Bank of Namibia

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Financial Stability Committee

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THE BANK'S CORPORATE CHARTER

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

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

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

We uphold open communication, diversity and integrity.

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

LIST OF ABBREVIATIONS

AML/CFT	Anti-money laundering and combating of financing of terrorism
BoN	Bank of Namibia (the Bank)
CBS	Central Statistics Bureau
CMA	Common Monetary Area
EMEs	Emerging market economies
FIA	Financial Intelligence Act
FIC	Financial Intelligence Centre
FNB	First National Bank
FSR	Financial Sector Review
GC12	Government Internal Registered Stock Maturing in 2012
GC15	Government Internal Registered Stock Maturing in 2015
GC18	Government Internal Registered Stock Maturing in 2018
GC21	Government Internal Registered Stock Maturing in 2021
GC24	Government Internal Registered Stock Maturing in 2024
HI	Herfindahl Index
IMF	International Monetary Fund
JSE	Johannesburg Stock Exchange
LHS	left-hand side (of graph)
NAD	Namibia dollar
NISS	Namibia Inter-bank Settlement System
NPL	non-performing loan
NSX	Namibian Stock Exchange
RHS	right-hand side (of graph)
SA	South Africa
SACU	Southern African Customs Union
SARB	South African Reserve Bank
T-Bill	Treasury bill
US(A)	United States (of America)

CONTENTS

PREFACE

In terms of Section 3(a) of the Bank of Namibia Act, 1997 (No. 15 of 1997), as amended, one of the objectives of the Bank is "to promote and maintain a sound monetary, credit and financial system in Namibia and sustain the liquidity, solvency and functioning of that system". For that purpose, the Bank compiles and publishes its financial stability review (FSR) on a half-yearly basis. The Bank of Namibia has finalised its regular assessment of the state of financial stability in Namibia during the second half of 2010. The FSR highlights the Bank's assessment of key risks and vulnerabilities to financial stability emanating from developments in the national and international environment, since the last publication in September 2010. The Bank of Namibia, accordingly, takes appropriate actions where there are financial instability concerns. By publishing the Report, the Bank of Namibia aims to promote understanding of, and contribute to informed debate on, financial stability issues.

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

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

Each main section of the FSR concludes with a relative ranking of the degree of apparent impact of developments and factors on financial system stability. The rankings, in ascending order of the degree of impact, are: low; moderate; and high impact[1].

[1] An issue is rated *high* if its impact could result in significant disruptions to the operations of the financial system. The other ratings (low and moderate) are interpreted accordingly.

1. EXECUTIVE SUMMARY

The global economy continued to recover in the second half of 2010, but at different speeds and downside risks persisted. In advanced economies, output growth was somewhat subdued and unemployment remained high. In emerging and developing economies, economic growth was stronger, supported by private demand, policy stimulus measures and capital inflows. Although the downside risks to the recovery continued to be elevated, the IMF in its latest World Economic Outlook for January 2011 expected the global economic recovery to continue.

Global financial conditions broadly improved in the second half of 2010 and were expected to remain stable in 2011, albeit with downside risks. According to the IMF's January 2011 Global Financial Stability Report (GFSR) Update, equity markets rose and bank lending conditions eased in the major advanced economies. In many emerging economies, inflation pressures were emerging and signs of overheating from strong capital inflows were developing. As noted in the GFSR, global financial conditions were expected to remain broadly stable in most regions or to improve in 2011. Bank lending in major advanced economies were expected to ease further. In emerging markets, capital inflows were expected to remain strong and financial conditions to be robust. However, downside risks remained, in particular, there were risks of the financial turmoil in the euro zone spreading, and of high commodity prices, and overheating in emerging markets. In addition, according to the IMF, the global financial stability was still at risk because of failures to impose regulatory reforms and policies to tackle financial and banking sector vulnerabilities that caused the worst financial crisis since the Great Depression.

In the second half of 2010, domestic economic activity continued to improve in line with global economic recovery, with GDP estimated to have expanded by 4.6 percent in 2010. Output expansion was recorded in the agriculture and mining sectors. The rise in global commodity demand and prices led to increases in outputs of diamond, zinc, uranium, copper and gold. The secondary sector also improved during the period. Growth in the sector benefitted mainly from increased public expenditure that was part of expansionary fiscal policy. On the other hand, in the tertiary industry, the tourism and transport and communication sectors moderated. The two sectors were likely constrained by the Namibia Dollar appreciation against major currencies. Domestic economic recovery was further reflected in higher credit demand by the private sector.

The Bank, in its latest economic outlook for 2011, projected the economic recovery to continue, notwithstanding downside risks, and expected GDP to grow by 4.1 percent in 2011. The recovery in domestic economic conditions was expected to improve the financial position of households, support domestic demand and further stimulate output expansion, with eventual spinoffs for banking stability. Similarly, a continued rebound in domestic economic activity would improve corporate financial performance. Both circumstances would result in improved repayment capacity of banking borrowers and in further decreases in non-performing loans for the banking sector. This positive financial situation would be favourable to banking stability, going forward. The main downside risks to the domestic economic recovery in 2011 were the possible weakening in global economic recovery and, consequently, overshadowing the outlook for the country's major exports.

The domestic currency appreciation negatively affected exports and tourism, but the country's reserves were enough to support the currency peg despite reductions in SACU revenues. The real effective exchange rate (REER) of the Namibia Dollar (NAD) continued to appreciate against the currencies of the major trading partners in the second half of 2010. The real appreciation resulted in loss of competitiveness for Namibia’s exports and tourism. The country’s international reserves fell during the period, but continued to be adequate to maintain the currency peg. Moreover, the level of reserves was also sufficient to support both the financial health of the domestic economy and financial stability. Namibia’s reserves, nevertheless, continue to be constrained by recent reductions in SACU inflows.

Overall inflation in Namibia fell in the second half of 2010, despite rising global commodity prices. In the medium term, however, domestic inflation pressures were likely to rise in line with rapid increase in global food and oil prices.

Banking profitability improved further, liquidity was sufficient and bad loans fell, supporting banking stability. The banking sector was adequately liquid, profitable and well capitalised during the second half of 2010. In addition, both non-performing loans and overdue loans fell. The former sustained the descending trend that was observed since the fourth quarter of 2009, while the latter increased in the first half of 2010. Cost efficiency also improved after deterioration in the first half of 2010. The banking sector, consequently, remained sound and stable.

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

2. EXTERNAL ENVIRONMENT

2.1 MACRO-ECONOMIC AND -FINANCIAL CONDITIONS

The economies around the world were moving along the road to recovery, but this increasingly appeared to be a two-speed recovery, according to the latest forecast from the IMF. Charging ahead the road to recovery were emerging and developing markets, which the IMF expected to grow by an average of 6.3 percent in 2011. Trundling along the side road were the advanced economies, which would manage expansion of just 2.5 percent in 2011.

The IMF also highlighed significant different financial risks around the world. In advanced economies the risks were at the backdrop of balance sheets of banks and spiraling sovereign debts particularly in the Euro Area. By contrasts, in emerging markets the main peril was overly strong portfolio inflows that began to create overheating concerns. Several other financial vulnerabilities lingered and most of them remained unattended, balance sheet restructuring was incomplete and progressed slowly, and leverage remained high. Sovereign credit risks in the euro area continued to be a critical factor, and policies were needed to tackle fiscal and banking sector vulnerabilities. Regulatory reforms were also required to put the financial sector on a sound footing at the global level.

As noted by the IMF, despite downside risks to the recovery, the global economic recovery was set to continue, although expectations were that it will remain uneven across regions. This disparity was evident in the two IMF updates – the World Economic Outlook (WEO) and Global Financial Stability Report (GFSR) – that were released in January 2011. The IMF projected the global economy's output to expand by 4.4 percent in 2011. This reflected stronger-than-anticipated activity in the second half of 2010, as well as new policy initiatives that was expected to boost activity in 2011. Advanced economies were projected to grow by 2.5 percent, following an output expansion of 3.0 percent in 2010. In 2012, economic growth in the advanced economies was forecast to grow by 2.5 percent, but to remain generally sluggish. In emerging and developing economies, on the other hand, economic performance was projected to remain buoyant, at 6.5 percent in both 2011 and 2012.

In advanced economies, output would remain subdued and unemployment high. The IMF warned that growth in developed countries would not be strong enough to address the unemployment crisis. However, new fiscal packages, in the US and Japan especially, were expected to boost activity in 2011. In addition, stronger domestic demand was expected to support growth in Europe, mainly Germany. In emerging and developing economies, growth would be driven by domestic demand and capital inflows, as well as rising global demand for commodities. Favourable economic fundamental would also bode well for growth in these groups of economies.

Although global financial stability continued to be at risk as significant challenges remained, the IMF was of the view that global financial conditions in most regions were expected to remain stable or improve in 2011. The improvement was expected to emanate from bank lending conditions in the major advanced economies that were expected to ease further. Nevertheless, fiscal and financial stresses from the euro sovereign debt crisis that remained elevated were expected to create uncertainy in the global financial system. On the other hand, financial conditions in emerging market economies were expected to remain buoyant. This condition will be sustained by the strong capital inflows to emerging market economies from advanced economies. However, low interest rates in mature markets and fairly strong investor appetite would continue to pose upward risks in emerging markets flows and asset prices. At the same time, policymakers in emerging market countries should begin to assess the possibility of asset price bubbles and put in place mechanisms to mitigate the impact thereof.

2.2 INFLATION RATES

Global inflation pressures remained subdued in the second half of 2010. However, a broad range of global commodity prices (i.e., prices of both oil and non-oil commodities) rose considerably during the period (Table 1). Such broad-based strength in commodity prices probably stemmed, in large part, from the recovery in the global economy, in particular the recorded growth in emerging markets during 2010. While strong demand growth was likely to be a key factor driving prices, the prices of some commodities were further boosted by supply developments over the past year. This reflected a number of adverse weather events including a

Table 1: Selected economies, policy and inflation rates

Countries	Policy Rate	Current Rate (%)	Policy Rate % Δ	Last Meeting	January Inflation	Real Interest
Advanced						
USA	**Fed Funds rate**	**0.00-0.25**	**0.0**	**January**	**1.5**	**-1.0**
Canada	Overnight rate	1.00	0.00	January	2.4	-1.4
Australia	Cash rate	4.75	0.00	February	2.7	2.1
Euro Area	Refinance rate	1.00	0.00	January	2.2	-1.2
UK	Base rate	0.50	0.00	January	3.7	-3.2
Japan	Call rate	0.09	0.00	January	0.0	0.1
BRICS						
Brazil	Short term interest rate	11.25	0.50	January	5.9	5.4
Russia	**Refinancing rate**	**7.75**	**0.00**	**December**	**8.8**	**-1.1**
India	Repo rate	5.50	0.25	January	9.5	-4.0
China	Lending rate	6.06	0.25	February	4.6	1.5
South Africa	Repo rate	5.50	0.00	January	3.5	2.0

Source: Respective Central/Reserve Banks

heatwave in Russia and Eastern Europe, and more recently flooding in Australia and droughts in China. Those events reduced the expected size of the harvest for a number of crops, pushing up their prices. The IMF projected consumer prices in emerging and developing countries to reach 6.0 percent in 2011, compared with the recorded inflation of 6.3 percent in 2010. In advanced economies, on the other hand, inflation pressures were expected to remain subdued due to still ample economic slack and well secured inflation expectations. Consequently, inflation was projected to remain at 1.5 percent in 2011, unchanged from the recorded inflation of 2010. The upside risks to outlook, however, remained, at the backdrop of rising energy and food prices in the international markets.

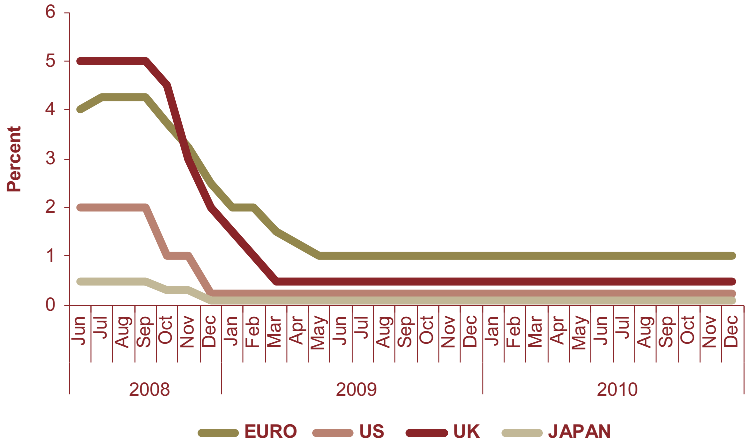
2.3 INTEREST RATES

During the second half of 2010, most advanced and many emerging economies maintained their accommodative monetary policy stances in the face of sluggish economic recovery and uncertain outlook. However, some countries raised their rates during the period to restrain inflationary pressures.

The four major central banks, the European Central Bank (ECB), the US Federal Reserve (Fed), the Bank of England (BOE) and the Bank of Japan (BOJ), kept their respective official policy rates at 1.0 percent, 0/0.25 percent, 0.5 percent and 0/0.10 percent since the second half of 2009 (Chart 1). The ECB held its benchmark interest rate at 1.0 percent since May 2009, as the region grappled with a sovereign debt crisis that forced governments to cut spending, hindering the outlook for economic growth. At the same time, inflation in the Eurozone accelerated to 2.2 percent in December 2010, breaching the ECB's 2.0 percent limit for the first time in more than 2 years.

A sluggish recovery in the US housing and labour markets was among the factors that deterred the Fed from raising interest rates. The BOE kept rates unchanged, despite the persistently high inflation above the 2.0 percent target. The rates were kept constant for two reasons; to help with the recovery and the fact that it was considered that inflation pressures were rather transitory. The BOJ kept the overnight call rate target in the range of zero percent to 0.1 percent since October 2010 and had started to buy financial assets to spur economic growth and stamp out deflation.

Chart 1: Major policy interest rates



Source: Bloomberg

In emerging and developing economies, some central banks raised policy rates, while others reduced them. For instance, China' central bank raised interest rates twice in the second half of 2010, from 5.31 percent since December 2008 to 5.81 percent. The first rise in rates, of 25 basis points, came on October 19, 2010, while the second increase, again of 25 basis points, was announced on December 25, 2010. The policy rate increases were aimed at countering persistent inflation, which reached the fastest rate in more than two years. In China, annual consumer price inflation rose to 5.2 percent in November 2010 from 4.4 percent in October 2010, but slowed to 4.6 percent in December 2010. The rise in inflation was chiefly attributed to excess liquidity that drove up consumer prices, rising commodity prices and salaries.

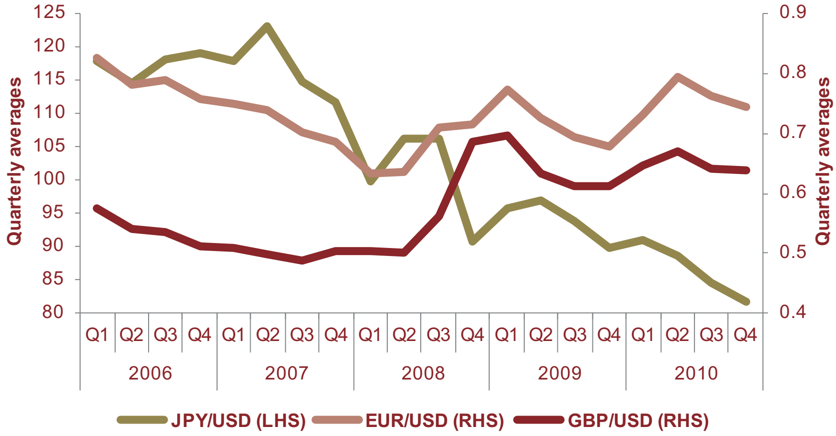
The South African Reserve Bank (SARB), on the other hand, reduced its repo rate twice by 10 basis points between September and November 2010. The combined cuts reduced the repo rate from 6.5 percent to 5.5 percent. The repo rate cuts were partly aimed at boosting economic growth after the economy fell into recession in 2009.

The SARB's action was supported by continued attainment, lower-than expected, in inflation target. Targeted inflation averaged 3.5 percent in the third quarter of 2010. A similar outcome was expected in the fourth quarter of 2010, resulting in an average inflation rate of 4.3 percent for 2010. South Africa's inflation was unchanged at 3.6 percent in December 2010. However, given the rising global and domestic prices, signs of recovery in household and consumer expenditure and credit extension, the scope for further downward movement were seen to be limited.

2.4 EXCHANGE RATES

Sluggish US economic recovery and renewed fears about European debt crisis, fuelled by sovereign credit risks, continued to dominate the major international currency markets in the second half of 2010. The US currency depreciated against the three major currencies in the second half of 2010 (Chart 2). The US Dollar fell by 1.2 percent, 2.8 percent and 7.2 percent against Euro, Pound and Yen, respectively, to 0.7609 Euros, 0.6577 Pounds and 89.7000 Yen. The Dollar weakness was mostly ascribed to sluggish US economic rebound, weak external account, federal deficit, and loose monetary expansion relative to the rest of the world.

Chart 2: Currency per US dollar



Source: Bloomberg

The Dollar also depreciated against the same three currencies on quarterly basis. The currency exchanged at 0.7440 Euro, 0.63573 Pound, and 81.7633 Yen at the end of December 2010. By contrast, the Dollar traded at 0.7623 Euro, 0.6416 Pound, and 81.6766 Yen at the end of September 2010. This represented a weakening of 2.4 percent, 3.4 percent, and 0.9 percent, respectively, against the three currencies between the third and fourth quarters of 2010.

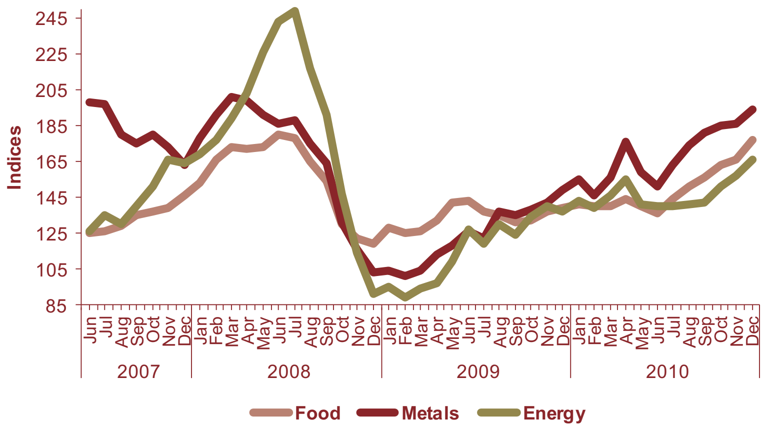
2.5 COMMODITY MARKETS

Global commodity prices rose significantly in the second half of 2010, as investors continued to buy raw materials in anticipation of even higher prices. Most commodity prices rose in July 2010, after a general decline in the second quarter of 2010. The rise came from all the three main categories: food, energy and metal prices (Chart 3).

The international food price index rose sharply, after being subdued for a year up to June 2010. According to the United Nations' Food and Agriculture Organisation (FAO), world food price index rose by 32.0 percent in the second half of 2010, surpassing its 2007-2008 food price crisis peak. The FAO attributed the food price inflation to several risk factors, including weather, record demand, and worsening outlook for crops in key food producing countries. A combination of these factors could put pressure on world food stock levels and result in tighter global demand and supply conditions in 2011, leading to further food price increases.

Metal prices, supported by strong demand from Asia, sustained the rally that began in July 2010. The metal price index rose by 28.1 percent in the second half of 2010.

Chart 3: Selected commodity price indices



Source: IMF

On-going uncertainties over the euro zone debt and increasing inflation pressures in China, especially, created a positive environment for gold price gains. Gold price rose in the second half of 2010, reaching yet another all-time record high level of around US$1,430 an ounce in December 2010 from US$1,232 an ounce at the end of June 2010. Investment demand for the metal became the principal driver of demand in the gold market. The metal's strong appeal to investors as a safe haven continued to be supported mainly by the sustained weakness of the dollar and by concerns about rising inflation. Most gold demand in recent years has come from China, the world's second-biggest gold user. China's gold imports jumped almost fivefold in the first 10 months of 2010 from the entire amount shipped in 2009, as concerns over rising inflation increased the metal's appeal as a store of value. The better prospects for global economic recovery, however, dampened gold's safe-haven appeal and prices dropped.

The copper price increased by 40.8 percent from US$6,501 a metric tonne in June 2010 to US$9,152 a metric tonne in December 2010. The sharp rise in copper prices, after a trendless first half of 2010, was attributed mainly to strong demand from China; a decline in ore grades; expectations that supply would not keep up with demand; depleting stock piles; and scarcity in new mines. Copper price also surged as investors sought to hedge against rising prices and weaker currencies. The introduction of exchange-traded products backed by the metal also boosted metal usage. China is the world's largest consumer of copper. China's imports of copper rose by 29 percent between October and November 2010. Further gains in the metal's price were expected, given the undimmed demand from China as the economy continued to grow and the prospects of fresh fund for investment in the metal.

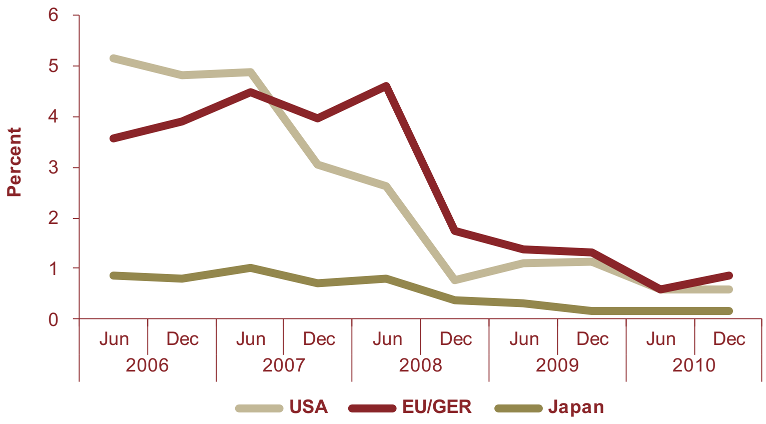
The average price of zinc increased from US$1,746 per metric tonne at the end of the first half of 2010 to US$2,287 per metric tonne at the end of December 2010. The rise in the metal price continued to be supported mainly by manufacturing growth in Asia. The average spot price for uranium climbed uninterruptedly by 48.6 percent to US$60.65 per pound in December 2010 from US$40.82 per pound in June 2010.

The energy price index rose by 18.7 percent in the second half of 2010. The crude oil market was affected by, *inter alia*, speculation and geopolitical issues that contributed to volatility and price instability during the review period. Crude oil prices reached a two-year high level in December 2010, as energy prices continued to recover. The steady rise in crude oil prices in December 2010 was mainly fuelled by expectations of a stronger economic growth, fears of supply constraints, and recent uncertainties about weather-related oil production disruptions in the US and Europe. The weak US dollar also boosted crude oil prices. The latter increased by 20.6 percent from US$74.73 per barrel in June 2010 to US$90.00 a barrel in December 2010. In early February 2011, crude oil price hovered above the US$100 per barrel price level, which level it broke on January 31, 2011.

2.6 BOND MARKETS

The bond yields increased in the second half of the year as improved economic outlook hit demand for safe-haven bonds. The treasury yields also rose on fears that proposed extension of tax cuts for middle nd higher income individuals could exacerbate and extend the US budget deficit problems. This also raised concern over inflation. The yields on the US two-year bonds fell albeit marginally from 0.6 percent in June 2010 to 0.5 percent in December 2010 (Chart 4).

Chart 4: Two-year Government bond yields



Source: Bloomberg

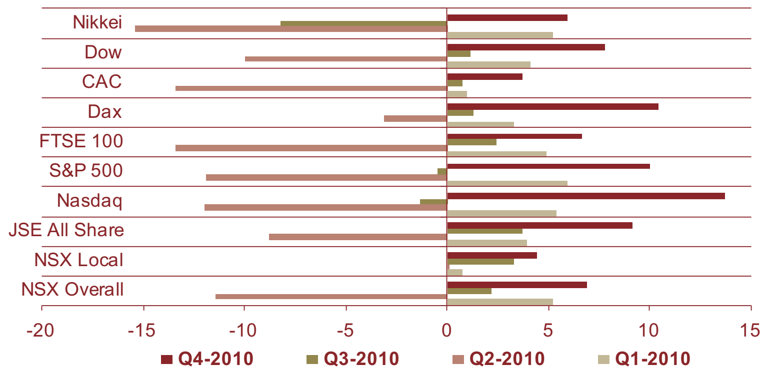
In Europe, the yield on Euro bonds, proxied by German bunds, rose slightly from 0.6 percent in June 2010 to 0.9 percent in December 2010. The rise in the return on German bonds came, partly, amid concerns that the new measures to address the debt crisis in Europe would reduce their demand. The demand for German bonds were also subdued somewhat on the prospects of improved economic growth for Germany and widened inflation expectations. The commitment by the Bank of Japan to keep interest rates low, through easy monetary policy, left limited room for bond yields to rise. The yield on the Japanese two-year bonds fell in October 2010, as speculation that the global economic recovery was waning boosted demand. However, as that concern waned, the yield rose to 0.8 percent in December 2010, compared with 0.2 percent in June 2010.

2.7 EQUITY MARKETS

Most global stock markets recovered in the second half of 2010, during continuing global economic recovery (Chart 5). Emerging markets performed better than developed markets during the period. Overall, U.S. equities performed well amid the improving economic outlook. In December the S&P even hit the highest level since the Lehman Brothers collapse in 2008. The S&P 500 and Nasdaq indices rose by 10.0 percent and 13.7 percent, respectively, in the fourth quarter of 2010. The two indices declined by 11.9 percent and 12.0 percent, respectively in the second quarter of 2010. European stock markets moderated in the third quarter of 2010, but rose significantly in the fourth quarter of 2010. The indices were negatively affected by heightened sovereign default risk in Euorpe. The CAC and DAX indices, respectively, rose to 3.7 percent and 10.4 percent in the fourth quarter, after falling by 13.4 percent and 3.1 percent in the second quarter.

The US and European equities gained as market sentiment of global economic growth and the consumer confidence improved, boosting hopes for the recovery in the world's largest economies. Increase in commodity prices, largely on a weak dollar, also led to the advance in equities. The copper price for example hit a record high in December.

Chart 5: Global stock exchanges quarterly growth rates (USD terms)



Source: Bloomberg

In Japan equity market improved, aided by quantitative easing measures. The Nikkei rose by 5.9 percent in the fourth quarter of 2010, compared with a decline of 15.4 percent in the second quarter of 2010. In most Asian equity market performances were also higher supported by continued economic growth. There were also strong regional performances from Africa. The JSE All Share indices, for instance, rose by 3.7 percent and 9.1 percent, respectively, in the third and fourth quarters of 2010. This rise compared favourably with a decline of 0.8 percent in the second quarter of 2010.

3. DOMESTIC ENVIRONMENT

3.1 ECONOMIC CONDITIONS AND FINANCIAL MARKETS

3.1.1 Economic performance

Economic activities in Namibia continued to strengthen in the second half of 2010. High global commodity demand led to improved exports of the country's major commodity exports, supporting domestic economic recovery. The economic strengthening was also supported by domestic demand. The latter resulted from the accommodative policies pursued in the last two years. The economic rebound in 2010 was led by improvements in output of agriculture, and mining and quarrying. The latter sector was estimated to have expanded by 30.3 percent in 2010, after contracting by 45.0 percent in 2009.

The recovery came on the back of improved global demand for mineral and metal commodities. Consequently, the outputs of diamonds, zinc, uranium, copper and gold increased during the second half of 2010. Gold output, in particular, was helped by the weak US Dollar. However, the fragile economic recovery in advanced economies, coupled with the NAD appreciation against the major currencies, contributed to modest performances in the tertiary sector.

The global economic recovery was set to continue in 2011 and 2012. The accompanying increase in global commodity demand and prices would support recovery in many emerging and developing economies. Namibia was expected to profit from the resulting favourable commodity prices. Uranium output was projected to increase due to on-going expansions at existing mining sites and planned new mines. Furthermore, improved global outlook for uranium, especially due to high demand from Asia, was estimated to have a positive impact on the output of uranium. Output of copper was also expected to increase in 2011 due to a recovery in international copper prices.

The domestic economy was projected to continue to expand by 4.1 in 2011, slightly lower that an estimated 4.6 percent in 2010. The continued recovery of the domestic economic activity would boost both household incomes and business confidence. Moreover, as indicated by growth in credit extension to the private sector, recovery in domestic demand was already underway. This development would ultimately boost the balance sheets of banking institutions and subsequently enhance financial stability.

Global commodity prices rose significantly in the second half of 2010 and the upward trend continued in early 2011. The projected strengthening recovery in the global economy would sustain, inter alia, commodity prices for Namibia's major export commodities, with positive spinoffs for the domestic economy. In addition, domestic accommodative policies, both fiscal and monetary, would continue to support the recovery momentum in the domestic sector. However, downside risks to the domestic economy remained. In particular, a continued appreciation of the NAD could reduce export competitiveness and hamper the domestic recovery. In addition, the slow recovery of the global economy would have a negative impact on the domestic economic growth. Furthermore, rising food and oil prices might put pressure on consumer price inflation and negatively affect domestic growth outlook. At the same time, unemployment remained a major challenge for the domestic economy.

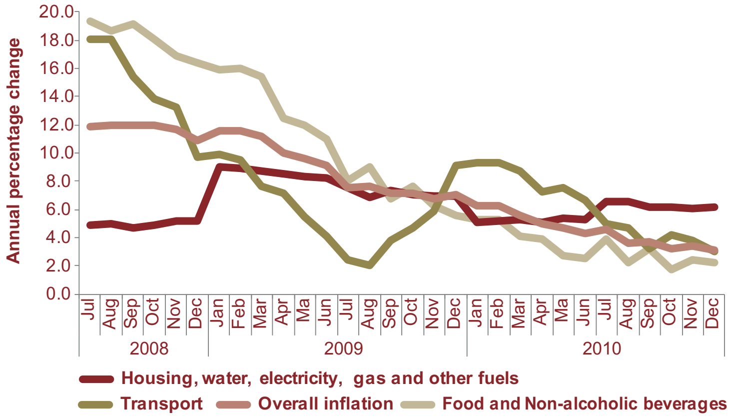
3.1.2 Consumer prices

The overall annual inflation rate in Namibia continued to trend downwards in the second half of the year (Chart 6). The main driver supporting the decline in the overall inflation pressure was the transport price inflation, which dropped from 6.6 percent in June 2010 to 3.0 percent in December 2010. The transport price category accounts for 14.8 percent of the total consumption basket and is positively correlated with movements in crude oil prices.

The housing price inflation, which remained elevated over the same period, rose from 5.3 percent in June 2010 to 6.2 percent in December 2010. The food price inflation fell, albeit slightly, during the period from 2.5 percent in June 2010 to 2.2 percent at the end of the year. However, food price inflation rose between December 2010 and January 2011, in line with rising food prices worldwide. There were also increases in rental payments, education and health during the same period. Consequently, annual inflation rate rose from 3.1 percent in December 2010 to 3.5 percent in January 2011.

The outlook for inflation in Namibia would continue to be influenced by the prevailing global environment, in the medium term. However, in the longer term, inflation pressures could mount due to rising global commodity prices, particularly food and energy prices, as the global economic recovery strengthens. In addition, Namibia faces growing risks to its inflation outlook due to increasing domestic prices and rising inflation in South Africa. According to the South African Reserve Bank in January 2011, inflation was likely to reach the upper end of the three to six percent target range sooner than previously expected. About 69.0 percent of Namibia's imports of goods come from South Africa.

Chart 6: Contributions to CPI

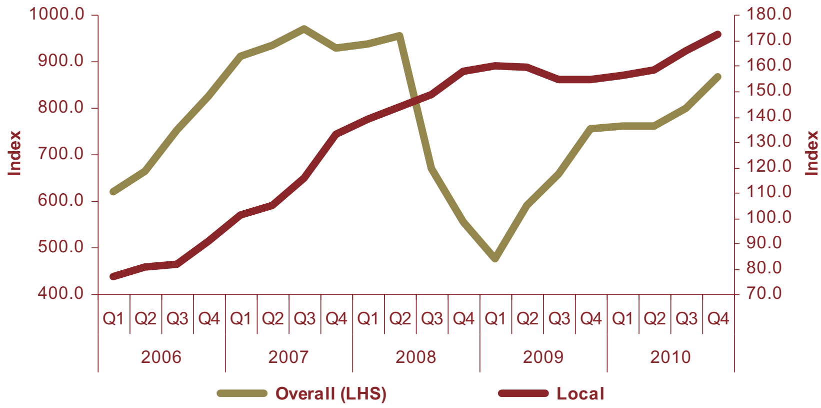


Source: Central Bureau of Statistics

3.1.3 Equity markets

The overall index of the Namibian Stock Exchange (NSX) comprises the performance of both local and dual-listed companies. The latter group of companies are at the same time listed on both the NSX and the Johannesburg Stock Exchange (JSE). The overall price index of the NSX reached 867.2 points in December 2010 from 763.3 points in June 2010 (Chart 7). The rise in the price index translated into a 13.6 percent growth rate during the second half of 2010, which dwarfed the meagre 0.1 percent growth in the first half of the same year. The stellar performance of the overall price index of the NSX mirrored the JSE, which rose by 22.3 percent during the period. The JSE, in turn, was in line with performance in global equities. The total overall market capitalisation of the NSX also increased, by 20.1 percent, from N$958.5 billion at the end of June 2010 to N$1,151.5 billion at the end of December 2010. The increase in market capitalisation followed a significant rise in the share prices of a major company listed on the NSX.

Chart 7: Namibia stock exchange price indices



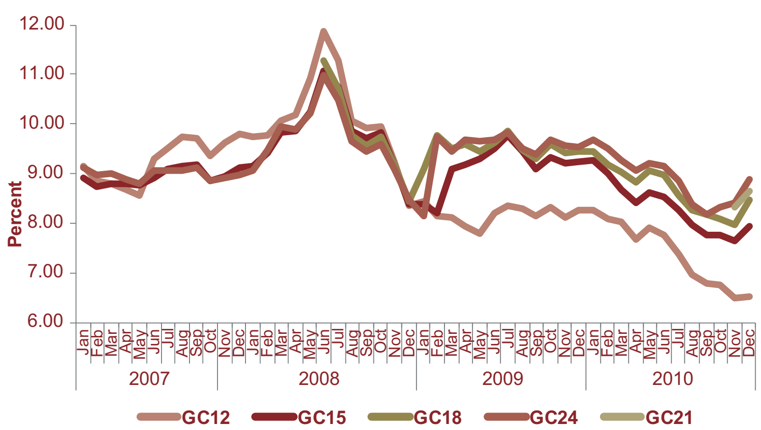
Source: Namibia Stock Exchange

The local index of the NSX also increased by 8.9 percent from 158.6 points at the end of June 2010 to 172.72 points at the end of the second half of 2010. The local market capitalisation rose by 8.3 percent from N$7.2 billion in the first half of 2010 to N$7.8 billion at the end of the second half of 2010. The impact of international financial markets on the Namibian financial system remained largely limited to the NSX, through the JSE. The performance of the JSE, on the other hand, was in line with international stock markets. However, the insulation of the local market from the global equity markets and the lack of trading of the listed shares continued to act as a relative stabilisation force on the NSX.

3.1.4 Bond markets

The yields on all Namibian bonds through the yield curve fell in most of the second half of 2010. The bond yields followed the general direction of the benchmark. Currently, both South African and Namibia policy rates are relatively low. However, international investors are attracted to South African bonds by a stronger rand and relatively higher interest rates. The fall in the South African bond yields tracked the increase in the US treasury yields in the fourth quarter as global demand for government paper increased. South African bond yields historically have a fair directional correlation with US treasuries, signalling the likely lead from the US bonds. The increase in the RSA bond yields was also exacerbated by rand weakness during September and November 2010. The increase in the yields on the Namibian government bonds on the other hand could also be explained by the increase in the supply of government bonds, particularly in December. The yield on the GC12 fell from 7.76 percent in June 2010 to 6.53 percent in December 2010. On the other hand, the yields on maturities longer than 12 years fell during most of the period but rose at the end of the period. The yields on the GC15 and GC18 fell from 8.54 percent and 8.98 percent in June 2010 to 7.93 percent and 8.47 percent in December 2010. The yield on the GC24 declined from 9.15 percent in June to 8.87 percent in December. At the same time the yield on the GC21, which was introduced in November 2010, increased from 8.33 in November 2010 to 8.64 in December 2010.

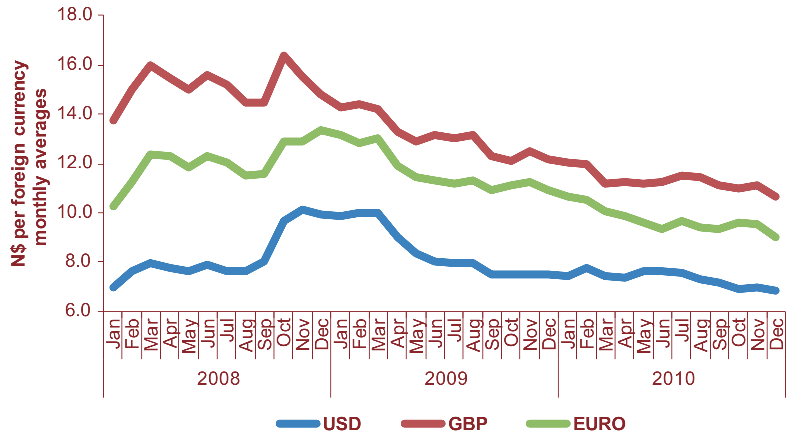
Chart 8: Government Bond yields



3.1.5 Exchange rates

In the second half of 2010, the Namibia Dollar (NAD) sustained the appreciation against the US dollar, Pound and Euro that started mostly in the first half of the year[2]. During the period, the local currency exchanged at averages of N$7.1, N$11.1, and N$9.4 against the USD, Pound and Euro, respectively, (Chart 9). This compared favourably with exchange rate averages of N$7.5, N$12.4 and N$10.0 against the USD, Pound and Euro, respectively, during the first half of 2010. As a result of the appreciation, the NAD gains against these currencies during the second half amounted to 5.3 percent, 10.5 percent and 6.9 percent, respectively. These gains compared with the gains of 1.4 percent, 8.3 percent and 10.1 percent, respectively, in the first half of the year.

Chart 9: Namibia dollar per foreign currency



Source: South African Reserve Bank

The ZAR's strength was reinforced by the continued inflows into the fixed income, mainly bond, market. Foreign buying of South African bonds was reported to have gone up by nearly five fold by the end of October 2010. The latest interest rate cuts and prospects for further reductions were believed to have drawn in a lot of international flows into South African bonds. The international flows, in turn, supported the currency. The NAD appreciation was also aided by the general weakness of the US Dollar stemming from a high federal fiscal deficit.

The real effective exchange rate (REER)[3] index of the NAD rose from 94.0 points in June 2010 to 95.10 points in December 2010. This denoted an appreciation of 2.2 percent in real terms. However, the real appreciation means that the country's export commodities became more expensive relative to the major trading economies during the period. Hence, the real appreciation of the NAD entailed a loss in export competitiveness due to a strong NAD against the USD, GBP and EUR. On the other hand, a real appreciation can have a moderating effect on inflation by leading to lower import prices, helping to control import costs.

3.1.6 Interest and inflation rates

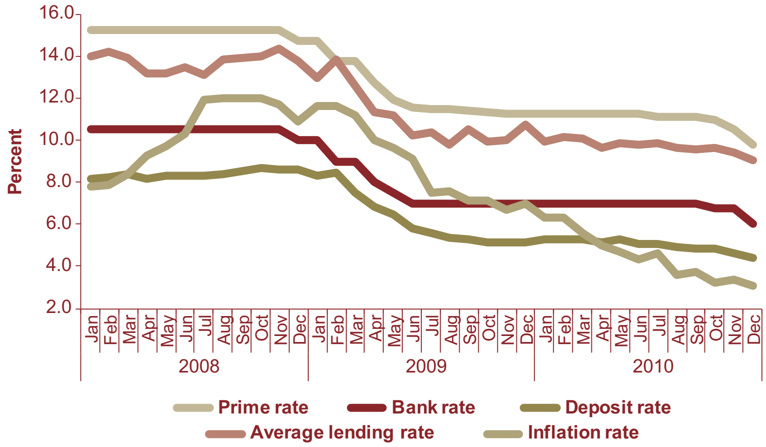
The general trend in the Namibian interest rates was descending in the second half of 2010 (Chart 10). The Bank of Namibia adjusted its Repo rate in October 2010 from 7.0 percent to 6.75 percent and again in December 2010 to 6.0 percent. The aim of the cuts in the policy rate was to further support domestic demand and strengthen economic growth. The sustained fall in the domestic inflation rate that started since December 2009, coupled with the need to support economic recovery, permitted the lowering of the policy rate during the period.

In response to the policy rate cuts by the BON, banking institutions adjusted their rates. The prime lending rate fell by 1.5 percentage points from 11.25 percent in June 2010 to 9.75 percent in December 2010. The average nominal lending rate and the average nominal deposit rate also declined. The former fell by 0.77 percentage points from 9.78 percent at the end of the first half of 2010 to 9.01 percent at the end of the second half of 2010. During the same period, the latter rate declined from 5.06 percent to 4.41 percent. Consequent to these developments, the spread between the lending and deposit rates narrowed to 4.6 percentage points in December 2010, compared with 4.8 percentage points in November 2010.

[2] The Namibia Dollar trades on par with the South African Rand (ZAR) and is therefore referred to interchangeably against international currencies. The rates being referred to are period averages of mid-rates, per one foreign currency.

[3] The REER index is the deflation of the NEER with the relative consumer price index, that is, the rations of Namibai's CPI and those of six below mentioned major trading partners. The NEER index is a trade-weighted index of the bilateral nominal exchange rate of the Namibia Dollar against the currencies of six major trading economies, namely, the Euro, Pound Sterling, Rand, US Dollar and Yen.

Chart 10: Interest and inflation rates



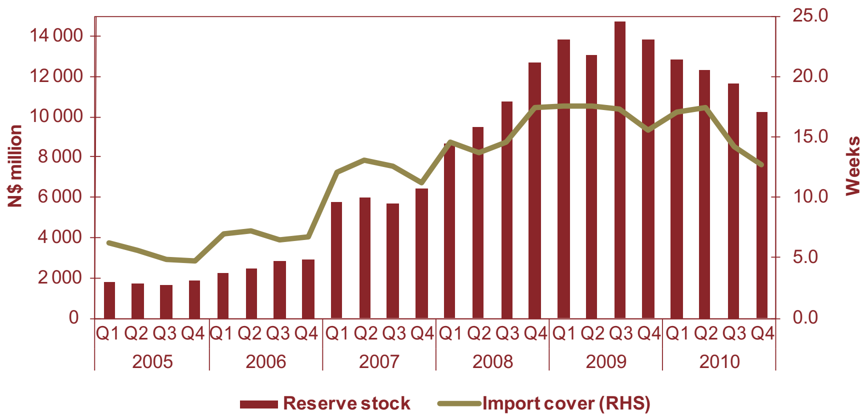
Source: Central Bureau of Statistics

3.1.7 Foreign Exchange Reserves adequacy

Foreign-exchange reserves serve to mitigate the impact of a foreign currency-liquidity shortage or shock that might follow when access to foreign borrowing and credit lines are limited or withdrawn. Adequate foreign-exchange reserves are critical to a country's ability to withstand external shocks and, therefore, to financial stability.

The level of foreign exchange reserves in Namibia declined by 16.9 percent from N$12.3 billion at the end of June 2010 to N$10.2 billion at the end of December 2010 (Chart 11). Namibia's international reserves fell by 26.1 percent between December 2009 and December 2010. The international reserves fell mainly as a result of: purchases of ZAR by banking institutions from the Bank of Namibia; and Government payments to foreign countries. The level of Namibia's international reserves remained adequate to back the currency peg, notwithstanding the decline.

Chart 11: Quarterly international reserve stock and import cover



Foreign exchange reserves also allow a country to pay for its imports and to discharge its other external obligations. Import cover[4] is the conventional measure of the ability of a country to withstand external shocks while at the same time meeting its external obligations. Namibia's import cover fell from 17.43 weeks of import cover in June 2010 to 12.72 weeks of import cover in December 2010. This brought the measure to just slightly above the international benchmark of 12 weeks of import cover. The consequence is that, if all other inflows of foreign earnings became dry, the country could still continue to import goods and services for up to 13 weeks. The fall in import cover was mainly attributed to a reduction in foreign exchange reserves during the review period.

[4] The measure, in weeks of import cover, is expressed as the ratio of total foreign exchange reserves over total imports. It is an indicator of how long a country would continue importing goods and services when all other sources (inflows) of foreign exchange are unavailable.

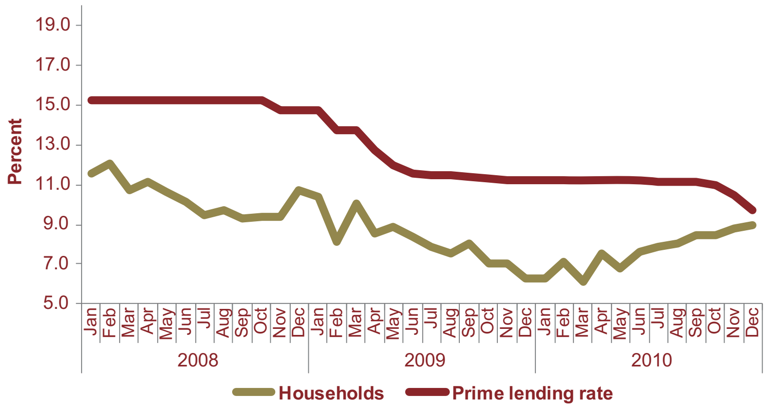
3.2 PRIVATE SECTOR CREDIT EXTENSION

The Bank maintained the accommodative monetary position that started in December 2008. Consequently, private sector demand for credit continued to grow. Other depository corporations' total claims on private businesses and households grew to N$40.3 billion at the end of December 2010 from N$37.5 billion in June 2010. The growth represented an annual growth rate of 10.9 percent, or 7.8 percent in real terms, compared with 10.7 percent, or 6.0 percent in real term, at the end June 2010. Strengthening nominal demand for credit and restrained overall inflation supported the real growth in total private sector credit demand during the period. The trend in private sector credit extension was projected to continue in 2011, in line with favourable domestic economic conditions and the ease monetary policy.

3.2.1 Household sector borrowing

Aggregate lending to the household sector grew to N$25.3 billion, during the second half of 2010, from N$24.1 billion at the end of June 2010. This denoted a growth rate of 4.9 percent at the end of December 2010 from 3.4 percent at the end of June 2010 (Chart 12). Most of the growth in loans to households stemmed from the total *loans and advances* category, which rose by 5.1 percent. The largest sub-category of the *total loans and advances* category, mortgage loans, grew by 5.1 percent during the same period.

Chart 12: Claims on households

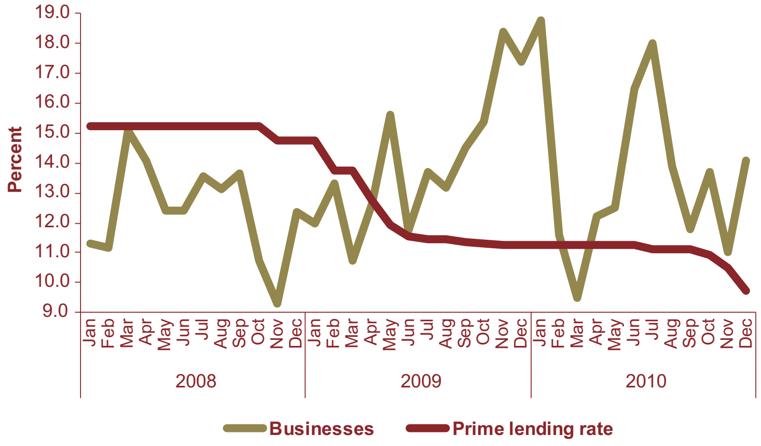


3.2.2 Corporate sector borrowing

Total credit extension to the corporate sector amounted to N$15.0 billion at the end of December 2010 compared to N$13.5 billion at the end of June 2010. The marked improvement in credit extension to the corporate sector was attributed to the strengthening in domestic economic activity during the period. Credit extension to businesses accounted for 37.2 percent of total private sector credit at the end of December 2010. Corporate balance sheet performance was, thus, important for banking performance and financial stability.

Credit extension to the corporate sector accelerated from 0.6 percent in first half of 2010 to 11.4 percent in second half of 2010 (Chart 13). Most of the growth in corporate credit extension came from the *loans and advances* category, which rose by 12.7 percent during the period. The category made up about 90.0 percent of total credit to the sector. The second major category, *instalment credit* also grew by 7.4 percent.

Chart 13: Claims on businesses



The expansion in credit extension to the corporate sector, anticipated to follow the strengthening in domestic economic conditions, was not expected to result in disproportionate increase in non-performing loans for the banking sector.

3.3 BANKING SECTOR PERFORMANCE

3.3.1 Banking structure

The structure of the banking system is, *inter alia*, a measure of the likely access to credit and cost of borrowing. Since June 2010, the banking sector comprised five (5) banking institutions licensed to do banking business in Namibia. But the operations of the newly licensed micro-finance bank are relatively minor. As a result, the banking sector continued to be dominated by four (4) banking institutions, holding almost 100 per cent of total banking assets. Although the principal indicators of banking sector concentration declined during the period, they still remained significantly above their thresholds. The Gini and HHI indices fell from 12.0 points and 2,692 points at the end of June 2010 to 11.1 points and 2680 points, respectively, at the end of December 2010. By comparison, an HHI of 1,000 points is the universal threshold for concentration. Likewise, a Gini index of more than 10 points designates a concentrated banking sector.

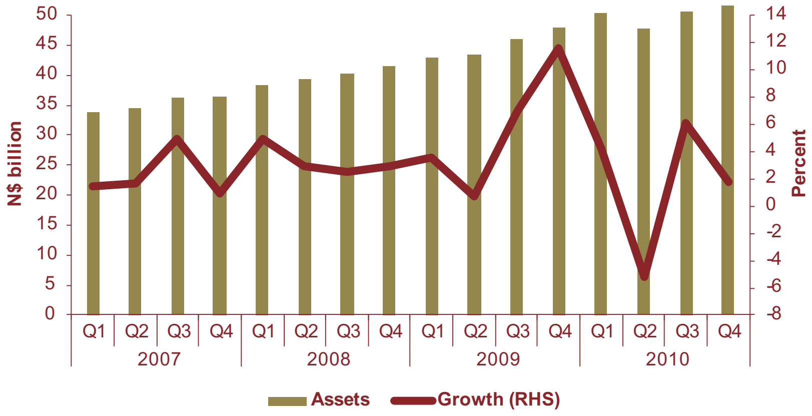
As was the case in the previous reports, a banking sector with such concentration levels is considered less competitive. The high level of concentration, therefore, could result in relatively costly banking services and limited access to credit.

3.3.2 Balance sheet structure

Significant deviations in the structure of the balance sheet of a banking sector could be an indication of the risks borne by the sector. After advancing by a meagre 0.3 percent in first six months of 2010, the total assets of the banking sector grew by a respectable 7.9 percent in the last six months of 2010 (Chart 14). Assets grew by 6.1 percent in the third quarter of 2010, but slipped by 4.2 percentage points in the fourth quarter of the year. The growth in assets in the fourth quarter was mainly ascribed to the increase in net loans and advances, and in trading and investment securities.

Similarly, the expansion on the liabilities side of the balance sheet was mainly a consequence of an increase in non-banking funding, which rose by 8.4 percent in the second half of 2010. Within the category of funding growth stemmed mainly from fixed and notice deposits, call deposits and foreign currency deposits. Bank funding, on the other hand, remained largely unchanged during the same period. Consequently, banking institutions raised their employment of non-bank funding in the review period.

Chart 14: Banking sector assets and growth rates



By comparison, in the first half of 2010, banking institutions raised their utilisation of bank funding, intra-group and interbank deposits, while non-bank funding fell. The deposit category of non-banking funding rose by 8.3 percent. At the same time, the deposit sub-categories of call deposits, current account and negotiable certificates of deposit rose by 12.9 percent, 7.6 percent and 5.2 percent, respectively, during the second half of 2010.

Non-banking funding as a fraction of total funding liabilities declined slightly from 96.1 in the first half of 2010 to 95.9 percent at the end of 2010. However, the funding category continued to constitute the principal source of asset funding for the banking sector during the review period. At the same time, loans and advances, which fell to 84.1 percent of total funding liabilities from 87.8 percent in the first six months of 2010, remained the primary use of funds. Investment category stayed in second position, at 9.3 percent of total funding liabilities. Consequently, there were no substantial variations in the balance sheet structure of the banking sector during the second half of 2010. By extension, therefore, the risk structure borne by the sector did not change much during the period reviewed.

The assets of the banking sector grew by 7.9 percent in the second half of 2010. During the same period, the banking sector's loans and advances rose by 6.9 percent. Subsequently, the growth rates in loans and assets were restrained and, therefore, constituted no grounds for any supervisory concern.

3.3.3 Profitability, capitalisation and cost efficiency

Profitability

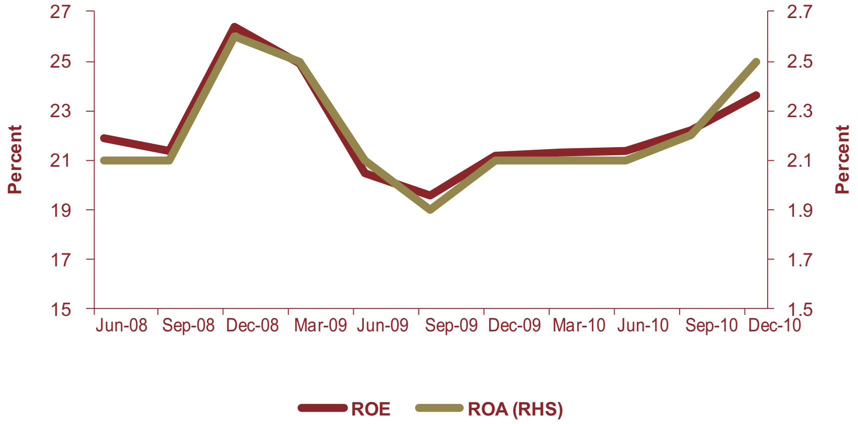
The profitability of the banking sector is a critical requirement for banking solvency and financial stability. In turn, banking profitability is a function of total income, provisions and write-downs, and operational expenses. The breakdown below shows how banking profitability was determined by the interaction among these variables in the second half of 2010.

The earnings of the banking sector improved during the review period, driven more by income from lending operations than by non-interest income. After-tax income rose by 20.4 percent, compared with a modest increase of 4.7 percent in the first half of 2010. The upsurge in after-tax income was largely owing to a 14.2 percent growth in net interest income. Non-interest income, by contrast, edged up by a meagre 0.2 percent during the period, after rising by a massive 26.2 percent in the first part of the year. Banking profitability was also assisted by favourable developments in expenses. Operating expense declined by 0.2 percent and interest expense fell by 7.3 percent.

Subsequent to the improvement in the after-tax income, both return on assets (ROA) and return on equity (ROE) expanded in the last six months of 2010. The two ratios[5] rose to 2.5 percent and 23.6 percent in December 2010, respectively (Chart 15). This compared with 2.1 percent and 21.4 percent in June 2010. The improved profitability allowed the banking sector to maintain efficient banking operations and augured for cpital adequacy. Furthermore, efficient banking operations and adequate capital levels are critical for the solvency of the banking sector and the enhancement of banking stability.

[5] The internal trigger benchmarks for ROA and ROE are 1.0 percent and 15.0 percent, respectively.

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



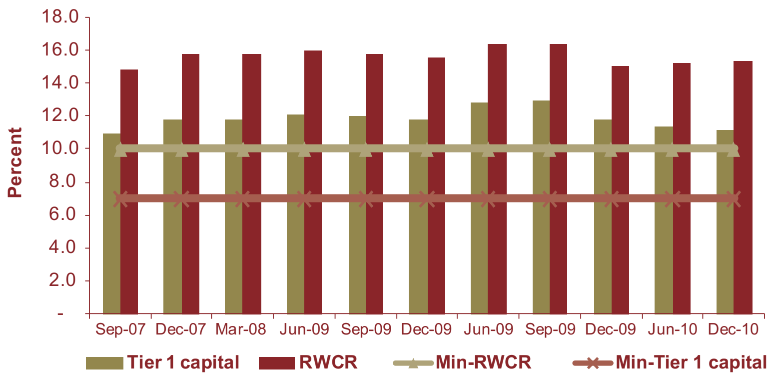
Capitalisation

Capital cushions a banking institution against unexpected losses. Consequently, capital adequacy ratio, together with non-performing loan ratio and liquidity ratio, serves as a core indicator of banking stability. Thus, a rising trend in capital adequacy is necessary to enhance the banking system stability and support efficient financial market operations. Adequate capital is, therefore, indispensible for the maintenance of a sound and stable banking system.

The Determination on Measurement and Calculation of Capital Charges for Credit risk, Operational risk and Market risk (BID-5) requires all banking institutions authorised to conduct banking business in Namibia to maintain prescribed capital minima. The prevailing leading indicator of capital adequacy is the regulatory risk-weighted capital ratio (RWCR) of not less than 10 percent. In addition, 7.0 percent of that ratio should be tier 1 or primary capital. The Tier 1 capital leverage ratio of 6.0 percent is a third capital-adequacy requirement.

The banking sector continued to be sufficiently capitalised during the review period, with the sector exceeding the minimum legal risk-weighted capital ratio (RWCR) of 10 percent. The RWCR averaged 15.3 percent at the end of the second half of 2010, from 15.2 percent at the end of the first half of 2010 (Chart 16). The Tier 1 capital ratio, on the other hand, slipped marginally from 11.4 percent to 11.1 percent, during the same period.

Chart 16: Capital adequacy for banking institutions



The profitability of the banking sector was sustained in the second half of the year. In addition, the industry's capital levels surpassed supervisory minima, even though the Tier-1-capital ratio fell somewhat. The banking sector, thus, continued to be well and adequately capitalised to cushion against unanticipated losses. The implementation of the Basel II capital accord, since beginning 2010, further enhanced the banking sector's capital adequacy. The implementation of the accord introduced market and operational risks in the determination of risk-weighted assets, resulting in additional risk coverage. Hence, the present level of capitalisation in the banking sector was no basis for financial stability concerns.

Cost efficiency

The conventional measure of efficiency in the management of operating costs, relative to income, in the banking sector is the cost-to-income (C/I) ratio[6]. The measure improved from 62.5 percent in the first six months of 2010 to 57.3 percent in the second half of 2010 (Chart 17). The deceleration in the ratio was a result of an 8.8 percent increase in total income, while other operating expenses fell by 0.2 percent. Consequently, the cost-income interaction kept the cost efficiency ratio not far above the international benchmark of 50.0 percent.

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

The most decrease in operating expenses came from its largest cost category, staff costs, which fell by 1.5 percent during the review period. By contrast, the second largest cost category of operating costs, administration and other overheads costs, rose by 32.9 percent during the same period. The improvements in the banking sector's ability to control operating expenses needs to be sustained in order to advance banking sector efficiency and, hence, banking profitability and stability.

3.3.4 Liquidity risk

The recent financial crisis highlighted effective liquidity management as a key tool to boost banking stability. Liquidity risk is the threat that assets may not be readily available to meet demand for cash to finance asset growth and to meet due commitments. A liquidity problem can originate from one banking institution and spread to other parts of the banking sector. Liquidity management is, therefore, critical to the banking system as a whole, to prevent liquidity problems from becoming systemic.

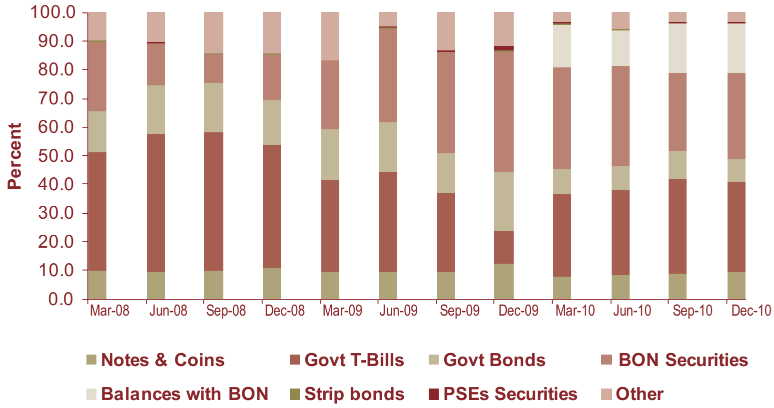
Several indicators are utilised to gauge banking liquidity. The most frequently used include: the relationships between actual liquidity held and liquidity required; composition of liquid assets; loans-to-assets; loans-to-deposits; composition of funding-related liabilities, for example, retail deposits; and liquidity conditions in the interbank market.

The banking sector's liquid asset rose by 12.2 percent, from N$4.9 billion at the end of June 2010 to N$5.5 billion at the end of December 2010. At the same time, the liquid assets prescribed by the minimum liquid asset requirement increased by 2.2 percent to N$4.6 billion from N$4.5 billion. Thus, the banking sector complied with the regulatory minimum liquid assets holding requirements with an average excess asset holding of N$0.9 billion during the second half of 2010.

The Government T-bills and the Securities of the Bank of Namibia maintained their principal position in the mixture of liquid assets held by the banking sector, during the second half of 2010. Government T-Bills rose to prominence from 29.4 percent of liquid assets held to 31.5 percent (Chart 18). Bank of Namibia Securities, on the other hand, slipped to second position from 34.7 percent of total liquid assets held to 30.1 percent. The sector's balances with the BON became the third largest liquid asset category, rising from 12.6 percent in June 2010 to 17.0 percent at the end of the second half of 2010.

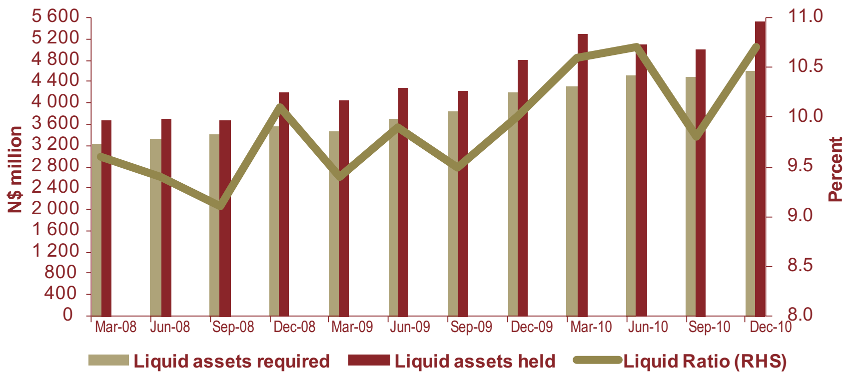
[6] Cost-to-income ratio is also referred to as cost efficiency ratio and measures the relationship between operating expenses and total income (net interest income plus operating income).

Chart 18: Structure/Composition of liquid assets



The liquid asset ratio or liquid ratio is traditionally used to measure the state of liquidity in the banking sector. It is expressed as total liquid assets held to total assets. The ratio only rose slightly from 12.1 percent at the end of June 2010 to 12.4 percent at the end of December 2010 (Chart 19). The increase in the ratio was a result of the 10.7 percent growth in liquid assets held that outstripped the 7.9 percent rise in total assets during the period.

Chart 19: Liquid assets and liquidity ratio



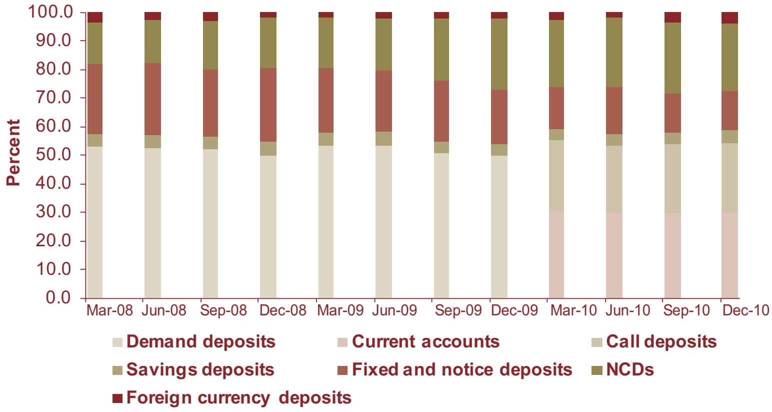
The ratio of loans to total banking assets fell from 74.9 percent in June 2010 to 74.1 percent in December 2010. Despite the decline, the magnitude of the ratio still signified the eminence of the loan category in the industry's balance sheet. A ratio higher or approaching the international benchmark of 75.0 percent of assets might lead to liquidity concerns as loans are less liquid than other types of assets. The current level of the ratio is still below the threshold and is, therefore, no reason for immediate stability concerns.

The proportion of total loans to total deposits (LTD ratio) fell slightly from 87.8 percent at the end of June 2019 to 86.6 percent at the end of the second half of 2010. The LTD ratio is an indicator of the degree to which the banking sector funds its loans with core deposits. The latter are considered to be relatively more stable and cheaper than borrowed funds. In addition, given that the ratio was well below the 100 percent threshold, the sector had sufficient room for asset growth before the need to resort to other more expensive funding sources. The level of the LTD ratio, therefore, did not pose any liquidity concerns.

The structure of core or non-bank deposits employed by banking institutions has significant long-term implications for the liquidity risks to which those institutions are exposed. This is the case because the cost and volatility of funding sources is important. The deposit application by the banking sector did not change significantly between June 2010 and December 2010. Core deposits, a cheaper and stable funding source, maintained their dominant position as the premier funding source of the banking institutions. Their share of total funding liabilities averaged 96.2 percent in the second half of 2010, largely unchanged from 96.1 percent in the first half of 2010. The proportion of current account deposits in total core deposits rose, albeit marginally, from 29.3 percent of total deposits to 29.9 percent during the second half of 2010 (Chart 20). At the same time, the share of call deposits rose from 23.4 percent to 24.5 percent. The share of NDCs, by contrasts, fell from 24.4 percent in June 2010 to 23.5 percent at the end of December 2010.

The last, but not the least, determinant of banking institutions' vulnerability to liquidity risk is the liquidity conditions in the interbank market. These conditions govern the ease with which banking institutions can obtain funds on short notice through interbank borrowing. Interbank exposure among Namibian banking institutions is small relative to industry capital funds. At December 2010, inter-bank borrowings and deposits comprised 8.9 percent of industry qualifying capital, or equivalently, 1.0 percent of industry capital and reserves. By this measure, the local inter-bank market is small, and hence less interdependent. It is, therefore, less likely that a liquidity problem in one banking institution would become systemic.

Chart 20: Composition of core/non-bank deposits



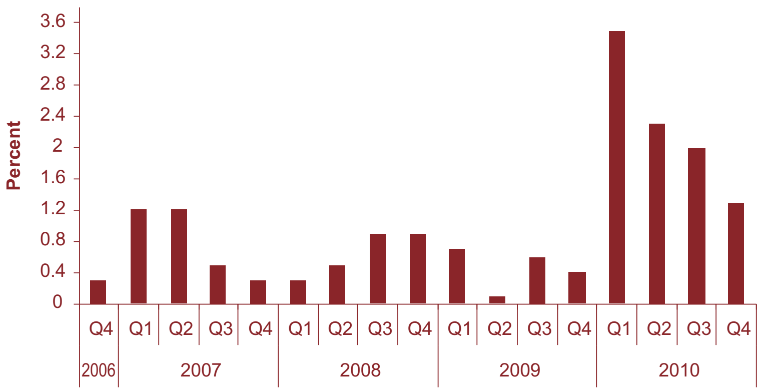
In view of the suitable levels of the key liquidity indicators, the banking sector's susceptibility to liquidity risk and, hence, financial instability, remained minimal in the second half of 2010.

3.3.5 Exchange rate risk

Net open position in foreign currency is a measure of the extent of mismatches, or open positions, of foreign currency assets and liabilities. It is expressed as a proportion of net foreign currency assets to the banking institutions' tier-1 capital funds. The measure is generally used to assess the probable susceptibility or openness of banking capital to movements in exchange rates. Net open position in the banking sector fell from 2.3 percent in June 2010 to 1.3 percent in December 2010 (Chart 21).

The sharp fall in the ratio, during the second half of 2010, resulted from a 39.3 percent drop in net open position, the numerator, which overtook a 4.7 percent increase in tier-1 capital funds, the denominator. By implications, a fall in the ratio implies a decrease in the exchange rate risk of the banking sector. At the same time, the ratio fell far below the regulatory limit of 20 percent. Accordingly, there were no significant financial stability concerns originating from exchange rate risk during the review period.

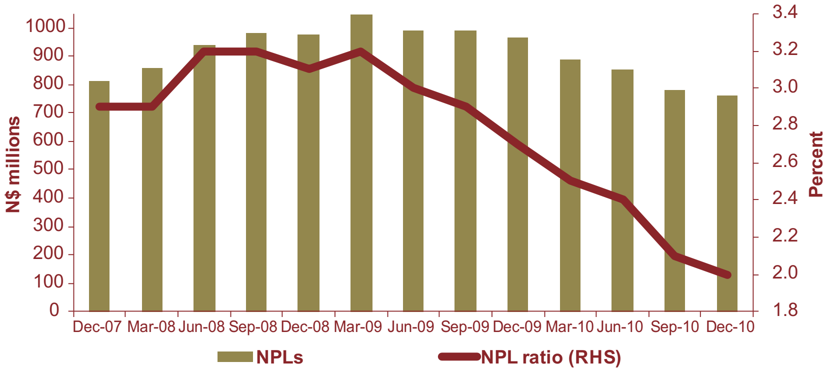
Chart 21: Net open position as percent of tier-1 capital



3.3.6 Credit risk

The quality improvements in the banking sector's loan portfolio that started in the second quarter of 2009 was sustained in the second half of 2010. One of the indicators of vulnerabilities stemming from credit risk in banking loan portfolio is the non-performing loan (NPL) ratio. The latter ratio improved from 2.4 percent at the end of June 2010 to 2.0 percent at the end of December 2010 (Chart 22). Loans and advances grew by 6.9 percent, while the NPLs fell by 10.7 percent, during the period. The fall in the sector NPLs was mainly a result of write-offs, mostly in the loss sub-category of non-performing mortgage loans. At the same time, lower interest rates improved the borrowers' capacity to service debt. The NPL ratio, thus, remained well within the acceptable range[7].

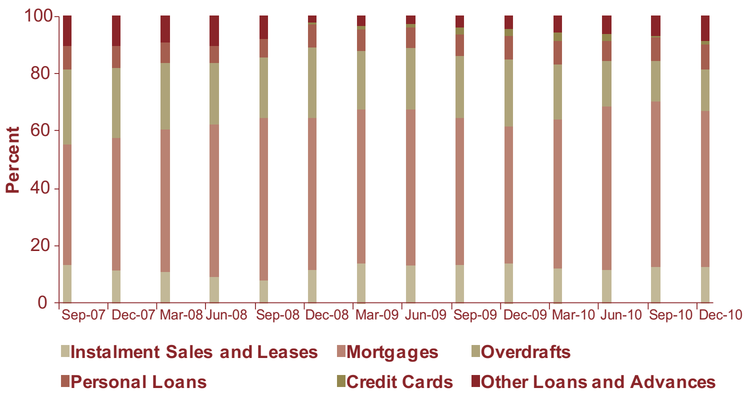
Chart 22: Banking asset quality



Overdue loans in the banking sector fell by 3.8 percent to N$1.6 billion at the end of December 2010 from N$1.7 billion at the end of June 2010. However, NPLs fell by 10.7 percent over the same period. Subsequently, the fraction of NPLs to overdue loans fell from 49.6 percent to 46.0 percent, during the period. The prevailing low interest rate environment and the improving domestic economic conditions continued to provide a favourable influence on overdue loans during the review period.

The share of non-performing mortgage loans to total non-performing loans declined to 54.0 percent at the end of the second half of 2010 from 57.4 percent at the end of June 2010 (Chart 23). Non-performing mortgage loans as a proportion of total mortgage loans extended by banking institutions fell from 2.6 percent at the end of June 2010 to 2.0 percent at the end of December 2010 (Chart 24). At the same time, the proportion of overdue mortgage loans in total mortgage loans declined from 5.4 percent at the end of June 2010 to 4.1 percent in December 2010. As was the case in the previous review period, the largest decrease in overdue mortgage loans came from the category "amount overdue for less than one month".

Chart 23: Non-performing loans by category



[7] In term of the CAMELS rating system of BON, the NPL ratio of less than 5 percent is considered to be very low.

During the review period, the asset quality of the banking sector sustained the improvement that began in the first half of 2009. In particular, the NPL ratio continued the decline during the period. Furthermore, the structure of NPLs reflected the mixture of total loans and advances, while overdue loans declined. Accordingly, credit risk was considered to be inconsequential, requiring only low monitoring.

The statutory large exposures of the banking sector, exposures that are at least 10 percent of industry qualifying capital, accounted for 19.9 percent of the total loan portfolio of the banking sector, at the end of the second half of 2010, compared with 16.9 percent six months previously. As a proportion of banking industry capital funds, large exposures rose from 110.9 percent to 130.0 percent, during the same period. The Determinations on Single Borrower Limit (BID 4) set 30 percent and 800 percent statutory limits for single borrowers and aggregate large exposures as a percentage of industry capital funds, respectively.

Chart 24: Non-performing mortgage loans

The banking sector's exposure to the mining and related sectors increased in the second half of 2010. However, large exposures to the mining and related sectors, as a share of banking industry capital funds fell slightly from 28.7 percent in June 2010 to 28.5 percent in December 2010. The reduction in the share was mainly attributed to a faster increase in the capital funds of the banking sector of 8.9 percent as opposed to the growth in mining large exposure of 6.7 percent. Given the modest nature of the exposure, therefore, the potential impact on banking stability of the exposure to the mining and related sectors is assessed to be moderate.

Box A: The G20 Seoul Summit

In Pittsburgh, September 24-25, 2009, the G20 launched the Framework for Strong, Sustainable and Balanced Growth. They also committed to work together to assess the collective implications of their national policies on global growth and development, and identify potential risks to the global economy. Since the Pittsburg Summit, the group have made important progress through country-led, consultative Mutual Assessment Process (MAP) of the Framework. Consequently:

* Supportive economic policies have been put in place to promote on-going recovery and job creation;
* Explicit commitments have been made to put public finances on a sustainable track;
* Strong measures have been adopted and are being implemented to safeguard the stability of our financial system;
* Important structural reforms have been launched and/or planned to boost global demand and potential growth; and
* Significant steps have been taken to strengthen the capacity of international financial institutions (IFIs) in support of development.

The G-20 met in Seoul South Korea from November 11-12, 2010 and agreed on the Framework for Strong, Sustainable and Balanced Growth; and The Seoul Action Plan. The latter Plan was launched with the purpose to: ensure an unwavering commitment to cooperation; outline an action-oriented plan with each member's concrete policy commitments; and deliver on all three objectives of strong, sustainable and balanced growth. Specifically, the summit committed to actions in five policy areas. In terms of Financial Reforms, the G20 members committed themselves to taking action at the national and international level to raise standards, and ensure that their national authorities implement global standards developed to date consistently. In particular, they undertook to implement fully the new bank capital and liquidity standards and address too-big-to-fail problems. The Basel III regulatory framework was endorsed by the G20 Leaders at their Seoul Summit. Under the new rules for Basel III, tier 1 capital will rise from 4.0 percent to 4.5 by 2013, and reach 6.0 percent in 2019. Banks would be required to keep an emergence reserve of 2.5 percent.

The new liquidity standards involve: the liquidity ratio, net stable funding ratio and monitoring tools. For implementation, banks are expected to report the underlying data for the ratios on January 1, 2012. Global regulators confirmed at the G20 meeting in Seoul that the world's biggest banks will be required to hold more capital or come up with other means to make themselves more resilient to collapse. The process of indentifying about 20 "global systemically important financial institutions" (GSifis) and writing tighter rules for them will take until the end of 2012. Once regulators have tackled the biggest international banks (GSifis), they would move on to the next level, those that are dangerously large in their home markets but not as international banks. The G20 members also agreed to further work on financial regulatory reforms.

Table 2: Banking sector indicators

Structure	Dec-07	Jun-08	Dec-08	Jun-09	Dec-09	Jun-10	Dec-10
Number of banks	**4**	**4**	**4**	**4**	**4**	**5**	**5**
Total assets of banks (N$'000)	36,504,795	39,398,740	41,562,708	43,275,865	47,669,192	47,698,656	51,501,023
Gini concentration index	11.6	12.2	11.3	10.8	11.45	12.0	11.07
Herfindahl index	2,678	2,705	2,689	2,677	2,690	2,692	2,680
Capital adequacy (%)							
Tier 1 leverage ratio	7.9	7.9	7.9	8.6	7.8	8.6	8.3
Tier 1 capital ratio	11.8	11.9	11.8	12.8	11.7	11.4	11.1
Total RBC (regulatory capital RWA's)	15.8	15.8	15.5	16.4	15.0	15.2	15.3
Asset quality (%)							
NPL's/Total gross loans	2.9	3.2	3.1	3.0	2.7	2.4	2.0
Gross overdue/Total loans and advances	3.8	3.9	5.7	6.5	8.0	4.7	4.3
Provisions/Total loans	2.1	2.1	2.0	1.9	1.8	1.8	1.5
Provisions/NPL's	77.2	68.6	64.7	62.8	66.2	74.8	78.6
Specific provision/NPLs	37.0	33.8	29.2	27.2	28.7	30.5	30.3
Earnings and profitability (%)							
Return on assets	2.4	2.1	2.6	2.1	2.1	2.1	2.5
Return on equity	26.6	21.9	26.4	20.5	21.2	21.4	23.6
Net interest margin	5.7	468	4.7	4.3	4.5	4.9	5.2
Cost to income ratio	56.9	59.2	51.9	61.2	57.9	62.5	57.3
Liquidity (%)							
Liquid asset to total assets	9.2	9.3	10.1	9.9	11.6	12.1	12.4
Total loans/Total deposits	89.9	86.4	87.9	87.1	85.3	87.7	86.6
Total loans/Total assets	76.2	74.2	75.2	74.6	72.8	74.9	74.1

3.4 FINANCIAL INFRASTRUCTURE AND REGULATORY DEVELOPMENTS

3.4.1 Financial infrastructure

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

3.4.2 Regulatory developments

The Banking Institutions Amendment Act, 2010 (Act No.14 of 2010)

In 2010, the Bank carried out various activities in order to strengthen the regulatory and supervisory framework to ensure that banking institutions comply with international best practices. The Banking Institutions Amendment Act, 2010 was promulgated in October 2010 and became effective on November 5, 2010.

The major changes in the Amendment Act of 2010 included: provisions permitting the establishment of branches of foreign banks, envisioned to stimulate local competition among banking institutions; provisions for the Bank to carry out consolidated supervision of bank holding companies and banking groups in order to mitigate contagion risk; powers for the Bank to apply spot fines on banking institutions for non-compliance with prudential requirements; authority for the Ministry of Finance to issue regulations relating to ownership and citizenship of board directors or executive officers of banking institutions and banking control companies; and outlawing pyramid schemes.

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