Bank of Namibia

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Bank of Namibia

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CORPORATE CHARTER

VISION
“Our vision is to be the 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

AACB	Association of African Central Bank
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
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
NAD	Namibia dollar
NISS	Namibia Inter-bank 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)

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INTRODUCTION

The Financial Stability Report provides a biannual review of the assessment of Namibia's financial system's ability to withstand shocks and its role in facilitating economic development. It also provides a summary of the Bank of Namibia's activities aimed at promoting financial system stability. The Report covers the period since the last review, of September 2008.

The financial system comprises financial institutions, financial markets, and payment and settlement systems. Much of the emphasis of the assessment of financial stability is on the banking institutions in view of the key role that they play in the financial system in general and Namibia in particular.

The FSR also reviews relevant international, regional and domestic developments and highlight their possible impact on financial system stability in Namibia. In addition, the report examines regulatory issues that have a bearing on the country's financial stability. Special attention is given to the likely impact of the global financial and economic crises on financial stability in Namibia.

The major sections conclude with an indicative rating of the impact of the issues raised on financial stability relative to the previous assessment period. The ratings, in ascending order of degree of impact, are as follows: low, moderate, and high impact.

1. SUMMARY OF THE STABILITY ASSESSMENT

The volatility in the global financial markets that started in August 2007 has intensified and spread in the second half of 2008 and adversely affected global financial stability during the period. In September 2008, threats to global financial stability were growing in intensity as several key international financial institutions started to fail. The collapse of the Lehman Brothers accelerated the banking problem and prompted a round of co-ordinated central bank rate cuts in October 2008. These were followed by more cuts in subsequent months, in a bid to avert or moderate the economic slowdown. Governments around the globe also introduced stimulus and rescue packages. The resulting loss of confidence in financial institutions and markets led to serious liquidity shortages as banking institutions stopped lending. Rescue measures to restore confidence and provide support to troubled lending institutions had little impact as banking institutions continued to limit inter-bank lending and credit extension.

The fallout from the financial crisis has not been confined to the financial sector. The effect on the real global economy included collapsing house prices, slowing economic growth and falling inflation. Furthermore, as the economic slowdown worsened, particularly with the recession in advance economies, inflation in these economies has started to slow since October 2008, as demand diminished and commodity prices started to fall.

The financial crisis has also affected conditions in emerging market and developing country economies. The contraction of the global economic growth reduced demand for exports of these countries. A sharp increase in net outflows of foreign funds, particularly in September 2008, underscored emerging market vulnerability to rising risks in global financial markets. Stock exchanges in emerging markets were also negatively affected, and falling commodity prices undermined currencies. This has a significant adverse effect on economic growth rates in emerging and developing economies.

Given the stagnation in global consumer demand and investment activity, in addition to the turmoil in international financial markets and volatility in asset prices and exchange rates, the IMF projected a decrease in global output to 0.5 percent in 2009 from 3.4 percent in 2008. The forecast for emerging market and developing economies was revised downward to 3.3 percent in 2009.

The impact of the fall-out from the global financial and economic crises on the Namibian banking sector has been largely limited. However, the impact on real economic activities, in particular export oriented industries such as mining has been more adverse. Consequently, the Bank's latest economic outlook forecast GDP growth to slow to only 1 percent in 2009, from an estimated growth rate of 2.7 percent in 2008.

The limited exposure of the local banking institutions to the markets afflicted by the crisis insulated the banking system from the direct impacts of global financial crisis in 2008. Improved profitability in the second half of 2008 significantly boosted banking solvency and resilience. The average return on equity (ROE) in the banking sector rose substantially in the last six months of 2008, after a weakening in the first half of 2008. Similarly, capital adequacy ratios continued to exceed their regulatory requirements, a fact that bodes well for the stability of the banking sector. However, capital ratios have been falling and rising overdue loans have been gathering pressure on non-performing loans (NPLs). There have also been sporadic liquidity pressures in the banking system. Overall, the soundness of the banking sector remains intact going forward.

The prevailing unfavourable global economic environment has adversely affected the productive sectors in Namibia, more particularly, the mining and tourism sectors, with envisaged job losses in excess of 1,500 in the former. This will erode household incomes and exacerbate already weak domestic demand. At the same time, poor corporate profits resulting from slow economic activities will diminish corporate finances. This situation could have negative implications for NPLs.

The turmoil in the international financial markets and the resultant risk aversion contributed to the sharp depreciations of some emerging and developing market currencies. The Namibian currency depreciated against all major currencies in the second half of 2008. The weakness of the Namibia Dollar (NAD) was also a function of the decline in export metal prices; the sharp fall in the growth of property prices; and labour market unrest, particularly in South Africa.

Despite subdued economic conditions, Namibia’s international reserves continued to increase, mainly because of Southern African Customs Union (SACU) inflows and the NAD depreciation. The improvement in reserves is vital for the strengthening financial stability and financial health in Namibia.

The Bank continuously monitors and oversees the operations of the payment system, with the aim of identifying and mitigating risks in the system. On this basis, the payment system has performed on a sound basis in the second half of 2008, with no operational risks that could lead to system malfunction. The payment system, thus, does not pose any systemic risk to the financial system.

In summary, therefore, although the global financial stability has worsened since the last Financial Stability Report, the impact on the Namibian banking sector is low. However, the financial crisis has adverse effects on economic growth and the employment situation. Although this could put further pressure on the future performance of the banking system, its impact on banking stability is assessed as moderate at this stage.

2. EXTERNAL ENVIRONMENT

2.1 MACRO-FINANCIAL CONDITIONS

The global financial market crisis that first started with U.S. subprime mortgage collapse in August 2007 entered a new phase and began to accelerate in September 2008. The institutional failures and accompanying violent volatility in the global financial markets had badly shaken confidence in financial markets and institutions. The impact of the financial crisis has also been felt in emerging markets and developing countries to an increasing extent. Accordingly, the IMF, in its Global Financial Stability Report of October 2008, noted that the systemic risks had risen in September. Wide ranging concerns over solvency intensified and triggered a host of bankruptcies and collapses of key financial institutions. Shortages of liquidity and unwillingness by banking institutions to lend ensued.

Governments and central banks across the world intervened, mostly in October 2008, to stem the financial crisis and to restore confidence and provide support to ailing financial institutions. The interventions included a variety of measures, such as: nationalisation (e.g., Northern Rock in 2008), take-overs (mergers and acquisitions, purchase of weaker banks by stronger ones), coordinated interest rate cuts, capital injections (bail-outs) and lending guarantees to restore liquidity and revive the ailing banking systems and to rebuild investors' confidence in financial markets and institutions. Some governments also provided fiscal stimulus, asset purchase and banned short selling.

However, efforts made towards stabilising the financial markets and governments' stimulus packages appear to have little impact, as banking institutions continued to limit credit availability, thus, preventing businesses from making growth stimulating investments. Moreover, financial institutions' bad loans worldwide are expected to increase further. Lack of confidence in financial markets and institutions also helped prevent genuine global economic turnaround.

Initially, emerging markets had been relatively insulated from the financial crisis, but came under pressure as global financing conditions deteriorated. Emerging and developing country economic growth rates began to slow as commodity prices started to drop. Stock exchanges were also negatively impacted. Net outflows of foreign funds accelerated as investors' risk aversion, particularly towards emerging markets, increased and investors preferred the dollar and the yen. Furthermore, sharp decreases in key export commodity prices reduced export earnings and undermined currencies in emerging economies.

The fallout from the crisis has not been confined to the financial sector. The effect on the real (global) economy included collapsing house prices, slowing economic growth, and falling inflation. In its *update* for January 2009, the IMF revised the global economic growth for 2008 to 3.4 percent from 3.7 percent projected in October 2008. The IMF expected the global economy to slow to 0.5 percent in 2009 and output in advanced economies to contract by 2.4 percent. Emerging economies were forecast to slacken to 3.3 percent in 2009 from a growth rate of 6.3 percent in 2008. Furthermore, the IMF noted that the economic outlook was fairly uncertain and the timing and pace of economic recovery critically depended on firm policy actions. Accordingly, world income per capita, in both developed and many developing countries, is expected to decline in 2009.

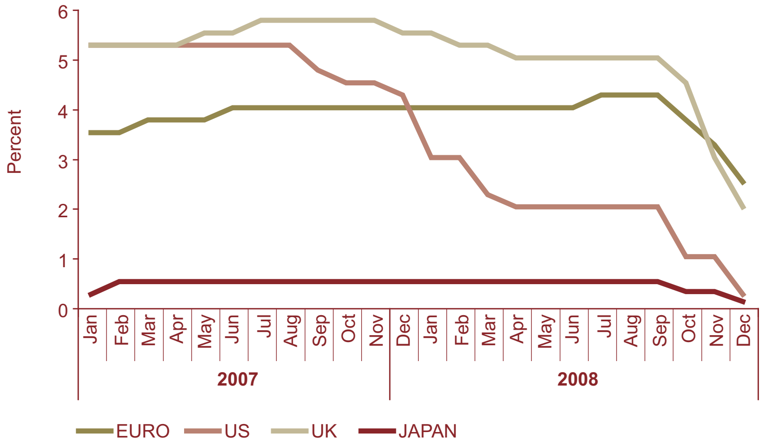
2.2 INFLATION RATES

Global inflation rate has fallen significantly in the second half of 2008, following notable decreases in fuel and commodity prices. Fuel supply increases and slowing demand due to deepening economic uncertainty, in both developed and emerging economies, contained the swell in international energy and food prices. In advanced economies, inflation was expected to fall from 3.5 percent in 2008 to a record low level of 0.3 percent in 2009. Inflation in emerging and developing economies was predicted to drop from 9.5 percent in 2008 to 5.8 percent in 2009.

2.3 INTEREST RATES

Except for the ECB, which raised its rates in July, major central banks kept their policy rates unchanged since the end of the second half of 2008. However, commodity prices have fallen sharply since then (over the past few months), helping to alleviate inflation pressures in the global economy and allowing many central banks to move forward with much needed interest rate reductions. On October 8, for instance, the Federal Reserve, European Central Bank, Bank of England, and Bank of Japan, among others, lowered their policy rates and citing slowing price growth as one of the reasons why they were able to participate in the unprecedented coordinated rate cuts (Chart 1).

Chart 1: Major policy interest rates



Source: Bloomberg

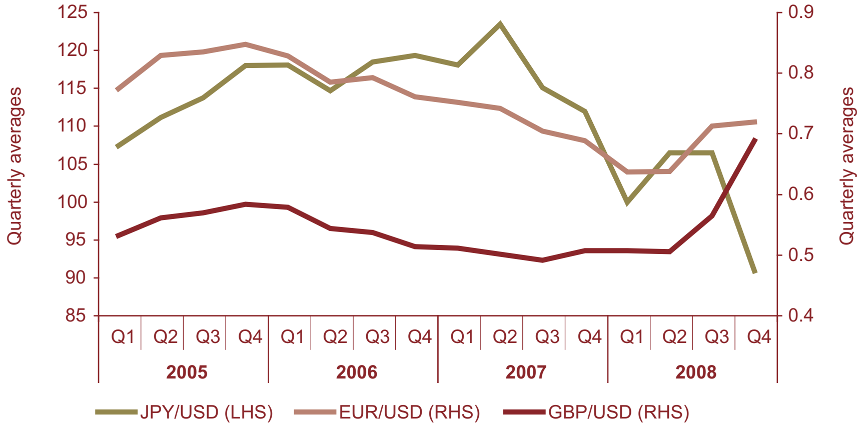
In emerging market and developing economies, some central banks have kept their policy rates unchanged since June 2008. Other central banks, on the other hand, reduced their policy rates. In China, the central bank lowered interest rates for the first time in six (6) years in September and followed up with two more reductions in October, leaving the key one-year lending rate at 6.6 percent. Further rate cuts brought the Chinese policy rate to 5.31 percent at the end of 2008.

The South African Reserve Bank (SARB) cut its benchmark interest rate by half a percentage point to 11.5 percent in December 2008, the first reduction in more than three years. The cut in rates was made possible by falling economic growth and a sharp drop in oil prices that reduced global inflation. The SARB further trimmed the official repo rate by a full percentage point in February 2009 to 10.5 percent. The central bank noted that although it did not expect South Africa to be in a recession soon the country was not insulated from the difficulties facing the world economy.

2.4 EXCHANGE RATES

The currency markets in advance economies continued to be very volatile in the third quarter of 2008. Volatility was symptomatic of the uncertainty over economic outlook that characterised these markets since the first half of 2008. The Euro and Pound depreciated against the Dollar in the second half of 2008 (Chart 2). The principal reason for the Dollar's relative strength was the fact that the currency was considered a safe haven during uncertainty. The yen, on the other hand strengthened, against the dollar during the period. The yen chiefly drew its strength from the carry trade.

Chart 2: Currency per US dollar

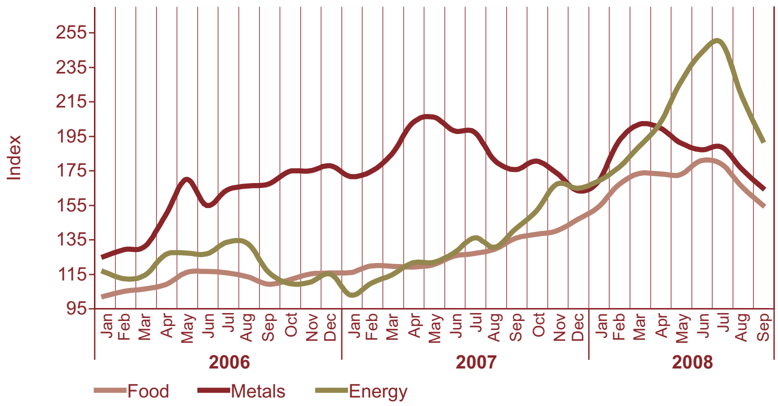


Source: Bloomberg

2.5 COMMODITY MARKETS

The downward trend in commodity prices that started in July, 2008 continued through September 2008 (Chart 3). The fall in commodity prices was first driven by speculations that the slowing global economy would damp demand for industrial and precious metals, and intensified (after September), as the U.S., the euro region and Japan fell into recession. As the financial and economic crises continue, the outlook for commodities remains weak and uncertain.

Chart 3: Selected commodity price indices



Source: IMF

The spot uranium prices have fallen sharply in 2008, partly owing to hedge funds selling their holdings to cover losses in other financial markets. Prices have also been kept subdued by the excess of supply over demand. Uranium spot prices, which reached a record US$138 a pound in June 2007, declined to US$44 a pound in October 2008 before recovering to US$53 by the end of 2008. Uranium prices rose by 8 percent in December alone, but fell to UD$43.75 at the beginning of March 2009.

The copper price was mainly negatively affected by concerns over the global recession, which eroded demand for the metal. In the third quarter, copper price fell (on quarterly basis) by 9.3 percent from US$8 454 per metric tonne. Booming demand from China, the world's biggest metal buyer, which fuelled the surge in copper prices for six straight years through 2007, slackened in the third quarter of 2008. Excess of supply for the metal over its demand also suppressed prices in the third quarter. The unchanged excess-supply-demand relationship continued to weigh down on copper prices in the fourth quarter of 2008. Copper prices continued to decline as the global recession led to a reduction in demand for the metal and boosted inventories to five-year high levels. In early March 2009 copper was trading at US$3,475.00 per metric tonne, 58.8 percent lower than a year before.

In the second half of 2008, movements in gold prices were mainly influenced by the performance of banks in Europe and USA, house prices and stock market conditions. On a quarterly basis, the gold price decreased by 3.0 percent to US$869 an ounce in the third quarter of 2008. Gold price, which rose 31 percent in 2007 as the US inflation rate reached 4.1 percent, fell in most of the fourth quarter on expectations that the slumping global economy would reduce demand for the commodities and erode the appeal for the precious metal as a hedge against inflation. Dollar appreciation also reduced the metal's appeal as an investment alternative and safe haven in times of trouble. In December, however, gold price rose by 8 percent as investors started to buy the precious metal as an investment vehicle. Gold price reached US$912.50 per ounce in March 2009, 5.8 percent lower than at the same time last year.

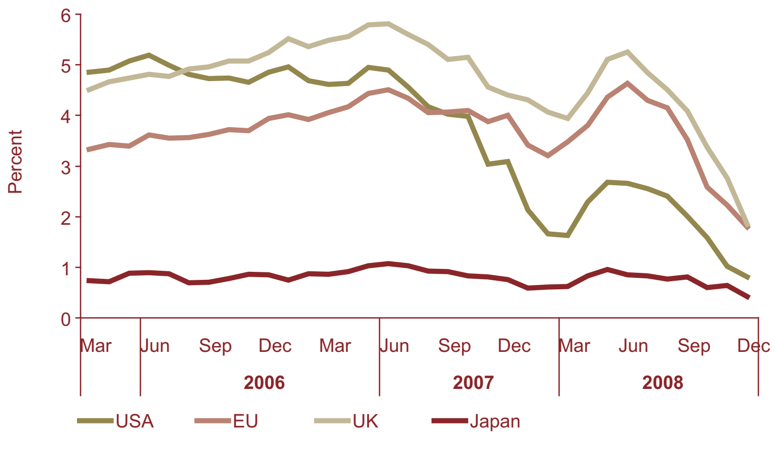
In the third quarter of 2008, the price of zinc declined by 16.1 percent, following an oversupply of the metal coupled with weak global demand for the metal. The price of zinc continued to trend lower in the fourth quart of 2008, in the face of suppressed global demand for the metal. In December, zinc price declined by 8 percent, before rising to US$1, 104.00 per metric tonne in March 2009.

The fall in commodity price indices, in the third quarter of 2008, was more pronounced in the energy category. The downward trend in oil prices continued in the fourth quarter of 2008 as the worsening global economy weakened oil demand. Efforts by Organisation for Economic Co-operation and Development (OPEC) to support oil prices by supply cuts had little impact. After striking a record high of US$147.27 a barrel on July 11, 2008, crude oil prices began to fall significantly, reaching US$32.40 a barrel on the New York Mercantile Exchange on December 19, 2008. On average, crude oil prices slumped by 23.4 percent in December due to declining demand and rising supplies. The slide in the oil price came as the financial turmoil evolved into a worst global economic crisis since the Great Depression and weakened global oil demand. Weak global demand for crude oil would likely continue to weigh down on oil prices. Oil supply increases and geopolitical tensions have also contributed to fluctuations in oil prices. By early March 2009, oil prices have climbed to US$43.37 a barrel, but still 70.6 percent below its peak at US$147.27 in July 2008.

2.6 BOND MARKETS

Two-year bond yields in the major international bond markets declined sharply in the second half of 2008 (Chart 4). The sharp fall in most bond yields came on the back of huge policy (interest) rate cuts aimed at reviving slumping economic growth in major advance countries. Investors opted to by government securities (bonds), thus bidding up their prices and driving down their yields given the inverse relationship between bond prices and yields. In the US, Euro-zone and UK, two-year bond yields plunged from 2.6, 4.6 and 5.2 percent in June 2008 to 0.8, 1.7 and 1.8 percent in December 2008, respectively. Yields in Japan, by contrast, fell moderately, from 0.8 percent in June 2008 to 0.3 percent in December 2008.

Chart 4: Two-year bond yields

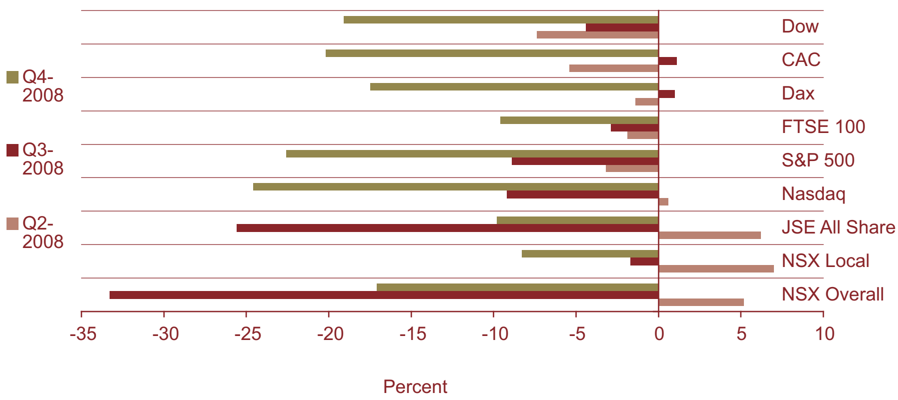


Source: Bloomberg

2.7 STOCK MARKETS

The volatility that characterised the major international stock markets in the first half of 2008 intensified in the second half of 2008, as expectations grew stronger that the financial-market turmoil would push the US, Europe, UK and Japan into recession and resulting reduced company profits. Most global stock indices fell as the stocks of commodity producers slid along with oil and metal prices on speculations that a recession would drain demand for raw-materials and reduce corporate profits (Chart 5). The swings in stock prices also increased as the collapse of the Lehman Brothers Holdings Inc. in September 2008 and international government actions to bail out banks heightened concerns that financial losses would worsen. In the third quarter, for example, the Dow Jones index, FTSE 100 index, and the S&P 500 index continued to decline and recorded negative growth rates of 4.4, 2.9 and 8.9 percent, respectively. At the same time, the CAC index, Dax index, JSE All Share index, and the Nasdaq index reversed their second-quarter fortunes to record growth rates of 1.1, 1.0, -25.6 and -9.2 percent, respectively, in the third quarter.

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



Source: Bloomberg

The intense stock market volatility continued in the fourth quarter of 2008, as signs that the worldwide recession slump was worsening pushed down stock prices. The principal drivers included concerns over the impact of the global recession on company earnings, swings in oil/raw-material prices and the (future outlook) prospects in the credit markets. For example, profits for most companies (especially in the S&P 500 index) fell in the fourth quarter of 2008, completing a sixth straight quarter decline. Although all major stocks fell in the fourth quarter, the following indices dropped the most: the Nasdaq (-24.6 percent); the S&P500 (-22.6 percent); the CAC (-20.2 percent); and the Dow (-19.1 percent).

2.8 SUMMARY ASSESSMENT

Although the impact of the global financial and economic crises on the Namibian financial system remained largely limited, the economy, nonetheless, was adversely affected through a variety of channels. The economic slowdown, particularly, in Namibia's major trading partners, has led to declining demand for the country's commodities and, consequently, their prices. Lower global demand for primary commodities led to a further deceleration in overall economic growth in Namibia; resulting in declining output in some sectors, especially, mining and tourism, and, consequently, in labour shedding. This could eventually strain the performance of the banking sector going forward. Furthermore, slower economic growth could also result in reduced tax revenue for the government.

3. DOMESTIC ECONOMY

3.1 ECONOMIC CONDITIONS AND FINANCIAL MARKETS

3.1.1 Economic performance

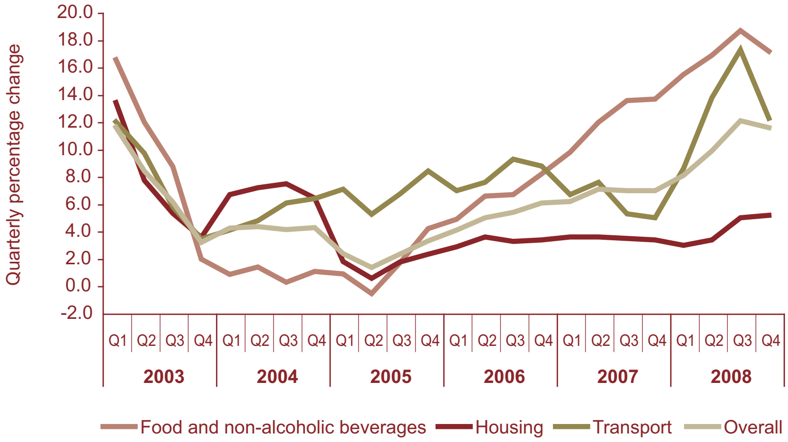
The Namibia's economic growth slowed to an estimated 2.7 percent in 2008. This moderation reflects the impact of external economic developments. The global financial crisis led to dampened commodity demand. This has negatively impacted the domestic real economy, in particular, the mining and tourism sectors, and led to job losses. The pace of economic growth in 2009 is, therefore, estimated to have moderated further to 1.0 percent.

The downside risks to the domestic outlook continue to be the possibility of a deepening and prolonged financial crisis. The slump in the global economy will continue to limit export growth and adversely affect domestic economic growth. Slow economic activity will negatively impact the incomes of both firms and households, with possible adverse consequences for banking institutions and financial stability.

3.1.2 Consumer prices

The rising trend in overall inflation intensified further in the second half of 2008 (Chart 6). The foremost drivers pushing the rise in the inflation index continued to be the *food and non-alcoholic beverage* sub-category, and the transport sub-category. Consequently, the overall inflation averaged 12.0 percent in the third quarter from a quarterly average of 9.8 percent in the second quarter. However, in the second half of the year, the fall in key commodity prices such as food and energy products had eased inflationary pressure. As a result, overall inflation fell to 10.9 percent in December from 11.7 percent in November. However, in January 2009, the inflation rate has risen to 11.6 percent.

Chart 6: Contributions to CPI

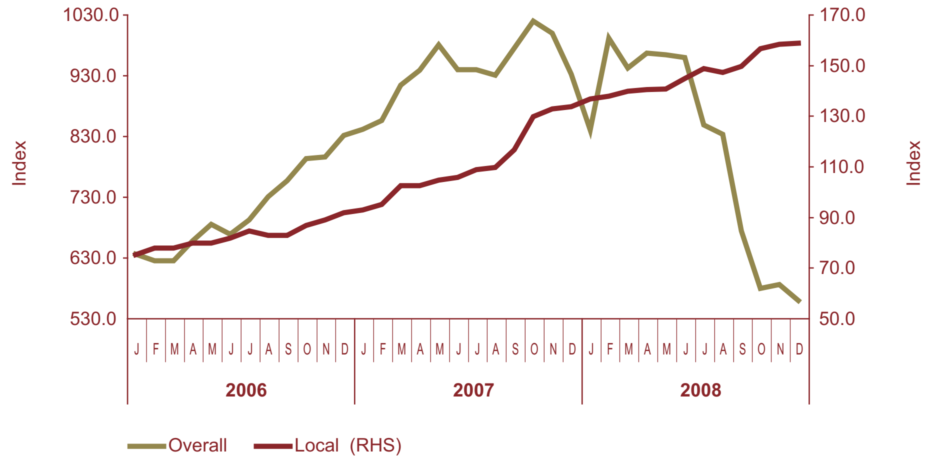


Source: Central Bureau of Statistics

3.1.3 Equity market

The overall price index of the Namibia Stock Exchange (NSX) fell sharply by 41.8 percent in the second half of 2008 from 956 points in June to 556 points in December (Chart 7). The overall index comprises the performance of both local and dual-listed companies. Dual listed companies are simultaneously listed on both the NSX and the Johannesburg Stock Exchange (JSE). This impact of the credit crisis and the subsequent deepening economic recession on the overall index came through the JSE and mirrored the general downward trend in stock markets in US, Europe and Asia during the period.

Chart 7: Namibia stock exchange price indices



Source: Namibia Stock Exchange

The NSX overall index declined by 30.0 percent at the end of the third quarter of 2008 to close at 671 points, from 956 points at the end of the second quarter. The local index of the NSX was somewhat shielded from the turmoil in the global markets. It closed at 3.5 percent higher at 149 points at the end of the third quarter of 2008 from 144 points, compared with the previous quarter.

The NSX overall index slowed further in the fourth quarter of 2008, following declines in share prices. The NSX overall index declined by 17.1 percent at the end of the fourth quarter of 2008 to close at 556 points, from 671 points at the end of the third quarter. The local index, on the other hand, rose by 6.1 percent to 148 points at the end of the fourth quarter of 2008.

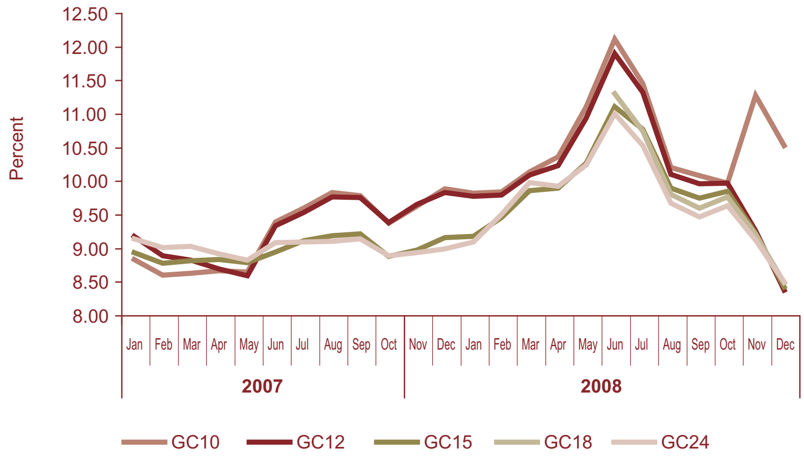
3.1.4 Bond markets

The yields for the Namibian Government bonds were noticeably trending upwards in the first half of 2008 in a view of expected interest rate hike due to the deterioration in the inflation outlook (Chart 8). However, the trend changed in the second half of 2008 as market views shifted to expectations of a rate reduction as worsening global economic developments contributed to downward inflation pressures worldwide.

The shorter dated bond yields, the most sensitive to interest rate expectations, rose the most, with the GC10 and GC12, reaching the highest levels of 12.00 percent in May.

Developments on the South African bond market were largely responsible for the movements in the local market since Namibian bonds are priced off the South African yield curve. At the end of 2008, RSA bond yields trended lower as traders remained concerned that the deepening losses at the world's biggest banks and securities firms will hurt global economic growth.

Chart 8: Government Bond yields



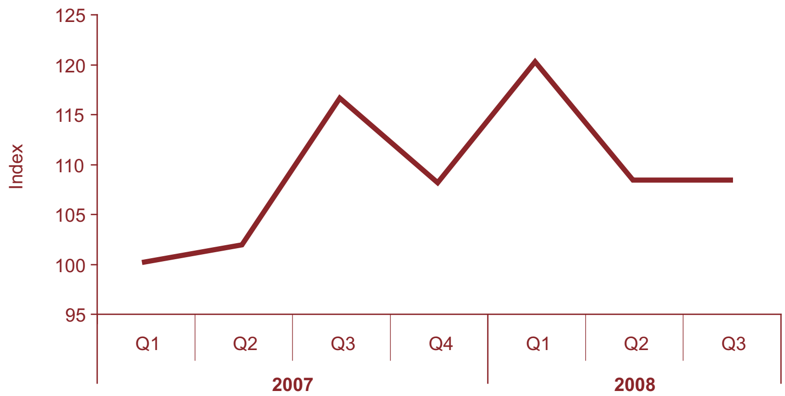
Source: Bank of Namibia

As expected, the bond prices gained sharply in the last quarter of 2008 after the market began pricing-in the possibility of interest rate declines, as both consumer price inflation and producer-price inflation started to slow. The yield on the GC12, a shorter dated bond, eased to 8.35 percent in December 2008 from 10.91 percent in May 2008. With the exception of the GC10, the yields for other bonds also ended the year significantly lower, below 8.50 percent. In contrast, the yields on the GC10, which matures in January 2010 increased significantly since November 2008 as the market began pricing this bond off the money market rates. The latter were significantly higher than the bonds yields, particularly in the last quarter of the year.

3.1.5 Housing sector

The Windhoek house price index showed no clear price trend in the last eight months of 2008. It declined in the second quarter of 2008, falling by 10 percent from the first quarter of 2008 (Chart 9).

Chart 9: Windhoek House Price Index



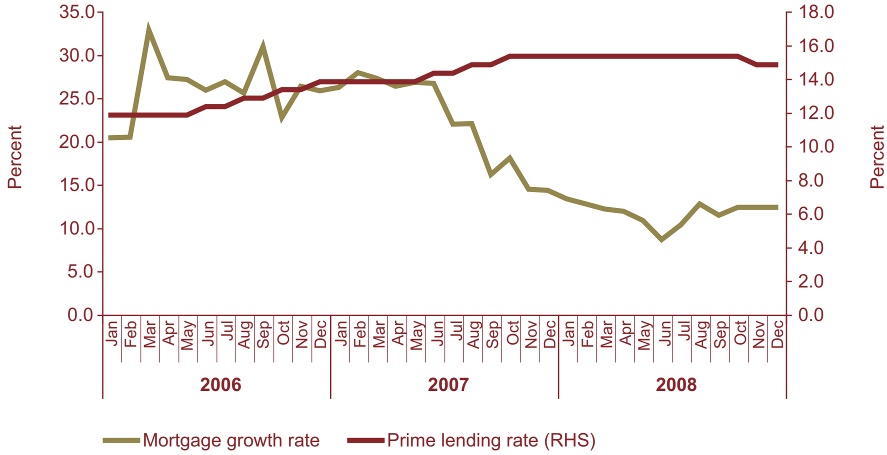
Source: First National Bank

In the third quarter, the Windhoek quarterly housing price index increased slightly. The generally low growth in house prices in the third quarter was caused by financial strains that forced house owners to sell their houses during the period. The fuel price increases in the third quarter of 2008 increased the financial strains on house owners.

The number of houses traded declined in the third quarter of 2008 partly because of a Municipality Auction that was scheduled for October 2008. Prospective house owners postponed house purchases in hope for bargain purchases at the auction.

The mortgage growth rate rose slightly to average 11.8 percent in the second half, after averaging 11.5 percent in first half (Chart 10).

Chart 10: Mortgage growth and prime lending rate



Source: Bank of Namibia

The subdued performance in the housing market could be attributable to a combination of relatively high interest rates, and higher cost of living, coupled with high food inflation. The risk to banking stability in the housing market is, however, considered moderate under the circumstances.

3.2 BANKING INSTITUTIONS' BORROWERS

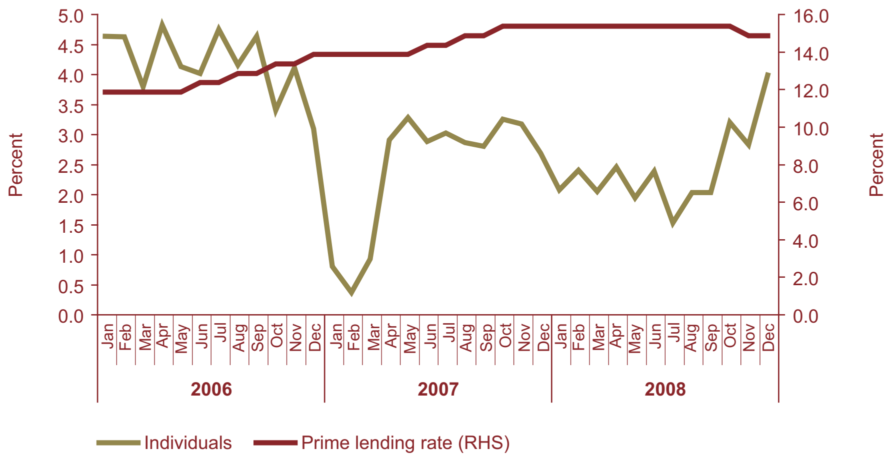
Claims on the private sector (that is, private corporations and households) amounted to N$33.3 billion or 46.8 percent of GDP at the end of 2008. The growth in total claims on the private sector by banking institutions decelerated from 13.5 percent in 2007 to 11.4 percent in 2008. The deceleration could be attributed to low disposable income (given high interest rates) and high cost of living (given high inflation). In real terms, therefore, private sector credit extension has declined, which has partially suppressed the country's economic growth prospects. Following the 100 basis points rate cut by the Bank in February 2008, banking institutions lowed their lending rate by 1 percentage point, from 14.75 percent to 13.75. The move would likely relieve the pressure on borrowers.

3.2.1 Household sector

Growth in credit to household slowed to 2.0 percent at the end of the third quarter of 2008 from an increase of 2.4 at the end of the second quarter of 2008 (Chart 11). The decline in credit to households was due to declines in credit extended to categories: *other loans and advances* and *instalment credit*. Quarter-on-quarter, the latter category fell by 2.3 percent, while the former declined by 3.4 over the third quarter of 2008. In the fourth quarter of 2008, credit to households rose by 4.0 percent from 2.0 percent in the third quarter. The rise was due to increases in credit extended to categories: "*other loans and advances*" and "*instalment credit*". Other loans and advances rose by 4.3 percent in the fourth quarter of 2008 from 3.4 percent in the third quarter of 2008. During the same period, "Instalment credit" to the household sector increased by 2.7 percent after declining by 2.3 percent. On an annual basis, credit to households rose by an average of 2.6 percent in the second half of 2008 compared with an average increase of 2.2 percent in the first half of 2008.

The ratio of credit extended to households as a percentage of GDP has risen from 29.2 percent in June 2008 to 31.0 percent in December 2008. The debt-to-GDP ratio for SA declined from 47.4 percent in the first quarter of 2008 to 46.8 percent in the second quarter of 2008. Household indebtedness to the banking sector has risen marginally in the second half of 2008. Consequently, household incomes could come under pressure if unemployment increase or economic conditions worsen. This, in turn, could result in an increase in banking losses and strain financial stability.

Chart 11: Claims on individuals

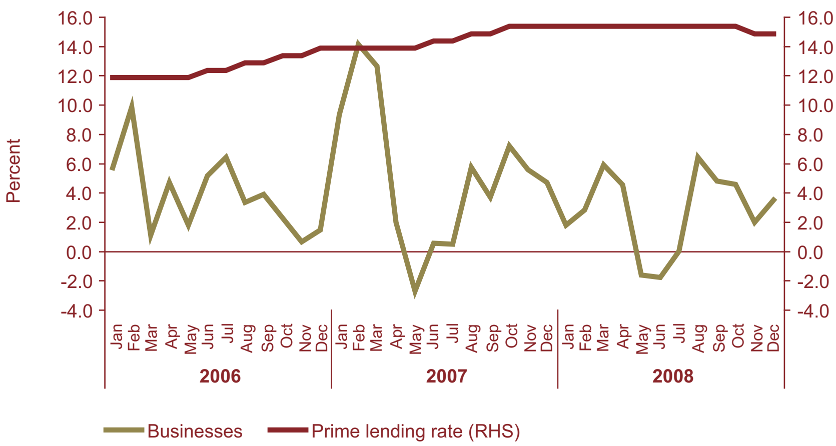


Source: Bank of Namibia

3.2.2 Corporate sector

Credit extended to the corporate sector increased by 4.7 percent, on a quarterly basis, in the third quarter of 2008 after declining by 1.9 percent in the second quarter (Chart 12). In the fourth quarter of 2008, credit to the business sector rose by 3.4 percent, on a quarterly basis. The moderation in growth in loans to the business sector was mainly a result of the decline in *other loans and advances* that fell by 5.6 percent in the fourth quarter.

Chart 12: Claims on businesses



Source: Bank of Namibia

On an annual basis, growth in credit to the business sector was constant, at 12.4 percent in both the first half and second half of 2008.

The indebtedness of the corporate sector to the other depository corporations, as measured by corporate debt to GDP, rose from 14.7 percent in June 2008 to 15.9 percent in December 2008. The corporate sector's profitability and the strength of corporate balance sheet have important implications for financial stability. The mining and tourism sectors are important components of the corporate sector. The two sectors are adversely affected by the impact of the global economic slowdown in the second half of 2008, resulting in deteriorating corporate profits and lost jobs. A worsening of the current conditions could put some pressure on the banking sector, and, hence for financial stability.

3.3 OVERALL ASSESSMENT

The appreciable fall in commodity prices has led to a decline in global inflation in the second half of 2008. This decline resulted in a marginal reduction in the overall inflation in Namibia in the fourth quarter of 2008. The transport component was the main contributor to the moderation in the overall inflation. Declining inflation might carry positive implications for the economy, in terms of, lower interest rates, faster growth, and better corporate profitability and enhanced credit affordability.

The overall index of the NSX was again negatively affected by the turmoil in the global financial markets in the second half of 2008, with the most impact coming through the JSE. However, the impact on the local component of the NSX continued to be modest during the period. Furthermore, the impact of the decline in the NSX on the banking institutions remained limited as these institutions do not invest in equities.

The impact of the global economic slowdown on the Namibian economy, in the second half of 2008, was felt mostly by the mining and tourism sectors. This has resulted in job losses, leading to a fall in credit demand and consumption by households. At the same time, reduced corporate earnings could have diminished the ability corporate to service debts. The current capacity of both corporate and household borrowers to repay their debt obligations appears reasonably strong. But, as the impact of the deepening global economic slowdown intensifies on the real economy, the banking borrowers' debt repayment capacity may be curtailed. However, these adverse impacts could be mitigated by the recent cut in interest rates.

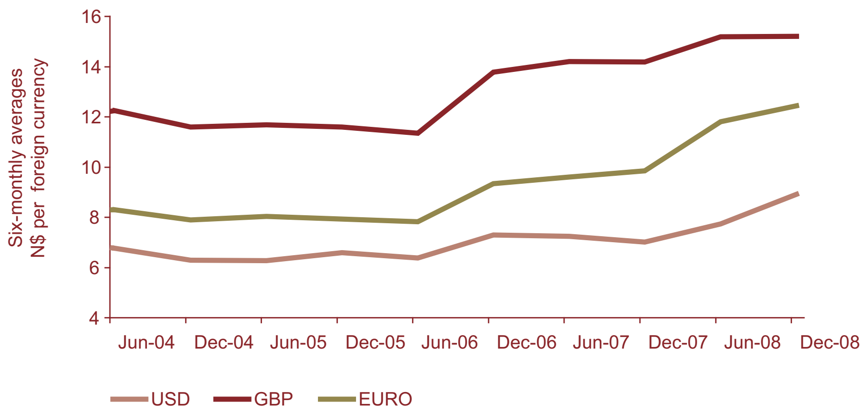
3.4 MONETARY AND FINANCIAL SECTOR

3.4.1 Exchange rate

Given the one-to-one peg between the Namibia Dollar (NAD) and the South African Rand (ZAR), the NAD followed the ZAR[1] movements against major currencies. The local currency depreciated against the US dollar in the third quarter of 2008. Conversely, the NAD appreciated against both the Euro and the Pound Sterling during the same period. The significant weakness against the dollar emanated from sharp declines in gold and platinum prices. The NAD further depreciated against the US currency following a slump in the South African house prices, unrest in that country's labour market, and after a decrease in demand for higher-yielding, emerging market assets.

Consequently, the NAD exchanged at quarterly averages of N$7.7814, N$14.7023 and N$11.6922 against the USD, Pound and Euro, respectively, in the third quarter of 2008 (Chart 13). This brought the quarterly loss against the USD to 0.04 percent, and the gain against the Pound and Euro to 4.0 and 3.8 percent, respectively. Year-on-year, the NAD depreciated by 9.4, 2.4 and 19.7 percent against the US Dollar, Pound sterling and Euro, respectively, in the third quarter of 2008.

Chart 13: Namibia dollar per foreign currency



Source: South African Reserve Bank

[1] The Namibia Dollar trades one to one against 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.

In the fourth quarter of 2008, the NAD, tracking the ZAR, depreciated the Dollar, Pound and Euro. The ZAR weakness was mainly attributable to the worsening international crisis that led to large-scale withdrawal of capital from emerging markets (rising risk aversion), including South Africa. Consequently, the Rand has depreciated by about 30 percent against the USD during the period. Furthermore, the burgeoning South African current account deficit, due to falling export mineral prices (on the one hand) and higher oil and fuel imports (on the other), has also impacted the Rand negatively.

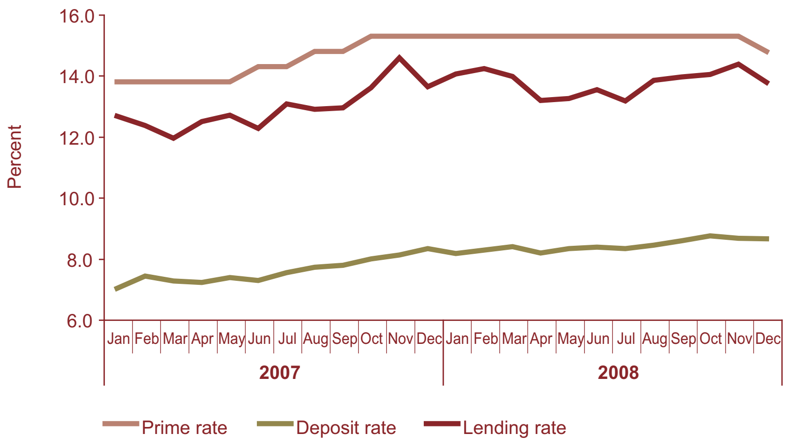
Accordingly, the local currency traded at quarterly average of N$8.46, N$15.10 and N$11.82 against the USD, Pound and Euro, respectively, during the fourth quarter of 2008. This brought the depreciation of 8.71 percent against the USD; 2.71 percent against the Pound; and 2.40 against the Euro. On annual basis, the NAD depreciated by 25.0, 9.1 and 22.1 percent against the USD, Pound and Euro, respectively, in the fourth quarter of 2008.

The NAD depreciation may decelerate the fall in inflation, which will have implications for financial stability, going forward.

3.4.2 Interest rates

The Bank of Namibia (the Bank) cut its Repo rate from 10.50 percent, since October 2007, to 10.00 percent in December 2008 (Chart 14). Consequently, commercial banks adjusted their rates downward. In December, the average lending rate declined by 58 basis points to 13.75 percent from 14.32 in November 2008. At the same time, the average deposit rate fell slightly by 2 basis points to 8.60 from 8.62 percent in November 2008.

Chart 14: Interest and inflation rates



Source: Bank of Namibia

The Bank further cut its Repo rate on February 18, 2009 by 100 basis points to 9 percent. Lower interest rates will relieve debt repayment pressures on household and corporate borrowers by reducing their interest repayment.

3.4.3 Reserve adequacy

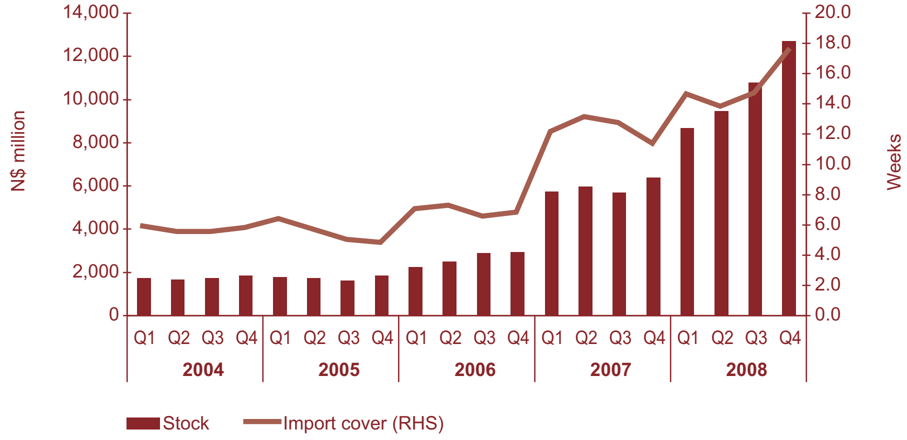
Foreign-exchange reserves act as cushion against foreign-currency liquidity shortages that might result when access to foreign borrowing and credit lines is limited or withdrawn.

The total foreign exchange reserves level increased markedly from N$ 9.4 billion at the end of June 2008 to N$12.7 billion as at the end of December 2008. The increase in reserves during the second half of 2008 could mainly be attributed to the following factors: SACU revenues; interest income received; ZAR notes repatriated to South Africa; net purchases of foreign currencies; and net realized gains. The N$542 million currency revaluation that resulted from the NAD weakness against the major currencies (such as USD and EUR) was another major contributor to the record increase in reserves in 2008.

Foreign exchange reserves play an important role as an indicator of an economy's liquidity position. Sufficient reserves are, therefore, critical to a country's ability to discharge its external obligations and withstand external shocks. The import cover is a measure that is widely used to determine this ability. The measure indicates how long a country would continue importing goods and services if all other inflows of foreign exchange reserves dried up.

As measured in weeks of import cover, Namibia's total foreign exchange reserves increased from 14 weeks of import cover in June 2008 to a forecast 17 weeks of import cover at the end of December 2008 (Chart 15). This means that it will take Namibia 17 weeks of continued importing goods and services without running short of reserves if all foreign exchange earnings dry up. Furthermore, the country's import cover is well above international import-cover target of 12 weeks of imports.

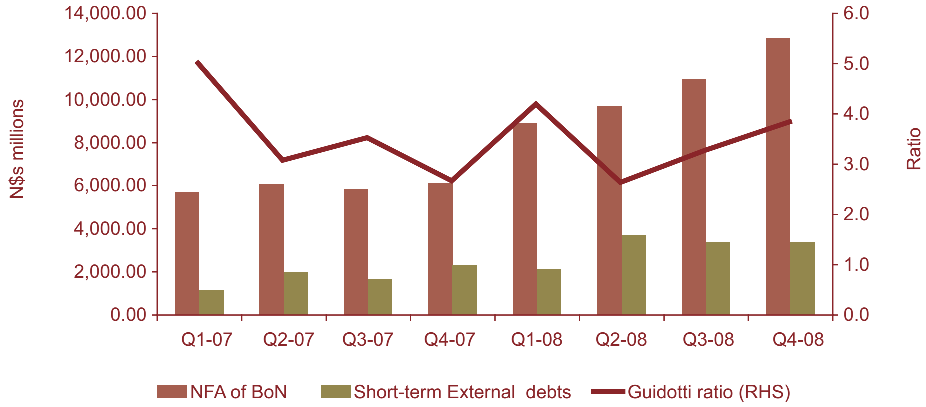
Chart 15: Quarterly international reserve stock and import cover



Source: Bank of Namibia

The Guidotti ratio (the ratio of official reserves to short-term external debt falling due within 12 months) is another measure widely used to determine the economy's foreign currency liquidity risk and, therefore, the vulnerability to external shocks. Chart 16 shows Namibia's Guidotti ratio between June 2007 and December 2008. As a rule of thumb, a country should hold reserves such that its resulting Guidotti ratios are greater than unit (one). The chart shows that the country's ratio rose in the second half of the year from 2.6 in June 2008 to 3.8 in December 2008. The value 3.6 means that the country's reserves were adequate to cover 380 percent (or 3.8 times) of its short-term liabilities if foreign borrowing became inaccessible. A similar ratio for South Africa was 1.18 and 1.14 at the end of the first and second quarter of 2008, respectively.

Chart 16: Guidotti ratio



Source: Bank of Namibia

The Namibian foreign reserve adequacy, as based on the above indicators, has significantly improved over the two past years. The foreign exchange reserve accumulation would mitigate the impact of a foreign exchange liquidity crisis. The improvement in the ratio should, therefore, serve as a positive development for financial stability.

3.5 OVERALL ASSESSMENT

The NAD continued to depreciate against the US dollar, pound and euro in the second half of 2008. The currency weakness emanated from uncertainty in the global financial markets (due to worsening financial and economic crises and leading to risk aversion against emerging market currencies); falling key export commodity prices; and widening current account balance in South Africa. The real depreciation of the NAD would slow the fall in inflation. Relatively high inflation could erode consumer income and diminish their capacity for debt repayment. This could destroy the financial soundness of the banking sector and, hence, the safety of financial stability.

The improvement in the overall position of Namibia's international reserves continued in the second half of 2008. As a result, the financial health and stability of the country has improved. Most of the increase in reserves came from SACU revenues, rendering the country vulnerable to fluctuations in SACU revenue. However, at the moment, reserves are at the level that does not cause a concern for financial stability.

3.6 BANKING SECTOR PERFORMANCE

3.6.1 Banking structure

The banking structure in Namibia continued to be highly concentrated as indicated by the presence of a few number of banks (4) and by high levels of concentration indices, (e.g., the Gini index and the HHI). The Gini index is generally utilized to estimate the degree of in-equality overtime, indicating how equally a variable is distributed among participants. In this case, the variable is market share, in terms of assets, and participants are all four banks in the banking sector. If every bank has the same asset share, a Gini Index of zero would result. However, if only one bank owns all the assets and no other bank has any, there is perfect concentration, inequality, and the Gini index is 100. The Gini index for Namibian banks declined slightly from 12.2 in June 2008 to 11.3 in December 2008 (Table 1). This might be interpreted to mean that, in terms of asset market share, Namibian banks have become more equal during the review period. The calculation also shows that the two smaller banks have gained market share during the period from (12.3 and 26.1 percent to 13.2 and 28.0 percent, respectively). High levels of concentration might limit competition and lead to costly banking services.

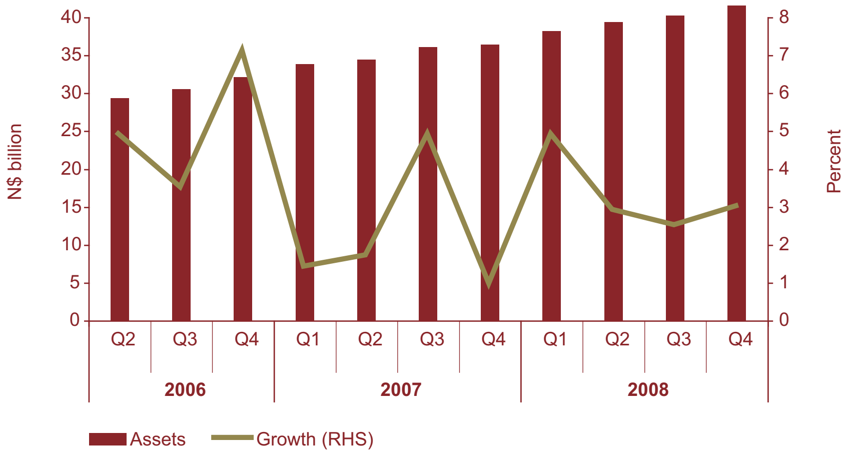
Table 1: Banking sector indicators

	Amount in N$'000					
Structure	**Jun-06**	**Dec-06**	**Jun-07**	**Dec-07**	**Jun-08**	**Dec-08**
Number of banks	4	4	4	4	4	4
Total assets of banks	30,130,094	33,397,304	34,448,220	36,504,795	39,443,450	41,562,708
Gini concentration index	13.2	14.1	12.5	11.6	12.2	11.3
Herfindahl index	2,712	2,730	2,769	2,678	2,705	2,689
Capital adequacy (%)						
Tier 1 leverage ratio	8.2	7.5	7.4	7.9	7.9	7.9
Tier 1 capital ratio	11.8	11.2	10.9	11.8	11.9	11.8
Total RBC (regulatory capital RWA's)	14.8	14.2	14.9	15.8	15.8	15.5
Asset quality (%)						
NPL's/Total gross loans	2.9	2.6	3.0	2.9	3.2	2.7
Gross overdue/Total loans and advances	3.7	3.3	3.8	3.8	3.9	5.2
Provisions/ Total loans	2.2	2.4	2.3	2.1	2.1	2.0
Provisions/NPL's	65.7	90.3	78.9	77.2	69.3	77.4
Specific provision/NPLs	28.4	45.6	41.8	37.0	31.8	33.4
Earnings and profitability (%)						
Return on assets	2.0	1.0	2.1	2.4	1.9	2.8
Return on equity	20.3	10.9	24.0	26.6	20.0	29.0
Interest margin to gross income	4.8	5.4	5.0	5.7	5.0	5.0
Cost to income ratio	56.3	63.7	57.5	56.9	59.2	51.9
Liquidity (%)						
Liquid asset to total assets	9.5	9.1	9.8	9.2	9.3	9.3
Total loans/Total deposits	93.7	92.8	98.4	95.9	91.6	92.3

3.6.2 Assets and lending

The balance sheet of the banking sector has grown by 13.9 percent, on an annual basis, in 2008 compared with 9.3 percent in 2007 (Chart 17). This is not an alarming rate, and, therefore, calls for only a minimum monitoring.

Chart 17: Banking sector assets and growth rates



Source: Bank of Namibia

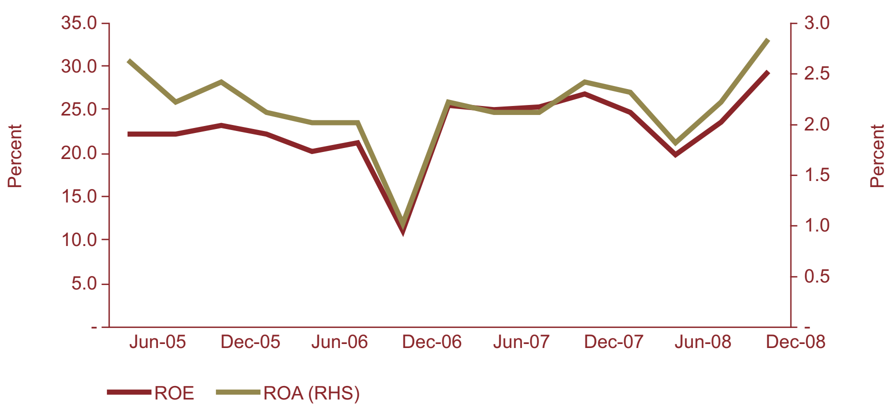
3.6.3 Profitability and capitalisation

Profitability

In the third quarter of 2008, a rise in interest income and other income, aided by a decline in operating expenses, led to an improvement in earnings of the banking sector. Operating expenses declined by 5.9 percent, during the period, and supported improvements in the cost-to-income ratio and in post-tax income (25.7 percent). However, interest expenses rose further by 4.8 percent in the third quarter, adversely affecting net interest income.

Following a 25.7 percent increase in post-tax income, the return on assets (ROA) and return on equity (ROE) rose to 2.2 and 23.4 percent in September 2008 from 1.9 and 20.0 percent in June 2008, respectively (Chart 18). Further, all banking institutions, with the exception of one, recorded an improvement in profitability in the fourth quarter. The increase in total income coupled with the significant decline in provision charges caused the after-tax profits to increase by 30.9 percent at the end of December 2008. Consequently, return on assets (ROA) and return on equity (ROE) both increased to 2.8 percent and 29.0 percent, respectively.

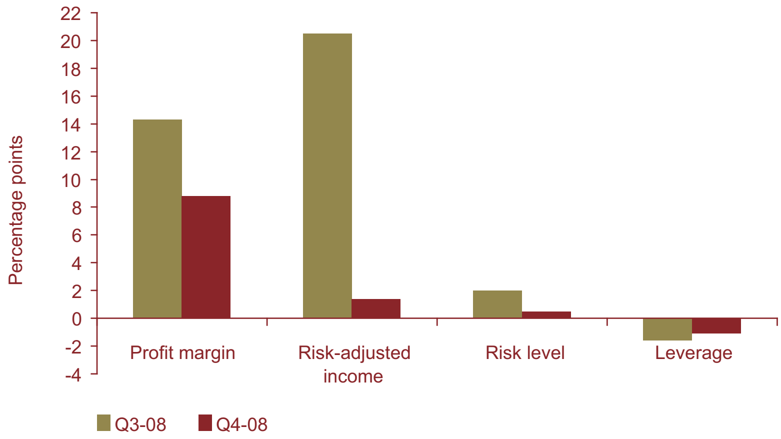
Chart 18: Post-tax return on assets an return on equity



Source: Bank of Namibia

A decomposition of pre-tax ROE provides insight into the factors that contributed to improvements in after-tax ROE in the second half of 2008. The increase in ROE mainly came from increased profit margin (between income and costs) and from improved efficiency (on risk-adjusted basis). The profit margin rose by 14.3 and 8.8 percentage points in the third and fourth quarter, respectively (Chart 19). Improved profitability in the second half of 2008 was also aided by (financial) leverage (a measure of gearing), but hurt by (credit) risk appetite. Financial leverage declined by 1.6 and 1.1 percentage points in the third and fourth quarter, respectively. The risk propensity, on the other hand, rose by 2.0 and 0.5 percentage points over the same periods.

Chart 19: Composition of pre-tax ROE



Source: Bank of Namibia

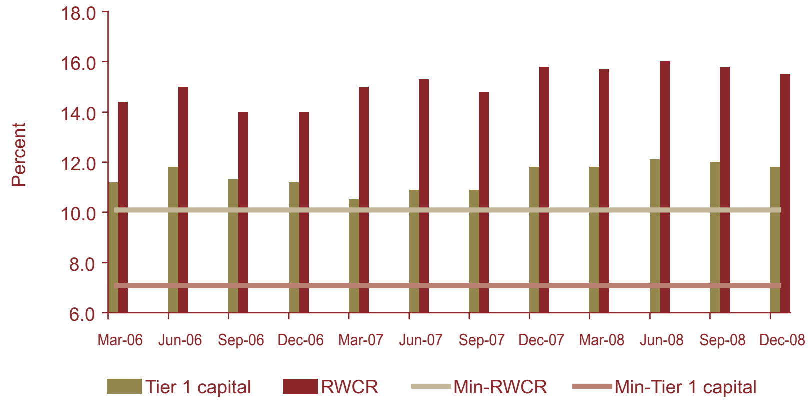
The increased ROE reflected improvements in financial uncertainty (greater difference between income and costs), more income relative to risk-weighted assets (that is better efficiency), and decreased vulnerability due to lower leverage, all of which indicates a gain in financial strength and bodes well for financial stability. The banking industry has, however, been subject to high risk exposure (due to increased risk-taking). A rise in risk-taking could be assumed to lessen financial strength in that, for example, it might mean that the banking institutions have built up assets by lending capital for projects that are more risky. The mitigating factor in this case is the fact that risk-taking has only risen marginally, by 2 percentage points in the third quarter and by half a percentage point in the fourth quarter.

Capitalisation

In terms of the capital minima prescribed by the Bank of Namibia, through the Banking Institution Determination 5 (BID-5), banking institutions should hold a regulatory risk-weighted capital ratio (RWCR) of at least 10 percent, of which 7.0 percent should by tier 1 capital. In addition, banking institutions should hold a tier 1 capital leverage ratio of 6.0 percent.

At the end of the third quarter of 2008, the RWCR and the tier 1 capital ratio averaged 15.8 and 12.0 percent, respectively (Chart 20). Both the RWCR and the tier 1 capital of the industry fell from 16.0 and 12.1 percent, respectively, in the second quarter.

Chart 20: Capital adequacy for banking institutions



Source: Bank of Namibia

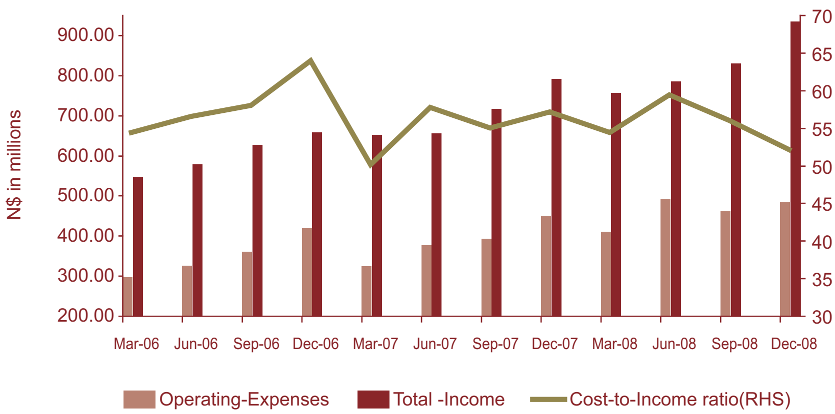
In the fourth quarter, the tier 1 risk-weighted capital and total risk-weighted capital ratios continued to decline from 12.0 percent and 15.8 percent to 11.8 percent and 15.5 percent, respectively. The declining trend in the capital adequacy ratios could be ascribed to the steady relative growth in assets of the banking industry. During the quarter, total qualifying capital grew by 2.1 percent; with the increase attributable to a growth in general reserves that grew by 9.0 percent, as well as general provisions, which grew by 3.5 percent. The increase in general reserves mainly resulted from the transfer of year-end profits.

The overall capital adequacy of the industry weakened in the second half of 2008 as reflected in declining trends in the capital adequacy ratios. However, all banking institutions complied with the prudential requirements with all the actual ratios (RWCR and tier 1) well above the regulatory minima. The banking industry, thus, remained adequately capitalised and well positioned to cushion against unexpected losses and to expand business operations (to fund their activities).

Cost efficiency

Given an increase in income and decline in costs, the cost efficiency of the banks improved in the third quarter of 2008, compared with the preceding period. The cost-to-income (C/I) ratio, which measures the cost efficiency of the banking industry, fell from 62.6 percent in the second quarter to 55.8 percent in the third quarter (Chart 21).

Chart 21: Banking costs, income and cost-to-income ratio



Source: Bank of Namibia

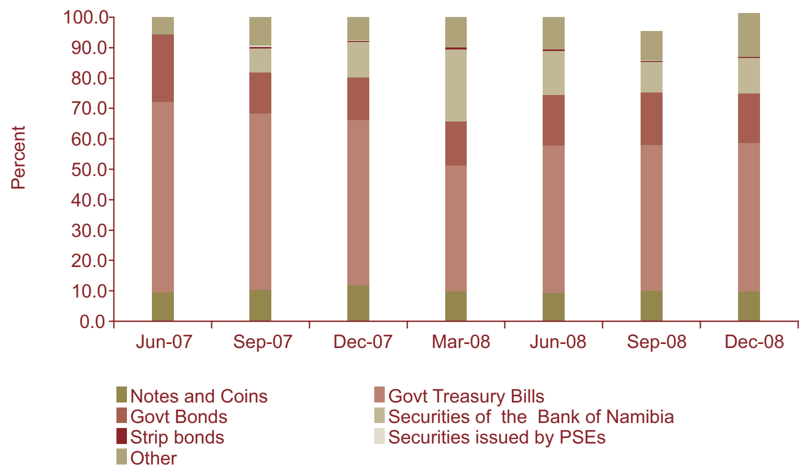
The cost-to-income ratio[2] continued to improve during the fourth quarter, declining from 55.8 percent in the third quarter to 51.9 percent. The improvement in the ratio resulted from the increase in total income by 12.6 percent (operating income rose by 16.8 percent) that outpaced the 4.8 percent increase in operating costs during the period. The increased in operating expenses mainly resulted from a 7.3 percent increase in staff cost and a 13.6 percent rise in administration and other overheads. However, despite improvements, the C/I ratio exceeded the international benchmark of 50 percent or less.

3.6.4 Liquidity

Liquidity is the ability of the banking institution to fund increases in assets and meet financial obligations as they fall due at acceptable costs and is crucial for the existence of any banking institution. The management of liquidity is, therefore, one of the most important requirements of banking institutions due to the fact that a liquidity shortfall at one banking institution can easily have a systemic effect.

The banking sector's liquid asset holdings improved in the second half of 2008, from N$3.7 billion at the end of June 2008 to N$4.2 billion at the end of December 2008. However, the composition of liquid assets held by the banking industry remained largely unchanged during the period (Chart 22). Government securities make up the highest share of liquid asset held by the banking industry, at a combined 65 percent. At the end of the second half of 2008, the share of Government Treasury Bills in total liquid assets rose slightly to 48.8 percent from 48.5 percent at the end of the first half of 2008. Government Bonds, which constituted the second largest share, edged down from 16.5 percent to 16.3 percent, over the same period.

Chart 22: Structure of liquid assets

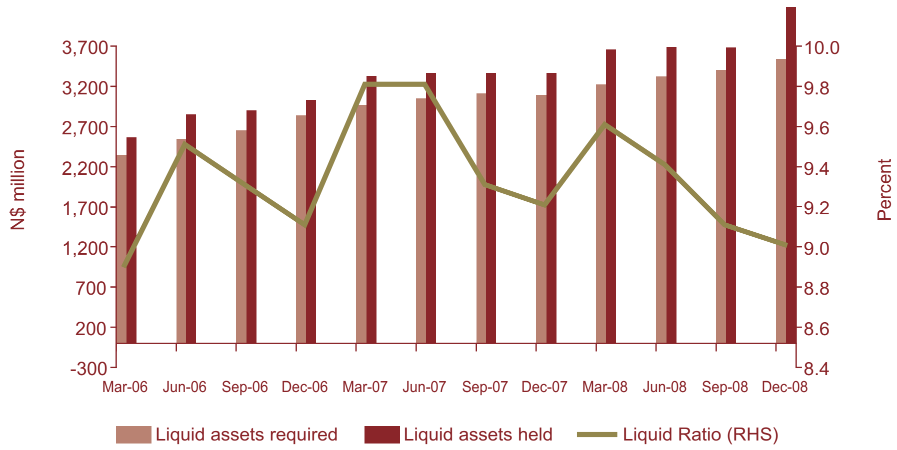


Source: Bank of Namibia

The banking industry as a whole complied with the minimum liquid assets requirement in the second half of 2008. The liquid assets holdings by banking institutions continued to be in excess of the required during the period. Total industry liquid assets holding remained static at N$3.7 billion at 30 September 2008 compared to the two previous quarters. At the same time, liquid assets required stood at N$3.3 billion. In the fourth quarter, industry liquid asset holdings rose from N$3.7 billion at the end of 30 September 2008 to N$4.2 billion at the end of December 2008.

[2] 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 23: Liquid assets and liquidity ratio



Source: Bank of Namibia

Industry liquid assets required, on the other hand, increased from N$3.4 billion in September to N$3.5 billion in September. At these levels, the holdings of liquid assets by the banking institutions were, therefore, not a cause for concern. The liquid assets ratio[3], however, declined from 9.3 percent at the end of June 2008 to 9.0 percent at the end of December 2008 (Chart 23). What was a cause for concern was the fact that the ratio had fallen for the third consecutive quarter in 2008.

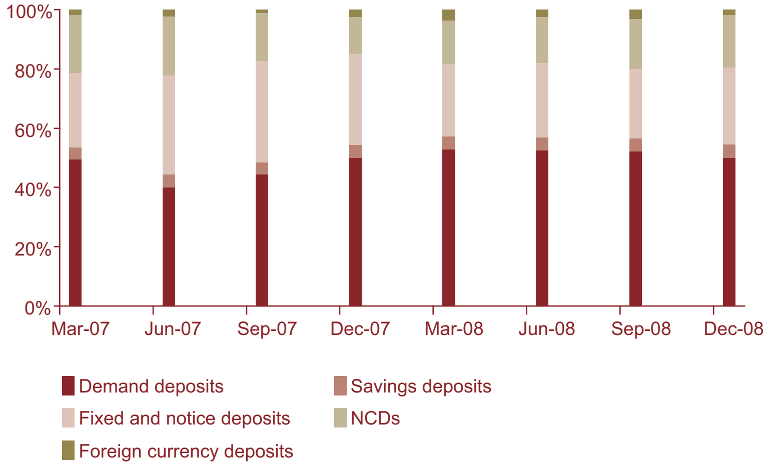
The composition of customer deposits also has a critical bearing on the liquidity risk facing banking institutions. Since June 2008, there has been a shift from demand deposits and foreign currency deposits to fixed and notice deposits and NCDs. The share of savings deposits has also edged up slightly. Reflecting these changes, the share of fixed and notice (time) deposits, which are more stable than demand deposits, has risen from 25.3 percent in June 2008 to 26 percent in December 2008 (Chart 24). Over the same period, the share of NCDs rose from 15.2 percent to 17.6 percent. The share of foreign currency deposits fell from 2.6 percent to 1.8 percent.

Over the longer-term, however, the structure of funding-related liabilities has influence by the degree of liquidity in the banking sector. Customer deposits are normally less costly and less variable than other sources of funding. Their share of total funding-related liabilities continues to be stable, although slightly down from 94 percent in June to 92 percent in December 2008. The decline in the ratio indicates that the banking institutions continued to be funded predominately by core deposits. Thus, customer deposits, which are regarded as stable and cheaper source of funding, account for the largest share of Namibian banking institutions'funding liabilities.

On the funding side, there was a notable switch from intra-group and inter-bank (bank-funding) to non-bank funding[4], as bank-funding decreased by 29.1, and 4.2 percent in the third and fourth quarter of 2008, respectively. On the other hand, Non-bank funding increased by 2.8 percent in the fourth quarter of 2008. The latter increase, which was mainly due to an increase in savings and negotiable certificate of deposits, could indicate that banks rely more on cheaper funding from the public than on potentially variable and risky bank funding.

[3] Liquid assets ratio means total liquid assets held expressed as a percentage of total assets.
[4] Non-bank funding refers to all deposits and borrowings from the public. This excludes intra-group funding since most parent companies are banking institutions.

Chart 24: Composition of customer deposits



Source: Bank of Namibia

Also critical for banking liquidity is the extent to which customer deposits are used to fund illiquid assets/ loans. The banking system in Namibia has continued to run a positive "customer funding gap", where customer deposits exceed customer loans. The ratio of customer loans to deposits averaged 92.2 percent in second half of 2008. The ratio, however, remained below the 100 percent threshold, above which funding might be sought by increasing short-term inter-bank deposit, issuing long-term securities, or by accessing financing outside the domestic market. A ratio of below 100 percent, therefore, underlines the ability of the banking sector to fund loans with core deposits and, hence, the limited exposure to the volatility of the international financial markets.

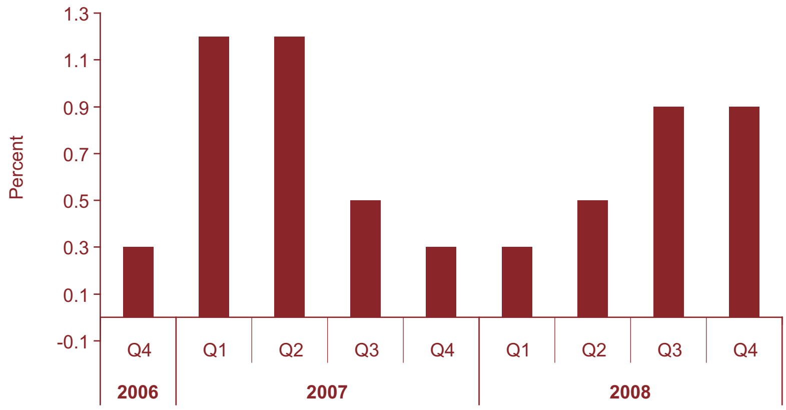
The loan-to-total assets ratio rose from 74.2 percent in June 2008 to 75.2 percent in December 2008. The rise in this ratio might have negative implications for the banking sector given that loans are less liquid. However, the ratio is only a fraction above the international benchmark of 75.0 percent and stable.

Given the minimal dependence on external funding and the loan-to-deposit ratio of 92 percent, liquidity risk in the banking system remains within manageable limits, although some key liquidity indicators have deteriorated in last six months of 2008. Consequently, the banking sector's vulnerability of liquidity risk and, hence, financial stability is nominal.

3.6.5 Exchange rate risk

The net open position in foreign currency as proportion of the banking institutions' tier 1 capital funds rose from 0.5 percent in the second quarter of 2008 to a constant 0.9 percent in the third and fourth quarters of 2008 (Chart 25). The ratio rose because the net open position increased more than the capital funds: 90.6 percent against 1.2 percent in the third quarter and 4.7 percent against 2.3 percent in the fourth quarter. The increase in the ratio meant that the exchange rate risk of the banking sector has risen, although it remained below the regulatory limit of 20 percent of capital funds.

Chart 25: Net open position

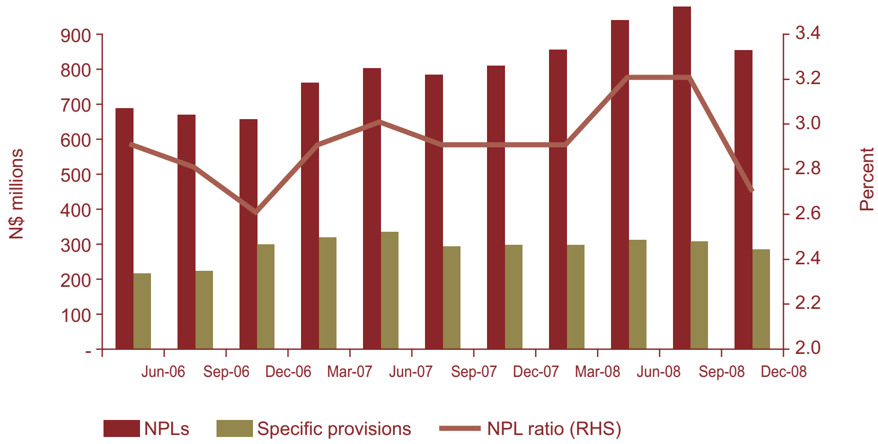


Source: Bank of Namibia

3.6.6 Credit risk

The banking sector's asset quality improved during the fourth quarter of 2008. The NPL ratio, after deteriorating to 3.2 percent in the third quarter, improved to 2.7 percent in December (Chart 26). Growth in loans and advances during the year outpaced the growth in NPLs, resulting in the decrease in the NPL ratio (the ratio of NPLs as a percentage of the loan book) from 2.8 percent in 2007 to 2.7 percent in 2008. The ratio is still considered to be within the acceptable range[5]. In the third quarter, the *mortgage category* led the increase in NPLs, followed by the *overdraft* and *other loans category*. Conversely, the decline in the ratio in the fourth quarter was brought about by decreases in the level of defaults in mortgages and other loans and advances, falling by 11.2 and 81.9 percent, respectively, during the period.

Chart 26: Banking asset quality

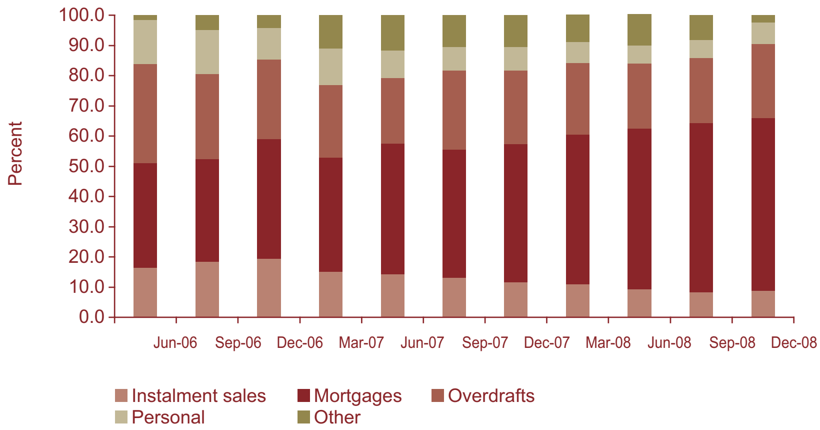


Source: Bank of Namibia

Overdue loans increased significantly by 51.3 percent to N$1.7 billion at the end of December 2008, while non-performing loans increased by 5.5 percent to N$854.7 million. The NPLs constituted 50.7 percent of overdue loans as at December 2008 compared to 72.6 percent in 2007. At December 2008, mortgages took the largest share of NPLs (57.1 percent), followed by overdrafts (24.6 percent), instalment sales (8.7 percent), personal loans (7.2 percent) and other loans and advances (1.7 percent) (Chart 27).

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

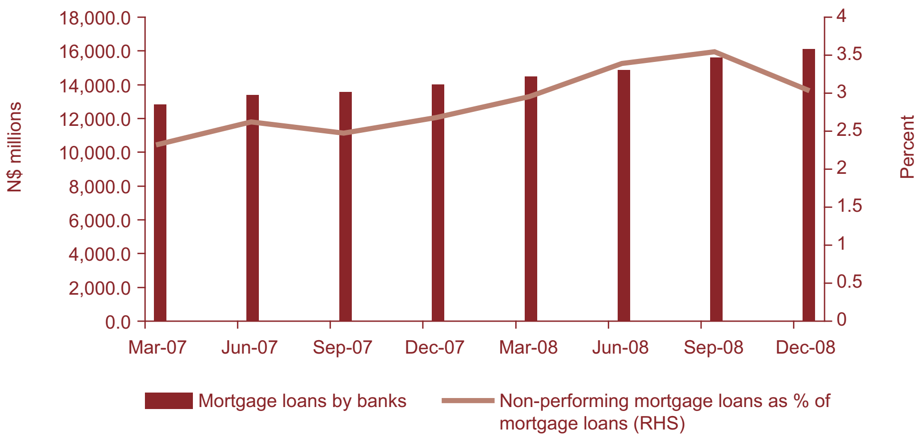
Chart 27: Non-performing loans by category



Source: Bank of Namibia

The proportion of non-performing mortgage loans out of total mortgage loans extended by banking institutions has declined from 3.4 percent in June to 3.0 percent in December 2008 (Chart 28). The proportion of overdue loans in total loans, which rose from 3.9 percent in second quarter to 5.9 percent in the third quarter, however, fell to 5.2 percent in the fourth quarter.

Chart 28: Non-performing mortgage loans



Source: Bank of Namibia

In the fourth quarter of 2008, large exposures accounted for 18.2 percent of the total loan portfolio of banking institutions, compared with 17.6 percent in the third quarter. As a proportion of banking industry capital funds, large exposures stood at 129.5 percent compared with 131.2 percent in the third quarter. The Determinations on Single Borrower Limit (BID 4) set an 800 percent statutory-limit.

During the fourth quarter, the banking sector's large exposure (exposures that are at least 30 percent industry qualifying capital) to the mining and related sectors increased by 15.4 percent (from N$1.3 billion to N$1.5 billion). Consequently, large exposure to the mining and related sectors as a proportion of the banking industry capital rose from 30.2 percent in third quarter of 2008 to 34.1 percent in the fourth quarter of 2008. However, the exposure of the banking sector to the crisis-affected mining and related sectors is about N$1.1 billion or about 25 percent of banking industry capital. The likely impact of this exposure on banking stability is, therefore, moderate.

3.7 OVERALL ASSESSMENT

Namibia's banking institutions have very limited exposure to financial markets afflicted by the fallout from the global financial crisis. Hence, the overall impact of the deepening financial crisis on the local banking sector has been modest in the second half of 2008. In addition, the banking institutions sustained a favourable environment operating and their financial position remained strong. Furthermore, the banking institutions continued to be well-capitalised and solvent, even though capital ratios have been declining. In addition, liquidity remained at manageable levels, although some key indicators have deteriorated in second half of 2008.

The ROE has improved markedly in the second half of 2008, following a rise in banking profit. Furthermore, the cost-to-income ratio improved after a fall in expenses. In addition, non-performing loans have declined appreciably during the period.

By and large, the banking sector performance has been satisfactory in the second half of 2008. The level of profitability, liquidity and capitalisation attained will allow the banking sector to withstand shocks. The overall assessment of the sector, therefore, is that the banking sector continues to operate in a stable environment. This assessment is largely in line with the conclusion of the previous FSR. However, there are notable challenges: with declining capital ratios and pressures on liquidity, as well as pressures on NPLs emanating from rising overdue loans. These issues warrant close monitoring, going forward. These challenges notwithstanding, the impact on banking stability is assessed to be moderate at this stage.

Box A: Liquidity Management in Namibian banking institutions

Introduction

Liquidity risk is a natural part of banking institutions' activities, that is, obtaining short-term funding and providing long-term loans. Liquidity risk is the risk of a banking institution not having access to sufficient liquid assets to fund its operations. There are, however, different factors affecting the availability and management of liquidity in banking institutions. This article is intended to describe how Namibian banking institutions manage their liquidity and the factors affecting that management. It is based on responses by all four banking institutions to a questionnaire that was conducted between December 2008 and February 2009. The main areas covered are: internal liquidity management processes; and risks connected with liquidity management. Special emphasis will be on: confidence problems; liquidity risks in the market; operational risks in infrastructure; and operational risks in practical liquidity management.

All four banking institutions have internal guidelines (policies) and structures for day-to-day management of liquidity. However, the final responsibility for the management of liquidity risk rests with the Board of Directors. They also have fairly similar methods for liquidity management, although there are some substantive differences. The differences between the methods are based on different focuses of their operations that lead to diverse demands. The latter, in turn, call for specific measures and methods to effectively manage liquidity. There are also differences in the level of sophistication of the banking institutions' liquidity management.

Liquidity risk management

The initial stage in liquidity management calls for the assessment of the amount or size of incoming and outgoing payment/cash flows, for all four banking institutions. Any deficits in the flows are funded at the lowest possible cost, while surpluses must be invested at the best return.

The main sources of short-term liquidity (funding) for the four banking institutions are: top corporate; non-banking financial institutions; pension funds; and retail depositors. Intra-day liquidity is mostly obtained from Bank of Namibia through repo transaction, and surplus liquid assets. Inter-company/banking sources are also utilised at times by the banking institutions with parent companies. The local inter-bank market does not appear to be widely sourced. All four banking institutions cited the decline or shortage of liquidity in the market as the common cause of liquidity shortages in their institutions. Two banking institutions mentioned a break-down in the payment system (for example, flow of funds could be curtailed) as an additional cause of liquidity shortage they experienced in the past. One banking institution noted that other causes of liquidity shortages include: interest rate differential between Namibian and South African markets (causing an outflow of funds from

Namibia to South Africa), and unexpected changes in investor's immediate and future liquidity needs.

The major challenges in managing and assessing liquidity risk faced by banking institutions include:

* the presence of too few large investors (who are very volatile and inconsistent); limited expertise and too little knowledge of the workings of the money and capital markets;
* unpredictability of cash flows;
* insufficient forecast of cash inflows and outflows based on TBs and Government Bonds issuance;
* high interest rate differentials in the Common Monetary Area; investment in short-term instruments; communications systems offline;
* lack of access to additional source of liquidity;
* lack of "big brother" (parent company); and
* reluctance to fund Emerging Market institutions by offshore banking institutions.

The requirement of collateral has a negative impact on the banking institutions' funding liquidity because of the prudential provisions made for daily usage. For one banking institution, it entails uncertainty by in-trading (re-purchase from BON) assets held as collateral. While one banking institution sees the usage of collateral as a facilitator of liquidity management, others are indifferent.

All four banking institutions have liquidity contingency plans. However, they see the following areas in liquidity management process with scope for improvements: cash flow generation for complex financial instruments (including trading books); cash flow generation for off-balance sheet items and other contingency items; better planned action when communication systems are offline; increase in client base; increased information from investors to banking institutions; daily contact with large liability holders; and BON assistance, for example, advice on when systems would be offline and accounting for collateral in timely manner to reduce risk of insufficient liquidity requirement in the financial system.

Some banking institutions consider depositor concentration risk and have limits for single and top 10 clients' exposure limits, and limits set for overnight/call deposits. One banking institution also targets new depositors to limit concentration risk.

Almost all banking institutions conduct liquidity stress/scenario analyses. In most cases, these analyses capture/involve/measure the following: short-term cash flow analysis; funds at risk within 31 days; percentage of deposits that could be exposed in the event of flight risk; assets that could be realized immediately in the event of flight risk; impact of complex financial instruments; stresses from off-balance sheet vehicles; market-wide stresses (e.g., disturbances of selected primary or secondary financial markets); and disruptions in sources of contingency liquidity (e.g., inability to liquidate assets or constraints in cross-border liquidity, i.e., freezing of FX swap market). Stress tests suggest how much contingency funding facility the institution should maintain.

The historical data and judgement modelling techniques are the most common liquidity estimation methods used among the local banking institutions. Banking institutions that responded to this specific question have liquidity limits or targets, such as: foreign currency lending; depositor's concentration; counterparty (single client exposure, to 10 exposures); maturity; geographic (regional vs. offshore); and professional market limits. At the same time, they have liquidity reserves. The size of the reserves kept relate to: funds at risk within 31 days; 10 percent of total liabilities to the public (for statutory requirements); and surplus balances.

Operational risks in practical liquidity management

There are several reasons why a banking institution may experience an unexpected need for liquidity. Regular liquidity planning is primarily aimed at the management of the liquidity requirements that can arise in the banking institution's normal operations. There is, however, uncertainty in the forecasts of large outflows as a result of problems experienced by a counterparty or large customer. To deal with sudden, unforeseen liquidity requirements, banking institutions normally utilise: surplus liquid assets, interbank market, institutional deposits, credit facilities (with parent companies), and additional liquidity (held above forecast).

There is always the risk of making systematic errors in forecasting liquidity, but these measures serve as mitigation. In order to minimise systematic errors in liquidity forecast, forecasts are updated on daily basis so that errors are not carried forward. Although systematic forecast errors are rare, when they do occur banking institutions are forced to resort to overnight utilisation, which involves a penalty rate that raises the cost of funding. Off-balance sheet items (e.g., unutilised credit commitments) are included in the liquidity forecasts of only three banking institutions.

Liquidity risk in banking institutions is identified by key liquidity early warning indicators and triggers, such as increased cost of funding unrelated to changes in market conditions, liquidity benchmarks, and monthly and daily reports [contractual Liquidity Gap Analysis report, "Business as Usual" Liquidity Gap Analysis report]. Assumptions underlying liquidity forecast are reviewed variably: daily, monthly, quarterly, yearly, or as often as necessary.

Operational risks in the infrastructure

The second potential cause of liquidity problems is the existence of operational risks in the infrastructure, for instance, the payment and information systems. These risks lie mainly outside the individual banking institution's field of influence. Disturbances in the communications between the payment or information systems could lead to an inability to execute payments or to non-transmittal of the information that a payment has been executed. If payments cannot be executed, it will not be possible to redistribute the liquidity in the system between those with liquidity surplus and those with a deficit.

Three of the banking institutions have reported experiencing operational risks in infrastructure [breakdown in data communication lines with Namclear or with SWIFT], and system downtime (with regard to telephones, Reuters, SWIFT, Namibia Inter-bank Settlement System). These disruptions, however, happened very seldom for one banking institution, and did not cause payment system break down for another (banking institution). Operational risks of this kind are minimised by: keeping manual spreadsheets to effect settlement after the system is operational again; through contingency/disaster recovery plans; duplication of hardware, software and data backup; reverting to Disaster Recovery Plan; (for system offline) communicating with other NISS participants on payments due by all parties; and by using inflows and outflows of payment communicated before NISS cut off.

Liquidity risk in the market

Turbulences on the financial markets can lead to a decline in market liquidity. However, no banking institution has yet experienced any serious market liquidity problem. Local banking institutions' dependence on international markets for liquidity is minimal or zero.

For one banking institution, the local market for liquidity is moderately efficient, while another finds it not very efficient (as other Namibian banking institutions don't have enough sufficient overnight lending limits for it). Two banking institutions do not depend on international markets for liquidity, while the other two only to an insignificant extent. For the former banking institutions, therefore, the recent global financial market turbulence had no impact. In case of the latter, the impact of recent financial market turbulence was limited to the shock felt in South Africa. One banking institution, while not dependant on international financial funding, expects a significant impact on liquidity due to the sluggish economic activities resulting from the current global financial crisis.

The reason why Namibian banking institutions were not, or are not significantly, affected by the financial market crisis was that they had relatively modest exposure towards the worst-hit markets.

Confidence problems for the banking institutions

Confidence problems (or negative information about a banking institution) can lead to a banking institution's depositors and other financiers withdraw their money or reduce their limits towards the banking institution in question. A rapid withdrawal of the banking institution's financing would naturally create very severe liquidity problems for the institution and could directly threaten the institution's survival. No banking institution has yet experienced difficulty in finding funding during certain periods due to low credit standing. However, some banking institutions have noted that any negative information will be discussed by the executive management and dealt with immediately, in terms of media response and increasing surplus liquidity until negative information/publicity has filtered through.

According to the four banking institutions, a run on a banking institution, though probable, is unlikely. None of the four banking institutions use any complex (structured finance) instruments such as credit default swaps (CDS), though one banking institution suggested that they could use them in future.

Summarising comments

All four banking institutions have fairly sufficient internal liquidity management processes and units. Shortages of liquidity are not frequent in the local banking institutions. A few banking institutions feel that BON's involvement could facilitate access to liquidity. Local banking institutions do not depend much on international markets for liquidity funding. In addition, they do not use structured instruments; although one expect to do so in future. These two conditions are mainly responsible for the insulation from the impact of the recent financial market turbulences that the local banking institutions enjoy.

3.8 FINANCIAL INFRASTRUCTURE AND REGULATORY DEVELOPMENTS

3.8.1 Financial infrastructure

All economic transactions involve some form of payment. A strong and smoothly functioning payment system that facilitates the efficient and effective allocation of financial resources, and thereby contributing to economic efficiency is, therefore, one of the key components of financial stability. Hence, a key role of the Bank of Namibia in the national payment system (NPS) is the oversight function of the system. The payment system is fundamental to the functioning of the economy. The objective of the payment system oversight, therefore, is to ensure efficiency and safety so that transactions are processed and settled timely for the benefit of the whole economy.

The Bank of Namibia has undertaken a host of oversight activities in the third quarter of 2008. To this end, the Bank reviewed performance of the payment system as well as key issues pertaining to the payment system. In this regard, the Bank conducted a self-assessment and on-site inspection at Namibia Post Limited (NPL). The findings of the assessment of the smartcard scheme showed that the scheme was well managed from a risk perspective. Consequently, the Bank authorised NPL to continue issuing smartcards to its clients. The Bank will conduct the next assessment of NPL smartcard in 2009.

The year 2008 also saw the roll-out of onsite inspection at Namclear. The objective of the inspection was to assess whether the retail clearing system operated by Namclear was operating in terms of Bank's oversight policy; provide recommendation for efficient and secured operations; and devise on an action plan to improve identified operational weaknesses.

During the last six months of 2008 the Bank of Namibia monitored operational risk within the National Payment System through its risk management reporting. The key system monitored is the Namibia Inter-bank Settlement System (NISS), which settles both retail and high value payments. In this context, operational risk is the risk that the settlement system will malfunction, thus, preventing payments from being settled and intended beneficiaries not receiving value on time.

The NISS settlement system was available most of the time during the period under review. Availability ratio of 96 percent on average was registered for the system. This means the system was not available for about 4 percent of the time. This is not far from the availability target of more than 99 percent required by the Bank of Namibia each time.

All the downtimes, both minor and major ones, were handled well. The full disaster recovery (DR) test for the NISS system carried out by Bank of Namibia, from 25th through 29th September 2008; show that the core system and the back-up environment are operationally reliable. The full DR test went well because there were significant issues identified and all the participant banks were able to transact as normal during the test. No settlement information was lost during the entire DR test.

Based on the above assessment the Bank concludes that, from a financial stability perspective, the payment system continued to operate satisfactorily and a sound basis in the second half of 2008 and that there are no systemic risks.

3.8.2 Regulatory developments

Directive on early square-off within the Namibia inter-bank settlement system

In January 2009, the Bank of Namibia has issued a directive on early square-off in the Namibia inter-bank settlement system (NISS). The purpose of the directive is to ensure that participants (Namclear and banking institutions) in the Payment Clearing House (PCH) implement the necessary system, operational and infrastructure changes and re-align their clearing, settlement arrangements and business processes in order to facilitate early square-off in NISS. In addition, the directive will contribute to the efficiency and safety of the National Payment System.

Participants in the PCH should have implemented system changes in line with the Directive by December 31, 2009.

4. OUTLOOK, RISKS AND OVERALL ASSESSMENT

4.1 GLOBAL OUTLOOK

With increased signs of a deepening economic recession, the IMF continued to revise its global economic outlook and growth rates downwards. The IMF had forecast global growth to slow from 5.0 percent in 2007 to 3.7 percent in 2008. Growth was revised further to 0.5 percent in 2009 and to slow more in advanced economies than in developing economies.

As major advanced economies fell into recession in the third quarter of 2008, uncertainty about the global economy increased. The resulting decline in demand led to falling commodity prices and dampening inflationary pressure world wide. In advanced economies, inflation was expected to fall from 3.5 percent in 2008 to a record low level of 0.3 percent in 2009. Similarly, inflation in emerging and developing economies inflation would drop from 9.5 percent to 5.8 percent.

Hence, the main challenge, going forward, has shifted from inflationary pressure to the increasing fear that declining economic growth could degenerate into a recession. The financial crisis left the outlook for commodities vulnerable and uncertain. A further collapse in the price of assets, such as stocks and houses, is the largest risk facing the world economies in 2009 and asset losses could exceed US$1.4 trillion, according to a World Economic Forum study. Although prices for assets – housing, equities and corporate bonds – have declined dramatically, there is continued scope for further losses. Furthermore, the Global Risks 2009 report said that most countries face a “grim” economic outlook, with increasing market volatily, rising unemployment and falling consumer and business confidence.

4.2 DOMESTIC OUTLOOK

As small open economy, Namibia is vulnerable to vagaries of external developments. In this regard, the impact of the global economic slowdown on the Namibian economy was mainly felt on the export sector, most notably the mining and tourism sectors. After the collapse of mineral prices in the second quarter of 2008, several major mining companies in Namibia scaled down their operations in 2008 and in the medium term. As a result, the pace of economic growth in 2008 was estimated to have slowed to about 2.7 percent after contracting by 4.1 percent in 2007.

The economy is expected to further slow in 2009 due mainly to weak performance of the primary sector and reflecting the depressed global demand. It would require appropriate fiscal and monetary policy responses to address the current adverse economic climate. At the same time, Namibia has to content with structural challenges, such as high unemployment, poverty, income inequality and the dearth of skills. The future outlook is, therefore, bleak, with the average real GDP growth for 2009 projected at about 1.0 percent.

4.3 SUMMARY ASSESSMENT

The volatility in the global financial markets intensified and spread in the second half of the year. After a failure of several major financial institutions in US and Europe, interbank lending in most developed markets was curtailed. Loss of confidence in the banking sector worsened as banking institutions began to ration credit to private and business borrowers.

In October 2008, Governments and Central Banks around the world intervened with measures to restore confidence in the financial system and to revive economic growth. However, the crisis intensified as major advanced economies fell into recession in the second half of 2008. The impact of the economic slowdown in advanced economies eventually reached emerging economies. The global economic slowdown led to a decline in global demand for commodities. The result was a fall in commodity prices and dampening inflationary pressures. The decrease in commodity prices reduced export revenues for commodity exporting emerging countries and also led to a depreciation of emerging currencies. By the third quarter of 2008, the economies of a number of emerging and developing countries, especially commodity exporters, have started to falter.

The impact of the global financial crisis on the Namibian banking sector continued to be low up to now. This insulation derives from the limited exposure of the local banking institutions to the markets afflicted by the crisis. The banking system in Namibia continued to be liquid and well capitalised. Profitability has improved in the second half of 2008, thus significantly contributing to improved banking solvency and resilience. The average ROE of the banking sector improved sizeably in last six months of 2008, after a deterioration in the first half of the year. At the time, capital adequacy ratios remained well above their regulatory requirements, despite some slight moderation due to a relatively faster growth in assets. In addition, the increase in overdue loans could develop into pressures on non-performing loans and asset quality, and occurrences of liquidity shortages could worsen.

The financial crisis has adversely affected economic growth and employment in Namibia in the second half of 2008, with possible pressure on the future performance of the banking sector. However, the impact on banking stability is considered moderate at the moment.

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