BANK OF NAMIBIA

FINANCIAL STABILITY REPORT

MARCH 2008

BANK OF NAMIBIA

FINANCIAL STABILITY REPORT

MARCH 2008

Registered Office

71 Robert Mugabe Avenue
P.O. Box 2882
WINDHOEK
NAMIBIA

Published by the Bank of Namibia.

Enquiries related to this publication should be directed to:

The Bank of Namibia

P O Box 2882

WINDHOEK

NAMIBIA

Tel: +264 61 283 5111

Fax: +264 61 283 5228

email: viljoen.williams@bon.com.na

http://www.bon.com.na

ISBN: 99916-61-44-1

Bank of Namibia

Corporate Charter

VISION

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

MISSION

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

VALUES

"Our values guide us to be a center of excellence, and we value our contribution to the organization".

We uphold integrity, impartiality, open communication and transparency. We care for each other's well-being and value teamwork.

LIST OF ABBREVIATIONS

AACB	Association of African Central Banks
AML/CFT	Anti-money laundering and combating of financing of terrorism
BIS	Bank for International Settlement
BoN	Bank of Namibia
CAR	Capital Adequacy Requirement
CBS	Central Statistics Bureau
CIC	Currency in circulation
CMA	Common Monetary Area
EMEs	Emerging market economies
FIA	Financial Intelligence Act
FIC	Financial Intelligence Centre
FNB	First National Bank
FSR	Financial Sector Review
GC08	Government Internal Registered Stock Maturing in 2008
GC10	Government Internal Registered Stock Maturing in 2010
GC12	Government Internal Registered Stock Maturing in 2012
GC15	Government Internal Registered Stock Maturing in 2015
GC24	Government Internal Registered Stock Maturing in 2024
HI	Herfindahl Index
IMF	International Monetary Fund
IPPR	Institute of Public Policy Research
IRMC	International Reserves Management Committee
JSE	Johannesburg Stock Exchange
MoF	Ministry of Finance
MTC	Mobile Telecommunications Company
NAD	Namibia dollar
NISS	Namibia Interbank Settlement System
NPL	non-performing loan
NSX	Namibian Stock Exchange
ODCs	other depository corporations
PAN	Payment Association of Namibia
RHS	right-hand side (of graph)
SA	South Africa
SACU	Southern African Customs Union
SADC	Southern African Development Community
SARB	South African Reserve Bank
T Bill	Treasury Bill
UEPS	Universal Electronic Payment System
US(A)	United States (of America)

TABLE OF CONTENT

Introduction

The Financial Stability Review (FSR) is a biannual publication of the Bank of Namibia that provides an analysis of the stability of the financial system. The purpose of the *Report* is to identify potential risks in the financial system and assess its ability to withstand unforeseen shocks. Publishing the *Report* serves to promote public understanding of financial stability issues and contributes to a well informed debate concerning Namibia's financial system.

The Report highlights the Bank of Namibia's assessment of key risks and vulnerabilities to financial stability emanating from developments in the national and international environment (financial and other economic markets). The analysis of financial stability concerns the ability of the financial system to withstand unforeseen shocks to financial institutions as well as to the financial infrastructure. The assessment starts with the external factors that can affect the agents in the financial system.

The analysis of financial institutions focuses on the four banks because of their crucial importance for the payment system's stability. The analysis also includes a survey of how the banks' borrowers have been affected and whether their environment might cause the banks to become more vulnerable. In addition, the *Report* looks at developments in the insurance.

The Bank of Namibia also oversees the financial infrastructure to obtain a picture of any structural weaknesses that could generate contagious effects via the payment system. In addition to the analyses and assessments of the financial stability in the Namibian financial system, the FSR also contains various articles. These can be either in-depth articles on a particular field or issues related to financial stability.

Each major section concludes with a rating of the developments and factors analysed. The rating provides a relative indication of the degree of perceived impact of developments and factors on financial system stability. The following categories of rating, in ascending order of severity of impact, will be utilised: low impact; moderate impact; and high impact.

1. OVERVEIW

1.1 INTERNATIONAL DEVELOPMENTS

According to the IMF's World Economic Outlook *Update* of January 2008, global economic growth slowed markedly in the final quarter of 2007, following a stronger than expected third quarter performance. It further projects the world economic growth to slow to 4.1 percent in 2008, down from an estimated 4.9 percent in 2007. The slowdown is aided by recent financial market turbulence and a weakening United States economy.

Regarding the global financial system, the IMF noted in its January update of the Global Financial Stability Report Update that global financial market conditions have worsened, since the publication of the last Global Financial Stability Report, in October 2007. Coordinated central bank operations, together with rate cuts, have helped ease liquidity tensions in the interbank market; however, strains persist and term premiums are likely to remain elevated for some time.

Credit and market risks have continued to rise, and the global macroeconomic outlook looks less favourable. The credit concerns now extend beyond the subprime mortgage sector. Although the focal point is still the United States, European banks have also felt the effects. While other regions' financial institutions appear to have less exposure, subprime related write-downs are still possible.

Emerging markets, the IMF noted, have been resilient so far to the fallouts from the US subprime mortgage crisis, but face challenges ahead. Emerging market equities have outperformed mature equity markets, but prices in some markets have declined steeply since the start of 2008 on expectations that the U.S. economy may slow more rapidly. Signs of spill over are most evident in the sharp fall in private emerging market bond issuance, particularly in some emerging European economies whose banks have relied heavily on external financing to support rapid domestic credit growth.

1.2 STATE OF THE NAMIBIAN FINANCIAL INDUSTRY

Economic growth in Namibia is estimated to have slowed during 2007 to a forecast 3.8 percent from 4.1 percent in the preceding year. The slackening was due largely to the negative effect of the US sub-prime mortgage market on global economic activities. The global economic slowdown also has implications for Namibia through reduced commodity demand.

In 2007, Namibia witnessed persistent inflationary pressures as a result of high food prices, supported by high and volatile international oil prices. In an effort to contain inflationary pressures, the Bank of Namibia tightened the monetary conditions by increasing the Bank rate by a total of 150 basis points in 2007. Tight monetary policy led to high interest rates. In line with these developments, domestic credit extended by the banking sector moderated, especially during the second half of the year. However, strong balance sheet positions for companies, especially those in the mining sector, augmented by a slowing down in credit extension, led to high liquidity in the banking system.

The domestic financial system, however, continued to be characterised by robust financial institutions, banks in particular, stable financial markets and resilient infrastructure. Although adverse conditions in the global financial markets are bound to continue to influence the financial system in Namibia, this impact on the overall stability of the financial system is expected to be moderate in 2008.

2. International Developments

2.1 Macro Financial Conditions

After an extended period of exceptionally favourable financial market conditions, the international financial markets have entered a difficult period in recent times. Available evidence indicates that global credit and market risks have continued to rise, thereby leading to increased volatility and broad loss of liquidity. Driving the recent developments in global financial markets have mainly been events in the US sub-prime mortgage market. Furthermore, risks have been intensified by signs of credit indiscipline on the side of the leveraged buyout sector. According to the IMF's September 2007 *Global Financial Stability Report*, the benign economic and financial conditions of recent years have weakened incentives to conduct due diligence on borrowers and counterparties.

2.1.1 Industrial Economies

The US sub-prime mortgage market experienced significant stress from early 2007, with further deterioration since then. The market has suffered from rising delinquencies on principal as well as interest payments. This deterioration mainly reflects a combination of lax underwriting standards and adverse trends in employment and income in certain regions. The crisis in this market segment has extended beyond the US to the European and Asian markets, as credit deteriorates more broadly.

A handful of European institutions have already reported difficulties due to their exposure to the US mortgage markets and due to the withdrawals of their short-term funding. Furthermore, more European banks are believed to be exposed to the indirect mark-to-market losses stemming from their credit lines to conduits and structured investment vehicles in the US.

According to the Global Financial Stability Report Market *Update*, January 2008, signs of future slowdown in credit growth are just emerging in Europe and there is potential for worsening credit quality as lending has been very robust in some countries and several countries face housing markets that are considered overvalued. In the Asian Pacific region, exposure to mortgage-related products is concentrated in Japan and Australia.

2.1.2 Emerging Markets

Although emerging markets have been resilient so far to the fallouts from the US sub-prime mortgage crisis, they face challenges ahead. Emerging market equities have outperformed mature equity markets, but prices in some markets have declined steeply since the start of 2008 on expectations that the US economy might slow more rapidly. The IMF notes that signs of spill over are most evident in the sharp fall in private emerging market bond issuance, particularly in emerging economies whose banks have relied heavily on external financing to support rapid domestic credit growth.

Various market analyses suggest that exposure to mortgage-related products is also high in the Taiwan Province of China, and the Republic of Korea. Overall, however, emerging market risks remain low relative to historical experience, with many countries benefiting from improved macroeconomic fundamentals and strong external balances. Nevertheless, developments in mature markets raise concerns that vulnerabilities may be growing in emerging markets, with some emerging market economies more exposed than others.

2.1.3 Developments in South Africa

The NAD is pegged to the South African rand on a one-to-one basis, and about 80 percent of Namibia's imports, in particular food stuffs and oil, come from South Africa. Furthermore, NSX is strongly linked to the JSE by the dual-listed companies that comprise the largest share of the former's market capitalisation. Given the strong economic and financial links between the two economies, events in South Africa, therefore, have important implications for financial system stability in Namibia.

South Africa's real GDP rose by 5.1 percent, year on year growth, during the third quarter of 2007. The key contributors to the robust increase in economic activity were sectors such as finance, real estate and business services, wholesale and retail trade, hotels and restaurants, transport, storage and communication, as well as General Government services. The economy is projected to slow to 4.9 percent in 2007 and 4.2 percent in 2008, respectively. The expected slowdown in 2008 is mainly attributed to the impact of a tighter monetary policy stance, as well as slower growth in developed economies.

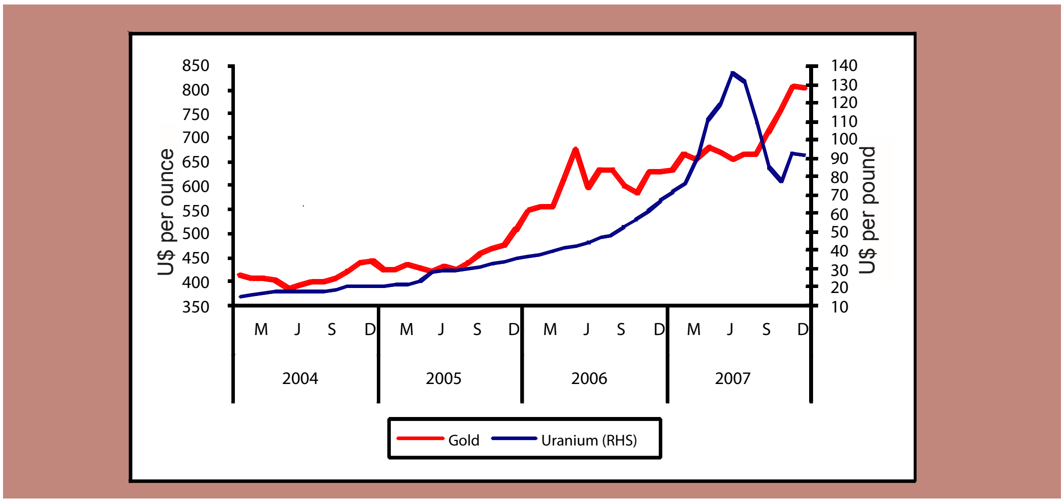
Furthermore, the continued power supply interruptions have raised questions about the long-term outlook for economic growth in South Africa. Such power interruptions not only weaken business confidence in the economy but also negatively impact on the retail sector and industrial output, especially in the mining sector. Expansion of the power generation capacity, thus, remains a challenge to be addressed for the economy to remain on the growth path in the medium term.

Inflation in South Africa, as measured by the CPIX and excluding mortgage costs, averaged 7.9 during the fourth quarter of 2007 up from an average of 6.5 percent recorded in the third quarter of 2007. This acceleration in inflation was mainly ascribed to increases in the transport sub-category, due to rising international oil prices, and to increases in food prices. In the medium term, the major upside risks to the inflation outlook remains oil and food prices.

2.2 COMMODITY PRICES

Most mineral prices have been rising since the beginning of 2006. In particular, uranium price has risen significantly and nearly quadrupled. The rise in mineral prices has been driven by high energy demand mainly from Asia, and, especially, from China and India. The uranium price, however, decelerated in most of the third quarter of 2007. (Chart 1.) This third quarter trend was reversed in the last quarter of the year.

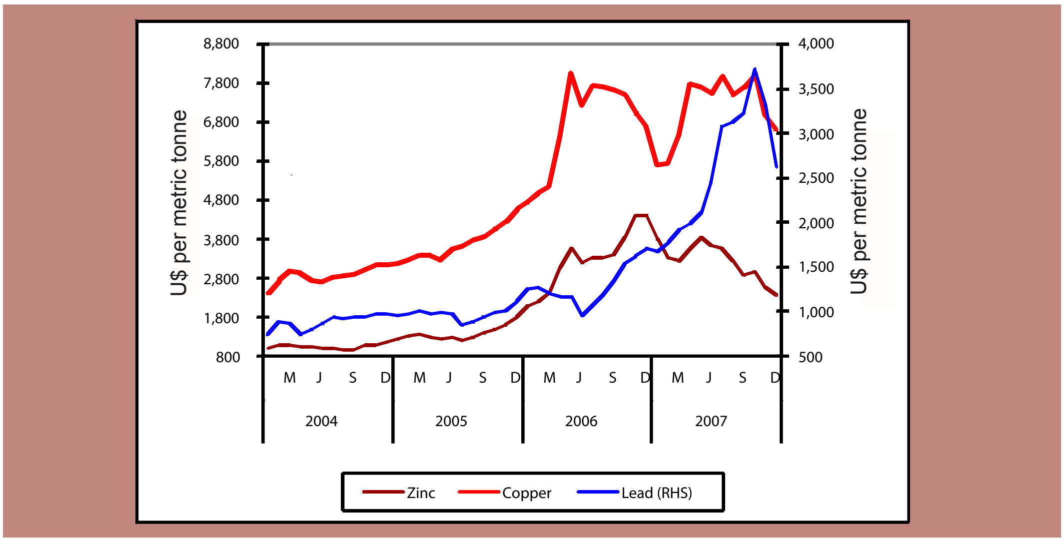
Chart 1: Monthly average mineral prices



Source: IMF & London Gold Price

The prices of copper, lead and zinc have also started to fall since September 2007. In mid-November 2007, copper and zinc prices have slumped to multi-month lows on concerns that the US mortgage crisis that started in August 2007 could slow economic growth and curtail demand for commodities. (Chart 2). The prices of most minerals have changed since the beginning of the year. By mid-March 2008, the prices of gold, copper and zinc have risen by 16.8, 26.0, and 6.6 percent, respectively. The uranium price, however, has fallen by 17.8 percent during the same period.

Chart 2: Monthly average mineral prices

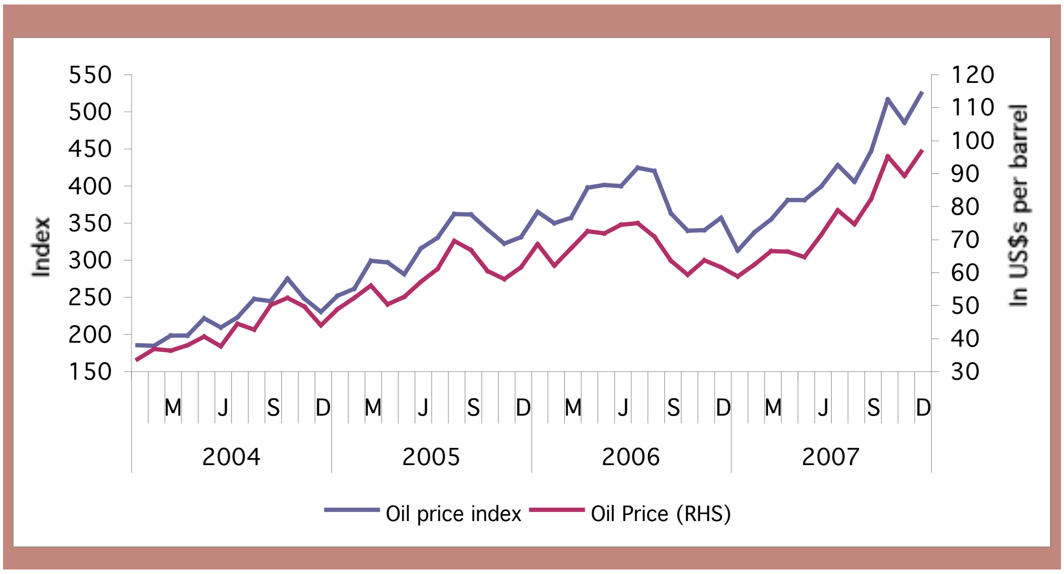


Source: IMF & London Gold Prices

Gold price increase was mainly due to investment demand, inflationary concerns in the US and speculative demand. Gold's strong performance is expected to continue to benefit from its role in asset diversification as a hedge against economic uncertainty. Uranium price fell mainly because of aggressive sellers offering discounted prices in an effort to draw buyers into the market.

Rising world energy prices has made food production more costly and created a strong incentive for farmers to switch from food production to fuel production, thus creating a shortage in the supply of food. All these effects feed into higher consumer prices and inflation. Sustained global economic expansion, especially led by China and India, is expected to keep commodity prices high in 2008.

Chart 3: Crude oil price and index



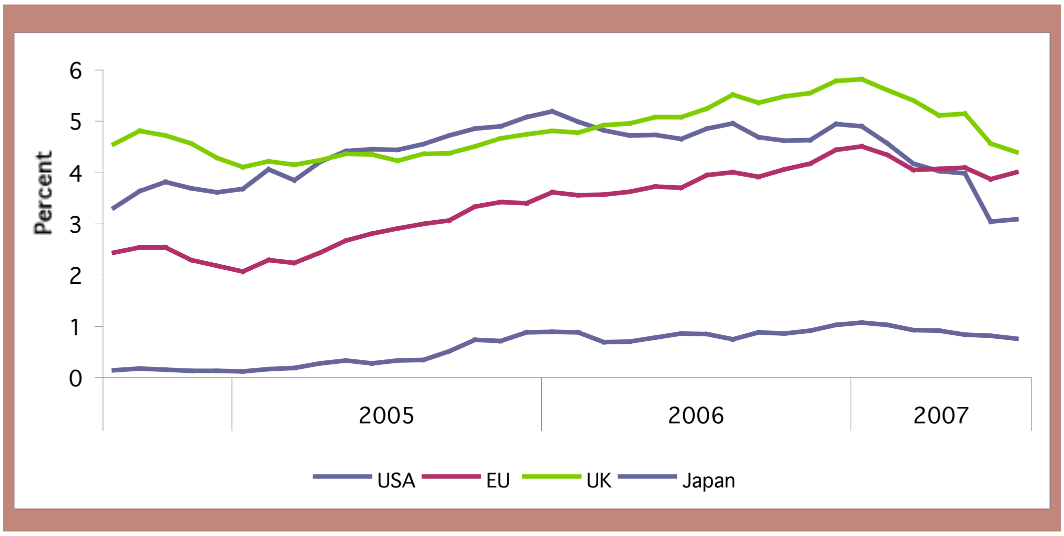
Source: Bloomberg

Energy prices have also been soaring in recent months, supported by strong demand, chiefly from in China and India. Oil prices reached a record of US$99.29 late in November 2007, boosted by the weak dollar amid concerns over falling oil supplies ahead of winter in the US and speculative inflows. (Chart 3). Oil prices are also a function of supply, geopolitical tensions in oil producing regions, speculation, and exchange rates, and expectations of economic performance. According to the IMF's October 2007 World Economic Outlook, oil prices are likely to remain elevated in 2008 due to supply constraints.

2.3 BOND MARKETS

In August 2007, the yields on U.S. Treasury bills fell the most in two decades on speculation that the Fed will cut its benchmark lending rate at its September meeting, at least a quarter-percentage point in response to subprime mortgage losses. (Chart 5) In September, the yield on the two-year notes fell by 6 basis points (or 0.6 percentage points) to 3.85 percent, after the Federal Reserve Bank of Atlanta President revealed that job growth rate started weakening back in June 2007.

Chart 4: Two-year bond yield



Source: Bloomberg.

In December 2007, two-year note yields fell as investors anticipated a Fed interest rate cut. The yields on the U.S. two-year bonds have declined by 88 basis points since November 2007 as subprime mortgage losses mounted. For various reasons, including the subprime mortgage debacle, two-year bond yields have also been subdued in the Euro Zone, Japan and United Kingdom.

2.4 Stock Markets

The performance of the major stock exchanges has been mixed throughout 2007. (Chart 6) In September 2007, most U.S. Stocks dropped for two consecutive days after Federal Reserve officials suggested the economy may be faltering because of the housing slump. In November 2007 U.S. stocks declined after General Motors Corp. posted its biggest loss ever, and shares of the largest U.S. savings and loan Mutual Inco. fell the most in 20 years. Similarly, the stock of the world's largest automaker dropped after the company reported a US$39 billion quarterly loss.

Chart 5: Performance of major stock exchanges

Source: Bloomberg

Equities around the world continued to fall in early December as the fallout of problems in the US subprime mortgage market appeared to be deepening as banks in the United States and Europe have announced billions of dollars in mortgage-related losses. In mid-December, European and Asian stock markets fell heavily, even after Wall Street (US) had ended higher. The Paris CAC 40 was down by 1.65 percent, London's FTSE 100 shed 1.46 percent and in Frankfurt the DAX 30 gave up by 0.89 percent.

Over the same period, Japanese share prices closed down by 2.48 percent, while Hong Kong and Chinese equities each shed 2.7 percent, while in Australia, share prices fell by 0.3 percent. Asian and European stocks tumbled further in December 2007 as strong US inflation data reduced expectations the Federal Reserve would deliver further interest rate cuts. The FTSEurofirst 300 index reacted by falling by 1.3 percent, while Asia fell even deeper by 3.5 percent.

2.5 IMPLICATIONS OF GLOBAL DEVELOPMENTS FOR NAMIBIA

So far, the impact of the global economic downturn on Namibia has not been severe. Furthermore, the economic outlook for China and India, the major importers of some of Namibia's minerals, is expected to be positive in 2008. However, a deeper than anticipated slowdown in the global economy would dampen demand for commodities and lower their prices. For Namibia as a commodity exporter, this would translate into less revenue for exporting firms, in particular. Furthermore, the country could also experience a reduction in economic activity, which in turn might lead to reduced incomes for both households and businesses. Consequently, adverse conditions in the global economy are only expected to have a moderate impact on financial stability in Namibia in 2008.

Tighter liquidity conditions in international capital markets would imply that Namibian banks would not be able to obtain sufficient fund from these markets. Similarly, the South African parent banks would also face difficulties acquiring funds for their Namibian subsidiaries. However, the risk to financial system stability posed by the inaccessibility to international capital markets is low, given that Namibian banks heavily rely on domestic deposits to fund their lending.

Namibia is a net importer of oil and the country also imports most of its food stuffs. Rising oil and food prices would, therefore, stoke inflationary pressures in the domestic economy and may compel the Bank of Namibia to raise interest rates to contain the inflationary pressures. High interest rates have the effect of raising the debt repayment burden for borrowers, thereby reducing their solvency and increasing the likelihood of an adverse impact on the bank balance sheets. Impaired bank balance sheets would put pressure on financial system.

A sharp decline in international bond yield would affect Namibian institutional investors (for example, pension funds) who invest in international bond markets. In the US, in particular, bond yields have fallen sharply following aggressive rate cuts by the Fed. This fall brought the return on bonds down to very low levels in recent months. As the Fed is expected to continue cutting rates in 2008, the return on bonds would decline even further.

However, the hostile impact on Namibian institutional investors is mitigated by the fact that the exposure of these investors to the securities of developed markets is somehow limited. Thus, the risk to financial system stability emanating from unfavourable movements in global bond returns is judged to be low in the medium term.

Namibian institutional investors could also lose value if the international stock exchanges lose value. However, this impact is alleviated by a limited exposure to international equity markets, which are more affected by the fallouts from the US housing crisis, given the exchange control environment of the CMA. Under these circumstances, the risk to financial system stability from international equity markets is considered low.

3. STATE OF THE NAMIBIAN FINANCIAL INDUSTRY

This section provides analyses of the domestic economic and financial conditions that influenced the performance of the financial system in the second half of 2007. It also highlights areas of concern or comfort from a financial system stability perspective.

The domestic economy continued to provide favourable conditions to the banking sector that are well capitalised and profitable. The Bank of Namibia judges that the four banks are sound and in a position to absorb unexpected losses.

3.1 FOREIGN EXCHANGE RESERVE ADEQUACY

Namibia's public finance and external balance sheet numbers have strengthened significantly in 2007 due to a confluence of factors, including strong exports receipts, exceptional revenues from the Southern African Customs Union (SACU), and a continued disciplined approach to public finance. Consequently, Namibia's foreign exchange reserves level has risen from NAD 3.3 billion at the beginning of 2007 to NAD6.5 billion at the end of 2007..

Table 1: Foreign reserve holdings in terms of import cover and currency in circulation

	2005				**2006**				**2007**			
	Mar	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**	**Sep**	**Dec**	**Mar**	**Jun**	**Sept**	**Dec (f)**
Import Cover in Weeks	6.3	5.6	4.9	4.7	6.9	7.2	6.5	6.7	12.0	13.5	14.2	13.8

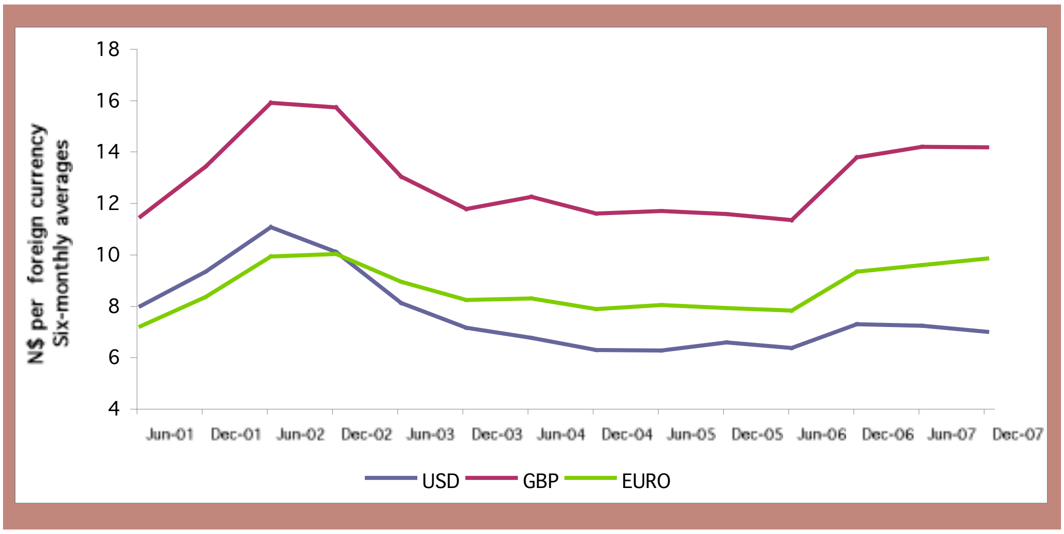
This rise in reserves will help mitigate concerns about weak international liquidity within the context of very large capital outflows by Namibian pension and insurance funds to South Africa's capital markets. Sufficiency of reserves is an essential assessment of a country's ability to withstand external shocks. This is mostly judged using the equivalent number of months of imports. This measure mainly determines how long a country could continue importing goods and services if all other inflows of foreign exchange were to dry up.

As measured in weeks of import cover, Namibia's foreign exchange reserves increased from 6.7 weeks in December 2006 to 13.8 weeks cover as at the end of December 2007. (Table 1) This level of weeks of import cover compares favourably with the IMF recommended cover of 12 weeks of imports. The country's reserves have been growing at a healthy pace. The risk emanating from the reserves is low and there is, therefore no threat on financial stability.

3.2 EXCHANGE RATE DEVELOPMENTS

The Namibia dollar (NAD) exchange rate strengthened on average by 3.2 percent and 0.2 percent in the second half of 2007 against the US Dollar and the Pound Sterling, respectively, but weakened by 2.7 percent against the Euro. The appreciation against the US Dollar and the Pound Sterling was a continuation of the gains that started in the first half of 2007. On the other hand, the depreciation in terms of the Euro was a repetition of the first half performance.

Chart 6: Namibia Dollar per foreign currency



Source: South African Reserve Bank

In December 2007, NAD reached a sixth-month average rate of N$6.9, N$14.1 and N$9.8 against the US Dollar, the Pound Sterling and Euro, respectively. (Chart 6).

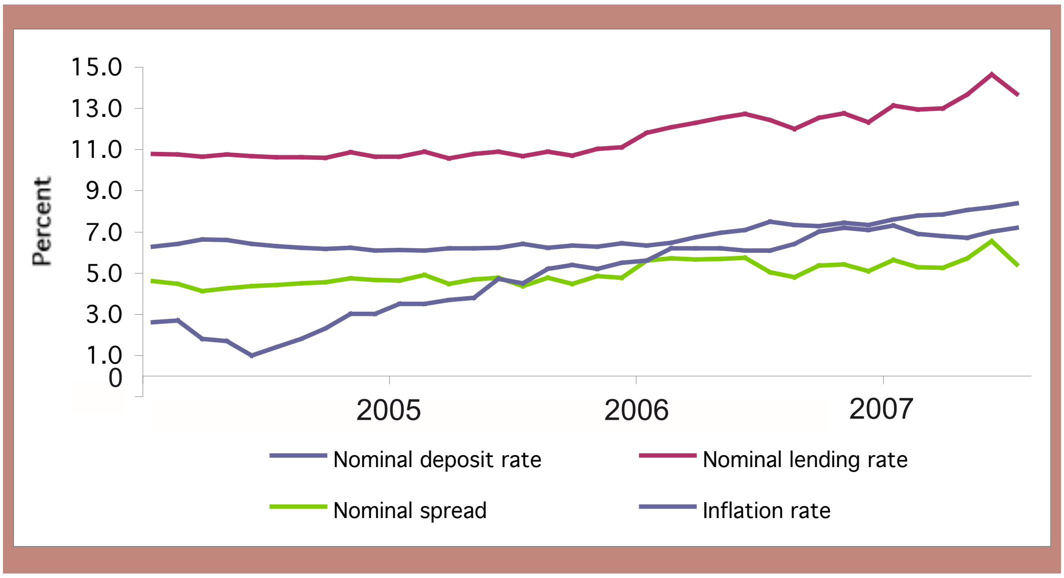
The NAD has been more volatile in recent months. The reasons for this elevated volatility included uncertainty in the international markets resulting from the US subprime mortgage crisis, and concerns about the future of the mining sector in South Africa in the wake of the current electricity emergency.

Consequently, the NAD fell against the US Dollar by 2.3 percent from N$6.8 in December 2007 to N$6.9 in January 2008. The fall was in tandem with the South African currency because of the one-to-one peg between the two currencies. The weakening NAD might drive inflation higher in Namibia and lead to further interest rate increases. High interest rates are likely to slow down the economy and exacerbate indebtedness of borrowers, with possible adverse consequences for the banking sector and financial stability.

3.3 INTEREST RATE DEVELOPMENTS

Developments in interest rates have wide and varied effects upon the economy and financial system, by having an impact on factors that influence the behaviours and fortunes of both households and businesses. For Namibia, perhaps the most important and visible influence of changes in interest rates is on the property market and vehicle sales.

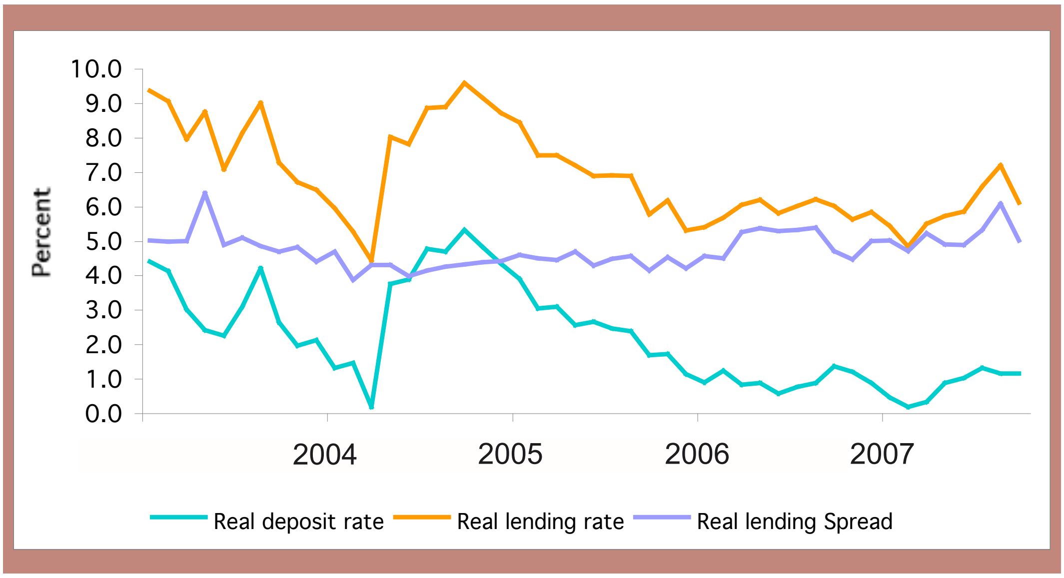
Chart 7: Nominal rates, spread and inflation



Source: Bank of Namibia

The average nominal lending rate rose from 12.2 percent in the second quarter of 2007 to 13.6 in the fourth quarter. (Chart 7). The inflation rate went up slightly from 7 percent to 7.1 percent during the period. In agreement with its nominal counterparty, therefore, the real average lending rate rose from 4.9 percent to 6.1 percent over the same period. (Chart 8).

Chart 8: Real interest rate



Source: Bank of Namibia

A continued rise in interest rates raises the debt repayment burden for both households and business, and could result in high non-performing loans for the banks. High interest rates have a negative impact on bank balance sheet and, therefore, high risk implications for financial stability in general.

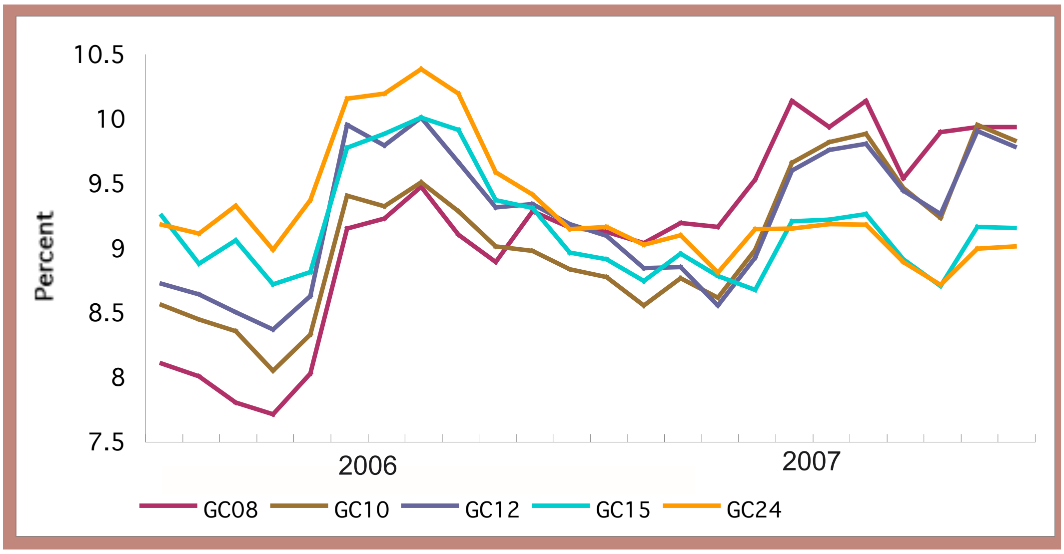
3.4 CAPITAL MARKETS

The yields on Government bonds in Namibia are influenced largely by movements in the bank rate, and the interchange between the demand for and the supply of bonds. Bond yields were generally lower towards the end of 2006 when the bank rate was also lower. In mid-2007, the bank rate rose and the respective bond yields followed suit. The bank rate rose from 9.00 percent in May to 9.50 percent in June, to 10.00 percent in August, and to 10.50 percent in November.

Although generally high in the second half of 2007, the yields fluctuated. The movements in yields could be explained by developments in short-term monetary rates because trading in the secondary market was minimal, as the Government did not issue bonds in the primary market over the period. (Chart: 9) In the last quarter of 2007, the yields on GC08, GC15, and GC24 flattened at about 9.92, 9.14, 9.00 percent, while those on GC10 and GC12 fell marginally from 9.94 and 9.89 percent to 9.82 and 9.77 percent, respectively. The yield on GC08 was the highest in 2007, and ended the year at 9.92 percent.

The short supply of securities in the local market does not augur well for the goal of market deepening, which implies availability of securities for investment. The dearth of securities for trading in the market also means that liquidity which is already a concern in the bond market was exacerbated in the second half of 2007.

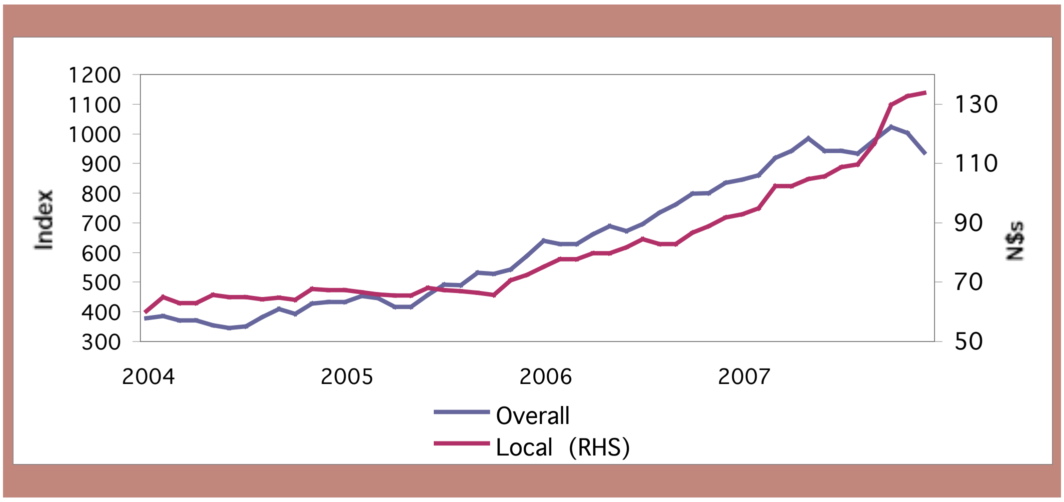
Chart 9: Government Bond Yields



Source: Bank of Namibia

In addition, a shortage of securities could hamper credit extension because banks would not find enough securities to pledge when they borrow from the Bank of Namibia. This inadequate supply could also prevent banks from obtaining sufficient securities to meet statutory liquidity requirements. In order to alleviate the shortage in the bond market liquidity, the Bank of Namibia issued short-term debt securities (Bank of Namibia bills) in August 2007. The risk to financial system stability emanating from the shortage in the supply of debt securities in the local bond market is, consequently, considered low.

Chart 10: Namibia stock exchange prices and indices



Source: Bank of Namibia

With respect to the stock market, the local share price index of the NSX rose by 25 percent in December 2007 to 133 points from 105 points in June 2007. (Chart: 10). The growth came on the back of a stellar performance by some of the local companies whose share prices increased significantly. The index was also aided by the scarcity factor. There are few local shares available in the market, as shares are tightly held, and those who want to buy them should, therefore, offer higher prices. In addition, the local part of the index has not been affected by international financial events, to a large extent.

The overall price index, which contains shares listed on both the Johannesburg Stock Exchange (JSE) and NSX, fell by three-quarters of one percent (0.75 percent) from 936 points in June to 929 points in December 2007. However, by the end of January 2008, the NSX overall index has decreased by 24 percent since October and 15.4 percent since the end of last year. The decline was in line with the JSE where share prices fell by 19.4 percent between October 2007 and January 2008 and by 12.2 percent between December and January. The fall was mainly seen as fallout from the US housing market crisis and the subsequent fears of a US recession that could lead to a world-wide economic slowdown.

The local market capitalization rose from N$4.6 billion in October to N$4.8 billion in December 2007, following new listings. Over the same period, the overall market capitalization fell from N$1.3 trillion to N$1.2 trillion. The decline in capitalisation could mean that the net asset value of the shares of Namibian institutional investors has also decreased. The decrease, if significant enough, might affect the financial position of these funds. This effect, however, only has a low risk impact on financial stability.

3.5 BANKING-, HOUSEHOLD-, CORPORATE-, AND HOUSING SECTORS

3.5.1 Banking sector

Banks are the central components of the financial system. All economic transactions involve some form of payment, and a crisis in the banking system could, therefore, have serious consequences for payments. Moreover, banks are systemic in nature. A problem in one bank is liable to spread to other banks and thereby develop into a threat to the banking system as a whole. This means that adverse shocks originating from the banking sector can spill over both to the rest of the financial system and to the real economy.

This part of the *Report* analyses developments in the banking sector and the factors there that could exacerbate the risks in the banking system since the publication of the previous Report in September 2007. The analysis reviews the implication of the banking structure on the banking sector performance, and, then, focuses on risks in profitability, asset quality, the structure of funding and liquidity, and on capital. The section also assesses the impact of the major borrowers' balance sheets on the banks.

Structure

The structure of the banking system is captured by the number of banks and the extent of differentiation between them as credit providers – which reflect on potential borrowers' credit-accessibility costs. The number of banking organizations in the Namibian banking system has remained unchanged, at four, in recent years. The extent of differentiation between banks summarises various factors, such as banking sector regulation, banks' deliberate product differentiation strategies, credit market friction, and lack of transparency.

The banking sector has registered a Herfindahl-Hirschman index (HHI) of 2,768 points at December 2007, signifying a high level of banking concentration, compared with an HHI of 1,000 points considered as a limited concentration level. A banking sector with such a high level of concentration is considered to be less competitive.

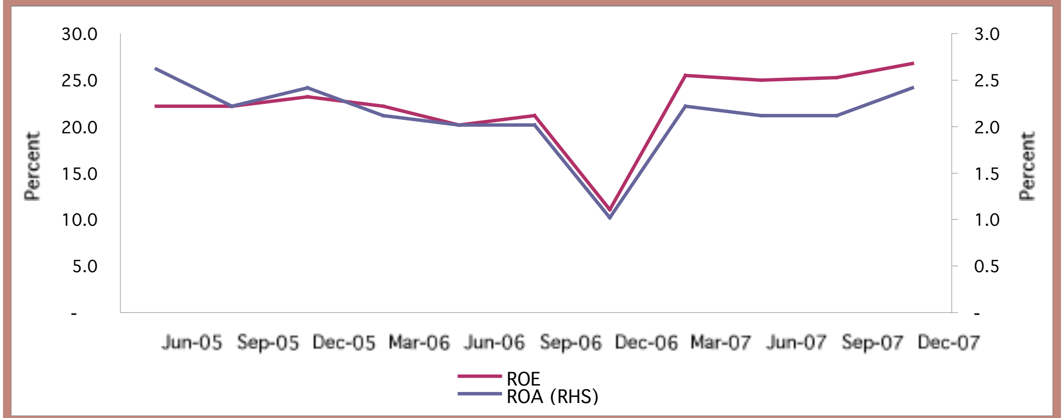
Income and Profitability/Earnings

Bank profitability is a crucial factor for financial stability. As a rule, sound profitability enhances a bank's capacity for coping with unforeseen negative effects. Changes in profitability, therefore, can indicate the extent to which banks are exposed to strategic risks[1]. In the third quarter of 2007, the net income after tax of the banks rose by 13.2 percent, partly as a result of increased net interest income that rose by 10.5 percent in the period. The increase in net interest income came, mainly, in the form of mortgage loans to the household sector and overdrafts. Another factor behind the increase in net after-tax income was *other operating income*, which grew by 10.4 percent as a result of a boost by income from *available for sale securities* and *transaction fee income*.

1 Strategic risk is the current and prospective impact on earnings arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes.

The return on assets (ROA) and return on equity (ROE) continued the improvement that started in the first half of 2007, after dipping in the fourth quarter of 2006 following a heavy fall in income at two banks. The two ratios improved to 2.4 and 26.6 percent, respectively, in the fourth quarter of 2007. (Chart 11).

Chart 11: Post-tax return on assets and return on equity

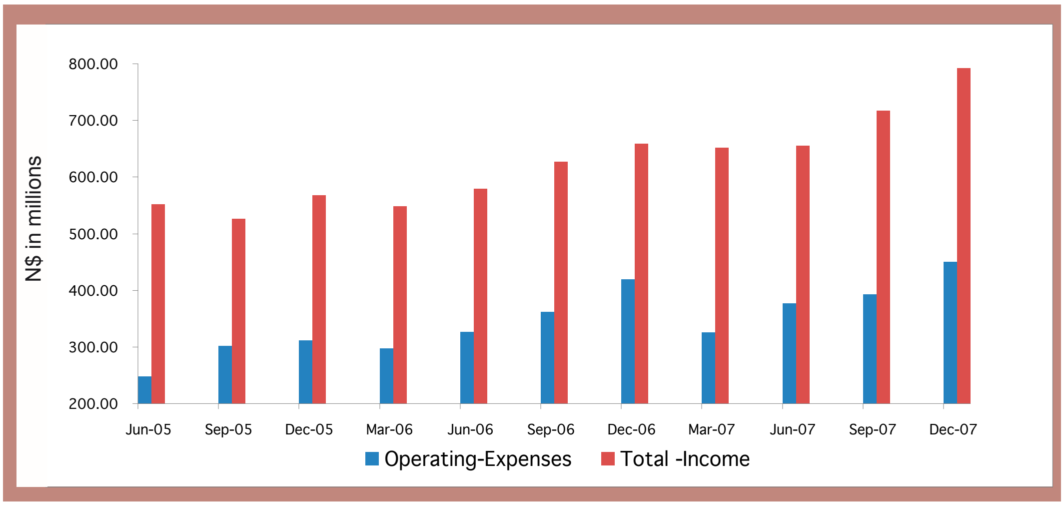


Source: Bank of Namibia

Costs

The operating costs of the four banks rose by 14.5 percent in the second half of 2007. The increase was led by increases in consultancy and management fees and staff costs, accompanied by marginal increase in occupancy expenses. The increase in staff costs is partly explained by higher performance-related compensation, but the banks also employed additional staff, from 4,034 permanent employees in June to 4,224 permanent employees in December, 2007.

Chart 12: Costs and Income of banks



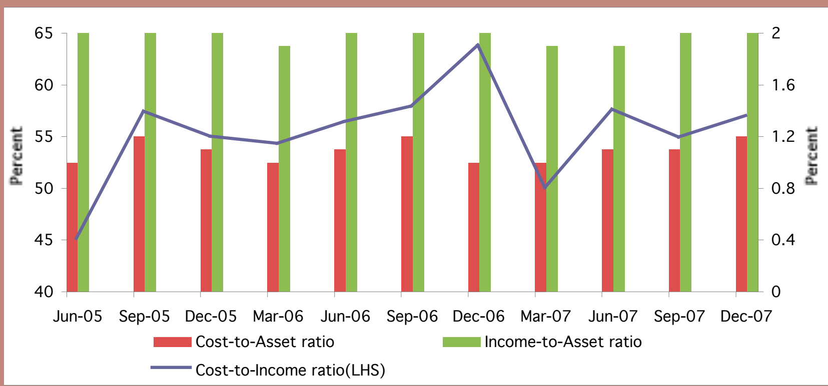
Source: Bank of Namibia

Cost efficiency deteriorated, given relatively higher increase in costs (14.5 percent) compared with a slower rise in total income (10.5 percent). (Chart 13). In the last quarter of 2007, the costs to income (C/I) ratio that measures the cost efficiency of banks relative to their income was 56.8 percent, as opposed to 54.8 percent in the preceding quarter. The decline in cost efficiency is also evident in the rise in the costs to assets (C/A) ratio, which measures cost efficiency relative to assets.

Funding – liquidity

The maturity of a bank's funding in relation to its lending is an important determinant of its vulnerability to liquidity risk. Holdings of assets that can be liquidated, via sale or repo, to raise funds quickly in the market is a key part of banks' protection against liquidity risk. That is, liquidity is primarily managed by holding a buffer of liquid assets.

Chart 13: Banks' cost efficiency

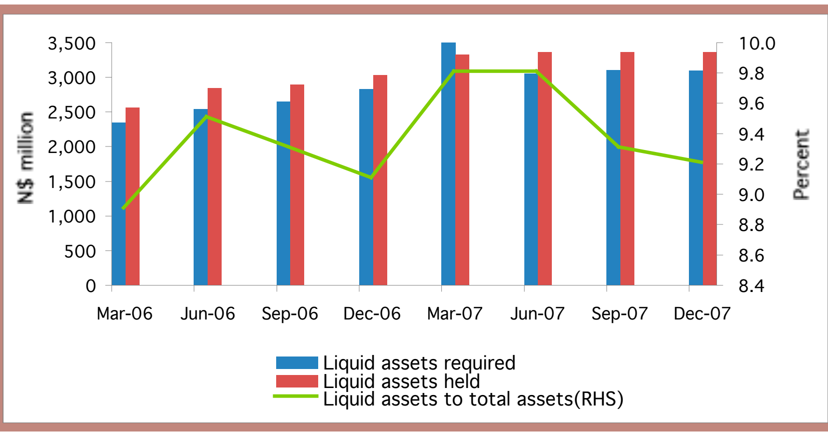


Source: Bank of Namibia

One factor tracked in analysing the financial instruments that banks can utilise to support their liquidity is the level of liquid assets. Namibian banks' holdings of liquid assets comfortably exceed the regulatory minimum; although there was some slight decrease in holdings of total liquid assets as a proportion of balance sheets over the past six months. The proportion of liquid assets to total assets fell slightly from 9.3 percent at the end of September 2007 to 9.2 percent at the end of December 2007. (Chart14.)

Liquidity is also managed by limiting the dependency on short-term borrowings and

Chart 14 Liquid assets and liquid ratio



Source: Bank of Namibia

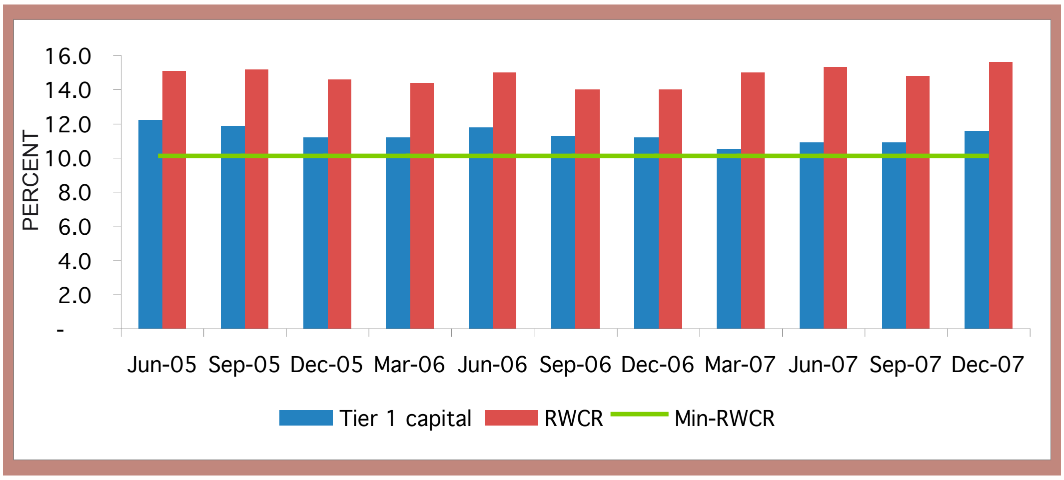
individual financiers and markets. To achieve this, banks normally take long-term funding positions and diversify their funding sources.

A medium-term measure of liquidity risk is the ratio of non-financial customers' loans to deposits (LTD ratio). The Namibian banks have a deposit surplus in their domestic market in recent years – deposits have exceeded lending to the public. In December 2007, the LTD ratio averaged 95.9 percent as against 92.8 percent a year earlier. (Table 4.) The ratio was thus still below the 100 percent threshold, above which it might prove essential to increase short-term interbank deposit market, issue long-term securities, or to seek refinancing outside the domestic market. Participation in these markets could increase funding expenses and make liquidity contingent on those markets.

The structure of bank funding is a central issue for stability. This is because the nature of banking – with predominantly illiquid assets in the form of loans, and the short-term liabilities in the form of deposits and borrowed funds – renders banks vulnerable to problems with funding and liquidity.

While deposits are traditionally regarded as a stable source of funds, the interbank and securities markets are much more sensitive to market confidence. The latter sources are, therefore, likely to dry up if banks capacity to meet commitments were to be questioned. The banking sector's vulnerability to liquidity risk, and, hence, financial instability is very minimal, given that Namibian banks fund their lending operations exclusively with stable deposits.

Chart 15: Capital adequacy for banks



Source: Bank of Namibia

Bank capital

Adequate capital is the foundation of a safe banking system, as it provides banks with a “cushion” against unexpected losses. Bank capital adequacy is one of the two most important areas of banking stability, the other being non-performing loans. A decreasing trend in capital adequacy, therefore, undermines the stability of the banking system and the efficient operation of financial markets.

The Bank of Namibia, through the *Banking* Institution Determination *5* (BID-5), requires all banking institutions to hold prescribed minima. Currently, the leading indicator of capital adequacy, the regulatory risk-weighted capital ratio (RWCR) of at least 10.0 percent is in force. Of this figure, 7.0 percent should be tier 1 or primary capital. Another measure of capital adequacy is the tier 1 capital leverage ratio, at 6.0 percent.

At the end of the fourth quarter of 2007, the capital adequacy and Tier 1 capital ratio of the Namibian banks averaged 15.7 and 7.8 percent, respectively. (Chart 15.) The increase in the RWCR came from a faster growth in total qualifying capital of 7.5 percent compared with a 1.9 percent increase in risk-weighted assets. The growth in total qualifying capital, in turn, was due to an additional N$250 million issue of share (tier 1) capital by one bank and to the transfer of profits to retained income. Another factor that contributed to the growth in total qualifying capital was an increase in revaluation reserves.

Table 2: Banking sector indicators

Income Statement ratios are annualised							
Amounts in N$'000							
	2006			2007			
	30-Jun	30-Sep	31-Dec	31-Mar	30-Jun	30-Sep	31-Dec
Total Assets	30,130,094	31,178,408	33,397,304	33,879,451	34,448,220	36,158,403	36,504,795
Tier 1 Leverage Ratio	8.20%	8.00%	7.50%	7.30%	7.40%	7.20%	7.80%
Tier 1 Capital Ratio	11.80%	11.30%	11.10%	10.50%	10.90%	10.90%	11.60%
Total Capital Adequacy Ratio	14.80%	14.30%	14.20%	14.60%	14.90%	14.80%	15.70%
Non-performing Loans	687,705	670,149	657,827	761,858	802,835	784,536	810,095
NPLs to Total Loans	2.90%	2.80%	2.60%	2.90%	3.00%	2.90%	2.90%
Provisions to Total Loans	2.00%	2.00%	2.40%	2.40%	2.30%	2.20%	2.10%
Specific Provision to NPLs	28.40%	33.10%	45.60%	40.60%	41.80%	37.60%	37.00%
Net Income After Tax	148,889	155,998	83,225	189,586	179,142	196,987	222,939
ROA	2.00%	2.00%	1.00%	2.20%	2.10%	2.20%	2.40%
ROE	20.30%	20.70%	10.90%	25.30%	24.00%	25.10%	26.60%
Net interest margin	4.80%	5.20%	5.40%	5.10%	5.00%	5.30%	5.70%
Net interest spread	5.00%	5.50%	6.00%	5.70%	5.40%	5.70%	6.10%
Cost-to-income ratio	56.30%	57.80%	63.70%	49.90%	57.50%	54.80%	56.90%
Liquid Assets Held	2,850,759	2,896,752	3,031,234	3,329,862	3,368,886	3,369,993	3,367,865
Liquid Assets Required	2,540,777	2,650,767	2,833,494	2,966,044	3,050,454	3,105,497	3,094,273
Liquid Assets to Total Assets	9.50%	9.30%	9.10%	9.80%	9.80%	9.30%	9.20%
Loans to Deposits	93.70%	95.10%	92.80%	97.70%	98.40%	91.60%	95.90%
Loans to Total Assets	77.60%	76.80%	73.60%	76.80%	76.80%	74.30%	76.20%
Herfindahl index(points)	2,712		2,730		2,769		2,678
Branches and Agencies	134	133	142	144	144	149	153
Permanent Employees	3,751	3,869	3,893	3,973	4,034	4,111	4,224
Temporary Employees	121	120	218	147	189	170	169

Source: Bank of Namibia

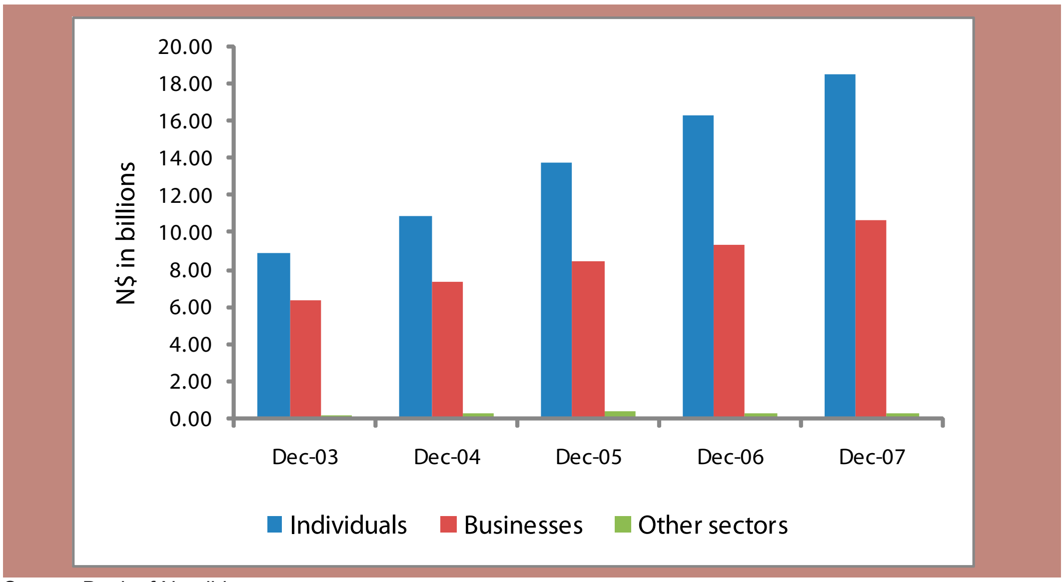
Asset quality – credit risk

The assets of the four banks rose by about 6 per cent in period between June and December 2007, and their value at December totalled over N$36 billion. Increased lending contributed to the rise in assets.

The total loan stock of the four banks rose by 13.7 percent to N$29.6 billion at the end of December 2007, up from N$26.1 billion in the preceding year. The balance sheet of the banking sector as a whole shows a high but stable loan-to-asset ratio accounting for 76.2 percent. (Chart 16.) Lending to households comprise 62.8 percent of total bank lending, compared with 35.9 percent for lending to businesses.

Bank residential mortgage lending, which has shown a steady growth since December 2003, was approximately 42 percent of total bank lending. (Table 3.) Another item, not less significant, in bank balance sheets is claims on depository corporations, particularly on other banks. However, the risk involved in lending to depository institutions is small, as information on these counterparties is more readily available and they are required to meet the prudential standards set by bank supervision. Furthermore, since placements are generally short-term, the counterparty's financial condition can be more accurately foreseen. Loans to general government institutions represent a minor part of banking sector assets and the credit risk arising on these loans is comparatively minimal.

Chart 16: Lending by banking institutions



Source: Bank of Namibia

Non-performing loans (NPLs) are one of the two most important fields in assessing banking stability, the other being the capital adequacy. Indeed, an increasing trend (the problem) of NPL undermines the stability of the banking system and hampers its effectiveness in performing its most important channel of financial intermediation. The availability of reliable information on the level, size, structure and characteristics of NPLs is, therefore, crucial for the assessment of asset/loan quality and banking stability.

Asset quality at the banks improved in 2007. At year end, the rate of credit not accruing income out of total credit –the indicator that reports the assessment of NPLs – stood at 2.9 percent at the end of December 2007, compared with 3.0 percent at June 2007. (Chart 18.) This decline in the NPL ratio in the last six months can be considered an improvement, albeit minor, in asset quality for the banks. Although the overall quality of assets remains good, it is important to keep a close watch.

Statutory large exposures[2]

Statutory large exposures remained almost unchanged at N$4.8 billion for 2007. N$2.7 billion of the figure represented outstanding exposure balances.[3] Due to the growth in loans and advances, statutory large exposures as a percentage of total loans, fell from 18.9 percent in 2006 to 16.8 percent in 2007. Large exposures expressed as a percentage of qualifying capital equalled 123.5 percent, decreasing from 148.6 percent in 2006, and is well within the limit of 800 percent allowed under the Determinations on Single Borrower Limit (BID 4). The decrease in the two ratios indicates a reduction in credit concentration risk with regard to large exposures to single borrowers.

Chart 17: Statutory large exposures relative to total loans

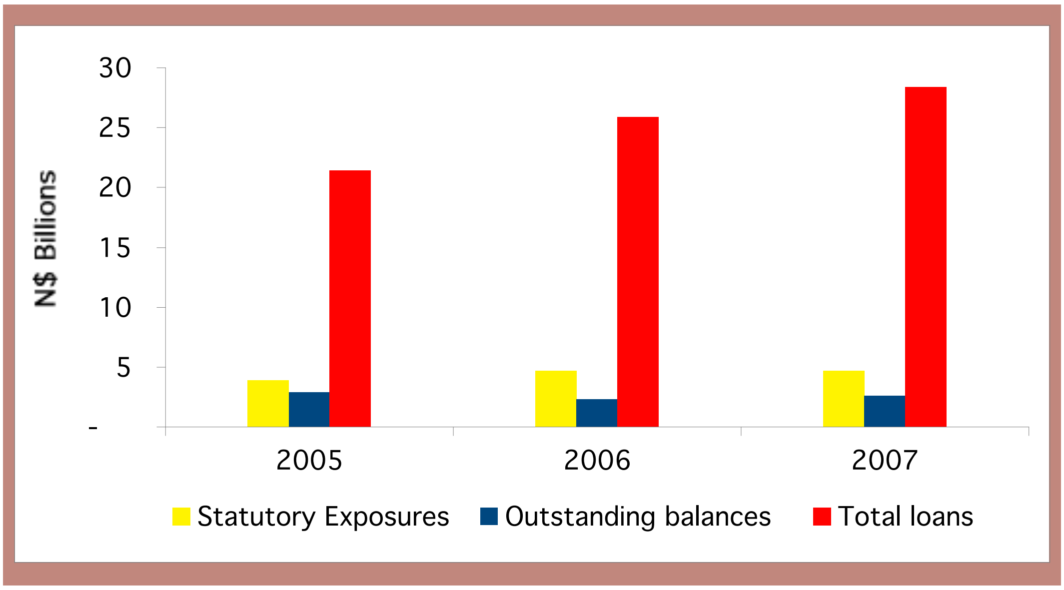
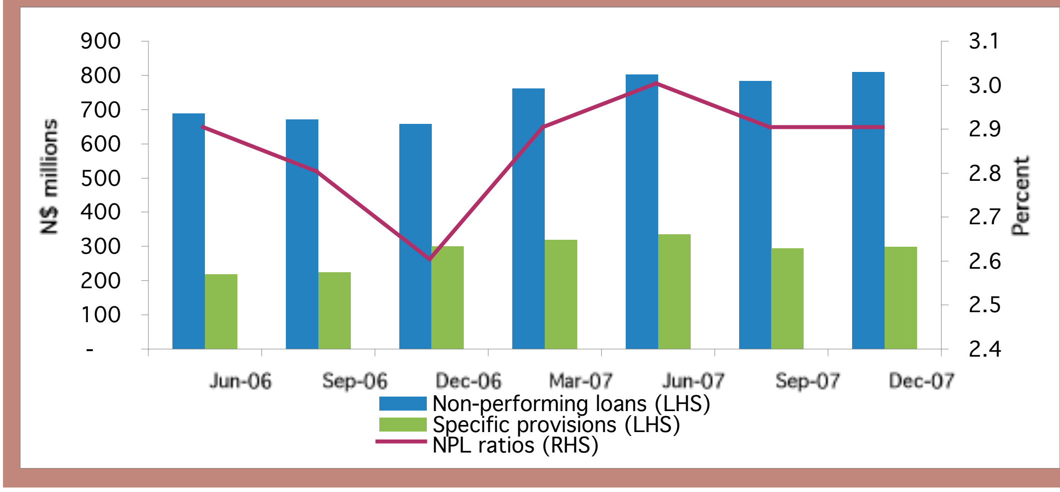


Chart 17 compares statutory large exposures and outstanding balances (balances utilised) with total loans and advances. Although the industry increased its loans and advances steadily (Chart 16), statutory large exposures remained relatively unchanged between 2006 and 2007.

2 Large exposures refer to all loans or credit facilities granted to a single borrower or a group of related borrowers that are equal to or exceed 10% of the banking institution's capital funds (regulatory capital). Statutory large exposures, on the other hand, refer to the higher of the approved limit and the outstanding balance.

3 An outstanding exposure balance refers to an amount actually utilised by the borrower.

Chart 18: Non-performing loans amounts and ratios



Source: Bank of Namibia

On the whole, the banking sector is generally stable; with adequate capital buffers, improving asset quality and earnings, and declining NPL ratios. However, the outlook for the sector will continue to be characterised by high concentration, which curtails competition and credit accessibility. Furthermore, rising costs relative to income, if not checked in time, could hamper future profitability.

3.5.2 Household sector

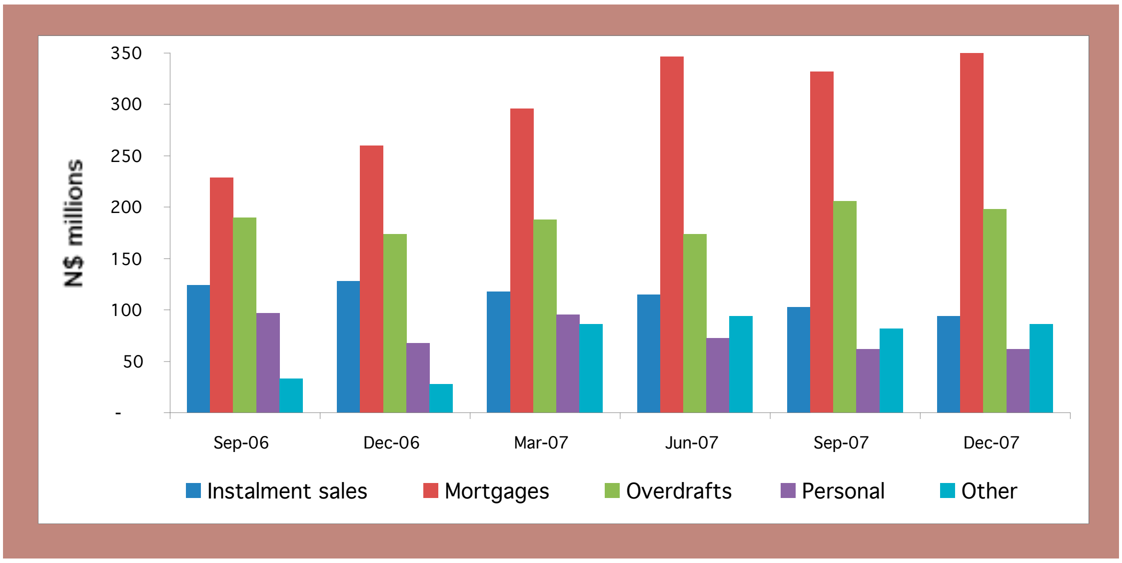
The financial health of the household sector has a significant and direct impact on banking stability, and, hence, on financial system stability. This is the case given that of all the loans made by banks to businesses and individuals, as at December 2007, 62.8 percent was extended to households. Banks are, therefore, the largest providers of household credit in Namibia.

A high level of household debt can create vulnerabilities in banks. In particular, if credit to households grows too rapidly, household debt may reach unsustainable levels and, if sufficiently large, can in turn jeopardise the stability of the financial system and overall economic growth. Household indebtedness to the banking sector, as measured by the debt to GDP ratio, rose from 34.8 percent at the end of 2006 to 35.8 percent at the end of 2007. The GDP amount for 2007 is a projection by the Bank of Namibia.

Household debt comprised 65.5 percent of loans extended by the *other depository corporations* in 2007. Loans to household grew by 2.6 percent on quarterly basis, and by 12.4 percent on annual basis, in the last quarter of 2007. This growth rate in debt cannot continue in the long term. The combination of rising food and fuel costs are exerting pressures on household budgets, which are already stretched as a result of the 350 basis point interest rate hikes since June 2006. Bank loan losses could, therefore, rise.

Figure 19 below shows the distribution of non-performing loan amounts by category of loans extended by banks. The mortgage category is showing an upward trend. Given that at December 2007 mortgage loans to the household sector constituted 42 percent of total mortgage loans extended by banks, the overall performance of the banks' loan portfolio is contingent on the credit quality in the household sector. (Table 3.) This quality might be compromised by deterioration in the financial position of the household sector.

Chart 19: Non-performing loans by category



Source: Bank of Namibia

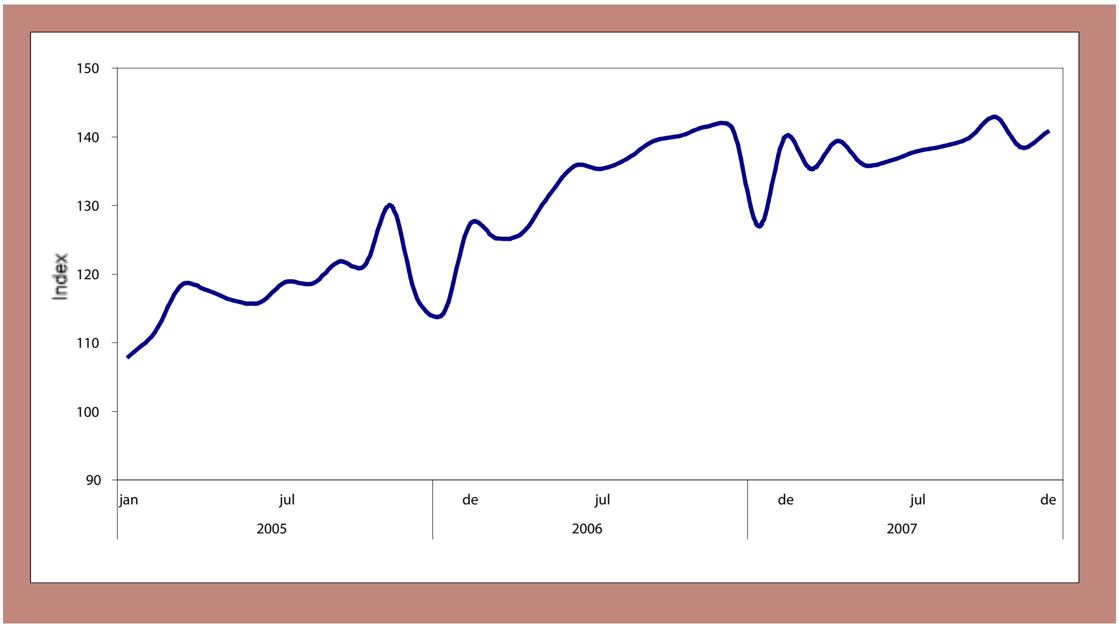
3.5.3 Corporate sector

Loans to the corporate sector accounted for 34.5 percent of the *other depository corporations*' total loan portfolio, and 36 percent of loans extended by banks to non-financial customers. (Table 2, Table 3) The indebtedness of the corporate sector to the *other depository corporations*, as measured by corporate debt to GDP, increased from 20 percent in 2006 to 21 percent in 2007. The GDP amount for 2007 is a projection by the Bank of Namibia. A comparable ratio for South Africa was 33.8 percent of GDP in the fourth quarter of 2006 and 36.3 percent of GDP in the second quarter of 2007. Credit extended to the corporate sector grew by 13.9 percent in 2007, compared with a growth rate of 11.4 percent in 2006. While these debt ratios compare favourably with their South African counterparts, they should be interpreted with care because of the possibility of differences in economic conditions in the two countries.

The performance of the corporate loan portfolio thus has important implications for financial system stability. The IJG Business Index declined in the fourth quarter of 2007. (Chart 20.) This subdued business climate is attributed, among others, to a fall in the prices of copper and zinc over the same period. (Chart 2) Other factors that could also explain this downturn include high inflation, rising oil prices and high interest rates.

All of these factors could have a significant impact on the economy. High fuel, for instance, will have a negative effect (in terms of higher input costs) on the mining, fishing and agriculture sectors. As profit margins get squeezed, loan repayment capabilities could also diminish.

Chart 20: Business Climate Index



Source: Institute for Public Policy Research

The Bank of Namibia estimated the economy to have grown at a respectable pace of 4.7 percent in 2007 and projects it to slow to 4.2 percent in 2008. The GDP growth projection is based on mining, manufacturing, construction, and transport and communications sectors, which are all set for growth.

The economic situation, however, could worsen if the looming power shortages lead to a deeper economic slowdown. A severe decline in economic activity would affect the creditworthiness of both companies and households. Such a development would aggravate if property prices fell at the same time. A significant deterioration in creditworthiness in the banks' borrowers would tangibly affect the Namibian banks.

Box A: What drives banks' ROE?

Profits represent a bank's first buffer against adverse shocks. The return on equity (ROE), calculated as the profit in relation to equity, is commonly used to measure bank profitability. An increased ROE is generally positive but needs to be interpreted with some caution because it may reflect changes in factors other than profits, such as increased risk or leverage. Hence, a rise in ROE does not necessarily represent (bank's) financial strength.

This Box introduces a risk-return framework to assess and compare banks' ROE across time. One way of decomposing the definition of pre-tax ROE is to beak the concept down into four factors (ratios): pre-tax profit margin, risk-adjusted income (efficiency), risk taking and leverage (Table B1).[1] This results in the following arrangement: An increased ROE driven by a higher profit margin (pre-tax profit/operating income) can be assumed to reduce the financial uncertainty in a bank because it indicates a greater difference between income and costs.

A rise in risk-adjusted income (operating income/risk-weighted assets) can also be seen as positive for stability in that it represents more income relative to risk-weighted assets. An increase due to greater leverage (total assets/equity), on the other hand, may indicate a loss of financial strength because it implies increased indebtedness and that can be assumed to increase a bank's risk.

An increased risk exposure (risk-weighted assets/total assets) can likewise be assumed to lessen financial strength in that, for example, it may mean that the bank has built up assets by lending capital for projects that are more risky. Consequently, whether a higher ROE implies that a bank is resistant towards negative chocks is dependent on the underlying factors of profitability; good margins and high efficiency or big risk taking and high leverage.

The breakdown of pre-tax ROE in the four ratios, ordered as in the table, is as follows:

$$\text{Pre-tax ROE} = \left(\frac{\text{Pre-tax profit}}{\text{Operating income}}\right) \times \left(\frac{\text{Operating income}}{\text{RWA}}\right) \times \left(\frac{\text{RWA}}{\text{Assets}}\right) \times \left(\frac{\text{Assets}}{\text{Equity}}\right);$$

where RWA stands for risk weighted assets.

Table B1. Decomposition of pre-tax ROE.

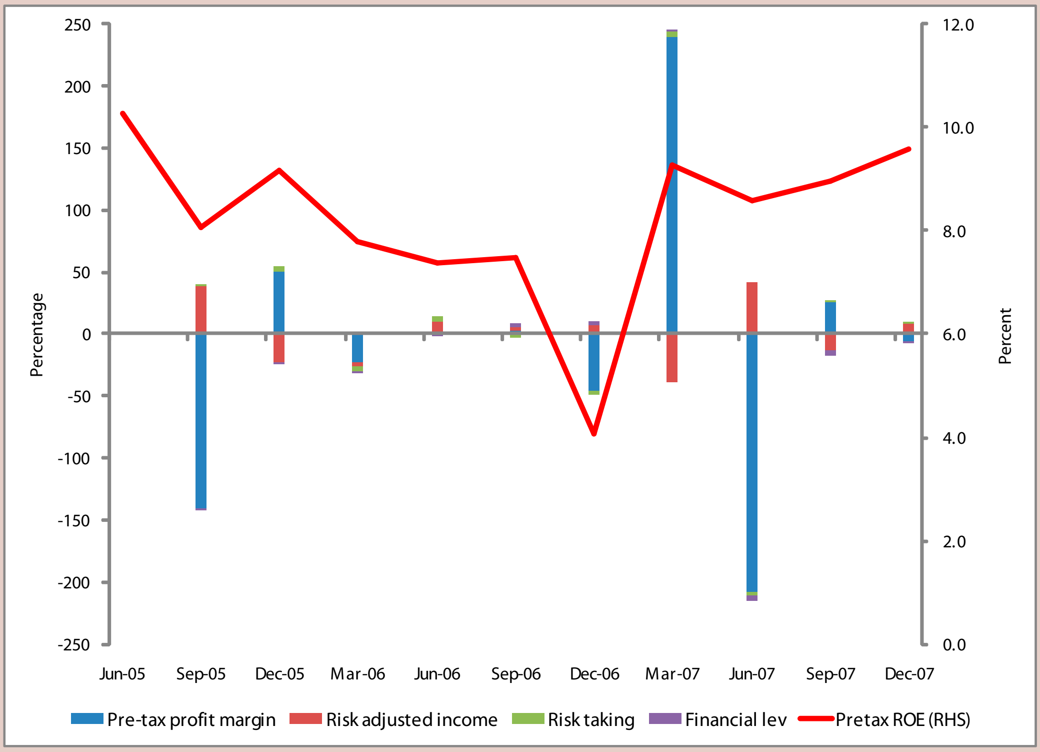
Factor	Description and financial stability implications
Pre-tax profit margin	Measures margin between income and costs
	Effect of rise: positive
Risk-adjusted income	Measures efficiency on a risk-adjusted basis
	Effect of rise: positive

[1] This approach has been used earlier by the Bank of England in *Financial Stability Review*, December 2003.

Risk taking	Measures (credit) risk (appetite) propensity Effect of rise: negative
Financial leverage	Measures gearing Effect of rise: negative

In the case of the four Namibian banks, the changes in ROE in recent years/quarters have come mainly from fluctuations in profit margins Chart B1). In December 2006, ROE dropped about 3.4 percentage points. This had mainly to do with a decrease in profit margin, although there was also a marginal loss in efficiency, measured as risk-weighted income.

Chart B1. Contributions to changes in banks' aggregate pre-tax ROE



In June 2007, the fall was due to a combination of decreased profit margins and lower risk taking, as well as lower financial leverage. In other words, the decreased ROE reflected not just a loss of financial strength but also a lower exposure to risks. Lower leverage could indicate that the banks have become less vulnerable. The downward shift in ROE was, however, countered by increased efficiency on a risk basis (risk-adjusted income).

The increased ROE in fourth quarter of 2007 was not due to either increased profit margin (between income and costs) or decreased financial leverage; it came instead entirely from better efficiency (on risk-adjusted basis), which (rising 10.1 percentage points) can be seen as positive for (financial) stability in that it represents more income relative to risk-weighted assets.

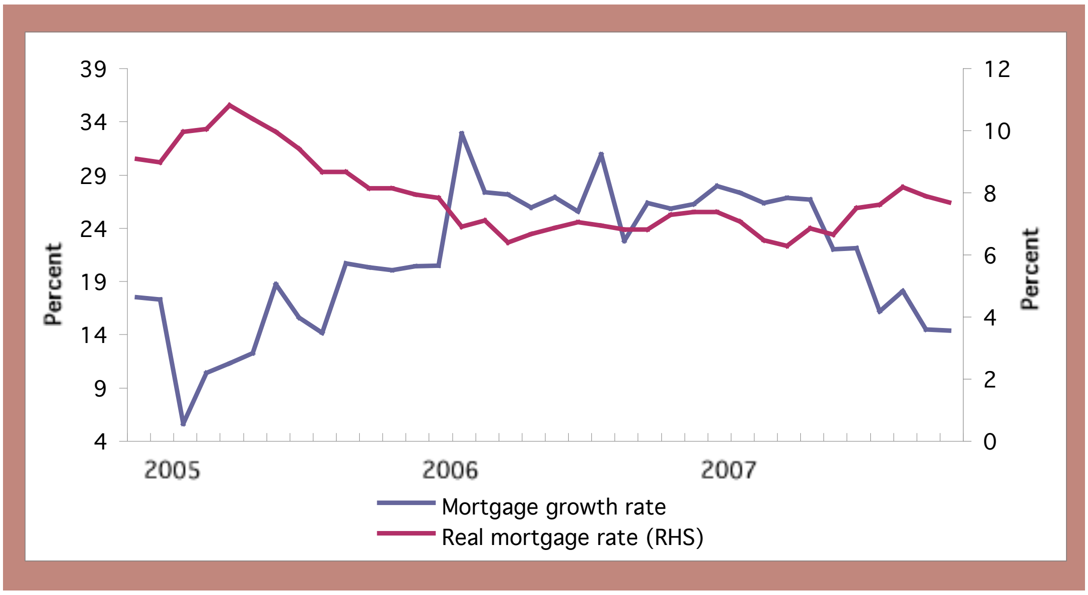
3.5.4 Housing market

Recent international experiences, such as the United States sub-prime housing crisis, indicate that banking sector stability can be jeopardised by a steep fall in property prices, in a situation where banks are overexposed to loans to finance the purchase of real estate (mortgage loans). Although the emergence of this danger on the Namibian property market is currently unlikely, the situation on this market has to be monitored, as does the banks' exposure to financing this market.

For both households and property developers, banks are the main source of financing for real estate (property) investment. (Table 2) Approximately 47 percent of all loans made by lending institutions to non-financial customers, at the end of December 2007, were mortgage loans. This fraction, none-the-less, represents a decline in growth of 1.8 percentage points from the third quarter, where the fraction was 49.2 percent.

The decline in mortgage loans was a result of an increase in real mortgage rate that started in the first half of 2007. (Chart 21) Excessive mortgage lending could, however, contribute to the inherent vulnerabilities of property markets to boom-bust cycles and the attendant cyclicality in the banking sector. The rise in interest rates in 2007 has impacted negatively on the housing market, as marked by the deceleration in mortgage growth rate, especially in the last half of the year. Mortgage advances would decline further if more interest rate hikes take place, and the affordability of housing will diminish further with the rising cost of debt servicing. Default rates might also rise in this loan category.

Chart 21: Mortgage growth and real mortgage rate (year-on-year)

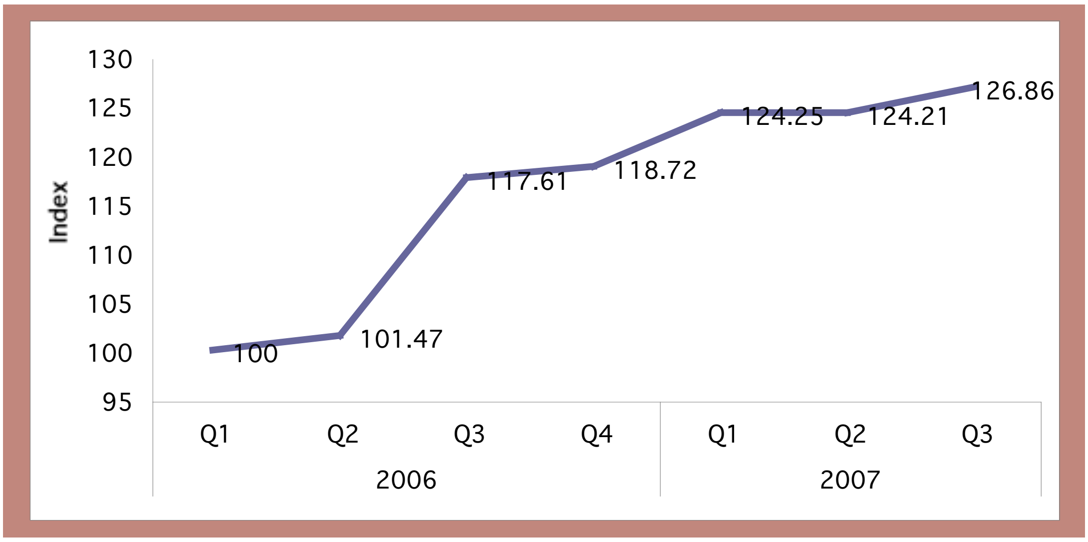


Source: Bank of Namibia

The house price index for Windhoek grew by a meagre 2.1 percent during the third quarter of 2007, after stagnating in the previous quarter. (Chart 22.) Most of the price growth came from the relatively less expensive suburbs of the town. House price growth in these suburbs is testimony to higher house demand in these areas. Prices were, however, depressed, and even declined in some cases, in the upper price-suburbs where house demand is more responsive to higher interest rates.

The quality of property loans, particularly those involving residential property, is currently considered higher than the average quality of lending to non-financial customers. The majority of these loans, around 85 percent, constituted residential loans that are secured by mortgages and, therefore, less default risky. However, there might be some risks associated with this category of bank lending. The NPL amounts for the mortgage category rose by 43.1 percent from December 2006 to December 2007 and, therefore, in general displayed the lowest loan quality of all loan categories. (Chart19). Although falling prices would not in themselves give rise to substantial loan losses in the banking sector, they could entail financial losses for both individual households and banks as the value for collateral falls.

Chart 22: Windhoek House Price Index



Source: First National Bank

The overall trend is that the high interest rates environment is dampening the prospects for the housing market. This conclusion is warranted by the marked deceleration in housing loans approved by financial institutions and by subdued increase in the house prices in Windhoek during the period under review. NPLs related to the mortgage category have been rising, at 7.2 percent between June 2007 and December 2007. Continued increases in interest rates could further raise borrowers' debt repayment burden. This might entail dire consequences for the housing market lenders. The risk to financial stability in the housing market is, therefore, considered high under the circumstances.

The level of capitalisation and profitability of the banking sector has improved in the second half of 2007. At the same time, asset quality is solid as NPLs has been on the decline. There is no threat of banking liquidity problems, with lending solely funded by stable deposits. The risk to financial system stability emanating from the banking sector is, therefore, low.

3.6 Non-bank financial institutions

Long-term insurance industry

The insurance sector is important to the rest of the financial system because of the links between the payment system and the insurance sector. The sector is also a significant part of the savings of Namibian households. Furthermore, the sector is involved in the payment system through: large-value payments; retail (insurance) premium that go through the clearing house (Namclear) before settlement in NISS (EFT); cheque payments; and card payments. There are 16 long-term insurance companies registered in Namibia as at 31 December 2007. Three companies hold about 88 percent of the premium market share, and dominate in terms of assets and membership.

The total assets of the long-term group grew by 8.7 percent from N$19.8 billion in the second quarter of 2007 to N$21.5 billion in the fourth. Growth in assets was led by increases in foreign assets (offshore and CMA), bonds, and balances held with banks. Foreign assets invested in the offshore and CMA increased by 76 and 21 percent, respectively, while investment in bond rose by 13.4 percent.

The income of the industry fell by 5.6 percent from N$1.2 billion to N$1.1 billion between the second and fourth quarters of 2007. A 34-percent decrease in investment income counteracted a 26-percent increase in premium income over the period to cause the fall in income. During the same period, total expenses rose by 13 percent from N$173.4 million to N$195.8 million over the period, due to increase in expense categories such as sales and remuneration, asset management fees and re-insurance.

At the same time, insurance claims paid soared by 43.8 percent from N$535 million to N$764 million. This was chiefly a result of huge increases in the categories: annuity benefits (51.8 percent); deaths (30.5 percent); and surrenders (19.2 percent). During the same period, the number of policy lapses fell from 19,149 to 16,474 (N$2.4 million). Of this figure, 7,887 (N$1.3 million) cases were lapses within the first year. Policy lapses normally result from lack of policy-premium affordability, mainly due to economic hardship, or prior misunderstanding, on the part of the policy holder, of policy benefits.

Long-term insurers are required to hold capital to protect their clients from any adverse effects and to protect the insurer from unexpected claims. However, there is no explicit method to determine the amount/level reserve/capital, apart from the requirement that assets should exceed liabilities. By this measure, the long-term insurance sector appears to be adequately capitalised, with surplus assets amounted to about N$2.7 billion at the end of 2007. Due to lack of data and data integrity problems, no analysis of other performance standards was included. Furthermore, the supervision of long-term insurers has been revamped and solvency requirements will now be based on the risks encountered by the underlying business.

Challenges and sources of vulnerability continue to face the long-term insurance sector. Furthermore, very few have changed in the sector since the last review. HIV/AIDS continues to negatively impact the sector. Inflation and increases in interest rates have implications on the investments made by the sector.

An economic slowdown could result in a decline in the demand for life insurance products, and could also increase the number of policy lapses. For example, the amount of benefits paid out with respect to surrenders, maturities and deaths increased significantly from the first to the third quarter of 2007. On the other hand, the sector has benefited from sustained equity returns although this level of profitability is not expected to continue.

Namfisa is also expected to introduce a new supervisory regime for long-term insurers that will require them to maintain a prescribed amount of capital. Furthermore, the new (accounting) reporting standards are likely to present some valuation problems. The insurance sector is also vulnerable to volatility in international capital markets because of their significant equity investment. A fall in the JSE index, for example, would also translate into a fall in the net asset value of the long-term insurance sector. Data limitations notwithstanding, the overall operations of the long-term insurance sector do not pose any significant risks to financial stability, although the outlook for the sector warrants close monitoring.

3.7 FINANCIAL INFRASTRUCTURES

In the third quarter of 2007, as part of the Bank of Namibia's responsibility for payment system of oversight, activities were undertaken to ensure that the system is in compliance with best practices as regards operational robustness, security, timeliness and resilience.

As a result, the payment system in Namibia continued to show a high level of robustness in terms of international standards. In particular, the high value payment systems are in compliance with the Core Principles for Systemically Important Systems (BIS Core Principles), and Namclear retail payment system availability remained very high in 2007. In addition, the high value payment systems compared very favourably with the high value payment systems in other countries.

The Bank of Namibia is taking a keen interest in, and closely monitoring, the activities of payment services providers, payment collectors and payment facilitators in the national payment system. The proliferation of non-bank financial intermediaries operating outside the regulatory framework could lead to the undermining of the stability and integrity of the national payments system, if they are not closely monitored.

The Bank of Namibia also examined the payment system participants' utilization of both the intraday and overnight repurchase agreement. The idea is to discourage frequent borrowing from the Bank of Namibia. The latter also reviewed the effectiveness of the goals of its credit policy. The goals of the credit policy are to ensure that intraday borrowings are repaid on the same day.

In addition, the Bank of Namibia started to study and compile the profiles of individual participants of the payment system in order to: (i) strengthen the general purpose of oversight; (ii) acquire an overall view of the likely source of risk on a participant-by-participant basis; and (iii) be able to act quickly before such risk becomes systemic.

There are, however, a number of areas were work is continuing; aimed at further reducing systemic risk, or the potential causes of systemic risk, in the National Payment System. These areas and/or activities include:

a. A review of settlement times, to ensure that a large part of settlement obligations is settled early in the day as opposed to settlement at the end of the day;

b. An introduction of intermittent settlement throughout the day, which shall result in the bulk of settlement obligations being reduced throughout the day, thereby reducing risk build up in the system in the day;

c. Implementation of measures aimed at reducing risks in the Namibian payment system, thereby ensuring its safety and efficiency;

d. Investigation of risk implications of a previously non-payment system participant converting to full participant status and signing up to all settlement agreements. Coupled with this, is the investigation of the risk of a payment system participant settling all its settlement obligations through another system participant; and

e. Reducing the cheque clearing cycle to 5 days.

In general, the nature and scale of the risks is dynamic, however, the measures that a currently being implemented to minimize liquidity risk in the payment system are expected to mitigate these risks. The Bank of Namibia also faces a challenge to respond, in its oversight activities, to global technological advances in key areas of the payment system that may change the risk focus and create new focus areas and dependencies.

The overall assessment of the payment and settlement system in Namibia, from the financial stability perspective, is that the system continued to operate satisfactorily in 2007. As mentioned above, there is no evidence of liquidity or collateral constraints in the system, or in the operations of domestic participants in the system.

4. Regulatory Developments

This section of the Report is devoted to the discussion of developments in some aspects of the regulatory framework that have implications for the operations of the financial system in Namibia.

4.1 Banking sector

In May 2007, the Bank of Namibia has issued a determination on country risk management. The purpose of this determination is to ensure that banks maintain effective and ongoing country risk management systems. The Determination applies to all banks authorized and operating in Namibia. It defines the six main types of country risk, and requires banks to have clearly defined policies and procedures for country risk management.

The determination also set specific requirements on, *inter alia*, country risk analysis and ratings, country exposure limits, monitoring, and country risk reporting requirements. The determination became effective on June 1, 2007.

4.2 Anti-money laundering

On July, 20, 2007 the Financial Intelligence Act (FIA) was passed by the parliament of the Republic of Namibia. This Act deals with money laundering control measures within the Republic of Namibia. Its stated purpose is:

To provide for the combating of money laundering and to establish an Anti-Money Laundering Advisory Council; to provide the Bank of Namibia with the necessary powers to collect, assess and analyse financial intelligence data, which may lead or relate to money laundering; to impose certain duties on institutions which, and other persons who, may be used for money laundering; and to provide for incidental matters.

While *a de facto* Financial Intelligence Centre (FIC) was established within the Bank of Namibia, on 13 October 2006, the year 2007 was regarded as a year of "institutionalizing" the FIC. The Bank appointed two professional staff as the Director and Deputy Director for the FIC, and is currently in the process of completing the recruitment of other staff. July 1, 2008 is earmarked as the day on which the FIC will open its doors for suspicious transactions reporting from accountable institutions and supervisory bodies.

Regulations accompanying the FIA are in advanced stage of completion. These, together with the FIA, will be made operational by the relevant authority in due course.

4.3 Companies act

The Companies Amendment Bill is at Parliament and if passed will have important regulatory implications for companies, including banks, in Namibia. The Namibian Companies Act was amended in 2004. It was published in the same year in the Government Gazette; however, the new law has not yet been enacted. A typo error slipped into section 82(4) during the printing process, which meant that the Companies Act of 2004 could not be put into operation until the error has been rectified. Section 82 deals with the premium account of a company. As premiums are regarded as share capital of a company, the premium accounts are strictly regulated in terms of what the company may use such premiums for. The Companies Act, 1973 (Act No. 61 of 1973), specifies what the premium account may be used for. The new Companies Act, 2004, added two more restrictions on what the premium account may be used towards. The restrictions, however, may not apply to redeemable preference shares issued before the commencement of the Companies Act of 2004. If this exclusion is not done, it will render all such transactions prior to the commencement of 2004 Act invalid. This exclusion was missing in the 2004 Act, due to the 'typo', and the position is now rectified with the Companies Amendment Bill 2007.

Box B: COMPANIES BILL, 2002

1. This box provides a broad overview of the contents of the new Companies Act, 2002, and the main changes that are not in the existing Companies Act, 1973. The Act applies to every company in Namibia except companies and institutions to which other acts apply, in so far as those acts are inconsistent with the Companies Act (for example, the Banking Institutions Act).

2. SUMMARY OF CHANGES TO THE EXISTING COMPANIES ACT APPEARING IN THE NEW COMPANIES ACT

2.1 The Act has been simplified as regards structure and content. Where the current Companies Act has been inherited from South Africa, the new Act will be a completely Namibian Companies Act (Namibianised).

2.2 Various provisions appear in the existing Act that are actually unconstitutional, but have not been removed since the introduction of the Namibian Constitution. For example, certain invasions of individual privacy are authorized. In the new Act those provisions, in so far as they are unconstitutional, have either been adapted or removed.

2.3 The existing Companies Act contains a myriad of criminal offences that are clogging up the judicial system. Such transgressions are more effectively dealt with by the creation of civil penalties instead, thereby reducing the criminal burden on the Courts.

2.4 Certain administrative functions have been delegated from the Minister to the Registrar of Companies, as the Registrar is the more appropriate functionary to deal with such matters.

2.5 The Act further introduces more streamlined and modern methods of payment of fees to the Registrar's Office. The amendments also include provision for eventual electronic payment when such a system can be introduced in future. The method of only paying by means of stamps was deemed cumbersome and outdated.

2.6 The existing Advisory Committee on Company Law has been restructured and made more effective.

2.7 In terms of the existing Companies Act, a company's capacity (to act) is expressly limited in its memorandum of understanding and a company can only do what it stated in its stated objects. To a great extent, this situation has been done away with by the rule of *ultra vires*, namely that the limitation on a company's capacity now only applies internally (or with respect to people who know or ought to have known the objects) and not externally. In most countries this limitation has been removed and companies have full legal capacity.

2.8 The doctrine of constructive knowledge is abolished. According to this doctrine, everybody is deemed to have knowledge of a company's information (memo, articles, and other documents) that has been lodged with the Registrar. This was found unrealistic and unfair since very few people actually inspect those documents (or have access to inspect them if they are not resident in Windhoek) before they deal with a company.

2.9 In general, companies are not allowed to buy back their own shares as the practice may diminish their capital. In modern day business, however, there may be reasons why a financially sound company may want to buy back its own shares (for example, to avoid a hostile take-over). The new Bill permits companies under certain conditions (prior special resolution and as long as the company remains solvent) to buy back their own shares and to provide financial assistance to buy their shares.

2.10 The new Act makes provision for the registration and renewal of defensive names for a period of two years. It also provides for the Registrar to allocate registration numbers to companies, which the company must mention in their documents.

2.11 The new Act authorizes banking institutions to prepare broker's transfer forms for the transfer of securities. This is a common practice around the world.

2.12 The Companies Act streamlines the provisions relating to "rights offers" and allows companies, with the approval of the Registrar, to exclude certain foreign members from such offers.

2.13 Provision is also made for the disclosure of beneficial interests in securities held by nominee companies so that it can be determined who the actual people behind such

5. Conclusions

The global economic growth slowed markedly in the second half of 2007 and the outlook for 2008 is less favourable. Similarly, global financial market conditions have worsened sharply in the second half of 2007 as fallout from the US subprime mortgage crisis widened. Credit and market risks have continued to rise, with increased volatility and broad loss of liquidity. Conditions in the global markets pose a moderate risk to financial stability in Namibia.

High oil and food prices in 2007 have fuelled inflationary pressures in Namibia. It is expected that economic growth in commodity importing countries will keep upward pressures on the prices of oil and food. This could in turn result in high interest rates and, consequently, adverse effect on financial stability.

International bond yield fell sharply in second half of 2007 as the Fed continued to cut interest rates to prevent a possible economic recession. Further rate cuts are expected in 2008. Namibian institutional investor could be negatively affected by falling international bond yields. However, the low risk posed by adverse movements in bond yield is mitigated by asset diversification.

International equity markets have also been affected by housing market crisis in the US and share prices fell in the second half of 2007. The impact on Namibian institutional investors flowing from these developments is mitigated by limited exposure to the affected markets. The risk to financial stability posed by these developments is thus low.

In the local equity market, share prices fell following a similar development at JSE. The latter was affected by the global events in the aftermath of the US housing market crisis. Although some Namibian institutional investors might have experience declines in net asset value, the total impact on financial stability is considered to be low.

The environment in which banks in Namibia operate continues to be characterised by favourable conditions. This contributed to the positive developments observed in the banking sector since the previous FSR. Banks reported growth in banking profits in 2007, with interest margins expanding steadily. Much of the increase in profitability came from the growth in lending to both the household and corporate sector. Capital buffers are ample and above regulatory minima.

Solvency ratios are stable thanks to a strengthening of capital base, aided by additions to retained profits. The profitability and capitalisation level should enhance safety and soundness of banks and strengthen the stability of the sector and improve its ability to serve as a source of sustainable growth for the broader economy. The banking sector is, therefore, judged to be in position to absorb shocks.

Asset quality is good, and NPL ratios are declining, but it is important to keep a close watch. There is potential for asset quality to deteriorate further, particularly in the mortgage loan category, given rising lending rates. Cost escalation, through increases in staff especially, contributed to a decline in efficiency in some banks.

Currently high levels of interest rates are depressing the housing market, with house prices stagnant in some areas and falling in others. Therefore, further increases in interest rates could result in more falling house prices. This would cause financial losses to banks as the value of their collateral falls. The risk is highest for the households with mortgages. Despite these risks, the housing market is not in any serious risk of financial instability.

Given current market conditions, though, there is little concern regarding the banking sector's resilience and future earning capacity. In addition, major risks identified in this report are judged to be manageable and, therefore, pose no imminent threats to banking stability. There are possible risks for the banks, nonetheless. Among the downside risks are: the possibility that the economic slowdown in the US economy could spread to the Namibian economy; and inflationary pressures from high and volatile fuel/oil and food prices could increase. The current electricity problem in South Africa could worsen, slowing down the economy and hurting the rand.

Important activities were performed in the third quarter of 2007 to ensure compliance and minimise systemic risks in the payment system. While there are still areas where work is continuing and challenges remain in other areas, the present state of the payment system does not appear to present any significant financial stability concerns.

Although the downside risks pointed out above could materialise with adverse repercussions for the financial system, the overall diagnosis, nonetheless, is that the outlook for the financial sector in Namibia is under no foreseeable threats that could obstruct the competence of the financial system.

Appendix

Table 2: Claims on business and individuals

	Dec-2005	Mar-2006	Jun-2006	Sep-2006	Dec-2006	Mar-2007	Jun-2007	Sep-2007	Dec-2007
Claims on non-financial sector (N$ million)	23,835.6	24,661.0	25,696.3	26,759.8	27,404..5	28,588.8	29,147.1	29,995.0	30,943.6
Mortgage loans	10,621.6	11,051.7	11,522.5	12,719.4	13,344.3	14,046.3	14,576.6	14,755.9	14,493.1
Mortgage loans as a proportion of claims on non-financial sector (%)	44.6	46.4	44.8	47.5	48.7	49.1	50.0	49.2	46.8
Nominal growth in mortgage loans (%)[1]	9.2 (19.8)	4.0 (32.7	4.3 (25.7)	10.4 (30.7)	4.9 (25.6)	5.3 (27.1)	3.8 (26.5)	1.2 (16.0)	-1.8 (8.6)
Proportion of mortgage to individuals (%)	93.5	93.2	93.5	88.5	87.5	86.9	86.7	89.2	88.4
Proportion of mortgage to businesses (%)	6.5	6.8	6.5	11.5	12.5	13.1	13.3	10.8	11.4
Proportion of loans to individuals (%)	64.7	65.3	65.1	65.4	65.8	65.4	66.1	65.9	65.5
Growth in loans to individuals (%)[1]	3.6 (25.0)	4.3 (21.7)	4.0 (24.1)	4.6 (17.6)	3.1 (16.9)	3.5 (16.1)	3.2(15.2)	2.6 (12.9)	2.6(12.4)
Proportion of loans to business (%)	35.3	34.7	34.9	34.6	34.2	34.6	33.9	34.1	34.5
Growth in loans to business (%)[1]	4.9 (12.1)	1.9 (13.6)	4.6 (10.4)	3.3 (15.5)	1.2 (11.4)	5.8 (15.7)	-0.4(10.1)	3.6 (10.5)	4.3(13.9)

Source: Bank of Namibia

(Footnotes)
[1] Quarter-on-quarter growth, annual growth in brackets.

Table 3: Bank lending to non-financial sector

Commercial banks lending N$ millions	Dec-03	Dec-04	Dec-05	Dec-06	Dec-07
Individuals	8935.4	10927.8	13772.2	16356.8	18612.1
Businesses	6457.3	7401.0	8469.4	9360.2	10663.1
Total loans	15700.1	19057.5	22604.5	26062.4	29629.7
Mortgage loans to individuals	5084.2	6717.2	8792.6	10490.9	12356.4
Mortgage loans to businesses	1478.8	1043.1	696.8	1662.5	1654.7
Individuals as % of total	56.9	57.3	60.9	62.8	62.8
Businesses as % of total	41.1	38.8	37.5	35.9	36.0
Mortgage to individuals as % of total loans	32.4	35.2	38.9	40.3	41.7

Source: Bank of Namibia