%. The share of gross payment[16] value reached 62.6% in NISS and that of final settlement of ancillary systems[17] in NISS stood at 37.4% in terms of value (Figure 29).

Figure 29: Value of Payments Processed in NISS



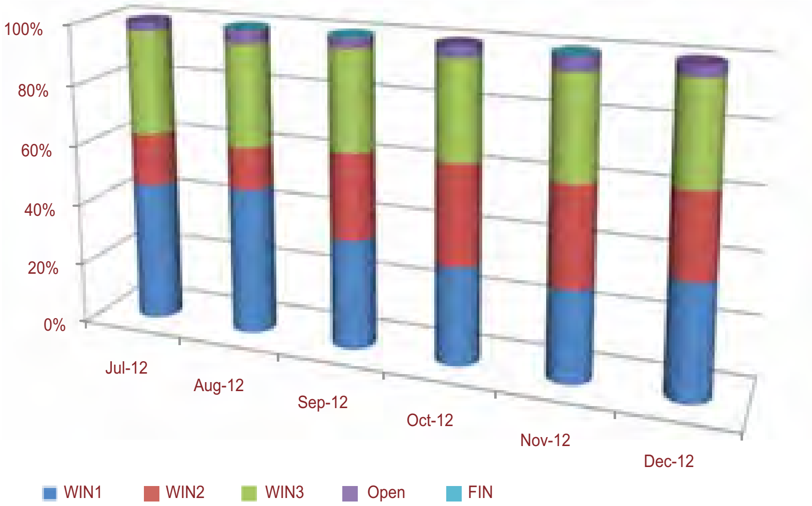
Source: Bank of Namibia

Settlement Windows

Operational and settlement risks remain as summarized by the relatively large amount of payments settled late in the day. Settlement window periods for payments submitted and processed daily indicate that around 38 percent, or N$96 billion in payments, was settled in Window 1 (08h00 to 12h00 hours); 25 percent or N$64 billion in Window 2 (12h00 to 15h00 hours) and 33 percent or N$84 billion in Window 3 (15h00 to 16h40 hours). The expectation before the early square-off was implemented was to have the largest portion of settlement to take place in Windows 1 and 2. However, as shown in Figure 30 below, a third of the settlement in value terms is undertaken during Window 3. Having a lot of transactions settled late in the day heightens operational risk to the Namibian payment system. A failure in the system at such point, does not give sufficient time to resolve the problem. As such, those transactions disrupted may not be settled on the exact date intended.

[16] Interbank and customer payments
[17] The EFT, Cheque and NamSwitch systems.

Figure 30: Values Settled Per Settlement Window

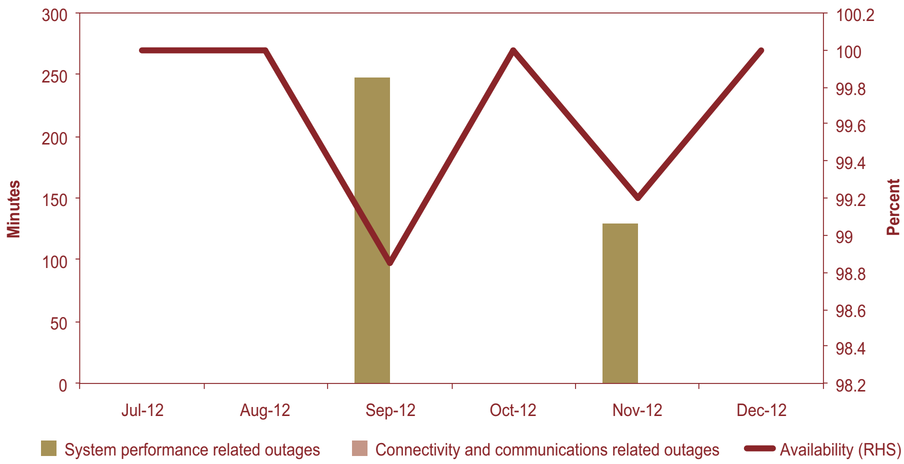


Source: Bank of Namibia

Disruptions to the System

Disruptions to the system were recorded over the last half of 2012, but did not pose any threat to financial stability. The system experienced 2 operational failures[18] and, overall, the NISS was not available for 6 hours and 18 minutes (Figure 31). The failures where temporary and were overcome within a reasonable period of time and posed no threat to Namibia's financial stability. The failures related to an inappropriately applied change management processes which impacted the availability of NISS and created problems with the settlement file. However, the availability of NISS was still above the accepted availability level of 98.5%.

Figure 31: System Performance Outages



Source: Bank of Namibia

Security of Retail Payments

Total card fraud per transaction type varied over the period under review. Forged or counterfeit fraud accounted for 54 percent of the total fraud, while the share of card-not-present (CNP) fraud accounted for 38 percent and card identity theft and lost or stolen card accounted for 5 percent and 3 percent, respectively. There are no significant differences from the past regarding the transaction channels used by fraudsters. Fraud acquired at the ATMs accounted for 32 percent of total fraud, while the share of card-not-present (CNP) fraud accounted for 39 percent and the share of point-of-sale (POS) fraud accounted for 29 percent.

[18] The longest lasted 4 hours and 10 minutes

Overall card fraud losses have remained negligible, accounting for 0.16 percent of total value of retail card payment transactions in the second half of 2012. As online transactions and e-commerce volumes continue to rise, it is clear that CNP fraud might become more relevant in the future. This conclusion is supported by the fact that CNP fraud has not yet benefited from measures such as Europay-MasterCard-Visa (EMV) migration, which is aimed at fighting fraud at ATMs and POS terminals. Industry wide migration to the EMV standards commenced in earnest during 2012.

Future Developments in Payment and Settlement Systems

There are developments underway to increase transparency in the way the payments and settlement system is operated and to reduce risks associated with outstanding regulatory gaps. A framework which defines the eligibility of prospective players will be gazetted during the course of the first quarter of 2013. Additionally, a prospective study will assess the costs of obtaining accurate and up-to-date information for paper-based and electronic-based payment methods. This information should assist the Bank of Namibia in transiting towards complete electronic payment transacting and determining the efficiency of the national payments systems.

Box Article II: A Look at Loan-to-Value Ratios as a Macroprudential Policy Tool

Introduction

Macroprudential policy is seen as policy aimed at maintaining financial stability by focusing on the risks arising primarily within the financial system or risks amplified by the financial system (IMF, 2011). There is an array of macroprudential tools available to the central bank to use in its goal to maintain stability. One such tool employed world-wide is loan-to-value (LTV) ratios in the mortgage segment of the market as a means to minimise risk.

In line with the purpose of the Financial Stability Report, (Bank of Namibia, 2012), this box article will introduce the concept of loan-to-value (LTV) ratios, as a way to monitor risk to the financial system based on experience from other countries[19]. The LTV ratio is a financial term used by commercial lenders to express the ratio of a loan underwritten to a value of an asset purchased.

Background: The Namibian Housing Market

The housing prices in Namibia increased significantly during the last decade, prompting the Bank of Namibia to introduce the Banking Institution Guideline No.1 (BIG-1). The Bank of Namibia through its Banking Supervision Department introduced a guideline to the banking industry, BIG-1, in May 2010 as a measure aimed at safeguarding financial stability.

The regulatory limit introduced through the BIG-1 is applicable in cases where there is a sale of land (serviced or unserviced). However, transactions involving the purchasing or improvements of existing residential properties and new buildings are excluded. As shown in Table 1, LTV ratios are not applicable when purchasing or making improvements on existing residential properties and constructing a building. The guideline emphasizes that an assessment on a property should be detailed and physically undertaken (both inside and outside of the property).

Table 1: Regulatory Limits regarding LTV

Loan Category[20]	LTV limits (%)
Unserviced land and land development	60
Serviced land	70
Construction or erecting building	100
Purchasing of existing property	100
Improvement of existing property	100

Source: Bank of Namibia

19 The focus is on Hong Kong SAR, Denmark and Peru.
20 Where banking institutions grant the loan amount above the regulatory limit, such exposure will be risk-weighted at 100% instead of 50%

The International Experience: Macroprudential Policy as Employed in the Housing Market

Countries around the world currently face surges in residential property prices, with the tools available to policymakers varying depending of the country's monetary regime. Countries with currency boards (e.g. Hong Kong SAR), pegs, and/or dollarized economies (e.g. Peru) are generally responding to housing inflation through the use of macro-prudential policies. By contrast, countries with independent monetary policy frameworks have, at times, used standard interest rate hikes to complement macro-prudential policies in their fight against housing inflation and rapidly rising financial institutions mortgage lending.

The experiences of Hong Kong (a currency board) and Peru (a partially dollarized economy) are possibly important benchmarks for Namibia for addressing the property market's volume of transactions, housing inflation, the growth of mortgage lending, and correlation between price surges in different types of residential properties.

- **In Hong Kong, authorities have used differential caps on loan-to-value (LTV) ratios determined by the type of housing (high-end, small-and/or medium-size flats), combined with tight caps on individuals' debt service to disposable income ratios (Table 2, below).** While these measures are aimed at limiting household leverage in the property sector, they also managed to limit access to external financing and reduced foreign demand by Mainland Chinese residents buying high-end properties in Hong Kong. Further, statistical analysis suggests that the use of LTV caps, especially for high-end properties, has helped arrest inflation in mass housing markets that usually follow (with a lag) the market dynamics of the high-end segment.[21]
- Hong Kong has complemented its macro-prudential initiatives with the introduction of a steep **Special Stamp Duty** (SSD) levied on housing transactions (in an effort to arrest speculative short-term trading of residential properties) and the targeted expansion of **land auctions** for the building of small and mass housing. The statistical evidence regarding the impact of these measures on the housing market is still unknown.

Table 2: Summary of Macroprudential Measures, 2009-2011 (Policy Timeline)

Date	Price Range	LTV cap	Max. Loan Amnt.	Other conditions
Oct 2009	Greater or equal to HK$20mn	Reduced from 70% to 60%		
Aug 2010	Greater or equal to HK$12mn Less than HK$12mn Not owner occupied, any price range	Reduced from 70% to 60% for properties valued btwen HK$12mn & HK$20mn Kept at 70% Reduced from 70% to 60%	 HK$7.2mn	Debt service-to-income ratio capped to 50% for all income groups; also must be set such that were mortgages rates to increase by 200bps, the DTI ratio would not exceed 60%.
Nov 2010	Greater or equal to HK$12mn Greater or equal to HK$8mn and less than HK$12mn Less than HK$8mn Not owner occupied, any price range	Reduced from 60% to 50% Reduced from 70% to 60% Remains at 70% Reduced from 60% to 50%	 HK$6.0mn HK$4.8mn	**Special Stamp Duty** raised to 15% for proprerties sold within 6 months or purchase.
June 2011	Greater or equal to HK$10mn Greater or equal to HK$7mn and less than HK$10 Less than HK$7mn	50% Reduced from 70% to 60% for properties valued between HK$7mn and HK$8mn Remains at HK$70mn		LTV cap lowered by a furhter 10% for borrowers with main income from outside Hong Kong

Source: Safeguarding Banks and Containing Property Booms: Cross-Country Evidence on Macroprudential Policies and Lessons from Hong Kong SAR. IMF Working Paper.

[21] See, for example, Ashvin Ahuja and Malhar Nabar, "Safeguarding Banks and Containing Property Booms: Cross-Country Evidence on Macroprudential Policies and Lessons from Hong Kong SAR," IMF Working Paper WP/11/284, December 2011, 26 pages. See also the Appendix to this note, for a summary of this FSR.

The approach of Peru is to monitor the conditions under which mortgage credit is granted by bank and non-banks financial intermediaries, with emphasis on the LTV caps and the debt service ratios self-imposed by the financial institutions in their lending operations, as well as overall credit ceilings per case and maximum maturity of the loans granted (Table 3, below). Reportedly, financial institutions also use complementary information, such as the job tenure, for example, to assess their financial decisions on mortgage lending. In a dollarized economy like Peru, monitoring of the currency denomination of the underlying lending also takes place.

Table 3: Summary of Mortgage Lending Conditions in Peru

I. Banking institutions	
LTV caps	Range between 80% and 90%
Loan maturity	Up to 30 years
Overall credit ceiling	No limit
Other considerations	1-year job tenure for dependent workers 2-year job tenure for self-employed
II. Non-bank financial intermediaries	
LTV caps	Up to 80%
Loan maturity	Up to 20 years
Overall credit ceiling	Up to US$ 90 000
Other considerations	6-month to 1-year job tenure for dependent workers 5-month to 2-year job tenure for self-employed

Source: Central Bank of Peru, Financial Stability Report, May 2012, pages 20-21

Elaborated frameworks of mortgage financing across the world include Denmark's approach, in which specialized mortgage credit institutions have applied the "balance principle" that imposes strict matching rules between the credit institutions' assets (i.e., mortgage loans) and their liabilities (i.e., mortgage bonds). Each new loan is in principle funded by the issuance of a new mortgage bond of equal size and identical cash flow and maturity characteristics. The proceeds from the sale of the bonds are passed on to the borrower, while interest and principal repayments are passed directly to investors holding the mortgage bonds.[22] The Danish approach[23], however, could be very difficult to apply in a country like Namibia.

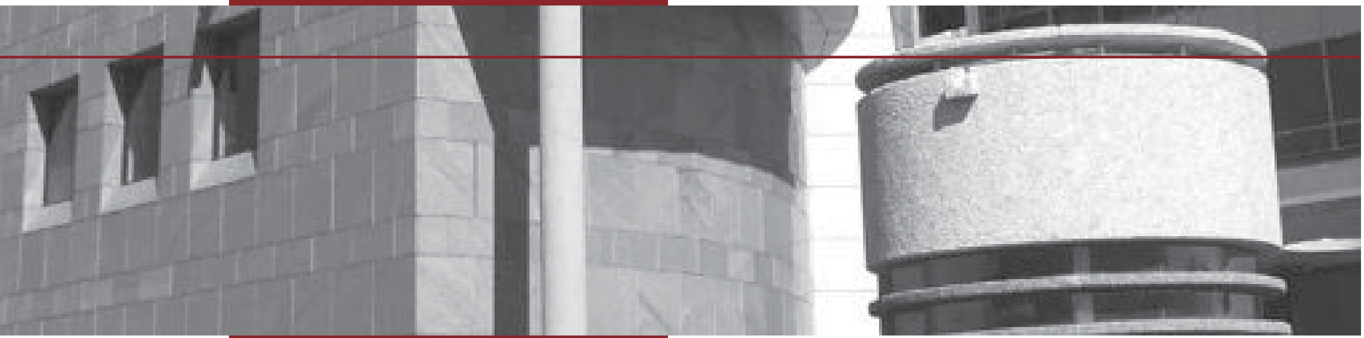
Besides the "balance principle," the Danish mortgage market contains a number of relevant features for the Namibian case:

- Lending rules differ depending on the property financed. Maximum LTV ratios and lending periods are set up for each category of property.
- In assessing the "mortgageable" value of properties, mortgage credit institutions are expected to adopt a conservative approach.
- Properties serving as collateral must be valued on sight.
- Effective land and mortgage registration support the good functioning of the Danish mortgage system.
- Speedy forced sales and repossession procedures add to the efficiency of the Danish mortgage system.
- Strict credit risk management has shielded mortgage bonds from default risk.

The Bank of Namibia notes lessons from countries which have enacted LTV ratios and continues to study the impact of the ratios in different countries and circumstances. The introduction of the use of LTV ratios in the residential mortgage market is a possibility that the Bank of Namibia is considering, and studying various countries has revealed that this can take on varying forms and can be implemented to varying degrees as well.

22 Technical Note on "The Danish Mortgage Market: A Comparative Analysis," FSAP, Denmark, September 2006. See also the Appendix to this paper, for a summary of the paper.

23 In recent years, amendments to the Danish Mortgage Credit Act have relaxed the strict matching requirements imposed on individual loans and bonds, and introduced instead specific requirements on aggregate risks (i.e., interest rate, liquidity, exchange rate and counterpart risk), therefore allowing for enhanced product innovation while maintaining tight asset and liability management constraints.



VIII. CONCLUDING REMARKS AND POLICY RECOMMENDATIONS

Macroeconomic Environment

Since the previous issue of the Financial Stability Report, the global economic rebound remains fragile, although less so than in the first half of 2012. Some improvements were seen in early 2013, following the temporary resolution of the fiscal cliff in the US in late-2012, although the macroeconomic impact from the US spending cuts launched in February 2013, are still being discerned by markets. On the regional front, South Africa's economic prospects remain uncertain given rising domestic and external imbalances, on top of credit rating downgrades in the aftermath of labour unrest and persistent socioeconomic challenges.

Global trade developments have also remained volatile, with the deterioration of international terms of trade registered in the last few years persisting to date. In particular, international commodity prices for uranium have declined further, while food and energy prices remain elevated.

Recommendations

- As noted in the October 2012 FSR, addressing the financial vulnerabilities arising from a weak international environment demands preventive policy actions to limit the build up of systemic financial risks and minimize negative impact on the real sector. In this context, strong policy coordination among the Ministry of Finance, the Bank of Namibia (in its capacity of guardian of the domestic payment system and regulator of domestic banking institutions), and the regulator of non-bank financial intermediaries (NAMFISA) is warranted. Fiscal solvency and the implementation of a sustainable medium-term fiscal consolidation framework is critical to build policy buffers in the event of a prolonged and volatile external environment. Prudential policy by the Bank of Namibia entails system-wide (macro) analysis to identify looming systemic risks, as well as micro prudential policies to guarantee the safety and soundness of commercial banking institutions. Correspondingly, prudential policy by NAMFISA demands a strong safeguarding of the safety and soundness of the nonbank financial institutions to protect their customers.
- Efforts to reduce the current account deficit and increase the country's external position should be pursued, particularly with a focus on addressing an excessively rapid growth of aggregate demand, while promoting export growth and diversification.

Private Sector Debt: Households

Since the last issuance of the FSR in October 2012, private sector debt levels remained high, even though household debt to disposable income declined slightly. The household debt to disposable income ratio declined from 85 percent to 84 percent, while the debt servicing ratio remained unchanged at 21 percent. The indicators are above the regional levels.

Recommendations

- The level of household debt warrants monitoring by the Bank of Namibia and by the country's commercial banking institutions. Both levels of household debt to disposable income and debt servicing ratios are potentially of concern and warrant monitoring; particularly should interest rates increase in the future.
- The Bank of Namibia as Regulator has tools in place to ensure that the local commercial banking institutions measure, monitor and control risks identified. Banking institutions are required to conduct regular stress testing on the impact of possible interest rate shocks on their financial performance. In addition, the Bank of Namibia applies a 50 percent risk-weight to residential mortgage loans

to ensure that banking institutions have an adequate capital buffer to absorb possible losses. At the same time, the Bank is investigating the possibility of the use of the loan-to-value ratio for second properties to contain household leverage. A position paper on this matter is currently under preparation.

Private Sector Debt: Corporations

Preliminary debt figures for 2012 suggest that corporate debt levels have declined somewhat in 2012 as a result of lower levels of foreign debt. Overall, the corporate debt to GDP ratio fell from 44 to 38 percent between 2011 and 2012. However, the sizable decline in foreign debt was largely counteracted by increases in local debt uptake by corporations. Similarly, the total large exposures to commercial banking institutions also declined markedly in 2012, although concentration remains in the food and manufacturing sector of the large exposures, which makes up approximately 37.5 percent of total large exposures.

Recommendations

- Current levels of corporate debt to GDP are acceptable, and the trend of deleveraging is seen as favourable for financial stability, though the correction is business specific (i.e. stronger deleveraging by local representatives of multinational corporations). As such, no immediate action is required, but the situation will be monitored for changes going forward.

Banking Sector

Financial soundness indicators suggest that domestic banking institutions remain liquid, profitable and solvent. The stress testing results for credit risk, further attest to well capitalised commercial banking institutions. Of concern, however, is the concentration of banking assets in mortgage assets.

Recommendations

- Current policies and regulations of the Bank of Namibia remain adequate to ensuring stability in the banking sector. As stated above, the Bank of Namibia applies a 50% risk-weight to residential mortgage loans and 100% risk-weight to commercial real estate loans to ensure that commercial banking institutions have an adequate capital buffer to absorb possible losses. Potential risk, however, may exist in the concentration of loans to mortgages, which warrants continuous monitoring.

Non-Banking Sector

Non-bank financial intermediaries manage relatively large amounts of private sector savings in the economy. While their balance sheets appear to be robust, NBFIs' linkages into the domestic and external economy warrant monitoring. On the domestic front, holdings of unlisted investment vehicles are on the rise, albeit from very low levels, as a result of government regulations. On the external front, NBFIs are creditors vis-à-vis the rest of the world and, therefore, are exposed to financial market contagion from overseas.

Recommendations

- Little can be done to remove the contagion risk from global financial markets domestically, and as such local priority should be to mitigate and manage the risk through the existing prudential regulation framework. For instance, pension funds are required to invest 35 percent of the total assets into domestic assets. This regulation, though originally intended to develop the local domestic capital market, also helps in cushioning pension funds from direct global headwinds.
- NBFIs' allocate large amounts of their financial liabilities in short-term money market instruments. A significant portion of that originates from money market unit trust schemes where fund managers have no choice but to invest in money market instruments. Accordingly, extending the yield curve on government debt could potentially prove a welcome development for the NBFIs, especially pension funds and long-term insurers, while providing a leading indicator to private sector issuance of long-term debt.
- NBFIs (particularly unit trusts) are an important source of liquidity for banking institutions in Namibia, and as such care should be taken to ensure that NBFIs continue to hold deposits with the local commercial banking institutions.

Payments Infrastructure and Regulatory Developments

Payment systems represent a critical part of the financial system, through their role in ensuring that smooth and efficient transaction can take place within the system. Since the last issuance of the Financial Stability Report in October 2012, payments systems witnessed increased use, as well as reduced outages and disruptions.

Recommendations

- Current procedures conform to internationally accepted principles and good practices of payment systems, and should be monitored and maintained to ensure continuation of such.

IX. APPENDICES

A. Macroeconomic Environment

Table 1: Moody's Investor Services ratings[24]

	From	To	From	To
Standard Bank	**1/BFSR**		**Stand Alone Credit Assessment Equiv.**	
	C (stable outlook)	C- (stable outlook)	A3	Baa1
	Local Currency Long-term Deposit Rating			
	A2 (negative outlook)	A3 (negative outlook)		
	Local Currency Short-term Deposit Rating			
	P-1	P-2		
	Foreign Currency Long-term Deposit Rating			
	A3 (negative outlook)	Baa1 (negative outlook)		
	Foreign Currency Short-term Deposit Rating			
	P-2	P-2		
Absa Bank	**BFSR**		**Stand Alone Credit Assessment Equiv.**	
	C- (stable)	C- (stable)	Baa1	Baa1
	Local Currency Long-term Deposit Rating			
	A3(stable)	A3 (negative)		
	Local Currency Short-term Deposit Rating			
	P-2 (stable)	P-2 (negative)		
	Foreign Currency Long-term Deposit Rating			
	A3 (negative)	Baa1 (negative)		
	Foreign Currency Short-term Deposit Rating			
	P-2	P-2		
FirstRand Bank Ltd	**BFSR**		**Stand Alone Credit Assessment Equiv.**	
	C- (stable)	C- (stable)	Baa1	Baa1
	Local Currency Long-term Deposit Rating			
	A3 (stable)	A3 (negative)		
	Local Currency Short-term Deposit Rating			
	P-2 (stable)	P-2 (negative)		
	Foreign Currency Long-term Deposit Rating			
	A3 (negative)	Baa1 (negative)		
	Foreign Currency Short-term Deposit Rating			
	P-2	P-2		
Nedbank Ltd	**BFSR**		**Stand Alone Credit Assessment Equiv.**	
	C- (stable)	C- (stable)	Baa1	Baa1
	Local Currency Long-term Deposit Rating			
	A3 (stable)	A3 (negative)		
	Local Currency Short-term Deposit Rating			
	P-2 (stable)	P-2 (negative)		
	Foreign Currency Long-term Deposit Rating			
	A3 (negative)	Baa1 (negative)		
	Foreign Currency Short-term Deposit Rating			
	P-2	P-2		

1/Bank Financial Strength Rating

Source: Moody's Investors Service

[24] The principal methodology used in this rating was "Moody's Consolidated Global Bank Rating Methodology", published in June 2012. See the Credit Policy page on www.moodys.com for methodologies.

B. Performance of the Banking Sector

Financial Soundness Indicators

Table 2: Financial Soundness Indicators

Structure	Jun '10	Dec '10	Jun '11	Dec '11	Jun '12	Dec '12
Number of banking institutions	5	5	5	5	5	5
Total assets of banking institutions (N$ '000 000)	47,699	51,501	52,782	59,971	62,886	67,068
Assets/GDP	61.1	63.5	61.4	66.0	65.5	65.0
Capital Adequacy (%)						
Tier 1 leverage ratio	8.6	8.3	8.7	7.8	8.5	8.0
Tier 1 capital ratio	11.4	11.1	11.1	10.8	11.5	11.2
Total RWCR	15.2	15.3	14.7	14	14.5	14.6
Asset Quality						
NPL/Total gross loans	2.4	2	1.8	1.5	1.4	1.3
Gross overdue/ Total loans and advances	4.7	4.3	4.5	3.5	3.9	3.6
Provisions/Total loans	1.8	1.5	1.5	1.4	1.3	1.2
Provisions/NPLs	74.8	78.6	84.6	94	93.0	91.6
Specific provision/NPLs	30.5	30.3	31.3	33.3	32.0	29.4
Earnings and Profitability						
Return on assets	2.1	2.5	1.9	2.6	2.0	2.2
Return on equity	21.4	23.6	19.2	26.4	20.2	22.7
Net interest margin	4.9	5.2	4.9	5.7	5.4	5.6
Cost to income ratio	62.5	57.3	60.1	52.3	61.4	56.6
Liquidity (%)						
Liquid assets to total assets	10.5	10.7	10.2	12.4	11.1	10.9
Total loans/Total deposits	87.7	86.6	89.1	82.2	84.5	85.6
Total loans/Total assets	74.9	74.1	76.1	71	73.0	74.5

Source: Bank of Namibia

Stress Testing

Methodology

Stress testing is an exercise where the stability and resilience of a system is tested by applying a shock to it. Broadly, central banking institutions test for credit risk, market risk and liquidity risk to determine how the financial health of the banking sector would fare under certain probable scenarios. The scenarios are determined based on an understanding of the financial and real sectors as well as tail risks.

The Bank of Namibia, as part of its surveillance of the banking sector, conducts stress tests on the banking sector based on low probability but significant impact risks. The results presented in the current issue of the Financial Stability Report are derived from a model used by the Bank.

The model links trends in Probability of Default (PD) and Loss Given Default (LGD) of the banking institutions observed by the various sectors of the economy to which they are exposed, to the balance sheets, income statements and capital returns of the banking institutions. Shocks are applied by way of imposing PD, LGDs and credit loss on sectors of the economy and calculating the impact of the shocks on the capital held by the commercial banking institutions. The data used for the purposes of the exercise is confidential; the results do not identify a specific commercial banking institution.

A shock was applied to the 13 category exposures of the commercial banking institutions to stress test credit risk. The simulations were done to examine the effects of increase in default rates on Core Tier 1 ratio, which serves as the first 'line of defence' against capital loss. The assumption is a possible increase in default rate in all the sectors, at a rate of 10 percent to the base and subsequent losses in the years under shock (i.e. into Year 4). Each year saw a subsequent additional increase in default rates of 10 percent due to secondary and follow-through effects in the economy (Table 3 below).

Table 3: PD and LGD ratios used

	Sector Aggregate (%)									
	Start		2013		2014		2015		2016	
	PD	LGD	PD	LGD	PD	LGD	PD	LGD	PD	LGD
Agriculture & Forestry	0.64	0.18	0.70	0.20	0.77	0.22	0.83	0.24	0.90	0.26
Fishing	0.65	0.13	0.72	0.14	0.78	0.15	0.85	0.17	0.91	0.18
Mining	1.66	0.09	1.83	0.10	1.99	0.10	2.16	0.11	2.32	0.12
Manufacturing	1.40	0.71	1.54	0.78	1.68	0.85	1.82	0.93	1.96	1.00
Construction	1.24	0.29	1.36	0.32	1.49	0.34	1.61	0.37	1.74	0.40
Elec., Gas & Water	0.55	0.15	0.61	0.16	0.66	0.17	0.72	0.19	0.77	0.20
Trade & Accom.	0.88	0.20	0.97	0.22	1.06	0.24	1.14	0.26	1.23	0.28
Transport and Comm.	0.78	0.17	0.86	0.19	0.94	0.21	1.01	0.22	1.09	0.24
Finance & Insurance	1.05	0.20	1.16	0.22	1.26	0.24	1.37	0.26	1.47	0.28
Real Estate & Bus. Services	0.64	0.13	0.70	0.15	0.77	0.16	0.83	0.17	0.90	0.19
Govt Services	0.30	0.08	0.33	0.09	0.36	0.10	0.39	0.11	0.42	0.11
Individuals	1.98	0.42	2.38	0.50	2.57	0.55	2.77	0.59	2.97	0.63
Other	1.03	0.38	1.13	0.42	1.24	0.45	1.34	0.49	1.44	0.53

Source: Bank of Namibia

C. Performance of the Non-Banking Financial Sector

The non-bank financial sector forms part of the financial system of Namibia, with total assets of over 100 percent of GDP. Non-bank financial intermediaries include asset managers, long term insurance, short term insurance, pension funds, unit trusts and micro lenders; whose consolidated assets amount to over 100 percent of GDP or 62 percent of the financial industry. This section reviews the main financial risks stemming from the performance of the non-bank financial institutions using data through September 2012. The information used to analyse the sector was provided by NAMFISA.

The structure of the section is as follows. The section commence with the analysis of the performance of asset managers. The performance of asset managers somewhat acts as a mirror of the performance of the main non-bank financial institutions, whose assets are under their management. About 58 percent of NFBIs assets are managed by local based asset managers. Subsequent to the discussion of asset managers, the section expound on the individual NFBIs, which serves as the source of funds for the asset managers. Finally, micro lenders, being one of the main sources of uncollateralised lending in the economy are analysed in the light of increased household indebtedness.

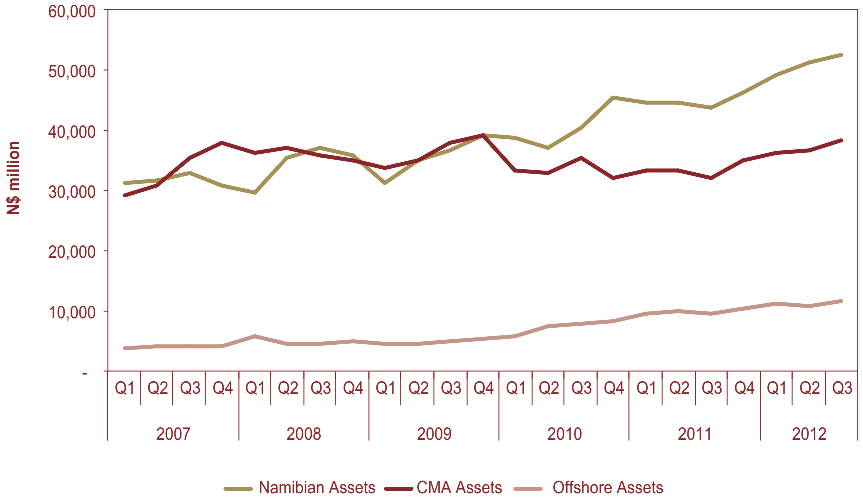
Asset Management Institutions[25]

Asset managers play an important role to other nonbank financial institutions and hence to the financial system as a whole. Asset Management deals with the management of financial assets in order to meet the specific investment goals of the client and it forms a vital component to financial stability by providing an avenue to manage excess liquidity. To this end, asset managers manage the assets of their own as well as other NBFIs, and as such, the performance and hence, stability of the financial system partly hinges on the effective management and performance of these assets.

Total assets under management have been growing annually and stood at over N$102 billion (or about 100 percent of GDP) as at 2012:Q3, with a rising share of assets allocated to offshore territories in total assets. The last quarter of 2009 saw a shift in asset allocation, with more assets being allocated in offshore territories, away from the CMA. Offshore asset allocation to total assets grew from 6 percent in 2009:Q4 to 11 percent as at 2012:Q3. Conversely, asset allocation in the CMA as a proportion of total assets allocated declined by 10 percentage points from 47 percent in 2009:Q4 to 37 percent of total assets allocated as at 2012:Q3 (Figure 1).

[25] Due to data availability limitations, this section excludes asset management being done by management companies in terms of the Unit Trust Control Act.

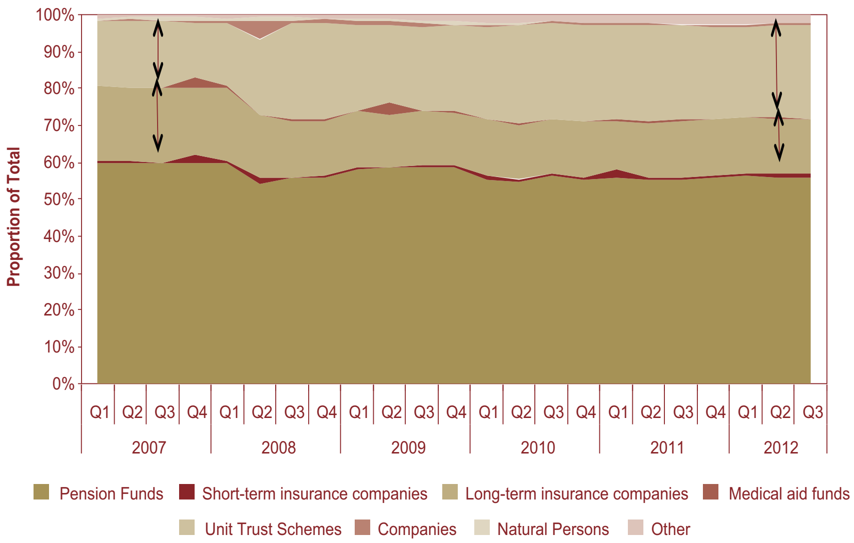
Figure 1: Asset Allocation by geographic location



Source: NAMFISA

According to BoN's estimates, about 58 percent of NFBIs assets are managed by local based asset managers, and are sourced from various clients (Figure 2). Regulations 28, 8, and 15 respectively requires pension funds, short and long term insurance companies to invest 35 percent of their assets domestically and can be managed by anyone. The latter includes dual listed companies on the NSX and JSE. It should be noted that the proportion of funds which are not legally required to be invested domestically could be placed with foreign managers or foreign parent companies, although NBFIs will still be accountable to the local regulator and have to report on a regular basis.

Figure 2: Funds under management by domestic asset management companies



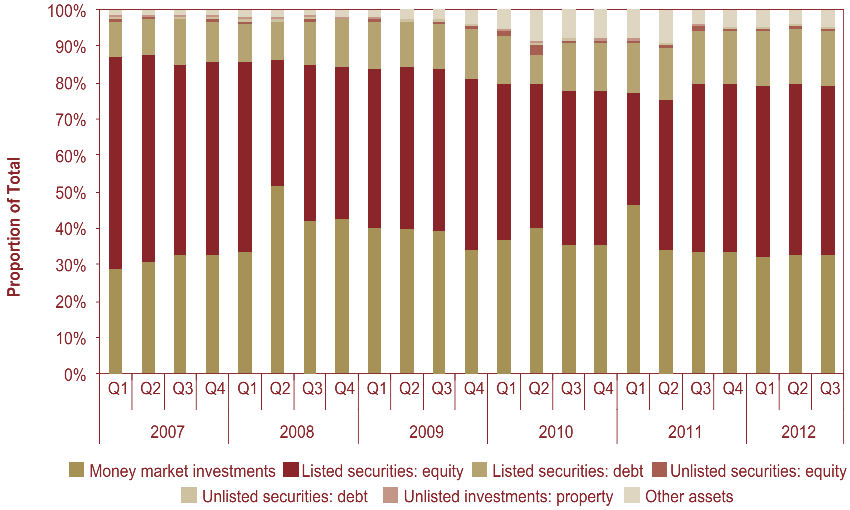
Source: NAMFISA

Pension funds have on average accounted for over 55 percent of assets under management. The breakdown between long-term insurance and unit trusts as sources of assets under management has begun to reverse over the years, with long-term insurance companies accounting 18.1 percent of funds sourced in 2007:Q4 to 14.7 percent in 2012:Q3. At the same time, funds invested in unit trusts schemes increased as a proportion of total assets under management, from 14.9 percent in 2007:Q4 to 25.1 percent in 2012:Q3.

Asset Management companies are bound by the prudential regulations governing the investment of funds from specific classes/sources of investment, such as pensions, long and short term insurance and medical aid schemes[26]. As such Figure 3 below is representative of funds allocation by instrument over the period 2007 -2012. The figure below shows a great exposure (approximately 50 percent of funds invested) to listed equities, followed by money market investments[27] (a third of funds invested) and listed debt (15 percent of funds invested).

[26] Regulations 28 for pension funds, Regulations 8, 15 for the insurance sector and Regulation 9 for medical aid schemes
[27] The following are included under the categorisation: treasury bills, negotiable certificates of demand, bankers' acceptances, debentures and notice and call accounts.

Figure 3: Allocation of funds into various instruments for 2007:Q3 – 2012: Q3

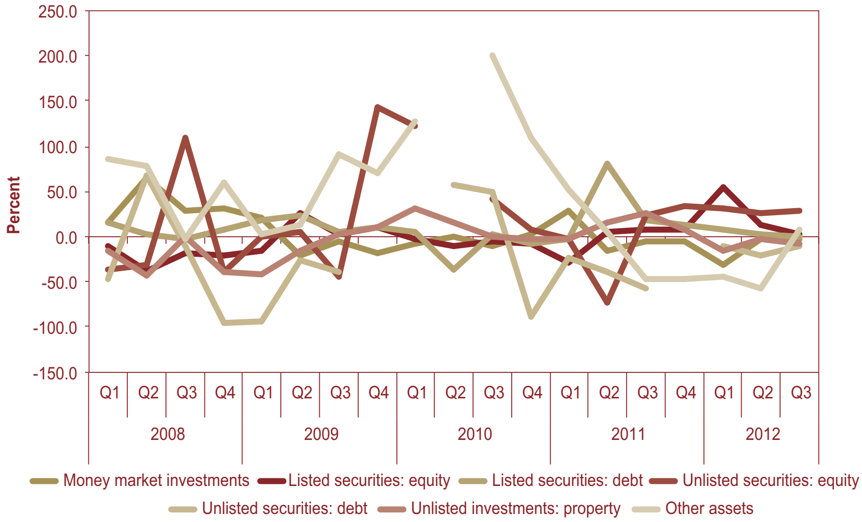


Source: NAMFISA

The choice of investment instruments appears not to have changed over time (Figure 4 below). This suggests that decisions are undertaken as a combination of the risk appetite and investment mandate given to the asset management company and prudential requirements.

Whereas there is no preferred security for investment, the most activity is observed in the instrument class of unlisted equities, which is also relatively insignificant. The particular sector is risky to invest in as non-listed companies are not quoted on a stock exchange and hence, valuation is difficult. Unlisted debt instruments have also revealed significant activity. The riskiness of the sector is somewhat mitigated by its relative insignificance to total assets. Investments in the other (listed) asset classes are purely a function of expectations of their relative performance and as a consequence historical trends are very volatile.

Figure 4: Annual growth rate of securities preference



Source: NAMFISA

Pension Funds

Pension fund assets, return on investment and consequently, net investment income increased between 2010 and 2011. During the period, total assets under management increased by N$5.3 billion to N$68.1 billion, while the number of active pension funds declined from 167 to 146. Also, the number of pensioners, as a percentage of members increased from 13 percent to 16 percent. Investments at the end of 2011 continued to make up 99.7 percent of pension funds current assets, and 98 percent of total assets, as was the case at the end of 2010. Net investment income increased by approximately 6 percent from 2010 to 2011, swelling to N$4.9 billion from N$4.6 billion. Over the year, and across the pension funds, the average return on investment was approximately 7.8 percent, in both 2010 and 2011.

Pension funds investments remain highly in favour of equities in 2011, as was the case in 2010 even though the relative share has dropped sharply, while that of fixed interest income went up (Table 4). The percentage share of overall investments in equities has fallen from 64 percent in 2010 to 58 percent in 2011. However, in terms of monetary value, the value of investment in equities fell only by 0.2 percent from 2010 to 2011. Fixed interest income investments, such as non-inflation linked government bonds, made up the second largest investment category on the pension funds balance sheet in both 2010 and 2011, at 21 and 24 percent of total investments, respectively.

Table 4: Pension Fund Investments by Portfolio Type

Investments		2010 N$'000'000	2011 % of Total	N$'000'000	% of Total	Y-o-Y Growth
1	Equities	39 915	64%	39 838	58%	-0.2%
2	Fixed Interest	13 292	21%	16 410	24%	23.5%
3	Property	502	1%	612	1%	21.7%
4	Cash/Money market	4 209	7%	5 003	7%	18.9%
5	Unlisted investments	149	0%	685	1%	359.2%
6	Other	4 706	7%	5 566	8%	18.3%
	TOTALS	**62 773**	**100%**	**68 114**	**100%**	**8.5%**

Source: NAMFISA

Unlisted investments rose rapidly between 2010 and 2011, albeit from a very low base. Unlisted investments saw notable growth of 359 percent from 2010 to 2011, as total investments in this category increased from N$149 million, to N$685 million.

Table 5: Pension Fund Investments by Location

N$'000'000		Namibia		CMA		Outside CMA		Total	
		2010	2011	2010	2011	2010	2011	2010	2011
1	Equities	14 108	15 278	13 722	12 058	12 084	12 502	39 915	39 838
2	Fixed Interest	4 450	5 691	6 001	6 737	2 840	3 982	13 292	16 410
3	Property	315	404	186	194	1	13	502	612
4	Cash/Money market	3 248	3 719	673	878	288	406	4 209	5 003
5	Unlisted investments	123	350	20	5	7	330	149	685
6	Other	3 676	4 150	42	-298	988	1 714	4 706	5 566
	TOTALS	**25 921**	**29 592**	**20 644**	**19 574**	**16 208**	**18 948**	**62 773**	**68 114**

Source: NAMFISA

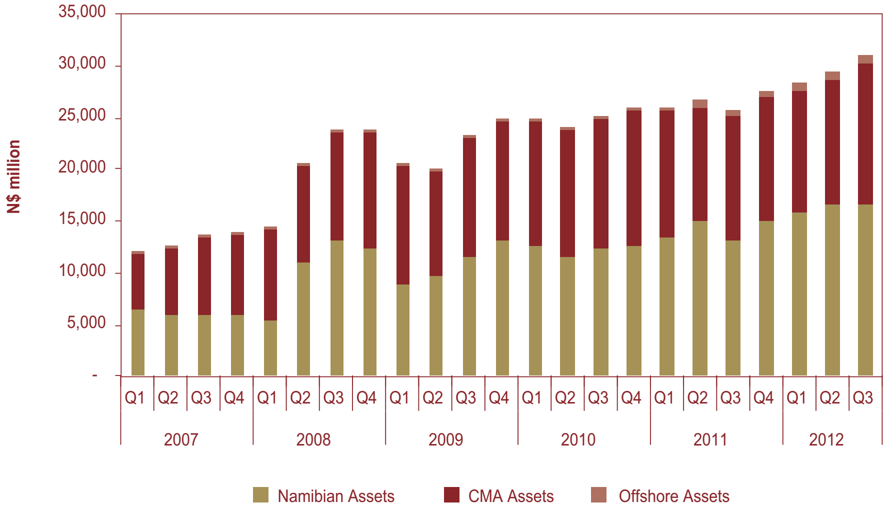
Forty-three percent of pension fund investments are located in Namibia, while the remaining 57 percent of investments are outside of the country (Table 5). Investments within the Common Monetary Area (CMA) and outside the CMA are similar in size at approximately 29 and 28 percent of total investments, respectively. Since 2010, investments in Namibia have grown by N$3.7 billion, while investments in the CMA have fallen somewhat, by approximately N$1.1 billion. Investments outside the CMA too have increased, by N$2.7 billion, since 2010.

Unit Trusts

Investments in unit trust investments have made up the second-largest portion of the overall funds managed by asset managers over the past three years. In the third quarter of 2012, funds managed by unit trusts stood at N$31.1 billion. Since the third quarter of the previous year, the funds in unit trusts increased by 21 percent.

The majority of unit trust investments are invested in Namibia (54 percent) with the remainder being split between the CMA (43 percent) and the rest of the world (3 percent) (Figure 5). The total share of investments in Namibia has increased over the past 5 years, illustrative of financial sector deepening in Namibia.

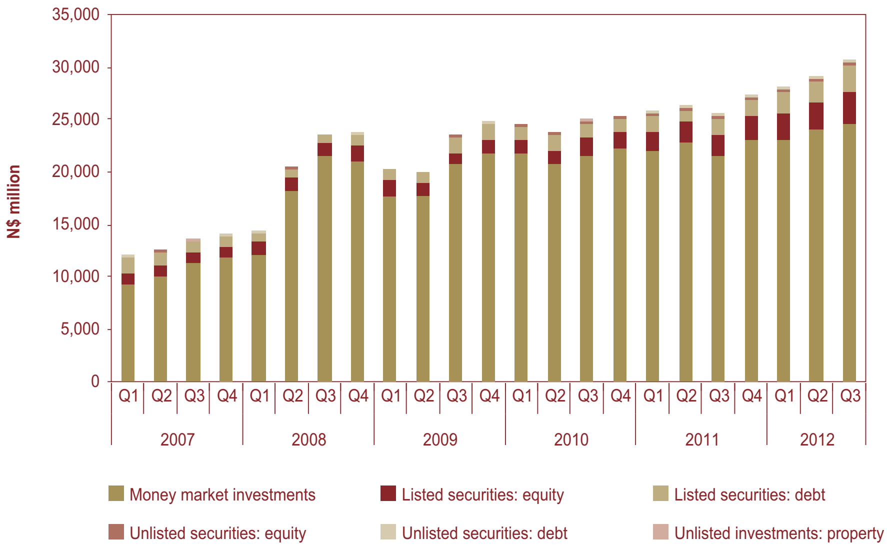
Figure 5: Unit Trusts Allocation by Country



Source: NAMFISA

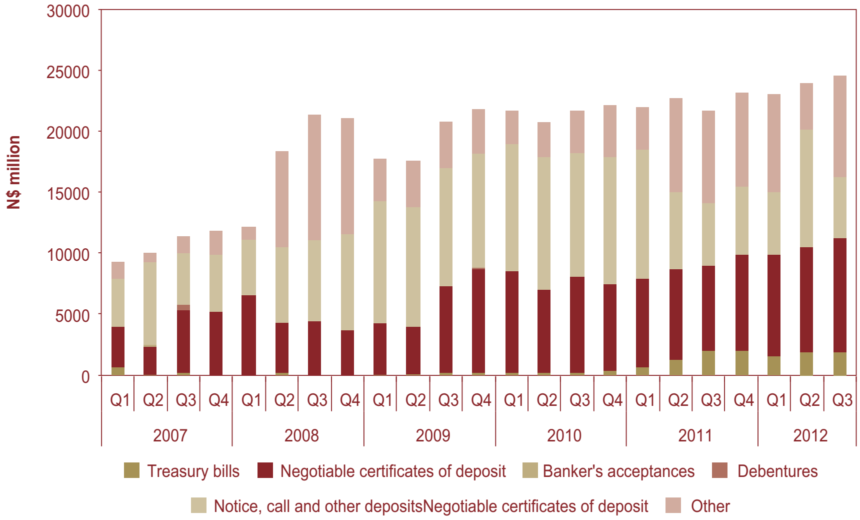
Unit trust investments are in the highly liquid money market, with approximately 81 percent of total investments falling into this category (Figure 6). This ratio has been largely unchanged, however in 2008 and 2009, this number increased to 89 and 88 percent, respectively. Listed debt and equities make up approximately 7 percent and 9 percent of total investments, respectively. Of money market investments, the large investments are *negotiable certificates of deposit* (38 percent), *notice, call and other deposits* (20 percent) and *"other"* (34 percent). Since 2007, there has been a noticeable shift away from *notice, call and other deposits*, which went from making up approximately 50 percent of total money market investments, to treasury bills (from approximately 1 percent of investments to 8 percent) and "other" investments (13 percent to 34 percent) (Figure 7). The shift could be explained by the interest rate dynamics. Deposit rates are at historic low- a shift into *treasury bills* could be indicative of a search for higher returns.

Figure 6: Investments by asset type



Source: NAMFISA

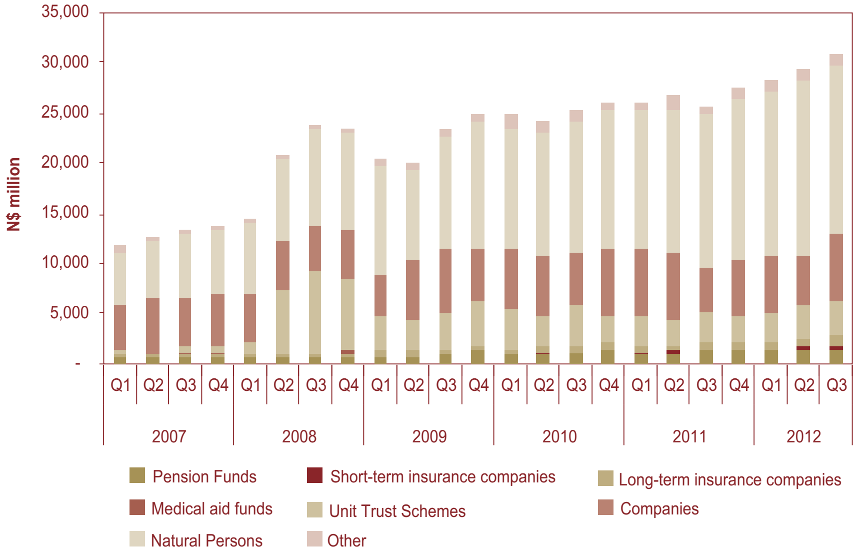
Figure 7: Money Market breakdown



Source: NAMFISA

Unit trust funds in Namibia are largely sourced from natural persons (i.e., individuals; see Figure 8). Over the past five years, the ratio has increased from approximately 45 percent to the current levels of over 50 percent. On the other hand, company's investments in unit trusts have fallen as a percent of total, from approximately 40 percent, down to 21 percent. Pension funds in unit trusts make up approximately 5 percent of total unit trust investments, while long term and short term insurance make up 3 percent and 1 percent of total investments, respectively.

Figure 8: Unit trusts investments by source of funds



Source: NAMFISA

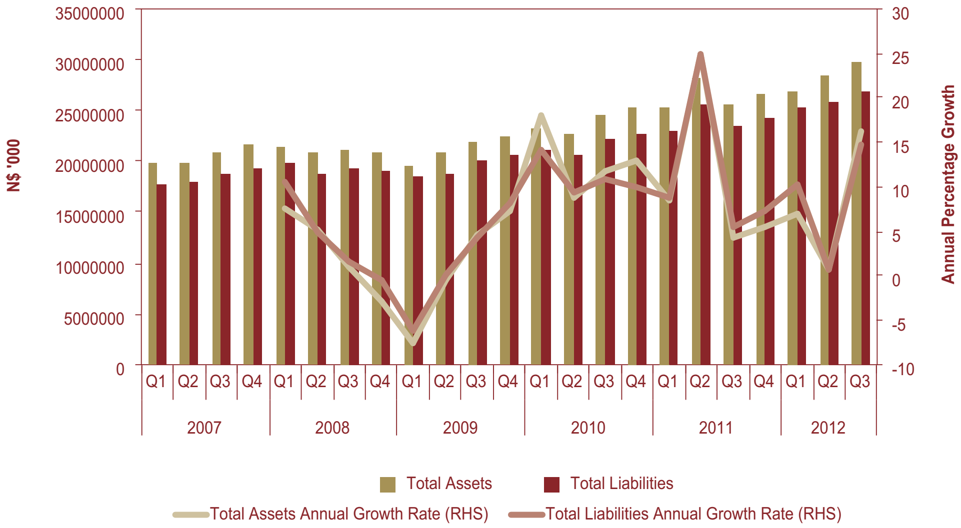
Insurance Sector

Insurance companies are vital to the financial system due to their role as risk takers and the contagion links between the insurance and the banking sectors. As at September 2012 the total assets of insurance companies (long and short term) amounted to N$32.8 billion; up N$4.6 billion, compared to the corresponding period of the preceding year. Potential contagion effect between the banking and the insurance sectors exists via the life insurance channel: close cooperation exists between the insurance sector and the banking sector as it is standard practice by the banking institutions to require mortgage owners to take out life insurance for collateral. As at 2012:Q3, exposure of the insurance sector to the banking sector (i.e. direct claims on banking institutions) amounted to 14.7 percent of their total assets, down from 19.5 percent over the same period, in the preceding year.

Long-term Insurance

The balance sheet of the industry reveals that the assets base of the sector (Figure 9) grew on average by 7.0 percent since 2007. For all time periods, total assets have covered total liabilities by an annual margin of N$2 billion, though for 2011:Q3 –2012:Q2, the annual rate of growth of total liabilities has been faster than that of total assets. Liabilities in the industry comprise of reserves for policies in force, current liabilities and capital adequacy requirements. Long-term insurance as a sector plays an important role in financial stability as it provides partial collateral for mortgage loans extended by the banking system[28]. Long-term insurance also presents an avenue for contractual savings.

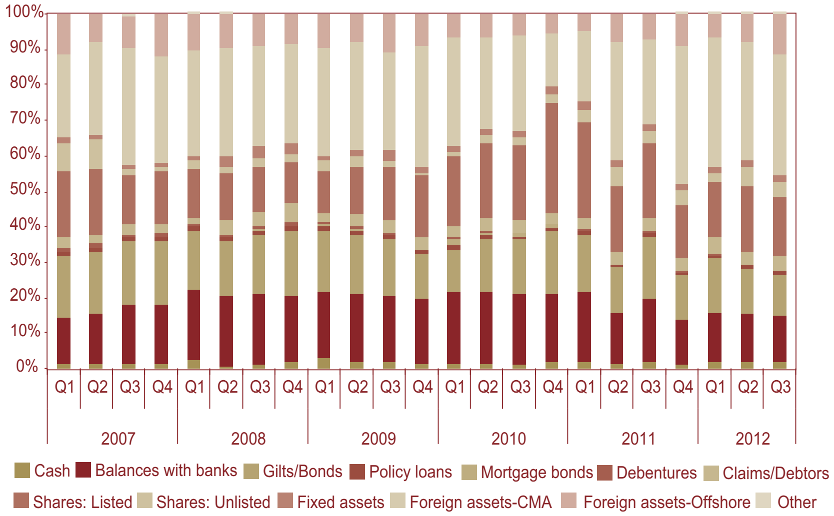
Figure 9: Total Assets and Liabilities



Source: NAMFISA

As with pension funds, unit trusts and others, equity investment is one of the dominant asset classes for long term insurance. As Figure 10 shows, the majority of the assets over the period 2007 – 2012:Q3 were comprised of balances with foreign assets in the CMA (29.3 percent), listed shares (17.3), banking institutions (17.2 percent) and gilts/bonds (15.7 percent).

Figure 10: The Composition of Total Assets

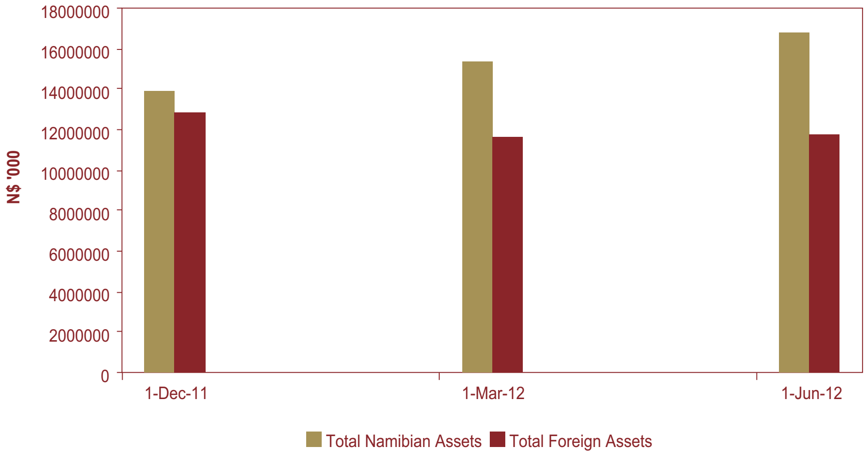


Source: NAMFISA

The allocation of assets by geographical region has been consistent over the past years, mainly because allocation is regulated by the legal provision, Regulation 15. On an aggregated level there exists an almost even spread of assets held in Namibia and those held outside of the country on a quarter-by-quarter basis, with a slightly growing biased of holding assets within the country (Figure 11).

28 Commercial banking institutions require persons to pledge a life cover insurance against their mortgage loan, of the same value or more. The right of surrender of the life cover is exercised by a bank to settle the debt, in case of death of a borrower.

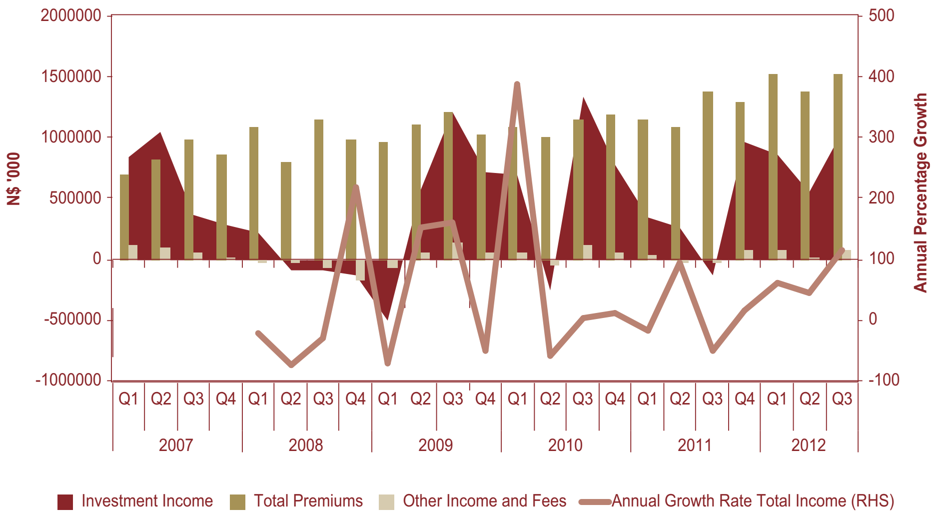
Figure 11: Assets Spread by Geography



Source: NAMFISA

The income of the long-term insurance sector is made up of premiums received, investment income and other income. Investment income has comprised an average 34.3 percent of total income for the period 2012. As Figure 12 indicates, there has been great volatility in the investment income subcategory and this could be attributed to track to global trends (most notably end 2007 and all of 2008).

Figure 12: Income Spread

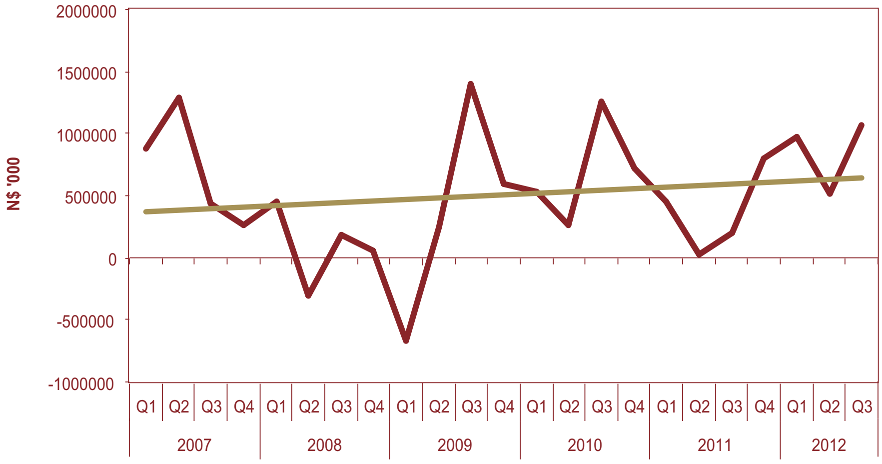


Source: NAMFISA

A balanced take on income and 'expenses'[29] reveals that the performance of the long-term insurance fund shows an overall recovery of 2012:Q2 and 2012:Q3 (Figure 13).

[29] This includes benefits paid out, expeses and taxes

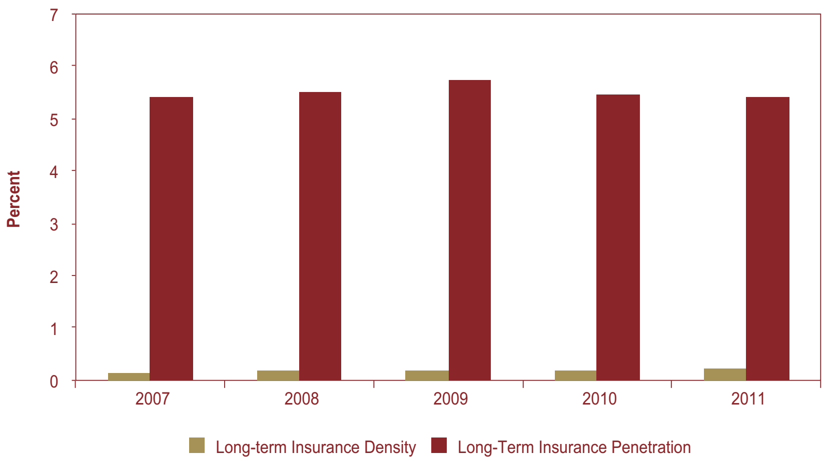
Figure 13: Increases in the Long-term fund



Source: NAMFISA

The measures used to gauge the pervasiveness of insurance products indicate that it is relatively low in Namibia (Figure 14). Insurance density is expressed as per capita premium received and insurance penetration is defined as the ratio of insurance premiums relative to GDP. It is accepted[30] that it is difficult to generalise about insurance markets given the level of socioeconomic fragmentation and differentiation between economic and demand attributes in different segments. Nonetheless, the penetration numbers indicate potential for future growth.

Figure 14: Insurance density and penetration



Source: Author's calculations

Short-term Insurance

Short term insurance is defined as insurance taken for a set period, usually 12 months. The sector is a dynamic one, with 546 registered entities in 2012, which is an increase of 17 entities when compared to 2011.

The assets spread of the short-term insurance sector indicates that the majority is held in the financial banking system in the form of cash and deposits (Table 6 and Figure 15). Investments make up the second largest portion of assets and they are relatively evenly distributed between the domestic and foreign markets. As at 30 June 2012, the two largest subcategories made up 97.1 percent of the total, which is a slight increase from 96.9 percent as at 31 March 2012.

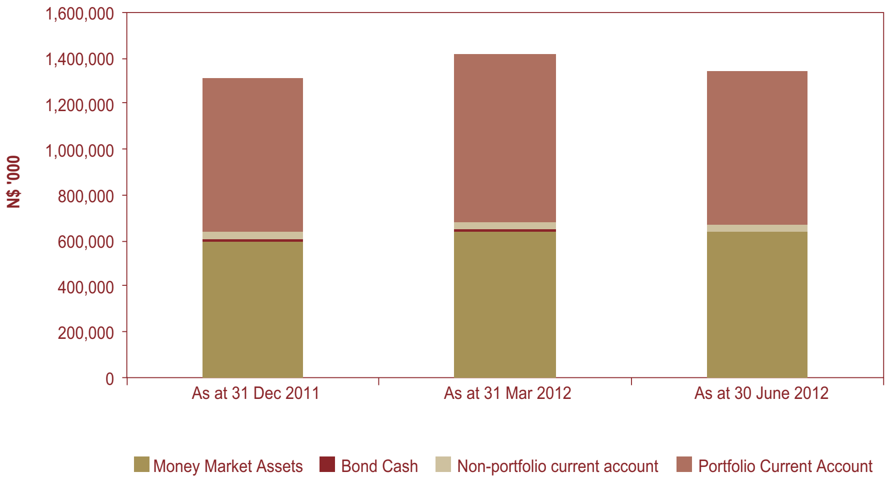
[30] South Africa Life Insurance Insight Report 2012

Table 6: Assets Spread by Asset Class

	Domestic As at 31 Dec 2011	1/Foreign As at 31 Mar 2012	Domestic As at 30 June 2012	Foreign	Domestic	Foreign
	N$ '000					
Current Assets	576 726	16 313	714 258	18 427	804 956	17 826
Cash, Bank Balances & Deposits	1 297 982	12 360	1 402 076	12 740	1 333 378	13 167
Investments	349 718	354 224	320 440	354 657	324 214	364 446

Source: NAMFISA, 1/ Offshore and CMA

Figure 15: Composition of Cash, Bank Balances and Deposits



Source: NAMFISA

Other asset classes constitute the listed investment and unlisted investment. The composition of the sub-categories classified under the 'Investment' category indicates that the majority of the assets under the category are invested in listed equities and bonds[31] (Table 7). Though not sizeable (less than 2.5 percent for all 3 available periods) the industry has an exposure to the property market as part of its unlisted investment asset class.

Table 7: Composition of Investments

		As at 31 Dec 2011	As at 31 Mar 2012	As at 30 June 2012
Investment	Listed Equities	176 895	184 054	218 131
	Listed Bonds	220 215	182 329	183 371
	Long-term Money Market Investments	3 874	3 867	3 861
Unlisted	Shares	91 727	94 180	95 190
	Redeemable Preference Shares	94 319	94 319	79 319
	Property	16 382	16 382	16 382
	Debentures	85 693	85 129	77 569
	Subsidiary	14 837	14 837	14 837
	Total	**703 942**	**675 097**	**688 660**

Source: NAMFISA

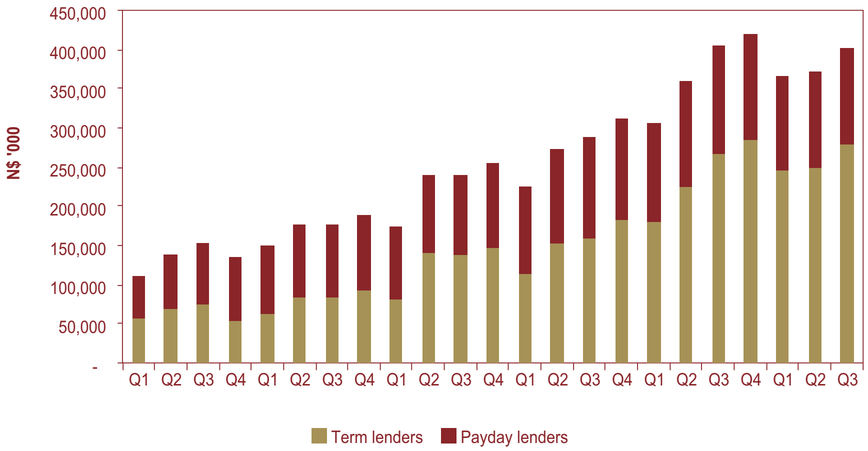
[31] 56.4 percent, 54.3 percent and 58.3 percent for the periods as at 31 December 2011, 31 March 2011 and 30 June respectively

Microlending

Microlending partly represents the extent of uncollateralised lending activities in the economy. Surveillance is vital to monitor credit risk, more so in the light of increased household indebtedness. Given the level of indebtedness in the economy, it is expected that there will be people who will look for funding outside of the commercial banking institutions, to avenues with less stringent qualification criteria. Microlenders have less stringed criteria in that credit is offered with no collateral, and consequently higher interest rates are charged to cater for this risk. Microlenders extend funds with a once-off repayment schedule, known as Pay Day lenders, or at an instalment repayment plan, known as Term lenders.[32]

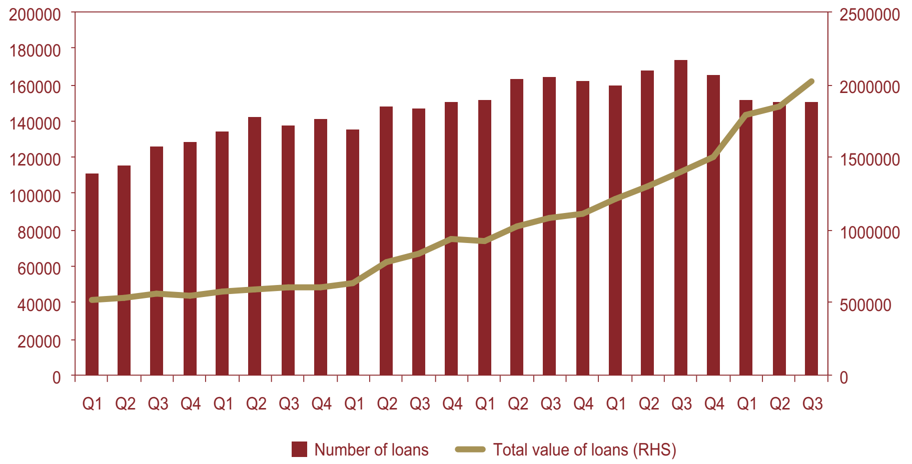
The rate of loan extension by microlenders has been on an upward trend. It increased from an average of N$357 million for 2011:Q1 – Q3 to an average of N$380 million 2012:Q1-Q3 (Figure 16). The number of loans extended by microlenders in the first three quarters of 2012 was slightly less than those in the first three quarters of 2011 (150 592 compared to 166 740, respectively). Nevertheless the overall trend is an increasing one as reflected in the total value of loans, which amounted to over N$2 billion in 2012:Q3 compared to N$1.4 billion for the corresponding period in the preceding year (Figure 17).

Figure 16: Value of New Loans Extended



Source: NAMFISA

Figure 17: Number of Loans Extended and Total Value of Loans



Source: NAMFISA

The number of microlenders has been increasing annually, which complements the numbers presented in Table 8.

[32] Pay-Day lenders are legally allowed to charge interest up to 30 percent, while Term lenders are allowed to charge interest of prime times two

Table 8: Number of Microlenders

As at 31 March for the Year:	Total number of microlenders	Annual percentage growth
2007	255	
2008	312	+22.35
2009	329	+5.45
2010	347	+5.47
2011	388	+11.82
2012	398	+2.58

Source: NAMFISA

Given the nature of microlending (high risk clients, therefore higher interest charges), the increase in the sector signifies an untenable situation, which could negatively impact the financial system. The Bank of Namibia has reported on the level of household debt servicing to gross income[33], which stood at 23 percent for 2012, up from 21 percent in 2011. The majority of cases where microloans are extended relate to covering consumption costs or other debt. Thus, a debt cycle is perpetuated. The extension of credit by microlenders should be monitored in light of increasing household debt.

D. Payments Infrastructure and Regulatory Developments

Table 9: Large- value Payment Systems in relation to GDP

Selected European countries (2006) and Namibia		
Country	**System**	**Payments Turnover/GDP**
Belgium	ELLIPS	64.9%
Netherlands	TOP	59.9%
Namibia	NISS	5.4%
Switzerland	SIC	92.2%
Turkey	EFT	20%

Source: BoN staff compilations.

33 See Section IV

E. Box Article: A Look at Loan-to-Value Ratios as a Macroprudential Policy Tool

The case of Hong Kong

As part of the study, a range of outcome variable were considered by the authors to get a comprehensive impact of policy instruments LTV and DTI on the safeguarding the banking sector financial stability. The outcomes studied fell into three broad categories:

✓ Property Sector (Loans to Property and Property Prices)

✓ Capital and financial stability metrics (Capital / Assets)

✓ Asset quality and profitability / performance (Non-Performing Loans; Return on Assets)

The impact of the two macro-prudential instruments (LTV and DTI caps) on each outcome was studied. The findings are presented, highlighting which macro-prudential instruments have the biggest impact. Impulse responses from vector autoregressive models suggested the following about LTV policy and the land sale mechanism during the past decade:

- ✓ The design of LTV policies appear to be forward looking, with ceilings tightened to counter downward movements in mortgage interest rates, and growth in mortgage lending and volumes of transactions.
- ✓ Over the short term, changes in LTV ratios did not appear to significantly affect the rate of residential property price inflation. More binding LTV limits appeared to reduce transaction volume growth in both the luxury segment and mass market. Property price inflation appeared to fall around 2 years after the change in the LTV ratios, affecting in a similar way both the luxury and mass market property price.
- ✓ A tightening of maximum LTV limits in Hong Kong SAR appeared to have little effect on total mortgage lending.
- ✓ With regard to other instruments used in Hong Kong SAR, the Land Application System and government initiated land sales strategy tend to be counter-cyclical (i.e. they tend to dampen the cycle). However, the empirical evidence on the impact of government land sales on price and transaction volume growth is inconclusive.
- ✓ **At the cross-country level, across the broader sample as well as in the subset of economies with pegged exchange rates and currency boards, the use of LTV caps tends to have a decelerating effect on property price growth.** In addition, both LTV and DTI caps slow the growth of lending to the property sector. The use of the LTV instrument also appears to strengthen bank capital buffers and bank performance. The instrument affects a broader range of financial stability indicators in economies with pegged exchange rates and currency boards. For Hong Kong SAR, the design of LTV policies appear to be forward looking, with ceilings tightened to counter downward movements in mortgage interest rates, growth in mortgage lending, and rising volumes of transactions.
- ✓ In general, the impact of LTV caps on leading indicators for the housing sector operated with a lag. LTVs caps operate with a one-year lag on the volume of <u>transactions</u> and with a two-year lag on housing <u>inflation</u>. The tightening of LTV caps has an uncertain statistical effect on mortgage <u>lending</u> (even after two years), possibly due to the use of mortgage insurance which helps ease the liquidity constraints imposed by LTV caps. However, Hong Kong's limited (statistical) impact of LTV caps on mortgage lending appears to be a singularity of that market, as cross-country analysis suggests a negative relationship between a tightening in LTV caps and mortgage lending, albeit with a one year lag.

Case of Denmark

Figure 1. The Balance Principle

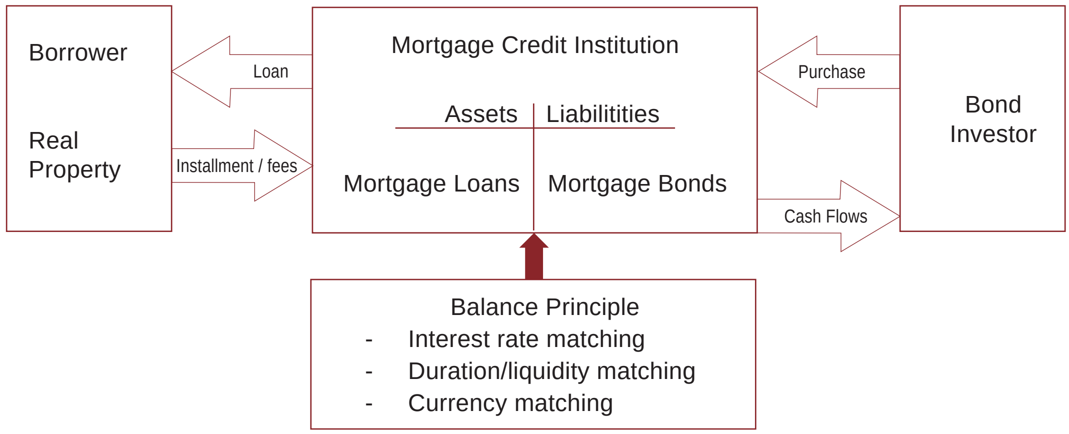


Table 9: Loan-to-value ratios

Property type	Maximum LTV	Maximum maturity
Private residential property	80	30
Vacation homes/weekend cottages (secondary residences)	60	30
Residential rental property	80	30
Office and shop property	60	30
Industrial property	60	30
Agricultural property	70	30
Loans w/guarantee from local government	80 - 100	30

Additional Source: BRF Kredit

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