Bank of Namibia

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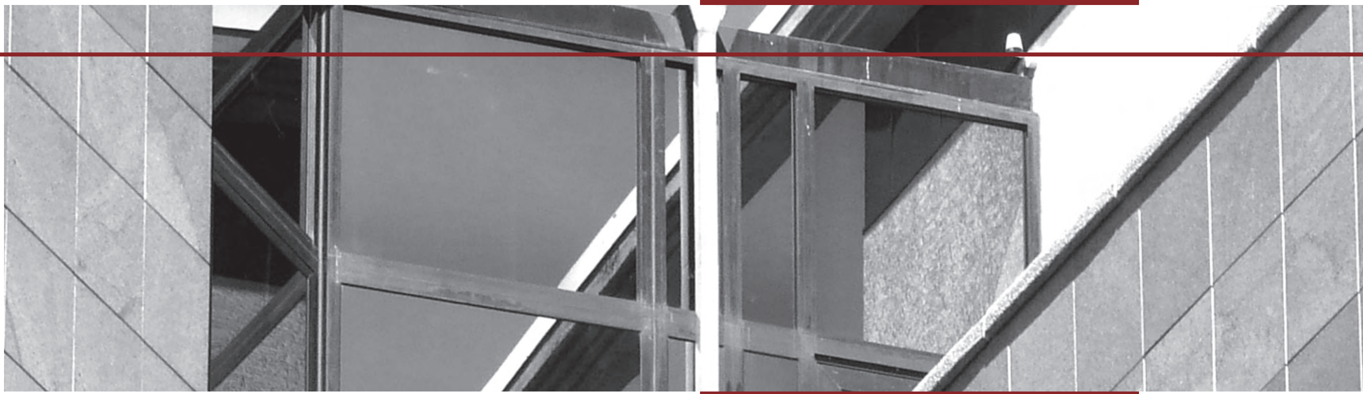


THE BANK'S CORPORATE CHARTER

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

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

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

We uphold open communication, diversity and integrity.

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

LIST OF ABBREVIATIONS

List of abbreviations

AML/CFT	Anti-money laundering and combating of financing of terrorism
BoN	Bank of Namibia
CBS	Central 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
GC10	Government Internal Registered Stock Maturing in 2010
GC12	Government Internal Registered Stock Maturing in 2012
GC15	Government Internal Registered Stock Maturing in 2015
GC18	Government Internal Registered Stock Maturing in 2018
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

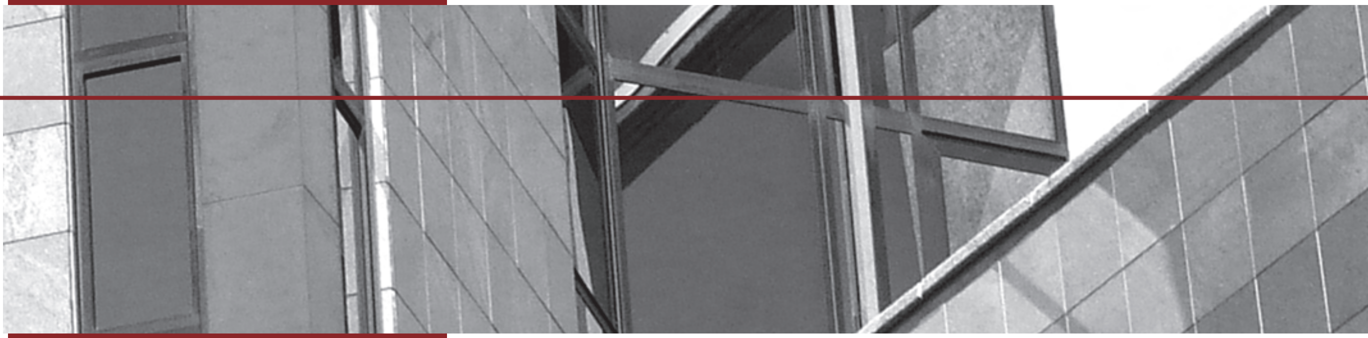
INTRODUCTION

In terms of section 3(a) of the Bank of Namibia Act, 1997 (No. 15 of 1997), 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". Against this background, the Bank 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 first 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 March 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 first 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. Much of the assessment of financial stability centres on banking institutions, given their importance to the stability of the payment system, in particular, and the financial system, in general. The review begins with a brief overview of recent developments in the real economy and financial markets that has implications on financial stability, and concludes with a summary of risks, anticipated global and domestic developments, and the overall assessment.

A relative indication of the degree of perceived impact of developments and factors on financial system stability concludes all major sections of the FSR. The ratings are in ascending order of the degree of impact and are as follows: low; moderate; and high[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. OVERALL ASSESSMENT OF THE FINANCIAL STABILITY

The first half of 2010 depicted that the global economy was on the recovery path. The recovery, though modest and uneven, was supported mainly by accommodative macroeconomic policies in the advanced economies. However, unemployment remained high in some economies. The recovery pace has been stronger in many emerging and developing economies, where household spending has been healthy and investment has been propelling job creation. Meanwhile, the global economic outlook points to an expansion in economic activity going forward. Although risks to the growth forecasts are on the down side, there is a low probability of a sharp global slowdown. The IMF in its latest World Economic Outlook (October 2010) therefore expects economic recovery to continue.

The global financial stability suffered a setback, during the period, according to the October 2010 Global Financial Stability Report (GFSR), despite the economic recovery. Concerns over sovereign credit risks intensified and uncertainty about the banking institutions' holdings of sovereign debt heightened. Market volatility increased and investor confidence fell. This uncertainty led to pressures in the interbank markets and banking institutions reduced lending. Risk appetite diminished and markets revised expectations of future economic growth. This resulted in volatility and sharp movements in currency, equity and commodity markets. Policy actions helped to stabilise funding markets and decrease risks. As a result, financial market conditions improved. However, the GFSR noted that the underlying sovereign and banking vulnerabilities remain. In addition, the global financial outlook is subject to considerable downside risks and to concerns about risks to the global recovery.

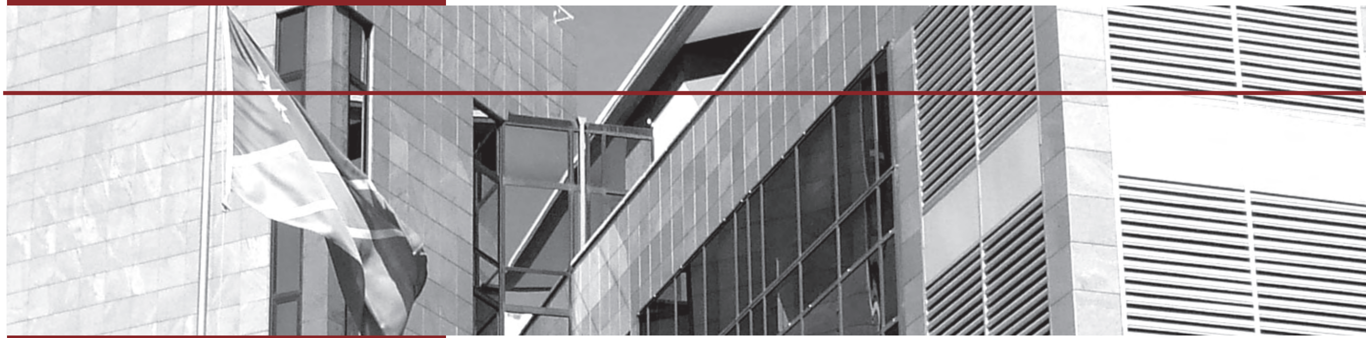
In the first half of 2010, the domestic economic activity improved, in line with global economic recovery. Notable signs appeared mainly in agriculture and mining sectors, where output expanded. The secondary and tertiary industries also improved. Domestic demand also improved, as reflected in higher growth in credit extended to the private sector. Consequently, the Bank, in its latest economic outlook for 2010, projected the economic recovery to continue to improve and expected GDP to grow by 4.2 percent in 2010, from a contraction of 0.8 percent in 2009. The main downside risks to the domestic economic recovery in 2010 were the possible reversal in global economic recovery and, therefore, the outlook for Namibian key exports.

The financial situation of households would likely improve with recovering economic conditions. The improvement would further support internal demand and stimulate output. By the same token, a rebound in domestic economic activity would sustain corporate financial performance. Both circumstances would result in further decreases in non-performing loans for the banking sector as a result of improved repayment ability of banking borrowers. Going forward, the favourable financial environment would be conducive to banking stability.

The real effective exchange rate (REER) of the Namibia Dollar (NAD) appreciated against the currencies of the major trading partners in the first half of 2010. The real appreciation could have resulted in reduced proceeds of some of Namibia's exports. Namibia's international reserves have fallen slightly in the first half of 2010, but remained sufficient to maintain the currency peg. The level of reserves is also adequate to support both the financial health of the domestic economy and financial stability. The country's reserves, however, are negatively affected by recent reductions in SACU inflows.

The banking sector's limited links, to international financial markets, continued to act as a shield against the negative impacts of the recent financial turbulence. Consequently, the banking sector remained adequately liquid, profitable and well capitalised in the first half of 2010. Furthermore, both non-performing loans and overdue loans fell, with the latter continuing the downward trend that started in the fourth quarter of 2009. The situation, therefore, augurs well for banking sector stability. The banking sector, thus, remains sound and stable, even though the cost efficiency has deteriorated during the period.

The Bank continued to carry out its oversight function of the performance of the National Payment System (NPS). The principal aim of these oversight activities is to ensure that the NPS is efficient and safe. Thus, the payment system poses no systemic risk to the financial system.



2. EXTERNAL ENVIRONMENT

2.1 MACRO-FINANCIAL CONDITIONS

The global economic recovery continued to strengthen in the first half of 2010. During the period, global activity expanded at annual rate of 5.25 percent. In advanced economies, output expanded by 3.5 percent during the first half of 2010 and their recovery was expected to remain fragile. By contrast, many emerging and developing economies, which did not experience significant financial excesses just before the recession, experienced strong growth.

Progress towards financial stability, on the other hand, suffered a setback since April 2010. The global financial system is still in a period of significant uncertainty and remains the main weakness of the economic recovery, according to the IMF's *Global Financial Stability Report* for October 2010. The increased vulnerabilities of bank and sovereign balance sheets were highlighted by the recent turmoil in sovereign debt markets in Europe. Although the financial situation has subsequently improved to some extent, following policy responses that helped stabilise the markets and reduce risks, substantial financial market risks remain. In addition, debt sustainability is rendered less certain by sovereign balance sheets that remain highly vulnerable to growth shocks.

As noted in the October 2010 IMF *World Economic Outlook Update*, the global recovery remains fragile and downside risks continue. Global activity is, therefore, forecast to expand by 4.8 percent in 2010 and by 4.2 percent in 2011, broadly in line with earlier expectations. Advanced economies are projected to grow by 2.7 percent in 2010, following an output decline in 2009. For 2011, economic growth in these economies was forecast to expand by 2.2 percent. Economic growth in emerging and developing economies, by contrast, was projected to be robust overall, at 7.1 percent and 6.4 percent, respectively, in 2010 and 2011. According to the IMF, unemployment remained high in advanced economies and inflation was, therefore, projected to stay generally low. In addition, risks to growth forecast were mainly to the downside, although the probability of a sharp global slowdown appeared low in advanced economies.

2.2 INFLATION RATES

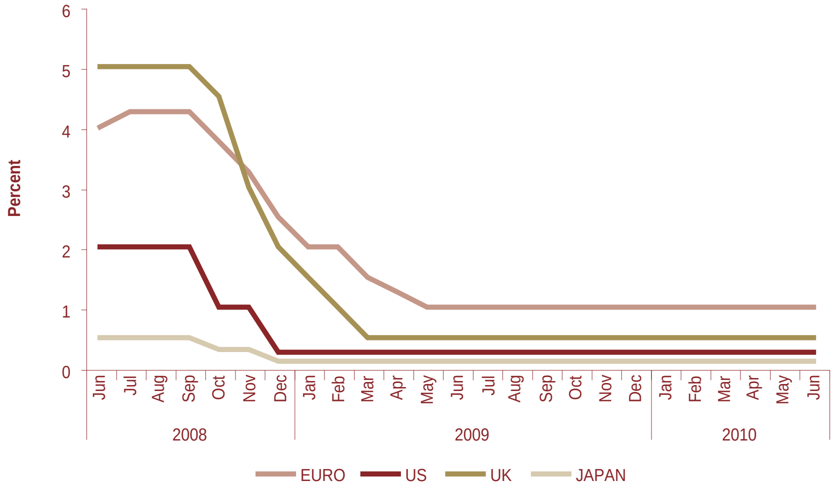
Global inflationary pressures continued to ease with the sustained weakness in the global economy in the first half of 2010. Year-on-year inflation moderated to 1.7 percent in May 2010, down from around 6 percent one year earlier. Global inflation pressures are projected, by the IMF, to remain low in 2010, held down by high unemployment rates and significant excess capacity. Inflation has been high and volatile in emerging economies, and inflation pressures could resurface more easily in those economies than in advanced economies.

In advanced economies, headline inflation fell below zero percent in May 2010 as oil prices remained far below those levels, despite their recent pickup. Inflation pressures are expected to remain subdued in advanced economies. Low levels of capacity utilisation and well-anchored inflation expectations should contain inflation pressures in these economies. Headline inflation in advanced economies was expected to remain around 1.25-1.5 percent in 2010 and 2011, while core inflation was still running around 1.5 per cent, down from 2 per cent in May 2010. In contrasts, in emerging and developing economies, where inflation developments have been uneven, inflation is expected to rise to 6.25 percent in 2010, before subsiding to 5.0 percent in 2011. Headline inflation in the emerging markets has moderated, falling to around 1 per cent in May 2010.

2.3 INTEREST RATES

Most advanced and many emerging economies maintained their accommodative monetary stances during the first half of 2010. However, some countries raised their rates during the period. Economic recovery remained tentative in advanced economies during the period, following lingering doubt about sovereign risks and sluggish private sector consumption demand. Consequently, the major central banks, the European Central Bank, the US Federal Reserve, the Bank of England and the Bank of Japan, kept their respective official policy rates at 1.0, 0/0.25 percent, 0.5 percent and 0.10 percent since the second half of 2009 (Chart 1).

Chart 1: Major policy interest rates



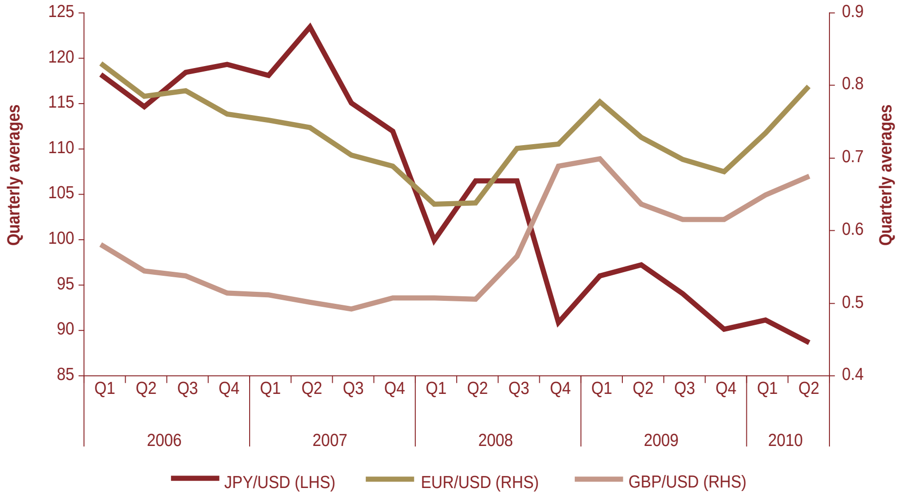
Source: Bloomberg

In emerging and developing economies, China kept its policy rate unaltered in the second half of 2009, at 5.31 percent since December 2008. Similarly, the South African Reserve Bank (SARB) kept its repo rate unchanged at 6.5 percent, following a 50-basis-point rate cut in March 2010. The SARB's decision was influenced by increased global uncertainty and the economic slowdown in the U.S. and China that partly led to a 21 percent contraction in mining output in the second quarter of 2010. In early September 2010, however, the SARB cut it repo rate to 6.0 percent to boost the economy in the wake of slower gross domestic product growth figures and poor credit and factory data. The rate cut was also supported by a favourable inflation outlook.

2.4 EXCHANGE RATES

The uncertainties about the global economic recovery, fuelled by sovereign risks, continued to dominate the major international currency markets in the first half of 2010. The Dollar appreciated against the Pound and Euro during the first half of 2010 (Chart 2). The Dollar rose by 7.4 and 10.7 percent against the former and latter, respectively, from 0.61236 Pounds and 0.6875 Euros, to 0.6577 Pound and 0.7609 Euros. The US currency, however, depreciated, by about 1.0 percent, against the Yen during the period, from 91.743 Yen to 90.900 Yen. The Dollar weakness was mostly a result of doubts about the US economic recovery.

Chart 2: Currency per US dollar



Source: Bloomberg

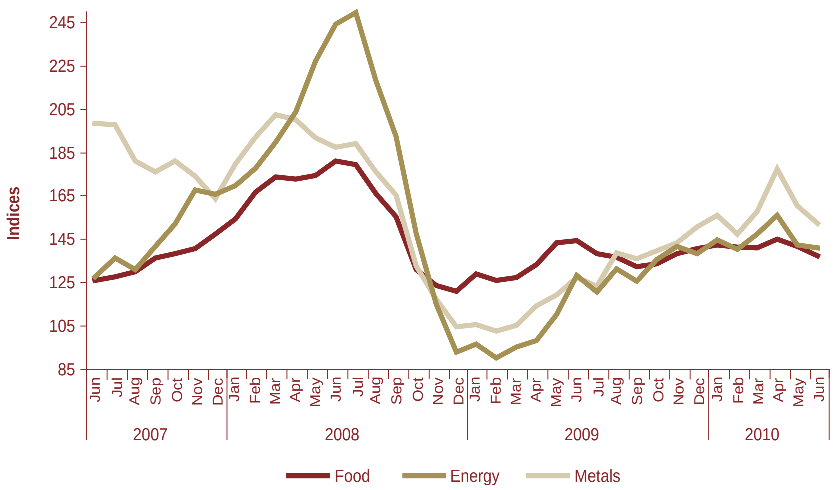
On quarterly basis, the dollar appreciated against the Pound and Euro, but depreciated against the Yen. At the end of June 2010, the Dollar closed at 0.6700 Pound, 0.7930 Euro and 88.5000 Yen. This compares with 0.6460 Pound, 0.7310 Euro and 90.9000 Yen at the end of March 2010.

2.5 COMMODITY MARKETS

Most commodity prices rose in the first quarter of 2010, but fell during the second quarter of the year. This movement was mirrored by the IMF all-commodity index that rose by 5.1 percent from 137.5 points in December 2009 to 144.2 points in March 2010 and declined by 3.5 percent to 139.1points in June 2010.

During the first quarter of 2010, most of the rise in commodity prices came from energy and metal prices, which went up by 6.6 percent and 4.9 percent, respectively (Chart 3). Food prices remained largely unchanged, during the period. In the second quarter, energy, metals, and food prices declined, respectively, by 4.2 percent, 3.3 percent and 2.6 percent. However, most commodity prices rose in July. Many mineral prices rebounded in July supported by strong demand from Asia, where growth in manufacturing output has been strong. However, gold and uranium prices remained subdued. The IMF expects commodity prices to remain relatively strong during the remainder of 2010 and in 2011, in line with expected more favourable global economic outlook. The outlook for minerals also remains positive, with nuclear fuels forecast to grow significantly.

Chart 3: Selected commodity price indices



Source: IMF

Gold price attained an all-time record high level of US$1, 232 an ounce at the end of June 2010 from US$1,226 an ounce in December 2009. The metal's stronger appeal to investors as a safe haven, in the second quarter, came in the wake of the European debt crisis and its accompanying impact on global economic outlook, when investors started to diversify into the metal. The gold price fell in August 2010 but rebounded to about US$1,270 an ounce in mid-September.

The copper price fell by 2.7 percent to US$6,501 a metric tonne in June 2010. However, the copper price fluctuated during the period, from US$7,367 in January to US$6867 in February and from US$7,729 in May to US$6,501 in June. The metal price recovered in July, rising by 3.8 percent month-on-month, on the back of stronger manufacturing growth in Asia.

The average price of zinc fell from US$2,197 per metric tonne at the end of December 2009 to US$1,746 per metric tonne at the end of the first half of 2010. However, zinc price rose by 5.8 percent in July 2010, supported by manufacturing growth in Asia.

The average spot price for uranium fell by 6.9 percent from US$44.00 per pound at the close of the second half of 2009 to US$40.78 per pound in June 2010. However, the uranium price rose in July by 2.8 percent, but fell by 15.6 percent on a yearly basis. Nonetheless, the market outlook for uranium for 2010 remains strong due to a continued interest in nuclear energy, according to the *International Energy Agency* and the *OECD Nuclear Energy Agency* forecast.

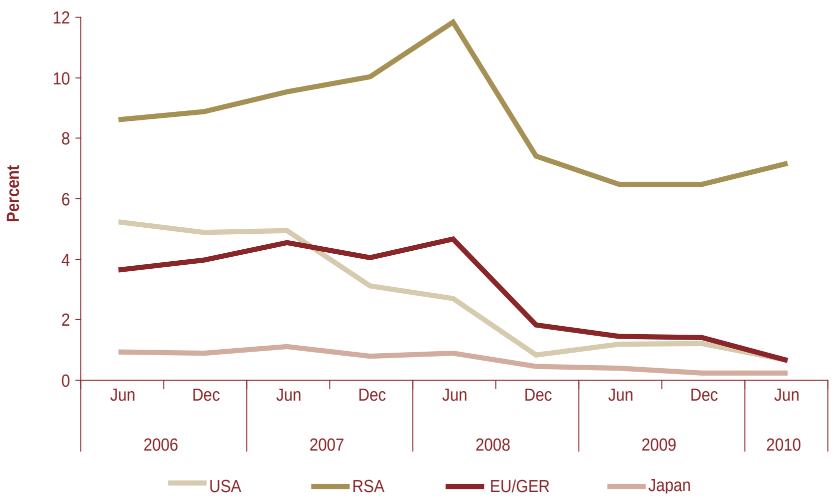
Crude oil prices rose slightly from US$74.49 per barrel at the end of December 2009 to US$74.73 a barrel in June 2010. There were, however, some fluctuations in oil prices during the period. For instance, oil prices fell from US$76.37 in January to US74.78 in February, before rising to US$84.18 in April. In the first half of 2010, oil prices were mostly driven by the advent of the European sovereign debt crisis, which sparked fresh fears about global economic recovery that could curtail global energy demand.

In contrast, by mid-September, oil prices rose to an average of US$78.78 per barrel. Global oil demand was forecast to grow this year and the next, with mostly developing countries driving consumption. This, in turn, is expected to boost oil prices.

2.6 BOND MARKETS

The two-year bond yields in most major international bond markets continued to fall since the second half of 2009 (Chart 4). Fragile market confidence drove investors to buy traditional safe haven assets such as U.S. treasuries and Germany bunds, thus bidding up their prices and driving down their yields given the inverse relationship between bond prices and yields. As a consequence, yields on the US, Euro-zone, proxied by German bunds, and Japan two-year bonds fell from 1.1 percent, 1.3 percent and 0.3 percent in December 2009 to 0.6 percent, 0.6 percent, and 0.16 percent in June 2010, respectively.

Chart 4: Two-year Government bond yields



Source: Bloomberg

By contrast, in South Africa the South African Government bond yields rose from 6.4 percent in December 2009 to 7.1percent in June 2010. The relatively high yields, in both nominal and real terms, offering a safe haven for investors hit by sluggish global economic growth and lingering investor uncertainty, led to strong portfolio inflows into the country's bond market.

2.7 EQUITY MARKETS

In the first quarter of 2010, most global stock market indices extended the rebound that started since the fourth quarter of 2009, following global economic recovery and improvements in financial markets conditions at the end of the global economic recession (Chart 5). The S&P 500 index rose the highest by 5.9 percent, followed by the Nasdaq and Nikkei indices at 5.4 percent and 5.2 percent, respectively. At the same time, the FTSE 100, Dow Jones and the JSE All Share indices rose by 4.9 percent, 4.1 percent and 4.3 percent, respectively.

In the second quarter of 2010, however, the major global equity market indices were negatively affected by the recurrent fears of global economic slowdown driven by concerns arising from the European sovereign debt crisis. As a result, the Nikkei fell the lowest by 15.4 percent, followed by the CAC and the FTSE 100 indices, both indices falling by 13.4 percent. Part of the fall in the Nikkei index came as investors were reluctant to take large positions due to the yen's rise against the US dollar, which hurts Japan's all-important export sector. The three major US indices also fell during the period, as pessimism over the US economic recovery prevailed. The Nasdaq, S&P 500, and the Dow Jones indices fell by 12.0 percent, 11.9 percent and 10.0 percent, respectively.

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

Source: Bloomberg

The NSX local index rose mildly by 0.1 percent, in the second quarter of 2010. The NSX overall, on the other hand, fell by 11.4 percent, in line with global stock market indices, and, in particular, in line with the JSE All Share index.

However, negative Stock Markets performance at the end of the first half of 2010 was reversed in July, following renewed investor confidence and positive results from the European banking stress tests, as well as revised global economic growth figures by the IMF. The JSE All Share index was the top performer with a growth of 8.0 percent, month-on-months.

In early September 2010, global banking stocks rose in Europe and Asia as regulators gave banks more time than analysts expected to comply with stiffer capital requirements of Basel III aimed at preventing future financial crises. For instance, German's benchmark DAX share index rallied 6.0 percent in September, taking its gain for 2010 to more than 5.0 percent.

2.8 SUMMARY ASSESSMENT

The global economic recovery continued to strengthen during the first half of 2010, with economic activity expanding by 5.25 percent. The recovery was, however, sluggish in most advanced economies and a few emerging economies, but strong in many emerging and developing economies. Global activity is forecast to expand by 4.8 percent and 4.2 percent in 2010 and 2011, respectively. At the same time, the global financial stability suffered a major setback and, although financial markets have stabilised somewhat, the global financial system is still characterised by significant uncertainties.

Global inflation pressures have eased and global inflation is projected to remain generally low, given high unemployment and excess capacity. Some countries maintained their accommodative monetary stances, while others raised their rates, in response to prevailing economic conditions. The global foreign exchange markets were characterised by a weak US Dollar and a strong Japanese Yen. In the commodity markets, prices remained elevated and are expected to remain relatively strong during the remainder of 2010 and in 2011, in line with expectations of more favourable global economic outlook. In equity markets, many prices fell in the latter part of the first half of 2010, but recovered in early September 2010.

3. DOMESTIC ECONOMY

3.1 ECONOMIC CONDITIONS AND FINANCIAL MARKETS

3.1.1 Economic performance

Economic activities in Namibian continued to improve in the first half of 2010. However, the slackening in global demand, in the second quarter of 2010, was mirrored by a decline in the country's major commodity exports during July. The economic recovery, which is projected to continue, is in line with the strengthening global economy. Consequently, the economy is forecast to expand by 4.2 percent in 2010, compared with an estimated contraction of 0.8 percent in 2009. Signs of economic improvements have been most notable in the agriculture and mining and quarrying sectors. Outputs of diamonds, zinc, uranium and gold increased during the first half of 2010. The tourism sector, on the other hand, was negatively affected by the closure of European airspace during mid-April 2010, due to volcanic eruptions in Iceland, and by the 2010 FIFA World Cup, which was hosted in neighbouring South Africa.

The continuing global economic recovery, coupled with the current rebound in global trade, would support recovery in many emerging and developing economies. Namibia also stands to benefit from the resulting, favourable commodity prices. Many commodity prices recovered more recently, as concerns about the real spill-overs of the financial turbulence has eased. Improvement in domestic economic activity would boost the incomes and confidence of both businesses and households. Furthermore, domestic demand has already started to recover, as signified by growth in credit extension to the private sector. This would ultimately improve the balance sheets of banking institutions and would enhance financial stability.

The projected recovery in the global economy is the necessary pre-condition for sustained domestic economy recovery, *inter alia*, through the revival of the export of major commodities and prices. Current domestic policies, both fiscal and monetary, on the other hand, are geared towards maintaining the recovery momentum in the domestic sector. There are, however, downside risks to the domestic economy. In particular, the future growth prospects of the global economy and the impact of oil prices, cast a cloud over the domestic growth outlook, in the medium term.

3.1.2 Consumer prices

In the second half of 2010, the overall inflation rate in Namibia extended its downward slope, which prevailed since the second half of 2009 (Chart 6). The overall inflation decelerated from 5.6 percent in December 2009 to 2.5 percent in June 2010. The chief driver supporting the decline in the overall inflation pressure was the food price inflation. The food category inflation, which excludes non-alcoholic beverages, fell from 6.5 percent in December 2009 to 2.9 percent in June 2010. The easing in food price inflation followed a steady decline in the international prices of yellow maize and wheat since the second half of 2008. The decline was mostly due to the general slowdown in global economic conditions. A record bumper maize harvest in South Africa, in 2009 and 2010, also contributed to low food price pressures in Namibia.

Transport price inflation, the second main inflation driver, accounts for 14.8 percent of the total consumption basket and moves in correlation with crude oil price. The latter was subdued in line with the weakening in the global economic outlook due, *inter alia*, to the European debt crisis. A cut in the fuel prices in June 2010 should also aid the easing in fuel price inflation and consequently help in the easing in transport inflation. In addition, the Namibia dollar has been appreciating against the US dollar most of the first half of 2010. The appreciation would lead to a decrease in the local pump price of fuel. The annual transport inflation fell from 9.1 percent in December 2009 to 6.6 percent in June 2010. Over the same period, housing price inflation declined from 6.9 percent to 5.3 percent. Accordingly, the overall average annual inflation rate declined from 7.0 percent to 4.3 percent during the same period.

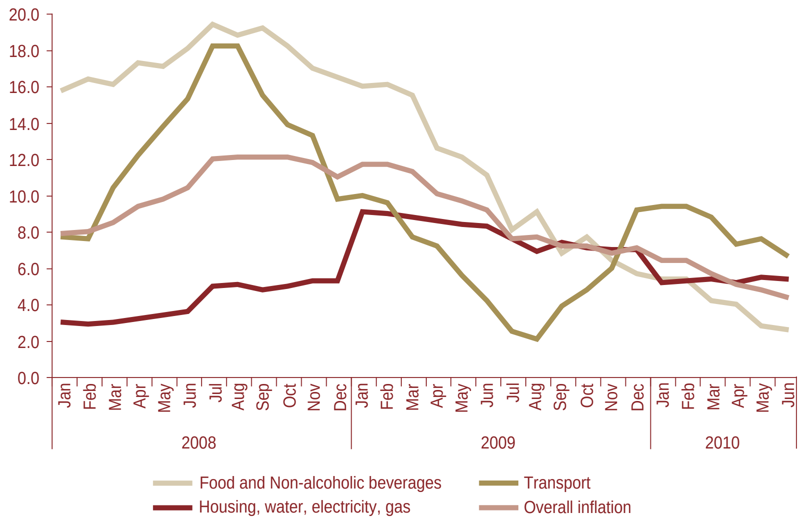
Housing inflation rose slightly from 5.2 percent in the first quarter of 2010 to 5.3 percent at the end of second quarter. All sub-items under this category showed stability in their prices between the first and second quarters of the year.

Inflationary pressure remained subdued, with the overall annual inflation falling to 3.6 percent in August from 4.6 percent in July. The decrease in the overall inflation rate in August was mainly due to food price inflation, which slowed to 2.2 percent in August, after rising to 3.9 percent in July. Transport inflation fell further from 5.0 percent to 4.7 percent, during the period.

In early August 2010, international wheat prices soared to their highest levels since April 2008, on fears of global shortages fuelled by Russia's wheat output shortfall. Consequently, global food prices rose in August on the back of surging wheat and higher sugar and oilseeds prices. The FAO Food Price Index reached its highest level in two years, averaging 175.9 points in August. FAO forecast global wheat output to fall in 2010, chiefly due to lower crops in drought-stricken Russia.

The outlook for inflation in Namibia would continue to be influenced by the prevailing global deflationary environment, in the medium term. However, in the longer term, inflation pressures could mount if commodity prices, including oil and wheat, increase as the global economic recovery gathers momentum. In addition, the outlook for inflation in Namibia is clouded by rising wage demands in Namibia and South Africa that might add to price pressures. Most of Namibia's imports come from, or go through, South Africa.

Chart 6: Contributions to CPI

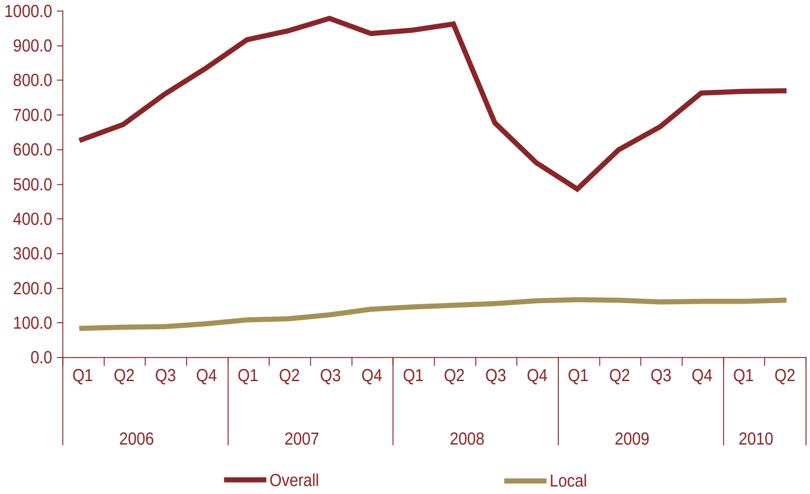


Source: Central Bureau of Statistics

3.1.3 Equity markets

The overall price index of the Namibian Stock Exchange (NSX) closed slightly high at 763.3 points in June 2010 from 762.3 points in December 2009 (Chart 7). The overall index comprises the performance of both local and dual-listed companies. The latter group of companies are simultaneously listed on both the NSX and the Johannesburg Stock Exchange (JSE). The moderate performance of the overall price index of the NSX, particularly in the second quarter of 2010, followed the fall in the JSE, which in turn, was in line with a decline in the global equities on persistent concerns about the global economic recovery. The total overall market capitalisation of the NSX also fell by 6.4 percent to N$958.5 billion at the end of June 2010 from N$1, 024.1 billion at the end of December 2009.

Chart 7: Namibia stock exchange price indices



Source: Namibia Stock Exchange

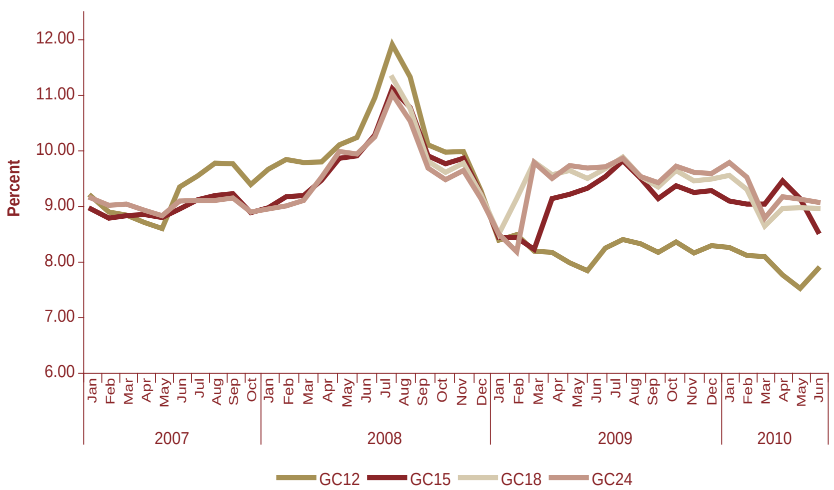
The local index of the NSX rose by 2.3 percent from 155 points at the end of December 2009 to 158.6 points at the end of the first half of 2010. The local market capitalisation edged up slightly by 1.4 percent from N$7.1 billion in the second half of 2009 to N$7.2 billion at the end of the first half of 2010. The impact, albeit modest, of the recent financial market turmoil on the Namibian financial system was 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 the first half of 2010. The bond yields follow the general direction of the benchmark and central bank rates, both for Namibia and for the benchmark country, South Africa. Currently, both South African and Namibia policy rates are relatively low. International investors are buying more South African bonds, lured by slowing inflation, a stronger rand and higher interest rates than in developed markets. The purchases sent yields on South African bonds down. For instance, the surge in purchase of South Africa's benchmark bond has led to a reduction in bond yields.

The yield on the GC12 fell from 8.25 per cent in December 2009 to 7.83 percent in June 2010. Similarly, the yields on the GC15, GC18 and GC24 declined from 9.24 percent, 9.45 percentand 9.55 percent to 8.50 percent, 8.93 percent and 9.02 percent, during the same period, respectively.

Chart 8: Government Bond yields



The fall in bond yields continued through the end of August. The four yields fell by 0.53 percentage points, 0.08 percentage points, 0.55 percentage points, and 0.67 percentage points, respectively.

3.1.5 Exchange rates

The Namibia Dollar (NAD) sustained the appreciation against the US dollar, Pound and Euro that started mostly in the first half of 2010[2]. During the period, the local currency exchanged at averages of N$7.5, N$12.4 and N$10.0 against the USD, Pound and Euro, respectively, following the appreciation (Chart 9). In addition, the appreciation brought the NAD gains against these currencies during the period to 1.4 percent, 8.3 percent and 10.1 percent, respectively.

Chart 9: Namibia dollar per foreign currency

Source: South African Reserve Bank

During July 2010, the NAD appreciated against the US Dollar, but depreciated against the Pound and Euro. The NAD strengthened by 1.3 percent against the US Dollar, while the currency weakened by 2.3 percent and 3.2 percent against the Pound and Euro, respectively. The appreciation against the US Dollar came partly from the US currency's recent weakness that was driven by renewed concerns about slowing US economy, following a series of poor economic indicators. The ZAR's strength was also attributed to massive inflows of short-term capital into the South African bond market[3].

Globally, bonds have become the asset class of choice due to sluggish global growth and lingering investor uncertainty. South African bonds offer a higher return of about 8.0 percent, compared to a paltry one or two percent in many advanced economies. In addition, the ZAR's strength was also underpinned by the involvement of South African importers and exporters in the currency markets. The NAD averaged N$7.2 per US dollar in the second week of September 2010.

The depreciation against the Pound and Euro, by contrast, was fuelled by the expansion in second quarter UK GDP figures and by the fall in Euro area unemployment rate, which might have restored confidence in the economic recovery.

The real effective exchange rate (REER)[4] index of the NAD rose from 92.0 points in December 2009 to 94.0 points in June 2010, presenting an appreciation of 2.2 percent in real terms. The real appreciation implies a loss in competitiveness for Namibia's export commodities as they became more expensive relative to the major trading economies, due to a strong NAD against the USD, GBP and EUR. On the other hand, a real appreciation can lead to lower import prices.

[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] This is referred to as the 'carry trade", where investors borrow at lower costs and invest in markets offering higher returns, prompting appreciations in local currencies.

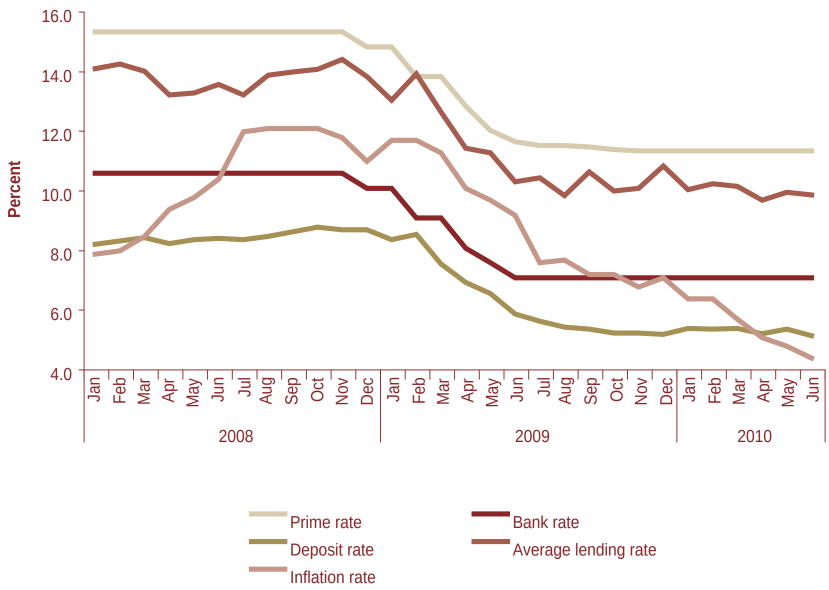
[4] The REER index is the deflation of the NEER with the relative consumer price index, that is, the rations of Namibai's CPI and those of six below mentioned major trading partners. The NEER index is a trade-weighted index of the bilateral nominal exchange rate of the Namibia Dollar against the currencies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

3.1.6 Interest and inflation rates

The general trend in Namibian interest rates, in the first six months of 2010, was either constant or downward. The bank rate and the prime lending rate continued to be level, while the average nominal deposit rate and the average lending rate trended downwards (Chart 10). The Bank of Namibia kept its Repo rate constant, since its last cut in June 2009 from 7.5 percent to 7.0 percent to help stimulate sluggish domestic demand and slowing economic growth. The rate of inflation lowed significantly since December 2009. The fall in inflation rate, combined with the continuing need to boost economic growth, permitted the Bank to keep the policy rate unchanged.

Since June 2009, banking institutions adjusted their rates in response to the Bank's Repo rate cut. While the prime lending rate remained at 11.25 percent since December 2009, the average nominal lending rate and the average nominal deposit rate fell. The former declined by 0.97 percentage points from 10.75 percent at the end of the second half of 2009 to 9.78 percent at the end of the first half of 2010. At the same time, the latter rate declined from 5.11 percent to 5.06 percent. Following these developments, the spread between the lending and deposit rate widened to 4.72 percentage points in June 2010, compared with 4.58 percentage points in the previous month.

Chart 10: Interest and inflation rates



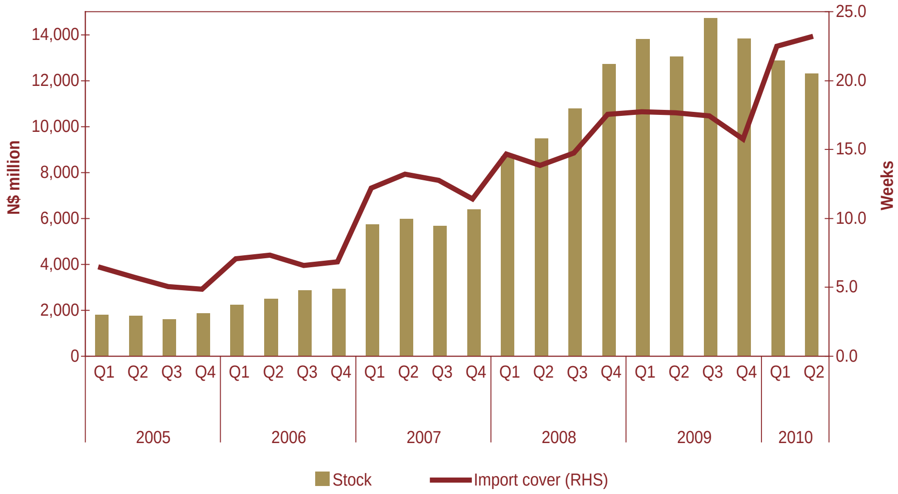
Source: Central Bureau of Statistics

3.1.7 Foreign Exchange Reserves adequacy

Foreign-exchange reserves function to lessen the impact of the shortage or shock that might follow when access to foreign borrowing and credit lines are limited or withdrawn. This function makes adequate foreign-exchange reserves critical to a country's ability to withstand external shocks.

The level of foreign exchange reserves in Namibia declined by 10.9 percent from N$13.8 billion at the end of December 2009 to N$12.3 billion at the end of June 2010 (Chart 11). The international reserves fell mainly due to: a decline in SACU revenue inflows; purchases of ZAR by banking institutions from the Bank of Namibia; and Government payments to foreign countries. At the end of July 2010, the stock of international reserves fell slightly by 0.5 percent, month-on-month, and 13.0 percent, year-on-year. Despite the decline, the level of international reserves remained sufficient to support the currency peg.

Chart 11: Quarterly international reserve stock and import cover



The second major function performed by foreign exchange reserves is to allow a country to pay for its imports and to discharge its other external obligations. Import cover[5] 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 rose significantly from 15.6 weeks of imports in December 2009 to 23 weeks of imports in June 2010. This meant that the country could continue to import goods and services for up to 23 weeks, if all other sources of foreign exchange earnings dried up. In addition, the international benchmark is 12 weeks of import cover. The country's import cover rose during the period due to the favourable exchange rate, as well as to the reduction in import volumes.

Namibia's foreign reserve position remained adequate in the first half of 2010, despite a moderate fall. Moreover, the import cover improved considerably. Adequate foreign exchange reserves would lower the impact of a foreign exchange liquidity shock. This should, therefore, in turn, enhance financial stability.

3.1.8 Summary assessment

Commodity prices fell in the first quarter of 2010, but most recovered in the second quarter. In addition, global inflation pressures continued to ease in line with weak global economic recovery. Consequently, global inflation was expected to continue to be suppressed mainly on account of a sluggish world economy. In Namibia, the overall inflation fell since the second half of 2009 and inflation pressures subdued in the first half of 2010. However, overall inflation rose between June and July, although, inflationary pressures continued to be subdued. The Bank of Namibia's ability to protect the currency peg was enhanced by the level of reserves. In addition, the adequate level of reserves allowed the Bank to maintain low interest rate environment.

The international equity markets performed poorly in the first half of 2010 on account of concerns about the global economic recovery. The impact on the NSX was transmitted through the JSE. However, the influence on the local component of the NSX remained modest in most part. The impact of international stock markets on the banking sector remained minimal, in the first half of 2010, mainly because Namibian banking institutions have limited linkages to those markets.

The NAD appreciated against the US dollar, Pound and Euro in most of the first half of 2010. The strength of the currency against the dollar was chiefly due to uncertainties about the strength of the US economic recovery. The trade-weighted real effective exchange rate appreciated in the first half of 2010, making Namibian export commodities less competitive against its major trading partners. The currency, however, depreciated against the Pound and Euro in July 2010.

Namibia's international reserves decreased slightly in the first half of 2010. Despite the contraction, the current level of reserves was sufficient to maintain the currency peg, contributed to financial health, and strengthened financial stability. As noted in previous FSRs, the country's reserves were adversely affected by the reduction in SACU revenues. The level of foreign exchange reserves was not a downside risk for financial stability, despite the above factors.

[5] 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.

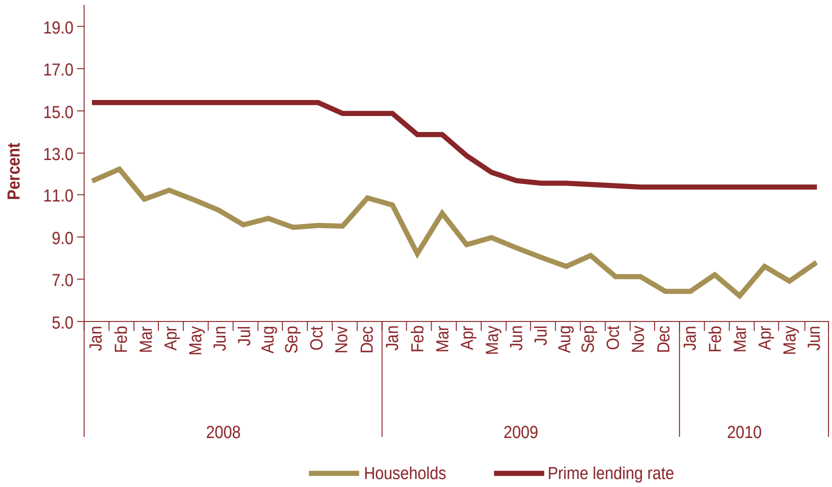
3.2 PRIVATE SECTOR CREDIT EXTENSION

The more accommodative monetary stance pursued by the Bank of Namibia, since December 2008, led to stronger private sector demand for credit in the first half of 2010. Total claims on private businesses and households increased to N$37.5 billion in June 2010 from N$36.4 billion at the end of December 2009. This expansion represented an annual growth of 10.6 percent, or 6.0 percent in real terms, compared with 7.4 percent at the end December 2009. This trend in private sector credit extension is projected to continue for the rest of 2010.

3.2.1 Household sector borrowing

Credit extension to the household sector expanded by 7.6 percent, on annual basis, at the end of June 2010, from 6.3 percent at the end of December 2009 (Chart 12). The credit expansion to the sector lifted the aggregate lending to the sector to N$24.1 billion, during the period, from N$23.2 billion at the end of December 2010. Most of the growth in loans to households emanated from the hefty mortgage loan category, which represented the largest share of total loans advanced to individuals. The category expanded at an annual rate of 3.0 percent in the first half of 2010.

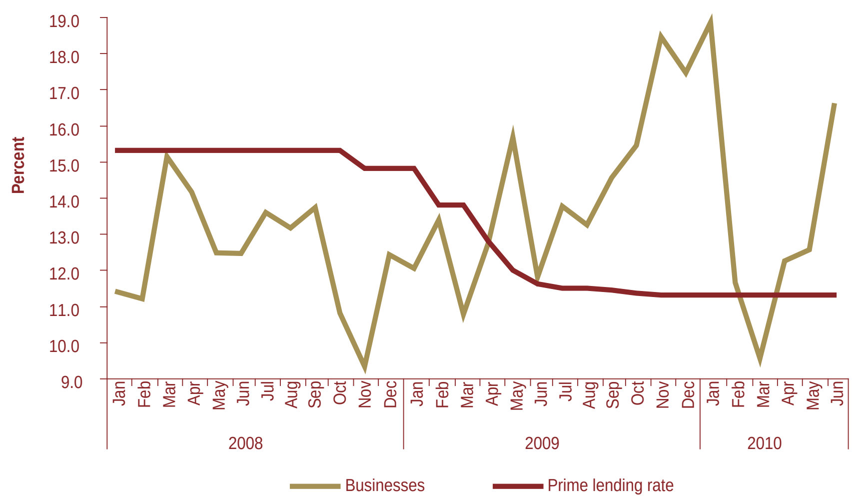
Chart 12: Claims on households



3.2.2 Corporate sector borrowing

Corporate balance sheet performance is influential to banking performance, and consequently, to financial stability. Corporate Namibia, in particular, mining and tourism sectors, were mostly affected by the global financial crisis in the second half of 2009. Credit extended to the corporate sector declined, on annual basis, from 17.4 percent in December 2009 to 9.5 percent in March 2010, before recovering to 16.5 percent in June 2010 (Chart 13). This pushed total credit extension to the corporate sector to N$13.5 billion at the end of June 2010 from N$13.2 billion at the end of December 2010. Most of the growth in loans to the business sector came from the weighty *loans and advances* category that grew at an annual rate of 1.8 percent in the first half of 2010.

Chart 13: Claims on businesses



The growth in credit extension to the business sector was mostly in categories: other loans and advances, instalment credit, and overdraft facilities. The overdraft facilities categroy rose by 13 percent at the end of June 2010.

Credit extension to the corporate sector grew to some extent; however, the rise in corporate indebtedness was not expected to result in a proportionate increase in non-performing loans in the future, given improvements in domestic economic conditions.

3.2.3 Summary assessment

The Namibian economy rebounded in the first half of 2010, after a contraction in 2009 due to the global economic recession. The rebound was in line with the current global economic recovery. Noticeable signs of improvement appeared in both the agriculture, mining, secondary and tertiary sectors of the domestic economy. Domestic demand has also picked up. Given the favourable economic conditions, the financial positions of both households and corporates were expected to improve.

The current global economic recovery would stimulate economic activity and improve the financial position of the banking borrowers, banking institutions and financial stability. In addition, the sustained lower interest rate environment would help strengthen the domestic economic recovery. The latter would, in turn, further enhance the banking borrowers' financial situation and, thus, their capacity for debt repayment. In line with the previous reviews, the negative impact of the recent global financial crisis on financial stability in Namibia remains low.

3.3 BANKING SECTOR PERFORMANCE

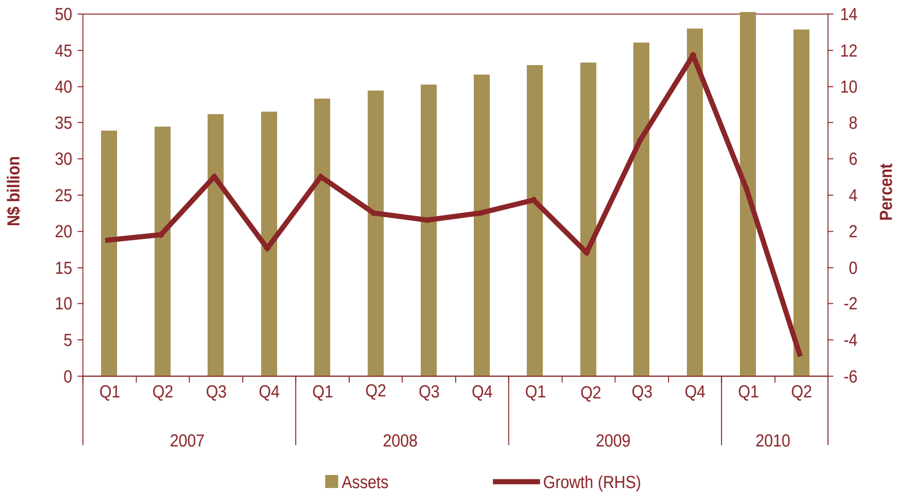
3.3.1 Banking structure

The banking sector, as at June 2010, comprised five (5) banking institutions licensed to carry on banking business in Namibia. However, the operations of the newly licensed micro-finance bank are relatively insignificant. Consequently, the sector continued to be dominated by 4 banks, holding almost 100 per cent of total banking assets. In addition, the Gini and the HHI indices of sector concentration increased from 11.5 points and 2,690 points at the end of 2009 to 12.0 points and 2692 points, respectively, during the first half of 2010. By comparison, an HHI of 1, 000 points is the universal threshold for restricted concentration. By the same token, a Gini index above 10 points is indicative of a concentrated banking sector. The rise in concentration could lead to costly banking services and limited access.

3.3.2 Balance sheet structure

The structure of the balance sheet of a banking sector could be indicative, among others, of the risk profile of the banking sector. The aggregate assets of the banking sector advanced slightly by 0.2 percent in the first six months of 2010 (Chart 14), after growing by 10.2 percent in the last six months of 2009. The meagre growth in assets was a combination of opposing movements in the first and second quarters of the year. Assets grew by 5.7 percent in the first quarter of 2010, but fell by 5.2 percent in the second quarter. The fall in assets in the second quarter was mainly driven by the sector's withdrawals of cash balances with other banks to repay non-bank funding or retail deposits. The 5.0 percent decline in non-bank funding, thus, outweighed the 3.0 percent increase in total loans and advances.

Chart 14: Banking sector assets and growth rates



On the liabilities side of the balance sheet, similar growth was mainly caused by an increase in banking funding, while non-bank funding fell, in the first half of 2010. During the period, banking institutions, therefore, raised the utilisation of bank funding, intra-group and interbank deposits, while non-banking funding fell. The deposit category of banking funding rose significantly by 87.7 percent over the same period.

Non-banking funding continued to constitute the major source of asset funding, despite having declined from 99.3 percent of total funding liabilities in the second half of 2009 to 96.1 percent in the first half of 2010. During the latter period, loans and advances, which rose to 87.8 percent of total funding liabilities from 85.5 percent in the last six months of 2009, remained the principal use of funds. Investments held second position, at 9.2 percent of total funding liabilities. There were, therefore, no significant changes in structure of balance sheet of the banking sector during the first half of 2010.

While the banking sector's loans and advances rose by 2.5 percent in the second half of 2010, the banking sector assets only grew by a meagre 0.2 percent during the same period. The growth rates in both loans and assets were , therefore, not a cause for concern as they were moderate and insignificant, respectively.

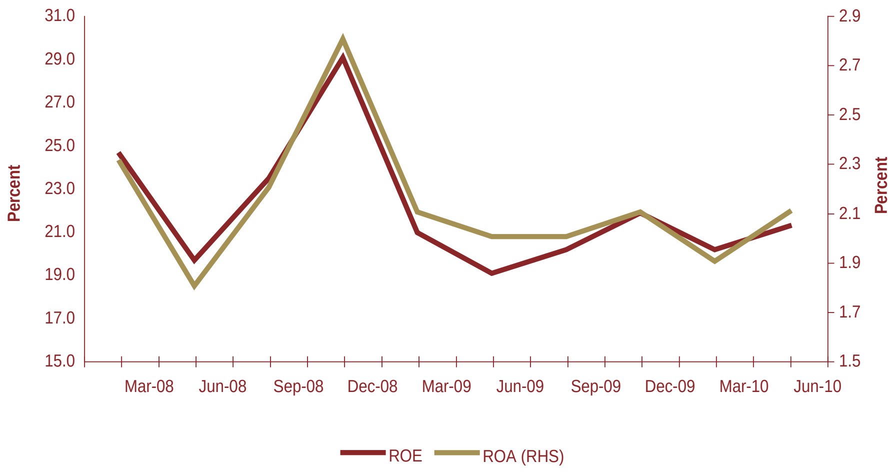
3.3.3 Profitability, capitalisation and cost efficiency

Profitability

Banking profitability is a pre-requisite for banking solvency, capital adequacy and financial stability. In turn, banking profitability is determined by the interactions among total income, provisions and expenses. The analysis below looks at the interaction among these variables to determine the profitability of the banking sector in the first half of 2010.

The earning of the banking sector improved rather modestly in the first half of 2010. After-tax income rose by 3.3 percent, compared with an increase of 13.4 percent in the second half of 2009. The rise in after-tax income was mainly due to a 4.6 percent increment in net interest income, the measure of banking earnings from lending. Non-interest income, on the other hand, fell by 27.3 percent, while operating expense rose by 10.5 percent.

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



The improvement in the after-tax income translated into an expansion in both return on assets (ROA) and return on equity (ROE). These ratios stood at 2.1 percent and 21.2 percent in June 2010, respectively (Chart 15). The profitability allowed the banking sector to sustain efficient operations and to keep adequate capital levels. Moreover, efficient banking operations and adequate capital levels are vital for banking solvency and the enhancement of financial stability.

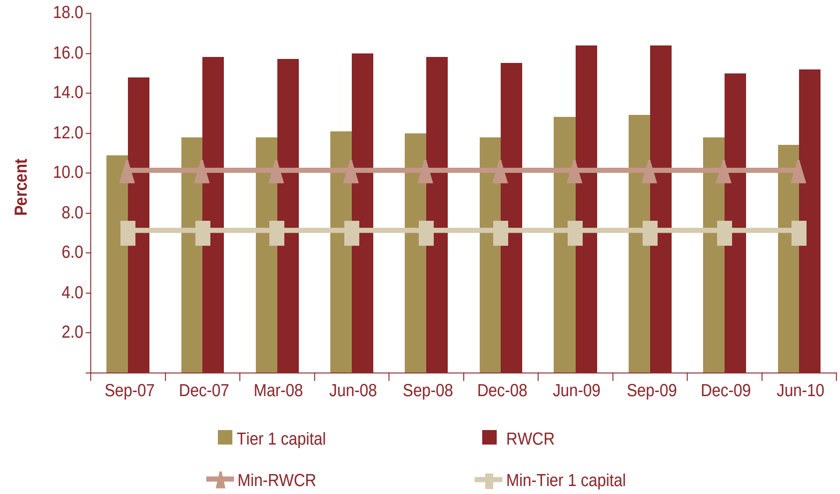
Capitalisation

Banking capital serves as a cushion to absorb unexpected losses. Banking capital adequacy, therefore, together with non-performing loans ratio, is a vital indicator of banking stability. Consequently, an increasing trend in capital adequacy is desirable to boost the banking system stability and support efficient financial market operations. Adequate banking capital is, hence, essential for a sound and stable banking system.

The Banking Institutions Determination 5 (BID-5) prescribes the required capital minima to be maintained by all banking institutions in Namibia. The prevailing leading indicator of capital adequacy is the regulatory risk-weighted capital ratio (RWCR) of not less than 10 percent. 7.0 percent of that figure should be tier 1 or primary capital. Another capital-adequacy measure is the tier 1 capital leverage ratio of 6.0 percent.

The banking sector remained adequately capitalised during the first half of 2010, as the sector surpassed the minimum statutory risk-weighted capital ratio (RWCR) of 10 percent. The RWCR of the banking sector averaged 15.2 percent at the end of the first half of 2010, from 15.0 percent at the end of the second half of 2009 (Chart 16). The Tier 1 capital ratio, on the other hand, fell slightly from 11.7 percent to 11.4 percent, during the same period.

Chart 16: Capital adequacy for banking institutions

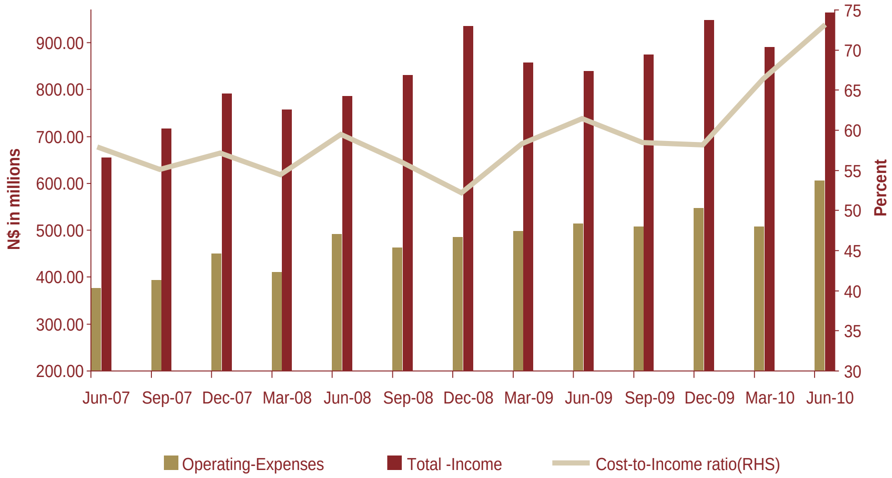


The banking sector continued to be profitable in the first half of the year. In addition, the industry capital levels exceeded regulatory minima, although the Tier-1-capital ratio has slipped slightly. The banking industry, therefore, continued to be well capitalised and its capital was in position to serve as a buffer against unexpected losses. The capital adequacy of the banking sector was further enhanced by the implementation of the Basel II capital accord since beginning 2010. The Basel II implementation resulted in more risk coverage by introducing market and operational risks in the determination of risk-weighted assets. The current level of capitalisation in the banking sector was, therefore, no cause for financial stability concerns.

Cost efficiency

The cost-to-income (C/I) ratio is the conventional measure of efficiency in the use of operating costs relative to income in the banking sector. The measure deteriorated significantly during the first half of 2010, from 57.9 percent in the last six months of 2009 to 72.7 percent in the first half of 2010 (Chart 17). The escalation in the ratio came as total income fell by 12.1 percent, while other operating expenses rose by 10.5 percent, causing the C/I ratio[6] to accelerate. Consequently, the acceleration in the cost-to-income relationship pushed the cost efficiency ratio significantly above the international benchmark of 50.0 percent.

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



[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).

Most of the increase in operating expenses came from staff, administration and other overheads costs. These costs, which make up huge chunk of operating costs, rose by 19.4 percent, in the second quarter of 2010 alone. The significant deterioration in the banking sector's ability to control costs needs to be reversed in order to improve banking sector efficiency and, hence, banking profitability and stability.

3.3.4 Liquidity risk

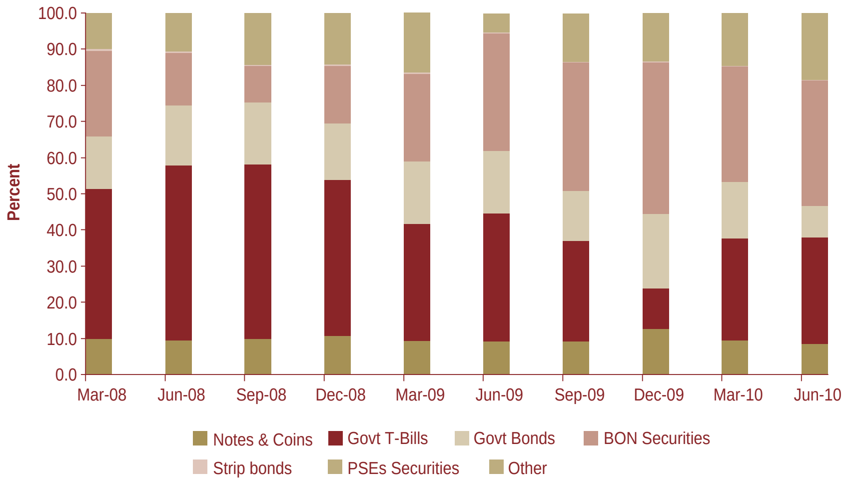
Liquidity risk is the danger that assets may not be readily available to meet demand for cash to finance asset growth and to meet due commitments. A liquidity problem emanating from a single banking institution can spread to other parts of the banking sector. Liquidity management is, therefore, critical to the banking system as a whole, to prevent liquidity problems from spreading from one bank to another and become systemic. By extension, effective liquidity management, as highlighted by the recent financial crisis, is a key tool used to boost banking stability.

A host of indicators are used to gauge banking liquidity. They include: the relationships between actual liquidity held relative to 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 holdings rose by 6.3 percent, from N$4.8 billion at the end of December 2009 to N$5.1 billion at the end of June 2010. Liquid assets prescribed by the minimum liquid asset requirement increased by 7.1 percent to N$4.5 billion, during the same period. The banking sector, on average, therefore, complied with the regulatory minimum liquid assets holding requirements in the first half of 2010.

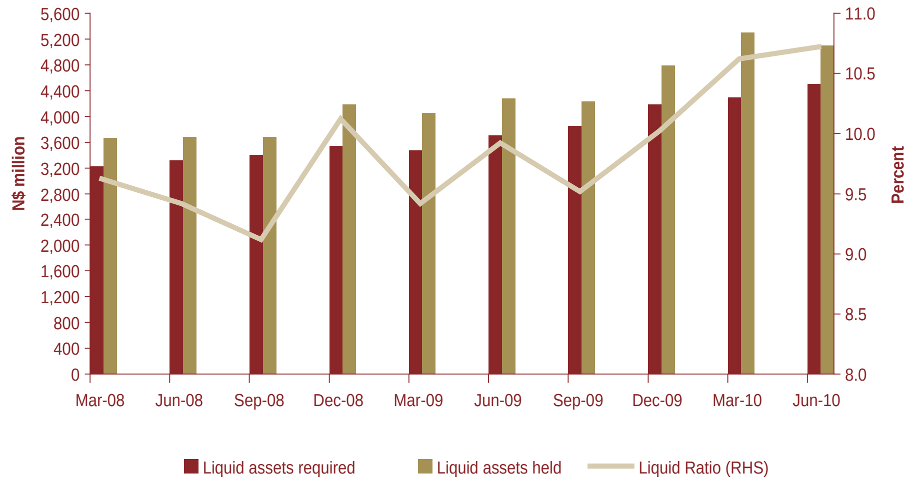
Securities of the Bank of Namibia and Government continued to dominate the mixture of liquid assets held by the banking sector, during the first half of 2010. Bank of Namibia Securities rose to prominence from 32.6 percent of total liquid assets held to 34.7 percent (Chart 18). Government securities, on the contrary, slipped to second position, from 35.3 percent of liquid assets to 29.4 percent.

Chart 18: Structure/Composition of liquid assets



The liquid assets ratio or liquid ratio is the traditional tool used to gauge liquidity in the banking sector. It is expressed as total liquid assets held as a percentage of total assets. The ratio only rose fractionally from 10.0 percent at the end of December 2009 to 10.7 percent at the end of June 2010 (Chart 19). The increase in the ratio was due to the growth in liquid assets held of 6.3 percent that outpaced the growth in total assets of 0.2 percent at the end of the first half of 2010.

Chart 19: Liquid assets and liquidity ratio

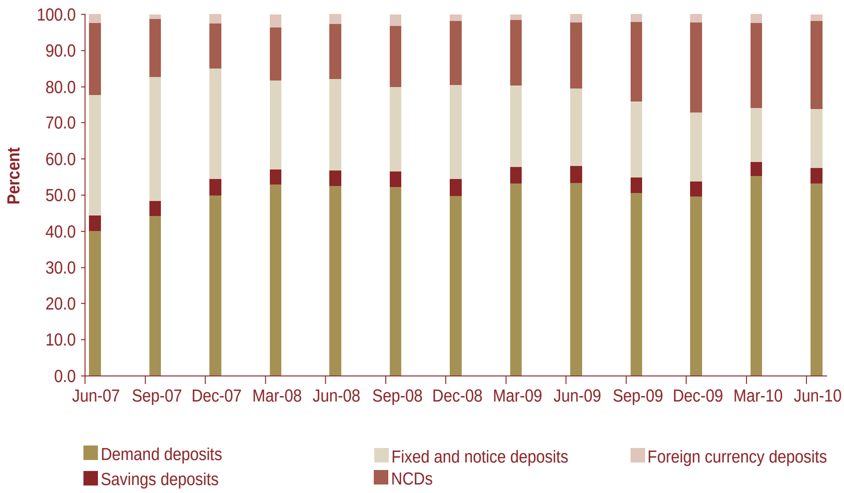


As a percentage of total banking assets, loans rose from 72.8 percent in December 2009 to 74.8 percent in June 2010. The ratio increase maintained the prominence of the loan category in the industry's balance sheet. Since loans are less liquid, a high proportion or a ratio approaching the international benchmark, might lead to liquidity concerns. The current level of the ratio, however, is no cause for immediate stability concerns as it is still within the international benchmark of 75 percent.

The ratio of loans to deposits (LTD ratio) rose slightly, from 87.1 percent, at the end of December 2009, to 87.7 percent, at the end of the first half of 2010. The LTD ratio is an indicator of the extent to which the sector is able to fund its loans with core deposits, which are relatively stable and cheaper than wholesale deposits. Since the ratio was well below the 100 percent threshold, the sector had an adequate cushion for asset growth before having to call on expensive, non-deposit funding sources. The level of the ratio, therefore, did not pose any liquidity concerns.

The composition of retail deposits has an important impact on the liquidity risk to which banking institutions are exposed. The deposit utilisation in the banking sector did not change significantly between December 2009 and June 2010. The usually cheaper and stable funding source, retail deposits, remained the major source of funding by banking institutions, with their share of total funding liabilities at about 96.1 percent in the first half of 2010. The share of demand deposits in total deposits rose from 49.7 percent of total deposits to 53.4 percent (Chart 20). At the same time, the shares of fixed and notice deposits and NCDs fell, respectively, from 19.1 percent and 24.9 percent to 16.4 percent and 24.4 percent.

Chart 20: Composition of retail deposits

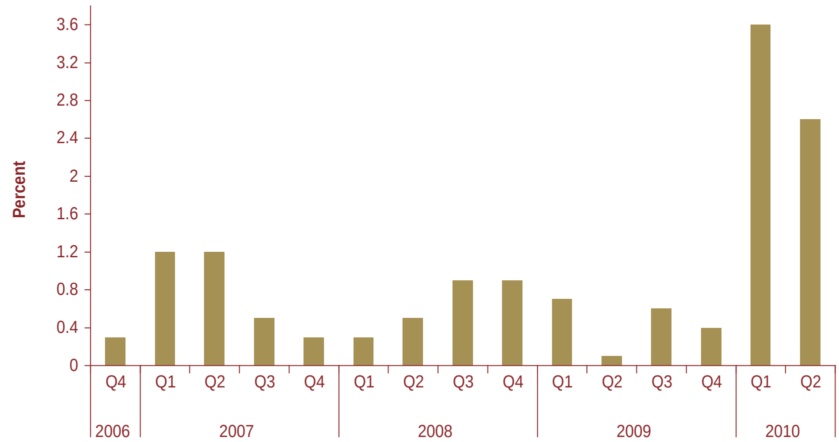


Given the satisfactory levels of crucial liquidity indicators, the banking sector's vulnerability to liquidity risk and, hence, financial instability, remained minimal in the first half of 2010.

3.3.5 Exchange rate risk

The net open position in foreign currency measures the mismatch or open position of foreign currency assets and liabilities. The measure, expressed as a fraction of net foreign currency assets to the banking institutions' tier-1 capital funds, assesses potential vulnerability of banking capital to exchange rate movements. Net open position fluctuated from 0.4 percent in the fourth quarter of 2009 to 3.6 percent in the first quarter of 2010, before falling to 2.6 percent in the second quarter of 2010 (Chart 21).

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

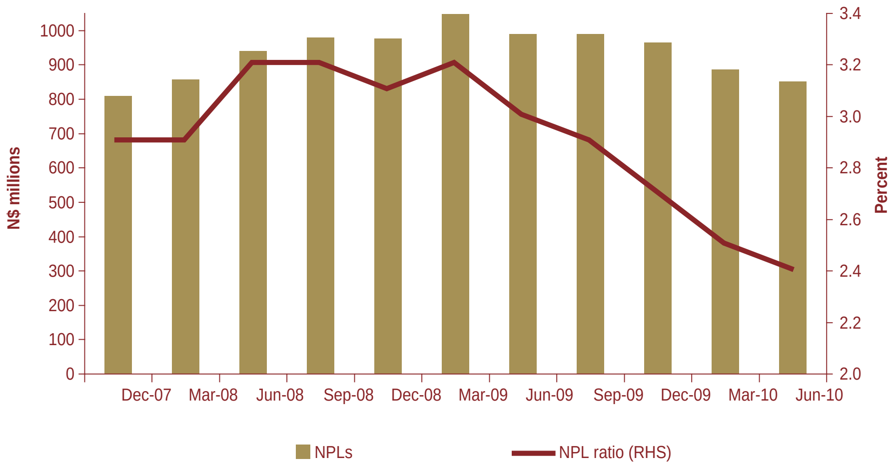


The sharp rise in the ratio, in the first half of 2010, was a result of a 687.5 percent escalation in net open position, the numerator, which outpaced a 4.2 percent increase in tier-1 capital funds, the denominator. As the ratio rose significantly in the first half of 2010, by implications, the exchange rate risk of the banking sector likewise increased. However, the level of net open position falls well below the regulatory limit of 20 percent of tier-1 capital funds. There was, thus, no financial stability concerns emanating from exchange rate risk.

3.3.6 Credit risk

The quality of the banking sector's loan portfolio sustained the improvement that started in the first quarter of 2009. The non-performing loan ratio, one of the indicators of vulnerabilities stemming from credit risk in banking loan portfolio, improved from 2.7 percent at the end of December 2009 to 2.4 percent at the end of June 2010 (Chart 22). During the period, loans and advances grew by 5.2 percent, while the NPLs fell by 11.8 percent. The fall in the sector NPLs was mainly a result of write-offs, mostly in the loss sub-category. The ratio was, thus, well within the acceptable range[7].

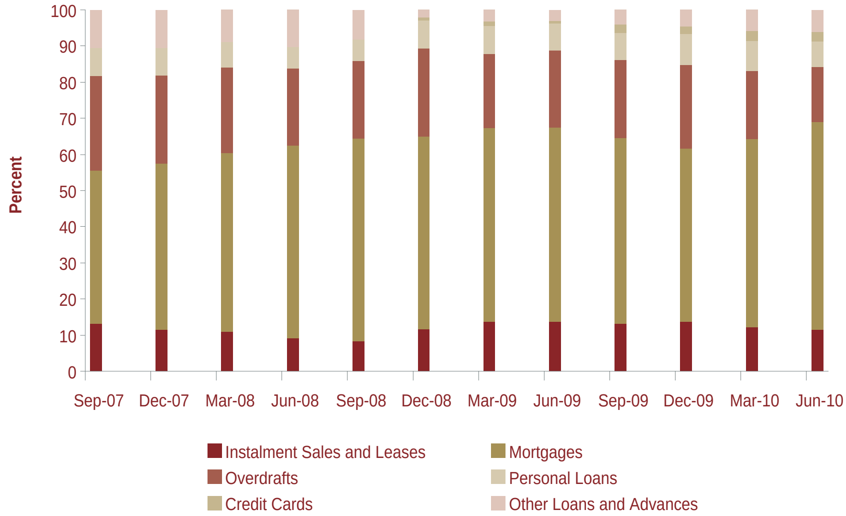
Chart 22: Banking asset quality



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

Overdue loans fell by 35.7 percent to N$1.8 billion at the end of June 2010 from N$2.8 billion at the end of December 2009. Following the 11.8 percent fall in NPLs, the proportion of NPLs to overdue loans fell from 34.2 percent to 25.0 percent, during the period. The significant decline in overdue loans could be credited to the prevailing low interest rate environment as well as improving domestic economic conditions.

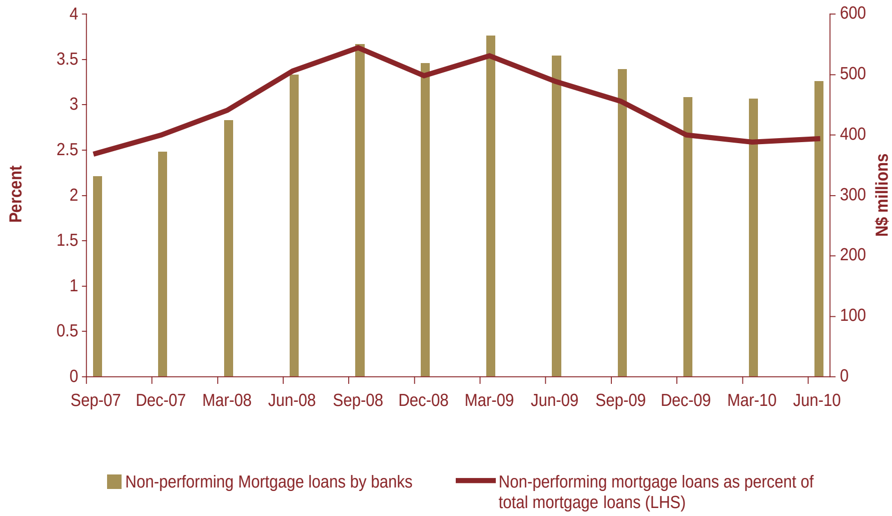
Chart 23: Non-performing loans by category



The proportion of non-performing mortgage loans to total non-performing loans rose to 52.1 percent at the end of the first half of 2010, from 47.9 percent at the end of December 2009 (Chart 23). The rise was caused by the fact that the total non-performing loans declined due to write-offs in the overdraft category while non-performing mortgage loans increased. Non-performing mortgage loans as a proportion of total mortgage loans extended by banking institutions was unchanged at 2.6 percent at the end of June 2010 (Chart 24). However, the proportion of overdue mortgage loans in total mortgage loans declined from 11.3 percent at the end of December 2009 to 6.0 percent in June 2010. Most of the decrease was in the “amount overdue for less than one month” category.

The banking sector’s asset quality continued to improve and it was considered to be satisfactory; the NPL ratio had fallen since March 2009. In addition, the composition of NPLs was generally similar to the structure of total loans and advances. Furthermore, overdue loans declined by about 35.7 percent. Consequently, credit risk was assessed to be minimal and, hence, requires only minimal monitoring.

Chart 24: Non-performing mortgage loans



The statutory large exposures of the banking sector, exposures that are at least 10 percent of industry qualifying capital, accounted for 16.9 percent of the total loan portfolio of the banking sector, at the end of the first half of 2010, compared with 14.1 percent at the end of the second half of 2009. As a proportion of banking industry capital funds, large exposures fell from 137.5 percent to 108.7 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.

The banking sector's exposure to the mining and related sectors subsided in the first half of 2010. Large exposures to the mining and related sectors, as a share of banking industry capital funds fell from 34.0 percent in December 2009 to 24.7 percent in June 2010. The improvements in the share could be attributed to the general domestic economic recovery that spurred mining activities. The likely impact of the exposure to the mining and related sectors on banking stability was assessed to be moderate, given small magnitude of the exposure.

3.3.7 Summary assessment

The overall impact of the financial crisis on the Namibian banking sector largely dissipated in the first half of 2010. At the same time, the fallouts from the sovereign credit risk were insignificant. This was, once again, thanks to the limited links to financial markets adversely affected.

The banking institutions continued to be liquid, adequately capitalised and solvent. In addition, banking earnings, as measured by ROE and ROA, remained relatively stable since 2009. The profitability in the sector, in turn, boosted the sector's capital adequacy position; although the deterioration in banking cost efficiency might dent banking profitability, going forward. Furthermore, the fraction of impaired loans in total loans (NPLs) extended the downward trend underway since the first half of 2009. At the same time, the proportion of overdue loans in total loans has started to fall in the first half of 2010.

The present global economic recovery, despite recurrent financial instability, was expected to continue. This would boost external demand for Namibian exports, with favourable consequences for both the domestic real economy and the private sector. Improvements in the financial positions of banking borrowers would eventually have a positive impact on the performance of the banking sector.

On the whole, therefore, the banking sector remained stable, adequately capitalised and solvent, as it was in the previous reviews. Consequently, the overall impact on the banking sector of the recent financial instability that originated from the sovereign debt risk is assessed to be negligible.

Box A: The Global Plan for Recovery and Reform

The G-20 met in Toronto, Canada, on June 26-27, 2010, in their first summit in their new capacity as the premier forum for international economic cooperation. The G-20 summit reviewed progress made in their previous summits including the recent one in Pittsburg. The group recognised that their efforts so far have borne fruitful results. For instance, the unprecedented and globally coordinated fiscal and monetary stimulus was playing a major role in helping to restore private demand and lending.

The G-20 leaders also agreed on the next steps: to ensure a full return to global growth with jobs; to reform and strengthen financial systems; and to create strong, sustainable and balanced global growth. The leaders, however, admitted that serious challenges remained. Although economic growth was returning, the recovery was uneven and fragile, unemployment in many countries remained at unacceptable levels, and the social impact of the crisis was still widely felt.

At the same time, recent events emanating from the euro sovereign debt crisis highlighted the importance of sustainable public finances and the need for credible, properly phased and growth-friendly plans to deliver fiscal sustainability, differentiated for, and tailored to, national circumstances. Furthermore, progress is also required on financial repair and reform to increase transparency and strengthen the balance sheets of financial institutions, and support credit availability and rapid growth. There is also a pressing need to complete the reforms of the international financial institutions. The G-20 took new steps to build a better regulated and more resilient financial system.

a) The framework for Strong, Sustainable and Balanced Growth

In this regard, the highest priority is to safeguard and strengthen the recovery and lay the foundation for strong, sustainable and balanced growth, and strengthen the financial systems against risks. The G-20 leaders have committed to take concerted actions to this end. A number of G-20 countries have already taken actions and have committed to boost demand rebalance growth, strengthen public finances, and make the financial system strong and more transparent. The G-20 leaders have further committed to narrow the development gap and to consider the impact of their policy actions on low-income countries.

b) Financial Sector Reform

There is need to build a more resilient financial system that serves the needs of global economies, reduce moral hazards, limits systemic risks, and supports strong and stable economic growth. The G-20 has committed to build such a financial system. The global financial system have been strengthened by fortifying prudential oversight, improving risk management, promoting transparency, and reinforcing international cooperation. Although a great deal has been accomplished, a lot more work was required. The financial reform agenda proposed by the G-20 has four pillars: a strong regulatory framework; effective supervision; resolution and addressing systemic institutions; and transparent international assessment and peer review. The leaders have agreed to achieve the commitments to reform the financial sector by the agreed or accelerated time frames.

Substantial progress has been made on reforms towards a new global regime for bank capital and liquidity that will materially raise levels of resilience of banking systems. The amount of capital will be significantly higher and the quality of capital will be significantly improved when the new reforms are fully implemented. The major central banks, on September 12, 2010, in Basel Switzerland, agreed to rules will significantly increase the banking institutions' capital. Under the new rules, tier 1 capital will rise from 4.0 percent to 4.5 percent by 2013, and reach 6.0 percent in 2019. In addition, banks would be required to keep an emergency reserve, "conservation buffer", of 2.5 percent. The agreement, Basel III, will be presented to the leaders of the G-20 forum in November and ratifies by national governments before they come into force. The G-20 agreed that new, stronger rules must be complemented with more effective oversight and super vision. The Financial Stability Board (FSB), in consultations with the IMF, will report in October 2010 on recommendations to strengthen oversight and supervision.

The G-20 are committed to design and implement a system with the powers and tools to restructure or resolve all types of financial institutions in crisis, without taxpayers ultimately bearing the burden. Furthermore, to reduce moral hazard, there is need to have a policy frame work including effective resolution tools, strengthen prudential and supervisory requirements, and core financial market infrastructures. To this end, the Summit called upon the FSB to consider and develop concrete policy recommendations to effectively address problems associated with, and resolve systemically important institutions by the Seoul Summit.

The Summit have strengthened the commitment to the IMF/World Bank Financial Sector Assessment Programme (FSAP) and pledged to support strong and transparent peer review through the FSB. Non-cooperative jurisdictions are addressed based on comprehensive, consistent, and transparent assessment with respect to tax havens, the fight against money laundering and terrorist financing and the adherence to prudential standards.

c) International Financial Institutions and Development

The G-20 committed to strengthen the legitimacy, credibility and effectiveness of the International Financial Institutions to make them stronger partners for the G-20 in the future. To this end, the G-20 has fulfilled their commitment on MDBs, made in Pittsburg in September 2009. This included US$350 billion in capital increases for the Multilateral Development Banks (MDBs), allowing them to nearly double their lending. They have also endorsed the voice reforms agreed by shareholders at the World Bank, which will increase the voting power of developing and transition countries. The G-20 summit further called for the acceleration of the work still needed for the IMF to complete the quota reform by the Seoul Summit in November 2010 and to deliver, in parallel, on other governance reforms in line with commitments made at Pittsburg.

d) Fighting Protectionism and Promoting Trade and Investment

The Summit noted that they kept their markets open for trade and investment, during the global economic crisis. They further commit to minimise any negative impact on trade and investment of their trade policy actions[8]. They also pledged to maintain momentum for Aid for Trade and asked international agencies, including the World Bank and other MDBs to step up their capacity and support trade facilitation to boost trade.

The G-20 recognised that open markets play a pivotal role in supporting growth and job creation, and in achieving the goals under the G-20 Framework for Strong Sustainable and Balanced Growth. Accordingly, the G-20 Summit called on the OECD, the ILO, World Bank, and the WTO to report on the benefits of trade liberalisation for employment and growth at the Seoul Summit.

e) Other Issues and Forward Agenda

The G-20 leaders also agreed that corruption threatens market integrity, undermines fair competition, distorts resource allocation, destroys public trust and undermines the rule of law. They called on all G-20 members to ratify and implement the United Nations Convention against Corruption.

The next G-20 Summit is in Seoul, South Korea on November 11-12, 2010.

[8] G-20 governments have implemented 395 measures that hurt their trading partners since disavowing protectionism in November 2008, said Simon Evenett, professor in international trade at the University of St. Gallen in Switzerland.

Table 1: Banking sector indicators

	Jun-07	Dec-07	Jun-08	Dec-08	Jun-09	Dec-09	Jun-10
Structure							
Number of banks	4	4	4	4	4	4	5
Total assets of banks	34,448,220	36,504,795	39,443,450	41,562,708	43,275,865	47,669,192	47,759,180
Gini concentration index	12.5	11.6	12.2	11.3	10.8	11.45	12.0
Herfindahl index	2,769	2,678	2,705	2,689	2,677	2,690	2,692
Capital adequacy (%)							
Tier 1 leverage ratio	7.4	7.9	7.9	7.9	8.6	7.8	8.6
Tier 1 capital ratio	10.9	11.8	11.9	11.8	12.8	11.7	11.4
Total RBC (regulatory capital RWA's)	14.9	15.8	15.8	15.5	16.4	15.0	15.2
Asset quality (%)							
NPL's/Total gross loans	3.0	2.9	3.2	3.1	3.0	2.7	2.4
Gross overdue/Total loans and advances	3.8	3.8	3.9	5.7	6.5	8.0	5.1
Provisions/ Total loans	2.3	2.1	2.1	2.0	1.9	1.8	1.8
Provisions/NPL's	78.9	77.2	68.6	64.7	62.8	66.2	74.8
Specific provision/NPLs	41.8	37.0	33.8	29.2	27.2	28.7	30.5
Earnings and profitability (%)							
Return on assets	2.1	2.4	1.9	2.8	2.0	2.1	2.1
Return on equity	24.0	26.6	20.0	29.0	19.7	21.8	21.2
Net interest margin	5.0	5.7	468	4.7	4.3	4.5	4.9
Cost to income ratio	57.5	56.9	59.2	51.9	61.2	57.9	72.7
Liquidity (%)							
Liquid asset to total assets	9.8	9.2	9.3	10.1	9.9	10.0	10.6
Total loans/Total deposits	89.2	89.9	86.4	87.9	87.1	85.3	87.7
Total loans/Total assets	76.8	76.2	74.2	75.2	74.6	72.8	74.8

3.4 FINANCIAL INFRASTRUCTURE AND REGULATORY DEVELOPMENTS

3.4.1 Financial infrastructure

The Bank of Namibia continued its oversight function in assessing the performance of the payment system and related activities, in the first half of 2010. The emphasis of the oversight was mainly on payment business activities and risk control. The conclusion was that the payment system performed satisfactorily and inherent risks were well managed, during the review period. In addition, the on-site inspection revealed that participant banking institutions were compliant with the Bank's oversight policy and payment system regulations. Key reform projects were also on track. Efforts are also underway to ensure effective on-going payment system oversight, going forward. During the period, the Bank of Namibia awarded MobiCash Payment Solutions (PTY) Limited, a financial infrastructure that facilitates payments, a permanent licence to provide mobile payment services in Namibia.

3.4.2 Regulatory developments

Directive on the practice of sorting-at source of EFT Payment Instructions

In July 2010, the Bank of Namibia issued a directive (PSDIR-5), under the Payment System Management Act, 2003 (ACT NO. 18 OF 2003), to prohibit the practice of sorting-at-source of EFT payment instructions within the Namibian national payment system. Sorting-at-source' is a process whereby the beneficiary of payment instructions sorts each paying banks' payment instructions together and then submits those payment instructions directly to each paying banking institution, where the proceeds of such payment instructions are credited to an account in the name of the beneficiary. The purpose of the directive was to eliminate sorting-at-source practices, which by-passes the payment clearing house, NamClear.

The directive shall become effective on November 1, 2010.

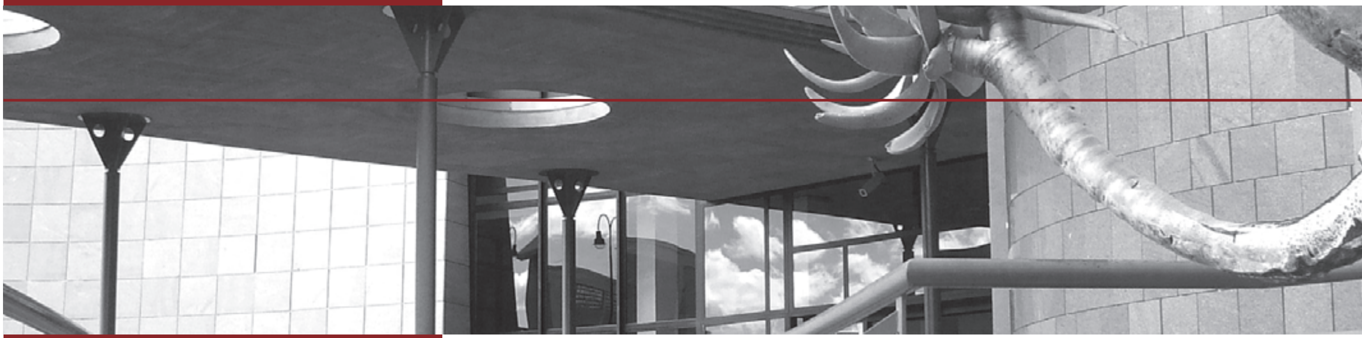
Implementation of the Basel II Capital Accord

The Basel II capital accord became effective at the beginning of 2010, i.e. 1 January 2010. The implementation of the new accord brought about greater risk sensitivity in the capital requirement and hence enhanced the capital adequacy of the banking sector. The accord, in addition to credit risk, captures market and operational risks in the calculation of the required capital. For example, the standardised approach calibrated risk-weighted asset for market and operational risks amounted to N$4.3 billion, increasing the aggregated risk-weighted assets from N$32.1 billion at 31 December 2009 to N$36.4 billion at 30 June 2010. This would result in the increase in the minimum capital requirement in absolute terms.

The implementation of Basel II is expected to have a positive impact on and to strengthen the stability of banking system. The banks will be more risk-focused as they will be encouraged to shift their attention towards their respective risk appetite frameworks. The accord will assist the banks in determining the amount of risk they need to take in order to obtain return they are seeking. This represents a shift in focus from product-based to risk-based. The introduction of market disclosure requirement would further promote prudent management by enhancing the degree of transparency in banks' public reporting. The disclosure will enable the various users of information to make accurate assessment of the banks' financial position, business activities, and risk profile risk management practices. This in turn will put them in a better position to make informed investment decisions.

3.4.3 Summary assessment

The National Payment System has performed adequately in the first half of 2010. The system was available for 98 percent of the time and safe, and there were no major system disruptions. The NPS, therefore, presented no systemic risk to financial system stability during the period under review.



4. OUTLOOK, RISKS AND OVERALL ASSESSMENT

4.1 GLOBAL OUTLOOK

The global economic recovered better than expected in the first half of 2010, however, at varying speeds - modest but steady in most advanced economies and strong in many emerging and developing economies. Consequently, according to the IMF's World Economic Outlook (WEO) *Update* for October 2010, world economic growth was projected at about 4.8 percent in 2010 and 4.2 percent in 2011. The IMF noted further that the economic recovery was on-going and global economic output has expanded in line with its earlier projections. However, macro-economic risks have increased, mostly as result of heightened market pressures for fiscal consolidation that have complicated transitional efforts to self-sustaining growth.

According to the IMF's Global Financial Stability Report of October 2010, despite on-going economic recovery, the global financial system remains in a period of significant uncertainties and substantial risks remain. The turmoil in sovereign debt markets in Europe highlighted increased vulnerabilities of banks and sovereign balance sheets emanating from the debt crisis. The strong response by European policymakers helped to stabilise the funding markets and decrease risks. Consequently, financial market conditions have improved again. In addition, transparency provided by the disclosure of the European Central Bank stress test results also helped reduce uncertainty over sovereign exposures, and provided relief for bank and sovereign funding markets. However, the global financial outlook remains subject to considerable downside risks and tail risks remain high. In addition, underlying sovereign and bank vulnerabilities remain, as well as concerns about risks to the global recovery.

4.2 DOMESTIC OUTLOOK

Domestic economic activity improved in the first half of 2010, after contracting by an estimated 0.8 percent in 2009, as a result of the recent global economic and financial crises. The Namibian economy was expected to continue to improve, with GDP estimated to expand by 4.2 percent in 2010, despite downside risks to the domestic economic recovery.

Downside risks to the global outlook for both 2010 and 2011 rose sharply in recent months. The main risk, in the intermediate time, was the possible acceleration in financial stress and contagion arising from increasing uncertainty about the sustainability of sovereign debt risk. This could eventually lead to significantly lower global demand and put current global economic recovery at risk. In addition, the recovery in external demand and prices for Namibian exports would be destabilised. Furthermore, ensuing lower domestic economic growth would lead to reduced incomes and diminished government revenues.

4.3 OVERALL ASSESSMENT

The global economy improved better than expected in the first half of 2010. However, the global economic outlook was characterised by continued volatility, sluggish global economic growth and lingering investor uncertainty. Economic recovery was modest but steady in advanced economies and strong in emerging and developing economies. Sovereign risks intensified in late April and early May and concerns spread: first, to the banking sectors in Europe and, later, to other banking systems. Heightened risks adversely affected investor risk appetite, led to tighter lending conditions, and reversed portfolio flows, including, to emerging economies.

Although financial market tensions receded recently, market confidence remained fragile. At the same time, the strength of the global recovery became questionable, as the feedback loops from the financial sector to the real economy became apparent and the downside risks to global growth rose sharply. Persistent uncertainty about global economic recovery led to sharp movements in currency, equity, and commodity markets. Consequently, global inflation was expected to remain mostly subdued on concerns over the sluggish global economic recovery. The Namibian banking sector was not adversely affected by the recent turbulence in global financial markets. This shield was due to the fact that the sector was not directly linked to the root of the problem, sovereign risk. There was, however, mild impact on the NSX that came through the JSE. The impact of the global financial markets on the banking sector, therefore, continued to be insignificant in the first half of 2010.

The profitability (ROE) of the banking sector improved further in the second half 2010. This enhanced the capital adequacy and solvency of the sector, while maintaining satisfactory liquidity. In addition, the ratio of non-performing loans to total loans continued to fall. Overdue loans as a share of total loans fell, after rising in 2009. On the overall, therefore, the banking asset quality enhanced in the first half of 2010.

The Namibian economy improved in the first half of 2010, after contracting in 2009, because of weak external demand, due to the global financial and economic crises. Weak external was also reflected in the country's exported values of major commodities that fell in July 2010. Improvements in the domestic economy were, particularly, notable in the important economic sectors of agriculture and mining. Outputs of key exports, such as diamonds, zinc and gold, rose during the period. Domestic demand also picked up. Economic rebound was expected to continue in line with global economic recovery. Accordingly, domestic economic expansion was projected at 4.2 percent in 2010. Positive economic performance would, in turn, improve the financial conditions of both banking institutions and their borrowers. Consequently, the risk to banking stability was evaluated to remain low in the intermediate time.

Bank of Namibia